

# Emerging Markets Macro and Strategy Outlook

## A framework for why there's no framework\*

- Investing in emerging markets has been a frustrating experience recently. Returns of over 9% from US or Japanese equities during the past quarter look exceptionally attractive compared to the loss-making proposition that has been, say, EM equities or EM investment grade credit. Anecdotally, too, the mood among investors is directionless. There is a sense that EM lacks a framework these days, without an overarching story that drives asset prices and keeps the asset class more or less coherent: idiosyncratic stories seem more important than any overall theme.
- We can detect two kinds of frustration. The first comes from a breakdown in some of the relationships that investors used to rely on: EMFX, for example, doesn't seem to respond, as it used to, to broader indicators of risk appetite. And within EM, there seems to be a breakdown of cross-correlations both in FX and CDS, giving the impression that EM is fragmenting as an asset class. Again, it is idiosyncratic stories that drive prices.
- The rising importance of idiosyncrasy may be a good thing, but it is also a bit of a surprise, for 2 reasons. The first is that we're living in a world where there is supposed to be a heavy 'push factor' driving capital towards EM, in the form of extremely loose monetary policy in DM, notwithstanding the mild threat of a future Fed exit from QE. Since this push factor of liquidity is often described as 'floating all boats', it is odd that the recent evidence demonstrates a) that not all EM boats are being lifted, and that b) there are other boats – DM equities, for example – that are enjoying a much nicer ride than EM. Another reason why it seems odd that EM is fragmenting has to do with the fact that in the past few months we see some important signs of economic recovery: the big EM growth slowdown that took place in 2012 has come to an end, and it is maybe surprising that investors haven't responded more enthusiastically to that recovery.
- We think we might have an explanation for this apparent lack of framework in EM, and think the cause lies in the *kind* of growth that EM is enjoying. The era of export-led growth for EM is past, and *domestic* spending is generally more important in explaining EM economic activity. The counterpart to this is a virtual disappearance of EM's current account surplus, less reserves accumulation and, at the margin, deterioration in EM's collective balance sheets: EM is leveraging up while DM goes in the opposite direction. This overall threat of deterioration might help explain why country fundamentals seem so important now. And it may also help explain why EM asset prices seem to underperform DM: if domestically driven growth in EM allows more export-driven growth in DM, that's likely to be better news for DM asset prices than for EM. All this may go some way towards providing a framework for why there's no framework.
- **\*Correction:** We amend the Ukraine FX forecasts on page 129.

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### EM Economics and Strategy

**Guillermo Mondino**  
+1-212-816-6499  
guillermo.mondino@citi.com

### Head of EM Economics

**David Lubin**  
+44-20-7986-3302  
david.p.lubin@citi.com

### Head of Asia Economics

**Johanna Chua**  
+852-2501-2357  
johanna.chua@citi.com

### Head of Latam Economics

**Joaquin A Cottani**  
+1-212-816-2735  
joaquin.cottani@citi.com

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

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David Lubin  
+44 20 7986 3302  
[david.p.lubin@citi.com](mailto:david.p.lubin@citi.com)

**Figure 1. EM asset classes don't feature highly in year-to-date returns**

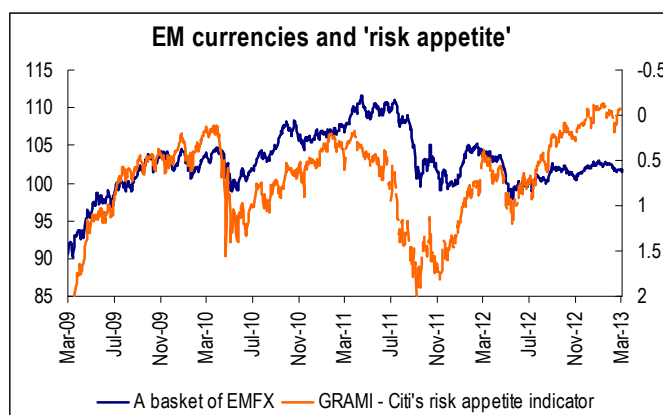
MSCI US	9.4%
MSCI JAPAN	9.1%
MSCI EUROPE	5.8%
US HY	2.6%
Citi Global Bond Index - EM	1.5%
MSCI ASIAPAC	1.2%
JPM CEMBI	0.6%
MSCI LATAM	0.6%
JPM ELM I	0.4%
JPM EMBI HY	-0.5%
US IG	-0.7%
UST	-0.7%
JPM EMBI TOTAL	-2.0%
MSCI EM	-2.1%
MSCI EM ASIA	-2.4%
EMBI IG	-2.9%
MSCI EM EMEA	-4.4%

Source: Citi Research

## A framework for why there's no framework

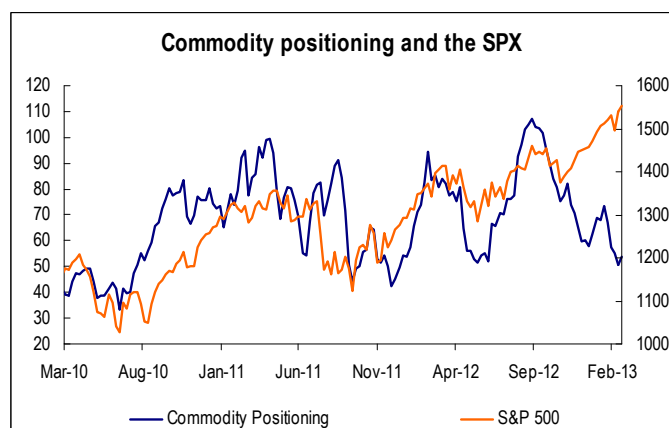
Investing in emerging markets has been a frustrating experience recently, and we will try to explain what lies behind this frustration. Certainly equity and fixed income returns have been dreary compared to a number of other markets during Q1, as Figure 1 shows. Returns of over 9% from US or Japanese equities during the past quarter look exceptionally attractive compared to the loss-making proposition that has been, say, EM equities or EM investment grade credit. Anecdotal, too, the mood among investors is somewhat directionless: there seems to be the sense that emerging markets lacks a framework these days: there is no over-arching story that drives asset prices and keeps the asset class more or less coherent. The basic building blocks of the emerging markets story – fast growth and an improvement in relative creditworthiness – are still intact, but these are not sufficient conditions to attract capital. In fact, as we'll show, the underperformance of EM assets during the past quarter has taken place despite some decent signs of recovery in EM, and in spite of the support to EM assets that is supposed to come from very loose monetary policy in developed countries. In this note we'll try to identify what lies behind this sense that the EM framework is less robust or visible than it used to be. What we'll try to argue is that the apparent breakdown of the EM framework may have something to do with a change in the growth model in EM – a theme we've addressed in the past but which is still, we think, very relevant (see "Emerging Markets: To a New Growth Model" in [Global Economic Outlook and Strategy - Prospects for Economies and Financial Markets in 2013 and Beyond](#)). In short: it isn't just the EM-DM growth differential that matters for asset prices, but the composition of EM's growth. And since there are signs that EM's growth model is moving towards one that is driven more by domestic spending than by exports, the biggest gainer from this process might well be DM, rather than EM.

**Figure 2. Emerging markets currencies haven't strengthened alongside risk appetite as we would have expected from past experience**



Source: Bloomberg, Citi Research

**Figure 3. ...and risk appetite – here proxied by SPX – seems to have a changing relationship with commodity prices**



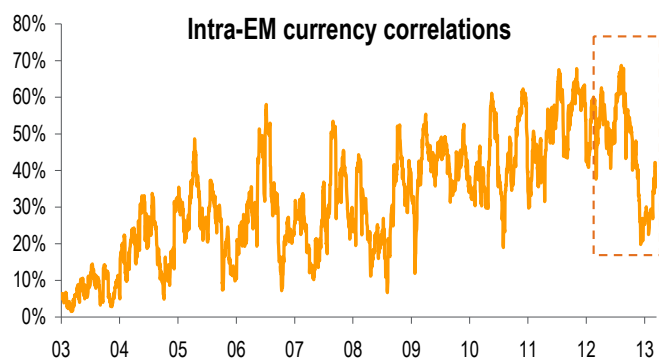
Source: Bloomberg, Citi Research

**We can detect two kinds of frustration.** The first has to do with a breakdown in some of the relationships that investors have come to rely on as signals that the world should want to buy risky assets. There are a couple of ways of seeing this. In Figure 2, we show the relationship between GRAMI, our measure of global risk appetite, and a basket of 23 EM currencies against the dollar, equally weighted. Since the world's recovery from the Lehman crisis, there has been a reasonable relationship between the performance of EMFX and GRAMI, as one might expect – but that relationship has broken down in the past 9 months. A broader indication of

the breakdown in the 'normal' set of relationships between risky assets and indicators of risk appetite can be seen in Figure 3, which shows the changing relationship between risky assets (here proxied by SPX) and commodities: while it used to be the case that commodity demand was positively associated with risk appetite, that no longer seems to be the case.

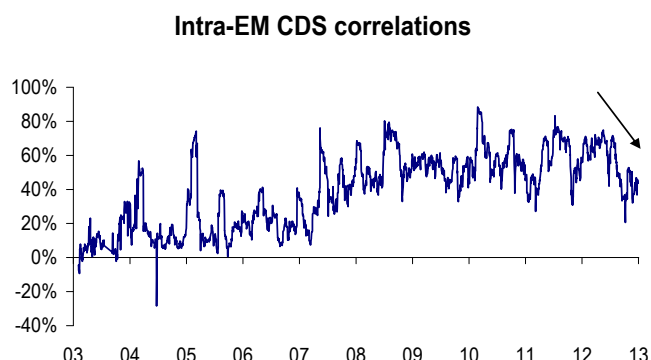
**Within emerging markets, investor frustration reflects the apparent fragmentation of EM as an asset class.** There is something about the definition of an 'asset class' that seems to require some degree of co-movement of asset prices on the back of a common theme among the suppliers of the assets concerned. Historically that's been the case with EM, and its emergence as an asset class in the 2000s coincided with a rise in intra-EM correlations. This is illustrated in Figures 4 and 5, which show that for both fx and credit, there was a rise in intra-EM correlations that helped to define EM as an asset class. But both sets of correlations show a notable decline in recent quarters, which at least lends some support to the idea that EMFX and EM credit seem to be less coherent as asset classes than they used to be. Country differentiation has, apparently, become more important than it used to be.

Figure 4. Intra-EM fx correlations rose during the 2000s as EM came to be more and more defined as an asset class, but that's broken down...



Source: Citi Research. The calculation is a rolling 22-day correlation of 22 EM currencies.

Figure 5. ...and the same pattern seems evident in EM CDS correlations too

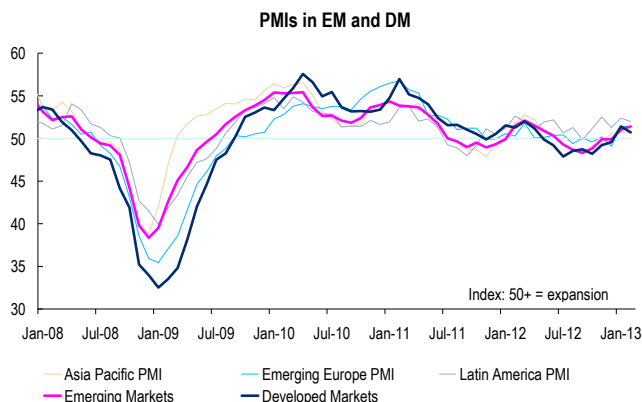


Source: Citi Research. The calculation is a rolling 22-day rolling correlation of 22 sovereign CDS names

**The rising importance of country fundamentals may be a good thing, but it is also a bit of a surprise.** There are two main reasons for thinking that this is an odd time for correlations across EM assets to be breaking down. The first is that we're living in a world where there is supposed to be a heavy 'push factor' driving capital towards EM, in the form of extremely loose monetary policy in DM. Since this push factor of liquidity is often described as 'floating all boats', it is odd that that the recent evidence demonstrates a) that not all EM boats are being lifted, and that b) there are other boats – DM equities, for example – that are enjoying a much nicer ride than EM. Another reason why it seems odd that EM is fragmenting has to do with the fact that in the past few months we have seen some important signs of economic recovery: the big EM growth slowdown that took place in 2012 has come to an end, and it is maybe surprising that investors haven't responded more enthusiastically to that recovery. In the next section we'll describe some of that recovery, and then suggest that it may be the *nature* of that recovery which is helping to fragment EM as an asset class.

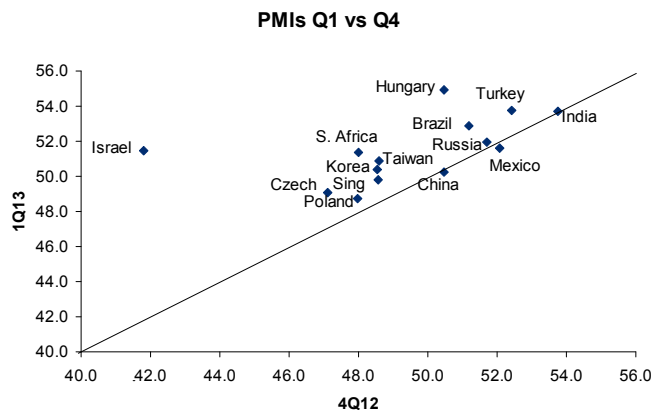
**There is growing evidence of an EM recovery these days.** We first identified some 'green shoots' towards in October 2012 ([Emerging Markets Macro and Strategy Outlook - Shoots, green and not so green](#)), which turned out to be the point at which PMIs in EM started to pick up (Figure 6), and there is some evidence that the pick up in EM is, overall, a little stronger than that in DM. During the first few months of 2013, that acceleration has become a little more pronounced, as Figure 7 shows. Indeed, this picture may understate the positive recovery story in EM, as it probably understates the dynamism of Chinese activity. Although China's industrial production growth rate slipped back into single digits in the first 2 months of this year, the slowdown seems insignificant: we think Q1 industrial production growth to date has essentially been maintaining the same pace as late 2012. In addition, the recently published PBOC survey for Q1 suggests that both entrepreneurs and bankers feel that the economy is heating up compared to Q4. While this carries some risk of inflation – and a policy tightening to deal with those price pressures – the fact is that, overall, China's 8% growth path seems to be fully sustained for the time being.

**Figure 6. EM PMIs have been picking up since Q4 last year, and EM seems to be in a slightly better position than DM**



Source: Haver Analytics, Citi Research

**Figure 7. There are plenty of large EMs that are enjoying some good news from PMIs (and we think China's dynamics are quite satisfactory)**

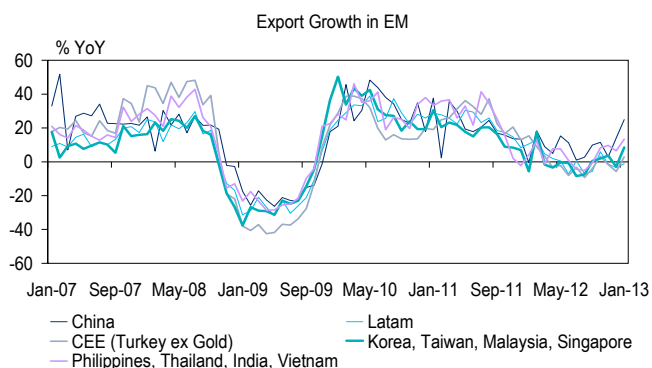


Source: Haver Analytics, Citi Research

**EM exports are also showing signs of life.** Perhaps the most remarkable aspect of China's economic performance in the past couple of months has been the rise in its export growth, which helped to produce a \$39 bn trade surplus last month: a record high. To be sure, there are some doubts about whether Chinese export growth can be sustained at such elevated levels, particularly since some survey evidence points to some weakness in export orders. But the acceleration of Chinese export growth in the past couple of months echoes similar data in numerous other EMs, illustrated in Figure 8. For virtually every country that's already reported February export data, growth rates were either more positive (Korea, Taiwan, Israel, Vietnam, Chile) or less negative (Brazil, India, Singapore) than in recent months. We've argued in the past that the 2012 collapse in export growth was a big component in the slowdown that EM suffered last year, and so the revival of export growth is consistent with our view EM GDP growth will show a recovery this year to 5.2% from last year's 4.7%. One big issue though is how dramatic the recovery in EM exports will be.

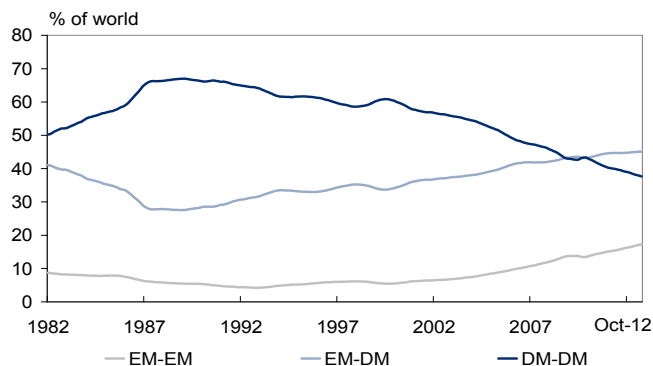
**EM exports are being supported by the growth of intra-EM trade, but there is evolution here, not revolution.** One reason to be optimistic about a continued revival of EM exports is the growing importance of intra-EM trade, illustrated in Figure 9. Between October 2011 and October 2012, the share of intra-EM trade in total world trade grew by 1.3 pts, from 15.9% to 17.2%; while the share of EM-DM trade grew by only 0.4 pts. But there are two points to bear in mind here. The first, which Figure 9 illustrates well, is that the potential of EM-EM trade is only realized relatively slowly: this is evolution, not revolution. The second has to do with how intra-EM trade affects growth and the balance of payments. Put in very simple terms: if EM exports rise strongly to DM, then EM enjoys both a current account surplus and a strong contribution of net exports to GDP growth. But if EM exports to EM, the balance of payments consequences for EM as a group are more ambiguous; and it is also much less obvious that net exports will be a driver of GDP growth for EM as a whole. Indeed, we remain relatively pessimistic that net exports will drive EM GDP growth in the next few years: better to assume that we are in a transition towards a growth model more driven by EM domestic spending. *In fact, it is the nature of this transition that might provide a clue about why EM seems to be losing coherence as an asset class.*

Figure 8. Exports are staging something of a recovery, led of course by China...



Source: Haver Analytics, Citi Research

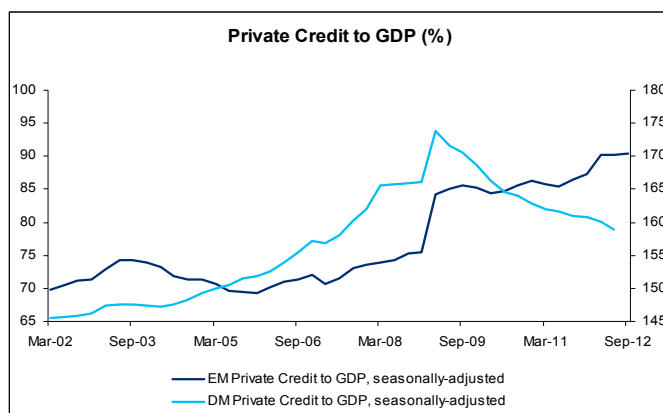
Figure 9. ...and while we don't think that exports will drive GDP growth for EM as it did in the 2000s, rising intra-EM trade provides a boost



Source: Citi Research. See [Global Economics View - Slow trade, fast trade transformation](#) by Ebrahim Rahbari and Deimante Kupciuniene

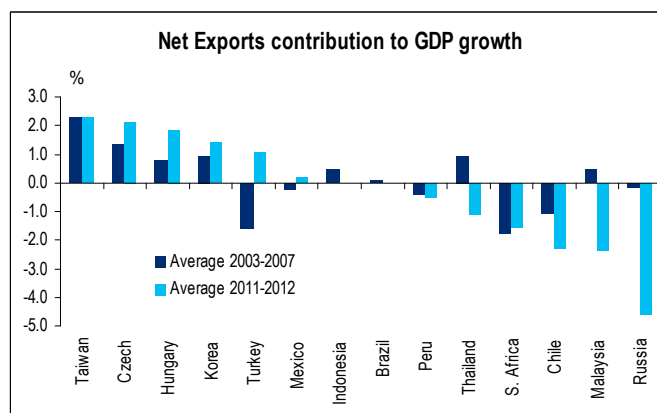
**In any case, the signs are still that EM growth is becoming more driven by domestic spending.** We've argued in the past that there are two main reasons to think that the era of export-led growth in EM is at an end. First, real exchange rates are no longer as cheap as they were in the 2000s. That's not to say that any EM currencies are dramatically overvalued; all we're saying is that just as an obviously undervalued exchange rate will tend to bias the sources of GDP growth towards net exports, it is equally true that a less obviously undervalued exchange will tend to bias the sources of GDP growth away from net exports. Another reason has to do with the fact that we are unlikely to see GDP growth in advanced economies grow at the circa 2.5% pace that they generated in the years before the Lehman crisis. What this means in practice is that domestic spending will become a bigger driver of GDP growth compared to previous years. There are already some signs that this is happening. Figure 10 shows the diverging trends of private sector credit as a share of GDP in DM and in EM. Using a new BIS database for private sector credit (<http://www.bis.org/statistics/credtopriv.htm>), we can show that DM's deleveraging lies in sharp contrast to EM's releveraging (central European EMs being a notable exception). And Figure 11 provides some tentative evidence that net exports is, in many countries, providing less support to GDP growth than was the case in the 2000s.

Figure 10. New BIS data on private sector credit confirms the picture of a deleveraging DM and a continuously leveraging EM...



Source: BIS, Citi Research.

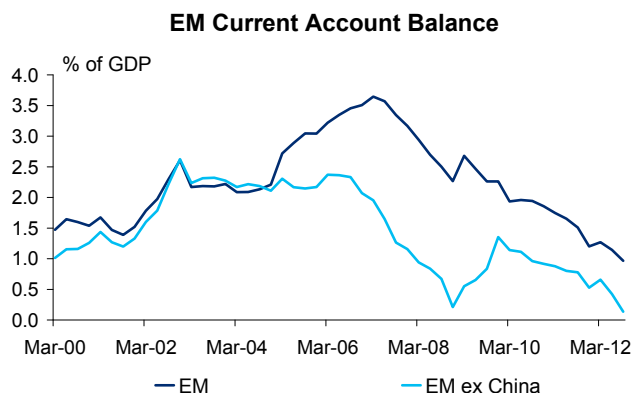
Figure 11. ...and for many countries (particularly except deleveraging Central Europe), net exports is now contributing less to GDP growth



Source: Citi Research

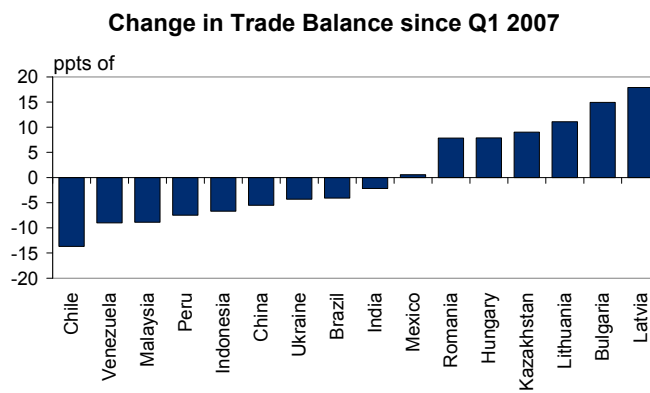
**And it may be that the changing nature of growth in EM provides a clue as to why the EM 'framework' seems to be so fragile these days, and why EM has lost some coherence as an asset class.** One important consequence of a growth model that's increasingly driven by domestic spending rather than exports is that EM's current account surplus will, over time, disappear. Indeed, there's some evidence to suggest that it already has (Figure 12). For the global economy, of course, there is an important pay-off if EM growth becomes increasingly driven by domestic spending: it very much increases the chance that the world enjoys a rebalancing of global growth. That being said, the benefits of such a rebalancing are likely to be enjoyed more by developed countries than by developing ones. Moreover, as EM current accounts deteriorate, country fundamentals probably become more important than they might have been in the past. In this way, we end up with a tentative explanation of the two forces that we described at the start: i) the underperformance of EM compared to DM; and ii) the apparent fragmentation of EM as an asset class. We don't pretend that this is anywhere near a full explanation of why EM seems to be losing its 'mojo' as an asset class: but it might be a start.

Figure 12. The EM current account surplus practically disappeared in Q3 2012...



Source: Citi Research

Figure 13. ...and a number of countries have seen notable deteriorations in their trade balance



Source: Citi Research

## LOCAL MARKETS STRATEGY

Guillermo Mondino  
+1 212 816 6499  
[guillermo.mondino@citi.com](mailto:guillermo.mondino@citi.com)

Alex Demyanets  
+1 212 816 1024  
[alexander.demyanets@citi.com](mailto:alexander.demyanets@citi.com)

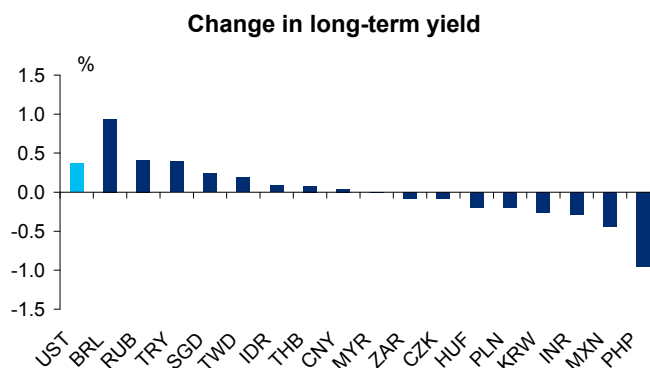
**Local currency bonds appear to have shrugged off the headwinds created by higher interest rates in advanced economies.** Over the past three months, the yield on the 10-year treasury rose 37 bps relative to its trough in December (see Figure 14). The drift in AE interest rates, however, has not triggered a generalized sell-off in local currency bonds. Although the dynamics have been variegated, the overall distribution of local markets' reactions has been centered about zero (Figure 15). BRL, RUB and TRY bonds tumbled – for idiosyncratic reasons above all - but gains on MXN, INR and PHP pared off the underperformance.

Figure 14. Treasuries have drifted upwards since the end of last year...



Source: Bloomberg, Citi Research

Figure 15. ...but EM local currency bonds remained resilient.



Source: Bloomberg, Citi Research

**The muted response of EM local rates to tighter liquidity suggests that the markets have been largely driven by idiosyncratic factors.** In Brazil, Russia and Turkey, worsening outlook for growth, accelerating inflation, and elevated policy uncertainty pushed up local risk premiums. In Mexico, by contrast, risk premiums came down spurred by the expectations of structural reforms and looser financial conditions. The decreased probability of tail risks in the Eurozone buoyed CZK and PLN while better than expected fiscal outcomes underpinned HUF bonds' resilience. In Asia, investors largely appeared to take comfort in relatively stronger growth-inflation profiles.

**We continue to see upside in local currency bonds, though we also think that some markets may now be rich.** On a 6-12 month horizon, we prefer to be overweight in KRW, MYR, and TWD bonds on the view that local curves will not significantly steepen and stronger currencies will provide a welcome boost to returns. For the same reasons, we also prefer to underweight RUB and TRY where we also see higher risk premiums. In Mexico, we are less bullish than the market. Part of the story is the recent rally that has eroded expected returns and high co-movement with Treasury yields. More importantly, in our view, the market does not give its due to the possibility that the recent cut could have been premature; we think that the jury is still out and attach 50% probability that Banxico has got the timing right.

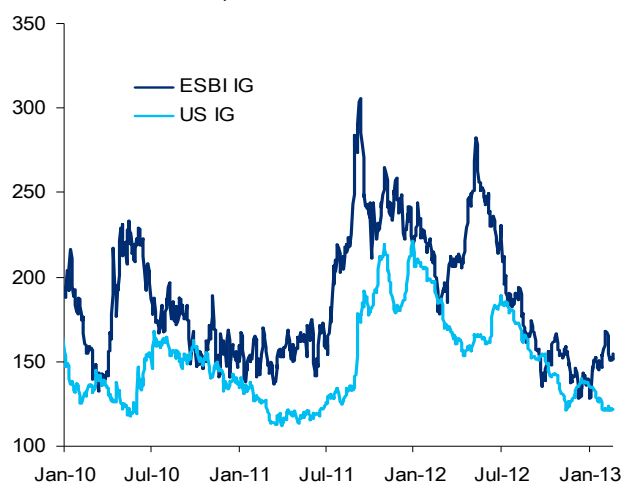
## CREDIT STRATEGY

Jeff Williams  
+1 212 723 1470  
[jeff.williams@citi.com](mailto:jeff.williams@citi.com)

**Emerging market bonds have continued to struggle relative to other credit markets over the past month** (Figure 16). Of the major CDS indices (CDX.IG, CDX.HY, Itraxx Main, etc.), the only ones that are wider on the year are those with emerging market issuers. This can not be explained as a simple variant of investors taking money out of emerging markets, since it seems to be only affecting hard currency emerging market debt. Local currency EM funds continue to perform well. Fund flows also reflect this. EM hard currency funds have seen outflows in 4 out of the past 6 weeks, while local currency funds continue to see a steady stream of inflows (Figure 17). These weak flow numbers, combined with near record quarterly issuance, have been the primary drivers of the underperformance. We do not believe it is likely to go much further as the relative value of EM issuers relative to other credit markets begins to look more compelling.

**Figure 16. EM has lagged other credit markets since the start of the year.**

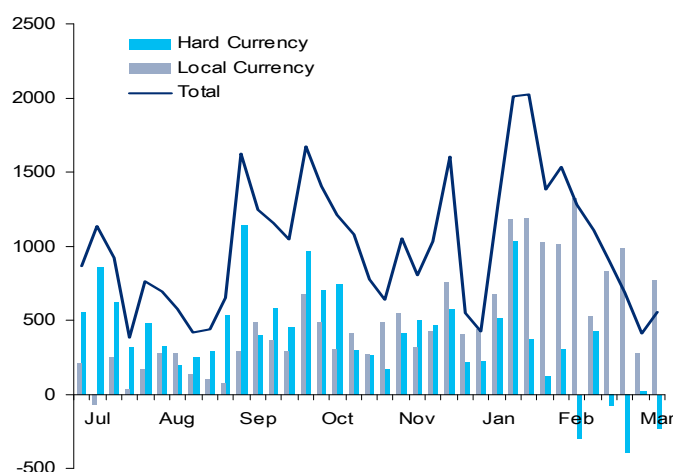
OAS spread of IG component of ESBI index compared to the Credit component of the USBIG index



Source: Citi Research

**Figure 17. EM hard currency funds have begun to see outflows, while local currency flows remain positive.**

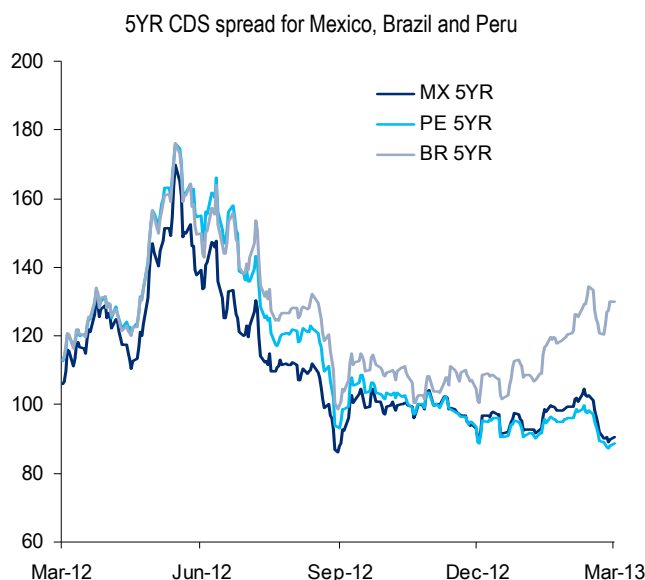
Weekly inflows, USD mm



Source: EPFR

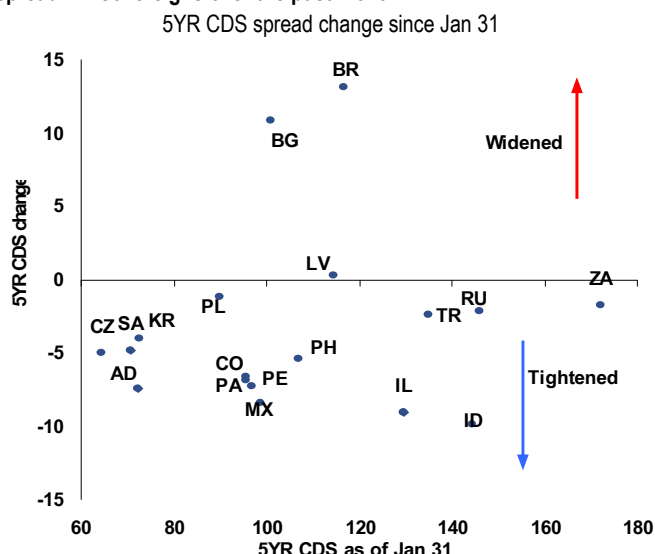
**In addition to global EM correlations having reduced (discussed above), there has also been a decrease of correlation within specific regions.** This has been most evident in Latin America, thanks not only to the idiosyncrasies in traditional high beta credits, but also largely to Brazil. Until recently the traditional low beta LatAm credits – Brazil, Mexico, Colombia, Panama and Peru – have essentially moved in virtual lock-step with one another (Figure 18). Brazil has broken out of this pattern, and is now at its widest level compared to these other credits since at least before the financial crisis. In fact, among all low spread EM sovereigns, Brazil has been the biggest underperformer since the start of the year, with its 5YR CDS now essentially flat to Turkey (Figure 19).

Figure 18. Brazil spreads have parted ways with its LatAm IG peers



Source: Markit

Figure 19. Brazil has been the biggest underperformer among lower spread EM sovereigns over the past month



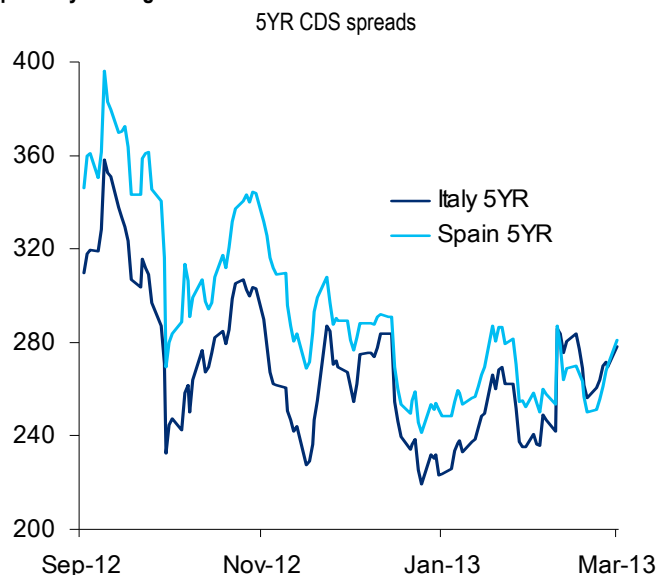
Source: Markit

**We have increased our Brazil overweight in our model portfolio considering this move.** We do not think that there is much scope for the relative spread differential versus other low spread LatAm names to move much wider from here, given the amount of pessimism that is already priced in. Local investors have been a large driver of the underperformance of the sovereign spreads, with many having purchased protection as a relatively cheap hedge given growth and inflation concerns. A decisive move by the central bank to raise interest rates, combined with what we believe will be relatively strong first quarter growth numbers will help lessen those concerns. Given the amount of bad news that is already priced in, along with the potential for spread compression and the extra carry offered by Brazil, we have raised Brazil to be our largest overweight in our model portfolio.

**Latin America in general has underperformed other regions in recent months, especially relative to CEEMEA.** There is the potential that the recent Cyprus news may spark renewed worries around the Euro zone. Indeed, spreads of the peripherals have already begun to move wider this week (Figure 20). If these concerns linger in the headlines once again, we are likely to see a spillover into CEEMEA credits, as we did from late 2011 through early 2012. We have therefore reduced our overall exposure to CEEMEA credits in our model portfolio. Ukraine remains our biggest underweight in the region. The government is likely to continue to stall discussions with the IMF until it is forced to do so by the markets, and the market is likely to react less positively to a Ukrainian deal with Russia than it would to a deal with the IMF. While there have been some positive signs in recent months, the near to medium term risks remain high. This is somewhat borne out by a relatively flat curve – at least compared to other high spread names.

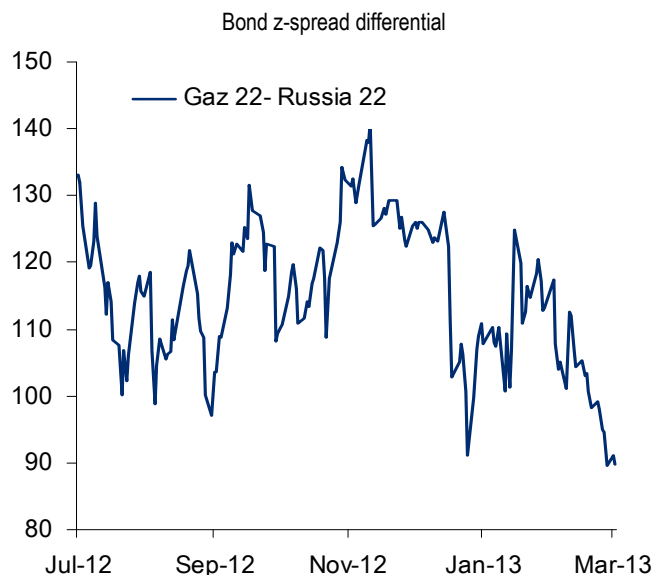
**On the other hand, we have maintained our overweight on Russia, which we continue to recommend allocating into quasi-sovereign issuers.** Russian quasies still offer attractive upside, especially relative to the sovereign despite some recent outperformance (Figure 21). Technicals in the quasies should remain strong through the end of the month due to an index effect. Due to a rule change, loan participation notes will be added to the Barclays Global Aggregate index. This change will benefit primarily Gazprom and VTB. There is approximately \$2 trillion of funds benchmarked against that index, so although the weights of the Russian quasies will be relatively low, the incremental demand could be large. One caveat is that much of that \$2 trillion is likely benchmarked to the ex-USD sub-index which decreases that demand, but the net effect should still be a positive for the Russia quasies.

**Figure 20. Peripheral CDS has widened some on the Cyprus news, possibly leading to a renewal of Euro zone fears.**



Source: Markit

**Figure 21. Russia quasies have been tightening relative to the sovereign but remain at absolute wide levels.**



Source: Bloomberg

**Venezuela has shown some weakness after the death of President Chavez.**

Despite this recent sell-off, we believe there is still significant downside risk in Venezuela bonds. According to the recent polls, Nicolas Maduro is expected to win in the presidential elections, now scheduled for April 14. While there is a possibility that a new administration, though still PSUV, will be more pragmatic than its predecessor, the economy remains on a downward trajectory. The recent altering of the FX policy does not dramatically alter that. The initial devaluation was a necessary step, but probably did not go far enough in our view. The bigger concern however is the lack of a true alternative FX market. The announcement of a secondary FX rate, SICAD, to take place via an auction process, does not resolve these concerns. There is still a fundamental dislocation between the supply and demand of hard currency – PDVSA sells \$41bn per year to the central bank, but imports total over \$50bn. The government has effectively now created a secondary CADIVI system, but there is still no alternative to relieve the huge pent up demand for USD. The prior system, SITME, effectively created approximately \$8bn per year through bond issuance. This was very inefficient as it forced the government and PDVSA to issue at very high interest rates, but now there is still nothing to fill the gap in USD demand. The new system is better than the old in many respects but is

far from fixing the underlying problems. Unless there is a clear sign of more orthodox policies being undertaken by the new administration, we believe the risks remain, especially as we go into 2014 when cash flows on external debt increase dramatically. In our view, the market is still far from pricing these risks appropriately.

**The perceived likelihood of a default on Argentina debt has increased following the oral arguments in the appeals court on February 27<sup>th</sup>.** Before the hearing there was growing hope that the trustee would be exempt from the injunction, but the judges seemed to indicate very clearly that is unlikely to be the case. Prices largely have compressed close to where we believe is fairly valued (See [Argentina: My Way or the Highway](#)). The largest exception is the Global 17s, which we see as the richest bond at the moment. Argentina now has until March 29<sup>th</sup> to submit an alternative formula for paying the holdout creditors in this case. By far, the most likely scenario in our view is that they submit a proposal in line with the 2005 and 2010 exchanges, most likely offering the Par bonds. If they were to use similar terms, the value of the plaintiffs' settlement would be less than \$300mm, compared to the \$1.45bn claim. We think it is highly unlikely that the judges would accept such an offer (see [Argentina: Alternate outcome still unlikely](#)). As such, our base case scenario remains that the current injunction will be upheld and that Argentina will run out of legal options, and be forced into a default by the end of the year.

## Annual Indicators

Figure 22. Emerging Markets – Economic Forecasts, 2012-2014F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F
<b>Asia</b>	<b>6.2</b>	<b>6.5</b>	<b>6.5</b>	<b>3.7</b>	<b>3.8</b>	<b>4.1</b>	<b>2.0</b>	<b>1.7</b>	<b>1.5</b>	<b>-2.6</b>	<b>-2.5</b>	<b>-2.4</b>
China	7.8	7.8	7.3	2.6	2.8	3.6	2.6	2.4	2.2	-2.0	-2.0	-2.0
Hong Kong	1.4	3.0	3.5	4.1	4.3	3.7	5.0	5.6	6.2	3.2	1.8	1.0
India*	5.0	5.7	6.4	7.5	7.0	6.0	-4.7	-4.3	-3.6	-8.6	-8.3	-7.8
Indonesia	6.2	6.2	6.3	4.3	4.7	4.7	-2.8	-2.1	-1.8	-1.8	-1.5	-1.4
Korea	2.0	3.2	4.1	2.2	2.5	3.0	3.8	2.5	1.9	1.4	1.1	1.4
Malaysia	5.6	5.5	6.0	1.6	2.0	2.8	6.4	5.0	4.0	-4.5	-4.0	-3.5
Mongolia	12.3	13.8	11.0	14.3	12.0	10.0	-31.3	-22.4	3.1	-8.3	-2.4	-2.0
Philippines	6.6	6.2	6.6	3.1	3.5	3.8	3.9	3.2	2.2	-2.3	-2.3	-2.0
Singapore	1.3	2.0	4.0	4.6	4.0	3.4	18.6	14.0	13.5	1.1	0.7	0.5
Sri Lanka	6.4	6.7	7.1	7.5	7.1	6.5	-5.5	-4.7	-4.0	-6.7	-6.2	-5.5
Taiwan	1.3	3.5	4.0	1.9	1.7	2.0	10.5	8.4	8.0	-1.6	-1.2	-1.3
Thailand	6.4	4.7	4.8	3.0	3.3	3.5	0.7	-0.3	-0.5	-2.1	-2.2	-2.1
Vietnam	5.0	5.4	5.8	9.3	7.6	7.2	3.2	2.4	0.7	-5.2	-3.8	-4.0
<b>Latin America</b>	<b>2.4</b>	<b>3.4</b>	<b>3.9</b>	<b>5.8</b>	<b>6.2</b>	<b>5.9</b>	<b>-1.4</b>	<b>-1.8</b>	<b>-1.8</b>	<b>-2.3</b>	<b>-2.2</b>	<b>-2.1</b>
Argentina	1.9	3.0	3.0	10.0	12.6	14.5	0.7	0.4	0.2	-2.4	-2.7	-2.9
Brazil	0.9	3.1	4.0	5.4	6.3	5.5	-2.5	-3.1	-3.2	-2.6	-2.4	-2.2
Chile	5.6	4.8	5.1	3.0	2.2	2.8	-3.4	-2.4	-2.5	0.6	-0.3	-0.4
Colombia	3.6	3.8	4.5	3.2	2.1	3.0	-3.2	-3.3	-3.1	-0.1	-1.1	-0.7
Mexico	3.9	3.6	3.8	4.1	3.7	3.6	-0.6	-1.4	-1.5	-2.6	-2.1	-2.0
Panama	10.7	9.0	8.0	5.7	4.6	4.4	-9.0	-8.5	-7.5	-2.1	-3.0	-3.0
Peru	6.3	6.2	6.4	3.7	2.4	2.6	-3.6	-2.6	-2.7	1.9	-0.6	-2.0
Venezuela	5.6	1.0	2.0	21.1	24.6	24.0	4.5	5.0	5.7	-5.0	-4.0	-4.0
<b>Europe</b>	<b>2.5</b>	<b>2.6</b>	<b>3.5</b>	<b>5.3</b>	<b>5.8</b>	<b>5.2</b>	<b>0.2</b>	<b>-0.5</b>	<b>-1.5</b>	<b>-1.7</b>	<b>-2.2</b>	<b>-3.3</b>
Czech Republic	-1.2	-0.2	0.9	3.3	2.1	1.5	-2.0	-1.5	-1.8	-4.8	-3.0	-2.7
Hungary	-1.7	-0.1	1.2	5.7	2.7	3.1	1.8	3.0	3.5	-2.7	-2.9	-3.6
Kazakhstan	5.5	4.8	4.1	5.1	6.9	6.4	6.6	3.7	2.2	1.6	2.7	1.8
Poland	2.0	1.3	2.8	3.7	1.7	2.4	-3.5	-2.7	-3.5	-3.5	-3.5	-2.8
Romania	0.0	1.0	2.8	3.3	5.3	3.6	-3.9	-3.8	-4.5	-2.2	-2.2	-2.5
Russia	3.4	3.0	3.6	5.1	6.7	5.4	4.2	2.8	0.9	-0.7	-2.0	-4.2
Slovakia	2.0	0.7	1.6	3.6	2.2	2.5	2.3	3.6	3.3	-5.1	-3.2	-2.9
Turkey	2.5	4.0	4.3	8.9	7.4	7.3	-5.8	-6.8	-6.9	-2.0	-2.2	-2.7
Ukraine	0.5	0.0	4.1	0.6	4.2	6.8	-8.4	-9.2	-6.5	-3.4	-4.8	-2.8
<b>Africa/Mideast</b>	<b>4.9</b>	<b>5.1</b>	<b>5.6</b>	<b>4.9</b>	<b>5.8</b>	<b>6.2</b>	<b>10.5</b>	<b>7.9</b>	<b>6.0</b>	<b>3.3</b>	<b>0.7</b>	<b>-1.2</b>
Bahrain	3.5	3.6	4.4	2.8	4.0	2.5	11.5	9.7	5.4	1.6	3.7	3.4
Egypt	2.1	1.2	3.5	7.1	12.6	12.7	-3.6	-3.0	-3.2	-10.0	-9.7	-8.6
Ghana	7.4	7.0	6.8	9.2	9.5	10.7	-11.7	-10.0	-8.9	-7.6	-12.7	-8.5
Iraq	9.0	12.1	9.9	6.1	6.0	6.0	23.3	20.1	16.2	-2.0	2.0	0.4
Israel	2.9	2.9	3.8	1.7	2.3	2.6	-1.4	-0.6	0.0	-3.7	-1.6	-2.5
Jordan	2.5	3.0	4.0	4.8	5.5	5.0	-19.7	-14.2	-12.0	-7.8	-7.7	-7.7
Kenya	5.0	5.4	6.1	9.6	6.4	9.2	-10.5	-8.9	-7.6	-5.3	-5.0	-4.7
Kuwait	8.4	3.9	4.0	2.9	5.0	5.0	50.6	48.7	45.6	33.5	25.1	20.1
Lebanon	2.0	2.0	4.5	6.4	5.0	5.0	-14.6	-15.7	-15.9	-7.3	-8.7	-8.8
Nigeria	7.4	6.8	7.2	12.2	9.8	9.7	2.4	3.7	3.3	-2.8	-2.6	-2.8
Oman	7.1	6.7	6.7	2.9	3.0	3.0	2.9	9.4	6.0	11.0	12.3	8.8
Qatar	6.0	8.3	7.2	1.9	3.0	3.0	28.2	17.7	9.3	5.4	2.4	0.5
Saudi Arabia	6.8	6.2	7.3	4.0	6.0	8.0	24.2	15.7	11.2	14.2	4.6	-0.7
South Africa	2.4	2.8	3.1	5.7	5.9	5.3	-6.0	-5.7	-5.5	-5.0	-5.2	-5.0
Tanzania	6.4	6.8	7.0	16.1	9.0	8.8	-11.9	-10.2	-11.5	-5.4	-5.0	-5.6
UAE	2.1	4.6	4.9	1.0	1.3	1.5	3.7	5.9	8.1	NA	NA	NA
Uganda	4.0	4.7	5.5	14.7	5.6	5.5	-11.0	-11.7	-11.5	-5.5	-5.2	-4.5
Zambia	6.5	6.9	7.5	6.6	7.2	7.4	-3.4	0.5	3.1	-4.3	-3.5	-3.3
<b>Total</b>	<b>4.7</b>	<b>5.2</b>	<b>5.5</b>	<b>4.5</b>	<b>4.7</b>	<b>4.8</b>	<b>2.1</b>	<b>1.4</b>	<b>0.9</b>	<b>-1.8</b>	<b>-2.1</b>	<b>-2.4</b>

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

## Economic Framework

Figure 23. Citi's Global Economic Forecasts

	GDP Growth (% YoY)			CPI Inflation (% YoY)			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
<b>Global</b>	<b>2.7</b>	<b>3.1</b>	<b>3.6</b>	<b>2.8</b>	<b>3.1</b>	<b>2.5</b>	<b>0.4</b>	<b>0.2</b>	<b>0.0</b>	<b>-4.1</b>	<b>-3.4</b>	<b>-2.9</b>
<i>Based on PPP weights</i>	3.2	3.6	4.1	3.2	3.5	2.9	0.2	0.0	-0.2	-4.0	-3.4	-3.0
<b>Industrial Countries</b>	<b>1.1</b>	<b>1.5</b>	<b>2.4</b>	<b>1.6</b>	<b>1.9</b>	<b>0.9</b>	<b>-0.3</b>	<b>-0.3</b>	<b>-0.3</b>	<b>-5.5</b>	<b>-4.1</b>	<b>-3.2</b>
United States	2.1	2.8	3.5	1.7	2.1	2.1	-2.7	-3.0	-3.0	-7.0	-4.9	-4.0
Japan	1.5	1.3	1.5	0.0	1.8	0.7	0.3	1.5	1.5	-9.8	-7.0	-6.2
Euro Area	-0.5	-0.3	1.1	1.7	1.5	1.4	2.6	2.5	2.5	-2.7	-2.4	-1.4
Canada	1.6	2.5	3.2	1.1	1.8	2.0	-3.2	-2.7	-1.7	-0.9	-0.4	-0.1
Australia	2.4	3.0	3.5	2.8	2.5	2.8	-4.7	-5.3	-3.5	-0.8	0.0	0.2
New Zealand	2.6	2.8	3.0	1.2	2.3	2.3	-5.5	-6.8	-7.3	-3.1	-0.9	-0.5
Germany	0.8	0.8	1.8	1.6	2.3	2.1	6.8	5.7	5.6	-0.2	-0.2	-0.2
France	-0.2	0.2	1.0	1.0	1.7	1.6	-1.7	-0.9	-0.3	-3.6	-3.0	-2.4
Italy	-1.6	-1.4	0.3	2.3	1.4	0.6	-0.3	-0.2	-0.1	-3.0	-3.2	-0.7
Spain	-2.2	-2.1	0.8	1.8	0.7	0.8	2.3	3.7	3.0	-6.4	-5.9	-5.6
Greece	-6.0	-11.2	-3.9	0.7	17.5	13.4	-3.3	2.1	3.9	-5.7	-1.3	-0.4
Ireland	0.7	1.9	2.4	1.3	1.4	1.6	5.8	6.7	7.5	-7.1	-4.2	-2.2
Portugal	-3.7	-2.8	0.0	0.3	0.5	0.5	-0.3	1.7	2.6	-5.7	-6.1	-5.2
Netherlands	-1.0	0.0	1.0	2.9	1.8	1.6	9.9	9.0	9.6	-3.8	-3.3	-1.8
Belgium	-0.1	0.3	1.2	1.5	2.0	2.0	-0.7	-0.8	-0.7	-2.6	-2.2	-1.4
Denmark	0.4	1.8	1.8	1.8	1.9	1.9	4.7	4.0	4.2	-2.0	-1.2	-1.0
Norway	2.8	2.8	3.0	1.7	1.8	2.1	14.5	14.9	15.2	13.2	13.0	14.0
Sweden	1.0	1.9	2.2	0.4	1.4	1.8	7.3	7.1	6.9	-1.2	-1.5	-0.4
Switzerland	1.1	1.1	1.5	-0.4	-0.4	0.7	12.8	12.0	12.1	0.4	0.4	0.3
United Kingdom	0.4	0.7	1.7	3.1	2.9	2.9	-4.5	-4.4	-4.2	-8.4	-8.0	-7.1

Source: National sources and Citi Research

Figure 24. G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 20 March 2013

	20-March	2Q 13F	3Q 13F	4Q 13F	1Q 14F	2Q 14F	3Q 14F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	1.96	2.05	2.30	2.60	2.85	3.00	3.20
Euro Area: US\$/€	1.31	1.30	1.30	1.29	1.29	1.29	1.30
Euro Repo Rate	0.75	0.50	0.50	0.25	0.25	0.25	0.25
10-Yr. Bunds (Period Average)	1.36	1.40	1.65	1.55	1.35	1.55	1.55
Japan: Yen/US\$	96	99	98	97	95	94	93
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.62	0.70	0.70	0.90	1.00	0.90	0.90

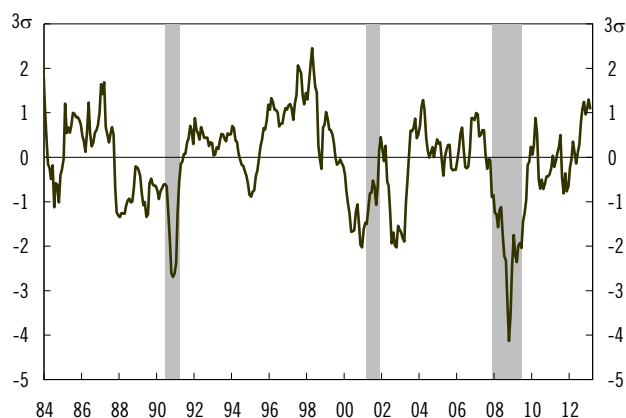
### Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US\$						Spread vs. Germany					
	Current	2Q 13	3Q 13	4Q 13	1Q 14	1Q 14	Current	2Q 13	3Q 13	4Q 13	1Q 14	1Q 14
<b>United States</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>61</b>	<b>66</b>	<b>66</b>	<b>107</b>	<b>152</b>	<b>147</b>
<b>Japan</b>	<b>-127</b>	<b>-136</b>	<b>-141</b>	<b>-162</b>	<b>-197</b>	<b>-212</b>	<b>-66</b>	<b>-70</b>	<b>-75</b>	<b>-55</b>	<b>-45</b>	<b>-65</b>
<b>Euro Area</b>	<b>-61</b>	<b>-66</b>	<b>-66</b>	<b>-107</b>	<b>-152</b>	<b>-147</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>
Canada	-15	5	5	0	-15	-10	46	71	71	107	137	137
Australia	161	147	137	122	107	102	222	213	203	229	259	249
New Zealand	169	172	162	147	132	132	230	239	229	254	284	280
France	6	4	14	-7	-52	-47	66	70	80	100	100	100
Italy	270	354	284	293	248	253	330	420	350	400	400	400
Spain	303	384	314	293	248	253	363	450	380	400	400	400
Netherlands	-13	-41	-31	-67	-102	-97	47	25	35	40	50	50
Belgium	25	14	14	13	-32	-27	85	80	80	120	120	120
Austria	-28	-36	-31	-67	-102	-97	32	30	35	40	50	50
Finland	-38	-51	-46	-87	-112	-107	22	15	20	20	40	40
Ireland	217	184	184	143	173	178	277	250	250	250	325	325
Denmark	-43	-61	-66	-107	-147	-137	17	5	0	0	5	10
Switzerland	-128	-144	-155	-200	-238	-240	-68	-78	-89	-93	-86	-93
United Kingdom	-11	5	10	-20	-56	-56	49	71	76	86	96	92

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

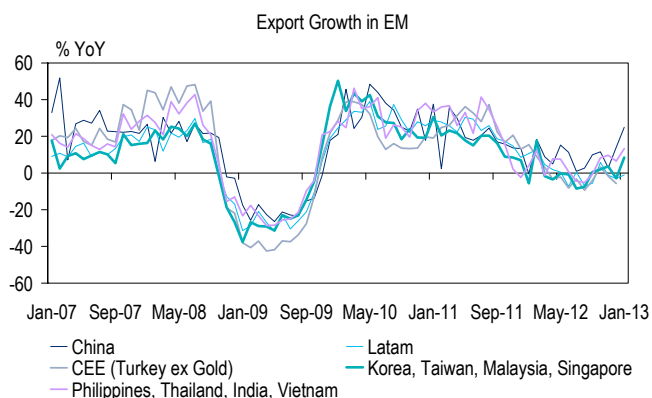
## Regional Indicators

**Figure 25. Upbeat data and improving financial conditions have steadied the outlook for the US.**



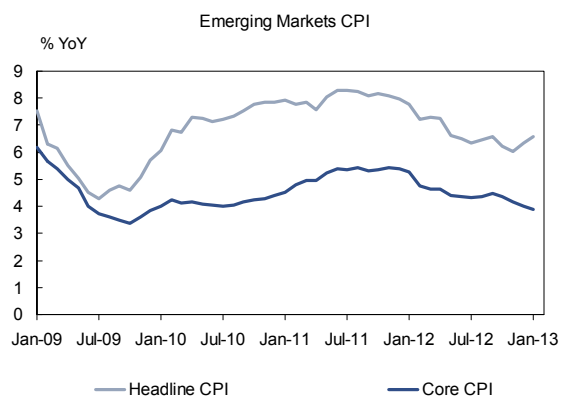
Source: Haver Analytics, Citi Research. Note: Shaded sections mark recession periods.

**Figure 27. Exports may have turned the corner.**



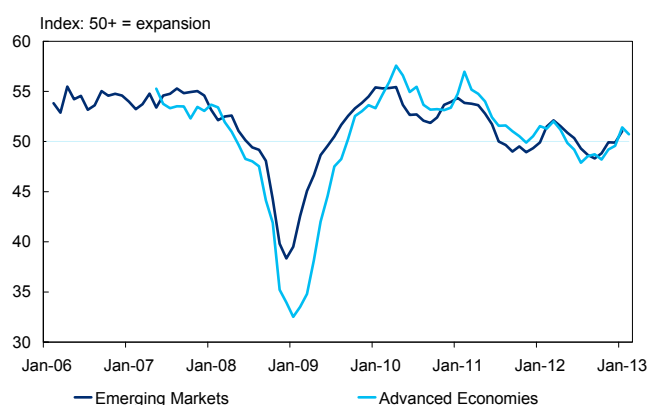
Source: Haver Analytics, Citi Research. F = forecast

**Figure 29. There remains a considerable gap between headline and core CPI.**



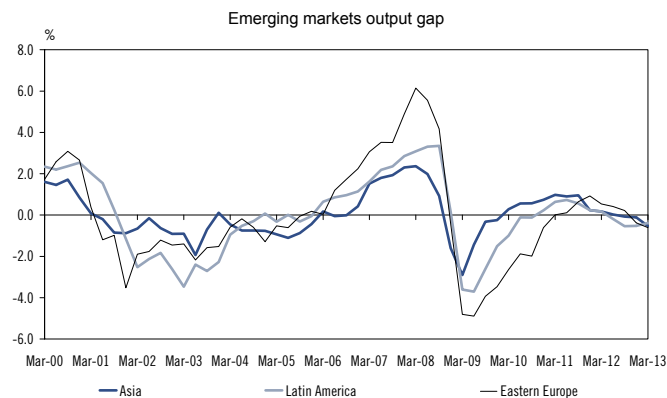
Source: Haver Analytics, Citi Research

**Figure 26. PMI suggests a picking up of activity.**



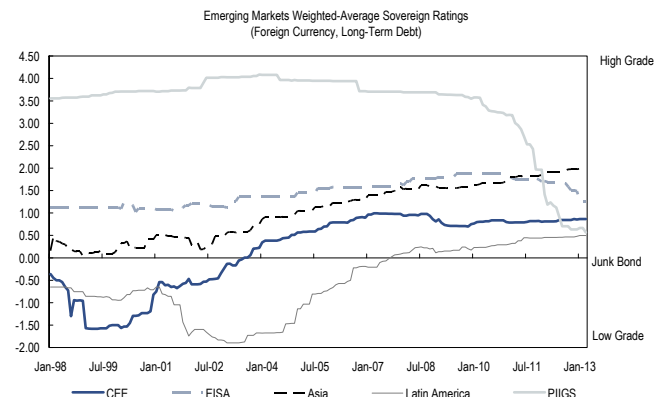
Source: Haver Analytics, Citi Research

**Figure 28. Little slack in the economy remains.**



Source: Haver Analytics, Citi Research

**Figure 30. On the whole, ratings for foreign currency long-term debt for EM continue to improve.**



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

## Monetary Policy Watch

Figure 31. Asia Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2013
			Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	3.00	Jul-12	-25	Dec-13	+25	3.25
India	Repo Rate	7.75	Mar-13	-25	May-13	-25	7.25
Indonesia	FasBI	4.00	Aug-12	+25	May-13	+25	4.25
Korea	BOK Policy Rate	2.75	Oct-12	-25	Apr-13	-25	2.75
Malaysia	Overnight Policy Rate	3.00	May-11	+25	Mar-14	+25	3.00
Philippines	Overnight Policy Rate	3.50	Oct-12	-25	Mar-14	+25	3.50
Taiwan	Discount Rate	1.875	Jun-11	+12.5	Sep-14	+25	1.875
Thailand	Overnight Repo Rate	2.75	Oct-12	-25	May-13	+25	3.75

Source: Bloomberg, Citi Research

Figure 32. CEEMEA Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2013
			Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.05	Nov-12	-20	4Q14	+20	0.05
Hungary	14-Day Repo Rate	5.25	Feb-13	-25	Mar-13	-25	4.50
Israel	Base Rate	1.75	Dec-12	-25	Dec-13	+25	2.00
Poland	7-Day Repo Rate	3.25	Mar-13	-50	Nov-14	-25	3.25
Romania	Refinancing Rate	5.25	Mar-12	-25	1Q14	+25	5.25
Russia	Refinancing Rate	8.25	Sep-12	+25	2Q13	-25	7.75
S. Africa	Average Repo rate	5.00	Jul-12	-50	4Q14	+50	5.00
Turkey	1-week repo rate	5.50	Dec-12	-25	2Q13	-25	5.00
Ukraine	Discount Rate	7.50	Mar-12	-50	Aug-13	-25	7.25

Source: Bloomberg, Citi Research

Figure 33. Latin America Policy Rates and Movement

			Last Move		Likely Next Move		End-2013
Spot			Date	Amount (bp)	Forecast	Amount (bp)	forecast
Brazil	SELIC	7.25	Oct-12	-25	May-13	+50	8.75
Chile	CAMARA (Overnight)	5.00	Jan-12	-25	Sep-13	-25	4.50
Colombia	Central Bank Repo Rate	3.75	Feb-13	-25	Mar-13	-25	3.75
Mexico	Official Overnight Rate	4.00	Mar-13	-25	Jun-15	+25	4.00
Peru	Reference Rate	4.25	May-11	+25	Jun-13	-25	3.75

Source: Bloomberg, Citi Research

## FX Views

Figure 34. Asian Currencies Exchange Rates

	19 March	2Q13			3Q13			1Q14		
		Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)
<b>vs USD</b>										
China yuan	6.22	6.16	6.28	1.9	6.13	6.29	2.6	6.08	6.32	3.8
Hong Kong dollar	7.76	7.76	7.76	0.0	7.76	7.76	-0.1	7.76	7.75	-0.1
India rupee	54.38	54.97	55.42	0.8	55.53	56.31	1.4	55.78	58.49	4.6
Indonesia rupiah	9720	9797	9817	0.2	9853	9935	0.8	9796	#VALUE!	#VALUE!
Korea won	1111	1088	1117	2.7	1072	1122	4.4	1032	1134	9.0
Malaysia ringgit	3.12	3.12	3.14	0.5	3.06	3.15	3.1	3.02	#VALUE!	#VALUE!
Philippines peso	40.7	40.1	40.6	1.3	40.0	40.6	1.6	40.3	40.6	0.9
Singapore dollar	1.25	1.24	1.3	0.9	1.23	1.3	1.8	1.21	1.3	3.6
Taiwan dollar	29.8	29.69	29.69	0.0	29.31	29.60	1.0	28.65	29.33	2.3
Thailand baht	29.3	29.8	29.39	-1.5	30.2	29.53	-2.2	30.2	#VALUE!	#VALUE!

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

Figure 35. CEEMEA Currencies Exchange Rates

	19 March	2Q13			3Q13			1Q14		
		Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)
<b>vs EUR</b>										
Czech Republic koruna	25.6	25.9	26	-1.1	26.0	25.6	-1.5	25.4	25.6	0.7
Hungary forint	306	307	309	0.6	303	309	1.8	296	309	4.2
Poland zloty	4.17	4.18	4.17	-0.4	4.22	4.17	-1.3	4.10	4.17	1.6
<b>vs USD</b>										
Israel shekel	3.69	3.65	3.70	1.5	3.70	3.71	0.3	3.94	3.74	-5.4
Russia ruble	31.0	31.1	31.5	1.2	31.5	31.9	1.4	32.4	33.3	2.7
Turkey new lira	1.82	1.84	1.84	0.3	1.86	1.87	0.3	1.89	1.94	2.4
S. Africa rand	9.26	9.36	9.40	0.4	9.44	9.51	0.8	9.50	9.87	3.7

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

Figure 36. Latin American Currencies Exchange Rates

	19 March	2Q13			3Q13			1Q14		
		Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)
<b>vs USD</b>										
Brazil reais	1.99	1.96	2.01	2.3	1.97	2.04	3.3	2.03	2.13	4.7
Chile peso	473	473	479	1.2	477	485	1.6	484	500	3.2
Colombia peso	1811	1800	1827	1.5	1800	1841	2.2	1800	1881	4.3
Mexico new peso	12.5	12.2	12.5	2.3	12.1	12.5	2.6	12.2	12.5	2.2

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

## Our Forecasts vs. Consensus

Figure 37. Citi vs. Consensus forecasts

	GDP Growth (% YoY)				CPI Growth (% YoY)				Current Account Balance (US\$ bil)			
	2012	Consensus	2013F	Consensus	2012	Consensus	2013F	Consensus	2012	Consensus	2013F	Consensus
<b>Asia</b>	<b>6.5%</b>	<b>6.8%</b>	<b>6.5%</b>	<b>6.0%</b>	<b>3.5%</b>	<b>3.9%</b>	<b>3.9%</b>	<b>3.1%</b>	<b>271.9</b>	<b>278.8</b>	<b>274.4</b>	<b>351.3</b>
China	7.8	8.2	7.3	8.0	2.8	3.2	3.6	3.5	223.6	222.8	229.3	206.6
Hong Kong	3.0	3.5	3.5	4.1	4.3	4.2	3.7	4.0	15.9	2.7	18.7	2.5
India	5.7	6.3	6.4	-	7.0	7.8	6.0	-	-89.9	-80.5	-88.3	-
Indonesia	6.2	6.2	6.3	6.2	4.7	5.1	4.7	5.1	-20.5	-18.4	-19.1	-13.9
Korea	3.2	3.0	4.1	3.7	2.5	2.5	3.0	2.8	31.6	32.8	26.6	30.0
Malaysia	5.5	5.1	6.0	5.2	1.7	2.2	2.4	2.8	17.0	17.8	15.4	19.1
Philippines	6.2	6.1	6.6	5.9	3.5	3.6	3.8	3.9	9.3	8.3	7.1	8.1
Singapore	2.0	2.7	4.0	3.9	4.0	3.7	3.4	3.3	41.6	46.8	44.2	51.7
Sri Lanka	6.7	6.6	7.1	7.0	7.1	7.7	6.5	6.6	-3.1	-3.2	-3.0	-2.9
Taiwan	3.5	3.5	4.0	4.0	1.7	1.8	2.0	2.0	43.6	45.7	44.2	45.5
Thailand	4.7	4.8	4.8	4.8	3.3	3.4	3.5	3.4	-1.0	3.1	-2.0	4.4
Vietnam	5.4	5.5	5.8	5.8	7.6	8.2	7.2	8.2	3.7	1.0	1.2	0.2
<b>Latin America</b>	<b>3.3%</b>	<b>3.4%</b>	<b>4.0%</b>	<b>3.8%</b>	<b>6.8%</b>	<b>6.8%</b>	<b>6.6%</b>	<b>6.6%</b>	<b>-102.3</b>	<b>-95.0</b>	<b>-111.0</b>	<b>-102.7</b>
Argentina	3.0	2.8	3.0	2.4	12.6	11.1	14.5	11.8	2.0	1.7	1.0	0.8
Brazil	3.1	3.1	4.0	3.7	6.3	5.6	5.5	5.5	-67.7	-65.8	-77.9	-69.2
Chile	4.6	5.0	5.0	4.8	2.2	3.1	2.8	3.1	-7.0	-11.8	-7.9	-10.5
Colombia	3.8	4.0	4.5	4.7	2.1	2.8	3.0	3.2	-12.8	-12.7	-12.7	-12.8
Mexico	3.6	3.5	3.8	3.9	3.7	3.7	3.6	3.8	-24.8	-13.3	-27.7	-16.7
Panama	9.0	8.0	8.0	7.4	4.4	4.9	4.4	4.5	-3.5	-4.9	-3.5	-5.1
Peru	6.2	6.1	6.4	6.2	2.4	2.7	2.6	2.6	-5.8	-7.5	-6.9	-8.1
Venezuela	1.0	1.3	2.0	2.4	24.6	29.5	24.0	26.4	17.3	19.3	24.6	19.0
<b>Europe</b>	<b>2.6%</b>	<b>2.8%</b>	<b>3.4%</b>	<b>3.7%</b>	<b>5.7%</b>	<b>5.3%</b>	<b>5.2%</b>	<b>5.1%</b>	<b>-18.2</b>	<b>-4.0</b>	<b>-71.4</b>	<b>-34.6</b>
Czech R	-0.2	0.1	0.9	1.8	2.1	3.0	1.5	2.5	-3.0	-0.4	-3.7	-0.5
Hungary	-0.1	0.0	1.2	1.3	2.7	3.6	3.1	3.4	3.7	2.3	4.7	2.1
Kazakhstan	4.8	5.7	4.1	5.9	6.9	4.8	6.4	6.1	9.9	10.2	7.3	10.2
Poland	1.3	1.4	2.8	2.8	1.7	2.1	2.4	2.4	-14.0	-14.7	-19.6	-17.9
Romania	1.0	1.5	2.8	2.6	5.3	4.9	3.6	3.7	-7.0	-6.9	-9.0	-7.9
Russia	3.0	3.2	3.6	3.8	6.7	5.9	5.4	5.6	60.2	64.5	20.6	43.7
Slovak Rep	0.7	1.1	1.6	2.5	2.2	2.7	2.5	2.7	3.5	1.9	3.3	1.8
Turkey	4.0	3.8	4.3	4.8	7.4	6.9	7.3	6.1	-59.7	-50.2	-66.1	-56.7
Ukraine	0.0	1.5	4.1	3.7	4.2	5.2	6.8	6.3	-11.9	-10.7	-9.1	-9.4
<b>Above Total</b>	<b>5.1%</b>	<b>5.4%</b>	<b>5.4%</b>	<b>5.1%</b>	<b>4.6%</b>	<b>4.8%</b>	<b>4.7%</b>	<b>4.2%</b>	<b>151.4</b>	<b>179.8</b>	<b>92.0</b>	<b>214.0</b>

Source: Consensus Economics, Citi Research

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## Asia-Pacific

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## China

Minggao Shen  
+852 2501 2485  
minggao.shen@citi.com

Shuang Ding  
+852 2501 2769  
shuang.ding@citi.com

Enjiang Cheng  
+86 10 5937 6038  
enjiang.cheng@citi.com

- **Summary view** – The adjusted data after removing distortions in Jan-Feb remains supportive to the trend of a weak recovery. We continue to expect around 8% yoy GDP growth in 1Q this year. The monetary policy may gradually shift towards neutral from last year's expansionary stance.
- **Things to watch** – Stable growth and reforms are two priorities of the new government. The short term growth prospect should be affected more by policies related to local government funding and property market. March data which is less distorted by seasonal effects shall be directional to the near-term growth.
- **Strategy** – We believe the new government will likely speed up interest rate and capital account liberalization, and improve FX regime flexibility in the near future. This may support a gradual normalization of capital cost and RMB appreciation going forward. The equity market may continue to gain support in the near term from weak economic recovery and thus earnings upside.

### Macro-data show a weak economic recovery

**The Jan-Feb data indicate a weak recovery** – Economic data were mixed in the beginning of the year, partly distorted by seasonal effects. Fixed asset investment (FAI) grew by 21.2%YoY in Jan-Feb, stronger than expected. Its growth in the secondary industry (e.g., manufacturing and construction), however, dropped from 20.2% in 2012 to 15.6%YoY in Jan-Feb as excessive capacity continued to weigh on investment. China's day-adjusted exports surged 25.7% yoy from 9.6% in the previous quarter. Retails sales growth fell from 15.2% in Dec 2012 to 12.3%YoY in Jan-Feb, hit by the campaign to curb lavishing government spending. But the slowdown could be distorted by the fact there was 29 days in Feb last year. If measured by daily average growth, power consumption might have grown 7.3% YoY instead of the reported 5.5% YoY in Jan-Feb. The industrial production had gained 11.8% vs. the reported 9.9%, roughly in line with 8% YoY GDP in 1Q.

**Feb witnessed a slow money and credit growth** – M2 growth fell from 15.9% YoY in Jan off to 15.2%YoY in Feb before the day-adjustment, but was higher than market expectations and significantly higher than the PBOC's target of 13% for the year. Total social financing had come down sharply from Rmb2.54 tn in Jan to Rmb1.07 tn in Feb. However, the abundant liquidity and credit early in the year remains supportive to the economy. The uptrend of inflation would raise concerns to the authorities likely in 2H. We thus expect the central bank to steadily bring broad money growth down to 13% and cap new RMB lending at Rmb8.5-9.0 tn.

### A tough balance between reform and growth ahead

**New leaders have called for the China 2.0 version of economic growth** – The new government that was installed in the 1<sup>st</sup> session of the 12<sup>th</sup> National People's Congress (NPC) has pledged to upgrade its economy through exploring reform dividend, domestic consumption potential and innovation efficiency. It has determined to restrain the government's visible hands to improve the ease of doing business in China and also to streamline government spending, make the budget system more transparent and inclusive, and carry on interest rate liberalization and FX regime reform. These reforms are likely painful adjustments and, if implemented successfully, are expected to facilitate structural adjustment and contribute to sustainable growth in the longer term.

**But the economy is short of near-term growth drivers** – We don't think the strong export growth in Jan-Feb can be sustained due to still weak external demand. Deceleration in retail sales may continue as the government is likely to keep curbing government spending. The accelerated investment in the property market could be short-lived due to rising uncertainty after the government kicked start another round of property policy tightening in Feb. Both manufacturers and property developers may hold off their capex before they have better views about policy and reform outlook, adding some downside risks to our GDP forecast.

**Local government-led investment growth may drift down if reform measures are implemented** – In the short term, intended reforms will likely restrain local governments' capacity of investment, which was a key driver of recent economic recovery. The investment in real economy will likely stay soft until de-capacity and consolidation take place in the manufacturing sector. On the positive side, the increased government spending on social welfare may support consumption sentiment. Only actions not words from the new government can boost the confidence of private investors in our view. The new government may also increase investment on urban infrastructure, such as subways, and renovation of old towns to promote urbanization. Given the weak manufacturing investment, new policy measures could be taken by the government to promote the development of the service sector.

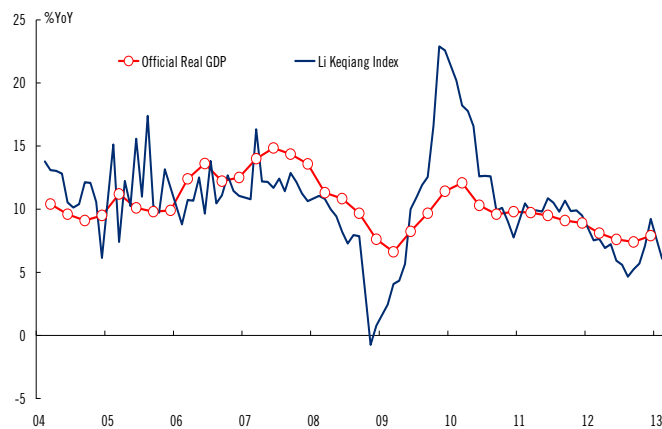
**The policy stance may gradually return to neutral this year** – The annual meeting of the NPC have provided more specifics about macro policies for 2013. The government targets M2 growth at 13%. We expect monetary policy to gradually shift towards neutral from last year's expansionary stance, but not much more than that. The economy will have to go downtrend if the government tightens both property and monetary policies simultaneously. The regulators may take measures to discipline the shadow banking activities in order to contain credit risks. The fiscal policy tends to be more supportive to the economy, but would be constrained by slower growth of fiscal revenue and land sales.

## March data matters

**The weak recovery needs to be confirmed by less distorted March data** – The new government puts growth on top of its agenda. The 7% annual growth is likely the bottom line but it's not clear what the authorities would do if this bottom line is tested. In coming months, a few trends are worth noting. First, whether can exports continue to stay elevated, exceeding the government's annual target of 8% and our forecast of 10%? Second, whether is the external funding able to sustain the uptrend of infrastructure investment in the near term? Third, whether can the weak restocking be followed by better economic activities? Lastly, whether monetary policy will remain accommodative before CPI mounts persistently to above 3% yoy?

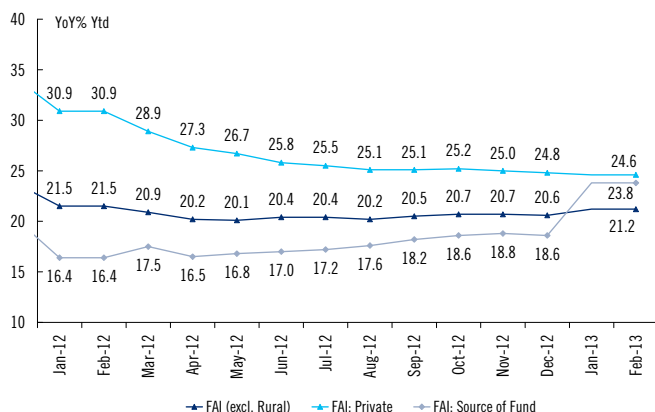
**Investors are waiting for policy directions** – All policy changes will likely be carefully managed as the new administration tends to balance between growth and reform. The interest rate liberalization, if carried on this year, should lift the cost of capital in general. The daily trading band of the RMB exchange rate could be further widened, leading to a gradual but steady appreciation of the RMB against the dollar. We believe the pace of economic recovery shall determine the upside of corporate earnings and the equity market rebound after recent correction. In general, a slower but better quality growth through reform or rebalancing can lift the market sentiment more than a faster growth based on the old model in our view.

