Citi Research

Economics

23 January 2015 | 176 pages

Emerging Markets

GEMS

Emerging Markets Macro and Strategy Outlook

Can EM Save Itself From Downgrades?

- EM sovereign creditworthiness has improved visibly over the past 10 years, but now there is a group of countries – which includes Russia, South Africa, Brazil, Turkey – which have a non-negligible risk of losing their 'investment grade' status over the next couple of years. These four by themselves make up just under 30% of Citi's USD EM government bond index, and so downgrades for these countries could conceivably negatively impact EM as an asset class.

- Since 2004 the overall improvement in EM sovereign ratings was disproportionately explained by upgrades of commodity-exporting economies. Nowadays the commodity price environment is more hostile to EM creditworthiness, and other factors – slower growth in China, weaker world trade growth, an uncertain outlook for capital flows – also underline the risk to EM sovereign ratings. In addition, there has been a notable rise in public debt levels in a number of vulnerable emerging economies, closely linked to a post-Lehman rise in primary government spending.

- What's happened in the past few months is that EM policymakers have woken up to these risks. Although EM *fundamentals* may point to the risk of downgrades in some countries, EM *policymaking* is improving, precisely in order to help shore up creditworthiness. Brazil is the clearest example of this process, where a new Finance Minister is engaged in a strenuous effort to tighten fiscal policy and fend off a downgrade. But in other countries too, the past few months have seen a visible improvement in the quality of policymaking. Tighter fiscal policy has been announced in South Africa and Turkey in the past few months, and central bank prudence has picked up in both countries. Russia macro policy too has an almost textbook-like quality to it, adhering very strictly to the principle that spending must fall when income does.

- In some ways, therefore, EM is characterised by a struggle between deteriorating fundamentals and improving policy, almost equivalent to a struggle between falling 'ability' to pay and rising 'willingness' to pay.

- One consequence of this environment is that there may still be value in local EM curves, especially if the commodity price outlook remains disinflationary. A pull-back after a 30bp ytd rally in EM bonds is always possible, particularly as the market squares positions after the ECB decision and the 28 January FOMC approaches. However, we find some reasons why EM local currency bonds may continue to tighten. Likely dovish monetary policy action in most emerging markets combined with an attractive steepness relative to the US curve suggests a still-attractive return profile for the asset class. This is especially the case if recent weaker US data keeps the Fed on hold for longer.

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

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

Contents

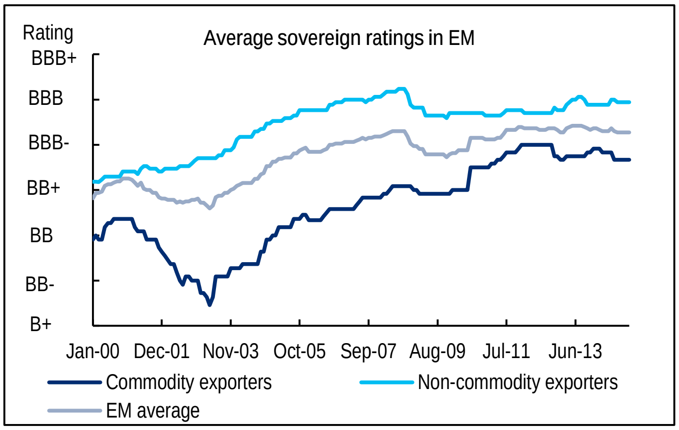
Can EM save itself from downgrades?	**3**
Monetary Policy Watch	14
FX Views	15
Global Assumptions	16
EM: Key Forecasts	17
Our Forecasts vs. Consensus	18
EM most requested regional charts	19
Asia Pacific	**21**
China	22
Hong Kong	26
India	30
Indonesia	34
Malaysia	38
Philippines	42
Singapore	46
South Korea	50
Taiwan	54
Thailand	58
Frontier Asia	62
CEEMEA	**69**
Czech Republic	70
Egypt	74
GCC	78
Hungary	82
Israel	86
Kazakhstan	90
Levant	94
Nigeria	98
Poland	102
Romania	106
Russia	110
Slovakia	114
South Africa	118
Turkey	122
Ukraine	126
Other Africa	130
Other Europe	134
Latin America	**139**
Argentina	140
Brazil	144
CCA	148
Chile	152
Colombia	156
Mexico	160
Peru	164
Venezuela	168
Appendix A-1	**173**

Can EM save itself from downgrades?

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

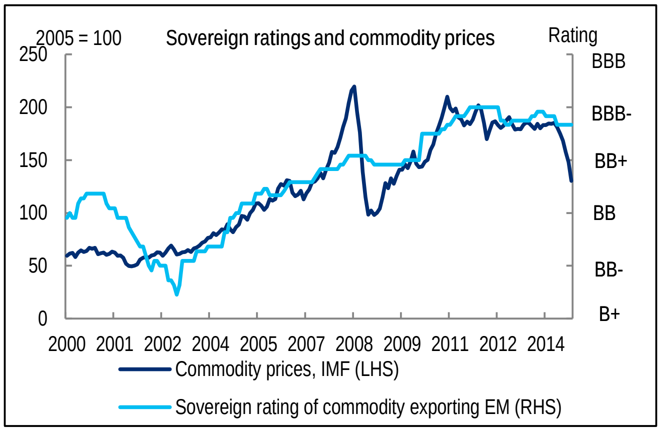
There is a critical mass of emerging economies that is at risk of losing investment-grade status in the next couple of years. This group includes Russia, South Africa, Brazil and Turkey, and these four by themselves make up 28% of the Citi's USD Emerging Markets Government Bond Index (see *Emerging Markets Macro and Strategy Outlook - Prospects For 2015 And Beyond*). What's notable about these four countries – as well as others, including Indonesia and India – is that there has been a marked improvement in the quality of economic policymaking in recent months, as policymakers try to confront the pressures they face from falling commodity prices, uncertain global risk appetite, and weak external demand growth. In other words: emerging markets *fundamentals* seem to be pushing for downgrades, while the quality of *policymaking* is struggling against this pressure. The aim of this note is to describe some of the policy improvements that are evident across EM, and ask the question: will the improvement in the policy environment be enough to stave off the risk of downgrades in EM? Our answer is tentatively pessimistic.

Figure 1. The improvement in EM sovereign ratings during the past 10 years is largely a story about commodity exporters...



Source: Haver; Fitch Ratings; Citi Research

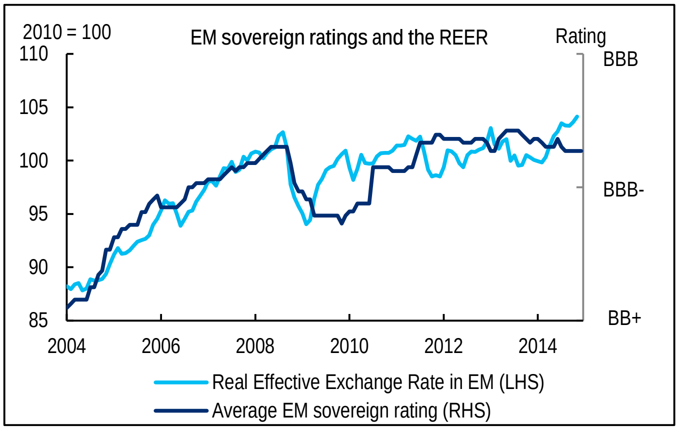
Figure 2. ...and the upgrades of commodity exporters were facilitated by the rise in commodity prices – which has now come to an end



Source: Haver; Fitch Ratings; Citi Research

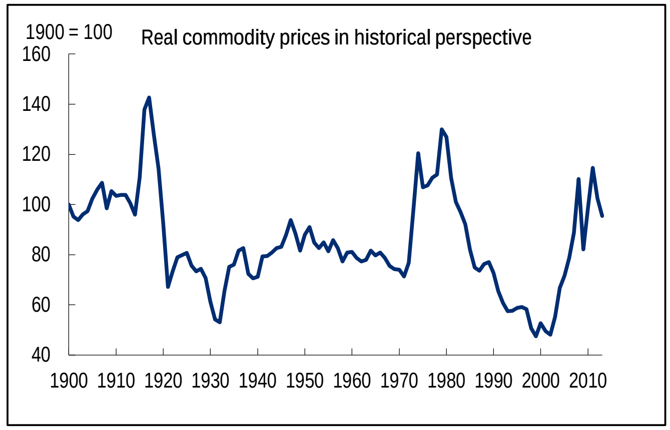
The improvement in emerging markets sovereign ratings in the past 10 years has been largely a story about commodity prices. Without question there's been a visible improvement in sovereign creditworthiness during the past decade: the average EM sovereign rating (unweighted) has gone from a level just below BB+ in 2002 to just above BBB- at the end of 2014. What Figure 1 shows is how reliant this average improvement has been on the creditworthiness of commodity exporters in EM, which have enjoyed a disproportionate rise in their sovereign rating, thanks to the rise in commodity prices (Figure 2). An obvious issue is to what extent the fall in commodity prices – assuming it is sustained – will threaten EM sovereign creditworthiness. And it is not just EM 'country risk' that might be threatened by weaker commodity prices, but 'currency risk' too: Figure 3 shows that the improvement in sovereign ratings in EM has been closely associated with an appreciation of the real exchange rate. If sovereign creditworthiness becomes more questionable following the end of a historically unusual rise in commodity prices (Figure 4), then a real exchange rate adjustment is also very likely to be necessary.

Figure 3. 'Country risk' and 'currency risk' have moved together: EM sovereign upgrades have moved alongside the real exchange rate…



Source: Citi Research; BIS

Figure 4. …which means that both currency and country risk are likely to come under pressure with a sustained fall in commodity prices



Source: IFS, Citi Research

The current pressure on EM sovereign ratings isn't just about a deteriorating external environment, but about a loss of policy discipline in recent years. We've tried to draw attention in our research to the relative weakness of the external environment facing EM, the fall in real Chinese import growth, and the uncertainty regarding capital flows. These external pressures might be enough by themselves to raise doubts about whether emerging markets sovereign creditworthiness is bound to deteriorate. Yet in addition to these external factors, we think that an important ingredient in the risk facing emerging markets sovereigns comes from their own policy weakness in recent years. Some measure of that policy weakness is evident in Figure 5, which shows the change in primary public spending across a selection of emerging economies between 2007 and recent quarters. For some countries – Argentina, Mexico[1], Turkey, South Africa, Chile, Colombia, Malaysia, Russia, Brazil for example – there was a measurable increase in the ratio of primary public spending to GDP.

There was an understandable need for governments to allow automatic stabilisers to work after the Lehman crisis. But equally it seems that, in a number of these countries, the loss of fiscal discipline has been sustained and was driven by explicit political choices. In Chile, for example, the increase in primary spending was due to President Bachelet's decision to increase the number of public employees: public payroll increased by 1.4 percentage points of GDP between 2006 and 2013. In addition, an increase in subsidies – for example, an increase in the home-purchase subsidy provided to low-income households – helped to bring the total increase in primary spending to just under 4 percentage points of GDP. A similar trend is evident in South Africa, where public labour costs rose from 33% GDP in 2007/8 to 36% GDP in 2013/14. The deterioration in South Africa's relative fiscal position has already taken a toll on its creditworthiness: downgrades were announced both in 2012 and 2013 (an IMF paper has recently argued the case for a debt ceiling in South Africa[2]). There are some countries which cut primary spending as a share GDP during the past few years, but the countries we highlighted above as having 'downgrade risk' are all guilty of a more or less permanent increase in primary public spending in the recent past.

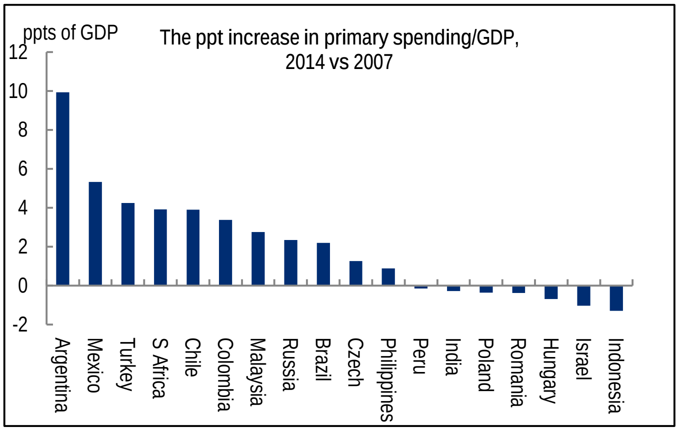
---

[1] It should be made clear that the increase in Mexican primary spending is almost entirely due to an accounting change, and not additional fiscal stimulus: investment by PEMEX that had previously been accounted for as extra-budgetary spending under the PIDIREGAS programme.

[2] See 'Safe Debt and Uncertainty in Emerging Markets: An Application to South Africa', IMF WP/14/231, http://www.imf.org/external/pubs/cat/longres.aspx?sk=42546.0.

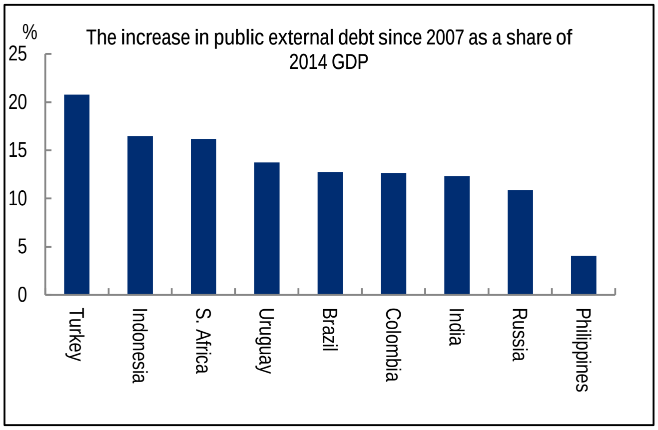
While there's been considerable focus in recent literature on the build-up of *private* sector external debt in EM, it is also worth bearing in mind that balance-sheet deterioration has also taken place in the public sector. The BIS has established itself as the intellectual leader of official-sector assessments of the build-up of debt in the corporate sector in EM[3]. Less attention has been given to the build-up of public external debt, partly because emerging markets sovereigns are (correctly) perceived to have generally smaller debt burdens than their developed-country counterparts. But there has been deterioration in the public sector balance sheets of EM in the past few years, and this has importance from a sovereign rating perspective. According to Fitch data, the average public debt/GDP ratio in EM fell from 57% in 2002 to 37% in 2007; but has fallen to 46% in 2014. And for certain countries that are sitting around the edges of the investment-grade bracket, there have been some notable increases in public external debt. These increases are illustrated in Figure 6.

Figure 5. The countries most at risk of sovereign downgrades were all guilty of quite large increases in primary spending in recent years...



Source: Moody's, Citi Research

Figure 6. ...and public external debt burdens have risen quite sharply in some countries in the past few years.



Source: Moody's, Citi Research

Policymakers have woken up to the risk of rating downgrades, and the quality of policymaking in EM has visibly improved in recent months. As we mentioned above, the most important countries in this list are Brazil, Turkey, South Africa and Russia: all hovering just above investment grade, and all facing a non-negligible threat of losing that status in the next few quarters. What's notable about these countries, we think, is the very visible effort that policymakers are making in each case to fend off the risk of becoming a 'junk' credit.

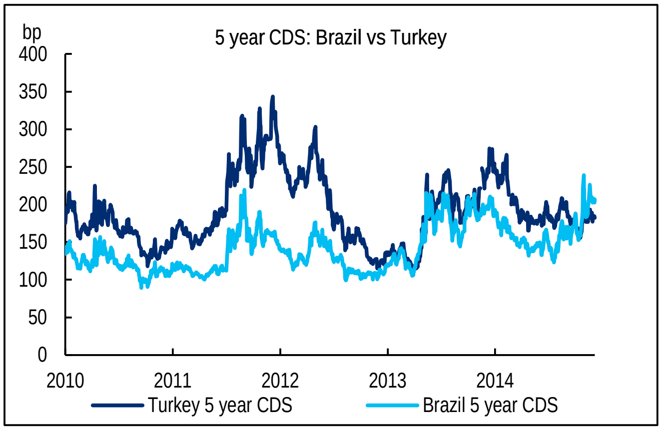
The poster-child for the recent improvement in the quality of EM policymaking is Brazil. President Rousseff's appointment of Joaquim Levy as Finance Minister was a decisive signal that Brazil aims to reverse the steady deterioration in public finances that has taken place since 2011 (Figure 7). This fiscal deterioration has given Brazil the 'wrong' policy mix: loose fiscal policy has had to be offset by tight monetary policy, which in turn has crowded out the private sector and made it difficult for Brazil to achieve a smooth adjustment in the real exchange rate. And that policy mix has already helped to produce a sovereign downgrade by S&P in March 2014, to BBB- (long-term foreign currency). While Fitch and Moody's still keep Brazil two notches above investment grade, the improvement in policymaking will need to be sustained in order to minimise the threat of downgrades, as the Finance Minister himself has acknowledged.

[3] See, for example, 'Non-financial corporations from emerging market economies and capital flows', BIS Quarterly Review, December 2014, http://www.bis.org/publ/qtrpdf/r_qt1412h.pdf

Figure 7. Brazilian fiscal deterioration has already helped to secure one rating downgrade, and more would follow if this trend continues…

Source: Haver Analytics, Citi Research

Figure 8. … and the market still seems sceptical given the rise in Brazil CDS spreads even in the wake of recent fiscal announcements

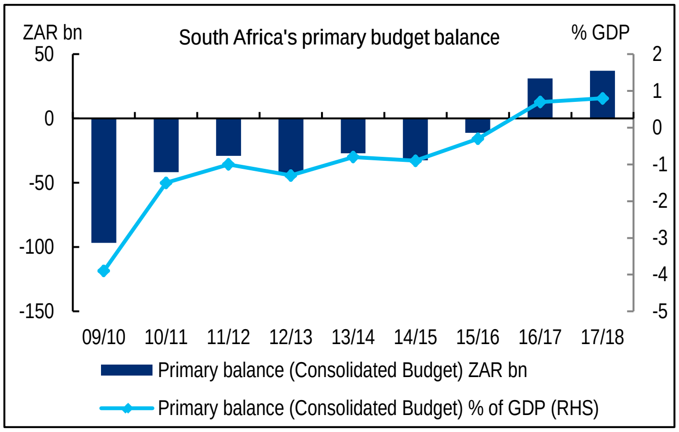


Source: Bloomberg, Citi Research

'Implementation risk' remains a threat to Brazilian policymaking. Dr Levy has presided over a number of announcements that have helped to improve Brazil's fiscal credibility, all in an effort to reach a new target for the primary budget surplus of 1.2% GDP this year, and 2% GDP next year. To this end, the government has i) raised the TJLP, the interest rate charged on loans from BNDES, for the first time since 2003; ii) announced measures to limit the eligibility criteria for worker benefits and for pensions; iii) restricted spending in the early months of 2015 to 1/18th of the draft budget, rather than 1/12th as set out in the constitution; and iv) decided to scrap electricity subsidies. Momentum towards a more sustainable fiscal position has been established, though it is clear that implementation risk remains a concern: social and political opposition to fiscal tightening will likely make it difficult for the government to pass all the legislation necessary for the adjustment. In any case, the market seems to have its doubts that the effort Brazil is making to avoid downgrade can be sustained, partly due to corruption issues and the growing risk of energy rationing this year: Figure 8 shows a consistent widening of Brazilian spreads relative to Turkey, a worse-rated credit.

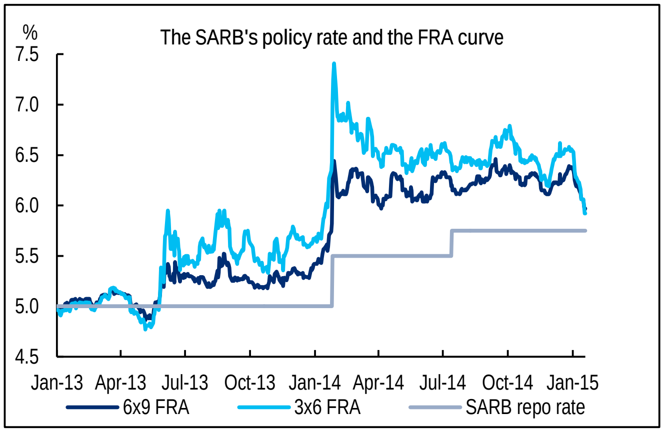
The effort South Africa is making to fend off the risk of a rating downgrade is also mainly evident in fiscal policy. As Figures 5 and 6 suggest South Africa was at the forefront of fiscal deterioration in EM after the Lehman crisis, and the stock of public *external* debt has risen dramatically: from \$24bn in 2007 to \$70bn in 2013. Yet in the past few months there is a much stronger sense of discipline in South African macro policy, particularly fiscal policy. The clearest evidence of this has come in the form of the October 2014 Medium Term Budget Policy Statement, which promised a more decisive fiscal tightening than had previously been planned, and announced a fall in the non-interest expenditure ceiling by ZAR10bn in FY15/16 and by ZAR15bn in FY 16/17. As a result of this, the government is now targeting a primary surplus of 0.7% GDP in 2016/17, up from a target of 0.4% that was presented in the February 2014 budget. We expect the February 2015 budget to confirm that South African fiscal policy is now on a more disciplined path, though there are still doubts about the government's ability to keep public sector wage increases in check over the medium term.

Figure 9. 'Make me virtuous'...South African fiscal policy is turning more disciplined in an effort to stop the debt/GDP ratio from rising...



Source: Haver Analytics, Citi Research

Figure 10. ...and the SARB has also turned more hawkish, though disinflation has recently allowed a more dovish market view to prevail



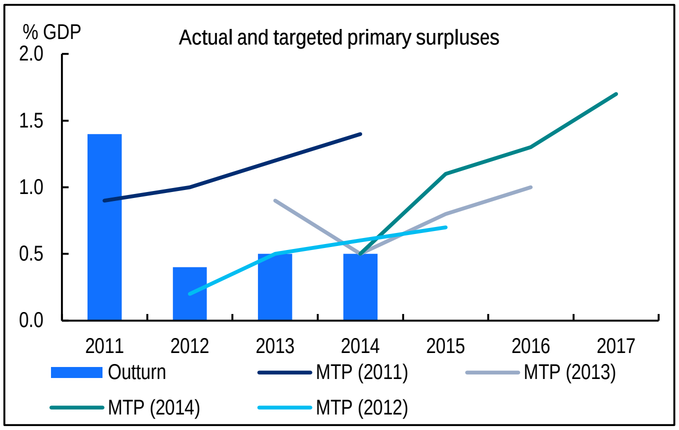
Source: Bloomberg, Haver Analytics, Citi Research

South African monetary policy has also changed. South African monetary policy credibility was undermined during the course of 2013 by its persistent commitment to maintain a very low level of real interest rates – a commitment that seemed consistent with the weakness of domestic spending growth and the SARB's determination to interpret its inflation targeting mandate 'flexibly'. That commitment ended in January 2014 with monetary tightening (Figure 10), and 'normalising monetary policy' remains the bank's goal. Although falling oil prices arguably gives the SARB some scope to ease policy, our guess is that it will resist, given the inflationary pressures resulting from food prices, utility prices, as well as the scope for further rand depreciation given South Africa's still-large external financing needs.

Stronger macro policy is also apparent in Turkey. Figures 5 and 6 above suggest that Turkey was also rather inclined to loosen fiscal policy following the Lehman crisis, and even more recently than that: the primary budget surplus has fallen from 1.4% of GDP in 2011 to 0.5% in 2014. But in recent months there has been a notable shift in fiscal targets – just as there has been in South Africa. The Medium Term Programme announced in October 2014 is targeting a primary budget surplus of 1.1% for 2015. As Figure 11 shows, this is the first time since 2012 that the Turkish government has aimed for a primary surplus in excess of 1% GDP. It could also be argued that monetary credibility has improved in Turkey in the past few months: Figure 12 shows the relative tightening of monetary conditions since September 2014, notwithstanding the cut in one-week repo rate announced by the CBT on 20 January. As we discuss below, however, challenges remain in solidifying these gains in policy credibility.

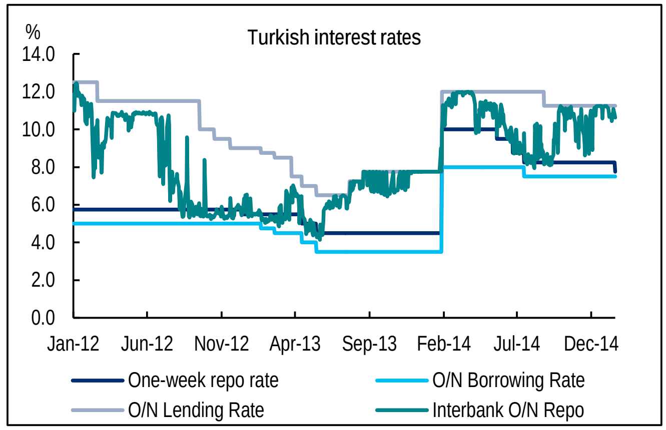
Structural reform is also making an appearance in Turkey. In some of the other reforming economies – Brazil, South Africa, Russia, for example – there has been no visible change in the commitment to structural reform in recent months. In Turkey, by contrast – along with India and Indonesia – the new government has made structural reform more or less a centrepiece of its economic strategy, and aims to increase domestic saving; support the investment climate by easing regulatory restrictions; attract financial services investment to Istanbul; and improve the quality of public revenues. We have no view about whether this structural reform agenda will be successfully implemented. But the fact that the agenda has been set out in so much detail is, we think, a sign of 'policy seriousness' that is consistent with the effort that many countries are making to shore up their creditworthiness at a time when balance sheet fundamentals are raising the threat of sovereign downgrades.

Figure 11. Turkey's Medium Term Programme (MTP) for fiscal policy has set out more ambitious targets over the next three years...



Source: Turkey Ministry of Finance, Citi Research

Figure 12. ...and the interbank overnight repo rate has been stuck at the ceiling of the CBT corridor since the summer of 2014



Source: Bloomberg, Citi Research

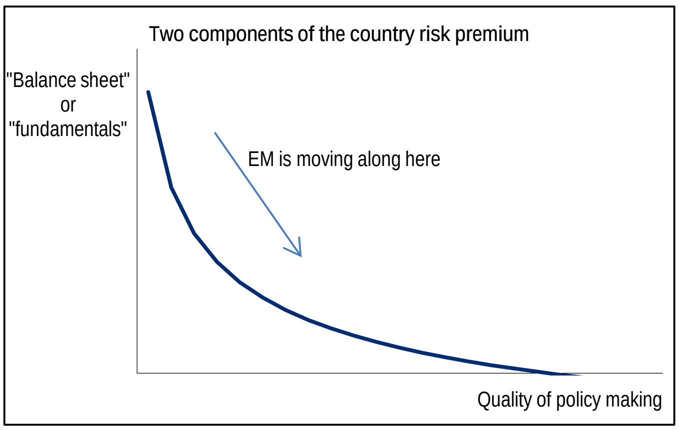
And Russian macro policy is textbook-like in its discipline. While there are many obstacles to Russian creditworthiness – the falling oil price, the effect of sanctions, the deterioration of the investment climate in recent years – it is difficult for rating agencies to criticise the implementation of fiscal and monetary policy in recent months. Indeed, Russian fiscal and monetary and exchange rate policy seem precisely focused on the need to maintain Russian creditworthiness. To see this point, it is only necessary to understand that the most important objective of Russian macro policy these days is to maintain the current account surplus, in order to minimise the loss of fx reserves. And since the stock of fx reserves is the central variable for the rating agencies' assessment of Russia, effort to keep hold of them amounts to a policy aimed to please the rating agencies.

Textbook-like policy might not be sufficient to hold Russia's ratings at Baa3/ BBB-/BBB- (Moody's/Fitch/S&P). Rating agencies will remain highly sensitive to the trajectory of Russian fx reserves, which – since early 2014 at least – have remained under downward pressure. Russia at least has the advantage of being a net external creditor – with only $52bn of public external debt at the end of 2014, compared to just under $400bn of fx reserves – but there is no guarantee that a net external creditor can keep its investment grade sovereign rating: Angola and Nigeria are both examples of net creditors whose sovereign rating is sub-investment grade.

And policy discipline may not be enough in any of the countries we have discussed. In spite of the visible improvement that has taken place in all four of the economies we've highlighted, an improvement in the quality of policymaking is a necessary, not sufficient, condition to maintain a particular sovereign rating. This is most evidently true for commodity exporters, whose sovereign ratings have been supported by the rise in commodity prices since the early 2000s (Figure 1). But it is also true for Turkey, given the dramatic collapse in the domestic savings ratio since the late 1990s, since it is this which has entrenched Turkey's reliance on external financing. Turkey's savings ratio has fallen from 23% of GDP in 1998 to 13% in 2013. And in all of these countries, there are lingering concerns about whether high-quality policymaking will be dwarfed by other concerns. Brazil has to navigate the effect of corruption scandals and drought; South Africa remains a victim of its fractious labour relations; economic policy discipline in Turkey is sometimes overshadowed by concerns, for example, about the amount of political interference in monetary policy decision-making.

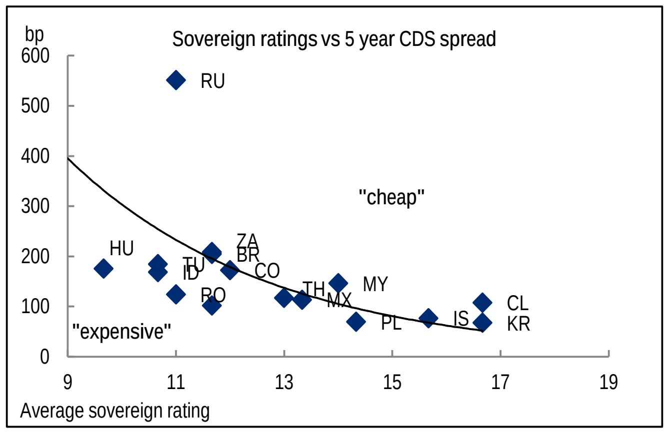
EM these days is locked in a struggle between deteriorating 'fundamentals' and improving 'policymaking'. The improvement in policymaking that we can detect across a number of large emerging economies is best understood as the appropriate response to the deterioration in EM 'fundamentals' that we've seen in the past couple of years: the slowdown in EM growth; the volatility of US interest rates; the changes in China which have made it a less 'EM-friendly' force; the fall in commodity prices; the fall in world trade growth; the shakiness of risk appetite, and the uncertainty about flows to the asset class. What's been happening in recent months can be summed up in Figure 13, which shows that there is a trade-off between 'fundamentals' and the 'quality of policymaking'. When 'fundamentals' are strong – producing, let's say, a really strong sovereign balance sheet – then a country's sovereign rating will improve regardless of the quality of policymaking. But when the balance sheet starts to deteriorate, policymaking must improve in order to maintain a given rating, or a given sovereign spread. The question that will resolve itself over the next couple of years is: *in the long run, which of these two factors is most important in determining sovereign risk*?

Figure 13. As EM fundamentals deteriorate, policymakers have to 'get serious' in order to maintain the same credit rating or risk premium...



Source: Citi Research

Figure 14. ...but the market is doubtful that Russia, South Africa or Brazil will make it



Source: Fitch Ratings, Bloomberg, Citi Research

The market seems to think that Russia, South Africa and Brazil are most likely to fail to improve their policies adequately enough to offset deteriorating fundamentals. Figure 14 places Russia, South Africa and Brazil in a category where the market seems unconvinced that the sovereign rating is adequately reflecting the sovereign risk. We broadly agree, and think Russia is most likely to lose its investment grade status, followed by (in order) South Africa, Brazil and Turkey. Yet that ranking is far from giving any probability to these downgrades. That depends on how policy evolves in the next few quarters. But if the fall in commodity prices that we've seen in the past few quarters is sustained, it will take a much bigger improvement in the quality of policymaking to offset the deterioration in EM fundamentals that may be ahead of us.

Is there still value in EM bonds?

Dirk Willer
+1 212 723 1016
dirk.willer@citi.com

Luis Costa
+44 20 7986 9757
luis.costa@citi.com

Siddharth Mathur
+65 6657 4183
sidharth.mathur@citi.com

The rally in EM rates has been large, will it continue? The moves have been driven by low-flation (and low growth) fears, which have spread from G3 bond markets to several EM. With EMFX having stabilised, EM rates were able to rally (Citi's GBI local currency bond index yields dropped by more than 30bp year to date). At this stage a natural question is whether we still find value in EM bonds.

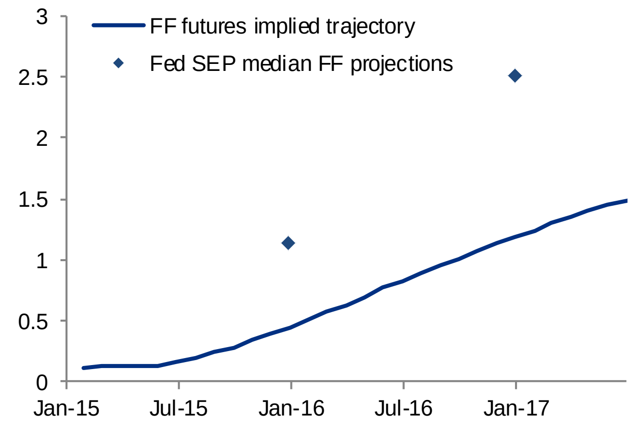
After an initial decline in breakeven inflation, the year-to-date drop in nominal US 10y yields is now matched almost one-for-one with a decline in real yields. The spreading concerns over low-flation seem to have had a short impact on US rates. At this point, most of the decline in yields is explained by a nearly 40bp drop in real interest rates. Such large drops in real rates are usually explained by greater concerns over activity or by an equivalent drop in term premia. The relative weakness in US activity data and the flight to quality, given higher risk aversion, suggest that lower real rates are explained by a downward revision in growth expectations. This suspicion finds some validation in the estimates of term premia produced by researchers at the NY Fed (the ACM model) which has declined, year to date, by "only" 10 basis points in the case of 10y bonds. One could further speculate that expectations of QE in Europe and a compression in European term premia might drive the US premia. Interestingly, year to date, 10y German Bunds have also compressed by, roughly, 10bp suggesting that they may explain about 25% of the total drop in US (real) rates, but not much more.

The US curve (5-10) flattened significantly towards the end of 2014 but has remained relatively stable year to date. After a 20bp flattening of the 5-10 curve late in 2014, the last few weeks have shown a relatively stable slope. Another suggestive source of evidence that real rates may be moving because of expectations of weaker growth emerges from the fact that 2-5, a slope more likely responsive to expectations of medium term monetary policy rather than term premia, flattened by about 15bp. Given the relatively unchanged 5-10 slope, the 2-10 slope also flattened by 15bp in that period.

Markets seem to have pushed out Fed hikes significantly. The weaker than expected activity data (highlighted by a sharp decline in the Citi economic surprise index) and the soft inflation measures seem to have convinced markets that the Fed will delay its actions. Indeed, we are currently pricing a much later take-off than what is consistent with the December Fed communication of mid-2015 (see Figure 15). It is therefore likely that markets will turn a bit more nervous as we approach the 28 January FOMC since the Fed is unlikely to correct its previous (more hawkish?) message.

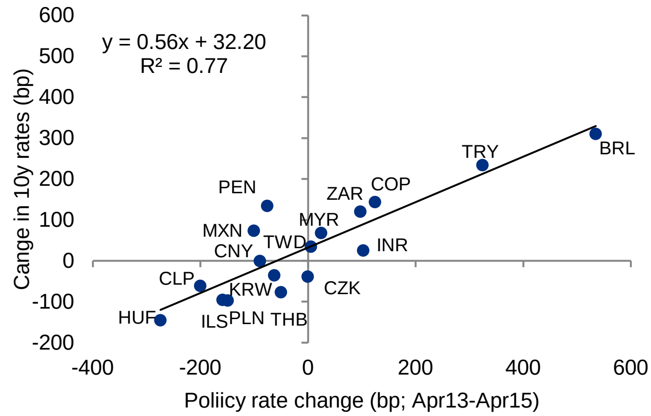
The move by the ECB has surprised for its size and has depressed periphery bonds. The actions by the ECB can have an important potential spillover effect on EM securities. The scope of ECB purchases has had a disproportionate impact on periphery bonds, relative to Germany and even France. Spain, Italy, and Portugal 5y bonds tightened upon announcement (relative to Germany) by 9bp, 9.5bp and 11.5bp. A continued tightening of spreads is likely to drive investors towards other "riskier" and higher yielding investments in EM. As a result, QE in Europe and flatter US curves could, ultimately, lead to continued support for EM bonds – perhaps after some short-term volatility associated to the FOMC and ECB position clean-up. But, for this to be true, we would need to still find some value in EM curves. The answer to this question is likely to be a combination of changes in short-term policy rates and in the steepness of EM curves.

Figure 15. Market questions Fed guidance



Source: Bloomberg, Citi Research

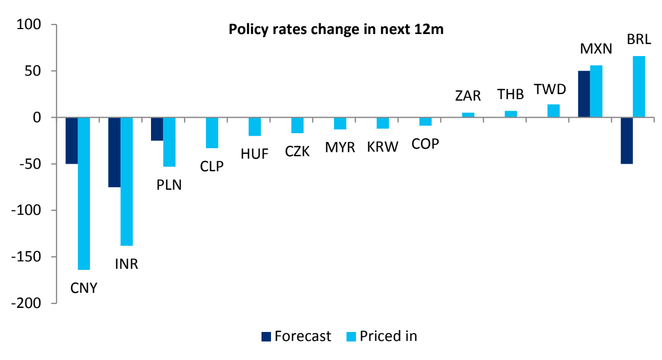
Figure 16. EM Interest Rate Swaps Explained by Central Banks



Source: Bloomberg, Citi Research

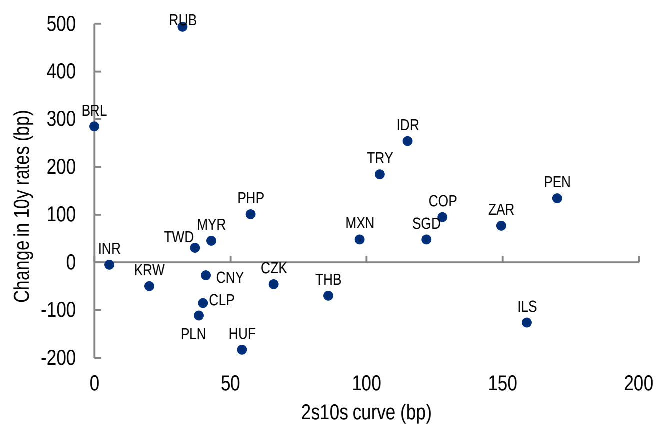
Medium term, given the monetary policy outlook, we think there is still value in rates. We usually focus mostly on likely monetary policy steps as an explanatory variable. Figure 16 suggests that differential monetary policy explained around 77% of the relative performance of EM bonds since the start of tapering in 2013. At this stage, Citi is forecasting further cuts in China, India, Poland, and on a 12m view, also in Brazil (where rates will keep rising first, though). The market is also pricing cuts in many other markets (see Figure 17), which may not be Citi's base case, but where risks for cuts are likely rising. Typically, rates only bottom when easing cycles are close to being concluded (almost irrespective of what is priced in advance of these events). This dovish monetary policy outlook should at the very least still offer opportunities in the short to mid part of the curve in these countries, though our Asia strategist notes that for the short term too much may be priced already in both China and India. The only hikes forecast are in Mexico, but with inflation falling and Fed hikes being pushed out, even that is not clear.

Figure 17. Rate Cutting in EM Still in Full Swing (12m)



Source: Bloomberg, Citi Research

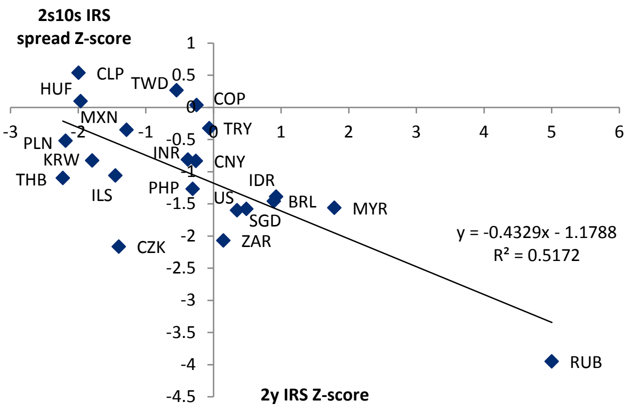
Figure 18. There is a mild (positive) correlation between the change in EM Interest Rate Swaps (since May 2013) and Curve Steepness



Source: Bloomberg, Citi Research

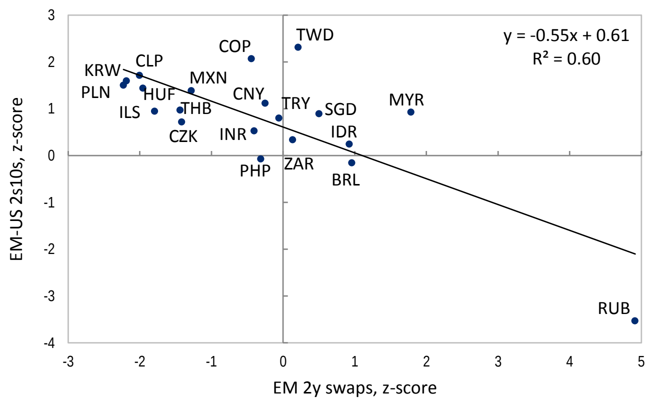
Local curves are flat compared to history, but curves in Chile, Colombia and Turkey are steep relative to central bank target rates. Steepness is less important in explaining repricing of bonds than the monetary policy outlook. Figure 18 shows that the initial steepness going into the 2013 sell-off does not explain much of the subsequent re-pricing of the 10yr point. But nevertheless steepness is a relevant factor, given roll-down returns and carry. We analyse the question of whether the steepness of curves still offer value in Figure 19 to Figure 21. Figure 19 compares the z score of the 2s/10s to the z-score of the 2-year rates across countries. The reason is that the steepness has to be corrected for whether the short end of the curve is above or below "neutral", which we proxy here by long-term averages, which the z score is picking up. On this analysis, curves do not look overly steep compared to its history as z scores are broadly negative. However, they are negative for both 2-year rates and for 2s/10s. Controlling for this, the curves that are steeper than our regression line are Chile, Taiwan, Colombia and Turkey. We would downplay the result for Taiwan given as the curve trades in very tight ranges impacting z scores more than justified.

Figure 19. Value in the Curve? 2s/10s against 2s



Source: Bloomberg, Citi Research

Figure 20. 2s10s in EM over 2s10s in the US



Source: Bloomberg, Citi Research

In terms of spreads to the US, Colombia and Malaysia still look steep. Another angle is to compare the curve to the slope of the US curve, again using 2s/10s in z-score space. This time z scores are much more often positive for 2s/10s, suggesting that the EM flattening has underperformed the US flattening. This is shown in Figure 20. This suggests value in curves if the US curve does not sell off. Here the z score of Colombia again stands out, as does Taiwan (which we would largely disregard, as discussed above). This time Malaysia also shows up as steep, relative to the US.

From a roll-down and carry perspective, Mexico and Colombia look the best. Lastly, we also look at roll-down and carry in Figure 21 below. We focus on the FX hedged analysis. On this basis, the horizon returns are the best in Mexico and Colombia, followed by Hungary and South Africa.

Figure 21. Horizon returns

3m Returns (not annualized in percent)												
	Asia			CEEMEA				Latam				
Duration	IDR	MYR	THB	HUF	RUB	TRY	ZAR	BRL	CLP	COP	MXN	PEN
0-3 years	**1.84**	0.99	0.68	0.72	*4.13*	1.21	**2.46**	**2.95**	0.79	1.35	1.17	1.10
3-7 years	**2.02**	1.12	0.79	1.05	**3.81**	**1.52**	**2.02**	**2.80**	1.05	**1.78**	**1.57**	1.48
7-12 years	**2.07**	1.19	0.80	0.97	***NA***	***NA***	**2.06**	*NA*	1.07	**1.82**	**1.76**	**1.72**
12-20 years	**2.03**	1.09	0.77	0.92	**3.96**	1.42	**2.05**	**2.86**	0.99	**1.71**	**1.52**	**1.60**
20+	**2.03**	1.09	0.77	0.92	**3.96**	1.42	**2.05**	*2.86*	*0.99*	**1.71**	**1.52**	**1.60**
Horizon Return	**2.03**	1.09	0.77	0.92	**1.83**	1.42	**2.05**	**2.86**	0.99	**1.71**	**1.52**	**1.60**
Horizon Return net of NDF	0.02	0.13	-0.20	0.59	-3.49	-0.38	0.59	0.32	0.22	0.74	0.91	0.20
Annualized Returns (based on 3m horizon, in percent)												
Horizon Return	8.38	4.43	3.11	3.72	7.52	5.79	8.44	11.95	4.02	7.03	6.22	6.55
NDF Implied Yield	8.30	3.93	3.92	1.37	21.50	7.30	6.10	10.67	3.16	4.05	2.60	5.75
Horizon Return net of NDF	0.08	0.50	-0.81	2.35	-13.98	-1.51	2.34	1.28	0.86	2.98	3.62	0.80

Source: Citi Research

We would use a pullback to receive again. As we increasingly believe that risks from an aggressive re-pricing of the US curve are less likely, the relative analysis to the US curve may be more relevant than the outright analysis. Therefore, putting it all together it appears that relative to the US curve there still is value in Emerging Market bonds. Relative to the US, it is mostly in Colombia and Malaysia, where curves are still steep. Not surprisingly, this is linked to the oil shock that is posing question marks on the fiscal accounts. This is the reason why our Asia strategist thinks it is too early to pick up duration in Malaysia. In Latam, we are overweight duration in Colombia, as rate cuts are coming closer. But we do acknowledge risks from oil if there should be another leg lower. More generally, we would note that with monetary policy broadly biased towards cuts and with z score of slopes relative to the US still positive, the asset class overall still offers value. A potential pullback after a powerful rally over the last month, maybe driven by US rates, is likely to offer good entry opportunities in local bond markets.

Monetary Policy Watch

Figure 22. Asia Policy Rates and Movement

			Last Move		Likely Next Move		End-2015
		Spot	Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	2.75	Nov-14	-25	Feb-15	-25	2.25
India	Repo Rate	7.75	Jan-15	-25	Jun-15	-25	7.25
Indonesia	FasBI	5.75	Nov-13	+25	2016	+25	5.75
Korea	BOK Policy Rate	2.00	Oct-14	-25	Jun-16	+25	2.00
Malaysia	Overnight Policy Rate	3.25	Jul-14	+25	Sep-15	+25	3.50
Philippines	Overnight Policy Rate	4.00	Sep-14	+25	Mar-16	+50	4.00
Taiwan	Discount Rate	1.875	Jun-11	+12.5	Mar-16	+12.5	1.875
Thailand	Overnight Repo Rate	2.00	Mar-14	-25	Jun-16	+25	2.00

Source: Bloomberg, Citi Research

Figure 23. CEEMEA Policy Rates and Movement

			Last Move		Likely Next Move		End-2015
		Spot	Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.05	Nov-12	-20	1Q17	+20	0.05
Hungary	14-Day Repo Rate	2.10	Jul-14	-20	Mar-16	+25	2.10
Israel	Base Rate	0.25	Aug-14	-25	Mar-15	-25	0.25
Poland	7-Day Repo Rate	2.00	Oct-14	-50	Mar-15	-50	1.50
Romania	Refinancing Rate	2.50	Jan-15	-25	Feb-15	-25	2.25
Russia	Refinancing Rate	17.00	Dec-14	+650	Jul-15	-100	13.00
S. Africa	Average Repo rate	5.75	Jul-14	+25	Jan-16	+25	5.75
Turkey*	Average Funding rate	8.42			by end-2Q15	-140	8.25
Ukraine	Discount Rate	14.00	Nov-14	+150	4Q15	-200	12.00

Source: Bloomberg, Citi Research.

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

Figure 24. Latin America Policy Rates and Movement

			Last Move		Likely Next Move		End-2015
		Spot	Date	Amount (bp)	Forecast	Amount (bp)	forecast
Brazil	SELIC	12.25	Jan-15	+50	Apr-15	+25	11.75
Chile	CAMARA (Overnight)	3.00	Oct-14	-25	Mar-16	+25	3.00
Colombia	Central Bank Repo Rate	4.50	Aug-14	+25	Apr-16	-25	4.50
Mexico	Official Overnight Rate	3.00	May-14	-50	Oct-15	+25	3.50
Peru	Reference Rate	3.25	Jan-15	-25	Jun-17	+25	3.25

Source: Bloomberg, Citi Research

FX Views

Figure 25. Asian Currencies Exchange Rates

		Mar-15			Jun-15			Dec-15		
	23-Jan	**Forecast**	**Forward**	**Returns**	**Forecast**	**Forward**	**Returns**	**Forecast**	**Forward**	**Returns**
vs USD				(%)			(%)			(%)
China yuan	6.23	6.23	6.29	0.8	6.26	6.34	1.2	6.27	6.43	2.5
Hong Kong dollar	7.75	7.76	7.75	-0.1	7.77	7.75	-0.3	7.78	7.75	-0.4
India rupee	61.44	62.77	61.91	-1.4	63.33	62.87	-0.7	64.08	64.60	0.8
Indonesia rupiah	12459	12830	12577	-2.0	12999	12795	-1.6	13167	n.a.	n.a.
Korea won	1084	1107	1087	-1.9	1122	1090	-3.0	1140	1094	-4.2
Malaysia ringgit	3.60	3.65	3.62	-0.9	3.66	3.65	-0.3	3.66	n.a.	n.a.
Philippines peso	44.2	45.3	44.3	-2.5	45.6	44.4	-2.8	46.0	44.6	-3.1
Singapore dollar	1.34	1.35	1.34	-0.7	1.36	1.34	-1.3	1.37	1.34	-1.9
Taiwan dollar	31.3	31.95	31.30	-2.1	32.07	31.24	-2.6	32.17	31.16	-3.2
Thailand baht	32.6	33.27	32.73	-1.7	33.42	32.94	-1.4	33.50	n.a.	n.a.

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

Figure 26. CEEMEA Currencies Exchange Rates

		Mar-15			Jun-15			Dec-15		
	23-Jan	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs EUR				(%)			(%)			(%)
Czech Republic koruna	27.8	28.0	28	-0.8	28.1	27.8	-1.0	27.9	27.8	-0.6
Hungary forint	310	324	313	-3.5	322	313	-2.9	320	313	-2.2
Poland zloty	4.22	4.32	4.22	-2.4	4.27	4.22	-1.1	4.18	4.22	0.9
vs USD										
Israel shekel	3.98	3.98	3.98	0.1	4.03	3.98	-1.4	4.07	3.97	-2.5
Russia ruble	64.2	64.0	n.a.	n.a.	63.6	n.a.	n.a.	63.9	n.a.	n.a.
Turkey new lira	2.34	2.38	2.37	-0.2	2.43	2.41	-1.0	2.52	2.49	-1.1
S. Africa rand	11.40	11.69	11.52	-1.5	11.88	11.69	-1.6	12.13	12.58	3.5

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

Figure 27. Latin American Currencies Exchange Rates

		Mar-15			Jun-15			Dec-15		
	23-Jan	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
Brazil reais	2.58	2.78	2.62	-5.8	2.83	2.67	-6.2	2.92	2.83	-2.9
Chile peso	627	630	630	0.1	630	634	0.6	630	644	2.1
Colombia peso	2371	2459	2386	-3.1	2478	2399	-3.3	2500	2446	-2.2
Mexico new peso	14.7	14.7	14.7	0.0	14.5	14.7	1.5	14.1	14.7	3.8

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

Global Assumptions

Macroeconomic Forecasts

	GDP Growth (% YoY)			CPI Inflation (% YoY)			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2015F	2016F	2017F	2015F	2016F	2017F	2015F	2016F	2017F	2015F	2016F	2017F
Global	3.0	3.4	3.4	1.9	2.7	2.9	0.6	0.5	0.4	-3.4	-3.1	-2.8
Industrial Countries	2.4	2.4	2.1	0.3	1.7	1.8	0.1	0.0	0.2	-3.3	-3.1	-2.7
United States	3.6	3.0	2.5	0.3	1.8	1.9	-1.4	-1.4	-0.8	-4.1	-4.5	-4.3
Japan	1.1	1.9	0.5	1.0	1.0	2.1	2.7	2.4	2.0	-6.6	-6.2	-5.4
Euro Area	1.3	1.9	1.9	-0.1	1.6	1.5	2.7	2.4	2.2	-2.2	-1.8	-1.4
Germany	1.5	2.0	1.8	0.0	1.7	1.8	7.6	6.7	6.5	0.2	0.1	0.1
United Kingdom	3.0	3.0	2.8	0.3	1.6	1.7	-5.1	-5.3	-5.0	-4.0	-1.9	-0.4

G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 21 January 2015

	1Q 15F	2Q 15F	3Q 14F	4Q 15F	1Q 16F	2Q 16F
United States: Federal Funds	0.25	0.25	0.25	0.50	0.50	0.75
10-Yr. Treasuries (Period Ave.)	1.95	2.20	2.35	2.55	2.65	2.65
Euro Area: US$/€	1.14	1.12	1.10	1.08	1.05	1.02
Euro Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05
10-Yr. Bunds (Period Average)	0.55	0.55	0.65	0.65	0.75	0.75
Japan: Yen/US$	118	124	129	132	134	136
Call Money	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.25	0.35	0.40	0.45	0.50	0.50

Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US$						Spread vs. Germany					
	Current	1Q 15F	2Q 15F	3Q 15F	4Q 15F	1Q 16F	Current	1Q 15F	2Q 15F	3Q 15F	4Q 15F	1Q 16F
United States	NA	NA	NA	NA	NA	NA	133	141	166	171	192	192
Japan	-157	-171	-186	-196	-212	-217	-23	-30	-20	-25	-20	-25
Euro Area (Germany)	-133	-141	-166	-171	-192	-192	NA	NA	NA	NA	NA	NA
United Kingdom	-27	-30	-40	-20	-30	-25	106	111	126	151	161	166

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

Commodities Price Outlook

		3M	6-12M	LT
Metals and Bulks				
Gold Price	US$/oz	1270	1240	1050
Silver Price	US$/oz	17.25	16.80	16.50
Platinum Price	US$/oz	1300	1400	1763
Energy				
WTI Oil Price	US$/bbl	52	50	81
Brent Oil Price	US$/bbl	60	58	85
Henry Hub Gas Price	US$/MMbtu	2.90	2.80	5.50
Agriculture				
CBOT Corn - North America	US¢/bu	360	388	
CBOT Wheat - North America	US¢/bu	515	540	
CBOT Soybeans - North America	US¢/bu	1000	980	
CBOT Rice - North America	US¢/cwt	13.00	14.00	

Source: Citi Research

EM: Key Forecasts

Figure 28. Emerging Markets – Economic Forecasts, 2014F-2016F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F
Asia	6.2	6.1	6.1	2.9	2.3	2.6	2.7	3.0	2.6	-2.4	-2.6	-2.5
China	7.4	6.9	6.7	2.0	1.5	1.9	2.5	2.7	2.5	-2.1	-2.5	-2.5
Hong Kong	2.3	2.6	3.0	4.4	4.4	3.9	0.6	2.9	2.4	1.3	0.7	1.0
India*	5.6	6.5	7.0	6.8	5.5	5.5	-1.2	-0.2	-0.8	-6.7	-6.4	-6.1
Indonesia	5.1	5.1	5.3	6.3	6.8	4.6	-3.1	-2.6	-2.5	-2.4	-2.0	-1.8
Korea	3.3	3.4	3.7	1.3	1.4	2.4	6.6	7.2	6.7	0.9	0.3	0.2
Malaysia	5.7	5.0	5.1	3.2	2.6	3.0	5.3	4.0	5.0	-3.5	-3.2	-2.5
Mongolia	6.5	9.0	8.0	12.8	11.1	8.9	-7.8	0.0	-5.8	-8.1	-7.2	-6.5
Pakistan	5.4	4.5	4.3	8.6	6.0	7.0	-1.2	0.0	-0.6	-5.5	-4.8	-4.8
Philippines	5.9	6.3	6.5	4.2	2.6	3.1	4.0	5.9	5.8	-0.6	-1.4	-1.3
Singapore	2.8	3.0	3.0	1.0	0.1	1.4	18.0	18.0	17.0	-0.3	0.2	1.5
Sri Lanka	7.7	7.2	7.1	3.3	2.8	5.0	-3.0	-2.6	-2.1	-5.4	-5.2	-5.2
Taiwan	3.6	3.6	3.8	1.2	1.2	1.8	12.0	11.0	8.0	-1.4	-1.6	-1.3
Thailand	0.5	3.0	3.8	1.9	1.0	2.1	3.9	7.0	5.1	-2.7	-2.4	-2.3
Vietnam	6.0	6.2	6.4	4.1	3.8	4.5	5.5	4.7	3.9	-6.4	-6.0	-5.7
Latin America	0.8	1.2	2.8	7.6	7.6	7.9	-2.7	-2.9	-2.8	-4.6	-4.5	-4.1
Argentina	0.0	-1.0	1.0		18.3	32.9	-1.0	-1.4	-1.2	-3.7	-4.7	-3.7
Brazil	0.0	0.1	1.6	6.3	6.7	6.0	-4.0	-3.8	-3.7	-6.1	-5.3	-4.5
Chile	1.5	2.5	4.0	4.4	2.9	3.0	-1.3	-2.4	-3.0	-2.0	-2.2	-1.9
Colombia	4.8	3.8	4.0	2.8	3.0	3.1	-4.5	-4.6	-4.6	-1.6	-1.5	-1.5
Costa Rica	3.5	2.7	3.5	4.5	4.0	4.5	-5.2	-4.8	-4.8	-6.7	-7.3	-8.0
Dominican Republic	7.1	5.4	4.8	3.0	1.0	3.0	-3.1	-3.0	-3.2	-4.0	-3.6	-4.5
El Salvador	2.0	2.2	2.5	1.1	-0.2	1.8	-4.8	-4.3	-4.5	-3.4	-3.6	-3.5
Mexico	2.2	3.4	4.4	4.0	3.6	3.6	-2.1	-2.3	-2.4	-3.6	-3.5	-3.5
Panama	6.2	5.5	6.5	2.6	0.5	2.1	-9.0	-8.5	-6.7	-4.5	-3.5	-3.0
Peru	2.5	3.8	4.6	3.3	2.6	2.6	-5.6	-4.8	-5.9	0.5	-2.7	-1.7
Venezuela	-4.0	-4.4	1.9	61.3	70.3	80.0	4.4	2.4	4.2	-12.3	-12.9	-12.7
Europe	1.4	0.0	2.4	6.1	7.7	5.6	0.2	0.0	-0.7	-1.5	-2.5	-2.1
Bulgaria	1.5	1.2	2.0	-1.4	1.4	1.3	0.2	-0.5	-1.5	-3.7	-3.8	-2.0
Croatia	-0.7	0.3	1.3	-0.2	0.2	1.5	1.0	0.5	-0.5	-5.5	-5.6	-5.4
Czech Republic	2.3	2.5	3.1	0.4	0.6	2.2	0.0	0.2	-0.8	-1.9	-2.3	-2.0
Hungary	3.4	2.5	1.5	-0.2	0.0	2.4	4.2	4.7	4.0	-2.6	-2.4	-2.1
Kazakhstan	3.7	3.0	4.0	6.6	6.3	5.7	1.9	1.2	1.1	-2.4	-2.2	-1.9
Poland	3.3	3.4	3.6	0.0	-0.2	2.4	-1.2	-1.6	-2.3	-2.9	-2.3	-2.2
Romania	2.8	3.0	3.0	1.1	1.5	2.6	-0.5	-1.8	-2.2	-2.0	-1.9	-2.1
Russia	0.6	-3.0	1.5	7.8	12.5	6.8	3.2	3.2	2.3	0.0	-2.6	-1.5
Serbia	-2.0	-0.6	1.5	2.1	2.5	4.0	-6.5	-5.0	-4.5	-7.8	-6.0	-4.5
Slovakia	2.4	2.6	3.2	-0.1	0.6	2.2	0.5	0.0	0.3	-2.9	-2.8	-2.2
Turkey	2.9	3.3	3.4	8.9	5.5	7.0	-5.6	-4.3	-4.8	-1.3	-1.5	-2.9
Ukraine	-6.5	-3.0	1.9	12.1	17.5	8.6	-3.7	-2.6	-2.0	-10.0	-6.0	-4.0
Africa/Mideast	3.7	2.1	3.7	4.4	4.9	4.9	5.5	-0.8	0.2	-3.0	-7.3	-6.0
Bahrain	4.8	-2.4	1.5	2.5	2.1	2.2	5.8	-3.5	-2.4	-4.3	-8.5	-6.5
Egypt	3.2	3.4	4.3	10.1	8.9	8.7	-2.0	-2.3	-3.0	-11.7	-10.6	-10.4
Ghana	4.6	4.0	6.0	15.2	13.2	8.0	-8.9	-7.8	-8.3	-9.8	-7.6	-6.5
Iraq	0.1	6.0	4.2	2.5	5.0	5.0	-5.8	-8.7	-5.4	-4.5	-10.0	-8.6
Israel	2.4	2.2	2.5	0.5	0.3	1.4	2.0	1.9	3.3	-3.0	-3.3	-2.5
Jordan	3.6	3.8	4.3	3.0	4.0	4.2	-8.9	-4.5	-6.0	-6.4	-6.8	-6.8
Kenya	5.2	6.0	6.2	6.9	5.5	6.1	-12.3	-8.9	-8.5	-6.2	-6.0	-5.6
Kuwait	3.7	2.1	2.2	3.0	3.5	3.5	34.5	13.5	13.6	12.8	-12.2	-9.7
Lebanon	0.8	1.5	2.0	1.1	1.8	2.5	-27.9	-21.6	-20.7	-9.5	-9.6	-9.6
Nigeria	6.2	4.5	6.2	8.1	11.0	8.8	1.3	-2.5	-0.6	-2.0	-2.7	-2.3
Oman	5.0	-2.3	2.7	1.0	0.9	1.2	6.8	0.4	4.6	-1.9	-8.8	-5.3
Qatar	5.6	3.8	4.1	3.0	3.5	4.5	30.5	15.7	14.4	-2.6	-13.3	-12.9
Saudi Arabia	3.4	-3.3	1.7	2.9	3.0	3.4	12.1	-2.0	0.2	-1.8	-8.9	-6.2
South Africa	1.6	2.4	2.8	6.1	5.1	5.0	-5.3	-4.4	-4.1	-4.1	-4.1	-3.5
Tanzania	7.1	7.2	6.4	6.1	3.9	5.4	-13.7	-13.1	-12.5	-6.2	-6.5	-5.5
UAE	4.0	4.0	4.4	2.0	2.4	2.9	8.6	3.3	3.1	NA	NA	NA
Uganda	6.1	6.5	6.9	4.3	3.1	6.6	-9.7	-10.1	-11.0	-5.3	-5.6	-5.3
Zambia	6.5	6.0	6.1	7.8	7.5	6.8	0.5	-0.8	-1.5	-5.3	-5.0	-5.2
Total	4.2	3.9	4.7	4.4	4.3	4.2	1.7	1.3	1.1	-2.8	-3.5	-3.1

Source: National sources, Citi Research forecasts

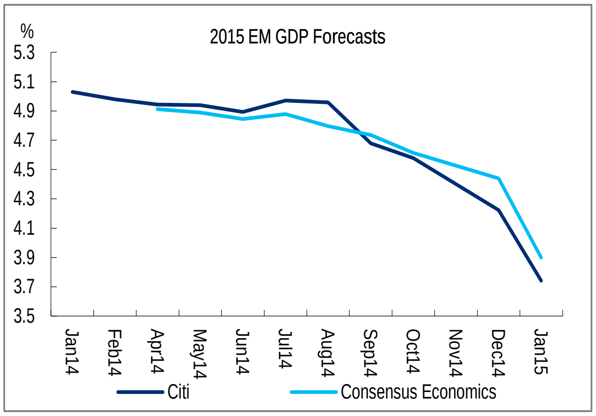
Our Forecasts vs. Consensus

Figure 29. Citi vs Consensus Forecasts

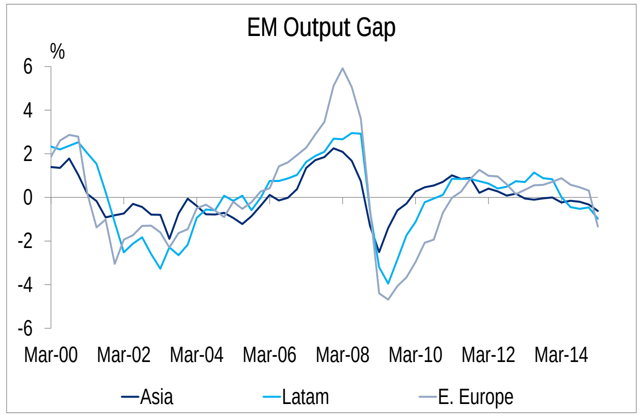
	GDP Growth (%)				CPI Inflation (%)				Current Account Balance (US$ bn)			
	2015F	Consensus	2016F	Consensus	2015F	Consensus	2016F	Consensus	2015F	Consensus	2016F	Consensus
Asia	6.1%	6.1%	6.1%	6.1%	2.3%	2.7%	2.6%	2.9%	558	507	523	475
China	6.9	7.0	6.7	6.9	1.5	1.8	1.9	2.2	301	300	304	279
Hong Kong	2.6	2.7	3.0	2.8	4.4	3.3	3.9	3.2	9	7	8	8
India	6.5	5.6	7.0	6.3	5.5	6.7	5.5	5.9	-5	-33	-20	-39
Indonesia	5.1	5.4	5.3	5.8	6.8	6.6	4.6	4.7	-23	-22	-24	-22
South Korea	3.4	3.6	3.7	3.7	1.4	1.4	2.4	2.1	98	94	95	87
Malaysia	5.0	4.9	5.1	5.0	2.6	3.7	3.0	3.0	13	12	17	15
Philippines	6.3	6.1	6.5	6.1	2.6	3.2	3.1	3.5	18	12	19	12
Singapore	3.0	3.1	3.0	3.4	0.1	0.9	1.4	1.9	54	58	53	61
Sri Lanka	7.2	7.3	7.1	7.1	2.8	4.9	5.0	5.7	-2	-3	-2	-3
Taiwan	3.6	3.6	3.8	3.5	1.2	0.9	1.8	1.4	58	65	45	62
Thailand	3.0	3.8	3.8	4.0	1.0	1.4	2.1	2.5	27	9	21	8
Vietnam	6.2	5.9	6.4	6.1	3.8	4.0	4.5	5.1	9	7	8	7
Latin America	1.2%	1.3%	2.7%	2.7%	10.2%	10.4%	10.8%	9.0%	-141	-151	-146	-144
Argentina	-1.0	-0.7	1.0	1.7	24.0	23.8	35.0	29.0	-7	-8	-6	-6
Brazil	0.1	0.4	1.6	1.9	6.9	6.4	5.5	5.6	-76	-79	-77	-74
Chile	2.5	2.7	4.0	3.7	2.6	2.5	3.0	3.0	-6	-3	-8	-3
Colombia	3.8	3.8	4.0	4.3	3.0	3.2	3.0	3.1	-17	-17	-18	-16
Mexico	3.4	3.2	4.4	3.7	3.3	3.4	3.7	3.5	-30	-30	-34	-33
Panama	5.5	6.2	6.5	6.2	1.6	2.9	2.5	3.2	-4	-5	-4	-5
Peru	3.8	4.4	4.6	5.1	2.6	2.6	2.6	2.7	-10	-10	-12	-10
Venezuela	-4.4	-4.1	1.9	0.1	75.0	82.4	85.0	54.3	7	1	12	2
Europe	0.0%	-0.5%	2.4%	2.0%	7.8%	7.2%	5.5%	5.2%	0.0	-0.2	-23.1	-2.5
Bulgaria	1.2	1.6	2.0	2.2	1.4	0.6	1.3	1.8	-0.2	0.1	-0.7	-0.3
Croatia	0.3	0.3	1.3	1.3	0.2	0.6	1.5	1.7	0.2	0.2	-0.2	0.2
Czech R	2.5	2.5	3.1	2.8	0.6	0.7	2.2	1.8	0.4	-1.0	-1.6	-1.4
Hungary	2.5	2.2	1.5	2.2	0.0	0.8	2.4	2.5	5.4	4.4	4.3	3.9
Kazakhstan	3.0	3.7	4.0	4.7	6.3	6.6	5.7	6.2	2.6	-1.3	2.5	2.1
Poland	3.4	3.3	3.6	3.6	-0.2	0.4	2.4	1.9	-7.5	-8.3	-10.7	-10.6
Romania	3.0	2.9	3.0	3.3	1.5	1.6	2.6	2.4	-3.1	-3.0	-3.6	-3.8
Russia	-3.0	-4.1	1.5	0.3	12.5	10.8	6.8	6.4	40.3	49.2	30.4	51.0
Serbia	-0.6	0.1	1.5	1.8	2.5	3.1	4.0	4.0	-1.8	-2.3	-1.4	-2.3
Slovak Rep	2.6	2.7	3.2	3.1	0.6	0.8	2.2	1.8	0.0	2.0	0.2	1.8
Turkey	3.3	3.4	3.4	3.8	5.5	6.3	7.0	6.2	-33.5	-37.3	-39.8	-40.0
Ukraine	-3.0	-3.4	1.9	2.2	17.5	16.6	8.6	9.9	-2.9	-2.9	-2.7	-3.1
MEA	1.0%	3.6%	3.5%	4.2%	5.6%	5.5%	5.4%	5.7%	-42.0	2.7	-17.4	13.1
Egypt	3.4	3.8	4.3	4.3	8.9	10.7	8.7	9.7	-6.9	-8.6	-9.9	-8.6
Israel	2.2	2.9	2.5	3.5	0.3	0.8	1.4	1.7	5.2	7.6	9.5	8.4
Nigeria	4.5	5.6	6.2	6.1	11.0	9.1	8.8	8.7	-12.9	-1.9	-3.4	3.1
S. Africa	2.4	2.4	2.8	2.9	5.1	5.2	5.0	5.6	-15.0	-19.0	-15.1	-19.6
S. Arabia	-3.3	3.1	1.7	3.5	3.0	3.2	3.4	3.5	-12.5	24.6	1.5	29.8
Above Total	3.9%	3.9%	4.7%	4.7%	5.0%	5.1%	4.7%	4.5%	381.5	367.6	347.0	350.0

Source: Consensus Economics, National Sources, Citi Research forecasts

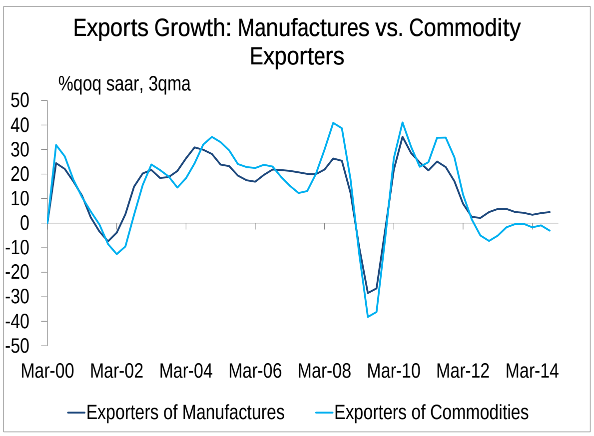
EM most requested regional charts



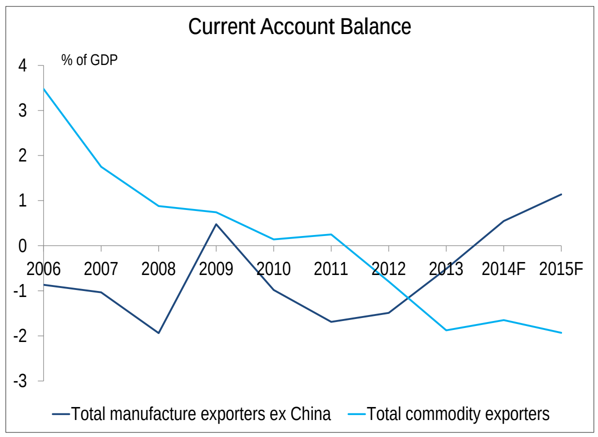
Source: Haver Analytics, Citi Research



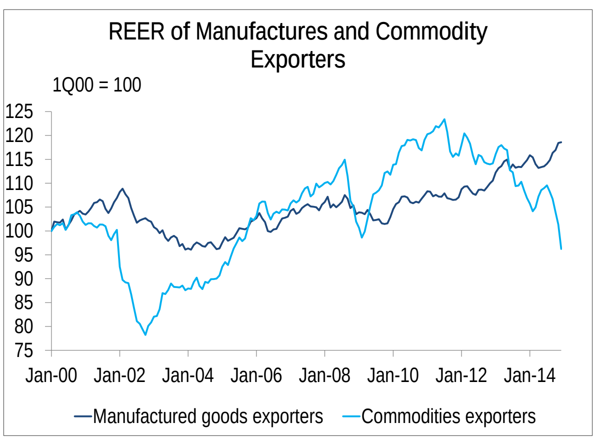
Source: Haver Analytics, Citi Research



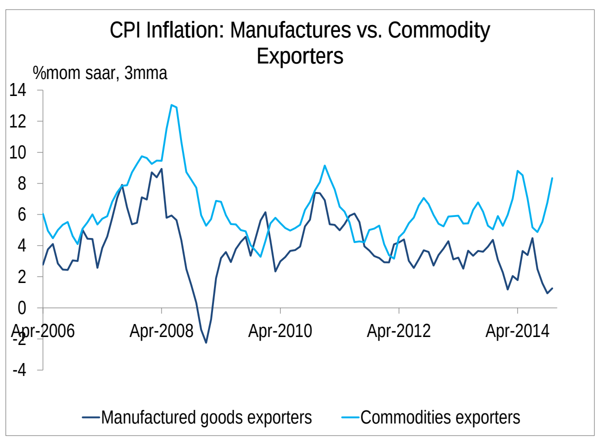
Source: Haver Analytics, Citi Research



Source: Haver Analytics, Citi Research



Source: Haver Analytics, Citi Research



Source: Central banks, Haver Analytics, Citi Research

Asia Pacific

China

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

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

- **Summary view** — China would enjoy *slower growth dividend*, i.e. benefits of low commodity price, possibly together with *reform dividend* in 2015 and beyond. The friendly oil price this year could save the cost of imports equivalent to 0.9% of GDP. It may not notably lift the official GDP growth, but could trim the downside risks to the economy and improve the underlying growth momentum.

- **Things to watch** — The Chinese economy could not stabilize unless the property sector ftatterns out in the near term or new growth drivers emerge in the longer term. Combined policy easing and structural reforms are necessary to avoid the short-term pain of transition. Investment shall continue to play the leading role in growth but is constrained by a slower pace of re-leveraging.

- **Strategy** — We expect the cost of funding to decline gradually alongside two more rate cuts in 1H and 3-4 RRR cuts this year. Within the two-way bet framework, the RMB shall weaken against the US dollar but strengthen in REER terms. The bond market may expand to accommodate bond issuance by provincial governments starting this year.

Underlying growth better than the headline

China's slowdown occurred as traditional growth drivers ran out of steam, further new growth drivers are still absent — While investment growth normalized, consumption contribution to GDP growth also weakened to 2.8 ppts in 3Q 2014, the slowest 3Q growth post the global financial crisis. Investment and consumption together only delivered 4.9 ppts of growth in 3Q 2014, probably the lowest reading in the past two and half decades. Considering the possibility of over-invoicing in exports, weak Li Keqiang Index and corrected GDP deflator, the actual quarterly GDP growth rate could already be 6% or even 5-6%. Otherwise, the official GDP growth rate of 7.3% in 3Q could not justify the rate cut in Nov, but the actual growth rate does.

China's GDP growth may remain soft in 2015 on extended investment slowdown — In our view, investment growth may gradually normalize towards low teens in the coming a few years and to single digit in the medium term, largely due to slower pace of re-leveraging and then de-leveraging in the economy. Chinese leaders had admitted that the marginal effect of stimulus is diminishing. On one hand, the government might have lowered its growth target for 2015 to 7%, signaling the policy intention to tolerate slower growth but avoid a big short-term pain. On the other hand, it may accept the fact that the actual GDP growth rate comes in below the target as long as the job market remains relatively stable. We continue to forecast the reported growth at 6.9% this year, but the underlying growth could improve amid oil surprise.

The Chinese economy could enjoy *slow growth dividend* alongside possible *reform dividend* this year — According to customs, falling commodity prices in 2014 dragged import growth by 3.3ppts, or Rmb395bn cost savings, equivalent to 3% of fiscal revenue and 0.6% of GDP. Those benefits of falling commodity prices, i.e., slow growth dividend, could be bigger in 2015. Citi sees the average Brent oil price to drop by 37% in 2015; cost savings from which would be equivalent to roughly 4% of the fiscal revenue and boost GDP growth rate by 0.4-0.9ppt. Our estimate suggests that falling oil price often takes two quarters to benefit economy.

Chinese policy-makers will have to manage the delicate balance between cyclical and structural policies (i.e., reform dividend) in 2015 — The growth slowdown last year was partly intended as the authorities tried to avoid stimulating the economy. But we believe two more rate cuts for 1H and possibly 3-4 RRR cuts for the year are necessary to curb deflation and trim the downside risks in the economy; some monetary actions of easing could be taken before the Chinese New Year (Feb 19). Within the two-way bet framework, the RMB shall weaken against the US dollar but strengthen in REER terms. On structural policies, China aims at turning reform measures into growth momentum this year, and fiscal, hukou and SOE reforms announced last year are expected to be implemented with an investment angle.

Key downside risks in 2015

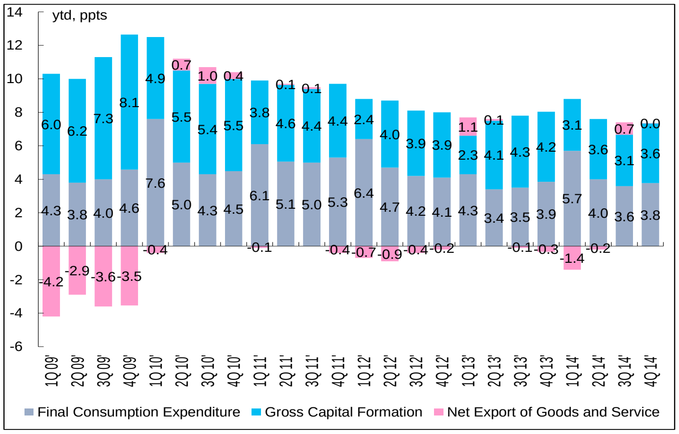
First, investment stallout may cause a hard landing in the economy — Investment stallout because of bubble burst, credit constraint on infrastructure investment, SOEs going asset light and SME bankruptcy remains top risks to the economy this year. Cautious investors were debating the possible scenario of zero or even negative investment growth in the property and construction sector. However, Japan and Korea's experiences suggest investment could maintain a single-digit growth before urbanization rate hits the threshold of 75%. China's urbanization rate was 53.7% in 2013, far from the inflection point of negative investment growth. We expect property and construction investment to grow at 9% this year.

Second, deflation is destructive to growth — China's 4Q credit demand, an index formed by PBOC based on banker survey, reached new low since 2004, which requires timely monetary policy reaction. The policy reluctance and declining commodity prices may cause the steepening of deflationary pressure in the coming quarters. We downgrade our CPI forecast from previously 1.9% to 1.5% for 2015, assuming part of the deflation will be offset by price and tax reforms. Deflation shall discourage re-stocking and demand in the near-term and thus add to the downside risks to growth.

Third, defaults in the credit market could trigger financial crisis — The risk of credit default may rise amid the restructuring of local government debts. Local debts will be divided into general, special and other debts. Other debts will be pushed to the market through PPP and other channels, a new class of debt which was part of local debts but is no longer guaranteed by local governments after the budget reform. The concern over local defaults could rise if a significant portion of debts is left unsecured by the government.

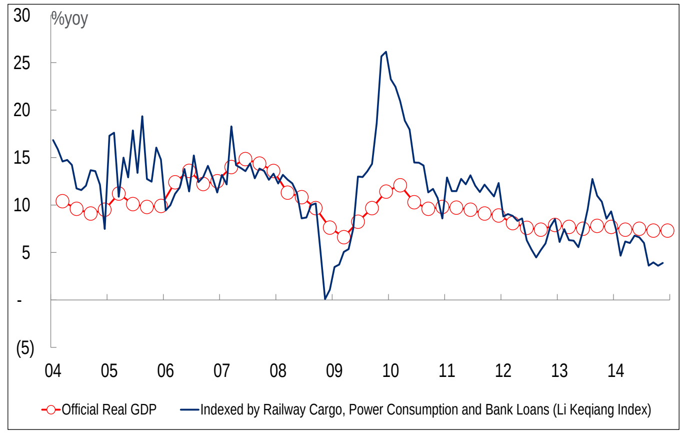
Fourth, RMB depreciation may exacerbate capital flight — We expect the USDCNY to trade within the range of 6-6.3, but there is a risk that the two-way bets could be tested. RMB had shifted to the depreciation end after the widening of the daily trading band early last year, and then strengthened in the middle of the year due to the change of stronger net export growth. Recent RMB softness is likely linked to the expectation of lower risk-free rates and strong US dollar going forward. China would generally avoid the exchange rate shifting from two-way bets to one-way depreciation this year barring the scenario of hard landing. Capital outflows, due to speculation of weak RMB relative to the US dollar, converging interest rates between China and the US, and even portfolio diversification, may drag down the RMB more than our expectation.

