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Emerging Markets
GEMS

Emerging Markets Macro and Strategy Outlook

Is the rally safe?

- Late last year, we identified three forces that would shape the outlook for EM economies and asset prices in 2014. The first was the outlook for capital flows to EM; the second was the outlook for China; and the third was the outlook for EM exports. As things stand, none of these three forces are generating much in the way of bad news for EM. The fall in 10 year US treasury yields is helping to push capital flows to EM, and the volatility in the US treasury market is coinciding with low volatility in 5 year China CDS. Meanwhile, EM exports have recovered, somewhat, from the shock they faced in 2012-13.
- Yet we think there are reasons to doubt that this benign environment for EM can be sustained. This isn't the same as saying the rally is about to end. But we think the factors governing the EM rally are not well-entrenched.
- In the first place, our US colleagues think the winter weakness of the US economy has passed and that the economy is now rebounding sharply, setting up for solid growth in the next two quarters. Citi's Financial Conditions Index for the US is at its loosest for over 15 years, and we suspect that will drive a notable acceleration in activity soon. In short, we seen no reason to change our view that US Treasury yield will be edging up soon: to 2.95% in Q3, and to 3.2% in Q4.
- Second, China. The weakest link in China's macro story is the property sector, mainly as this is the sector which has the biggest capacity to transmit contagion risk throughout the rest of the economy: in 2013, 44% of the loans of the H-share banks were secured by mortgages. This might be worrying enough, but the statistic understates the dominance of property collateral in China, since the shadow banking system relies heavily on this kind of collateral. In order for the EM rally to stay 'safe', concerns about China risk will need to disappear, somehow.
- Finally, exports. Although EM's export 'crisis' is over, the news is not that encouraging. Looking at an 'exports sub-index' of Citi's Economic Surprise Index, it seems that export performance is a particular source of disappointment (partly thanks to underperforming Asian exports). We continue to think that there might be some permanent change in the sensitivity of EM exports to DM growth. Certainly DM industrial production is rising more rapidly than imports, so a very informal 'import substitution index' suggests that DM IP is increasingly 'home-grown'.
- In spite of all this, remarkably, we find inconclusive evidence of EM markets being over-stretched. As a result, we are increasingly weary but, under the circumstances, we are still looking to receive. EM investors would find life easier if the rally were built on stronger foundations.

EM Economics and Strategy

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Is the rally safe?

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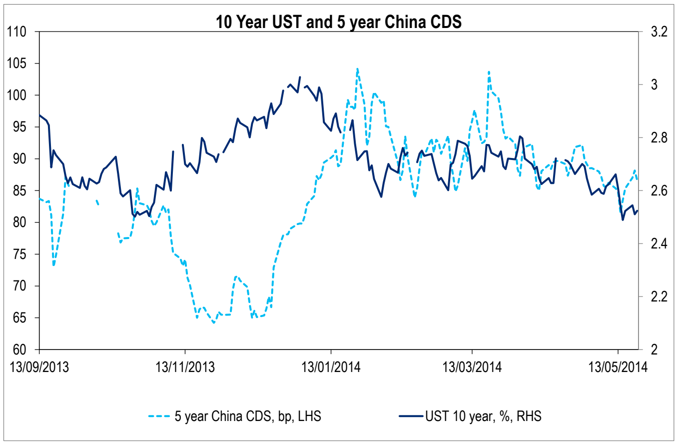
Late last year, we identified three forces that would shape the outlook for EM economies and asset prices in 2014. The first was the outlook for capital flows to EM; in particular, whether the risk of imminent US monetary tightening would suck capital from EM. The second was the outlook for China; would 'China risk' re-emerge as a threat to EM growth and risk-appetite as it did in mid-2013 and again in early 2014? And the third was the outlook for EM exports, and whether a strong recovery of exports would help confidence around EM economies (particularly those whose current account deficits had widened in 2012 and 2013).

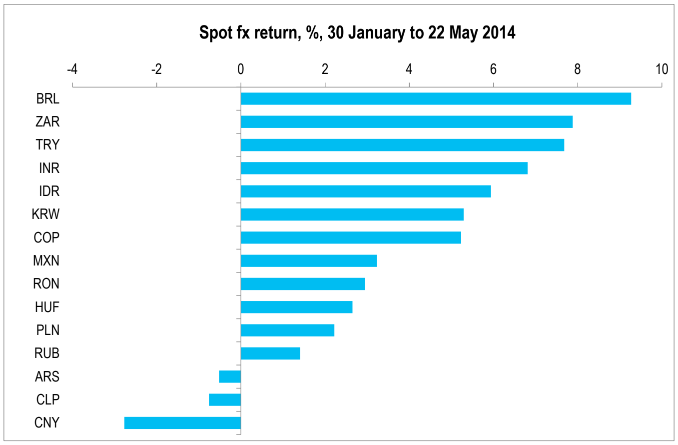
As things stand, none of these three forces are generating much in the way of bad news for EM. While the low volatility of 10 year US treasury yields is now well-flagged, it is interesting to note (Figure 1) that this low volatility has coincided with low volatility in 5 year China CDS. Since it was a sharp rise in China CDS during early 2014 that helped to generate pressure on EM – culminating in rate hikes from Turkey, South Africa and India - the absence of stress from China helps to create a benign environment for EM. The result can be seen in Figure 2, which shows that the 'Fragile 5' currencies are precisely those that have gained the most since late January. This is a *correlated* rally; in a sense it is simply the flipside of the correlated sell off that took place in May-July last year when the direction of US yields and China CDS was opposite to that of the past three months.

Figure 1. It's not just the rally in UST that has created a benign environment for EM, but pressure from China is also absent…



Source: Citi Research

Figure 2. …which has allowed the Fragile 5 – whose *correlated* sell-off dominated 2013 – to enjoy a *correlated* rally since late January



Source: Citi Research

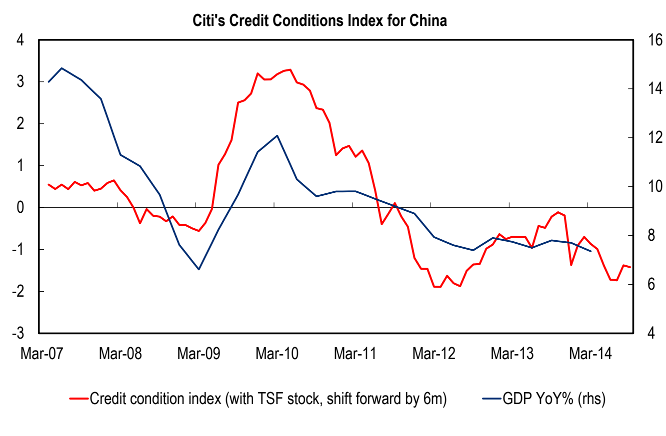
We think there are reasons to doubt that this benign environment can be sustained. This isn't the same as saying the rally is about to end. Our objective here is simply to highlight that the factors governing the EM rally are not well-entrenched. Citi's US macro story argues for higher yields and more uncertainty about US monetary policy; there are reasons to remain concerned about China; and the EM export story is very mixed: current account deficit adjustment is not strongly evident across the board, leaving EM's external financing needs at a relatively elevated level.

Our US forecasts are not especially EM-friendly, unless the US recovery is strongly supportive of EM exports. Essentially our view is that the winter weakness of the US economy has passed and now the economy is rebounding sharply, setting up for solid growth in the next two quarters. The bounce back in growth, especially in private domestic demand, will continue to drive down the unemployment rate toward 6% this year. The economy has key supports from

ample slack and a strong financial tailwind. Inflation is likely to edge up over time, underpinned by domestic demand growth, tightening labor market. In short, we seen no reason to change our view that US Treasury yield will be edging up soon: to 2.95% in Q3, and to 3.2% in Q4. If, as we suspect, the days of a highly benign US treasury market are behind us, this very important source of support for EM asset prices will be withdrawn. Citi's Financial Conditions Index for the US is at its loosest for over 15 years, and we suspect that will drive a notable acceleration in activity soon.

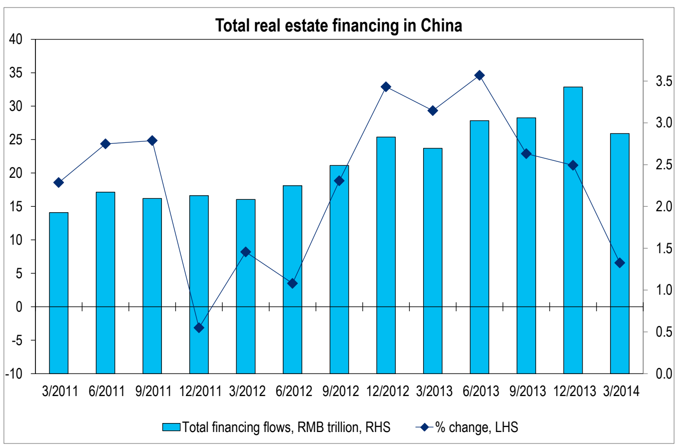
The 'China factor' that's helping to stabilise EM is also fragile, we think. Although the decline in 'China risk' is not as influential in driving the EM rally as the decline in US Treasury yields, it is an important factor. We think there are 2 broad ways of explaining the market's calm assessment of China risk these days. The first can be flippantly described as the 'Beijing put': the idea that weakening Chinese data simply induce Chinese policymakers to intensify their effort to introduce stimulus measures to the economy in order to put a floor under GDP growth at 7% or so. And indeed, the weakness of economic data in Q1 does seem to have unleashed a raft of measures aimed at stabilizing demand. In addition to measures to increase railway investment and social housing construction, the market has also absorbed several other measures: local governments are relaxing home purchase restrictions; the PBOC has asked banks to provide more mortgages at lower rates; tax benefits for SMEs have been introduced; and a set of measures has been introduced to encourage trade, by simplifying export inspections, expediting tax rebates, and increasing export credit insurance. And in addition to the 'Beijing put', it seems that the market has been positively surprised by the fact that China's policymakers seem to be exercising more caution about introducing default risk into the financial system than seemed likely at the start of year.

Figure 3. Credit conditions in China remain weak, in spite of the stimulus efforts that have been put in place…



Source: Citi Research

Figure 4. …and financing to the real estate sector in particular fell sharply in Q1, and a sharp recovery seems unlikely



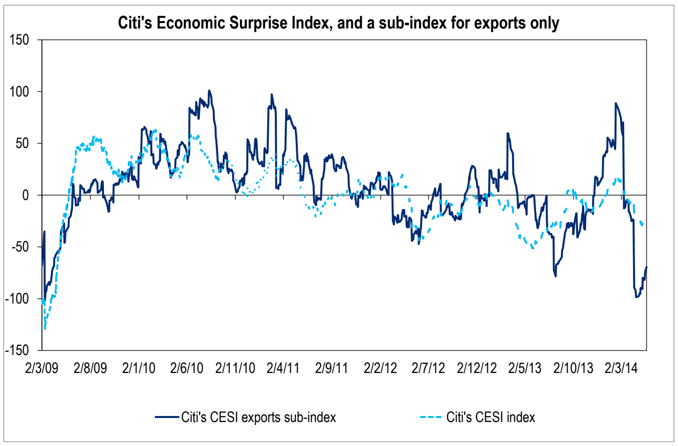
Source: Citi Research

There is a case to be made that 'China risk' is unlikely to disappear for long. It seems increasingly clear that the weakest link in China's macro story is probably the property sector. Property market weakness remains an important topic of concern, not least because of its capacity to transmit contagion throughout the financial sector. In 2013, 44% of the loans of the H-share banks that Citi covers were secured by mortgages.[1] This might be worrying enough, but the statistic

[1] Add reference to Simon Ho note, Chinese Banks, 21 May 2014

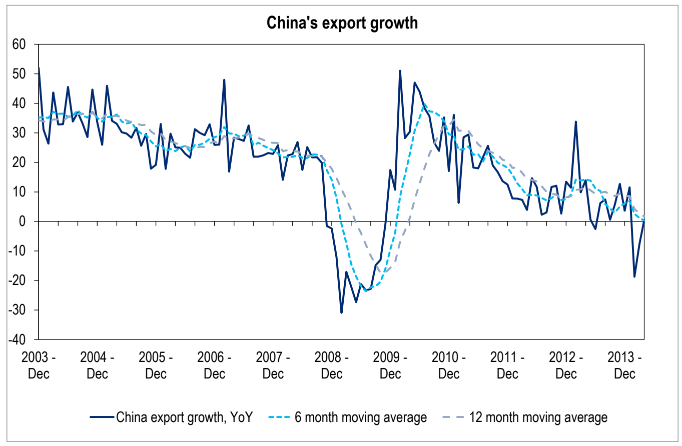
understates the dominance of property collateral in China, since shadow banking system relies heavily on this kind of collateral. Just as a rising property price environment creates a virtuous circle – allowing borrowers to increase leverage on the back of rising asset values – the current environment begins to threaten a vicious circle, in which the falling asset values - or the threat of falling asset values – causes risk appetite to unwind. And the economic effect of lower risk appetite might be magnified by the demand on the part of lenders for additional collateral as property prices fall. The only point we're trying to make here is that EM asset prices have, in the past year, demonstrated a high degree of sensitivity to 'China risk' and that this risk might be growing. As we've described it in recent research, 'the tail is getting fatter'.[2] Some of the largest listed Chinese banks – CRCB, CCB, ABC, HSB, BOC – have property exposure equal to between 20 and 30% of their total loans.

Figure 5. EM exports have been a much bigger negative surprise than EM economic activity overall in recent months…



Source: Citi Research

Figure 6.. …to some extent led by China whose export performance – however distorted by mis-invoicing – looks weak in historical context



Source: Citi Research

Figure 7. ASEAN exports have high correlations with China's exports, but not with final demand in China

	CN exports to US	CN exports to Japan	CN exports to Europe	CN domestic demand ex inventories
Indo exports to CN	0.68	0.87	0.67	0.65
Malay exports to CN	0.7	0.77	0.96	0.69
Phil exports to CN	0.93	0.75	0.76	0.01
Sing NODX to CN	0.89	0.78	0.66	0.08
Thai exports to CN	0.78	0.7	0.83	0.22

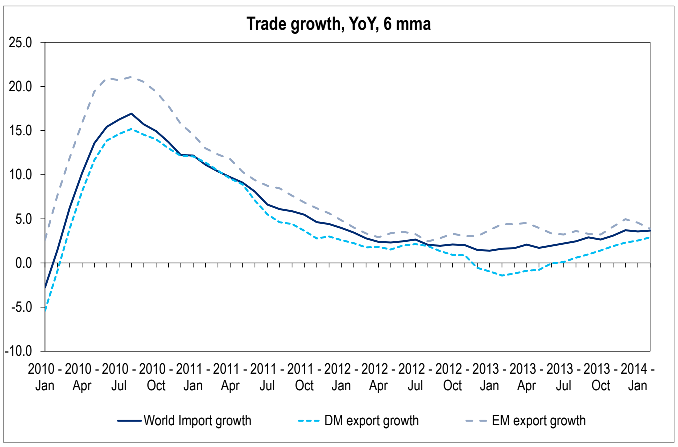
Source: Citi Research

Finally, the EM exports story. We've written in the past that some of the most important economic developments in EM during the past couple of years – the slowdown in growth, the widening of current account deficits – can be explained partly as the result of a negative external shock faced by emerging economies. That shock came in the form of a sharp decline in the growth rate of import volumes in developed (DM) economies: DM import volume growth was negative between August 2012 and September 2013. The reappearance of positive rates of DM import growth since late 2013 has helped to support a recovery of EM exports, but the recovery is relatively small, and certainly small compared to expectations. Figure 5 compares Citi's Economic Surprise Index (CESI) for EM with a sub-index for exports alone. The chart suggests that while economic data overall have been disappointing, exports have been even more so. To some extent this reflects the very disappointing export data from China (Figure 6), though uncertainty about exactly how to adjust Chinese export data for mis-invoicing makes it difficult to define precisely how disappointing is the story behind some Asian exports and in a number of other countries too. Certainly, if there is downward pressure on Chinese exports that will tend to depress ASEAN's performance: Figure 7 shows how much more correlated ASEAN exports are to Chinese exports than they are to Chinese final demand. But the weakness of the export story in Asia is broad-based: even Indian export growth, having accelerated to double-digits between July and October last year, has lost some momentum.

2 Reference Shuang Ding China Macro View 19 May.

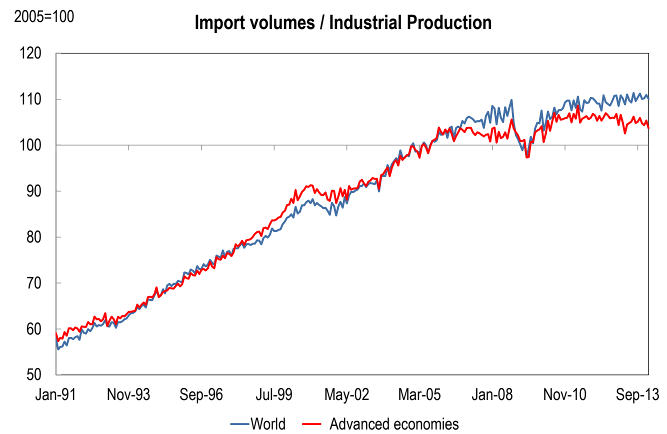
Why are EM exports performing relatively poorly? As we mention above, there is no 'crisis' in the EM export story. Indeed, the recovery of EM export growth has been one of the factors that has helped to stabilize emerging markets asset prices since early 2014, as Figure 9 illustrates. But the differential between EM export growth and DM export growth – which was once a significant source of the EM-DM growth differential – has narrowed considerably. And slightly more worrying, there is still a nagging possibility that the import content of the world economy is on a decline. It certainly seems true that the ratio of world trade growth to world GDP growth has fallen in recent years, and one consequence of this might be to constrain the prospects for further acceleration in EM export growth. Figure 10 shows the relationship between real imports and real industrial output for the world and for advanced economies. While the 1990s and 2000s saw the world becoming considerably more import-intensive, that process seems to have ended with the Lehman crisis, particularly in the advanced economies.

Figure 8. DM export growth has accelerated much more strongly than EM export growth (though DM exports did suffer a bigger shock)…



Source: Citi Research

Figure 9. …but world imports seem to be lagging world production growth, which doesn't bode well for EM export growth

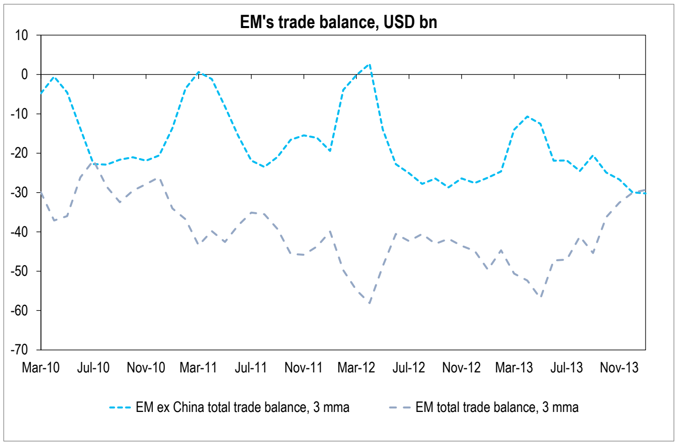


Source: Citi Research

One consequence of subdued export performance is that the closing of EM's trade deficits could be more challenging. And that makes it more difficult for EM to shrink financing gaps. This is evident from Figure 11, which shows the trade balance for EM has only narrowed in recent months thanks to China. Looking simply at the aggregate trade deficit ex-China, there seems to have been a deterioration in the months through to early 2014. In other words, the overall financing needs of EM are still at relatively unadjusted levels, which presumably means that vulnerability to bad news about capital flows remains rather high. And this vulnerability is probably accentuated by the appreciation of real exchange rates that EM has seen in the past few months. By April 2014, the strengthening of the real trade-weighted exchange rates in the Fragile 5 that we've seen in the past few months has eroded just over a third of the competitiveness improvements that these countries gained through currency depreciation in 2013.

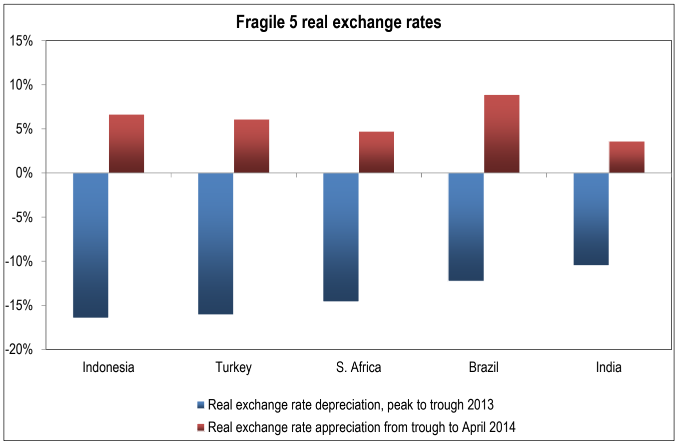
For all these reasons we think the EM rally is built on foundations which are not all that strong. But equally, as we show below, it is difficult to argue that EM valuations are overstretched.

Figure 10. The EM trade deficit (ex China) hasn't seen much reduction in the aggregate...



Source: Citi Research

Figure 11. ...and real exchange rate appreciation since late 2013/early 2014 is helping to undermine the competitiveness gains of last year



Source: Citi Research

Strategy: No decoupling from global macro

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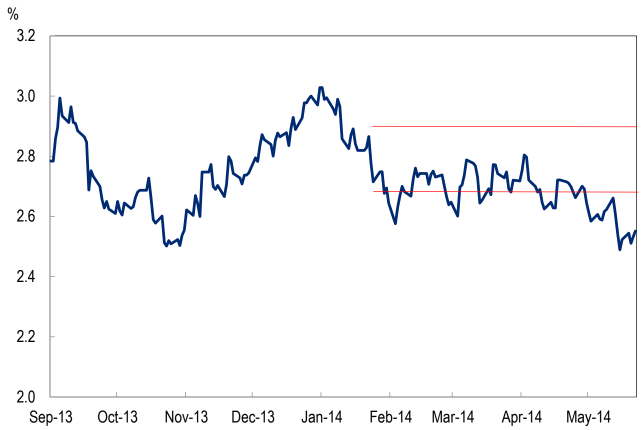
We do not seem to be able to decouple from global macro drivers. Idiosyncratic news matters little, if at all, and we are all expert Fed watchers. The carry trade dominates thanks to extraordinarily well behaved US rates and because the Fed signals that the exit strategy will be quite measured. If the Fed and the ECB do not generate significant shocks, volatility will be low, the market seems to think. And, if volatility is low, carry is king. Never mind other (large) global macro risks. If they do not blow up in 2014, the returns offered by EM dominate –if, that is, prices later in the year don't discount conditions looking shakier. We keep asking ourselves if current conditions will last. When we decompose the drivers behind US Treasury movements, we wonder if the current configuration will be stable.

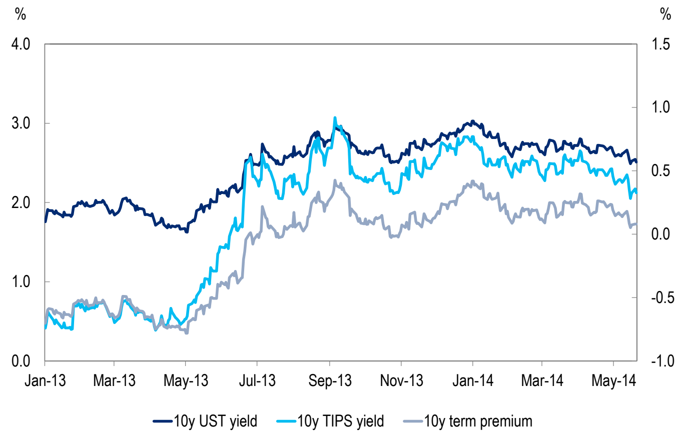
The stability in US Treasury yields has broken, but it has done so by moving lower. Until a few weeks ago, the dominant argument behind carry trades emerged from the stability of UST yields. However, as Figure 13 shows, we now have broken the perceived corridor of stability (2.60-2.80 in 10y yields). Furthermore, there is a clear perception that the Fed has changed its exit strategy towards one that attempts to provide plenty of guidance (signaling) over the future path of policy rates and asset purchases to reduce potential instability in long-term rates.

Figure 12. 10y UST have broken the recent range, but moving down, not up as was the consensual view



Source: Citi Research, Bloomberg

Figure 13. Movement in US yields is mostly explained by real rates (TIPS) which in turn mostly reflect changes in term premia.



Source: Citi Research

The movement in UST yields is dominated by movements in real interest rates, which suggests real forces are behind the move. During the large UST repricing of 2013 (May-Sep) the fundamental force behind the move was the long term real interest rate. Interestingly, the trough to peak change in real rates during that period was equal to 160bp, as Figure 14 shows, 120bp of which seem to be explained by term premia (we approximate term-premium through the Kim-Wright method). The other 40bp can be explained by expected increases in future real interest rates. What is more interesting is that the decline in UST yields ytd seems to be also explained by a fall in expected real rates (42bp), with term premia explaining a similar fraction (34bp).

Table 1. Campbell and Shiller 10y UST variance decomposition: It's all term premia

	09:2013 - 04:2014	05:2012 - 04:2014
Var(inflation)	0.007	0.005
Var(real rate)	0.008	0.009
Var(risk premium)	1.027	1.041
2Cov(inflation, real rate)	-0.015	-0.012
2Cov(inflation, risk premium)	-0.107	0.128
2Cov(real rate, risk premium)	0.079	-0.170

Source: Citi Research

What drives these movements in term premia, is it just pure uncertainty or is it the risk of future (real) interest rates or inflation movements? This is a question difficult to answer. In financial economics, the benchmark framework for studying market expectations is the one proposed by Campbell and Shiller.[3] Campbell and Shiller exploit the familiar present value (PV) formula – price is equal to the present discounted value of expected cash flows – where any bond price movement has to follow either from changes in expectations of cash flows (the numerator) or of discount rates (the denominator). In the case of UST bonds, the only source of variability can emerge from expected inflation rates, expected real interest rates and expected risk premium components, all of which can be extracted from observed prices via a transformation of the present value equation.
Table 1 shows the shares of expected inflation, real rates and expected risk premium components in total variance of 10yr UST returns. The numbers add up to 1 (total variance) to provide a sense of the quantitative importance of each

[3] We follow the methodology in Campbell and Ammer (John Y. Campbell and John Ammer, "What Moves the Stock and Bond Market? A Variance Decomposition for Long-Term Asset Returns," Journal of Finance, March 1993). Formally, the decomposition states

Var(bond return) = Var(changes in expectations of future inflation) + Var(changes in expectations of future short-term real rate) + Var(changes in expectations of risk premium) + Cov(between the three components)

We use the log-linear present discounted value formula developed by Campbell and Shiller to decompose returns and estimate a vector-autoregressive model to approximate market expectations.
Changes in expectations are obtained from the VAR error vector. Var(…) and Cov(…) are then simple variances and co-variances of the shocks to the component series.

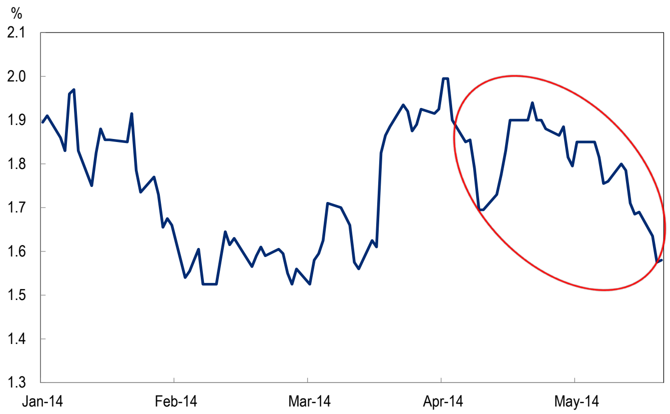
component in explaining the variance of total returns. A number like Var(inflation) shows, for instance, that the variance of the inflation component explained approximately half of a percent of the total variance of 10yr return since May 2013. Much like Figure 4 suggested (following a different methodology to compute the risk premia) the variance of the risk premium component explained nearly all the variance of total 10yr return and future real rate volatility a very small fraction.

The Campbell and Shiller methodology also indicates that the co-movement between risk premia and inflation, or real interest rates, is small. As Table 1 shows, the covariance between risk and inflation is low and positive (higher inflation leads to higher risk premia) though the covariance with real rates is a bit higher and negative. However, the fact that both change signs as we expand the sample, and that the numbers are relatively small, suggest that neither is very significant. The results suggest that not only term premia is the most important driver of changes in UST yields but also that this component has moved mostly in response to other forces, not future inflation or real interest rates.

If term premia has fallen significantly (towards levels close to zero in Figure 14**) and is relatively independent of expected future real rates and inflation, then it is likely explained by the Fed's future bid for duration risk.** Yet, it is unclear whether once the Fed wraps up its asset purchases, the term premia will continue to be so depressed. Rather, it would seem logical to expect risk premia to return towards its pre-QE (and pre-Operation-Twist) average level of close to 50bp. If that movement is relatively sudden, as it was in 2013, then high-beta EM assets could be subject to another meaningful jolt.

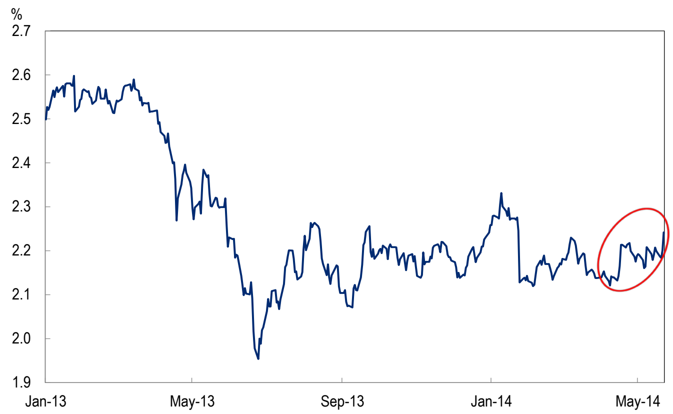
But expected future short rates and inflation did change recently. The Campbell and Shiller variance decomposition requires the use of some econometric assumptions to compute future expected inflation and real interest rates. Similarly, the Kim-Wright method uses strict model assumptions. Therefore, both approaches may underestimate the importance of movements in these key economic variables. A quick glance at changes in some market proxies for these components suggest that since the beginning of the year, and in particular the last few weeks, these components may have changed meaningfully. Figure 15 illustrates that expected future policy rates have declined since April. In approximately a month, markets price that Fed Funds will be 30bp lower towards the end of 2016 than what was thought to be the case after Chairwoman Yellen's press conference in March. The drop in Fed Funds rates could be the reflection of either expectations of a later start to the rate normalization process or a more gradual path, or both. Conversely, in the same period, long-run breakeven inflation (10y) has increased about 12bp (Figure 16). Expected U.S. long term inflation (plus inflation risk premia) remains, however, significantly below the levels observed in early 2013. The message, seems to us, is that while risk premia unquestionably played an important role in the recent UST movement, its importance may be somewhat over-estimated in the models.

Figure 14. Market perceives a more dovish Fed with a less aggressive normalization path: Dec 16 Fed-Funds futures yields…



Source: Citi Research

Figure 15. …and long-term expected inflation (10y breakevens) has increased a little in the last month.

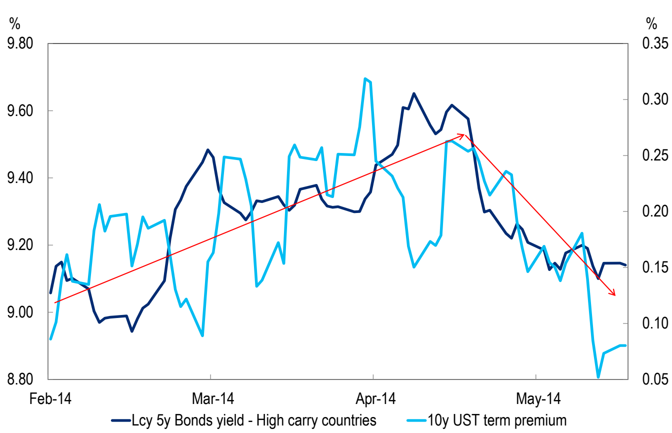


Source: Citi Research

The reduced volatility in UST and the recent decline in risk premia have added impulse to the demand for high yielding EM assets. This is particularly true of the demand for LCY bonds. We think that the decomposition of movements in US Treasuries explains their impact on EM bonds. The hypothesis is simple: local currency bonds depend on local interest rates and on term premia. When exchange rates are allowed to float, they tend to bolster the independence of monetary policy and thus only the effect of US term premia tends to cross borders; US interest rates have, in that case, a more modest effect. Figure 17 shows that an index of the high yielding EM local currency bonds has tended to commove with US term premia. In particular, as US risk premia increased in the period Feb-April 2014, high yielding 5y LCY bonds also sold off. On the other hand, once US term premia started to decline (by about 20bp), local bonds rallied by more than 40bp.

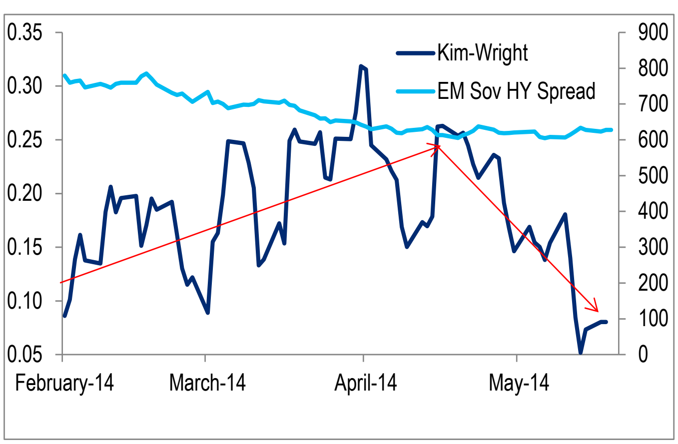
LCY bonds seem to be far more sensitive to US term premia than sovereign credit. Figure 18 shows that high yielding sovereign spreads have tended to tighten throughout the year, despite the clear fluctuations in term premia. In fact, the drive towards higher yielding assets in EM credit in response to falling term premia does not seem to have been reflected in the sovereign high yielders but elsewhere (quasi-sovereigns and corporates).

Figure 16. The movements in term premia seem to have been an important driver of the rally in the LCY high-yielding bonds…



Source: Citi Research

Figure 17. The impact on high-yielding sovereign debt is not clear.



Source: Citi Research

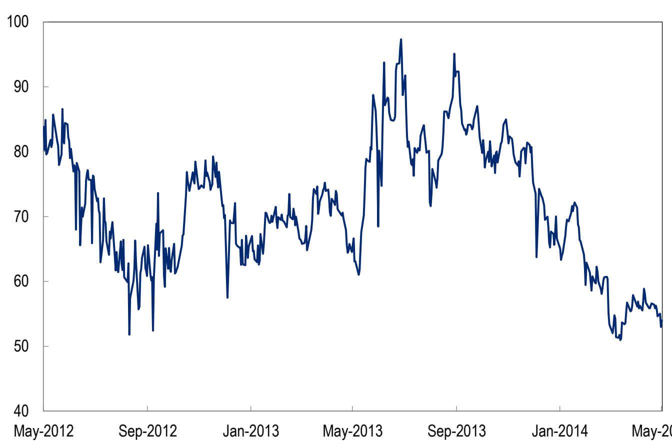
A low US term premia threatens EM assets, if it were to return to normal. One of the usual side-effects of carry periods is that positions build-up and the risk of corrections is significantly augmented. Is there evidence that carry trades have led to excesses? Below, we look at a couple of indicators.

The quest for yield drives investors to move down the asset quality spectrum. With sovereign spreads having returned to levels similar to those observed before last summer's sell-off, quasi-sovereign names have benefited. Many quasi-sovereigns are at their tightest levels in years relative to their sovereign (Russia quasis are an exception to this with most of them still at relatively high levels). Figure 19 below graphs the average historic spread of 10-year bonds for a group of 20 investment grade quasi-sovereign names – excluding Russia's - versus their sovereign counterpart. The average spread has fallen by over 40bp from the peaks last summer and 20bp since January.

The current environment has also spurred issuance from EM corporates. While overall EM issuance in 2014 is only slightly above the pace set in 2013, sovereigns accounted for most of the bonds brought to market during the early part of the year. That has changed in the last several weeks, as corporate issuance has taken off, setting a single month record in April and accounting for essentially all of EM issuance in May.

Figure 18. EM quasisovereigns, ex-Russia, are at recent historic tights relative to their corresponding sovereign

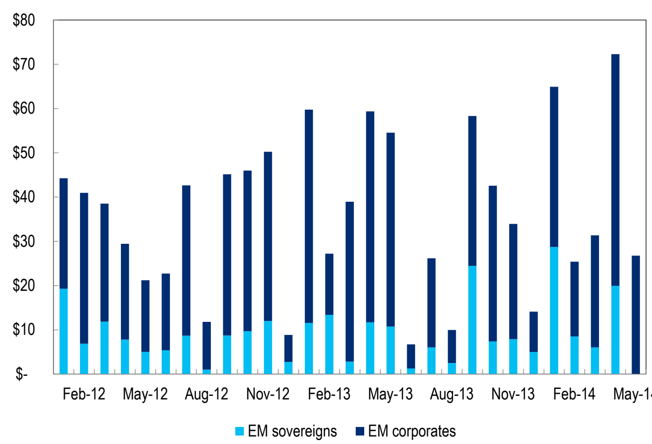
Average spread of 20 EM quasi-sovereign 10-year bonds versus their sovereign



Source: Citi Research

Figure 19. Corporate issuance has taken off the last several weeks after starting the year down

Monthly EM hard currency issuance



Source: Citi Research, Bloomberg

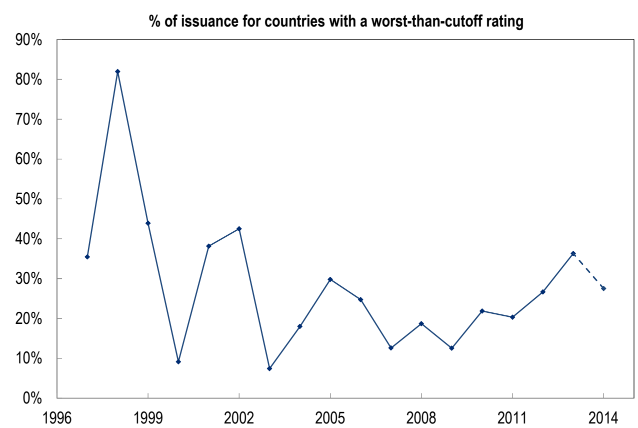
Fed Governor Jeremy Stein, based on research by Greenwood and Hanson,[4] has alerted that periods of carry trades result in increased acceptance of lower quality securities in the U.S. credit market. The cited paper finds that a peak in the portion of new issues that are of low credit quality is a better indicator of an overextended market than the actual level of spreads. Furthermore, they find that when the proportion of high-yield new issuance peaks, a significant market sell-off follows within a couple of years.

[4] R. Greenwood, S. G. Hanson "Issuer Quality and Corporate Bond Return," 2013

We find that, when we adapt the analysis to emerging markets sovereign credit, markets are showing some signs of being overextended. We adapt the Greenwood-Hanson methodology and look at the portion of new issuance from the bottom 30% of the distribution of the existing universe of EM sovereign debt in a given year (measured by the lowest credit ratings). An increase in the relative issuance of the lowest quality sovereigns is suggestive of increased risk tolerance and, potentially, of markets having over-reached.

The proportion of EM issuance that has been below the threshold has steadily risen from 2009 through 2013. If Greenwood and Hanson are correct, EM sovereign credit participants ought to anticipate deteriorating excess returns in the future. Given the rapid market dynamics, and the fact that issuers respond to changing conditions on a higher frequency basis, we tested their hypothesis on a quarterly basis. We run regression of excess returns (in excess of U.S. Treasuries) for both the ESBI overall, as well for both the lower-grade portion of the index. Again, by "lower grade" we mean the portion of the ESBI that is below our 30% rating cutoff. Our independent variables are the percentage of issuance that is lower grade (LGS) as well as the ESBI spread. We used rolling four-quarter low-grade issuance along with the ESBI spread. We find a consistently negative beta with respect to LGS, as we would intuitively expect –though its statistical significance is limited (Figure 22). We show here results for 1-quarter forward returns, but we also performed the analysis for longer periods with better results the longer we go. Using these regressions, the first quarter of 2014 issuance, and current spreads we forecast excess return over treasuries for the 2nd quarter of +0.13% and +1.07% for the remainder of 2014. While positive, these numbers are less than what simple carry would give and imply overall spreads moving wider by 15bp through the end of the year.

Figure 20. The proportion of EM issuance below our cutoff has risen steadily since 2009, though has dropped so far in 2014



Source: Citi Research

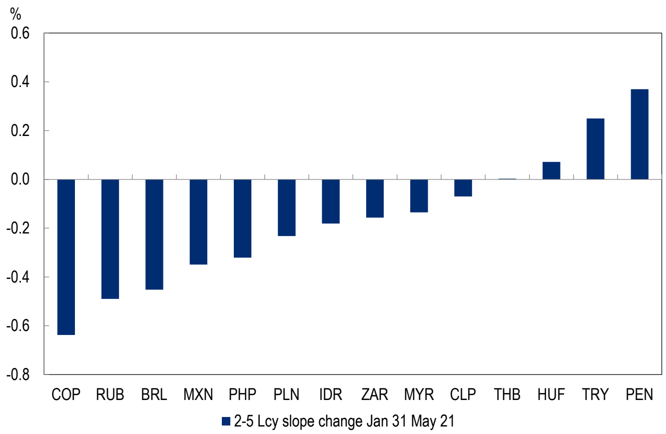
Figure 21. Forecasting next-quarter returns does show that high amount of low grade issuance leads to lower near term returns

	ESBI	ESBI-LG
R^2	0.09	0.16
Credit Spread	0.0000607	0.000125
t-stat	(2.22)	(3.24)
HY issuance/total	-0.046	-0.045
t-stat	(-0.95)	(-0.65)

Source: Citi Research

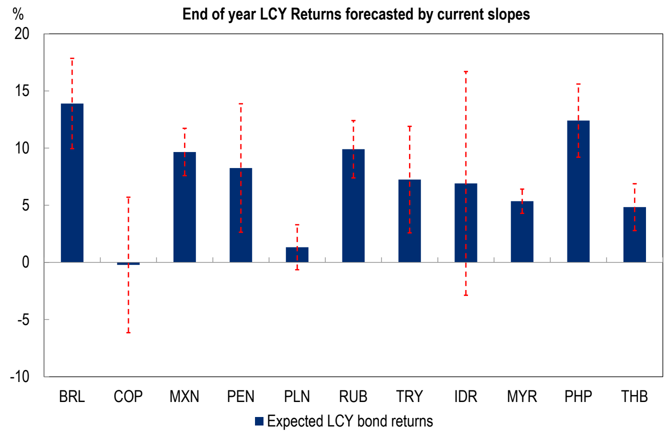
In local bond markets, an alternative indication of over-extension can emerge from an excessively flat yield curve. A normal LCY bond curve tends to be (significantly) upward sloping. However, during episodes when investors stretch for yield, the demand tends to shift towards longer duration instruments and curves flatten. Figure 23 shows that LCY slopes (2s-5s) have flattened significantly in most EM countries since February. The phenomenon is particularly noticeable since April, as we illustrated before. The curves in Colombia, Russia, Brazil, Mexico, Philippines, and Poland show the most striking flattening while Turkey and Peru have steepened.

Figure 22. By and large LCY bond slopes have flattened since February…



Source: Citi Research

Figure 23. Despite the flattening, LCY bond expected returns are still attractive (standard errors in parenthesis).



Source: Citi Research

In previous work we found that the steepness of a LCY yield-curve helped forecast future returns in five-year bonds.[5] This is an intuitive result: if the curve is steep, the long bond is cheap and as a result one would anticipate, on average, positive future returns. Using that simple principle, we estimate regressions for LCY bond returns on the slope of each country's yield curve. We use the model to forecast returns and present the results in Figure 24. Interestingly, despite the rally in the longer bonds, the yields remain high enough to suggest that returns will be positive (with the exception of Colombia, where the rally has been strong). The figure also illustrates a confidence interval for the forecasts. All returns, except for Poland and Israel are predicted to be positive for LCY 5 year bonds.

Summarizing, carry dominates the EM landscape. It has been fueled, among other factors by stable UST and, lately, by yields that have pierced the lower bound of the range. The movement was significantly influenced by a fall in term premia, though it is clear that the expected path of the exit strategy has also had an effect beyond the price of risk. Chances of a reversal in such dynamics are a threat to EM and other high beta assets. However, remarkably, we find inconclusive evidence of EM markets being over-stretched. As a result, we are increasingly weary but, under the circumstances, we are still looking to receive.

[5] A. Demyanets: *Through the forward curve looking-glass, and what we found there about expected returns on local bonds.* 3 February 2014.

Annual Indicators

Figure 24. Emerging Markets – Economic Forecasts, 2013-2015F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013	2014F	2015F	2013	2014F	2015F	2013	2014F	2015F	2013	2014F	2015F
Asia	**6.3**	**6.2**	**6.3**	**3.7**	**3.5**	**3.8**	**2.2**	**2.1**	**1.5**	**-2.3**	**-2.4**	**-2.2**
China	7.7	7.3	7.0	2.6	2.6	3.2	2.0	2.0	1.5	-1.9	-2.1	-2.0
Hong Kong	2.9	3.2	3.6	4.3	3.9	3.7	2.1	2.8	3.2	1.0	1.3	0.7
India*	4.9	5.6	6.5	9.5	8.0	6.5	-2.0	-2.3	-2.5	-6.9	-6.7	-6.5
Indonesia	5.8	5.3	5.5	6.4	6.5	6.7	-3.3	-2.4	-2.1	-2.2	-2.3	-1.7
Korea	3.0	3.9	4.0	1.3	2.1	3.1	6.1	3.9	2.9	1.0	0.9	1.5
Malaysia	4.7	5.4	5.6	2.1	3.5	4.5	4.0	4.4	4.0	-3.9	-3.5	-3.0
Mongolia	11.7	10.0	9.0	10.5	13.1	12.0	-30.9	-17.9	-19.7	-7.8	-7.5	-4.3
Philippines	7.2	6.9	7.3	2.9	4.1	4.0	3.5	3.4	2.9	-1.4	-1.8	-1.6
Singapore	3.9	3.5	4.0	2.4	1.8	1.3	18.3	18.0	18.0	1.1	-0.3	0.2
Sri Lanka	7.3	7.2	7.4	6.9	5.7	6.5	-3.9	-3.3	-3.0	-5.9	-5.6	-5.3
Taiwan	2.1	3.2	3.8	0.8	1.2	2.0	11.7	11.0	10.2	-1.4	-1.4	-0.8
Thailand	2.9	0.5	2.8	2.2	2.4	2.1	-0.7	2.2	-1.1	-1.8	-1.2	-1.8
Vietnam	5.4	5.7	5.9	6.6	5.4	6.8	5.3	4.1	2.9	-5.3	-5.3	-4.5
Latin America	**2.4**	**1.9**	**2.8**	**7.3**	**9.3**	**10.1**	**-2.5**	**-2.7**	**-2.6**	**-3.2**	**-3.6**	**-3.1**
Argentina	3.0	0.0	1.0	10.6		31.8	-0.7	-1.1	-1.2	-1.9	-2.4	-2.4
Brazil	2.3	1.3	1.8	6.2	6.4	6.3	-3.7	-3.8	-3.8	-3.3	-3.9	-3.4
Chile	4.1	3.5	4.5	1.9	3.6	2.8	-3.3	-2.6	-4.0	-0.3	-0.4	-0.4
Colombia	4.3	4.6	5.0	2.0	2.8	3.3	-3.4	-3.7	-3.7	-1.4	-1.3	-0.7
Costa Rica	3.5	3.1	2.2	5.2	3.9	5.0	-5.1	-7.5	-7.9	-6.5	-7.2	-7.7
Dominican Republic	4.1	4.5	4.5	4.8	4.0	4.6	-4.4	-4.8	-5.0	-4.1	-4.0	-4.2
Ecuador	4.5	4.5	4.5	2.7	3.6	2.4	-1.3	-1.1	-1.2	-2.4	-1.9	-1.5
El Salvador	1.8	2.2	2.5	0.8	0.8	1.8	-6.1	-6.3	-5.7	-4.2	-4.1	-3.7
Mexico	1.1	3.0	4.0	3.8	4.0	3.6	-1.8	-2.1	-1.8	-2.4	-3.5	-2.5
Panama	8.4	6.2	5.5	4.0	2.7	2.8	-11.3	-9.0	-8.5	-3.0	-3.0	-3.0
Peru	5.0	5.4	6.2	2.8	3.2	2.5	-4.9	-5.1	-4.8	0.8	0.0	0.0
Venezuela	1.3	-1.0	1.9	38.5	62.5	82.1	3.3	4.1	5.1	-11.9	-11.2	-10.3
Europe	**2.0**	**1.7**	**2.9**	**5.3**	**5.6**	**5.3**	**-1.3**	**-0.2**	**-0.8**	**-2.2**	**-2.4**	**-3.6**
Bulgaria	0.9	1.5	2.5	0.9	-0.5	2.5	1.9	-0.2	-0.5	-1.5	-2.0	-1.2
Croatia	-1.0	-0.6	1.2	2.2	0.4	2.8	1.3	0.5	-0.5	-4.9	-5.0	-3.5
Czech Republic	-0.9	1.9	2.6	1.4	0.9	2.1	-1.4	0.2	0.8	-1.5	-2.0	-2.5
Hungary	1.1	2.5	1.9	1.7	0.5	2.6	2.9	2.6	2.2	-2.2	-2.9	-2.9
Kazakhstan	6.0	5.0	6.0	5.7	6.5	5.9	-0.1	1.0	1.3	3.2	2.3	2.2
Poland	1.6	3.4	3.6	0.9	0.8	2.5	-1.3	-2.5	-3.7	-4.3	5.2	-2.7
Romania	3.5	3.0	3.4	4.0	2.0	3.4	-1.1	-2.5	-4.2	-2.5	-2.3	-2.3
Russia	1.3	1.0	2.3	6.8	6.8	5.8	1.5	2.7	1.9	-2.1	-4.4	-4.9
Serbia	2.5	1.2	2.0	7.9	3.5	5.8	-4.8	-4.8	-5.0	-5.7	-7.0	-6.5
Slovakia	0.9	2.1	2.6	1.4	0.2	1.2	2.4	2.8	3.4	-2.8	-3.0	-2.5
Turkey	4.0	2.2	3.5	7.5	8.6	7.9	-7.9	-5.2	-5.3	-1.2	-2.8	-3.2
Ukraine	0.0	-3.2	2.1	-0.3	7.2	7.3	-9.3	-5.3	-3.6	-6.7	-4.3	-3.4
Africa/Mideast	**3.9**	**4.6**	**5.2**	**4.2**	**4.4**	**5.0**	**11.1**	**9.8**	**7.4**	**1.7**	**1.4**	**-0.3**
Bahrain	5.3	4.0	4.0	3.3	2.5	2.0	6.8	5.5	1.3	-2.3	-3.5	-5.9
Egypt	1.5	2.4	3.2	9.5	9.1	7.1	-1.3	-1.1	-1.9	-9.3	-9.5	-8.4
Ghana	7.4	4.6	6.5	11.7	13.3	10.0	-12.7	-14.4	-14.1	-10.8	-10.2	-9.0
Iraq	3.1	10.4	11.6	1.9	3.0	5.5	13.3	13.6	12.6	-5.8	-2.3	-1.2
Israel	3.2	3.2	3.5	1.5	1.0	3.0	2.5	1.9	1.7	-2.7	-3.0	-2.5
Jordan	2.8	4.0	4.5	5.5	3.5	5.0	-11.3	-10.2	-7.9	-5.5	-9.6	-9.4
Kenya	4.7	5.5	6.1	5.4	6.6	6.7	-9.0	-7.6	-7.5	-7.8	-6.5	-5.5
Kuwait	5.7	3.8	3.9	2.6	3.0	4.5	37.9	40.4	38.3	28.8	32.2	26.5
Lebanon	1.4	2.0	2.4	2.1	3.8	5.0	-9.0	-9.8	-10.7	-9.3	-8.7	-8.0
Nigeria	6.6	6.4	6.4	8.5	8.8	10.6	3.8	2.4	1.4	-1.4	-1.7	-1.6
Oman	3.4	4.7	4.7	2.1	1.5	3.0	10.8	8.5	6.6	9.9	8.4	6.1
Qatar	6.5	5.9	6.2	3.1	2.5	3.5	30.9	29.4	25.1	8.2	4.2	1.2
Saudi Arabia	3.8	4.8	5.9	3.5	3.5	4.1	18.2	14.8	8.9	7.4	6.2	1.3
South Africa	1.9	2.3	2.9	5.8	6.5	5.8	-5.8	-4.9	-4.2	-4.3	-4.2	-4.2
Tanzania	6.8	7.0	8.1	7.9	7.4	6.6	-10.2	-14.1	-12.4	-5.0	-5.2	-5.9
UAE	3.7	4.0	4.0	1.1	1.8	2.1	26.2	21.4	17.0	NA	NA	NA
Uganda	6.0	6.0	5.5	5.5	5.9	6.8	-12.0	-13.9	-14.9	-3.4	-3.3	-4.5
Zambia	6.2	6.4	6.3	7.0	7.8	8.0	0.2	-1.0	-1.5	-6.5	-6.1	-5.5
Total	**4.5**	**4.5**	**5.0**	**4.7**	**5.0**	**5.2**	**1.8**	**1.9**	**1.2**	**-2.0**	**-2.2**	**-2.4**

Source: National sources, Citi Research forecasts

Economic Framework

Figure 25. Citi's Global Economic Forecasts

	GDP Growth (% YoY)			CPI Inflation (% YoY)			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F
Global	**3.0**	**3.5**	**3.7**	**2.9**	**3.1**	**3.4**	**0.8**	**0.7**	**0.3**	**-3.6**	**-3.2**	**-2.9**
Based on PPP weights	3.4	3.9	4.1	3.3	3.5	3.9	*0.5*	*0.4*	*0.1*	*-3.7*	*-3.3*	*-3.0*
Industrial Countries	**2.0**	**2.4**	**2.5**	**1.5**	**1.7**	**1.6**	**0.1**	**0.2**	**0.1**	**-4.6**	**-3.7**	**-3.3**
United States	**2.3**	**3.1**	**3.2**	**1.5**	**1.8**	**2.2**	**-2.0**	**-1.5**	**-1.8**	**-6.4**	**-5.6**	**-5.6**
Japan	**1.4**	**0.9**	**1.2**	**2.8**	**1.7**	**1.6**	**-0.2**	**-0.2**	**0.0**	**-8.0**	**-6.2**	**-5.8**
Euro Area	**1.2**	**1.8**	**1.9**	**0.6**	**0.9**	**1.2**	**2.9**	**2.9**	**2.8**	**-2.6**	**-2.0**	**-1.5**
Canada	2.4	2.7	2.7	1.8	2.0	2.0	-2.4	-2.0	-1.9	-0.1	0.3	0.4
Australia	2.9	2.9	3.1	2.7	2.5	2.4	-2.5	-2.4	-2.4	-3.0	-2.1	-1.4
New Zealand	3.2	2.7	2.4	2.1	2.2	2.2	-4.2	-5.4	-5.0	-1.6	-0.4	0.5
Germany	2.2	2.4	2.5	1.3	1.8	2.1	7.1	6.8	6.3	0.1	0.3	0.4
France	0.8	1.4	1.7	0.8	1.2	1.4	-0.6	0.1	0.6	-4.1	-3.5	-2.7
Italy	0.3	1.2	1.1	0.3	-0.2	0.2	1.6	1.5	1.4	-3.0	-2.7	-2.0
Spain	1.0	1.6	2.0	0.0	0.2	0.4	1.0	0.9	0.9	-5.8	-4.8	-3.6
Greece	-0.8	1.2	1.5	-1.6	-1.7	-1.0	1.5	1.8	1.7	-2.5	-2.8	-2.0
Ireland	2.1	3.3	3.0	0.8	1.0	1.1	8.6	8.7	7.8	-5.4	-2.8	-2.1
Portugal	1.2	2.0	1.7	-0.4	-0.6	0.0	1.5	1.1	1.2	-4.0	-2.8	-2.4
Netherlands	0.6	1.4	1.7	0.7	1.3	1.5	10.5	10.2	9.8	-2.8	-2.2	-1.7
Belgium	1.3	1.5	1.6	0.6	1.1	1.8	1.0	1.7	1.8	-2.4	-2.0	-1.2
Denmark	1.0	1.5	1.8	1.5	1.7	1.8	6.8	5.8	5.5	-1.3	-2.4	-1.4
Norway	2.0	2.2	2.5	2.0	2.1	2.1	11.1	11.4	11.9	11.9	11.0	10.0
Sweden	2.6	2.7	2.9	0.1	1.2	2.2	5.9	5.6	5.6	-1.6	-0.8	-0.3
Switzerland	2.2	2.3	2.6	-0.2	0.9	1.1	12.2	11.7	12.6	0.7	1.1	1.6
United Kingdom	3.5	3.6	2.6	1.7	2.0	2.1	-3.6	-3.7	-3.8	-5.6	-3.8	-1.7

Figure 26. G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 21 May 2014

	21-May	3Q 14F	4Q 14F	1Q 15F	2Q 15F	3Q 15F	4Q 15F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.75	1.00
10-Yr. Treasuries (Period Ave.)	2.51	2.95	3.20	3.40	3.45	3.50	3.55
Euro Area: US$/€	1.37	1.38	1.36	1.35	1.36	1.38	1.39
Euro Repo Rate	0.25	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. Bunds (Period Average)	1.39	1.60	1.60	1.70	1.70	1.80	1.80
Japan: Yen/US$	102	102	104	106	107	108	109
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.59	0.65	0.70	0.85	0.95	0.95	0.85

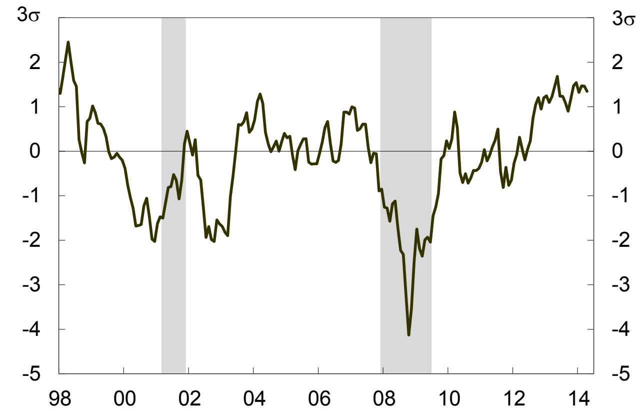
Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US$						Spread vs. Germany					
	Current	3Q 14	4Q 14	1Q 15	2Q 15	3Q 15	Current	3Q 14	4Q 14	1Q 15	2Q 15	3Q 15
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**114**	**137**	**163**	**173**	**178**	**173**
Japan	**-194**	**-232**	**-253**	**-258**	**-253**	**-258**	**-80**	**-95**	**-90**	**-85**	**-75**	**-85**
Euro Area	**-114**	**-137**	**-163**	**-173**	**-178**	**-173**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	-23	-30	-25	-20	-15	-15	90	107	137	153	163	158
Australia	117	122	122	128	133	138	230	259	285	300	311	311
New Zealand	178	178	173	163	169	184	292	316	336	336	347	357
France	-67	-87	-123	-133	-138	-133	45	50	40	40	40	40
Italy	78	3	-43	-53	-58	-53	190	140	120	120	120	120
Spain	61	13	-43	-53	-58	-53	173	150	120	120	120	120
Netherlands	-83	-112	-138	-148	-153	-148	29	25	25	25	25	25
Belgium	-53	-77	-113	-123	-128	-123	59	60	50	50	50	50
Austria	-90	-112	-148	-158	-163	-158	22	25	15	15	15	15
Finland	-85	-107	-138	-148	-153	-148	27	30	25	25	25	25
Ireland	29	-17	-83	-93	-98	-93	141	120	80	80	80	80
Portugal	147	53	-13	-23	-28	-23	259	190	150	150	150	150
Switzerland	-174	-202	-228	-241	-246	-243	-62	-65	-65	-68	-68	-70
United Kingdom	10	5	10	10	10	15	122	142	173	183	188	188

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

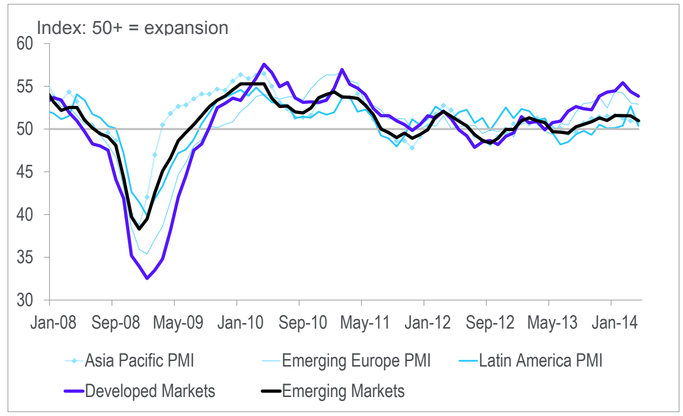
Regional Indicators

Figure 27. QE appears on target to end early this fall, and the latest refinement to forward guidance makes future short-term policy rates completely dependent on future economic developments.



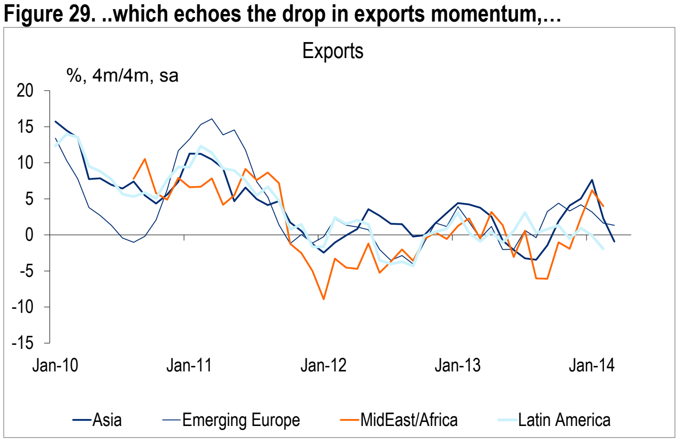
Source: Haver Analytics, Citi Research. Note: Shaded sections mark recession periods.

Figure 28. PMIs slid in recent months…



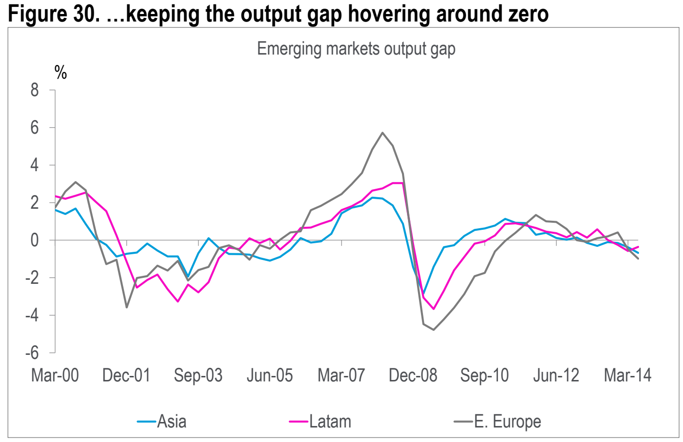
Source: Haver Analytics, Citi Research

Figure 29. ..which echoes the drop in exports momentum,…



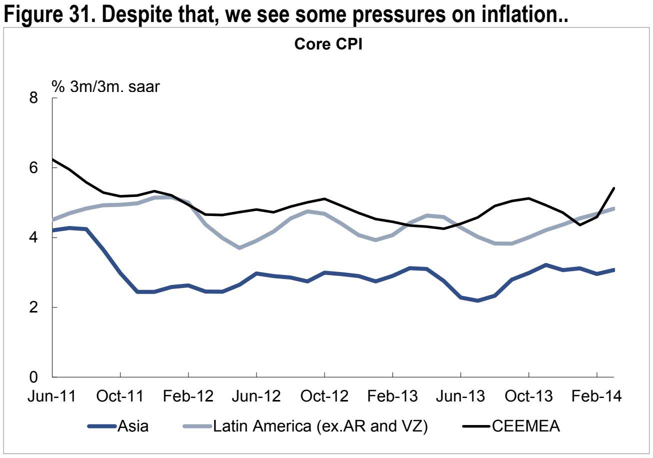
Source: Citi Research

Figure 30. …keeping the output gap hovering around zero



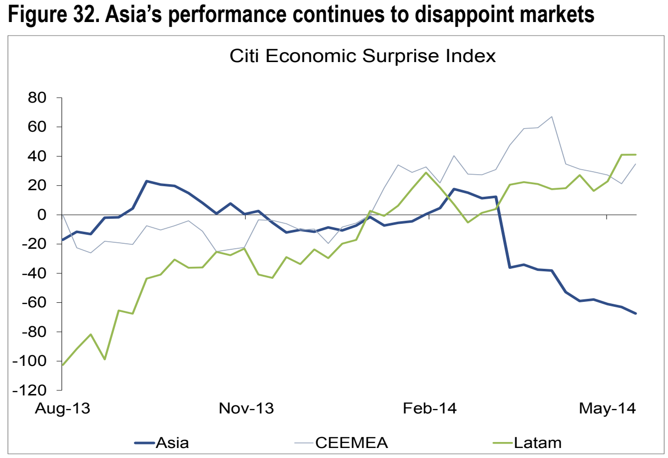
Source: Haver Analytics, Citi Research

Figure 31. Despite that, we see some pressures on inflation..



Source: Citi Research

Figure 32. Asia's performance continues to disappoint markets



Source: Haver Analytics, Citi Research

Monetary Policy Watch

Figure 33. Asia Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2014
			Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	3.00	Jul-12	-25	2016	+25	3.00
India	Repo Rate	8.00	Jan-14	+25	FY16/17	-50	8.00
Indonesia	FasBI	5.75	Nov-13	+25	Dec-14	+25	6.00
Korea	BOK Policy Rate	2.50	May-13	-25	Mar-15	+25	2.50
Malaysia	Overnight Policy Rate	3.00	May-11	+25	Jul-14	+50	3.50
Philippines	Overnight Policy Rate	3.50	Oct-12	-25	Sep-14	+25	4.00
Taiwan	Discount Rate	1.875	Jun-11	+12.5	Mar-15	+12.5	1.875
Thailand	Overnight Repo Rate	2.00	Mar-14	-25	2016F	+150	2.00

Source: Bloomberg, Citi Research

Figure 34. CEEMEA Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2014
			Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.05	Nov-12	-20	4Q15	+20	0.05
Hungary	14-Day Repo Rate	2.50	Apr-14	-10	May-14	-10	2.25
Israel	Base Rate	0.75	Feb-14	-25	May-14	-25	0.50
Poland	7-Day Repo Rate	2.50	Jul-13	-25	Jun-15	+25	2.50
Romania	Refinancing Rate	3.50	Feb-14	-25	1Q15	+25	3.50
Russia	Refinancing Rate	7.50	Apr-14	+50	Aug-14	-50	7.00
S. Africa	Average Repo rate	5.50	Jan-14	+50	Jul-14	+25	6.00
Turkey*	Average Funding rate	10.00			by end-2014	+150	11.50
Ukraine	Discount Rate	9.50	Apr-14	+300	2015	-25	9.50

Source: Bloomberg, Citi Research.
Note: *For Turkey we use the average funding rate of the CBT instead of the 1-week repo rate.

Figure 35. Latin America Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2014
			Date	Amount (bp)	Forecast	Amount (bp)	forecast
Brazil	SELIC	11.00	Apr-14	+25	Jan-15	+50	11.00
Chile	CAMARA (Overnight)	4.00	Mar-14	-25	Jun-14	-25	3.50
Colombia	Central Bank Repo Rate	3.50	Apr-14	+25	May-14	+25	4.25
Mexico	Official Overnight Rate	3.50	Oct-13	-25	Jun-15	+25	3.50
Peru	Reference Rate	4.00	Nov-13	-25	Jan-15	+25	4.00

Source: Bloomberg, Citi Research

FX Views

Figure 36. Asian Currencies Exchange Rates

		Jun-14			Sep-14			Jun-15		
	21-May	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
China yuan	6.23	6.29	6.25	-0.6	6.20	6.27	1.1	6.06	6.31	4.1
Hong Kong dollar	7.75	7.76	7.75	-0.1	7.76	7.75	-0.1	7.76	7.75	-0.1
India rupee	58.78	59.17	59.08	-0.2	60.30	60.05	-0.4	62.29	63.16	1.4
Indonesia rupiah	11509	11440	11534	0.8	11703	11694	-0.1	12012	n.a.	n.a.
Korea won	1027	1031	1028	-0.2	1034	1033	-0.1	1022	1045	2.2
Malaysia ringgit	3.22	3.31	3.22	-2.7	3.34	3.24	-3.3	3.39	n.a.	n.a.
Philippines peso	43.8	44.1	43.8	-0.7	44.4	43.8	-1.4	44.4	44.1	-0.8
Singapore dollar	1.25	1.26	1.25	-0.6	1.26	1.25	-0.6	1.26	1.25	-0.6
Taiwan dollar	30.2	30.48	30.19	-1.0	30.37	30.12	-0.8	30.08	29.91	-0.6
Thailand baht	32.5	32.53	32.55	0.1	32.72	32.73	0.0	33.00	n.a.	n.a.

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

Figure 37. CEEMEA Currencies Exchange Rates

		Jun-14			Sep-14			Jun-15		
	21-May	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs EUR				(%)			(%)			(%)
Czech Republic koruna	27.5	27.4	27	0.2	27.5	27.5	-0.3	27.3	27.4	0.1
Hungary forint	305	310	308	-0.8	312	308	-1.4	318	308	-3.3
Poland zloty	4.19	4.21	4.19	-0.4	4.24	4.19	-1.3	4.21	4.19	-0.5
vs USD										
Israel shekel	3.49	3.41	3.49	2.2	3.49	3.49	0.0	3.67	3.49	-5.3
Russia ruble	34.5	35.7	34.8	-2.7	36.6	35.5	-3.2	37.8	37.2	-1.6
Turkey new lira	2.11	2.09	2.13	1.8	2.13	2.17	1.9	2.26	2.31	2.3
S. Africa rand	10.41	10.35	10.47	1.1	10.65	10.63	-0.2	11.01	11.42	3.6

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

Figure 38. Latin American Currencies Exchange Rates

		Jun-14			Sep-14			Jun-15		
	21-May	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
Brazil reais	2.22	2.26	2.24	-1.3	2.36	2.29	-2.8	2.54	2.46	-3.3
Chile peso	553	552	555	0.6	563	561	-0.4	583	575	-1.5
Colombia peso	1921	1905	1926	1.1	1939	1943	0.2	2008	2002	-0.3
Mexico new peso	12.9	12.8	12.9	0.7	12.9	12.9	-0.2	13.0	12.9	-0.6

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

Our Forecasts vs. Consensus

Figure 39. Citi vs Consensus Forecasts

	GDP Growth (%)				CPI Inflation (%)				Current Account Balance (US$ bn)			
	2014F	Consensus	2015F	Consensus	2014F	Consensus	2015F	Consensus	2014F	Consensus	2015F	Consensus
Asia	**6.2%**	**6.2%**	**6.2%**	**6.3%**	**3.5%**	**3.4%**	**3.7%**	**3.6%**	**347**	**349**	**284**	**337**
China	7.3	7.3	7.0	7.2	2.6	2.5	3.2	3.0	201	208	169	208
Hong Kong	3.2	3.4	3.6	3.5	3.9	3.8	3.7	3.6	8	5	10	5
India	5.6	5.4	6.5	6.0	8.0	7.7	6.5	7.0	-47	-48	-58	-55
Indonesia	5.3	5.3	5.5	5.8	6.5	6.3	6.7	5.7	-21	-23	-19	-21
South Korea	3.9	3.6	4.0	3.7	2.1	1.9	3.1	2.6	57	67	47	56
Malaysia	5.4	5.1	5.6	5.0	3.5	3.3	4.5	3.6	14	13	13	15
Philippines	6.9	6.4	7.3	6.3	4.1	4.1	4.0	3.9	10	9	10	9
Singapore	3.5	3.8	4.0	4.0	1.8	2.4	1.3	2.7	57	54	60	56
Sri Lanka	7.2	7.3	7.4	7.2	5.7	5.9	6.5	6.7	-2	-3	-3	-3
Taiwan	3.2	3.2	3.8	3.6	1.2	1.2	2.0	1.8	55	57	55	57
Thailand	1.8	2.3	2.9	4.2	2.4	2.5	2.1	2.8	8	5	-4	5
Vietnam	5.7	5.7	5.9	5.9	5.4	5.8	6.8	6.9	7	5	6	4
Latin America	**2.1%**	**2.0%**	**2.9%**	**2.8%**	**8.6%**	**11.4%**	**12.7%**	**9.9%**	**-139**	**-130**	**-139**	**-124**
Argentina	0.0	-0.9	1.0	0.9	-	30.7	31.8	30.4	-5	-3	-5	-2
Brazil	1.3	1.7	1.8	2.0	6.4	6.3	6.3	5.9	-83	-79	-85	-72
Chile	3.5	3.2	4.5	4.1	3.6	3.8	2.8	3.1	-9	-8	-11	-8
Colombia	4.6	4.6	5.0	4.6	2.8	3.2	3.3	3.2	-14	-13	-15	-13
Mexico	3.3	2.9	4.0	3.9	4.1	3.9	3.7	3.6	-27	-24	-26	-27
Panama	6.2	6.6	5.5	6.0	2.7	3.2	2.8	3.3	-4	-4	-4	-4
Peru	5.4	5.3	6.2	5.7	3.2	2.9	2.5	2.6	-11	-10	-11	-9
Venezuela	-1.0	-1.7	1.9	1.0	62.5	62.6	82.1	46.6	15	10	18	12
Europe	**1.7%**	**1.6%**	**2.9%**	**2.7%**	**5.5%**	**5.2%**	**5.3%**	**4.9%**	**-4.5**	**-30.4**	**-32.5**	**-49.3**
Bulgaria	1.5	1.7	2.5	2.5	-0.5	0.9	2.5	2.3	-0.1	-0.1	-0.3	-0.7
Croatia	-0.6	-0.2	1.2	1.1	0.4	1.1	2.8	2.2	0.3	0.3	-0.3	0.1
Czech R	1.9	2.1	2.6	2.6	0.9	1.0	2.1	2.2	0.3	-1.8	1.6	-2.3
Hungary	2.5	2.2	1.9	2.2	0.5	1.0	2.6	2.9	3.5	3.4	3.1	3.3
Kazakhstan	5.0	4.8	6.0	6.3	6.5	6.5	5.9	6.5	2.1	1.3	2.9	2.7
Poland	3.4	3.1	3.6	3.5	0.8	1.3	2.5	2.3	-13.9	-10.4	-21.8	-14.5
Romania	3.0	2.8	3.4	3.2	2.0	2.2	3.4	3.0	-5.1	-3.2	-9.2	-3.8
Russia	1.0	0.9	2.3	1.9	6.8	6.1	5.8	5.3	54.9	32.6	39.2	20.3
Slovak Rep	2.1	2.3	2.6	3.0	0.2	0.7	1.2	1.8	2.8	2.3	3.6	2.3
Turkey	2.2	2.3	3.5	3.7	8.6	8.1	7.9	6.7	-41.9	-47.6	-45.8	-49.4
Ukraine	-3.2	-3.9	2.1	1.3	7.2	6.6	7.3	6.7	-7.3	-7.2	-5.4	-7.3
MEA	**4.3%**	**4.2%**	**4.9%**	**4.5%**	**4.7%**	**4.6%**	**5.5%**	**5.0%**	**120.6**	**109.6**	**74.0**	**94.5**
Israel	3.4	3.4	3.5	3.6	1.2	1.8	3.0	2.4	5.9	5.1	5.2	6.3
Nigeria	6.4	6.8	6.4	6.6	8.8	8.5	10.6	8.9	15.8	14.0	10.7	11.9
S. Africa	2.3	2.5	2.9	3.3	6.5	6.2	5.8	5.7	-17.1	-18.5	-15.4	-17.5
S. Arabia	4.8	4.2	5.9	4.6	3.5	3.4	4.1	3.9	116.0	109.0	73.5	93.8
Above Total	**4.5%**	**4.4%**	**4.9%**	**4.9%**	**4.9%**	**5.4%**	**5.8%**	**5.1%**	**323.7**	**297.6**	**186.8**	**258.2**

Source: Consensus Economics, National Sources, Citi Research forecasts

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- **Summary view** – Mild easing did not reverse the investment-led growth downturn in April. President Xi Jinping called for accepting the "new normal", hinting more tolerance of slower growth. We keep 2014 growth forecast at 7.3%, assuming better export performance and targeted policy accommodation.

- **Things to watch** – Macro policy fine-tuning continued to gain momentum amid concerns over property price correction and growth slowdown. We expect PBOC to maintain adequate liquidity to lower the borrowing cost, and government to take more measures to support demand and prevent a property market crash.

- **Strategy** – Headline exports growth may improve substantially from May, leading to higher trade surplus. This would result in mounting political pressures from not only the US but also G20 on currency issues. We expect RMB appreciation to resume ahead of the China-US Strategy and Economic Dialogue in early July.

Policy fine-tuning amid growth woes

Apr data show no sign of economic recovery. Growth in fixed asset investment, industrial production and retail sales was all weaker than market expectations. Investment has been the key drag on growth this year due to tightened credit in the real economy. On the fiscal side, value-added tax growth dropped from 10.5%YoY in Mar to 4.9%YoY in Apr. In particular, property-related business tax and income tax registered negative growth. The property price will likely correct nationwide this year, and the risk of a property price bubble bust is rising starting in lower tier cities. The long-awaited regulation on inter-bank business should further restrain off-balance sheet activities and increase the market-based cost of capital. Growth for the rest of the year will largely depend on better export growth and/or further policy accommodation.

President Xi Jinping called for China to adapt to the "new normal". This hints that the Chinese policy-makers may tolerate somewhat slower growth as long as the labor market remains largely intact. Our analysis suggests that 1Q GDP growth could be much weaker than the officially reported number. After augmenting the GDP deflator, the GDP growth in year-on-year terms might have fallen into the range of 6-7%. (See *China Macro View - A Reality Check on GDP Deflator and Job Creation*, 9-May) Citi Li Keqiang index in April also ticked down a bit as power consumption growth slowed from 7.2%YoY in Mar to 4.6%YoY in Apr, and railway cargo growth remained in the red at -3.2%YoY. Due to the mild easing, the rebound of the Li Keqiang Index this time will be much weaker than those in the past two years.

Policy initiatives have revealed government preference for targeted easing. Over the past month, the State Council published a follow-up document on supporting trade. PBOC cut RRR for selected rural banks, and urged commercial banks to extend more mortgage loans at lower rates to reduce the risk of a sharp slowdown in the property sector. Some local governments relaxed home purchase restrictions to secure real housing demand. Meanwhile, the upward adjustment of the railway projects and plans to allow local governments to issue municipal debt to finance infrastructure is likely to provide a buffer for investment. We expect PBOC to maintain adequate liquidity to lower the borrowing cost, and the government to take more measures (including loosening housing purchase restrictions) to prevent a property market crash.

Risk of a property market slump

A property market slump remains a tail risk, but the tail is getting fatter. From a medium-term perspective, the current inventory and incoming supply can be mostly digested by rising demand amid ongoing urbanization and upgrading of living conditions. But in the near term, China's housing market suffers from demand over-drafting and supply mislocation, and there are signs that a correction is around the corner. We expect government policies to be geared toward supporting demand while avoiding another construction boom that could disrupt the medium-term supply/demand balance.

Property investment slowdown would put downward pressure on growth. Since property investment accounted for roughly one-fourth of total FAI and FAI made up nearly half of China's GDP, property investment directly contributes about 12% to GDP. We now estimate that total property investment may decelerate to about 14% this year, a main factor that would slow GDP growth to an estimated 7.3% in 2014. If residential new starts drop by 25% this year in the absence of policy support, GDP growth may fall below 7%.

We expect the government to take targeted policies to support house demand. Policies could include: (i) increasing land supply in 1st tier cities; (ii) relaxing home purchase restrictions; (iii) linking hukou with house purchase; (iv) making mortgages more available and less costly; (v) government purchase of commodity houses to meet social housing targets.

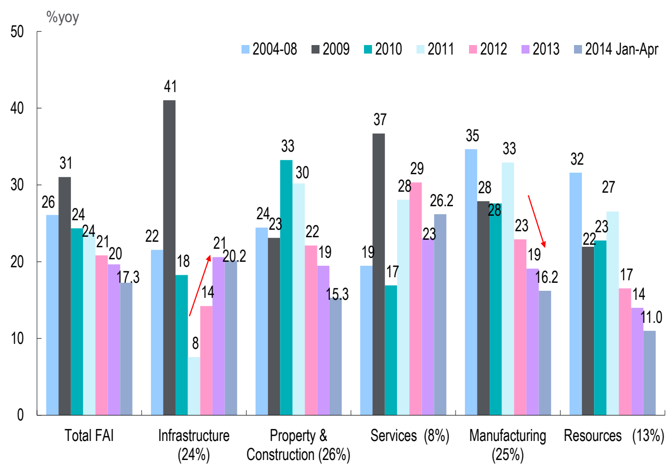
Apart from policy support, price cuts may be necessary to stabilize demand. The NBS data on the 70 large- and medium-sized cities show new house price rose only by 0.1%MoM in Apr, and YoY price increase has slowed since Jan 2014. As market expectation starts to shift, sales could remain sluggish in the months ahead, forcing more developers to cut prices. We expect 70-city average house prices to decline MoM as early as in May, and see price cuts necessary to improve affordability and unleash potential demand.

For details, please see *China Macro View - Risk of a Property Market Slump: The Tail Is Getting Fatter* (19-May)

RMB to resume appreciation along a volatile path in 2H

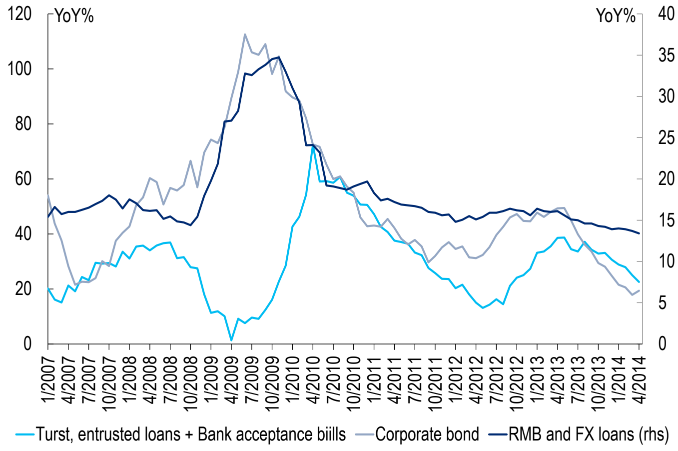
RMB depreciation is likely to be reversed as early as June. The widening of the USDCNY trading band and increased volatility of the RMB has started to dampen speculation on the currency. The RMB has depreciated against the US dollar by about 3% year to date. The FX position data suggest a small-scale non-FDI capital outflow in Apr, the first monthly outflow since last Oct. Going forward, with inflated base fading out and recovery in advanced economies, the headline exports growth may improve substantially from May, leading to a higher trade surplus. This would result in mounting political pressures from not only the US but also G20 on currency issues. We expect RMB appreciation to resume ahead of the China-US Strategy and Economic Dialogue scheduled for early Jul and USDCNY spot rate to fall back to 6.12 by the year-end.