Figure 38. LKQI has shown some weakness but trend likely stays intact



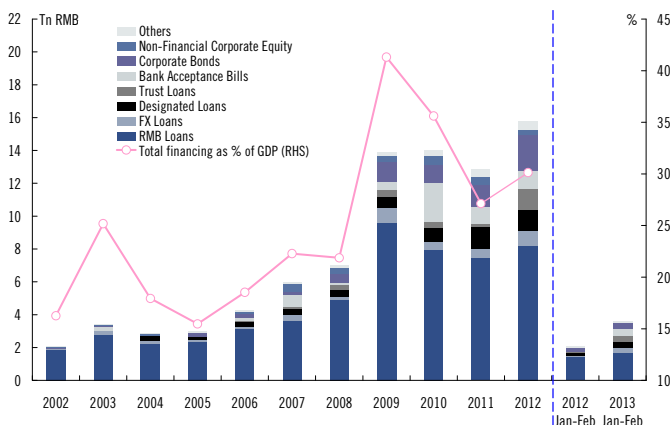
Source: CEIC and Citi Research

Figure 40. FAI accelerated, supported by easy funding



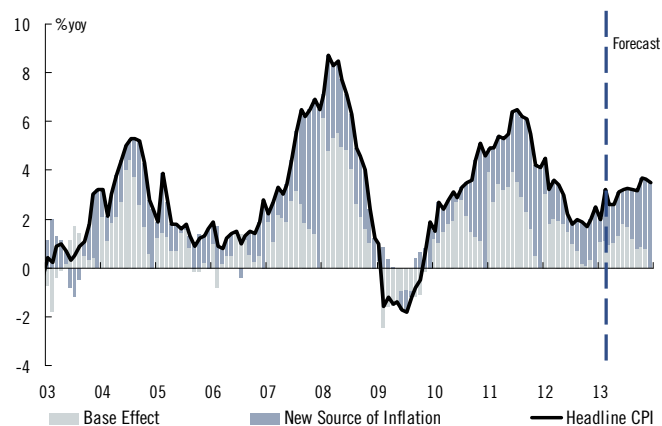
Source: CEIC and Citi Research

Figure 42. Total social financing reached record high



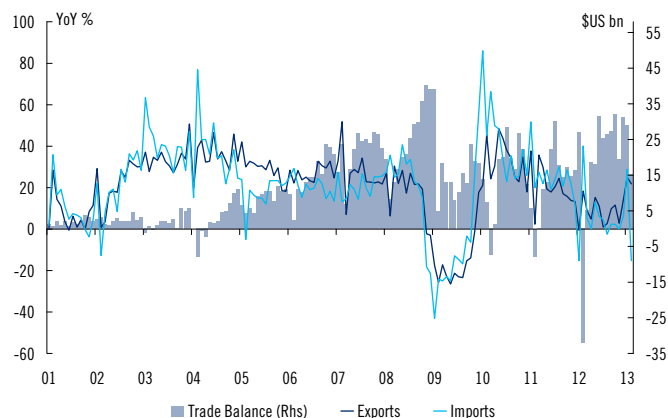
Source: CEIC and Citi Research

Figure 39. Inflation may normalize in Mar but uptrend likely continue



Source: CEIC and Citi Research

Figure 41. Stronger exports in Jan-Feb but may not be sustained



Source: CEIC and Citi Research

Figure 43. Main Economic targets for 2013

	2013 Target	2012 Target	2012 Actual
GDP (YoY%)	7.5	7.5	7.8
CPI (YoY%)	3.5	4.0	2.6
M2 (YoY%)	13.0	14.0	13.8
Retail Sales (YoY%)	14.5	14.0	14.3
FAI (YoY%)	18.0	16.0	20.3
Budget Deficit (as % GDP)	2.0	1.5	1.5
Social Housing new starts (mn units)	6.3	7.0	7.81
Social Housing completed (mn Units)	4.7	5.0	6.01
Urban unemployment rate (%)	below 4.6	below 4.6	4.1
Urbanization (%)	53.37	52.07	52.6
New jobs creation (mn)	9.0	9.0	12.66

Source: Xinhua, Reuters and Citi Research

Figure 44. China Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	2,787.2	3,494.5	4,544.0	5,070.5	5,932.5	7,319.0	8,244.5	9,318.7	10,420.8
Nominal GDP, local currency bn	22,224	26,583	31,490	34,632	40,151	47,310	51,932	57,439	63,371
GDP per capita, US\$	2,120	2,645	3,422	3,800	4,424	5,432	6,089	6,855	7,635
Population, mn	1,314.5	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,359.5	1,364.9
Unemployment, % of labour force	4.1	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2
<b>Economic Activity</b>									
Real GDP, % yoy	12.7	14.2	9.6	9.2	10.4	9.3	7.8	7.8	7.3
Real investment growth % yoy	13.6	14.7	11.0	19.2	11.9	9.7	8.4	8.2	7.3
Real consumption growth % yoy	9.8	11.0	8.5	9.4	9.2	10.7	8.2	8.5	8.1
private consumption growth % yoy	11.3	11.1	9.2	10.3	8.5	17.1	8.4	8.7	8.3
Real export growth, % yoy	--	--	--	--	--	--	--	--	--
Real import growth, % yoy	--	--	--	--	--	--	--	--	--
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	2.8	6.5	1.2	1.9	4.6	4.1	2.5	3.5	4.0
CPI, % avg	1.5	4.8	5.9	-0.7	3.3	5.4	2.6	2.8	3.6
Nominal wages, % yoy	14.6	18.5	16.9	11.6	13.3	17.8	9.8	10.6	10.3
Credit extension to private sector, % yoy	14.3	19.3	14.0	33.2	20.3	15.1	14.8	13.6	13.4
Policy interest rate, % eop	2.52	4.14	2.25	2.25	2.75	3.50	3.00	3.25	3.75
1 month inter-bank rate, % eop	2.58	3.61	1.23	1.79	6.17	6.00	4.90	5.15	5.65
Long term yield, % eop	2.62	4.19	1.80	3.06	3.61	3.27	3.33	3.58	4.08
lc/US\$, eop	7.81	7.30	6.82	6.83	6.59	6.29	6.23	6.10	6.06
lc/US\$, avg	7.97	7.61	6.95	6.83	6.77	6.46	6.31	6.15	6.07
<b>Balance of Payments, US\$ bn</b>									
Current account	231.8	353.2	420.6	243.3	237.8	201.7	213.8	223.6	229.3
% of GDP	8.3	10.1	9.3	4.8	4.0	2.8	2.6	2.4	2.2
Trade balance	177.5	264.3	298.1	195.7	181.5	154.9	231.1	268.8	262.8
Exports	969.0	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.9	2,232.6	2,502.7
Imports	791.5	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,817.8	1,963.8	2,239.8
Service balance	-8.8	-7.9	-11.8	-29.4	-31.2	-55.2	-89.5	-98.5	-108.3
Income balance	-5.1	8.0	28.6	-8.5	-25.9	-11.9	-23.5	-0.6	-1.9
FDI, net	102.9	143.1	121.7	87.2	185.7	170.4	180.1	125.6	94.3
International reserves	1,066.3	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,686.0	3,883.1
Total Amortisations	17.9	20.3	23.3	34.2	27.2	33.2	38.8	41.8	46.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-1.0	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-2.0	-2.0
Consolidated gov primary balance	-0.5	1.0	0.1	-1.8	-1.7	-0.9	-1.6	-1.6	-1.6
Public debt	18.6	39.0	37.4	47.8	49.2	44.3	43.3	42.0	40.4
of which Domestic	17.4	38.0	36.6	47.0	48.6	43.7	42.8	41.5	39.9
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	338.6	389.2	390.2	428.6	548.9	695.0	764.5	840.9	925.0
Private	304.2	354.3	356.9	391.8	510.1	657.6	723.4	795.7	875.3
Public	34.4	34.9	33.3	36.9	38.8	37.4	41.1	45.2	49.7
External debt / GDP	12.1	11.1	8.6	8.5	9.3	9.5	9.3	9.0	8.9
External debt / XGS	31.9	29.0	24.7	32.2	31.5	33.4	34.0	34.3	33.7
Short-term debt	199.2	235.7	226.3	259.3	375.7	475.7	523.2	575.5	633.1
Short-term debt/International Reserves (%)	18.7	15.4	11.6	10.8	13.2	15.0	15.8	15.6	16.3
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	7.4	7.9	8.0	8.2	7.7	7.5	7.1	7.2	7.4
CPI, % yoy	1.9	2.5	2.2	2.7	3.1	3.5	3.5	3.3	3.5
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.50	3.50
1 month inter-bank rate, % eop	3.99	4.90	4.90	4.90	4.90	5.15	5.40	5.40	5.40
Long term yield, % eop	3.24	3.33	3.33	3.33	3.33	3.58	3.83	3.83	3.83
lc vs USD, eop	6.28	6.23	6.20	6.16	6.13	6.10	6.09	6.08	6.07

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

\*Note: Public debt is based on official data, not including the local government debt as audited by the National Auditing Office in summer 2011. External debt is based on the residency of the holder of the debt (not by currency denomination).

## Hong Kong

Adrienne Lui  
+852 2501 2753  
adrienne.lui@citi.com

- **Summary view** – Economic recovery in 1Q likely continued but at a slower pace, mainly as net exports recovery still on uneven recovery. Inflation pressures will likely rise going into 2013E. The first new mortgage hike by key banks is a fair warning that interest rates are bound to normalize in our view.
- **Things to watch** – 1) The pace of inflation pick up; 2) Pace of trade recovery; 3) How the property market reacts to the latest set of property curbs and mortgage rate hike; 4) Look out for regulation details on how the HK financial sector can benefit from Qianhai developments.
- **Strategy** – The HKD pulled back from its strong end of the trading band on USD strength, slow Chinese economic recovery and choppy equity markets. 5Y EFN bills are likely to continue to rise in tandem with its US counterparts in the near-term. Our equity strategists target for the HSI Index in FY13 is 22,700.

### Gentle recovery in 1Q expected

**Leading indicators affirms our case of a 1Q modest growth recovery.** Feb PMI, although remains in expansion (index above 50 threshold), slowed to a four-month low. In particular, new orders increased only modestly in the month, but firms did registered improving market conditions and new client deals. The March update of the quarterly Business Tendency Survey indicated that business expectations for the coming quarter actually is declining, all components turned south in March except for 'professional and business services'. This is in line with our view that recovery remains fragile with 1Q GDP growth could be at a more gradual pace of 2.3%yoy and a more solid footing could take place in the 2H.

**Retail sales recovery in progress.** Jan retail sales grew steadily at 10.5%yoy by value, despite a high base of comparison associated with the different CNY timing. Tourist spending and local customers taking advantage of final sales likely drove the encouraging sales in Jan. The Feb print should benefit from a favorable base and the 9 days long golden week holiday in Mainland China likely encouraged Chinese tourists to shop in HK. The real test will be March reading to see if consumption recover indeed sustain after the festive stretch. Despite a rosier sales figure, retailers continue to suffer from weak profit margin as hinted by the narrow difference between the retail sales growth by value and volume.

**CPI inflation will likely rise starting in Feb,** as first exaggerated by Chinese New Year low base effect, and later to reflect faster pass-through of private rentals and overall warming of economic activities. The hiking of statutory minimum wage from HK\$28/hour to HK\$30/hour on 1<sup>st</sup> May, will once again increase labor cost for some low-paid service sectors (such as: estate management, security and catering industries). The resulting higher labor cost will inevitably be passed back to consumers in our view, pushing up inflation, given many of these affected industries already operate a slim margins. We expect CPI inflation to average around 4.3%yoy in 2013E (slightly higher than 2012's 4.1%), however we expect inflation could spike in July to above 7% on public housing subsidy distortion. This is mainly because last year the regular 2-months public rental waiver was administered in July, and this year likely in August.

**Official residential property price data indicates that home prices rise unabated, as of Jan13.** The lower end residential home price index reached 203.3 in Jan, which is 17% above the peak seen in 1997 (Figure 17). Although data is lagged, it does endorse the Government's property measures announced in late-Feb.

## Impacts of property curbs trickling through the system

### **The 6th round of property market cooling measures is yielding initial success.**

The doubling of stamp duties and HKMA's tightening of prudential measures on the 22 Feb appear successful at lowering transaction volumes. Our property analyst, Ken Yeung, has also noted more flexible pricing strategy in the primary residential market, but he sees limited downside to secondary market as rentals are still rising ([HK Property - 3 Positive Developments: Impact of Higher Mortgage Rate Limited](#)).

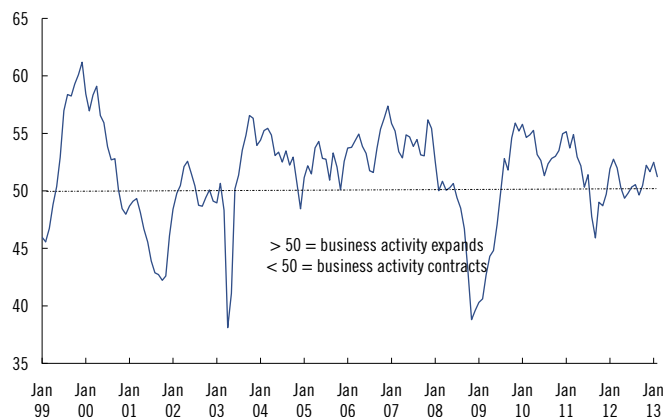
**Policy driven new mortgage rate hike.** On 13-14 Mar, three key banks in HK raised new mortgage rates by 25 bps, raising new mortgage rates to 2.25%-2.50%. This round of rate hikes is a result of key banks passing through their higher capital cost associated with recent HKMA's regulation change. HKMA starting from 23rd Feb requires banks that use the Internal Ratings-Based (IRB) approach for mortgage risk assessment, to set aside capital equivalent to 15% of risk weighted asset (previously below 10%) for all new mortgages. Our banking analyst, Gary Lam, thinks other HK banks likely to follow suit ([HK Banks - The First Mortgage Rate Hike Since '12 - Mid-Cap Banks as Net Winners: Positive Cross-Read on Banks' Pricing Power](#)).

**Beginning of interest rates normalization?** Although this round of mortgage rate hike is policy driven, we again caution that market interest rates could rise faster than policy rates (which currently are suppressed by the US Fed's commitment of low interest rate till 2015 via the HKD peg). However, as US economic recovery gathers momentum, the growing odds of an earlier-than-2015 policy rate hike will continue to pressure market rates upwards. Market rates in HK are also affected by the availability of market liquidity (which is a function of economic growth differentials between the US and China/HK and relative equity market performances). Interest rates charged by individual banks would also be adjusted according to respective loan-to-deposit ratio and lending strategies (i.e. when banks prefer other higher-margin-loans over mortgages, new mortgage rates can once again be raised). Note mortgage is about 26% of total loans currently.

## Planning more cross-boarder activities in Qianhai

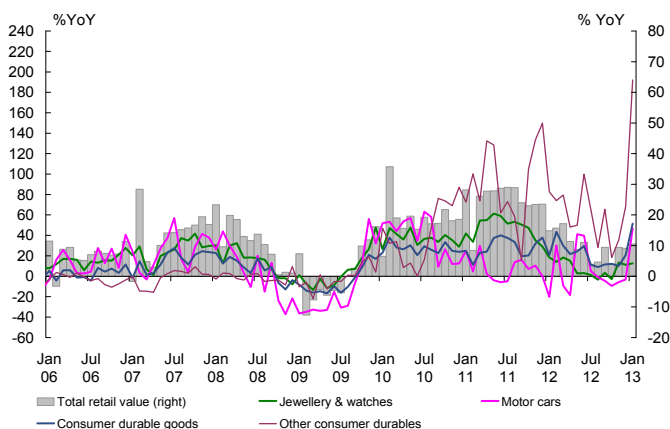
**HK firms likely to take advantage of Qianhai initiatives.** The focus thus far for HK investments in Qianhai special economic zone in Shenzhen has been related to cross boarder RMB financing. This likely will be a key channel for HK banks to circulate accumulated RMB deposit back to onshore, and this was kick started in late-Jan when 15 HK banks lent a total of RMB2bn to corporates in Qianhai. In March, Shenzhen regulators announced the Qualified Foreign Limited Partner (QFLP) scheme and designated Qianhai as the first trial area. The scheme will allow foreign (including HK) firms to make cash investments into equity investment firms or equity investment management firms in Qianhai. The preferential policies (esp. corporate tax benefits) in Qianhai will likely be attractive to private equities from HK. Aside from financials, other services types in HK are waiting for the list of key industries allowed to operate in Qianhai. Announcement by NDRC on 12 March has set the overall tone that the eligible service industries would include financials, logistics, info/communications, tech services, environmental and professional (e.g. law, evaluation, accounting, consulting, engineering, cultural, conventions, education, medical, human resources and knowledge protection rights). Policy details will soon be announced by the Qianhai regulators. Given the attractiveness of personal tax rebate provided by the Shenzhen government for foreign professionals working in Qianhai, the diverse types of modern industry opportunities offered there will likely encourage more cross boarder labor movements and business activities as this Qianhai zone takes scale.

Figure 45. PMI slowed in Feb suggesting modest recovery in 1Q



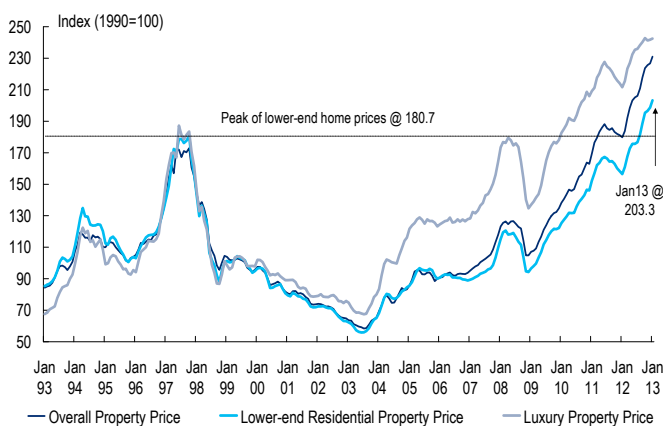
Source: Markit, Haver, and Citi Research

Figure 47. Consumption recovery thus far seems broad based



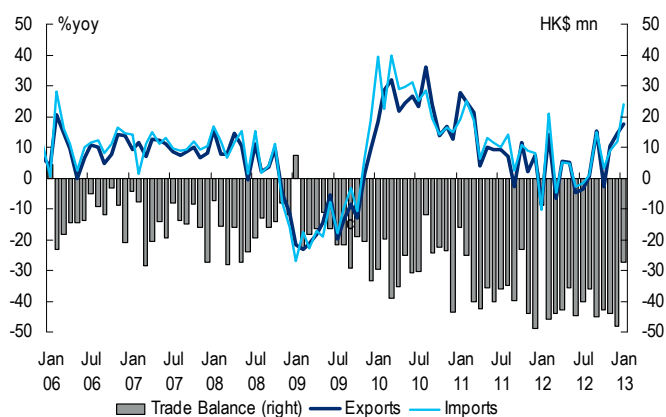
Source: CEIC, and Citi Research

Figure 49. Property price rise unabated as of Jan13



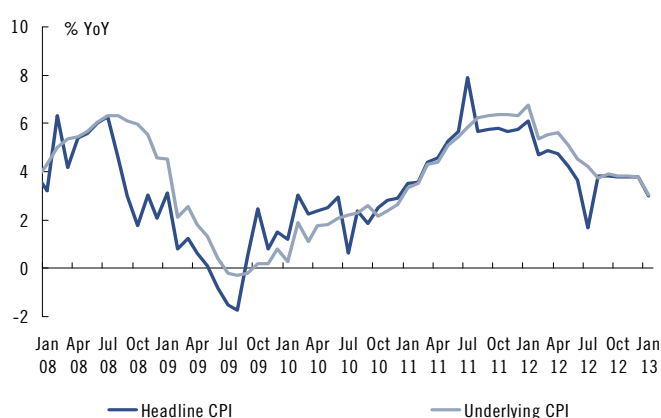
Source: CEIC, and Citi Research

Figure 46. Expect uneven, but nonetheless, trade recovery in 2013E



Source: CEIC, and Citi Research

Figure 48. Price pressures likely to accumulate in 2013E



Source: CEIC, and Citi Research

Figure 50. HKD edged off from the strong end of trading band



Source: Reuters, and Citi Research

Figure 51. Hong Kong Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	193.5	211.6	219.3	214.0	228.7	248.7	263.0	282.2	302.8
Nominal GDP, local currency bn	1,503	1,651	1,707	1,659	1,777	1,936	2,040	2,189	2,347
GDP per capita, US\$	28,031	30,497	31,488	30,594	32,429	34,970	36,705	39,072	41,582
Population, mn	6.9	6.9	7.0	7.0	7.1	7.1	7.2	7.2	7.3
Unemployment, % of labour force	4.8	4.1	3.4	5.2	4.4	3.5	3.3	3.3	3.2
<b>Economic Activity</b>									
Real GDP, % yoy	7.0	6.5	2.1	-2.5	6.8	4.9	1.4	3.0	3.5
Real investment growth % yoy	8.4	7.8	-0.3	1.0	10.4	3.1	4.4	5.7	2.1
Real consumption growth % yoy	5.4	7.9	1.9	1.0	5.9	8.1	3.9	2.1	2.0
private consumption growth % yoy	6.1	8.6	1.9	0.8	6.3	9.0	4.0	2.1	2.1
Real export growth, % yoy	9.4	8.3	2.5	-10.2	16.8	3.7	1.3	1.9	4.3
Real import growth, % yoy	9.1	9.1	2.2	-9.0	17.4	4.6	2.5	1.9	3.7
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	2.3	3.8	2.1	1.5	2.9	5.7	3.8	4.2	3.5
CPI, % avg	2.1	2.0	4.3	0.6	2.3	5.3	4.1	4.3	3.7
Nominal wages, % yoy	2.1	2.4	4.0	-1.9	2.4	9.9	5.0	3.5	4.5
Credit extension to private sector, % yoy	2.3	15.2	11.0	-2.1	20.9	12.5	7.0	8.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	3.84	3.31	0.89	0.13	0.33	0.33	0.50	0.75	1.15
Long term yield, % eop	3.69	3.10	1.19	1.93	1.76	0.96	0.32	1.00	2.10
lc/US\$, eop	7.78	7.80	7.75	7.75	7.77	7.77	7.75	7.76	7.75
lc/US\$, avg	7.77	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.75
<b>Balance of Payments, US\$ bn</b>									
Current account	24.6	27.6	32.9	20.3	15.0	16.2	13.2	15.9	18.7
% of GDP	12.7	13.0	15.0	9.5	6.6	6.5	5.0	5.6	6.2
Trade balance	-17.9	-23.5	-25.9	-28.9	-43.1	-54.8	-61.6	-52.4	-53.3
Exports	316.8	344.7	363.0	318.7	390.4	429.2	443.1	479.8	524.7
Imports	334.7	368.2	388.9	347.6	433.5	484.0	504.7	532.2	577.9
Service balance	-9.3	-4.3	-2.7	3.4	10.1	19.0	18.0	18.2	18.4
Income balance	4.6	6.8	12.9	6.4	4.8	8.8	7.1	7.1	7.2
FDI, net	-15.5	-19.0	-8.9	-6.4	-10.5	-6.9	-9.8	-11.0	-12.0
International reserves	133.2	152.6	182.5	255.7	268.6	285.3	317.2	340.0	365.0
Total Amortisations	--	--	--	--	--	--	--	--	--
<b>Public Finances, % of GDP</b>									
Consolidated government balance	3.8	7.3	0.1	1.5	4.1	3.8	3.2	1.8	1.0
Consolidated gov primary balance	3.9	7.4	0.1	1.6	4.2	3.8	3.2	1.8	1.1
Public debt	1.4	1.2	1.0	0.7	0.6	0.6	0.5	1.0	1.3
of which Domestic	0.6	0.4	0.2	0.1	0.0	0.0	0.1	0.2	0.3
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	1.4	2.5	2.3	2.9	3.4	3.5	3.6	4.7	3.3
CPI, % yoy	3.8	3.8	3.8	4.5	4.4	4.1	3.8	3.4	4.1
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	0.33	0.35	0.25	0.37	0.55	0.67	0.77	0.87	0.97
Long term yield, % eop	0.32	0.33	0.65	0.75	0.85	1.00	1.20	1.40	1.50
lc vs USD, eop	7.75	7.75	7.76	7.76	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.

Rohini Malkani  
+91 22 6631 9876  
rohini.malkani@citi.com

## India

- **Summary view** – While the reforms seen since Sept 12 are encouraging, underlying macro trends remain weak with quarterly GDP in the 4% handle, deficits – both centre and current account over 5%.
- **Things to watch** – The withdrawal of a key government ally could undermine the reform momentum. More-over, political uncertainty could once again bring up the chatter of early elections, threats of even slower growth and possible ratings action.
- **Strategy** – Despite GDP growth at decadal lows and core inflation moderating to sub 4% levels, we believe elevated levels of CPI and CAD is likely to result in only a further 25bps of rate cuts in 2013. High deficits are likely to result in the INR trading in the Rs54-56 range over the next few months.

### GDP – maintain estimates of a shallow recovery in FY14

**Quarterly GDP in the 4% handle:** Following the 5.5% and 5.3% growth in 1Q and 2QFY13, growth in 3QFY13 (Oct-Dec) slowed to 4.5%. While a sub 5% GDP reading would have surprised a few months ago, given the CSO's advance GDP estimates of 5% for FY13 ([FY13 GDP at a Decade Low](#)), the 4.5% print was largely in line. With 9M FY13 growth at 5%, growth in 4QFY13 would need to rise to 5% to meet the CSO's advance GDP estimate of 5%. We believe this is likely and maintain our view of a modest uptick in the coming quarters.

**Maintain 5.7% GDP estimate for FY14:** Latest high frequency numbers are encouraging with the Jan factory output coming in at 2.4%. However, key to note is that underlying trends remain weak with growth on a 3mma basis a mere 0.3%. Assuming continued incremental policy momentum, we maintain our view of a shallow recovery to 5.7% in FY14 v/s 5.0% in FY13. This factors in: (1) The RBI easing rates by a further 25bps by 1H13; (2) A pick-up in consumption as FY14 is a pre-election year and lower rates could help; (3) A marginal uptick in investments, which rests on continued government efforts – both policy change and execution.

### External – CAD concerns remain on the forefront

**Current Account Deficit (CAD) to Remain Elevated.** Worries on India's current account deficit continue unabated. Rising deficits and consequently the minimum external funding requirements to the tune of US\$90bn or ~5% of GDP bring to fore concerns on (1) India's rising vulnerability if the current global risk environment changes (2) Structural issues relating to the CAD such as rise in investment income outflows, impact of fuel reform on oil consumption and India's unabated demand for gold (3) Need to speed up measures to attract dollar inflows.

**Capital raising to remain a Priority:** As mentioned earlier, policy makers are aware of the gravity of the problem as reflected in Governor Subbarao's recent comments on the level, the quality and financing of the CAD. Over the last few months, officials have taken several steps to boost dollar inflows including (1) de-regulating NRI deposit rates, (2) relaxing ECB norms, (3) increasing FII debt limits, (4) liberalization of FDI, (5) postponement of GAAR, and (6) higher duties on gold. Given India's rising external financing requirements, we expect capital raising to remain priority.

**INR – Cautious Talk But Optimistic Walk:** A key take-away in our recent marketing trip was the universal bearishness on the INR. However, interestingly, the bearish outlook was not reflected investors' positions given (1) the attractive carry, and (2) ability of policymakers to dangle carrots (bond market incentives, higher FDI limits, possible commercial bond issuance.) We maintain our view of the INR trading in the Rs54-56 range.

## **RBI – limited headroom for monetary easing**

**RBI cuts, but says limited room** — In line with expectations, the RBI in its March 19 policy cut the repo rate by 25bps to 7.50%. Going forward, despite GDP growth at decadal lows and core inflation moderating to sub 4% levels, we concur with the RBI's latest guidance that "***the headroom for further monetary easing remains quite limited***" due to (1) Double-digit trends in the CPI and (2) Elevated current account deficits. We thus maintain our view of the RBI likely to ease policy rates by only a further 25bps in 2013, likely in its Annual Policy on May 3.

## **Fiscal – good for now, but will it sustain?**

**Budget Disappoints Investor Expectations** — The FM's global road shows had raised budget expectations of a platter of growth/capital raising measures being unveiled. While the budget did offer a bit – some investment tax incentives, a kicker for mortgages, savings initiatives and capital/bond market deepening, these are not particularly big, or likely to impact the economy near term. As regards the budget arithmetic, consensus view was that meeting fiscal targets in FY13 helped avert a downgrade (for now), but most doubt the ability of the govt to rein in deficits in a pre-election year.

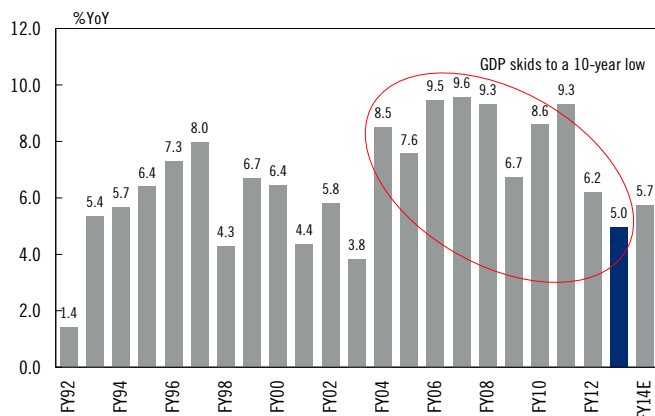
**Ratings – Relief for Now, But Stay on Guard:** Recent reform measures have been encouraging and reduce probability of a downgrade. However, risks persist due to (1) the fiscal situation – while meeting fiscal targets helped avert a rating downgrade in FY13, the same could be uncertain in FY14, given it is a pre-election year. (2) Growth-Inflation dynamics – GDP growth is at a decadal low, while Inflation remains sticky largely due to (1) high food price inflation and (2) wage inflation.

## **Politics – earlier than expected uncertainty**

**Key Ally Declares Withdrawal of Support** — Shortly after the RBI rate announcement, the DMK – a key ally (18 seats) of the govt declared that it was withdrawing support in protest against the government's position on a US-backed UN resolution on alleged war crimes carried out during Sri Lanka's civil war. While the UPA government was already in a minority (quick recap – The TMC withdrew support following the Sept 12 reforms), it had a "working" majority in parliament thanks to the support of regional parties. With the DMK's announcement, the working majority could reduce to 281 (majority needed: 271 seats).

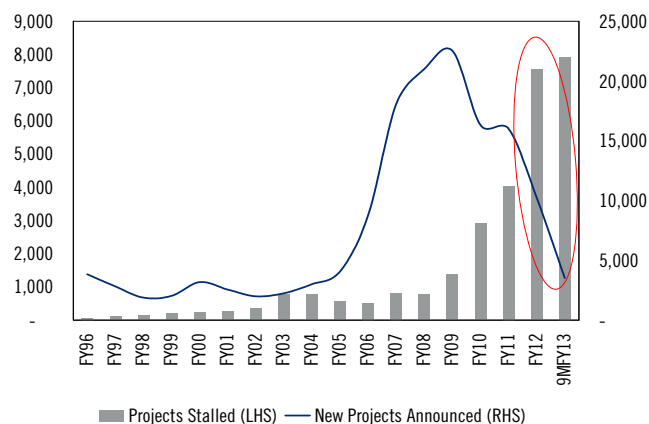
**Macro Implications of Political Uncertainty**— While investors had priced in politics dominating economics from Sept/Oct (See [Asia Trip Notes](#)) it has come into play sooner than expected. Although the govt still has a working majority in the Lower House, its position in the Upper House is relatively weaker. This could undermine the reform momentum seen since Sept 12. More-over, political uncertainty would once again bring up the chatter of early elections, threats of even slower growth and possible ratings action.

Figure 52. GDP – Expect a Shallow Recovery (%)



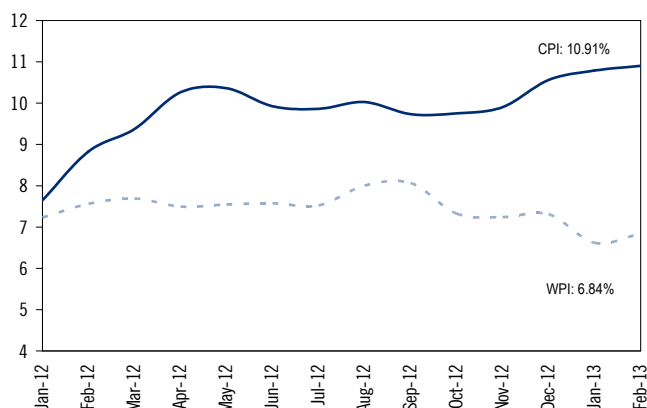
Source: CSO; Citi Research

Figure 53. As Projects Cancelled and Announced Stay High (Rs bn)



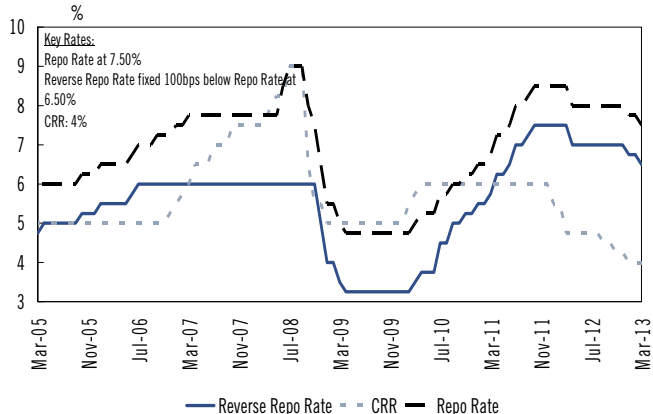
Source: CMIE

Figure 54. Diverging Trends in WPI and CPI to Continue (%)



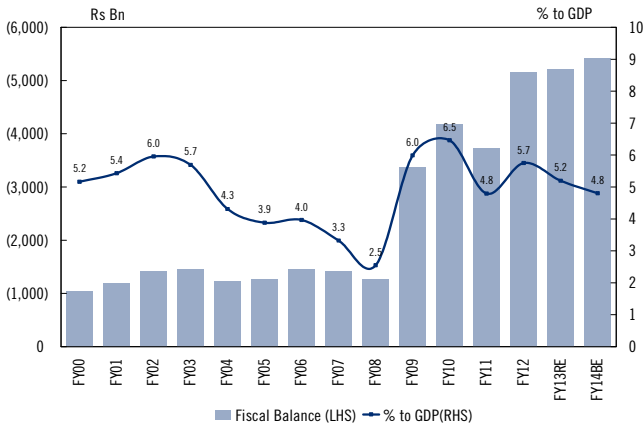
Source: Office of the Economic Advisor

Figure 55. Limited Room for Monetary Easing (%)



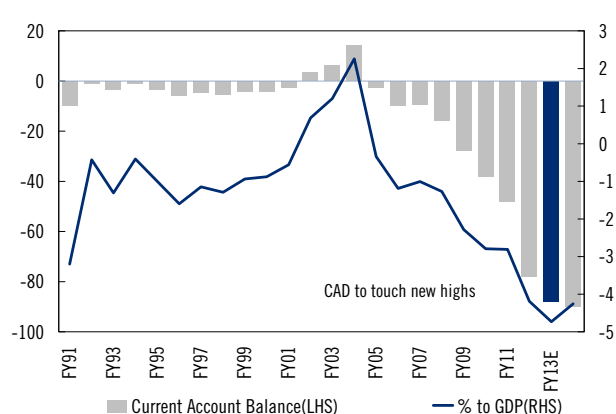
Source: Bloomberg

Figure 56. Fiscal Consolidation – Key for Ratings (Rs bn, %)



Source: Budget Documents; Citi Research

Figure 57. Elevated CAD – Headwind for the INR



Source: RBI; Citi Research

Figure 58. India Economic Indicators

	FY07	FY08	FY09	FY10	FY11	FY12	FY13F	FY14F	FY15F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	950.2	1,240.6	1,223.9	1,366.6	1,710.2	1,865.9	1,857.1	2,112.5	2,430.9
Nominal GDP, local currency bn	42,947	49,871	56,301	64,778	77,953	89,749	100,281	113,017	128,839
GDP per capita, US\$	847	1,090	1,061	1,168	1,442	1,552	1,522	1,706	1,934
Population, mn	1,122.0	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,220.0	1,238.3	1,256.9
Unemployment, % of labour force	--	--	--	--	--	--	--	--	--
<b>Economic Activity</b>									
Real GDP, % yoy	9.6	9.3	6.7	8.6	9.3	6.2	5.0	5.7	6.4
Real investment growth % yoy	13.4	18.1	-5.2	16.7	16.2	1.5	3.9	4.2	4.5
Real consumption growth % yoy	7.9	9.3	7.6	8.2	8.1	8.1	4.1	5.7	6.6
private consumption growth % yoy	8.7	9.2	7.1	7.1	8.6	8.0	4.1	5.5	6.7
Real export growth, % yoy	19.9	5.9	15.2	-4.7	19.7	15.3	5.1	10.0	11.0
Real import growth, % yoy	21.3	10.2	23.0	-2.1	15.8	21.5	5.7	12.0	9.5
<b>Prices, Money &amp; Credit</b>									
WPI, % yoy	6.8	7.7	1.5	10.6	9.7	7.7	7.5	7.0	6.0
WPI, % avg	6.5	4.8	8.1	3.8	9.6	8.9	7.5	7.0	6.0
Nominal wages, % yoy	--	--	--	--	--	--	--	--	--
Credit extension to private sector, % yoy	28.5	23.0	19.0	16.0	17.0	17.5	17.5	17.5	17.5
Policy interest rate, % eop	7.50	7.75	5.00	5.00	6.75	8.50	7.75	7.25	7.50
1 month inter-bank rate, % eop	9.43	8.00	5.68	4.49	9.54	10.90	8.50	8.50	8.50
Long term yield, % eop	7.98	7.96	7.01	7.83	7.99	8.25	8.25	8.25	8.25
lc/US\$, eop	44.12	39.41	48.62	46.41	44.71	53.02	55.00	55.98	55.58
lc/US\$, avg	45.19	41.18	43.42	48.30	45.68	46.63	53.38	55.19	55.73
<b>Balance of Payments, US\$ bn</b>									
Current account	-9.6	-15.7	-27.9	-38.2	-48.1	-78.2	-87.9	-89.9	-88.3
% of GDP	-1.0	-1.3	-2.3	-2.8	-2.8	-4.2	-4.7	-4.3	-3.6
Trade balance	-61.8	-91.5	-119.5	-118.2	-127.3	-189.8	-200.3	-206.4	-221.8
Exports	128.9	166.2	189.0	182.4	256.2	309.8	294.3	317.8	349.6
Imports	190.7	257.6	308.5	300.6	383.5	499.5	494.5	524.2	571.4
Service balance	29.5	38.9	53.9	35.8	44.1	64.1	62.0	64.1	73.1
Income balance	-7.3	-5.1	-7.1	-8.0	-18.0	-16.0	-17.0	-17.0	-11.0
FDI, net	7.7	15.9	19.8	18.0	11.8	22.1	23.0	28.0	30.0
International reserves	191.9	299.1	241.6	252.8	273.7	260.9	259.6	257.3	255.6
Total Amortisations	11.4	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-5.4	-4.1	-8.4	-9.6	-8.2	-8.2	-8.6	-8.3	-7.8
Consolidated gov primary balance	0.0	-1.1	3.4	4.6	2.7	2.2	--	--	--
Public debt	79.9	76.1	76.8	75.8	70.7	69.9	67.6	66.8	66.2
of which Domestic	74.7	71.4	72.2	70.8	66.0	65.9	63.2	63.0	62.8
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	172.4	224.4	224.5	260.9	305.9	345.4	360.4	375.4	390.4
Private	123.0	166.3	168.6	193.9	227.9	263.5	278.4	291.4	304.4
Public	49.4	58.1	55.9	67.1	78.1	81.9	82.0	84.0	86.0
External debt / GDP	18.1	18.1	18.3	19.1	17.9	18.5	19.4	17.8	16.1
External debt / XGS	86.1	88.5	77.7	95.2	81.5	77.5	79.9	--	--
Short-term debt	28.1	45.7	43.3	52.3	65.0	78.2	83.2	88.2	93.2
Short-term debt/International Reserves (%)	14.7	15.3	17.9	20.7	23.7	30.0	32.0	34.3	36.5
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	5.3	4.5	5.0	5.3	5.7	5.9	6.0	6.0	--
WPI, % yoy	8.1	7.3	7.0	7.0	6.8	6.5	7.0	7.0	--
Policy interest rate, % eop	8.00	8.00	7.50	7.25	7.25	7.25	7.25	7.25	--
1 month inter-bank rate, % eop	8.46	8.52	8.00	8.00	8.00	8.00	8.00	8.00	--
Long term yield, % eop	8.25	8.25	8.00	8.00	8.00	8.00	8.00	8.00	--
lc vs USD, eop	52.86	55.00	54.27	54.97	55.53	55.98	55.88	55.78	55.68

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).

Helmi Arman  
+62 21 5290 8960  
helmi.arman@citi.com

## Indonesia

- **Summary view** – Growth momentum so far has been kept in check. Coincident indicators such as consumer confidence, car sales still look robust. Investment indicators, which had dropped in 2H12, have also bottomed. We continue to see GDP growing 6.2% this year; i.e. flat from last year.
- **Things to watch** – Concern over the trade deficit has been toned down a notch, as latest trade data showed further improvements in the non-oil and gas trade balance. However inflation is expected to further increase in coming months and could exceed 5.5% YoY in 2Q in our view. The growing oil deficit could also haunt again in 2H.
- **Strategy** – Although balance in the FX market has improved recently, foreign reserves continue to drop, indicating continued pressure. Amid a series of global bond issuances in 2Q, BI may still have ammo to defend the IDR in 2Q; however we are cautious on the 6-12M outlook and have revised up our forecast to 9,900.

### Eyes turning from trade balance to inflation

**Growth momentum so far has been kept in check.** Coincident indicators such as car sales still grew 22% YoY in 2M13 and consumer confidence is still at historically high levels. Meanwhile investment indicators such as truck and heavy machinery sales, which had dropped in 2H12 due to lower demand from mining industries, have shown some sign of recovery. Yet prices of key commodity exports such as coal and palm oil have been relatively stagnant. Manufacturing commodity exports have also not seen signs of broad based recovery. We expect the economy to grow 6.2% this year; i.e. flat versus last year.

**Concern over the trade deficit has been toned down a notch.** Trade data in January showed a further improvement in the non-oil and gas trade deficit. YoY growth of non-oil and gas imports have come down and is now negative following the decline in heavy equipment and truck imports, and more recently food and possibly electronics imports (following increased import regulations).

**However eyes are turning more on inflation, which we expect to creep up further in coming months.** Electricity tariffs, higher wages and more recently spice supply shortages (which followed the implementation of tighter import regulations) have been key factors which drove up inflation to 5.2% by Feb-13, from 4.3% in Dec-12. Although we are maintaining our YE13 inflation forecast at 5.5%, the inflation rate may rise closer to 6% in mid-2013. We do expect an eventual normalization of spice supply, but it may not happen very swiftly.

**Despite the rise in headline inflation, BI may still not see a strong fundamental reason to hike interest rates.** This is because the rise in inflation has been due to factors other than monetary policy, such as government policy on electricity tariffs as well as import regulations. Therefore BI will likely focus more on core inflation instead of the headline. As most of the price increases have been more on the non-core components, core currently stands at 4.3% and will probably stay within BI's 3.5 – 5.5% inflation target in our view. However considering potentially increased market concern on forthcoming inflation numbers, we are still penciling in 1 x 25bps hike in the FasBI rate by end-2Q. We continue to think that any BI rate hike will be used reactively in the event of an adverse movement in capital flows.

## A new momentum on subsidy reform?

**President SBY hinted at forthcoming policy on fuel subsidies**, which will be unveiled within a couple of weeks. Based on past proposals, there are several possibilities: raising subsidized fuel prices or rationing quantity. The magnitude of any rise will be mindful of political implications. It can be by 11%, as proposed by MoF officials late last year, or by 33% as proposed early last year (and was eventually hampered by parliament). In our view any 33% hike will likely be accompanied by a social safety net program and could require a mid-year revision of the government budget or APBN-P, thereby a lengthier political process.

**Policies involving rationing: implementation has never been easy.** The government had also once proposed policies to limit subsidized fuel usage only to public transport vehicles. But the issue has been in making sure the public transport vehicles adhere to their quotas and do not profiteer by exceeding them and reselling fuel to private vehicles, which could lead to supply scarcity. Putting in a mechanism to supervise the quotas (e.g. through bar codes / smart cards) is costly and may not be timely enough. Implications to social order must also be watched if subsidized fuel becomes scarce even for the eligible parties.

**Another option: Wait and see.** Recently Brent crude oil prices have pulled back. There may be temptation to wait further (although consumption volumes will continue to grow and the IDR remains weaker than the budget assumption). Burgeoning fuel subsidies, as in previous years, can be accommodated in the mid-year budget revision through cuts in non-priority spending and/or a higher budget deficit target—financed primarily from the government's cumulative excess financing balance (SAL) which stands at Rp77tn (0.8% GDP). We think this is still the likely scenario; we maintain our baseline forecasts pending any clear decision.

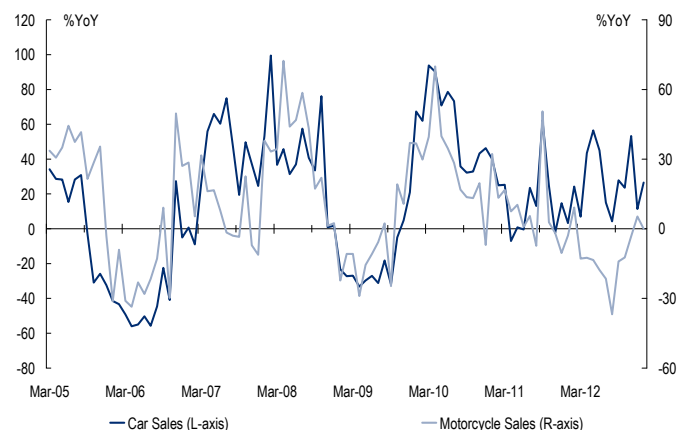
## Reserves keep falling: Is it sustainable?

**Foreign reserves declined in Feb-12 indicating exchange market pressure.** Foreign reserves fell by \$3.6bn to \$105.2bn as of Feb after dropping by \$4bn in the previous month. Even after accounting for revaluation effects, the drop still indicates continued pressure on the exchange market, despite BI managing to keep the IDR hovering close to Rp9,700/\$.

**BI's efforts to increase liquidity and directly cater to oil import demand may have improved market balance, but haven't solved the fundamental problem.** Given the structural current account and basic balance deficits, we think that the best policy is to gradually allow the IDR to depreciate further and for policymakers not to be fixated on certain psychological levels (e.g. 10,000). The IDR has weakened 8% YoY bilaterally against USD, but depreciation in trade weighted terms has been milder (at around 5%), and even more so if the index is also inflation-adjusted (i.e. 3%).

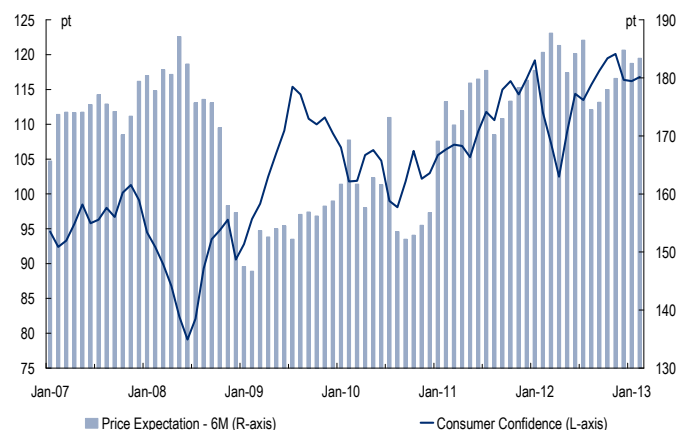
**Policymakers probably can still buy more time, for now but we revise our 6-12M IDR forecast weaker to 9,900/\$.** in March, BI foreign reserves may receive a boost from possibly \$2 – 2.5bn of global bond sales, which may be followed by a quasi sovereign issuance later in the year. Gross foreign assets of commercial banks also still stands close to \$14bn as at Jan, representing a pool to tap for BI's US\$ term deposit facility. However we are upping caution in 2H13, especially if commodity exports do not pick up and there remains lack of effective policy to stem the growing oil trade deficit.

**Figure 59. Car sales growth remains robust**



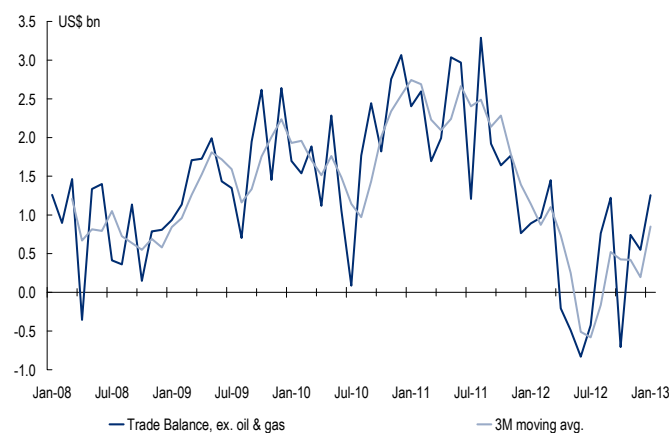
Source: CEIC, and Citi Research

**Figure 60. Consumer confidence resilient despite inflation rising**



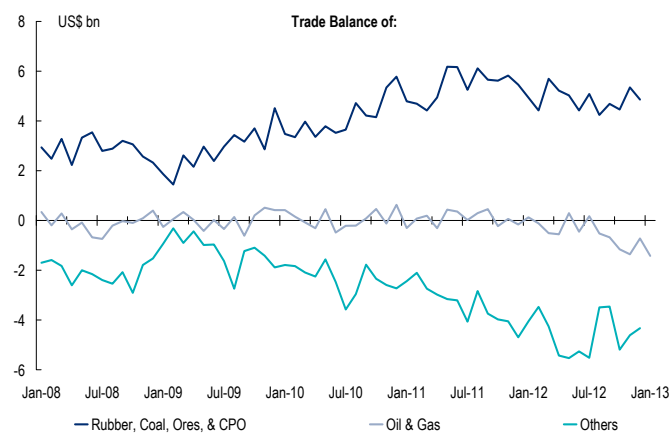
Source: CEIC, and Citi Research

**Figure 61. The non oil and gas trade balance has improved**



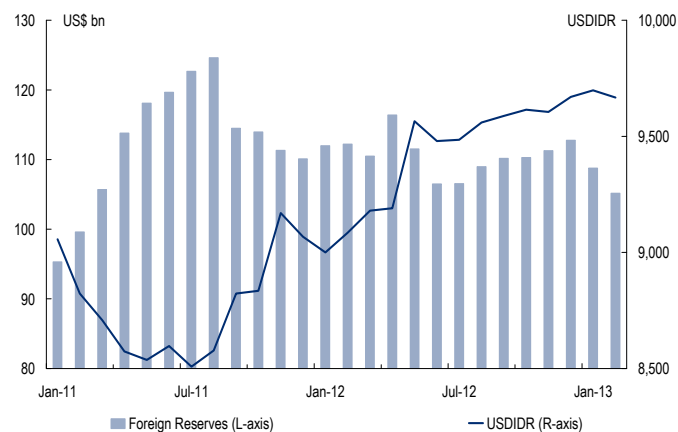
Source: CEIC, and Citi Research

**Figure 62. Oil and gas balance may further widen without policy**



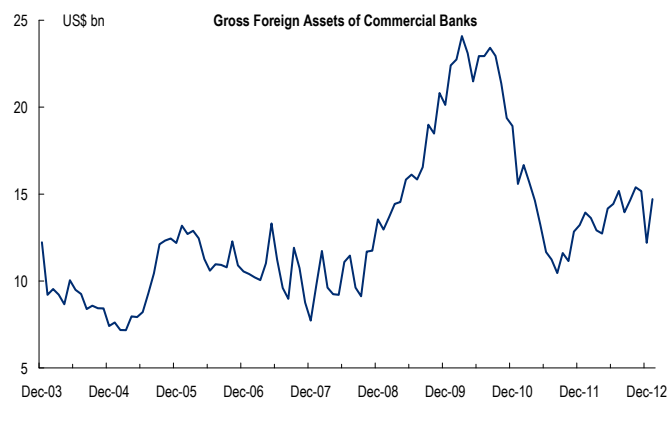
Source: CEIC, and Citi Research

**Figure 63. FX liquidity has improved but reserves dropping**



Source: CEIC, and Citi Research

**Figure 64. Gross foreign assets of commercial banks at \$14bn**



Source: CEIC, and Citi Research

Figure 65. Indonesia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	364.4	432.2	510.7	538.6	709.5	845.8	878.3	958.2	1,087.0
Nominal GDP, local currency bn	3,339,217	3,950,893	4,948,688	5,606,203	6,446,852	7,422,781	8,241,864	9,407,966	10,621,769
GDP per capita, US\$	1,636	1,915	2,235	2,328	2,986	3,486	3,596	3,887	4,358
Population, mn	222.8	225.6	228.5	231.4	237.6	242.6	244.2	246.5	249.4
Unemployment, % of labour force	10.3	9.1	8.4	7.9	7.1	6.6	6.1	5.9	5.8
<b>Economic Activity</b>									
Real GDP, % yoy	5.5	6.3	6.0	4.6	6.2	6.5	6.2	6.2	6.3
Real investment growth % yoy	1.3	1.9	12.4	2.4	11.1	8.2	16.9	7.1	8.7
Real consumption growth % yoy	3.9	4.9	5.9	6.2	4.1	4.5	4.8	5.7	5.9
private consumption growth % yoy	3.2	5.0	5.3	4.9	4.7	4.7	5.3	5.2	5.1
Real export growth, % yoy	9.4	8.5	9.5	-9.7	15.3	13.6	2.0	5.0	9.1
Real import growth, % yoy	8.6	9.1	10.0	-15.0	17.3	13.3	6.6	5.1	10.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	6.6	5.8	11.1	2.8	7.0	3.8	4.3	5.5	4.3
CPI, % avg	13.1	6.3	9.9	4.8	5.1	5.4	4.3	4.7	4.7
Nominal wages, % yoy	6.3	4.2	7.6	5.3	12.2	4.6	12.0	28.0	15.0
Credit extension to private sector, % yoy	12.1	22.4	30.7	18.0	20.8	25.7	22.0	18.0	20.0
Policy interest rate, % eop	4.75	3.00	8.75	6.00	5.50	4.50	4.00	4.25	4.50
1 month inter-bank rate, % eop	5.75	3.35	9.44	6.39	5.66	4.57	4.24	4.65	4.80
Long term yield, % eop	10.18	10.02	11.92	10.07	7.83	6.05	5.39	5.70	6.00
lc/US\$, eop	8994	9393	10900	9425	9010	9068	9638	9892	9699
lc/US\$, avg	9171	9140	9673	10376	9078	8763	9361	9818	9772
<b>Balance of Payments, US\$ bn</b>									
Current account	10.9	10.5	0.1	10.6	5.1	1.7	-24.2	-20.5	-19.1
% of GDP	3.0	2.4	0.0	2.0	0.7	0.2	-2.8	-2.1	-1.8
Trade balance	29.7	32.8	22.9	30.9	30.6	34.8	8.4	12.4	15.9
Exports	103.5	118.0	139.6	119.6	158.1	200.8	188.1	209.1	256.4
Imports	73.9	85.3	116.7	88.7	127.4	166.0	179.7	196.7	240.5
Service balance	-9.9	-11.8	-13.0	-9.7	-9.3	-10.6	-10.8	-11.0	-11.2
Income balance	-13.8	-15.5	-15.2	-15.1	-20.8	-26.7	-25.8	-25.8	-28.0
FDI, net	2.2	2.3	3.4	2.6	11.1	11.5	14.4	14.4	15.5
International reserves	42.6	56.9	51.6	66.1	96.2	110.1	112.8	112.2	114.1
Total Amortisations	16.4	18.8	16.7	20.4	24.0	25.1	40.3	41.0	42.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.9	-1.3	-0.1	-1.6	-0.7	-1.1	-1.8	-1.5	-1.4
Consolidated gov primary balance	1.5	0.8	1.7	0.1	0.6	0.1	-0.8	-0.4	-0.2
Public debt	39.6	34.1	29.3	31.4	26.3	23.5	23.6	21.9	20.9
of which Domestic	22.6	19.7	16.2	19.3	16.7	15.5	16.1	15.6	15.6
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	132.6	141.2	155.1	172.9	202.4	225.4	250.0	285.0	310.0
Private	56.8	60.6	68.5	73.6	83.8	106.7	116.5	146.5	168.0
Public	75.8	80.6	86.6	99.3	118.6	118.6	133.5	138.5	142.0
External debt / GDP	36.4	32.7	30.4	32.1	28.5	26.6	28.5	29.7	28.5
External debt / XGS	115.3	108.2	100.1	130.2	115.8	101.8	118.3	122.3	110.2
Short-term debt	12.2	18.7	20.5	24.0	31.6	36.6	39.0	42.0	45.0
Short-term debt/International Reserves (%)	28.7	32.8	39.7	36.4	32.8	33.2	34.6	37.4	39.4

**Quarterly Economic Indicators**

	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	6.2	6.1	6.0	5.9	6.3	6.5	6.7	6.7	6.2
CPI, % yoy	4.3	4.3	5.4	5.8	5.1	5.5	4.3	3.8	4.4
Policy interest rate, % eop	4.00	4.00	4.00	4.25	4.25	4.25	4.50	4.50	4.50
1 month inter-bank rate, % eop	4.11	4.24	4.20	4.20	4.45	4.65	4.80	4.80	4.80
Long term yield, % eop	5.98	5.39	5.30	5.60	5.50	5.70	5.80	5.90	6.00
lc vs USD, eop	9570	9638	9729	9797	9853	9892	9844	9796	9748

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).

Kit Wei Zheng  
+65 6657 5079  
wei.zheng.kit@citi.com

## Malaysia

- **Summary view** – We maintain our 2013 GDP forecast at 5.5%. BNM has signaled that rates are “appropriate” even as inflation remains low. Media reports suggest that PM Najib may dissolve Parliament around 25th March, though armed conflict in Sabah has thrown a wrench in the electoral calculus.
- **Things to watch** – (1) Newsflow on election timing; (2) Export performance, especially E&E, and spillovers on employment; (3) Implementation of fiscal spending and ETP projects; (4) Developments in Sabah stand-off.
- **Strategy** – Notwithstanding near term cyclical outperformance, heavy foreign positioning in bonds and bills may leave MYR and MGS/bills vulnerable to pre-election jitters, although onshore investors may pick up some of the slack.

### 1Q GDP growth looks on track with improving E&E

**Electrical and electronics (E&E) sector improved in Jan despite disappointing IP.** While Jan IP declined 0.8%MoM SA (Dec: -2.0%) on sequential declines in Mining and Manufacturing IP, our estimates suggest E&E appears to have risen 2.3%MoM SA (Dec: -1.6%), bringing Jan seasonally-adjusted E&E IP levels 2.8% above the 4Q average. Our seasonal adjustment also suggests exports rose 5.1%MoM SA (Dec: -5.9%), with most major products rising sequentially, including E&E which surged 11.8%MoM SA (Dec: -9.4%).

**Resilient domestic demand fueled imports which narrowed the trade surplus sharply.** Robust domestic demand is also indicated by the sequential surge in Jan Electricity IP. We estimate Jan seasonally-adjusted capital good imports are 9.4% above 4Q while consumption good imports are just 0.4% above 4Q, which continues to indicate a rebalancing in domestic demand away from consumption towards investments. The sharply narrower trade surplus and near-term pre-election jitters are however not supportive of MYR strength at least in the near term.

**Bright spots are emerging on the export outlook, though we remain cautious overall.** With semiconductor sales running ahead of production, manufacturers may have to increase production at some stage to rebuild inventories. The surge in intermediate good imports also suggests that export-oriented manufacturers may be preparing to increase production in coming months. Meanwhile, leading indicators of tech demand have improved recently, with the semiconductor book-to-bill ratio climbing above 1 in Jan for the first time in eight months. Nonetheless, given still considerable uncertainties in the external front, we continue to see ample reasons to remain cautious in 1H13. Moreover Malaysia is less exposed to “star” product segments like tablets and smartphones that have lifted North Asian tech exports – though the smaller exposure could limit the impact from weak iPhone 5 shipments on exports and production.

**Consumption and investment should remain resilient.** Consumption will likely remain supported by low unemployment as well as more handouts announced in the Budget including the second round of BR1M handouts, half-month civil service bonus, higher minimum pensions, and incentives to military personnel. This has been further fueled by recent announcements of pay hikes for police, military, and civil servants in the technical and agricultural sector. Assuming a somewhat faster pace of QoQ growth momentum given continued implementation of investment projects and a 2H13 export recovery, we maintain our 2013 growth forecast at 5.5%.

**The investment revival has been further boosted by announcements of joint projects with Singapore.** At focus is the long-anticipated high-speed rail link between Singapore and KL that will cut travel time to just 90 minutes, with operations targeted to begin in 2020. Meanwhile, Khazanah Malaysia and Singapore's Temasek also announced details on two wellness projects in Iskandar worth a combined RM3bn. This comes on top of an RM8bn deal by Singapore's CapitaLand and Temasek, and Malaysia's Iskandar Waterfront Holdings to develop a waterfront township in Danga Bay, Johor Bahru. Meanwhile Iskandar also plans to propose a twin-airport concept to Singapore. That these projects are announced before elections could suggest confidence that the convergence of bilateral economic interests will continue regardless of the election outcome.

### **BNM signals rates are “appropriate”**

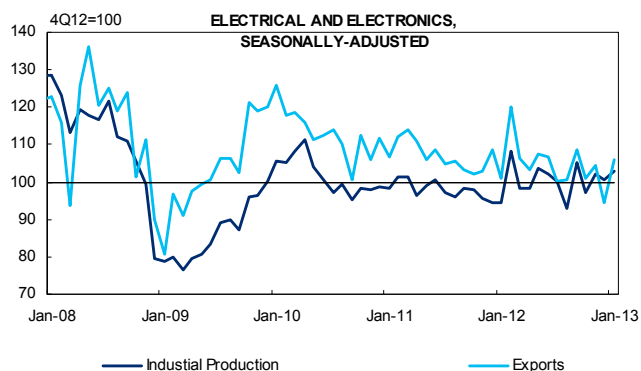
**Feb CPI inflation rose to 1.5%YoY as expected (Jan: 1.3%) on base effects.** Core inflation however (ex food and transport) dipped to 0.8% (Jan: 1.1%) and eased on a 3-month/3-month basis. Going forward, we now expect inflation to average 2.0% in 2013 (prev: 1.7%), picking up to 2-2.5% in 2H13.

**The Mar MPC statement confirmed that rates are “appropriate”.** The MPC's use of the term “appropriate” is the clearest signal yet that changes in the OPR are not under consideration in our view. The policy stance was flagged in similar comments by Governor Zeti to Bloomberg that rates are “appropriate” given that domestic demand is “strong”, with inflation “well below” BNM's implicit tolerance threshold of 3% this year. It is also noteworthy that Gov Zeti's comments on inflation already incorporated some rationalization of subsidies – but even here, the rationalization of petroleum subsidies remains highly conditional upon the outcome of general elections, which remains far from certain in our view. Meanwhile, financial stability concerns are not a major factor yet at this stage – though the highly leveraged positions of household balance sheets relative to history and the region should be monitored, macroprudential measures since end-2010 seem to have successfully moderated household loan growth. Loans to the business sector appear to have moderated, including that for non-residential property, which we had previously identified as a potential pocket of vulnerability. Corporate balance sheets also remain in good shape, with the Malaysian corporate sector standing out as the only one amongst regional peer with lower debt-to-equity ratios and higher interest coverage ratios relative to 2007. In any case, BNM is more likely to use targeted macroprudential measures to tackle pockets of vulnerability rather than interest rates, which would be reserved for broad based financial stability or inflation concerns. We maintain our expectation for the OPR to remain at 3% in 2013 with 50bps hikes in 1H14 but conditional upon inflation approaching 3% within 2014.

### **Sabah stand-off the latest twist in the race to elections**

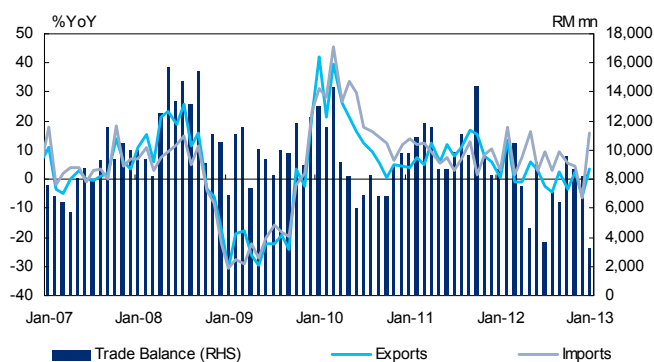
**PM Najib will have to call elections by end-April 2013.** Latest reports suggest PM Najib will dissolve parliament on 25 March and hold elections in mid-April. The outbreak of full-blown hostilities with the armed Filipino intruders in Sabah has thrown a wrench into the electoral calculus – while PM Najib has attempted to rouse nationalistic fervor (and support for the ruling BN coalition) in a show of military force, the situation remains uncertain and not yet decisively resolved, which could provide further openings for the Opposition to question the handling of the intrusion. Given the electoral importance of the state as a BN stronghold, developments in Sabah could prove crucial in an already tight race.

Figure 66. Electrical and electronics (E&E) sector improved in Jan



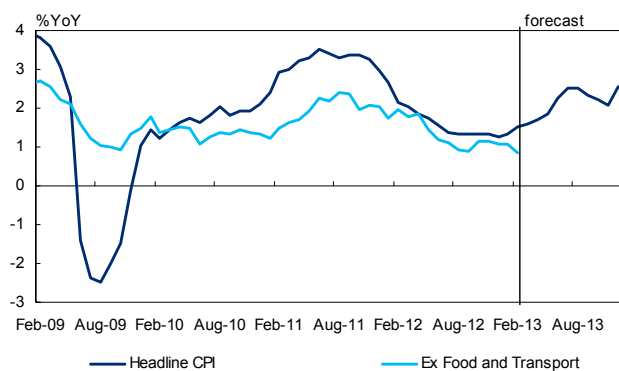
Source: CEIC, Citi Research

Figure 68. Trade surplus sharply narrowed in Jan



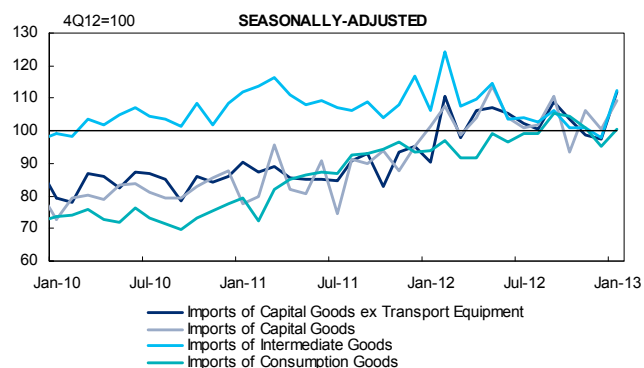
Source: CEIC, Citi Research

Figure 70. Inflation remains low far below 3%



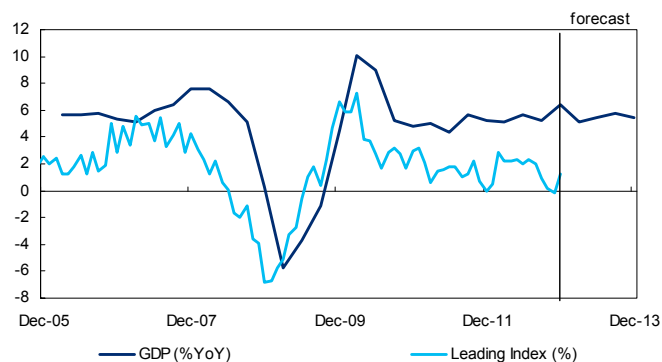
Source: Haver, Citi Research

Figure 67. Resilient domestic demand fueled imports



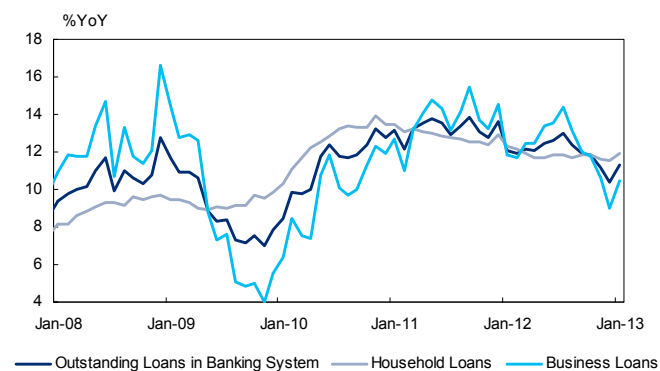
Source: CEIC, Citi Research

Figure 69. We maintain our 2013 growth forecast at 5.5%



Source: CEIC, Citi Research

Figure 71. Household loan growth has moderated since end-2010



Source: CEIC, Citi Research

Figure 72. Malaysia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	162.8	193.7	231.1	202.4	247.0	288.2	303.8	338.7	380.8
Nominal GDP, local currency bn	597	665	770	713	795	881	938	1,043	1,154
GDP per capita, US\$	6,067	7,123	8,393	7,255	8,639	9,949	10,357	11,328	12,485
Population, mn	26.8	27.2	27.5	27.9	28.6	29.0	29.3	29.9	30.5
Unemployment, % of labour force	3.3	3.2	3.3	3.7	3.2	3.1	3.0	2.9	2.9
<b>Economic Activity</b>									
Real GDP, % yoy	5.6	6.3	4.8	-1.5	7.2	5.1	5.6	5.5	6.0
Real investment growth % yoy	8.6	9.1	1.8	-9.4	23.8	3.2	20.7	14.1	8.8
Real consumption growth % yoy	6.4	9.7	8.4	1.4	5.8	8.9	7.1	5.3	5.6
private consumption growth % yoy	6.6	10.4	8.7	0.6	6.6	7.1	7.7	6.1	6.6
Real export growth, % yoy	6.7	3.8	1.6	-10.9	11.3	4.2	0.1	3.0	4.9
Real import growth, % yoy	8.2	5.9	2.3	-12.7	15.6	6.2	4.5	5.4	5.5
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.1	2.3	4.5	1.0	2.1	3.0	1.2	2.3	2.7
CPI, % avg	3.6	2.0	5.4	0.6	1.7	3.2	1.6	1.7	2.4
Nominal wages, % yoy	2.1	4.3	4.5	2.5	8.2	3.8	6.4	5.0	5.0
Credit extension to private sector, % yoy	6.8	9.2	10.2	6.8	10.6	12.3	12.0	11.0	11.0
Policy interest rate, % eop	3.50	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50
1 month inter-bank rate, % eop	3.71	3.61	3.37	2.17	2.98	3.22	3.21	3.21	3.70
Long term yield, % eop	3.70	3.78	3.00	3.79	3.39	3.23	3.24	3.30	3.70
lc/US\$, eop	3.53	3.31	3.45	3.42	3.08	3.17	3.06	3.00	3.04
lc/US\$, avg	3.67	3.44	3.33	3.52	3.22	3.06	3.09	3.08	3.03
<b>Balance of Payments, US\$ bn</b>									
Current account	26.2	29.7	39.5	31.4	27.4	31.8	19.4	16.9	15.2
% of GDP	16.1	15.4	17.1	15.5	11.1	11.0	6.4	5.0	4.0
Trade balance	37.4	37.7	51.6	40.0	41.9	48.4	40.6	26.2	27.0
Exports	160.9	176.1	199.3	157.1	198.8	227.8	227.8	236.2	242.0
Imports	123.5	138.5	147.7	117.1	157.0	179.4	187.2	210.0	215.0
Service balance	-2.0	0.8	0.0	1.1	0.5	-2.6	-4.3	-1.0	-3.0
Income balance	-4.7	-4.1	-6.9	-4.0	-8.2	-7.2	-10.9	-12.0	-12.0
FDI, net	0.0	-2.7	-7.8	-6.3	-4.2	-3.3	-7.1	-2.0	-1.0
International reserves	82.5	101.3	91.5	96.7	106.5	133.6	139.7	151.0	157.0
Total Amortisations	5.3	7.8	6.3	9.8	11.3	9.0	9.3	10.0	10.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-3.2	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-4.0	-3.5
Consolidated gov primary balance	-1.1	-1.2	-3.0	-4.7	-3.5	-2.8	-2.3	-1.8	-1.3
Public debt	40.6	40.1	39.8	50.8	51.2	51.8	53.7	53.7	53.0
of which Domestic	36.4	37.1	37.2	48.9	49.1	49.7	51.8	52.0	51.5
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	52.0	56.2	66.6	68.3	72.6	81.5	87.6	94.7	98.5
Private	30.8	37.8	41.5	41.9	44.7	53.7	82.0	89.0	93.0
Public	21.2	18.4	25.2	26.3	27.9	27.8	5.6	5.7	5.5
External debt / GDP	32.0	29.0	28.8	33.7	29.4	28.3	28.8	27.9	25.9
External debt / XGS	28.5	27.4	29.0	36.9	31.3	30.9	33.0	33.9	34.3
Short-term debt	12.1	16.3	22.5	22.7	25.4	32.9	35.0	40.0	42.0
Short-term debt/International Reserves (%)	14.6	16.1	24.6	23.5	23.8	24.6	25.0	26.5	26.8
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	5.3	6.4	5.1	5.4	5.8	5.5	6.5	6.4	6.4
CPI, % yoy	1.3	1.2	1.3	2.0	2.0	2.3	2.4	2.6	2.5
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.50
1 month inter-bank rate, % eop	3.20	3.21	3.21	3.21	3.21	3.21	3.40	3.60	3.70
Long term yield, % eop	3.31	3.24	3.20	3.25	3.25	3.30	3.40	3.50	3.60
lc vs USD, eop	3.06	3.06	3.15	3.12	3.06	3.00	3.01	3.02	3.03

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

Jun Trinidad  
+63 2 894 7270  
jun.trinidad@citi.com

- **Summary view** – Recent indicators of manufacturing output and non-farm employment support our 2013 GDP growth forecast of 6.2%. Strong mfg output in Jan was consistent with upbeat sales and coincident with favorable non-farm job gains. Election ban on new government projects in 2Q13 remain a risk.
- **Things to watch** – Election surveys on the Senate slate that serves as a gauge of voter acceptance of Aquino's agenda. Upturn of CPI ex-cigarettes & liquor. Impact of early budgetary approvals to skirt the election ban. BSP's actual financial 'savings' and possible liquidity shift due to SDA cuts.
- **Strategy** – Continue to overweight 20yr-25yr bond segment with potential for 20y10y spread to narrow to 80bp-90bp on the back of strong liquidity, unchanged overnight rate and SDA cut. Peso not as vulnerable to JPY weakness on bilateral trade surplus prospects and improving investment setting.

### Mfg index up sharply with support from non-farm jobs

**Our 2013 GDP forecast of 6.2% is unchanged as recent economic indicators provide support for our higher than consensus estimate (consensus: 5.9%).** Other than likelihood of persistent strong discretionary spending including durable goods demand in 1Q13<sup>1</sup> and election spending, we noted strong income support from robust manufacturing output in Jan and potential for sustained non-farm job creation during the quarter. We project 1Q GDP growth of 6%YoY that corresponds to a quarterly gain of 2%QoQ SA compared to 1.8%QoQ SA in 4Q12.

**Seasonally-adjusted mfg production index grew 13.7%MoM SA in Jan, eclipsing its weak end-2012 close of -0.5%MoM SA.** Robust mfg volume (18.7%YoY) was consistent with 19.6%YoY expansion of net sales volume in suggesting limited risk of significant inventory overhang occurred in Jan. Tech exports fell by 32%YoY in Jan although mitigated by a 36.5%YoY expansion in non-tech manufactured exports, which we believe may have primed some of the top industry performers like chemicals (chemical exports grew 312.6%YoY). Electrical machinery, which includes micro circuits for exports, rose 2.7%YoY amid tech export weakness. With lackluster exports, the strong sales volume which elevated output of 14 industries, some by 2-digits, can be attributed to domestic demand.

**According to the Jan employment survey, non-farm jobs of 1.17mn were created in sync with non-farm GDP growth of 7.3%YoY in 4Q12.** For the 5th straight quarter, construction jobs generated exceeded 100K. Other than strong real estate development, we believe infra spending or public construction also supported construction jobs. In 4Q12, private construction rose 23.3%YoY while public construction eased to 7.8%YoY. Government is attempting to skirt the election ban on new projects by accelerating the budgetary approvals for FY13 budget projects and programs exceeding Php800bn. This supports creation of construction jobs that can absorb unskilled labor. Entertainment city that involves mega construction of resorts and gambling casinos also give construction activity an added boost. Job generation in mfg exceeded 120K as the sector recovered from the 3Q12 job losses of 50K, which may be a positive sign of upbeat non-tech exports. Recovery of farm employment with weather improving in 1Q, sustained non-farm job creation with support from fiscal spending, upbeat business sentiment, and 1Q13 election spending support 1Q prospects.

<sup>1</sup> See Philippines country section in [Asia Macro and Strategy Outlook](#) Feb 2013.

## Budget shortfall risk with PPP delays likely to persist

**We tweaked up our 2013 fiscal deficit forecast to 2.3% of GDP.** While expecting a larger budget deficit this year, the ratio to GDP will probably be in line with last year's deficit to GDP ratio given the following assumptions: 1) PPP project delays, if these were to persist, would continue to be the fiscal challenge to hiking primary spending (12.5% growth forecast) if we consider last year's budget shortfalls. 2) Risk of election ban on new projects, likely to be enforced in 2Q13 during the summer months or peak infra spending season, could still be a drag on the budget unless early budget approvals and releases covering project activities and service deliveries are granted. 3) Tax to GDP ratio likely to hit 13.4% this year and 13.7% next year on the back of new proceeds from the higher excise taxes on cigarettes & liquor and sustained collection efficiency gains. Aquino's governance and fiscal reform agenda benefitted collection efficiency in our view but have yet to work in reducing much of the expenditure shortfall.