Figure 30. GDP growth breakdown, YTD YoY



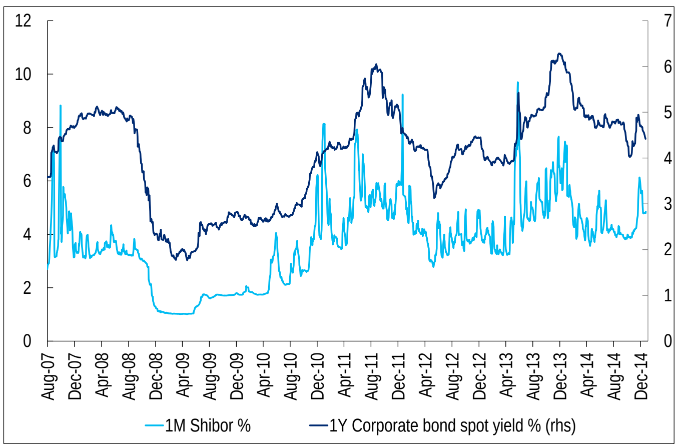
Source: NBS, CEIC and Citi Research

Figure 31. Li Keqiang Index fell to a new low after global financial crisis



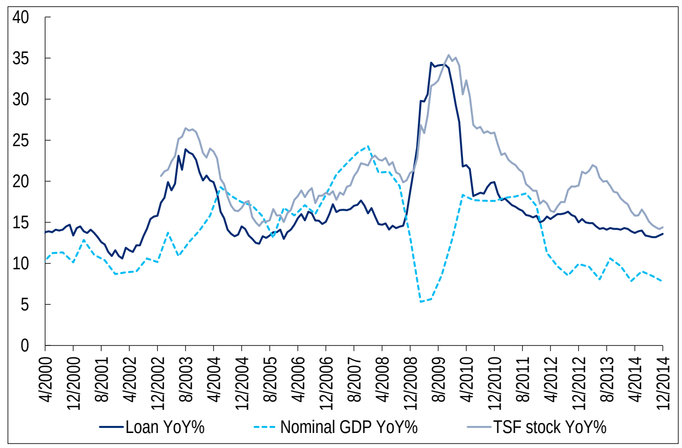
Source: NBS, CEIC and Citi Research

Figure 32. Interbank rate vs. corporate bond yield



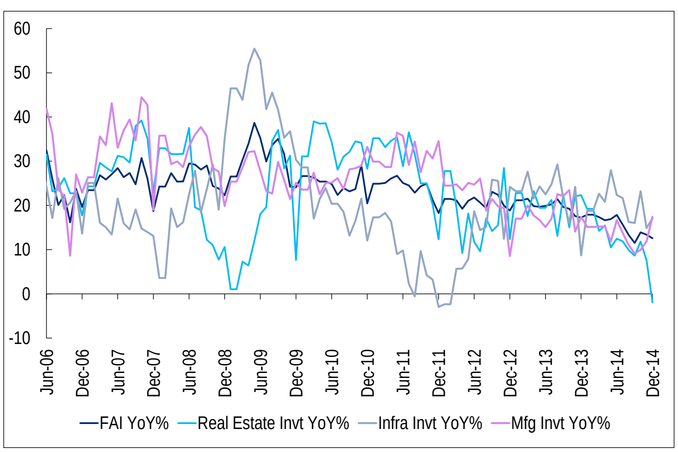
Source: NBS, CEIC and Citi Research

Figure 33. Nominal GDP vs. Credit and Total Social Financing



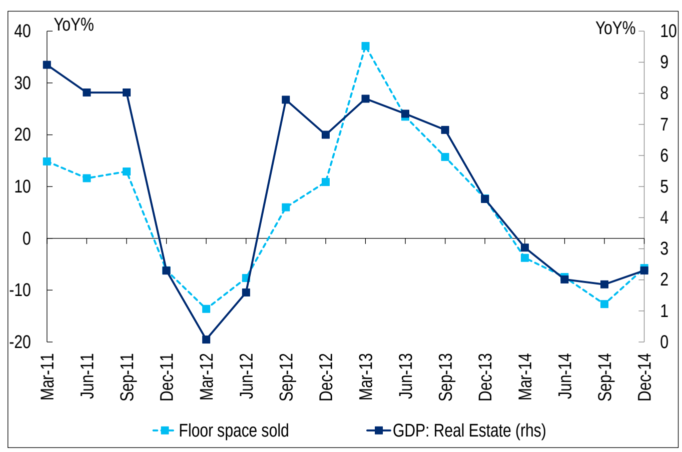
Source: NBS, CEIC and Citi Research

Figure 34. Investment growth by key sector



Source: NBS, CEIC and Citi Research

Figure 35. Property transaction volumes vs. Real estate GDP



Source: NBS, CEIC and Citi Research

Figure 36. China Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	4,544.0	5,070.5	5,932.5	7,319.0	8,246.9	9,557.0	10,446.3	11,157.4	12,141.7
Nominal GDP, local currency bn	31,490	34,632	40,151	47,310	51,947	58,802	64,366	69,128	74,656
GDP per capita, US$	3,422	3,800	4,424	5,432	6,091	7,023	7,637	8,146	8,841
Population, mn	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,360.7	1,367.8	1,369.7	1,373.4
Unemployment, % of labour force	4.2	4.3	4.1	4.1	4.1	4.1	4.1	4.1	4.3
Economic Activity									
Real GDP, % yoy	9.6	9.2	10.4	9.3	7.7	7.7	7.4	6.9	6.7
Real investment growth % yoy	11.0	19.2	11.9	9.4	7.7	8.9	7.5	6.0	6.3
Real consumption growth % yoy	8.5	9.4	9.2	10.9	8.6	7.9	7.6	7.1	7.1
private consumption growth % yoy	9.2	10.3	8.5	18.2	7.8	10.8	7.8	7.3	7.3
Prices, Money & Credit									
CPI, % yoy	1.2	1.9	4.6	4.1	2.5	2.5	1.5	2.0	2.4
CPI, % avg	5.9	-0.7	3.3	5.4	2.6	2.6	2.0	1.5	1.9
Nominal wages, % yoy	16.9	11.6	13.3	14.4	11.9	10.1	10.0	7.9	8.5
Credit extension to private sector, % yoy	14.0	33.2	20.3	15.1	15.6	14.1	12.7	12.4	12.1
Policy interest rate, % eop	2.25	2.25	2.75	3.50	3.00	3.00	2.75	2.25	2.25
Short-term market rate, % eop	1.78	1.83	4.62	5.47	3.90	5.56	5.14	4.25	4.46
Long term yield, % eop	1.80	3.06	3.61	3.27	3.33	4.49	3.53	3.49	3.69
lc/US$, eop	6.82	6.83	6.59	6.29	6.23	6.05	6.21	6.27	6.11
lc/US$, avg	6.95	6.83	6.77	6.46	6.31	6.15	6.16	6.27	6.17
Balance of Payments, US$ bn									
Current account	420.6	243.3	237.8	136.1	215.4	182.8	261.2	301.2	303.5
% of GDP	9.3	4.8	4.0	1.9	2.6	1.9	2.5	2.7	2.5
Trade balance	298.1	195.7	181.5	154.9	230.3	259.0	382.5	459.8	508.5
Exports	1,430.7	1,201.6	1,577.8	1,898.4	2,048.7	2,209.0	2,342.9	2,499.0	2,629.2
Imports	1,132.6	1,005.9	1,396.2	1,743.5	1,818.4	1,950.0	1,960.8	2,039.2	2,120.8
Service balance	-11.8	-29.4	-31.2	-61.6	-89.7	-124.5	-107.7	-139.3	-171.2
Income balance	28.6	-8.5	-25.9	-70.3	-19.9	-43.8	-13.6	-19.2	-33.7
FDI, net	114.8	87.2	185.7	231.7	176.3	185.0	174.0	114.5	44.1
International reserves	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,821.3	3,840.0	4,174.2	4,446.8
Total Amortisations	23.3	34.2	27.2	33.2	33.0	39.2	41.2	45.3	49.9
Public Finances, % of GDP									
Consolidated government balance	-0.4	-2.2	-2.2	-1.3	-2.0	-1.9	-2.1	-2.5	-2.5
Consolidated gov primary balance	0.1	-1.8	-1.7	-0.9	-1.5	-1.4	-1.6	-2.0	-1.5
Public debt	37.4	47.8	49.2	44.3	53.5	52.8	53.1	54.2	54.9
of which Domestic	36.6	47.0	48.6	43.7	53.0	52.4	52.7	53.9	54.6
Foreign Assets & Liabilities, US$ bn									
External debt	390.2	428.6	548.9	695.0	737.0	863.2	949.5	1,044.4	1,148.9
Private	356.9	391.8	510.1	657.6	700.4	828.8	911.7	1,002.9	1,103.2
Public	33.3	36.9	38.8	37.4	36.6	34.3	37.8	41.5	45.7
External debt / GDP	8.6	8.5	9.3	9.5	8.9	9.0	9.1	9.4	9.5
External debt / XGS	24.7	32.2	31.5	33.4	32.8	35.6	36.9	38.1	39.8
Short-term debt	226.3	259.3	375.7	500.9	540.9	676.6	744.3	818.7	900.6
Short-term debt/International Reserves (%)	11.6	10.8	13.2	15.7	16.3	17.7	19.4	19.6	20.3

Quarterly Economic Indicators

	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	7.5	7.3	7.3	6.7	6.8	7.0	6.9	7.0	6.8
CPI, % yoy	2.3	1.6	1.5	1.2	1.3	1.4	2.0	2.0	1.4
Policy interest rate, % eop	3.00	3.00	2.75	2.50	2.25	2.25	2.25	2.25	2.25
Short-term market rate, % eop	4.75	4.54	5.14	4.04	4.10	3.94	4.25	3.95	4.29
Long term yield, % eop	3.84	3.90	3.53	2.86	2.69	3.43	3.49	4.01	3.54
lc vs USD, eop	6.20	6.14	6.21	6.23	6.26	6.29	6.27	6.23	6.19

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates.
*Note: Public debt includes the debt of central, local govt and Ministry of Railway. Long term yield refers to 5Y Sovereign Bond yield. External debt is based on the residency of the holder of the debt (not by currency denomination). BOP is reported using BPM5.

Hong Kong

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

- **Summary view** — The economy will need to ride through impacts of US rate normalization, strong USD and China's slowdown vs. easing process in 2015E. Higher welfare commitment costs likely limit handouts in the upcoming budget. HKD peg to stay status quo, with an eventual re-peg to RMB.
- **Things to watch** — 1) Liquidity flow patterns; 2) trade recovery & property market adjustment; 3) tourist shopping (lower volume & value/pax); 4) electoral reforms and protests; 5) co-operating measures with Qianhai and Shanghai FTZ; 6) expansion of Stock Connect; 8) more RQFII quota.
- **Strategy** — We continue to believe that the HKD peg will stay status quo until an one-off shift to peg to CNY when the CNY is fully convertible. Citi expects mass market home prices would rise by 8% in 2015E; and the HSI target for 2015 year-end is 25,000. HK's interest rates to follow the US rates normalization.

Our 2015 outlook remains the same despite lower oil prices — As portrayed in our year-end report (starting pg. 26), the economy will need to ride through impacts of US rate normalization and China's slowdown-easing process in 2015E. Consumption slowdown remains our biggest concern, but warming of global trade should benefit HK's logistics sector. Oil prices decline is unlikely to lower HK's inflation as much of the CPI basket is heavily weighted by food and housing rentals. But the cheaper oil bill does offer some cushioning to various uncertainties that HK faces (e.g. lower consumption, China slowdown, political events, etc.).

HKD peg to stay status quo

HKD de-peg chatters resurfacing — The HKD saw a knee jerk reaction to strengthen against the USD like the CHF appreciation against the EUR after the SNB abandoned its three-year currency peg. The testing of the strong end of HKD trading band is unlikely to be successful given HKMA has unlimited ammunition to defend the strong end of the peg by printing money. While in the reverse case (a more relevant case in the medium term of expected USD strength), where the HKD tests the weak side of the convertibility band will be met by HKMA's intervention that is solidly backed by HK's large reserves (which stands at US$328.5bn as of Dec14).

"It is still in the best interest of HK to maintain the HKD-USD peg." — HK's key officials have reiterated the importance of not changing its currency regime. One repeatedly mentioned point is that HK, being a small open economy can easily be destabilized by large external shocks, and the Linked Exchange Rate System (LERS) has offered a stability anchor for HK's economy since 1983. The Swiss change is now a cited example of FX shocks destabilizing businesses. HK government values most the current simple, automatic and transparent exchange rate regime to provide a stable operating environment for businesses in HK. The LERS has undergone multiple stringent tests of economic shocks and policy mixes since its adoption. Hence, HKMA's creditability of maintaining the HKD peg is hard earned, any adjustments to the current LERS is likely to yield further speculations.

HKD to stay status-quo, with an eventual re-peg to RMB — Our long standing house view is that HKD peg would remain as such until a one-off switch from USD to RMB, when it would become fully convertible. An eventual HKD-RMB peg, say in 5-10 years, will eliminate currency risks and minimize transaction costs, as cross-border business activities and demographic movements take it to the next level with the pan-Pearl River Delta economic integration. By then, the alignment of the two economies' business cycles via a HKD-RMB peg would be even more legitimate.

But now is not the time! — First, Article 111 of Basic Law (Chapter 5, Section 1) states that "the HKD, as the legal tender in the HKSAR, shall continue to circulate". Article 112 specifies that "the HKD shall be freely convertible", and this is widely read as the HKD has to be pegged to currencies that are also fully convertible. A final interpretation of the Basic Law by the Standing Committee of the National People's Congress would be necessary in order for the HKD-RMB peg to take place before the latter is free floating and we think the odds of this happening is very low. Article 111 also states that "the issue of HK currency must be backed by a 100 per cent reserve fund" and a full switch to link to RMB would require an even bigger swap line to be set up with the PBOC. Second, the full convertibility of the RMB will take time for China to complete its ongoing financial reforms – a move likely to take more than five years.

Policies to improve livelihoods and attract talent

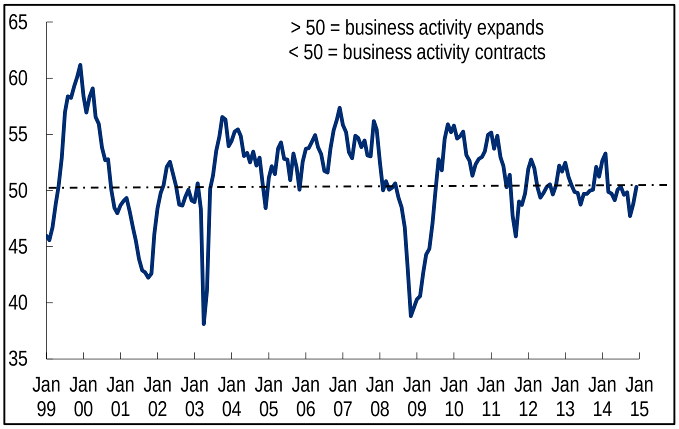
Third Policy Address (PA) of Chief Executive CY Leung on Livelihood — The newly released PA focused on improving people's livelihoods, attracting talent and pursuing electoral reform. CE Leung continues to devote significant fiscal resources to address social welfare issues, e.g. alleviating poverty, support for the elderly and the needy – a pattern that can be observed in his previous PAs and his election mandate. These social issues indeed must be tackled given widening income disparity and an aging society, and such policy measures are also more politically viable to be implemented swiftly given the current political environment.

Still expect an 8% rise in home prices in 2015 — Housing/land developments are also detailed in this PA as they are key to people's livelihoods. CE confirmed private supply of only 14,600 units per year in the next five years (against 10-year target of 19k units), while 77,100 public housing units will be completed in FY15-19. The latest PA emphasize on efforts to increase land/housing supply in mid- to long-term. Our property analyst continues to see home prices could rise by 8%yoy in 2015E.

New immigration policies to attract talent and not just money — To help alleviate shortages of skilled workers/professionals in construction and healthcare, and in general to attract foreign talent (especially youth talent and second generation of HK permanent residents) for better economic development, the government is looking at bringing more construction workers for public works and is relaxing existing employment policies and talent-admission schemes. These policy amendments are being pushed forward despite loud objections from local worker groups and politicians. In turn, the Capital Investment Entrant Scheme has been suspended as of 15 Jan, disallowing cash-rich immigrants to gain HK residency by investing >HK$10mn in local markets (mostly in equities). The impact of suspension will likely be limited, as the property investment option under this scheme has already been banned since Oct 2010; hence there would be no more new immigrant's fund inflows, but would not cause outflows of existing funds.

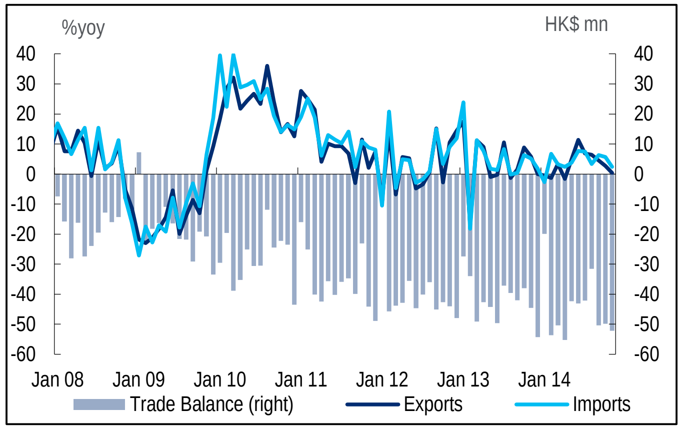
Limited alleviation measures to strive for fiscal balance — More welfare commitments in the PA will add to the fiscal burden, and we expect the Financial Secretary to raise fees of various government services in the 2015 Budget Speech (25 Feb) and some of the taken-for-granted one-off handouts could be reduced, let alone hopes for cash handouts. In this year's budget speech, we also expect further elaboration of last year's proposed Future Fund (of HK$220bn seed money plus additions from each year's surplus) to finance HK's strategic infrastructure building during economic downturn and expenditures arising from the aging population. Further details would clarify requirements for using this fund and the fund's own rate of return which would cater to HK's long term needs. We continue to ponder on whether bond issuance for infrastructure projects is more appropriate?

Figure 37. HK PMI recovers post protest



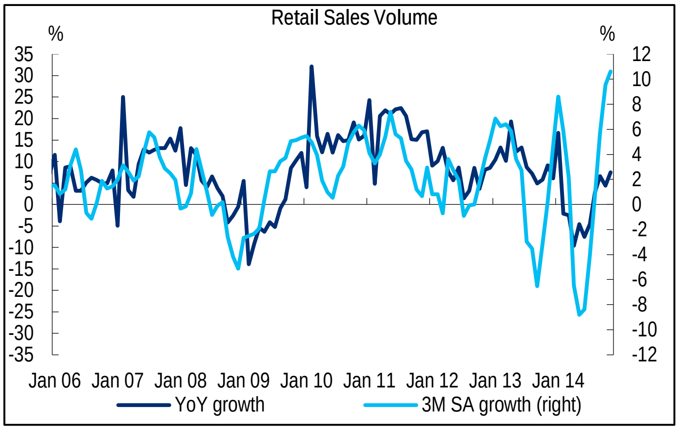
Source: Markit, Haver, Citi Research

Figure 38. Trade fragilities persist, and probably more evident in 1Q15E



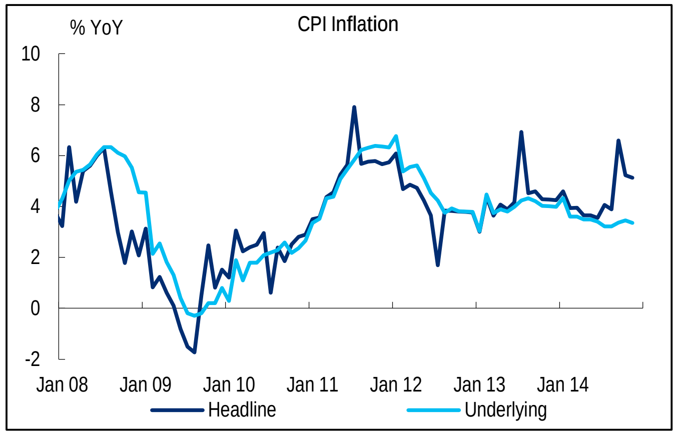
Source: CEIC, Citi Research

Figure 39. Retail sales to slow on selective local/foreign spending



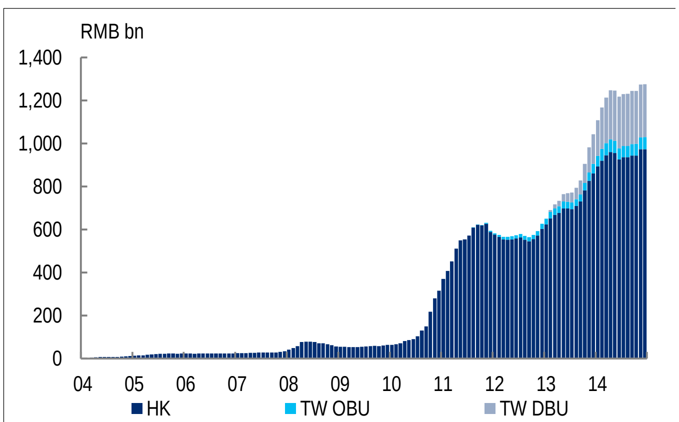
Source: CEIC, Citi Research

Figure 40. Mild price pressures with tame private rentals& food prices



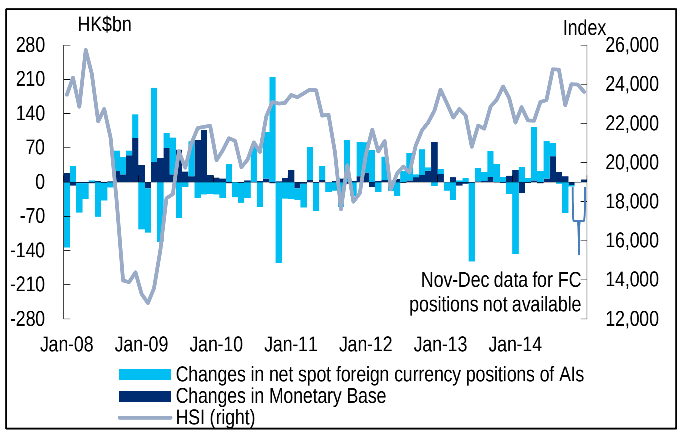
Source: CEIC, Citi Research

Figure 41. Offshore RMB deposits continue to build



Source: CEIC, Citi Research

Figure 42. Net outflows seen in Oct14



Source: CEIC, Citi Research

Figure 43. Hong Kong Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	219.3	214.1	228.7	248.5	262.6	274.0	283.1	296.3	311.1
Nominal GDP, local currency bn	1,707	1,659	1,776	1,934	2,037	2,125	2,195	2,296	2,411
GDP per capita, US$	31,491	30,595	32,424	34,941	36,587	37,942	39,127	40,881	42,845
Population, mn	7.0	7.0	7.1	7.1	7.2	7.2	7.2	7.2	7.3
Unemployment, % of labour force	3.5	5.3	4.3	3.4	3.3	3.4	3.3	3.6	3.5
Economic Activity									
Real GDP, % yoy	2.1	-2.5	6.8	4.8	1.5	2.9	2.3	2.6	3.0
Real investment growth % yoy	-0.3	1.0	11.1	2.3	3.5	3.7	1.1	0.6	2.7
Real consumption growth % yoy	1.9	0.5	5.8	7.6	4.0	4.0	2.0	1.6	1.4
private consumption growth % yoy	1.9	0.2	6.1	8.4	4.1	4.2	1.9	1.7	1.5
Real export growth, % yoy	2.5	-10.0	16.8	3.9	1.9	6.5	2.3	4.4	5.0
Real import growth, % yoy	2.2	-9.0	17.4	4.6	2.9	6.9	2.1	3.9	4.5
Prices, Money & Credit									
CPI, % yoy	2.1	1.5	2.9	5.7	3.8	4.3	4.9	3.4	4.3
CPI, % avg	4.3	0.6	2.3	5.3	4.1	4.3	4.4	4.4	3.9
Nominal wages, % yoy	3.4	-1.0	2.5	8.1	5.7	4.7	4.5	4.5	4.0
Credit extension to private sector, % yoy	11.0	-2.1	20.9	12.5	7.0	10.6	11.0	8.0	6.0
Short-term market rate, % eop	0.95	0.14	0.28	0.38	0.40	0.38	0.38	0.60	1.30
Long term yield, % eop	1.19	1.93	1.76	0.96	0.32	1.40	1.44	1.80	2.30
lc/US$, eop	7.75	7.75	7.77	7.77	7.75	7.75	7.75	7.78	7.75
lc/US$, avg	7.79	7.75	7.77	7.78	7.76	7.76	7.75	7.77	7.76
Balance of Payments, US$ bn									
Current account	32.9	21.2	16.0	13.8	4.1	4.9	1.7	8.5	7.5
% of GDP	15.0	9.9	7.0	5.6	1.6	1.8	0.6	2.9	2.4
Trade balance	-25.8	-28.8	-43.0	-54.9	-61.6	-64.6	-69.4	-67.3	-67.0
Exports	362.7	318.5	390.2	428.7	442.8	458.9	475.6	495.3	526.0
Imports	388.6	347.3	433.1	483.6	504.3	523.5	544.9	562.6	593.0
Service balance	-2.7	3.6	10.1	17.0	21.9	28.5	30.0	29.6	28.1
Income balance	12.9	6.4	4.8	6.8	3.8	5.2	13.3	6.4	3.1
FDI, net	-8.9	-6.4	-10.5	-8.7	-11.2	-11.3	-11.0	-12.0	-13.0
International reserves	182.5	255.7	268.6	285.3	317.2	311.1	330.0	355.0	370.0
Public Finances, % of GDP									
Consolidated government balance	0.0	1.5	4.1	3.8	3.1	1.0	1.3	0.7	1.0
Consolidated gov primary balance	0.0	1.6	4.2	3.8	3.2	1.0	1.3	0.7	1.1
Public debt	1.5	3.9	4.9	4.3	4.5	4.2	3.3	3.5	3.5
of which Domestic	0.7	3.3	4.3	3.7	4.0	3.6	2.8	3.0	3.0

Quarterly Economic Indicators

	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	1.8	2.7	2.0	1.7	2.0	3.4	3.2	3.0	2.6
CPI, % yoy	3.6	6.6	4.9	5.1	5.2	4.3	3.4	3.6	3.7
Short-term market rate, % eop	0.38	0.38	0.38	0.40	0.40	0.50	0.60	0.70	0.85
Long term yield, % eop	1.36	1.47	1.44	1.10	1.40	1.60	1.80	1.90	2.10
lc vs USD, eop	7.75	7.77	7.75	7.76	7.77	7.79	7.78	7.78	7.77

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates.
*Note: Public debt is general government debt. BOP is reported using BPM6.

India

Rohini Malkani
+91 22 6175 9876
rohini.malkani@citi.com

Anurag Jha
+91 22 6175 9877
anurag.jha@citi.com

- **Summary view** — 2015 is off to an eventful start with reforms momentum picking up and RBI embarking on the rate easing cycle. Sustained lower commodity prices have brightened the outlook on current account and inflation further. We maintain our view of GDP growth picking up to 6.5% in FY16.

- **Things to watch** — The budget in February will be key as it will be the first full budget of the Modi government. The market will not only watch out for the fiscal consolidation roadmap and quality of government expenditure, but also government's broad policy priorities and some out of box thinking.

- **Strategy** — We expect INR to display relatively lower volatility and stay close to its fair value range of 62-64 due to on-going macro stabilization i.e. lower CAD, rising FX reserves and RBI's long forwards position. With RBI commencing its rate cut cycle, the 10yr bond yields should come off towards 7.50%.

2015 starts on a positive note… still more to come

Reform momentum pick up — The government has stepped up the pace of reforms by (1) introducing a constitutional amendment bill for Goods & Services tax in the winter session of parliament (2) passing key legislations as *ordinances* in the area of land acquisition, coal block auctions, insurance and mining. The govt's usage of the ordinance route reflects its strong reform intent and willingness to act outside of conventional avenues.

RBI begins easing cycle with 25bps cut — Post the release of the Dec inflation prints which saw downward surprises on the CPI and WPI, the RBI commenced its easing cycle by cutting the repo rate by 25bps to 7.75%. This was not entirely unexpected given the RBI's Dec policy statement of the possibility of acting *"outside the policy review cycle".* We maintain our view of a further 75bps cut till FY16, taking the repo rate to 7% by Mar-16.

Commodity prices extend their decline — With international commodity prices declining further this year, the outlook for India's current account and inflation has improved. Incorporating our global team's revised forecast on crude prices, we now expect India's current account to narrow to 0.2% of GDP in FY16 and 0.8% in FY17.

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

Maintain view of GDP at 6.5% in FY16E — Following two years of sub 5% growth, we expect GDP growth to print 5.6% in FY15 rising to 6.5% in FY16. The ongoing reforms coupled with continued de-bottlenecking of stalled investments and easier monetary stance is likely to revive investment demand further. As detailed in our 2015 prospects, we believe India could make material strides in reforming the 'factors of production' – land, labor, capital and enterprise.

Early signs of recovery — There are signs of a rebound in manufacturing activity as indicated by (1) manufacturing PMI rising to two year high of 54.5 in Dec; (2) pick up in industrial production; (3) new projects announced by both private and public sector increased sharply for the second consecutive quarter.

RBI easing cycle begins with 25bps rate cut; expect further 75bps by FY16

Headline inflation eases, likely to undershoot RBI's 6% target — Following the 5.0% print in Dec, CPI will likely trend to 5.5% in Jan-Mar quarter as base effects reverse. Outlook remains sanguine due to (1) commodity prices; (2) moderate MSP hikes; and (3) deceleration in rural wages. We expect CPI to undershoot RBI's 6% target through 2015 and average 5.5%.

RBI cuts rates by 25bps, expect further 75bps cuts by FY16 — Following the benign December inflation prints, the RBI commenced its easing cycle, cutting the repo rate by 25bps to 7.75%. This was not entirely unexpected given the RBI's Dec policy statement of the possibility of acting "*outside the policy review cycle*". RBI's forward guidance mentions that further easing will be dependent on "*data that confirm disinflationary pressures… and sustained high quality of fiscal consolidation*". Following the 25bps rate cut, we maintain our view of additional 75bps cut by FY16. In terms of timing, we see rates unchanged in the Feb policy, and the next cut post clarity on the budget.

External sector outlook brightens…CAD at <1% of GDP

CAD to compress to <1% of GDP in FY16 and FY17 — Lower crude and normalization in gold imports helped narrow the Dec trade deficit. Going forward as crude sustains at lower levels, we expect the trade deficit to narrow further, and expect CAD to come in at 0.2% of GDP in FY16 and 0.8% of GDP in FY17. Our assumptions include (1) crude price avg US$60/bbl in FY16 and US$70/bbl in FY17, (2) gold imports at 850 tonnes in FY16 and 875 tonnes in FY17, (3) exports growth at 3.5% in FY16 and 6.5% in FY17, non-petro exports at 8.6% in FY16, (4) non-oil non-gold imports recording a strong 10% growth in FY16 and 9% in FY17.

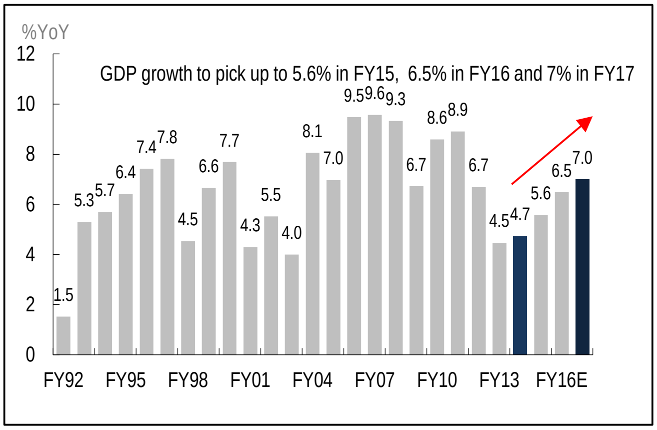
INR view: Range bound in 62-64 — While there could be occasional bouts of EM risk aversion, we expect INR to display relatively lower volatility due to on-going macro stabilization i.e. lower CAD, rising FX reserves (US$320bn) and RBI's forwards position (+US$13bn). Given the need to keep currency competitive relative to its trading partners, we expect INR to stabilize close to its fair value range of 62-64 based on productivity adjusted REER terms.

Fiscal deficit target challenging but achievable; all eyes on budget

FY15 fiscal deficit target challenging, but achievable — Though recent increases in excise duty are positive on the revenue front, the fiscal deficit target of 4.1% GDP in FY15 could only be met with sharp compression in both plan and non-plan expenditure. While near term targets are challenging, over the medium term, the structural reforms such as implementation of GST, direct cash transfer for subsidies and expenditure rationalization could help fiscal consolidation.

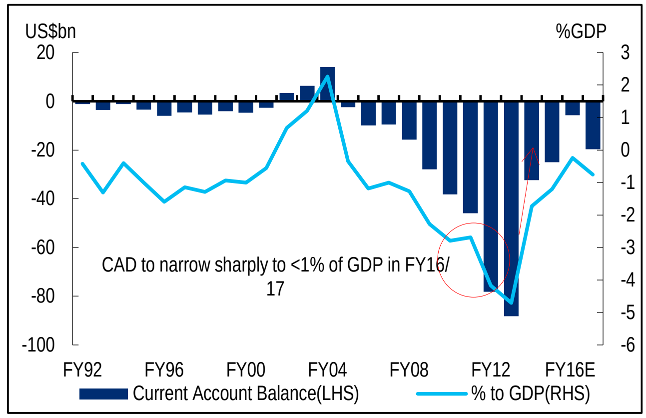
All eyes on Feb budget — The budget in February will be key as it will be the first full budget of the Modi government. The market will not only watch out for the fiscal consolidation roadmap and quality of government expenditure, but also for the government's broad policy priorities and some out-of-the-box thinking.

Figure 44. Trends in Annual GDP growth (%YoY)



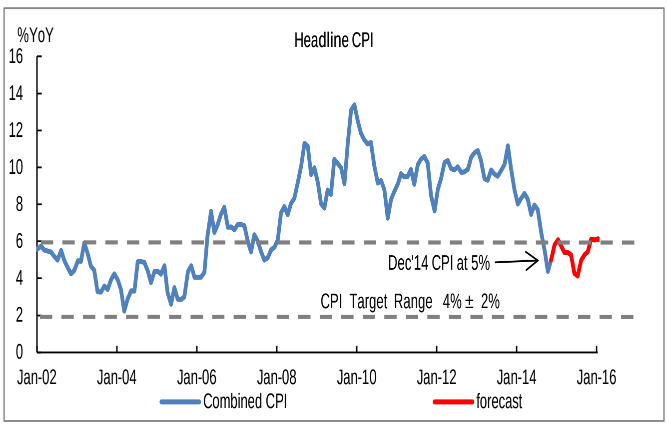
Source: CSO, Citi Research

Figure 45. Trends in Current Account Deficit (US$bn, %GDP)



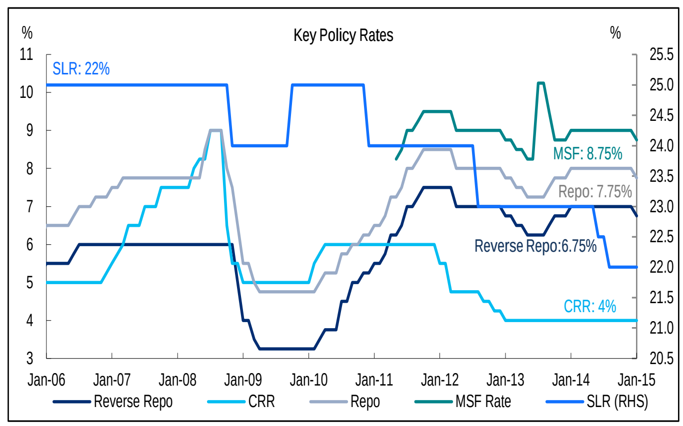
Source: CSO, Citi Research

Figure 46. Trends in Headline CPI and Core CPI (%YoY)



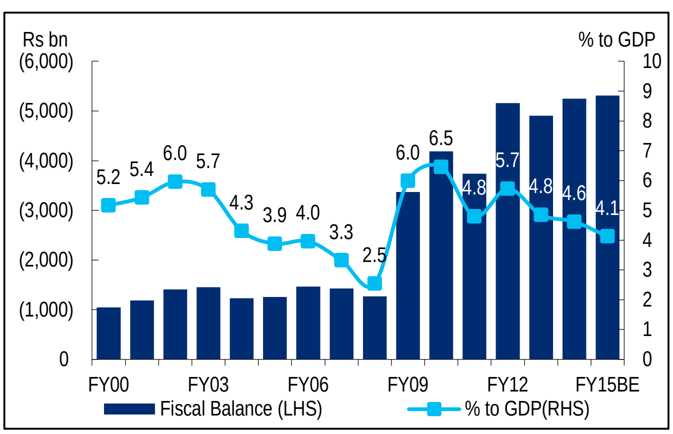
Source: CSO

Figure 47. Trends in Key Policy Rates (%)



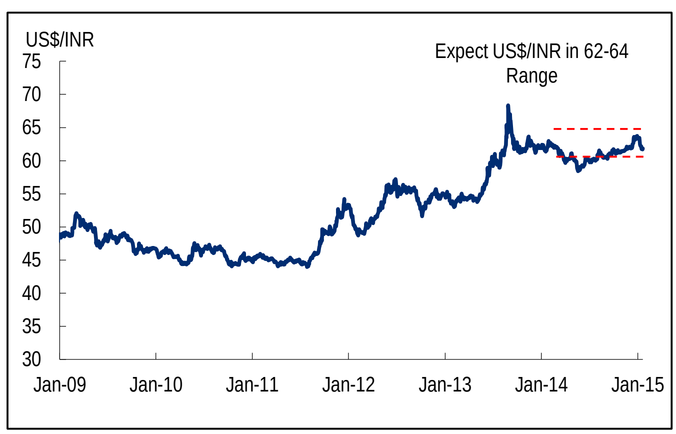
Source: Budget Documents, CGA

Figure 48. Trends in Fiscal Deficit (Rs bn, %GDP)



Source: Budget Documents

Figure 49. Trends in US$ / INR



Source: Bloomberg

Figure 50. India Economic Indicators

	FY09	FY10	FY11	FY12F	FY13F	FY14F	FY15F	FY16F	FY17F
Summary Data									
Nominal GDP, US$ bn	1,223.9	1,366.6	1,707.8	1,873.1	1,872.8	1,880.0	2,069.6	2,321.8	2,605.8
Nominal GDP, local currency bn	56,301	64,778	77,841	90,097	101,133	113,551	128,312	146,276	165,467
GDP per capita, US$	1,061	1,168	1,440	1,558	1,539	1,522	1,651	1,825	2,017
Population, mn	1,154.0	1,170.0	1,186.0	1,202.0	1,217.0	1,235.3	1,253.8	1,272.6	1,291.7
Economic Activity									
Real GDP, % yoy	6.7	8.6	8.9	6.7	4.5	4.7	5.6	6.5	7.0
Real investment growth % yoy	-5.2	17.3	14.1	3.9	4.9	-2.5	4.8	5.7	7.5
Real consumption growth % yoy	7.7	8.4	8.2	8.9	5.2	4.7	5.6	6.8	6.8
private consumption growth % yoy	7.2	7.4	8.7	9.3	5.0	4.8	5.5	7.0	7.0
Real export growth, % yoy	14.6	-4.7	19.6	15.6	5.0	8.4	11.0	9.3	9.0
Real import growth, % yoy	22.7	-2.1	15.6	21.1	6.6	-2.5	9.5	9.0	9.3
Prices, Money & Credit									
CPI, % yoy	8.0	14.9	8.8	9.0	10.4	8.3	6.8	5.5	5.5
CPI, % avg	9.1	12.4	10.4	8.4	10.2	9.5	6.8	5.5	5.5
Credit extension to private sector, % yoy	19.0	16.0	17.0	17.5	17.5	17.5	17.5	17.5	18.5
Policy interest rate, % eop	5.00	5.00	6.75	8.50	7.50	8.00	7.75	7.00	7.00
Short-term market rate, % eop	5.68	4.49	9.54	10.90	9.30	8.36	7.85	7.10	7.10
Long term yield, % eop	7.01	7.83	7.99	8.56	8.00	8.50	8.25	7.50	7.50
lc/US$, eop	48.62	46.41	44.71	53.02	55.00	61.81	63.04	64.08	64.48
lc/US$, avg	43.42	48.30	45.68	46.63	53.38	58.57	61.02	63.52	64.33
Balance of Payments, US$ bn									
Current account	-27.9	-38.2	-45.9	-78.2	-88.2	-32.4	-24.0	-4.7	-20.4
% of GDP	-2.3	-2.8	-2.7	-4.2	-4.7	-1.7	-1.2	-0.2	-0.8
Trade balance	-119.5	-118.2	-130.6	-189.8	-195.7	-147.6	-134.9	-116.3	-137.0
Exports	189.0	182.4	250.5	309.8	306.6	318.6	331.4	342.9	363.5
Imports	308.5	300.6	381.1	499.5	502.2	466.2	466.2	459.2	500.6
Service balance	53.9	36.0	48.8	64.1	64.9	73.0	72.6	77.7	83.8
Income balance	-7.1	-8.0	-17.3	-16.0	-21.5	-23.0	-28.0	-34.0	-36.0
FDI, net	22.4	18.0	9.4	22.1	19.8	21.6	24.6	27.6	32.6
International reserves	241.6	252.8	273.7	260.1	259.7	276.4	332.9	402.7	464.8
Total Amortisations	15.6	19.1	18.7	22.8	23.0	18.7	19.9	21.0	14.5
Public Finances, % of GDP									
Consolidated government balance	-8.3	-9.3	-6.9	-8.1	-7.2	-6.8	-6.7	-6.4	-6.1
Consolidated gov primary balance	3.3	4.5	2.4	3.6	--	--	--	--	--
Public debt	76.8	75.5	70.2	69.5	69.3	70.4	69.2	67.2	65.6
of which Domestic	72.2	70.6	65.6	65.9	64.9	66.0	65.1	63.6	62.3
Foreign Assets & Liabilities, US$ bn									
External debt	224.5	260.9	317.9	360.8	409.4	442.2	455.9	470.9	485.9
Private	168.6	193.9	239.8	278.9	327.8	360.6	372.3	385.3	398.3
Public	55.9	67.1	78.1	81.9	81.7	81.7	83.7	85.7	87.7
External debt / GDP	18.3	19.1	18.6	19.3	21.9	23.5	22.0	20.3	18.6
External debt / XGS	77.7	95.2	84.7	80.7	91.1	94.8	85.7	75.7	66.8
Short-term debt	43.3	52.3	65.0	78.2	96.7	89.2	94.2	99.2	104.2
Short-term debt/International Reserves (%)	17.9	20.7	23.7	30.1	37.2	32.3	28.3	24.6	22.4

Quarterly Economic Indicators

	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	5.7	5.3	5.5	5.9	6.0	6.2	6.6	7.0	7.0
CPI, % yoy	8.1	7.4	5.0	5.8	5.5	5.0	6.3	5.5	5.5
Policy interest rate, % eop	8.00	8.00	8.00	7.75	7.50	7.50	7.25	7.00	7.00
Short-term market rate, % eop	8.25	8.25	8.10	7.85	7.60	7.60	7.35	7.10	7.10
Long term yield, % eop	8.75	8.50	8.50	8.25	8.00	8.00	7.75	7.50	7.50
lc vs USD, eop	60.06	61.94	63.04	62.77	63.33	63.90	64.08	64.18	64.28

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). BOP is reported using BPM5.

Indonesia

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

- **Summary view** — After a surge in inflation, disinflation should follow as the oil price slide has led to cuts in fuel prices. Households will save on fuel but for now we maintain our growth forecast of 5.1%. LPG and electricity tariffs remain higher than they were last year; IDR depreciation may also affect the investment cycle
- **Things to watch** — On the political front, internal rifts within Golkar have weakened the solidity of the opposition. The revised 2015 budget is up for deliberation and we expect no blockages there. But the budget will have potential slippages on both the revenue and spending side, in our view.
- **Strategy** — Despite a still soft growth outlook and declining inflation, we expect the central bank to remain on the cautious side and leave rates steady. This comes amid an environment of broad dollar strengthening.

Disinflation forthcoming; growth outlook remains soft

Growth rebound yet to be seen — Economic data up to 4Q14 still points to a soft trajectory on growth. December retail sales growth fell to 4% YoY from 18% in October. Cement consumption and vehicle sales growth were also weak, with the latter down by double digits YoY. Households were likely feeling the pinch from the 30% increase in fuel prices, accompanied by higher LPG as well as electricity tariff hikes. Inflation increased higher than expected to 8.4% in December, exacerbated also by supply side issues on certain foods / spices.

Fuel price cut will lead to disinflation, but growth impact will be mixed — The strong slide in oil prices has led the government to lower the price of fuel by around 10% in early January; and another cut of 15% is due in mid-Jan. This may bring the inflation rate towards around 7% by March. Households would be able to save money on gasoline. However it remains to be seen whether consumer confidence will rebound fast enough to boost consumer discretionary purchases. Compared to the fuel price hike before November 2014, households still have to deal with higher electricity tariffs and LPG prices. Commodity prices (i.e. coal and plantation commodities) are on average still lower than where they were last year. The IDR is also weaker against the USD which may impact the price of big ticket items such as electronics and automobiles.

The expected rebound of the investment cycle is also conditional on exchange rate movements — We have been expecting the economy to rebalance as the investment cycle picks up and consumption growth see headwinds. However the strength of the investment rebound will also depend on movements of the exchange rate. As capital goods are mostly imported, a continued depreciation of the IDR may lead firms and project managers to recalculate the cost of planned investments.

On a positive note, we have lowered our 2015 CAD forecast to US$22.5bn from $25.4bn previously — This amounts to around 2.5% of GDP using the current exchange rates. Lower oil prices would most obviously impact the CA deficit via the trade balance, partially offset by lower gas prices. However there should also be positive impact to the services deficit via a reduction in shipping / freight costs. Reduced profits of foreign oil companies would also lower the deficit on the income account. Separately for 2014, we maintain our CA deficit forecast at 3.1% GDP (US$26.5bn).

Budget dynamics changing; politics improving

MoF has recently unveiled the proposed revised 2015 budget deficit at 1.9% GDP, vs. 2.2% currently — This number may still change during the month-long deliberations. Several issues need to be highlighted in our view. Firstly, fuel subsidies would come down from Rp276tn to ~Rp81tn; however what is rarely mentioned is that a big chunk of this would be offset by declining oil revenues. With petrol now unsubsidized and diesel subsidies fixed, we think that declining oil prices may no longer have a positive impact to the fiscal deficit. As an indication of government concerns on the fiscal impact of lower oil prices, the energy ministry is mulling a floor on domestic petrol prices to limit the net impact on fiscal deficit.

Higher infrastructure budget partly supported by the higher tax collection ratio assumption — The new 2015 budget draft projects a higher tax collection ratio of over 13% GDP from previously around 12% GDP. Given no increases in the government's GDP growth assumption, the higher tax target apparently hinges a lot on better enforcement. In our view, this maybe a potential source of slippage on the revenue side. However on the spending side, capital expenditures are unlikely to be fully realized, as in previous years.

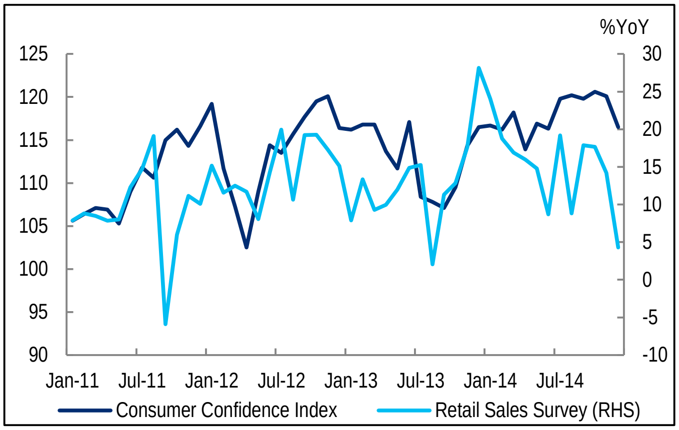
Despite a lower fiscal deficit, net debt issuances expected to rise — The government has indicated that bond issuances may rise by around Rp30tn than initially planned, leading to a gross issuance target of about Rp460tn. This is due to lower expected net dividend payments from state owned enterprises. SOE dividends are included in the budget in the financing side (below the line), instead of the revenue side.

Politics remain sub-optimal but opposition's solidity has weakened — With Golkar being beset by an internal rift, the solidity of the opposition coalition has apparently been weakened. Talks among rival factions in Golkar are still ongoing and the possibility of a court settlement to determine the legally recognized leader of the party is still open. But overall the chances are growing in our view for Golkar to become an independent opposition member such as Partai Demokrat; i.e. one that may give conditional or occasional support for government policies, as opposed to being always aligned with the red-white coalition.

Policy and market implications

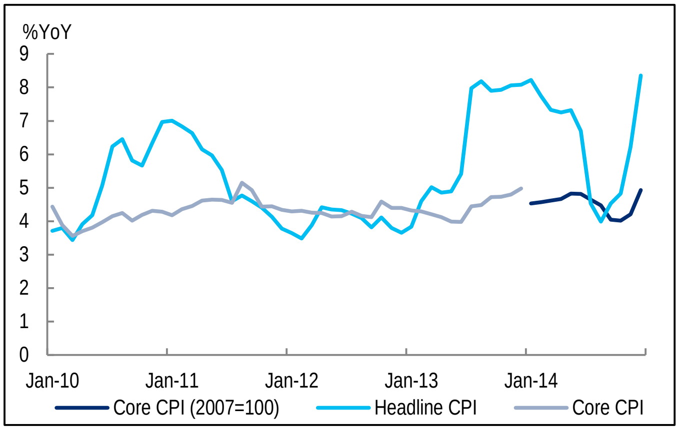
Disinflation and weak growth still in the cards; but will BI cut interest rates? — Declining inflation and weak growth may add public pressure against the central bank to start reversing the interest rate cycle. However we are of the view that BI will still hold rates steady in 2015. Policymakers should still be keeping in mind potential FX volatility stemming from an environment of a strong US dollar against both G-10 currencies as well as emerging markets. Furthermore although the current account balance may improve, the basic balance (i.e. CA plus FDI flows) would remain negative, which may give rise to occasional imbalances in the FX market. Citi views that the dollar will continue to strengthen this year against the IDR. We do not think that policymakers will risk weakening the perceived credibility it obtained after hiking the BI rate in November, especially as BI still needs to beef up foreign reserves to maintain adequate coverage over short term external debt.

Figure 51. Retail sales growth weakened in 4Q



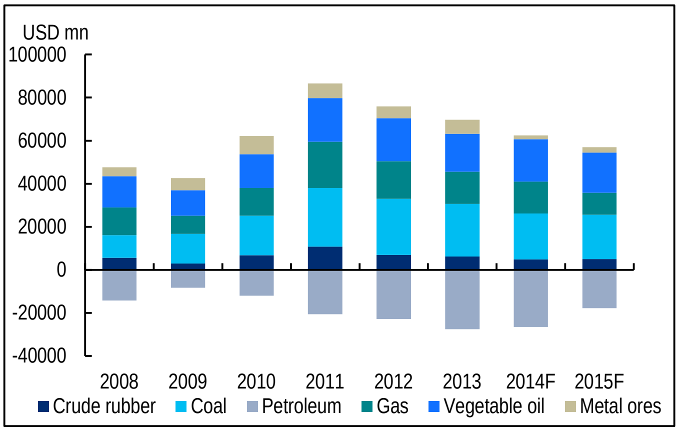
Source: CEIC, Citi Research

Figure 52. Inflation surprised on the upside but disinflation coming



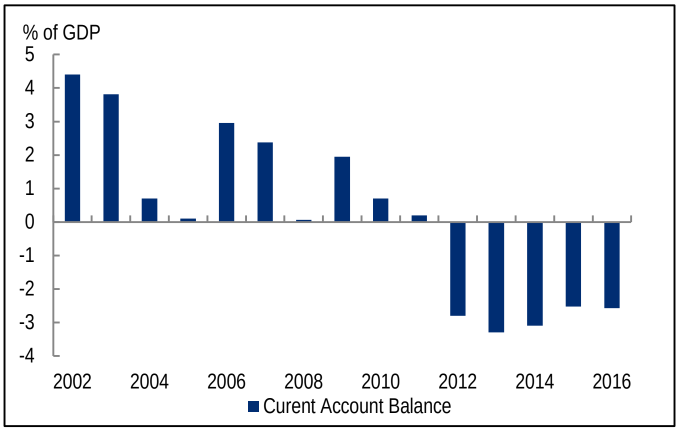
Source: CEIC, Citi Research

Figure 53. We expect the oil trade deficit to shrink in 2015



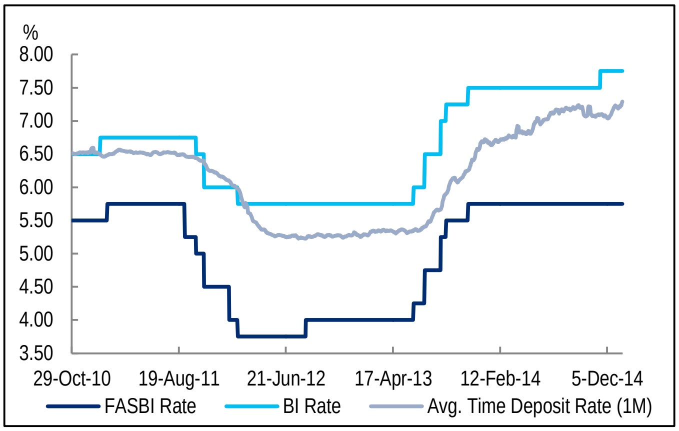
Source: CEIC, Citi Research

Figure 54. The current account deficit will narrow vs. 2014



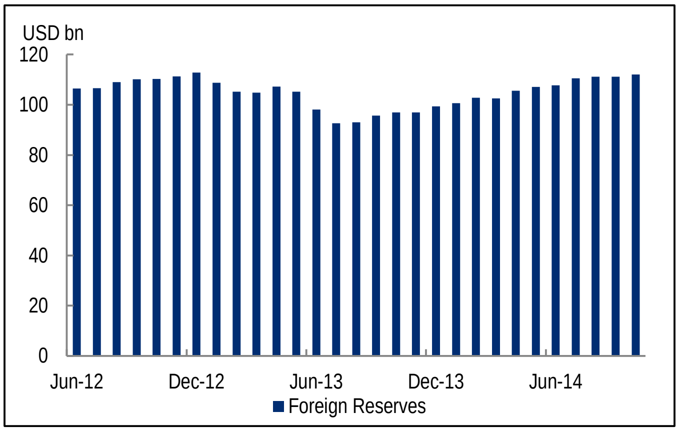
Source: CEIC, Citi Research

Figure 55. The policy rate should stay unchanged in 2015



Source: CEIC, Citi Research

Figure 56. Foreign reserves on upward trend



Source: CEIC, Citi Research

Figure 57. Indonesia Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	510.7	538.6	709.5	845.4	876.9	868.5	848.0	858.5	962.8
Nominal GDP, local currency bn	4,948,688	5,606,203	6,446,852	7,419,187	8,229,439	9,083,972	10,064,314	11,196,463	12,580,464
GDP per capita, US$	2,207	2,292	2,975	3,493	3,573	3,491	3,362	3,360	3,722
Population, mn	231.4	235.0	238.5	242.0	245.4	248.8	252.2	255.5	258.7
Unemployment, % of labour force	8.4	7.9	7.1	6.6	5.8	5.8	5.9	6.1	6.0
Economic Activity									
Real GDP, % yoy	6.0	4.6	6.2	6.5	6.3	5.8	5.1	5.1	5.3
Real investment growth % yoy	12.4	2.4	8.8	10.1	16.3	4.9	6.1	5.6	5.8
Real consumption growth % yoy	5.9	6.2	4.1	4.5	4.8	5.2	5.0	4.2	4.4
private consumption growth % yoy	5.3	4.9	4.7	4.7	5.3	5.3	5.3	4.1	4.4
Real export growth, % yoy	9.5	-9.7	15.3	13.6	2.0	5.3	-1.3	4.2	4.1
Real import growth, % yoy	10.0	-15.0	17.3	13.3	6.7	1.2	-4.0	2.5	2.6
Prices, Money & Credit									
CPI, % yoy	11.1	2.8	7.0	3.8	3.7	8.1	7.3	4.0	4.0
CPI, % avg	9.9	4.8	5.1	5.3	4.0	6.4	6.3	6.8	4.6
Nominal wages, % yoy	5.0	6.3	18.2	-2.9	20.0	16.3	17.1	13.0	11.0
Credit extension to private sector, % yoy	30.7	18.0	20.6	25.9	22.3	19.5	13.0	14.0	16.0
Policy interest rate, % eop	8.75	6.00	5.50	4.50	4.00	5.75	5.75	5.75	5.75
Short-term market rate, % eop	12.13	7.06	6.64	5.27	5.02	7.84	7.17	7.25	7.25
Long term yield, % eop	11.92	10.07	7.83	6.05	5.39	8.60	7.97	8.25	8.50
lc/US$, eop	10,900	9,425	9,010	9,068	9,638	12,170	12,385	13,167	13,007
lc/US$, avg	9,673	10,376	9,078	8,763	9,361	10,449	11,866	13,042	13,067
Balance of Payments, US$ bn									
Current account	0.1	10.6	5.1	1.7	-24.4	-29.1	-26.7	-22.6	-24.1
% of GDP	0.0	2.0	0.7	0.2	-2.8	-3.3	-3.1	-2.6	-2.5
Trade balance	22.9	30.9	30.6	34.8	8.6	6.0	6.4	9.5	8.9
Exports	139.6	119.6	158.1	200.8	188.5	183.3	176.2	168.4	174.4
Imports	116.7	88.7	127.4	166.0	179.9	177.3	169.8	158.9	165.5
Service balance	-13.0	-9.7	-9.3	-10.6	-10.3	-12.1	-10.3	-9.5	-10.0
Income balance	-15.2	-15.1	-20.8	-26.7	-26.8	-27.0	-27.4	-26.5	-27.0
FDI, net	3.4	2.6	11.1	11.5	13.7	13.7	15.0	16.5	17.5
International reserves	51.6	66.1	96.2	110.1	112.8	99.4	112.6	125.3	139.5
Total Amortisations	16.7	20.4	24.0	25.2	29.5	41.0	42.0	44.0	46.0
Public Finances, % of GDP									
Consolidated government balance	-0.1	-1.6	-0.7	-1.1	-1.9	-2.2	-2.4	-2.0	-1.8
Consolidated gov primary balance	1.7	0.1	0.6	0.1	-0.6	-0.9	-1.2	-0.8	-0.6
Public debt	29.3	31.4	26.4	23.6	23.3	22.4	26.0	26.5	26.7
of which Domestic	16.2	19.3	16.7	15.5	16.1	15.7	15.6	16.0	16.0
Foreign Assets & Liabilities, US$ bn									
External debt	155.1	172.9	202.4	225.4	252.4	265.9	295.0	333.4	366.7
Private	68.5	73.6	83.8	106.7	126.2	142.4	165.5	197.8	224.2
Public	86.6	99.3	118.6	118.6	126.1	123.5	129.5	135.5	142.5
External debt / GDP	30.4	32.1	28.5	26.7	28.8	30.6	34.8	38.8	38.1
External debt / XGS	100.1	130.2	115.8	101.8	119.3	129.3	146.6	173.3	183.9
Short-term debt	20.5	24.0	31.6	36.6	43.4	42.9	50.0	55.0	57.0
Short-term debt/International Reserves (%)	39.7	36.4	32.8	33.2	38.4	43.1	44.4	43.9	40.9

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	5.1	5.0	4.9	5.0	5.1	5.2	5.3	5.0	5.3
CPI, % yoy	6.7	4.3	8.4	7.0	7.2	7.0	4.0	5.1	4.8
Policy interest rate, % eop	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75
Short-term market rate, % eop	8.15	8.07	7.50	7.25	7.25	7.25	7.25	7.25	7.25
Long term yield, % eop	8.35	8.10	7.75	7.90	8.10	8.20	8.25	8.40	8.50
lc vs USD, eop	11,855	12,185	12,385	12,830	12,999	13,170	13,167	13,127	13,087

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates.
*Note: Public debt is central government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).We refer to the FasBI rate to better reflect actual money market rates for Indonesia's policy rate. BOP is reported using BPM6.

Malaysia

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

Kim Leng Yap
kim.leng.yap@citi.com

- **Summary view** — Growth data thus far has not been significantly affected by commodity price declines. The budget restructuring on 20th Jan maintained a less alarmist tone on the oil price impact. With the fall in oil prices expected to lower inflation to just 2.6%, we no longer expect rate hikes in 2015.

- **Things to watch** — [1] Monthly growth related data, [2] drivers of monthly trade surplus movements, [3] commodity prices, [4] 1MDB related developments, [5] FX reserves data, [7] budget restructuring.

- **Strategy** — Despite resilient macro data and a less alarmist budget restructuring, we remain cautious on the MYR as the US dollar has resumed strengthening, the fall in energy prices has yet to be conclusively arrested and the CA surplus is likely to remain slim relative to the size of the net capital outflows.

Macro data resilient to commodity slump thus far

Growth data remains largely resilient despite concerns over lower commodity prices — Oct-Nov IP data surprised positively, with Oct-Nov IP levels 2.4% above 3Q average levels, with a surge in mining offsetting weakness in electricity production and manufacturing. The construction sector growth remains resilient with loans to the construction sector in Oct-Nov increasing 14.1% YoY. However, agriculture is likely to be a drag on 4Q GDP growth, with monthly data pointing to slump in CPO and rubber production, possibly exacerbated by the floods. We see 4Q GDP on track to moderate to 4.5-5% YoY, bringing 2014 GDP growth to a respectable 5.7% YoY. We downgraded our 2015 growth forecast to 5% YoY (Prev: 5.3%), on expected cutbacks in oil and gas capex from Petronas, though this should be partly offset by (1) the lift to manufactured exports from a weaker MYR and a stronger US economy, (2) lift to consumer discretionary incomes from lower pump prices.

Monthly swings in the trade surplus have been dominated by Electrical and Electronic Products (E&E) rather than commodities thus far — The E&E sector dominated the MoM swings in trade surplus, accounting for RM 5.6bn of the RM 8.2bn fall in trade surplus in Oct and RM6.8bn of the RM10bn rise in trade surplus in Nov, with commodities playing a secondary role. With the better-than-expected Nov trade surplus allaying market fears over a 4Q CA deficit, we expect 2014 CA surplus at a respectable 5.3% (Previous 5.7%) and the 2015 CA surplus at 4% of GDP (Previous: 4.5%). We note that these revisions only partly reflect lower forecast of crude oil prices. More importantly, we assume modest declines in LNG export prices, but even so Japan's import prices of LNG from Malaysia have yet to decline significantly, as of Oct data. A weaker MYR and a US recovery may strengthen manufacturing exports, while curbing imports. Imports could also be curbed by weaker O&G related capital goods imports.

Resilient macro data is likely to be overshadowed by market concerns on FX reserve coverage and 1MDB — 1MDB's delay in the repayment of a RM2bn bridging loan has sparked fears that a realization of explicit government guarantees of around RM5bn of 1MDB's debt, and other possible implicit guarantees could cause the Federal government debt to bust the 55% of GDP limit, possibly triggering a sovereign ratings downgrade. The 7.7% MoM decline in FX reserves in Dec to RM116bn has also brought FX reserve coverage to just 1.1 times ST external debt, although Malaysia has comfortable solvency metrics and limited solvency risks.

Budget restructuring takes less alarmist tone

PM Najib announced a restructured 2015 Budget with 3.2% deficit target, 4.5-5.5% GDP growth and 2.5-3.5% inflation — Though the deficit target was raised from the Oct announcement of a 3% budget deficit, it is nevertheless an improvement from the 2014 budget deficit of 3.5% and reflects the government's commitment to fiscal reform. 2015 GDP growth (2015F: 4.5-5.5%, Citi: 5%) and inflation (2015F: 2.5-3.5%, Citi: 2.6%) forecasts were revised downwards.

Revenue enhancements and OPEX cuts to cover fall in oil-related revenues — The oil price assumption was lowered from USD 100/bbl of Brent in Oct to USD 55/bbl. The lower oil revenues from the new price assumption will be partly offset by the fiscal savings arising from the removal of fuel subsidies. Accounting for the savings from the removal fuel subsidies, the government estimates a shortfall of RM 8.3bn in revenues, which would raise the budget deficit to 3.9% of GDP. To meet the new fiscal deficit target of 3.2% of GDP, the government plans to maintain development expenditure, and instead cut operating expenditure by about RM 5.5bn. Revenue enhancements to the tune of RM 1.4bn, 1bn of which is expected to come from higher-than-expected GST collections as 304k companies have now registered for GST vs 140K assumed in the budget, will further offset the revenue shortfall.

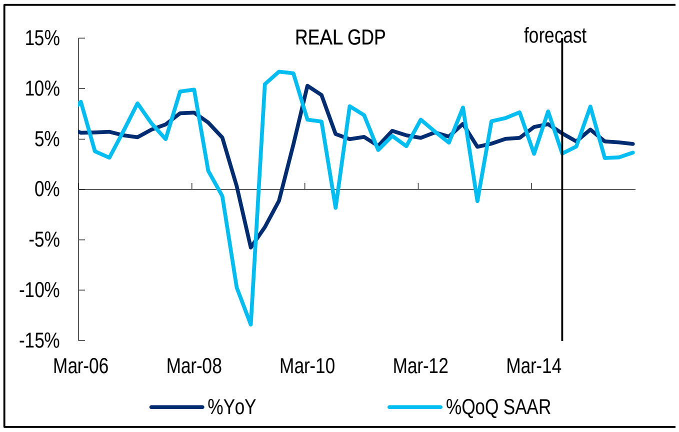
PM Najib raised awareness and dispelled misconceptions — Najib re-iterated the benefits of lower pump prices to private consumption. He also pointed out the support that manufacturing, which makes up 76% of Malaysia's exports as opposed to crude oil that makes up only 4.5%, is expected to obtain from the boost lower oil prices is likely to provide the world economy. He also dispelled the misconception that Malaysia is a net oil exporter, by pointing out that if both crude oil and petroleum products are considered together, as we have been doing, then Malaysia has been a net oil importer in 2014.

Budget restructuring may not allay all fears — Despite the less alarmist tone in the budget restructuring, Fitch indicated that it is 'more likely than not' to downgrade Malaysia's ratings as the dependence on commodities remains a "key credit weakness" for the economy.

2015 inflation forecast cut, rate hikes in 2015 unlikely

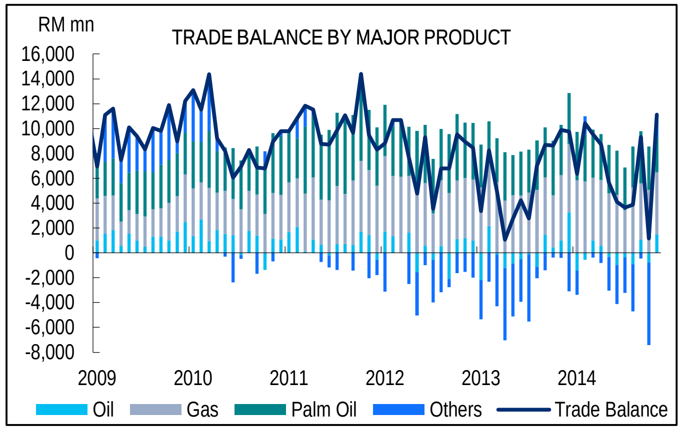
We cut our 2015 inflation forecast on fuel led disinflation — Under the managed float mechanism introduced on Dec 1, fuel prices for a particular month will be determined by the average product prices in the first 19 days of the preceding month. Given in the weakness in oil prices over Dec, fuel prices were cut by 14.3% MoM (on average) wef 1 Jan. Since, fuel and lubricants make up about 8.77% of the CPI basket this would lead to more than a 1% pts drop in headline CPI inflation in Jan, following the 0.2% pts disinflation impact from a 4 sen/litre drop in fuel prices in Dec. As such, headline inflation could fall to 1.3% in 1Q15 (Previous: 2.5%). Considering the possibility of second-round effects (especially if private consumption proves more resilient than expected), we expect CPI inflation to jump close to 3% from 2Q15 upon GST implementation, averaging 3.1% for the rest of the year. Thus, assuming no significant rebound in crude oil prices, inflation could average just 2.6% in 2015 (2014: 3.2%), well below the official forecast of 4-5%. **All else equal, this should imply real OPR rates will not turn negative post GST and we no longer expect a rate hike in 2015.**

Figure 58. We expect GDP at 5.7% YoY (2014) and 5% YoY(2015)



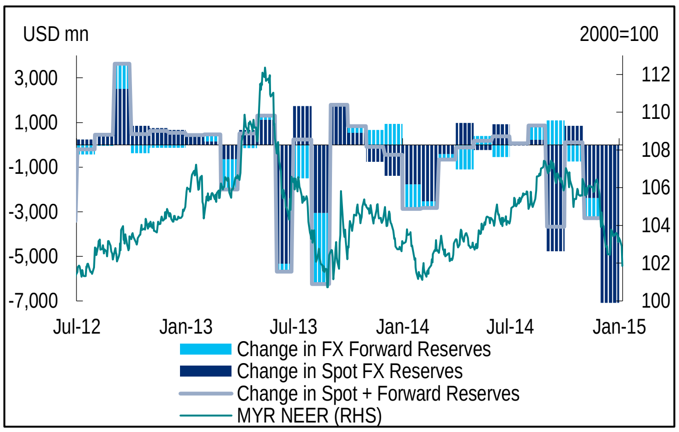
Source: CEIC, Citi Research

Figure 59. EE has led the recent swings in trade surplus



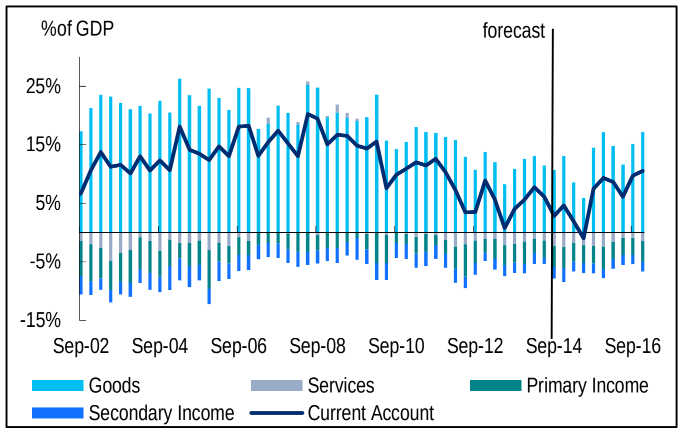
Source: CEIC, Citi Research

Figure 60. There was 7.7% MoM drop in FX reserves in Dec



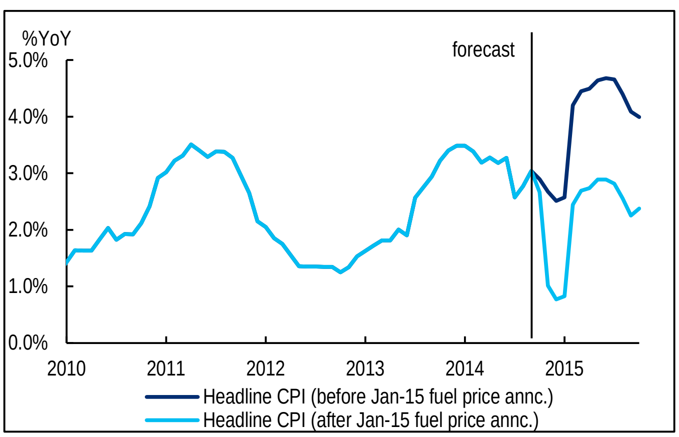
Source: Citi Research

Figure 61. We expect CA surplus at 4% of GDP in 2015



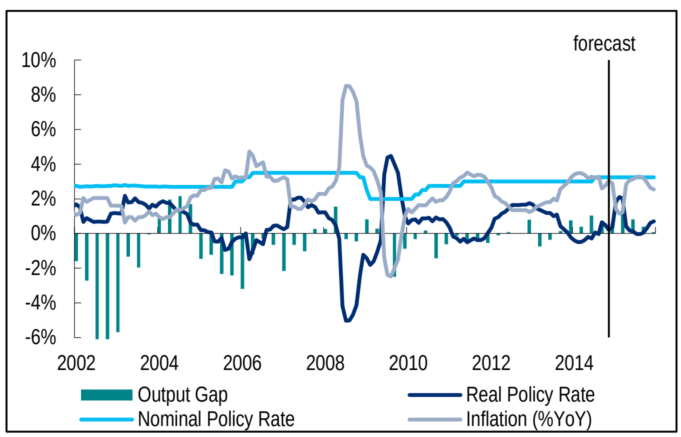
Source: Citi Research

Figure 62. We lowered our inflation forecasts on the 15-Jan fuel price announcement



Source: Citi Research

Figure 63. We do not expect OPR to turn negative post-GST



Source: Citi Research

Figure 64. Malaysia Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	231.1	202.4	247.7	289.5	305.3	313.3	328.9	321.9	344.5
Nominal GDP, local currency bn	770	713	797	885	942	987	1,076	1,159	1,254
GDP per capita, US$	8,393	7,255	8,664	9,997	10,405	10,474	10,868	10,487	11,114
Population, mn	27.5	27.9	28.6	29.0	29.3	29.9	30.3	30.7	31.0
Unemployment, % of labour force	3.3	3.7	3.4	3.1	3.0	3.1	2.9	2.9	3.0
Economic Activity									
Real GDP, % yoy	4.8	-1.5	7.4	5.2	5.6	4.7	5.7	5.0	5.1
Real investment growth % yoy	1.8	-9.4	25.3	3.0	20.3	4.9	-0.4	3.5	1.6
Real consumption growth % yoy	8.4	1.4	6.2	8.8	7.5	7.0	6.4	5.0	5.3
private consumption growth % yoy	8.7	0.6	6.9	6.9	8.2	7.2	6.8	5.7	6.3
Real export growth, % yoy	1.6	-10.9	11.1	4.5	-1.8	0.6	5.3	5.1	6.9
Real import growth, % yoy	2.3	-12.7	15.6	6.2	2.5	2.0	3.8	4.7	6.2
Prices, Money & Credit									
CPI, % yoy	4.5	1.0	2.1	3.0	1.2	3.2	2.9	2.5	3.0
CPI, % avg	5.4	0.6	1.7	3.2	1.6	2.1	3.2	2.6	3.0
Nominal wages, % yoy	4.5	2.5	8.2	3.8	6.4	7.8	6.2	5.5	5.5
Credit extension to private sector, % yoy	10.2	6.8	10.6	12.3	12.1	10.4	9.0	8.0	8.0
Policy interest rate, % eop	3.25	2.00	2.75	3.00	3.00	3.00	3.25	3.25	3.50
Short-term market rate, % eop	3.37	2.17	2.98	3.22	3.21	3.32	3.86	3.85	4.10
Long term yield, % eop	3.00	3.79	3.39	3.23	3.24	3.66	3.84	3.90	4.15
lc/US$, eop	3.45	3.42	3.08	3.17	3.06	3.28	3.50	3.66	3.60
lc/US$, avg	3.33	3.52	3.22	3.06	3.09	3.15	3.27	3.66	3.62
Balance of Payments, US$ bn									
Current account	39.4	31.4	27.1	33.5	17.6	12.7	17.4	12.9	17.2
% of GDP	17.1	15.5	10.9	11.6	5.8	4.0	5.3	4.0	5.0
Trade balance	51.1	39.8	42.5	49.6	40.6	34.4	39.3	36.2	47.6
Exports	198.9	157.0	199.2	228.8	222.3	215.6	223.8	196.5	204.3
Imports	147.7	117.1	156.7	179.2	181.8	181.3	184.5	160.3	156.8
Service balance	0.5	1.2	-0.4	-2.1	-5.3	-5.3	-5.7	-6.8	-6.0
Income balance	-12.2	-9.6	-15.0	-14.0	-17.7	-16.4	-16.2	-16.5	-24.3
FDI, net	-7.8	-6.3	-4.3	-3.1	-7.9	-1.7	-3.0	-1.0	-1.0
International reserves	91.5	96.7	106.5	133.6	139.7	134.9	116.0	118.0	122.0
Total Amortisations	3.3	7.8	3.6	4.7	4.1	6.7	10.5	11.0	11.0
Public Finances, % of GDP									
Consolidated government balance	-4.6	-6.7	-5.4	-4.8	-4.5	-3.9	-3.5	-3.2	-2.5
Consolidated gov primary balance	-3.0	-4.7	-3.5	-2.8	-2.4	-1.8	-1.3	-1.0	-0.7
Public debt	39.8	50.8	51.1	51.5	53.3	54.7	52.8	51.0	50.0
of which Domestic	37.2	48.9	49.0	49.5	51.5	53.0	51.3	50.0	49.0
Foreign Assets & Liabilities, US$ bn									
External debt	103.0	113.9	138.8	170.1	196.5	213.8	235.0	230.0	225.0
Private	--	75.5	87.3	109.8	124.5	140.1	160.0	155.0	150.0
Public	--	38.4	51.5	60.4	72.0	73.7	75.0	75.0	75.0
External debt / GDP	44.6	56.3	56.0	58.8	64.4	68.2	71.5	71.4	65.3
External debt / XGS	44.8	61.6	60.1	64.2	75.5	83.5	89.5	96.5	91.0
Short-term debt	--	48.8	61.0	81.2	92.3	103.9	120.0	115.0	110.0
Short-term debt/International Reserves (%)	--	50.4	57.2	60.8	66.0	77.0	103.4	97.5	90.2

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	6.5	5.6	4.8	5.9	4.8	4.7	4.5	5.0	4.7
CPI, % yoy	3.3	2.6	2.9	1.2	3.1	3.2	2.5	3.8	2.6
Policy interest rate, % eop	3.00	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Short-term market rate, % eop	3.55	3.74	3.86	3.85	3.85	3.85	3.85	3.85	3.85
Long term yield, % eop	3.70	3.69	3.73	3.90	3.90	3.90	3.90	3.90	3.90
lc vs USD, eop	3.21	3.28	3.50	3.65	3.66	3.67	3.66	3.64	3.63

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). BOP is reported using BPM6.

Philippines

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

- **Summary view** — Our GDP forecasts of 5.9% in 2014 and 6.3% in 2015 are unchanged. Fiscal underspending risk to dissipate as Aquino's legacy spending takes hold in 2015 – last full fiscal year. This could sustain upbeat investments amid improving consumption due to low oil prices and job creation.

- **Things to watch** — [1] Response of tax revenues to low oil prices and compressed inflation; [2] inflation uptick from 2Q15 power crisis (was it a one-off event?); [3] resumption of strong fiscal spending as reflected in the government's cash budget; [4] Aquino's 'heir apparent' likely known in 2H15.

- **Strategy** — With 2015 prospects in a 'sweet spot' of upbeat growth and inflation below BSP's mid-point inflation target range (3%), policy bias unlikely to change materially. Bond market sentiment likely to respond favorably to strong disinflation. Sweet spot condition likely to ease PHP vulnerability to strong USD.

All set for sanguine GDP prospects

Following 3Q14 GDP growth of 5.3%YoY, we are maintaining our growth forecasts of 5.9% and 6.3% for 2014 and 2015 — In 4Q14, fiscal underspending risk likely persisted, which poses downside risks to our 4Q GDP estimate (6.2%YoY). Primary fiscal expenditures in 4Q14 rose by a lackluster 1%YoY, on our estimates, following a 1.4% drop in 3Q, despite end-Dec expenditures often getting lifted by 13-month payments and disbursements in maintenance & operations.

Private-side GDP to provide lift and close 2014 to within 6% range — Leading catalyst would be exports (customs trade) in which growth bulked up by ~20%YoY in Nov for a 4Q14 estimate of 8%YoY (vs 12.9%YoY in 3Q). Lower oil price effect and sustained OFW remittance flows would likely lift consumption growth to 5.6% or more (3Q: 5.4%). Non-farm job creation of 504K according to Oct labor survey led by industrial (219K) and services (285K) supported 4Q consumption. Investment spending through increased private construction and business capital spending would likely support an investment share to GDP at 22.2% range for full year estimate of 21.9%. Industrial GDP led by construction and manufacturing would benefit from upbeat domestic demand. Mfg index probably grew 7%YoY in 4Q14 (Nov: +8.2%). 4Q domestic demand ex-inv could potentially rise by 6.2%.

We continue to highlight resurgence in fiscal expenditures is key to another sanguine outlook of 6.3% in 2015 — Strong govt. consumption expenditure gains (5% vs 2014 estimate of 0.5%) alongside faster public construction are likely to peak in 2Q-3Q15. Aquino's legacy spending in 2015 paced by rehabilitation and reconstruction in Eastern Visayas would probably boost private expenditure. Using 2006 I/O table, Php57bn of annual fiscal spending under Yolanda rehab program could potentially increase output by 0.74% for a cumulative 3-yr GDP growth of 2.2%pt. Despite 2014 investment approvals down 14.5%YoY, the size of these approvals at Php634bn or 5% of 2014 GDP (vs 6.4% in 2013) would contribute to sustained upbeat private investment outlook. Breakout in rollout of some PPP projects delayed by legal issues particularly in 2H15 would be additional catalyst. With easing legal bottlenecks, public and private investments support a larger GDP contribution of 22.2% this year (vs estimated 21.9% in 2014). Investments strengthen job creation prospects and coupled with windfall income gains from low oil prices, favorable consumption prospects would be sustained. Domestic demand ex-inv would probably rise by 6.6% (vs 5.7% in 2014). Stimulated import volume would probably result in net 'import' volume of -1.1% of GDP (vs -0.4% in 2014).

Potential for current account surplus at 5.9% of 2015 GDP

If we use Citi's 2015 oil forecasts, we estimate oil imports down 22.5%YoY to extend the preceding year's oil import growth estimated at 4.2% — Were it not for demand-induced expected oil import volume growth of 3.4%, the oil bill would have fallen by more although unlikely to match the 40.6%YoY plunge during the 2009 GFC. Since oil imports account for roughly 20% of total imports, the estimate that the oil bill decline coupled with flattish non-oil imports probably resulted in overall imports down by 5.1% this year. BOP export gains likely at 6.5% (vs an estimated 11.4% in 2014) against an oil price-driven import drop would result in a leaner trade deficit of US$10.4bn (vs estimated 2014 trade deficit of US$16.9bn). Coupled with OFW remittance growth of 5.5%YoY, we estimate a current account surplus of 5.9% of 2015 GDP (vs previous forecast exceeding 4% of 2015 GDP).

Upgraded 2015 inflation forecast to 2.6%

We revised our 2015 average inflation forecast to 2.6% from 3.5% with persistent low oil price effects amid CPI volatility likely from the 2Q15 power crisis — Extending monthly headline CPI series with Dec inflation of 2.7%YoY, we obtained lows of 2.3%-2.5%YoY in Jan-Feb prior to a slight nudge up to 2.6-2.7%YoY in Mar-Apr which reflects tightening power supply in 2Q15. Our 2006 input-output analysis of electricity power crisis yielded average inflation scenarios of 2.6%YoY (300MW deficit) – 3.7%YoY (900MW deficit) in 2Q15. Post-2Q power supply crisis and assuming this is a one-off event, our updated extrapolations flagged headline CPI 'mean-reverting' to fundamentals that could result in Jun-Oct inflation of 2.1-2.3%YoY before probing higher rates later in 2015.

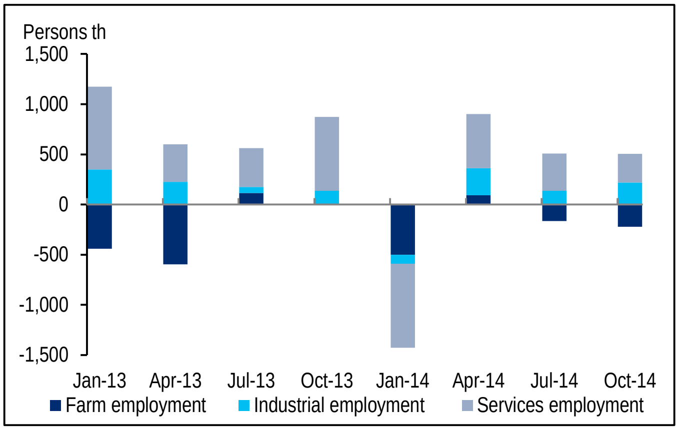
Fiscal scenarios in a compressed inflation environment

Oil price-induced inflation downside risk can erode tax revenues and thus threaten fiscal position at a time when there's strong government resolve to spend — If tax revenues ease due to inflation compression owing to softer oil prices, we obtain a tax growth of 11.6% that yielded a fiscal deficit of 1.5% of GDP (Php211.8bn) vs 2015 fiscal deficit ratio target of 2%. Key growth assumption is buoyant tax elasticity (1.44%) (compared to inflation elasticity); GDP growth would account for 78% of tax gains while inflation accounts for the rest. Collection efficiency accounts for < 1% of tax growth. Assuming actual taxes lag potential tax gains as in 2014, fiscal deficit can expand to 1.8% of GDP. Another possible scenario is that government curbs spending in line with slower revenue gains to ease swelling fiscal deficit risk. Combination of fiscal scenarios suggest low inflation can be a revenue handicap but unlikely to cause fiscal deficit overshoot.

In the 'sweet spot' of upbeat growth and low inflation

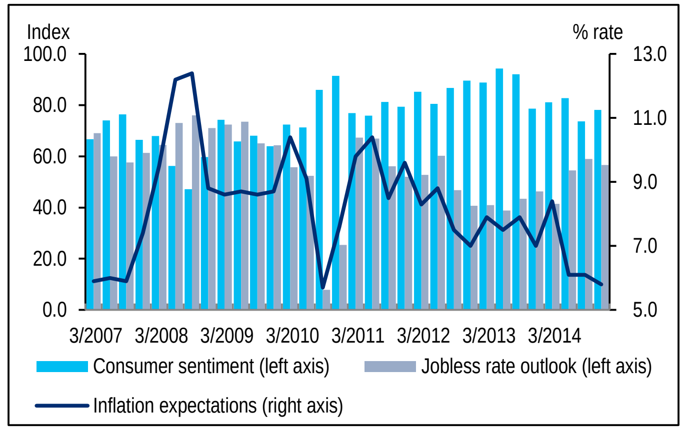
Economic prospects in a 'sweet spot' of upbeat growth and inflation below BSP's mid-point target of 3%, lower the likelihood of a monetary policy bias shifting away from a neutral stance — Moreover with the possible power crisis creating inflation upticks and restraining growth prospects in 2Q15, we can expect BSP to be wary of making abrupt policy rate changes in the near-term. Real interest rate turning positive in 2H15 would be a policy concern. But if positive real rates (depending on inflation downtrend) stay modest and do not threaten investment-driven growth, policy bias would continue to stay the course and seek liquidity mechanisms to ease any sharp real interest rate uptick. PHP would likely stay vulnerable to strong USD episode but the 'sweet spot' condition and its appeal to portfolio flows would temper PHP weakness.