Figure 40. Investment has been the key drag on growth this year



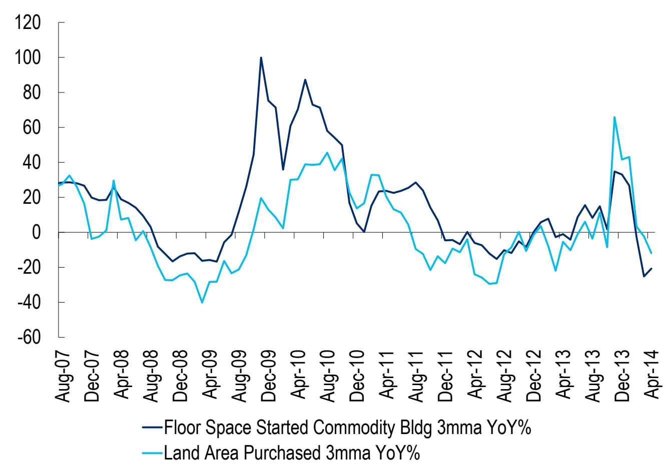
Source: CEIC and Citi Research

Figure 41. Off-balance sheet activities slowed since 2H 2013



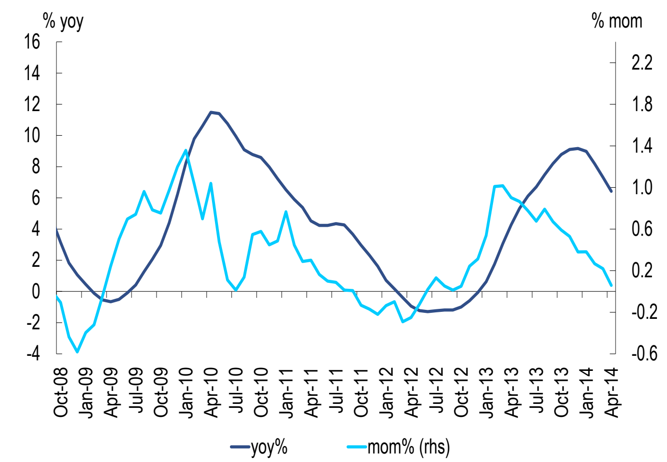
Source: CEIC and Citi Research

Figure 42. Weak demand in the property sector



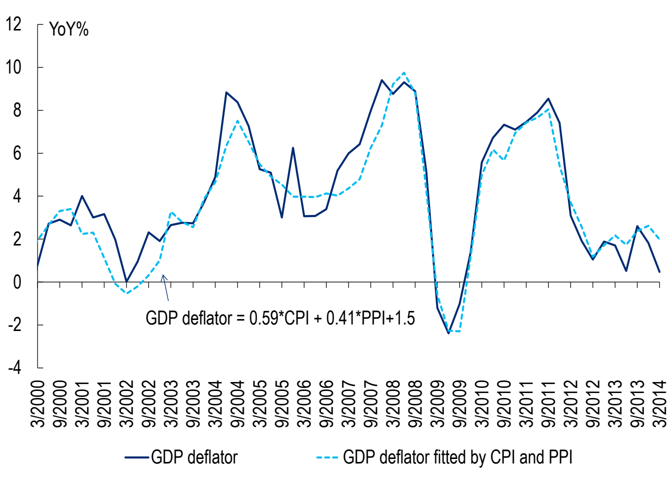
Source: CEIC and Citi Research

Figure 43. 70-city YoY property price increase has slowed since Jan 2014



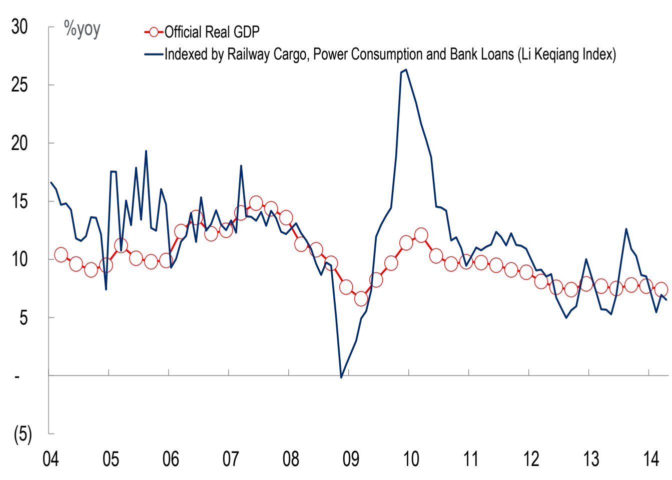
Source: CEIC and Citi Research

Figure 44. GDP deflator could have been understated in 1Q 2014



Source: CEIC and Citi Research

Figure 45. Citi Li Keqiang index ticked down in Apr



Source: CEIC and Citi Research

Figure 46. China Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	3,494.5	4,544.0	5,070.5	5,932.5	7,319.0	8,238.5	9,244.8	10,063.1	11,256.4
Nominal GDP, local currency bn	26,583	31,490	34,632	40,151	47,310	51,894	56,881	62,138	67,988
GDP per capita, US$	2,645	3,422	3,800	4,424	5,432	6,084	6,794	7,366	8,218
Population, mn	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,360.7	1,366.2	1,369.7
Unemployment, % of labour force	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2	4.3
Economic Activity									
Real GDP, % yoy	14.2	9.6	9.2	10.4	9.3	7.7	7.7	7.3	7.0
Real investment growth % yoy	14.4	11.0	19.2	11.9	9.4	8.1	8.9	7.3	6.6
Real consumption growth % yoy	11.0	8.5	9.4	9.2	10.9	8.3	7.8	7.1	7.6
private consumption growth % yoy	11.1	9.2	10.3	8.5	18.2	8.5	8.0	7.3	7.8
Real export growth, % yoy	--	--	--	--	--	--	--	--	--
Real import growth, % yoy	--	--	--	--	--	--	--	--	--
Prices, Money & Credit									
CPI, % yoy	6.5	1.2	1.9	4.6	4.1	2.5	2.5	3.2	3.5
CPI, % avg	4.8	5.9	-0.7	3.3	5.4	2.6	2.6	2.6	3.2
Nominal wages, % yoy	18.5	16.9	11.6	13.3	14.4	11.9	9.6	9.2	9.4
Credit extension to private sector, % yoy	19.3	14.0	33.2	20.3	15.1	15.6	14.1	13.5	13.1
Policy interest rate, % eop	4.14	2.25	2.25	2.75	3.50	3.00	3.00	3.00	3.00
Short-term market rate, % eop	3.61	1.23	1.79	6.17	6.00	4.90	5.91	5.13	5.13
Long term yield, % eop	4.19	1.80	3.06	3.61	3.27	3.33	4.49	4.33	4.33
lc/US$, eop	7.30	6.82	6.83	6.59	6.29	6.23	6.05	6.12	6.02
lc/US$, avg	7.61	6.95	6.83	6.77	6.46	6.31	6.15	6.21	6.05
Balance of Payments, US$ bn									
Current account	353.2	420.6	243.3	237.8	136.1	215.4	182.8	201.3	168.8
% of GDP	10.1	9.3	4.8	4.0	1.9	2.6	2.0	2.0	1.5
Trade balance	264.3	298.1	195.7	181.5	154.9	230.3	259.2	291.4	298.4
Exports	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.7	2,209.5	2,328.7	2,484.1
Imports	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,818.4	1,950.3	2,037.3	2,185.7
Service balance	-7.9	-11.8	-29.4	-31.2	-61.6	-89.7	-124.5	-137.0	-150.7
Income balance	8.0	28.6	-8.5	-25.9	-70.3	-19.9	-43.8	-13.6	-19.2
FDI, net	139.1	114.8	87.2	185.7	231.7	176.3	185.0	170.3	118.1
International reserves	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,821.3	4,084.1	4,292.5
Total Amortisations	20.3	23.3	34.2	27.2	33.2	33.0	39.2	41.2	45.3
Public Finances, % of GDP									
Consolidated government balance	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-1.9	-2.1	-2.0
Consolidated gov primary balance	1.0	0.1	-1.8	-1.7	-0.9	-1.5	-1.4	-1.6	-1.5
Public debt	39.0	37.4	47.8	49.2	44.3	53.5	53.7	54.0	53.4
of which Domestic	38.0	36.6	47.0	48.6	43.7	53.1	53.3	53.6	53.0
Foreign Assets & Liabilities, US$ bn									
External debt	389.2	390.2	428.6	548.9	695.0	737.0	863.2	949.5	1,044.4
Private	354.3	356.9	391.8	510.1	657.6	700.4	828.8	911.7	1,002.9
Public	34.9	33.3	36.9	38.8	37.4	36.6	34.3	37.8	41.5
External debt / GDP	11.1	8.6	8.5	9.3	9.5	8.9	9.3	9.4	9.3
External debt / XGS	29.0	24.7	32.2	31.5	33.4	32.8	35.6	37.1	38.3
Short-term debt	235.7	226.3	259.3	375.7	500.9	540.9	676.6	744.3	818.7
Short-term debt/International Reserves (%)	15.4	11.6	10.8	13.2	15.7	16.3	17.7	18.2	19.1

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	7.7	7.4	7.0	7.1	7.4	7.4	7.2	6.8	6.7
CPI, % yoy	2.5	2.4	2.6	2.5	3.2	3.2	2.9	3.0	3.5
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Short-term market rate, % eop	5.91	4.62	4.80	4.96	5.13	5.29	5.45	5.61	5.91
Long term yield, % eop	4.49	4.21	4.25	4.29	4.33	4.37	4.41	4.45	4.49
lc vs USD, eop	6.05	6.22	6.29	6.20	6.12	6.07	6.06	6.04	6.02

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

Hong Kong

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- **Summary view** – We think 2Q GDP could still see some headwinds, but is likely to turn better in 2H14E. Recent minor housing regulation adjustments do not change overall property tightening policy stance. Mild disinflation likely forming a trend, despite food prices. Political debate on election process took a new turn.
- **Things to watch** – 1) Lingering liquidity concerns on taper and China's credit tightening; 2) Sustainability of trade recovery; 3) Property market adjustment; 4) Tourist shopping trends (volume vs. value/pax); 5) Political debate on electoral reforms; 6) Measures to enhance cooperation with Qianhai and Shanghai FTZ.
- **Strategy** – EFN yields are likely to continue to trend up with US yields as the Fed normalizes policies. Our equity strategist's HSI target for 2014 year-end is 25,000, as few catalysts for a re-rating are visible. Citi's house view is that home prices will drop 10% in 2014E.

Lingering macro uncertainties in 2Q

We lowered our 2014 GDP forecast to 3.2%YoY on disappointing 1Q real GDP. HK only grew 2.5%YoY in 1Q on slower-than-expected private consumption and weak trade contribution. On a seasonally adjusted basis, 1Q grew only 0.2% qoq, from 4Q's 0.9% qoq. As a result of this unexpected dip in 1Q, we nudge down our full-year forecast by 0.2ppt to 3.2%YoY.

We expect economic momentum in 2Q, albeit in recovery mode, but pace could still see some headwinds externally and domestically; our new forecast is at 2.9%YoY. Although overall exports improved in March to 3.4%YoY from Jan-Feb's average of -0.8%YoY; the impacts of the China slowdown was clearly observed as exports to China fell 2.3%YoY, while developed markets appear to be rebounding at double-digit growth. We therefore expect another small drag in net exports contribution in 2Q, as ongoing China slowdown worries likely will offset in part recovery expected in the US/Europe/Japan.

Domestic demand is also indirectly affected by China slowdown. We think consumption trends will remain unexciting in 2Q, given China and geopolitical news will dominate headlines, which in turn will make financial market volatility inevitable in the near term and thus affecting wealth effect. Moreover, recent slowing in retail sales could become a trend (Mar retail sales unexpectedly declined 1.3%YoY (value) and 2.3% (volume)). We think the tourist spending trend may be turning away from high-end purchases, as affected by the slowing China economy and anti-corruption drive, but more toward middle-to-low end spending, given that many tourists nowadays do not stay overnight and are affected by the ongoing anti-corruption campaign in China. We are also less hopeful of significant improvements in April or China's golden week holiday in May. This trend deserves monitoring as it would have implications on the labor market and rent price (especially for the numerous high-end retail stores on the street, although many of these luxury chain stores remain cash rich), which in turn will affect local spending.

Investment plans also will be affected by China headline risks. The support from ongoing large-scale public infrastructure projects to GFCF is expected to continue, but China reform/deleveraging risks likely weighed and will continue to prompt businesses to defer machinery and equipment acquisitions beyond 2Q. Understandably, a bigger swing factor could be how China risks will take a toll on HK's property prices. If China risks significantly deteriorate investor sentiment in the physical asset market, then private housing developments would also be delayed.

Recent property policy adjustments are only technical. On 13th May, the government (1) relaxed the six-month timeline of the Double Stamp Duty (DSD) refund, which a HK permanent resident can now effectively benefit from an extra 30-45 days with the bill adjusted to commence from the conveyance on sale instead of the agreement for sale and purchase of the newly acquired property; (2) exempted stamp duty of purchasing one car parking space that is together acquired with the residential property. We consider these minor policy adjustments are driven by practicality rather than a change of policy stance. Our property analyst, Ken Yeung, believes that these relaxations will help attract home upgraders to primary launches and further stabilize prices (see *Hong Kong Property: Developers the Beneficiaries of DSD Relaxation*). We think overall demand controls (except these technical adjustments) will remain largely in place as overall property prices of the mass market only softened by 4.1%YoY since its latest peak seen in Feb13. The ultimate goal for policymakers is to create more supply ASAP via building both public and private housing.

Leading indicators appear to indicate near-term pressure points too: April Markit PMI dipped into contraction zone of 49.7, and in particular new orders from Mainland China were particularly weak. Business tendency survey for 2Q showed mixed profiles among industries, with trade, logistics, retail, accommodation and food services deteriorating or still in contraction mode, but expectations for financial and insurance sector, and information/communications doing slightly better.

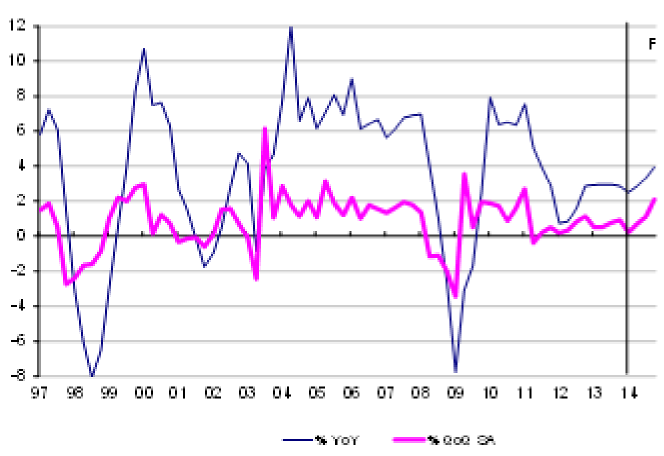
Potential lifting of daily RMB conversion cap soon

Personal RMB convertible quota need to be raised or removed to facilitate retail participation in the Shanghai-HK Stock Connect program. HKMA Chief Norman Chan was quoted in the news that HKMA on 6 May is seeking PBOC's approval to remove daily conversion quota before the pilot Shanghai-HK Stock Connect becomes effective in Oct14. The pilot scheme requires cross-exchange securities purchase to be settled in RMB only, as northbound investors (i.e., HK/overseas investors trading Shanghai Stock Exchange's securities) will need to first obtain sufficient RMB prior to transaction. Retail clients currently are subjected to a maximum RMB20,000 per daily conversion limit, while institution clients can access the accumulated CNH deposit pool in HK (which size is RMB944.9bn as of Mar14). Therefore an enlargement or removal of the personal conversion quota would make it easier for retail participants to access the pilot program.

Election reform update

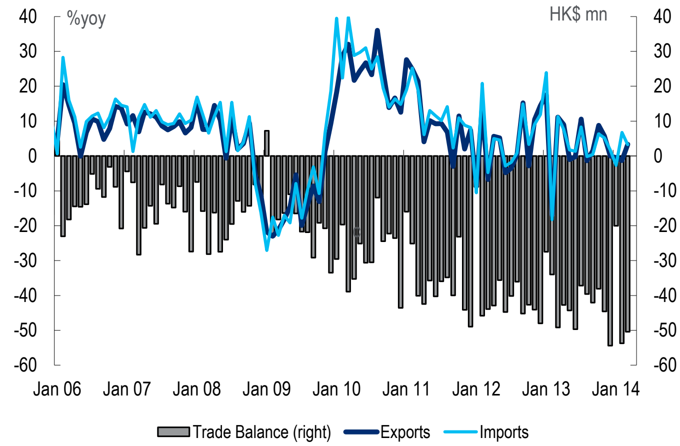
Political noise will further escalate. According to the Chief Executive, the government has received over 130,000 submissions of diverse views during phase I of the constitutional reform consultation. A comprehensive report will be compiled and submitted to the central government and a phase II consultation will be launched in 4Q. However, shortly after the end of phase I consultation, the government has indicated that civil or party nomination mechanism for the 2017 Chief Executive will likely be excluded from future political consultation. Activist group Occupy Central will be hosting a public referendum on June 22 on three pre-elected electoral procedures for the 2017 elections, all of which included the element of civic nomination. Although there are criticisms raised against the legitimacy of this vote, the voting turnout and actual results will be closely watched as the referendum is supposed to legitimize the act of occupying the streets of Central, despite high profile warnings by China and HKSAR governments that the act is illegal.

Figure 47. 1Q14 GDP dips, expect gradual recovery in 2Q



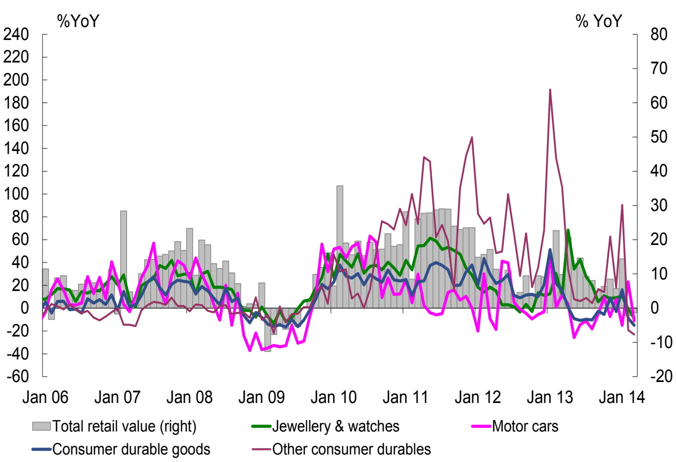
Source: CEIC, Citi Research

Figure 48. Trade recovery still rather weak



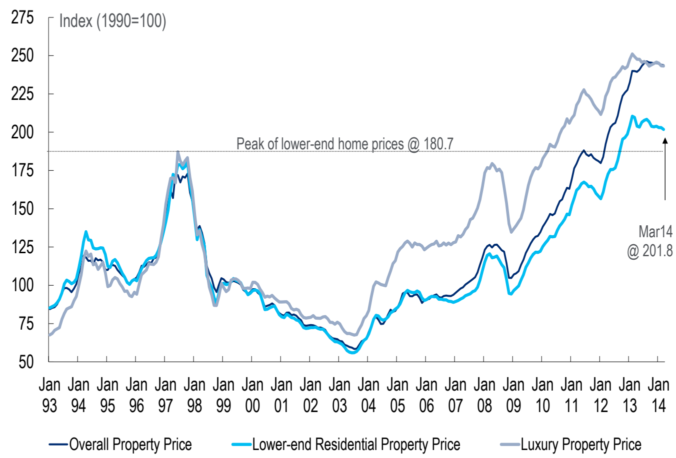
Source: CEIC, Citi Research

Figure 49. Retail sales slowdown may become trend



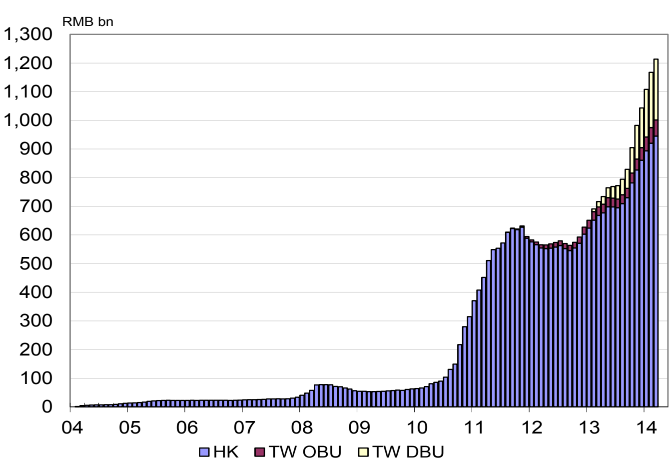
Source: CEIC, Citi Research

Figure 50. Price softening insufficient for bold property policy easing



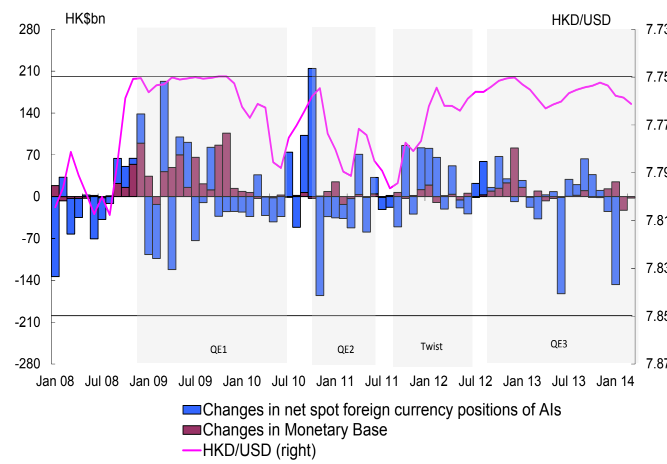
Source: CEIC, Citi Research

Figure 51. Offshore RMB Deposits in HK+TW to stay abundant



Source: CEIC, Citi Research

Figure 52. Net outflows recorded in Jan14; HKD easing from strong end



Source: CEIC, Citi Research
Note: Net FC positions data not available for Feb-Mar14 yet

Figure 53. Hong Kong Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	211.6	219.3	214.1	228.7	248.5	262.6	274.0	285.2	301.4
Nominal GDP, local currency bn	1,651	1,707	1,659	1,776	1,934	2,037	2,125	2,213	2,338
GDP per capita, US$	30,495	31,491	30,595	32,424	34,941	36,587	37,953	39,390	41,503
Population, mn	6.9	7.0	7.0	7.1	7.1	7.2	7.2	7.2	7.3
Unemployment, % of labour force	4.0	3.5	5.3	4.3	3.4	3.3	3.4	3.1	3.1
Economic Activity									
Real GDP, % yoy	6.5	2.1	-2.5	6.8	4.8	1.5	2.9	3.2	3.6
Real investment growth % yoy	7.9	-0.3	1.0	11.1	2.3	3.5	3.7	4.6	2.7
Real consumption growth % yoy	7.9	1.9	0.5	5.8	7.6	4.0	4.0	2.0	2.3
private consumption growth % yoy	8.6	1.9	0.2	6.1	8.4	4.1	4.2	2.1	2.4
Real export growth, % yoy	8.3	2.5	-10.0	16.8	3.9	1.9	6.5	4.1	6.3
Real import growth, % yoy	9.1	2.2	-9.0	17.4	4.6	2.9	6.9	3.9	5.7
Prices, Money & Credit									
CPI, % yoy	3.8	2.1	1.5	2.9	5.7	3.8	4.3	3.4	3.4
CPI, % avg	2.0	4.3	0.6	2.3	5.3	4.1	4.3	3.9	3.7
Nominal wages, % yoy	2.4	4.0	-1.9	2.4	9.9	4.7	4.9	4.5	4.5
Credit extension to private sector, % yoy	15.2	11.0	-2.1	20.9	12.5	7.0	10.6	11.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	3.45	0.95	0.14	0.28	0.38	0.40	0.38	0.55	1.30
Long term yield, % eop	3.10	1.19	1.93	1.76	0.96	0.32	1.40	2.10	2.90
lc/US$, eop	7.80	7.75	7.75	7.77	7.77	7.75	7.75	7.76	7.75
lc/US$, avg	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.76	7.76
Balance of Payments, US$ bn									
Current account	27.6	32.9	21.2	16.0	13.8	4.1	5.6	8.1	9.6
% of GDP	13.0	15.0	9.9	7.0	5.6	1.6	2.1	2.8	3.2
Trade balance	-23.1	-25.8	-28.8	-43.0	-54.9	-61.6	-64.6	-65.0	-66.7
Exports	344.5	362.7	318.5	390.2	428.7	442.8	458.9	483.7	515.7
Imports	367.6	388.6	347.3	433.1	483.6	504.3	523.5	548.7	582.4
Service balance	-4.3	-2.7	3.6	10.1	17.0	21.9	29.1	29.7	30.3
Income balance	6.8	12.9	6.4	4.8	6.8	3.8	5.4	7.0	7.0
FDI, net	-19.0	-8.9	-6.4	-10.5	-8.7	-11.2	-10.9	-11.0	-12.0
International reserves	152.6	182.5	255.7	268.6	285.3	317.2	311.1	335.0	360.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	7.3	0.0	1.5	4.1	3.8	3.1	1.0	1.3	0.7
Consolidated gov primary balance	7.4	0.0	1.6	4.2	3.8	3.2	1.1	1.3	0.8
Public debt	1.2	1.0	0.7	0.6	0.6	0.5	0.6	1.0	1.4
of which Domestic	0.4	0.2	0.1	0.0	0.0	0.0	0.1	0.1	0.1
Foreign Assets & Liabilities, US$ bn									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.9	2.5	2.9	3.3	3.9	3.1	3.6	3.9	3.8
CPI, % yoy	4.3	3.9	3.8	6.1	3.4	4.0	3.5	3.4	3.4
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.38	0.38	0.40	0.45	0.50	0.60	0.80	1.00	1.20
Long term yield, % eop	1.39	1.45	1.40	1.60	2.00	2.20	2.40	2.60	2.90
lc vs USD, eop	7.75	7.76	7.76	7.76	7.76	7.76	7.76	7.76	7.75

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

India

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- **Summary view** – India's election result is unanimously seen as positive (*Big Win, Big Possibilities*). The BJP's clear majority implies a stable/decisive govt that now needs to deliver. We believe the economy's revival will be investment-led but gradual with GDP at 5.6% in FY15 and picking up to 6.5% in FY16.

- **Things to watch** – The new government's pace of policy implementation and effectiveness in removing supply-side bottlenecks will be under scrutiny. The upcoming ministerial appointments are also crucial, particularly that of Finance Minister. We also await the new government's budget, expected in early July.

- **Strategy** –Given BJP's focus on manufacturing, but supportive capital flows, we expect INR to trade close to its equilibrium value in the Rs59-62 band. A positive INR bias, political will to contain food inflation and a focused monetary policy, could see 10-year bond yields trending toward 8.5% in the next 3 to 6 months.

Election results: big win with big possibilities

BJP Sweeps General Election: The BJP beat expectations by gaining "absolute majority" (282 seats of a total of 543) in the 2014 general elections. This is the largest majority for a single party in 30 years, giving the government significant legislative firepower and no excuses. The mandate is both clear and complete. This suggests the government will need to deliver, and deliver fast

The New Government can deliver, but there are some risks: The change in government is significant, and we believe it can deliver given its emphasis on the economy and decisive governing structure. While this could bode well for the macro, there are some risks:(1) El Nino, (2) Global risk environment, (3) high inflation environment, tight monetary/ fiscal policy and (4) political factors like ministerial appointments and minority status in the upper house.

Real economy: gradual, investment-led recovery in FY16

Maintain 5.6% GDP growth in FY15, FY16 GDP revised up to 6.5%: While the new political formation is likely to set the wheel in motion immediately, effects on the economy will be lagged and a full-fledged recovery will be realized only in FY16/17E as (1) governance and institutional reforms will start reflecting in the numbers with a lag, (2) high inflation and interest rates could impede growth in the short term. Consequently, whilst retaining our FY15 GDP estimate of 5.6%, we revise up our FY16 GDP growth estimate to 6.5% on an accelerated pick-up in investments

'Unlocking' Investments is the key to Higher Growth: A sustainable recovery would only be possible by addressing issues on the investment and infrastructure front. Given the overwhelming mandate, there is now more than ever a need to bring project execution/implementation back in focus. The pick-up in growth will be a function of (1) pace of policy de-bottlenecking, (2) investment appetite of the corporate sector and (3) extent of the government's own role in capital formation. Furthermore, in order to ensure that a pick-up in investments is financed largely by domestic savings, the next step should be to revive domestic financial savings that offer competitive real return.

Inflation edges up: govt. to focus on structural issues

CPI Inflation to come off with a lag – Headline CPI inflation edged higher to 8.6% in April while core CPI inflation remained unchanged at 7.8%. "Price rise" has been identified as one of the foremost agenda topics in BJP's manifesto. Accordingly, we expect the government to take appropriate measures such as offloading excess food stocks, calibrating MSP with market prices, reducing suppressed inflation in administered fuel, etc., to achieve stable price dynamics. Overall, we maintain our view of CPI averaging 8% in FY15 vs. 9.5% in FY14, but we revise down our FY16 inflation estimate to 6.5% on the renewed political will of the government.

Maintain view of Extended Pause: As regards monetary policy, we maintain our view of an extended pause on rates through 2014 as CPI inflation roughly meets RBI's target of 8% by Jan'15 and 6% by Jan'16. In the event that the new government takes definite measures to reduce food inflation, the space could open up for an easing of policy rates in 2015. **In the near term,** however, risks on inflation are balanced including an upside that could come from occurrence of El Nino. Note that the central bank can achieve a higher effective operating rate by keeping liquidity tight, e.g., overnight rates have been close to 50bps higher than repo since Nov 2013.

Fiscal indicators: Watch out for quality of deficit

Consolidation to Continue, Quality will be Key. India's fiscal deficit seems to be going in the right direction with the outgoing government achieving more than 1% reduction in fiscal deficit in the last two years. The new government is expected to maintain the trends of fiscal consolidation and simultaneously aim to improve the quality of fiscal spending. While the BJP manifesto is silent on subsidies, the broad expectation is of rationalization of subsidies and directing the expenditure toward social infrastructure and other productive sectors.

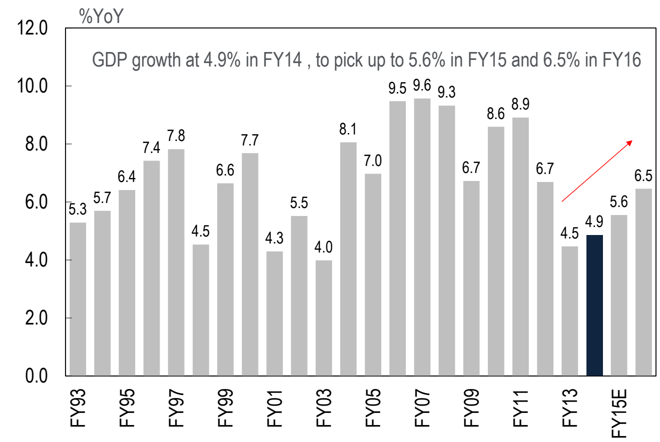
Sovereign rating downgrade risk to recede: Political stability at the center and a gradual revival will provide necessary fillip to the credit profile of the sovereign (S&P ratings: BBB-, negative outlook). In contrast, as the economy gathers momentum, the rating agencies may consider revising the outlook to stable from negative.

External front: INR range bound, CAD under control

Gold Import restrictions could be relaxed: Thanks to measures taken to contain imports, primarily gold, the current account deficit is expected to be within US$36bn or 2% of GDP in FY14 from US$88bn last year. As stability returns to external sector, we expect the new government to gradually relax gold import restrictions but not withdraw them completely. However, we expect higher gold imports to be largely offset by resumption of iron-ore exports as well as easing supply bottlenecks in coal production. Thus, we expect the CAD to be contained at 2.3% of GDP in FY15.

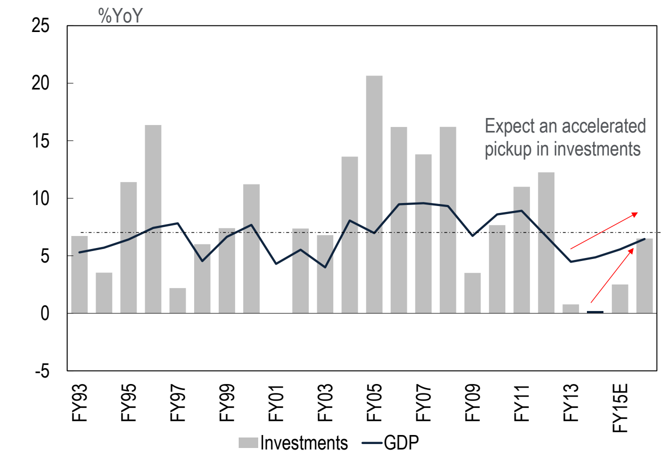
Rupee to trade with a positive bias: On back of an improved political environment and a supportive balance of payments environment, the Rupee is likely to trade with a positive bias. While the central bank has proactively intervened to prevent the Rupee from appreciating much below 60/US$ ahead of election results, the decisive election outcome could see the Rupee stabilizing in a Rs59-62 range over the next 12 months. Key to note is the need to rebuild reserves given (1) The US$ 31bn short forward position – largely a result of the FCNR deposit scheme; (2) Rise in external debt to US$426bn and (3) Volatile global risk environment.

Figure 54. Trends in annual GDP growth (%YoY)



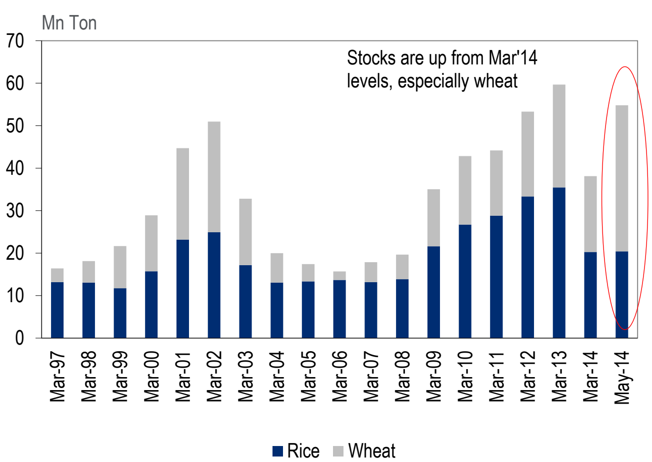
Source: CSO, Citi Research

Figure 55. Trends in investments (%YoY)



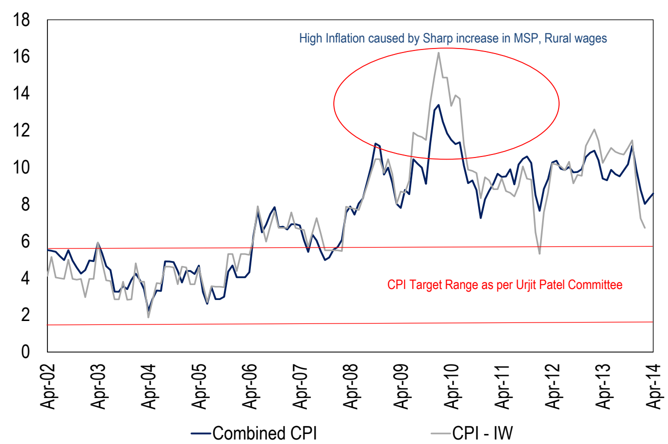
Source: CSO, Citi Research

Figure 56. Trends in foodgrain stocks (Mn T)



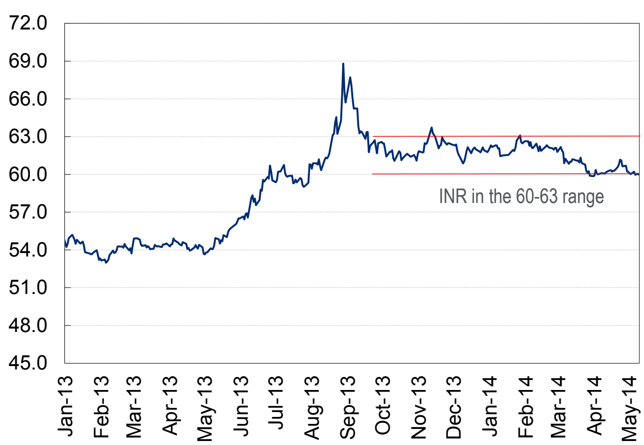
Source:FCI

Figure 57. Trends in CPI-combined and CPI-IW (%YoY)



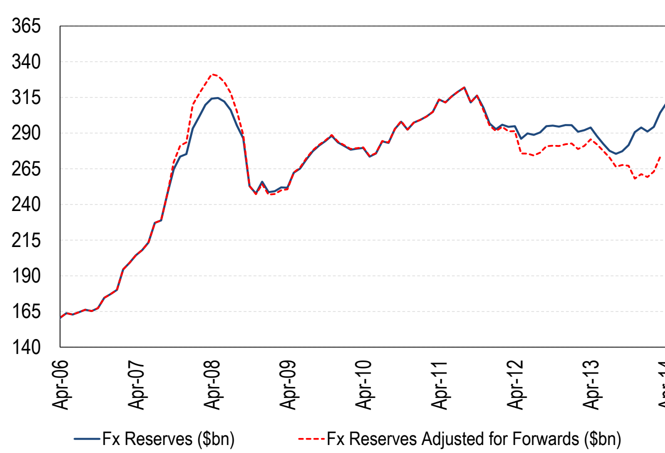
Source: RBI, CSO

Figure 58. Trends in INR / US$



Source: Bloomberg

Figure 59. FX reserves and forwards-adjusted reserves (US$bn)



Source: RBI, Citi Research

Figure 60. India Economic Indicators

	FY08	FY09	FY10	FY11	FY12	FY13	FY14F	FY15F	FY16F
Summary Data									
Nominal GDP, US$ bn	1,240.6	1,223.9	1,366.6	1,707.8	1,873.1	1,872.8	1,874.2	2,063.2	2,352.1
Nominal GDP, local currency bn	49,871	56,301	64,778	77,841	90,097	101,133	113,205	127,921	145,830
GDP per capita, US$	1,090	1,061	1,168	1,440	1,558	1,539	1,517	1,646	1,848
Population, mn	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,217.0	1,235.3	1,253.8	1,272.6
Unemployment, % of labour force	--	--	--	--	--	--	--	--	--
Economic Activity									
Real GDP, % yoy	9.3	6.7	8.6	8.9	6.7	4.5	4.9	5.6	6.5
Real investment growth % yoy	18.1	-5.2	17.3	14.1	3.9	4.9	0.0	3.4	5.6
Real consumption growth % yoy	9.4	7.7	8.4	8.2	8.9	5.2	4.4	5.6	6.8
private consumption growth % yoy	9.4	7.2	7.4	8.7	9.3	5.0	4.1	5.5	7.0
Real export growth, % yoy	5.9	14.6	-4.7	19.6	15.6	5.0	8.0	11.0	9.3
Real import growth, % yoy	10.2	22.7	-2.1	15.6	21.1	6.6	-1.6	9.5	9.0
Prices, Money & Credit									
CPI, % yoy	7.9	8.0	14.9	8.8	9.0	10.4	8.3	8.0	6.5
CPI, % avg	6.2	9.1	12.4	10.4	8.4	10.2	9.5	8.0	6.5
Nominal wages, % yoy	--	--	--	--	--	--	--	--	--
Credit extension to private sector, % yoy	23.0	19.0	16.0	17.0	17.5	17.5	17.5	17.5	17.5
Policy interest rate, % eop	7.75	5.00	5.00	6.75	8.50	7.50	8.00	8.00	8.00
Short-term market rate, % eop	8.00	5.68	4.49	9.54	10.90	8.50	8.50	8.50	8.50
Long term yield, % eop	7.96	7.01	7.83	7.99	8.56	8.00	8.50	8.50	8.50
lc/US$, eop	39.41	48.62	46.41	44.71	53.02	55.00	61.81	61.42	62.70
lc/US$, avg	41.18	43.42	48.30	45.68	46.63	53.38	58.57	60.20	62.40
Balance of Payments, US$ bn									
Current account	-15.7	-27.9	-38.2	-45.9	-78.2	-88.2	-36.8	-46.7	-58.1
% of GDP	-1.3	-2.3	-2.8	-2.7	-4.2	-4.7	-2.0	-2.3	-2.5
Trade balance	-91.5	-119.5	-118.2	-130.6	-189.8	-195.7	-148.7	-165.3	-181.8
Exports	166.2	189.0	182.4	250.5	309.8	306.6	323.4	349.3	384.3
Imports	257.6	308.5	300.6	381.1	499.5	502.2	472.1	514.6	566.1
Service balance	38.9	53.9	36.0	48.8	64.1	64.9	72.1	77.8	84.0
Income balance	-5.1	-7.1	-8.0	-17.3	-16.0	-21.5	-24.0	-24.0	-26.0
FDI, net	15.9	22.4	18.0	9.4	22.1	19.8	20.0	18.0	23.0
International reserves	299.1	241.6	252.8	273.7	260.9	264.7	278.0	294.8	314.2
Total Amortisations	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9	21.0
Public Finances, % of GDP									
Consolidated government balance	-4.0	-8.3	-9.3	-6.9	-8.1	-7.2	-6.9	-6.7	-6.5
Consolidated gov primary balance	-1.2	3.3	4.5	2.4	3.6	--	--	--	--
Public debt	76.1	76.8	75.5	70.2	69.7	69.8	69.5	68.1	66.3
of which Domestic	71.4	72.2	70.6	65.6	65.9	65.4	65.6	64.6	63.2
Foreign Assets & Liabilities, US$ bn									
External debt	224.4	224.5	260.9	317.9	360.8	404.9	426.0	441.0	456.0
Private	166.3	168.6	193.9	239.8	278.9	323.2	349.5	362.5	375.5
Public	58.1	55.9	67.1	78.1	81.9	81.7	76.4	78.4	80.4
External debt / GDP	18.1	18.3	19.1	18.6	19.3	21.6	22.7	21.4	19.4
External debt / XGS	88.5	77.7	95.2	84.7	80.7	90.1	92.3	84.4	73.6
Short-term debt	45.7	43.3	52.3	65.0	78.2	96.7	92.7	97.7	102.7
Short-term debt/International Reserves (%)	15.3	17.9	20.7	23.7	30.0	36.5	33.4	33.1	32.7

Quarterly Economic Indicators

	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	4.7	5.0	5.2	5.6	5.8	5.8	6.5	6.6	6.0
CPI, % yoy	10.4	8.4	8.5	7.5	7.0	8.5	7.9	7.0	6.4
Policy interest rate, % eop	7.75	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00
Short-term market rate, % eop	9.00	8.36	8.25	8.25	8.10	8.10	8.10	8.10	8.10
Long term yield, % eop	8.80	8.78	8.75	8.50	8.50	8.50	8.50	8.50	8.50
lc vs USD, eop	61.81	60.02	59.17	60.30	61.42	62.09	62.29	62.50	62.70

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

Indonesia

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- **Summary view** – We expect the elections to be finished in one round or July. A quick conclusion would raise the chance of a fuel price hike happening in 2H14 instead of 1Q15. This is positive, though must be weighed against the possibility of a rise in the fiscal debt issuance of up to Rp65tn (eq. US$5.7bn).

- **Things to watch** – Short term CA deficit concerns have eased as the momentum on import compression has been persistent. We think attention will start to focus on the medium term current account sustainability, which we don't think is in the bag yet. Regulatory reforms in the financial sector are also needed.

- **Strategy** – Policy rate should be remain paused although we don't rule out a 25bps increase in 4Q amid a fuel price hike. IDR may see appreciation pressure in the near term (0-3M) which should also be driven by inflows from carry trade, although we remain relatively cautious on a 6-12M horizon.

The reality of slowing growth kicks-in

Policymakers revising down their FY14 GDP growth forecasts. As GDP growth slowed to 5.2% YoY in 1Q14 from 5.7% in the previous quarter, policymakers have toned down their expectations for the full year. Bank Indonesia has lowered its FY14 mid-point growth forecast to 5.3% (at par with Citi's baseline forecast) from 5.7% previously. Meanwhile the government may also revise down its proposed growth assumption in the 2014 budget to 5.5%, from 6% previously.

The 2014 fiscal budget will be discussed with parliament in May. Officials have signaled that the deficit could reach the high end of our 2 – 2.5% GDP forecast range. This is due to bloating fuel subsidies and lower realization of oil revenues. MoF officials indicate that the increase in the debt issuance may reach up to Rp65tn (from the existing Rp357tn gross issuance target), which by our calculation could increase the targeted bond issuance in the bi-weekly auctions by up to 50% from currently around Rp8tn per auction.

Although near term CA deficit concerns have subsided, policymakers still appear cautious. The current account deficit in 1Q14 shrank further to 2.06% GDP from 2.12% in the previous quarter. However the quarterly deficit may see a hump-shaped trajectory. We expect it to rise towards 2.8% GDP in 2Q amid seasonally high imports in the run up to the Ramadan fasting month and travel season. There are also seasonal dividend repatriations peaking in May and June. We sense BI is still in a cautious mood and do not expect them to turn dovish anytime soon.

Fuel price hike possible in 2H14 instead of 1Q15

We have moved our baseline forecast for the next fuel price hike to 2H14 from previously 1Q15. Presidential candidate Joko Widodo has said that he plans to abolish the fuel subsidies in 4 years if he were elected president. The complementing programs that usually accompany a fuel price hike (e.g. compensatory social spending) are also being proposed in the forthcoming 2014 budget revision. This should pave the way for any new government to move quickly on the subsidies in order to ease the burden on the budget. Furthermore with the elections looking likely to finish in one round (Jul) instead of two (Sep), the incoming president should have time to prepare and hit the ground running after the 20-Oct inauguration.

Raising our YE14 inflation forecast to 7.3% from 5.3% previously. For a given magnitude fuel price hike, we think the inflation impact will not be as high as in 2013. Under the 2012 CPI base year, the weights on fuel and food are lower vs. in the previous CPI (base 2007). As the fuel price hike may improve the medium term sustainability of the current account, higher short term inflation should not be taken too negatively by the bond markets, Market participants also have seen that the inflation impact of the price hike in Jun-13 was one off and did subside after several months.

We do not think that a fuel price hike warrants further tightening, but do not rule out a 25bps rate hike to anchor inflation expectations. On the IDR, Citi believes that the IDR may see appreciation pressure in the near term (0-3M). We believe the catalyst would be inflows from carry trade and also a quick win in the elections. However we remain relatively cautious on a 6-12M horizon given expectations of rising UST yields and also medium term questions on Indonesia's current account outlook.

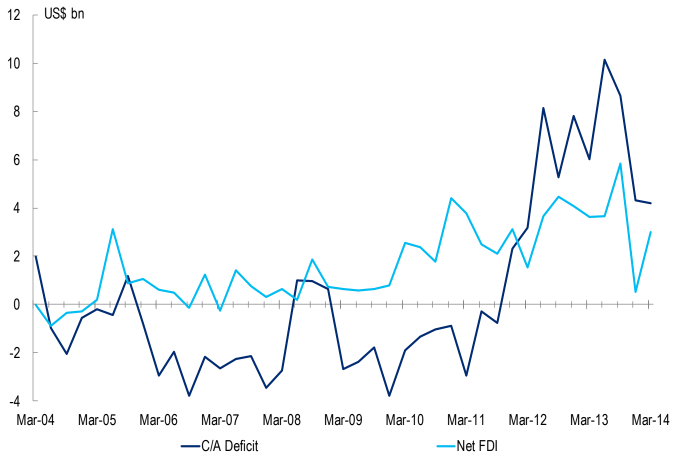
Medium-term outlook in the spotlight

Although we think the CA deficit may have reached sustainable levels in the short term, its medium term sustainability still needs to be chased after. Our concerns relate to the factors driving the narrowing of the CA deficit (the savings – investment gap). Indonesia's savings-investment gap has indeed narrowed, but this was due to a collapse in the investment ratio as opposed to a rise in the savings ratio. The CA deficit improvement would have been of better quality had it been driven by a rising savings rate (i.e. due to consumption growth slowing). With the current account deficit still at 2% of GDP at a time when investment growth is suppressed, we think there is risk that it may resurge towards elevated levels when the investment cycle peaks again towards 2016, if not 2015.

The era of excess liquidity also appears to be reaching the end of the road. Apart from the structural current account deficit, we also think that the depletion of excess liquidity in the banking system would be a key determinant of the medium term macro and policy outlook. The balance of liquidity absorbed through BI's open market operations has come down towards pre-1998 levels, while average bank loan to deposit ratios (LDR) crawl towards 95%. With the current account in structural deficit, money supply growth may no longer see a strong push from rising foreign assets. We think the average rate of loans growth in Indonesia will head south towards a new normal.

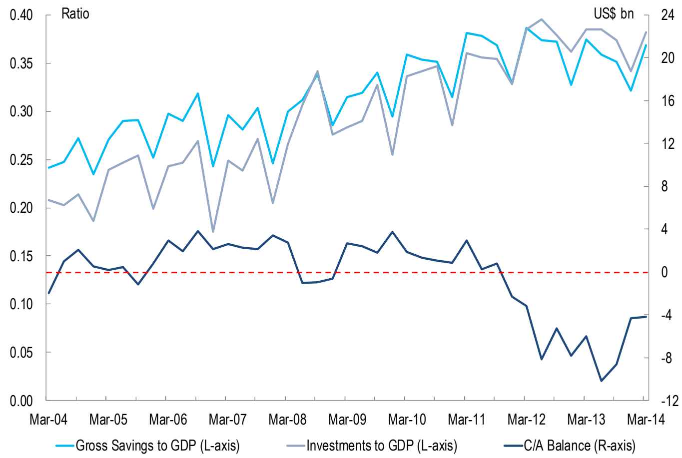
Business as usual, not an option. Under the backdrop of structural CA deficit and no longer abundant with liquidity in the banking sector, we believe Indonesia undoubtedly needs to fine-tune its growth model towards a more outward-looking one in order to avoid a downgrade in its medium-term growth prospects. The financial sector too must be adapted to the new realities. We think that a review of regulatory regimes is forthcoming, especially those related to 1) restrictions on non-resident deposit holdings; 2) regulatory thresholds on bank LDRs; and 3) hedging of currency risk. With bank margins being compressed and lower tier banks seeing a tougher operating environment, we also think that policymakers may become more accommodative towards banking sector consolidation. Monetary policy may also see a change in paradigm as BI may have to play a more central role in extending liquidity and expanding base money; e.g. through its repo facility.

Figure 61. CA deficit more sustainable? Basic balance narrows



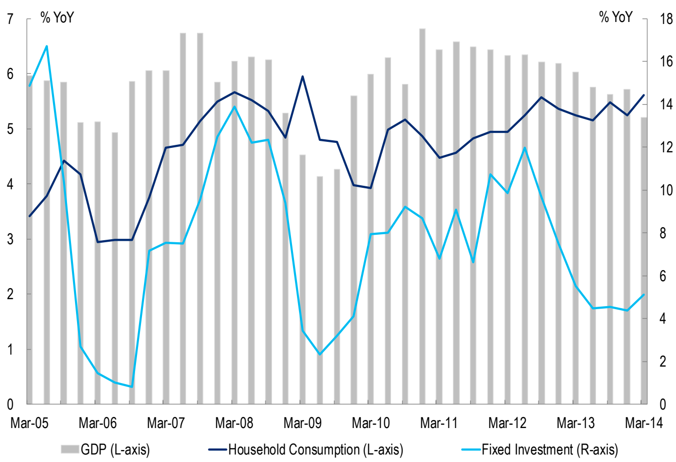
Source: CEIC, Citi Research

Figure 62. But CA deficit improvement not due to rising savings rate



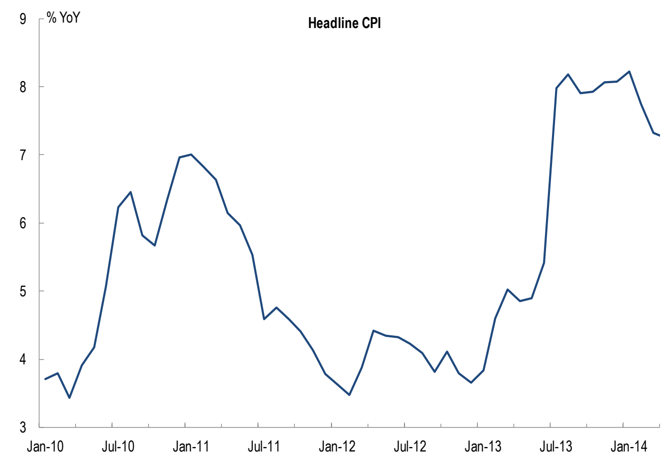
Source: CEIC, Citi Research

Figure 63. Reality of slower growth kicking in



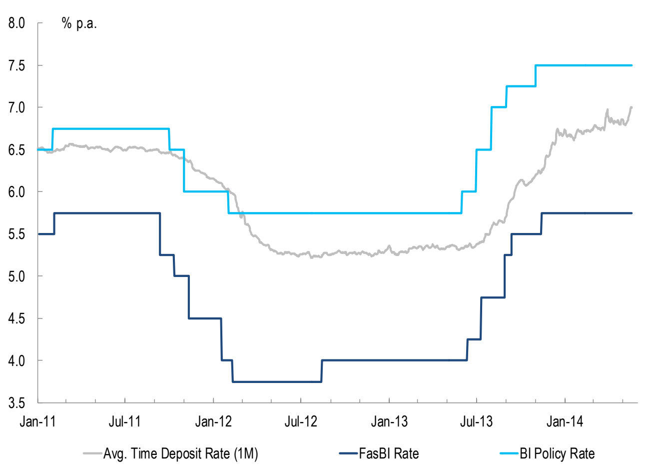
Source: CEIC, Citi Research

Figure 64. YE14 CPI inflation may stick at 7% figure if fuel prices hiked



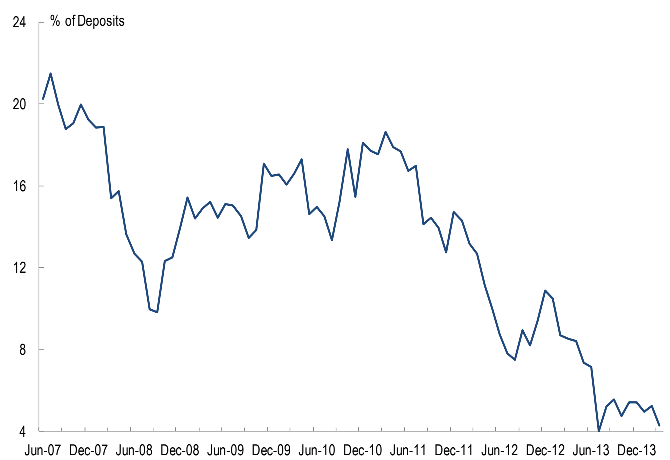
Source: CEIC, Citi Research

Figure 65. TD rates still see upward push though policy rate unmoved



Source: CEIC, Citi Research

Figure 66. The excess liquidity era reaching the end of the road



Source: CEIC, Citi Research

Figure 67. Indonesia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	432.2	510.7	538.6	709.5	845.4	876.9	868.5	863.8	932.6
Nominal GDP, local currency bn	3,950,893	4,948,688	5,606,203	6,446,852	7,419,187	8,229,439	9,083,972	10,035,224	11,173,188
GDP per capita, US$	1,915	2,235	2,328	2,986	3,484	3,591	3,510	3,464	3,695
Population, mn	225.6	228.5	231.4	237.6	242.6	244.2	247.4	249.4	252.4
Unemployment, % of labour force	9.1	8.4	7.9	7.1	6.6	5.8	5.8	6.5	6.3
Economic Activity									
Real GDP, % yoy	6.3	6.0	4.6	6.2	6.5	6.3	5.8	5.3	5.5
Real investment growth % yoy	1.9	12.4	2.4	8.8	10.1	16.3	4.9	4.7	6.0
Real consumption growth % yoy	4.9	5.9	6.2	4.1	4.5	4.8	5.2	4.7	3.9
private consumption growth % yoy	5.0	5.3	4.9	4.7	4.7	5.3	5.3	5.1	4.4
Real export growth, % yoy	8.5	9.5	-9.7	15.3	13.6	2.0	5.3	1.1	5.7
Real import growth, % yoy	9.1	10.0	-15.0	17.3	13.3	6.7	1.2	-1.4	3.1
Prices, Money & Credit									
CPI, % yoy	5.8	11.1	2.8	7.0	3.8	3.7	8.1	7.3	4.3
CPI, % avg	6.3	9.9	4.8	5.1	5.3	4.0	6.4	6.5	6.7
Nominal wages, % yoy	4.9	7.6	5.3	12.2	3.4	20.4	11.5	17.1	15.0
Credit extension to private sector, % yoy	22.4	30.7	18.0	20.6	25.9	22.1	18.0	16.0	17.0
Policy interest rate, % eop	3.00	8.75	6.00	5.50	4.50	4.00	5.75	6.00	6.00
Short-term market rate, % eop	3.35	9.44	6.39	5.66	4.57	4.24	6.01	6.00	6.90
Long term yield, % eop	10.02	11.92	10.07	7.83	6.05	5.39	8.60	8.50	8.70
lc/US$, eop	9,393	10,900	9,425	9,010	9,068	9,638	12,170	11,966	11,890
lc/US$, avg	9,140	9,673	10,376	9,078	8,763	9,361	10,449	11,617	11,981
Balance of Payments, US$ bn									
Current account	10.5	0.1	10.6	5.1	1.7	-24.4	-28.5	-20.9	-19.3
% of GDP	2.4	0.0	2.0	0.7	0.2	-2.8	-3.3	-2.4	-2.1
Trade balance	32.8	22.9	30.9	30.6	34.8	8.6	6.2	11.0	13.3
Exports	118.0	139.6	119.6	158.1	200.8	188.5	183.5	190.6	201.9
Imports	85.3	116.7	88.7	127.4	166.0	179.9	177.4	179.6	188.6
Service balance	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-11.4	-10.7	-11.1
Income balance	-15.5	-15.2	-15.1	-20.8	-26.7	-26.8	-27.2	-25.4	-26.0
FDI, net	2.3	3.4	2.6	11.1	11.5	13.7	14.8	14.0	14.5
International reserves	56.9	51.6	66.1	96.2	110.1	112.8	99.4	107.9	113.6
Total Amortisations	18.8	16.7	20.4	24.0	25.2	29.4	41.0	42.0	42.0
Public Finances, % of GDP									
Consolidated government balance	-1.3	-0.1	-1.6	-0.7	-1.1	-1.9	-2.2	-2.3	-1.7
Consolidated gov primary balance	0.8	1.7	0.1	0.6	0.1	-0.6	-0.9	-1.0	-0.5
Public debt	34.1	29.3	31.4	26.4	23.6	23.3	23.5	26.0	25.0
of which Domestic	19.7	16.2	19.3	16.7	15.5	16.1	16.2	15.6	16.0
Foreign Assets & Liabilities, US$ bn									
External debt	141.2	155.1	172.9	202.4	225.4	252.4	264.1	280.0	302.4
Private	60.6	68.5	73.6	83.8	106.7	126.2	140.5	150.5	166.9
Public	80.6	86.6	99.3	118.6	118.6	126.1	123.5	129.5	135.5
External debt / GDP	32.7	30.4	32.1	28.5	26.7	28.8	30.4	32.4	32.4
External debt / XGS	108.2	100.1	130.2	115.8	101.8	119.3	128.1	129.9	132.7
Short-term debt	18.7	20.5	24.0	31.6	36.6	43.4	46.6	46.0	49.0
Short-term debt/International Reserves (%)	32.8	39.7	36.4	32.8	33.2	38.4	46.9	42.6	43.1

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	5.7	5.2	5.2	5.3	5.3	5.4	5.3	5.6	5.6
CPI, % yoy	8.1	7.3	6.9	4.8	7.3	7.0	7.2	7.0	4.3
Policy interest rate, % eop	5.75	5.75	5.75	5.75	6.00	6.00	6.00	6.00	6.00
Short-term market rate, % eop	6.01	5.86	5.90	6.00	6.00	6.00	6.00	6.00	6.00
Long term yield, % eop	8.60	8.21	8.25	8.40	8.50	8.60	8.70	8.70	8.70
lc vs USD, eop	12,170	11,360	11,440	11,703	11,966	12,072	12,012	11,951	11,890

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

Malaysia

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- **Summary view** – The upside surprise in 1Q GDP, including private consumption coming in above the 7% threshold, leaves little room to further delay rate hikes – more to address financial imbalances than inflation, though negative real rates after GST implementation may necessitate more hikes.

- **Things to watch** – [1] Private consumption growth; [2] improvements in external demand; [3] fuel price hikes and impact on inflation; [4] pervasiveness of inflation; [5] inflation expectations and wage growth; [6] progress on fiscal consolidation; [7] household credit growth; [8] guidance from Gov Zeti on monetary policy.

- **Strategy** – While a strong USD backdrop and heavy foreign positioning in bonds remain a headwind for MYR, this could be offset by an improving CA surplus and tightening bias in monetary policy, which may impute a bear flattening bias to the MGS curve near term.

Upside surprise in 1Q GDP growth…

1Q GDP growth surprised on the upside with acceleration to 6.2%YoY (4Q: 5.1%). Official seasonally adjusted data show 0.8%QoQ SA growth (4Q: 1.9%), or 3.3%QoQ SAAR (4Q: 7.6%). The acceleration in gross exports helped net export contribution turn positive even as the drag from inventories widened. Meanwhile domestic demand surprisingly accelerated, boosted by public consumption which surged 23.2%QoQ SAAR (4Q: -3.4%) due to supplies and services. Private consumption growth notably remained above 7%YoY (1Q: 7.1%, 4Q: 7.4%) – against BNM's previous expectations of a moderation toward its long-term average of 6.6% – with a 6.8%QoQ SAAR increase (4Q: -0.8%). Fixed investments also surged 12.4%QoQ SAAR (4Q: -7%) – our estimates suggest more due to public than private investments. By sector, the sequential pick-up was led by construction (1Q: 53.5%QoQ SAAR, 4Q: 12.1%) and agriculture (1Q: 9.6%, 4Q: 5.4%).

Positive net exports were mirrored in a wider 1Q CA surplus of RM19.8bn, 7.7% of GDP (4Q: RM14.8bn, 5.6%). The improvement was led by a narrowing of the services deficit (1Q: -RM2.7bn, 4Q: -RM4.1bn) as well as the primary income deficit (1Q: -RM6.4bn, 4Q: -RM10.0bn), even as the goods surplus widened marginally to RM33.6bn (4Q: 33.3bn). Meanwhile, direct investments saw net outflows (1Q: -RM14.6bn, 4Q: RM4.0bn), reflecting a tripling of ODI while inward FDI halved. The basic balance (CA+net DI) thus saw its surplus narrow to RM5.2bn or 2% of GDP (4Q: RM18.8bn, 7.1%). Net portfolio outflows accelerated to RM13.4bn (4Q: RM769mn), though partly offset by slower net outflows in other investments – the financial account deficit thus widened to RM37.6bn (4Q: RM9.7bn).

However the external debt reclassification leaves reserve coverage less favorable vs ASEAN. The new definition includes non-resident holdings of MYR-denominated debt securities, non-resident deposits, trade credits provided by foreign trade counterparts, and other debt liabilities in line with international standards. This would result in external debt coming in at 65.2% of GDP vs 30.5% previously. BNM's calculation of reserve coverage, i.e. reserve to ST external debt ratio, comes in at just 1.3 (previous definition: 3.3), which we estimate does not fare so well on a relative basis against the rest of the ASEAN-5, though this measure does not take into account Malaysia's current account surplus. Nonetheless this is not new information – we have highlighted this in previous reports.

…leaves little room to further delay rate hikes

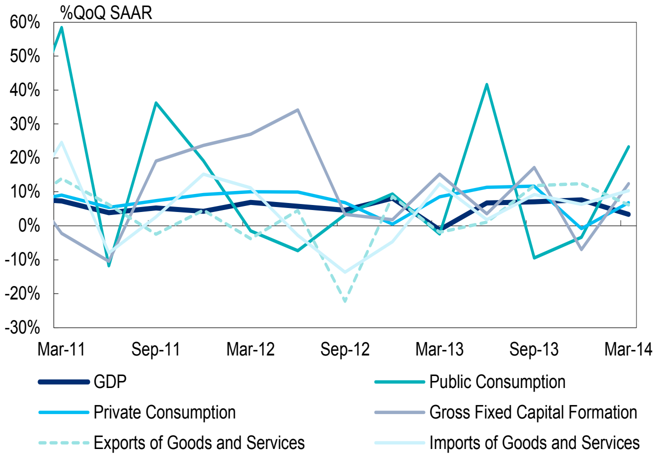
We raised our 2014 and 2015 GDP growth forecasts to 5.4% and 5.6% respectively (prev: 5%, 5%). While the Composite Leading Indicator hints at some moderation in domestic demand in subsequent quarters, some front-loading of consumer spending in late 2014/early 2015 is likely ahead of GST implementation, as the experience of Japan and Singapore suggest. Meanwhile exports could be further supported as the US shakes off the worst of the 1Q14 winter chill, even if the sensitivity of Malaysia's exports to US domestic demand has fallen, possibly reflecting the failure of tech capex to pick up thus far. Healthy G3 demand should also help support Malaysia's exports of intermediate goods to China meant ultimately to the G3 and provide a cushion against the slowdown in China.

1Q intermediate good imports point to improving manufacturing output. Despite two straight months of sequential decline, we estimate average 1Q14 seasonally-adjusted imports of intermediate goods were still 1.2% above 4Q13 levels, likely reflecting restocking by exporters catching up with improving external demand which could foreshadow further strength in exports, as was the case in 1H13. We note that the surge in manufacturing sales growth continued to outstrip IP growth into Mar, suggesting production still has not caught up with demand, with inventories consequently drawn down, reflected in the inventory drag to 1Q GDP.

With private consumption growth exceeding the 7% threshold, there is little room to further delay rate hikes. We had previously argued that with inflation still manageable for now, financial imbalances may be the larger consideration for the interest rate outlook – our conversations with policymakers suggest that while targeted macroprudential measures have tackled pockets of imbalances, an improving growth outlook could spur excessive risk taking amidst negative real interest rates – which could prompt a re-assessment of the policy rate outlook. The latest MPC statement now confirms that "there are signs of the continued build-up of financial imbalances" and that "current monetary and financial conditions could lead to a broader build up in economic and financial imbalances". With the MPC thus concluding that "the degree of monetary accommodation may need to be adjusted", we confirm our call for an initial 25bps hike in July, which could possibly follow a 20sen/litre fuel price hike, with a second 25bps hike in Sep, but do not rule out further hikes thereafter. We note that prior to the last OPR hike in May 2011, the MPC likewise signaled in the Mar-11 meeting that "the degree of monetary accommodation may be reviewed".

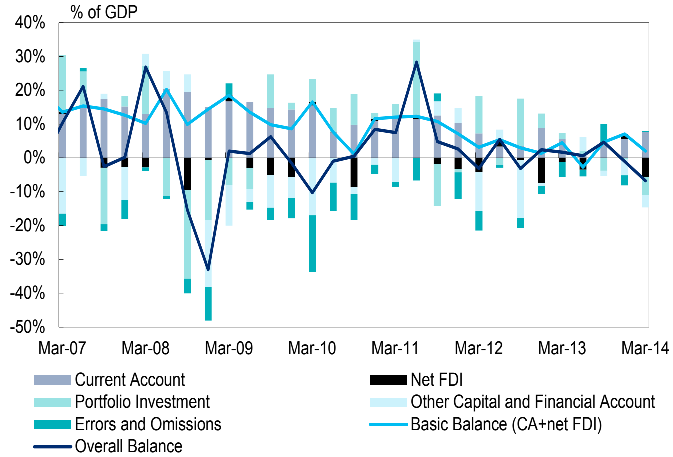
Inflation less of a concern for now – but may keep real rates in negative territory after GST. Headline inflation remained stable into Mar at 3.5%YoY, though excluding food, alcoholic beverages and tobacco, transport, and electricity, our estimate of core inflation edged up to 2.1%YoY (Feb: 2.0%). Nonetheless there are signs that inflation became less pervasive – our inflation diffusion index suggests that the share of the CPI basket seeing MoM price increases declined into Mar, while our proxy for BNM's inflation pervasiveness index indicates that a slightly smaller (unweighted) proportion of the CPI basket is now seeing above-2% inflation. But with inflation possibly climbing to 4.5% in 2015 on GST implementation and fuel price hikes amidst strong growth, the extent to which further hikes may be required to arrest the slide in real interest rates into negative territory remains to be seen.

Figure 68. Domestic demand surprisingly accelerated in 1Q14



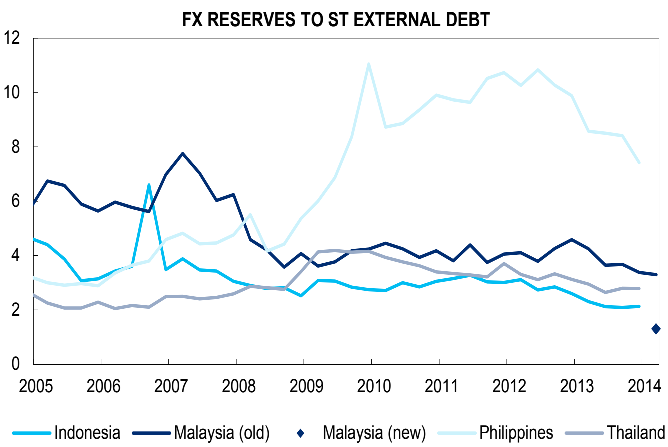
Source: CEIC, Citi Research

Figure 69. Positive net exports were mirrored in a wider 1Q CA surplus



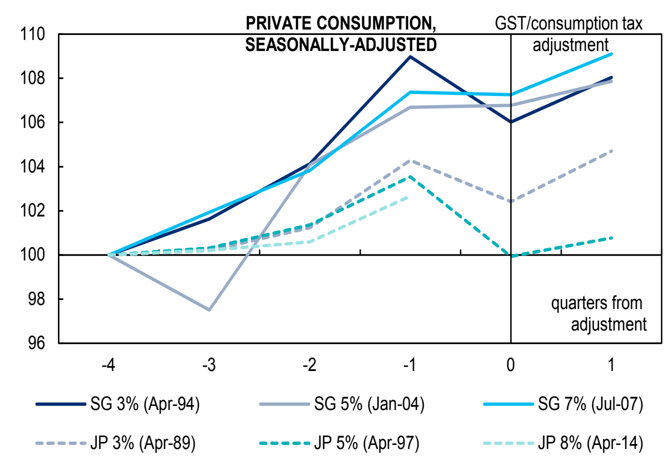
Source: CEIC, Citi Research

Figure 70. The new reserve to ST external debt ratio comes in at just 1.3



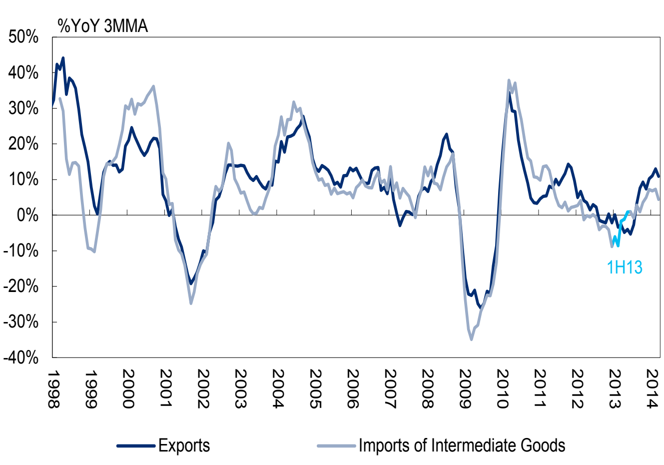
Source: CEIC, Citi Research

Figure 71. GST implementation could spur front-loaded consumption



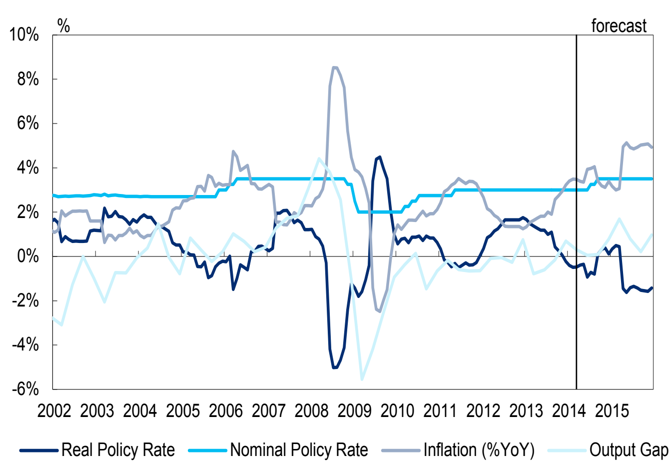
Note: We show seasonally-adj. private consumption levels indexed to 4Q before the implementation/hiking of GST (in SG) and consumption tax (JP).
Source: CEIC, Citi Research

Figure 72. Intermediate good imports point to improving mfg output



Source: CEIC, Citi Research

Figure 73. Real interest rates may turn more negative after GST



Note: Prior to April 2004, BNM used the Intervention Rate to affect the Base Lending Rate; however since Apr 2004 it has used the O/N Policy Rate.
Source: CEIC, Citi Research

Figure 74. Malaysia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	193.7	231.1	202.4	247.7	289.5	305.3	313.3	320.1	333.6
Nominal GDP, local currency bn	665	770	713	797	885	942	987	1,063	1,131
GDP per capita, US$	7,123	8,393	7,255	8,664	9,997	10,405	10,544	10,495	10,763
Population, mn	27.2	27.5	27.9	28.6	29.0	29.3	29.7	30.5	31.0
Unemployment, % of labour force	3.2	3.3	3.7	3.4	3.1	3.0	3.1	2.9	2.9
Economic Activity									
Real GDP, % yoy	6.3	4.8	-1.5	7.4	5.2	5.6	4.7	5.4	5.6
Real investment growth % yoy	9.1	1.8	-9.4	25.3	2.3	22.3	7.2	-0.9	2.7
Real consumption growth % yoy	9.7	8.4	1.4	6.2	8.6	7.1	7.3	6.4	5.6
private consumption growth % yoy	10.4	8.7	0.6	6.9	6.8	7.7	7.6	6.9	6.3
Real export growth, % yoy	3.8	1.6	-10.9	11.1	4.6	-0.1	-0.3	6.0	7.1
Real import growth, % yoy	5.9	2.3	-12.7	15.6	6.1	4.7	1.9	4.5	6.3
Prices, Money & Credit									
CPI, % yoy	2.3	4.5	1.0	2.1	3.0	1.2	3.2	3.4	4.9
CPI, % avg	2.0	5.4	0.6	1.7	3.2	1.6	2.1	3.5	4.5
Nominal wages, % yoy	4.3	4.5	2.5	8.2	3.8	6.4	7.8	5.0	5.0
Credit extension to private sector, % yoy	9.2	10.2	6.8	10.6	12.5	12.1	11.0	11.0	11.0
Policy interest rate, % eop	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50	3.50
Short-term market rate, % eop	3.61	3.37	2.17	2.98	3.22	3.21	3.32	3.80	3.80
Long term yield, % eop	3.78	3.00	3.79	3.39	3.23	3.24	3.66	4.00	4.00
lc/US$, eop	3.31	3.45	3.42	3.08	3.17	3.06	3.28	3.38	3.38
lc/US$, avg	3.44	3.33	3.52	3.22	3.06	3.09	3.15	3.32	3.39
Balance of Payments, US$ bn									
Current account	29.7	39.4	31.4	27.1	33.5	17.6	12.7	14.1	13.3
% of GDP	15.4	17.1	15.5	10.9	11.6	5.8	4.0	4.4	4.0
Trade balance	38.1	51.1	39.8	42.5	49.6	40.6	34.4	34.0	35.0
Exports	176.5	198.9	157.0	199.2	228.8	222.3	215.6	257.4	265.0
Imports	138.5	147.7	117.1	156.7	179.2	181.8	181.3	223.4	230.0
Service balance	0.4	0.5	1.2	-0.4	-2.1	-5.3	-5.3	-3.8	-3.0
Income balance	-8.7	-12.2	-9.6	-15.0	-14.0	-17.7	-16.4	-16.1	-18.7
FDI, net	-2.7	-7.8	-6.3	-4.3	-3.1	-7.9	-1.7	-3.0	-1.0
International reserves	101.3	91.5	96.7	106.5	133.6	139.7	134.9	135.0	140.0
Total Amortisations	7.8	6.3	9.8	11.3	9.0	7.4	10.0	11.0	12.0
Public Finances, % of GDP									
Consolidated government balance	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-3.9	-3.5	-3.0
Consolidated gov primary balance	-1.2	-3.0	-4.7	-3.5	-2.8	-2.4	-1.8	-1.3	-0.9
Public debt	40.1	39.8	50.8	51.1	51.5	53.3	54.7	55.0	55.0
of which Domestic	37.1	37.2	48.9	49.0	49.5	51.5	53.0	53.5	53.5
Foreign Assets & Liabilities, US$ bn									
External debt	56.2	66.6	68.3	72.6	81.5	82.8	97.9	97.0	96.0
Private	37.8	41.5	41.9	44.7	53.7	55.6	69.2	67.0	67.0
Public	18.4	25.2	26.3	27.9	27.8	27.1	28.7	30.0	29.0
External debt / GDP	29.0	28.8	33.7	29.3	28.1	27.1	31.2	30.3	28.8
External debt / XGS	27.4	29.0	36.9	31.4	30.7	31.8	38.3	32.7	31.4
Short-term debt	16.3	22.5	22.7	25.4	32.8	30.4	39.4	42.0	42.0
Short-term debt/International Reserves (%)	16.1	24.6	23.5	23.8	24.6	21.8	29.2	31.1	30.0

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	5.1	6.2	5.3	5.7	4.5	6.4	5.8	5.1	5.2
CPI, % yoy	3.2	3.5	3.9	3.4	3.4	3.1	4.9	5.0	4.9
Policy interest rate, % eop	3.00	3.00	3.00	3.50	3.50	3.50	3.50	3.50	3.50
Short-term market rate, % eop	3.32	3.33	3.31	3.80	3.80	3.80	3.80	3.80	3.80
Long term yield, % eop	3.53	3.65	3.80	3.90	4.00	4.10	4.10	4.00	4.00
lc vs USD, eop	3.28	3.26	3.31	3.34	3.38	3.40	3.39	3.39	3.38

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

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- **Summary view** – We maintain our 1Q14 GDP growth forecast of 6.8%YoY although risk to growth and inflation for duration of 2014 had been elevated by scorching weather that may preview El Niño. Non-farm output expected to drive much of growth. Upbeat credit ratings outlook enhances investment prospects.

- **Things to watch** – Moody's rating action (or inaction) in 3Q. End to bank reserve hike on the back of slower broad money gains. Whether El Niño risk is certain. Fiscal mitigation measures to address supply constraints that include rice imports and its deficit impact. When CPI would peak given rice supply constraints.

- **Strategy** – BSP's intervention down to sub-44 given an upbeat ratings cycle alongside recovery of portfolio flows. Upside food CPI risk also support BSP's preference for a firmer PHP. End of bank reserve hikes bode well for long duration. Prefer the curve's belly with the ratings upgrade and firmer PHP.

Upbeat 1Q GDP but with persistent El Niño downside risk

First quarter economic indicators support our view of 6.8%YoY GDP growth in 1Q14. OFW remittances logged US$6.1bn in 1Q for growth of 6.6%YoY. We estimate that the corresponding real peso value of these remittances grew 12.3%YoY. With this strong income capacity of remittance households to support basic and discretionary spending, first quarter consumption probably resumed its pace of 6%YoY. Car sales soaring by ~23%YoY in 1Q14 mirrored upbeat consumption and consumer sentiment as well. Meanwhile 1Q exports grew 6.5%YoY following a material correction of 2-digit export gain in Feb. Cash budget rose 12%YoY in 1Q14 with primary expenditures up 14%YoY. Upswing in 1Q fiscal spending left in its wake a strong contribution to 1Q growth. Pace of fiscal expenditures exceeded revenues (9%YoY) despite 1Q Customs revenues up 26%YoY. Between domestic demand and net trade, the former probably underpinned 1Q growth driven by onshore private and public spending.

Fiscal spending slippage in 1Q implies foregone growth opportunities. Bloomberg reported a 1Q budget deficit short of the program deficit target of Php145.8bn by Php61.7bn. 1Q revenues of Php398bn were 7% below target. Despite upbeat expenditure gains, 1Q disbursements were 16% short of the goal for a Php77bn shortfall that translates to 2.6% of our nominal 1Q GDP forecast. Whether absorptive capacity constraints are in play, underspending implies foregone growth and, as such, 1Q growth of 7% or more from fiscal lift would be difficult to realize.

Risks to growth and inflation in 2014 had been elevated by scorching weather that may be a prelude to El Niño. Water elevation in a major dam that supplies water to Metro Manila fell to less than critical level due to soaring temperatures forcing water cutoff to irrigation for 27,000 hectares of surrounding rice farm lands. Facing potential El Niño episode this year, growth should be concentrated in non-farm output driven mainly by strong internal demand and favorable exports. Infra spending, up by nearly 50% in Jan-Feb, resilient remittances, strong imports, upbeat durable goods demand, and double-digit bank loan growth are among the indicators supporting and reflecting robust domestic demand. On the back of non-farm output, our 2014 forecast of 6.9% stays. Farm output is vulnerable to weather shocks, suggesting growth in excess of 7% may be tough to beat. During the El Niño episode in 2010, water-dependent key crops, led by rice (-3%), corn (-9.6%), sugar (-21.8%), and pineapples (-1.8%) posted declines that resulted in a 2.6% drop in crop output (50% of total farm output).

Upside food price risk likely to persist

Another El Niño episode would sustain an elevated food inflation risk led by CPI rice (8.9% CPI weight). 2-digits rice inflation remained for the 4th straight month (Apr: 12.1%YoY) as lingering effects of supply constraints due to typhoons in 4Q13 and reduced rice inventory has led to material food price pressures. Our extrapolation of rice inflation easing to a high 1-digit in Sep-Oct would be at risk if El Niño, that may come in 2H14, lowers the average rainfall and cuts local food output. In 2Q10, stable CPI rice running at an average of 1.3%YoY soared to a high of more than 5%YoY in 4Q10 largely due to the El Niño impact. With prevailing CPI rice posting 2-digits, an El Niño episode in 2H14 could extend upside risk of CPI food. Not to mention the risk of supply cutback faced by other cash crops — mainly fruits & vegetables, particularly in the smaller farms heavily dependent on rains.

Rice imports would be key to stabilizing rice CPI while social spending may focus on sagging farmers' incomes. Rice imports buoyed up the national inventory up 22% to 2.18mn mtons (64-days consumption). Current rice inventory and more rice imports would be better poised to either mitigate or offset the price threat of El Nino on farm output. We believe timely rice importation of the National Food Authority (NFA) — a fiscal intervention measure that could contribute more to easing rice inflation than a strong PHP. NFA's cheap rice policy (selling imported rice below market prices) is unlikely to get a lift from a strong PHP.

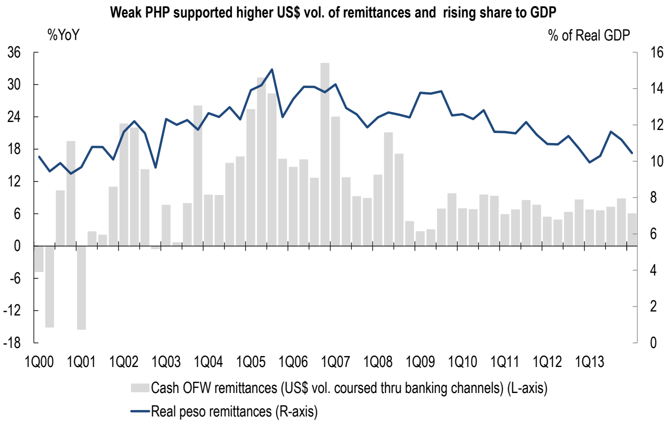
Hawkish bias still in place amid an upbeat rating cycle

No shift in the policy bias appears imminent since the focus is still on excess liquidity although strong PHP implications of an upbeat credit rating cycle may result in benign view of rate actions. The unexpected S&P ratings upgrade (BBB from BBB -) with Moody's on a positive rating outlook, would result in new country weighting adjustments in an investor's portfolio that could unleash offshore inflows into the local markets and give PHP a boost. Prior to the S&P upgrade, portfolio investments turned to net inflows of US$323mn to reverse net outflows of US$2.3bn in 1Q14. Upbeat ratings cycle and its PHP impact, the 200bp hike in bank reserves as well as the missing global episode of a strong USD conspire to favor a benign view of policy rate adjustments in 2H14. With CPI's upside risk coming from food supply shocks that may still impact inflation expectations and consumer sentiment as well as willingness to spend, the hawkish bias may not require immediate rate action. Our rate hike call of 50bp in 2H14 or 25bp hike distributed over the last two quarters would still qualify as benign adjustments although timing of the first hike seems a lot more fluid now. Another possible scenario would be to start with the SDA rate to narrow the gap with the policy rate of 3.5% later in the year while delaying policy rate adjustments to 1Q15.

Upbeat ratings cycle, duration risk and rate hike timing

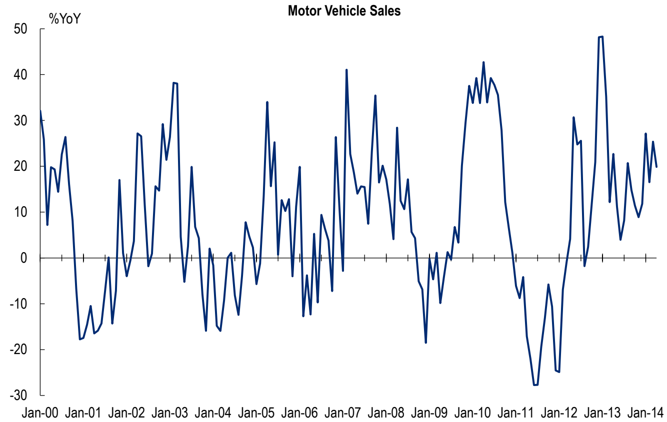
BSP's intervention in the spot market should retreat to sub-44 given an upbeat ratings cycle alongside recovery of portfolio flows positioning for strong macro readings starting with buoyant 1Q GDP. Food inflation risk could extend the run of inflation past 4% and support BSP's willingness to allow a firmer PHP without massively diluting remittance income. End of bank reserve hikes in addressing excess liquidity rather than strong PHP bode well for long duration risk exposure. We prefer the curve's belly with the ratings upgrade and firmer PHP in the near-term while a hawkish bias remains that eventually could lead to rate tightening. With the tightening bias intact, timing of the rate adjustments might be blurred by strong PHP and upside food CPI risk.