## Given the currency wars, is JPY weakness a big risk?

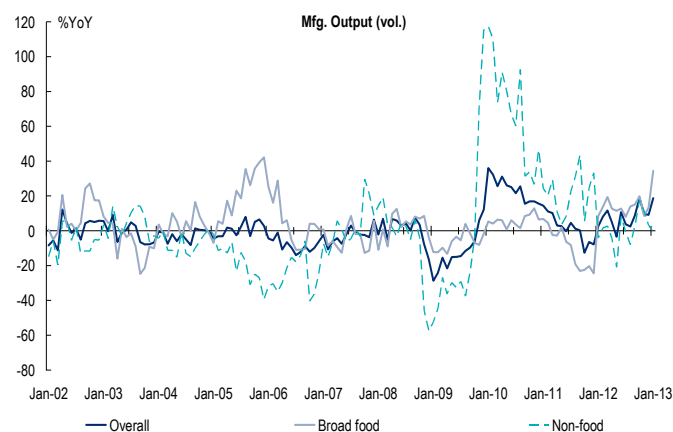
**The bilateral trade surplus with Japan (a key trading partner) since 2006 belied the lack of the currency impact. It also downplayed the trade/product disparity between Philippines (common notion of selling 'bananas & pineapples') and Japan (while buying cars and flat screens from Japan).** On average during 2006-12, over 90% of the trade surplus with Japan came from net exports of intermediate goods: woodcrafts & related items and minerals, ores & other related products. The bilateral trade surplus however remains a modest 2% share of GDP in 2012. As such the surplus is not a material contributor to GDP unlike OFW remittance flows although it supported the build-up in official reserves. Our regression results indicated FDI approvals--forward looking investments, rather than currency shifts have an economic influence on the bilateral trade surplus. A 1% growth in Japanese FDI approvals contributes an average surplus of US\$37mn to the bilateral trade gap. Japanese FDI approvals grew by over 40% during the last 10yrs implying a potential trade surplus contribution of US\$1.77bn.

## Strong peso, SDA cuts and flatter long bonds

**On the back of favorable trade and investment fundamentals, we believe JPY weakness should not impede bilateral trade surplus prospects with Japan and thus pose no obstacle to a strong Php outlook.** If JPY weakness will not stand in the way of a strong peso, BSP will be compelled to undertake macro prudential responses led by SDA rate cuts – likely down to the range of 1%-2% (currently at 2.5%). Lower SDA rate led the nominal 10yr yield to new lows. We expect the 10yr yield inversion against the overnight rate (currently -36bp) to widen if the SDA rate is lowered further. With the 20y10y gap at 143bp (Mar 12 session) up from 107bp in early Feb, prospects for a narrower 20y10y gap have been implied by the strong peso outlook and BSP's macro prudential responses. Last year's 20y10y spread of 80bp-90bp can serve as an ideal gap to facilitate the 20yr yield compression.

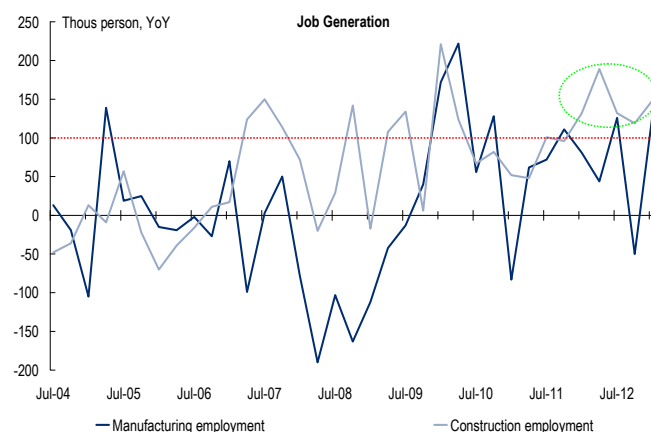
**Having a 2013 budget gap forecast of Php265bn (vs government deficit target of Php238bn) should not spook the market.** Government's cash balances stood at Php588bn (end-Jan) or roughly 2.75x the standard deviation of the monthly average cash deposit that can easily fund a large segment of the budget gap. Assumed a Php15bn tax take (or half the revenue potential of Php31bn) from the higher 'sin' taxes that suggests upside revenue potential. Low primary expenditure surprise not because of the election spending ban but more of PPP project delays results in an implicit freeze on fiscal disbursements for specific PPP projects.

Figure 73. Mfg output expanded 13.7%MoM s.a. in Jan



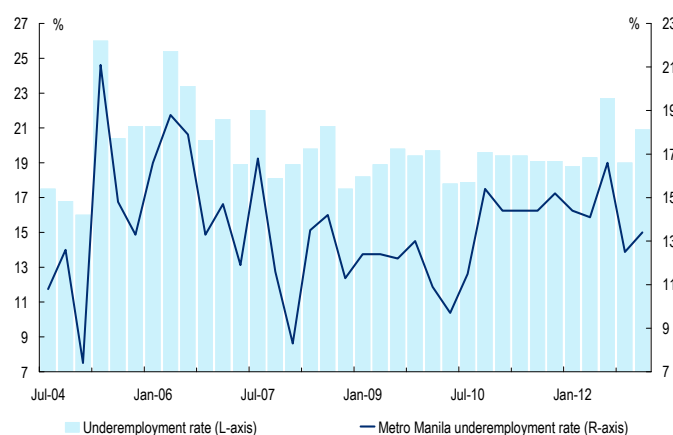
Source: CEIC, and Citi Research

Figure 74. Higher jobs due to fiscal spending and private construction



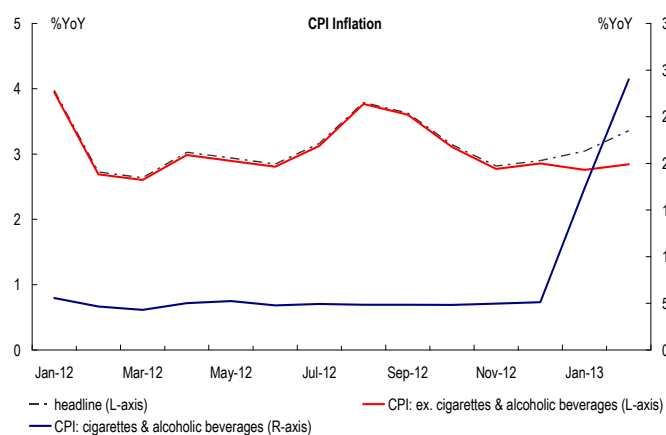
Source: CEIC, and Citi Research

Figure 75. Higher underemployment serves to cap demand pressures



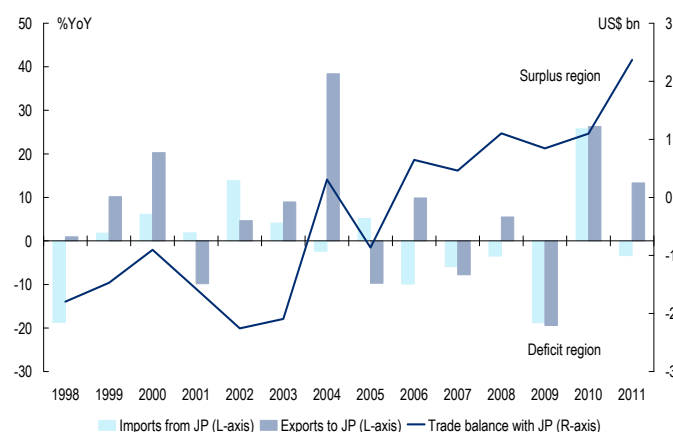
Source: CEIC, and Citi Research

Figure 76. Ex-'sin' tax effects, inflation in Jan-Feb at 2.8%YoY



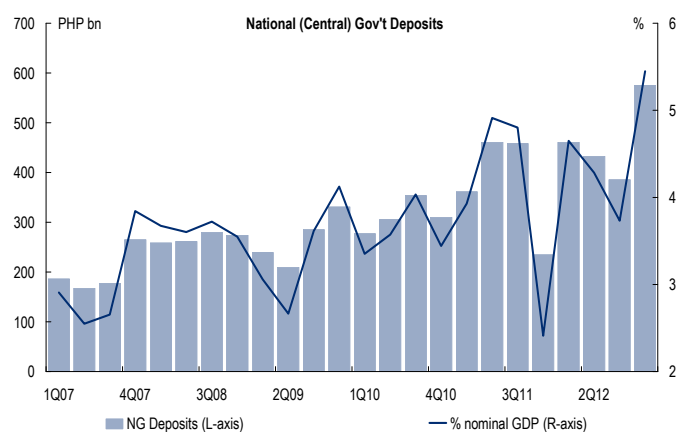
Source: CEIC, and Citi Research

Figure 77. Persistent bilateral trade surplus with Japan since 2006



Source: CEIC, and Citi Research

Figure 78. Treasury's deposits >Php500bn can fund >50% of FY13 fiscal deficit target



Source: CEIC, and Citi Research

Figure 79. Philippines Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	122.4	150.2	173.4	168.6	200.0	224.7	250.6	289.1	318.7
Nominal GDP, local currency bn	6,271	6,893	7,721	8,026	9,003	9,736	10,568	11,592	12,877
GDP per capita, US\$	1,408	1,693	1,916	1,853	2,160	2,386	2,616	2,897	3,162
Population, mn	87.0	88.7	90.5	91.0	92.6	94.2	95.8	99.8	100.8
Unemployment, % of labour force	8.0	7.3	7.4	7.5	7.3	7.0	7.0	6.5	6.0
<b>Economic Activity</b>									
Real GDP, % yoy	5.2	6.6	4.2	1.1	7.6	3.9	6.6	6.2	6.6
Real investment growth % yoy	-15.1	-0.5	23.4	-8.7	31.6	8.1	-4.4	10.8	16.4
Real consumption growth % yoy	4.9	4.9	3.3	3.3	3.4	5.6	6.8	6.1	6.1
private consumption growth % yoy	4.2	4.6	3.7	2.3	3.4	6.3	6.1	5.8	6.0
Real export growth, % yoy	12.6	6.7	-2.7	-7.8	21.0	-4.2	8.7	6.3	7.7
Real import growth, % yoy	3.5	1.7	1.6	-8.1	22.5	0.2	4.2	7.6	10.9
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	4.3	3.9	8.0	4.3	3.6	4.2	2.9	3.6	4.0
CPI, % avg	6.3	2.8	9.3	3.2	4.1	4.7	3.1	3.5	3.8
Nominal wages, % yoy	7.7	3.4	5.5	0.0	5.8	5.4	5.0	6.5	6.0
Credit extension to private sector, % yoy	9.0	10.6	12.8	4.3	13.8	16.2	13.5	11.3	15.0
Policy interest rate, % eop	7.50	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.50
1 month Philippine Reference rate, % eop	6.35	6.03	5.20	4.11	0.75	1.68	-1.38	1.00	2.75
Long term yield, % eop	5.99	5.70	6.55	6.25	4.78	4.21	3.70	3.00	4.00
lc/US\$, eop	49.05	41.23	47.47	46.50	43.65	43.84	41.06	39.88	40.65
lc/US\$, avg	51.28	46.05	44.48	47.56	45.06	43.29	42.22	40.08	40.36
<b>Balance of Payments, US\$ bn</b>									
Current account	5.3	7.1	3.6	9.4	8.9	7.1	9.8	9.3	7.1
% of GDP	4.4	4.7	2.1	5.5	4.5	3.1	3.9	3.2	2.2
Trade balance	-6.7	-8.4	-12.9	-8.8	-11.0	-15.5	-13.2	-13.9	-16.4
Exports	46.5	49.5	48.3	37.6	50.7	47.2	51.1	55.8	61.9
Imports	53.3	57.9	61.1	46.5	61.7	62.7	64.3	69.7	78.4
Service balance	0.1	2.2	1.2	2.1	2.7	3.6	3.8	3.4	3.1
Income balance	-1.3	-0.9	0.1	-0.2	0.5	1.3	0.8	0.5	0.2
FDI, net	2.8	-0.6	1.3	1.6	0.7	1.3	1.5	2.0	3.0
International reserves (ex-gold)	23.0	33.8	37.6	44.2	62.4	75.3	83.8	92.5	100.0
Total Amortisations	9.4	6.3	8.2	6.4	9.5	7.3	8.5	9.3	9.7
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-1.0	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-2.3	-2.0
Consolidated gov primary balance	3.9	3.7	2.6	-0.2	-0.2	0.8	0.7	0.7	1.0
Public debt	61.4	53.9	54.7	54.8	52.4	50.9	51.4	50.0	49.5
of which Domestic	34.3	31.9	31.3	30.8	30.2	29.5	32.8	32.5	32.0
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	53.9	55.5	54.3	54.9	60.0	61.7	63.5	65.0	68.7
Private	16.5	17.5	13.7	11.6	13.9	14.1	15.2	17.0	21.2
Public	37.4	38.0	40.6	43.2	46.2	47.6	48.3	48.0	47.5
External debt / GDP	44.0	36.9	31.3	32.5	30.0	27.5	25.3	22.5	21.6
External debt / XGS	101.8	93.6	93.7	112.8	92.6	98.5	93.0	88.0	84.8
Short-term debt	5.0	7.1	7.0	4.0	6.3	7.0	8.0	10.5	11.8
Short-term debt/International Reserves (%)	21.8	21.0	18.6	9.0	10.1	9.3	9.5	11.4	11.8
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	7.2	6.8	6.0	5.8	6.4	6.7	6.6	6.8	6.4
CPI, % yoy	3.6	2.9	3.3	3.4	3.5	3.6	3.7	3.9	4.1
Policy interest rate, % eop	3.75	3.50	3.50	3.50	3.50	3.50	3.75	4.25	4.50
1 month Philippine Reference rate, % eop	0.85	-1.38	0.50	0.50	0.75	1.00	1.25	1.50	2.00
Long term yield, % eop	4.35	3.70	2.50	2.65	2.75	3.00	3.25	3.50	3.75
lc vs USD, eop	41.68	41.06	40.40	40.09	39.96	39.88	40.07	40.26	40.45

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

Kit Wei Zheng  
+65 6657 5079  
wei.zheng.kit@citi.com

- **Summary view** – Growth should remain modest in early 2013. With labour market tightness to persist, core inflation will likely rise from recent lows as the output gap stabilizes in our view. As such, the hurdle for MAS easing in Apr will remain high.
- **Things to watch** – (1) Near term export momentum, especially electronics, (2) inflation related developments, particularly Feb core CPI (4) Labour market developments (5) Hints of further property measures, (6) Newsflow on Iskandar
- **Strategy** – SGD NEER has returned to the upper quartile of the band, but the low core CPI and Jan IP print for Jan could renew speculation of MAS easing in Apr, which is not our base case. Any dip to below the upper quartile of the band may provide good opportunities to long the SGD NEER.

### Modest growth in early 2013; labour market stays tight

**Modest growth in 1Q13, despite weak manufacturing activity...** Incoming Jan-Feb data points to lackluster growth of 2-3%QoQ SAAR growth in 1Q GDP, as continued weakness in manufacturing and exports was offset by a pick up activities related to domestic and regional demand. The latter was reflected by Jan-Feb non-oil re-exports surging to about 2.6% above 4Q levels, as well as a jump in ACU loans and DBU lending to non-residents in Jan. Domestic demand was reflected in higher public construction progress payments, DBU consumer loan growth and domestic stock market activity. Disappointments in headline manufacturing and NODX were largely due to lumpy and volatile biomedical and ships, whilst Jan-Feb electronics NODX are now 8% above 4Q levels. Overall, modest positive sequential growth rates are consistent with signals provided by leading indicators, including the 1.6%QoQ rise in the 4Q Composite Leading Indicator and EDB's Survey of Business Expectations for Biomedical Output in 1Q13.

**...though headwinds suggest a stabilization of the positive output gap at best.** Headwinds from lingering fiscal uncertainties in US growth could cap the pace of demand recovery, while weak iPhone 5 shipments may hit supply chains, though the impact on Singapore's electronics sector may be more muted due to less exposure to the smartphone/tablet product segments. Volatility in biomedical and lumpy marine and offshore engineering output may also weigh on headline GDP. REER appreciation and labour shortages may have contributed to Singapore's export underperformance. Domestically, the unusually wet weather in Jan-Feb may have dampened some festive shopping as did a possible further rise in the portion in the residents' consumption expenditure abroad amidst the strength of the SGD. Overall, we see a stabilization (rather than widening) of the positive output gap

**Employment surveys suggest recovery in hiring activity, especially services.** The Manpower Inc Survey showed a rise in the net employment outlook to 17% in 2Q, after a fall to 10% in Q1, the lowest since Sep-09. A surge in hiring intentions in Services (to 37% from 10% – the strongest hiring climate since late 2008) is indicative of significant labour shortage in stemming from foreign worker quota cuts. Public administration and education also recorded better hiring plans, as did finance, insurance and real estate – the latter likely indicative of improving cyclical demand. Overall, the Manpower Survey suggests that evidence of tightness in the Ministry of Manpower's 2012 Labour Market Report – slowing foreign worker employment, labour turnover rates edging up, and swifter re-hiring of redundant workers – will likely persist into 2013.

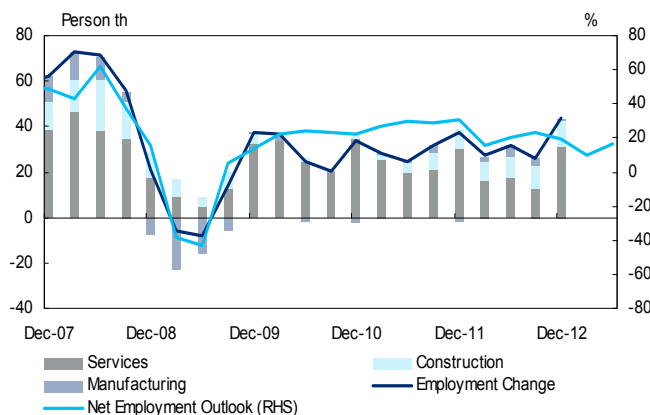
## High hurdle for MAS easing

**We expect no change in MAS's policy stance in Apr**, despite some speculation of easing, as cyclical drag to dissipate going forward. Lackluster GDP growth from elevated levels has been at the weaker range of MAS's Oct expectations for slightly below potential growth, but the output gap remains positive – consistent with policymakers' observations of an economy at "full capacity". While headline inflation has met expectations, core inflation has been better behaved – reflecting a sharper than expected narrowing of the positive output gap in 2H13. Despite these *historical* downside surprises, MAS's cautiously optimistic *forward looking* forecasts point to improving external demand in 2H13, which should bring full year growth in line with earlier expectations of 1-3%. While a nudging down of full year core and headline inflation forecasts on historical downside surprises could give wiggle room for MAS to ease, we do not see this as our base case, as a likely future widening of the positive output gap and structural wage pressures could push up core for the rest of the year. Headline inflation should moreover stay above tolerance levels. Of the 9 episodes where MAS lowered inflation forecasts since 2001, it eased policy only in 4, and only when the outlook for inflation was subdued.

**Structural arguments for REER "catch up" remain intact.** The real exchange rate may have further room to catch up, relative to the widening gap between tradables and non-tradables productivity since the late 1990s. While tradables productivity may improve, non-tradables productivity is likely to lag for a variety of reasons – for example, the tight labour market exacerbating labour turnover in the non-tradables sector. Not only will a cyclical upturn from 2014 widen the productivity gap between tradables and non-tradables, historically global competition has been more conducive to secular productivity improvements in tradables even as non-tradables productivity has been stagnant. Productivity enhancing measures in recent Budgets have tended to focus on capital-labour substitution and are therefore skewed in favour of the tradables sector. We believe part of the REER catch-up will have to be borne by a "slightly steeper" NEER appreciation path, if only to forestall deterioration in real incomes. Policymakers are prepared to accept inevitably slower GDP growth from restructuring and structural REER appreciation. Minister Lim had mentioned that the 3-4% growth expected for the rest of the decade will be a significant change for a country that has enjoyed twice that rate of growth since 2003, as the tight labour market means that growth opportunities may have to be forgone, but nonetheless such restructuring is "unavoidable".

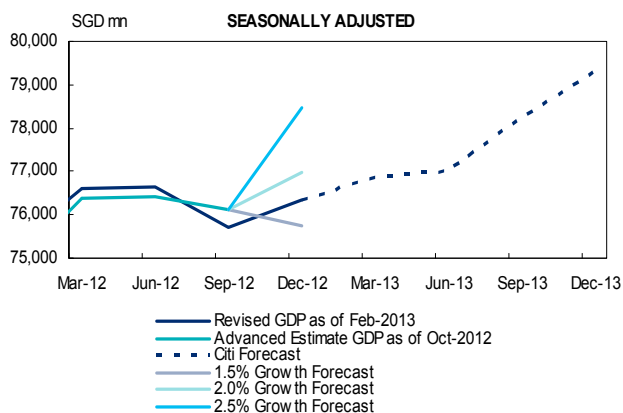
**We see other secondary factors that argue against easing.** Only in the unlikely event that cyclical drags outweigh these structural considerations (manifested by a rise in the unemployment rate) do we expect MAS to ease. [1] With inflation at the forefront of voter concerns, the political backdrop favours a hawkish bias in anchoring *inflation expectations* or even reversing recent increases in price *levels*. Seen from another angle, accepting that the REER has to appreciate at a faster pace, it would be far more politically expedient to accommodate this via a stronger nominal exchange rate rather than higher inflation. [2] Financial stability considerations, including preventing an unwanted easing of monetary conditions amidst QE by global central banks, may also matter. While the primary tool for tackling financial stability risks will remain increasingly aggressive macroprudential policy tightening, MAS easing could end up being counterproductive in achieving financial stability objectives. Reducing the band slope against the tide of capital inflows would force MAS to increase FX intervention, which may not be fully sterilized, and the resultant increase in money supply could fuel asset price inflation.

Figure 80. Employment surveys suggest recovery in hiring activity



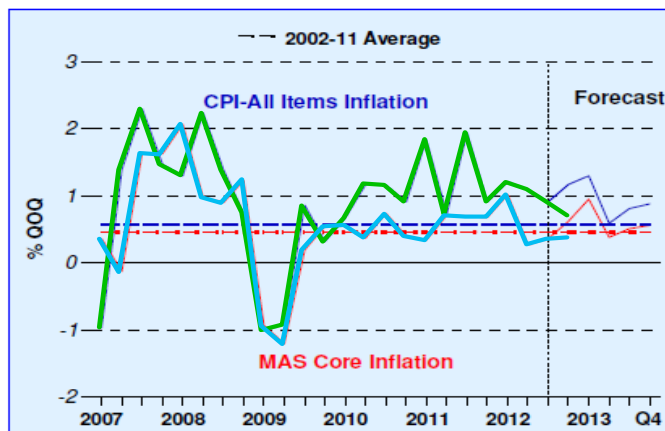
Source: Manpower Inc, CEIC, Citi Research

Figure 82. GDP growth at weaker range of MAS's Oct expectations...



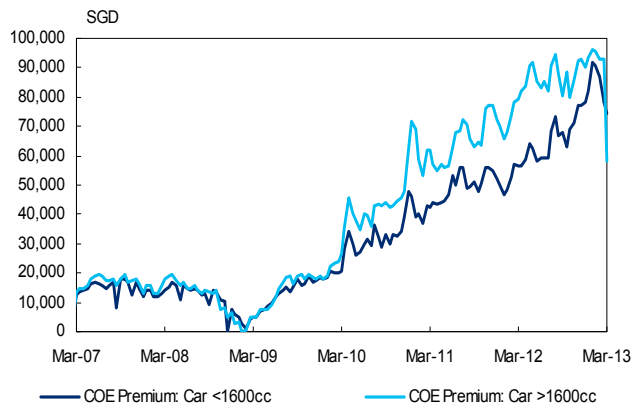
Note: We project the implied 4Q12 seasonally-adjusted GDP based on the government's 1.5-2.5% GDP growth forecast as of Oct-2012  
Source: CEIC, Citi Research

Figure 84. Core inflation has behaved better than MAS expectations



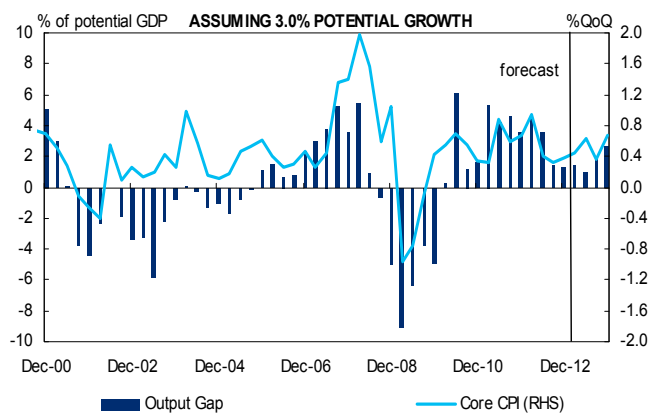
Note: Green line denotes actual headline inflation, sky blue line denotes actual core inflation  
Source: MAS Macroeconomic Review Oct-2012, Haver, Citi Research

Figure 81. COE premiums eased sharply in Mar



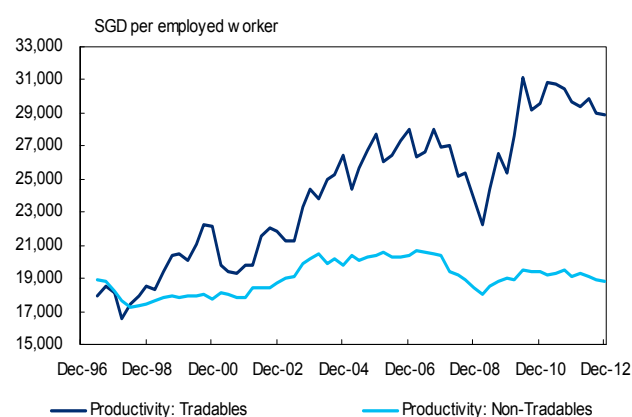
Source: CEIC, Citi Research

Figure 83. ...but the output gap remains positive



Note: We assume 3% potential growth from 2011, reflecting foreign worker tightening  
Source: CEIC, Citi Research

Figure 85. Widening gap between tradables/non-tradables productivity



Note: Due to constraints on data availability, we include manufacturing; wholesale & retail trade; and transport and storage, and communications in tradables  
Source: CEIC, Citi Research

Figure 86. Singapore Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	145.8	178.2	190.8	189.4	232.2	265.8	276.8	297.0	327.4
Nominal GDP, local currency mn	231	268	270	275	316	334	346	365	393
GDP per capita, US\$	33,131	38,827	39,434	37,970	45,741	51,275	52,098	54,974	59,532
Population, mn	4.4	4.6	4.8	5.0	5.1	5.2	5.3	5.4	5.5
Unemployment, % of labour force	2.7	2.1	2.3	3.0	2.2	2.0	2.0	1.9	1.8
<b>Economic Activity</b>									
Real GDP, % yoy	8.6	9.0	1.7	-0.8	14.8	5.2	1.3	2.0	4.0
Real investment growth % yoy	17.2	16.8	28.5	-21.0	5.4	12.7	26.8	-2.9	3.5
Real consumption growth % yoy	4.5	5.9	3.6	0.5	7.2	3.7	0.9	2.5	3.3
private consumption growth % yoy	4.5	6.7	2.9	-0.5	6.2	4.6	2.2	2.8	3.3
Real export growth, % yoy	10.8	9.0	5.0	-7.6	18.6	3.5	0.3	2.2	3.2
Real import growth, % yoy	11.1	8.1	9.6	-11.2	15.9	3.6	3.2	2.4	2.9
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	0.8	3.7	5.5	-0.5	4.6	5.5	4.3	3.3	3.5
CPI, % avg	1.0	2.1	6.6	0.6	2.8	5.2	4.6	4.0	3.4
Nominal wages, % yoy	3.2	6.2	5.4	-2.7	5.6	6.0	2.3	5.0	5.5
Credit extension to private sector, % yoy	4.8	17.2	23.4	4.9	4.7	19.0	14.0	12.0	11.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
3 month inter-bank rate, % eop	3.44	2.38	1.00	0.69	0.44	0.38	0.38	0.30	0.40
Long term yield, % eop	3.05	2.68	2.05	2.66	2.71	1.63	1.30	1.70	2.40
lc/US\$, eop	1.53	1.44	1.43	1.41	1.28	1.30	1.22	1.22	1.19
lc/US\$, avg	1.59	1.51	1.41	1.45	1.36	1.26	1.25	1.23	1.20
<b>Balance of Payments, US\$ bn</b>									
Current account	36.1	46.4	28.8	33.5	62.1	65.4	51.5	41.6	44.2
% of GDP	24.8	26.0	15.1	17.7	26.7	24.6	18.6	14.0	13.5
Trade balance	50.6	57.8	42.8	49.3	66.0	72.7	61.0	59.8	66.0
Exports	281.0	312.5	354.5	288.6	371.2	434.4	436.0	443.9	456.0
Imports	230.4	254.7	311.7	239.3	305.2	361.7	375.1	384.1	390.0
Service balance	-7.3	-2.7	-1.6	-1.7	2.3	0.7	0.4	1.4	2.0
Income balance	-7.2	-8.7	-12.4	-14.1	-6.3	-8.0	-9.9	-18.7	-24.0
FDI, net	18.1	10.1	5.4	0.9	28.3	29.7	33.6	33.0	32.0
International reserves	136.3	163.0	174.2	187.8	225.8	237.7	259.3	260.0	270.0
Total Amortisations	--	--	--	--	--	--	--	--	--
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.0	2.8	0.1	-0.3	0.3	1.2	1.1	0.7	0.5
Consolidated gov primary balance	0.6	2.7	1.1	-0.8	0.2	1.3	1.5	0.4	1.0
Public debt	89.2	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0
of which Domestic	89.2	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	0.0	1.5	-0.4	0.2	4.2	4.2	4.6	4.8	3.4
CPI, % yoy	4.7	4.3	3.8	3.7	3.2	3.3	3.4	3.4	3.4
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	0.38	0.38	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Long term yield, % eop	1.47	1.30	1.30	1.40	1.60	1.70	2.00	2.10	2.30
lc vs USD, eop	1.23	1.22	1.25	1.24	1.23	1.22	1.21	1.21	1.20

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

\*Note: Public debt is general government debt.

## South Korea

Jaechul Chang  
+82 2 2077 4160  
jaechul.chang@citi.com

- **Summary view** – Jan industrial activities contracted over the month, weighed on by temporary factors. However, Feb exports excluding holiday effect and product breakdown data showing positive growths in ITC products suggest that IP likely improved in Feb.
- **Things to watch** – The government's supplementary budget, the size of which is planned to be about KRW10trn, will likely be implemented in Apr. We also expect boosting measures for the housing market along with the supplementary budget.
- **Strategy** – We expect the policy rate to be lowered by 25bps in Apr and KTB yields to rise afterwards as expectation of economic recovery increases. In addition to North Korea risk and Eurozone uncertainties, strong USD and weak JPY lead us to hold a less strong KRW outlook.

### Tepid recovery in need of more accommodative policies

#### **Jan industrial activities and Feb trade contracted on sequential basis.**

Industrial production (IP) on MoM sa basis shifted to a negative terrain in Jan, at -1.5%, in five months. IT products mainly led the fall, with inventory adjustment of semicons and mobile phones. LCD manufacturing also dropped, after increasing in Dec on the back of switchover from analog to digital television transmission. Moreover, with the Lunar New Year falling in Feb this year instead of in Jan, YoY IP growth moved drastically to 7.3% from -0.5% in Dec. Service activities and retail sales also contracted over the month. Termination of property acquisition tax cut discouraged construction service and the end of individual consumption tax cut on autos and large home appliances weighed on retail sales. Feb exports plunged by 8.6%YoY, following a 10.9% increase in Jan, due to fewer working days caused by different timing of the Lunar New Year holidays, and seasonally-adjusted exports was also down by 4.2%MoM. However, daily average exports registered its highest in 24 months, indicating the contraction without the holiday distortion was not as severe. Given Feb export data showing that smartphones and LCDs continued to lead exports, we expect Feb IP growth to shift back to a positive on a MoM sa basis as manufacturing of ITC goods likely improved.

**We expect slowdown in job growth to continue.** The seasonally adjusted jobless rate rose for the second month in Feb to 3.5%, from 3.2% in Jan and 3.0% in Dec. The number of employed declined over the month by 14K as the Lunar New Year holidays overlapping with the survey period led fall in temporary and daily workers, resulting in YoY job growth narrowed to 201K from 322K in Jan. Going forward, we expect high base effect and slowing growth of independent businessmen to limit YoY job growth. We believe the unemployment rate will likely stay at around 3.3% s.a. in 1H13 on the back of weak domestic demand and increased job seeking activities due to the government's job creation projects and expectation of economic recovery.

**Weak economic data to bring boosting measures.** The new government will announce a supplementary budget of around KRW10trn on Mar 26th when it states its policy direction. In addition, active measure to revitalize the real estate market – such as reduction of transfer tax on multiple home owners and, by extension, relaxed DTI and LTV – are highly likely to follow. With the planned size of the supplementary budget in line with our estimate, we maintain our 2013 real GDP growth forecast at 3.2%YoY.

## Rate cut likely in Apr in conjunction with fiscal stimulus

**BoK held the policy rate, unlike our expectation.** The policy rate was left unchanged at 2.75% for the fifth month at Mar MPC meeting. However, the decision was not unanimous and against our expectation of 25bps cut. Our call was based on recent escalated geopolitical risk, sluggish domestic demand and exports, and low inflation. CPI inflation inched down to 1.4%YoY in Feb, from 1.5%YoY and in Jan, due to the high base of a year ago and government subsidy on childcare, school meals, and college tuition. However, we forecast CPI inflation to trend up as base effect subside and as resuming public tariff hikes which were delayed last year manifest into higher inflation.

**We now expect a rate cut in Apr alongside govt's expansionary measures.** The BoK Governor's rhetoric for policy coordination has continued over the past few months. The nominee for Deputy Prime Minister and also the Minister of Strategy and Finance, have asserted the necessity of a supplementary budget and further accommodative monetary policies to boost the economy. Alongside the government's stimulus package likely to be implemented in Apr, we expect the BoK in coordination to lower the policy rate by 25bps at the Apr MPC meeting. However, if rate cut does not happen in Apr, the BoK may keep the rate on hold for longer until it begins a rate hike cycle at the end of this year, at the earliest.

## Heightened geopolitical risk but limited market impact

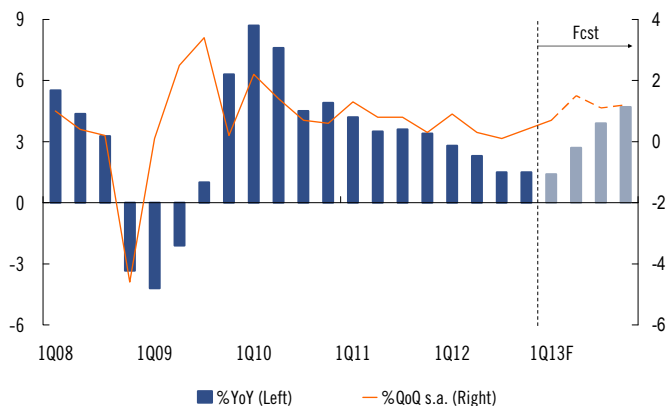
**Geopolitical risk intensifies after the UN sanctions against North Korea.** In response to North Korea's latest nuclear test in Feb, the UN Security Council approved tougher sanctions against North Korea (NK) on Mar 8th. The new resolution is focused on restraining North Korea's development of nuclear weapons and ballistic missiles via financial and trade sanctions. More recently, South Korea and the US began their annual joint military drills, Key Resolve (Mar 11th-21st) and Foal Eagle (Mar 1st-Apr 30th). NK has been reacting to uncompromising stance of South Korea as well as the international community by using harsher rhetoric and defiant attitude. In addition to cutting hotline with the South, NK declared to nullify armistice agreement, non-aggression pact, and joint denuclearization pledge. On Mar 15th, NK test-fired two short-range missiles into the East Sea.

**Impact of NK issues to financial markets may last longer than before.** Though NK's former provocations had short-lived impacts to financial markets, we think the case could be different this time. NK's hostile stance and intensified tension in the Korean Peninsula may persist longer given the US and Japan individually seeking measures to pressure NK to abandon its nuclear program, and South Korea-US joint military drills being conducted for some length of time. In this circumstance, we do not exclude the possibility of small NK-engineered flashpoints, but major aggression seems unlikely as security wariness is at maximum.

**With USD/KRW up its highest for the year, we hold a less strong KRW outlook.**

After the approval of UN sanctions, USD/KRW leveled up higher to 1,110 levels as tension in the Korean Peninsula intensified. USD gain on the back of improved macro data also pushed up USD/KRW. We expect KRW to stay weak in the near term with increased volatility due to USD strength and concerns over weak JPY amid geopolitical risk, but gradually strengthen on economic improvement and current account surplus. We forecast USD/KRW at 1,100 over the 0-3 month horizon and 1,060 over the 6-12 month.

Figure 87. Real GDP growth will likely show a visible rebound in 2H13



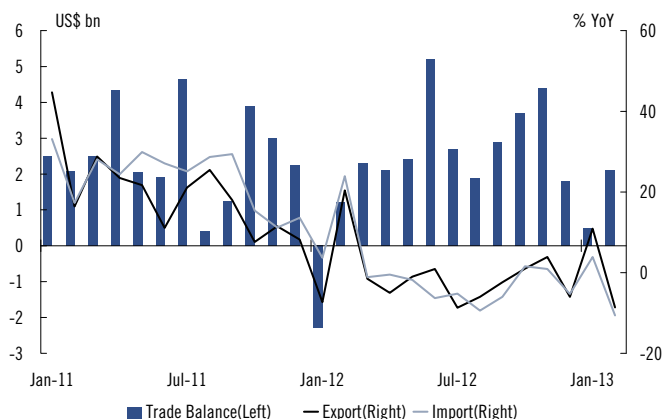
Source: Bank of Korea, and Citi Research estimates

Figure 88. KRW weakened on USD strength and NK risk since mid-Jan



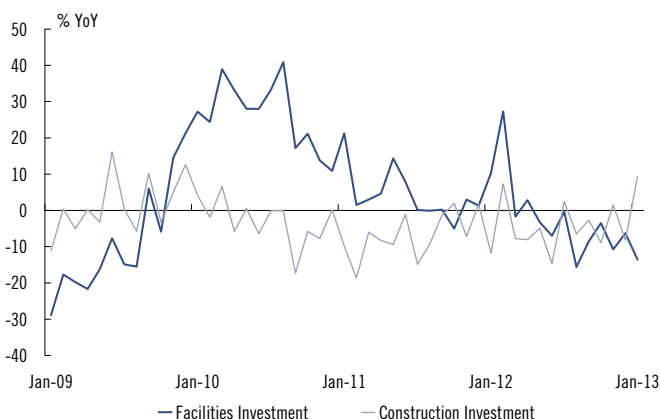
Source: Bank of Korea

Figure 89. Feb exports plummeted but trade surplus widened



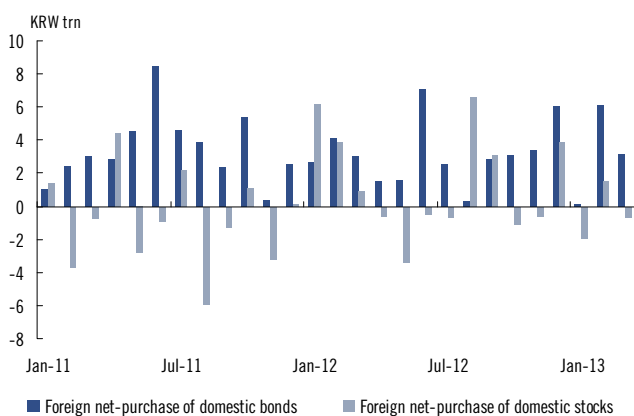
Source: Korea International Trade Association

Figure 90. Investment: Construction improved but equipment plunged



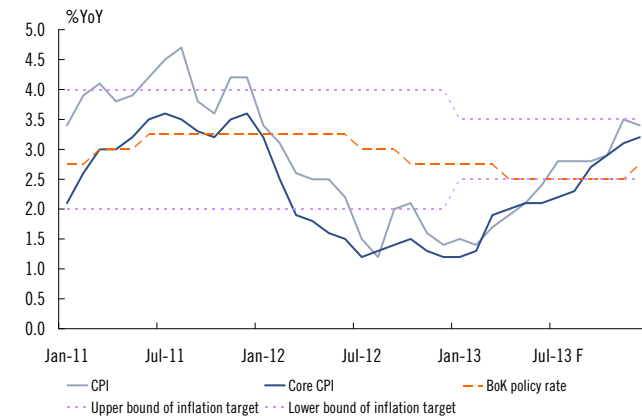
Source: Statistics Korea

Figure 91. Foreign fund inflows to domestic bond market continued



Source: Financial Supervisory Service, and Infomax

Figure 92. We expect a 25bps rate cut in Apr along with fiscal stimulus



Source: Bank of Korea, and Citi Research estimates

Figure 93. Korea Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	954.0	1,048.0	929.1	834.7	1,014.9	1,116.6	1,142.1	1,258.6	1,422.5
Nominal GDP, local currency bn	908,744	975,013	1,026,452	1,065,037	1,173,275	1,237,128	1,286,889	1,360,284	1,458,073
GDP per capita, US\$	19,722	21,565	18,981	16,972	20,540	22,431	22,840	25,062	28,211
Population, mn	48.4	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4
Unemployment, % of labour force	3.5	3.2	3.2	3.6	3.7	3.4	3.2	3.3	3.2
<b>Economic Activity</b>									
Real GDP, % yoy	5.2	5.1	2.3	0.3	6.3	3.6	2.0	3.2	4.1
Real investment growth % yoy	4.4	3.5	0.0	-13.5	15.8	1.5	-1.5	1.3	3.5
Real consumption growth % yoy	5.1	5.1	2.0	1.2	4.1	2.2	2.2	2.9	3.3
private consumption growth % yoy	4.7	5.1	1.3	0.0	4.4	2.3	1.8	2.4	3.4
Real export growth, % yoy	11.4	12.6	6.6	-1.2	14.7	9.5	3.7	4.8	9.5
Real import growth, % yoy	11.3	11.7	4.4	-8.0	17.3	6.5	2.3	4.3	9.3
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	2.1	3.6	4.1	2.8	3.0	4.2	1.4	3.4	3.1
CPI, % avg	2.2	2.5	4.7	2.8	3.0	4.0	2.2	2.5	3.0
Nominal wages, % yoy	5.7	0.7	3.1	2.6	6.8	1.0	5.3	4.3	5.2
Credit extension to private sector, % yoy	14.7	12.4	15.0	2.3	3.6	5.1	4.7	5.3	7.0
Policy interest rate, % eop	4.50	5.00	3.00	2.00	2.50	3.25	2.75	2.75	3.50
91-Day CD Rate, % eop	4.76	5.73	4.68	2.82	2.80	3.55	2.89	2.95	3.70
Long term yield, % eop	5.00	5.78	3.77	4.92	4.08	3.46	2.97	3.20	4.10
lc/US\$, eop	930	936	1263	1166	1121	1159	1064	1058	1006
lc/US\$, avg	955	929	1102	1275	1156	1108	1127	1081	1025
<b>Balance of Payments, US\$ bn</b>									
Current account	14.1	21.8	3.2	32.8	29.4	26.1	43.1	31.6	26.6
% of GDP	1.5	2.1	0.3	3.9	2.9	2.3	3.8	2.5	1.9
Trade balance	16.1	14.6	-13.3	40.4	41.2	30.8	28.3	23.4	21.8
Exports	325.5	371.5	422.0	363.5	466.4	555.2	547.9	576.7	633.2
Imports	309.4	356.8	435.3	323.1	425.2	524.4	519.6	553.2	611.4
Service balance	-13.3	-12.0	-5.7	-6.6	-8.6	-4.4	2.7	3.9	2.2
Income balance	-4.0	-3.4	3.8	1.6	-2.1	0.3	2.1	2.1	0.3
FDI, net	-7.6	-17.9	-16.9	-14.9	-22.2	-16.4	-18.6	-12.5	-8.6
International reserves	238.9	262.2	201.1	270.0	291.5	304.2	323.2	335.6	350.2
Total Amortisations	17.7	43.8	42.9	43.6	40.0	42.0	46.0	44.0	41.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.4	3.5	1.2	-1.7	1.4	1.5	1.4	1.1	1.4
Consolidated gov primary balance	1.7	4.9	2.6	-0.2	2.8	2.9	2.7	2.4	2.7
Public debt	30.1	29.7	29.0	32.5	31.9	32.6	34.0	33.0	31.0
of which Domestic	28.9	28.6	28.1	31.4	31.0	31.7	33.3	32.4	30.1
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	225.2	333.4	317.4	345.7	359.8	398.7	413.4	426.0	441.8
Private	225.0	333.1	317.1	345.4	359.4	358.3	373.2	384.8	399.6
Public	0.2	0.3	0.3	0.3	0.4	40.4	40.2	41.2	42.2
External debt / GDP	23.6	31.8	34.2	41.4	35.5	35.7	36.2	33.8	31.1
External debt / XGS	58.9	75.0	61.9	79.1	65.0	61.3	62.9	61.6	57.9
Short-term debt	113.8	160.3	149.9	149.2	139.8	137.4	126.7	130.3	140.4
Short-term debt/International Reserves (%)	47.6	61.1	74.5	55.3	48.0	45.2	39.2	38.8	40.1
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	1.5	1.5	1.4	2.7	3.9	4.7	3.9	3.6	4.8
CPI, % yoy	2.0	1.4	1.7	2.4	2.8	3.4	3.2	2.8	2.7
Policy interest rate, % eop	3.00	2.75	2.75	2.50	2.50	2.75	3.00	3.25	3.50
91-Day CD Rate, % eop	3.09	2.89	2.80	2.60	2.60	2.95	3.20	3.45	3.70
Long term yield, % eop	2.87	2.97	2.70	2.85	2.85	3.20	3.45	3.75	4.00
lc vs USD, eop	1114	1064	1105	1088	1072	1058	1045	1032	1019

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

Adrienne Lui  
+852 2501 2753  
adrienne.lui@citi.com

- **Summary view** – Despite weaker than expected economic recovery thus far, we expect Taiwan to engage in economic recovery in 2013 driven by both trade and capex improvements, a certain degree of consumption recovery, as well as progress in cross-straits and partnerships with other countries (e.g. FTAs).
- **Things to watch** – 1) The momentum of RMB deposits accumulation. 2) Awaiting for RMB swap line, ECFA for services and the broader goods list. 3) FTA negotiations with Singapore & New Zealand. 4) Political undercurrent ahead of 2014's "seven-in-one" local elections. 5) Referendum on 4<sup>th</sup> nuclear plant.
- **Strategy** – TWD likely to depreciate further with the JPY and KRW in the near term, however, we still expect a mild appreciation in 2013. We maintain a call on CBC policy rate on hold in 2013, while long bond yields are rising along with US treasuries. Our strategist, Peter Kurz, has set 8,200 as TAIEX year-end target.

### Recovery starting slow at the beginning of the year

**Trade recovery appears fragile in Jan-Feb.** Exports for the first two months of the year only grew 2.9%yoy, as Jan's strong performance was offset by Feb's negative growth rate. The two months growth average being lower than Dec's growth rate implies that trade has slowed down again after Christmas. We expect recovery in tech exports will take more time as the next key new product launch will likely be in the 2H. Non-tech exports in particular suffered in Feb, as key trading partners also have lesser working days in the month due to Chinese New Year celebrations. We think non-tech exports likely to resume recovery starting in March. We further expect global (especially US) trade recovery will benefit Taiwan in 2013.

**Consumer confidence improvement is conducive for consumption outlook.** Feb consumer confidence headline series posted the second consecutive month of positive MoM growth of 2.42%. Although the sub-category "investment prospects" remain the driver, other subcategories also posted improvements. If the rise in consumer confidence could be sustained, consumption recovery could take place faster than we expect, which we earlier thought would need till 2H.

**Forward looking indicators suggest modest recovery ahead.** CEPD's leading index rose 1.3%mom in Jan, with positive cyclical movements seen in six out of seven of the index components. The fifth consecutive months of 'yellow-blue' monitoring indicator categorizes current economy as transitional (to growth). Markit's PMI also indicates operating conditions continue to improve for the third successive month (albeit Feb index fell 1.3pt from previous month, partly due to lesser working days). TIER's business climate survey also indicated that improving external conditions is kindling local businesses confidence. In this backdrop, we also see 2013 as a year of capex recovery sponsored by both pent up private investments and government's new initiatives to attract FDI from both foreign nationals and Mainland investors. Narrowing cost differentials of production and labor between Mainland and Taiwan will likely help attract foreign nationals to relocate production back to Taiwan in our view.

**CBC likely keep policy rate at 1.875% on 28<sup>th</sup> Mar quarterly MPC meeting.** A neutral policy stance continues to be appropriate given concerns of capital inflows and home prices. Sinyi residential price indices for Taipei City and Taipei Area continue to post record highs as of Jan13. CBC Governor recently endorsed property market regulations are appropriate and do not have plans to withdraw regulations anytime soon. Given gradual economic recovery and stable inflation, as well as currency devaluations in the region, a policy rate change appears unlikely.

**Benign inflation likely in 2013E, despite higher electricity fees and import costs.** CPI averaged to be 2.1%yoy in Jan-Feb, as expected. Inflation in 2013 likely remain benign (Citi F: 1.7%yoy) and slightly lower than 2012's 1.9%; favorable comparison base and lower commodity prices likely offset some of the depreciation-induced-higher-import-cost and the expected electricity tariff hike on 1<sup>st</sup> Oct. We think the impact of the pending electricity hike on CPI likely to be small (>0.5ppt), given electricity only weights 2.2% in the CPI basket and one-third of households are low voltage users. From a long-term point of view (2015 and beyond), Taiwan's reliance on nuclear power (currently ~15-20% of total power and whether to go ahead with commercial production plans of the near-complete 4<sup>th</sup> nuclear plant) is in question. Anti-nuclear sentiment amongst the public is running high in Taiwan; and the new Premier proposed a nationwide referendum (possibly in July/Aug) on the issue. De-nuclear could raise utility prices by 40% by 2025 (Taipower's estimate); and the associated financial losses will most likely become fiscal burden and higher utility costs will be passed on to consumers.

**TWD follows regional trends to depreciate near term.** We expect USD/TWD to weaken to 30 in 0-3 months, given recent KRW weakness and USD strength. Although CBC doesn't seem to be following regional FX movements with day-by-day adjustments, it seems to be gradually allowing the TWD to trade in higher ranges. However, we expect the TWD to gain from its strong links with China and CNY and move towards 29 in 6-12 months (meanwhile, we forecast KRW to resume appreciation, but JPY to remain still in depreciation mode).

### **Further liberalization needed for global integration**

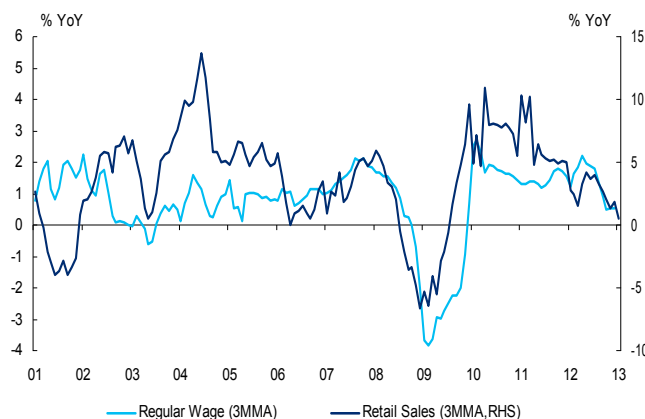
**Financial liberalization associated with cross-strait developments.** After the milestone of domestic banking units (DBU) commencing to offer RMB banking services, DBUs attracted RMB13.4bn deposits (~0.25% of total deposit) as of 15<sup>th</sup> Mar, slightly more than a month since commencement. The Minister without Portfolio Chi Schive forecasted that RMB deposits could rise to RMB48.3b (~0.9% of total deposits) by year end, while the market has more aggressive forecasts of RMB120-150bn (~2.2-2.8% of total) by year-end.

**CBC and PBOC are in discussion of a bilateral currency swap line,** which we think is the key for broadening the scope of RMB trade settlements and financial deepening of RMB products; and paves way for CBC to invest its FX reserves in RMB assets. CBC Governor Perng has expressed hopes that the swap line would be similar size to Korea's (currently at RMB360bn, which was doubled from original size in 2011) and signed by year-end. Just for reference, the other offshore RMB center -- HK's RMB swap line is RMB400bn (also was doubled once).

**FSC also quickening related approvals.** The first Formosa (RMB denominated) bond was launched by Chinatrust Financial holding company on Feb 25. Swift approvals by FSC for this debut yuan bond launch and allowing for insurers to buy Taiwan yuan products are useful for enhancing RMB circulation in Taiwan in our view.

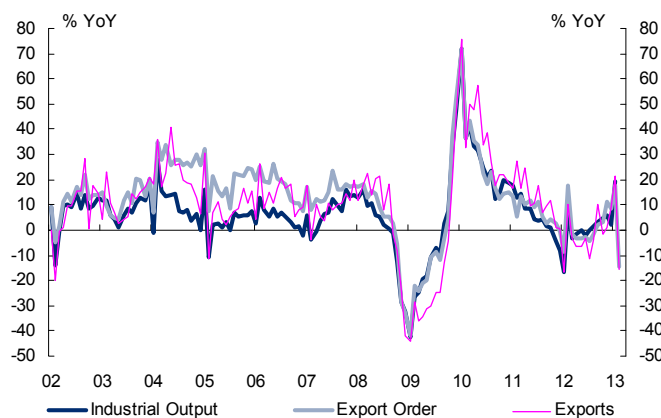
**Economic and trade liberalization are also in progress.** President Ma reiterated that the Free Trade Agreements (FTA) with Singapore and New Zealand will be signed soon. This is alongside with discussions of ECFA for services, and trade talks with US has also resumed. FTA deals should boost business sentiments and enhance Taiwan's export competitiveness. We also need to monitor the developments in the proposed free economic pilot zones (FEPZs), where limitations on investment and regulations (regarding land, labor and taxation) will be adjusted to attract investment. We believe a FEPZ success will eventually pave the way for Taiwan to join the Trans-Pacific Partnership – a goal of President Ma.

Figure 94. Consumption recovery still awaiting for wage improvements



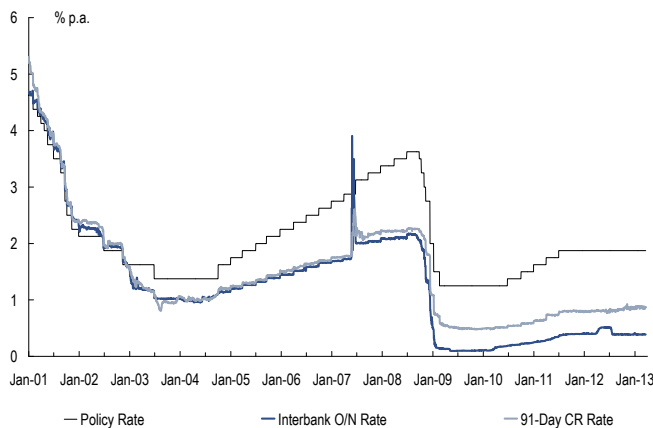
Source: MOEA, CEIC and Citi Research

Figure 96. Mar data needs monitoring, as Jan-Feb slowed



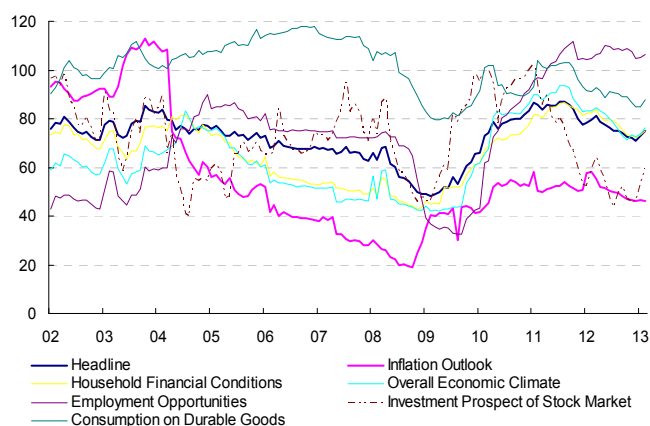
Source: CEIC and Citi Research

Figure 98. CBC likely to keep policy rate on hold in 28-Mar meeting



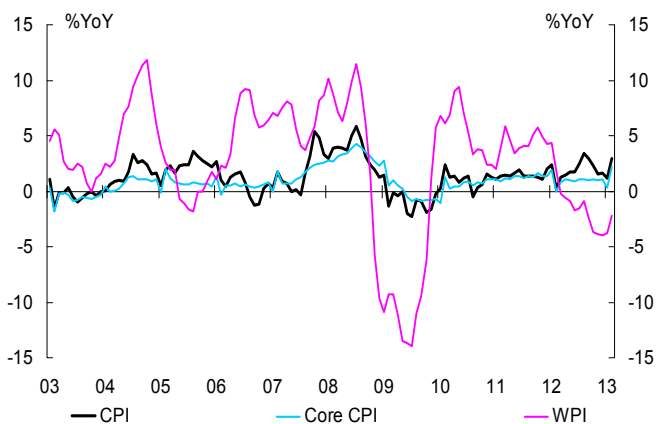
Source: Bloomberg

Figure 95. Consumer confidence improves -- positive for spending



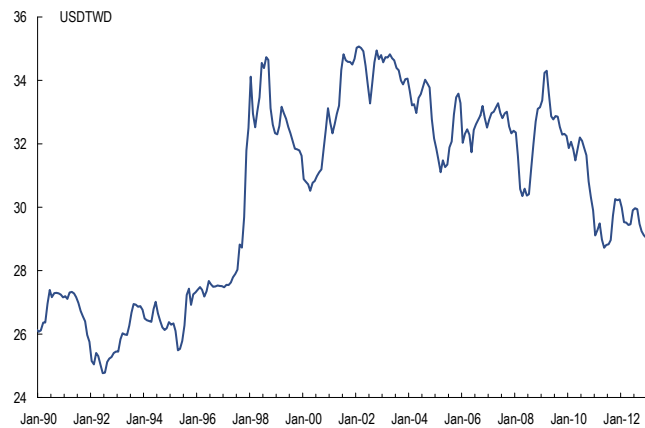
Source: CEIC and Citi Research

Figure 97. Benign inflation expected, despite Feb's uptick on CNY



Source: CEIC and Citi Research

Figure 99. TWD depreciating along with regional trends



Source: CEIC and Citi Research

Figure 100. Taiwan Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	376.3	393.1	400.2	377.6	428.2	464.0	474.0	518.1	552.9
Nominal GDP, local currency bn	12,243	12,911	12,620	12,481	13,552	13,674	14,037	14,750	15,631
GDP per capita, US\$	16,513	17,191	17,444	16,404	18,574	20,078	20,437	22,295	23,747
Population, mn	22.8	22.9	22.9	23.0	23.1	23.1	23.2	23.2	23.3
Unemployment, % of labour force	3.9	3.9	4.1	5.8	5.2	4.4	4.2	4.1	4.0
<b>Economic Activity</b>									
Real GDP, % yoy	5.4	6.0	0.7	-1.8	10.8	4.1	1.3	3.5	4.0
Real investment growth % yoy	0.5	-0.7	-7.9	-21.2	36.8	-7.5	-4.2	4.7	5.9
Real consumption growth % yoy	1.1	2.1	-0.6	1.3	3.3	3.0	1.3	1.6	2.4
private consumption growth % yoy	1.5	2.1	-0.9	0.8	4.0	3.1	1.5	1.9	2.7
Real export growth, % yoy	11.4	9.6	0.9	-8.7	25.6	4.4	0.1	4.3	4.3
Real import growth, % yoy	4.6	3.0	-3.7	-13.1	27.7	-0.5	-1.9	2.7	3.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	0.7	3.3	1.3	-0.2	1.2	2.0	1.6	2.7	2.0
CPI, % avg	0.6	1.8	3.5	-0.9	1.0	1.4	1.9	1.7	2.0
Nominal wages, % yoy	0.8	2.1	0.0	-5.1	5.5	2.7	1.0	1.8	3.0
Credit extension to private sector, % yoy	4.7	3.9	2.7	-0.8	6.7	5.7	4.2	5.5	7.0
Policy interest rate, % eop	2.75	3.38	2.00	1.25	1.63	1.88	1.88	1.88	2.13
1 month inter-bank rate, % eop	1.69	2.04	1.02	0.57	0.74	0.87	0.87	1.27	1.39
Long term yield, % eop	1.99	2.53	1.44	1.47	1.47	1.27	1.15	1.35	1.47
lc/US\$, eop	32.59	32.43	32.78	32.23	29.17	30.29	29.06	28.97	28.33
lc/US\$, avg	32.52	32.85	31.58	33.04	31.50	29.40	29.57	29.46	28.57
<b>Balance of Payments, US\$ bn</b>									
Current account	26.3	35.2	27.5	42.9	39.9	41.2	49.6	43.6	44.2
% of GDP	7.0	8.9	6.9	11.4	9.3	8.9	10.5	8.4	8.0
Trade balance	11.6	16.8	4.4	20.3	11.0	11.3	14.4	19.1	32.9
Exports	213.2	235.1	243.8	193.8	261.6	291.9	284.2	303.5	331.9
Imports	201.6	218.2	239.5	173.5	250.5	280.6	269.8	284.4	298.9
Service balance	-3.5	-1.6	1.9	2.0	2.5	3.9	6.1	25.0	18.4
Income balance	9.6	10.1	10.0	12.5	13.6	13.2	15.3	17.5	19.0
FDI, net	0.0	-3.3	-4.9	-3.1	-9.1	-14.7	-9.8	-8.5	-7.0
International reserves	266.1	270.3	291.7	348.2	382.0	385.5	403.2	425.0	450.0
Total Amortisations	5.8	3.8	8.8	2.5	3.2	6.8	3.0	3.3	4.5
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.1	0.3	-0.5	-3.5	-2.3	-1.9	-1.6	-1.2	-1.3
Consolidated gov primary balance	1.2	1.4	0.5	-2.5	-1.4	-0.9	-0.6	-0.3	-0.6
Public debt	29.6	28.8	29.9	33.1	33.5	34.9	39.2	39.5	42.0
of which Domestic	19.0	25.3	28.4	27.2	25.5	30.4	32.4	32.6	36.6
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	85.8	94.5	90.4	82.0	101.6	122.5	124.0	125.5	127.0
Private	75.2	91.1	88.9	76.0	93.5	118.0	119.0	120.5	121.9
Public	10.6	3.5	1.5	5.9	8.0	4.5	5.0	5.0	5.1
External debt / GDP	22.8	24.0	22.6	21.7	23.7	26.4	26.2	24.2	23.0
External debt / XGS	33.9	33.8	31.0	34.9	32.3	34.7	35.6	32.6	30.9
Short-term debt	74.2	83.3	78.8	68.2	83.7	107.8	120.0	115.0	110.0
Short-term debt/International Reserves (%)	27.9	30.8	27.0	19.6	21.9	28.0	29.8	27.1	24.4
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	0.7	3.7	3.0	3.1	3.7	4.1	4.0	4.4	3.8
CPI, % yoy	2.9	1.8	2.2	1.1	1.1	2.7	2.3	1.6	1.6
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	2.00
1 month inter-bank rate, % eop	0.87	0.87	0.87	0.87	0.87	0.93	0.99	0.99	1.05
Long term yield, % eop	1.19	1.17	1.28	1.30	1.32	1.35	1.38	1.41	1.44
lc vs USD, eop	29.32	29.06	29.86	29.69	29.31	28.97	28.81	28.65	28.49

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).

Jun Trinidad  
+63 2 894 7270  
jun.trinidad@citi.com

## Thailand

- **Summary view** – Despite bullish expectations following Fitch's surprising upgrade, we maintain our GDP forecast of 4.7% in 2013 and 4.8% next year. FDI approvals in response to easing political tensions and public investment activity will be the crucial in sustaining last year's investment-driven growth in our view.
- **Things to watch** – Parliamentary approval of the MT public investment program. BoT's hawkish signals after parliamentary approval. Inflation trend post-base effects in 2Q13. Strong export recovery in 2H13 that supports improved current account, upbeat Baht outlook and phaseout of policy accommodation.
- **Strategy** – Strong growth view and rate normalization to avert financial market instability risk supports a strong Baht. While 'tightening' has begun with a Baht strengthening to less than 29.60, rate normalization cannot be delayed indefinitely. Extend duration with imminent prospects of rate tightening.

### High hopes for investment-driven growth in 2013-14

**We are maintaining our 2013 growth forecast of 4.7% and 2014 forecast of 4.8% although policymakers continue to expect growth at 5% in 2013-14.**

Fitch's surprising upgrade of the country's long-term foreign currency issuer debt rating to BBB+ provided additional fuel to strong growth expectations. Fitch's upgrade came on the back of demonstrated economic resilience to repeated shocks and 'easing' of political and social tensions that should not derail government's pursuit of its Bt2tr medium-term (MT) public investment program (PIP). Lower risk premia enhanced potential for investment-driven growth led by needed fiscal investments that over time, can lower logistical/transport costs and position the country as a supply/logistical hub within ASEAN eg Greater Mekong subregion, and South Asian eg Bay of Bengal initiative, networks. Fiscal crowding-in effect as a result of PIP will be led by deployment of new lines of urban mass transit projects in our view.

**In the meantime, government wants to 'rebalance' the economy by boosting domestic demand** through measures like the wage hike to Bt300/day, rice pledging scheme, corporate income tax cut from 30% to 20%, tax deduction for first time home buyers and soft loans, tax incentives for SMEs to 'enhance productivity', etc. While most of these measures were directed at incomes of low income groups, we are concerned by the populist underpinnings. Hopefully government will fade these measures and shift to productive spending via the MT PIP.

**Will we see investment-driven growth extended following last year's flood-induced spending that elevated real investments (ex-inv) to 22.8% of GDP?**

Much of it would really depend on FDI approvals--a forward looking investment indicator. Last year, FDI approvals stood at Bt548.9bn--a record high post 1997-98 AFC with 100% FDI approvals accounting for 53.2% of total with joint ventures and local investments accounting for the large residual. While it's difficult to project the volatile series of FDI approval prospects (forward looking investments), we obtained empirical results that show total FDI approvals elevate real investments (SA ex-inv) over the current and next two quarters by an average of 0.03% for every 1% rise in real FDI approvals (SA) per quarter. On an annualized basis over three quarters, a 10% jump in FDI approvals (since 2006 FDI approvals on average rose 25% even if we include the 2009 crisis) can generate 3.75% growth in real investments. A conducive political setting alongside strong execution of public investments would be key to attracting FDI approvals that can sustain investment-driven growth.

## Potential for more investments to curb the output gap

Following the investment surge last year (actual FDI surged to US\$8.9bn vs US\$7.8bn in 2011), we are awaiting the private investment response to 1QFY13 infra spending (up 100%YoY/20.5%QoQ SA) and reduced risk premia. We expect a larger investment contribution to GDP (public & private) implies higher capital intensity of production that serves to restrain the output gap from expanding materially. This signals less buildup of potential inflation risk. Over the past 12 years, we estimate the output gap eased by 0.027% in response to an average quarterly change of Bt2.7bn in real investments (ex-inv). With real investments driving growth that mitigates output gap risk to inflation, policymakers can therefore take their time in adjusting the policy rate. An output gap of +2.6% closed out 2012 following robust 4Q GDP and have yet to elevate inflation.

## Risks of rising HH debt

**Among the macro risks given the strong private spending backdrop and accommodative policies is likelihood of sharply rising HH debt and potential bank NPL results.** Extending last year's accommodative fiscal and monetary policies despite lacking the urgency for policy stimulus may be sowing the seeds of macro instability. HH debt grew 21.7% in 2012 or 25.6% of GDP, up from a share of 22.7% in 2011. The bulk of the increase in the HH debt came from loans for cars and motorcycles, up 33.9%, perhaps largely due to the government's first-car buyer scheme. A senior government official noted that 'delinquency for personal loans rose 28.1%YoY in 4Q12 that hiked NPL for personal loans by 20.5% to Bt56.6b, or 22.3% of total bad debt (Bloomberg). As such, HH debts have to be monitored since the 'savings rate is very low'. HH numbering 9.09mn (45% of total HH) are at risk since they lack savings capacity with expenses and debt exceeding their incomes. Despite higher NPL of personal loans, banks' NPL ratio closed 2012 at 1.05%.

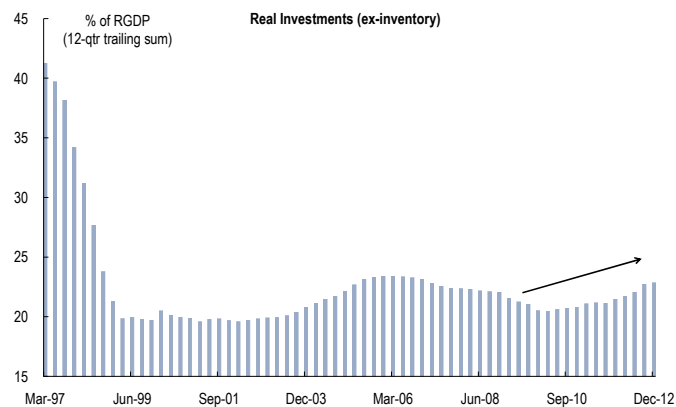
## Other reasons constraining possible rate easing

Aside from ballooning HH debt last year with potential for higher prospective NPL, there are other reasons why further overnight rate easing isn't urgent at this stage in our view. Real interest rates are already negative with a nominal policy rate of 2.75% lower than inflation expectations. In BoT's Jan survey, median expectations were at 3.59% to record the 5th month of rising expectations following a low of 3.51% last Aug. Private consumption index rose 2%MoM SA while private investment index grew 0.6%MoM SA to resume its robust pace. Despite mfg output's dip of 0.6%MoM SA in Jan, key industries posted strong gains like textiles (5.7%MoM SA), vehicles (6.9%MoM SA), and chemicals (9.4%MoM SA). Capacity utilization rate improved to 66.7% SA vs 65.6% SA in Dec. Our empirical results show a rate differential that's not a statistically significant determinant of the nominal effective exchange rate unlike the change in total FX reserves and trade-weighted USD. Despite subdued inflation risk and core still to bottom out amid upbeat GDP prospects, we estimate the 'base effect' will wane in 2Q13 and expose inflation's upside, if any.

## Strong Baht outlook on growth and rate hike expectations

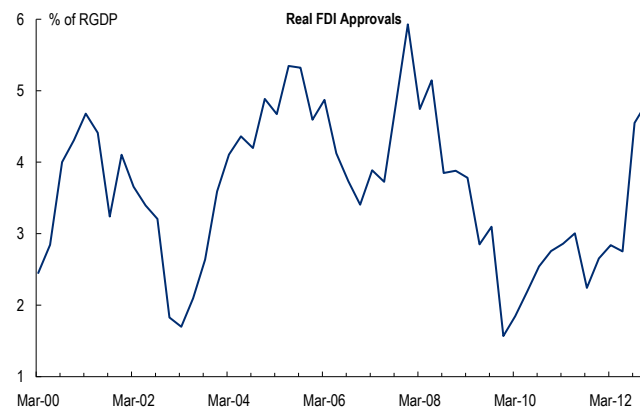
**Investment-driven growth expectations and likelihood that we are past the period of policy rate cuts, support a strong Baht outlook.** With policymakers guarding against asset bubble risk and the economy likely to move from its sweet spot to an inflation hot spot, accommodative policy rates will not be maintained for an extended period in our view. BoT awaits parliamentary approval of the MT PIP prior to sending out tightening signals although political pressures continue restrain rate normalization. Macro prudential measures including reserve accumulation may accompany tightening signals to deter severe Baht speculation.

Figure 101. Rising real investment contribution to GDP



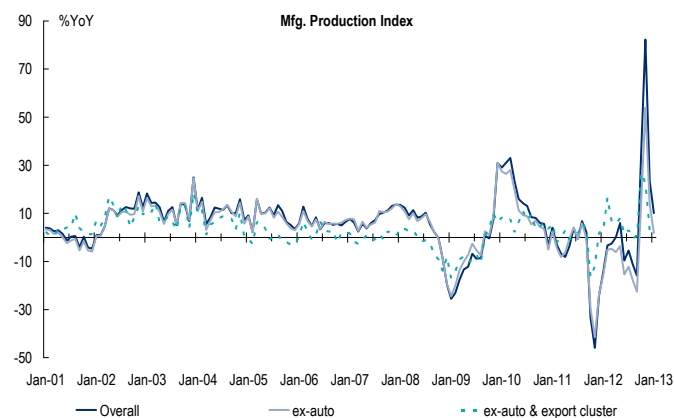
Source: CEIC, and Citi Research

Figure 102. Uptrend of FDI approvals



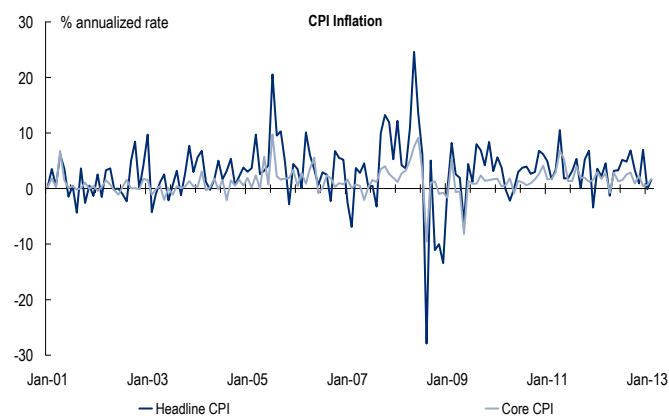
Source: CEIC, and Citi Research

Figure 103. Ex-auto, mfg output posted 1.8%YoY growth in Jan



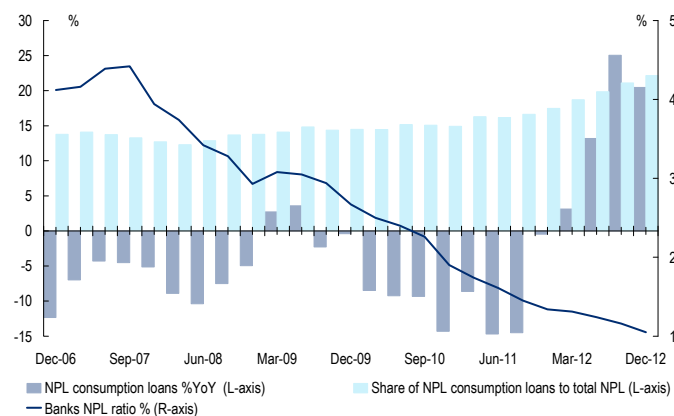
Source: CEIC, and Citi Research

Figure 104. Still a benign pace of annualized inflation in Feb



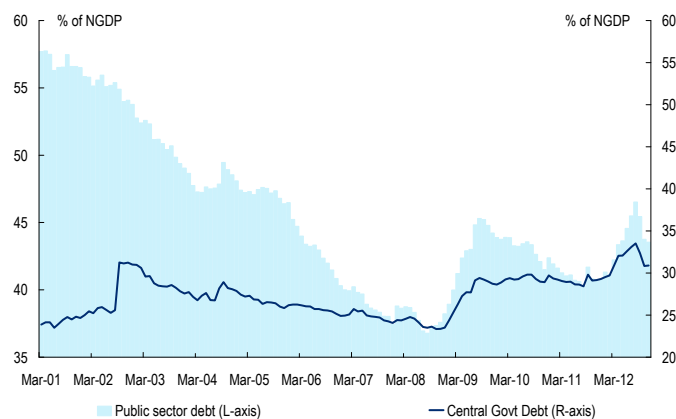
Source: CEIC, and Citi Research

Figure 105. Rising share of consumption NPL relative to total NPL



Source: CEIC, and Citi Research

Figure 106. Non-budgetary stimulus tends to bloat public sector debt



Source: CEIC, and Citi Research

Figure 107. Thailand Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	207.4	265.2	276.1	263.8	319.3	346.1	366.0	404.1	432.7
Nominal GDP, local currency bn	7,845	8,525	9,080	9,042	10,105	10,540	11,363	12,122	13,067
GDP per capita, US\$	3,301	4,207	4,355	4,153	4,998	5,401	5,678	6,237	6,552
Population, mn	62.8	63.0	63.4	63.5	63.9	64.1	64.5	64.8	66.0
Unemployment, % of labour force	1.5	1.4	1.4	1.5	1.0	0.7	0.7	0.8	1.0
<b>Economic Activity</b>									
Real GDP, % yoy	5.1	5.0	2.5	-2.3	7.8	0.1	6.4	4.7	4.8
Real investment growth % yoy	-3.6	1.0	8.1	-25.2	28.7	0.1	17.0	9.9	7.4
Real consumption growth % yoy	3.0	2.9	2.9	0.1	5.1	1.3	6.7	4.1	3.2
private consumption growth % yoy	3.2	1.8	2.9	-1.1	4.8	1.3	6.6	3.9	3.1
Real export growth, % yoy	9.1	7.8	5.1	-12.5	14.7	9.5	2.9	9.1	10.6
Real import growth, % yoy	3.3	4.4	8.9	-21.5	21.5	13.7	6.2	11.8	11.2
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.6	3.1	0.4	3.5	3.1	3.5	3.6	3.3	4.3
CPI, % avg	4.6	2.2	5.5	-0.9	3.3	3.8	3.0	3.3	3.5
Nominal wages, % yoy	5.8	3.0	10.5	-1.9	5.8	7.2	11.9	5.5	4.0
Credit extension to private sector, % yoy	4.5	29.3	6.3	2.5	18.9	18.0	16.0	13.5	11.5
Policy interest rate, % eop	5.00	3.25	2.75	1.25	2.00	3.25	2.75	3.75	3.75
1 month inter-bank rate, % eop	5.22	3.74	3.07	1.28	2.03	3.26	2.79	3.50	3.50
Long term yield, % eop	5.04	5.13	2.84	4.37	3.74	3.28	3.55	4.00	4.00
lc/US\$, eop	35.45	30.05	34.79	33.36	30.07	31.57	30.60	30.48	30.00
lc/US\$, avg	37.93	32.33	33.03	34.33	31.71	30.48	31.08	30.00	30.18
<b>Balance of Payments, US\$ bn</b>									
Current account	2.3	15.7	2.2	21.9	10.0	5.9	2.7	-1.0	-2.0
% of GDP	1.1	5.9	0.8	8.3	3.1	1.7	0.7	-0.3	-0.5
Trade balance	13.7	26.6	17.3	32.6	29.8	17.0	8.3	4.3	3.9
Exports	127.9	151.3	175.2	150.8	191.6	219.1	226.2	252.6	285.7
Imports	114.3	124.6	157.9	118.2	161.9	202.1	217.8	248.3	281.8
Net service and Transfer accounts	-8.0	-8.0	-12.9	-6.4	-10.7	-10.6	-3.9	-6.1	-7.0
Income balance	-3.4	-3.0	-2.3	-4.4	-9.0	-0.5	-1.7	0.2	0.0
FDI, net	8.5	8.3	4.4	0.7	4.5	-0.4	-3.0	4.2	3.1
International reserves	67.0	87.5	111.0	138.4	172.1	175.1	181.6	190.0	197.8
Total Amortisations	12.8	20.5	15.0	10.7	9.4	8.9	17.3	18.0	19.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.7	-1.6	-1.0	-5.7	0.0	-1.0	-2.1	-2.2	-2.1
Consolidated gov primary balance	0.9	-0.3	0.2	-4.5	1.2	0.2	-0.8	-0.9	-0.7
Public debt	40.3	37.4	38.2	43.9	42.4	40.8	43.7	47.5	48.0
of which Domestic	34.3	32.7	33.7	39.7	38.8	37.5	40.5	41.2	42.3
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	70.0	74.4	76.1	75.3	100.6	104.6	128.0	132.3	135.0
Private	64.7	71.6	72.7	69.4	87.9	88.4	101.1	106.7	108.4
Public	5.2	2.8	3.4	5.9	12.7	16.2	26.9	25.6	26.6
External debt / GDP	33.7	28.1	27.6	28.5	31.5	30.2	35.0	32.7	31.2
External debt / XGS	45.9	41.0	36.5	41.6	44.5	40.1	46.5	43.3	39.4
Short-term debt	27.2	34.0	33.6	33.1	50.7	47.3	58.0	60.0	59.8
Short-term debt/International Reserves (%)	40.7	38.9	30.3	23.9	29.4	27.0	31.9	31.6	30.2
<b>Quarterly Economic Indicators</b>									
	2012 Q3F	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	3.1	18.9	5.5	4.8	4.3	4.0	4.5	4.8	5.0
CPI, % yoy	3.4	3.6	3.5	3.7	3.6	3.3	3.5	3.7	4.0
Policy interest rate, % eop	3.00	2.75	2.75	3.00	3.50	3.75	3.75	3.75	3.75
1 month inter-bank rate, % eop	3.05	2.79	2.50	2.75	3.25	3.50	3.50	3.50	3.50
Long term yield, % eop	3.62	3.55	3.50	3.65	3.75	4.00	4.00	4.00	4.00
lc vs USD, eop	30.83	30.60	29.51	29.81	30.19	30.48	30.36	30.24	30.12

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

Adrienne Lui  
+852 2501 2753  
adrienne.lui@citi.com

**Bank of Mongolia introduced a new interest rate corridor to constrain short term interest rates within the corridor;** while the policy rate (at 12.5%) should continue to signal policy stance towards growth and inflation. The new corridor is created with two new instruments: the overnight repo rate (which will act as the corridor's ceiling and is set at 2ppt above the policy rate) and the overnight deposit rate (which will act as the corridor's floor; 2ppt below the policy rate). The new framework should help BoM reduce interbank rate volatility by allowing banks to borrow from BoM at the repo facility or banks to deposit funds with BoM. By introducing this framework, we believe the BoM aims to enhance the efficiency of the interbank market, decrease the volume of outstanding central bank bills, reduce the interest rate of financing to banks as well as promote economic activity.