Figure 65. Non-farm employment leading job creation



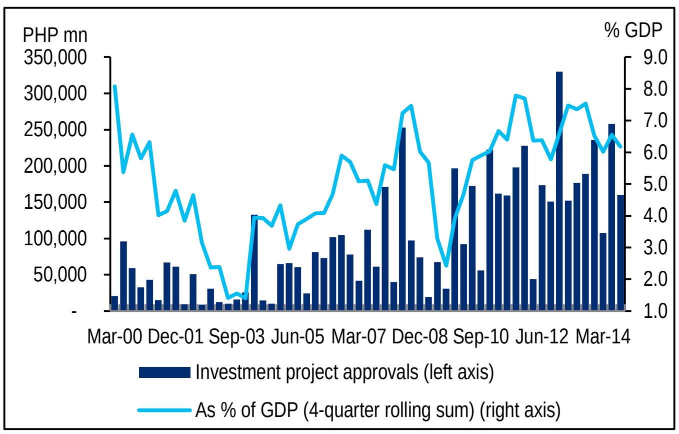
Source: CEIC, Citi Research

Figure 66. Easing inflation expectations with low oil prices



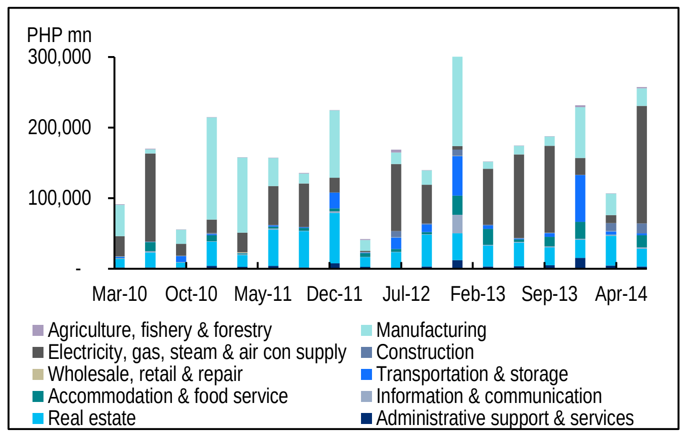
Source: CEIC, Citi Research

Figure 67. Investment project approvals running at 6% of GDP



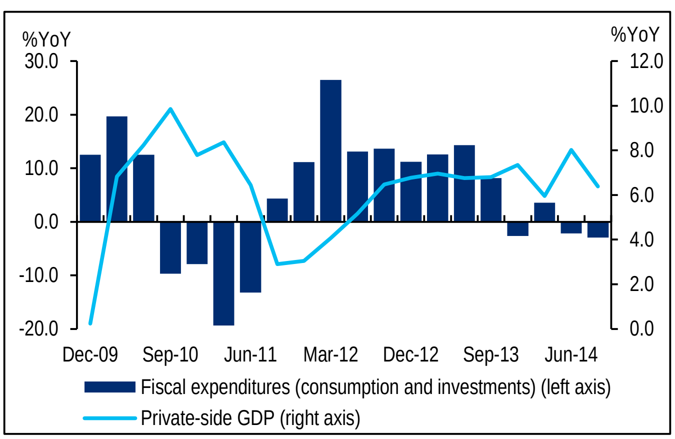
Source: CEIC, Citi Research

Figure 68. Investment approvals favored energy, mfg & real estate



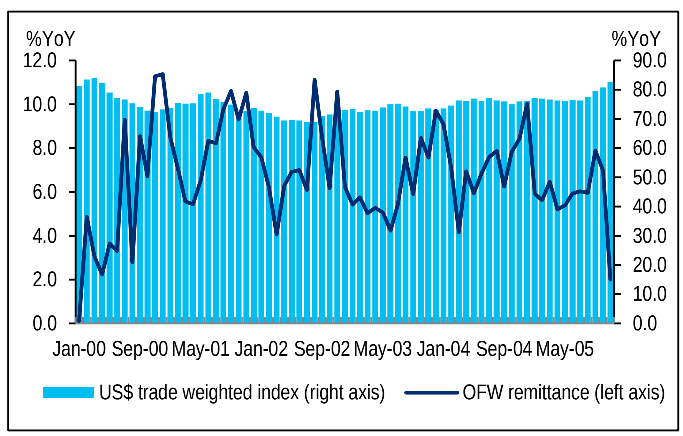
Source: CEIC, Citi Research

Figure 69. Private-side GDP remains robust despite weak fiscal spending



Source: CEIC, Citi Research

Figure 70. Base effect and strong USD probably curbed Nov remittance gains



Source: CEIC, Citi Research

Figure 71. Philippines Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	173.4	168.6	200.0	224.1	250.6	271.9	283.6	302.0	331.3
Nominal GDP, local currency bn	7,721	8,026	9,003	9,708	10,567	11,548	12,594	13,810	15,241
GDP per capita, US$	1,917	1,829	2,127	2,364	2,597	2,769	2,838	2,968	3,200
Population, mn	90.5	92.2	94.0	94.8	96.5	98.2	100.0	101.8	103.5
Unemployment, % of labour force	7.4	7.5	7.3	7.0	7.0	7.1	6.8	6.5	6.0
Economic Activity									
Real GDP, % yoy	4.2	1.1	7.6	3.7	6.8	7.2	5.9	6.3	6.5
Real investment growth % yoy	23.4	-8.7	31.6	2.8	-5.3	29.9	0.8	11.6	8.5
Real consumption growth % yoy	3.3	3.3	3.4	5.1	7.7	5.9	4.9	5.9	6.0
private consumption growth % yoy	3.7	2.3	3.4	5.6	6.6	5.7	5.6	6.0	6.1
Real export growth, % yoy	-2.7	-7.8	21.0	-2.5	8.5	-1.1	9.8	4.6	5.7
Real import growth, % yoy	1.6	-8.1	22.5	-0.6	4.9	5.4	5.5	6.3	5.9
Prices, Money & Credit									
CPI, % yoy	8.0	4.3	3.6	4.2	3.0	4.1	2.7	3.5	3.3
CPI, % avg	9.3	3.2	4.1	4.7	3.2	2.9	4.2	2.6	3.1
Nominal wages, % yoy	5.5	0.0	5.8	5.4	7.0	2.2	0.0	2.5	3.0
Credit extension to private sector, % yoy	12.8	4.3	13.8	16.2	14.1	17.2	13.5	15.0	17.0
Policy interest rate, % eop	5.50	4.00	4.00	4.50	3.50	3.50	4.00	4.00	4.50
Short-term market rate, % eop	5.20	4.11	0.75	1.68	-1.38	-0.15	1.92	1.00	2.00
Long term yield, % eop	6.55	6.25	4.78	4.21	3.70	2.91	3.33	4.25	5.00
lc/US$, eop	47.47	46.50	43.65	43.84	41.06	44.39	44.79	46.00	46.00
lc/US$, avg	44.48	47.56	45.06	43.29	42.22	42.46	44.40	45.73	46.00
Balance of Payments, US$ bn									
Current account	0.1	8.4	7.2	5.6	7.0	10.4	11.4	17.9	19.2
% of GDP	0.1	5.0	3.6	2.5	2.8	3.8	4.0	5.9	5.8
Trade balance	-18.6	-13.9	-16.9	-20.4	-18.9	-17.7	-17.0	-10.4	-10.3
Exports	34.7	29.1	36.8	38.3	46.4	44.5	49.6	52.8	56.0
Imports	53.3	43.0	53.6	58.7	65.3	62.2	66.6	63.2	66.3
Service balance	2.0	4.9	5.8	6.6	6.2	6.4	5.1	3.9	3.5
Income balance	16.8	17.4	18.3	19.5	19.7	21.7	23.2	24.5	26.0
FDI, net	0.6	-0.2	1.6	0.3	1.0	0.2	2.0	3.0	2.5
International reserves (ex-gold)	37.6	44.2	62.4	75.3	83.8	83.2	79.8	82.5	85.0
Total Amortisations	7.0	5.7	8.3	6.3	2.7	9.3	9.7	10.0	10.5
Public Finances, % of GDP									
Consolidated government balance	-0.9	-3.7	-3.5	-2.0	-2.3	-1.4	-0.6	-1.4	-1.3
Consolidated gov primary balance	2.6	-0.2	-0.2	0.8	0.7	1.4	1.9	1.1	1.2
Public debt	54.7	54.8	52.4	51.0	51.5	49.2	46.0	45.0	44.5
of which Domestic	31.3	30.8	30.2	29.6	32.8	32.3	31.6	31.0	30.5
Foreign Assets & Liabilities, US$ bn									
External debt	54.3	54.9	60.0	60.4	60.3	58.5	58.0	58.5	58.3
Private	13.7	11.6	13.9	14.1	15.2	18.0	17.0	17.5	18.3
Public	40.6	43.2	46.2	46.4	45.2	40.5	41.0	41.0	40.0
External debt / GDP	31.3	32.5	30.0	27.0	24.1	21.5	20.4	19.4	17.6
External debt / XGS	113.8	126.9	110.1	105.7	90.3	87.1	78.4	74.2	69.5
Short-term debt	7.0	4.0	6.3	7.0	8.5	11.2	10.0	10.3	10.0
Short-term debt/International Reserves (%)	18.6	9.0	10.1	9.3	10.1	13.5	12.5	12.5	11.8

Quarterly Economic Indicators

	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	6.4	5.3	6.2	6.2	5.8	6.5	6.7	6.7	6.6
CPI, % yoy	4.4	4.8	3.6	2.5	3.1	2.1	2.6	2.7	3.0
Policy interest rate, % eop	3.50	4.00	4.00	4.00	4.00	4.00	4.00	4.50	4.50
Short-term market rate, % eop	0.79	0.98	0.85	0.70	0.80	0.85	1.00	1.30	1.50
Long term yield, % eop	3.50	4.00	3.75	3.65	3.85	4.00	4.25	4.50	4.75
lc vs USD, eop	43.63	44.97	44.79	45.34	45.64	45.95	46.00	46.00	46.00

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). BOP is reported using BPM6.

Singapore

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

Kim Leng Yap
kim.leng.yap@citi.com

- **Summary view** — With lackluster growth against a backdrop of intensifying disinflation, we see a 30-40% chance of MAS easing in 2015, possibly in Apr. The government may call for early elections in 2H15, possibly implying an expansionary budget on 23rd Feb.

- **Things to watch** — [1] Near-term export and production momentum, [2] house prices and sale volumes; [3] household debt, [4] labor market conditions, [5] signs of financial stress in the SME sector, [6] short-term interest rates, [7] core inflation, [8] Budget 2015.

- **Strategy** — Even in the absence of a formal MAS slope reduction, given intensifying disinflation, the MAS could allow the SGD NEER to stay below the mid-point of the band on a sustained basis, as a form of de-facto easing. Tight liquidity and a stronger USD backdrop lead us to revise up our year end 3M SIBOR forecast to 0.8% (Prev: 0.6%).

Growth decelerated in 4Q on manufacturing weakness

Advance estimates for 4Q GDP show a rise of 1.5% YoY, 1.6% QoQ SAAR (3Q: 2.8% YoY, 3.1% QoQ SAAR) — The slowdown from 3Q was led by manufacturing which fell 5.8% QoQ SAAR and 2% YoY on a pullback in transport engineering, electronics and general manufacturing. The 4Q GDP figure brings the 2014 full year growth rate to 2.8% YoY, slightly below the MTI forecast of 3%. However, the year-end GDP level still remains well within that implied by the earlier forecast range of 2.5-3.5%, with a positive output gap persisting – suggesting that GDP outcomes have thus far not materially deviated from official forecasts. We see small downside risks to our below consensus 2015 GDP forecast of 3% (Consensus: 3.1%), but still within the MTI's forecast range of 2-4%, predicated on uneven export growth and domestic headwinds from the housing downturn, labour shortages, household deleveraging and tighter liquidity.

Trimming our inflation forecasts for 2015

We expect headline CPI inflation to average 0.1% YoY (Prev: 0.4%) in 2015, below the current official forecast of 0.5%-1.5% — The increase in COE supply from Feb to Apr, on vehicle de-registrations, is likely to cause COE premiums to fall, intensifying the drag on private transport prices. The drag from accommodation costs is likely to intensify as well with the rising pipeline of private housing completions expected to raise vacancy rates from the 3Q14 level of 7.1%. The introduction of one-off medical subsidies, in Sep 2014 is likely to depress YoY inflation figures until Aug 2015. Further disinflationary pressures are expected from electricity tariffs, with SP Services lowering electricity tariffs by ~8% for 1Q15 compared to 4Q14, as the cost of fuel used for power generation fell on lower gas prices. On the whole, we see these factors dragging headline CPI inflation to 0.1% YoY in 2015, with core CPI averaging 1.1% YoY, below the current official forecast of 2-3%. These forecasts do not fully take into account the impact of lower oil prices, which has been relatively muted thus far. If Brent prices average $63/bbl in 2015 as we forecast, a full pass through of lower crude oil prices could shave about 1.1-1.3% pt off CPI inflation in 2015.

Interest rate forecast raised on recent SIBOR/SOR surge

SIBOR/SOR surged on a weak SGD and tight liquidity in domestic markets — The SIBOR and SOR have surged recently, with the 3M SIBOR currently at 0.65% and the 3M SOR at 0.69% from levels of around 0.45% in Dec, even before the Fed hikes. Not only do the FX market participants seem confident that the SGD NEER will trade in the lower half of the band ahead of the April MAS review, but given the perceived signaling effects, they view the drop below the mid-point as increasing the possibility of MAS easing. SGD has thus become the preferred funding currency, adding pressure to the domestic markets where the loans to deposits ratio has increased steadily to around 110% (close to the 1997 Crisis level of 116%). If these factors persist and the Fed hikes rates by 25 bps in in 4Q15, we see the 3M SIBOR rate at 0.8% by the end of the year.

Higher short-term interest rates may dampen private consumption spending — Since most mortgages in Singapore are linked to the SIBOR and SOR rates, a rise in the SIBOR and SOR profile is likely to drag property demand. Higher short-term rates may also accelerate consumer de-leveraging, further crimping private consumption spending. This in turn will limit producers' pricing power, placing downside risks to our core inflation forecasts.

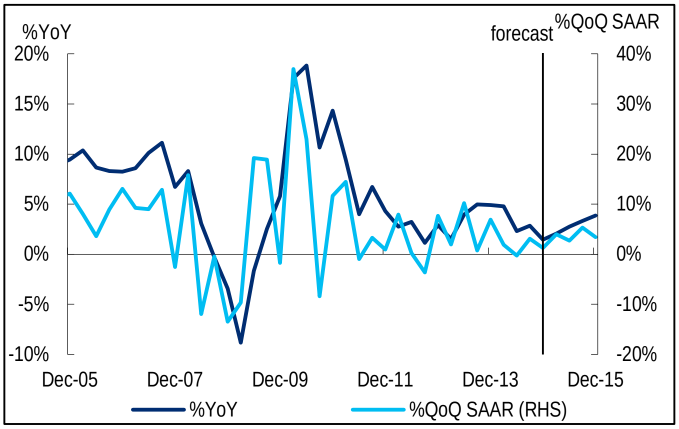
Chance of MAS slope reduction in 2015, possibly in Apr

We see a 30-40% chance of a MAS slope reduction in 2015, possibly in Apr — Growth has remained lackluster, with downside risks to current forecasts for 2015. Disinflation is expected to intensify as well with the MAS being more explicit in its Nov statement (as compared to Oct) in acknowledging the downside risks to the official inflation forecasts. MAS noted that both headline and core inflation could come in slightly below their forecasts ranges in 2015 if oil prices stay at their current levels. With lackluster growth against a backdrop of intensifying disinflation, we see a 30-40% chance of MAS slope reduction in 2015, possibly in Apr, with stronger conviction requiring cracks in the labour market. But even without a slope reduction, we would not be surprised if MAS allows the SGD NEER to stay below the mid-point of the band on a sustained basis, as a form of de-facto easing.

Possible early elections could trigger policy calibrations

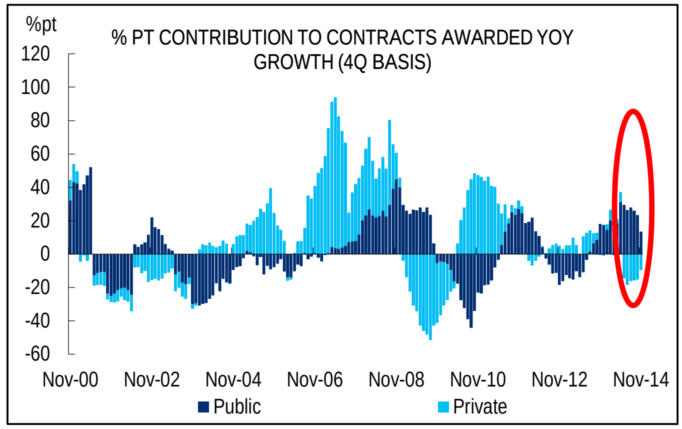
Early elections may be held in 2H15 — This may be to capitalize on the feel good factor accompanying the 50th anniversary of independence. We note that PAP's vote share has been negatively correlated with growth and inflation. The current sluggish growth and disinflationary trend, is thus likely to lend further support to an early election in 2H15, which may imply an expansionary fiscal stance in the budget, to be announced on 23rd Feb, via subsidies and direct transfers for lower and middle income groups, and increased support for SMEs. A favorable result for the incumbent may facilitate fine-tuning of economic policies in a more growth-friendly direction thereafter, though outright policy reversal is unlikely. Election timing aside, recent comments by the National Development Minister suggests that any material relaxation in property policies on the demand side will likely require at least another 10% fall in prices.

Figure 72. Advanced estimated show 2014 GDP growth at 2.8% YoY



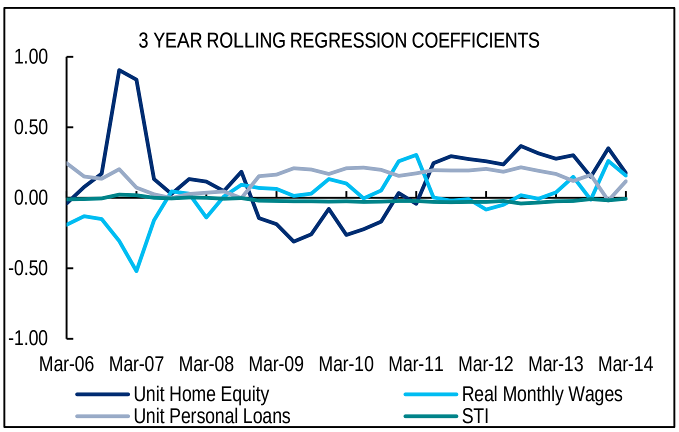
Source: CEIC, Citi Research

Figure 73. Contracts awarded dragged by private sector since Jun-14



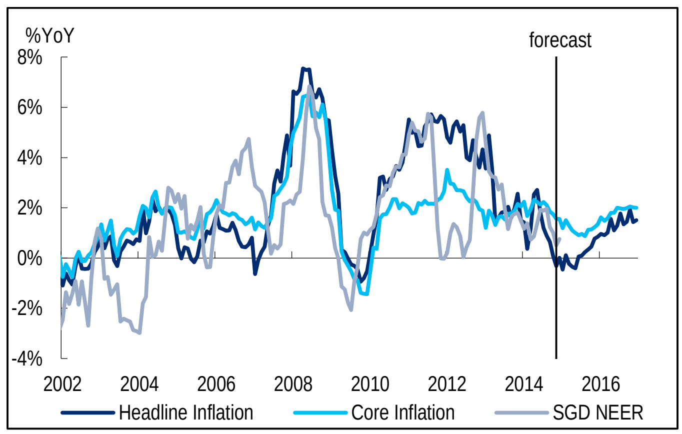
Source: CEIC, Citi Research

Figure 74. Wealth effect of home equity has turned positive



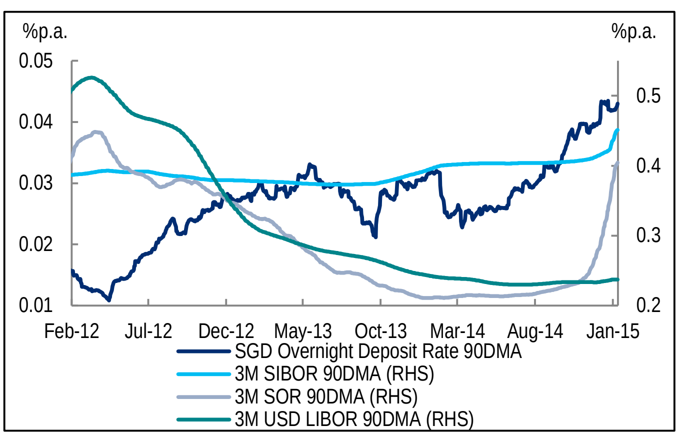
Note: Regression: Private Consumption/person growth = a* (Monthly Wages growth) + b*(Personal Loans/per person growth) + c*(Home Equity/per person growth) + d*(STI);
Source: CEIC, Citi Research

Figure 75. Disinflation is expected to intensify



Source: CEIC, Citi Research

Figure 76. We should keep an eye out for short-term rates



Source: CEIC, Citi Research

Figure 77. Early elections could herald policy changes

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

Source: CEIC, Citi Research

Figure 78. Singapore Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	192.5	193.0	236.9	274.3	287.2	298.0	304.8	301.4	312.0
Nominal GDP, local currency mn	272	280	322	345	359	373	387	399	417
GDP per capita, US$	39,772	38,694	46,671	52,908	54,058	55,199	55,724	54,315	55,227
Population, mn	4.8	5.0	5.1	5.2	5.3	5.4	5.5	5.6	5.7
Unemployment, % of labour force	2.3	3.0	2.2	2.0	1.9	1.9	2.0	2.2	2.3
Economic Activity									
Real GDP, % yoy	1.8	-0.6	15.2	6.1	2.5	3.9	2.8	3.0	3.0
Real investment growth % yoy	29.6	-11.3	24.4	4.3	14.9	-2.2	-5.7	2.2	0.9
Real consumption growth % yoy	4.0	0.0	6.9	3.1	3.1	4.1	1.2	1.6	1.0
private consumption growth % yoy	3.5	-1.1	5.9	4.3	3.9	2.6	1.5	0.5	-0.1
Real export growth, % yoy	4.6	-7.5	17.4	4.6	1.5	3.6	3.3	3.6	3.7
Real import growth, % yoy	10.0	-10.4	16.2	3.2	3.1	3.1	2.0	2.4	2.7
Prices, Money & Credit									
CPI, % yoy	5.5	-0.5	4.6	5.5	4.3	1.5	0.0	0.8	1.5
CPI, % avg	6.6	0.6	2.8	5.2	4.6	2.4	1.0	0.1	1.4
Nominal wages, % yoy	5.4	-2.7	5.6	6.0	2.3	4.3	3.5	3.5	3.0
Credit extension to private sector, % yoy	15.2	2.0	13.4	18.6	13.2	15.4	9.0	8.0	7.0
Short-term market rate, % eop	1.00	0.69	0.44	0.38	0.38	0.40	0.46	0.80	1.35
Long term yield, % eop	2.05	2.66	2.71	1.63	1.30	2.56	2.28	3.25	3.05
lc/US$, eop	1.43	1.41	1.28	1.30	1.22	1.26	1.33	1.37	1.37
lc/US$, avg	1.41	1.45	1.36	1.26	1.25	1.25	1.27	1.36	1.37
Balance of Payments, US$ bn									
Current account	27.7	32.4	56.0	62.6	50.2	54.6	54.9	54.3	53.0
% of GDP	14.4	16.8	23.6	22.8	17.5	18.3	18.0	18.0	17.0
Trade balance	41.6	47.6	62.9	69.6	63.5	67.8	65.0	65.0	68.0
Exports	352.9	287.4	370.5	432.0	434.5	437.7	440.0	445.0	453.0
Imports	311.3	239.8	307.6	362.5	371.0	369.9	375.0	380.0	385.0
Service balance	-1.5	-2.3	-0.4	2.8	0.9	0.8	2.0	4.0	6.0
Income balance	-12.4	-12.9	-6.5	-9.8	-14.2	-14.0	-12.1	-14.7	-21.0
FDI, net	5.4	-2.4	21.7	26.9	47.7	36.8	36.5	36.0	37.0
International reserves	174.2	187.8	225.8	237.7	259.3	273.1	262.0	250.0	255.0
Public Finances, % of GDP									
Consolidated government balance	0.1	-0.3	0.3	1.2	1.7	1.1	-0.3	0.2	1.5
Consolidated gov primary balance	1.1	-0.8	0.2	1.3	2.0	1.3	0.7	0.5	1.0
Public debt	93.9	104.2	99.6	102.7	107.4	104.7	110.0	110.0	110.0
of which Domestic	93.9	104.2	99.6	102.7	107.4	104.7	110.0	110.0	110.0

Quarterly Economic Indicators

	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	2.3	2.8	1.5	2.0	2.7	3.3	3.9	3.7	3.2
CPI, % yoy	1.8	0.6	0.0	-0.2	0.1	0.4	0.8	1.0	1.3
Short-term market rate, % eop	0.40	0.41	0.46	0.65	0.70	0.75	0.80	0.85	1.00
Long term yield, % eop	2.32	2.47	2.28	2.90	3.15	3.30	3.25	3.15	3.15
lc vs USD, eop	1.25	1.28	1.33	1.35	1.36	1.37	1.37	1.37	1.37

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates.
*Note: Public debt is general government debt. BOP is reported using BPM6.

South Korea

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

Jin-Wook Kim
jinwook.kim@citi.com

- **Summary view** — Reflecting weaker-than-expected growth in 4Q14, we revised down 2014 and 2015 growth both by 0.1%p to 3.3% and 3.4%, respectively. Lower oil price is positive to net-exports, widening current account surplus, and it also lower inflation, while impacts on consumption seem limited.
- **Things to watch** — Jan MPC decided to hold the rate unanimously, unlike our call of 25bps cut. With the BoK's hawkish view on growth and inflation during the Jan MPC, particularly with its complacent view about potential growth of 3.4%, we changed our call for the BoK's policy rate from a cut to no change in this year.
- **Strategy** — We believe KRW to weaken against the USD to 1140 over the 6-12m horizon on the back of the across-board USD strength and further weakening of JPY amidst divergence of major central banks monetary policy and smoothing operation to limit KRW strength against JPY.

2015E growth and inflation at 3.4% and 1.4% respectively

Weak growth in 4Q14 led us to adjust down 2015 growth by 0.1%p to 3.4% while leaving 2016 growth at 3.7% — We attribute the downward revision to weaker-than-expected growth in 4Q14, led by continued fiscal drag and sluggish consumption and construction investment, which lowered the growth path for the coming quarters. We now expect 4Q14 growth to slow down to 0.4%QoQ sa and 2.7%YoY from the previous forecast of 0.7%QoQ sa and 3.0%YoY. Looking ahead, in 1H15, we expect mild recovery path of 2.7% in 1Q15 and 3.2% in 2Q15. On QoQ terms, growth rates are expected to maintain average 1%QoQ in 2015, which will be higher than average 0.7%QoQ in 2014.

Lower oil price is positive for net-exports and widens current account surplus — Citi recently downgraded its Brent oil price forecasts to average $63/bbl for 2015 from its previous forecasts of average $80/bbl for 2015. A lower oil price is expected to be beneficial for Korea's exports to countries that import commodities, which accounted for 73% of Korea's total exports (in Jan-Nov 2014), while exports to countries that export commodities are likely to worsen. Furthermore, oil related trade deficit will narrow sharply if crude oil price remains at current level or falls further. Oil related products including crude oil and petrochemicals, etc. all make up 18% of exports and 37% of imports with cUS$90bn of trade deficit in 2014. Reflecting all these factors and recent trade growth momentum, we adjust down growth forecasts for exports and imports in 2015 by 2.7%p and 5.9%p to 3.1% and 1.2% respectively. Current account surplus is now expected to widen to US$98.1bn (+7.2% of GDP) in 2015 (vs. previous US$81.6bn (+5.8% of GDP)).

Consumption recovery is likely to remain lukewarm despite positive oil shock — Lower oil price may provide extra income to household as households' fuel expenditure accounted for 7.5% of total expenditure in 3Q14. In our view, however, this windfall gain is unlikely to lead households to expand consumption meaningfully since 1) household's ratio of total expenditure to total income has structurally decreased to 78% in 3Q14 from 82% in 1Q04 as burden of non-consumption part such as pension, social security and interest expense over total income has risen by 2.5%p during the period, 2) weak nominal wage growth and rising Jeonse price will weigh on consumption, and lastly 3) lowered oil price sensitivity to consumption. The Korea Development Institute (KDI) pointed out that the impact of 10% oil price fall to private consumption fell to 0.06%p in 2001-2014 from 0.58%p in 1988~2002.

The BoK is likely to hold the rate throughout 2015

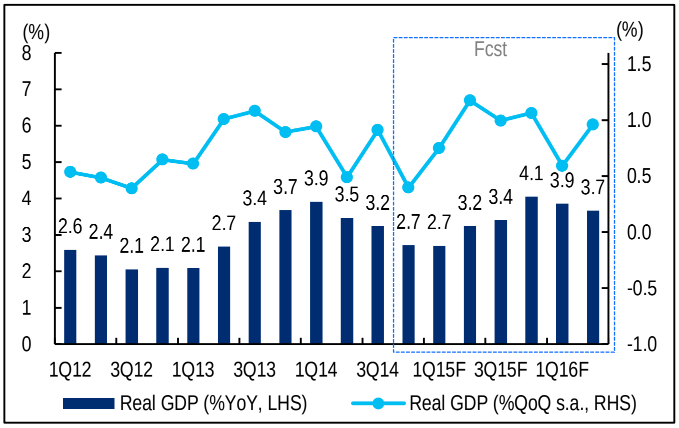
2015-16 inflation forecasts are lowered both by 0.2%p to 1.4% and 2.4%, respectively — This is mainly due to prolonged deflationary pressure of low oil price despite tobacco price hike in Jan15. With the expected decline of crude oil import price by 34%YoY, in our view, retail gasoline price is likely to fall just by 16%YoY because of a FX conversion factor and unit-tax factor. It is likely to contribute -0.9%p to headline CPI inflation in 2015, -1.1%p in 1H15 and -0.7%p in 2H15. With that, headline CPI inflation is likely to post 0.8%YoY in 1H15 and rise gradually to mid-2% at end-2015 along with the expected moderate rebound of oil price, low base a year ago and public tariff hikes.

Jan MPC unanimously held the rate, unlike our call of a 25bps cut — We expected Jan MPC to take an easing stance with downgrade of growth and inflation forecast as it did last Oct. That call was based on our view that the economy remains weak in 1H15, especially in 1Q amidst disinflationary pressure and weak economic sentiments, leading annual growth to stay below the potential level of higher than 3.5%. As we thought, the BoK announced its downgrade of 2015 forecasts for growth and inflation to 3.4% and 1.9%, both 0.5%p lower than earlier forecasts, during Jan MPC meeting but left the rate at 2.00%. Unlike our view of weak recovery in 1H15 to lead economic growth at mid-3%, the BoK attributed downward revision of growth forecast to the history, i.e., unexpectedly low growth in 4Q14. The BoK Governor, furthermore, said the economy will expand at a speed of its potential growth of 3.4% in this year and added that it is undesirable to employ monetary easing to manage low inflation caused by supply shocks such as oil price decline.

We no longer expect a rate cut until the first rate hike in 1H16 — With the BoK's hawkish views on growth and inflation at Jan MPC, particularly with its complacent view about the potential growth of 3.4%, we changed our call for the BoK's policy rate from a cut to no change in this year. Despite the pace of recovery at the potential growth rate, the BoK expected negative output gap to extend till early 2016. However, an extended period of negative output gap does not necessarily triggers the BoK to take further easing stance since, in our view, what really matters is whether the output gap widens further or not. Considering the favorable recovery pace expected in the coming quarters, output gap would narrow down gradually. In particular, we believe, the QoQ growth of real GDP and expected inflation are key indicators to determine the direction of monetary policy. Thus, we are unlikely to reverse our call unless the recovery pace suggests a growth significantly below c1%QoQ sa in 1Q15 and expected inflation plunges further below 2%.

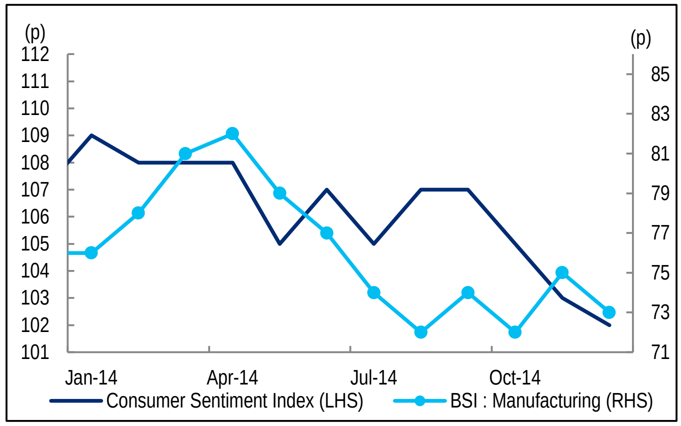
USDKRW is expected remain higher than 1,100 for a while — In Jan, USDKRW fell sharply below 1080 level mainly due to consolidation of USDJPY after the BoJ's QE announcement in 4Q14 and synchronization of KRW to JPY. Going forward, USDKRW is likely to be influenced by both upward and downward pressure, while we believe that the former probably outweigh the latter in 2015. First, difference in monetary policies of major central banks and smoothing operations to restrain KRW's strength against weak JPY are likely to lead to USDKRW to rise. Second, the forecasted lower US rates as well as larger current account surplus due to lower oil price are likely to limit the degree of KRW weakness against USD. Based on these two factors, KRW is likely to depreciate further from 1100 in 0-3m to 1140 in 6-12m horizon.

Figure 79. Mild recovery path of economic growth expected in 2015



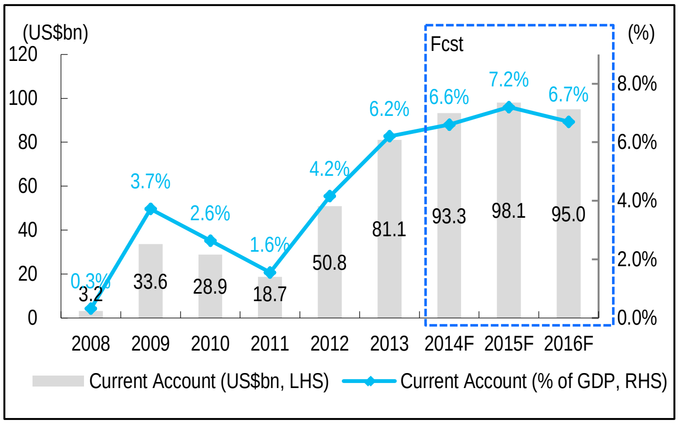
Source: BoK, CEIC, Citi Research

Figure 80. Subdued consumer and business sentiments



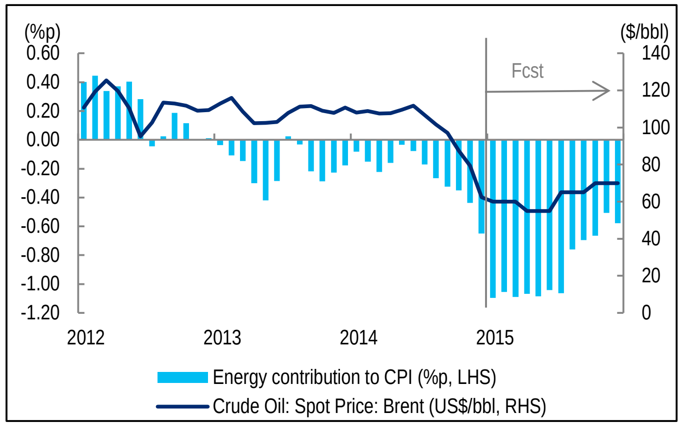
Source: BoK, CEIC, Citi Research

Figure 81. Lower oil price likely to widen current account surplus



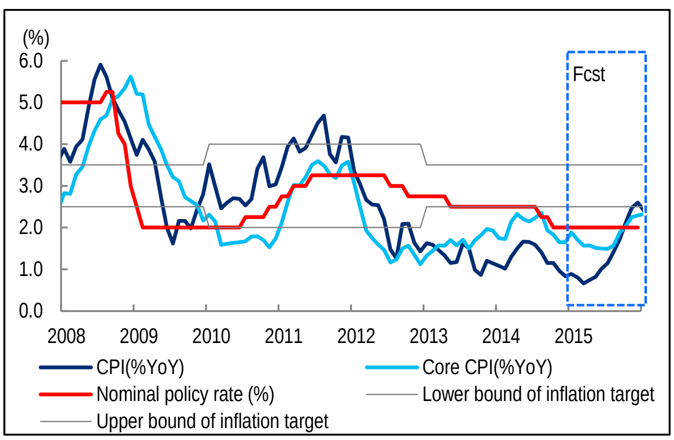
Source: BoK, CEIC, Citi Research

Figure 82. Decline of oil price is expected to slow inflation



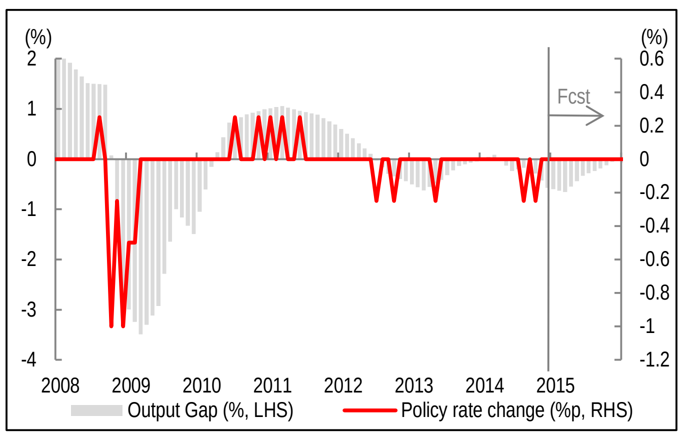
Source: EIA, Statistics Korea, CEIC, Citi Research

Figure 83. Inflation and policy rate forecast



Source: BoK, Statistics Korea, CEIC, Citi Research

Figure 84. Output gap and policy rate forecast



Source: BoK, CEIC, Citi Research

Figure 85. Korea Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	1,001.0	902.3	1,094.6	1,202.8	1,222.5	1,304.3	1,404.6	1,358.7	1,413.7
Nominal GDP, local currency bn	1,104,492	1,151,708	1,265,308	1,332,681	1,377,457	1,428,295	1,479,210	1,530,566	1,611,568
GDP per capita, US$	20,450	18,347	22,152	24,163	24,448	25,972	27,856	26,843	27,827
Population, mn	48.9	49.2	49.4	49.8	50.0	50.2	50.4	50.6	50.8
Unemployment, % of labour force	3.2	3.6	3.7	3.4	3.2	3.1	3.5	3.5	3.4
Economic Activity									
Real GDP, % yoy	2.8	0.7	6.5	3.7	2.3	3.0	3.3	3.4	3.7
Real investment growth % yoy	-1.0	-10.1	17.8	3.5	-2.3	0.0	4.8	2.1	6.6
Real consumption growth % yoy	2.2	1.3	4.3	2.7	2.2	2.2	2.1	2.7	3.0
private consumption growth % yoy	1.4	0.2	4.4	2.9	1.9	2.0	1.9	2.6	3.0
Real export growth, % yoy	7.5	-0.3	12.7	15.1	5.1	4.3	3.3	4.7	7.0
Real import growth, % yoy	3.2	-6.8	17.3	14.3	2.4	1.6	2.6	4.2	7.8
Prices, Money & Credit									
CPI, % yoy	4.1	2.8	3.0	4.2	1.4	1.1	0.8	2.6	2.2
CPI, % avg	4.7	2.8	2.9	4.0	2.2	1.3	1.3	1.4	2.4
Nominal wages, % yoy	3.1	2.6	6.8	0.9	5.4	3.9	2.1	2.8	3.6
Credit extension to private sector, % yoy	14.9	5.0	4.0	6.5	3.2	4.7	5.7	7.3	8.1
Policy interest rate, % eop	3.00	2.00	2.50	3.25	2.75	2.50	2.00	2.00	2.25
Short-term market rate, % eop	3.93	2.86	2.80	3.55	2.89	2.66	2.13	2.13	2.40
Long term yield, % eop	4.22	5.39	4.52	3.79	3.16	3.58	2.60	2.75	3.05
lc/US$, eop	1,263	1,166	1,121	1,159	1,064	1,051	1,094	1,140	1,140
lc/US$, avg	1,102	1,275	1,156	1,108	1,127	1,095	1,053	1,127	1,140
Balance of Payments, US$ bn									
Current account	3.2	33.6	28.9	18.7	50.8	81.1	93.3	98.1	95.0
% of GDP	0.3	3.7	2.6	1.6	4.2	6.2	6.6	7.2	6.7
Trade balance	-13.3	40.4	41.2	30.8	28.3	44.0	47.5	59.1	54.9
Exports	422.0	363.5	466.4	555.2	547.9	559.6	573.1	590.9	624.0
Imports	435.3	323.1	425.2	524.4	519.6	515.6	525.6	531.8	569.0
Service balance	-6.5	-9.6	-14.2	-12.3	-5.2	-6.5	-7.2	-10.8	-10.5
Income balance	-2.5	-4.6	-4.8	1.8	6.6	4.9	5.9	5.8	5.5
FDI, net	-16.9	-14.9	-22.2	-16.4	-18.9	-13.1	-8.6	-4.3	-3.7
International reserves	201.2	270.0	291.6	306.4	327.0	346.5	362.5	372.3	392.3
Total Amortisations	31.0	30.2	35.7	42.7	43.2	43.6	44.2	44.8	46.6
Public Finances, % of GDP									
Consolidated government balance	1.4	-1.5	1.3	1.4	1.3	1.0	0.9	0.3	0.2
Consolidated gov primary balance	2.7	-0.2	2.6	2.7	2.6	2.1	2.0	1.4	1.3
Public debt	28.0	31.2	31.0	31.6	32.2	34.3	35.6	37.4	38.8
of which Domestic	26.1	29.1	26.4	29.4	27.4	29.6	30.9	32.5	34.0
Foreign Assets & Liabilities, US$ bn									
External debt	315.9	344.6	355.9	400.0	408.9	416.1	427.7	440.1	451.5
Private	291.1	310.4	305.2	339.7	348.1	353.1	363.4	374.1	383.5
Public	24.9	34.2	50.7	60.3	60.8	63.0	64.3	66.1	68.0
External debt / GDP	31.6	38.2	32.5	33.3	33.5	31.9	30.4	32.4	31.9
External debt / XGS	61.5	79.0	64.8	61.9	62.8	62.7	63.1	62.6	60.3
Short-term debt	149.0	148.7	136.5	139.8	128.0	115.3	111.6	108.3	111.1
Short-term debt/International Reserves (%)	74.0	55.1	46.8	45.6	39.1	33.3	30.8	29.1	28.3

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	3.5	3.2	2.7	2.7	3.2	3.4	4.1	3.9	3.7
CPI, % yoy	1.7	1.1	0.8	0.7	1.0	1.7	2.6	2.5	2.6
Policy interest rate, % eop	2.50	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.25
Short-term market rate, % eop	2.65	2.35	2.13	2.13	2.13	2.13	2.13	2.15	2.40
Long term yield, % eop	3.17	2.85	2.60	2.55	2.60	2.65	2.75	2.95	3.00
lc vs USD, eop	1,012	1,055	1,094	1,107	1,122	1,137	1,140	1,140	1,140

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). BOP is reported using BPM6.

Taiwan

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

- **Summary view** — Modest export recovery in 2H likely to keep 2015E GDP growth steady at 3.6%yoy, but near term exports and manufacturing could moderate. The net effect of currency depreciation and lower oil prices would keep inflation benign and lower import drag to GDP.

- **Things to watch** — 1) Cross-strait momentum: Taiwanese banks allowed to set up branches in China, RMB swap line, relaxation in RMB conversion quota; 2) export competitiveness; 3) politics ahead of 2016's Elections; 4) TPP and RECP talks; 5) 4th nuclear plant referendum; and 6) pension reforms.

- **Strategy** — We see CBC likely to hold interest rates till 1Q16E, CBC prefers to use NCD for liquidity management; while long term bond likely to creep up along with Fed's normalization. We expect TWD depreciation to reflect USD strength and regional depreciation. Citi expects TAIEX to re-climb to 10,000 by mid-2015.

Our 2015 outlook remains the same despite lower oil prices — As portrayed in our year-end report (pg. 54), modest export recovery in 2H, lower oil import bill and better business margins are likely to keep 2015E GDP growth steady at 3.6%yoy.

1Q tech exports to see more seasonal slowdown — In Dec, exports fell 2.8%yoy or 2.8%mom sa. Some pre-stocking ahead of Chinese New Year can be expected to cushion Jan data, but the reverse could hit Feb's numbers. Overall the usual tech demand is likely to come in 2H.

Net oil impacts likely positive for trade balance, GDP and current account — Citi sees a step-up in oversupply, more volatility and turmoil for oil in 1H15E and expect Brent averaging US$63/bbl in 2015, with significant market weakness into Q2 with price reaching US$55/bbl. The oil impact on Taiwan's trade is two sided: on the one hand, this takes toll on commodities exports, on the other hand, the import bill also significantly falls. This pattern was already witnessed in Dec trade data, with non-tech exports like mineral products (-39.7%yoy), rubber/plastics (-12.3%yoy) and chemicals (-5.1%yoy) performing poorly. Meanwhile, Dec imports of raw materials declined 13.6%yoy, mainly reflecting lower commodity prices. These two developments have thus widened the trade surplus since Dec. For 4Q, the trade surplus widened to US$13.3bn (a 24.1%yoy increase). This would in turn allow net exports contribution to GDP to turn positive in 4Q, in our view. We believe this pattern would continue to be present in 1H15E, cushioning GDP and adding to the current account surplus (our previous simulation shows a 10% decline in oil price would boost Taiwan's current account by 0.8ppts).

Lower oil prices = worldwide disinflation, and Taiwan is no exception — The WPI into deflation zone in the past four months, with Dec WPI reaching -4.2%yoy. CPI as of Dec14 was at 0.61%yoy. We believe the pass-through to CPI will be more noticeable in 1H2015E, after the distortions from the first two months of Chinese New Year. Specifically, electricity weighs 2.2ppt in the CPI basket and fuels & lubricants weighs 3.5ppt. The Central Bank has also requested energy suppliers to reflect latest oil price developments in their pricing as soon as possible. The benign inflation outlook is likely to allow CBC to maintain maximum policy accommodation by holding policy rates unchanged till 1Q16E, even if the liftoff date of the Fed is in 2H15E. Meanwhile, if the property market requires further tightening, CBC is likely to step up on its macro prudential measures to deter speculations. Sinyi property prices have tamed after CBC lowered LTV ratios for third/luxury/corporate mortgaged flat in Jun14. However we need to monitor the recent pickup in the New Taipei City index in Dec, as a sustained rise is likely to invite further policy actions.

Oil buffers sharp TWD drop, but we maintain a 6-12M depreciation call — Our medium term TWD forecast is at 32.3 against the greenback, mainly reflecting our expectation of a general USD strength and regional depreciation to continue. Our house view of depreciation in JPY and KRW as well as CNY, suggest TWD is likely to move along in order to maintain export competitiveness. Aside from trade flows, we think fund flows into Taiwan equities matters for the TWD, and we see likely inflows into equity plays with our call of TAIEX of 10,000 by mid-year.

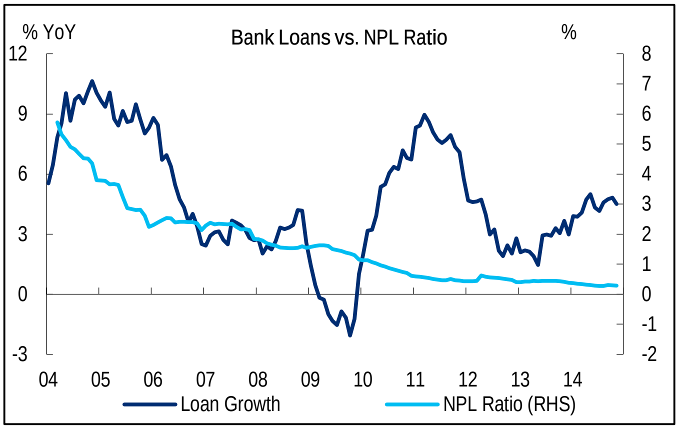
We see competition from Korea on two fronts — (1) KRW deprecation (as mentioned above), and (2) China-Korea FTA. We have highlighted available quantified impacts of the China-Korea FTA in 2H15E in our year-end report (pg. 55). A further study into the details of the FTA details reveals a few caveats. See Korea Macro View - Revisit Korea-China FTA: Low Level FTA to Bring Limited Impacts.

Taiwan needs to hurry up on its FTA developments — In our view, the slow liberalization timeline of China-Korea FTA gives Taiwan a short time window to catch up in terms of signing FTAs and cross-strait liberalization after 2016's elections. Korea appears to see the same issue of a need to protect its agricultural and fisheries sectors, like Taiwan. This requirement appears to have limited the tariff concessions in manufacturing during Korea's FTA negotiations with China, and according to our Korea economist Jaechul Chang, it has resulted in a low level FTA. In particular, the timespan needed to remove tariff 71% (91%) of tariff in 10 (20) years appears long when compared to other trade deals of Korea (with US or EU). In addition, the key overlapping exports that Korea and Taiwan ships to China include stainless hot rolled steel sheet (tariff to be removed immediately), semiconductor manufacturing equipment (five years), glass lens (15 years), ABS resins (20 years), etc. This deal turnout, in our view, buys Taiwan some time to catch up with its FTA signings, and Taiwan should not be complacent, as Korea-China FTAs can always be enhanced if implementation appears smooth and when sectorial impact reviews are done. Moreover, Taiwan is striving to reinvent itself in participating in the global (China included) production chain of autos and other machineries. The relaxation of tariff in 5-10 years' time for Korean exports to China in various aircraft parts, shock absorbers, LCD panel, etc. will hurt Taiwan's diversification process. A more general argument for why Taiwan must hurry up is that the active participation of countries in FTA nowadays is due to fierce competition; exports of those who are left out of the various trading blocs might become non-competitive.

Limited cross strait developments expected before 2016 Elections — After Dec's warm up battle of KMT-DPP at the Local Elections, fiscal spending will likely increase in 2015, it being a pre-election year but we think it is an uphill struggle for the ruling government to pass major policies, especially related to cross strait liberalization like ECFA for services or goods, despite ongoing bilateral talks. Campaigns of the early-2016 Legislative and President Elections appear to have kick started, we think the passing of ECFA for services pact by the Legislative Yuan will only come after the Elections.

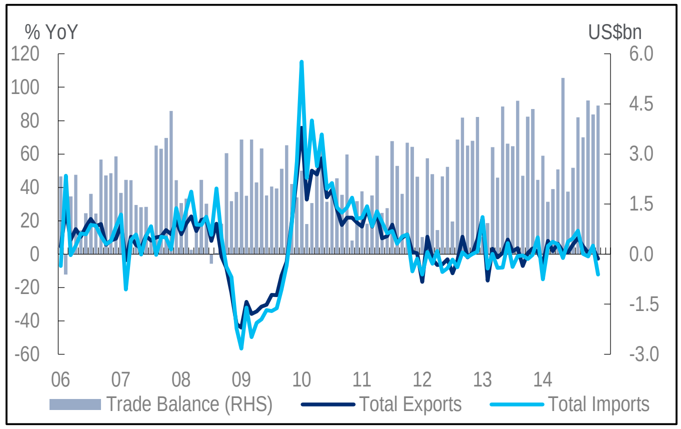
… in turn delaying foreign investments into Taiwan — Taiwan is a logical production destination for the expanding China consumer market given its proximity, language compatibility and skilled labor for the high tech segment. However, without a trade agreement that allows for tariff reduction for Chinese goods to be produced in Taiwan, foreign investors may opt for other countries having tariff benefits instead. Meanwhile, the market still hopes that there will be a green signal from China that Taiwanese banks can set up branches in China, separating this sector from the ECFA for services pact.

Figure 86. Loan growth still likely on uptrend



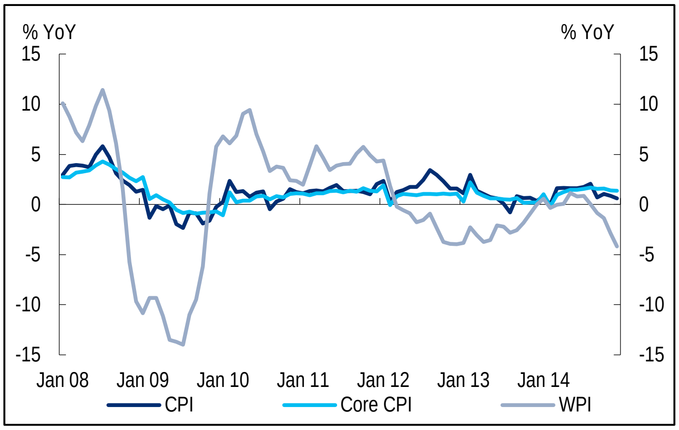
Source: CEIC, Citi Research

Figure 87. Trade headwinds likely in 1H15E



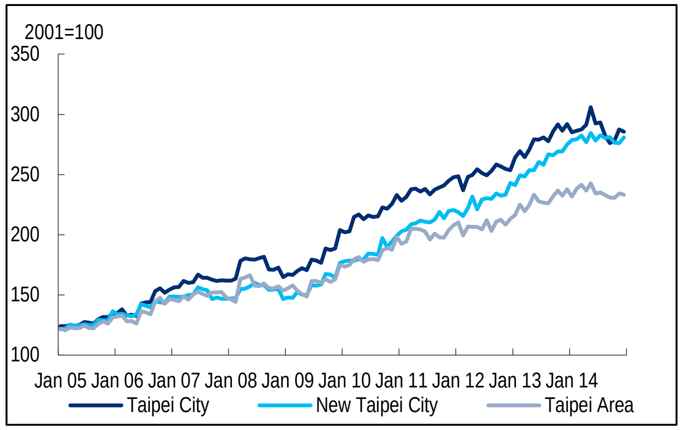
Source: CEIC, Citi Research

Figure 88. Disinflation gives room for CBC's accommodation



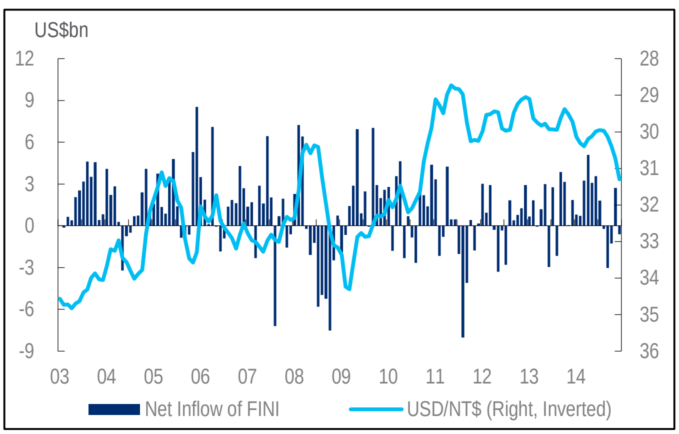
Source: CEIC, Citi Research

Figure 89. But policy will act on property price trends



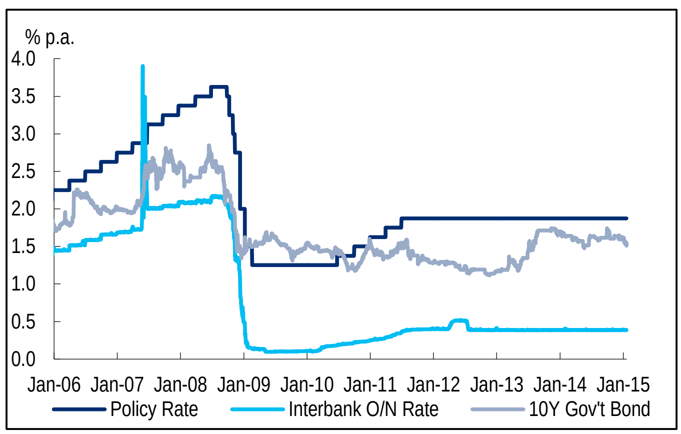
Source: CEIC, Citi Research

Figure 90. TWD could depreciated with strong USD & mixed FINI flows



Source: CEIC, Citi Research

Figure 91. 10Y gvt bonds could edge up with US rate normalization



Source: Bloomberg, Citi Research

Figure 92. Taiwan Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	400.2	378.0	430.3	466.5	476.3	490.6	503.4	527.3	562.3
Nominal GDP, local currency bn	12,620	12,481	13,552	13,709	14,077	14,561	15,255	15,976	16,868
GDP per capita, US$	17,370	16,348	18,579	20,084	20,429	20,991	21,483	22,455	23,898
Population, mn	23.0	23.1	23.2	23.2	23.3	23.4	23.4	23.5	23.5
Unemployment, % of labour force	4.1	5.8	5.2	4.4	4.2	4.2	4.0	3.9	3.9
Economic Activity									
Real GDP, % yoy	0.7	-1.8	10.8	4.2	1.5	2.1	3.6	3.6	3.8
Real investment growth % yoy	-7.9	-21.2	36.8	-6.8	-4.6	2.2	6.3	0.7	3.1
Real consumption growth % yoy	-0.6	1.3	3.3	2.9	1.5	1.6	2.7	2.7	1.6
private consumption growth % yoy	-0.9	0.8	4.0	3.1	1.6	2.0	2.6	3.2	3.4
Real export growth, % yoy	0.9	-8.7	25.6	4.5	0.1	3.8	4.7	5.2	5.1
Real import growth, % yoy	-3.7	-13.1	27.7	-0.5	-2.2	3.9	4.4	3.5	3.8
Prices, Money & Credit									
CPI, % yoy	1.3	-0.2	1.2	2.0	1.6	0.3	0.6	3.4	0.8
CPI, % avg	3.5	-0.9	1.0	1.4	1.9	0.8	1.2	1.2	1.8
Nominal wages, % yoy	-0.1	-5.0	5.3	2.6	0.1	0.2	0.5	1.0	1.8
Credit extension to private sector, % yoy	2.7	-0.8	6.7	5.6	4.1	5.3	6.0	7.0	8.0
Policy interest rate, % eop	2.00	1.25	1.63	1.88	1.88	1.88	1.88	1.88	2.38
Short-term market rate, % eop	1.07	0.27	0.49	0.79	0.76	0.64	0.83	0.94	1.17
Long term yield, % eop	1.44	1.47	1.47	1.27	1.15	1.69	1.60	1.72	1.94
lc/US$, eop	32.78	32.23	29.17	30.29	29.06	29.83	31.64	32.17	32.01
lc/US$, avg	31.58	33.04	31.50	29.40	29.57	29.68	30.31	32.09	32.07
Balance of Payments, US$ bn									
Current account	27.5	42.9	39.9	41.8	50.7	57.4	60.4	58.0	45.0
% of GDP	6.9	11.4	9.3	9.0	10.6	11.7	12.0	11.0	8.0
Trade balance	15.2	29.3	23.4	26.8	30.7	35.5	39.6	42.7	46.7
Exports	255.6	203.7	274.6	308.3	301.2	305.4	313.8	327.4	343.6
Imports	240.4	174.4	251.2	281.4	270.5	269.9	274.2	284.6	296.9
Service balance	1.8	2.0	2.5	3.9	6.3	10.4	9.0	14.6	19.3
Income balance	10.0	12.5	13.6	13.2	15.3	14.3	19.2	21.0	23.0
FDI, net	-4.9	-3.1	-9.1	-14.7	-9.9	-10.7	-10.7	-11.0	-10.0
International reserves	291.7	348.2	382.0	385.5	403.2	416.8	419.0	440.0	460.0
Total Amortisations	2.5	3.2	6.8	3.4	2.9	3.1	3.2	3.2	3.2
Public Finances, % of GDP									
Consolidated government balance	0.9	-2.2	-1.2	-0.5	-1.4	-1.3	-1.4	-1.6	-1.3
Consolidated gov primary balance	1.9	-1.2	-0.3	0.3	-0.5	-0.5	-0.6	-0.5	-0.3
Public debt	34.7	38.0	38.3	40.0	41.0	39.9	39.5	38.7	38.4
of which Domestic	34.7	38.0	38.2	40.0	41.0	39.9	39.5	38.7	38.4
Foreign Assets & Liabilities, US$ bn									
External debt	90.4	82.0	101.6	122.5	130.8	170.1	190.0	210.0	230.0
Private	88.9	76.0	93.5	118.0	127.5	165.8	184.7	204.6	224.6
Public	1.5	5.9	8.0	4.5	3.3	4.3	5.3	5.4	5.4
External debt / GDP	22.6	21.7	23.6	26.3	27.5	34.7	37.7	39.8	40.9
External debt / XGS	30.9	34.7	32.0	34.6	37.4	47.6	51.2	53.2	54.0
Short-term debt	78.8	68.2	83.7	107.8	116.5	155.6	180.0	200.0	220.0
Short-term debt/International Reserves (%)	27.0	19.6	21.9	28.0	28.9	37.3	43.0	45.5	47.8

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	3.9	3.6	3.5	3.3	3.6	3.5	3.8	3.1	3.6
CPI, % yoy	1.6	0.7	0.6	0.8	0.2	1.0	3.4	2.2	2.1
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	1.88	2.00	2.13
Short-term market rate, % eop	0.83	0.83	0.84	0.86	0.90	0.96	1.02	1.08	1.14
Long term yield, % eop	1.56	1.72	1.60	1.63	1.66	1.69	1.72	1.75	1.78
lc vs USD, eop	29.87	30.43	31.64	31.95	32.07	32.18	32.17	32.13	32.09

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

Thailand

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

- **Summary view** — We are keeping our 2014 GDP forecast of 0.5% and 2015 forecast of 3%. Potential growth triggers range from windfall incomes due to low oil prices, fiscal spending and improving investments. However caveats persist from elevated HH debt, reforms that trim subsidies to low utilization rates.

- **Things to watch** — 1) Resumption of faster fiscal disbursement rate, particularly for current expenditures; 2) size of oil import decline and current account impact; 3) investment plans/action of state owned enterprises; 4) pace of disinflation in 2015; 5) risk to tax revenues of low oil prices/inflation and impact on fiscal deficit.

- **Strategy** — Diminished risks to growth heighten likelihood of an unchanged overnight rate despite inflation compression. However faster disinflation likely to sustain a low interest rate setting extending to the long end of the curve. Key risk to bond market sentiment would be the impact of low inflation on revenues.

Windfall consumption gains and improving investments

We maintain our growth forecasts of 0.5% and 3% in 2014 and 2015 respectively — Good start for FY15 fiscal spending in Oct (23.9%YoY) only to sputter in Nov (-21.6%). Initial reports suggest that fiscal spending gains resumed in Dec. Between current ex-interest – bulk of government spending at ~17% of GDP, and capital expenditures (~2% of GDP), the former grew by 2.3%YoY in Oct-Nov while the latter expanded 36%YoY. Size of spending however makes a difference at this juncture as fiscal reform measures taken to ease energy dependence and curb fiscal subsidies/transfers probably restrain current fiscal expenditures that go into government consumption. Upside surprise to public investments would also come from state owned enterprises although some may lack a strong financial position to entertain strong capex. Primary expenditures in Oct-Nov grew 3.4%YoY that doesn't signal upbeat near-term fiscal expenditures. For 2015 we remain hopeful on fiscal expenditures contribution to the favorable outlook, particularly infrastructure.

Potential windfall income gain from low oil prices could be as much as an estimated 8% (Citi forecasts ~40% decline in oil price in 2015) that can elevate consumption by 4.4% — According to BoT, some consumption lift was evident in Nov-14 private consumption index when non-durable goods indicators gained against durable goods demand. However actual consumption may not be as upbeat as low income households may opt to reduce elevated debt (84.7% of GDP) amid declining net interest receipts due to persistently low rates. In past recoveries, strong durable goods demand supplied bulk of the consumption lift. While consumer sentiment has rallied in Nov due to low oil prices and fiscal spending revival, gradual consumption gains may sustain 4Q14 consumption gains of at least 2.5%YoY en route to 3% growth in 2015. Upside consumption surprise can be 3.2%YoY growth in 4Q14 and 4.3% in 1Q15 with strong base effects.

Just like 3Q14, private investments may get a lift from capex despite a capacity utilization rate entrenched in the low 60% SA threshold — With stabilizing political risk and normalized regulatory processes, investment approvals contribute largely to improving investment stats with base effect lift. Capex component of real investments ex-inv have started to show favorable quarterly gains (+3.4%QoQ SA in 2Q14 and +5.7%QoQ SA in 3Q14). While monthly private investment indicators eg commercial car sales, continue to be plagued by the base effect, roll out of investment project approvals have started. As of Nov 2014, investment approvals stood at Bt417bn down 11%YoY but with Oct-Nov estimates sharply rising mainly from Japanese FDI in metal products & machinery.

Current account surplus uplifted by low oil prices

We estimate a current account surplus rising sharply to 7% of GDP in 2015 from an estimated 3.9% of 2014 GDP — Last year's current account surplus was due to the collapse of non-oil imports (-9% to -10%) while for 2015, the roughly 40% of forecasted decline in oil prices (Citi's Brent estimate) would lower oil & fuel imports by 29%. We also assume a positive oil import volume effect (5.5%). Oil imports however account for roughly 20% of total imports while the larger non-oil import value is projected to rise by at least 3.5% in 2015. Composition of imports would lower overall imports by 5.1% alongside a modest export gain of 3.2%. The trade surplus can easily balloon to nearly US$40bn and thus provide strong basis for a hefty current account surplus this year. The surplus may not buoy up FX reserves materially due to portfolio exit risk in case of US Fed tightening signals alongside sustained overseas TH investments.

Is there a risk of revenue erosion with low inflation?

We sense risk of tax revenue erosion by slumping oil prices and reduced inflation. However this would be mitigated by effects of a highly elastic tax income elasticity parameter which we estimate at 1.78% (vs inflation elasticity of taxes at 0.7%) — Economic recovery prospects and the income effect on tax collections would be crucial to lower the likelihood of lower collections due to disinflation. But due to lack of inflation lift to revenues in FY15, we expect a fiscal deficit overshoot >Bt300bn (FY15 target: Bt250bn) leading to deficit to FY15 GDP of 2.4% (vs FY14 budget deficit ratio of 2.7%). Overshoot risk could weaken bond market sentiment although deficit funding in the event of an overshoot could partially come from draw down of government's cash balances just like in FY14.

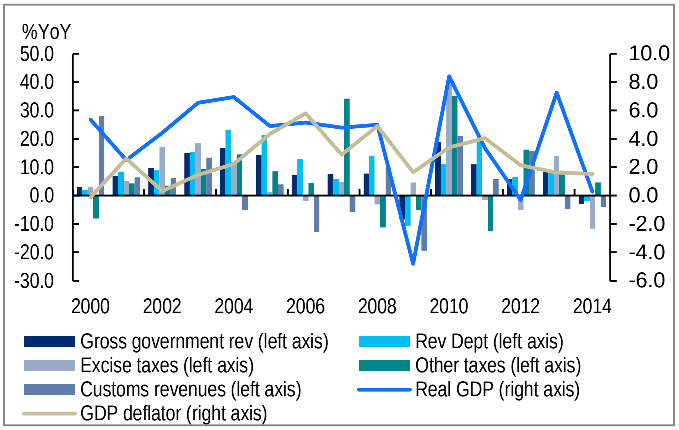
Core disinflation unlikely to be as rapid

Core uptick (1.7%YoY) despite declining energy prices in Dec strongly suggests muted 'contagion' oil price impact on a 'commodity basis' — Ex-rent, core inflation inched down to 1.84%YoY from 1.85% in Nov to further support limited oil pass-through effects on services and components of core. Slow disinflation was registered in several key core items. Fiscal objective of deterring faster transmission of lower oil prices that allowed OPSF surplus (Bt15.9bn as of end-Dec) and compensate past LPG/CNG subsidies may have contributed to core CPI bucking downtrend. However with sustained soft oil prices, we sense resumption of core disinflation is likely, as reflected by our updated monthly extrapolations hitting a low of 1.3%YoY-1.4%YoY in Apr-May (with base effects) and steady thereafter. With fiscal bias towards prioritizing energy pricing reforms, 2015 core disinflation pace may slowdown. Compression of non-core CPI due to declining oil prices would be the key driver to 2015 inflation averaging at 1% (vs BoT's mid-point inflation target of 2.5%).

Unchanged overnight rates with declining risk to growth

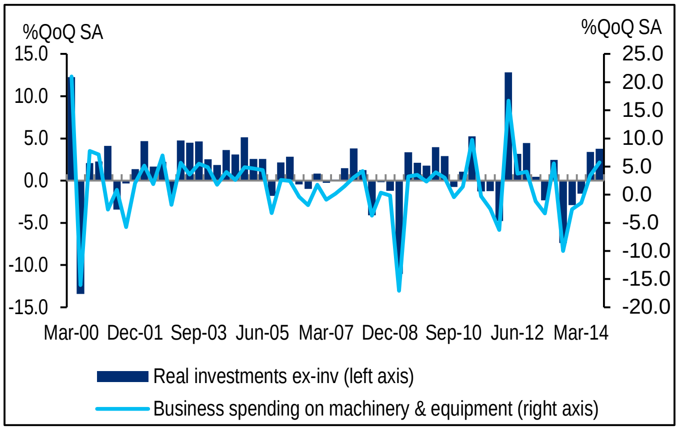
A shift to headline inflation as a policy target and a CPI trajectory that is likely to fall below BoT's mid-point inflation target doesn't necessarily guarantee a rate cut event, clarified by a senior BoT official — Another key trigger would be downside risk to growth which doesn't appear to be severe as it was in 1H14. While v-shaped recovery is no longer imminent, factors such as a functioning government (reforms being prioritized), windfall income gains from low oil prices and more promising investments, contribute to a sanguine GDP outlook that may not require another policy rate cut stimulus. A hefty current account surplus could mitigate THB's weakness against USD but shift to US monetary tightening remains a risk.

Figure 93. GDP impact on taxes is key to easing deficit overshooting



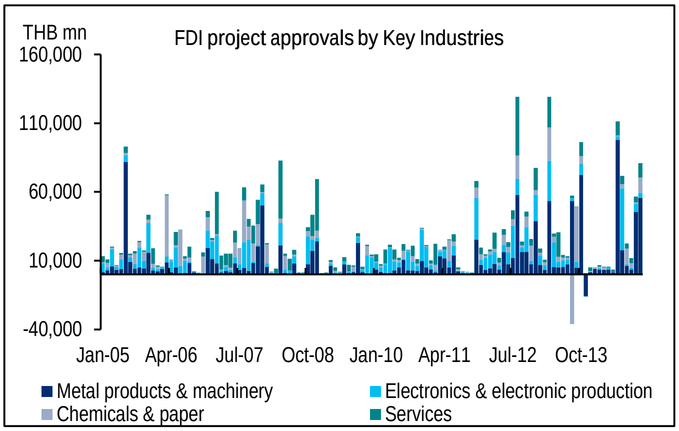
Source: CEIC, Citi Research

Figure 94. Real investments posted quarterly upticks



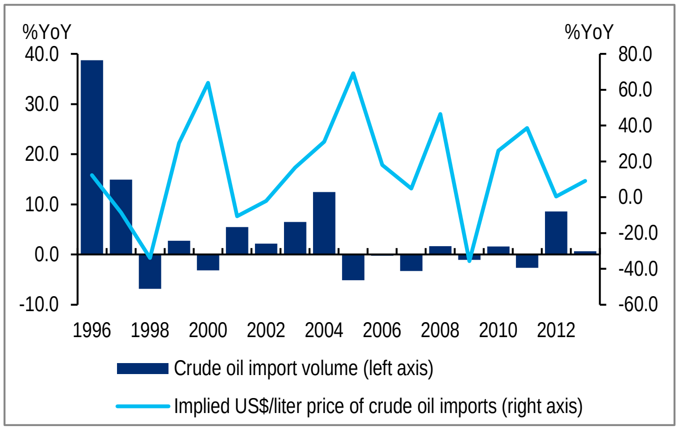
Source: CEIC, Citi Research

Figure 95. Investment approvals skyrocketed in June-July and Oct-Nov



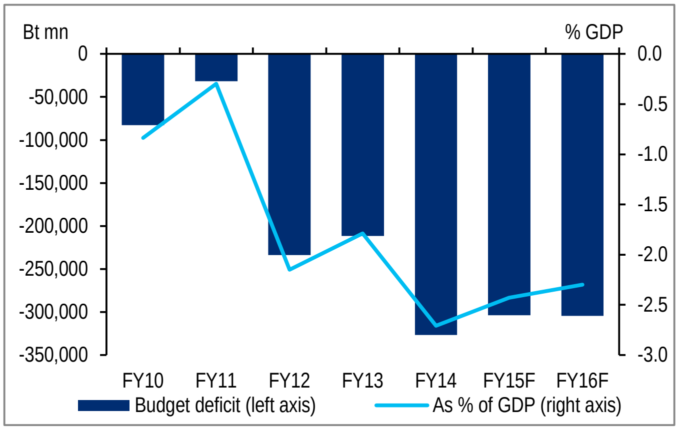
Source: CEIC, Citi Research

Figure 96. Oil import volume could perk up with an upbeat GDP outlook to ease the oil price effect



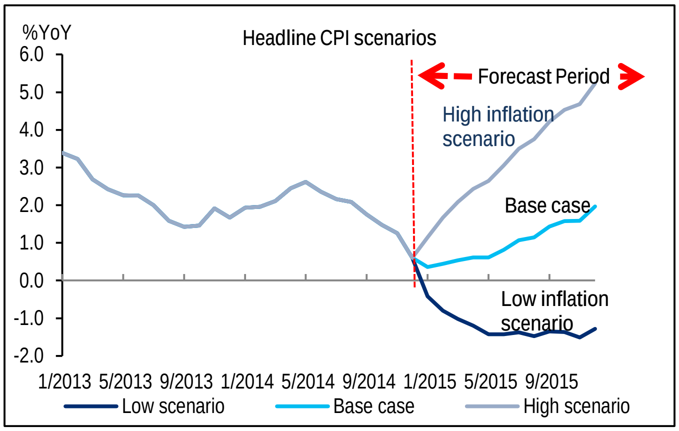
Source: CEIC, Citi Research

Figure 97. Actual budget gap could exceed the FY15 deficit target



Source: CEIC, Citi Research

Figure 98. Likelihood of moderately rising inflation in 2H15



Source: CEIC, Citi Research

Figure 99. Thailand Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	276.1	263.8	319.3	346.1	366.4	387.8	373.2	386.0	409.3
Nominal GDP, local currency bn	9,080	9,042	10,105	10,540	11,375	11,899	12,140	12,662	13,465
GDP per capita, US$	4,355	4,153	4,998	5,401	5,685	5,987	5,732	5,900	6,224
Population, mn	63.4	63.5	63.9	64.1	64.5	64.8	65.1	65.4	65.8
Unemployment, % of labour force	1.4	1.5	1.0	0.7	0.7	0.7	0.8	0.8	0.7
Economic Activity									
Real GDP, % yoy	2.5	-2.3	7.8	0.1	6.5	2.9	0.5	3.0	3.8
Real investment growth % yoy	8.1	-25.2	28.7	0.1	16.8	2.2	-9.1	1.9	8.0
Real consumption growth % yoy	2.9	0.1	5.1	1.3	6.8	1.1	0.8	3.4	2.9
private consumption growth % yoy	2.9	-1.1	4.8	1.3	6.7	0.3	0.5	3.0	2.6
Real export growth, % yoy	5.1	-12.5	14.7	9.5	3.1	4.2	-1.1	2.7	4.1
Real import growth, % yoy	8.9	-21.5	21.5	13.7	6.2	2.3	-4.7	2.3	4.8
Prices, Money & Credit									
CPI, % yoy	0.4	3.5	3.1	3.5	3.6	1.7	1.0	1.7	2.5
CPI, % avg	5.5	-0.9	3.3	3.8	3.0	2.2	1.9	1.0	2.1
Nominal wages, % yoy	10.5	-1.9	5.8	7.2	11.9	7.9	4.0	4.0	5.0
Credit extension to private sector, % yoy	6.3	2.5	18.8	18.3	14.0	10.5	8.5	10.0	11.2
Policy interest rate, % eop	2.75	1.25	2.00	3.25	2.75	2.25	2.00	2.00	2.50
Short-term market rate, % eop	3.07	1.28	2.03	3.26	2.79	2.31	2.09	1.70	2.25
Long term yield, % eop	2.84	4.37	3.74	3.28	3.55	4.07	2.87	3.00	3.75
lc/US$, eop	34.79	33.36	30.07	31.57	30.60	32.70	32.91	33.50	33.02
lc/US$, avg	33.21	34.33	31.71	30.48	31.08	30.72	32.48	33.44	33.20
Balance of Payments, US$ bn									
Current account	2.2	21.9	10.0	8.9	-1.5	-2.5	14.7	27.1	20.9
% of GDP	0.8	8.3	3.1	2.6	-0.4	-0.6	3.9	7.0	5.1
Trade balance	17.3	32.6	29.8	17.0	6.0	6.7	25.7	39.0	32.9
Exports	175.2	150.8	191.6	219.1	225.9	225.4	224.7	231.9	241.9
Imports	157.9	118.2	161.9	202.1	219.9	218.7	199.1	193.0	209.0
Net service and Transfer accounts	-12.9	-6.4	-10.7	-10.6	-3.4	3.7	-0.4	-0.8	1.0
Income balance	-2.3	-4.4	-9.0	2.5	-4.0	-12.8	-10.6	-11.1	-13.0
FDI, net	4.4	0.7	4.5	-2.8	-2.2	6.1	3.6	-1.0	2.5
International reserves	111.0	138.4	172.1	175.1	181.6	167.3	160.0	165.0	170.0
Total Amortisations	15.4	11.3	9.4	8.8	13.3	18.0	19.0	20.0	20.5
Public Finances, % of GDP									
Consolidated government balance	-1.0	-5.7	0.0	-1.0	-2.2	-1.8	-2.7	-2.4	-2.3
Consolidated gov primary balance	0.2	-4.5	1.1	-1.5	-1.6	-1.2	-1.8	-1.6	-1.3
Public debt	37.3	45.2	42.6	41.7	45.4	45.9	46.5	47.5	48.3
of which Domestic	33.0	40.9	39.0	38.4	42.3	42.7	43.2	44.2	44.8
Foreign Assets & Liabilities, US$ bn									
External debt	76.1	75.3	100.6	104.3	130.7	141.9	150.0	156.8	160.0
Private	72.7	69.4	87.9	88.1	104.5	116.7	120.0	125.3	127.0
Public	3.4	5.9	12.7	16.2	26.2	25.2	30.0	31.5	33.0
External debt / GDP	27.6	28.5	31.5	30.1	35.7	36.6	40.2	40.6	39.1
External debt / XGS	36.5	41.6	44.5	40.0	47.5	49.9	54.6	55.1	53.0
Short-term debt	32.5	33.3	50.7	47.3	58.2	61.9	62.0	63.5	65.8
Short-term debt/International Reserves (%)	29.3	24.0	29.4	27.0	32.0	37.0	38.8	38.5	38.7

Quarterly Economic Indicators

	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	0.4	0.6	1.5	2.1	3.0	3.3	3.5	3.7	3.8
CPI, % yoy	2.4	1.8	0.6	0.6	0.9	1.5	1.7	1.9	2.1
Policy interest rate, % eop	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.25
Short-term market rate, % eop	2.18	2.18	2.18	1.70	1.70	1.70	1.70	1.70	1.80
Long term yield, % eop	3.76	3.56	2.87	2.50	2.75	2.90	3.00	3.00	3.40
lc vs USD, eop	32.44	32.43	32.91	33.27	33.42	33.57	33.50	33.38	33.26

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). BOP is reported using BPM6.

Frontier Asia

Mongolia

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

Slightly late than expected but strong rate hike by BoM — Bank of Mongolia hiked its policy rate by 1ppt to 13% on 15 Jan, on the back of the 11% CPI inflation, MNT depreciation, lack of FDI revival and copper price decreases. Note that the MNT depreciated 13.7% in 2014 and a further 2.7% since the new year.

Parliament revised law to raise debt-GDP ratio to 58.3% of GDP — According to the previous Fiscal Stability Law, the public debt ceiling was set at 40% of GDP, and according to the Central Bank Governor the latest public debt level stands at 53%, thus this debt ceiling revision paves way to more concessional loans and possibility of quasi-sovereign bond issuance in late 2015.

The tumbling copper prices are taking toll on Mongolia exports & CA outlook — Mongolia's current account (CA) improved significantly thanks to the additional copper output of 148.4K tonnes by Oyu Tolgoi in 2014. Turquoise Hill expects the mine to produce another 175K-1958K in 2015E, however the sharp fall in copper prices would likely offset the expected volume increase in value terms.

TT successful tender not sufficient to excite the market, waiting for OT — The Shenhua Energy, Sumitomo Corporation and Energy Resource LLC consortium has won the bid for Tavan Tolgoi (TT) coal deposit, and this paves way to FDI to build railway and a 30mn tons of coal per year within 2.5 years. However, aside from a still dismal coal price outlook, we think most of the incremental revenues from coal exports from the new capacity would likely be used to repay the existing debt that ETT owes Chalco (as it is now transferred to the consortium).

The silence on OT2 front is keeping investors cautious — Aside from verbal commitments from the new PM at reviving large infrastructure projects including OT, investors are still waiting for: (1) the reviewing process of the Feasibility Study that is pending Minerals Council approval and (2) the MIGA documents submitted to the parliament by the then MP Saikhanbileg in Oct14.

Figure 100. Mongolia Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	5.6	4.6	6.2	8.8	10.3	10.3	11.2	13.5	16.3
GDP per capita, US$	2,138	1,717	2,287	3,186	3,595	3,525	3,762	4,461	5,325
Population, mn	2.6	2.7	2.7	2.8	2.9	2.9	3.0	3.0	3.1
Real GDP, % yoy	8.9	-1.3	6.4	17.5	12.4	11.7	6.5	9.0	8.0
CPI, % yoy	22.1	4.2	13.0	10.2	14.0	12.5	11.0	10.2	7.8
CPI, % avg	28.0	8.0	10.1	9.2	14.3	10.5	12.8	11.1	8.9
Policy interest rate, % eop	9.75	10.00	11.00	12.25	13.25	10.50	12.00	13.75	14.25
Long term yield, % eop	20.58	21.67	20.07	16.61	18.11	18.48	19.90	20.90	21.40
lc/US$, eop	1,275	1,433	1,233	1,378	1,378	1,660	1,888	1,846	1,791
lc/US$, avg	1,167	1,434	1,349	1,256	1,353	1,505	1,813	1,867	1,804
Current account (US$ bn)	-0.7	-0.4	-0.9	-3.4	-3.2	-3.2	-0.9	0.0	-0.9
% of GDP	-12.8	-8.9	-15.0	-38.4	-30.9	-30.9	-7.8	0.0	-5.8
Trade balance (US$ bn)	-0.7	-0.3	-0.3	-1.8	-2.4	-2.1	0.5	1.5	0.8
Exports (US$ bn)	2.5	1.9	2.9	4.8	4.4	4.3	5.8	6.1	6.2
Imports (US$ bn)	3.2	2.1	3.2	6.6	6.7	6.4	5.2	4.5	5.4
FDI, net (US$ bn)	0.8	0.6	1.6	4.6	3.9	-2.1	0.6	1.1	2.0
International reserves (US$ bn)	0.6	1.3	2.2	2.3	3.9	2.2	1.4	3.0	4.2
Consolidated government balance (% of GDP)	-4.5	-5.2	0.5	-6.9	-9.9	-7.3	-8.1	-7.2	-6.5
Public debt (% of GDP)	30.6	44.2	28.7	28.9	42.1	67.3	72.0	75.2	75.0
External debt (% of GDP)	38.8	65.1	95.7	109.9	149.2	184.1	182.9	158.7	134.3

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

Pakistan

Farouk Soussa
+971 4 509 9750
farouk.soussa@citi.com

Adrian Thomas
adrian.thomas@citi.com

On balance, we are bullish on Pakistan's macro outlook for 2015 — The conclusion of the IV and V IMF reviews resulted in the disbursement of a US$1.1bn disbursement in December as we had expected. This was made possible with the implementation of energy tariff hikes that could bolster the fiscal outlook in 2015, along with the fall in oil prices. We expect further progress on the programme, including further cuts in tax loopholes (SROs), implementing the Gas Infrastructure Development Cess (GIDC – a tariff on non-personal gas use), as well as other measures aimed at strengthening the tax base.

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

Finally, falling oil prices could provide some relief to external balances and inflation — We calculate that fall in oil prices will reduce the country's trade deficit by US$6.5bn in FY15, leading to a roughly balanced current account. This, along with softening food prices, will ease inflationary pressures and potentially allow the State Bank of Pakistan to continue cutting rates, as it did in November by 50bp to 9.5%. This will further support the economic growth outlook in the medium term.

This relatively rosy outlook is, of course, dependent on a supportive political environment — Although the protest movement which led to heightened uncertainty and partial government paralysis in August and September has receded greatly, the threat of social and political instability, especially in an environment of fiscal austerity, is ever present in our view, along with the corollary risk of military intervention, as highlighted by events in August. Moreover, rising anti-militant activity following the Peshawar attacks spells risks of greater terrorism.

Figure 101. Pakistan Economic Indicators

	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F	FY17F
Summary Data									
Nominal GDP, US$ bn	169.7	167.1	176.7	213.3	223.1	231.7	246.2	267.8	260.8
GDP per capita, US$	1,031	994	1,029	1,217	1,247	1,269	1,322	1,409	1,345
Population, mn	164.7	168.2	171.7	175.3	178.9	182.5	186.3	190.1	194.0
Real GDP, % yoy	1.7	2.8	1.6	2.7	3.5	4.4	5.4	4.5	4.3
CPI, % yoy	21.5	11.0	11.8	13.3	11.3	5.9	8.2	6.0	7.0
CPI, % avg	12.0	19.6	10.1	13.7	11.0	7.4	8.6	6.0	7.0
Policy interest rate, % eop	12.00	14.00	12.50	14.00	12.00	9.00	10.00	9.50	9.50
Long term yield, % eop	14.13	13.34	10.89	12.93	10.90	10.88	10.87	10.88	10.87
lc/US$, eop	79.1	84.4	85.7	89.9	97.3	105.4	100.8	102.8	116.0
lc/US$, avg	69.9	81.5	85.2	86.4	93.3	101.4	100.9	102.0	112.4
Current account (US$ bn)	-13.9	-9.3	-3.9	0.2	-4.7	-2.5	-3.0	0.0	-1.7
% of GDP	-8.2	-5.5	-2.2	0.1	-2.1	-1.1	-1.2	0.0	-0.6
Trade balance (US$ bn)	-14.8	-12.5	-11.5	-10.4	-15.7	-15.4	-16.5	-14.4	-15.1
Exports (US$ bn)	20.4	19.1	19.7	25.4	24.7	24.8	25.2	25.4	26.7
Imports (US$ bn)	35.3	31.7	31.1	35.8	40.4	40.2	41.7	39.8	41.8
FDI, net (US$ bn)	-5.3	-3.7	-2.1	-1.6	-0.7	-1.3	-1.5	2.9	4.5
International reserves (US$ bn)	11.1	11.6	15.1	17.7	14.2	8.0	11.2	11.2	11.2
Consolidated government balance (% of GDP)	-7.3	-5.2	-6.2	-6.5	-6.8	-8.2	-5.5	-4.8	-4.8
Public debt (% of GDP)	53.9	51.6	57.1	55.9	60.0	62.8	64.8	64.4	70.7
External debt (% of GDP)	27.2	31.3	34.8	31.1	29.3	26.3	26.6	28.0	28.1

Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and Citi Research estimates. * Pakistan Fiscal year runs from July-June. BOP is reported using BPM6.

Sri Lanka

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

Political change may bode well for safeguarding democratic institutions ... The surprise presidential win of opposition candidate Maithriapala Sirisena, with the handover of power going smoothly, is seen as positive for democracy – new government vowed to address issues corruption and "executive" presidency. One early move was the cabinet formation: Pres. Sirisena kept only one post (defense) while Rakapaksa held four (finance, highways, ports &shipping, and law & order) and the size of the rest of the cabinet was cut to 27 members (vs. Rajapaksa's 59).

…but we remain cautious over implications on the economy and policy-making for three reasons — First, we expect investment uncertainty will weigh highly – anti-corruption efforts would ensnare big projects (e.g. port city development) slowing investment at a time when construction contributed ~2%ppts to real GP growth (we downgrade our 2015F growth to 7.2%). We would not be surprised if under greater scrutiny, previously strong real GDP statistics is revised lower. Second, we see significant risk of a weaker coalition government given diverse parties and interests making up the new ruling coalition. Third and most importantly, fiscal discipline is at risk – the pronouncements on the upcoming interim budget suggest more spending (e.g. proposed wage hikes for government workers) with no talk of where revenues will come from (in fact, taxes of "essential goods" will reportedly be brought down) or acknowledgement of risks to high public debt.

We remove rate cut call in order to preserve FX "insurance" — All else equal, CA should benefit from lower oil (we estimate a 10% decline improves CA by ~0.3ppts of GDP), but recent export momentum is waning, and imports of consumer goods have accelerated sharply. For now, we don't materially change our 2015F CAD forecast but revise up the 2014F figure slightly (on the late year surge of imports). Sri Lanka has notable FX mismatch risks given its reliance on offshore borrowings, and CBSL has limited FX reserves. Notwithstanding benign inflation, in a strong USD environment, CBSL will likely need to safeguard external stability (portfolio outflows in fixed income is ~US$400mn since mid-2014), and thus, we remove our call for a rate cut for insurance purposes.