Figure 75. 2-digit gains in 1Q for real peso value of remittances



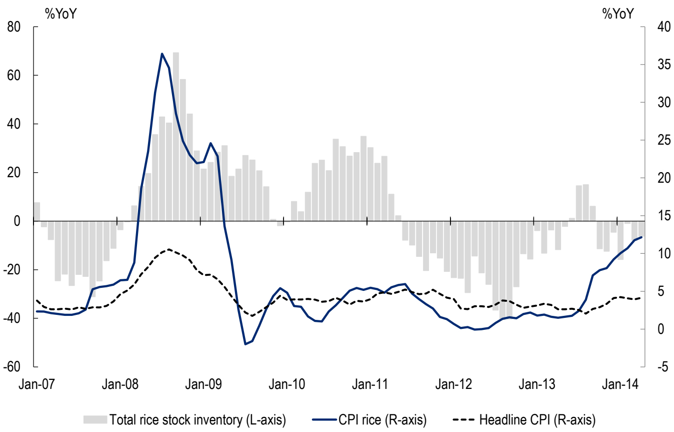
Source: CEIC, Citi Research

Figure 76. Upbeat discretionary spending boosts consumption as well



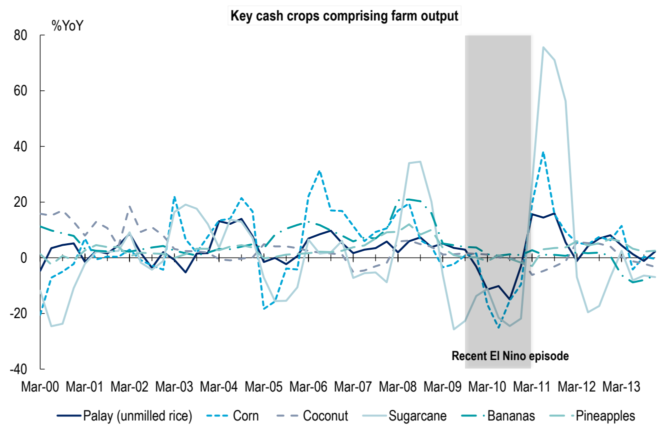
Source: CEIC, Citi Research

Figure 77. Higher rice inventory bode well for stabilizing CPI rice



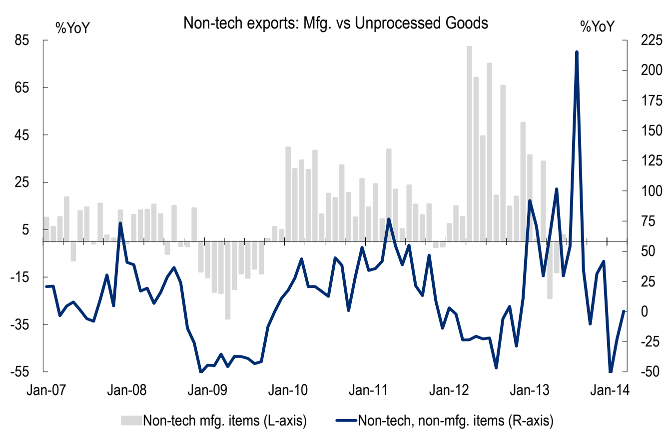
Source: CEIC, Citi Research

Figure 78. Scorching weather may be a prelude to El Niño



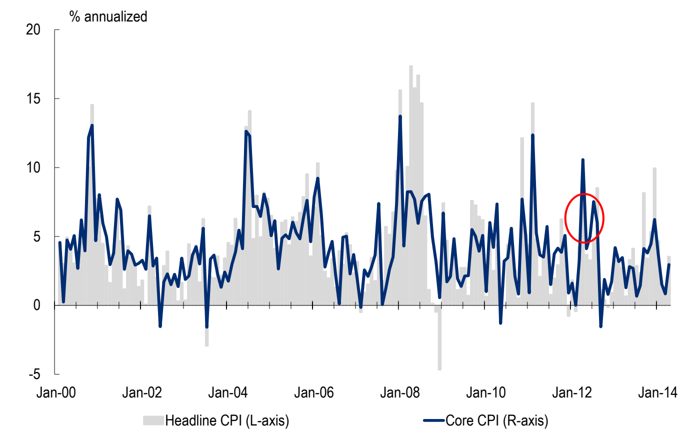
Source: CEIC, Citi Research

Figure 79. Exports of non-tech manufactures did not disappoint in Mar



Source: CEIC, Citi Research

Figure 80. Faster annualized rate of headline and core CPI in Apr



Source: CEIC, Citi Research

Figure 81. Philippines Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	150.2	173.4	168.6	200.0	224.1	250.5	271.9	287.0	348.5
Nominal GDP, local currency bn	6,893	7,721	8,026	9,003	9,706	10,565	11,546	12,849	14,205
GDP per capita, US$	1,693	1,917	1,829	2,127	2,339	2,567	2,735	2,835	3,380
Population, mn	88.7	90.5	92.2	94.0	95.8	97.6	99.4	101.2	103.1
Unemployment, % of labour force	7.3	7.4	7.5	7.3	7.0	7.0	7.1	6.8	6.5
Economic Activity									
Real GDP, % yoy	6.6	4.2	1.1	7.6	3.6	6.8	7.2	6.9	7.3
Real investment growth % yoy	-0.5	23.4	-8.7	31.6	2.0	-3.2	18.2	10.6	15.0
Real consumption growth % yoy	4.9	3.3	3.3	3.4	5.2	7.3	6.0	6.3	6.2
private consumption growth % yoy	4.6	3.7	2.3	3.4	5.7	6.6	5.6	6.0	6.2
Real export growth, % yoy	6.7	-2.7	-7.8	21.0	-2.8	8.9	0.8	5.3	3.9
Real import growth, % yoy	1.7	1.6	-8.1	22.5	-1.0	5.3	4.3	5.6	4.9
Prices, Money & Credit									
CPI, % yoy	3.9	8.0	4.3	3.6	4.2	3.0	4.1	4.2	3.8
CPI, % avg	2.8	9.3	3.2	4.1	4.7	3.2	2.9	4.1	4.0
Nominal wages, % yoy	3.4	5.5	0.0	5.8	5.4	7.0	2.2	5.0	5.0
Credit extension to private sector, % yoy	10.6	12.8	4.3	13.8	16.2	14.1	10.0	13.5	15.0
Policy interest rate, % eop	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.00	4.50
Short-term market rate, % eop	6.03	5.20	4.11	0.75	1.68	-1.38	-0.15	2.25	3.25
Long term yield, % eop	5.70	6.55	6.25	4.78	4.21	3.70	2.91	4.00	4.50
lc/US$, eop	41.23	47.47	46.50	43.65	43.84	41.06	44.39	44.81	43.60
lc/US$, avg	46.05	44.48	47.56	45.06	43.29	42.22	42.46	44.53	44.21
Balance of Payments, US$ bn									
Current account	8.1	0.1	8.4	7.2	5.6	7.0	9.4	9.8	10.0
% of GDP	5.4	0.1	5.0	3.6	2.5	2.8	3.5	3.4	2.9
Trade balance	-14.0	-18.6	-13.9	-16.9	-20.4	-18.9	-18.5	-14.4	-15.1
Exports	32.8	34.7	29.1	36.8	38.3	46.4	44.7	51.7	55.5
Imports	46.8	53.3	43.0	53.6	58.7	65.3	63.3	66.0	70.5
Service balance	6.0	2.0	4.9	5.8	6.6	6.2	6.8	3.3	3.4
Income balance	16.1	16.8	17.4	18.3	19.5	19.7	21.1	20.8	21.7
FDI, net	2.5	0.6	-0.2	1.6	0.3	1.0	-0.2	3.0	3.0
International reserves (ex-gold)	33.8	37.6	44.2	62.4	75.3	83.8	83.2	83.5	90.0
Total Amortisations	4.7	7.0	5.7	8.3	6.3	2.7	9.3	9.7	10.0
Public Finances, % of GDP									
Consolidated government balance	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-1.4	-1.8	-1.6
Consolidated gov primary balance	3.7	2.6	-0.2	-0.2	0.8	0.7	1.4	1.1	1.1
Public debt	53.9	54.7	54.8	52.4	51.0	51.5	49.2	46.0	45.0
of which Domestic	31.9	31.3	30.8	30.2	29.6	32.8	32.3	30.0	29.5
Foreign Assets & Liabilities, US$ bn									
External debt	55.5	54.3	54.9	60.0	60.4	60.3	58.5	61.0	63.5
Private	17.5	13.7	11.6	13.9	14.1	15.2	18.0	18.0	18.5
Public	38.0	40.6	43.2	46.2	46.4	45.2	40.5	43.0	45.0
External debt / GDP	36.9	31.3	32.5	30.0	27.0	24.1	21.5	21.3	18.2
External debt / XGS	119.8	113.8	126.9	110.1	105.7	90.3	87.9	84.6	82.6
Short-term debt	7.1	7.0	4.0	6.3	7.0	8.5	11.2	11.1	12.0
Short-term debt/International Reserves (%)	21.0	18.6	9.0	10.1	9.3	10.1	13.5	13.3	13.3

Quarterly Economic Indicators

	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	6.5	6.8	7.1	6.8	7.0	6.8	7.3	7.5	7.6
CPI, % yoy	4.1	3.9	4.2	4.2	4.2	4.1	4.0	3.9	3.8
Policy interest rate, % eop	3.50	3.50	3.50	3.75	4.00	4.25	4.50	4.50	4.50
Short-term market rate, % eop	-0.15	0.94	1.50	2.00	2.25	2.50	2.75	3.00	3.25
Long term yield, % eop	2.91	3.38	3.75	4.00	4.00	4.25	4.50	4.75	4.50
lc vs USD, eop	44.39	44.76	44.06	44.43	44.81	44.81	44.41	44.01	43.60

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

Singapore

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- **Summary view** – 1Q GDP was revised after a rebasing to 2010 prices, but leaves no strong reason to change monetary policy stance for the time being. The revival in Apr primary home sales in response to developer price discounts renders any relaxation of property policies less likely for now.
- **Things to watch** – [1] Near-term export and production momentum; [2] house prices, which could trigger property policy easing; [3] household debt; [4] labour market and core inflation trends; [5] signs of financial stress in the SME sector.
- **Strategy** – MAS intervention could provide some support for the SGD near term, but further out SGD NEER movements should be driven more by broad DXY movements and expected disinflation trends. We remain alert for upward pressures on SOR on tighter banking liquidity and eventual Fed hikes.

1Q GDP reflects the realities of restructuring

1Q GDP was revised to +4.9%YoY, +2.3%QoQ SAAR after the GDP data was rebased to 2010 prices (prev: 2005p) vs Advance Estimates +5.1%YoY, +0.1%QoQ SAAR (4Q: 4.9%YoY, +6.9%QoQ SAAR). Ex biomed, we estimate 1Q GDP was revised to 4.5%YoY, 0%QoQ SAAR (4Q: 5.1%YoY, 6.2%QoQ SAAR). The 1Q sequential expansion appears to be narrowly-based in manufacturing and trade-related activities – and even in the case of manufacturing, our estimates suggest this was more due to biomedicals rather than more cyclical segments like electronics which are probably weighed by the stronger REER and labour shortages. The more domestically- and regionally-oriented sectors like construction and restaurants and accommodation also performed more poorly likely due to labour shortages as well as demand weakness – which likely drove greater pessimism amongst firms in the Business Times-UniSIM Business Climate Survey over their business prospects for the next six months – with the exception being the Integrated Resorts, which are reflected in the Other Services. By expenditure, external demand contributed +4.8%pts YoY (4Q: +4.3%pts) while final domestic demand contribution posed a small drag (1Q: -0.2%pt, 4Q: +0.2%pt).

The realities of restructuring are manifesting in NODX underperformance vs regional peers. Labour constraints and a strong SGD have caused manufacturing exports to underperform regional peers even as an improvement in re-exports suggests tradeable services are benefitting from improving regional trade. Upside surprise notwithstanding, exuberance over the 9%MoM SA jump in Apr NODX (which should now be clear of Chinese New Year distortions) has to be tempered by the fact that this was a rebound after the unexpected 8.9% drop in Mar. While there were other bright spots – non-oil retained imports of intermediate goods (NORI) surged 11.3%MoM SA (Mar: -1.2%) bringing Apr seasonally-adjusted levels 6.2% above 1Q14 levels – NODX appears to have yet to break out of the choppy profile that has characterized the last 2-3 years, with seasonally-adjusted levels seesawing between expansion and decline each month since 4Q13. Despite the improvement in external demand reflected in the pick-up in NORX since Dec, the choppy and at best flattish NODX continues to suggest that the domestic manufacturing sector is underperforming regional peers, especially in tech. While the NODX data is unlikely to sway monetary policy decisions in the near term, it indicates the toll that economic restructuring and possibly the strong SGD has taken on the manufacturing demand thus far.

Going forward, recent data is consistent with a moderate if somewhat patchy expansion. [1] The Composite Leading indicator – which leads GDP by one quarter – fell into sequential decline (1Q: -2%QoQ, 4Q: +0.6%); [2] EDB's Survey of Business Expectations for Biomedicals Output shows a sequential increase in 2Q with a net 28% of manufacturers expecting to raise output; [3] the rise in Apr domestic PMI new orders to inventories ratio suggests possible production increases for re-stocking; [4] Apr seasonally-adjusted NODX and NORX levels are 4.7% and 2.6% above average 1Q14 levels respectively.

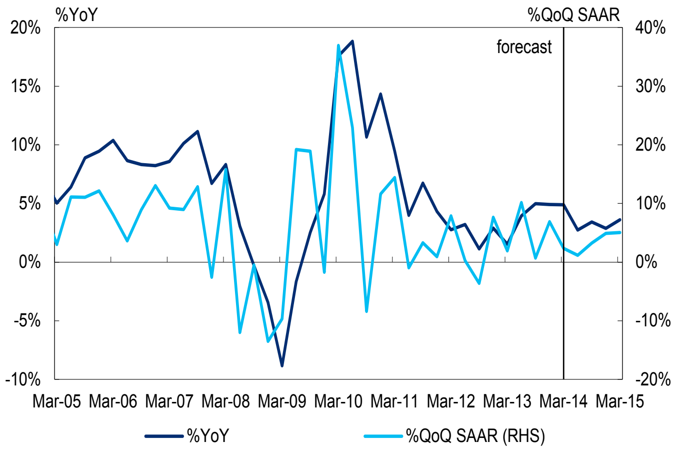
Any relaxation of property policies is less likely for now after private home sales surged to 745 units in Apr (Mar: 480) – the highest since Nov – in response to developer price discounts, revealing still present underlying demand. Singapore Real Estate Exchange flash estimates showed Apr resale prices of non-landed private homes falling 1.7% to a 16-month low while HDB flat resale prices edged down just 0.2% but saw a 4.4% increase in volumes to the highest since Jul. Applications for the Special CPF Housing Grant for the purchase of HDB flats have also surged after it was extended to middle-income households in Aug, with 2320 households receiving the grant in 1Q14 vs 1243 in 2013. Nonetheless even if property policies are relaxed in 2015, the impending spike in completions till 2016 rules out any sustained rebound.

High hurdle to changes in MAS policy

MAS sees a risk that core inflation breaches the 2-2.5% implicit tolerance threshold, given the still tight labour market. With growth likely to fall in the upper half of the official forecast range, we see the positive output gap persisting. The labour market remains tight, with the 1Q14 unemployment rate still low despite rising to 2.1%s.a. (4Q13: 1.8%), especially with the ratio of job vacancies to unemployed persons (a measure of demand-supply balance in the labour market) at 1.44 as of 4Q (3Q: 1.41) – an all-time high since 1997. 1Q ULC growth edged down to 1.4%YoY (4Q: 1.5%), helped by a marginal increase in labour productivity growth (1Q: 0.9%, 4Q: 0.8%), which could hint at continued but slowing cost pressures. Indications are that the labour market will remain consistently tight given relatively stable hiring intentions indicated in the recent Manpower Inc. survey (2Q14 net employment outlook: +18%, 1Q: +16%) and the tightening in foreign worker supply forcing firms to further draw down the resident labour force.

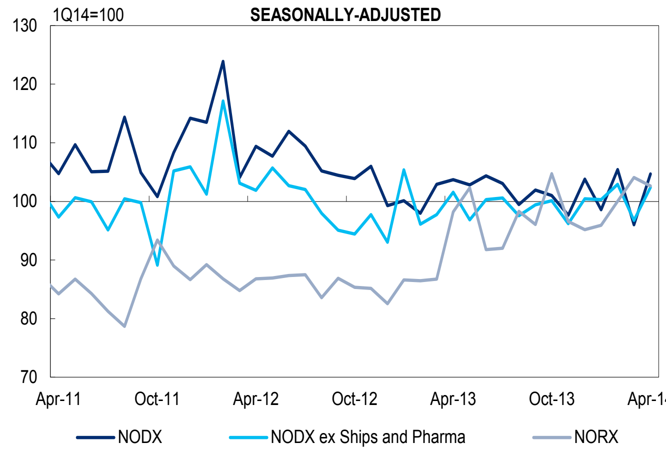
We see the MAS core, rather than headline, inflation forecast as an indication of policy bias. Should inflation data and pipeline pressures suggest a risk that MAS' implicit 2-2.5% core inflation tolerance threshold is breached, we would not rule out a slope steepening to the "new normal" slope of 3% at some stage, though this is not our base case for now – MAS views the current policy stance as "appropriate" for ensuring medium-term price stability as the basis for sustainable growth. Headline disinflationary forces on the other hand will likely be welcomed after the recent years of high inflation – we maintain our 2014 headline inflation forecast of 1.8% as the correcting housing market and caps in car price increases from higher COE supply gather steam, on top of disinflationary forces from lower industrial and commercial rentals as well as the strong SGD and household deleveraging curbing demand-pull pressures.

Figure 82. 1Q GDP was revised to +4.9%YoY, +2.3%QoQ SAAR



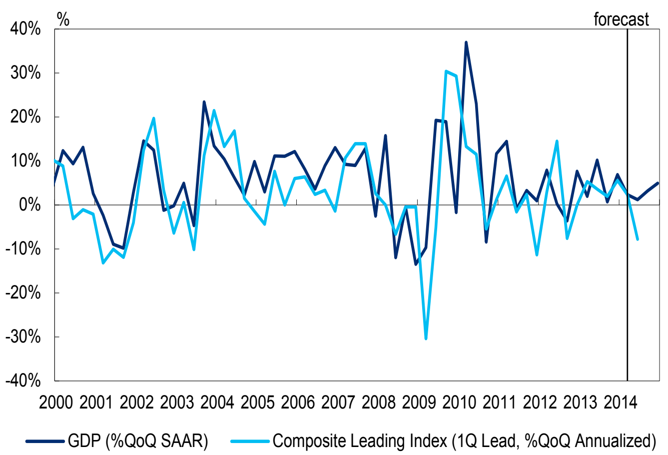
Source: CEIC, Citi Research

Figure 83. NODX appears to have yet to break out of the choppy profile



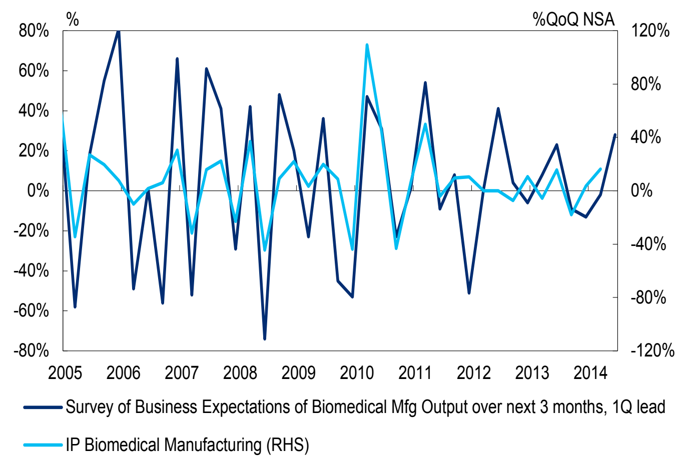
Source: IE Singapore, CEIC, Citi Research

Figure 84. CLI fell into sequential decline



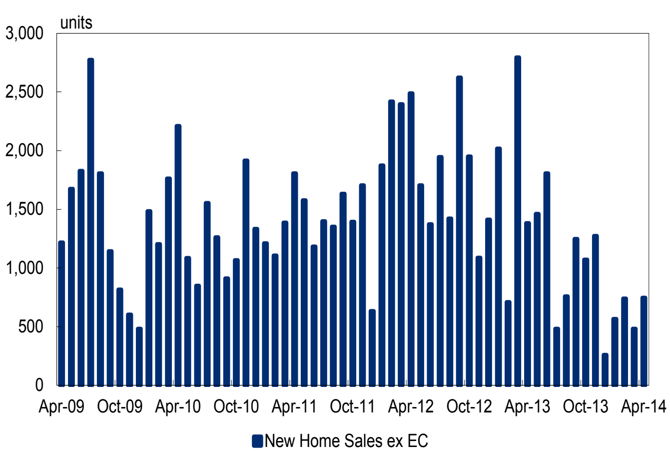
Source: CEIC, Citi Research

Figure 85. EDB survey shows a sequential increase in 2Q biomed



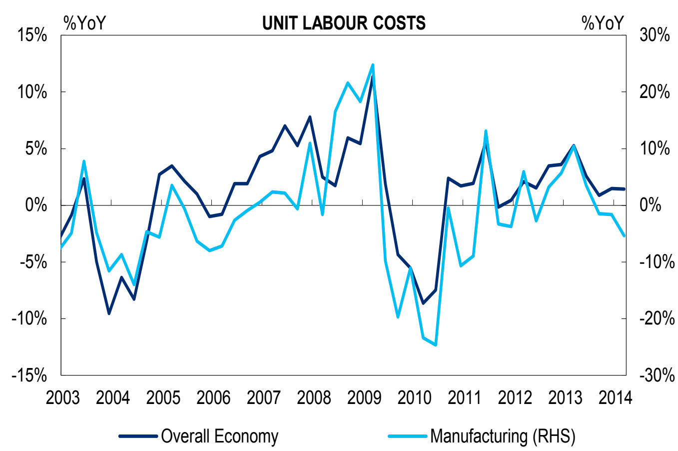
Source: CEIC, Citi Research

Figure 86. Private home sales surged to 745 units in Apr



Source: URA, Business Times, Citi Research

Figure 87. 1Q ULC growth edged down to 1.4%YoY



Source: CEIC, Citi Research

Figure 88. Singapore Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	180.3	192.5	193.0	236.9	274.3	287.2	298.0	343.1	371.2
Nominal GDP, local currency mn	271	272	280	322	345	359	373	432	468
GDP per capita, US$	39,287	39,772	38,694	46,671	52,908	54,058	55,199	62,386	66,283
Population, mn	4.6	4.8	5.0	5.1	5.2	5.3	5.4	5.5	5.6
Unemployment, % of labour force	2.1	2.3	3.0	2.2	2.0	1.9	1.9	1.8	1.8
Economic Activity									
Real GDP, % yoy	9.1	1.8	-0.6	15.2	6.1	2.5	3.9	3.5	4.0
Real investment growth % yoy	12.1	29.6	-11.3	24.4	4.3	14.9	-2.2	3.9	1.5
Real consumption growth % yoy	5.4	4.0	0.0	6.9	3.1	3.1	4.1	-0.1	-1.0
private consumption growth % yoy	6.1	3.5	-1.1	5.9	4.3	3.9	2.6	1.6	-0.8
Real export growth, % yoy	8.6	4.6	-7.5	17.4	4.6	1.5	3.6	4.4	4.0
Real import growth, % yoy	7.4	10.0	-10.4	16.2	3.2	3.1	3.1	3.8	2.4
Prices, Money & Credit									
CPI, % yoy	3.7	5.5	-0.5	4.6	5.5	4.3	1.5	1.4	1.4
CPI, % avg	2.1	6.6	0.6	2.8	5.2	4.6	2.4	1.8	1.3
Nominal wages, % yoy	6.2	5.4	-2.7	5.6	6.0	2.3	4.3	5.0	5.0
Credit extension to private sector, % yoy	16.6	14.8	3.1	13.6	19.9	13.9	12.0	10.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	2.38	1.00	0.69	0.44	0.38	0.38	0.40	0.40	0.80
Long term yield, % eop	2.68	2.05	2.66	2.71	1.63	1.30	2.56	3.00	3.20
lc/US$, eop	1.44	1.43	1.41	1.28	1.30	1.22	1.26	1.26	1.26
lc/US$, avg	1.51	1.41	1.45	1.36	1.26	1.25	1.25	1.26	1.26
Balance of Payments, US$ bn									
Current account	46.8	27.7	32.4	56.0	62.6	50.2	54.6	61.8	66.8
% of GDP	25.9	14.4	16.8	23.6	22.8	17.5	18.3	18.0	18.0
Trade balance	57.8	41.6	47.6	62.9	69.6	63.5	67.8	65.0	65.0
Exports	312.4	352.9	287.4	370.5	432.0	434.5	437.7	455.0	462.0
Imports	254.6	311.3	239.8	307.6	362.5	371.0	369.9	390.0	397.0
Service balance	-2.3	-1.5	-2.3	-0.4	2.8	0.9	0.8	1.0	2.0
Income balance	-8.7	-12.4	-12.9	-6.5	-9.8	-14.2	-14.0	-4.2	-0.2
FDI, net	10.8	5.4	-2.4	21.7	26.9	47.7	36.8	32.0	32.0
International reserves	163.0	174.2	187.8	225.8	237.7	259.3	273.1	280.0	290.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	2.8	0.1	-0.3	0.3	1.2	1.7	1.1	-0.3	0.2
Consolidated gov primary balance	2.7	1.1	-0.8	0.2	1.3	2.0	1.3	0.7	0.5
Public debt	86.3	93.9	104.2	99.6	102.7	107.4	104.7	110.0	110.0
of which Domestic	86.3	93.9	104.2	99.6	102.7	107.4	104.7	110.0	110.0
Foreign Assets & Liabilities, US$ bn									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	4.9	4.9	2.7	3.4	2.9	3.6	3.6	4.6	4.1
CPI, % yoy	1.5	1.2	2.6	1.7	1.4	1.4	1.0	1.3	1.5
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.40	0.41	0.40	0.40	0.40	0.45	0.50	0.60	0.80
Long term yield, % eop	2.56	2.49	2.75	2.90	3.00	3.00	3.10	3.20	3.20
lc vs USD, eop	1.26	1.26	1.26	1.26	1.26	1.26	1.26	1.26	1.26

South Korea

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- **Summary view** – Despite recent favorable production and export data, the Sewol ferry sinking incident and slower housing transactions and prices led concerns over a setback in economic recovery. However, the government's preemptive measures seem to offset the impact and thus we maintain our growth forecasts.
- **Things to watch** – KRW has recently appreciated against USD by c6% from its previous peak in the middle of Feb or by c13.6% from the level in the middle of last year. Given recent outperformance and the FX authorities' strong intention to support KRW, we think there is not much room for KRW to strengthen further.
- **Strategy** – With negative output gap likely to maintain this year amidst downside risks to headline inflation, we expect the BoK's monetary stance to stay accommodative, with no change in the policy rate until early next year.

Concerns over a setback in economic recovery grow

Mar IP improved and continued export rebound bodes well. Industrial production (IP) in Mar shifted to expand on sequential terms by 0.9% after two consecutive months of fall, maintaining positive YoY growth at 2.7%. Export rebound continued in Apr at a stronger than expected 9.0%YoY points to a pickup in IP growth in coming months. Export gains in Apr were broad-based across key products, particularly shipbuilding, semiconductors, and autos. By destination, exports to the US, ASEAN, and Japan grew sharply by double digits. However, exports to China grew at a slower pace than in Mar, with continued sluggishness of LCD and petroleum products due to increased domestic supply in China and decline in unit export price. While exports will likely continue to improve, we think the resiliency of export rebound in Apr may be somewhat exaggerated given the rush before the long holiday weekend in early May, and thus expect export growth to be softer in May.

Domestic demand recovery may be delayed. Retail sales and service activities also turned to grow sequentially in Mar, both posting higher YoY growth of 2.1%. While retail sales growth in 1Q14 accelerated to 2.5%YoY from 1.2% in the 4Q13, the risk of delayed recovery has increased with the Sewol ferry sinking tragedy (Apr 16th) as it has discouraged consumer spending and suppressed marketing. Flash numbers of credit card use after the incident showed slowdowns in leisure, restaurant, transportation, and lodging businesses. Moreover, housing market transactions and prices rose at a slower pace after the government announced its plan to collect taxes on lease income, which acted as a disincentive to house buying.

In response, government puts in measures preemptively. In light of slowdown in consumption and service activities after the ferry incident, the government decided to advance its spending in 2Q14 by KRW7.8trn, executing 57% of the annual budget in 1H (vs. the originally planned 55%). The extra spending should support the affected retailers, travel & transportation & lodging businesses, and SMEs, resulting in upside potential to 2Q14 real GDP growth by 0.2%p on a quarter-on-quarter basis. Moreover, fiscal, financial, and taxation measures were announced to be arranged for the affected industries, fishermen, and small-scale businessmen. For example, low interest loans, extensions on loans, special low cost guarantees, and tax payment deferrals will be allowed. In our view, these measures could offset the setback, leaving the impact as temporary, and we maintain economic growth for this year at 3.9%.

BoK remains accommodative but rate cut unlikely

Policy rate unchanged but BoK governor's rhetoric turns hawkish. The BoK governor assessed external risks have eased over the month but domestic risks from the Sewol ferry tragedy have emerged as it could hamper economic recovery. Nevertheless, the policy rate was kept on hold at 2.50% at the May MPC meeting based on the BoK's unchanged view of a continued economic recovery and narrowing negative output gap. To counter negative impact from the ferry incident, the BoK plans an early execution of the unused portion of KRW2.9trn of its Bank Intermediate Lending Support Facility. The governor still sees the current policy rate as accommodative to support economic recovery and believes the chances of a rate hike are greater than a cut when assuming economic growth exceeding potential growth. Despite his hawkish rhetoric and higher inflation likely in 2H14, we expect the BoK to leave the policy rate unchanged this year as inflationary pressures from the demand side are unlikely to materialize amid continued negative output gap. We think the rate hike will begin early next year.

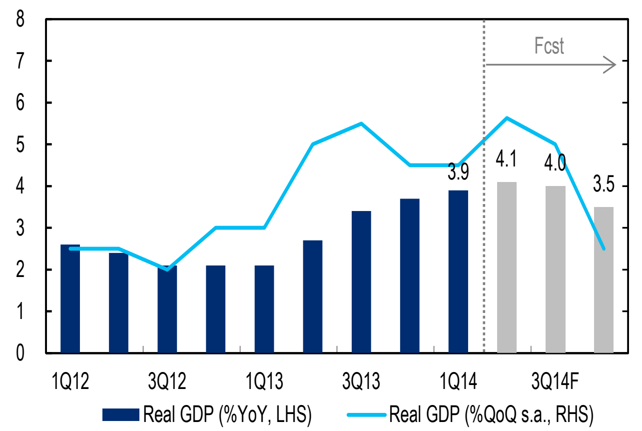
Uptrend in CPI inflation confirmed but downside risk to our forecast. CPI inflation further rose in Apr to 1.5%YoY (Mar: 1.3%) mainly due to the low base of industrial product prices last year and an increase in personal service prices. With deflation of agricultural goods and oils, core CPI inflation rose to 2.3%YoY (Mar: 2.1%). We expect headline inflation to rise to 2.7% in 2H14, led by further increases in service prices and a low base of a year ago. However, we see some downside risks from: 1) expanded free school meals and delayed public tariff hikes, 2) imported manufacturing products given the likelihood of further weakening of raw material demand due to EM growth risks, 3) industries at risk of sluggish domestic demand likely to refrain from price hikes in the near term, and 4) stronger than previously expected KRW against USD lowering import prices.

Strong KRW makes it difficult for exporters to stay competitive

Continued current account surplus amid weak USD led KRW strength. Exporters' rush of USD selling since late Apr before the long holiday weekend in early May had led KRW to appreciate against USD to 1,030 levels. In addition to continued current account surplus and weak USD, foreigners' selling of export stocks on worries about the falling USDKRW drove down the currency further to 1,022.5 on May 7th, the lowest since Aug 7th, 2008 (1,016.5). Though foreigners reversed back to net purchase in the local stock market recently, the currency rate testing 1,020 levels led to verbal intervention by the FX authorities on May 9th, followed by an assumed smoothing operation on the 14th.

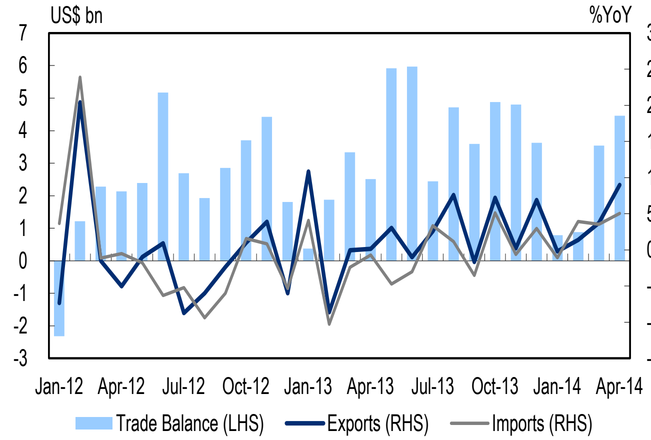
Price competitiveness and profitability of exporters deteriorated. Sharp appreciation of KRW against USD has aggravated the concerns over exporters' price competitiveness and profitability, especially given that the USD is the most favored currency for export settlement (85% of total in 1Q14). The BoK's latest business survey in Apr already showed that manufacturing firms' concerns over the FX rate increased notably amid KRW appreciation. Moreover, according to a survey held during May 8-12 by Korea International Trade Association (KITA), the break-even USDKRW is estimated at 1,045. If the currency rate maintains its recent level near 1,020, 87.1% of the firms cited their exports will fall short of their plans. The FX authorities appeared to defend the 1,020 level actively with verbal or direct intervention. We expect USDKRW at 1,030 over the 0-3 month horizon and, with the end of Fed tapering, at 1,040 for the 6-12 month period.

Figure 89. Recovery likely to continue despite worries over a setback



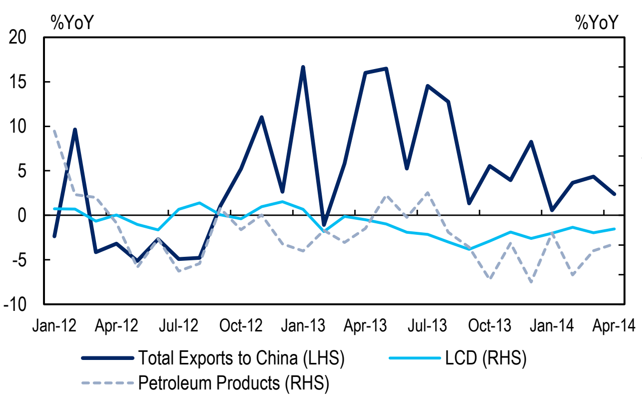
Source: Bank of Korea, Citi Research

Figure 90. Rebound of exports looks favorable to economic recovery



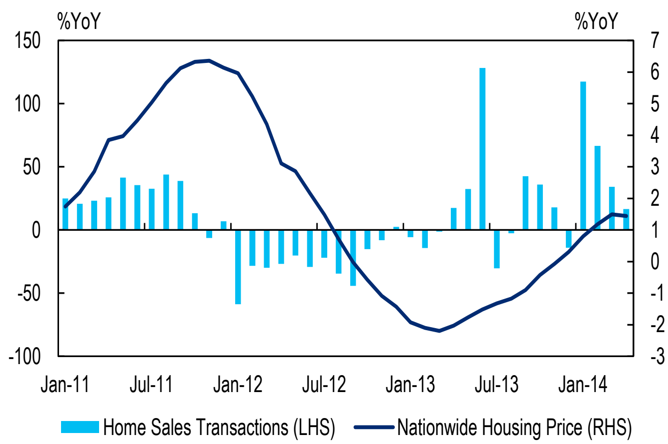
Source: Korea International Trade Association

Figure 91. Export growth to China waned



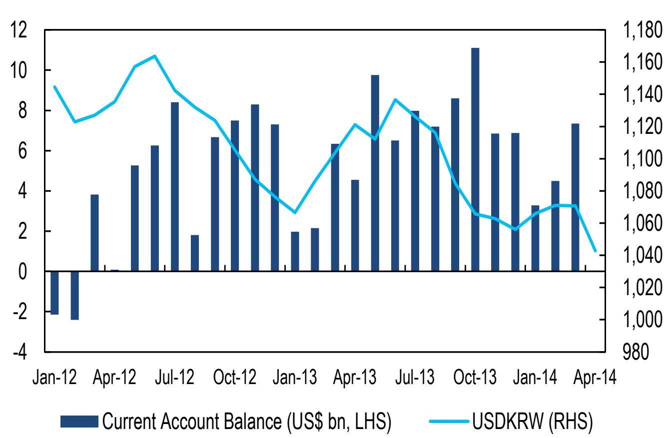
Source: Korea International Trade Association

Figure 92. Growth of housing transactions and price slowed recently



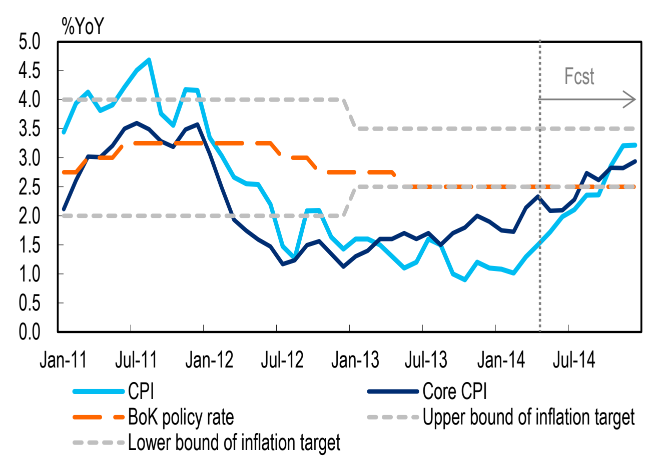
Source: Ministry of Land, Infrastructure and Transport, Korea Appraisal Board

Figure 93. Current account surplus amid USD led KRW appreciation



Source: Bank of Korea

Figure 94. Inflation to rise but policy rate likely to stay accommodative



Source: Bank of Korea, Statistics Korea, Citi Research

Figure 95. Korea Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	1,121.3	999.7	902.6	1,094.6	1,203.0	1,222.0	1,304.0	1,456.0	1,594.0
Nominal GDP, local currency bn	1,043,258	1,104,492	1,151,708	1,265,308	1,332,681	1,377,457	1,428,295	1,516,883	1,619,556
GDP per capita, US$	23,073	20,423	18,352	22,153	24,167	24,438	25,966	28,875	31,491
Population, mn	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4	50.6
Unemployment, % of labour force	3.2	3.2	3.6	3.7	3.4	3.2	3.1	3.3	3.1
Economic Activity									
Real GDP, % yoy	5.5	2.8	0.7	6.5	3.7	2.3	3.0	3.9	4.0
Real investment growth % yoy	4.5	-1.0	-10.1	17.8	3.5	-2.3	0.0	6.0	5.7
Real consumption growth % yoy	5.3	2.2	1.3	4.3	2.7	2.2	2.2	2.5	3.2
private consumption growth % yoy	5.1	1.4	0.2	4.4	2.9	1.9	2.0	2.7	3.3
Real export growth, % yoy	12.7	7.5	-0.3	12.7	15.1	5.1	4.3	5.9	6.9
Real import growth, % yoy	11.6	3.2	-6.8	17.3	14.3	2.4	1.6	6.3	6.7
Prices, Money & Credit									
CPI, % yoy	3.6	4.1	2.7	3.1	4.2	1.4	1.1	3.2	2.9
CPI, % avg	2.5	4.7	2.8	3.0	4.0	2.2	1.3	2.1	3.1
Nominal wages, % yoy	5.6	-4.1	2.6	6.8	1.0	5.3	3.9	4.8	5.1
Credit extension to private sector, % yoy	12.5	14.9	5.0	4.0	6.5	3.2	4.7	5.7	7.9
Policy interest rate, % eop	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.50	3.50
Short-term market rate, % eop	5.73	4.68	2.82	2.80	3.55	2.89	2.66	2.75	3.60
Long term yield, % eop	5.78	3.77	4.92	4.08	3.46	2.97	3.23	3.65	4.25
lc/US$, eop	936	1,263	1,166	1,121	1,159	1,064	1,051	1,038	998
lc/US$, avg	929	1,102	1,275	1,156	1,108	1,127	1,095	1,042	1,016
Balance of Payments, US$ bn									
Current account	11.8	3.2	33.6	28.9	18.7	50.8	79.9	56.5	46.7
% of GDP	1.1	0.3	3.7	2.6	1.6	4.2	6.1	3.9	2.9
Trade balance	14.6	-13.3	40.4	41.2	30.8	28.3	44.0	38.7	35.6
Exports	371.5	422.0	363.5	466.4	555.2	547.9	559.6	590.9	642.1
Imports	356.8	435.3	323.1	425.2	524.4	519.6	515.6	552.2	606.5
Service balance	-12.0	-5.7	-6.6	-8.6	-5.8	-5.2	-1.4	-0.8	-1.2
Income balance	-3.4	3.7	1.6	-2.1	0.3	6.6	7.2	0.5	-1.0
FDI, net	-17.9	-16.9	-14.9	-22.2	-16.4	-18.9	-13.1	-8.6	-4.3
International reserves	262.2	201.1	270.0	291.5	304.2	323.2	341.7	377.5	391.5
Total Amortisations	24.5	31.0	30.2	35.7	42.7	43.5	44.3	45.1	46.0
Public Finances, % of GDP									
Consolidated government balance	3.2	1.1	-1.5	1.3	1.4	1.3	1.0	0.9	1.5
Consolidated gov primary balance	4.5	2.4	-0.2	2.6	2.7	2.5	2.3	2.2	2.7
Public debt	27.7	27.0	30.1	29.5	30.2	30.9	32.5	30.7	28.9
of which Domestic	26.7	26.1	29.1	28.7	29.4	30.1	31.7	29.9	28.2
Foreign Assets & Liabilities, US$ bn									
External debt	333.4	317.4	345.7	359.8	398.7	409.4	416.6	420.5	428.5
Private	279.8	264.9	277.9	280.1	314.7	311.2	312.3	314.6	319.8
Public	53.6	52.5	67.8	79.7	84.0	98.2	104.3	105.9	108.7
External debt / GDP	29.7	31.7	38.3	32.9	33.1	33.5	31.9	28.9	26.9
External debt / XGS	75.0	61.9	79.1	65.0	61.3	62.1	61.8	58.9	55.1
Short-term debt	160.3	149.9	149.2	139.8	137.4	127.2	112.8	104.0	108.0
Short-term debt/International Reserves (%)	61.1	74.5	55.3	48.0	45.2	39.4	33.0	27.5	27.6

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	3.7	3.9	4.1	4.0	3.5	3.5	3.5	4.1	5.0
CPI, % yoy	1.1	1.3	2.0	2.4	3.2	3.1	3.3	3.1	2.9
Policy interest rate, % eop	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.25	3.50
Short-term market rate, % eop	2.66	2.65	2.67	2.68	2.75	2.90	3.10	3.35	3.60
Long term yield, % eop	3.23	3.16	3.49	3.55	3.65	3.75	3.95	4.15	4.25
lc vs USD, eop	1,051	1,065	1,031	1,034	1,038	1,034	1,022	1,010	998

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

Taiwan

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- **Summary view** – April exports and orders data kick start recovery in 2Q, likely leading to manufacturing improvements too. Taiwanese businesses operating in Vietnam suffered severe damages in recent anti-China protests. Fund inflows have supported the equity market and helped ease depreciation.
- **Things to watch** – 1) Cross-strait momentum: Banks M&A, RMB swap line, ECFA for services and goods; 2) Pension reform; 3) 2014's local elections; 4) Liberalization efforts in FEZ; 5) Efforts to kickstart TPP and RECP talks mid-year; 6) 4th nuclear plant refrendum; 7) China impacts via exports, financials, RMB and geopolitics.
- **Strategy** – Policy rate likely stable till 2015; 10Y government bond yields likely on a gradual uptrend despite recent jump in global yields. TWD likely to see spurts of depreciation along with the CNH in the near term, but could appreciate mildly over time on macro recovery. Citi's TAIEX 2014 year-end target at 9,300.

April trade related data turning slightly more promising

1Q real GDP (advanced estimates) met expectations at 3.04%yoy, with pretty even improvements noted in both external and domestic demand, contributing 1.47%pt and 1.57%pt, respectively, to GDP. However, overall recovery momentum remains mild, with QoQ SA momentum at 0.27% or 1.07% when annualized.

April exports (+6.2%yoy) and export orders (+8.9%yoy) kick started the recovery trend that we expected in 2Q, as more new tech products are being launched and better demand seen from advanced economies. The diffusion indices (from surveys to manufactures about their export orders outlook for May) rose to 56.7 by value (50 is the expansion threshold), giving some hope for further momentum building in May.

The lingering market concern is whether a managed slowdown in China would derail Taiwan's export recovery for the rest of the year? We are of the view that a China domestic slowdown will take a toll on Taiwan's exports, but it will likely be manageable, as only ~30% of what Taiwan exports to China is being used in China, the remaining ~70% is used for re-exports (by our estimations). Specifically, we think China's domestic slowdown will be more reflected in Taiwan's non-tech exports like commodities, rubber/plastics, chemicals and basic metals, which could be affected by China's commodities glut and investment slowdown. Using April's export orders data by product type and destination breakdown as a reference of China domestic impacts on individual non-tech categories, China orders most of Taiwan's commodities export (44.5%), and similarly for rubber/plastics (35.5%), machineries (28.8%) and basic metals (18.5%). Taiwan also exports other non-tech goods like electric appliances, finished products of textile, prepared foodstuff/beverages and perishable goods to China, but demand for these types of goods are likely more resilient.

Somewhat better macro data and FINI inflows support the TWD, but RMB and therefore TWD depreciation risks still lingering in 0-3M period. USD/TWD drifted higher in the latter half of April, though it has retraced lower since the start of the month, in line with CNY. China's data for April show further macro weakness and reforms could potentially generate negative headline risks, thus we are maintaining our 0-3M USD/CNY call of 6.30. This in turn would subject TWD to another spurt of currency weakness, despite continued inflows in Taiwan's equity market (especially for the tech names) have well supported the currency. In 6-12M time, we expect better Taiwan macro outlook and sizable current account surplus (1Q at US$15.3bn) should support USD/TWD at around 30.2.

Affected by China-Vietnam territorial conflict

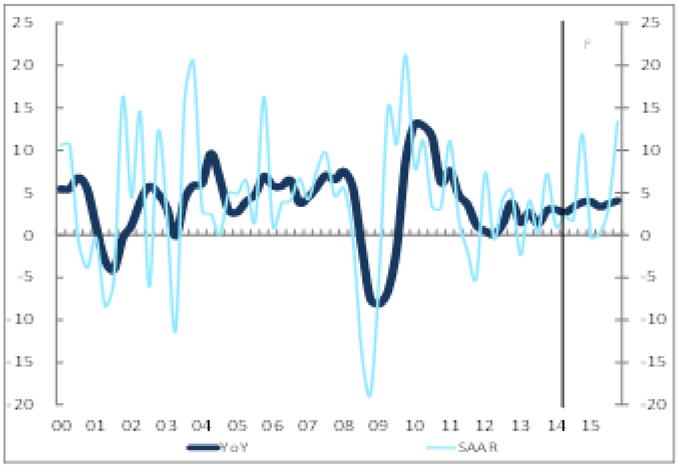
Taiwanese businesses operating in Vietnam suffered severe damages in recent anti-China protests. Placement of a China state-owned gigantic oil rig in disputed waters with Vietnam sparked tensions. Anti-China protests erupted on 13th May, it started outside of the China embassy in Hanoi but spilled over to disruptions in industrial parks where many Taiwanese factories are located and 11 Taiwanese factories were set ablaze. The political standoff doesn't involve Taiwan. According to Ministry Of Economic Affairs, 224 companies were damaged in Vietnam protests and 400 Taiwanese factories suspended operations for safety reasons.

Taiwan cumulated FDI in Vietnam is the fifth largest, at US$15.6bn since 2001, after Japan, South Korea, Singapore and Malaysia, according to available Vietnam FDI data. Vietnam has been an attractive destination in the eyes of Taiwanese investors since 1991 (before Asian Financial Crisis), with two more waves of Taiwanese investments destined for Vietnam in 2008 and 2013. Looking at Taiwan's approved outward investment statistics, 2012-13 were years where Taiwanese investments may have deliberately been diversified from China to Vietnam (on average ODI to Vietnam grew 95%yoy but to China dropped 19%yoy), likely due to China's more stringent environmental and labor standards in recent years. Large listed and smaller private Taiwanese businesses of various types of non-tech manufacturing have ventured into Vietnam, ranging from food, paper & printing, plastics, textile, garment & apparels, furniture, chemicals, steel, bicycles to home appliances, etc. The entrenched production chains that Taiwanese now have operating in various parts of Vietnam are likely due to Vietnam's low cost of manufacturing, a growing domestic market as well as access to economic blocs (ASEAN, APEC) and countries it has bilateral trade agreements (with Japan, New Zealand, potentially EU by 2015) -- thereby allowing Taiwanese exporters operating in Vietnam to potentially enjoy preferential tariff treatment.

Taiwan will likely have to go through a prolonged process to seek for compensation from Vietnam. The total cost of damage is still being tallied. Vietnam government is stepping up efforts to ensure the safety of foreign investors in the country, as well as mulling over options of reducing or removing land or business taxes, and possibly offering the affected businesses concessional loans or debt relief on overdue loans. Taiwan Government in the meantime is providing emergency loan lines and facilitating loans renegotiation with banks; and for longer term operation purposes, the Government is seeking to expand an investment protection agreement with Vietnam.

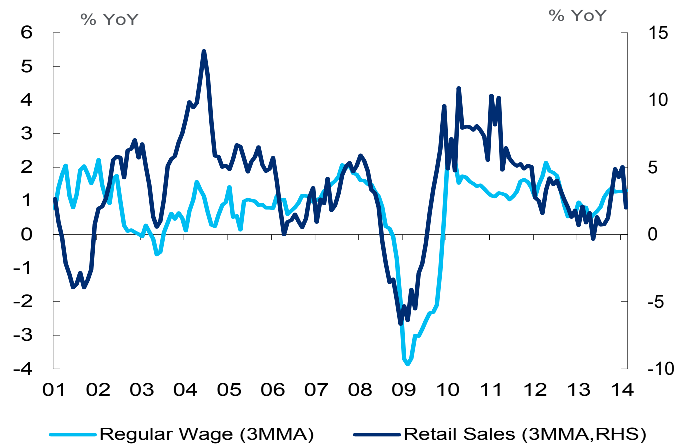
Although some factories are restarting operations despite the geopolitical situation, Taiwanese manufacturers are re-thinking their FDI strategies for the longer run. It does appear to us that there are limited options of nearby countries that can offer such low production costs, hard & soft infrastructure and market access. Other things being equal, on a cost comparison of manufacturing wages across Asia, in 2013, hourly cost in Vietnam is US$1.52 only, making relocating to China (cost is at US$3.52) expensive and most likely many manufacturers would have explored this option already. Perhaps selected garment/textile manufacturing could consider Sri Lanka where hourly wages is lower at US$0.63, but this may not be suitable for all industry types. Some have argued that Taiwan manufacturers in Vietnam should reconsider moving their production chain back to Taiwan, but hourly manufacturing cost of Taiwan (US$9.23) would make it almost impossible for these non-tech production lines (even if the government were to provide tax incentives and to help locate land). Moreover, if comparing productivity (using output per employed person as proxy for available country data), Vietnam ranks third in the region after China and India.

Figure 96. GDP recovered mildly in 1Q, but could dampen in 2Q



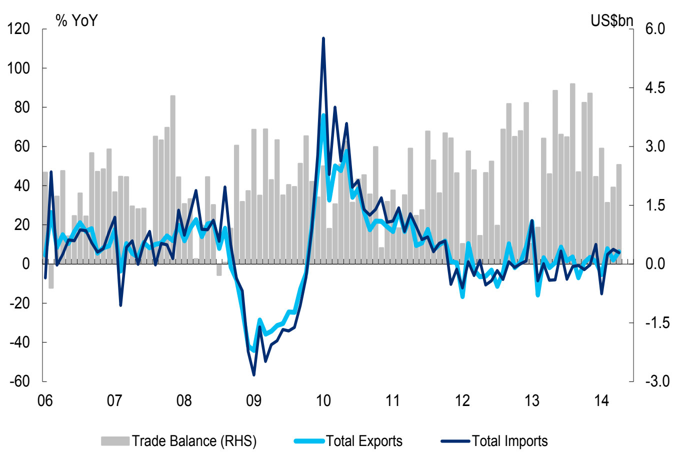
Source: CEIC, Citi Research

Figure 97. Consumption (ex-CNY effects) on a general recovery path



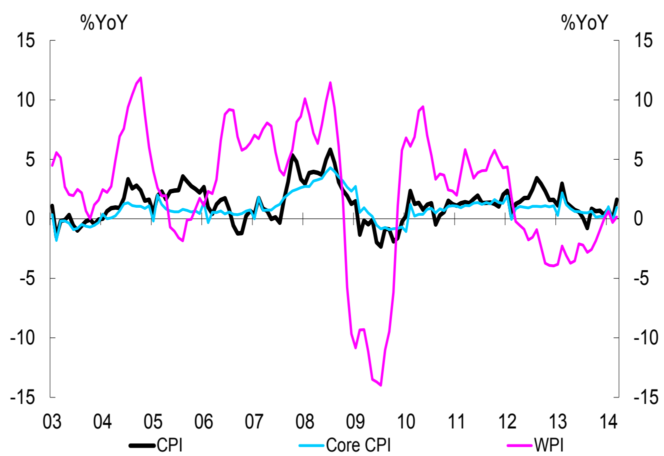
Source: CEIC, Citi Research

Figure 98. Gradual trade recovery likely to step up pace in 2H



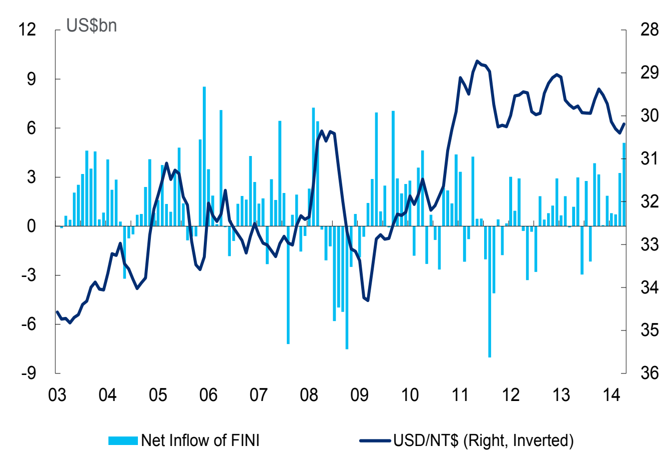
Source: CEIC, Citi Research

Figure 99. Benign inflation gives room for CBC's accommodation



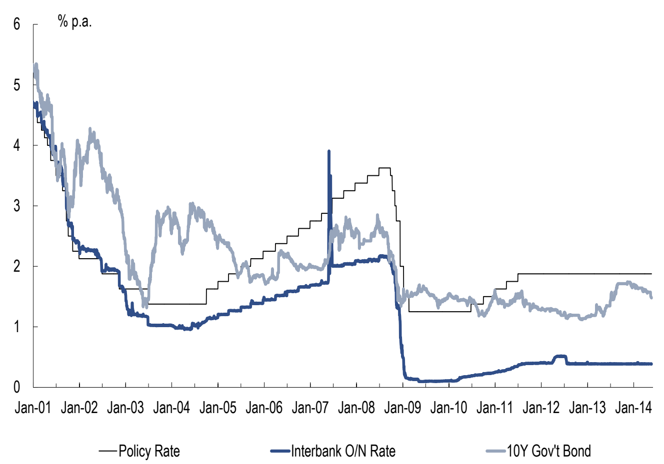
Source: CEIC, Citi Research

Figure 100. FINI inflows continued, pacifying TWD depreciation



Source: CEIC, Citi Research

Figure 101. 10Y govt bonds could rise again with US tapering



Source: CEIC, Citi Research

Figure 102. Taiwan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	393.0	400.2	378.0	430.3	466.5	476.3	490.8	500.9	536.6
Nominal GDP, local currency bn	12,911	12,620	12,481	13,552	13,709	14,077	14,564	15,214	16,094
GDP per capita, US$	17,118	17,370	16,348	18,579	20,084	20,429	20,996	21,388	22,866
Population, mn	23.0	23.0	23.1	23.2	23.2	23.3	23.4	23.4	23.5
Unemployment, % of labour force	3.9	4.1	5.8	5.2	4.4	4.2	4.2	4.0	3.9
Economic Activity									
Real GDP, % yoy	6.0	0.7	-1.8	10.8	4.2	1.5	2.1	3.2	3.8
Real investment growth % yoy	-0.7	-7.9	-21.2	36.8	-6.8	-4.6	3.5	5.0	3.6
Real consumption growth % yoy	2.1	-0.6	1.3	3.3	2.9	1.5	1.4	1.6	2.1
private consumption growth % yoy	2.1	-0.9	0.8	4.0	3.1	1.6	1.8	1.8	2.7
Real export growth, % yoy	9.6	0.9	-8.7	25.6	4.5	0.1	3.8	4.6	6.2
Real import growth, % yoy	3.0	-3.7	-13.1	27.7	-0.5	-2.2	4.0	3.7	5.2
Prices, Money & Credit									
CPI, % yoy	3.3	1.3	-0.2	1.2	2.0	1.6	0.3	2.5	2.8
CPI, % avg	1.8	3.5	-0.9	1.0	1.4	1.9	0.8	1.2	2.0
Nominal wages, % yoy	2.1	-0.1	-5.0	5.3	2.6	0.1	0.2	1.5	3.0
Credit extension to private sector, % yoy	3.9	2.7	-0.8	6.7	5.6	4.1	5.3	7.0	8.5
Policy interest rate, % eop	3.38	2.00	1.25	1.63	1.88	1.88	1.88	1.88	2.38
Short-term market rate, % eop	2.04	1.02	0.57	0.74	0.87	0.87	0.87	0.93	1.17
Long term yield, % eop	2.53	1.44	1.47	1.47	1.27	1.15	1.69	1.66	2.04
lc/US$, eop	32.43	32.78	32.23	29.17	30.29	29.06	29.83	30.26	29.92
lc/US$, avg	32.85	31.58	33.04	31.50	29.40	29.57	29.68	30.40	30.04
Balance of Payments, US$ bn									
Current account	35.2	27.5	42.9	39.9	41.7	50.7	57.4	55.1	54.7
% of GDP	8.9	6.9	11.4	9.3	8.9	10.6	11.7	11.0	10.2
Trade balance	27.4	15.2	29.3	23.4	26.8	30.7	35.5	38.7	51.0
Exports	246.7	255.6	203.7	274.6	308.3	301.2	305.4	320.9	352.0
Imports	219.3	240.4	174.4	251.2	281.4	270.5	269.9	282.2	301.1
Service balance	-1.6	1.8	2.0	2.5	3.9	6.3	10.4	11.6	7.4
Income balance	10.1	10.0	12.5	13.6	13.2	15.3	14.1	17.0	19.0
FDI, net	-3.3	-4.9	-3.1	-9.1	-14.7	-9.9	-10.3	-10.0	-9.0
International reserves	270.3	291.7	348.2	382.0	385.5	403.2	416.8	440.0	460.0
Total Amortisations	3.8	8.8	2.5	3.2	6.8	3.4	2.9	3.0	3.0
Public Finances, % of GDP									
Consolidated government balance	0.9	0.9	-2.2	-1.2	-0.5	-1.4	-1.4	-1.4	-0.8
Consolidated gov primary balance	1.9	1.9	-1.2	-0.3	0.4	-0.5	-0.5	-0.6	-0.5
Public debt	33.3	34.7	38.0	38.3	40.0	40.9	39.9	39.6	39.3
of which Domestic	33.3	34.7	38.0	38.2	40.0	40.8	39.9	39.6	39.3
Foreign Assets & Liabilities, US$ bn									
External debt	94.5	90.4	82.0	101.6	122.5	130.8	150.0	160.0	150.0
Private	91.1	88.9	76.0	93.5	118.0	127.5	146.3	156.0	146.0
Public	3.5	1.5	5.9	8.0	4.5	3.3	3.7	4.0	4.0
External debt / GDP	24.1	22.6	21.7	23.6	26.3	27.5	30.6	31.9	28.0
External debt / XGS	33.4	30.9	34.7	32.0	34.6	37.4	41.9	43.2	37.0
Short-term debt	83.3	78.8	68.2	83.7	107.8	116.5	125.0	130.0	120.0
Short-term debt/International Reserves (%)	30.8	27.0	19.6	21.9	28.0	28.9	30.0	29.5	26.1

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.9	3.0	2.7	3.3	3.9	4.0	3.3	3.7	4.1
CPI, % yoy	0.3	1.6	0.6	0.7	2.5	0.9	1.7	2.3	2.8
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	2.00	2.13	2.25	2.38
Short-term market rate, % eop	0.87	0.87	0.87	0.87	0.93	0.99	1.05	1.11	1.17
Long term yield, % eop	1.68	1.56	1.58	1.61	1.66	1.74	1.84	1.94	2.04
lc vs USD, eop	29.83	30.45	30.48	30.37	30.26	30.16	30.08	30.00	29.92

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

Thailand

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- **Summary view** – Amid signs of domestic demand 'recession' in 1Q14, we revised our 2014 GDP growth to 0.5%YoY (1.8% previously) and 2015 growth to 2.8% (4.1% previously). Domestic demand fell 1.7%QoQ SA for the 3rd straight quarter underpinned by a streak of at least 3 quarterly declines in private spending.
- **Things to watch** – Military-backed initiative to cobble together an interim, 'reconciliation' gov't. NACC's findings on the role of ex-PM Yingluck and other cabinet ministers in the rice pledging scheme. Agreement on the new election date. New GDP trajectory and any shift in MPC's rate bias.
- **Strategy** – MPC dovish bias strengthened by 1Q GDP although missing disinflation risk may not necessarily prompt rate cut signals. Dovish MPC, downside GDP risk and expectations of tighter US monetary conditions would sustain our medium-term forecast for USD/THB at 33.

Signs of 1Q14 domestic demand already in recession

1Q14 GDP fell 0.6%YoY for lower than expected weakness (-2.1%QoQ s.a.). Domestic demand (ex-inv) fell 4.2%YoY in 1Q14 for the 3rd straight quarterly drop. Consumption posted another decline of 3%YoY (Citi: -2%YoY) to record the 3rd straight quarterly decline. Durable goods consumption largely driven by falling demand for transport equipment plunged by 29%YoY, to sustain the drag on private consumption. We believe this resulted from severe savings propensity in response to political uncertainty. Gross domestic savings to GDP soared to a new high of 42.7% in 1Q14 despite lack of significant deterioration in the jobless rate. Ex-durable goods, private consumption grew 3.1%YoY during the period providing the silver lining to the private spending collapse. Real investments (ex-inv) fell 9.8%YoY for a 3rd straight quarterly drop driven by broadening slack and contraction in public investments owing to the protracted crisis. Machinery & equipment investments as well as construction for the 7.3%YoY decline in private investment while public investments fell 19.3%YoY. Government consumption grew 2.9%YoY to buck the private spending downtrend. Net exports expanded by 28.8%YoY in 1Q14 to cushion domestic demand impact. Commodity exports eked out growth of 0.8%YoY but the 12%YoY contraction in real imports facilitated strong net exports roughly contributing >20% of 1Q GDP.

We believe domestic demand is already in recession. This domestic spending measure fell 1.7%QoQ SA for its 3rd straight quarterly decline, giving the impression bulk of GDP is already in a recession. Private consumption declined 0.5%QoQ SA for the 5th straight quarterly drop. Real investments (ex-inv) reported a 1Q decline of 2.8%QoQ SA for the 3rd straight quarterly drop. Severe savings propensity and broadening slack contributed to sustained drag to private spending.

Farm output managed 0.8%YoY gain while non-farm GDP dipped 0.7%YoY in 1Q14. Manufacturing (-2.7%YoY), construction (-12.4%YoY) and utilities (-3.1%YoY) underpinned stagnant non-farm output. Falling tourist arrivals contributed to the 3.1%YoY drop in hotels & restaurant services as this segment posted the heftiest drop in the services sector. On a quarterly basis, farm output fell 1%QoQ SA while non-farm GDP declined by 2.2%QoQ SA in 1Q14. Manufacturing GDP fell by 3.2%QoQ SA to weigh down on 1Q industrial GDP. Capital-intensive mfg industries including automotive posted a hefty drop (-6.1%YoY) in output mainly in response to weak domestic demand. Both private and public construction conspired to lower construction output by 4%QoQ SA. Subdued fiscal disbursements, higher raw material costs, lack of skilled labor, extended crisis and poor investment climate weighed on 1Q construction.

2014 GDP forecast revised lower to 0.5% (1.8% previously)

Extended crisis, absence of a functioning government that could pursue fiscal initiatives as well as public investments, and lackluster export recovery led us to downgrade our forecasts to 0.5% growth in 2014 and 2.8% gain in 2015. Below potential GDP would be the 2yr outlook with 2H15 upside risk to growth likely assuming elections are held late 2014 or early 2015. Government declared martial law recently, creating additional uncertainty although one possibility is that military intervention could cut short the process of cobbling together an 'interim' government as 'back-channeling' may take time while averting potential clash between rallying red shirt and PDRC groups. Whether the military backed government would inspire confidence and reconciliation would depend on the 1) cabinet appointments and 2) political/ economic agenda. Lacking strong exports, assuming tech recovery remains moderate to uncertain, and with durable goods onshore demand unlikely to go through a v-shaped recovery, 2014 growth already looks compromised while in 2015, below potential growth remains a possibility.

Unlikely v-shaped recovery this time

Imminent tech recession risk is not a key issue as far as we are concerned, since we believe domestic demand is already in a 'recession'. A 'reconciliation' government that bodes well for the political outlook may not be able to restore the ability of the fiscal authority to facilitate or contribute to a 'v-shaped' recovery that has been a hallmark of previous economic recoveries. In the past, despite hefty GDP drops owing to external (e.g. 2009 global recession)/internal (e.g. 4Q11 flooding event) shocks, recovery materialized after 1-3 quarters based on GDP's quarterly gains (adj.) and enabled the domestic economy to resume its potential growth pace. This strong capacity to bounce back after strong income shocks offers a testament to Thai economic resilience. While v-shaped recoveries were driven essentially by the private sector, we worry this time around that consumer and business sentiment may take a long while to recover from the current crisis alongside FDI diversion risk. We estimate a share of real investment to GDP of 19.4%, slightly higher than 4Q13 (18.8%). We highlighted earlier that this pattern of sluggish contribution of real investment (ex-inv) to GDP may persist with the protracted crisis and breach downside of 20% which we believe would be the start of a mediocre to bleak investment setting. A falling investment ratio could reflect near-term production slack but also the start of structural investment decay. On a 4-quarter rolling sum, the real investment share to GDP stood at slightly above 21% in 1Q14. The investment ratio hit a high of 23.1% in 2006.

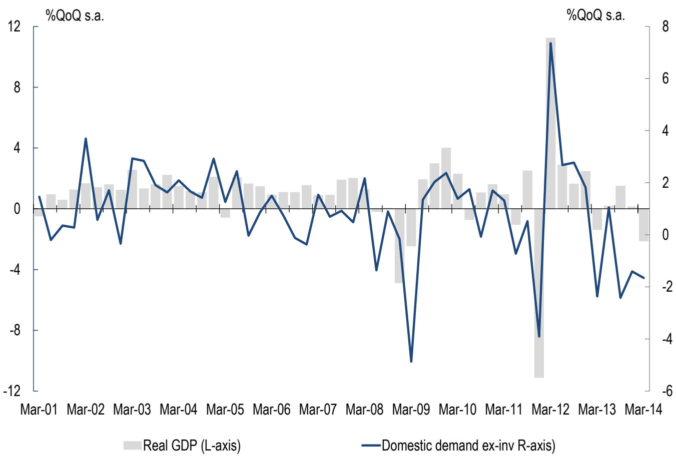
Needing a hefty export upside to drive away recession

To soak up mfg slack and approximate potential growth of 3% or more this year, a major export rebound is required in our view. In our sensitivity test, external demand has to generate commodity export gains (forget tourism for now) of close to 10% in 2Q14 rising to 15% in 4Q14. Even if we incorporate an export lift to import volume, net export contribution could elevate to 19%-21% of GDP in 2H14. This modest 2-digit export gain has been attained in the past but recent regional demand (Asian exJ) doesn't signal any upbeat export recovery soon.

Awaiting MPC signals amid THB expected at 33

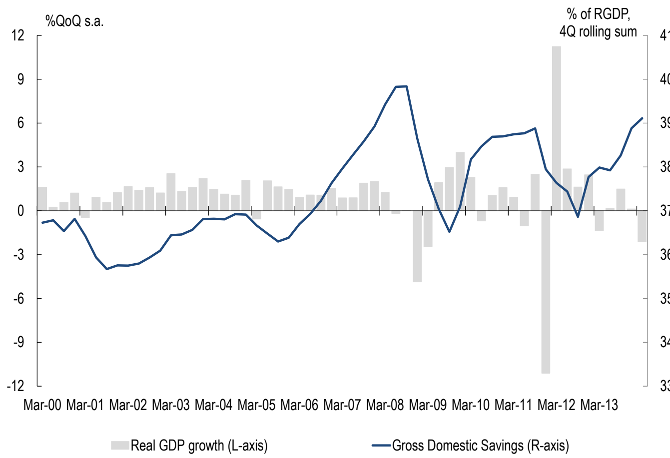
Despite signs of demand recession, disinflation remains missing. Core CPI peaking and BoT's GDP forecast downgrade may signal likely shifts in the policy rate bias currently stuck at 2%. GDP deflator consistent with headline CPI rose to 1.8%YoY in 1Q14. Dovish MPC, downside GDP risk and expectations of tighter US monetary conditions sustain our medium-term forecast for USD/THB at 33.

Figure 103. Domestic demand already likely in recession in 1Q14



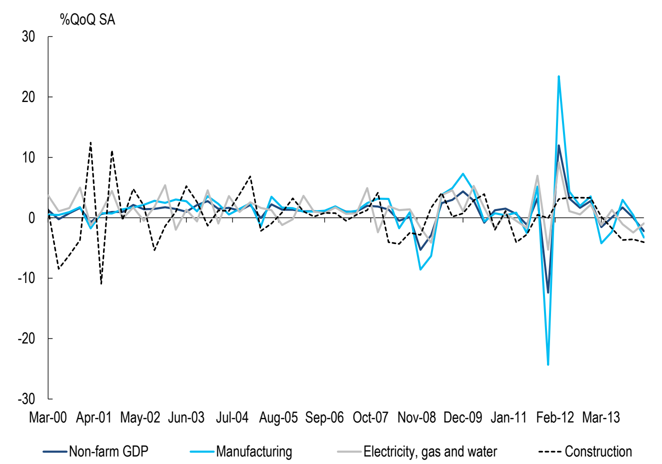
Source: CEIC, Citi Research

Figure 104. Savings ratio soars to 42.7% amid significant job losses



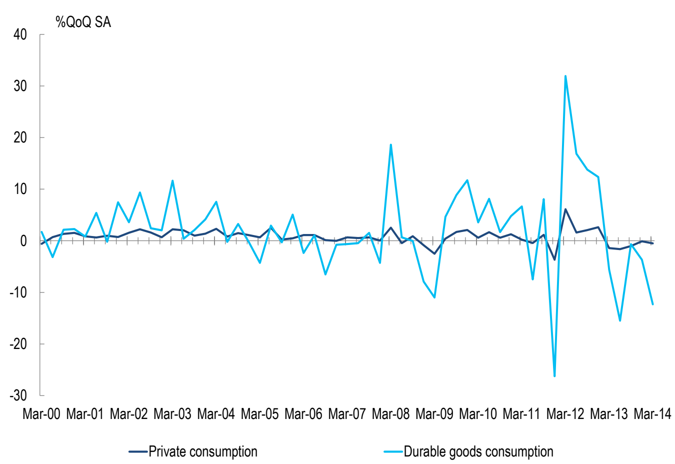
Source: CEIC, Citi Research

Figure 105. Bearish industrial GDP due to mfg and construction decline



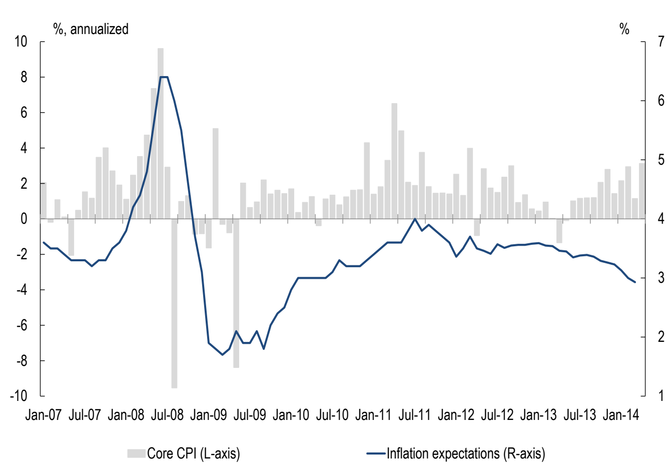
Source: CEIC, Citi Research

Figure 106. Flipside of higher savings is cut in durable goods demand



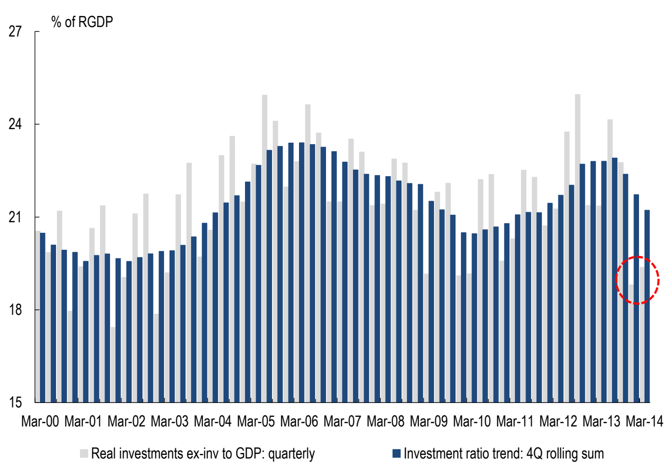
Source: CEIC, Citi Research

Figure 107. Soaring core in Apr against slower inflation expectations



Source: CEIC, Citi Research

Figure 108. Higher likelihood of <20% ratio of investments to real GDP



Source: CEIC, Citi Research

Figure 109. Thailand Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	265.2	276.1	263.8	319.3	346.1	366.4	387.8	371.9	386.4
Nominal GDP, local currency bn	8,525	9,080	9,042	10,105	10,540	11,375	11,899	12,309	12,916
GDP per capita, US$	4,207	4,355	4,153	4,998	5,401	5,685	5,987	5,713	5,906
Population, mn	63.0	63.4	63.5	63.9	64.1	64.5	64.8	65.1	65.4
Unemployment, % of labour force	1.4	1.4	1.5	1.0	0.7	0.7	0.7	0.8	0.8
Economic Activity									
Real GDP, % yoy	5.0	2.5	-2.3	7.8	0.1	6.5	2.9	0.5	2.8
Real investment growth % yoy	1.0	8.1	-25.2	28.7	0.1	16.8	2.2	-2.2	0.0
Real consumption growth % yoy	2.9	2.9	0.1	5.1	1.3	6.8	1.1	-0.3	2.5
private consumption growth % yoy	1.8	2.9	-1.1	4.8	1.3	6.7	0.3	-1.0	2.2
Real export growth, % yoy	7.8	5.1	-12.5	14.7	9.5	3.1	4.2	1.0	3.4
Real import growth, % yoy	4.4	8.9	-21.5	21.5	13.7	6.2	2.3	-0.7	2.0
Prices, Money & Credit									
CPI, % yoy	3.1	0.4	3.5	3.1	3.5	3.6	1.7	2.3	2.3
CPI, % avg	2.2	5.5	-0.9	3.3	3.8	3.0	2.2	2.4	2.1
Nominal wages, % yoy	3.0	10.5	-1.9	5.8	7.2	11.9	7.9	4.0	3.5
Credit extension to private sector, % yoy	29.3	6.3	2.5	18.8	18.3	14.0	10.5	8.5	10.0
Policy interest rate, % eop	3.25	2.75	1.25	2.00	3.25	2.75	2.25	2.00	2.00
Short-term market rate, % eop	3.74	3.07	1.28	2.03	3.26	2.79	2.31	2.05	2.10
Long term yield, % eop	5.13	2.84	4.37	3.74	3.28	3.55	4.07	3.65	3.85
lc/US$, eop	30.05	34.79	33.36	30.07	31.57	30.60	32.70	32.90	33.00
lc/US$, avg	32.33	33.03	34.33	31.71	30.48	31.08	30.72	32.64	33.00
Balance of Payments, US$ bn									
Current account	15.7	2.2	21.9	10.0	8.9	-1.5	-2.8	8.3	-4.3
% of GDP	5.9	0.8	8.3	3.1	2.6	-0.4	-0.7	2.2	-1.1
Trade balance	26.6	17.3	32.6	29.8	17.0	6.0	6.4	16.2	2.5
Exports	151.3	175.2	150.8	191.6	219.1	225.9	225.4	233.7	246.5
Imports	124.6	157.9	118.2	161.9	202.1	219.9	219.0	217.4	244.1
Net service and Transfer accounts	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	3.7	-0.6	-0.8
Income balance	-3.0	-2.3	-4.4	-9.0	2.5	-4.0	-12.8	-7.3	-6.0
FDI, net	8.3	4.4	0.7	4.5	-2.8	-2.2	6.4	1.2	1.0
International reserves	87.5	111.0	138.4	172.1	175.1	181.6	167.2	170.0	180.0
Total Amortisations	20.3	15.4	11.3	9.4	8.8	9.5	18.0	19.0	20.0
Public Finances, % of GDP									
Consolidated government balance	-1.6	-1.0	-5.7	0.0	-1.0	-2.1	-1.8	-1.2	-1.8
Consolidated gov primary balance	-0.3	0.2	-4.5	1.1	-1.5	-1.6	-1.2	-0.3	-0.7
Public debt	38.3	37.3	45.2	42.6	41.7	45.4	45.9	47.2	48.1
of which Domestic	33.4	33.0	40.9	39.0	38.4	42.3	42.7	43.0	43.3
Foreign Assets & Liabilities, US$ bn									
External debt	74.4	76.1	75.3	100.6	104.3	130.7	139.9	135.0	140.0
Private	71.6	72.7	69.4	87.9	88.1	104.5	114.7	108.4	112.9
Public	2.8	3.4	5.9	12.7	16.2	26.2	25.2	26.6	27.1
External debt / GDP	28.1	27.6	28.5	31.5	30.1	35.7	36.1	36.3	36.2
External debt / XGS	41.0	36.5	41.6	44.5	40.0	47.5	49.2	45.5	44.6
Short-term debt	33.7	32.5	33.3	50.7	47.3	58.2	59.9	59.8	61.0
Short-term debt/International Reserves (%)	38.6	29.3	24.0	29.4	27.0	32.0	35.8	35.2	33.9

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	0.6	-0.6	0.0	0.7	1.8	2.3	3.0	2.8	3.0
CPI, % yoy	1.7	2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Policy interest rate, % eop	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Short-term market rate, % eop	2.32	2.08	2.10	2.08	2.05	2.08	2.10	2.10	2.10
Long term yield, % eop	4.07	3.80	3.60	3.60	3.65	3.70	3.75	3.80	3.85
lc vs USD, eop	32.70	32.43	32.53	32.72	32.90	33.00	33.00	33.00	33.00

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

Frontier Asia

Mongolia

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We see supply risk 4Q14/early 2015 with new Debt Management Law. In our view, the likely amendment of the public debt law paves the way for more concessional loans as well as potential debt issuance by quasi sovereigns that comes with gov't guarantee. The new Debt Management Law will lift the public debt ceiling from the existing 40% of GDP to 70%, plus another limit of 20% of sov. guaranteed debt and will exclude SOE debt and guaranties from the calculation; but the debt will no longer be calculated in Net Present Value terms and will be more transparently calculated in nominal terms. The criteria amendments would provide the Gov't with more room to raise funds domestically and abroad and yet comply with the Fiscal Stability Law. The supply risk, depending on the quasi-sov. entity issued and whether issued in the int'l market, may be credit negative, but the additional needed funds would likely enable the gov't to engage in key infrastructure investments that would lift MN's potential growth. We will have to monitor how the extra ammunition will be spent, but for the time being we exit from our previous tactical long position on the Mongolia sovereign, and see more relative value in the quasi-sov. DBMMN (given its recent underperformance, sovereign guarantee and potential benefit from an OT deal by Sep14).

Total improvements from net FDI and current account were reduced in March. We continue to expect exports to improve in April, mainly due to OT copper/gold exports, but imports pick up could weigh on trade improvements in the near term. FDI in March rose by US$155mn, smaller than the Jan-Feb average (US$194mn /month), but still not a bad figure. We expect more incremental FDI improvements in the near future, but the real jump may have to wait for Rio/Gov't to strike a deal on Phase II of Oyu Tolgoi. Recent updates from both parties regarding the negotiation continues to be constructive, including confirmation that 14 out of 15 of the banks consortium has agreed to extend financing agreement to Sep14.

We believe international reserves continue to fall, especially with the continued MNT depreciation. The Turgrik reached 1818/USD on 15 May, indicating locals' lack of confidence in the MNT (BoM representative attributed part of the currency weakness is caused by some mineral exports having experienced delayed receipt of payment). With the likely intervention of the exchange rate amidst an expired but under negotiation RMB swap line, plus continued draw down of the Chinggis bond proceeds, we think the reserves have fallen further from Jan's (published) US$2.4bn to somewhere slightly below US$2bn in recent months .

Sri Lanka

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Inflation pressures mildly up on the back of food prices, CBSL likely on prolonged hold. April inflation rose to 4.9%YoY largely due to an uptick on food prices which may already be symptomatic of some spillover impact from the drought. While headline inflation may recede in May on favorable base effect, we see the trend as bottoming and should rise in subsequent months, with risk of another electricity price hike looming as Ceylon Electricity Board's losses rise. Nonetheless, trends in broad money and credit look fairly benign, and with external imbalances being relatively well contained, we think CBSL will keep policy on hold for awhile. We *remove* our further expectation of another 50bps cut this year. CBSL's latest monetary policy statement was more hawkish, citing that the economy is "poised for stronger performance with the recovery observed in the external sector, sustained momentum in construction and manufacturing sectors", and the language on inflation was not as dovish as before. We do think growth will disappoint vis-à-vis their expectations, but the bottoming of inflation and the need to support savings would raise the hurdle for them to ease further.

External position bolstered by external borrowings. Despite some disappointments last year (vis-à-vis what we had hoped), recent external trends still look favorable with the Feb goods trade deficit being contained on the back of muted import growth, especially imports of investment goods which may be a reflection of government's nearing its completion phase, and modest export recovery. Gross tourism flows continue to grow very healthily, likely benefiting from some tourism diversion flows due to the Thai political crisis. We still believe the CA deficit will narrow gradually this year to about 3.3% of GDP. FX reserves rose to a new historical high at US$8.3bn in Feb with the help of the US$1bn bond issuance in Jan, and should be further bolstered by US$500mn issuance in April.

We continue to like longer duration LKR Treasury bonds. Given carry friendly environment trends, we expect the rupee should be stable with a medium term appreciation bias amid improving external accounts and more prudent policies (vis-à-vis history). However, lack of revenue improvements will likely remain a drag on the rating, and government's resolve to contain SOE losses will be tested this year with how losses from CEB are contained. We remain constructive LK Tsy bonds and we recommend investors shift to longer duration bonds (up to 5yrs). Dollar bonds have already rallied significantly, but with sovereign supply out of the way, there is no clear trigger for a sell off, it may grind a bit tighter, though we see more residual value in the National Savings Bank (NSBLK) which lagged the sovereign slightly.