**Inflation retreated in Feb to 11.3%yoy (from 13%yoy in Jan) on high base effects.** We expect inflation to be on a descending trend in the coming months thanks to more favorable base. However, prices are likely to edge up on a MoM basis on higher food prices (which accounts for 40% of the CPI basket), while credit and M2 growth remain in double digits (Feb: 25.6%yoy and 16.1%yoy, respectively).

**Slight relaxation in the Foreign Investment Law (FIL),** a year after the law was adopted. The FIL requires all foreign acquisitions of more than 49% of an entity in a strategic sector (mining, banking/finance, media and telecommunications) would need prior parliamentary approval. On 2 Mar, the Parliament raised the investment quota (from MNT100bn to 1trn), to facilitate foreign investments in SMEs. The application period for parliamentary approval is reduced from 45 days to 30 days.

**Aside from the awaiting the final mining law draft in April, market eyes on the Government/Rio negotiations over Oyu Tolgoi's (OT) copper-gold mine.** The Government owns 34% of OT's share, while Rio controls the rest. Although OT is said to be on track for commercial production in June (therefore we are not changing our forecast), newsflows related to the ongoing negotiations between two parties have dealt another blow to foreign investment sentiments. The negotiations surrounds 6 main issues:-- OT cost overruns, the funding/feasibility study for phase 2 of the mine, the employment of Mongolian workers/contractors and corporate governance, according to Ministry of Economic Development.

## Sri Lanka

Johanna Chua  
+852 2501 2357  
johanna.chua@citi.com

**Currency is stabilizing with external imbalances somewhat moderating even amid the negative IMF news.** After an initial knee-jerk reaction to the news last month about government no longer pursuing an IMF program – hitting the dollar bonds more than the local bonds – the situation has now reversed with dollar bonds rallying, we think partly on ETF rebalancing moves. However, even the local bond and FX market has also remained stable –non-resident investors in Sri Lanka government securities shifted out of Treasury bonds and into Treasury bills since the IMF news, but the amount is tiny and overall foreign holdings of combined bonds and bills as of March 6<sup>th</sup> is still at an upward trajectory. While January trade balance is not yet released as we write this, we suspect the trade deficit has narrowed further given slower domestic demand (note, we adjust our 2014F growth forecast a little lower to 6.7% versus 6.8% previously) and recovering external demand. After Sri Lanka hiked fuel prices (gasoline by 1.9%, diesel by 5.2%) this February, the trade gap may stay contained, while inflation risks will likely mean CBSL will remain on hold for now, with only limited room to ease monetary policy this year (we have penciled in 25bps in repo and reverse repo by 2Q 2013 and the corridor may narrow in 2H by cutting reverse repo another 50bps).

**Moody's recent negative comments raise the odds that the revise the 'positive' outlook on the B1 rating back to 'stable' in the next 12 months.**

Moody's sent out a special commentary that talks about Sri Lanka's post-IMF backdrop especially as it no longer seeks a new IMF program. It cites Sri Lanka's rising external vulnerability, fading post-growth momentum and challenges to fiscal consolidation given build up of arrears as being negative developments. We think the two comforting factors Moody's cites – that Sri Lanka is reducing external financing dependence in the budget is falling and that external debt is still mostly concessional – are quite inaccurate. If we include foreign purchases of government securities to finance the budget as "external financing", Sri Lanka's reliance on external borrowings have actually surged. Moreover, government's external debt is now mostly from commercial sources –almost 51% of total in 2012 vs. 43% in 2011.

**We think Moody's may revise the outlook back to "stable" from "positive" in the next 12M, possibly as early as 2H 2013.** Overall, we think Sri Lanka is a stable credit. Moody's "positive" outlook was put in place in July 2011 at an "unfortunate" time as shortly after, Sri Lanka had undergone significant external and macro imbalances that precipitated a return to the IMF prescriptions and tightening policies starting in early 2012. While things have stabilized since then, we think the underlying credit improving story in Sri Lanka has now stalled. We are not too worried either, but we think the prospects for an upgrade seem less likely now.

## Vietnam

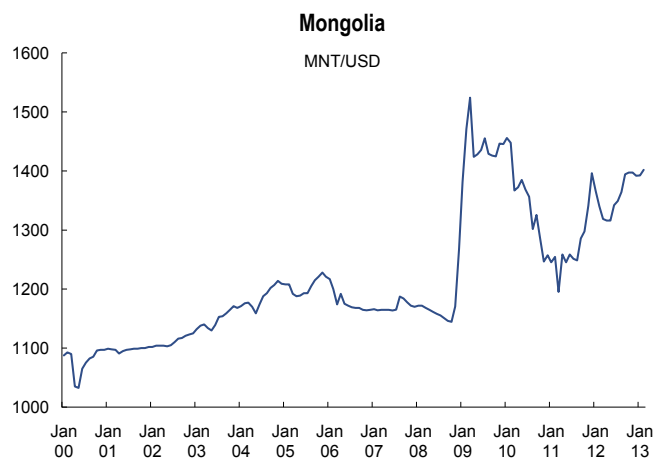
Johanna Chua  
+852 2501 2357  
johanna.chua@citi.com

**SBV shuts down talk of dong devaluation.** There has been a pick up of anticipation that dong could weaken again as a means for SBV to boost flagging growth, which appear to have had a slow start this year. However, senior SBV officials have said there is no plan to devalue the dong and have continued to maintaining dong stability, with the USD-VND fixing remaining unchanged since late 2011. Nonetheless, the dong spot has moved 0.5% weaker, and forward points moved higher as market became somewhat jittery.

**We think SBV deliberately devaluing the dong makes no economic sense –** First, inflation still remains relatively high and SBV should be increasingly sensitive to inflation expectations given the reversal of the favorable base effect likely to drive average inflation this year closer to 8% -- the government's target. Second, Vietnam's exports remain very competitive, expanding 23% YoY in Jan-Feb 2013, outperforming Asia peers except for China, with both high tech and garments up 48% YoY and 36% YoY, respectively. Coupled with still weak domestic demand, monthly trade surpluses are rising. Third, we believe devaluing the dong is a very risky strategy that could undermine financial stability given history of fragile sentiment in the currency and track record of gold holdings and dollarization in the economy. We think the last thing SBV wants to do is the replicate the period of VND volatility in 2008-2010 that led domestic capital flight and serious pressure on liquidity in the banking system which would further hurt the economy.

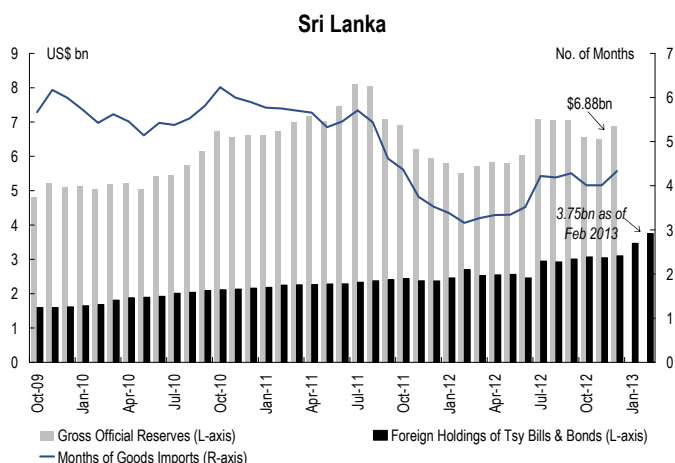
**External position still remains strong and we continue to like the dong (VND), gaining exposure via local bonds.** Vietnam trade surplus continues to expand this year and we think there is upside to our CA forecast this year of 2.4% of GDP. We estimate SBV saw its FX reserves rise at least \$10bn in 2012F (SBV said it purchased \$15bn) –and SBV's FX purchases this year reversed recently as it sold dollars to keep the dong stable. We expect this intervention to remain muted, and we continue to forecast foreign reserves to exceed \$30bn by year-end.

Figure 108. Mongolia – MNT still in depreciating mode as of Feb



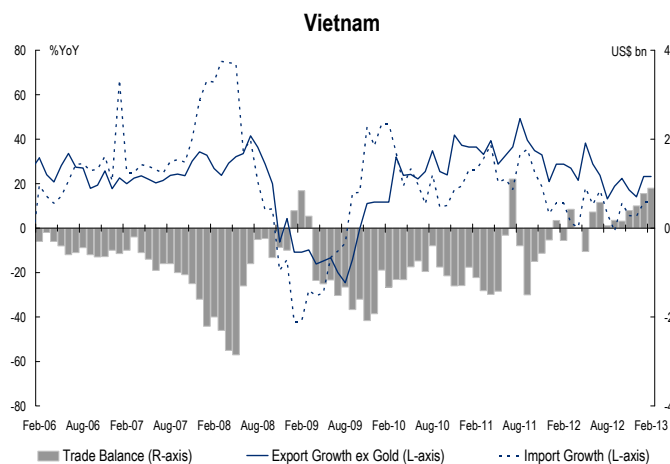
Source: BoM, CEIC, and Citi Research

Figure 110. Sri Lanka – FX reserve ratio may not be so weak given the stability of foreign holdings of Tsy bonds & bills



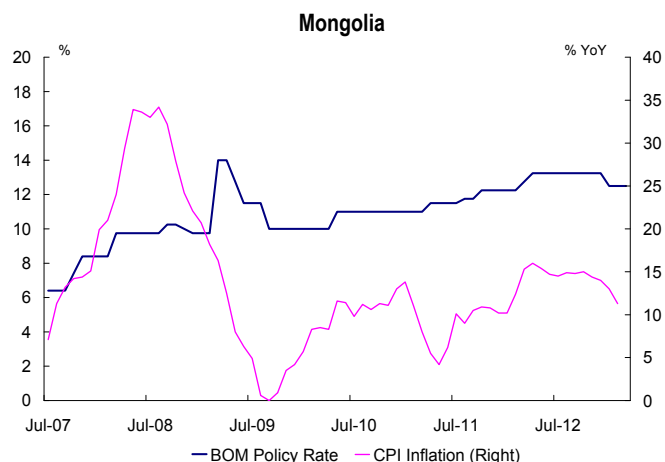
Source: CBSL, CEIC, and Citi Research

Figure 112. Vietnam – Trade flows still remain very supportive of sustained current account surpluses



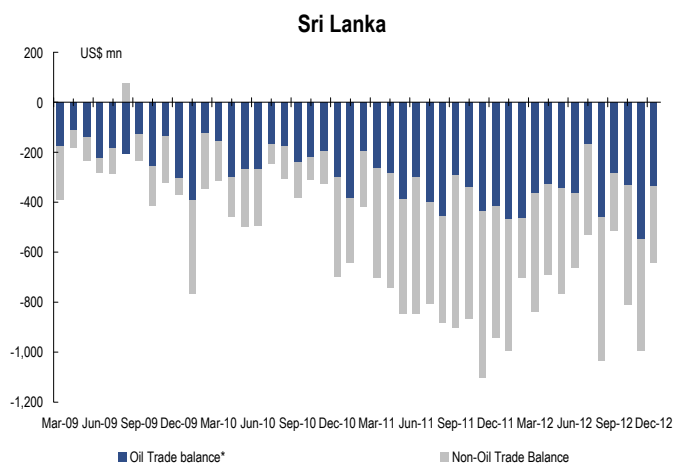
Source: CEIC, and Citi Research

Figure 109. BoM sees lower inflation risks, CPI fell in Feb on high base



Source: BoM, CEIC, and Citi Research

Figure 111. Trade deficit has narrowed recently led by a decline in petroleum imports – we'll need to monitor oil prices though



Source: CBSL, and Citi Research

Note: \*Data on petroleum exports for Dec are not yet available—we assume they are unchanged vs. Nov

Figure 113. USD-VND likely remain within the official range – expect pressures to abate



Source: Citi Research

Figure 114. Asia Frontier Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Mongolia</b>									
Nominal GDP, US\$ bn	3.4	4.2	5.6	4.6	6.2	8.7	10.3	12.5	15.9
GDP per capita, US\$	1326	1616	2100	1688	2262	3110	3607	4309	5383
Population, mn	2.6	2.6	2.7	2.7	2.8	2.8	2.8	2.9	3.0
Real GDP, % yoy	8.6	10.2	8.9	-1.3	6.4	17.3	12.3	13.8	11.0
CPI, % yoy	6.0	15.1	22.1	4.2	13.0	10.2	14.0	10.2	10.0
CPI, % avg	4.5	9.0	28.0	8.0	10.1	9.2	14.3	12.0	10.0
Policy interest rate, % eop	--	8.40	9.75	10.00	11.00	12.25	13.25	12.50	13.00
Long term yield, % eop	26.93	21.83	20.58	21.67	20.07	16.61	18.11	19.31	20.51
lc/US\$, eop	1164	1172	1275	1433	1233	1378	1378	1380	1312
lc/US\$, avg	1181	1171	1167	1434	1349	1256	1353	1403	1332
Current account (US\$ bn)	0.2	0.3	-0.7	-0.4	-0.9	-2.8	-3.2	-2.8	0.5
% of GDP	6.5	6.3	-12.9	-9.0	-14.9	-31.7	-31.3	-22.4	3.1
Trade balance (US\$ bn)	0.1	-0.2	-1.1	-0.2	-0.4	-1.7	-2.4	-2.0	-1.9
Exports (US\$ bn)	1.5	1.9	2.5	1.9	2.9	4.8	4.3	5.6	6.8
Imports (US\$ bn)	1.5	2.1	3.6	2.1	3.3	6.5	6.7	7.7	8.7
International reserves (US\$ bn)	0.6	0.8	0.6	1.3	2.2	2.3	4.1	4.6	5.1
Consolidated government balance (% of GDP)	7.6	2.6	-4.5	-5.2	0.5	-4.8	-8.3	-2.4	-2.0
Public debt (% of GDP)	40.3	37.7	32.0	43.2	38.3	46.1	62.8	55.9	60.0
<b>Sri Lanka</b>									
Nominal GDP, US\$ bn	28.3	32.4	40.7	42.1	49.6	59.2	59.5	65.1	74.0
GDP per capita, US\$	1422	1615	2014	2058	2400	2836	2820	3054	3431
Population, mn	19.9	20.0	20.2	20.5	20.7	20.9	21.1	21.3	21.6
Real GDP, % yoy	7.7	6.8	5.9	3.5	8.0	8.3	6.4	6.7	7.1
CPI, % yoy	13.5	18.8	13.9	5.0	6.8	4.9	9.2	6.2	6.5
CPI, % avg	10.0	15.8	22.5	3.6	6.2	6.8	7.5	7.1	6.5
Policy interest rate, % eop	10.00	10.50	10.50	7.50	7.25	7.00	7.50	7.25	7.50
Long term yield, % eop	12.98	19.96	19.12	9.33	7.55	9.31	11.76	10.00	10.50
lc/US\$, eop	107.5	108.7	113.0	114.4	110.9	113.9	127.7	130.0	130.0
lc/US\$, avg	103.9	110.6	108.3	114.9	113.0	110.5	127.2	129.5	130.0
Current account (US\$ bn)	-1.5	-1.4	-3.9	-0.2	-1.1	-4.6	-3.3	-3.1	-3.0
% of GDP	-5.3	-4.3	-9.5	-0.5	-2.2	-7.8	-5.5	-4.7	-4.0
Trade balance (US\$ bn)	-3.4	-3.7	-6.0	-3.1	-4.8	-9.7	-9.3	-10.6	-11.4
Exports (US\$ bn)	6.9	7.6	8.1	7.1	8.6	10.6	9.7	10.5	11.9
Imports (US\$ bn)	10.3	11.3	14.1	10.2	13.5	20.3	19.0	21.1	23.2
International reserves (US\$ bn)	2.5	3.1	1.8	5.1	6.6	6.0	6.9	8.3	9.1
Consolidated government balance (% of GDP)	-7.0	-6.9	-7.0	-9.9	-8.0	-6.9	-6.7	-6.2	-5.5
Public debt (% of GDP)	87.9	85.0	81.4	86.1	81.9	78.5	84.1	80.0	78.0
<b>Vietnam</b>									
Nominal GDP, US\$ bn	60.9	71.2	90.0	91.9	102.4	121.6	139.0	157.1	176.3
GDP per capita, US\$	724	836	1044	1054	1163	1366	1544	1728	1920
Population, mn	84.1	85.2	86.2	87.2	88.1	89.0	90.0	90.9	91.8
Real GDP, % yoy	8.2	8.5	6.3	5.3	6.8	5.9	5.0	5.4	5.8
CPI, % yoy	6.6	12.6	19.9	6.5	11.7	18.1	6.8	7.8	7.0
CPI, % avg	7.5	8.5	23.2	7.0	9.2	18.6	9.3	7.6	7.2
Policy interest rate, % eop	6.50	6.50	9.50	8.00	9.00	15.00	9.00	8.00	8.00
Long term yield, % eop	8.29	8.73	10.00	11.68	11.50	12.55	9.75	10.00	10.00
lc/US\$, eop	16056	16028	17483	18474	19498	21034	20840	20850	21000
lc/US\$, avg	15990	16081	16445	17806	19123	20648	20875	20850	21000
Current account (US\$ bn)	-0.2	-7.0	-10.7	-7.2	-4.3	-0.7	4.4	3.7	1.2
% of GDP	-0.3	-9.8	-11.9	-7.8	-4.2	-0.6	3.2	2.4	0.7
Trade balance (US\$ bn)	-2.8	-10.4	-12.8	-8.3	-5.1	-0.5	5.4	5.2	2.2
Exports (US\$ bn)	39.8	48.6	62.7	57.1	72.2	96.9	114.5	133.9	150.3
Imports (US\$ bn)	42.6	58.9	75.5	65.4	77.3	97.4	109.1	128.7	148.0
International reserves (US\$ bn)	13.4	23.5	23.9	16.4	12.5	13.8	23.6	33.7	36.2
Consolidated government balance (% of GDP)	-1.1	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-3.8	-4.0
Public debt (% of GDP)	37.5	39.0	34.9	40.0	45.5	45.9	44.2	43.8	44.3

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

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# CEEMEA

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## Czech Republic

Jaromir Sindel  
+ 420 233 061 485  
[jaromir.sindel@citi.com](mailto:jaromir.sindel@citi.com)

- **Summary view** — We see a larger downside risk of -0.4%YoY GDP fall in 2013 compared to our baseline at -0.2% owing to a likely milder positive pass-through of a weaker koruna. Though it will likely be slightly offset by a milder fall in value added compared to the flash estimate, followed by a 0.9% recovery in 2014.
- **Things to watch** — The market will focus on the CNB's decision in late March. We expect the Governor's presentation will sound more dovish compared to February, but do not expect any bold action unless a rally in koruna requires it.
- **Strategy** — We continue to expect the CNB's desired level of EURCZK to be at around 26 by the end-2013, given our outlook on weaker foreign demand.

### Recovery likely from mid 2013

**The mix of downward revision in private consumption and upward in investment activity in 4Q12 could be a dovish signal for CNB.** While the CZSO confirmed the flash estimate of 0.2%QoQ fall in GDP in 4Q12, it revised down private consumption. It actually fell 3.5%YoY in 2012, while CNB expected -2.9%. As a result, private consumption fell 4.1%YoY in 4Q12, while the CNB had expected -3.5%, which is a dovish signal for CNB. By contrast, investment activity was revised up in 2012 and 4Q12's data was better than the CNB had expected (though the difference probably mainly reflects the inventories. However, fixed investment activity fell by 5%YoY in 4Q12 and the lower utilisation in production capacities in industry from early 2013 suggests a further mild worsening in 1Q13. Overall, we estimate the effective domestic demand contracted by 3.3%YoY in 4Q12 compared to 1.7% fall in GDP. The approved higher progressivity of PIT since January 2013 probably led to pre-payments of bonuses in 4Q12. This suggests the real "ex-bonuses" average wage is set to fall by 0.6%YoY in 4Q12 instead of 0.9%YoY increase in headline number. Nevertheless, our below-consensus forecast for foreign demand means we think that Czech GDP will still fall by 0.2%YoY in 2013. Though we see a larger downside risk of -0.4%YoY GDP fall in 2013 compared to our baseline at -0.2% (followed by 0.9% recovery in 2014) owing to likely milder positive pass-through of weaker koruna though it is slightly offset by a milder fall in value added compared to the flash estimate and also by recent improvement in confidence indicators.

**We expect a mild recovery in industry, but less than confidence indicators suggest.** Industrial output eased its contraction to -4%YoY swda in January from an upwardly revised -4.7% swda a month ago (-5.6% previously). Revised data actually show a positive development in industry in Dec 12-Jan 13, however this is not reflected in labour market data and is not supported by new orders. We keep our forecast of a recovery in industrial production to -3%YoY in 1Q13, compared to more optimistic levels suggested by both the PMI and confidence indicators that point to a recovery in a range from -1.5 to +1.5%YoY in 1Q13 from -4.7%YoY in 4Q12. We argue that this move would require an 8% cumulative increase in industrial production in Feb-Mar 2013, which we do not see as realistic. Moreover, both improved industrial production and confidence are not backed by improved order books. However, if the scenario (suggested by confidence indicators) materialises, it would suggest industrial production will increase by 5.5%YoY in 2013, while our new forecast points to flat industrial production (in YoY terms) in 2013 (2.4%YoY in 2H13) after -1.1% in 2012.

## **CNB still wants a weaker CZK ...**

**Overall, we view data published in March as a disinflationary risk to the CNB's forecast.** Though the January retail sales were better than expected, they still fell and in our view reflected temporary factors. February monetary-policy relevant CPI is below CNB's target, total CPI at 1.7%YoY is below CNB's forecast at 2%, stronger wage growth in 4Q12's was driven by bonuses and there was a downward revision to private consumption in 2012 that is closer to the CNB's dovish sensitivity scenario from February that implied further cut in the policy rate. However, we expect the CNB to remain less dovish in the near term until there is a stronger fall in consensus on German GDP or a clear signal from ECB on further loosening. By contrast, adjusted core CPI eased its contraction to -0.4%YoY, which is an upside risk to the CNB's forecast, though the difference to the CNB's forecast of 0.5% in our view reflects a transfer of deregulated rents to this "demand-pull" basket of CPI.

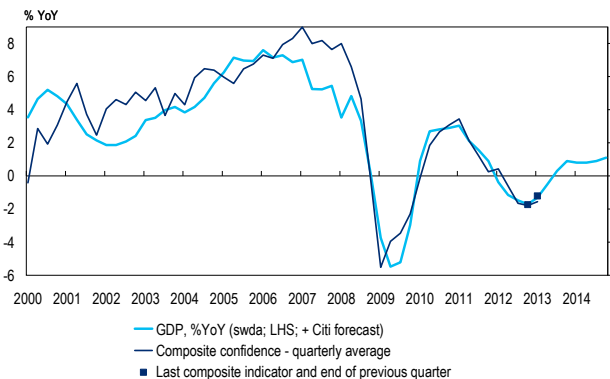
**Having said this we continue to expect the CNB's desired level of EURCZK at around 26 by the end-2013, given our outlook on weaker foreign demand.** We do not expect the domestic demand to create inflationary pressures and we can say similar about expected subdued recovery in foreign demand. Therefore, we expect the CNB to continue in its loosening monetary policy through 2013, which is likely to result into a higher EURCZK compared to CNB's forecast at 25.1 for end of 2013. Moreover, we estimate disinflationary risks from recent Czech data compared to CNB's forecast. If we apply a less negative outlook to our foreign growth assumptions (but still below consensus) and only a 25bp cut in the ECB's policy rate (in our baseline we expect a total 50bp cut in 2013), it would suggest the "desired level" of EURCZK at 25.7-25.8 by end-2013. We expect the koruna to start appreciation in 2014 given our expectation of stronger recovery, which is likely to allow the expected monetary policy tightening through the FX channel first.

## **... but doubts still remain**

**Moreover, national accounts details show that weaker koruna was not a dominant factor for residents shopping abroad or for foreigners' locally and also was not directly reflected in export and profit.** We estimate that if "foreign consumption" had reflected the weaker koruna, domestic private consumption would have contracted less by 0.5%pts in 2012, which, we estimate, would have led to a milder cut in CNB's policy rate by 12bp in 2012. We estimate the effect of weaker koruna at around 0.2-0.8%pt on domestic consumption growth in 2013, which we find equivalent to 5-20bp in the policy rate. However, the implications are unclear: the lower impact of the koruna's influence would suggest a further loosening in CNB's policy rate on one side, but could also raise more doubts among the Bank Board members about the FX channel being the next measure in CNB's easing policy. By contrast, if there is a positive impact from the koruna, it would not be our call for tightening the policy as this assumes our forecast of a weaker koruna. Also, weaker koruna has not been supportive for profit margin in industry according to national accounts. The same holds for the "outperformance" of Czech exporters compared to German that used to be apparent when koruna was weaker.

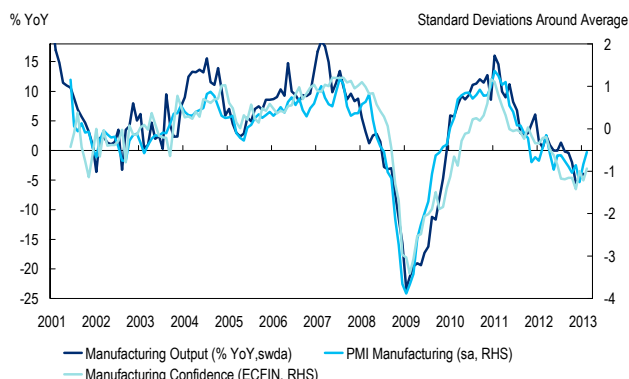
**The risk to our FX forecast could represent a higher global commodity prices** as in that case the weaker koruna could represent a downside risk for adjusted core CPI owing to its quicker pass-through to food and fuel prices. In our view it could lead to some doubts among some Bank Board member though we understood from the Bank Board members after CNB's February decision that a weaker koruna is the preferred monetary policy tool to "just" achieve the inflation target.

**Figure 115. February confidence improve in line with our forecast of GDP**



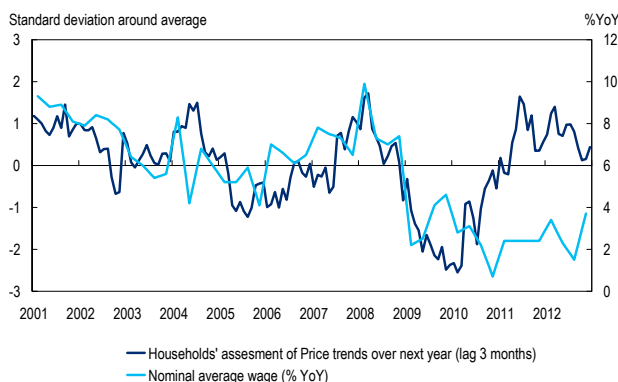
Source: Czech Statistical Office, Citi Research

**Figure 116. Milder recovery in industry likely than confidence suggests**



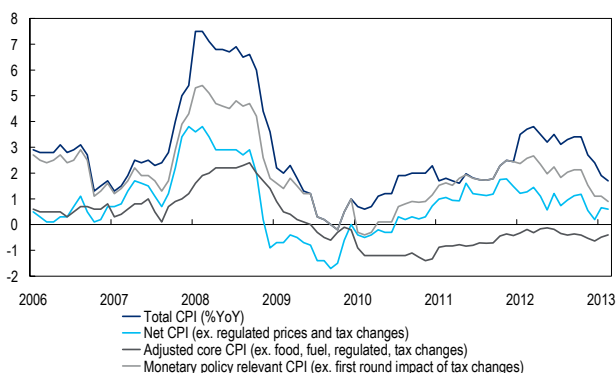
Source: CZSO, Haver Analytics, Citi Research

**Figure 117. Wage growth was driven by temporary tax optimization**



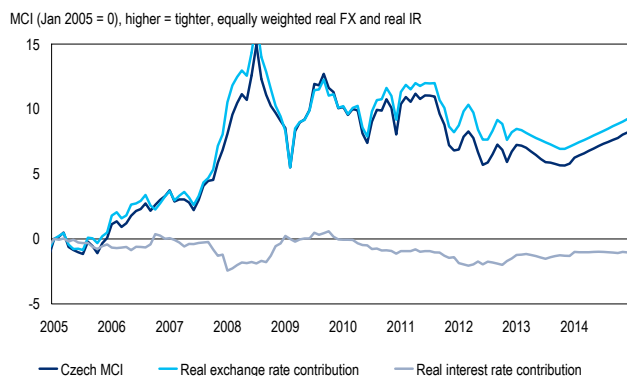
Source: CZSO, EC, Citi Research

**Figure 118. ... that does not represent an inflationary pressure**



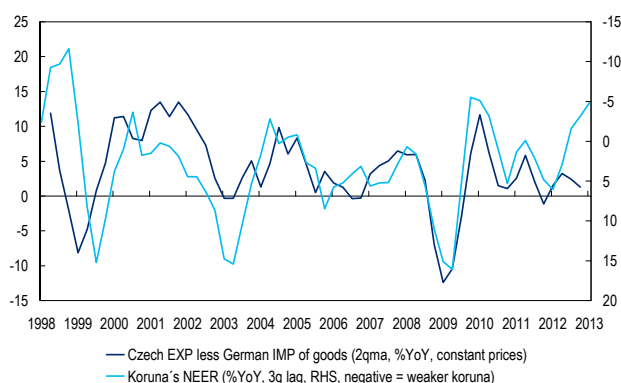
Source: CNB, Citi Research.

**Figure 119. We expect koruna to ease the monetary conditions index**  
...



Source: Czech National Bank, Czech Statistical Office, Citi Research

**Figure 120. ... while it has not yet reflected in Czech export performance**



Source: CNB, CZSO, Haver Analytics, Citi Research.

Figure 121. Czech Republic Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	148	180	225	197	199	217	196	199	203
Nominal GDP, local currency bn	3,353	3,663	3,848	3,759	3,800	3,841	3,844	3,865	3,952
GDP per capita, USD	14,452	17,484	21,614	18,795	18,916	20,683	18,698	18,909	19,318
Population, mn	10.3	10.3	10.4	10.5	10.5	10.5	10.5	10.5	10.5
Unemployment, % of labour force	7.2	5.3	4.4	6.7	7.3	6.7	7.0	7.6	7.7
<b>Economic Activity</b>									
Real GDP, yoy avg	7.0	5.7	3.1	-4.5	2.2	2.2	-1.2	-0.2	0.9
Real investment growth % yoy	10.2	15.5	1.9	-20.2	5.8	0.3	-3.0	-1.4	15.5
Real consumption growth % yoy	2.9	3.1	2.3	1.3	0.9	-0.3	-2.7	-0.4	0.1
private consumption growth % yoy	4.4	4.2	2.8	0.2	1.0	0.7	-3.5	-0.5	0.0
Real export growth, % yoy	13.8	11.2	4.0	-10.9	15.5	9.4	4.1	1.8	2.4
Real import growth, % yoy	10.8	12.8	2.7	-12.1	15.8	6.7	2.1	0.6	4.5
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	1.7	5.5	3.6	1.0	2.3	2.4	2.4	2.2	1.6
CPI, % avg	2.5	2.9	6.3	1.0	1.5	1.9	3.3	2.1	1.5
Nominal wages, % yoy	6.5	7.2	7.9	3.4	2.2	2.4	2.7	1.3	2.4
Credit extension to private sector, % yoy	20.5	26.6	16.1	0.8	3.0	5.5	2.6	1.5	7.5
Policy Interest Rate, % eop	2.50	3.50	2.25	1.00	0.75	0.75	0.05	0.05	0.25
1 month inter-bank rate, %, eop	2.52	3.94	3.21	1.29	0.99	0.94	0.33	0.30	0.45
Long-term yield, %, eop	3.68	4.64	4.15	4.01	3.86	3.69	1.90	2.50	2.80
CZK/US\$, eop	20.8	18.2	19.2	18.4	18.7	19.8	19.0	20.2	19.1
CZK/US\$, avg	22.5	20.2	17.0	19.0	19.1	17.7	19.5	19.9	19.5
CZK/EUR, eop	27.5	26.5	26.8	26.4	25.0	25.6	25.1	26.0	24.8
CZK/EUR, avg	28.3	27.8	25.0	26.4	25.3	24.6	25.1	25.9	25.2
<b>Balance of Payments, USD bn</b>									
Current account	-3.1	-7.9	-4.8	-4.8	-7.6	-6.3	-4.0	-3.0	-3.7
% of GDP	-2.1	-4.4	-2.1	-2.5	-3.8	-2.9	-2.0	-1.5	-1.8
Trade balance	2.6	2.2	1.7	4.6	2.8	5.3	7.5	7.5	7.6
Exports	85.6	106.5	125.1	99.1	114.0	138.5	132.5	133.5	137.3
Imports	83.0	104.3	123.4	94.6	111.2	133.2	125.0	126.0	129.8
Service balance	2.2	2.9	4.4	3.9	3.9	3.8	2.8	2.8	2.7
Income balance	-7.4	-12.7	-10.6	-13.2	-14.8	-15.6	-14.3	-14.1	-14.2
FDI, net	4.0	9.0	2.3	2.0	4.9	4.2	9.3	6.1	6.1
International reserves	31.1	34.4	36.5	39.7	40.3	37.9	42.4	42.6	44.1
Total amortisations	6.0	6.0	7.7	10.1	9.9	12.9	13.7	11.5	14.2
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-2.4	-0.7	-2.2	-5.8	-4.8	-3.3	-4.8	-3.0	-2.7
Consolidated gov primary balance	-1.3	0.4	-1.2	-4.5	-3.4	-1.9	-3.1	-1.3	-0.9
Public debt	28.3	27.9	28.7	34.2	37.8	40.8	45.6	48.4	50.0
of which Domestic	21.0	20.3	20.7	24.1	25.4	28.5	31.5	33.3	34.6
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	57.3	76.2	84.2	89.2	94.2	93.9	91.9	98.0	105.6
Public	12.0	15.0	15.3	19.8	24.0	22.6	29.4	32.0	35.6
External debt / GDP	38.6	42.2	37.4	45.3	47.4	43.3	46.8	49.3	52.0
External debt / XGS	57.4	61.5	57.3	75.3	69.8	58.1	59.3	62.6	65.6
Short-term debt	15.4	22.6	27.1	23.9	23.6	27.7	24.5	26.0	27.0
Short-term debt/International reserves (%)	49.6	65.5	74.2	60.2	58.5	73.1	57.8	61.1	61.2
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	-1.5	-1.7	-1.3	-0.5	0.3	0.9	0.8	0.8	0.9
CPI, % yoy	3.5	2.4	2.1	2.2	2.0	2.2	1.5	1.5	1.6
Policy interest rate, %, eop	0.50	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Short-term market rate, % eop	0.62	0.33	0.30	0.30	0.30	0.30	0.25	0.25	0.25
Long-term yield, %, eop	2.39	1.90	1.96	2.11	2.26	2.50	2.58	2.65	2.73
CZK/EUR, eop	25.13	25.09	25.66	25.89	26.01	26.04	25.73	25.41	25.08

Source: National Sources, Citi Research

# Egypt

David Cowan  
+44 20 7986 3285  
[david.cowan@citi.com](mailto:david.cowan@citi.com)

- **Summary view** — The current political uncertainty should continue until parliamentary elections are held. Meanwhile, we believe the government will continue to muddle through in terms of economic policy for much of 2013 relying on a constant drip of external financing from the Gulf states led by Qatar.
- **Things to watch** — Having let the EGP start to adjust in early 2013 after reserves fell to “critical levels” according to the CBE, the main question is how much will the currency adjust and when will stability start to re-emerge.
- **Strategy** — Ultimately the government is hoping that a deal with the IMF will crowd in both official and private sector finance. Coupled with the catalyst it would provide to the reform programme, we believe this should provide a short-term kick to the economy which remains in a state of stagflation.

## EGP moves: but to where by when?

**After two years of holding the line on the exchange rate and running down foreign exchange reserves, the Central Bank of Egypt (CBE) eventually changed policy tack in late December 2012.** By introducing an auction system after accepting that reserves had fallen to, in its words, “critical levels”, the EGP has plummeted on the new auction in early 2013 (by mid February it was trading at EGP6.7:US\$1). The move raises two important questions. First when will the adjustment run its course, and at what level will EGP eventually stabilize?

**According to some of the measures of the real exchange rate the EGP was probably overvalued by around 25-30%.** From EGP6:USD1, this would imply a stabilization level around EGP7.5 to 7.8:USD1. Of course, it is possible that the exchange rate will overshoot, even if only temporarily, or that the CBE will seek to impose more drastic capital and foreign exchange controls to try and halt the slide, especially as inflation picks up in 2H 2013 and the political environment remains uncertain.

**How long it takes to reach this level could potential depend on the signing of a deal with the IMF.** While reaching a deal with the IMF is probably now too late in the day to immediately halt the slide, it would provide substantial stability to the EGP when it reaches its new equilibrium level, even if this is still only for a couple of months. At present, the IMF is continuing to talk with the Egyptian authorities, but we believe the speed in which a deal can be signed will depend more on the Egyptian government than the Fund, and the willingness of the new government to make moves on subsidies prior to the parliamentary elections and when these are held. Having made the difficult decision to let the EGP adjust, the main focus of the talks with the IMF is now bound to be about the budget deficit.

## There will be a difficult adjustment in 2013

**The second question that a large exchange rate adjustment poses is what will be the macroeconomic impact?** The immediate answer is that adjustments of the size and scale occurring to the EGP have complicated dynamic knock on effects in the economy and the outcome is uncertain. But, the most obvious negative impact is usually a sharp rise in imported inflation which we do expect: at present we forecasts that inflation could rise up to somewhere between 15-20% by the end of 2013. But in the case of Egypt, the impact on prices should at least partially be mitigated by the subsidy provided on some food and fuel products, although this will have a negative impact on the size of the fiscal deficit in our view.

**We also think that the rise in inflation is also set to negatively impact on consumption.** In fact, after two years of low growth and running down savings, the fall in the EGP and rising foreign exchange shortages look set to drive import compression and to further slow growth. This means that we expect real GDP growth to slow to only 1.2%. Meanwhile, in terms of the twin deficits the impact is likely to be mixed. While the EGP adjustment should help boost export competitiveness in the medium term, in the short term the reality may well be significant import compression is likely to be the most important factor reducing the current account deficit in 2013. For the fiscal deficit while the rising cost of food and fuel price subsidies is negative, while slowing growth will lower domestic revenue generation. But in some cases the move can boost revenue, for example from Suez Canal earnings.

### **From crisis to reform: A deal with the IMF**

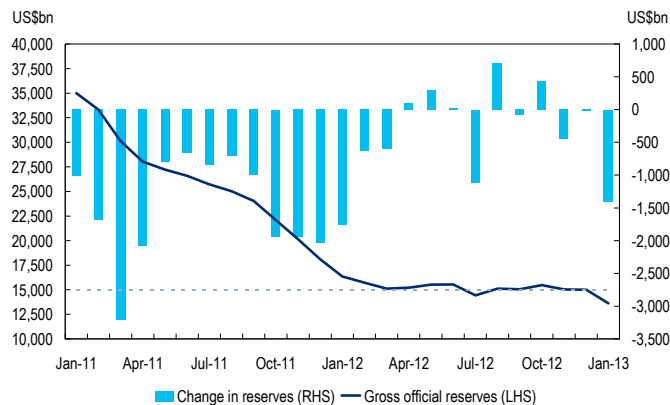
**We also think that the spur of an EGP crisis, against the backdrop of struggling to fund crucial wheat import, will eventually kick-start a reform effort.** The first short-term goal in this respect will likely to be the formal signing of a new deal with the IMF although this may only be possible in 2H 2013, or after the new parliament is in place. Having already allowed an adjustment in the exchange rate the key area of where there will need to be an agreement is on how to cut the fiscal deficit; the current goal is for a deficit of 8.5% of GDP for the 2013/14 fiscal year (starting on June 1), improve government control over its finances and to improve the overall business environment to support job creation. At present, given the slowdown in growth expected in 2013, the main focus of efforts is likely to be on cutting subsidies, which account for around 30% of government spending, and is likely to be on fuel subsidies, rather than food subsidies.

**But where investors will really want to see details of the agreement with the IMF is over the financing package.** In addition to the Fund's commitment to provide US\$4.8bn to Egypt over the life of the 22-month life of the programme, we think a potential Stand By Agreement (SBA) should also be able to attract an additional US\$10bn of external funding from a range of bilateral and multilateral partners on favourable terms (this will probably include some debt relief). If the money arrives fairly quickly, or is front loaded, it means that EGP stability should be obtainable in 2H 2013. This is especially the case as given the scale and size of EGP adjustment that now seems likely, an IMF deal should encourage private sector investors to start buying Egyptian Treasury bills: in effect the official commitments will "crowd in" other private sector investors.

### **Politics and economics**

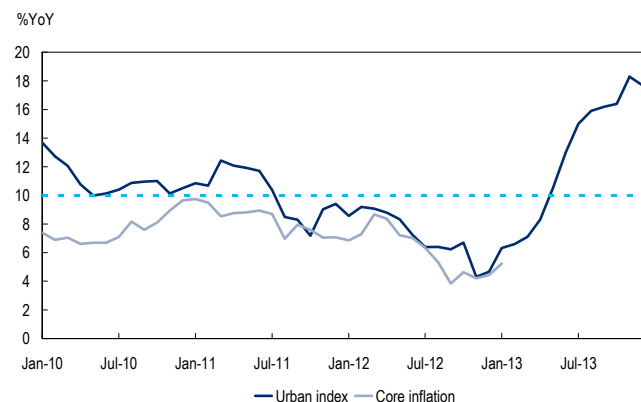
**At present we think that the holding of parliamentary elections will mark the start of a decline in political protests.** But if the new government is to more effectively curtail protests driven by the potential economic dislocation in 2013, we believe it will have to flesh out in more details some of its ideas about "capitalism with attention to the poor". Certainly, the greater provision of social services, probably directly by political parties, in challenging economic times should help. It then has to hope that with rising external support allows it to start to fund infrastructural spending, which should start to help boost growth, investment and employment in 2014. But even then it will still have to push ahead with fiscal consolidation, or at least switching spending away from subsidies, or targeting spending on subsidies more effectively. But in the short run there appears to be a growing acceptance among a range of market participants as well as ourselves that without getting the economy up and running, the long-term economic outlook will look bleaker.

Figure 122. The reserve cut off point proved to be US\$15bn



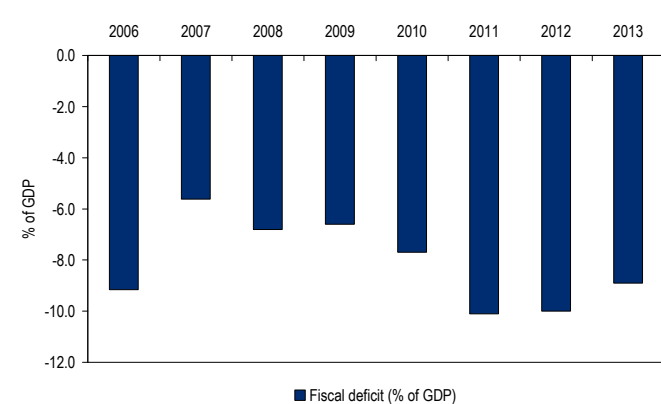
Source: Central Bank of Egypt, Haver Analytics

Figure 124. We do expect inflation to start to rise in 2013



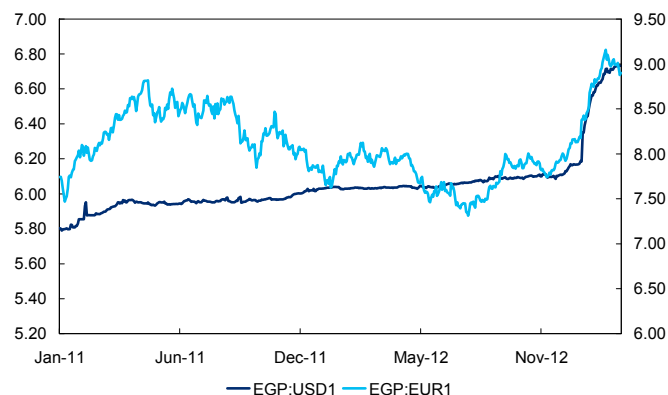
Source: Haver Analytics, Central Bank of Egypt and Citi forecasts for 2013

Figure 126. The fiscal deficit is still a significant problem



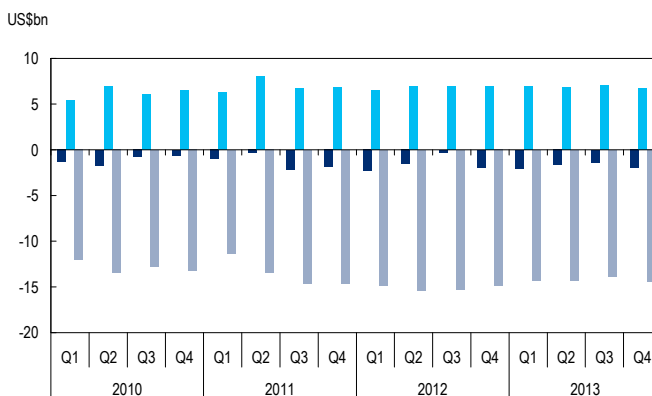
Source: Haver Analytic and Citi forecasts for 2013

Figure 123. The EGP falls sharply in early 2013



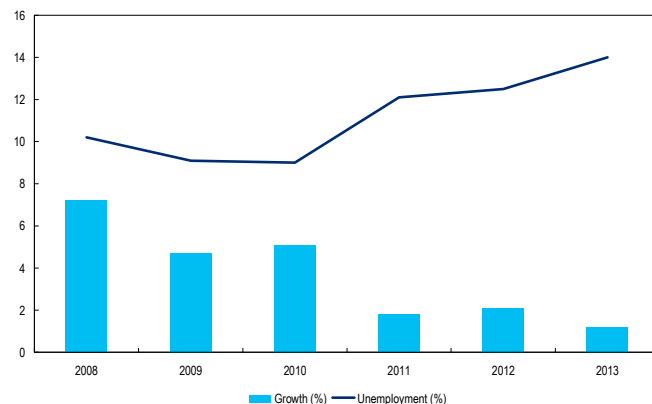
Source: Reuters

Figure 125. And import compression in 2013



Source: Central Bank of Egypt, Haver Analytics

Figure 127. Only a slow recovery in growth in 2013



Source: Haver Analytics, Citi and Citi forecasts for 2013

Figure 128. Egypt Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	108	132	165	188	214	231	247	236	254
Nominal GDP, local currency bn	618	745	896	1,042	1,207	1,371	1,498	1,706	1,981
GDP per capita, USD	1,427	1,717	2,101	2,352	2,634	2,785	2,919	2,744	2,895
Population, mn	75.6	77.0	78.4	79.9	81.4	82.9	84.5	86.0	87.7
Unemployment, % of labour force	10.6	8.9	8.7	9.4	9.0	12.1	12.5	14.0	15.0
<b>Economic Activity</b>									
Real GDP, yoy avg	6.8	7.1	7.2	4.7	5.1	1.8	2.1	1.2	3.5
Real investment growth % yoy	13.8	23.7	15.5	-9.1	8.0	-2.1	-0.8	1.8	4.6
Real consumption growth % yoy	5.9	7.6	5.2	5.7	4.2	5.3	4.0	-0.8	2.4
private consumption growth % yoy	6.4	8.8	5.7	5.7	4.1	5.5	2.8	-0.7	2.5
Real export growth, % yoy	21.2	20.2	28.8	-14.5	-3.0	1.2	-1.1	1.7	6.1
Real import growth, % yoy	21.7	30.5	26.3	-17.9	-3.2	8.4	2.7	-3.4	3.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	12.3	6.9	18.4	13.2	10.6	9.5	4.7	17.7	9.7
CPI, % avg	7.6	9.5	18.3	11.8	11.1	10.1	7.1	12.6	12.7
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	10.3	10.0	12.0	3.0	6.7	6.1	4.0	5.0	9.5
Policy Interest Rate, % eop	8.75	8.75	11.50	8.25	8.25	9.25	9.25	12.00	12.00
1 month inter-bank rate, %, eop	9.00	8.75	11.95	8.30	8.30	10.05	5.16	18.10	10.16
Long-term yield, %, eop	10.75	9.50	9.00	9.00	9.00	9.50	10.00	13.50	11.00
EGP/US\$, eop	5.71	5.53	5.50	5.48	5.81	6.03	6.36	7.50	8.10
EGP/US\$, avg	5.74	5.64	5.44	5.55	5.63	5.94	6.07	7.22	7.81
<b>Balance of Payments, USD bn</b>									
Current account	2.5	0.2	-1.3	-3.2	-5.6	-7.6	-8.9	-7.0	-8.0
% of GDP	2.3	0.2	-0.8	-1.7	-2.6	-3.3	-3.6	-3.0	-3.2
Trade balance	-12.7	-20.8	-26.8	-22.5	-27.7	-28.2	-33.2	-29.3	-29.7
Exports	20.5	24.5	29.8	23.1	25.0	27.9	27.3	27.6	28.0
Imports	33.3	45.3	56.6	45.6	52.7	56.1	60.5	56.9	57.7
Service balance	9.5	12.7	15.7	11.3	9.6	5.4	5.0	5.7	6.0
Income balance	-	-	-	-	-	-	-	-	-
FDI, net	9.9	10.9	7.6	6.1	5.2	-1.1	4.1	4.8	2.0
International reserves	26.1	31.7	34.2	34.2	36.0	18.1	15.0	18.0	21.0
Total amortisations	2.5	2.3	2.1	2.1	1.0	1.0	2.3	2.3	2.3
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-7.7	-5.2	-6.4	-6.6	-7.7	-10.1	-10.0	-9.7	-8.6
Consolidated gov primary balance	-2.1	0.0	-1.8	-2.4	-2.6	-4.5	-5.9	-5.7	-5.1
Public debt	62.8	64.2	53.5	54.0	59.8	69.0	80.5	79.5	76.0
of which Domestic	62.8	64.2	53.5	54.0	59.8	69.0	80.5	79.5	76.0
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	29.0	32.8	32.1	33.3	35.0	31.1	27.3	25.5	23.0
Public	19.0	21.6	26.0	27.2	28.3	27.2	28.2	29.7	29.7
External debt / GDP	26.8	24.8	19.5	17.7	16.3	13.5	11.1	10.8	9.1
External debt / XGS	73.9	68.8	55.6	73.0	70.9	65.6	57.2	52.1	45.9
Short-term debt	1.7	2.2	2.8	2.6	3.1	3.1	3.1	3.1	3.1
Short-term debt/International reserves (%)	6.6	7.0	8.3	7.5	8.7	17.4	20.9	17.4	15.0
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	0.0	-0.3	0.5	1.0	1.5	1.6	2.2	3.3	4.1
CPI, % yoy	6.4	4.7	7.1	13.0	16.2	17.7	16.2	12.3	10.8
Policy interest rate, %, eop	9.25	9.25	9.50	10.00	12.00	12.00	12.00	12.00	12.00
Short-term market rate, % eop	10.00	5.16	7.53	13.44	16.64	18.10	16.63	12.80	11.25
Long-term yield, %, eop	10.00	10.00	10.25	12.00	13.50	13.50	13.50	13.50	13.00
EGP/US\$, eop	6.09	6.36	7.00	7.40	7.50	7.50	7.70	7.80	7.90

Source: National Sources, Citi Research

## GCC

### Saudi Arabia

Farouk Soussa  
+971 (4) 509 9750  
[farouk.soussa@citi.com](mailto:farouk.soussa@citi.com)

**Saudi oil production continues to fall, standing at 9mbpd at end-February from a peak of 9.8mbpd last August (Bloomberg data).** Although a certain amount of decline is explained by lower domestic consumption in the summer months, we note that production at end-February 2013 was almost 9.7mbpd, suggesting broader Saudi concerns regarding supply and demand risks, and a desire to avoid sharp declines in the price, are behind the production cuts as well. Average oil production in 2012 was almost 6% up on 2011, and, combined with sustained high oil prices, boosted total revenues to the government to over SAR 1.2tr, higher than our own projections. Expenditure, however, also exceeded projections, up 6.1% on 2011 outlays, resulting in an overall surplus of SAR 386bn (14.3% of GDP), only slightly above our projection of SAR 342bn (12.6% of GDP). For 2013, we are projecting a decline in both oil production and prices, resulting in a decrease of over 13% in government revenues, although at SAR 1.1tr our figure is still a third higher than the government's own very conservative revenue projections. With expenditures expected to rise by around 5% this year, we see the overall surplus shrinking to around 6.6% of 2013 GDP, a trend that should continue in the future as oil production and prices soften going forward, while expenditure will probably rise steadily. We have calculated the 2013 fiscal breakeven oil price (assuming average oil production of 9.5mbpd) to be US\$80 per barrel. In terms of economic activity, our projected reduction in production this year would result in a shrinking of the oil economy of almost 3%, which should be compensated by a surge in non-oil growth (helped by government expenditure and housing) of 8.5%, leading to overall growth of just over 6% for 2013.

## Kuwait

**After controversial elections boycotted by the opposition, a new government and national assembly have taken their place in Kuwait.** The opposition boycott, which was due to discontent over an Emiri decree amending the electoral law under which elections were held, has resulted in a parliamentary mix that appears to be much more government-friendly than many of the parliaments that have preceded it since 2006. The opposition has continued efforts to discredit the new national assembly, claiming the low voter turnout (just under 40%) means it lacks legitimacy, and 9 legal motions against the assembly are currently being reviewed by the country's constitutional court. We do not, however, expect that these efforts will result in the dissolution of parliament in the near term.

**As a result, expectations are high that the new national assembly will co-operate with the government more effectively than previous opposition-dominated assemblies have, and that progress on implementation of the country's stalled US\$104bn development plan will finally materialize.** Early indications have been positive. The re-appointment of Mohamed Al Shammali as finance minister, months after he was forced out of the job by opposition, shows the growing confidence of the government and the desire to press on with the development plan, in our view. Contracts with foreign companies were signed for much-delayed projects such as the US\$2.5bn Az Zour power plant (awarded to a consortium led by GDF Suez) and the US\$2.6bn Subiya Causeway (awarded to Hyundai Engineering and Construction).

**That said, there have since been signs that tensions may be resurfacing between the newly elected parliament and the government.** Most notably, the two contracts mentioned above have been referred to a special parliamentary panel that has until May to investigate alleged irregularities in their award. This is despite warnings from the government that failure to move forward with the power project may result in electricity shortages by next summer. Moreover, parliament has continued to resort to its prerogative to question ministers openly in parliament, a process that has been termed 'grilling' locally due to the often forthright and aggressive nature of the MPs' interrogation. The ministers of Interior, Oil and Finance are all facing such motions at present.

**Parliament has also embarked on a populist campaign to grant debt relief to Kuwaiti nationals.** According to reports (Middle East Online, March 12), the government has agreed with parliament to buy all bank loans taken out by Kuwaitis between 2002 and 2008. The government will then forgive the interest portion (we estimate this at around US\$6bn) and reschedule repayment of the principle. It is also proposed that a cash payment of around US\$3,500 be made to all citizens who do have any debt. Details of the terms under which the government would purchase the loans are not known, nor are the total size and cost of the transaction. We believe that if the government were to go through with the plans, this would be a major stimulus to domestic consumption and would also fuel credit growth through the injection of cash into the banking system. While generally positive from a growth perspective, this does also carry risks to the inflation outlook as well as potentially raising moral hazard concerns for private borrowers and lenders alike.

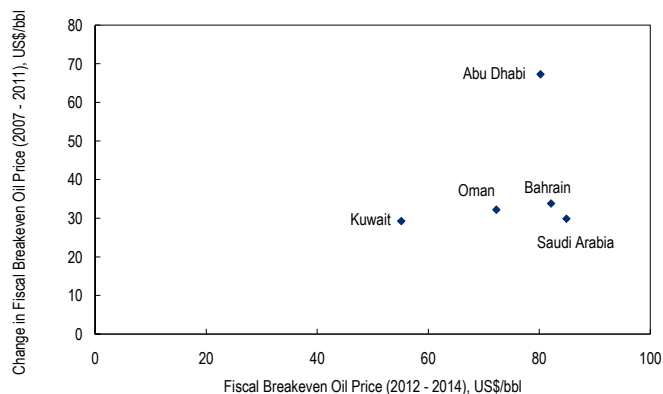
## United Arab Emirates

Draft legislation allowing up to 100% foreign ownership in companies outside free zones has been rejected by the UAE's Federal National Council (FNC), the country's consultative council. The clause of an amended companies law that would allow foreign ownership will now be included in a new foreign investment law, subject to amendments. In Dubai, Dubai Group, the private equity arm of Dubai Holdings, has struck a deal with four banks that had last year threatened litigation due to frustration in the company's ongoing US\$6bn debt restructuring. According to reports (FT, March 3), the banks will take a haircut of over 80% in order to receive funds up front rather than be rolled into a lengthy restructuring. The Investment corporation of Dubai (ICD) has also entered into talks to refinance US\$2bn in loans coming due this summer (Reuters, Feb 11).

## Bahrain, Qatar and Oman

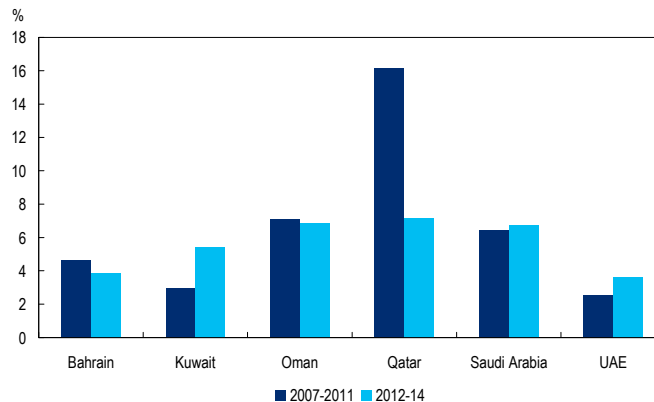
**Oman's growth in 2012 exceeded expectations, at 8.3%, according to the country's finance minister.** According to our calculations, this is partly due to a higher than expected rise in oil production but mainly due to a surge in non-oil GDP of close to 10%. The political scene in Bahrain remains unstable as a national dialogue between opposition and government limps forward amid renewed violence. Qatar's CPI is beginning to creep up as the property market recovers. Until recently, rental declines have acted as a dampener on inflation in recent years, but annual rental inflation was positive for the third consecutive month in December 2012, rising to almost 3%. Overall inflation was only slightly up, to 2.6%, thanks to a sharp decline in food prices.

Figure 129. Fiscal breakeven oil prices on the rise



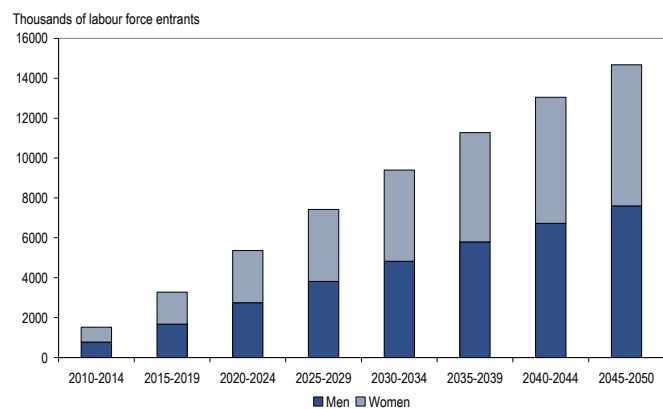
Source: Citi Research estimates

Figure 130. Economic growth will be uneven going forward



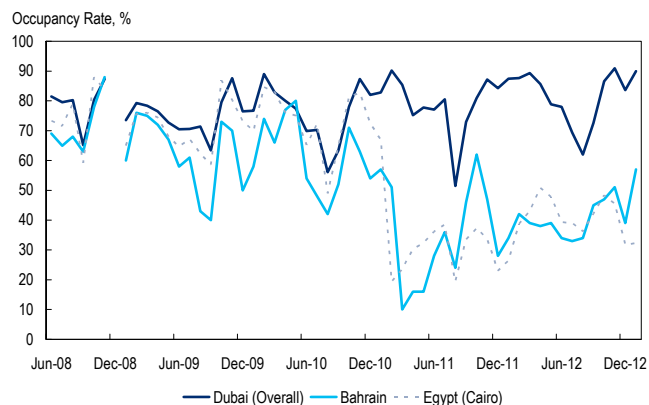
Source: Haver Analytics, Citi Research

Figure 131. 3 million entrants in Saudi job market by end of decade



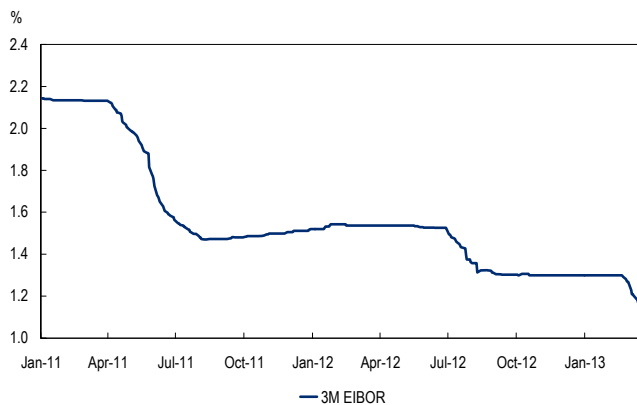
Source: Saudi Central Statistics Office, Citi Research

Figure 132. Dubai hotel occupancy continues to outperform its peers



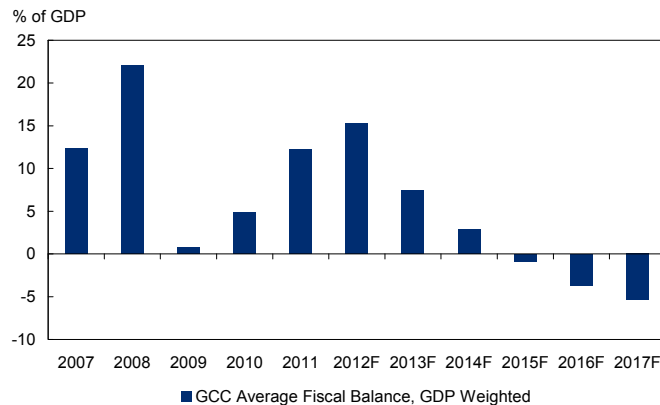
Source: Ernst & Young, Citi Research

Figure 133. EIBOR rates have begun to decline again



Source: Haver Analytics

Figure 134. High government expenditure will drive balances lower



Source: Haver Analytics, Citi Research estimates

Figure 135. GCC Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>BAHRAIN</b>									
Nominal GDP, USD bn	18.5	21.7	25.6	22.9	25.6	28.9	28.6	33.2	35.5
GDP per capita, USD	22,756	23,485	24,381	19,553	20,320	21,837	20,786	23,219	23,816
Real GDP, yoy avg	-	8.3	6.2	2.5	4.3	1.9	3.5	3.6	4.4
CPI, % avg	2.0	3.3	3.5	2.8	1.9	-0.4	2.8	4.0	2.5
BHD/US\$, avg	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
Current account	2.0	2.8	2.1	0.4	0.6	3.0	3.3	3.2	1.9
% of GDP	11.1	12.7	8.1	1.7	2.3	10.3	11.5	9.7	5.4
Consolidated government balance	4.0	2.7	6.4	-4.3	-4.8	-0.3	1.6	3.7	3.4
<b>KUWAIT</b>									
Nominal GDP, USD bn	101.6	114.6	147.3	105.8	119.8	156.2	190.0	166.5	164.9
GDP per capita, USD	43,195	46,811	57,815	39,985	43,771	55,429	65,465	55,692	53,567
Real GDP, yoy avg	8.1	6.5	4.2	-7.8	7.9	4.1	8.4	3.9	4.0
CPI, % avg	3.1	5.5	10.6	4.0	4.0	4.7	2.9	5.0	5.0
KWD/US\$, avg	0.29	0.28	0.27	0.29	0.29	0.28	0.28	0.29	0.29
Current account	45.5	43.0	58.5	28.3	39.0	70.1	96.2	81.2	75.3
% of GDP	44.8	37.5	39.7	26.8	32.6	44.9	50.6	48.7	45.6
Consolidated government balance	18.1	22.2	14.4	13.9	11.4	22.9	33.5	25.1	20.1
<b>OMAN</b>									
Nominal GDP, USD bn	36.8	41.9	59.9	53.4	53.4	53.4	76.2	77.3	81.8
GDP per capita, USD	14,756	15,259	20,887	18,015	17,438	16,881	22,896	22,000	22,176
Real GDP, yoy avg	3.7	10.4	14.6	9.5	-0.5	1.5	7.1	6.7	6.7
CPI, % avg	3.0	5.9	12.5	3.6	3.2	4.0	2.9	3.0	3.0
OMR/US\$, avg	0.38	0.38	0.38	0.38	0.38	0.39	0.39	0.39	0.39
Current account	5.7	2.5	5.0	-0.6	5.9	10.3	2.2	7.3	4.9
% of GDP	15.4	5.9	8.4	-1.1	11.0	19.2	2.9	9.4	6.0
Consolidated government balance	-0.4	3.4	0.3	0.2	3.5	6.5	11.0	12.3	8.8
<b>QATAR</b>									
Nominal GDP, USD bn	60.5	80.8	110.7	98.3	98.3	173.3	200.8	222.4	253.0
GDP per capita, USD	72,192	86,829	100,831	80,717	72,717	115,469	123,890	127,055	133,795
Real GDP, yoy avg	26.2	18.0	17.7	12.0	15.2	18.1	6.0	8.3	7.2
CPI, % avg	11.8	13.6	15.2	-4.9	-2.4	1.9	1.9	3.0	3.0
QAR/US\$, avg	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64
Current account	9.5	11.5	26.6	6.4	23.8	52.0	56.6	39.3	23.4
% of GDP	15.6	14.2	24.0	6.5	24.2	30.0	28.2	17.7	9.3
Consolidated government balance	8.5	10.9	10.0	15.2	2.9	8.6	5.4	2.4	0.5
<b>SAUDI ARABIA</b>									
Nominal GDP, USD bn	381.4	416.2	512.6	436.6	526.8	669.5	727.2	725.1	776.3
GDP per capita, USD	16,093	17,137	20,587	17,110	20,178	25,645	27,309	26,698	28,020
Real GDP, yoy avg	3.4	3.1	3.7	13.1	3.7	8.5	6.8	6.2	7.3
CPI, % avg	2.3	4.1	9.9	5.0	5.4	4.9	4.0	6.0	8.0
SAR/US\$, avg	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Current account	99.6	94.3	133.0	21.5	67.4	159.3	176.2	113.5	87.2
% of GDP	26.1	22.7	25.9	4.9	12.8	23.8	24.2	15.7	11.2
Consolidated government balance	19.6	11.3	30.2	-5.3	4.4	11.6	14.2	4.6	-0.7
<b>UNITED ARAB EMIRATES</b>									
Nominal GDP, USD bn	222.0	257.9	314.4	259.7	283.9	307.1	325.9	354.1	385.7
GDP per capita, USD	52,488	57,474	65,987	52,919	56,166	58,974	60,013	62,272	64,854
Real GDP, yoy avg	9.8	3.2	3.2	-4.8	1.3	4.2	2.1	4.6	4.9
CPI, % avg	-	-	-	1.6	0.9	0.9	1.0	1.3	1.5
AED/US\$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account	33.9	15.5	66.8	8.2	24.3	48.7	12.0	20.7	31.1
% of GDP	15.3	6.0	21.3	3.2	8.6	15.9	3.7	5.9	8.1

Source: Citi Research

Source: National Sources, Citi Research

## Hungary

Eszter Gargyan  
+36 (1) 374 5559  
[eszter.gargyan@citi.com](mailto:eszter.gargyan@citi.com)

- **Summary view** — Given disappointing growth, easing inflation and sustained supportive external risk environment monetary conditions will likely ease further with potential new tools under the new NBH governance.
- **Things to watch** — NBH communication and new monetary policy tools in order to revive LC lending, policy steps to reduce private sector FX debt exposure and potential new fiscal measures to keep the deficit under 3% of GDP will be key to watch.
- **Strategy** — Uncertainty related to monetary policy changes and further gradual rate cuts may keep the currency under pressure. The end of the rate cutting cycle may depend on the timing and impacts of new monetary policy tools.

### Policy efforts to revive growth constrained by debt

**We have lowered our GDP forecast to -0.1% for 2013 and 1.2% for 2014** from 0.2% and 1.3%, respectively, on the basis of disappointing January industrial output and retail sales data. The breakdown of 4Q12 GDP confirmed that household consumption remained in a contracting trend despite the improvement in consumer confidence. A positive growth in net real wages, the government's utility price cuts and slowing bank deleveraging may provide some support to consumption this year, but weak labour market and contracting retail sales suggests consumption is unlikely to turn into positive growth. There are no signs of a positive turn in fixed investments as the unstable business environment, extraordinary corporate taxes and nationalization in the utility sector may continue to hold back capacity expansion. We expect that the new NBH governance will focus on corporate lending stimulus by lowering funding costs significantly, but we are skeptical about the potential take up of even much cheaper credit in the absence of improved growth prospects. While PMIs and core Euro Zone business indicators confirm growth shoots in external demand, the fragility of European growth outlook poses the key risk Hungary's recovery from 1.7%YoY recession in 2012. Policy measures in the run up to the spring 2014 general elections and potential corrective measures keep uncertainties to the outlook elevated.

**A positive turn in growth and job creation will be the key challenge for policy decisions in the run up to the elections in spring 2014.** Government sponsored public work programs will likely help to reduce official unemployment this year. The adverse fiscal measures burdening corporates, unstable external growth outlook and Hungary's weak (17% of GDP) investment ratio however suggest that long term growth prospects remain poor which may constrain a recovery in private sector employment close to pre-crises levels. Given the high (60%) import share of export and the country's outstanding high FX denominated debt (56% of GDP owed by the private sector and 30% of GDP owed by the public sector), currency weakening may only have short term positive impact to exporters profitability but have a negative net impact on the economy as a whole and would lift debt ratios further. Therefore we believe policy decisions do not target a permanently weaker currency to boost growth. The recently hinted government plans to reduce household and SMEs FX debt likely aim to reduce the economy's vulnerability to FX volatility, to mute the negative impacts of deleveraging by reducing private sector debt burden potentially through haircuts or restructuring.

## Chances for exiting the EDP in June have weakened

**The government's confidence about no need to adjust the 2013 budget and recently increased political tension with EU about constitutional amendments weaken the chances that the June ECOFIN meeting may lift the EDP on Hungary.** The EC's budget deficit forecasts from February projected the fiscal deficit to widen from 2.5% in 2012 to 3.4% of GDP for both 2013 and 2014. Newly appointed EconMin Varga however insisted that a budget correction would be premature before the first 4-5 months of the year. This in our view suggests that the government's Convergence Report that is due by mid-April is unlikely to present any significant fiscal corrections. The EC's spring forecast early May will be the basis for the June ECOFIN decision. Given the political nature of the ECOFIN decision the recent concerns raised by EU officials about amendments to the Hungarian constitution may weaken Hungary's chances to exit the EDP if the projected deficit will be close to 3% of GDP. In our view the most likely scenario is that Hungary remains in the EDP in June but without any financial sanctions, given that the projected fiscal gap versus the 3% limit is likely to be small. The next opportunity to exit the EDP may be in December when the 2014 budget should be almost finalized.

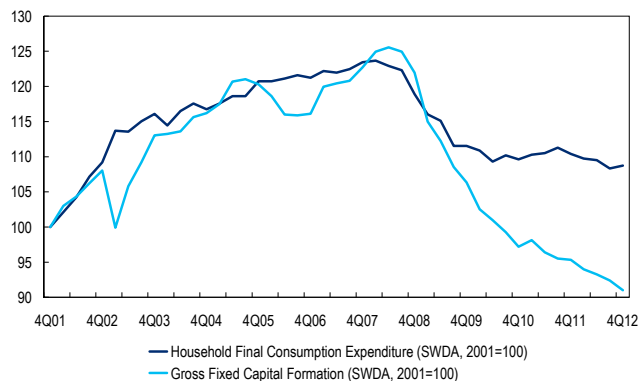
**We believe pre-election fiscal spending risks are lower** as Hungary likely remains under the ties of the EDP this year and newly appointed EconMin Mihály Varga, who represents the technocrat side of the government, may be more conservative on fiscal issues. Based on the political focus on public debt reduction and control over public deficit we do not expect any significant blow up in the budget with the upcoming elections even if the EDP will be closed. We believe populist measures will likely be implemented at the cost of the corporate sector – like regulated retail utility price cuts – and through off-balance sheet items that may not have a short term negative budget impact.

## Softer inflation helps rate cuts, new measures key risk

**Short term inflation outlook declined further** as February CPI once again came out below expectations and fell to 2.8%YoY. Headline CPI may remain below the 3% target for most of the year, likely bottoming out close to 2% in 3Q13. Regulated utility price cuts, base effects and softening food prices are the key drivers of inflation collapse, but the first two months of the year also indicated moderation in core price trends. Additional household gas and utility price cuts may pull headline inflation even lower, as further 20% cut in gas and electricity prices hinted by government officials is not yet reflected in the current forecasts. We expect inflation to return to the 3.5-4.0%YoY range over the medium term as elevated inflation expectations, weaker currency and the indirect impacts of corporate tax hikes may pass through into higher consumer prices and the impact of one-off price cuts fade out of the annual index.

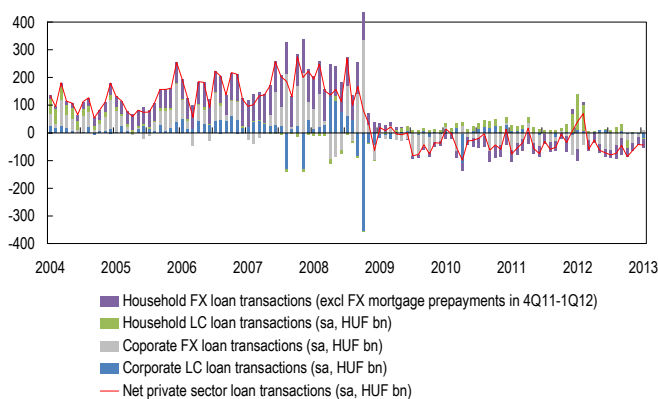
**We have lowered our short term base rate forecast from 5.00% to 4.50% previously in line with the reduction in our inflation projection** (to 2.8%YoY in 2013). Gradual rate cuts however are unlikely to be the only tool utilized by the new NBH Governance to support growth. We believe, the scope for rate cuts may be limited if new monetary policy measures add to HUF liquidity, reduce the effective interest rates or deliver a sharp drop in the CB's FX reserves and thereby add to Hungary's risk premiums. Given that the policy direction is biased towards further aggressive easing we do not see scope for a sharp rebound in the currency as long as the MPC does not clarify its plans about potential new measures.

Figure 136. No signs of domestic demand recovery...



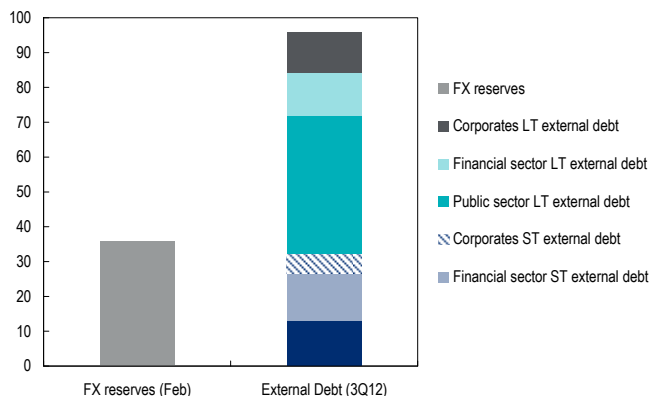
Source: Haver, Citi Research

Figure 138. NBH looking for new tools to revive LC lending...