Figure 102. Sri Lanka Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	40.7	42.1	49.6	59.2	59.4	67.2	73.6	80.0	102.6
GDP per capita, US$	2,011	2,055	2,400	2,836	2,920	3,281	3,564	3,845	4,888
Population, mn	20.2	20.5	20.7	20.9	20.3	20.5	20.6	20.8	21.0
Real GDP, % yoy	6.0	3.5	8.0	8.2	6.3	7.3	7.7	7.2	7.1
CPI, % yoy	13.9	5.0	6.8	4.9	9.2	4.7	2.1	4.6	5.8
CPI, % avg	22.6	3.6	6.2	6.7	7.5	6.9	3.3	2.8	5.0
Policy interest rate, % eop	12.00	12.00	9.75	9.00	8.50	9.50	8.00	7.50	7.50
Long term yield, % eop	19.08	19.20	11.54	9.24	10.00	11.93	9.82	9.00	9.00
lc/US$, eop	113.0	114.4	110.9	113.9	127.7	130.8	131.2	129.0	129.0
lc/US$, avg	108.3	114.9	113.0	110.5	127.2	129.1	130.6	132.3	129.0
Current account (US$ bn)	-3.9	-0.2	-1.4	-4.6	-4.0	-2.6	-2.2	-2.1	-2.2
% of GDP	-9.5	-0.5	-2.8	-7.8	-6.7	-3.9	-3.0	-2.6	-2.1
Trade balance (US$ bn)	-6.0	-3.1	-5.2	-9.7	-9.4	-7.6	-7.7	-7.8	-8.6
Exports (US$ bn)	8.1	7.1	8.3	10.6	9.8	10.4	11.4	12.3	13.2
Imports (US$ bn)	14.1	10.2	13.5	20.3	19.2	18.0	19.0	20.1	21.8
FDI, net (US$ bn)	0.7	0.4	0.4	0.9	0.9	0.9	1.1	0.8	1.0
International reserves (US$ bn)	1.8	5.1	6.6	6.0	6.9	7.2	8.2	8.7	9.4
Consolidated government balance (% of GDP)	-7.0	-9.9	-8.0	-6.9	-6.4	-5.9	-5.4	-5.2	-5.2
Public debt (% of GDP)	81.4	86.1	81.9	78.5	79.2	78.3	75.9	75.0	73.0
External debt (% of GDP)	43.6	49.7	50.1	55.3	62.5	59.1	56.2	60.0	50.7

Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and Citi Research estimates. BOP is reported using BPM5.

Vietnam

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

Growth has outperformed expectations — Real GDP hit almost 6% in 2014, with optimism over continued manufacturing competitiveness (exports were up 12.8% in 2014, *far* outperforming the rest of Asia) and strong FDI inflows. We are optimistic that growth can accelerate a bit more in 2015-16 if global demand is aided by lower oil prices (Vietnam has been a *tiny* net oil importer in recent years). The conclusion of the FTA with Korea is an important boost (removing tariffs in >90% of goods), and FTA with EU is on track for completion soon. There are also palpable signs that despite lingering glut, the property sector may be turning a corner, with some help from the government's housing support policies. The government reported a sharp bounce in housing transactions in Hanoi and HCMC last year (up 100% and 30%, respectively), with signs that prices in prime locations inched marginally higher (though overall prices are still weak). Last Nov, the government also passed a new law that allowed foreigners with valid visa or foreign companies operating in Vietnam to finally be able to purchase residential properties.

Banking sector still faces challenges but credit is on the mend – watch Circular 36 — While inflation has decelerated sharply, nominal credit growth was still up about 12.6% in 2014, implying marginal support in the economy in real terms vs. being a significant drag in previous years. We expect monetary policy to remain accommodative – expect lower policy rates (by 50-100bps) to compliment earlier moves on the FX (1% dong deval). We are watchful of market impact of Circular 36 (effective Feb 1st) – among other prudential ratios, the circular caps government bonds at 15% of short term funds—but there are no signs of bond impact yet as domestic liquidity looks ample, supported by rising net foreign assets.

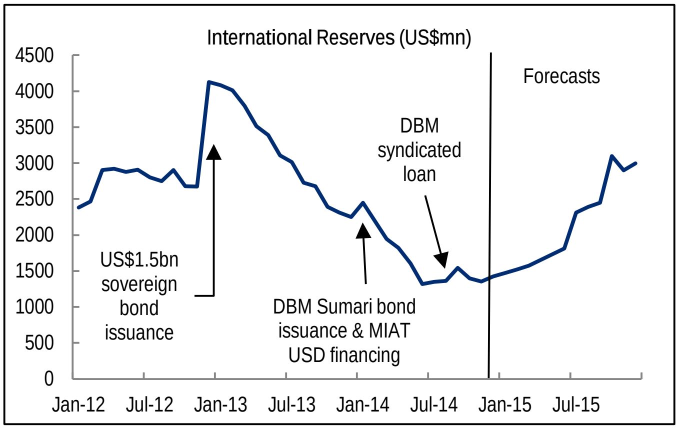
Weak public finances remain an ongoing issue — Weak revenues on the back of lower taxes and oil-related revenues, plus capex spending pressures, will likely keep fiscal deficits high (we estimate ~6% of GDP). Public debt will likely remain in an upward trajectory, testing the 65% public debt ceiling by possibly next year However, a rising proportion of debt is now funded domestically, and with appetite for offshore sovereign issue looking resilient, another deal is possible this year.

Figure 103. Vietnam Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, US$ bn	98.3	101.6	112.8	134.5	155.5	170.4	185.3	199.9	219.4
GDP per capita, US$	1,154	1,181	1,297	1,532	1,751	1,900	2,043	2,183	2,376
Population, mn	85.1	86.0	86.9	87.8	88.8	89.7	90.7	91.6	92.3
Real GDP, % yoy	5.7	5.4	6.4	6.2	5.2	5.4	6.0	6.2	6.4
CPI, % yoy	18.1	6.8	6.0	1.8	6.8	6.0	1.8	8.6	5.0
CPI, % avg	18.6	9.3	6.6	4.1	9.3	6.6	4.1	3.8	4.5
Policy interest rate, % eop	9.50	8.00	9.00	15.00	9.00	7.00	6.50	6.50	6.50
Long term yield, % eop	10.00	11.68	11.49	12.55	9.75	8.50	6.50	6.50	7.00
lc/US$, eop	17,483	18,474	19,498	21,034	20,840	21,095	21,388	21,767	21,659
lc/US$, avg	16,445	17,806	19,123	20,648	20,875	21,028	21,198	21,659	21,659
Current account (US$ bn)	-10.8	-6.6	-4.3	0.2	9.3	9.5	10.2	9.4	8.5
% of GDP	-11.0	-6.5	-3.8	0.2	6.0	5.6	5.5	4.7	3.9
Trade balance (US$ bn)	-12.8	-7.6	-5.1	-0.5	8.7	8.7	11.7	11.7	10.0
Exports (US$ bn)	62.7	57.1	72.2	96.9	114.5	132.1	149.0	166.2	186.1
Imports (US$ bn)	75.5	64.7	77.4	97.4	105.8	123.4	137.3	154.5	176.2
FDI, net (US$ bn)	9.3	6.9	7.1	6.6	7.2	6.9	7.0	7.2	7.4
International reserves (US$ bn)	23.9	16.4	12.5	13.5	25.6	25.9	38.1	49.0	59.3
Consolidated government balance (% of GDP)	-2.2	-7.2	-3.0	-3.2	-4.8	-5.6	-6.4	-6.0	-5.7
Public debt (% of GDP)	39.4	46.9	41.2	39.7	38.2	42.2	44.8	45.8	47.4
External debt (% of GDP)	31.0	36.6	38.1	38.1	38.1	38.4	38.0	38.6	38.4

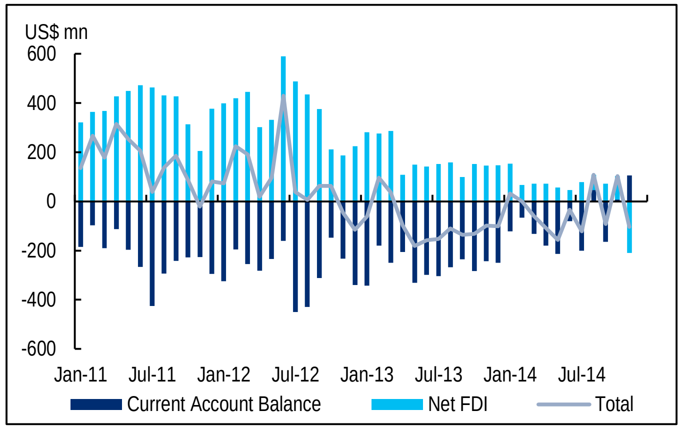
Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and Citi Research estimates

Figure 104. MONGOLIA – FX reserves to rise on foreign borrowings



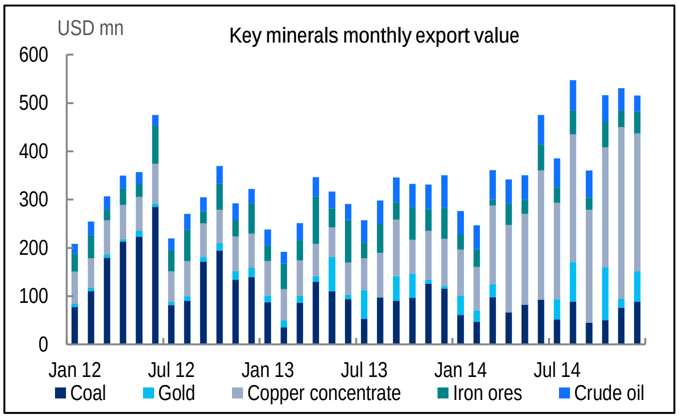
Source: BoM, CEIC and Citi Research

Figure 105. MONGOLIA – Negative FDI probably one-off, C/A continues to improve ...



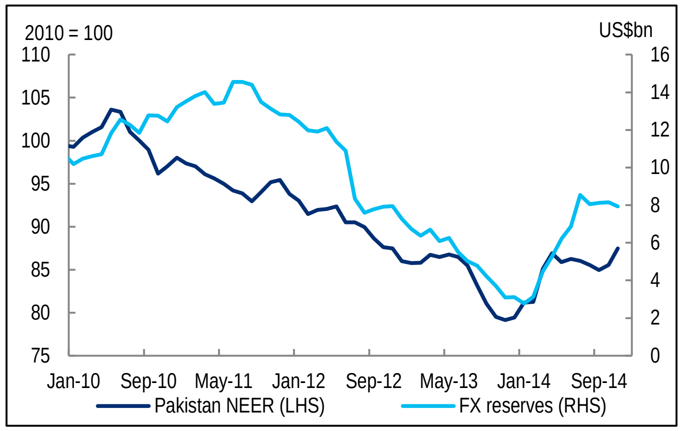
Source: BoM, CEIC and Citi Research

Figure 106. MONGOLIA – ... with the help of copper exports



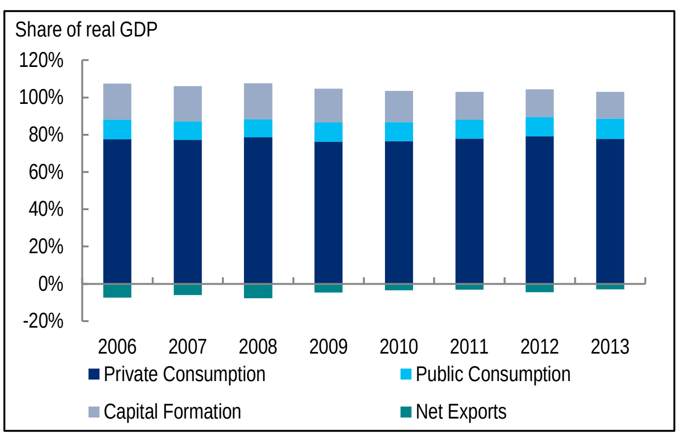
Source: BoM, CEIC and Citi Research

Figure 107. PAKISTAN – Reserves rebuilding on back of rupee strength



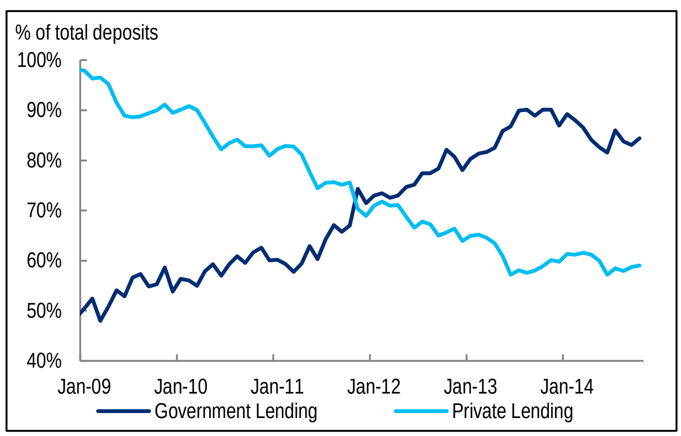
Source: Haver Analytics, Citi Research

Figure 108. PAKISTAN – While the private sector drives economic growth



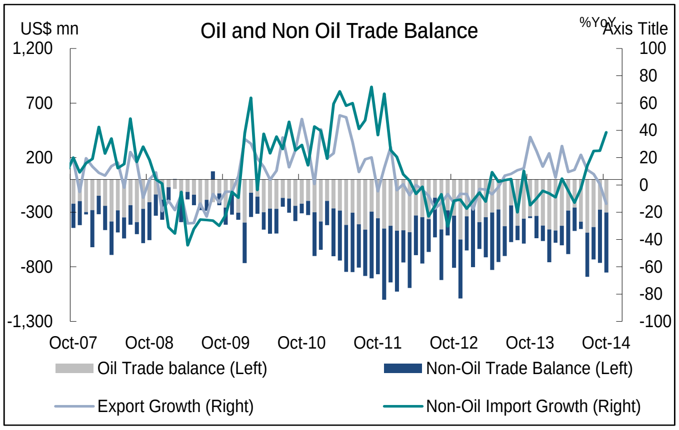
Source: Haver Analytics, Citi Research

Figure 109. PAKISTAN – The government has been crowding out private sector credit



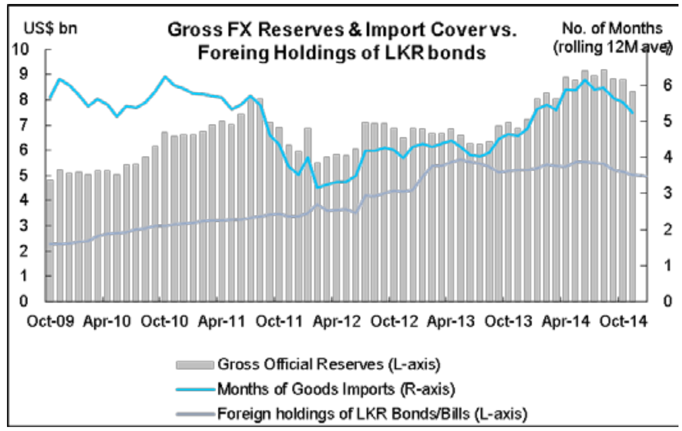
Source: Haver Analytics, Citi Research

Figure 110. SRI LANKA– Non-oil trade deficit is on the rise despite Oil balance improvement



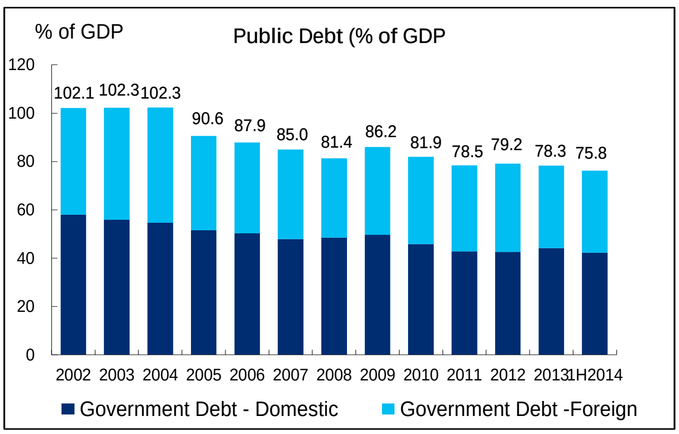
Source: CBSL, CEIC, Citi Research

Figure 111. SRI LANKA– FX Reserves are not at comfortable level – and on the decline



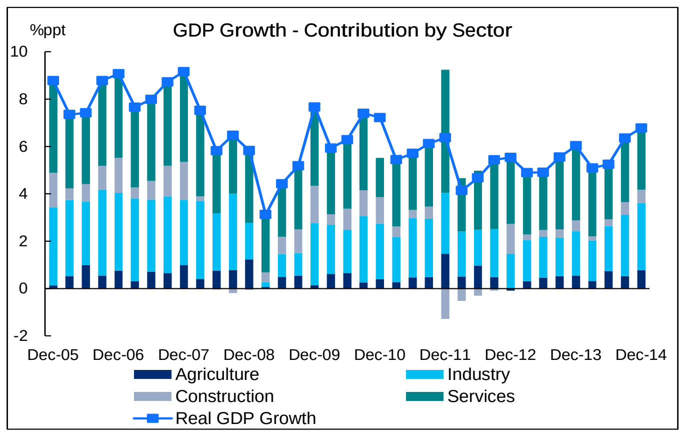
Source: Haver, CEIC, Citi Research

Figure 112. SRI LANKA– More fiscal spending by interim government doesn't bode well for fiscal consolidation



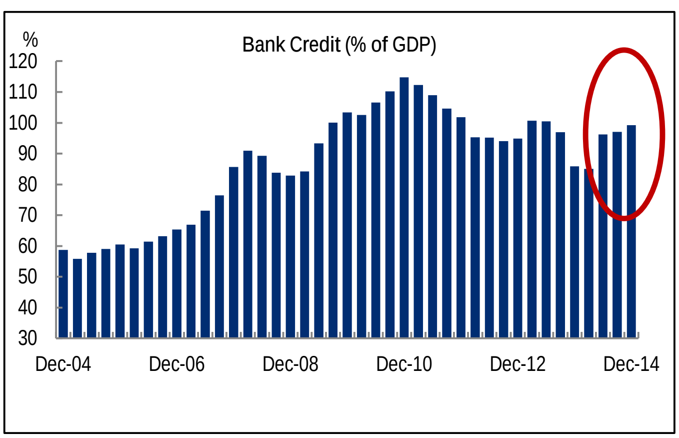
Source: Haver, Citi Research

Figure 113. VIETNAM – Real GDP posting broad-based growth



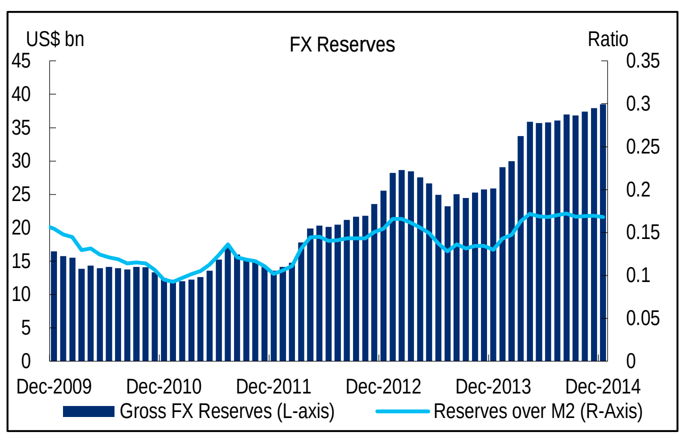
Source: Haver, CEIC, Citi Research

Figure 114. VIETNAM– Banking sector has stopped deleveraging



Source: Haver, CEIC, Citi Research

Figure 115. VIETNAM– FX reserves remain elevated



Source: Haver, IMF, Citi Research (Note: Dark shaded bars indicate estimates)

CEEMEA

Czech Republic

Jaromir Sindel
+420 233 061 485
jaromir.sindel@citi.com

- **Summary view** — For the first time since August 2014 we have slightly raised our 2015's GDP growth forecast by 0.2%pt to 2.5%YoY. This reflects a better dynamics in end of 2014, improved outlook on foreign demand, weaker koruna and lower oil prices. By contrast, we cut our CPI forecast for 2015 by 0.6%pt to 0.6%YoY due to lower oil and food prices, while domestic demand is inflationary.

- **Things to watch** — The impact of eventual ECB's QE on Czech koruna and assessment of CNB's Bank Board how ECB's QE could limit external disinflationary pressures in Czech economy. We believe that wage data from 1H15 will be important for CNB's Bank Board. If they are weak and our upwardly revised outlook on foreign demand becomes lackluster, it would be a reason to again expect more talks about the hike in EURCZK floor. We expect the gov´t to continue, but summer discussion about 2016´s budget could be hot.

- **Strategy** — We keep our outlook for a weaker koruna compared to its performance in 2014, though we do not assume a hike in the EURCZK floor. We continue to expect the CNB's exit from this floor to 4Q16, with the first hike in policy rate in 1Q17, but we expect a milder increase in policy rate than before and we see a risk of later exit from the FX intervention mode if ECB's QE program is prolonged beyond 2016. Light bond issuance, together with the ECB's QE, are likely to be supportive for Czech 10y yields.

Better growth prospect

The new data and assumptions suggest a slightly stronger growth. What has changed since end of November, when the last forecast was prepared? First, the oil prices fell by 44% in CZK terms since end of 3Q14. Second, while the total CPI at 0.1%YoY in Dec14 undershot the CNB's forecast, the adjusted core CPI accelerated to 1.1%, the highest annual growth since end of 2008. Third, our momentum guide based on monthly economic data is supportive for stronger quarterly GDP growth in 4Q14 than our forecast of 0.6% and 0.4% seen in 3Q14. Fourth, December confidence suggests even stronger GDP growth in 4Q14. Fifth, the outlook on GDP growth of Czech trade partners improved for 2015.

Hence, we increased our GDP growth estimates by 0.2%pt for 4Q14 and similarly for 2015. Our momentum guide suggests a stronger GDP growth in 4Q14. Industrial production increased by 1.2%MoM in November, slightly above our forecast of 1%, and 4.7%YoY swda. Though retail sales decelerated to 0.8%YoY nsa (due to fewer working days), total retail sales increased by 0.4%MoM and by 0.2% excluding cars. Moreover, the core segment (ex. food and fuel) has posted solid gain as well. By contrast, construction output fell by 1.8%MoM. Car production growth recovered to 15%YoY in December that is supportive for industrial production, where the PMI and confidence points to around 4%YoY growth in the near-term. On the back of that we slightly increased our estimate of GDP growth dynamics to 0.8%QoQ from previously forecasted 0.6% in 4Q14. If our forecast materialized, the annual growth should show a milder deceleration to 2%YoY from 2.4% in 3Q14. The confidence indicator suggests even a better GDP dynamics at 3.5%YoY in 4Q14. This and better outlook on foreign demand (supported by weaker koruna in effective terms) and lower oil prices lead to revise upward also our 2015's GDP growth forecast to 2.5%YoY from 2.3% forecasted initially. Stronger outlook on foreign demand and continuous currency weakness lead to a mild upward revision in 2016´s GDP growth, with slightly lower unemployment rate.

Lower inflation, but we do not expect higher EURCZK floor

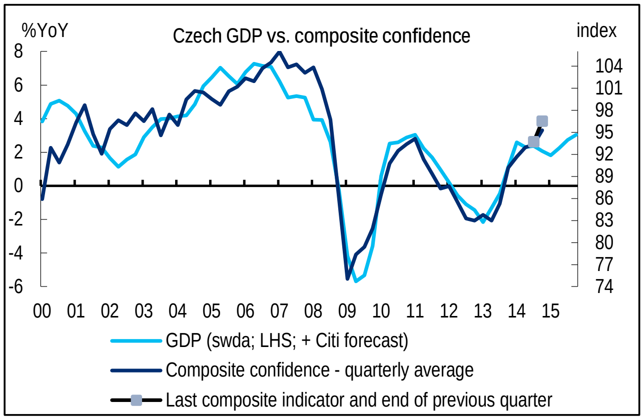
Though we expect a larger disinflation, but CNB's Governor and Chief Economist do not call for higher EURCZK floor. We cut our 2015's CPI growth forecast to 0.6%YoY from 1.2% forecasted in late November. Major part of this revision reflects lower oil prices and partly also lower food and energy prices. By contrast, the adjusted core CPI was slightly revised upward reflecting weaker koruna and slightly stronger economy. The CNB´s Chief Economist Tomas Holub said (at Czech Television on Sunday, 11 January) that we cannot exclude a possibility of hike in EURCZK floor, but he stressed that the December Minutes from the CNB´s Bank Board meeting show that current drop in oil and gas prices represents a benign supply side shock, which will support profit margins and demand in the Czech economy. Though, CNB´s Holub does not exclude negative prints of annual CPI growth 1H15 due to lower oil prices, he does not see a risk of long-term deflation due to weak domestic demand. Hence, it will be worth to watch wage data, if they are negatively influenced - in real terms - by lower CPI growth. Governor Singer also mentioned experience from the surge in oil and food prices in 2008, when the secondary impact was negligible. By contrast, he mentioned that secondary impact could actually partly offset the primary impact of lower commodity prices (as Czech is net importer of oil, in contrast to electricity, of which is net exporter, to compare the story from 2013). On balance, these comments support our expectations of keeping the EURCZK floor for longer than to hike this floor. This our view holds until there is a drop in foreign demand or ECB fails to deliver monetary easing (to limit external disinflationary pressures coming to Czech economy) or until the Czech labour market/domestic demand worsen.

We slightly increased our short-term forecast from previous month. However, this rather reflects the USD move than local factors as we still believe that current deflation risk (caused by commodities, not by domestic demand) will be not reflected in CNB's hike in EURCZK floor, but rather in prolonged period of CNB's intervention regime. This could lead to cut in short CZK positions of leverage money in the short-term. Meanwhile, we think that koruna will be supported by ECB's policy and solid economic recovery, including the exports. By contrast, trend of stronger USD and low-inflation environment will be negative-koruna forces. Our 2year forecast with EURCZK at 27 reflects our view that CNB will exit from EURCZK floor by end of 2016 or later if ECB does not meet our QE's expectations.

2015 should see limited bond supply

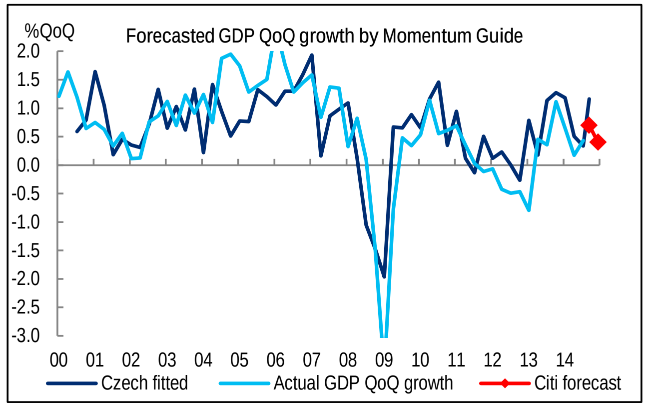
Though the annual central gov't cash deficit widened on monthly basis to CZK78bn ytd in December (1.8% of GDP), it was by CZK4bn narrower compared to its performance in 2013 and by CZK34bn narrower compared to initial plan for 2014. We can decompose the positive surprise into three areas. First, some 50% of narrower outcome reflects the improvement in economy. Second, net interest rate expenditures were lower by CZK10bn (and likely similarly in 2015). Third, non-investment expenditures and transfers to state funds by CZK16bn compared to plan. For 2015 the central gov't cash deficit is planned at CZK100bn (-2.2%of GDP). Proposed revenues (CZK1,118bn) suggests to us they will fall by 1%YoY due to expected lower EU funds inflow (-30%YoY), while we assume the MinFin expect 2% increase in tax and social insurance revenues in 2015. The expenditures are likely to increase by 1% in 2015 compared to 2014. Our baseline scenario suggests tradable T- bond issuance at CZK145bn in 2015 after the issuance of CZK153bn in 2014. The fact that bond issuance is lower than GFN reflects the rollover of T-bills and utilization of the single treasury account. Overall, it looks that net local tradable bond issuance will likely reach CZK17bn in 2015 and CZK39bn in 2016.

Figure 116. December confidence data is an upside risk to our GDP forecast ...



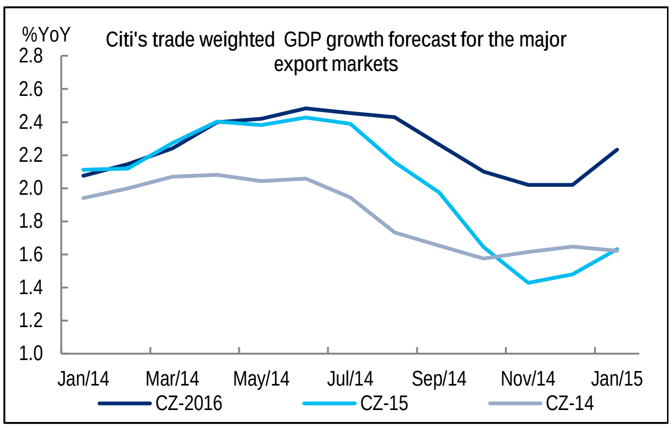
Source: CZSO, Citi Research forecast

Figure 117. We increased our 4Q's GDP growth forecast due to a better momentum guide



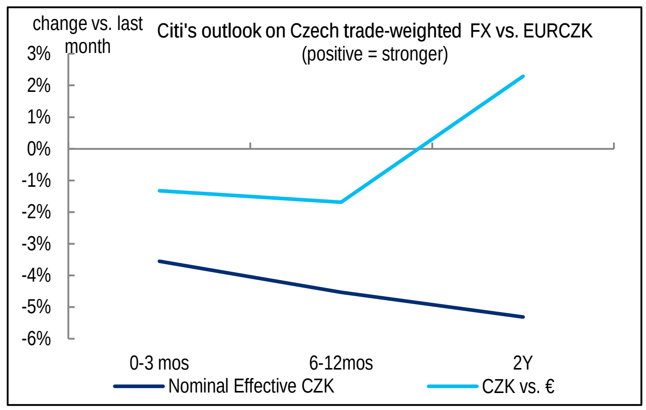
Source: CZSO, Eurostat, Citi Research calculation and forecast

Figure 118. Outlook on foreign demand improved for both 2015 & 2016



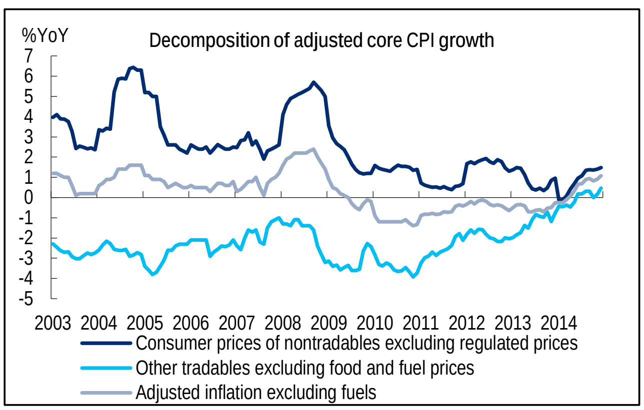
Source: Citi Research calculation and forecast

Figure 119. ... should be supported by weaker koruna in effective terms



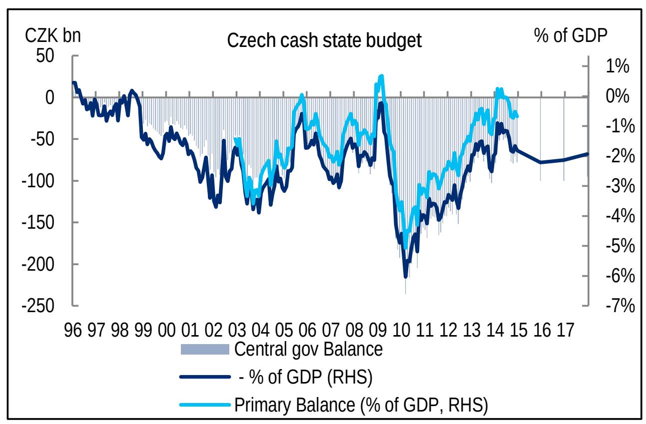
Source: Citi Research calculation and forecast

Figure 120. While oil prices are clearly disinflationary, the adjusted core CPI was slightly above CNB's forecast in December



Source: CNB, Citi Research.

Figure 121. For 2015 the central gov't cash deficit is planned at CZK100bn (-2.2%of GDP)



Source: Haver Analytics, Citi Research calculation. Note: Total deficits for 2015-17 are gov't plans.

Figure 122. Czech Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	235	206	207	227	207	209	219	217	189
Nominal GDP, local currency bn	4,015	3,922	3,954	4,022	4,048	4,086	4,281	4,514	4,696
GDP per capita, USD	22,552	19,609	19,684	21,655	19,673	19,865	20,791	20,649	17,976
Population, mn	10.4	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5
Unemployment, % of labour force	4.4	6.7	7.3	6.7	7.0	7.0	6.1	5.6	5.3
Economic Activity									
Real GDP, yoy avg	2.7	-4.8	2.0	2.2	-0.8	-0.7	2.3	2.5	3.1
Real investment growth % yoy	1.2	-18.1	4.4	1.9	-3.7	-5.1	6.0	6.3	8.2
Real consumption growth % yoy	2.4	0.4	0.8	-0.7	-1.5	0.9	1.5	1.7	2.3
private consumption growth % yoy	2.9	-0.7	1.0	0.2	-1.8	0.4	1.6	2.3	2.5
Real export growth, % yoy	4.2	-9.8	14.8	9.3	4.1	0.3	7.5	5.6	8.6
Real import growth, % yoy	3.2	-11.0	14.9	6.7	2.4	0.3	8.4	5.9	10.1
Prices, Money & Credit									
CPI, % yoy eop	3.6	1.0	2.3	2.4	2.4	1.4	0.1	1.1	2.4
CPI, % avg	6.3	1.0	1.5	1.9	3.3	1.4	0.4	0.6	2.2
Nominal wages, % yoy	7.9	3.4	2.2	2.5	2.5	0.0	2.9	3.0	4.4
Credit extension to private sector, % yoy	16.1	0.8	3.0	5.5	2.6	3.7	3.2	6.4	6.0
Policy Interest Rate, % eop	2.25	1.00	0.75	0.75	0.05	0.05	0.05	0.05	0.05
3 month inter-bank rate, %, eop	3.63	1.54	1.22	1.17	0.50	0.38	0.34	0.30	0.25
Long-term yield, %, eop	4.15	4.01	3.86	3.69	1.90	2.30	0.76	1.00	1.50
CZK/US$, eop	19.2	18.4	18.7	19.8	19.0	19.9	22.9	26.0	28.3
CZK/US$, avg	17.0	19.0	19.1	17.7	19.5	19.6	20.7	25.2	27.4
CZK/EUR, eop	26.8	26.4	25.0	25.6	25.1	27.3	27.7	27.9	27.0
CZK/EUR, avg	25.0	26.4	25.3	24.6	25.1	26.0	27.5	28.0	27.4
Balance of Payments, USD bn									
Current account	-4.4	-5.1	-7.7	-4.8	-3.2	-2.9	0.0	0.4	-1.6
% of GDP	-1.9	-2.5	-3.7	-2.1	-1.6	-1.4	0.0	0.2	-0.8
Trade balance	0.0	3.5	2.0	4.3	6.4	8.3	11.5	13.5	10.6
Exports	127.8	103.2	114.9	135.2	136.1	136.1	145.3	130.5	131.1
Imports	127.8	99.7	112.9	130.9	129.6	127.8	133.8	117.0	120.5
Service balance	5.4	4.4	4.1	4.5	4.0	3.5	2.7	2.3	1.8
Income balance	-9.0	-11.9	-13.1	-12.6	-12.3	-14.2	-14.8	-15.0	-13.5
FDI, net	-2.2	-1.9	-5.0	-2.6	-6.2	-2.9	-6.8	-4.0	-4.0
International reserves	36.5	39.7	40.3	37.9	42.4	53.9	54.6	48.1	43.2
Total amortisations	4.2	6.2	5.4	8.6	5.9	7.6	7.1	5.9	5.8
Public Finances, % of GDP									
Consolidated government balance	-2.1	-5.5	-4.4	-2.9	-4.0	-1.3	-1.9	-2.3	-2.0
Consolidated gov primary balance	-1.1	-4.3	-3.1	-1.5	-2.5	0.0	-0.2	-1.5	-1.1
Public debt	28.7	34.1	38.2	41.0	45.5	45.7	43.8	41.7	41.6
of which Domestic	19.9	23.3	24.7	33.1	37.9	36.9	35.8	34.1	33.9
Foreign Assets & Liabilities, USD bn									
External debt	96.3	106.5	115.4	116.0	127.7	136.9	122.5	111.2	104.9
Public	15.3	21.0	25.2	23.8	29.5	31.4	28.0	25.3	23.8
External debt / GDP	40.9	51.8	55.8	51.0	61.8	65.6	56.0	51.2	55.4
External debt / XGS	63.4	85.7	84.4	72.7	79.5	85.7	72.1	72.7	68.4
Short-term debt	38.1	37.2	39.6	43.7	44.4	51.7	46.0	41.7	39.4
Short-term debt/International reserves (%)	104.4	93.8	98.2	115.3	104.6	95.9	84.3	86.8	91.1

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	2.3	2.4	2.1	1.8	2.2	2.7	3.0	3.3	3.3
CPI, % yoy eop	0.0	0.8	0.1	0.2	0.6	0.9	1.1	2.3	2.2
Policy interest rate, %, eop	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Short-term market rate, % eop	0.35	0.35	0.34	0.30	0.30	0.30	0.30	0.30	0.30
Long-term yield, %, eop	1.55	1.20	0.76	0.63	0.75	0.88	1.00	0.23	0.35
CZK/EUR, eop	27.45	27.50	27.66	28.02	28.06	28.09	27.92	27.70	27.48

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

Egypt

David Cowan
+44 20 7986 3285
david.cowan@citi.com

- **Summary view** — The holding of parliamentary elections in April 2015 will mark the end of the political roadmap. While with the holding of a major investor and development conference in March, the focus will be increasingly on the economy.
- **Things to watch** — Gulf support has helped stabilize the exchange rate. But reserves have fallen in the final months of 2015 and there is still a backlog of foreign exchange shortages. Coupled with a strong US dollar, this may push the CBE to allow a moderate weakening of the EGP at some point in 2015.
- **Strategy** — The government plans to outline a comprehensive plan/vision for the economy at its investor and development conference to rebalance the economy away from its recent dependence on consumption. But significant fiscal consolidation remains unlikely.

The end of the roadmap, improving security

Late April 2015 should mark the end of the president's political roadmap with the holding of parliamentary elections. And while the executive will continue to be politically dominant, the elections are important as we believe they would illustrate to the international community that the president, Abdelfattah el Sisi, can deliver on his promises. But after years of political turmoil, the weak and fragmented nature of political parties in Egypt probably means that no political party will be able to mount a successful campaign to secure a parliamentary majority.

But with parties coalescing into various coalitions, we expect that the president will be able to construct a supportive parliamentary alliance. Moreover, even if he were to face pressure in achieving this, his ability to appoint 27 MPs means that he has a fall back trump card if required. Following the election of a new parliament it will also be interesting to see the composition of a new government. We would expect only modest changes, and the new government not to differ significantly from the current broadly technocratic government that is committed to pushing ahead with economic reform.

With the roadmap completed, we believe the president is likely to increasingly focus his attention on restoring the security situation in the country, notably in the Sinai. This is arguably not only important as part of the country's economic recovery, but important to maintain his popularity. In light of this, we would expect the government to continue the ongoing clampdown on the Muslim Brotherhood (MB). But pushing the MB underground raises the risk of it returning to the low level insurgency of the 1990s. And the challenge for the new president is to get the balance right in terms of ensuring the clampdown is on more radical groups, while allowing enough political space to emerge in a country that has clearly been through a major political awakening in the last three years.

Attracting investment and boosting growth

In addition to the elections, the other focus of early 2015 will be the government's planned investor and development conference. This is set to be held in March, with two goals. First to sell the Egyptian story to investors and outline a range of new reforms and initiatives. These are likely to include large domestic mega projects, such as around the Suez Canal, but also projects based around the theme of growth with social justice, such as the building of low-cost housing or improving health and education facilities in the country. The government will also stress its interest in PPP infrastructure projects.

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

Fiscal stabilisation, so the focus is on monetary policy

We do not expect a significant reduction in the fiscal deficit in the coming years. Instead, the best way to think about fiscal policy is that it will first seek to achieve fiscal stabilization against the background of two additional goals: maintaining the current investment push and the government's view that there is overwhelming need to prioritise social spending with any spare revenue. It is only when there is clear progress with these two goals and an upturn in revenue will it then move ahead with fiscal consolidation.

As such, the main policy focus is likely to be on monetary policy. As long as there is ongoing provision of Gulf support in 2015, we believe the Central Bank of Egypt (CBE) will continue to clear the foreign exchange backlog and rebuild reserves. But it may have to allow a gradual weakening of the EGP, with greater flexibility, as the US dollar continues to strengthen on global markets, although any moves will be cautious and gradual in our view.

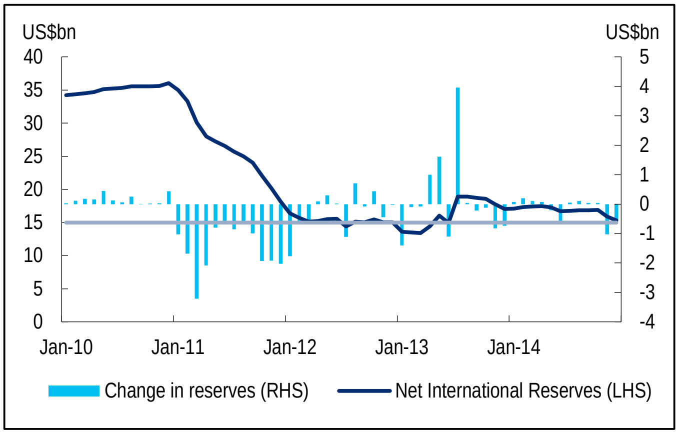
Meanwhile, the overall thrust of monetary policy still seems to be on an easing bias. Although policy was quickly tightened following the decision to reduce the fuel price subsidy, which has pushed up inflation in 2H 2014, this was illustrated by the early 50 basis point in the overnight lending rate in January 2015. This was justified by lower global oil prices, but we still have concerns over the inflation outlook related to whether the government moves to implement VAT and whether it opts for further fuel subsidy cuts in the 2015/16 budget. Both would push up inflation, potentially delaying any further easing of monetary policy until late 2015.

The need for reality

With the end of the political roadmap drawing near, it is clear that an economic roadmap for Egypt is emerging. This is likely to become a formalised policy during 2015, but the lack of fiscal consolidation and differing views over the exchange rate mean reaching a deal with the IMF may be difficult to achieve. And it is worth stressing that the current fragile economic stability is still heavily dependent on the current high levels of Gulf support which we expect to continue. But we do expect private transfers to start to fall back in the coming years, and this will continue to highlight the need to rebalance the economy away from personal consumption, and to boost growth in investment, tourism and agriculture

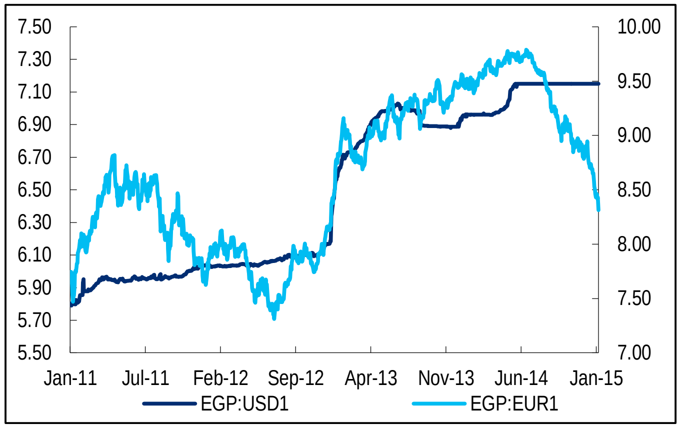
And arguably on a positive note, the lack of an IMF deal also highlights that the government remains realistic in what can be achieved and what is politically possible. The reality remains that even as the recovery gains traction, the state of the economy is still precarious after years of political turmoil and political views remain highly polarised. When set against the background of longer-term structural issues, such as a weak civil service and a poor education system, we think the realities of running the country while boosting growth and job creation are likely to become quickly apparent to the new president in 2015-16, even as political stability improves.

Figure 123. Reserves have stabilised since late 2013, but remain low



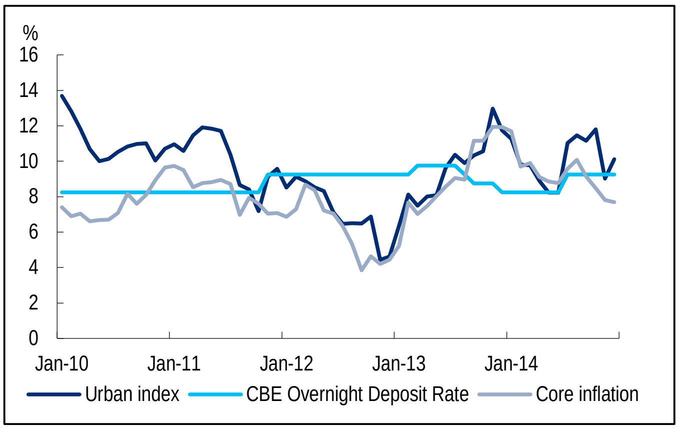
Source: Central Bank of Egypt, Haver Analytics

Figure 124. EGP –Recent stability against the US dollar; strengthening quickly against the EUR



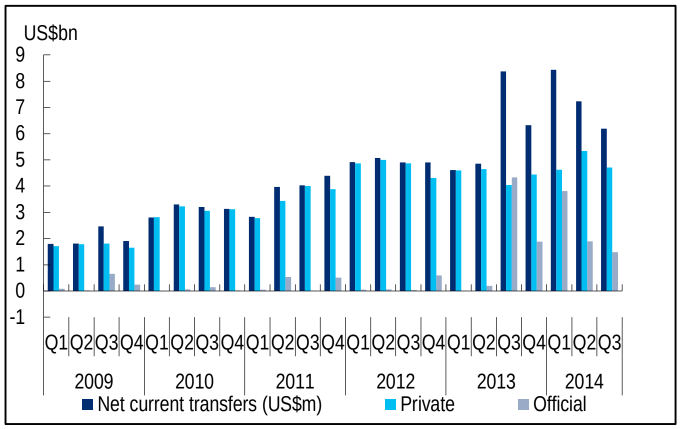
Source: Reuters

Figure 125. Despite the rate rise in mid-2014, monetary policy still seems to be on an easing bias



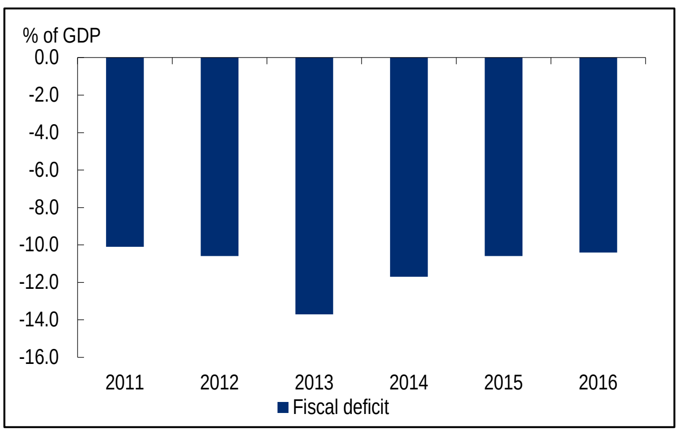
Source: Central Bank of Egypt, Haver Analytics and Citi forecasts for 2H 2013

Figure 126. Robust transfers have limited the deterioration in the current account and helped support consumption



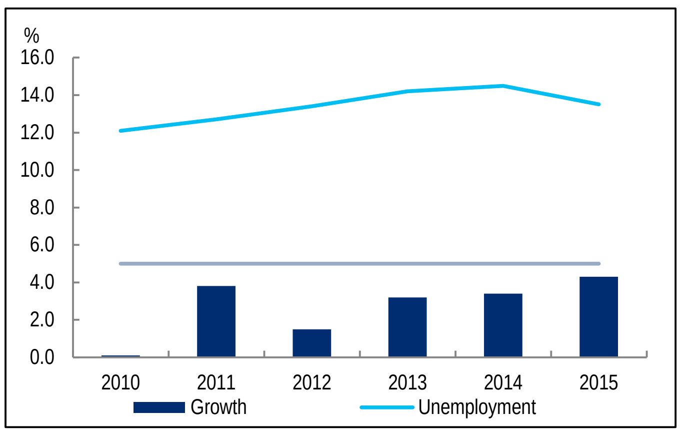
Source: Central Bank of Egypt, Haver Analytics

Figure 127. Only slow fiscal consolidation is likely going forward



Source: Haver Analytics and Citi forecasts for 2013-2015

Figure 128. A slow recovery should gain momentum in 2015-16



Source: Haver Analytics and Citi forecasts for 2013-15

Figure 129. Egypt Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	165	188	214	231	260	255	280	305	337
Nominal GDP, local currency bn	977	1,124	1,308	1,461	1,663	1,887	1,980	2,223	2,512
GDP per capita, USD	2,187	2,454	2,755	2,920	3,233	3,115	3,366	3,613	3,923
Population, mn	75.4	76.6	77.8	79.1	80.4	81.7	83.1	84.4	85.8
Unemployment, % of labour force	8.7	9.4	9.0	12.0	12.7	13.2	14.2	14.5	13.5
Economic Activity									
Real GDP, yoy avg	6.0	4.6	5.5	0.1	3.8	1.5	3.2	3.4	4.3
Real investment growth % yoy	9.2	-10.0	12.2	-3.6	7.2	-10.8	9.5	12.1	19.4
Real consumption growth % yoy	5.4	4.7	4.9	4.3	5.3	2.1	3.7	2.6	2.1
private consumption growth % yoy	5.7	4.6	5.0	4.6	5.7	2.0	3.9	2.8	2.1
Real export growth, % yoy	14.1	-18.8	8.1	-12.5	-5.0	1.5	-2.8	5.6	6.0
Real import growth, % yoy	13.7	-24.0	10.5	-0.9	5.4	-3.9	4.8	7.2	6.7
Prices, Money & Credit									
CPI, % yoy eop	18.4	13.2	10.6	9.5	4.7	11.7	10.1	8.5	8.9
CPI, % avg	18.3	11.8	11.1	10.1	7.1	9.5	10.1	8.9	8.7
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	12.0	3.0	6.7	6.1	7.6	6.4	6.3	7.6	9.0
Policy Interest Rate, % eop	11.50	8.25	8.25	9.25	9.25	8.25	9.25	8.00	8.50
1 month inter-bank rate, %, eop	11.95	8.30	8.30	10.05	10.10	9.25	9.25	8.95	9.39
Long-term yield, %, eop	9.00	9.00	9.00	9.50	10.00	13.50	11.00	10.00	10.50
EGP/US$, eop	5.50	5.48	5.81	6.03	6.36	6.95	7.15	7.40	7.60
EGP/US$, avg	5.44	5.55	5.63	5.94	6.07	6.87	7.08	7.29	7.46
Balance of Payments, USD bn									
Current account	-1.3	-3.2	-5.6	-7.9	-9.5	-3.5	-5.5	-6.9	-9.9
% of GDP	-0.8	-1.7	-2.6	-3.4	-3.7	-1.4	-2.0	-2.3	-3.0
Trade balance	-26.8	-22.5	-27.7	-28.5	-34.7	-29.3	-36.8	-35.7	-38.3
Exports	29.8	23.1	25.0	27.9	25.1	26.5	25.8	22.7	23.5
Imports	56.6	45.6	52.7	56.5	59.8	55.8	62.6	58.4	61.8
Service balance	15.7	11.3	9.6	5.4	5.4	1.6	3.4	3.2	3.5
Income balance	-	-	-	-	-	-	-	-	-
FDI, net	7.6	6.1	5.2	-1.1	5.8	3.9	5.6	6.9	8.4
International reserves	34.2	34.2	36.0	18.1	15.0	17.1	15.3	17.3	19.8
Total amortisations	1.8	2.4	2.0	2.2	2.3	2.5	2.8	3.1	3.4
Public Finances, % of GDP									
Consolidated government balance	-6.4	-6.6	-7.7	-10.1	-10.6	-13.7	-11.7	-10.6	-10.4
Consolidated gov primary balance	-1.8	-2.4	-2.6	-4.5	-4.7	-6.0	-2.7	-1.1	-1.1
Public debt	53.5	54.0	59.8	69.0	77.7	78.6	77.0	75.3	76.6
of which Domestic	53.5	54.0	59.8	69.0	77.7	78.6	77.0	75.3	76.6
Foreign Assets & Liabilities, USD bn									
External debt	32.1	33.3	35.0	33.7	38.8	45.8	37.0	39.7	49.2
Public	26.0	27.2	28.3	27.4	32.8	40.5	31.5	31.5	31.5
External debt / GDP	19.5	17.7	16.3	14.6	14.9	18.0	13.3	13.0	14.6
External debt / XGS	55.6	73.0	70.9	71.1	82.4	101.7	79.9	91.7	109.0
Short-term debt	2.8	2.6	3.1	3.0	6.7	2.8	2.8	2.8	2.8
Short-term debt/International reserves (%)	8.3	7.5	8.7	16.7	44.3	16.5	18.5	16.3	14.3

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	1.8	3.0	3.2	3.0	3.2	3.0	3.5	4.0	5.5
CPI, % yoy eop	8.2	11.2	10.1	9.2	11.4	7.9	8.5	8.4	8.7
Policy interest rate, %, eop	8.25	9.25	9.25	8.75	8.75	8.75	8.00	8.00	8.25
Short-term market rate, % eop	9.25	9.25	9.25	9.69	11.82	8.38	8.95	8.85	9.17
Long-term yield, %, eop	13.50	13.00	12.50	12.00	11.50	11.50	11.00	11.00	11.00
EGP/US$, eop	7.15	7.15	7.15	7.30	7.20	7.35	7.40	7.40	7.45

Source: National Sources, Citi Research forecasts

GCC

Farouk Soussa
+971 (4) 509 9750
farouk.soussa@citi.com

Adrian Thomas
adrian.thomas@citi.com

Saudi Arabia

As our oil price forecast for 2015 was cut to US$63 per barrel in January, from US$80 previously, we have updated our forecasts for all GCC countries accordingly (see GCC Macro View - GCC oil exporters: updated macro forecasts, 13 Jan). We now expect total Saudi government revenues to fall by some 33% in 2015, which we think will inevitably lead to sharper expenditure cuts and a wider deficit than we had previously been projecting. Although the Kingdom announced a budget of SAR860bn, up from the SAR855bn in spending budgeted for 2014, in reality we expect spending to fall sharply. This is because actual spending in 2014 overshot the budget by almost SAR250bn, at SAR1.1tr, and we believe that the overshoot this year which will be much smaller, in the order of SAR900bn. This represents an 18% decline in spending, most of which should come from capital expenditure.

Given the strong historic link between government expenditure and economic growth, we are consequently expecting a contraction of the non-oil economy of somewhere in the order of 5% yoy this year, with the overall economy shrinking by 3.3% (oil production is expected to remain flat). This is the first time Saudi Arabia will post negative growth since 1999, according to our data.

The kingdom has close to US$500bn in sovereign reserves, which will allow it comfortably to finance expected deficits and avoid any major cuts to current expenditure, including social spending, in the medium term. It also has virtually no public debt, providing it with ample scope to leverage. However, we believe the government will use this fiscal space in order to implement reforms that will put public finances and growth on a longer-term sustainable footing. Broadly, this means we expect progress in three key areas, namely (i) broadening the revenue base, (ii) rationalizing expenditures, and (iii) promoting private sector growth and employment (in order to shift the onus of economic growth away from public expenditure and towards private enterprise).

The Saudi stock market should be opened to direct foreign investment in H1 of 2015, subject to rules currently being finalized by the country's Capital Markets Authority (CMA). The rules, a draft of which were published in August 2014, introduce the concept of Qualified Foreign investors, which will restrict entrants to only the largest, most established international investors. Moreover, the CMA has proposed significant limits on foreign ownership that are likely to limit actual access opportunities and could keep the Tadawul out of the MSCI emerging markets index. We expect all these issues to be clarified in the first few months of the year.

United Arab Emirates

The UAE is also vulnerable to the drop in oil prices, but less so than regional peers. In Abu Dhabi, we expect government expenditure to continue growing at between 2%-4% yoy, opening up notional fiscal deficits of around 6% of GDP on average over the next five years (assuming an average oil price of around $70 per barrel). In reality, however, the government will have no financing requirement as the deficits should be more than covered by investment income from its assets, which we estimate at around 7.5% of GDP on average over the forecast period. We therefore do not expect any significant increase in issuance out of Abu Dhabi as we believe the government will continue to rein in its related entities (GREs) and its drive towards deleverage.

We expect growth in Dubai to face some headwinds in 2015, but for the emirate to remain economically stable. Although Dubai may well be the ultimate regional success story in terms of diversification, this does not insulate the emirate from the effects of lower oil prices. Dubai's hub and spoke model, based on financial services, transportation, trade, logistics and tourism, is highly dependent on regional prospects overall, which are in turn sensitive to oil prices. To watch in 2015 will be the real estate market, which has been showing signs of overheating over the past 18 months, and which may receive a knock if regional prospects sour. On the upside, the recent extension of the P5+1 talks with Iran until mid-2015 keep a deal in play, with potential benefits to Dubai should sanctions be rolled back.

That said, while we are expecting other GCC economies to experience a sharper economic contraction that in 2008/2009 (the last time oil prices retreated this aggressively) we believe things are different in Dubai this time round. The global macro environment is more supportive of Dubai's trade and logistics sector than during the global economic downturn, domestic leverage has been on the decline, with maturities smoothed out to more manageable schedules, and domestic liquidity conditions are more stable. So while a sharp decline in house prices is possible in the coming months, we expect the financial and economic fallout to be much more limited than was the case six years ago.

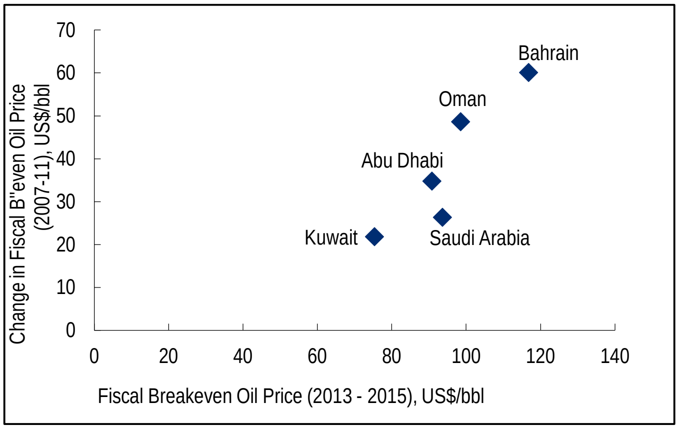
Kuwait

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

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

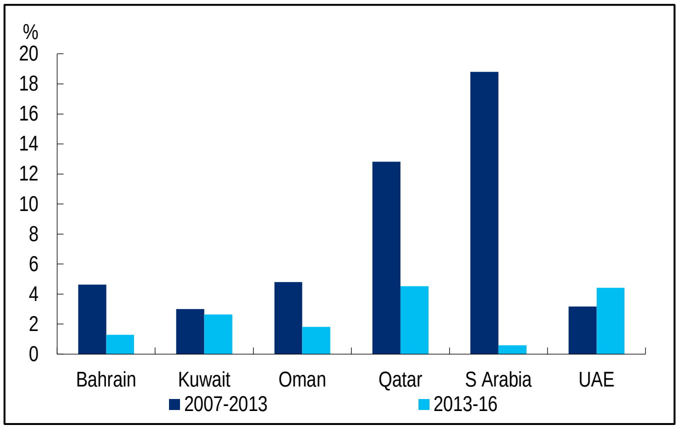
That said, 2015 will be a critical year in determining whether these early encouraging signs will be sustained. There are two things to watch: first, despite the apparent progress made over the past year or so as outlined above, we believe that the potential for political dysfunction to interfere with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

Figure 130. Fiscal breakeven oil prices on the rise



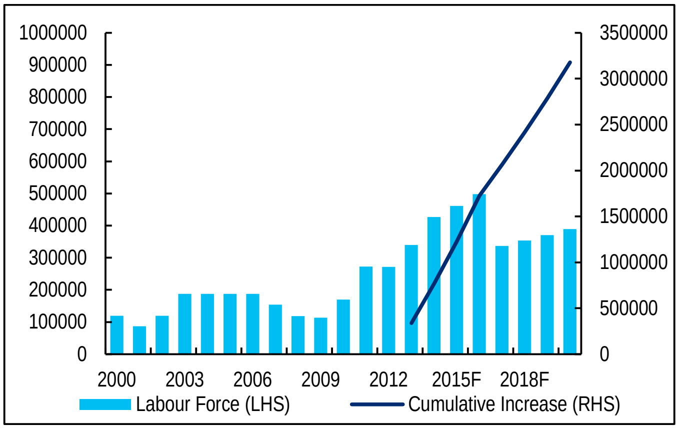
Source: Citi Research estimates

Figure 131. Economic growth will be uneven going forward



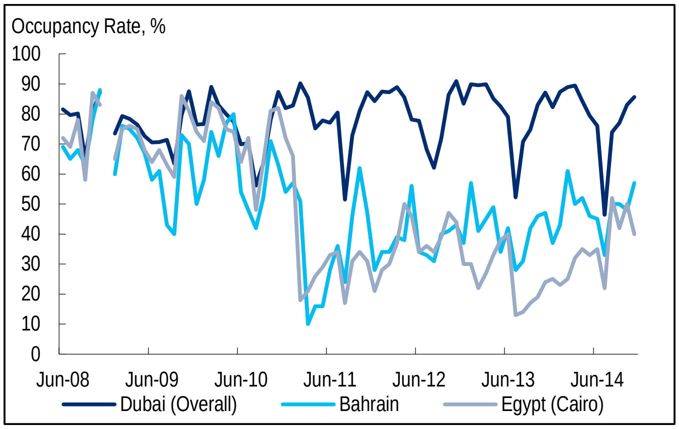
Source: Haver Analytics, Citi Research

Figure 132. 3.3 million entrants in Saudi job market by end of decade



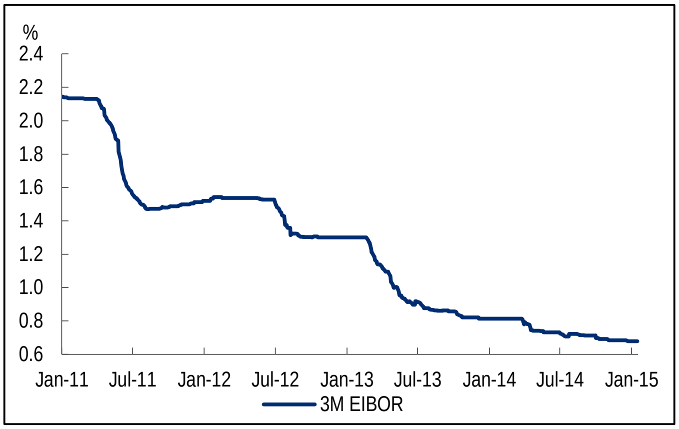
Source: Saudi Central Statistics Office, Citi Research

Figure 133. Dubai hotel occupancy continues to outperform its peers



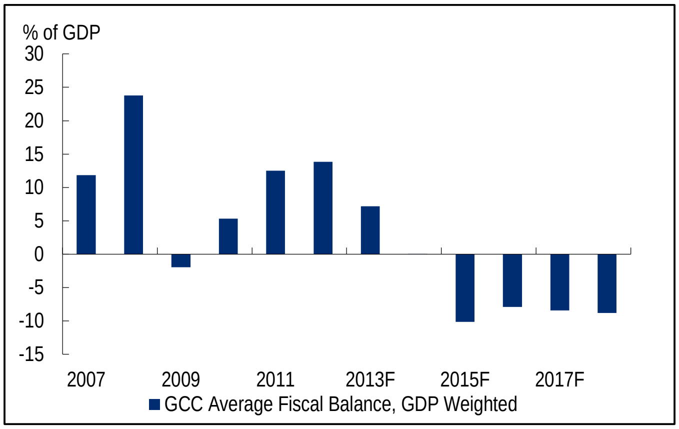
Source: Ernst & Young, Citi Research

Figure 134. EIBOR rates stablise at low levels



Source: Haver Analytics

Figure 135. High government expenditure will drive balances lower



Source: Haver Analytics, Citi Research estimates

Figure 136. GCC Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
BAHRAIN									
Nominal GDP, USD bn	25.6	22.9	25.6	29.0	30.7	32.8	34.2	31.0	32.6
GDP per capita, USD	22,983	19,192	20,482	22,401	23,272	23,931	24,008	20,877	21,119
Real GDP, yoy avg	6.2	2.5	4.3	2.1	3.4	5.5	4.8	-2.4	1.5
CPI, % avg	3.5	2.8	1.9	-0.4	2.8	3.3	2.5	2.1	2.2
BHD/US$, avg	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
Current account, US$bn	2.3	0.6	0.8	3.2	2.2	2.6	2.0	-1.1	-0.8
% of GDP	8.8	2.4	3.0	11.2	7.2	7.8	5.8	-3.5	-2.4
Consolidated gov. balance, % of GDP	6.4	-4.3	-4.8	-0.3	-2.0	-3.3	-4.3	-8.5	-6.5
KUWAIT									
Nominal GDP, USD bn	147.3	105.8	115.3	153.8	173.9	177.5	176.5	146.3	158.8
GDP per capita, USD	54,520	37,123	38,538	49,214	54,028	53,540	51,689	41,582	43,823
Real GDP, yoy avg	2.5	-7.1	-2.4	9.6	6.6	5.7	3.7	2.1	2.2
CPI, % avg	10.6	4.0	4.0	4.7	2.9	2.6	3.0	3.5	3.5
KWD/US$, avg	0.27	0.29	0.29	0.28	0.28	0.28	0.28	0.29	0.29
Current account, US$bn	58.5	28.3	37.7	66.5	78.4	70.3	60.9	19.7	21.6
% of GDP	39.7	26.8	32.7	43.3	45.1	39.6	34.5	13.5	13.6
Consolidated gov. balance, % of GDP	32.4	11.4	24.2	34.5	33.2	21.4	12.8	-12.2	-9.7
OMAN									
Nominal GDP, USD bn	60.8	48.3	58.6	69.4	77.4	84.3	87.4	73.6	80.8
GDP per capita, USD	21,197	16,302	19,125	21,949	23,452	24,363	24,200	19,482	20,454
Real GDP, yoy avg	8.2	6.1	4.8	0.9	5.8	3.4	5.0	-2.3	2.7
CPI, % avg	12.5	3.6	3.2	4.0	2.9	2.1	1.0	0.9	1.2
OMR/US$, avg	0.38	0.38	0.38	0.39	0.39	0.38	0.39	0.39	0.39
Current account, US$bn	5.0	-0.5	5.0	8.9	7.8	5.1	6.0	0.3	3.7
% of GDP	8.2	-1.0	8.6	12.9	10.1	6.1	6.8	0.4	4.6
Consolidated gov. balance, % of GDP	0.3	-0.1	3.1	-0.4	-0.3	0.8	-1.9	-8.8	-5.3
QATAR									
Nominal GDP, USD bn	115.3	97.8	125.1	169.8	189.9	203.2	211.4	194.9	219.6
GDP per capita, USD	104,982	80,294	92,546	113,128	117,172	116,084	111,819	95,430	99,578
Real GDP, yoy avg	17.7	12.0	16.7	13.0	6.0	6.3	5.6	3.8	4.1
CPI, % avg	15.2	-4.9	-2.4	1.9	1.9	3.1	3.0	3.5	4.5
QAR/US$, avg	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64
Current account, US$bn	26.6	6.4	24.0	52.0	62.0	62.6	64.5	30.7	31.6
% of GDP	23.1	6.5	19.1	30.6	32.7	30.8	30.5	15.7	14.4
Consolidated gov. balance, % of GDP	1.9	-1.8	-5.2	3.6	5.3	1.6	-2.6	-13.3	-12.9
SAUDI ARABIA									
Nominal GDP, USD bn	519.4	429.0	526.8	669.5	733.8	744.2	744.0	615.6	664.6
GDP per capita, USD	20,861	16,811	20,178	25,645	27,559	27,401	26,857	21,783	23,056
Real GDP, yoy avg	8.4	1.8	97.4	9.9	5.3	2.7	3.4	-3.3	1.7
CPI, % avg	9.9	5.1	5.3	3.9	2.9	3.5	2.9	3.0	3.4
SAR/US$, avg	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Current account, US$bn	133.0	21.5	67.4	159.3	165.7	133.6	90.0	-12.5	1.5
% of GDP	25.6	5.0	12.8	23.8	22.6	18.0	12.1	-2.0	0.2
Consolidated gov. balance, % of GDP	29.8	-5.4	4.4	11.6	13.6	6.5	-1.8	-8.9	-6.2
UNITED ARAB EMIRATES									
Nominal GDP, USD bn	315.5	253.5	286.0	347.4	372.3	402.3	431.0	461.8	496.4
GDP per capita, USD	66,205	51,659	56,586	66,727	68,563	70,757	72,478	74,285	76,046
Real GDP, yoy avg	3.2	-5.2	1.6	4.9	4.7	5.2	4.0	4.0	4.4
CPI, % avg	12.3	1.6	0.9	0.9	0.7	1.1	2.0	2.4	2.9
AED/US$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account, US$bn	22.3	7.8	7.2	50.9	69.0	64.7	37.2	15.1	15.4
% of GDP	7.1	3.1	2.5	14.7	18.5	16.1	8.6	3.3	3.1

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6 for Kuwait and Saudi Arabia.

Hungary

Eszter Gargyan
+36 (1) 374 5559
eszter.gargyan@citi.com

- **Summary view** — External debt reduction continues amidst slowing but stable growth and blow-target but positive inflation. The oil price fall is likely to be supportive to household consumption and widen the CA surplus further in 2015.
- **Things to watch** — Monetary policy response to external volatility and potential unexpected political responses to the government's sinking popularity may be key themes to watch.
- **Strategy** — Low global inflation environment and a switch from FX sensitivity to interest rate sensitivity in household balance sheets suggests the base rate is likely to remain low for a prolonged time.

GDP to slow from around 3%YoY in 4Q14

We expect growth to slow this year and the next. Incoming data from November confirm that growth has likely remained close to 3% in 4Q14. Industrial output and retail sales data have both beaten expectations in November. Retail sales growth remained at 5.2%YoY in November as lower fuel prices supported consumer spending, which may get further support by a reduction in FX debt burden in 2015. Overall, the incoming data is in line with our 3.0%YoY growth forecast on 4Q14 GDP, which may bring annual GDP growth to 3.4% in 2014.

Industrial output, the key engine of growth is likely to slow in 2015 following an initial rebound in 1Q15 as new car producer capacities will be fully utilized and as external demand slows. Slowing external demand has been already reflected in industrial new orders. Growth is likely to continue to shift towards domestic demand however the uncertain impacts of Sunday shop closure on retail sales pose downside risks to consumer spending this year. Agriculture and fixed investments are unlikely to provide another strong stimulus to growth this year following record high absorption of EU funds in 2014 and two consecutive years of outstanding agriculture harvest. We expect to see a negative drag on growth in 2016 related to lower EU fund absorption as the 2007-2013 EU budget programs will be closed. The above factors suggest GDP growth may slow to around 2.5% this year and to around 2% in 2016, whereas risks are pointing to the downside.

Government popularity eroded sharply since Oct-14

The government's popularity has fallen sharply since the municipal elections in Oct-14, which has ended the series of three elections (parliamentary, EU and local) in 2014. Pre-election political communication has been focused on the FX debt relief program but the governing party (Fidesz) refrained from presenting any agenda for its second four-year term. This year's budget plans revealed after the October elections were slightly disappointing, compared to our expectations of more ambitious structural reform agenda. Although the 2014 fiscal deficit has likely undershot the 2.9% deficit target and this year's budget deficit plan is slightly tighter (2.4% of GDP), declining debt burden and new extraordinary taxes provide the key pillars of deficit reduction, while the government failed to cut public expenditures and the high centralization rate. Increased state involvement in the real economy, redistribution of market shares among key market players and increased fiscal reliance on extraordinary taxes continue to drag down competitiveness and may hold back FDI inflows to Hungary.

MPC unlikely to slash rates further due to stability risks

Series of soft inflation surprises continues but not in core prices. CPI has fallen to -0.9%YoY, extending the series of soft inflation surprises. Oil prices add another negative contribution to inflation and offset the elimination of utility price cuts from the annual price index. The gap between headline CPI and core CPI (0.8%YoY) reflect that energy, food and administered utility prices drag down inflation into negative territory, while core prices – adjusted by taxes and regulatory measures – remained around 1.2-1.5% in 4Q14. We project CPI to remain in negative territory until 4Q14 but rebound to around 2.4% by early 2016 on base effects. Low imported inflation, weakening FX pass through and a gradual recovery in household consumption suggests that inflation risks are likely to remain muted over the medium term, allowing to keep monetary conditions lose.

Financial stability concerns are likely to hinder further rate cuts. Despite the firming downside risks to headline inflation outlook we believe the MPC will stick to its neutral stance due to increased FX volatility and external risks. Although the reduction of household FX debt exposure decreases FX vulnerability and CHF mortgages have been already hedged, the government debt is still heavily exposed to foreign funding. Government debt held by off-shore investors is close to 50% of GDP, of which 29% of GDP is FX denominated. This suggests that excess FX weakening would risk the reduction in the public debt ratio but may also trigger outflows or accelerate FX hedges by off-shore portfolio investors. Therefore we believe the MPC will strengthen its cautious tone citing external risk factors and refrain from further cuts. At the same time low inflation may help to postpone the beginning of rate hikes, therefore we expect rate to remain on hold until 1H16.

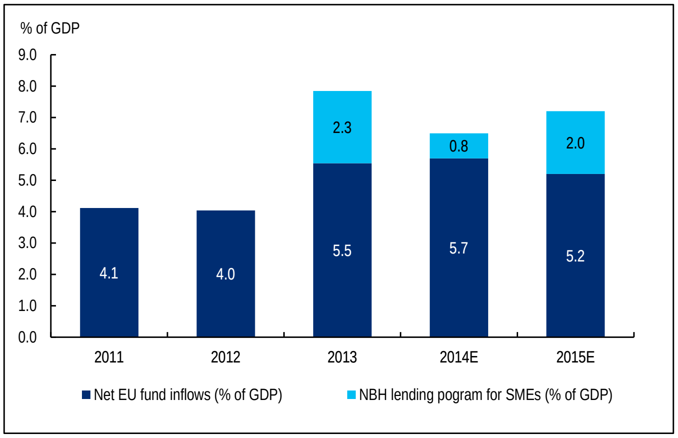
Lower oil prices widen the CA surplus further

CA surplus may widen further due to the sharp fall in oil prices. Fundamentals remain supportive to the HUF as the collapse in energy prices may offset the impacts of domestic demand recovery and widen Hungary's current account surplus from 4.3% of GDP in 2014 to around 4.7% in 2015. EU transfers registered on the capital account may remain around 3.5% of GDP this year but decline in 2016. Inflows from EU transfers provide FX liquidity to the NBH to cover the FX mortgage conversion and replace maturing FX denominated government debt with LC funding without sharp erosion in the FX reserves. Given the above factors, we believe external driven HUF volatility is likely to be short lived and we forecast the HUF to remain relatively stable around 320 levels against the EUR over the medium term.

Government FX debt reduction continues

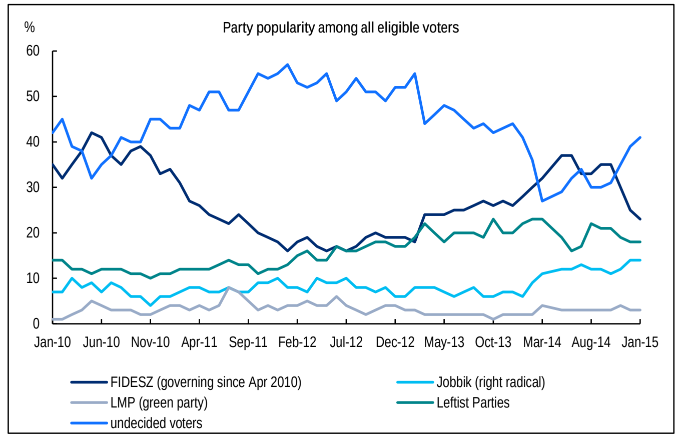
FX debt reduction remains an important target of government debt management. The debt agency plans no Eurobond issuance until end-2015 and continues to replace maturing FX debt via retail issuance and LC-denominated funding sources. Given the replacement of FX debt by LC funding, net HGB issuance may decline only marginally this year, compared to 2014. Demand from local banks may be weaker this year, as the NBH's self-financing plan triggered reallocations from 2-week NBH bills into government papers in 2014. HUF liquidity tightening related to the FX mortgages is likely to be gradual and spread over the next three years and may be partly offset by the extension of the FGS. In case of market stress, we believe the NBH may utilize additional tools to support the local absorption of government bonds.

Figure 137. EU fund inflows and NBH lending program support growth



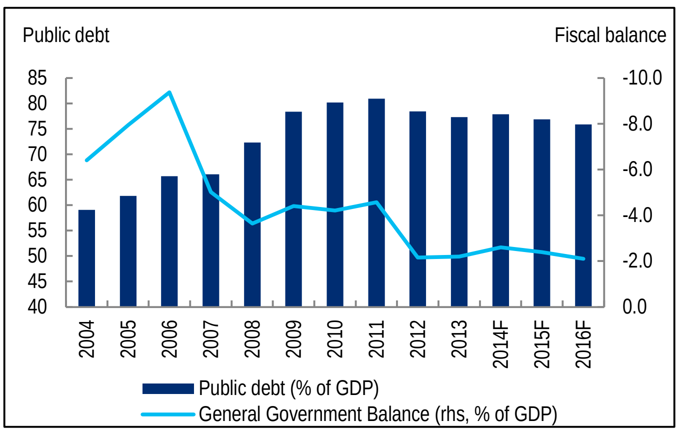
Source: National Bank of Hungary, Citi Research estimates

Figure 138. Government popularity has fallen since Oct-14 elections



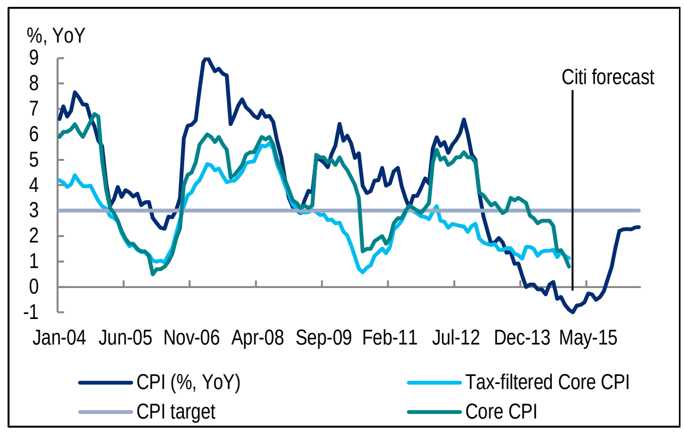
Source: Szonda-Ipsos, Citi Research

Figure 139. 2014 fiscal balance likely to undershoot the target



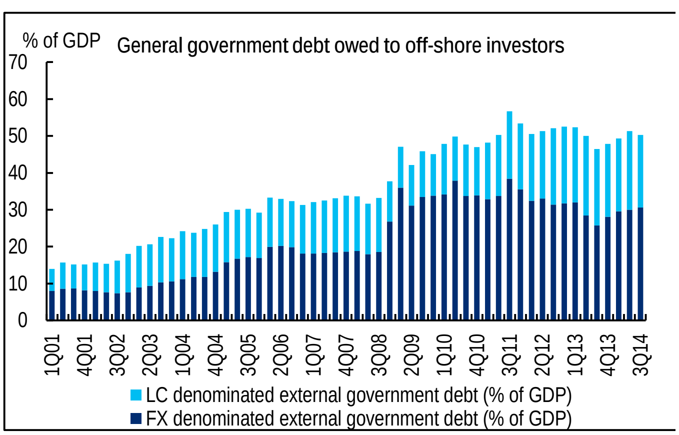
Source: European Commission estimates, Citi Research

Figure 140. Inflation may remain negative until 3Q14 and catch up towards the 3% target by 2016



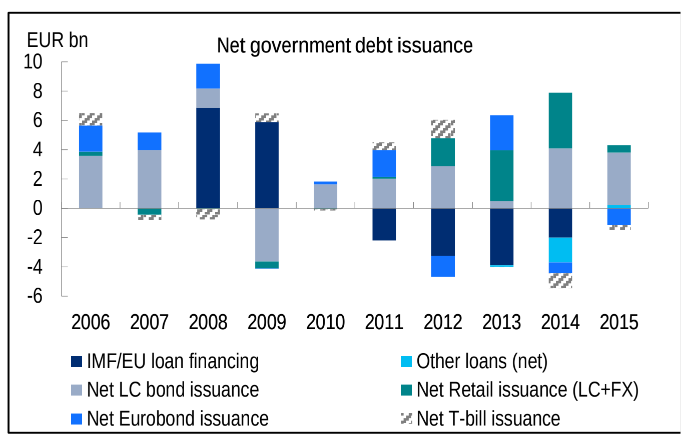
Source: National Bank of Hungary, Citi Research

Figure 141. Government largely exposed to external debt albeit with declining FX share...



Source: National Bank of Hungary, Citi Research

Figure 142. ...as maturing FX debt will be replaced by LC funding



Source: Government Debt Management Agency, Citi Research

Figure 143. Hungary Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	157	129	130	139	127	133	135	114	108
Nominal GDP, local currency bn	26,949	26,175	26,946	28,035	28,549	29,846	31,385	33,006	34,438
GDP per capita, USD	15,586	12,896	12,939	13,950	12,713	13,403	13,593	11,493	10,873
Population, mn	10.0	10.0	10.0	10.0	10.0	10.0	9.9	9.9	9.9
Unemployment, % of labour force	7.8	10.0	11.2	11.0	11.0	10.2	7.5	6.8	6.5
Economic Activity									
Real GDP, yoy avg	0.9	-6.6	0.8	1.8	-1.5	1.5	3.4	2.5	1.5
Real investment growth % yoy	0.4	-23.8	5.4	-3.0	-7.6	2.7	12.0	3.5	-1.5
Real consumption growth % yoy	0.1	-4.4	-2.1	0.6	-1.7	0.8	1.8	2.3	1.5
private consumption growth % yoy	-1.1	-6.7	-2.8	0.8	-1.9	-0.1	1.6	2.6	2.2
Real export growth, % yoy	6.9	-11.4	11.3	6.6	-1.5	5.9	6.6	6.0	6.2
Real import growth, % yoy	6.0	-14.7	10.1	4.5	-3.3	5.9	7.5	6.4	6.0
Prices, Money & Credit									
CPI, % yoy eop	3.4	5.4	4.6	4.1	5.1	0.6	-0.9	1.7	2.7
CPI, % avg	6.0	4.0	4.7	3.9	5.7	1.7	-0.2	0.0	2.4
Nominal wages, % yoy	7.4	0.5	1.3	5.2	4.6	3.4	4.4	4.2	4.0
Credit extension to private sector, % yoy	21.7	-2.7	4.1	-0.5	-12.5	-5.7	1.1	-5.0	0.9
Policy Interest Rate, % eop	10.00	6.25	5.75	7.00	5.75	3.00	2.10	2.10	3.60
3 month inter-bank rate, %, eop	10.00	6.25	5.75	7.08	5.75	3.00	2.10	2.10	3.60
Long-term yield, %, eop	8.28	7.99	7.97	9.75	6.11	5.61	3.60	4.00	4.50
HUF/US$, eop	190	189	208	244	221	216	262	298	335
HUF/US$, avg	171	201	208	201	225	223	232	290	320
HUF/EUR, eop	266	271	278	315	291	297	317	320	320
HUF/EUR, avg	252	280	275	279	289	297	309	322	320
Balance of Payments, USD bn									
Current account	-11.2	-1.1	0.4	1.0	2.4	5.5	5.7	5.4	4.3
% of GDP	-7.2	-0.8	0.3	0.8	1.9	4.1	4.2	4.7	4.0
Trade balance	-1.4	3.7	3.5	4.1	3.9	4.8	4.2	4.0	2.8
Exports	105.7	79.3	87.7	100.0	90.4	96.2	99.0	84.9	80.8
Imports	107.1	75.6	84.3	95.9	86.5	91.4	94.8	80.9	77.9
Service balance	1.9	1.6	3.5	4.6	4.9	5.4	5.8	5.2	4.8
Income balance	-9.9	-6.0	-6.1	-6.8	-5.4	-3.9	-3.5	-2.9	-2.6
FDI, net	-3.5	-0.2	-1.0	-1.4	-2.6	-0.5	-1.3	-0.7	-1.0
International reserves	33.2	41.1	43.1	45.4	43.5	47.0	39.6	31.9	27.4
Total amortisations	15.2	21.9	20.5	25.8	21.6	21.5	19.3	17.7	16.5
Public Finances, % of GDP									
Consolidated government balance	-3.7	-4.6	-4.5	4.3	-2.0	-2.2	-2.6	-2.4	-2.1
Consolidated gov primary balance	0.4	-0.1	-0.4	8.5	2.6	2.4	1.1	1.2	1.4
Public debt	72.3	78.4	80.2	80.9	78.5	77.3	77.9	76.9	75.9
of which Domestic	38.1	37.8	40.9	40.3	42.9	43.8	48.8	50.3	50.3
Foreign Assets & Liabilities, USD bn									
External debt	172.6	196.3	185.1	172.5	164.9	164.4	147.6	135.2	126.1
Public	51.8	62.1	59.6	58.4	63.8	62.5	60.5	58.5	57.0
External debt / GDP	110.2	151.7	142.8	123.7	130.0	123.2	109.4	118.6	117.1
External debt / XGS	136.7	200.7	172.7	141.1	148.3	138.7	120.9	129.0	127.1
Short-term debt	27.5	28.0	32.9	31.7	22.8	22.9	16.5	13.6	11.1
Short-term debt/International reserves (%)	82.8	68.2	76.1	69.9	52.4	48.6	41.7	42.5	40.5

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	3.9	3.2	3.0	2.6	2.5	2.5	2.4	2.2	1.7
CPI, % yoy eop	-0.3	-0.5	-0.9	-0.5	-0.1	0.0	1.7	2.3	2.4
Policy interest rate, %, eop	2.30	2.10	2.10	2.10	2.10	2.10	2.10	2.35	3.10
Short-term market rate, % eop	2.34	2.09	2.10	2.10	2.10	2.10	2.10	2.35	3.10
Long-term yield, %, eop	4.39	4.63	3.60	3.50	3.80	3.90	4.00	3.55	3.70
HUF/EUR, eop	310	311	317	324	322	320	320	320	320

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

Israel

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

- **Summary view** — We think Israel will stay stuck in a relatively low-growth equilibrium for the next couple of years, caught between weak global demand growth and weak growth in domestic spending.