Vietnam

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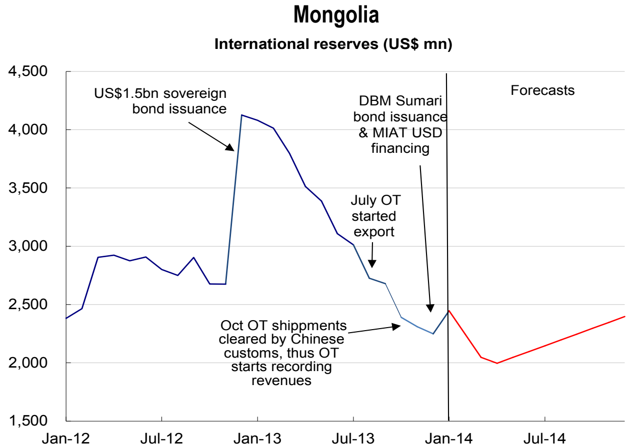
China-Vietnam political tensions rise on Chinese oil rig in disputed waters. Geopolitical concerns have risen over the last month after China's CNOOC placed a gigantic deepwater oil rig in disputed waters about 130 nautical miles off the coast of Vietnam, sparking confrontations between Chinese and Vietnamese vessels, verbal complaints by the Prime Minister at the ASEAN summit, as well as relatively rare public protests being held outside of the Chinese embassy. While we expect cooler heads will prevail, these escalating tensions could put pressure on the gov't to step up defense spending at a time when debt is on the rise.

While in terms of trade, Vietnam has more to lose if the situation worsen due to the high reliance on exports to CCN (10.2% of VN total exports, after 18.2% to US, and 10.4% to JP) [EU is 18% of VN's exports]. And on the other hand, CN's exports to VN only consists 2.3% of total exports, hence, China is clearly more significant to Vietnam as a trading partner than the other way around.

As well, damaged FDI sentiment following the riots may pose downside risk on VN's growth via exports. Despite the weak domestic demand led by a sharp slowdown in investment in the last three years, an important driver to VN's growth has been export and strong FDI flows in recent years, now dominated by mfg.-related FDI (exports rose by 14.6%YoY in the first four month of 2014, of which 10.3%pt were contributed by FIE). However, protests and riots targeting Chinese firms in Vietnam caused damages on 400 foreign factories, and forced 1,100 others to shut down (including KR, JP, SG, TW), this could deteriorate foreign investors' sentiments amid the unstable investment environment.

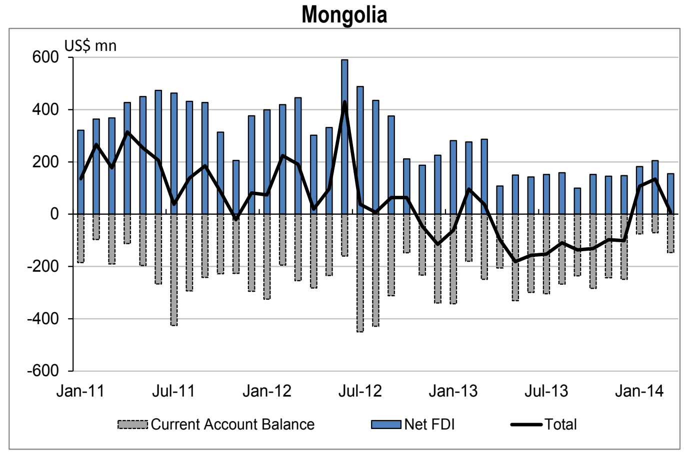
We expect Vietnamese dong to remain stable, and still provide a decent carry via LCY bonds despite yields already having rallied. There is a risk given CNY weakness and benign inflation, that Vietnamese authorities may try to artificially push the dong weaker, but we don't see more than a 1-2% move a year, still giving us good risk-reward for the carry. Vietnam CDS/dollar bonds have lagged the other strong sovereign performers recently and could marginally catch up if, as we expect, geopolitical risks recede.

Figure 110. Mongolia – More reserves likely drained with MNT weakness



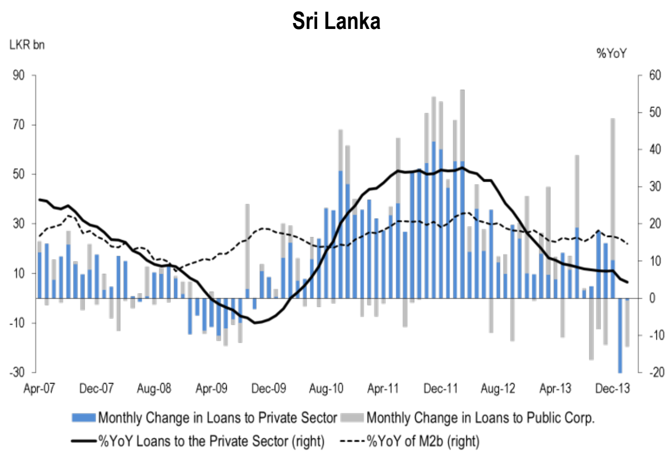
Source: BoM, CEIC and Citi Research

Figure 111. Net FDI and trade improvements shrank in March



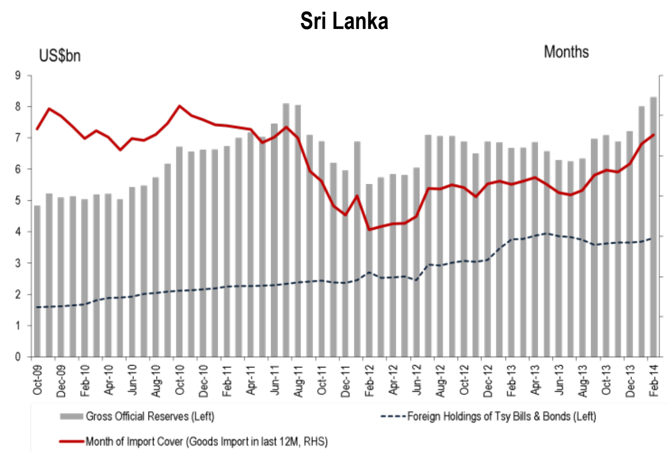
Source: BoM, CEIC and Citi Research

Figure 112. Sri Lanka – Credit and Monetary aggregates show very subdued growth



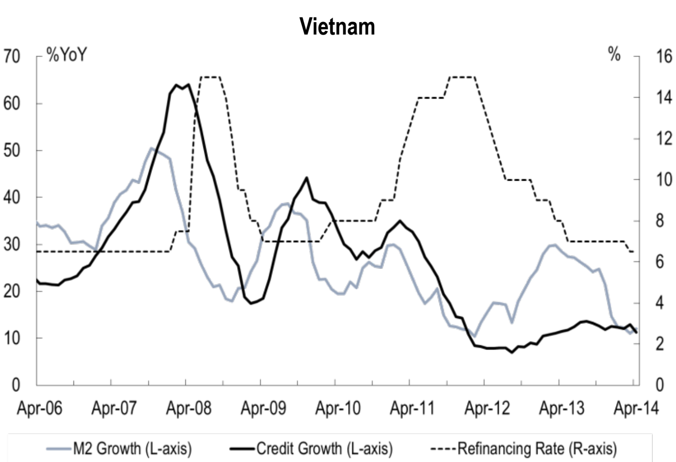
Source: CBSL, CEIC and Citi Research

Figure 113. FX Reserves rise with the help of foreign borrowings



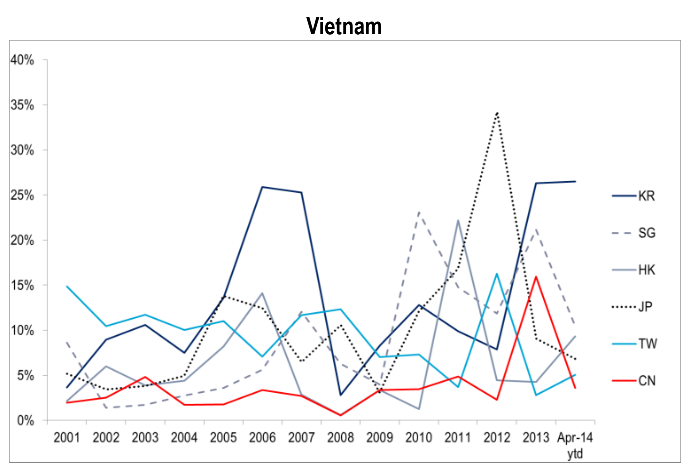
Source: CBSL, CEIC, and Citi Research

Figure 114. Vietnam – Credit and M2 growth still looks very anemic



Source: CEIC, Citi Research

Figure 115. FDI flows by registered capital, by country of origin, as a % of total FDI by registered capital



Source: CEIC, Citi Research

Figure 116. Asia Frontier Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Mongolia									
Nominal GDP, US$ bn	4.2	5.6	4.6	6.2	8.8	10.3	10.3	11.9	15.0
GDP per capita, US$	1,629	2,138	1,717	2,287	3,186	3,595	3,525	4,005	4,967
Population, mn	2.6	2.6	2.7	2.7	2.8	2.9	2.9	3.0	3.0
Real GDP, % yoy	10.2	8.9	-1.3	6.4	17.5	12.4	11.7	10.0	9.0
CPI, % yoy	15.1	22.1	4.2	13.0	10.2	14.0	12.5	14.0	11.5
CPI, % avg	--	28.0	8.0	10.1	9.2	14.3	10.5	13.1	12.0
Policy interest rate, % eop	8.40	9.75	10.00	11.00	12.25	13.25	10.50	11.00	11.50
Long term yield, % eop	21.83	20.58	21.67	20.07	16.61	18.11	18.48	19.68	21.08
lc/US$, eop	1,172	1,275	1,433	1,233	1,378	1,378	1,660	1,787	1,717
lc/US$, avg	1,171	1,167	1,434	1,349	1,256	1,353	1,505	1,813	1,743
Current account (US$ bn)	0.3	-0.7	-0.4	-0.9	-3.4	-3.2	-3.2	-2.1	-2.9
% of GDP	6.3	-12.8	-8.9	-15.0	-38.4	-31.1	-30.9	-17.9	-19.7
Trade balance (US$ bn)	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-2.1	-0.6	-1.1
Exports (US$ bn)	1.9	2.5	1.9	2.9	4.8	4.4	4.3	5.6	6.7
Imports (US$ bn)	2.2	3.2	2.1	3.2	6.6	6.7	6.4	6.1	7.8
FDI, net (US$ bn)	0.4	0.8	0.6	1.6	4.6	3.9	-2.1	2.4	3.4
International reserves (US$ bn)	0.8	0.6	1.3	2.2	2.3	3.9	2.2	2.4	3.5
Consolidated government balance (% of GDP)	2.6	-4.5	-5.2	0.5	-6.9	-9.9	-7.8	-7.5	-4.3
Public debt (% of GDP)	36.0	30.6	44.2	28.7	28.9	42.1	67.3	73.5	74.6
Sri Lanka									
Nominal GDP, US$ bn	32.4	40.7	42.1	49.6	59.2	59.4	67.2	74.8	85.9
GDP per capita, US$	1,617	2,014	2,057	2,400	2,836	2,923	3,281	3,621	4,128
Population, mn	20.0	20.2	20.5	20.7	20.9	20.3	20.5	20.6	20.8
Real GDP, % yoy	6.8	5.9	3.5	8.0	8.2	6.3	7.3	7.2	7.4
CPI, % yoy	18.8	13.9	5.0	6.8	4.9	9.2	4.7	8.1	6.0
CPI, % avg	15.8	22.5	3.6	6.2	6.8	7.5	6.9	5.7	6.5
Policy interest rate, % eop	12.00	12.00	9.75	9.00	8.50	9.50	8.50	8.00	8.00
Long term yield, % eop	19.96	19.20	11.50	9.24	10.00	11.81	9.91	9.50	9.00
lc/US$, eop	108.7	113.0	114.4	110.9	113.9	127.7	130.8	131.0	129.0
lc/US$, avg	110.6	108.3	114.9	113.0	110.5	127.2	129.1	131.1	129.9
Current account (US$ bn)	-1.4	-3.9	-0.2	-1.1	-4.6	-4.0	-2.6	-2.5	-2.6
% of GDP	-4.3	-9.5	-0.5	-2.2	-7.8	-6.7	-3.9	-3.3	-3.0
Trade balance (US$ bn)	-3.7	-6.0	-3.1	-4.8	-9.7	-9.4	-7.6	-7.8	-8.3
Exports (US$ bn)	7.6	8.1	7.1	8.6	10.6	9.8	10.4	11.2	12.0
Imports (US$ bn)	11.3	14.1	10.2	13.5	20.3	19.2	18.0	19.0	20.3
FDI, net (US$ bn)	0.5	0.7	0.4	0.4	0.9	0.9	0.9	0.9	1.0
International reserves (US$ bn)	3.1	1.8	5.1	6.6	6.0	6.9	7.2	7.3	7.9
Consolidated government balance (% of GDP)	-6.9	-7.0	-9.9	-8.0	-6.9	-6.4	-5.9	-5.6	-5.3
Public debt (% of GDP)	85.0	81.4	86.1	81.9	78.5	79.2	78.3	77.0	76.0
Vietnam									
Nominal GDP, US$ bn	77.5	98.3	101.6	112.8	133.4	155.7	169.8	174.3	196.7
GDP per capita, US$	920	1,154	1,181	1,297	1,518	1,754	1,893	1,926	2,154
Population, mn	84.2	85.1	86.0	86.9	87.8	88.8	89.7	90.5	91.3
Real GDP, % yoy	7.1	5.7	5.4	6.4	6.2	5.2	5.4	5.7	5.9
CPI, % yoy	12.6	19.9	6.5	11.8	18.1	6.8	6.0	6.4	7.0
CPI, % avg	8.3	23.1	7.0	9.2	18.6	9.3	6.6	5.4	6.8
Policy interest rate, % eop	6.50	9.50	8.00	9.00	15.00	9.00	7.00	6.00	6.00
Long term yield, % eop	8.73	10.00	11.68	11.49	12.55	9.75	9.29	7.50	8.50
lc/US$, eop	16,028	17,483	18,474	19,498	21,034	20,840	21,095	21,036	21,036
lc/US$, avg	16,081	16,445	17,806	19,123	20,648	20,875	21,028	21,063	21,036
Current account (US$ bn)	-7.1	-10.8	-6.6	-4.3	0.2	9.1	8.9	7.1	5.6
% of GDP	-9.1	-11.0	-6.5	-3.8	0.2	5.8	5.3	4.1	2.9
Trade balance (US$ bn)	-10.4	-12.8	-7.6	-5.1	-0.5	9.9	9.4	8.6	6.9
Exports (US$ bn)	48.6	62.7	57.1	72.2	96.9	114.6	133.3	157.3	180.9
Imports (US$ bn)	59.0	75.5	64.7	77.4	97.4	104.7	123.9	148.7	174.0
FDI, net (US$ bn)	6.5	9.3	6.9	7.1	6.6	7.2	7.3	7.6	7.7
International reserves (US$ bn)	23.5	23.9	16.0	12.1	13.5	25.6	33.3	35.8	40.8
Consolidated government balance (% of GDP)	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-5.3	-5.3	-4.5
Public debt (% of GDP)	40.9	39.4	46.9	44.6	43.2	46.6	45.7	41.3	45.0

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

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CEEMEA

Czech Republic

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- **Summary view** — For the time being we maintain our 2014 growth forecast at 1.9%YoY, followed by 2.6% and 3.0% in 2015 and 2016 respectively.

- **Things to watch** — 2H14 inflation data is likely to be key for the CNB as it assumes its acceleration should start to be driven by a stronger contribution from domestic demand.

- **Strategy** — We expect the CNB to start exiting its FX intervention in the middle of 2015 with a lower desired level of EURCZK from 27+ currently, but we continue to see a risk of later hike in CNB policy rate than in 4Q15.

Flash estimate of GDP was solid in 1Q14

For the time being we maintain our 2014 growth forecast at 1.9%YoY, followed by 2.6% and 3.0% in 2015 and 2016 respectively. Overall, the 1Q14 YoY data is in line with confidence data. The flash estimate does not provide any clue of any revisions, but the recovery does appear to be on track. Though GDP remained unchanged sequentially 1Q14, in YoY terms it accelerated to 2% from the 1.2% initially published in 4Q13 – a number we believe was revised to around 0.6%YoY. We think these distortions reflect a change in the tax base owing to large forward buying of tobacco in 4Q13 to avoid a tax hike. However, the valued added has continued to grow – we believe in both QoQ and YoY terms - supported by industry and services. The statistical office said both consumption and fixed investment accelerated in YoY terms. However, we estimate fixed investments were weaker than what the CNB expected and could explain the undershooting of its forecast (2.7%YoY) and should neutralize any disinflationary implications from weaker GDP growth. We continue to expect a later exit from the current CNB FX intervention mode (mid 2015) and first hikes in CNB's rate (end of 2015) compared to CNB's "in early 2015, eventually later". The CZSO will publish the 2nd GDP estimate on 4th June and 3rd estimate on 1st July and these will be more important for the CNB.

Monthly data from the economy are supportive. Czech manufacturing PMI increased to 56.5 in April from 55.5 a month ago and surpassed both our forecast and consensus (both at 55.7). Both Czech manufacturing PMI and industrial confidence have remained supportive for industrial production growth. Industrial confidence improved in April, supported by better assessment of orders, but foreign orders worsened after a weak improvement in 1Q14. While industrial confidence suggests only 3.8%YoY growth in industrial output, this is countered by the manufacturing PMI, which points to a 7-8% pace in growth – on balance, this points to around 5.8%YoY growth, which is below our forecast of 6.3% growth in 1H14. Our forecast envisages the industrial production growth to accelerate to 5.2%YoY growth in 2014 after 0.7% in 2013. Construction output accelerated further in 1Q14 in line with recent improvement in construction confidence and supported with improvements in value of construction permits. This is likely to remain supportive for construction investment activity, which contracted in YoY terms in 4Q12-4Q13. We expect this segment to be also supported by government investment activity in next quarters reflecting two factors: i) higher pressure to utilize the EU funds, and ii) surprisingly lower investment activity of local government in 2012-2013.

Lower inflation and interest environment for longer

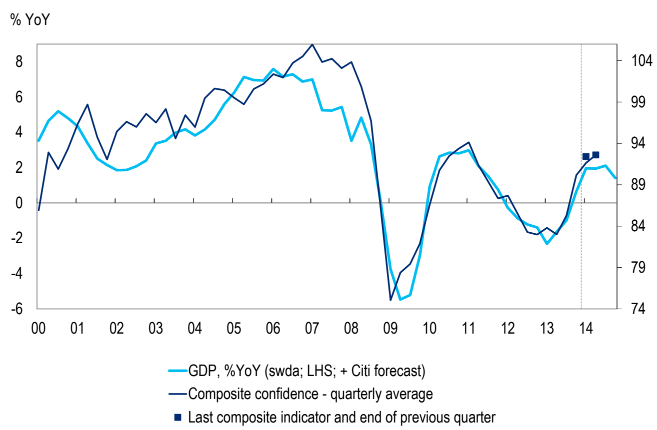
There is downside risk to our CPI forecast of 0.9%YoY in 2014 which should accelerate to 2.1% in 2015. Our forecast is close to the CNB's projection for both 2014 and 2015, which was lowered to 0.8% and 2.2% respectively from 1.2% and 2.6% previously at May Bank Board meeting. Consumer price growth continued to decelerate to 0.1%YoY in April from 0.2% in the previous three months in 1Q14. This reflects the base effect as the CPI index remained unchanged on a monthly basis in April – the seasonal increase in clothes prices was offset by lower food and alcohol prices, which was stronger than we had expected, and cut 0.25%pt from CPI growth. April CPI growth confirmed the downside risk to our forecast of 0.2%YoY that we had mentioned in the weekly preview. April CPI growth was also below the CNB's forecast (0.2%) and market consensus (0.3%). The CNB expects inflation to accelerate to 0.6%YoY in May and 0.5% in June.

CNB Minutes requires milder tightening in CNB's policy. A milder tightening in interest rate should ensure inflation approaching to the target more from its upper bound, which is not apparent in current CNB's forecast. The Minutes said that it was many times repeated that the exit strategy from current FX regime should start once it is clear that the inflation outlook will be close to CNB's target. Interestingly, the Minutes said – probably reflecting the fact that the new forecast does not show the inflation approaching to the target from its upper bound – that the interest rate should not rise so quickly as the CNB's forecast suggests to create desirable inflationary pressures. However, there were also some notes in the Minutes that the assumption of larger exchange rate pass-through at the Zero Lower Bound could be optimistic. Nevertheless, for the time being the adjusted core CPI is following the CNB's forecast. It seems there was some disagreement regarding the natural interest rate level as the economy is gradually approaching its equilibrium with implied negative rates. Overall, there are two factors that sounds dovish: i) possible easing in ECB policy which in our view suggest longer period of current monetary policy; ii) inflation closer to upper bound of the target before the exit, which in our view suggest talking about later hikes to lower the forward rates.

We keep our forecast of later tightening. We expect the CNB to start exiting its current intervention mode in mid-2015, with a gradual decrease in the CNB's desired level of EURCZK from 27+ currently to 26 later in 2015. However, we see a risk of a later hike in the CNB's policy rate than 4Q15 owing to the possibility of more pronounced ECB easing. By contrast, our GDP forecast is not so optimistic, but is accompanied by upside risk. ECB QE could bring more volatility into EURCZK and Czech short-term rates, particularly if we see outperformance of the Czech economy. This could cause difficulties for the CNB in smoothly managing its commitment to no sharp FX appreciation after its exit strategy starts.

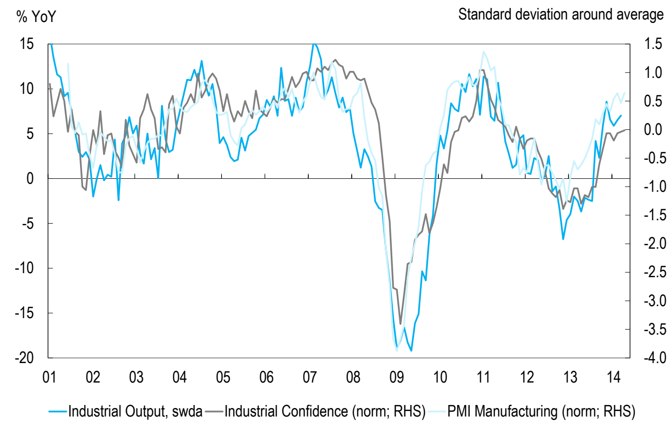
Tiny issuance in summer and is conditional for the rest of the year. Issuance in the rest of the year is conditional on: First, obviously, market conditions. Second, the more buybacks and switch auctions (MinFin will start with them), the larger issuance will be in Sep-4Q14. Third, there is uncertainty regarding the demand for retail bonds in the new (likely less attractive) conditions and also it is a question whether there will be a X-mas retail bond issuance. Overall, the MinFin assumes the issuance of local marketable bonds could reach CZK30bn in 2H14 if there is a demand for buybacks and switch auctions, CZK10-15bn excluding these operations, or CZK20bn in the case of low demand for retail bonds. Overall, this plan suggests to us coverage of this year's local issuance at 80% or 92% if there are no buybacks and switches.

Figure 117. Confidence suggests GDP growth around 2% …



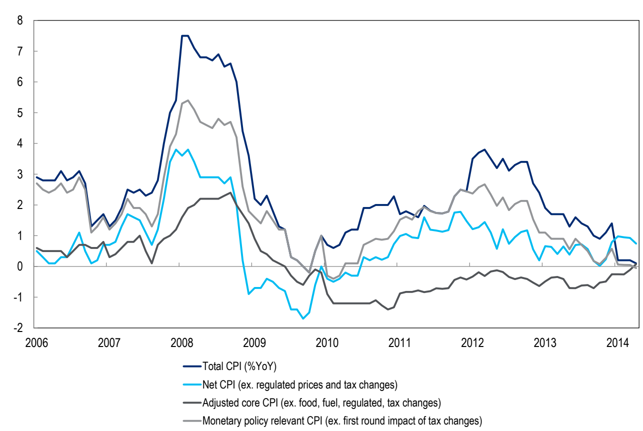
Source: CZSO, Citi Research

Figure 118. … and points to almost 6% growth in industrial production



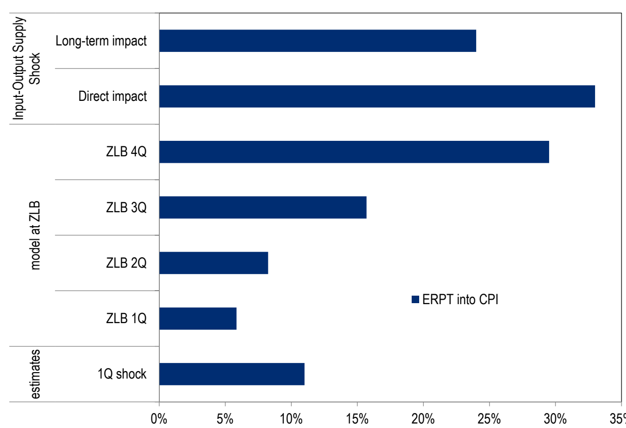
Source: CZSO, Haver Analytics, Citi Research calculation

Figure 119. While monetary relevant CPI is in mild deflation, adjusted core showed a first positive growth since June 2009



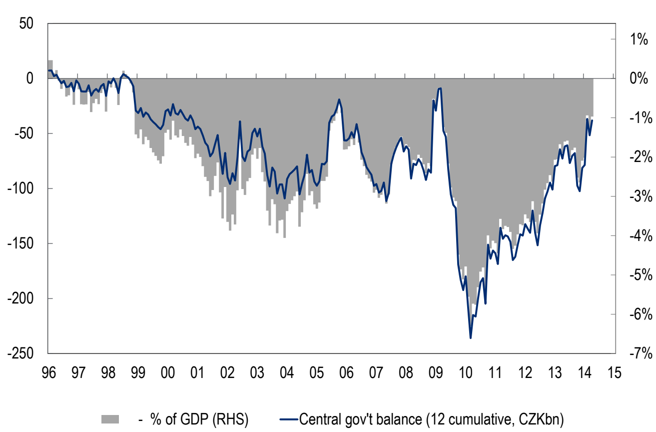
Source: CNB and Citi Research

Figure 120. Various exchange-rate pass-through coefficients



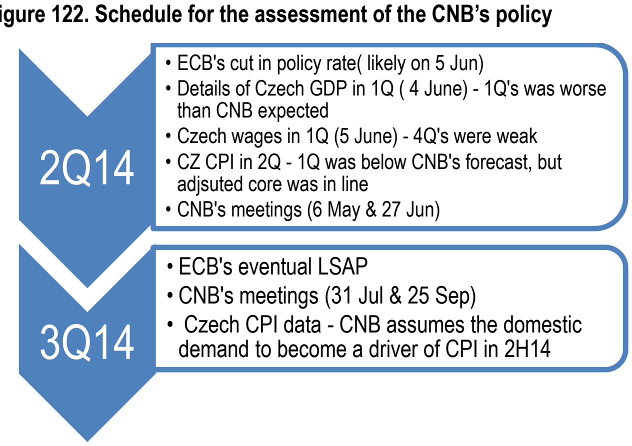
Source: Citi Research – based on CNB's sources: CNB – Meeting with analysts, November 2013 (page 21), CNB's Inflation Report 1/2014, CNB's RPN 1/2013.

Figure 121. April central cash state deficit still solid



Source: MinFin, CZSO, Citi Research calculation.

Figure 122. Schedule for the assessment of the CNB's policy



Source: Citi Research

Figure 123. Czech Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	180	225	197	198	216	196	198	206	212
Nominal GDP, local currency bn	3,663	3,848	3,759	3,791	3,823	3,846	3,884	4,041	4,226
GDP per capita, USD	17,484	21,614	18,795	18,873	20,584	18,693	18,881	19,626	20,147
Population, mn	10.3	10.4	10.5	10.5	10.5	10.5	10.5	10.5	10.5
Unemployment, % of labour force	5.3	4.4	6.7	7.3	6.7	7.0	7.0	7.0	6.8
Economic Activity									
Real GDP, yoy avg	5.7	3.1	-4.5	2.2	2.1	-1.0	-0.9	1.9	2.6
Real investment growth % yoy	15.5	1.9	-20.2	5.4	0.8	-5.0	-4.4	3.8	4.0
Real consumption growth % yoy	3.1	2.3	1.3	0.7	-0.4	-2.1	0.6	0.6	1.7
private consumption growth % yoy	4.2	2.8	0.2	0.9	0.5	-2.1	0.1	0.4	1.8
Real export growth, % yoy	11.2	4.0	-10.9	15.4	9.5	4.5	0.2	6.5	8.0
Real import growth, % yoy	12.8	2.7	-12.1	15.4	7.0	2.3	0.6	5.7	7.7
Prices, Money & Credit									
CPI, % yoy eop	5.5	3.6	1.0	2.3	2.4	2.4	1.4	1.8	2.0
CPI, % avg	2.9	6.3	1.0	1.5	1.9	3.3	1.4	0.9	2.1
Nominal wages, % yoy	7.2	7.9	3.4	2.2	2.5	2.7	0.1	2.1	3.6
Credit extension to private sector, % yoy	26.6	16.1	0.8	3.0	5.5	2.6	3.7	5.3	9.0
Policy Interest Rate, % eop	3.50	2.25	1.00	0.75	0.75	0.05	0.05	0.05	0.25
1 month inter-bank rate, %, eop	3.94	3.21	1.29	0.99	0.94	0.33	0.29	0.25	0.45
Long-term yield, %, eop	4.64	4.15	4.01	3.86	3.69	1.90	2.30	2.00	2.50
CZK/US$, eop	18.2	19.2	18.4	18.7	19.8	19.0	19.9	20.4	19.3
CZK/US$, avg	20.2	17.0	19.0	19.1	17.7	19.5	19.6	20.0	19.9
CZK/EUR, eop	26.5	26.8	26.4	25.0	25.6	25.1	27.3	27.6	26.9
CZK/EUR, avg	27.8	25.0	26.4	25.3	24.6	25.1	26.0	27.5	27.2
Balance of Payments, USD bn									
Current account	-7.9	-4.8	-4.8	-7.6	-6.3	-4.7	-2.9	0.3	1.6
% of GDP	-4.4	-2.1	-2.5	-3.8	-2.9	-2.4	-1.4	0.2	0.8
Trade balance	2.2	1.7	4.6	2.8	5.3	7.5	9.6	13.5	15.2
Exports	106.5	125.1	99.1	114.0	138.5	131.7	135.6	145.3	156.0
Imports	104.3	123.4	94.6	111.2	133.2	124.2	126.0	131.8	140.9
Service balance	2.9	4.4	3.9	3.9	3.8	2.5	2.7	3.5	4.0
Income balance	-12.7	-10.6	-13.2	-14.8	-15.6	-14.7	-16.0	-17.2	-18.1
FDI, net	9.0	2.3	2.0	4.9	4.2	9.2	1.7	6.0	6.4
International reserves	34.4	36.5	39.7	40.3	37.9	42.4	53.9	58.4	62.7
Total amortisations	4.0	4.2	6.2	5.4	8.6	5.4	7.4	7.1	7.1
Public Finances, % of GDP									
Consolidated government balance	-0.7	-2.2	-5.8	-4.7	-3.2	-4.2	-1.5	-2.0	-2.5
Consolidated gov primary balance	0.4	-1.2	-4.5	-3.3	-1.8	-2.7	-0.1	-0.2	-1.0
Public debt	27.9	28.7	34.6	38.4	41.4	46.2	46.0	44.8	45.2
of which Domestic	20.3	20.7	24.4	25.8	34.8	39.9	29.9	35.1	34.6
Foreign Assets & Liabilities, USD bn									
External debt	76.2	84.2	89.2	94.2	94.2	102.5	111.3	102.4	113.4
Public	15.0	15.3	19.8	24.0	22.6	28.3	30.2	23.4	29.4
External debt / GDP	42.2	37.4	45.3	47.5	43.6	52.2	56.1	49.6	53.4
External debt / XGS	61.5	57.3	75.3	69.8	58.3	66.7	70.5	60.6	62.4
Short-term debt	22.6	27.1	23.9	23.6	27.1	24.1	29.4	36.0	39.0
Short-term debt/International reserves (%)	65.5	74.2	60.2	58.5	71.5	56.8	54.6	61.6	62.2

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.2	2.2	2.2	2.3	1.1	2.0	2.5	2.8	3.0
CPI, % yoy eop	1.4	0.2	0.6	1.6	1.8	2.3	1.9	1.9	2.0
Policy interest rate, %, eop	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.25
Short-term market rate, % eop	0.29	0.27	0.27	0.25	0.25	0.25	0.25	0.25	0.45
Long-term yield, %, eop	2.30	2.18	1.94	1.97	2.00	2.13	2.25	2.38	2.50
CZK/EUR, eop	27.34	27.46	27.42	27.53	27.64	27.59	27.35	27.10	26.86

Source: National Sources, Citi Research forecasts

Egypt

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- **Summary view** — Following the holding of the constitutional referendum, the military's political roadmap to a new political dispensation should continue to unfold in the coming months. Even with periodic upsurges in violence, we still expect the political transition to be completed by year end.
- **Things to watch** — Gulf support has helped stabilize the exchange rate and eased, but not eliminated, foreign exchange shortages. But it is not a long-term economic solution to the problems facing the economy or stabilizing the EGP.
- **Strategy** — As the political situation stabilises in 2014, the government plans to use Gulf support to part fund a big push in capital spending. But a more coherent economic policy remains elusive, notably a medium- to long-term strategy to reduce the fiscal deficit.

Greater political stability in 2014

Despite periodic upsurges in violence in early 2014, the holding of the constitutional referendum now means the military's political roadmap for Egypt is moving forward. The next important step in this will be the holding of presidential elections on May 26/27. This will now be a two horse race between the former military leader, Abdelfattah el Sisi (standing as in independent) and Hamdeen Sabahi (standing for the Popular Current), with polls showing the former has a substantial lead in popularity at this point of time.

This will be followed by parliamentary elections, probably in July or August. In contrast to the presidential vote, we think that the parliamentary vote will be quite widely split over a range of parties, meaning that a coalition government of some sort will have to be formed by the president, an outcome which is likely to lead to a strong presidency.

We believe this outcome is also likely to be supported by most foreign governments. But it is clear that the political environment has changed in recent months, with the Gulf States now taking the political and economic lead in supporting Egypt's political transition, while US and European influence has diminished as they struggled to react to political developments since June 2013.

The need to keep the Islamist political community on side

It is also possible that the current level of bombings and violent incidents subsides given the major clampdown on the Muslim Brotherhood (MB) that is underway. But pushing the MB underground raises the risk of returning to the low level insurgency of the 1990s. Attempts by the MB to reignite protests against the new political regime have had some success, although it seems from opinion poll data that the MB is increasingly seen as the cause of the political violence and instability, which has undermined some of its support. There certainly seems strong support within Cairo for the return to normality on the streets, which opinion poll data also indicates is a strong factor behind support for an el Sisi presidential bid. But political positions remain deeply polarized in Egypt.

But despite the clampdown on the MB, we think the military is keen to keep significant elements of the Islamist political community on side during the transition. Without this it would lack wider political legitimacy. This seems to be working, with the Nour party supporting the transition, while blaming the MB for putting paid to the Political Islam Project and allowing it to succeed the MB as the main Islamic political voice in the country.

The re-emergence of a fragile economic stability…

The shift in external political support has also been positive for the economy as Gulf States, led by Saudi Arabia, have provided significant external support for the new government. This has allowed the Central Bank of Egypt (CBE) to stabilise reserves and reduce foreign currency shortages, which has translated into a more stable EGP since July. But it is also clear that the economy remains very weak with consumption under pressure and investment low.

At present, the current government seems to be banking on a policy where further inflows from the Gulf in 2014 allow it to push ahead with infrastructure spending with a strong social dimension. This should help boost growth, and coupled with the emergence of greater political stability should allow investment and tourism start to recover in 2H 2014 and into 2015.

…but more comprehensive reform programme still needed

But even if a slow pick-up in growth is possible in 2014, we still think that a new government will have to think more comprehensively about economic policy at some point. In particular, the root cause of many economic problems remains the fiscal deficit, which has been widening steadily since 2008 and looks set to remain firmly in double digits in 2014. The fiscal deficit rose to 11.2% of GDP in calendar year 2012 and provisional data for 1H 2013 show that there could be a worse outcome this year.

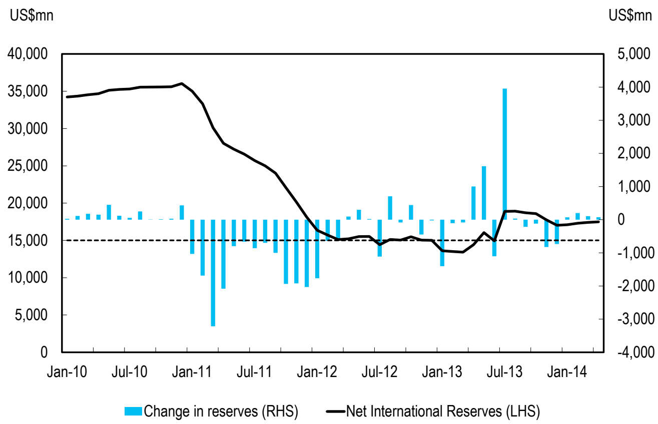
On a more positive note, with only modest EGP depreciation expected in 2014 and a still weak growth environment, we think that inflation is unlikely to rise sharply. While, it could be argued that the CBE's cuts in the Overnight Deposit Rate (ODR) in 2013 were premature given the rise in inflation in late 2013 back into double digits; we think that once the hump is passed, inflationary pressures will start to ease during 2014 allowing further cautious cuts in the ODR to help support growth and to ease the local cost of funding the deficit.

But a longer-term solution to reducing the fiscal deficit is only possible with real reform in our view. This would involve a programme to reduce subsidies on food and crucially, energy, firm control of the public sector wage bill and the return of growth to boost domestic revenue collection. Solving the energy subsidy issue is a particularly difficult problem, but has to become a policy priority in our view, however difficult. As such, while there may be a modest fall back in the deficit going forward, the prospects for more fundamental fiscal consolidation seem unlikely for some time, in our view, given current political agenda.

A homegrown reform programme

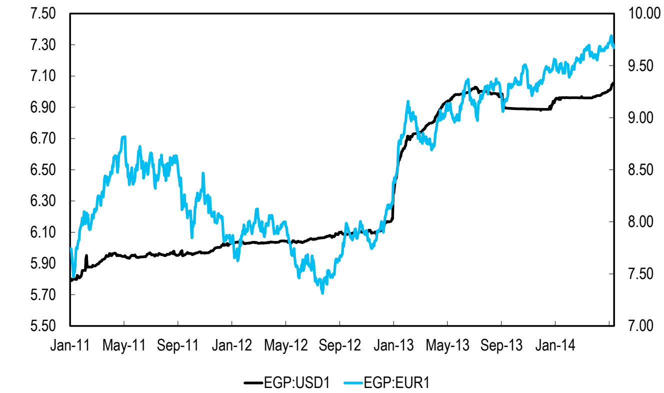
Having said that, the provision of Gulf support means that such difficult choices can be put off and the government can continue to operate in "muddle through" fiscal mode, probably well into 1H 2015. But at some point, the government will have to think about a more comprehensive reform programme. While this could potentially be based around a deal with the IMF, we think it is more likely to be a homegrown economic reform programme with IMF buy in and more logical external financing, of which a large part would be Gulf funding. But whichever route is chosen, the goal would be for external support to help fund socially important infrastructural spending, which should start to help boost growth, investment and employment in 2015, while outlining a slow programme of fiscal consolidation over the medium term.

Figure 124. Reserves have stabilised since late 2013, but remain low



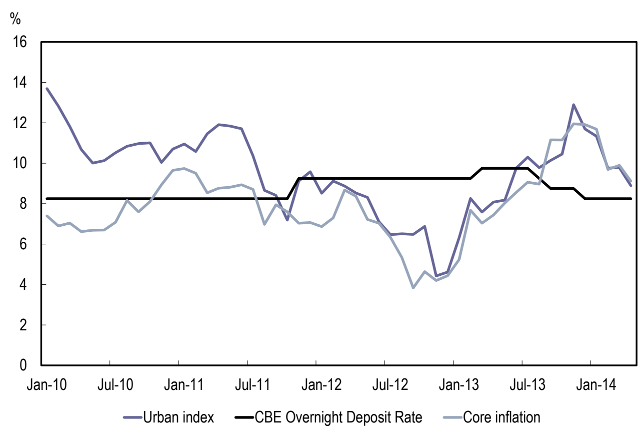
Source: Central Bank of Egypt, Haver Analytics

Figure 125. The EGP is still under some pressure



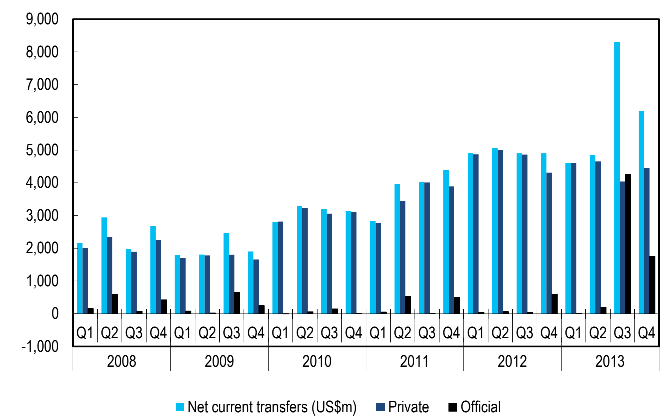
Source: Reuters

Figure 126. The CBE has cut rates, despite the rise in inflation in 2H 2013



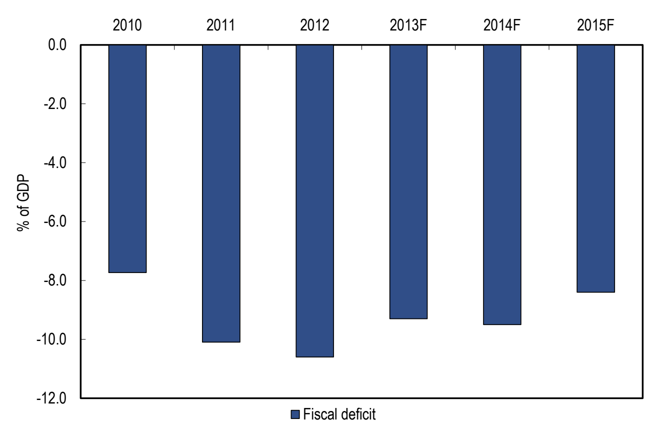
Source: Central Bank of Egypt, Haver Analytics and Citi forecasts for 2H 2013

Figure 127. Robust transfers have limited the deterioration in the current account and helped support consumption



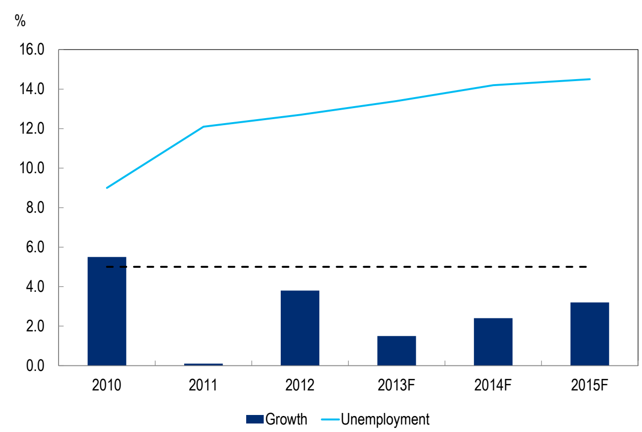
Source: Central Bank of Egypt, Haver Analytics

Figure 128. The fiscal deficit remains large and is a problem



Source: Haver Analytics and Citi forecasts for 2013-2015

Figure 129. A weak recovery may now be possible in 2014-15



Source: Haver Analytics and Citi forecasts for 2013-15

Figure 130. Egypt Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	132	165	188	214	231	260	255	274	285
Nominal GDP, local currency bn	745	896	1,042	1,207	1,371	1,576	1,753	1,950	2,151
GDP per capita, USD	1,783	2,187	2,454	2,755	2,920	3,233	3,114	3,299	3,379
Population, mn	74.1	75.4	76.6	77.8	79.1	80.4	81.7	83.1	84.4
Unemployment, % of labour force	8.9	8.7	9.4	9.0	12.0	12.7	13.4	14.2	14.5
Economic Activity									
Real GDP, yoy avg	-	6.0	4.6	5.5	0.1	3.8	1.5	2.4	3.2
Real investment growth % yoy	-	9.2	-10.0	12.2	-3.6	7.2	-10.8	9.5	12.1
Real consumption growth % yoy	-	5.4	4.7	4.9	4.3	4.6	3.8	2.0	2.4
private consumption growth % yoy	-	5.7	4.6	5.0	4.6	4.9	3.7	2.0	2.6
Real export growth, % yoy	-	14.1	-18.8	8.1	-12.5	-2.0	-6.3	2.2	5.6
Real import growth, % yoy	-	13.7	-24.0	10.5	-0.9	4.9	-3.4	4.7	7.2
Prices, Money & Credit									
CPI, % yoy eop	6.9	18.4	13.2	10.6	9.5	4.7	11.7	9.1	7.2
CPI, % avg	9.5	18.3	11.8	11.1	10.1	7.1	9.5	9.1	7.1
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	10.0	12.0	3.0	6.7	6.1	7.6	6.4	6.3	7.6
Policy Interest Rate, % eop	8.75	11.50	8.25	8.25	9.25	9.25	8.25	8.00	7.50
1 month inter-bank rate, %, eop	8.75	11.95	8.30	8.30	10.05	10.10	9.25	9.58	7.68
Long-term yield, %, eop	9.50	9.00	9.00	9.00	9.50	10.00	13.50	11.00	10.00
EGP/US$, eop	5.53	5.50	5.48	5.81	6.03	6.36	6.95	7.35	7.65
EGP/US$, avg	5.64	5.44	5.55	5.63	5.94	6.07	6.87	7.12	7.54
Balance of Payments, USD bn									
Current account	0.2	-1.3	-3.2	-5.6	-7.9	-10.7	-3.3	-2.9	-5.5
% of GDP	0.2	-0.8	-1.7	-2.6	-3.4	-4.1	-1.3	-1.1	-1.9
Trade balance	-20.8	-26.8	-22.5	-27.7	-28.5	-36.8	-30.2	-30.1	-30.1
Exports	24.5	29.8	23.1	25.0	27.9	23.2	25.1	26.1	27.3
Imports	45.3	56.6	45.6	52.7	56.5	59.9	55.3	56.2	57.4
Service balance	12.7	15.7	11.3	9.6	5.4	6.3	2.9	1.7	2.7
Income balance	-	-	-	-	-	-	-	-	-
FDI, net	10.9	7.6	6.1	5.2	-1.1	6.7	5.3	-0.1	3.0
International reserves	31.7	34.2	34.2	36.0	18.1	15.0	26.5	27.5	28.8
Total amortisations	2.3	1.8	2.4	2.0	2.1	2.3	2.3	2.6	2.4
Public Finances, % of GDP									
Consolidated government balance	-5.2	-6.4	-6.6	-7.7	-10.1	-10.6	-9.3	-9.5	-8.4
Consolidated gov primary balance	0.0	-1.8	-2.4	-2.6	-4.5	-4.7	-3.6	-3.1	-1.3
Public debt	64.2	53.5	54.0	59.8	69.0	77.7	78.6	78.2	77.8
of which Domestic	64.2	53.5	54.0	59.8	69.0	77.7	78.6	78.2	77.8
Foreign Assets & Liabilities, USD bn									
External debt	32.8	32.1	33.3	35.0	33.7	38.8	33.3	29.9	26.1
Public	21.6	26.0	27.2	28.3	27.4	32.8	31.5	31.5	31.5
External debt / GDP	24.8	19.5	17.7	16.3	14.6	14.9	13.1	10.9	9.2
External debt / XGS	68.8	55.6	73.0	70.9	71.1	85.9	76.4	68.1	56.0
Short-term debt	2.2	2.8	2.6	3.1	3.0	6.7	6.7	6.7	6.7
Short-term debt/International reserves (%)	7.0	8.3	7.5	8.7	16.7	44.3	25.1	24.2	23.1

Quarterly Economic Indicators

	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.4	1.5	1.8	3.0	3.2	3.0	3.2	3.0	3.5
CPI, % yoy eop	11.7	9.9	9.2	8.4	9.1	7.1	7.0	6.7	7.2
Policy interest rate, %, eop	8.25	8.25	8.25	8.25	8.00	8.00	7.50	7.50	7.50
Short-term market rate, % eop	9.25	9.25	9.67	8.83	9.58	7.57	7.46	7.15	7.68
Long-term yield, %, eop	13.50	13.50	13.50	13.00	12.50	12.00	11.50	11.50	11.00
EGP/US$, eop	6.95	6.97	7.10	7.30	7.35	7.50	7.60	7.60	7.65

Source: National Sources, Citi Research forecasts

GCC

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Saudi Arabia

Saudi crude oil production continued at an elevated level in excess of 9.5 mbpd in April. Although on a declining trajectory over the past couple of months, production has been in the 9.6mbpd-10mbpd range since mid-2013, while prices have held up in the US$106/bbl to US$110bbl range. Interestingly, a large proportion of this increase has been directed towards exports to the United States, which (according to the US EIA) has increased imports from Saudi Arabia to offset declining Venezuelan imports by the US, and some is being directed towards Saudi Arabia's expanded refining capacity in the United States. Either way, these suggest a firm underpinning to the rise in Saudi production, in our view, which we believe is likely to be sustained in the near term.

We recently raised our expected average 2014 production for Saudi Arabia from 9.2mbpd to 9.5mbpd (on par with 2013) as a result. We expect public finances and external balances to remain robust in the near term, with a likely current account surplus of 14.8% this year, real GDP growth of 4.8%, and a fiscal surplus of 6.2%. That said, we think rising expenditures and an expected levelling off in oil revenues and production present a challenge in the medium- to long-term. We forecast the fiscal breakeven oil price will rise to close to US$100 per barrel in 2015 and will continue to rise, resulting in forecast deficits as early as 2016. Although Saudi has ample resources to finance expected deficits from current cash reserves, the outlook does underscore the need for structural reform to set public finances on a long-term sustainable footing.

That said, we do see downward bias in Saudi production going forward. In our view, this bias will reflect the slight softening in oil prices that we are forecasting going forward, along with increased production elsewhere in the region, most notably Iraq, where we anticipate an increase of around 500kbpd in exports this year. The ongoing talks between the P5+1 and Iran may, in our opinion, result in an easing of some sanctions on oil exports. If this were to happen, it would represent an additional down-side risk to Saudi production and our economic forecasts.

United Arab Emirates

As Dubai's property market booms and large-scale projects are announced, parallels are emerging with the property bubble that affected the emirate six years ago. While we have for some time been highlighting our concerns regarding the sustainability of asset price inflation we consider that Dubai today is much more resilient to such shocks than it was at the height of the previous cycle in mid-2008, for three main reasons.

First, the banking system is more sound and liquid. In contrast to mid- 2008, bank liquidity is less vulnerable to exogenous shocks and is likely to remain supportive of local asset markets. Second, Dubai has made considerable progress on deleveraging and smoothing debt maturities. Refinancing risk among some of Dubai's most significant Government Related Entities (GREs) has been significantly reduced. Finally, rising property prices have not, to date, led to a significant rise in construction and leverage.

Despite the differences, we also recognize that Dubai's is a dynamic and fast changing economic landscape. Signs may emerge that construction activity is responding to potential speculative demand in the real estate market, and that this is leading to oversupply issues and rising corporate sector leverage. In such circumstances, we believe vulnerability to exogenous shocks is likely to creep back into Dubai's economy.

There are mixed signals regarding the trajectory of house prices and the real estate market at present. Cluttons data suggest there has been a levelling off in residential prices in 2014, with the international property consultancy arguing that measures taken by the authorities, particularly the cap on mortgage values, having been successful in cooling the market. But data from Jones Lang Lasalle's Q1 Dubai property market report suggests that prices continue their upward trajectory, albeit at a somewhat reduced pace. Either way, rates are up around a third on average across Dubai, with some areas seeing prices in excess of the 2008 peek. The number of announced projects and the sharp rise in land transactions over the past year and during the first quarter (value of transactions rose 57% yoy) suggest to us that the momentum remains driven by strong investor confidence, and we expect further gains in future.

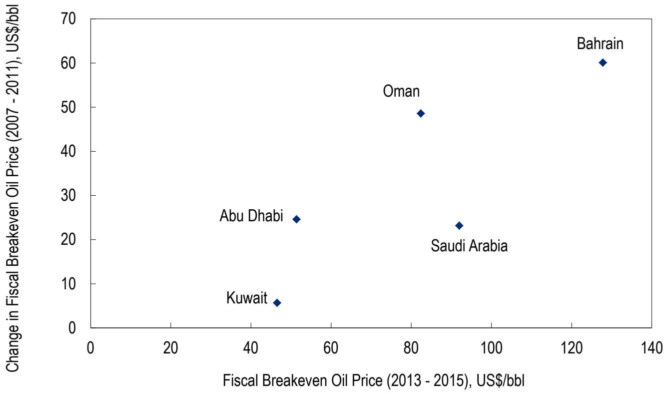
Qatar

The Qatari economy continued to slow in 4Q with growth easing to 5.6%YoY from 6.9% reported in the 3Q. Despite this slow down, growth for 2013 actually came in at 6.5%YoY –higher than our own expectations (5.9%). As was the case in 2012, the majority of growth in 2013 came from the non-mining and quarrying sectors. On the sectoral breakdown the strongest performances came from Construction, Trade, Restaurants & Hotels and Government Services. There are a significant number of public investment projects underway and in planning (see our latest monthly MENA Projects Tracker) and this has supported growth in construction. Going forward we believe that the construction sector will continue to have a significant influence on headline growth. We think that growth in 2014 and 2015 will be close to 6%.

Bahrain

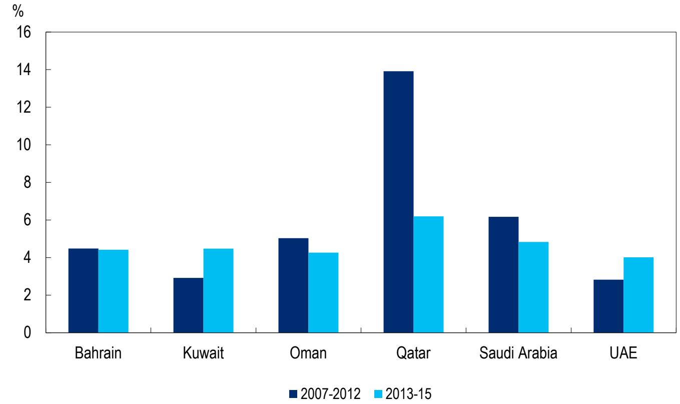
Unrest in Bahrain continues, with the Formula 1 race in April providing a focal point for protests, as expected. The race, a significant component in the country's bid to attract foreign tourism and investment, went ahead successfully, despite opposition marches and the explosion of a car bomb on the day of the main event. But the impasse between government and opposition persists. Hopes that an end to the ongoing unrest was in sight were raised in January, when Crown Prince Salman bin Hamad al-Khalifa, upon the instructions of King Hamad, met with opposition leaders to agree the resumption of talks under a new guise. Since then, an escalation in violence has left little room for dialogue. The escalation has been at the grassroot level and has been condemned by opposition leadership, which leads us to believe that the control opposition leadership exerts over the protests is limited, and that the impact of any dialogue between leaders on violence at the street level is questionable.

Figure 131. Fiscal breakeven oil prices on the rise



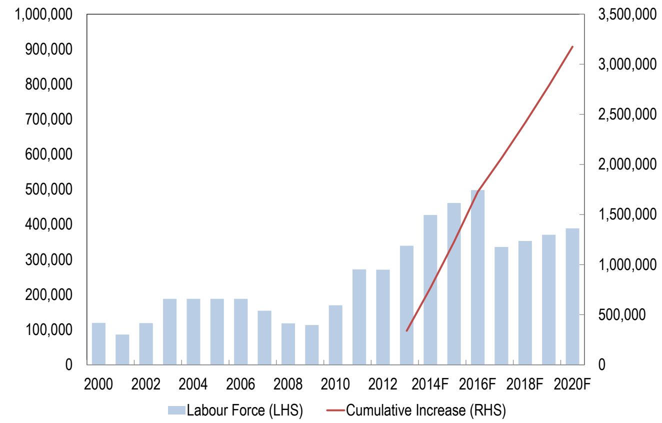
Source: Citi Research estimates

Figure 132. Economic growth will be uneven going forward



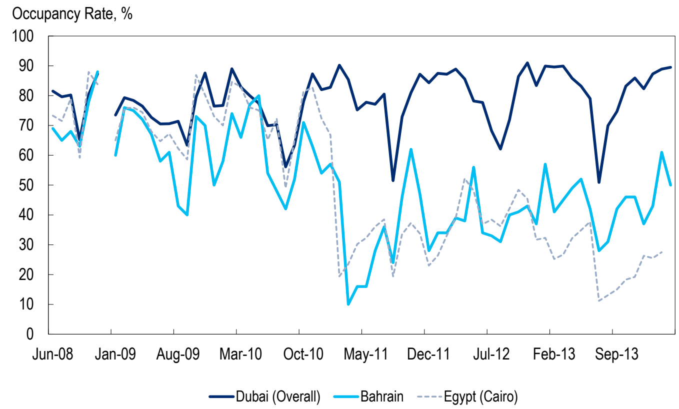
Source: Haver Analytics, Citi Research

Figure 133. 3.3 million entrants in Saudi job market by end of decade



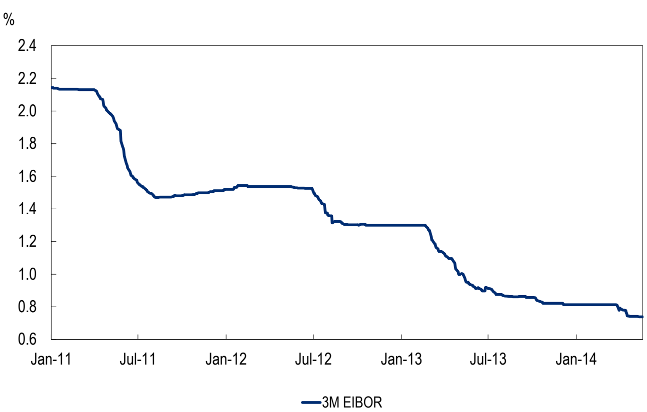
Source: Saudi Central Statistics Office, Citi Research

Figure 134. Dubai hotel occupancy continues to outperform its peers



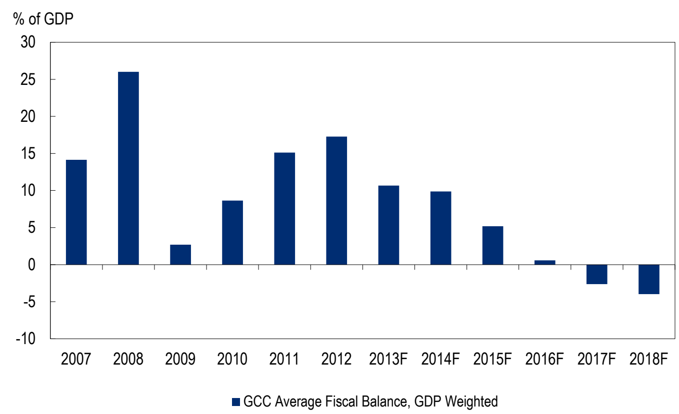
Source: Ernst & Young, Citi Research

Figure 135. EIBOR rates have begun to decline again



Source: Haver Analytics

Figure 136. High government expenditure will drive balances lower



Source: Haver Analytics, Citi Research estimates

Figure 137. GCC Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
BAHRAIN									
Nominal GDP, USD bn	21.7	25.6	22.9	25.6	29.1	30.3	32.7	35.0	37.4
GDP per capita, USD	21,072	22,983	19,192	20,482	22,489	22,969	23,856	24,563	25,193
Real GDP, yoy avg	8.3	6.2	2.5	4.3	2.1	3.4	5.3	4.0	4.0
CPI, % avg	3.3	3.5	2.8	1.9	-0.4	2.8	3.3	2.5	2.0
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	2.8	2.1	0.4	0.6	3.0	2.0	2.2	1.9	0.5
% of GDP	12.7	8.1	1.7	2.3	10.3	6.4	6.8	5.5	1.3
Consolidated gov. balance, % of GDP	2.7	6.4	-4.3	-4.8	-0.3	-2.0	-2.3	-3.5	-5.9
KUWAIT									
Nominal GDP, USD bn	112.3	136.6	105.2	118.5	152.8	176.9	191.3	210.4	211.8
GDP per capita, USD	43,971	50,563	36,898	39,610	48,908	54,947	57,706	61,608	60,218
Real GDP, yoy avg	6.0	2.5	-7.1	-2.4	10.2	8.3	5.7	3.8	3.9
CPI, % avg	5.5	10.6	4.0	4.0	4.7	2.9	2.6	3.0	4.5
KWD/US$, avg	0.28	0.27	0.29	0.29	0.28	0.28	0.28	0.29	0.29
Current account, US$bn	41.9	57.8	29.1	37.8	66.2	78.8	72.6	85.0	81.2
% of GDP	37.3	42.3	27.6	31.9	43.3	44.6	37.9	40.4	38.3
Consolidated gov. balance, % of GDP	30.0	36.4	19.0	30.8	40.1	39.4	28.8	32.2	26.5
OMAN									
Nominal GDP, USD bn	42.0	59.9	53.4	53.4	53.4	53.4	84.3	89.8	94.8
GDP per capita, USD	15,326	20,887	18,015	17,438	16,881	16,180	24,363	24,858	25,097
Real GDP, yoy avg	4.5	8.2	6.1	4.8	0.9	5.8	3.4	4.7	4.7
CPI, % avg	5.9	12.5	3.6	3.2	4.0	2.9	2.1	1.5	3.0
OMR/US$, avg	0.38	0.38	0.38	0.38	0.39	0.39	0.38	0.39	0.39
Current account, US$bn	2.5	5.0	-0.5	5.0	9.0	8.1	9.1	7.7	6.3
% of GDP	5.8	8.4	-0.9	9.4	16.8	15.2	10.8	8.5	6.6
Consolidated gov. balance, % of GDP	2.7	0.3	-0.1	3.1	-0.4	-0.3	9.9	8.4	6.1
QATAR									
Nominal GDP, USD bn	79.7	115.3	97.8	125.1	171.5	192.4	202.5	216.1	231.1
GDP per capita, USD	85,712	104,982	80,294	92,546	114,241	118,688	115,635	114,314	113,188
Real GDP, yoy avg	18.0	17.7	12.0	16.7	13.0	6.2	6.5	5.9	6.2
CPI, % avg	13.6	15.2	-4.9	-2.4	1.9	1.9	3.1	2.5	3.5
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	11.5	26.6	6.4	24.0	52.0	62.0	62.6	63.5	58.0
% of GDP	14.4	23.1	6.5	19.1	30.3	32.2	30.9	29.4	25.1
Consolidated gov. balance, % of GDP	10.9	9.8	13.4	2.7	7.8	11.9	8.2	4.2	1.2
SAUDI ARABIA									
Nominal GDP, USD bn	415.6	519.4	429.0	526.8	669.5	733.8	745.2	784.7	827.6
GDP per capita, USD	17,111	20,861	16,811	20,178	25,645	27,559	27,436	28,323	29,287
Real GDP, yoy avg	6.0	8.4	1.8	6.4	8.6	5.8	3.8	4.8	5.9
CPI, % avg	4.1	9.9	5.1	5.3	3.9	2.9	3.5	3.5	4.1
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	94.3	133.0	21.5	67.4	159.3	165.7	135.3	116.0	73.5
% of GDP	22.7	25.6	5.0	12.8	23.8	22.6	18.2	14.8	8.9
Consolidated gov. balance, % of GDP	12.2	30.8	-3.0	6.3	13.2	15.4	7.4	6.2	1.3
UNITED ARAB EMIRATES									
Nominal GDP, USD bn	257.9	315.5	254.8	287.4	348.6	383.8	409.8	439.1	470.4
GDP per capita, USD	57,467	66,205	51,915	56,858	66,946	70,678	72,074	73,830	75,673
Real GDP, yoy avg	3.2	3.2	-4.8	1.7	3.9	4.4	3.7	4.0	4.0
CPI, % avg	11.1	12.3	1.6	0.9	0.9	0.7	1.1	1.8	2.1
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	15.5	22.7	7.9	7.4	74.3	108.6	107.3	93.8	80.0
% of GDP	6.0	7.2	3.1	2.6	21.3	28.3	26.2	21.4	17.0

Source: National Sources, Citi Research forecasts

Hungary

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- **Summary view** — Positive growth surprise supported by firming European demand, EU-fund absorption and consumption pick up. Inflation remains soft supporting further minor rate reductions amidst supportive external environment.
- **Things to watch** — Conditions of the NBH's new monetary policy instruments and amendment in local debt issuance plans may be key factors to watch.
- **Strategy** —Domestic investors and new NBH facilities may support to local bond markets but the erosion in the HUF carry poses risks to FX under external stress.

We have lifted our 2014 GDP forecast on upbeat 1Q14 data

We have further lifted our GDP forecasts based on the positive surprise in 1Q14 flash GDP data. 1Q14 GDP jumped to 3.5%YoY helped by mild weather conditions and accelerated EU-funded public investments prior to the general elections in April. Export driven industrial production helped by European cyclical recovery and construction boom related to public investments have been the key contributors to growth but retail and service sectors – apart from financial services – also expanded reflecting a broader recovery. Retail sales data suggest a sharp rebound in household consumption also contributing to growth but since methodological changes distort retail sales indices upward, a detailed breakdown of 1Q14 due on 4th June may provide more important inputs to consumption outlook that may be relevant to monetary policy, in our view.

So far there are no signs of geopolitical conflicts impacting the Hungarian economy as manufacturing PMIs and industrial new orders have remained on a rising trend. The strong 1Q14 data suggests upside risks even to our upgraded GDP forecasts thus our current forecasts reflect the risk of the Russian-Ukraine crises causing temporary disruptions in energy supply or imports to Russia. The positive investment stimulus related to the accelerated absorption of EU cohesion funds may fade in 2015 as access to the 2007-2013 EU budgets will mature. The credit cycle is still negative but the slowdown in private sector deleveraging and declining domestic lending rates provide support to a permanent domestic demand recovery. The Central Bank's SME lending program may have minor positive impact on growth this year, which may as fade in 2015 as the utilization is unlikely to accelerate relative to the 2013-2014 flows. Considering that the above mentioned stimulus to investments run out next year, we expect domestic demand growth to slow from 2015 and project GDP growth to remain around 2% over the medium term.

Stable fiscal outlook but stock of debt still major risk

We expect the fiscal balance to remain within the government's 2.9% of GDP target this year after undershooting the deficit target with 2.2% of GDP deficit outturn in 2013 in ESA terms. The stable deficit outlook suggests that fiscal policy may turn more predictable in the second four-year term of the renewed government. A government proposal on the long awaited FX mortgage aid scheme is only likely to be delivered following the Supreme Court verdict about legal intervention in the applied interest rate margins which may be due during the autumn months. Despite the stable deficit outlook Hungary's public debt ratio may slightly rise this year on weaker FX. The prospect for a gradual reduction in public debt over the next decade may be jeopardized by the government's nuclear power plant upgrade plans, which would be financed by central government loans.

Broad based soft Inflation surprise suggests more cuts

Disinflation continues in line with European trends but no deflation risk in Hungary. April CPI turned negative (-0.1%YoY) on broad based factors. While utility price cuts, food and energy prices remain the key contributors to the negative headline CPI, seasonally adjusted core CPI has also slowed markedly (down from 2.7%YoY in March to 2.4%YoY in April) below the NBH's 3% official target. The moderation in prices has been broad based, impacting services, alcohol and non-durable goods prices. We expect CPI to remain close to zero in the coming months and pick up in 4Q14 on base effects. We have lowered our Dec-14 CPI forecast from 2.4%YoY to 2.0%YoY on the back of the soft April CPI data and now expect inflation at 0.5% for the annual average in 2014 and 2.6% in 2015, below the 3% official inflation target.

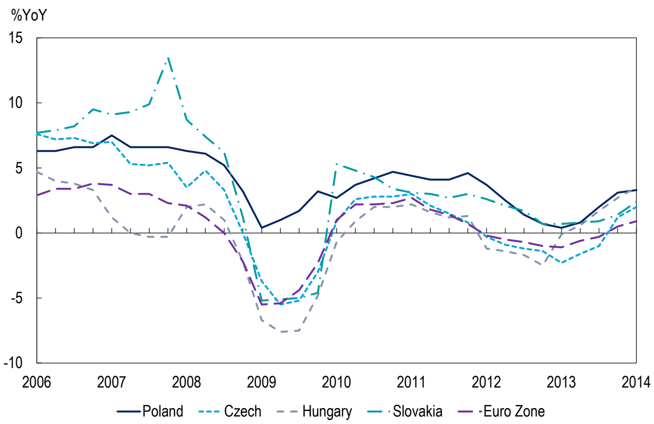
Rate cuts may continue during the summer months. Soft incoming data, the recent exchange rate firming and downward revisions in Eurozone inflation outlook, suggest that the NBH's new inflation forecast due in June is likely to shift downwards relative to the recent March forecast. The downward shift in the inflation outlook and recent external yield reduction on the back of ECB QE expectations may provide room for further minor rate cuts in 10bp steps. External environment will likely determine the scope for further NBH rate cuts. Our baseline scenario of rates bottoming out and remaining unchanged until 1Q15 at 2.25% is exposed to downside risks related to ECB policy action while a hawkish shift in Fed Fund rate expectations or escalating financial stress related to the Russian-Ukraine conflict may force the NBH to halt with cuts earlier or start gradual hikes late 2014.

Change in monetary instruments to support local bonds

The announced switch from 2-week NBH bonds into deposits and an additional IRS facility to limit banks duration risk aims to provide incentives for local banks to increase allocations into government papers rather than replace HUF liquidity into NBH 2-week facility. Liquidity constrains may also force some local banks to buy government papers, as NBH deposits are not repoable, not accepted as collaterals in the payment system and the Funding for Growth Scheme and are considered as less liquid under the tightening Basel III liquidity coverage regulation. Foreign accounts and domestic non-bank funds will not have access to the new instruments. The chances aim to increase domestic source of funding and cut Hungary's external debt and the FX denominated exposure of public debt by replacing maturing external debt with new inflows to local currency papers. The NBH is also hoping to reduce fiscal sterilization costs by shrinking its balance sheet.

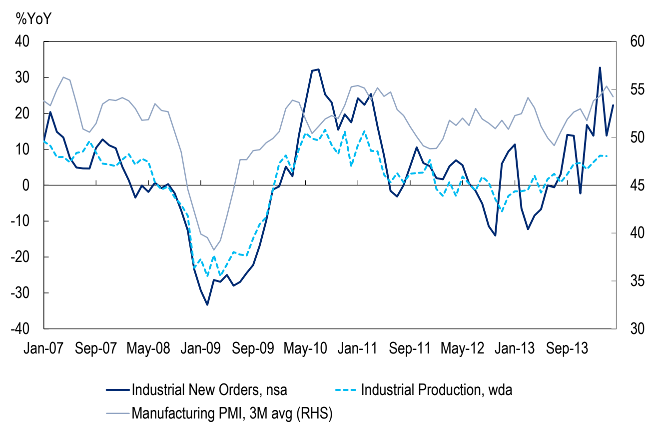
The Debt Management Agency is planning to increase local bond issuance relative to the original plans and may refrain from further Eurobond issuance this year if auction demand remains strong. Impacts on the yield curve may largely depend on the supply of individual papers. Over the long term the measures may improve Hungary's credit quality by helping to accelerate external debt reduction but the shorter duration profile of domestic investors or any regulatory forces on banks to buy government papers may create new sources of risks, in our view.

Figure 138. 1Q14 GDP surprises to the upside outpacing CEE growth



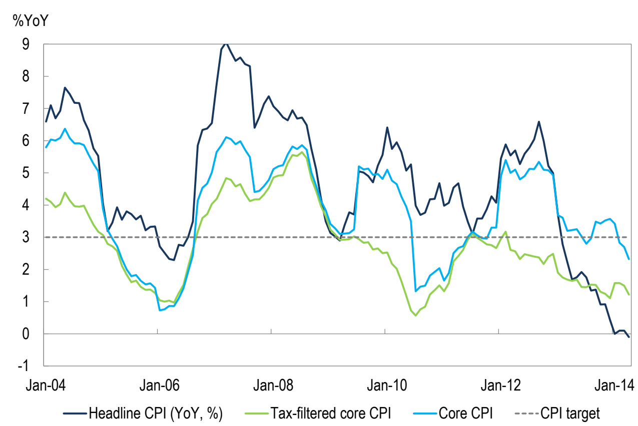
Source: Bloomberg, Citi Research

Figure 139. Industrial rebound helped by external demand



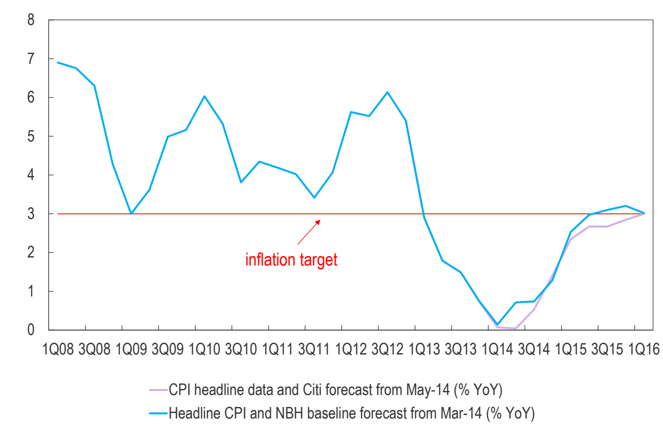
Source: Haver, Citi Research

Figure 140. Unexpected slowdown in core prices in April…



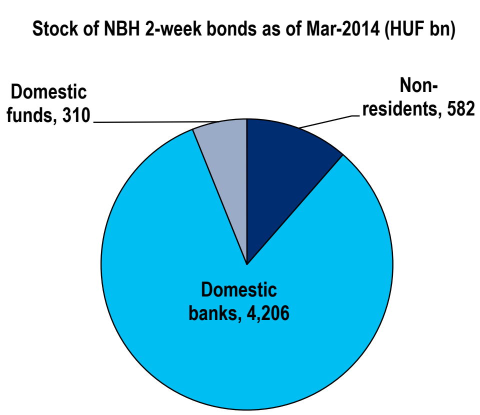
Source: National Bank of Hungary, Citi Research

Figure 141. …suggest downward shift in the NBH's inflation forecast



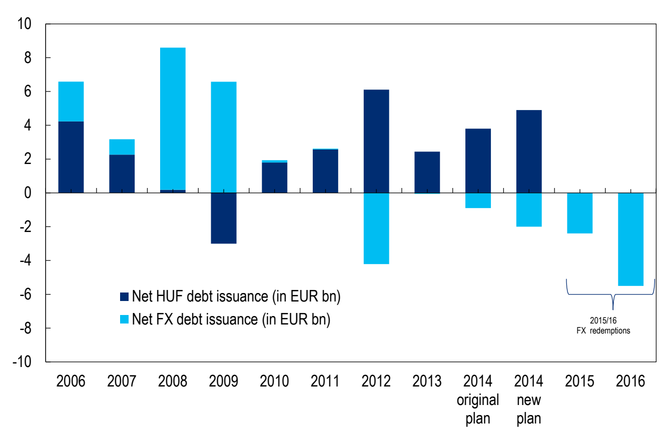
Source: National Bank of Hungary, Citi Research Forecasts

Figure 142. The NBH expects inflows from NBH assets into government papers



Source: National Bank of Hungary, Citi Research

Figure 143. …helping to shift towards LC debt issuance



Source: Government Debt Management Agency, Citi Research

Figure 144. Hungary Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	145	141	136	127	115	127	135	132	138
Nominal GDP, local currency bn	25,143	26,543	25,730	26,600	27,714	28,082	29,275	30,537	31,986
GDP per capita, USD	14,390	14,061	13,584	12,688	11,487	12,726	13,590	13,292	13,933
Population, mn	10.1	10.0	10.0	10.0	10.0	10.0	9.9	9.9	9.9
Unemployment, % of labour force	7.7	8.0	10.5	10.8	10.7	10.7	9.1	8.6	8.5
Economic Activity									
Real GDP, yoy avg	0.1	0.9	-6.8	1.1	1.6	-1.7	1.1	2.5	1.9
Real investment growth % yoy	-1.5	3.7	-29.6	11.5	-3.6	-11.2	2.1	2.5	0.0
Real consumption growth % yoy	-1.4	-0.2	-4.5	-2.5	0.3	-1.5	0.5	1.7	1.5
private consumption growth % yoy	1.1	-0.7	-6.6	-3.0	0.4	-1.6	0.2	1.8	1.9
Real export growth, % yoy	15.0	5.7	-10.2	11.3	8.4	1.7	5.3	5.9	6.0
Real import growth, % yoy	12.8	5.5	-14.8	10.9	6.4	-0.1	5.3	5.7	5.9
Prices, Money & Credit									
CPI, % yoy eop	7.4	3.4	5.4	4.6	4.1	5.1	0.6	2.0	2.8
CPI, % avg	7.9	6.0	4.0	4.7	3.9	5.7	1.7	0.5	2.6
Nominal wages, % yoy	8.0	7.4	0.5	1.3	5.2	4.6	3.8	4.4	4.2
Credit extension to private sector, % yoy	18.8	21.7	-2.7	4.1	-0.5	-10.1	-2.6	0.2	-0.5
Policy Interest Rate, % eop	7.50	10.00	6.25	5.75	7.00	5.75	3.00	2.25	3.50
1 month inter-bank rate, %, eop	7.50	10.00	6.25	5.75	7.08	5.75	3.00	2.25	3.50
Long-term yield, %, eop	7.08	8.28	7.99	7.97	9.75	6.11	5.61	5.60	6.00
HUF/US$, eop	173	190	189	208	244	221	216	231	232
HUF/US$, avg	183	171	201	208	201	225	223	226	233
HUF/EUR, eop	253	266	271	278	315	291	297	314	322
HUF/EUR, avg	251	252	280	275	279	289	297	311	319
Balance of Payments, USD bn									
Current account	-9.9	-11.4	-0.3	0.3	0.6	1.1	3.9	3.5	3.1
% of GDP	-6.8	-8.1	-0.2	0.2	0.5	0.8	2.9	2.6	2.2
Trade balance	-0.9	-1.8	3.3	3.2	4.3	4.5	5.7	6.7	5.9
Exports	93.0	106.1	80.0	88.8	103.7	97.3	103.4	110.8	115.0
Imports	93.9	107.9	76.7	85.5	99.4	92.8	97.7	104.1	109.1
Service balance	1.8	2.2	2.8	3.8	4.4	4.3	4.6	4.5	4.6
Income balance	-10.1	-11.0	-6.9	-7.3	-8.9	-8.2	-7.9	-9.1	-8.8
FDI, net	0.3	3.9	0.2	1.0	1.4	2.6	0.8	1.7	1.8
International reserves	23.2	33.2	41.1	43.1	45.4	43.5	47.3	50.0	56.2
Total amortisations	9.3	15.2	21.9	20.5	25.8	21.6	21.5	20.8	20.5
Public Finances, % of GDP									
Consolidated government balance	-5.1	-3.7	-4.6	-4.3	4.3	-2.0	-2.2	-2.9	-2.9
Consolidated gov primary balance	-1.0	0.5	0.0	-0.1	8.5	2.4	2.2	1.1	1.0
Public debt	66.5	72.3	78.1	79.9	81.9	79.8	79.2	80.5	80.3
of which Domestic	35.9	37.5	36.8	40.8	40.8	43.6	45.1	48.3	48.6
Foreign Assets & Liabilities, USD bn									
External debt	151.7	172.6	196.3	185.1	172.5	164.9	164.4	159.2	156.3
Public	47.4	51.8	62.1	59.6	58.4	63.8	62.5	63.0	63.5
External debt / GDP	104.8	122.2	144.1	145.7	150.3	129.9	121.8	120.7	113.2
External debt / XGS	137.7	136.5	199.2	171.2	137.3	140.0	131.6	119.0	112.8
Short-term debt	32.9	27.5	28.0	32.9	31.7	22.8	22.9	21.2	20.3
Short-term debt/International reserves (%)	141.7	82.8	68.2	76.1	69.9	52.4	48.3	42.4	36.2

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.7	3.5	2.5	2.0	2.0	1.7	1.8	1.8	2.1
CPI, % yoy eop	0.4	0.1	0.2	0.4	2.0	2.4	2.8	2.6	2.8
Policy interest rate, %, eop	3.00	2.60	2.30	2.25	2.25	2.50	3.25	3.50	3.50
Short-term market rate, % eop	3.00	2.60	2.30	2.25	2.25	2.50	3.25	3.50	3.50
Long-term yield, %, eop	5.61	5.54	5.00	5.40	5.60	6.00	6.00	6.00	6.00
HUF/EUR, eop	297	307	310	312	314	316	318	320	322

Source: National Sources, Citi Research forecasts

Israel

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- **Summary view** — We think Israel will stay stuck in a relatively low-growth equilibrium for the next couple of years, caught between weak global demand growth and weak consumer confidence.
- **Things to watch** — The Bank of Israel and the government remain concerned about the risk that a strong shekel might pose to the economy's recovery, most recent evidence of which was the late-February decision to cut the Bank's rate by 25bp. Another cut seems likely in Q2. But we doubt that the Bank is anywhere close to setting a 'minimum exchange rate' along the lines of the Swiss and Czech National Banks unless deflation becomes a threat.
- **Strategy** — We see the ILS trading more or less sideways for now, since the Bank's strategy is not to weaken the shekel but to create stability and give time for exporters to adjust to a stronger real exchange rate. With Citi's forecast that US 10-year yield is likely to rise this year, Israeli curve-steepening seems likely.

Some signs of recovery?

A few data points in recent weeks suggest there's some improvement taking place. The PMI, for example, touched 50 in February after staying below that level for 7 consecutive months (although it dipped back below that level in March); but in addition, manufacturing output has shown some signs of recovery in late 2013 and early 2014; and export growth seems to be accelerating on the back of a recovery in the growth rate of import volumes in the developed world ('rich-country' import volume growth has been positive in YoY terms since September 2013) – although export growth did turn negative in March. Against this background, it is a little surprising that the Bank of Israel chose last month to reduce its growth forecast for 2014 to 3.1% from 3.3%. It is true that consumer confidence is still extremely weak – although expectations have improved a little – but the recent data makes us a little more confident about our more optimistic growth forecast for 2014 of 3.4%.

The external sector remains a focus for policymakers…

'Dutch disease' risks are still a concern. Like many other countries, Israel suffered a shock to export growth in 2012 and 2013, in spite of the fact that the shekel gained competitiveness over many other emerging economies. One of Israel's problems in this regard is that the destination of much of its exports remains the US and EU, with relatively little trade exposure to Asia (although this has been growing). So the Bank of Israel remains concerned about the need to maintain as competitive an exchange rate as possible, particularly because of the impact of gas production: Tamar, the smaller of two large gas fields being developed off Israel's northern coast, began production in April 2013. Gas from Tamar substituted some US$2.1bn of energy imports in 2013, with the result that Israel's current account has essentially disappeared, and there are good chances that Israel will sustain a long run of current account surpluses in the foreseeable future. Since these current account surpluses (US$7bn in 2013) have increased investors' enthusiasm to own the shekel, the Bank of Israel remains concerned that gas-driven shekel appreciation could threaten Israel's recovery. We think the Bank has some good reasons to be worried: the real effective exchange rate appreciated by 10% last year. And the Bank now has a long track record, dating to 2008, of aggressively seeking to avoid shekel appreciation to minimize the threats to the real economy.

…and the problem won't go away

In the medium term, the outlook for Israel's balance of payments is exceptionally good, due to very large offshore gas discoveries in the past couple of years, which could add around 2% GDP per year to Israel's balance of payments (both through import-substitution as well as exports). The government is in the process of creating a Sovereign Wealth Fund to capture the net income from gas production, and it reckons that the Fund will reach over US$80bn by 2040 (Israel's GDP this year is around US$230bn). 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.

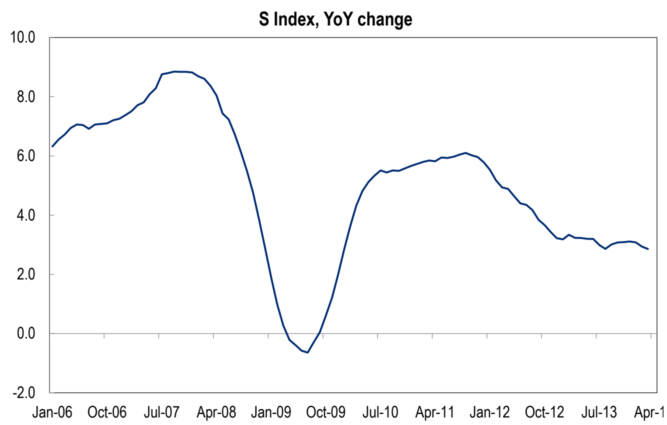
March interest rate cut makes sense

The Bank's surprise 25bp rate cut for March (to 0.75%) was a response to "Dutch Disease" and falling inflation pressures. Shekel appreciation might well end up being disinflationary, since it puts particular pressure on lower-tech firms that are labour intensive. And there might be other sources of disinflation too. First, the government's efforts to increase workforce participation among the ultra-Orthodox and Arab Israelis seem likely to increase labour supply. Second, recent increases in housing supply should help to ease housing-related inflation, as well as a proposal to exempt first-time buyers from VAT. Third, in the wake of a recent government commission to increase competition and reduce concentration of ownership in the economy, it seems likely that efforts will be made soon to increase competition in the retail food sector, in telecoms, TV services and in auto retail. All in all, we see sub-1% CPI in 2014, making room for another cut to 0.5% in Q2 – in spite of the evidence of economic recovery. Inflation expectations continue to fall.