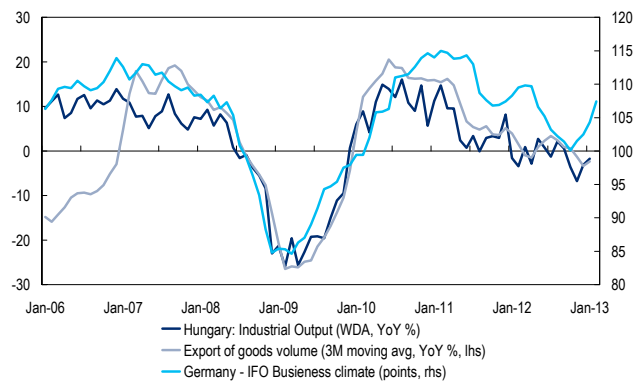
Source: National Bank of Hungary, Citi Research

Figure 140. External debt limits room for CB FX reserve utilization



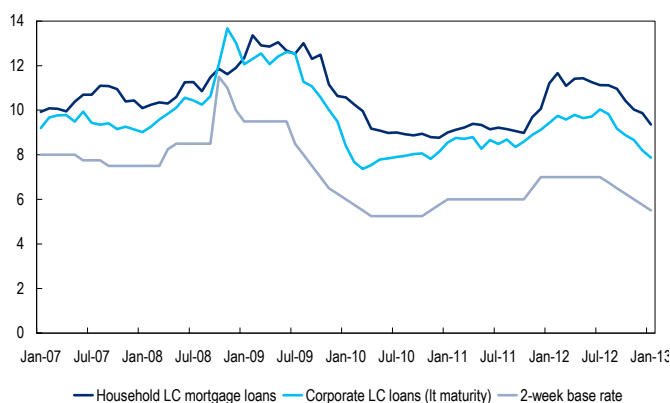
Source: National Bank of Hungary, Citi Research

Figure 137. ...and outlook for industrial exports rebound remains fragile



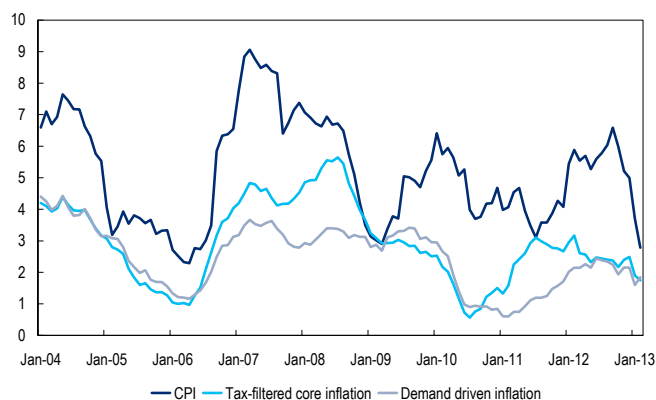
Source: Hungarian CSO, Haver, Citi Research

Figure 139. ...and further reduction in LC borrowing costs (%)



Source: National Bank of Hungary, Citi Research

Figure 141. Inflation continues to surprise to the downside (YoY, %)



Source: National Bank of Hungary, Citi Research

Figure 142. Hungary Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	124	145	141	136	128	116	128	125	135
Nominal GDP, local currency bn	23,725	25,052	26,609	25,697	26,667	27,938	28,341	29,086	30,375
GDP per capita, USD	12,277	14,416	14,095	13,623	12,773	11,626	12,884	12,609	13,623
Population, mn	10.1	10.0	10.0	10.0	10.0	10.0	9.9	9.9	9.9
Unemployment, % of labour force	7.5	7.4	7.8	10.0	11.2	11.0	10.9	10.0	10.2
<b>Economic Activity</b>									
Real GDP, yoy avg	3.9	0.1	0.9	-6.8	1.3	1.6	-1.7	-0.1	1.2
Real investment growth % yoy	-0.3	-1.5	3.7	-29.6	7.6	-0.4	-11.5	-7.0	-3.0
Real consumption growth % yoy	2.2	-1.4	-0.2	-4.5	-2.3	0.3	-1.7	-0.5	-0.1
private consumption growth % yoy	1.7	1.1	-0.7	-6.6	-3.0	0.5	-1.5	-0.5	-0.2
Real export growth, % yoy	19.1	15.0	5.7	-10.2	14.2	6.3	2.0	2.3	3.9
Real import growth, % yoy	15.1	12.8	5.5	-14.8	12.7	5.0	0.1	1.1	2.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	6.6	7.4	3.4	5.4	4.6	4.1	5.0	2.9	3.4
CPI, % avg	4.0	7.9	6.0	4.0	4.7	3.9	5.7	2.7	3.1
Nominal wages, % yoy	8.2	8.0	7.4	0.5	1.3	5.2	5.0	4.5	5.2
Credit extension to private sector, % yoy	16.7	18.8	21.7	-2.7	4.1	-0.5	-8.9	-1.0	0.3
Policy Interest Rate, % eop	8.00	7.50	10.00	6.25	5.75	7.00	5.75	4.50	4.50
1 month inter-bank rate, %, eop	8.08	7.50	10.00	6.25	5.75	7.08	5.75	4.50	4.50
Long-term yield, %, eop	6.71	7.08	8.28	7.99	7.97	9.75	6.11	6.50	6.05
HUF/US\$, eop	190	173	190	189	208	244	221	232	225
HUF/US\$, avg	210	183	171	201	208	201	225	234	227
HUF/EUR, eop	251	253	266	271	278	315	291	300	292
HUF/EUR, avg	264	251	252	280	275	279	289	304	295
<b>Balance of Payments, USD bn</b>									
Current account	-8.3	-9.9	-11.4	-0.3	1.4	1.3	2.4	3.7	4.7
% of GDP	-6.7	-6.8	-8.1	-0.2	1.1	1.1	1.8	3.0	3.5
Trade balance	-3.1	-0.9	-1.8	3.3	4.3	4.7	5.4	6.3	6.8
Exports	73.3	93.0	106.1	80.0	91.5	104.7	97.7	101.5	105.1
Imports	76.4	93.9	107.9	76.7	87.2	100.1	92.3	95.2	98.3
Service balance	1.8	1.8	2.2	2.8	3.9	4.5	4.5	4.9	5.3
Income balance	-6.7	-10.1	-11.0	-6.9	-7.2	-8.6	-7.9	-7.8	-7.7
FDI, net	2.9	0.3	3.9	0.2	1.0	0.2	2.2	1.9	2.2
International reserves	20.9	23.2	33.2	41.1	43.1	45.4	43.5	47.4	54.3
Total amortisations	7.7	9.3	15.2	16.1	15.4	14.0	14.3	13.9	14.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-9.4	-5.1	-3.7	-4.6	-4.2	4.3	-2.7	-2.9	-3.6
Consolidated gov primary balance	-5.5	-1.0	0.4	0.0	0.0	8.5	1.7	1.4	0.6
Public debt	65.7	67.0	72.3	78.4	80.2	81.4	79.1	78.7	79.0
of which Domestic	35.9	36.1	37.5	37.0	40.9	40.6	43.2	44.9	46.7
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	126.8	155.6	161.4	182.7	174.4	158.4	162.2	157.4	158.7
Public	41.6	51.7	56.2	68.4	70.4	70.9	69.1	67.6	68.7
External debt / GDP	102.7	107.5	114.3	134.1	136.8	136.7	126.8	125.6	117.4
External debt / XGS	145.8	141.2	127.7	185.4	157.2	125.3	137.3	128.3	125.0
Short-term debt	21.9	32.0	26.8	27.3	31.3	28.5	30.4	28.4	28.6
Short-term debt/International reserves (%)	105.0	138.1	80.7	66.4	72.5	62.7	69.7	59.8	52.6
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	-1.5	-2.7	-1.3	-0.2	0.3	0.6	1.0	1.1	1.2
CPI, % yoy	6.6	5.0	2.6	2.7	2.2	2.9	3.0	3.1	3.2
Policy interest rate, %, eop	6.50	5.75	5.00	4.50	4.50	4.50	4.50	4.50	4.50
Short-term market rate, % eop	6.55	5.75	5.00	4.50	4.50	4.50	4.50	4.50	4.50
Long-term yield, %, eop	7.24	6.11	6.50	6.50	6.50	6.50	6.40	6.15	6.05
HUF/EUR, eop	285	291	307	307	303	300	298	296	294

Source: National Sources, Citi Research

## Israel

David Lubin  
+44 20 7986 3302  
[david.p.lubin@citi.com](mailto:david.p.lubin@citi.com)

- **Summary view** — We believe Israel will stay stuck in a relatively low-growth equilibrium for the next couple of years, caught between weak global demand growth and weak consumer confidence, but recent activity indicators have picked up.
- **Things to watch** — With this background, the Bank of Israel will do what it can to make sure the shekel stays competitive - as long as that can be done without jeopardizing the 1-3% inflation target – and we think their strategy will rely more on macro-prudential measures and fx intervention than on rate cuts.
- **Strategy** — The recovery in the data and the prolonged absence of a 2013 budget seems to us sufficient reason for the Bank of Israel to stay on hold this year. Rates should stay low for a long time, but probably not below the current 1.75%

### Signs of some recovery in Q1

**The Bank of Israel has clearly been unhappy with the state of the economy, but things are picking up.** Macro data in the past few weeks has turned positive. The 'S' index of economic activity rose in early 2013 for the first time in 19 months, and there is some good news coming out of the surveys: the PMI has recovered strongly from its lows, business expectations have risen, and the February consumer confidence index has staged a small recovery. In addition, the Bank of Israel thinks that GDP growth in Q4 would have been closer to 3% than 2.5% were it not for the crisis in Gaza at the end of last year. At the same time, unemployment is very low indeed, and according to one view, the economy is quite close to its potential growth rate. All in all, there are good reasons for the Bank of Israel to turn progressively less 'dovish' than it was during 2012. Taken together with the Bank's usual concern about housing market strength, we think the risk of another rate cut is much smaller than we'd anticipated, and now do not think that the Bank's rate will be cut this year. The market is still pricing in most of one cut in the policy rate to 1.5%.

### On the verge of gas production

**Exports are also showing signs of life.** Like virtually every other country, Israel suffered a shock to export growth in 2012, in spite of the fact that the shekel gained competitiveness over many other emerging economies. One of Israel's problems in this regard is that the destination of much of its exports remains the US and EU, with relatively little trade exposure to Asia (although this has been growing). The most recent news is more encouraging: export growth in February shifted up dramatically. And in April, it is expected that Tamar, the smaller of two large gas fields which are being developed off Israel's northern coast, will begin production. Gas from Tamar is likely to substitute some US\$2.5 bn of energy imports in 2013, with the result that Israel's current account deficit, which was a drain on investor enthusiasm towards the shekel last year, will disappear, and there are good chances that Israel will sustain a long run of current account surpluses in the foreseeable future. The Bank of Israel assesses that, including gas, Israeli GDP growth will be 3.8% this year; and 2.8% excluding this import-substitution effect. An update to the Bank's forecast is due imminently, though, and we think the risks are that their growth forecast edges up a bit.

## Gas production gives the Bank a dilemma...

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

## ...but rate cuts are probably not the answer

**The Bank of Israel will be uncomfortable with a stronger shekel.** For these reasons, we believe the BOI will be uncomfortable with a stronger shekel, particularly if it results from an inflow of speculative foreign capital. The question is: what is the best set of tools the Bank can use to limit shekel appreciation? With its policy rate at 1.75%, we think it is unlikely that lower interest rates will play much of an effective role in weakening investors' appetite for the ILS. And with the signs of economic recovery referred to above, the case for a rate cut is very weak, we think. And there are two further arguments against a rate cut, which means that the BOI's effort to weaken the shekel will rely more on fx intervention and macro-prudential measures. The first is the recent rise in inflation expectations: the past 4 months has seen a rise in 12-month CPI expectations from 2.2% to 2.7%, approaching the ceiling of the 1-3% inflation target range. Although inflation expectations for longer horizons haven't moved up recently, they remain in the upper part of the inflation target range. A second argument against further easing comes from fiscal policy, a critical area of focus for the PM Netanyahu's new government.

## Fiscal policy is an urgent challenge for the government

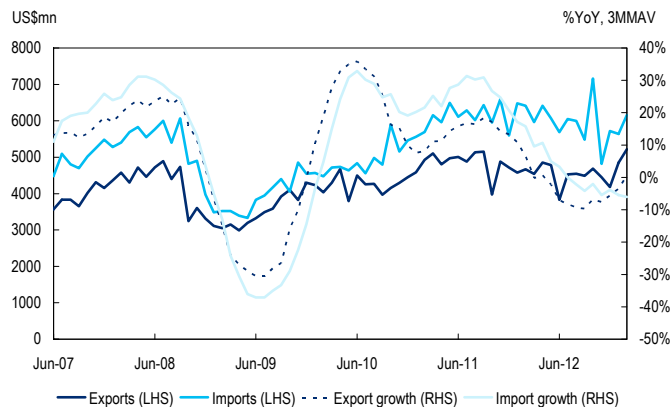
**Israel's new government will have an important challenge in sorting out public finances.** Last year's budget deficit of 4.2%, compared to the original 2% target, thanks mostly to a NIS 14 bn revenue shortfall that resulted from weaker-than-expected wage growth and a fall in housing supply, both of which had a bad effect on the tax base. The Bank of Israel has been vocal in its attempt to make the government aware of Israel's poor fiscal dynamics. According to the Bank's analysis, the cost of programmes approved by the government would produce an increase in total spending in 2013 of NIS 28 bn, much higher than the NIS 15 bn that would be allowed by Israel's fiscal rule. This increase would produce a deficit of 4.9% GDP, much higher than the 3% ceiling required by Israeli law. In other words, the new government will face a serious fiscal challenge.

Figure 143. An up tick in activity...



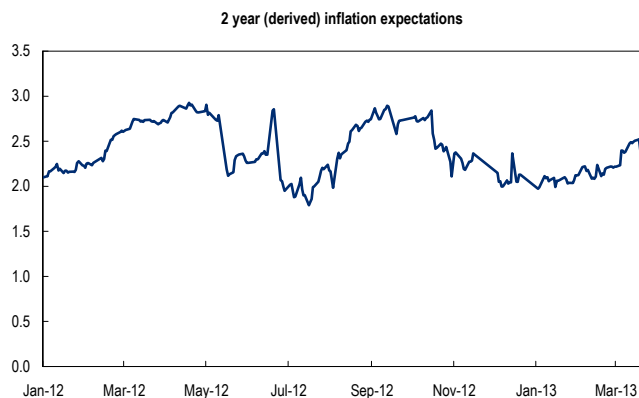
Source: Haver Analytics, Citi Research

Figure 144. ...coincides with a small pick up in the current account



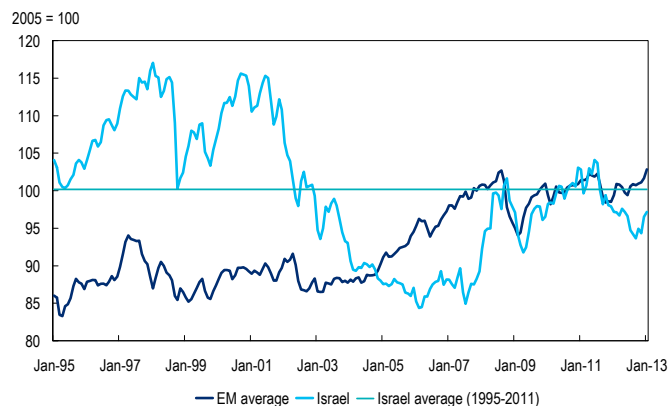
Source: Haver Analytics, Citi Research

Figure 145. Inflation expectations have pick up in recent months...



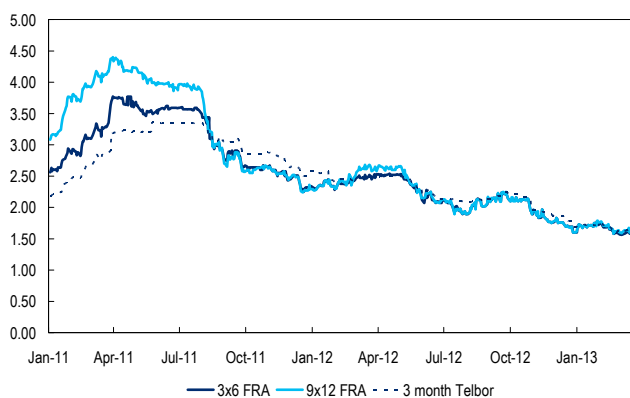
Source: Haver Analytics, Citi Research

Figure 146. ...so rate cuts won't do as a means to weaken the ILS



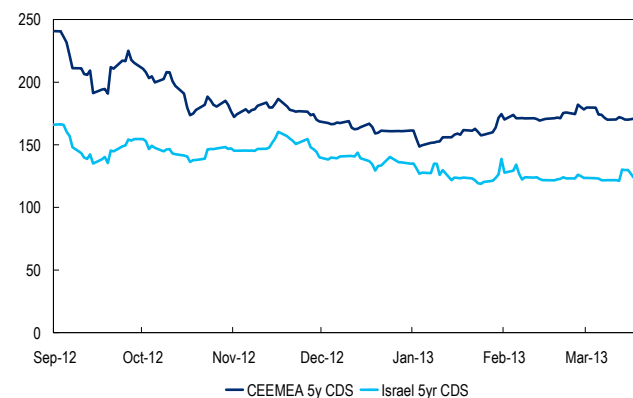
Source: Bloomberg

Figure 147. ...and so the market is probably wrong to price in a cut



Source: Bloomberg, Citi Research

Figure 148. Gas production and diminished political risk help CDS



Source: Bloomberg, Citi Research

Figure 149. Israel Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	145	166	202	195	218	244	242	268	262
Nominal GDP, local currency bn	648	685	722	766	814	872	932	988	1,044
GDP per capita, USD	21,484	24,038	28,416	26,824	28,317	28,006	30,607	33,051	31,900
Population, mn	6.8	6.9	7.1	7.3	7.7	8.7	7.9	8.1	8.2
Unemployment, % of labour force	10.5	9.2	7.7	9.4	8.3	7.1	6.9	6.5	6.5
<b>Economic Activity</b>									
Real GDP, yoy avg	5.6	5.5	4.6	0.7	5.2	4.7	2.9	3.2	3.0
Real investment growth % yoy	11.7	12.5	4.4	-3.4	11.3	17.5	3.2	-1.0	4.3
Real consumption growth % yoy	4.4	6.8	1.7	2.0	4.4	1.8	0.9	1.2	2.9
private consumption growth % yoy	5.1	8.3	1.6	2.1	4.9	1.4	0.0	1.7	2.8
Real export growth, % yoy	5.2	9.8	6.8	-12.2	14.9	5.1	0.5	3.4	3.4
Real import growth, % yoy	2.7	11.7	2.5	-13.9	12.3	11.5	3.5	-6.3	1.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	-0.1	3.4	3.8	4.0	2.7	2.2	1.6	2.7	2.8
CPI, % avg	2.1	0.5	4.6	3.3	2.7	3.5	1.7	2.0	2.8
Nominal wages, % yoy	-	-	-	-	-	-	5.5	7.2	7.3
Credit extension to private sector, % yoy	6.3	7.6	12.2	5.0	6.0	6.3	6.1	6.9	6.5
Policy Interest Rate, % eop	4.50	4.25	2.50	1.00	2.00	2.75	2.00	1.75	2.50
1 month inter-bank rate, %, eop	5.03	4.50	1.90	1.31	2.06	2.74	1.75	2.00	2.75
Long-term yield, %, eop	5.61	6.17	4.72	5.11	4.75	4.24	3.62	4.20	4.50
ILS/US\$, eop	4.22	3.86	3.78	3.79	3.52	3.81	3.73	3.77	4.13
ILS/US\$, avg	4.46	4.11	3.58	3.93	3.73	3.58	3.85	3.69	3.99
<b>Balance of Payments, USD bn</b>									
Current account	7.0	4.6	2.2	7.3	8.2	1.9	-0.9	0.5	4.9
% of GDP	4.8	2.7	1.1	3.8	3.8	0.8	-0.4	0.2	1.9
Trade balance	-3.2	-5.2	-6.3	0.8	-1.7	-7.8	-10.4	-8.0	-5.0
Exports	43.9	50.8	58.1	46.8	56.4	64.2	61.1	66.0	71.0
Imports	47.2	56.0	64.4	46.0	58.1	72.0	71.5	74.0	76.0
Service balance	3.6	2.7	4.1	4.3	6.6	6.6	8.9	8.0	8.0
Income balance	-0.8	-0.3	-4.1	-5.2	-5.1	-5.6	-7.5	-7.0	-6.1
FDI, net	-0.2	0.2	3.7	2.7	-3.6	-3.6	4.0	2.5	4.0
International reserves	29.1	28.6	42.5	60.6	70.9	74.9	76.0	75.0	75.0
Total amortisations	5.3	5.6	4.7	4.5	5.0	5.0	4.0	3.8	4.2
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.4	0.5	-1.2	-4.4	-3.0	-2.6	-3.7	-4.3	-2.5
Consolidated gov primary balance	6.0	6.5	4.3	1.0	2.4	2.7	1.5	0.9	3.0
Public debt	83.2	76.5	75.6	77.9	79.2	78.2	77.2	76.5	74.3
of which Domestic	62.4	59.4	60.6	63.5	61.4	60.8	60.1	58.7	56.5
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	87.5	90.8	88.4	93.3	106.5	103.9	97.0	102.0	104.0
Public	33.4	32.0	28.2	31.2	40.3	36.5	37.0	38.0	40.0
External debt / GDP	60.3	54.6	43.8	47.9	48.9	42.6	40.1	38.1	39.8
External debt / XGS	140.5	127.9	107.7	136.5	131.3	114.2	108.9	106.3	99.0
Short-term debt	37.0	39.9	40.3	42.2	54.4	49.6	44.0	45.0	45.0
Short-term debt/International reserves (%)	127.3	139.6	94.7	69.7	76.7	66.2	57.9	60.0	60.0
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	2.8	2.6	2.9	3.1	3.5	3.8	3.2	3.0	3.0
CPI, % yoy	2.1	1.6	1.3	2.3	2.2	2.7	2.8	2.8	2.7
Policy interest rate, %, eop	2.25	2.00	1.75	1.75	1.75	1.75	2.00	2.50	2.50
Short-term market rate, % eop	2.25	1.75	1.75	1.75	1.75	1.75	2.00	2.50	2.50
Long-term yield, %, eop	2.83	3.00	3.00	3.20	3.20	3.50	4.75	4.75	4.75
ILS/US\$, eop	3.92	3.73	3.64	3.65	3.70	3.77	3.85	3.94	4.04

Source: National Source, Citi Research

## Kazakhstan

Natalia Novikova  
+7 495 643 1507  
[natalia1.novikova@citi.com](mailto:natalia1.novikova@citi.com)

David Lubin  
+44 (20) 7986-3302  
[david.p.lubin@citi.com](mailto:david.p.lubin@citi.com)

- **Summary view** — Mixed signals from the real sector support our GDP growth forecast of 5-5.5% this year. Meanwhile the government is looking at budget sources to support growth. We see inflation fluctuating at 6-7%YoY in 2013.
- **Things to watch** — The budget envisages ‘conditional’ spending and more flexible project management. In 2013 the NBK plans to gradually strengthen interest rate policy. While growth of lending and housing prices continues, banks remain loaded with NPLs.
- **Strategy** — NBK likely refrain from rate moves with inflation in the middle of target range. We see tenge broadly stable at about 150 KZT/USD in the short run, but it will likely follow RUB weakening trend in 2H in our view.

### Growth below potential

**Mixed signals from the real sector support our GDP growth forecast of 5-5.5% this year.** Industrial production improved on the margin in early 2013. IP growth accelerated to 0.9%YoY in Jan-Feb from 0.6%YoY in 2012 on the back of slight improvement in manufacturing. Mining and quarrying sector continued to show 1-1.5%, except for gas production (up 13%YoY supported by the base effect). Retail sales remain strong at 14%YoY in February but likely to decelerate as inflation eats up hikes in nominal wages. Real wages were down 0.1% last month for the first time since 2008. The short-term economic indicator (2/3 of GDP) accelerated to 3.3% in Feb, but its growth remains well below the levels of 2012.

### More flexible budget spending

**Meanwhile the government is looking at budget sources to support growth, and money from the oil fund should go to finance infrastructure.** The government reiterated target growth rate of 6% this year and keeps 7% growth target in the medium term. The budget is based on a GDP growth assumption of 6%, 6-8% inflation and US\$90/bbl oil price. The central budget deficit is expected at KZT785bn. We forecast an overall budget balance of 2.4% and 3% of GDP in 2013 and 2014 respectively. The guaranteed annual transfer from the oil fund will decline from KZT1.38 in 2013 to 1.188tn in 2014. Following the requests by banks to place the National Oil Fund (NOF) deposits with Kazakh banks, the government drafted the law that allows investing some of the NOF’s assets into infrastructure. The infrastructure projects will get interest bearing financing. Last year Marchenko mentioned that large industrial projects will get about US\$3.5bn from NFRK in 2013-2015 (Interfax, Mar 2013). KazMunaiGas is also expected to get US\$4bn loan from the national fund in two tranches in 2013 and 2015.

**The budget envisages ‘conditional’ spending and more flexible project management.** The new form of fiscal rule implies that, at most, 3% of overall spending may be classified as ‘conditional’, or implemented if the certain conditions are met. We estimate each US\$10/bbl increase in the oil price brings some US\$2bn increase in fiscal oil revenue. General government spending is around US\$45bn, so this “conditional” rule is an insurance against a US\$6/bbl drop in the oil price. Moreover, the government plans to introduce project management practice and allow usage next year’s revenues.

## NBK is developing interest rate policy

**NBK likely refrain from rate moves with inflation in the middle of target range.**

**We see inflation fluctuating at 6-7%YoY in 2013.** Inflation accelerated to 7.0%YoY in February from 4-5% in the middle of the 2012. CPI came under pressure from food and regulated prices. The NBK expects that inflation may exceed 7%YoY in Q1 2013, but will decelerate to 6.6-6.8%YoY in Q2. Subdued economic growth hints CPI likely to remain within the 6-8% target range, in our view.

**In 2013 the NBK plans to gradually strengthen interest rate policy, though keeping a managed float for the tenge** as stated in the Monetary Policy Guidelines. It plans to introduce new facilities for liquidity withdrawal and promote a new policy rate, a base rate, while the refinancing rate will have a more indicative role.

## Banks are still fragile despite gradual recovery

**The share of NPLs remains elevated (over 30%), though it started to decline last year as banks brisked up lending.** Lending growth reached its peak of just below 14%YoY in October 2012 and moderated to 12.6% in January due to lower lending to companies (9%YoY in Jan). Demand for consumer loans remains strong (23%YoY) as suggested by the recent survey results published by the NBK.

**The government is starting to address the NPLs problem, but will probably bear the fruits only in a couple of years.** It was announced the Distressed Assets Fund would buy only KZT133bn of bad loans, or two times less than was previously expected. The DAF will focus on loans backed by assets other than real estate. 15 banks are expected to create SPVs for the bad debt. According to NBK Deputy Governor Tadzhiyakov, banks may transfer around KZT800bn into these subsidiaries. The SPVs will have limited life until 2018. Together with recapitalizing of the hardest-hit BTA bank this indicates the government is ready to help the banking system, however not at any cost and on a lower scale than might have previously been expected. The schemes suggested by the government should bring NPLs to some KZT3tn.

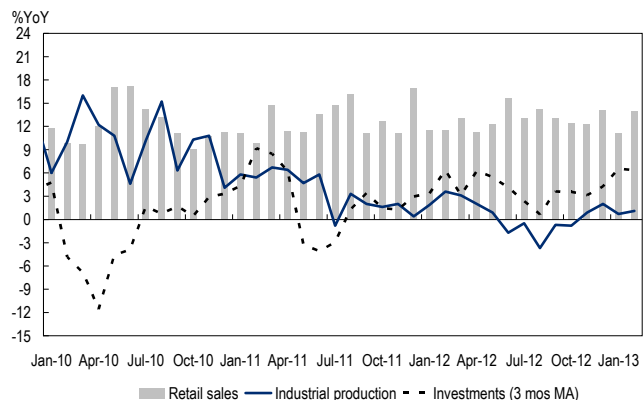
## Tenge broadly stable

**External borrowing and FDI should support the capital account next year.**

MinFin is intending to issue Eurobond next year that will serve as a benchmark for corporate borrowers. Given the overall low debt levels and relative stability of the economy, we expect both sovereign and corporate issues to be attractive for some EM investors. Furthermore, FDI inflows are likely to remain steady next year given the number of the already declared projects and a possible decrease in the income tax rate to 15% from 20% in 2014.

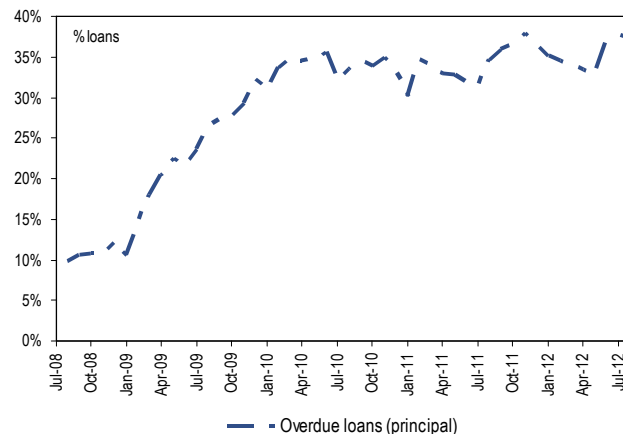
**We see tenge broadly stable in the short run.** The current level of about 150KZT/USD looks supportive to Kazakhstan's competitiveness versus the ruble. The NBK likely to adjust the tenge exchange rate in line with the overall trends in the Russian ruble, albeit ignoring the short-term fluctuations. We forecast the Russian ruble to be supported by corporate external borrowings and tight domestic liquidity in the short run, but weakening in 2H 2013. And KZT could also join the trend. Significant KZT devaluation should be triggered only if ruble slumps, which we think is likely if Urals oil remains at or above US\$80/bbl.

Figure 150. Mixed signals from the real sector



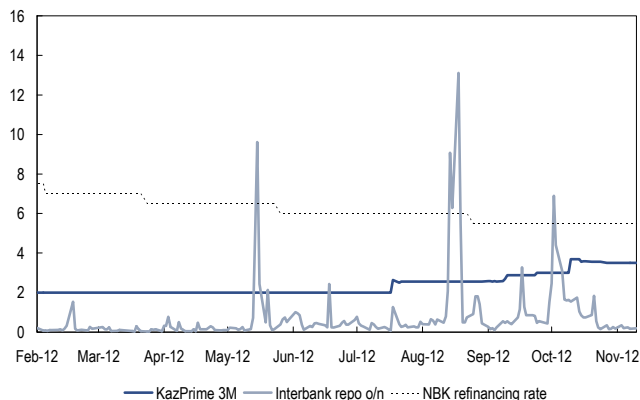
Source: Kazstat, Citi Research

Figure 151. The share of NPLs remains elevated



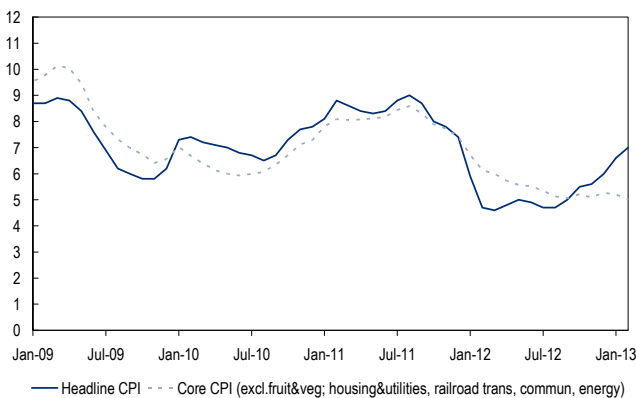
Source: NBK, Citi Research

Figure 152. NBK likely refrain from rate moves...



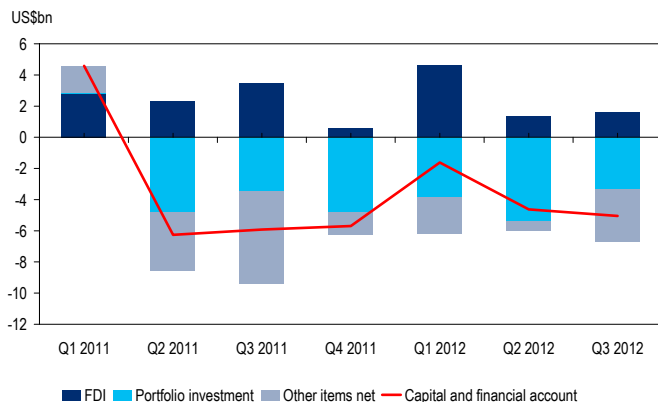
Source: Bloomberg, Citi research

Figure 153. ...with inflation in the middle of target range



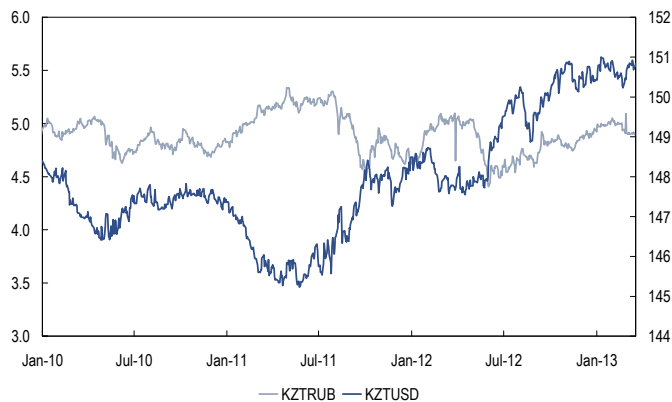
Source: NBK, Citi Research

Figure 154. We expect FDI to remain positive



Source: NBK, Citi Research

Figure 155. The NBK keeps tenge stable and competitive vs Russia



Source: Bloomberg, Citi Research

Figure 156. Kazakhstan Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	81	105	133	115	146	186	222	269	326
Nominal GDP, local currency bn	10,059	12,740	15,968	16,695	21,302	27,294	33,052	40,387	48,806
GDP per capita, USD	5,290	6,775	8,524	7,279	9,111	11,486	13,537	16,233	19,467
Population, mn	15.3	15.5	15.7	15.8	16.0	16.2	16.4	16.6	16.7
Unemployment, % of labour force	7.8	7.3	6.6	6.6	5.8	5.4	5.3	5.3	5.3
<b>Economic Activity</b>									
Real GDP, yoy avg	10.7	8.9	3.3	1.2	7.3	7.5	5.5	4.8	4.1
Real investment growth % yoy	31.7	23.4	-12.8	2.3	2.0	5.6	-2.7	9.6	6.7
Real consumption growth % yoy	11.6	11.4	4.8	0.7	10.0	11.0	7.6	4.9	4.5
private consumption growth % yoy	11.7	11.8	3.9	0.5	11.0	11.9	8.0	5.0	4.5
Real export growth, % yoy	6.5	9.0	0.9	-11.6	1.9	3.5	2.0	2.0	2.0
Real import growth, % yoy	12.2	25.8	-11.3	-16.0	0.9	6.9	7.0	7.0	6.2
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	8.4	18.8	9.5	6.2	7.8	7.4	6.0	6.1	6.7
CPI, % avg	8.6	10.8	17.1	7.3	7.1	8.3	5.1	6.9	6.4
Nominal wages, % yoy	20.6	28.1	16.2	10.8	14.9	15.9	8.1	9.0	10.0
Credit extension to private sector, % yoy	80.2	55.2	5.2	7.3	0.3	15.8	12.1	10.0	15.0
Policy Interest Rate, % eop	9.00	11.00	10.50	7.00	7.00	7.50	5.50	6.25	6.00
1 month inter-bank rate, %, eop	6.25	11.50	9.00	6.50	1.50	1.50	1.50	1.50	1.75
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US\$, eop	127	121	121	149	147	148	150	150	149
KZT/US\$, avg	126	123	120	147	147	147	149	150	150
<b>Balance of Payments, USD bn</b>									
Current account	-2.0	-8.3	6.3	-4.1	1.8	13.6	14.6	9.9	7.3
% of GDP	-2.5	-7.9	4.7	-3.6	1.2	7.3	6.6	3.7	2.2
Trade balance	14.6	15.1	33.5	15.0	28.7	47.9	49.7	49.3	48.8
Exports	38.8	48.4	72.0	43.9	61.6	88.5	96.5	99.4	102.3
Imports	24.1	33.3	38.5	29.0	32.9	40.5	46.7	50.0	53.5
Service balance	-5.9	-8.2	-6.7	-5.8	-7.1	-6.4	-8.3	-11.0	-12.0
Income balance	-9.5	-13.1	-19.5	-12.6	-19.4	-27.7	-26.2	-27.4	-28.5
FDI, net	6.7	8.0	13.1	10.1	3.7	9.1	8.9	8.8	5.0
International reserves	19.1	17.6	19.9	22.7	27.4	27.6	32.5	36.3	26.6
Total amortisations	8.5	19.7	25.2	16.0	14.0	16.8	11.5	11.7	12.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	7.8	4.5	-9.3	-9.6	2.6	5.9	1.6	2.7	1.8
Consolidated gov primary balance	8.0	4.7	-9.0	-9.2	3.0	6.3	2.2	3.2	2.3
Public debt	5.9	5.3	6.3	9.5	10.3	10.0	8.8	8.4	7.7
of which Domestic	3.7	4.0	5.1	7.6	7.8	7.6	6.8	6.8	6.3
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	74.0	96.9	107.9	112.9	118.3	125.2	132.2	136.9	141.1
Public	2.6	1.6	1.7	3.2	4.8	5.1	5.7	7.4	8.6
External debt / GDP	91.4	92.4	80.9	97.9	81.0	67.2	59.6	50.9	43.3
External debt / XGS	178.0	186.6	141.3	234.3	179.6	134.6	127.4	129.0	137.9
Short-term debt	12.7	12.0	10.0	10.3	9.1	9.2	11.1	13.6	15.6
Short-term debt/International reserves (%)	66.2	67.8	50.2	45.2	33.3	33.3	34.2	37.5	58.7
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	4.6	4.6	6.7	5.2	4.7	4.2	4.2	4.7	5.1
CPI, % yoy	4.9	6.0	7.2	7.2	6.9	6.1	6.3	6.3	6.4
Policy interest rate, %, eop	5.50	5.50	5.50	6.25	6.25	6.25	6.00	6.00	6.00
Short-term market rate, % eop	1.50	1.50	1.50	1.50	1.50	1.50	1.75	1.75	1.75
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US\$, eop	150	150	149	151	151	150	149	149	149

Source: National Sources, Citi Research

# Levant

## Iraq

Farouk Soussa  
+971 (4) 509 9750  
[farouk.soussa@citi.com](mailto:farouk.soussa@citi.com)

**The 2013 budget has been passed amid considerable controversy, setting the stage for more confrontations between Baghdad and Erbil further down the line.** Despite fierce opposition (and a boycott) from the Kurdish bloc, PM Nouri al Maliki was able to exploit anti-Kurdish sentiment among Arab MPs across the political spectrum to narrowly push through a budget that fails to satisfy Kurdish demands. The two main sticking points in the budget that had delayed its passing in the past few weeks were (i) the question of settlement of arrears to oil companies operating in the North through the federal budget and (ii) the question of funding for the Peshmerga (Kurdish independent military). On both of these questions, the Kurds were overruled. The budget allocates just US\$625m for oil companies operating in the North, while the Kurds had insisted on a number closer to US\$3.5bn. Moreover, the budget does not include any funding for the peshmerga.

**We believe that the budget sets up further opportunities for confrontation between Baghdad and Erbil.** A key assumption in the budget is that the KRG will export 250kbpd through the Kirkuk-Ceyhan pipeline. We believe the oil companies in the north are highly unlikely to agree to resume pumping oil through the pipeline without a more complete settlement of their arrears and more concrete assurances (including budget allocations) for payments in the future. As the budget fails to do this, we expect the KRG will not be able to live up to its obligations under the budget, and that this will be a cause for further disagreement going forward. The lack of reconciliation through the budget process could also strengthen efforts by the KRG to seek independent means through which to monetize its oil resources, particularly through a pipeline route through Turkey. This will further exacerbate tensions in our view.

**The budget itself is based on expected expenditures of ID138tr, and revenues of ID119tr, with an expected deficit of almost ID119tr (13% of GDP).** The budget assumes an oil price of US\$90 per barrel, and crude exports of 2.9mbpd. The headline figures are in line with our expectations and we have not, as a result, altered our medium-term forecasts. We still expect expenditure in the order of ID115tr, implying an execution rate of around 83% of budget, in line with historical averages. Our revenue figure of ID118tr is almost identical to the government's own projections; however, our figure is based on the expectation of oil prices at US\$99 per barrel, but exports, at 2.77mbpd, considerably lower than the authorities are assuming. On the whole, we expect a small fiscal surplus in the order of 2% of GDP.

**Anti Maliki protests continues as sectarian violence rises.** Protests in the Anbar province against PM Nouri Al Maliki have raged for weeks, as the Sunni population expresses its anger against what it perceives as Maliki's majoritarian rule and his attempts to monopolise political power. The Sunni community has complained of marginalization since the fall of Saddam Hussein's regime, and fears are growing that Maliki's perceived persecution of members of the political opposition (most notably the Sunni-backed Iraqiya bloc) as well as developments in Syria could be empowering extremists and result in a return to the kind of sectarian violence witnessed in 2006/2007. We have long argued that this is unlikely, and expect Maliki to make further concessions to the Sunni population, both economic and political.

## Jordan

**Following consultations between Fayez Tarawneh, the newly appointed Chief of the Royal Court, and parliament, the King has asked incumbent PM Abdullah Ensour to form a government.** Ensour is now consulting with parliament before proposing a cabinet. The whole process is intended to convey the message that Jordan is progressing on the path towards a parliamentary democracy, as previous PMs and governments have been appointed without consultation.

**The political opposition, lead by the Islamic Action Front (IAF), remains unconvinced, and has called the process ‘cosmetic’ (Arab News, Feb 20).** The consultation process is informal and opaque, and the King ultimately retains the prerogative to appoint the government, a point vehemently contended by the opposition who want a genuinely elected government. Moreover, the lack of opposition representation within parliament (due to an opposition boycott of elections in January) further undermines the legitimacy of the process from an opposition view-point. The re-appointment of Ensour further enforces perceptions that despite efforts to convey an image of reforms, its business as usual. Consequently, we expect a continuation in the protest movement that has now entered its third year.

**On the economic front, Ensour’s re-appointment signals Jordan’s commitment to economic reform and getting the IMF deal back on track.**

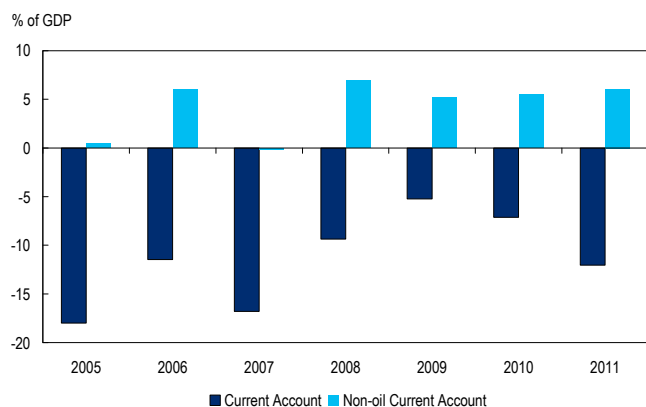
Ensour, himself an international economist, is acutely aware of the difficult conditions facing the Jordanian state budget and economy, and was quick to lift subsidies on fuel towards the end of last year. We anticipate that electricity tariffs are likely to be the next major port of call for the reform-minded PM, as called for under the IMF agreement signed last year. We believe this raises inflationary risks (February inflation reached almost 8% yoy), as well as the likelihood of further social and political instability in the medium term.

## Lebanon

**No end seems in sight to the debate raging over which electoral law will govern the upcoming parliamentary elections, currently scheduled for June. Opposition to the so-called Orthodox law,** which stipulates that voters cannot vote for candidates not of their own sect and introduces proportional representation, remains fierce in the Presidency and Prime Ministership, as well as within the main Sunni bloc (Future movement) and among the Druze community. In early March, registration for candidates opened under the existing 1960 electoral law, which is opposed by most other political parties, including the powerful March 8 coalition, although most parties have abstained from registering until some agreement is reached. In the meantime, it appears that the risk of a delay in elections is rising.

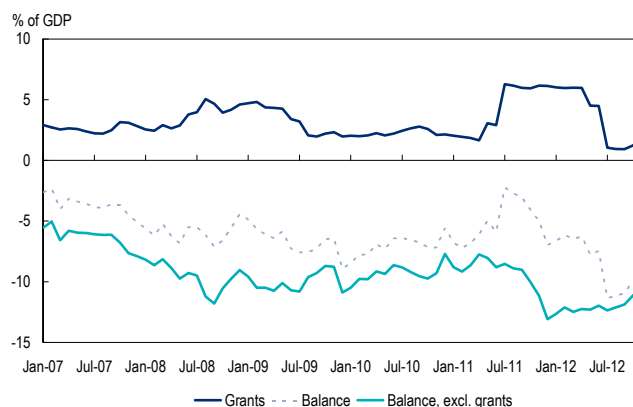
**Controversy over a planned sharp rise in the civil service pay scale rages. Workers’ unions continue a campaign of open-ended strikes to force its passage, while** the private sector is adamantly opposed to any such rise, putting Prime Minister Mikati in the centre of a battle between two key constituencies. Attempts at compromise have failed, and we do not expect that the pay scale will pass at least before the formation of a new government after the June elections. The rise in public sector wages envisaged in the current proposal would cost the government an additional US\$1.2bn, and would widen the deficit by around 2.5% of GDP. Measures to pay for the wage increase, such as an increase in VAT to 12% from 10%, are opposed by the private sector.

Figure 157. Jordan current account dominated by oil imports ...



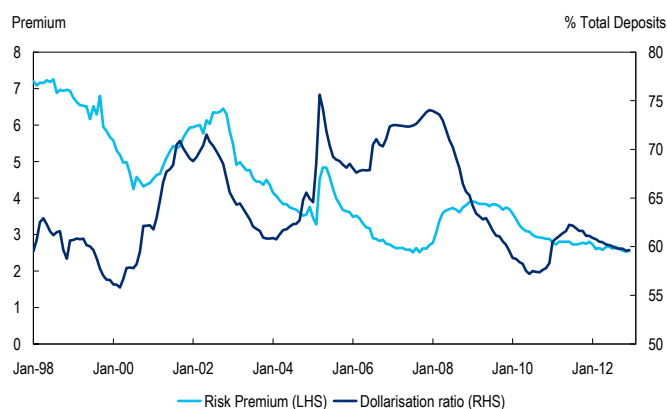
Source: Haver Analytics, Citi Research

Figure 158. Without grants Jordan's fiscal situation would be worse



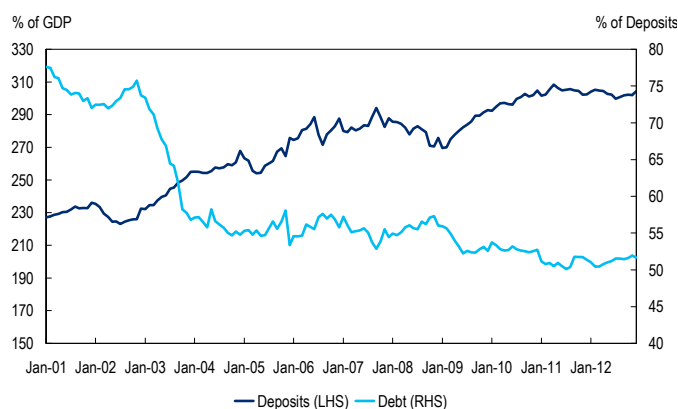
Source: Haver Analytics, Citi Research

Figure 159. Lebanon dollarization has gone up, but risk premium stable



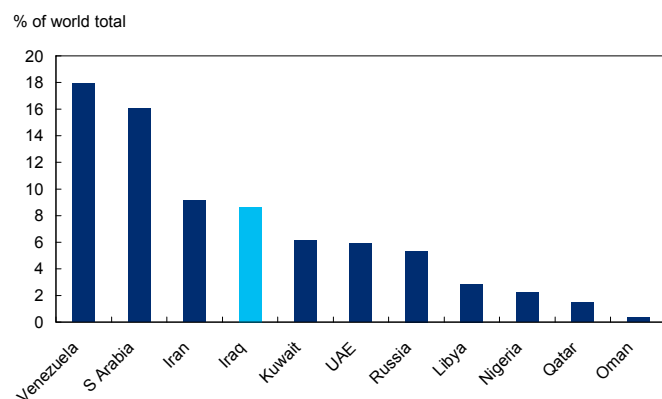
Source: Haver Analytics, Citi Research

Figure 160. Deposit growth slows, but still plenty of capacity



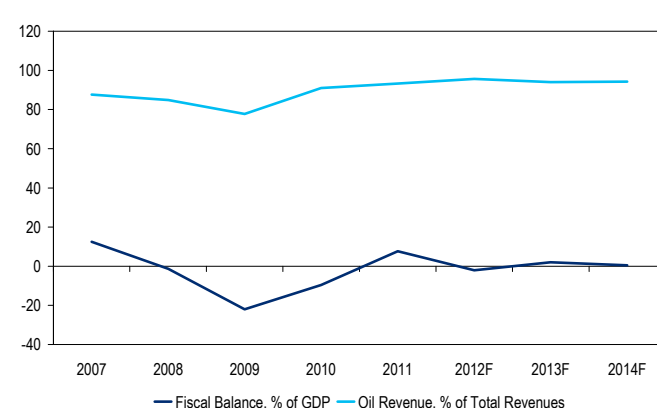
Source: Haver Analytics, Citi Research

Figure 161. Iraq has world's fourth largest proven oil reserves and ...



Source: BP, Citi Research

Figure 162. ... public finances to strengthen on greater oil revenues



Source: IMF, Citi Research

Figure 163. Levant Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>IRAQ</b>									
Nominal GDP, USD bn	46.3	58.8	85.8	65.5	78.1	114.4	125.1	126.7	131.6
GDP per capita, USD	1,645	2,031	2,878	2,132	2,466	3,505	3,719	3,657	3,686
Real GDP, yoy avg	10.1	1.4	7.2	4.2	5.9	1.0	9.0	12.1	9.9
CPI, % avg	-	32.6	2.8	-2.8	2.4	5.6	6.1	6.0	6.0
IQD/US\$, avg	1,463	1,253	1,189	1,156	1,167	1,171	1,164	1,162	1,162
Current account	1.3	20.0	28.4	-1.3	6.3	26.2	29.1	25.5	21.3
% of GDP	2.7	34.1	33.1	-2.0	8.1	22.9	23.3	20.1	16.2
Consolidated government balance	-	12.4	-1.4	-22.0	-9.5	7.6	-2.0	2.0	0.4
<b>JORDAN</b>									
Nominal GDP, USD bn	15.0	17.1	22.0	23.9	26.5	28.0	30.1	31.8	33.4
GDP per capita, USD	2,736	3,023	3,764	3,962	4,263	4,362	4,550	4,668	4,753
Real GDP, yoy avg	8.1	8.2	7.2	5.5	2.3	2.6	2.5	3.0	4.0
CPI, % avg	6.3	4.7	13.9	-0.7	5.0	4.4	4.8	5.5	5.0
JOD/US\$, avg	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71
Current account	-1.7	-2.9	-2.1	-1.2	-1.9	-3.5	-5.9	-4.5	-4.0
% of GDP	-11.5	-16.8	-9.3	-5.2	-7.1	-12.4	-19.7	-14.2	-12.0
Consolidated government balance	-4.2	-5.1	-4.4	-8.9	-5.6	-7.0	-7.8	-7.7	-7.7
<b>LEBANON</b>									
Nominal GDP, USD bn	22.4	25.1	30.1	34.7	37.1	39.0	41.8	44.3	48.0
GDP per capita, USD	5,969	6,666	7,899	8,984	9,499	9,863	10,345	10,751	11,436
Real GDP, yoy avg	0.6	7.5	9.3	8.5	7.0	1.5	2.0	2.0	4.5
CPI, % avg	5.6	4.1	10.8	1.2	4.0	5.1	6.4	5.0	5.0
LBP/US\$, avg	1,508	1,512	1,507	1,504	1,502	1,506	1,504	1,508	1,508
Current account	-1.1	-1.4	-4.1	-6.7	-7.6	-4.9	-6.1	-7.0	-7.6
% of GDP	-5.1	-5.5	-13.8	-19.5	-20.4	-12.5	-14.6	-15.7	-15.9
Consolidated government balance	-13.5	-10.2	-9.7	-8.5	-7.8	-6.0	-7.3	-8.7	-8.8

Source: National Sources, Citi Research

## Nigeria

David Cowan  
+44 20 7986 3285  
[david.cowan@citi.com](mailto:david.cowan@citi.com)

- **Summary view** — Despite the ongoing political uncertainties in the north due to the activities of Boko Haram, we still expect growth to remain robust in 2013-14 driven by strong activity in the south and some modest progress with economic reform and a slow rebound in oil production.
- **Things to watch** — The key economic indicator to watch in 2013 will be foreign exchange reserves: rising reserves, which seems to be the case at present, should boost confidence in the naira allowing the CBN to ease monetary policy in 2H 2013; while falling reserves should increase pressure on the naira.
- **Strategy** — With Ngozi Okonjo-Iweala as finance minister, alongside incumbent central bank governor, Lamido Sanusi, we believe Nigeria has a respected economic team committed to improving fiscal discipline and driving a return to more orthodox monetary policies and improved fiscal discipline.

### Building momentum in 2013

**In 2H 2012 there have been clear signs that the economic reform programme in Nigeria has slowly started to gather some momentum, although with periodic setbacks.** This has been supported by a considerable degree of macroeconomic stability, which has been most visible in the rebuilding of foreign exchange reserves. But the challenge for the government is to now make real progress with structural reform in 2013.

**The first two steps in this direction would be concrete progress with establishing the Sovereign Wealth Fund (SWF) and the completion of reforms in the electricity sector.** The former would mean that efforts to rebuild savings could really gather momentum in 2013, while the latter is a crucial platform for the president, Goodluck Jonathan, if he really intends to seek re-election 2015 as it would provide a concrete sign of what he has actually achieved while in office. The icing on the cake would be if the government also made progress with the Petroleum Industry Bill (PIB), the passage of which should potentially kick start new investment into the oil sector.

**Growth would also be supported by a pick up in the crucial agricultural and oil sectors.** Both were adversely affected by floods and politically motivated disruptions to production in 2012, but assuming this dies away we expect that overall growth in 2013 will be more robust than last year. However, it is worth noting that the growth story could be slightly complicated by a proposed revision to GDP data following a rebasing exercise. If a similar change in Ghana in 2010 is a guide, this could increase total GDP in the order of 40% and could be introduced as early as 2Q 2013.

### Rates and reserves

**During 2H 2012 the CBN has been able to maintain a stable naira on the back of strong portfolio inflows.** This in part, reflects its tight monetary policy, oil prices over US\$100/barrel and the inclusion of Nigerian in various EM bond indexes. Moreover, the tight monetary policy has been justified by high inflation and levels of government spending, despite the slowdown in growth. But this policy could become more complicated in 2013 if inflation was to fall back and political demands for lower interest rates rise.

**We think that movements in the inflation rate in 1H 2013 will be erratic.** But in 2H, assuming a normal harvest, inflation should start to trend down into high single digits. This would provide justification for cutting the Monetary Policy Rate (MPR) but the speed and scale with which the CBN considers cutting will not just depend on the outlook for inflation. It will also be looking at the value of the naira.

**On the one hand, rising growth and progress with structural reform should be naira supportive.** But in the short term, the speed with which the CBN can continue to build reserves will be as, if not more, important. Further portfolio inflows should help push reserves above US\$50bn in 2013 giving the CBN scope to make modest cuts in the MPR. But getting the SWF established or making more payments into the Excess Crude Account would allow an even more rapid reserve build and the reserves would reflect real savings. This would allow more aggressive cuts.

## The oil price question

**The other variable that has to be considered in the CBN's equation is the oil price.** At present we forecast that the price of Brent Crude will average US\$100/barrel in 2013. But there will be times when it dips below this level. When this happened in May and June 2012 the naira did come under pressure and if this were to happen again in 2013, the question facing the CBN would be whether it thinks the fall in the oil price is temporary, or likely to be more prolonged?

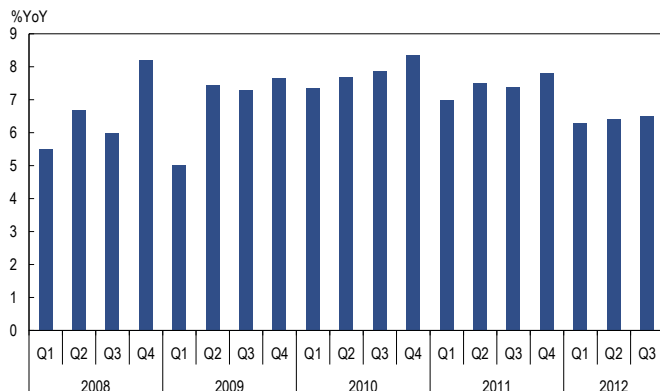
**If the former, then it will probably seek to act as it did in May and June, using reserves to meet any increase in demand for foreign exchange and maintaining its current "soft peg".** But we think that the CBN governor, Lamido Sanusi, has made it clear that if the fall in the oil price was considered more permanent, the CBN would have to revisit its current exchange rate policy. In particular, we think the response of the CBN will be driven by the rate of reserve burn and the potential emergence of differential between the parallel and official exchange rates. In particular, we think that once reserves fall towards the US\$35bn level, the CBN will have to consider the prospects of devaluing the naira.

## Things could get more complicated in 2014

**While we think the overall macroeconomic and political outlook in 2013 is likely to be stable, things could become more complicated in 2014.** The first hurdle to be crossed is that the term of the current CBN governor ends in June and we think there is a strong chance that he will not seek a second term. Given his high profile and prominent role in recent years, this has the potential to undermine confidence in the naira and monetary policy, although much will depend on the choice of his replacement.

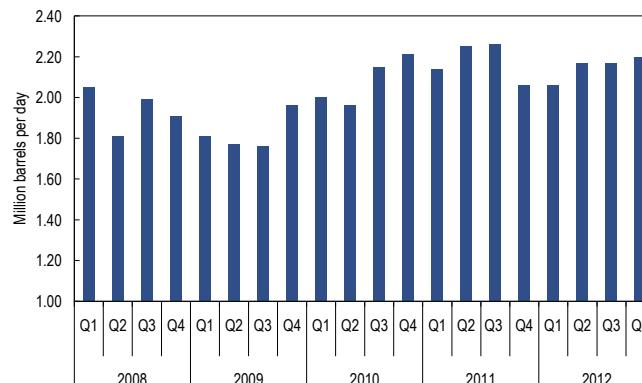
**The instability will be compounded by the fact that in 2H 2014 electioneering is bound to gather pace as Nigeria rapidly heads to presidential, legislative and state elections in 1H 2015.** If this was to lead to rising pressures for increased government spending against the background of falling oil prices, the outlook for Nigeria in the short term would clearly be much more complicated. But the flip side of this, is that if the president were to secure the nomination of the ruling People's Democratic Party (PDP) as its candidate before the year end, then the prospects for policy continuation and macroeconomic stability could improve considerably.

Figure 164. Growth slows, but remains robust in 2012



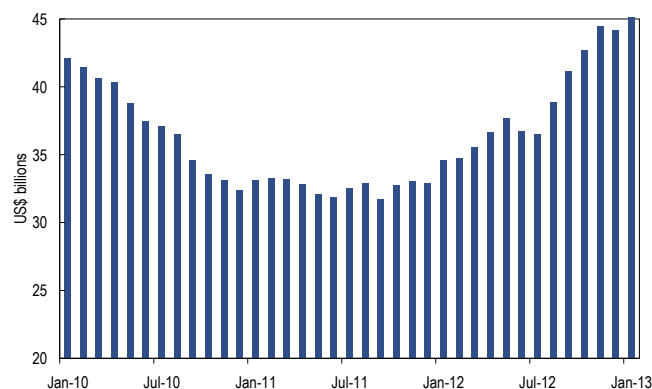
Source: National Bureau of Statistics

Figure 165. Oil production moves sideways in 2012



Source: International Energy Agency

Figure 166. Reserves rebound steadily in 2012



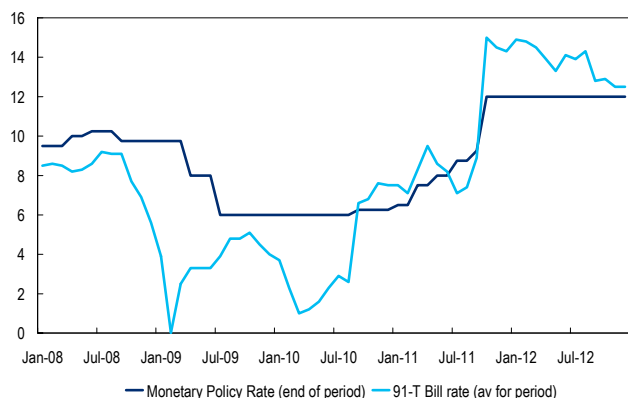
Source: Haver Analytics, Central Bank of Nigeria

Figure 167. The naira remained stable in early 2013



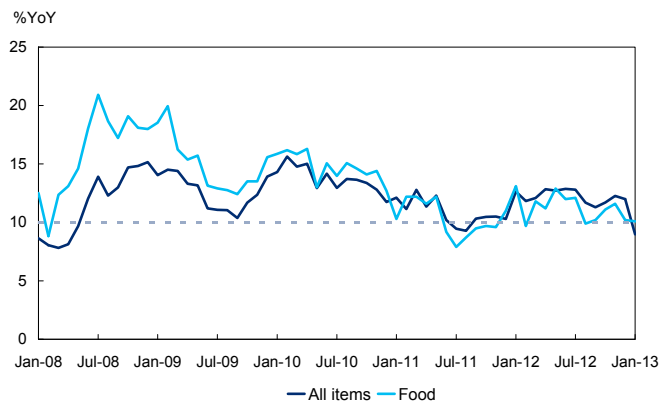
Source: Reuters

Figure 168. No cuts in the MRP since late 2011



Source: Central Bank of Nigeria

Figure 169. Inflation almost in double digits, but under control



Source: National Bureau of Statistics and Citi forecasts from September 2011

Figure 170. Nigeria Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	144	164	204	166	193	239	282	323	371
Nominal GDP, local currency bn	18,565	20,657	24,296	24,794	29,206	37,303	40,064	42,788	45,848
GDP per capita, USD	1,008	1,119	1,357	1,074	1,224	1,479	1,703	1,903	2,130
Population, mn	143.3	146.8	150.4	154.1	157.9	161.8	165.8	169.9	174.1
Unemployment, % of labour force	-	-	-	-	-	-	-	-	-
<b>Economic Activity</b>									
Real GDP, yoy avg	6.0	6.4	6.0	7.0	7.9	7.5	7.4	6.8	7.2
Real investment growth % yoy	59.3	24.5	-6.8	9.1	-3.6	2.9	-	-	-
Real consumption growth % yoy	-9.7	27.6	-19.9	-0.6	-6.7	-1.4	-	-	-
private consumption growth % yoy	-18.7	6.6	-34.3	6.4	-26.7	-10.0	-	-	-
Real export growth, % yoy	60.2	-11.7	43.4	-30.0	11.4	-9.1	-	-	-
Real import growth, % yoy	10.8	54.4	-18.8	-15.8	-15.3	-15.4	-	-	-
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	8.5	6.6	15.1	13.9	11.7	10.3	12.0	8.4	8.4
CPI, % avg	8.2	5.4	11.6	12.5	13.7	10.8	12.2	9.8	9.7
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	27.8	97.1	59.4	26.6	-4.9	46.2	38.0	23.0	18.0
Policy Interest Rate, % eop	10.00	9.50	9.75	6.00	6.25	12.00	12.00	11.50	10.50
1 month inter-bank rate, %, eop	12.00	12.50	18.00	15.79	12.75	12.25	12.50	10.00	9.00
NGN/US\$, eop	129	118	138	150	152	162	156	162	166
NGN/US\$, avg	128	126	119	150	151	156	159	161	164
<b>Balance of Payments, USD bn</b>									
Current account	36.5	27.6	29.1	13.8	13.3	8.8	6.9	11.9	12.3
% of GDP	25.3	16.8	14.3	8.3	6.9	3.7	2.4	3.7	3.3
Trade balance	34.9	37.8	45.9	25.3	30.3	30.9	29.9	35.5	38.3
Exports	56.9	66.1	85.7	56.1	76.5	92.5	86.0	91.0	94.5
Imports	22.0	28.3	39.8	30.8	46.2	61.6	56.1	55.5	56.2
Service balance	-11.6	-16.9	-22.1	-16.5	-18.3	-21.2	-21.0	-21.9	-23.8
Income balance	-4.6	-11.8	-15.1	-14.4	-19.4	-22.8	-21.1	-21.4	-22.6
FDI, net	-	-	-	-	-	-	-	-	-
International reserves	42.3	51.3	53.0	42.4	32.3	32.9	44.2	53.4	54.6
Total amortisations	6.5	0.9	0.6	0.5	0.5	0.4	0.3	0.3	0.3
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.5	-0.6	-0.2	-3.3	-3.3	-3.1	-2.8	-2.6	-2.8
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	9.6	10.9	8.5	13.0	13.3	14.5	14.2	14.2	14.0
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	3.5	3.4	3.7	4.6	4.6	5.7	7.1	7.5	9.9
Public	2.9	3.0	3.2	3.9	4.4	4.6	5.2	5.5	7.2
External debt / GDP	2.5	2.1	1.8	2.8	2.4	2.4	2.5	2.3	2.7
External debt / XGS	6.0	5.0	4.2	7.8	5.8	6.1	8.2	8.2	10.4
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Source: National Sources, Citi Research

## Other Africa

### Ghana

David Cowan  
+44 20 7986 3285  
[david.cowan@citi.com](mailto:david.cowan@citi.com)

- With the National Democratic Congress having won both the presidential and parliamentary elections in December 2012 we expect considerable continuity of economic policy in 2013-14. However, the fiscal deficit was considerable in 2012 at 12.7% of GDP, which will make the task for achieving significant fiscal consolidation in the coming years extremely difficult even with strong domestic revenue growth in our view.
- Confidence in the overall policy direction would be helped if the government was to sign a new deal with the IMF in 2013, even if there was only limited financial support. There is also a strong probability in our view that the government could return to the Eurobond market to help finance its deficit and to take pressure off domestic issuance and reducing rates at the short end and reducing its interest rate bill.
- Given the likely size of the fiscal and current account deficits in 2013-14, and the low level of foreign exchange reserves, we still think the cedi will come under pressure at some point in the next 18 months and that once it starts to fall the momentum will be hard for the Bank of Ghana (BoG) to stop. Much will depend on its willingness to continue to run a very tight monetary policy in 2013. This seems to be the case at present but much will depend on inflation trends, especially with the introduction of a new CPI basket in March.

### Kenya

- Although legal challenges to the election result and the looming ICC hearing will hang over the new president, Uhuru Kenyatta, creating some political uncertainty, he does now have a window to put in place a new government and a more proactive economic policy, which has been driven largely by adherence to the IMF programme in recent years.
- Although the election should have acted as drag on investment in early 2013, we still think growth in 2013-14 will pick up steadily driven by the private sector boosting trade with the East Africa region, the ongoing recovery in the tourism and the agricultural sectors and strong government spending (in particular, ambitious plans to end the current power constraint on growth)
- The Kenyan shilling (KES) has probably over reacted to the peaceful election outcome and rebounded too strongly. However, with monetary policy still remaining relatively tight, we still expect it to only weaken gradually in 2013-14, with periodic bouts of instability, given the large current account deficit and the slowness in bringing the fiscal deficit under control.

### Tanzania

- The review of Tanzania's constitution will continue into 2013 following the creation of a Constitutional Review Commission. However, the main focus of the government will be on economic reform, and crucially the implementation of policy. The most immediately pressing priorities are resolving the ongoing power sector crisis, which has led to prolonged electricity shutdowns in major urban centres acting as a brake on growth, and bringing down the inflation rate which has fallen more slowly than in the rest of East Africa in 2012.

- Growth should continue to be robust in 2013-14, although for it to really pick up into double digits the government will have to make real progress in implementing its *Kilimo Kwanza* (Agriculture First) policy in our view. The current account deficit is set to remain substantial despite ongoing increases in gold exports, but with aid and FDI inflows, increasingly into the gas sector, remaining high, the deficit should prove relatively easy to finance compared to Kenya and Uganda, especially if the government does issue a Eurobond in 2h 2013.
- Given the fiscal and current account deficits and relatively high inflation rate, it is not surprising the Tanzanian shilling came under pressure again in late 2012. Although this moderated in early 2013, unless the deficits are substantially reduced, or monetary policy kept very tight, we expect the shilling will continue to weaken in 2013-14.

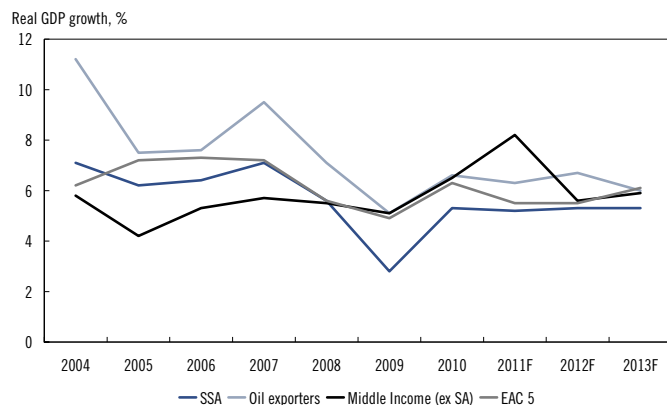
## Uganda

- 2012 was a difficult year for the Uganda economy as growth has slowed to its lowest level for over a decade and the fiscal and current account deficits remain substantial. Moreover, with growth only expected to pick up modestly in 2013 and the inflation rate subdued, the Bank of Uganda (BoU) will continue to face difficult choices about how much further monetary policy easing is required and how much Uganda shilling depreciation it is willing to tolerate.
- With weak growth negatively impacting on domestic revenue and various spats with donors in 2H 2012, the fiscal deficit is a particular source of concern. We think the government will have to rebuild bridges with donors as well as make difficult spending decisions as it prepares the 2013/14 budget for presentation in mid-June. The budget will also provide important indications on the overall direction of economic policy and the outlook for shilling stability in 2H 2013.
- On a positive note in late 2014, the country may become an oil producer, although the impact on growth and government revenue will, initially, be minimal given that production will initially only be very limited. While the development of the field will push up the current account deficit, it should be largely fully funded through FDI inflows.

## Zambia

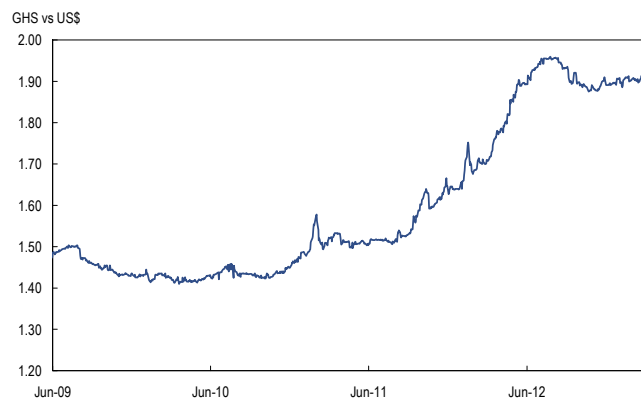
- We expect a rise in government spending over the next few years initially funded from the US\$750m debut Eurobond and then from rising tax revenues, notably from the mining sector. But while government spending is set to increase, the rise may be slower than budgeted for as the new government struggles to implement projects given the general inexperience of many of the new ministers.
- Having plateaued at around 850,000 tonnes in 2010-12, we expect copper production to rise in again in 2013-14, helping underpin growth. But the copper price crash of late 2008 is still fresh in the minds of the government, and reinforced by recent copper price weakness, and the focus of policy will continue to be economic diversification and the need to create jobs and push ahead with infrastructure development.
- Despite the late June rally in the kwacha, it has since weakened as the current account and balance of payments have moved into deficit in 2012. But rising copper exports should push the current account in a modest surplus at some point in 2013. Coupled with rising tax inflows onto the foreign exchange market, this should place a firm floor under further kwacha depreciation

**Figure 171. Growth should be robust in 2012-13**



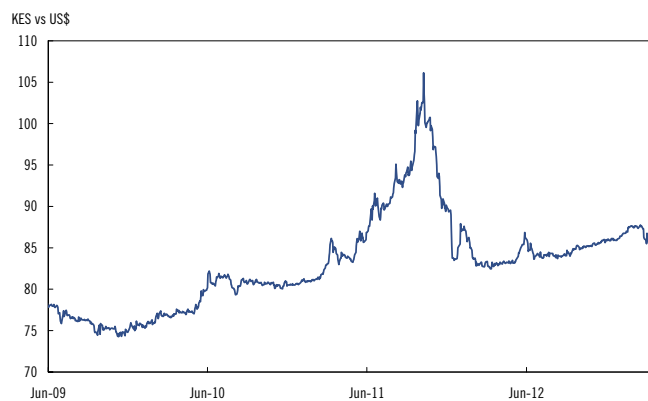
Source: IMF

**Figure 172. The cedi has clearly stabilized since late 2012**



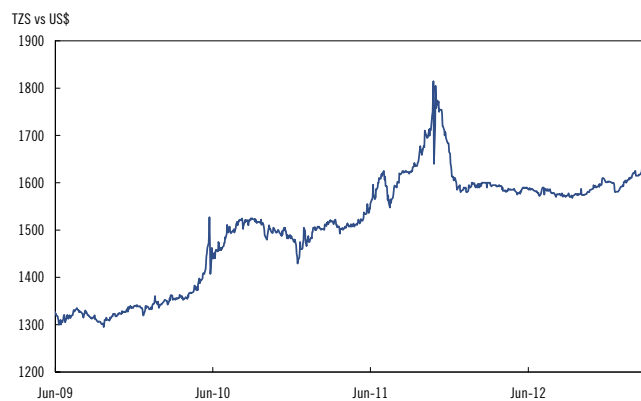
Source: Haver Analytics

**Figure 173. The Kenyan shilling starts to come under pressure**



Source: Haver Analytics

**Figure 174. A Tanzanian shilling wobble in late 2012**



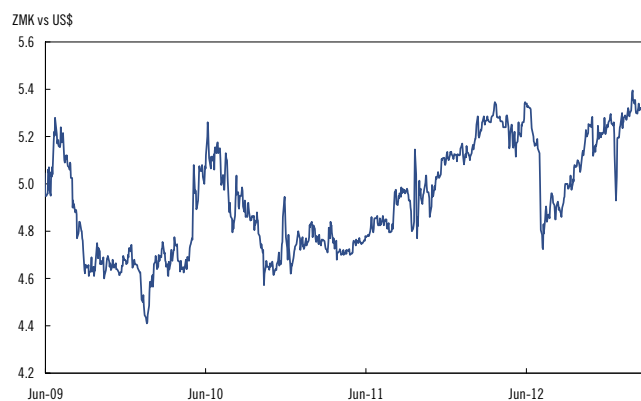
Source: Haver Analytics

**Figure 175. The Uganda shilling is under pressure**



Source: Haver Analytics

**Figure 176. The roller coaster ride for the kwacha continues**



Source: Haver Analytics

Figure 177. Other Africa Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>GHANA</b>									
Nominal GDP, USD bn	20.4	24.8	28.5	26.0	32.2	39.2	38.5	42.1	45.1
GDP per capita, USD	920	1,090	1,226	1,090	1,319	1,570	1,506	1,611	1,687
Real GDP, yoy avg	6.1	6.5	8.4	4.0	8.0	14.4	7.4	7.0	6.8
CPI, % avg	11.7	10.8	16.5	19.2	10.7	8.7	9.2	9.5	10.7
Policy Interest Rate, % eop	12.5	13.5	17.0	18.0	13.5	12.5	15.0	13.5	10.0
GHS/US\$, avg	0.91	0.95	1.07	1.43	1.43	1.55	1.85	1.95	2.17
Current account	-1.0	-2.1	-3.5	-1.6	-2.6	-3.7	-4.5	-4.2	-4.0
% of GDP	-5.1	-8.6	-12.4	-6.2	-8.2	-9.4	-11.7	-10.0	-8.9
International Reserves, USD	2.3	2.8	2.0	3.2	4.7	5.4	5.4	5.5	5.9
Consolidated government balance	-5.0	-6.1	-8.5	-5.8	-7.2	-5.4	-7.6	-12.7	-8.5
<b>KENYA</b>									
Nominal GDP, USD bn	22.5	28.5	30.4	30.6	32.2	34.0	41.0	43.8	55.1
GDP per capita, USD	616	760	792	776	794	818	960	997	1,220
Real GDP, yoy avg	6.3	7.0	1.5	2.7	0.0	5.8	5.0	5.4	6.1
CPI, % avg	6.0	4.3	15.1	10.6	4.1	14.0	9.6	6.4	9.2
Policy Interest Rate, % eop	10.0	8.8	8.5	7.0	6.0	18.0	11.0	9.0	8.5
KES/US\$, avg	72.1	67.3	68.8	77.3	79.2	88.4	84.5	88.5	93.4
Current account	-0.5	-1.0	-2.0	-1.7	-2.4	-3.3	-4.3	-3.9	-4.2
% of GDP	-2.3	-3.6	-6.5	-5.5	-7.4	-9.8	-10.5	-8.9	-7.6
Consolidated government balance	-2.5	-3.0	-3.9	-5.2	-5.1	-4.3	-5.3	-5.0	-4.7
<b>TANZANIA</b>									
Nominal GDP, USD bn	14.3	16.8	20.7	21.4	22.9	24.2	29.8	30.7	32.7
GDP per capita, USD	359	410	490	491	511	524	625	624	646
Real GDP, yoy avg	6.7	7.1	7.4	6.0	7.0	6.3	6.4	6.8	7.0
CPI, % avg	7.3	7.0	10.3	12.1	7.2	12.7	16.1	9.0	8.8
TZS/US\$, avg	1,249	1,237	1,198	1,324	1,439	1,582	1,586	1,688	1,844
Current account	-1.7	-2.3	-3.2	-2.5	-2.7	-4.6	-3.5	-3.1	-3.8
% of GDP	-11.6	-13.9	-15.2	-11.5	-11.9	-18.8	-11.9	-10.2	-11.5
Consolidated government balance	-4.5	-1.9	-2.6	-6.0	-6.5	-5.0	-5.4	-5.0	-5.6
<b>UGANDA</b>									
Nominal GDP, USD bn	10.8	12.9	15.9	16.0	17.0	18.2	21.8	21.7	23.3
GDP per capita, USD	367	424	506	495	508	528	612	591	615
Real GDP, yoy avg	9.5	8.6	7.7	7.0	6.1	5.7	4.0	4.7	5.5
CPI, % avg	7.2	6.1	12.0	13.0	4.0	18.7	14.7	5.6	5.5
UGX/US\$, avg	1,830	1,723	1,714	2,025	2,173	2,511	2,501	2,773	2,892
Current account	-0.4	-0.7	-1.3	-1.3	-1.9	-2.3	-2.4	-2.5	-2.7
% of GDP	-3.7	-5.5	-8.3	-7.8	-10.9	-12.5	-11.0	-11.7	-11.5
Consolidated government balance	0.6	0.1	-1.6	-1.9	-6.3	-4.8	-5.5	-5.2	-4.5
<b>ZAMBIA</b>									
Nominal GDP, USD bn	10.7	11.5	14.6	12.8	16.2	18.0	19.3	21.4	23.1
GDP per capita, USD	911	957	1,183	1,006	1,237	1,339	1,389	1,497	1,564
Real GDP, yoy avg	6.2	6.2	5.7	6.4	7.6	6.6	6.5	6.9	7.5
CPI, % avg	9.0	10.7	12.4	13.4	8.5	6.4	6.6	7.2	7.4
ZMK/US\$, avg	3,554	3,992	3,702	5,020	4,791	4,861	5,139	5,425	5,775
Current account	-0.1	-1.0	-1.4	0.2	0.9	0.1	-0.7	0.1	0.7
% of GDP	-0.6	-8.4	-9.3	1.9	5.7	0.4	-3.4	0.5	3.1
Consolidated government balance	20.2	-1.3	-0.9	-2.5	-3.1	-3.0	-4.3	-3.5	-3.3

Source: National Sources, Citi Research

## Poland

Piotr Kalisz  
+48 (22) 692 9633  
[piotr.kalisz@citi.com](mailto:piotr.kalisz@citi.com)

Cezary Chrapek  
+48 (22) 692 9421  
[cezary.chrapek@citi.com](mailto:cezary.chrapek@citi.com)

- **Summary view** — Domestic demand remains weak but could recover in 2H of the year, which along with positive signals from German economy and prospects of CPI above low NBP projection in 2014, could result in no further monetary policy easing from the MPC.
- **Things to watch** — Fast realization of budget deficit could signal need for budget amendment in the course of the year.
- **Strategy** — Further decline of inflation could support more rate cuts expectations and bond prices in the near term though the end of the monetary policy easing cycle, upward revision of budget deficit and higher core bond yields could put pressure on domestic bonds later this year

### GDP growth to remain weak

**Central bank projections show weak GDP growth and low inflation ahead.** NBP projection forecasts weakening of GDP growth in 2013 to 1.3%YoY on continued weakness in domestic demand and recovery to 2.6%YoY in 2014 and 3.1% in 2015. Central bank also estimates inflation to stay around 1.5-1.6%YoY in 2013-2015. The NBP expects poor labour market conditions to remain and a drop in employment by 1.1%YoY in both 2013 and 2014 and weak private consumption growth of 0.5% this year. At the same time public consumption growth estimate for 2013 was revised upwards (to 1.8%YoY) on lower base in 2012. Moreover, NBP presumes drop of investments by 3.8%YoY this year (vs. our forecast of -3.1%YoY), which stems from continued decline of both public and private investments. Despite expected economic growth recovery in the next quarters the NBP still presumes negative output gap in the projection horizon till 2015 of around 1.5%-1.8% of GDP. At the same time the NBP inflation projections presume an asymmetric risk to the upside due to probable lack of VAT tax decrease, which is incorporated in the NBP projection's central scenario.