- **Things to watch** — Israeli price deflation is now a reality, and it is difficult to see how inflation will move back up to the 1-3% target range without further action by the Bank of Israel. We believe this would require a) a further cut in the policy rate to zero, followed by b) aggressive action in the fx market. We had thought that the BOI would be inclined to introduce a Minimum Exchange Rate but the Swiss National Bank's abandonment of its own MER is likely to deter future 'experiments'.

- **Strategy** — The shekel is likely to stay very weak. Not only is the market primed to expect the kind of central bank action outlined above, but there is also evidence that Israeli portfolio managers are less inclined to fx-hedge their purchases of foreign securities.

Growth prospects still quite glum

Israeli data isn't disastrous, but equally nothing to cheer about. There's been good news in manufacturing for example: annualised growth rates have pushed above 3% in recent months, an improvement over the early part of the year which was largely characterised by contraction. Partly against this background the Bank of Israel recent increased its forecast for 2015 growth to 3.2% from 3.0%, following a growth rate in 2014 of 2.6%. One factor which might support economic activity is a likely revival in the construction sector, which had ground to a halt pending the outcome of a now-dead proposal to introduce a zero VAT rate on couples' first purchase of newly built homes. But Israel's PMI shows the lack of energy in Israeli economic activity: the index has been below 50 for the past six months, and recent data point to a particular decline in export orders. Overall, therefore, we expect slightly worse economic performance than official forecasts point to: the Bank of Israel's 3.2% forecast for this year stands against our own 2.4% forecast.

The shekel is part of the problem…

Israeli gas production set to grow. Tamar, the smaller of two large gas fields being developed off Israel's northern coast, began production in April 2013. Gas from Tamar (around 300 bcm) substituted some US$2.1bn of energy imports in 2013. A larger field, Leviathan (around 600 bcm), will commence production in 2017 or just after. We think it's worth assuming that more gas and oil will be discovered in the Eastern Mediterranean, and so Israel's emergence as an energy exporter is likely to become a an even stronger story than it is at the moment: the US Geological Survey estimates that the Levantine Basin – 40% of which is in Israeli waters – contains more than 3.4 trillion cubic meters of gas, suggesting that Israel might end up with twice the amount of gas that it has found to date.

Partly as a result of these developments, the shekel was one of the strongest currencies in the world in 2013 and H1 2014: the real effective exchange rate appreciated by 10% during this period alone. This is part of the background to the relative weakness in Israeli economic activity, and to the increasingly deflationary environment that the central bank is having to confront. And the shekel's depreciation since the summer of 2014 has only partly helped to relieve the problem: the real exchange rate is still stronger than it was in 2012.

…and disinflation looks like it's here to stay

Inflation has now been negative for four consecutive months. The exchange rate's impact on CPI is evident from the collapse of tradeables inflation. Tradeables inflation has been negative every month of 2014, reaching -2.0% in December. That is dragging down overall CPI, and in turn that is pushing inflation expectations down. Moreover, it is not only the exchange rate that is creating disinflationary pressure in Israel. First, the government's efforts to increase workforce participation among the ultra-Orthodox and Arab Israelis seem likely to increase labour supply, possibly putting downward pressure on wages. Second, in the wake of a recent government commission to increase competition and reduce concentration of ownership in the economy, efforts are being made to increase competition in the retail food sector, in telecoms, TV services and in auto retail. The 'cost of living' remains a major focus in Israeli political debate.

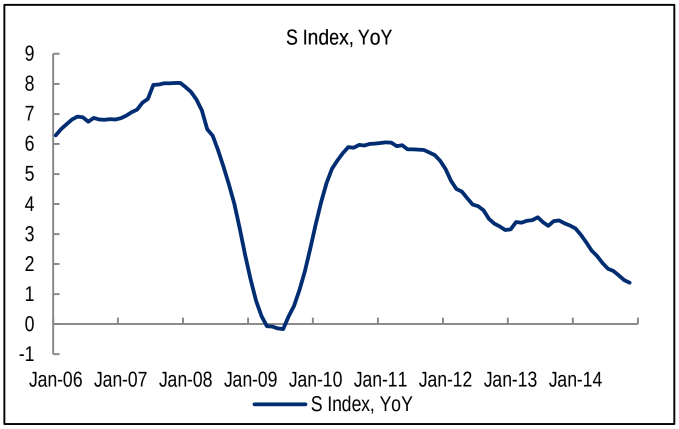
Less chance of radical exchange rate policy

The central bank is now close to running out of traditional policy tools. The BOI's policy rate has fallen from 1% at the start of last year, and now having nearly reached the zero lower bound the central bank could be forced to consider alternative ways of delivering monetary stimulus if CPI is to return to its 1-3% target range. For the time being the central bank wants to stick with doing nothing, with two main arguments: i) the Bank of Israel law makes it possible to undershoot the inflation target for a considerable time; ii) its upward revision of growth suggests that it might want to give time a chance to heal the deflation problem. In our view, some kind of effort to weaken the exchange rate is still likely to be required – though the end of the SNB's Minimum Exchange Rate in January is likely to deter the BOI from experimenting with its own version of one, particularly since the BOI had deep reservations about a shekel floor. The next couple of months' worth of inflation data will be particularly important in shaping the outlook for a final rate cut and an unconventional exchange rate policy. We expect a final rate cut in March.

Political noise isn't economic-policy noise

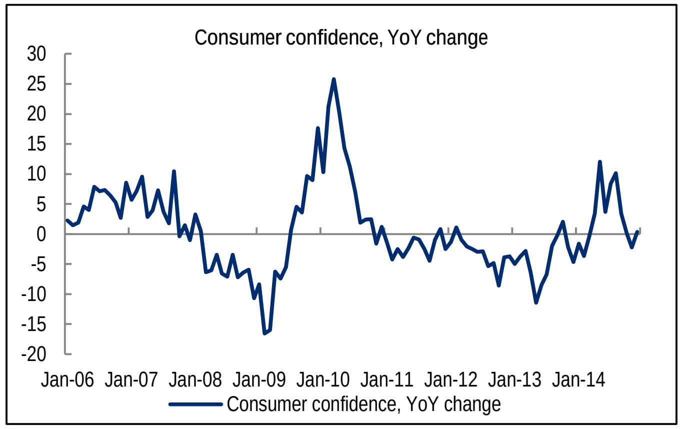
An election on 17 March is unlikely to change the direction of economic policy. There could be a change in government, however, since opinion polls are suggesting that the alliance between the Labour Party and Tsipi Livni's Hatnuah may end up with a plurality of Knesset seats. Yet economic policy in Israel is characterised by a high degree of consensus about the need to address the cost of living crisis without putting dangerous pressure on public finances. The 2014 budget deficit ended at a respectable 2.8%, much lower than originally feared, and while the outgoing government won agreement for a relaxation of the 2015 target, the passage of the 2015 budget will have to wait until a new government is formed. Yet fiscal policy is unlikely to be a major consideration for the Bank of Israel. Much more important, we think, will be the path of the shekel and its assessment of the chances that the US Fed will tighten policy in 2015.

Figure 144. Economic activity is stabilizing at a weak level, partly due to what the BOI describes as a 'virtual standstill' in world trade...



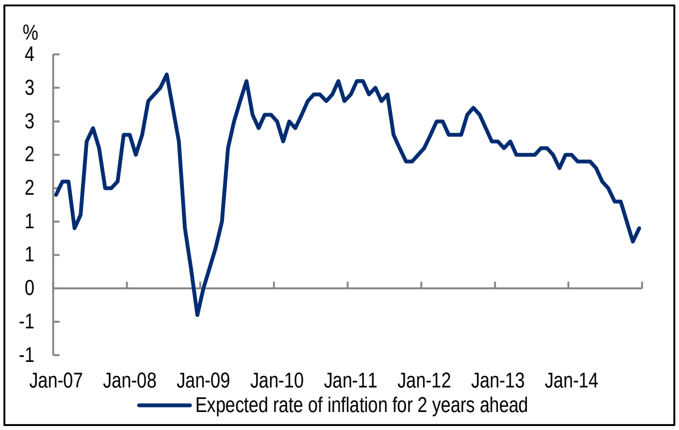
Source: Haver Analytics, Citi Research

Figure 145. ...and consumer confidence is fragile even though household borrowing has been relatively robust



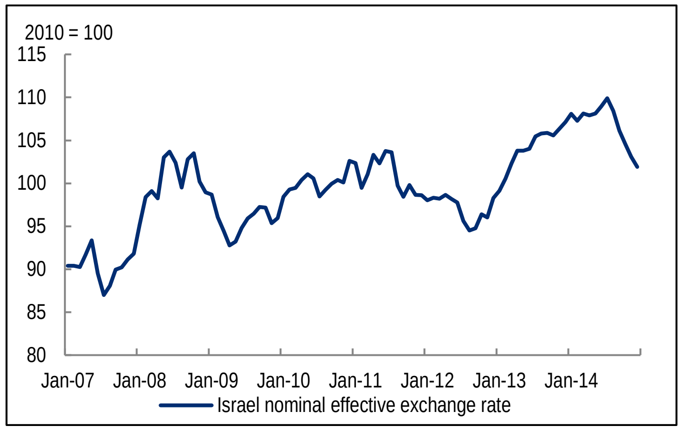
Source: Haver Analytics, Citi Research

Figure 146. Inflation expectations have fallen sharply...



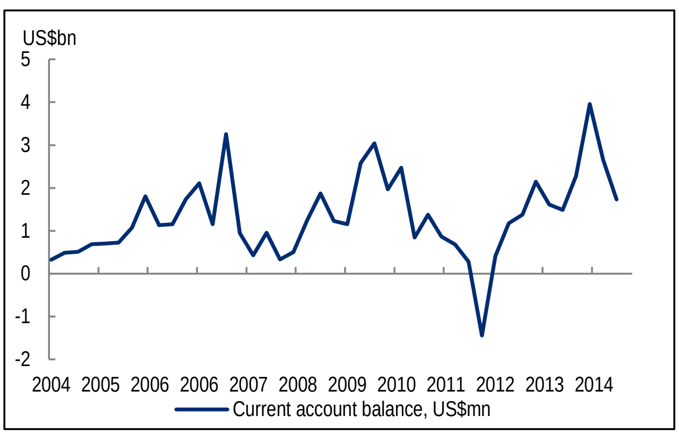
Source: Haver Analytics, Citi Research

Figure 147. ...largely thanks to the appreciation of the shekel...



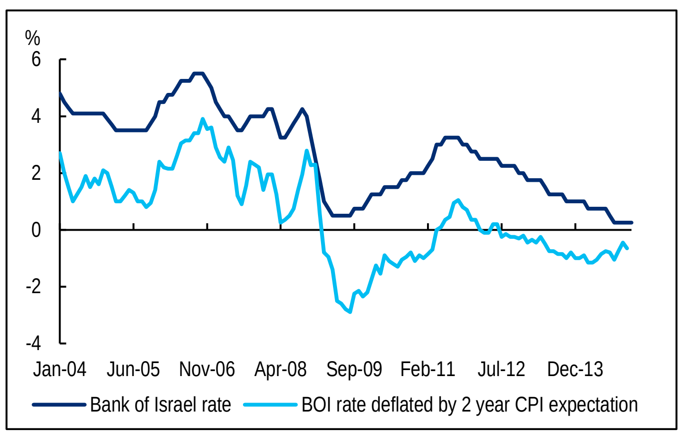
Source: Haver Analytics, Citi Research

Figure 148. ...on the back of a sharply improving current account balance...



Source: Bloomberg, Citi Research

Figure 149. ...giving room for the BOI to cut rates, and, probably, increase its effort to weaken the shekel.



Source: Bloomberg, Citi Research

Figure 150. Israel Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	214	206	233	258	257	291	302	274	286
Nominal GDP, local currency bn	768	812	871	925	992	1,049	1,079	1,106	1,134
GDP per capita, USD	30,101	28,383	31,440	34,263	33,648	37,573	38,560	34,559	35,603
Population, mn	7.1	7.3	7.4	7.5	7.6	7.7	7.8	7.9	8.0
Unemployment, % of labour force	7.7	9.4	8.3	7.1	6.9	6.3	6.4	6.8	6.5
Economic Activity									
Real GDP, yoy avg	4.0	1.7	5.5	4.4	3.1	3.2	2.4	2.2	2.5
Real investment growth % yoy	4.8	-2.6	9.8	14.8	3.1	1.0	4.5	6.5	2.5
Real consumption growth % yoy	1.4	2.6	4.0	3.0	3.2	3.3	2.0	2.1	-1.3
private consumption growth % yoy	1.3	2.4	4.4	3.1	3.0	3.4	2.1	2.4	-1.6
Real export growth, % yoy	7.4	-12.4	16.2	6.0	1.1	2.0	3.0	4.0	4.9
Real import growth, % yoy	2.2	-12.8	14.1	10.9	3.6	-1.6	1.6	3.5	3.6
Prices, Money & Credit									
CPI, % yoy eop	3.8	3.9	2.7	2.2	1.6	1.8	0.2	0.3	1.5
CPI, % avg	4.6	3.3	2.7	3.5	1.7	1.5	0.5	0.3	1.4
Nominal wages, % yoy	3.8	0.7	3.4	3.8	2.6	2.5	5.0	5.0	5.0
Credit extension to private sector, % yoy	-0.4	6.4	7.1	4.9	3.4	1.9	4.0	4.5	5.0
Policy Interest Rate, % eop	2.50	1.00	2.00	2.75	2.00	1.00	0.25	0.25	0.50
3 month inter-bank rate, %, eop	1.90	1.31	2.06	2.74	1.75	0.99	0.25	0.25	0.50
Long-term yield, %, eop	4.72	5.11	4.75	4.24	3.62	3.65	2.31	4.50	5.75
ILS/US$, eop	3.78	3.79	3.52	3.81	3.73	3.47	3.90	4.07	3.91
ILS/US$, avg	3.58	3.93	3.73	3.58	3.85	3.61	3.58	4.04	3.97
Balance of Payments, USD bn									
Current account	3.2	8.0	7.9	3.9	2.1	6.9	5.9	5.2	9.5
% of GDP	1.5	3.9	3.4	1.5	0.8	2.4	2.0	1.9	3.3
Trade balance	-6.4	0.7	-1.9	-8.1	-9.7	-9.3	-5.0	-2.3	3.0
Exports	58.0	46.8	56.4	64.3	62.0	62.0	71.0	75.3	80.5
Imports	64.4	46.1	58.3	72.4	71.8	71.3	76.0	77.5	77.5
Service balance	5.2	5.1	6.7	6.8	10.2	13.5	9.0	12.0	11.0
Income balance	-4.0	-5.1	-5.2	-3.6	-6.5	-6.3	-6.1	-4.5	-4.5
FDI, net	-3.7	-2.7	3.6	0.1	-4.8	-7.1	4.0	6.0	7.0
International reserves	42.5	60.6	70.9	74.9	76.0	81.8	87.0	95.0	100.0
Total amortisations	4.1	4.7	5.2	16.2	7.8	7.3	6.8	7.2	5.0
Public Finances, % of GDP									
Consolidated government balance	-1.2	-4.2	-2.8	-2.5	-3.5	-2.7	-3.0	-3.3	-2.5
Consolidated gov primary balance	4.0	1.0	2.3	2.5	1.4	2.1	1.6	3.0	3.0
Public debt	71.2	73.5	74.1	73.8	72.6	72.0	71.9	71.4	72.3
of which Domestic	57.1	59.9	57.4	57.3	56.5	55.3	54.7	54.2	52.9
Foreign Assets & Liabilities, USD bn									
External debt	89.6	94.6	107.8	105.6	97.5	95.4	104.0	105.0	108.0
Public	28.2	31.2	40.3	36.5	37.0	38.0	40.0	42.0	42.0
External debt / GDP	41.9	45.8	46.2	40.9	37.9	32.8	34.5	38.4	37.8
External debt / XGS	107.9	136.4	131.9	115.1	104.6	99.7	99.0	94.4	91.1
Short-term debt	40.3	42.2	55.7	51.0	43.3	42.2	45.0	45.0	45.0
Short-term debt/International reserves (%)	94.7	69.7	78.6	68.1	56.9	51.6	51.7	47.4	45.0

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	2.6	1.8	3.0	2.8	2.4	2.0	1.6	3.0	2.8
CPI, % yoy eop	0.5	-0.3	0.2	0.0	0.3	0.6	0.3	1.7	1.1
Policy interest rate, %, eop	0.75	0.25	0.25	0.00	0.00	0.00	0.25	0.25	0.25
Short-term market rate, % eop	0.65	0.21	0.25	0.05	0.05	0.05	0.25	0.25	0.25
Long-term yield, %, eop	1.72	1.36	1.39	4.75	4.75	4.75	4.75	4.75	4.75
ILS/US$, eop	3.43	3.68	3.90	3.98	4.03	4.09	4.07	4.03	3.99

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

Kazakhstan

Ivan Tchakarov
+7 495 643 1507
ivan.tchakarov@citi.com

Ekaterina Vlasova
+7 495 643 1576
ekaterina.vlasova@citi.com

- **Summary view** — Heightened geopolitical uncertainty in the CIS region, China slowdown and lower oil prices should keep economic activity subdued in 2015. We forecast 2014 and 2015 GDP growth at 3.7% and 3% (6% in 2013). More activist government policy may provide support to growth.
- **Things to watch** — One recent key macro concern has been the deterioration of the current account position, driven by a steady decline in exports related to sluggish global growth. Citi's forecast for oil prices in 2015 at US$63/bbl may continue to exert pressures on the current account.
- **Strategy** — The National Bank of Kazakhstan (NBK) devalued the tenge by 20% in Feb 2014 by announcing a new central level for the USDKZT of 185 within a 182-188 band. The NBK widened the corridor to 170-188 on 11 September. NBK has now the resources to support the KZT, but pressures will grow in 2015.

Growth to remain subdued in 2015

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

We now estimate 2014 GDP will decelerate to 3.7% on heightened regional uncertainty and a China slowdown. Events in Ukraine and Russia already act as some headwinds for the economy. Industrial production has struggled during the course of 2014, eking out a meagre 0.2%YoY during Jan-Dec. Consumption remained a key driver in 2014, although the pace of expansion has been moderating. A slowdown in China would also bite. As a result, we see 2014 GDP growth weakening to 3.7% from 5.9% 2013. So far, GDP grew by 4.1%YoY during Jan-Sep, but the more sizable slowdown in Russia related to the currency crisis there will also have an appreciable impact on Kazakhstan in our view.

Economic performance in 2015 will be additionally challenged by lower oil prices, although relatively low break-even oil price will ensure macroeconomic stability. Citi commodity strategists see Brent oil prices moderating to US$63/bbl in 2015 from US$101/bbl, which will provide a fresh headwind to economic activity. As a result, we forecast that GDP growth will remain subdued for Kazakhstani standards at 3.0% in 2015 (6.4% average over 2010-2013). At the same time, Kazakhstan has one of the lowest break-even oil prices among oil-exporters at US$65bbl and this should ensure that macroeconomic performance will still be relatively robust even in the face of already materializing sizable decline in oil prices.

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

We believe growth will continue to be supported by consumption, but investment and industrial production should make a stronger contribution in 2015. The last couple of years were characterized by diverging behavior of retail sales and industrial production. While real retail sales grew at 12.8% during 2013, industrial production increased only 2.3% in the same time period. The rift has deepened in 2014, with retail sales expanding by 12.0%YoY during Jan-Dec and industrial production increasing by only 0.2% in the same period. However, the infrastructure spending that the government plans for 2015 may boost real investment spending from an estimated 2.5% in 2014 to 3.0% in 2015.

While the broader macro-economy has been reasonably solid, the worsening current account position is a key reason for concern. The current account surplus dipped from 5.5% of GDP in 2011 to only 0.5% in 2013 on slower global growth. The current account surplus improved to US$6.2bn in 1Q and US$0.3bn in 2Q, before turning into a US$1.4bn deficit in 3Q. We estimate that the full-year surplus will amount to 1.9% of GDP. However, lower oil prices in 2015 should weaken the surplus to 1.2% of GDP in 2015. The deterioration of the external position has also led to a decline in reserves. Gross foreign reserves have followed current account's performance, falling from a high of US$35.0bn in April 2012 to a low of US$23.7bn in October 2013. Foreign reserves have more recently improved, rising to US$28.9bn in December 2014.

Another devaluation may be in store in 2015

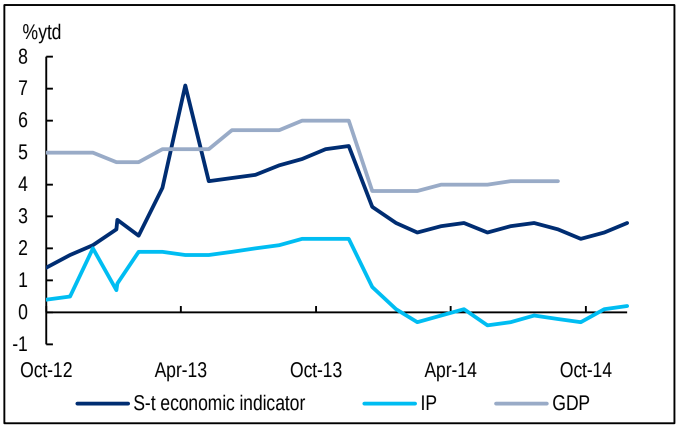
This led to the National Bank of Kazakhstan (NBK) to devalue the tenge by 20% in early February 2014. The new central level for the USDKZT is 185, with the tenge being allowed to fluctuate between 182 and 188. The NBK has a history of adjusting the tenge to sizable moves in the RUB (early 2009 a prime example) and the NBK's statement explicitly cites concerns about the RUB and, more generally, about potential loss of competitiveness.

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

However, the move to a free float in Russia has led to the RUBKZT reaching levels well below those at which the tenge was devalued in Feb, inviting fresh concerns that another devaluation may be imminent. The NBK has argued that it is now comfortable with the a range for the RUBKZT at 3.5-4.5, which suggests that another drop of 25% of the KZT against the RUB will be needed for the RUBKZT to return to the lower level of that band. From a broader perspective, the KZT REER is still running at levels that suggest that the tenge is now broadly fairly valued. Still, if geopolitical uncertainty intensifies, putting additional pressure on the RUB and forcing the RUBKZT to consistently remain below 3.5, the NBK may have a stronger incentive to consider bringing the tenge more in line with the RUB.

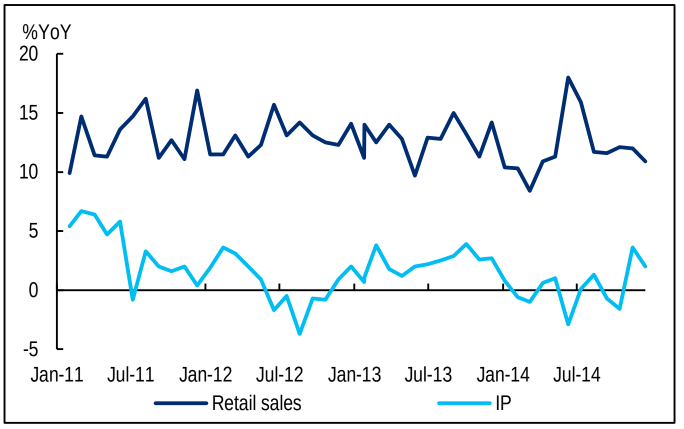
The social aspects of effecting another devaluation also need to be considered. The Feb 2014 devaluation brought about significant dissatisfaction among the population, although social unrest was minimal. Therefore, we believe authorities will be very cautious to introduce another devaluation so soon after the last one in order not to run the risk of inviting stronger public dissatisfaction. Given the significant devaluation implemented in Feb, we think that a further step down that road will only be taken very carefully in the event of oil prices remaining sustainably at current levels and/or geopolitical tensions significantly intensifying.

Figure 151. Economic activity is seeing headwinds



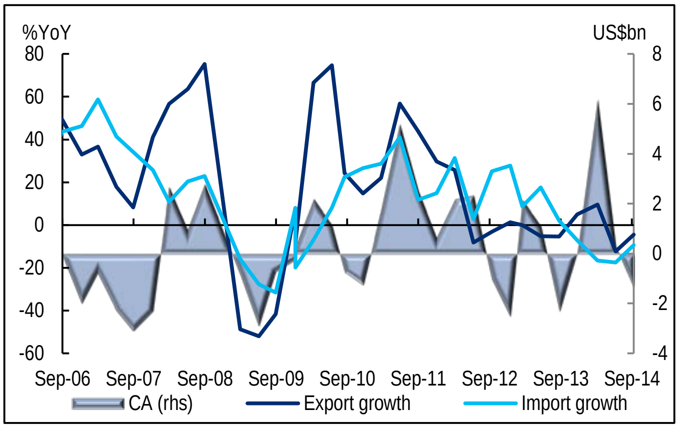
Source: Kazstat, Citi Research

Figure 152. Growth is mainly consumption driven as production struggles



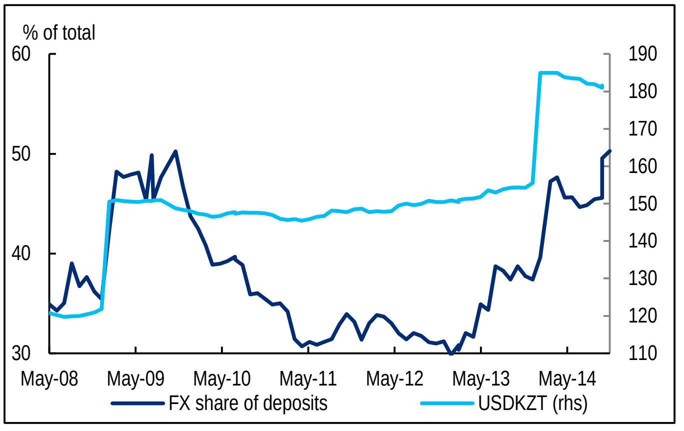
Source: Kazstat, Citi Research

Figure 153. Current account improved in 1H



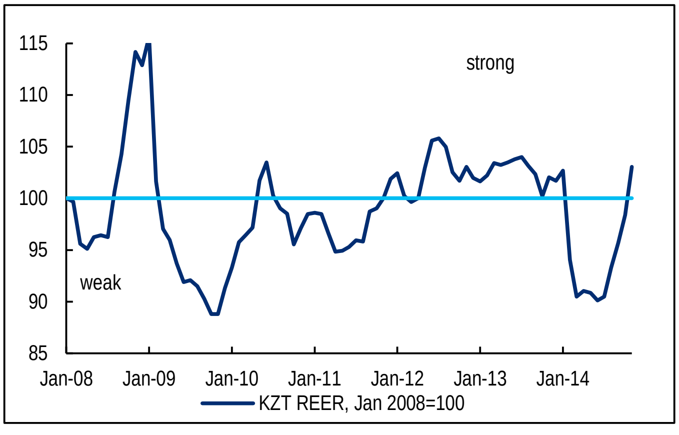
Source: NBK, Citi research

Figure 154. FX share of deposits are peaking again



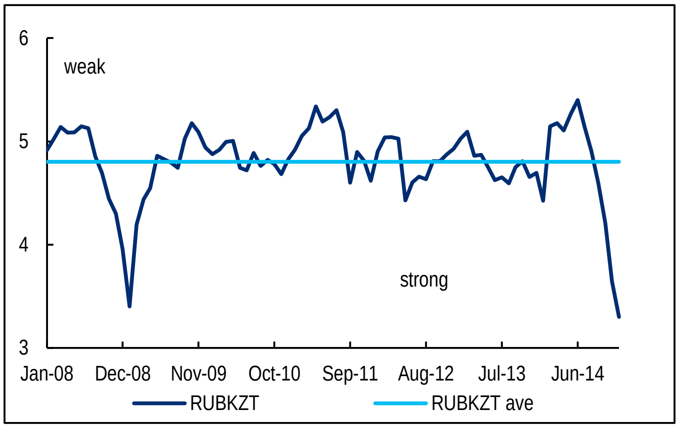
Source: NBK, Citi Research

Figure 155. Tenge is still not too strong when judged by the REER…



Source: NBK, Citi Research

Figure 156. …although it has now fallen against the RUB to levels below seen only during the 2009 crisis



Source: Bloomberg, Citi Research

Figure 157. Kazakhstan Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	136	111	146	186	202	222	207	220	239
Nominal GDP, local currency bn	16,350	16,386	21,323	27,305	30,147	33,777	37,146	40,495	44,162
GDP per capita, USD	8,730	7,056	9,171	11,568	12,426	13,505	12,459	13,089	14,016
Population, mn	15.6	15.7	15.9	16.1	16.3	16.4	16.6	16.8	17.0
Unemployment, % of labour force	6.6	6.6	5.8	5.4	5.3	5.2	5.2	5.2	5.2
Economic Activity									
Real GDP, yoy avg	3.6	0.8	7.3	7.5	5.0	5.9	3.7	3.0	4.0
Real investment growth % yoy	-12.8	2.3	2.0	5.9	12.2	6.2	1.9	2.3	3.5
Real consumption growth % yoy	6.0	0.7	10.0	10.9	11.4	10.5	3.8	3.1	4.1
private consumption growth % yoy	6.4	0.7	10.9	10.9	11.2	11.5	4.1	3.2	4.0
Real export growth, % yoy	0.9	-11.9	3.1	0.4	4.7	-0.2	-1.0	1.5	2.0
Real import growth, % yoy	-11.5	-15.7	2.9	2.8	20.9	5.8	3.0	6.0	4.0
Prices, Money & Credit									
CPI, % yoy eop	9.5	6.2	7.8	7.4	6.1	4.6	7.5	5.7	5.5
CPI, % avg	17.1	7.3	7.1	8.3	5.2	5.8	6.6	6.3	5.7
Nominal wages, % yoy	16.2	10.8	14.9	15.9	13.5	6.8	7.0	6.0	7.0
Credit extension to private sector, % yoy	5.2	7.3	0.3	15.8	12.1	12.8	12.0	10.0	15.0
Policy Interest Rate, % eop	10.50	7.00	7.00	7.50	5.50	5.50	-0.55	5.50	5.50
3 month inter-bank rate, %, eop	12.00	4.95	2.00	2.00	3.00	6.50	9.00	8.00	7.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	121	149	147	148	150	154	183	185	185
KZT/US$, avg	120	147	147	147	149	152	179	184	185
Balance of Payments, USD bn									
Current account	6.3	-4.1	1.4	10.2	1.0	1.1	4.0	2.6	2.5
% of GDP	4.6	-3.7	0.9	5.5	0.5	0.5	1.9	1.2	1.1
Trade balance	33.6	15.0	28.5	44.8	38.1	34.8	37.0	37.5	39.0
Exports	72.0	43.9	61.4	85.2	86.9	85.6	89.9	93.5	97.2
Imports	38.4	28.9	32.9	40.3	48.8	50.8	52.8	56.0	58.2
Service balance	-6.9	-6.0	-7.2	-6.6	-7.9	-6.9	-6.0	-7.0	-7.5
Income balance	-19.4	-12.4	-19.4	-27.7	-28.1	-25.2	-26.1	-26.9	-27.9
FDI, net	-13.1	-10.1	-3.7	-8.6	-11.9	-8.1	-6.0	-8.6	-8.6
International reserves	19.9	22.7	27.7	28.8	27.7	24.1	29.1	32.1	34.0
Total amortisations	34.1	39.0	25.4	29.6	32.0	31.8	10.5	12.4	5.0
Public Finances, % of GDP									
Consolidated government balance	-2.0	-3.1	-2.6	-2.1	-3.0	-2.0	-2.4	-2.2	-1.9
Consolidated gov primary balance	-8.8	-9.3	3.0	6.3	4.4	4.5	3.0	2.9	2.9
Public debt	6.2	9.9	10.3	10.0	12.0	13.0	14.0	15.0	15.7
of which Domestic	5.0	7.9	7.8	7.6	9.6	10.7	11.7	12.7	13.3
Foreign Assets & Liabilities, USD bn									
External debt	67.7	63.2	65.9	62.7	69.3	76.7	87.3	88.6	92.8
Public	1.7	3.2	4.8	5.1	5.5	5.7	7.3	8.6	11.8
External debt / GDP	49.8	56.9	45.2	33.7	34.3	34.5	42.1	40.2	38.9
External debt / XGS	88.8	131.7	100.7	70.1	75.5	84.5	97.2	94.8	95.5
Short-term debt	9.5	7.0	8.9	7.9	9.1	10.2	10.5	10.6	12.6
Short-term debt/International reserves (%)	47.7	30.8	32.0	27.3	32.7	42.1	36.2	33.2	37.2

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	3.2	3.9	5.0	5.1	5.3	4.0	3.2	4.4	4.6
CPI, % yoy eop	6.8	7.2	7.5	6.4	6.3	6.0	5.7	5.9	5.7
Policy interest rate, %, eop	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50
Short-term market rate, % eop	6.50	6.50	9.00	9.00	8.00	8.00	8.00	7.00	7.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	184	182	183	185	185	185	185	185	185

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

Levant

Farouk Soussa
+971 (4) 509 9750
farouk.soussa@citi.com

Adrian Thomas
adrian.thomas@citi.com

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

On the political front, the immediate threat of significant further territorial gains by ISIS has been largely addressed by a robust international military response. Indeed, ISIS appears to be no longer in expansion mode, but has become bogged down in the process of trying to govern territory it has captured. According to press reports, the difficulty of doing so, particularly given local discontent with ISIS's draconian rule of law and practices, along with mounting military defeats and casualties, is having an adverse effect on morale and leading to in-fighting, especially between jihadists from different countries (Financial Times, 19 December).

But we believe a sustainable solution to Iraq's security and political troubles requires a rebuilding of Iraq's security forces, the restoration of the state's infrastructure and its ability to provide the basic needs of its citizens across all territories, and a rejection of sectarian agendas in favour of a national vision. Here, Iraq has its work cut out for it.

The appointment of Haider al-Abadi's unity government in September marked a promising beginning. Indeed, in the few months since he has come to power, Mr al-Abadi has made some significant progress. Military reform has already begun, with the firing of dozens of senior military officers and the instigation of probes into corruption. National security forces are also being replaced by locally recruited National Guard units, placating concerns of Sunni communities suspicious of the Shia dominated national forces.

Mr Abadi has also worked to mend sectarian bridges, sometimes at the risk of alienating his own Shia constituency. The deal between Erbil and Baghdad (see below for details) is deeply unpopular among many in the Shia community, and has led to calls by Basra, the Shia oil-producing province in the South, for similar treatment. Al-Abadi has also made concession to Sunni political leaders, and has reached out to the powerful Gulf states to mend diplomatic ties. Such overtures have been positively received, with Saudi announcing that it will re-open its embassy in Baghdad after a 25 year absence. Given the tribal and financial links between the Gulf and Iraq's sunni leadership, maintaining good relations is critical for Iraq's own national unity.

But Iraq is by no means out of the woods. ISIS remains a powerful force, and discontent runs deep and will require further sustained progress on the reform front in our view. A comprehensive 'grand bargain' on outstanding issues with the Kurds, including the status of disputed territories and a final resolution of oil disputes, remains elusive and politically difficult. Reform of the security forces is only in its initial stages, and proceeding cautiously as the army is on a war footing and needs to remain stable. The Sunni community remains suspicious of Baghdad and further political and economic concessions are likely to be needed.

One area where the challenge seems greatest is in rebuilding the capacity of the Iraqi state to provide basic services to its citizens across all territories. The rise in internally displaced persons, damage to infrastructure and a poor security situation compromise the ability to do so in the near term. Longer term, corruption and institutional weakness are key challenges. Added to this, the fall in oil prices complicate matters significantly. Iraq's budget in 2015 is based on an average oil price of $60, and envisages significant deficits despite a deep cut in expenditure. But without the restoration of state infrastructure, the goal of securing

the allegiance of Iraq's disparate sectarian communities will be difficult to achieve, in our view.

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

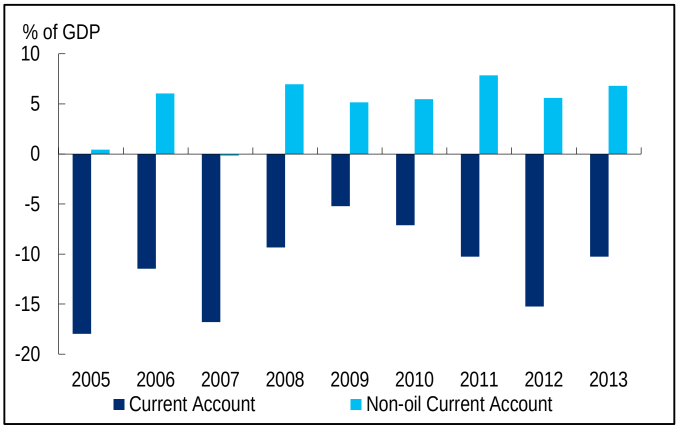
The prolonging of the conflict in Syria spells risks for neighbouring Lebanon, in our view. Not only has the Lebanese economy been overwhelmed by the arrival of over 1 million displaced Syrians (20% of the Lebanese population), the Syrian civil war has also threatened to flare up already heightened sectarian tensions within Lebanon. There has been continued sporadic fighting in the Northern city of Tripoli, where pro- and anti-Assad communities live in close proximity. Earlier in January, a suicide bombing which killed nine people, mainly from the Alawite community, was blamed on ISIS. More such attacks and fighting appear likely, in our view, with associated risks of escalation.

The economic back drop in Lebanon is also challenging. The fall in oil prices provide some near-term relief to Lebanon's twin deficits. Lower oil prices directly benefit the current account: at current price levels, we calculate that Lebanon's import bill for oil should drop by around US$1.2bn in 2015 (we estimate it at around US$5.2bn this year), which means savings to the current account of around 2.3% of GDP. On the fiscal side, lower oil prices help narrow the deficit at EDL, and we would expect expenditures to fall by around 1.5% of GDP as a result (although this is lagged by around 6 months given the payment structures to EDL).

Paradoxically, however, as the Governor of the Banque du Liban recently outlined, lower oil prices represent a serious threat to Lebanese economic stability in the medium term. This is because Lebanon is highly dependent on remittances, more so than Egypt, on which we published a similar analysis recently (see Egypt Macro View - Are lower oil prices good for Egypt?). Remittance Inflows account for around 20% of GDP, and two thirds of these come from the gulf. A drop of 25% in gulf remittances would therefore mean a widening of the current account deficit by almost 4% of GDP, more than compensating for the lower import bill. Gulf inflows in the tourism and real estate sectors have also been a historical support to the Lebanese economy.

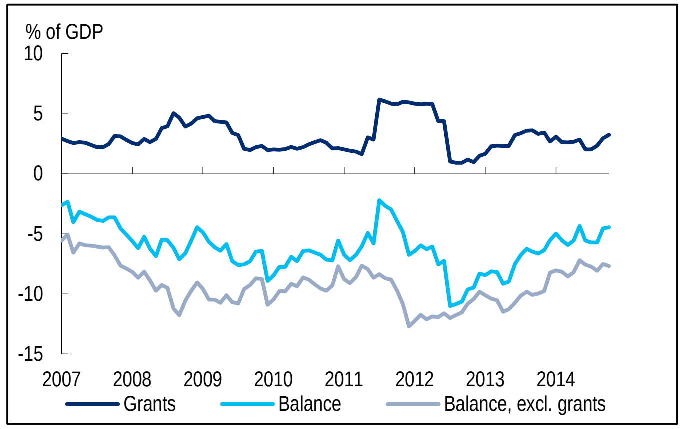
Despite the challenges, our view remains that the slide in country risk does not necessarily signal a slide in Lebanese sovereign risk. This is because we believe the stability of the sovereign risk profile rests on the robustness of the Lebanese banking sector and its ability to continue funding the government. In our view, the banking sector remains sound and liquid and retains significant capacity to continue financing the Lebanese sovereign through the purchase of government securities. This keeps sovereign risk in check, despite an evidently deteriorating country risk profile.

Figure 158. Jordan current account dominated by oil imports ...



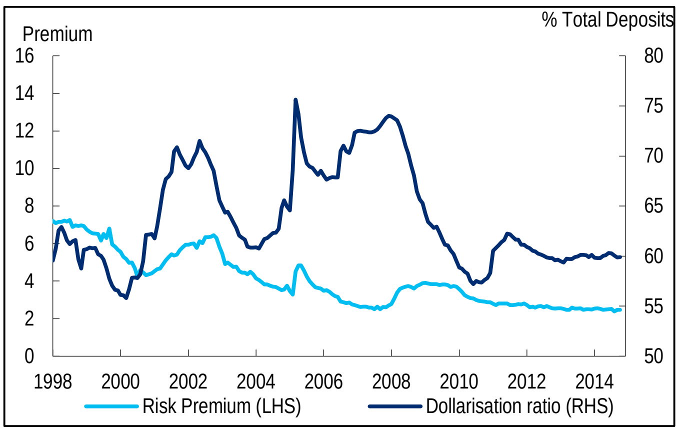
Source: Haver Analytics, Citi Research

Figure 159. Without grants Jordan's fiscal situation would be worse



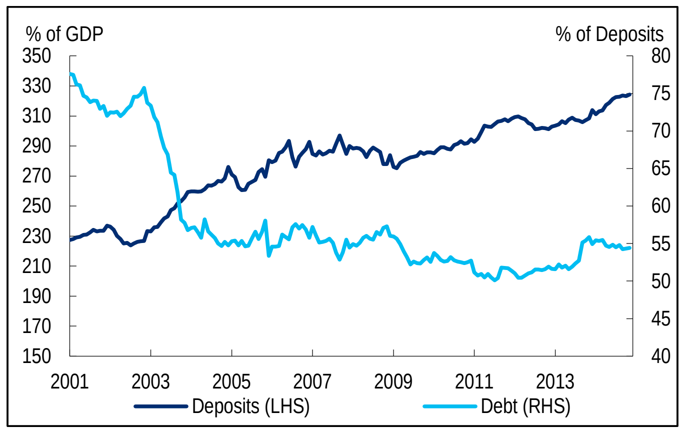
Source: Haver Analytics, Citi Research

Figure 160. Lebanon dollarization has gone up, but risk premium stable



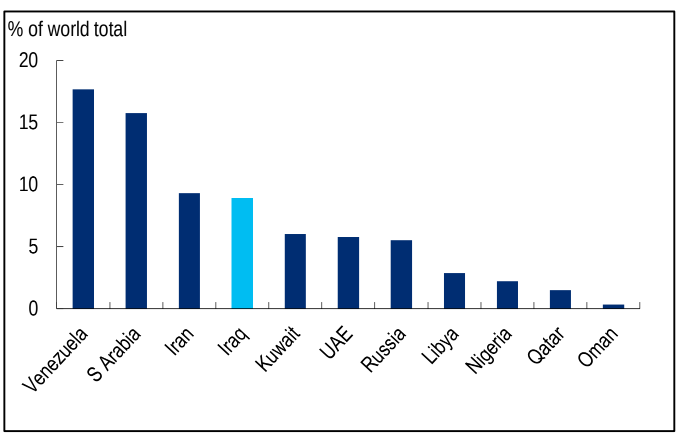
Source: Haver Analytics, Citi Research

Figure 161. Deposit growth slows, but still plenty of capacity



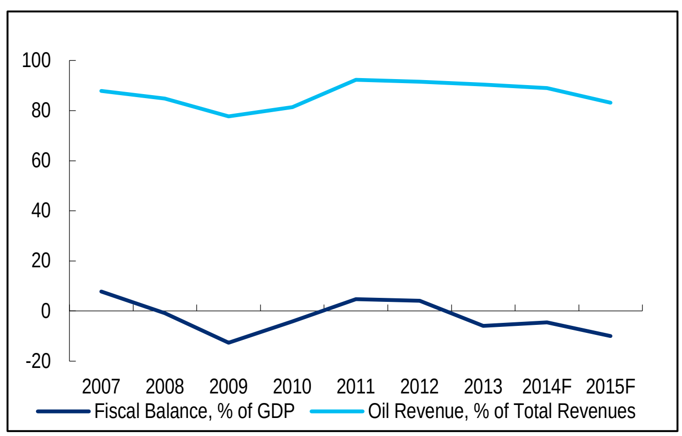
Source: Haver Analytics, Citi Research

Figure 162. Iraq has world's fourth largest proven oil reserves and ...



Source: BP, Citi Research

Figure 163. ... public finances should strengthen as a result



Source: Haver Analytics, Citi Research

Figure 164. Levant Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
IRAQ									
Nominal GDP, USD bn	135.6	113.6	138.9	186.3	216.6	230.1	224.5	227.2	244.5
GDP per capita, USD	4,607	3,766	4,487	5,871	6,655	6,892	6,557	6,472	6,790
Real GDP, yoy avg	6.6	5.8	5.5	10.2	10.3	6.8	0.1	6.0	4.2
CPI, % avg	2.7	-2.2	2.4	5.6	6.1	1.9	2.5	5.0	5.0
IQD/US$, avg	1,189	1,156	1,167	1,171	1,164	1,162	1,163	1,162	1,162
Current account, US$bn	28.4	-1.3	6.3	26.2	31.5	15.1	-12.9	-19.7	-13.2
% of GDP	20.9	-1.1	4.6	14.1	14.5	6.5	-5.8	-8.7	-5.4
Consolidated gov. balance, % of GDP	-0.9	-12.7	-4.2	4.7	4.1	-5.9	-4.5	-10.0	-8.6
JORDAN									
Nominal GDP, USD bn	22.0	23.9	26.5	28.8	30.9	33.6	35.8	38.1	40.9
GDP per capita, USD	3,722	3,866	4,104	4,284	4,404	4,615	4,728	4,839	4,995
Real GDP, yoy avg	7.2	5.5	2.3	2.6	2.7	2.8	3.6	3.8	4.3
CPI, % avg	13.9	-0.7	5.0	4.4	4.8	5.5	3.0	4.0	4.2
JOD/US$, avg	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71
Current account, US$bn	-2.1	-1.2	-1.9	-3.0	-4.7	-3.5	-3.2	-1.7	-2.4
% of GDP	-9.3	-5.2	-7.1	-10.3	-15.3	-10.3	-8.9	-4.5	-6.0
Consolidated gov. balance, % of GDP	-4.4	-8.9	-5.6	-6.8	-8.3	-5.5	-6.4	-6.8	-6.8
LEBANON									
Nominal GDP, USD bn	29.2	35.5	38.4	40.1	44.1	45.9	46.8	48.6	50.8
GDP per capita, USD	7,675	9,198	9,831	10,125	10,924	11,151	11,132	11,352	11,630
Real GDP, yoy avg	9.2	10.1	8.0	0.9	2.8	3.0	0.8	1.5	2.0
CPI, % avg	10.8	1.2	4.0	5.0	6.6	2.1	1.1	1.8	2.5
LBP/US$, avg	1,507	1,504	1,502	1,506	1,504	1,507	1,510	1,508	1,508
Current account, US$bn	-3.2	-4.4	-5.1	-5.1	-5.5	-5.8	-13.0	-10.5	-10.5
% of GDP	-11.0	-12.4	-13.2	-12.8	-12.4	-12.6	-27.9	-21.6	-20.7
Consolidated gov. balance, % of GDP	-10.0	-8.3	-7.5	-5.8	-8.9	-9.2	-9.5	-9.6	-9.6

Source: National Sources, Citi Research forecasts

Nigeria

David Cowan
+44 20 7986 3285
david.cowan@citi.com

- **Summary view** — While naira devaluation pushes up inflation and slows growth in 2015, the adjustment should have fed through the economy by 2016. But a more sustained pick up in the economy is dependent on a more aggressive push with structural reform, led by electricity sector reform.
- **Things to watch** — The devaluation of the naira in November 2014 is likely to prove insufficient given the current oil price weakness. Given there is a limit to reserve burn that the CBN can tolerate, we think further stepped devaluations will be required in 1H 2015.
- **Strategy** — The finance minister, Ngozi Okonjo-Iweala, will seek to maintain fiscal discipline despite the approaching elections and weaker oil price. All eyes will then focus on the outcome of the elections and the policy choices the new government outlines in 2H 2015.

Many strains show as elections rapidly approach

Entering 2015 Nigeria has increasingly seemed a country under pressure. On the political front the rapidly approaching elections in February have increased political tensions, against the background of the ongoing battle against Boko Haram. Meanwhile, although the economy has been growing robustly according to the GDP data, corporate earnings in the banking and consumer sector have been poor. And to top it off, the naira has come under sustained pressure as the world oil price has collapsed. None of these stresses and strains are likely to ease before the elections or in their immediate aftermath. And in particular, in the next six months, the main focus will be on the naira and the CBN's response to this in our view.

Naira policy will be under the spotlight

Having tightened monetary policy, allowed a modest devaluation and imposed various new trading regulations at its November 2014 MPC meeting, the CBN has bought some stability to the naria since late 2013. And these moves also indicate that the CBN does accept the need to allow the currency to move in the face of a weakening oil price. So perhaps the best way to understand these moves, is that they were the limit of what was politically acceptable prior to the February polls. Very few members of Nigeria's political elite see devaluation as a positive.

But having maintained broad naira stability up to the polls, the question is what does it do next? This is likely to depend heavily on the rate of reserve burn over the coming months. If, as we expect, demand for foreign exchange continues to remain high and reserves continue fall to around the US$30bn level, the options facing the CBN will quickly become much starker: either it opts to keep spending reserves to support the currency; or it allows further depreciation. Or more worryingly, it imposes greater currency and capital controls.

With our forecasts for the oil price being at its weakest in 2Q 2015, we think a devaluation is most likely after the elections, but before the new National Assembly is sitting, or when political opposition is potentially most limited. At this point, perhaps at the March MPC meeting, we think the CBN will take the RDAS rate down to around NGN185:US$1 with the IFEM rate moving to around NGN200:US$1. It will then have to assess whether this is sufficient move, or whether a third and probably final devaluation is necessary in April or May,

Our devaluation scenario is based on our US$63/b oil price forecast for 2015 with a modest recovery in 2016. But if the oil price was to be much lower, clearly a larger adjustment may be required. But knowing the scale of the devaluation is very hard and in addition to the uncertainty over this, it is also not clear what sort of exchange rate policy that the CBN will adopt after allowing such a major move. While initially it is likely to want a short term period of new stability, with the oil price remaining low it is going to have to think about a more flexible exchange rate policy unless it wants to continue to run a very tight monetary policy. But the overall economic impact is still the same, just with a slightly larger magnitude of adjustment.

The economic impact of naira devaluation

The most obvious impact of any is that it will push up imported inflation. But if 2009-10 is a guide following a more significant devaluation, this will be more modest than is often forecast. And devaluation is also important to provide a boost to government revenue so we expect a modest rise in the fiscal deficit. While it will also push the current account into a deficit in 2015, the future path of this depends heavily on oil production trends. But even with a modest deficit, Nigeria has low debt levels and can easily finance deficits of the forecast magnitude through increased borrowing. But, coupled with the political tensions, all these trends mean that the economy will be under pressure in 2015. But as the impact of the devaluation works its way through the real economy, and the agricultural sector starts to respond, it should start to recover towards the end of 2015.

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

Lower oil prices are a potential spur to reform

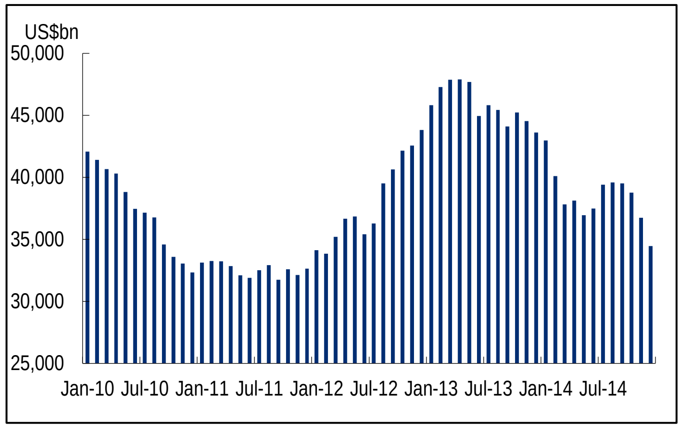
But whoever wins the polls will also face the ongoing and major challenge of running Nigeria in an era of lower oil prices. Even if, as we think, the new Nigerian government can broadly live with the new projected oil prices, both the Federal government and state governors will have to face a new financial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

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

Figure 165. Pressure on the naira has come and gone, and is currently on as the oil price has weakened in early 2015

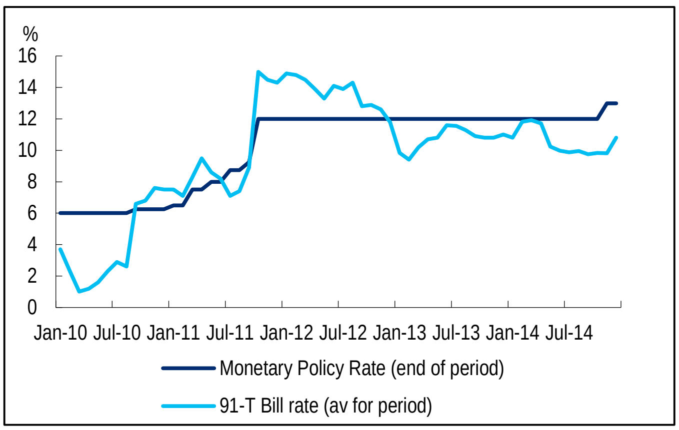
Source: National Bureau of Statistics

Figure 166. Reserves have also started to come pressure again in late 2014



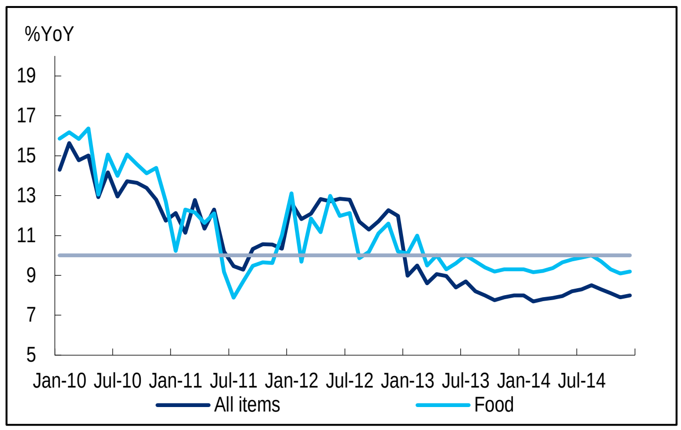
Source: International Energy Agency

Figure 167. In response, the CBN had to tightening a long unchanged monetary policy in late 2014, but will probably need to do more



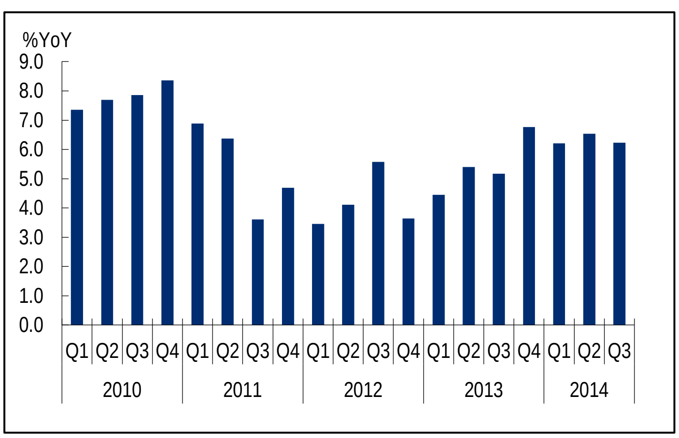
Source: National Bureau of Statistics

Figure 168. Even though inflation has remained in single digits so far in 2014



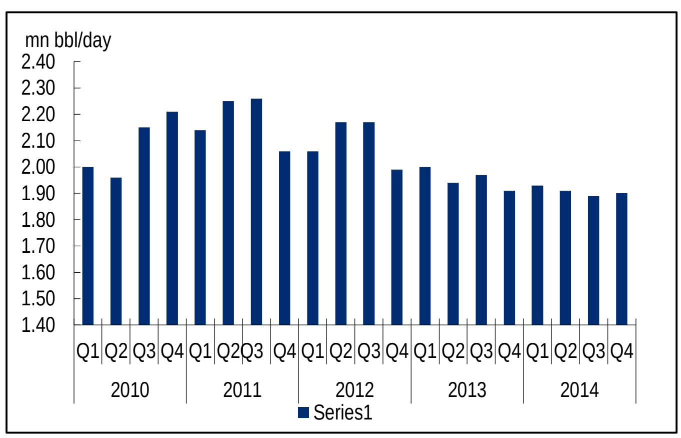
Source: Central Bank of Nigeria

Figure 169 New growth data shows an economic recovery since 2H 2013, but we expect growth to slow in 2015



Source: Reuters

Figure 170. At least oil production seems to have stabilized in 2014



Source: Haver Analytics and Central Bank of Nigeria

Figure 171. Nigeria Economic Forecasts

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	-	-	361	404	452	509	562	518	572
Nominal GDP, local currency bn	-	-	54,612	62,980	71,714	80,093	91,956	106,677	123,219
GDP per capita, USD	-	-	2,283	2,488	2,712	2,983	3,207	2,886	3,106
Population, mn	150.6	154.4	158.4	162.4	166.6	170.8	175.2	179.7	184.2
Unemployment, % of labour force	-	-	-	-	-	-	-	-	-
Economic Activity									
Real GDP, yoy avg	-	-	-	5.3	4.2	5.5	6.2	4.5	6.2
Real investment growth % yoy	-	-	-	-	-	-	-	-	-
Real consumption growth % yoy	-	-	-	-	-	-	-	-	-
private consumption growth % yoy	-	-	-	-	-	-	-	-	-
Real export growth, % yoy	-	-	-	-	-	-	-	-	-
Real import growth, % yoy	-	-	-	-	-	-	-	-	-
Prices, Money & Credit									
CPI, % yoy eop	15.1	13.9	11.7	10.3	12.0	7.9	8.0	11.9	6.7
CPI, % avg	11.6	12.5	13.7	10.8	12.2	8.5	8.1	11.0	8.8
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	59.4	26.8	-3.8	44.3	6.8	9.0	10.1	15.0	11.5
Policy Interest Rate, % eop	9.75	6.00	6.25	12.00	12.00	12.00	13.00	13.50	12.00
3 month Tbill rate, %, eop	18.00	15.79	13.07	17.17	14.39	12.61	13.60	14.00	-
Long-term yield, %, eop	12.45	8.32	7.15	16.50	11.90	11.77	12.70	15.17	13.70
NGN/US$, eop	138	150	152	162	156	160	183	214	216
NGN/US$, avg	119	150	151	156	159	159	165	207	215
Balance of Payments, USD bn									
Current account	29.1	14.0	14.5	12.6	18.9	20.6	7.4	-12.9	-3.4
% of GDP	-	-	4.0	3.1	4.2	4.0	1.3	-2.5	-0.6
Trade balance	45.9	25.7	31.7	35.0	40.9	43.7	29.6	2.5	13.7
Exports	85.7	56.8	78.5	97.2	94.3	95.1	82.8	55.3	68.2
Imports	39.8	31.1	46.8	62.2	53.4	51.4	53.2	52.8	54.5
Service balance	-22.1	-16.7	-18.5	-21.4	-21.7	-20.1	-21.8	-20.6	-21.4
Income balance	-15.1	-14.6	-19.7	-23.0	-22.3	-25.2	-23.4	-18.0	-19.0
FDI, net	-	-	-	-	-	-	-	-	-
International reserves	53.0	42.4	32.3	32.9	43.8	43.6	34.9	32.4	37.6
Total amortisations	0.6	0.5	0.5	0.4	0.3	0.3	0.3	0.3	0.3
Public Finances, % of GDP									
Consolidated government balance	-0.1	-1.8	-2.0	-1.8	-1.4	-1.6	-2.0	-2.7	-2.3
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	5.5	7.1	8.2	8.4	9.2	8.8	9.1	11.3	11.5
Foreign Assets & Liabilities, USD bn									
External debt	3.7	4.6	4.6	5.7	6.5	8.8	9.2	12.3	14.1
Public	3.2	3.9	4.4	5.0	6.0	7.3	7.7	10.0	11.1
External debt / GDP	-	-	1.3	1.4	1.4	1.7	1.6	2.4	2.5
External debt / XGS	4.2	7.7	5.6	5.6	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	6.5	6.2	6.0	3.5	4.0	4.5	6.0	5.5	6.3
CPI, % yoy eop	8.2	8.3	8.0	8.9	11.9	11.9	11.9	11.2	7.8
Policy interest rate, %, eop	12.0	12.0	13.0	13.5	13.5	13.5	13.5	13.5	13.5
Short-term market rate, % eop	12.1	13.4	13.6	14.0	15.0	16.0	14.0	13.0	12.0
Long-term yield, %, eop	12.2	11.8	12.7	13.3	13.9	14.6	15.2	14.8	14.4
NGN/US$, eop	163	164	183	198	210	215	214	215	215

Source: National Sources, Citi Research forecasts

Poland

Piotr Kalisz
+48 (22) 692 9633
piotr.kalisz@citi.com

Cezary Chrapek
+48 (22) 692 9421
cezary.chrapek@citi.com

- **Summary view** — Although sharp appreciation of CHF against the zloty can negatively affect balance sheets of some households the macroeconomic and financial stability risks appear contained. We expect growth to exceed 3% in 2015.

- **Things to watch** — The approaching parliamentary elections increase a risk of populist measures to help mortgage borrowers.

- **Strategy** — A mix of slower growth among Poland's trading partners and possibility of additional rate cuts by the MPC increase a risk of additional PLN weakening in the near term.

Swiss shock with limited impact

The decision of the Swiss National Bank to abandon the currency floor has raised questions about the impact on Poland's financial stability. The reason is that before 2009 Swiss franc mortgage loans were very popular among Polish households mostly due to very low interest rates. Although the access to new FX loans were closed by the regulator several years ago, the outstanding of CHF mortgages amounts to approximately 7.7% of GDP (CHF 38bn). Now with appreciation of the franc against zloty the debt service burden is rising, while quality of loan portfolio may deteriorate.

Despite the recent large FX move it seems the overall impact on the economy and households' finances should be manageable. According to our estimates with EUR/CHF at 1.0 the monthly instalment calculated for an average franc loan would rise by only PLN 140 (EUR 33), while at the macro level the debt service costs would rise by less than 0.1% of GDP. Obviously if SNB decides to cut interest rates even deeper into negative territory, the eventual impact on monthly instalments will be even smaller. This means that actual drag from weaker franc on Polish consumption should be limited and would be more than offset by the recent decline in fuel prices. Some increase in non-performing loans appears likely but from a very low level of 3.7% (this includes non-performing FX loans that were converted into local currency as a part of restructuring effort). Given high capital buffers of the banking sector the rise in NPLs should not constitute a threat to financial stability, in our view. According to stress tests conducted by Polish regulator the depreciation of the zloty against Swiss franc up to CHF/PLN 5.2 would reduce common equity Tier 1 ratio from 13.5% to 12.5%.

What worries us more is a risk that in a pre-election period there may appear strong political pressure to choose 'Hungarian way" of tackling the problem. Indeed, this year Poland will have presidential and parliamentary elections. Given that there are over 500 thousands CHF loans, approximately 1.0-1.5 million people may be affected by the surge in Swiss franc, though only a small fraction of this number would really need some form of restructuring. This creates substantial incentive for political parties to come up with proposals to help indebted households. Although in case of most affected borrowers the loan restructuring may be both a necessary and a logical solution, there is some risk that actual solution will be driven by populist considerations. Having said this, we believe the political developments are worth watching as they may potentially complicate – otherwise manageable – situation.

Growth to exceed 3% again

FX shocks aside, the Polish economy appears to be growing at a relatively fast pace. Although some weakening in economic activity is expected in 4Q/1Q the GDP growth should remain close to 3%YoY. The domestic demand remains a driver of the expansion, thanks to both robust private consumption and further increase in fixed investment. The improvement in the labour market suggests the recovery is not short lived and should be sustained in the coming quarters.

An important source of uncertainty is related to the intensification of the Russian crisis. Unlike sanctions in 2014 that affected only a part of Polish exports, this time the total exports from Poland to Russia are likely to suffer because of sharp weakening of the RUB. At present exchange rates Polish exports are simply too expensive for Russian and some other CIS markets. However it is striking that despite double digit drop in exports to Russia, Poland is able to record close to 10% increase in exports to several eurozone countries. Generally we treat CIS crisis as an important risk factor for Poland. On the positive side we see the decline in crude oil and fuel prices to act as a buffer. According to our estimates cheaper fuels can add 0.5-1.0% point to economic growth, depending on how much of this windfall gain is spent by households. This would be sufficient to offset the impact of both slower Russian growth and the impact of stronger Swiss franc.

Taking into account these factors we keep our forecasts of 3.4% GDP growth in 2015. This would be slightly above the 2014 growth though we expect also that the beginning of the year is likely to see a bit slower growth followed by approximately 4% expansion in the final quarter of the year.

Monetary policy dilemmas

Falling commodity prices are to keep CPI below zero for most of the year. According to our estimates if fuel prices do not rebound soon the deflation could last until August or even longer while annual average CPI will be slightly negative. Although domestic demand remains strong and the labour market recovery continues the threat of prolonged deflation might be sufficient to tilt the balance of votes towards policy easing. Already in January the MPC has softened its tone and practically suggested a possibility of additional easing.

What complicates the picture is the strengthening of the CHF versus the zloty and resulting fears of financial stability risks. This is a new factor that the MPC hasn't had chance to analyze properly and we believe it may contribute to cautious monetary policy in the near term. Taking this into account we expect interest rates to stay unchanged in February but we see chances of 50bps of rate cuts later this year. The March meeting looks like a first likely moment for such a move as by then the MPC will have to analyze details of a new inflation projection. However policy decisions may be affected by the FX market developments and any signs of more significant depreciation pressures would probably stop the central bank from cutting rates.

Figure 172. Number & value of mortgage loans (2013)

Housing loans portfolio	Total	PLN	FX	Of which: CHF	EUR	Other
Number of loans	1,771,191	1,093,626	677,565	562,487	109,463	5,615
Outstanding value (PLN mn)	328,768	161,877	166,891	135,684	30,271	936
Average loan (PLN thous.)	185.6	148	246.3	241.2	276.5	166.6

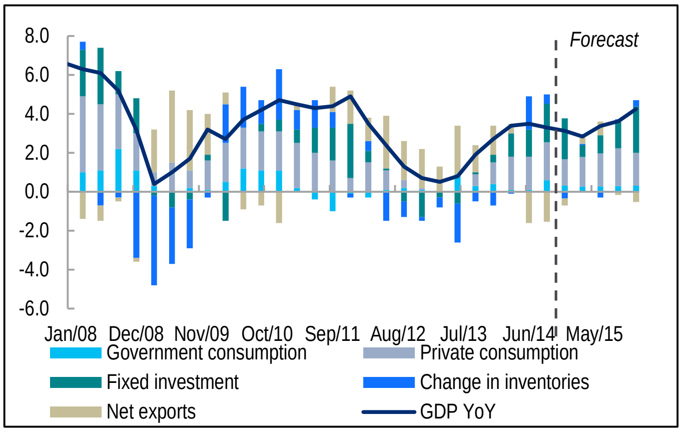
Source: KNF, NBP

Figure 173. Loan-to-value breakdown (as of end-2013)

Housing loans portfolio	Number of loans: Total	PLN	FX	CHF	Outstanding value (PLN mn): Total	PLN	FX	CHF
Total	1,762,793	1,085,278	677,515	562,441	328,694	161,803	166,891	135,684
LTV below 80%	1,204,194	777,750	426,444	359,082	164,126	92,739	71,387	58,451
80% - 100%	345,594	248,743	96,851	67,811	86,989	53,461	33,529	22,716
above 100%	213,005	58,785	154,220	135,548	77,578	15,603	61,975	54,517

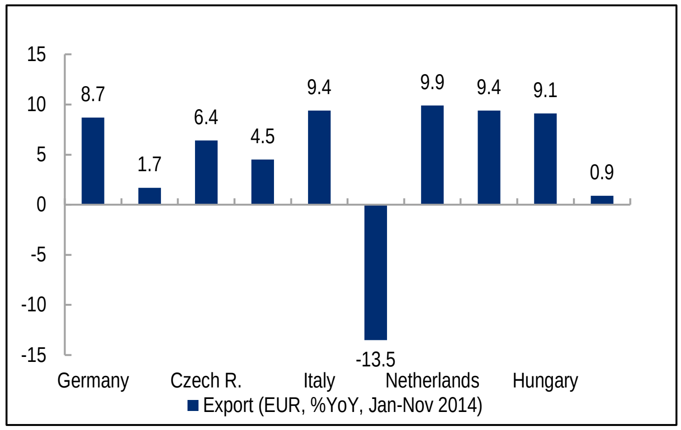
Source: KNF, NBP

Figure 174. ... which translates into the lowest jobless rate in 5 years



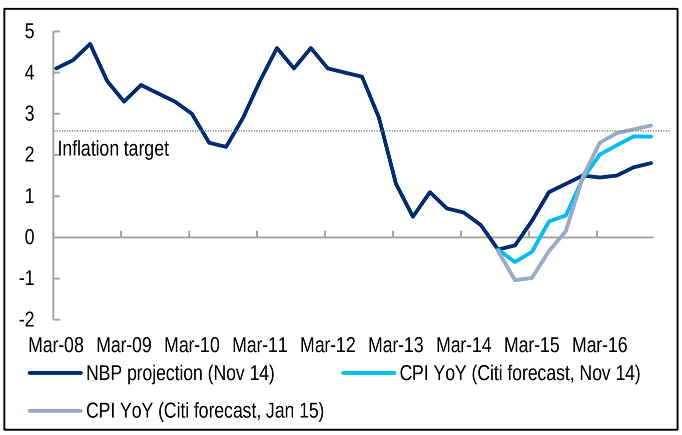
Source: CSO, Citi Research

Figure 175. Export growth with 10 biggest export partners.



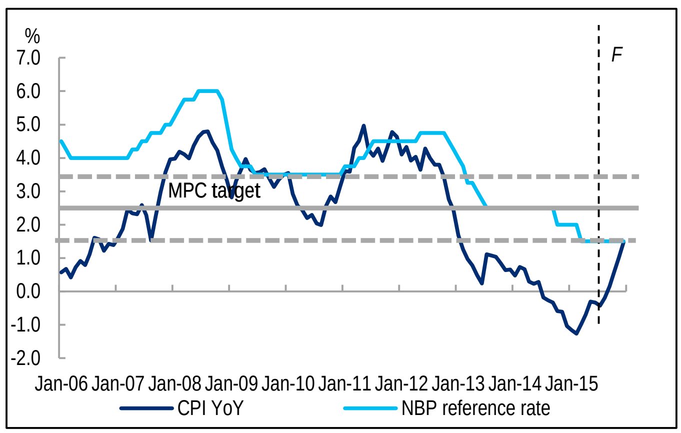
Source: CSO

Figure 176. Drop in oil prices will contribute to longer period of deflation than previously expected



Source: CSO, Citi Research forecasts

Figure 177. The MPC will likely cut rates by 50bp more on prolonged deflation



Source: CSO, Citi Research forecasts

Figure 178. Poland Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	534	439	477	525	496	526	548	468	461
Nominal GDP, local currency bn	1,277	1,362	1,437	1,554	1,616	1,662	1,726	1,790	1,904
GDP per capita, USD	14,010	11,508	12,382	13,626	12,879	13,662	14,235	12,175	11,983
Population, mn	38.1	38.2	38.5	38.5	38.5	38.5	38.5	38.5	38.5
Unemployment, % of labour force	9.5	12.1	12.4	12.5	13.4	13.4	11.7	10.8	10.0
Economic Activity									
Real GDP, yoy avg	3.9	2.6	3.7	4.8	1.8	1.7	3.3	3.4	3.6
Real investment growth % yoy	2.2	-12.7	9.7	12.2	-4.3	-3.7	10.8	6.6	7.2
Real consumption growth % yoy	5.9	3.5	2.8	1.7	0.7	1.3	2.9	2.7	3.2
private consumption growth % yoy	6.1	3.4	2.7	2.9	0.9	1.0	3.0	3.0	3.2
Real export growth, % yoy	7.0	-6.3	12.9	7.9	4.3	5.0	4.3	4.0	6.0
Real import growth, % yoy	9.4	-12.4	14.0	5.5	-0.6	1.8	6.8	4.8	7.0
Prices, Money & Credit									
CPI, % yoy eop	3.4	3.7	3.2	4.6	2.6	0.8	-1.0	1.5	2.4
CPI, % avg	4.2	3.5	2.6	4.3	3.7	0.9	0.0	-0.2	2.4
Nominal wages, % yoy	10.5	4.2	3.6	4.9	3.5	2.6	3.7	3.7	4.8
Credit extension to private sector, % yoy	36.4	7.0	8.5	13.9	2.4	4.5	6.5	7.5	9.0
Policy Interest Rate, % eop	5.00	3.50	3.50	4.50	4.25	2.50	2.00	1.50	2.50
3 month inter-bank rate, %, eop	5.88	4.27	3.95	4.99	4.11	2.71	2.06	1.63	2.98
PLN/US$, eop	2.97	2.87	2.97	3.45	3.09	3.02	3.54	3.89	4.30
PLN/US$, avg	2.39	3.10	3.01	2.96	3.25	3.16	3.15	3.82	4.13
PLN/EUR, eop	4.15	4.10	3.97	4.47	4.08	4.15	4.29	4.18	4.10
PLN/EUR, avg	3.52	4.32	3.99	4.12	4.18	4.20	4.19	4.25	4.13
Balance of Payments, USD bn									
Current account	-34.9	-17.3	-24.1	-27.0	-17.6	-7.0	-6.4	-7.5	-10.7
% of GDP	-6.5	-3.9	-5.0	-5.1	-3.6	-1.3	-1.2	-1.6	-2.3
Trade balance	-33.5	-10.2	-13.8	-17.4	-9.2	0.9	0.6	-0.7	-3.9
Exports	166.3	133.1	156.3	184.2	181.0	197.8	190.6	177.5	175.4
Imports	199.8	143.3	170.1	201.6	190.2	196.9	190.0	178.2	179.3
Service balance	7.4	7.0	4.4	7.3	8.0	10.6	8.6	8.1	8.1
Income balance	-10.2	-12.7	-16.5	-18.0	-16.2	-18.0	-15.8	-14.9	-14.6
FDI, net	-9.9	-8.1	-11.3	-14.0	-6.6	-3.7	-9.0	-10.0	-11.0
International reserves	58.9	73.4	86.3	89.7	100.3	99.3	94.1	94.1	94.1
Total amortisations	44.0	46.9	44.1	38.3	47.5	48.7	49.2	51.0	49.6
Public Finances, % of GDP									
Consolidated government balance	-	-	-7.6	-4.9	-3.7	-4.0	-2.9	-2.3	-2.2
Consolidated gov primary balance	-	-	-5.1	-2.4	-1.0	-1.5	-0.8	-0.5	-0.5
Public debt	46.8	49.2	52.8	53.4	52.7	53.1	47.0	47.4	47.4
of which Domestic	34.7	36.3	37.8	35.9	35.7	37.0	29.4	29.3	29.2
Foreign Assets & Liabilities, USD bn									
External debt	245.0	280.5	318.6	323.4	366.7	382.1	380.1	360.1	370.1
Public	69.4	92.2	117.9	121.2	156.8	163.9	163.0	154.4	158.7
External debt / GDP	45.9	63.9	66.8	61.6	73.9	72.7	69.4	76.9	80.3
External debt / XGS	119.8	170.6	166.2	143.7	165.1	157.4	163.7	166.2	172.6
Short-term debt	51.3	54.3	48.4	44.8	42.4	46.3	44.3	40.3	40.3
Short-term debt/International reserves (%)	87.0	73.9	56.1	50.0	42.3	46.6	47.1	42.8	42.8

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	3.5	3.3	3.1	2.8	3.4	3.6	4.2	4.0	3.5
CPI, % yoy eop	0.3	-0.3	-1.0	-1.0	-0.3	0.2	1.5	2.1	2.6
Policy interest rate, %, eop	2.50	2.50	2.00	1.50	1.50	1.50	1.50	1.50	1.75
Short-term market rate, % eop	2.68	2.28	2.06	1.52	1.58	1.61	1.63	1.72	2.23
PLN/EUR, eop	4.16	4.18	4.29	4.32	4.27	4.21	4.18	4.16	4.14

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

Romania

Ilker Domac
+90 212 319 4623
ilker.domac@citi.com

Gultekin Isiklar
+90 212 319 4915
gultekin.isiklar@citi.com

- **Summary view** — While nascent signs of recovery in investment spending are encouraging, we remain skeptical about the effectiveness of the current monetary policy approach in stimulating lending activity.
- **Things to watch** — Whether the new President will seek to undermine Mr. Ponta's power with a view to creating conditions for a vote of confidence motion and the fate of the IMF-EU supported economic program deserves close monitoring.
- **Strategy** — The current level of interest rates falls short of providing an adequate buffer to the currency. Concurrently, the wide divergence between the policy rate and money market rates remains a cause for concern in our view.

Investment spending shows some signs of hope

The revised data of 2.9%YoY for the first nine months points to a moderately higher GDP growth than what was announced previously (2.8%YoY). In particular, the final 3Q GDP data, along with other indicators, suggest to us that private consumption and—to a lesser extent—investment seem to be gaining some traction. Standing at about 1.8 %QoQ (SWDA), it looks like economic activity in 3Q has gained considerable momentum when compared with 2Q (-0.4%QoQ) and 1Q 2013 (0.8%QoQ).

Against this backdrop, we look for a moderate pick-up in economic activity this year with GDP growth reaching 3.0% from an estimated 2.8% in 2014. In our view, private consumption is likely to remain resilient thanks to the combination of low inflation and an accommodative monetary policy stance. This, coupled with recent developments such as a tax exemption for reinvested profits and a cut in social security contributions, should finally boost investment, in our view.

Inflation plunges thanks to low oil and food prices

At 0.8% YoY, the inflation print in December came in lower than the consensus (0.9%YoY) and the NBR's forecast of 1.5%. With the December reading, the average inflation in 2014 declined to 1.1%, which is the lowest on record, from 4% in 2013. Historically low food inflation, the sharp decline in oil prices and the VAT cut for bread were the key drivers of the country's better-than-expected inflation performance last year. Using seasonally adjusted data, the December print translates into a drop of about 0.15%MoM compared with a similar decline in November and a flattish inflation reading in October.

Regarding this year's inflation, we remain somewhat more cautious than the NBR, which sees it at 2.2% compared with our forecast of about 2.5%. Our view is underpinned by the notion that the sharp decline in inflation in 2014 was driven largely by the above-noted temporary factors without a commensurate improvement in underlying inflation dynamics. Moreover, while we recognize the noticeable improvement in forward-looking inflation expectations, we argue this picture can change quite rapidly, since our analysis suggests the causality runs from actual inflation outturns to forward-looking expectations and not the other way around. With year-end core inflation (Core2 excluding administered prices and highly volatile prices such as vegetables, fruit, eggs and fuels) last year standing at about 2%YoY (compared with the headline reading of 0.8%YoY), we believe that it makes sense to err on the side of caution.

NBR leaves the door open for further easing

Based on our inflation forecast trajectory, we still think that it is hard to put forward a credible case for further easing. In our view, unimpressive capital inflows and the bleak prospects for additional VAT cuts further weaken the case for additional easing. Regarding the inflation outlook, we note that the possibility of a sharp reversal in food prices and strong base effects overshadow price dynamics in 2015. In our view, a weaker-than-expected leu and uncertainties related to the timetable for the deregulation of natural gas/electricity further cloud the inflation outlook. In fact, given the large confidence bands in the NBR's inflation forecast trajectory, we are somewhat surprised by the Bank's assertive position on the inflation outlook.

Where do we go from here? Despite the above-noted concerns, however, the Governor's remarks in the aftermath of the January Board Meeting suggests to us that the NBR is probably considering additional easing thanks in part to lower oil prices. Against this backdrop and today's inflation reading, we believe that a 25bp cut in the February meeting is likely. In this respect, we believe that the new Inflation Report (to be discussed on February 4, 2015) will shed more light on the nature and the magnitude of the possible easing for the remainder of the year.

Will fiscal discipline and reforms continue without IMF?

Romania registered a considerably narrower budget gap (RON 0.2bn) in the first eleven months of 2014, compared with a deficit of RON 9.8bn in the same period of 2013. While revenues during the period under consideration increased by almost 7.0%YoY, expenditures rose only by about 1.5%YoY. As was also pointed out by senior officials, the 2014 budget gap is estimated to be 1.98% of GDP, which is narrower than the target (2.2% of GDP). Concerning this year, under the umbrella of the IMF-EU supported program, the authorities' budget deficit target is 1.8% of GDP, which, in our view, looks attainable. Looking ahead, it is worth noting that the likelihood of another pre-cautionary IMF-EU program once the current one expires in 2015 is very low, in our view. While there are signs suggesting that the Government wants to opt for a different kind of program with the IMF— such as the flexible credit line—we are not sure about the feasibility of such an arrangement for Romania.

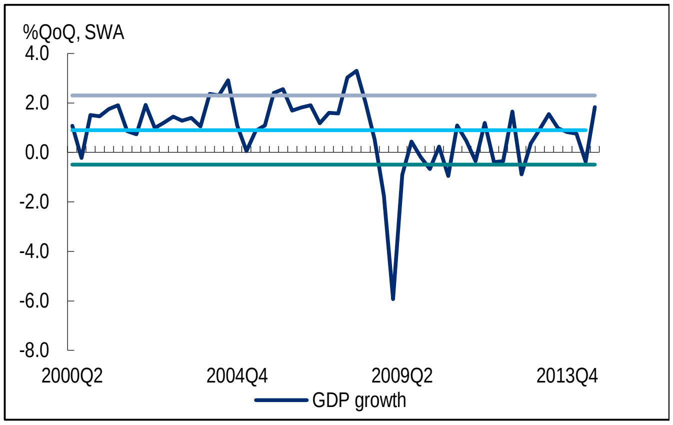
Low yields overshadow the FX outlook…

In our view, low yields and subdued capital inflows—coupled with the NBR's inclination to keep money market rates below the policy rate and the possibility of higher political noise—cloud the outlook for the leu. Even if one employs the NBR's official inflation forecast of 2.2% for 2015, it is hard to argue that the current level of interest rates provides adequate buffer to the currency. Against this backdrop, we expect the EUR/RON to be around 4.58 by the end of 2015 with risks tilted towards a weaker currency.

Bond Market: A repeat of 2014 this year looks difficult

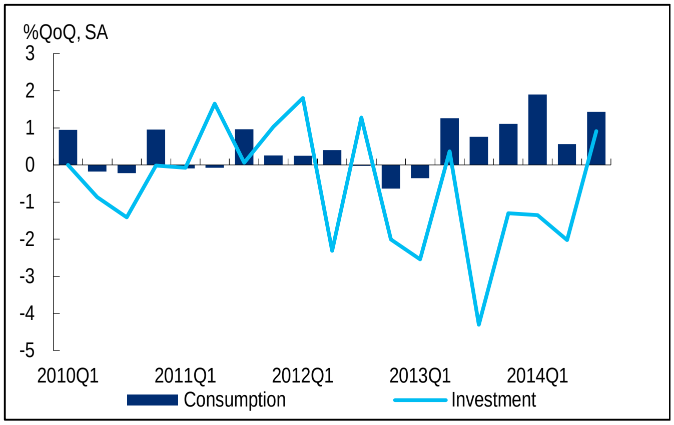
The country's moderate (domestic) borrowing needs this year and favorable macro backdrop bode well for the bond market, in our view. Nonetheless, we believe that the wide divergence between the policy rate and money market rates remains a cause for concern, as adverse FX and/or inflation shocks may lead the NBR to bring money market rates closer to the policy rate in an abrupt manner.

Figure 179. The strong rebound in 3Q and ...



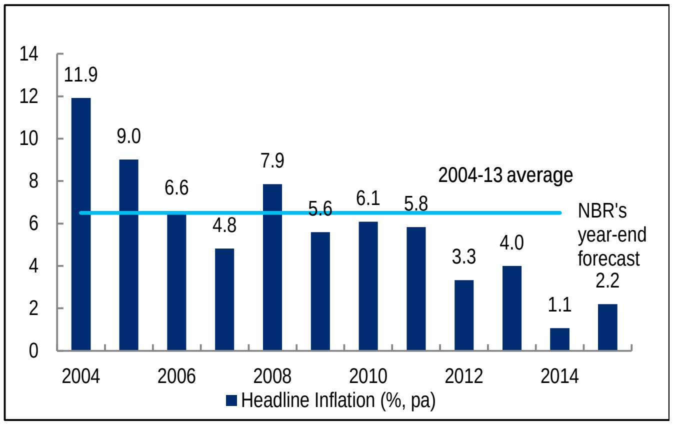
Source: Haver Analytics, Citi Research

Figure 180. ... signs of recovery in investment spending are encouraging



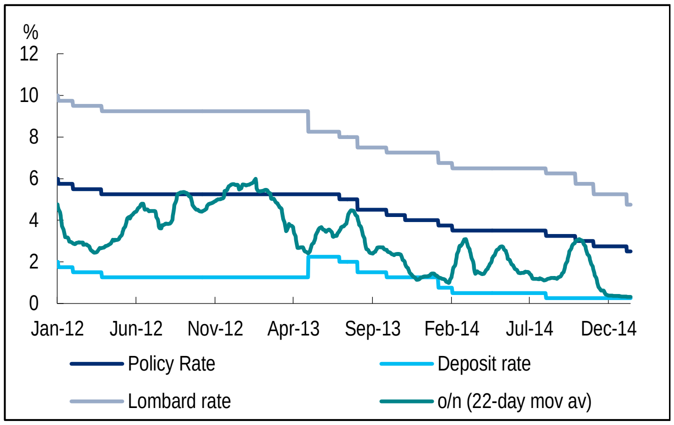
Source: Haver Analytics, Citi Research

Figure 181. The benign inflation outlook...



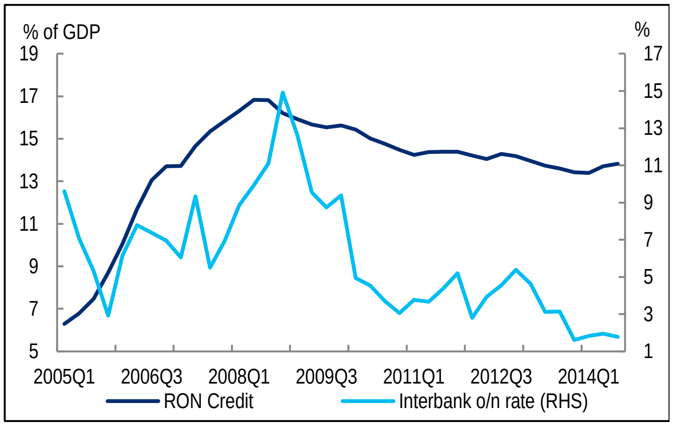
Source: Haver Analytics, Citi Research

Figure 182. ...allows NBR to leave the door open for further easing...