A better fiscal outlook

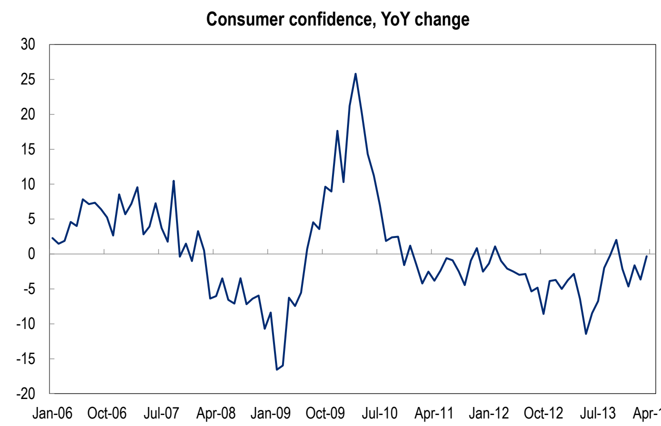
One of the factors that facilitated a more aggressive stance by the BOI is that fiscal uncertainties have eased somewhat. Due to some expenditure restraint and higher-than-expected revenues, the 2013 deficit was 3.2% GDP, compared to the 4.65% deficit that had been forecast earlier. In addition, changes in national accounting methodology have pushed GDP up by around 7% compared to the previous data, which has reduced the end-2012 debt/GDP ratio from 73.5% to 68.4%. Nonetheless, programmed spending plans by the government are likely to push the public debt up moderately over the next few years, and this leaves little room for the Israeli yield curve – very steep by international standards – to flatten. And given the strong correlation between Israeli and US yields, Citi's forecast that the US 10-year yield will rise above 3% means that further steepening is probably on the cards.

Figure 145. 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 146. ...and consumer confidence is fragile even though household borrowing has been relatively robust

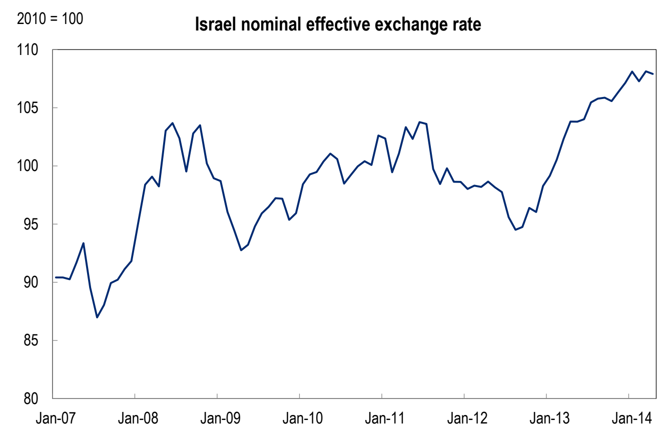


Source: Haver Analytics, Citi Research

Figure 147. Inflation expectations are more or less stable…

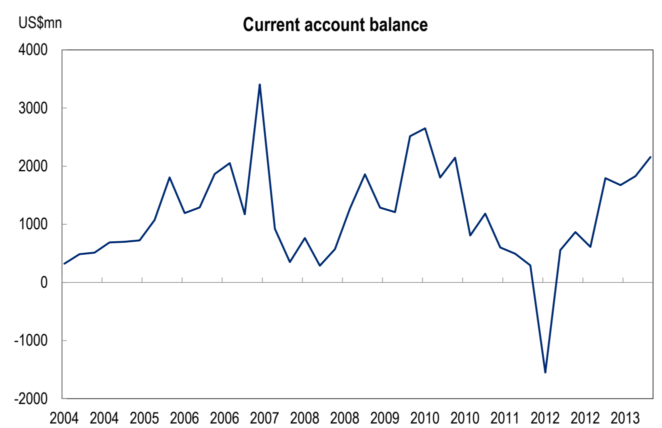
Source: Haver Analytics, Citi Research

Figure 148. …but the shekel has strengthened sharply in nominal terms in the past year…



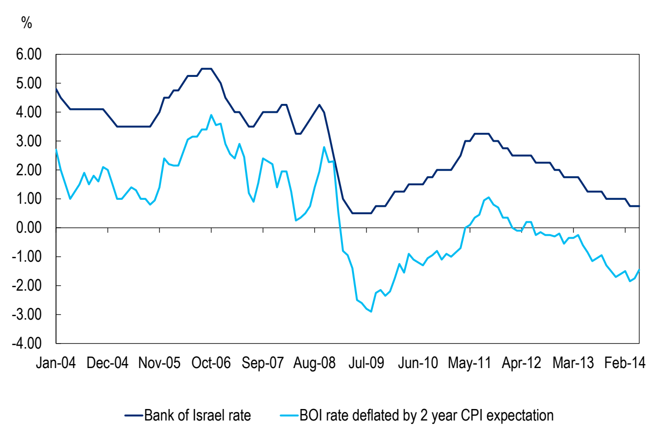
Source: Haver Analytics, Citi Research

Figure 149. …on the back of a sharply improving current account balance…



Source: Bloomberg, Citi Research

Figure 150. …giving room for the BOI to cut rates in an effort to ensure that real interest rates don't rise too much.



Source: Bloomberg, Citi Research

Figure 151. Israel Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	175	213	206	232	258	258	292	315	316
Nominal GDP, local currency bn	719	765	809	866	924	993	1,053	1,097	1,168
GDP per capita, USD	25,248	29,990	28,289	31,273	34,236	33,702	37,704	40,208	39,863
Population, mn	6.9	7.1	7.3	7.4	7.5	7.6	7.7	7.8	7.9
Unemployment, % of labour force	9.2	7.7	9.4	8.3	7.1	6.9	6.3	6.0	5.8
Economic Activity									
Real GDP, yoy avg	6.8	5.0	1.0	5.2	4.7	3.5	3.2	3.2	3.5
Real investment growth % yoy	9.6	8.9	-4.4	9.4	15.6	3.6	1.3	5.6	3.6
Real consumption growth % yoy	6.6	1.6	2.5	4.4	3.6	3.2	3.5	2.6	-0.3
private consumption growth % yoy	8.1	1.5	2.4	4.9	4.0	3.1	3.8	2.6	-0.5
Real export growth, % yoy	11.2	6.6	-12.1	15.2	7.2	1.1	0.7	3.4	6.7
Real import growth, % yoy	10.6	2.3	-12.7	14.2	10.9	3.2	-1.6	1.6	5.4
Prices, Money & Credit									
CPI, % yoy eop	3.4	3.8	3.9	2.7	2.2	1.6	1.8	0.6	1.0
CPI, % avg	0.5	4.6	3.3	2.7	3.5	1.7	1.5	1.0	3.0
Nominal wages, % yoy	2.2	3.8	0.7	3.4	3.8	2.6	2.6	5.0	5.0
Credit extension to private sector, % yoy	10.8	-0.5	6.5	7.0	5.0	3.4	2.0	4.0	4.5
Policy Interest Rate, % eop	4.25	2.50	1.00	2.00	2.75	2.00	1.00	0.50	1.25
1 month inter-bank rate, %, eop	4.50	1.90	1.31	2.06	2.74	1.75	0.99	1.50	1.25
Long-term yield, %, eop	6.17	4.72	5.11	4.75	4.24	3.62	3.65	4.20	4.50
ILS/US$, eop	3.86	3.78	3.79	3.52	3.81	3.73	3.47	3.56	3.77
ILS/US$, avg	4.11	3.58	3.93	3.73	3.58	3.85	3.61	3.49	3.70
Balance of Payments, USD bn									
Current account	5.6	3.1	7.9	7.2	3.3	0.8	7.2	5.9	5.2
% of GDP	3.2	1.4	3.8	3.1	1.3	0.3	2.5	1.9	1.7
Trade balance	-5.2	-6.4	0.7	-2.0	-8.2	-9.3	-9.4	-5.0	-2.3
Exports	50.8	58.0	46.8	56.4	64.3	62.3	61.7	71.0	75.3
Imports	56.0	64.4	46.1	58.4	72.5	71.7	71.1	76.0	77.5
Service balance	3.7	5.0	5.0	6.0	6.9	9.8	12.9	9.0	12.0
Income balance	-0.2	-4.0	-5.1	-5.2	-4.4	-8.0	-5.5	-6.1	-4.5
FDI, net	17.4	18.1	6.1	14.6	16.1	11.8	16.7	4.0	6.0
International reserves	28.6	42.5	60.6	70.9	74.9	76.0	81.8	87.0	95.0
Total amortisations	5.6	4.7	4.5	5.0	5.0	4.0	3.8	4.2	3.0
Public Finances, % of GDP									
Consolidated government balance	0.5	-1.2	-4.2	-2.8	-2.5	-3.5	-2.7	-3.0	-2.5
Consolidated gov primary balance	6.1	4.1	1.0	2.3	2.5	1.4	2.1	3.0	3.0
Public debt	72.8	71.5	73.8	74.5	73.8	72.5	71.7	70.8	67.6
of which Domestic	56.5	57.3	60.1	57.7	57.4	56.4	55.1	53.8	51.4
Foreign Assets & Liabilities, USD bn									
External debt	92.3	89.6	94.6	107.8	105.3	96.9	95.6	104.0	105.0
Public	32.0	28.2	31.2	40.3	36.5	37.0	38.0	40.0	42.0
External debt / GDP	52.8	42.0	46.0	46.5	40.8	37.6	32.8	33.1	33.3
External debt / XGS	127.9	108.1	136.4	132.8	114.8	104.0	100.8	99.0	94.4
Short-term debt	39.9	40.3	42.2	54.4	49.6	44.0	45.0	45.0	45.0
Short-term debt/International reserves (%)	139.6	94.7	69.7	76.7	66.2	57.9	55.0	51.7	47.4

Quarterly Economic Indicators

	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.9	3.2	3.0	3.0	3.0	3.5	4.5	4.5	4.5
CPI, % yoy eop	1.8	1.3	0.5	1.1	0.6	0.9	1.3	1.0	1.0
Policy interest rate, %, eop	1.00	0.75	0.50	0.50	1.25	1.00	1.00	1.00	1.25
Short-term market rate, % eop	0.99	0.73	0.50	0.50	0.50	1.00	1.00	1.00	1.25
Long-term yield, %, eop	3.50	2.07	4.75	4.75	4.75	4.75	4.75	4.75	4.75
ILS/US$, eop	3.47	3.48	3.41	3.49	3.56	3.62	3.67	3.72	3.77

Source: National Sources, Citi Research forecasts

Kazakhstan

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- **Summary view** — We see GDP growth decelerating to 5% in 2014 on the back of heightened uncertainty in the CIS region and a China slowdown. Still, prospects remain favorable in the medium term, as the Kashagan oil field should finally start making a positive contribution to economic activity.
- **Things to watch** — The only macro concern recently has been the deterioration of the CA position, which was driven by a steady decline in exports related to sluggish global growth. The CA should be structurally supported by Kashagan-related trade flows, although the effect will be felt more strongly only from 2017.
- **Strategy** —The National Bank of Kazakhstan (NBK) effectively devalued the tenge by 20% by announcing a new central level for the USDKZT of 185. The tenge will be allowed to fluctuate between 182 and 188. The NBK has the resources to maintain this new level of the exchange rate, in our view.

Growth has been strong, but will moderate in 2014

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 5.7%YoY year-to-date in the first three quarters of 2013. Sequentially, the economy has accelerated for a fourth consecutive quarter from 4.3%YoY in 3Q12 to 7.3% in 3Q13.

Growth is mainly driven by consumption as production struggles. This is best exemplified by the diverging behavior of retail sales and industrial production. Real retail sales grew at 12.8%YoY during Jan-Dec 2013, broadly on par with its pace over 2011 and 2012. At the same time, industrial production has faced some headwinds, increasing by only 2.3%YoY during Jan-Dec 2013. Still, this is up from the broadly flat pace of expansion of industrial production in 2012.

Consumption itself is increasingly led by robust retail loan growth. While consumption was initially supported by disposable incomes, which were growing at double digits in real terms, retail loans have taken over since about mid-2011. Real retail loan growth turned positive around that time, but has since accelerated to almost 27%YoY as of December 2013 (corporate loans grow at about 10%). This may be at least partly related to catching-up with post-crisis times as consumers deleveraged during 2009.

2014 GDP will likely decelerate to 5% on heightened regional uncertainty and a China slowdown. Events in Ukraine and Russia will create some headwinds for the economy. Industrial production has already started the year on a downbeat note, growing by only 0.8%YoY in January, but contracting by 0.6% in February and 1.0% in March. Consumption will remain a key driver, although the pace of expansion should moderate. A slowdown in China should also bite.

First quarter GDP data already showed some fragility. Preliminary data showed that 1Q14 GDP grew only at 3.8% YoY, confirming our view that Kazakhstan will not be able to emerge unscathed from the broader EM malaise and the regional geopolitical uncertainty. The short-term economic indicator, which captures around two thirds of the economy, expanded by a mere 2.7% during Jan-April on an YoY basis, while industrial production contracted by 0.1% during the same time period.

Weaker external position leads to a currency devaluation

While the broader macro-economy has been healthy, the worsening current account position has been one key reason for concern. The current account was in deficit in 4 out of the last 6 quarters. After posting deficits of US$1.0bn in 3Q12 and US$2.5bn in 4Q12, the current account went into a surplus of US$2.2bn in 1Q13, before transitioning to a small deficit in 2Q13 (US$0.01bn) and plunging into a much bigger deficit in 3Q (US$2.2bn). 4Q13 current account was almost flat at -US$0.06bn. Correspondingly, the annual current account surplus dipped from 5.5% of GDP in 2011 to only 0.5% in 2012 and a deficit of 0.1% in 2013.

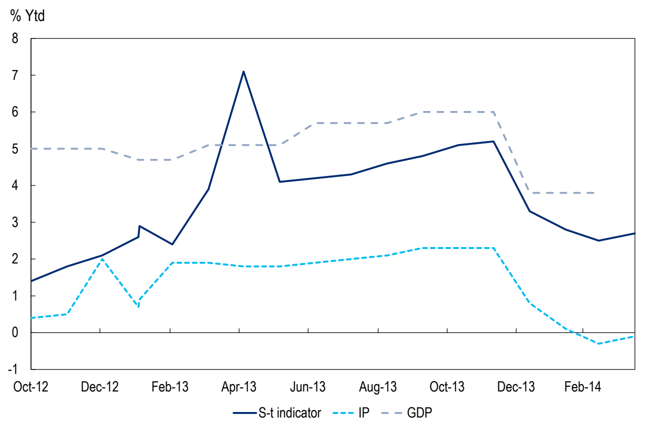
The recent deterioration of the external position has also led to a decline in foreign reserves. Gross foreign reserves have followed current account's performance, falling from US$35.5bn in February 2012 to US$26.5bn in March 2014. This has become the key indicator that has focused market concerns in Kazakhstan.

This led to the National Bank of Kazakhstan (NBK) to devalue the tenge by 20% in early February, citing concerns of a loss of external competitiveness. The new central level for the USDKZT is 185, with the tenge being allowed to fluctuate between 182 and 188. The NBK has a history of adjusting the tenge to sizable moves in the RUB (early 2009 a prime example) and the NBK's statement explicitly cites concerns about the RUB and, more generally, about potential loss of competitiveness. Devaluation fears had also been growing in the country with the FX share of deposits rising rapidly from 29.8% in December 2012 to 39.6% in January 2014. The share rose sharply to 47.7% in March 2014.

The magnitude of the currency adjustment looks too large. According to the REER (a measure of external competitiveness that the NBK has always referred to), the tenge does not look too strong. The slight loss of competitiveness observed since early 2012 when the REER rose was offset by allowing the tenge to weaken significantly against the EUR (almost 10% over the last year) even when the USDKZT was kept broadly constant. The tenge was only about 2% stronger in Dec relative to its 2008-13 REER average. For comparison, in Jan 2009, the REER was about 15% overvalued, which was mostly consistent with the 20% devaluation implemented in February 2009. The same can be gleaned from looking directly at RUBKZT, which also does not indicate levels of stress that existed around early 2009. While in January 2009 RUBKZT was 17% stronger relative to its long-term average, justifying a 20% devaluation, in January 2014, it was only 8% stronger relative to its long-term average. Therefore, macroeconomic fundamentals, in our view, could have justified a maximum of about 10% devaluation. The NBK argued the relatively large magnitude of the devaluation was related to expectations emerging market currencies may continue to be under pressure, thus necessitating further devaluations in the future, which the central bank wanted to avoid.

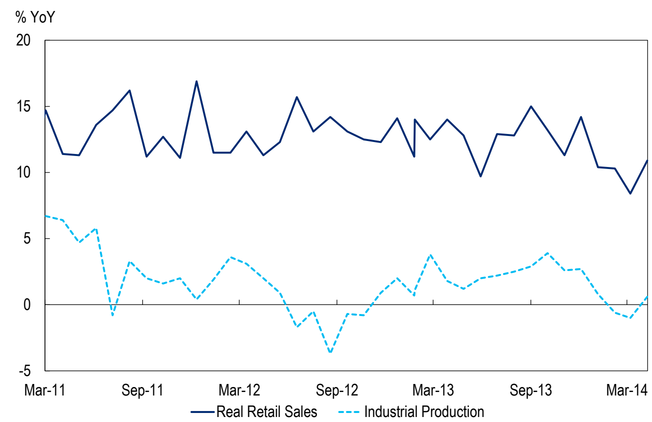
However, softer growth and currency devaluation have boosted CA in 1Q. 1Q14 CA surplus came in very strong at US$5.5bn. this was driven by a significant 7.4% YoY drop in import growth on the back of slowing internal demand and a healthy 10.8% YoY increase in export growth related to the weaker currency. Correspondingly, foreign reserves also benefited, rising to US$28.4bn in April from US$26.5bn in March.

Figure 152. Growth is still strong, but some weakness is evident…



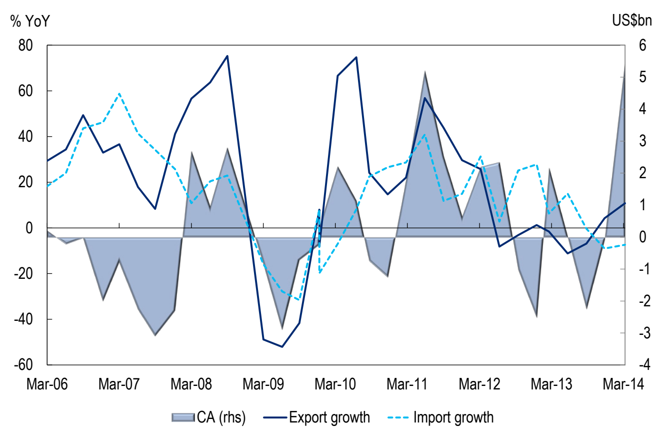
Source: Kazstat, Citi Research

Figure 153. It is mainly consumption driven as production struggles



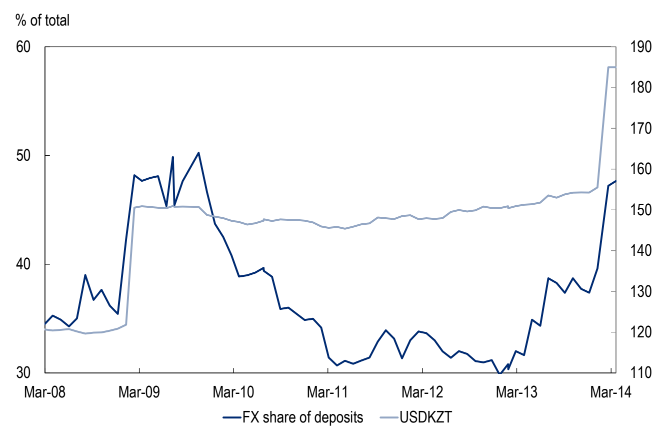
Source: Kazstat, Citi Research

Figure 154. Current account improved in 1Q…



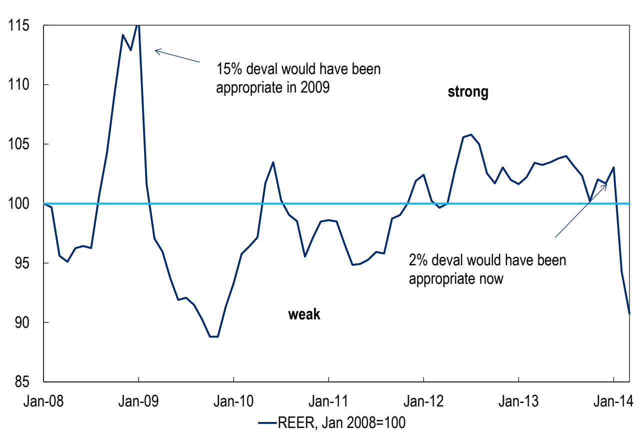
Source: NBK, Citi research

Figure 155. …as tenge devaluation boosted exports and slowing growth crimped imports



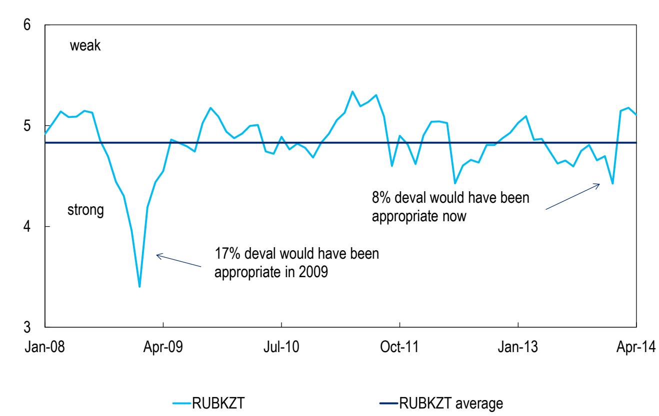
Source: NBK, Citi Research

Figure 156. The magnitude of the devaluation appears too big on REER…



Source: NBK, Citi Research

Figure 157. …and RUBKZT basis



Source: Bloomberg, Citi Research

Figure 158. Kazakhstan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	105	133	115	146	186	202	222	217	227
Nominal GDP, local currency bn	12,529	16,053	17,008	20,554	27,279	30,093	33,717	37,523	41,910
GDP per capita, USD	6,810	8,572	7,324	9,171	11,557	12,403	13,460	12,998	13,441
Population, mn	15.4	15.6	15.7	15.9	16.1	16.3	16.5	16.7	16.9
Unemployment, % of labour force	7.3	6.6	6.6	5.8	5.4	5.3	5.3	5.3	5.3
Economic Activity									
Real GDP, yoy avg	9.2	3.6	0.8	6.9	7.4	4.9	6.0	5.0	6.0
Real investment growth % yoy	23.4	-12.8	2.3	2.1	5.6	6.8	-1.7	2.4	3.2
Real consumption growth % yoy	11.4	5.2	0.7	9.4	11.0	11.2	9.6	5.6	5.9
private consumption growth % yoy	11.1	5.3	0.7	10.2	11.0	11.2	10.3	5.5	6.0
Real export growth, % yoy	9.0	0.8	-11.6	1.9	3.5	4.1	-2.0	4.0	6.0
Real import growth, % yoy	25.8	-11.5	-16.0	0.9	6.9	17.2	7.0	2.0	8.0
Prices, Money & Credit									
CPI, % yoy eop	18.8	9.5	6.2	7.8	7.4	6.1	4.5	6.9	5.6
CPI, % avg	10.8	17.1	7.3	7.1	8.3	5.2	5.7	6.5	5.9
Nominal wages, % yoy	28.1	16.2	10.8	14.9	15.9	13.5	6.8	7.0	8.0
Credit extension to private sector, % yoy	55.2	5.2	7.3	0.3	15.8	12.1	12.8	12.0	12.0
Policy Interest Rate, % eop	11.00	10.50	7.00	7.00	7.50	5.50	-0.55	5.50	6.00
1 month inter-bank rate, %, eop	11.50	9.00	4.00	1.50	1.50	1.50	5.50	3.48	3.98
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	121	121	149	147	148	150	154	185	185
KZT/US$, avg	123	120	147	147	147	149	152	173	185
Balance of Payments, USD bn									
Current account	-8.4	6.3	-4.1	1.4	10.2	1.1	-0.1	2.1	2.9
% of GDP	-8.0	4.7	-3.6	0.9	5.5	0.5	-0.1	1.0	1.3
Trade balance	15.2	33.6	15.0	28.5	44.8	38.1	33.7	35.7	39.1
Exports	48.3	72.0	43.9	61.4	85.2	86.9	83.4	88.4	95.5
Imports	33.1	38.4	28.9	32.9	40.3	48.8	49.7	52.7	56.4
Service balance	-8.4	-6.9	-6.0	-7.2	-6.6	-7.9	-6.9	-6.0	-7.0
Income balance	-12.9	-19.4	-12.4	-19.4	-27.7	-28.1	-25.3	-26.6	-28.2
FDI, net	-8.0	-13.1	-10.1	-3.7	-8.6	-11.8	-7.8	-6.0	-8.6
International reserves	17.6	19.9	22.7	27.7	28.8	27.7	20.0	23.1	26.3
Total amortisations	25.5	31.8	30.5	21.1	22.5	23.7	13.2	9.8	9.8
Public Finances, % of GDP									
Consolidated government balance	4.5	-9.3	-9.4	2.7	5.9	0.9	3.2	2.3	2.2
Consolidated gov primary balance	4.8	-8.9	-9.0	3.1	6.3	1.3	3.8	3.0	2.7
Public debt	5.3	6.3	9.5	10.3	10.1	12.1	12.8	13.9	14.6
of which Domestic	4.0	5.1	7.6	7.8	7.6	9.6	10.4	11.6	12.3
Foreign Assets & Liabilities, USD bn									
External debt	66.8	67.7	63.2	65.9	64.8	70.6	77.2	78.7	80.0
Public	1.6	1.7	3.2	4.8	5.1	5.5	4.1	5.6	6.9
External debt / GDP	63.7	50.8	54.8	45.2	34.8	35.0	34.8	36.3	35.3
External debt / XGS	129.0	88.8	131.7	100.7	72.4	76.9	87.0	89.0	83.7
Short-term debt	11.5	9.5	7.0	8.9	8.8	9.3	10.2	10.5	10.6
Short-term debt/International reserves (%)	65.4	47.7	30.8	31.9	30.4	33.7	51.3	45.7	40.4

Quarterly Economic Indicators

	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	6.6	3.7	5.5	4.5	6.1	7.8	5.9	6.0	4.7
CPI, % yoy eop	4.6	6.2	6.9	6.9	6.9	5.7	5.7	5.8	5.6
Policy interest rate, %, eop	5.50	5.50	5.50	5.50	5.50	5.50	6.00	6.00	6.00
Short-term market rate, % eop	5.50	5.00	3.48	3.48	3.48	3.48	3.98	3.98	3.98
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	154	182	185	185	185	185	185	185	185

Source: National Sources, Citi Research forecasts

Levant

Iraq

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Incumbent Prime Minister Nouri al-Maliki's State of Law coalition leads parliamentary elections, having won 92-93 seats according to preliminary results released today by the Iraqi High Electoral Commission (IHEC). This represents a slight improvement on the coalition's performance in 2010 parliamentary elections, when it won 89 seats, but does by no means guarantee a return to office of PM Nouri Al Maliki, in our view.

We note that Iyad Alawi's Iraqqiya bloc won the most seats (91) in the 2010 elections, and yet failed to gather support from other political groupings to attain a 165-seat majority. Instead, the two other main Shia groupings, led by Shia clerics Moqtada al Sadr and Ammar al-Hakim, joined the main Kurdish parties in supporting the State of Law coalition and a second term for Maliki.

The preliminary results indicate that Maliki has fallen 71-72 seats short of a majority. The two smaller Shia groupings together won 57 votes, meaning that a majority Shia-grouping government is not likely to be possible. Indeed, as things stand, Maliki would need the support of the smaller Shia groupings plus another significant bloc, effectively forming another national unity government and making the Kurds once again likely 'king makers' in the process.

There is also the possibility of an alternative national unity government, where the three main Sunni parties (which won 53 seats together) enter a deal with the smaller Shia parties and the Kurdish parties to squeeze State of Law out of office. Indeed, there remains stern opposition to a third Maliki term among a number of Maliki's rivals, which should greatly complicate his efforts to form a government.

Either way, in line with our expectations, we believe we are almost certainly headed for a prolonged period of horse-trading. The relative weakness of Maliki's position, despite having garnered most seats, means that significant concessions will have to be made to his rivals in order to secure a third term. Such concessions will have to be deeper and more binding, in our view, than the ones made to secure support for a Maliki government in 2010 (collectively referred to as the Erbil agreement). Likewise, a broader coalition excluding State of Law would have to be based on significant compromise.

A downside scenario which may materialize in the coming days, particularly upon the announcement of final results (due May 25) would be the refusal of Maliki's rivals to recognize the count (or indeed Maliki). In Iraq's highly tense political and security environment, such political conflict may have a significant impact on the country's overall stability, in our view.

Lebanon

At the time of writing, Lebanon is heading for another political vacuum and potential constitutional crisis as law-makers have yet to agree on a new President. Incumbent Michel Sleiman's term ends on 25 May, and the lack of successor opens the prospect of a vacuum at the head of state level. This happened in the last presidential succession, after Emile Lahood stepped down at the end of 2007 with no successor appointed. It was another six months until Michel Sleiman assumed office, and in the interim the country teetered on the brink of civil war, with fighting in the streets between Hizbollah and the Sunni Future Movement. In the current political environment, the destabilizing potential of this political vacuum is not, in our view, positive for the country's political or economic trajectory.

Indeed, the overall macroeconomic picture remains somewhat bleak as political instability and violence, largely as a result of the civil war raging in neighbouring Syria, are negatively impacting Lebanese investment and commerce (particularly in the tourism sector). We estimate that the Lebanese economy grew by an average of 2% per year in real terms over the past three years, compared with an average annual growth of over 9% between 2008 and 2010.

The sharp slowdown in growth has also had a detrimental impact on the fiscal dynamics, with the latest data showing that the budget deficit widened to 9.3% in 2013, compared with 9.1% a year earlier. This is the largest deficit seen since 2008, and the trend reduction in the government debt burden reversed in 2013, with the first increase in the government debt to GDP ratio since 2006.

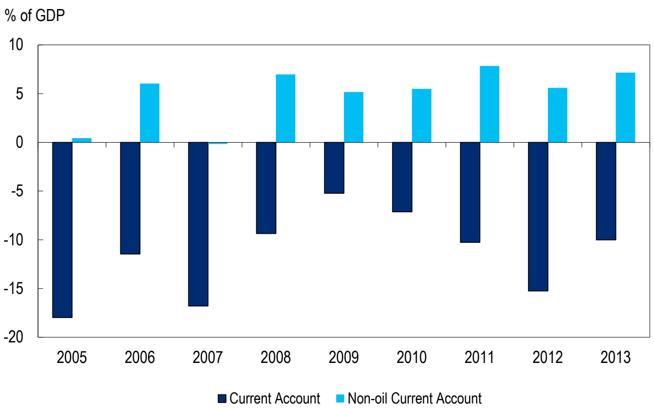
At the same time, banking sector indicators remain robust. Overall deposit growth was 7% yoy in February, with non-resident deposit growth remaining in the double digits (11%). The dollarization ratio remained stable at under 60%, and the risk premium on Lebanese Lira deposits has likewise hardly moved in recent months. In our view, the banking sector remains sound and liquid and retains significant capacity to continue financing the Lebanese sovereign through purchase of government securities. This keeps sovereign risk in check, despite an evidently deteriorating country risk profile (see Lebanon Macro View - The gap widens between country and sovereign risk).

The formation of Prime Minister Tammam Salam's new government of 'national interest' will have limited influence on Lebanon's economic and political outlook in our view. Given the general elections in November, we believe the current government's term will be short-lived and will focus on two key tasks. First, it is to prevent the country from sliding further into sectarian strife by filling the leadership vacuum and providing a forum for inter-sectarian dialogue. We believe the cabinet will have limited success in quelling wider sectarian tensions as it is itself a forum in which such tensions often come to the fore. Co-operation among cabinet members from different political factions is very poor, and is unlikely to resolve broader communal differences.

Its second task is to manage the upcoming election schedule. Presidential elections have begun, and as mentioned above, no winner has emerged since the March 14 candidate, Samir Geagea, was rejected by parliamentarians in an April 23 Vote.

Parliamentary elections are also due in November. Disagreement between the various political groupings over the law that will govern the elections was one of the factors behind the collapse of the previous government of Najib Mikati. As far as we can see, there has been no progress in closing the gap between the different parties, and the 10-month delay in appointing a new government has eaten into the time available to strike a deal. The prospects of a deal are not encouraging, and we believe Lebanon is in for continued political instability for the foreseeable future.

Figure 159. Jordan current account dominated by oil imports …

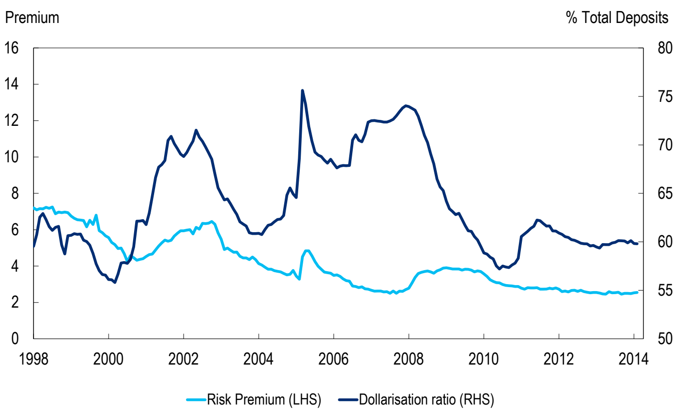


Source: Haver Analytics, Citi Research

Figure 160. Without grants Jordan's fiscal situation would be worse

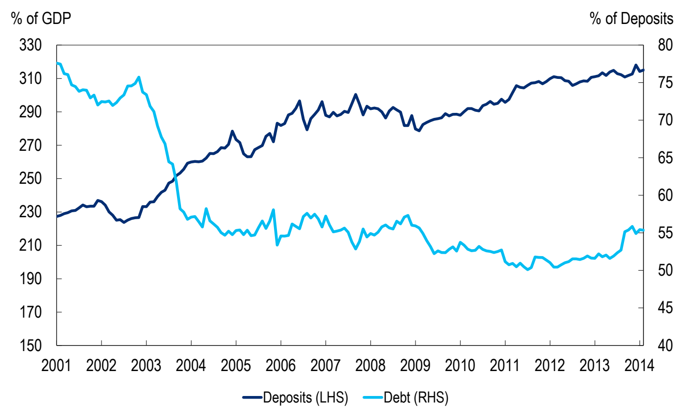
Source: Haver Analytics, Citi Research

Figure 161. Lebanon dollarization has gone up, but risk premium stable



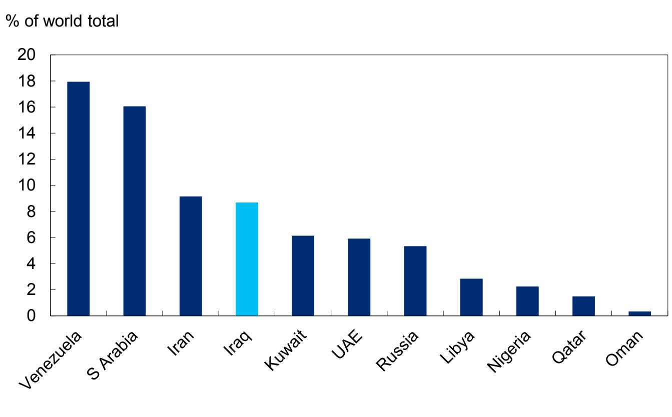
Source: Haver Analytics, Citi Research

Figure 162. Deposit growth slows, but still plenty of capacity



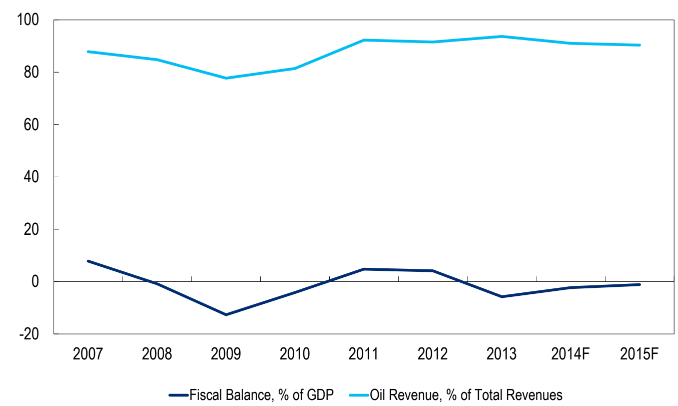
Source: Haver Analytics, Citi Research

Figure 163. Iraq has world's fourth largest proven oil reserves and …



Source: BP, Citi Research

Figure 164. … public finances should strengthen as a result



Source: Haver Analytics, Citi Research

Figure 165. Levant Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
IRAQ									
Nominal GDP, USD bn	91.7	135.6	113.6	138.9	186.3	216.6	234.8	272.0	318.7
GDP per capita, USD	3,190	4,607	3,766	4,487	5,871	6,655	7,032	7,946	9,076
Real GDP, yoy avg	1.4	6.6	5.8	5.5	10.2	10.3	3.1	10.4	11.6
CPI, % avg	20.8	2.7	-2.2	2.4	5.6	6.1	1.9	3.0	5.5
IQD/US$, avg	1,253	1,189	1,156	1,167	1,171	1,164	1,162	1,162	1,162
Current account, US$bn	20.0	28.4	-1.3	6.3	26.2	38.0	31.1	36.9	40.2
% of GDP	21.9	20.9	-1.1	4.6	14.1	17.5	13.3	13.6	12.6
Consolidated gov. balance, % of GDP	7.8	-0.9	-12.7	-4.2	4.7	4.1	-5.8	-2.3	-1.2
JORDAN									
Nominal GDP, USD bn	17.1	22.0	23.9	26.5	28.8	30.9	33.6	35.8	38.5
GDP per capita, USD	3,026	3,722	3,866	4,104	4,284	4,404	4,593	4,699	4,848
Real GDP, yoy avg	8.2	7.2	5.5	2.3	2.6	2.7	2.8	4.0	4.5
CPI, % avg	4.7	13.9	-0.7	5.0	4.4	4.8	5.5	3.5	5.0
JOD/US$, avg	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71
Current account, US$bn	-2.9	-2.1	-1.2	-1.9	-3.5	-5.4	-3.8	-3.6	-3.0
% of GDP	-16.8	-9.3	-5.2	-7.1	-12.0	-17.4	-11.3	-10.2	-7.9
Consolidated gov. balance, % of GDP	-5.1	-4.4	-8.9	-5.6	-6.8	-8.3	-5.5	-9.6	-9.4
LEBANON									
Nominal GDP, USD bn	24.6	28.8	35.1	38.0	40.1	43.0	45.3	48.1	51.1
GDP per capita, USD	6,538	7,572	9,111	9,726	10,126	10,647	11,006	11,441	11,936
Real GDP, yoy avg	9.3	9.1	10.3	8.0	2.0	2.5	1.4	2.0	2.4
CPI, % avg	4.1	10.8	1.2	4.0	5.0	6.6	2.1	3.8	5.0
LBP/US$, avg	1,512	1,507	1,504	1,502	1,506	1,504	1,507	1,508	1,508
Current account, US$bn	-1.4	-4.1	-6.7	-7.6	-4.4	-3.5	-4.1	-4.7	-5.5
% of GDP	-5.6	-14.4	-19.2	-20.0	-10.9	-8.2	-9.0	-9.8	-10.7
Consolidated gov. balance, % of GDP	-10.4	-10.1	-8.4	-7.6	-5.8	-9.1	-9.3	-8.7	-8.0

Source: National Sources, Citi Research forecasts

Nigeria

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- **Summary view** — Although political uncertainty is set to rise towards the February 2015 elections, we still expect growth to remain robust at over 6% in 2014-15. But the fiscal picture could deteriorate, notably in 2H 2014 if supplementary budgets are passed or there is no recovery in oil production.

- **Things to watch** — MPC meetings during 2H 2014 will start to provide an insight into the policy thinking of the new governor of the Central Bank of Nigeria (CBN), Godwin Emefiele, notably in terms of naira policy.

- **Strategy** —We expect finance minister, Ngozi Okonjo-Iweala, will seek to maintain fiscal discipline despite approaching elections. But this should become increasingly difficult, while progress with structural reform is likely to stall.

Africa's largest economy heads to the polls

With the provisional outcome of the GDP rebasing exercise conducted by the National Bureau of Statistics (NBS) published in early April, Nigeria's economy is now estimated at US$586bn in 2013. This makes it the largest in Africa, although it does not change the myriad of challenges facing the government, such as the need to reduce high levels of poverty, boost electricity production or re-build savings in the excess crude account (ECA).

The complex challenges facing the country are also clear on the political side as the country heads towards presidential and parliamentary elections set for February 2015. Not only should political tensions within the political elite rise sharply as the polls approach, but the elections will be set against the background of the on-going conflict with Boko Haram in the north and potential terrorist incidents such as the recent bus-stop bombing in Abuja.

Given the likely rise of political tensions as the year progresses, we only expect very limited progress with structural reform this year. This includes the passage of the proposed Petroleum Industry Bill (PIB) or the start of formal government savings into the Sovereign Wealth Fund (SWF). However, there could be some modest progress with electricity sector reform, and crucially an increase in generation levels, as this is a crucial platform for President Goodluck Jonathan re-election campaign.

The political jostling in the run up to the polls is also clear from the recent very public divisions within the ruling People's Democratic Party (PDP). In early 2014 a significant number of its existing governors and National Assembly representatives switched political allegiance to the opposition All Progressives Congress (APC). Since then, there have been further defections and counter defections, with the full political outcome of these changes only really becoming clear in August/September when the parties elect their presidential candidates.

But growth should remain robust

While a deteriorating political environment is not good for growth, we expect it to remain over 6%. In particular, robust service sector growth will be supported by an acceptable performance in the agricultural sector. But overall we still think that growth will be constrained by only limited increases in oil production given recent problems with production and with the approaching elections potentially raising political tensions in the Niger Delta.

Macroeconomic and naira stability for now

Despite positive macroeconomic data, the naira and foreign exchange reserves have been under pressure since late 2013. This pressure notably intensified when the president suspended the former CBN governor, Lamido Sanusi, which led to a surge in demand for foreign exchange, both domestically and locally. But demand has eased since the start of April, with reserves and the naira stabilizing although this does not mean that the challenges of maintaining macroeconomic and naira stability in the rest of 2014 and into 2015 have ended.

The key variables to consider when thinking about the naira outlook and policy are the oil price and the level of production. Since 2012 it has been production that has been under pressure, but this has been offset by a high oil price of well over US$100/ barrel. This equation could be reversed as 2014 progresses with rising oil production offsetting an easing price, but if either, or both, were to come under more sustained pressure in 2014, the CBN would have to revisit its exchange rate policy.

In particular, we think the CBN's response to naira pressure will be driven by the rate of reserve burn and the potential emergence of differential between the parallel and official exchange rates. Although the CBN has been ambiguous about what it considers a suitable level of foreign exchange reserves, it has increasingly mentioned that the internationally acceptable level of cover is three months of goods and services. This would indicate an ultimate cut off level of around US$20.5bn on our data forecasts, at which point the supply of foreign currency, and support for the naira, would need to be re-evaluated.

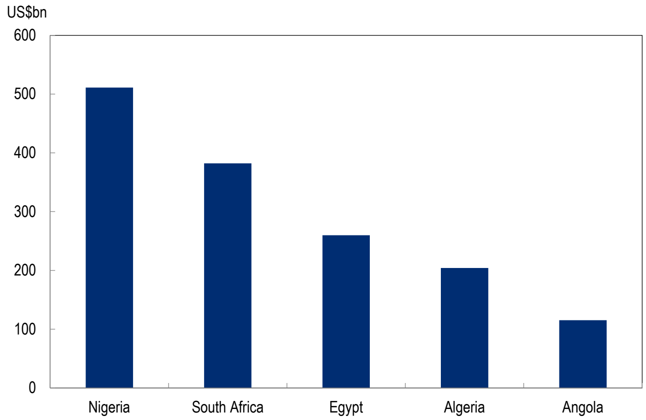
The fate of the naira is in the government's own hands

When thinking about the naira outlook, it is worth remembering that in 2008 the significant devaluation was driven by the collapse of the oil price. But in 2014 and into 2015 whether there is a need to devalue is very much in the government's own hands. If it can get oil production back up towards the 2.2 or 2.3m b/d level, boosting revenue and foreign exchange inflows, while keeping a tighter rein on disbursements from the ECA than in recent years, it should be able to slowly, if only very modestly rebuild its savings. And if this means that it can keep reserves in the US$35-US$40bn level, pressure on the naira will be less intense than in early 2014 even with the approach of the elections.

In addition, it could opt to tighten monetary policy further. We think inflation will start to trend back up again in 2H 2014, and if fiscal spending pressures were to rise, this could provide the excuse to raise interest rates. And with stable reserves this would probably attract portfolio inflows back into the government debt market.

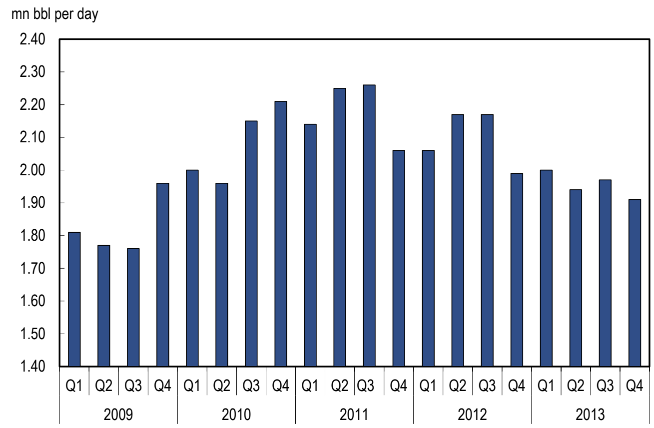
But, while we would not expect any significant change in monetary policy under the acting governor, Sarah Alade, the new governor, Godwin Emefiele, will be under the spotlight in 2H 2014 and certainly in 2015. In particular, even if the CBN can maintain broad naira stability up to the elections, the more fundamental question is can it continue to do so after the polls without a significant increase in the ECA and reserves. So unless these start to rise in 2015, at some point more fundamental decisions may have to be made on naira policy by Mr Emefiele.

Figure 166. Nigeria is now Africa's largest economy



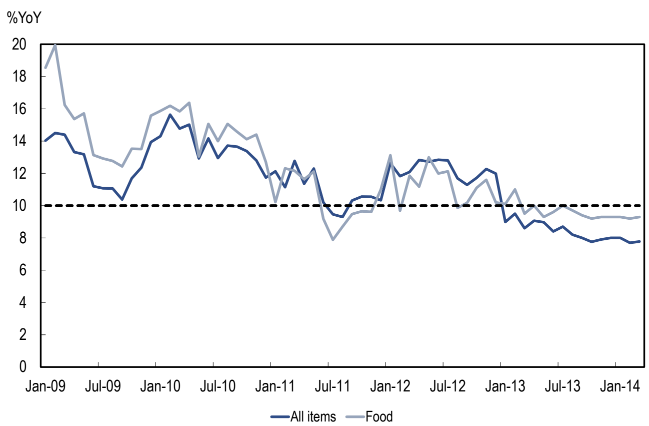
Source: National Bureau of Statistics, Citi and IMF

Figure 167. Even though oil production has been on a downward trend since mid-2012



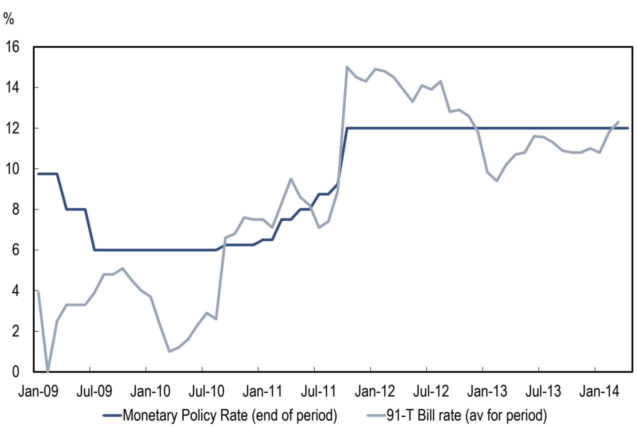
Source: International Energy Agency

Figure 168. Inflation has remained in single digits throughout 2013 and into 2014



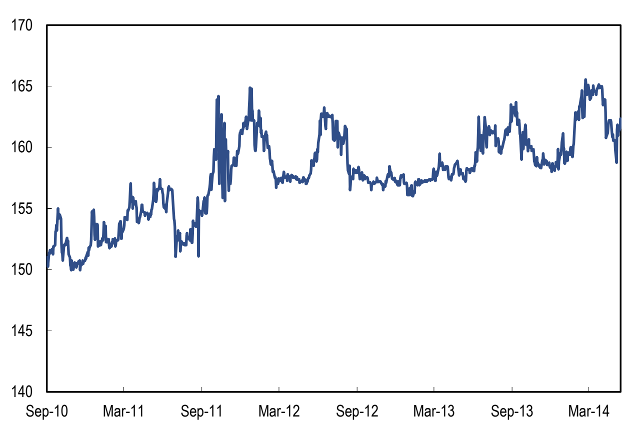
Source: National Bureau of Statistics and Citi forecasts from October 2013

Figure 169. The MPR has been left unchanged since October 2011



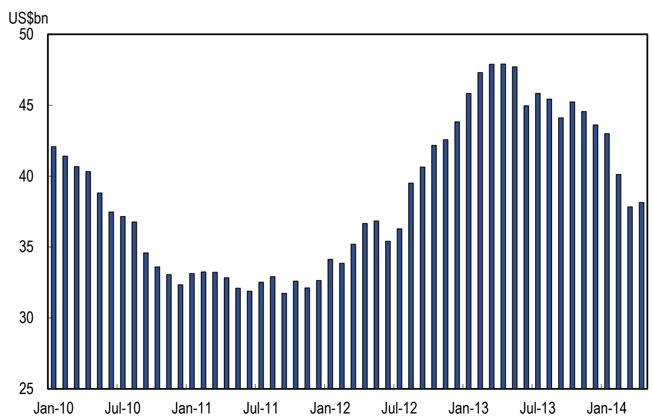
Source: Central Bank of Nigeria

Figure 170. Pressure on the naira has resurfaced in 2014



Source: Reuters

Figure 171. Reserves have been rebuilt, but come under pressure again in 2H 2013 and into 2014



Source: Haver Analytics and Central Bank of Nigeria

Figure 172. Nigeria Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	-	-	-	359	406	448	586	656	746
Nominal GDP, local currency bn	-	-	-	54,205	63,259	71,187	82,319	95,271	112,026
GDP per capita, USD	-	-	-	2,266	2,499	2,692	3,431	3,744	4,153
Population, mn	146.8	150.6	154.4	158.4	162.4	166.6	170.8	175.2	179.7
Unemployment, % of labour force	-	-	-	-	-	-	-	-	-
Economic Activity									
Real GDP, yoy avg	-	-	-	-	5.1	6.7	6.6	6.4	6.4
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	6.6	15.1	13.9	11.7	10.3	12.0	8.0	10.0	10.1
CPI, % avg	5.4	11.6	12.5	13.7	10.8	12.2	8.5	8.8	10.6
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	97.1	59.4	26.8	-3.8	44.3	6.8	9.0	11.0	19.0
Policy Interest Rate, % eop	9.50	9.75	6.00	6.25	12.00	12.00	11.75	11.75	12.50
1 month inter-bank rate, %, eop	12.50	18.00	15.79	13.07	17.17	14.39	15.00	14.00	13.00
Long-term yield, %, eop	9.25	9.25	11.80	8.50	8.00	0.00	0.00	12.00	13.50
NGN/US$, eop	118	138	150	152	162	156	160	168	172
NGN/US$, avg	126	119	150	151	156	159	159	164	169
Balance of Payments, USD bn									
Current account	27.6	29.1	14.0	14.5	12.6	20.4	22.4	15.8	10.7
% of GDP	-	-	-	4.0	3.1	4.6	3.8	2.4	1.4
Trade balance	37.8	45.9	25.7	31.7	35.0	42.4	43.6	39.4	36.9
Exports	66.1	85.7	56.8	78.5	97.2	96.0	95.4	93.2	93.8
Imports	28.3	39.8	31.1	46.8	62.2	53.6	51.8	53.8	56.9
Service balance	-16.9	-22.1	-16.7	-18.5	-21.4	-21.7	-22.5	-24.4	-25.6
Income balance	-11.8	-15.1	-14.6	-19.7	-23.0	-22.3	-20.1	-19.6	-21.3
FDI, net	-	-	-	-	-	-	-	-	-
International reserves	51.3	53.0	42.4	32.3	32.9	43.8	43.6	37.8	39.2
Total amortisations	0.9	0.6	0.5	0.5	0.4	0.3	0.3	0.3	0.3
Public Finances, % of GDP									
Consolidated government balance	-0.4	-0.1	-1.8	-2.0	-1.6	-1.2	-1.4	-1.7	-1.6
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	7.0	5.5	7.1	8.2	7.5	8.1	7.6	7.8	7.7
Foreign Assets & Liabilities, USD bn									
External debt	3.4	3.7	4.6	4.6	5.7	6.5	8.8	9.2	12.3
Public	3.0	3.2	3.9	4.4	5.0	6.0	7.3	7.7	10.0
External debt / GDP	-	-	-	1.3	1.4	1.5	1.5	1.4	1.6
External debt / XGS	5.0	4.2	7.7	5.6	5.6	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2015 Q4F
GDP, % yoy	7.0	6.6	6.2	6.8	6.8	6.2	6.3	6.4	7.1
CPI, % yoy eop	12.0	8.6	8.4	7.9	7.9	7.8	8.8	9.5	10.1
Policy interest rate, %, eop	12.0	12.0	12.0	12.0	12.0	12.0	12.5	12.5	12.0
Short-term market rate, % eop	13.0	10.9	11.0	11.4	11.1	11.4	12.0	14.0	13.0
Long-term yield, %, eop	12.0	11.0	13.6	13.3	13.3	14.0	12.7	12.2	13.5
NGN/US$, eop	156	159	163	161	160	165	163	166	172

Source: National Sources, Citi Research forecasts

Poland

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- **Summary view** — The Polish economy reached its sweet spot, experiencing already above-potential growth, which is expected to strengthen further and inflation running well below target. We still expect 2014 GDP growth to reach 3.4% driven by private consumption and investment.

- **Things to watch** — Although recent foreign trade data showed a drop in exports to Russia and Ukraine were offset by a recovery of exports to EU, the Russia-Ukraine crisis remains the most important risk factors to GDP.

- **Strategy** — QE by the ECB, low inflation, delayed prospects for rate hikes and lower bond supply in 2H14 is likely to delay expected increase in yields. Zloty is still expected to experience some weakening on QE tapering by Fed

Growth still robust despite external tensions

Economic growth in 1Q accelerated to 3.3%YoY (1.1%QoQ s.a.) exceeding market expectations. The flash GDP release did not include a detailed breakdown, but we think the stronger growth was driven mainly by a recovery in domestic demand. At the same time however, the decline of the positive contribution of net exports was most likely less than we expected, as monthly industrial output data and retail sales for Jan-March were slightly weaker than expected and at the same time NBP showed positive surprise in the foreign trade balance, especially for March. Despite the domestic demand driven economic recovery, the NBP data for the first three months of this year showed a record high quarterly surplus in the trade balance of €1.2bn as compared to record high annual foreign trade balance of €2.3bn in 2013 (and first surplus since the CSO started to release data in 1994). This confirms the strengthening of the economy is healthy and broad-based and is supported by all channels in the economy.

Falling PMI leading indicator poses some risk to our still above-consensus GDP growth forecast at 3.4%YoY, though this is still not yet reflected in the data from the real economy. The most recent leading indicator, PMI for manufacturing sector unexpectedly dropped for second consecutive months reaching 52 pts in April versus 55.9 pts in February. This contrasts with the rebound of PMI indicators in Germany and the euro zone and was explained by weaker growth in new export orders due to lower demand from European markets and tensions between Russia and Ukraine, among other factors. However, this weakening has not yet been confirmed by data from the real economy. Although, the recently released CSO data on foreign trade for March confirmed significant weakening in exports growth to both Russia (to around -11%YoY) and Ukraine (to around -30%) it also showed this was more than offset by strengthening of exports to EU (to 19.6% and mainly to Germany to 22.5%) and other developed countries. At the same time consumer confidence shows no sign of deterioration in April, and retail sales growth in March was in our view only temporarily weakened by high base in the previous year and effect of later Easter holiday this year. Therefore, we maintain our forecast of GDP growth acceleration this year to 3.4%YoY on stronger domestic demand driven by recovery in the labour market, loans growth and investments. At the same time although the conflict between Russia and Ukraine had a limited impact on Polish economy so far, we still see some downside risk to GDP growth forecast depending on future developments of the geopolitical situation as risks could materialize in case of more serious US/EU sanctions against Russia and Russian sanctions against the West.

Rates hikes prospects likely delayed till 2Q15

In April inflation fell to 0.3%YoY from 0.7% in March and was much below expectations at 0.6%-0.7%Y. The main reason for the downward surprise was the large and seasonally unusual drop in food prices (-0.5%MoM), which to a large extent resulted from the slump in sugar prices (-7.8%). Moreover, there were also downside surprises in communication prices (-1.5%MoM) and also in most of other categories, except of fuel prices. The low April release has lowered our inflation forecast path for the coming months. We now expect the CPI to fluctuate in the 0.6-0.8%YoY range over the next three months and to rise to 1.4%YoY by the end of the year. However, he strong performance of the labour market and the robust economic growth does not point to deflation risks. We expect the inflation to rise towards the 2.5% target in April next year and we see risks it could actually surprise to the upside in 2015.

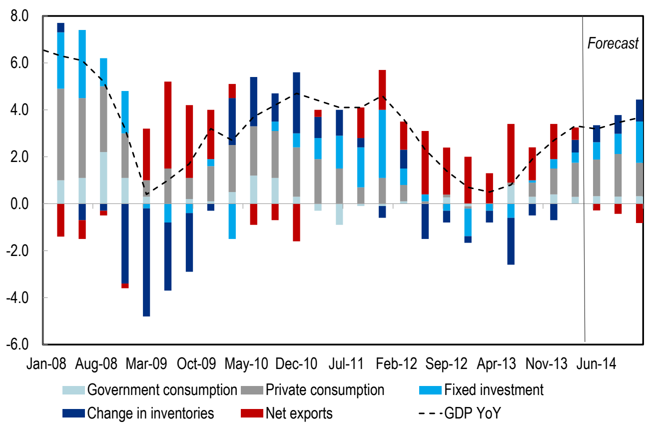
Taking into account he lower inflation path and the tone of the MPC members we currently expect that the first rate hike will only likely happen in 2Q15. At the last press conference the NBP governor suggested that that July, when NBP will publish updated GDP and inflation projections, will be a good moment to update the signaling on future prospects of interest rates. In our view this means the MPC will likely extend its forward guidance (of stable rates) until end of 4Q2014 in July though we do not rule out that after a downward surprise in CPI data this could happen even in June. Although the MPC remains optimistic on the economic recovery and see risks connected from Ukraine as limited, the NBP governor said that lower inflation delays the prospects for higher interest rates. Given the lower inflation forecast path and potential for QE by ECB we believe the Council could wait with rate hikes longer than previously expected and we decided to push out the first rate hike forecast from 1Q to 2Q 2015 (most likely June).

Lower yields path and mild zloty weakness ahead

The lower inflation path and relatively small bond supply in 2H14 will likely delay expected yields increase. After May the Finance Ministry will have realized around 86% of its annual borrowing needs plan and as we assume the budget deficit is likely to be smaller this year by PLN 8bn this ratio is likely even higher. We expect that FinMin will need to issue only around PLN 10bn to cover all its 2014 financing needs, which will most probably happen till early July, a month when around PLN 9bn will flow to investors from FinMin due to maturing bonds. In 2H15 the supply used to prefinance 2015 needs will likely be smaller, which will allow the FinMin to flexibly react to market conditions. Moreover, lowered inflation path and delayed rate hikes as well as prospect for QE easing by the ECB will likely lower the expected yields path and delay their increase. However, as we expect rate hikes will still come sooner than expected by the market we expect some upward move in FRA rates and 1y1y in the coming months.

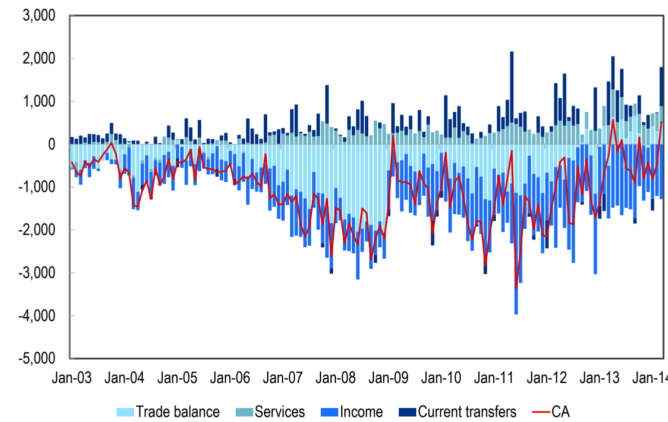
We still expect QE tapering by Fed will likely weaken the zloty in the coming few months and will be more important than QE easing by ECB and strong fundamentals. In the current market environment, the low carry does not benefit the zloty even as economic growth accelerates, CDS rates and current account deficit are near historical lows, real rates are relatively high and domestic political situation is stable. Also despite prospects for QE easing by ECB we still assume the negative effect of QE tapering by Fed will weaken the zloty toward 4.30 over 6-12M horizon. The zloty would be also influenced by geopolitical situation in Eastern Europe in case of additional economic sanctions.

Figure 173. Ongoing recovery supported by stronger domestic demand



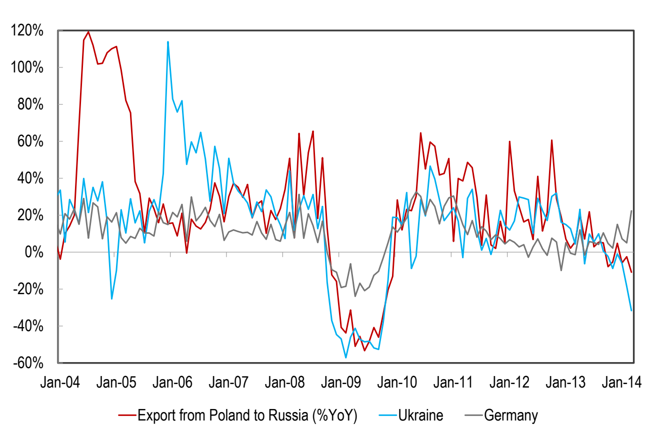
Source: CSO, Citi Research

Figure 174. 1Q GDP growth supported by high foreign trade surplus …



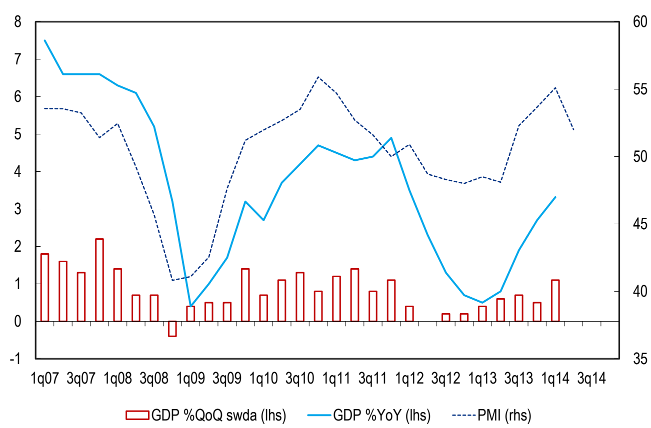
Source: NBP

Figure 175. … Ukraine/Russia export growth slowdown offset by recovery to EU and other developed countries



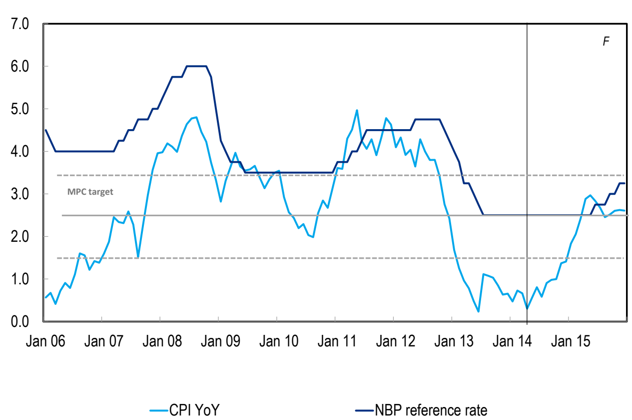
Source: Eurostat, CSO, Citi Research estimates for March based on CSO and Eurostat data

Figure 176. However, falling PMI still signals some downside risk to GDP growth in 2Q



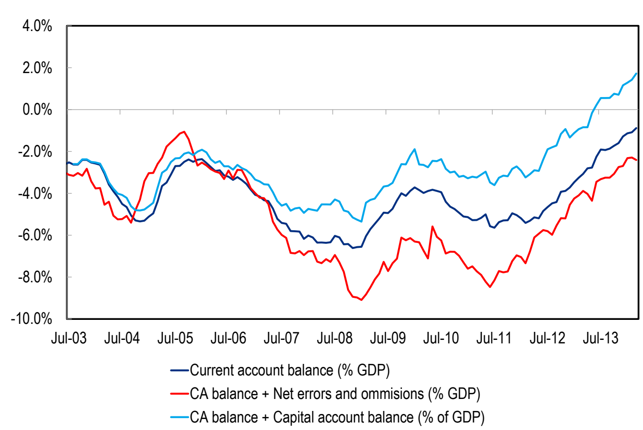
Source: Eurostat, CSO, Reuters, Citi Research

Figure 177. MPC will likely delay first rate hike till 2Q15 on low inflation



Source: CSO, Citi Research estimates

Figure 178. Record low current account deficit will likely limit zloty's sensitivity to risk aversion



Source: Ministry of Finance

Figure 179. Poland Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	426	534	433	470	517	490	516	554	589
Nominal GDP, local currency bn	1,177	1,276	1,345	1,417	1,528	1,596	1,632	1,698	1,796
GDP per capita, USD	11,185	13,994	11,347	12,210	13,404	12,721	13,416	14,395	15,321
Population, mn	38.1	38.1	38.2	38.5	38.5	38.5	38.5	38.5	38.5
Unemployment, % of labour force	11.2	9.5	12.1	12.4	12.5	13.4	13.4	12.4	11.7
Economic Activity									
Real GDP, yoy avg	6.8	5.1	1.6	3.9	4.5	2.0	1.6	3.4	3.6
Real investment growth % yoy	24.3	4.0	-11.5	9.3	11.2	-4.0	-4.7	8.3	4.5
Real consumption growth % yoy	4.6	6.1	2.0	3.4	1.6	1.0	1.2	2.5	3.0
private consumption growth % yoy	4.9	5.7	2.1	3.2	2.6	1.3	0.8	2.7	3.2
Real export growth, % yoy	9.1	7.1	-6.8	12.1	7.7	3.9	4.6	5.9	6.5
Real import growth, % yoy	13.7	8.0	-12.4	13.9	5.5	-0.7	1.2	6.7	7.5
Prices, Money & Credit									
CPI, % yoy eop	3.9	3.4	3.7	3.2	4.6	2.6	0.8	1.4	2.6
CPI, % avg	2.5	4.2	3.5	2.6	4.3	3.7	0.9	0.8	2.5
Nominal wages, % yoy	9.1	10.5	4.2	3.6	4.9	3.5	2.6	5.0	4.8
Credit extension to private sector, % yoy	31.5	36.4	7.0	8.5	13.9	2.4	4.5	8.0	12.0
Policy Interest Rate, % eop	5.00	5.00	3.50	3.50	4.50	4.25	2.50	2.50	3.25
1 month inter-bank rate, %, eop	5.52	5.61	3.76	3.66	4.77	4.21	2.61	2.62	3.35
Long-term yield, %, eop	5.93	5.46	6.24	6.07	5.91	3.73	4.34	4.20	4.80
PLN/US$, eop	2.47	2.97	2.87	2.97	3.45	3.09	3.02	3.15	2.94
PLN/US$, avg	2.76	2.39	3.10	3.01	2.96	3.25	3.16	3.06	3.05
PLN/EUR, eop	3.60	4.15	4.10	3.97	4.47	4.08	4.15	4.28	4.09
PLN/EUR, avg	3.78	3.52	4.32	3.99	4.12	4.18	4.20	4.22	4.18
Balance of Payments, USD bn									
Current account	-26.5	-34.9	-17.3	-24.1	-25.8	-18.1	-6.6	-13.9	-21.8
% of GDP	-6.2	-6.5	-4.0	-5.1	-5.0	-3.7	-1.3	-2.5	-3.7
Trade balance	-19.1	-30.7	-7.6	-11.8	-14.1	-6.7	3.1	2.1	-2.3
Exports	145.3	178.7	142.1	165.9	195.2	191.0	207.2	233.2	269.9
Imports	164.4	209.4	149.7	177.7	209.3	197.7	204.2	231.1	272.1
Service balance	4.8	5.0	4.8	3.1	5.7	6.0	7.0	6.1	6.2
Income balance	-16.4	-12.8	-16.6	-19.1	-23.6	-22.6	-21.7	-27.8	-32.6
FDI, net	18.0	10.4	8.5	6.9	12.3	5.2	5.2	4.0	6.0
International reserves	54.6	57.2	69.7	81.4	86.8	96.1	94.0	87.5	89.2
Total amortisations	43.0	44.0	46.9	43.4	42.8	44.5	49.3	46.9	45.7
Public Finances, % of GDP									
Consolidated government balance	-1.9	-3.7	-7.5	-7.8	-5.1	-3.9	-4.3	5.2	-2.7
Consolidated gov primary balance	0.4	-1.5	-4.9	-5.1	-2.4	-1.1	-1.7	7.3	-0.5
Public debt	44.8	46.9	49.8	52.8	53.4	52.7	53.9	47.5	46.6
of which Domestic	34.3	34.8	36.7	38.4	36.5	36.1	37.6	30.3	30.3
Foreign Assets & Liabilities, USD bn									
External debt	233.3	244.8	280.2	317.1	323.3	365.7	379.3	367.3	361.3
Public	86.8	69.4	92.2	116.5	121.0	155.9	161.1	156.0	153.4
External debt / GDP	54.7	45.9	64.7	67.4	62.6	74.6	73.4	66.3	61.3
External debt / XGS	133.9	114.2	163.8	159.6	138.9	159.8	153.3	132.3	112.5
Short-term debt	60.9	65.9	70.0	77.2	71.9	70.5	75.5	73.5	72.5
Short-term debt/International reserves (%)	111.4	115.1	100.4	94.9	82.8	73.3	80.3	83.9	81.2

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.3	3.3	3.2	3.5	3.7	3.3	3.3	3.7	3.9
CPI, % yoy eop	0.7	0.7	0.8	1.0	1.4	2.4	2.8	2.5	2.6
Policy interest rate, %, eop	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.25
Short-term market rate, % eop	2.61	2.61	2.61	2.62	2.62	2.62	2.90	3.15	3.35
Long-term yield, %, eop	4.42	4.27	3.90	4.05	4.20	4.35	4.60	4.75	4.80
PLN/EUR, eop	4.15	4.17	4.21	4.24	4.28	4.27	4.21	4.15	4.09

Source: National Sources, Citi Research forecasts

Romania

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- **Summary view** — We expect growth drivers to gradually switch from net exports to domestic demand this year. In this respect, the recent data provide some hope that private consumption is probably gaining some traction, as investment recovery continues to lag behind.
- **Things to watch** — Political stability ahead of the November 2014 presidential election and the implementation of the IMF-EU supported economic program deserve close monitoring.
- **Strategy** — We are encouraged to see that NBR has started moving money market rates closer to the policy rate of 3.5%. This trend, if sustained, should bode well for the leu.

Is private consumption finally gaining some traction?

At 3.8%YoY, Romania's flash estimate for the first quarter GDP reading came in broadly in line with the consensus projection (3.9%). While the preliminary data on the detailed components of GDP will be released on June 6, the 1Q GDP outturn is widely expected to be shaped mainly by strong exports and industrial output. In terms of the momentum of economic activity, standing at 0.1%QoQ (SWA), the 1Q print represents a slowdown when compared with the last two quarters of 2013 (1.6% in 4Q and 1.8% in 3Q).

A quick look at the recent high frequency data suggests to us that domestic demand is probably on track to play a more significant role in shaping economic growth. In particular, the recent growth indictors—including the retail trade turnover—offer hope that private consumption is gaining traction, as investment recovery, which is expected to become more visible in 2015, continues to lag behind. All in all, developments to date are in line with our expectations of a pick-up in non-agricultural growth in 2014, as we see this year's GDP growth at around 3%.

Favorable food prices continue to shape inflation, for now

At 1.2%YoY, the April inflation outturn was lower than the consensus (1.4%MoM). Favorable food prices, which dropped by about 0.1%MoM, turned out to be considerably below its seasonal average of an increase of about 0.3%MoM (2004-13). Using seasonally adjusted data, the April print translates into a rise of about 0.25%MoM compared with a flattish monthly inflation reading in March and an increase of 0.14%MoM in February. In our view, the better-than-expected April inflation reading doesn't change the big picture given sticky service and non-food prices as well as the importance of downward administrative price adjustments in the disinflation process so far this year.

Looking ahead, we believe that the possibility of a sharper reversal in food inflation, uncertainties related to the timetable for the deregulation of natural gas/electricity markets and a weaker leu emerge as the key risk factors that require close monitoring. By contrast, additional reductions in the VAT rate for certain products could lead to a lower inflation reading than we currently envisage. All in all, with service and non-food inflation (SA, 6-month moving average annualized) standing at around 4.6% and 3.8%, respectively—coupled with our expectations of a reversal in food prices—we have a more pessimistic year-end forecast (3.8%) compared with the NBR (3.3%)

NBR drives money market rates closer to the policy rate

We are encouraged to see that NBR has started moving money market rates closer to the policy rate of 3.5%. Although money market rates still remain below the policy rate, if this trend is sustained and the NBR eliminates the divergence between interbank rates and the policy rate, which was also recommended by the IMF, the monetary stance would become more leu-supportive. Nonetheless, it remains to be seen whether the NBR will do so going forward.

Whether the NBR will carry out further cuts in RRRs emerges as one of the main policy issues in the near-term. Given the fact that money market rates still remain below money market rates, we believe that the NBR isn't very likely to lower RRR in the near future. Where do we go from here? The risks on the inflation front and the possibility of a weaker-than-expected leu lead us to believe that the NBR will keep rates steady at 3.5% for the remainder of the year.

Fiscal stance remains prudent

Standing at around RON 1 billion, the budget gap in the first quarter of the year is considerably narrower than the deficit seen in the same period of 2013 (around RON 4.2bn). This outcome is largely driven by the strong base effect related with the payment of the arrears and co-payments of EU funds last year. Looking ahead, under the umbrella of the existing EU-IMF supported program, the authorities intend to continue fiscal adjustment in 2015 with a view to attaining a structural deficit of 1% of GDP, while also accommodating expected further increases in co-financing of projects supported by the EU.

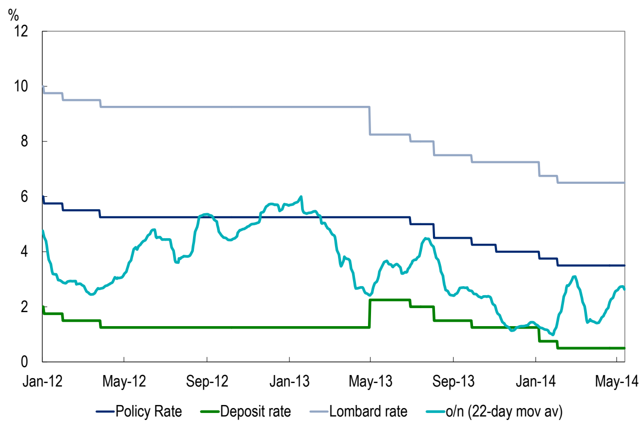
Current account gap is on track to widen moderately

Romania's current account balance printed a deficit of €0.3bn in the first quarter of 2014 compared with a small surplus in the same period of 2013. This outcome was mainly driven by a wider deficit in in the income balance. In line with our expectations of a moderate pick up in domestic demand and private credit growth, we expect the current account deficit to widen to around 2.5% of GDP this year from 1.1%.

S&P's upgrade to IG bodes well for the leu

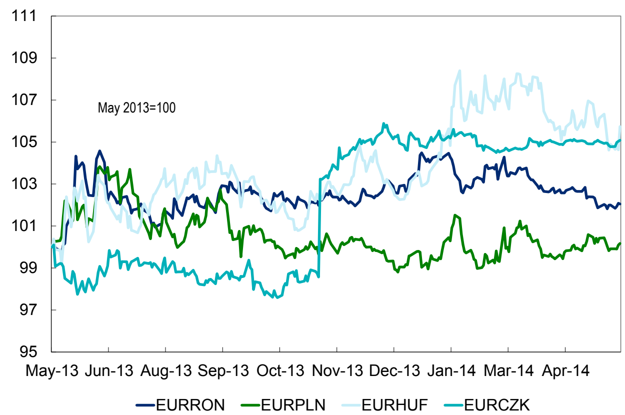
We believe that the NBR's decision to drive money markets closer to the policy rate—if sustained—augurs well for the leu. Moreover, the recent upgrade by S&P to IG should further buttress the performance of Romanian assets. Despite the noted encouraging backdrop, we believe that the following risk factors deserve close monitoring: (i) *the marked increase in the volatility of the leu, which probably reflects the NBR's increased pain threshold for FX volatility*; (ii) *whether with the 3 year bond yield standing at below 4% provides adequate buffer for downside risks (even if one employs the NBR's 2015 inflation forecast of 3.3%)*; and (iii) *the possibility of a pickup in political noise ahead of the upcoming European parliament elections and the presidential elections*.

Figure 180. NBR is moving money markets closer to the policy rate…



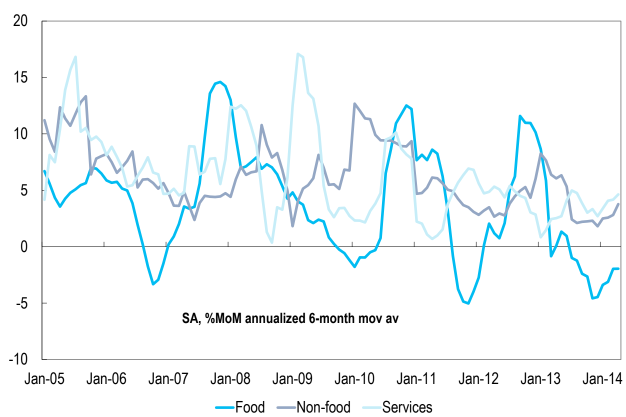
Source: Haver Analytics and Citi Research

Figure 181. …which, if sustained, bodes well for the leu.



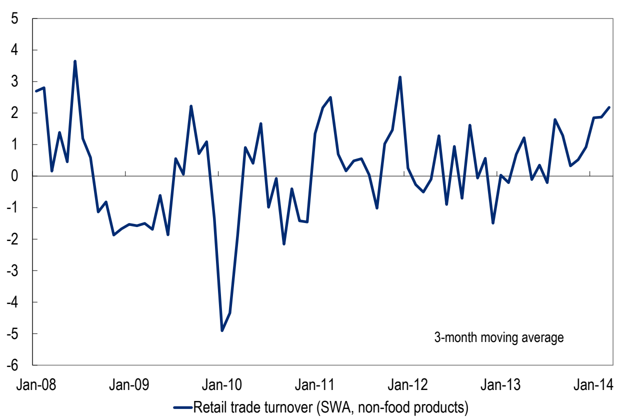
Source: Haver Analytics and Citi Research

Figure 182. Recent better-than-expected inflation data don't change big picture



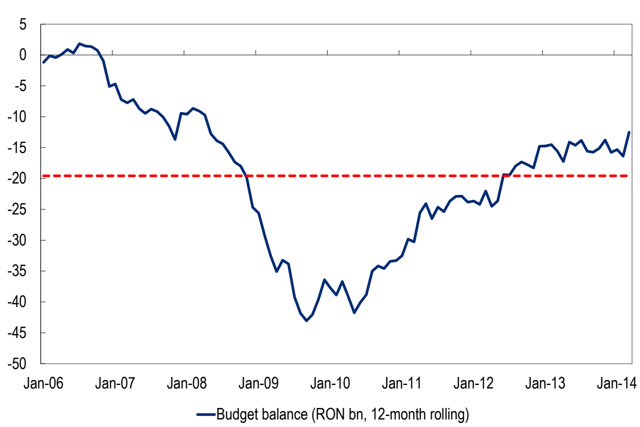
Source: Haver Analytics and Citi Research

Figure 183. There are signs suggesting that private consumption may be gaining traction…



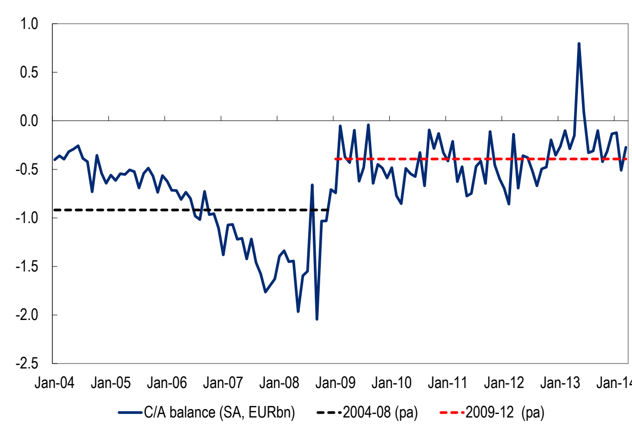
Source: Haver Analytics and Citi Research

Figure 184. …which augurs well for fiscal performance…



Source: Haver and Citi Research

Figure 185. …as the current account deficit remains in check



Source: Haver and Citi Research

Figure 186. Romania Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	171	204	165	165	183	169	189	204	218
Nominal GDP, local currency bn	416	515	501	524	557	587	629	661	706
GDP per capita, USD	7,653	9,176	7,397	7,413	8,246	7,642	8,550	9,233	9,910
Population, mn	22.3	22.3	22.2	22.2	22.2	22.1	22.1	22.1	22.0
Unemployment, % of labour force	4.3	4.0	6.3	7.6	5.4	5.1	5.3	5.5	5.5
Economic Activity									
Real GDP, yoy avg	6.3	7.5	-6.6	-1.2	2.4	0.5	3.5	3.0	3.4
Real investment growth % yoy	42.6	3.0	-34.3	8.9	12.1	-0.3	-8.7	3.1	1.9
Real consumption growth % yoy	10.6	9.3	-9.0	-0.8	1.4	1.4	1.0	1.5	3.3
private consumption growth % yoy	12.0	9.5	-10.4	-0.3	1.5	1.4	1.3	1.5	3.5
Real export growth, % yoy	7.7	7.6	-6.3	14.2	12.0	-1.8	13.1	5.5	4.5
Real import growth, % yoy	27.8	7.6	-21.4	12.5	10.6	-0.3	2.3	3.0	4.0
Prices, Money & Credit									
CPI, % yoy eop	6.6	6.3	4.7	8.0	3.1	5.0	1.6	3.8	3.0
CPI, % avg	4.8	7.9	5.6	6.1	5.8	3.3	4.0	2.0	3.4
Nominal wages, % yoy	22.6	23.6	8.4	2.5	4.9	5.0	5.0	5.0	4.5
Credit extension to private sector, % yoy	60.4	33.7	0.9	4.7	6.6	1.3	-3.3	4.6	8.2
Policy Interest Rate, % eop	7.50	10.25	8.00	6.25	6.00	5.25	4.00	3.50	4.50
1 month inter-bank rate, %, eop	8.24	15.35	10.60	4.05	5.72	6.04	4.60	4.10	5.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/US$, eop	2.47	2.89	2.96	3.17	3.33	3.37	3.25	3.32	3.16
RON/US$, avg	2.43	2.50	3.04	3.17	3.04	3.46	3.33	3.24	3.24
RON/EUR, eop	3.61	4.03	4.24	4.24	4.32	4.45	4.46	4.50	4.40
RON/EUR, avg	3.33	3.68	4.24	4.21	4.24	4.46	4.42	4.47	4.44
Balance of Payments, USD bn									
Current account	-22.9	-23.8	-6.8	-7.3	-8.2	-7.5	-2.0	-5.1	-9.2
% of GDP	-13.4	-11.6	-4.2	-4.4	-4.5	-4.4	-1.1	-2.5	-4.2
Trade balance	-24.4	-28.1	-9.6	-10.1	-10.3	-9.5	-4.6	-7.3	-11.6
Exports	40.5	49.6	40.5	49.6	63.0	57.9	65.8	68.4	72.4
Imports	64.9	77.7	50.1	59.6	73.3	67.4	70.4	75.8	84.0
Service balance	0.6	1.0	-0.4	0.5	0.5	1.5	3.6	0.6	0.7
Income balance	-5.7	-5.4	-2.6	-2.5	-3.1	-3.9	-6.1	-3.1	-3.3
FDI, net	9.7	13.7	5.0	3.0	2.6	2.9	3.5	2.0	2.6
International reserves	37.3	36.5	39.4	42.3	42.4	41.8	45.7	47.1	50.5
Total amortisations	12.2	18.1	17.7	19.7	19.6	25.0	34.1	34.6	36.9
Public Finances, % of GDP									
Consolidated government balance	-2.3	-4.8	-7.3	-6.4	-4.3	-2.2	-2.5	-2.3	-2.3
Consolidated gov primary balance	-1.5	-3.9	-5.7	-4.9	-2.6	-0.4	-0.3	-0.1	-0.1
Public debt	19.8	21.3	29.4	37.1	40.1	41.0	42.8	42.0	41.0
of which Domestic	10.2	12.6	15.4	19.8	21.9	18.5	19.0	17.5	15.6
Foreign Assets & Liabilities, USD bn									
External debt	80.3	105.8	113.0	122.4	137.3	128.1	127.6	146.7	152.8
Public	13.9	14.2	19.6	24.8	28.9	34.2	40.3	44.8	50.1
External debt / GDP	47.0	51.8	68.7	74.3	75.1	75.7	67.5	72.0	70.0
External debt / XGS	160.8	169.4	224.4	209.7	187.7	186.4	159.2	174.0	171.1
Short-term debt	28.7	28.5	22.5	26.2	29.5	28.0	26.8	27.1	29.2
Short-term debt/International reserves (%)	77.1	78.1	57.0	61.9	69.7	66.9	58.6	57.6	57.8

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	5.4	3.8	3.6	2.6	1.6	2.2	2.7	3.1	3.5
CPI, % yoy eop	1.6	1.1	1.4	2.8	3.8	3.7	3.5	3.3	3.0
Policy interest rate, %, eop	4.00	3.50	3.50	3.50	3.50	4.25	4.50	4.75	4.50
Short-term market rate, % eop	4.50	4.00	4.00	4.00	4.00	4.75	5.00	5.25	5.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/EUR, eop	4.46	4.46	4.45	4.47	4.50	4.47	4.45	4.43	4.40

Source: National Sources, Citi Research forecasts

Russia

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- **Summary view** — The lingering tensions in Ukraine make for a challenging backdrop to the economy. The combination of more subdued investment and consumption related to heightened uncertainty, and tighter monetary policy, led us to downgrade our 2014 GDP forecast from 2.6% to 1.0%.
- **Things to watch** — Uncertainty should remain elevated at least until the end-May elections in Ukraine. The central bank has a very difficult task navigating between the need to maintain financial stability and the desire to support flagging growth. Risks to our new growth forecast are slanted to the downside.
- **Strategy** — The expected transition from a current account surplus to current account deficit over the next couple of years will put structural pressure on the currency. Cyclical pressures will also weigh on the currency as tapering fears may weaken the RUB basket to 44.0 by the end of the year.