**In our view NBP projection is quite realistic in terms of GDP growth but we expect higher inflation next year.** Although economic data for January positively surprised in case of industrial output and retail sales taking out calendar effect and seasonal patterns they are still weak and next few months will rather show continued weakness. Consequently, we still expect the economy will bottom in 1Q with GDP growth at 0.5%YoY down from 1.1% in 4Q12 and will start to recover starting from 2Q this year reaching 2%YoY in 4Q. Gradual recovery should be supported by both falling statistical base in 2012 and improving foreign demand on upward revision of GDP growth forecast for Germany and positive surprises in leading indicators (Ifo, Zew). We also expect some acceleration of private consumption in 2H on easing of lending condition by the KNF and some positive effect on private investments from the BGK programme "Polish Investments" offering corporate loans directly and providing guarantees to corporate loans in commercial banks. We maintain our economic growth forecast for this year at 1.3%YoY, as we presume a rebound in GDP growth to 2.8%YoY in 2014 and over 3% in 2015. In terms of GDP our forecast for 2013-2015 is quite in line with the projection of the NBP (and also latest forecasts of European Commission).

## **Inflation to fall toward 1% in the short term**

**Inflation in February surprised to the downside falling to 1.3%YoY and could reach 1% in April, though it will rebound to NBP target in 2014.** Inflation fell again in February to 1.3%YoY from 1.7% in January, which was below market consensus and our forecast of 1.5%. The surprise resulted mainly from a very low price growth in food category (first drop in food prices in February since 2005) and large decline in communication prices (-3%MoM). Prices growth was slightly lower than we had expected also in most of remaining categories. In contrast to expectations there was nearly no effect on inflation from changes in weights in the CPI basket. Our inflation forecast shows the CPI is likely to reach 1% in April, thanks to both lack of demand side pressures as well as favourable base effects. We expect inflation to rebound later this year towards 2%, albeit the annual average inflation should reach only 1.5%, which is below the MPC target but in line with NBP's projection. However, in our view in contrast to NBP's forecast inflation will return toward the target in 2014, as we presume no reduction in VAT tax in 2014 as the government would be rather unwilling to resign from additional revenues.

## **Rates to stay flat after surprising 50 bp rate cut**

**Surprising 50 bp rate cut in March probably end the easing cycle though another fine tuning rate cut cannot be rule out if data from the economy substantially surprise to the downside.** In March the Monetary Policy Council surprised markets by cutting the base rate by 50bps to a record low level of 3.25%. The surprise came from the fact that since the beginning of this MPC's term its members had signaled they would not want to cut interests rates in bigger steps than 25bp, as – in their view - Poland was only undergoing a typical economic slowdown, not a crisis. Moreover, in the last few months the change of the MPC's communique and of the tone of Council members' comments was becoming less and less dovish signaling a pause in monetary policy easing cycle. After rate cut in March The MPC signaled the end of an easing round and move to wait-and-see approach. The MPC did not close a door for further rate cuts, however this would be possible only if data from the economy significantly surprised to the downside or if decline of CPI below the NBP target was long-lasting. Despite yet another disappointment in MPC's communication we find the decision of bigger rate cut as positive for the economy and we treat it as an attempt to catch up for the lost time.

## **Bonds yields to increase later this year**

We believe that building expectations for more rate cuts by the NBP could support bond prices in the next several weeks. However, in our baseline scenario we expect no more rate cuts this year (probability 2/3) and we expect a budget amendment in the course of this year. This environment is likely eventually to put upward pressure on bond yields. The negative impact on the bond market should be partly limited by the fact the Finance Ministry has already managed to finance around 55% of annual borrowing needs. Additionally long end of the curve will be under pressure from expected surge in US bond yields.

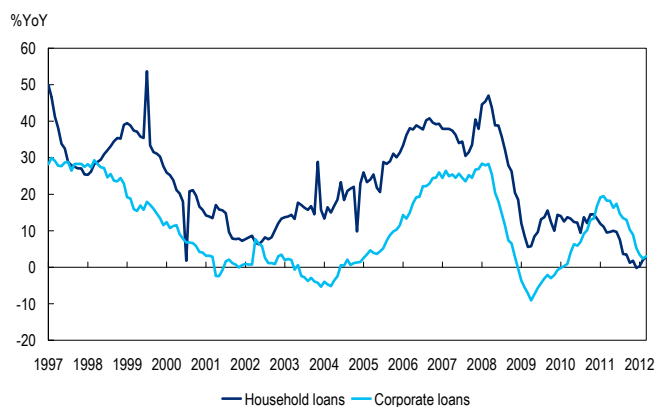
Moreover, we expect that limited reaction of the zloty on larger than expect rate cut by the MPC and improving prospects for economy especially for the 2H13 could limit potential for zloty weakening this year, though we still expect PLN/EUR to rise toward 4.25 in the next 12 months.

**Figure 178.** NBP's GDP projection is quite realistic though we expect higher inflation in 2014 on assumption of no VAT cut

		NBP November projection	NBP March projection	Citi forecasts	Market consensus (Reuters survey)
<b>GDP (%YoY)</b>	<b>2013</b>	1.5	1.3	1.3	1.5
	<b>2014</b>	2.3	2.6	2.8	2.6
	<b>2015</b>		3.2	3.3	3.4
<b>CPI (%YoY)</b>	<b>2013</b>	2.5	1.6	1.8	1.9
	<b>2014</b>	1.6	1.6	2.4	2.5
	<b>2015</b>		1.6	2.5	2.5

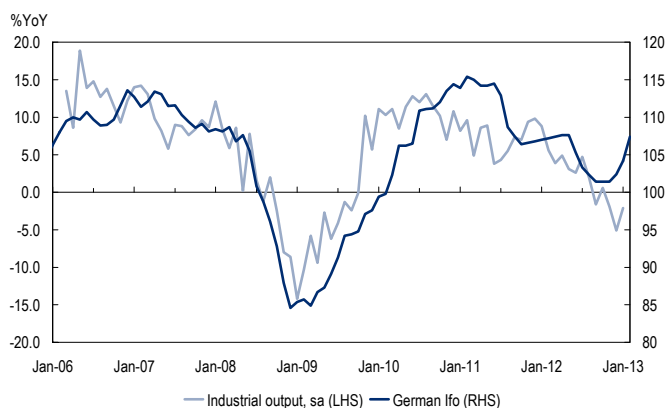
Source: National Bank of Poland, Reuters, Citi Research

**Figure 180.** Easing of lending conditions by KNF could support acceleration of loans growth, consumption and investments in 2H



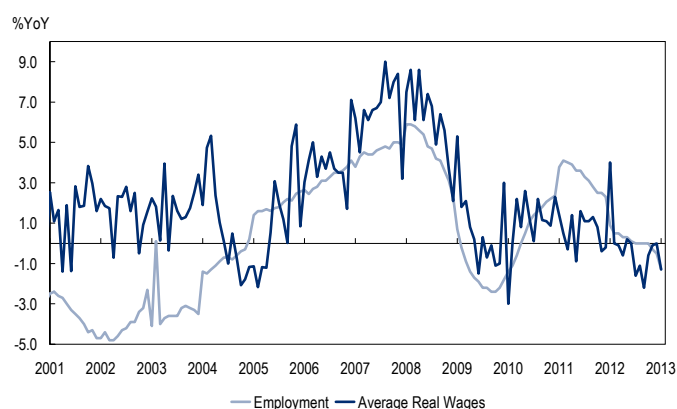
Source: Central Statistical Office, Citi Research

**Figure 182.** German green shoots improve industrial output prospects



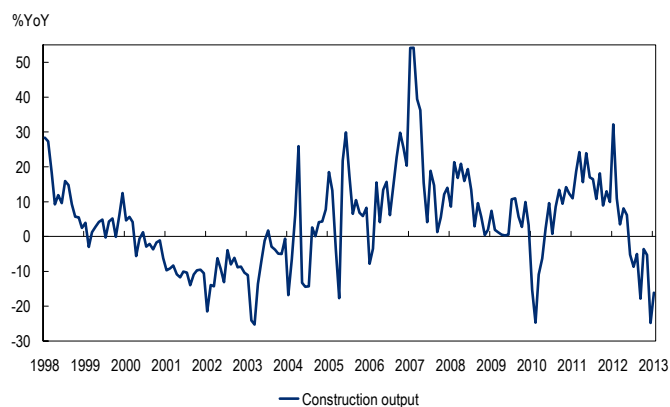
Source: CSO

**Figure 179.** Weak labour market hurts private consumption and budget revenues



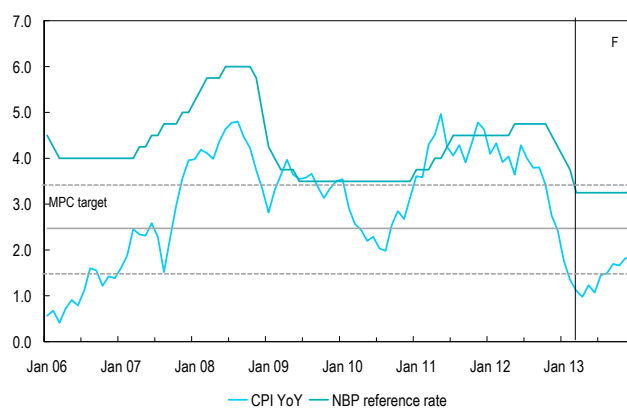
Source: Central Statistical Office

**Figure 181.** "Polish investments" activity could help limit the deterioration in construction



Source: CSO

**Figure 183.** 2013 inflation below target but will rise to 2.5% next year



Source: CSO, NBP, Citi Research forecasts

Figure 184. Poland Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	342	426	534	433	470	515	495	515	559
Nominal GDP, local currency bn	1,059	1,175	1,275	1,343	1,414	1,521	1,610	1,663	1,754
GDP per capita, USD	8,969	11,185	13,994	11,347	12,210	13,361	12,837	13,357	14,525
Population, mn	38.1	38.1	38.1	38.2	38.5	38.5	38.5	38.5	38.5
Unemployment, % of labour force	14.9	11.2	9.5	11.9	12.2	12.2	13.3	14.2	13.4
<b>Economic Activity</b>									
Real GDP, yoy avg	6.2	6.8	5.1	1.6	3.9	4.3	2.0	1.3	2.8
Real investment growth % yoy	16.1	24.3	4.0	-11.5	9.3	10.5	-1.0	-3.3	3.7
Real consumption growth % yoy	5.2	4.6	6.1	2.0	3.4	1.5	0.4	1.1	3.0
private consumption growth % yoy	5.0	4.9	5.7	2.1	3.2	2.5	0.5	1.1	3.1
Real export growth, % yoy	14.6	9.1	7.1	-6.8	12.1	7.7	1.6	2.2	8.5
Real import growth, % yoy	17.4	13.7	8.0	-12.4	13.9	5.5	-2.5	-0.1	9.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	1.4	3.9	3.4	3.7	3.2	4.6	2.4	2.1	2.5
CPI, % avg	1.0	2.5	4.2	3.5	2.6	4.3	3.7	1.7	2.4
Nominal wages, % yoy	5.0	9.1	10.5	4.2	3.6	4.9	3.4	2.3	4.2
Credit extension to private sector, % yoy	24.6	32.1	37.0	6.9	8.6	13.8	4.5	0.5	5.6
Policy Interest Rate, % eop	4.00	5.00	5.00	3.50	3.50	4.50	4.25	3.25	3.50
1 month inter-bank rate, %, eop	3.96	5.37	5.41	3.56	3.46	4.57	4.01	3.47	3.97
Long-term yield, %, eop	5.20	5.93	5.46	6.24	6.07	5.91	3.73	4.45	5.00
PLN/US\$, eop	2.90	2.47	2.97	2.87	2.97	3.45	3.09	3.28	3.05
PLN/US\$, avg	3.10	2.76	2.39	3.10	3.01	2.96	3.25	3.23	3.14
PLN/EUR, eop	3.83	3.60	4.15	4.10	3.97	4.47	4.08	4.24	3.96
PLN/EUR, avg	3.90	3.78	3.52	4.32	3.99	4.12	4.18	4.20	4.06
<b>Balance of Payments, USD bn</b>									
Current account	-13.2	-26.5	-34.9	-17.3	-24.1	-25.0	-17.3	-14.0	-19.6
% of GDP	-3.8	-6.2	-6.5	-4.0	-5.1	-4.9	-3.5	-2.7	-3.5
Trade balance	-7.4	-19.1	-30.7	-7.6	-11.8	-14.1	-7.1	-3.8	-5.8
Exports	117.4	145.3	178.7	142.1	165.9	195.2	187.6	205.7	225.2
Imports	124.8	164.4	209.4	149.7	177.7	209.3	194.8	209.5	231.0
Service balance	0.7	4.8	5.0	4.8	3.1	5.7	6.2	7.4	8.5
Income balance	-9.7	-16.4	-12.8	-16.6	-19.1	-22.9	-21.9	-22.6	-26.0
FDI, net	10.7	18.0	10.4	8.5	6.9	11.6	3.1	6.5	8.0
International reserves	45.1	54.6	57.2	69.7	81.4	86.8	96.1	102.0	104.0
Total amortisations	23.5	30.2	32.4	32.8	32.1	37.6	39.6	41.1	44.3
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-3.6	-1.9	-3.7	-7.4	-7.9	-5.0	-3.5	-3.5	-2.8
Consolidated gov primary balance	-1.0	0.4	-1.5	-4.8	-5.2	-2.3	-0.8	-0.8	-0.1
Public debt	47.8	44.8	46.9	49.8	52.8	53.5	52.2	52.6	51.3
of which Domestic	35.6	34.3	34.8	36.7	38.4	36.6	36.5	35.7	35.5
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	169.8	233.3	244.8	280.2	315.3	324.5	355.5	374.5	395.5
Public	69.1	86.8	69.4	92.2	116.5	120.2	134.5	141.7	149.6
External debt / GDP	49.6	54.7	45.9	64.7	67.0	63.0	71.8	72.7	70.7
External debt / XGS	123.0	133.9	114.2	163.8	158.7	139.4	157.5	150.4	144.6
Short-term debt	34.6	60.9	65.9	70.0	76.5	73.0	80.0	84.0	88.0
Short-term debt/International reserves (%)	76.7	111.4	115.1	100.4	93.9	84.1	83.2	82.3	84.6
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	1.6	1.1	0.5	1.5	1.3	2.0	2.4	2.8	2.9
CPI, % yoy	3.8	2.4	1.4	1.3	2.0	2.1	2.4	2.4	2.4
Policy interest rate, %, eop	4.75	4.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Short-term market rate, % eop	4.70	4.14	3.45	3.42	3.42	3.47	3.47	3.47	3.52
Long-term yield, %, eop	4.87	3.90	4.05	4.07	4.31	4.45	4.60	4.75	4.95
PLN/EUR, eop	4.12	4.08	4.15	4.18	4.22	4.24	4.17	4.10	4.03

Source: National Sources, Citi Research

## Romania

Ilker Domac  
+90 212 319 4623  
[ilker.domac@citi.com](mailto:ilker.domac@citi.com)

Gultekin Isiklar  
+90 212 319 4915  
[gultekin.isiklar@citi.com](mailto:gultekin.isiklar@citi.com)

- **Summary view** — All eyes are on the IMF program (originally scheduled to expire in end-March) was extended by three months. While the markets seem to have priced in the best-case scenario, we believe that the possibility of the Government not opting for a new program is higher than before.
- **Things to watch** — Political stability following the December 2012 elections and the implementation of the IMF-EU supported economic program deserve close monitoring.
- **Strategy** — We believe that the NBR's tendency to pursue a more accommodative monetary policy may hurt the performance of the leu.

### Nascent signs of a pick up emerge...

**While GDP growth remained flat last year, recent data offer a glimmer of hope for 2013.** Growth indicators in the last quarter of 2012 don't paint an encouraging picture for the outlook for the recovery. At 0.1%QoQ (SWA), the economy barely grew in the last quarter of 2012. Moreover, the absence of any revival in lending activity doesn't bode well for the much needed rebound in domestic demand. Despite the challenging backdrop, the January readings for industrial production and retail sales offer some hope for a pick up in economic activity. This, coupled with the strong export performance in January, provides some ground for optimism. In light of the noted backdrop and our expectations of an increase in the absorption of EU funds, we look for a moderate pick up in GDP growth this year to about 1.0% from 0% in 2012. In our base case, we continue to include another EU-IMF arrangement once the current one expires in end-March. Deviations from these assumptions will lead us to revisit our growth forecasts, as risks to the outlook are mostly on the downside owing to the country's exposure to the euro area crisis.

### ...as year-end inflation is likely to exceed NBR's forecast

**At 5.7% YoY, the inflation outturn in February came in line with the consensus.** Using seasonally adjusted data, the February print translates into a 0.16%MoM rise in inflation, compared with a 0.93%MoM and 0.55%MoM increases in January and December, respectively. In light of the February print, we maintain our view that the prospects for meeting this year's target of 2.5% (+/- 1pp variation band) look very challenging. In the February Inflation Report, the NBR envisages the annual CPI inflation rate staying above the  $\pm 1$  percentage point variation band around the central target until 2013 Q2, before reaching the upper bound of the band (3.5%) at the end of 2013 Q3 and Q4. The pace of disinflation that we envision is slower than that of the NBR. We acknowledge that appreciation in leu since mid-December, coupled with improvement in forward looking inflation expectations and negative output gap, will likely improve the inflation dynamics in the remaining of the year. Nevertheless, we think that volatile food prices and the possibility of administrative price adjustments warrant concern, as we expect inflation to be 4.5% by the end of 2013 (vs. the NBR's forecast of 3.5%).

## **NBR signals for a more accommodative stance**

**The recovery of the leu and risings concerns about recovery seem to have led the NBR to relax its stance, in our view.** This is evidenced by the decline in money markets, which have been hovering below the 5.25% policy rate in recent weeks. Recent comments by senior NBR officials and the evolution of money market rates in recent weeks also corroborate the NBR's intention to pursue a more accommodative monetary policy so long as the currency remains stable and inflation remains broadly in line with the Bank's inflation forecast trajectory. Looking ahead, we believe that the challenging inflation outlook, the risks associated with the IMF program and potential spillovers from the euro area crisis limit the ability of the NBR to relax liquidity conditions further without hurting the currency.

## **Budget performance remains encouraging...**

**Standing at around RON 1.04 billion, the budget balance surplus in January compares favorably with the same period of 2012 (RON 1.01bn).** Despite a moderate decline in revenues (1.8%YoY), a sharper contraction in spending (2.2%YoY) led the government to avoid a deterioration in the budget performance for the first reading of the year. Looking ahead, all eyes are on the upcoming IMF mission in May or June, which will assess the status of corrective actions to achieve the objectives of the program. While the markets seem to have priced in the best-case scenario—completion of the current program and a new arrangement thereafter, we now believe that the possibility of the Government not opting for a new program (or the program being declared off track) is higher than before, partly because of the improved financing conditions for the Treasury and increased foreign-investor interest.

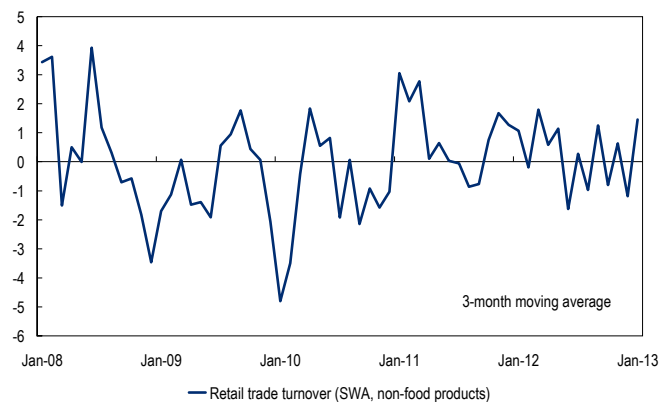
## **...as the current account gap remains in check**

**At around €0.5 bn, the current account surplus in January brought the 12-month rolling deficit to €4.6bn from €5.0bn in December.** Improvements in the services and transfers accounts were the key drivers of the January current account reading. In line with our expectations of a sluggish recovery in domestic demand and limited scope for private credit growth, we expect the current account deficit to remain around 4.0% of GDP this year. Notwithstanding the remarkable improvement in the current account balance, we remain concerned about the downward trend in capital inflows, which overshadows the currency outlook.

## **NBR's inclination to ease may stall the recent leu rally**

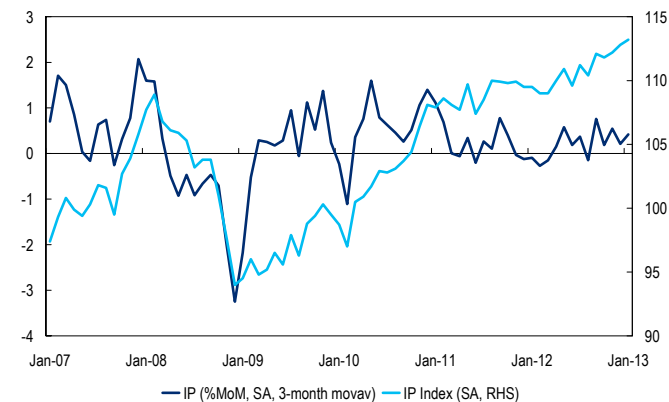
**Although there are encouraging signs suggesting that a revival of capital flows is underway, we believe that the NBR's tendency to pursue a more accommodative monetary policy may hurt the performance of the leu.** At the time of writing, the 3-month forward implied yield stood at about 4.8% compared with about 6% (period average) in January and February. Regarding the bond market outlook, with the likely stabilization of foreign inflows into the bond market, we expect the shape of the yield curve to normalize in 2Q or earlier. In fact, the yield curve has already steepened moderately compared with end-February. The risks associated with the IMF program and potential spillovers from the euro area crisis, which continue to overshadow the FX outlook, need to be monitored closely.

Figure 185. The recent pick up in retail trade turnover...



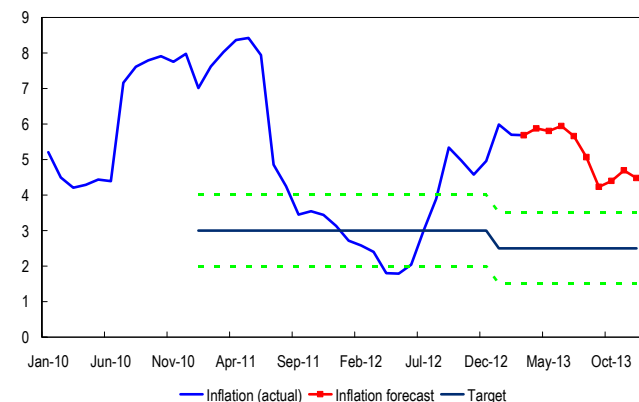
Source: Haver Analytics

Figure 186. ...and industrial production offer some hope...



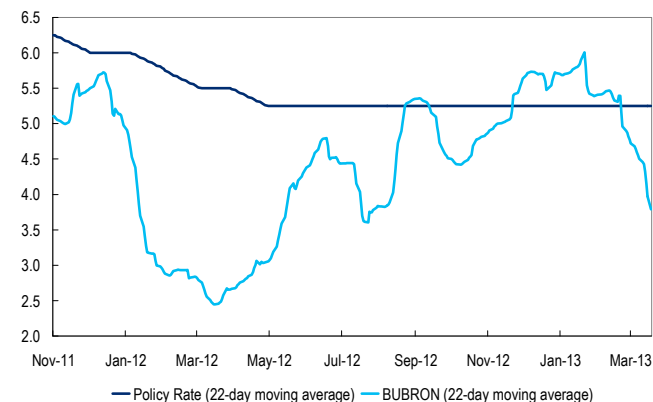
Source: Haver Analytics, Citi Research

Figure 187. ...as the inflation outlook remains challenging



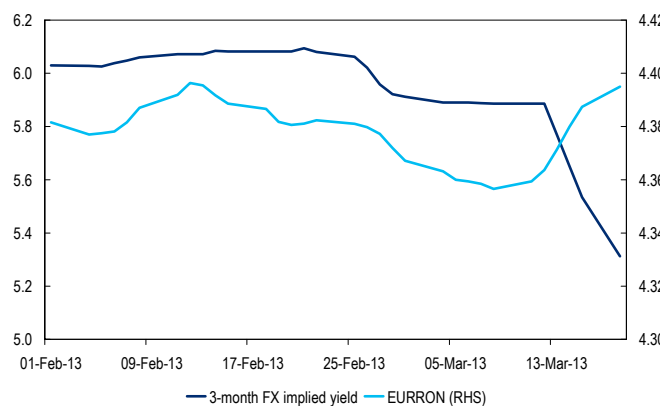
Source: Haver Analytics

Figure 188. The NBR's inclination to relax liquidity...



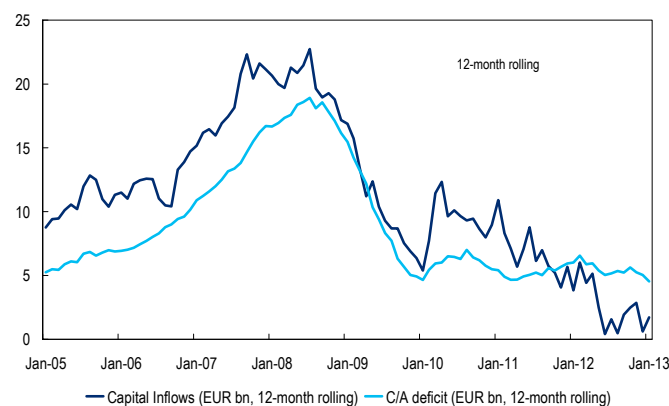
Source: Bloomberg.

Figure 189. ...doesn't bode well for the performance of the leu



Source: Bloomberg

Figure 190. ...and for the revival in capital inflows



Source: Haver Analytics, Citi Research

Figure 191. Romania Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	123	171	204	165	165	183	168	183	199
Nominal GDP, local currency bn	345	416	515	501	524	557	583	612	652
GDP per capita, USD	5,496	7,653	9,176	7,397	7,413	8,236	7,587	8,277	9,032
Population, mn	22.3	22.3	22.3	22.2	22.2	22.2	22.1	22.1	22.1
Unemployment, % of labour force	5.4	4.3	4.0	6.3	7.6	5.4	5.0	5.2	5.5
<b>Economic Activity</b>									
Real GDP, yoy avg	7.9	6.3	7.4	-6.6	-1.2	2.2	0.0	1.0	2.8
Real investment growth % yoy	21.7	29.9	12.1	-28.8	0.0	12.4	-11.6	2.2	3.9
Real consumption growth % yoy	10.6	10.5	8.9	-8.9	-0.8	1.2	0.2	0.7	2.3
private consumption growth % yoy	12.8	11.8	9.0	-10.3	-0.3	1.2	0.2	0.7	2.4
Real export growth, % yoy	9.8	7.8	7.3	-6.2	14.2	11.0	-0.6	2.0	4.0
Real import growth, % yoy	22.7	27.9	7.1	-21.4	12.4	10.3	0.2	1.5	3.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	4.9	6.6	6.3	4.7	8.0	3.1	5.0	4.5	3.4
CPI, % avg	6.6	4.8	7.9	5.6	6.1	5.8	3.3	5.3	3.6
Nominal wages, % yoy	18.9	22.6	23.6	8.4	2.5	4.9	5.0	6.3	5.0
Credit extension to private sector, % yoy	54.5	60.4	33.7	0.9	4.7	6.6	-0.7	5.0	6.5
Policy Interest Rate, % eop	8.75	7.50	10.25	8.00	6.25	6.00	5.25	5.25	5.50
1 month inter-bank rate, %, eop	8.67	8.24	15.35	10.60	4.05	5.72	5.65	5.85	6.10
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/US\$, eop	2.56	2.47	2.89	2.96	3.17	3.33	3.37	3.33	3.23
RON/US\$, avg	2.80	2.43	2.50	3.04	3.17	3.04	3.46	3.35	3.27
RON/EUR, eop	3.38	3.61	4.03	4.24	4.24	4.32	4.45	4.30	4.20
RON/EUR, avg	3.52	3.33	3.68	4.24	4.21	4.24	4.46	4.35	4.24
<b>Balance of Payments, USD bn</b>									
Current account	-12.8	-22.9	-23.8	-6.8	-7.3	-8.3	-6.5	-7.0	-9.0
% of GDP	-10.4	-13.4	-11.6	-4.2	-4.4	-4.5	-3.9	-3.8	-4.5
Trade balance	-14.8	-24.4	-28.1	-9.6	-10.1	-10.3	-9.4	-9.3	-9.4
Exports	32.5	40.5	49.6	40.5	49.6	63.0	57.9	62.0	66.8
Imports	47.2	64.9	77.7	50.1	59.6	73.3	67.3	71.4	76.1
Service balance	0.0	0.6	1.0	-0.4	0.5	0.5	0.7	0.5	0.6
Income balance	-4.1	-5.7	-5.4	-2.6	-2.5	-3.1	-2.1	-2.6	-7.2
FDI, net	11.0	9.7	13.7	5.0	3.0	2.6	2.0	2.2	4.8
International reserves	28.1	37.3	36.5	39.4	42.3	42.4	41.6	42.7	46.1
Total amortisations	8.6	12.2	18.1	17.7	19.7	19.6	23.4	22.6	22.3
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-1.7	-2.3	-4.8	-7.3	-6.4	-4.3	-2.2	-2.2	-2.5
Consolidated gov primary balance	-0.6	-1.5	-3.9	-5.7	-4.9	-2.6	-0.4	-0.4	-0.7
Public debt	18.4	19.8	21.3	29.4	37.1	40.1	41.1	39.9	39.0
of which Domestic	6.7	10.2	12.6	15.4	19.8	22.0	20.2	20.7	20.4
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	51.7	80.3	105.8	113.0	122.4	137.3	126.4	135.4	143.5
Public	13.1	13.9	14.2	19.6	24.8	28.9	31.0	31.0	32.5
External debt / GDP	42.1	47.0	51.8	68.7	74.3	75.2	75.3	74.0	72.0
External debt / XGS	131.0	160.8	169.4	224.4	209.7	187.8	187.1	186.9	184.3
Short-term debt	16.7	28.7	28.5	22.5	26.2	29.5	28.9	28.4	29.9
Short-term debt/International reserves (%)	59.6	77.1	78.1	57.0	61.9	69.7	69.5	66.6	64.8
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	-0.3	0.3	0.4	0.5	1.4	2.0	2.4	2.8	3.0
CPI, % yoy	5.3	5.0	5.7	5.9	4.2	4.5	3.7	3.6	3.5
Policy interest rate, %, eop	5.25	5.25	5.25	5.25	5.25	5.25	5.50	5.50	5.50
Short-term market rate, % eop	5.49	6.04	5.75	5.75	5.75	5.75	6.00	6.00	6.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/EUR, eop	4.54	4.45	4.40	4.36	4.33	4.30	4.28	4.25	4.22

Source: National Sources, Citi Research

## Russia

Natalia Novikova  
+7 495 643 1507  
[natalia1.novikova@citi.com](mailto:natalia1.novikova@citi.com)

David Lubin  
+44 (20) 7986-3302  
[david.p.lubin@citi.com](mailto:david.p.lubin@citi.com)

- **Summary view** — Russia is likely to maintain 3% growth in 2013, should the external environment remain supportive. However, there are risks from a further slowdown in consumer spending and falling producer expectations.
- **Things to watch** — The CBR is under pressure to support the economy. We forecast inflation to remain at about 7% in 2Q, slowing down to 5.9-6% by December. We expect a cut in 2H 2013.
- **Strategy** — External corporate borrowings and tight liquidity likely to keep ruble below 35/BASK in the short run. Meanwhile the CBR tends to intervene asymmetrically – more interventions when the ruble is appreciating.

### Growth is unlikely to exceed 3% in the coming years

**GDP growth is decelerating faster than consensus, but broadly in line with our expectations**, falling to 2.2%YoY in 4Q12 from 4.5%YoY in 1H12. In January retail sales slowed to 3.5% from 7.4% in 1H2012 as effects of the pre-election spending tapered off. Industrial production turned negative YoY and investments stagnated. The post-crisis catch up is largely over in our view.

**Medium-term potential is probably about 3%.** Using credit to boost GDP growth above potential is likely to be counter-productive. Without investments and productivity improvements even 3% growth might be hard to achieve as labour supply is expected to be flat at best. We believe pre-crisis real wages grew in double digits as a result of the economy overheating, rather than real improvements in productivity. Large oil-driven inflows were not fully sterilized causing strongly negative real rates. As a result of the Dutch disease manufacturing sector shrank.

### Budget effect on liquidity is about neutral in the short run

**Deficit could exceed budgeted 0.8% of GDP, according to our estimates.** We forecast annual gap of the consolidated budget to reach about RUB800-1100bn. At the same time under the stable oil-price scenario, budget likely remain in surplus or balanced till 3Q and have neutral effect on banks liquidity from the budget operations in the next few months (except, probably May). In contrast to last year there are no massive wage increases in the beginning of 2013. Therefore we assume expenditures will be as usual skewed towards the end of the year. The new fiscal rule requires surplus oil proceeds resulting from oil being above US\$91/bbl to be transferred into the Reserve Fund. MinFin expects the transfer to reach RUB0.5tn. The MinFin plans to borrow net RUB0.5tn on the domestic market and US\$8.5bn from abroad should borrowing conditions be favorable. The excess borrowing is motivated by the need to develop local capital markets and increase banking system collateral for operations with the CBR.

### CBR on hold for now, easing ahead

**In March CBR left all policy rates on hold as we have expected.** In its statement CBR said rates are acceptable given the balance of macro risks: on the one hand inflation remains high (7.3%YoY in Feb) and growth in the consumer sector looks strong. On the other hand, investments and industrial production are weak. We are waiting for monetary easing in 2H 2013 including 50bp rate cut and narrower spread between repo and swap operations. Meanwhile CPI likely to moderate to 7%YoY in May, and the CBR could do a symbolic cut in refinancing rate in 2Q even before the new governor (expected former MinEcon minister, E. Nabiullina) takes the position.

**The government is committed to increase the investment-to-GDP ratio**, as was stated in the President's post-election promises. While most of the work is concentrated on improving the business climate, there is likely to be significant pressure on the CBR to chip in with cheap, possibly long-term, funding. Further developments will depend crucially on the next governor. The current governor's term expires in June 2013.

**In the monetary policy guidelines for 2013-2015, the CBR plans to introduce updates to monetary policy.** The regulator plans to provide repo with maturity of more than 1 week at a floating rate. We view this as a form of marginal loosening, since the banks are reluctant to borrow long-term under the current high 7-8% rates. The CBR also intends to include precious metals in the list of eligible collateral. Furthermore, the regulator will try to coordinate tariff indexation and budget spending with the ministries. We doubt the government will abandon its plan of the 15% annual indexation of tariffs. However, we do not rule out the possibility that the CBR might adjust its inflation-measuring framework to better account for these first round effects in the administrative price changes (non-core components). The CBR also stated it would be introducing the third-party repo to allow banks to manage their securities portfolio pledged with the CBR. At the same time the CBR is taking supervisory measures to slow rapid uncollateralized consumer credit growth.

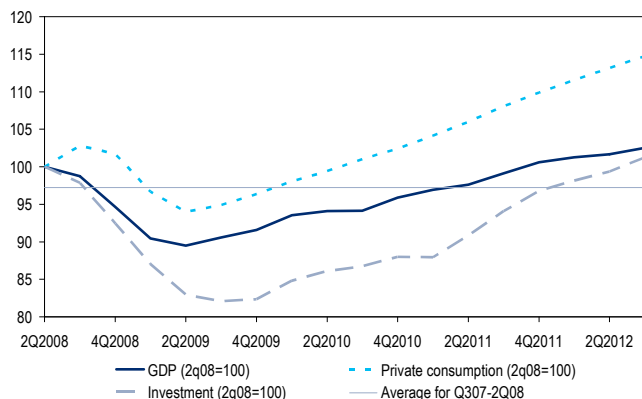
**We believe the proposed changes address most of the inefficiencies in the monetary transmission channel** such as refinancing and collateral risk. However, it is not clear whether the volume will be sufficient and secondly they still favour large banks. For example, the amount of precious metals on the balance sheet of the 30 largest banks is RUB160bn, while only RUB6bn is in the small banks. Still, the decrease of the reliance on the overnight CBR repo auctions will increase the role of the interdealer market and probably raise the role of the small banks in the transmission channels.

### **Ruble strengthening in 1Q13 is likely to be temporary**

**We expect the current account surplus to fall to about US\$50-60bn in 2013 from US\$80bn in 2012.** In our base case scenario of oil trading at US\$100/bbl next year, zero growth of oil extraction and slowing domestic demand we expect a weaker current account next year. The current account outlook might be more optimistic for three reasons: imports could be lower due to slower growth; migrant workers might keep more of their wages in Russia; the BP-Rosneft deal could bring US\$5bn annually in dividends.

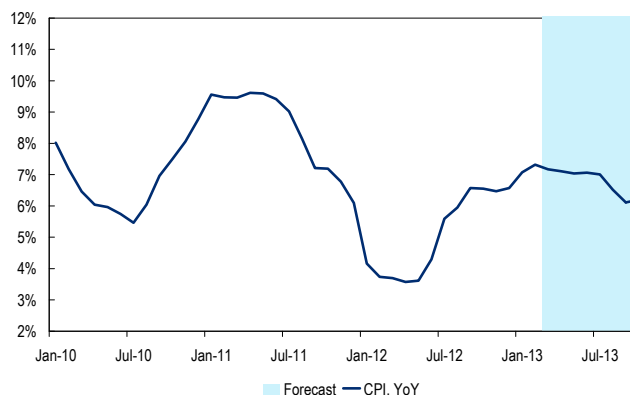
**External corporate borrowings and tight liquidity likely to keep ruble below 35/BASK in the short run.** Russian sovereign bonds became Euroclear in February and we expect corporate bonds to follow in the coming months. With the seasonally higher current account in 1Q, the ruble is likely to strengthen. However, we expect bond portfolio flows to become more volatile, and 1Q inflows might turn out to be impermanent. One takeaway from our meetings with authorities ([Russia Macro View - Trip Notes](#)) is that capital outflows will not necessarily slow when the current account declines, so we retain our view, over the longer term, the ruble is likely to weaken. Meanwhile the CBR is likely to continue intervening asymmetrically on the FX in order to provide domestic ruble liquidity. We expect ruble to weaken once CBR accommodative stance is confirmed and CA narrows in 2H.

Figure 192. The post-crisis catch up is largely over



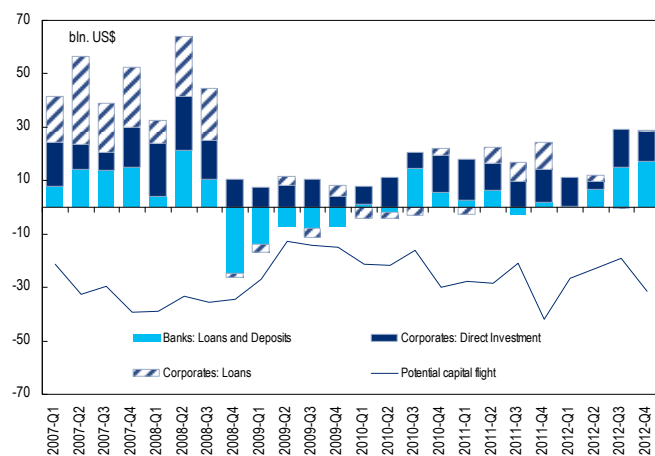
Source: Rosstat, Citi Research

Figure 194. Inflation is likely to stay near 6.5% in 2013



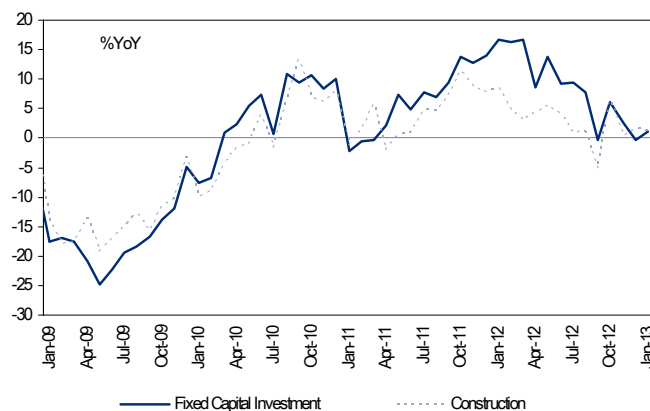
Source: Rosstat, Citi Research

Figure 196. While higher external borrowing helped cover capital outflows



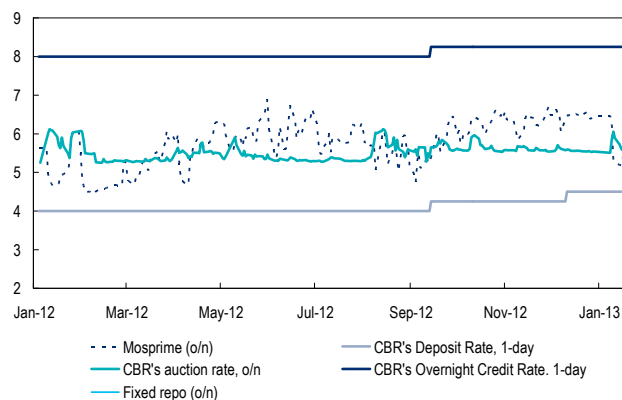
Source: CBR, Citi Research

Figure 193. High interest rates weight on investments



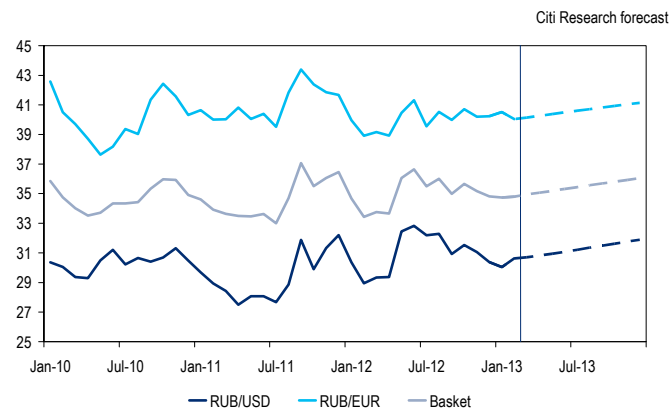
Source: Rosstat, Haver, CBR, Citi Research

Figure 195. CBR on hold for now



Source: Bloomberg, Citi Research

Figure 197. ...we are looking for weaker ruble in 2H



Source: Bloomberg, Citi Research

Figure 198. Russia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	990	1,300	1,661	1,223	1,487	1,850	1,945	2,165	2,309
Nominal GDP, local currency bn	26,917	33,247	41,277	38,807	45,173	54,586	60,455	67,744	75,009
GDP per capita, USD	6,898	9,070	11,601	8,546	10,404	12,955	13,629	15,189	16,216
Population, mn	143.5	143.3	143.2	143.1	143.0	142.8	142.7	142.6	142.4
Unemployment, % of labour force	7.2	6.1	6.4	8.4	7.5	6.6	5.7	6.5	7.0
<b>Economic Activity</b>									
Real GDP, yoy avg	8.2	8.5	5.2	-7.8	4.5	4.3	3.4	3.0	3.6
Real investment growth % yoy	17.7	22.0	10.5	-41.0	28.8	20.8	5.3	4.3	6.2
Real consumption growth % yoy	8.8	10.7	8.4	-3.9	3.3	4.8	5.5	4.2	4.1
private consumption growth % yoy	11.9	14.2	10.4	-5.1	5.1	6.3	6.6	5.0	5.0
Real export growth, % yoy	7.3	6.3	0.6	-4.7	7.0	0.4	1.8	1.1	1.7
Real import growth, % yoy	21.3	26.2	14.8	-30.4	25.8	20.3	8.7	4.5	4.5
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	9.0	11.9	13.3	8.8	8.8	6.1	6.6	6.2	5.0
CPI, % avg	9.7	9.0	14.1	11.6	6.8	8.4	5.1	6.7	5.4
Nominal wages, % yoy	25.5	26.0	27.4	9.1	12.8	11.7	13.3	8.0	7.0
Credit extension to private sector, % yoy	48.7	49.3	37.2	2.6	12.9	28.1	19.4	18.0	15.0
Policy Interest Rate, % eop	11.00	10.00	13.00	8.75	7.75	8.00	8.25	7.75	7.00
1 month inter-bank rate, %, eop	5.71	6.09	20.20	6.32	3.78	6.37	6.90	6.04	4.99
Long-term yield, %, eop	6.60	6.58	10.90	9.45	8.23	8.77	8.00	7.20	7.00
RUB/US\$, eop	26.3	24.6	30.5	30.3	30.6	32.2	30.6	31.9	32.8
RUB/US\$, avg	27.2	25.6	24.9	31.7	30.4	29.4	31.1	31.3	32.5
RUB/EUR, eop	34.7	35.9	42.7	43.4	40.9	41.7	40.3	41.1	42.6
RUB/EUR, avg	34.2	35.1	36.6	44.2	40.3	41.0	40.0	40.7	42.1
<b>Balance of Payments, USD bn</b>									
Current account	94.7	77.8	103.5	48.6	95.3	122.2	81.1	60.2	20.6
% of GDP	9.6	6.0	6.2	4.0	6.4	6.6	4.2	2.8	0.9
Trade balance	139.3	130.9	179.7	111.6	151.7	198.2	195.4	178.6	141.0
Exports	303.6	354.4	471.6	303.4	400.4	522.0	530.8	523.6	520.0
Imports	164.3	223.5	291.9	191.8	248.7	323.8	335.4	345.0	379.0
Service balance	-13.6	-18.9	-24.3	-19.8	-7.8	-12.6	-44.7	-46.8	-48.4
Income balance	-29.4	-30.8	-49.2	-40.3	-48.6	-60.2	-64.9	-67.6	-67.0
FDI, net	6.6	9.2	19.4	-7.2	-9.2	-14.4	-18.1	12.4	22.3
International reserves	295.3	466.4	410.7	405.8	432.9	441.2	452.5	464.0	474.6
Total amortisations	0.4	0.4	30.4	117.0	90.0	60.0	50.0	72.7	75.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	9.4	6.7	5.3	-5.7	-3.3	2.0	-0.7	-2.0	-4.2
Consolidated gov primary balance	10.0	7.2	5.6	-5.2	-2.8	2.5	-0.1	0.4	-2.1
Public debt	8.3	6.6	5.2	7.3	7.8	8.4	7.9	7.7	10.1
of which Domestic	3.8	3.8	3.4	4.7	5.4	6.5	6.0	5.6	7.9
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	308.8	471.2	480.0	469.7	489.7	509.7	519.7	507.0	492.0
Public	44.7	37.4	29.5	31.3	34.5	34.7	38.1	44.1	50.8
External debt / GDP	31.2	36.3	28.9	38.4	32.9	27.5	26.7	23.4	21.3
External debt / XGS	92.3	119.7	91.8	136.2	109.9	88.5	87.5	87.5	85.8
Short-term debt	40.6	100.3	73.0	48.0	53.0	58.0	65.5	67.3	68.6
Short-term debt/International reserves (%)	13.8	21.5	17.8	11.8	12.2	13.1	14.5	14.5	14.5
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	2.9	2.2	2.2	2.7	3.3	3.6	3.8	3.7	3.5
CPI, % yoy	6.6	6.6	7.2	7.1	6.1	6.2	5.7	5.2	5.5
Policy interest rate, %, eop	8.25	8.25	8.25	8.25	8.00	7.75	7.75	7.50	7.50
Short-term market rate, % eop	6.42	6.85	6.25	6.29	5.84	6.24	5.42	4.99	4.99
Long-term yield, %, eop	8.16	7.04	7.45	7.39	6.89	7.14	7.02	6.99	6.99
RUB/US\$, avg	32.0	31.1	30.7	31.1	31.5	31.9	32.1	32.4	32.6

Source: National Sources, Citi Research

## Slovakia

Jaromir Sindel  
+ 420 233 061 485  
[jaromir.sindel@citi.com](mailto:jaromir.sindel@citi.com)

- **Summary view** — Although the recent downward revision shows a milder GDP dynamics accompanied with a milder growth of industrial production, we keep our forecast of a further deceleration of GDP growth to 0.7%YoY in 2013 from 2% in 2012.
- **Things to watch** — Central government budget dynamics have disappointed this year. The government budget has improved only slightly in first two months of 2013, while annual deficit is even somewhat wider compared to year ago.
- **Strategy** — There has not been an issuance of bonds after €1.75bn of first 10Y bond in late February this year that kept a total year-to-date bond issuance at €4.2bn compared to ARDAL plan of total GBR at €8.3bn in 2013.

### Keeping our current GDP forecasts despite revisions

**Although the recent downward revision shows a milder GDP dynamics accompanied with a milder growth of industrial production, we keep our forecast of a further deceleration of GDP growth to 0.7%YoY in 2013 from 2% in 2012** owing to the subdued foreign outlook demand and the likely introduction of new fiscal measures to keep the consolidation process on track. Our forecast of 2013 and 2014 GDP growth (0.7% and 1.6%) is below MinFin's expectation of 1.2% and 2.9%. Our variances can be explained in particular by our expectation of milder foreign demand as we estimate GDP growth of Slovak trade partners to be around 0.6-0.8%YoY in 2014, while Slovak MinFin expects 1.8%.

**We have said for a long-time that we do not believe Slovak statistics are completely reliable.** We have argued that there has been a large "errors and omissions" item in the balance of payments that reached -4.3% of GDP in 2012 after -5.5% in 2011. That signaled to us a possible overestimate of the value added part of GDP. The recent GDP data releases were accompanied with downward revisions to previous quarters that now put average QoQ growth to 0.3% in 1Q-3Q12 from 0.6% previously. This was accompanied with a downward revision of industrial production for the full year 2012 was revised to 8.2%YoY from the 10.3% previously reported (and to 5.5% from 7% in 2011). The revision particularly applied to the transport equipment production industry (likely particularly car production). Its growth was revised downward to an average 26%YoY in 2012 from 44% initially. We think the revised time series data are more in line with the development in the economy, the employment, and revenues of the state budget.

**Confidence indicators were mixed in February and we forecast the industrial production to increase by around 1.5% in 2013 (from -4% previously) due to less adverse base effect.** However, the manufacturing confidence, though improved in February, still suggests a drop in industrial production by 5%YoY in the near-term. However, these downside risks are somewhat limited by the composition of development in manufacturing confidence. While the car industry has eased its better expectations, they are still above levels seen in 4Q12 and, moreover, the assessment of order books has even markedly improved. By contrast, the confidence in steel and electronics industry worsened, both owing to expectations and orders books.

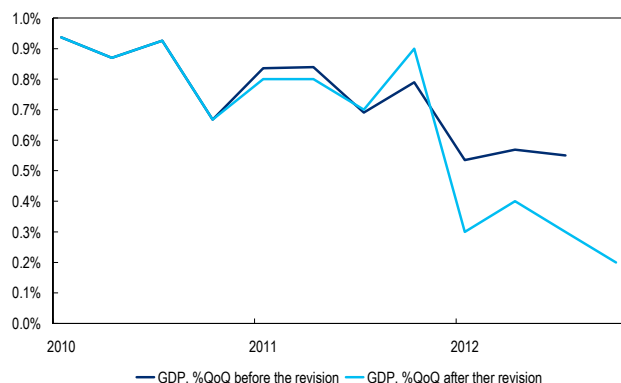
## Central government deficit has improved only marginally

**The government budget has improved only slightly in first two months of 2013, while annual deficit is even somewhat wider compared to year ago.** The central government deficit reached -€0.7bn in the first two months of 2013, narrower by €132mn compared to the same period in 2012. The improvement reflects a drop in expenditures (-5%YoY year-to-date), while revenues slightly increased (+1.4%). As a result, the 12m cumulative budget deficit is €3.7bn in February, only marginally better compared to €3.8bn a year ago (-5.1% of GDP vs. -5.4% of GDP a year ago). As we noted earlier the MinFin has already reflected the prospect of weaker economic growth in its tax prospects, as seen in the additional gap of €361mn in 2013. Nevertheless, for the time being we do not expect the MinFin to struggle in 2013 unless there is a larger-than-expected drop in domestic demand (MinFin expect the growth of effective domestic demand around 0.2%YoY), particularly the total consumption that fell by around 1%YoY in 4Q12 together with more than 6% drop in fixed investment. We think that MinFin's budget pegs the ECB policy rate at 0.57% in 2013 and 1% in 2014. That is higher than our expectations of 0.25% from 2H13. The approved budget for 2013 includes a reserve of up to €542mn, but if our forecast is right and GDP this year only grows 0.7%YoY rather than the 1.2% expected by MinFin, then this reserve will likely be depleted. However, current recovery (despite very solid compared to regional peers and the Euroarea average) represent a new, not benign, era for the government finances as the nominal GDP growth is much slower at average 4.4%YoY in 2010-2012 vs. 10% in 1996-2008.

**There has not been an issuance of bonds after €1.75bn of first 10Y bond in late February this year that kept a total year-to-date bond issuance at €4.2bn** (of which 75% were bought by non-residents) compared to ARDAL plan of total GBR at €8.3bn in 2013 that increased from €7.7bn in 2012. If we take into account that the State Treasury had around €4bn in cash at the end of 2012 (which can be used if needed, as was done in 2011) and there was a maturity of €1.5bn in 1Q13 and the central government deficit is likely to reach €1.2bn in that period, we could estimate the financing reserve at €1.5bn without the State Treasury (and €5.4bn with the Treasury). While it (without Treasury) covers the remaining maturity of bonds in 2013, it does not cover the likely another €1bn of the central government deficit in 2Q-4Q13 (or even another €2bn if the adverse dynamics in the central government deficit remains in place).

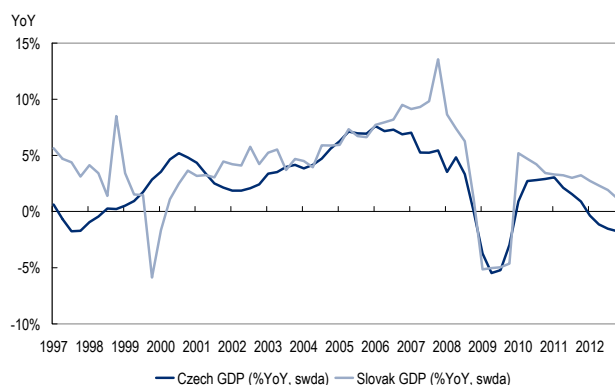
**From a relative credit point of view, the Slovak fiscal consolidation experience has been worse compared to Slovenia** where the central government deficit has been narrowed down to around -3% of GDP in January 2013 from -4.5% in January/February 2012 even as its GDP contracted by 2.2%YoY in 2012 while Slovak GDP increased by 2.2%. However, in contrast to Slovenia, Slovakia does not suffer from political instability nor does it face a bleak situation in the banking sector that will be actually fiscal costly in Slovenia.

Figure 199. GDP growth was revised downward



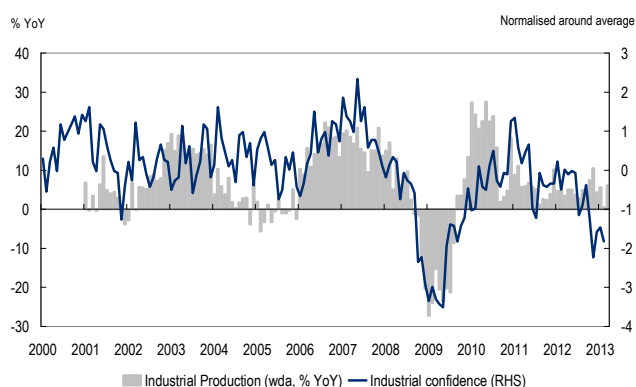
Source: Statistical Office of the Slovak Republic, Citi Research

Figure 201. Outperformance vs. Czech economy narrowed



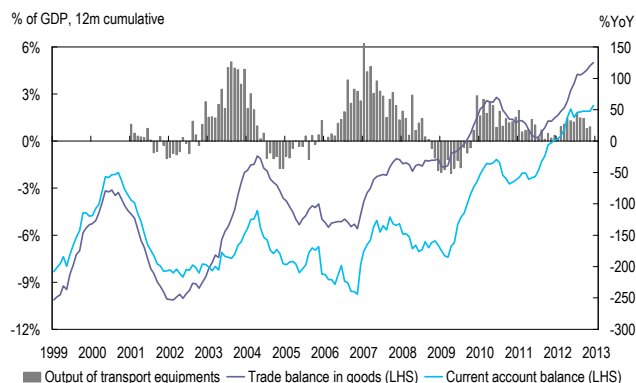
Source: Statistical Office of the Slovak Republic, CZSO, Citi Research

Figure 203. Industrial confidence remains subdued due to order-books



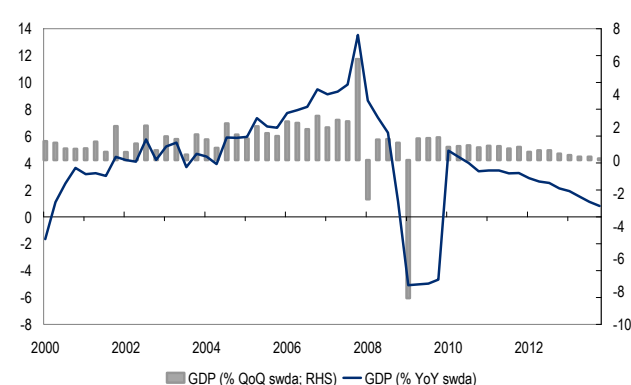
Source: Statistical Office of the Slovak Republic, Citi Research

Figure 200. Car production in 2012 was revised to 26%YoY from 44%



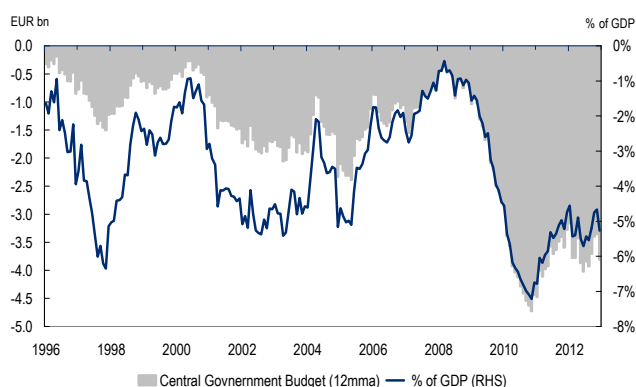
Source: Statistical Office of the Slovak Republic, Haver Analytics, Citi Research

Figure 202. We expect Slovak GDP growth to decelerate further



Source: Statistical Office of the Slovak Republic, Citi Research

Figure 204. Central gov't deficit remains virtually unchanged - elevated



Source: Haver Analytics and Citi Research calculation.

Figure 205. Slovakia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	56	75	95	88	87	96	92	97	100
Nominal GDP, local currency bn	55	61	67	62	66	69	71	73	77
GDP per capita, USD	10,371	13,872	17,410	16,076	15,995	17,585	16,777	17,694	18,237
Population, mn	5.4	5.4	5.4	5.5	5.5	5.5	5.5	5.5	5.5
Unemployment, % of labour force	10.4	8.4	7.7	11.4	12.5	13.2	13.6	14.8	15.4
<b>Economic Activity</b>									
Real GDP, yoy avg	8.3	10.5	5.8	-4.9	4.4	3.2	2.0	0.7	1.6
Real investment growth % yoy	6.1	9.7	4.7	-31.5	19.9	10.2	-10.3	-22.8	15.2
Real consumption growth % yoy	6.6	5.1	6.1	1.6	-0.3	-1.5	-0.6	-0.2	0.4
private consumption growth % yoy	5.9	6.8	6.1	0.2	-0.7	-0.5	-0.6	0.1	0.5
Real export growth, % yoy	21.0	14.3	3.1	-16.3	16.0	12.7	8.6	3.3	2.9
Real import growth, % yoy	17.8	9.2	3.1	-18.9	14.9	10.1	2.8	1.3	2.4
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	4.2	3.4	4.4	0.5	1.3	4.4	3.2	2.6	2.4
CPI, % avg	4.5	2.8	4.6	1.6	1.0	3.9	3.6	2.2	2.5
Nominal wages, % yoy	8.6	7.5	8.2	3.0	3.3	3.0	2.2	2.0	2.3
Credit extension to private sector, % yoy	23.7	22.7	17.4	0.8	4.8	8.6	2.9	2.0	5.4
<b>Balance of Payments, USD bn</b>									
Current account	-5.0	-4.1	-5.9	-2.3	-3.3	-1.9	2.1	3.5	3.3
% of GDP	-8.9	-5.4	-6.2	-2.6	-3.7	-2.0	2.3	3.6	3.3
Trade balance	-3.2	-1.0	-1.1	1.3	1.0	1.4	4.7	6.2	6.2
Exports	51.4	64.9	72.9	55.4	64.0	79.0	80.7	85.1	87.0
Imports	54.6	65.9	74.0	54.1	63.0	77.6	76.0	78.8	80.8
Service balance	0.8	0.5	-0.7	-1.4	-1.0	-0.5	0.4	0.5	0.7
Income balance	-2.5	-3.2	-2.8	-1.2	-2.7	-2.3	-2.2	-2.7	-3.1
FDI, net	4.2	3.0	4.3	-0.9	0.8	1.7	1.5	1.2	1.0
Total amortisations	1.6	1.7	1.7	1.8	2.1	2.1	2.3	2.5	2.6
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-2.6	-1.6	-2.0	-8.0	-7.7	-4.9	-5.1	-3.2	-2.9
Consolidated gov primary balance	-1.7	-0.4	-0.8	-6.6	-6.3	-3.2	-3.6	-1.7	-1.4
Public debt	30.5	29.6	27.9	35.6	41.1	43.3	52.1	53.5	54.4
of which Domestic	22.5	20.1	19.1	20.3	25.5	30.6	33.2	35.0	36.0
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	32.2	44.3	52.5	65.3	65.8	68.5	76.3	80.8	84.8
Public	7.7	9.5	10.3	11.4	13.3	15.5	17.7	19.7	20.8
External debt / GDP	57.3	58.8	55.5	74.5	75.3	71.2	83.0	83.2	84.6
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	11.1	17.4	20.1	30.3	29.9	29.8	34.6	34.9	36.7
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	1.9	1.2	3.2	0.8	-0.6	2.0	2.2	2.3	2.4
CPI, % yoy	3.6	3.2	2.3	2.2	2.0	2.6	2.5	2.5	2.5
Short-term market rate, % eop	0.12	0.11	0.10	0.02	-0.01	-0.03	-0.03	-0.03	-0.03
Long-term yield, %, eop	2.68	2.91	3.15	2.90	3.25	3.00	3.20	2.90	3.20

Source: National Sources, Citi Research

## South Africa

David Cowan  
+44 20 7986 3285  
[david.cowan@citi.com](mailto:david.cowan@citi.com)

Gina Schoeman  
(On Leave)

- **Summary view** — We continue to see socio-political issues as a major theme owing to union rivalry and the looming 2014 National Elections. This also means that we expect only a slight improvement in GDP growth to 2.8% in 2013.
- **Things to watch** — Despite inflation remaining around the top of the SARB band of 3-6% we still think the MPC will leave rates unchanged for some time. With no narrowing of the current account deficit and weak growth the rand will remain under pressure and the rating agencies might make further downgrades in our view.
- **Strategy** — With the monetary and fiscal policy options increasingly limited, against the background of rising political and social unrest, we do expect the government to come under pressure to really address the structural obstacles constraining economic growth and employment creation.

### Mining 'strikes' again

**4Q 2012 GDP growth was once again held back by the mining sector as ongoing labour unrest and operational closure in the mining sector pushed production down to a record low since the 2009 recession.** Moreover, the outlook for mining looks bleak as labour unrest continues in the sector, although a concord between government, Anglo American and the National Union of Mineworkers is a positive for the sector. But the absence of rival union AMCU is a concern as inter union rivalry has also been a factor in the recent unrest. The retail sector is also losing momentum as consumers remain stretched and real income growth wanes due to rising inflation. In 2013, higher inflation, a pull-back in unsecured lending and government's attempts to contain the public sector wage bill mean that we only expect a sideways move in consumption growth.

**A positive development in Q4 was improved manufacturing production but we remain wary of the beneficiation link between it and the mining sector.** What's more, as low business confidence persists, private sector investment is unlikely to expand rapidly; instead, we believe it will be geared toward only replacing and maintaining current capex. This may limit private sector capital imports, but government's commitment to infrastructure means that the public sector imports remain resilient. Exports should see some growth in 2013 as production levels eventually normalise however, we do not believe this will be enough to narrow the current account deficit substantially. Overall, we look for GDP to only pick up slightly in 2013, to 2.8% (from 2.4% in 2012).

**A significantly narrower current account deficit is unlikely in 2013.** End-2012 trade figures disappointed, particularly in December where, due to importers front-loading festive season inventory into November, typically allows exports to push the trade balance into a surplus. But, because of persistent mine closures, exports fell harder than usual and the trade balance remained in deficit. We believe it will be even more disappointing when the 2013 current account deficit proves to narrow at a slower pace than the current consensus suggests. Some normalisation in exports will help however, flare-ups in labour unrest will count against this while resilient imports (owing to consumption and public sector infrastructure demands) means the current account deficit averages a still-wide 5.7% of GDP in 2013 (6.0% in 2012) in our view. The financing of the deficit remains questionable given that except for offshore bond inflows, appetite for equities and FDI is expected to remain scant so long as economic growth remains at sub-par levels.

## Limited policy flexibility to counter rising inflation

**Socio-economic issues such as labour unrest and political uncertainty, together with a wide current account and budget deficit means that the ZAR vulnerable and by year-end we expect ZAR9.5/USD1.** A 10-15 month lag between currency depreciation and a rise in inflation means that the ZAR weakness that has persisted since Q2 12 is starting to show up more meaningfully in the inflation trajectory. January CPI may have slowed to 5.4% YoY but this was mostly due to once-offs and the introduction of the new CPI basket.

**Currency pass-through and food inflation is still expected to push CPI above the 6% target ceiling in Q2 13.** For CPI food, a 6-9 month lag within the supply chain means that higher grain prices in mid-2012 are already pushing through. A weaker currency will only exacerbate this. The newly weighted CPI basket will also place upward pressure on consumer prices and according to our calculations, will add around 0.3pp to overall 2013 inflation. This is mostly due to a stronger bias toward administered pricing. A blatant example of this will show up in mid-2013 when electricity tariffs are hiked. Following a breach of the 6% target ceiling in Q2 13, we expect a peak of 6.58% in Q3 before CPI tapers back within the target band.

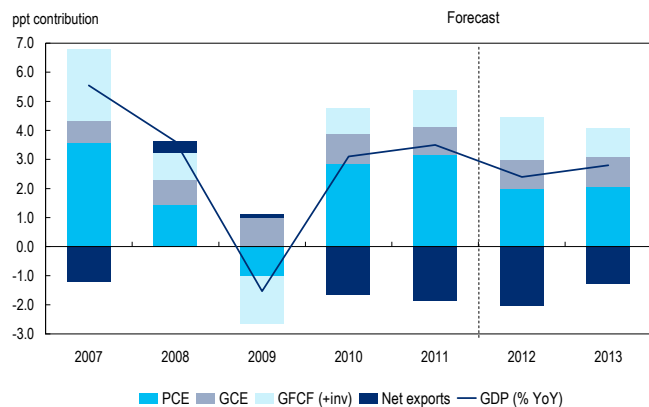
**Sub-par GDP growth means the SARB will remain tolerant of inflationary pressures.** Even though the most recent MPC statements have laboured the upside risks to inflation (currency, food and wages) which have pushed the SARB's inflation outlook higher (and above the 6% target ceiling for a short period), poor GDP growth rates have led to a degree of inflation tolerance. The SARB appears intent on only responding only if the inflation rate remains outside the target band on a sustainable basis. This, alongside sub-par GDP expected in 2013 leaves us expecting policy rates unchanged (repo at 5.0%) until at least Q4 14. We would add that the near-term risk for rates remains a cut, rather than a hike, but this is only if inflation changes course and heads down rapidly over coming months and/or unforeseen global tail risks push GDP expectations far lower.

## The showdown between fiscal policy and politics

**Fiscal policy is both constrained by recent ratings downgrades yet still pressurized by political needs.** Lower growth projections have once again forced a widening in the path of fiscal consolidation over coming years. Revenue projections have been lowered off the back of lower nominal GDP growth estimates yet at the same time, expenditure remains rigid due to the political limitation of cutting back social spending (particularly ahead of the 2014 National Election) and the watchful eye of rating agencies that infrastructure expenditure remains a priority.

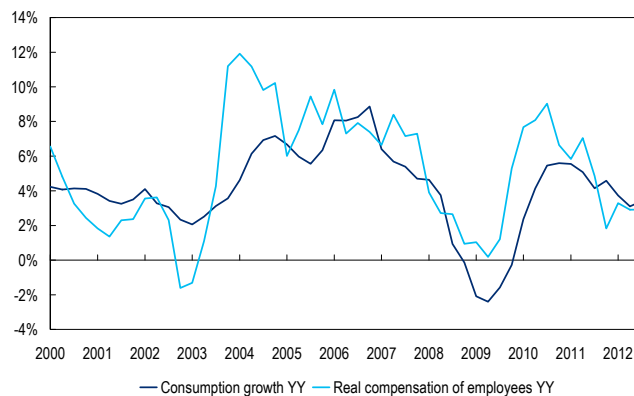
**This has left Treasury with little scope other than reprioritization of policies.** In particular, an announced assessment of tax policy means that previous concerns that government would look to match public sector expenditure needs with higher taxes will be felt in future budgets. The mining sector is certainly at risk with a variety of resources taxes already mooted and we caution that on top of labour unrest, production cuts and higher electricity tariffs, any unreasonable tax burden would further detract from the sector's attractiveness as an investment destination. We also caution that on the whole, a slower path of fiscal consolidation requires more financing and with national government debt already pushing above 40% of GDP in the outer years, investors and rating agencies are likely to remain wary of South Africa's fiscal sustainability.

Figure 206. GDP to remain lackluster in 2013



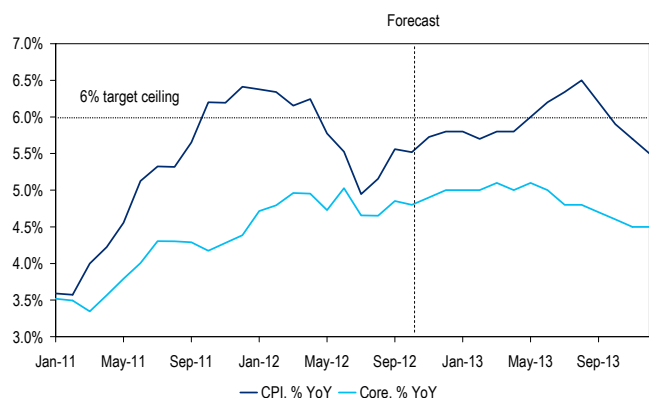
Source: SARB, Citi Research Projections

Figure 207. Consumption is slowing as real incomes decelerate



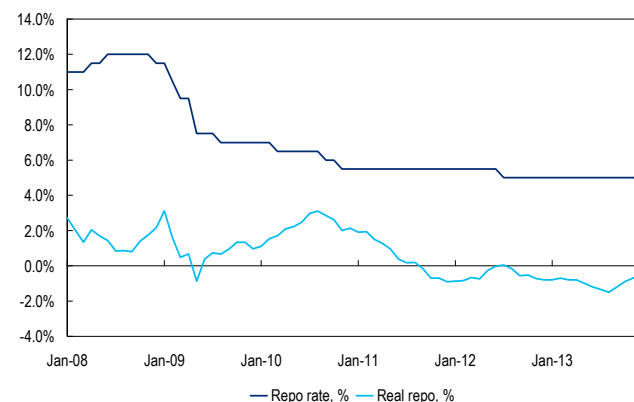
Source: SARB, Citi Research calculations

Figure 208. A temporary breach of the CPI ceiling in Q3 13



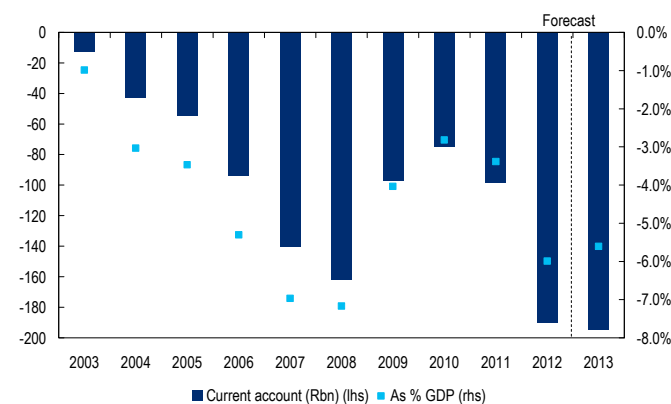
Source: Stats SA, Citi Research projections.

Figure 209. Negative real rates suggest further cuts unlikely



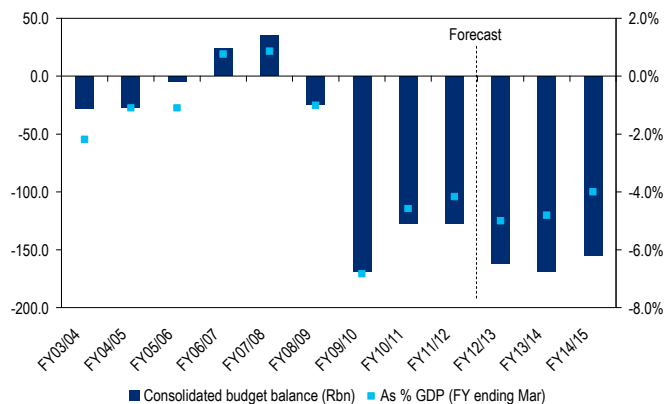
Source: SARB, Stats SA

Figure 210. No meaningful narrowing in the current account deficit



Source: SARB, Citi Research projections

Figure 211. Fiscal consolidation will likely be slow



Source: National Treasury, Haver Analytics, Citi Research projections

Figure 212. South Africa Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	261	286	273	287	364	402	385	380	400
Nominal GDP, local currency bn	1,767	2,016	2,256	2,406	2,659	2,918	3,160	3,430	3,750
GDP per capita, USD	5,511	5,993	5,613	5,820	7,272	8,039	7,533	7,346	7,660
Population, mn	47.3	47.7	48.7	49.3	50.0	50.0	51.1	51.7	52.3
Unemployment, % of labour force	23.9	23.3	22.9	24.0	25.5	125.5	25.7	26.5	27.0
<b>Economic Activity</b>									
Real GDP, yoy avg	5.6	5.5	3.6	-1.5	3.1	3.5	2.4	2.8	3.1
Real investment growth % yoy	12.9	12.0	4.4	-8.6	4.5	6.3	7.0	4.7	7.3
Real consumption growth % yoy	7.5	5.2	2.8	-0.1	4.6	4.8	3.4	3.5	3.8
private consumption growth % yoy	8.3	5.5	2.2	-1.6	4.4	4.8	3.0	3.1	3.4
Real export growth, % yoy	7.5	6.6	1.8	-19.5	4.5	5.9	-0.6	0.2	3.1
Real import growth, % yoy	18.3	9.0	1.5	-17.4	9.6	9.7	7.8	4.1	6.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	481.9	757.1	934.3	604.2	337.2	641.2	5.7	5.5	5.2
CPI, % avg	324.4	617.9	1,004.8	722.2	408.3	502.2	5.7	5.9	5.3
Nominal wages, % yoy	6.5	6.8	9.8	8.9	7.8	7.2	7.5	8.0	8.3
Credit extension to private sector, % yoy	25.8	21.5	13.6	-0.1	5.5	6.2	7.6	10.5	12.0
Policy Interest Rate, % eop	9.00	11.00	11.50	7.00	5.50	5.50	5.00	5.00	5.50
1 month inter-bank rate, %, eop	8.98	11.18	11.35	6.94	5.44	5.47	5.02	5.10	5.60
Long-term yield, %, eop	7.86	8.58	7.33	9.05	8.14	7.93	6.39	7.40	8.00
ZAR/US\$, eop	7.01	6.87	9.49	7.41	6.62	8.09	8.46	9.50	9.50
ZAR/US\$, avg	6.77	7.05	8.27	8.41	7.32	7.26	8.21	9.39	9.50
<b>Balance of Payments, USD bn</b>									
Current account	-13.8	-19.9	-19.6	-11.6	-10.2	-13.6	-23.2	-21.6	-21.9
% of GDP	-5.3	-7.0	-7.2	-4.0	-2.8	-3.4	-6.0	-5.7	-5.5
Trade balance	-4.3	-5.2	-4.3	0.3	3.7	2.3	-9.3	-8.3	-12.8
Exports	66.1	76.2	85.3	66.4	85.5	102.8	89.4	91.3	92.9
Imports	70.4	81.4	89.6	66.1	81.8	100.6	98.7	99.7	105.7
Service balance	-2.1	-2.7	-4.1	-2.8	-4.4	-4.7	-2.4	-3.3	-3.2
Income balance	-5.1	-9.8	-8.9	-6.4	-7.2	-9.2	-8.0	-6.6	-3.2
FDI, net	-6.6	1.8	12.5	4.2	4.8	4.8	3.4	3.2	3.2
International reserves	23.1	29.6	30.6	35.3	38.2	42.6	50.0	52.8	54.0
Total amortisations	2.0	1.8	2.0	2.5	1.4	1.4	7.3	4.2	4.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.8	0.9	-1.0	-5.2	-4.9	-3.9	-5.0	-5.2	-5.0
Consolidated gov primary balance	3.6	3.3	1.9	-3.1	-2.7	-1.6	-2.6	-2.1	-1.9
Public debt	32.6	28.3	27.3	30.9	35.3	39.2	40.6	42.1	43.3
of which Domestic	28.1	24.5	22.9	27.3	32.0	35.4	36.5	37.9	39.3
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	51.2	63.0	60.4	63.8	80.6	89.7	85.2	91.8	95.0
Public	30.5	43.5	42.3	41.2	44.8	48.2	34.0	36.0	33.8
External debt / GDP	19.6	22.0	22.1	22.2	22.2	22.3	22.1	24.2	23.7
External debt / XGS	65.4	70.0	61.6	81.4	81.1	76.2	81.7	83.5	85.7
Short-term debt	20.6	24.0	25.5	21.3	21.7	20.5	19.2	19.8	20.0
Short-term debt/International reserves (%)	89.1	81.2	83.2	60.4	56.9	48.2	38.4	37.5	37.0
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	2.3	2.5	2.4	2.8	3.0	3.0	3.0	3.3	3.2
CPI, % yoy	5.6	5.7	5.8	6.2	6.2	5.5	5.4	5.1	5.0
Policy interest rate, %, eop	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
Short-term market rate, % eop	4.95	5.02	5.00	5.10	5.10	5.10	5.10	5.10	5.10
Long-term yield, %, eop	6.53	6.39	6.50	6.90	7.00	7.40	7.45	7.60	7.70
ZAR/US\$, eop	8.31	8.46	9.25	9.36	9.44	9.50	9.50	9.50	9.50

Source: National Sources, Citi Research

## Turkey

Ilker Domac  
+90 212 319 4623  
[ilker.domac@citi.com](mailto:ilker.domac@citi.com)

Gultekin Isiklar  
+90 212 319 4915  
[gultekin.isiklar@citi.com](mailto:gultekin.isiklar@citi.com)

- **Summary view** — The outcome of the February MPC meeting suggests that the CBT has become more aggressive on its intention to weaken the currency, while turning more complacent on inflation.
- **Things to watch** — Developments in the Middle East, the ongoing negotiations in Turkey on the Kurdish issue and discussions on a new constitution deserve close monitoring.
- **Strategy** — We think that the CBT's willingness to sacrifice inflation and the currency may further undermine investor's appetite in Turkish assets

### Hard data on growth continues to paint a mixed picture

**Recent data on economic activity corroborates our view that economy will continue to expand slowly in 2013.** The January import outturn, coupled with the recent PMI and consumer confidence prints, points to a relatively strong pick-up in economic activity. However, a number of key indicators such as capacity utilization, the unemployment rate and real sector confidence index raise doubts about the strength of the widely expected rebound. Against this backdrop, we believe that accommodative monetary policy and the stability of the lira are likely to boost domestic demand, as we continue to look for a GDP growth rate of about 4% this year from an estimated 2.5% in 2012. It is worth noting while we still stick to our 4% GDP growth for 2013, we take a less assertive stance than the CBT on this issue.