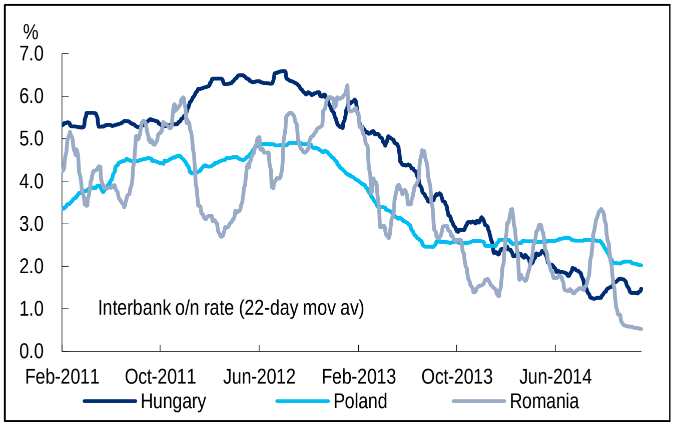
Source: Haver Analytics, Citi Research

Figure 183. ... but rate cuts have so far failed to stimulate lending...



Source: : Haver Analytics, Citi Research

Figure 184. ...and could undermine the performance of the leu



Source: Haver Analytics, Citi Research.

Figure 185. Romania Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	208	168	168	185	172	192	199	170	162
Nominal GDP, local currency bn	524	511	534	565	597	639	665	695	734
GDP per capita, USD	9,348	7,536	7,557	8,360	7,772	8,695	9,006	7,705	7,390
Population, mn	22.3	22.2	22.2	22.2	22.1	22.1	22.1	22.0	22.0
Unemployment, % of labour force	4.0	6.3	7.6	5.4	5.1	5.3	5.5	5.5	5.5
Economic Activity									
Real GDP, yoy avg	8.6	-7.1	-0.8	1.1	0.6	3.5	2.8	3.0	3.0
Real investment growth % yoy	8.8	-33.7	4.6	8.6	-8.8	-4.7	-3.5	3.5	1.5
Real consumption growth % yoy	7.1	-8.8	0.3	0.8	1.1	0.6	4.5	3.2	3.3
private consumption growth % yoy	7.1	-10.2	1.0	0.8	1.1	0.9	5.0	3.5	3.5
Real export growth, % yoy	-5.3	-4.8	16.9	12.3	1.7	21.6	7.1	4.0	4.6
Real import growth, % yoy	-0.2	-21.4	13.6	10.4	-1.8	8.7	5.8	4.1	4.0
Prices, Money & Credit									
CPI, % yoy eop	6.3	4.7	8.0	3.1	5.0	1.6	0.8	2.6	2.7
CPI, % avg	7.9	5.6	6.1	5.8	3.3	4.0	1.1	1.5	2.6
Nominal wages, % yoy	23.6	8.4	2.5	4.9	5.0	5.0	5.0	4.5	4.5
Credit extension to private sector, % yoy	33.7	0.9	4.7	6.6	1.3	-3.3	-2.7	1.3	2.3
Policy Interest Rate, % eop	10.25	8.00	6.25	6.00	5.25	4.00	2.75	2.25	3.50
3 month inter-bank rate, %, eop	15.46	10.65	6.17	6.05	6.05	2.44	1.70	2.05	3.30
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/US$, eop	2.89	2.96	3.17	3.33	3.37	3.25	3.71	4.26	4.71
RON/US$, avg	2.50	3.04	3.17	3.04	3.46	3.33	3.34	4.10	4.52
RON/EUR, eop	4.03	4.24	4.24	4.32	4.45	4.46	4.48	4.58	4.50
RON/EUR, avg	3.68	4.24	4.21	4.24	4.46	4.42	4.44	4.55	4.52
Balance of Payments, USD bn									
Current account	-24.1	-7.6	-7.7	-8.6	-7.8	-1.6	-1.0	-3.1	-3.6
% of GDP	-11.6	-4.5	-4.6	-4.6	-4.5	-0.8	-0.5	-1.8	-2.2
Trade balance	-31.8	-12.0	-11.9	-12.5	-11.5	-7.2	-7.4	-7.5	-7.8
Exports	39.9	33.6	43.4	55.8	51.3	58.3	61.6	52.3	50.7
Imports	71.7	45.6	55.4	68.3	62.8	65.5	68.9	59.7	58.5
Service balance	4.3	1.3	2.0	2.3	3.2	6.2	7.4	5.6	5.4
Income balance	-2.2	-2.2	-2.0	-2.3	-3.0	-4.1	-4.2	-4.6	-4.4
FDI, net	13.3	4.7	3.0	2.4	3.1	3.9	4.2	3.9	3.7
International reserves	36.5	40.8	43.3	42.9	41.2	44.9	39.0	34.6	31.2
Total amortisations	18.1	17.7	19.7	19.6	25.0	33.7	30.1	26.9	23.9
Public Finances, % of GDP									
Consolidated government balance	-3.8	-6.9	-6.5	-4.7	-2.9	-3.1	-2.0	-1.9	-2.1
Consolidated gov primary balance	-3.0	-5.7	-5.1	-3.2	-1.1	-1.4	-0.4	0.3	0.1
Public debt	20.9	28.9	36.4	39.5	40.4	41.8	41.8	42.3	43.0
of which Domestic	12.4	15.1	19.4	21.6	18.2	18.2	20.6	19.6	21.3
Foreign Assets & Liabilities, USD bn									
External debt	105.8	113.0	122.4	137.3	128.1	127.6	127.2	105.2	97.5
Public	14.2	19.6	24.8	28.9	34.2	40.9	37.5	34.6	31.5
External debt / GDP	50.8	67.4	72.9	74.0	74.4	66.4	64.0	62.0	60.0
External debt / XGS	188.0	249.1	227.4	202.2	200.2	167.7	157.7	151.9	145.4
Short-term debt	28.5	22.5	26.2	29.5	28.0	26.3	23.0	21.5	20.1
Short-term debt/International reserves (%)	78.1	55.1	60.4	68.8	67.9	58.5	58.9	62.1	64.2

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	1.4	3.3	2.6	2.7	3.8	2.8	3.1	3.2	3.3
CPI, % yoy eop	0.7	1.5	0.8	1.1	1.4	1.7	2.6	2.7	2.5
Policy interest rate, %, eop	3.50	3.00	2.75	2.25	2.25	2.25	2.25	2.50	3.00
Short-term market rate, % eop	2.42	3.10	1.70	2.05	2.05	2.05	2.05	2.30	2.80
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/EUR, eop	4.39	4.41	4.48	4.51	4.54	4.56	4.58	4.55	4.53

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

Russia

Ivan Tchakarov
+7 495 643 1507
ivan.tchakarov@citi.com

Ekaterina Vlasova
+7 495 643 1576
ekaterina.vlasova@citi.com

- **Summary view** — We recently downgraded our 2015 Russian GDP growth to -3% from -1% previously on Citi's new oil price forecasts. Citi's commodity strategists now see Brent averaging US$63/bbl this year (US$80/bbl previously) with a US$60-65 range in their baseline scenario.
- **Things to watch** — Plenty of downside risks may weigh on our baseline, including lower-than-forecast oil prices and the increasing likelihood that Russia loses its investment grade status. However, geopolitical tensions may ease as Russia and the West try to find some common ground in Ukraine.
- **Strategy** — While the current account surplus has been performing better than expected, it will continue to be challenged by large capital account outflows, thus putting pressures on the rouble. The formal adoption of inflation targeting from 2015 may also add to currency volatility.

Russian economy to suffer in 2015

We downgrade 2015 Russian GDP growth to -3% from -1% previously on Citi's new oil price forecasts. Citi's commodity strategists now see Brent averaging US$63bbl this year (US$80bbl previously) with a US$60-65 range in their baseline scenario. We prefer to take the lower boundary of US$60bbl as the assumed average oil price for 2015. Under this assumption, we estimate that 2015 GDP growth will contract by 3.0%. If that materializes, 2015 will be the 5th consecutive year of decelerating GDP performance.

The balance of risks is slanted to the downside. Plenty of downside risks may weigh on our baseline scenario, including lower-than-forecast oil prices and the increasing likelihood that Russia may lose its investment grade status in 2015. One positive risk that should not be underestimated is the possibility that geopolitical tensions ease as Russia and the West find some common ground in resolving the situation in Ukraine.

However, two key factors will provide a floor to how much GDP growth may fall. Even if oil prices average the same US$60bbl that were seen during 2009, we think temptations to draw parallels with the magnitude of the 2009 growth collapse (-7.8%) are erroneous for two key reasons. First, in sharp contrast to the 2009 episode, the Russia economy is now under-heating, which should limit the magnitude of the current recession. Second, in an important policy difference to the previous crisis, authorities have responded in a much more proactive manner by letting the RUB float well earlier now, thus allowing the exchange rate to perform its textbook role of a shock-absorber. In combination, these factors should ensure that 2015 GDP contraction will be more muted even if oil prices are lower than that during 2009.

We also guard against seemingly easy allusions to the 1998 financial meltdown. Given that clear elements of panic were evident in Dec, it has now become popular to evoke the unpleasant memories of the 1998 financial meltdown. Prophecies about a repetition of the 1998 sovereign default have sprouted up and taken the discussion to a feverish pitch. Yet we deem such comparisons inappropriate. In 1998, Russia faced insurmountable macroeconomic pressures. Russia ran a 3.7% of GDP fiscal deficit, 2.2% of GDP current account deficit and FX reserves fell to US$10bn, or only 1.1 months of imports. Now Russia runs a broadly balanced fiscal position, a healthy current account surplus and holds FX reserves of just under US$400bn or 11 months of imports.

We foresee private consumption as the main cause of the recession. Against the background of anemic GDP growth in the last couple of years, it has only been private consumption delivering strong results on the back of the retail lending–driven consumer boom that reigned during 2011-2013. However, more restrictive regulatory behavior and heightened uncertainty has been cooling consumer behavior in recent quarters and we anticipate spending will come to a complete halt in 2015 on the back of elevated inflation and weaker RUB eating away at real purchasing power. As a result, we forecast private consumer spending will contract by 4.0%, marking the first negative growth since 2009.

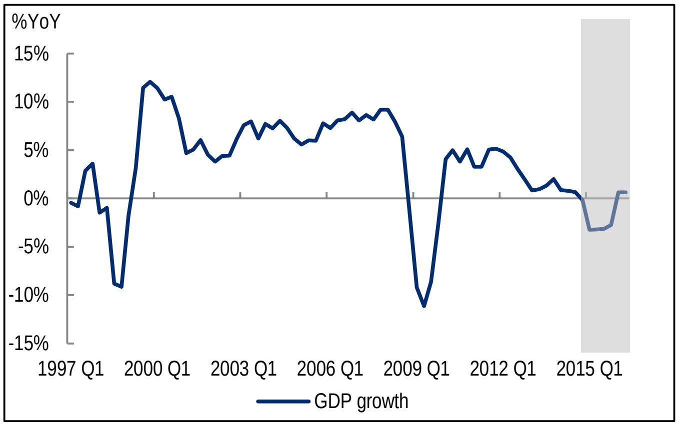
Investment will continue to be hampered by broader uncertainty. Deep-seated structural impediments have been providing heavy headwinds to investment spending for a number of years and we see the current economic backdrop extending into 2015. We forecast that investment contraction will deepen from 0.1% in 2013 and an estimated 3.5% in 2014 and to 5.6% in 2015.

As is typical for EMs going through crises, net exports will be the only balm to the sore wound of a recessionary economy. Even if lower oil prices do undercut commodity-heavy exports, significant aggregate demand compression will likely limit the scope for the reduction of the current account surplus. In particular, we see the current account surplus slowing from an estimated 3.6% of GDP (US$60bn) in 2014 to 3.1% of GDP (US$40bn) in 2015, thus providing a useful prop to the economy. At the same time, net capital outflows should continue to outweigh the current account surplus, ensuring FX reserves remain on a downtrend during the year. For example, if net capital outflows halve from US$120bn in 2014 to US$60bn in 2015, FX reserves would decline by about US$20bn during the year from US$390bn at end-2014 to US$370bn at end-2015.

We believe the fiscal position will deteriorate, but by a smaller amount than generally believed. Currently the official 2015 budget is based on an oil price of US$96/bbl and USDRUB at 37.7. Hence at the RUB price of oil 3620 (96 times 37.7), the 2015 fiscal deficit is estimated at 0.6% of GDP. Since the macro-framework underlying this government forecast being dated, the budget needs to be revised early in the year on more realistic assumptions. If we assume USDRUB at 62 (Citi's official 2015 forecast) and Brent oil prices at US$63/bbl (also Citi's official 2015 forecast), RUB price of oil would be 3906, i.e. even higher than what is currently budgeted. In other words, in RUB terms oil-related revenues (50 percent of all revenues) will change little in our view. This should ensure that the deterioration of the fiscal deficit will be smaller than generally anticipated. Of course, non-oil revenues should suffer due to the expected significant GDP decline.

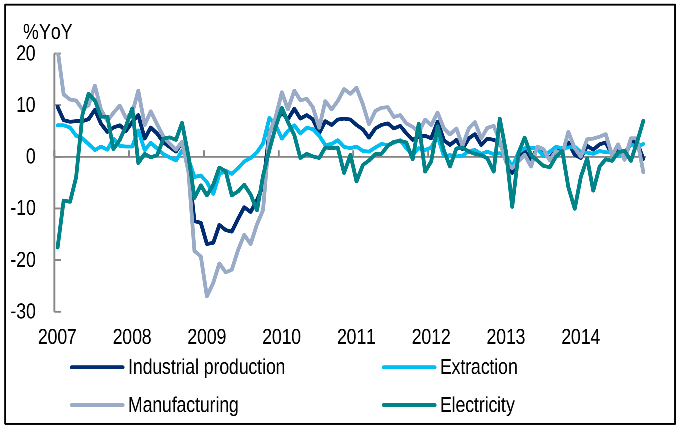
The CBR has embarked on a new monetary policy paradigm that promises more FX volatility in 2015. The CBR learned a critical lesson from the 2008-2009 crisis episode, when it stuck to its heavily managed FX policy for too long before allowing the RUB to respond more nimbly to market forces. These hard-learned lessons were applied to the current situation as the regulator has become more agnostic to RUB moves via permitting a gradual currency weakening as a means to letting the economy adjust to unfavorable external shocks. In November the CBR effectively moved to a free float and in Dec, in response to the formidable FX pressures, the CBR raised policy rates by 6.5% to 17%. The CBR has thus adopted the modus operandi of a traditional emerging markets central bank, which only intervenes at irregular intervals to smooth out excessive RUB volatility. In the current sanction-based environment, we expect that this new monetary policy paradigm will be consistent with larger than normal FX volatility.

Figure 186. Growth is set to contract in 2015



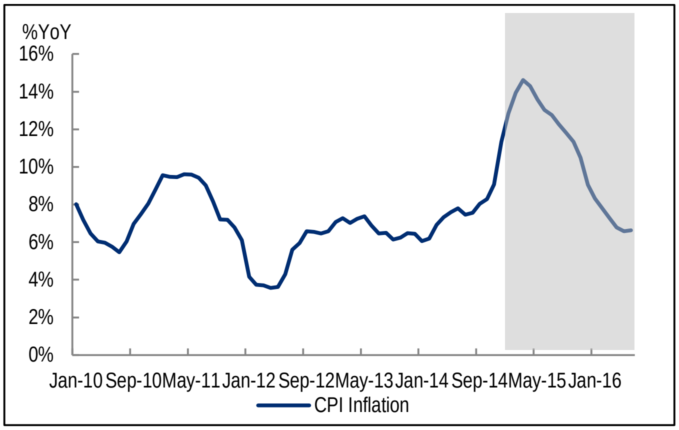
Source: Rosstat, Citi Research (shaded area is Citi forecast)

Figure 187. Industrial activity is also weak



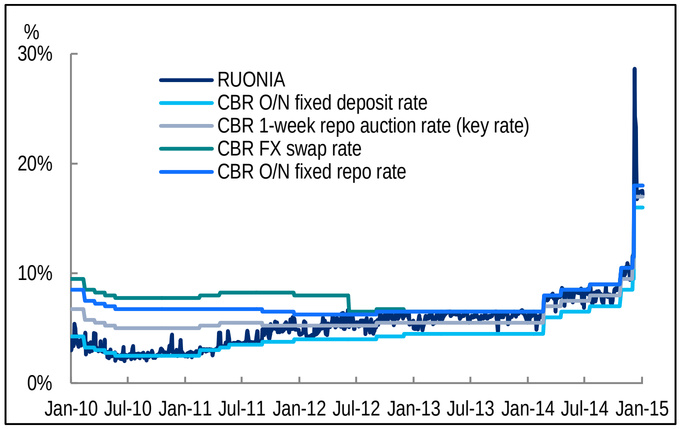
Source: Rosstat, Citi Research

Figure 188. Inflation will peak at around 15% in 1Q.



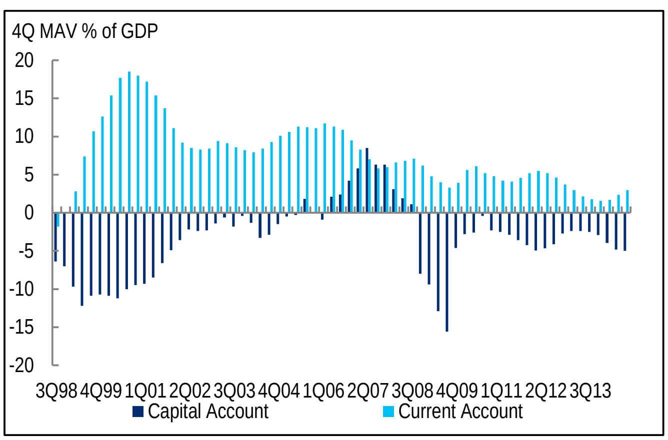
Source: Rosstat, Citi Research (shaded area is Citi forecast)

Figure 189. Rates may start declining, but only in 2H15



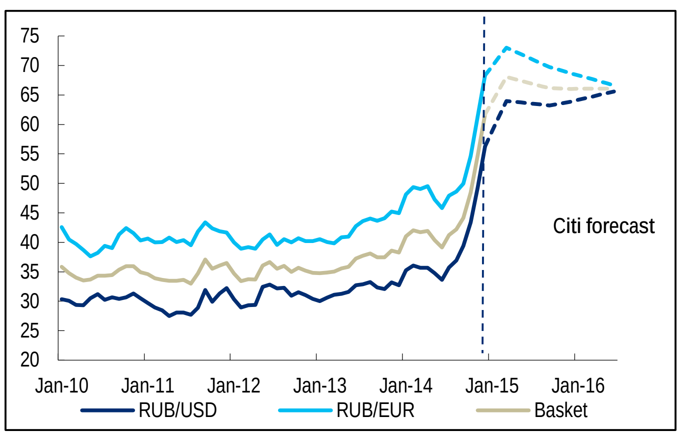
Source: Bloomberg, Citi Research

Figure 190. The gradual disappearance of the current account…



Source: CBR, Citi Research

Figure 191. …poses risks for the ruble



Source: Bloomberg, Citi Research

Figure 192. Russia Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	1,665	1,229	1,524	1,903	2,000	2,093	1,870	1,241	1,309
Nominal GDP, local currency bn	41,277	38,807	46,309	55,967	62,147	66,194	71,771	79,021	86,453
GDP per capita, USD	11,585	8,554	10,611	13,267	13,969	14,656	13,124	8,733	9,235
Population, mn	143.7	143.7	143.6	143.4	143.2	142.8	142.5	142.1	141.7
Unemployment, % of labour force	6.2	8.2	7.4	6.5	5.5	5.5	5.7	6.5	6.0
Economic Activity									
Real GDP, yoy avg	5.2	-7.8	4.5	4.3	3.4	1.3	0.6	-3.0	1.5
Real investment growth % yoy	10.5	-41.0	28.5	21.0	1.5	-6.1	-4.7	-8.0	2.7
Real consumption growth % yoy	8.4	-3.9	3.5	5.3	7.0	3.6	0.4	-3.0	0.8
private consumption growth % yoy	10.4	-5.1	5.5	6.7	7.9	4.7	0.5	-4.0	1.0
Real export growth, % yoy	0.6	-4.7	7.0	0.3	1.4	4.2	0.0	-1.0	1.0
Real import growth, % yoy	14.8	-30.4	25.8	20.3	8.8	3.7	-3.0	-5.0	4.6
Prices, Money & Credit									
CPI, % yoy eop	13.3	8.8	8.8	6.1	6.6	6.5	11.3	9.0	6.0
CPI, % avg	14.1	11.6	6.8	8.4	5.1	6.8	7.8	12.5	6.8
Nominal wages, % yoy	27.4	9.1	12.8	11.7	13.3	12.3	13.5	12.7	10.0
Credit extension to private sector, % yoy	37.2	2.6	12.9	28.1	19.4	17.2	15.0	5.0	6.0
Policy Interest Rate, % eop	9.50	6.00	5.00	5.25	5.50	5.50	17.00	13.00	7.00
3 month inter-bank rate, %, eop	21.80	7.05	4.06	7.22	7.47	7.15	23.77	14.15	11.99
Long-term yield, %, eop	10.90	9.45	8.23	8.77	7.04	7.88	13.01	14.20	12.05
RUB/US$, eop	30.5	30.3	30.6	32.2	30.6	32.9	58.0	63.9	67.4
RUB/US$, avg	24.9	31.7	30.4	29.4	31.1	31.9	38.6	63.7	66.1
RUB/EUR, eop	42.7	43.4	40.9	41.7	40.3	45.2	70.2	68.7	64.4
RUB/EUR, avg	36.6	44.2	40.3	41.0	40.0	42.3	51.3	70.7	66.1
Balance of Payments, USD bn									
Current account	103.9	50.4	67.5	97.3	71.3	34.1	60.3	40.3	30.4
% of GDP	6.2	4.1	4.4	5.1	3.6	1.6	3.2	3.2	2.3
Trade balance	177.6	113.2	147.0	196.9	191.7	181.9	192.3	179.6	174.8
Exports	466.3	297.2	392.7	515.4	527.4	523.3	536.4	520.3	535.9
Imports	288.7	183.9	245.7	318.6	335.8	341.3	344.1	340.6	361.1
Service balance	-20.4	-17.6	-26.1	-33.5	-46.6	-58.3	-54.0	-59.9	-64.5
Income balance	-46.5	-39.7	-47.1	-60.4	-67.7	-80.2	-69.0	-70.5	-70.9
FDI, net	19.1	-6.7	-9.4	-11.8	-18.1	12.4	-5.0	-5.0	5.0
International reserves	410.7	405.8	432.9	441.2	473.1	456.4	396.7	367.0	352.5
Total amortisations	47.2	49.9	40.8	52.0	90.5	139.1	163.1	81.4	106.4
Public Finances, % of GDP									
Consolidated government balance	4.1	-5.9	-3.9	0.8	-0.1	-0.5	0.0	-2.6	-1.5
Consolidated gov primary balance	4.4	-5.4	-3.4	1.2	0.6	1.6	1.8	-0.8	0.2
Public debt	5.2	9.5	9.3	9.4	11.4	11.2	12.0	12.7	13.5
of which Domestic	3.4	4.7	5.3	6.3	5.9	4.6	7.2	10.6	9.6
Foreign Assets & Liabilities, USD bn									
External debt	479.9	466.3	488.6	538.9	636.4	728.9	655.9	594.4	618.0
Public	29.5	31.3	34.5	34.7	38.1	43.1	30.5	32.9	39.0
External debt / GDP	28.8	37.9	32.1	28.3	31.8	34.8	35.1	47.9	47.2
External debt / XGS	91.7	136.0	110.6	94.0	107.9	122.8	111.2	104.4	106.4
Short-term debt	70.6	51.4	59.7	68.2	81.5	85.3	74.5	54.2	67.6
Short-term debt/International reserves (%)	17.2	12.7	13.8	15.5	17.2	18.7	18.8	14.8	19.2

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	0.8	0.7	-0.1	-3.2	-3.2	-3.1	-2.7	0.7	0.6
CPI, % yoy eop	7.8	8.0	11.3	14.6	13.0	11.8	9.0	7.3	6.6
Policy interest rate, %, eop	7.50	8.00	17.00	17.00	17.00	15.00	13.00	11.00	9.00
Short-term market rate, % eop	9.20	9.45	19.05	14.82	14.64	14.26	13.70	12.90	12.11
Long-term yield, %, eop	8.53	9.44	13.01	16.15	15.54	14.86	14.20	13.40	12.61
RUB/US$, avg	35.0	36.3	48.1	64.0	63.6	63.2	63.9	64.7	65.6

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

Slovakia

Jaromir Sindel
+420 233 061 485
jaromir.sindel@citi.com

- **Summary view** — We maintain our 2014 GDP growth forecast at 2.4%YoY due a deterioration in our momentum indicator. However we have lifted both the 2015 and 2016 forecasts by 0.1%pt to 2.6%YoY and 3.2% respectively on lower oil prices and the improved foreign demand outlook. We continue to expect domestic demand to support growth in 2015 due to the improving labour market and larger 2015 fiscal buffer. However, downside risks still remain in our view.

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

- **Strategy** — ECB's QE may indirectly cover 30-65% of ARDAL's issuance in 2015 and 2016. ARDAL has already covered 42% (incl. t-bills) of its planned GBR at €5.1bn in 2015

While we upgraded 2015's forecast, risks are still there

Though November quarterly momentum and monthly data on real economic activity suggest a milder quarterly GDP growth in 4Q14, confidence indicators remain supportive, though they worsened in December. Our momentum indicator worsened in November on weaker industrial production and retail sales. This came after October monthly data represented a positive risk to our forecast. Nevertheless, we remain constructive on current economic developments as the unemployment rate decreased to 12.25%sa in November from 12.35% a month earlier and 13.5% a year ago. Moreover, though December confidence worsened the quarterly average points to solid unchanged annual GDP growth and remains supportive for retail sales and industrial production ahead. Overall, we kept our forecast of a milder 4Q14 GDP growth at 0.4% QoQ after 0.6% in 3Q14 – this should result in a mild deceleration of annual growth to 2.2%YoY after 2.5% a quarter earlier. This means our 2014 growth forecast remains unchanged at 2.4%YoY after 1.3% in 2013.

However, lower oil prices, benign trends at the labour market and somewhat stronger foreign demand outlook boost our outlook for 2015 and 2016 GDP growth by 0.1%pt to 2.6%YoY and 3.2% respectively. First, oil prices will likely lead to a stronger disinflation, which will probably result in a milder inflation in 2015 at 0.6%YoY (initially at 1.1%YoY). Hence, private consumption is likely to be supportive. Second, mainly lower oil prices, but also weaker forecast of EUR and the prospect of ECB Quantitative Easing (QE) points to an improved foreign demand outlook despite a deeper recession in Russia. Hence, export demand will likely also be supportive for the recovery. We do not see a significant political risk this year. However, in 2016 is a general election year and thus government spending will likely support the economy somewhat as seen below in government plans for capital expenditures. Though the socialist SMER is likely to lose the majority one-party government after these elections, we do not think the opposition is too diverse and would be unable to set up a functioning government.

Fiscal policy should be supportive in pre-election year

The central government cash deficit widened to €2.9bn YTD in Dec14 (3.8% of GDP) from €2bn a year ago (-2.7%). While this is €300mn narrower compared to the approved -€3.2bn, it was somewhat larger than we had assumed (-€2.6bn) and the fiscal performance is somewhat disappointing due to lower EU funds inflow. However, this did not result in a larger deficit as lower-than-planned EU funds inflow (by -€1.9bn) was offset by a cut in current (-€1.4bn) and capital (-€0.5bn) expenditures. Moreover, tax revenues were larger-than-planned by €0.6bn, mainly due to CIT. In 2015 the government assumes an unchanged deficit, but with a 16% increase in revenues (driven by EU funds inflow, but also tax revenues are expected to increase by 8%YoY), that should be reflected in 13%YoY increase in expenditures (capital by 29%YoY).

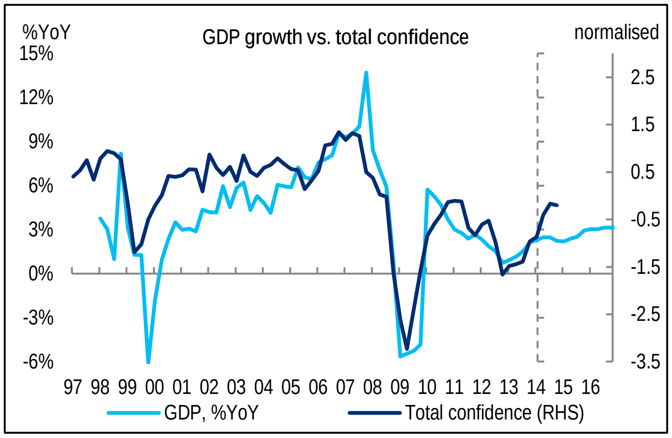
The following factors will form the basis for Slovak Republic's Debt and Liquidity Management Agency (ARDAL) financing in 2015: a) better-than-planned cash deficit in 2014; b) likely narrower central government deficit in 2015; c) QE by the ECB (though a straight capital-key approach is unlikely to be enforced strictly). In more details, the central government cash deficit of €2.9bn in 2014 was larger than a year ago (€2bn). While it was by €300mn narrower vs. the initial plan, it was actually wider vs. updated plan of €2.6bn.

ARDAL plans gross borrowing requirement (GBR) of €5.1bn in 2015, of which maximum €3bn should be placed in auctions and up to €2.5bn as syndicated bonds after it issued €4.88bn in 2014. ARDAL's plan is in line with our estimate and though GFN's are likely to be close to €6bn, the gap will be covered by the borrowing from the STA. Looking into more details, the GFN reflects the total redemption of bonds of €3.1bn, of which local bonds of €0.6bn in January this year, followed by syndicated bonds of €2bn in January and Czech retail bond of €0.5bn in September. Moreover, the cash deficit is expected at €3bn (narrower deficit would likely lead to larger buybacks). This is together €6.1bn. However, government planned in October to utilize €0.95bn of cash from the single treasury account (STA). Hence, the ARDAL's GBR are planned at €5.1bn, of which €1.5bn was already covered in January this year. The utilisation of cash from the STA should decrease the GBR by €1.3bn also in 2016. While the cumulative utilization of cash from the STA should increase to 67% of the STA level in 2016-17, the drop in redemption profile to €2bn in 2018 from around €4.8bn in 2016-17 should enable to decrease the borrowing from the STA afterwards. For details see our comments. The debt-brake rule has become less acute after the upward revision of nominal GDP. However, we doubt the quality of revision and if this is shared by Eurostat, it could return the debt-brake rule question back on table.

ECB's QE may indirectly cover 30-65% of ARDAL's issuance in 2015 and 2016. Citi assumes the ECB will aim to buy €600bn of government bonds over a two year period. If the capital-key[4] approach is applied (Slovak share is 1.1%), the ECB would buy up to €6.6bn of Slovak bonds over next two years that we estimate to be 65% of ARDAL's GBR or 53% of GFN. If ECB buys 30% of GBR, it could buy €3bn. Foreigners held 50% of bonds at the end of 2014, unchanged compared to end of 2013. By contrast, the share of local banks decreased to 32.4% from 38%. The monetary statistics points to somewhat lower share on government related assets in banks' balance sheets (19% in Nov14 vs. 22% in 1H13).

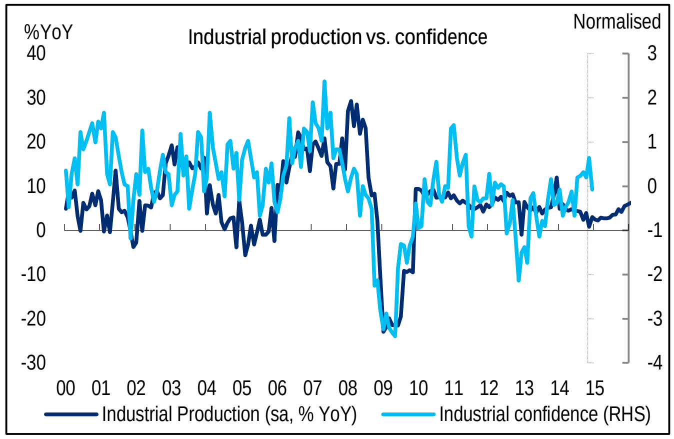
[4] This is calculated by size of population and GDP equally.

Figure 193. December confidence – though lower - remained supportive



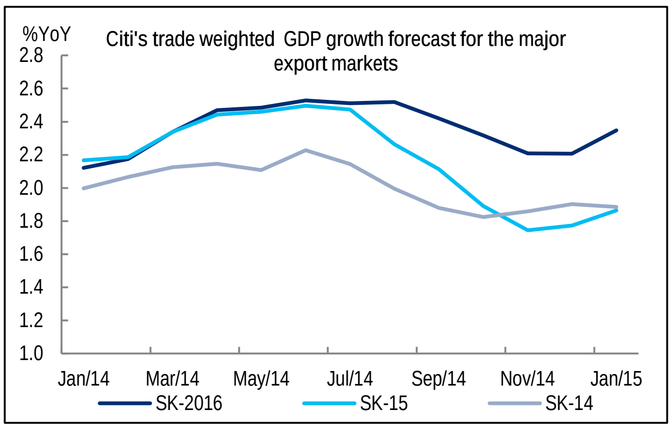
Source: Statistical Office of the Slovak Republic, Citi Research estimates

Figure 194. The same holds for the industrial sector



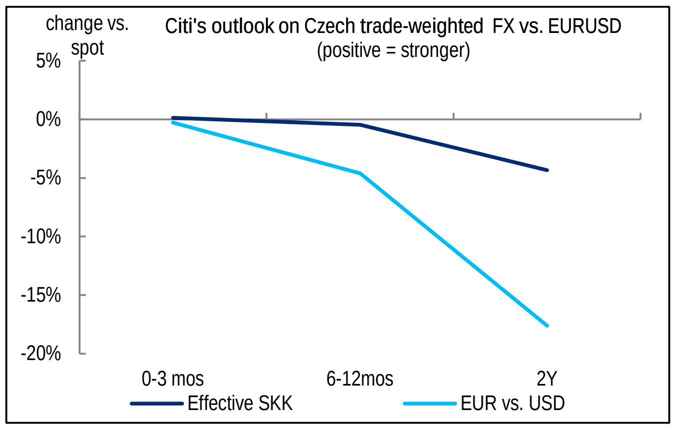
Source: Statistical Office of the Slovak Republic, Citi Research estimates

Figure 195. Outlook on foreign demand improved for both 2015 & 2016



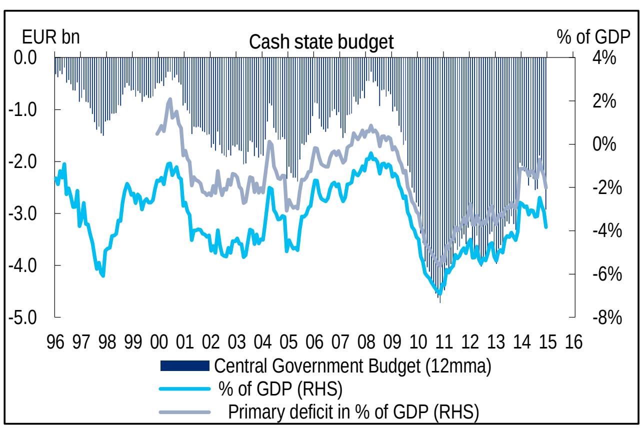
Source: Statistical Office of the Slovak Republic, Haver Analytics, Citi Research

Figure 196. Currency will be also supportive, though less than EURUSD would suggest



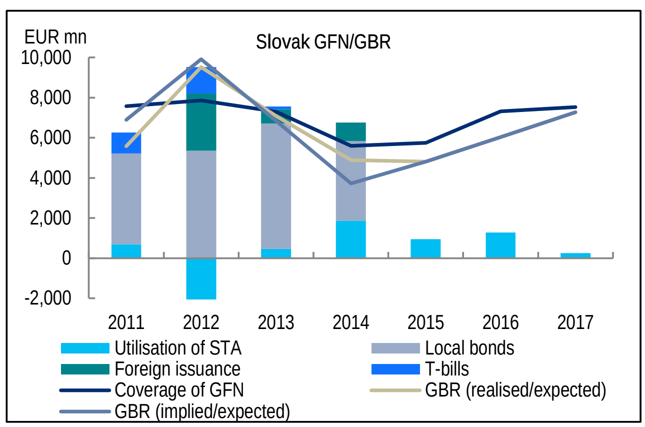
Source: Citi Research calculation and forecast

Figure 197. In 2015 the government assumes an unchanged deficit



Source: MinFin, Citi Research calculation.

Figure 198. ARDAL already covered 42% (incl. t-bills) of its planned GBR at €5.1bn in 2015



Source: MinFin, Citi Research calculation.

Figure 199. Slovakia Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	100	89	89	98	93	98	99	86	82
Nominal GDP, local currency bn	66	64	67	70	72	74	75	77	80
GDP per capita, USD	18,518	16,402	16,410	17,953	17,050	17,939	18,204	15,839	14,984
Population, mn	5.4	5.4	5.4	5.4	5.4	5.5	5.5	5.5	5.5
Unemployment, % of labour force	7.7	11.4	12.5	13.2	13.6	14.1	12.8	11.8	11.1
Economic Activity									
Real GDP, yoy avg	5.4	-5.3	4.8	2.7	1.6	1.4	2.4	2.6	3.2
Real investment growth % yoy	5.8	-29.2	18.8	7.6	-14.0	-0.1	5.4	4.2	4.9
Real consumption growth % yoy	5.9	1.2	0.5	-1.0	-0.8	0.0	2.7	2.1	2.3
private consumption growth % yoy	6.0	-0.5	0.1	-0.7	-0.4	-0.7	2.3	2.0	2.4
Real export growth, % yoy	3.0	-17.0	15.7	12.0	9.3	5.2	5.3	4.9	7.3
Real import growth, % yoy	3.6	-19.1	14.7	9.7	2.6	3.8	6.4	5.8	7.6
Prices, Money & Credit									
CPI, % yoy eop	4.4	0.5	1.3	4.4	3.2	0.4	-0.1	1.4	2.2
CPI, % avg	4.6	1.6	1.0	3.9	3.6	1.4	-0.1	0.6	2.2
Nominal wages, % yoy	8.2	3.0	3.3	2.2	2.5	2.4	4.3	3.5	4.0
Credit extension to private sector, % yoy	16.3	0.9	4.8	8.6	2.8	5.6	3.0	2.4	4.9
Balance of Payments, USD bn									
Current account	-8.2	-3.1	-4.2	-4.9	0.9	1.5	0.5	0.0	0.2
% of GDP	-8.2	-3.5	-4.7	-5.0	0.9	1.5	0.5	0.0	0.3
Trade balance	-2.8	0.3	-0.1	-0.1	3.2	4.5	4.9	3.5	3.5
Exports	69.8	53.5	61.7	76.1	77.4	82.7	83.8	78.6	77.8
Imports	72.6	53.1	61.8	76.2	74.2	78.2	78.9	75.2	74.3
Service balance	-0.7	-1.3	-0.9	-0.4	0.5	0.5	0.2	0.2	0.2
Income balance	-3.4	-0.8	-2.5	-3.3	-1.6	-1.8	-2.9	-2.6	-2.7
FDI, net	-3.1	0.9	-0.8	-2.8	-3.0	-1.0	-0.3	-0.6	-1.2
Total amortisations	1.7	1.8	2.1	2.1	2.2	2.6	2.6	2.8	3.0
Public Finances, % of GDP									
Consolidated government balance	-2.3	-7.9	-7.5	-4.1	-4.2	-2.6	-2.9	-2.8	-2.2
Consolidated gov primary balance	-0.8	-6.6	-6.3	-3.5	-3.2	-1.7	-2.1	-1.9	-1.3
Public debt	29.3	36.0	41.1	43.5	52.1	54.6	54.6	54.8	52.6
of which Domestic	20.0	20.6	25.5	30.7	49.1	93.4	59.0	65.9	68.3
Foreign Assets & Liabilities, USD bn									
External debt	52.5	65.3	65.8	68.5	70.9	82.3	85.4	92.2	95.7
Public	10.3	11.4	13.3	15.5	25.9	34.2	35.1	36.2	38.2
External debt / GDP	52.4	73.4	73.8	70.1	76.4	84.2	86.0	106.5	116.8
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	27.1	37.4	36.3	36.7	28.1	25.0	28.7	30.9	31.4

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	2.5	2.5	2.2	2.2	2.4	2.6	3.0	3.2	3.2
CPI, % yoy eop	-0.1	-0.1	-0.1	0.2	0.6	0.9	1.4	2.2	2.2
Short-term market rate, % eop	0.24	0.10	0.08	0.00	0.00	0.00	0.00	0.00	0.00
Long-term yield, %, eop	2.05	1.49	1.24	1.10	1.13	1.20	1.08	0.35	0.35

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

South Africa

David Cowan
+44 207 986 3285
david.cowan@citi.com

Gina Schoeman
(On Maternity Leave)

- **Summary view** — While we only expect a slow pick-up in growth in South African in 2015, inflation should consistently trend down in 2015 as the positive impact of low global oil prices feeds through the economy.
- **Things to watch** — The changed oil price outlook means that the SARB can now put rates rises on hold in 2015, unless the rand comes under significant pressure, while still remaining committed to policy normalization.
- **Strategy** — With limited scope to significantly alter fiscal and monetary policy, the main mechanism for adjustment will continue to be the rand. We still expect gradual depreciation, but with potential for bouts of volatility.

Only a weak recovery in GDP growth in 2015

With real GDP growth of only 1.6% now expected in 2014, the focus is really on whether there are signs that growth will pick up in 2015. In some ways the prognosis is poor. The rebalancing of the economy away from consumption as an engine of growth towards production, as seemed to be happening in early 2014, has not gained momentum. Moreover, going into 2015, the combination of still relatively high inflation, tight lending standards, high consumer indebtedness, lackluster consumer confidence and rising electricity tariffs, all point to a sub-par purchasing power environment. Moreover, labour unrest could potentially rear its head again in mid-year when the coal and gold sector start wage negotiations.

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

Rebalancing is some way off and the ZAR under pressure

The clear widening of the current account deficit in 2014 reflects the lack of rebalancing in the economy to date. But while we expect the current account deficit was over 5% of GDP in 2014, it should start to trend down in the coming years reflecting both short and long term trends. First, as lower oil prices positively impact imports. Second, as wider African growth continues, coupled with the EU showing signs of a modest recovery, interact with a weaker rand it should help export competiveness and growth. Moreover, despite short-term problems such as misplaced fears of Ebola contagion, the weaker rand has made South Africa an increasingly attractive tourist destination. The combination of these trends should ultimately push the current account deficit down towards 4% of GDP by 2016.

But the deficit will still be substantial and mean that the government needs to attract around ZAR200bn a year to fund the deficit. And with financial account flows still relatively unpredictable, notably portfolio flows and unrecorded transactions, we continue to expect the ZAR to remain on the backfoot weakening to around R12.00/USD on a 6-12 month basis.

Monetary policy normalisation

With lower global oil prices, we think that the current downward trend in inflation will become more firmly entrenched in 2015. But the trajectory may prove slower and more sticky than the market expects, due to contradictory forces: downward pressures in food and fuel prices being offset by upward pressure from ZAR pass-through in the form of higher core inflation, even if muted versus previous cycles and rising electricity tariffs. The lack of a more significant ZAR pass-through to-date is not surprising given the efforts of the listed retail sector to push volumes while absorbing cost push pressures. This is affirmed by both the BER retail survey and financial statements of the listed retail sector. Put together, this allows CPI to trend down below the 5% level, but still in the upper half of the SARB's 3-6% target band.

But the positive oil price shock of recent months, and low global inflation trends, clearly give the SARB much more policy flexibility in the coming year than seemed the case even six months ago. The SARB hiked twice in 2014: first by 50bp in January and then by 25bp in July raising the policy rate to 5.75%, with the rationale for the slow moderate hiking being the explicit trade off trade-off between upside inflation risk, and concerns about the growth outlook. In addition, the SARB moved to smaller incremental hikes of 25bp as a way of signaling that it remains tough on inflation risks, but remains concerned about GDP prospects.

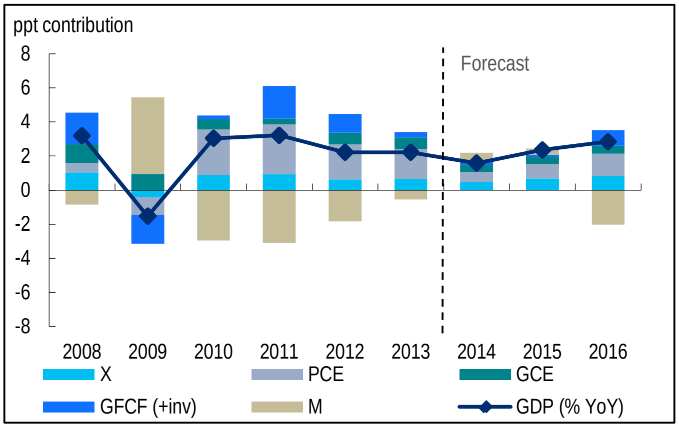
But while concerns about the growth outlook will remain, the downward path for inflation should allow the SARB to adapt this policy. In 2015 it will probably be able to leave the key Repo rate unchanged, helping support the recovery, while the same time it will be slowly moving towards achieving its long term goal of normalizing monetary policy. This outlook would only come under pressure if ZAR was to come under significant pressure, perhaps because of an unexpected tightening of US monetary policy, or inflation was to fall more quickly than we forecast. But it is also important to bear in mind that we would still only expect the SARB to change its policy tack if it felt that ZAR weakness was substantial enough to significantly change the current inflation outlook.

Tough structural policy decisions

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

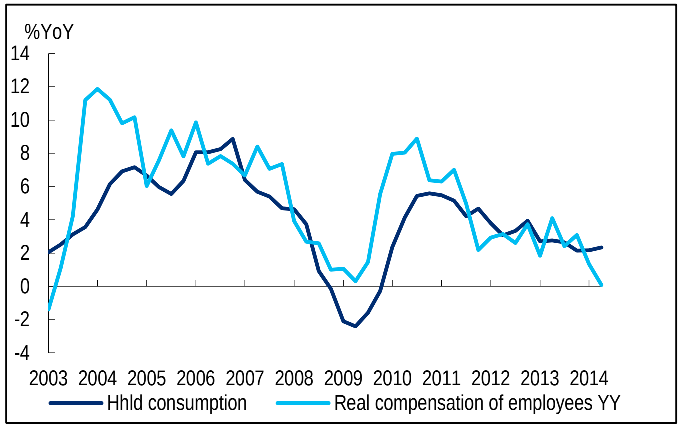
While Mr Nene explicitly stated that the tax increases outlined in the budget will be based on the current Davis Tax Committee review, our research points to a higher VAT rate as the most obvious tax policy shift. But we also acknowledge how difficult it will be for National Treasury to find an acceptable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

Figure 200. GDP growth will only pick up slowly in 2015



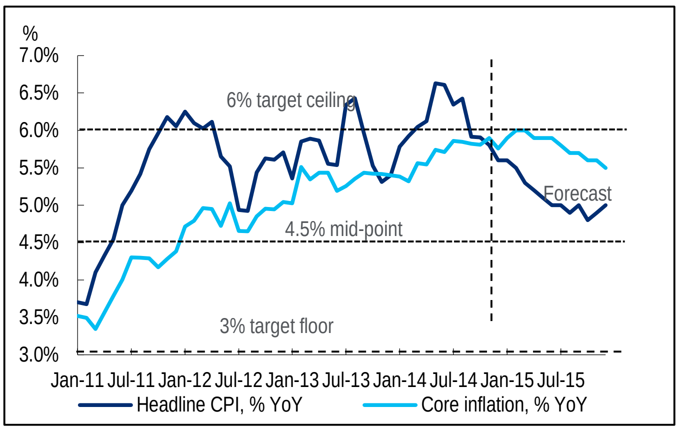
Source: SARB, Citi Research Projections

Figure 201. Consumption growth is under pressure along with real incomes



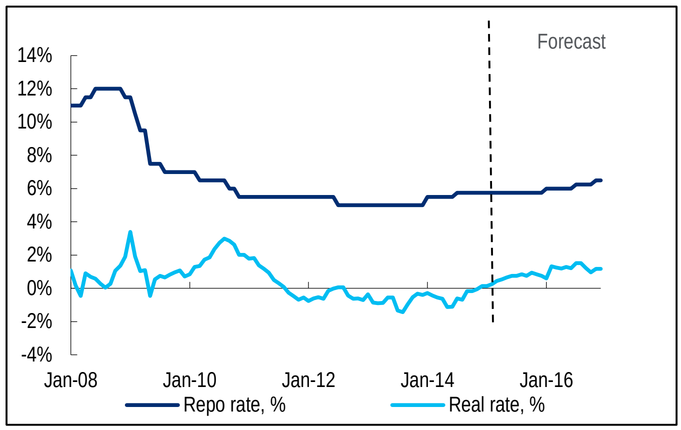
Source: SARB, Citi Research calculations

Figure 202. Although on a downward trend, the CPI will only ease slowly



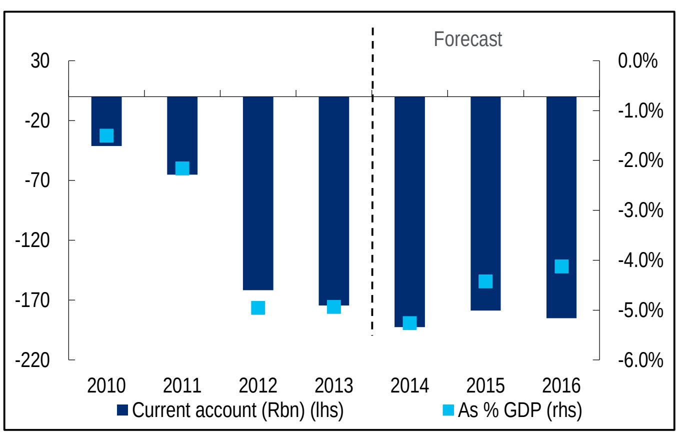
Source: Stats SA, Citi Research projections

Figure 203. Rand volatility suggests further Repo rates cuts are unlikely



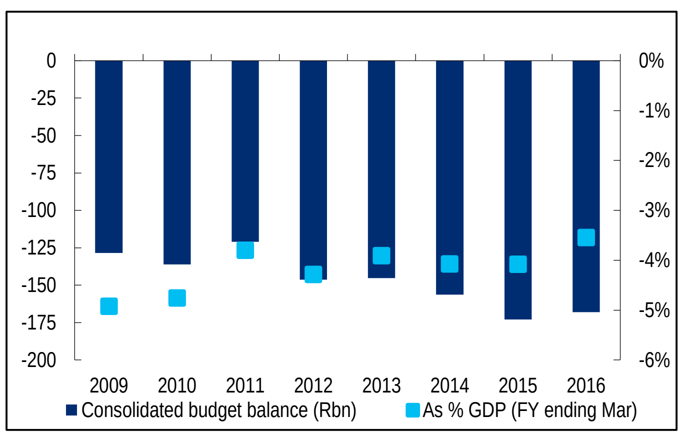
Source: SARB. Stats SA

Figure 204. Only a very slow narrowing in the current account deficit



Source: SARB, Citi Research projections

Figure 205. Fiscal consolidation will likely be slow



Source: National Treasury, Haver Analytics, Citi Research projections

Figure 206. South Africa Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	287	299	376	417	397	366	338	338	367
Nominal GDP, local currency bn	2,369	2,508	2,748	3,025	3,263	3,534	3,661	4,038	4,487
GDP per capita, USD	5,893	6,065	7,515	8,335	7,947	7,293	6,712	6,709	7,258
Population, mn	48.7	49.3	50.0	50.0	50.0	50.2	50.3	50.4	50.5
Unemployment, % of labour force	22.5	23.7	24.9	24.8	24.9	24.7	25.0	24.6	24.2
Economic Activity									
Real GDP, yoy avg	3.2	-1.5	3.0	3.2	2.2	2.2	1.6	2.4	2.8
Real investment growth % yoy	8.6	-8.5	1.1	9.3	5.2	1.5	1.4	0.7	4.3
Real consumption growth % yoy	2.1	-0.2	4.1	4.1	3.4	3.0	1.2	1.6	2.2
private consumption growth % yoy	1.0	-1.8	4.5	4.9	3.4	2.9	1.0	1.4	2.2
Real export growth, % yoy	1.5	-17.0	7.7	4.3	0.1	4.6	1.3	1.9	5.9
Real import growth, % yoy	2.8	-17.7	10.8	10.5	6.0	1.8	-1.5	-1.2	7.1
Prices, Money & Credit									
CPI, % yoy eop	9.3	6.0	3.4	6.4	5.7	5.3	5.6	5.0	5.3
CPI, % avg	10.0	7.2	4.1	5.0	5.7	5.8	6.1	5.1	5.0
Nominal wages, % yoy	12.8	11.8	13.5	7.2	7.5	8.1	8.5	8.7	9.0
Credit extension to private sector, % yoy	13.6	-0.1	5.5	6.2	10.1	6.1	8.2	9.0	10.5
Policy Interest Rate, % eop	11.50	7.00	5.50	5.50	5.00	5.00	5.75	5.75	6.50
3 month rate, %, eop	11.43	7.23	5.55	5.60	5.13	5.22	6.13	6.10	6.85
Long-term yield, %, eop	7.33	9.05	8.14	7.93	6.39	7.91	7.80	8.00	8.20
ZAR/US$, eop	9.49	7.41	6.62	8.09	8.46	10.50	11.57	12.13	12.29
ZAR/US$, avg	8.27	8.41	7.32	7.26	8.21	9.65	10.85	11.94	12.23
Balance of Payments, USD bn									
Current account	-15.9	-8.2	-5.6	-9.0	-19.7	-18.1	-17.8	-15.0	-15.1
% of GDP	-5.5	-2.7	-1.5	-2.2	-5.0	-4.9	-5.3	-4.4	-4.1
Trade balance	-1.8	3.4	8.2	7.0	-3.8	-7.1	-7.8	-5.2	-4.9
Exports	88.3	70.3	91.4	109.5	100.5	96.6	92.0	89.5	96.9
Imports	90.0	66.9	83.3	102.5	104.3	103.7	99.8	94.7	100.9
Service balance	-2.9	-2.1	-3.5	-3.4	-1.3	-1.2	-1.6	-2.1	-2.0
Income balance	-8.9	-6.7	-8.0	-10.7	-10.8	-6.6	-5.5	-5.2	-5.7
FDI, net	12.3	6.4	3.7	4.5	1.6	1.7	2.0	1.8	1.5
International reserves	30.6	35.3	38.2	42.6	44.0	44.8	46.4	47.2	47.8
Total amortisations	2.7	2.1	1.7	2.4	7.4	4.0	5.5	2.8	4.4
Public Finances, % of GDP									
Consolidated government balance	-1.0	-4.9	-4.8	-3.8	-4.3	-3.9	-4.1	-4.1	-3.5
Consolidated gov primary balance	2.3	-2.9	-2.6	-1.6	-1.9	-1.4	-1.4	-1.4	-0.9
Public debt	26.5	30.1	34.7	38.2	40.9	44.2	49.6	50.8	50.7
of which Domestic	22.3	26.6	31.4	34.5	37.3	40.1	45.6	46.7	47.2
Foreign Assets & Liabilities, USD bn									
External debt	60.4	63.8	80.6	89.7	113.7	108.6	101.3	106.8	112.0
Public	18.1	22.6	35.8	41.5	55.9	52.8	55.7	55.7	56.7
External debt / GDP	21.1	21.3	21.5	21.5	28.6	29.7	30.0	31.6	30.5
External debt / XGS	59.1	76.4	75.0	70.7	96.3	95.8	95.3	103.4	99.2
Short-term debt	25.5	21.3	21.7	20.5	27.9	27.2	28.7	29.2	30.7
Short-term debt/International reserves (%)	83.2	60.4	56.9	48.2	63.3	60.9	61.9	62.0	64.3

Quarterly Economic Indicators	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	1.3	1.4	4.4	1.1	1.7	3.1	0.9	2.9	2.9
CPI, % yoy eop	6.6	5.9	5.6	5.3	5.0	5.0	5.0	4.8	4.8
Policy interest rate, %, eop	5.50	6.00	5.75	5.75	5.75	5.75	5.75	6.00	6.00
Short-term market rate, % eop	5.83	6.13	6.13	6.11	6.10	6.10	6.10	6.35	6.35
Long-term yield, %, eop	8.17	8.13	7.80	8.00	8.05	8.00	8.00	8.10	8.20
ZAR/US$, eop	10.64	11.29	11.57	11.69	11.88	12.07	12.13	12.17	12.21

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

Turkey

Ilker Domac
+90 212 319 4623
ilker.domac@citi.com

Gultekin Isiklar
+90 212 319 4915
gultekin.isiklar@citi.com

- **Summary view** — Whether Turkey can capitalize on the current favorable cyclical backdrop and create a virtuous circle by putting forward a credible narrative remains to be seen.
- **Things to watch** — Political developments ahead of the 2015 general elections, ratings reviews and geopolitical risks require close monitoring.
- **Strategy** — Lower oil prices and the likely temporary decline in inflation in 1H can create cyclical opportunities.

Falling oil prices: A strong Boon for the economy?

The recent growth indicators suggest that the economy struggles to gain traction. Industrial production growth (SWDA) averaged by about -1%MoM in the first two months of 4Q, which doesn't compare well with the January-September average of 0.34%. Moreover, sentiment indicators capturing consumption and investment tendencies suggest to us that a strong rebound in domestic demand in the near-term is unlikely. Against this backdrop, we decided to revise our 2014 GDP growth forecast to 2.9% from 3.1%. Looking ahead, we are inclined to think that relatively over-stretched corporate and household balance sheets will probably limit the favorable impact of the sharp decline in oil prices on private spending. With this in mind, we look for another sub-par growth this year (3.3%), with risks tilted toward a higher print if oil prices remain subdued.

CA gap is on track to narrow to about 4% of GDP

At US$5.6 billion, the current account deficit in November came in wider than the consensus (US$5.4bn). With the November outturn, the current account gap in the first 11 months of 2014 stands at US$38.7bn, which is considerably narrower than the deficit seen in the same period of 2013 (US$56.7bn). At around US$11.0bn, the magnitude of the correction in the case of Turkey's underlying deficit excluding energy and gold during the same period points to a less aggressive but still meaningful adjustment. We expect the current account gap to narrow from 7.9% of GDP in 2013 to about 5.5% in 2014 owing to a weaker lira and sub-par growth. Due to recent developments—including the revision of Citi's oil forecast (from US$80 per barrel to US$63pb)—we now look for a narrower current account gap for this year (4.2% of GDP vs. our previous forecast of 5.1%).

With inflation on track to drop considerably in 1H…

At 8.2%YoY, the December inflation print came in lower than the consensus (8.8%YoY). Using seasonally adjusted data, the December inflation reading translates into a flattish monthly inflation, compared with an increase of 0.40% in November and 0.7%MoM in October. While year-on-year underlying inflation indicators don't display considerable improvements, core measures (SA, 3-month moving average annualized, suggest that inflationary momentum continues to soften. Nonetheless, standing at around 7.0% and 6.5% (SA, 3-m moving average annualized H and I, respectively), core measures still remain high with respect to the 5% target (headline inflation). Looking ahead, assuming a normal harvest year, we believe that year-on-year inflation may fall as low as about 5.0% by the summer before creeping up in 2H due to the reversal of favorable base effects and the likely administrative price adjustments, reaching 6.7% by end of 2015 from 8.2% in 2014.

… CBT prepares the groundwork for further easing

At the first MPC meeting of the year, the CBT cut the one-week repo rate by 50bp to 7.75%—contrary to our expectations and the consensus—while keeping the interest rate corridor (11.25%-7.50%) intact. According to the CBT, the noted move is largely driven by lower commodity prices as well as the improvement in core inflation and forward-looking expectations. In our view, the fact that the CBT refrained from cutting the upper band suggests that the Bank is likely to keep money market rates at elevated levels—above the one week repo rate (7.75%)—until we see a visible improvement in inflation and the lira's performance.

Where do we go from here? We believe that a sustained decline in the interbank o/n rate would be a leading indicator for further easing. Provided that the lira holds up well, we expect the CBT to bring its average funding rate (currently at 8.3%) to as low as 7.00% in 1H 2015. Depending on the performance of the lira, surprises in both directions cannot be ruled out. Nonetheless, we think that the CBT will be forced to reverse its stance in the second half of 2015, with inflation creeping up and the Fed rate hike cycle beginning in 4Q.

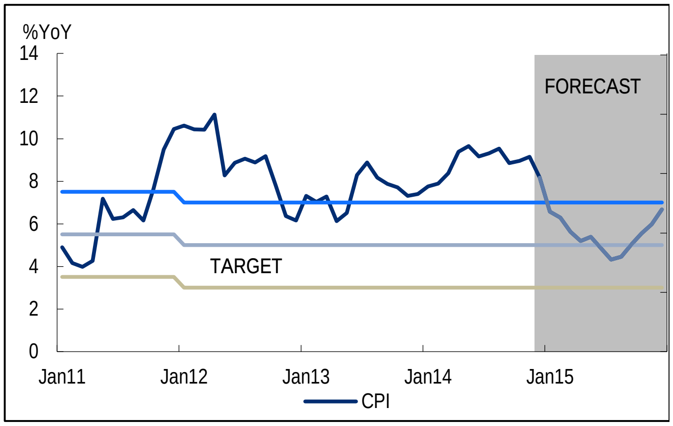
Central budget deficit meets the MTP target but…

Standing at 1.3% of GDP, the 2014 central budget deficit ends the year in line with the MTP target released in October. Although primary surplus (1.6% of GDP) also turned out to be broadly consistent with the MTP, the underlying fiscal stance, which excludes privatization revenues (0.6% of GDP) as well as amnesty and other one-off revenues, points to a less impressive fiscal stance (a surplus of 0.4% of GDP). It is worth noting that the favorable headline budget figure was largely driven by non-tax revenues, which rose by over 15%YoY. Tax revenues, on the other hand, increased only by 8.1%, remaining below the inflation rate (8.9%), compared with a brisk pick-up in primary spending (11%), which led to breach of the budget envelope (target of TRY 384.4bn vs TRY398.5bn). All in all, we believe that the underlying fiscal stance isn't as strong as the headline budget figure suggests. We foresee a similar fiscal performance this year, as one-off revenues associated with the tax amnesty, which could be as high as 2% of GDP over the next 18 months, should allow the authorities to meet the 2015 deficit target of 1.1% of GDP.

Can the strong start to 2015 be sustained?

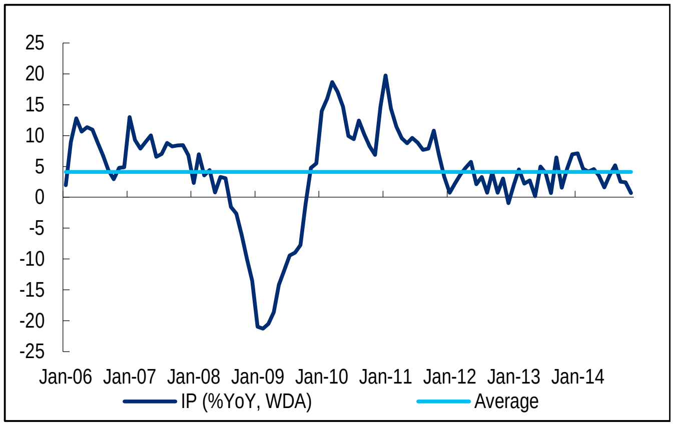
Lower oil prices and greater acknowledgment of the likely cyclical decline in annual inflation have played an important role in improving investor sentiment toward Turkish assets. In our view, the CBT's cautious stance has also been supportive of the lira. The lira has been one of the best performing EM currencies so far this year. Concurrently, bonds have rallied considerably. The 2-year bond yield declined to as low as about 7.30% from 8.8% in mid-December. The Treasury's relatively light domestic debt redemption schedule this year is another factor which provides further support to the positive sentiment in the fixed income market. While we acknowledge the presence of cyclical opportunities in the bond market, valuation concerns, the low likelihood of a durable deceleration in inflation beyond 1H and poor liquidity conditions curb our enthusiasm. Regarding the currency outlook, we are concerned with the following risks/uncertainties: (i) the possibility of the CBT getting carried away and easing aggressively, thereby hurting the performance of the lira; (ii) major fiscal slippages ahead of the upcoming elections that could undermine investor sentiment; and (iii) uncertainties associated with the domestic political outlook and geopolitical risks.

Figure 207. A sharp decline in annual inflation in 1H is likely...



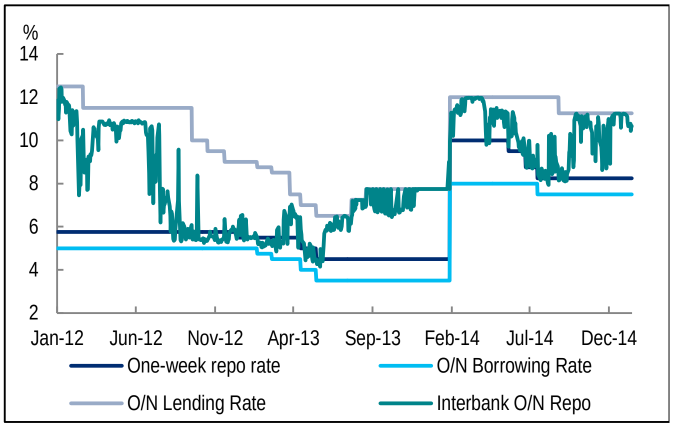
Source: Haver Analytics and Citi Research

Figure 208. ...as activity struggles to gain momentum



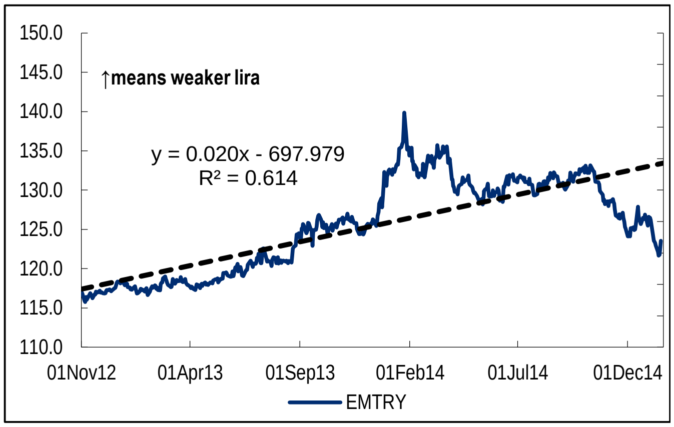
Source: CBT and Citi Research

Figure 209 While the CBT continues to play it safe, at least so far,...



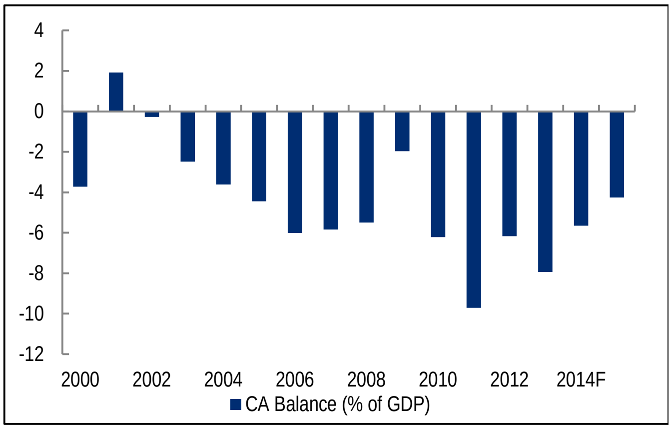
Source: Haver Analytics and Citi Research.

Figure 210. ..., easing is likely, if the lira holds up.



Source: Bloomberg and Citi Research.
Note: EMTRY represent the lira vs other EM currencies

Figure 211. CA gap is set to narrow thanks to lower oil prices...



Source: Haver Analytics and Citi Research.

Figure 212. ...but mind the large external financing needs.

External debt maturing within 1 year or less regardless of the original maturity	November 2014
CENTRAL BANK	**1,454**
OVERDRAFTS	0
DEPOSITS WITH CBRT	1,454
GENERAL GOVERNMENT (**)	**4,664**
BANKS	**111,432**
CREDITS	62,221
FX DEPOSITS	13,268
BANKS ACCOUNTS	22,567
Branches and Affiliates Abroad	*13,974*
TRY DEPOSITS	13,376
Branches and Affiliates Abroad	*5,209*
OTHER SECTORS	**55,457**
TRADE CREDITS	32,489
DUE TO IMPORTS	28,260
PRE-EXPORT FINANCING	4,229
OTHER CREDITS	22,968
PUBLIC	192
PRIVATE	22,776
Branches and Affiliates Abroad	*5,614*
TOTAL	**173,007**

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

Figure 213. Turkey Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	731	615	731	775	789	822	801	778	824
Nominal GDP, local currency bn	951	953	1,099	1,298	1,417	1,565	1,753	1,910	2,114
GDP per capita, USD	10,282	8,530	10,016	10,473	10,531	10,746	10,357	9,959	10,429
Population, mn	71.1	72.1	73.0	74.0	74.9	76.5	77.3	78.2	79.0
Unemployment, % of labour force	10.0	13.0	11.2	9.1	8.5	9.1	10.0	10.8	10.9
Economic Activity									
Real GDP, yoy avg	0.7	-4.8	9.2	8.8	2.1	4.1	2.9	3.3	3.4
Real investment growth % yoy	-4.8	-28.6	48.4	16.8	-8.5	11.3	-2.1	2.0	2.5
Real consumption growth % yoy	-0.1	-1.0	6.0	7.3	0.4	5.3	1.9	3.4	3.5
private consumption growth % yoy	-0.3	-2.3	6.7	7.7	-0.5	5.1	1.3	3.2	3.5
Real export growth, % yoy	2.7	-5.0	3.4	7.9	16.3	-0.3	6.2	4.4	4.5
Real import growth, % yoy	-4.1	-14.3	20.7	10.7	-0.4	9.0	-0.9	3.5	4.0
Prices, Money & Credit									
CPI, % yoy eop	10.1	6.5	6.4	10.4	6.2	7.4	8.2	6.7	6.4
CPI, % avg	10.4	6.3	8.6	6.5	8.9	7.5	8.9	5.5	7.0
Nominal wages, % yoy	11.1	-2.5	15.8	15.9	15.6	14.4	15.8	10.5	11.0
Credit extension to private sector, % yoy	22.4	13.4	40.4	32.8	19.8	33.5	18.5	15.0	15.0
Policy Interest Rate, % eop	15.00	6.50	6.50	5.75	5.55	7.10	8.51	8.25	9.00
3 month inter-bank rate, %, eop	17.48	7.42	7.68	11.57	5.93	9.34	10.02	9.50	10.20
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	1.54	1.50	1.54	1.89	1.78	2.15	2.33	2.52	2.60
TRY/US$, avg	1.31	1.55	1.51	1.68	1.80	1.91	2.19	2.45	2.57
TRY/EUR, eop	2.15	2.15	2.06	2.44	2.35	2.95	2.82	2.71	2.48
TRY/EUR, avg	1.92	2.17	2.00	2.34	2.32	2.53	2.91	2.73	2.57
Balance of Payments, USD bn									
Current account	-40.2	-12.1	-45.4	-75.2	-48.6	-65.3	-45.2	-33.5	-39.8
% of GDP	-5.5	-2.0	-6.2	-9.7	-6.2	-7.9	-5.6	-4.3	-4.8
Trade balance	-52.9	-24.8	-56.3	-89.1	-65.3	-79.9	-62.9	-54.6	-63.2
Exports	140.9	109.7	121.0	142.4	161.9	161.8	170.4	166.1	176.8
Imports	193.8	134.5	177.3	231.5	227.2	241.7	233.3	220.7	240.0
Service balance	18.8	18.5	16.6	20.0	22.4	22.8	25.2	27.9	29.7
Income balance	-8.4	-8.3	-7.2	-7.9	-7.2	-9.4	-8.8	-8.1	-7.7
FDI, net	17.3	7.0	7.6	13.8	9.2	9.2	5.5	9.5	10.5
International reserves	71.0	70.7	80.7	78.5	99.9	110.9	106.3	110.3	117.3
Total amortisations	41.1	47.4	45.0	37.9	33.5	36.5	29.5	35.0	39.0
Public Finances, % of GDP									
Consolidated government balance	-1.8	-5.5	-3.6	-1.3	-2.0	-1.2	-1.3	-1.5	-2.9
Consolidated gov primary balance	3.5	0.1	0.8	1.8	1.4	2.0	1.6	1.3	0.7
Public debt	41.2	47.7	44.4	41.2	38.8	38.8	36.3	35.5	35.3
of which Domestic	28.9	34.6	32.1	28.4	27.3	25.7	25.0	24.7	24.5
Foreign Assets & Liabilities, USD bn									
External debt	280.9	268.9	291.9	303.9	339.0	389.5	417.7	434.7	458.5
Public	92.4	96.6	100.6	103.6	111.1	121.1	121.8	124.8	130.8
External debt / GDP	38.4	43.8	39.9	39.2	43.0	47.4	52.2	55.9	55.7
External debt / XGS	158.0	185.0	185.7	166.0	165.3	186.9	190.6	199.8	197.6
Short-term debt	52.5	49.0	77.2	81.6	100.2	130.5	138.0	145.0	152.3
Short-term debt/International reserves (%)	74.0	69.3	95.7	104.0	100.3	117.6	129.8	131.4	129.8

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	2.2	1.7	3.1	2.7	3.1	3.4	4.1	3.8	3.6
CPI, % yoy eop	9.2	8.9	8.2	5.6	4.9	5.0	6.7	7.3	7.1
Policy interest rate, %, eop	8.82	8.72	8.51	7.75	7.00	7.50	8.25	8.50	8.75
Short-term market rate, % eop	9.25	10.95	10.02	9.00	8.20	8.70	9.50	9.70	10.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	2.12	2.28	2.33	2.38	2.43	2.49	2.52	2.54	2.56

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

Ivan Tchakarov
+7 495 643 1507
ivan.tchakarov@citi.com

Ekaterina Vlasova
+7 495 643 1576
ekaterina.vlasova@citi.com

Ukraine

- **Summary view** — Ukraine's classic balance of payment crisis was exacerbated by geopolitical uncertainty, leading to a significant GDP contraction, which we estimate at -6.5% in 2014. We anticipate the economy will continue to shrink in 2015 at -3.0% as uncertainty lingers on.
- **Things to watch** — The IMF Program concluded in April 2014 provided much needed financial resources needed to meet existing obligations, but the deteriorating macroeconomic backdrop will most likely invite a renegotiation of IMF terms in 2015 to include additional financing.
- **Strategy** — USDUAH has since slid by almost 100% relative to the start of 2014. The NBU raised policy rates by 750bp in 2014, with an aim to halting currency-driven inflation, but the fraught political backdrop may continue to exert pressures on the currency in 2015.

Economy to continue shrinking in 2015

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

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

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

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

The economy is already feeling the strain of tighter policies. 3Q14 GDP contracted by 5.3%YoY vs 4.6%YoY and 1.2% in 2Q14 and 1Q14. As a result, GDP has fallen by 3.7%YoY during Jan-Sep. The economic pain has been spread across different sectors of the economy, with particularly sharp drops in mining, quarrying and manufacturing. Economic contraction is much deeper in the East, with output falling by an estimated 15-20%YoY and industrial production collapsing by 75.0%YoY and 59.5% in Sep in Lugansk and Donetsk, respectively. We see deeper fall in 4Q14 at 14.9%, bringing 2014 GDP growth at -6.5%.

We forecast that the economy will continue to shrink in 2015, albeit at a much more modest pace. We anticipate that the still fraught geopolitical backdrop will continue to exert pressure on the macro-economy, leading to another year of negative economic growth of 3.0%. Real investment growth should fall for a third consecutive year by 3.5% (vs 6.7% and 7.0% contractions in 2012 and 2014), while real consumption spending will contract by 2.8% vs an estimated 5.3% in 2014 as high inflation and weaker currency eats away at real purchasing power. We see the economy transitioning to a modestly positive GDP growth of 1.9% only in 2016.

Central bank policy rate hikes are also weighing on growth. The National Bank of Ukraine (NBU) raised its key policy rate by a cumulative 750bp to 14.5% in 2014. According to the NBU, the hikes were aimed at dealing with higher inflation risks. Inflation has indeed accelerated on weaker currency since the start of the year. CPI inflation rose sharply from 0.5%YoY in Jan to 24.9% in Dec on the back of a currency that has seen a significant depreciation against the US dollar from just 8.25 at the start of the year to 15.80 now. Similarly, producer prices have increased from 1.9%YoY in Jan to 31.8% in Dec.

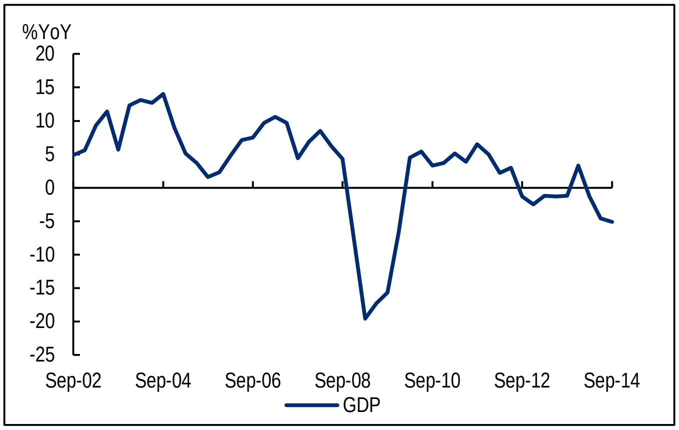
More broadly, Ukraine faces a classic stagflation scenario against the backdrop of fraught political and geopolitical environment. The combination of lower growth and rising inflation is pointing to a painful stagflation despite some welcome improvements in the current account and stabilization of local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

Lower growth and IMF conditionalities will impose significant economic pain on the population, manifesting itself in almost 40% decline in incomes. The forecast 3.0% 2015 GDP contraction would follow on the sharp 6.4% estimated fall in output in 2014 and two consecutive years of almost no growth in 2012 and 2013. This will engender a substantial fall in per-capita incomes from US$3,994 in 2013 to an estimated US$2,452 in 2015–a painful drop of about 40%.

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

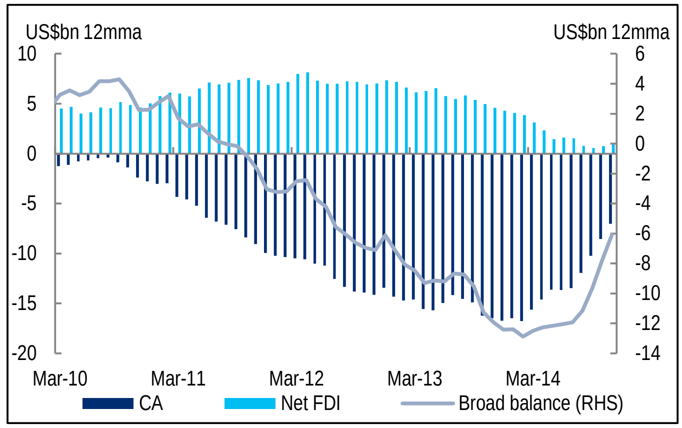
On the positive side, the current account deficit has improved, but gains in the broad balance have been limited by the collapse of net FDIs related to the very unstable geopolitical environment. The Jan-Nov 2014 current account deficit amounted to US$4.5bn, which marks a significant improvement on the US$14.7bn current account deficit posted for the same period in 2013. However, the fraught geopolitical backdrop has led to net FDI transitioning from a surplus of US$3.4bn during Jan-Nov 2013 to almost zero during Jan-Nov this year. Still, we forecast the current account deficit to improve from 9.1% of GDP in 2013 to and 3.7% of GDP in 2014 and 2.6% of GDP in 2015.

Figure 214. Economic contraction has deepened…



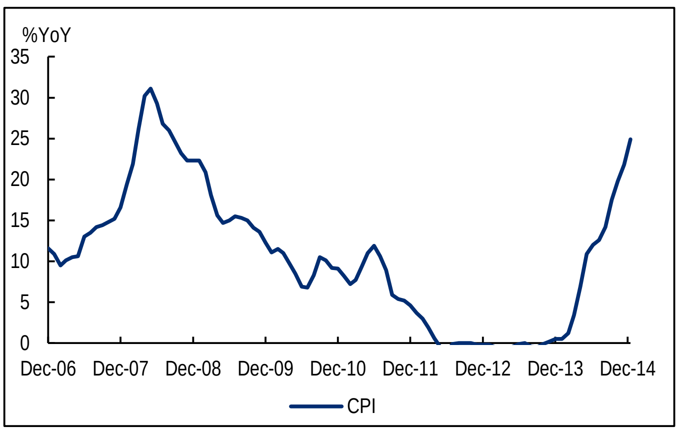
Source: UKR Statistics, Citi Research

Figure 215. … but the external position has started to improve



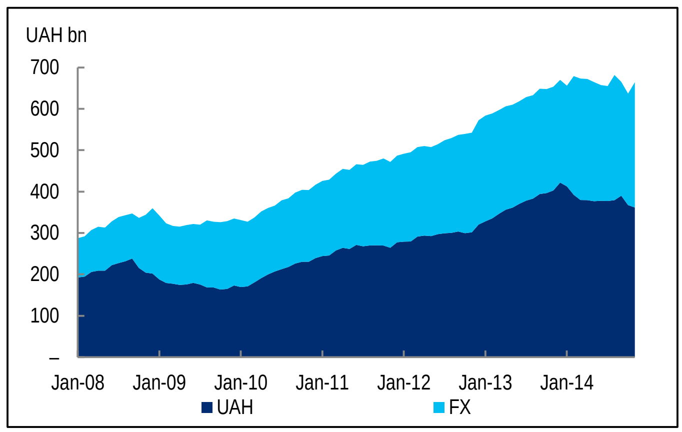
Source: UKR Statistics, Citi Research

Figure 216. Inflation has accelerated



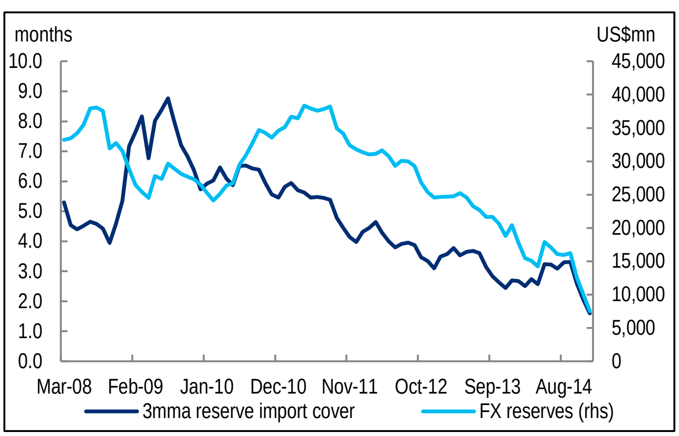
Source: Haver Analytics, Citi Research

Figure 217. Deposit withdrawals have resumed



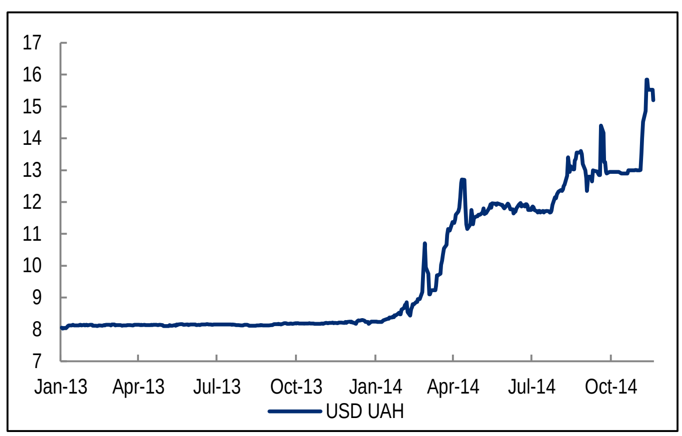
Source: UKR Statistics, Citi Research

Figure 218. Reserves are now less than 2 months of imports …



Source: UKR Statistics, Citi Research

Figure 219. …while the exchange rate has been weakening



Source: Haver Analytics

Figure 220. Ukraine Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	180	117	136	163	176	181	125	110	132
Nominal GDP, local currency bn	975	921	1,077	1,291	1,402	1,449	1,492	1,671	1,850
GDP per capita, USD	3,871	2,533	2,955	3,561	3,854	3,994	2,774	2,452	2,942
Population, mn	46.5	46.2	46.0	45.8	45.6	45.4	45.2	45.0	44.8
Unemployment, % of labour force	6.4	8.8	8.1	7.9	7.8	7.4	9.2	9.5	9.0
Economic Activity									
Real GDP, yoy avg	2.3	-14.8	3.8	5.5	0.8	1.2	-6.5	-3.0	1.9
Real investment growth % yoy	-	-	-	12.9	-4.6	-17.9	-16.1	-6.8	5.5
Real consumption growth % yoy	10.1	-12.3	6.1	11.3	7.4	5.7	-5.3	-2.8	3.0
private consumption growth % yoy	12.8	-14.9	6.7	15.6	8.1	7.8	-6.5	-3.7	3.5
Real export growth, % yoy	5.7	-22.0	3.1	2.7	-5.6	-9.3	-5.0	-2.0	2.0
Real import growth, % yoy	17.0	-38.9	10.6	15.4	3.8	-6.4	-8.0	-2.5	5.0
Prices, Money & Credit									
CPI, % yoy eop	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	9.2	8.1
CPI, % avg	25.2	15.9	9.4	8.0	0.6	-0.3	12.1	17.5	8.6
Nominal wages, % yoy	33.7	5.5	17.7	17.5	14.9	8.0	9.7	8.5	5.5
Credit extension to private sector, % yoy	67.1	-4.2	0.7	8.9	2.8	13.8	10.0	10.0	10.0
Policy Interest Rate, % eop	12.00	10.25	7.75	7.75	7.50	6.50	14.00	12.00	10.00
3 month inter-bank rate, %, eop	23.58	18.00	8.25	20.83	24.00	16.00	20.00	15.60	14.50
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US$, eop	8.05	8.05	7.97	8.01	8.05	8.24	15.82	15.00	14.00
UAH/US$, avg	5.16	8.06	7.97	7.99	8.08	8.15	11.63	15.15	14.04
UAH/EUR, eop	11.25	11.53	10.66	10.37	10.62	11.33	19.14	16.13	13.37
UAH/EUR, avg	7.60	11.21	10.55	11.11	10.39	10.83	15.51	17.09	14.26
Balance of Payments, USD bn									
Current account	-12.8	-1.7	-3.0	-10.2	-14.3	-16.5	-4.6	-2.9	-2.7
% of GDP	-7.1	-1.5	-2.2	-6.3	-8.1	-9.1	-3.7	-2.6	-2.0
Trade balance	-16.1	-4.3	-8.4	-16.3	-19.5	-20.0	-12.4	-8.7	-9.0
Exports	67.7	40.4	52.2	69.4	70.2	65.0	59.8	62.8	64.7
Imports	83.8	44.7	60.6	85.7	89.7	85.0	72.2	71.5	73.7
Service balance	1.7	2.4	4.4	6.1	5.2	4.4	6.0	5.5	6.0
Income balance	-1.5	-2.4	-2.0	-3.8	-3.0	-3.0	-1.5	-3.0	-3.0
FDI, net	9.9	4.7	5.8	7.0	7.2	4.1	0.0	-3.0	5.0
International reserves	31.5	26.4	34.6	31.8	24.5	20.4	7.5	14.6	16.9
Total amortisations	13.9	17.9	23.1	23.6	20.1	20.5	18.0	22.1	25.0
Public Finances, % of GDP									
Consolidated government balance	-1.2	-7.3	-8.8	-3.9	-5.6	-6.6	-10.0	-6.0	-4.0
Consolidated gov primary balance	-0.8	-6.2	-7.6	-2.9	-4.7	-5.7	-8.8	-4.8	-2.9
Public debt	14.4	25.6	31.6	28.3	29.1	34.2	62.4	69.8	66.2
of which Domestic	4.7	10.0	13.1	12.4	13.5	17.7	25.0	25.8	25.2
Foreign Assets & Liabilities, USD bn									
External debt	101.7	103.4	117.3	126.2	134.6	142.1	145.0	154.9	175.6
Public	16.7	24.0	32.5	33.4	32.2	31.7	36.5	37.3	58.0
External debt / GDP	56.5	88.3	86.3	77.4	76.6	78.4	115.6	140.4	133.3
External debt / XGS	118.7	190.6	169.4	142.1	149.5	166.2	174.7	246.7	271.5
Short-term debt	20.3	19.0	23.5	29.5	31.2	34.8	35.2	35.3	35.3
Short-term debt/International reserves (%)	64.4	72.0	68.1	92.9	127.1	170.5	470.3	242.1	208.7

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	-2.2	-7.0	-15.9	-7.8	-6.7	-1.8	3.9	-0.6	1.1
CPI, % yoy eop	11.9	17.5	24.9	24.4	17.3	14.6	9.2	8.7	9.1
Policy interest rate, %, eop	9.50	12.50	14.00	14.00	14.00	14.00	12.00	11.00	10.00
Short-term market rate, % eop	18.00	18.00	20.00	16.50	16.25	16.00	15.60	15.50	15.25
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US$, eop	11.75	12.95	15.82	15.00	15.00	15.00	15.00	14.00	14.00

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6.