Growth slows in early 2014

First-quarter GDP grew at 0.9%YoY. Preliminary estimates from Rosstat point to economic growth slowing to 0.9%YoY, down from the 2.0% expansion posted in 4Q13. While on a downtrend, GDP grew better than the consensus estimate of 0.7%YoY.

Investment spending was the key avenue via which heightened geopolitical uncertainty weighed on growth performance. Investment contracted by an estimated 5.0%YoY in 1Q as business confidence struggled in the face of higher uncertainty and rising borrowing costs. This disappointing performance is much more broad-based relative to what we saw last year when the sectoral breakdown investment suggested that private-sector consumption-related investment had been growing, while it had been oil and gas investment holding back overall investment activity. Broader lack of visibility has now led to both private and public investment losing steam.

Consumer spending was, however, resilient as households shifted spending forward. In contrast to investment, consumer spending performed well, with real retail sales increasing by 3.5%YoY, broadly on par with that in 4Q13. This was chiefly driven by households drawing on savings to shift spending forward as the weaker currency and rising inflation were signaling less robust spending power in the future. However, we think that this is only a temporary factor that will fade away over the next couple of quarters. More importantly, consumer spending faces medium-term challenges as fears of a consumer boom turning into a bubble have led to more restrictive regulatory behavior.

Still, the risks to our 1.0% 2014 GDP growth are squarely slanted to the downside. Despite our belief that the geopolitical uncertainty will start to dissipate gradually in the aftermath of the May 25th Presidential Elections in Ukraine, headwinds to Russian growth will continue to batter the economy in our view. Policy is also limited in its scope to provide some respite. The fiscal rule implies a conservative fiscal stance while the two emergency rate hikes by the CBR, which brought policy rates higher by 200bpts to 7.50%, have made it increasingly more expensive for corporates to access credit, thus further weighing on growth expectations. This all implies downside risks to our 1.0% GDP forecast for 2014 (1.3% in 2013).

CBR's rate hike will further constrain growth. The Central Bank of Russia raised the one-week REPO rate by 150bpts to 7.00% on March 3rd and a further 50bpts to 7.50% on April 25th. The CBR argued that the decision was driven by a desire to ensure financial stability and ward off the build-up of inflationary expectations against the backdrop of heightened market volatility. The CBR was right, in our view, to hike rates, but this will also come at the cost of stronger headwinds to growth, including because of the S&P downgrade.

More generally, Russia faces a tight fiscal-monetary policy mix. In addition to the CBR being unwilling to jeopardize its credibility on inflation, Russia is pursuing a tight fiscal policy, which limits the borrowing requirement to no more than 1% of GDP. The MinFin argues that the small output gap and sensitivity of public finances to lower energy prices is a strong argument for pursuing a prudent fiscal policy at this juncture.

Long-term potential has been downgraded

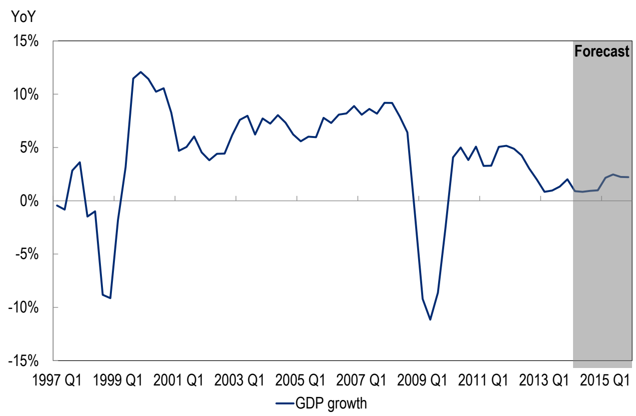
In a refreshing, if belated, recognition of Russia's dimmed economic potential, the Ministry of Economy has significantly downgraded its long-term growth forecasts. On 6 November 2013, the Ministry of Economy revised its long-term macroeconomic forecast until 2030. Average GDP growth for 2013-2030 is seen at 2.8%, down from the 4.3% expected only in March 2013. As a result, Russia's share of world GDP is anticipated to fall to 3.4% by 2030 compared to 4% in 2012. More worryingly, the forecasts suggest income inequality will widen with the share of the middle class in 2030 shrinking to a third from a half now.

Improvements in the investment climate are coming through, but slowly. The authorities seem well aware of the limits of Russia's investment climate, and President Putin has declared an objective to have Russia ranked 20th in the World Bank's Doing Business Survey by 2018 (it currently ranks 92th). Bottlenecks exist in construction permits, access to electricity, inadequate infrastructure, poor corporate governance, low levels of protection for IP, and limited competition in the financial sector. The government does however plan to pass a new PPP law to facilitate infrastructure spending. However, the amounts available from the National Welfare Fund to support infrastructure spending are relatively limited.

Structural challenges pose medium-term risks for the rouble. Most importantly, Russia is likely to gradually transition from a twin surplus to a twin deficit economy over the next couple of years – a phenomenon that historically has been associated with downward pressure on EM currencies. While Russia already runs (admittedly small) budget deficits, the positive, but fast diminishing, current account balance still provides some currency cover during periods of market turbulence. However, we project its disappearance in the not too distant future will constitute a major drag on the rouble. In addition, the expected medium-term deterioration in the public sector balance sheet will also likely weigh on medium-term rouble prospects.

Cyclical developments are also rouble negative. The Central Bank of Russia reported that 2013 current account surplus came in at US32.8bn, or 1.5% of GDP. This is significantly less than the US$71.3bn (3.6% of GDP) surplus that was posted in 2012. In addition, net capital outflows came in at USD50bn in 1Q14 vs USD 59.7bn for the whole of 2013. Against that background, the Ukraine contagion risks have served to expose Russia as a proxy for expressing bearish views on the region, with equity and fixed income markets coming under severe market pressure. As a result, we see the rouble basket weakening towards 44 by the end of the year.

Figure 187. Growth continues to struggle in early 2014

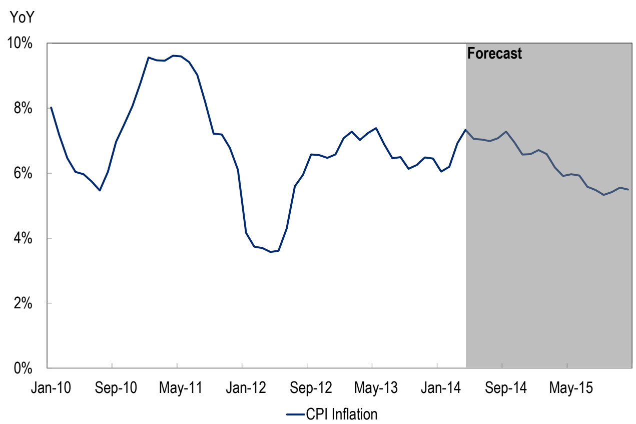


Source: Rosstat, Citi Research

Figure 188. Industrial activity is also weak

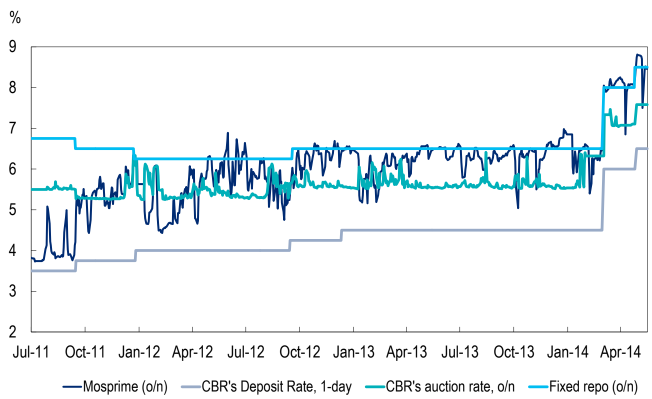
Source: Rosstat, Citi Research

Figure 189. CBR will miss its 5.0% end-2014 target...



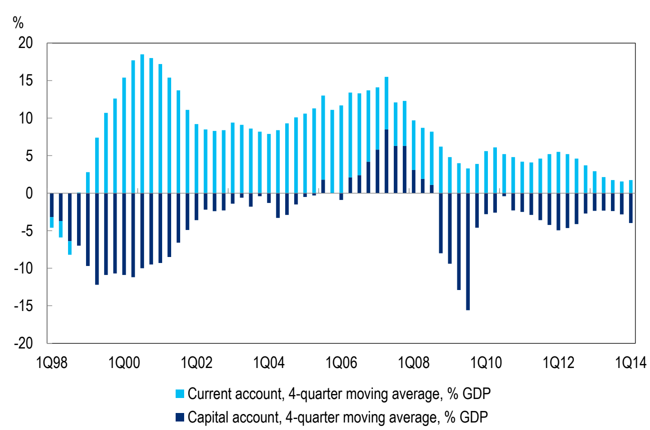
Source: Rosstat, Citi Research

Figure 190. …despite raising policy rate by 200bpts since early March



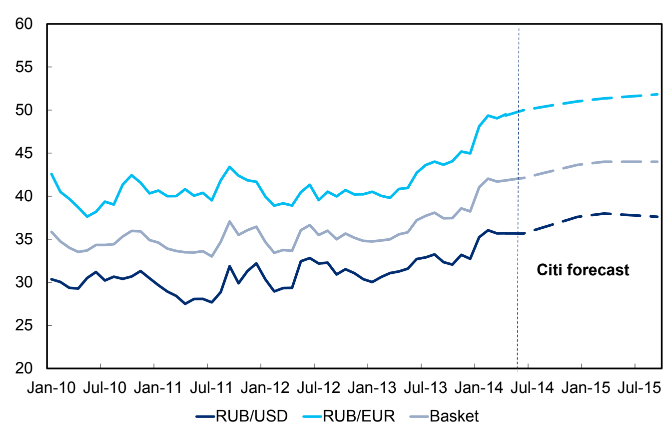
Source: Bloomberg, Citi Research

Figure 191. The gradual disappearance of the current account…



Source: CBR, Citi Research

Figure 192. …should keep the ruble under pressure during 2014



Source: Bloomberg, Citi Research

Figure 193. Russia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,304	1,665	1,229	1,524	1,903	2,000	2,114	2,002	2,103
Nominal GDP, local currency bn	33,248	41,277	38,807	46,309	55,967	62,218	67,293	72,599	79,288
GDP per capita, USD	9,081	11,585	8,554	10,611	13,267	13,969	14,798	14,050	14,797
Population, mn	143.7	143.7	143.7	143.6	143.4	143.2	142.8	142.5	142.1
Unemployment, % of labour force	6.1	6.4	8.4	7.5	6.6	5.5	5.5	5.7	5.8
Economic Activity									
Real GDP, yoy avg	8.5	5.2	-7.8	4.5	4.3	3.4	1.3	1.0	2.3
Real investment growth % yoy	22.0	10.5	-41.0	28.5	22.6	6.6	-0.3	0.0	3.3
Real consumption growth % yoy	10.7	8.4	-3.9	3.5	4.8	5.0	3.3	2.5	2.4
private consumption growth % yoy	14.2	10.4	-5.1	5.5	6.3	6.7	4.3	3.2	3.1
Real export growth, % yoy	6.3	0.6	-4.7	7.0	0.3	1.4	1.5	2.0	2.1
Real import growth, % yoy	26.2	14.8	-30.4	25.8	20.3	9.5	5.5	4.5	5.0
Prices, Money & Credit									
CPI, % yoy eop	11.9	13.3	8.8	8.8	6.1	6.6	6.5	6.5	5.4
CPI, % avg	9.0	14.1	11.6	6.8	8.4	5.1	6.8	6.8	5.8
Nominal wages, % yoy	26.0	27.4	9.1	12.8	11.7	13.3	12.3	13.5	12.7
Credit extension to private sector, % yoy	49.3	37.2	2.6	12.9	28.1	19.4	17.2	15.0	15.0
Policy Interest Rate, % eop	6.50	9.50	6.00	5.00	5.25	5.50	5.50	7.00	5.50
1 month inter-bank rate, %, eop	6.09	20.20	6.32	3.78	6.37	6.90	6.81	7.48	6.59
Long-term yield, %, eop	6.58	10.90	9.45	8.23	8.77	7.04	7.88	8.98	8.09
RUB/US$, eop	24.6	30.5	30.3	30.6	32.2	30.6	32.9	37.6	37.4
RUB/US$, avg	25.6	24.9	31.7	30.4	29.4	31.1	31.9	36.3	37.7
RUB/EUR, eop	35.9	42.7	43.4	40.9	41.7	40.3	45.2	51.0	52.0
RUB/EUR, avg	35.1	36.6	44.2	40.3	41.0	40.0	42.3	50.0	51.7
Balance of Payments, USD bn									
Current account	72.2	103.9	50.4	67.5	97.3	71.3	32.8	54.9	39.2
% of GDP	5.5	6.2	4.1	4.4	5.1	3.6	1.5	2.7	1.9
Trade balance	123.4	177.6	113.2	147.0	196.9	191.7	180.3	186.9	178.5
Exports	346.5	466.3	297.2	392.7	515.4	527.4	523.3	536.4	552.5
Imports	223.1	288.7	183.9	245.7	318.6	335.8	343.0	349.5	374.0
Service balance	-16.7	-20.4	-17.6	-26.1	-33.5	-46.6	-58.6	-54.0	-59.9
Income balance	-28.8	-46.5	-39.7	-47.1	-60.4	-67.7	-79.8	-69.0	-70.5
FDI, net	11.1	19.1	-6.7	-9.4	-11.8	-18.1	12.4	-5.0	10.0
International reserves	466.4	410.7	405.8	432.9	441.2	473.1	492.6	457.5	471.6
Total amortisations	28.5	47.2	49.9	40.8	52.0	90.5	139.0	103.1	105.3
Public Finances, % of GDP									
Consolidated government balance	6.7	5.1	-5.6	-3.2	2.1	-0.7	-2.1	-4.4	-4.9
Consolidated gov primary balance	5.8	4.4	-5.4	-3.4	1.2	0.6	1.6	1.8	0.8
Public debt	6.6	5.2	7.3	7.6	8.2	7.7	6.7	9.5	13.2
of which Domestic	3.8	3.4	4.7	5.3	6.3	5.9	4.6	7.2	10.7
Foreign Assets & Liabilities, USD bn									
External debt	471.2	480.6	467.3	488.9	538.9	636.4	727.1	714.0	728.7
Public	37.4	29.5	31.3	34.5	34.7	38.1	43.1	45.3	51.5
External debt / GDP	36.1	28.9	38.0	32.1	28.3	31.8	34.4	35.7	34.7
External debt / XGS	120.7	91.8	136.3	110.7	94.0	107.9	122.6	121.0	121.2
Short-term debt	99.7	73.6	52.7	60.2	68.2	81.5	84.0	88.2	91.9
Short-term debt/International reserves (%)	21.4	17.9	13.0	13.9	15.5	17.2	17.1	19.3	19.5

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.0	0.8	0.7	1.1	1.2	2.3	2.7	2.2	2.1
CPI, % yoy eop	6.5	6.9	7.0	7.2	6.5	6.1	5.8	5.3	5.4
Policy interest rate, %, eop	5.50	7.00	7.50	7.00	7.00	6.50	6.00	5.50	5.50
Short-term market rate, % eop	6.83	8.74	8.04	7.57	7.48	6.68	6.59	6.59	6.59
Long-term yield, %, eop	7.88	8.80	9.54	9.07	8.98	8.71	8.09	8.09	8.09
RUB/US$, avg	32.6	35.0	35.7	36.6	37.6	38.0	37.8	37.6	37.4

Source: National Sources, Citi Research forecasts

Slovakia

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- **Summary view** — Reflecting dynamics in 1Q14 and better employment we have revised up our 2014 GDP growth forecast to 2.1% from 2.0% previously, and look for growth to rise to 2.6%YoY in 2015 (weaker than our original expectation of 2.8%) and 3.1% in 2016.

- **Things to watch** — Ukraine crisis and large errors in the BoP represent a downside risk to our outlook. Though the government has prepared relatively sizeable measures to avoid a debt-to-GDP ratio of 57%, an eventual downward revision to GDP would put this level at risk. The planned privatisation of a telco company will be watched to avoid the 57% debt-brake trigger.

- **Strategy** — Activated trigger in debt-brake rule – which is now reflected in partly frozen expenditures and at risk of enforced balance budget – are likely, together with monetary policy to provide support for bonds. The government gross borrowing requirements of €6bn for 2014 are 65% covered.

Mild rise in 2014 forecast; domestic demand supportive

Reflecting 1Q14 dynamics and better employment we revise up our 2014 GDP growth forecast to 2.1% from 2.0% previously, before accelerating to 2.6%YoY in 2015 and 3.1% in 2016, although fiscal policy probably represents a downside risk. However, we expect looser ECB monetary policy should support the recovery. We believe April confidence levels support our less optimistic forecast compared to the 2.3%-2.4% forecast by the MinFin, NBS, EC, and IMF. The Ukraine crisis and large errors in the balance of payments represent a downside risk to our forecast.

GDP increased by 0.6%QoQ in 1Q14 (a tick above our forecast), which together with an upward revision in 2Q-4Q13 accelerated the YoY growth to 2%, above our forecast and consensus. However, it was probably offset by a downward revision in 1Q14. Foreign trade dynamics look better and the trade surplus grew in both QoQ and YoY terms in 1Q14. Employment has continued to grow for the third consecutive quarter. This was already apparent earlier as the unemployment rate decreased to 13.3% in March from 13.5% a month ago and 14.7% a year ago. Though the seasonally adjusted rate remained virtually unchanged at 13.1% as a month ago (moreover, supported by an increase in the labour force), it decreased compared to 13.5% in 4Q13. Unemployment dropped by 7.9%YoY to around 350k sa, which is the lowest number since mid-2011.

We believe economic activity remains supportive for 1Q GDP despite weaker industry. Retail sales accelerated 4.5%YoY in March resulting in a 2.6%QoQ gain, the strongest quarterly growth since 1Q08. The milder winter was not supportive for industry, which continued to grow at close to 0%YoY and offset strong gains from 2H13. The carry-over effect points to mild contraction this year. Industrial production decelerated sharply to 5.9%YoY wda in March from 9% a month ago and almost 13% in Nov13-Jan14. This deceleration particularly reflects a drop car sector growth to 8%YoY in March from above 22% in previous four months. Performance in other sectors was mixed in March with electronics and machinery industry negative, while metal industry improved to 12%YoY from 7% in January. However, the confidence in the car sector, which stabilized at level last seen in 2013, reflects mixed developments – the assessment of production trend decreased, production expectations only marginally improved (but still below 2013's level); by contrast, though the assessment of both total and export order books decreased in April, they have remained above 2013 levels.

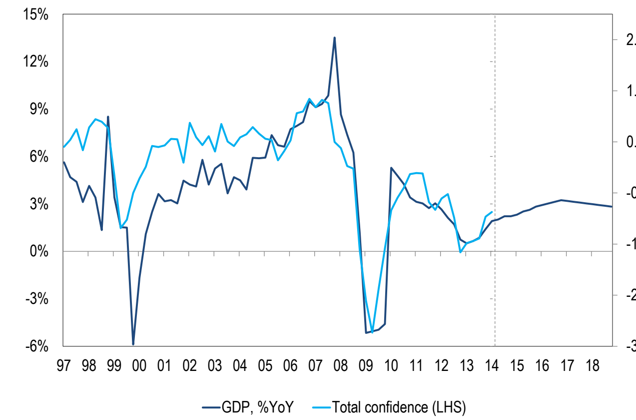
CPI is still falling

Consumer price growth continued to ease in April with the 12moving average reached the historical lows of 0.7%YoY, a tick lower compared to 0.8% seen around 3Q10. While the easing in contraction reflects a milder fall in regulated prices (-0.8%YoY vs. -1.4% a month ago), ongoing contraction was also caused by falling food prices (-0.8%YoY vs. +0.5% a month ago). As a result, the core CPI (non-regulated) eased its growth to zero in April from 0.2% in March and net CPI (excluding food prices) kept its growth at 0.1%YoY. Other price related information do not point to any soon acceleration in CPI growth with industrial producer prices falling by 3.5%YoY, relatively stable price expectations in production area and falling price expectations of households. We expect CPI growth of around 0%YoY also in 2Q14 before accelerating in 2H14. Acceleration inflating should reflect several factors, among others, increasing food prices and a milder fall in fuel prices and weaker EUR on a 9m horizon. We also expect this to be supported by stronger domestic demand, supported by further loosening in ECB's monetary policy. Overall our forecast assumes the CPI growth of 0.2%YoY in 2014 and 1.2% in 2015, followed by 2% growth in 2016. Hence, our forecast remains below both MinFin and the central bank reflecting our view on lower oil prices and a relatively stronger euro – though we expect it lower on the 9m horizon – which should result in lower energy and fuel prices compared to these forecasts. MinFin forecasts CPI will decelerate to 0.8%YoY in 2014, followed by stronger growth of 2.1% in 2015 and 2.3-2.4% in the following two years, an acceleration that should be broad-based. The CNB expects a stronger disinflation to 0.2%YoY in 2014, followed by 1.9-2% in 2015-16.

A lot of measures in play to avoid another debt-rule trigger

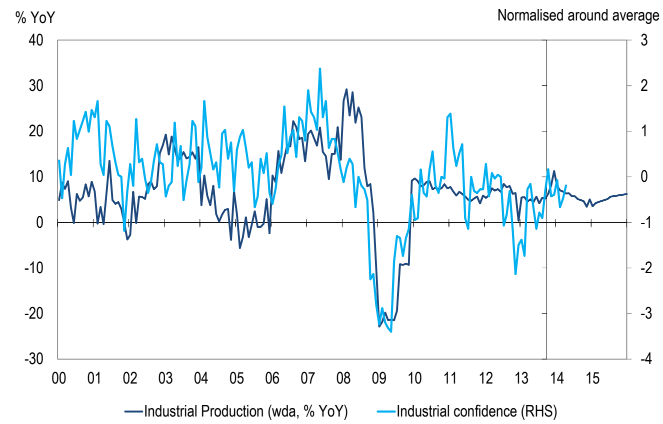
Deficit worsened in April and it will be worth watching tax collection developments. The central government deficit widened to €1.5bn ytd in April (3.4% of GDP) on weaker tax revenues and EU fund inflows. Hence, it will be worth watching if this is just volatility or a trend deterioration as recent robust fiscal performance has been stronger than nominal GDP suggests. As 2013 government debt reached 55.4% of GDP, and in the process breaching the 55% rule trigger, the government has to freeze 3% of total expenditures excluding social, natural disasters and debt related expenditures. Hence, MinFin announced it froze €305mn on the expenditure side, the equivalent of 0.4% of GDP in 2014. However, only part of it will have negative impact on real expenditures as €200mn is taken from the reserve and the rest, €105mn should be cut in operational expenditures; something worth doing given their recent larger increase (by €100mn YoY ytd). The Stability Programme suggests – as was already approved by government – measures of €470mn (0.6% of GDP) for 2015 (savings on expenditures, not tax cut and slightly higher taxes). The government further weakened its plan for fiscal consolidation with a 2.6% of GDP deficit this year (risk of wider deficit by 0.2%) and -2.5% next year, but the scenario without any new measures suggests the deficit of 3.7% of GDP in 2015 and -3% in 2017. However, the additional measures in range of 0.3-0.7% of GDP has to be introduced to reached plan deficit of 0.5% of GDP in 2017 according to the MinFin and to comply with EU requirement of fiscal consolidation effort of around 0.5% of GDP annually. Reflecting a larger debt level the government assumes a change in management of state oil reserve, which increased debt by €500mn (0.7% of GDP) in 2013. Moreover, the government plans privatization of 49% of a telecom company (€1bn). So together, this is about 2.6% of GDP, plus an eventual 0.3% from the real estate tax. By contrast, we see a risk that large errors in balance of payments could be reflected in drop in nominal GDP level by 2-3%.

Figure 194. April confidence remains supportive for the recovery



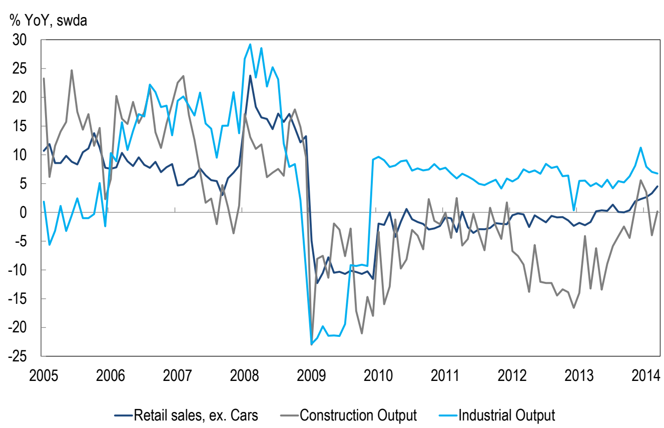
Source Statistical Office of the Slovak Republic, Citi Research estimates

Figure 195. with somewhat better, but mixed, industrial confidence



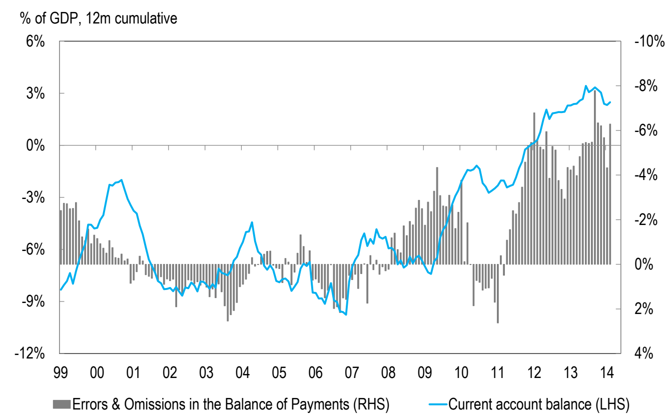
Source: Statistical Office of the Slovak Republic, Citi Research estimates

Figure 196. March data from real economy were supportive mainly from domestic demand



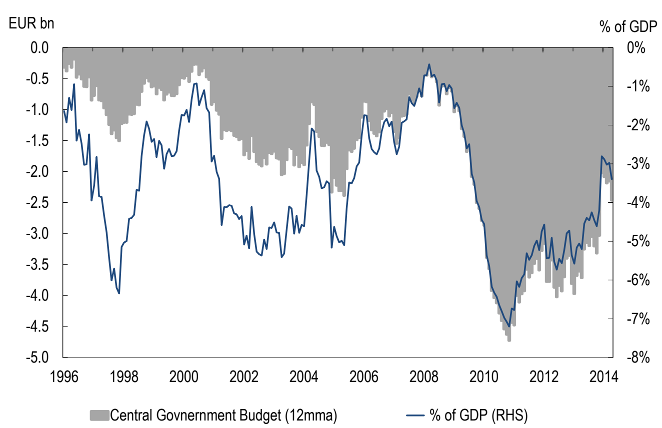
Source: Statistical Office of the Slovak Republic, Eurostat, Citi Research

Figure 197. Large errors in the BoP represent a risk of GDP revision



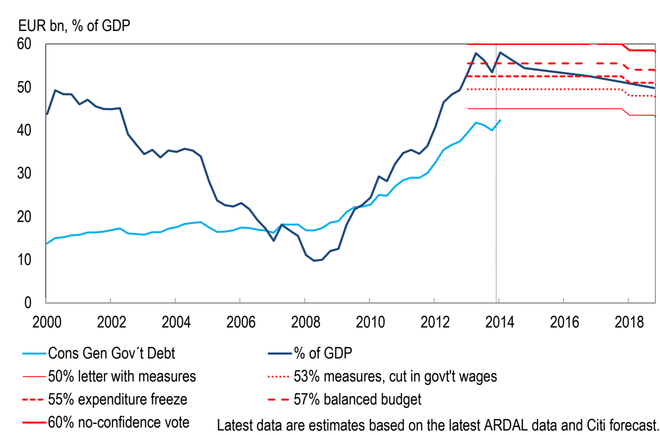
Source: Haver Analytics, Citi Research calculations

Figure 198. Central government budget worsened in April



Source: Haver Analytics and Citi Research calculations

Figure 199. Knocking on debt-brake rule door, but privatization revenues should provide a relief



Source: ARDAL, Eurostat, Haver Analytics and Citi Research

Figure 200. Slovakia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	75	95	88	87	96	91	96	102	105
Nominal GDP, local currency bn	61	67	62	66	69	71	72	74	77
GDP per capita, USD	13,936	17,493	16,156	16,087	17,654	16,781	17,577	18,601	19,210
Population, mn	5.4	5.4	5.4	5.4	5.4	5.4	5.5	5.5	5.5
Unemployment, % of labour force	8.4	7.7	11.4	12.5	13.2	13.6	14.1	13.0	12.4
Economic Activity									
Real GDP, yoy avg	10.5	5.8	-4.9	4.4	3.0	1.8	0.9	2.1	2.6
Real investment growth % yoy	9.7	4.7	-31.5	20.0	9.5	-16.0	-5.1	5.0	2.0
Real consumption growth % yoy	5.1	6.1	1.6	-0.3	-1.4	-0.4	0.3	1.1	1.6
private consumption growth % yoy	6.8	6.1	0.2	-0.7	-0.5	-0.2	-0.1	1.0	1.8
Real export growth, % yoy	14.3	3.1	-16.3	16.0	12.2	9.9	4.5	6.2	8.6
Real import growth, % yoy	9.2	3.1	-18.9	14.9	9.7	3.3	2.9	6.4	7.8
Prices, Money & Credit									
CPI, % yoy eop	3.4	4.4	0.5	1.3	4.4	3.2	0.4	0.6	1.4
CPI, % avg	2.8	4.6	1.6	1.0	3.9	3.6	1.4	0.2	1.2
Nominal wages, % yoy	7.5	8.2	3.0	3.3	2.2	2.5	2.5	2.3	3.1
Credit extension to private sector, % yoy	23.4	16.3	0.9	4.8	8.6	2.8	1.5	2.0	4.1
Balance of Payments, USD bn									
Current account	-4.1	-5.9	-2.3	-3.3	-3.6	2.0	2.3	2.8	3.6
% of GDP	-5.4	-6.2	-2.6	-3.7	-3.8	2.2	2.4	2.8	3.4
Trade balance	-1.0	-1.1	1.3	1.0	1.4	4.6	5.9	4.1	2.7
Exports	64.9	72.9	55.4	64.0	79.0	79.9	85.7	93.0	99.4
Imports	65.9	74.0	54.1	63.0	77.6	75.4	79.8	89.0	96.8
Service balance	0.5	-0.7	-1.4	-1.0	-0.5	0.4	0.2	2.2	4.7
Income balance	-3.2	-2.8	-1.2	-2.7	-4.0	-2.1	-2.4	-2.9	-3.3
FDI, net	3.0	4.3	-0.9	0.8	2.8	2.9	1.2	1.0	1.5
Total amortisations	1.7	1.7	1.8	2.1	2.1	2.3	2.5	2.6	2.7
Public Finances, % of GDP									
Consolidated government balance	-1.6	-2.0	-8.0	-7.5	-4.8	-4.5	-2.8	-3.0	-2.5
Consolidated gov primary balance	-0.4	-0.8	-6.6	-6.3	-3.5	-3.2	-1.5	-1.7	-1.3
Public debt	26.6	27.9	35.7	40.6	43.6	52.7	55.4	56.3	55.6
of which Domestic	18.1	19.0	20.4	25.2	30.8	49.6	96.2	61.1	67.4
Foreign Assets & Liabilities, USD bn									
External debt	44.3	52.5	65.3	65.8	68.5	76.3	80.8	84.8	87.8
Public	9.5	10.3	11.4	13.3	15.5	17.7	19.7	20.8	21.8
External debt / GDP	58.8	55.5	74.5	75.3	71.3	83.5	84.3	83.5	83.6
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	17.4	20.1	30.3	29.9	29.8	34.6	34.9	36.7	37.5

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.4	1.5	1.7	2.2	2.4	2.6	2.8	2.7	2.8
CPI, % yoy eop	0.4	-0.2	0.1	0.4	0.6	1.1	1.2	1.3	1.4
Short-term market rate, % eop	0.21	0.23	0.14	0.06	0.06	0.06	0.25	0.25	0.25
Long-term yield, %, eop	2.78	2.49	2.28	2.33	2.32	2.42	2.42	2.52	2.53

Source: National Sources, Citi Research forecasts

South Africa

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- **Summary view** — The debate of magnitude, timing and increments of rate hikes remains given the trade-off between high inflation and low GDP growth.
- **Things to watch** — Upcoming cabinet reshuffle is key to the general policy direction of the country.
- **Strategy** — Risk of ZAR volatility and weakness remains. Another sovereign ratings downgrade is minimized but still cannot be ruled out entirely.

A necessary rebalancing

South Africa's macro outlook has changed significantly since the start of the year. Following the surprising 50bp rate hike by the SA Reserve Bank in January we have reduced our rate outlook (owing to ZAR strength mostly) and now expect a total 100bp in this interest rate cycle. The weak ZAR until February leaves inflation trending higher and this should erode real disposable income growth. But tighter monetary policy should also weigh down on consumer spending given that it will take some time to result in lower inflation. Higher rates and the expectation of rising rates dampens corporate earnings, corporate credit take-up and likely boosts corporate savings. Alongside electricity troubles and labour disruptions this is sufficient reason to expect less from private sector fixed investment. We continue to expect below-consensus GDP growth of 2.3% in 2014 with some downside risk from electricity shortages and labour unrest, particularly now that Q1 GDP looks to dive down to 0% QoQ saar at best. Aside ongoing strike action in the platinum sector (since January) we are flagging that the metals manufacturing sector is at risk of labour strikes mid-year given that its wage agreement is up for negotiation.

The current account deficit is starting to narrow. As seen in recent GDP data, rebalancing from consumption to production is taking place and we expect this to express through the current account deficit this year. The Q1 14 current account deficit may see a slight setback from electricity outages in March (which also brought about greater oil imports) but we only factor in a slight deterioration from 5.1% in Q4 13. Local limits (labour unrest, high wages, rising costs of production and inefficient logistics) have dampened exports ability to respond to a weaker currency, but some improvement is starting to emerge. Concurrently more significant import compression has emerged in direct relation to a loss of momentum in gross domestic expenditure (falling 3.5% in Q4). It is obvious now that the consumer and the private sector are importing less and what is also emerging is that Eskom's capex import bill is running down but sadly in the near-term, its imported diesel requirement will overshoot its budget. This, together with the platinum strike now compromising export contracts (from April) is another setback to the Q2 current account deficit. Of course, a metals manufacturing strike in July would also not help the Q3 deficit. Looking past these once-offs, the current account is still expected to narrow to 4.2% of GDP which is an improvement on 2013. For the ZAR this still requires about R180bn in financing which is difficult in a global environment that lacks liquidity. What's more, questions remain as to the make-up of unrecorded transactions (3% of GDP currently) which is a key reason why we continue to see ZAR risk through the year.

It's all about vulnerabilities

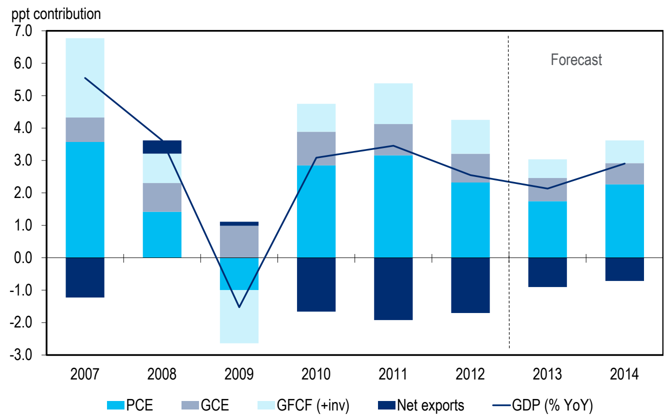
We see more ZAR pass-through to inflation this year. Company margins are under pressure in the face of rising costs and low domestic demand leaving retailers with no other choice but to try pass-through more currency weakness than before. Anecdotal evidence from surveys and the listed retail sector affirms this. We also expect upside pressure form rental inflation given the rapid fall in housing supply which is significant in the CPI basket. Despite global food deflation, droughts have cost South Africa's maize market dearly since December and local grain prices are up. This takes 9 months to filter through the food supply chain, leaving CPI food far higher by Q3 14. Finally, the coupling of above inflation wages and low productivity keeps unit labour costs elevated and a certain upside risk to the inflation outlook. Despite the many upside price pressures, inflation variance remains low, which we believe is due to the opposing forces of limited consumer appetite and rising cost push pressures. As a result, the downside risk of a still-negative output gap (particularly if one takes 150bp in rate hikes into account) should keep headline CPI peaking at 6.8% in June. Nevertheless, the many upside risks keep inflation out the target range until Q1 15.

Monetary policy faces another year of fierce debate. Following the surprise 50bp rate hike in January, lower ZAR variance and downside GDP growth risks have allowed for a less hawkish monetary policy debate. This aligns to the SARB's communication that a slow and moderate hiking cycle is its preferred option when normalizing policy rates and was conducive to its decision to keep the repo rate unchanged in March and why we changed our May MPC call to flat rates from having expected a 25bp hike previously. That said, upside risks to inflation expectations (the ZAR, food and wages mostly) and the prolonged period that the SARB expects CPI to remain above-target still justifies additional tightening but, in smaller increments. We have adjusted our base case and now look for a 25bp rate hike in July and another 25bp hike in September. This brings our total 2014 rate cycle to 100bp up from a total of 150bp previously. The caveat to a September rate hike is where the ZAR is trading at the time. This is unfortunate for rates markets, as the monetary policy debate is likely to remain rather fierce given its data dependency on both global and local factors – many of which are highly unpredictable. Further out, we believe the 2015 rates cycle will start in reaction to market pricing of Fed hiking. We are currently forecasting a first rate hike in mid-2015.

Quiet elections but get ready for the shuffle

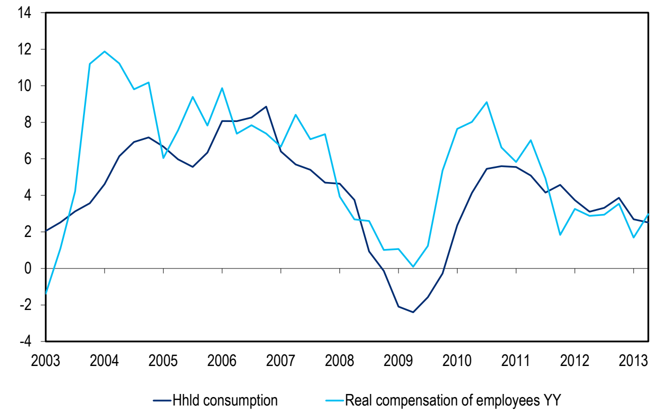
The 2014 national elections is a turning point for South Africa politics. While the ANC won the national elections with a 62% majority, this is somewhat lower than its 2009 victory of 65%. Upcoming opposition strength was seen in both the Democratic Alliance and the Economic Freedom Fighters. To the former, the gap of voter support on a provincial basis is narrowing. The DA performed a lot stronger in the province of Gauteng while the ANC lost significant ground. This means that by the 2016 municipal elections a tight race is likely between the two parties. The significance to this lies in the fact that the DA already runs the Western Cape and should it capture Gauteng it would control 50% of the economy. Looking out sooner, the ANC will reshuffle its cabinet after the President's inauguration on 24 May. This is pertinent to the policy direction of the economy – particularly for positions of Finance Minister, Trade and Industry, Labour and Education. Markets will also be watching for any news on the SARB Governor's term which expires in November 2014.

Figure 201. GDP to remain lackluster in 2013 and 2014



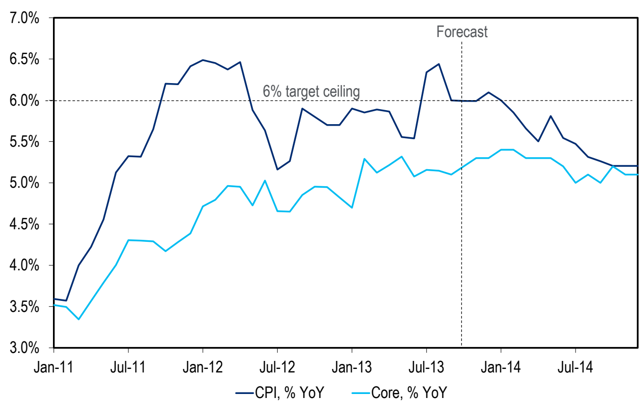
Source: SARB, Citi Research Projections

Figure 202. Consumption is slowing as real incomes decelerate



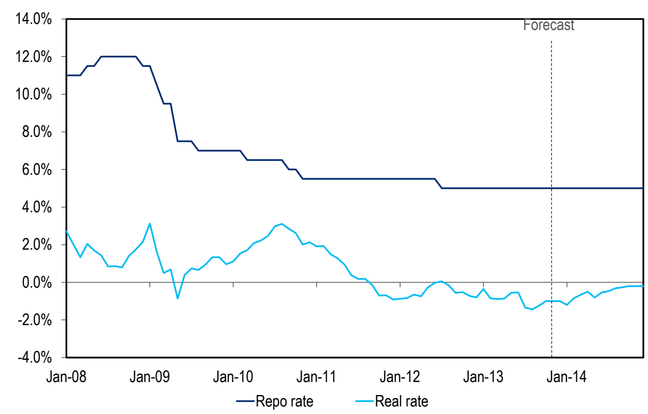
Source: SARB, Citi Research calculations

Figure 203. The CPI will remain at the top of the SARB ceiling in 2H 2013



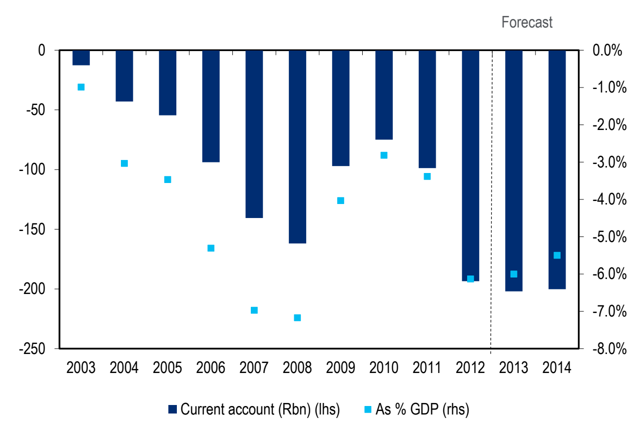
Source: Stats SA, Citi Research projections

Figure 204. Rand volatility suggests further Repo rates cuts are unlikely



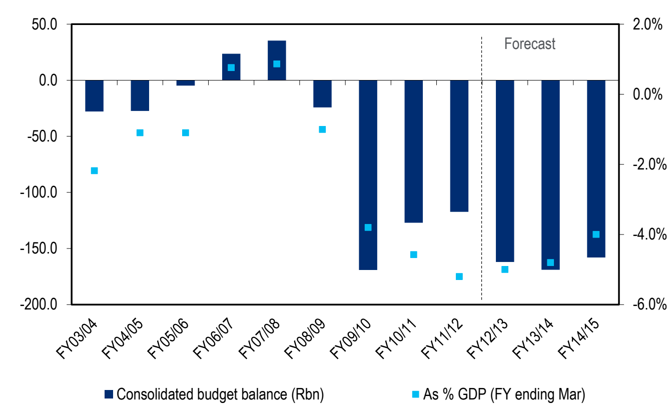
Source: SARB. Stats SA

Figure 205. No meaningful narrowing in the current account deficit



Source: SARB, Citi Research projections

Figure 206. Fiscal consolidation will likely be slow



Source: National Treasury, Haver Analytics, Citi Research projections

Figure 207. South Africa Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	286	273	287	366	404	382	351	348	371
Nominal GDP, local currency bn	2,016	2,256	2,408	2,674	2,933	3,139	3,385	3,697	4,074
GDP per capita, USD	5,763	5,613	5,825	7,312	8,081	7,646	6,986	6,925	7,361
Population, mn	49.6	48.7	49.3	50.0	50.0	50.0	50.2	50.3	50.4
Unemployment, % of labour force	-	22.5	23.7	24.9	24.8	24.9	24.7	25.0	24.6
Economic Activity									
Real GDP, yoy avg	5.5	3.6	-1.5	3.1	3.6	2.5	1.9	2.3	2.9
Real investment growth % yoy	12.0	4.4	-8.6	4.3	7.0	4.9	2.4	1.1	8.0
Real consumption growth % yoy	5.2	2.8	-0.1	4.4	4.7	3.7	2.5	2.4	3.0
private consumption growth % yoy	5.5	2.2	-1.6	4.4	4.9	3.5	2.6	2.4	3.1
Real export growth, % yoy	6.6	1.8	-19.5	9.0	6.8	0.4	4.2	6.6	5.5
Real import growth, % yoy	9.0	1.5	-17.4	11.0	10.0	6.0	4.7	4.0	6.8
Prices, Money & Credit									
CPI, % yoy eop	7.6	9.3	6.0	3.4	6.4	5.7	5.3	6.8	5.5
CPI, % avg	6.2	10.0	7.2	4.1	5.0	5.7	5.8	6.5	5.8
Nominal wages, % yoy	7.9	12.8	11.8	13.5	7.2	7.5	8.1	9.2	9.7
Credit extension to private sector, % yoy	21.5	13.6	-0.1	5.5	6.2	10.1	6.2	8.2	9.0
Policy Interest Rate, % eop	11.00	11.50	7.00	5.50	5.50	5.00	5.00	6.00	7.00
1 month inter-bank rate, %, eop	11.18	11.35	6.94	5.44	5.47	5.02	5.10	6.14	7.14
Long-term yield, %, eop	8.58	7.33	9.05	8.14	7.93	6.39	7.91	7.90	8.00
ZAR/US$, eop	6.87	9.49	7.41	6.62	8.09	8.46	10.50	10.95	10.89
ZAR/US$, avg	7.05	8.27	8.41	7.32	7.26	8.21	9.65	10.61	10.98
Balance of Payments, USD bn									
Current account	-19.9	-19.6	-11.6	-7.2	-9.4	-20.0	-20.4	-17.1	-15.4
% of GDP	-7.0	-7.2	-4.0	-2.0	-2.3	-5.2	-5.8	-4.9	-4.2
Trade balance	-5.2	-4.3	0.3	6.8	6.5	-4.8	-7.6	-4.4	-3.6
Exports	76.2	85.3	66.4	89.8	108.8	99.2	95.1	94.2	96.2
Imports	81.4	89.6	66.1	83.0	102.3	104.0	102.7	98.6	99.8
Service balance	-2.7	-4.1	-2.8	-4.4	-4.7	-2.5	-2.2	-1.9	-2.3
Income balance	-9.8	-8.9	-6.4	-7.2	-9.2	-8.9	-7.4	-8.0	-6.8
FDI, net	3.6	12.3	6.4	3.7	4.5	1.6	2.6	2.3	2.2
International reserves	29.6	30.6	35.3	38.2	42.6	44.0	44.8	46.4	47.2
Total amortisations	2.5	2.7	2.1	1.7	2.4	7.4	4.8	6.4	4.5
Public Finances, % of GDP									
Consolidated government balance	0.9	-1.0	-5.3	-4.9	-4.0	-4.4	-4.3	-4.2	-4.2
Consolidated gov primary balance	3.3	2.4	-3.1	-2.7	-1.7	-1.9	-1.6	-1.6	-1.6
Public debt	28.3	27.8	31.3	35.6	39.4	42.5	46.1	47.3	48.3
of which Domestic	24.5	23.4	27.7	32.3	35.6	38.8	42.2	43.8	44.8
Foreign Assets & Liabilities, USD bn									
External debt	63.0	60.4	63.8	80.6	89.7	113.7	108.6	101.3	106.8
Public	19.5	18.1	22.6	35.8	41.5	55.9	52.8	55.7	55.7
External debt / GDP	22.0	22.1	22.2	22.1	22.2	29.7	31.0	29.1	28.8
External debt / XGS	70.0	61.6	81.4	77.7	72.6	99.4	99.4	93.1	96.0
Short-term debt	24.0	25.5	21.3	21.7	20.5	27.9	27.2	28.7	29.2
Short-term debt/International reserves (%)	81.2	83.2	60.4	56.9	48.2	63.3	60.9	61.9	61.9

Quarterly Economic Indicators

	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.0	2.3	2.0	2.6	2.3	2.6	2.8	3.2	2.9
CPI, % yoy eop	5.3	6.1	6.9	6.7	6.8	6.3	5.7	5.6	5.5
Policy interest rate, %, eop	5.00	5.50	5.50	6.00	6.00	6.00	6.25	6.75	7.00
Short-term market rate, % eop	5.10	5.63	5.89	6.14	6.14	6.14	6.39	6.89	7.14
Long-term yield, %, eop	7.91	8.30	7.70	7.80	7.90	8.00	8.05	8.00	8.00
ZAR/US$, eop	10.50	10.53	10.35	10.65	10.95	11.07	11.01	10.95	10.89

Source: National Sources, Citi Research forecasts

Turkey

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- **Summary view** — Despite the relative strength in growth data, we continue to look for a sub-par growth performance this year.
- **Things to watch** — Political developments—as we approach the first round of the presidential election on August 10—forward-looking growth indicators and the CBT's resolve to avoid premature easing need to be monitored closely.
- **Strategy** —The lira isn't out of the woods yet owing to the country's large external financing needs, the possibility of an increase in political noise given the election heavy calendar and the risk of premature monetary policy easing.

What explains the resilience of economic activity in 1Q?

The relative strength in growth data has stimulated much discussion. Industrial production surprised on the upside in March, expanding by 4.2%YoY. This has brought the industrial production growth to a robust 5.3%YoY in 1Q. The noted backdrop, in turn, begs the following question: what is the source of this resilience? Our analysis leads us to believe that this can be attributed to the strong government spending and the positive contributions from net exports. Moreover, we believe that the adverse impact of higher rates and the sharp lira depreciation are yet to kick in fully. In short, we acknowledge that the 1Q GDP reading may be stronger than our earlier expectations. However, underlying growth dynamics remain weak, as the composition of demand remains tilted toward government spending and a largely cyclical contribution from net exports—not to mention soft private demand. Against this backdrop, we keep our 2014 growth forecast at 2.2%.

The external adjustment is gaining traction

The current account gap in the first quarter of the year is about US$5.1bn narrower than the deficit seen in the same period of 2013. The magnitude of the correction during the same period still remains significant (around US$2.9bn) in the case of the underlying deficit excluding energy and gold. A quick glance at the seasonally adjusted data also confirms that a meaningful adjustment is underway, as the current account gap in 1Q (SA, annualized) stands at about US$40bn, which is considerably narrower than the 2013 deficit of around US$65bn. We expect the current account gap to narrow from 7.9% of GDP in 2013 to about 5% this year owing to a weaker lira, a sub-par growth and a marked reversal in net gold exports. While the overall financing picture warrants concerns, there are some encouraging signs suggesting that residents are reducing their reliance on short-term external borrowing in 1Q when compared with the same period of 2013.

The inflation outlook continues to worsen

At 9.4%YoY, the April inflation reading came in higher than the consensus (8.8%). The outcome was driven by food prices, which, at 1.4%MoM, turned out to be well above its seasonal average (0.11%).Using seasonally adjusted data, the April inflation print translates into a rise of 1.04%MoM, compared with a rise of 1.01% in March and 0.57% in February. The deterioration in underlying inflation indicators continued in April. This, coupled with the large credibility gap, paints a challenging outlook for the CBT. Specifically, with core measures (SA, 3-month moving average annualized) standing at around 11.4%-13.0%, we believe that the CBT's year-end forecast looks too optimistic. Against this backdrop and in light of the April inflation print, we revise our year-end inflation from 8.5% to 9.0%.

The CBT risks repeating past mistakes…

At the May MPC meeting, the CBT surprised the markets through cutting the one week repo rate by 50bp to 9.5%. According to the CBT, the 50bp cut is justified by the relative improvement in risk premium indicators and other factors including the decline in market interest rates at all tenors. We argue that it is really difficult to put forward a credible case for today's easing—particularly if one remembers how the CBT was forced to hike rates aggressively not so long ago. More importantly, we remain concerned about the sustainability of the rally in Turkish assets given the disconnect between inflows, which have so far been unimpressive, with the marked recovery of the lira and the decline in bond yields. In addition, with the 2-year bond yield standing at about 9%, it is hard to argue that the current level of real rates provides adequate buffer for downside risks given the difficult inflation outlook and the possibility of a pick-up in political noise owing to an election heavy calendar.

Where do we go from here? We don't rule out additional easing so long as global markets permit. However, the fact that external factors can easily become less benign—coupled with the above-noted risks—leads us to believe that the CBT risks repeating past mistakes..

…as fiscal stance remains accommodative

A quick glance at tax revenue and primary expenditure trends suggests to us that fiscal policy remains fairly accommodative. Specifically, the pace of primary spending, which, in real terms, rose by almost 8%YoY in the first four months of the year, remains elevated. Standing at about 1.0%YoY in the same period, real tax revenue growth isn't keeping up with the sharp rise in spending. Moreover, we also observe that tax revenue growth in recent months, particularly in February, is no longer broad-based: it is driven by indirect taxes, largely reflecting rate adjustments to the "usual suspects" (e.g., tobacco, alcohol, fuel), while direct (both income and corporate) and import taxes perform relatively poorly. Projected by us at 2.8% of GDP, the budget deficit this year, which may be somewhat wider than the target (2%), is unlikely to undermine the market sentiment. However, one cannot rule out even a more noticeable deviation from the target owing to the heavy election calendar ahead, which may lead to even higher primary expenditure growth, while tax collections may disappoint because of a weak economy.

Lira: So far so good, but…

The lira's strong performance this year has been underpinned by considerable decline in political noise following the March local elections, the strong external adjustment, the absence of valuation problems and high interest rates. By and large, we expect these factors to remain supportive of the lira in the near-term. Looking ahead, however, we still think that the lira is not completely out of the woods yet owing to the country's large external financing needs (despite the ongoing external adjustment) and the possibility of an increase in political noise given the election heavy calendar. We also recognize that the likelihood of further premature easing has increased following the May MPC meeting. In this respect, whether the CBT will get carried away with will be important in terms of shaping the performance of the lira.

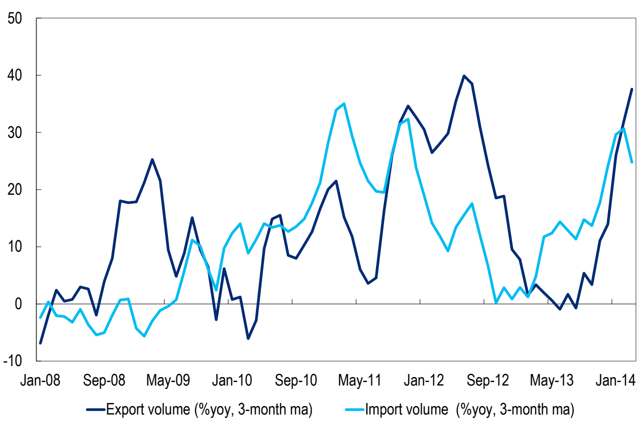
Figure 208. Inflation remains an obstacle to the CBT's intention to ease…

Source: Haver Analytics and Citi Research Note: 3-month mov av, annualized.

Figure 209. … as CBT's credibility gap warrants concern

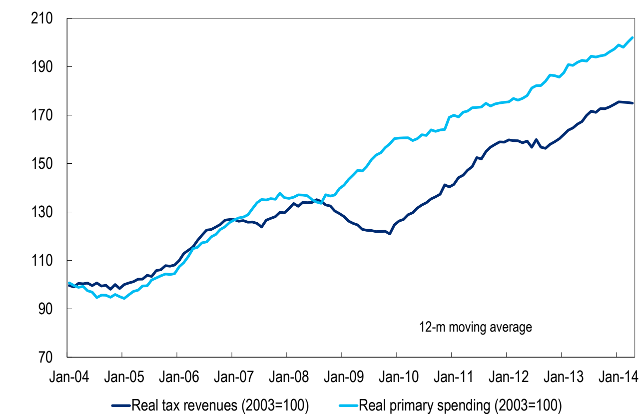
Source: CBT and Citi Research

Figure 210 Strong net exports…



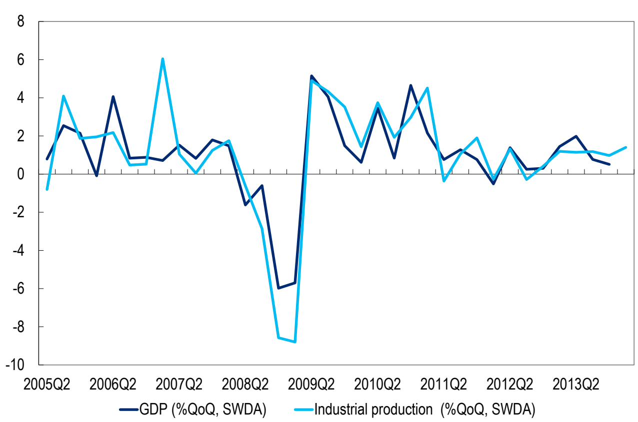
Source: Bloomberg and Citi Research

Figure 211. … and government spending…



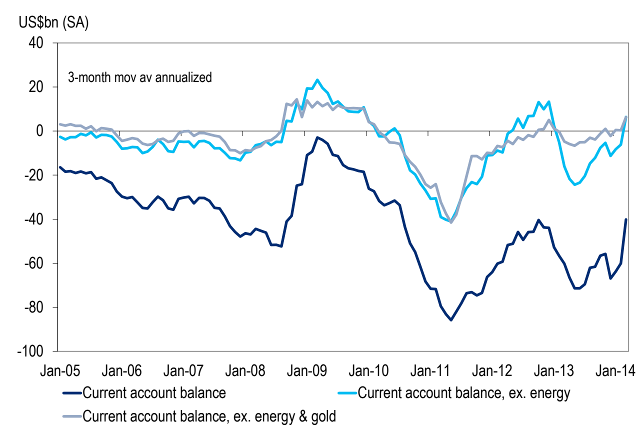
Source: Haver and Citi Research Note:12-month rolling sum.

Figure 212. …prop up economic activity



Source: CBT and Citi Research

Figure 213. … as external adjustment gains traction



Source: CBT, Haver and Citi Research

Figure 214. Turkey Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	646	731	615	731	775	789	820	812	849
Nominal GDP, local currency bn	843	951	953	1,099	1,298	1,417	1,562	1,732	1,934
GDP per capita, USD	9,207	10,282	8,530	10,016	10,473	10,531	10,721	10,504	10,859
Population, mn	70.2	71.1	72.1	73.0	74.0	74.9	76.5	77.3	78.2
Unemployment, % of labour force	10.3	11.0	14.0	12.0	9.8	9.2	9.8	9.5	9.5
Economic Activity									
Real GDP, yoy avg	4.7	0.7	-4.8	9.2	8.8	2.1	4.0	2.2	3.5
Real investment growth % yoy	5.8	-4.8	-28.6	48.4	16.8	-8.5	11.4	-10.0	4.0
Real consumption growth % yoy	5.6	-0.1	-1.0	6.0	7.3	0.4	4.8	0.5	3.2
private consumption growth % yoy	5.5	-0.3	-2.3	6.7	7.7	-0.5	4.6	0.0	3.2
Real export growth, % yoy	7.3	2.7	-5.0	3.4	7.9	16.3	0.1	8.6	4.4
Real import growth, % yoy	10.7	-4.1	-14.3	20.7	10.7	-0.4	8.5	-7.2	4.0
Prices, Money & Credit									
CPI, % yoy eop	8.4	10.1	6.5	6.4	10.4	6.2	7.4	9.0	7.4
CPI, % avg	8.8	10.4	6.3	8.6	6.5	8.9	7.5	8.6	7.9
Nominal wages, % yoy	9.5	11.6	9.9	11.8	9.7	11.5	8.5	7.5	7.5
Credit extension to private sector, % yoy	27.8	22.4	13.4	40.4	32.8	19.8	33.5	15.0	15.0
Policy Interest Rate, % eop	15.75	15.00	6.50	6.50	5.75	5.55	7.10	11.50	10.50
1 month inter-bank rate, %, eop	17.21	17.16	7.20	6.89	11.54	5.80	8.66	12.70	11.70
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	1.17	1.54	1.50	1.54	1.89	1.78	2.15	2.18	2.34
TRY/US$, avg	1.31	1.31	1.55	1.51	1.68	1.80	1.91	2.13	2.28
TRY/EUR, eop	1.70	2.15	2.15	2.06	2.44	2.35	2.95	2.95	3.25
TRY/EUR, avg	1.79	1.92	2.17	2.00	2.34	2.32	2.53	2.94	3.13
Balance of Payments, USD bn									
Current account	-37.8	-40.4	-12.1	-45.4	-75.1	-48.5	-65.1	-42.0	-45.2
% of GDP	-5.8	-5.5	-2.0	-6.2	-9.7	-6.1	-7.9	-5.2	-5.3
Trade balance	-46.9	-53.0	-24.9	-56.4	-89.1	-65.3	-80.0	-61.0	-66.9
Exports	115.4	140.8	109.6	120.9	143.4	163.2	163.4	182.4	197.6
Imports	162.2	193.8	134.5	177.3	232.5	228.6	243.4	243.4	264.5
Service balance	14.0	18.9	18.6	16.7	20.2	22.6	23.1	26.7	28.8
Income balance	-7.1	-8.4	-8.3	-7.2	-7.9	-7.2	-9.3	-8.9	-8.5
FDI, net	19.9	17.2	7.1	7.6	13.8	9.2	9.8	10.5	11.0
International reserves	73.3	71.0	70.7	80.7	78.5	99.9	109.8	116.3	114.3
Total amortisations	37.6	41.1	47.4	45.0	37.9	33.5	36.4	44.0	50.0
Public Finances, % of GDP									
Consolidated government balance	-1.6	-1.8	-5.5	-3.6	-1.3	-2.0	-1.2	-2.8	-3.2
Consolidated gov primary balance	4.1	3.5	0.1	0.8	1.8	1.4	0.9	0.3	0.3
Public debt	40.4	41.2	47.7	44.4	41.2	38.8	38.7	37.7	36.7
of which Domestic	30.3	28.9	34.6	32.1	28.4	27.3	25.8	25.3	25.0
Foreign Assets & Liabilities, USD bn									
External debt	250.4	281.1	269.1	292.0	304.4	337.5	391.3	411.5	429.5
Public	89.3	92.4	96.6	100.6	90.0	101.8	116.8	122.3	127.3
External debt / GDP	38.7	38.5	43.8	39.9	39.3	42.8	47.7	50.7	50.6
External debt / XGS	172.4	158.1	185.1	185.8	165.4	163.6	186.3	176.6	170.2
Short-term debt	43.2	52.5	49.0	77.3	81.9	100.8	129.1	129.1	134.1
Short-term debt/International reserves (%)	58.9	74.0	69.3	95.8	104.4	100.9	117.5	111.0	117.3

Quarterly Economic Indicators

	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	4.4	4.0	1.0	1.4	2.6	2.9	3.6	3.8	4.4
CPI, % yoy eop	7.4	8.4	8.4	8.2	9.0	8.2	7.8	7.8	7.4
Policy interest rate, %, eop	7.10	10.27	10.00	11.00	11.50	11.00	10.50	10.50	10.50
Short-term market rate, % eop	8.66	12.28	11.20	12.20	12.70	12.20	11.70	11.70	11.70
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	2.15	2.14	2.09	2.13	2.18	2.22	2.26	2.30	2.34

Source: National Sources, Citi Research forecasts

Ukraine

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- **Summary view** —The 27 March announcement of an IMF deal should alleviate market concerns of an imminent sovereign default, but at the risk of inflicting severe economic pain. In addition, there are significant execution risks attached to the IMF program. The first tranche was disbursed in early May.
- **Things to watch** — The focus of attention will continue to be on external sustainability and political maneuvering in the run-up to the May Presidential elections. We think it will be hard to avoid a deepening recession in 2014 even in our baseline case of a relatively speedy resolution of the political crisis.
- **Strategy** — The NBU devalued the hryvnia by 10% in early Feb, but the USDUAH has since moved well beyond its fair value of around 10.50. The NBU raised policy rates by 300 bpts to halt currency decline, but the fraught political backdrop may continue to exert pressures on the currency.

IMF deal, but at what price?

The 27 March announcement of a new IMF deal should alleviate, at least for the time being, market concerns of an imminent sovereign default. The confluence of unsustainable external position, overvalued exchange rates, 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$14-18bn from the IMF, has significantly reduced fears of an imminent sovereign default.

The first tranche of IMF money was already disbursed in early May. The Executive Board of the IMF approved the SBA on April 30th with the immediate disbursement of US$3.2bn as the first tranche of the agreement. The second and third disbursements will be based on bi-monthly reviews and performance criteria, and the remainder of the program period will be subject to standard quarterly reviews and performance criteria. The government has already adopted and implemented some prior actions, including passing an amended 2014 Budget, a package of anti-crisis measures and raising gas tariffs for the households by 50% from 1 May.

More broadly, the key planks of the IMF programme focus on exchange rate policies, fiscal policies, financial sector reforms, energy sector reforms, and reforms with respect to governance and business climate. Commitment to a more flexible and market-determined exchange rate should ensure that the currency fairly reflects underlying macro fundamentals. While understandably there is no reference to a specific level of the exchange rate, our estimates suggest that a fair value for the USD-UAH is around 10:50. The fiscal deficit will need to be cut from 4.5% of GDP in 2013 to 2.5% of GDP by 2016. Financial sector reforms should ensure that banks are sound, liquid and well-capitalized, while upgrading the regulatory and supervisory powers of the NBU. Energy sector reform should bring retail and gas and heating tariffs to full cost recovery. Finally, reforms to transparency and business climate should focus, among other things, on adopting a new procurement low for public purchases, speeding up VAT refunds to business and implementing an independent quarterly audit of Naftogas accounts.

These IMF conditionalities will impose significant economic pain on Ukraine. The above conditions should force the economy back into recession, and we forecast a GDP of contraction of 3.2% in 2014, with the risks squarely slanted to the downside. This would follow on the steps of two consecutive years of no growth, meaning a fall in per-capita incomes from US$3,872 in 2012 to an estimated US$3,030 in 2014–a painful drop of about 16%. The 2014 GDP fall is expected to be accompanied by a continuing contraction in real investment spending, which we see declining for a third consecutive year by 8.3%. We also forecast that real consumer spending will decrease for the first time in five years by 3.3% in 2014.

Despite the positive effect from providing much-needed financial help, there are significant execution risks attached to the IMF programme. In addition to the more well-quantifiable risk of still having to bridge the gap between the overall estimated US$27bn financial need and the US$14-18 provided by the IMF, the ability of the government to press ahead with the painful reforms is a significant concern.

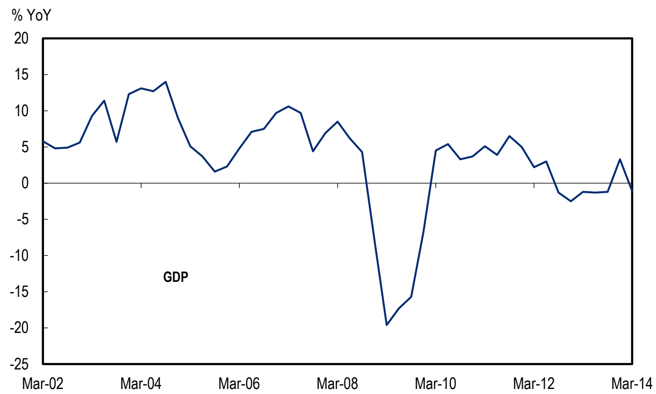
The adoption of the anti-crisis package on 27 March after very long discussions and only on the second attempt serves to underscore the potency of the implementation risk. The anti-crisis package includes freezing profit and VAT tax rates at 18% and 20%, respectively (versus previous plans to have them reduced to 16% and 17% by 2015), introducing massive lay-offs in police at 50% of existing staff and in public administration at 10% of existing staff, freezing minimum wages and minimum subsistence levels, and stopping indexation of pensions, among other things. The severity of the proposals led to the law failing to pass at the first attempt, with only 189 PMs voting in favour against a required minimum of 226. Only after protracted internal discussions did the anti-crisis law clear the hurdle late in the evening of 27 March. In our view, this serves to underscore that many MP’s felt quite uncomfortable with the drastic nature of the proposals, many of which will start biting in the second half of the year, potentially testing the resolve of the government to continue inflicting economic pain on the population. This risk will also need to be put in the context of Russia effectively doubling pensions in Crimea to bring them to the average pension in Russia, creating a stark contrast in the living standards in Ukraine and Crimea. .

Risk of military escalation remains

With Russian troops still massed on the border, the risk of further military intervention is non-negligible. At the time of this writing, Russian troops remain massed along Ukraine’s eastern border. Post-election tail risks remain: the election result could be disputed, civil disturbances could mar voting or prompt military intervention, and Russia could reduce or halt its gas exports to Ukraine.

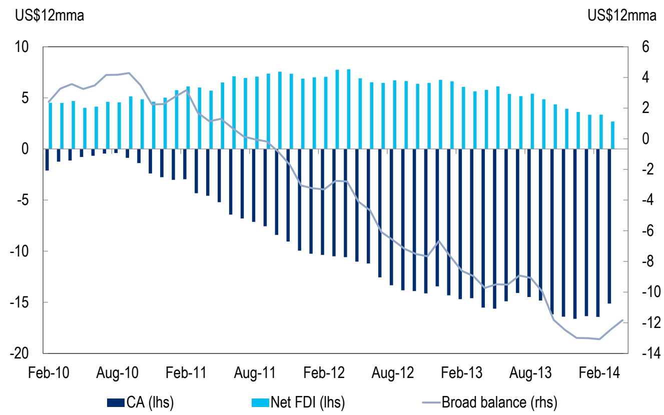
What is Ukraine’s new political math without Crimea? The next critical signpost for the Ukraine crisis is the snap presidential election on 25 May. The vote will take place in a highly charged domestic political environment and amid ongoing civil disturbances and tensions with Russia. One hard fact we can assess is the country's new electoral math, with 1 million pro-Russia votes lost in now-annexed Crimea. In our view, a pro-European candidate will be successful in the second round, even if turnout is low and the election fails to provide a political mandate for the incoming administration. Given tensions with Moscow, this suggests that friction between Russia and an incoming administration would continue, and could intensify.

Figure 215. Economy struggles…



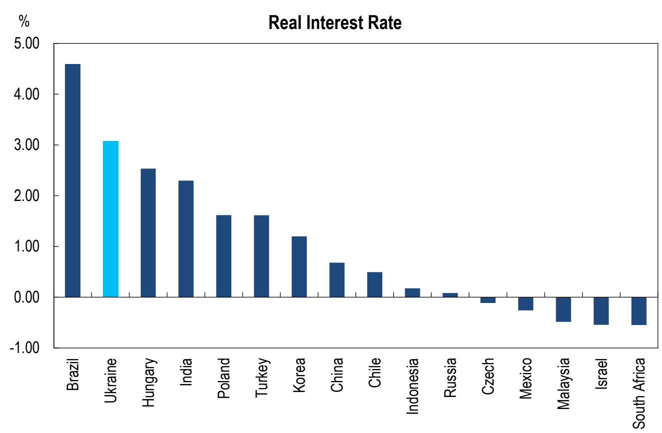
Source: UKR Statistics, Citi Research

Figure 216. … but external position has started to improve



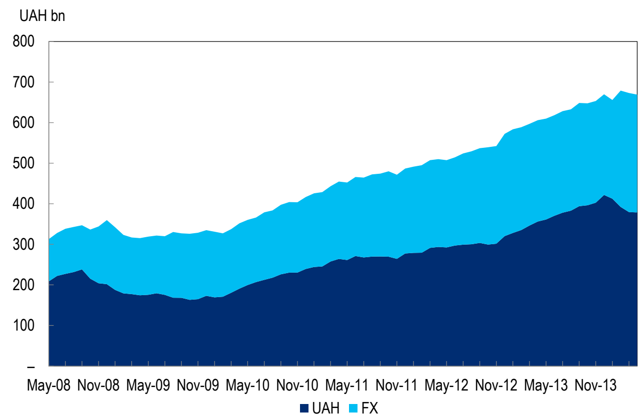
Source: UKR Statistics, Citi Research

Figure 217. Despite very high real interest rates…



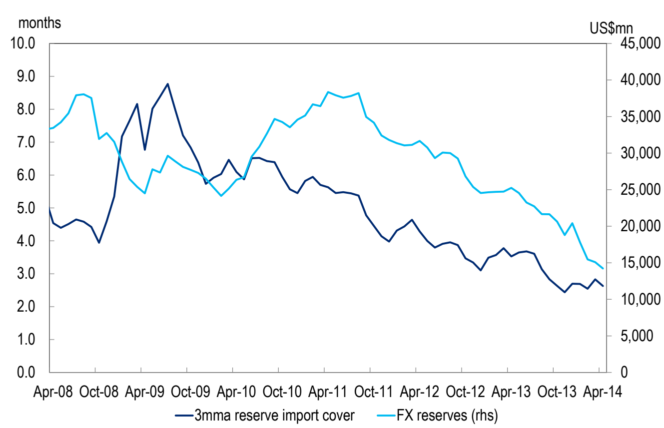
Source: Citi Research

Figure 218. …population has started to reduce UAH deposits



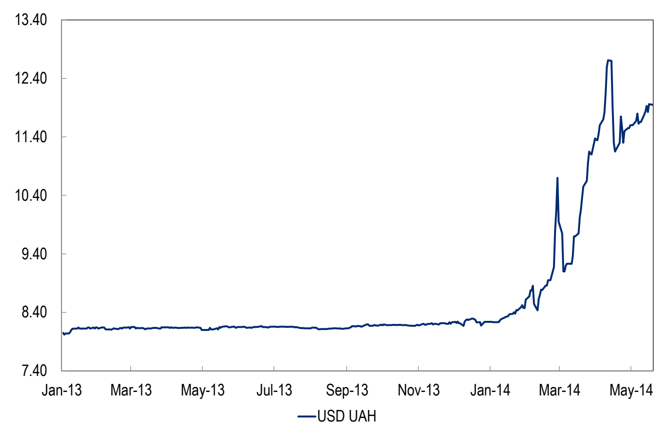
Source: UKR Statistics, Citi Research

Figure 219. Reserves are below 3 months of imports …



Source: UKR Statistics, Citi Research

Figure 220. …as the exchange rate has been weakening



Source: Haver Analytics

Figure 221. Ukraine Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	143	180	117	136	163	177	176	139	150
Nominal GDP, local currency bn	715	946	913	1,080	1,292	1,409	1,455	1,461	1,600
GDP per capita, USD	3,059	3,875	2,536	2,964	3,566	3,872	3,877	3,085	3,331
Population, mn	46.7	46.5	46.2	46.0	45.8	45.6	45.4	45.2	45.0
Unemployment, % of labour force	6.4	6.4	8.8	8.1	7.9	7.5	7.7	7.7	7.5
Economic Activity									
Real GDP, yoy avg	7.6	2.3	-14.8	4.1	5.2	0.3	0.0	-3.2	2.1
Real investment growth % yoy	26.6	1.8	-57.1	15.9	18.0	-7.5	-23.6	-21.3	13.2
Real consumption growth % yoy	13.1	10.1	-12.3	6.4	11.3	7.9	5.8	-3.3	2.2
private consumption growth % yoy	17.0	12.8	-14.9	7.1	15.5	8.8	7.9	-4.0	2.5
Real export growth, % yoy	2.8	5.7	-22.0	3.9	4.3	-7.2	-8.8	1.0	2.0
Real import growth, % yoy	23.9	17.0	-38.9	11.3	17.7	1.8	-5.9	0.0	6.0
Prices, Money & Credit									
CPI, % yoy eop	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	10.5	5.8
CPI, % avg	12.8	25.2	15.9	9.4	8.0	0.6	-0.3	7.2	7.3
Nominal wages, % yoy	29.7	33.7	5.5	17.7	17.5	14.9	8.0	9.7	8.5
Credit extension to private sector, % yoy	73.7	67.1	-4.2	0.7	8.9	2.8	13.8	10.0	10.0
Policy Interest Rate, % eop	8.00	12.00	10.25	7.75	7.75	7.50	6.50	9.50	9.00
1 month inter-bank rate, %, eop	8.41	23.78	19.10	10.75	20.25	25.00	16.25	15.00	11.25
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US$, eop	5.05	8.05	8.05	7.97	8.01	8.05	8.24	10.50	10.80
UAH/US$, avg	5.03	5.16	8.06	7.97	7.99	8.08	8.15	10.48	10.68
UAH/EUR, eop	7.37	11.25	11.53	10.66	10.37	10.62	11.33	14.25	15.02
UAH/EUR, avg	6.89	7.60	11.21	10.55	11.11	10.39	10.83	14.35	14.59
Balance of Payments, USD bn									
Current account	-5.3	-12.8	-1.7	-3.0	-10.2	-14.3	-16.4	-7.3	-5.4
% of GDP	-3.7	-7.1	-1.5	-2.2	-6.3	-8.1	-9.3	-5.3	-3.6
Trade balance	-10.6	-16.1	-4.3	-8.4	-16.3	-19.5	-19.6	-14.7	-11.2
Exports	49.8	67.7	40.4	52.2	69.4	70.2	65.0	68.2	71.6
Imports	60.4	83.8	44.7	60.6	85.7	89.7	84.6	82.9	82.9
Service balance	2.4	1.7	2.4	4.4	6.1	5.2	4.1	6.0	5.5
Income balance	-0.7	-1.5	-2.4	-2.0	-3.8	-3.0	-3.0	-2.0	-3.0
FDI, net	9.2	9.9	4.7	5.8	7.0	6.6	3.4	0.0	6.8
International reserves	32.5	31.5	26.4	34.6	31.8	24.5	20.4	26.8	35.0
Total amortisations	8.5	13.9	17.9	23.5	23.6	20.1	20.5	18.0	22.1
Public Finances, % of GDP									
Consolidated government balance	-0.8	-1.2	-7.3	-8.8	-3.9	-5.6	-6.7	-4.3	-3.4
Consolidated gov primary balance	-0.3	-0.7	-6.2	-7.6	-2.9	-4.7	-5.8	-3.0	-2.2
Public debt	10.8	14.4	25.5	31.5	28.3	29.0	34.0	49.7	54.2
of which Domestic	2.5	4.7	10.0	13.1	12.4	13.5	17.8	19.3	19.0
Foreign Assets & Liabilities, USD bn									
External debt	80.0	101.7	103.4	117.3	126.2	135.1	142.5	147.8	154.9
Public	12.3	16.7	24.0	32.5	33.4	32.2	31.7	36.5	37.3
External debt / GDP	56.0	56.5	88.2	86.0	77.2	76.5	81.0	106.0	103.4
External debt / XGS	124.9	118.7	190.6	169.4	142.1	150.0	167.1	161.7	216.2
Short-term debt	20.7	20.3	19.0	23.5	30.7	33.2	37.6	38.0	35.3
Short-term debt/International reserves (%)	63.7	64.4	72.0	68.1	96.7	135.2	184.1	141.9	100.8

Quarterly Economic Indicators

	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	3.3	-1.1	-2.7	-4.1	-4.4	-0.1	1.5	2.8	3.6
CPI, % yoy eop	0.5	3.4	8.1	10.3	10.5	10.1	6.4	5.9	5.8
Policy interest rate, %, eop	6.50	6.50	9.50	9.50	9.50	9.00	9.00	9.00	9.00
Short-term market rate, % eop	16.25	23.00	18.00	15.00	15.00	11.25	11.25	11.25	11.25
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US$, eop	8.24	11.12	11.00	10.50	10.50	10.60	10.70	10.75	10.80

Source: National Sources, Citi Research forecasts

Other Africa

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Ghana

- We think the government has around a year to outline credible plans for fiscal consolidation before it hits a period of intensive cedi bond repayments in 2H 2015 and into 2016. But, fiscal consolidation will be tough, with the government needing to significantly boost revenue collection which is well below the levels of other middle income governments in Africa. Whether the government can sign a new agreement with the IMF to provide credibility to the programme is not yet clear, but would be helpful to restore donor and foreign investor confidence.

- With the cedi under huge pressure in early 2014, and inflation creeping up, the Bank of Ghana (BoG) tightened monetary policy at an emergency MPC meeting in February as well as re-enforcing foreign exchange regulations. But its scope for further tightening is growing more limited and the reality is that the ability of the BoG to limit cedi depreciation depends on fiscal developments. So the real question will be whether progress in fiscal consolidation means that we enter a new period of lower cedi depreciation at some point in 2015-16 even if the currency continues to fall steadily in 2H 2014.

- Without a more concerted effort at fiscal consolidation there is a chance that the government could face a wider loss of investor confidence in Ghanaian debt with few investors willing to roll their maturing cedi bonds, while struggling to issue a new Eurobond. This could potentially lead to a wider economic crisis in 2015-16 and a complete loss in confidence in the cedi.

Kenya

- A steady pick-up in growth towards 6% looks set to continue in 2014-15, but we believe the pick-up will be constrained by ongoing political uncertainty, sporadic terrorist incidences, periodic drought and infrastructure bottlenecks.

- Proposed revisions to the GDP and balance of payments statistics in 2014 should reduce the twin fiscal and current account deficits and provide a more logical explanation of only gradual Kenyan shilling depreciation in recent years and the ability of the CBK to build foreign exchange reserves. But the government will have to avoid the temptation of a lower fiscal deficit and lower debt stock as an excuse not to continue with its programme of gradual fiscal consolidation.

- Although the Central Bank of Kenya (CBK) will be sorely tempted to cut rates to support the recovery in 2014, with inflation remaining at the top end of its inflation target (5%, +/- 2.5pp) we think it will act cautiously. Moreover, a too rapid cut in rates could spill over into more substantial KES depreciation than the CBK may be comfortable with.

Tanzania

- Over the next two years, we expect Tanzanian politics will be dominated by the battle to succeed current president, Jakaya Kikwete, and adopting a new constitution. A revised draft was released in December, but, given various contentious issues, could distract the government's much needed focus on economic reform. The most immediate pressing priority is resolving 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.