### January's current account signals tougher days ahead

**At US\$5.6 billion, the current account deficit in January came in wider than the consensus (US\$5.3bn).** With the January's print, the 12-month rolling current account deficit narrowed slightly to US\$46.8bn in January from US\$46.9bn previous month. In addition, the revised data on the current account series now puts the Turkey's 2012 current deficit at US\$46.9bn or about 5.8% of GDP (vs. US\$48.9bn using the old series). Despite the noted favorable developments, our analysis suggests that the recent data on external front point to a notable deterioration on the external front. For example, seasonally adjusted current account deficit widened markedly in January to an annualized level of \$54.8bn in January—highest since February 2012—from US\$46.4bn previous month, raising the likelihood of a sharp reversal on current account ahead. In addition, the poor quality of the external financing, which remains tilted toward short-term inflows, further aggravates our concerns on external front. All in all, we expect Turkey's current account deficit to widen from an estimated 5.8% of GDP in 2012 to about 6.8% this year, rendering the country vulnerable to sudden shifts in investor sentiment.

### February CPI raises further doubt on CBT's 2013 forecast

**At 7.0%YoY, the February inflation reading for the year came broadly in line with the consensus.** The absence of a meaningful improvement in inflation dynamics and the recent deterioration in core inflation lead us to believe that the CBT's 2013 inflation forecast of 5.3% remains on the optimistic side. Moreover, the risk of an abrupt FX movement remains high owing to the wide current account gap and the low level of interest rates, further complicates inflation dynamics. The noted backdrop, suggests to us that year-end inflation is likely to be around 7.5% – well above the 5% target and the CBT's most recent projection of 5.3%.

## The going is likely to get tougher for the CBT

**The CBT's excessive discretion and the changing rhetoric regarding its targets, as well as instruments, make it difficult to predict the future course of monetary policy.** With this caveat in mind, the January Inflation Report, the February MPC meeting and the recent comments of senior officials suggest to us that more of the same—further RRR hikes and further narrowing of the interest rate corridor—is likely going forward. We note that since the Bank's decision to narrow the interest rate corridor depends mainly on the evolution of the lira; exchange rate developments around the time of the MPC meetings will shape the outcome. Consequently, the CBT may opt for RRR hikes alone if the lira goes outside the CBT's comfort zone, which, in our view, takes place when the TRY basket exceeds the 2.10 level

## Tax-and-spend approach underpins fiscal policy

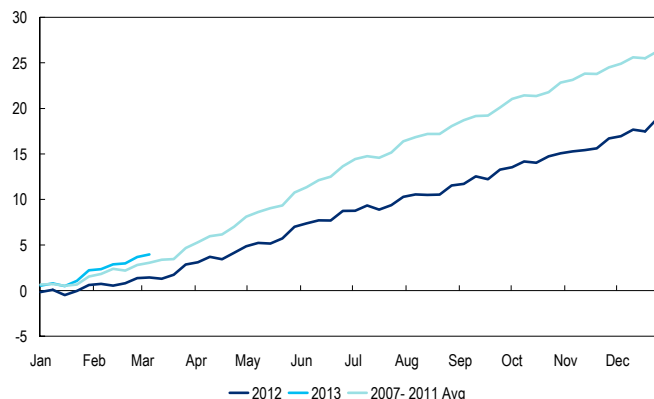
**Driven by transfers and investment expenditures, non-interest expenditures in February rose by about 26%YoY in real terms.** In our view, the noted unsustainable surge in primary spending is largely being concealed by strong increase in revenues. As a result, the overall budget deficit seems to be in check. The underlying fiscal position is, however, less favorable, as is evidenced by the evolution of the IMF-defined primary surplus, which excludes one-off revenues (e.g., privatization) and the CBT profit transfers to the Treasury. The noted definition of primary balance is barely in positive territory through February, with the wedge between the MoF and IMF definitions having reached an all time high (of near-TL20 billion). Looking ahead, we believe that the heavy election calendar (the likely referendum on a new constitution later this year and local as well as presidential elections in 2014) may intensify populist policies. We think that headline budget figures are unlikely to deteriorate markedly thanks to strong revenues. Nonetheless, if the recent sharp increase in non-interest expenditures continues, it could undermine budget performance and thus affect sentiment adversely.

## What is in store, as investors become more selective?

**Our recent discussions with investors in New York, Boston and London paint a more challenging outlook for Turkish assets going forward.** In light of our discussions, this can be attributed to three factors. First, investors have clearly turned less constructive on the lira, as the CBT's revealed preference for a weaker currency has become more evident following the February MPC meeting. Second, investors find it difficult to get excited about nominal bonds at the prevailing rates. Third, uncertainty and confusion surrounding monetary policy continues to undermine investors' interest in Turkish assets.

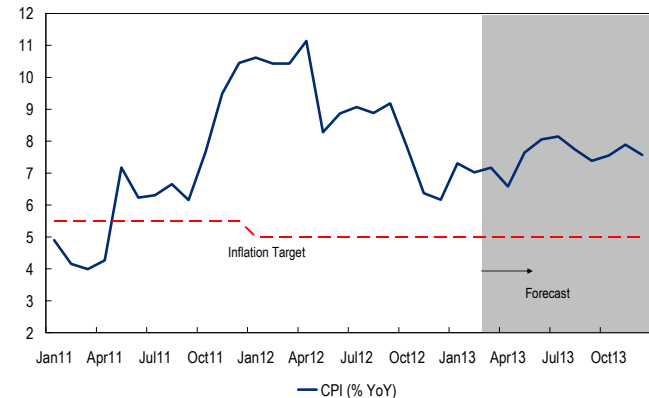
**In line with our recent findings ([Turkey Macro View - Lira Carry Trade: More Like 2011 or 2012?](#)), our recent meetings with investors confirm that Turkey's current interest rate differential fails to provide an adequate buffer for potential downside risks.** Investors, however, pointed out that stronger signs of an upgrade to IG (possibly by Moody's) and further evidence of a robust pick up in economic activity, which would alleviate pressures on the CBT, could be catalysts for renewed interest in Turkish assets, as they wait for more attractive entry levels.

Figure 213. While credit growth seems to be picking up...



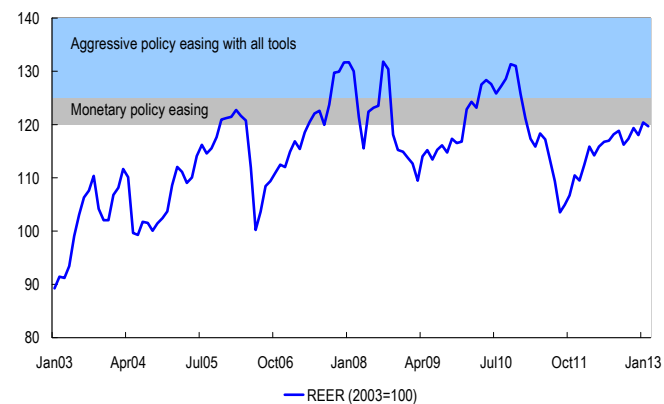
Source: Haver Analytics and Citi Research Note: Consumer loan growth % YTD

Figure 215. While inflation is likely to remain elevated...



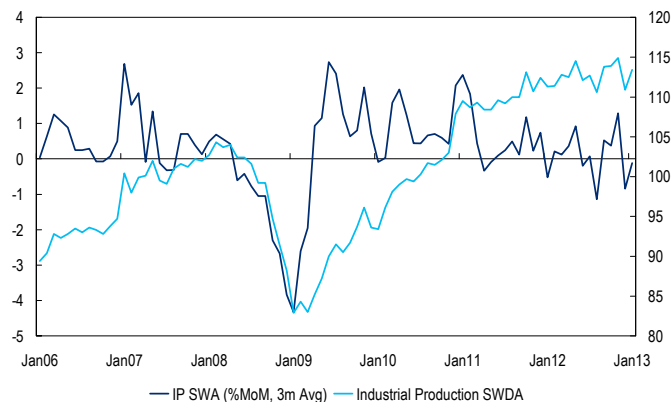
Source: Haver Analytics and Citi Research

Figure 217. REER continues to hover around 120...



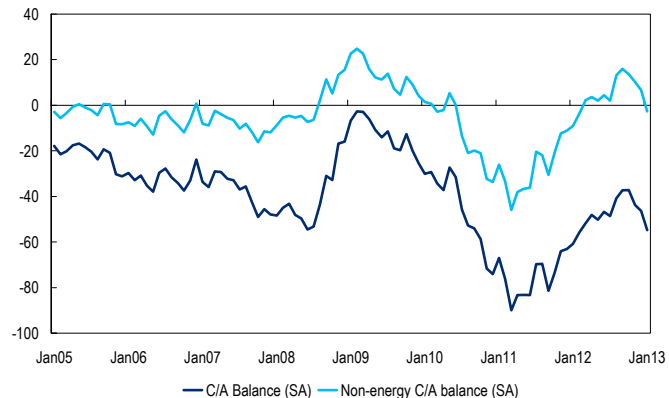
Source: Haver Analytics and Citi Research

Figure 214. ... manufacturing sector continues to paint a mixed picture



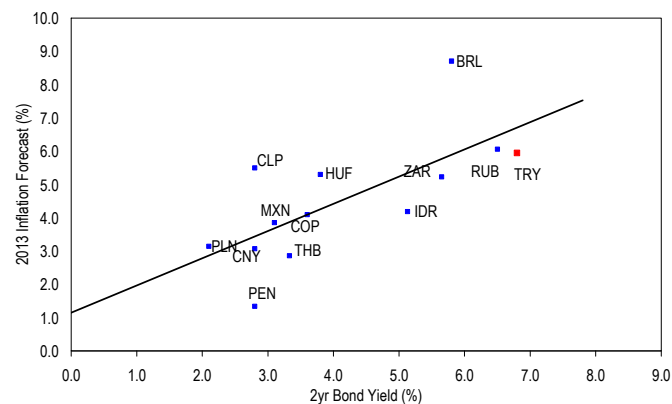
Source: Haver Analytics and Citi Research

Figure 216. ...focus will probably shift towards deterioration in C/A .



Source: Haver Analytics and Citi Research Note: USD bn, annualized

Figure 218. ...as valuation concerns in bond market turn more evident



Source: Bloomberg and Citi Research

Figure 219. Turkey Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	529	646	731	615	731	775	807	876	959
Nominal GDP, local currency bn	758	843	951	953	1,099	1,298	1,450	1,619	1,813
GDP per capita, USD	7,624	9,207	10,282	8,530	10,016	10,476	10,775	11,552	12,499
Population, mn	69.4	70.2	71.1	72.1	73.0	74.0	74.9	75.8	76.7
Unemployment, % of labour force	10.2	10.3	11.0	14.0	12.0	9.8	9.2	9.5	9.5
<b>Economic Activity</b>									
Real GDP, yoy avg	6.9	4.7	0.7	-4.8	9.2	8.5	2.5	4.0	4.3
Real investment growth % yoy	13.3	5.8	-4.8	-28.6	48.4	17.2	-6.2	4.4	6.9
Real consumption growth % yoy	5.1	5.6	-0.1	-1.0	6.0	7.3	0.3	3.2	4.1
private consumption growth % yoy	4.6	5.5	-0.3	-2.3	6.7	7.8	-0.3	3.2	4.3
Real export growth, % yoy	6.6	7.3	2.7	-5.0	3.4	6.4	13.0	4.5	4.2
Real import growth, % yoy	6.9	10.7	-4.1	-14.3	20.7	10.9	-2.9	2.5	6.1
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	9.7	8.4	10.1	6.5	6.4	10.4	6.2	7.5	7.0
CPI, % avg	9.6	8.8	10.4	6.3	8.6	6.5	8.9	7.4	7.3
Nominal wages, % yoy	11.0	9.5	11.6	9.9	11.8	8.0	9.9	8.5	7.5
Credit extension to private sector, % yoy	36.1	27.8	22.4	13.4	40.4	32.8	17.0	15.0	13.0
Policy Interest Rate, % eop	17.50	15.75	15.00	6.50	6.50	5.75	5.50	5.00	8.00
1 month inter-bank rate, %, eop	19.58	17.21	17.16	7.20	6.89	11.54	5.80	5.25	8.50
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US\$, eop	1.41	1.17	1.54	1.50	1.54	1.89	1.78	1.88	1.90
TRY/US\$, avg	1.44	1.31	1.31	1.55	1.51	1.68	1.80	1.85	1.89
TRY/EUR, eop	1.87	1.70	2.15	2.15	2.06	2.44	2.35	2.43	2.46
TRY/EUR, avg	1.81	1.79	1.92	2.17	2.00	2.34	2.32	2.40	2.45
<b>Balance of Payments, USD bn</b>									
Current account	-31.8	-37.8	-40.4	-12.2	-45.4	-75.1	-46.9	-59.7	-66.1
% of GDP	-6.0	-5.8	-5.5	-2.0	-6.2	-9.7	-5.8	-6.8	-6.9
Trade balance	-41.1	-46.9	-53.0	-24.9	-56.4	-89.1	-65.6	-80.7	-89.4
Exports	93.6	115.4	140.8	109.6	120.9	143.4	163.3	172.2	181.9
Imports	134.7	162.2	193.8	134.5	177.3	232.5	228.9	252.9	271.3
Service balance	14.0	14.0	18.8	18.6	16.7	20.1	24.0	25.7	27.5
Income balance	-6.7	-7.1	-8.4	-8.3	-7.2	-7.8	-6.7	-6.1	-5.6
FDI, net	19.3	19.9	17.2	7.1	7.6	13.7	8.3	13.0	15.5
International reserves	60.9	73.3	71.0	70.7	80.7	78.5	99.9	104.9	109.9
Total amortisations	30.3	37.6	41.1	47.3	45.0	37.7	33.1	41.2	45.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.6	-1.6	-1.8	-5.5	-3.6	-1.3	-2.0	-2.2	-2.7
Consolidated gov primary balance	5.4	4.1	3.5	0.1	0.8	1.8	1.4	0.3	0.3
Public debt	46.4	40.4	41.2	47.7	44.4	41.2	38.2	37.2	36.2
of which Domestic	33.2	30.3	28.9	34.6	32.1	28.4	27.0	26.0	25.5
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	208.4	250.4	281.2	269.4	292.0	305.2	354.9	394.6	440.2
Public	87.3	89.3	92.4	96.8	100.9	91.1	120.7	137.5	156.5
External debt / GDP	39.4	38.7	38.5	43.8	39.9	39.4	44.0	45.1	45.9
External debt / XGS	174.0	172.4	158.2	185.4	185.8	165.8	171.0	179.9	189.4
Short-term debt	42.9	43.2	52.5	49.0	77.4	83.0	101.0	114.0	128.0
Short-term debt/International reserves (%)	70.4	58.9	74.0	69.3	95.9	105.8	101.0	108.6	116.4
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	1.6	1.8	1.8	3.5	3.9	6.8	5.8	4.8	4.0
CPI, % yoy	9.2	6.2	7.3	7.9	7.1	7.5	7.5	7.3	7.3
Policy interest rate, %, eop	5.75	5.50	5.50	5.25	5.00	5.00	5.75	6.50	7.25
Short-term market rate, % eop	6.11	5.80	5.50	5.40	5.25	5.25	6.00	7.00	7.75
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US\$, eop	1.80	1.78	1.82	1.84	1.86	1.88	1.88	1.89	1.89

Source: National Sources, Citi Research

## Ukraine

Natalia Novikova  
+7 495 643 1507  
[natalia1.novikova@citi.com](mailto:natalia1.novikova@citi.com)

David Lubin  
+44 (20) 7986-3302  
[david.p.lubin@citi.com](mailto:david.p.lubin@citi.com)

- **Summary view** — The economy was pushed into recession by weak external demand and tight internal liquidity at the end of 2012. We expect about a 4-5% contraction of private consumption and low double-digit fall in investments this year. Near zero inflation looks unsustainable in our view.
- **Things to watch** — IMF deal is close, but there could be some back and forth in the coming weeks. Negotiations may result in a revision of budget expenditures and an increase of retail gas and utility prices. The latter could push headline inflation back to 9% by the year end.
- **Strategy** — Risks of 10-15% FX correction over the next 3-6 months are high. While Ukraine may benefit from risk on in the short term, it remains highly sensitive to negative news flow.

## Worrying signs

**Economy was pushed into recession by weak external demand and tight internal liquidity, 2013 outlook revised to zero growth.** GDP fell 1.3%YoY in 3Q and about 2.5%YoY in 4Q as the trade balance continued to deteriorate and stock building slowed. Metals and chemicals exports were down 15% and 3% in US\$ terms leading to 1.8%YoY decrease in industrial output last year. Industrial production was supported by relatively strong performance of domestic-oriented sector, nevertheless slowed the eighth month in a row to 3.2%YoY in Jan from about 7%YoY in Dec. Consumer spending, spurred by double-digit growth in real wages, is now the only economic driver, and retail sales continued to advance (up 14%YoY) in Jan. Meanwhile gross capital formation plunged by 23%YoY in 4Q. Corporations are constrained from borrowing in the high-interest-rate environment. NBU has been tightening banking liquidity to preserve hryvnia stability, as a result real interest rates on commercial credits stood at about 20% in the end of 2012. We believe companies were selling their inventories, and this factor probably contributed the most to the overall slump. 2013 likely be a year of stagnation despite gradually improving external markets. We expect about 4-5% contraction of private consumption as a result of lower real incomes. At the same time we do not rule out a double-digit fall in investments this year. Weaker internal demand however should result in decline of import volumes keeping GDP growth at about zero for the year as a whole.

**External financing requirements exceeding US\$30bn is a primary threat to financial stability.** By the end of 2012, international reserves fell to less than 3 months of imports and 40% of the short term debt. The current account (CA) widened to US\$14.4bn (8% of GDP) in 2012, despite a major fall in the volume of energy investment goods in the second half of the year. We forecast only a marginal improvement in 2013 under the current exchange rate. The government owes about US\$6bn to the IMF this year and will need to make US\$3-4 billion of repayments to private foreign creditors and the private sector will need to roll over a certain amount of external debt. It is difficult to get much clarity on how big this number will be, though. The last official estimate of external debt maturing in the next 12 months dates was from Jan 2012. At that stage the headline number was very large: US\$57 billion. But US\$34bn of this is owed by the corporate sector, where rollover rates are very high because corporates depend on offshore affiliates for external financing. So, the 'true' level of private sector amortization is probably less than US\$10 bn. Still, all told, the gross total external financing requirement almost certainly exceeds US\$30bn this year.

## The IMF likely require actions rather than promises

**IMF deal is probably close, but there could be some back and forth in the coming weeks.** The government hopes for a US\$12bn-15bn stand-by loan from the IMF this year. Of the two main options available – ‘Russia’ vs the ‘IMF’ – the latter seems to be much more likely, albeit the government will pay a high political price as domestic gas tariffs rise. Since presidential elections are not due until 2015, the political timetable appears to give some space to implement the reforms. An IMF mission is expected in the end of March, and the major points of discussion remain the same i) a reasonable budget plan; ii) a reduction in the government’s domestic gas subsidies, and ii) liberalization of the FX market.

**While 2013 budget is based on conservative revenue assumptions, under the current expenditure plan the deficit could exceed 4%,** according to our estimates. According to the fiscal plan adopted in Dec, the cabinet forecasts flat tax revenues at about UAH300bn (US\$37bn). Expenditures are set to grow 5%YoY vs 2012 plan to UAH411bn (US\$51bn) including transfers of UAH83bn (US\$10.3bn) to the Pension Fund (up almost 30%YoY). Budget financing is planned to come from domestic borrowings (UAH78bn, US\$9.6bn), external borrowing (UAH37bn, US\$4.6bn) and privatization proceeds (UAH11bn, US\$1.3bn). MoF plans to borrow US\$3bn on the global market before May in addition to US\$1bn issued in the beginning of the year. MoF also estimated could take about US\$3-5bn from the local banks in FX bonds. The Naftogaz deficit of UAH8bn will also be financed by government bonds. Meanwhile the NBU has already become a major holder of government debt owning about 56% of the public hryvnia debt securities.

**On gas tariffs, the IMF wants to see a plan in which gas subsidies are fully eliminated over a 4-5 year period.** Gas subsidies are estimated at 87% of the import costs and about 5% of GDP. Meanwhile should there be 20-30% increase in retail gas and electricity tariffs (about 7% of the CPI basket).

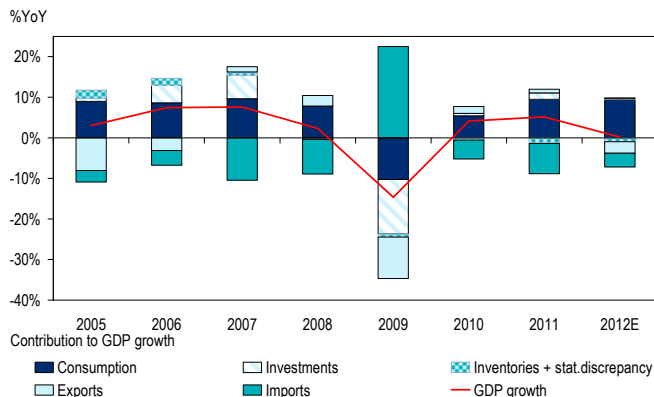
## On the verge of adjustment

**Risks of 10-15% FX correction over the next 3-6 month are high.** We do not rule out the possibility the NBU will allow UAH depreciation to 9-9.5 range by mid-2013. The effect of administrative measures introduced in the end of won’t last long, in our view. We expect NBU will wait for a positive background for FX adjustment (like progress in the IMF negotiations or seasonal improvement in the current account). Although the exchange rate is likely to weaken if a more flexible regime is introduced, that won’t automatically lead to an uncontrolled depreciation: banks are well-capitalized, and domestic FX loans exceed domestic FX deposits by only US\$9bn now, versus US\$40bn in October 2008.

**Weaker currency and higher utilities prices should bring inflation back to 9% in 2H,** according to our base case scenario. We estimate<sup>2</sup> the exchange rate pass-through to be around 0.3-0.4 (10% devaluation leads to about 3pp increase in yoy inflation rate) for both headline and core inflation. Utilities prices appear to affect only headline inflation with a lag of about 3-6 months and pass-through close to 0.15. Assuming 10% hryvnia devaluation and 20% adjustment of gas and utilities prices we forecast inflation to hit 9% by the year end.

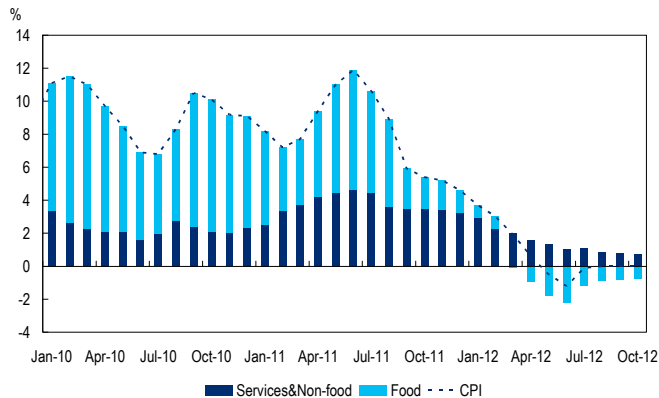
<sup>2</sup> [Ukraine Macro View: Inflation probably close to peak – July 2011](#)

Figure 220. 2013 outlook revised to zero growth



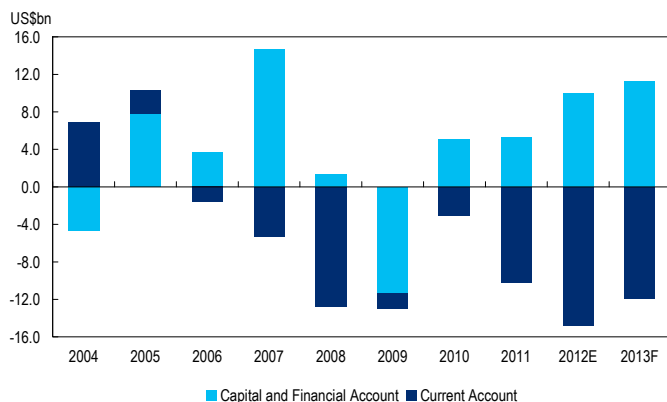
Source: Ukrstat, MinFin, Citi Research

Figure 222. Inflation at 10-year low does not look sustainable



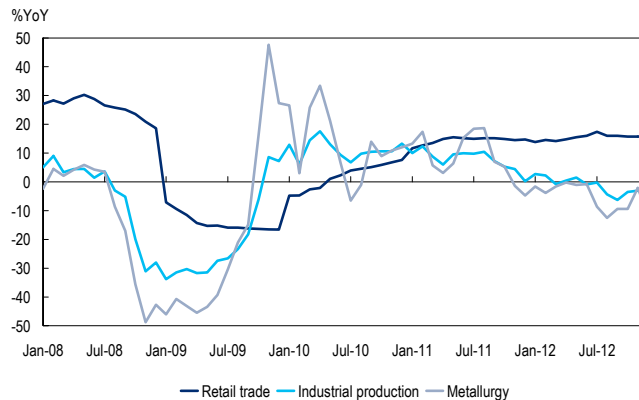
Source: Ukrstat, Haver Analytics, Citi Research

Figure 224. BoP likely in deficit without FX correction



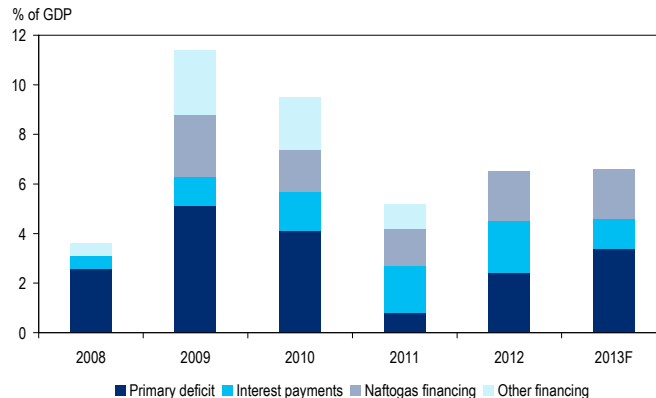
Source: Ukrstat, MinFin, Citi Research

Figure 221. ... despite still strong consumption growth



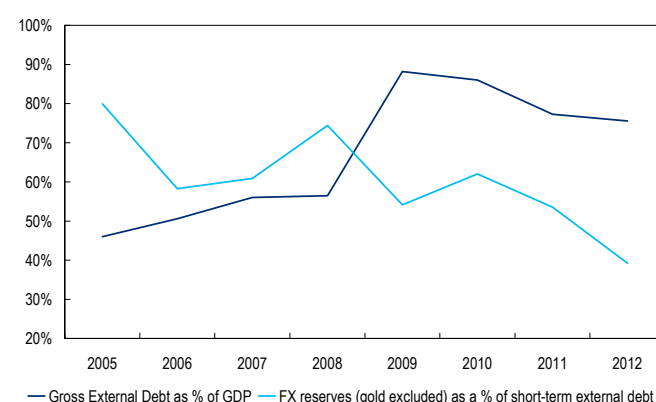
Source: Ukrstat, Haver, Citi Research

Figure 223. Not much space for the fiscal stimulus



Source: Bloomberg, Citi Research

Figure 225. FX reserves close to critical level



Source: Ukrstat, Haver, Citi Research

Figure 226. Ukraine Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	108	143	180	117	136	163	175	129	140
Nominal GDP, local currency bn	541	715	946	913	1,079	1,293	1,400	1,503	1,685
GDP per capita, USD	2,313	3,084	3,914	2,566	3,006	3,624	3,912	2,899	3,176
Population, mn	46.6	46.3	46.0	45.7	45.4	45.1	44.8	44.5	44.2
Unemployment, % of labour force	6.9	6.4	6.4	8.8	8.1	7.9	8.0	7.9	7.9
<b>Economic Activity</b>									
Real GDP, yoy avg	7.4	7.6	2.4	-14.7	4.2	5.2	0.5	0.0	4.1
Real investment growth % yoy	17.9	26.6	1.8	-57.1	15.9	19.8	-12.4	-16.8	9.4
Real consumption growth % yoy	12.2	13.1	10.1	-12.3	6.4	11.3	10.4	-3.7	4.2
private consumption growth % yoy	15.4	17.0	12.8	-14.9	7.1	15.5	12.4	-3.6	5.0
Real export growth, % yoy	-5.8	2.8	5.7	-22.0	3.9	4.3	-7.0	2.6	3.0
Real import growth, % yoy	8.3	23.9	17.0	-38.9	11.3	17.7	6.8	-7.4	5.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	8.6	4.1
CPI, % avg	9.1	12.8	25.2	15.9	9.4	8.0	0.6	4.2	6.8
Nominal wages, % yoy	29.4	29.7	33.7	5.5	17.7	17.5	14.9	5.0	6.0
Credit extension to private sector, % yoy	69.8	73.7	67.1	-4.2	0.7	8.9	2.8	10.0	20.0
Policy Interest Rate, % eop	8.50	8.00	12.00	10.25	7.75	7.75	7.50	7.25	7.00
1 month inter-bank rate, %, eop	-	8.41	23.78	19.10	10.75	20.25	25.00	9.06	8.75
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US\$, eop	5.05	5.05	8.05	8.05	7.97	8.01	8.05	9.30	9.40
UAH/US\$, avg	5.04	5.03	5.16	8.06	7.97	7.99	8.08	8.95	9.27
UAH/EUR, eop	6.67	7.37	11.25	11.53	10.66	10.37	10.62	12.00	12.20
UAH/EUR, avg	6.32	6.89	7.60	11.21	10.55	11.11	10.39	11.64	12.00
<b>Balance of Payments, USD bn</b>									
Current account	-1.6	-5.3	-12.8	-1.7	-3.0	-10.2	-14.8	-11.9	-9.1
% of GDP	-1.5	-3.7	-7.1	-1.5	-2.2	-6.3	-8.4	-9.2	-6.5
Trade balance	-5.2	-10.6	-16.1	-4.3	-8.4	-16.3	-20.3	-16.9	-15.4
Exports	38.9	49.8	67.7	40.4	52.2	69.4	69.7	71.9	76.0
Imports	44.1	60.4	83.8	44.7	60.6	85.7	90.0	88.7	91.3
Service balance	2.1	2.4	1.7	2.4	4.4	6.1	5.3	4.6	6.0
Income balance	-1.7	-0.7	-1.5	-2.4	-2.0	-3.8	-2.8	-2.9	-3.0
FDI, net	5.7	9.2	9.9	4.7	5.8	7.0	5.8	7.8	8.0
International reserves	22.4	32.5	31.5	26.4	34.6	31.8	24.5	23.9	22.6
Total amortisations	7.0	8.5	13.9	17.9	23.4	23.6	20.1	21.5	20.8
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.6	-0.8	-1.2	-7.3	-8.8	-3.9	-3.4	-4.8	-2.8
Consolidated gov primary balance	0.2	-0.3	-0.7	-6.2	-7.6	-2.9	-2.4	-3.4	-1.7
Public debt	13.2	10.8	14.4	25.5	31.5	28.3	29.0	30.2	28.8
of which Domestic	3.1	2.5	4.7	10.0	13.1	12.4	13.6	8.2	108.2
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	54.5	80.0	101.7	103.4	117.3	126.2	134.7	144.1	142.2
Public	11.8	12.3	16.7	24.0	32.5	33.4	34.3	32.6	29.3
External debt / GDP	50.6	56.0	56.5	88.2	86.0	77.2	76.9	111.7	101.3
External debt / XGS	108.5	124.9	118.7	190.6	169.4	142.1	150.2	153.1	143.4
Short-term debt	15.2	20.7	20.3	19.0	23.5	30.7	29.9	30.3	30.7
Short-term debt/International reserves (%)	68.0	63.7	64.4	72.0	68.1	96.7	122.0	127.0	136.2
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	-1.3	-2.5	-0.9	-1.6	1.0	1.9	2.4	3.4	3.5
CPI, % yoy	0.0	-0.2	0.5	4.3	6.6	8.6	9.7	6.7	5.3
Policy interest rate, %, eop	7.50	7.50	7.50	7.50	7.25	7.25	7.00	7.00	7.00
Short-term market rate, % eop	23.50	25.00	6.69	10.00	9.06	9.06	8.75	8.75	8.75
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US\$, eop	8.15	8.05	8.15	9.30	9.35	9.30	9.20	9.20	9.30

Source: National Sources, Citi Research

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# Latin America

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# Argentina

Joaquin A Cottani  
+1 212 816 2735  
[joaquin.cottani@citi.com](mailto:joaquin.cottani@citi.com)

- **Summary view** — BCRA reserves have continued dropping, and have already shrunk USD1.9bn since the beginning of the year, while the peso has depreciated markedly in the unregulated markets. If the drain of BCRA reserves continues, authorities will have to choose between tightening import controls or/and letting the peso to depreciate at a faster pace. The federal public sector posted a 0.2% of GDP primary fiscal deficit in 2012, the first one in more than a decade. Meanwhile, the government's popularity has failed to pickup.
- **Things to watch** — The evolution of the FX market should be followed closely. The drop in BCRA's reserves could have not only consequences for the FX and activity, but also for the Republic's credit. Politics are likely to start heating up, as we are getting closer to October's mid-term elections.
- **Strategy** — We continue to believe there will be no GDP warrant payment in 2014. We believe that the rapid deterioration of the BoP may push the government to allow interest rates to increase.

## BCRA's headache

**Despite the tight capital controls introduced by authorities during the last year and a half, the central bank (BCRA)'s reserves continue dropping.** After decreasing by USD5.8bn and USD3.1bn in 2011 and 2012, respectively, BCRA's reserves have shrunk USD2.1bn so far in 2013 to USD41.2bn, their lowest level in almost five years. As a result, BCRA's reserves currently account for roughly 70% of the monetary base, compared to around 100% and 130% one and two years ago, respectively.

**During the first 45 days of 2013, the BCRA foreign currency purchases were slightly negative (-USD45mn), compared to USD2.1bn and USD2.3bn during the same periods of 2011 and 2012.** Foreign currency purchases by the BCRA have been under pressure during the first days of 2013, in opposition to what has happened in other LatAm countries, and even though public-sector agencies have been selling foreign currency to ease the pressure in the official FX market, as evidenced by the drop of USD0.8bn in public-sector USD deposits. Some government officials have blamed agro-exporters for the low level of FX purchases by the BCRA during early 2013, but that explanation looks insufficient in light of the available data. According to the Argentine Chamber of Grains (CIARA), agro-exporters have sold USD2.3bn of foreign currency in the official FX market during the first two months of 2013, compared to USD2.6bn and USD3.2bn during the same period of 2011 and 2012, respectively.

**Meanwhile, peso has depreciated 19% year-to-date in the unregulated blue chip market to 8.4ARS/USD.** Similarly, the peso has weakened 13% in the informal "blue" market to USD/ARS8. As a result, the USDARS exchange rate is currently 64% higher in the blue chip market than in the official one, while the spread between the "blue" USDARS and the official exchange rate has increased to 58%. Naturally, the increasing premium in the parallel markets is an incentive for illegal transactions that lead to a lower balance of payments' surplus, such as over-invoicing of imports and under-invoicing of exports.

**We have recently published an analysis on the sustainability of Argentina's and Venezuela's multiple exchange rate systems, and the paper's main conclusion is that they are undoubtedly unsustainable in the medium/long term.** For more information, please see [Argentina & Venezuela Macro View - The \(Unstable\) Economics of Dual Exchange Rate Regimes](#)

**The recent drain in reserves and the fast decline of capital controls' effectiveness to stop outflows implies a downward risk for our activity forecasts.** It also means an upward bias for our forecast for the official USDARS. If BCRA's reserves continue decreasing, authorities will have to choose between depreciating the peso or/and increasing controls on imports (a measure that will, in all likelihood, harm growth). Also, it should not go overlooked that the drought that took place during January and February will likely lead to a lower 2012/13 harvest, and consequently to lower activity and (marginally) lower exports. For instance, The U.S. Department of Agriculture (USDA) reduced its forecast for Argentina's 2012/13 soybean crop to 51.5 million tons, down from 53 million tons. Additionally, and also according to March's USDA World Agricultural Supply and Demand Estimates, Argentina's 2012/13 corn harvest is expected to stand at 26.5 million tons, down from a previous forecast of 27 million tons. A few months ago, the USDA was expecting Argentina's 2012/13 soybean and corn crops to stand at 55 and 28 million tons, respectively.

## **2012, the return of the primary fiscal deficit**

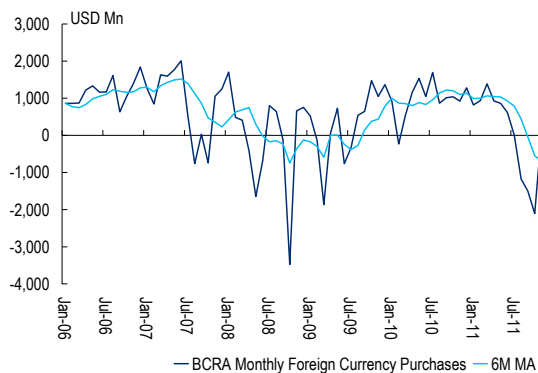
**Finally, after a 40 day delay, the Ministry of Finance (MECON) reported December 2012 fiscal results for the federal government.** According to the MECON, primary expenditure increased 29.1% YoY in December, while revenues grew 26.9% YoY. The increase in primary expenditure was driven by capital spending which soared 53.2% YoY, while current expenditure (excluding interest payments) increased 26.9% YoY. As a result, the primary deficit increased to ARS11bn in December 2012, up from ARS8.1bn. Moreover, the overall deficit increased to ARS33.1bn, up from ARS22.4bn in December 2011. For 2012 as a whole, the primary deficit stood at ARS4.4bn or 0.2% of GDP, compared with an ARS4.9bn (0.3% of GDP) surplus in 2011. Additionally, the overall deficit came in at ARS55.6bn (2.6% of GDP), up from an ARS30.7bn (1.7% of GDP) deficit in 2011. In 2012, primary expenditure increased 29% and interest payments rose 43.9%, while revenues improved 26.6%.

**While in 2012 the gap between government expenditure and revenues growth shrank, we expect the opposite to happen in 2013 due to the mid-term elections.** Since Cristina Fernández de Kirchner was elected President for the first time in 2007, fiscal policy has turned very expansionary in election years. For instance, in 2011 primary expenditure increased 32% in nominal terms, while revenues rose 24%. In 2009 the gap between expenditure and revenues growth was even bigger and stood at 11%, as revenues rose 19% compared to an increase in primary expenditure of 30%. For this year, we expect revenues to increase 28%, not due to higher activity growth but due to the acceleration of inflation, while we expect primary expenditure to expand 33.5%. As a result, the primary deficit should widen to 1.4% of GDP. However, the overall deficit should increase "only" to 2.7% of GDP, as interest payments will decrease significantly.

## **Cristina's headache**

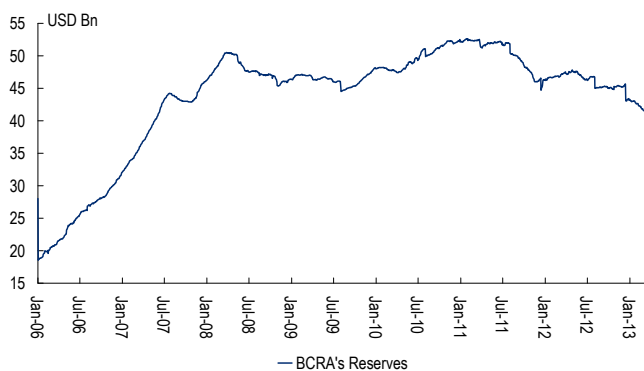
**Available data suggests that the government's popularity remains depressed.** For example, Universidad Torcuato Di Tella (UTDT)'s Trust in Government Index dropped 28.5% YoY in February, 30.2% lower than on October 2011, when CFK was reelected with 54% of the votes. Moreover, the survey conducted by UTDT also showed that the government's approval rating stood at only 33% in February, compared to 54% in October 2011.

Figure 227. BCRA's FX purchases have been under pressure...



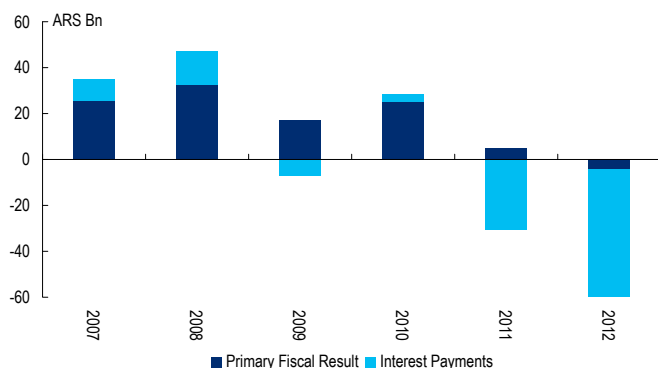
Source: BCRA and Citi Research

Figure 229. BCRA's reserves have dropped USD2.1bn in 2013



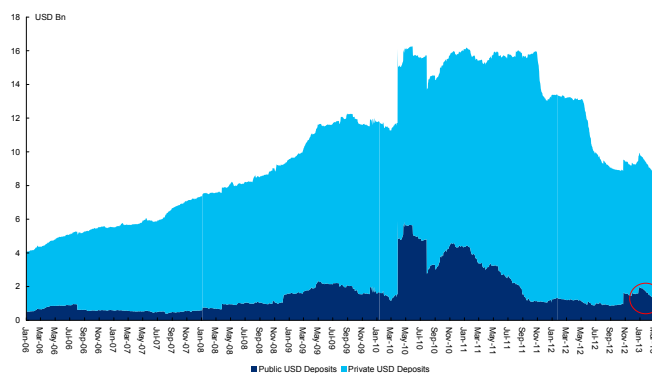
Source: BCRA and Citi Research

Figure 231. The fiscal deficit widened significantly in 2012



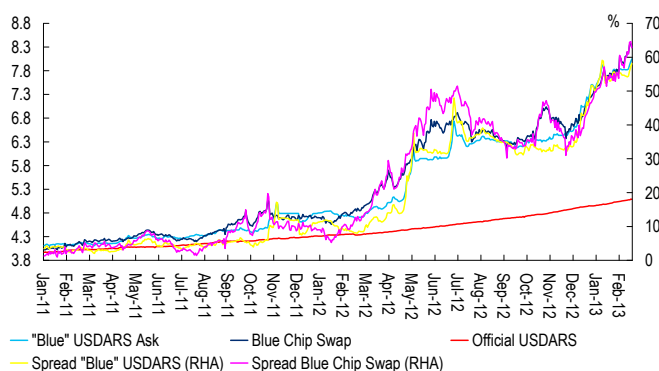
Source: MECON and Citi Research

Figure 228. ... despite that public agencies have been selling USD



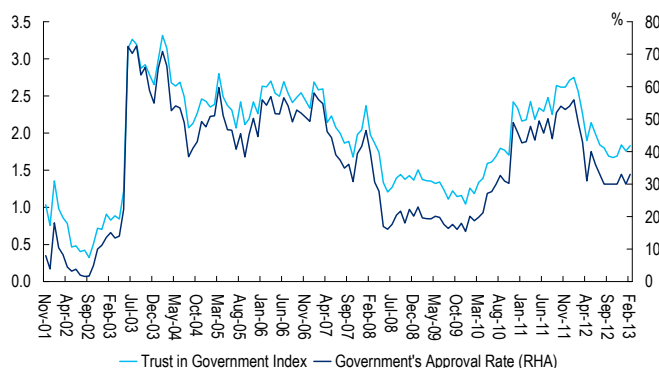
Source: BCRA and Citi Research

Figure 230. Unregulated FX market's premium has been increasing



Source: Bloomberg and Reuters

Figure 232. The government's popularity continues depressed



Source: UTDT and Citi Research

Figure 233. Argentina Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	214	262	329	308	370	448	474	485	494
Nominal GDP, local currency bn	654	812	1,033	1,145	1,443	1,842	2,158	2,647	3,329
GDP per capita, USD	5,498	6,666	8,271	7,683	9,131	10,948	11,476	11,629	11,738
Population, mn	39.0	39.4	39.7	40.1	40.5	40.9	41.3	41.7	42.1
Unemployment, % of labour force	10.2	8.5	7.9	8.7	7.8	7.2	7.2	7.6	7.8
<b>Economic Activity</b>									
Real GDP, yoy avg	8.4	8.7	3.3	-3.9	7.7	5.7	-0.2	3.0	2.0
Real investment growth % yoy	17.8	14.8	15.4	-9.1	19.6	10.7	-8.0	1.7	2.0
Real consumption growth % yoy	7.4	8.8	6.6	1.5	9.1	10.7	4.4	3.8	3.1
private consumption growth % yoy	7.8	9.0	6.5	0.5	9.0	10.7	4.0	3.5	3.2
Real export growth, % yoy	7.3	9.1	1.2	-6.4	14.6	4.3	-4.5	2.2	-1.9
Real import growth, % yoy	15.4	20.5	14.1	-19.0	34.0	17.8	-5.9	4.4	-2.3
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	-	20.1	20.7	14.8	26.8	24.2	25.2	30.0	30.0
CPI, % avg	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	18.0	20.3	22.4	20.0	21.7	27.5	27.1	27.5	28.0
Credit extension to private sector, % yoy	37.6	25.4	10.5	11.5	31.6	34.6	39.0	35.0	32.0
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	9.88	13.63	19.75	10.00	11.25	17.19	15.44	20.00	22.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	3.06	3.15	3.45	3.80	3.97	4.30	4.92	6.00	7.50
ARS/USD, avg	3.07	3.12	3.16	3.73	3.91	4.13	4.54	5.46	6.74
<b>Balance of Payments, USD bn</b>									
Current account	7.8	7.4	6.8	11.0	2.8	-0.3	3.5	2.0	1.0
% of GDP	3.6	2.8	2.1	3.6	0.8	-0.1	0.7	0.4	0.2
Trade balance	14.0	13.5	15.4	18.5	14.3	13.2	16.0	15.7	14.8
Exports	46.5	56.0	70.0	55.7	68.1	84.0	81.6	86.9	86.6
Imports	32.6	42.5	54.6	37.1	53.9	70.7	65.6	71.2	71.9
Service balance	-0.5	-0.5	-1.3	-1.3	-1.1	-2.3	-1.8	-0.7	-0.7
Income balance	-6.2	-5.9	-7.6	-9.0	-9.9	-10.7	-10.3	-12.3	-12.3
FDI, net	5.5	6.5	9.7	4.0	7.1	8.7	9.0	4.4	4.4
International reserves	32.0	46.2	46.4	48.0	52.2	46.4	42.3	44.2	44.2
Total amortisations	14.8	5.2	4.7	11.2	10.7	12.0	12.2	12.6	12.6
<b>Public Finances, % of GDP</b>									
Consolidated government balance	1.7	1.1	1.4	-0.6	0.2	-1.7	-2.4	-2.7	-2.9
Consolidated gov primary balance	3.5	3.1	3.1	1.5	1.7	0.3	-0.2	-1.4	-1.6
Public debt	63.8	55.2	44.4	47.7	44.4	40.0	39.0	39.9	42.0
of which Domestic	35.3	28.2	24.8	27.7	25.6	23.6	23.7	24.4	25.6
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	108.8	124.5	124.9	115.6	129.3	140.7	143.9	148.5	155.2
Public	61.1	70.8	64.4	61.8	69.5	73.2	72.6	75.5	80.8
External debt / GDP	50.8	47.5	38.0	37.5	35.0	31.4	30.4	30.6	31.4
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	-1.4	0.3	0.0	5.1	3.7	3.1	2.9	2.2	1.6
CPI, % yoy	25.1	25.2	25.9	27.8	28.7	30.0	30.0	30.0	30.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	14.88	15.44	16.25	17.50	18.75	20.00	20.00	21.00	21.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	4.70	4.92	5.10	5.40	5.70	6.00	6.30	6.60	7.05

Source: National Sources, Citi Research

## Brazil

Marcelo Kfoury Muinhos  
+55-11-4009-3470  
[marcelo.kfoury@citi.com](mailto:marcelo.kfoury@citi.com)

Leonardo Porto de Almeida  
+55-11-4009-2947  
[leonardo.porto@citi.com](mailto:leonardo.porto@citi.com)

- **Summary view** — A gradual acceleration continues, supporting our 2013 GDP growth estimate of 3.1%. On the inflation front, recent high CPI figures have raised concerns among policymakers. This evidence prompted a change in our monetary policy call, and we now expect a tightening cycle to begin in May, with the Selic rate reaching 8.75% at the end of process. On the FX front, price concerns will likely motivate government to manage FX intervention in order to keep USD/BRL below the 2.0 level. Finally, the approval of 2013 Budget Law consolidated a scenario of looser fiscal policy, with the primary surplus stabilizing at a level significantly below the full target of 3.1% of GDP.
- **Things to watch** — Market analysts will focus their attention on the inflation front, especially monitoring the impact on prices of food/personal care products from tax exemptions. The persistence of high inflation figures tends to increase the likelihood of an earlier tightening cycle.
- **Strategy** — With the change in our monetary policy call, there is no significant premium embedded in the yield curve, in our view. On the FX front, given that inflation concerns will likely dominate the government's actions in the near term, we believe USD/BRL will likely hover around USD/BRL 1.95 in coming weeks.

### High inflation continues to dominate CB concerns

**2012 GDP grew 0.9%, confirming the gradual acceleration embedded in our 3.1% estimate for this year.** 4Q12 GDP expanded 0.6% q/q, in line with our estimate and faster relative to the 0.4% figure (data revised from 0.6% q/q) seen in the previous quarter. For the coming quarters, we expect growth acceleration to continue taking place, supporting our 2013 GDP growth estimate of 3.1%. For 2014, the narrower output gap and the expected tightening cycle point to some deceleration on a quarterly basis, suggesting annual GDP growth forecast of around 4.0%. Focusing on employment, our growth outlook is consistent with a scenario where the labor market will likely remain tight. Finally, the likelihood of an alternative scenario of power rationing continues to decline markedly, given higher precipitation in the first few months of this year.

**We keep our 2013 CPI inflation forecast at 5.6%.** January's and February's monthly CPI inflation figures (0.86% and 0.60%, respectively) surprised to the upside, leading to higher inflation expectations for this year. On the other hand, the government announced federal tax exemptions for basic food and personal care products, which will likely offset the high CPI prints seen at the beginning of the year. In the near term, we expect monthly CPI inflation to decline significantly from March onwards, reflecting more favorable contributions from food prices. Nonetheless, 12-month accumulated CPI inflation should reach its peak in June-July (around 6.7%) hurt by the end of tax rebates to cars and home appliances purchases. Afterwards, we expect 12-month CPI inflation to decline steadily, stabilizing at around 5.6% by 2013 year end, above the midpoint target of 4.5%, but inside the band (until 6.5%). Our forecast also implies a slight decline compared to the 5.84% figure registered in 2012. For next year, given our scenario of a tightening cycle throughout 2013 (see paragraph below), we reduced our 2014 CPI inflation forecast to 5.7% from 5.8%.

**Stronger concerns about inflation will likely motivate the central bank (CB) to initiate a tightening cycle in May.** After recent CPI prints, the central bank changed its evaluation of the inflation outlook. In particular, Copom minutes mentioned that "recent unfavorable inflation dynamics may not represent a temporary phenomenon, but rather an accommodation of inflation figures at higher level". This worse inflation outlook motivated the Copom to exclude the sentence that "stability in monetary conditions for a sufficiently prolonged period is the most adequate strategy to ensure the convergence of inflation to the target". This being the case, we now expect Copom to initiate a process of monetary policy normalization in May, hiking the Selic rate by 50bp. Looking forward, we expect Selic rate to be raised until it reaches 8.75%.

## **Price concerns contribute to sustain USD/BRL below 2.0**

**Stronger concerns on the inflation front contribute to keep USD/BRL around 1.95 in the near term.** Fundamentals (terms of trade, net foreign assets, risk aversion) continue to point toward BRL appreciation. Recently, high inflation figures have raised the government's concerns about this issue, leading the central bank to allow the USD/BRL to reach 1.95. Looking ahead, we see some inflationary pressures receding, which together with the concerns over economic growth will likely drive USD/BRL up in the medium term. Under this FX outlook, we continue to see a trade surplus of around US\$10 billion this year, with the current account deficit at US\$67.7 billion (around 3.0% of GDP).

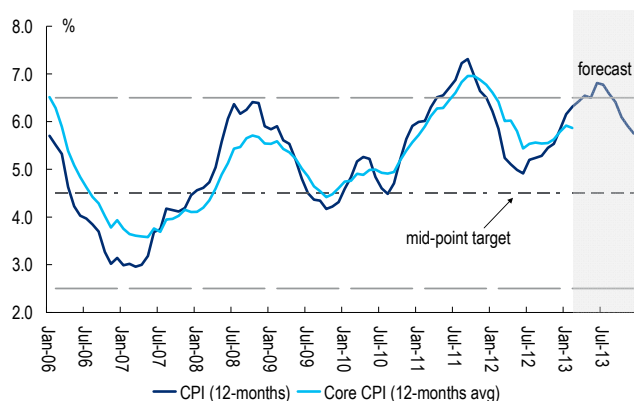
## **Government will pursue looser fiscal policy**

**The primary surplus will be reduced to around 2.0% of GDP.** Although the 2013 Budget Law sets a primary surplus target of 3.1% of GDP, it allows deductions of up to BRL65 billion (representing around 1.3% of GDP) in tax cuts and investment spending (linked to PAC program) from that target. This allows government to pursue an effective primary fiscal result of 1.8% of GDP compared to 2.4% in 2012. Overall, we continue to expect a primary surplus of around 2.0% of GDP. If our fiscal evaluation proves right, there would not be great concerns about public debt sustainability so far as a primary surplus at this level still keeps a slight downward path in the net public debt-to-GDP ratio (currently at 35%).

## **Investment implications**

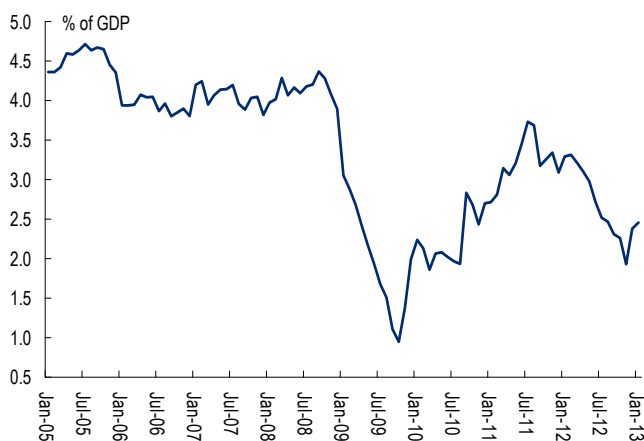
**Our change in monetary policy call practically eliminated premiums in receiving PreDIJan14.** On the FX front, given the high concerns about inflation dynamics, we expect the government/central bank to manage exchange rate interventions to sustain USD/BRL around 1.95. Therefore, we believe any meaningful deviations of exchange rate from this level suggest profit opportunities.

Figure 234. CPI inflation will likely stabilize above the mid point target



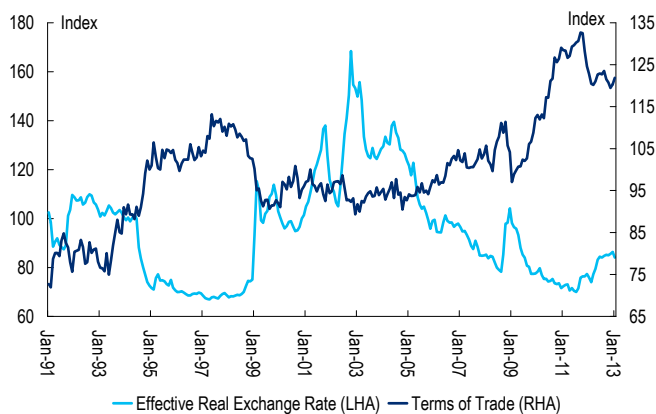
Sources: Citi Research and IBGE

Figure 236. We expect the primary surplus to stabilize around 2% this year



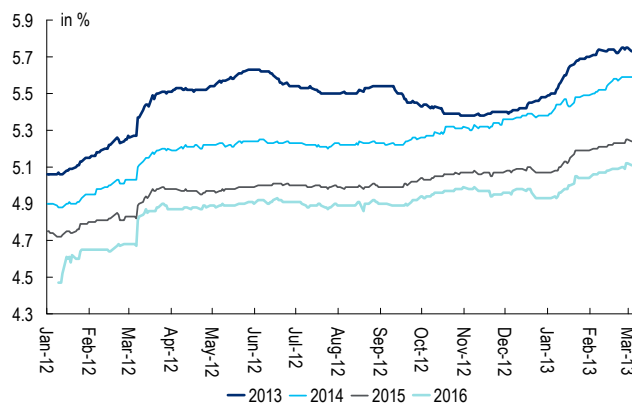
Sources: Citi Research and Central Bank of Brazil

Figure 238. Terms of trade continue to suggest BRL appreciation



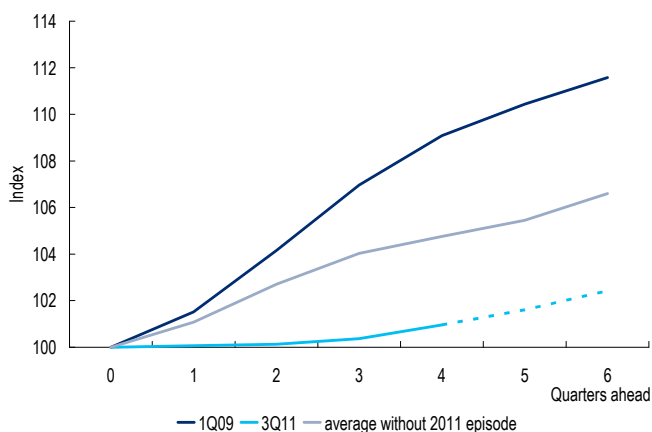
Sources: Citi Research and Central Bank of Brazil

Figure 235. Long term inflation expectations are also above the 4.5% level



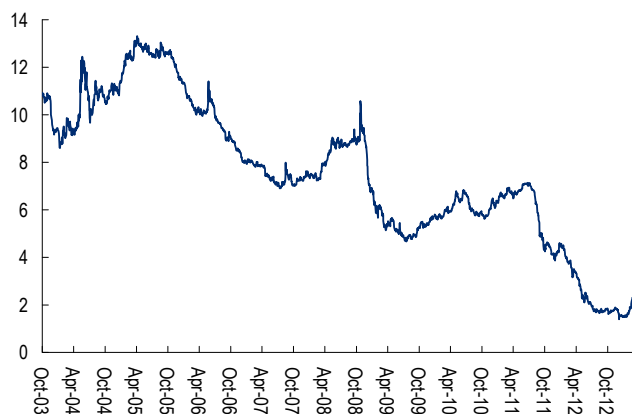
Sources: Citi Research and Central Bank of Brazil

Figure 237. Current recovery is the slowest in monetary easing episodes



Sources: Citi Research and IBGE

Figure 239. Real interest rate remains low, despite the recent increase



Sources: Citi Research, Central Bank of Brazil and Bloomberg

Figure 240. Brazil Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	1,089	1,375	1,678	1,587	2,034	2,343	2,143	2,217	2,431
Nominal GDP, local currency bn	2,369	2,661	3,032	3,170	3,581	3,923	4,169	4,525	4,958
GDP per capita, USD	5,983	7,474	9,015	8,424	10,664	12,125	10,988	11,265	12,238
Population, mn	182.1	184.0	186.1	188.4	190.8	193.2	195.1	196.8	198.6
Unemployment, % of labour force	10.0	9.3	7.9	8.1	6.7	6.0	5.5	5.5	5.4
<b>Economic Activity</b>									
Real GDP, yoy avg	4.0	6.1	5.2	-0.3	7.5	2.7	0.9	3.1	4.0
Real investment growth % yoy	9.9	16.9	16.4	-16.0	33.4	4.0	-8.1	3.2	7.0
Real consumption growth % yoy	4.5	5.8	5.1	4.1	6.3	3.6	3.1	3.9	4.1
private consumption growth % yoy	5.2	6.1	5.7	4.4	6.9	4.1	3.1	4.1	4.5
Real export growth, % yoy	5.0	6.2	0.5	-9.1	11.5	4.5	0.5	5.2	5.1
Real import growth, % yoy	18.4	19.9	15.4	-7.6	35.8	9.7	0.2	8.6	8.1
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	3.1	4.5	5.9	4.3	5.9	6.5	5.8	5.6	5.7
CPI, % avg	4.2	3.6	5.7	4.9	5.0	6.6	5.4	6.3	5.5
Nominal wages, % yoy	7.4	7.0	10.4	4.8	12.7	8.9	10.7	10.5	10.3
Credit extension to private sector, % yoy	20.7	27.8	31.1	15.2	20.6	19.0	16.9	19.2	19.0
Policy Rate (eop)	13.25	11.25	13.75	8.75	10.75	11.00	7.25	8.75	8.75
1 month inter-bank rate, %, eop	13.07	11.11	13.49	8.61	10.64	10.87	6.59	8.75	8.75
Long-term yield, %, eop	12.33	12.95	12.27	12.25	12.24	10.66	7.96	9.50	12.00
BRL/USD, eop	2.14	1.78	2.31	1.74	1.66	1.86	2.05	1.98	2.08
BRL/USD, avg	2.18	1.95	1.84	2.00	1.76	1.67	1.95	1.97	2.04
<b>Balance of Payments, USD bn</b>									
Current account	13.6	1.6	-28.2	-24.3	-47.6	-52.5	-54.2	-67.7	-77.9
% of GDP	1.3	0.1	-1.7	-1.5	-2.3	-2.2	-2.5	-3.1	-3.2
Trade balance	46.5	40.0	24.8	25.3	19.8	29.8	19.5	9.7	4.7
Exports	137.8	160.6	197.9	153.0	201.6	256.0	242.6	247.2	262.0
Imports	91.4	120.6	173.1	127.7	181.8	226.2	223.1	237.6	257.3
Service balance	-9.6	-13.2	-16.7	-19.2	-30.8	-38.0	-41.1	-43.9	-47.1
Income balance	-27.5	-29.3	-40.6	-33.7	-39.5	-47.3	-35.4	-37.0	-39.1
FDI, net	18.8	34.6	45.1	25.9	48.5	66.7	64.7	55.0	60.0
International reserves	85.8	180.3	206.8	239.1	288.6	352.0	378.6	384.6	384.6
Total amortisations	44.1	38.2	22.4	30.1	33.8	29.8	35.8	43.7	38.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-3.6	-2.8	-2.0	-3.3	-2.6	-2.6	-2.6	-2.4	-2.2
Consolidated gov primary balance	3.8	3.8	3.9	2.0	2.7	3.1	2.4	2.0	-
Public debt	55.1	55.0	55.9	60.9	53.4	54.2	58.6	58.6	58.6
of which Domestic	48.9	50.9	51.2	57.5	50.5	51.5	55.7	55.7	-
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	172.5	193.6	198.3	198.2	255.2	257.6	212.7	218.7	224.7
Public	89.2	86.0	84.2	91.7	99.2	100.8	99.1	89.5	89.6
External debt / GDP	15.8	14.1	11.8	12.5	12.5	11.0	9.9	9.9	9.2
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	20.3	38.9	36.4	31.0	57.3	40.1	37.2	40.0	42.0
Short-term debt/International reserves (%)	23.7	21.6	17.6	13.0	19.9	11.4	9.8	10.4	10.9
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	0.9	1.4	2.3	2.7	3.4	3.9	4.1	4.3	4.1
CPI, % yoy	5.3	5.8	6.6	6.7	6.3	5.6	5.4	5.6	5.4
Policy interest rate, %, eop	7.50	7.25	7.25	7.75	8.50	8.75	8.75	8.75	8.75
Short-term market rate, % eop	7.36	6.59	7.25	7.75	8.50	8.75	8.75	8.75	8.75
Long-term yield, %, eop	8.41	7.96	8.28	8.68	9.50	9.50	10.00	11.50	12.00
BRL/USD, eop	2.03	2.05	1.96	1.96	1.97	1.98	2.01	2.03	2.06

Source: National Sources, Citi Research

## Chile

Camilo Gonzalez  
+1 212 816 9901  
[camilo.gonzalezgarcia@citi.com](mailto:camilo.gonzalezgarcia@citi.com)

Fernando Diaz  
+54 11 4329 1931  
[fernando.jorge.diaz@citi.com](mailto:fernando.jorge.diaz@citi.com)

- **Summary view** — Activity growth has accelerated recently, while consumption growth remains strong and the labor market is still tight. However, we believe the BCCh is comfortable with the status quo. After all, not only headline inflation has been subdued but also core measures, while non-tradable inflation has been trending down.
- **Things to watch** — We are getting closer to June's primaries and to November's presidential elections. We therefore expect politics to heat up. The Socialist Party's president Osvaldo Andrade has already announced that Michelle Bachelet will take part in the June 30 primary elections.
- **Strategy** — The BCCh has showed some concern about G4 countries' expansionary monetary policies. This is another reason to expect the BCCh to remain on hold during the upcoming months.

### Activity, consumption and labor market dynamics

**Activity growth has been accelerating recently.** After standing at 4.6% in December, the annual growth rate of the BCCh's monthly GDP proxy, the IMACEC, accelerated to 6.7% in January. January's annual increase was the third highest one in the last 18 months. More importantly, IMACEC's seasonally-adjusted growth has been accelerating recently. For instance, the IMACEC grew 1.9% in seasonally-adjusted terms during the quarter ending in January 2013, when compared to the August-October 2012 quarter. In other terms, activity rose at an annualized rate of 8% during the November 2012 – January 2013 quarter. Moreover, the average monthly seasonally-adjusted growth rate stood at 0.9% during that quarter, compared to only 0.1% during the previous one. This situation is opposed to what happened during most of 2H12, when activity growth in annual terms remained strong due to a strong carryover effect, but seasonally-adjusted growth was slowing down.

**Meanwhile, consumption growth continues unabated.** According to the National Statistics Institute (INE), real retail sales improved 10.6% YoY during the quarter ending in January. Moreover, real retail sales quarterly seasonally-adjusted growth has been trending up recently, reaching 3.5% during the three months period ending in January. In line with these figures, the BCCh reported that consumption good imports rose 10.6% YoY in February, after soaring 20.5% YoY in January. As a result, consumption good imports have risen 12.1% YoY during the quarter ending in February, the most since November 2011.

**Unsurprisingly, the labor market remains tight.** For instance, Universidad de Chile informed that the unemployment rate in Great Santiago dropped to 5.2% in 4Q12, down from 6.9% and 6.2% in 3Q12 and 4Q11, respectively, and consequently reached its lowest level since 1973. Similarly, the INE reported that the three months moving average unemployment rate dropped to 6% in January, reaching its lowest level since the current methodology was introduced in March 2009. However, it should not go overlooked that, despite the very low unemployment rate, job creation has remained tame, while wage growth has not accelerated. Annual job creation stood at 2% in the quarter ending in January, while a year and a half ago it was running at around 5%. Additionally, the INE informed that its Remunerations Index rose 6% YoY in January, down from 6.3% YoY in December, while its Labor Costs Index (ICMO) increased 6.5% YoY, compared to a 7% YoY rise in the previous months.

## Inflation continues below BCCh's target lower bound

**The INE reported that February's inflation came in at 0.1% MoM.** As a result annual headline inflation has declined to 1.3%, the lowest point since April 2010. The print was heavily influenced by the decline in food prices (-0.73% MoM), which subtracted 14bp from the overall inflation print. Nonetheless, this was more than offset by the increase in the Energy category (1.9% MoM, adding 17bp to the print), resulting from the rise in fuel prices. Overall, 5 out of the 12 categories posted MoM declines.

**Once again, core and non-tradable inflation continued heading south.** The IPCX and IPCX1 rose 0.1% and 0.2% on a monthly inflation, while the YoY figures declined to 1% and 1.5%, respectively. Inflation excluding food and energy rose 0.13% MoM, standing at 0.8% YoY. Finally, non-tradable inflation continued moving toward the 3% target, after rising 0.35% MoM (3.2% YoY).

**Even though inflation has surprised on the downside recently, we maintain our view that inflation will rise very gradually in 2013.** Our prognosis is based on the fact that there is little room for tradable prices to continue falling. However, the improvement in the relative price mix outlook, with sticky non-tradable inflation now hovering closer to the 3% target, should bring relief to authorities, in our view.

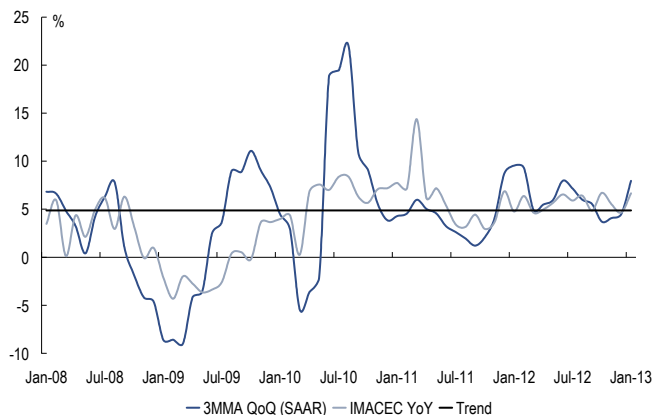
## BCCh in wait-and-see mode

**The BCCh kept the policy rate unchanged on March for the 14th consecutive month at 5%.** We expect the bank to continue on hold during the upcoming months accumulating information on the evolution of activity. In the minutes corresponding to February's decision, the BCCh mentioned that the reason why strong activity and tight labor markets have yet to translate to the inflation front is still a puzzle, and that it will continue following the situation closely. Our view is also based on the fact that recent communiqués from the BCCh have addressed the implications of G4 expansionary monetary policies on small open economies such as Chile, and the latter's relative monetary policy vis-à-vis those countries. Given this scenario, macroprudential measures cannot be ruled out. Furthermore, it is worthwhile remembering that BCCh's governor Rodrigo Vergara recently mentioned that monetary policy is too blunt of a tool to address issues in some particular sectors.

## November is getting closer

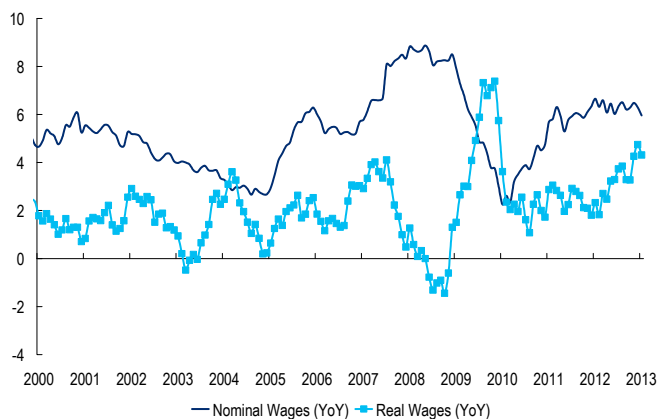
**Presidential elections are to be held on next November 17, and Michelle Bachelet is the candidate to beat.** On March 15, Mrs. Bachelet announced that she will leave her role as executive director of UN Women. Following this news, the Socialist Party's president Osvaldo Andrade announced that Michelle Bachelet will take part in the June 30 primary elections. Mrs. Bachelet is, undoubtedly, the candidate to beat in the next presidential elections. According to the latest survey conducted by the Center for Public Studies (CEP), which was conducted during November and December 2012, 54% of those surveyed said that they would vote for Mrs. Bachelet in the November elections, while only 15% and 7% of them answered that they would vote for Renovación Nacional's pre-candidates Laurence Golborne (former Minister of Public Works) and Andrés Allamand (Former Minister of Defence).

Figure 241. Growth accelerated once again...



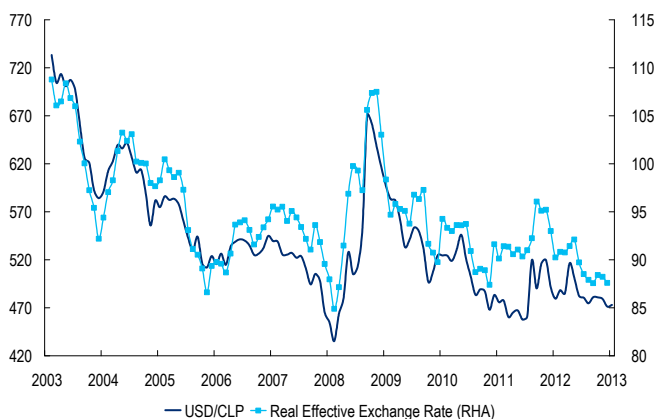
Source: BCCh and Citi Research

Figure 243. ...despite tight labor market conditions.



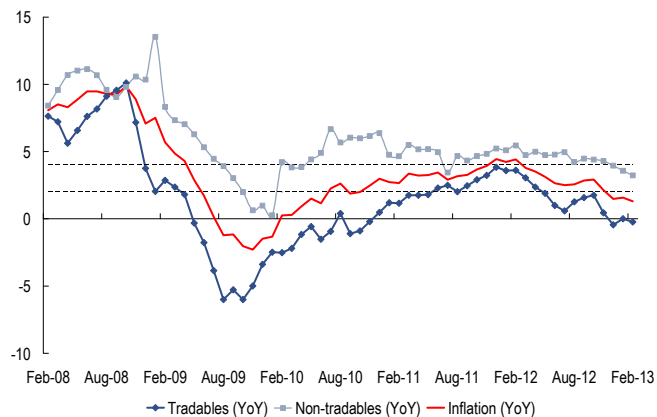
Source: INE

Figure 245. CLP remains relatively strong in real effective terms



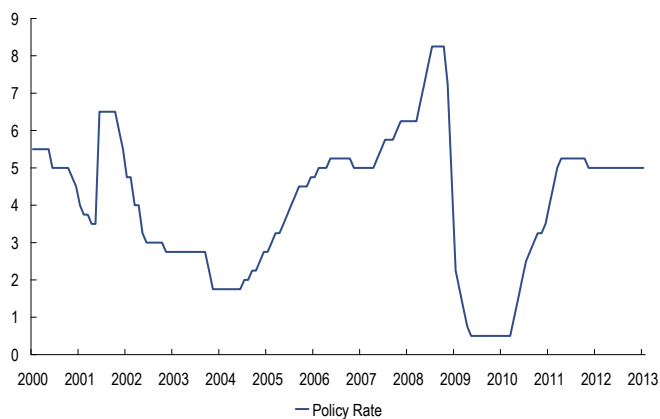
Source: Bloomberg and BCCh

Figure 242.... but inflation is heading in the opposite direction...