Other Africa

David Cowan
+44 20 7986 3285
david.cowan@citi.com

Ghana

- The November budget presentation outlined an aggressive reduction in the 2015 fiscal deficit, but it is based on very optimistic revenue projections, especially as it seems to have now accepted that growth will slow significantly in 2015. While we think the revenue projections will not be met, what is less clear is whether it can serve as a base for a deal with the IMF in 1Q 2015. And reaching a deal is becoming increasingly important as Ghana rapidly approaches a period of intensive cedi bond repayments in 2H 2015 and into 2016.

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

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

Kenya

- Robust growth in recent years looks set to accelerate in the next few years, boosted by ongoing improvements in infrastructure, a lower global oil price and an improved political outlook. In particular, the end of the ICC trial of the president, Uhuru Kenyatta, should allow him to focus more fully on the ongoing problems created by Al Shabaab and domestic politics.

- The lower oil price should help drive a reduction in the current account deficit in 2015, which ballooned significantly in 2014, but the real challenge will be to make sure the government maintains fiscal discipline. The deficit seems to have widened significantly in the first half of the fiscal year and with the current account deficit and a strong US dollar spilled over into KES weakness in recent months.

- While a weaker global oil price is a positive for the Kenyan inflation outlook, recent KES weakness robust growth and high levels of fiscal spending will all mitigate the benefits. As long as there is not a drought, this means we expect inflation to fall in 2015 to pretty much the middle of the Central Bank of Kenya (CBK) inflation target (5%, +/- 2.5pp). The interesting question then becomes to what extent it cuts rates to support the economic pick-up. We think that with one eye on KES, there will be very limited and cautious rate cuts.

Tanzania

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

- Given political developments, the prospects for a rapid progress towards gas production are now very limited. But growth should continue to be robust at around 7%. The current account deficit is set to remain substantial, but with donor support and FDI inflows remaining high, the balance of payments will remain in surplus, especially if the government does issue a Eurobond.

- After two years of relative stability, the substantial fiscal and current account deficits have started to translate into more significant shilling weakness in late 2014 and early 2015. Once this has run its course, the Bank of Tanzania (BoT) is likely to try and manage a new period of Tanzanian shilling stability in the run up the elections in late 2015 which will severely limit its scope to loosen monetary policy.

Uganda

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

- In this environment, the Bank of Uganda (BoU) will face a difficult balancing act. While it probably wants to cut the Central Bank Rate (CBR) in 2015 in line with its inflation outlook, this is likely to spill over into further Ugandan shilling (UGX) weakness than we have already seen in early 2015 given the fiscal stance. This would especially be the case if the government bows to raising recurrent spending in 2015 as the February 2016 elections loom closer.

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

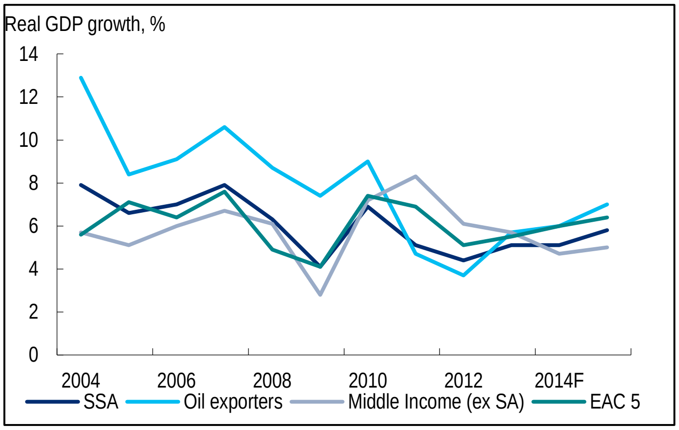
Zambia

- The sharp fall in the copper price and the political uncertainty over the January 20 presidential by election have put pressure on the kwacha in early 2015. Moreover, the former means that whoever wins the polls may have to revisit the changes in the copper mining tax regime in the 2014 budget. This, in turn, will impact on the fiscal outlook and mean a further reduction in the fiscal deficit is unlikely in 2015-16. Especially with new presidential polls to be held in late 2016

- Without a rapid recovery in the copper price and uncertainty over the tax regime, we think that Zambia is now likely to run a small current account deficit in 2015, although this will be relatively easy to finance with strong FDI inflows. But with the limited fiscal consolidation, we think the kwacha could be on the back foot in 2015 even if the growth outlook continues to remain positive.

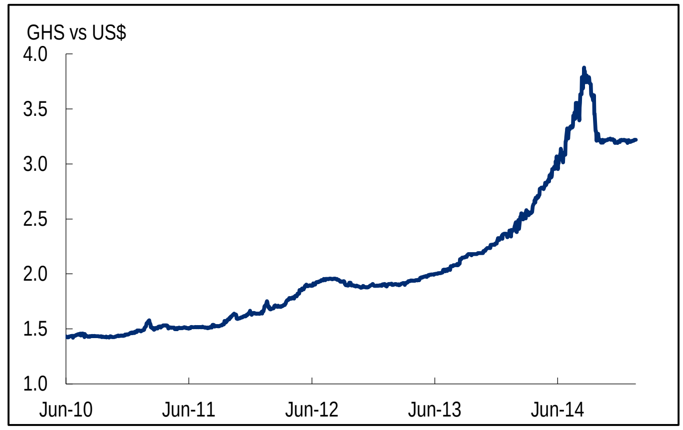
- However, Kwacha stability would be helped if the government can agree on a new programme with the IMF in early 2015 and Bank of Zambia (BoZ) could build foreign exchange reserves which are low by regional standards. In the meantime, the BoZ will have to maintain a relatively tight monetary policy to help support the currency in our view.

Figure 221. Growth should remain robust in 2014-15



Source: IMF

Figure 222. A temporary cedi stabilization, but for how long?



Source: Haver Analytics

Figure 223. A gradual depreciation of the Kenyan shilling in 2014

Source: Haver Analytics

Figure 224. The Tanzanian shilling has eventually started to weaken

Source: Haver Analytics

Figure 225. The Ugandan shilling is now coming under more pressure

Source: Haver Analytics

Figure 226. The kwacha remains under only moderate pressure

Source: Haver Analytics

Figure 227. Other Africa Economic Forecasts

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
GHANA									
Nominal GDP, USD bn	28.5	26.0	32.2	39.6	41.7	45.2	39.3	37.0	38.6
GDP per capita, USD	1,234	1,096	1,326	1,594	1,646	1,744	1,487	1,370	1,402
Real GDP, yoy avg	8.4	4.0	8.0	15.0	8.8	7.2	4.6	4.0	6.0
CPI, % avg	16.5	19.3	10.7	8.7	9.2	11.7	15.2	13.2	8.0
Policy Interest Rate, % eop	17.0	18.0	13.5	12.5	15.0	16.0	19.0	16.0	12.0
GHS/US$, avg	1.07	1.43	1.43	1.55	1.85	2.06	2.99	3.67	4.08
Current account, US$bn	-3.5	-1.6	-2.6	-2.5	-4.9	-5.2	-3.5	-2.9	-3.2
% of GDP	-12.4	-6.2	-8.2	-6.3	-11.8	-11.5	-8.9	-7.8	-8.3
Consolidated gov. balance, % of GDP	-8.4	-7.0	-9.4	-5.2	-12.1	-10.0	-9.8	-7.6	-6.5
KENYA									
Nominal GDP, USD bn	35.9	37.0	40.0	42.0	50.3	55.2	62.7	70.0	76.5
GDP per capita, USD	926	929	978	999	1,165	1,245	1,377	1,497	1,594
Real GDP, yoy avg	0.2	3.3	8.4	6.1	4.5	5.7	5.2	6.0	6.2
CPI, % avg	15.1	10.6	4.3	14.0	9.4	5.7	6.9	5.5	6.1
Policy Interest Rate, % eop	8.5	7.0	6.0	18.0	11.0	8.5	8.5	7.5	8.0
KES/US$, avg	68.8	77.3	79.2	88.4	84.5	86.1	87.9	92.8	97.9
Current account, US$bn	-1.9	-1.7	-2.4	-3.7	-4.2	-4.8	-7.7	-6.2	-6.5
% of GDP	-5.4	-4.6	-5.9	-8.9	-8.4	-8.7	-12.3	-8.9	-8.5
Consolidated gov. balance, % of GDP	-3.3	-4.4	-4.4	-4.0	-5.0	-5.7	-6.2	-6.0	-5.6
TANZANIA									
Nominal GDP, USD bn	20.6	21.4	22.9	23.9	28.5	33.3	36.6	40.2	44.3
GDP per capita, USD	486	490	509	515	595	676	721	770	823
Real GDP, yoy avg	6.7	3.9	5.8	9.5	5.1	8.2	7.1	7.2	6.4
CPI, % avg	10.3	12.1	7.2	12.7	16.0	7.9	6.1	3.9	5.4
TZS/US$, avg	1,198	1,324	1,439	1,582	1,586	1,617	1,664	1,766	1,839
Current account, US$bn	-2.1	-2.1	-2.1	-3.5	-4.5	-4.6	-5.0	-5.3	-5.5
% of GDP	-10.3	-9.8	-9.3	-14.5	-15.9	-13.8	-13.7	-13.1	-12.5
Consolidated gov. balance, % of GDP	-2.6	-6.0	-6.5	-5.0	-5.7	-5.9	-6.2	-6.5	-5.5
UGANDA									
Nominal GDP, USD bn	16.4	16.5	17.2	18.2	21.2	22.9	26.1	26.9	28.7
GDP per capita, USD	515	503	506	518	584	610	672	671	692
Real GDP, yoy avg	10.4	8.1	7.7	6.8	2.6	4.7	6.1	6.5	6.9
CPI, % avg	12.0	13.0	4.0	18.7	14.0	5.5	4.3	3.1	6.6
UGX/US$, avg	1,714	2,025	2,173	2,511	2,501	2,584	2,595	3,012	3,158
Current account, US$bn	-1.2	-1.1	-1.6	-2.1	-1.7	-1.5	-2.5	-2.7	-3.2
% of GDP	-7.5	-6.4	-9.6	-11.4	-7.9	-6.5	-9.7	-10.1	-11.0
Consolidated gov. balance, % of GDP	-2.7	-1.6	-6.6	-3.9	-3.8	-4.5	-5.3	-5.6	-5.3
ZAMBIA									
Nominal GDP, USD bn	17.9	15.3	20.3	23.7	25.0	27.1	27.1	29.1	30.7
GDP per capita, USD	1,438	1,195	1,533	1,740	1,774	1,861	1,804	1,876	1,917
Real GDP, yoy avg	7.8	9.2	10.3	6.4	6.8	6.7	6.5	6.0	6.1
CPI, % avg	12.4	13.4	8.5	6.4	6.6	7.0	7.8	7.5	6.8
ZMK/US$, avg	3,702	5,020	4,791	4,861	5,139	5,195	5,195	7	7
Current account, US$bn	-1.0	0.6	1.2	0.7	0.8	0.2	0.1	-0.2	-0.5
% of GDP	-5.6	3.8	5.9	3.0	3.1	0.7	0.5	-0.8	-1.5
Consolidated gov. balance, % of GDP	-0.7	-2.1	-2.4	-1.8	-3.2	-6.7	-5.3	-5.0	-5.2

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GHS/US$, eop	3.33	3.29	3.19	3.40	3.80	3.90	3.90	4.00	4.00
KES/US$, eop	87.65	89.25	90.55	92.00	92.50	93.00	94.00	95.00	97.00
TZS/US$, eop	1,658	1,677	1,733	1,760	1,770	1,760	1,785	1,810	1,840
UGX/US$, eop	2,600	2,645	2,771	2,950	3,000	3,100	3,155	3,200	3,100
ZMK/US$, eop	5,195.00	5,195.00	5,195.00	6.50	6.50	6.50	6.60	6.80	7.00

Source: National Sources, Citi Research forecasts. Note: BOP is reported using BPM6 for Uganda

Ilker Domac
+90 212 319 4623
ilker.domac@citi.com

Gultekin Isiklar
+90 212 319 4915
gultekin.isiklar@citi.com

Other Europe

Bulgaria

Economic activity grew by 0.4%QoQ (SWDA) in the third quarter of 2014, compared with a rise of 0.3%QoQ in 2Q and an increase of 0.1%QoQ in 1Q. With the 3Q reading, GDP growth reached 1.7%YoY in the first three quarters of 2014. A closer look at the data suggests that consumption expenditures recovered in 3Q, rising by 0.3%QoQ following a contraction of 0.3%QoQ in 2Q. Exports declined quite sharply by 2.6%QoQ in 3Q—the largest QoQ drop since 1Q 2012—corroborating our view that exports are losing traction. Although investment activity remained strong in 3Q (0.7%QoQ), the going will get tougher, as EU funded investment will likely decline during the next programming period. Where do we go from here? It is true that there is an improvement in sentiment indicators following the snap elections. Economic sentiment index rose to 100.6 in December—first reading above 100 since August 2014—from 96.8 in October. Nonetheless, due to the above-noted reasons, we maintain our view that the economy faces more headwinds than tailwinds in 2015, as we see growth to come in at around 1.2% this year following an estimated 1.5% growth in 2014.

Regarding price developments, it looks like deflationary pressures accelerated in December when compared with November. The noted outcome was driven largely by transport, food, health and communication components. We recognize that a number of factors—such as lower energy prices and continued softness in global food prices—will likely keep deflationary pressures in early-2015. However, we expect base effects to kick in thereafter with inflation creeping up and reaching 1% by the year-end. Concerning external developments, the current account balance in the first eleven months of the year printed a surplus of €0.26bn, compared with a surplus of €1.20bn in the same period of 2013. Going forward, our expectations of weaker exports this year leads us to look for a current account deficit of about 0.5% of GDP in 2015, compared with an estimated surplus of 0.2% in 2014.

Croatia

Recent developments continue to paint a relatively bleak picture for the near-term growth prospects. GDP rose by 0.15%QoQ in 3Q following a 0.17%QoQ decline in 2Q and a 0.3%QoQ increase in 1Q. With this outcome, economic activity in the first three quarters of 2014 contracts by 0.6%YoY. The 3Q GDP outturn was mainly shaped by the weak private consumption and export growth, while government spending and investment activity turned out to be relatively strong. Specifically, household consumption expenditures contracted 1%QoQ in 3Q—the largest QoQ decline since June 2012. Looking ahead, while consumption spending is likely to remain soft, we expect to see a gradual rebound in investment activity in the coming months thanks to EU-funded projects. Against this backdrop, we keep our 2015 GDP growth forecast at 0.3% compared with an estimated contraction of about 0.7% in 2014.

Regarding inflation, consumer prices fell by 0.8%MoM in December, bringing the annual inflation rate to -0.5%YoY from 0.2%YoY in November. The monthly inflation print in December was about 0.7pp lower than its seasonal average of a drop of 0.10%MoM—an outcome mainly driven by below-average readings in food and transport. Looking ahead, low oil prices and weak domestic demand is likely to keep inflationary pressures in check. However, we think that inflation is likely to rise gradually to about 1.0% by end-2015 owing to base effects.

Concerning external developments, the trade balance in the first ten months of the year printed a surplus of EUR5.9bn, which is slightly less than the surplus observed in the same period of 2013 (EUR6.0bn). Looking ahead, we expect the current account balance to remain in positive territory this year. Specifically, the combination of subdued domestic demand and softer export leads us to look for a decline Croatia's current account surplus to 0.5% of GDP this year from an estimated 1% in 2014.

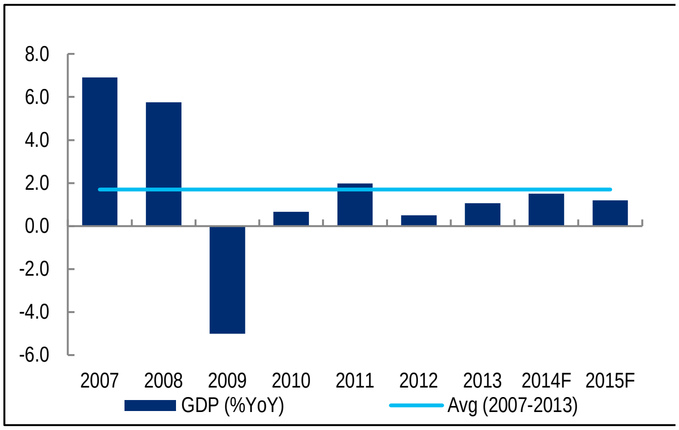
Serbia

In our view, recent developments demonstrate the Government's determination to put its fiscal house in order under the umbrella of a 36-month precautionary Stand-By Arrangement with the IMF. The arrangement, which is worth about €1bn, is expected to be approved by the IMF Board in the second half of February 2015. In line with the IMF program, the authorities took measures including a 10% cut in public salaries, a reduction in subsidies and the pension bill. The government aims at narrowing the augmented general government deficit (including payments for guarantees and bank resolution costs) from about 8% of GDP in 2014 to below 6% in 2015 and below 4% by 2017.

In our view, the IMF program—if implemented successfully—could play an important role in bolstering investor sentiment and helping Serbia to reform its economy. However, the potential contractionary impact of the envisaged fiscal consolidation could complicate the implementation of the arrangement if the program falls short of boosting investor sentiment and capital inflows. With this backdrop in mind, we expect the economy to contract this year by about 0.6%, following an estimated 2% contraction in 2014. We don't look for significant pick-up in activity in the near term owing mainly to the government's austerity measures, which will weigh on domestic demand. However, the potential re-launch of some manufacturing plants affected by the floods provide some upside risks for 2015.

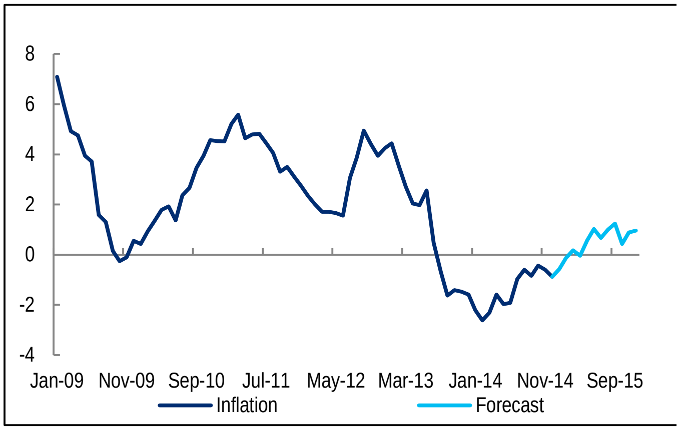
Regarding external developments, the current account deficit is projected to have remained wide in 2014, at an estimated 6.5% of GDP. This partly reflects the reconstruction efforts following the May floods, which led to an increase in imports. While car exports could further weaken in 2015, the subdued domestic demand will limit import growth, which should help narrow the current account gap this year to 4.8% of GDP. Turning to price developments, at 1.7%YoY, inflation finished 2014 well below the target (4%, +/-1.5pp). Based on our estimates, inflation will likely rise above the NBS' target of 4% by 2Q 2015 on the back of base effects and the likely administrative price adjustments. The depreciation of the EURRSD since the beginning of the year—probably along with the noted backdrop—led the NBR to keep rates on hold at the January MPC meeting. In the meantime, the NBS remains active in the FX market to smooth out short-term volatility. Looking ahead, we believe that the combination of a benign inflation outlook and the approval of the program by the IMF's Board, is likely to pave the path for rate cuts, as we see the policy rate declining to 7% in 1H from 8%. It is worth noting that the envisaged monetary policy easing depends on the performance of the currency.

Figure 228. Bulgaria: We see growth to come in at around 1.2% this year following an estimated 1.5% growth in 2014. ...



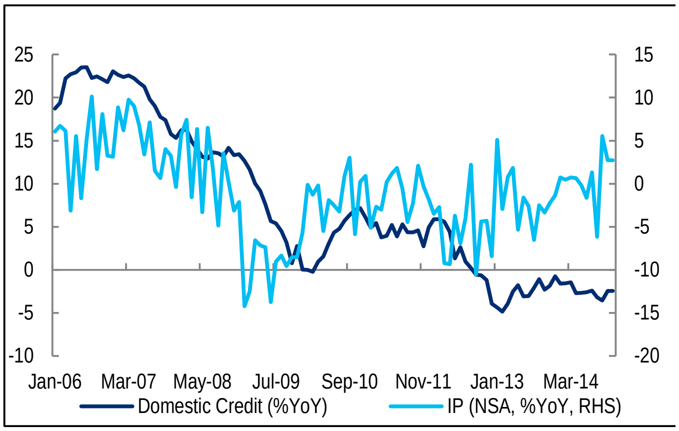
Source: Haver Analytics and Citi Research

Figure 229. ...as inflation is likely to rise to about 1% at the year-end, driven largely by base effects.



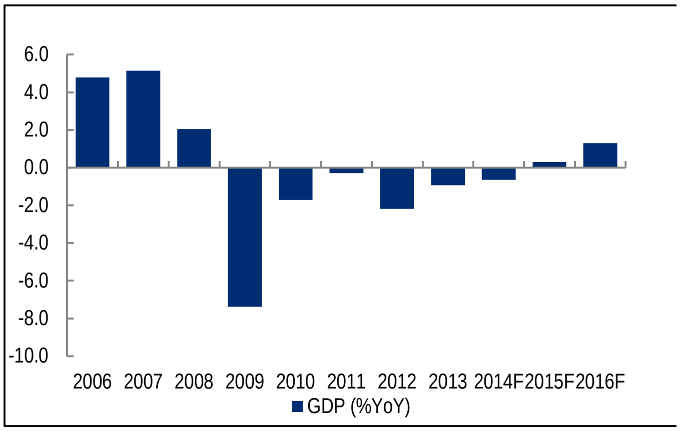
Source: Haver Analytics and Citi Research

Figure 230. Croatia: While consumption spending is likely to remain soft, we look for a gradual rebound in investment activity...



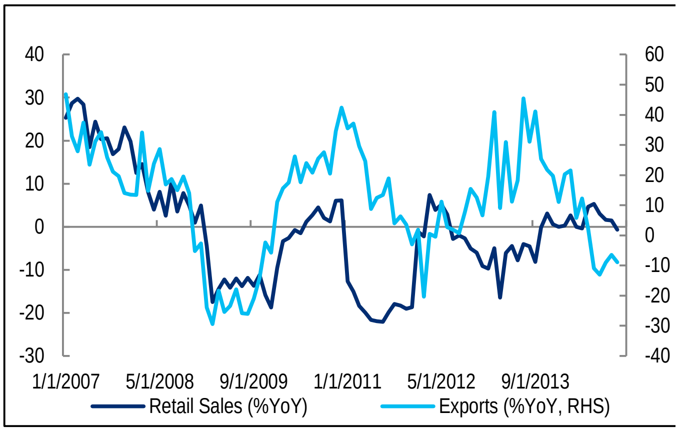
Source: Haver Analytics and Citi Research

Figure 231. ... as we expect the GDP growth to register its first positive growth in six years



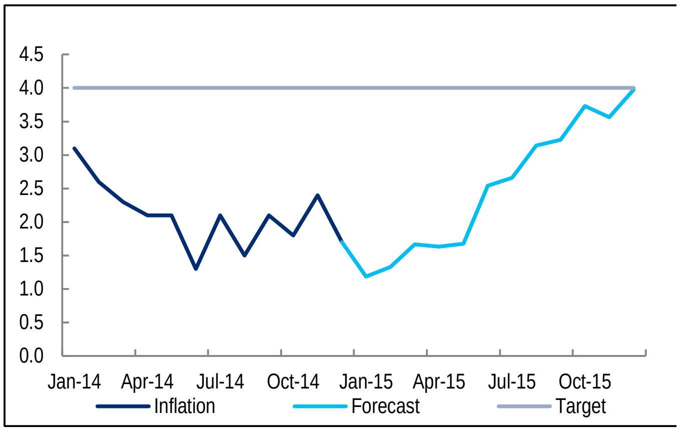
Source: Haver Analytics and Citi Research

Figure 232. Serbia: Recent data suggest that economic activity remains soft...



Source: Haver Analytics and Citi Research

Figure 233. ... but inflation is set to rise due to administrative price hikes and base effects, moving closer to the target by end-2015



Source: Haver and Citi Research

Figure 234. Other Europe Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
BULGARIA									
Nominal GDP, USD bn	53.6	50.3	48.8	55.8	52.6	54.5	54.6	46.8	43.6
GDP per capita, USD	7,047	6,646	6,500	7,617	7,225	7,532	7,579	6,530	6,109
Real GDP, yoy avg	6.2	-5.5	0.4	1.8	0.6	1.1	1.5	1.2	2.0
CPI, % avg	12.3	2.8	2.4	4.2	3.0	0.9	-1.4	1.4	1.3
BGN/US$, avg	1.33	1.40	1.47	1.40	1.52	1.47	1.47	1.77	1.96
BGN/EUR, avg	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
Current account, US$bn	-12.0	-4.3	-0.7	0.0	-0.6	1.1	0.1	-0.2	-0.7
% of GDP	-22.4	-8.6	-1.4	0.1	-1.1	2.1	0.2	-0.5	-1.5
Consolidated gov. balance, % of GDP	1.7	-4.3	-3.1	-2.0	-0.8	-1.5	-3.7	-3.8	-2.0
CROATIA									
Nominal GDP, USD bn	70.5	62.6	59.7	62.2	56.5	57.9	57.0	47.4	43.4
GDP per capita, USD	16,159	14,399	13,754	14,393	13,115	13,495	13,343	11,130	10,226
Real GDP, yoy avg	2.1	-6.9	-2.3	-0.2	-2.2	-0.9	-0.7	0.3	1.3
CPI, % avg	6.1	2.4	1.0	2.3	3.4	2.2	-0.2	0.2	1.5
Policy Interest Rate, % eop	9.00	9.00	9.00	7.00	7.00	7.00	7.00	7.00	7.00
HRK/US$, avg	4.91	5.26	5.49	5.34	5.84	5.70	5.75	6.94	7.80
HRK/EUR, avg	7.23	7.34	7.29	7.43	7.51	7.58	7.63	7.71	7.80
Current account, US$bn	-6.2	-3.2	-0.7	-0.5	-0.1	0.5	0.6	0.2	-0.2
% of GDP	-8.8	-5.1	-1.1	-0.9	-0.2	0.9	1.0	0.5	-0.5
Consolidated gov. balance, % of GDP	-	-5.3	-6.4	-7.8	-5.0	-4.9	-5.5	-5.6	-5.4
SERBIA									
Nominal GDP, USD bn	49.3	42.6	39.5	46.5	40.7	45.5	43.9	35.1	31.7
GDP per capita, USD	6,701	5,819	5,413	6,399	5,660	6,324	6,105	4,874	4,404
Real GDP, yoy avg	5.4	-3.1	0.6	1.4	-1.0	2.6	-2.0	-0.6	1.5
CPI, % avg	12.5	8.2	6.2	11.2	7.3	7.9	2.1	2.5	4.0
Policy Interest Rate, % eop	17.75	9.50	11.50	9.75	11.25	9.50	8.00	7.00	7.00
RSD/US$, avg	55.2	67.4	77.5	73.2	87.8	85.1	88.2	112.6	131.5
RSD/EUR, avg	81.4	94.0	102.9	102.0	112.9	113.1	117.2	125.1	131.6
Current account, US$bn	-10.5	-2.9	-2.8	-4.0	-4.1	-2.1	-2.9	-1.8	-1.4
% of GDP	-21.2	-6.8	-7.2	-8.6	-10.2	-4.6	-6.5	-5.0	-4.5
Consolidated gov. balance, % of GDP	-2.0	-3.9	-3.9	-4.4	-7.2	-5.7	-7.8	-6.0	-4.5

Source: National Sources, Citi Research forecasts

This page is intentionally left blank

Latin America

Argentina

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

Fernando Díaz
+1 212 816 9891
fernando.jorge.diaz@citi.com

- **Summary view** — Monetary policy has shifted. Since October, the policy stance has turned much more expansionary. This change in monetary policy threatens the stability of the FX market, putting pressure on the country's credit. However, the market seems to be ignoring the potential source of instability and competing demand for FX reserves. The situation has been muffled by the availability of a short term swap line with China. As the elections draw closer, a holdout deal in 2015 becomes increasingly unlikely and pressures on the FX market mount.

- **Things to watch** — the evolution of the money market and net reserves. Investors underestimate the monetary challenges, the eventual FX realignment, and the complex legacy for the administration expected to take over in December.

- **Strategy** — Lack of an effective debt resolution significantly increases the expected volatility in the credit. On FX, we continue to believe that the current pace of crawl is only sustainable in the short term.

Monetary policy: an unappreciated shift

The monetary base (M0) rose 22.6% in 2014, or ARS85.4bn. The increase was similar to that of 2013 (in %), when it grew 22.7%. However, the composition was significantly different. In 2013, the Central Bank of Argentina (BCRA) printed pesos to assist the Treasury and partially absorbed them back through FX sales. Last year, however, the BCRA issued ARS to finance the fiscal deficit but also to purchase foreign currency, while "sterilization" (i.e., the issuance of short-term central bank notes) increased.

The strong "sterilization" was a key reason behind the shift in the dynamics of the FX market observed last year, in our view. Before, the excess of local currency consequence of the monetary financing of the fiscal deficit was being counterbalanced by the selling of foreign currency by the BCRA and the subsequent absorption of pesos. In 2014, the fiscal money printing was "sterilized" through the issuance of short-term debt, and therefore the BCRA was not forced to sell foreign currency to equilibrate the monetary market. The strong "sterilization" is the reason why, despite the much-higher fiscal money printing and the FX purchases from the BCRA, money growth remained moderate (by Argentine standards) in 2014.

Yet, this situation seems to have changed since Alejandro Vanoli replaced Juan Carlos Fábrega at the helm of the BCRA in October. According to our estimates, the monetary base rose at a seasonally-adjusted annualized rate of 50.9% during 4Q14. The only reason why the annual growth rate of the monetary base remained relatively in check is the low growth during 1H14 and the strong increase during the end of 2013, which provided a favorable base for comparisons.

Money printing has accelerated because the transfers from the BCRA to the Treasury have soared and the pace of "sterilization" slowed down. Since October, the BCRA has transferred ARS85.5bn to the Treasury, only sterilizing ARS6.5bn. On the contrary, during January–September 2014, the BCRA transferred ARS76bn to the Treasury and "sterilized" ARS88.1bn.

Restoring equilibrium to the money market takes place through the sale of reserves or higher FX depreciation. In the first case, by selling international reserves the authorities absorb local currency, reestablishing a temporary equilibrium in the money market. In the second case, the higher exchange rate

pushes inflation up destroying the “real” supply of money (or diluting “domestic credit” growth via inflation).

FX, inflation, and interest rates: a consistently inconsistent plan

Despite the slowdown in sterilization, the authorities have reduced the pace of crawl of the ARS in the official FX market. While the USDARS had increased at an annualized rate of 55.6% during 1H14, it rose at an annualized rate of 10.6% in 2H14 and of only 6% in 4Q14. The lower pace of depreciation in the official FX market does not bode well for international reserves and, thus, for the country’s credit. A slower devaluation may (temporarily) lead to lower inflation (something that is already happening), reducing the nominal money demand growth. As a result, if the BCRA sterilizes a small fraction of the fiscal money printing, the demand for foreign currency will surely go up. Maintaining a slow pace of crawl and a fast pace of money printing is likely to result in an increase in the parallel FX which, in turn, is likely to lead to lower exports and greater pressure on reserves.

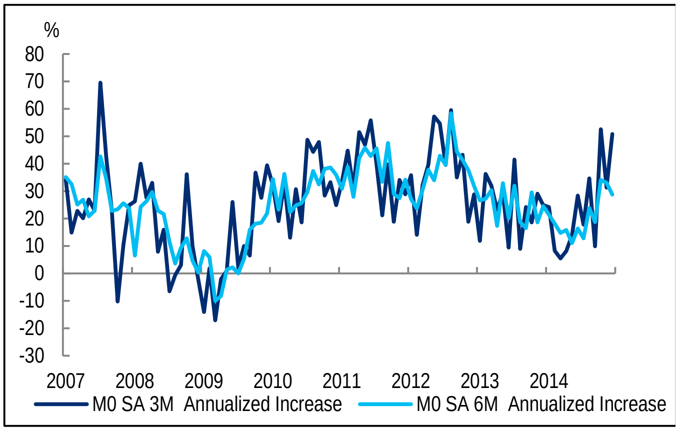
A possible way out would be to increase sterilization, but that requires higher interest rates. To maintain the pace of sterilization of H1 2014, the central bank needs to increase interest rates. The result becomes contractionary for economic activity. The BCRA seems bent to move in the opposite direction and attempt to cut interest rates — markets are starting to price in some easing. If interest rates are lowered, the pressures on the FX market will almost inevitably increase.

Economic and FX stability is threatened by the above scenario, unless the government regains access to debt markets, in our view. The inconsistency between stronger “domestic credit” growth and slower FX depreciation is bad news for the external accounts. Since the country services its public debt using international reserves, this becomes a competing demand for the scarce reserves. The authorities can compensate for this through access to USD external credit. There are two channels for this: The authorities borrow reserves from other central banks or they reach a solution with the holdouts.

Finance Minister Kicillof has made clear that the government’s position in the pari-passu case remains little changed. Argentina does not seem to be in a hurry to negotiate, and it is waiting for the courts to compile a full list of creditors and amounts and to make a proposal of how the process ought to proceed. Furthermore, Mr. Kicillof has repeatedly argued that Argentina should pay similar terms to holdouts as it paid to exchange bondholders, a proposal that has repeatedly been rejected. Naturally, the closer we get to the elections, the lower the incentives for the authorities and holdouts to settle. At this point, it would seem unlikely that negotiations will gain sufficient momentum to facilitate the financing of the budgetary gap.

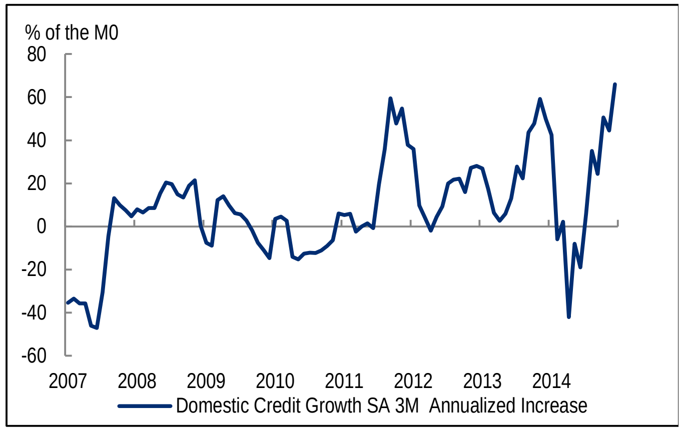
Short-term credit lines with other central banks have become the short-term funding vehicle of choice. The central bank has secured a swap line with the People’s Bank of China, and there is a long standing line with the Banque de France. Utilizing both lines may provide the government some short-term relief, as reserves are temporarily available. But these are borrowed reserves with very short-term maturity. As a result, as the elections approach, if reserves net of these short term-lines dwindle, the pressures on the FX market and economic stability promise to increase. After all, a new administration with a full four years ahead is likely to seek a more permanent monetary resolution, and this will very likely involve a full revamping of the FX regime, with a realignment of the currency. Will markets have the patience to wait until that realignment materializes, or will events precipitate much earlier?

Figure 235. M0 growth is accelerating...



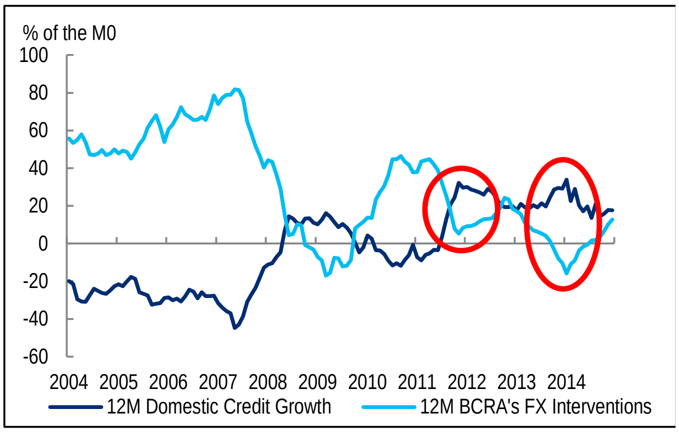
Source: BCRA and Citi Research

Figure 236. ... on the back of stronger “domestic credit” growth



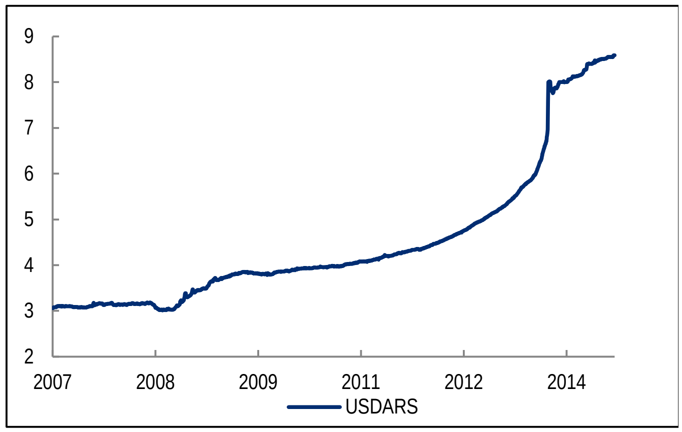
Source: BCRA and Citi Research

Figure 237. “Domestic credit” growth rules BCRA’s FX interventions



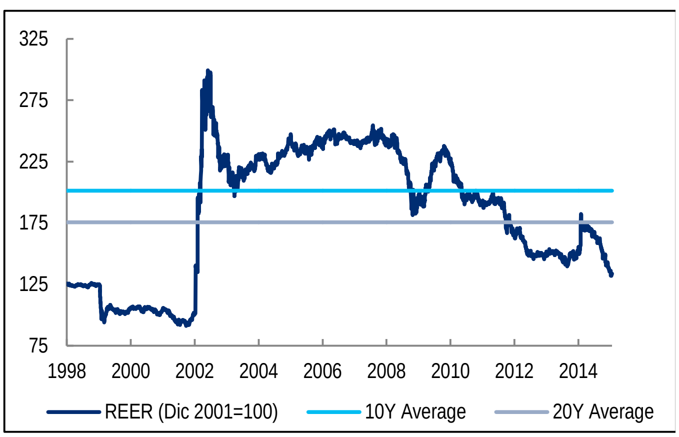
Source: BCRA and Citi Research

Figure 238. The FX rate is being used as the only nominal anchor...



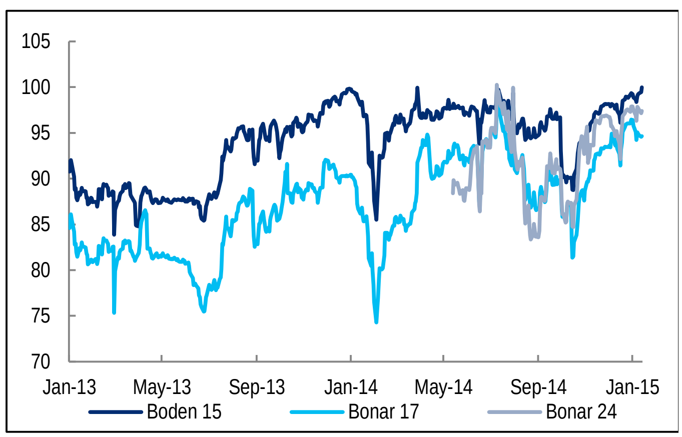
Source: Bloomberg and Citi Research

Figure 239. ... causing the ARS to become overvalued



Source: Bloomberg, MyS Consultores and Citi Research

Figure 240. Oddly, the credit has been rallying



Source: Bloomberg and Citi Research

Figure 241. Argentina Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	409	380	464	560	604	605	511	473	479
Nominal GDP, local currency bn	1,284	1,412	1,810	2,303	2,745	3,346	4,240	5,287	7,507
GDP per capita, USD	10,281	9,470	11,456	13,684	14,628	14,515	12,140	11,137	11,166
Population, mn	39.7	40.1	40.5	40.9	41.3	41.7	42.1	42.5	42.9
Unemployment, % of labour force	7.9	8.7	7.8	7.2	7.2	7.4	8.6	8.9	9.5
Economic Activity									
Real GDP, yoy avg (Citi estimates)	2.3	-3.9	7.5	5.0	-0.1	2.9	-2.3	-2.5	1.0
Real GDP, yoy avg (INDEC)	3.1	0.1	9.1	8.6	0.9	2.9	0.0	-1.0	1.0
Real investment growth % yoy	6.2	-24.0	38.4	15.6	-11.5	2.0	-0.1	-5.8	-1.2
Real consumption growth % yoy	5.5	4.1	7.2	10.5	4.5	4.5	-0.5	-0.2	1.3
private consumption growth % yoy	5.6	3.5	7.1	10.8	4.2	4.4	-1.1	-0.7	1.4
Real export growth, % yoy	0.8	-8.7	14.4	4.9	-5.9	-4.2	-5.7	-2.5	-0.2
Real import growth, % yoy	13.5	-19.3	35.0	19.8	-4.7	2.1	-6.2	-3.4	-0.6
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	20.7	14.8	26.8	24.2	25.2	28.8	38.0	37.0	35.0
CPI, % yoy eop (reported)	7.2	7.7	10.9	9.5	10.8	10.9	23.9	24.0	35.0
Nominal wages, % yoy	22.4	20.0	21.7	27.5	27.1	25.0	31.8	32.0	38.3
Credit extension to private sector, % yoy	10.5	11.5	31.6	34.6	39.0	23.8	26.0	36.0	35.0
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	19.75	10.00	11.25	17.19	15.44	21.63	20.40	29.00	40.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	3.45	3.80	3.97	4.30	4.92	6.52	8.55	12.00	16.00
ARS/USD, avg	3.16	3.73	3.91	4.13	4.54	5.45	8.09	9.83	14.07
Balance of Payments, USD bn									
Current account	6.6	10.9	-1.5	-3.7	-1.2	-4.8	-5.1	-6.6	-5.9
% of GDP	1.6	2.9	-0.3	-0.7	-0.2	-0.8	-1.0	-1.4	-1.2
Trade balance	15.4	18.5	14.0	12.9	15.2	11.1	11.0	11.2	11.9
Exports	70.0	55.7	68.2	84.1	80.2	81.7	76.3	71.0	76.6
Imports	54.6	37.1	54.2	71.1	65.1	70.5	65.3	59.8	64.7
Service balance	-1.3	-1.3	-1.2	-2.2	-3.1	-4.1	-3.5	-4.1	-4.1
Income balance	-7.7	-9.1	-13.9	-13.8	-12.8	-11.0	-12.2	-13.1	-13.1
FDI, net	9.7	4.0	11.3	10.8	14.9	11.4	4.9	10.0	10.0
International reserves	46.4	48.0	52.2	46.4	43.3	30.6	30.5	19.0	22.0
Total amortisations	4.7	11.2	10.7	12.0	9.7	9.5	8.6	8.9	10.1
Public Finances, % of GDP									
Consolidated government balance	1.1	-0.5	0.2	-1.2	-1.9	-1.8	-3.7	-4.7	-3.7
Consolidated gov primary balance	2.5	1.2	1.4	0.3	-0.1	-0.6	-2.0	-3.0	-2.0
Public debt	35.7	38.7	35.4	32.0	31.6	31.6	37.9	45.6	54.0
of which Domestic	19.7	22.2	20.1	18.7	19.5	19.8	24.4	29.1	34.1
Foreign Assets & Liabilities, USD bn									
External debt	125.9	116.6	130.8	142.5	143.3	141.1	127.5	132.3	150.2
Public	65.4	62.9	71.0	74.6	73.2	71.6	69.0	78.1	95.3
External debt / GDP	30.8	30.7	28.2	25.5	23.7	23.3	25.0	27.9	31.3
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	-1.7	-3.0	-3.9	-2.9	-3.9	-2.2	-0.9	-0.1	0.8
CPI, % yoy	39.9	41.3	38.0	31.2	29.8	30.9	37.0	38.8	41.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	22.75	21.38	20.40	21.00	22.00	25.00	29.00	35.00	40.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	8.13	8.43	8.55	8.80	9.20	10.50	12.00	12.89	13.86

Source: National Sources, Citi Research

Brazil

Marcelo Kfoury Muinhos
+55-11-4009-3470
marcelo.kfoury@citi.com

Leonardo Porto de Almeida
+55-11-4009-2947
leonardo.porto@citi.com

Mauricio Une
+55-11-4009 3412
mauricio.une@citi.com

- **Summary view** — Dilma Rousseff began her second term by implementing a turnaround in fiscal policy. Joaquim Levy announced several fiscal measures implemented since the end of last year, encompassing public spending cuts and tax hikes, increasing our conviction that the primary surplus will reach 1.0% of GDP in 2015 and 2.0% in 2016. Part of this fiscal tightening came from a strong correction in monitored prices that should lead CPI inflation to surpass the target band this year. Given this challenging inflation scenario, we see the CB hiking the Selic rate up to 12.5% amid a stagnated activity outlook, making it the second year in a row of roughly stagnant GDP.

- **Things to watch** — Approval of the fiscal measures in the Congress and the reservoir levels are key items to monitor.

- **Strategy** — While a reversal in the fiscal accounts deterioration should support the domestic currency, the steady decline in commodity prices suggests limits to BRL appreciation. Bearing this in mind, the likely approval of the expenditure cuts in Congress in the near future would seem to be a potentially good entry point to go long USD/BRL, all else equal.

Monetary and fiscal tightening constrain GDP growth

We see Brazil pursuing a tighter fiscal policy this year. One of the challenges Joaquim Levy, the newly appointed Minister of Finance, faces this year is to arrest and reverse the recent trend in fiscal deterioration. This should limit the need for external financing. Despite being appointed only a few weeks ago, Mr. Levy has already announced over-arching (quasi-) fiscal measures to tackle this issue. Many of the measures announced do improve fiscal accounts. However, their full impact is still uncertain as further details are still to be unveiled. By end-2014, the steadily-declining primary budget balance should reach 0.0% of GDP. Mr. Levy pledged to raise the primary surplus to 1.2% of GDP by end-2015. On the back of such a result, gross public debt would reach 66.7% of GDP in end-2015 (from 62.8% in end-2014). We believe that Mr. Levy will improve the primary surplus to 1.0% of the GDP in 2015, falling short of his target, bearing in mind the political cost.

Political threats may undermine Rousseff's positive momentum. Some measures on the expenditure side, like curbing some social benefits, will face strong social and political opposition and might eventually get ditched. An important additional challenge that Mrs. Rousseff will face is the election to the leadership position in each house. The candidate from PMDB, a political opponent of Mrs. Rousseff, may be the new speaker of the house. Also, the Petrobras scandal may consume President Rousseff's political capital. All in all, setbacks in the political camp might undermine the government's capacity to approve unpopular fiscal measures and may disturb the market's honeymoon with Joaquim Levy

Domestic and global factors are pressuring the BRL in opposite directions. The U-turn in the Rousseff government's fiscal policy has served to reduce Brazil's risk premium, consequently favoring BRL appreciation, in our view. However, the steady decline in commodity prices limits the appreciation of the BRL. In the medium term, we see global factors driving BRL movements, leading us to estimate a USD/BRL of 2.92 by 2015 year-end. In the meantime, prospects of a weaker currency amid a stagnant domestic economy point to some improvement in the trade balance, suggesting a current account deficit slightly below the 4% level seen in 2014.

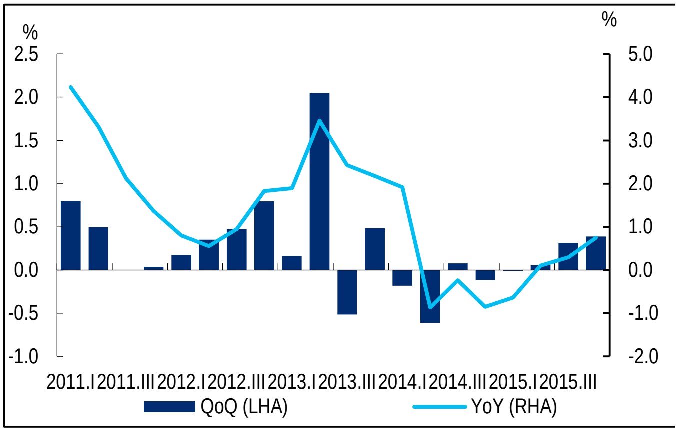
We now expect 2015 GDP growth to be 0.1%, accelerating gradually in 2016 to 1.6%. In addition, significant increases in some monitored prices (especially the residential energy fee and bus fares) will reduce disposable income of consumers, hurting private consumption further. Putting all of these factors together, we see GDP remaining roughly unchanged in 1H15 and increasing slightly thereafter. We estimate GDP growth will reach 0.1% in 2015, roughly the same figure expected for last year (0%). Because we do not expect the CB to have much leeway to ease monetary policy in the medium term while fiscal tightening continues, economic growth will likely remain sluggish. Given that our estimates put potential GDP growth at around 2%, we see GDP growth expanding at this pace only in 2H16.

No water under the bridge. In 2015, a major risk revolves around water supply (or lack thereof). In an economy where hydroenergy accounts for 73% of the electricity supply (thermal energy is around 23%), it is time to worry when the rainy season (Dec-Apr) disappoints. For instance, Brazil was forced to implement an unpopular power-rationing plan in 2001. In January, reservoir levels in the Southeast/Midwest are expected to reach only 18% of their maximum capacity, compared to a historical range of roughly 50%–80%. Should the summer bring a greater number of hotter days in the rainy season, water supply might be compromised, either for power supply or, in some areas, even consumption. Needless to say, political and economic risks could be significant. According to Citi analysts (see Living on the Edge (Part VIII)), if annual rainfall falls below 75% of normal levels, the system cannot cope with current levels of consumption.

We now expect Copom to raise the Selic rate to 12.5% in 1Q15, but then cut it back later in the year to 11.75% by year-end. The change in relative prices during 2015 (monitored prices and the adjustment between tradable and non-tradable items) is an important input in determining the length of the hiking cycle, as well as fiscal consolidation. As for the latter, the appointment of Mr. Levy as the new Minister of Finance supports Copom in helping inflation move back to the target, given his reputation for austerity. If confidence is restored with a sound fiscal policy, this will ease the burden on the central bank. Thus, we expect a monetary policy loosening towards the end of the year. Overall, from our expected 12.5% during 1Q15, we see the Selic rate declining to 11.75% and 10% by the end of 2015 and 2016, respectively.

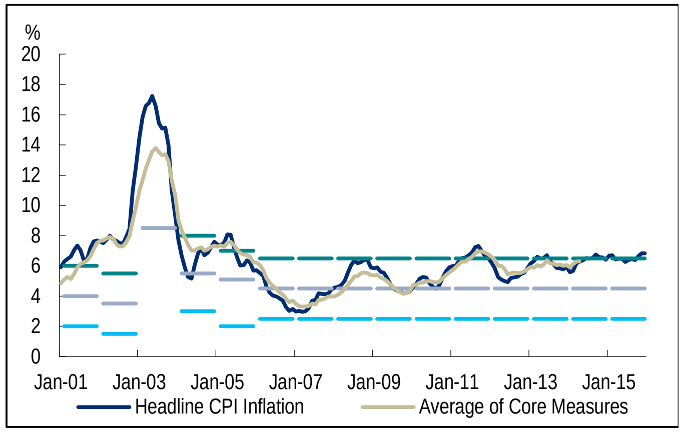
We see CPI inflation slightly above the target in 2015 at 6.8%, due to the necessity of price realignments. Monitored prices should increase by 8.9% in 2015, if our forecasts of a 30% hike in regulated energy bills and a 12% rise in urban bus fares materialize. Much of this year's hikes in monitored prices, particularly in the electricity sector, stems from Mr. Levy's policy that the sector should be funded by the energy consumer rather than the taxpayer. Another adjustment, already mentioned above, is between tradable and non-tradable prices in the event of depreciation in the real exchange rate. We do not expect the deceleration in non-tradable inflation to offset the higher increases in tradable and monitored prices. Therefore, we see CPI inflation overshooting the BCB target's upper limit in 2015. Furthermore, we expect CPI inflation to stand at 5.5% next year.

Figure 242. We see no meaningful GDP recovery ahead



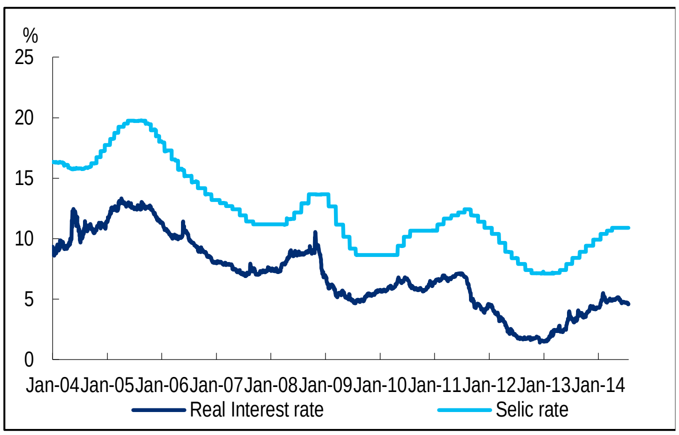
Source: Citi Research and IBGE

Figure 243. We continue expecting CPI inflation above the target in 2015



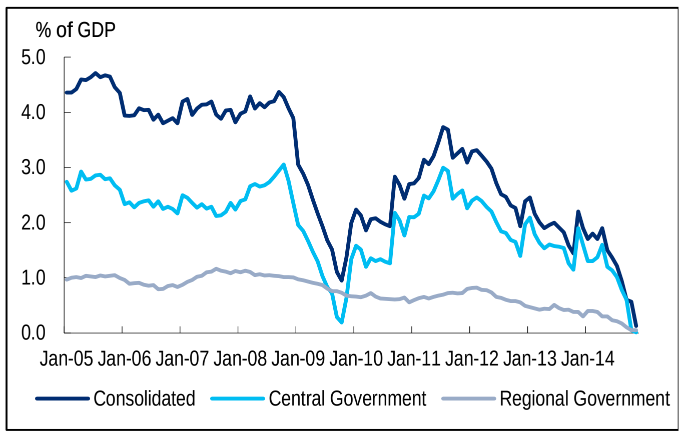
Source: Citi Research, IBGE and BCB

Figure 244. We expect Copom to hike Selic rate up to 12.5%



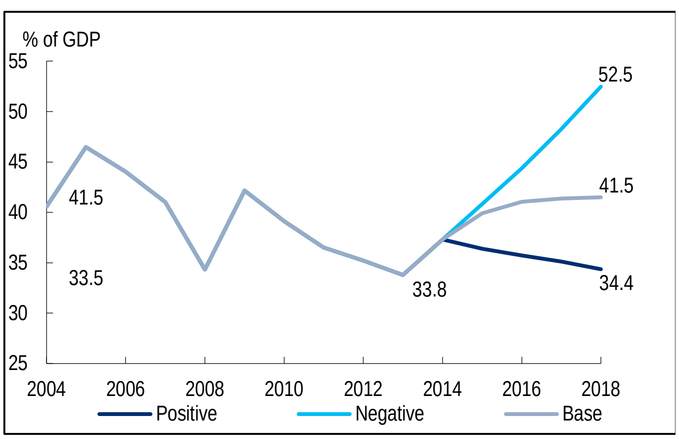
Source: Citi Research and BCB

Figure 245. We estimate primary fiscal surplus below 2% of GDP in 2015



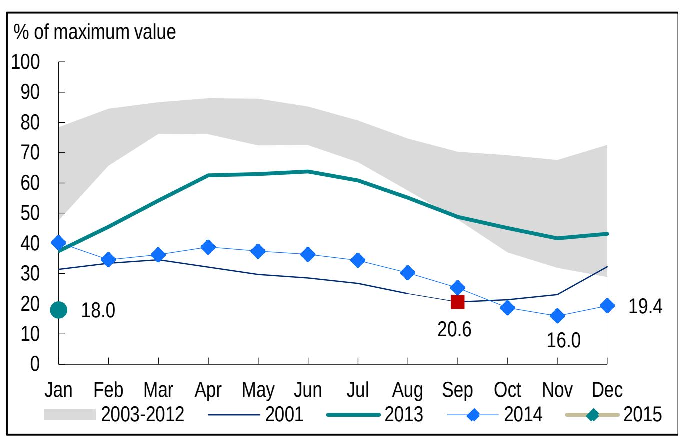
Source: Citi Research and BCB

Figure 246. Insufficient primary fiscal result will increase public debt/GDP



Source: Citi Research and BCB

Figure 247. Reservoir levels Southeast/Midwest



Source: Citi Research and ONS

Figure 248. Brazil Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	1,746	1,622	2,142	2,475	2,247	2,215	2,163	1,994	2,057
Nominal GDP, local currency bn	3,032	3,239	3,770	4,143	4,392	4,815	5,110	5,447	5,871
GDP per capita, USD	9,114	8,379	10,955	12,536	11,278	11,019	10,668	9,747	9,964
Population, mn	191.5	193.5	195.5	197.4	199.2	201.0	202.8	204.6	206.4
Unemployment, % of labour force	7.9	8.1	6.7	6.0	5.5	5.4	4.9	5.3	5.8
Economic Activity									
Real GDP, yoy avg	5.2	-0.3	7.5	2.7	1.0	2.5	0.0	0.1	1.6
Real investment growth % yoy	16.4	-16.0	33.4	4.0	-7.9	7.9	-6.0	-1.2	3.9
Real consumption growth % yoy	5.1	4.1	6.3	3.6	3.2	2.4	1.1	0.1	1.3
private consumption growth % yoy	5.7	4.4	6.9	4.1	3.2	2.6	0.8	0.5	1.7
Real export growth, % yoy	0.5	-9.1	11.5	4.5	0.5	2.5	2.7	1.8	1.5
Real import growth, % yoy	15.4	-7.6	35.8	9.7	0.2	8.3	-0.1	0.1	2.4
Prices, Money & Credit									
CPI, % yoy eop	5.9	4.3	5.9	6.5	5.8	5.9	6.4	6.9	5.5
Nominal wages, % yoy	10.4	4.8	12.7	8.9	10.7	10.8	11.3	11.8	11.0
Credit extension to private sector, % yoy	30.7	15.1	20.6	18.8	16.4	14.7	11.5	12.6	12.7
Policy Rate (eop)	13.75	8.75	10.75	11.00	7.25	10.00	11.75	11.75	10.00
1 month inter-bank rate, %, eop	13.49	8.61	10.64	10.87	6.59	9.78	11.51	11.75	10.00
Long-term yield, %, eop	12.27	12.25	12.24	10.66	7.96	12.00	12.00	12.50	13.00
BRL/USD, eop	2.31	1.74	1.66	1.86	2.05	2.36	2.66	2.92	3.00
BRL/USD, avg	1.84	2.00	1.76	1.67	1.95	2.16	2.35	2.85	2.97
Balance of Payments, USD bn									
Current account	-28.2	-24.3	-47.3	-52.5	-54.2	-81.1	-87.2	-75.5	-76.8
% of GDP	-1.6	-1.5	-2.2	-2.1	-2.4	-3.7	-4.0	-3.8	-3.7
Trade balance	24.8	25.3	20.1	29.8	19.4	2.6	-3.3	12.7	15.6
Exports	197.9	153.0	201.9	256.0	242.6	242.2	227.0	213.1	222.1
Imports	173.1	127.7	181.8	226.2	223.2	239.6	230.3	200.4	206.5
Service balance	-16.7	-19.2	-30.8	-37.9	-41.0	-47.2	-49.5	-52.7	-55.1
Income balance	-40.6	-33.7	-39.5	-47.3	-35.4	-39.8	-36.4	-39.1	-40.9
FDI, net	45.1	25.9	48.5	66.7	65.3	64.0	61.2	60.0	60.0
International reserves	193.8	238.5	288.6	352.0	373.1	375.8	374.1	374.1	374.1
Total amortisations	22.4	30.1	33.8	37.7	39.7	60.1	57.6	63.6	65.6
Public Finances, % of GDP									
Consolidated government balance	-2.0	-3.3	-2.6	-2.6	-2.5	-3.3	-6.1	-5.3	-4.5
Consolidated gov primary balance	3.9	2.0	2.7	3.1	2.4	1.9	0.0	1.0	2.0
Public debt	55.9	60.9	53.4	54.2	58.8	56.7	62.8	66.7	67.1
of which Domestic	51.2	57.5	50.5	51.5	55.9	53.6	59.4	63.0	63.4
Foreign Assets & Liabilities, USD bn									
External debt	198.3	198.2	256.8	298.2	312.9	322.8	345.5	351.3	357.3
Public	84.2	93.3	103.6	102.1	113.7	119.5	133.3	135.6	137.9
External debt / GDP	11.4	12.2	12.0	12.1	13.9	14.6	16.0	17.6	17.4
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	36.4	31.0	57.3	40.1	37.2	40.0	52.6	44.0	45.0
Short-term debt/International reserves (%)	18.8	13.0	19.9	11.4	10.0	10.6	14.1	11.8	12.0

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	-0.9	-0.2	-0.9	-0.6	0.1	0.3	0.7	1.2	1.5
CPI, % yoy	6.3	6.5	6.4	6.4	6.3	6.8	6.9	6.4	6.2
Policy interest rate, %, eop	11.00	11.00	11.75	12.50	12.50	12.50	11.75	11.00	10.50
Short-term market rate, % eop	10.80	10.82	11.51	12.48	12.50	12.50	11.75	11.01	10.50
Long-term yield, %, eop	12.24	11.50	12.00	12.50	12.50	12.50	12.50	13.00	13.00
BRL/USD, eop	2.21	2.45	2.66	2.78	2.83	2.89	2.92	2.94	2.96

Source: National Sources, Citi Research

CCA

Jorge Pastrana
+1 212 816 5728
jorge.armando.pastranavillegas@citi.com

- **Summary view** — We think that the risks to growth in the Caribbean and Central America are tilted to the upside. As net commodity importers, these countries are benefiting from the downturn in commodity prices.

- **Things to watch** — In Costa Rica, the government is expected to send Congress a bill to transform the sales tax into a value-added tax (VAT). In El Salvador, politics are at full steam ahead of the March 1 congressional and municipal elections.

- **Strategy** — In Costa Rica, the fate of the likely-to-be-announced VAT bill is vital for the credit. In our view, Fitch's recent downgrade to a negative outlook opened the door for further outlook downgrades by other rating agencies. In our view, if the government fails to get approval of the tax reform, rating agencies could likely downgrade the country's rating, all else equal.

DomRep takes the lead over Panama

The Governor of the Central Bank of the Dominican Republic (BCRD), Héctor Valdez Albizu, announced that the Dominican economy grew 7.1% in 2014. The Governor made this announcement in a press conference (January 7). The fastest-growing sectors last year were mining (20.9%) and construction (11.4%). Sectors associated with tourism (hotels, bars, and restaurants) posted an increase of 7.9%, while local manufacturing rose 5% and *Zonas Francas* 4.3%. If we assume that there was no revision in previous growth prints, this announcement implies that real GDP increased around 6.7%–7.0% YoY during 4Q14. This growth rate is higher than that of 3Q14 (6.3%).

Panama continues to grow fast, but it is unlikely it grew as much as the Dominican Republic in 2014. The INEC reported that real GDP increased 6.2% YoY in 3Q14 — roughly unchanged from the growth rate of 2Q14 (6.3%). Construction grew 16.9% YoY in 3Q14, commerce (retail and wholesale), 5.4%; and transportation, 4.5%. These results translate into a growth rate of 6.1% YoY during January–September 2014 — thereby suggesting that growth in Panama is unlikely to reach the growth rate posted by the Dominican Republic in 2014.

Growth remained relatively stable in both Costa Rica and El Salvador in 3Q14. Real GDP in Costa Rica increased 3.6% YoY in 3Q14, while it was 2% in El Salvador in the same period. These growth rates are roughly the same as those witnessed during 1Q14 and 2Q14. In the case of Costa Rica, manufacturing output accelerated to 4% in 3Q14 from 1% in 2Q14. Nonetheless, we still think that the full effect of the exit of Intel from the country will be seen in 1H15. In El Salvador, manufacturing continues to grow at a rate slightly above 2%.

We think that the risks to growth in the Caribbean and Central America are tilted to the upside. Since the publication of our year-end publication, commodity prices have continued to decline. As net commodity importers, these countries are benefiting from the downturn in commodity prices. Despite this, we are not calling for acceleration in growth in 2015 (compared to 2014) across these countries, as idiosyncratic factors could work against growth this year. Among these are the exit of Intel in Costa Rica, the less favorable comparison base for gold exports in the Dominican Republic, and the wrapping up of the Canal expansion in Panama. While in El Salvador growth is expected to accelerate, it should remain modest, providing little reason to celebrate.

Costa Rica is expected to propose a VAT tax

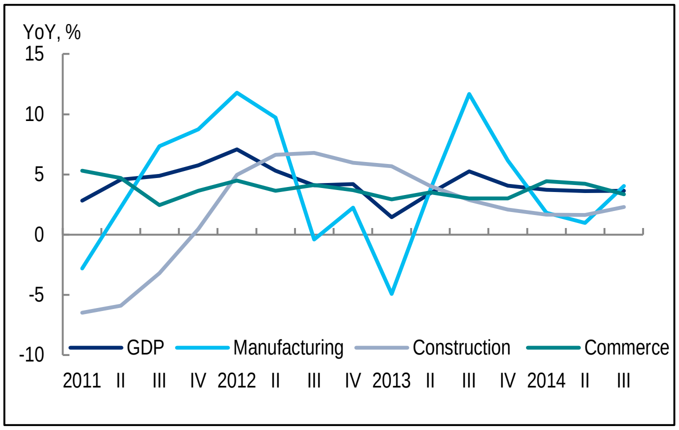
The government is expected to send Congress a bill to transform the sales tax into a value-added tax (VAT). The bill would propose an increase in the VAT rate in 2016 and 2017, but not in 2015. Currently, the sales tax rate is 13% and, according to the media, the proposal would set the new VAT rate at 14% and 15% for 2016 and 2017, respectively. Our understanding is that if the bill were to be approved this year, the VAT would become effective as soon as possible, but the rate would be set at 13% until the end of 2015. The VAT would extend to most services, compared to the current situation in which almost all services do not have a “sales tax”. Some services would likely remain exempted or would have a low tax rate.

By our estimation, tax collection could increase by almost 1.5% of GDP by the end of the reform. We estimate that an increase to 14% in the VAT rate on goods would yield an additional 0.37% of GDP in new tax collection for 2016. Additional tax collection should increase by the same magnitude in 2014, yielding a total increase of 0.74% of GDP. In the case of services, we prefer to stick to the government’s previous estimates. According to its figures, if services were to be taxed at a 13% rate, tax collection would increase by 0.62% of GDP. In turn, we estimate that if the tax rate on services were to be 14%, new tax collection would be 0.67% of GDP. A tax rate of 15% would yield an additional tax collection of 0.72% of GDP. Our estimations do not include effects from efficiency gains and price elasticity, and they treat the sales tax and VAT as the same.

Panama takes seriously the Nicaragua Canal

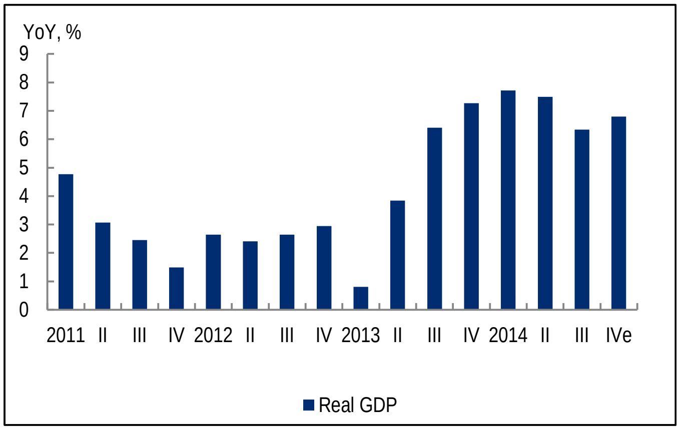
Panamanian authorities have opted to be serious about the Nicaragua Canal. We have been surprised by how seriously the country takes the threat of a canal in Nicaragua. While there is not a consensus about the feasibility and economic viability of the Nicaragua Canal, Panamanian authorities have opted to adopt a serious stance and assume that a Nicaragua Canal will be completed at some point in the future. The threat of a Nicaragua Canal is not a short-term concern, but rather a medium- and long-term issue. Authorities are preparing to make the Panama Canal more competitive than a potential Nicaragua Canal. This edge would come from the construction of additional ports and other facilities to continue transforming Panama into a logistics cluster. Once authorities assess the full benefits from the third set of locks (the expanded Canal), they could begin to evaluate the possibility of a fourth set of locks — namely, an additional expansion to the Canal. Our understanding is that the construction of the third set of locks took into account that at some point the country could build an additional set of locks.

Figure 249. Costa Rica: Real GDP increased 3.6% YoY in



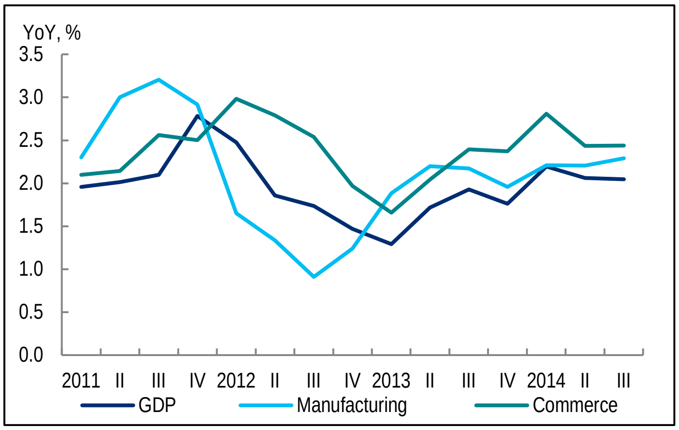
Source: BCCR, Haver and Citi Research

Figure 250. DomRep: Growth remained at high levels in 4Q14



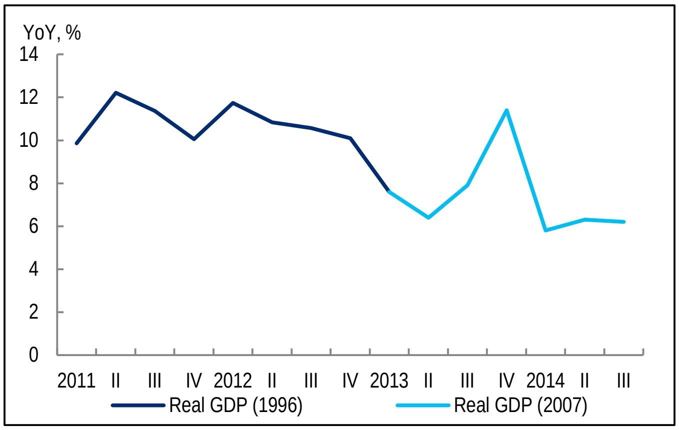
Source: BCRD and Citi Research

Figure 251. El Salvador: Real GDP increased 2% YoY in 3Q14



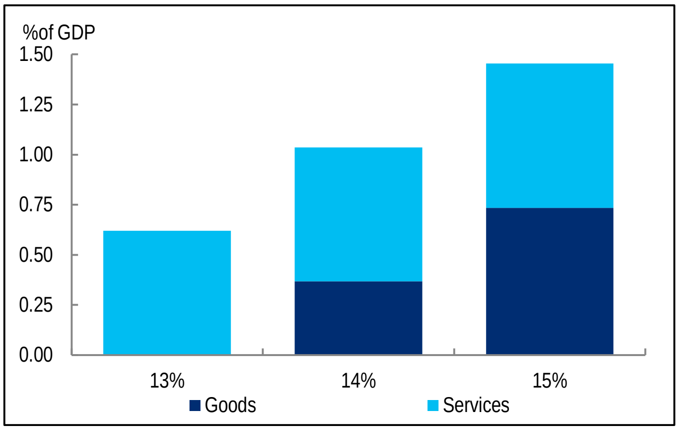
Source: BCRES, Haver and Citi Research

Figure 252. Panama: Growth was 6.2% YoY in 3Q14



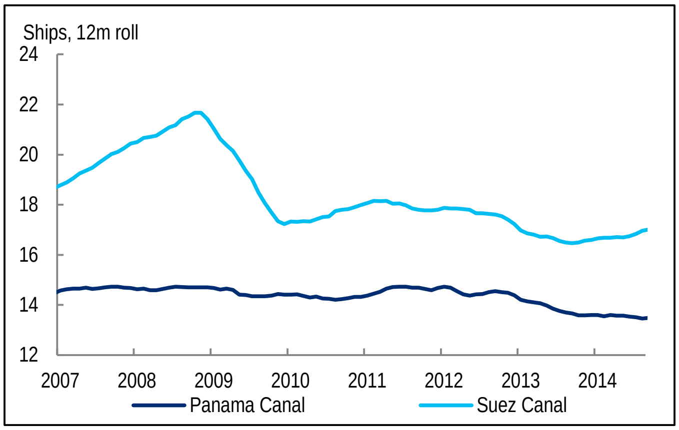
Source: INEC (Contraloria), Haver and Citi Research

Figure 253. Costa Rica: The bill proposal would push up tax revenues



Source: MoF (Hacienda), La Nación and Citi Research

Figure 254. Panama: Traffic in the Canal is not picking up



Source: ACP, SCA, Haver and Citi Research

Figure 255. CCA Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Costa Rica									
Nominal GDP, USD bn	29.8	29.4	36.3	41.2	45.4	49.6	49.8	52.3	54.6
GDP per capita, USD	6,583	6,359	7,955	8,964	9,654	10,557	10,377	10,899	11,140
Real GDP, yoy avg	2.7	-1.0	5.0	4.5	5.1	3.5	3.5	2.7	3.5
CPI, % yoy eop	13.9	4.0	5.8	4.7	4.6	3.7	5.1	4.3	4.8
CRC/US$, avg	525	570	521	502	503	501	537	548	568
CRC/US$, eop	560	555	504	506	513	501	541	555	565
Current account	-2.8	-0.6	-1.3	-2.2	-2.4	-2.5	-2.6	-2.5	-2.6
% of GDP	-9.3	-2.0	-3.5	-5.3	-5.3	-5.1	-5.2	-4.8	-4.8
Consolidated government balance	0.5	-3.9	-5.3	-4.2	-4.5	-6.1	-6.7	-7.3	-8.0

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Dominican Republic									
Nominal GDP, USD bn	48.2	48.2	53.9	58.5	60.5	61.3	64.9	66.4	69.0
GDP per capita, USD	5,053	4,967	5,454	5,816	5,909	5,955	6,304	6,451	6,637
Real GDP, yoy avg	3.1	0.9	8.3	2.9	2.7	4.6	7.1	5.4	4.8
CPI, % yoy eop	4.5	5.8	6.2	7.8	3.9	3.9	1.6	2.4	3.2
Policy Interest Rate, % eop	9.50	4.00	5.00	6.75	5.00	6.25	6.25	6.25	6.25
DOP/US$, avg	34.4	35.9	36.8	38.0	39.2	41.7	43.5	45.2	47.0
DOP/US$, eop	35.4	36.2	37.4	38.7	40.4	42.7	44.3	46.0	47.8
Current account	-4.5	-2.3	-4.0	-4.4	-4.0	-2.5	-2.0	-2.0	-2.2
% of GDP	-9.4	-4.8	-7.4	-7.5	-6.6	-4.0	-3.1	-3.0	-3.2
Consolidated government balance	-4.3	-4.8	-3.7	-3.8	-7.9	-4.1	-4.0	-3.6	-4.5

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
El Salvador									
Nominal GDP, USD bn	21.4	20.7	21.4	23.1	23.8	24.3	25.0	25.5	26.6
GDP per capita, USD	3,485	3,343	3,443	3,696	3,780	3,835	3,909	3,987	4,162
Real GDP, yoy avg	1.3	-3.1	1.4	2.2	1.9	1.7	2.0	2.2	2.5
CPI, % yoy eop	5.5	0.0	2.1	5.1	0.8	0.8	1.3	1.2	2.0
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
SVC/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
SVC/US$, eop	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.5	-0.3	-0.5	-1.1	-1.3	-1.6	-1.2	-1.1	-1.2
% of GDP	-7.1	-1.5	-2.5	-4.8	-5.4	-6.5	-4.8	-4.3	-4.5
Consolidated government balance	-2.8	-5.5	-4.4	-4.0	-3.5	-4.2	-3.4	-3.6	-3.5

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Panama									
Nominal GDP, USD bn	24.9	25.9	28.8	33.3	38.0	42.6	46.5	49.3	53.6
GDP per capita, USD	7,312	7,482	8,170	9,242	10,543	11,668	12,566	12,967	14,107
Real GDP, yoy avg	9.1	4.0	5.9	10.8	10.2	8.4	6.2	5.5	6.5
CPI, % yoy eop	6.8	1.9	4.9	6.3	4.6	3.7	1.0	1.6	2.5
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
PAB/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
PAB/US$, eop	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-2.7	-0.2	-2.8	-5.0	-3.8	-4.8	-4.2	-4.2	-3.6
% of GDP	-10.9	-0.7	-9.6	-15.0	-10.1	-11.3	-9.0	-8.5	-6.7
Consolidated government balance	0.4	-1.0	-1.9	-2.2	-1.5	-3.0	-4.5	-3.5	-3.0

Source: National Sources, Citi Research

Chile

Jorge Pastrana
+1 212 816 5728
jorge.armando.pastranavillegas@citi.com

Fernando Diaz
+1 212 816 9891
fernando.jorge.diaz@citi.com

- **Summary view** — The most recent drop in copper prices is partially offset by lower oil prices, but the net effect on activity and fiscal accounts is still negative. However, we think it would be untimely to reduce our 2015 real GDP growth forecast of 2.5%.
- **Things to watch** — We consider confidence indicators (consumer and business) to be crucial to understanding if economic activity would rebound at the pace the BCCh is expecting.
- **Strategy** — While our 2015 real GDP growth forecast stands at the lower end of the BCCh's growth expectations (2.5%–3.5%), we are not yet calling for rate cuts. For the BCCh to begin thinking in terms of cuts, expected growth should first get closer to 2%, provided that core and non-tradable inflation do not become a headwind against easing.

Copper down, copper down

The price of copper has dropped roughly 11% during the first half of January. If we compare the current price of copper with its average for 2014, it has decreased 18%. Given that roughly half of the country's exports of goods (in nominal terms) are copper (USD38.7bn in 2014), this development should not go overlooked. However, while Chile is a big exporter of Copper, it is also a big oil importer. Last year, 14% of Chile's imports were oil-related products (USD10.4bn), making the country the largest (net) oil importer (relative to its GDP) in South America. Therefore, while the drop in the price of copper should be seen as a negative shock to the country's terms of trade, lower oil prices should partially counterweight this shock, particularly because the price of oil has decreased significantly more than that of copper. In our recent year-end piece (Latin America Macro & Strategy Outlook - Prospects for 2015 and Beyond: Forgettable Years) we concluded that as of December, the country was still experiencing a positive Terms of Trade shock, but that was when we took into account a wider sample in commodities. Moreover, the price of copper has decreased further since then.

All in all, we estimate that the recent changes in copper and oil prices should negatively affect net exports by USD1.7bn, or 0.7% of GDP. These estimates assume that quantities do not vary, which may be an optimistic assumption. Yet, our point is still fair — the decline in the price of oil partially offsets the lower price of copper. In addition, it is worth noting that while the current account balance will likely be affected by the lower price of copper, most of the private mining companies (which account for roughly 2/3 of the total production) are foreign and, therefore, the income balance of the current account should improve, partly offsetting the lower trade balance surplus. In other words, the impact of the lower price of copper in national income (and thus private consumption) should be smaller than its impact on GDP.

FDI should not suffer significantly as a result of weak copper prices. While the BCCh has yet to release the information for 2014 on FDI by sector, the available data (up to 2013) already shows a clear downward trend in the resources going to the mining sector. For instance, FDI to the mining sector went from USD17.9bn in 2011 to USD13bn in 2012 and plummeted to USD2.3bn in 2013. As a result, mining is no longer the sector receiving the highest share of FDI, for it has been surpassed by electricity, gas, and water and communications. The lower FDI going into mining is likely to be the result of lower copper prices combined with the higher costs of production Chile faces.

The consequences of lower copper prices on fiscal accounts should not go overlooked. We estimate that if the price of copper were to remain at the current level throughout the remainder of 2015, the government's revenues would decrease by, roughly speaking, 1% of GDP. Meanwhile, the 2015 budget approved by Congress does not include an improvement in the fiscal accounts but a (roughly) similar deficit in 2015 to the one sustained in 2014 — the effects from the fiscal reform should be offset by a projected 9.8% increase in expenditure. Therefore, the outlook for the fiscal accounts in 2015 does not appear to be very encouraging. The only silver lining may be that the bulk of the projected rise in public spending is related to stronger capital expenditures (mostly in education, health, and transportation and communications), which are usually more flexible than current spending. According to the 2015 budget, public investment should soar 27.5%.

Growth and inflation

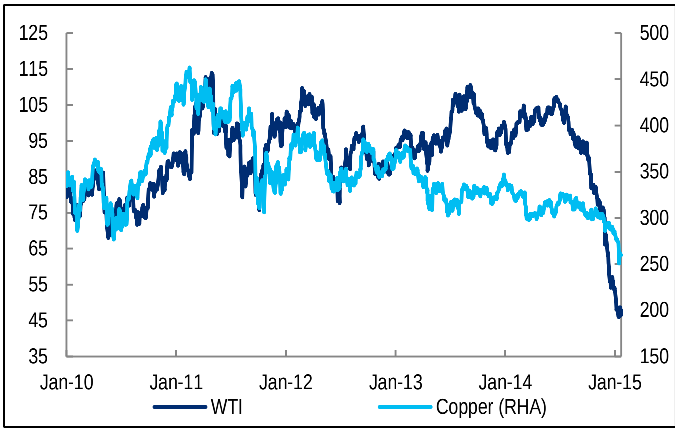
We are maintaining our activity growth forecasts, but with a downward bias. Naturally, the negative shock in terms of trade and its negative consequences for the fiscal accounts, which may push the authorities to curb public spending, are not good news in terms of activity growth. Nonetheless, we are maintaining our 2015 real GDP growth forecast at 2.5%, at least while we gather more information.

As expected, inflation decelerated in December. However, the "mix" of inflation was not that benign. The CPI dropped 0.4% in December and, consequently, annual inflation decelerated to 4.6% (still above the target's upper bound). However, despite the drop in headline prices, core inflation measures posted monthly increases: The IPCX and the more restrictive IPCX1 each rose 0.3% MoM. As a result, the IPCX increased 5.1% YoY, while the IPCX1 rose 4.6% YoY. In addition, non-tradable prices, which tend to be more linked to the evolution of the output gap, rose 0.6% MoM in December, while annual non-tradable inflation accelerated to 5.3%.