- But, growth should continue to be robust at around 7% in 2014, although for it to really pick up into double digits we think the government will have to make real progress in implementing its Kilimo Kwanza (Agriculture First) policy. The current account deficit is set to remain substantial, despite ongoing increases in gold exports, but, with aid and FDI inflows (increasingly into the gas sector) remaining high, the deficit should prove relatively easy to finance compared to Kenya and Uganda.

- While the Bank of Tanzania's (BoT) tight monetary policy and capital controls have helped maintain shilling stability in 2013, we think the reality is that, after two years of relative stability, the substantial fiscal and current account deficits should drive more significant shilling depreciation in 2H 2014.

Uganda

- Despite the suspension of some donor support in early 2014, we still think that the government will be able to maintain a relatively restrained fiscal stance going forward. Coupled with the Bank of Uganda (BoU) maintaining a tight monetary policy this should help provide considerable Uganda shilling (UGX) stability in 2014 despite large current account deficit (at present the current account deficit can be relatively easily financed and if push comes to shove the government could also potentially issue a Eurobond given its relatively low debt levels).

- Growth slowed sharply in 2012 to its lowest level for over a decade, but does seem to have recovered in 2013 and we expect this recovery to continue in 2014-15, although perhaps more slowly than had seemed the case in late 2013 as the government is likely to struggle to ramp up spending as quickly as it would have liked and monetary policy will have to remain tight in our view.

- At some point in the next five years, Uganda will become an oil producer, although the impact on growth and government revenue will, initially, be minimal given that production will be limited. While the development of the fields will push up the current account deficit, it should be largely funded through FDI.

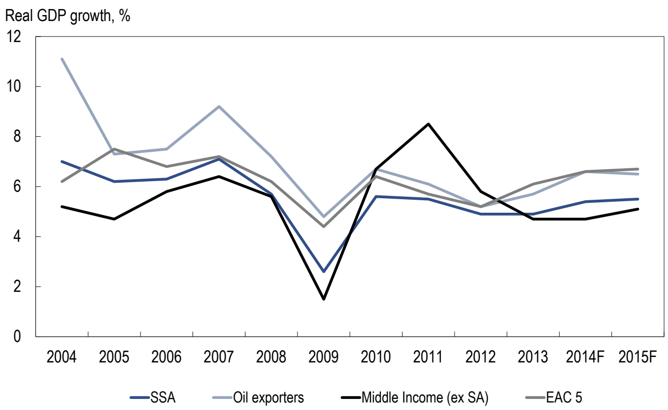
Zambia

- The widening of the fiscal deficit was a worrying development in 2013. Moreover, with government wage rises spilling over into strong demand for imports and concerns about the outlook for the copper price, the combination has resulted in significant kwacha depreciation in early 2014.

- While the current account is likely to move into a small deficit in 2014, we expect it to be largely funded by FDI inflows. In addition, we do expect an improvement in the deficit in 2014-15 as the government freezes government wages and domestic revenue collection improves. The rise in the cost of financing the deficit could also prove an important factor in clarifying government thinking on the need to bring the fiscal deficit back under control. Although inflationary pressures will remain in 1H 2014, we think inflation will largely track sideways over the year. We also expect a modest recovery in growth on the back of rising agricultural and copper production in 2014.

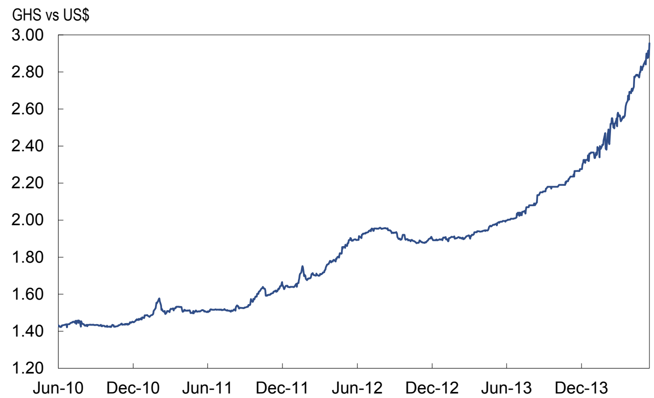
- These developments should provide considerable support for the kwacha, with only modest depreciation going forward once the current bout of weakness has run its course. And it should allow the Bank of Zambia (BoZ) to rebuild foreign exchange reserves which are low by regional standards.

Figure 222. Growth should be robust in 2014-15



Source: IMF

Figure 223. How quickly can the cedi reach the GHS3:US$1 level?



Source: Haver Analytics

Figure 224. A very gradual weakening of the Kenyan shilling in 2014

Source: Haver Analytics

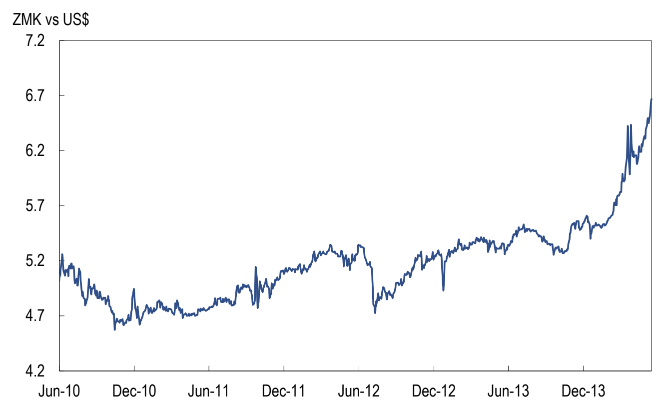
Figure 225. Is the Tanzanian shilling now too strong?

Source: Haver Analytics

Figure 226. A stable Ugandan shilling in 1H 2014

Source: Haver Analytics

Figure 227. The kwacha is volatile, with a sharp weakening in 2014



Source: Haver Analytics

Figure 228. Other Africa Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
GHANA									
Nominal GDP, USD bn	24.8	28.5	26.0	32.2	39.6	40.7	41.0	34.6	35.5
GDP per capita, USD	1,099	1,234	1,096	1,326	1,594	1,605	1,582	1,309	1,314
Real GDP, yoy avg	6.5	8.4	4.0	8.0	15.0	7.9	7.4	4.6	6.5
CPI, % avg	10.7	16.5	19.3	10.7	8.7	9.2	11.7	13.3	10.0
Policy Interest Rate, % eop	13.5	17.0	18.0	13.5	12.5	15.0	16.0	19.0	16.0
GHS/US$, avg	0.95	1.07	1.43	1.43	1.55	1.85	2.06	2.94	3.40
Current account, US$bn	-2.1	-3.5	-1.6	-2.6	-2.5	-4.9	-5.2	-5.0	-5.0
% of GDP	-8.6	-12.4	-6.2	-8.2	-6.3	-12.1	-12.7	-14.4	-14.1
Consolidated gov. balance, % of GDP	-5.6	-8.4	-7.0	-9.4	-5.5	-9.3	-10.8	-10.2	-9.0
KENYA									
Nominal GDP, USD bn	27.2	30.5	30.6	32.2	34.3	40.7	44.0	51.1	56.8
GDP per capita, USD	721	786	768	788	817	943	992	1,121	1,216
Real GDP, yoy avg	7.0	1.5	2.7	5.8	4.4	4.6	4.7	5.5	6.1
CPI, % avg	4.3	15.1	10.6	4.3	14.0	9.4	5.4	6.6	6.7
Policy Interest Rate, % eop	8.8	8.5	7.0	6.0	18.0	11.0	8.5	8.5	8.0
KES/US$, avg	67.3	68.8	77.3	79.2	88.4	84.5	86.1	87.6	92.4
Current account, US$bn	-1.1	-2.0	-1.8	-2.1	-3.3	-3.8	-4.0	-3.9	-4.3
% of GDP	-4.0	-6.6	-5.8	-6.5	-9.6	-9.3	-9.0	-7.6	-7.5
Consolidated gov. balance, % of GDP	-4.2	-3.5	-6.2	-4.7	-5.5	-9.0	-7.8	-6.5	-5.5
TANZANIA									
Nominal GDP, USD bn	16.8	20.7	21.4	22.9	23.9	29.1	31.9	34.9	37.5
GDP per capita, USD	409	489	490	509	515	609	648	689	717
Real GDP, yoy avg	7.1	7.4	6.0	7.0	6.4	6.9	6.8	7.0	8.1
CPI, % avg	7.0	10.3	12.1	7.2	12.7	16.0	7.9	7.4	6.6
TZS/US$, avg	1,237	1,198	1,324	1,439	1,582	1,586	1,617	1,646	1,730
Current account, US$bn	-2.3	-3.2	-2.5	-2.7	-4.6	-3.5	-3.3	-4.9	-4.6
% of GDP	-13.9	-15.2	-11.5	-11.9	-19.1	-11.9	-10.2	-14.1	-12.4
Consolidated gov. balance, % of GDP	-1.9	-2.6	-6.0	-6.5	-5.0	-5.4	-5.0	-5.2	-5.9
UGANDA									
Nominal GDP, USD bn	13.5	16.4	16.5	17.2	18.2	21.2	22.6	24.7	26.8
GDP per capita, USD	441	515	503	506	518	584	601	636	668
Real GDP, yoy avg	8.1	10.4	4.1	6.2	6.2	2.8	6.0	6.0	5.5
CPI, % avg	6.1	12.0	13.0	4.0	18.7	14.0	5.5	5.9	6.8
UGX/US$, avg	1,723	1,714	2,025	2,173	2,511	2,501	2,584	2,555	2,735
Current account, US$bn	-0.6	-1.3	-1.1	-1.7	-2.1	-1.9	-2.7	-3.4	-4.0
% of GDP	-4.8	-7.8	-6.7	-10.0	-11.7	-9.0	-12.0	-13.9	-14.9
Consolidated gov. balance, % of GDP	-1.1	-2.8	-2.4	-6.7	-3.2	-3.6	-3.4	-3.3	-4.5
ZAMBIA									
Nominal GDP, USD bn	11.5	14.6	12.8	16.2	19.2	20.6	22.3	22.1	24.4
GDP per capita, USD	953	1,175	998	1,225	1,408	1,465	1,530	1,473	1,575
Real GDP, yoy avg	6.2	5.7	6.4	7.6	6.8	7.3	6.2	6.4	6.3
CPI, % avg	10.6	12.4	13.4	8.5	6.4	6.6	7.0	7.8	8.0
ZMK/US$, avg	3,992	3,702	5,020	4,791	4,861	5,139	5,195	6	6
Current account, US$bn	-0.8	-1.1	0.5	1.1	0.7	0.0	0.0	-0.2	-0.4
% of GDP	-6.5	-7.2	4.2	7.1	3.7	0.1	0.2	-1.0	-1.5
Consolidated gov. balance, % of GDP	-1.3	-0.8	-2.5	-3.0	-2.2	-3.1	-6.5	-6.1	-5.5

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GHS/US$, eop	2.37	2.69	3.00	3.20	3.20	3.30	3.40	3.50	3.45
KES/US$, eop	86.45	86.40	87.50	88.00	89.50	90.00	92.00	92.00	93.50
TZS/US$, eop	1,587	1,638	1,640	1,660	1,680	1,700	1,725	1,750	1,785
UGX/US$, eop	2,523	2,547	2,550	2,580	2,600	2,700	2,700	2,800	2,825
ZMK/US$, eop	5,195.00	5,195.00	6.30	6.30	6.30	6.40	6.40	6.45	6.45

Source: National Sources, Citi Research forecasts

Other Europe

Bulgaria

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According to the flash estimate, GDP grew by 1.1%YoY in the first quarter of the year. Private consumption and investment expenditures, which rose by 2%YoY and 3.2%, respectively, were the main driver of the 1Q outturn. The recent data also suggest that the economic activity is decelerating, as is evidenced by a 0.2%QoQ drop in GDP growth from a rise of 0.4% in 4Q 2013 and 0.6% in 3Q 2013. On the supply side, growth is mainly driven by industrial production (3.2%YoY) followed services (1.2%), while agriculture output contracted by 0.4%. All in all, the 1Q GDP outturn, coupled with the continued recovery in consumer confidence index, corroborates our view that domestic demand is likely to recover in 2014. Concurrently, we expect investment activity to remain strong this year thanks to a higher absorption rate of EU funds. Against this backdrop, we expect the GDP growth to accelerate to 1.5% in 2014 from 0.9% in 2013.

Turning to price developments, at -1.6%YoY, deflationary pressures continued in April although it eased when compared with March (-2.3%). In parallel, at 0.3%MoM, April's monthly inflation came in somewhat below its seasonal average. Nonetheless, food and clothing price inflation, which came above their respective seasonal averages in April signal that a reversal in deflationary pressures is underway. Looking ahead, while the deflationary environment is likely to prevail in the short-term, we expect inflation to be in the 1.5% - 2.0% range by end of the year on the back of stronger economic activity and base effects, with the impact of the latter becoming more evident after August 2014. Regarding external developments, the current account balance recorded a surplus of €323mn in March, compared with a surplus of about €93mn in the same month of 2013. With the March data, the current account deficit in the first three months of the year stood at €83mn and represents a considerable improvement when compared with the same period of 2013 (€412mn). Going forward, our expectation of stronger domestic demand this year lead us to look for a current account gap of about 0.2% of GDP in 2014, compared with a surplus of 2% of GDP in 2013.

Croatia

On April 24, the government adopted a reform program for the 2014-17 period. The reform program focuses on four major areas: public finance, the financial sector, the labor market and competitiveness. The program aims at reducing the general budget deficit to from 5.2% of GDP in 2014 to below 3% of GDP in 2016. The envisaged fiscal contraction in the program led the government to revise its official growth forecast to 0% from 0.2%. Turning to recent economic data, the recent retail and industrial production data point to a pickup in economic activity in 1Q compared with 4Q 2013. Specifically, the retail trade rose in the first quarter by 0.5%QoQ (SA) following a drop of 1.8% in 4Q 2013. Similarly, industrial production rose 3.2%QoQ (SA) in the first quarter of the year, compared with a 0.9% rise in 4Q 2013. Nevertheless, the unemployment rate remains elevated at 17.3% (SA), unchanged from end-2013 and domestic credit growth is yet to display a meaningful recovery. In light of the recent developments, we now look for a moderate contraction of 0.6% this year compared with our earlier estimate of 0.5%.

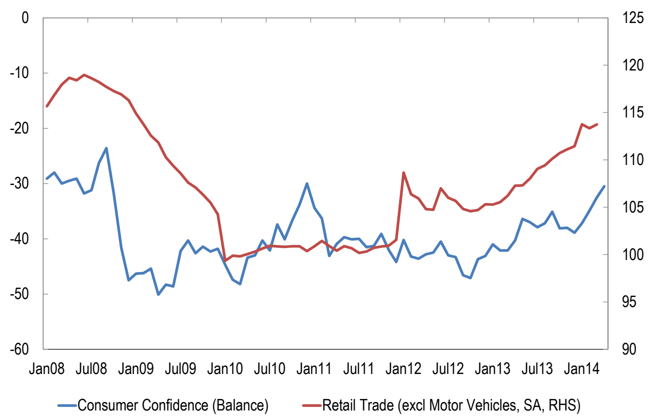
Regarding price developments, consumer prices rose 0.27%MoM in April, bringing the annual inflation to -0.46%YoY from -0.37%YoY in March. The monthly inflation print in April was markedly lower than its seasonal average (0.58%MoM)—an outcome mainly driven by below-average readings in food and transport inflation, which outweighed the increase in utility prices. Looking ahead, while weak domestic demand is likely to keep inflationary pressures in check, we think that inflation is likely to rise gradually to about 1.5% by end-2014 owing to base effects and the unwinding of cyclical factors. In parallel, our expectations of the continued weakness in domestic demand and a relatively strong export outlook lead us to look for a current account surplus of 0.5% of GDP, compared with a surplus 1.3% of GDP in 2013.

Serbia

At 0.4%YoY, the preliminary 1Q GDP print came in weaker than our expectations (about 1%). The recent data also point to a decline in the momentum of economic activity, as, standing at -0.3%QoQ, GDP growth registered its second consecutive drop following a 0.4%QoQ fall in 4Q. While we were looking for softer economic activity in 1Q owing to a much smaller contribution from net exports, the extent of the weakness suggests to us that private consumption hasn't pickup as much as we had penciled in. This conjecture is also supported by the limited acceleration in real retail trade in 1Q (1.2%YoY) from 1.1% in the last quarter of 2013. Moreover, the anemic lending activity, the elevated unemployment rate and the upcoming fiscal consolidation cloud the outlook for domestic demand. All in all, while we maintain our view that domestic demand will gain some traction in 2014, recent developments suggest to us that the improvement could be more gradual than we envisioned, tilting the risks associated with our 2014 GDP growth forecast of 1.2% toward a lower reading.

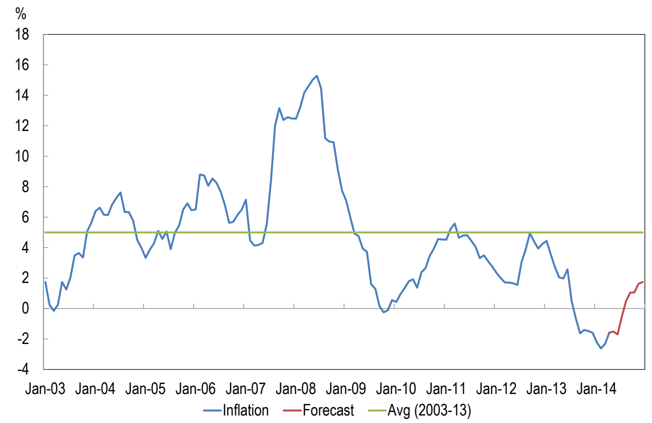
Turning to price developments, inflation fell to 2.1%YoY in April from 2.3% in March. Price developments in the first four months of the year have been markedly more favorable than our expectations thanks to softer-than-expected food inflation and aggregate demand. Looking ahead, we maintain our view that inflation is likely to increase considerably in the second half of the year owing to a partial reversal in food prices and unfavorable base effects, as we expect inflation to rise above 5% by end of this year. The deceleration in inflation pressures, coupled with reduced tensions from geopolitical developments and Fed's QE tapering, led the NBS to cut its policy rate by 50bp in May to 9%. The Bank also signaled that further easing is likely on the grounds that the new government's measures support the disinflation process. We acknowledge that the emerging backdrop—softer domestic demand, lower inflation outturn, the likely IMF arrangement in the coming months and lower risk premium—strengthen the NBS's hand to carry out further easing in the short-term. Against this backdrop and the improved policy environment following the elections, we now expect to see an additional 100 bp cut in the policy rate by end of the year. Regarding external developments, we expect the current account deficit to remain unchanged at 4.8% of GDP and EURRSD to remain at about 115 by the end of the year.

Figure 229. Bulgaria: Recent high frequency data suggest that domestic demand is likely to recover in 2014…



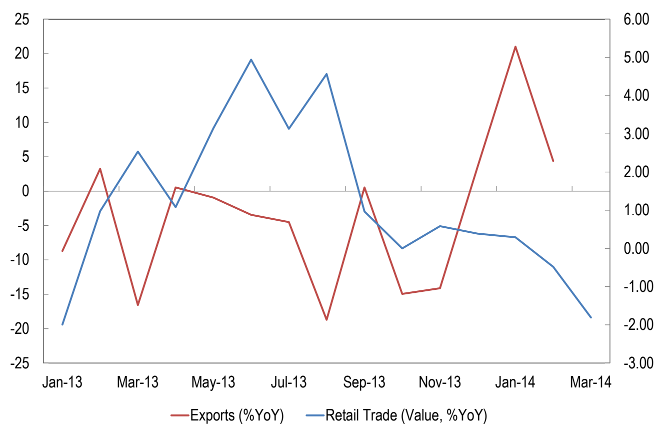
Source: Haver Analytics and Citi Research

Figure 230. …as we expect deflationary pressures to fade away in the coming months due to a reversal in food inflation and base effects



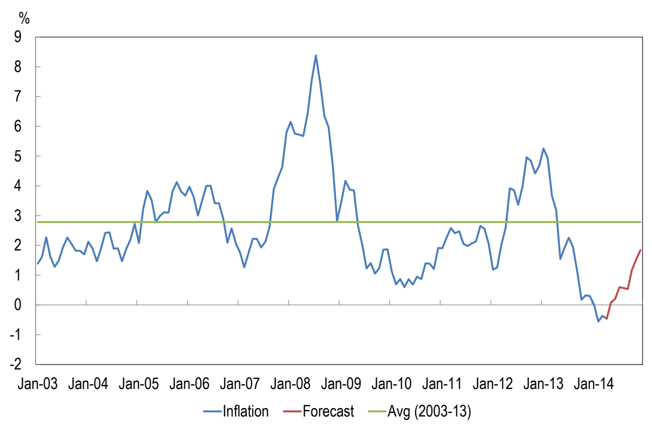
Source: Haver Analytics and Citi Research

Figure 231. Croatia: While domestic demand remains weak, there are nascent signs of a recovery in exports…



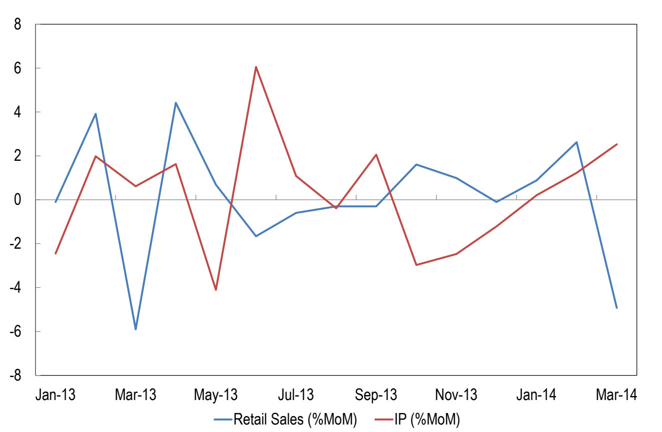
Source: Haver Analytics and Citi Research

Figure 232. … as unfavorable base effects are likely to drive inflation closer to its norm



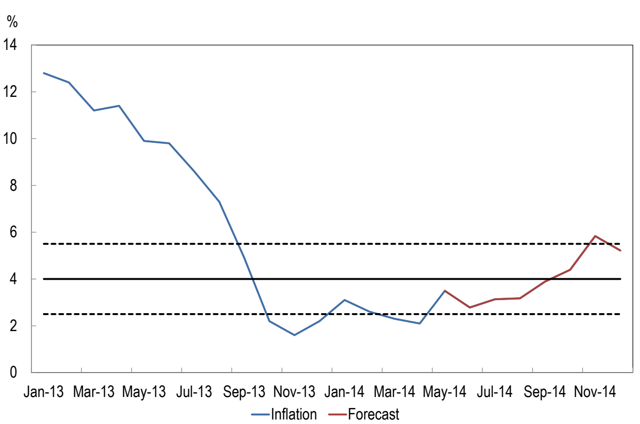
Source: Haver Analytics and Citi Research

Figure 233. Serbia: Recent high frequency growth indicators paint a mixed picture …



Source: Haver Analytics and Citi Research

Figure 234.…as inflation is set to rise on the back of a reversal in cyclical factors and unfavorable base effects



Source: Haver Analytics and Citi Research

Figure 235. Other Europe Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
BULGARIA									
Nominal GDP, USD bn	42.1	51.8	48.6	47.7	53.5	51.0	53.9	56.5	59.0
GDP per capita, USD	5,512	6,812	6,421	6,360	7,307	6,997	7,446	7,840	8,234
Real GDP, yoy avg	6.4	6.2	-5.5	0.4	1.8	0.8	0.9	1.5	2.5
CPI, % avg	8.4	12.3	2.8	2.4	4.2	3.0	0.9	-0.5	2.5
BGN/US$, avg	1.43	1.33	1.40	1.47	1.40	1.52	1.47	1.42	1.43
BGN/EUR, avg	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
Current account, US$bn	-10.8	-11.9	-4.3	-0.8	0.1	-0.7	1.0	-0.1	-0.3
% of GDP	-25.6	-23.0	-8.8	-1.6	0.3	-1.4	1.9	-0.2	-0.5
Consolidated gov. balance, % of GDP	1.2	1.7	-4.3	-3.1	-2.0	-0.8	-1.5	-2.0	-1.2
CROATIA									
Nominal GDP, USD bn	59.3	69.6	62.2	58.9	61.8	56.4	57.6	59.0	60.3
GDP per capita, USD	13,376	15,690	14,044	13,331	14,432	13,106	13,418	13,819	14,174
Real GDP, yoy avg	5.1	2.1	-6.9	-2.3	0.0	-2.0	-1.0	-0.6	1.2
CPI, % avg	2.9	6.1	2.4	1.0	2.3	3.4	2.2	0.4	2.8
Policy Interest Rate, % eop	9.00	9.00	9.00	9.00	7.00	7.00	7.00	7.00	7.00
HRK/US$, avg	5.35	4.91	5.26	5.49	5.34	5.84	5.70	5.55	5.66
HRK/EUR, avg	7.34	7.23	7.34	7.29	7.43	7.51	7.58	7.65	7.75
Current account, US$bn	-4.3	-6.1	-3.0	-0.8	-0.4	-0.1	0.7	0.3	-0.3
% of GDP	-7.3	-8.7	-4.9	-1.4	-0.7	-0.2	1.3	0.5	-0.5
Consolidated gov. balance, % of GDP	-	-	-5.3	-6.4	-7.8	-5.0	-4.9	-5.0	-3.5
SERBIA									
Nominal GDP, USD bn	39.0	47.8	40.2	37.1	43.7	38.5	43.5	47.1	48.4
GDP per capita, USD	5,277	6,497	5,496	5,085	6,026	5,348	6,039	6,536	6,729
Real GDP, yoy avg	5.4	3.8	-3.5	1.0	1.6	-1.5	2.5	1.2	2.0
CPI, % avg	5.6	11.9	8.7	6.1	11.0	7.8	7.9	3.5	5.8
Policy Interest Rate, % eop	10.00	17.75	9.50	11.50	9.75	11.25	9.50	8.00	8.00
RSD/US$, avg	58.3	55.2	67.4	77.5	73.2	87.8	85.1	82.4	86.3
RSD/EUR, avg	80.0	81.4	94.0	102.9	102.0	112.9	113.1	113.6	118.4
Current account, US$bn	-6.9	-10.4	-2.9	-2.8	-4.0	-4.1	-2.1	-2.3	-2.4
% of GDP	-17.7	-21.9	-7.1	-7.5	-9.1	-10.6	-4.8	-4.8	-5.0
Consolidated gov. balance, % of GDP	0.6	-1.8	-3.5	-3.5	-4.1	-5.7	-5.7	-7.0	-6.5

Source: National Sources, Citi Research forecasts

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- **Summary view** — The FX market continues going through a period of calm. However, the authorities are not attacking the main unbalances and, thus, pressures may resurge in the second half of the year. Meanwhile, activity seems to be heading to a prolonged period of weakness. We now expect (non-official) activity to shrink 1.5% this year, and to remain flat in 2015.

- **Things to watch** — Watch for fiscal announcements. Also, keep an eye on monetary policy, as the authorities are facing a challenging trade-off on this front.

- **Strategy** — Despite the government's attempt at improving the country's standing with some of its creditors, economic mismanagement continues and, therefore, we remain bearish on the country's credit.

Economic activity: similarities and differences

It is not the first time, but this time is somewhat different. This is not the first time President Fernández de Kirchner (CFK) faces a challenging outlook in terms of activity. CFK faced a severe recession in 2008/2009 and a mild drop in output in 2012. The 2008/2009 recession was mainly the result of external and "exogenous" forces – agricultural output roughly halved in 2009 and the H1N1 virus took a large toll. The slight drop in output in 2012 was the result of a combination of "exogenous" - particularly a drought and the resulting lower crop - and "endogenous" factors. The expansionary monetary policy undertaken by the Central Bank of Argentina (BCRA) in 2011, aimed to boost private consumption and growth ahead of the presidential election, fueled large capital outflows that forced the government to introduce distortionary FX controls. The controls affected construction, a fully dollarized sector, and the industry, which faced some input shortages. During these two episodes, activity suffered abrupt but brief contractions, and the recoveries were fast. This time, external or "exogenous" factors play a very limited role (if at all) with only low growth in Brazil playing a minor dampening effect, and a record crop with high commodity prices producing a large boost. The situation, rather, emerges as a consequence of the "endogenous" scarcity of foreign currency and the policies implemented to address it. With low international reserves, the government is in no position to sacrifice foreign currency holdings to give some air to activity, as it did following the 1H12 contraction. Thus, we anticipate a more protracted recession, with low growth characterizing the period through the end of 2015, when a new policy framework is expected to be deployed. We expect non-official activity to shrink 1.5% this year and to remain flat next year. Despite the recently released new national accounts series, official growth estimates will likely remain "optimistic", showing real GDP growth at 0% and 1% in 2014 and 2015, respectively. Nonetheless, even official figures show activity is shrinking: the official EMAE shrank 0.9% MoM SA in March (0.9% YoY), posting its third consecutive drop.

The longer recession is likely to impact the labor market, and could lead to higher social unrest. Unemployment responds with a lag and smoothes fluctuations in output. That is why the unemployment rate remained roughly unchanged during 2012. However, this time, the expectations of a protracted period of low activity could lead to a contraction in labor demand. There already are some early indications of lower formal employment. According to official figures, social security contributions rose 19.4% YoY in April, after increasing 24.3% YoY in March. These prints are not only below (non-official) inflation (i.e., negative in real terms); they are also lower than the annual growth in wages, which the National Statistics Institute (INDEC) reports grew 29.5% YoY in March – with private formal wages increasing 27% YoY.

Pressures to "seasonally" increase in the second half

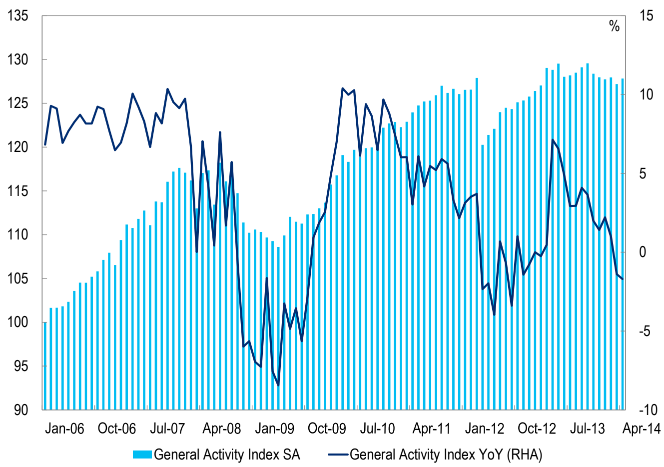
The second semester tends to be more challenging due to the seasonality of agricultural exports. According to Grain Exporters Chamber (CEC), during the last three years 35% of the exports took place during the second quarter (USD8.3bn on average). The percentage drops to 28% in the third quarter (USD6.7bn on average) and 19% in the fourth quarter (USD4.4bn on average) – roughly similar to the first quarter. In line with these figures, the central bank's (BCRA) data shows the bulk of official currency purchases as taking place in the first semester, particularly in the second quarter. For instance, the average FX purchases in Q2 during the period 2011-13 was 2.6bn, and USD4.7bn in the first semester, while it sold USD2.3bn of foreign currency during the second semester (i.e., an USD7bn difference). Such FX intervention typically results in monetary expansion that oils economic activity.

Furthermore, fiscal accounts face greater challenges during the second semester. In 2011-2013, only 8% of the peso transfers from the BCRA to the Treasury took place during the first semester, with the remaining 92% happening in the second half of the year. During the first four months of 2014, the BCRA transferred ARS8.7bn to the Treasury. This is a very big figure, judging by historical standards. Typically, peso transfers from the BCRA to the Treasury during January-April only account for 2% of the total transfers in the year. However, we acknowledge that extrapolating this result would be misleading, particularly because the Treasury faced in January the maturity of the Bocan 14, which was not fully rolled-over and added around ARS4bn to the fiscal needs. Still, after taking this fact into account, money printing due to fiscal needs in January-April 2014 remains large (ARS4.7bn). If we extrapolate this figure, peso transfers from the BCRA to the Treasury could stand at ARS224.7bn in 2014, increasing 139% when compared to the previous year (after rising 98% in 2013). We believe, however, that BCRA transfers to the Treasury will be around ARS150bn, though the released fiscal figures are not very encouraging. The government's primary expenditure rose 43.2% YoY in January-February, and revenues increased 36.9% YoY. Therefore, the gap between public spending and revenue growth has widened significantly – it stood at 3% in 2013 and at 2.5% in 2012. The fact that March's fiscal accounts have not been made public does not bode well, in our view.

The monetary dilemma

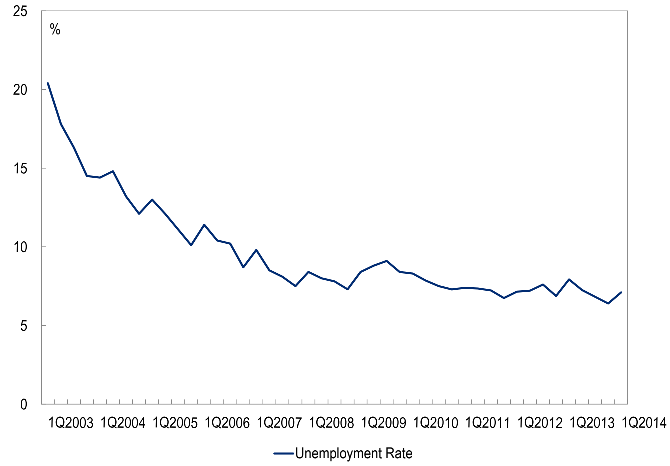
The central bank is in a difficult position. In the absence of a fiscal correction, and given the pace of transfers from the BCRA to the Treasury, maintaining monetary aggregates growth at bay while buying foreign currency will require unusually strong "sterilization" (and a high interest rate). The "sterilization" conducted since January has caused credit to the private sector to plummet in real terms – it has remained roughly flat YTD, compared to a 15/16% increase in prices. Against a challenging activity front, the central bank introduced a reduction in interest rates of 200bps in recent weeks. However, the timing for this move could be problematic. The BCRA will, most likely, need to start allowing the ARS to depreciate as we go into H2. Lower interest rates and higher expected depreciation (i.e., lower carry) could threaten FX stability. Particularly as the recent stabilization benefitted from some short-term inflows (i.e., exports pre-financing, import financing) which could now turn.

Figure 236. Non-official estimates show activity shrinking since 2H13



Source: OJF and Citi Research

Figure 237. The (official) unemployment rate remained low in 1Q14…

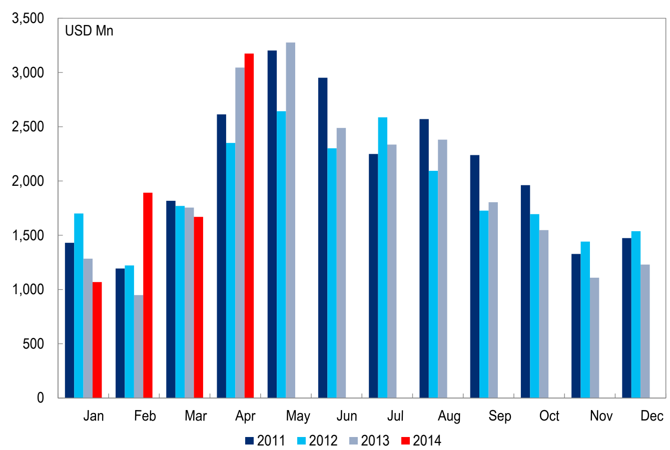


Source: INDEC and Citi Research

Figure 238. …but on the back of lower participation

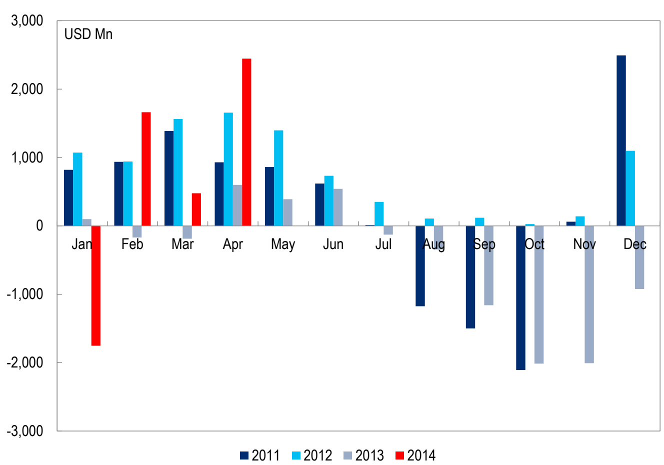
Source: INDEC and Citi Research

Figure 239. Agricultural exports peak in April-May and then start dropping…



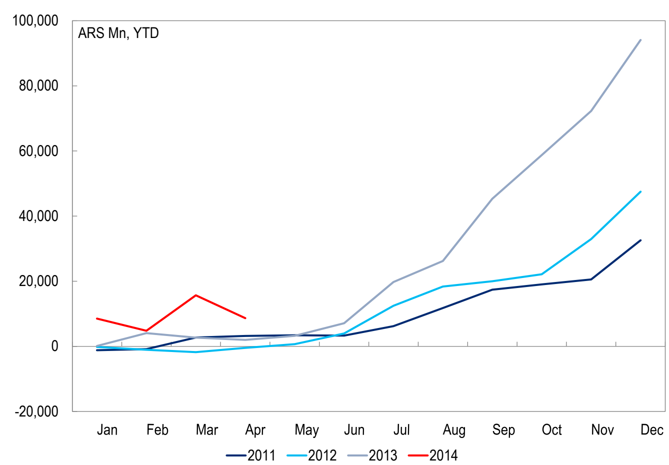
Source: CEC and Citi Research

Figure 240. … leading to lower official foreign currency purchases



Source: BCRA and Citi Research

Figure 241. BCRA's financing to the Treasury increases in the 2H



Source: BCRA and Citi Research

Figure 242. Argentina Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	332	409	380	464	560	604	605	477	450
Nominal GDP, local currency bn	1,027	1,284	1,412	1,810	2,303	2,745	3,347	4,178	5,315
GDP per capita, USD	8,428	10,281	9,470	11,456	13,684	14,628	14,519	11,324	10,584
Population, mn	39.4	39.7	40.1	40.5	40.9	41.3	41.7	42.1	42.5
Unemployment, % of labour force	8.5	7.9	8.7	7.8	7.2	7.2	7.1	7.7	8.1
Economic Activity									
Real GDP, yoy avg	8.4	2.6	-3.9	7.7	5.1	-0.3	2.8	-1.5	0.0
Real investment growth % yoy	16.3	6.2	-24.0	38.4	15.6	-11.5	1.6	-4.5	-0.3
Real consumption growth % yoy	8.9	5.5	4.1	7.2	10.5	4.5	4.7	0.8	1.5
private consumption growth % yoy	9.0	5.6	3.5	7.1	10.8	4.2	4.3	0.6	1.4
Real export growth, % yoy	8.0	0.8	-8.7	14.4	4.9	-5.9	-5.3	-1.5	-1.5
Real import growth, % yoy	21.9	13.5	-19.3	35.0	19.8	-4.7	1.6	-2.0	0.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	20.1	20.7	14.8	26.8	24.2	25.2	28.8	38.0	35.0
CPI, % avg	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	20.3	22.4	20.0	21.7	27.5	27.1	24.7	29.8	32.0
Credit extension to private sector, % yoy	25.4	10.5	11.5	31.6	34.6	39.0	22.0	35.0	30.0
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	13.63	19.75	10.00	11.25	17.19	15.44	21.63	30.00	37.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	3.15	3.45	3.80	3.97	4.30	4.92	6.52	10.00	13.50
ARS/USD, avg	3.12	3.16	3.73	3.91	4.13	4.54	5.45	8.75	11.81
Balance of Payments, USD bn									
Current account	7.4	6.8	11.0	-0.8	-2.3	0.1	-4.3	-5.0	-5.3
% of GDP	2.2	1.7	2.9	-0.2	-0.4	0.0	-0.7	-1.1	-1.2
Trade balance	13.5	15.4	18.5	14.3	12.9	15.4	12.2	12.1	12.6
Exports	56.0	70.0	55.7	68.1	84.1	80.9	83.0	81.5	82.3
Imports	42.5	54.6	37.1	53.9	71.1	65.6	70.9	69.4	69.7
Service balance	-0.5	-1.3	-1.3	-1.2	-2.2	-3.4	-5.1	-4.1	-4.1
Income balance	-5.9	-7.6	-9.0	-13.5	-12.4	-11.5	-10.7	-12.3	-13.1
FDI, net	6.5	9.7	4.0	11.3	10.7	12.1	9.1	10.0	10.0
International reserves	46.2	46.4	48.0	52.2	46.4	43.3	30.6	26.0	17.5
Total amortisations	5.2	4.7	11.2	10.7	12.0	9.7	9.3	9.3	9.3
Public Finances, % of GDP									
Consolidated government balance	0.9	1.1	-0.5	0.2	-1.3	-2.0	-1.9	-2.4	-2.4
Consolidated gov primary balance	2.5	2.5	1.2	1.4	0.2	-0.2	-0.7	-1.1	-1.1
Public debt	43.6	35.7	38.7	35.4	32.0	31.7	31.3	38.1	46.0
of which Domestic	22.3	20.0	22.4	20.4	18.9	19.7	19.8	25.0	29.7
Foreign Assets & Liabilities, USD bn									
External debt	124.5	124.9	115.6	129.3	141.1	142.2	137.6	116.1	124.1
Public	70.8	64.4	61.8	69.5	73.2	72.0	70.1	62.2	73.1
External debt / GDP	37.5	30.6	30.4	27.9	25.2	23.5	22.7	24.4	27.6
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.8	-0.5	-1.7	-2.2	-1.4	-0.9	-0.2	0.3	0.6
CPI, % yoy	28.8	37.2	39.0	39.9	38.0	32.8	34.5	34.7	35.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	21.63	26.40	25.00	27.00	30.00	33.00	34.00	35.00	37.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	6.52	8.00	8.30	9.20	10.00	10.78	11.62	12.52	13.50

Source: National Sources, Citi Research

Brazil

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- **Summary view** — The FIFA World Cup in Brazil will start in less than a month, June 12th. However, and contrary to the preliminary expectations, the sentiment is that the World Cup may be a liability to the federal government. We still have Rousseff's reelection as our base case scenario, winning in the second round in October 2014. However, if her rate approval keeps hovering around 35% or lower, the probability of the opposition candidates winning the election will increase. The World Cup should have a temporary effect on inflation, with prices returning to previous levels after the end of the event. Thus, we keep our 2014 year-end CPI inflation forecast at 6.6%. Moreover, we maintain our bearish view on economic activity, expecting GDP to expand 1.3% this year and 1.8% in 2015. The net effect of the World Cup is expected to be modest, so we keep 0.3% QoQ growth forecast for 2Q14 - the same expected growth rate as for 1Q14. Regarding monetary policy, we expect no more hikes to the Selic rate in 2014, while we still assume a further 150bps of increases for next year reaching 12.5% at year-end 2015. Fiscal results continue to disappoint and we do not see a meaningful fiscal adjustment in 2015, forecasting the primary surplus at 2.0% of GDP that year. Better global conditions support capital flows and a USDBRL around 2.25 in the near term. We see the USDBRL at 2.45 and 2.60 at the end of 2014 and 2015, respectively (from USDBRL 2.47 and 2.61).

- **Things to watch** — Besides inflation and activity, Rousseff's approval rate should be closely monitored as it is at a critical level. Monthly fiscal results will continue in the spotlight as the fiscal accounts are still under a lot of scrutiny due to the weak results so far this year.

- **Strategy** — Our model suggests that 2.2 is a reasonable level for the USDBRL, given the new levels of commodity prices and risk aversion. Under this inference and taking into account our bearish view concerning domestic fundamentals, we see value at staying long USDBRL at the levels close to 2.20. On rates, our scenario of persistent inflation pressures and the CB on hold until yearend suggests the yield curve should steepen. An alternative scenario of power rationing this year would be favorable to our FX strategy, while making our call on rates and the implied trade less attractive, given that the CB would be forced to raise the Selic rate further in the near term.

The Impact of World Cup on Economy Might Be Tepid

Despite having greater visibility and vast external publicity, the 2014 FIFA World Cup might not be the most important episode in Brazil in 2014. In our view, the presidential election may have more long lasting effects than this sporting event. We think that the World Cup will likely have more downside than upside effects for the incumbent federal government. Given that President Rousseff's approval rate has been falling since February, hovering around 35%, any drawback during the World Cup might jeopardize her reelection. We still believe that President Rousseff is the favorite, but the chances of the two opposition candidates (Aecio Campos from PSDB, and Eduardo Campos from PSB) are on the rise. Moreover, the current energy situation (which continues to be denied by the authorities), the possibility of new demonstrations during the World Cup in June/July and an increasing inflation pose serious risks for Rousseff's reelection, in our view.

World Cup should have a temporary effect on inflation. We expect that the items that will most likely be affected by the World Cup are airfare, hotel and restaurants. Taking these pressures into account, we have increased our June CPI inflation forecast to 0.51% MoM (from 0.29% previously). However, this impact will be mostly temporary with prices returning to previous levels after the end of the World Cup. Thus, we are keeping our year-end 2014 CPI inflation forecast at 6.6%. If this forecast materializes, 2014 would be the first year since 2003 in which the CB fails to keep inflation within the 2.5%–6.5% target band. For 2015, we still see inflation at 6.3%, but risks are on the upside, given the urgency on realigning monitored prices.

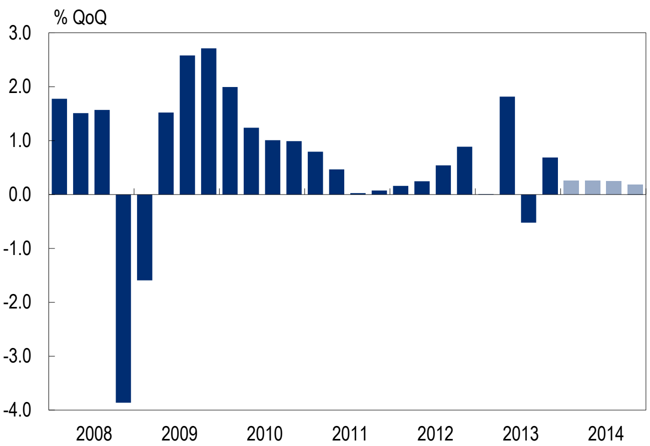
We maintain our bearish view for economic activity, expecting GDP to expand 1.3% this year. Our skepticism lies on the lack of potential drivers to boost economic growth, assuming that the impact of 2014 FIFA World Cup on economic activity will be very mild. Most of the infrastructure projects that were announced have not materialized yet. Moreover, the higher real interest rate will likely reduce the contribution of domestic demand to growth this year (especially private consumption and investment). It is worth noting that the release of a new industrial production series may exacerbate this difference, implying a potential upward revision in 2013 GDP growth figure (from the current 2.3% print). Overall, we are keeping our 2014 and 2015 GDP growth estimates at 1.3% and 1.8% respectively. Regarding the labor market, the low level of unemployment rate continues to be supported by depressed labor force participation (not by employment growth), suggesting it is unlikely to last long.

We expect no more hikes to the Selic rate in 2014, but we still see 150bps of rises next year. For 2014, we are keeping our call for no more hikes, because we believe part of the current food price (perishable items) shock is already fading away. With monthly inflation likely declining and weak activity data, Copom will likely stay on hold. For 2015, we believe the Copom will resume monetary tightening, in order to fight the persistent inflation problem. Because of that, we still see further 150bps hikes in Selic rate in the first meetings of 2015, putting the reference interest rate at 12.50% by the end of the monetary tightening process. Even so, we do not see inflation converging to the mid-point target in 2015.

Fiscal results continue to disappoint. During 1Q14 the primary surplus was 17%, smaller than one year ago, despite the larger dividends received from state-owned companies. Government is once again counting on one-off revenues (such as a debt refinancing program – REFIS – and the auction of 4G cellphone licenses) to fulfill the fiscal target. All in all, we continue to expect a 1.5% of GDP primary surplus in 2014. Looking ahead, we do not see a meaningful fiscal adjustment in 2015, and continue to expect a primary surplus of 2.0% of GDP that year. As a result, gross public sector debt would reach 57.7% of GDP in 2015 increasing slightly thereafter and likely reaching 58.4% in 2018.

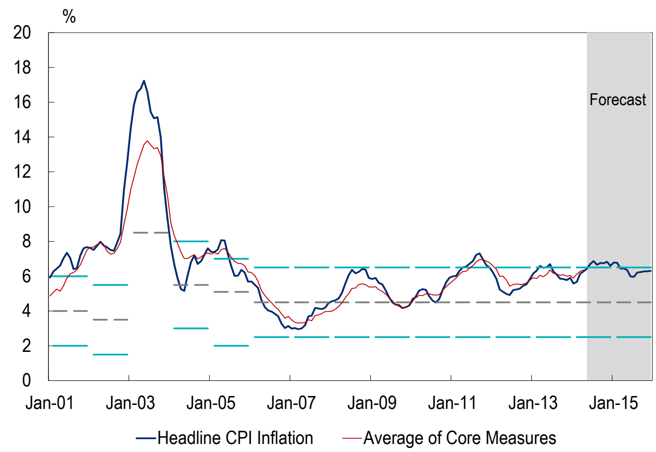
Global conditions continue to support a stronger BRL in the near term relative to our medium/long term view. We have already mentioned higher commodity prices and lower risk aversion since last February explain the bulk of the recent domestic currency appreciation to levels around USDBRL2.20. As nothing has changed materially on the external outlook, we continue to see the exchange rate depreciating ahead, reflecting the steady deterioration of domestic fundamentals, particularly the fiscal accounts. Overall, we see USDBRL at 2.45 and 2.60 at the end 2014 and 2015, respectively. Given these forecasts, our models suggest that the current account will show a deficit slightly higher than USD80 billion this year. Finally, as emphasized previously, the risk of power rationing continues to rise, putting an additional bias toward a more depreciated BRL in the medium/long term.

Figure 243. We expect 2014 GDP growth to reach 1.3%



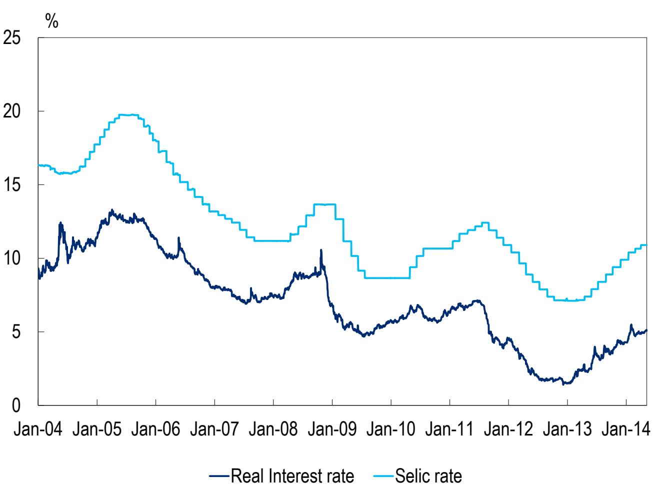
Sources: Citi Research and IBGE

Figure 244. Inflation will likely breach the 6.5% upper bound of target



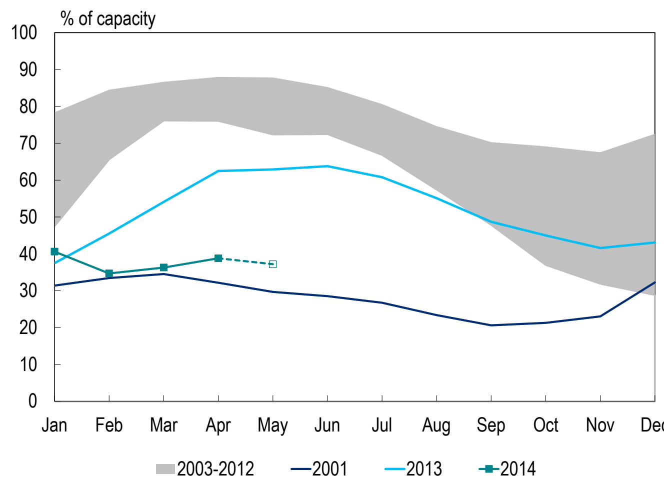
Sources: Citi Research, BCB and IBGE

Figure 245. We expect Selic rate to remain at 11% until 2014 year end



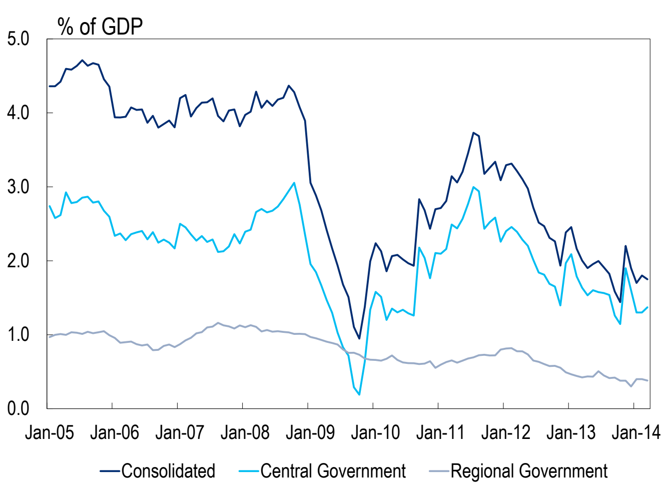
Sources: Citi Research and Bloomberg

Figure 246. Low reservoir levels point to risks of a power rationing



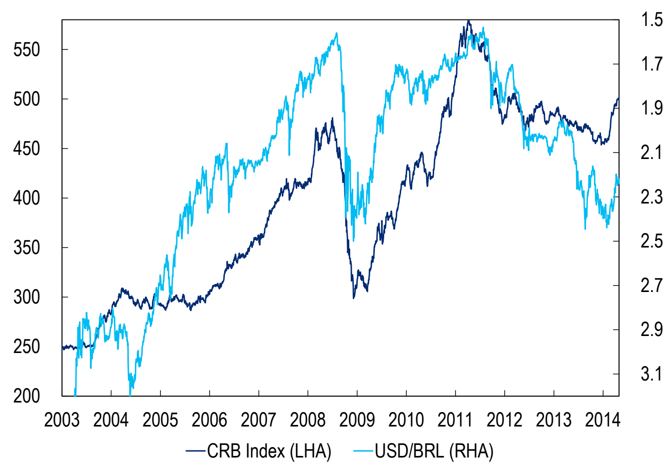
Sources: Citi Research and ONS

Figure 247. The primary fiscal surplus continues below 2% of GDP



Sources: Citi Research and BCB

Figure 248. Commodity prices and USD/BRL: a negative correlation



Sources: Citi Research and Bloomberg

Figure 249. Brazil Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,317	1,746	1,622	2,142	2,475	2,247	2,212	2,169	2,218
Nominal GDP, local currency bn	2,661	3,032	3,239	3,770	4,143	4,392	4,808	5,180	5,600
GDP per capita, USD	6,950	9,114	8,379	10,955	12,536	11,278	11,002	10,697	10,840
Population, mn	189.5	191.5	193.5	195.5	197.4	199.2	201.0	202.8	204.6
Unemployment, % of labour force	9.3	7.9	8.1	6.7	6.0	5.5	5.5	5.8	5.9
Economic Activity									
Real GDP, yoy avg	6.1	5.2	-0.3	7.5	2.7	1.0	2.3	1.3	1.8
Real investment growth % yoy	16.9	16.4	-16.0	33.4	4.0	-7.9	8.0	-0.8	0.9
Real consumption growth % yoy	5.8	5.1	4.1	6.3	3.6	3.2	2.2	1.7	1.8
private consumption growth % yoy	6.1	5.7	4.4	6.9	4.1	3.2	2.3	1.7	1.9
Real export growth, % yoy	6.2	0.5	-9.1	11.5	4.5	0.5	2.5	2.5	6.8
Real import growth, % yoy	19.9	15.4	-7.6	35.8	9.7	0.2	8.4	2.3	4.4
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	4.5	5.9	4.3	5.9	6.5	5.8	5.9	6.6	6.3
CPI, % avg	3.6	5.7	4.9	5.0	6.6	5.4	6.2	6.4	6.3
Nominal wages, % yoy	7.0	10.4	4.8	12.7	8.9	10.7	10.8	11.5	10.9
Credit extension to private sector, % yoy	-	30.9	15.1	20.6	19.0	16.4	14.7	14.2	14.5
Policy Rate (eop)	11.25	13.75	8.75	10.75	11.00	7.25	10.00	11.00	12.50
1 month inter-bank rate, %, eop	11.11	13.49	8.61	10.64	10.87	6.59	9.78	11.00	12.50
Long-term yield, %, eop	12.95	12.27	12.25	12.24	10.66	7.96	12.00	13.41	13.91
BRL/USD, eop	1.78	2.31	1.74	1.66	1.86	2.05	2.36	2.45	2.60
BRL/USD, avg	1.95	1.84	2.00	1.76	1.67	1.95	2.16	2.34	2.56
Balance of Payments, USD bn									
Current account	1.6	-28.2	-24.3	-47.3	-52.5	-54.2	-81.4	-83.2	-84.6
% of GDP	0.1	-1.6	-1.5	-2.2	-2.1	-2.4	-3.7	-3.8	-3.8
Trade balance	40.0	24.8	25.3	20.1	29.8	19.4	2.6	5.3	9.0
Exports	160.6	197.9	153.0	201.9	256.0	242.6	242.2	247.8	263.5
Imports	120.6	173.1	127.7	181.8	226.2	223.2	239.6	242.5	254.5
Service balance	-13.2	-16.7	-19.2	-30.8	-37.9	-41.0	-47.5	-54.3	-58.1
Income balance	-29.3	-40.6	-33.7	-39.5	-47.3	-35.4	-39.8	-37.8	-39.1
FDI, net	34.6	45.1	25.9	48.5	66.7	65.3	64.0	60.0	60.0
International reserves	180.3	193.8	238.5	288.6	352.0	373.1	375.8	375.8	375.8
Total amortisations	38.2	22.4	30.1	33.8	29.8	35.8	41.8	47.8	53.8
Public Finances, % of GDP									
Consolidated government balance	-2.8	-2.0	-3.3	-2.6	-2.6	-2.5	-3.3	-3.9	-3.4
Consolidated gov primary balance	3.8	3.9	2.0	2.7	3.1	2.4	1.9	1.5	2.0
Public debt	55.0	55.9	60.9	53.4	54.2	58.8	56.8	57.2	57.7
of which Domestic	50.9	51.2	57.5	50.5	51.5	55.9	53.8	54.2	54.7
Foreign Assets & Liabilities, USD bn									
External debt	193.6	198.3	198.2	256.8	298.2	312.9	322.8	318.6	312.0
Public	86.0	84.2	93.3	103.6	102.1	113.7	119.5	116.5	114.1
External debt / GDP	14.7	11.4	12.2	12.0	12.1	13.9	14.6	14.7	14.1
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	38.9	36.4	31.0	57.3	40.1	37.2	40.0	42.0	44.0
Short-term debt/International reserves (%)	21.6	18.8	13.0	19.9	11.4	10.0	10.6	11.2	11.7

Quarterly Economic Indicators	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.9	2.1	0.6	1.6	1.0	1.3	1.6	1.9	2.3
CPI, % yoy	5.9	5.6	6.3	6.9	6.6	6.4	6.0	6.2	6.3
Policy interest rate, %, eop	10.00	10.75	11.00	11.00	11.00	12.00	12.50	12.50	12.50
Short-term market rate, % eop	9.78	10.56	11.00	11.00	11.00	12.00	12.50	12.50	12.50
Long-term yield, %, eop	8.57	12.88	12.91	13.41	13.41	13.91	13.91	13.91	13.91
BRL/USD, eop	2.36	2.27	2.26	2.36	2.45	2.51	2.54	2.57	2.60

Source: National Sources, Citi Research

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- **Summary view** — Panamanian President-elect Juan Carlos Varela and the incoming Minister of Finance Dulcidio de la Guardia will take office at a time in which the economy is slowing down. In Costa Rica, President Luis Guillermo Solis has changed the tone of his views about the fiscal deficit.
- **Things to watch** — The National Assembly in El Salvador will discuss the approval of external debt issuance and the tax reform.
- **Strategy** — We expect the Dominican Republic to issue an additional USD250 million in external debt (bonds) later this year. El Salvador wants to raise USD800 million in external debt (bonds), as the stock of short-term debt (Letes) increased to USD784 million as of March 2014.

Varela wins the presidential election in Panama

Juan Carlos Varela won the May 4th presidential election and became President-elect. The polls released before the election suggested that he was getting closer to the "official" candidate Jose Domingo Arias, but none suggested that he would win by a wide margin. It is worth remembering that Mr. Varela ran under an alliance (*El Pueblo Primero*) formed by the PPA and PP, while Mr. Arias ran under an alliance (*Vamos Por Más Cambios*) formed by CD and Molirena. Juan Carlos Navarro (who finished third) was the candidate from the PRD and did not make an alliance for this election. The results for the congressional election suggest that the alliance between the CD party and Molirena would have the largest parliamentary group in Congress, followed by the PRD. Mr. Varela's alliance would be the third political force in Congress.

President-elect Varela announced that Dulcidio de la Guardia will become Minister of Economy and Finance[6]. According to Mr. de la Guardia, there are no plans to increase taxes (tax reform), as this was a campaign promise from Mr. Varela. In addition, Mr. de la Guardia said that the incoming administration will be respectful of the fiscal responsibility law and its deficit ceilings. Mr. de la Guardia will face an economy that is slowing down. The first growth numbers of 2014 have been disappointing. The monthly indicator of economic activity (IMAE) shows an annual growth of only 4.4% in January-February 2014, while trend-cycle growth stood at 5.5%. The average growth rates in these indicators during 4Q13 were 8.8% and 8.1%, respectively. We think that 1Q14 figures will be affected by the temporary halt in works in the Panama Canal expansion (see Panama Macro View - Spillover Effects, February 10, 2014).

We have mixed feelings about the stance of fiscal accounts at a time in which the country seems to be transitioning to more "normal" growth rates. A breakdown of the nonfinancial public sector (NFPS) outlays shows that capital expenditures (as a percentage of GDP) increased during the past few years as a result of the government's involvement in infrastructure projects. Conversely, current expenditures (as a percentage of GDP) decreased moderately. However, the fact that the country did not take advantage of the recent high real GDP growth (double-digit growth in 2010-11 and 8.4% in 2013) to lower significantly the fiscal deficit is somewhat disappointing.

6 Source: Bloomberg (May 12).

Solis is more receptive about fiscal issues in Costa Rica

President Luis Guillermo Solis has changed the tone of his views about the fiscal deficit. In his inauguration speech (May 8), President Solis acknowledged that the fiscal deficit is a risk for the stability of "public finances". This and other comments in the local media suggest that his administration would take some action to try to prevent the deficit from rising. However, these potential actions would only be associated with the expenditure side. In turn, we still think that a meaningful (i.e., that tackles both revenue and spending) fiscal reform is unlikely to happen over the next couple of years.

In the meantime, available activity and export data is still pre-Intel's exit. The available data is from before the announcement by Intel that it will partially exit from the country. Intel is considered to be the main exporter in Costa Rica. Intel's production in Costa Rica is regarded as a Zona Franca — meaning that it can import virtually anything without paying duties, as long as it exports its output. Zonas Francas are the main growth engine for manufacturing activity and exports, and given the importance of Intel within this sector we think that the partial exit of Intel from the country will pull down growth.

DomRep beefs up reserves

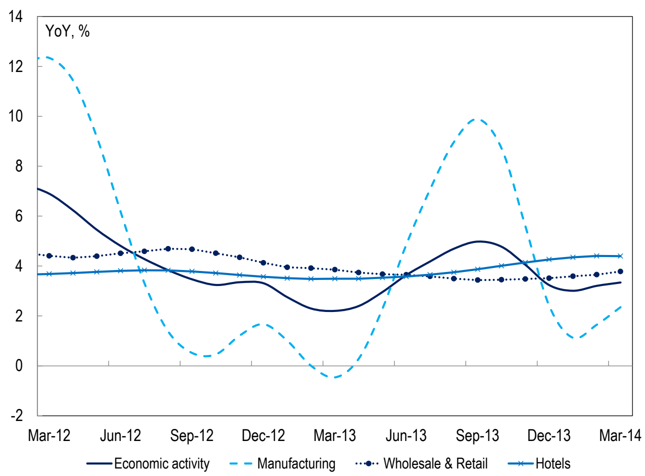
The recent issuance of external debt is part of the Dominican Republic's plan to beef up reserves. The country issued debt for USD1.25 billion in late April. The budget assumes that total external bond issuance would be USD1.5 billion, and consequently we would expect the government to issue an additional USD250 million later this year. This will most likely be done through a reopening of an existing bond. Higher international reserves would allow the Central Bank of the Dominican Republic to hold a tighter grip on the FX. As of May 7, international reserves were almost USD5 billion, slightly above (according to our estimations) three months of imports of goods and services.

Slight improvement in fiscal accounts in El Salvador

There was a slight improvement in fiscal accounts during 1Q14 in El Salvador. According to our estimations, the four-quarter rolling nonfinancial public sector (NFPS) deficit was 3.5% of GDP in 1Q14. This figure is lower than the 4.1% deficit of 4Q13. The improvement stems mainly from a decline in the primary deficit. This decline in the primary deficit was the result of reduced spending, as tax revenues (as a % of GDP) remained virtually unchanged.

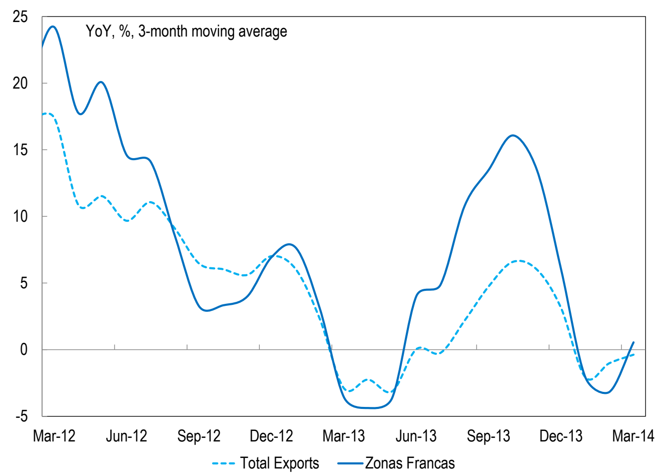
Despite the improvement, the government needs external financing to reduce the stock of short-term local debt (Letes). Finance Minister Carlos Caceres said that it will seek approval to issue USD800 million in external debt (bonds). The stock of Letes was USD784 million as of March 2014. Usually, when the stock of short-term debt breaches a certain threshold, the government ends up issuing longer-dated debt to face the Letes amortizations. In addition, the ruling FMNL party will seek a tax reform that would deliver USD200 million in new revenues for the government.

Figure 250. Activity data in Costa Rica is still pre-Intel's exit …



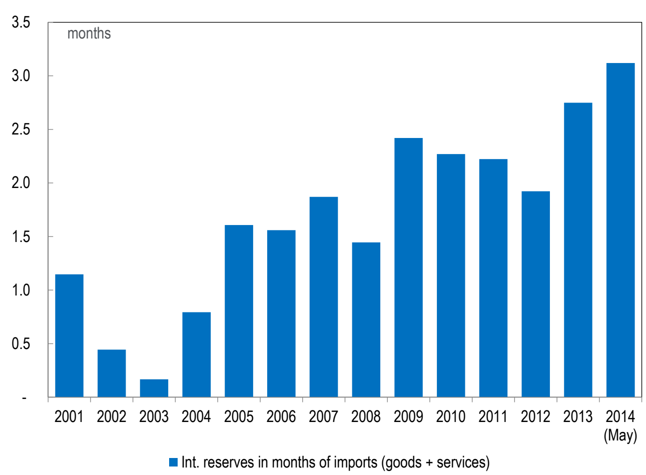
Source: BCCR, Haver and Citi Research

Figure 251. … and export data is still pre-Intel's exit from Costa Rica



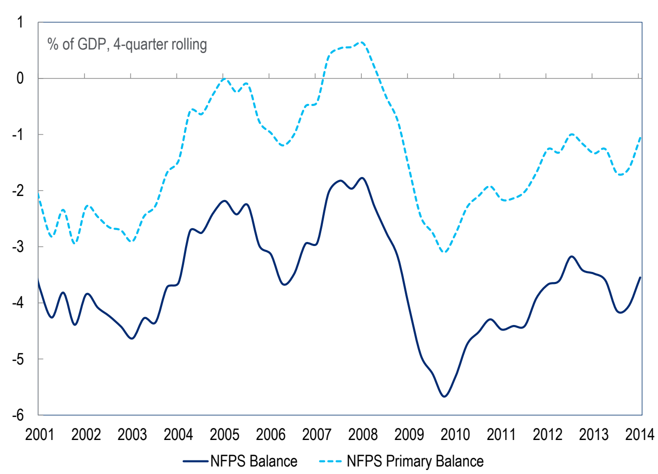
Source BCCR, Haver and Citi Research

Figure 252. Issuance pushed up international reserves in DomRep



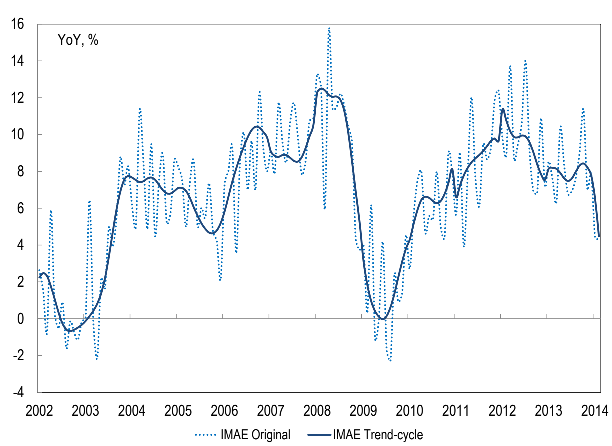
Source: BCRD, Haver and Citi Research

Figure 253. Fiscal accounts improved in 1Q14 in El Salvador



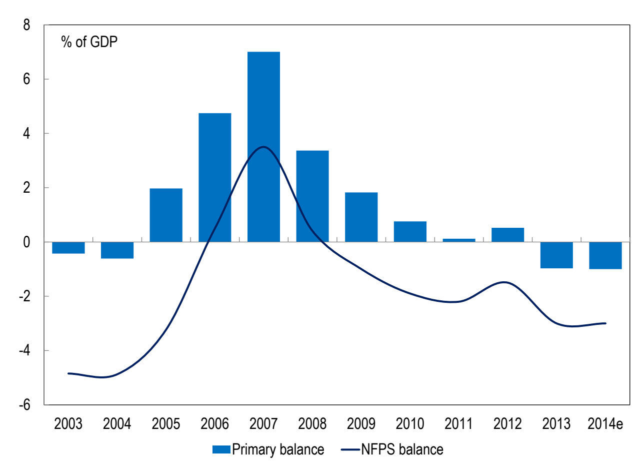
Source: BCRES, Hacienda and Citi Research

Figure 254. Activity is slowing down in Panama



Source: Contraloria, INEC, Haver and Citi Research

Figure 255. The ruling party's candidate is ahead in the polls in Panama



Source: MEF, GlobalSource and Citi Research

Figure 256. CCA Economic Indicators

Costa Rica	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Nominal GDP, USD bn	26.3	29.8	29.4	36.3	41.2	45.4	49.6	47.3	47.9
GDP per capita, USD	5,925	6,583	6,359	7,955	8,964	9,654	10,557	9,846	9,974
Real GDP, yoy avg	7.9	2.7	-1.0	5.0	4.5	5.1	3.5	3.1	2.2
CPI, % avg	9.4	13.4	7.8	5.7	4.9	4.5	5.2	3.9	5.0
CRC/US$, avg	517	525	570	521	502	503	501	562	595
CRC/US$, eop	496	560	555	504	506	513	501	585	610
Current account	-1.6	-2.8	-0.6	-1.3	-2.2	-2.4	-2.5	-3.6	-3.8
% of GDP	-6.3	-9.3	-2.0	-3.5	-5.3	-5.3	-5.1	-7.5	-7.9
Consolidated government balance	0.8	0.5	-3.9	-6.0	-5.6	-5.7	-6.5	-7.2	-7.7

Dominican Republic	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Nominal GDP, USD bn	41.3	45.8	46.8	51.8	55.8	59.0	60.6	62.7	65.2
GDP per capita, USD	4,414	4,807	4,822	5,241	5,544	5,770	5,888	6,091	6,335
Real GDP, yoy avg	8.5	5.3	3.5	7.8	4.5	3.9	4.1	4.5	4.5
CPI, % avg	6.1	10.6	1.4	6.3	8.5	3.7	4.8	4.0	4.6
Policy Interest Rate, % eop	7.00	9.50	4.00	5.00	6.75	5.00	6.25	6.25	5.00
DOP/US$, avg	32.8	34.4	35.9	36.8	38.0	39.2	41.7	43.8	46.1
DOP/US$, eop	33.0	35.4	36.2	37.4	38.7	40.4	42.7	44.8	47.0
Current account	-2.2	-4.5	-2.3	-4.3	-4.4	-4.2	-2.7	-3.0	-3.3
% of GDP	-5.2	-9.9	-5.0	-8.4	-7.9	-7.2	-4.4	-4.8	-5.0
Consolidated government balance	-1.7	-4.3	-4.8	-3.7	-3.8	-7.9	-4.1	-4.0	-4.2

El Salvador	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Nominal GDP, USD bn	20.1	21.4	20.7	21.4	23.1	23.9	24.5	25.2	26.3
GDP per capita, USD	3,500	3,705	3,548	3,653	3,919	4,014	4,079	4,203	4,385
Real GDP, yoy avg	3.8	1.3	-3.1	1.4	2.0	1.6	1.8	2.2	2.5
CPI, % avg	4.6	7.3	0.5	1.2	5.1	1.8	0.8	0.8	1.8
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
SVC/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.2	-1.5	-0.3	-0.6	-1.1	-1.3	-1.5	-1.6	-1.5
% of GDP	-6.1	-7.1	-1.5	-2.7	-4.6	-5.3	-6.1	-6.3	-5.7
Consolidated government balance	-1.9	-2.8	-5.5	-4.4	-4.0	-3.5	-4.2	-4.1	-3.7

Panama	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Nominal GDP, USD bn	21.1	24.9	25.9	28.8	33.3	38.0	42.6	46.5	50.4
GDP per capita, USD	6,318	7,312	7,482	8,170	9,242	10,543	11,668	12,575	13,274
Real GDP, yoy avg	12.1	9.1	4.0	5.9	10.8	10.2	8.4	6.2	5.5
CPI, % avg	4.2	8.8	2.4	3.5	5.9	5.7	4.0	2.7	2.8
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
PAB/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.4	-2.7	-0.2	-2.8	-5.0	-3.8	-4.8	-4.2	-4.3
% of GDP	-6.7	-10.9	-0.7	-9.6	-15.0	-10.1	-11.3	-9.0	-8.5
Consolidated government balance	3.5	0.4	-1.0	-1.9	-2.2	-1.5	-3.0	-3.0	-3.0

Source: National Sources, Citi Research forecasts

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- **Summary view** — Activity continues to lack "dynamism", while inflation is accelerating on the back of a weaker CLP. Despite higher inflation, we continue to expect 50bps of additional cuts to the policy rate, starting in June. The Lower House has approved the fiscal reform bill, which now will be discussed at the Senate.

- **Things to watch** — Keep a close eye on the discussions around the fiscal and educational reforms. Also, activity and inflation indicators deserve being followed closely, as the BCCh continues in "data dependent" mode.

- **Strategy** — We expect a stable CLP in the short term (0-3 months horizon). We expect two additional consecutive 25bps cuts to the policy rate, starting in June. However, we acknowledge that the timing of the next move is a close call, and monetary easing could be delayed.

Activity growth: below potential and with lower investment

Real GDP grew 2.6% YoY in 1Q14, slightly above expectations. Additionally, activity growth was higher than the one implied by the Central Bank of Chile (BCCh) monthly GDP proxy, the IMACEC (2.4% YoY). The real GDP growth rate for 4Q13 was kept unchanged at 2.7% YoY. In seasonally-adjusted (SA) terms, real GDP grew 0.7% QoQ, after shrinking 0.1% QoQ SA in 4Q13 but remaining below potential. The composition of growth was probably more interesting than the overall figure; domestic demand continued losing "dynamism", while next exports contribution to growth increased.

Despite annual GDP growth remaining roughly unchanged, domestic demand shrank. According to the data released by the BCCh, domestic demand shrank 0.3% YoY in 1Q14, after increasing 1.1% YoY in 4Q13. This was the first time domestic demand annual growth stood in negative territory since 3Q209. Moreover, the drop in domestic demand was mainly driven by investment. Gross capital formation shrank 5% YoY in 1Q14, posting negative annual growth for the third quarter in a row. Moreover, the machinery and equipment component decreased 16.9% YoY in 1Q14, after shrinking 28.5% YoY in 4Q13. Meanwhile, total consumption rose 4.4% YoY in 1Q14, down from 4.6% YoY in 4Q13. The slower total consumption growth was mainly the result of a meaningful deceleration in private consumption (mostly on durable goods): private consumption rose 3.7% YoY in 1Q14, down from 4.9% YoY in 4Q13. On the contrary, government consumption rose 9.6% YoY in 1Q14, the fastest since 4Q09 and up from 3.1% YoY in 4Q13. Net exports contribution to growth increased when compared to 4Q13 to 2.9%, up from 1.4% in 4Q13 and partially offsetting the lower domestic demand growth. However, while exports improved (rising 5.4% YoY in 1Q14, compared to a 0.9% YoY drop in 4Q13), the higher contribution to growth from net exports was also the consequence of a 3.6% YoY drop in imports, which had already shrunk 5.3% YoY in 1Q14.

The current account deficit narrowed in 1Q14

The current account deficit stood at USD0.8bn in 1Q14, compared to USD1.9bn one year ago. As a result, the 4-quarter current account deficit stood at USD8.4bn, the smallest since 3Q2012 and down from USD9.5bn in 4Q13. Additionally, the trade balance surplus rose to USD2.1bn in 1Q14, compared to USD0.6bn in 1Q13. According to 1Q14 balance of payment statistics, goods exports rose 1.8% YoY while imports decreased 6.4% YoY. Lastly, FDI decreased in 1Q14 to USD3.4bn, compared to USD5.9bn one year before.

It's not about the level of inflation, but about the "mix"

Inflation surprised on the upside in April, with core and non-tradable inflation measures rising more than the overall figure. According to the National Statistics Institute (INE), consumer prices rose 0.6% MoM in April. As a result, annual inflation accelerated to 4.3%, up from 3.5% in March and above the upper bound of BCCh's 2-4% inflation target band. Year-to-date, consumer prices have increased 2.1% - this is the strongest increase in prices for the first four months of the year in nearly two decades. Probably more importantly, and in opposition to previous months, the rise in prices was generalized, with ten out of the twelve divisions forming the CPI posting monthly increases. Additionally, core measures showed monthly increases above headline CPI. Both the IPCX and the more restrictive IPCX1 rose 0.8% MoM. As a result, the IPCX has increased 3.7% in the last 12 months, while the IPCX1 has risen 3.6%. It is worth noting that in March, both measures had fallen below BCCh's 3% midpoint target. Interestingly, non-tradable goods posted bigger monthly increases than tradable ones. According to INE, non-tradable prices rose 0.9% MoM, increasing 5.1% YoY. Year-to-date, non-tradable prices have already risen 2.6%. Meanwhile, tradable inflation was 0.4% MoM and 3.8% YoY.

Inflation expectations remain well anchored. Inflation expectations are of vital importance in an inflation-targeting regime. In this respect, the expectations surveys conducted by the BCCh suggest that medium-term inflation expectations have not increased significantly despite the recent surprises. According to the BCCh's monthly economists survey, analysts see annual inflation at 3.1% in 11 months, up from 3% in the previous survey. Additionally, 24 months ahead expected inflation remained unchanged at 3%. Similarly, the latest bi-weekly traders expectations survey shows 12 and 24 months ahead expected annual inflation at 3%, unchanged from the previous poll.

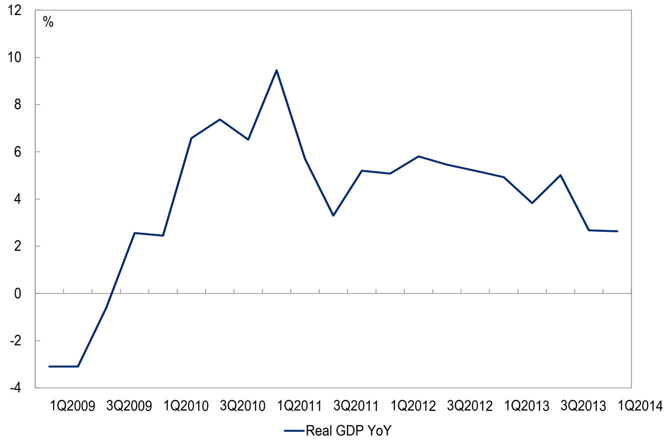
Monetary policy: as "data-dependent" as it can be

We continue to expect additional monetary easing. Despite April's inflation surprise, we believe that the inflationary pressures are likely to prove transitory and, thus, we are forecasting 50bps of additional cuts to the policy rate later this year. We expect two consecutive 25bps cuts to the policy rate, starting in June. This said, it is worth noting that the communiqué released by the BCCh after May's monetary meeting highlights the rebound in inflation but, at the same time, says that the most likely scenario is that the rebound is transitory; it acknowledges that the rebound is linked — among other things — to the weakening of the local currency. However, the fact that the communiqué was little-changed from the previous meeting suggests that the BCCh will likely adopt a "wait and see" stance, and it may remain on hold for a longer period of time if the inflation results for May are not positive.

The tax reform goes to the Senate

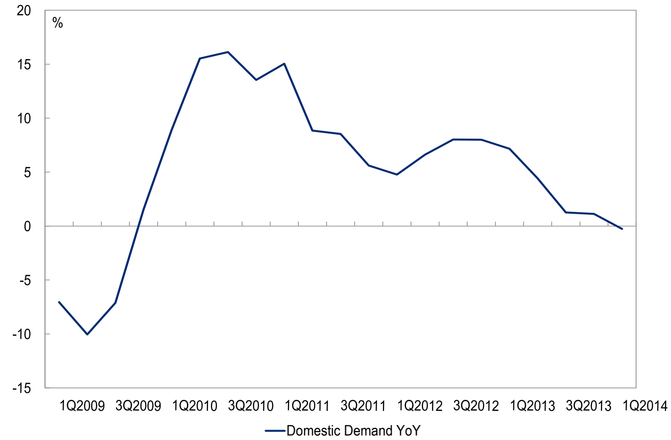
The House of Representatives approved the tax reform. Now, the tax reform will be discussed at the Senate, where the new administration has a (tight) majority. The tax reform, which aims to boost tax collection by USD8.2bn per annum, increases the corporate tax from 20% to 25% during the next four years. Additionally, it eliminates the so-called FUT, which allows shareholders to defer tax payments on re-invested profits, by 2018. Conversely, the reform includes a reduction on the maximum income tax for individuals to 35%, down from 40% currently (excluding government officials). Also, the reform permits instant depreciation for small and medium enterprises during the year following the enacting of the law.

Figure 257. GDP growth remained low in 1Q14…



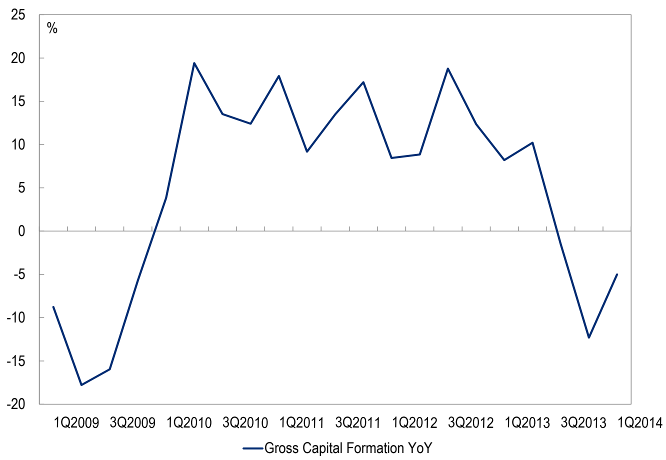
Source: BCCh and Citi Research

Figure 258. … on the back of weak domestic demand…



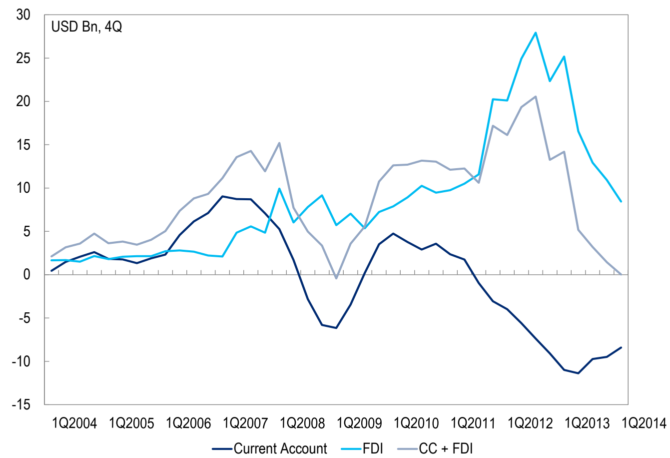
Source: BCCh and Citi Research

Figure 259. … particularly capital formation



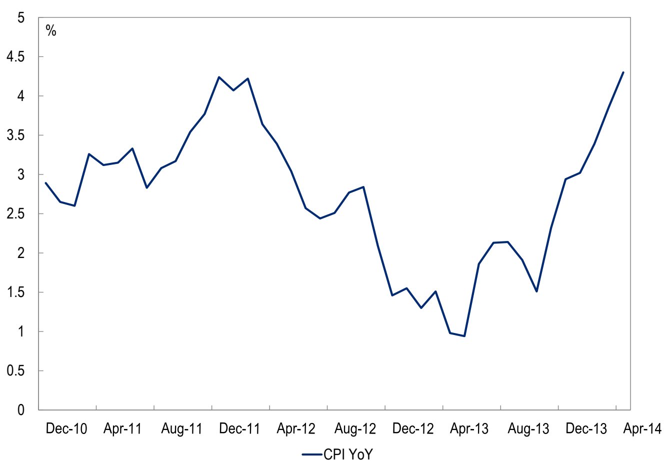
Source: BCCh and Citi Research

Figure 260. The CC deficit has been decreasing, as well as FDI



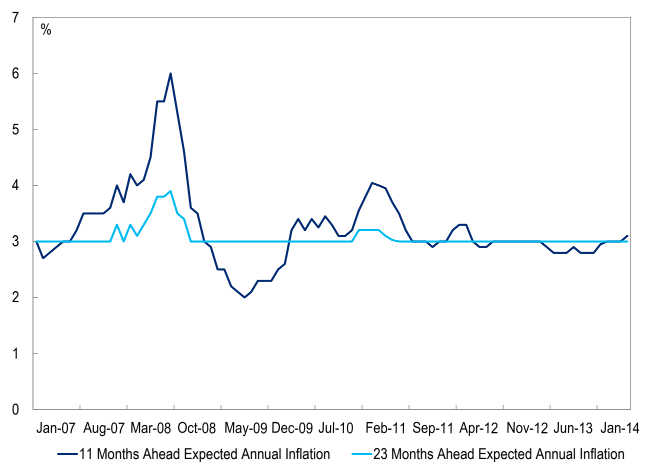
Source: BCCh and Citi Research

Figure 261. Inflation has been rising, but…



Source: INE and Citi Research

Figure 262. … expectations remain well anchored



Source: BCCh's Economists Survey and Citi Research

Figure 263. Chile Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	173	183	173	218	251	267	277	264	270
Nominal GDP, local currency bn	90	94	96	111	121	130	137	147	158
GDP per capita, USD	10,414	10,876	10,199	12,861	14,639	15,398	15,863	14,939	15,164
Population, mn	16.6	16.8	17.0	17.0	17.1	17.3	17.5	17.7	17.8
Unemployment, % of labour force	7.1	7.8	10.8	8.2	7.1	6.4	5.9	6.1	6.4
Economic Activity									
Real GDP, yoy avg	5.2	3.3	-1.0	5.8	5.8	5.4	4.1	3.5	4.5
Real investment growth % yoy	6.4	20.8	-23.5	27.3	14.2	11.0	-2.5	-3.2	6.2
Real consumption growth % yoy	7.5	4.4	0.8	9.8	7.8	5.6	5.4	4.6	4.7
private consumption growth % yoy	7.6	5.2	-0.8	10.8	8.9	6.0	5.6	4.3	4.8
Real export growth, % yoy	7.2	-0.7	-4.5	2.3	5.5	1.1	4.3	4.1	3.2
Real import growth, % yoy	14.3	11.2	-16.2	25.9	15.6	5.0	2.2	-0.9	4.6
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	7.8	7.1	-1.5	3.0	4.4	1.5	2.9	3.3	3.0
CPI, % avg	4.4	8.7	1.5	1.4	3.3	3.0	1.9	3.6	2.8
Nominal wages, % yoy	7.1	8.5	5.8	3.5	5.8	6.3	5.0	4.5	4.5
Credit extension to private sector, % yoy	21.0	18.7	-1.4	7.1	16.9	12.1	6.4	7.3	6.5
Policy Rate (eop)	6.00	8.25	0.50	3.25	5.25	5.00	4.50	3.50	4.00
1 month inter-bank rate, %, eop	5.93	8.24	0.45	3.13	5.23	4.99	4.50	3.50	4.00
Long-term yield, %, eop	6.30	5.93	5.38	5.81	4.92	5.45	5.10	5.00	5.00
CLP/USD, eop	498	638	507	468	520	479	525	574	587
CLP/USD, avg	522	524	559	510	484	486	496	560	584
Balance of Payments, USD bn									
Current account	7.1	-5.8	3.5	3.2	-3.3	-9.5	-9.1	-6.8	-10.8
% of GDP	4.1	-3.2	2.0	1.5	-1.3	-3.6	-3.3	-2.6	-4.0
Trade balance	24.1	6.1	15.4	15.6	10.5	3.4	2.5	4.5	0.5
Exports	68.6	64.5	55.5	71.1	81.5	78.3	77.1	75.1	76.1
Imports	44.4	58.4	40.1	55.5	70.9	74.9	74.6	70.6	75.6
Service balance	-1.3	-1.2	-2.0	-2.1	-2.6	-2.4	-3.0	-0.9	-0.1
Income balance	-18.9	-13.6	-11.4	-14.7	-14.1	-12.7	-10.9	-12.6	-13.2
FDI, net	12.6	15.5	12.9	15.4	22.9	30.3	20.8	16.1	14.0
International reserves	16.9	23.2	25.4	27.9	42.0	41.6	41.1	39.2	40.2
Total amortisations	14.3	14.3	16.4	12.3	12.8	22.4	22.7	22.8	23.3
Public Finances, % of GDP									
Consolidated government balance	8.4	4.3	-4.3	-0.3	1.4	0.6	-0.3	-0.4	-0.4
Consolidated gov primary balance	9.0	4.8	-3.8	0.2	2.0	1.1	0.2	0.0	0.0
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	2.0	2.4	4.9	7.4	7.7	6.3	5.5	5.4	6.2
Foreign Assets & Liabilities, USD bn									
External debt	53.4	63.7	71.9	84.5	98.7	117.8	120.7	114.7	117.5
Public	4.0	3.3	4.0	5.6	7.1	7.9	4.2	3.9	4.0
External debt / GDP	30.8	34.9	41.5	38.7	39.3	44.2	43.5	43.5	43.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	9.0	14.0	15.8	16.2	19.6	22.8	21.8	20.3	20.8
Short-term debt/International reserves (%)	53.4	60.6	62.4	58.3	46.6	54.9	53.0	51.9	51.8

Quarterly Economic Indicators	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.7	2.6	3.3	3.4	4.8	5.5	5.2	4.2	3.4
CPI, % yoy	2.9	3.5	4.0	3.4	3.3	2.5	2.5	3.1	3.0
Policy interest rate, %, eop	4.50	4.00	3.75	3.50	3.50	3.50	3.75	4.00	4.00
Short-term market rate, % eop	4.50	4.00	3.75	3.50	3.50	3.50	3.75	4.00	4.00
Long-term yield, %, eop	5.10	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
CLP/USD, eop	525	549	552	563	574	581	583	585	587

Source: National Sources, Citi Research

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- **Summary view** — The presidential election will be the center of attention and main source of headlines during May, with a runoff in June as the most likely outcome. On the monetary policy front, we consider that technical elements will weigh more than political economic considerations at the next board meetings, taking the CB to follow a more Taylor-like dynamic than we initially anticipated. Thus our new path considers three consecutive 25bps hikes to the policy rate on May, June and July, taking the repo rate to 4.25%.
- **Things to watch** — Watch for the presidential election to be held on May 25, and the likely runoff on June 15.
- **Strategy** — We now expect a faster monetary normalization. Nonetheless, the behavior of offshore investors should be supportive of the local curve throughout 3Q, mitigating the effect of monetary policy normalization in longer tenors and causing a "bear-flattening".

The presidential race

The presidential election will likely be the center of attention and main source of headlines during May, with a runoff in June as the most likely outcome. The latest political poll results have shown that President Juan Manual Santos and former president Uribe's *Centro Democrático* candidate, Oscar Ivan Zuluaga, will likely be competing in June's election runoff. In addition, the trend of such polls has shown a relatively steady vote intention for Mr. Santos, while Mr. Zuluaga has been gaining momentum. This situation implies that the days before the elections and the campaign during the runoff could be "intense". In our view, none of the candidates with higher vote intentions would advocate, if elected, for a sizeable change to macroeconomic policy.

Economic outlook

We expect a gradual increase in economic activity for 2014; we are keeping our 4.6% GDP growth forecast. Our 4.6% GDP growth forecast incorporates that construction (8.5%), financial services (5.3%), retail (5.2%) and oil and mining (5.0%) will be the best performers. On the other hand, agriculture (2.6%) and the industrial sector (3.4%) will likely continue displaying below-average growth. Regarding the expected behavior for the industrial sector, we see some moderate recovery this year, but mostly as a result of a low base of comparison. Yet, we still expect overall poor results for the manufacturing sector throughout 1Q14. Also, we expect the construction sector to be the best performer; nonetheless we also acknowledge its performance is the major source of uncertainty, as during the past two years the construction sector and particularly civil works projects have shown significant volatility. While we acknowledge that some fundamental problems (corruption scandals, microeconomic bottlenecks, and insufficient coordination among ministries) have taken their toll on construction, we expect to see a significant improvement in 2014 driven by ongoing civil works projects, spending at the regional level and private works. Most of the effects steaming from civil works projects are expected to materialize in 2H14 and in 2015.

Infrastructure projects and their impact on growth. One of the most important opportunities that Colombia will have during the next years will be related to the infrastructure projects that the country needs. The first round of auctions began this month, and we would expect most of these nine projects to have been awarded by the end of this quarter. However, the impact of these auctions on growth should not materialize until 2H15.

Inflation and monetary policy

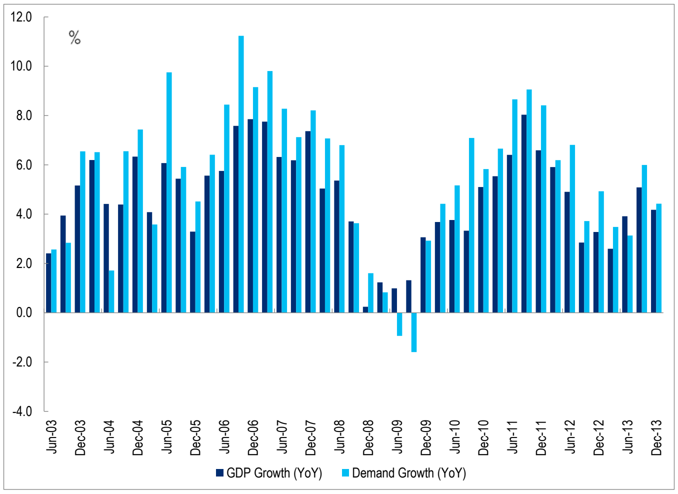
Surprise, surprise…In its April's monthly meeting, the CB's Board decided to increase the Repo rate to 3.50%, as expected by us (see our Colombia Macro View - Banrep's decision: Why to wait for tomorrow if you can do it today), but earlier than market expectations. Although we thought the CB would take a more gradual approach in its monetary policy normalization process, there have been some recent pieces of information which point toward a more active Banrep than what we initially expected in terms of monetary policy rate increases. This means that we now expect Banrep to follow closer what our Taylor rule model suggests: continuous hikes to the policy rate, which should stand at 4.25% by August.

It is important to note that we now expect a faster normalization of monetary policy, but not a higher policy rate at the end of the process. In other words, we continue to believe the repo rate will be at 4.25% by yearend, while we expect a faster convergence. Among the elements behind our change of heart with regards to the speed of adjustment to the monetary policy stance, the first one is associated with the voting outcome of the previous board meeting - which was made public in the CB's minutes. During the press conference, CB's governor Jose Dario Uribe said that interest rate increase was a split decision, but minutes show that six out of the seven CB's Board members voted for the hike, displaying a more hawkish stance than what we initially expected.

The second surprise came from the higher-than-expected inflation in April (0.46% MoM), a print higher than market consensus (0.32% MoM) and our own in-house expectation (0.33% MoM), which took annual inflation to 2.72%. This result had an impact on market inflation expectations; market participants now see annual inflation at 3.18% by yearend. It is worth noting that rather than the result itself, the fact that inflation has surprised on the upside in three out of the first four months of the year, and its effect on inflation expectations is what we are considering as important for Banrep's board. Finally, industrial production and retail sales results presented yesterday showed a good behavior of core economic activities during 1Q14. In March, industrial production rose 9.8% YoY (consensus: 7.9%, Citi forecast: 10.5%) while retail sales rose 8.3% YoY (consensus 6.2%, Citi forecast: 7.0%). Although we understand that at least in the IP number there are seasonal effects under consideration, these readings make it difficult for Banrep to justify a pause.

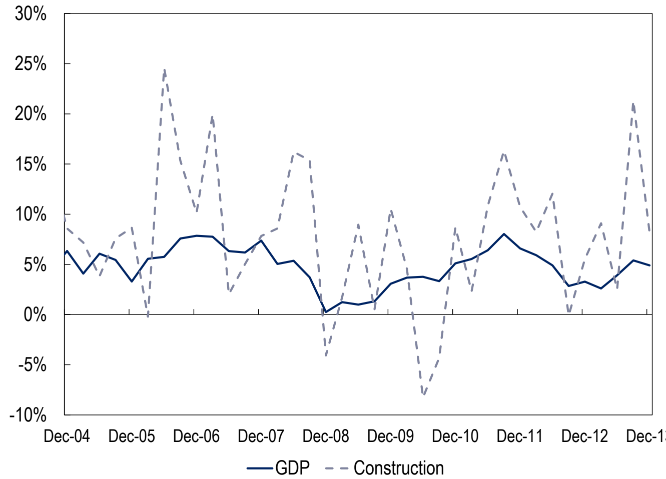
Hence we consider that technical elements will weigh more than political economic considerations at the next board meetings, taking the CB to follow a more Taylor-like dynamic than we initially anticipated. Thus our new path considers three consecutive 25bps hikes to the policy rate in May, June and July, taking the repo rate to 4.25%. We believe that at this level the central bank will feel either closer to the neutral rate (which some of them have mentioned in the past should be around 5%) or at the neutral rate itself. Last but not least, the current behavior of the exchange rate should not affect the monetary policy rate decision, as board members expect most of the recently observed appreciation in the COP to be transitory. Therefore, we would expect Banrep's approach to portfolio inflows to be reactive, rather than a proactive one.

Figure 264. A mild recovery is expected in 2014



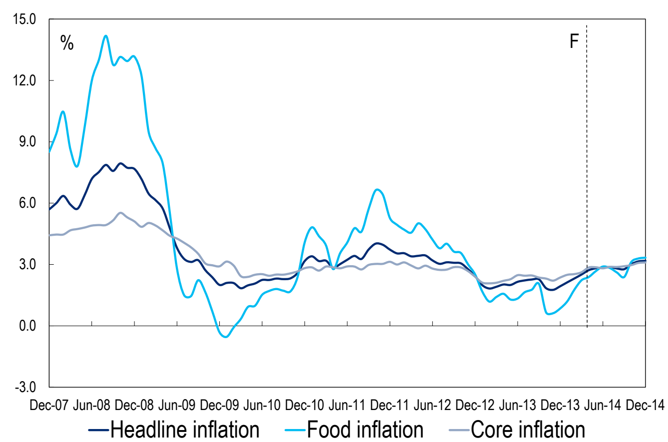
Source: Dane and Citi Research

Figure 265. The construction sector is the main source of uncertainty



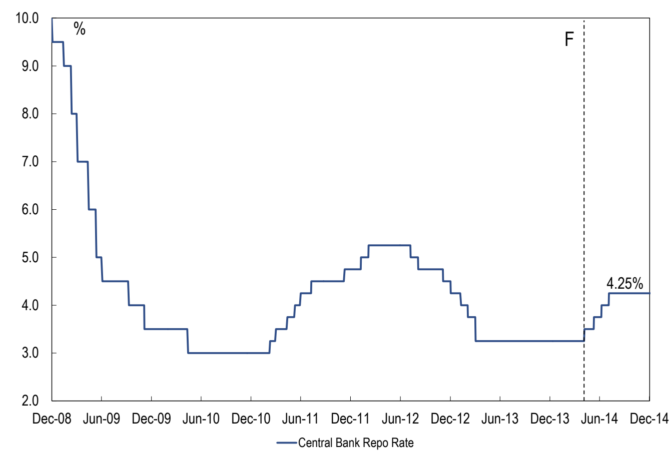
Source: Dane and Citi Research

Figure 266. Inflation is expected to stand at 3.18% by yearend



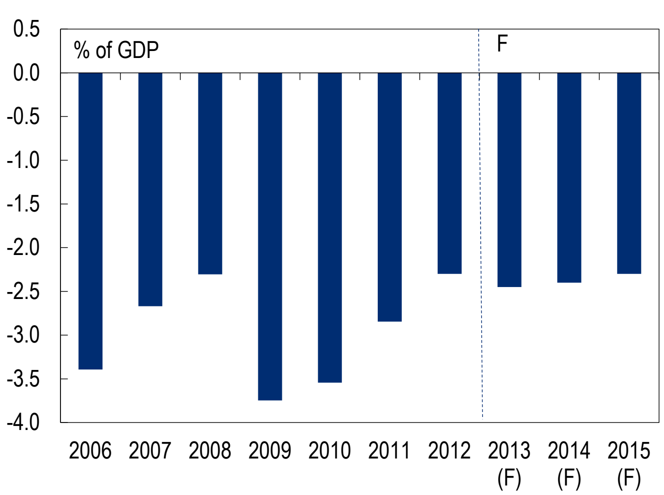
Source: Dane and Citi Research

Figure 267. We expect the repo rate to continue increasing



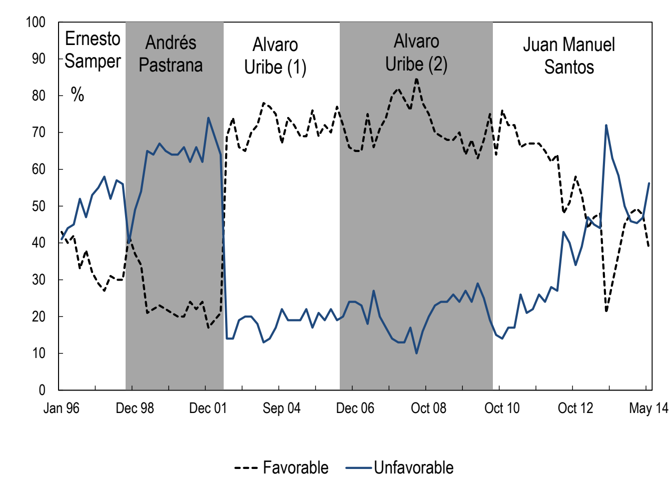
Source: Banrep and Citi Research

Figure 268. Central government deficit should continue relatively stable



Source: Ministry of Finance and Citi Research

Figure 269. Politics in the frontline



Source: Gallup and Citi Research's rendering

Figure 270. Colombia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	208	242	231	285	334	370	376	386	406
Nominal GDP, local currency bn	431	480	505	544	616	673	732	762	824
GDP per capita, USD	4,726	5,447	5,136	6,262	7,269	7,954	7,979	8,115	8,445
Population, mn	43.9	44.5	45.0	45.5	46.0	46.5	47.1	47.6	48.1
Unemployment, % of labour force	11.4	11.5	13.0	12.4	11.5	11.2	10.6	9.5	8.4
Economic Activity									
Real GDP, yoy avg	6.9	3.5	1.7	4.0	6.6	4.0	4.3	4.6	5.0
Real investment growth % yoy	12.8	9.0	-3.9	7.7	18.5	4.6	4.9	4.6	3.3
Real consumption growth % yoy	7.0	3.5	1.6	5.1	5.5	4.7	4.8	4.4	5.5
private consumption growth % yoy	7.3	3.5	0.6	5.0	6.0	4.4	4.5	4.2	5.5
Real export growth, % yoy	6.9	4.5	-2.8	1.3	11.8	6.1	5.3	3.1	4.5
Real import growth, % yoy	14.0	10.5	-9.1	10.8	21.5	8.9	2.1	5.0	4.6
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	5.7	7.7	2.0	3.2	3.7	2.4	1.9	3.2	3.5
CPI, % avg	5.5	7.0	4.2	2.3	3.4	3.2	2.0	2.8	3.3
Nominal wages, % yoy	5.4	19.1	3.0	4.1	4.2	4.3	4.4	4.5	4.6
Credit extension to private sector, % yoy	19.9	14.3	6.8	9.8	18.3	10.0	13.7	14.0	15.9
Policy Rate (eop)	9.50	9.50	3.50	3.00	4.75	4.25	3.25	4.25	5.00
1 month inter-bank rate, %, eop	9.35	8.87	3.10	3.00	4.81	4.27	3.30	4.27	5.02
Long-term yield, %, eop	10.27	12.76	8.47	7.70	7.60	5.86	6.75	7.07	7.82
COP/USD, eop	2,018	2,249	2,043	1,920	1,939	1,767	1,930	1,973	2,032
COP/USD, avg	2,076	1,968	2,154	1,898	1,848	1,798	1,869	1,947	2,014
Balance of Payments, USD bn									
Current account	-6.0	-6.9	-5.1	-8.9	-9.9	-11.8	-12.7	-14.4	-15.0
% of GDP	-2.9	-2.8	-2.2	-3.1	-2.9	-3.2	-3.4	-3.7	-3.7
Trade balance	-0.6	1.0	2.5	2.3	6.1	4.7	2.8	1.2	4.1
Exports	30.6	38.5	34.0	40.8	58.3	61.4	60.0	61.2	64.7
Imports	31.2	37.6	31.5	38.5	52.2	56.7	57.2	60.0	60.6
Service balance	-2.6	-3.1	-2.9	-3.7	-4.7	-5.5	-5.5	-8.7	-11.2
Income balance	-8.0	-10.2	-9.3	-12.0	-16.0	-15.7	-14.7	-11.9	-13.1
FDI, net	9.0	10.6	7.1	6.7	13.4	15.5	16.8	17.2	17.6
International reserves	20.9	24.0	25.4	28.5	32.3	37.5	43.6	47.2	50.8
Total amortisations	5.7	5.1	5.8	6.5	6.3	12.1	6.8	7.5	7.5
Public Finances, % of GDP									
Consolidated government balance	-0.6	-0.1	-2.7	-3.3	-2.9	0.3	-1.4	-1.3	-0.7
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	32.9	34.0	36.7	37.2	34.6	32.5	32.1	30.6	28.8
of which Domestic	21.9	22.6	24.9	26.3	24.3	23.6	23.2	22.1	20.9
Foreign Assets & Liabilities, USD bn									
External debt	44.6	46.4	53.7	64.1	75.9	78.8	90.2	93.5	97.5
Public	28.8	29.4	37.1	38.9	42.8	46.1	51.2	55.2	59.2
External debt / GDP	21.5	19.1	23.2	22.5	22.7	21.3	24.0	24.2	24.0
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	5.1	5.7	3.9	8.1	10.8	9.8	10.0	10.2	10.5
Short-term debt/International reserves (%)	24.6	23.5	15.6	28.3	33.4	26.2	22.8	21.7	20.6

Quarterly Economic Indicators	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	4.9	5.0	4.2	4.1	5.3	4.9	4.9	5.0	5.1
CPI, % yoy	1.9	2.5	2.8	2.8	3.2	3.3	3.2	3.4	3.5
Policy interest rate, %, eop	3.25	3.25	4.00	4.25	4.25	4.50	4.50	4.75	5.00
Short-term market rate, % eop	3.30	3.27	3.77	4.27	4.27	4.27	4.52	4.77	5.02
Long-term yield, %, eop	6.75	6.93	6.57	7.07	7.07	7.07	7.32	7.57	7.82
COP/USD, eop	1,930	1,972	1,905	1,939	1,973	1,996	2,008	2,020	2,032

Source: National Sources, Citi Research

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- **Summary view** — The latest data on economic activity suggest that the economy started to rebound during 2H13. We expect economic activity in 2014 to display favorable results and keep a good momentum. Our current GDP growth forecast for 2014 stands at 4.5%, with government consumption and investment as the main drivers. In our view, the main goal of the government continues to be guaranteeing enough inflows of FDI to finance the new oil production projects.

- **Things to watch** — The evolution of the current account deficit will be the main variable to follow during the year. Watch for 1Q14 balance of payments results.

Inflation and activity outlook

In 2013 GDP growth stood at 4.5%, and we expect a similar print for 2014. According to the Central Bank of Ecuador, GDP growth displayed an important recovery during 2H14. According to the report, GDP growth during 4Q13 was 5.6%, taking the GDP print for the year as a whole up to 4.5%.

The main drivers of the result for the year as a whole were investment (gross capital formation) and real exports, even despite the slow increase in oil production. Investment rose 6.6% in 2013, while exports expanded 4.5%. Growth in government spending decelerated in 2013 standing at 4.3%, while imports increased 4.2%. Regarding consumption, while it rose "only" 3.4% in 2013 as a whole, it showed some improvement during 2H13. On the supply side, construction was the main driver of the result, contributing 87bps to the total annual GDP print, followed by oil and mining with a 51bps contribution. According to the report, the ongoing projects in Esmeraldas refinery negatively affected growth, reducing GDP growth by 33bps in the oil refining sector.

We expect activity growth to remain healthy in 2014, and real GDP to rise 4.5%. Although the economy seems to be entering into a recovery phase, some considerations regarding the evolution of the trade balance and the outlook regarding commodity prices lead us to have a relatively conservative expectation regarding GDP growth for the time being. We forecast a 4.5% increase in GDP for the year as a whole. That print is based on a 5.5% rise in government consumption and a 5.4% expansion in household consumption. The main risk, in our view, arises from the external front, namely the evolution of oil prices. Exports, investment and household consumption should be the sectors with higher growth in 2014. Nonetheless, we expect real imports to offset some of these figures, as the maintenance of the Esmeraldas refinery will imply higher oil derivatives imports.

We expect the government to continue increasing fiscal spending to boost activity growth as long as oil revenues permit. Having said that, we acknowledge that there are questions regarding the sustainability of the current oil production levels going forward, providing an additional reason for the government to back the Yasuni project, as we have mentioned before. In that sense, it is important to note that the National Electoral Council rejected a referendum that was aimed to stop the projects in the Yasuni National Park. According to the National Electoral Council, the petition received insufficient votes.

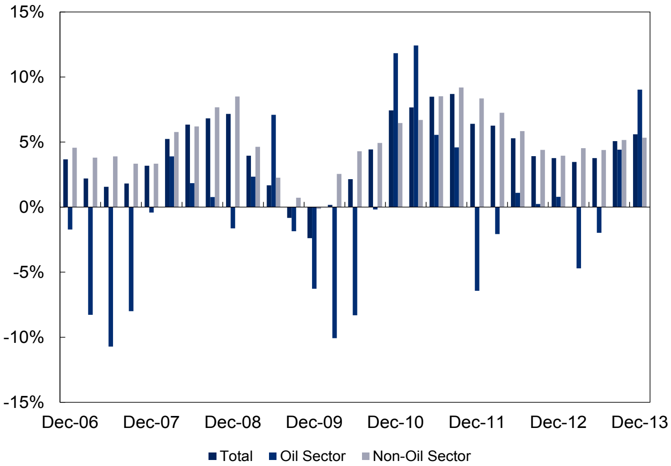
External accounts will continue to rely on the evolution of commodity prices. According to our commodity strategist, commodities have outperformed most other asset markets by a wide margin in the first quarter of the year, but the outlook going forward continues to be somewhat bearish. Also, as a result of the increase in oil derivatives purchases, imports should continue negatively weighting on the current account balance. Thus, our baseline scenario contemplates current account deficit of 1.1% of GDP in 2014 and 1.2% of GDP deficit in 2015. We expect this situation to revert in 2016 when we anticipate a 0.8% of GDP current account surplus.

The trade balance deficit is the flipside of domestic growth, but its financing poses medium term concerns. The trade balance showed a deficit of USD1084mn during 2013, versus a deficit of USD440.6mn in 2012. In particular, the deficit was explained by higher imports of raw materials and oil derivatives. Growth in raw materials and capital goods imports are usually related with higher real GDP growth, at least as long as they are financed through capital inflows.

Imports should continue to be the main driver behind the deterioration of the trade balance. The increase in oil derivatives imports has to do with the Esmeraldas refinery overhang, the biggest in the country and which is expected to be fully completed and reach its maximum processing capacity (110 thousand barrels per day) by 2015. In the meantime, the lower local refinement capacity will have to be substituted by imports.

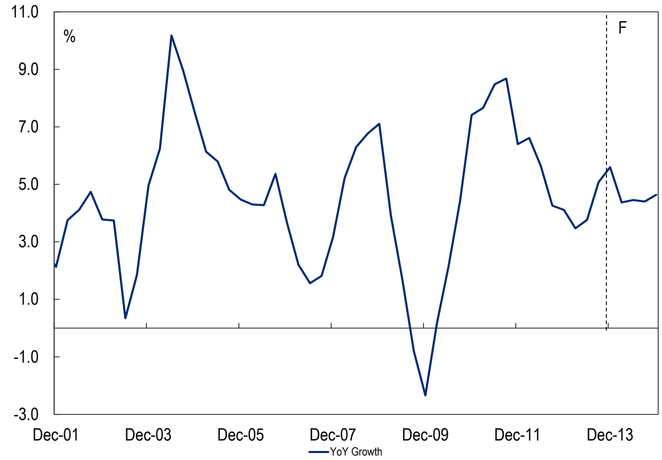
A return to the markets? In early April, President Rafael Correa said that the government plans to issue around USD700mn in global bonds in 2014. Ecuador's relationships with international markets were affected by the 2008 government decision of declaring "illegitimate" USD3.2 billion in sovereign bonds. Although the amount announced by Mr. Correa is relatively low, we believe the issuance would represent an important development for the country.

Figure 271. 4Q13 GDP growth breakdown



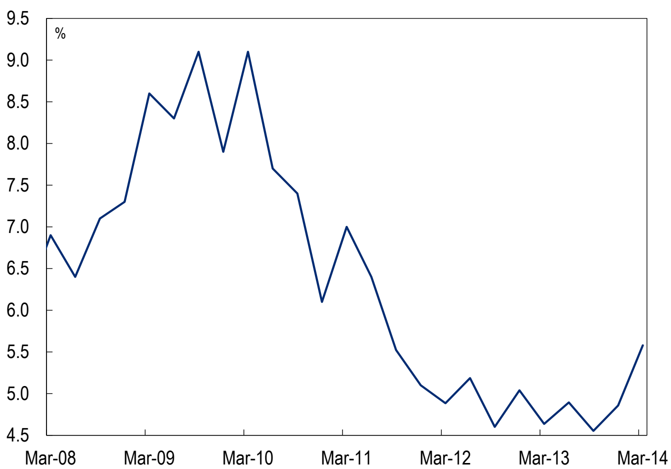
Source: Central Bank of Ecuador and Citi Research

Figure 272. GDP is expected to keep a good momentum



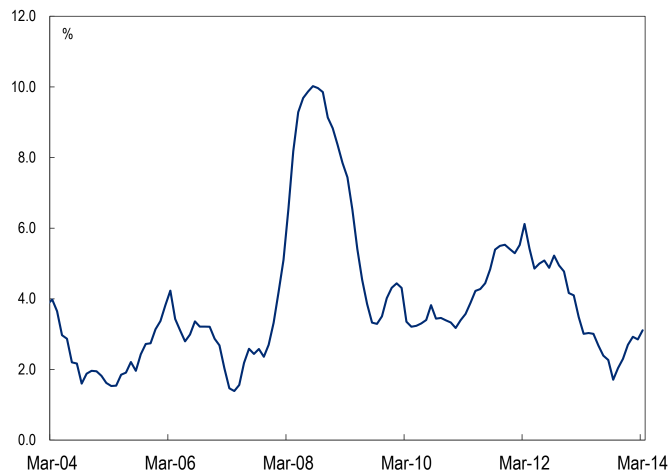
Source: Central Bank of Ecuador and Citi Research

Figure 273. Unemployment rate



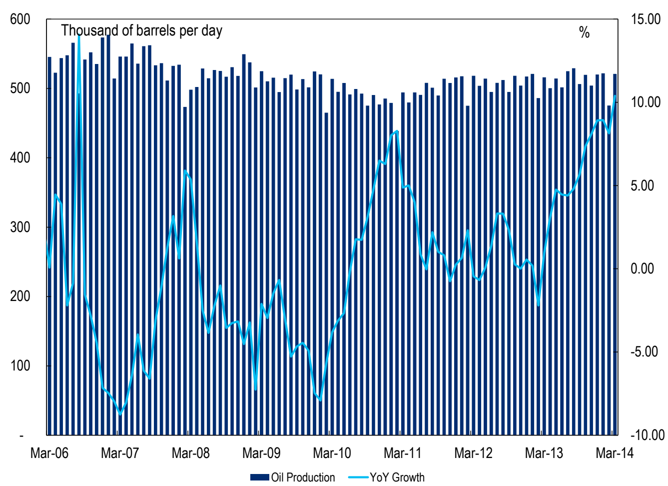
Source: Central Bank of Ecuador and Citi Research

Figure 274. Inflation rate



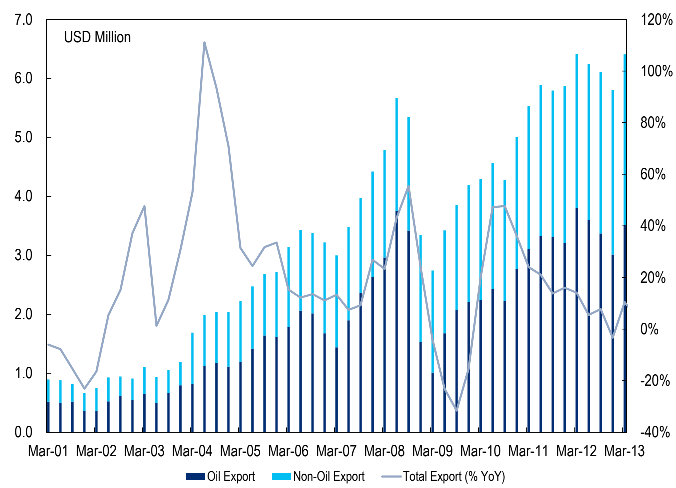
Source: Central Bank of Ecuador and Citi Research

Figure 275. Oil production



Source: Central Bank of Ecuador and Citi Research

Figure 276. Exports breakdown



Source: Central Bank of Ecuador and Citi Research

Figure 277. Ecuador Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	51	62	63	70	80	88	93	100	107
Nominal GDP, local currency bn	51	62	63	70	80	88	93	100	107
GDP per capita, USD	1,856	2,211	2,203	4,637	5,233	5,648	5,903	6,196	6,549
Population, mn	27.5	27.9	28.4	15.0	15.2	15.5	15.8	16.1	16.4
Unemployment, % of labour force	6.1	7.3	7.9	6.1	5.1	5.0	4.9	5.0	5.0
Economic Activity									
Real GDP, yoy avg	2.2	6.4	0.6	3.5	7.8	5.1	4.5	4.5	4.5
Real investment growth % yoy	4.2	22.5	-7.3	10.5	12.5	4.7	6.9	5.1	6.4
Real consumption growth % yoy	4.4	6.2	0.9	7.2	5.8	4.8	3.5	5.4	4.5
private consumption growth % yoy	4.2	5.4	-1.0	7.7	5.9	4.3	3.4	5.4	4.3
Real export growth, % yoy	0.0	3.0	-4.8	-0.2	4.6	2.7	4.5	4.5	4.8
Real import growth, % yoy	7.1	14.4	-9.9	14.8	3.9	1.9	4.2	7.5	6.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.3	8.8	4.3	3.3	5.4	4.2	2.7	3.0	3.1
CPI, % avg	2.3	8.4	5.2	3.6	4.5	5.1	2.7	3.6	2.4
Nominal wages, % yoy	6.3	17.6	9.0	10.1	10.0	10.6	8.0	8.5	11.7
Credit extension to private sector, % yoy	-	34.3	13.0	7.9	12.4	19.2	22.0	21.9	21.9
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	-	5.09	0.20	0.20	0.20	0.20	0.20	0.20	0.20
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ECD/USD, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Balance of Payments, USD bn									
Current account	1.6	1.3	-0.3	-1.6	-0.2	-0.3	-1.2	-1.1	-1.3
% of GDP	3.1	2.1	-0.5	-2.3	-0.3	-0.3	-1.3	-1.1	-1.2
Trade balance	1.8	1.4	-0.1	-1.5	-0.2	0.0	-0.6	-0.5	-0.7
Exports	14.9	19.1	14.2	18.1	23.1	24.6	25.7	26.0	26.0
Imports	13.0	17.8	14.3	19.6	23.2	24.5	26.3	26.5	26.7
Service balance	-1.4	-1.6	-1.3	-1.5	-1.6	-1.5	-1.5	-1.5	-1.5
Income balance	-2.0	-1.5	-1.4	-1.0	-1.2	-1.3	-1.4	-1.4	-1.5
FDI, net	0.2	1.0	0.3	0.2	0.6	0.6	0.7	1.6	2.5
International reserves	3.5	4.5	3.8	2.6	3.0	2.5	4.4	4.2	4.2
Total amortisations	11.8	9.5	8.6	7.5	7.4	6.9	6.4	6.4	6.4
Public Finances, % of GDP									
Consolidated government balance	-0.1	-1.0	-4.2	-1.6	-1.5	-1.9	-2.4	-1.9	-1.5
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	27.2	22.2	16.4	19.2	18.3	21.3	23.2	21.5	20.6
of which Domestic	6.4	5.9	4.5	6.7	5.6	8.9	9.4	8.6	8.0
Foreign Assets & Liabilities, USD bn									
External debt	17.5	16.9	13.4	13.9	15.3	16.0	18.3	18.3	19.4
Public	10.6	10.1	7.4	8.7	10.1	10.9	12.9	12.9	13.5
External debt / GDP	34.3	27.4	21.5	19.9	19.2	18.3	19.6	18.4	18.0
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	5.1	5.6	4.4	4.5	4.4	4.6	4.3	4.4	4.7
CPI, % yoy	1.7	2.7	3.1	4.1	4.1	3.0	2.2	2.2	2.2
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-

Source: National Sources, Citi Research

Mexico

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- **Summary view —** Recent data have shown that economic activity has grown slightly more slowly in 1Q14 than we anticipated, leading us to revise down our 2014 GDP growth forecast to 3.0% from 3.3% a month ago. We have also revised down our 2014 inflation forecast to 3.8% from 4.0%. We reiterate our view that the monetary policy rate will be 3.5% at year-end 2014.

- **Things to watch —** We think markets have already discounted the fact that local inflation is set to remain relatively low for the rest of this year and to decline in 2015, and they are now more focused on the economic activity outlook for this year and 2015, as well as possible rate hikes by Banxico next year.

- **Strategy —** We have revised our USD/MXN outlook on the 3-month horizon to 12.8 on the back of the Fed's accommodative rhetoric and local fundamental strength. We think the recovery in economic activity and constructive developments in structural reforms will continue to offset the FX volatility associated with the Fed's normalization process in the next 3 months.

Economic activity: recovery still slow

Economic activity continued to show a very slow recovery, and at a slower pace than we anticipated. Industrial production grew only 1.6% YoY in the first quarter of this year, versus our 2.0% YoY forecast. More important, in its short-run dynamic, IP based on monthly data also grew by a weak quarterly annualized rate (SAAR) of 1.6%. Although manufacturing output recovered well, up by 4.3%YoY in 1Q14 and by 6.1% SAAR, thanks to higher export demand mainly from the US, the result was also less than we expected (4.8%YoY in 1Q14). Meanwhile, construction reported a sharper-than-anticipated contraction, suggesting a lag in public spending. We expect the government to increase its spending during the rest of the year. The IP prints point to an economic growth rate in March that was slightly lower than we had anticipated. Thus, we have made a downward adjustment to our 1Q14 GDP growth forecast – to 2.1% YoY from 2.5% a month ago. We also assume a slower pace of growth in 2Q14. However, we continue to expect an acceleration in growth for the second half of the year – activity should gain momentum from stronger external demand, public spending and housing construction. All in all, we have revised down our 2014 GDP growth forecast to 3.0% from 3.3% a month ago.

For 2015 we continue to expect 4.0% GDP growth. We are sticking to our expectation of further U.S. manufacturing growth and an important role from improved housing construction next year, with a corresponding stimulus to Mexican exports and domestic demand. We therefore expect a better performance for Mexico's industrial production in 2015, which will have a positive impact on the annual growth of the service sector. We expect a smaller fiscal stimulus in 2015 compared to this year. Nevertheless, we think there will be an additional positive effect on investment coming from the materialization of the structural reforms, while the extension of an expansionary monetary policy should provide further fuel for growth. The combination of these events has therefore led us to keep our annual GDP growth forecast for next year unchanged.

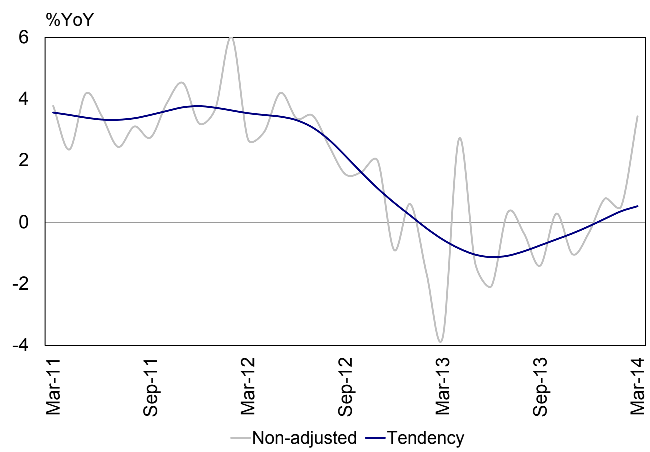
Monetary policy will remain untouched

We reaffirm our view that Banxico will remain on hold for the rest of the year. Annual headline inflation continued to fall in April – to 3.5% from 3.8% in March – implying a lower trough than we had expected. Furthermore, and although we continue to expect a rebound in annual inflation in coming months, we now see annual inflation ending the year at 3.8%, versus our previous forecast of 4.0%, given the absence of inflationary pressures. In fact, Banxico has recently acknowledged the downside risks to growth and expressed a rather relaxed view on inflation, arguing about the absence of second-round effects from higher taxes and tariffs on public goods. We therefore think it is unlikely that Banxico will alter its stance this year and, thus we are sticking to our view that Banxico will hold its policy rate unchanged at 3.5% until mid-2015.

A favorable climate for progress on approving reforms in extraordinary periods

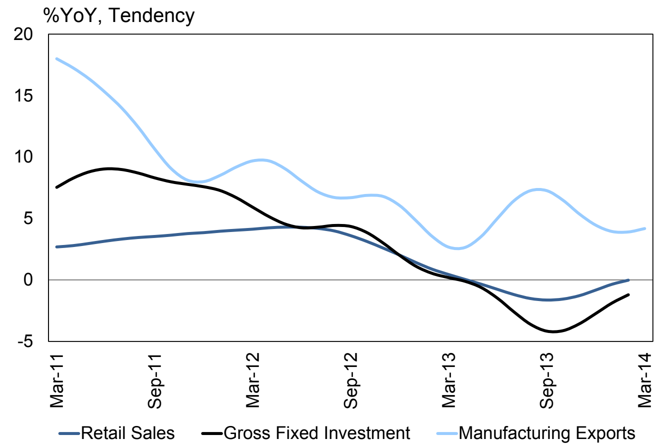
Mexico's Congress approved the politico-electoral reforms, allowing the telecommunications and energy reforms to be discussed as soon as next June. During a giddy extraordinary period, Mexico's Congress finally approved the politico-electoral reforms that will allow a new legal framework for the National Electoral Institute (INE) to regulate the 2015 elections. The main changes are: a) INE involvement in local elections; b) modification of the electoral communication model; c) regulation of independent and common candidacies; d) gender parity; e) financing; f) abolition of the COFIPE; g) new motives for annulling elections; and h) promulgation of the new General Law on Political Parties. These reforms pretend to limit the power of governors in local elections, increase the regulation of media content and raise penalties. The approval of these reforms came after the opposition's demand to discuss the telecommunications and energy reforms in June.

Figure 278. Industrial production is recovering, but slowly



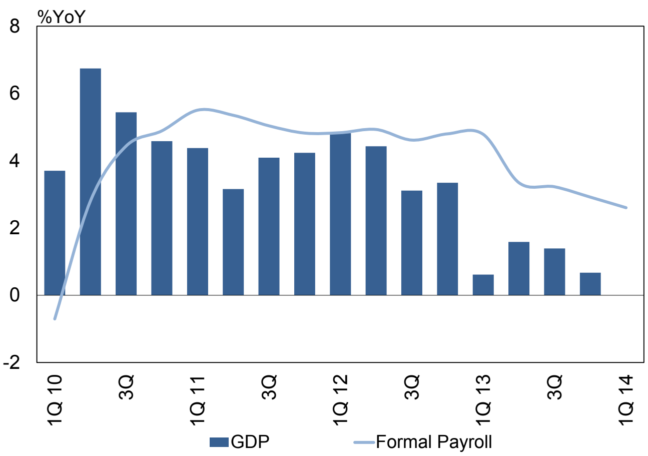
Sources: INEGI and Banamex

Figure 279. Activity is driven by exports; local demand still lagging behind



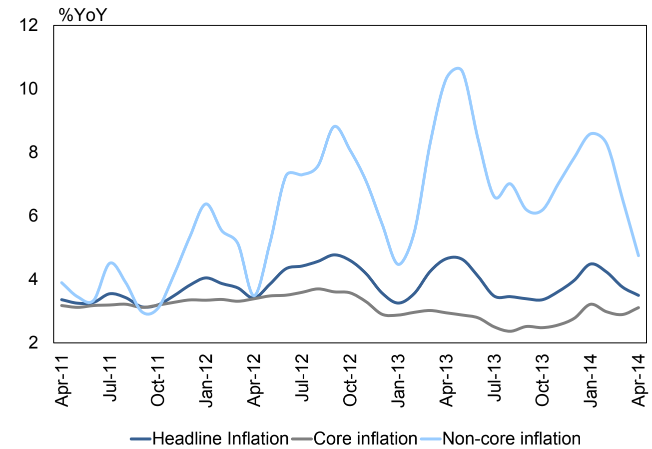
Sources: INEGI and Banamex

Figure 280. Payroll growth is declining, but keeps above GDP



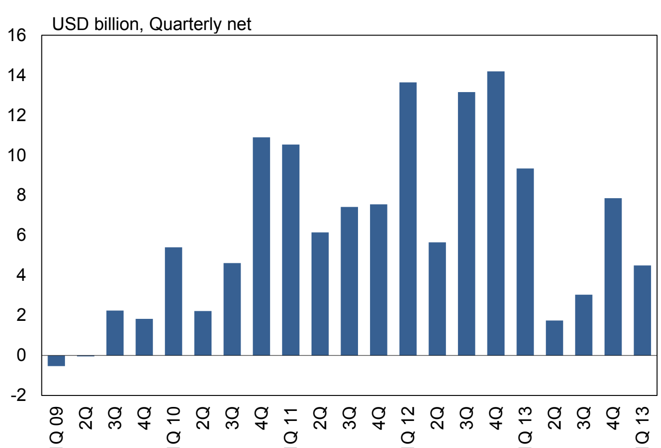
Sources: STPS, INEGI and Banamex.

Figure 281. Annual headline inflation is declining quickly



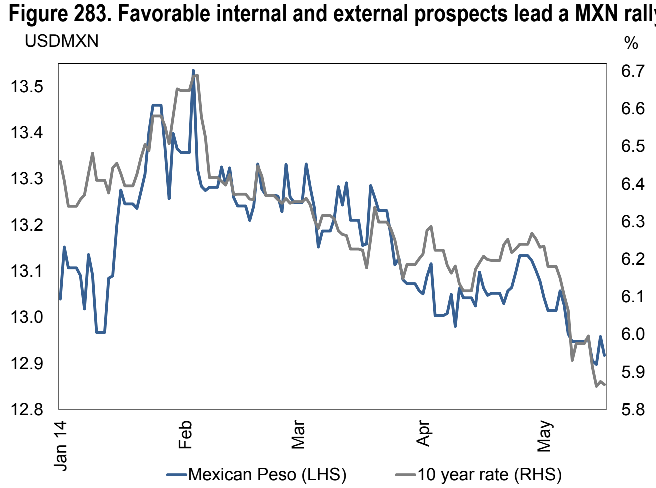
Sources: INEGI and Banamex.

Figure 282. Foreign investment in local government securities continues to soar



Sources: Banxico and Banamex.

Figure 283. Favorable internal and external prospects lead a MXN rally



Sources: Bloomberg and Banamex.

Figure 284. Mexico Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,044	1,109	897	1,052	1,170	1,184	1,259	1,299	1,438
Nominal GDP, local currency bn	11,403	12,257	12,094	13,282	14,531	15,588	16,077	17,173	18,584
GDP per capita, USD	9,507	9,967	7,952	9,206	10,117	10,130	10,659	10,886	11,946
Population, mn	109.8	111.3	112.9	114.3	115.6	116.9	118.1	119.3	120.4
Unemployment, % of labour force	3.7	4.0	5.5	5.4	5.2	5.0	5.0	4.8	4.5
Economic Activity									
Real GDP, yoy avg	3.1	1.4	-4.7	5.1	4.0	3.9	1.1	3.0	4.0
Real investment growth % yoy	3.7	6.2	-13.3	4.5	5.4	5.7	-2.3	2.1	5.4
Real consumption growth % yoy	3.0	2.1	-5.2	4.7	4.6	4.5	2.3	2.8	3.7
private consumption growth % yoy	3.0	1.9	-6.5	5.3	4.9	4.7	2.5	2.9	4.0
Real export growth, % yoy	3.6	-1.3	-11.8	20.5	8.2	5.9	1.4	6.5	5.5
Real import growth, % yoy	5.9	4.4	-17.6	20.5	8.0	5.4	1.2	6.6	7.6
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.8	6.5	3.6	4.4	3.8	3.6	4.0	3.8	3.5
CPI, % avg	4.0	5.1	5.3	4.2	3.4	4.1	3.8	4.0	3.6
Nominal wages, % yoy	5.4	5.3	4.2	3.0	5.4	4.4	4.6	4.2	4.3
Credit extension to private sector, % yoy	12.0	9.6	0.6	5.6	7.4	6.8	6.7	8.5	9.8
Policy Rate (eop)	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.50	4.25
1 month inter-bank rate, %, eop	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.50	4.25
Long-term yield, %, eop	8.03	8.35	7.99	6.95	6.51	5.38	6.45	7.14	7.53
MXN/USD, eop	10.91	13.67	13.06	12.36	13.95	12.87	13.04	13.04	12.82
MXN/USD, avg	10.93	11.16	13.50	12.63	12.44	13.16	12.76	12.96	12.94
Balance of Payments, USD bn									
Current account	-14.3	-19.6	-7.7	-2.7	-11.4	-12.0	-22.3	-27.4	-25.8
% of GDP	-1.4	-1.8	-0.9	-0.3	-1.0	-1.0	-1.8	-2.1	-1.8
Trade balance	-10.1	-17.3	-4.7	-3.0	-1.5	0.0	-1.0	-4.6	-3.2
Exports	271.9	291.3	229.7	298.5	349.4	370.7	380.2	413.1	466.2
Imports	281.9	308.6	234.4	301.5	350.8	370.8	381.2	417.7	469.4
Service balance	-7.6	-8.2	-10.0	-9.9	-14.1	-14.0	-11.7	-12.6	-12.3
Income balance	-23.0	-19.5	-14.6	-11.3	-18.8	-20.5	-31.4	-32.1	-33.1
FDI, net	31.6	27.9	16.7	22.6	23.8	15.6	35.0	22.5	26.5
International reserves	78.0	85.4	90.8	113.6	142.5	163.5	176.5	194.7	208.5
Total amortisations	37.3	46.0	79.0	57.0	47.7	52.9	50.5	43.3	39.9
Public Finances, % of GDP									
Consolidated government balance	0.0	-0.1	-2.3	-2.8	-2.5	-2.6	-2.4	-3.5	-2.5
Consolidated gov primary balance	2.2	1.8	-0.1	-0.9	-0.6	-0.6	-0.4	-1.3	-1.3
Public debt	33.7	36.5	40.3	38.8	39.6	39.5	38.2	38.1	37.9
of which Domestic	22.1	24.8	26.8	24.0	23.9	18.9	17.8	18.3	18.8
Foreign Assets & Liabilities, USD bn									
External debt	196.8	205.3	195.0	247.9	282.1	346.9	381.1	399.3	415.3
Public	121.0	129.3	120.9	155.1	183.0	242.6	259.7	275.8	290.9
External debt / GDP	18.9	18.5	21.7	23.6	24.1	29.3	30.3	30.7	28.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	26.1	25.1	21.3	21.3	22.8	22.4	21.3	22.0	22.7
Short-term debt/International reserves (%)	33.4	29.4	23.5	18.8	16.0	13.7	12.1	11.3	10.9

Quarterly Economic Indicators	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	0.7	2.1	2.0	3.4	4.3	5.0	4.3	3.8	3.1
CPI, % yoy	4.0	3.8	3.9	4.1	3.8	3.4	3.7	3.7	3.5
Policy interest rate, %, eop	3.50	3.50	3.50	3.50	3.50	3.50	3.75	4.00	4.25
Short-term market rate, % eop	3.50	3.50	3.50	3.50	3.50	3.50	3.75	4.00	4.25
Long-term yield, %, eop	6.45	6.20	6.36	6.70	7.14	7.44	7.47	7.50	7.53
MXN/USD, eop	13.04	13.06	12.82	12.93	13.04	13.06	12.98	12.90	12.82

Source: National Sources, Citi Research

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- **Summary view** — Although economic activity is growing below what is locally accepted as potential and March's economic activity came in below expectations, the fact that inflation continues on the upper bound of the target limits the central bank's room to cut its policy rate. In addition, we think the analysis of the balance of payments and the trade balance will be the main variables to assess eventual vulnerabilities during 2014 and 2015.

- **Things to watch** —The National Statistics Office (INEI) will update the national accounts base year.

- **Strategy** — We expect the BCRP to keep its policy interest rate unchanged during the month.

Economic activity

The economic activity index displayed 4.9% YoY growth in March, a print below both market (5.9%) and our own-in-house expectations, taking 1Q14 economic growth to 4.8% and 12-month accumulated growth to 5.8%. According to the National Statistics Institute (INEI), core activities such as manufacturing, retail and most services seem to be performing well during March, while mining and construction displayed a deceleration during the month. Although we continue to expect Peru to be one of the best performing economies in the region, the recent results lead us to fine-tune our GDP growth forecast for the year as a whole to 5.4%, down from 5.7%.

Commodity prices continue to be our main concern for GDP growth. We acknowledge that the fact that terms of trade have slightly fallen since 2011 does not bode well for the external sector as a main driver of economic growth going forward. Having said that, the fact that new mining projects should begin early production by 2015 does matter for GDP determination and we believe this should have a positive impact on the country's exports in the future. In addition, and as mentioned by our commodity strategists, growing Chinese macro concerns have impacted the prices for industrial metals, particularly copper.

Domestic-driven growth should support economic performance in 2014 and 2015. 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: consumption and investment. Household consumption has been increasing recently and we expect these dynamics to continue throughout 2014 as credit conditions remain favorable, even despite the recent increases in non-performing loans.

On the investment side, the government and the private sector are expected to continue with infrastructure and residential construction projects, something that should support growth. According to the Public Office for Investment Promotion (*Proinversion*) there are still 24 infrastructure projects worth USD5bn which should be allocated during the rest of the year, in addition to the ongoing expansion of Lima's metro system. Although the disbursements associated with these projects are expected to take place throughout the next three years, we consider they should shore up investment in case the external outlook deteriorates.

Inflation and monetary policy

During April inflation continued above the target range. During 2014 inflation has stood systematically above the 1-3% target range. Inflation has been mostly driven by supply shocks associated with foodstuffs and, thus, we expect inflation to gradually converge to the inflation target. Nonetheless, we slightly increase our inflation forecast for 2014 to 2.7%, given the recent dynamics of consumer prices. This still represents an important deceleration of prices during 2H14.

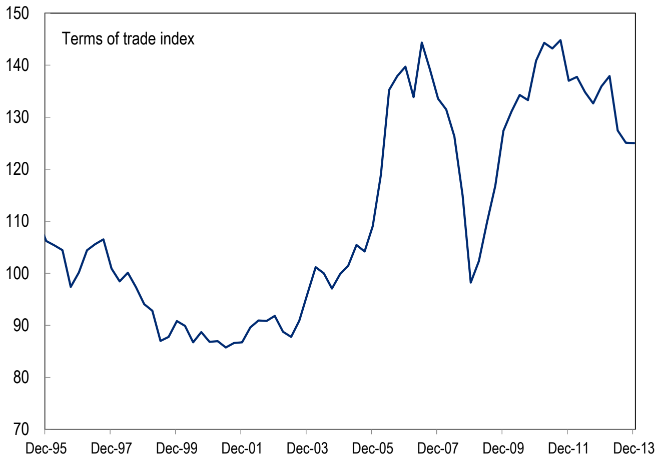
Monetary policy. Although economic activity is growing below what is locally accepted as potential and March's economic activity came below expectations, the fact that inflation continues on the upper bound of the target limits the central bank's room to cut its policy rate. This situation has caused real interest rate to decrease so far this year. However, the monetary authority could continue using reserve requirements as an alternative tool to boost economic activity if conditions permit. In fact, the reduction in reserve requirements has had a positive impact on loans in local currency. In addition, using a Taylor-rule based approach to assess the possibility of movements in the interest rate, we found that a significant reduction in the annual inflation (consistently below the 3% mark) is necessary for "conventional" monetary easing. Thus, we are keeping our call that the monetary policy interest rate will remain unchanged.

External sector

Falling metal prices and the overall appetite for emerging market risk could create some pressures in the exchange rate. In our view, the overall outlook for commodity prices continues to be challenging. Therefore, we expect the USDPEN to increase to 2.85 by yearend. In our view, levels beyond that mark would lead to aggressive interventions by the BCRP in the FX market, as occurred back in February.

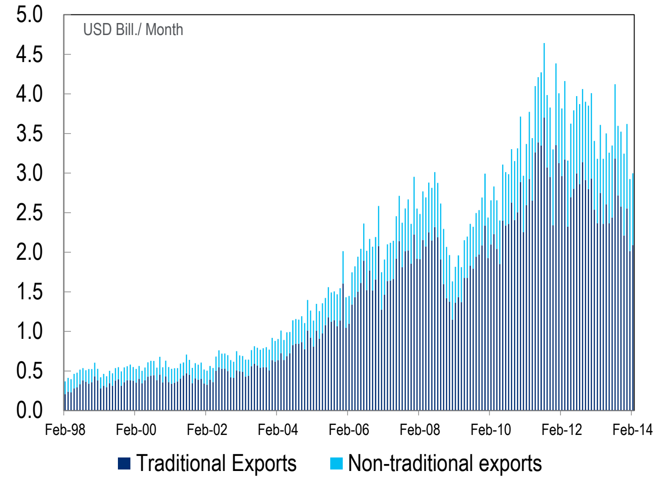
Balance of payments. During 2013, the current account deficit stood at 4.9% of GDP, increasing 1.6 percentage points versus the previous year. This increase in the current account deficit was mostly driven by the deterioration of the trade balance, which went from 2.6% of GDP surplus in 2012 to a 0.2% of GDP deficit. For 2014, we have revised our forecasts and we now expect the current account to further deteriorate and post a 5.1% of GDP deficit this year, on the back of stagnant exports and lower commodity prices. For the time being, the current account deficit continued to be comfortably financed by strong inflows of foreign direct investment, something that has led to significant increases in international reserves. Nonetheless, we expect a slower reserves accumulation moving forward.

Figure 285. Terms of trade dynamics…



Source: Bloomberg and Citi Research

Figure 286. Could translate into weaker traditional exports…

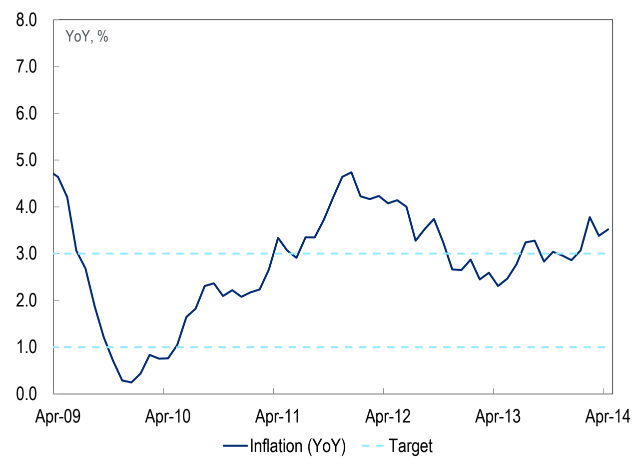


Source: BCRP and Citi Research

Figure 287. And a weaker exchange rate

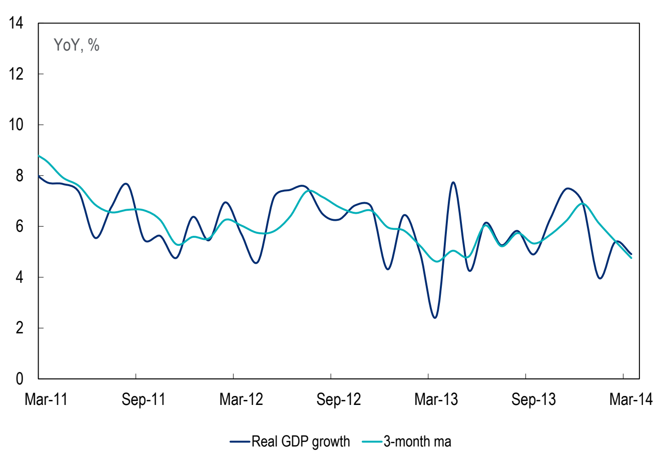
Source: Bloomberg and Citi Research

Figure 288. Inflation dynamics



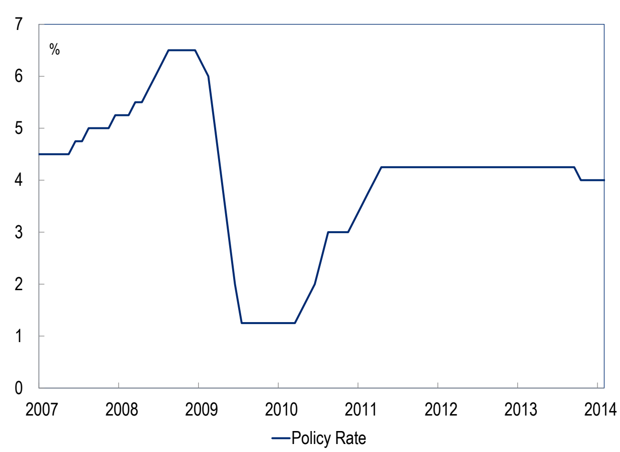
Source: BCRP, Haver and Citi Research

Figure 289. GDP Dynamics



Source: INEI, Haver and Citi Research

Figure 290. The BCRP is expected to keep the interest rate on hold



Source: BCRP, Haver and Citi Research

Figure 291. Peru Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	107	127	127	153	176	199	208	217	238
Nominal GDP, local currency bn	336	371	382	435	486	526	567	612	667
GDP per capita, USD	3,906	4,562	4,482	5,344	6,033	6,712	6,909	7,091	7,679
Population, mn	27.4	27.8	28.3	28.7	29.2	29.7	30.1	30.6	31.0
Unemployment, % of labour force	8.4	8.4	8.4	7.9	7.7	6.8	5.8	5.7	5.6
Economic Activity									
Real GDP, yoy avg	8.9	9.8	0.9	8.8	6.9	6.3	5.0	5.4	6.2
Real investment growth % yoy	25.8	25.8	-20.6	35.9	9.6	9.7	6.8	5.0	4.9
Real consumption growth % yoy	7.9	8.0	3.9	6.5	6.2	6.3	5.3	5.9	6.5
private consumption growth % yoy	8.3	8.7	2.4	6.3	6.2	5.8	5.2	5.7	6.7
Real export growth, % yoy	6.9	8.2	-3.2	1.3	8.8	5.9	1.0	4.9	4.5
Real import growth, % yoy	21.4	20.1	-18.6	24.0	9.8	10.4	5.1	6.1	4.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.9	6.7	0.2	2.1	4.7	2.6	2.9	2.7	2.5
CPI, % avg	1.8	5.8	2.9	1.5	3.4	3.7	2.8	3.2	2.5
Nominal wages, % yoy	5.0	12.8	23.1	-8.8	15.1	5.4	5.0	5.0	0.0
Credit extension to private sector, % yoy	29.9	14.3	10.4	20.1	14.2	13.8	11.0	11.0	12.0
Policy Rate (eop)	5.00	6.50	1.25	3.00	4.25	4.25	4.00	4.00	4.50
1 month inter-bank rate, %, eop	5.51	6.68	1.28	3.20	4.17	4.22	4.60	4.10	4.60
Long-term yield, %, eop	6.44	7.69	6.31	6.34	6.16	4.24	5.40	5.30	5.00
PEN/USD, eop	3.00	3.13	2.89	2.81	2.70	2.55	2.80	2.85	2.80
PEN/USD, avg	3.13	2.92	3.01	2.82	2.75	2.64	2.70	2.82	2.80
Balance of Payments, USD bn									
Current account	1.5	-5.3	-0.7	-3.8	-3.3	-6.5	-10.2	-11.2	-11.3
% of GDP	1.4	-4.2	-0.6	-2.5	-1.9	-3.3	-4.9	-5.1	-4.8
Trade balance	8.5	2.6	6.0	6.8	9.3	5.1	-0.4	0.0	0.2
Exports	28.1	31.0	27.0	35.6	46.3	46.2	41.8	42.4	45.8
Imports	19.6	28.4	21.0	28.8	37.0	41.1	42.2	42.4	45.6
Service balance	-1.2	-2.1	-1.2	-2.3	-2.1	-2.3	-1.8	-2.1	-2.2
Income balance	-8.3	-8.7	-8.4	-11.2	-13.7	-12.7	-11.2	-12.5	-13.1
FDI, net	5.5	6.9	6.4	8.5	8.2	12.2	10.2	11.8	11.6
International reserves	27.7	31.2	33.1	44.1	48.8	64.0	65.7	69.7	74.5
Total amortisations	6.8	3.3	2.2	4.1	1.4	4.0	4.1	4.3	4.5
Public Finances, % of GDP									
Consolidated government balance	2.6	2.3	-1.6	-0.3	1.8	1.9	0.8	0.0	0.0
Consolidated gov primary balance	4.4	3.8	-0.3	0.8	2.9	2.9	1.9	1.1	1.1
Public debt	29.8	24.1	27.2	23.5	21.8	19.9	17.4	17.4	17.0
of which Domestic	11.1	9.0	10.9	10.5	10.3	10.3	8.9	8.9	8.7
Foreign Assets & Liabilities, USD bn									
External debt	31.8	34.0	35.5	40.6	43.9	51.5	52.9	55.2	57.8
Public	20.1	19.2	20.6	19.9	20.2	19.0	17.6	18.3	19.3
External debt / GDP	29.8	26.8	28.0	26.4	24.9	25.9	25.4	25.4	24.3
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	20.6	19.5	20.1	22.9	24.2	26.3	25.9	26.6	28.6
Short-term debt/International reserves (%)	74.2	62.5	60.7	52.0	49.6	41.1	39.5	38.2	38.3

Quarterly Economic Indicators	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	5.1	4.9	5.4	5.7	5.7	6.4	6.1	5.9	6.3
CPI, % yoy	2.9	3.4	3.4	3.0	2.7	1.9	1.8	1.8	2.6
Policy interest rate, %, eop	4.00	4.00	4.00	4.00	4.00	4.50	4.50	4.50	4.50
Short-term market rate, % eop	4.60	4.10	4.10	4.10	4.10	4.35	4.60	4.60	4.60
Long-term yield, %, eop	5.40	5.30	5.30	5.30	5.30	5.70	5.70	5.70	5.70
PEN/USD, eop	2.80	2.81	2.82	2.83	2.85	2.85	2.85	2.85	2.90

Source: National Sources, Citi Research

Venezuela

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- **Summary view** — Economic activity most likely contracted in the first quarter in an environment where investment was the worst performer due to reductions in public project executions. We expect inflation to continue accelerating and to stand above the 60% mark in the upcoming months, given the upward pressures associated with goods scarcity. We continue to expect annual inflation to sit at 75% by yearend. On the FX front, trading volumes in the new SICAD II system have stabilized at around USD43-47 million a day, with allocations mostly coming in the form of bonds. Although one of the goals of SICAD II was to reduce the excess liquidity available in the economy, so far the growth of monetary aggregates remains high. In addition, we have heard of discussions associated with increases in gasoline prices and regulated services such as electricity and water, which should help to improve public finances.

- **Things to watch** — Watch for the evolution of SICAD II operations and a possible announcement on an increase in gasoline prices.

- **Strategy** — In our view, the evolution of oil prices and USD denominated resources will continue to be the main variables to assess Venezuela's economic outlook.

Economic outlook

Economic activity most likely contracted in the first quarter. The Venezuelan Central Bank should release GDP figures for 1Q14 at some point in the upcoming days (at the time of this writing the preliminary release dates were between May 19 and May 26). Our forecast for 1Q14 GDP growth stands at -1.50% YoY, driven by a deceleration in consumption, government spending and investing. We continue to expect real GDP to drop 1% in the year as a whole, on the back of lower consumption and government spending growth. We forecast consumption and government spending will grow 0.1% and 0.2%, respectively, this year. Real exports are expected to increase 1.3%, but mostly thanks to a low base of comparison. In our forecast, the worst performer component of GDP will be investment, which we expect to fall 3.6%.

As we mentioned in our previous report, inflation and scarcity should continue increasing this year. The Central Bank of Venezuela reported that the national inflation gauge stood at 4.1% MoM in March, in line with market expectations (consensus 4.1%, Citi 3.5% MoM). This result took the yearly inflation print up to 59.3%, above February's print. The Central Bank avoided informing on scarcity in the report, a course of action that suggests that the situation continued aggravating in March. At the time of this writing the results of April were not available, but we expect the national CPI to display a 4.8% monthly change, taking the annual print to 60.1%.

The inflation outlook in Venezuela continues to be challenging. We expect yearly inflation and scarcity to increase during the year as a result of the delays in USD disbursements, local production bottlenecks and the ample liquidity in local currency. The scarcity of goods and its inflationary consequences will likely continue to be the main problem faced by the government. All in all, we still expect inflation to accelerate up to 75% by yearend.

USD Allocations

CENCOEX informed that USD allocations during the January-April period stood at USD5.87 billion. According to a report from the national Center for Foreign Trade (CENCOEX) - the entity that replaced CADIVI – USD allocations stood at USD5.87 billion during the January-April period. According to the report, USD4 billion were for imports (USD1.2 billion for ALADI/Sucre agreement imports and USD2.8 billion for regular imports). From the USD2.8 billion allocated for regular imports, the sectors that received higher allocations were the food (USD905 million), healthcare (USD756 million) and agro-industrial sectors (USD256 million). Regarding other USD allocations, CENCOEX approved USD1.15 billion for credit cards, USD189.7 million in cash for travelling, USD162 million for students and USD341 million for other concepts.

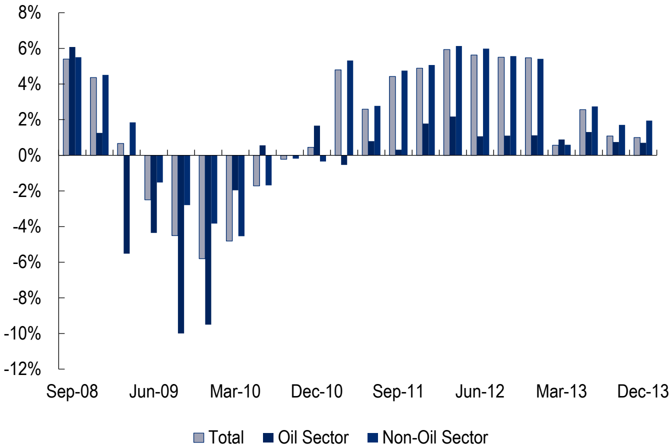
SICAD I and II. Although SICAD II volumes have not been published yet, local think thank Ecoanalítica has reported that trading volumes have stabilized around USD43-47 million a day, with allocations mostly coming in the form of bonds. Although one of the goals of SICAD II was to reduce the excess liquidity available in the economy, so far the growth of monetary aggregates remains high, meaning that financing from the central bank to non-public entities has not ceased. Regarding SICAD I, during the year (up to Auction 25th) allocations have stood at USD1.9 billion, averaging USD160 million per auction (below the USD220 million weekly limit). In our view, the evolution of CENCOEX allocations, along with SICAD I and SICAD II, during the year will be of vital importance to assess the performance of domestic demand and the private sector.

Oil production and prices

The main component of FX sources is oil exports' revenue, which in turn depends on oil production and prices. Regarding oil production, we have not seen (net) increases in recent years, and most of the new projects (in the Orinoco Basin) seem to have been compensating reductions in older ones. According to the latest OPEC report, Venezuela oil production, based on secondary sources, stood at 2.30 million barrels per day in April. According to May's monthly oil market report released by OPEC, Venezuela's crude oil production displayed a 35.1 thousand barrel per day decrease in April when compared to March's print. In addition, this report shows that Venezuelan oil production represented 7.8% of OPEC's production. Based on information gathered by the Venezuelan government, oil production stood at 2.85 million barrels per day on average during March. We do not expect to see major increases in oil production during 2014. Consequently, oil revenue dynamics in Venezuela will rely almost exclusively on the evolution of oil prices.

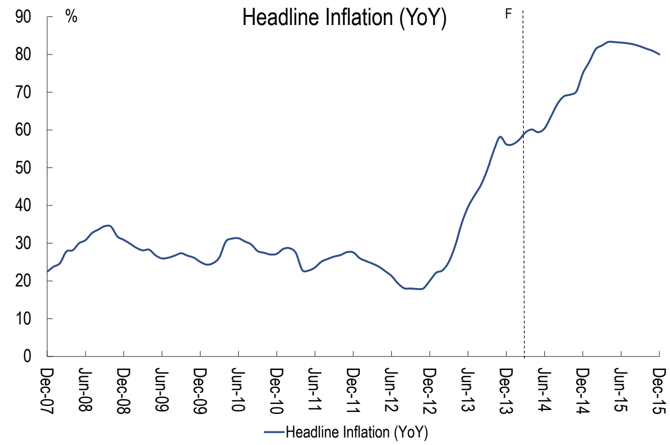
Regarding oil prices, we keep a cautious and bearish view for 2014, especially as we have seen the Venezuelan basket moving below WTI prices. Specifically, our Commodity team forecasts WTI and Brent prices to stand at USD97 and USD104 per barrel, respectively. Assuming that the spread between the WTI prices relative to one of the Venezuelan oil baskets stays relatively constant, our base scenario is for Venezuela to sell its oil at an average price of USD95 per barrel, since we recognize that recently the Venezuelan basket oil price has been trading lower than WTI prices. This situation is important to follow, given its potential implications for the current account.

Figure 292. GDP growth performance in 4Q13



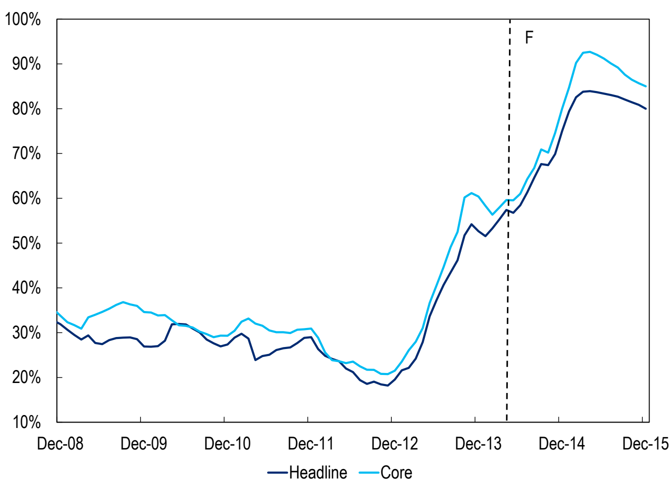
Source: BCV and Citi Research

Figure 293. Inflation should accelerate despite the week GDP growth



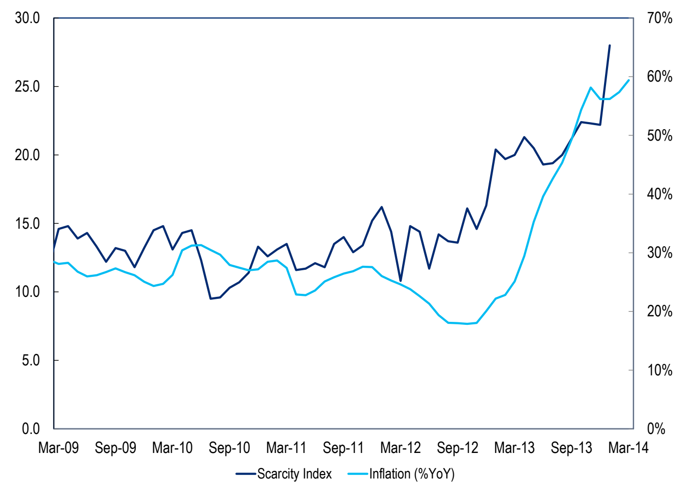
Source: BCV and Citi Research

Figure 294. Caracas inflation



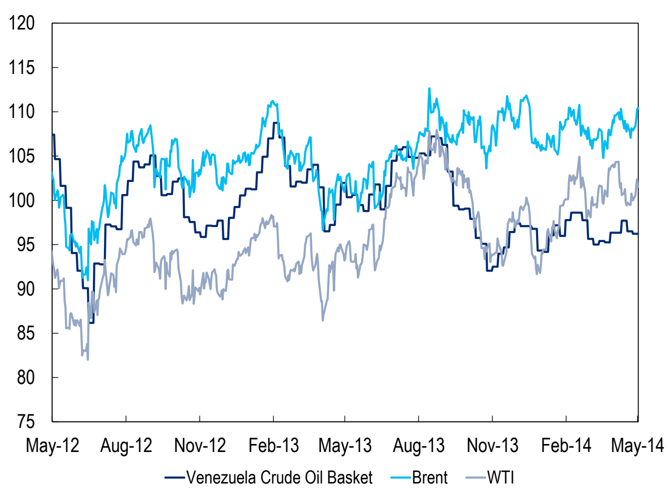
Source: BCV and Citi Research

Figure 295 Scarcity continues to be one of the drivers of inflation



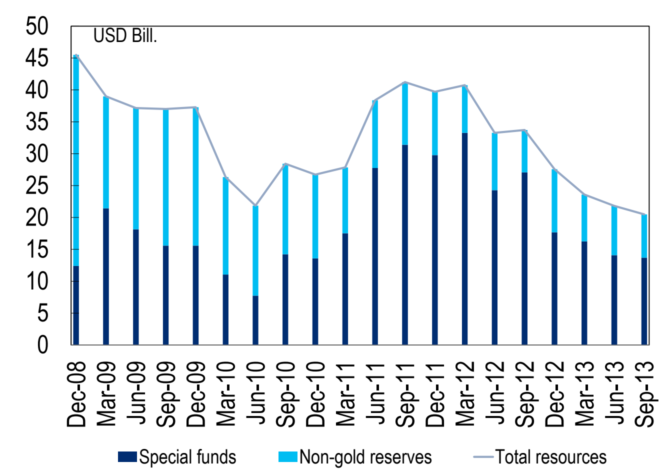
Source: BCV and Citi Research

Figure 296. Venezuelan oil basket prices and WTI prices



Source: BCV and Citi Research

Figure 297. Could total liquid resources continue its downtrend?



Source: BCV and Citi Research

Figure 298. Venezuela Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	213	298	284	257	298	361	372	368	359
Nominal GDP, local currency bn	495	678	707	1,017	1,357	1,642	2,595	4,152	6,778
GDP per capita, USD	7,738	10,683	9,996	8,925	10,188	12,141	12,341	12,025	11,578
Population, mn	27.5	27.9	28.4	28.8	29.3	29.7	30.2	30.6	31.0
Unemployment, % of labour force	6.2	6.1	6.6	6.5	6.5	5.9	5.6	5.2	4.8
Economic Activity									
Real GDP, yoy avg	8.8	5.3	-3.2	-1.5	4.2	5.6	1.3	-1.0	1.9
Real investment growth % yoy	28.2	2.2	-19.1	1.0	15.2	24.1	-7.5	-3.6	1.5
Real consumption growth % yoy	16.3	6.0	-2.1	-1.1	4.4	6.9	3.5	0.1	0.3
private consumption growth % yoy	16.9	6.3	-2.9	-1.9	4.0	7.0	3.7	0.1	0.3
Real export growth, % yoy	-7.6	-1.0	-13.7	-12.9	4.7	1.6	-3.8	1.3	4.2
Real import growth, % yoy	33.0	1.4	-19.6	-2.9	15.4	24.4	-4.6	-0.7	-1.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	22.5	31.9	26.9	27.4	29.0	19.5	52.7	75.0	80.0
CPI, % avg	18.7	31.4	28.6	29.1	27.1	21.1	38.5	62.5	82.1
Nominal wages, % yoy	20.7	25.0	23.7	24.5	27.0	30.0	45.0	60.0	60.0
Credit extension to private sector, % yoy	43.3	30.6	18.0	27.6	36.8	55.3	65.8	80.0	80.0
Policy Rate (eop)	18.00	28.10	14.00	12.50	-	-	-	-	-
1 month inter-bank rate, %, eop	18.00	28.10	11.30	12.30	14.50	14.50	14.50	14.50	14.50
Long-term yield, %, eop	12.00	12.00	14.38	13.02	13.93	9.18	12.88	15.20	16.88
VEF/USD, eop	2.15	2.15	2.15	4.29	4.29	4.29	6.29	12.00	19.80
VEF/USD, avg	2.15	2.15	2.15	4.20	4.29	4.29	5.99	10.58	19.80
Balance of Payments, USD bn									
Current account	18.1	37.4	8.6	12.1	27.3	11.0	12.2	14.9	18.2
% of GDP	8.5	12.5	3.0	4.7	9.1	3.1	3.3	4.1	5.1
Trade balance	23.0	45.7	19.2	27.1	46.4	38.0	36.7	33.5	36.8
Exports	69.0	95.1	57.6	65.7	92.7	97.3	89.2	83.5	88.9
Imports	46.0	49.5	38.4	38.6	46.2	59.3	52.4	50.0	52.0
Service balance	-7.0	-8.4	-7.6	-9.2	-10.7	-16.0	-13.8	-7.7	-7.8
Income balance	2.5	0.7	-2.7	-5.3	-7.9	-10.0	-9.8	-9.8	-9.8
FDI, net	1.0	-0.9	-4.9	-1.5	5.1	0.8	2.4	0.8	0.8
International reserves	34.3	43.1	35.8	30.3	29.9	26.5	25.0	23.5	22.0
Total amortisations	4.0	7.5	4.3	6.9	11.0	4.1	6.8	4.5	0.1
Public Finances, % of GDP									
Consolidated government balance	-2.8	-3.5	-8.7	-10.4	-11.6	-15.0	-11.9	-11.2	-10.3
Consolidated gov primary balance	-1.2	-2.0	-7.2	-8.6	-9.4	-12.3	-9.4	-8.9	-8.2
Public debt	25.5	21.6	31.3	42.0	44.2	43.4	42.0	40.7	40.2
of which Domestic	7.3	4.5	7.5	8.9	11.4	14.1	12.3	9.6	7.2
Foreign Assets & Liabilities, USD bn									
External debt	56.3	66.4	81.9	97.1	110.7	118.9	124.3	128.5	132.7
Public	38.7	50.9	67.4	85.3	98.0	105.8	110.5	114.5	118.5
External debt / GDP	26.5	22.2	28.9	37.7	37.1	33.0	33.4	34.9	36.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	18.1	19.9	17.4	16.8	16.7	21.1	21.8	21.5	21.0
Short-term debt/International reserves (%)	52.8	46.1	48.4	55.3	55.8	79.6	87.0	91.5	95.4

Quarterly Economic Indicators	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.1	-1.5	-0.9	-1.1	-0.4	2.6	1.4	2.0	1.8
CPI, % yoy	52.7	55.4	58.5	67.6	75.0	83.7	83.4	82.1	80.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	12.88	13.53	13.41	14.71	15.88	14.53	14.41	15.71	16.88
VEF/USD, eop	6.29	6.29	12.00	12.00	12.00	19.80	19.80	19.80	19.80

Source: National Sources, Citi Research

Notes

Appendix A-1

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