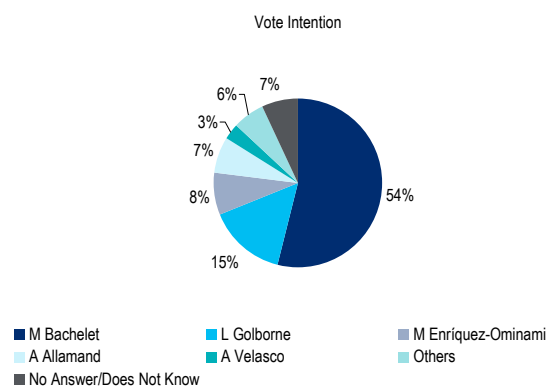
Source: INE

Figure 244. BCCh comfortable with rates on hold



Source: BCCh

Figure 246. Michelle Bachelet is the candidate to beat in November



Source: CEP

Figure 247. Chile Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	147	165	174	162	204	240	268	296	312
Nominal GDP, local currency bn	78	86	89	90	104	116	131	141	153
GDP per capita, USD	8,932	9,911	10,374	9,536	12,014	14,017	15,509	16,191	16,130
Population, mn	16.4	16.6	16.8	17.0	17.0	17.1	17.3	18.3	19.3
Unemployment, % of labour force	7.9	0.0	0.0	10.8	8.2	7.1	6.5	6.2	6.5
<b>Economic Activity</b>									
Real GDP, yoy avg	5.7	5.2	3.3	-1.0	5.8	5.9	5.6	4.8	5.1
Real investment growth % yoy	9.1	6.4	20.8	-23.5	33.4	10.2	12.3	5.7	8.3
Real consumption growth % yoy	7.5	7.5	4.4	0.8	9.8	7.8	5.8	5.1	5.2
private consumption growth % yoy	7.8	7.6	5.2	-0.8	10.8	8.7	6.1	5.3	5.6
Real export growth, % yoy	5.1	7.2	-0.7	-4.5	2.3	5.2	1.0	3.2	3.7
Real import growth, % yoy	11.4	14.3	11.2	-16.2	25.9	14.5	4.9	8.1	6.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	2.6	7.8	7.1	-1.5	3.0	4.4	1.5	2.8	3.0
CPI, % avg	3.4	4.4	8.7	1.5	1.4	3.3	3.0	2.2	2.8
Nominal wages, % yoy	5.5	7.1	8.5	5.8	3.5	5.8	6.3	4.8	4.5
Credit extension to private sector, % yoy	16.8	21.0	18.7	-1.4	7.1	16.9	12.1	6.4	7.3
Policy Rate (eop)	5.25	6.00	8.25	0.50	3.25	5.25	5.00	4.50	5.25
1 month inter-bank rate, %, eop	5.36	5.93	8.24	0.45	3.13	5.23	4.99	4.50	5.25
Long-term yield, %, eop	-	6.30	5.93	5.38	5.81	4.92	5.45	5.35	6.10
CLP/USD, eop	532	498	638	507	468	520	479	480	488
CLP/USD, avg	530	522	524	559	510	484	486	475	485
<b>Balance of Payments, USD bn</b>									
Current account	7.1	7.1	-5.8	3.5	3.3	-3.2	-9.3	-7.0	-7.9
% of GDP	4.8	4.3	-3.3	2.2	1.6	-1.3	-3.4	-2.4	-2.5
Trade balance	22.9	24.1	6.1	15.4	15.3	10.8	3.5	5.9	8.1
Exports	59.4	68.6	64.5	55.5	70.9	81.4	78.4	87.3	91.1
Imports	36.4	44.4	58.4	40.1	55.6	70.6	74.9	81.4	82.9
Service balance	-0.9	-1.3	-1.2	-2.0	-1.8	-2.4	-1.7	-2.3	-2.6
Income balance	-18.4	-18.9	-13.6	-11.4	-14.8	-14.0	-12.7	-14.0	-15.2
FDI, net	7.4	12.6	15.5	12.9	15.4	17.3	29.1	20.5	19.0
International reserves	19.4	16.9	23.2	25.4	27.9	42.0	41.6	44.1	46.3
Total amortisations	12.5	9.7	14.3	16.4	12.3	12.8	22.2	23.5	24.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	7.9	8.4	4.3	-4.3	-0.3	1.4	0.6	-0.3	-0.4
Consolidated gov primary balance	8.5	9.0	4.8	-3.8	0.2	2.0	1.2	0.2	0.0
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	2.4	2.1	2.5	5.3	8.0	8.2	6.3	5.5	5.4
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	48.3	53.4	63.7	71.9	84.1	98.6	116.7	129.0	135.5
Public	4.5	4.0	3.3	4.0	5.6	7.1	7.9	4.5	4.6
External debt / GDP	32.9	32.5	36.6	44.4	41.3	41.0	43.5	43.5	43.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	8.1	9.0	14.0	15.8	16.5	19.4	23.4	25.6	26.8
Short-term debt/International reserves (%)	41.7	53.4	60.6	62.4	59.0	46.3	56.3	58.0	58.0
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	5.8	5.7	5.3	4.6	4.6	4.6	5.1	5.2	5.3
CPI, % yoy	2.8	1.5	1.7	2.6	2.4	2.8	2.7	2.7	2.8
Policy interest rate, %, eop	5.00	5.00	5.00	5.00	4.75	4.50	5.25	5.25	5.25
Short-term market rate, % eop	5.02	4.99	5.00	5.00	4.75	4.50	5.00	5.25	5.25
Long-term yield, %, eop	5.32	5.45	5.60	5.58	5.55	5.35	5.70	6.00	6.10
CLP/USD, eop	475	479	471	473	477	480	482	484	486

Source: National Sources, Citi Research

## Colombia

Munir Jalil  
+57 1 639 4195  
[munir.jalil@citi.com](mailto:munir.jalil@citi.com)

José Vicente Romero  
+57 1 638 4025  
[jose.v.romero@citi.com](mailto:jose.v.romero@citi.com)

- **Summary view** — The Colombian economy has gone into full deceleration mode at a faster-than-expected pace. That raises questions about the length of this business cycle phase. We continue to believe the economy will reach a trough in 1H13, and that throughout 2H13 we will experience the beginning of a new expansion phase. Inflation would react accordingly and increase from current below-target levels, but would still stand below the mid point of the inflation target by yearend. Under this scenario, Banrep will reduce its repo rate for the last time this year in the upcoming meeting, reaching 3.5%, and this rate will stay constant throughout most of the year.
- **Things to watch** — Watch for the health and pension reform bills which will be submitted by the government to Congress for approval.
- **Strategy** — In our view, the weaker internal outlook, inflationary pressures at bay, and a more accommodative monetary policy stance should be supportive of the local fixed rate curve in the short run. Nevertheless, we continue to believe that at some point during the second half of the year, local rates will find an inflection point.

### Macro outlook: Did Phil the groundhog cast his shadow?

**By now it is clear the economy is in a deceleration phase of its business cycle; the relevant question then is for how much longer?** Today it is no surprise that the Colombian economy is experiencing a period of weakness. But among economists, the question these days is not about the fact the winter is here, but rather about its duration. Our expectation in terms of GDP growth for the year (3.8% YoY) has always assumed a second half where activity reacts and a new expansion phase of the business cycle begins. We see no reason to think otherwise at the moment but there are concerns about what would happen if Phil the groundhog saw his shadow and the deceleration lasts a little bit longer.

**Investment, and in particular construction, is the reason behind the uncertainty associated with economic activity.** The highly volatile behavior of the construction sector has a lot to do with the questions being raised about this sector's potential to fulfill its countercyclical role. Within construction, public works have shown an extremely volatile performance due to the fact that it has not been possible to have a smooth and continuous set of projects undergoing at any given point in time. Hence, and after two years and a half of this situation, we decided to take a skeptical view that does not consider the construction sector capable of being a growth driver for the time being.

### Inflation: When it hurts so good

**The first months of the year have brought inflation below the 2% inflation target floor.** For some, the low inflation in months in which normally we expect indexation is another achievement of monetary policy as inflation is posing no concern to monetary authorities at the moment. However, in our view, the low inflation prints are a symptom of the weakness of economic activity and hence they should be interpreted with caution by the central bank.

**We expect inflation to react in the months to come and reach 2.5% by yearend.** In particular, February's annual inflation (1.76%) was the lowest inflation print we expect this year, and in the coming months we expect inflation to recover, finishing at 2.5% by December. Behind our view for inflation expansion, is our expectation of a recovery of economic activity in 2H13.

**For monetary policy purposes, it is inflation expectations, rather than the current observation, that matter.** In particular, we expect the board to decide based on the inflation forecast provided by the staff, which is based on the fan chart provided in the latest inflation report, to expect a rebound on inflation taking place later this year.

### **Monetary policy: Iron ore cannot be educated into gold**

**In an environment in which activity has weakened more than initially expected and favorable inflation results, Banrep has reacted in the right direction by loosening its monetary policy stance, but can they go any further?** As we have mentioned before, with our current GDP and inflation forecasts the Taylor rule states that Banrep's repo rate should display an additional decrease in March. After this, we expect the Repo rate to remain on hold at 3.50% until yearend, a point at which we expect the monetary policy stance to be less accommodative. Why wouldn't Banrep go any further? This has to do with the limits of monetary policy and the fact that it is impossible to substitute with interest rate reductions what fiscal policy has not been able to do so far in terms of countercyclical spending.

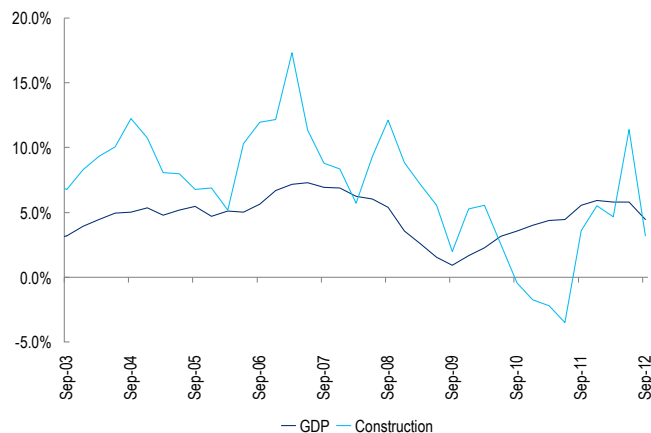
### **FX: What will the market do when it discovers it is in the placebo group?**

**Actions to fight appreciation of the COP against the USD have involved outright purchases by the National Treasury, increases in daily purchases by Banrep and lots of verbal intervention.** Among these measures it is important to highlight the increase in the CB's intervention (USD3 billion between February and May) and changes in the Ministry of Finance's (MoF) fiscal plan, which added USD1 billion of discretionary intervention in the local FX market as a result of lower external debt issuance. As we have stated before, we think appreciation of the COP is mostly explained by global factors (i.e. international liquidity and commodity prices), and although we think these measures will have some temporary impact on the FX front, at the end of day they are not even close to a real "cure" for the problem, which will consist on raising government savings. We have always wondered about the high credibility the market assigns to all forms of verbal intervention used by the government, but at the same time we expect the market to react once it realizes it has been in the placebo group and that what it has been receiving is not a structural solution. This is the reason why, assuming the recent risk-off environment is short lived, we expect the USDCOP to reach 1,775 in April.

### **Investment implications**

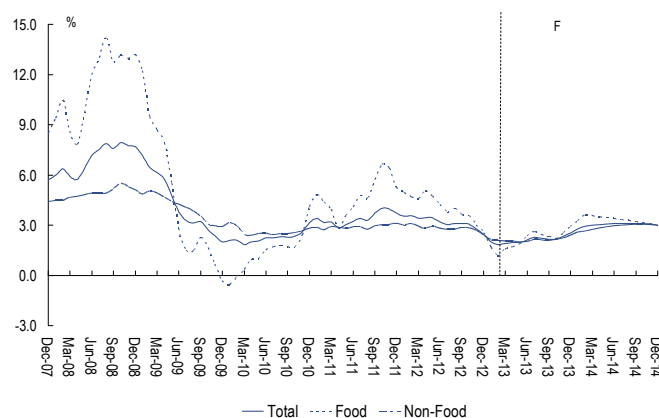
**In our view, the weaker internal outlook, inflationary pressures at bay, and a more accommodative monetary policy stance should be supportive of the local fixed rate curve in the short run.** Although these expectations should theoretically benefit short and mid tenors of the curve, we do not think that we would see a pronounced steepening of the curve. This situation is the result of the tax reduction for offshore investors, which would also benefit the longer tenors of the fixed rate curve. All these elements should favor the local fixed rate TES curve at least during 1H13. For the second part of the year, it should be important to assess how the fiscal figures are behaving (something that requires a more detailed analysis given the recent tax reform and the uncertainty regarding spending) and the consequences in the local market of eventual increases in US Treasury rates.

Figure 248. Construction sector should drive down GDP growth...



Source: DANE and Citi Research

Figure 250. ...translating into lower demand-side inflationary pressures...



Source: Banrep and Citi Research

Figure 252. USDCOP dynamics



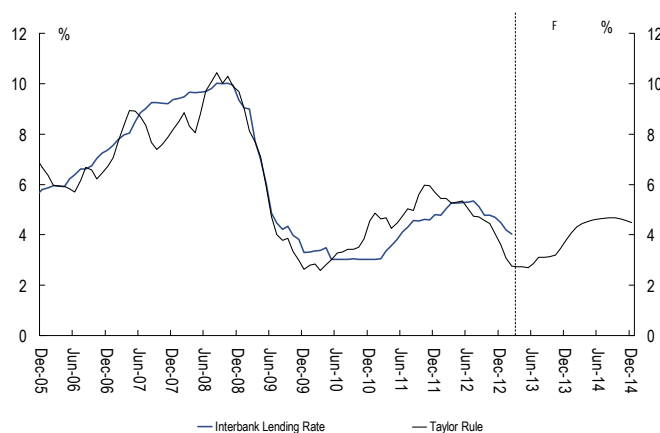
Source: Bloomberg and Citi Research

Figure 249. ... and should only start rebounding by 2H13...



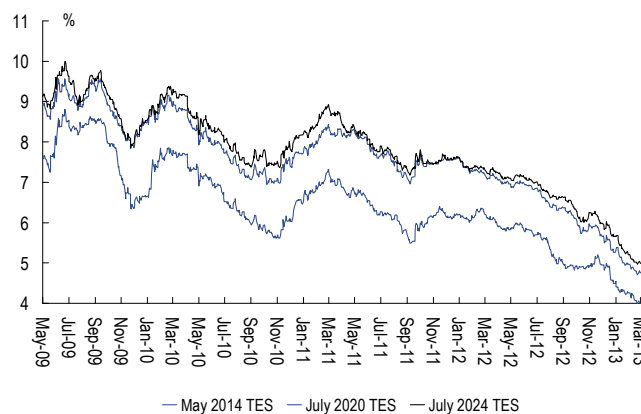
Source: DANE and Citi Research

Figure 251. ...and lower interest rate according to our Taylor Rule model



Source: Banrep and Citi Research

Figure 253. The TES market would behave favorably throughout 1H13



Source: Bloomberg and Citi Research

Figure 254. Colombia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	163	208	242	231	285	332	363	384	413
Nominal GDP, local currency bn	384	431	480	505	544	616	653	689	740
GDP per capita, USD	3,744	4,726	5,447	5,136	6,248	7,220	7,804	8,144	8,675
Population, mn	43.4	43.9	44.5	45.0	45.5	46.0	46.5	47.1	47.6
Unemployment, % of labour force	12.9	11.4	11.5	13.0	12.4	11.5	11.2	10.8	10.8
<b>Economic Activity</b>									
Real GDP, yoy avg	6.7	6.9	3.5	1.7	4.0	5.9	3.6	3.8	4.5
Real investment growth % yoy	19.2	12.8	9.0	-3.9	7.4	17.2	6.1	5.3	4.1
Real consumption growth % yoy	6.3	7.0	3.5	1.6	5.1	5.7	4.1	4.0	4.8
private consumption growth % yoy	6.4	7.3	3.5	0.6	5.0	6.5	4.2	4.0	4.7
Real export growth, % yoy	8.6	6.9	4.5	-2.8	1.3	11.4	4.2	8.0	10.4
Real import growth, % yoy	20.0	14.0	10.5	-9.1	10.5	21.5	9.0	7.4	8.4
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	4.5	5.7	7.7	2.0	3.2	3.7	2.4	2.5	3.0
CPI, % avg	4.3	5.5	7.0	4.2	2.3	3.4	3.2	2.1	3.0
Nominal wages, % yoy	9.2	5.4	19.1	3.0	4.1	4.2	4.3	4.4	4.5
Credit extension to private sector, % yoy	18.5	19.9	14.3	6.8	9.8	18.3	10.0	12.8	14.0
Policy Rate (eop)	7.50	9.50	9.50	3.50	3.00	4.75	4.25	3.75	4.50
1 month inter-bank rate, %, eop	7.50	9.35	8.87	3.10	3.00	4.81	4.27	3.80	4.52
Long-term yield, %, eop	9.00	10.27	12.76	8.47	7.70	7.60	5.86	5.05	5.77
COP/USD, eop	2,239	2,018	2,249	2,043	1,920	1,939	1,767	1,800	1,800
COP/USD, avg	2,360	2,076	1,968	2,154	1,898	1,848	1,798	1,800	1,800
<b>Balance of Payments, USD bn</b>									
Current account	-3.0	-6.0	-6.8	-5.0	-8.8	-10.0	-11.5	-12.8	-12.7
% of GDP	-1.8	-2.9	-2.8	-2.1	-3.1	-3.0	-3.2	-3.3	-3.1
Trade balance	0.3	-0.6	1.0	2.5	2.2	5.6	4.8	4.6	5.1
Exports	25.2	30.6	38.5	34.0	40.9	57.7	61.4	67.9	73.5
Imports	24.9	31.2	37.6	31.5	38.6	52.2	56.6	63.3	68.4
Service balance	-2.1	-2.6	-3.1	-2.8	-3.6	-4.6	-4.7	-3.8	-3.8
Income balance	-5.9	-8.0	-10.2	-9.3	-11.8	-15.8	-16.2	-18.5	-18.9
FDI, net	6.7	9.0	10.6	7.1	6.7	13.6	16.0	17.2	16.7
International reserves	15.4	20.9	24.0	25.4	28.5	32.3	37.0	41.8	46.6
Total amortisations	8.0	5.7	5.1	5.8	6.5	6.3	9.6	9.2	9.1
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.7	-0.6	-0.1	-2.7	-3.3	-2.9	-0.1	-1.1	-0.7
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	37.5	32.9	34.0	36.7	37.3	34.9	32.6	35.4	32.5
of which Domestic	23.8	21.9	22.6	24.9	26.4	24.5	23.5	22.4	20.6
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	40.1	44.6	46.4	53.7	64.1	75.9	80.8	85.9	86.4
Public	26.3	28.8	29.4	37.1	38.9	42.8	45.6	49.4	49.4
External debt / GDP	24.7	21.5	19.1	23.2	22.5	22.8	22.3	22.4	20.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	4.6	5.1	5.7	3.9	8.1	10.8	9.8	10.4	11.2
Short-term debt/International reserves (%)	29.6	24.6	23.5	15.6	28.3	33.4	26.5	24.8	23.9
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	2.1	2.9	3.1	3.8	3.5	4.8	4.1	4.4	5.0
CPI, % yoy	3.1	2.4	1.9	2.1	2.2	2.5	3.0	3.1	3.1
Policy interest rate, %, eop	4.75	4.25	3.50	3.50	3.50	3.75	4.25	4.50	4.50
Short-term market rate, % eop	4.78	4.27	3.52	3.54	3.54	3.80	4.02	4.52	4.52
Long-term yield, %, eop	6.13	5.86	4.90	4.79	4.79	5.05	5.27	5.77	5.77
COP/USD, eop	1,800	1,767	1,799	1,800	1,800	1,800	1,800	1,800	1,800

Source: National Sources, Citi Research

## Mexico

Sergio Luna  
+52 55 2226 6799  
[sergio1.luna@banamex.com](mailto:sergio1.luna@banamex.com)

- **Summary view** — Economic performance improved at the beginning of the first quarter. We kept our GDP forecast of 3.6% for 2013. Inflation resumes its upward climb, although we see that this will be temporary. Having lowered its monetary policy rate to 4%, we expect Banxico to stay on hold until May 2015.
- **Things to watch** — Congress is now in possession of a far-reaching Bill to increase competition in media and telecoms, and an agreement on this may be reached in the next few days, increasing the possibility of progress on other structural reforms.
- **Strategy** — The unusually brief spike in the USD/MXN that followed Banxico's 50bp rate cut invigorated bullish views on the Mexican currency. We revise our 0-3 month and year-end USD/MXN forecast to 12.20 and 12.10, respectively.

### The economic slowdown probably bottomed in 1Q13

**Economic activity rebounded at the beginning of the first quarter.** IP rebounded in January, growing by 1.1%MoM, after declining in December (-2.2%MoM). Several other indicators also point to an improvement in domestic demand for January. We therefore estimate that the growth of economic activity – measured by the IGAE – will be around 3%YoY in January, after growing by just 1.4% in December, with a monthly growth rate of close to 0.5%. However, we have reassessed a negative calendar effect (a leap year in 2012 added a working day in 1Q12 and the Easter Holiday this year will subtract working days from 1Q13) on economic activity in February-March, lowering our annual growth forecast for first quarter GDP to 1.7% from 2.5%. However, using seasonally adjusted figures our expectation is practically unchanged with an increase of 2.7% saar for GDP during the quarter, a moderate slowdown from 3.1% saar in 4Q12.

**Our forecast for the whole of 2013 stays at 3.6%.** A reassessment of the calendar effect for the same reason leads to an upward adjustment in our 2Q13 GDP growth forecast, also supported by better outlook for the primary sector (4.9% saar). Meanwhile, we maintain the forecast for an improvement in the second half of the year, supported by better performance of external demand, and gradual but sustained growth in domestic demand, as drivers of consumption continue performing well: the wage mass was up 4.5%YoY in February and consumer credit was up 15%YoY.

### Banxico's monetary policy unchanged through 2013

**Annual inflation has started to rise, but this should be short-lived.** Headline inflation stood at 3.6% in February versus 3.3% in January, mainly reflecting rising farm prices and increased cell-phone charges. Core inflation was moderate, at 2.96% after 2.88% in January. The rebound reflects a low annual base of comparison. We anticipate a downturn in inflation in the second half of 2013, and continue to expect headline and core inflation at around 3.6% and 3.3% in 2013. It is important to keep in mind that the local statistical institute INEGI will perform a re-weighting of the CPI in April this year, a process that could create a downward bias in inflation numbers.

**As we anticipated, Banxico cut its policy rate by 50 basis points at its March meeting, to 4% from 4.5%, its first move since July, 2009.** Banxico had argued that an improved structural dynamic for inflation, greater resistance to second-order effects after relative price shocks, the anchoring of inflation expectations and the dive in inflation premiums provided an opportunity for the cut. When announcing its decision, the board also mentioned the impact of lax monetary policies elsewhere and its corollary in the guise of stronger capital inflows as one factor behind the decision.

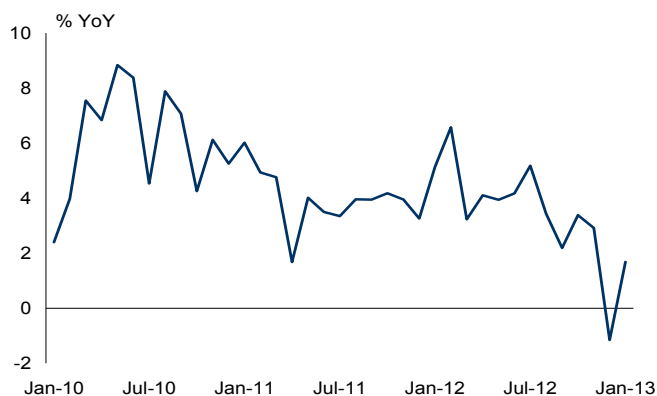
**Policymakers have made clear this action was not the beginning of an easing cycle.** In our view, the idea is actually to allow the Mexican economy to adapt to a set of macroeconomic circumstances that are radically different from the recent past and that are characterized by a constructive view about Mexico amid a world abundant in liquidity. This could lead to the kind of “rich man’s problem” faced by many other EMs in the recent past, often symbolized by substantial currency appreciation. In the case of Mexico, policymakers are unlikely to try to avoid this trend – after all, currency appreciation would be the logical outcome of a successful reform program – but will try to adapt the macro framework in order to assimilate the new set of circumstances. Thus, the main challenge for policymakers is to make clear to the market that there is no FX “rule of thumb” that could automatically lead to a new window of opportunity for discrete adjustments in the policy rate. In our scenario of a stronger peso, conditions should allow Banxico to remain on hold at 4% until May 2015, when we expect is a rate hike. The alternative scenario of potential rate cuts – which we view as limited in any case – would require first the materialization of structural reforms that could herald meaningful gains in productivity – and thus a stronger real exchange rate and fewer inflationary pressures. This of course is a scenario that could take several quarters to occur; the question is whether financial markets anticipate this scenario in a way that they believe would create a policy dilemma.

## **The good momentum of the structural reforms**

**Material progress in the structural reform front so far is impressive.** The federal congress plus more than 50% of the local legislatures passed the educational reform, a constitutional change, and President Peña has already signed the bill. Immediately after this in a surprising move, the powerful leader of the Teacher’s Union was arrested on several charges, increasing the chance of far-reaching changes in Mexico’s educational system. Two weeks later President Peña and leaders of the four political parties that signed the “pact for Mexico” submitted to Congress another bill involving a major breakthrough in competition in telecoms and broadcasting. This would also imply a constitutional change and, at the time of writing, the bill has not only received substantial backing from Congress, media and telecom firms likely to be affected are apparently not opposing its approval. Also, the labor reform approved at year-end of 2012 and several other initiatives (legislators no longer enjoy immunity, injunction processes no longer allowed, in order to stop regulatory rulings) and progress is indeed impressive.

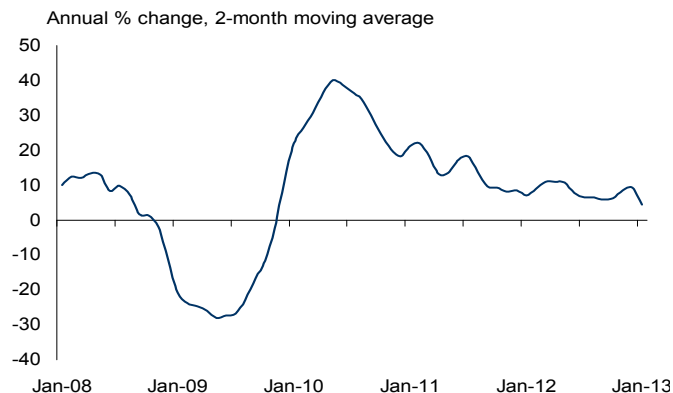
**While this creates momentum for fiscal or energy reforms, we still believe these cannot be taken for granted.** There are reasons to be optimistic about further progress in the reform agenda, but it is important to keep in mind that in issues such as the energy reform, the stances of participants in the pact for Mexico differ and thus reaching a consensus will be harder. Alternatively, guaranteeing consensus would probably require diluted proposals – when it comes to reforms, “the devil is in the details”. In other words, achieving meaningful progress in these areas will probably involve President Peña risking some of the political capital he has rightfully gained so far.

Figure 255. Industrial production growth picks up



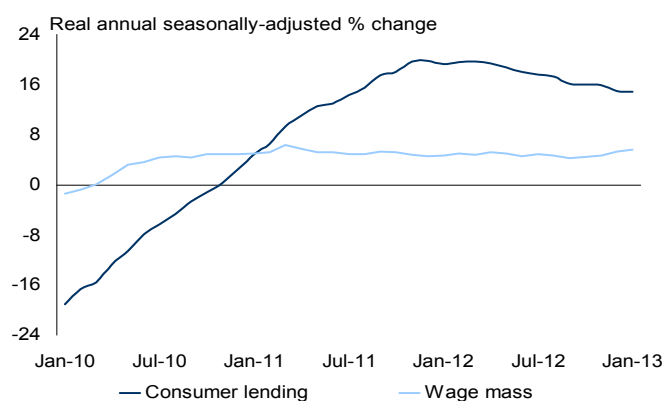
Sources: INEGI and Banamex

Figure 256. Manufacturing exports still losing momentum



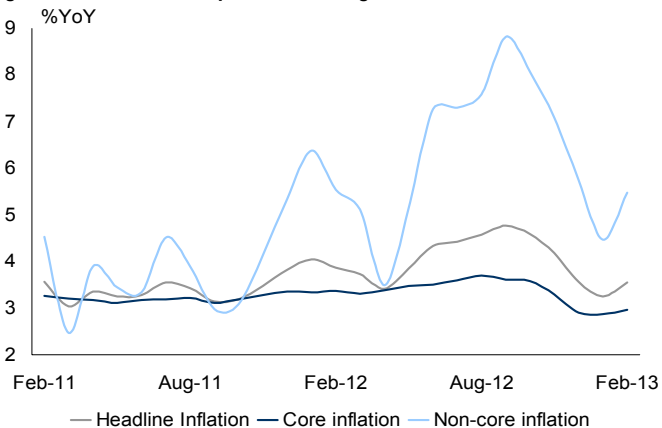
Sources: INEGI and Banamex

Figure 257. Consumption determinants go on growing strongly



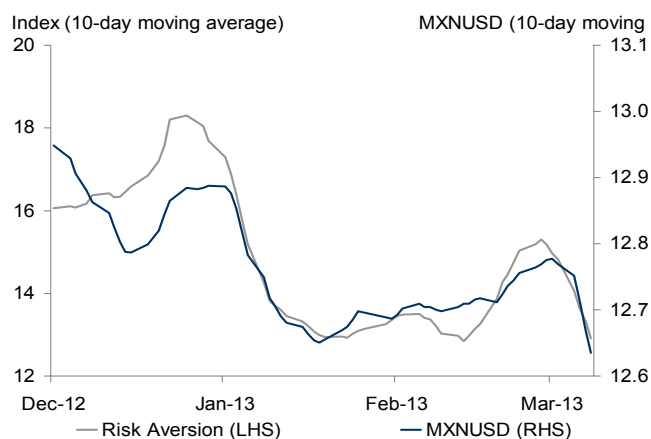
Sources: STPS, Banxico and Banamex

Figure 258. Inflation has passed its trough



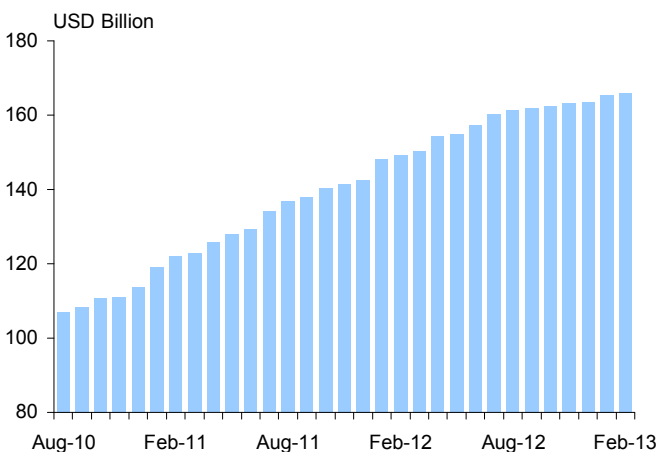
Sources: Banxico and Banamex

Figure 259. Risk aversion still driving the FX market



Sources: Bloomberg and Banamex

Figure 260. FX Reserves continue to strengthen



Sources: INEGI and Banamex

Figure 261. Mexico Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	952	1,036	1,103	886	1,035	1,159	1,190	1,355	1,460
Nominal GDP, local currency bn	10,379	11,321	12,181	11,937	13,072	14,396	15,656	16,908	18,251
GDP per capita, USD	8,780	9,439	9,907	7,852	9,060	10,022	10,176	11,469	12,238
Population, mn	108.4	109.8	111.3	112.9	114.3	115.6	116.9	118.1	119.3
Unemployment, % of labour force	3.6	3.7	4.0	5.5	5.4	5.2	5.0	5.1	4.5
<b>Economic Activity</b>									
Real GDP, yoy avg	5.2	3.3	1.2	-6.0	5.3	3.9	3.9	3.6	3.8
Real investment growth % yoy	7.9	3.3	2.6	-14.7	6.4	2.7	6.7	5.8	3.0
Real consumption growth % yoy	5.1	3.9	1.6	-5.8	4.6	4.0	2.8	3.0	3.3
private consumption growth % yoy	5.7	4.0	1.7	-7.2	4.9	4.4	3.1	3.4	3.7
Real export growth, % yoy	11.0	5.8	0.5	-13.5	21.6	7.5	4.9	3.2	7.4
Real import growth, % yoy	12.6	7.1	2.6	-18.4	19.6	7.1	4.0	3.3	5.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	4.1	3.8	6.5	3.6	4.4	3.8	3.6	3.6	3.7
CPI, % avg	3.6	4.0	5.1	5.3	4.2	3.4	4.1	3.7	3.6
Nominal wages, % yoy	5.1	5.4	5.3	4.2	3.0	5.4	4.4	4.6	4.2
Credit extension to private sector, % yoy	11.4	12.0	9.6	0.5	5.6	7.5	7.4	7.1	6.9
Policy Rate (eop)	7.05	7.50	8.25	4.50	4.50	4.50	4.50	4.00	4.00
1 month inter-bank rate, %, eop	7.05	7.50	8.25	4.50	4.50	4.50	4.50	4.00	4.00
Long-term yield, %, eop	7.46	8.03	8.35	7.99	6.95	6.51	5.38	5.97	6.34
MXN/USD, eop	10.80	10.91	13.67	13.06	12.36	13.95	12.87	12.11	12.27
MXN/USD, avg	10.91	10.93	11.16	13.50	12.63	12.44	13.16	12.18	12.21
<b>Balance of Payments, USD bn</b>									
Current account	-6.1	-12.4	-18.0	-5.2	-1.7	-9.2	-7.1	-18.9	-21.7
% of GDP	-0.6	-1.2	-1.6	-0.6	-0.2	-0.8	-0.6	-1.4	-1.5
Trade balance	-6.1	-10.1	-17.3	-4.7	-3.0	-1.5	0.2	-11.3	-14.9
Exports	249.9	271.9	291.3	229.7	298.5	349.4	370.9	384.7	420.4
Imports	256.1	281.9	308.6	234.4	301.5	350.8	370.8	396.0	435.3
Service balance	-5.7	-6.3	-7.4	-8.3	-9.5	-13.5	-13.0	-13.7	-13.3
Income balance	-20.1	-22.4	-18.8	-13.8	-10.7	-17.2	-16.9	-17.0	-17.2
FDI, net	20.2	31.8	27.2	16.3	20.9	20.4	20.1	37.7	22.1
International reserves	67.7	78.0	85.4	90.8	113.6	142.5	163.5	184.7	201.0
Total amortisations	22.8	26.2	30.1	27.7	32.4	51.5	50.2	52.7	51.6
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.1	0.0	-0.1	-2.3	-2.8	-2.5	-2.6	-2.1	-2.0
Consolidated gov primary balance	2.5	2.2	1.8	-0.1	-0.9	-0.6	-0.6	0.0	-
Public debt	33.7	33.7	36.5	40.3	38.8	39.6	39.5	38.2	38.1
of which Domestic	22.8	22.0	24.7	26.7	23.9	23.8	21.4	21.0	21.4
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	171.4	196.8	205.3	195.0	247.6	281.0	314.9	333.9	354.1
Public	104.2	121.0	129.3	120.9	155.1	183.0	214.6	226.8	240.9
External debt / GDP	18.0	19.0	18.6	22.0	23.9	24.2	26.5	24.6	24.3
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	25.6	26.1	25.1	21.3	21.3	22.7	22.9	23.7	24.9
Short-term debt/International reserves (%)	37.8	33.4	29.4	23.5	18.8	16.0	14.0	12.9	12.4
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	3.2	3.2	2.5	3.6	3.8	4.4	4.8	3.8	3.4
CPI, % yoy	4.8	3.6	4.0	3.9	3.5	3.6	3.4	3.6	3.6
Policy interest rate, %, eop	4.50	4.50	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Short-term market rate, % eop	4.50	4.50	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Long-term yield, %, eop	5.34	5.38	5.24	5.65	5.90	5.97	6.13	6.31	6.32
MXN/USD, eop	12.86	12.87	12.31	12.17	12.13	12.11	12.15	12.19	12.23

Source: National Sources, Citi Research

## Panama

Jorge Pastrana

+1-212-816-5728

[jorge.armando.pastranavillegas@citi.com](mailto:jorge.armando.pastranavillegas@citi.com)

Camilo Gonzalez

+1-212-816-9901

[camilo.gonzalezgarcia@citi.com](mailto:camilo.gonzalezgarcia@citi.com)

- **Summary view** — We expect real GDP growth to decelerate to 9% in 2013 from 10% in 2012. The current account (as a percentage of GDP) fell below the double digit threshold last year and we expect it to remain below that level in 2013 and 2014. We also expect foreign direct investment (FDI) to continue financing a high portion of the current account.
- **Things to watch** — Polls on the 2014 presidential election are worth monitoring, particularly after Juan Carlos Varela (PPA) and Juan Carlos Navarro (PRD) won the main opposition parties' primary elections. The ruling CD party will hold its primary election until May 12. A total of 10 candidates will try to seek the nomination of the CD party.
- **Strategy** — Economy and Finance Minister Frank de Lima said that he was "sure" that the country will have an "international placement" this year.<sup>3</sup> In our view, the external debt amortization schedule is comfortable for Panama as the nonfinancial public sector (NFPS) only faces external debt amortizations of US\$189 million this year. The next amortization of an external debt bond is scheduled for March 2015 and therefore it does not seem that the country should be in a hurry to issue.

### Real GDP would decelerate

**Real GDP increased 10% YoY in 4Q12, slightly below the growth rate of 3Q12 (10.5% YoY).** The Contraloría General de la República and the INEC reported that with this outcome, real GDP increased 10.7% during 2012. In 4Q12, construction increased 30.4% YoY, while transportation, storage and communications grew 30.4% YoY. Commerce (retail and wholesale) increased 6% YoY, thereby showing a sharp deceleration from 3Q12 (9.5% YoY).

**We expect real GDP growth to decelerate to 9% in 2013.** According to the Wall Street Journal (March 16, 2013), the government is expecting the economy to grow 8.5% in 2013. In addition it says that the government sees its own forecast as a conservative one. The Panama Canal expansion and the construction of Panama City's subway would continue translating into high growth rates in the construction sector. However, we would expect commerce and transportation to contribute slightly less to growth. Our 2013 and 2014 real GDP growth forecasts are 9% and 8% respectively.

### Current account falls below the double digit threshold

**The current account (as a percentage of GDP) fell below the double digit threshold last year.** The Contraloría and INEC also released that the current account deficit amounted to almost US\$3.3 billion in 2012, which is about 9% of GDP. It is worth remembering that in 2011 the current account deficit reached a high of 12.2% of GDP. We expect the current account to post deficits of 8.5% and 7.5% of GDP in 2013 and 2014, respectively. We also expect foreign direct investment (FDI) to continue financing a high portion of the current account. FDI amounted to US\$3 billion in 2012.

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<sup>3</sup> Quoted by Bloomberg on March 14.

## Opposition parties nominate candidates

### **The PRD and PPA nominated its presidential candidates for the 2014 election.**

The *Partido Revolucionario Democrático* (PRD) held its primary election on March 10. The winner was former Panama City Mayor Juan Carlos Navarro. On March 17, Vice President Juan Carlos Varela won the Partido Panameñista's (PPA) primary election. The latest available poll by Dichter & Neira (February 2013) puts Juan Carlos Navarro ahead in the presidential race even if President Ricardo Martinelli is included in the poll—although the incumbent president is prohibited from running for office.

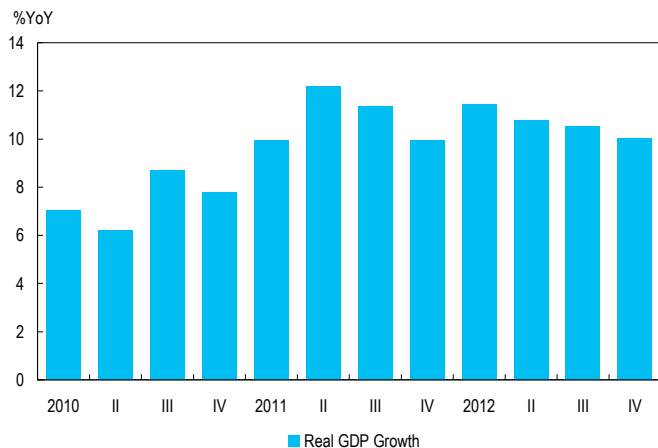
### **A total of 10 candidates will try to seek the nomination in the May 12 primary elections of the ruling Cambio Democrático (CD) party.**

Economy and Finance Minister Frank de Lima will not seek the nomination (La Estrella de Panamá, February 27), while Social Development Minister Guillermo Ferrufino will run for Panama City Mayor as a candidate of CD. With Guillermo Ferrufino and Frank de Lima out of the presidential race, it is worth monitoring who President Martinelli would support in the ruling CD party's primary election. In our view, President Martinelli ran out of time to modify the ban that prevents him from running for office.

## Investment implications

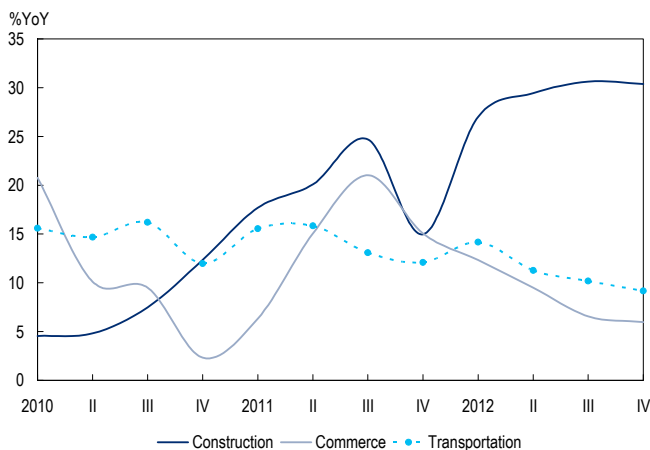
**Panama may issue this year.** Bloomberg (March 14) quoted Economy and Finance Minister Frank de Lima saying that he was “sure” that the country will have an “international placement” this year. In our view, the external debt amortization schedule is comfortable for Panama. According to the 2013 budget, the nonfinancial public sector (NFPS) only faces external debt amortizations of US\$189 million this year. In addition the next amortization of an external debt bond is scheduled for March 2015. At least from the amortization side, it does not seem that the country should be in a hurry to issue.

**Figure 262. Real GDP increased 10%YoY on 4Q12**



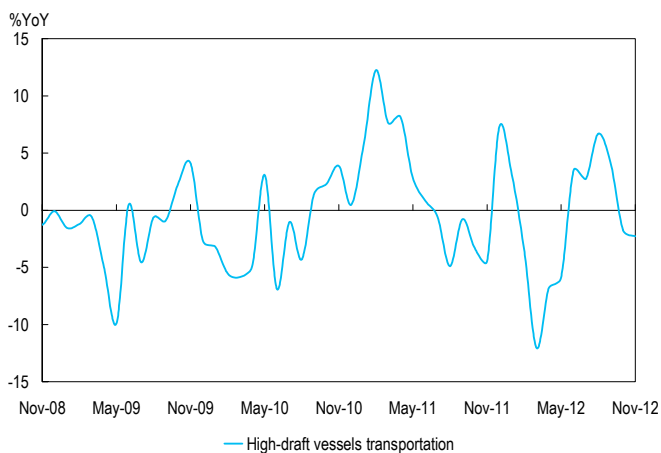
Source: Contraloria, INEC, Haver and Citi Research

**Figure 264. Construction is outperforming other sectors**



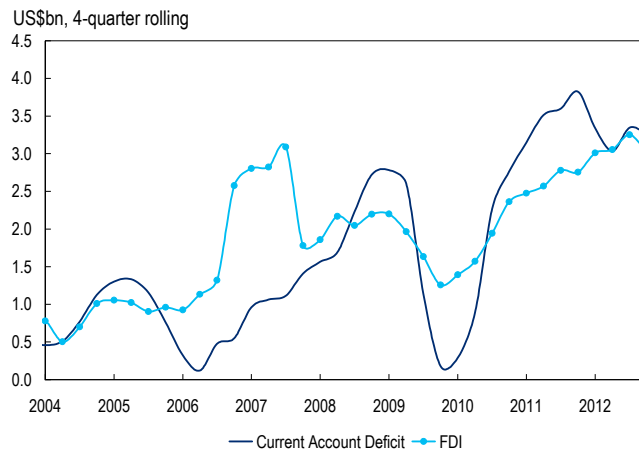
Source: Contraloria, INEC and Citi Research

**Figure 266. Traffic in the Panama Canal has continued to fall**



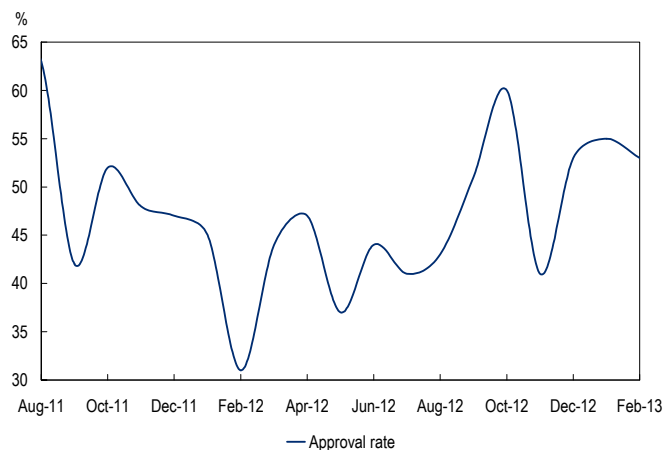
Source: ACP, Contraloria, Haver, Bloomberg and Citi Research

**Figure 263. FDI is financing a large portion of the current account**



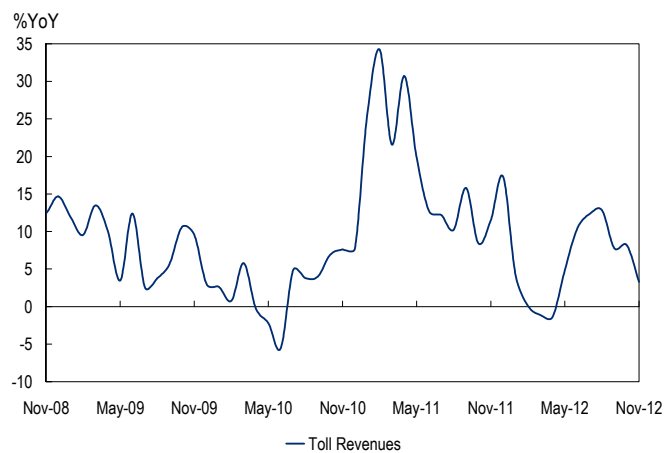
Source: Contraloria, INEC and Citi Research

**Figure 265. President Martinelli's approval rate has been volatile**



Source: Dichter & Neira and Citi Research

**Figure 267. Growth in toll revenues has slowed down**



Source: ACP, Contraloria, Haver and Citi Research

Figure 268. Panama Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	17	20	23	24	27	31	36	41	47
Nominal GDP, local currency bn	17	20	23	24	27	31	36	41	47
GDP per capita, USD	5,218	5,921	6,759	6,973	7,670	8,699	10,070	11,309	12,596
Population, mn	3.3	3.3	3.4	3.5	3.5	3.6	3.6	3.7	3.7
Unemployment, % of labour force	9.1	6.8	5.8	5.0	4.5	4.3	4.0	3.8	-
<b>Economic Activity</b>									
Real GDP, yoy avg	8.7	12.1	10.1	3.9	7.6	10.6	10.7	9.0	8.0
Real investment growth % yoy	13.5	38.9	24.2	-6.2	-	-	-	-	-
Real consumption growth % yoy	4.2	1.4	-1.4	0.8	-	-	-	-	-
private consumption growth % yoy	4.4	0.9	-2.1	-0.2	-	-	-	-	-
Real export growth, % yoy	11.1	22.0	17.8	-5.6	-	-	-	-	-
Real import growth, % yoy	7.4	18.1	12.2	-12.2	-	-	-	-	-
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	2.2	6.4	6.8	1.9	4.9	6.3	4.6	4.8	4.5
CPI, % avg	2.5	4.2	8.8	2.4	3.5	5.9	5.7	4.6	4.4
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	-	-	-	-	-	-	-	-	-
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
PEN/USD, eop	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
PEN/USD, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
<b>Balance of Payments, USD bn</b>									
Current account	-0.4	-1.4	-2.7	-0.2	-2.8	-3.8	-3.3	-3.5	-3.5
% of GDP	-2.2	-7.2	-11.8	-0.7	-10.2	-12.2	-9.0	-8.5	-7.5
Trade balance	-1.8	-3.2	-4.5	-2.2	-4.5	-6.0	-5.8	-5.9	-
Exports	8.5	9.3	10.3	12.0	12.7	16.9	18.9	20.1	-
Imports	10.3	12.5	14.9	14.2	17.2	22.9	24.6	26.0	-
Service balance	2.2	2.8	3.2	3.3	3.5	3.9	5.1	4.9	-
Income balance	-1.3	-1.3	-1.6	-1.4	-1.8	-1.9	-2.7	-2.7	-
FDI, net	2.5	1.8	2.2	1.3	2.4	2.8	3.0	3.2	-
International reserves	1.3	1.9	2.4	3.0	2.7	2.3	2.2	2.3	-
Total amortisations	-	-	-	-	-	-	-	-	-
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.5	3.5	0.4	-1.0	-1.9	-2.2	-2.1	-3.0	-3.0
Consolidated gov primary balance	4.9	6.9	3.5	1.9	0.8	0.1	-0.1	-0.9	-
Public debt	61.0	52.9	45.4	45.6	43.4	41.8	41.0	41.0	-
of which Domestic	15.5	11.1	8.5	3.4	4.4	6.2	9.0	10.0	-
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	-	-	-	-	-	-	-	-	-
Public	-	-	-	-	-	-	-	-	-
External debt / GDP	-	-	-	-	-	-	-	-	-
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	-
Short-term debt/International reserves (%)	11.2	7.9	6.4	5.2	5.8	8.7	9.1	8.7	-
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	10.5	10.0	9.5	9.2	9.0	8.3	8.5	8.0	8.0
CPI, % yoy	5.4	4.6	4.2	4.7	4.8	4.8	4.1	3.7	4.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
PAB/USD, eop	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Source: National Sources, Citi Research

## Peru

Camilo Gonzalez  
+1 212 816 9901  
[camilo.gonzalezgarcia@citi.com](mailto:camilo.gonzalezgarcia@citi.com)

- **Summary view** — Activity continues growing at a pace consistent with potential output. Expect some volatility in the monthly GDP series, due to the shift in working days related to the celebration of Easter in March.
- **Things to watch** — Watch for further measures from the central bank as it tries to prevent the financial stability outlook from deteriorating further. The BCRP will act to prevent excessive growth in foreign currency credit.
- **Strategy** — We expect 50bp worth of interest rate cuts in 2013 and aggressive intervention from the BCRP in the FX market. Locals' decision to play the carry trade has been influenced by widening interest rate differentials, PEN appreciation expectations and low FX volatility.

### Activity: In line with potential output

**In January, the economy grew 6.2% YoY, after the 4.3% annual rise registered in December.** The rebound was driven by the swift recovery in the construction sector, which expanded 15.5% YoY after a "measly" 5.3% YoY print in December. Overall, the activity story remains unchanged, with sectors linked to domestic demand driving the economy's resilience: retail trade, services and construction. In the meantime, manufacturing continues to act as a drag on growth, after having expanded only by 1.8% YoY.

**We do not see any mayor reasons for the economy to accelerate beyond this point in 2013.** First of all, external demand is likely to remain suppressed. In January, data from the INEI showed that demand for Peru's exports has yet to fully recover as exports slumped 18% YoY, as a result of lower demand for traditional exports. Furthermore, our commodities strategists expect metal prices to remain range-bound at current levels, which suggests there is little upside for exports. On the domestic front, we believe there are some indications calling for a moderation of private demand. Chief among them is the slowdown in credit growth, especially after the latest round of central bank measures (more on this below). Nonetheless, we expect fiscal policy to be more expansionary this year, which should help offset slower private demand.

**Our forecast calls for the economy to grow 6.2% in 2013, in line with potential output.** Nonetheless, we are likely to see some volatility in the monthly GDP series as a result of the shift in working days related to the celebration of Easter in March instead of April. This should result in lower year-over-year growth numbers during the first quarter, offset by stronger performance in 2Q13. According to our GDP path, the economy would be operating in line with potential output throughout 2013.

### Inflation: Benign outlook remains base case

**Lower food prices led inflation to 2.5% YoY in February, its lowest level in two years.** February's substantial drop in food prices (-0.27% MoM) also helped offset the effect from rising energy and gasoline prices, resulting from increases in international fuel prices. March's CPI print is unlikely to be as benign as February's, thanks to the seasonal spike in items such as transportation and food resulting from the celebration of Easter. Nonetheless, we see no major risks for the inflation outlook.

**We still see inflation ending the year at 2.8%, as the low comparison base drives annual inflation up slightly in 2H13.** Our view that the economy is operating in line with potential output and that it is likely to continue doing so in the months to come suggests that there are no substantial pressures on the inflation front coming from domestic demand. Thus, we see inflation hovering close to the 2% midpoint target throughout 1H13. However, it is still important to continue monitoring volatile food prices, considering they represent over a third of the CPI basket.

### **BCRP acts decisively to tighten foreign currency credit**

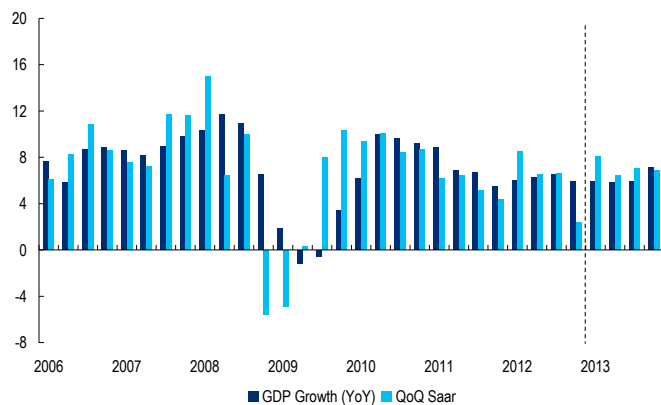
**The central bank recently announced a new set of macroprudential measures designed to control the expansion of bank loans.** On February 27, the BCRP announced a new round of increases in reserve requirements for the third consecutive month. Once again, the change in reserve requirement was geared toward foreign currency liabilities. This time around, the BCRP increased legal reserve requirements by 50bp, up to a limit of 50%. Institutions that surpass this threshold do not need to comply with the increase in legal reserve requirements (RR).

**Nonetheless, the BCRP announced a second set of measures specifically designed to slow down credit growth, especially in foreign currency.** The BCRP will raise RR on financial institutions that show particularly strong growth in mortgage and auto loans, which are for the most part, denominated in foreign currency. According to the BCRP, 45% of mortgage loans are denominated in USD, while for auto loans that figure rises to 77%. For institutions where credit in any of these segments is 10% above the level registered in February 2013, the increase in reserve requirements will be 75bp. If in turn, credit growth in these segments surpasses 20% (relative to February 2013), the increase in RR will be equivalent to 150bp.

**We still believe the BCRP will have room to cut the policy rate by 50bp.** Widening differentials between PEN and USD interest rates, persistent expectations of future PEN strength and low currency volatility have all played a role in the deterioration in the financial stability outlook. The aforementioned factors have created incentives for the private sector to play the carry trade (borrowing in foreign currency to invest in PEN assets). In the event of a negative shock, private sector balance sheets would be weakened and the effect on economic activity could be greater than in previous episodes. Although 50bp worth of cuts will not eliminate interest rate differentials, they will help weaken the incentives to borrow in foreign currency.

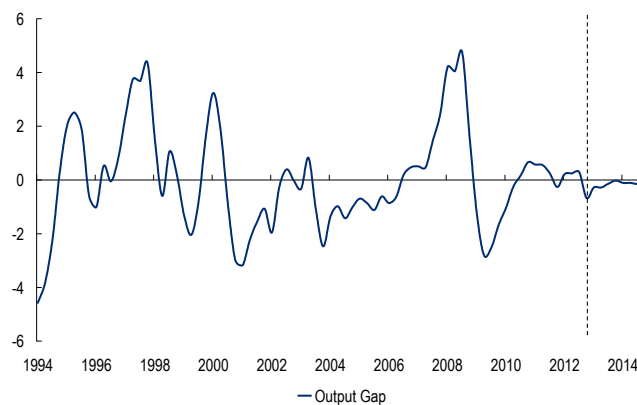
**For the policy to work, the BCRP will also need to continue intervening in the FX market.** As we mentioned above, one-sided expectations for the USD/PEN and low FX volatility have also played an important role. This is why we believe the central bank will continue intervening aggressively in the FX market in the future. Although FX fundamentals remain solid, we believe the BCRP will be more active than in the past intervening in the FX market through increases in reserve requirements, spot market purchases and increases in pension funds' foreign investment limits.

Figure 269. We have upgraded our 2013 growth forecast...



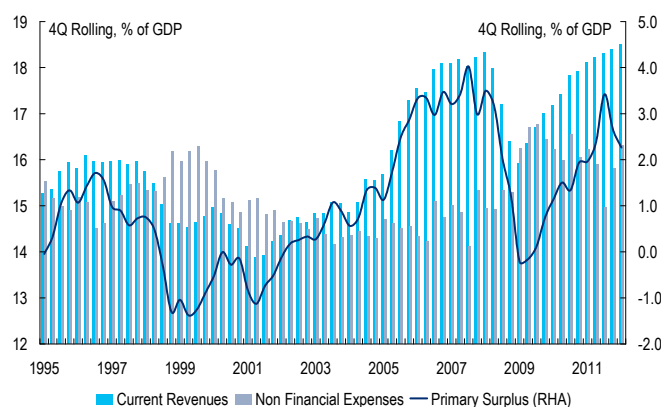
Source: BCRP and Citi Research

Figure 270. but the output gap should remain neutral



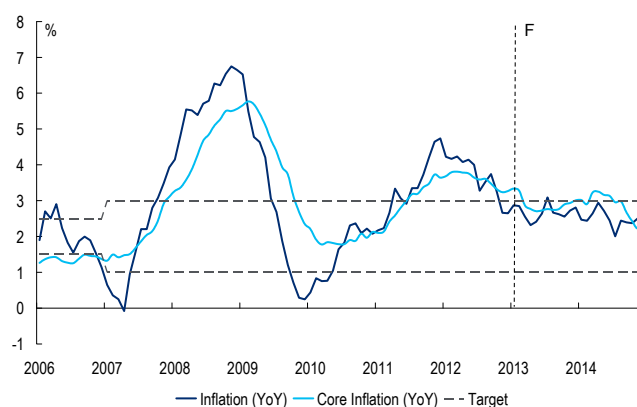
Source: Citi Research

Figure 271. Fiscal policy should provide a boost to growth



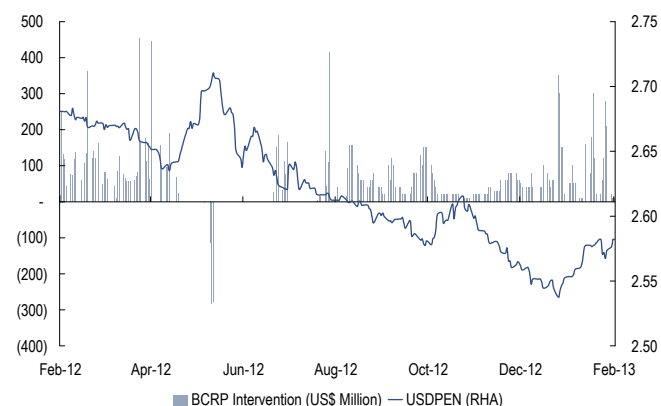
Source: MEF and Citi Research

Figure 272. We see stable inflation in 2013



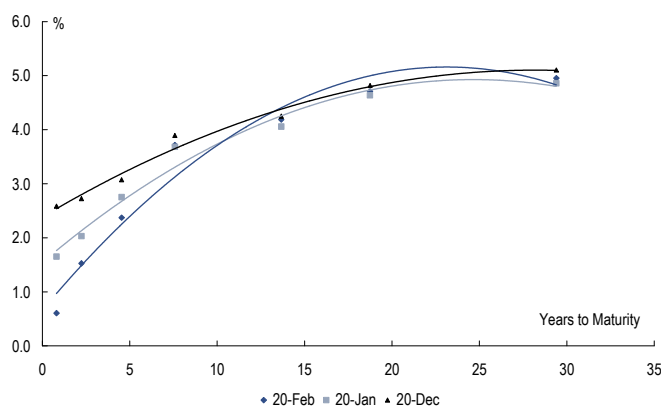
Source: INEI, BCRP and Citi Research

Figure 273. PEN under pressure thanks to BCRP actions.



Source: Bloomberg and Citi Research

Figure 274. Little carry in short term Soberano bonds



Source: Bloomberg and Citi Research

Figure 275. Peru Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	92	107	127	127	154	176	199	226	256
Nominal GDP, local currency bn	302	336	371	382	435	487	526	573	625
GDP per capita, USD	3,415	3,906	4,562	4,482	5,346	6,036	6,726	7,498	8,366
Population, mn	27.0	27.4	27.8	28.3	28.7	29.2	29.7	30.1	30.6
Unemployment, % of labour force	8.5	8.4	8.4	8.4	7.9	7.7	6.8	7.3	7.4
<b>Economic Activity</b>									
Real GDP, yoy avg	7.7	8.9	9.8	0.9	8.8	6.9	6.3	6.2	6.4
Real investment growth % yoy	26.5	25.8	25.8	-20.6	36.3	10.0	10.0	9.0	7.7
Real consumption growth % yoy	6.6	7.9	8.0	3.9	6.5	6.2	6.4	5.7	6.0
private consumption growth % yoy	6.4	8.3	8.7	2.4	6.0	6.4	5.8	5.3	5.7
Real export growth, % yoy	0.8	6.9	8.2	-3.2	1.3	8.8	4.8	5.2	6.1
Real import growth, % yoy	13.1	21.4	20.1	-18.6	24.0	9.8	10.4	7.5	6.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	1.1	3.9	6.7	0.2	2.1	4.7	2.6	2.8	2.2
CPI, % avg	2.0	1.8	5.8	2.9	1.5	3.4	3.7	2.4	2.6
Nominal wages, % yoy	7.1	5.0	12.8	23.1	-8.8	15.1	5.4	5.0	5.0
Credit extension to private sector, % yoy	15.9	29.9	14.3	10.4	20.1	14.2	13.6	10.8	6.5
Policy Rate (eop)	4.50	5.00	6.50	1.25	3.00	4.25	4.25	3.75	4.25
1 month inter-bank rate, %, eop	5.48	6.69	1.24	3.11	4.46	4.22	4.25	3.75	4.25
Long-term yield, %, eop	-	6.44	7.69	6.31	6.34	6.17	4.23	4.50	5.50
PEN/USD, eop	3.20	3.00	3.13	2.89	2.81	2.70	2.55	2.48	2.41
PEN/USD, avg	3.27	3.13	2.92	3.01	2.82	2.75	2.64	2.54	2.44
<b>Balance of Payments, USD bn</b>									
Current account	2.9	1.5	-5.3	-0.7	-3.8	-3.3	-7.1	-5.8	-6.9
% of GDP	3.2	1.4	-4.2	-0.6	-2.5	-1.9	-3.6	-2.6	-2.7
Trade balance	9.0	8.5	2.6	6.0	6.8	9.3	4.5	6.1	6.0
Exports	23.8	28.1	31.0	27.0	35.6	46.3	45.6	46.6	51.4
Imports	14.8	19.6	28.4	21.0	28.8	37.0	41.1	40.5	45.4
Service balance	-0.7	-1.2	-2.1	-1.2	-2.3	-2.1	-2.3	-2.4	-2.9
Income balance	-7.5	-8.3	-8.7	-8.4	-11.2	-13.7	-12.7	-13.9	-14.9
FDI, net	3.5	5.5	6.9	6.4	8.5	8.2	12.2	9.0	9.7
International reserves	17.3	27.7	31.2	33.1	44.1	48.8	64.0	75.9	87.1
Total amortisations	1.6	6.8	3.3	2.2	4.1	1.4	4.0	4.5	5.1
<b>Public Finances, % of GDP</b>									
Consolidated government balance	1.9	2.6	2.3	-1.6	-0.3	1.8	1.9	-0.6	-2.0
Consolidated gov primary balance	3.8	4.4	3.8	-0.3	0.8	2.9	2.9	0.3	-1.2
Public debt	33.1	29.8	24.1	27.2	23.5	21.7	19.9	17.4	17.4
of which Domestic	9.3	11.1	9.0	10.9	10.5	10.3	10.0	8.7	8.7
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	28.7	31.8	34.0	35.5	40.6	43.5	52.0	57.9	65.7
Public	22.0	20.1	19.2	20.6	19.9	20.2	19.8	19.5	22.2
External debt / GDP	31.2	29.8	26.8	28.0	26.4	24.7	26.1	25.7	25.7
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	21.6	20.6	19.5	20.1	22.9	24.2	26.3	30.6	34.9
Short-term debt/International reserves (%)	125.0	74.2	62.5	60.7	52.0	49.6	41.1	40.4	40.1
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	6.8	5.9	5.9	5.9	5.9	7.1	6.6	6.4	6.2
CPI, % yoy	3.7	2.6	2.2	2.4	2.3	2.8	2.9	2.7	2.6
Policy interest rate, %, eop	4.25	4.25	4.25	3.75	3.75	3.75	4.25	4.25	4.25
Short-term market rate, % eop	4.25	4.25	4.25	4.00	3.75	3.75	4.25	4.25	4.25
Long-term yield, %, eop	4.71	4.23	4.20	4.50	4.50	4.50	5.40	5.50	5.50
PEN/USD, eop	2.60	2.55	2.58	2.54	2.51	2.48	2.46	2.44	2.42

Source: National Sources, Citi Research

## Venezuela

Munir Jalil

+57 1 639 4195

[munir.jalil@citi.com](mailto:munir.jalil@citi.com)

José Vicente Romero

+57 1 638 4025

[jose.v.romero@citi.com](mailto:jose.v.romero@citi.com)

- **Summary view** — The presidential race will be the most important event in the coming weeks. The campaign will last 10 days and it is scheduled to begin on April 2. Given that campaigns will be short, we expect the PSUV to focus on the continuation of Mr. Chávez's social and economic reforms and for the opposition to offer an alternative to the status quo. The fact that Mr. Maduro was named by Mr. Chávez as his political heir during his last public appearance back in December, along with PSUV's strong political base and the sympathy that Mr. Chávez's passing away will create among the electorate, make Mr. Maduro the likely winner of the presidential election against Mr. Capriles, in our view. Also, we expect the government to make economic announcements that could boost its popularity, such as an increase in the minimum wage.
- **Things to watch** — Watch the presidential race and the presidential election result on April 14<sup>th</sup>. Watch for the implementation of the government's new FX mechanism (*Sicad* for its Spanish acronym) which will replace SITME.
- **Strategy** — Considering the ongoing political outlook and the expected deterioration of overall macroeconomic performance, we maintain our underweight recommendation on the credit.

### A crucial month ahead

**President Chávez's death represented an inflection point in Venezuela's political history, leading to a month in which the confrontation between the PSUV and the MUD will be the main highlight once again.** The Venezuelan political arena is once again in the spotlight. A short and intense campaign should be the main focus this month. The presidential race will be the most important event in the coming weeks. The campaign will last 10 days and is scheduled to begin on April 2. Given that the campaigns will be short, we expect the PSUV to focus on the continuation of Mr. Chávez's social and economic reforms and for the opposition to offer an alternative to the status quo.

### Political outlook: Chavismo without Chávez

**We expect Mr. Maduro to win his presidential election bid given the strong PSUV performance in last year's elections plus a sympathy factor.** The fact that Mr. Maduro was named by Mr. Chávez as his political heir during his last public appearance back in December, along with PSUV's strong political base and the sympathy that Mr. Chávez's passing away will create among the electorate, will most likely make Mr. Maduro the winner of the presidential election against Mr. Capriles. Also, we expect the government to make economic announcements that could boost its popularity, such as an increase in the minimum wage.

**Maduro's pragmatism won't be enough to sustain economic growth, reduce inflation or improve the fiscal accounts.** We believe that an eventual presidency by Mr. Maduro will have to take a more pragmatic approach down the road. But initially, we expect him to show a continuation of Mr. Chávez's policies as well as the continuation of close political ties with Cuba. Mr. Maduro will have to be pragmatic over the medium term in order to avoid further macroeconomic unbalances, inflation and scarcity. Nevertheless, we expect GDP growth, consumer prices, and fiscal accounts to continue along the expected deterioration path. Also, uncertainty regarding future economic management creates an additional downward bias in macroeconomic performance over the 1-2 year horizon.

**Economic pressures on Chávez's expensive "Bolivarian socialist" model are mounting.** Initially Chavez's successors will aim to reassure continuity, especially funding for generous social programs. The initial phase of the new government is likely to be marked by a tolerant population, still much affected by a strong sympathy effect and the memory of the Chávez years. However, if economic and political difficulties mount, social demands on the administration are likely to increase. Under those circumstances, more radical action by the leadership to consolidate control, intervention by the country's military or other outcomes with negative implications for political stability cannot be excluded in the years ahead, as we mentioned in our [Global Political Insights - Adiós Presidente: Venezuela's Political, Economic & Energy Outlook After Chavez](#).

### **An increasingly complex economic outlook.**

**Venezuela's economy is in a weak position at this juncture.** During 2012, the government pressed hard on spending to lift the economy and to deliver on social programs that would allow an ailing President Chávez to fight the credible challenge being presented by Capriles. As a result, imbalances grew, though inflation was partially contained through price controls and good scarcity mitigated by government imports of foods and medicines and by increased allocation of dollars through an overvalued and dysfunctional FX regime.

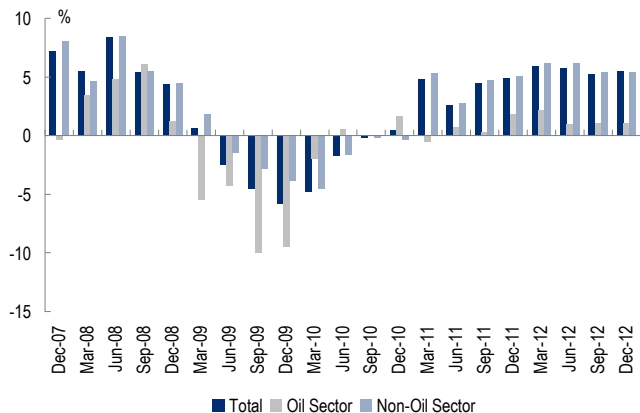
**That being said, we expect GDP growth of 1% and inflation of 25% in 2013, but recognize that risks for lower growth and higher inflation under the current conditions do exist.** Part of the solution to revamp economic activity will lie on the opening of an alternative market to SITME. This market should allow selling and buying of securities different than sovereign or PDVSA bonds, which would be an improvement over SITME, but will be highly regulated in order to avoid a full free parallel market.

**A new FX system is under way...** On March 19<sup>th</sup>, Mr. Maduro announced the creation of the Complementary System for FX Administration (*Sicad* for its Spanish acronym). Although no particular details were provided by Mr. Maduro at the time of this writing, this alternative FX system should supply USD to the private sector. Mr. Maduro said that all Venezuelans will have access to this new market and at the same time the government will work on tightening the controls to avoid situations in which the approved USD are not used for the purpose for which they were initially intended. We were expecting for this announcement to take place as it is clear the government needs to complement CADIVI in order to avoid further inflationary and scarcity problems.

### **After the elections...**

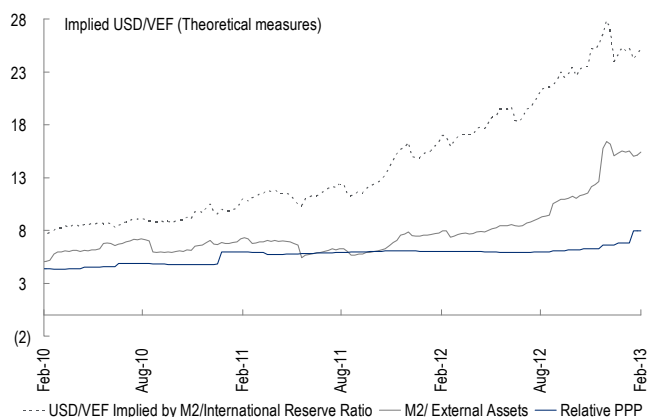
**During April all of the attention will be focused on the presidential race.** In that sense, poll results will be important, but not at the level they were in the previous elections in October. While we do not expect changes in the government's cabinet during the campaign, we expect to see some movements afterwards. Of these movements, the most important could be an eventual change of Mr. Giordani from the MoF, which depending on who is appointed as replacement will signal how pragmatic (or not) future economic policy will be.

Figure 276. GDP Growth should start to decelerate



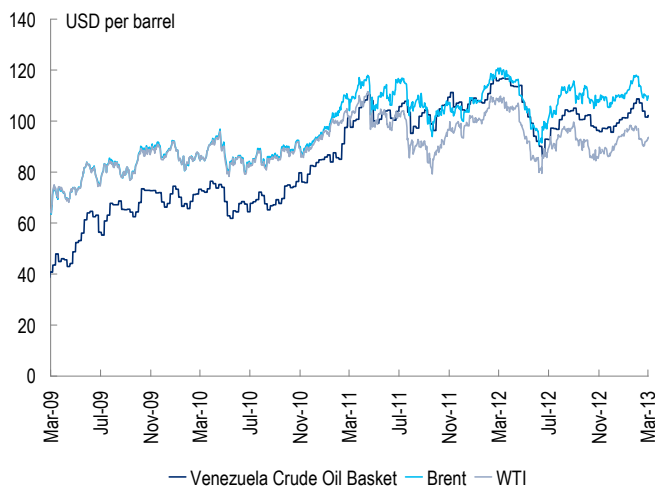
Source: Datanálisis Hinterlaces, Consultores 21, Varianzas, Citi Research

Figure 278. Theoretical FX measures still signal misalignments



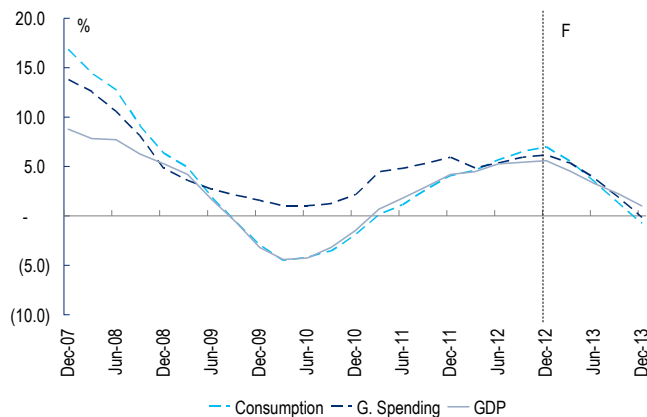
Source: BCV and Citi Research

Figure 280. Oil price dynamics



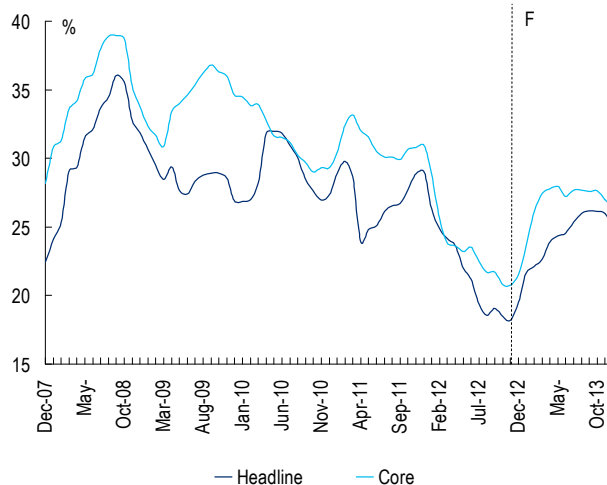
Source: BCV and Citi Research (SITME platform was eliminated in February, 2013)

Figure 277. GDP, consumption and government spending



Source: Datanálisis and Citi Research

Figure 279. Inflation will pick up in 2013



Source: BCV and Citi Research

Figure 281. We maintain our underweight recommendation on the credit



Source: Bloomberg and Citi Research

Figure 282. Venezuela Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, USD bn	188	213	298	284	257	298	377	343	434
Nominal GDP, local currency bn	394	495	678	707	1,017	1,357	1,713	2,163	2,737
GDP per capita, USD	6,940	7,738	10,683	9,996	8,925	10,188	12,670	11,387	14,406
Population, mn	27.0	27.5	27.9	28.4	28.8	29.3	29.7	30.2	30.2
Unemployment, % of labour force	8.4	6.2	6.1	6.6	6.5	6.5	5.9	6.4	6.8
<b>Economic Activity</b>									
Real GDP, yoy avg	9.9	8.8	5.3	-3.2	-1.5	4.2	5.6	1.0	2.0
Real investment growth % yoy	36.3	28.2	2.2	-19.1	1.0	15.2	21.8	0.6	2.0
Real consumption growth % yoy	14.3	16.3	6.0	-2.1	-1.1	4.4	6.8	-0.6	0.0
private consumption growth % yoy	15.5	16.9	6.3	-2.9	-1.9	4.0	7.0	-0.8	0.0
Real export growth, % yoy	-3.0	-7.6	-1.0	-13.7	-12.9	4.7	1.6	2.6	4.8
Real import growth, % yoy	34.8	33.0	1.4	-19.6	-2.9	15.4	22.2	-1.9	-1.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	17.0	22.5	31.9	26.9	27.4	29.0	19.5	25.0	24.0
CPI, % avg	13.7	18.7	31.4	28.6	29.1	27.1	21.1	24.6	24.0
Nominal wages, % yoy	19.3	20.7	25.0	23.7	24.5	27.0	28.0	29.0	30.0
Credit extension to private sector, % yoy	94.0	43.3	30.6	18.0	27.6	36.8	55.3	54.0	53.0
Policy Rate (eop)	5.90	18.00	28.10	14.00	12.50	-	-	-	-
1 month inter-bank rate, %, eop	5.90	18.00	28.10	11.30	12.30	14.50	14.50	14.50	14.50
Long-term yield, %, eop	5.41	12.00	12.00	14.38	13.02	13.93	9.30	9.10	8.80
VEF/USD, eop	2.15	2.15	2.15	2.15	4.29	4.29	4.29	6.30	6.30
VEF/USD, avg	2.15	2.15	2.15	2.15	4.20	4.29	4.29	6.13	6.30
<b>Balance of Payments, USD bn</b>									
Current account	26.5	18.1	37.4	8.6	12.1	27.3	17.1	17.3	24.6
% of GDP	14.1	8.5	12.5	3.0	4.7	9.1	4.5	5.0	5.7
Trade balance	32.0	23.0	45.7	19.2	27.1	46.4	39.0	33.8	41.1
Exports	65.6	69.0	95.1	57.6	65.7	92.7	97.3	84.2	85.9
Imports	33.6	46.0	49.5	38.4	38.6	46.2	58.4	50.4	44.8
Service balance	-4.4	-7.0	-8.4	-7.6	-9.2	-10.7	-16.0	-7.7	-7.7
Income balance	-1.0	2.5	0.7	-2.7	-5.3	-7.9	-8.2	-8.3	-8.3
FDI, net	-2.0	1.0	-0.9	-4.9	-1.5	5.1	-1.6	-3.5	-3.4
International reserves	37.4	34.3	43.1	35.8	30.3	29.9	25.4	25.0	23.5
Total amortisations	7.4	4.0	7.5	4.3	6.9	11.0	4.1	2.8	1.5
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-1.5	-2.6	-2.6	-5.8	-6.0	-5.0	-5.0	-4.0	-4.0
Consolidated gov primary balance	0.6	-1.0	-1.2	-4.4	-5.5	-3.5	-3.5	-2.5	-2.5
Public debt	23.4	25.6	20.1	29.2	41.2	44.2	41.3	46.1	41.3
of which Domestic	9.2	7.3	4.5	7.5	8.9	11.4	13.2	14.1	15.1
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	41.8	55.9	60.7	73.8	92.8	111.1	118.9	123.1	127.3
Public	26.6	38.9	46.7	61.6	83.2	97.9	105.8	109.8	113.8
External debt / GDP	22.3	26.3	20.3	26.0	36.1	37.2	31.6	35.9	29.3
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	11.5	18.1	19.9	17.4	16.8	19.3	21.2	23.1	23.9
Short-term debt/International reserves (%)	30.8	52.8	46.1	48.4	55.3	64.7	83.5	92.3	101.6
<b>Quarterly Economic Indicators</b>									
	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F
GDP, % yoy	5.2	5.5	1.4	1.0	1.0	0.7	1.6	1.5	2.6
CPI, % yoy	19.1	19.5	22.7	24.5	26.2	25.0	23.8	24.1	24.2
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	10.84	9.30	9.20	12.00	14.50	15.00	15.50	15.00	14.40
VEF/USD, eop	4.29	4.29	6.30	6.30	6.30	6.30	6.30	6.30	6.30

Source: National Sources, Citi Research

**Notes**

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## Appendix A-1

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