Monetary policy

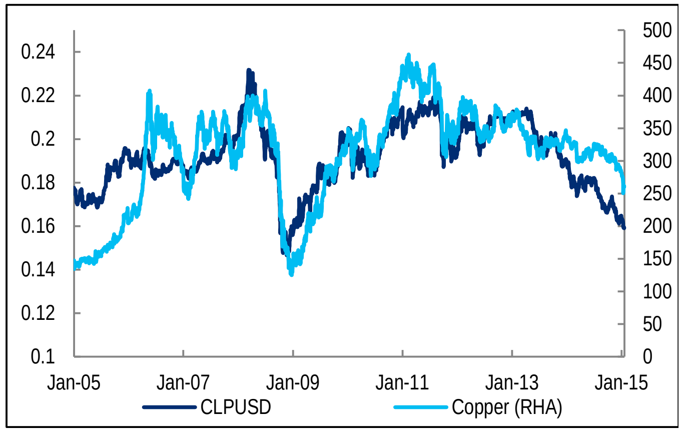
The market is now divided in terms of the future direction of monetary policy. Clearly, the question is if additional cuts will take place or the authorities will keep the policy rate unchanged at 3%. We believe there are two reasons why the BCCh would remain on hold — unless activity surprises on the downside. Firstly, its 2015 real GDP growth forecast of 2.5%–3.5% is consistent with an early recovery in growth. Given the available data, for real GDP to grow at the midpoint of the BCCh's forecast (3%), activity should start growing at an annualized (seasonally adjusted) rate close to potential (4%) as soon as 1Q15. While a 3% increase in GDP is still below potential growth, it would be the result of the low carryover from 2014. While we acknowledge that the BCCh's forecast may be too optimistic (our forecast of 2.5% is in the lower bound of the central banks' expectation), market forecasts are not that far away from the BCCh's estimates. Secondly, the high non-tradable inflation and the still-tight labor market conditions may be seen by the authorities as a sign that the output gap probably did not widen that much during 2014. In our view, the upcoming readings on core and non-tradable inflation will become a more important input in monetary policy meetings.

Figure 256. Oil and copper prices nose-dive



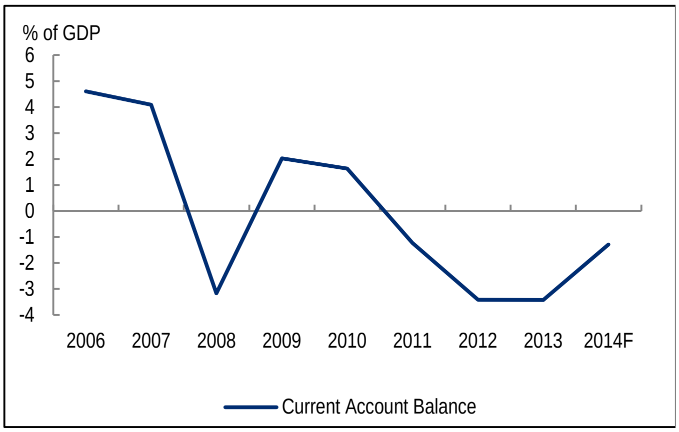
Source: : Bloomberg and Citi Research

Figure 257. The CLP reflects the lower price of copper



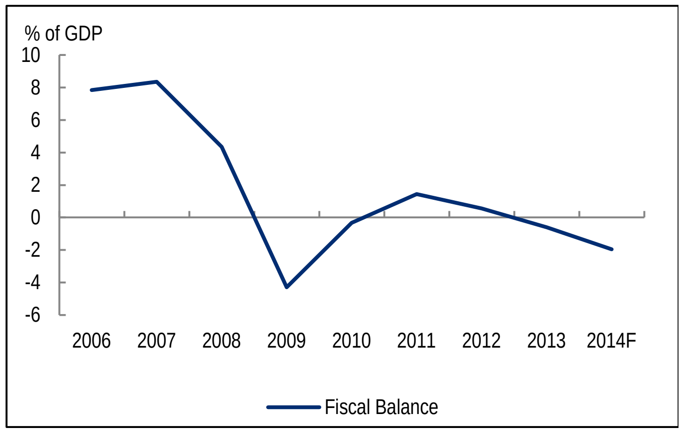
Source: Bloomberg and Citi Research

Figure 258. The current account deficit decreased in 2014...



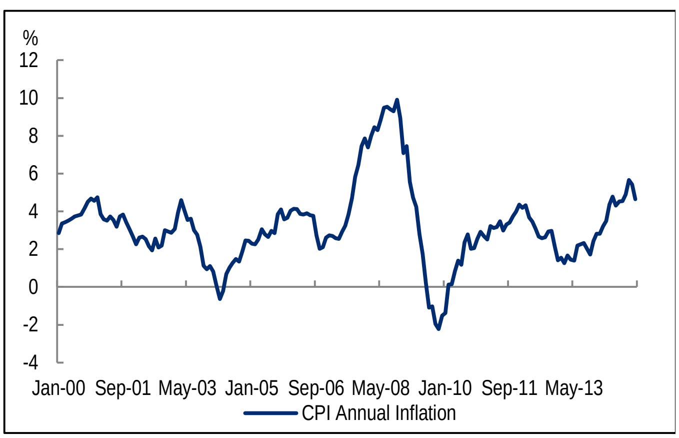
Source: BCCh and Citi Research

Figure 259. ... but the fiscal deficit continued widening



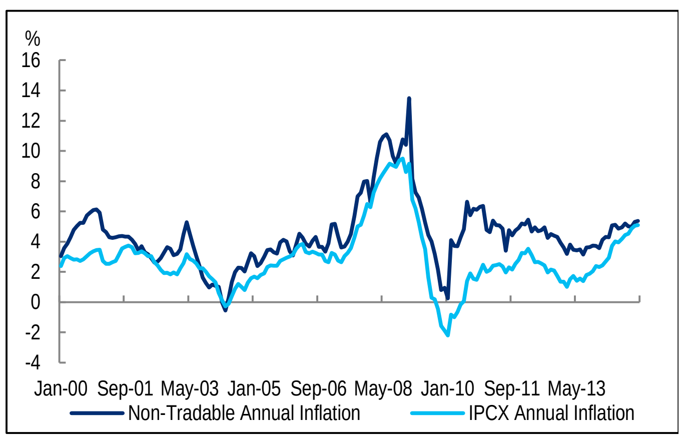
Source: Dipres and Citi Research

Figure 260. While headline inflation has decelerated...



Source: : INE and Citi Research

Figure 261. ... non-tradable and core measures continue on the rise



Source: INE and Citi Research

Figure 262. Chile Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	183	173	218	251	267	277	252	241	258
Nominal GDP, local currency bn	94	96	111	121	130	137	144	152	163
GDP per capita, USD	10,876	10,199	12,861	14,639	15,398	15,863	14,292	13,546	14,329
Population, mn	16.8	17.0	17.0	17.1	17.3	17.5	17.7	17.8	18.0
Unemployment, % of labour force	7.8	10.8	8.2	7.1	6.4	5.9	6.5	7.2	7.6
Economic Activity									
Real GDP, yoy avg	3.3	-1.0	5.8	5.8	5.4	4.1	1.5	2.5	4.0
Real investment growth % yoy	20.8	-23.5	33.4	10.7	10.6	-3.7	-8.1	2.4	5.4
Real consumption growth % yoy	4.4	0.8	9.8	7.8	5.6	5.4	2.5	3.7	4.6
private consumption growth % yoy	5.2	-0.8	10.8	8.9	6.0	5.6	2.3	3.6	4.8
Real export growth, % yoy	-0.7	-4.5	2.3	5.5	1.1	4.3	1.5	2.6	3.9
Real import growth, % yoy	11.2	-16.2	25.9	15.6	5.0	2.2	-6.3	3.3	6.0
Prices, Money & Credit									
CPI, % yoy eop	7.1	-1.5	3.0	4.4	1.5	2.8	4.6	2.6	3.0
Nominal wages, % yoy	8.5	5.8	3.5	5.8	6.3	5.8	6.4	4.9	4.5
Credit extension to private sector, % yoy	18.7	-1.4	7.1	16.9	12.1	9.7	7.2	6.5	6.7
Policy Rate (eop)	8.25	0.50	3.25	5.25	5.00	4.50	3.00	3.00	4.00
1 month inter-bank rate, %, eop	8.24	0.45	3.13	5.23	4.99	4.50	3.00	3.00	4.00
Long-term yield, %, eop	5.93	5.38	5.81	4.92	5.45	5.10	5.00	5.00	5.00
CLP/USD, eop	638	507	468	520	479	525	607	630	630
CLP/USD, avg	524	559	510	484	486	496	571	630	630
Balance of Payments, USD bn									
Current account	-5.8	3.5	3.6	-3.1	-9.1	-9.5	-3.2	-5.7	-7.8
% of GDP	-3.2	2.0	1.6	-1.2	-3.4	-3.4	-1.3	-2.4	-3.0
Trade balance	6.1	15.4	15.7	11.0	2.5	2.1	8.7	6.5	5.4
Exports	64.5	55.5	71.1	81.4	78.0	76.7	76.1	70.4	74.4
Imports	58.4	40.1	55.4	70.4	75.5	74.6	67.4	63.9	69.0
Service balance	-1.2	-2.0	-1.9	-3.1	-2.3	-2.9	-3.5	-4.6	-5.1
Income balance	-13.6	-11.4	-14.7	-13.9	-11.5	-11.1	-10.6	-9.7	-10.3
FDI, net	15.5	12.9	15.7	23.4	28.5	20.3	19.9	14.0	24.0
International reserves	23.2	25.4	27.9	42.0	41.6	41.1	39.0	39.0	39.0
Total amortisations	14.3	16.4	12.3	12.8	22.4	22.6	22.7	23.6	24.9
Public Finances, % of GDP									
Consolidated government balance	4.3	-4.3	-0.3	1.4	0.6	-0.6	-2.0	-2.2	-1.9
Consolidated gov primary balance	4.8	-3.8	0.2	2.0	1.2	0.0	-1.4	-1.6	-1.3
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	2.4	4.9	7.4	8.2	9.9	10.2	5.8	6.7	7.5
Foreign Assets & Liabilities, USD bn									
External debt	63.7	71.9	84.5	98.4	117.6	130.7	129.2	124.4	132.8
Public	3.3	4.0	5.6	7.1	7.9	7.5	7.3	7.2	7.7
External debt / GDP	34.9	41.5	38.7	39.2	44.1	47.1	51.2	51.5	51.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	14.0	15.8	16.2	19.4	23.1	20.5	17.7	16.8	17.9
Short-term debt/International reserves (%)	60.6	62.4	58.3	46.3	55.4	49.9	45.3	43.0	45.9

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	1.9	0.8	0.7	1.2	1.7	3.6	3.4	3.3	3.9
CPI, % yoy	4.3	4.9	4.6	3.5	3.0	2.5	2.6	3.0	3.0
Policy interest rate, %, eop	4.00	3.25	3.00	3.00	3.00	3.00	3.00	3.25	4.00
Short-term market rate, % eop	4.00	3.25	3.00	3.00	3.00	3.00	3.00	3.25	4.00
Long-term yield, %, eop	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
CLP/USD, eop	552	598	607	630	630	630	630	630	630

Source: National Sources, Citi Research

Colombia

Munir Jalil
+57 1 639 4195
munir.jalil@citi.com

- **Summary view** — After the steep fall in international oil prices and COP depreciation being the main the focus of late 2014, their consequences on local factors should take the spotlight this year. Inflationary risks have an upward bias, while the oil price shock should take its toll on activity in the latter half of the year. These two risks should set the tone for monetary policy discussions, though we believe they should cancel each other out. On the fiscal side, while 2015 funding is not a source of big worries, the fall in oil prices should have a more resounding impact next year, and thus the real question is what 2016 holds in store.

- **Things to watch** — Watch for evidence of pass-through to inflation and its effects on inflation expectations.

Inflation and Activity: Diverging Outlook for Policy

After the fall in international oil prices and quick COP depreciation, the focus should now shift to how local variables respond to these swings. As 2014 was coming to a close, the market's attention in Colombia focused mainly on these two particular topics. With expectations across the economic spectrum coming to terms with these facts, market players are now turning their attention on the effect on prices, activity, and in turn, potential policy responses.

The extent of a pass-through effect from the recent COP depreciation to consumer prices will be a hot topic in the year's first few months. The most immediate channel for this effect is the rise in consumer import goods, but second-round effects could still materialize down the road through increased mark-ups from local producers who rely on imported raw materials and intermediate goods and, more worrisome still, through rising inflation expectations. While estimates for the magnitude of this effect are wide-ranging, the central bank has said that it should be low, an assessment which we share. Hence, we expect inflation pressures to pop up in 1H15, if at all. We continue to expect 2015 inflation to stand at 3.3%.

Activity indicators continued to show mixed results at the end of 2014. The latest data released for November show the retail sector was still on an uptrend, with retail sales growing 8.4% on a yearly basis. On the other hand, industrial production continued to underperform, surprising both the market and us with a negative 0.9% YoY print. This situation has been the norm through the latter half of 2014, and we expect GDP growth to have stood at 4.5% for the year as a whole.

Going forward, a possible slowdown associated with low oil prices should begin to materialize in 2H15. With oil accounting for close to 55% of Colombian exports and just below 15% of fiscal revenues, the recent drop in prices means that activity is bound to take a hit, although we believe this should become evident later in the year. We are expecting exports to drop around USD12 billion in 2015 compared to last year's total (data to be released in February). However, the steep COP depreciation should also lead to a USD10 billion fall in imports, which would imply that the current account deficit would widen by USD5 billion based on trade alone, finishing 2015 at USD18.8 billion, or around 5.1% of GDP. Regarding government expenditures, President Juan Manuel Santos has already started to publicly mention that this situation is bound to affect revenues and could imply a reduction in spending. However, we will have to wait until the second half of the year to see if this materializes. Furthermore, with oil representing a considerable portion of FDI flows, we expect these to decrease by around USD2.5 billion (16.6%), which will also take its toll on economic activity. Taking these issues into account, we expect GDP to grow by 3.8% in 2015.

We stand by our call of a stable policy rate at 4.5% in 2015, though the aforementioned pressures will heat up discussions within the CB board. Risks for this call are on the upside in 1H15 as upward inflation pressures might pop up. However, it would be an unlikely rise in inflation expectations, and not actual inflation prints per se, that could potentially trigger an upward shift in rates. In our view, inflation expectations will remain in check. As we move into 2H15, decelerating economic growth would become the main discussion topic within the CB board. In addition, it is likely that talk about the 2016 budget will generate media buzz to pressure policy makers to take action, which puts a downward risk on our call in the year's second half. However, with inflation standing most of the year above the CB's 3.0% midpoint of the target, we expect the majority of board members to be reluctant to lower rates and thus risk generating unwelcomed upward pressures on consumer prices.

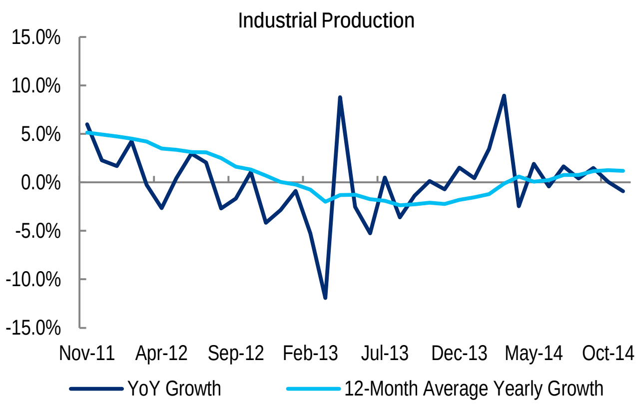
Fiscal policy in the spotlight

Congress approved a tax reform securing further financing for 2015. The tax reform passed in December seeks to find resources for a COP12.5 trillion gap in financing, and to extend the financial transactions and wealth taxes on both companies and individuals for four more years. In addition, it seeks to increase the income tax (CREE) on companies with larger revenues.

More importantly, the MoF introduced an update about the Government's investment plan. After the reform was approved, the MoF updated its plan for sources and uses of funds in 2015, and explained that the recent fall in oil prices implied an additional COP4.5 trillion gap in its finances for 2015, on top of what the tax reform accounted for. This gap would be filled mainly by a COP3.5 trillion decrease in planned debt amortization to COP 23.6 trillion (when compared to the original plan presented in June), which resulted from a debt swap carried out by the MoF in October. In addition, local TES issuances will total COP31.8 trillion, down from COP34.5 trillion before. The additional financing is actually found in this line, since the swap should have led to a greater reduction in planned TES issuances. Other relevant figures that were updated include external debt issuance rising to COP11.7 trillion from COP10 trillion before, though this is mainly due to the recent COP depreciation, and an increase in the expected Central Government deficit to COP23 trillion (2.8% of GDP), from COP19.4 trillion before.

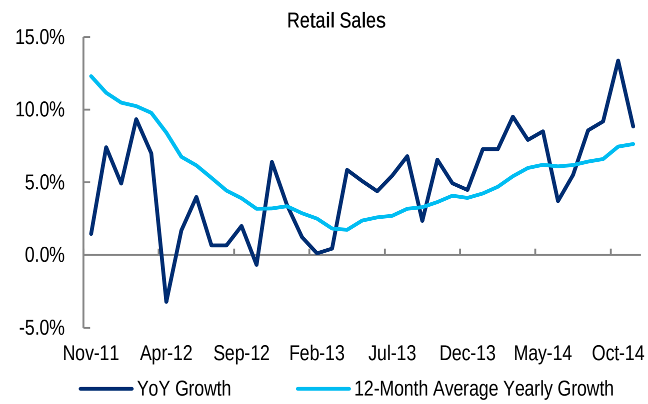
These numbers show that 2015's fiscal story is almost written beforehand, but surprises lurk in the horizon for 2016. While there is no denial that the fall in oil prices will take its toll on fiscal figures, 2015 is a story that has been mostly written beforehand. Most oil-related tax revenues scheduled to be received this year, along with dividend's from the Government's stake in Ecopetrol, are based on results from 2014, so current revenue estimates should not be too far from reality. The big question that remains is how hard the blow will be when the 2016 budget is drafted and the MoF's investment plan is published in June.

Figure 263. IP continues to underperform



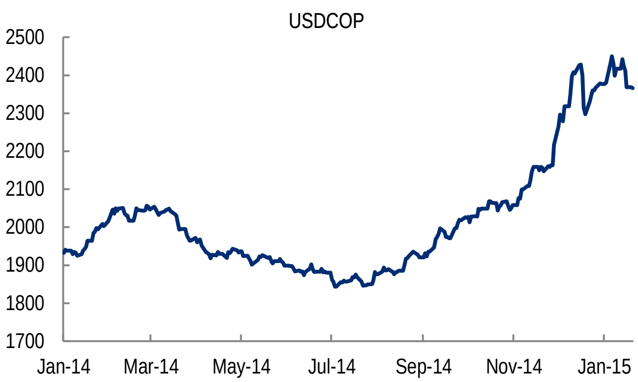
Source: Dane and Citi Research

Figure 264. While RS still shows resilience



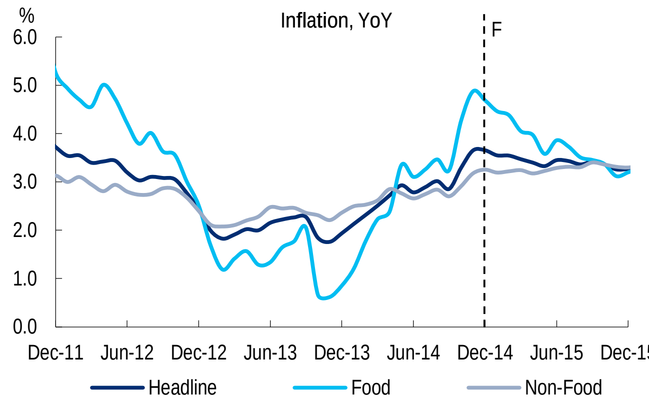
Source: Dane and Citi Research

Figure 265. The USDCOP remains at last year's highs



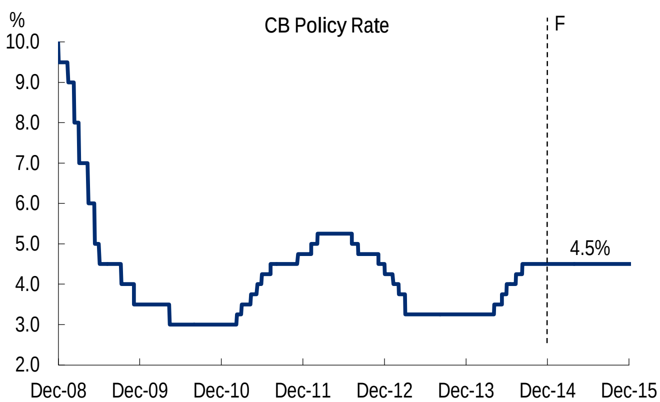
Source: Bloomberg and Citi Research

Figure 266. With FX pass-through being a possible risk for inflation



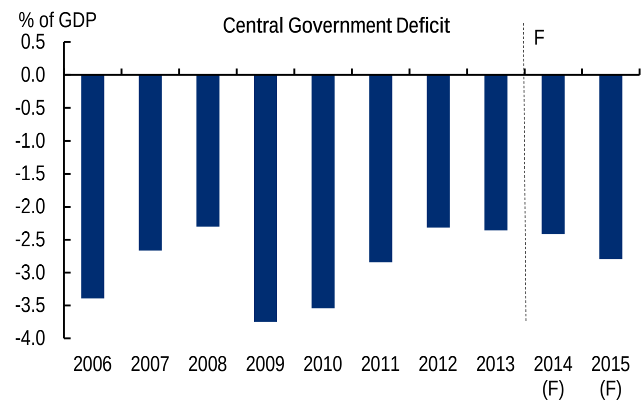
Source: Dane and Citi Research

Figure 267. We expect for Banrep to remain on hold throughout 2015



Source: Banrep and Citi Research

Figure 268. The government could be in need of a new tax reform



Source: Ministry of Finance and Citi Research

Figure 269. Colombia Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	242	231	285	334	370	376	382	369	385
Nominal GDP, local currency bn	480	505	544	616	673	732	762	824	890
GDP per capita, USD	5,447	5,136	6,262	7,269	7,954	7,985	8,030	7,671	7,915
Population, mn	44.5	45.0	45.5	46.0	46.5	47.1	47.6	48.1	48.6
Unemployment, % of labour force	11.5	13.0	12.4	11.5	11.2	10.6	9.8	9.9	9.8
Economic Activity									
Real GDP, yoy avg	3.5	1.7	4.0	6.6	4.0	4.7	4.8	3.8	4.0
Real investment growth % yoy	9.0	-3.9	7.7	18.5	4.6	5.1	12.1	3.9	3.2
Real consumption growth % yoy	3.5	1.6	5.1	5.5	4.7	4.5	5.6	4.8	4.6
private consumption growth % yoy	3.5	0.6	5.0	6.0	4.4	4.2	5.2	4.7	4.5
Real export growth, % yoy	4.5	-2.8	1.3	11.8	6.1	5.4	-3.5	1.0	3.4
Real import growth, % yoy	10.5	-9.1	10.8	21.5	8.9	4.5	8.1	4.0	4.5
Prices, Money & Credit									
CPI, % yoy eop	7.7	2.0	3.2	3.7	2.4	1.9	3.2	3.0	3.0
Nominal wages, % yoy	19.1	3.0	4.1	4.2	4.3	4.4	4.5	4.6	4.7
Credit extension to private sector, % yoy	14.3	6.8	9.8	18.3	10.0	13.7	14.0	15.9	14.0
Policy Rate (eop)	9.50	3.50	3.00	4.75	4.25	3.25	4.50	4.50	4.00
1 month inter-bank rate, %, eop	8.87	3.10	3.00	4.81	4.27	3.30	4.52	4.52	4.02
Long-term yield, %, eop	12.76	8.47	7.70	7.60	5.86	6.75	7.32	7.32	6.40
COP/USD, eop	2,249	2,043	1,920	1,939	1,767	1,930	2,389	2,500	2,500
COP/USD, avg	1,968	2,154	1,898	1,848	1,798	1,869	2,003	2,483	2,500
Balance of Payments, USD bn									
Current account	-6.9	-5.1	-8.9	-9.9	-11.8	-12.7	-17.3	-16.9	-17.5
% of GDP	-2.8	-2.2	-3.1	-2.9	-3.2	-3.4	-4.5	-4.6	-4.6
Trade balance	1.0	2.5	2.3	6.1	4.7	2.8	-1.7	-1.3	-1.7
Exports	38.5	34.0	40.8	58.3	61.4	60.0	57.1	59.3	60.8
Imports	37.6	31.5	38.5	52.2	56.7	57.2	58.9	60.6	62.5
Service balance	-3.1	-2.9	-3.7	-4.7	-5.5	-5.5	-8.7	-11.2	-13.6
Income balance	-10.2	-9.3	-12.0	-16.0	-15.7	-14.7	-11.7	-9.4	-7.5
FDI, net	10.6	7.1	6.7	13.4	15.5	16.8	15.9	15.1	15.5
International reserves	24.0	25.4	28.5	32.3	37.5	43.6	47.2	47.6	50.1
Total amortisations	5.1	5.8	6.5	6.3	12.1	6.3	7.2	8.1	8.1
Public Finances, % of GDP									
Consolidated government balance	-0.1	-2.7	-3.3	-2.9	0.3	-0.9	-1.6	-1.5	-1.5
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	34.0	36.7	37.2	34.6	33.7	34.8	34.9	34.2	34.1
of which Domestic	22.6	24.9	26.3	24.3	23.6	25.5	25.4	24.5	23.6
Foreign Assets & Liabilities, USD bn									
External debt	46.4	53.7	64.1	75.9	78.8	91.9	98.7	102.7	102.7
Public	29.4	37.1	38.9	42.8	46.1	52.1	58.6	62.6	62.6
External debt / GDP	19.1	23.2	22.5	22.7	21.3	24.4	25.8	27.8	26.7
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	5.7	3.9	8.1	10.8	9.8	10.0	10.1	10.3	10.2
Short-term debt/International reserves (%)	23.5	15.6	28.3	33.4	26.2	22.8	21.4	21.6	20.3

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	4.3	3.9	4.5	2.7	3.8	4.3	4.3	4.0	4.0
CPI, % yoy	2.9	2.9	3.2	3.2	2.9	3.0	3.0	3.0	3.1
Policy interest rate, %, eop	4.00	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Short-term market rate, % eop	3.53	4.52	4.52	4.52	4.52	4.52	4.52	4.52	4.52
Long-term yield, %, eop	6.60	7.32	7.32	7.32	7.32	7.32	7.32	7.32	7.32
COP/USD, eop	1,880	2,025	2,389	2,459	2,478	2,497	2,500	2,500	2,500

Source: National Sources, Citi Research

Mexico

Sergio Luna
+52 55 2226 6799
sergio1.luna@banamex.com

- **Summary view —** Economic activity maintained its upward trend in 4Q14, as we had anticipated. Thus, we are holding our 2014 and 2015 GDP growth forecasts unchanged at 2.2% and 3.4%, respectively. Annual headline inflation ended 2014 slightly above Banxico's target range, but it will likely decline in January. We are confirming our expectation for Banxico to remain on hold until late 2015.

- **Things to watch —** While it may be still too early to accurately gauge the effects of the oil price slump on activity, we would expect its impact to be marginal in 2015. Banxico's monetary policy communiqué and quarterly inflation report are scheduled for January 29 and February 18, respectively. The electoral race toward the June 7 mid-term elections should not go overlooked.

- **Strategy —** Based on recent events, we have revised our 0–3 month USDMXN forecast to 14.8 from the previous 14.7, although we still expect MXN gains in 2H15. Moreover, we have also lowered our expected trajectory for the benchmark 10-year M-Bono rate — we now expect 6.4% for year-end, down from 6.7% before.

Activity ended 2014 with good momentum

Domestic demand showed some signs of acceleration, as we expected. Activity grew by 2.5% YoY in October 2014, following an expansion of 3.0% YoY in September. Nevertheless, recent data point to a faster pace in coming months. Manufacturing production and construction activity — the two main industrial sectors — reported solid monthly increases in November, with annual growth rates of 3.6% and 5.3%, respectively. Manufacturing is responding to a better performance in the U.S. manufacturing sector, and we estimate an even higher rate in December, mirroring the strong growth reported by auto-industry output, which grew by 27% YoY in unit terms during that month — this industry was crucial for activity growth during 2014. On the demand side, private consumption and gross fixed investment strengthened further in October, growing strongly in monthly terms and pointing to an improvement in domestic demand during 4Q14, as we expected. Therefore, we reiterate our 2014 GDP growth forecast of 2.2%.

We are maintaining our 2015 GDP growth forecast at 3.4%. New elements of uncertainty have emerged for the 2015 global outlook, the oil price slump being the most important for Mexico. Despite Mexico's being a net exporter of oil, we only expect a modest negative impact in 2015. The fiscal effects will be limited due to the government's hedging strategy to guarantee incomes. Also relevant is the arbitrage between international and local gasoline prices and an indirect economic hedge arising from better US growth prospects and higher USDMXN levels — inversely related to oil prices. Moreover, we estimate that Mexico's Oil Stabilization Fund may cover forgone revenues. On the economic front, we expect the improved US growth outlook to have spillover effects on Mexico via higher manufacturing exports, offsetting the lower investment expected from Round One and the weaker business confidence.

We confirm our call for Banxico to remain on hold until late 2015

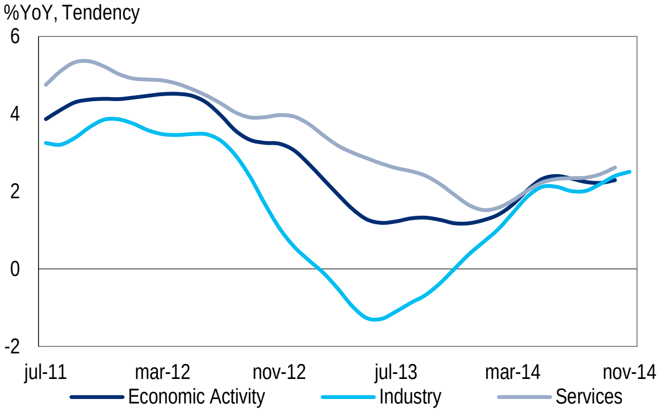
Inflation ended 2014 slightly above Banxico's target range, but it should decline in January. Annual headline inflation closed 2014 at 4.08%, which implied a decline from the 4.17% registered in November. This print reflects lower pressures from non-core items (6.7% YoY in December) and well-behaved core components (3.2%). This said, we expect a sharp decline in January's annual inflation to 3.6%, mostly explained by the high annual comparison related to fiscal changes that came into effect a year ago. We expect annual inflation to remain below 4% throughout the year and to close 2015 at 3.3. In an environment of lower inflation and a narrowing output gap (albeit still in negative territory), Banxico should have room to hike rates shortly before the Fed — a recent statement by Governor Carstens about the strong probability of observing higher interest rates this year supports our view. We see the USDMXN at 14.50 in three months and by year-end.

The mid-term elections will put the federal government's performance at the center of the debate

The first half of 2015 will be a period of great challenges for the Mexican government. The debate ahead the midterm elections will likely focus on economic performance, security and violence, human rights, fighting poverty, and the Rule of Law and justice, among other issues. The opposition parties will try to persuade voters of the government's poor performance, while the government alliance will defend President Enrique Peña Nieto's achievements during these two years of government.

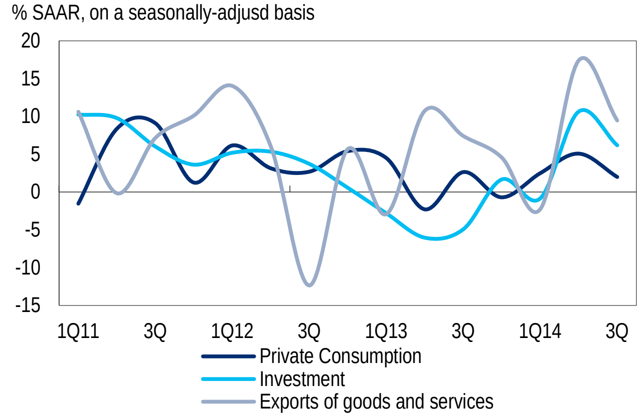
The very-complex mid-term elections will take place on June 7. A huge number of posts are to be renewed: all the seats in the Chamber of Deputies, nine state governments, more than 1,000 municipal presidencies, and 17 local congresses. It is expected that most of the elections for state governor will end in a close race and that the Chamber of Deputies at a national level will remain divided, without one party having an absolute majority of seats. Nevertheless, the government alliance made up of the PRI-PVEM parties will likely remain as the first minority, followed by the parliamentary group of the conservative PAN.

Figure 270. Economic activity up in 4Q14



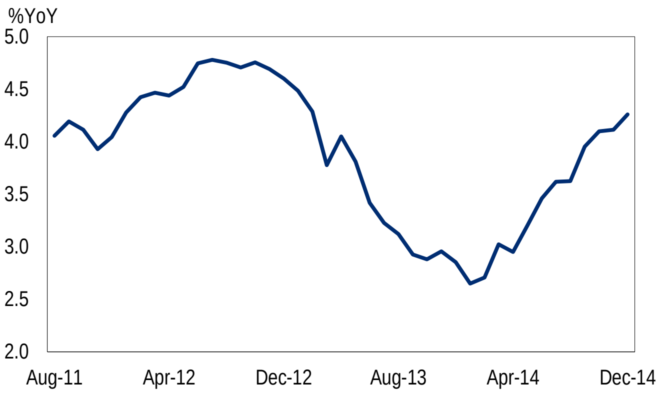
Sources: INEGI and Banamex

Figure 271. External demand still the main driver



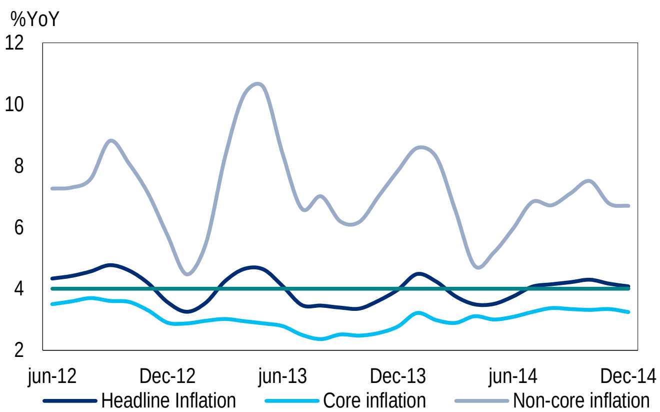
Sources: INEGI and Banamex

Figure 272. Formal sector job creation still gaining momentum



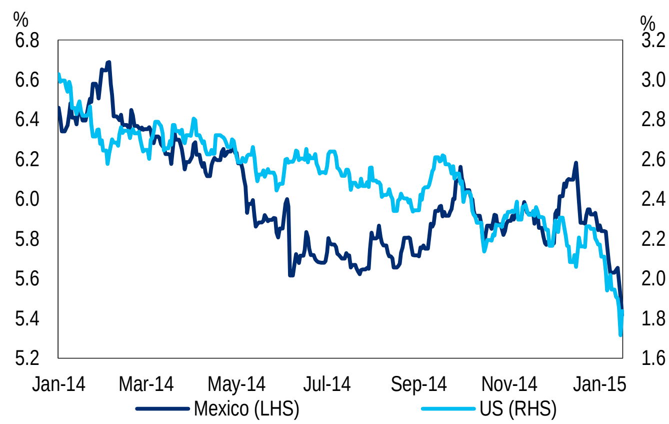
Sources: IMSS and Banamex

Figure 273. Inflation ended 2014 slightly above Banxico's target range



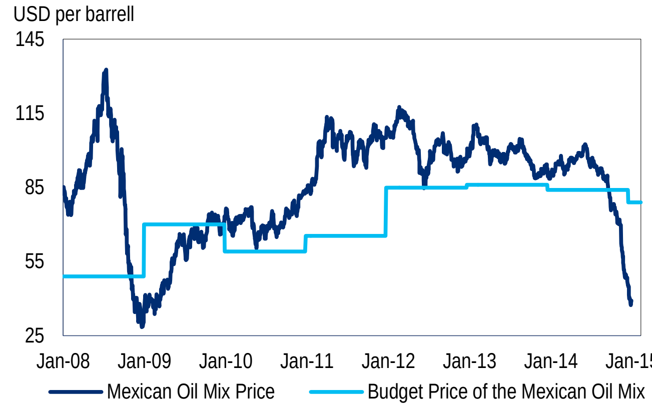
Sources: INEGI and Banamex

Figure 274. 10-yr rates at their minimums since mid-2013



Sources: Bloomberg and Banamex

Figure 275. Oil price slump, a factor of uncertainty



Source: Finance Ministry, Pemex and Banamex

Figure 276. Mexico Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	1,109	897	1,052	1,171	1,187	1,263	1,279	1,270	1,430
Nominal GDP, local currency bn	12,257	12,094	13,282	14,550	15,628	16,121	17,090	18,378	20,020
GDP per capita, USD	9,967	7,952	9,209	10,124	10,143	10,664	10,685	10,499	11,693
Population, mn	111.3	112.9	114.3	115.7	117.1	118.4	119.7	121.0	122.3
Unemployment, % of labour force	4.0	5.5	5.4	5.2	5.0	5.0	4.9	4.6	4.4
Economic Activity									
Real GDP, yoy avg	1.4	-4.7	5.1	4.0	4.0	1.4	2.2	3.4	4.4
Real investment growth % yoy	6.2	-13.3	4.5	5.4	5.5	-2.4	2.3	4.1	5.6
Real consumption growth % yoy	2.1	-5.2	5.1	4.5	4.6	2.3	2.0	3.2	4.0
private consumption growth % yoy	1.9	-6.5	5.7	4.8	4.9	2.5	2.0	3.5	4.3
Real export growth, % yoy	-1.3	-11.8	20.5	8.2	5.9	1.2	6.4	6.8	9.9
Real import growth, % yoy	4.4	-17.6	20.5	8.0	5.5	1.5	4.7	7.3	8.9
Prices, Money & Credit									
CPI, % yoy eop	6.5	3.6	4.4	3.8	3.6	4.0	4.1	3.3	3.7
Nominal wages, % yoy	5.3	4.2	3.0	5.4	4.4	4.6	4.2	8.0	4.3
Credit extension to private sector, % yoy	9.6	0.5	5.7	7.4	6.8	6.3	7.3	7.9	7.4
Policy Rate (eop)	8.25	4.50	4.50	4.50	4.50	3.50	3.00	3.50	4.50
1 month inter-bank rate, %, eop	8.25	4.50	4.50	4.50	4.50	3.50	3.00	3.50	4.50
Long-term yield, %, eop	8.35	7.99	6.95	6.51	5.38	6.45	5.84	6.41	6.96
MXN/USD, eop	13.67	13.06	12.36	13.95	12.87	13.04	14.75	14.13	13.81
MXN/USD, avg	11.16	13.50	12.63	12.44	13.16	12.76	13.31	14.38	13.93
Balance of Payments, USD bn									
Current account	-20.2	-8.4	-4.0	-12.7	-15.2	-26.5	-26.8	-29.7	-34.0
% of GDP	-1.8	-0.9	-0.4	-1.1	-1.3	-2.1	-2.1	-2.3	-2.4
Trade balance	-17.3	-4.7	-3.0	-1.4	0.0	-1.2	-2.2	-10.6	-15.9
Exports	291.3	229.7	298.5	349.4	370.8	380.0	397.4	418.7	457.4
Imports	308.6	234.4	301.5	350.8	370.8	381.2	399.7	429.3	473.3
Service balance	-8.2	-10.0	-9.9	-14.1	-14.0	-11.5	-13.0	-9.6	-8.1
Income balance	-20.2	-15.2	-12.6	-20.1	-23.7	-35.9	-35.1	-33.9	-35.4
FDI, net	28.7	18.0	25.9	23.6	18.1	42.1	21.1	25.5	30.5
International reserves	85.4	90.8	113.6	142.5	163.5	176.5	193.2	201.5	211.9
Total amortisations	46.0	79.0	57.0	47.7	52.9	50.5	43.3	39.9	38.6
Public Finances, % of GDP									
Consolidated government balance	-0.1	-2.3	-2.8	-24.0	-2.6	-2.3	-3.6	-3.5	-3.5
Consolidated gov primary balance	1.8	-0.1	-0.9	-0.6	-0.6	-0.4	-1.5	-1.4	-1.4
Public debt	33.2	36.2	36.2	37.5	37.7	40.4	42.2	43.3	43.3
of which Domestic	21.5	22.8	21.5	21.8	17.3	19.0	19.4	21.4	21.7
Foreign Assets & Liabilities, USD bn									
External debt	200.1	189.8	240.8	278.4	342.1	391.1	420.9	438.8	481.2
Public	129.3	120.9	155.1	183.0	242.6	270.2	294.7	305.2	335.5
External debt / GDP	18.0	21.1	22.9	23.8	28.8	31.0	32.9	34.5	33.7
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	25.1	21.3	21.3	22.8	22.4	21.9	23.3	24.3	25.3
Short-term debt/International reserves (%)	29.4	23.5	18.8	16.0	13.7	12.4	12.0	12.1	11.9

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	1.6	2.2	3.0	3.6	3.4	3.6	3.1	3.6	4.7
CPI, % yoy	3.8	4.2	4.1	3.6	3.8	3.6	3.3	3.4	3.6
Policy interest rate, %, eop	3.00	3.00	3.00	3.00	3.00	3.00	3.50	3.75	4.00
Short-term market rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.50	3.75	4.00
Long-term yield, %, eop	5.68	6.11	5.84	5.87	6.05	6.22	6.41	6.49	6.51
MXN/USD, eop	12.97	13.43	14.75	14.69	14.47	14.24	14.13	14.05	13.97

Source: National Sources, Citi Research

Peru

Munir Jalil
+57 1 639 4195
munir.jalil@citi.com

- **Summary view** — Economic activity is expected to have performed poorly in 2014 and to post some slightly better numbers in 2015. We expect a growth rate of 2.5% in 2014 and 3.8% in 2015, although at this point it is clear there are downside risks to our forecasts. With the government announcing a series of measures to boost investment and consumption and the central bank reducing its policy rate by 25bp in its last meeting in January, the country is following the standard recipe to counteract an adverse economic environment. As we have mentioned before, the balance of payments and the trade balance will continue to be the main variables to assess eventual vulnerabilities during 2015 and 2016.

- **Things to watch** — Inflation and the monthly economic activity will be important to gauge the future evolution of monetary policy. At the same time, the discussion of possible presidential candidates will begin in the second half of next year.

- **Strategy** — Activity has taken center stage in the policy reaction function, and hence further cuts to the policy rate are likely to come if economic activity continues to underperform. The PEN should depreciate further against the USD on the back of a deteriorating current account and reductions in FDI.

Economic activity

Throughout 2014, economic activity surprised on the downside on the back of weak external demand numbers as well as lower-than-expected investment. That is the case of the November economic activity index, which negatively surprised the market by showing the economy growing by a low 0.3% YoY on the back of heavy reductions in fishing (-68.8% YoY) and manufacturing activities (-13.1% YoY). Although we currently forecast economic activity to post 2.5% YoY growth in 2014 and 3.8% this year, the negative surprise of November's activity print creates a downward bias to our forecasts. Having said that, comparing these numbers with the Peruvian economy's over-performance in recent years raises many questions regarding the level of potential output. With regard to this topic, we continue to believe the average growth level throughout this decade should be lower than the one the country experienced in the previous one, but this situation is more a generalized phenomenon in the region than an idiosyncratic situation for Peru.

On the back of weak economic performance, the government has been making announcements aimed at providing favorable conditions for investments and increasing consumption. The measures have included offering tax stability agreements to investors, improvements in the time to get permits and other kinds of red tape, announcements of infrastructure projects, and reductions in taxes aimed at boosting consumption. We believe the government realized that it has to boost domestic sectors in order to withstand the setback originated by weaker external conditions.

For this year, commodity prices continue to be our main concern for GDP growth. We acknowledge that the fact that terms of trade have fallen since 2011 does not bode well for the external sector as a main driver of economic growth. In addition, we have to take into account that some new mining projects that were originally expected to begin their production by 2015 would only open up until 2016. In addition, and as mentioned by our commodity strategists, growing Chinese macro concerns have had an impact on the prices for industrial metals (particularly copper) although a mild recovery on copper prices is expected to take place next year, which could help to improve exports.

Given our view that external factors will likely fail to boost growth in Peru, we believe it is important to look at the health of domestic drivers. Household consumption has been increasing recently, although mildly, and we expect these dynamics to continue throughout 2015 as credit conditions remain favorable despite the recent increases in non-performing loans. This is why we expect GDP growth to be 3.8% this year.

Inflation and monetary policy

Inflation has been outside the target range for most of the year but we expect it will converge to the upper half of the inflation target range this year. The most important reason for these inflation prints last year were higher-than-expected rises in foodstuff prices. We expect inflation to end 2015 at 2.5%, as weaker activity and reductions in gasoline and natural gas prices will likely lend a hand to reduce inflationary pressures. Risks to our call stem from the transmission of FX depreciation to local prices, which could end up imposing further inflationary pressures.

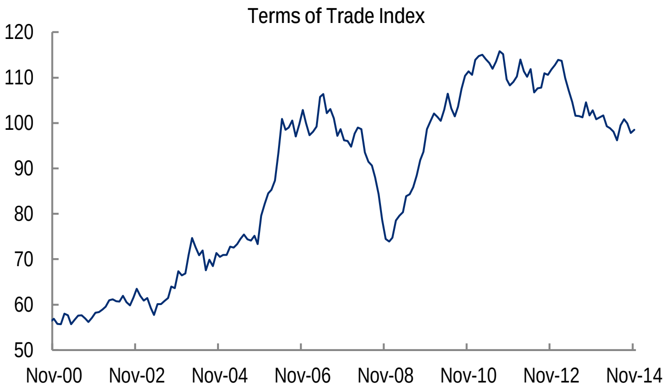
The Central Bank of Peru (BCRP) surprised the market in its January meeting by reducing the policy rate to 3.25%. From the statement, we infer that the CB's balance of risks has shifted toward activity, which implies that inflation has taken a secondary role in leading the future behavior of monetary policy. In our view, further downward economic activity revisions along with inflation dynamics in the months to come, particularly a convergence of headline inflation to the 1%–3% inflation target, will continue to be key when considering further policy actions. We believe the central bank will maintain the 3.25% rate for upcoming months, but if downward revisions to economic activity continue, we cannot rule out that further cuts could materialize at some point between March and April.

We are still waiting for the effects of fiscal and monetary policy. In our view, the reaction of both monetary and fiscal policies amid an environment of weakness in economic activity has been appropriate, with the government announcing increases in spending and reforms to promote investment, and the central bank reducing both its policy rate and its reserve requirements. Although the effects of fiscal policy should arrive earlier, due to the lag of monetary policy, we are cautiously optimistic about the reaction of the Peruvian economy to these measures, leading us to expect GDP growth to improve in 2015.

External sector

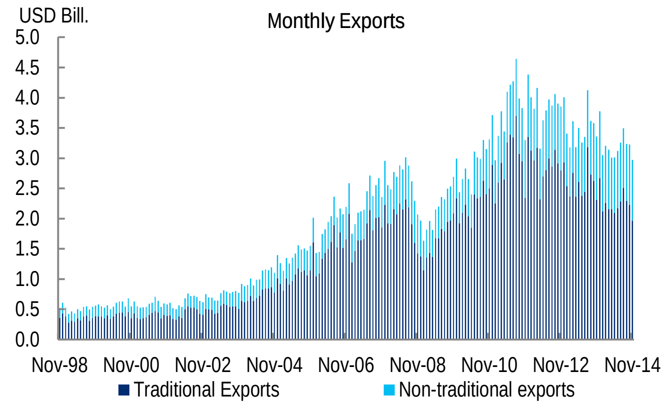
During 2013, the current account deficit stood at 4.8% of GDP, increasing by 1.6 percentage points versus the previous year. This increase in the current account deficit was mostly driven by the deterioration of the trade balance, a situation we anticipate to continue in 2014 and 2015. For 2014, we expect the current account to further deteriorate and post a deficit representing 5.6% of GDP, on the back of stagnant exports and lower commodity prices. For the time being, the current account deficit continues to be financed by foreign direct investment inflows, something that has led to significant increases in international reserves. Nonetheless, we expect a slower reserve accumulation going forward. A deterioration of both the current account and FDI inflows, as well as reductions to the policy rate, should provide arguments to expect more depreciation of the PEN. This is the reason why we now expect the USDPEN to be at 3.2 by year end.

Figure 277. Terms of trade dynamics…



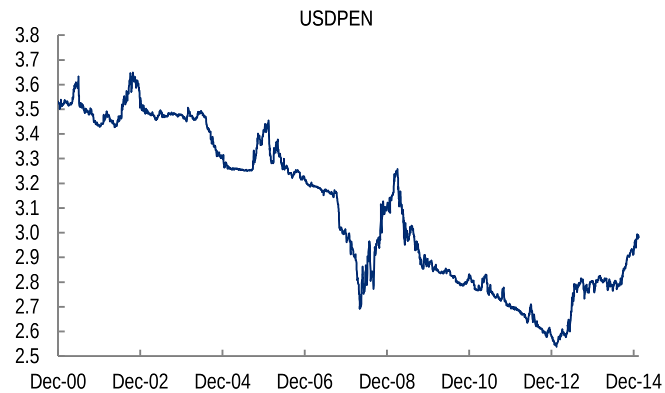
Source: Bloomberg and Citi Research

Figure 278. Could translate into weaker traditional exports…



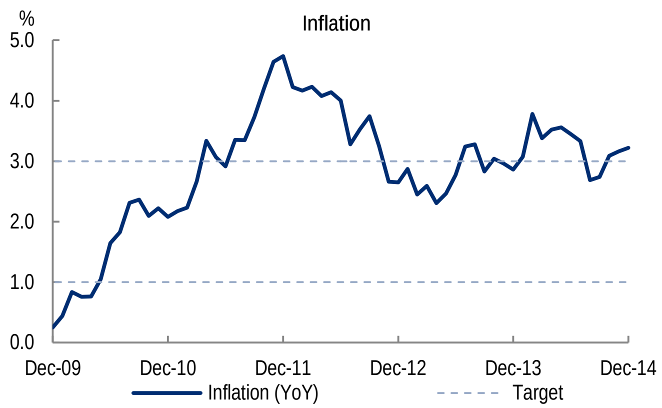
Source: BCRP and Citi Research

Figure 279. And a weaker exchange rate



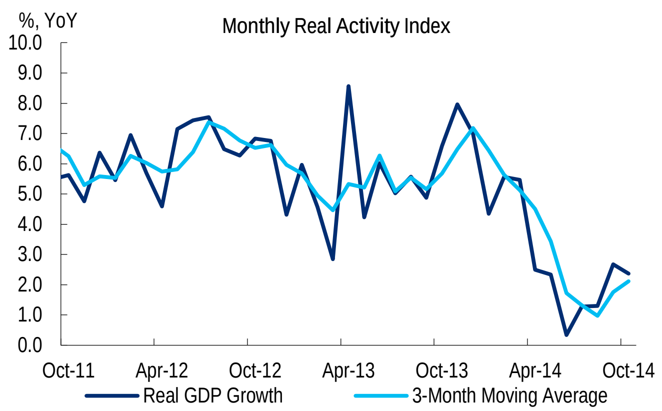
Source: Bloomberg and Citi Research

Figure 280. Inflation dynamics



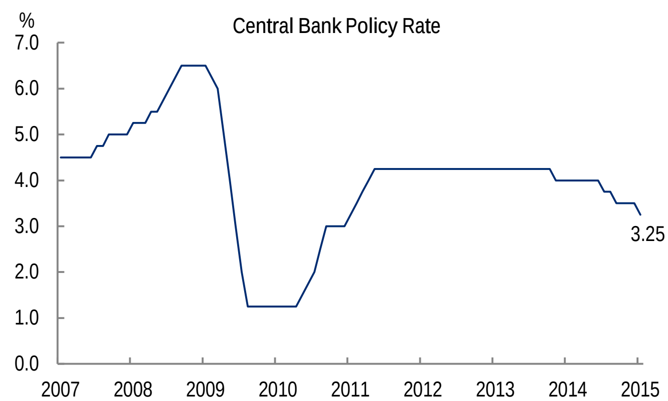
Source: BCRP, Haver and Citi Research

Figure 281. GDP Dynamics



Source: INEI, Haver and Citi Research

Figure 282. The BCRP surpised with a 25bps reduction in rates



Source: BCRP, Haver and Citi Research

Figure 283. Peru Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	127	127	153	176	199	208	204	202	213
Nominal GDP, local currency bn	371	382	435	486	526	563	578	615	660
GDP per capita, USD	4,562	4,482	5,344	6,033	6,712	6,909	6,664	6,509	6,761
Population, mn	27.8	28.3	28.7	29.2	29.7	30.1	30.6	31.0	31.5
Unemployment, % of labour force	8.4	8.4	7.9	7.7	6.8	5.9	6.1	6.0	6.5
Economic Activity									
Real GDP, yoy avg	9.1	1.0	8.5	6.5	6.0	5.8	2.5	3.8	4.6
Real investment growth % yoy	29.4	-22.9	38.8	12.9	12.3	10.5	-2.3	0.9	3.0
Real consumption growth % yoy	8.6	4.1	8.2	5.8	6.4	5.5	4.7	4.4	4.4
private consumption growth % yoy	8.9	2.8	8.7	6.0	6.1	5.3	4.4	4.3	4.3
Real export growth, % yoy	7.1	-0.7	1.3	6.9	3.7	-0.9	-1.9	1.5	3.0
Real import growth, % yoy	24.1	-16.7	26.1	11.6	11.3	3.6	-1.1	0.3	1.0
Prices, Money & Credit									
CPI, % yoy eop	6.7	0.2	2.1	4.7	2.6	2.9	3.3	2.6	2.6
Nominal wages, % yoy	12.8	23.1	-8.8	15.1	5.4	5.0	5.0	5.0	5.1
Credit extension to private sector, % yoy	14.3	10.4	20.1	14.2	13.8	12.4	13.0	13.0	12.0
Policy Rate (eop)	6.50	1.25	3.00	4.25	4.25	4.00	3.50	3.50	3.50
1 month inter-bank rate, %, eop	6.68	1.28	3.20	4.17	4.22	4.58	4.00	4.00	4.00
Long-term yield, %, eop	7.69	6.31	6.34	6.16	4.24	6.16	5.30	5.70	5.70
PEN/USD, eop	3.13	2.89	2.81	2.70	2.55	2.80	2.99	3.05	3.10
PEN/USD, avg	2.92	3.01	2.82	2.75	2.64	2.70	2.84	3.05	3.10
Balance of Payments, USD bn									
Current account	-5.3	-0.6	-3.5	-3.2	-6.3	-9.1	-11.4	-9.6	-12.5
% of GDP	-4.2	-0.5	-2.3	-1.8	-3.2	-4.4	-5.6	-4.8	-5.9
Trade balance	2.6	6.1	7.0	9.2	5.2	0.0	-2.5	-0.8	-3.2
Exports	31.0	27.1	35.8	46.4	46.4	42.2	37.0	38.8	38.8
Imports	28.4	21.0	28.8	37.2	41.1	42.2	39.5	39.6	42.0
Service balance	-2.1	-1.2	-2.4	-2.2	-2.4	-1.8	-1.8	-1.8	-1.9
Income balance	-8.7	-8.4	-11.2	-13.4	-12.4	-10.6	-10.6	-10.4	-11.0
FDI, net	6.9	6.4	8.5	7.7	11.9	9.3	9.9	9.0	9.8
International reserves	31.2	33.1	44.1	48.8	64.0	65.7	65.5	65.2	68.3
Total amortisations	3.3	2.2	4.1	1.4	4.0	4.2	4.0	4.0	4.2
Public Finances, % of GDP									
Consolidated government balance	2.3	-1.6	-0.3	1.8	1.9	0.6	0.5	-2.7	-1.7
Consolidated gov primary balance	3.8	-0.3	0.8	2.9	3.0	1.6	1.5	-1.7	-0.7
Public debt	24.1	27.2	23.5	21.8	19.9	17.4	17.4	18.0	19.7
of which Domestic	9.0	10.9	10.5	10.3	10.3	8.9	8.9	9.3	9.3
Foreign Assets & Liabilities, USD bn									
External debt	34.0	35.5	40.6	44.0	51.9	54.3	51.9	51.6	53.8
Public	19.2	20.6	19.9	20.2	19.0	17.5	17.2	17.9	18.6
External debt / GDP	26.8	28.0	26.4	25.0	26.1	26.1	25.4	25.6	25.3
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	19.5	20.1	22.9	24.2	26.5	24.0	23.7	23.8	24.9
Short-term debt/International reserves (%)	62.5	60.7	52.0	49.6	41.3	36.6	36.2	36.5	36.4

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	1.7	1.7	1.9	3.3	3.9	4.0	4.0	4.6	4.5
CPI, % yoy	3.4	2.9	3.3	2.5	2.4	2.5	2.6	2.5	2.5
Policy interest rate, %, eop	4.00	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Short-term market rate, % eop	4.99	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Long-term yield, %, eop	5.70	5.30	5.30	5.70	5.70	5.70	5.70	5.70	5.70
PEN/USD, eop	2.80	2.89	2.99	3.00	3.00	3.00	3.05	3.05	3.10

Source: National Sources, Citi Research

Venezuela

Munir Jalil
+57 1 639 4195
munir.jalil@citi.com

- **Summary view** — Over the past month, the government released data on economic activity for the first three quarters of 2014, showing that Venezuela has exhibited negative year-over-year growth of 4% in the 1Q14–3Q14 period. At the same time, official inflation has reached 63.6% as of November, which goes in line with our expectation for this rate to end the year at 64%. That being said, the steep reduction in oil prices is creating an even more challenging scenario for the government in 2015. We estimate that with an average price for the Venezuelan basket of oil of USD50, the financial needs in excess of what is entering the country as exports are USD32.1 billion. The latter means the government will face difficulties in financing of imports and servicing debt. As a consequence of this severe cash-flow constraint, goods are scarce, thereby translating into long lines to purchase groceries and basic goods. Like in the past, the longer this situation persists, the higher the probability of public demonstrations asking the government for action. On the FX front, the government announced by mid-December that a new FX system will be put in place, but the details about how this new system should work are still unknown as of the time of this writing. We believe that as part of the FX announcements the government will go back to a two-tier system where the CENCOEX rate currently at USDVEF6.3 will be increased to USDVEF12 and the SICAD I and SICAD II markets will be unified around an exchange rate that should be in the range of USDVEF35–52.

- **Things to watch** — Watch for government announcements on the new FX system.

- **Strategy** — Amid an environment where activity is weak, inflation is high, external liquidity is low, and the government has postponed any announcements aimed at improving the situation, the outlook for this credit is negative.

Economic outlook: weak and vulnerable

The past couple of years have proven to be harsh times for one of LatAm's most volatile markets. Venezuela has experienced a deterioration across a wide array of variables, including activity indicators, price gauges, and external sector figures. Indeed, this had been the case even before recent global events began taking their toll on the North Andean nation.

Economic activity has suffered in 2014, and with the release of GDP numbers up to 3Q14, the weakness is confirmed. One of the main challenges faced when constructing a macroeconomic outlook for Venezuela last year was the lack of timely publications of official figures. Finally, by mid-December the government allowed the release of principal activity, inflation, and external numbers up to 3Q14, confirming a picture of stagflation. According to the official data, the Venezuelan economy is in a recession as it completes three quarters of negative GDP growth in an environment where inflation has accelerated, and it is currently 63.6% as of November. On the investment side, we have seen several bottlenecks affecting production processes for local companies with no new relevant investment announcements, either public or private, being made. As for consumption, vehicle sales (one of the few indicators still published regularly) fell some 80.8% during January–November 2014. As a result, we expect investment and consumption to fall 6.2% and 4.0%, respectively, this year, thus supporting our call for 2014 GDP growth of –4.0%.

We expect growth to continue to lose ground in 2015, posting a 4.4% yearly decline. On the back of an ongoing negative environment, the country suffered an

external shock driven by the steep reduction in oil prices, a situation that does not bode well for activity in 2015.

Official inflation should stand at 64% in 2014, and we believe changes in the price level will continue to accelerate next year to 75%. Having said that, we note these inflation prints are the ones published by the central bank, and “real” inflation is likely to reach a higher number. In addition, inflation is entering into a wage-price spiral. Using data from the Ministry of Finance, we can now say that most of the growth in fiscal spending relates to increases in expenditures associated with government payrolls. This can be interpreted as evidence of increasing wage indexation, a factor that leads to persistent higher inflation.

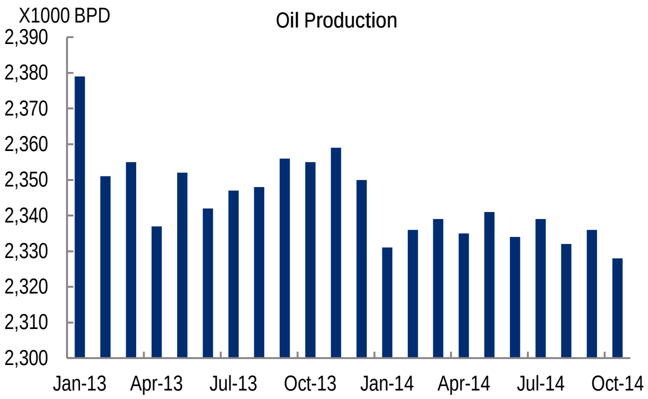
On the external front, the parallel USDVEF rate has reached new highs, associated, in part, with very low availability of foreign currency for importers. During January, the unofficial exchange rate has climbed to levels close to USDVEF180, which contrasts strongly with the USDVEF6.3 rate used through CENCOEX and with the USDVEF12 and USDVEF52 through SICAD I and II, respectively. This trend has consolidated as the government has been restricting imports by not approving foreign currency requests for a number of products. In particular, foodstuffs and medicine have received priority when it comes to receiving government approval of foreign currency for their imports, but approvals for other types of products generally present lengthy delays.

International reserves have been falling. As of January 16, international reserves, as reported by the central bank, stood at USD20.8 billion, which is close to the USD22 billion observed at the close of 2014. Furthermore, special funds held in USD have fallen from USD12.6 billion in December 2013 down to USD4.7 billion in 2014. It is interesting to note that this fall in foreign currency holdings comes despite the import restrictions mentioned above, which should imply a lower rate of decline of international reserves.

The recent FX situation implies an adjustment in the government’s official exchange rates is required. Hence, we believe the government will likely announce an increase in the CENCOEX rate aimed at matching it to the current SICAD I rate of USDVEF12, and for a possible unification of both SICAD rates into a single, higher rate in the range of USDVEF35–52.

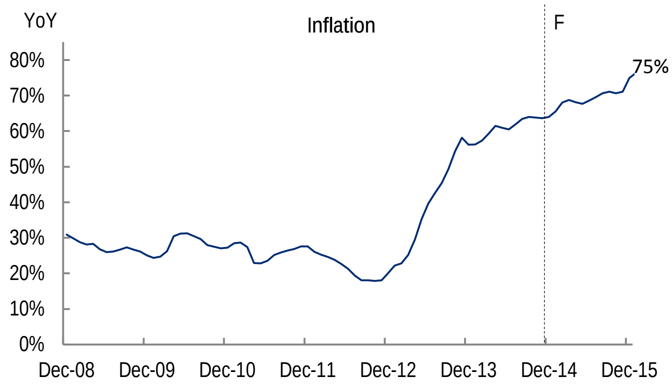
All in all, the current negative shock in oil prices is showing an economy that is vulnerable and not well prepared to withstand a structural correction in commodities. With international reserves slightly above USD20 billion and its cash portion significantly reduced, the country has been in need of looking for external forms of financing, prompting the government to begin the year with a trip to China and several oil-producing countries aimed at securing some loans. Although the announcements so far lack details, we believe the amount of cash obtained is not significant and the government will be forced to continue cutting imports which, in the current state of affairs, should most likely translate into street demonstrations sooner rather than later, given the increasing level of scarcity of all goods in the country.

Figure 284. Oil production has been stable, though below its average



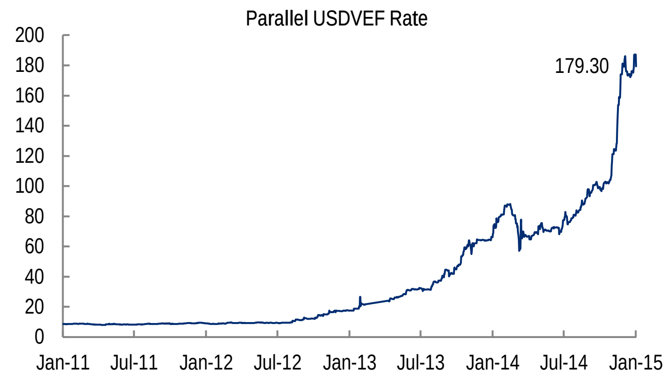
Source: OPEC

Figure 285. Inflation should accelerate despite weak GDP growth



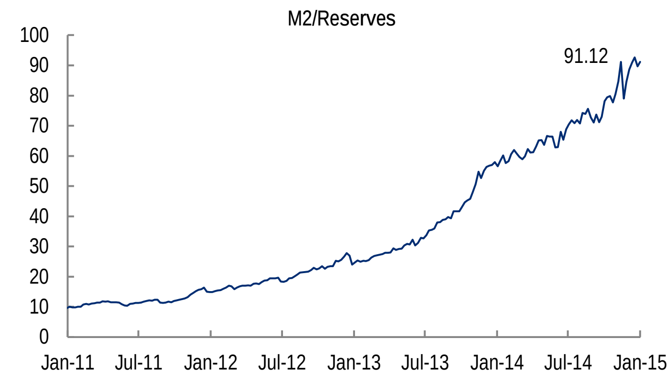
Source: BCV and Citi Research

Figure 286. Pressures on the exchange rate are mounting



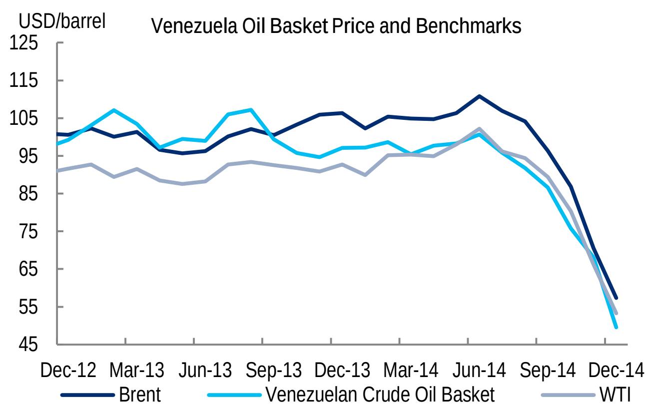
Source: Citi Research

Figure 287 With theoretical FX measures also deteriorating



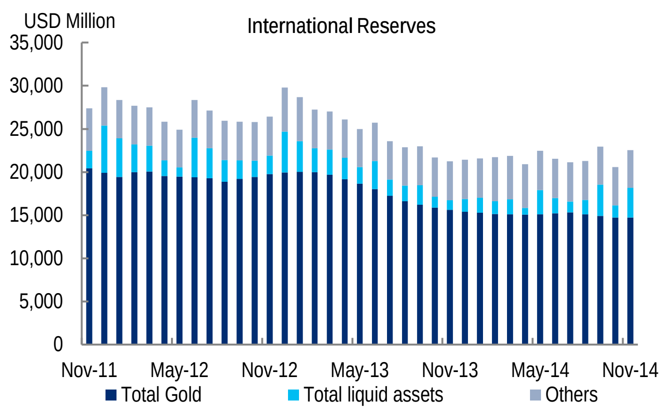
Source: BCV and Citi Research

Figure 288. Venezuelan oil basket prices and WTI prices



Source: BCV and Citi Research

Figure 289. Total liquid resources could continue their downtrend



Source: BCV and Citi Research

Figure 290. Venezuela Economic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Summary Data									
Nominal GDP, USD bn	298	284	257	298	361	372	334	286	292
Nominal GDP, local currency bn	678	707	1,017	1,357	1,642	2,595	4,152	6,778	11,067
GDP per capita, USD	10,683	9,996	8,925	10,188	12,141	12,343	10,926	9,236	9,262
Population, mn	27.9	28.4	28.8	29.3	29.7	30.2	30.6	31.0	31.5
Unemployment, % of labour force	6.1	6.6	6.5	6.5	5.9	5.6	7.0	8.0	8.5
Economic Activity									
Real GDP, yoy avg	5.3	-3.2	-1.5	4.2	5.6	1.3	-4.0	-4.4	1.9
Real investment growth % yoy	2.2	-19.1	1.0	15.2	24.1	-14.0	-6.2	-5.0	1.1
Real consumption growth % yoy	6.0	-2.1	-1.1	4.4	6.9	4.4	-4.0	-3.0	0.4
private consumption growth % yoy	6.3	-2.9	-1.9	4.0	7.0	4.7	-5.0	-4.0	0.2
Real export growth, % yoy	-1.0	-13.7	-12.9	4.7	1.6	-6.2	-1.0	-1.0	4.6
Real import growth, % yoy	1.4	-19.6	-2.9	15.4	24.4	-9.7	-5.0	-1.0	-1.0
Prices, Money & Credit									
CPI, % yoy eop	31.9	26.9	27.4	29.0	19.5	52.7	64.0	75.0	85.0
Nominal wages, % yoy	25.0	23.7	24.5	27.0	30.0	45.0	64.0	72.0	80.0
Credit extension to private sector, % yoy	30.6	18.0	27.6	36.8	55.3	65.8	69.0	74.0	82.0
Policy Rate (eop)	28.10	14.00	12.50	-	-	-	-	-	-
1 month inter-bank rate, %, eop	28.10	11.30	12.30	14.50	14.50	14.50	18.00	18.00	18.00
Long-term yield, %, eop	12.00	14.38	13.02	13.93	9.18	12.88	19.00	19.00	19.00
VEF/USD, eop	2.15	2.15	4.29	4.29	4.29	6.29	6.29	12.00	19.80
VEF/USD, avg	2.15	2.15	4.20	4.29	4.29	5.99	6.29	12.00	21.36
Balance of Payments, USD bn									
Current account	37.4	8.6	12.1	27.3	11.0	12.2	14.9	6.9	12.4
% of GDP	12.5	3.0	4.7	9.1	3.1	3.3	4.4	2.4	4.2
Trade balance	45.7	19.2	27.1	46.4	38.0	36.7	33.4	25.6	31.1
Exports	95.1	57.6	65.7	92.7	97.3	89.2	77.3	65.1	66.7
Imports	49.5	38.4	38.6	46.2	59.3	52.4	43.9	39.5	35.6
Service balance	-8.4	-7.6	-9.2	-10.7	-16.0	-13.8	-7.7	-7.8	-7.8
Income balance	0.7	-2.7	-5.3	-7.9	-10.0	-9.8	-9.8	-9.8	-9.8
FDI, net	-0.9	-4.9	-1.5	5.1	0.8	2.4	0.8	0.8	0.8
International reserves	43.1	35.8	30.3	29.9	29.9	21.5	20.0	18.5	17.0
Total amortisations	7.5	4.3	6.9	11.0	4.1	6.8	4.5	4.6	22.6
Public Finances, % of GDP									
Consolidated government balance	-3.5	-8.7	-10.4	-11.6	-15.0	-11.9	-12.3	-12.9	-12.7
Consolidated gov primary balance	-2.0	-7.2	-8.6	-9.4	-12.3	-9.3	-9.8	-10.3	-10.2
Public debt	21.6	31.3	42.0	44.2	43.4	41.5	44.3	49.8	50.8
of which Domestic	4.5	7.5	8.9	11.4	14.1	12.3	10.5	9.1	7.5
Foreign Assets & Liabilities, USD bn									
External debt	66.4	81.9	97.1	110.7	118.9	123.3	127.5	131.7	135.9
Public	50.9	67.4	85.3	98.0	105.8	108.8	112.8	116.8	120.8
External debt / GDP	22.2	28.9	37.7	37.1	33.0	33.1	38.2	46.0	46.6
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	19.9	17.4	16.8	16.7	21.1	21.8	19.5	16.7	19.0
Short-term debt/International reserves (%)	46.1	48.4	55.3	55.8	70.6	101.3	97.8	90.6	111.9

Quarterly Economic Indicators

	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F	2016 Q2F
GDP, % yoy	-4.2	-4.1	-3.8	-4.6	-4.5	-4.5	-4.2	1.8	1.8
CPI, % yoy	60.5	63.6	64.0	68.8	68.6	71.6	75.0	77.5	80.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	11.80	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00
VEF/USD, eop	6.29	6.29	6.29	12.00	12.00	12.00	12.00	19.80	19.80

Source: Citi Research

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability which includes investment banking revenues.

For important disclosures (including copies of historical disclosures) regarding the companies that are the subject of this Citi Research product ("the Product"), please contact Citi Research, 388 Greenwich Street, 28th Floor, New York, NY, 10013, Attention: Legal/Compliance [E6WYB6412478]. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments and historical disclosures, are contained on the Firm's disclosure website at https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company. Historical disclosures (for up to the past three years) will be provided upon request.

NON-US RESEARCH ANALYST DISCLOSURES
Non-US research analysts who have prepared this report (i.e., all research analysts listed below other than those identified as employed by Citigroup Global Markets Inc.) are not registered/qualified as research analysts with FINRA. Such research analysts may not be associated persons of the member organization and therefore may not be subject to the NYSE Rule 472 and NASD Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account. The legal entities employing the authors of this report are listed below:

Citigroup Global Markets Inc	Guillermo Mondino; Jorge A Pastrana; Fernando Jorge Diaz; Dirk Willer
Citigroup Global Markets Ltd	David Lubin; Farouk Soussa; David Cowan; Luis E Costa, CFA
Citigroup Global Markets Asia	Johanna Chua; Shuang Ding; Minggao Shen
Bank Handlowy w Warszawie	Cezary Chrapek; Piotr Kalisz
ZAO Citibank	Ivan Tchakarov
Citibank Europe plc Czech Republic	Jaromir Sindel
Banco Citibank S.A.	Leonardo Porto; Marcelo Kfoury
Citibank Europe Plc Hungary	Eszter Gargyan
Citibank - Colombia S.A.	Munir Jalil
Acciones y Valores Banamex, S.A. de C.V	Sergio Luna
Citibank Anonim Sirketi	Gultekin Isiklar; Ilker Domac
Citigroup Global Markets Singapore PTE LIMITED	Siddharth Mathur

OTHER DISCLOSURES

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the issuer(s) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. The Firm's research department has received assistance from the subject company(ies) referred to in this Product including, but not limited to, discussions with management of the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and these, plus any other information contained in the Product, are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Notwithstanding other departments within the Firm advising the companies discussed in this Product, information obtained in such role is not used in the preparation of the Product. Although Citi Research does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of Citi Research to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

Important Disclosures for Bell Potter Customers: Bell Potter is making this Product available to its clients pursuant to an agreement with Citigroup Global Markets Australia Pty Limited. Neither Citigroup Global Markets Australia Pty Limited nor any of its affiliates has made any determination as to the suitability of the information provided herein and clients should consult with their Bell Potter financial advisor before making any investment decision.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by. The Product is made available in Australia through Citigroup Global Markets Australia Pty Limited. (ABN 64 003 114 832 and AFSL No. 240992), participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in Australia to Private Banking wholesale clients through Citigroup Pty Limited (ABN 88 004 325 080 and AFSL 238098). Citigroup Pty Limited provides all financial product advice to Australian Private Banking wholesale clients through bankers and relationship managers. If there is any doubt about the suitability of investments held in Citigroup Private Bank accounts, investors should contact the Citigroup Private Bank in Australia. Citigroup companies may compensate affiliates and their representatives for providing products and services to clients. The Product is made available in Brazil by Citigroup Global Markets Brasil - CCTVM SA, which is regulated by CVM - Comissão de Valores Mobiliários, BACEN - Brazilian Central Bank, APIMEC - Associação dos Analistas e Profissionais de Investimento do Mercado de Capitais and ANBID - Associação Nacional dos Bancos de Investimento. Av. Paulista, 1111 - 11º andar - CEP. 01311920 - São Paulo - SP. If the Product is being made available in certain provinces of Canada by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. This product is available in Chile through Banchile Corredores de Bolsa S.A., an indirect subsidiary of Citigroup Inc., which is regulated by the Superintendencia de Valores y Seguros. Agustinas 975, piso 2, Santiago, Chile. The Product is distributed in Germany by Citigroup Global Markets Deutschland AG ("CGMD"), which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). CGMD, Reuterweg 16, 60323 Frankfurt am Main. Research which relates to "securities" (as defined in the Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong)) is issued in Hong Kong by, or on behalf of, Citigroup Global Markets Asia Limited which takes full responsibility for its content. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Research is made available through Citibank, N.A., Hong Kong Branch, for its clients in Citi Private Bank, it is made available by Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citibank N.A. is regulated by the Hong Kong Monetary Authority. Please contact your Private Banker in Citibank N.A., Hong Kong, Branch if you have any queries on or any matters arising from or in connection with this document. The Product is made available in India by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. 1202, 12th Floor, FIFC, G Block, Bandra Kurla Complex, Bandra East, Mumbai - 400051 Corporate Identity Number: U99999MH2000PTC126657 Tel:+9102261759999 Fax:+9102261759961. The Product is made available in Indonesia through PT Citigroup Securities Indonesia. 5/F, Citibank Tower, Bapindo Plaza, Jl. Jend. Sudirman Kav. 54-55, Jakarta 12190. Neither this Product nor any copy hereof may be distributed in Indonesia or to any Indonesian citizens wherever they are domiciled or to Indonesian residents except in compliance with applicable capital market laws and regulations. This Product is not an offer of securities in Indonesia. The securities referred to in this Product have not been registered with the Capital Market and Financial Institutions Supervisory Agency (BAPEPAM-LK) pursuant to relevant capital market laws and regulations, and may not be offered or sold within the territory of the Republic of Indonesia or to Indonesian citizens through a public offering or in circumstances which constitute an offer within the meaning of the Indonesian capital market laws and regulations. The Product is made available in Israel through Citibank NA, regulated by the Bank of Israel and the Israeli Securities Authority. Citibank, N.A, Platinum Building, 21 Ha'arba'ah St, Tel Aviv, Israel. The Product is made available in Italy by Citigroup Global Markets Limited, which is authorised by the PRA and regulated by the FCA and the PRA. Via dei Mercanti, 12, Milan, 20121, Italy. The Product is made available in Japan by Citigroup Global Markets Japan Inc. ("CGMJ"), which is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Shin-Marunouchi Building, 1-5-1 Marunouchi, Chiyoda-ku, Tokyo 100-6520 Japan. If the Product was distributed by SMBC Nikko Securities Inc. it is being so distributed under license. In the event that an error is found in an CGMJ research report, a revised version will be posted on the Firm's Citi Velocity website. If you have questions regarding Citi Velocity, please call (81 3) 6270-3019 for help. The Product is made available in Korea by Citigroup Global Markets Korea Securities Ltd., which is regulated by the Financial Services Commission, the Financial Supervisory Service and the Korea Financial Investment Association (KOFIA). Citibank Building, 39 Da-dong, Jung-gu, Seoul 100-180, Korea. KOFIA makes available registration information of research analysts on its website. Please visit the following website if you wish to find KOFIA registration information on research analysts of Citigroup Global Markets Korea Securities
Ltd. http://dis.kofia.or.kr/websquare/index.jsp?w2xPath=/wq/fundMgr/DISFundMgrAnalystList.xml&divisionId=MDIS03002002000000&serviceId=SDIS03002002000. The Product is made available in Korea by Citibank Korea Inc., which is regulated by the Financial Services Commission and the Financial Supervisory Service. Address is Citibank Building, 39 Da-dong, Jung-gu, Seoul 100-180, Korea. The Product is made available in Malaysia by Citigroup Global Markets Malaysia Sdn Bhd (Company No. 460819-D) ("CGMM") to its clients and CGMM takes responsibility for its contents. CGMM is regulated by the Securities Commission of Malaysia. Please contact CGMM at Level 43 Menara Citibank, 165 Jalan Ampang, 50450 Kuala Lumpur, Malaysia in respect of any matters arising from, or in connection with, the Product. The Product is made available in Mexico by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, Integrante del Grupo Financiero Banamex ("Accival") which is a wholly owned subsidiary of Citigroup Inc. and is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In New Zealand the Product is made available to 'wholesale clients' only as defined by s5C(1) of the Financial Advisers Act 2008 ('FAA') through Citigroup Global Markets Australia Pty Ltd (ABN 64 003 114 832 and AFSL No. 240992), an overseas financial adviser as defined by the FAA, participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in Pakistan by Citibank N.A. Pakistan branch, which is

regulated by the State Bank of Pakistan and Securities Exchange Commission, Pakistan. AWT Plaza, 1.1. Chundrigar Road, P.O. Box 4889, Karachi-74200. The Product is made available in the Philippines through Citicorp Financial Services and Insurance Brokerage Philippines, Inc., which is regulated by the Philippines Securities and Exchange Commission. 20th Floor Citibank Square Bldg. The Product is made available in the Philippines through Citibank NA Philippines branch, Citibank Tower, 8741 Paseo De Roxas, Makati City, Manila. Citibank NA Philippines NA is regulated by The Bangko Sentral ng Pilipinas. The Product is made available in Poland by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Nadzoru Finansowego. Dom Maklerski Banku Handlowego S.A. ul.Senatorska 16, 00-923 Warszawa. The Product is made available in the Russian Federation through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in Singapore through Citigroup Global Markets Singapore Pte. Ltd. ("CGMSPL"), a capital markets services license holder, and regulated by Monetary Authority of Singapore. Please contact CGMSPL at 8 Marina View, 21st Floor Asia Square Tower 1, Singapore 018960, in respect of any matters arising from, or in connection with, the analysis of this document. This report is intended for recipients who are accredited, expert and institutional investors as defined under the Securities and Futures Act (Cap. 289). The Product is made available by The Citigroup Private Bank in Singapore through Citibank, N.A., Singapore Branch, a licensed bank in Singapore that is regulated by Monetary Authority of Singapore. Please contact your Private Banker in Citibank N.A., Singapore Branch if you have any queries on or any matters arising from or in connection with this document. This report is intended for recipients who are accredited, expert and institutional investors as defined under the Securities and Futures Act (Cap. 289). This report is distributed in Singapore by Citibank Singapore Ltd ("CSL") to selected Citigold/Citigold Private Clients. CSL provides no independent research or analysis of the substance or in preparation of this report. Please contact your Citigold//Citigold Private Client Relationship Manager in CSL if you have any queries on or any matters arising from or in connection with this report. This report is intended for recipients who are accredited investors as defined under the Securities and Futures Act (Cap. 289). Citigroup Global Markets (Pty) Ltd. is incorporated in the Republic of South Africa (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in the Republic of China through Citigroup Global Markets Taiwan Securities Company Ltd. ("CGMTS"), 14 and 15F, No. 1, Songzhi Road, Taipei 110, Taiwan and/or through Citibank Securities (Taiwan) Company Limited ("CSTL"), 14 and 15F, No. 1, Songzhi Road, Taipei 110, Taiwan, subject to the respective license scope of each entity and the applicable laws and regulations in the Republic of China. CGMTS and CSTL are both regulated by the Securities and Futures Bureau of the Financial Supervisory Commission of Taiwan, the Republic of China. No portion of the Product may be reproduced or quoted in the Republic of China by the press or any third parties [without the written authorization of CGMTS and CSTL]. If the Product covers securities which are not allowed to be offered or traded in the Republic of China, neither the Product nor any information contained in the Product shall be considered as advertising the securities or making recommendation of the securities in the Republic of China. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security or financial products. Any decision to purchase securities or financial products mentioned in the Product must take into account existing public information on such security or the financial products or any registered prospectus. The Product is made available in Thailand through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 399 Interchange 21 Building, 18th Floor, Sukhumvit Road, Klongtoey Nua, Wattana ,Bangkok 10110, Thailand. The Product is made available in Turkey through Citibank AS which is regulated by Capital Markets Board. Tekfen Tower, Eski Buyukdere Caddesi # 209 Kat 2B, 23294 Levent, Istanbul, Turkey. In the U.A.E, these materials (the "Materials") are communicated by Citigroup Global Markets Limited, DIFC branch ("CGML"), an entity registered in the Dubai International Financial Center ("DIFC") and licensed and regulated by the Dubai Financial Services Authority ("DFSA") to Professional Clients and Market Counterparties only and should not be relied upon or distributed to Retail Clients. A distribution of the different Citi Research ratings distribution, in percentage terms for Investments in each sector covered is made available on request. Financial products and/or services to which the Materials relate will only be made available to Professional Clients and Market Counterparties. The Product is made available in United Kingdom by Citigroup Global Markets Limited, which is authorised by the Prudential Regulation Authority ("PRA") and regulated by the Financial Conduct Authority ("FCA") and the PRA. This material may relate to investments or services of a person outside of the UK or to other matters which are not authorised by the PRA nor regulated by the FCA and the PRA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in United States by Citigroup Global Markets Inc, which is a member of FINRA and registered with the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is authorised by the PRA and regulated by the FCA and the PRA.

Pursuant to Comissão de Valores Mobiliários Rule 483, Citi is required to disclose whether a Citi related company or business has a commercial relationship with the subject company. Considering that Citi operates multiple businesses in more than 100 countries around the world, it is likely that Citi has a commercial relationship with the subject company.

Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to Citi Research's Products can be found at https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures.

Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations.

The Product is not to be construed as providing investment services in any jurisdiction where the provision of such services would not be permitted.

Subject to the nature and contents of the Product, the investments described therein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Certain investments contained in the Product may have tax implications for private customers whereby levels and basis of taxation may be subject to change. If in doubt, investors should seek advice from a tax adviser. The Product does not purport to identify the nature of the specific market or other risks associated with a particular transaction. Advice in the Product is general and should not be construed as personal advice given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs. Prior to acquiring any financial product, it is the

client's responsibility to obtain the relevant offer document for the product and consider it before making a decision as to whether to purchase the product. Citi Research generally disseminates its research to the Firm's global institutional and retail clients via both proprietary (e.g., Citi Velocity and Citi Personal Wealth Management) and non-proprietary electronic distribution platforms. Certain research may be disseminated only via Citi's proprietary distribution platforms; however such research will not contain changes to earnings forecasts, target price, investment or risk rating or investment thesis or be otherwise inconsistent with the author's previously published research. Certain research is made available only to institutional investors to satisfy regulatory requirements. Individual Citi Research analysts may also opt to circulate published research to one or more clients by email; such email distribution is discretionary and is done only after the research has been disseminated.

The level and types of services provided by Citi Research analysts to clients may vary depending on various factors such as the client's individual preferences as to the frequency and manner of receiving communications from analysts, the client's risk profile and investment focus and perspective (e.g. market-wide, sector specific, long term, short-term etc.), the size and scope of the overall client relationship with Citi and legal and regulatory constraints.

Citi Research product may source data from dataCentral. dataCentral is a Citi Research proprietary database, which includes Citi estimates, data from company reports and feeds from Thomson Reuters. The printed and printable version of the research report may not include all the information (e.g., certain financial summary information and comparable company data) that is linked to the online version available on Citi's proprietary electronic distribution platforms.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST