

Emerging Markets Macro and Strategy Outlook

Prospects for 2014 and beyond

- Three questions are likely to dominate investors' thinking about EM in 2014. The *first* is about the future of capital flows to EM: will Fed 'tapering' and the prospect of US monetary tightening cause sustained outflows from EM? The *second* is about EM's export recovery: will EM's recent export slump ever reverse? And the *third* is about China: will 'China risk' re-emerge as a threat to EM growth?
- We think it is worth being cautious about the outlook for capital flows to EM. Net portfolio flows have been stronger in recent years than we've seen them since 1993 – the year that preceded the 'Tequila' crisis. To be sure, there are good reasons to think that the rise in flows to EM has some 'sticky' characteristics: investor 'home bias' has fallen in recent years, and the global fixed income asset class has grown.
- But equally there are reasons to think that there have been 'excessive' inflows into EM. Capital outflows from EM will pick up, we think, at whatever stage the *front-end* of the US Treasury curve starts to shift upwards. For some large EMs, cross-border borrowing from international banks has risen sharply, and these flows could be threatened when short-term US rates rise. We create a 'Vulnerability Index' that tries to identify where the risks lie.
- Could EM gain on the current account – through export growth – what it loses on the capital account? Structural reform might be one way to achieve this, but the evidence is mixed. Another is that EM might be 'bailed out' by a strong DM recovery, but we continue to worry that DM's recovery may be less EM-friendly than in the past. A third path towards export recovery is real exchange rate depreciation. Indeed, we expect EMFX to weaken by 4% on average next year.
- The third question is about China, and in recent months, investors have had good reasons to become less panicked about the downside risks to China's growth: August through October 2013 saw three consecutive months of double-digit industrial production growth, and the market has responded warmly to the reforms outlined in the Third Plenary. The result is that indicators of fear about China – the 5 year CDS spread, for example – are currently very low by historical standards.
- But we think the distribution of outcomes for China next year seems skewed. China's growth model shows vulnerability in a number of areas: poor demographics, falling productivity, over-investment and high leverage. We investigate the parallels between China today and two earlier episodes: Japan in the early 70s and Korea in the 1990s, both examples of credit-fuelled, investment-heavy growth that ended in an abrupt slowdown. If 'crisis = vulnerability + trigger', we think the market will continue to wrestle with the factors that might trigger 'China risk' in 2014.

EM Economics and Strategy

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

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Prospects for 2014 and beyond

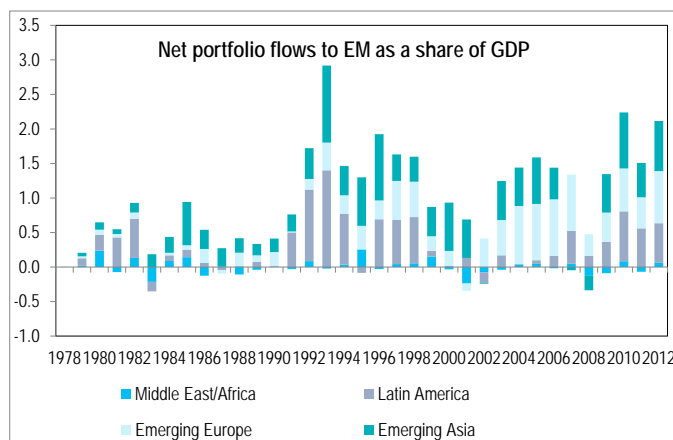
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With thanks to Ilker Domac

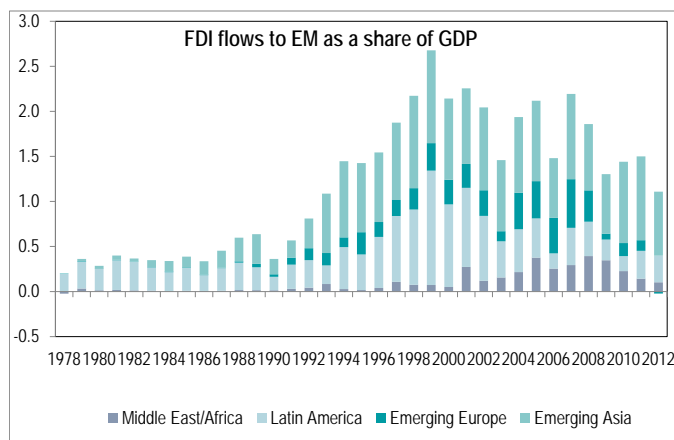
Three questions are likely to dominate investors' thinking about EM in 2014. The *first* is about the future of capital flows to EM: will Fed 'tapering' and the prospect of US monetary tightening cause sustained outflows from EM? The *second* is about EM's export recovery: will EM's recent export slump ever reverse? And the *third* is about China: will 'China risk' re-emerge as a threat to EM growth? These three questions were very broadly discussed among investors during the course of 2013, and so in a sense 'nothing's new' as we go into the New Year. Overall we find it difficult to come up with optimistic answers to any of these questions, and so we think it makes sense to be quite cautious about the environment facing emerging markets. That said, there are few market participants these days that are truly optimistic about EM: the risks facing this group of economies are increasingly well-understood. Since the perception of those risks is, to some degree, reflected in asset prices now, there probably isn't a strong case to argue that EM faces a 'crisis'. Indeed, a better way to think about EM is that it faces a '*chronis*' – no abrupt chaos necessarily, but rather a series of small, albeit painful, adjustments in asset prices as investors get used to a world where EM is no longer characterised by rapid, export-led growth and large accumulations of fx reserves; but is driven instead by slower growth, slightly weaker sovereign balance sheets, and more reliance on domestic spending.

Figure 1. Portfolio flows to EM in 2010 and 2012 reached levels, as a share of GDP, almost as high as in 1993, just before the Tequila crisis...



Source: IIF, Citi Research

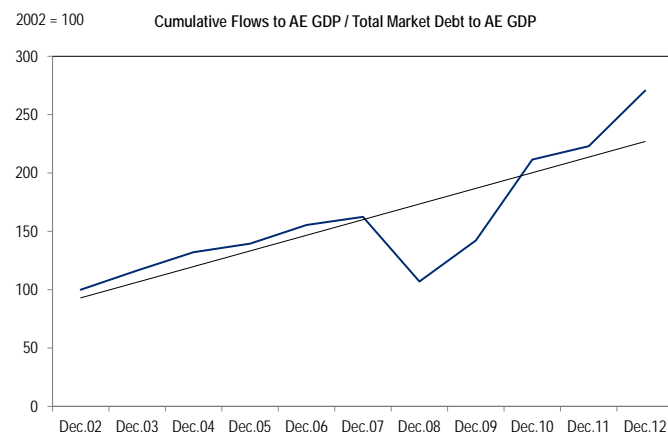
Figure 2. ...while FDI flows have diminished since their late 1990s peak



Source: IIF, Citi Research

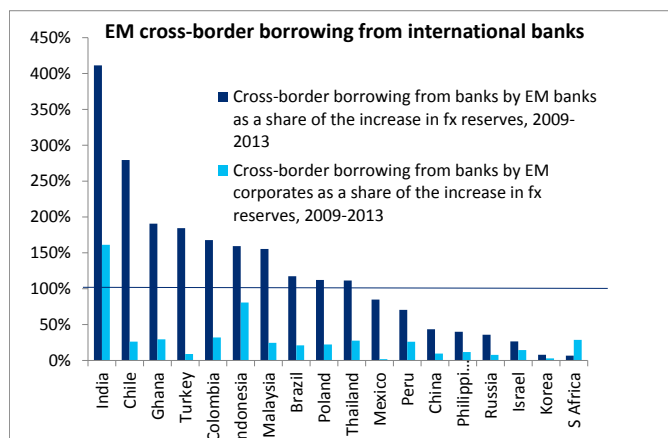
We think it is worth being cautious about the outlook for capital flows to EM. Net portfolio flows have been exceptionally strong in recent years (Figure 1), stronger than we've seen them since 1993 – the year that preceded the 'Tequila' crisis. And in some respects at least, the rationale behind the recent surge in capital inflows is similar to what it was then: a period of extremely loose US monetary policy. Of course, there are substantial differences between EM now and EM 20 years ago: the accumulation of fx reserves in recent years has created big pools of 'self-insurance'; pegged exchange rate regimes have, for the most part, given way to floating exchange rates; and the *composition* of capital flows has improved in the sense that currency risk is better-shared these days between debtors and creditors, whereas in the past it resided mostly with debtors in EM. And there are other reasons why 'this time might be different' for capital flows, and why capital flows to EM in particular should have increased over time. One is simply that the global fixed income asset class has grown over time. Fixed income share of advanced economies GDP grew 47% between 2002 and 2013. It is only natural that allocations to EM would grow in tandem with that growth. Nevertheless, cumulative inflows into EM captured a growing share of global fixed income portfolios representing today an allocation 170% larger than in 2002. Another reason for increasing capital flows to EM is the fall in 'home bias' among investors.

Figure 3. When standardised by the growth of global fixed income, EM inflows do appear 'excessive' in recent quarters...



Source: IMF, BIS and Citi Research.

Figure 4. ...and a substantial increase in cross-border exposure of international banks creates risks around a rise in short-term US rates



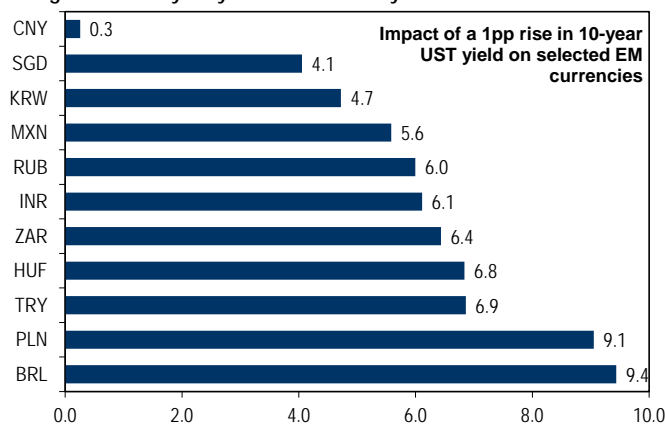
Source: BIS, Citi Research.

Much of the capital that has flowed into EM will be unwilling to leave, but there are also reasons to suspect that there have been 'excessive' inflows.

The IMF's analysis of this suggests that the 'excess' bond flow to EM has been between US\$370-470 bn in the past four years. Our own results, which consider the rise in flows to EM relative to the growth of the global fixed income market, are broadly similar (Figure 3). On this analysis, we find inflows were 'too high' by approximately US\$165bn. If we assume that there has been excess, the corollary of this is that there should be some pull-back in the coming quarters. Why? Simply that expected changes in US monetary policy create uncertainty about the outlook for capital flows to EM. Indeed, EM's sensitivity to rising US Treasury yields was a dominant theme of 2013, and it would probably be prudent to assume that further increases in US Treasury yields will remain a source of stress for EM currencies and bond markets. Figures 5 and 6 provide a statistical approach to understanding the sensitivity of fx and CDS spreads to rises in US 10 year yields, relying on 28 weeks' worth of data between May 2013 and November 2013.

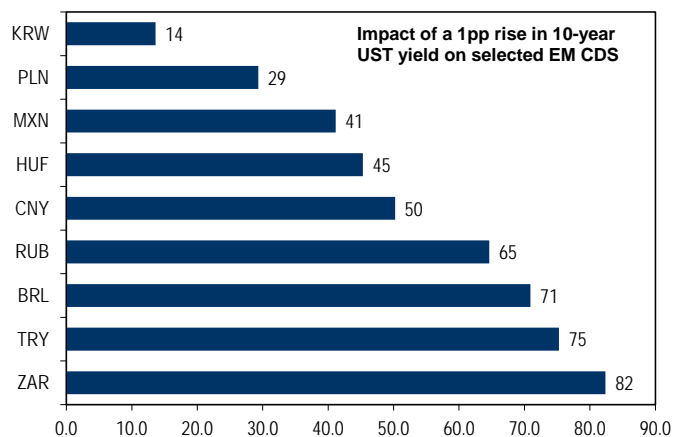
Capital outflows from EM will pick up further, we think, at whatever stage the front-end of the US Treasury curve starts to shift upwards. For some countries – India, Chile, Turkey, Colombia, Indonesia, Malaysia, Brazil – cross-border borrowing from *international banks* has also been an important feature of their capital inflows, and these flows could be threatened when short-term US rates rise. To be sure, banks are less important overall as a supplier of cross-border capital to EM than they used to be. In the 1970s, banks were the overwhelmingly dominant source of external financing from EM, and that's changed: between 2009 and 2012, banks were responsible for only 15% of net flows to EM (it was 65% between 1978 and 1982). But for some countries, especially those mentioned above, the rise in inflows from banks in recent years has been strong, and has in many cases helped to finance domestic credit booms. Between 2009 and June 2013, net cross-border inflows from banks amounted to US\$170 billion for Brazil; US\$580 bn for China; US\$116 bn for Turkey; US\$147 bn for India. Figure 4 suggests that flows from international banks to a range of countries have more than financed these countries' reserves accumulations since 2009. And why might banks lose risk appetite when the front end of the US curve rises? The reason for this is that banks tend to fund themselves at the shorter end of the US curve, and so their willingness to continue extending cross-border credit to EM might be constrained as we get closer to rising short term US rates. Certainly, the history of capital flows to EM points to a high degree of sensitivity to increases in Fed Funds.

Figure 5. EM currencies exhibited a high degree of sensitivity to changes in US 10 year yields between May and October...



Source: Citi Research. The equation used is $\Delta \text{EXR}_t = \text{constant} + \beta \Delta \text{UST}_t + u_t$, where ΔEXR is the weekly percentage change in the currency, and ΔUST is the change in the US 10 year yield.

Figure 6. ...and so did EM CDS spreads

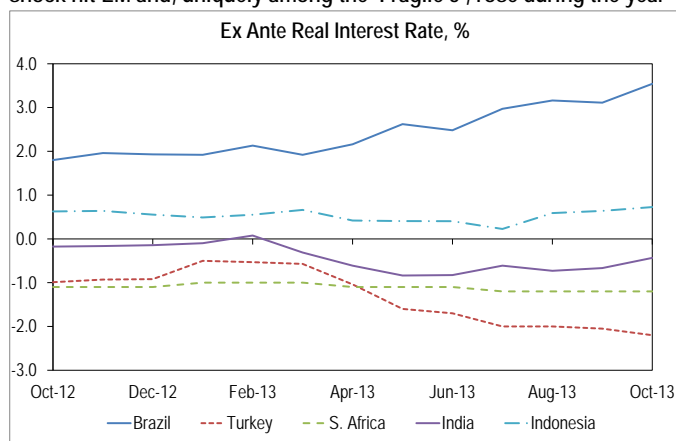


Source: Citi Research. The equation here is $\Delta \text{CDS}_t = \text{constant} + \beta \Delta (\text{UST})_t + u_t$

The shocks that EM received during 2013 from rising US yields raise the question: exactly what constitutes vulnerability?

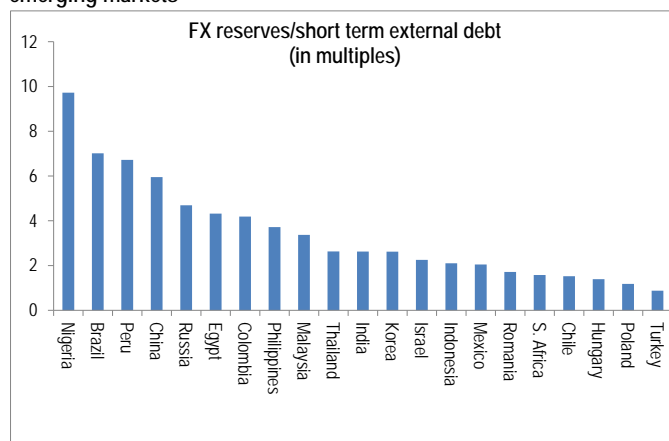
The casual answer to this question tends to focus on large current account deficits overwhelmingly financed by volatile capital flows; real interest rates that are too low to attract funding for external deficits; and levels of fx reserves that provide inadequate levels of self-insurance. Yet this is a partial approach to capturing the factors that constitute vulnerability in EM. Take Brazil for example: Brazil's real policy rate is very high by global standards and, uniquely in EM, actually went up during 2013. Moreover, Brazil's current account deficit, just over 3% of GDP, is largely financed by FDI, and its level of reserves adequacy is among the strongest in EM (Figures 7 and 8). So the inclusion of Brazil in the group of countries so badly affected by rising US Treasury yields suggests that the analysis of vulnerability must go deeper than a simple understanding of external financing constraints.

Figure 7. Brazilian ex-ante real interest rates were high before the May shock hit EM and, uniquely among the 'Fragile 5', rose during the year



Source: IMF, Citi Research.

Figure 8. Brazilian reserves adequacy is also among the highest in emerging markets

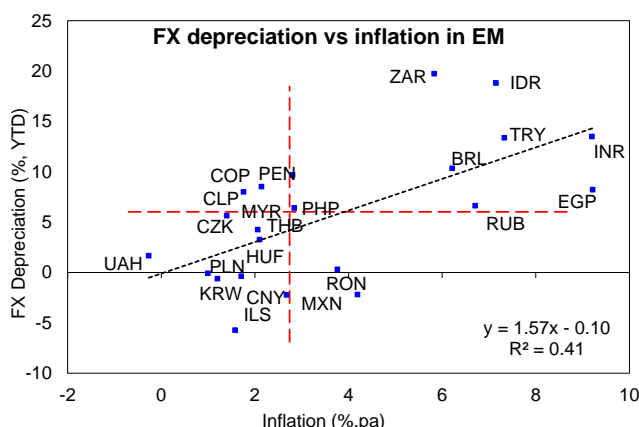


Source: Bloomberg, Citi Research

A broad approach to understanding vulnerability in EM will include measures of stress in the public sector, external accounts, financial system and in the corporate sector. Against this backdrop, the obvious starting point in our case is to investigate the link between the currency depreciation (our measure of crisis incident) and standard vulnerability indicators. To this end, we focus on the 2013 EM sell-off.

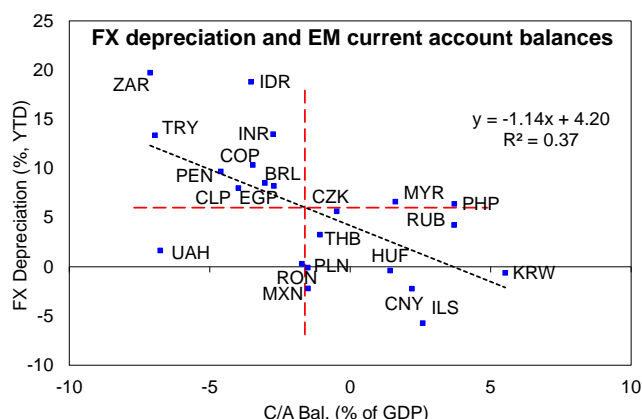
Specifically, we look at the link between year-to-date exchange rate depreciation and our (latest) 2013 forecasts for vulnerability indicators. Our findings suggest that credit growth, inflation, reserves (% of GDP) and current account balance (% of GDP) are the most relevant variables in explaining the currency depreciation during the most recent EM sell-off episode (Figures 9 and 10). Surprisingly, a number of standard vulnerability indicators (Reserves % of C/A balance + short-term external debt, short-term external debt/reserves, REER misalignment, and fiscal variables, etc.) contain little explanatory power for the exchange rate movements during the recent sell-off. It is worth noting that our findings don't suggest these variables aren't important in terms of capturing vulnerability. Instead, the results imply that headline vulnerability indicators such as credit growth, inflation and current account deficit itself have played a more important role in shaping investors' decisions during the recent sell-off.

Figure 9. Our analysis suggests that inflation dynamics are an important determinant of vulnerability to an fx sell-off...



Source: IMF, Citi Research.

Figure 10. ...in addition to the more intuitive vulnerability created by large current account deficits



Source: Bloomberg, Citi Research

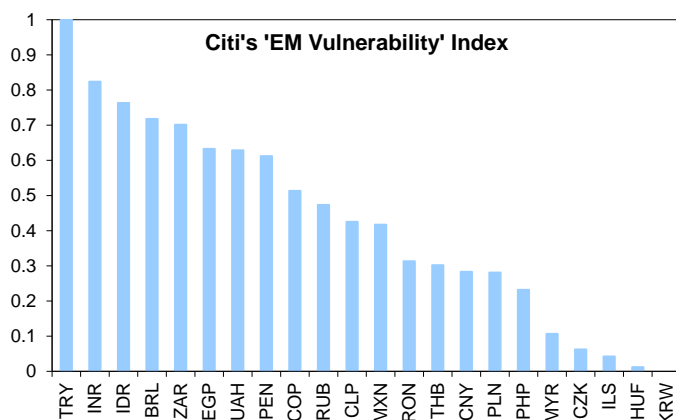
Based on our empirical results, we construct a Vulnerability Index consisting of variables that seem to have a closer link with the exchange rate movements during the recent sell-off: C/A balance as a % of GDP, inflation, credit growth and reserves as a % of GDP. In order to ensure robustness, we consider two versions: (i) using equal weights and (ii) using weights based on regression analysis (weighted).¹ Using our latest 2014 forecasts, Figure 11 presents a forward-looking version of our (weighted) Vulnerability Index. Given that the Index reasonably explains some of the exchange rate vulnerability that we saw in 2013 (Figure 12), the conclusion is that the countries most obviously affected by risk aversion this year – Brazil, India, Indonesia, Turkey, South Africa - continue to look vulnerable going into next year.

EM is unlikely to face a 'sudden stop', but if capital inflows prove to be scarcer, we doubt that EM will be able to offset the impact of this with a sharp increase in export growth. In the past, episodes of capital outflow from EM have often been described as 'sudden stops', as though flows are governed by a kind of 'on-off' switch. Bond issuance data for 2013 suggests that EM is far from suffering a 'sudden stop' in this way: monthly issuance in September 2013, following four months of fear about US 'tapering', was US\$58 bn, only US\$2 bn short of the US\$60 bn issued in January this year. One reason for this is that, after all, EM

¹ We regress the exchange rate depreciation (year-to-date) on variables under consideration. The estimated regression coefficients are as follows. C/A balance (% of GDP)= -0.8; credit growth=0.3; inflation=0.89; reserves (% of GDP)=-0.02.

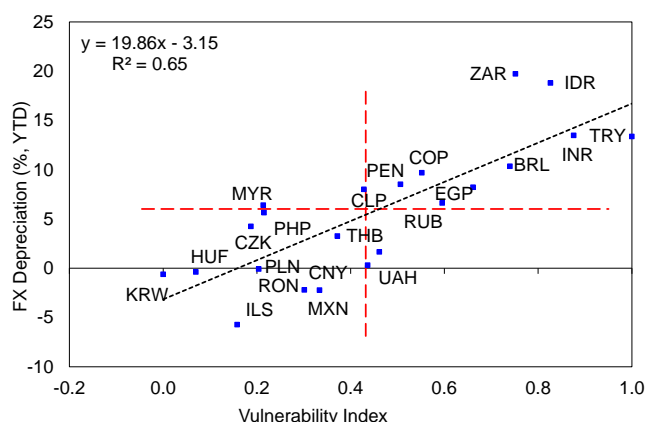
fundamentals are considerably better than they were during previous episodes of capital outflow. Another is based on the idea that what EM loses on the capital account (through capital outflows) it might recover on the current account (through export growth). In principle, there are three main paths towards optimism about EM export growth. One is that 'structural reform' in EM can impressively increase the supply capacity of EM exporters. Another is that a recovery in DM demand conditions will help to fuel a recovery in EM export growth. And if neither of these work, a third path towards export recovery is real exchange rate depreciation: EM re-prices its goods and services to levels that allow exports to grow.

Figure 11. Our EM vulnerability index - based on credit growth, C/A , reserves and inflation - provides a snapshot of risks going into 2014...



Source: Citi Research

Figure 12. ...given that the Index is reasonably helpful in explaining currency risk in 2013

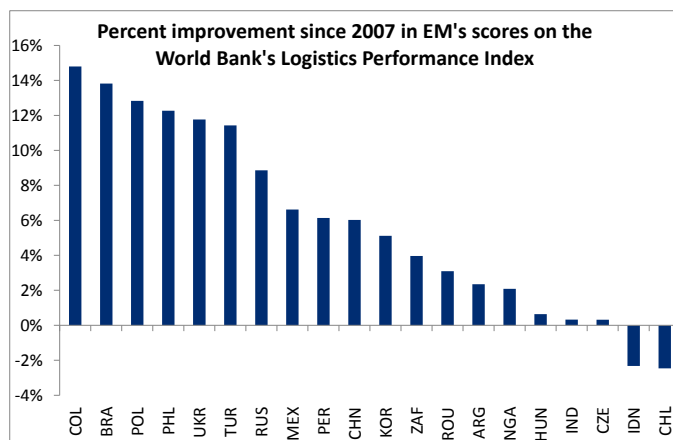


Source: Citi Research

A weaker environment for capital flows has led to a more visible debate about structural reform in EM. One question worth considering: why has it taken so long for 'structural reform' to occupy centre-stage in the debate about economic policy in EM? In some countries, of course – China, Mexico, India – the debate isn't new, but across EM it seems that structural reform is being discussed now with an urgency that was lacking in previous years. One reason for this, we think, can be traced back to the EM crises of the 1990s and early 2000s. During that period, the principal diagnosis of EM vulnerability was that it largely resulted from *weak sovereign balance sheets*: excessively high public debt/GDP ratios and inadequate levels of fx reserves. During the past 10 years, EM policymakers made a strenuous effort to address those balance sheet weaknesses, and in doing so – in the context of big gains in EM's terms of trade – helped to push into the background any other concerns about structural weaknesses. Now they are coming to the foreground.

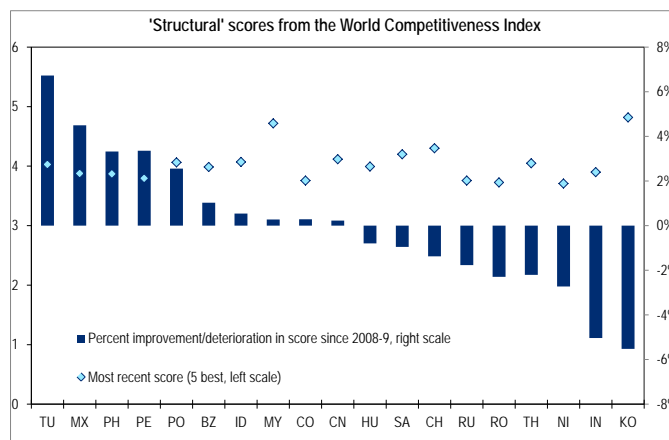
Recent progress in structural reform has been mixed, and is difficult to measure reliably. Although the debate about structural reform in EM has been reinvigorated recently, actual evidence of progress across EM is relatively mixed. Unfortunately, it is also difficult to find consistency across the most commonly known measures of microeconomic efficiency. Take, for example, the World Bank's Logistics Performance Index, whose overall score reflects perceptions of a country's logistics based on efficiency of customs clearance process, quality of trade- and transport-related infrastructure, ease of arranging competitively priced shipments, quality of logistics services, ability to track and trace consignments, and frequency with which shipments reach the consignee within the scheduled time. If we look at the performance of these indicators for various EMs over the past 5 years, the picture is relatively encouraging: with the exception of Chile and Indonesia, EMs have seen improving logistics scores between 2007 and 2012 (Figure 13).

Figure 13. The World Bank's Logistics Performance Index suggests that the microeconomic climate has improved in most EMs in recent years...



Source: IMF, Citi Research.

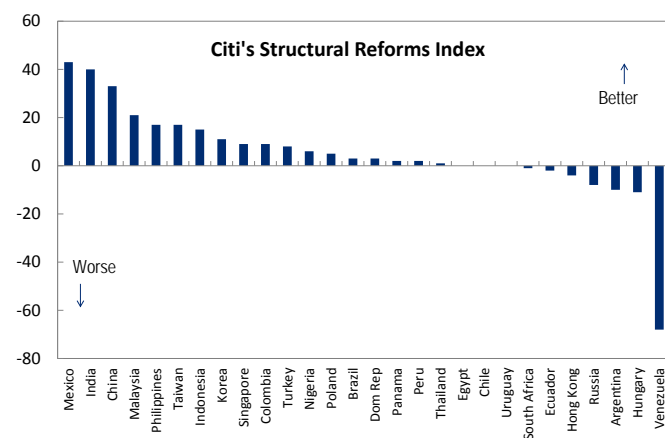
Figure 14. ...but the picture coming from the World Competitiveness Index is more mixed across countries



Source: Bloomberg, Citi Research

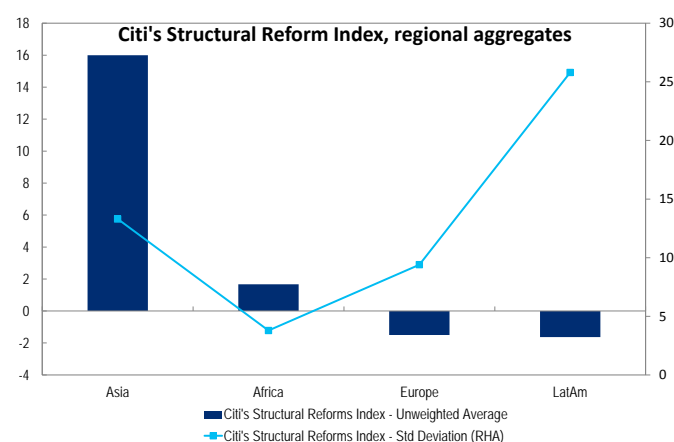
Progress according to the WEF's World Competitiveness Reports has been mixed. An alternative way of assessing what's been done in the area of structural reform is to consider the World Competitiveness Index (WCI) produced by the World Economic Forum. The WCI is divided into 12 'pillars', some of which are conjunctural – assessing the 'macroeconomic environment', for example – and some of which are purely structural. What we've done is to take some of the obviously structural pillars in the WEF's analysis and to see how countries' scores have changed in the past five years. The 'pillars' we think relevant are 'institutions' (which covers areas like intellectual property protection, judicial independence); 'infrastructure'; 'goods market efficiency'; 'labour market efficiency'; 'technological readiness'; 'business sophistication' and 'innovation'. The picture painted here (Figure 14) is much more mixed than the evidence from the Logistics Performance Index. While some countries – Turkey, Mexico, Philippines, Poland – have seen their World Competitiveness Scores improve on these structural measures there are plenty of others – Korea, India, Nigeria, Thailand, Russia, Romania – which have not.

Figure 15. Citi's structural reform index is based on our assessment of progress during 2014 in various policy areas relevant for growth



Source: Citi Research.

Figure 16. Led by India, China, Malaysia and the Philippines we expect Asia to deliver the strongest gains in structural reform next year

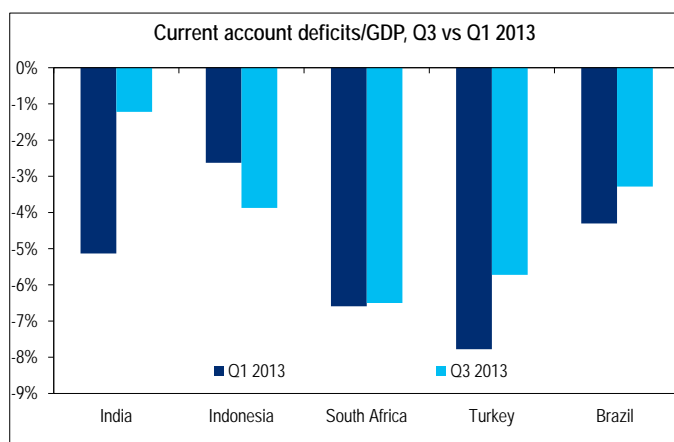


Source: Citi Research

We think structural reform, however measured, will remain an important theme next year, and we present a sketch of what we think the main issues are by country. We've surveyed Citi's EM economists to get their subjective assessment of the likelihood of structural reform progress in a number of areas: trade and capital account liberalisation; domestic financial liberalisation; tax reform; ownership; labour market reform; and land use. As Figure 16 makes clear, we expect the most from Asia, led by expected reforms in India, China, Malaysia, and the Philippines. But the picture is rather mixed across EM, and as with all reform: expectation is one thing, delivery another.

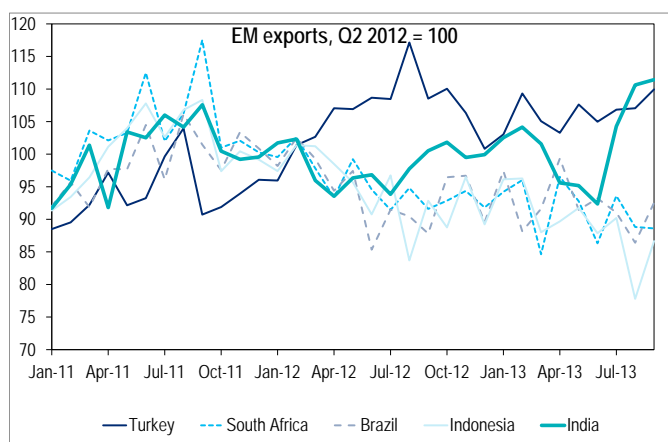
Our expectations about structural reform across EM confirm what has become evident during 2013: Asia's resilience stands in contrast to the vulnerabilities that exist in other parts of EM. Take India for example: we expect Indian reform process to accelerate next year; and it is, by a long way, the country that has done the most to shrink its current account deficit in the aftermath of the 2013 sell-off. This adjustment effort (Figure 17) is partly built on a recovery of exports – India's export growth rate is one of EM's highest currently – and is also a function of administrative efforts to restrict gold imports, which in 2012 accounted for 10% of India's import bill.

Figure 17. Current account adjustment has been much more impressive in India than in any of the other deficit economies...



Source: Citi Research.

Figure 18. ...partly generated by a much more rapid Indian export recovery than others have seen



Source: Citi Research

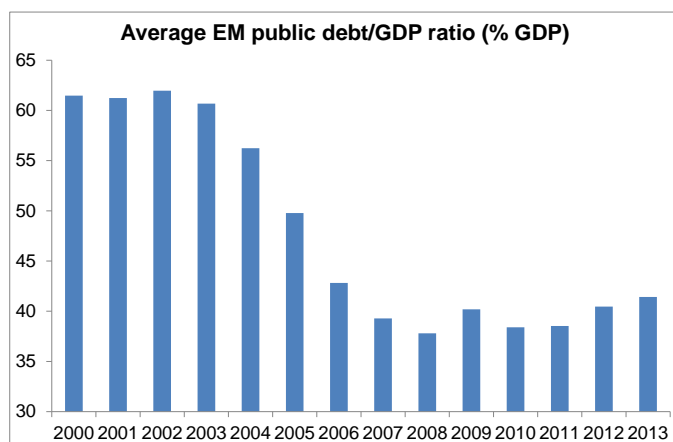
Vulnerability is partly enhanced by officials' reluctance to tighten policy. The weak growth environment in 2013 constrained the policy response to the capital outflows that started to become visible in May. A country can produce a nasty current account deficit in one of two ways: either i) the economy is overheating, causing import growth to accelerate; or ii) exports are weak because global demand conditions are poor. If it's the former, then it is easy for policymakers to put together a decisive response: the central bank will be happy to raise interest rates aggressively to address overheating concerns, and the government might also be willing to tighten fiscal policy for the same reasons. But when the deficit is generated by weak export growth, policymakers will be much less willing to do what's needed to shrink the external financing gap. The cost of tightening is just too great, in terms of lost GDP growth.

The unwillingness of EM officials to tighten policy is equally evident in central banks and finance ministries. EM central banks these days are faced with two problems. One is that - for many countries - inflation is uncomfortably high. In Brazil, Russia, South Africa, Indonesia, India, amongst others, inflation is above target, and that problem has been magnified by the exchange rate depreciation of recent months.

But at the same time, the persistence of weak activity (partly explained by weak export growth) makes central bankers reluctant to depress domestic spending. And central bankers feel entitled to think this way, because the intellectual climate in the past few years has moved away from 'pure' inflation targeting towards a greater emphasis on 'flexible' inflation targeting. There is barely an EM central banker on the planet these days who believes that their mandate is to pursue the inflation target no matter what the cost to the real economy.

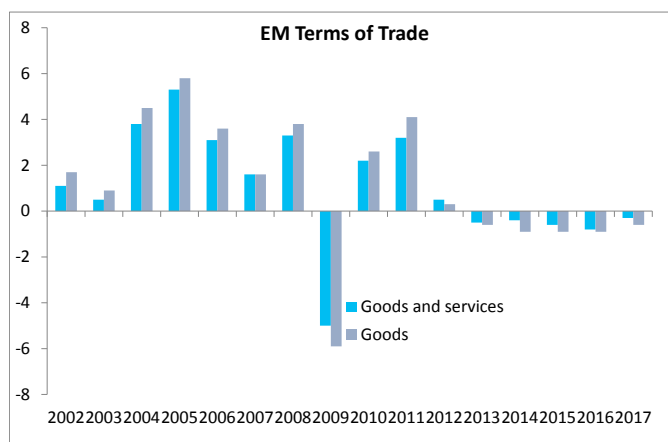
And it's not only monetary conditions that stay loose, but also the fiscal stance. As we've highlighted in past research, all of the large EMs with current account deficits and capital outflows – Brazil, India, Indonesia, South Africa and Turkey – have important elections coming up in 2014. That argues against a tighter fiscal stance, particularly since governments seem keen on pushing a slightly looser fiscal policy in order to compensate for weak external demand and to plug their admittedly substantial infrastructure deficits. And in general, we think it makes sense to expect some marginal deterioration in public debt ratios in EM. Average debt/GDP ratios have, we think, seen their best days, as Figure 19 suggests. Since EM can no longer rely on the very positive terms of trade improvement that characterised the period between 2002 and 2008 (Figure 20), public sector balance sheets should automatically take up some of the burden of supporting growth. One implication of this is that EM will probably find it difficult to sustain the steady improvement in sovereign creditworthiness that has helped to define the asset class since 2004.

Figure 19. Fiscal policy is likely to stay relatively loose...



Source: Fitch Ratings, Citi Research.

Figure 20. ...as long as the EM terms of trade stay substantially less benign than they were in the 2000s, which appears to be the IMF's view

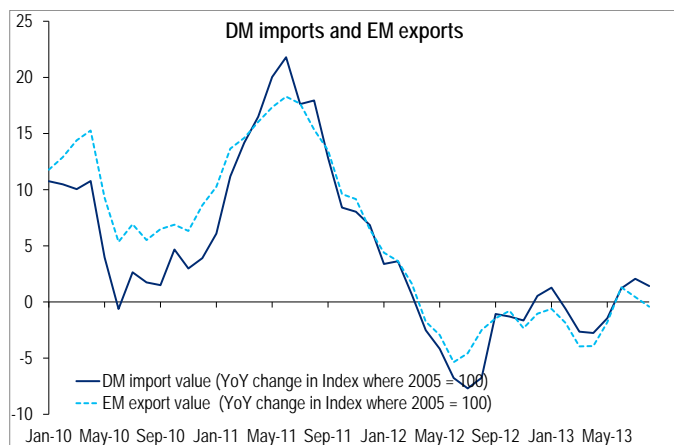


Source: IMF

EM could conceivably be 'bailed out' by a positive external demand shock, but the evidence so far is mixed. As we showed earlier, export growth from EM has had its bright spots in recent months: India, for example, or to a lesser extent Turkey (Figure 18). Yet overall, the EM's export performance has been disappointing in the past few quarters, and this is perhaps the central component in the whole story of EM's slowdown of 2012 and 2013. The biggest cause by far of this export disappointment has been the fact that world trade growth remains unusually weak. Data from the CPB in the Netherlands show world trade volumes (goods only) up by just 2.1% YoY in January-August, less than the IMF's 2.9% forecast for 2013 world GDP growth. By contrast, in the pre-Lehman period, world trade growth on average usually grew 1.5-2 times as fast as global GDP. For example, over 1980-2007 as a whole, global GDP growth (real terms) averaged 3.5% YoY, while world trade growth in goods and services averaged 6.1% YoY – an average elasticity of 1.8 times.

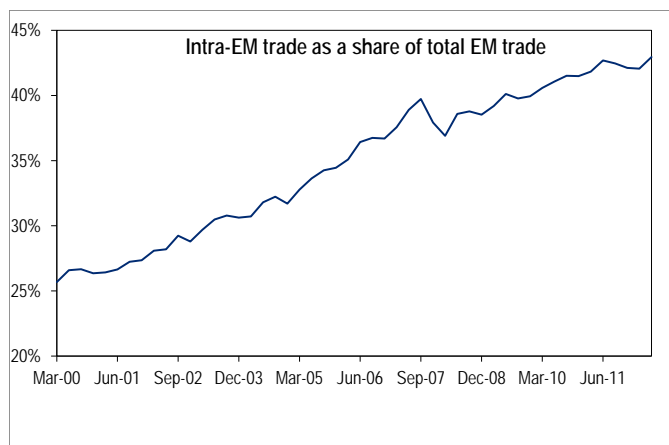
We continue to think that DM growth may not be as import intensive as it has been in recent years. (See [Emerging Markets Macro and Strategy Outlook - Will DM's Recovery Be EM-friendly?](#)) . Real exchange rates (deflated by unit labour costs) of the US, Japan and UK are 14%, 21% and 5% respectively below their 1994-2007 averages, making room for import-substitution. And since we expect a Eurozone current account surplus of some 2.6% GDP over the next 2 years, the external demand environment facing EM is likely to remain somewhat constrained. Although intra-EM trade may continue to grow, it remains less than half of EM's total trade; and the rate of its growth seems to have decelerated in recent years (Figure 22). All in all: if capital flows, structural reform and export growth are all subject to some doubt going into 2014, the burden would be on currencies to take the strain. On average, we expect EMFX to weaken by 4% in 2014. And that burden would grow if China is, once again, a source of shock for EM, as it seemed to be in the middle of 2013.

Figure 21. EM export growth seems constrained by weak DM demand, and a slight recovery in DM import values this year didn't help much



Source: CPB Netherlands; Citi Research

Figure 22. Intra-EM trade has grown, but the pace at which it has grown has been weakening recently



Source: IMF; Citi Research

China's growth model is looking increasingly strained. The ability of the economy to deliver sustained (high) growth, without continued policy impulse seems to be dwindling. As the authorities (including the PBOC and CBRC) move towards containing some financial excesses, economic activity could well show another leg of disappointing growth. Overall, we think the debate about China's susceptibility to a sharp slowdown will stay alive during 2014.

One way of assessing China's vulnerability to an abrupt slowdown is to look at Asia's economic history over the past 40 years. Chinese officials themselves sometimes talk about Japan's slowdown in the mid-1970s and Korea's slowdown in the late 1990s as a way of explaining the inevitability of China's transition to a weaker level of GDP growth. But Japan's experience in the 70s, and Korea's in the 90s, are not obviously auspicious precedents for China: both these countries suffered a very abrupt slowdown after a period of strong, credit-fuelled, investment-led growth which boosted their investment/GDP ratios to historically high levels².

² See, for example, 'China's Rebalancing: Lessons from East Asian Economic History', John L. Thornton China Center Working Paper Series, October 2013, by David Dollar; and 'Rebalancing China's Economic Growth: Some Insights from Japan's Experience', by Tomoyuki Fukumoto and Ichiro Muto, Bank of Japan Working Paper Series No. 11-E-5, July 2011; 'An Economy in search of stable growth: Japan since the oil crisis', by Nakamura Takafusa, The Journal of Japanese Studies, Winter 1980.

Japan and Korea's experience during these years were also associated with rapid appreciation of the real exchange rate, which has also been a feature of China's economic development in the past few years. Of course, the abrupt slowdown that 70s Japan and 90s Korea faced didn't put a stop to their development: per capita income levels continued to rise in PPP terms after a one-year shock (1974 for Japan, 1998 for Korea). But the decline in average GDP growth was notable in both cases. In Japan, GDP growth averaged 8.6% in the five years up to 1973, but only 3.1% in the five years from 1974; while in Korea, GDP growth averaged 7.4% in the five years up to 1997, but only 5% in the five years from 1998. Each country suffered a year of recession: 1974 in Japan, 1998 in Korea.

To be sure, there are plenty of differences between China now and other Asian economies in the past few decades. Japan and Korea were both somewhat richer economies than China is today; both were more urbanised; and Korea's economy in particular had a different path of development in the sense that it ran a current account deficit, rather than the surpluses that existed in 1970s Japan or 2000s China. These differences are summarised in Figure 23.

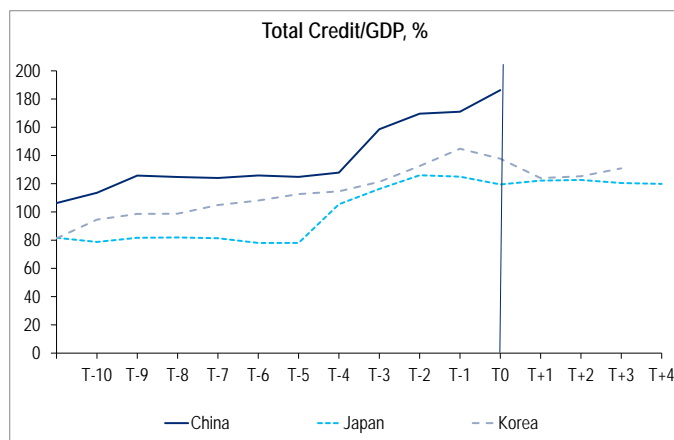
Figure 23. China now, Japan and Korea then: similarities and differences.

	GDP/capita	Urbanisation	CA/GDP	(X+M)/GDP	Peak I/GDP	Credit/GDP
Japan, early 1970s	13,771	72%	1.8	22%	39%	140%
Korea, mid 1990s	17,893	78%	-2.3	49%	39%	132%
China today	8,069	50%	2.2	44%	51%	186%

Source: Citi Research

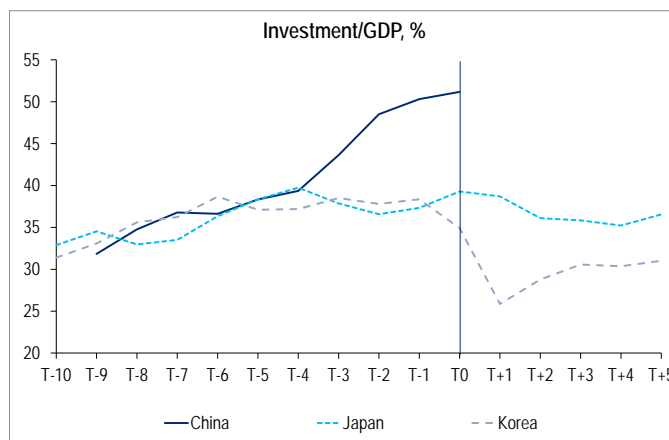
But the vulnerabilities created in Japan and Korea in past decades show some 'family resemblances' to what's going on in China these days. Japan saw a very large increase in private sector credit extension during the early 1970s, which led the total stock of bank credit to the private sector grow from 82% GDP in 1969 to 143% GDP in 1973. But one remarkable feature of the rise in Japanese leverage in the early 1970s is that bank loans to the private sector tell only a small part of the story. In order properly to understand Japan's credit boom in the early 1970s – very like China's today – a broader definition of credit is needed. Including credit from non-banks to local governments and to SOEs, the build-up in Japanese leverage at that time was remarkable, rising quickly to 199% of GDP in 1973. Pre-1973 Japan was characterised by very loose monetary policy which, among other things, led to speculative acquisition of land. Unlike today's China, though, Japan did also experience a sharp rise in inflation in 1971-1972, to which policymakers responded by tightening monetary policy in spring of 1973, several months before the economy's slowdown was triggered by the external shock of the oil crisis. In Korea, too, the years preceding 1997 saw a build-up of bank credit but, in a similar way to Japan, the economy's leverage wasn't purely a bank-led phenomenon: including credit from specialised institutions and other lenders, the total credit stock in Korea rose from around 108% GDP in 1993 to 145% in 1997.

Figure 24. Substantial accumulation of credit stocks was evident in Japan in the early 1970s and Korea in the 1990s...



Source: Citi Research

Figure 25. ...and those credit stocks helped to keep investment ratios high until an external shock triggered slowdown and rebalancing.

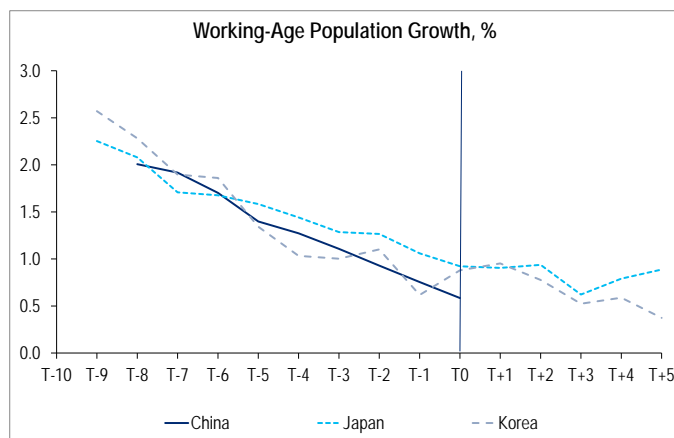


Source: Citi Research

The pre-crisis periods in Japan and Korea were also characterised by a big rise in investment spending. In Japan and Korea, the extension of credit was heavily oriented towards investment spending, as is the case in China today: the ratio of investment to GDP rose from 32% in 1967 to 36% in 1973 in Japan. And in Korea too, the investment/GDP ratio also rose from 32% to 37% between 1990 and 1997 (although it did briefly rise to 39% in 1991). In Japan's case, this credit-fuelled investment boom was also marked by a couple of other similarities to China: a network of cooperative relationships between banks, firms and suppliers (the *keiretsu* system); and a strong element of financial repression, in which the household sector was effectively providing a subsidy to manufacturing as a consequence of excessively low real interest rates.

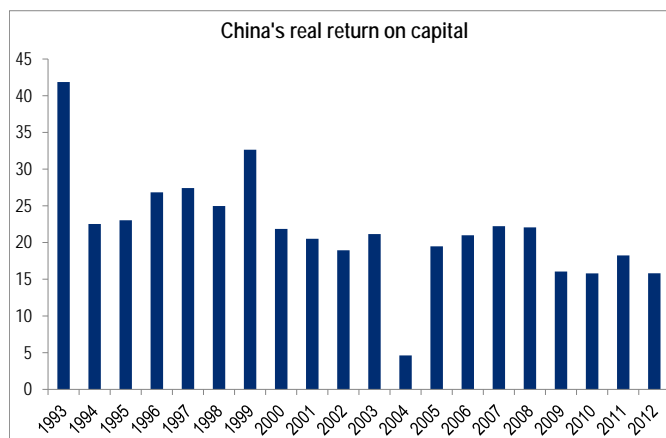
In Japan, the credit-fuelled investment boom was associated with a rise in the real exchange rate. Korea's pre-crisis experience didn't have much impact on the real exchange rate, which remained broadly stable in the years running up to the 1997 crisis. However, Japan's experience with its real effective exchange rate was arguably more similar to what we're seeing in China. The Yen appreciated by around 25% between 1969 and 1973. This was partly the result of the Smithsonian agreement of 1971, which revised exchange rates under the Bretton Woods regime that had been in place since 1944: the yen appreciated under from 360/\$ to 308/\$. China's real exchange rate has appreciated by 15% since late 2008, largely thanks to a hefty nominal exchange rate appreciation since the Yuan was 'de-pegged' in 2010. Nominal exchange rate appreciation seems to be consistent with China's objectives to 'internationalise' the Yuan. Since China lacks deep and liquid capital markets and an internationally accessible legal system – factors which help to underpin, say, the Euro or the Dollar as international currencies – it seems to be offering nominal exchange rate stability as a substitute.

Figure 26. Japan and Korea saw sharp declines in the growth rate of their working age populations in the run-up to their slowdowns



Source: Citi Research

Figure 27. Less efficient credit-dependent growth has put downward pressure on the return on capital in China

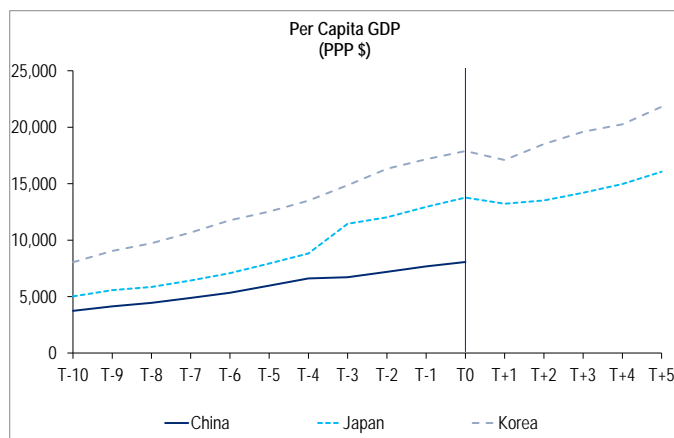


Source: Citi Research. The real return on capital is defined as the capital share of income divided by the capital output ratio, less depreciation and the difference between the investment goods deflator and the GDP deflator. Methodology follows (insert)

Demographic change helped to interrupt Japan and Korea's booms. Both Japan and Korea experienced sharp declines in the growth rate of their working age populations in the years running up to their sharp slowdowns. In the five years before 1973, the growth rate of Japan's working age population averaged 1.3%, and fell to 0.8% in the five years after. In Korea, working age population growth had been as high as 2.5% in the late 1980s, and had fall to just 1% in 1997, before falling further thereafter to just 0.3% in 2003. In China, very rapid growth in the working age population ended in the 1990s, but the change is accelerating: while WAP growth averaged 1.5% in the 10 years prior to 2008, the UN expects growth this year to be just 0.3%, before contracting from 2016. A declining working age population implies that without a simultaneous reallocation of workers to higher productivity jobs, potential GDP growth decelerates. And, if growth slows down for this structural reason, resolving other imbalances becomes increasingly taxing.

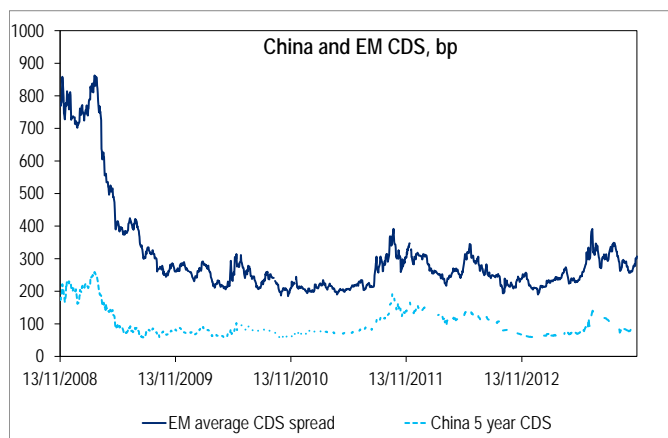
Vulnerability is not, by itself, enough to bring on a sharp slowdown. The overwhelming lesson of Japan's and Korea's experiences in the 1970s and 1990s is that their sharp slowdowns were, in each case, triggered by an external shock: the oil crisis in Japan's case, and the Asian Financial Crisis in Korea's case. And this probably provides the single most important lesson for China. Whatever vulnerabilities are created by China's credit-fuelled, investment-led growth, or by the associated decline in the return on capital in China, it seems right to suppose that it will take some nasty trigger to turn that into a sharp slowdown. It seems that some informal equation – $[crisis = vulnerability + trigger]$ – holds true. By definition, of course, no one is able to predict or identify a trigger. But it is reasonable to assume that market participants will remain highly alert to whatever might trigger a possible abrupt Chinese slowdown, given the sharp slowdowns that have occurred in countries with similar development paths in the past. In recent months, investors have had good reasons to become less panicked about the downside risks to China's growth: August through October 2013 saw three consecutive months of double-digit industrial production growth, and the market has responded warmly to the reforms outlined in the Third Plenary. The result of these developments is that indicators of fear about China – the 5 year CDS spread, for example – are currently very low by historical standards.

Figure 28. An abrupt slowdown in China won't derail the country's development if Japan and Korea's experiences are anything to go by...



Source: Citi Research.

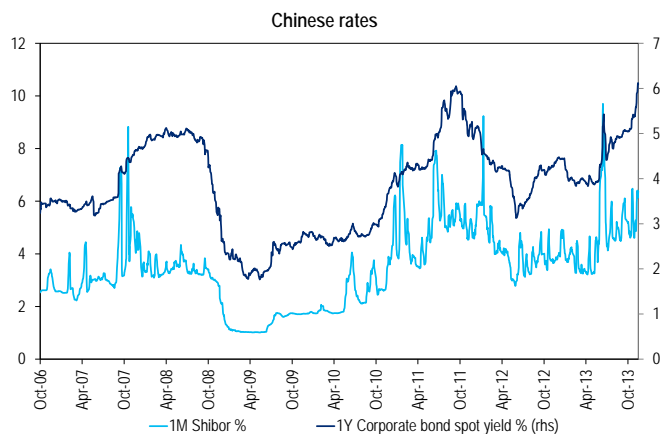
Figure 29. ...but China 5 year CDS has rarely traded at such a steep discount to the rest of EM as now



Source: Citi Research

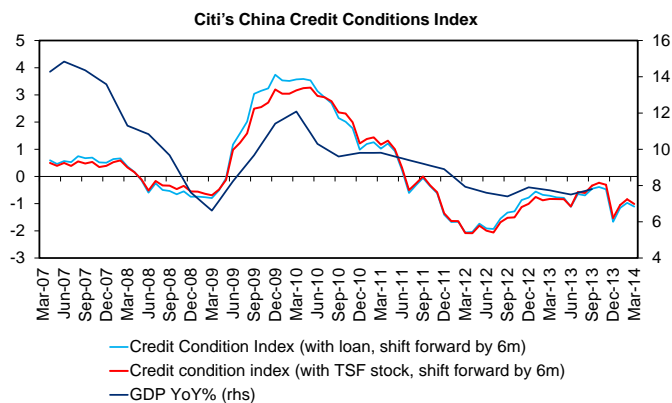
The distribution of outcomes for next year seems skewed. China's growth model exhibits problems in a number of areas: demographics, productivity, over-investment and high leverage. The reforms outlined in the Third Plenary of the 18th CCCPC last month contained elements that exceeded our expectation – land reform, for example, or investment deregulation – but implementation of the reforms may cause some deceleration in growth. Increases in land and utilities prices will probably erode profitability for the corporate sector as interest rate reform erodes the profitability of the financial sector; rural land reform, which involves redistribution of land sale proceeds in favour of farmers, will reduce the share of revenues accruing to local governments, with an impact on their capacity to invest in infrastructure; and stricter environmental standards could constrain the investment model on which China has depended in recent years. On the other hand, the reforms fell short in other key areas. There seems to be little progress on the household registration system (hukou) and rural land reform, limiting the medium term reallocation of workers to more productive activities. There is progress in opening certain sectors to investment but less progress on State Owned Enterprises, overcapacity or leverage. There is progress on financial reforms, but the risk is that deregulation proceeds faster in finance than in the rest of the economy potentially generating a credit problem. The lack of progress in these reforms could further affect that ability of the economy to sustain growth in the short term. Compounding the challenge, monetary policy has exhibited a tightening bias since June, with the result that credit conditions have tightened. And there is relatively little fiscal space in China. For all these reasons, we think it would be wise to expect further waves of nervousness about the risk of sharp slowdown in China next year, as investors grope to identify the trigger that could launch China into a major slowdown ([China Macro View - Economic Prospects for 2014: Making a Down Payment for Long-Term Growth](#)).

Figure 30. Market rates in China are drifting higher, which indicates some tightening of liquidity conditions...



Source: Citi Research.

Figure 31. ...and our credit conditions index suggests a slowdown before too long



Source: Citi Research. Note, the credit condition index uses M2, loan outstanding/TSF stock, lending attitude of banks, expected return on Wealth Management Products, corporate bond spot yield and 1M SHIBOR, assigning coefficients based on Principal Components Analysis.

Strategic thoughts for 2014

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As we look at prospects for 2014, we believe asset prices will be driven by two fundamental undercurrents. On the one hand, the global macro outlook seems somewhat less stormy than in previous years. There is, however, an emerging change in direction for US monetary policy which should impact fixed income asset markets across the board. On the other, the EM macroeconomic outlook looks mediocre in its baseline and with a significant dose of downside risks. Faced with such macroeconomic background, we ponder how should investors approach the year?

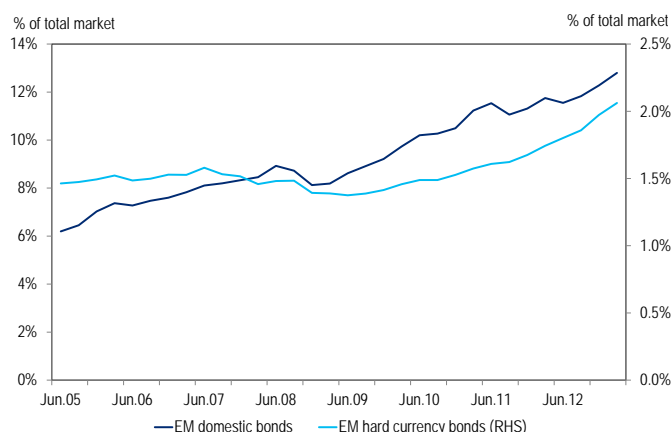
By and large, 2014 promises to be yet another global macro year. EM will perform to the tune of the global macro environment. Absent accidents in the EM space –more on that later– it is likely that market conditions in EM will fluctuate to the tune of international markets. In particular, events such as the tapering of the Fed's large scale asset purchases, and the eventual process of convergence to the first interest rate hike, look set to play a dominant role. Yet, other global uncertainties such as the first quarter fiscal discussions in the US, the consumption tax hike in Japan and the possible increase in the BoJ's asset purchase program, or the inevitable vicissitudes of Europe's grope towards debt sustainability, will also pepper the year. These factors will likely lead to volatility and, to some extent, a trend in fixed income assets. Yet, for the future of Ems, what matters most is what actions are not currently priced in or reasonably well understood.

Tapering seems to be largely priced in. Whether tapering begins in December 2013 or March 2014 is likely to have modest effects on US Treasuries markets. Since consensus holds the view that late in Q1 is the most likely date for the beginning of the process of winding down asset purchases, a December date would probably have a larger, if still somewhat modest impact (say an extra 10-15bp movement). Conversely, if tapering were to start in Q2, long rates would probably fall by a similar amount. A somewhat different story is likely to unfold as the year progresses and the focus shifts towards the first policy rate hike. At that point, we anticipate a larger response in 2-year bonds, with a potentially amplified effect on EM assets. All in all, we expect a gradual drift up of US Treasuries and, later in 2014, a flattening of the curve.

If movements in US Treasury markets exhibit moderate volatility, even if with a well-defined trend, EM asset prices are not likely to suffer as much as they did in the May-August 2013 period. However, volatility could still be an important consideration. And, late in 2014, if front end rates begin to slide, the effects on EM may be amplified. A critical force that will keep EM "en-guard" is the potential response of capital flows and one of its components, portfolio inflows into EM institutional investors.

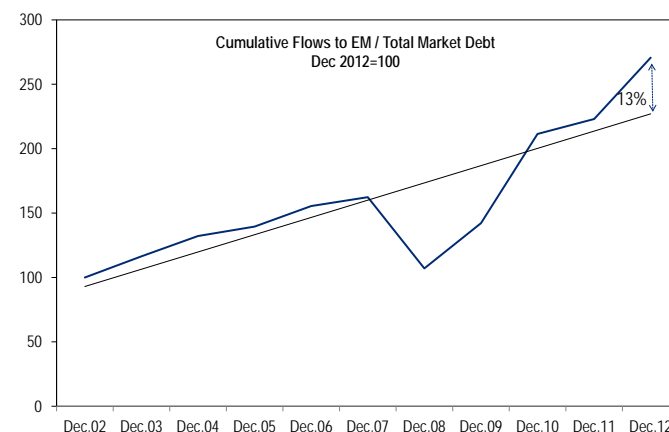
The EM asset class grew in the last few years faster than global fixed income assets did (Figure 32), in part explained by extraordinary financial conditions. The combination of low advanced economy interest rates, improved economic conditions in EM with better diversification features and greater opportunities for penetrating previously closed markets, all led to growing interest by institutional money managers into the asset class. However, inflows into the asset class exhibited a behaviour that resulted in allocations that are probably higher than those that will be observed in steady state and, thus, there is a latent risk of a correction. What may trigger a reversal of those flows is unknown. It may be a movement in US rates, a pick-up in volatility that is compounded by capital outflows, or some idiosyncratic forces. Anecdotal evidence suggests that dedicated money managers are still seeing positive inflows of AUM from institutional investors, which suggests that they are relatively stable. However, the tail event of a large capital outflow sparked by an unpredictable shock, could threaten the asset class and would likely keep investors alert.

Figure 32. The stock of EM bonds (local and external) assets has grown relative to the size of the global fixed income market...



Source: BIS and Citi Research

Figure 33. ...and cumulative fixed income flows into EM countries have grown, lately, more than would be predicted by trend growth.



Source: IMF, BIS and Citi Research

In a world where global macro factors generate moderate volatility, equity markets are expected to be driven by “the great rotation.” As fixed income markets’ yields trend higher, we anticipate investors will gradually shift their portfolio allocations towards equities. Under those circumstances, given the still abundant liquidity and low global rates, price-earnings ratios should go above their historical trends. Citi equity strategists expect that the equity markets will rally, with an anticipated increase of 15% for the MSCI and 7.5% for the S&P500. We, therefore, expect the US to underperform other markets. Given the importance of the S&P in our measures of risk aversion and most of our forecasting models, we expect the baseline for 2014 to be that of a moderate risk-on year. Naturally, we hold the same caveat for the downside risks expressed before.

There are a few idiosyncratic issues in EM that could produce some volatility during the year, but few look likely to have systemic consequences. We expect growth in EM to recover somewhat, though it is likely to remain a major concern. Questions over whether the growth slowdown is structural or cyclical are likely to continue. Key amongst those questions is China’s outlook, but it is not the only one. To spur growth and facilitate adjustment to a world with less abundant capital, structural reforms promise to gain a more central spot than hitherto. Elections in several countries, particularly those generally identified as the most vulnerable ones –the fragile five– could be an obstacle to adjustment and reforms in the short term, but could also unleash a process of reforms afterwards. The before and after of these political cycles could add some volatility. Finally, as we discuss later, a few individual countries appear vulnerable and capable of having some systemic consequences. 2014 looks like a year when EM fixed income will face a mediocre performance and when risks appear tilted to the down side. Equities, on the other hand, could perform well in the baseline scenario of no negative tail developments.

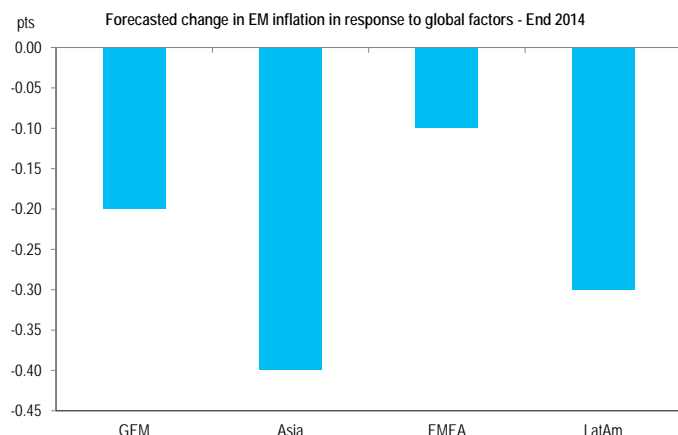
EM rates

The inflation picture in EM is diverse. In a number of EMs it is uncomfortably high (Brazil, India, Indonesia, Russia, for instance) while, in others, it is at levels that provide comfort to central banks (Korea, Chile, Colombia, Peru). Nevertheless, in 2014 we expect inflation across EM to be subject to two opposing forces. On the one hand, weak (and depreciating) exchange rates give rise to some pass-through – though very modest in our latest estimates. On the other hand, our commodities team anticipates softening commodity prices for the year (i.e. Brent oil at 95 or -9%).

Also, output gaps in EM are expected to shrink somewhat, but remain open (at about -0.4%) and thus they ought to help the disinflation effort. All things considered, we foresee EM inflation easing somewhat - about 20bp - in 2014 (Figure 34). Regionally, inflation is expected to decline 40bp in Asia, 30bp in LatAm and 10bp in EMEA.

As expected, monetary policy has tended to be responsive to domestic conditions. In countries where inflation is low and output gaps are sizeable or widening, central banks have cut interest rates (Chile, Colombia, Mexico, Korea); in others, either because inflation was a threatening force or because of concerns regarding external conditions, rates have been hiked (Brazil, India, Indonesia). As we move into 2014, the outlook for interest rate adjustments is largely dominated by expected rate increases. The process of normalization of monetary policy in the US and the need to keep current accounts properly financed (prevent sharp FX movements), concerns with stubborn though somewhat declining inflation, or the need to normalize domestic policy stances are expected to yield quite a few policy rate increases (Figure 35).

Figure 34. EM inflation is expected to ease, dominated by weaker commodity prices and some economic slack...



Source: Citi Research

Figure 35. ...yet, monetary policy is expected to tighten almost everywhere.

	Current Rate (%)	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Cumulative rate moves
Brazil	10.00	75	0	0	0	100	175
Turkey	6.58	62	30	50	50	25	217
Colombia	3.25	25	25	25	50	25	150
Hungary	3.40	-40	0	25	75	50	110
Poland	2.50	0	0	25	25	50	100
Philippines	3.50	0	0	25	25	25	75
China	3.00	0	0	0	25	25	50
Indonesia	5.75	25	0	0	0	25	50
Thailand	2.50	0	0	0	25	25	50
Israel	1.00	0	0	0	50	0	50
South Africa	5.00	0	0	0	0	50	50
India	7.75	25	0	0	0	0	25
Korea	2.50	0	0	0	0	25	25
Mexico	3.50	0	0	0	0	0	0
Peru	4.00	-50	0	0	0	0	-50
Chile	4.50	-50	0	0	0	0	-50
Russia	8.25	-25	-25	0	0	-25	-75

Source: Citi Research

Local bond yields are expected to drift higher in response to the changing domestic and global monetary policy environment. In our opinion, local bond yields depend critically on the outlook for domestic inflation, monetary policy responses and global financial conditions. Monetary policy, at home and abroad, is likely to put (significant) pressure on local bonds. On the other hand, if inflation eases, as we anticipate, and if our baseline of modest risk-on is validated, the previous effect should be somewhat muffled. Nevertheless, we imagine that in a world where 10y US Treasuries drift to 3.30 (about 55bp above current levels) EM (5y) yields should increase, on average, 42bp.

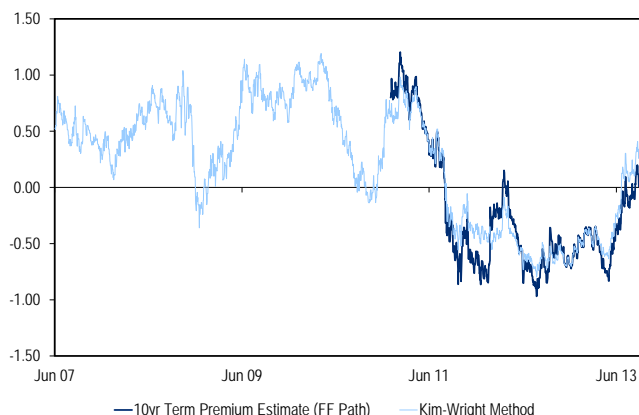
Local bond portfolios are nevertheless expected to deliver attractive returns (Figure 36). Despite the drift up in yields, the relatively short duration of local bond portfolios (slightly below 4 years) mitigates some of the impact on total returns. The anticipated movements in EMFX in our baseline forecasts represent a mixed bag with some depreciations (mostly among members of the 'fragile five') and some appreciations. Therefore, the potential attractiveness of USD returns is also reduced somewhat. Nevertheless, the high carry offered by local bonds more than compensates both factors and our market-weighted local market index is anticipated to deliver 'high' positive returns of 6.6% in 2014.

Figure 36. Despite higher yields, local market bond returns are expected to remain positive.

Country	Forecast Yield	Current Yield	Duration	FX return	Total Return (inc carry, USDs, US Funding)	Index Weights
Brazil	12.5	12.43	3.47	-6.07%	7.01%	8.02%
Chile	4.9	4.74	3.79	3.35%	7.67%	1.38%
Colombia	6.4	5.96	4.27	-0.60%	3.78%	6.50%
Mexico	5	4.72	3.43	4.35%	8.27%	16.54%
Peru	4.4	2.81	4.21	0.00%	-3.89%	1.23%
Hungary	5	4.95	4.15	-0.43%	4.50%	3.75%
Poland	4	3.75	4.26	4.51%	7.29%	12.86%
Russia	7	6.90	3.48	0.97%	7.89%	7.64%
South Africa	7.3	7.27	4	-1.37%	6.17%	8.16%
Turkey	9.1	8.98	3.96	-3.78%	5.28%	6.90%
Indonesia	8	8.02	3.85	3.14%	11.68%	6.39%
Malaysia	3.8	3.60	3.91	3.45%	6.32%	8.10%
Philippines	3.4	2.89	4.18	4.77%	5.55%	4.63%
Thailand	4	3.52	4.86	2.45%	3.69%	7.90%
Index					6.62%	

Source: Citi Research

Figure 37. Tapering talk has mostly affected “term-premia” rather than expectations of future Fed Funds rates...



Source: Citi Research

The risks to our baseline make it difficult to be very excited with local markets, despite our expected returns.

In previous historical episodes, local bonds had low betas to movements in US Treasuries. However, during 2013 local bond yields were very sensitive to changes in Treasuries. We think this is explained, to a great extent, by the fact that many of the moves in UST were driven by changes in ‘term-premia’ rather than movements in expected future interest rates. Monetary policy ought to be relatively independent across countries with floating exchange rates. However, term premia reflect deeper economic factors and could lead to greater correlation across assets and nations. In the past, term premia typically fluctuated around a mean of 0.5% with cycles of + or - 50bp (Figure 37). However, since the advent of Operation Twist and later QE3, term premia collapsed to close to -100bp. Yet, when tapering discussions gained hold, term premia corrected quickly with a move of more than 100bp. While we expect less volatility in UST once tapering gets under way, it is likely that term premia moves will still be the dominant force. Therefore, betas could remain high and high-frequency volatility could remain an important factor in EM local markets. Additionally, it is well known that FX levels are amongst the most difficult variables to forecast. In an environment like that which we expect to dominate 2014, and with risks that portfolio outflows may emerge, the uncertainty surrounding our current predictions is unusually high. In short, while returns in local markets look high relative to other fixed-income assets, they are simply compensation for the high risks involved.

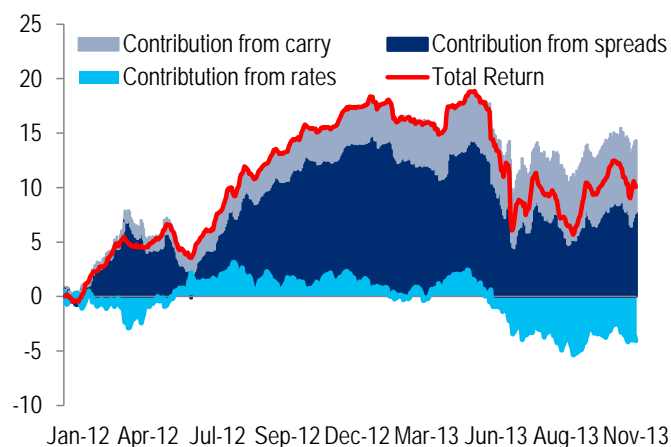
EM Credit

In our base case, we do expect modest spread tightening in credit in 2014, with the overall level compressing by about 10bp. This expectation of moderately lower spreads balances our belief that the cheapness of EM compared to other regions should drive spreads lower in most credits, offset somewhat by our view of the possibility of significantly wider spreads in the major high beta countries – Venezuela, Argentina and Ukraine. Our biggest concern is the potentially vulnerable technical landscape given low bond trading volume in the corporate space, and the lack of an efficient EM corporate CDS market to act as a hedge vehicle should larger outflows occur. Overall, we expect investment grade sovereigns to outperform EM corporates in 2014, as well as high yielding sovereigns.

Total returns should be modestly positive. Given the expected 10-year U.S. treasury rate move of 55bp higher, and combined with our expectation of mild spread compression, such a move would imply a modestly positive return for the ESBI of approximately 2.5% for the year. We think the correlation between spread moves and rate moves will remain negative, but it is likely to moderate preventing the double hit experienced this year (Figure 38).

Figure 38. We do not expect the double hit from both spreads and rates in 2014

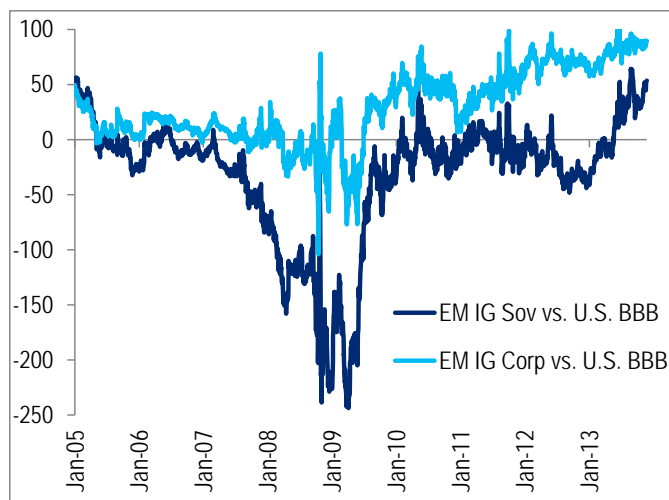
Return contribution of ESBI from different factors since Jan 1 2012



Source: Citi Research, Bloomberg

Figure 39. Despite some recent compression, EM spreads still look cheap to DM historically

EM investment grade spreads minus U.S. BBB corporates



Source: Citi Research

The summer volatility and fears of EM outflows have left EM credit spreads relatively cheap to comparable spreads in developed markets. This is most easily seen by comparing the spread of the investment grade component of the major EM indices to the BBB-component of the U.S. investment grade index (Figure 39). This comparison controls for the fact that EM indices combine a wide range of credit quality, while using the BBB sub-index allows a conservative comparison. There is still significant room for spread outperformance in EM. In addition, our model for the overall level of EM IG spreads, using a combination of VIX, treasuries, Fed Funds and EM economic surprises, suggests that EM IG spreads overall remain about 30bp cheap.

The technical landscape of the EM hard currency market seems more precarious than in other credit markets. In a period of extreme risk aversion, the relatively small natural investor base, the low liquidity in the bond market and the existence of limited hedging opportunities in CDS markets could exacerbate any moves wider.

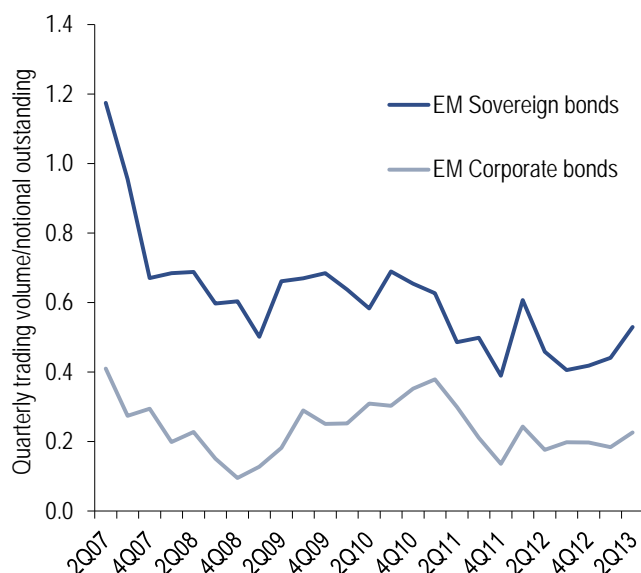
While the number of funds benchmarked to an EM corporate index has grown, the bulk of EM benchmarked investors continue to use a sovereign index. This is somewhat surprising since the EM corporate bond market is now nearly double the size of the sovereign one. Naturally, some of that gap is filled by the inclusion of some EM bonds in major USD and global investment grade indices. However, most EM corporates (including most investment grade EM corporate bonds) do not qualify for the U.S. indices. Many EM corporate bonds continue to be issued without registration, oftentimes a requirement for inclusion in those indices. Non-indexed investors (both EM funds and non-EM) have been filling this gap. Dedicated EM funds often hold a significant amount of EM corporate bonds as a vehicle for return enhancement. Also, developed market corporate bond funds increasingly hold EM paper for similar reasons.

Trading volume in EM bonds has not kept up with the growth of the market.

While the level of trading volume has marginally increased over the past few years, the increasing size of the market has meant that the liquidity per bond has been on a downtrend (Figure 40). In the sovereign bond space, some of this declining liquidity can be made up for in the CDS market. Despite concerns about the increasing regulation of derivatives having an adverse impact on the CDS market, overall CDS liquidity has increased sharply over the past few years (Figure 41).

Figure 40. Overall bond liquidity has not kept pace with the growing size of the market

Quarterly trading volume/total notional outstanding



Source: EMTA, Citi Research

Figure 41. CDS liquidity however has increased the past few years

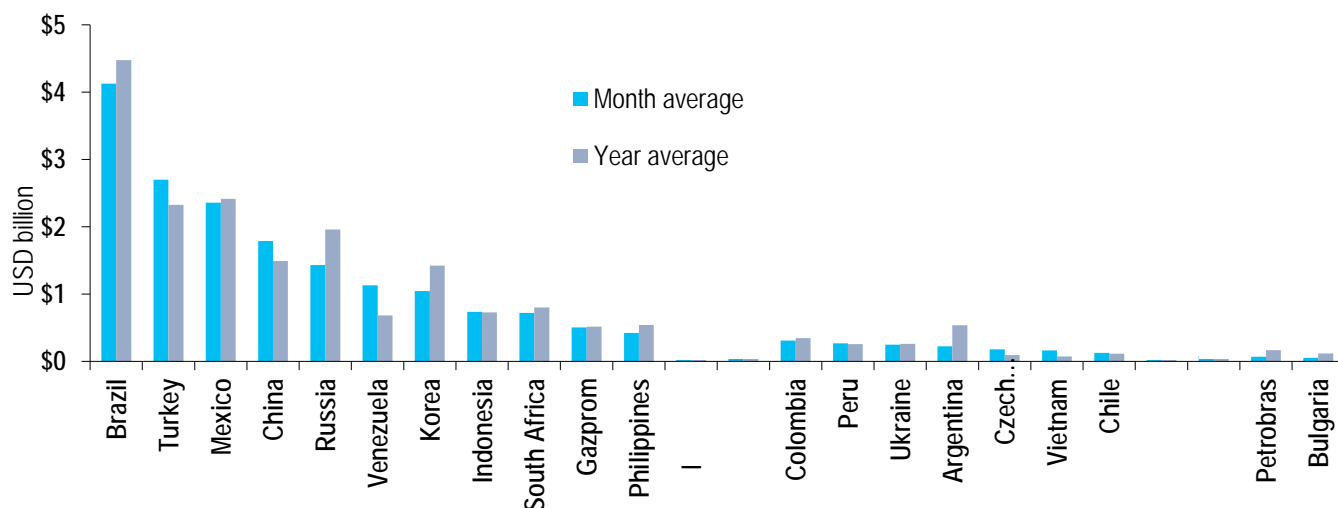
Total weekly CDS trading volume across EM issuer (USD billion), 8-week rolling average



Source: DTCC, Citi Research

In EM corporates, however, the liquidity in CDS is all but non-existent. Looking at the largest single name trading volume for CDS (Figure 42), only a handful of non-sovereigns appear. There was some hope a year ago that the gap could be partially filled by the then-newly released EM corporate indices – the LACX and Itraxx CEEMEA. So far, liquidity in those indices has been relatively low, especially in the LACX (Figure 43). Even in the Itraxx CEEMEA, total liquidity has only averaged approximately US\$300mm per week. A liquid EM corporate CDS market would offer another potential door should there be a sudden move to an exit. Should technicals falter in 2014, EM corporates are much more at risk given the issues mentioned above. This is particularly true when we consider the tightness of corporate spreads relative to sovereigns, particularly in light of the historically difference between both asset classes.

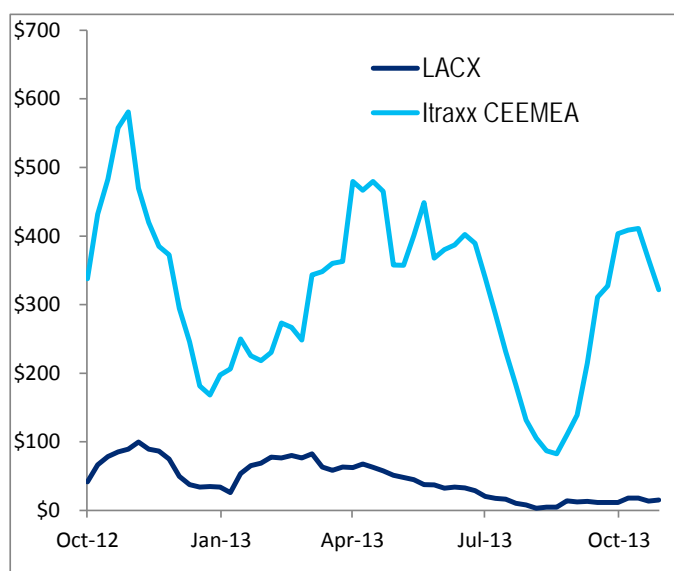
Figure 42. CDS liquidity though is concentrated in a few sovereigns, with hardly any liquidity in EM corporates
 Weekly trading volume of most liquid EM CDS, as reported by DTCC



Source: DTCC

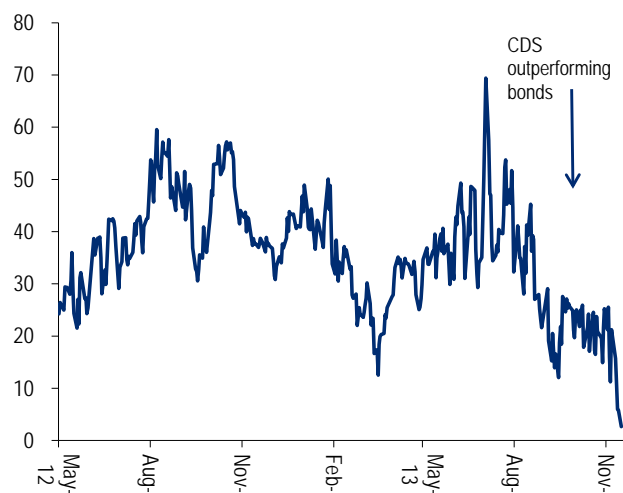
EM sovereign CDS is used as a proxy to help fill this void, but is an imperfect hedge. The use of sovereign CDS as a hedge for corporate exposures can be inferred from the performance of the CDS/bond basis during the summer crisis. Figure 44 plots the average basis for 10-year EM sovereign bonds. After reaching a bottom in March, the basis continued to rise through the summer months as sovereign bond spreads outperformed CDS on average. The basis has seen a sharp downward trend since the peak of the summer volatility. If the market were to experience another sharp bout of volatility, that trend could reverse again.

Figure 43. The EM corporate indices have not been able to maintain significant liquidity



Source: Citi Research

Figure 44. CDS/bond basis increased during the volatile period as CDS was used as a quick hedge, but has since fallen dramatically
 Average 10-year basis across 10 EM countries

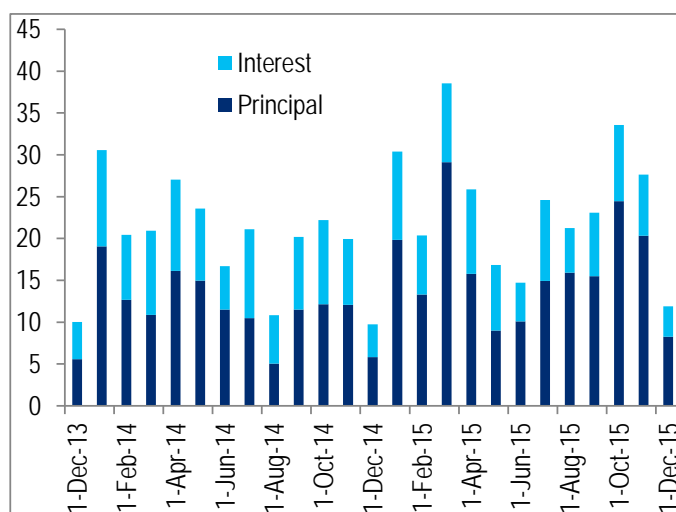


Source: Citi Research

A piece of good news for the technical picture emerges from the significant amount of cashflows on EM debt in 2014. As more EM corporates have been coming to market the past several years, much of that issuance has been relatively short-dated (at least compared to the sovereign market). We estimate that cashflows on EM external debt will be approximately US\$245 billion in 2014 (US\$142 billion of which is amortizations), with another US\$290 billion due in 2015 (Figure 45). These cashflows could provide some liquidity if portfolio outflows materialize and, importantly, provide supporting buying power in periods with a more positive outlook.

Figure 45. Cashflows on external debt are expected to be approximately US\$245 billion in 2014

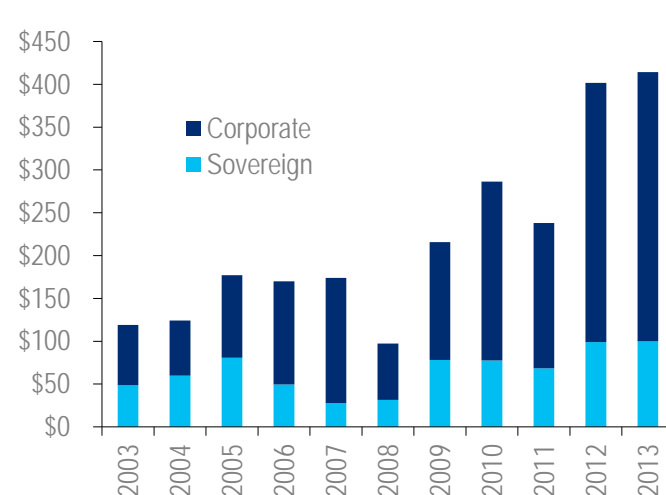
Monthly cashflows expected on EM hard currency debt (USD billion)



Source: Citi Research

Figure 46. EM issuance has already set a record for 2013. We expect some slowdown in 2014

Total issuance of EM hard currency bonds (USD billion)



Source: Bloomberg, Citi Research

Issuance in EM in 2013 has already broken another record with a month left to go. We expect total issuance to reach US\$390 billion in 2014 (with a similar split between sovereign and corporate as in 2013). We expect the decline in the large amount of prefunding we have seen the last few months in addition to the rise in U.S. interest rates to make the market for new issuance somewhat less attractive.

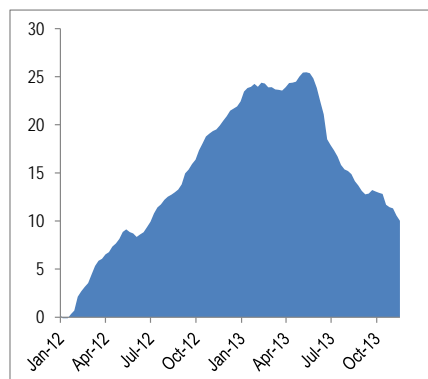
We view the recent retail outflows from EM hard currency funds as a stabilizing factor since a significant portion of the money that poured in over the last few years has now exited the market (Figure 47). Outflows from EM bond funds have continued at a slower - but fairly steady - pace since the summer. This clearing out of a significant portion of the retail money that flowed into the asset class over the last several years points to less crowded positions. However, retail money only represents a very small portion of the total asset class. Anecdotal evidence suggests that institutional money has been steady and is less return-sensitive than retail flows. Nevertheless, large outflows from institutional accounts seem to be a tail event for which the industry is not properly prepared.

Idiosyncratic risks

While we argued earlier that large systemic macroeconomic risks are relatively scarce for 2014, we continue to see further trouble in a few idiosyncratic stories.

Figure 47. Retail positions in EM hard currency have dropped significantly this year

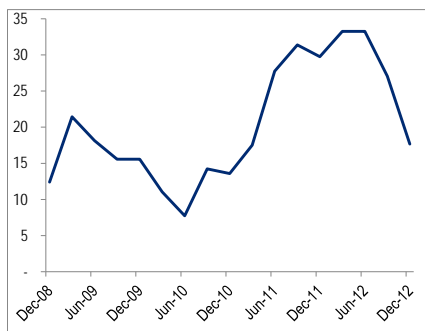
Cumulative inflows into EM hard currency bond funds



Source: EPFR

Figure 48. Venezuela special funds have been declining

Citi estimate of size of Venezuela special funds



Source: Citi Research

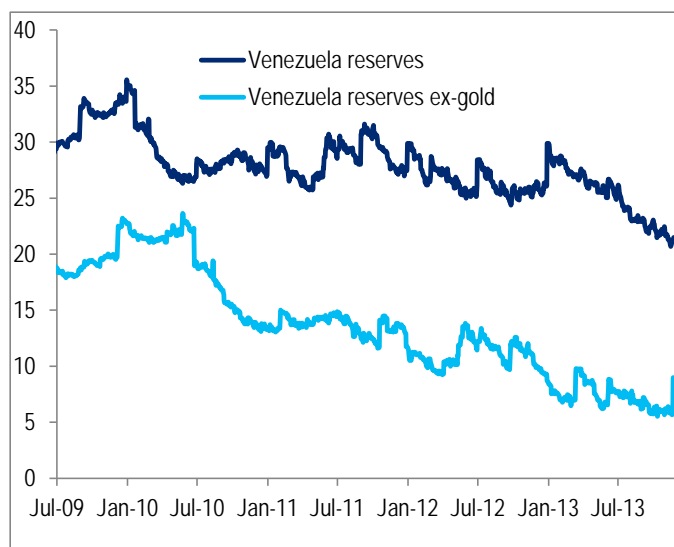
Our base case for Argentina envisions a technical default by the end of 2014.

Given the timeline for Argentina's Supreme Court petition (petition is due 90 days after the rejection, followed by two more months of reply petitions) and conferences, the Court is likely to rule on whether to hear Argentina's case before its summer recess starts at the end of June. At that time, it may ask for the Solicitor General's view, but, even with that, the Court is likely to have the SG's brief and decide whether to hear the case by the end of 2014. Our view is that the Supreme Court is unlikely to grant the petition. Additionally, despite recent news of exchange bondholders attempting to broker a deal with the holdouts, we see any deal that does not include a more generous contribution from the sovereign as unlikely. Beyond the legal risk, the underlying economic picture continues to deteriorate with gross reserves at US\$31.3 billion. There may be winds of political and policy change blowing in Argentina, yet in our opinion they do not seem enough to change the two key fundamentally destabilizing forces: (1) the need to sweeten the sovereign's contribution to holdouts to resolve the issue; and (2) the need to sufficiently change monetary and fiscal policy to restore sustainability to the FX regime. Therefore, we find current Argentina pricing to be rich, across the board.

2014 will be a pivotal year for Venezuela. Its declining external position leaves it vulnerable to large cashflows on external debt late in the year, especially if oil prices decline, as Citi forecasts. In our view, the biggest issue in Venezuela is the availability of hard currency, which appears to be outpacing demand. While the current account continues to show a significant positive, the change in the stock of hard currency assets presents a more troubling picture. Reserves have been on a sharp decline and liquidity has become a source of concern (Figure 48), with the latest reports showing that the central bank is attempting to engage in swaps to turn its gold holdings liquid. If we included the special funds along with the total reserves, the trend is even more disturbing. While it is difficult to know the true size of the special funds, there is a consensus among the estimates – including Citi's – that the amount available has declined significantly over the past year (Figure 49). We believe it is difficult to envision a reversal of this trend, barring a significant rise in oil prices. A devaluation, as we and the market expect following this December's municipal elections, is unlikely to help the underlying problem: imports have already been dramatically compressed and the only meaningful exports stem from oil. With cashflows on external debt increasing to nearly US\$11 billion in 2014, this trend of decreasing access to hard currency could be problematic, especially with the large amortizations coming due in October next year (Figure 50). Given the opacity of Venezuela's asset and cash position, we think the probability that the sovereign will face payment difficulties next October is material.

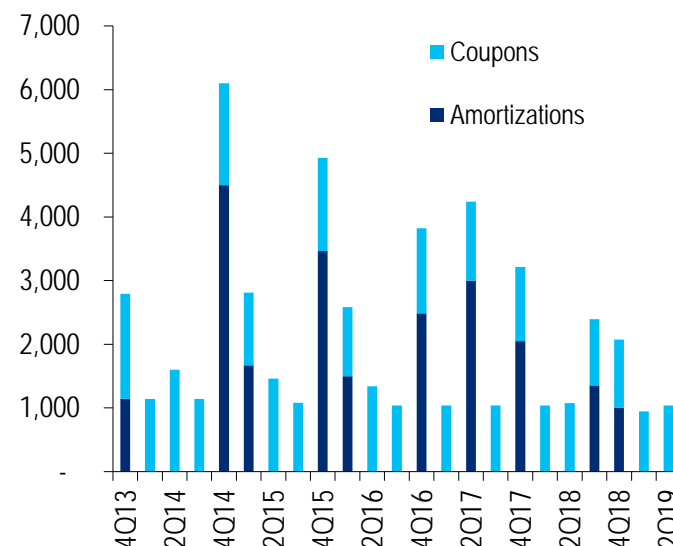
Figure 49. Venezuela reserves have been shrinking, including the non-gold portion

Venezuela reserves, USD billion



Source: IMF, Venezuela Central Bank, Bloomberg

Figure 50. Venezuela cashflows increase significantly late next year

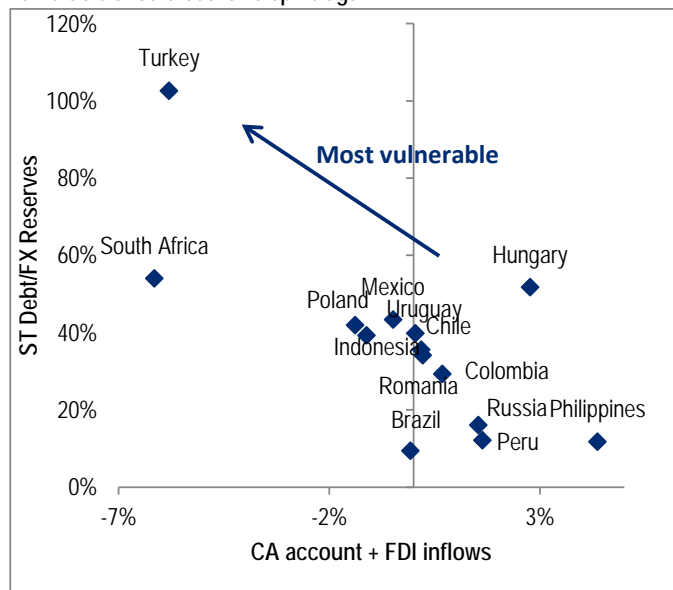


Source: Citi Research estimates

We are less concerned with a liquidity squeeze for Ukraine, but it faces its own financing hurdles in 2014 as well. The recent move to push back discussion of an EU trade pact is a negative for its medium-term prospects, but it does likely mean that it will continue to receive Russian support, which most likely will help get it over its financing hump in 2014. A large portion of Ukraine's external payments in 2014 are due to the IMF. While there has been recent talk of potential reforms that would put it closer to a deal with the IMF, the recent move on the EU treaty suggests that the government may be loath to make difficult choices, especially ahead of the elections in early 2015.

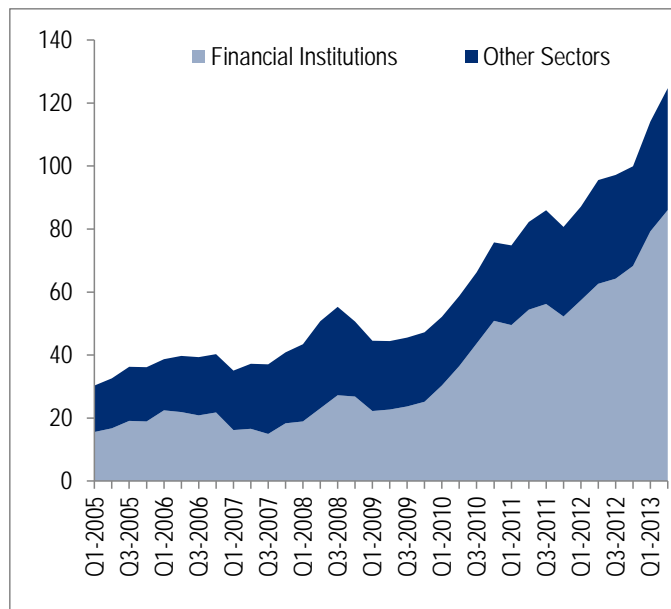
Turkey represents another complex idiosyncratic story. Turkey's current account and short-term external debt relative to reserves make it vulnerable (Figure 51). Furthermore, Turkey's short-term external debt has continued to increase (Figure 52), and the sources of its external financing have become more short term since the financial crisis (Figure 53). For this reason, we argue that Turkey leads the pack of vulnerable investment grade nations in the credit space.

Figure 51. Countries with high levels of ST external debt/FX reserves combined with CA deficits funded by short-term flows seem most vulnerable should outflows spike again



Source: Citi Research

Figure 52. Turkey's short-term debt has been rising quickly, both in financial and non-financial sectors

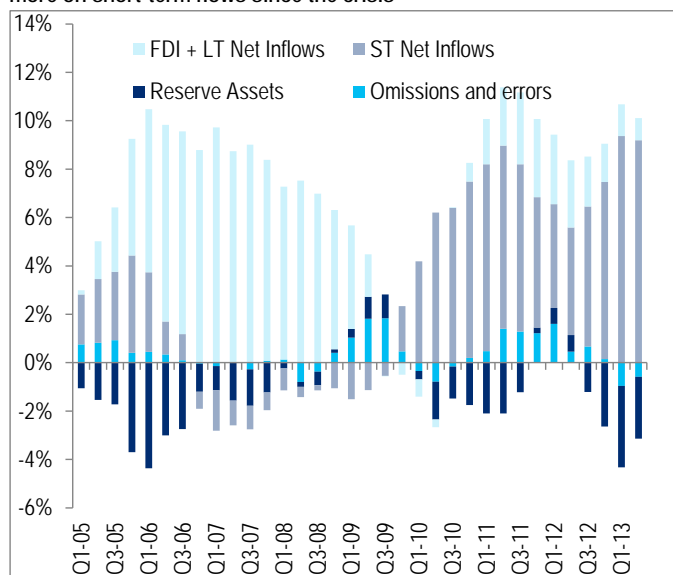


Source: BIS, Haver

We are not as concerned about all current account deficit countries, however.

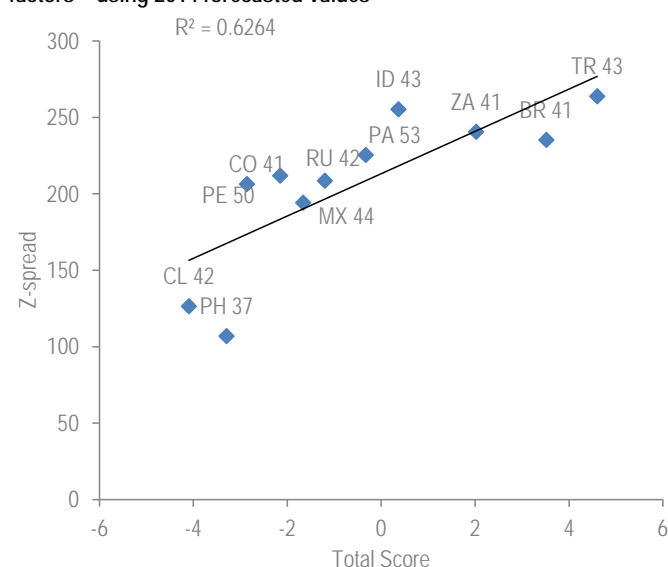
We have been arguing since the peak of the summer sell-off that the spread widening in Indonesia was not justified by its credit fundamentals. The rise in its current account deficit was certainly troubling, but even after the sharp increase, the level of its deficit is not far from the average of EM sovereigns (Figure 51). Considering a group of major macro indicators historically tied to sovereign crises, we construct scores for a number of investment grade countries (Figure 55). In contrast to Turkey, according to our model, Indonesia spreads continue to be the cheapest among IG sovereigns (Figure 54).

Figure 53. Turkey's funding of its current account deficit has relied more on short-term flows since the crisis³



Source: IMG, Haver

Figure 54. EM 30-year spreads versus our model based on 8 macro factors – using 2014 forecasted values



Source: Citi Research

Figure 55. Total score based on standard deviation rankings using 2014 forecasts

Each number represents how far many standard deviations a country is expected to be away from the sample average using our economists' 2014 forecasts

	ST Debt/FX				GDP		Fiscal	WB	Total Score
	Public Debt/GDP	External Debt/GDP	Reserves	CA/GDP	Growth	Inflation	Surplus	Governance	
Brazil	1.8	-0.7	-0.9	-0.1	1.3	1.3	-1.6	0.8	3.52
Chile	-1.7	0.0	0.0	0.2	-0.1	-0.5	-0.4	-2.0	-4.09
Colombia	-0.3	-0.7	-0.7	-0.1	-0.1	-0.5	-0.4	0.2	-2.15
Indonesia	-0.7	-0.4	0.0	-0.2	-0.6	0.7	-0.3	1.4	0.37
Latvia	0.1	3.0	2.5	-0.4	0.1	-1.2	0.7	-1.1	2.99
Lithuania	0.2	0.8	0.6	-0.6	0.6	-1.4	1.8	-1.2	-0.95
Mexico	0.2	-0.6	-0.9	-0.4	0.3	-0.1	1.2	-0.2	-1.66
Panama	0.4	-0.4	-1.0	2.7	-2.6	0.6	0.3	0.0	-0.33
Peru	-1.3	-0.6	-0.1	0.4	-0.6	-1.0	-0.7	0.3	-2.85
Philippines	1.1	-0.7	-0.9	-1.8	-1.4	-0.1	-1.2	0.6	-3.29
Poland	0.6	0.5	0.5	-0.1	0.7	-1.0	-1.0	-0.9	0.24
Romania	0.4	0.9	0.3	0.2	0.8	-0.3	0.1	0.5	2.77
Russian Federation	-1.8	-0.7	-0.8	-1.2	0.8	0.7	1.2	1.7	-1.20
South Africa	0.7	-0.6	-0.3	0.6	0.8	0.9	0.9	0.0	2.02
Turkey	0.1	0.1	1.5	0.9	0.2	2.0	-0.7	-0.2	4.60

Source: Citi Research

³ We have used the methodology from "Tackling Turkey's External and Domestic Macroeconomic Imbalances", 2012, by Rohn, Gonenc, Koen, Karasahin

Annual Indicators

Figure 56. Emerging Markets – Economic Forecasts, 2012-2014F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Asia	6.2	6.2	6.3	3.7	3.9	4.1	2.0	1.8	1.3	-2.3	-2.1	-1.7
China	7.6	7.3	7.0	2.7	3.3	3.7	2.2	2.0	1.5	-2.0	-2.0	-1.5
Hong Kong	3.0	3.4	3.8	4.3	3.6	4.0	2.8	3.1	3.9	2.2	1.6	0.7
India*	4.8	5.6	6.7	6.0	5.0	5.0	-2.7	-2.4	-2.4	-6.7	-6.4	-6.2
Indonesia	5.7	5.3	5.5	7.1	6.6	5.7	-3.5	-2.8	-2.3	-2.1	-1.8	-1.7
Korea	2.9	3.7	3.9	1.2	2.3	3.1	5.6	4.1	3.2	0.9	2.3	2.3
Malaysia	4.5	5.0	4.9	2.1	3.4	4.3	3.7	4.4	4.0	-4.2	-3.5	-3.0
Mongolia	12.0	11.0	8.0	10.3	12.0	9.0	-27.4	-21.4	-17.6	-8.0	-6.4	-3.0
Philippines	6.7	7.3	6.8	2.8	3.5	3.9	3.5	3.1	2.9	-1.7	-1.8	-1.2
Singapore	4.0	3.5	4.0	2.4	2.1	2.2	14.0	13.5	13.0	0.7	0.5	0.5
Sri Lanka	6.8	7.0	7.0	7.0	6.5	6.5	-4.6	-3.1	-3.6	-6.0	-5.7	-5.5
Taiwan	2.0	3.2	3.8	1.1	1.7	2.3	10.9	9.8	9.5	-1.5	-1.4	-1.2
Thailand	2.8	3.1	4.3	2.1	2.2	3.1	-0.9	-0.7	-1.0	-1.8	-2.0	-2.4
Vietnam	5.2	5.5	5.8	6.7	7.1	7.2	5.0	3.8	2.5	-5.3	-4.5	-4.0
Latin America	2.6	2.7	3.0	7.4	8.6	8.9	-2.5	-2.5	-2.1	-3.3	-3.7	-2.9
Argentina	5.1	3.0	2.0	10.5	12.4	13.8	-0.5	-0.4	-0.4	-2.3	-3.1	-2.3
Brazil	2.6	2.0	2.0	6.2	6.0	5.7	-3.5	-3.4	-3.1	-3.6	-3.9	-2.7
Chile	4.0	4.0	4.5	1.7	2.6	2.9	-3.5	-3.8	-4.0	-0.3	-0.4	-0.4
Colombia	3.9	4.6	5.0	2.0	2.4	3.3	-3.1	-3.2	-3.5	-1.1	-0.7	-0.7
Mexico	1.2	3.8	4.0	3.8	4.0	3.7	-1.7	-1.9	-1.7	-2.4	-3.5	-2.5
Panama	7.2	6.5	5.5	4.0	2.7	2.8	-14.3	-13.6	-9.2	-3.5	-3.0	-3.0
Peru	4.9	4.8	4.8	2.9	3.4	2.5	-5.5	-5.6	-1.5	0.8	0.0	0.0
Venezuela	2.0	0.0	2.0	38.8	59.0	63.8	3.6	3.8	3.3	-11.7	-11.8	-11.9
Europe	1.8	2.8	3.0	5.3	4.8	4.7	-1.0	-1.2	-1.4	-2.3	-2.5	-3.6
Bulgaria	0.5	1.5	2.5	1.2	2.8	2.5	0.0	-0.8	-1.5	-2.0	-2.0	-1.2
Croatia	-1.0	1.2	2.0	2.3	2.3	2.8	-0.1	-0.5	-1.0	-5.5	-5.7	-5.0
Czech Republic	-1.3	1.9	2.4	1.4	1.2	1.9	0.0	1.3	0.7	-2.4	-2.9	-2.9
Hungary	1.0	1.9	1.5	1.7	1.5	3.3	1.5	0.9	0.8	-2.9	-3.0	-2.9
Kazakhstan	5.1	4.0	4.4	5.8	5.5	5.3	0.2	1.6	2.1	2.7	1.8	1.7
Poland	1.4	3.1	3.6	1.0	1.9	2.8	-1.5	-2.4	-3.4	-4.6	5.2	-2.6
Romania	2.5	2.8	3.3	4.1	1.9	2.7	-1.2	-3.1	-4.2	-2.5	-2.3	-2.3
Russia	1.4	2.6	2.7	6.7	5.3	4.9	1.6	1.1	0.8	-2.0	-4.3	-4.9
Serbia	2.5	2.0	2.2	8.3	6.6	5.9	-5.5	-6.0	-6.5	-5.0	-5.0	-4.7
Slovakia	0.8	1.8	2.4	1.4	1.1	1.8	4.3	4.0	3.4	-3.4	-3.2	-2.6
Turkey	3.5	3.5	3.6	7.5	7.3	6.9	-7.0	-6.3	-5.8	-1.2	-2.8	-3.2
Ukraine	-0.7	1.6	3.3	-0.3	3.9	4.8	-6.8	-5.4	-5.0	-6.7	-4.2	-4.0
Africa/Mideast	4.4	5.0	5.3	4.2	4.5	5.0	12.5	10.3	8.1	2.8	1.1	-0.3
Bahrain	4.3	4.0	4.1	3.3	2.2	2.0	5.3	2.4	-1.5	-2.2	-3.3	-5.5
Egypt	2.0	2.9	3.4	9.2	8.1	6.8	-2.7	-2.8	-3.2	-12.8	-12.1	-10.0
Ghana	7.4	6.8	6.5	11.4	11.2	8.8	-12.0	-11.2	-10.2	-9.2	-7.7	-6.5
Iraq	3.1	10.4	11.6	2.2	5.8	6.0	13.5	13.8	12.8	1.6	3.5	4.3
Israel	3.2	3.4	3.5	1.6	2.3	3.0	2.6	2.0	0.7	-3.6	-3.0	-2.5
Jordan	3.0	4.0	4.5	5.7	4.8	5.0	-15.2	-14.2	-11.9	-8.2	-9.5	-9.3
Kenya	5.5	6.1	6.5	5.6	6.6	7.3	-10.1	-9.5	-9.0	-7.0	-5.5	-4.5
Kuwait	4.2	3.8	3.9	2.6	3.3	5.0	51.0	49.5	47.8	36.8	32.1	29.5
Lebanon	1.4	-0.9	-3.1	2.1	3.7	5.0	-4.5	-5.4	-6.5	-10.0	-9.6	-8.3
Nigeria	6.5	6.5	6.3	8.5	8.8	10.6	4.3	2.0	2.2	-2.1	-2.9	-2.9
Oman	6.7	6.7	6.7	1.3	2.0	3.0	10.3	8.1	6.2	-0.2	-3.4	-5.4
Qatar	5.6	5.9	6.1	3.1	3.0	3.5	29.7	25.5	20.7	8.1	4.2	1.2
Saudi Arabia	6.1	5.8	6.2	3.5	3.4	4.1	18.1	13.5	9.0	10.3	5.1	0.4
South Africa	1.9	2.8	3.5	5.8	5.6	5.5	-7.1	-5.7	-5.3	-4.4	-4.3	-4.4
Tanzania	6.8	7.0	8.1	8.0	6.5	6.7	-10.2	-14.1	-12.4	-5.0	-5.2	-5.9
UAE	3.7	4.0	4.0	1.1	1.3	1.5	28.0	23.3	19.1	NA	NA	NA
Uganda	5.0	5.6	6.5	5.9	8.7	6.0	-12.0	-13.9	-14.9	-3.4	-3.3	-3.5
Zambia	6.0	6.4	6.3	7.1	6.8	7.4	-3.2	-2.8	-3.0	-8.5	-6.4	-5.5
Total	4.6	4.9	5.0	4.7	5.0	5.2	1.9	1.6	1.1	-2.0	-2.2	-2.1

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

Economic Framework

Figure 57. 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	3.1	3.3	3.5	3.0	3.0	3.4	0.7	0.6	0.3	-3.2	-2.7	-2.5
<i>Based on PPP weights</i>	3.6	3.8	4.0	3.4	3.5	3.9	0.4	0.3	0.1	-3.2	-2.8	-2.6
Industrial Countries	2.0	2.1	2.3	1.7	1.6	1.5	0.1	0.2	0.1	-3.8	-3.1	-2.9
United States	2.7	3.1	3.2	1.8	2.0	2.2	-2.0	-1.7	-1.8	-4.6	-3.9	-3.9
Japan	1.6	0.9	1.2	2.3	1.4	1.6	1.6	1.7	1.5	-8.0	-6.2	-5.8
Euro Area	0.9	1.0	1.3	0.9	0.7	1.1	2.6	2.6	2.5	-2.6	-2.2	-2.1
Canada	2.4	2.7	2.7	1.5	1.9	2.0	-4.2	-4.2	-3.8	-0.3	0.2	0.2
Australia	2.9	3.0	3.2	3.1	2.4	2.4	-3.6	-4.3	-4.5	-2.6	-1.9	-1.0
New Zealand	3.0	2.7	2.5	2.1	2.2	2.3	-4.7	-4.9	-3.8	-1.8	-0.7	-0.9
Germany	1.9	1.7	1.7	1.5	1.6	1.8	6.8	6.2	5.3	0.0	-0.1	-0.3
France	0.8	0.9	1.4	1.2	1.3	1.5	-0.8	-0.1	0.4	-3.6	-3.2	-2.9
Italy	0.2	0.3	0.4	0.2	-0.3	0.4	1.4	1.5	1.6	-2.8	-2.7	-2.5
Spain	0.2	0.8	1.2	-0.4	-0.2	0.1	2.1	2.6	3.0	-6.2	-5.4	-4.8
Greece	-1.9	-0.5	1.1	-2.9	-2.4	-1.4	1.6	2.3	3.5	-2.3	-1.8	-1.3
Ireland	1.4	1.6	2.7	0.5	1.0	1.5	10.1	10.4	11.2	-5.6	-4.0	-3.4
Portugal	-0.5	0.4	0.7	-0.4	-1.2	-0.2	2.5	2.8	2.9	-5.0	-4.4	-3.8
Netherlands	0.4	0.9	1.2	1.3	1.3	1.4	10.0	8.6	8.1	-2.9	-2.2	-1.5
Belgium	0.6	1.0	1.4	1.3	1.1	1.1	-4.1	-3.9	-3.3	-2.3	-1.5	-1.0
Denmark	1.2	1.5	1.6	1.5	1.7	1.8	5.1	4.7	4.8	-1.8	-1.5	-1.0
Norway	2.1	2.4	2.6	2.0	2.2	2.0	13.1	13.4	13.7	11.8	11.0	10.0
Sweden	2.1	2.5	2.6	1.1	2.0	2.4	5.9	5.6	5.6	-1.6	-0.7	0.7
Switzerland	2.0	2.0	2.2	-0.1	0.9	1.1	13.0	12.8	13.8	0.6	0.8	1.2
United Kingdom	3.2	3.2	2.7	2.0	1.9	2.1	-3.0	-3.1	-3.2	-4.9	-3.7	-1.9

Source: National sources and Citi Research

Figure 58. G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 28 November 2013

	28-Nov-13	1Q 14F	2Q 14F	3Q 14F	4Q 14F	1Q 15F	2Q 15F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	2.75	2.80	2.95	3.15	3.25	3.40	3.50
Euro Area: US\$/€	1.34	1.37	1.39	1.40	1.40	1.40	1.40
Euro Repo Rate	0.25	0.25	0.00	0.00	0.00	0.00	0.00
10-Yr. Bunds (Period Average)	1.70	1.70	1.70	1.70	1.80	1.90	1.90
Japan: Yen/US\$	101	103	104	105	105	105	105
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.60	0.55	0.50	0.60	0.70	0.90	1.00

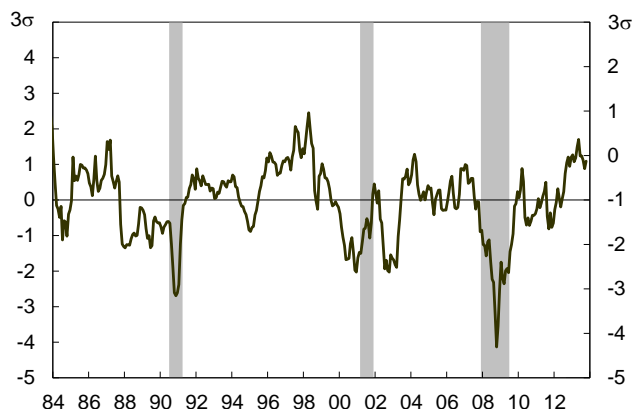
Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US\$					Spread vs. Germany				
	1Q 14	2Q 14	3Q 14	4Q 14	1Q 15	1Q 14	2Q 14	3Q 14	4Q 14	1Q 15
United States	NA	NA	NA	NA	NA	112	127	147	148	153
Japan	-232	-237	-247	-238	-243	-120	-110	-100	-90	-90
Euro Area	-112	-127	-147	-148	-153	NA	NA	NA	NA	NA
Canada	-20	-10	-10	-10	-10	92	117	137	137	143
Australia	153	148	138	138	138	265	275	285	285	291
New Zealand	214	219	230	240	266	326	347	377	388	419
France	-62	-82	-102	-103	-108	50	45	45	45	45
Italy	108	83	53	27	22	220	210	200	175	175
Spain	118	93	33	2	-3	230	220	180	150	150
Netherlands	-77	-92	-112	-113	-118	35	35	35	35	35
Belgium	-32	-42	-72	-78	-88	80	85	75	70	65
Austria	-72	-92	-112	-113	-118	40	35	35	35	35
Finland	-87	-102	-122	-123	-128	25	25	25	25	25
Ireland	63	38	8	-13	-18	175	165	155	135	135
Denmark	-102	-117	-137	-138	-143	10	10	10	10	10
Switzerland	-180	-195	-215	-221	-232	-68	-68	-68	-73	-79
United Kingdom	5	10	5	5	0	117	137	153	153	153

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

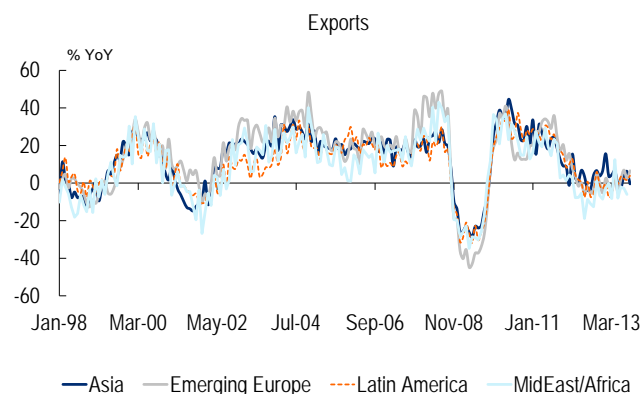
Regional Indicators

Figure 59. We still see a relatively flat probability distribution for tapering of QE over the next several meetings, with a slight nod to March as the most likely start.



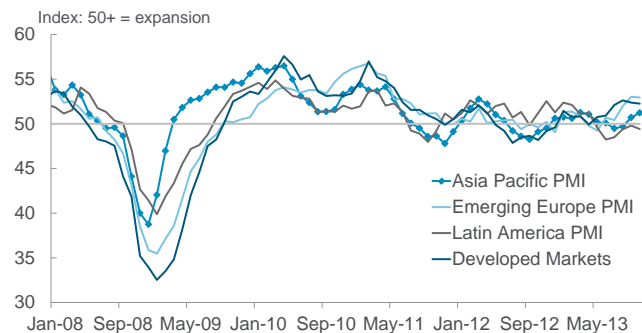
Source: Haver Analytics, Citi Research. Note: Shaded sections mark recession periods.

Figure 61. Exports need a boost



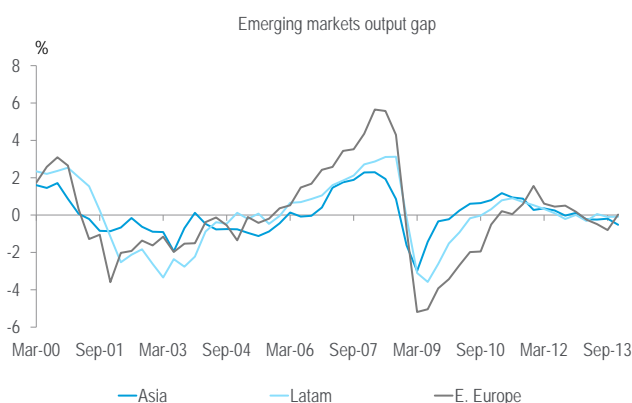
Source: Haver Analytics, Citi Research. F = forecast

Figure 63. PMI indicators are sanguine on growth, however



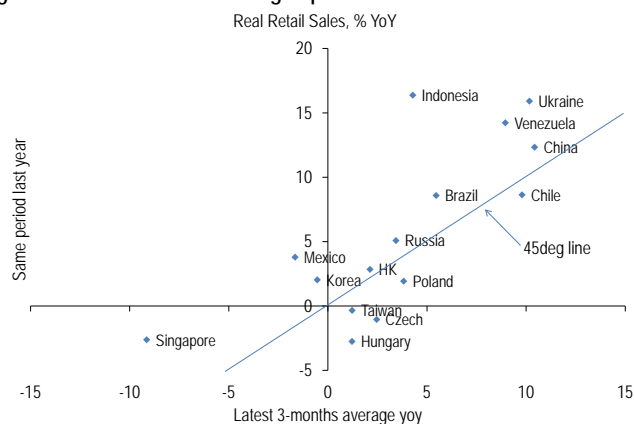
Source: Haver Analytics, Citi Research

Figure 60. EM output remain below trend



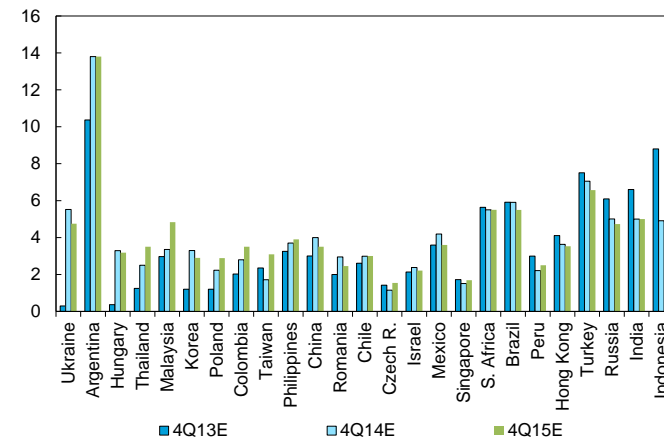
Source: Haver Analytics, Citi Research

Figure 62. Few EMs are showing improvement in retail sales



Source: Haver Analytics, Citi Research

Figure 64. CPI trend: ordered from the country with the highest rise in inflation expected to the country where the most disinflation is expected to 2015, end of period..



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

Monetary Policy Watch

Figure 65. 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	Dec-14	+25	3.25
India	Repo Rate	7.75	Oct-13	+25	Feb-14	+25	8.00
Indonesia	FasBI	5.75	Nov-13	+25	Feb-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	Jun-14	+25	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	Sep-14	+12.5	2.125
Thailand	Overnight Repo Rate	2.25	Nov-13	-25	Jan-14	-25	2.00

Source: Bloomberg, Citi Research

Figure 66. 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	1Q16	+20	0.05
Hungary	14-Day Repo Rate	3.20	Nov-13	-20	Dec-13	-20	3.80
Israel	Base Rate	1.00	Sep-13	-25	4Q14	+25	1.50
Poland	7-Day Repo Rate	2.50	Jul-13	-25	Sep-14	+25	3.00
Romania	Refinancing Rate	4.00	Nov-13	-25	1Q14	-25	3.75
Russia	Refinancing Rate	8.25	Sep-12	+25	Mar-14	-25	7.75
S. Africa	Average Repo rate	0.25	Jul-12	-50	1Q15	+50	5.00
Turkey*	Average Funding rate	6.50			by end-2014	+200	8.50
Ukraine	Discount Rate	6.50	Aug-13	-50	2015	-25	6.50

Source: Bloomberg, Citi Research.

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

Figure 67. Latin America Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2014
			Date	Amount (bp)	Forecast	Amount (bp)	forecast
Brazil	SELIC	10.00	Nov-13	+50	Jan-14	+50	10.75
Chile	CAMARA (Overnight)	4.50	Nov-13	-25	Feb-14	-25	4.00
Colombia	Central Bank Repo Rate	3.25	Mar-13	-50	Mar-14	+25	4.50
Mexico	Official Overnight Rate	3.50	Oct-13	-25	Jun-15	+25	3.50
Peru	Reference Rate	4.00	Nov-13	-25	Feb-14	-25	3.50

Source: Bloomberg, Citi Research

FX Views

Figure 68. Asian Currencies Exchange Rates

	29-Nov	1Q14			2Q14			4Q14		
		Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)
vs USD										
China yuan	6.09	6.07	6.14	1.1	6.06	6.14	1.2	6.04	6.16	1.6
Hong Kong dollar	7.75	7.75	7.75	0.0	7.76	7.75	-0.1	7.76	7.75	-0.1
India rupee	62.52	63.50	64.52	1.6	63.50	65.90	3.6	61.91	68.27	7.0
Indonesia rupiah	11965	11841	12471	5.0	11879	12749	7.1	11640	n.a.	n.a.
Korea won	1058	1045	1065	1.9	1035	1070	2.3	1020	1077	3.9
Malaysia ringgit	3.22	3.12	3.24	3.8	3.14	3.26	4.3	3.12	n.a.	n.a.
Philippines peso	43.8	42.6	43.6	2.2	42.2	43.5	2.1	41.7	43.5	3.0
Singapore dollar	1.26	1.24	1.24	-0.3	1.24	1.24	-0.3	1.23	1.24	-0.3
Taiwan dollar	29.6	29.38	29.49	0.4	29.26	29.41	0.1	29.14	29.22	-0.1
Thailand baht	32.1	32.0	32.51	1.7	31.9	32.71	2.3	31.3	n.a.	n.a.

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

Figure 69. CEEMEA Currencies Exchange Rates

	29-Nov	1Q14			2Q14			4Q14		
		Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)
vs EUR										
Czech Republic koruna	27.4	27.1	25.7	-5.5	27.0	25.7	-5.2	26.7	25.7	-4.1
Hungary forint	301	307	295	-4.3	309	296	-4.3	310	299	-3.6
Poland zloty	4.20	4.19	4.21	0.4	4.18	4.23	1.2	4.13	4.28	3.6
vs USD										
Israel shekel	3.52	3.59	3.53	-1.8	3.63	3.53	-2.7	3.68	3.54	-3.9
Russia ruble	33.2	32.7	33.9	3.3	32.7	34.4	4.9	32.8	35.4	7.2
Turkey new lira	2.02	2.08	2.07	-0.7	2.09	2.11	0.6	2.09	2.19	4.6
S. Africa rand	10.23	10.31	9.95	-3.6	10.37	10.08	-2.9	10.36	10.26	-0.9

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

Figure 70. Latin American Currencies Exchange Rates

	29-Nov	1Q14			2Q14			4Q14		
		Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)
vs USD										
Brazil reais	2.32	2.36	2.38	0.9	2.42	2.43	0.6	2.46	2.55	3.3
Chile peso	528	516	535	3.7	512	540	5.2	510	551	7.4
Colombia peso	1925	1908	1902	-0.3	1916	1917	0.0	1936	1947	0.6
Mexico new peso	13.1	12.6	13.1	3.8	12.6	13.2	4.5	12.5	13.4	6.4

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 71. Citi vs. Consensus forecasts

	GDP Growth (% YoY)				CPI Growth (% YoY)				Current Account Balance (US\$ bil)			
	2013F	Consensus	2014F	Consensus	2013F	Consensus	2014F	Consensus	2013F	Consensus	2014F	Consensus
Asia	6.2%	6.1%	6.2%	6.4%	3.3%	3.3%	3.6%	3.5%	314.1	302.1	310.5	305.4
China	7.6	7.6	7.3	7.5	2.7	2.6	3.3	3.1	203.8	218.1	205.1	220.3
Hong Kong	3.0	3.0	3.4	3.6	4.3	4.2	3.6	3.7	7.7	4.2	9.2	4.1
India	4.8	4.6	5.6	5.6	6.0	6.1	5.0	5.7	-50.4	-64.4	-55.4	-61.3
Indonesia	5.7	5.6	5.3	5.6	7.1	7.2	6.6	6.3	-30.7	-28.9	-24.4	-24.3
Korea	2.9	2.7	3.7	3.5	1.2	1.3	2.3	2.4	67.9	59.0	56.3	47.6
Malaysia	4.5	4.4	5.0	5.1	2.1	2.2	3.4	2.8	11.5	9.4	14.8	11.1
Philippines	6.7	7.0	7.3	6.3	2.8	2.9	3.5	3.6	9.5	8.6	9.8	8.4
Singapore	4.0	3.2	3.5	3.7	2.4	2.5	2.1	2.9	40.7	49.5	42.7	50.7
Sri Lanka	6.8	6.4	7.0	6.7	7.0	7.4	6.5	6.9	-3.1	-2.9	-2.3	-2.8
Taiwan	2.0	2.1	3.2	3.4	1.1	1.1	1.7	1.6	53.0	49.8	51.3	49.1
Thailand	2.8	3.4	3.1	4.4	2.1	2.2	2.2	2.7	-3.6	-3.3	-3.0	0.6
Vietnam	5.2	5.2	5.5	5.5	6.7	6.8	7.1	8.0	7.7	2.8	6.5	1.9
Latin America	2.8%	2.5%	2.8%	2.9%	7.8%	8.6%	9.2%	8.0%	-126.3	-126.3	-128.6	-122.3
Argentina	5.1	3.6	3.0	2.1	10.5	10.3	12.4	11.2	-2.5	-2.5	-1.9	-2.7
Brazil	2.6	2.4	2.0	2.4	6.2	5.8	6.0	5.8	-77.5	-77.1	-71.6	-72.0
Chile	4.0	4.2	4.0	4.1	1.7	2.3	2.6	2.8	-9.8	-10.8	-11.1	-11.5
Colombia	3.9	3.8	4.6	4.5	2.0	2.5	2.4	3.2	-11.9	-12.4	-12.8	-12.4
Mexico	1.2	1.2	3.8	3.2	3.8	3.6	4.0	3.9	-21.2	-18.5	-26.4	-20.2
Panama	7.2	7.6	6.5	7.0	4.0	4.5	2.7	3.5	-5.8	-4.7	-6.0	-5.0
Peru	4.9	5.3	4.8	5.6	2.9	3.0	3.4	2.5	-11.4	-9.7	-12.3	-10.0
Venezuela	2.0	1.1	0.0	0.4	38.8	51.3	59.0	44.7	13.7	9.4	13.5	11.7
Europe	1.7%	1.8%	2.8%	2.8%	5.2%	4.9%	4.7%	4.6%	-37.9	-28.6	-45.7	-49.3
Bulgaria	0.5	0.5	1.5	1.7	1.2	1.4	2.8	2.0	0.0	0.2	-0.5	-0.4
Croatia	-1.0	-0.7	1.2	0.8	2.3	2.6	2.3	2.6	-0.1	-0.2	-0.3	-0.3
Czech R	-1.3	-1.1	1.9	1.8	1.4	1.4	1.2	1.2	0.1	-2.4	2.7	-2.8
Hungary	1.0	0.6	1.9	1.6	1.7	1.8	1.5	2.1	1.9	2.5	1.2	2.2
Kazakhstan	5.1	5.5	4.0	6.0	5.8	6.1	5.5	6.1	0.5	2.8	5.0	3.3
Poland	1.4	1.2	3.1	2.7	1.0	1.1	1.9	2.0	-7.7	-7.9	-13.6	-11.1
Romania	2.5	2.3	2.8	2.4	4.1	4.3	1.9	2.7	-2.3	-1.7	-6.3	-3.1
Russia	1.4	1.6	2.6	2.5	6.7	6.0	5.3	5.1	34.0	46.6	24.0	31.3
Slovak Rep	0.8	0.9	1.8	2.2	1.4	1.6	1.1	1.7	4.2	3.2	4.2	3.1
Turkey	3.5	3.5	3.5	3.7	7.5	7.5	7.3	6.8	-56.6	-58.5	-52.4	-60.1
Ukraine	-0.7	-0.8	1.6	1.1	-0.3	-0.2	3.9	4.0	-11.9	-13.2	-9.6	-11.4
Above Total	4.6%	4.6%	4.9%	5.0%	4.6%	4.7%	5.0%	4.7%	150.0	147.2	136.3	133.8

Source: Consensus Economics, Citi Research

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- **Summary view** – We expect growth to moderate further to 7.3% in 2014. The risk of a more dramatic slowdown is low as the government sees 7% growth as the bottom line, and has the willingness and capacity to introduce small-scale stimulus in case of a sharp deceleration, even at the expense of slowing reforms.
- **Things to watch** – Relatively stable growth and job market allow the government to focus on reform. We see a better chance for gradual reforms to proceed following the 3rd Plenum. The reforms, if adequately implemented, may cause output loss in the near term, whereas the return can only be realized over time.
- **Strategy** – PBOC may raise benchmark rates by 25 bps in late 2014 when headline inflation hits 4% YoY. Sizable trade surplus in the foreseeable future implies moderate RMB undervaluation and residual pressure for appreciation. PBOC may sell FX to tackle a reversal of capital inflows when Fed starts tapering. We expect limited RMB appreciation, with more two-way volatilities in the next 12 months.

Slower growth for better quality

Macro indicators suggest that the economy continues to expand at a solid pace following the growth rebound in 3Q, but inflation is trending up. The growth target of 7.5% for 2013 is within reach (we forecast 7.6%). Meanwhile, the job market has been stable, with 10.7 million new jobs created in urban areas in the first nine months, better than the same period of last year. The economy is running within the reasonable range defined by the Premier, allowing the government to focus on addressing the deep-rooted structural problems through reforms.

The government may set a growth target of 7% next year. Even as the growth slows to below 8%, job market data suggest overall labor shortages. In addition, inflation starts to pick up. These are signs that China's potential growth is already below 8%, and any effort to boost growth above the current level may be inflationary. In recognition of changing demographic dynamics and to leave more room for structural reforms, we expect the government to lower its growth target to 7.0% next year, and maintain its target for annual average inflation at 3.5% with allowance for the impact of price reforms.

We expect growth to decelerate from 7.6% in 2013 to 7.3% in 2014. Based on the coincident Li Keqiang Index and leading credit condition index, we expect growth to soften to 7.5%YoY in 4Q 2013. In 2014, our baseline assumption is that fiscal policy would not be more expansionary, while monetary and credit conditions are likely to be tighter given the need to deleverage and reduce excess capacity. More specifically, the budget deficit will probably stay at 2% of GDP next year, and the M2 growth target is likely to be kept at 13%, but the PBOC may treat the target as a ceiling in 2014 instead of (as this year) a floor. We expect the PBOC will raise its benchmark interest rate by 25bps late next year, with inflation likely to exceed the one-year deposit rate, and market interest rate levels may rise gradually regardless of the benchmark rate as a result of tighter liquidity. Local government financing is likely to be constrained following the government debt audit. In addition, most of the reform measures, e.g., SOE reform, land reform and price reform, would be negative to growth in the short run.

Making a down payment for long-term growth

The leaders have pledged comprehensive but gradual reforms. The Decision approved by the third Plenary Session of the 18th CCCPC early this month lays out a broad-based reform plan, emphasizing that the market should play a decisive role (instead of a “basic” role featured in the previous official documents) in allocating resources. The Party leaders promised to make major achievements in key areas by 2020, suggesting reforms will be incremental. (see our assessment on reform details [China Macro Flash - China's Leaders Pledge Comprehensive but Gradual Reforms](#), 18 November 2013)

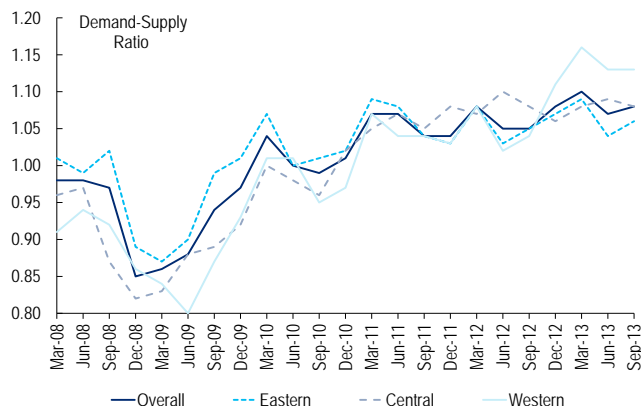
The reforms, if adequately implemented, may cause output loss in the near term. The reform measures should facilitate better allocation of resources over time, promote private investment to substitute government-driven investment, and increase disposable income of households. However, in the short run, the envisaged reform measures will be likely to slow down investment – 1) Price, land and interest rate reforms are expected to increase the cost of resources, land (including industrial land), and financing; 2) Rural land reform, which involves redistribution of land sale proceeds in favor of farmers, would reduce the share of revenues accruing to the local governments and their capability to invest in infrastructure; 3) Stricter environmental standards would constrain the old investment model that is resource intensive and pollution prone.

We expect more progress in investment, financial, and fiscal reforms in 2014.

The annual central economic work conference, likely to be held by mid-Dec, is expected to set a growth target and reform agenda for 2014. We think the following reforms are likely to be introduced next year:

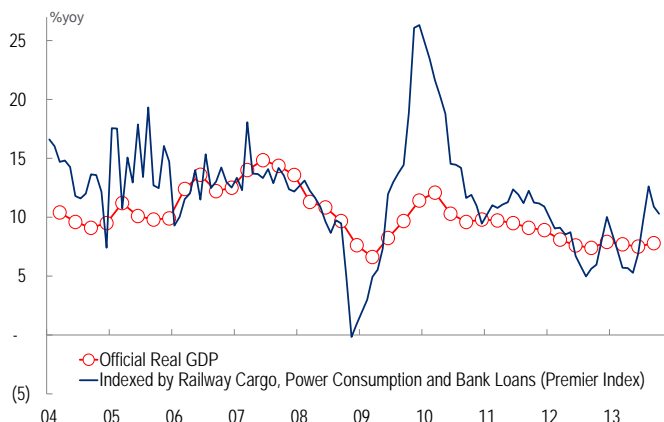
- Family planning: The policy of allowing couples to have a second child if one of the parents has no siblings (单独二胎政策) is likely to be introduced late this year or early next year.
- Investment deregulation: The negative list approach to investment approval is likely to be experimented in regions other than the Shanghai Free Trade Zone (SFTZ).
- Financial reforms: (i) Expand RMB trading band; (ii) issuance of certificate of deposits (CDs); (iii) liberalization of long-term (for example 5-year) deposit rates; (iv) introduction of deposit insurance scheme; (v) investment quota (QFII, QDII, RQFII and QDII2); (vi) securitization.
- Fiscal reforms: (i) 2014 budget is likely to be compiled based on the realignment of central and local government functions (事权) and spending responsibilities; (ii) re-distribution of VAT; (iii) property tax extension; (iv) natural resources are likely to be made ad valorem, and environment protection charges will probably be changed to taxes; (v) more local governments may be allowed to issue debt, subject to a quota system.
- Price reforms: as long as inflation is not a threat, tiered water pricing system and natural gas price reform are likely to be introduced.
- Other reforms: technical preparation for rural land reform and industrial land pricing reform may be initiated in the form of pilot programs; and the profit surrender ratio for SOEs may be raised by 5ppts.

Figure 72. Labor shortage affects all regions, especially the west



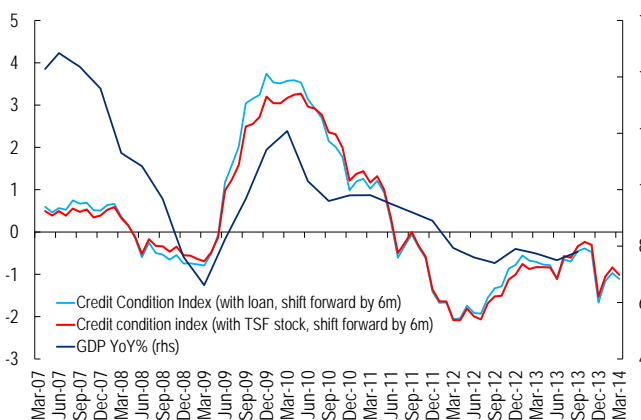
Source: CEIC and Citi Research

Figure 73. Macro indicators suggest 7.5% growth target is within reach



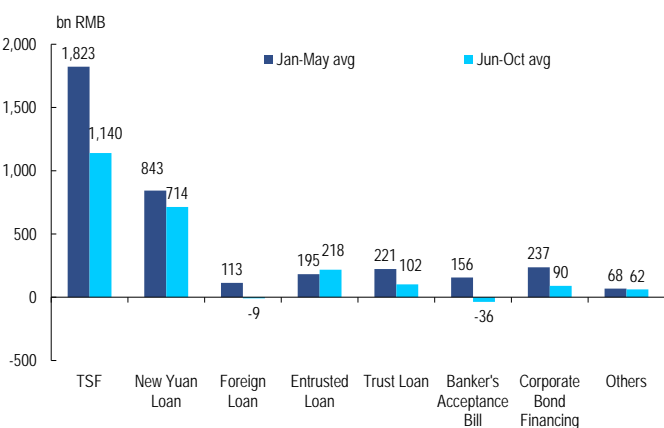
Source: CEIC and Citi Research

Figure 74. China Credit condition index predicts growth slowdown



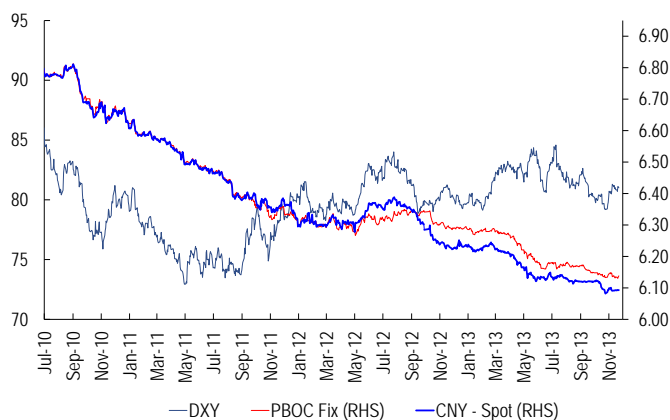
Source: CEIC, WIND and Citi Research

Figure 75. Credit condition tighter since Jun, especially for OBS items



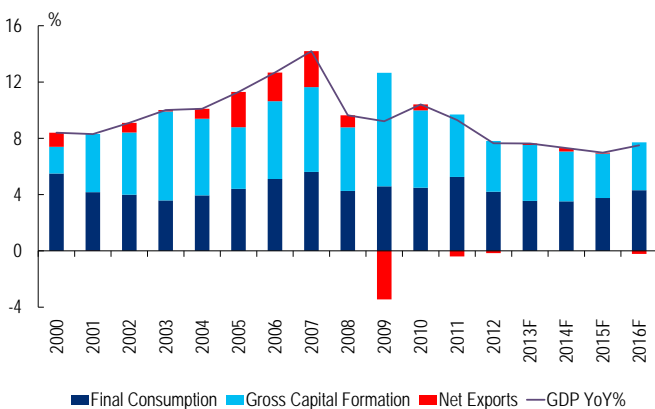
Source: CEIC and Citi Research

Figure 76. RMB may appreciate less amid US tapering



Source: Bloomberg and Citi Research

Figure 77. Contribution to GDP



Source: CEIC and Citi Research

Figure 78. 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	9,265.5	10,252.8	11,360.7
Nominal GDP, local currency bn	26,583	31,490	34,632	40,151	47,310	51,894	57,038	62,414	68,618
GDP per capita, US\$	2,645	3,422	3,800	4,424	5,432	6,084	6,816	7,512	8,294
Population, mn	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,359.5	1,364.9	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	7.6	7.3	7.0
Real investment growth % yoy	14.4	11.0	19.2	11.9	9.4	8.1	8.5	7.5	6.7
Real consumption growth % yoy	11.0	8.5	9.4	9.2	10.9	8.3	7.2	7.1	7.6
private consumption growth % yoy	11.1	9.2	10.3	8.5	18.2	8.5	7.4	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	3.0	4.0	3.5
CPI, % avg	4.8	5.9	-0.7	3.3	5.4	2.6	2.7	3.3	3.7
Nominal wages, % yoy	18.5	16.9	11.6	13.3	14.4	11.9	9.9	9.4	9.9
Credit extension to private sector, % yoy	19.3	14.0	33.2	20.3	15.1	15.6	14.8	14.1	13.6
Policy interest rate, % eop	4.14	2.25	2.25	2.75	3.50	3.00	3.00	3.25	3.75
1 month inter-bank rate, % eop	3.61	1.23	1.79	6.17	6.00	4.90	5.30	5.55	6.05
Long term yield, % eop	4.19	1.80	3.06	3.61	3.27	3.33	3.90	4.15	4.65
lc/US\$, eop	7.30	6.82	6.83	6.59	6.29	6.23	6.08	6.04	6.00
lc/US\$, avg	7.61	6.95	6.83	6.77	6.46	6.31	6.14	6.05	6.01
Balance of Payments, US\$ bn									
Current account	353.2	420.6	243.3	237.8	136.1	193.1	203.8	205.1	170.4
% of GDP	10.1	9.3	4.8	4.0	1.9	2.3	2.2	2.0	1.5
Trade balance	264.3	298.1	195.7	181.5	154.9	231.1	238.9	208.3	199.6
Exports	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.9	2,185.5	2,282.4	2,428.8
Imports	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,817.8	1,946.6	2,074.1	2,229.2
Service balance	-7.9	-11.8	-29.4	-31.2	-61.6	-89.7	-98.7	-108.5	-119.4
Income balance	8.0	28.6	-8.5	-25.9	-70.3	-42.1	-0.6	-13.6	-23.7
FDI, net	139.1	114.8	87.2	185.7	231.7	191.1	147.0	99.9	47.7
International reserves	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,769.0	3,917.2	4,066.7
Total Amortisations	20.3	23.3	34.2	27.2	33.2	38.8	41.8	46.0	50.6
Public Finances, % of GDP									
Consolidated government balance	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-2.0	-2.0	-1.5
Consolidated gov primary balance	1.0	0.1	-1.8	-1.7	-0.9	-1.6	-1.6	-1.6	-1.1
Public debt	39.0	37.4	47.8	49.2	44.3	45.0	45.1	45.2	44.1
of which Domestic	38.0	36.6	47.0	48.6	43.7	44.6	44.7	44.8	43.6
Foreign Assets & Liabilities, US\$ bn									
External debt	389.2	390.2	428.6	548.9	695.0	737.0	810.7	891.8	980.9
Private	354.3	356.9	391.8	510.1	657.6	700.4	770.4	847.4	932.2
Public	34.9	33.3	36.9	38.8	37.4	36.6	40.3	44.3	48.7
External debt / GDP	11.1	8.6	8.5	9.3	9.5	8.9	8.7	8.7	8.6
External debt / XGS	29.0	24.7	32.2	31.5	33.4	32.8	33.8	35.6	36.8
Short-term debt	235.7	226.3	259.3	375.7	475.7	504.4	554.8	610.3	671.4
Short-term debt/International Reserves (%)	15.4	11.6	10.8	13.2	15.0	15.2	14.7	15.6	16.5
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	7.5	7.8	7.5	7.6	7.4	7.0	7.2	7.3	7.1
CPI, % yoy	2.7	3.1	3.0	3.3	3.0	3.2	4.0	3.7	3.8
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.75
1 month inter-bank rate, % eop	7.35	5.30	5.30	5.30	5.30	5.30	5.55	5.80	6.05
Long term yield, % eop	3.32	3.90	3.90	3.90	3.90	3.90	4.15	4.40	4.65
lc vs USD, eop	6.14	6.12	6.08	6.07	6.06	6.05	6.04	6.03	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).

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Hong Kong

- **Summary view** – Concerns of a rise in interest rate and a decline in asset price associated with the Fed exit will turn even more prominent in 2014. Inflation could soften on slower pass-through of rentals. Policy Address/Budget Speech to focus on housing, financial developments, poverty and the elderly.
- **Things to watch** – 1) Liquidity outflows on taper concerns and China's credit tightening; 2) the 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 could move up again along with renewed tapering talks. HKD peg likely to remain status quo. Citi's houseview is that home prices are likely to drop by 10% in the primary market. Our equity strategist target for HSI for 2014 year-end is 25,000.

Adjusting to change in liquidity patterns

The next phase can turn to liquidity outflows. Since the start of QE1 in late-2008, HK has benefited from a large amount of liquidity inflows; and very broadly saying with the subsequent global monetary easing that resulted in ultra-low interest rates, liquidity in HK has been kept abundant since. More evident Mainland Chinese inflows have also entered HK's property and stock market since 2009. The main impacts on HK are asset inflation, encouraged lending via banks and debt issuance. With coming tapering/eventual interest rate hikes and tighter funding conditions in China, fund outflow could be more pronounced and the rise in interest rate could deflate asset bubbles, which negative wealth effect could in turn take a toll on consumption.

Housing risks still the top policy concern. Given the lack of monetary independence when maintaining the HKD peg with the USD, HK policymakers have adopted various macro-prudential measures to "lean against the wind" in the property market (stamp duties & addressing bottlenecks) and safeguarding the banking system (prevent excessive lending, e.g., mortgages & Mainland China exposure). Officials still regard the current property market as overheated, as flat prices in Sep13 are still 42% above the previous peak in 1997. We think the government will maintain all its existing property market cooling measures in 2014, to buy time for supply in residential and commercial property markets to catch up. Although officials have reiterated that previous cooling measures can be reversed in the event of a sharp property price adjustment, our house view that home prices could fall 10% in 2014 is well within policy tolerance. Our property strategist Ken Yeung thinks that new supply in the next three years would come in lower than the government's target (see [Hong Kong Property - 2014 Outlook: Home Price to Dip, Not Dive](#)).

A sustainable China growth story therefore would be the key buffer for HK during liquidity dynamic times. We expect the Chinese economy will run within the reasonable range defined by the Premier in 2014E. The opportunities associated with various reforms in China could lure foreign interests into the related H-share names. Further capital account liberalization and cooperation with Qianhai and Shanghai FTZs could attract more fund houses to domicile in HK. Chinese investments in HK in the form of QDII and ODI could step up going forward. All these are potential liquidity replenishments. The ability to maintain HK as an International Financial Center is also important for maintaining both the flow and stock of liquidity in HK.

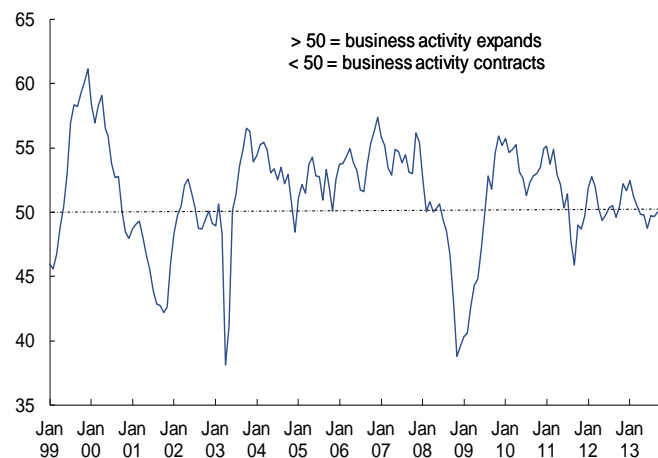
Credit lending likely to remain high in 2014E. Loan growth in HK climbed to 10.9%yoy in Sep13, with total loan-to-deposit ratio reaching 72% (a level that we have not seen since 2000 -- with HK\$ LDR at 82.6% and foreign currency LDR at 61.6%). As interest rates are likely to remain in this global ultra-low environment until the US Fed starts hiking rates, at least until mid-2015, we expect credit growth to remain in the low double digits in 2014E. Banks' exposure to China is likely to rise further in 2014E, given HK's economic links with China and funding pressures in China. We expect policymakers to step up warnings and implement more prudential and supervisory measures on this front.

We expect GDP to dip in 1Q14E. The HK economy bumped along the various uncertainties in 2013E. Overall we expect 2014E will see further GDP recovery from 2013E's 3%yoy to 3.4%yoy. But, we worry that the recovery will have a tough start in early 2014 as asset markets may be challenged by liquidity changes and trade performance could moderate after the festive periods. For the later quarters, we expect a modest global trade recovery is likely to benefit HK's logistics sector. The various large-scale transport/infrastructure projects (many to be completed in 2015-18) will likely keep investment spending strong and unemployment low. In fact, HK is debating the possibility of importing more foreign labor, especially for the construction sector. Overall, the tight labor market and vibrant tourism would likely continue to buffer consumption (but we think retailers will have to adjust to the changing tourist dynamic, i.e., more day-trip shoppers and less high-end retail spending going forward).

Stronger fiscal inclination expected in the Policy Address and Budget Speech in Jan/Feb 2014 with public spending on social housing, welfare/poverty reduction, elderly and education. We do not expect the government to distribute cash handouts, but current considerations of cash subsidies to the working poor could likely be implemented by the Commission on Poverty, further increase of the tax could also be possible. The almost recurrent "one-off" relief measures will likely again be administered, these include: public rental waiver, salaries/personal tax rebates (but likely to be smaller than last year's HK\$10,000), one-month allowance to be granted to the various assistance schemes, etc. In addition, to further enhance financial development, PBOC and HKMA will likely remove the daily RMB conversion quota for HK residents, and we think this policy could be announced as early as the 10th-year anniversary of HK RMB personal banking business (in Jan 14). Such an enhanced RMB conversion arrangement is conducive for the multiplier effect of offshore RMB and its product developments. Although details of the pilot zones are lacking thus far, HK must swiftly seize any opportunities to cooperate with Qianhai/Shanghai FTZ and Taiwan FEZ to avoid being marginalized.

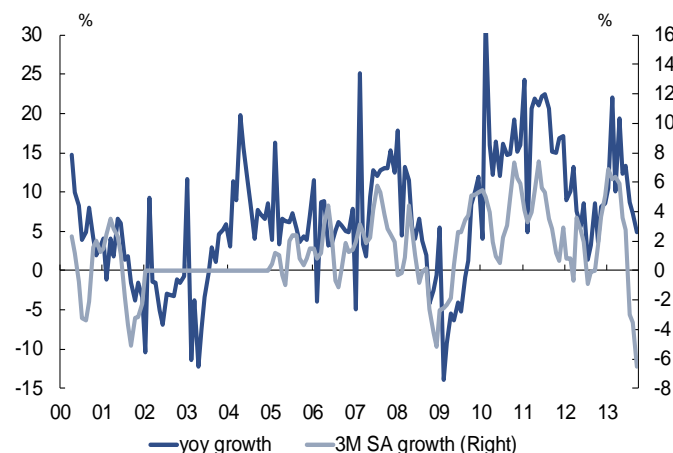
Social/political tension to escalate as HK looks for universal suffrage. In preparation for a direct Chief Executive Election in 2017 and Legislative Council Election in 2020, the HK government will start consultation in 2014. Officials, sector representatives, politicians and movements like Occupy Central will all become much more vocal on electoral reforms in 2014. Senior Chinese official Li Fei (Deputy Secretary-General of the Standing Committee of the NPC) has laid out the China government's stance in the matter in his recent visit to HK. The debate is to seek a viable plan for universal suffrage that can achieve as much democracy as the public can get within what is allowed under the Basic Law; the subjects of contention are the CE nomination process and the functional constituencies of LegCo. Also, mass demonstration (largely of a peaceful nature and within the parameters of the law) has become a regular expressive act of the public in recent years, and is expected to continue quite frequently in the remaining term of this government.

Figure 79. PMI bumping along the 50 threshold



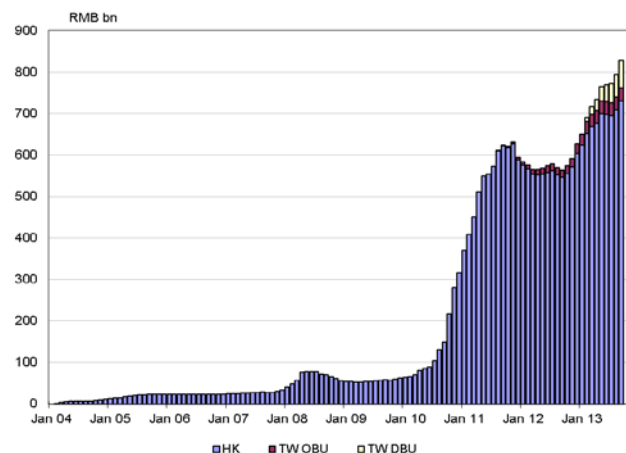
Source: Markit, Haver, Citi Research

Figure 81. Retail sales slowing on selective local/foreign spending



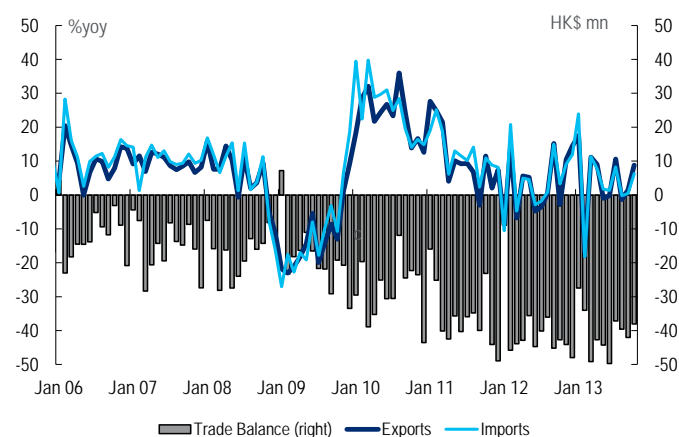
Source: CEIC, Citi Research

Figure 83. Offshore RMB deposits continue to build



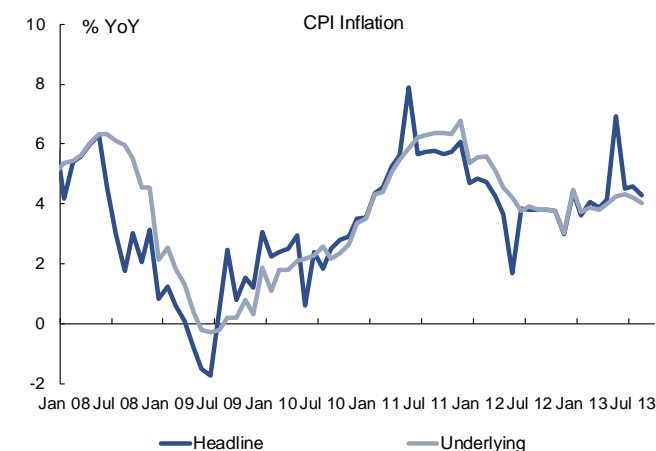
Source: HKMA, CBC, CEIC, Citi Research

Figure 80. Trade fragilities persist, and probably more evident in 1Q14E



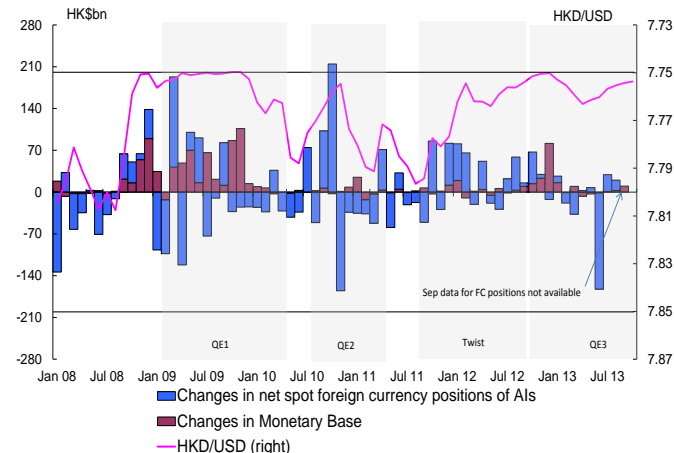
Source: CEIC, Citi Research

Figure 82. Mild price pressures as private housing pass-through slows



Source: CEIC, Citi Research

Figure 84. Net inflows continued in Aug13



Source: HKMA, CEIC, Citi Research

Figure 85. Hong Kong Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	211.6	219.3	214.0	228.7	248.7	263.3	278.8	293.8	310.9
Nominal GDP, local currency bn	1,651	1,707	1,659	1,777	1,936	2,042	2,163	2,279	2,410
GDP per capita, US\$	30,497	31,488	30,594	32,429	34,971	36,676	38,527	40,279	42,288
Population, mn	6.9	7.0	7.0	7.1	7.1	7.2	7.2	7.3	7.4
Unemployment, % of labour force	4.0	3.5	5.3	4.3	3.4	3.3	3.3	3.2	3.1
Economic Activity									
Real GDP, % yoy	6.5	2.1	-2.5	6.8	4.9	1.5	3.0	3.4	3.8
Real investment growth % yoy	7.9	-0.3	1.0	11.1	2.2	5.2	2.4	3.7	3.3
Real consumption growth % yoy	7.9	1.9	0.5	5.8	7.7	3.0	3.9	2.0	2.2
private consumption growth % yoy	8.6	1.9	0.2	6.1	8.4	3.0	4.1	2.0	2.4
Real export growth, % yoy	8.3	2.5	-10.0	16.8	3.9	1.9	7.0	5.2	6.2
Real import growth, % yoy	9.1	2.2	-9.0	17.4	4.6	2.8	7.2	4.8	5.7
Prices, Money & Credit									
CPI, % yoy	3.8	2.1	1.5	2.9	5.7	3.8	4.1	3.6	3.5
CPI, % avg	2.0	4.3	0.6	2.3	5.3	4.1	4.3	3.6	4.0
Nominal wages, % yoy	2.4	4.0	-1.9	2.4	9.9	4.7	3.5	4.5	4.5
Credit extension to private sector, % yoy	15.2	11.0	-2.1	20.9	12.5	7.0	16.0	11.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	3.31	0.89	0.13	0.33	0.33	0.50	0.38	0.40	0.85
Long term yield, % eop	3.10	1.19	1.93	1.76	0.96	0.32	1.05	1.90	2.70
lc/US\$, eop	7.80	7.75	7.75	7.77	7.77	7.75	7.75	7.76	7.75
lc/US\$, avg	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.76	7.75
Balance of Payments, US\$ bn									
Current account	27.6	32.9	21.2	16.1	14.0	6.1	7.7	9.2	12.0
% of GDP	13.0	15.0	9.9	7.0	5.6	2.3	2.8	3.1	3.9
Trade balance	-23.1	-25.8	-28.8	-43.0	-54.9	-61.6	-62.7	-63.9	-64.2
Exports	344.5	362.7	318.5	390.2	428.7	442.8	459.2	482.5	514.7
Imports	367.6	388.6	347.3	433.1	483.6	504.3	521.9	546.4	578.9
Service balance	-4.3	-2.7	3.6	10.2	17.2	24.6	28.7	29.7	30.3
Income balance	6.8	12.9	6.4	4.8	6.8	5.6	7.0	7.0	7.0
FDI, net	-19.0	-8.9	-6.4	-10.5	-8.7	-9.0	-10.0	-11.0	-12.0
International reserves	152.6	182.5	255.7	268.6	285.3	317.2	320.0	340.0	360.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	7.3	0.1	1.5	4.1	3.8	3.1	2.2	1.6	0.7
Consolidated gov primary balance	7.4	0.1	1.6	4.2	3.8	3.2	2.2	1.7	0.7
Public debt	1.2	1.0	0.7	0.6	0.6	0.5	0.6	1.0	1.4
of which Domestic	0.4	0.2	0.1	0.0	0.0	0.0	0.1	0.1	0.1
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 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	3.2	2.9	3.0	2.8	3.2	3.6	4.0	3.9	3.5
CPI, % yoy	4.2	4.6	4.1	4.0	3.7	3.9	3.6	3.9	3.7
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	0.21	0.22	0.22	0.25	0.25	0.25	0.25	0.45	0.50
Long term yield, % eop	1.12	1.15	1.05	1.15	1.35	1.60	1.90	2.10	2.30
lc vs USD, eop	7.76	7.76	7.75	7.75	7.76	7.76	7.76	7.76	7.75

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

*Note: Public debt is general government debt.

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- **Summary view** – While current growth data have been a bit disappointing, we expect GDP to pick up and average 4.8% in FY14 and further to 5.6% in FY15. Key drivers of the pick-up include the outcome of the good monsoons, mild export recovery and initiatives being taken to ‘unlock’ investments.
- **Things to watch** – For sustained recovery the structural factors to look out for are: (1) direction of fiscal deficit, (2) sustained compression in CAD, (3) monetary policy and its ability to contain inflation. Besides these, general elections in May 2014 will also be crucial for the policy environment.
- **Strategy** – With postponement of taper coupled with narrowing CAD, RBI has been unwinding its exceptional measures. But since inflationary pressures have persisted despite a prolonged period of negative output gap, RBI is likely to hike repo by another 25bps in the rest of FY14 and remain high through FY15.

Some “time”; but no room for complacency

India has got ‘some’ time. 2013 has been an eventful year for India. Initially benefiting from lower commodity prices and incremental policy steps, the taper fears in the summer led to mayhem in financial markets. Since September, India has bought itself some time, partly because of (1) postponement of taper, (2) hard work on the domestic policy front and (3) compression in the current account deficit (CAD) ahead of expectations.

No room for complacency. But, tapering will come and could ‘taper off’ improved expectations. This coupled with the upcoming general elections will be an important event for India. As discussed in [India Macroscope - No Room for Complacency](#), India's fortunes go well beyond the taper. It lies in (1) the direction of the fiscal deficit, (2) sustained compression in the CAD, (3) monetary policy – and its ability to contain inflation (4) the economy's response to these and other policy measures.

Investments key to a pick-up in growth

Current growth trends are lackluster with GDP at sub-5% levels for the third consecutive quarter, on account of decelerating trends in both consumption and investments. There has been both an increase in stalled projects and moderating new project announcements. As has been highlighted in our past publications, the accumulation/logjam of projects is due to issues like: 1. obtaining environmental/forest clearances; 2. land acquisition; 3. ministry delays; 4. fuel shortage.

Measures being taken to address investment bottlenecks: While current data trends are a bit disappointing with 1QFY14GDP at 4.4%, we expect growth to pick up and average 4.8% in FY14. Key drivers of the marginal pick-up include the outcome of the good monsoons, mild export recovery and initiatives being taken to ‘unlock’ investments. These include measures to enhance fuel supply – auctioning of coal blocks; increase in gas prices; SEB debt restructuring and fast tracking projects through the Project Monitoring Group. Continuation of these measures is key for a pick-up in growth to 5.6% in FY15.

External sector: on the recovery road

Measures to reduce the CAD begin to bear fruit: On the external front, the policy measures initiated earlier have begun to bear fruit. In contrast to other EMs where current account deficit (CAD) widened on slowing G-10 imports, India's record-high CAD (US\$88bn, 4.8% of GDP) was largely a result of oil, gold, and coal imports.

We expect the FY14 CAD to be contained at US\$50bn or 2.7% of GDP and 2.6% of GDP in FY15. This is on account of (1) a stronger than expected export recovery due to the INR depreciation and partner country growth, (2) a compression in imports primarily due to lower gold demand, sub-par trends in growth, curbs on non-essential imports and impact of INR depreciation. We highlight the possibility of an upside if mining/coal issues are sorted out soon.

Capital flows sufficient to finance the CAD: Complementing the measures to contain the CAD, policy makers undertook a host of measures to augment capital flows. On the capital account side, RBI's concessional swap scheme against mobilization of FCNR deposits and banks borrowing overseas has proved to be most effective. This coupled with positive trends in FDI and overseas borrowings are likely to result in an overall balance of payments thus alleviating fears of a drawdown in reserves.

Monetary and fiscal policy: A tightrope

Fiscal: Targets/Reforms Key to Sustain Ratings: On the fisc, assuming a partial rollover of subsidies, the moderation in expenditure coupled with the austerity measures bodes well for expenditure being contained within budgeted targets. However, trends in revenues appear challenging at this juncture and could result in a slippage in the fiscal deficit to 5% vs. budget estimates of 4.8%.

Monetary: Rates Likely to Stay Elevated: Inflation continues to be a bugbear for the economy. While there are disinflationary factors at play – negative output gap, moderating rural wages and lower MSP increases – there are also offsetting factors. These include the INR depreciation, sticky food prices and relatively high wage inflation, which is likely to result in the WPI and CPI averaging 6% and 9% respectively. With RBI's focus shifting more towards containing inflationary expectations and CPI, we expect that following the two consecutive rate hikes of 25bps each, another 25bps repo rate hike is likely taking repo to 8% in FY14. We expect rates to stay elevated in FY15 as well.

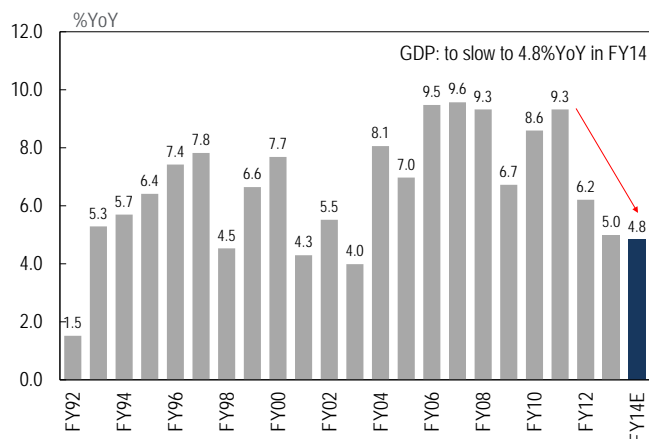
Politics

Reforms: Progress Continues: The last parliament session saw the passage of key bills like the Land Acquisition Bill, Companies Bill, Food Security Bill, and Pension Bill. These would impact infrastructure investments, business environment, the fisc, and FDI. They also show the government's willingness to take big policy decisions leading up to the elections.

Upcoming General Elections: The incumbent ruling alliance would have completed two full terms when the general elections are held in May 2014. As the present government heads into polls, it has passed several bills but the anti-incumbency wave continues to be strong. As reported in the media many opinion polls indicate that opposition parties have gained ground recently; the results of assembly elections in five states could provide important insights.

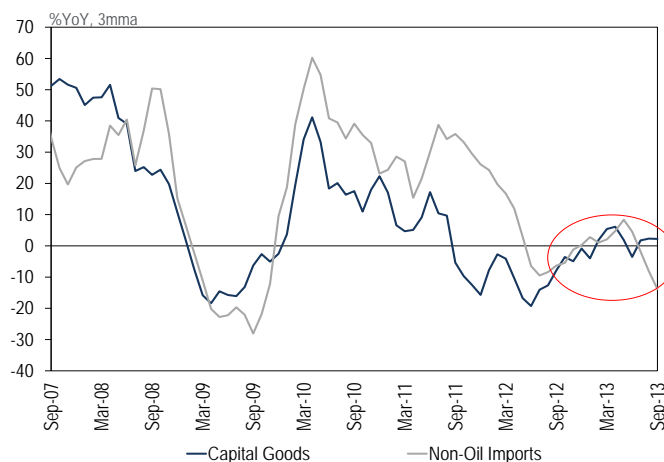
Elections: Recent Development: A key development is that the main opposition, the BJP, has announced Narendra Modi as its Prime Ministerial candidate for the general elections. As a political leader, Modi is perceived to be supportive of business activity and economic growth. Leading up to the general elections, important state elections remain –Delhi, Rajasthan, Madhya Pradesh, Chhattisgarh.

Figure 86. GDP – Expect FY14 GDP at 4.8%YoY



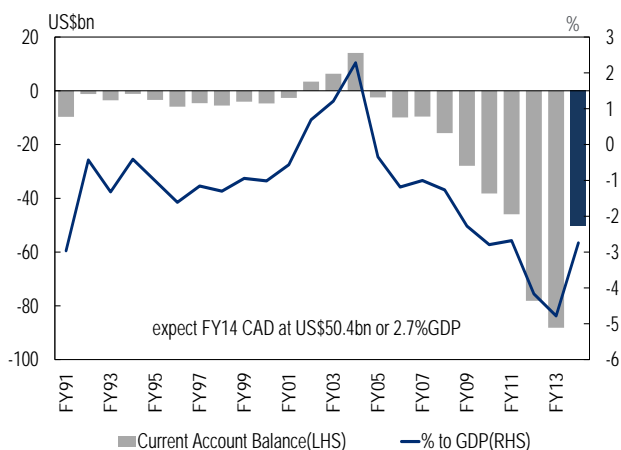
Source: CSO; Citi Research

Figure 87. Investments: capital goods & non-oil imports(%YoY, 3mma)



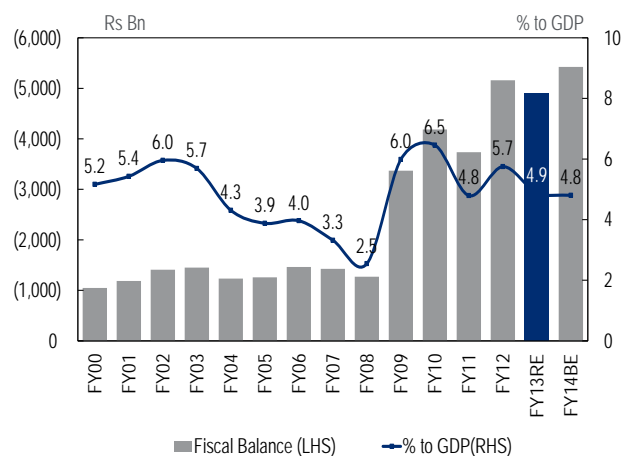
Source: CMIE

Figure 88. Current account deficit to narrow in FY14 (US\$bn, %GDP)



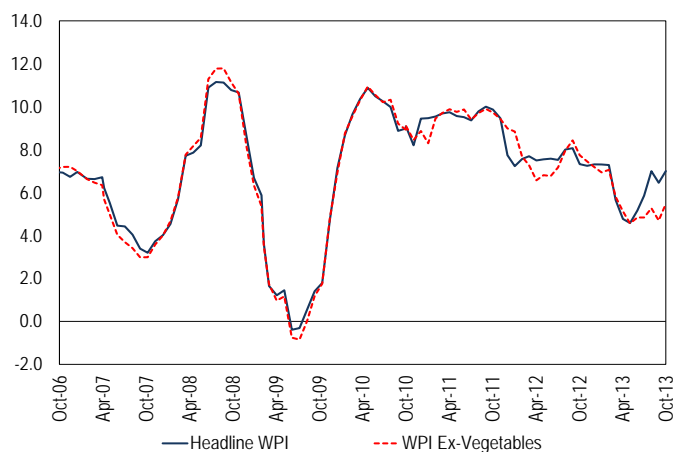
Source: RBI, Citi Research

Figure 89. Fiscal deficit could see some slippage



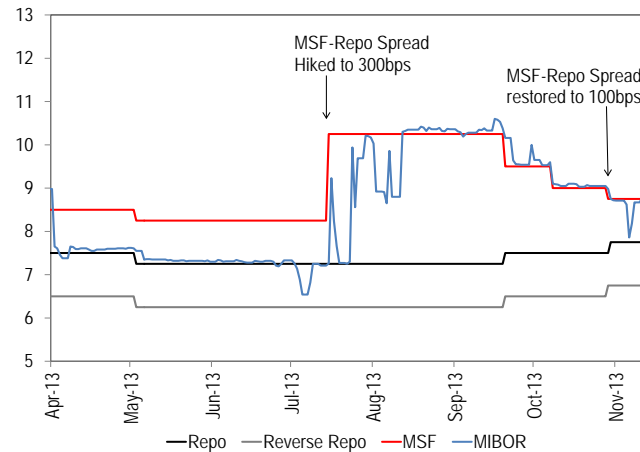
Source: Budget Documents

Figure 90. Headline WPI inflation led primarily by vegetables



Source: Office of the Economic Advisor

Figure 91. Rates likely to stay elevated



Source: RBI

Figure 92. 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	1,710.2	1,865.9	1,855.7	1,836.3	2,299.0	2,707.9
Nominal GDP, local currency bn	49,871	56,301	64,778	77,953	89,749	100,206	112,932	128,743	146,767
GDP per capita, US\$	1,090	1,061	1,168	1,442	1,552	1,521	1,483	1,829	2,123
Population, mn	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,220.0	1,238.3	1,256.9	1,275.8
Unemployment, % of labour force	--	--	--	--	--	--	--	--	--
Economic Activity									
Real GDP, % yoy	9.3	6.7	8.6	9.3	6.2	5.0	4.8	5.6	6.7
Real investment growth % yoy	18.1	-5.2	17.3	15.2	0.5	6.5	1.0	4.5	6.1
Real consumption growth % yoy	9.4	7.7	8.4	8.1	8.1	3.9	4.9	6.4	7.7
private consumption growth % yoy	9.4	7.2	7.4	8.6	8.0	4.0	4.5	6.5	8.0
Real export growth, % yoy	5.9	14.6	-4.7	19.7	15.3	3.0	5.2	11.0	9.0
Real import growth, % yoy	10.2	22.7	-2.1	15.8	21.5	6.8	5.0	9.5	9.3
Prices, Money & Credit									
WPI, % yoy	7.7	1.5	10.6	9.7	7.7	6.0	6.0	5.0	5.0
WPI, % avg	4.8	8.1	3.8	9.6	8.9	7.3	6.0	5.0	5.0
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
1 month inter-bank rate, % eop	8.00	5.68	4.49	9.54	10.90	8.50	8.50	8.50	8.50
Long term yield, % eop	7.96	7.01	7.83	7.99	8.56	8.00	8.50	8.50	8.50
lc/US\$, eop	39.41	48.62	46.41	44.71	53.02	55.00	63.50	61.91	57.85
lc/US\$, avg	41.18	43.42	48.30	45.68	46.63	53.38	59.95	62.98	59.26
Balance of Payments, US\$ bn									
Current account	-15.7	-27.9	-38.2	-45.9	-78.2	-88.2	-50.4	-55.4	-66.3
% of GDP	-1.3	-2.3	-2.8	-2.7	-4.2	-4.8	-2.7	-2.4	-2.4
Trade balance	-91.5	-119.5	-118.2	-130.6	-189.8	-195.7	-166.2	-178.0	-194.0
Exports	166.2	189.0	182.4	250.5	309.8	306.6	323.4	355.8	398.5
Imports	257.6	308.5	300.6	381.1	499.5	502.2	489.7	533.8	592.5
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	21.0	18.0	23.0
International reserves	299.1	241.6	252.8	273.7	260.9	264.7	277.9	298.0	317.3
Total Amortisations	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9	21.0
Public Finances, % of GDP									
Consolidated government balance	-4.0	-8.3	-9.4	-8.0	-8.1	-7.0	-6.7	-6.4	-6.2
Consolidated gov primary balance	-1.1	3.4	4.6	2.7	2.2	--	--	--	--
Public debt	76.1	76.8	75.5	69.6	69.1	68.4	67.4	65.6	63.7
of which Domestic	71.4	72.2	70.6	65.0	65.9	64.0	63.4	62.1	60.6
Foreign Assets & Liabilities, US\$ bn									
External debt	224.4	224.5	260.9	305.9	345.8	392.1	388.5	403.5	418.5
Private	166.3	168.6	193.9	227.8	263.9	310.5	310.2	323.2	336.2
Public	58.1	55.9	67.1	78.1	81.9	81.7	78.4	80.4	82.4
External debt / GDP	18.1	18.3	19.1	17.9	18.5	21.1	21.2	17.6	15.5
External debt / XGS	88.5	77.7	95.2	81.5	77.6	88.7	85.5	69.1	59.3
Short-term debt	45.7	43.3	52.3	65.0	78.2	96.7	96.8	101.8	106.8
Short-term debt/International Reserves (%)	15.3	17.9	20.7	23.7	30.0	36.5	34.8	34.1	33.6
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	4.4	4.7	5.3	5.0	5.2	5.6	5.8	5.8	6.5
WPI, % yoy	4.8	6.1	6.6	6.5	5.3	5.1	5.0	5.0	5.0
Policy interest rate, % eop	7.25	7.50	7.75	8.00	8.00	8.00	8.00	8.00	8.00
1 month inter-bank rate, % eop	8.05	10.50	9.00	8.10	8.10	8.10	8.10	8.10	8.10
Long term yield, % eop	7.50	8.40	8.50	8.50	8.50	8.50	8.50	8.50	8.50
lc vs USD, eop	59.53	62.59	63.50	63.50	63.50	63.02	61.91	60.83	59.73

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** – GDP growth may continue to decelerate in 2014 to 5.3%, from an expected 5.7% in 2013, following a slew of stabilization and tightening policies aimed to bring down imports. Inflation may revert back towards 5% as the effects of this year's fuel price adjustment and exchange rate depreciation fully subside.
- **Things to watch** – Elections will be held in April (legislative) and July (presidential). Post-2014 we do not see risk of change in broad economic policies under any new presidency. However the political environment during the election year may hamper reforms in the near term.
- **Strategy** – We still expect a 25bps rate hike, and bond yields may see upside in a Fed taper environment. A weaker currency will also remain a relevant trend for 2014.

A new (Bank) Indonesia?

Central bank appears to be changing course. The bank is now aiming for a deeper and liquid foreign exchange market. We have seen concrete change on the ground. Since September, BI has stopped giving guidance on quotes and moral suasion on the currency. This has led to a more transparent quotation on the spot exchange rate; and interbank FX volumes have recovered from a couple of hundred million dollars per day towards the \$0.5-\$1bn range.

Monetary policy becoming more prudent. We also see the central bank becoming focused on lowering the current account deficit. An exchange rate level weaker than 10,000 is no longer regarded negatively but is in contrast viewed positively in the context of curbing imports. We view BI's policy moves going forward will be "data-dependent" on the developments on the current account. Previously we sensed its approach was more "flows-dependent"; i.e., tolerating a wider current account deficit for as long as capital inflows were sufficient as an offset. In the Nov-13 meeting, BI raised the policy rate despite having seen a rise in its foreign reserve position and inflation pressures having subsided.

But the battle to restore external balance has yet to be won. The deceleration of domestic demand growth and imports is occurring gradually and not at a swift pace. The impact of previous rate hikes will come with a lag, and we expect loans growth to eventually slow down towards the 16% level next year. However, we do not rule out that further tightening of monetary policy may be needed in the near future. We expect BI will look into further macroprudential measures to curb loans growth to high import sectors other than property and also do not rule out a further rise in interest rates.

Will politics get in the way? We expect the current BI leadership to remain relatively focused on bringing down imports in 2014, even through unpopular tightening policies. They may be able to withstand pressures during the election year, as the service tenor of the BI Governor extends beyond that of the current administration and current parliament. However, we must not forget that the battle must be fought on two fronts. Apart from the short-term stabilization efforts through lowering imports, there must also be longer-term efforts to strengthen the export side, i.e., diversify Indonesia's export base away from volatile-price primary commodity exports into higher value-added manufacturing. Alas, we are not as confident when it comes to progress in structural reforms (e.g., reduction of energy subsidies, debottlenecking, which are pre-requisites for export diversification). Distractions will be significant as a number of key posts in the cabinet are headed by political figures, some with presidential ambitions.

2014 Elections: What is at stake?

We have highlighted that macroeconomic management will become increasingly challenging in the medium term. With the balance of power likely to remain in the hands of a strong parliament, the next President will need to have negotiating prowess to be able to push for reforms. There will still be pressing issues to deal with by the end of 2014, e.g., an ever growing energy subsidy bill which will have to be decided upon.

Up to now we have not been too concerned that the country will veer off course towards a nationalistic or protectionist style of policymaking. The macroeconomic dynamics; i.e., having a current account deficit thus need for capital inflows, will be a key factor shaping macroeconomic policies of the central government in the near term and post 2014. Inward-looking policies affecting foreign investment and trade, especially those that can affect relations with key trading partners, will likely be crafted more carefully compared to how it had been done in the recent past.

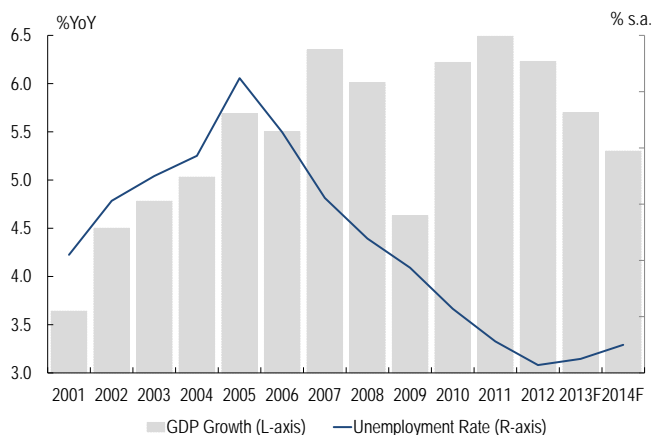
We think the adverse impact of the elections will be on the pace of reform in 2014. Reduction of fuel subsidies, land acquisition for infrastructure and labor reform are all politically sensitive issues, which many politicians may tend to shun away from during an election year. Some key economic posts in the cabinet are headed by figures who are either linked to a political party and/or have stated aspirations to contest the 2014 presidential elections. Policies emanating from regional governments and the judicial system will also be less predictable amid a rise in campaign financing needs. Regional government leaders come from various political backgrounds and are prone to coming up with policies that are not necessarily cognizant of the broader macroeconomic objectives.

Past experience shows capital flows are not too sensitive to election periods. Based on previous experiences, foreign direct investment flows have seen swings during election years, but it is not clear whether they can be directly attributable to election uncertainties. For example, parent–subsidiary lending (as % GDP) did come down during the 2009 election year, but this was concurrent with the global financial crisis. Meanwhile during the 2004 election year, parent–subsidiary lending did not see any significant downturn as it was actually higher compared to the following year.

Slower growth: a new reality?

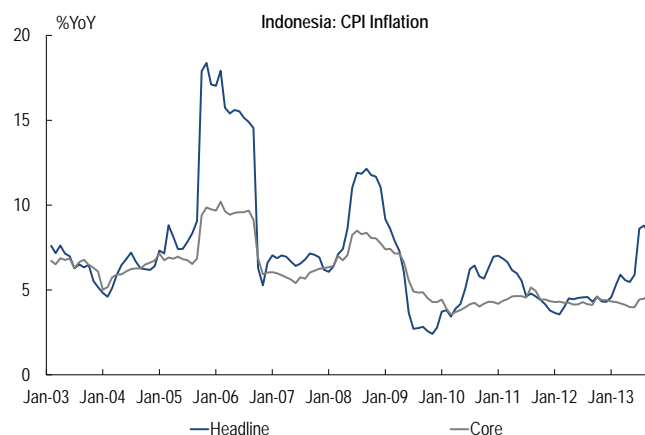
We believe Indonesia's GDP growth may decelerate in 2014 to 5.3%, from an expected 5.7% in 2013. Inflation generally will have abated closer toward the 5% level (although with the risk of the oil trade deficit potential still rising, the low-probability event of another fuel price hike could not be completely ruled out). Yet in spite of this, we still a high probability of monetary policy further tightening next year. We see the current account improvement to happen at slow pace, reaching 2.7% of GDP next year. As for the currency, it is no longer being propped up at certain psychological levels, and we do not see significant risk of another sharp and abrupt correction as in August. However with the Fed taper still on the horizon and ups and downs in the trajectory of the trade deficit, we also do not see any a quick rebound in store for the currency; local bond yields may also see some upside risk. With BI having a clear focus on bringing down the CA deficit, any strengthening of the currency that is driven by capital inflows may be used as an opportunity to re-accumulate foreign reserves and improve reserve adequacy.

Figure 93. Growth expected to slow towards 5.3%



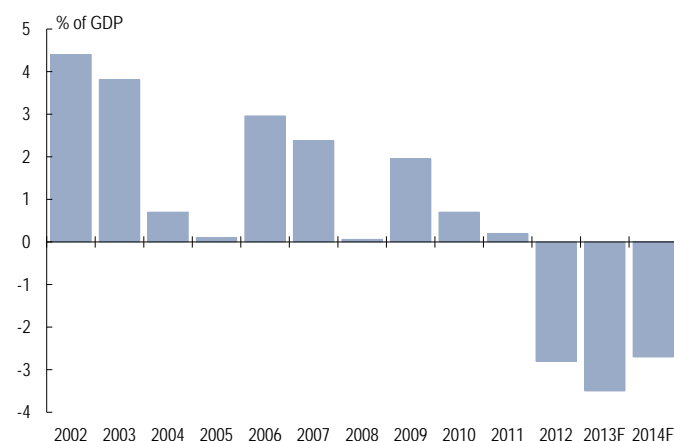
Source: CEIC, Citi Research

Figure 94. We expect inflation to head towards 5%



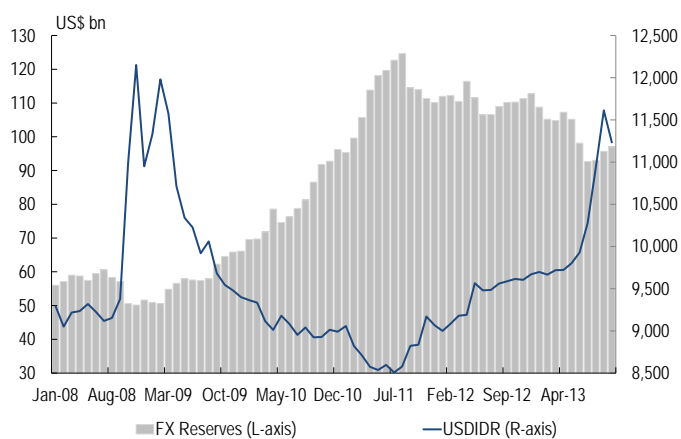
Source: CEIC, Citi Research

Figure 95. Current account deficit may turnaround but at gradual pace



Source: CEIC, Citi Research

Figure 96. With BI emphasizing prudence, reserves may be replenished



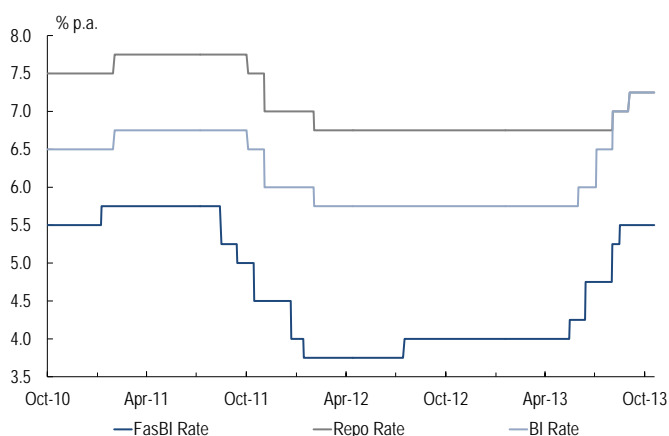
Source: CEIC, Citi Research

Figure 97. FDI inflows during election periods



Source: CEIC, Citi Research

Figure 98. We expect policy to remain on tight bias in 2014



Source: CEIC, Citi Research

Figure 99. Indonesia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	432.2	510.7	538.6	709.5	845.8	878.3	869.2	873.5	1,008.8
Nominal GDP, local currency bn	3,950,893	4,948,688	5,606,203	6,446,852	7,422,781	8,241,864	9,176,153	10,026,877	11,236,737
GDP per capita, US\$	1,915	2,235	2,328	2,986	3,486	3,596	3,526	3,503	3,997
Population, mn	225.6	228.5	231.4	237.6	242.6	244.2	246.5	249.4	252.4
Unemployment, % of labour force	9.1	8.4	7.9	7.1	6.6	6.1	6.3	6.5	6.3
Economic Activity									
Real GDP, % yoy	6.3	6.0	4.6	6.2	6.5	6.2	5.7	5.3	5.5
Real investment growth % yoy	1.9	12.4	2.4	8.8	10.5	16.9	5.0	4.5	6.0
Real consumption growth % yoy	4.9	5.9	6.2	4.1	4.5	4.8	5.0	4.7	4.7
private consumption growth % yoy	5.0	5.3	4.9	4.7	4.7	5.3	5.0	4.6	4.3
Real export growth, % yoy	8.5	9.5	-9.7	15.3	13.6	2.0	3.5	5.5	10.0
Real import growth, % yoy	9.1	10.0	-15.0	17.3	13.3	6.6	0.8	4.0	9.0
Prices, Money & Credit									
CPI, % yoy	5.8	11.1	2.8	7.0	3.8	4.3	8.8	4.9	6.0
CPI, % avg	6.3	9.9	4.8	5.1	5.4	4.3	7.1	6.6	5.7
Nominal wages, % yoy	4.9	7.6	5.3	12.2	3.4	20.6	28.0	10.0	10.0
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	6.50
1 month inter-bank rate, % eop	3.35	9.44	6.39	5.66	4.57	4.24	6.00	6.25	6.90
Long term yield, % eop	10.02	11.92	10.07	7.83	6.05	5.39	8.00	8.50	8.75
lc/US\$, eop	9393	10900	9425	9010	9068	9638	11804	11640	10945
lc/US\$, avg	9140	9673	10376	9078	8763	9361	10737	11795	11199
Balance of Payments, US\$ bn									
Current account	10.5	0.1	10.6	5.1	1.7	-24.4	-30.7	-24.4	-23.1
% of GDP	2.4	0.0	2.0	0.7	0.2	-2.8	-3.5	-2.8	-2.3
Trade balance	32.8	22.9	30.9	30.6	34.8	8.6	3.1	5.9	9.2
Exports	118.0	139.6	119.6	158.1	200.8	188.5	180.8	187.7	209.4
Imports	85.3	116.7	88.7	127.4	166.0	179.9	177.7	181.8	200.3
Service balance	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-11.1	-10.5	-10.8
Income balance	-15.5	-15.2	-15.1	-20.8	-26.7	-26.7	-26.6	-24.0	-26.0
FDI, net	2.3	3.4	2.6	11.1	11.5	14.0	15.8	14.0	14.5
International reserves	56.9	51.6	66.1	96.2	110.1	112.8	100.1	101.2	102.1
Total Amortisations	18.8	16.7	20.4	24.0	25.1	40.3	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	-2.1	-1.8	-1.7
Consolidated gov primary balance	0.8	1.7	0.1	0.6	0.1	-0.6	-1.0	-0.7	-0.5
Public debt	34.1	29.3	31.4	26.4	23.6	23.3	25.0	26.0	25.0
of which Domestic	19.7	16.2	19.3	16.7	15.5	16.0	15.6	15.6	16.0
Foreign Assets & Liabilities, US\$ bn									
External debt	141.2	155.1	172.9	202.4	225.4	252.4	265.0	277.0	290.0
Private	60.6	68.5	73.6	83.8	106.7	126.2	126.5	135.0	142.0
Public	80.6	86.6	99.3	118.6	118.6	126.1	138.5	142.0	148.0
External debt / GDP	32.7	30.4	32.1	28.5	26.6	28.7	30.5	31.7	28.7
External debt / XGS	108.2	100.1	130.2	115.8	101.8	119.3	129.5	130.2	123.2
Short-term debt	18.7	20.5	24.0	31.6	36.6	43.4	44.0	46.0	49.0
Short-term debt/International Reserves (%)	32.8	39.7	36.4	32.8	33.2	38.4	44.0	45.5	48.0
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	5.8	5.6	5.4	5.8	5.4	4.6	5.2	4.6	4.9
CPI, % yoy	5.9	8.4	8.8	7.4	7.4	5.3	4.9	5.9	7.0
Policy interest rate, % eop	4.25	5.50	5.75	6.00	6.00	6.00	6.00	6.25	6.50
1 month inter-bank rate, % eop	4.45	5.70	6.00	6.25	6.25	6.25	6.25	6.50	6.75
Long term yield, % eop	7.21	8.54	8.00	8.25	8.30	8.50	8.50	8.75	8.75
lc vs USD, eop	9925	11580	11804	11841	11879	11821	11640	11463	11284

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** – Rebalancing could pose headwinds to domestic demand and a G3 recovery will matter more for Malaysia's export prospects than before. The current account surplus may stabilize while cost-push inflation pressure above 3% need not provoke an aggressive monetary policy response near term.
- **Things to watch** – [1] Signs of slowing domestic demand; [2] Improvements in external demand, especially to the G3; [3] Private investments and FDI; [4] Fuel price hikes and impact on inflation.
- **Strategy** – Although a stabilizing CA surplus and fiscal reforms should in theory be near-term positive for the MYR and MGS, we remain mindful of the risk of fiscal slippage risks due to downside growth risks on non-oil revenues, on top of possible Fed Taper-related outflows in early 2014.

Rebalancing could pose headwinds to domestic demand

Domestic demand will likely face several headwinds in 2014, as the economy rebalances. With pre-elections stimulus behind us and Fed taper inevitable, 2014 could be a year of rebalancing and adjustment. Signs of slowing domestic demand have appeared despite the 6.8%QoQ SAAR sequential expansion in 3Q13 GDP (2Q: 5.8%), corroborating recent monthly import and IP data, which have hinted at flagging domestic demand. We see two major forces at play next year.

First, fiscal consolidation will take centre stage, including on a broader consolidated public sector basis. Into 2014, the Budget targets a 0.5%pt cut in the federal government's deficit to 3.5% of GDP from a projected 4% this year (though we suspect slippage to 4.2% is likely in 2013), which could impose a drag on growth of around 0.6-0.9%pt of GDP. Overall, the fiscal drag should offset favourable base effects to growth in 2014 and, coupled with weak external demand recovery, bring growth to our 2014 GDP forecast of 5% (2013F: 4.4%).

Second, rebalancing away from leverage-driven private consumption may not be painless. We estimate that household debt has climbed further to 84.3% of GDP as of 3Q13. If further macroprudential tightening is in the cards, mortgages and – especially – car loans are probably next in line. Tightening measures on car loans should have the least impact on growth and could have the biggest bang for the buck in reducing leverage, even as the government remains focused on encouraging home ownership. That said, the consumer will be cushioned by the resilient labour market and full implementation of minimum wage on 1 Jan 2014.

Notwithstanding delays in some import intensive projects, there remains a large implementation pipeline of previously approved projects which should sustain investment growth in 2014 and 2015, largely in the manufacturing, mining and services sectors. Work on the Klang Valley MRT Sungai Buloh-Kajang (SBK) line remains on schedule for completion in 2017 while Petronas had noted earlier that it would have to accelerate its capex as only 24% of its five-year RM300bn capex plan had been spent between 2011 and Jan-2013. There are also signs of returning FDI, especially from Japan. Nonetheless a sharp reversal of portfolio inflows and accompanying rise in long end interest rates remains a tail risk for the funding of major projects, particularly given the increased dependence on the private debt securities market for funding over the past year

G3 recovery will matter more for Malaysia's exports

Overall growth prospects may hinge more heavily on an export recovery – particularly to the G3. With Indonesia and China slowing, Malaysia can likely no longer rely on intra-Asian trade to prop up external demand. At face value, a slowdown in both these large regional economies could have a sizeable impact on Malaysia's goods exports, but the bulk of exports for China are likely really intermediate goods meant for final demand in developed markets.

Concerns that a G3 recovery could have less pronounced growth spillovers on Malaysia's exports than in the past may be exaggerated. While a cursory examination suggests the sensitivity of Malaysia's exports to the US has weakened after the Global Financial Crisis, this should reverse as the US recovery broadens to encompass tech capex spending. Moreover, exports to Japan appear to have undergone an upward shift relative to Japan's domestic demand while exports to the EU seem to have become more tightly linked to EU domestic demand.

With softer domestic demand moderating import growth, we thus expect the current account surplus to stabilize at 4.4% of GDP next year from 3.7% this year. From a savings-investment (S-I) perspective, the current account surplus widening will likely be supported by fiscal and macroprudential tightening gradually arresting the fall in public and private savings rates. Favourable price effects from earlier MYR weakness may also help net exporting sectors in the very near term, even if income effects from a G3 recovery do not materialize.

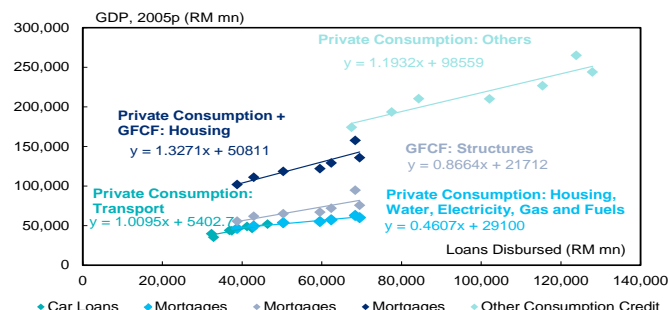
BNM in no hurry to hike even if inflation breaches 3%

We still sense BNM is in no hurry to hike rates. There are few signs of demand-pull inflation pressure or second round effects after the fuel price hike. Stripping out Food, Alcoholic Beverages and Tobacco, as well as Transport – to remove the impact of the tobacco excise tax hike – Oct inflation would in fact have continued falling to 1.1%YoY (Sep: 1.2%) versus the rise in headline to 2.8% (Sep: 2.6%).

Going forward, our base case is for another 5-10sen/liter fuel price hike by year-end and for another 20sen/liter hike before 1st July 2014. As we had argued in our assessment of Budget 2014, we suspect policymakers will probably opt for gradual but somewhat more frequent and frontloaded hikes. With the kick up from the tobacco excise hike, inflation may hit BNM's implicit tolerance threshold of 3% by year-end with a decisive breach coming in 1H14.

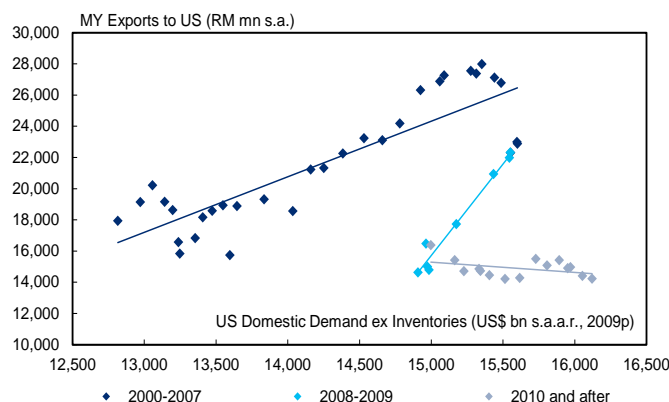
The risk of delays to rate hikes are increasing. Recent comments from Gov Zeti suggest that BNM may be prepared to tolerate what it views as a "temporary" rise in inflation due to supply-side cost-push factors while the growth outlook remains uncertain. Apart from broader growth uncertainties, two other considerations may shape the timing and magnitude of the monetary policy action in 2014: [1] with household debt now in excess of 83% of GDP, BNM will obviously be concerned over the debt servicing ratios of stretched households; and [2] the direct and second-round inflationary impact of 6% GST implementation in Apr 2015 has to be taken into account, especially when interacting with further prospective fuel price hikes that year. Overall, while our base case anticipates that BNM may tolerate inflation at around 3.3% in 1Q14 before hiking 25bps in May and again in July in anticipation of inflation hitting 3.8-3.9% from Jun-Aug, rate hikes have likely become increasingly contingent over the growth outlook firming up.

Figure 100. Tightening on car loans should have least impact on growth



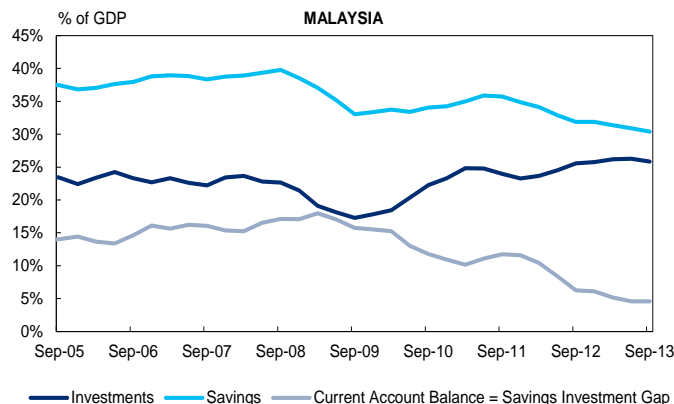
Note: We plot private consumption of transport against car loans disbursed and private consumption ex transport and housing against other consumption credit disbursed (personal loans, credit cards, and loans for consumer durables). We also plot private consumption of housing, water, electricity, gas and fuels; gross fixed capital formation of structures; and a combination of the two against mortgages disbursed.
Source: CEIC, Citi Research

Figure 102. Negative beta between exports to US and US demand...



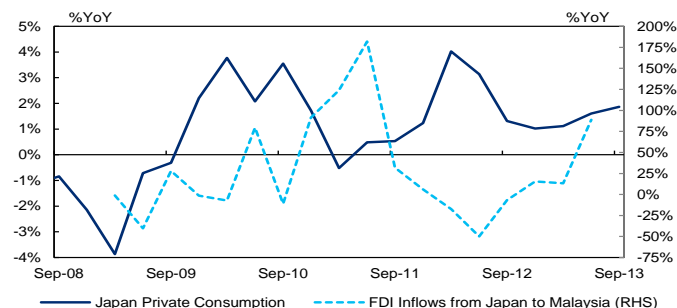
Source: CEIC, Citi Research

Figure 104. Arresting decline in savings rates should support CA



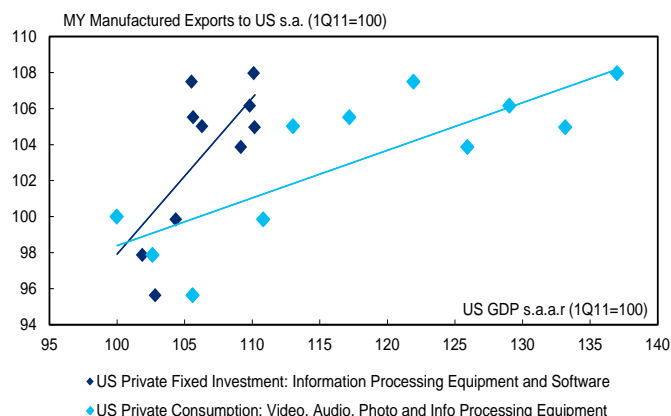
Note: We calculate the savings rate implied by investments and current account balances. Data is quarterly on a 4-quarter rolling sum basis.
Source: CEIC, Citi Research Estimates

Figure 101. Japanese private consumption leads FDI inflows from Japan



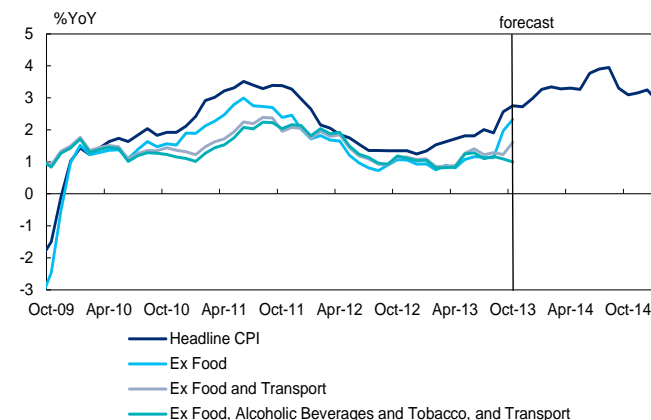
Source: CEIC, Citi Research

Figure 103. ...should reverse as US tech capex rises



Note: We combine manufactured goods and machinery and transport equipment to obtain manufactured exports. Time period is 1Q11-3Q13)
Source: CEIC, Citi Research

Figure 105. There are few signs of demand-pull inflation pressure



Source: Department of Statistics, Haver, Citi Research

Figure 106. Malaysia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	193.7	231.1	202.4	247.7	289.3	305.0	311.2	336.2	363.6
Nominal GDP, local currency bn	665	770	713	797	884	941	986	1,056	1,116
GDP per capita, US\$	7,123	8,393	7,255	8,664	9,987	10,398	10,407	11,022	11,730
Population, mn	27.2	27.5	27.9	28.6	29.0	29.3	29.9	30.5	31.0
Unemployment, % of labour force	3.2	3.3	3.7	3.2	3.1	3.0	2.9	2.9	2.9
Economic Activity									
Real GDP, % yoy	6.3	4.8	-1.5	7.4	5.1	5.6	4.5	5.0	4.9
Real investment growth % yoy	9.1	1.8	-9.4	25.3	2.3	22.3	7.8	3.1	8.0
Real consumption growth % yoy	9.7	8.4	1.4	6.2	8.6	7.1	6.6	5.0	3.4
private consumption growth % yoy	10.4	8.7	0.6	6.9	6.8	7.7	7.4	6.5	4.7
Real export growth, % yoy	3.8	1.6	-10.9	11.1	4.6	-0.1	-0.8	4.4	3.3
Real import growth, % yoy	5.9	2.3	-12.7	15.6	6.1	4.7	1.3	3.8	3.0
Prices, Money & Credit									
CPI, % yoy	2.3	4.5	1.0	2.1	3.0	1.2	3.0	3.4	4.8
CPI, % avg	2.0	5.4	0.6	1.7	3.2	1.6	2.1	3.4	4.3
Nominal wages, % yoy	4.3	4.5	2.5	8.2	3.8	6.4	5.0	5.0	5.0
Credit extension to private sector, % yoy	9.2	10.2	6.8	10.9	12.4	12.1	11.0	11.0	11.0
Policy interest rate, % eop	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50	3.50
3 month inter-bank rate, % eop	3.61	3.37	2.17	2.98	3.22	3.21	3.21	3.70	3.70
Long term yield, % eop	3.78	3.00	3.79	3.39	3.23	3.24	3.60	4.00	4.00
lc/US\$, eop	3.31	3.45	3.42	3.08	3.17	3.06	3.10	3.12	3.05
lc/US\$, avg	3.44	3.33	3.52	3.22	3.06	3.09	3.15	3.13	3.07
Balance of Payments, US\$ bn									
Current account	29.7	39.4	31.4	27.1	33.5	18.6	11.5	14.8	14.5
% of GDP	15.4	17.1	15.5	10.9	11.6	6.1	3.7	4.4	4.0
Trade balance	38.1	51.1	39.8	42.5	49.6	40.7	32.0	34.0	35.0
Exports	176.5	198.9	157.0	199.2	228.8	227.9	229.0	257.4	265.0
Imports	138.5	147.7	117.1	156.7	179.2	187.2	197.0	223.4	230.0
Service balance	0.4	0.5	1.2	-0.4	-2.1	-4.5	-4.7	-3.8	-3.0
Income balance	-8.7	-12.2	-9.6	-15.0	-14.0	-17.6	-15.8	-15.4	-17.5
FDI, net	-2.7	-7.8	-6.3	-4.3	-3.1	-7.0	-5.0	-3.0	-1.0
International reserves	101.3	91.5	96.7	106.5	133.6	139.7	137.0	135.0	140.0
Total Amortisations	7.8	6.3	9.8	11.3	9.0	9.3	10.0	11.0	12.0
Public Finances, % of GDP									
Consolidated government balance	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-4.2	-3.5	-3.0
Consolidated gov primary balance	-1.2	-3.0	-4.7	-3.5	-2.8	-2.4	-1.7	-1.3	-0.9
Public debt	40.1	39.8	50.8	51.1	51.6	53.3	54.8	55.0	55.0
of which Domestic	37.1	37.2	48.9	49.0	49.5	51.5	53.0	53.5	53.5
Foreign Assets & Liabilities, US\$ bn									
External debt	56.2	66.6	68.3	72.6	81.5	82.8	96.0	97.0	96.0
Private	37.8	41.5	41.9	44.7	53.7	55.6	65.0	65.0	64.0
Public	18.4	25.2	26.3	27.9	27.8	27.1	31.0	32.0	32.0
External debt / GDP	29.0	28.8	33.7	29.3	28.2	27.1	30.9	28.9	26.4
External debt / XGS	27.4	29.0	36.9	31.4	30.7	31.1	35.7	32.7	31.4
Short-term debt	16.3	22.5	22.7	25.4	32.9	30.4	40.0	42.0	42.0
Short-term debt/International Reserves (%)	16.1	24.6	23.5	23.8	24.6	21.8	29.2	31.1	30.0
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	4.4	5.0	4.5	5.6	4.7	5.5	4.2	4.1	5.3
CPI, % yoy	1.8	2.6	3.0	3.3	3.8	3.3	3.4	3.0	4.8
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.25	3.50	3.50	3.50	3.50
3 month inter-bank rate, % eop	3.20	3.21	3.21	3.20	3.45	3.70	3.70	3.70	3.70
Long term yield, % eop	3.20	3.52	3.60	3.70	3.80	3.90	4.00	4.10	4.10
lc vs USD, eop	3.16	3.26	3.10	3.12	3.14	3.14	3.12	3.10	3.08

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

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

Philippines

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- **Summary view** – We cut 4Q GDP growth forecast to 4.2%YoY on the back of Yolanda's fury that implies 2013 GDP growth easing to 6.7%. 4Q13 consumption would bear the brunt of the supply shock. Massive fiscal reconstruction in the Visayas starting 1Q14 would probably elevate 1Q14 growth to 8.2%YoY.
- **Things to watch** – Fiscal expenditures likely to accelerate in response to the disasters that imply a larger 4Q fiscal deficit. Food price shocks lack contagion risk to ensure benign core upticks. Trade deficit pressures due to foregone exports and higher imports given supply constraints. Rate tightening in 2H14.
- **Strategy** – Risk sentiment likely to recover with upbeat medium-term backdrop underpinned by an upbeat construction trend. Near-term PHP likely to stay in the 43 range but strong PHP outlook likely as it tracks growth prospects and rate tightening. Over the medium term, equities likely to outperform local bonds.

4Q consumption at risk from Yolanda's havoc

We now expect 4Q13 GDP growth to ease to 4.2%YoY (previously 7%YoY) on the assumption of Eastern Visayas (EV) GDP contribution of roughly 2.3% of national GDP was wiped out by typhoon Yolanda. This follows a robust 3Q GDP growth estimate of 7.8%YoY. Narrowing 4Q gains would curb overall 2013 GDP growth to 6.7% (previously 7.3%). In our estimate, the supply shock would run across EV's farm (over Php6bn damage to farm output) and non-farm sectors facing additional constraints of lack of power, damaged infrastructure and spotty communications at best. This income vacuum in the EV region would drastically cut basic and discretionary demand. EV's consumption accounts for 106.9% of the region's GDP (2012) to serve as the key demand catalyst. Lacking this, if we assume consumption takes the brunt of the negative income shock, national consumption in 4Q would probably ease to 4%YoY growth (previously 6.1%YoY). We tempered total export growth (3.9%YoY vs. 8.2%YoY previously) to account for missing agro-based exports from the regions. Initial fiscal spending through relief efforts/distribution of aid, remittances and local income transfers to typhoon victims from relatives based in Metro Manila and elsewhere would cushion EV's downturn.

At the national level, more than flow volume, we believe the real peso value of the remittances ought to bolster 4Q consumption and partially ease the missing EV consumption component. BSP's insistence to keep PHP 'undervalued' with 43 as the line in the sand, supports the 4Q retail season amid another strong remittance period. In 3Q13, real peso value of the remittances grew 8.1%YoY as evidence of strong purchasing power likely to extend to 4Q with BSP's accommodative stance. Private construction would be in its familiar pace with public construction distracted by the corruption scandals and recent spate of disasters. Reconstruction activities in the Visayas particularly in quake-struck Bohol have begun although the upbeat public construction cycle is likely to start in 1Q14. Private capex lacks the stimulus of a strong export market recovery.

Despite availability of spending catalysts associated with a festive 4Q13, these would not be sufficient to compensate for EV's 4Q GDP loss. Domestic demand (ex-inv) probably grew 4.8%YoY in 4Q13 vs. 8%YoY in 1H13. Pre-Yolanda, real GDP at the national level probably turned more robust in 3Q13 on the back of strong HH consumption (5.8%YoY) and government consumption (13.8%YoY), 2-digit construction gains, and exports heading back to positive territory (5%YoY). Non-farm output probably elevated incomes in support of 3Q domestic demand growth of 7.3%YoY.

Expecting strong 1Q14 recovery after the typhoon disaster

Reconstruction efforts would imply robust construction in 1Q14 that could underpin GDP growth of 8.2%YoY. Government is contemplating an additional infra budget of Php60bn for reconstruction particularly in the typhoon-hit areas that would elevate the 2014 infra budget to Php420bn (3.5% of GDP) from Php360bn (3% of GDP). Focus on public construction would elevate its share of total construction to 30% (vs. 28.1% share in 1H13) for growth of over 60%YoY. Share of real investments (ex-inv) to GDP could zoom up to 23.3% in 1Q14. Despite the pork barrel controversy, we believe this fiscal bias to deploy the infrastructure budget across the Visayas hardest hit by disasters and other poorer regions would carry over into the succeeding quarters. The lift to employment and incomes in the region would enable overall domestic demand to get back to the 7% growth range. Barring another severe storm and other disasters, 2014 GDP can shoot for 7.3% growth.

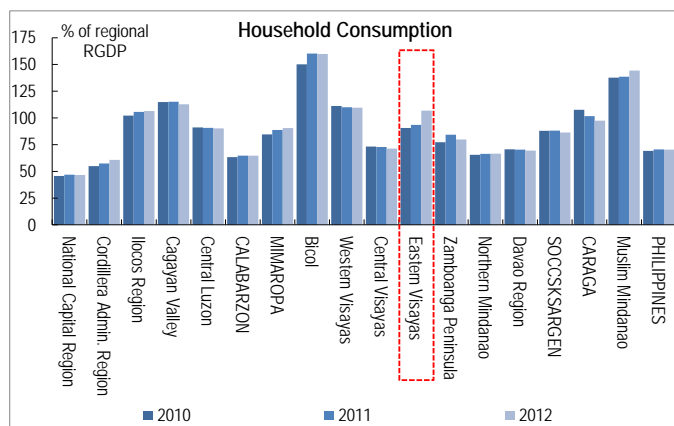
Near-term weakness for the macro imbalances

4Q current account surplus (CAS) may taper off to US\$1.6bn in 4Q13 or roughly 2.1% of our GDP forecast. We assume over US\$400mn of missing agro-based exports would curb 4Q export gains to 3.5%YoY and additional commodity imports of US\$200mn to feed food processing industries badly in need of commodity supplies including those for rice inventory build-up. The 4Q trade deficit may expand to US\$5bn and partially erode CAS. Trade deficit pressures due to commodity supply constraints would likely extend up to 1H14. Limited fixed wages could restrain potential for OFW relatives of typhoon victims to send more relief money. 2013 CAS could settle at US\$9.5bn or roughly 3.4% of GDP. Stronger fiscal spending commitments on disaster relief and reconstruction and slower tax gains due to waning 4Q GDP momentum would probably lead to a 4Q fiscal deficit swelling to Php100bn (3.2% of GDP) vs. a 4Q deficit target of Php93.6bn. Primary fiscal spending could match the 4Q target of Php479bn given spending pressures. 2013 fiscal gap could settle at Php202bn (1.7% of GDP) but still short of the 2013 budget deficit target of Php238bn. With public construction likely to intensify in 2014 as reconstruction efforts get under way, the FY budget deficit could swell to Php236bn (1.8% of GDP). Tax to GDP ratio exceeding 13.5% in the forecast period ushers potential for lower fiscal balances.

Other macro trends post-Yolanda

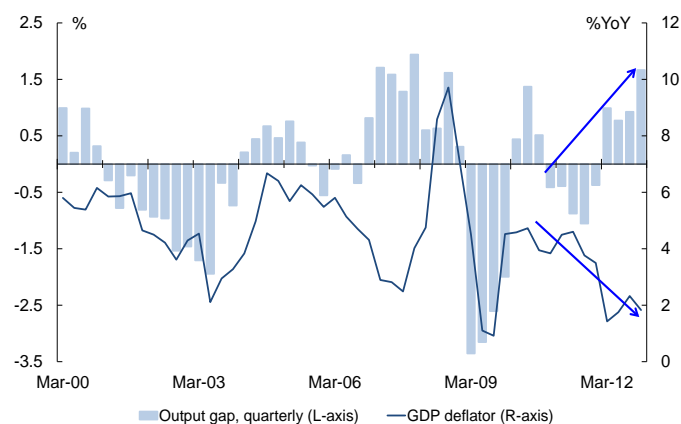
Downside risk from the super typhoon would impact near-term growth prospects rather than the macro imbalances. Over a 3-5 year period, a government official cited Php250bn additional spending for infrastructure repair, new shelter provisions for families affected, livelihood support and other relief activities to resurrect the devastated cities and towns. Upbeat trend of construction activity would drive growth prospects in the Visayas. Despite food prices spiking up, core's upturn would remain benign in our view, allowing policy makers time to adjust policy rates in 2H14 on the assumption GDP growth retraces 7% or more and inflation probes 4%. Expected tweaking of policy rates (+50bp) would not stall growth particularly if prospects are investment-driven. With 'flexibility or discretionary' component of the fiscal budget restricted by the High Court's decision on the 'pork barrel' issue, PPP's big-ticket infrastructure projects become essential in delivering additional stimulus and curbing logistical costs. 2-3 key PPP projects could be awarded within the remaining term of President Aquino. This backdrop assures growth of 6%-7% over the next 2-3 year period with upside surprises likely. Risk assets likely to benefit from upbeat medium-term setting with equities likely to outperform local bonds.

Figure 107. Eastern Visayas HH consumption exceeded 100% of its GDP



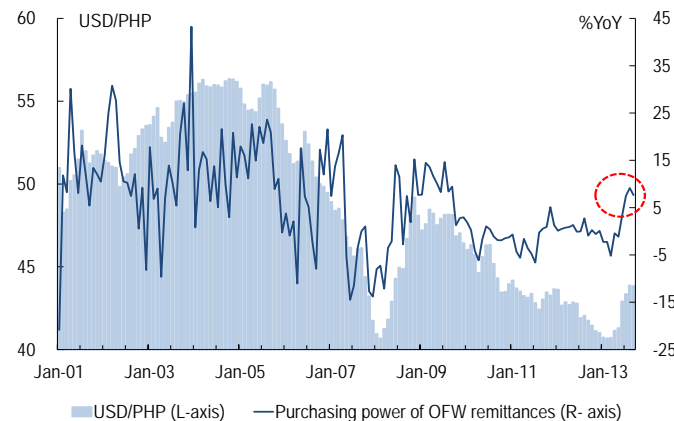
Source: NSCB, CEIC, Citi Research

Figure 108. Broken correlation of output gap and GDP deflator in 1H13



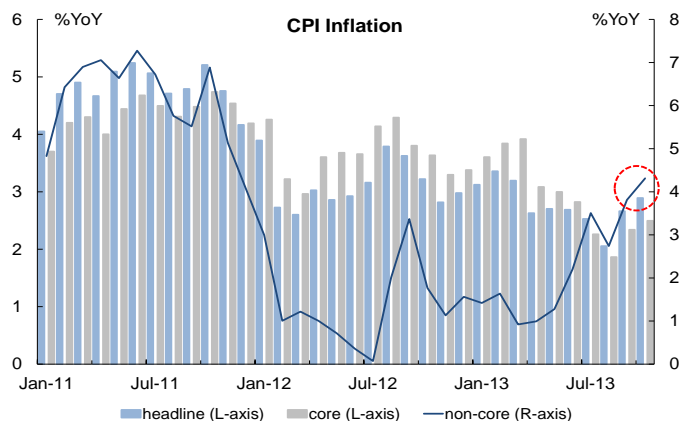
Source: CEIC, Citi Research

Figure 109. Weak PHP likely to elevate real peso value of remittances



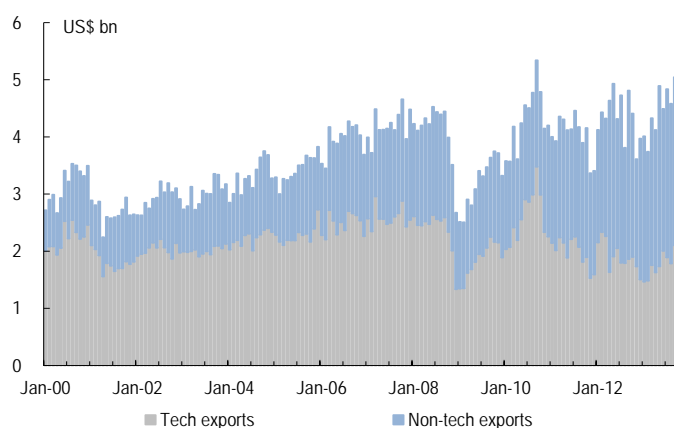
Source: CEIC, Citi Research

Figure 110. Pre-Yolanda, clear upturn for core and non-core CPI



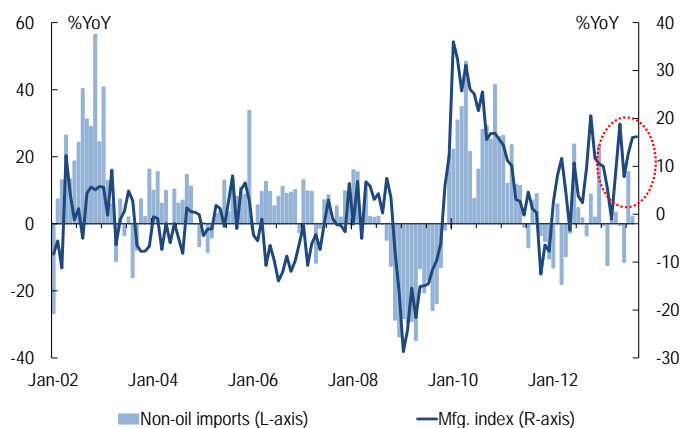
Source: CEIC, Citi Research

Figure 111. Shift to larger contribution of non-tech exports



Source: CEIC, Citi Research

Figure 112. Lean inventory with mfg gains eclipsing non-oil imports



Source: CEIC, Citi Research

Figure 113. Philippines Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	150.2	173.4	168.6	200.0	224.1	250.5	272.9	310.6	349.5
Nominal GDP, local currency bn	6,893	7,721	8,026	9,003	9,706	10,565	11,594	12,877	14,222
GDP per capita, US\$	1,693	1,917	1,829	2,127	2,339	2,567	2,745	3,068	3,389
Population, mn	88.7	90.5	92.2	94.0	95.8	97.6	99.4	101.2	103.1
Unemployment, % of labour force	7.3	7.4	7.5	7.3	7.0	7.0	6.5	6.0	5.7
Economic Activity									
Real GDP, % yoy	6.6	4.2	1.1	7.6	3.6	6.8	6.7	7.3	6.8
Real investment growth % yoy	-0.5	23.4	-8.7	31.6	2.0	-3.2	15.7	9.9	9.7
Real consumption growth % yoy	4.9	3.3	3.3	3.4	5.2	7.3	6.1	6.2	6.3
private consumption growth % yoy	4.6	3.7	2.3	3.4	5.7	6.6	5.1	5.8	6.0
Real export growth, % yoy	6.7	-2.7	-7.8	21.0	-2.8	8.9	-1.9	3.2	4.4
Real import growth, % yoy	1.7	1.6	-8.1	22.5	-1.0	5.3	0.4	2.4	4.7
Prices, Money & Credit									
CPI, % yoy	3.9	8.0	4.3	3.6	4.2	3.0	3.2	3.7	3.9
CPI, % avg	2.8	9.3	3.2	4.1	4.7	3.2	2.8	3.5	3.9
Nominal wages, % yoy	3.4	5.5	0.0	5.8	5.4	7.0	2.0	6.0	5.0
Credit extension to private sector, % yoy	10.6	12.8	4.3	13.8	16.2	14.1	10.0	13.5	15.0
Policy interest rate, % eop	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.00	4.50
1 month Philippine Reference rate, % eop	6.03	5.20	4.11	0.75	1.68	-1.38	-1.00	2.00	3.00
Long term yield, % eop	5.70	6.55	6.25	4.78	4.21	3.70	2.85	3.50	4.00
lc/US\$, eop	41.23	47.47	46.50	43.65	43.84	41.06	42.96	41.65	40.77
lc/US\$, avg	46.05	44.48	47.56	45.06	43.29	42.22	42.59	42.09	41.08
Balance of Payments, US\$ bn									
Current account	7.1	3.6	9.4	8.9	7.0	7.1	9.5	9.8	10.0
% of GDP	4.7	2.1	5.5	4.5	3.1	2.8	3.5	3.1	2.9
Trade balance	-10.4	-14.4	-9.7	-12.3	-17.0	-15.2	-13.2	-14.4	-15.1
Exports	34.1	35.2	29.8	37.6	38.3	46.3	48.4	51.7	55.5
Imports	44.4	49.5	39.4	49.9	55.2	61.5	61.6	66.0	70.5
Service balance	4.2	2.6	2.9	4.1	5.3	3.9	3.1	3.3	3.4
Income balance	13.3	15.4	16.1	17.2	18.7	18.4	19.6	20.8	21.7
FDI, net	0.6	-1.3	-1.6	-0.7	-1.3	-1.0	2.0	3.0	3.0
International reserves (ex-gold)	33.8	37.6	44.2	62.4	75.3	83.8	88.0	93.5	98.0
Total Amortisations	6.3	8.2	6.4	9.5	7.3	8.5	9.3	9.7	10.0
Public Finances, % of GDP									
Consolidated government balance	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-1.7	-1.8	-1.2
Consolidated gov primary balance	3.7	2.6	-0.2	-0.2	0.8	0.7	1.1	1.0	1.5
Public debt	53.9	54.7	54.8	52.4	51.0	51.5	50.0	49.5	48.1
of which Domestic	31.9	31.3	30.8	30.2	29.6	32.8	32.5	33.5	34.0
Foreign Assets & Liabilities, US\$ bn									
External debt	55.5	54.3	54.9	60.0	60.4	60.3	65.0	68.7	70.0
Private	17.5	13.7	11.6	13.9	14.1	15.2	17.0	21.2	22.0
Public	38.0	40.6	43.2	46.2	46.4	45.2	48.0	47.5	48.0
External debt / GDP	36.9	31.3	32.5	30.0	27.0	24.1	23.8	22.1	20.0
External debt / XGS	120.9	117.0	131.8	113.3	107.7	93.0	95.8	95.3	91.0
Short-term debt	7.1	7.0	4.0	6.3	7.0	8.5	10.5	11.8	13.0
Short-term debt/International Reserves (%)	21.0	18.6	9.0	10.1	9.3	10.1	11.9	12.6	13.3
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	7.5	7.8	4.2	8.2	7.4	6.9	6.6	6.7	7.2
CPI, % yoy	2.7	2.7	3.2	3.4	3.6	3.3	3.7	3.8	4.0
Policy interest rate, % eop	3.50	3.50	3.50	3.50	3.50	3.75	4.00	4.25	4.50
1 month Philippine Reference rate, % eop	0.26	-0.39	-1.00	-0.50	0.00	1.50	2.00	2.25	2.50
Long term yield, % eop	2.80	3.02	2.85	2.85	3.00	3.50	3.50	3.75	4.00
lc vs USD, eop	43.10	43.48	42.96	42.59	42.21	41.89	41.65	41.42	41.18

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** – Amidst demand uncertainties and domestic supply constraints, our 3.5% GDP forecast for 2014 anticipates a patchy growth profile, punctuated by lower house prices and household debt burdens. With the rise in core inflation within tolerance ranges, the hurdle for changes in MAS policy remain high,
- **Things to watch** – [1] Near-term export and production momentum; [2] house price trends, which could trigger policy changes; [3] labour market and core inflation trends; [4] signs of stress in the SME sector; [5] Budget 2014 in Feb.
- **Strategy** – Rising core inflation may keep the SGD NEER in the upper quartile of the policy band in the very near term. We remain mindful of a possible fall in SGD NEER as Fed tapering commences. While SOR and SIBOR will remain anchored by the Fed, 10Y SGS yields could head towards 3% as tapering commences.

Demand uncertainties amidst supply constraints

Uncertainties over external demand suggest a patchy growth profile in 2014 and we maintain our forecast of 3.5% growth. The impact of a modest slowdown in China and Indonesia will be felt both in manufacturing and in services such as tourism, financial services and – to a lesser extent – property, but should be offset by G3 recovery. Nonetheless, there are concerns that G3 recovery could have less pronounced growth spillovers on exports than in the past. This reduced export sensitivity to G3 domestic demand could reflect a mix of factors. First, a loss of cost competitiveness due to real exchange rate appreciation since 2010 may have resulted in a loss of market share and/or import substitution, especially for exports to Japan. Second, the narrowly based nature of the G3 recovery thus far has been in segments that are less sensitive to imports from Singapore – or indeed imports in general. Third, technological innovations may have shifted G3 demand away from traditional goods imports, perhaps towards services (both domestically produced and imported). On balance, we still expect a broadening G3 expansion to eventually offset headwinds from a slowdown in Asia, though by a smaller margin than before.

On the supply side, tighter labour policies will continue to constrain potential growth, though tightening may increasingly shift towards higher-wage EP holders. Notwithstanding a modest cyclical pick up, we remain skeptical about prospects for a near-term structural improvement in productivity growth given [1] over-emphasis on process vs product innovation, [2] higher labour turnover in a tight labour market reducing productivity, and [3] jobs creation dominated by low-productivity sectors.

Housing downturn impact on growth manageable, but possibly larger than in the past. We expect a turning demand-supply balance, alongside constraints to investment demand from the TDSR framework, to lower house prices by 10-15% over the course of the cycle. Applying sensitivity estimates from academic studies suggest a 10-15% decline in house prices would shave 0.4-0.6% off headline GDP growth per annum, all else being equal, though mitigated by other non-residential public sector construction projects. Previous academic studies suggest the impact on private consumption will be small, given [1] relatively illiquid nature of housing wealth and [2] higher house prices reduce discretionary incomes for other consumption, given higher down payments and mortgage installments. With recent financial innovations allowing monetization of housing equity via personal loans, impact on consumption could be somewhat larger than earlier studies suggest.

Whether or not house prices fall, consumer spending will be weighed down by rising debt service burdens, especially on “marginal” buyers who have over-leveraged for owner-occupied mass market private properties. Mortgage service burdens would likely rise by 8-12%, above 2007 peaks if mortgage rates were to normalize to the historical average of 3.5%, which will likely prove a headwind to consumption unless offset by a similar rise in wages. The slowdown in consumption spending during the early stages of the last Fed hiking cycle in 2004-2006 should serve as a cautionary tale. In fact, consumption could be hit even *before* an actual rise in interest rates as the TDSR framework is effectively a de facto rise in interest rates in determining the eligibility of new consumer loans, as well as existing mortgagees who wish to refinance their home loans.

Risk from cost competitiveness erosion, especially if demand fails to pick up.

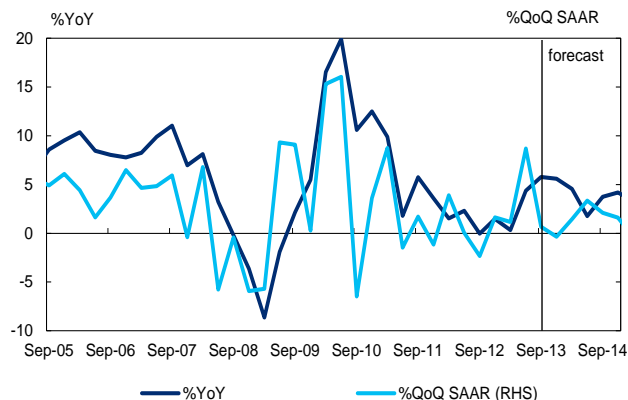
Ultimately, prospects for domestic demand will hinge on whether there will be sufficient growth in incomes, which in turn depends on whether the positive effects from a G3 recovery will be sufficiently strong to offset negative price effects from cost competitiveness erosion/REER appreciation. Presently, the economy has already endured two years of sluggish growth amid lackluster external demand, while cost competitiveness has been eroded as a result of the stronger SGD and restructuring induced factor cost increases, causing Singapore to lose market share in some segments. The combination of sluggish external demand and loss of cost competitiveness over the last two years has resulted in some pockets of stresses – especially, we suspect, amongst SMEs. Such trends, if they persist, could be deflationary if corporate failures or a relocation of activities out of Singapore results in excess capacity – similar to the competitiveness-induced recession in 1985. These trends will be arrested if a pick-up in growth allows firms to pass on pent-up cost pressures to consumers, restoring profit margins.

Upward pressures on core inflation, disinflationary pressures elsewhere.

Inflation trends will be complicated by cross currents from inflationary forces from continued cyclical expansion and domestic supply constraints against disinflationary forces from falling asset prices, household deleveraging, and cost competitiveness erosion. Core inflation will likely continue on a steady uptrend to 2-2.5% in 2014 as pent-up labour and other business cost pressures are passed through as the positive output gap gives more pricing power to firms, allowing them to restore profit margins. Outside of core however, car prices and imputed rents should see disinflationary trends, aided by favourable base effects such that headline inflation should remain broadly stable at 2-3% in 2014.

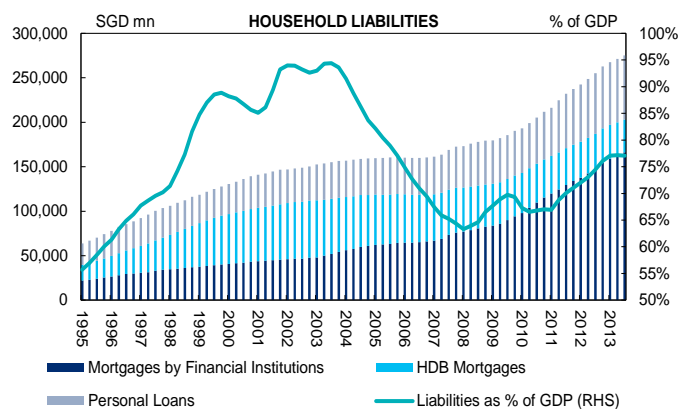
What does this mean for policy? Overall, with the rise in core inflation still within MAS's tolerance ranges, the hurdle for changes in MAS policy stance should remain high, though we sense a greater weight on pre-empting the medium-term inflation risks from pent-up cost pressures as opposed to near-term tail risks on external demand. Lower house prices and household balance sheet pressures could be tackled via reducing supply under the government land sales program and relaxation of sellers stamp duties and Additional Buyers Stamp Duty, though this will be more likely in 2015 when interest rates rise and house prices have fallen sufficiently to break the herd mentality of a one-way bet on house prices. Amidst the still fragile expansion, fiscal policy could have a mildly expansionary stance, with a continued focus on narrowing income gaps, enhancing social safety nets, and mitigating the transition pains of the productivity drive for SMEs via targeted cash support. As the current schedule already involves further hikes in FW levies and quota cuts through 2016, further tightening on this front will not be necessary.

Figure 114. Our 2014 GDP forecast anticipates a patchy growth profile



Source: CEIC, Citi Research

Figure 116. Given rising household debt to 77.1% of GDP in 3Q13...



Source: Department of Statistics, CEIC, Citi Research

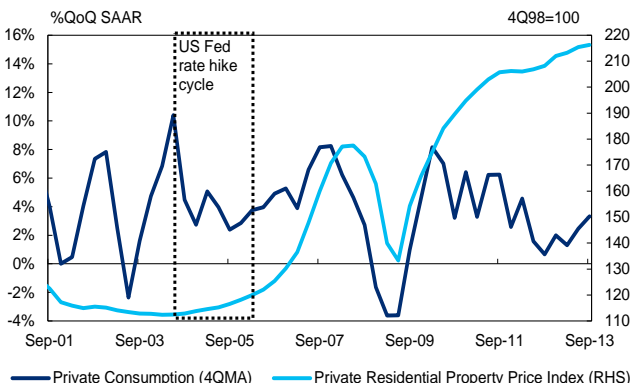
Figure 118. Some pockets of stresses especially amongst SMEs

Average Days Turned Cash (DTC)	4Q12	1Q13	2Q13	3Q13
Healthcare/Medical	31	26	15	27
Communications/Logistics	42	37	33	40
Paper/Wood/Apparel	48	50	45	52
Commerce - Retail	45	43	52	58
Shipping/Marine	52	60	63	67
Chemical	11	11	13	13
Commerce - Wholesale	42	43	39	39
Hotels/Restaurants	37	34	40	38
Construction	47	37	47	44
Credit Related	34	53	42	38
Manufacturing	28	24	35	31
Services	41	36	38	32
Utilities/Fuels	55	90	102	92
Electronics	55	54	69	58
NATIONAL AVERAGE	38	38	39	39

Note: Days Turned Cash measures the number of days a company takes to pay its creditor once the debt is due.

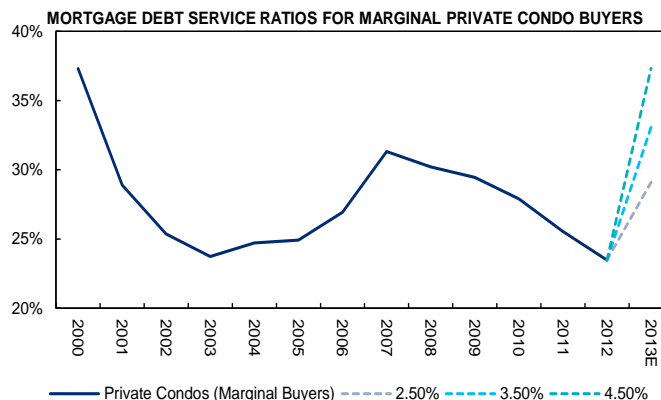
Source: DP Information Group

Figure 115. Housing downturn impact on growth should be manageable



Source: CEIC, Citi Research

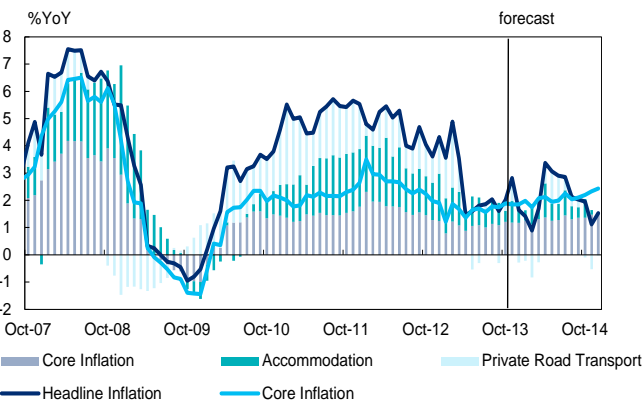
Figure 117. ...consumption will be eroded by rising debt service burdens



Note: Assuming 80% LTV, we calculate debt service ratios based on household incomes in the deciles of households which fall just above the HDB household income eligibility limits – the 71st -80th percentile of households from 2001-2007 and the 61st to 70th percentile from 2008.

Source: CEIC, Citi Research Estimates

Figure 119. Upward core inflation pressures, disinflation elsewhere



Source: CEIC, Citi Research

Figure 120. Singapore Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	178.2	190.8	189.4	232.2	265.8	276.8	290.8	316.3	344.8
Nominal GDP, local currency mn	268	270	275	316	334	346	363	389	414
GDP per capita, US\$	38,828	39,434	37,970	45,741	51,275	52,099	53,855	57,507	61,571
Population, mn	4.6	4.8	5.0	5.1	5.2	5.3	5.4	5.5	5.6
Unemployment, % of labour force	2.1	2.3	3.0	2.2	2.0	1.9	1.9	1.8	1.8
Economic Activity									
Real GDP, % yoy	9.0	1.7	-0.8	14.8	5.2	1.3	4.0	3.5	4.0
Real investment growth % yoy	16.8	28.5	-21.0	5.4	12.7	26.8	3.0	-5.0	5.9
Real consumption growth % yoy	5.9	3.6	0.5	7.2	3.7	0.9	4.1	3.0	1.9
private consumption growth % yoy	6.7	2.9	-0.5	6.2	4.6	2.2	2.6	2.4	1.3
Real export growth, % yoy	9.0	5.0	-7.6	18.6	3.5	0.3	3.3	3.6	2.9
Real import growth, % yoy	8.1	9.6	-11.2	15.9	3.6	3.2	3.3	2.9	2.9
Prices, Money & Credit									
CPI, % yoy	3.7	5.5	-0.5	4.6	5.5	4.3	1.7	1.5	1.7
CPI, % avg	2.1	6.6	0.6	2.8	5.2	4.6	2.4	2.1	2.2
Nominal wages, % yoy	6.2	5.4	-2.7	5.6	6.0	2.3	4.6	5.0	5.0
Credit extension to private sector, % yoy	16.9	15.2	2.0	13.4	18.6	13.2	12.0	10.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
3 month inter-bank rate, % eop	2.38	1.00	0.69	0.44	0.38	0.38	0.39	0.40	0.80
Long term yield, % eop	2.68	2.05	2.66	2.71	1.63	1.30	2.50	3.00	3.20
lc/US\$, eop	1.44	1.43	1.41	1.28	1.30	1.22	1.24	1.23	1.19
lc/US\$, avg	1.51	1.41	1.45	1.36	1.26	1.25	1.25	1.24	1.20
Balance of Payments, US\$ bn									
Current account	46.4	28.8	33.5	62.1	65.4	51.5	40.7	42.7	44.8
% of GDP	26.0	15.1	17.7	26.7	24.6	18.6	14.0	13.5	13.0
Trade balance	57.8	42.8	49.3	66.0	72.7	61.0	59.8	62.0	63.0
Exports	312.5	354.5	288.6	371.2	434.4	436.0	443.9	452.0	460.0
Imports	254.7	311.7	239.3	305.2	361.7	375.1	384.1	390.0	397.0
Service balance	-2.7	-1.6	-1.7	2.3	0.7	0.4	1.0	2.0	3.0
Income balance	-8.7	-12.4	-14.1	-6.3	-8.0	-9.9	-20.1	-21.3	-21.2
FDI, net	10.1	5.4	0.9	28.3	29.7	33.6	33.0	32.0	32.0
International reserves	163.0	174.2	187.8	225.8	237.7	259.3	280.0	290.0	300.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	2.8	0.1	-0.3	0.3	1.2	1.1	0.7	0.5	0.5
Consolidated gov primary balance	2.7	1.1	-0.8	0.2	1.3	1.5	0.4	1.0	1.0
Public debt	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0	120.0
of which Domestic	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0	120.0
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 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	4.4	5.8	5.6	4.5	1.8	3.8	4.2	3.3	4.2
CPI, % yoy	1.8	1.6	1.7	1.8	3.0	2.1	1.5	1.7	1.4
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	0.38	0.42	0.39	0.40	0.40	0.40	0.40	0.45	0.50
Long term yield, % eop	2.51	2.35	2.50	2.60	2.75	2.90	3.00	3.00	3.10
lc vs USD, eop	1.27	1.26	1.24	1.24	1.24	1.24	1.23	1.22	1.21

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

*Note: Public debt is general government debt.

South Korea

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- **Summary view** – We expect the economy to grow 3.7% in 2014, faster than 2.9% in 2013, as recoveries of domestic demand – particularly private consumption and facilities investment – and exports maintain. Job growth will likely expand by around 370K and we forecast annual inflation of 2.3%.
- **Things to watch** – Housing market recovery is critical for rebound of domestic demand, and political circles should pass the laws that the government had submitted to boost the market. Tightening of macro-prudential measures and active market intervention are likely to limit KRW appreciation amid weak JPY.
- **Strategy** – Contractionary fiscal stance in 2H14 will lead the BoK to hold the policy rate until the end of 2014 even though CPI inflation will likely rise to high 2% level in 2H. We think the first rate hike will come in early 2015 as the BoK confirms robustness of economic growth and headline inflation at above 3%.

Recovery continues to reach 3.7% real GDP growth

We expect further recovery of domestic demand and exports in 2014, resulting real GDP growth to attain 3.7%, potential GDP growth rate after two consecutive years of sub-par growth at 2% levels. First of all, growth contribution of domestic demand is likely to rise further on the back of visible recoveries of private consumption and facilities investment. We forecast private consumption would increase 3%, faster than 1.9% in 2013, supported by favorable asset market conditions and resilient job growth of about 370K. We see around 14% upside potential of KOSPI in 2014 and rebound in housing price in 1H14 alongside the government's boosting measures on the housing market. Facilities investment, one of the major dragging factors in 2013 growth, will likely grow by 7.4%, ending two years of negative growth in 2012-13, due to better prospects of the global economy, especially advanced economy, and recovery of consumption. Meanwhile, construction investment, which shifted to grow in 2013 after 2 consecutive years of contraction along with housing market slump in 2011-12, will slow down to expand by 2%, as the government plans to cut infrastructure budget and as the private sector is likely to adjust down apartment pre-sales after a rapid increase in 2013.

CPI inflation will likely remain low at 1% levels until 1H14 but rise to 2.9% in 2H, bringing annual inflation at 2.3%, as public service tariffs – such as electricity, city gas, and public transportation fees – will be raised and as base effect due to government subsidies on school meals and child care will dissipate. With upswing in ITC goods and autos, we expect exports in 2014 to increase by 5.4% (vs. 2.8% in 2013). Exports to the US and EU seem to show clear signs of rebound as the recoveries of those regions become more visible. Meanwhile, imports are likely to expand faster than exports, at 7.6%, as imports of consumer goods and capital goods increase. However, low commodity prices will continue to weigh on import growth and play a main role in a trade surplus of US\$3.4bn in 2014.

Current account surplus will continue in 2014 but narrow to US\$56.3trn, about 4.1% of GDP, supporting strength of KRW. We expect KRW to appreciate by 6% in 2014 as annual average of USDKRW falls to 1,032 from 1,096 in 2013. The appreciation of KRW will be also attributable to foreign funds flowing into equity markets on KOSPI market's upside potential. Nevertheless, we think market volatilities related to the US debt ceiling schedule and the BoJ's monetary easing likely after the consumption tax hike in April are inevitable.

Monetary policy will remain accommodative

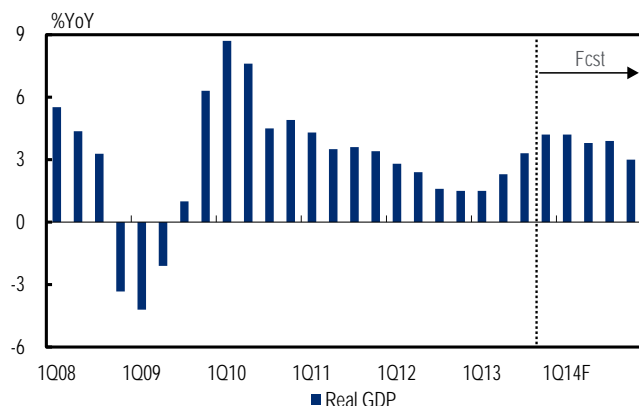
We think the BoK will hold the policy rate to the end of 2014. Despite some speculations that the BoK might begin the policy rate hike in 2H14 as headline CPI inflation rises to above the lower boundary of the BoK's inflation target band, 2.5~3.5%. However, in our view, the BoK will likely maintain the current policy rate of 2.5% for a while and begin the rate hike cycle in early 2015 since fiscal policy stance will be contractionary in 2H14. According to the government budget plan, the government's total spending will increase by 2.5% vs. 2013 figure including the supplementary budget. Given that nominal GDP is likely to grow by around 6% in 2014 and the government usually frontloads the budget in 1H, fiscal stance in 2H14 is highly likely to be contractionary. If the government's and the BoK's policy priority is securing economic recovery and growth momentum, the BoK would not shift its policy stance to tightening as the fiscal stance is. In the meantime, the BoK, in our view, seems not to consider a rate cut to confine KRW appreciation, given that 1) the BoK views inflation to pick up going forward and expects the economy to attain 3.8% real GDP growth in 2014, 2) inflation expectation remains high at around 3% despite actual inflation at below 1% recently, and 3) the BoK considers foreign fund flows a more influential factor for the exchange rate than the policy rate.

Downside risks: sluggish housing market, weakening JPY

As we noted earlier, we assume the housing market will show a meaningful recovery in 1H14 along with the government measures to boost the market. Housing market recovery is important as it could foster consumption growth by improving economic sentiments and wealth effect as well. However, the speed and the extent of the recovery going forward are likely to rely on how the government and political circles cooperate with each other to pass the related laws stalled at the National Assembly (NA). One important example is the permanent acquisition tax cut which the government already submitted to the NA. The government seems to put extra measures such as extension of transfer tax reduction in 2014 if the market recovery is delayed further. Yet, these measures would not bring intended impacts and increase uncertainties if political circles continue to leave them pending. Some attribute the sluggish housing market during the last two years to the aging population, but we think government regulations were more influential. Furthermore, the recent rise in Jeonse to purchase price, 66% for nationwide, will likely reduce overhanging demand once the market stabilizes on government measures.

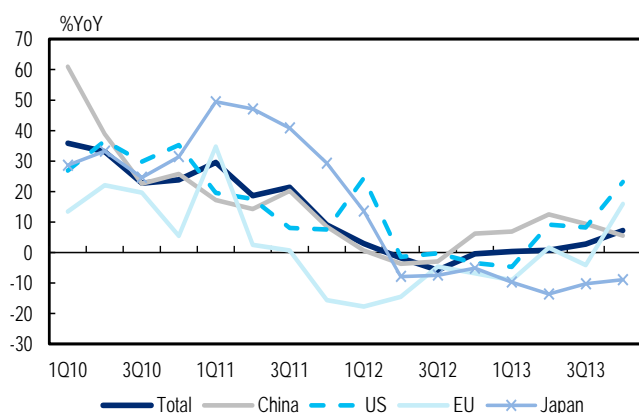
We also are concerned about further JPY weakness which can deteriorate price competitiveness of Korean exporters given high level of export similarity with Japan. Exporting SMEs will be more vulnerable than large companies. According to a survey by the Korea Chamber of Commerce and Industry, most exporting SMEs, which constitute 33% of total exports, cited that they will lose price competitiveness edge against Japanese counterparts if USDJPY rises to 103. Meanwhile, we forecast USDJPY to rise to 105 on the BoJ's extra QE in the mid-2014 while USDKRW will likely fall to 1,020 in a 6-12 months horizon. To mitigate the adverse FX impacts, the BoK is likely to engage in active smoothing operation to slow down the appreciation of KRW. Furthermore, the government could tighten macro-prudential measures, e.g., caps on forward contract and bank levy, if it thinks the speed of KRW appreciation is excessive. Some external events, such as US debt ceiling and Fed tapering, could also weaken KRW to some extent and interrupt steady appreciation of KRW. However, we think these risk-off events would just bring temporary impacts to the market and USDKRW would soon return to our projected appreciation path.

Figure 121. We expect GDP growth of 3.7% in 2014, faster than in 2013



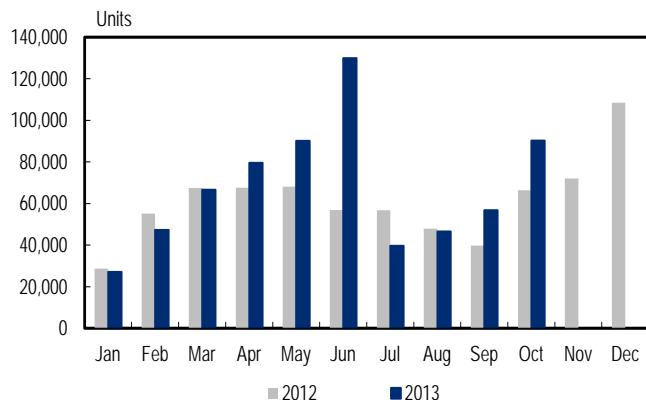
Source: Bank of Korea, Citi Research

Figure 123. Exports to the US and EU uplifted total export growth



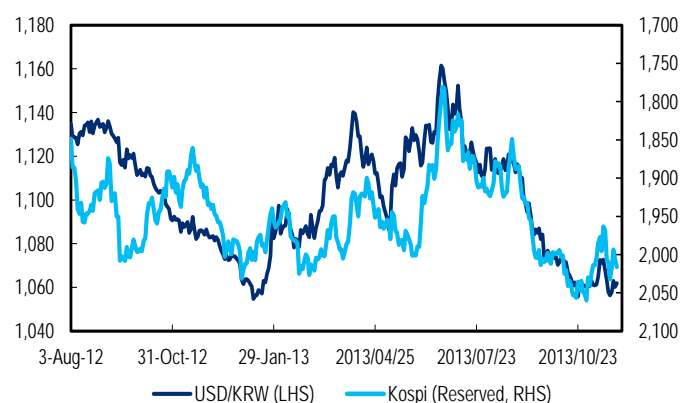
Source: Korea International Trade Association, Citi Research

Figure 125. Uptrend in housing transactions maintained in Oct



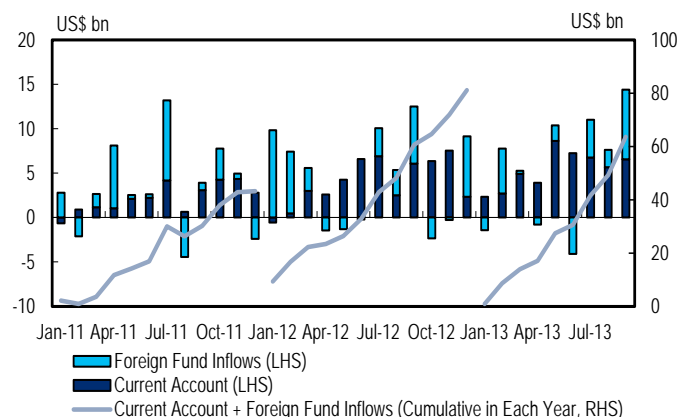
Source: Ministry of Land, Infrastructure and Transport, Citi Research

Figure 122. KRW has fluctuated with Kospi in Nov



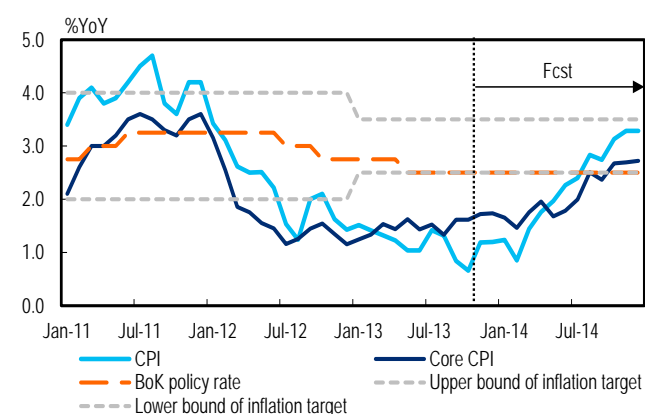
Source: Bank of Korea, Citi Research

Figure 124. Current account surplus and fund inflows continued in Sep



Source: Bank of Korea, Citi Research

Figure 126. BoK will likely keep the policy rate unchanged till end-2014



Source: Bank of Korea, Statistics Korea, Citi Research

Figure 127. Korea Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	1,048.0	929.1	834.7	1,014.9	1,114.8	1,129.3	1,206.9	1,359.1	1,490.7
Nominal GDP, local currency bn	975,013	1,026,452	1,065,037	1,173,275	1,235,161	1,272,460	1,322,722	1,402,269	1,495,564
GDP per capita, US\$	21,565	18,981	16,972	20,540	22,395	22,584	24,032	26,953	29,451
Population, mn	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4	50.6
Unemployment, % of labour force	3.2	3.2	3.6	3.7	3.4	3.2	3.1	3.1	3.1
Economic Activity									
Real GDP, % yoy	5.1	2.3	0.3	6.3	3.7	2.0	2.9	3.7	3.9
Real investment growth % yoy	3.5	0.0	-13.5	15.8	1.4	-1.8	2.4	2.7	4.7
Real consumption growth % yoy	5.1	2.0	1.2	4.1	2.3	2.2	2.2	2.7	3.1
private consumption growth % yoy	5.1	1.3	0.0	4.4	2.4	1.7	1.9	3.0	3.3
Real export growth, % yoy	12.6	6.6	-1.2	14.7	9.1	4.2	4.7	6.0	6.9
Real import growth, % yoy	11.7	4.4	-8.0	17.3	6.1	2.5	3.8	5.4	6.6
Prices, Money & Credit									
CPI, % yoy	3.6	4.1	2.8	3.0	4.2	1.4	1.2	3.3	2.9
CPI, % avg	2.5	4.7	2.8	3.0	4.0	2.2	1.2	2.3	3.1
Nominal wages, % yoy	5.6	-4.1	2.6	6.8	1.0	5.3	4.3	5.2	4.8
Credit extension to private sector, % yoy	12.4	15.0	2.3	3.6	5.1	1.9	5.3	7.0	8.9
Policy interest rate, % eop	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.50	3.50
91-Day CD Rate, % eop	5.73	4.68	2.82	2.80	3.55	2.89	2.70	2.75	3.60
Long term yield, % eop	5.78	3.77	4.92	4.08	3.46	2.97	3.35	3.65	4.25
lc/US\$, eop	936	1263	1166	1121	1159	1064	1054	1020	995
lc/US\$, avg	929	1102	1275	1156	1108	1127	1096	1032	1003
Balance of Payments, US\$ bn									
Current account	21.8	3.2	32.8	29.4	26.1	48.1	67.9	56.3	48.1
% of GDP	2.1	0.3	3.9	2.9	2.3	4.3	5.6	4.1	3.2
Trade balance	14.6	-13.3	40.4	41.2	30.8	28.3	42.7	33.4	39.1
Exports	371.5	422.0	363.5	466.4	555.2	547.9	563.1	593.3	642.3
Imports	356.8	435.3	323.1	425.2	524.4	519.6	520.3	559.9	603.2
Service balance	-12.0	-5.7	-6.6	-8.6	-5.8	5.7	9.8	12.5	9.8
Income balance	-3.4	3.7	1.6	-2.1	0.3	2.5	2.9	0.3	-1.0
FDI, net	-17.9	-16.9	-14.9	-22.2	-16.4	-18.9	-12.5	-8.6	-4.3
International reserves	262.2	201.1	270.0	291.5	304.2	323.2	334.1	343.1	356.9
Total Amortisations	43.8	42.9	43.6	40.0	42.0	46.0	47.0	48.2	49.1
Public Finances, % of GDP									
Consolidated government balance	3.5	1.2	-1.7	1.4	1.5	1.5	0.9	2.3	2.3
Consolidated gov primary balance	4.9	2.6	-0.2	2.8	2.9	2.7	2.3	3.7	3.7
Public debt	29.7	29.0	32.5	31.9	32.6	33.0	35.0	33.0	31.0
of which Domestic	28.6	28.1	31.4	31.0	31.8	32.6	34.4	32.3	30.6
Foreign Assets & Liabilities, US\$ bn									
External debt	333.4	317.4	345.7	359.8	398.7	413.6	426.0	441.8	444.7
Private	333.1	317.1	345.4	359.4	358.3	373.4	384.8	399.6	401.5
Public	0.3	0.3	0.3	0.4	40.4	40.2	41.2	42.2	43.2
External debt / GDP	31.8	34.2	41.4	35.5	35.8	36.6	35.3	32.5	29.8
External debt / XGS	75.0	61.9	79.1	65.0	61.3	62.7	62.9	61.7	57.2
Short-term debt	160.3	149.9	149.2	139.8	137.4	126.7	130.3	140.4	164.3
Short-term debt/International Reserves (%)	61.1	74.5	55.3	48.0	45.2	39.2	39.0	40.9	46.0
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	2.3	3.3	4.2	4.2	3.8	3.9	3.0	3.4	3.7
CPI, % yoy	1.0	0.8	1.2	1.4	2.3	2.7	3.3	3.3	3.3
Policy interest rate, % eop	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00
91-Day CD Rate, % eop	2.69	2.66	2.70	2.75	2.75	2.75	2.75	2.90	3.10
Long term yield, % eop	3.14	3.05	3.35	3.45	3.60	3.65	3.65	3.75	3.95
lc vs USD, eop	1142	1075	1054	1045	1035	1027	1020	1013	1006

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** – The economy is likely to pick up pace with benign inflation in 2014. Trade, manufacturing and investment are likely to improve with warming global trade, ECFA and FTAs; endorsing the current account surplus. Consumption recovery story could take hold in 2H. Fiscal hands remain tied.
- **Things to watch** – 1) Potential luxury tax revisions; 2) Additional consumption from recent rule change to allow more Mainland tourists; 3) Cross-strait momentum: Banks M&A, RMB swap line, ECFA for broader goods; 4) Pension reform; 5) 2014's local elections; 6) Liberalization efforts to join TPP by 2020.
- **Strategy** – We expect 10Y government bond yields will resume a gradual upward trend when Fed tapering talks reignite in early 2014. TWD likely to appreciate mildly on expected RMB, KRW appreciation, current account surplus and macro recovery. Citi's TAIEX 2014 year-end target at 8,700.

Trade issues persist but expect gradual recovery in 2014E

Real GDP likely to improve from 2013E's 2%yoy to 2014E's 3.2%. The path of recovery is expected to be a steady and gradual one, as we expect a small export-oriented economy like Taiwan would benefit from warming global trade, and associated manufacturing volume would subsequently be added as orders pick up. The recent signings of ECFA for services with China, FTA with New Zealand and Singapore, as well as the ECFA for goods (which is expected to be concluded early 2014) mark a sizeable expansion of market access under lower tariffs for Taiwanese exporters. Given the lack of investment in recent years (with the exception of semiconductor which has made substantial investment since late 2012), we expect Taiwanese businesses will have to add capex in 2014E to cater for new clients.

Taiwan needs to adapt to the new tech environment. In light of new potential client pool from the above mentioned bilateral agreements, a more meaningful recovery in Advanced Economies' demand, Taiwan being a well-developed tech export hub technically should rebound. However, we argue that tech developments have changed, as we think the technological demand on hardware has lessened as the focus has shift towards software enhancement supported by cloud and mobile technologies. Such a seismic shift would mean that Taiwan hardware producers will see slower growth in the upcoming expected recovery in global demand as compared to historical betas; and some sector adjustment is required.

The success of the Free Economic Pilot Zones (FEPZs) becomes critical for Taiwan to re-engineer itself. The Executive Yuan has approved the first-stage implementation plan for the development of FEPZs with the first wave of seven such zones, including six harbors and one airport; and start with four types of industries: (i) Smart logistics; (ii) International medical services; (iii) Value-added agricultural processing; and (iv) Industrial cooperation. The decentralized nature of the FEPZs differs from the typical free-economic-zones within the region, as it make use of existing transport infrastructures and established industrial parks and operates on the "shop in front and factory in the rear, with outsourced processing" concept. For the second stage, the government is also seeking a law amendment by enacting a "Special Act for Free Economic Pilot Zones" to allow for tax incentives. Through the various FTAs and the two-stage FEPZs, Taiwan hopes to (i) realign itself with international practices; (ii) enhance trade of goods and services; (iii) spur investment (first stage target: NT\$20 billion; Mainland Chinese investment also welcome but subject to prior review); (iv) address structural issues previously bounded by regulations, prepare Taiwan to join TPP.

Financial liberalization is also a theme to look for in 2014E. In our previous monthlies, we highlighted that the market appears encouraged with recent liberalization efforts by the new FSC Chairman. Of particular focus would be the expected announcement of a further lifting of restrictions allowing Overseas Banking Units (OBUs) to operate in the FEZ to offer non-TWD denominated products and fixed income services. RMB banking reached an initial year of success since the starting of business in Feb13. Mainland Chinese banks have immediately taken action to issue Formosa bonds post the recent rule change. We believe 2014 would be a year of financial development for Taiwan as an offshore RMB banking business, within the FEZ and DBUs too. A swap line with PBOC is expected to be set up by mid-2014, and this would likely foster more yuan financial products. Moreover, the greater allowed access into the China market for Taiwanese banks and brokers will likely remain a selling point for equities – a trend that has started in 2013 as foreign interests are returning to Taiwanese equities.

We think the fiscal hands remain tied as it suffers from frequent political hurdles and public debt is approaching its debt ceiling. The current fiscal mentality is for the government to spend on national defense and social welfare, while encourage private investments from locals and FDI, which can help ensure the effectiveness of money spent. However, given moderate economic recovery, politics, the need to first reform its pension system, there are not many plans to improve the fiscal position. The expectation of fiscal stimulus in 2014 is small, instead the government could engage in deregulation to help foster competition and economic growth.

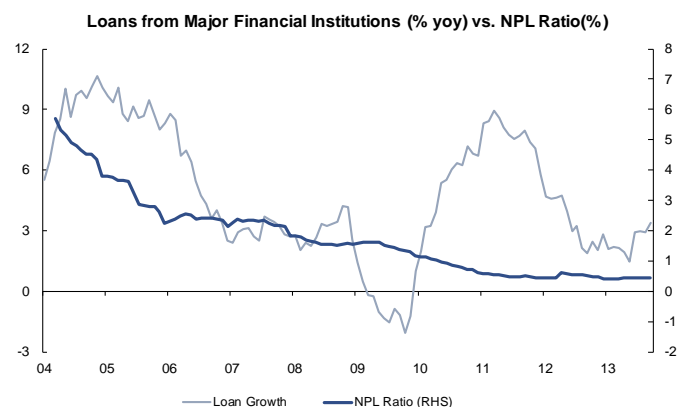
Politics will intensify in 2014E. External relations are improving with both China and other countries as Taiwan achieved various economic cooperation breakthroughs. Taiwan is looking to also sign free trade agreements with India and the Philippines. Territorial claims and disputes in South China Sea could very well likely reoccur periodically in the coming years. Domestic political heat will turn up further in 2014 as the super “7-in-1” municipal elections are scheduled at the end of the year. The combined election was aimed to reduce election cost, but in turn would intensify the political noise and could result in further political delays to key policies in the later part of the year. Having said that, the next presidential and legislative elections will be in 2016, granting the ruling party KMT two more years of majority control in the Legislative Yuan to push for political entrenching policies.

Market Implications

We expect policy rate to be on hold until Sep-14 while long-term bond yields to rise gradually in 2014E. We expect the CBC will maintain max. accommodation to spur economic growth in 2014E; however, as economic momentum including inflation could pick up in 2H14E and other central banks in the region could also start hiking policy rates; we see CBC could initiate a symbolic hike in 3Q14E. 10Y gov't bond yields although have shifted downwards after US Fed decision and poor macro data, we expect yields could rise again when tapering talks resume in 1Q14E. The mark-to-market nature of Taiwanese gov't bond investors will likely track global FI sentiments more closely, especially in an interest rate up-cycle.

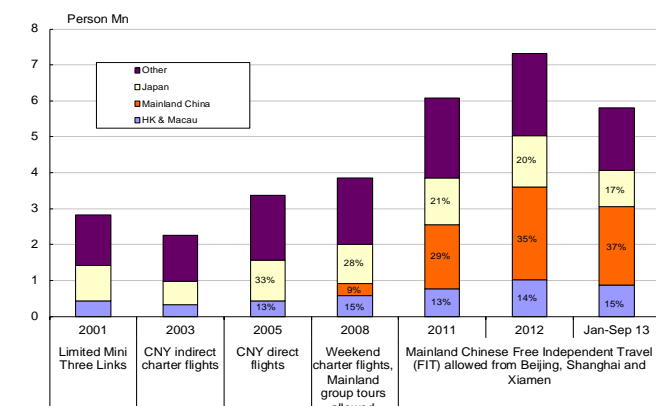
We expect the TWD to appreciate mildly in 6-12 months to 29.2/USD. The Central Bank appears to be very keen to balance exporters and consumer import needs, and has been smoothing FX volatilities. We believe weaker data will need to be reflected in the exchange rate, making a near-term rise more difficult, especially with KRW and CNY staying near current levels. In the medium term, we expect the TWD could appreciate gently amidst a gradual economic recovery, a stronger RMB and after the market adapts to tapering post March. The strong 3Q C/A reading also underscores why the TWD is relatively resilient amongst the region.

Figure 128. Loan growth likely to pick up with China's funding tightness



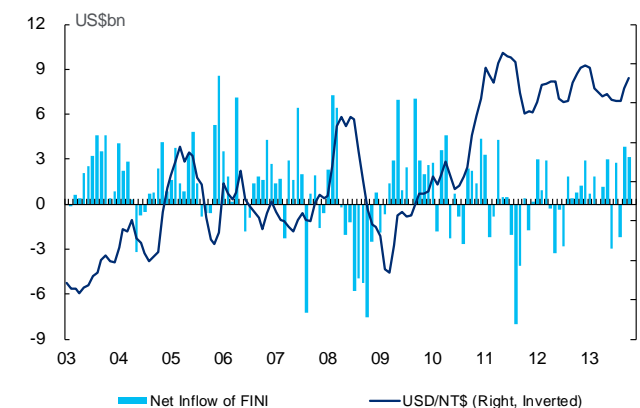
Source: CEIC, Citi Research

Figure 130. Mainland tourist contribution to consumption is rising



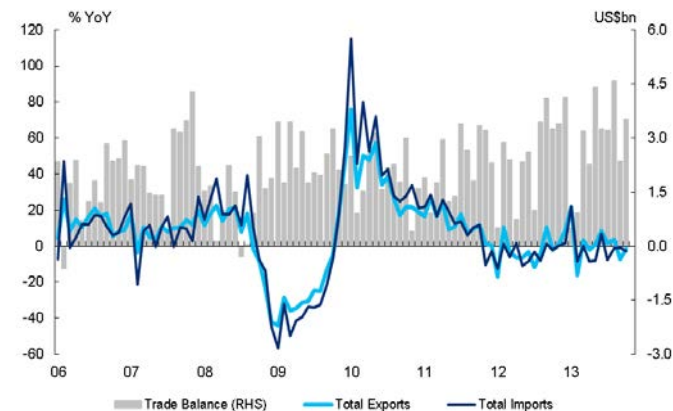
Source: CEIC, Citi Research

Figure 132. TWD continues to see support from FINI inflows



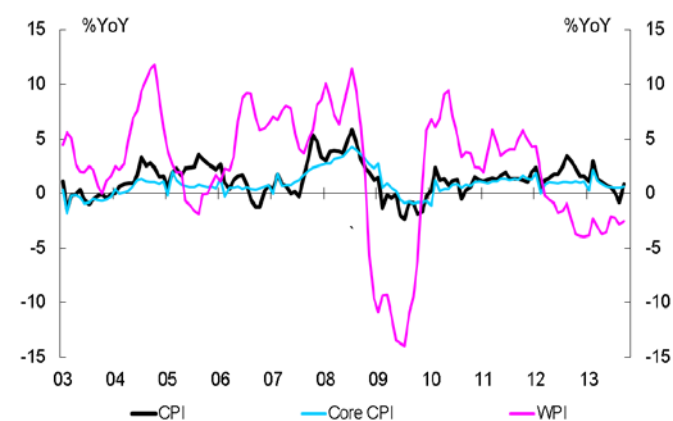
Source: CEIC, Citi Research

Figure 129. Trade is on a bumpy but recovering ride



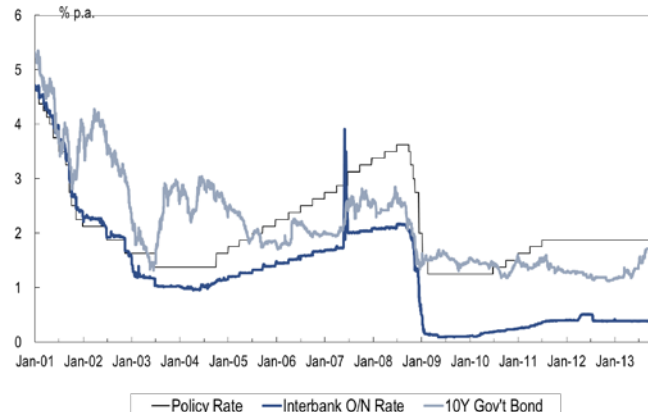
Source: CEIC, Citi Research

Figure 131. Benign inflation gives room for CBC's accommodation



Source: CEIC, Citi Research

Figure 133. 10Y gvt bonds could gradually rise again with US taper talks



Source: CEIC, Citi Research

Figure 134. Taiwan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	393.1	400.2	377.6	428.2	464.0	474.1	488.1	523.1	555.9
Nominal GDP, local currency bn	12,911	12,620	12,481	13,552	13,674	14,042	14,472	15,183	16,114
GDP per capita, US\$	17,122	17,372	16,331	18,488	19,980	20,336	20,892	22,346	23,700
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	4.1	1.3	2.0	3.2	3.8
Real investment growth % yoy	-0.7	-7.9	-21.2	36.8	-7.5	-4.5	2.5	5.0	3.2
Real consumption growth % yoy	2.1	-0.6	1.3	3.3	3.0	1.3	1.1	1.5	2.3
private consumption growth % yoy	2.1	-0.9	0.8	4.0	3.1	1.5	1.3	1.7	2.8
Real export growth, % yoy	9.6	0.9	-8.7	25.6	4.4	0.1	3.4	4.6	6.2
Real import growth, % yoy	3.0	-3.7	-13.1	27.7	-0.5	-2.1	3.1	3.6	5.2
Prices, Money & Credit									
CPI, % yoy	3.3	1.3	-0.2	1.2	2.0	1.6	2.3	1.7	3.1
CPI, % avg	1.8	3.5	-0.9	1.0	1.4	1.9	1.1	1.7	2.3
Nominal wages, % yoy	2.1	0.0	-4.9	5.5	2.7	0.3	0.5	1.5	3.0
Credit extension to private sector, % yoy	3.9	2.7	-0.8	6.7	5.6	4.1	5.5	7.0	8.5
Policy interest rate, % eop	3.38	2.00	1.25	1.63	1.88	1.88	1.88	2.13	2.63
1 month inter-bank rate, % eop	2.04	1.02	0.57	0.74	0.87	0.87	0.87	1.05	1.23
Long term yield, % eop	2.53	1.44	1.47	1.47	1.27	1.15	1.66	1.94	2.54
lc/US\$, eop	32.43	32.78	32.23	29.17	30.29	29.06	29.49	29.14	28.97
lc/US\$, avg	32.85	31.58	33.04	31.50	29.40	29.57	29.73	29.24	29.04
Balance of Payments, US\$ bn									
Current account	35.2	27.5	42.9	39.9	41.2	49.9	53.0	51.3	52.8
% of GDP	8.9	6.9	11.4	9.3	8.9	10.5	10.9	9.8	9.5
Trade balance	16.8	4.4	20.3	11.0	11.3	14.4	18.3	23.3	36.5
Exports	235.1	243.8	193.8	261.6	291.9	284.2	288.9	300.5	330.1
Imports	218.2	239.5	173.5	250.5	280.6	269.8	270.7	277.3	293.7
Service balance	-1.6	1.8	2.0	2.5	3.9	6.3	20.2	21.8	16.0
Income balance	10.1	10.0	12.5	13.6	13.2	15.2	14.0	17.0	19.0
FDI, net	-3.3	-4.9	-3.1	-9.1	-14.7	-9.8	-11.0	-10.0	-9.0
International reserves	270.3	291.7	348.2	382.0	385.5	403.2	420.0	440.0	460.0
Total Amortisations	3.8	8.8	2.5	3.2	6.8	3.4	2.9	3.0	3.0
Public Finances, % of GDP									
Consolidated government balance	0.9	0.9	-2.2	-1.2	-0.6	-1.6	-1.5	-1.4	-1.2
Consolidated gov primary balance	1.9	1.9	-1.2	-0.3	0.4	-0.7	-0.6	-0.6	-0.5
Public debt	33.3	34.7	38.0	38.3	40.1	41.0	41.8	41.0	42.0
of which Domestic	33.3	34.7	38.0	38.2	40.1	40.9	41.8	41.0	36.7
Foreign Assets & Liabilities, US\$ bn									
External debt	94.5	90.4	82.0	101.6	122.5	130.8	150.0	160.0	150.0
Private	91.1	88.9	76.0	93.5	118.0	127.5	146.3	156.0	146.0
Public	3.5	1.5	5.9	8.0	4.5	3.3	3.7	4.0	4.0
External debt / GDP	24.0	22.6	21.7	23.7	26.4	27.6	30.7	30.6	27.0
External debt / XGS	33.4	30.9	34.7	32.1	34.7	37.5	41.2	40.5	34.9
Short-term debt	83.3	78.8	68.2	83.7	107.8	116.5	125.0	130.0	120.0
Short-term debt/International Reserves (%)	30.8	27.0	19.6	21.9	28.0	28.9	29.8	29.5	26.1
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	2.5	1.6	2.2	2.7	2.9	3.5	3.7	4.1	3.4
CPI, % yoy	0.8	0.8	2.3	2.3	1.3	1.2	1.7	1.2	1.7
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	2.00	2.13	2.25	2.38
1 month inter-bank rate, % eop	0.87	0.87	0.87	0.93	0.93	0.99	0.99	1.05	1.11
Long term yield, % eop	1.41	1.69	1.66	1.71	1.76	1.84	1.94	2.09	2.24
lc vs USD, eop	29.96	29.56	29.49	29.38	29.26	29.18	29.14	29.10	29.06

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

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

Thailand

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- **Summary view** – We cut our 2013 GDP growth forecast to 2.8% on the back of slower 4Q13 GDP (0.5%YoY) but with a quarterly gain of 0.4%QoQ SA. Severe base effect, public investment delays, HH deleveraging dampen 4Q prospects. GDP prospects in 2014 likely hostage by political risk premia.
- **Things to watch** – Passage of the public investment program although opposition will challenge this in Court. Signals of early elections in 2014 following defeat of the amnesty/amendment bills. Likelihood of core inflation upticks to end 2013. Another rate cut in Jan 22nd –the first MPC rate meeting in 2014.
- **Strategy** – THB would be vulnerable to strong USD pressures with another rate cut expected in 1Q14 in response to public investment delays and elusive export recovery. Expected overnight rate of 2% in 2014 anchors the front end. Long bonds very exposed to structural fiscal drag of a rising public sector debt ratio.

Cut 2013 GDP forecast to 2.8% from 3.5% previously

We downgraded our 2013 GDP forecast to 2.8% on the back of bearish 4Q13 GDP growth projection of 0.5%YoY. Other than severe base effect, 4Q would lack strong spending catalysts because of public investment delays, expiration of populist stimulus programs, e.g., first car, tax rebate scheme, HH deleveraging, absent export recovery, and weak consumer/business sentiment. Political uncertainty during the quarter triggered by impending Parliamentary passage of the amnesty bills also dampened market sentiment. Risk premia narrowed with Senate rejection of the amnesty bills and Court's decision declaring some of these draft amendments as unconstitutional. Absence of the growth catalysts now constitutes larger downside risk. HH consumption could fall by 2%YoY following a 1.3%YoY decline in 3Q13. After a 13.6%YoY drop in 3Q13, we expect a 23.8%YoY plunge in durable goods demand (transport equipment) with the base effect exaggerating the downside. Fiscal subsidies/transfers (Bt2tn current expenditure budget up 6.1% in the FY14 budget) would cushion the drag. Lacking strong export gains undermine the capex outlook and probably sustained private investments weakness (-5%YoY vs -3.3%YoY in 3Q13). Utilization rates in the 63%-65% range since Mar would be neutral to capacity expansion. Likely enticed by new mass transit line projects in Bangkok, residential construction would stay firm. Delays and high base effect underpin a public investments decline of 20%YoY. Domestic demand probably fell by 2.8%YoY to extend its 3Q drop of 1.4%YoY.

Net exports probably grew 22.5%YoY for a 16.6% contribution to 4Q GDP (15.6% in 3Q13) largely because of tourism coupled with an expected import drop (-2.2%YoY). Despite commodity exports likely down by 2%YoY assuming persistent demand weakness for electrical appliances and vehicles & parts, service exports probably ensured total export gains of 2.5%YoY.

Despite defeat of the amnesty/amendment bills, we think the public investment program (PIP) now in its 2nd/3rd reading would also face political challenge and delays. If PIP is challenged in Court, like the Bt350bn waterworks projects, it won't require constitutional justification but probably compel compliance with 'technical studies/requirements'. Delays in public investments could be costly in 1Q14 (-10%YoY) but we expect public investments to rise close to 6%YoY in 2H14 and contribute 4.5% to 2014 GDP. Coupled with improving 2014 global prospects, investors may take this as a cue to start rolling out stalled projects. With HH debt stabilizing, durable goods demand would be in solid recovery by 2Q14. Domestic demand could expand 2.4% in support of 2014 growth of 3.1%.

Risk of larger fiscal deficit outlook over the medium term

Focus on the medium-term public investment program (PIP) but with initial delays likely suggests a buildup to larger fiscal deficits in 2016-17. Pursuit of PIP would drive infrastructure spending to rise from 2.3% of GDP in FY13 to 3.5% in FY17 that would underpin faster fiscal spending and cause budget gaps to swell. Government would moderate but not deviate from its one-off, stimulus programs as current expenditures excluding interest, could stay elevated with growth of 5%-7% over the medium-term (MT). Tandem of PIP and current expenditures could drive primary expenditures by 8%-9% and support GDP's return to trend growth. This would be at the cost of incurring a primary fiscal deficit in the Bt200bn range in FY16-FY17 or roughly -1.4% to -1.5% of GDP up from -0.8% to -1% in FY12-FY13. Among the fiscal tradeoffs in the pursuit of an aggressive MT fiscal strategy would be a higher effective interest rate (EIR) paid on government debt. From 4.55% in FY11, we anticipate EIR's future path peaking at 4.25% in FY17 that would imply a 10yr yield probably at new highs past 4%. Policy rate outlook assumes a policy rate probing 4% in 2016-17. Higher EIR implies a rising interest bill.

Larger fiscal borrowing appetite would also be among the factors putting pressure on the government's EIR. In line with a larger fiscal gap funding, the change in central government debt would gradually escalate from 2.2% of GDP in FY13 to a high of 3.2% -3.8% in FY16-FY17. Assuming no debt compression for SFI and other public sector debt at 14.3% of GDP, the trajectory of the overall public sector debt to GDP ratio could peak at 49.5% in FY18. Higher consumption and excise taxes can derail the public sector debt ratio's upward trajectory.

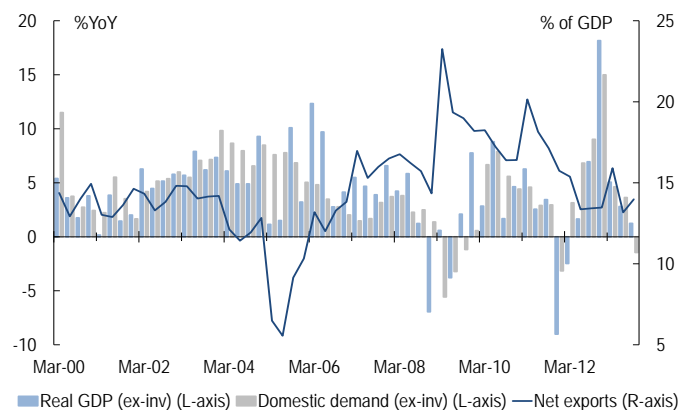
Current account deficit likely to persist

Potential risk that trade surpluses may disappear with heightened imports driven by higher fiscal spending over the medium-term. PIP's aggressive deployment over the next fiscal years that strengthen domestic demand would also accelerate imports faster than exports starting 2015. Eventually we court looming risk of a trade deficit starting 2016. Assuming no legislated tax hikes within the 3-5yr period amid moderate export gains, the current account deficit could rise from less than 1% of GDP in 2014-15 to 2% of GDP in 2017-18.

Near-term policy rate easing expected

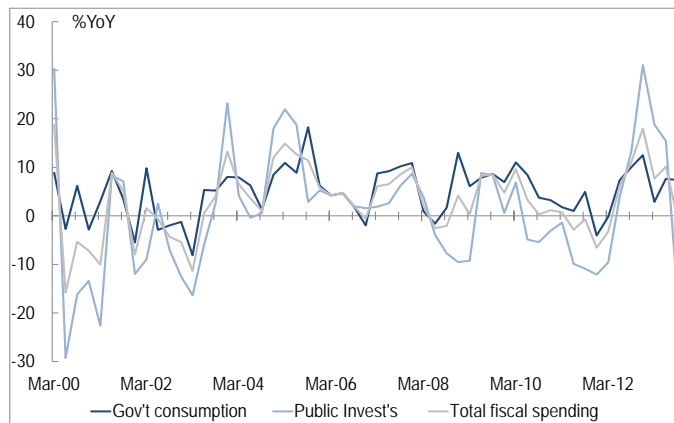
Heightened risk premia and public investment delays extended to 1Q14 would underpin another MPC decision to cut its policy rate by 25bp to 2% in Jan 22nd to extend its rate easing bias in Nov. We assume public investment approval and implementation delays would run to 1Q14 with strong export recovery still elusive. With the macro momentum likely a hostage to political risk premia in 2014—an election year, MPC's accommodative bias would prevail and sustain an overnight rate at 2%. A firmer public investment outlook and strong export recovery, if it happens in 2H14, comprise the caveat. THB would stay at 32 or weaker and absorb the brunt of MPC's accommodative bias. Rate cut outlook would help anchor the front end of the local bond curve amid risk premia, Fed tapering risk results in UST yields drifting up, and a weak THB aggravated by portfolio exit risk. However the long end of the curve would remain exposed to upside risk mainly because of structural fiscal weakness embodied by a rising public investment debt to GDP ratio. As public investments rise while lacking sharp cuts in populist programs, the long yields likely locked in at 4%-4.5% would not benefit from the low policy rate setting. Over the medium-term, we expect the policy rate to be adjusted back up to 4% as trend growth returns, inflation cycle normalizes with risk of higher wage cost pressures, and a current account deficit swells past 2% of GDP in 2017-18.

Figure 135. 3Q13 domestic demand (ex-inv) declined by 1.4%YoY



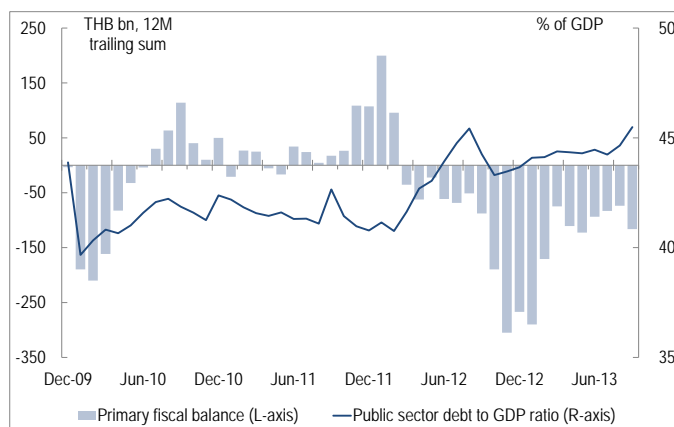
Source: CEIC, Citi Research

Figure 137. Sorely missing public investments in 3Q13



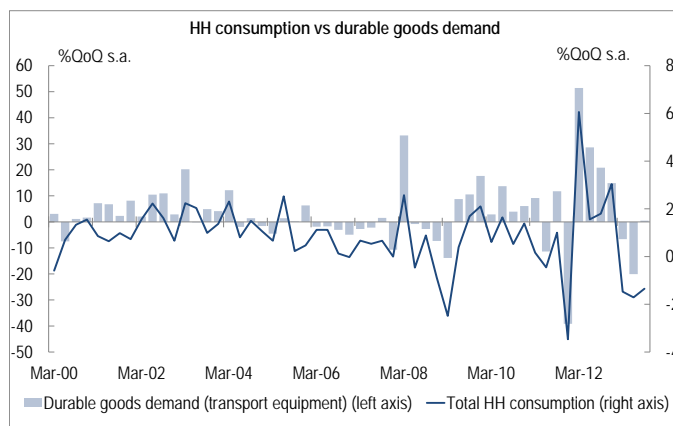
Source: CEIC, Citi Research

Figure 139. Rising public debt ratio not entirely due to primary deficit



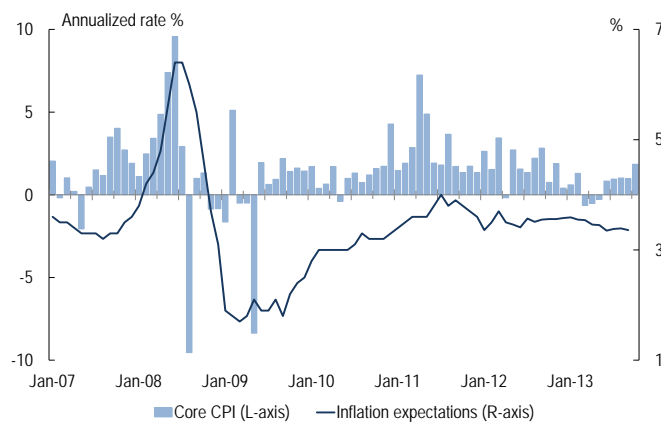
Source: CEIC, Citi Research

Figure 136. Durable goods demand in 3Q13 eked out +0.5%QoQ SA



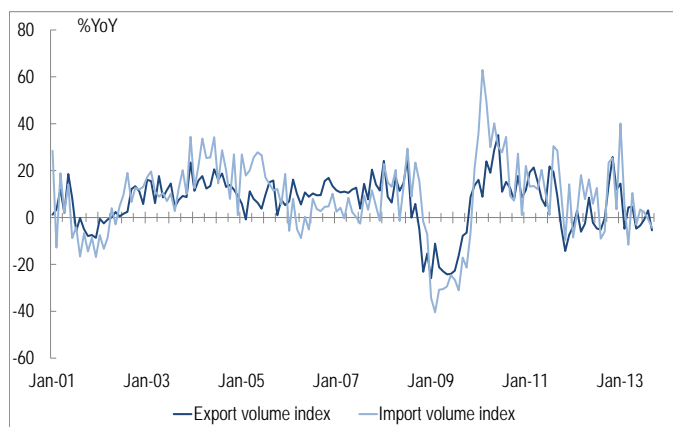
Source: CEIC, Citi Research

Figure 138. Amid weak demand, core's annualized rate in Oct edged up



Source: CEIC, Citi Research

Figure 140. Lacking strong exports, imports stumbled in Aug-Sep



Source: CEIC, Citi Research

Figure 141. Thailand Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	265.2	276.1	263.8	319.3	346.1	366.4	388.6	402.9	444.6
Nominal GDP, local currency bn	8,525	9,080	9,042	10,105	10,540	11,375	11,948	12,583	13,528
GDP per capita, US\$	4,207	4,355	4,153	4,998	5,401	5,685	5,999	6,189	6,795
Population, mn	63.0	63.4	63.5	63.9	64.1	64.5	64.8	65.1	65.4
Unemployment, % of labour force	1.4	1.4	1.5	1.0	0.7	0.7	0.9	0.8	0.8
Economic Activity									
Real GDP, % yoy	5.0	2.5	-2.3	7.8	0.1	6.5	2.8	3.1	4.3
Real investment growth % yoy	1.0	8.1	-25.2	28.7	0.1	16.8	0.6	0.5	7.2
Real consumption growth % yoy	2.9	2.9	0.1	5.1	1.3	6.8	1.7	2.5	3.6
private consumption growth % yoy	1.8	2.9	-1.1	4.8	1.3	6.7	0.9	2.2	3.5
Real export growth, % yoy	7.8	5.1	-12.5	14.7	9.5	3.1	4.3	3.8	5.3
Real import growth, % yoy	4.4	8.9	-21.5	21.5	13.7	6.2	2.6	2.4	5.7
Prices, Money & Credit									
CPI, % yoy	3.1	0.4	3.5	3.1	3.5	3.6	1.2	2.5	3.5
CPI, % avg	2.2	5.5	-0.9	3.3	3.8	3.0	2.1	2.2	3.1
Nominal wages, % yoy	3.0	10.5	-1.9	5.8	7.2	11.9	5.5	4.0	3.5
Credit extension to private sector, % yoy	29.3	6.3	2.5	18.8	18.2	13.6	10.5	11.5	12.5
Policy interest rate, % eop	3.25	2.75	1.25	2.00	3.25	2.75	2.25	2.00	3.00
1 month inter-bank rate, % eop	3.74	3.07	1.28	2.03	3.26	2.79	2.30	2.10	3.10
Long term yield, % eop	5.13	2.84	4.37	3.74	3.28	3.55	4.25	3.90	4.50
lc/US\$, eop	30.05	34.79	33.36	30.07	31.57	30.60	32.00	31.32	29.87
lc/US\$, avg	32.33	33.03	34.33	31.71	30.48	31.08	30.89	31.73	30.36
Balance of Payments, US\$ bn									
Current account	15.7	2.2	21.9	10.0	4.1	-1.5	-3.6	-3.0	-4.3
% of GDP	5.9	0.8	8.3	3.1	1.2	-0.4	-0.9	-0.7	-1.0
Trade balance	26.6	17.3	32.6	29.8	17.0	6.0	6.2	4.9	2.5
Exports	151.3	175.2	150.8	191.6	219.1	225.9	223.6	232.6	246.5
Imports	124.6	157.9	118.2	161.9	202.1	219.9	217.4	227.7	244.1
Net service and Transfer accounts	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	-2.5	-0.6	-0.8
Income balance	-3.0	-2.3	-4.4	-9.0	-2.3	-4.0	-7.2	-7.3	-6.0
FDI, net	8.3	4.4	0.7	4.5	5.0	-2.0	-0.7	1.2	1.0
International reserves	87.5	111.0	138.4	172.1	175.1	181.6	175.0	182.5	188.0
Total Amortisations	20.5	15.0	10.7	9.4	8.9	17.3	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	-2.0	-2.4
Consolidated gov primary balance	-0.3	0.2	-4.5	1.1	-1.5	-1.6	-1.2	-1.1	-1.3
Public debt	38.3	37.3	45.2	42.6	41.7	45.4	45.9	47.2	48.1
of which Domestic	33.4	33.0	40.9	39.0	38.4	42.3	42.7	43.0	43.3
Foreign Assets & Liabilities, US\$ bn									
External debt	74.4	76.1	75.3	100.6	104.3	130.7	132.3	135.0	140.0
Private	71.6	72.7	69.4	87.9	88.1	104.5	106.7	108.4	112.9
Public	2.8	3.4	5.9	12.7	16.2	26.2	25.6	26.6	27.1
External debt / GDP	28.1	27.6	28.5	31.5	30.1	35.7	34.0	33.5	31.5
External debt / XGS	41.0	36.5	41.6	44.5	40.0	47.5	47.7	46.5	45.4
Short-term debt	33.7	32.5	33.3	50.7	47.3	58.2	60.0	59.8	61.0
Short-term debt/International Reserves (%)	38.6	29.3	24.0	29.4	27.0	32.0	34.3	32.8	32.4
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	2.9	2.7	0.5	2.0	3.0	3.5	3.8	4.0	4.3
CPI, % yoy	2.3	1.4	1.2	1.7	2.3	2.4	2.5	2.7	2.9
Policy interest rate, % eop	2.50	2.50	2.25	2.00	2.00	2.00	2.00	2.25	2.50
1 month inter-bank rate, % eop	0.00	2.55	2.30	2.10	2.10	2.10	2.10	2.30	2.60
Long term yield, % eop	0.00	3.94	4.25	4.15	3.90	3.85	3.90	4.00	4.25
lc vs USD, eop	31.14	31.24	32.00	31.96	31.92	31.72	31.32	30.93	30.53

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). Fiscal data is for fiscal year ending September.

Frontier Asia

Mongolia

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We remain long term positive on Mongolia, but cognizant on BOP pressure in the near-term. GDP likely to remain in double digits in 2014E. But we think sizeable FDI revival will only come in 2H14E as the resumption of Oyu Tolgoi (OT) Phase II is likely delayed, as Turquoise Hill announced that project financing before year-end could not be complete and both parties are waiting for the new feasibility study in 1H14E. Although Mongolia has been active lately on foreign relations and as a result signed multiple investment deals with Japanese, Chinese and European investors, and supra-nationals; these smaller deals (and more expected post new investment law effective on Nov 1st) are unlikely sufficient to match the amount of FDI that the US\$5bn OT phase 2 could bring in. Basic balance could remain in stress in 1H14E, international reserves could see small replenishment with DBM's JPY bond issuance and recovery in exports revenues. It will also be a big plus if BoM is successful at doubling its RMB swap line with PBOC to CNY20bn.

Exports to support 2014 growth, aim to lower transportation cost. Copper, gold and coal exports likely to pick up in 4Q13E. Some recent progress has been made on transportation: 1) it appears that the government has overcome politics and will agree to use the same narrow gauge as China to reduce railroad transport cost to China. 2) A new paved road connecting Ulaanbaatar that runs through Sainshand (future industrial park) to China has just been completed. There are other positives regarding mineral exports: 1) OT deliveries could pick up as it has overcome the teething issues with Chinese customs held up and the mine likely reach full production by year-end as per schedule. 2) The resumption of TT coal shipment to Chalco is positive, but it will be after Jan/Feb14 when Erdenes TT is expected to have fully repaid the Chalco loan before export revenues will contribute to BOP. 3) ETT-Shenhua MOU on 1bn tons coal exports in 20 years is a long-term positive.

The need to reduce monetary stimulus. Bank of Mongolia's subsidies to stabilize prices and encourage mortgage have been effective in stimulating consumption. There are no plans yet to end the 8% subsidized mortgage program, thus keeping the BoM deposits in the banking system. Although the Mortgage Backed Securities program could help reduce the loan growth (50%yoy as of Oct13), but BoM will fuel the credit bubble again as it is the final buyer of the securitized mortgage backed bonds. High loan growth, rising NPL and concentrated lending practices are also a growing risk for the banking system. While there are plans to end the Price Stabilization Scheme soon, the end of scheme will exacerbate recent CPI uptrend beyond BoM's inflation targets of 8% next year. Monetary expansion contributed to a 25% depreciation in MNT this year (MNT reached 1745/USD on 22 Nov), amidst less BoM intervention under its current flexible exchange rate stance. The dollarized nature of the economy (~50% of loans & deposits are in USD) also makes MNT more vulnerable, in turn raising debt burden of the FC-denominated borrowings.

Mongolia complies with Fiscal Stability Law (FSL), but with DBM off-budget spending. We acknowledge fiscal restraints efforts with the Parliament rejected the bill to raise 2014's debt ceiling (which under FSL will be reduced to 40% of GDP in NPV terms). As a result, the pending DBM's Sumari bond issuance will likely be smaller (we think, US\$300-400mn) and has to be completed in 2013 (to maximize the remaining 0.5ppt of GDP gap under 2013's 50% cap). Also, the current practice of pacing fiscal expenditure against revenues has helped kept fiscal deficit at ~1% of GDP as of Oct13, comfortably below the 2% structural deficit FSL set ceiling. It is also understood that the government has plans to slow DBM spending and gradually bring off-budget financing items onto the budget in the coming few years. A successful Sumari DBM issuance and under-spending of Chinggis bond would in turn reduce the need for USD debt issuance in 1H14 for the Government.

Sri Lanka

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Growth likely to remain resilient 2014F with the help of expanding services sector and manufacturing recovery supported by global demand. Following this year's positive growth surprise (we revise growth forecast in 2013 up to 6.8% from 6.5%) after two quarters of surprisingly resilient economic activity unaffected by Fed taper, we expect this growth to be sustained in 2014 amid buoyant services sector buoyed by tourism and other services-related industries (business process outsourcing, logistics) and some associated with positive spillovers from the service-supportive infrastructure build up in recent years (roads, airport, ports). There is also some signs that after very weak export/manufacturing sector since 2H 2012, growth rate in this sector may have already bottomed and global demand recovery in advanced countries should provide some lift, though likely at a lower historical beta given competitiveness challenges in Sri Lanka's dominant industry—textile/garments (accounts for over 42% of total exports). We also assume weather conditions should remain favorable next year providing a continued stable environment for agriculture sector growth, in the same vein that weather has been kind in 2013 (as opposed to the prolonged drought in 2012).

Inflation should be manageable enough to facilitate another cut from CBSL in early 2014. A benign outcome for food prices, which account for 41% of the CPI basket, alongside other commodity prices like oil, should help keep inflation manageable in the 6.5% range in 2014F. A very favorable base effect on the back of the early 2013 fuel and electricity price hikes will likely depress headline inflation to sub 6% range early next year, which will make it too tempting for CBSL to cut at least another 50bps. However, with potential taper-led volatility resurfacing again and risks to external imbalances, plus headline inflation expected to gradually head higher, we think CBSL might partially reverse those cuts, particularly on the low end of the interest rate corridor.

Public debt will remain stubbornly high amid very slow pace of fiscal consolidation. The government is pursuing a very gradual pace of fiscal deficit reduction, with no major tax reform (or privatization) in the pipeline, and thus, quite vulnerable to sudden shift in both FX and interest rate movements alongside slower growth. Its major approach on the fiscal sustainability side appears to lean more on trying to boost real GDP growth well beyond real interest rates to keep debt-to-GDP on a gradual decline even as they run ~1% of GDP in primary deficits. We expect after reporting some fiscal slippage in 2013 (to 6.2% of GDP versus 5.8% of GDP target), the same will once again happen in 2014F. Moreover, with no plans to lift the foreign quota on Treasury securities (at 12.5%) given their view this is a more 'risky' source of financing in a taper environment, plus their need to boost foreign reserves, we expect Sri Lanka will tap the global bond market with at least another \$1bn bond issuance in 2014F. It would not surprise us to see other quasi-sovereign issuers tap the market as well. This will test market appetite in a less favorable external funding environment and put pressure on external debt spreads.

A persistent basic balance deficit, albeit narrowing, will continue to keep Sri Lanka vulnerable to external refinancing risk. We think improvement in services receipts and buoyant remittances will facilitate gradual improvements in the current account deficit, but given net FDI flows will likely only finance about 40% of the CAD, and FX reserves are relatively low, we think Sri Lanka will continue to try to mobilize more debt-related capital flows next year and may need to tolerate some rupee depreciation if global risk sentiment turns for the worse. The risk to Sri Lanka is that its net external debt position is among the highest in Asia (next to Mongolia), and willingness to freely float its currency will have its limits.

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Vietnam

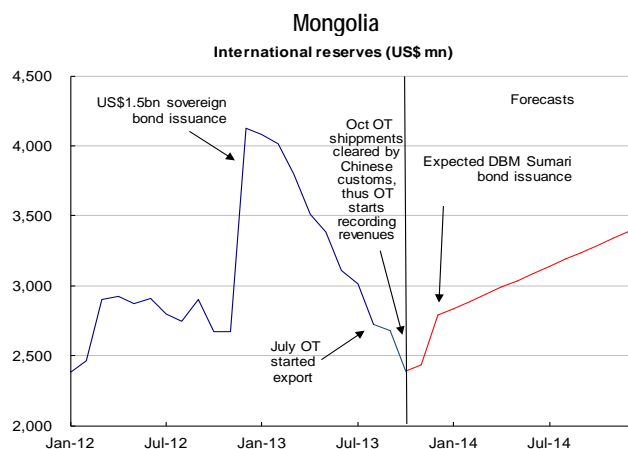
We think growth is going to surprise slightly on the upside in 2014F fueled by gains in manufacturing/export sector plus diminishing drag from credit deleveraging. Vietnam's economy continues to follow a dual track – part of the country is undergoing a radical transformation in the manufacturing space as it benefits from significant supply chain reconfiguration as China's domestic cost base is rising (and will continually do so). In fact, FDI from China is among the fastest growing (according to MPI data), taking China from 10th to 4th largest investor this year, with some investments involving building transport linkages from Vietnam to bordering cities in China. For a second year in a row, Vietnam's exports in high tech/electronics have continued to expand rapidly, up about 60% YoY in Jan-Oct versus 90% growth in 2012, and we expect this to continue. A large contributor to Vietnam's tech exports is Samsung, which is expanding its phone and tablet manufacturing plant in Bac Ninh province and constructing a larger second plant in the Northern province of Thai Nguyen, to be operational by August 2014F. Going forward, a key challenge for Vietnam is to expand both its power and transport infrastructure to meet demand. With subpar growth since 2008, we expect there will be some progress in improving foreign investment climate to support growth, including potentially altering foreign investment ceilings and relaxing land laws.

Meanwhile, parts of the economy continue to struggle amid protracted bank sector problems undermining credit. After much delay, the Vietnam Asset Management Company (VAMC) began operations in September and, as of this writing, issued VND11.12trillion (\$520mn) of zero coupon bonds to purchase NPLs from eight local banks, far short of the VND30-35trn targeted purchase this year. VAMC plans to purchase another VND100trn-150trn (US\$4.7-\$7bn) in bad loans in 2014F, but we are skeptical this amount will be achieved. Vietnamese banks are reporting much lower NPL ratio (4.6% as of Aug 2013 under Vietnamese accounting standards) than what outside analysts estimate, and there is still significant uncertainty on the success of VAMC in disposing the NPLs given significant legal ambiguities. Thus, in the absence of government funded recapitalization, banks will remain reluctant to lend and continue to park excess liquidity in government bonds, awaiting for gradual macro/profit recovery to improve their balance sheet, which will likely be a protracted process. We expect credit growth will pick up slightly to 12% in 2014F, just slightly behind the pace of nominal GDP growth.

Thus, domestic policy bias will likely remain accommodative for longer. While SBV has kept rates unchanged since May, and officials are sounding guarded about inflation, we think we could still see another (possibly last) rate cut next year as lack of sufficiently strong credit intermediation will frustrate monetary authorities. In fact, fiscal policy appears to have already been relaxed, with budget deficit in 2013F slipping to 5.3% of GDP vs. the target of 4.8% amid state revenue shortfalls.

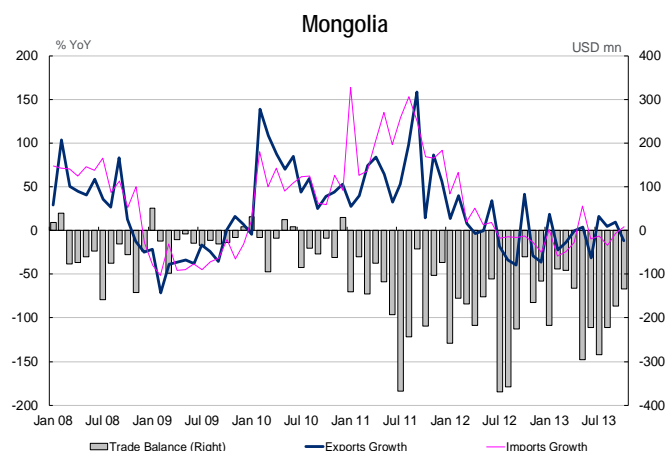
External position will likely be supported by a persistently wide current account surplus. We expect the current account surplus will gradually narrow after achieving an estimated 5% CA surplus in 2013F, as imports pick up and reliance on imported services to back trade remain large. A key issue to watch is to what extent Vietnam can move up the "value added" chain in manufacturing and catch-up the way China did. At the moment, reliance on imported parts/components still looks high. Nonetheless, we don't see the current account narrowing in a hurry given domestic demand is constrained by credit, and coupled with large net FDI flows, a managed FX regime and limited exposure to portfolio flows, SBV will likely continue to accumulate more reserves and strengthen its external position. We had been expecting a modest deliberate devaluation following Prime Minister Dung's statement, but we now think this looks increasingly unlikely.

Figure 142. Mongolia – Reserves declines could improve starting Dec13



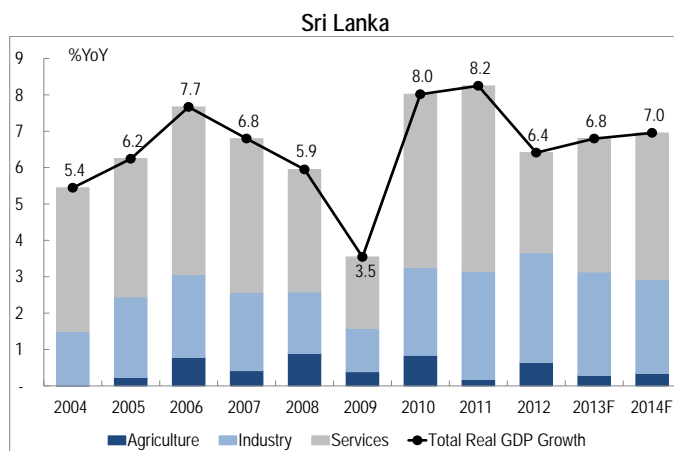
Source: BoM, CEIC and Citi Research

Figure 144. Mongolia – But exports likely to recover on coal and copper



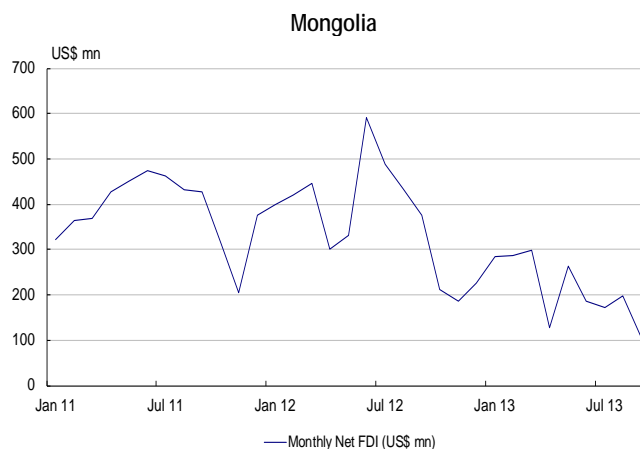
Source: NSO, CEIC and Citi Research

Figure 146. Sri Lanka – Real GDP growth is expected to mildly rebound led by services



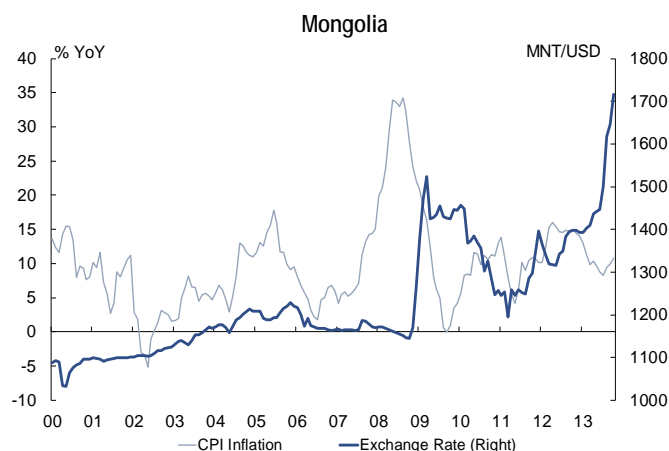
Source: CEIC, Citi Research

Figure 143. Material FDI recovery unlikely before 2H14E



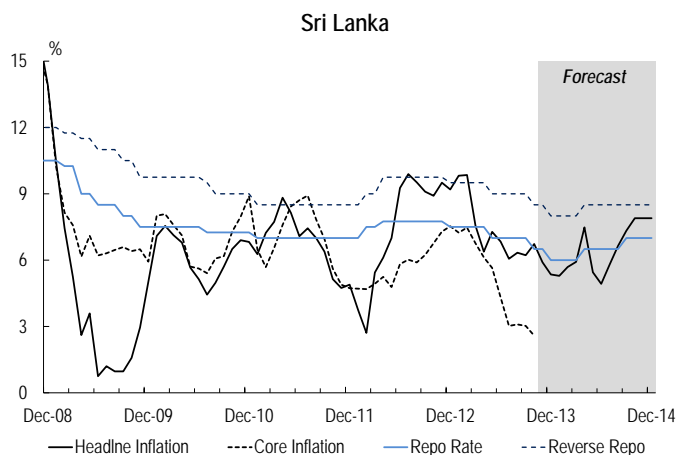
Source: BoM, CEIC and Citi Research

Figure 145. Unabated depreciation adding to price pressures



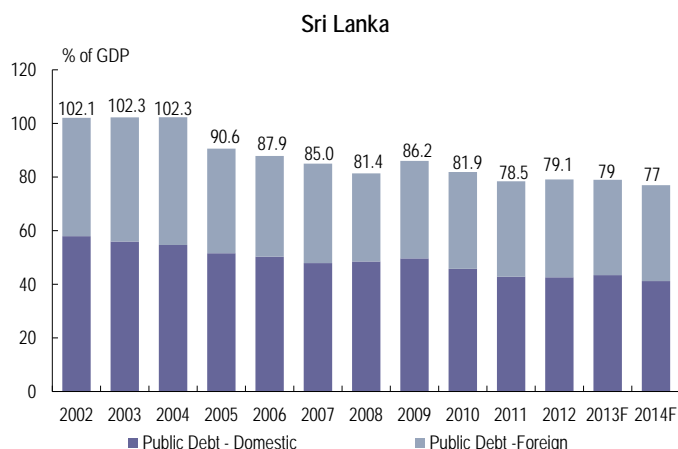
Source: BoM, CEIC and Citi Research

Figure 147. Decelerating inflation amid favorable base effect could leave room for another 50bps cut before having to reverse



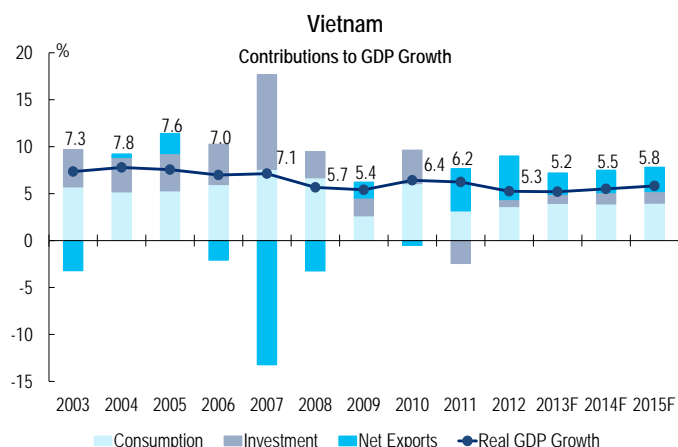
Source: CBSL, CEIC, Citi Research

Figure 148. Sri Lanka – Public debt will remain stubbornly high...



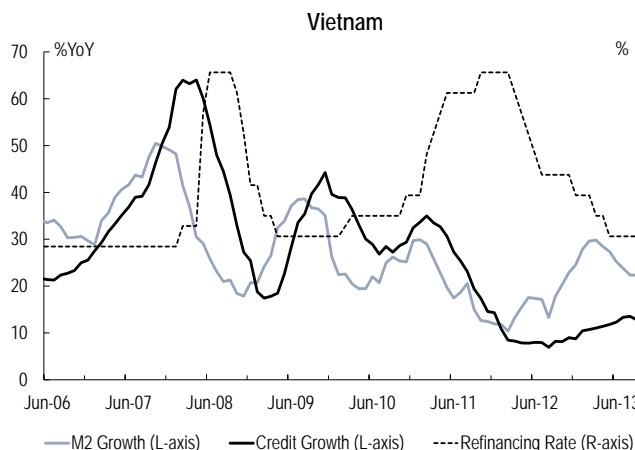
Source: CEIC, Citi Research

Figure 150. Vietnam – Real GDP growth should be on a gradually improving path



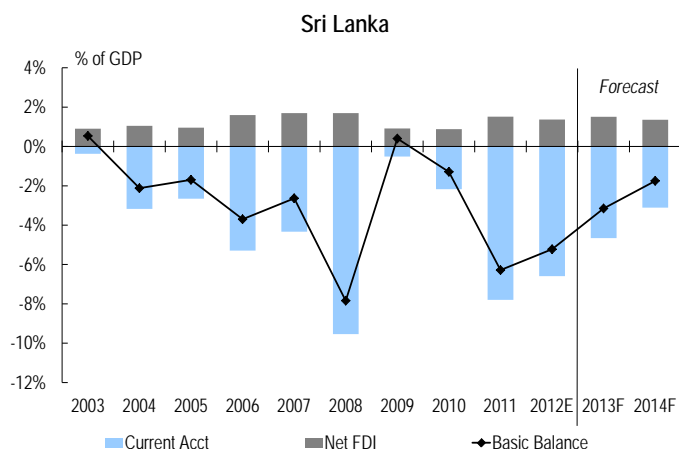
Source: CEIC, Citi Research. Note: Vietnam's GDP by expenditure breakdown tends to have large statistical discrepancies, and thus the components don't add to total.

Figure 152. Vietnam – Weak credit intermediation could still leave room for a rate cut even amid sticky inflation



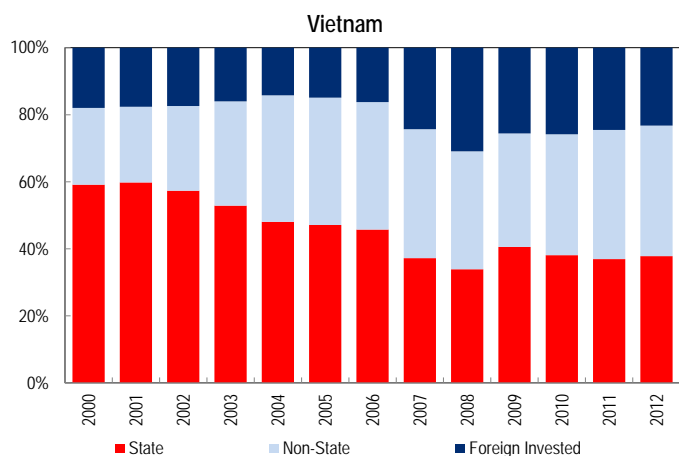
Source: CEIC, Citi Research

Figure 149. ...and will need to borrow offshore to fund its basic balance deficit



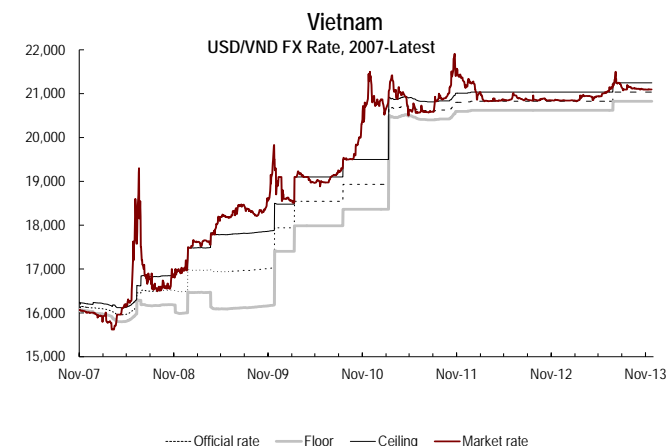
Source: CBSL, CEIC, Citi Research

Figure 151. Composition of investment – state, non state & foreign invested



Source: CEIC, Citi Research

Figure 153. ...pressure for VND appreciation will likely build next year amid mounting surpluses, but we think SBV will fight it.



Source: Citi Research

Figure 154. 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	10.9	12.1	14.8
GDP per capita, US\$	1629	2138	1717	2287	3186	3595	3759	4111	4927
Population, mn	2.6	2.6	2.7	2.7	2.8	2.9	2.9	3.0	3.0
Real GDP, % yoy	10.2	8.9	-1.3	6.4	17.5	12.4	12.0	11.0	8.0
CPI, % yoy	15.1	22.1	4.2	13.0	10.2	14.0	11.5	11.1	9.0
CPI, % avg	--	28.0	8.0	10.1	9.2	14.3	10.3	12.0	9.0
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	20.07	18.11	15.61	16.81	16.81
lc/US\$, eop	1172	1275	1433	1233	1378	1378	1755	1711	1644
lc/US\$, avg	1171	1167	1434	1349	1256	1353	1567	1735	1669
Current account (US\$ bn)	0.3	-0.7	-0.4	-0.9	-3.4	-2.8	-3.0	-2.6	-2.6
% of GDP	6.3	-12.8	-8.9	-15.0	-38.4	-26.8	-27.4	-21.4	-17.6
Trade balance (US\$ bn)	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-2.0	-1.5	-1.3
Exports (US\$ bn)	1.9	2.5	1.9	2.9	4.8	4.4	4.3	5.4	6.4
Imports (US\$ bn)	2.2	3.2	2.1	3.2	6.6	6.7	6.3	6.9	7.7
FDI, net (US\$ bn)	0.4	0.8	0.6	1.6	4.6	3.9	-2.6	3.6	3.0
International reserves (US\$ bn)	0.8	0.6	1.3	2.2	2.3	3.9	2.8	3.4	4.0
Consolidated government balance (% of GDP)	2.6	-4.5	-5.2	0.5	-6.9	-8.3	-8.0	-6.4	-3.0
Public debt (% of GDP)	36.0	30.6	43.3	38.5	50.6	63.7	64.0	71.9	72.0
Sri Lanka									
Nominal GDP, US\$ bn	32.4	40.7	42.1	49.6	59.2	59.4	66.2	73.7	82.3
GDP per capita, US\$	1615	2014	2057	2400	2836	2816	3104	3416	3775
Population, mn	20.0	20.2	20.5	20.7	20.9	21.1	21.3	21.6	21.8
Real GDP, % yoy	6.8	5.9	3.5	8.0	8.2	6.4	6.8	7.0	7.0
CPI, % yoy	18.8	13.9	5.0	6.8	4.9	9.2	5.4	7.9	6.0
CPI, % avg	15.8	22.5	3.6	6.2	6.8	7.5	7.0	6.5	6.5
Policy interest rate, % eop	12.00	12.00	9.75	9.00	8.50	9.50	8.50	9.00	9.00
Long term yield, % eop	19.96	19.12	9.33	7.55	9.31	11.54	10.20	10.50	7.25
lc/US\$, eop	108.7	113.0	114.4	110.9	113.9	127.7	132.0	134.6	135.0
lc/US\$, avg	110.6	108.3	114.9	113.0	110.5	127.2	130.3	132.9	135.0
Current account (US\$ bn)	-1.4	-3.9	-0.2	-1.1	-4.6	-3.9	-3.1	-2.3	-2.9
% of GDP	-4.3	-9.5	-0.5	-2.2	-7.8	-6.6	-4.6	-3.1	-3.6
Trade balance (US\$ bn)	-3.7	-6.0	-3.1	-4.8	-9.7	-9.4	-9.3	-10.7	-12.2
Exports (US\$ bn)	7.6	8.1	7.1	8.6	10.6	9.8	10.1	10.8	11.8
Imports (US\$ bn)	11.3	14.1	10.2	13.5	20.3	19.2	19.3	21.5	24.0
FDI, net (US\$ bn)	0.5	0.7	0.4	0.4	0.9	0.8	1.0	1.0	1.0
International reserves (US\$ bn)	3.1	1.8	5.1	6.6	6.0	6.9	7.0	7.8	8.4
Consolidated government balance (% of GDP)	-6.9	-7.0	-9.9	-8.0	-6.9	-6.4	-6.0	-5.7	-5.5
Public debt (% of GDP)	85.0	81.4	86.1	81.9	78.4	79.1	79.0	77.0	76.0
Vietnam									
Nominal GDP, US\$ bn	71.2	90.0	91.9	102.4	121.7	141.5	156.0	172.5	195.4
GDP per capita, US\$	845	1058	1068	1178	1385	1594	1741	1906	2140
Population, mn	84.2	85.1	86.0	86.9	87.8	88.8	89.6	90.5	91.3
Real GDP, % yoy	7.1	5.7	5.4	6.4	6.2	5.3	5.2	5.5	5.8
CPI, % yoy	12.6	19.9	6.5	11.7	18.1	6.8	6.5	8.0	7.5
CPI, % avg	8.5	23.2	7.0	9.2	18.6	9.3	6.7	7.1	7.2
Policy interest rate, % eop	6.50	9.50	8.00	9.00	15.00	9.00	6.00	7.00	7.00
Long term yield, % eop	8.73	10.00	11.68	11.50	12.55	9.75	8.50	9.00	8.50
lc/US\$, eop	16028	17483	18474	19498	21034	20840	21350	21670	21600
lc/US\$, avg	16081	16445	17806	19123	20648	20875	21154	21550	21500
Current account (US\$ bn)	-7.0	-10.7	-7.2	-4.3	0.2	9.1	7.7	6.5	4.9
% of GDP	-9.8	-11.9	-7.8	-4.2	0.2	6.4	5.0	3.8	2.5
Trade balance (US\$ bn)	-10.4	-12.8	-8.3	-5.1	-0.5	9.5	8.9	8.0	6.2
Exports (US\$ bn)	48.6	62.7	57.1	72.2	96.9	114.5	132.8	156.7	180.2
Imports (US\$ bn)	58.9	75.5	65.4	77.4	97.4	105.0	123.9	148.7	174.0
FDI, net (US\$ bn)	6.6	9.3	6.9	7.1	6.5	7.2	7.3	7.6	7.7
International reserves (US\$ bn)	23.5	23.9	16.4	12.5	13.5	25.6	34.8	37.3	42.3
Consolidated government balance (% of GDP)	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-5.3	-4.5	-4.0
Public debt (% of GDP)	35.9	34.5	42.8	44.9	43.3	43.0	44.5	44.6	45.0

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

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- **Summary view** — Going into 2014, the export-driven recovery, supported by improved foreign demand and a weaker koruna, should lead to growth accelerating to 1.9%YoY (vs. our previous forecast of 1.7%).
- **Things to watch** — Even if a centre-left coalition were formed, it is unlikely any positive impact on fiscal and economic policy would materialize any time soon.
- **Strategy** — We expect the CNB's preference, if new disinflationary risks emerge, to be for a prolonged period of EURCZK weakness, rather than an even weaker koruna, unless we see a larger drop in export demand. With further ECB easing likely in 2014 (ZLB, negative deposit rate and LTRO), FX interventions are likely to intensify and a slightly negative CNB policy rate cannot be ruled out.

EURCZK at 27 for one year, a year-and-a-half or two years?

Central bank intervention to weaken the koruna represents an upside risk to inflation, which we currently expect to be 1.2%YoY for 2014. For 2015, the effect will depend on the extent to which the CNB tries to maintain koruna weakness. However, our CPI forecast for 2015 is below the CNB's due to a weaker USD in our forecast. We see three reasons for the CNB to favour EURCZK at 27 plus a forecast of 3%YoY inflation in 1H15. The first is to have a buffer against disinflationary surprises. The second is to provide a stronger FX impulse to promote a stronger recovery in the economy and prices. The final reason is to prevent deflationary expectations by increasing expected price growth. While the CNB's FX target "with EURCZK close to 27" will be re-evaluated with every new forecast, the CNB has indicated that changes to the desired level of EURCZK will be rare. We would expect the CNB's preference, if new disinflationary risks emerge, to be for a prolonged period of EURCZK weakness, rather than an even weaker koruna, unless we see a larger drop in export demand. Even if there is a local disinflation factor, it will be not necessary followed by a higher EURCZK target, but a commitment to a longer period of weaker koruna and ZLB could be used instead as it could increase the likelihood of a positive impact from a weaker koruna on the economy.

No Swiss floor, rather discretionary interventions based on new forecast. The CNB's desired level of EURCZK could be changed meeting to meeting if there is a meaningful change in the CNB's forecast, but we do not expect this in the short term as the CNB still seems to prefer loosening monetary conditions later rather than earlier and presumably would wish to avoid the risk of losing credibility with regard to its communications. The CNB has committed to the size and duration of FX intervention unless a higher level of EURCZK ensures the future fulfillment of the CNB inflation target. The CNB wants to be more active than its Swiss counterparts to avoid the need for a larger devaluation as the Swiss central bank experienced.

Exit strategy is unlikely to happen soon, while FX interventions are likely to intensify. As we expect further easing in ECB policy and no ECB hike earlier than in 4Q16, we still expect local inflationary pressures to be limited in the future by a somewhat stronger koruna (if Czech GDP outperforms) rather than by a higher policy rate. With a looser ECB we expect the first CNB rate hike in 1H16. Also, Governor Singer has said that he currently assumes no immediate hike after CNB interventions are finished. At the same time, the CNB has adjusted the long-term trends in its G3 model, in line with what we discussed in February this year. The CNB expects a milder koruna real appreciation trend of 1.5% (2.4% previously), which could make exit easier, particularly with the likely stronger price differential.

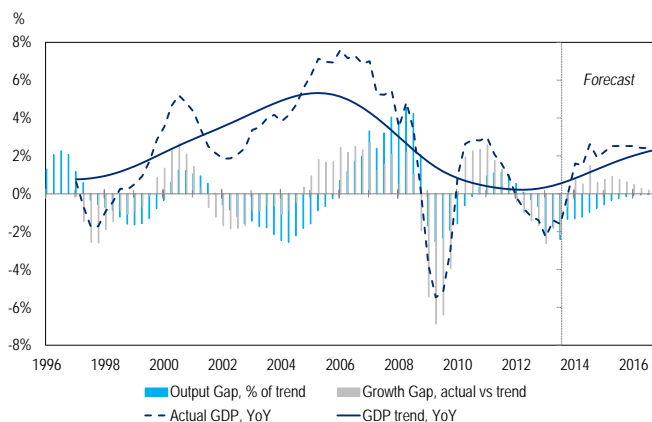
Strong government necessary to lower GBR

Czech election outcome: Almost a positive surprise, but there are still large differences in programmes of potential coalition partners – socialist CSSD, centrist ANO and Christian KDU-CSL. The prospect of a centre-left coalition seems to point to greater unity than the baseline scenario from the pre-election polls (one month before the election), which pointed to the majority of socialist and communist parties as the only viable outcome of the early election. The main differences are: i) Taxes: ANO and KDU-CSL are against the socialist proposal for a hike in CIT and special sector CIT. ANO is against progressivity of the PIT as proposed by the CSSD and KDU-CSL. ii) Deal with churches: CSSD would like to revise the "deal with churches" that was struck by the right-wing government of PM Necas. The Christian KDU-CSL is against this. iii) Stability of ANO: The movement (it is not a regular party) is quite heterogeneous. CSSD requires the party leaders to be in the government, but there is uncertainty as to whether the leader of ANO, Andrej Babis, will get through the screening process (which requires that members of the government never to have given evidence to the communist state intelligence service, StB) as a Slovak court is due to rule in January 2014 on alleged collaboration by Babis with the StB. iv) Stability of CSSD - The election outcome was pretty weak for the CSSD, and CSSD leader Sobotka has already faced significant pressure to step down. While he has so far kept his position and his opponents have instead left the party leadership, we cannot rule out that he may come under renewed pressure, particularly if the coalition agreement turns out to be disappointing to the CSSD. This political environment should be considered in the context of the upcoming elections for the EU Parliament in May 2014 and municipal and upper house elections in autumn 2014. The principal mid/long-term risk we see is that voters become disappointed by the new parties (for a second election period in a row), potentially increasing radicalism ahead of the next elections. Even if a centre-left coalition were formed, we doubt that we will see a positive impact on fiscal and economic policy any time soon. For now, the outlook for the central government deficit remains around CZK110-120bn for 2014-16E, which, together with larger redemptions, suggest a larger GBR. Hence, we think there will be a greater need to issue €-bonds than in the past and retail bond issuance is likely to remain in place to limit a negative supply factor on local bonds. This should be limited by a larger single Treasury account, which kept a solid financing reserve in 2013.

Is 3Q drop temporary or a sign of triple-V recession?

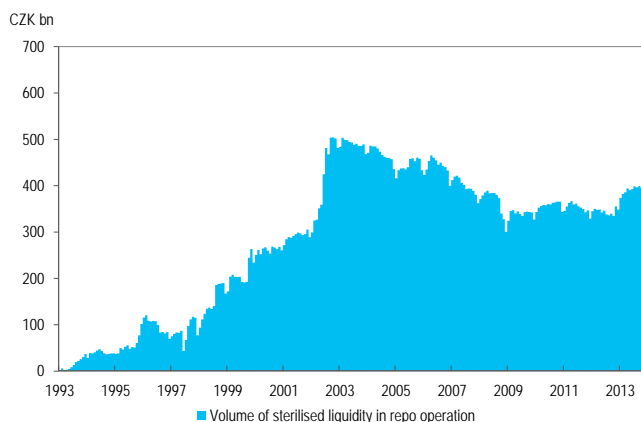
We continue to expect an ongoing recovery despite another drop in GDP in 3Q13, though we see three risks ahead. We forecast that, after contracting by 0.5% in 3Q13, working-day-adjusted GDP in 4Q will come in at 1.3%QoQ (from 0.5% initially), which could partly offset the 0.5% drop in 3Q13 (we argue that the monthly wda indicators suggest improvement). This should mean 0%YoY growth in 4Q and -1.3%YoY for 2013 as a whole (vs. our previous forecast of 1%). Going into 2014, the export-driven recovery, supported by improved foreign demand and a weaker koruna, should lead to growth accelerating to 1.9%YoY (vs. our previous forecast of 1.7%). We see three main risks to our view: i) FX interventions being less positive than we expect – particularly if the recent weaker relationship between the weaker koruna and export activity and profitability (employment) persists or if the impact of lower real interest rates is less supportive than we assume for private consumption; ii) failure to form a government, such that we face another round of early elections and fiscal policy remains paralyzed, with a negative impact on investment activity; iii) foreign demand remaining fragile. The CNB views weak 3Q Czech GDP as a sign of an ongoing bottoming out of the Czech economy.

Figure 155. GDP growth above-trend in 2014, output gap closed in 2H15



Source: CZSO, Citi Research calculations and forecasts.

Figure 157. Huge increase in liquidity withdrawn by the CNB



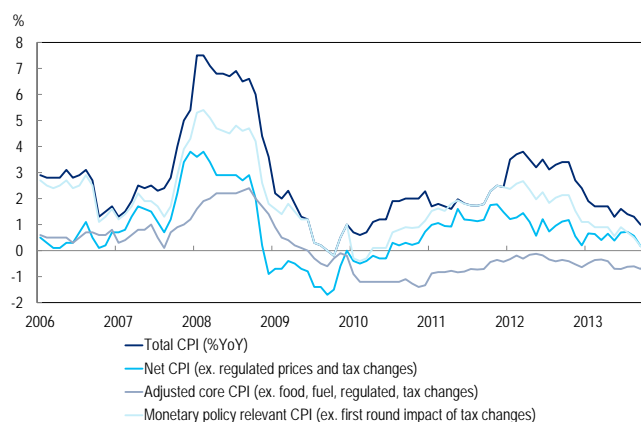
Source: CNB, Citi Research. Note: November data reflects our calculation based on daily reports until 22 November 2013.

Figure 5. There are not many effective options left on the CNB's menu

Type of measure	Our view from Sep12	Introduced ?
Zero bound policy rate	Very likely	Nov-12
Commitments	Very likely	Nov-12
Stop of daily EUR selling	Quite likely	Nov-12
FX intervention	Likely	Nov-13
Fine tuning of withdrawal the liquidity	Possible	No
Easing of collateral	Possible	No
Negative policy rate	Possible	No
Communicate the PRIBOR spread	Possible	No
Buying gov't bonds and other forms of Quantitative and Qualitative Easing	Not likely	No
Change of policy regime – FX targeting or lower inflation target	Less possible	No

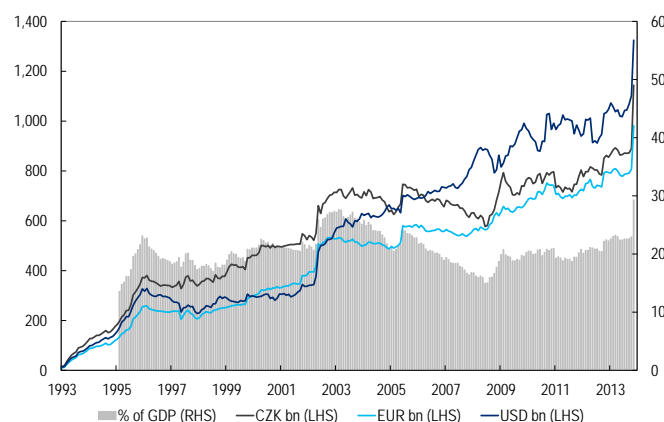
Source: Citi Research

Figure 156. CPI growth decelerated significantly in 3Q13



Source: CZSO, CNB, Citi Research.

Figure 158. ... and FX reserves



Source: CNB, Citi Research. Note: November data are based on our estimate that reflects the volume of increased withdrawn liquidity by the CNB.

Figure 159. Election campaign will stop in autumn 2014 for two years

Events - Elections & Nominations	Date
Presidential election	January 11, 2013
President Vaclav Klaus finished his 2nd term	March 7, 2013
Lower House of Parliament (Early Elections)	October 25-26, 2013
CNB's Zamrazilova - 1st term ends	Mar/2014
European Parliament	May/2014
Local Councils + Prague + 1/3 of Upper House	Oct/2014
CNB's Governor Singer - 2nd term ends	Jul/2016
CNB's Janacek - 1st term ends	Jul/2016
Regional Councils + 1/3 of Upper House	Oct/2016
CNB's Lizal - 1st term ends	Feb/2017
CNB's Rezabek - 2nd term ends	Feb/2017
CNB's Tomsik & Hampl - 2nd term ends	Nov/2018

Source: CNB, CZSO, Citi Research

Figure 160. Czech Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	180	225	197	198	216	196	197	204	211
Nominal GDP, local currency bn	3,663	3,848	3,759	3,791	3,823	3,846	3,863	4,000	4,131
GDP per capita, USD	17,484	21,614	18,795	18,873	20,584	18,693	18,772	19,418	19,985
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	7.1	6.6	5.7
Economic Activity									
Real GDP, yoy avg	5.7	3.1	-4.5	2.2	2.1	-1.0	-1.3	1.9	2.4
Real investment growth % yoy	15.5	1.9	-20.2	5.4	0.8	-5.0	-7.7	3.0	4.3
Real consumption growth % yoy	3.1	2.3	1.3	0.7	-0.4	-2.1	0.4	0.9	0.9
private consumption growth % yoy	4.2	2.8	0.2	0.9	0.5	-2.1	-0.3	1.2	0.9
Real export growth, % yoy	11.2	4.0	-10.9	15.4	9.5	4.5	1.1	6.4	7.1
Real import growth, % yoy	12.8	2.7	-12.1	15.4	7.0	2.3	0.9	5.9	6.2
Prices, Money & Credit									
CPI, % yoy	5.5	3.6	1.0	2.3	2.4	2.4	1.1	1.9	1.9
CPI, % avg	2.9	6.3	1.0	1.5	1.9	3.3	1.4	1.2	1.9
Nominal wages, % yoy	7.2	7.9	3.4	2.2	2.5	2.7	0.5	1.9	3.5
Credit extension to private sector, % yoy	26.6	16.1	0.8	3.0	5.5	2.6	2.9	5.3	9.0
Policy Interest Rate, % eop	3.50	2.25	1.00	0.75	0.75	0.05	0.05	0.05	0.05
1 month inter-bank rate, % eop	3.94	3.21	1.29	0.99	0.94	0.33	0.28	0.25	0.25
Long-term yield, % eop	4.64	4.15	4.01	3.86	3.69	1.90	2.30	2.25	2.50
CZK/US\$, eop	18.2	19.2	18.4	18.7	19.8	19.0	20.1	19.1	18.5
CZK/US\$, avg	20.2	17.0	19.0	19.1	17.7	19.5	19.8	19.4	18.7
CZK/EUR, eop	26.5	26.8	26.4	25.0	25.6	25.1	27.2	26.7	25.9
CZK/EUR, avg	27.8	25.0	26.4	25.3	24.6	25.1	26.2	26.9	26.2
Balance of Payments, USD bn									
Current account	-7.9	-4.8	-4.8	-7.6	-6.3	-4.7	-0.6	1.4	0.4
% of GDP	-4.4	-2.1	-2.5	-3.8	-2.9	-2.4	-0.3	0.7	0.2
Trade balance	2.2	1.7	4.6	2.8	5.3	7.5	10.0	12.5	13.7
Exports	106.5	125.1	99.1	114.0	138.5	131.7	133.8	145.9	158.6
Imports	104.3	123.4	94.6	111.2	133.2	124.2	123.8	133.4	144.9
Service balance	2.9	4.4	3.9	3.9	3.8	2.5	3.4	3.3	3.3
Income balance	-12.7	-10.6	-13.2	-14.8	-15.6	-14.7	-14.1	-14.6	-16.9
FDI, net	9.0	2.3	2.0	4.9	4.2	9.2	3.9	4.6	6.1
International reserves	34.4	36.5	39.7	40.3	37.9	42.4	56.7	72.8	77.0
Total amortisations	4.0	4.2	6.2	5.4	8.6	5.4	7.8	7.9	7.7
Public Finances, % of GDP									
Consolidated government balance	-0.7	-2.2	-5.8	-4.7	-3.2	-4.4	-2.9	-2.9	-2.9
Consolidated gov primary balance	0.4	-1.2	-4.5	-3.3	-1.8	-2.9	-1.1	-1.2	-1.7
Public debt	27.9	28.7	34.6	38.4	41.4	46.2	48.9	49.9	51.2
of which Domestic	20.3	20.7	24.1	25.5	28.6	31.6	33.3	34.2	35.0
Foreign Assets & Liabilities, USD bn									
External debt	76.2	84.2	89.2	94.2	94.2	101.9	98.9	106.3	112.0
Public	15.0	15.3	19.8	24.0	22.6	28.3	32.9	36.3	39.0
External debt / GDP	42.2	37.4	45.3	47.5	43.6	51.9	50.1	52.0	53.2
External debt / XGS	61.5	57.3	75.3	69.8	58.3	66.3	63.0	62.3	60.3
Short-term debt	22.6	27.1	23.9	23.6	27.1	26.2	26.0	27.0	28.0
Short-term debt/International reserves (%)	65.5	74.2	60.2	58.5	71.5	61.7	45.9	37.1	36.4

Quarterly Economic Indicators

	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	-1.5	-1.7	0.0	1.6	1.5	2.6	1.9	2.2	2.5
CPI, % yoy	1.6	1.0	1.1	0.7	0.8	1.6	1.9	1.9	1.9
Policy interest rate, % eop	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Short-term market rate, % eop	0.31	0.31	0.28	0.25	0.25	0.25	0.25	0.25	0.25
Long-term yield, % eop	2.14	2.47	2.30	2.29	2.28	2.26	2.25	2.31	2.38
CZK/EUR, eop	25.99	25.67	27.19	27.12	27.04	26.91	26.71	26.51	26.32

Source: National Sources, Citi Research forecasts

Egypt

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- **Summary view** — The military's political roadmap to a new political dispensation should clearly unfold in 2014. Despite periodic upsurges in violence, we still expect the new constitution to be approved and a detailed timetable for holding elections to be published.
- **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 hopefully stabilises in 2014, the government plans to use Gulf support to 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

2014 is likely to prove a decisive year for the military's political roadmap for Egypt. With the country now run by a civilian government led by interim president, Adly Mahmud Mansour, and the military, the goal is to draft a new constitution by early December 2013 which will be approved in a referendum, most likely in early 2014. This should then pave the way for the government to outline a clear timetable for holding parliamentary elections in 1H 2014 and presidential elections in 2H 2014.

Whether these elections will provide a spark for further protests is unclear, but we think it is unlikely given the major clampdown on the Muslim Brotherhood (MB). The extent to which this pushes the MB underground and risks the return to the low level insurgency of the 1990s is unclear, but it cannot be excluded as a possibility. Attempts by the MB to re-ignite protests against the new political regime since mid-August have had some success, although opinion poll data suggest 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.

The need to keep the Islamist political community on side

But, despite the clampdown on the MB, the military is keen to keep significant elements of the Islamist political community on side during the transition.

Without this, any democratic transition will lack wider political legitimacy. At present, although the position of the Nour party is complicated, it appears willing to support the transition, and blame the MB for putting paid to the Political Islam Project to succeed the MB as the main Islamic political voice in the country.

Who chooses to stand in the presidential elections in 2014 will remain unclear for some time. But we think all candidates will have to have at least the tacit support of the military. We would also expect the parliamentary vote to be quite widely split over a range of parties, implying that a coalition government of some sort may have to be formed by the president.

Such an outcome would likely 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 lead in supporting Egypt's political transition while Western powers have apparently lost influence as they took their time in deciding the position they should adopt over political developments since June.

The re-emergence of a fragile 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. 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 a more comprehensive reform programme is still desperately needed

But, even if a weak economic recovery 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 suggest that there could be a worse outcome this year.

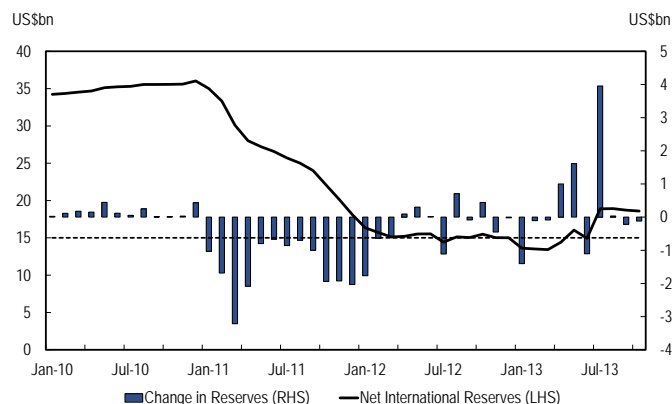
On a more positive note, a more stable exchange rate and a weak growth environment mean that inflation is unlikely to rise sharply in the coming 12 months. In fact, weak inflationary pressures have allowed the Central Bank of Egypt (CBE) to cut the Overnight Deposit Rate (ODR) twice this year. While a further cut in the final months of 2013 may be premature, we think inflationary pressures will remain subdued in 1H 2014 allowing further cautious cuts in the ONR 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 fiscal sector reform. This would involve a programme to reduce subsidies on food and energy, firm control of the public sector wage bill and the return of growth to boost domestic revenue collection. 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 the current political agenda.

A homegrown reform programme

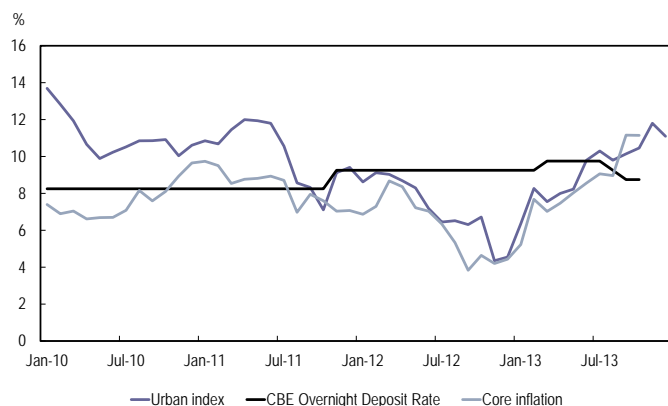
Having said that, the provision of Gulf support means that such difficult choices can be put off and the government can continue to operate in 'muddle-through' fiscal mode, probably well into 1H 2014. But at some point, the government will have to think about a more comprehensive reform programme. While 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, we expect the goal to be for external support to help fund infrastructural spending, which should start to help boost growth, investment and employment in 2H 2014, while outlining a slow programme of fiscal consolidation over the medium term.

Figure 161. Reserves tentatively start to stabilize in 2013



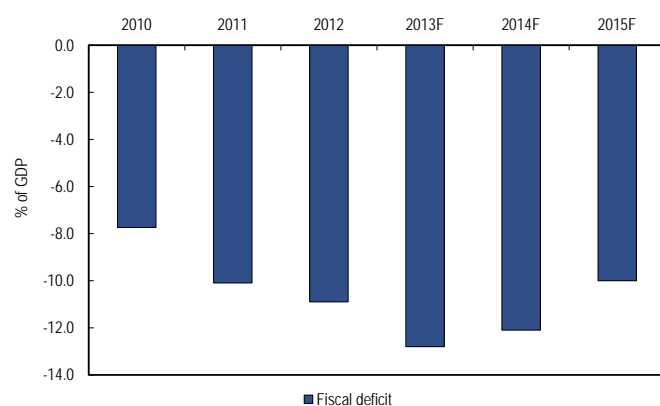
Source: Central Bank of Egypt, Haver Analytics

Figure 163. The CBE is keen to cut rates, but some inflationary pressures remain



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

Figure 165. The fiscal deficit remains large and is a problem



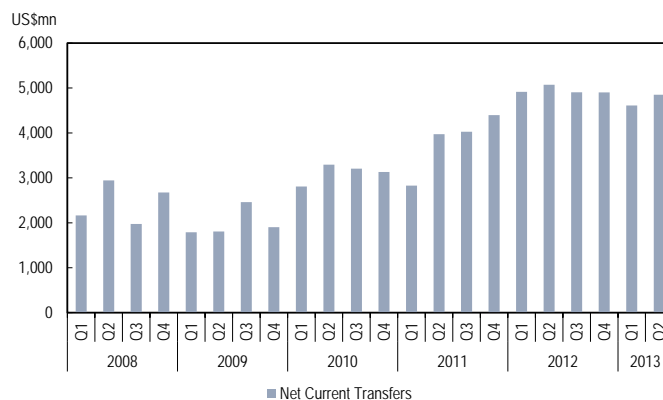
Source: Haver Analytics and Citi forecasts

Figure 162. The EGP also starts to stabilise against USD since mid-2013



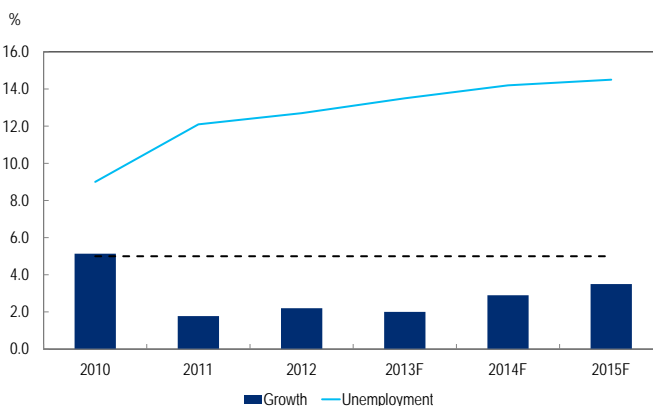
Source: Reuters

Figure 164. Robust transfers have limited the deterioration in the current account and helped support consumption



Source: Central Bank of Egypt, Haver Analytics

Figure 166. A weak recovery may now be possible in 2014-15F



Source: Haver Analytics and Citi forecasts

Figure 167. Egypt Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	132	165	188	214	231	254	249	266	278
Nominal GDP, local currency bn	745	896	1,042	1,207	1,371	1,542	1,715	1,903	2,099
GDP per capita, USD	1,783	2,187	2,454	2,755	2,919	3,164	3,047	3,201	3,295
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	13.5	14.2	14.5
Economic Activity									
Real GDP, yoy avg	7.1	7.2	4.7	5.1	1.8	2.2	2.0	2.9	3.4
Real investment growth % yoy	23.7	15.5	-9.1	8.0	-2.1	8.0	-3.8	5.6	10.1
Real consumption growth % yoy	7.6	5.2	5.7	4.2	5.3	5.5	3.2	3.3	5.1
private consumption growth % yoy	8.8	5.7	5.7	4.1	5.5	5.9	2.7	3.5	5.1
Real export growth, % yoy	20.2	28.8	-14.5	-3.0	1.2	-2.3	2.9	2.0	6.0
Real import growth, % yoy	30.5	26.3	-17.9	-3.2	8.4	10.8	2.3	4.7	13.4
Prices, Money & Credit									
CPI, % yoy	6.9	18.4	13.2	10.6	9.5	4.7	10.6	8.3	6.9
CPI, % avg	9.5	18.3	11.8	11.1	10.1	7.1	9.2	8.1	6.8
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	10.0	12.0	3.0	6.7	6.1	7.6	3.0	4.5	5.8
Policy Interest Rate, % eop	8.75	11.50	8.25	8.25	9.25	9.25	8.75	7.50	7.00
1 month inter-bank rate, %, eop	8.75	11.95	8.30	8.30	10.05	10.10	11.01	8.75	7.36
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	7.00	7.40	7.65
EGP/US\$, avg	5.64	5.44	5.55	5.63	5.94	6.07	6.89	7.16	7.54
Balance of Payments, USD bn									
Current account	0.2	-1.3	-3.2	-5.6	-7.6	-7.6	-6.8	-7.5	-9.0
% of GDP	0.2	-0.8	-1.7	-2.6	-3.3	-3.0	-2.7	-2.8	-3.2
Trade balance	-20.8	-26.8	-22.5	-27.7	-28.2	-33.8	-30.8	-29.9	-30.8
Exports	24.5	29.8	23.1	25.0	27.9	25.9	25.5	27.1	28.0
Imports	45.3	56.6	45.6	52.7	56.1	59.7	56.3	57.0	58.8
Service balance	12.7	15.7	11.3	9.6	5.4	6.4	4.9	3.9	4.1
Income balance	-	-	-	-	-	-	-	-	-
FDI, net	10.9	7.6	6.1	5.2	-1.1	3.5	6.0	2.0	4.7
International reserves	31.7	34.2	34.2	36.0	18.1	15.0	18.5	19.8	21.0
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	-10.9	-12.8	-12.1	-10.0
Consolidated gov primary balance	0.0	-1.8	-2.4	-2.6	-4.5	-4.8	-6.9	-5.5	-2.8
Public debt	64.2	53.5	54.0	59.8	69.0	79.4	80.1	80.1	79.8
of which Domestic	64.2	53.5	54.0	59.8	69.0	79.4	80.1	80.1	79.8
Foreign Assets & Liabilities, USD bn									
External debt	32.8	32.1	33.3	35.0	33.7	38.8	40.2	40.7	41.4
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	15.3	16.2	15.3	14.9
External debt / XGS	68.8	55.6	73.0	70.9	71.1	81.1	86.9	86.5	84.9
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	35.9	33.6	31.6
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	2.9	1.0	1.1	1.5	1.8	3.0	3.2	3.0	3.2
CPI, % yoy	9.8	10.3	10.6	8.3	7.0	8.3	8.3	6.8	6.6
Policy interest rate, %, eop	9.75	8.75	8.75	8.00	7.50	7.50	7.50	7.00	7.00
Short-term market rate, % eop	10.75	10.15	11.01	8.77	7.49	8.75	8.75	7.25	7.04
Long-term yield, %, eop	11.00	11.00	13.50	13.50	13.50	13.00	12.50	12.00	11.50
EGP/US\$, eop	7.02	6.89	7.00	7.00	7.00	7.30	7.40	7.50	7.60

Source: National Sources, Citi Research forecasts

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GCC

Saudi Arabia

We believe the Saudi non-oil economy is set to continue growing strongly, in the 8%-9% region, on the back of strong government spending, rising credit growth (particularly in the consumer sector), and ongoing labour market reforms which are reinforcing local employment growth. Oil production, however, will ease somewhat going forward. Despite record production since mid-summer (October figures show that Saudi produced 10mbpd again that month), overall production is set to shrink slightly, and we are forecasting an average for 2013 of 9.2mbpd, down from an expected average of around 9.5mbpd this year. The drop in production reflects the slight softening in oil prices that we are forecasting going forward, along with increased production elsewhere in the region, most notably Iraq. The ongoing talks between the P5+1 and Iran over the latter's nuclear programme may, in our opinion, result in an easing of some sanctions, notably in oil exports. If this were to happen, it would represent a downside risk to Saudi production and our economic forecasts in turn. Public finances and external balances are expected to remain robust in the near term: we see the current account surplus remaining in double digits in 2014, while the fiscal surplus should narrow from around 10% this year to a still healthy 5% in 2014. That said, we think rising expenditures and an expected leveling off in oil revenues present a significant challenge to public finances in the medium to long term. The fiscal breakeven oil price will rise to US\$90 per barrel in 2014 (from US\$80 this year) and will continue to rise, resulting in forecast deficits as early as 2016. Although Saudi Arabia 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, as we have argued in recent months and as the IMF has stated in its recently published Regional Economic Outlook.

United Arab Emirates

Dubai learnt at the end of November that its bid to host the 2020 World Expo had been successful. We believe a successful bid should provide a moderate stimulus to Dubai's economy, and do not believe the government's commitment to financing the required US\$7bn in capital outlays to host the event will present significant additional financing risks to the Dubai sovereign. However, we do have concerns that the impact on sentiment could lead to further exuberance in the real estate market. Cluttons data show that the average selling price of mid-range villas in August has risen 34% since the start of the year, and 50% compared with the same period a year earlier. The announcement of new real estate projects capitalizing on the resurgence of the property market continues unabated. For now, construction activity remains contained to new developments in prime locations, such as on the Palm or in the Downtown area. Should we see a surge in construction activity in less prime areas, accompanied by aggressive off-plan sales strategies, we believe the potential for further property-led volatility in the Dubai economy will become increasingly likely. Dubai Expo could, in our view, be a trigger for such activity.

Kuwait

Kuwait has embarked on a review of the country's subsidies programme, which costs the public purse US\$16bn, around one-fifth of total expenditures. The objective of the panel is to streamline subsidies (mainly fuel and energy) to the more needy, reducing inefficiency and waste, in line with recommendations made by the IMF in the concluding statement of its Article IV consultation with the Kuwaiti authorities (September 23).

Kuwait remains in a relatively comfortable fiscal position, even compared with its oil-rich GCC peers, but plateauing oil revenues and rising expenditures do pose a threat to the fiscal outlook in the medium to long term. This is true of most Gulf oil exporters, as we have recently argued ([Middle East Macro Monthly - Why the GCC's Structural Challenges Matter](#), September 30).

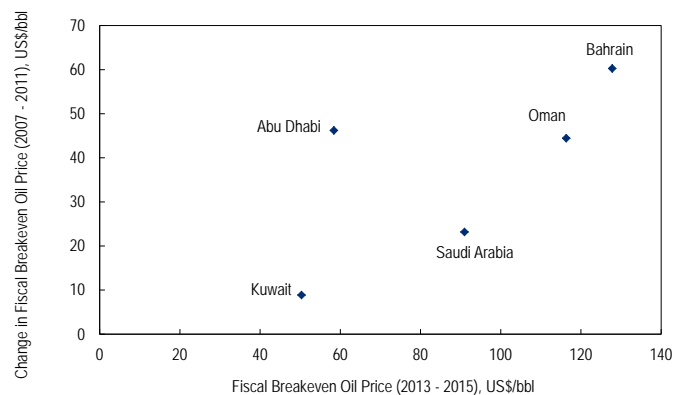
The initiative is entirely welcome, in our view, and is the first among what we believe will be many such initiatives across the GCC to rationalize expenditures in the face of rising fiscal pressures in coming years. However, as we have argued, such initiatives will be unpopular, and do risk raising political and social tensions. In the case of Kuwait, the primary concern is the historically acrimonious relationship between the national assembly and the government. The former tends to prefer populist measures that extend the benefits of the Kuwaiti citizenry, and thus any suggestion the government may be doing something contrary to this objective may be met with renewed hostility from the national assembly. Moreover, any measures to rationalize subsidies are likely to require parliamentary approval. The ability, therefore, of the government to carry through any recommendations made by the panel on subsidy reform is thus uncertain, in our view.

Bahrain, Qatar and Oman

Oman's financing options are fairly limited – its fiscal reserves are insufficient to finance growing deficits in the medium term. Its low debt to GDP level means it has some headroom to borrow in international markets, but we are expecting financing conditions for emerging markets to tighten next year as Fed tapering kicks in. Ultimately, we believe Oman has little option but to carry out reforms of its public finances. On the expenditure side, this means rationalisation of the burgeoning wage and subsidy bills. On the revenue side, this means diversifying into non-oil sources of income, notably taxes. The net impact of these measures is likely to be negative for the public, with a higher tax burden and slowing economy, and could well spark some measure of social unrest, although the popularity of Sultan Qaboos remains strong.

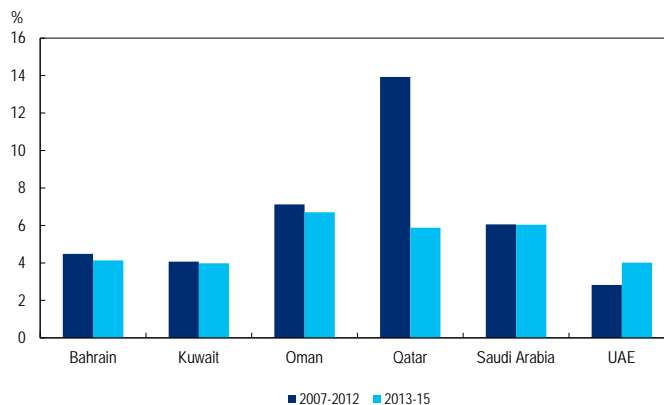
Oman's finance minister has said that a royal decree standardizing salaries across the public sector is likely to add OMR800-OMR900 million to the budget next year, potentially widening the deficit by as much as 2.2% of GDP. We see significant erosion of Oman's public finances in the coming years, as oil revenues plateau and expenditure pressures remain high. The rate of expenditure growth in recent years has been alarming, particularly current expenditures (mainly wages and subsidies) which have risen by 122% between 2010 and 2012. This rate of growth is unsustainable and has already increased Oman's fiscal vulnerabilities substantially as the breakeven oil price has crept up to US\$110 per barrel this year, from US\$70 in 2010. As such, we are expecting a small deficit this year, which will widen steadily in subsequent years in the absence of corrective measures. The recently announced wage normalisation package will only aggravate the situation, in our view, accelerating the widening of the deficit.

Figure 168. Fiscal breakeven oil prices on the rise



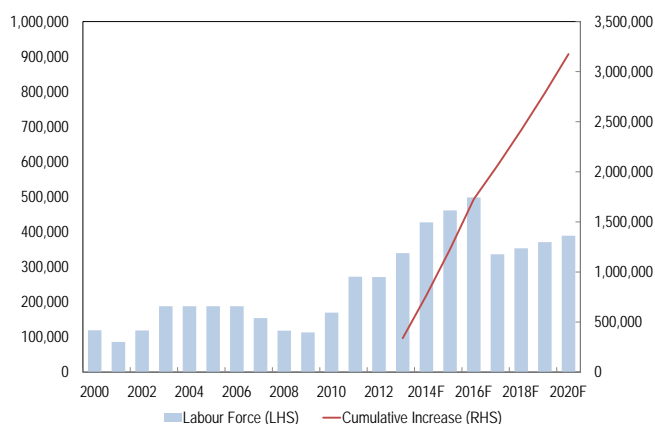
Source: Citi Research estimates

Figure 169. Economic growth will be uneven going forward



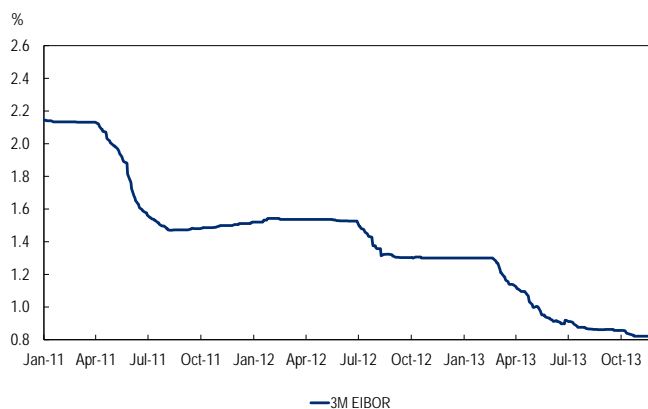
Source: Haver Analytics, Citi Research estimates (2013-15)

Figure 170. 3.3 million entrants in Saudi job market by end of decade



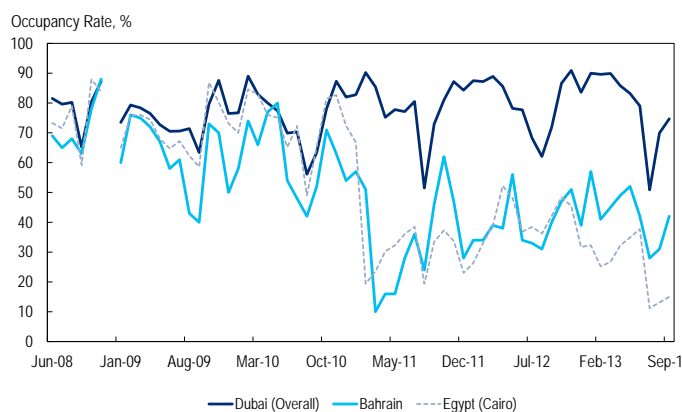
Source: Saudi Central Statistics Office

Figure 172. EIBOR rates have begun to decline again



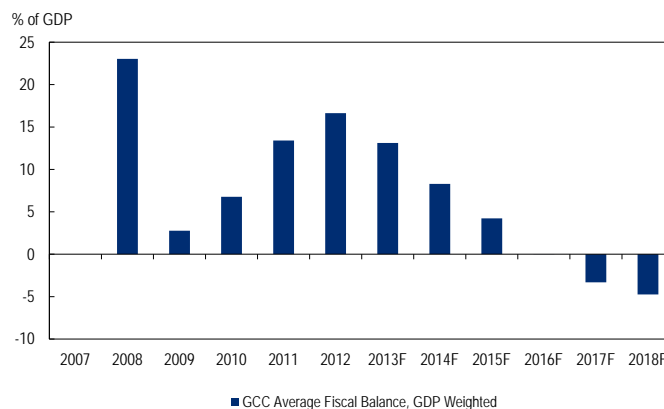
Source: Haver Analytics

Figure 171. Dubai hotel occupancy continues to outperform its peers



Source: Ernst & Young, Citi Research

Figure 173. High government expenditure will drive balances lower



Source: Haver Analytics, Citi Research estimates

Figure 174. 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	29.0	30.3	34.9	37.6	40.3
GDP per capita, USD	21,072	22,983	19,192	20,482	22,401	22,973	25,485	26,370	27,202
Real GDP, yoy avg	8.3	6.2	2.5	4.3	2.1	3.4	4.3	4.0	4.1
CPI, % avg	3.3	3.5	2.8	1.9	-0.4	2.8	3.3	2.2	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	1.8	0.9	-0.6
% of GDP	12.7	8.1	1.7	2.3	10.3	6.4	5.3	2.4	-1.5
Consolidated gov. balance, % of GDP	2.7	6.4	-4.3	-4.8	-0.3	-2.0	-2.2	-3.3	-5.5
KUWAIT									
Nominal GDP, USD bn	112.3	136.6	105.2	118.5	152.8	176.9	202.2	207.3	208.7
GDP per capita, USD	43,971	50,563	36,898	39,610	48,908	54,947	60,992	60,696	59,346
Real GDP, yoy avg	-	-	-	-	9.3	16.1	4.2	3.8	3.9
CPI, % avg	5.5	10.6	4.0	4.0	4.7	2.9	2.6	3.3	5.0
KWD/US\$, avg	0.28	0.27	0.29	0.29	0.28	0.28	0.29	0.29	0.29
Current account, US\$bn	41.9	57.8	29.1	37.8	66.2	79.2	103.1	102.7	99.7
% of GDP	37.3	42.3	27.6	31.9	43.3	44.8	51.0	49.5	47.8
Consolidated gov. balance, % of GDP	25.0	17.7	19.4	17.2	28.1	32.5	36.8	32.1	29.5
OMAN									
Nominal GDP, USD bn	41.9	59.9	53.4	53.4	53.4	53.4	87.6	94.4	100.8
GDP per capita, USD	15,259	20,887	18,015	17,438	16,881	16,180	25,324	26,126	26,703
Real GDP, yoy avg	10.4	14.6	9.5	-0.5	1.5	7.1	6.7	6.7	6.7
CPI, % avg	5.9	12.5	3.6	3.2	4.0	2.9	1.3	2.0	3.0
OMR/US\$, avg	0.38	0.38	0.38	0.38	0.39	0.39	0.39	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	5.9	8.4	-0.9	9.4	16.8	15.2	10.3	8.1	6.2
Consolidated gov. balance, % of GDP	3.4	0.3	0.2	3.5	-0.4	1.7	-0.2	-3.4	-5.4
QATAR									
Nominal GDP, USD bn	79.7	115.3	97.8	125.1	171.5	192.4	204.9	218.8	234.0
GDP per capita, USD	85,712	104,982	80,294	92,546	114,241	118,688	117,011	115,707	114,605
Real GDP, yoy avg	18.0	17.7	12.0	16.7	13.0	6.2	5.6	5.9	6.1
CPI, % avg	13.6	15.2	-4.9	-2.4	1.9	1.9	3.1	3.0	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	23.8	52.0	61.6	60.9	55.8	48.5
% of GDP	14.4	23.1	6.5	19.0	30.3	32.0	29.7	25.5	20.7
Consolidated gov. balance, % of GDP	10.9	9.8	13.4	2.7	7.7	11.8	8.1	4.2	1.2
SAUDI ARABIA									
Nominal GDP, USD bn	415.6	519.4	429.0	526.8	669.5	710.9	741.6	789.2	841.8
GDP per capita, USD	17,111	20,861	16,811	20,178	25,645	26,699	27,305	28,487	29,791
Real GDP, yoy avg	6.0	8.4	1.8	6.4	8.6	5.1	6.1	5.8	6.2
CPI, % avg	4.1	9.9	5.1	5.3	3.9	2.9	3.5	3.4	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	134.5	106.4	75.8
% of GDP	22.7	25.6	5.0	12.8	23.8	23.3	18.1	13.5	9.0
Consolidated gov. balance, % of GDP	12.2	30.8	-3.0	6.3	13.2	15.9	10.3	5.1	0.4
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	1.3	1.5
AED/US\$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account, US\$bn	15.5	66.9	7.9	13.7	80.9	115.5	114.8	102.5	90.1
% of GDP	6.0	21.2	3.1	4.8	23.2	30.1	28.0	23.3	19.1

Source: National Sources, Citi Research forecasts

Hungary

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- **Summary view** — Growth may accelerate further in the coming quarters helped by monetary and quasi-fiscal stimulus. CPI may fall close to 0.5% on utility price cuts but we doubt growth momentum and soft CPI can be sustained in 2015.
- **Things to watch** — FX mortgage bail-out plans, the possible extension of NBH lending program to mortgages and the impact of domestic demand recovery on underlying inflation trends and current account balance will be key to watch.
- **Strategy** — Easing eurozone monetary conditions, falling CPI and improved risk assessment as growth recovers supports rate cuts in the short term. Long term growth concerns and rising core yields may steepen the yield curve further.

Positive growth momentum helped by domestic stimulus

A gradual recovery in external demand together with domestic demand stimulus will likely keep growth on an improving trend in the coming quarters. Base effects will also contribute to a rebound in GDP from -1.7%YoY in 2012 to around 1.0% in 2013F, such as poor agricultural harvests last year and an unusually large seasonal fall in industrial output in 4Q12. Therefore agriculture, export-driven industry and construction, driven by higher absorption of EU funds, may be the key contributors to output growth this year. Domestic policies ahead of the spring 2014 elections are focused on delivering a positive turn in domestic demand, which has been contracting since 2009 (see Figure 176). While the fiscal drag has been eliminated this year, room for fiscal stimulus is limited given the 2% of GDP deficit outturn in 2012 in order to prevent the reopening of the EDP.

With efforts to keep headline deficit below the 3% threshold, quasi-fiscal tools are utilized to lift household consumption and fixed investments, such as utility price cuts, reduction in the FX mortgage debt burden and monetary stimulus implemented by the NBH. The NBH is planning to extend the size of its SME lending program (under which the NBH provides free funds to commercial banks for SME lending with a 2.5% capped margin) up to around 3% of GDP in 2013 and to 5% of GDP in 2014, which may help to reverse the downward trend in private investments. Given the upcoming elections we would not rule out the possibility the NBH may extend the funding scheme to retail or mortgage lending, as suggested recently by EconMin Varga. The above factors, together with a gradual euro zone recovery, may lead to growth accelerating close to 2% in 2014F. We are less constructive over the medium term outlook, based on the absence of any significant job creation in the private sector and the ongoing deleveraging. We believe that, without additional stimulus, GDP growth may lose momentum after 2014 and may remain in the range of 1-1.5% over the medium term, provided European growth stabilizes.

Elections unlikely to deliver sharp policy turn

Given the rise in the governing party's popularity since early 2013 (see Figure 175) the chances of major policy changes in 2014 seem low. The 2014 budget includes some populist measures, such as broadening family benefits and wage hikes for teachers and healthcare workers but the size of the loosening seems to be under control. Based on some optimistic revenue assumptions (such as VAT and mobile licence sales plans), the government may need to hold back spending in 2H14 after the election to stick to the 2.9% of GDP deficit target, but will likely not risk a major overshoot of the deficit due to the risk of EDP reopening.

Radical solutions to lower the FX mortgage debt burden also seem to be off the table. We expect this issue will remain on the political agenda and potentially not fully conclude by the spring 2014 elections. Given the NBH's refusal to provide FX reserves for a one-step conversion and the size of fiscal revenues from the financial sector in the budget (in the form of a FTT and extraordinary banking tax) currently the most likely outcome seems to impact banks over the long run without an upfront hit. The solutions may include a cap on applied interest rates margins on mortgage loans and increased participation in the currently open exchange rate fixing scheme that defers the difference between the spot and the fixed exchange rate for five years. These measures will likely reduce banking sector profitability long term. The government is aiming at replacing funds withdrawn by foreign-owned banks as they deleverage with funds from small, domestic banks and the NBH's lending program helps to provide funding for the BS extension of small local banks (see Figure 178).

CPI to bottom out around 0.5%YoY and rise from 1Q14

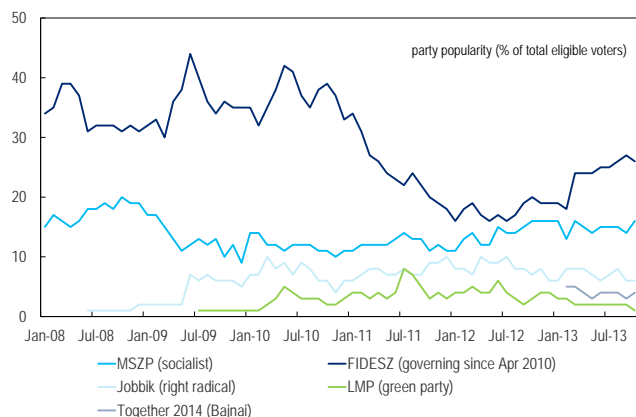
Inflation may continue to fall and bottom out at 0.3%YoY in Jan-2014 with another utility price cut implemented in Nov 2013 after the surprising drop to 0.9%YoY in October. The elimination of the impact of utility price cuts from 2013 will deliver a gradual rise in the price index from February, but we think headline CPI may remain under 2% until 4Q14 and may jump close to the 3% inflation target only in Dec-2014. The key question for the inflation outlook is whether the expected pick-up in household consumption will translate into higher pass-through of recent corporate tax hikes over the medium term. We expect headline inflation will rise above 3% in 2015 as the impact of utility price cuts is fully eliminated from the annual price index, but strengthening European disinflation concerns point towards long-term low imported inflation, which may mute the impact of any domestic demand recovery.

External rates, CPI drop support rate cuts

Further drop in headline CPI until 1Q14 and the likely postponement of Fed tapering create a supportive mix for further gradual NBH rate cuts. The MPC's dovish stance suggests to us that rate reductions may continue in 20bp or eventually 10bp steps, testing market tolerance. Given the relative level of real rates offered by HUF rates and Hungary's decent current and capital account surplus helping to stabilize the currency, we believe rates may bottom out at 3.0% in Dec-2013 or at 2.8% in 1Q14, depending on Fed-related noises. We doubt, however, whether interest rates around 3% will be sustainable beyond 4Q14 as inflation and domestic demand rises and global financing conditions tighten.

Monetary stimulus may lead to an erosion of the current account surplus. We expect improved growth prints may contribute positively to risk perception as it relates to Hungary. The key issue to watch, in our view, is how sustainable economic recovery is. Given Hungary's large stock of external debt (see Figure 6), we believe monetary stimulus cannot remain in place permanently without undermining the stability of the currency. Therefore the sustainability of these policies depends on how Hungary's current account surplus, the most important contributor to local assets' resilience to a recent EM sell-off, is impacted by domestic demand. Our base line scenario is that the current account surplus will narrow but not fully disappear in 2014, but we see the fragility of the euro area recovery and potential further monetary stimulus as downside risks to the external balance.

Figure 175. Upcoming elections likely to renew Fidesz' power



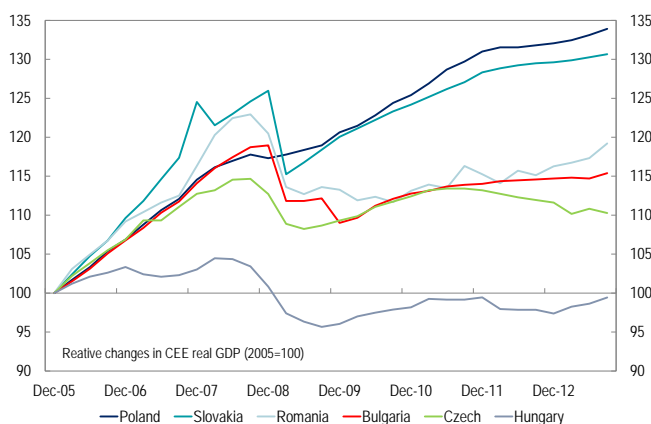
Source: Szonda-Ipsos, Citi Research

Figure 177. ...without damaging the headline fiscal balance



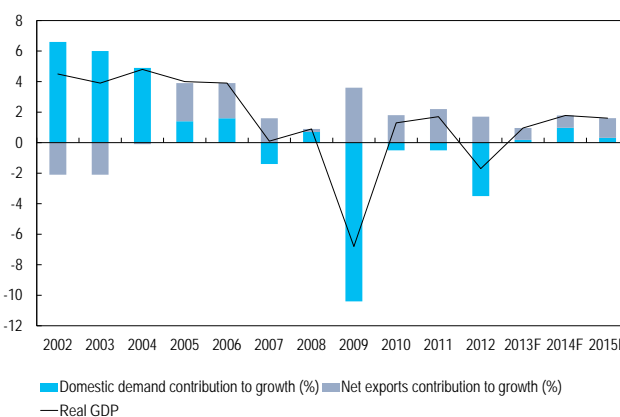
Source: Eurostat, Citi Research estimates, 2011 balance excludes private pension asset transfers

Figure 179. The key issue is if growth acceleration is permanent...



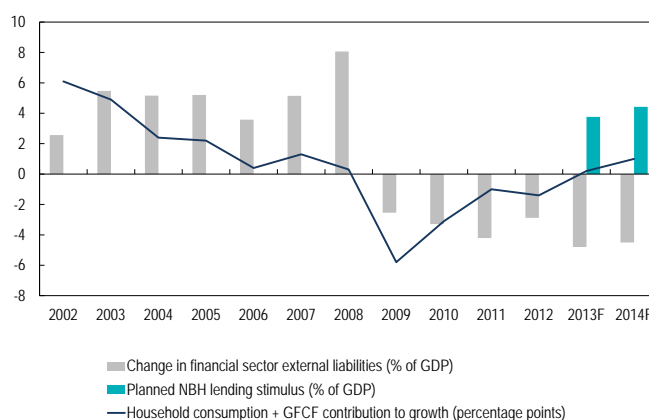
Source: Bloomberg, Eurostat, Citi Research

Figure 176. Policies to focus on domestic demand stimulus...



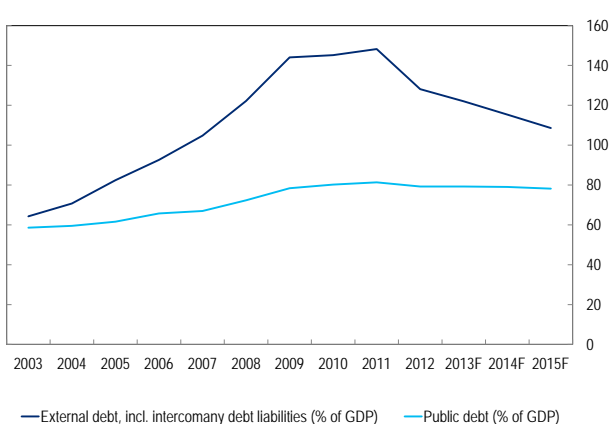
Source: Hungarian CSO, Citi Research estimates

Figure 178. NBH lending program to offset external outflows from banks



Source: National Bank of Hungary, Citi Research estimates

Figure 180. ...which is needed to help the economy grow out of debt



Source: Eurostat, Haver, National Bank of Hungary, Citi Research estimates

Figure 181. Hungary Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	145	141	136	128	116	128	130	138	144
Nominal GDP, local currency bn	25,153	26,569	25,734	26,699	27,974	28,275	29,265	30,546	31,867
GDP per capita, USD	14,390	14,061	13,584	12,733	11,591	12,819	13,051	13,897	14,499
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	9.7	9.5	10.1
Economic Activity									
Real GDP, yoy avg	0.1	0.9	-6.8	1.3	1.6	-1.7	1.0	1.9	1.5
Real investment growth % yoy	-1.5	3.7	-29.6	7.6	-0.4	-11.4	0.3	3.1	0.0
Real consumption growth % yoy	-1.4	-0.2	-4.5	-2.3	0.3	-1.7	0.2	0.8	0.6
private consumption growth % yoy	1.1	-0.7	-6.6	-3.0	0.5	-1.4	0.4	1.2	1.0
Real export growth, % yoy	15.0	5.7	-10.2	14.2	6.3	2.0	2.6	3.5	3.6
Real import growth, % yoy	12.8	5.5	-14.8	12.7	5.0	0.1	2.1	3.1	3.0
Prices, Money & Credit									
CPI, % yoy	7.4	3.4	5.4	4.6	4.1	5.1	0.4	3.3	3.2
CPI, % avg	7.9	6.0	4.0	4.7	3.9	5.7	1.7	1.5	3.3
Nominal wages, % yoy	8.0	7.4	0.5	1.3	5.2	4.7	3.8	4.4	4.2
Credit extension to private sector, % yoy	18.8	21.7	-2.7	4.1	-0.5	-10.1	2.0	4.9	2.5
Policy Interest Rate, % eop	7.50	10.00	6.25	5.75	7.00	5.75	3.00	3.80	4.00
1 month inter-bank rate, %, eop	7.50	10.00	6.25	5.75	7.08	5.75	3.00	3.80	4.00
Long-term yield, %, eop	7.08	8.28	7.99	7.97	9.75	6.11	5.80	6.80	6.50
HUF/US\$, eop	173	190	189	208	244	221	226	221	222
HUF/US\$, avg	183	171	201	208	201	225	227	222	221
HUF/EUR, eop	253	266	271	278	315	291	305	310	310
HUF/EUR, avg	251	252	280	275	279	289	300	309	310
Balance of Payments, USD bn									
Current account	-9.9	-11.4	-0.3	0.3	0.6	1.3	1.9	1.2	1.1
% of GDP	-6.8	-8.1	-0.2	0.2	0.5	1.0	1.5	0.9	0.8
Trade balance	-0.9	-1.8	3.3	3.2	4.3	4.6	5.1	4.7	4.3
Exports	93.0	106.1	80.0	88.8	103.7	97.3	102.6	111.2	115.9
Imports	93.9	107.9	76.7	85.5	99.4	92.7	97.5	106.6	111.6
Service balance	1.8	2.2	2.8	3.8	4.4	4.4	4.6	4.7	4.9
Income balance	-10.1	-11.0	-6.9	-7.3	-8.9	-8.2	-8.9	-9.0	-8.9
FDI, net	0.3	3.9	0.2	1.0	0.9	2.6	2.0	1.9	1.8
International reserves	23.2	33.2	41.1	43.1	45.4	43.5	46.2	49.0	51.8
Total amortisations	9.3	15.2	21.9	20.5	25.8	21.6	21.4	21.1	20.5
Public Finances, % of GDP									
Consolidated government balance	-5.1	-3.7	-4.6	-4.3	4.3	-1.9	-2.9	-3.0	-2.9
Consolidated gov primary balance	-1.0	0.5	0.0	-0.1	8.5	2.5	1.2	1.0	1.0
Public debt	66.5	72.2	78.1	79.9	81.1	79.2	79.2	78.9	78.1
of which Domestic	35.9	37.5	36.8	40.8	40.4	43.3	44.7	45.9	46.4
Foreign Assets & Liabilities, USD bn									
External debt	151.7	172.6	196.3	185.1	171.7	163.9	162.7	160.5	156.1
Public	47.4	51.8	62.1	59.5	58.3	63.8	62.5	63.0	63.5
External debt / GDP	104.8	122.2	144.1	145.1	148.2	128.1	125.5	116.3	108.6
External debt / XGS	137.7	136.5	199.2	171.2	136.6	139.2	131.3	119.8	112.1
Short-term debt	32.9	27.5	28.0	32.9	31.7	22.8	20.3	19.6	18.2
Short-term debt/International reserves (%)	141.7	82.8	68.2	76.1	69.9	52.4	43.9	40.0	35.1
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	0.5	1.7	2.4	2.0	2.0	1.7	1.5	1.2	1.1
CPI, % yoy	1.9	1.4	0.4	0.8	1.3	1.4	3.3	3.3	3.3
Policy interest rate, %, eop	4.25	3.60	3.00	2.80	2.80	3.05	3.80	4.00	4.00
Short-term market rate, % eop	4.25	3.60	3.00	2.80	2.80	3.05	3.80	4.00	4.00
Long-term yield, %, eop	6.12	5.83	5.80	5.90	6.20	6.50	6.80	6.80	6.80
HUF/EUR, eop	295	297	305	307	309	310	310	310	310

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 very concerned about the risk that a strong shekel might pose to the economy's recovery. In that context, the BOI cut its rate to 1% last month, which helps to complement measures introduced earlier this year to accumulate fx reserves and prevent ILS appreciation. The appointment of Karnit Flug as the new BOI governor should help to ensure policy continuity at the Bank.
- **Strategy** — Inflation expectations have fallen, raising some questions about whether the BOI might set a 'minimum exchange rate' for the shekel as the Czech National Bank has done. We doubt this for now but we expect strong effort to avoid ILS appreciation through conventional fx purchases.

A false dawn in Q2 data

A sharp increase in Q2 GDP was a one-off. The economy seemed to bloom in Q2, with GDP growing 4.6% QoQ, but the 2.2% growth in Q3 gives a better picture of the economy's dynamics. The Q2 data were inflated not only by the start of gas production in April, but also by front-loading of consumer purchases in the run-up to a VAT increase in June. The underlying picture for the Israeli economy remains relatively gloomy. The PMI has stayed below 50 for six consecutive months; credit growth has fallen sharply; industrial production growth staged a large collapse in August that was sustained in September; and the weak external demand picture has kept export growth negative in 7 of the past 12 months. In view of all this – in particular the weak outlook for net exports – the Bank of Israel has cut its growth forecast for 2013 from 3.8% (which includes the impact of gas production) to 3.6%. The Bank is slightly more optimistic about 2014, for which it has increased its forecast 20bp to 3.4% (again including gas)

The external sector remains a focus for policymakers...

'Dutch disease' risks are still a concern. Like many other countries, Israel has 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. Gas from Tamar is likely to substitute some US\$2.1bn of energy imports in 2013, with the result that Israel's current account deficit, which was a drain on investor enthusiasm towards the shekel last year, should disappear, 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 have increased investors' enthusiasm to own the shekel, the Bank of Israel remains very concerned that gas-driven shekel appreciation could threaten Israel's recovery. We think the Bank has some good reason to be worried: the real effective exchange rate appreciated by 7% in the first eight months of the year. And the Bank now has a long track record, dating back 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, we think the outlook for Israel's balance of payments is good, due to very large offshore gas discoveries in the past couple of years.

In addition to Tamar (1.6bn barrels of oil-equivalent), Leviathan (3bn barrels equivalent), which goes into production in 3-4 years, should have a transformative effect on the economy. At a rough guess, gas production from these two fields will add around 2% GDP per year to Israel's balance of payments (both through import-substitution as well as exports). The government is in the process of creating a Sovereign Wealth Fund to capture the net income from gas production, and it reckons that the Fund will reach over US\$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 an even stronger story than it is at the moment: the US Geological Survey estimates that the Levantine Basin – 40% of which is in Israeli waters – contains more than 3.4 trillion cubic meters of gas. The so-far-discovered reserves of Tamar and Leviathan are only around 700 billion cubic meters, which suggests that Israel might end up with twice the amount of gas that it has found to date.

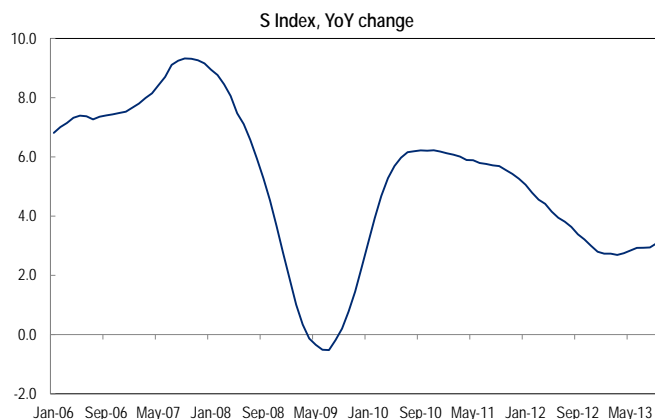
Interest rates are becoming a less effective tool

The Bank of Israel cut its rate twice in May by a total of 50bp to 1.25%, and cut again in September to 1%. In all of these exercises the main objective has been consistently to prevent the shekel from appreciating. The most recent cut was motivated also by signs that economic activity in August was particularly weak: VAT revenues rose by only 1%YoY, for example, and the boost to investment from the gas industry and from Intel's Israel operation can no longer be relied on. However, the closer Israel is to the zero lower bound, the less effective further interest rate cuts will be, and since longer-term inflation expectations are stuck around 2.4%, we think the Bank will probably not cut rates further. However, the decision by the Czech National Bank in November to set a 'minimum exchange rate for the koruna raises an interesting precedent for Israel. If, unexpectedly, inflation expectations stage a big collapse in the next few months, we don't rule out a similar experiment by the BOI. Absent that collapse, we expect the Bank to adopt a more aggressive strategy of fx intervention if the shekel strengthens meaningfully.

A better fiscal outlook, but Fed tapering could hurt

One of the factors that has facilitated a more aggressive stance by the BOI is that fiscal uncertainties have eased somewhat. Although fiscal performance in August was poor, the overall fiscal picture isn't as bad as previously feared. Thanks to some expenditure restraint, the deficit now seems headed for 3.5% GDP this year, compared to the 4.65% deficit that was 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 182. Economic activity is stabilizing at a weak level, partly thanks to what the BOI describes as a 'virtual standstill' in world trade...



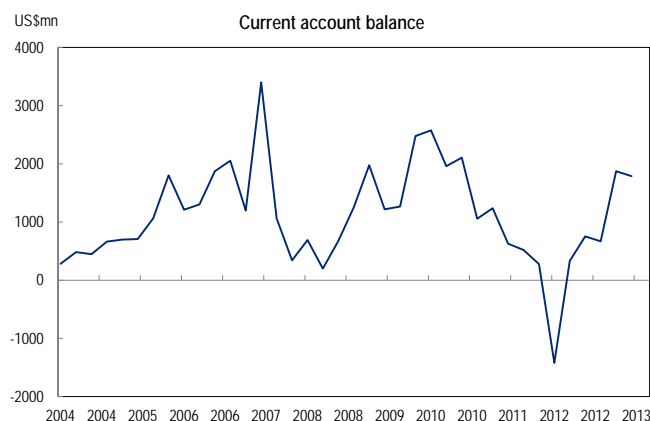
Source: Haver Analytics, Citi Research

Figure 184. Inflation expectations are more or less stable...



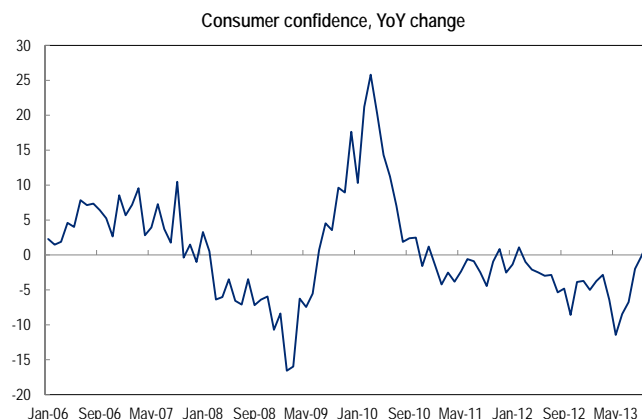
Source: Haver Analytics, Citi Research

Figure 186. ...on the back of a sharply improving current account balance...



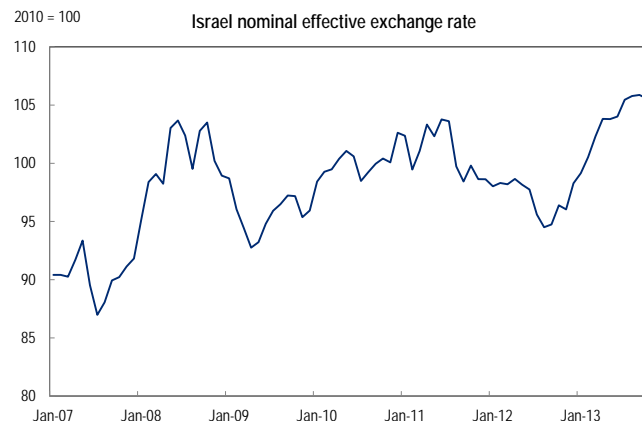
Source: Bloomberg, Citi Research

Figure 183. ...and consumer confidence is fragile even though household borrowing has been relatively robust



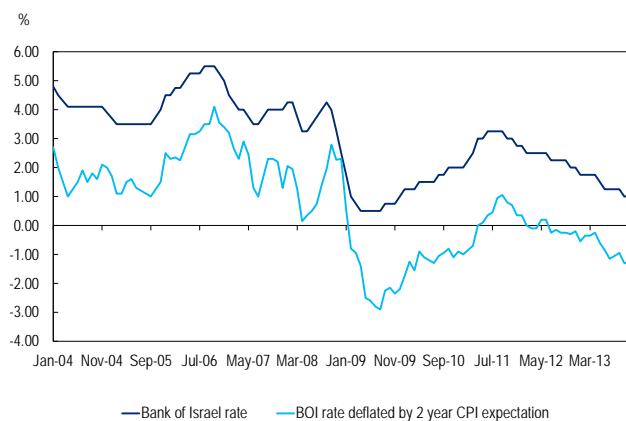
Source: Haver Analytics, Citi Research

Figure 185. ...but the shekel has strengthened sharply in nominal terms in the past year...



Source: Haver Analytics, Citi Research

Figure 187. ...but the Bank of Israel doesn't have much room to cut rates further



Source: Bloomberg, Citi Research

Figure 188. Israel Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	175	213	206	232	258	258	290	302	315
Nominal GDP, local currency bn	719	765	809	866	924	993	1,041	1,100	1,172
GDP per capita, USD	25,248	29,990	28,289	31,273	34,236	33,702	37,484	38,646	39,733
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	6.1	6.0	5.8
Economic Activity									
Real GDP, yoy avg	6.8	4.9	1.1	5.3	4.7	3.5	3.2	3.4	3.5
Real investment growth % yoy	9.5	9.0	-4.4	9.2	15.7	3.8	-2.7	5.6	3.6
Real consumption growth % yoy	6.6	1.6	2.6	4.4	3.5	3.2	2.1	3.0	-0.3
private consumption growth % yoy	8.1	1.5	2.4	4.9	3.9	3.2	2.8	3.0	-0.5
Real export growth, % yoy	11.2	6.6	-12.1	15.6	6.9	1.1	3.8	3.4	6.7
Real import growth, % yoy	10.6	2.3	-12.7	14.2	10.9	3.3	-6.5	1.6	5.4
Prices, Money & Credit									
CPI, % yoy	339.7	380.5	391.5	266.2	217.0	163.5	2.1	2.4	2.2
CPI, % avg	0.5	4.6	3.3	2.7	3.5	1.7	1.6	2.3	3.0
Nominal wages, % yoy	4.1	-0.2	1.7	4.7	3.1	5.5	4.5	5.0	5.0
Credit extension to private sector, % yoy	19.3	7.9	-0.7	8.5	6.3	4.0	3.0	4.0	4.5
Policy Interest Rate, % eop	4.25	2.50	1.00	2.00	2.75	2.00	1.00	1.50	1.50
1 month inter-bank rate, %, eop	4.50	1.90	1.31	2.06	2.74	1.75	1.00	1.50	1.50
Long-term yield, %, eop	6.17	4.72	5.11	4.75	4.24	3.62	4.20	4.50	4.50
ILS/US\$, eop	3.86	3.78	3.79	3.52	3.81	3.73	3.55	3.68	3.74
ILS/US\$, avg	4.11	3.58	3.93	3.73	3.58	3.85	3.59	3.64	3.72
Balance of Payments, USD bn									
Current account	5.6	3.1	7.9	7.2	3.3	0.8	7.5	5.9	2.2
% of GDP	3.2	1.4	3.8	3.1	1.3	0.3	2.6	2.0	0.7
Trade balance	-5.2	-6.4	0.7	-2.0	-8.2	-9.3	-8.0	-5.0	-2.3
Exports	50.8	58.0	46.8	56.4	64.3	62.3	66.0	71.0	75.3
Imports	56.0	64.4	46.1	58.4	72.5	71.7	74.0	76.0	77.5
Service balance	3.7	5.0	5.0	6.0	6.9	9.8	11.0	9.0	10.0
Income balance	-0.2	-4.0	-5.1	-5.2	-4.4	-8.0	-3.0	-6.1	-5.5
FDI, net	17.4	18.1	6.1	14.6	16.1	11.8	2.5	4.0	6.0
International reserves	28.6	42.5	60.6	70.9	74.9	76.0	82.0	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	-3.6	-3.0	-2.5
Consolidated gov primary balance	6.1	4.1	1.0	2.3	2.5	1.4	1.3	3.0	3.0
Public debt	72.9	71.5	73.8	74.5	73.8	72.5	72.5	70.5	67.4
of which Domestic	56.5	57.3	60.1	57.7	57.4	56.4	55.7	53.6	51.2
Foreign Assets & Liabilities, USD bn									
External debt	92.3	89.6	94.6	107.8	105.3	96.9	102.0	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	35.2	34.4	33.4
External debt / XGS	127.9	108.1	136.4	132.8	114.8	104.0	106.3	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	54.9	51.7	47.4
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	3.8	3.5	3.2	3.2	3.0	3.0	3.0	3.5	4.5
CPI, % yoy	2.0	1.3	2.1	2.8	2.8	2.7	2.4	2.5	2.4
Policy interest rate, %, eop	1.25	1.25	1.00	1.00	1.00	1.00	1.50	1.50	1.50
Short-term market rate, % eop	1.22	1.00	1.00	1.00	1.00	1.00	1.50	1.50	1.50
Long-term yield, %, eop	3.20	3.20	3.50	4.75	4.75	4.75	4.75	4.75	4.75
ILS/US\$, eop	3.64	3.53	3.55	3.59	3.63	3.66	3.68	3.70	3.72

Source: National Sources, Citi Research forecasts

Levant

Iraq

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Iraq's oil exports rose slightly in October, to 2.25mbpd, from 2.07mbpd in September. This remains well below the highs of 2.6mbpd achieved earlier in the year, but October exports were hampered by ongoing works to install a new metering platform near the Basra oil terminal. The installation of the new metering platform will help bring the total export capacity out of the South to over 4.5mbpd, or double current exports. The completion of works in late October therefore marks a major milestone in the development of Iraq's export infrastructure, and is supportive of economic growth and public finances going forward.

That said, unrest in Basra this month potentially presents new challenges to the implementation of oil targets going forward, in our view (see [Iraq Macro Flash - Immediate Fallout From Basra Violence Likely To Be Limited, But May Signal Future Obstacles To Production Targets](#), 14 November). Angry mobs attacked the camps of two foreign subcontractors working on the oil fields in the Basra area, the epicentre of Iraq's oil industry, forcing them to evacuate staff and shut down operations. We believe the immediate economic fallout from the closures is likely to be limited, but we do note that the outbreak of violence does take place against a back-drop of continued resentment on the part of the local community towards western oil companies operating in the region. We therefore believe the incident is unlikely to be a one-off, although it is too early to say whether it signals an escalation in the resentment that could beget further violence going forward. If this were to be the case, the rate of expansion of future operations, particularly in drilling and field servicing, in which these companies specialize, may slow, presenting fresh obstacles to Iraq's ambitious oil production targets.

The KRG appears to be finalizing the legal and logistical groundwork for a push towards energy independence. In Mid-November, the KRG declared that Baghdad owes it US\$384.7bn in reparations for crimes committed against the Kurds since 1963. This puts into context Law no. 5, passed by the Kurdish parliament earlier this year, which authorizes the KRG to export oil and gas in order to recoup unpaid claims by the Baghdad government. This legal cover, however, is vehemently refuted by Baghdad, which does not recognise the reparations demand, and which insists that any move to export oil and gas independently would be a violation of the constitution. Logistically, the KRG has taken a major step towards oil-independence by completing an export pipeline that bypasses Baghdad-controlled infrastructure, and that could see it begin independent exports by the end of this year. The new pipeline connects to the Iraq-Turkey pipeline (ITP) after the federal metering station of Feyshkhabour.

Jordan

The Jordanian government has endorsed the state budget draft law, which envisages a sharp increase in spending, which it expects to finance through a rise in overseas aid. The draft law calls for a 12.8% rise in expenditures, with an 11% rise in current expenditure, mainly on wages and interest payments. The spending rise comes despite a projected decrease in the subsidy bill on the back of the ongoing phasing out of energy subsidies under the auspices of the IMF programme.

The fiscal loosening is at odds, in our view, with the goals of the country's IMF programme, which stress above all the need for greater fiscal

consolidation. Indeed, the IMF this month waived two key missed targets (on primary deficit and losses at NEPCO) in order to push through a disbursement of funds under its 36-month US\$2.1bn stand-by agreement. While it is not unusual for the IMF to waive performance targets, we believe that Jordan is benefitting from international support as a result of its central role in dealing with the spillover of the conflict in Syria (particularly the refugee crisis), as well as its general geo-strategic regional importance. Indeed, the sharp rise in foreign aid registered so far this year is testament to the international community's interest in maintaining the country's economic stability. The underwriting of the Kingdom's recent US\$1.25bn bond issue by the US government is another case in point.

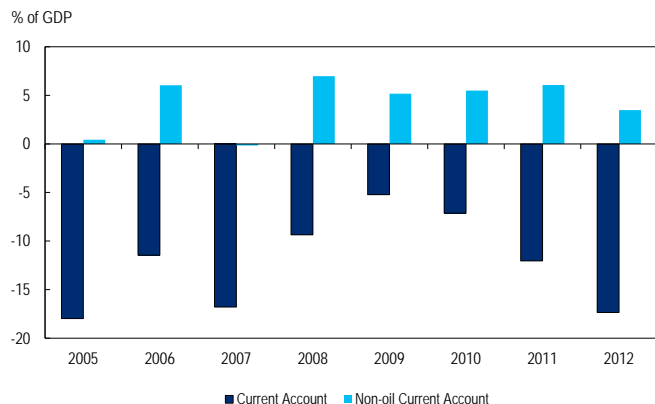
Lebanon

Lebanon's sectarian tensions, which have been re-kindled by the ongoing Syrian conflict, reached new highs this month after a deadly suicide bomb attack on the Iranian embassy in the heart of Shia-dominated South Beirut. An al-Qaeda-linked Lebanese Sunni extremist group claimed responsibility, stating it was in response to Hizbollah's ongoing military backing of the Assad regime in Syria, and the holding of Islamist prisoners in Lebanon. While sectarian violence has increased markedly in the past two years, we still do not anticipate a descent into all-out civil war in the near term, due mainly to the overwhelming military superiority of Hizbollah. We also continue to view sovereign risk as relatively stable despite the obvious deterioration in country risk (see [Lebanon Macro View - What's behind those Lebanese remittances?](#) 30 October).

Prime Minister designate Tammam Salam continues to be frustrated in his efforts to form a new government, seven months after the resignation of the previous government. This is not the first time that Lebanon has lacked a government for an extended period of time: indeed, it took Nagib Mikati five months to cobble together the previous government. However, there are a number of critical differences that make the current political impasse particularly detrimental to the country's socio-economic stability. First, the level of violence and insecurity in Lebanon has risen dramatically. Second, the lack of a government has coincided with a de facto lack of parliament, as the boycott by March 14 and affiliates has prevented parliament convening since its term was extended in June due to a lack of quorum. Day-to-day management of the country's affairs, such as approval of civil servant salaries, has become difficult and often reliant on presidential decree. The prospect of a government forming in the near future does not appear to be improving, with March 8 and March 14 blocs holding opposing views on fundamentals, such as the allocation of numbers, individual ministries and the cabinet statement.

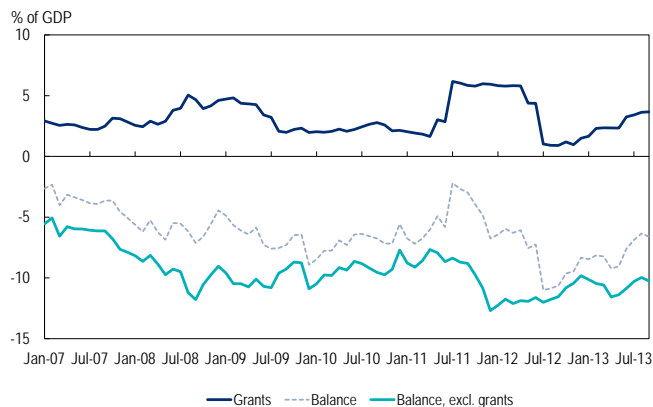
One victim of the political gridlock is Lebanon's oil and gas potential. Last month, caretaker energy Minister Gebran Bassil was forced to postpone the auction of offshore oil and gas blocks to international drillers due to the failure of the cabinet to pass the necessary laws. Bassil has stressed the urgency of moving ahead with oil and gas extraction in Lebanon's potentially sizable offshore reserves, given rival Israeli development, but the sour political atmosphere and mutual distrust between political actors is making any progress look highly unlikely at this stage.

Figure 189. Jordan current account dominated by oil imports ...



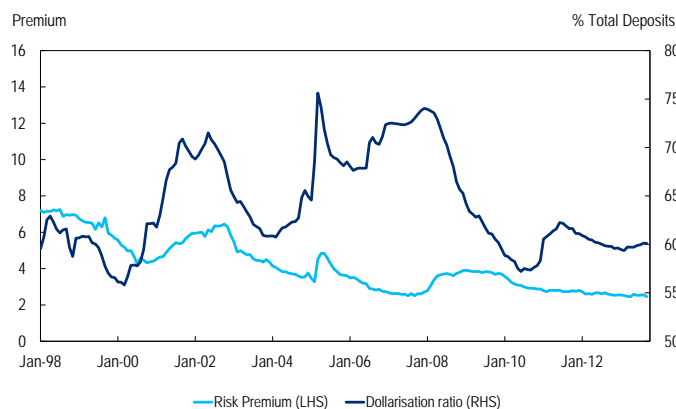
Source: Haver Analytics, Citi Research

Figure 190. Without grants Jordan's fiscal situation would be worse



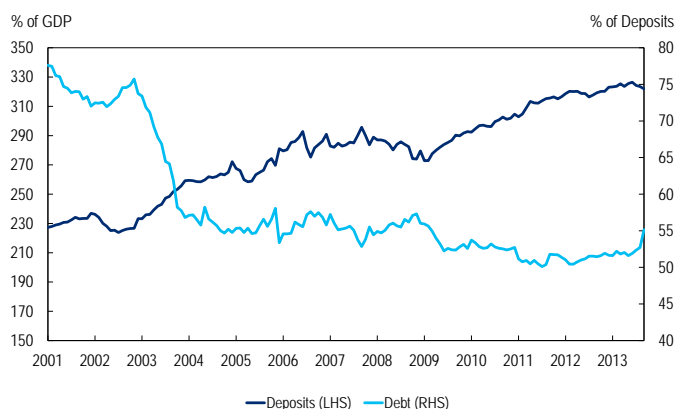
Source: Haver Analytics, Citi Research

Figure 191. Lebanon dollarization has gone up, but risk premium stable



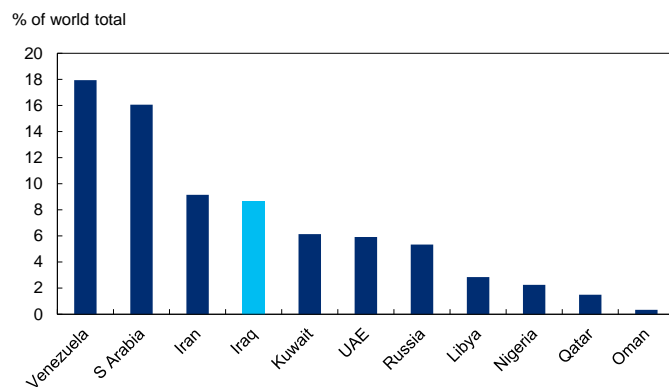
Source: Haver Analytics, Citi Research

Figure 192. Deposit growth slows, but still plenty of capacity



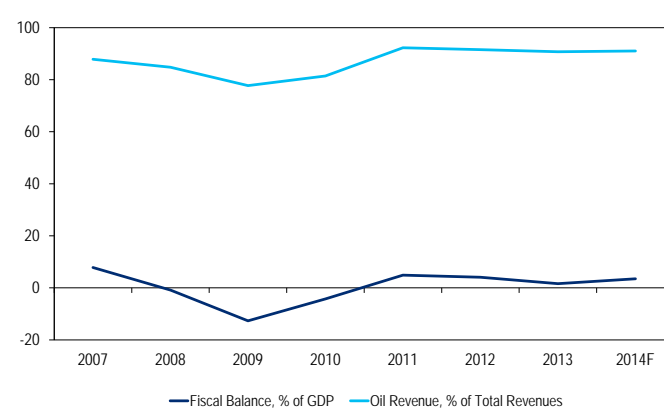
Source: Haver Analytics, Citi Research

Figure 193. Iraq has world's fourth largest proven oil reserves and ...



Source: BP, Citi Research

Figure 194. ... public finances to strengthen on greater oil revenues



Source: Haver Analytics, Citi Research estimates

Figure 195. Levant Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
IRAQ									
Nominal GDP, USD bn	91.7	135.6	113.6	135.9	181.2	213.0	230.6	267.4	313.5
GDP per capita, USD	3,190	4,607	3,766	4,389	5,708	6,545	6,908	7,811	8,928
Real GDP, yoy avg	1.4	6.6	5.8	5.9	8.6	8.4	3.1	10.4	11.6
CPI, % avg	32.6	2.8	-2.8	2.4	5.6	6.1	2.2	5.8	6.0
IQD/US\$, avg	1,253	1,189	1,156	1,167	1,171	1,164	1,163	1,163	1,163
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	4.7	14.5	17.8	13.5	13.8	12.8
Consolidated gov. balance, % of GDP	7.8	-0.9	-12.7	-4.3	4.9	4.1	1.6	3.5	4.3
JORDAN									
Nominal GDP, USD bn	17.1	22.0	23.9	26.5	28.8	30.9	32.7	35.0	37.6
GDP per capita, USD	3,026	3,722	3,866	4,104	4,284	4,404	4,475	4,594	4,739
Real GDP, yoy avg	8.2	7.2	5.5	2.3	2.6	2.7	3.0	4.0	4.5
CPI, % avg	4.7	13.9	-0.7	5.0	4.4	4.8	5.7	4.8	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	-5.0	-5.0	-4.5
% of GDP	-16.8	-9.3	-5.2	-7.1	-12.0	-17.4	-15.2	-14.2	-11.9
Consolidated gov. balance, % of GDP	-5.1	-4.4	-8.9	-5.6	-6.8	-8.3	-8.2	-9.5	-9.3
LEBANON									
Nominal GDP, USD bn	24.6	28.8	35.1	38.0	40.1	43.0	45.3	46.7	47.1
GDP per capita, USD	6,538	7,572	9,111	9,726	10,126	10,647	11,006	11,130	11,005
Real GDP, yoy avg	9.3	9.1	10.3	8.0	2.0	2.5	1.4	-0.9	-3.1
CPI, % avg	4.1	10.8	1.2	4.0	5.1	6.4	2.1	3.7	5.0
LBP/US\$, avg	1,512	1,507	1,504	1,502	1,506	1,504	1,508	1,508	1,508
Current account, US\$bn	-1.4	-4.1	-6.7	-7.6	-4.9	-1.7	-2.1	-2.5	-3.1
% of GDP	-5.6	-14.4	-19.2	-20.0	-12.1	-3.9	-4.5	-5.4	-6.5
Consolidated gov. balance, % of GDP	-10.4	-10.1	-8.4	-7.6	-5.8	-9.1	-10.0	-9.6	-8.3

Source: National Sources, Citi Research forecasts

Nigeria

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- **Summary view** — While political uncertainty is set to rise steadily in 2014, we still expect growth to remain over 6% in 2014 driven by strong consumption and agricultural sector growth. But the fiscal picture could deteriorate and inflation start to rise back into double digits in 2H 2014.
- **Things to watch** — The pressure on the naira in Q3 2013 highlights that it is vulnerable to sentiment: both Nigeria specific and towards emerging markets in general. If oil prices or production, or reserves, were to fall sharply in 2014, the pressure on the naira has the potential to rise sharply.
- **Strategy** — The combination of Ngozi Okonjo-Iweala as finance minister and Lamido Sanusi as central bank governor means Nigeria has a respected economic team committed to improving fiscal discipline and maintaining orthodox monetary policies.

2014 is a pre-election year

Although Nigeria will not hold presidential and parliamentary elections until early 2015, 2014 is essentially a pre-election year. This is already clear from the recent very public divisions within the ruling People's Democratic Party (PDP) about its potential presidential candidate. And the political tension could well mount in 4Q 2013 in the debate over the 2014 budget in the National Assembly. Ms Okonjo-Iweala is pushing hard to maintain a tight fiscal stance, but this is already running up against political demands for higher spending. All this would imply a political battle over the budget and it may well be that a final version of the budget is not approved until early 2014. On a positive note, a significant delay in passing the budget could partially limit fiscal slippage in 1H 2014.

In addition, the approaching elections probably mean the economic reform programme, which slowly gathered momentum in 2012-13 will end up on the backburner. We expect only very limited progress in the passage of the proposed Petroleum Industry Bill (PIB) and Sovereign Wealth Fund (SWF). However, there could be some further progress with electricity sector reforms as this is a crucial platform for President Goodluck Jonathan if he really intends to seek re-election in 2015, providing a concrete sign of what he has achieved while in office.

But growth should remain robust

But while a deteriorating political environment is not good for growth, we expect it to remain around the 6% level, supported by a pick-up in agricultural sector growth which has become a policy priority. Although the agricultural production was negatively affected in 2012 by the instability caused by Boko Haram and floods, both have become less important in 2013. An improved supply of fertilizer could also potentially significantly boost output in the coming 18 months. Recovery in agricultural sector growth will be supported by strong service sector growth, but overall growth will still be constrained by only very limited increases in oil production given recent problems with production and with the approaching elections raising political tensions in the Niger Delta.

The National Bureau of Statistics is planning to implement a GDP rebasing exercise in December 2013. This is likely to result in the value of GDP being increased around 40% and the overall trend of greater service sector driven growth further confirmed with the importance of the oil sector downgraded.

Rates, reserves and a stable naira

Since mid-2012 the CBN has been able to maintain a stable naira on the back of strong portfolio inflows. These have been attracted by the tight monetary policy and high nominal interest rates, oil prices over US\$100/barrel and the inclusion of Nigerian in various EM bond indexes and a robust economic management story. Moreover, the tight monetary policy has been justified by high inflation and levels of government spending.

But we think this policy will become more complicated over the next nine months as inflation has remained firmly fixed in single digits in 2013 and growth been less robust in 1H. This would seem to supporting the case for an easing of monetary policy, but we think a cut unlikely. This reflects the fact that the CBN not only considers inflationary trends when setting the MPR, but wider factors including a commitment to broad naira stability. And a key part of achieving this in the last nine months this has been the rebuilding of reserves to give additional confidence in the currency – a policy predicated on the tight monetary policy.

But it is also increasingly clear that Mr Sanusi is not going to seek a second term and will leave office in mid-2014. His potential successor will also face the problem of rising inflation, a deteriorating fiscal position and potentially portfolio outflows. This will put the naira under pressure and also provides a further justification for not prematurely easing monetary policy at any time soon. It also highlights the need for a more coherent and logical method of changing the governor than has been historically the case. If agreed, this may see the announcement of his replacement as early as March 2014, which would be a positive in terms of improving policy continuity.

The oil price-production question and reserves

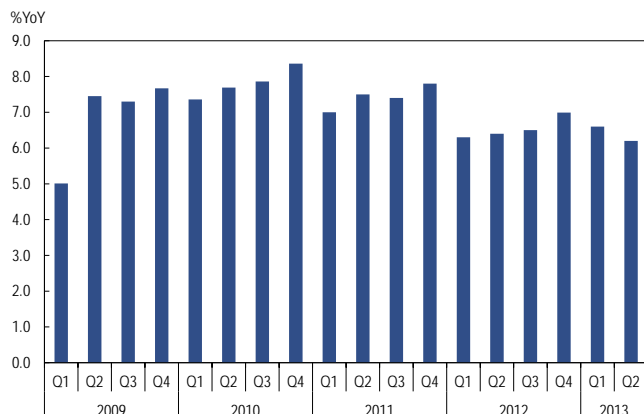
The other variables to consider when thinking about the naira outlook are the oil price and the level of production. In 2013, production has been under pressure, but this has been offset by a high oil price of well over US\$100/barrel. This equation could be reserved as 2014 progresses with rising oil production offsetting an easing price, but if either, or both, were to come under more sustained pressure, the current governor has made it clear that CBN would have to revisit its current exchange rate policy.

We also think the response of the CBN 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. In particular, we think that once reserves fall towards around the US\$35bn level, the CBN would have to more actively consider the prospects of devaluing the naira.

Macroeconomic and naira stability for now

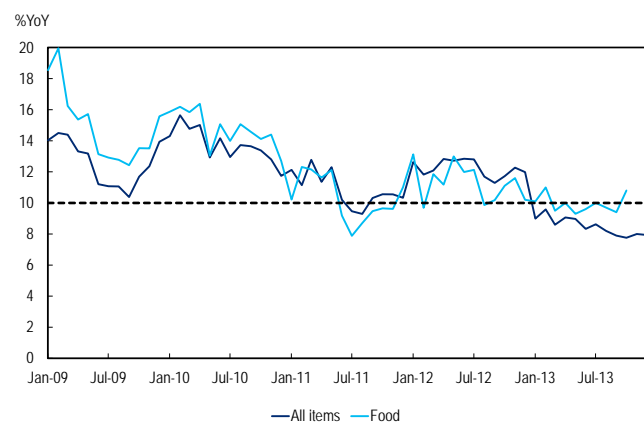
We expect that the current economic management team will be able to maintain macroeconomic and naira stability in 1H 2014. But in 2H the overall macroeconomic and political outlook will become distinctly more complicated as the pace of electioneering is bound to increase as Nigeria heads to elections in early 2015. But we still expect broad naira stability, unless there was a major change to the oil price-production equation or reserves really came under pressure. But while the naira will be under pressure, the positive aspect of this is that the political outlines of the polls should start to become much clearer in 2H 2014 and if the elections pass off successfully the prospects of further stability seem good.

Figure 196. Growth, although robust, has been under some pressure since 2012



Source: National Bureau of Statistics

Figure 198. Inflation has remained in single digits during 2013



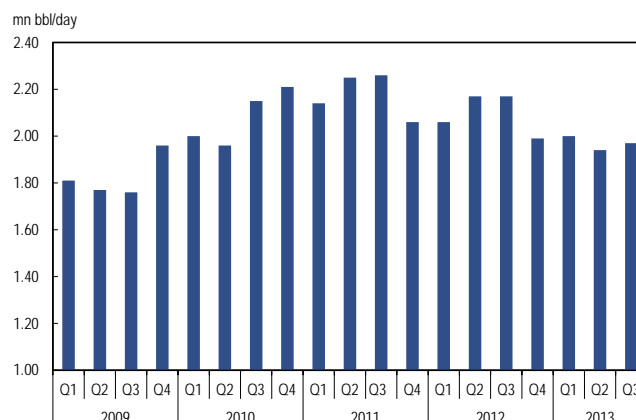
Source: National Bureau of Statistics and Citi forecasts from October 2013

Figure 200. The pressure on the naira from May to September does seem to have eased now



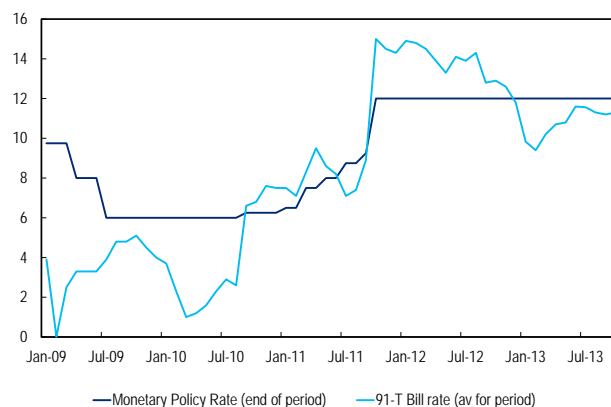
Source: Reuters

Figure 197. Oil production has been stuck around the 2m b/d level since late 2012



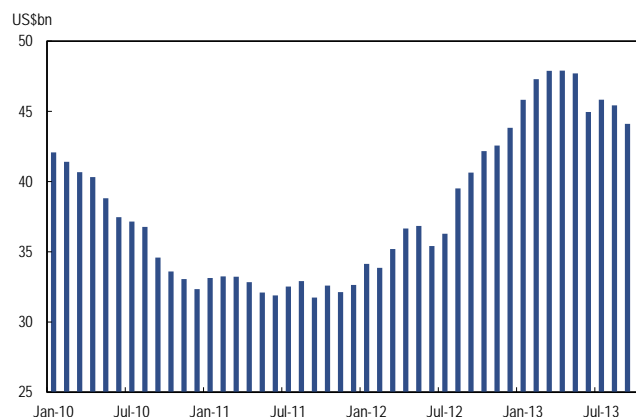
Source: International Energy Agency

Figure 199. The MPR has been left unchanged since October 2011



Source: Central Bank of Nigeria

Figure 201. Reserves have been rebuilt, but come under pressure in recent months



Source: Haver Analytics and Central Bank of Nigeria

Figure 202. Nigeria Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	164	204	166	225	240	255	322	362	412
Nominal GDP, local currency bn	20,657	24,296	24,794	33,985	37,410	40,544	46,863	54,279	63,833
GDP per capita, USD	1,119	1,356	1,072	1,421	1,478	1,533	1,885	2,065	2,292
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	6.4	6.0	7.0	8.0	7.4	6.6	6.5	6.5	6.3
Real investment growth % yoy	41.7	-0.7	34.7	18.3	-10.8	-19.9	-	-	-
Real consumption growth % yoy	42.4	-7.5	20.3	-2.5	8.4	-11.7	-	-	-
private consumption growth % yoy	37.6	-19.4	31.7	-9.0	8.9	-11.3	-	-	-
Real export growth, % yoy	-17.7	28.8	-30.7	53.5	32.4	2.7	-	-	-
Real import growth, % yoy	85.5	-11.3	11.7	12.7	22.7	-38.5	-	-	-
Prices, Money & Credit									
CPI, % yoy	6.6	15.1	13.9	11.7	10.3	12.0	7.9	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	12.0	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	14.00	13.00	12.00	13.50
NGN/US\$, eop	118	138	150	152	162	156	160	165	170
NGN/US\$, avg	126	119	150	151	156	159	159	164	168
Balance of Payments, USD bn									
Current account	27.6	29.1	14.0	14.5	12.6	20.4	14.0	7.2	9.1
% of GDP	16.8	14.3	8.5	6.4	5.2	8.0	4.3	2.0	2.2
Trade balance	37.8	45.9	25.7	31.7	35.0	42.4	35.2	30.8	35.3
Exports	66.1	85.7	56.8	78.5	97.2	96.0	91.0	92.0	93.8
Imports	28.3	39.8	31.1	46.8	62.2	53.6	55.8	61.2	58.5
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	46.1	43.8	47.2
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	-0.6	-0.2	-3.3	-3.3	-3.1	-2.2	-2.1	-2.9	-2.9
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	10.9	8.5	13.0	13.3	14.5	14.8	14.1	14.2	14.0
Foreign Assets & Liabilities, USD bn									
External debt	3.4	3.7	4.6	4.6	5.7	6.5	8.3	9.4	13.0
Public	3.0	3.2	3.9	4.4	5.0	6.0	6.8	7.2	10.0
External debt / GDP	2.1	1.8	2.8	2.0	2.4	2.6	2.6	2.6	3.2
External debt / XGS	5.0	4.2	7.7	5.6	5.6	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Source: National Sources, Citi Research forecasts

Poland

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- **Summary view** — We expect economic growth to accelerate further with chances of it exceeding the consensus view for 2014. However, inflation pressures remain muted and we expect it to rise only slowly.
- **Things to watch** — Changes in the pension system and the replacement of one of the MPC members are two key factors that may affect the conduct of economic policy in the coming quarters.
- **Strategy** — The zloty is likely to remain stable in the coming months as, despite economic recovery and still low current account deficit, Fed QE tapering will stay on the horizon and the tightening cycle could start later than previously expected.

Growth set to accelerate further

Our economic growth projections for Poland have been above consensus for some time but the recent series of data releases suggests that forecast risks are still skewed to the upside. GDP expanded 1.9%YoY in 3Q, more than expected, due to stronger private consumption, smaller decline in fixed investment and due to continued positive contribution from net exports. Business confidence indicators suggest the momentum will be maintained in the coming months. Probably the most important in the current recovery is the fact that it is driven by an acceleration of domestic demand, and not only by external demand. The improvement in the labour market is becoming more visible in the falling unemployment rate (seasonally adjusted) and continued healthy growth in real wages.

Our base case assumes growth will reach 1.4%YoY in 2013, accelerating to 3.1% in 2014. This would already be half a percentage point above potential growth, thus contributing to a gradual narrowing of the negative output gap. We do not see any serious demand-side inflationary pressures over next three or four quarters but, taking into account the likely structure of growth in 2014 (substantially stronger consumption), we believe the economic environment will be less deflationary and will become more neutral. This should help gradually push inflation higher from around 1% in 2013 towards 1.8-2.0% on average in 2014.

Pension system changes create fiscal space

In prior years, fiscal policy in Poland was shaped by the risk of public debt breaching the debt ceiling at 55% of GDP but this shouldn't be the case in the coming year. As a result of expected changes in the pension system (at the time of writing the bill hasn't been approved) more than half of assets of privately managed pension funds will be transferred to the public system, while Poles will be allowed to decide whether their future pension premiums should be directed to a private (funded) system or to the public sector (pay as you go, defined contribution). These should help lower the general government deficit permanently by around 1.3-1.5 percentage points, while public debt (calculated according to domestic methodology) should be reduced by around 8.4% of GDP and will fall towards 47% of GDP. Such a reduction in public debt will create some fiscal space that will be probably partly used by the government, thus eliminating the need to tighten fiscal policy further. According to our estimates, if the government was forced to abandon pension system overhaul plans (for example as a result of Presidential veto) it would need to tighten monetary policy by at least 2.5% of GDP to keep public debt safely below 55%.

Given that changes in the pension system should remove the need to tighten fiscal policy, from this perspective they are positive for short-term GDP growth. We believe the mere size of the fiscal cushion transferred to the budget and the resulting debt reduction imply that GDP growth risks are skewed to the upside versus our already above-consensus forecast of 3.1% in 2014.

No rate hikes until September?

In November, the Monetary Policy Council (MPC) declared the base interest rate would remain on hold at least until mid-2014, which raises bar for any policy action in 2014. We expect the next move in interest rates will be to the upside as accelerating economic growth and gradually rising inflation are likely to make the MPC start thinking about policy normalization, especially given the current level of the base rate (2.5%) is at a historical low. In our base case scenario, we assume the first rate hike comes in September 2014 and we believe the policy tightening process will be gradual, probably 25bp every two or three months. The risk factor is related to changes in the lineup of the MPC, with a new board member set to replace Zyta Gilowska who resigned from the board earlier this year. At this stage it is difficult to understand all the implications of this change, as a new member may vote in a different way than widely believed. In our baseline scenario, however, we assume the balance of powers is likely to become slightly more dovish or at best will remain unchanged. We do not think the “new” MPC will be more hawkish.

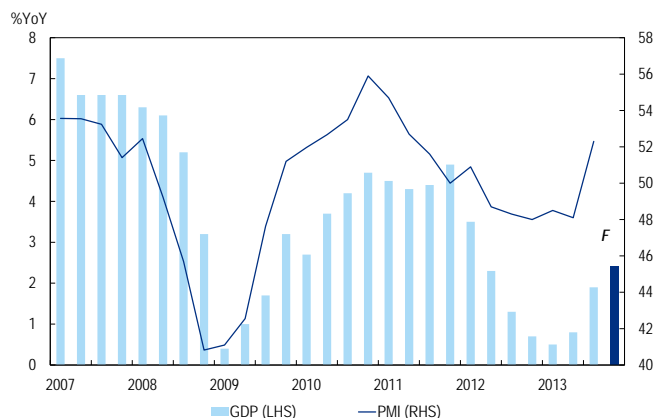
Very low current account deficit

Poland has gone through a significant current account adjustment and now the deficit is expected to reach around 1.5% of GDP in 2013. This improvement is due to a mix of a relatively weak currency and significant domestic demand slowdown in prior quarters. As the economy is accelerating we expect also the current account deficit to widen, but we believe this will be a gradual process and next year's deficit is likely to be around 2.5% of GDP, much smaller than the deficits recorded in previous years. This external adjustment means that one of the serious risk factors is likely to become much less important and Poland won't need to attract portfolio capital to fund the current account gap (it will be mostly funded by inflows of EU funds that are a relatively stable form of capital). This phenomenon should help limit (but only to some extent) the PLN's vulnerability to swings in foreign capital flows that might result from the prospect of asset purchases tapering by the Fed.

Zloty likely to stay stable

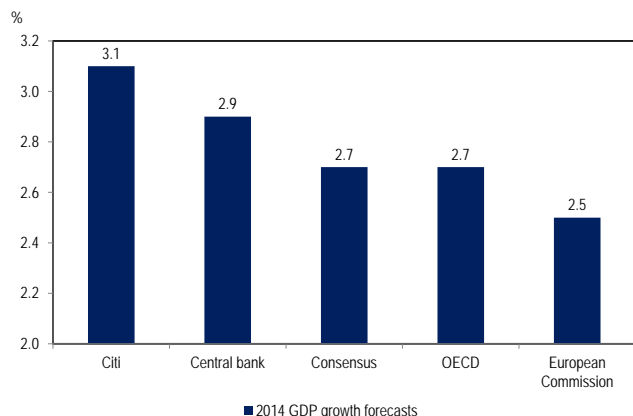
With a mix of negative and positive factors, the zloty is likely to remain relatively stable next year. We think the zloty is going to be supported by a gradual recovery of economic growth in the coming few quarters. Another supportive factor for the PLN will be a strong euro. On the other hand, the scale of monetary policy tightening is likely to be smaller than we expected previously and the QE tapering by Fed is still be on the horizon, which despite the still-low current account deficit will not allow for a fast appreciation of the zloty. Moreover, it still seems that the stable exchange rate would be the most favourable scenario for the central bank, at least until there are no inflation pressures ahead. At the same time, the zloty is likely to perform better than many other EM currencies.

Figure 203. PMI points to further economic growth acceleration in 4Q13



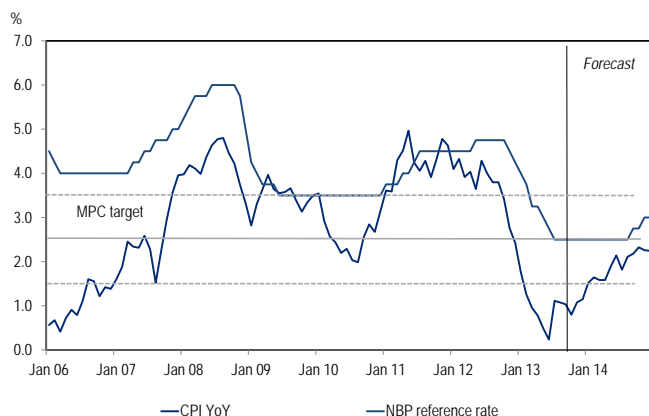
Source: CSO, Citi Research

Figure 205. We expect above-consensus GDP growth in 2014



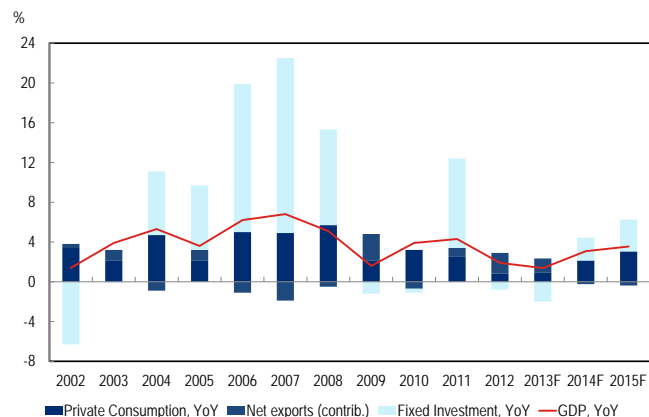
Source: Focus Economics - consensus forecasts, Citi Research

Figure 207. Inflation likely to rise slowly, with first rate hikes in 3Q14 at earliest



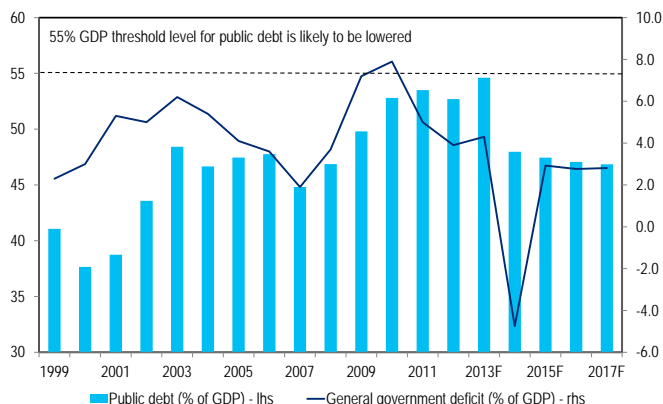
Source: CSO, Citi Research forecasts

Figure 204. Recovery will be driven mainly by domestic demand in 2014



Source: CSO, Citi Research

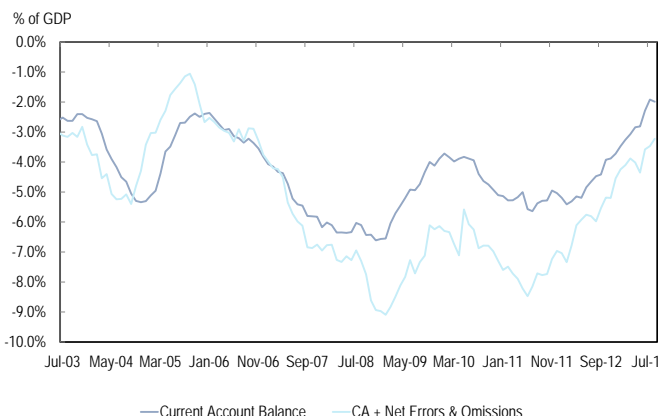
Figure 206. Transfer of pension assets leaves room to support the economy



Source: CSO, Eurostat, Citi Research forecasts

Note: Public debt based on domestic methodology, 55% threshold level corresponds to public debt according to Polish methodology

Figure 208. Current account deficit is likely to widen only moderately in 2014



Source: NBP, CSO, Citi Research

Figure 209. Poland Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	426	534	433	470	517	490	509	568	625
Nominal GDP, local currency bn	1,175	1,275	1,343	1,414	1,526	1,594	1,628	1,704	1,804
GDP per capita, USD	11,185	13,994	11,347	12,210	13,404	12,722	13,199	14,763	16,255
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	13.5	13.4	12.4
Economic Activity									
Real GDP, yoy avg	6.8	5.1	1.6	3.9	4.5	1.9	1.4	3.1	3.6
Real investment growth % yoy	24.3	4.0	-11.5	9.3	11.2	-3.3	-4.0	7.8	4.5
Real consumption growth % yoy	4.6	6.1	2.0	3.4	1.6	0.6	1.0	2.1	3.0
private consumption growth % yoy	4.9	5.7	2.1	3.2	2.6	0.8	0.9	2.3	3.2
Real export growth, % yoy	9.1	7.1	-6.8	12.1	7.7	2.8	3.8	6.1	6.5
Real import growth, % yoy	13.7	8.0	-12.4	13.9	5.5	-1.8	0.7	6.9	7.5
Prices, Money & Credit									
CPI, % yoy	3.9	3.4	3.7	3.2	4.6	2.4	1.1	2.2	2.9
CPI, % avg	2.5	4.2	3.5	2.6	4.3	3.7	1.0	1.9	2.8
Nominal wages, % yoy	9.1	10.5	4.2	3.6	4.9	3.5	2.6	3.7	4.8
Credit extension to private sector, % yoy	31.5	36.4	7.0	8.5	13.9	2.4	3.7	5.6	9.0
Policy Interest Rate, % eop	5.00	5.00	3.50	3.50	4.50	4.25	2.50	3.00	4.00
1 month inter-bank rate, % eop	5.37	5.41	3.56	3.46	4.57	4.01	2.62	3.32	4.07
Long-term yield, % eop	5.93	5.46	6.24	6.07	5.91	3.73	4.40	4.80	5.10
PLN/US\$, eop	2.47	2.97	2.87	2.97	3.45	3.09	3.11	2.95	2.85
PLN/US\$, avg	2.76	2.39	3.10	3.01	2.96	3.25	3.20	3.00	2.89
PLN/EUR, eop	3.60	4.15	4.10	3.97	4.47	4.08	4.20	4.13	4.00
PLN/EUR, avg	3.78	3.52	4.32	3.99	4.12	4.18	4.23	4.17	4.04
Balance of Payments, USD bn									
Current account	-26.5	-34.9	-17.3	-24.1	-25.8	-18.2	-7.7	-13.6	-21.3
% of GDP	-6.2	-6.5	-4.0	-5.1	-5.0	-3.7	-1.5	-2.4	-3.4
Trade balance	-19.1	-30.7	-7.6	-11.8	-14.1	-6.7	4.5	1.7	-3.0
Exports	145.3	178.7	142.1	165.9	195.2	190.9	207.6	243.0	278.9
Imports	164.4	209.4	149.7	177.7	209.3	197.6	203.1	241.3	281.9
Service balance	4.8	5.0	4.8	3.1	5.7	6.0	8.3	9.9	10.6
Income balance	-16.4	-12.8	-16.6	-19.1	-23.6	-22.7	-24.9	-30.8	-35.7
FDI, net	18.0	10.4	8.5	6.9	12.3	5.2	3.2	4.0	6.0
International reserves	54.6	57.2	69.7	81.4	86.8	96.1	97.5	90.6	91.8
Total amortisations	43.0	44.0	46.9	43.4	42.8	44.5	47.2	44.9	43.6
Public Finances, % of GDP									
Consolidated government balance	-1.9	-3.7	-7.5	-7.9	-5.0	-3.9	-4.6	5.2	-2.6
Consolidated gov primary balance	0.4	-1.5	-4.9	-5.2	-2.3	-1.1	-1.9	7.8	-0.1
Public debt	44.8	46.9	49.8	52.8	53.5	52.7	54.7	47.4	46.9
of which Domestic	34.3	34.8	36.7	38.4	36.5	36.1	37.1	30.1	30.3
Foreign Assets & Liabilities, USD bn									
External debt	233.3	244.8	280.2	317.1	323.3	365.7	363.0	351.0	345.0
Public	86.8	69.4	92.2	116.5	120.2	137.6	136.5	132.0	129.8
External debt / GDP	54.7	45.9	64.7	67.4	62.6	74.6	71.4	61.8	55.2
External debt / XGS	133.9	114.2	163.8	159.6	138.9	159.8	146.0	120.7	103.4
Short-term debt	60.9	65.9	70.0	77.2	71.9	70.5	75.4	73.4	72.4
Short-term debt/International reserves (%)	111.4	115.1	100.4	94.9	82.8	73.3	77.3	81.0	78.9
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	1.2	1.9	2.4	2.5	2.9	3.3	3.8	3.4	3.4
CPI, % yoy	0.2	1.0	1.1	1.6	2.1	2.2	2.2	2.9	3.0
Policy interest rate, % eop	2.75	2.50	2.50	2.50	2.50	2.75	3.00	3.50	3.75
Short-term market rate, % eop	2.66	2.41	2.62	2.62	2.62	2.90	3.32	3.67	4.07
Long-term yield, % eop	3.99	4.52	4.40	4.55	4.70	4.75	4.80	4.90	4.95
PLN/EUR, eop	4.32	4.22	4.20	4.19	4.18	4.16	4.13	4.09	4.06

Source: National Sources, Citi Research forecasts

Romania

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- **Summary view** — The excessive reliance on net exports and the absence of a meaningful pick-up in domestic demand cast doubt on the sustainability of the country's fragile recovery.
- **Things to watch** — Political stability ahead of the 2014 presidential election and the implementation of the new IMF-EU supported economic program deserve close monitoring.
- **Strategy** — Although the authorities' decision to opt for a new IMF program bodes well for the leu outlook, the possibility of the NBR keeping short-term rates lower than warranted by fundamentals overshadows the currency outlook.

Still waiting for domestic demand to recover

At 4.1%YoY, Romania's 3Q GDP print came in considerably stronger than the consensus (3.5%YoY) and our projection (3.0%). Standing at 1.6% QoQ (SWDA), there was a strong increase in growth momentum with respect to the previous quarters (0.6%QoQ in 2Q and 0.4% in 1Q). The noted outcome is largely driven by this year's bumper crop, as the country's demand recovery remains considerably behind its regional peers since the deleveraging process continues to be a significant drag on private consumption and investment spending. Consequently, the excessive reliance on net exports continues to overshadow the growth outlook.

In light of the developments to date, we see 2013 GDP growth at 2.5% and continue to look for a moderate pick-up in economic activity going forward. Specifically, we expect growth drivers to switch from net exports to domestic demand – private investment in particular owing to the likely acceleration in the absorption of EU funds – with GDP growth reaching 2.8% in 2014. We note that the balance of risks to the outlook appear tilted to the downside, given Romania's relatively high external debt rollover needs. Moreover, the banking system remains heavily dependent on parent funding, exposing the economy to spillover risks from the euro area, and is vulnerable to currency depreciation given substantial FX lending.

Inflation: A repeat of 2013 is unlikely

Inflation is expected to decline to around 2% in 2013 from 5% in 2012 due to benign food prices and the VAT reduction for some bakery products. The inflation outcome in 2013 has turned out to be much better than our expectations at the outset of the year. Moreover, forward looking inflation expectations and core measure have also displayed significant improvements. Nonetheless, we believe that a similar performance will be hard to repeat in 2014. Specifically, a quick glance at the CPI components suggests that the strong downward trend in food inflation is probably losing steam, as service prices remain sticky. With the favorable effect of the VAT reduction fading away (from September 2014) and food prices normalizing, we expect inflation to reach about 3% by the end of 2014. The possibility of a reversal in food inflation and a weaker leu emerge as the key risk factors that require close monitoring. Our inflation forecast trajectory is fairly similar to that of the NBR, which sees the annual CPI inflation rate declining temporarily below the lower bound of the ± 1 percentage point variation band around the 2.5% flat annual target in 2014 H1, before returning inside the band in 2014 Q3 and remaining there until the projection horizon.

NBR is set to maintain its accommodative stance

In light of the recent developments – the ECB’s unexpected rate cut, the November Inflation Report and Governor Isaescu’s remarks – we believe that a 25bp easing in 1Q 2014 is likely. Barring a stronger leu, however, we believe that there is not much room left for further easing in 2014. Looking ahead, as was pointed out by the Governor, it looks like the NBR will continue to keep money market rates well below the policy rate. This strategy is underpinned by the notion that the excess liquidity in the market will eventually lead banks to give credit. However, since supply-side related obstacles (such as lower parent funding) also play an important role in undermining banks’ ability/willingness to extend credit, we remain skeptical about the effectiveness of this approach. More importantly, we also believe that the NBR’s current strategy leaves the currency vulnerable.

Reform fatigue and growth risks cloud fiscal outlook

Standing at around RON 8.1 billion, the budget gap in the first nine months of the year is wider than the deficit seen in the same period of 2012 (RON 7.2bn). While revenues during the period under consideration increased by about 4.4%YoY, expenditures were up by about 4.9%. In light of the developments so far, the revised target for the 2013 budget deficit of 2.5% of GDP (in cash terms) seems within reach. However, meeting the 2014 budget deficit target of 2.2% of GDP (in cash and ESA terms) will be challenging, particularly if growth disappoints. Looking ahead, under the umbrella of the new IMF program, the authorities will focus on: (i) reducing SEO arrears; (ii) enhancing service delivery through greater transparency, and improved governance and oversight; (iii) improving the pricing framework and efficiency of the energy and transportation sectors. We believe that a weaker-than-expected growth, risks of reform fatigue and political noise in the run-up to the 2014 presidential election overshadow the fiscal outlook.

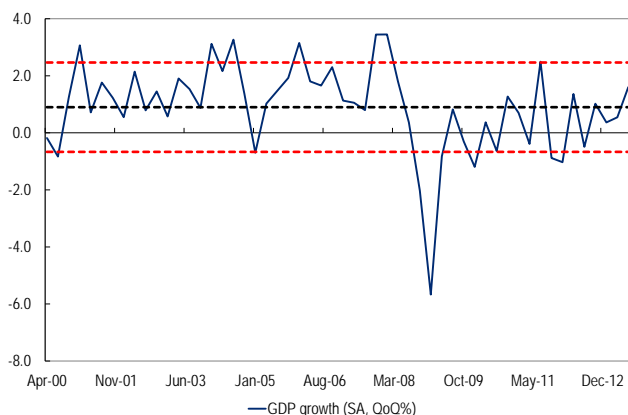
While external adjustment has surpassed expectations...

Projected at 1.2% of GDP, the current account gap is set to narrow more than our expectations at the outset of the year. In fact, standing at €0.6bn in the first nine months of the year, the current account deficit turned out to be considerably narrower than the deficit seen in the same period of 2012 (€4.8bn). 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 3.0% of GDP this year.

... leu is likely to face a challenging environment in 2014

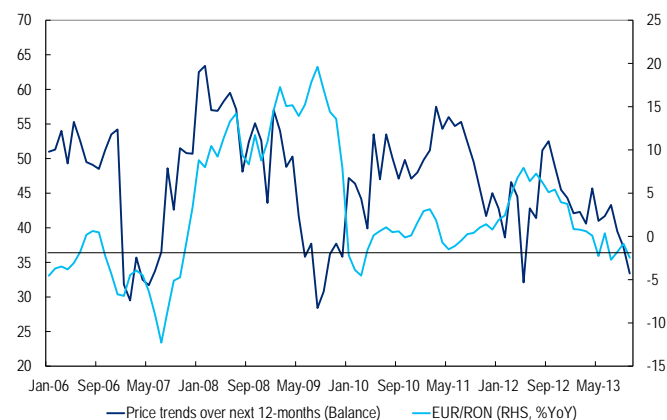
The leu volatility seems to have picked up recently, which may, in part, reflect the NBR’s increased tolerance for FX volatility. In our view, this is partly driven by the NBR’s accommodative stance, as money market rates have been hovering considerably below the policy rate. Looking ahead, while the authorities’ decision to opt for a new IMF program bodes well for the leu outlook, the possibility of the NBR keeping short-term rates lower than warranted by fundamentals overshadows the currency outlook.

Figure 210. While 3Q GDP reading is encouraging ...



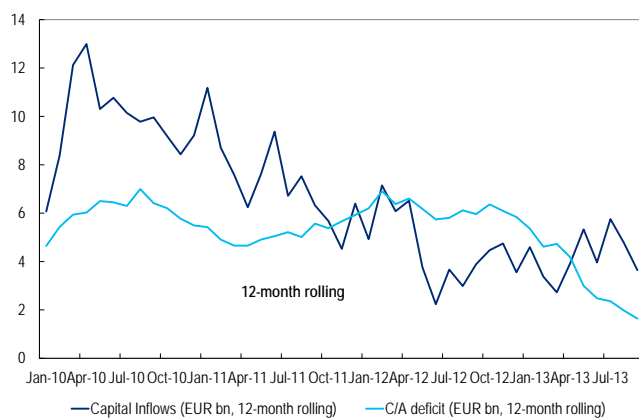
Source: Haver Analytics

Figure 212. ...which, coupled with benign inflation expectations,...



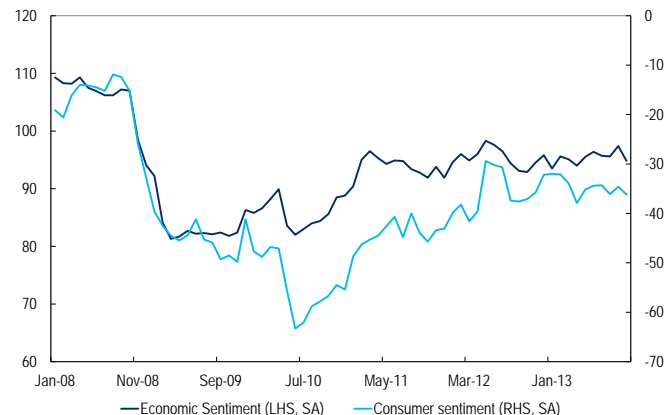
Source: Haver

Figure 214. Despite the impressive external adjustment,...



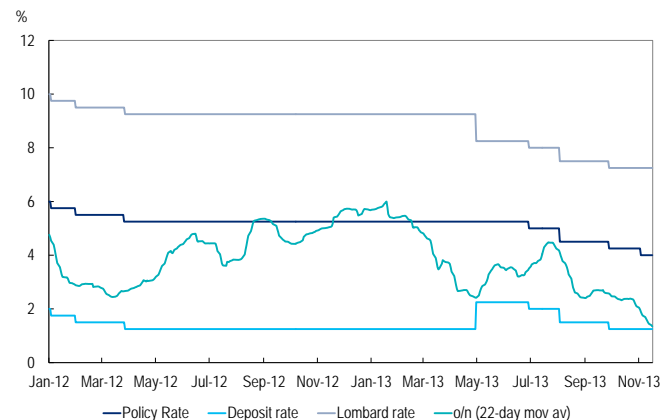
Source: Haver and Citi Research

Figure 211. ...prospects for demand recovery look dim...



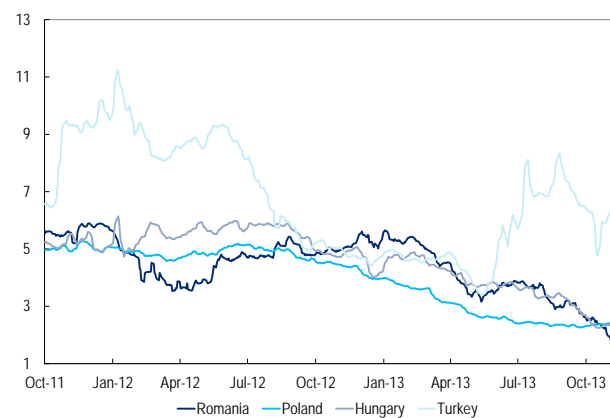
Source: Haver Analytics and Citi Research

Figure 213. ... leads the NBR to keep its accommodative stance



Source: Haver Analytics and Citi Research

Figure 215. ...NBR's expansionary stance clouds the leu's performance



Source: Bloomberg and Citi Research Note: 3-month forward implied yields

Figure 216. Romania Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	171	204	165	165	183	172	188	204	218
Nominal GDP, local currency bn	416	515	501	524	557	595	627	656	696
GDP per capita, USD	7,653	9,176	7,397	7,413	8,236	7,747	8,488	9,239	9,907
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	5.2	5.5	5.5
Economic Activity									
Real GDP, yoy avg	6.3	7.9	-6.8	-0.9	2.3	0.4	2.5	2.8	3.3
Real investment growth % yoy	40.6	4.0	-33.4	9.1	12.9	1.0	-6.6	2.8	3.3
Real consumption growth % yoy	10.6	9.3	-9.0	-0.8	1.2	1.0	0.3	2.0	3.2
private consumption growth % yoy	12.0	9.5	-10.4	-0.3	1.2	1.0	0.3	2.1	3.5
Real export growth, % yoy	7.7	7.6	-6.3	14.2	10.9	-3.1	9.0	4.5	4.5
Real import growth, % yoy	27.8	7.6	-21.4	12.5	10.3	-0.8	0.5	3.0	4.0
Prices, Money & Credit									
CPI, % yoy	6.6	6.3	4.7	8.0	3.1	5.0	2.0	2.9	2.5
CPI, % avg	4.8	7.9	5.6	6.1	5.8	3.3	4.1	1.9	2.7
Nominal wages, % yoy	22.6	23.6	8.4	2.5	4.9	5.0	5.1	5.0	4.5
Credit extension to private sector, % yoy	60.4	33.7	0.9	4.7	6.6	1.3	-1.5	5.9	9.3
Policy Interest Rate, % eop	7.50	10.25	8.00	6.25	6.00	5.25	4.00	3.75	5.00
1 month inter-bank rate, %, eop	8.24	15.35	10.60	4.05	5.72	6.04	4.60	4.35	5.50
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/US\$, eop	2.47	2.89	2.96	3.17	3.33	3.37	3.29	3.21	3.18
RON/US\$, avg	2.43	2.50	3.04	3.17	3.04	3.46	3.34	3.22	3.19
RON/EUR, eop	3.61	4.03	4.24	4.24	4.32	4.45	4.45	4.50	4.45
RON/EUR, avg	3.33	3.68	4.24	4.21	4.24	4.46	4.42	4.48	4.46
Balance of Payments, USD bn									
Current account	-22.9	-23.8	-6.8	-7.3	-8.3	-7.5	-2.3	-6.3	-9.2
% of GDP	-13.4	-11.6	-4.2	-4.4	-4.5	-4.4	-1.2	-3.1	-4.2
Trade balance	-24.4	-28.1	-9.6	-10.1	-10.3	-9.5	-6.2	-8.9	-12.4
Exports	40.5	49.6	40.5	49.6	63.0	57.9	62.9	70.9	78.0
Imports	64.9	77.7	50.1	59.6	73.3	67.4	69.1	79.8	90.4
Service balance	0.6	1.0	-0.4	0.5	0.5	1.5	3.0	0.6	0.7
Income balance	-5.7	-5.4	-2.6	-2.5	-3.1	-3.9	-3.4	-3.2	-3.5
FDI, net	9.7	13.7	5.0	3.0	2.6	2.9	2.0	2.3	2.8
International reserves	37.3	36.5	39.4	42.3	42.4	41.6	45.1	48.8	51.2
Total amortisations	12.2	18.1	17.7	19.7	19.6	25.0	32.6	35.7	37.1
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	40.5	41.2	40.4	39.9
of which Domestic	10.2	12.6	15.4	19.8	22.0	18.2	17.2	15.3	14.4
Foreign Assets & Liabilities, USD bn									
External debt	80.3	105.8	113.0	122.4	137.3	129.7	138.8	146.8	152.7
Public	13.9	14.2	19.6	24.8	28.9	34.2	40.6	46.2	50.4
External debt / GDP	47.0	51.8	68.7	74.3	75.2	75.6	74.0	72.0	70.0
External debt / XGS	160.8	169.4	224.4	209.7	187.8	188.7	185.8	174.3	165.5
Short-term debt	28.7	28.5	22.5	26.2	29.5	28.0	25.7	28.0	29.4
Short-term debt/International reserves (%)	77.1	78.1	57.0	61.9	69.7	67.3	57.0	57.3	57.4
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	1.5	4.1	2.1	3.4	3.4	2.4	2.4	2.6	2.9
CPI, % yoy	5.4	1.9	2.0	1.3	1.3	2.7	2.9	2.8	2.7
Policy interest rate, %, eop	5.25	4.25	4.00	3.75	3.75	3.75	3.75	4.25	4.50
Short-term market rate, % eop	5.75	4.75	4.50	4.25	4.25	4.25	4.25	4.75	5.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/EUR, eop	4.46	4.46	4.45	4.45	4.47	4.48	4.50	4.48	4.47

Source: National Sources, Citi Research forecasts

Russia

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- **Summary view** — Weak growth is raising the pressure for some sort of policy response. Ideally, this would involve a 'positive shock' to the investment climate, but, in our view, the more likely response is easier monetary conditions and a rise in the public debt/GDP ratio.
- **Things to watch** — Growth will likely pick-up pace in 2014 on account of a favorable base and economic recovery in Europe, although headwinds from less robust consumer spending and constrained investment should continue to hamper economic prospects.
- **Strategy** — The expected transition from a current account surplus to a current account deficit over the next couple of years will put structural pressures on the currency. Cyclical pressures will also weigh on the currency, as tapering fears should weaken the RUB to 38.5 within the next six months.

Growth is very weak, but modest recovery is on the cards

GDP growth has continued to disappoint. The preliminary 3Q GDP estimate surprised on the downside, with growth eking out a meagre 1.2%YoY, bringing year-to-date performance to only 1.3%. Expectations that 3Q GDP performance would be lifted by a much-improved harvest were dashed, as September turned out to be the rainiest month on record. More granular data paints a similar picture with industrial production flat so far in the year and investment spending growth down by almost a percent YoY during Jan-Oct. Consumer spending remains the one bright spot in the economy, with real retail sales expanding by almost 4.0%YoY so far in the year. Still, we are looking at a very subdued 1.4% full-year growth in 2013.

Economy activity should recovery modestly into year-end and 2014. Recent PMI indicators offer some hopes for mildly strengthening economic performance in 2014, but this is mainly related to expectations of stronger net exports to a slowly recovering Europe and a favorable base. However, investment spending will be constrained by the government's decision to freeze tariffs next year while consumer spending, while still robust, will likely moderate on decelerating retail lending, increased consumer indebtedness and more stringent regulatory oversight. As a result, we see 2014 growth gaining some momentum to 2.6%YoY.

The central bank has so far firmly resisted pressure to cut rates, but disinflation expectations may lead to mild easing in 2014. The CBR has disregarded struggling economic growth despite its admission that economic activity is now below potential, justifying its actions by pointing to inflation, which has stubbornly remained very close to, but still above the 5-6% 2013 target. The new monetary policy guidelines for 2014-16, released by the CBR in early November, targets 5% headline inflation in 2014. In our view, the achievement of this goal will be facilitated by the still-weak economic growth and the government's decision to freeze the utility tariffs paid by industry next year, and to charge households an increase that is 0.7 times the 2013 CPI. While this is a less-generous deal on tariffs than the government had previously suggested – when it had proposed a freeze for households – the deal is likely to be sufficient to push inflation towards 5% in 2014, from 6% at the end of this year. The CBR may have already opened the door to easier monetary policy into 2014 by recently removing a sentence from its policy statement about rates being appropriate in the near future.

Russia long-term growth 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 November 6th, the Ministry of Economy revised its long-term macro-economic forecast until 2030. The average GDP growth for 2013-2030 will be 2.8% down from the 4.3% expected only in March. As a result, Russia's share in world GDP is anticipated to fall to 3.4% by 2030 compared to 4% in 2012. More worryingly, the forecasts suggest that income inequality will widen while the share of the middle class in 2030 will shrink to a third from a half now.

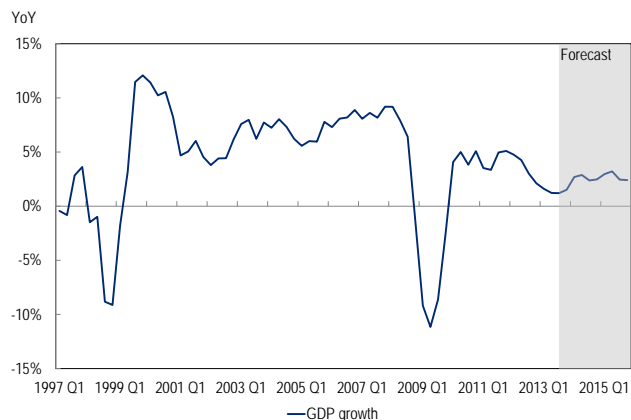
The recently adopted 2014-2016 budget framework preserves overall fiscal prudence, but entrenches structural weaknesses in the economy. Budget deficits are to be kept below 1% of GDP as mandated by the fiscal rule. However, military expenditures rise significantly as a share of overall federal outlays – from 15.7% in 2013 to 22% in 2016. As a share of GDP, defense spending rises from 3.2% in 2013 to 3.8% by 2016. This is achieved by curtailing education and health expenditures. For example, the share of health spending falls from almost 4% in 2013 to only 2.2% in 2016 despite the well-recognised longer-term demographic issues in the country. Similarly, education spending is reduced to 3.9% in 2016 from 5.1% in 2013. Thus, the budgetary framework entrenches already existing structural weaknesses, which we believe poses longer-term risks to the development of Russia as a competitive global EM economy.

A judicious and moderate increase in public indebtedness may offer the only chance of boosting economic potential. Ideally, medium- to longer-term economic performance should be lifted by economic reforms centred on improving labor productivity via private initiative and less regulation. Unfortunately, recent U-turns on previously stated privatization plans and pension reforms offer little hope that such avenues will be pursued. In our view, the only remaining viable option then would be for Russia to take advantage of its excellent balance sheet and embark on a moderate increase in its public debt/GDP ratio, the focus of which should be investment in infrastructure aimed at boosting potential growth. Such an approach may also be easier to defend politically given the upcoming 2016-2018 election cycle.

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 that 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 weigh on medium-term rouble prospects.

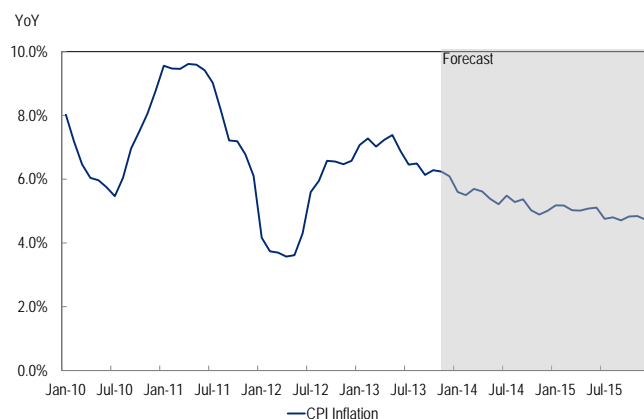
Cyclical developments are also rouble negative. The current account surplus is already collapsing: just US\$1.1bn in Q3, with the prospect of an overall surplus this year of just over US\$30bn, a level not seen since the early 2000s. With expectations of tapering in the US and monetary easing in Russia gathering strength, the interest rate differential will also be against the rouble, while the currency could also suffer from reversals in the foreign ownership of OFZ. As a result, we see the rouble weakening against the basket towards 38.5 within the next six months.

Figure 217. Growth struggles, but modest recovery is on the cards



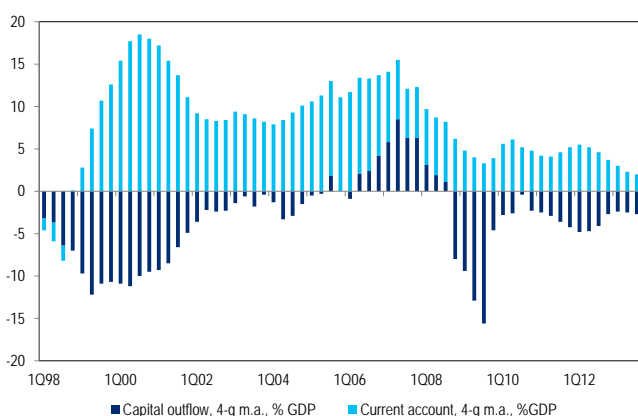
Source: Rosstat, Citi Research

Figure 219. CBR will miss its 2013 inflation target of 5-6%...



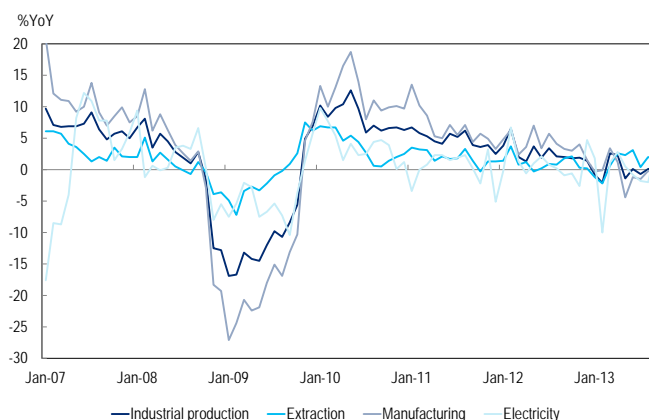
Source: Rosstat, Citi Research

Figure 221. The gradual disappearance of the current account...



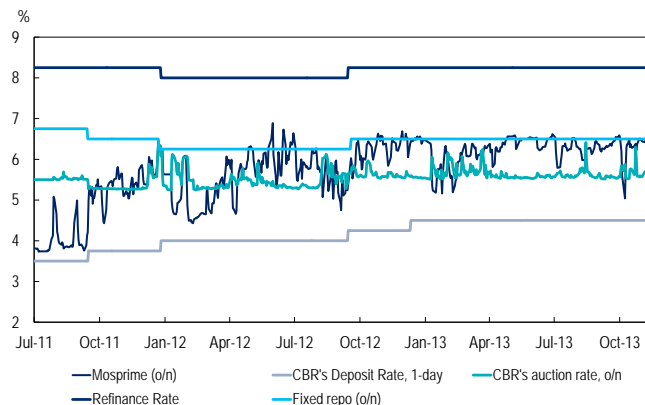
Source: CBR, Citi Research

Figure 218. Industrial activity is still weak



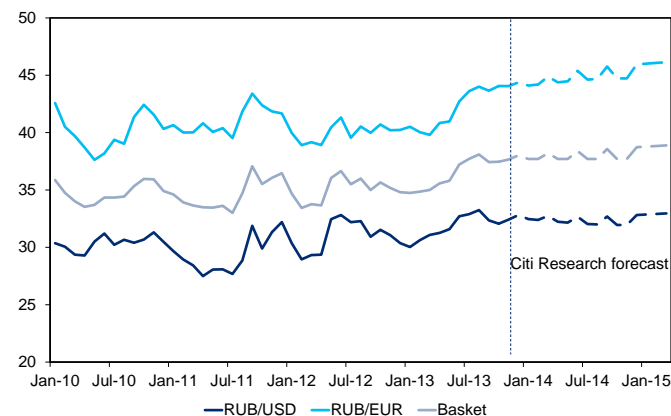
Source: Rosstat, Citi Research

Figure 220. ...and keep policy rates unchanged until 1Q14



Source: Bloomberg, Citi Research

Figure 222. ...we are looking for weaker ruble in 1H 2014



Source: Bloomberg, Citi Research

Figure 223. 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	1,897	2,012	2,116	2,254	2,442
Nominal GDP, local currency bn	33,248	41,277	38,807	46,309	55,800	62,599	67,749	73,231	79,666
GDP per capita, USD	9,081	11,585	8,554	10,611	13,227	14,055	14,815	15,820	17,183
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	5.6	5.7	5.8
Economic Activity									
Real GDP, yoy avg	8.5	5.2	-7.8	4.5	4.3	3.4	1.4	2.6	2.7
Real investment growth % yoy	22.0	10.5	-41.0	28.5	22.6	6.6	0.1	3.6	4.3
Real consumption growth % yoy	10.7	8.4	-3.9	3.5	4.8	5.0	3.3	3.5	3.4
private consumption growth % yoy	14.2	10.4	-5.1	5.5	6.3	6.7	4.4	4.2	4.1
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	7.2
Prices, Money & Credit									
CPI, % yoy	11.9	13.3	8.8	8.8	6.1	6.6	6.1	5.0	4.7
CPI, % avg	9.0	14.1	11.6	6.8	8.4	5.1	6.7	5.3	4.9
Nominal wages, % yoy	26.0	27.4	9.1	12.8	11.7	13.3	13.0	13.5	12.9
Credit extension to private sector, % yoy	49.3	37.2	2.6	12.9	28.1	19.4	18.0	15.0	15.0
Policy Interest Rate, % eop	10.00	13.00	8.75	7.75	8.00	8.25	8.25	7.75	7.25
1 month inter-bank rate, %, eop	6.09	20.20	6.32	3.78	6.37	6.90	6.26	5.58	4.96
Long-term yield, %, eop	6.58	10.90	9.45	8.23	8.77	7.04	7.76	7.58	6.96
RUB/US\$, eop	24.6	30.5	30.3	30.6	32.2	30.6	32.8	32.8	33.3
RUB/US\$, avg	25.6	24.9	31.7	30.4	29.4	31.1	32.3	32.7	33.1
RUB/EUR, eop	35.9	42.7	43.4	40.9	41.7	40.3	44.4	46.0	46.6
RUB/EUR, avg	35.1	36.6	44.2	40.3	41.0	40.0	42.7	45.5	46.4
Balance of Payments, USD bn									
Current account	72.2	103.9	50.4	67.5	97.3	72.0	34.0	24.0	18.6
% of GDP	5.5	6.2	4.1	4.4	5.1	3.6	1.6	1.1	0.8
Trade balance	123.4	177.6	113.2	147.0	196.9	192.3	168.6	164.0	154.0
Exports	346.5	466.3	297.2	392.7	515.4	528.0	523.6	536.7	552.8
Imports	223.1	288.7	183.9	245.7	318.6	335.7	355.0	372.8	398.8
Service balance	-16.7	-20.4	-17.6	-26.1	-33.5	-46.5	-63.0	-65.0	-59.9
Income balance	-28.8	-46.5	-39.7	-47.1	-60.4	-67.7	-67.6	-70.0	-70.5
FDI, net	11.1	19.1	-6.7	-9.4	-11.8	-18.1	12.4	22.3	10.0
International reserves	466.4	410.7	405.8	432.9	441.2	473.1	468.3	457.2	450.9
Total amortisations	28.5	47.2	49.9	40.8	52.0	90.5	67.7	67.7	77.0
Public Finances, % of GDP									
Consolidated government balance	6.7	5.2	-5.7	-3.2	2.1	-0.7	-2.0	-4.3	-4.9
Consolidated gov primary balance	5.8	4.4	-5.4	-3.4	1.2	0.6	1.0	1.2	0.8
Public debt	6.6	5.2	7.3	7.6	8.2	7.7	7.7	10.4	14.0
of which Domestic	3.8	3.4	4.7	5.3	6.4	5.8	5.6	8.1	11.6
Foreign Assets & Liabilities, USD bn									
External debt	471.2	480.6	467.3	488.9	538.9	636.4	708.7	730.9	773.9
Public	37.4	29.5	31.3	34.5	34.7	38.1	44.5	51.3	57.3
External debt / GDP	36.1	28.9	38.0	32.1	28.4	31.6	33.5	32.4	31.7
External debt / XGS	120.7	91.8	136.3	110.7	94.0	107.8	122.2	123.8	128.6
Short-term debt	99.7	73.6	52.7	60.2	68.2	81.5	94.6	107.6	118.4
Short-term debt/International reserves (%)	21.4	17.9	13.0	13.9	15.5	17.2	20.2	23.5	26.3
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	1.2	1.2	1.5	2.7	2.9	2.4	2.5	3.0	3.2
CPI, % yoy	6.9	6.1	6.1	5.7	5.2	5.4	5.0	5.0	5.1
Policy interest rate, %, eop	8.25	8.25	8.25	8.00	7.75	7.75	7.75	7.50	7.25
Short-term market rate, % eop	6.71	6.53	6.26	6.21	5.79	5.64	5.58	5.31	5.12
Long-term yield, %, eop	7.93	7.62	7.76	7.81	7.79	7.64	7.58	7.33	7.12
RUB/US\$, avg	31.7	32.8	32.8	32.7	32.7	32.7	32.8	33.0	33.1

Source: National Sources, Citi Research forecasts

Slovakia

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- **Summary view** — Exports are likely to continue to be supportive for growth, due to stronger investment activity, while consumption is likely to pick up at a later date because of a weaker labour market recovery and limitations of fiscal policy.
- **Things to watch** — Presidential election could influence economic policy in the long-term if PM Fico were to lose the election. The large errors and omissions in the balance of payments points to a risk of downward revision to GDP.
- **Strategy** — Government has a strong need for cash to avoid an enforced balanced budget, which is a risk if government debt exceeds 57% of GDP.

Solid recovery ahead after avoiding the recession

While the improvement in overall economic sentiment slowed in October, it still supports our expectation of ongoing positive GDP in 4Q 13 (0.2%QoQ), which would likely lead to YoY growth accelerating to 0.9% by the end of 2013. As a result, we leave our full-year 2013 forecast at 0.8%YoY. While the Q3 number was in line with our expectations, it was still somewhat disappointing given the better-than-expected industrial output data for September. We think that net exports may have acted as a drag on QoQ growth. The economy was probably supported by the construction sector in 3Q, which had shown the first positive QoQ growth (2.8%) following nine consecutive quarters of contraction. While the carry-over effect suggests the contraction in construction output will ease zero during in late 1Q14, it is only partly supported by a mild improvement in construction confidence. At the same time, we think that industrial production will accelerate in 4Q to 8%YoY from 3.7% in 3Q, though this was probably driven by base effects from December last year – something that will also influence 2014 dynamics, which we expect to decelerate to 4.7%, before accelerating to 6% in 2015.

We continue to believe GDP growth will rise to 1.8%YoY in 2014, accelerating further in 2015 to 2.4%. The recovery reflects our expectation of more robust quarterly growth through 2014 (0.7%) supported by a stronger foreign demand outlook. This will likely be limited by more fiscal tightening to avoid an enforced balanced budget due to the debt brake rule. Our expectations for growth are below the autumn European Commission forecast of 0.9%, 2.1% and 2.9%YoY for 2013-2015, which is close to the MinFin's forecast of 0.8%, 2.2% and 2.9%, respectively. However, we think the risk of downward revision to GDP remains, if the large errors and omissions on the balance of payments were to continue, amounting to some 5% of GDP, which would likely have negative implications for some GDP ratios, such as fiscal debt-to-GDP, which could be higher by 0.8%pt if there were a 1.5% downward revision in nominal GDP. In spite of this, we do not think that these developments will affect external vulnerability indicators, such as the current account excluding reinvested earnings, which we expect to reach a surplus above 4% of GDP. Despite ongoing solid economic growth, employment remains in contractionary territory (-0.8%YoY) although it remained flat on QoQ basis after five quarters of average contraction of 0.2%. At the same time, inflationary pressure remains weak and recent disinflation suggests 2013 CPI growth will come in at 1.4%YoY. We think inflation will ease further in 2014 (1.1%YoY) before rising to 2% in 2015 and 2.4% in 2016. Our expectation that inflation will remain low reflects a milder increase in core inflation, food prices and a negligible increase in regulated prices. The unemployment rate is likely to come in at around 14.3% this year and 2014 (2012: 13.6%), before falling modestly to 13.7% and 12.9% for 2015 and 2016, respectively.

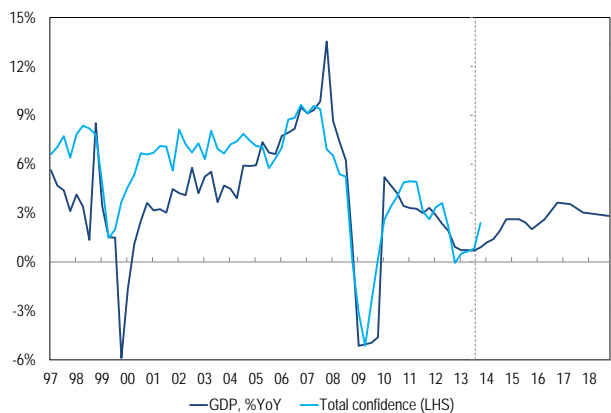
Fiscal policy has a fight on two fronts – EC & debt rule

The government plans to continue fiscal consolidation due to the large output gap. The official target for the general government deficit, following 2.9% of GDP this year, is 2.9%, 2.6% and 1.5% for 2014 to 2016, respectively. However, this plan requires a large surplus of €300-€600mn to be generated by the rest of the government and consolidation measures to raise €0.7-€1.5bn for 2014-16. Otherwise, the central government cash deficit would widen by €0.8-€1bn over the next three years. In response, the government has prepared consolidation measures worth €500-€600mn (in particular more effective governance and moves to combat the grey economy. The Commission highlighted that the consolidation measures in 2013 and 2015 were concentrated on the revenue side, with extra one-offs in 2013 – the sale of the oil reserve and transfers from the 2nd pension pillar. The consolidation for 2014 is supported by dividends and an extended period of paying extra tax for regulated companies. With a possible decrease in the VAT rate (by 1%pt to 19%) and no further measures being mooted after 2014 suggests that the fiscal deficit will widen to 3.8% in 2015 from around 3% this year and next. If no new measures are introduced this, along with the wider structural deficit of close to 3% of GDP for 2014/5 could put the exit of the Excessive Deficit Procedure at risk. However, we think new measures are likely given the Commission's outlook that government debt will increase from an estimated 54.3% of GDP this year to 57.2% in 2014, to 58.1% in 2015, despite privatization and extra dividend revenues. While the debt brake rule (if debt rises above 57% of GDP) suggests the budget would have to balance in 2014, we think that this scenario is not so likely given the larger buy-backs done by debt manager ARDAL. According to the debt rule, the government will have to freeze 3% of expenditures excluding debt services, EU-related expenditure and social expenditures in 2015, and will have to propose no spending growth for 2016. If government debt breaches 57% of GDP in 2014, it will have to propose a balanced budget by 2016, requiring a consolidation effort of more than €3bn. We think there is a risk government debt will breach the 57% ratio due to ESA2010 methodology.

Politics: Will PM Fico run for President?

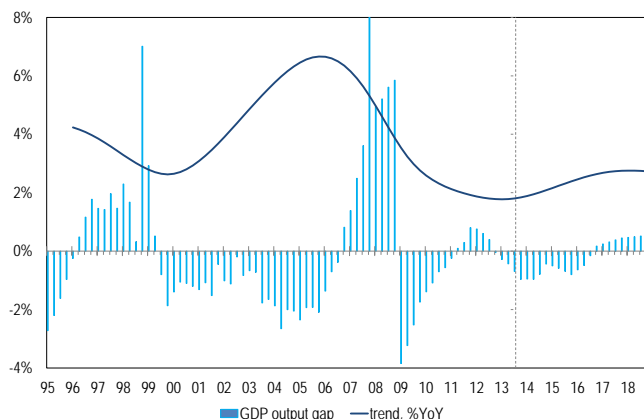
The popularity of the left-wing SMER and PM Fico among voters has remained strong ahead of Presidential election, albeit without a Parliamentary majority. The most watched political event in 2014 is likely to be the Presidential election, which is planned for March-April. While Prime Minister Fico has made no declaration that he will run for the Presidency, we think he may opt to do so rather than run for Prime Minister again. We feel there are many factors that support our view. Firstly, fiscal policy is likely to be even more complicated until the economic recovery becomes stronger, especially as the government's current debt limit of 50-60% of GDP is only temporary and will be gradually lowered by 1%pt every year reaching 40-50% in 2027. At the same time, lawmakers have been reluctant to retain the current brake limits or modify the definition of general government debt to exclude the MinFin from the financing reserve. If Mr Fico were to continue as PM he might have to enact tighter and hence more unpopular fiscal policies that might harm his ability to run for the offices of president or PM in the future. Second, if a right-wing candidate were to win the Presidential election, PM Fico could face stronger opposition to his economic policies. Finally, PM Fico leads voters' preference surveys as favoured presidential candidate, although the polls indicate he doesn't yet have sufficient votes to win in the first round.

Figure 224. October confidence support the recovery ...



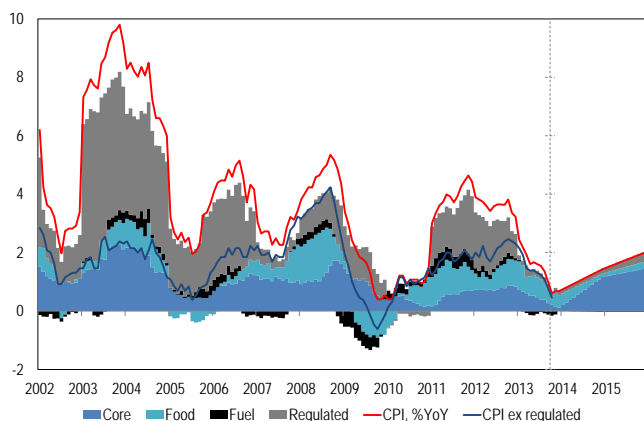
Source: Statistical Office of the Slovak Republic, Citi Research

Figure 226. ... but we expect output gap to be closed in 2016



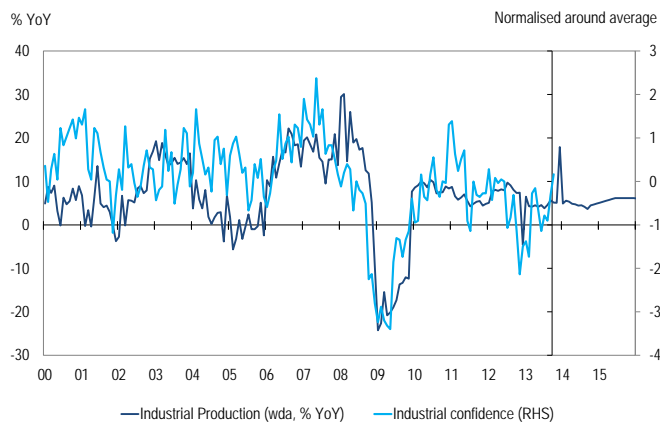
Source: Statistical Office of the Slovak Republic, Citi Research

Figure 228. There is low inflation prospect



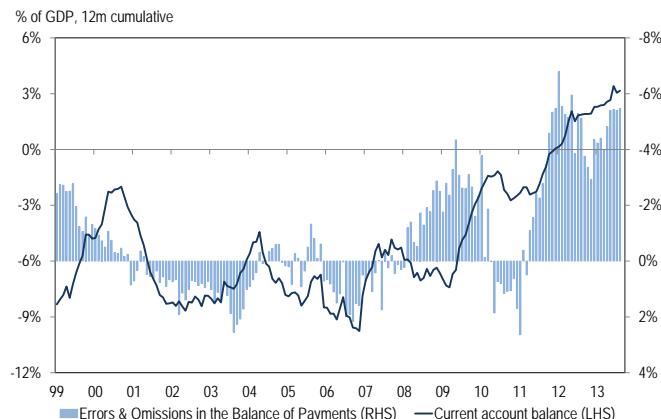
Source: Statistical Office of the Slovak Republic, Haver Analytics, Citi Research

Figure 225. ... driven by surge in industrial expectations



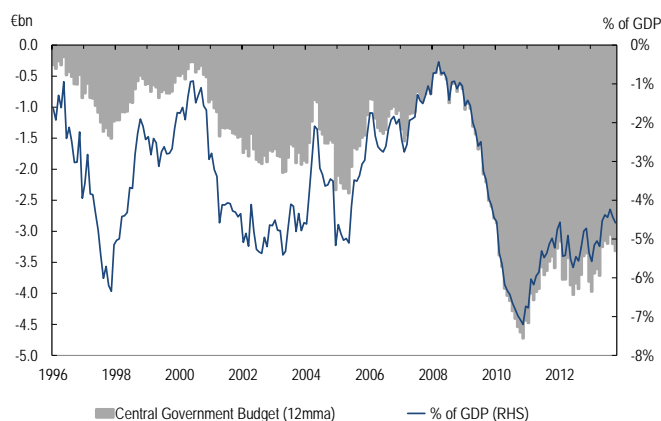
Source: Statistical Office of the Slovak Republic, EC, Citi Research

Figure 227. Large errors in the BoP still suggest negative GDP revision



Source: Haver Analytics, Citi Research calculations

Figure 229. Fiscal consolidation still has to continue



Source: Haver Analytics and Citi Research calculations

Figure 230. Slovakia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	75	95	88	87	96	91	97	104	111
Nominal GDP, local currency bn	61	67	62	66	69	71	73	76	79
GDP per capita, USD	13,936	17,493	16,156	16,087	17,654	16,781	17,864	19,130	20,219
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	14.3	14.4	13.7
Economic Activity									
Real GDP, yoy avg	10.5	5.8	-4.9	4.4	3.0	1.8	0.8	1.8	2.4
Real investment growth % yoy	9.7	4.7	-31.5	20.0	9.5	-16.0	-17.1	-1.2	5.4
Real consumption growth % yoy	5.1	6.1	1.6	-0.3	-1.4	-0.4	0.1	0.7	1.7
private consumption growth % yoy	6.8	6.1	0.2	-0.7	-0.5	-0.2	0.2	0.9	1.7
Real export growth, % yoy	14.3	3.1	-16.3	16.0	12.2	9.9	4.5	5.8	6.2
Real import growth, % yoy	9.2	3.1	-18.9	14.9	9.7	3.3	2.4	6.1	6.3
Prices, Money & Credit									
CPI, % yoy	3.4	4.4	0.5	1.3	4.4	3.2	0.7	1.4	2.0
CPI, % avg	2.8	4.6	1.6	1.0	3.9	3.6	1.4	1.1	1.8
Nominal wages, % yoy	-	-	-	-	-	-	-	2.3	3.1
Credit extension to private sector, % yoy	23.4	16.3	0.9	4.8	8.6	2.8	3.2	3.2	4.2
Balance of Payments, USD bn									
Current account	-4.1	-5.9	-2.3	-3.3	-3.6	2.0	4.2	4.2	3.7
% of GDP	-5.4	-6.2	-2.6	-3.7	-3.8	2.2	4.3	4.0	3.4
Trade balance	-1.0	-1.1	1.3	1.0	1.4	4.6	6.6	4.2	3.2
Exports	64.9	72.9	55.4	64.0	79.0	79.9	87.1	95.5	103.0
Imports	65.9	74.0	54.1	63.0	77.6	75.4	80.4	91.3	99.8
Service balance	0.5	-0.7	-1.4	-1.0	-0.5	0.4	0.8	3.4	4.4
Income balance	-3.2	-2.8	-1.2	-2.7	-4.0	-2.1	-2.4	-2.9	-3.4
FDI, net	3.0	4.3	-0.9	0.8	2.8	1.5	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	-7.7	-5.1	-4.5	-3.4	-3.2	-2.6
Consolidated gov primary balance	-0.4	-0.8	-6.6	-6.3	-3.5	-3.1	-2.0	-1.7	-1.1
Public debt	26.6	27.9	35.7	40.6	43.4	52.4	55.5	57.0	56.4
of which Domestic	18.1	19.0	20.4	25.2	30.6	22.3	31.2	31.2	28.9
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	82.9	81.2	79.4
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 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	0.8	0.8	0.9	1.2	1.4	1.9	2.6	2.6	2.6
CPI, % yoy	1.6	1.0	0.7	0.9	1.1	1.3	1.4	1.6	1.7
Short-term market rate, % eop	0.12	0.13	0.16	0.19	0.16	0.16	0.16	0.16	0.55
Long-term yield, % eop	2.64	3.15	2.80	2.71	2.61	2.61	2.60	2.70	2.69

Source: National Sources, Citi Research forecasts

South Africa

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- **Summary view** — Increased downside risk to 2013 and 2014 GDP forecasts due to labour unrest, limited export recovery and stretched consumer balance sheets.
- **Things to watch** — Revision of the current account adds speculation to its direction but a deficit smaller in size should be positive to ZAR sentiment. SARB to debate between with upside inflation risk and sluggish GDP prospects in 2014.
- **Strategy** — A twin deficit and uncertain labour dynamics sees South Africa's sovereign rating still being watched by rating agencies. ZAR to remain driven by expectations of Fed policy.

No clear driver of economic growth

There is now more downside risk to the 2013 and 2014 GDP outlook. This is mostly on account of prolonged strike action in the motor sector in September. Motor exports, manufacturing production and the PMI took a dive during the month, which we believe is key to why Q3 GDP will slow rapidly to 0.4% QoQ saar from 3.0% QoQ saar in Q2. The significance of Q3 GDP is that it may leave full 2013 economic growth below 2.0%. This follows a significant downgrade in forecasts since the start of the year and adds risk to a sub-2% GDP print, which would affect sentiment negatively. Business confidence remains at a decade-low, suggesting private sector fixed investment will remain geared to near-term capex and replacement. More forceful private sector capex seems unlikely when domestic demand continues to disappoint year after year. While the public sector will continue its infrastructure plans in line with the National Budget's counter-cyclical spending strategy, this is smaller in magnitude and comes at the price of a costly import bill given expected ZAR levels.

Perhaps near-term respite for the consumer but it's only temporary. On balance, the underpin to discretionary spending in Q4 13 and Q1 14 looks favourable to the consumer: CPI is expected to trend downwards, temporary employment may arise ahead of the April 2014 National Elections, wages remain sticky and the government's credit amnesty aims to 'free up' 1.6m consumers from their debt-ridden past. Unfortunately, short-term relief for consumption is not an improvement in consumer health and we believe vulnerable consumer balance sheets will be a key theme in 2014. As an indication of the increase in consumer vulnerability, the household debt to income ratio continues to rise – even more pronounced in actual household debt levels. Even if some disinflation and temporary employment helps lift consumption growth to 3.5% in 2014, we still believe that consumer spending is relatively 'capped' until balance sheets deleverage sufficiently. Regrettably, 5 years of record low interest rates has not prompted this, adding more policy dilemma to the SARB's monetary policy outlook.

Current account revisions are significant. Recent revisions that include more accurate trade data with neighbouring countries has proved significantly positive for the current account, leaving trade deficits since 2010 almost cut in half. Speculation is high ahead of the next current account print; however, we affirm that the trend remains: a widening is difficult to escape from in the near-term given strikes in Q3 and while some narrowing could occur from Q4 13 onwards, limit to global demand, local supply constraints and sticky imports make us wary that after the revision excitement dies down, this current account deficit may prove 'wide' for longer than usual. In fact, history suggests that devoid of a global trigger, the ZAR has not weakened sufficiently to offset the inelasticity of South Africa's import bill.

Domestic vulnerabilities amplify external shocks

ZAR likely to remain an upside risk to the inflation outlook. Market speculation about the impact on the ZAR on inflation continues but in our calculations a wide output gap diminishes the usual 15% coefficient. Despite the limitations of small samples, high-frequency CPI data affirms our view that pass-through has declined to around 10%. This aligns to our view that consumer demand is 'capped' by stretched balance sheets and that it is only the resulting rise in real incomes via some disinflation through 2014 that may allow the recent rise in ZAR-sensitive CPI categories like semi-durables to persist. Nevertheless, we think base effects (in transport and food in particular) are stronger, leaving consumer inflation hovering just below 6% in H1 14 and a touch higher than 5.5% in H2 14. All eyes will remain on core inflation given the general indecision in the consensus on currency pass-through. That said, we believe it is only if core inflation risks touching the 6% target that the market would start becoming increasingly hawkish.

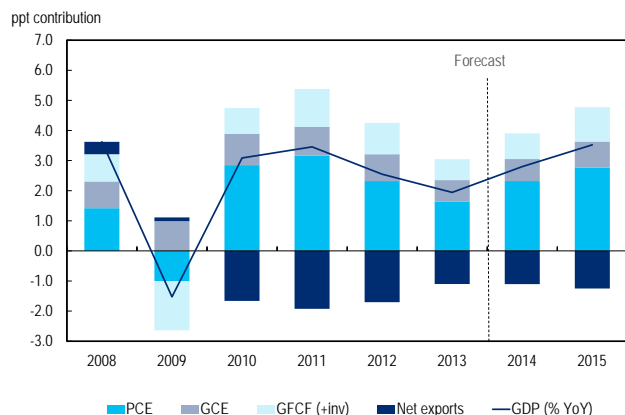
The SARB's outlook hinges on Fed tapering. And as long as the market tries to second-guess the timing of this, the currency will prove a key upside risk to the inflation outlook. Other upside risks are likely to be sticky wages and oil prices, but only if geopolitical tensions arise. We continue to believe that the SARB's fear of a significantly weaker currency will outweigh the sum of all other factors, however, we acknowledge that trade revisions may lessen the fear of South Africa's twin deficit, while a complicated labour market continues to highlight the downside risk to GDP (with the emphasis on Q3 13 GDP due to prolonged strikes in motor manufacturing). We affirm that, on balance, we think the risks will keep the repo rate unchanged at 5.0% through 2014.

Government's intentions are vital in 2014

The government has presented a strong stand against undue state spending but we are not convinced A detailed analysis of spending revisions in the outer years is weak in comparison to the Finance Minister's determined language in the October 2013 Medium-Term Budget. Revenues remain cramped by a poor GDP outlook, while spending is sticky due to infrastructure plans and a growing wage bill. Aside from underlying intentions within government, the budget deficit is forecasted to continue growing over the coming years, leaving debt consolidation further away. We believe this keeps the rating agencies, Moody's and S&P in particular, on watch but we acknowledge there is no rush to act. The February National Budget must first be presented and the country must navigate its April 2014 National Elections. We suspect rating agencies will want to see these results before making a thorough assessment.

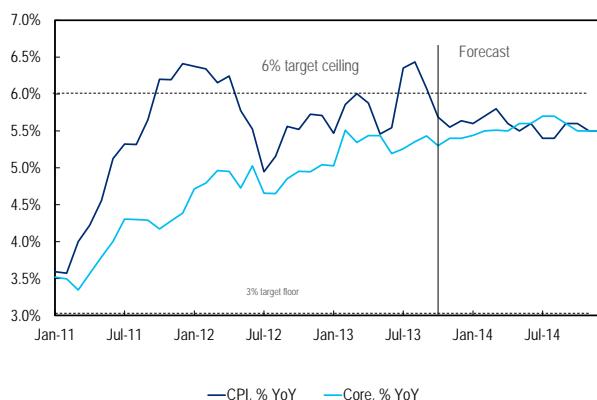
Heightened tensions likely ahead of the April 2014 National Elections. The ruling party, the African National Congress (ANC) is keenly aware of the service delivery failure that has resulted over recent years. If anything, the underpin to violent protests and strikes as of late is evidence of both this and a widespread hunger for income due to sluggish employment creation. The opposition is watching and has increased in size. The well-known Democratic Alliance (DA) won much support in the recent municipal elections, while the recent surge in the popularity of parties such as Agang and the Economic Fighters (EFF) is indicative of a need for progress. We are particularly watchful of the latter given its ability to mobilise members to protest against service delivery failure in the economy.

Figure 231. GDP to remain lackluster in 2013 and 2014



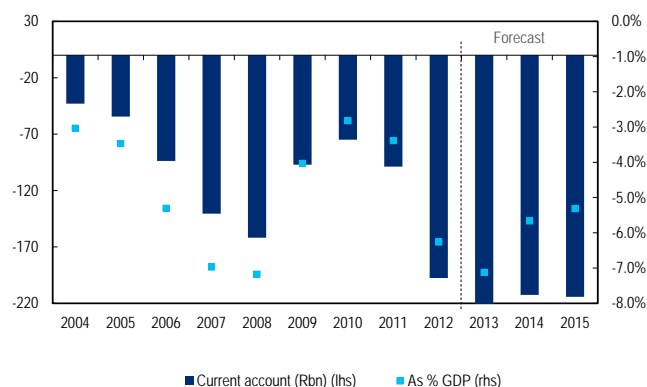
Source: SARB, Citi Research Projections

Figure 233. The CPI will remain at the top of the SARB ceiling in 2H 2013



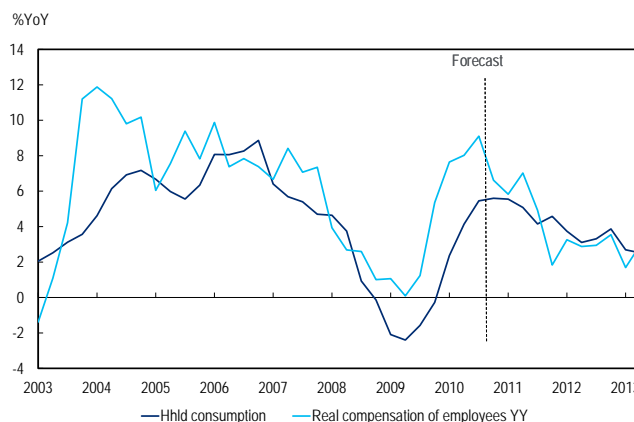
Source: Stats SA, Citi Research projections

Figure 235. No meaningful narrowing in the current account deficit



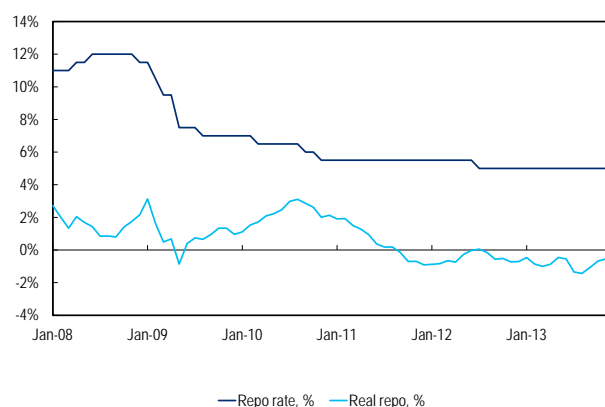
Source: SARB, Citi Research projections

Figure 232. Consumption is slowing as real incomes decelerate



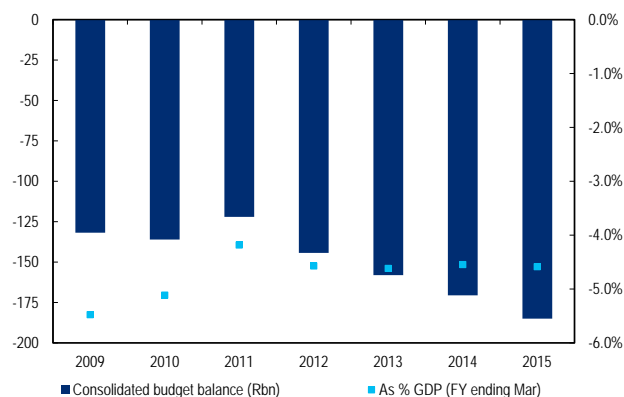
Source: SARB, Citi Research calculations

Figure 234. Rand volatility suggests further Repo rates cuts are unlikely



Source: SARB, Stats SA

Figure 236. Fiscal consolidation will likely be slow



Source: National Treasury, Haver Analytics, Citi Research projections

Figure 237. South Africa Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	286	273	287	364	402	384	347	362	392
Nominal GDP, local currency bn	2,016	2,256	2,406	2,659	2,918	3,155	3,424	3,752	4,032
GDP per capita, USD	5,993	5,613	5,820	7,272	8,039	7,685	6,919	7,203	7,778
Population, mn	47.7	48.7	49.3	50.0	50.0	50.0	50.2	50.3	50.4
Unemployment, % of labour force	23.3	22.9	24.0	24.9	24.9	25.1	25.5	25.0	24.6
Economic Activity									
Real GDP, yoy avg	5.5	3.6	-1.5	3.1	3.5	2.5	1.9	2.8	3.5
Real investment growth % yoy	12.0	4.4	-8.6	4.5	6.3	5.1	3.4	4.1	5.4
Real consumption growth % yoy	5.2	2.8	-0.1	4.6	4.8	3.7	2.7	3.4	4.1
private consumption growth % yoy	5.5	2.2	-1.6	4.4	4.8	3.5	2.5	3.5	4.1
Real export growth, % yoy	6.6	1.8	-19.5	4.5	5.9	0.1	5.4	4.4	5.4
Real import growth, % yoy	9.0	1.5	-17.4	9.6	9.7	6.3	6.4	6.6	7.5
Prices, Money & Credit									
CPI, % yoy	7.6	9.3	6.0	3.4	6.4	5.7	5.6	5.5	5.5
CPI, % avg	6.2	10.0	7.2	4.1	5.0	5.7	5.8	5.6	5.5
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	7.5	8.2	9.0
Policy Interest Rate, % eop	11.00	11.50	7.00	5.50	5.50	5.00	5.00	5.00	6.50
1 month inter-bank rate, %, eop	11.18	11.35	6.94	5.44	5.47	5.02	5.07	5.07	6.57
Long-term yield, %, eop	8.58	7.33	9.05	8.14	7.93	6.39	7.50	7.90	8.00
ZAR/US\$, eop	6.87	9.49	7.41	6.62	8.09	8.46	10.26	10.36	10.26
ZAR/US\$, avg	7.05	8.27	8.41	7.32	7.26	8.21	9.85	10.36	10.29
Balance of Payments, USD bn									
Current account	-19.9	-19.6	-11.6	-10.2	-13.6	-24.1	-24.7	-20.5	-20.8
% of GDP	-7.0	-7.2	-4.0	-2.8	-3.4	-6.3	-7.1	-5.7	-5.3
Trade balance	-5.2	-4.3	0.3	3.7	2.3	-9.2	-12.7	-8.5	-8.2
Exports	76.2	85.3	66.4	85.5	102.8	93.4	87.6	94.2	104.1
Imports	81.4	89.6	66.1	81.8	100.6	102.6	100.3	102.7	112.4
Service balance	-2.7	-4.1	-2.8	-4.4	-4.7	-2.5	-2.4	-2.8	-3.1
Income balance	-9.8	-8.9	-6.4	-7.2	-9.2	-8.5	-6.4	-6.4	-6.6
FDI, net	3.6	12.3	6.4	3.7	4.5	0.2	1.8	1.9	1.8
International reserves	29.6	30.6	35.3	38.2	42.6	44.0	47.0	49.8	52.0
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	-4.4	-4.3	-4.4
Consolidated gov primary balance	3.3	2.4	-3.1	-2.7	-1.7	-1.9	-1.8	-1.8	-1.7
Public debt	28.3	27.8	31.3	35.8	39.6	42.3	45.6	46.6	48.8
of which Domestic	24.5	23.4	27.7	32.5	35.8	38.6	41.7	43.1	45.3
Foreign Assets & Liabilities, USD bn									
External debt	63.0	60.4	63.8	80.6	89.7	113.7	91.6	97.9	102.7
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	22.2	22.3	29.6	26.4	27.0	26.2
External debt / XGS	70.0	61.6	81.4	81.1	76.2	104.7	87.4	86.5	83.1
Short-term debt	24.0	25.5	21.3	21.7	20.5	27.9	28.4	29.0	29.5
Short-term debt/International reserves (%)	81.2	83.2	60.4	56.9	48.2	63.3	60.3	58.2	56.7
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	2.0	1.6	2.3	2.8	2.7	2.9	2.7	3.4	3.5
CPI, % yoy	5.5	6.1	5.6	5.8	5.6	5.6	5.5	5.6	5.5
Policy interest rate, %, eop	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.50	5.50
Short-term market rate, % eop	5.05	5.08	5.07	5.07	5.07	5.07	5.07	5.57	5.57
Long-term yield, %, eop	7.58	7.58	7.50	7.70	7.70	7.80	7.90	8.00	8.05
ZAR/US\$, eop	9.88	10.03	10.26	10.31	10.37	10.39	10.36	10.33	10.30

Source: National Sources, Citi Research forecasts

Turkey

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- **Summary view** — The possibility of a prolonged period of slow growth and uncertainty regarding the implications of such a scenario for the economy and political stability paint a challenging outlook.
- **Things to watch** — Political developments and fiscal policy ahead of the upcoming elections, along with developments in the Middle East, deserve close monitoring.
- **Strategy** — The CBT's reluctance to hike rates and normalize monetary policy continue to overshadow the performance of Turkish assets.

Uncharted territory: A prolonged period of slow growth

In light of the likelihood of a more hostile external environment going forward, we believe that Turkey needs to formulate a new narrative underpinned by a tighter policy framework with a supply-side focus. In our view, this is not very likely to materialize due to an election heavy calendar (local elections in March 2014, Presidential elections in August 2014 and general elections in June 2015). Against this backdrop, we believe that the low level of domestic savings, a sizeable competitiveness gap and the country's poor inflation track record will continue to overshadow macroeconomic stability. At around 3.5%, we look for another sub-par growth performance in 2014 compared with an estimated 3.5% in 2013. While Turkey is used to coping with boom and bust cycles, the possibility of a prolonged period of slow growth would be uncharted territory for the country. Consequently, uncertainty regarding the implications of such a scenario for the economy and political stability further complicates the outlook.

Despite sub-par growth, C/A gap is set to remain wide

On the back of a weaker lira and sub-par growth, we expect the current account deficit to narrow moderately and stabilize around at 6.5% of GDP in 2014, compared with an estimated 7% in 2013. Our current account projection and short-term external debt rollovers (by remaining days to maturity) of some US\$165bn point to hefty external financing needs amounting to 25% of GDP. This will in turn keep the country vulnerable to sudden shifts in investor sentiment, particularly if one considers Turkey's dependence on portfolio debt flows and short-term bank flows with FDI stuck in the US\$8-10 billion per annum pace, or making up a rather meager 15%-20% of the current account deficit.

Disinflation doesn't seem to be a priority

Projected at around 7.5% by the end of 2013, inflation will be, once again, above the 5% target. The absence of any improvement in inflation dynamics, sticky forward-looking expectations and the CBT's increased tolerance for deviations from the inflation target paint a challenging outlook. Against this backdrop, we see inflation at around 7% by the end of 2014. Sticky service inflation (around 8%YoY) and the marked deterioration in core measures lead us to believe that the CBT's 2014 inflation forecast of 5.3% is on the optimistic side. All in all, developments to date suggest to us that, as long as inflation doesn't reach double-digit levels, disinflation is unlikely to be a priority for policymakers, who are likely to be more focused on growth given the heavy political calendar.

Monetary policy unorthodoxy is no free lunch

The CBT's unconventional framework has come under increased scrutiny following the recent EM sell-off during which the lira and bonds have underperformed with respect to their counterparts in the EM universe. Our empirical analysis suggests that, under the umbrella of its unorthodox framework, the CBT has paid less attention to deviations from the inflation target, while placing more emphasis on economic activity. Our findings also demonstrate that monetary policy uncertainty under the CBT's unconventional framework has been more elevated than it was during the 2008-09 global financial crisis ([Turkey Macro View - Unorthodoxy is no free lunch](#)).

In our view, Fed tapering worries and rising inflation concerns will make it harder for the CBT to keep its explicit commitment not to hike rates. In this respect, the CBT's recent decision to push interbank money market rates closer to the upper band of the interest rate corridor (7.75%) demonstrates that the CBT will have no choice but to tighten in the event of further unfavorable developments affecting the inflation outlook and the lira. Specifically, it is becoming more evident that benign neglect of the exchange rate is not a viable option in light of the exchange rate pass-through and corporate sectors' large open FX positions (US\$ 165.3bn). Notwithstanding the noted caveats, however, developments to date suggest to us that the CBT will likely try to navigate turbulent markets with the minimum possible monetary tightening.

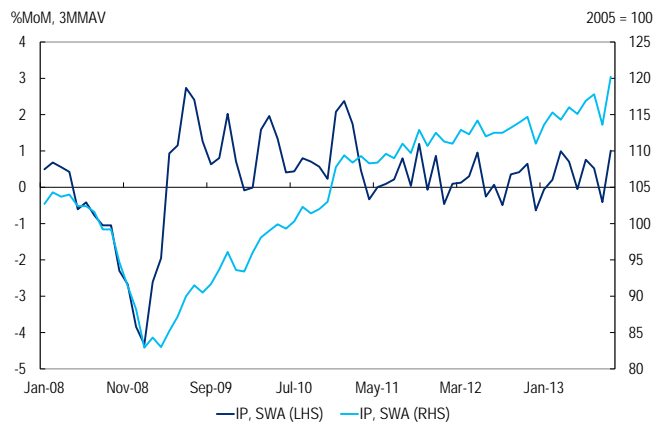
Fiscal policy needs to get more ambitious

Turkey's fiscal strategy, which is outlined by the 2014-2016 Medium Term Program (MTP), remains unambitious in the context of the wide current account deficit. From this prism, the trajectory for the primary balance for 2014 and thereafter does not seem tight enough in terms of reducing external vulnerabilities. Despite the better-than-expected headline performance, we remain concerned about the underlying strength of the budget, which has implications for meeting the 2014 targets. According to the 2014 Budget, primary balance is targeted at some TRY19bn (1.1% of GDP) and the overall budget deficit at some TRY33bn (1.9% of GDP). In our view, it will be difficult to hold primary expenditures below nominal GDP growth ahead of the upcoming elections. This, coupled with our softer growth projection, leads us to look for a wider overall deficit of 2.8% of GDP in 2014.

Turkish assets are heading for another volatile year

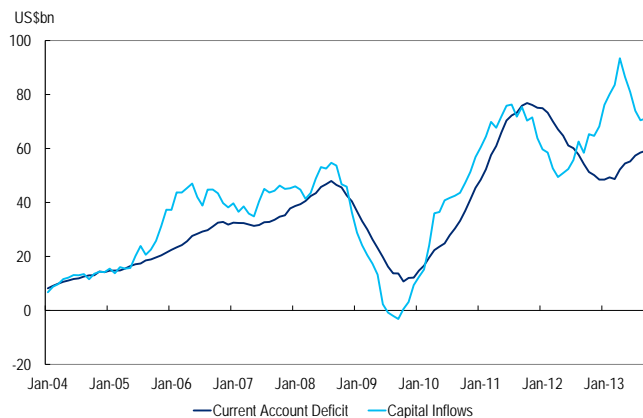
We believe that Turkish assets are heading for another volatile year. We argue that Turkey's large external financing needs and the CBT's unorthodox monetary policy framework will continue to overshadow the performance of Turkish assets, as the possibility of a more accommodative fiscal stance ahead of the elections further complicate the outlook. Moreover, we believe that rising growth concerns will likely keep the short-term real rates in negative territory, with the lira bearing the brunt of the adjustment during times of heightened FX market pressures. In our view, the noted backdrop also paints a challenging outlook for bonds. In particular, short-term rates are likely to remain under upward pressure, as the CBT continues to be behind the curve in terms of eliminating its accommodative bias and normalizing monetary policy.

Figure 238. While 3Q growth indicators look resilient



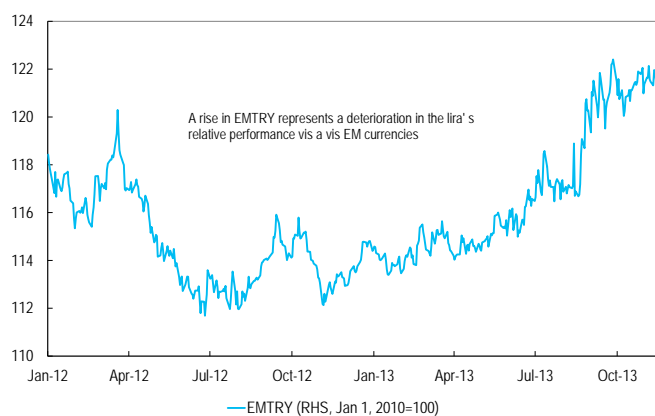
Source: Haver Analytics, Citi Research

Figure 240. ...as capital inflows subside...



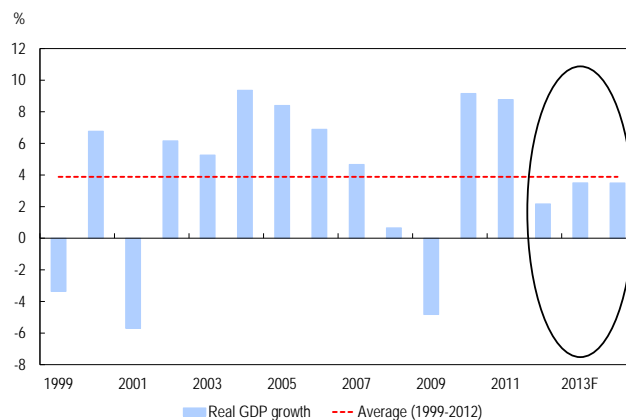
Source: Bloomberg, Citi Research

Figure 242. ...which is hurting the lira...



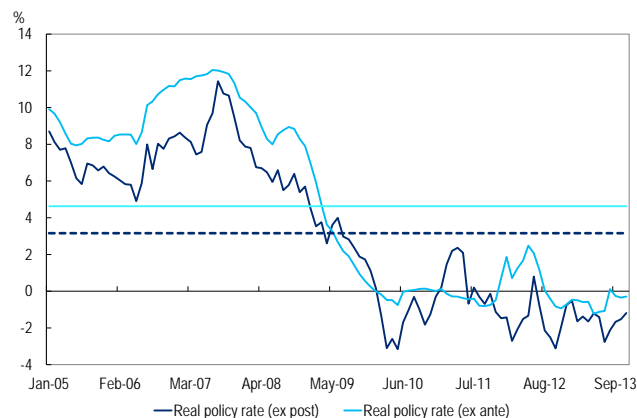
Source: Bloomberg and Citi Research

Figure 239. ...we expect to see sub-par growth in 2014...



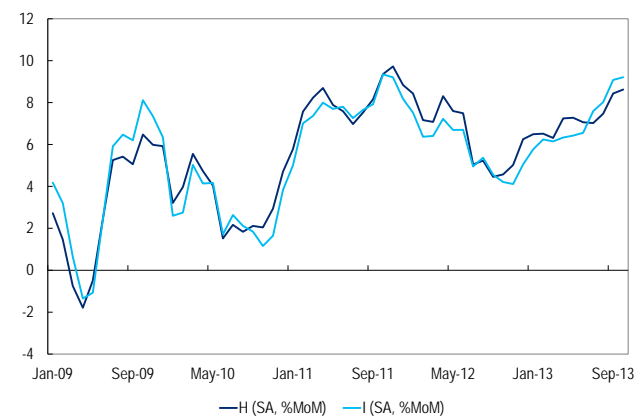
Source: Haver Analytics, Citi Research

Figure 241. ...due, in part, to CBT's reluctance to hike rates...



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

Figure 243. ...and complicating inflation dynamics



Source: Haver Analytics, Citi Research Note: 3-month moving average annualized

Figure 244. Turkey Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	646	731	615	731	775	788	805	837	934
Nominal GDP, local currency bn	843	951	953	1,099	1,298	1,416	1,576	1,751	1,939
GDP per capita, USD	9,207	10,282	8,530	10,016	10,473	10,523	10,529	10,829	11,950
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	9.5	9.5	9.5
Economic Activity									
Real GDP, yoy avg	4.7	0.7	-4.8	9.2	8.8	2.2	3.5	3.5	3.6
Real investment growth % yoy	5.8	-4.8	-28.6	48.4	16.8	-8.3	5.1	0.9	4.4
Real consumption growth % yoy	5.6	-0.1	-1.0	6.0	7.3	0.3	4.1	3.3	4.1
private consumption growth % yoy	5.5	-0.3	-2.3	6.7	7.7	-0.6	3.7	3.0	4.3
Real export growth, % yoy	7.3	2.7	-5.0	3.4	7.9	16.7	4.0	4.3	5.0
Real import growth, % yoy	10.7	-4.1	-14.3	20.7	10.7	-0.3	7.0	1.6	7.0
Prices, Money & Credit									
CPI, % yoy	8.4	10.1	6.5	6.4	10.4	6.2	7.5	7.0	6.6
CPI, % avg	8.8	10.4	6.3	8.6	6.5	8.9	7.5	7.3	6.9
Nominal wages, % yoy	9.5	11.6	9.9	11.8	8.0	9.9	8.5	7.5	7.5
Credit extension to private sector, % yoy	27.8	22.4	13.4	40.4	32.8	19.8	28.0	17.0	15.0
Policy Interest Rate, % eop	17.23	16.00	9.16	3.59	5.00	5.55	6.80	8.50	9.50
1 month inter-bank rate, %, eop	17.21	17.16	7.20	6.89	11.54	5.80	7.75	9.25	10.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US\$, eop	1.17	1.54	1.50	1.54	1.89	1.78	2.07	2.09	2.07
TRY/US\$, avg	1.31	1.31	1.55	1.51	1.68	1.80	1.96	2.09	2.08
TRY/EUR, eop	1.70	2.15	2.15	2.06	2.44	2.35	2.80	2.93	2.89
TRY/EUR, avg	1.79	1.92	2.17	2.00	2.34	2.32	2.59	2.91	2.91
Balance of Payments, USD bn									
Current account	-37.8	-40.4	-11.0	-44.7	-73.6	-46.1	-56.6	-52.4	-54.5
% of GDP	-5.8	-5.5	-1.8	-6.1	-9.5	-5.9	-7.0	-6.3	-5.8
Trade balance	-46.9	-53.0	-24.9	-56.4	-89.1	-65.3	-74.8	-73.7	-78.3
Exports	115.4	140.8	109.6	120.9	143.4	163.2	175.1	196.3	215.9
Imports	162.2	193.8	134.5	177.3	232.5	228.6	249.9	270.0	294.3
Service balance	14.0	18.8	18.6	16.7	20.1	22.6	20.9	23.2	25.3
Income balance	-7.1	-8.4	-7.1	-6.5	-6.3	-4.8	-4.1	-3.5	-3.0
FDI, net	19.9	17.2	7.1	7.6	13.7	9.0	8.8	10.0	11.0
International reserves	73.3	71.0	70.7	80.7	78.5	99.9	112.9	115.4	117.4
Total amortisations	37.6	41.1	47.3	45.0	37.7	33.4	38.2	45.0	52.0
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	36.9	37.2	36.7
of which Domestic	30.3	28.9	34.6	32.1	28.4	27.3	25.7	25.5	25.0
Foreign Assets & Liabilities, USD bn									
External debt	250.4	281.1	269.1	292.0	304.4	337.5	382.8	419.4	457.2
Public	89.3	92.4	96.6	100.6	91.6	105.8	112.6	124.6	135.6
External debt / GDP	38.7	38.5	43.8	39.9	39.3	42.8	47.5	50.1	49.0
External debt / XGS	172.4	158.1	185.2	185.8	165.4	163.5	176.0	172.8	171.7
Short-term debt	43.2	52.5	49.0	77.3	81.9	100.8	128.8	140.8	150.8
Short-term debt/International reserves (%)	58.9	74.0	69.3	95.8	104.4	100.9	114.1	122.0	128.5
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	4.4	3.7	3.8	2.6	3.3	4.0	4.3	4.3	4.1
CPI, % yoy	8.3	7.9	7.5	7.5	7.3	7.3	7.0	7.0	6.8
Policy interest rate, %, eop	5.11	6.45	6.80	7.20	7.50	8.00	8.50	8.75	9.00
Short-term market rate, % eop	7.24	7.34	7.75	8.00	8.20	8.75	9.25	9.50	9.75
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US\$, eop	1.93	2.02	2.07	2.08	2.09	2.10	2.09	2.09	2.08

Source: National Sources, Citi Research forecasts

Ukraine

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- **Summary view** — FX reserves dipped for the first time below 3 months of imports in October, which prompted two downgrades by S&P and Fitch in early November (Moody's downgraded in Sep). Without access to international capital markets, an IMF deal seems the only way to achieve financial stability.
- **Things to watch** — The government has decided to halt preparations for signing the EU Association agreement and initial indications point to Ukraine gradually shifting focus towards Russia for providing financing options. It will be critical to watch these discussions in the weeks and months to come.
- **Strategy** — We estimate that the hryvnia is overvalued by about 25-30% relative to medium-term fundamentals and see risks of a 10-15% correction in the exchange rate over the next 3-6. Increased exchange rate flexibility is likely to be a key requirement of any IMF deal.

Still stuck in recession

Economy falls deeper in recession. The slide in the economy intensified in 3Q as preliminary estimates showed that economic growth contracted by a larger-than-expected 1.5% YoY. This is the fifth consecutive quarterly contraction and follows up on the -1.1% YoY and -1.3% YoY decreases in GDP growth in 1Q and 2Q, respectively. While the pace of decline in industrial production and construction remained the same relative to 2Q, the disappointing 3Q number was primarily driven by a deceleration of retail sales growth (4.4% YoY in 3Q vs 6.2% YoY in 2Q and 10.9% YoY in Q1) and agriculture (1.2% YoY in 3Q vs 14.9% YoY in 2Q and 5.9% YoY in 1Q). External demand conditions are also proving challenging. Trade with Russia has been badly hit by Ukraine's pursuit of an Association Agreement with the EU, while the Eurozone's shift towards a large current account surplus is not conducive to Ukrainian export growth.

Ukrainian policymakers' anchor seems to be financial and exchange rate stability. An important part of the background in understanding Ukraine's weak growth outlook is the authorities' desire to avoid an exchange rate collapse due to the likely impact this would have on the banking system. The hryvnia (UAH) is essentially pegged to the USD. For that reason, real interest rates have been kept exceptionally high for an economy that isn't growing, with a view to maintaining FX stability. In addition, the NBU continues to impose restrictions on the availability of foreign exchange. Although a depreciation of the UAH might well be contractionary for the economy – given the private sector still has large net FX liabilities – the determination to preserve FX stability has come at a cost to growth.

FX reserves have now dipped below 3 months of imports. Although Ukrainian borrowers had plenty of capacity to borrow internationally in early 2013, that access to capital markets is no longer readily available and capital outflows are now threatening FX reserves. On November 8th, the central bank reported that reserves fell by US\$1bn in Oct to US\$20.6bn (2.8 months of imports) for a year-to-date decline of US\$4bn. The loss of reserves was driven by repayments to the IMF (US\$650mn), FX interventions (US\$297mn) and domestic FX bond repayments (US\$100mn). While the current account deficit is not worsening, the broad balance has deteriorated significantly in recent months as net FDI inflows have collapsed on heightened domestic uncertainty. We see foreign reserves falling by another US\$2bn by year-end on the back of heavy external repayments in Nov and Dec (US\$1.7bn).

IMF and Russia relations move to centre stage

The government finds itself between a rock and a hard place. The dilemma facing the Ukraine government is well known. The 2011 change in the constitution that transformed Ukraine from a Parliamentary to a Presidential republic ensured that the upcoming 2015 Presidential elections assume a much larger significance. Hence, raising gas tariffs for the population, which is a key IMF requirement, in the pre-election year is a tough political choice. On the other hand, the fast loss of reserves and continuing external repayments without IMF support may precipitate an economic collapse, which may also be blamed on the government. Navigating these shallow waters has become a key challenge for the government.

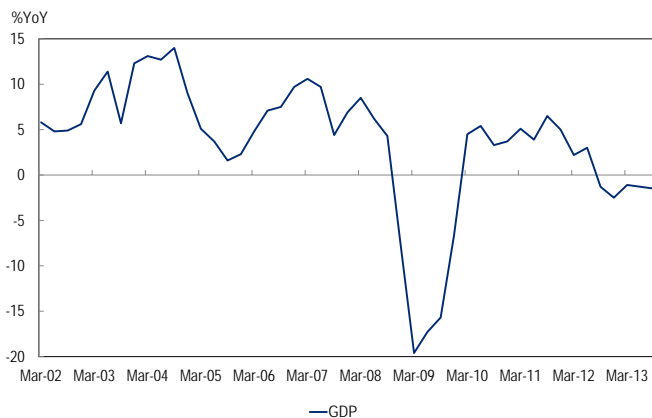
We do not get the sense that the government has in mind a certain level of reserves beyond which it would be ready to embrace IMF/EU/Russia. While the failure to vote on releasing Yulia Tymoshenko may end up postponing rather than ruling out an agreement with the EU, initial indications point to Ukraine gradually shifting focus towards Russia and continuing to test the boundaries in terms of engaging international organizations. Our view is that the government still feels that it has more time to find financing options, although end-1Q14 to beginning 2Q14 likely marks the deadline to secure much-needed support.

We think the only saving grace for the government so far is the still subdued retail demand for foreign exchange. One trump card that the government still holds is that the population, which traditionally has been sensitive to any suggestion of imminent devaluation, has so far remained enamored with the hryvnia. Local currency deposits continue to grow robustly at almost 30% YoY as of September vs FX deposit growth of only 9% YoY. This has at least partly been driven by very high local deposit rates, but also by financial repression, characterized by administrative measures to curb demand for foreign currency as a way of controlling devaluation concerns. As a result, the FX share of retail deposits has fallen from 43.8% in January to 39.3% in September.

However, the heavy 2014 sovereign FX repayment schedule leaves little doubt that the muddle-through scenario is no longer a viable option. Despite the still restrained retail demand for FX, external repayment obligations remain quite heavy into 2014. We estimate that in addition to the US\$1.6bn due by end-2013, Ukraine faces next year the following repayments: US\$3.7bn to the IMF, US\$1.6bn on a Naftogaz Eurobond, US\$1bn on a sovereign Eurobond and US\$1.2bn on domestic FX bonds. The quarterly distribution of these repayments suggest that Ukraine FX reserves may reach 2 months of imports already by end-March, which we consider the ultimate deadline for striking a deal with the IMF or Russia.

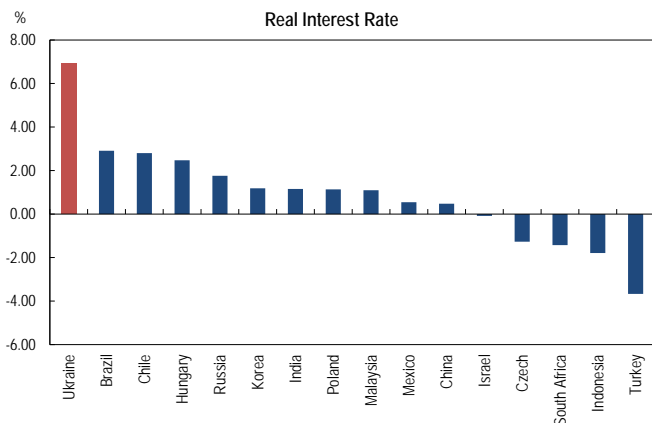
Risks of 10-15% FX correction over the next 3-6 month seem high. Either with or without an IMF agreement, the UAH seems more and more vulnerable. Using the so-called external sustainability approach, which estimates the potential exchange-rate misalignment as the required change in the real effective exchange rate that would remove the discrepancy between the current value of the current account and the level required to stabilize net foreign assets, we calculate that the hryvnia is now about 25-30% overvalued. This suggests a medium-term fair value of the hryvnia of about 10 against the US dollar. Such a currency scenario may develop quickly if no IMF deal is struck in the next couple of months. We think any IMF deal will likely be accompanied by a smaller 10-15% correction based on the above.

Figure 245. Recession has intensified...



Source: UKR Statistics, Citi Research

Figure 247. Very high interest rates are needed...



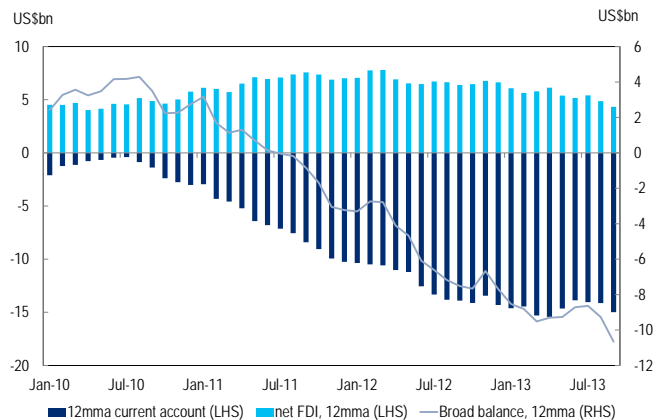
Source: Citi Research

Figure 249. Reserves have dipped below 3 months of imports...



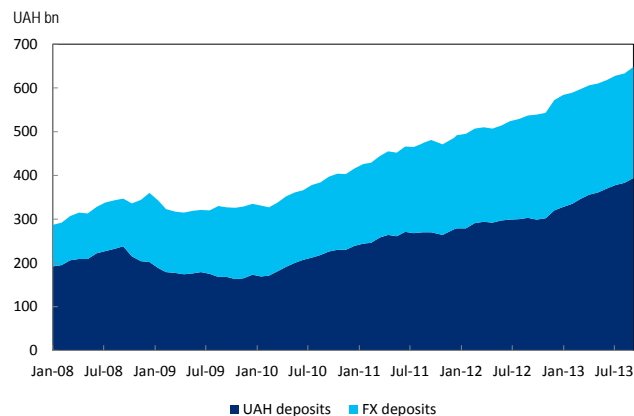
Source: UKR Statistics, Citi Research

Figure 246. ...while the broad balance has deteriorated



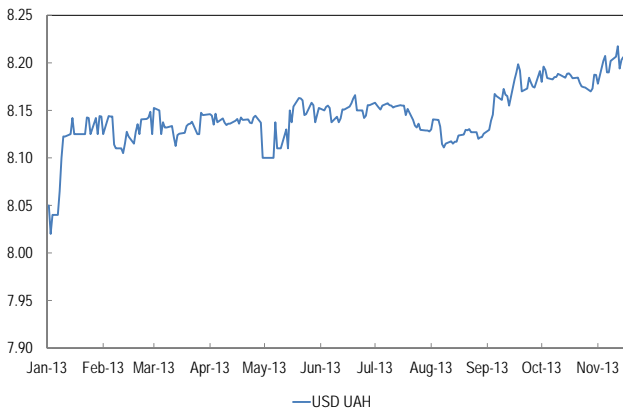
Source: UKR Statistics, Citi Research

Figure 248. ...to keep population away from dumping UAH deposits



Source: UKR Statistics, Citi Research

Figure 250. ...and the exchange rate has already come under pressure



Source: Haver Analytics

Figure 251. Ukraine Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	143	180	117	136	163	176	176	178	179
Nominal GDP, local currency bn	715	946	913	1,080	1,294	1,408	1,436	1,516	1,641
GDP per capita, USD	3,084	3,914	2,566	3,006	3,624	3,936	3,949	4,033	4,066
Population, mn	46.3	46.0	45.7	45.4	45.1	44.8	44.5	44.2	43.9
Unemployment, % of labour force	6.4	6.4	8.8	8.1	7.9	7.5	7.9	7.7	7.5
Economic Activity									
Real GDP, yoy avg	7.6	2.3	-14.8	4.1	5.2	0.2	-0.7	1.6	3.3
Real investment growth % yoy	26.6	1.8	-57.1	15.9	18.0	-13.9	-36.6	4.3	18.8
Real consumption growth % yoy	13.1	10.1	-12.3	6.4	11.3	9.7	3.3	3.9	4.3
private consumption growth % yoy	17.0	12.8	-14.9	7.1	15.5	11.6	4.0	4.5	5.0
Real export growth, % yoy	2.8	5.7	-22.0	3.9	4.3	-7.7	-19.2	1.0	2.0
Real import growth, % yoy	23.9	17.0	-38.9	11.3	17.7	1.9	-22.5	10.0	9.0
Prices, Money & Credit									
CPI, % yoy	16.6	22.3	12.3	9.1	4.6	-0.2	0.1	5.5	4.7
CPI, % avg	12.8	25.2	15.9	9.4	8.0	0.6	-0.3	3.9	4.8
Nominal wages, % yoy	29.8	33.7	5.5	17.5	17.6	14.9	9.1	9.7	8.5
Credit extension to private sector, % yoy	73.7	67.1	-4.2	0.7	8.9	2.8	7.0	10.0	10.0
Policy Interest Rate, % eop	8.00	12.00	10.25	7.75	7.75	7.50	6.50	6.50	6.50
1 month inter-bank rate, % eop	8.41	23.78	19.10	10.75	20.25	25.00	6.50	7.15	8.13
Long-term yield, % eop	-	-	-	-	-	-	-	-	-
UAH/US\$, eop	5.05	8.05	8.05	7.97	8.01	8.05	8.35	8.90	9.50
UAH/US\$, avg	5.03	5.16	8.06	7.97	7.99	8.08	8.17	8.50	9.19
UAH/EUR, eop	7.37	11.25	11.53	10.66	10.37	10.62	11.55	12.46	13.30
UAH/EUR, avg	6.89	7.60	11.21	10.55	11.11	10.39	10.72	11.86	12.86
Balance of Payments, USD bn									
Current account	-5.3	-12.8	-1.7	-3.0	-10.2	-14.8	-11.9	-9.6	-9.0
% of GDP	-3.7	-7.1	-1.5	-2.2	-6.3	-8.4	-6.8	-5.4	-5.0
Trade balance	-10.6	-16.1	-4.3	-8.4	-16.3	-20.5	-16.9	-15.9	-14.8
Exports	49.8	67.7	40.4	52.2	69.4	69.8	71.9	75.5	79.2
Imports	60.4	83.8	44.7	60.6	85.7	90.3	88.7	91.3	94.1
Service balance	2.4	1.7	2.4	4.4	6.1	5.7	4.6	6.0	5.5
Income balance	-0.7	-1.5	-2.4	-2.0	-3.8	-3.0	-2.9	-3.0	-3.0
FDI, net	9.2	9.9	4.7	5.8	7.0	6.6	3.5	5.0	6.8
International reserves	32.5	31.5	26.4	34.6	31.8	24.5	18.6	18.7	19.4
Total amortisations	8.5	13.9	17.9	23.4	23.6	20.1	21.5	20.8	22.1
Public Finances, % of GDP									
Consolidated government balance	-0.8	-1.2	-7.3	-8.8	-3.9	-5.6	-6.7	-4.2	-4.0
Consolidated gov primary balance	-0.3	-0.7	-6.2	-7.6	-2.9	-4.7	-5.1	-2.9	-2.8
Public debt	10.8	14.4	25.5	31.5	28.3	29.0	33.4	34.8	35.3
of which Domestic	2.5	4.7	10.0	13.1	12.4	13.5	17.4	18.9	19.7
Foreign Assets & Liabilities, USD bn									
External debt	80.0	101.7	103.4	117.3	126.2	135.0	137.5	150.6	151.0
Public	12.3	16.7	24.0	32.5	33.4	32.2	30.5	35.2	33.4
External debt / GDP	56.0	56.5	88.2	86.0	77.2	76.6	78.2	84.5	84.5
External debt / XGS	124.9	118.7	190.6	169.4	142.1	150.4	146.1	152.7	190.6
Short-term debt	20.7	20.3	19.0	23.5	30.7	33.2	33.6	34.0	35.3
Short-term debt/International reserves (%)	63.7	64.4	72.0	68.1	96.7	135.2	180.0	181.4	182.1
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	-1.3	-1.5	1.0	0.9	1.0	2.7	1.7	2.6	3.1
CPI, % yoy	-0.1	-0.5	0.1	3.0	3.5	5.4	5.5	5.1	4.8
Policy interest rate, % eop	7.00	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.50
Short-term market rate, % eop	5.40	5.97	6.50	7.00	7.15	7.15	7.15	8.13	8.13
Long-term yield, % eop	-	-	-	-	-	-	-	-	-
UAH/US\$, eop	8.16	8.19	8.35	8.35	8.45	8.60	8.90	9.05	9.20

Source: National Sources, Citi Research forecasts

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Other Africa

Ghana

- The next two years are set to be a crucial period of fiscal consolidation for the government if it is not to see further significant growth in the debt stock and pressure on the cedi, which will undermine its credibility as it heads to elections in December 2016. While all eyes will be on its ability to hold back spending, the reality is that the government just as much needs to boost revenue collection, which is well below the levels of other middle-income governments in Africa.
- To try and limit some of the pressure on the cedi and in response to a slow but steady rise in inflation, the Bank of Ghana (BoG) steadily tightened monetary policy in 2012 and has maintained this tight stance in 2013. This has been partially successful and also meant the cost of issuing domestic debt has been high. But the ability of the BoG to ease monetary policy in 2014 will depend heavily on fiscal developments and whether this helps restore cedi stability but we think a modest easing is likely in 2H.
- Despite the policy imbalances and weak cedi, GDP growth looks set to remain robust in 2014-15 even if it slows. So the real question will be whether progress in fiscal consolidation means that we enter a new period of cedi stability at some point in 2014 and into 2015 and at what new level.

Kenya

- Assuming that the recent terrorist attack on the Westgate shopping centre was a tragic one-off incident, we still expect a steady pick-up in growth in 2014-15. Instead, we think the key economic questions facing the government of the new president, Uhuru Kenyatta, is can the fiscal and current account deficits be brought under control in the coming years.
- Despite the cost of implementing the new constitution, we do expect some post-election fiscal consolidation. But with growth picking up and sucking in imports, reducing the current account deficit is likely to prove much harder. At present capital inflows, both official and short term, have remained robust and if this continues, as we suspect is likely, it means that Kenyan shilling (KES) depreciation will be limited.
- But, the policy balancing act facing the Central Bank of Kenya (CBK) will become harder into 2014. We expect inflation to pick up in 2H 2013 to the top end of its inflation target (5%, +/- 2.5pp), which will limit its scope to further loosen monetary policy although it would probably like to, to support the recovery. And a too rapid easing of monetary policy in 2014 against the background of the large current account deficit and rising growth could create inflationary pressures and more substantial KES depreciation.

Tanzania

- Over the next two years Tanzanian politics will be dominated by the battle to succeed current president, Jakaya Kikwete and adopting the new constitution – a draft was formally released in June. However, the main focus of the government will be on economic reform, and crucially the implementation of policy. The most immediately pressing priorities are resolving the ongoing power sector crisis, which has led to prolonged electricity shutdowns in major urban centres acting as a brake on growth, and bringing down the inflation rate, which has fallen more slowly than in the rest of East Africa since 2012 but is now firmly in single digits.

- Growth should continue to be robust in 2013-14, although for it to really pick up into double digits the government will have to make real progress in implementing its Kilimo Kwanza (Agriculture First) policy. The current account deficit is set to remain substantial, despite ongoing increases in gold exports, but with aid and FDI inflows, increasingly into the gas sector, remaining high, the deficit should prove relatively easy to finance compared to Kenya and Uganda, especially if the government does issue a Eurobond in 2014.
- While the Bank of Tanzania's (BoT) tight monetary policy and capital controls have helped maintain shilling stability in 2012-13, the reality is that after two years of relative stability, the substantial fiscal and current account deficits should drive more significant shilling depreciation in 2014.

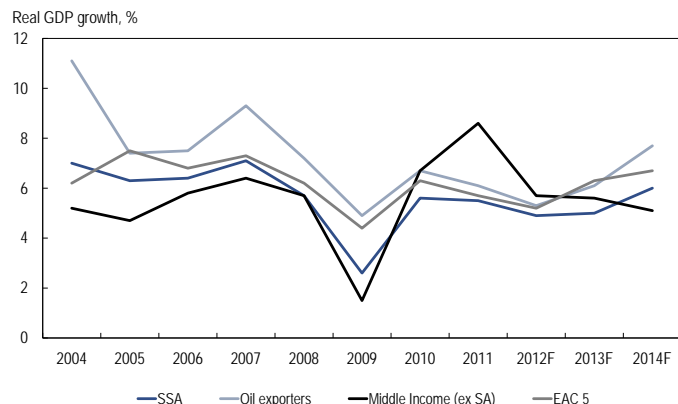
Uganda

- Growth slowed sharply in 2012 to its lowest level for over a decade. Coupled with the sharp rise in inflation in 2011-12, which undermined household incomes, delays to oil production and various spats with donors in 2H 2012 this seems to have created a new drive within the government to return to a more orthodox economic policy.
- Not only has the Bank of Uganda (BoU) maintained a tight monetary policy throughout 2013, but the ministry of finance also outlined a relatively tight budget for the 2013/14 fiscal year (starts 1 July) and a more restrained fiscal stance going forward. The combination of these trends has led to considerable Uganda shilling (UGX) stability in 2013 despite large current account deficit, a trend likely to be maintained into 2014 as long as the current account deficit can be relatively easily financed.
- At some point in the next five years, Uganda should 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

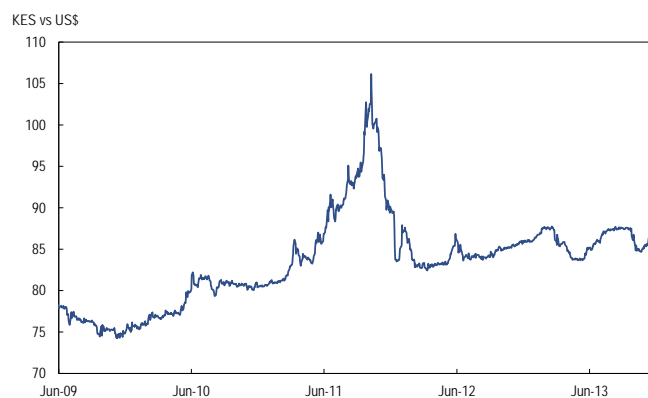
- With a slowing in growth and a sharp widening of the fiscal deficit. With the current account moving into a deficit and the political atmosphere remaining tense it is clear that 2013 was a difficult year for Zambia. The key question going into 2014-15 is whether we expect an improvement in these key variables.
- At present we do. In particular, we expect that the government will push ahead with some fiscal consolidation as aid inflows remain robust and domestic revenue collection continues to improve. And we also expect a modest recovery in growth. But, despite the recovery in copper production in 2013, we still think the current account will remain in deficit in the coming years at around 3% of GDP.
- All this means that while we expect some kwacha depreciation in 2014-15, this will be modest with pressure on the currency perhaps greatest in 1H 2014 when inflation remains above 7%. But as 2014 progresses, this pressure should ease assuming that the government does make progress with fiscal consolidation.

Figure 252. Growth should be robust in 2013-14



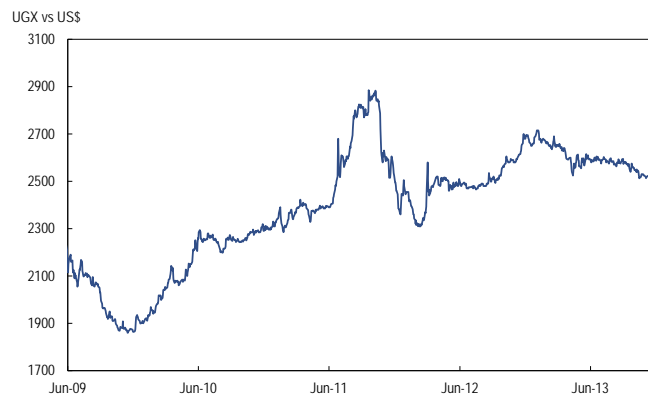
Source: IMF

Figure 254. The post election Kenyan shilling rally has ended



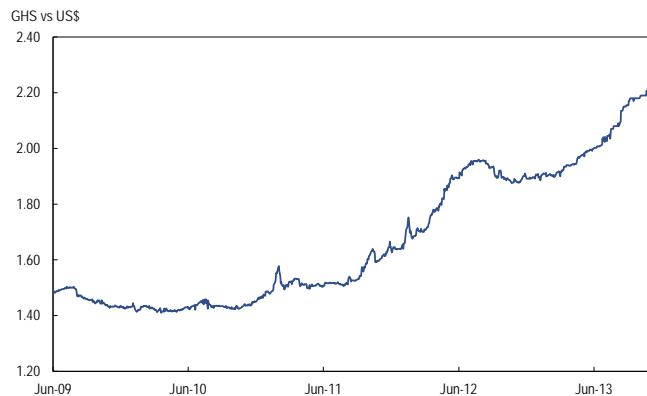
Source: Haver Analytics

Figure 256. Pressure on the Ugandan shilling has eased in 2013



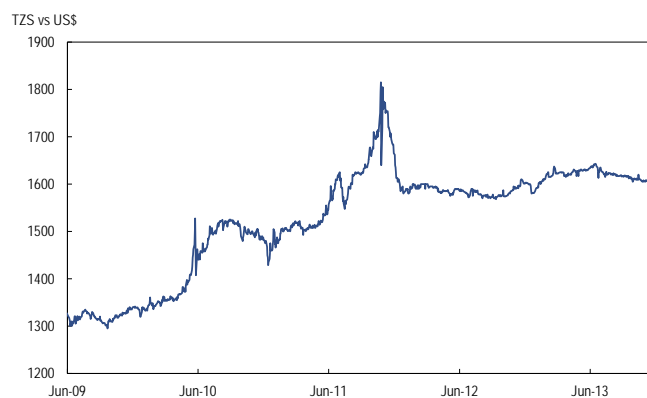
Source: Haver Analytics

Figure 253. The cedi crosses the GHS2:US\$1 level



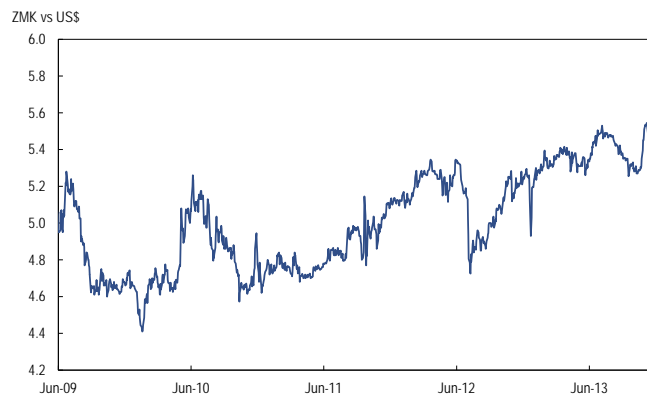
Source: Haver Analytics

Figure 255. Is the Tanzanian shilling now too strong?



Source: Haver Analytics

Figure 257. The roller coaster ride for the kwacha continues



Source: Haver Analytics

Figure 258. Other Africa Economic Indicators

	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	43.4	44.8	49.0
GDP per capita, USD	1,099	1,234	1,096	1,326	1,594	1,605	1,675	1,695	1,814
Real GDP, yoy avg	6.5	8.4	4.0	8.0	15.0	7.9	7.4	6.8	6.5
CPI, % avg	10.7	16.5	19.3	10.7	8.7	9.2	11.4	11.2	8.8
Policy Interest Rate, % eop	13.5	17.0	18.0	13.5	12.5	15.0	17.0	15.0	13.0
GHS/US\$, avg	0.95	1.07	1.43	1.43	1.55	1.85	2.04	2.36	2.54
Current account, US\$bn	-2.1	-3.5	-1.6	-2.6	-2.1	-4.9	-5.2	-5.0	-5.0
% of GDP	-8.6	-12.4	-6.2	-8.2	-5.3	-12.1	-12.0	-11.2	-10.2
Consolidated gov. balance, % of GDP	-5.6	-8.4	-7.0	-9.4	-5.5	-9.3	-9.2	-7.7	-6.5
KENYA									
Nominal GDP, USD bn	28.5	30.4	30.6	32.2	34.3	40.7	44.3	51.1	56.8
GDP per capita, USD	754	785	769	787	816	943	999	1,121	1,216
Real GDP, yoy avg	7.0	1.5	2.7	5.8	4.4	4.6	5.5	6.1	6.5
CPI, % avg	4.3	15.1	10.6	4.3	14.0	9.4	5.6	6.6	7.3
Policy Interest Rate, % eop	8.8	8.5	7.0	6.0	18.0	11.0	8.5	8.0	7.5
KES/US\$, avg	67.3	68.8	77.3	79.2	88.4	84.5	86.2	90.1	95.1
Current account, US\$bn	-1.0	-2.0	-1.7	-2.4	-3.8	-4.3	-4.5	-4.9	-5.1
% of GDP	-3.6	-6.5	-5.5	-7.4	-11.2	-10.4	-10.1	-9.5	-9.0
Consolidated gov. balance, % of GDP	-4.2	-3.5	-6.2	-4.7	-5.5	-9.0	-7.0	-5.5	-4.5
TANZANIA									
Nominal GDP, USD bn	16.8	20.7	21.4	22.9	23.7	29.1	31.9	34.9	37.5
GDP per capita, USD	409	489	490	509	510	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	8.0	6.5	6.7
TZS/US\$, avg	1,237	1,198	1,324	1,439	1,582	1,586	1,600	1,654	1,728
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	-19.3	-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	18.5	21.8	22.6	24.7	26.8
GDP per capita, USD	441	515	503	506	526	599	601	636	668
Real GDP, yoy avg	8.1	10.4	4.1	6.2	6.2	2.8	5.0	5.6	6.5
CPI, % avg	6.1	12.0	13.0	4.0	18.7	14.0	5.9	8.7	6.0
UGX/US\$, avg	1,723	1,714	2,025	2,173	2,511	2,501	2,584	2,569	2,735
Current account, US\$bn	-0.6	-1.3	-1.1	-1.7	-2.2	-1.9	-2.7	-3.4	-4.0
% of GDP	-4.8	-7.8	-6.7	-10.0	-11.7	-8.8	-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	-3.5
ZAMBIA									
Nominal GDP, USD bn	11.5	14.6	12.8	16.2	19.2	21.6	23.3	25.1	27.0
GDP per capita, USD	953	1,175	998	1,225	1,408	1,534	1,602	1,672	1,739
Real GDP, yoy avg	6.2	5.7	6.4	7.6	6.8	7.3	6.0	6.4	6.3
CPI, % avg	10.6	12.4	13.4	8.5	6.4	6.6	7.1	6.8	7.4
ZMK/US\$, avg	3,992	3,702	5,020	4,791	4,861	5,139	5	6	6
Current account, US\$bn	-0.8	-1.1	0.5	1.1	0.7	0.0	-0.7	-0.7	-0.8
% of GDP	-6.5	-7.2	4.2	7.1	3.7	0.0	-3.2	-2.8	-3.0
Consolidated gov. balance, % of GDP	-1.3	-0.8	-2.5	-3.0	-2.2	-3.1	-8.5	-6.4	-5.5

Source: National Sources, Citi Research forecasts

Other Europe

Bulgaria

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In our view, net exports will remain as the key engine of growth in the near-term, as domestic demand is yet to recover. We believe that while a modest recovery in domestic demand is in the making, the growth outlook is likely to be shaped by exports and the country's ability to absorb EU funds, as lingering uncertainty in the political sphere continues to undermine consumer confidence, thereby hurting domestic demand. Against this backdrop, we keep our 2013 growth forecast at 0.5% and look for a moderate rebound of about 1.5% in 2014. In parallel, we expect inflation to pick up in 2014 reaching 3% from an estimated 0.2% in 2013 on the back of unfavorable base effects and our expectations of a modest increase in domestic demand. On the fiscal front, we believe that the authorities' 2014 budget deficit target of 1.8% of GDP – compared with an estimated 2% in 2013 – can be justified by the likely subdued economic activity. While there are implementation risks, we think that the establishment of an independent fiscal council, which should take place fairly soon, will bolster fiscal credibility.

Bulgaria's prospects for converging toward European structures will hinge on a set of challenging institutional and structural reforms. When compared with its peers, Bulgaria fares well in the sphere of macroeconomic environment. However, the available evidence suggests to us that the country needs to intensify its reform efforts aimed at bolstering institutions (including reforming the judiciary, independent market supervision, promotion of competition and the anti-corruption regime). Concurrently, we believe that policy efforts directed at increasing the absorption of EU funds will have favorable implications for the labor market and productivity. Satisfactory progress in these areas, coupled with policy actions aimed at strengthening labor market outcomes to tackle declining labor-force participation and a loss of skills, will play an important role in achieving income convergence with other EU countries. However, political and social challenges – along with a more hostile external environment – suggest to us that the road to convergence will be long and bumpy.

Croatia

We believe that economic activity will remain below its potential in the coming quarters owing to continued deleveraging and the wide competitiveness gap. We look for a moderate recovery in domestic and expect GDP growth to be around 1.2% in 2014 from an estimated contraction of 1% in 2013. Concurrently, we have observed a marked decline in inflation pressures this year owing to the weak domestic demand and cyclical factors. However, we expect inflation to pick up next year reaching 2.5% from an estimated 1.1% in 2013, as favorable cyclical factors dissipate and domestic demand pick up moderately. On the fiscal front, the budget gap is set to reach 5.5% of GDP this year – well above the planned deficit of 3.6% – on the back of weaker growth, higher interest payments and clearance of health service arrears. The budget gap in relation to GDP in 2014 is likely to remain at a similar level, which is well above the level envisioned in the context of the excessive deficit procedure (EDP) by the EU. In this respect, it remains to be seen whether the authorities will be able to strike a balance between ensuring policy credibility and refraining from excessively rapid tightening in an environment of private sector debt reduction.

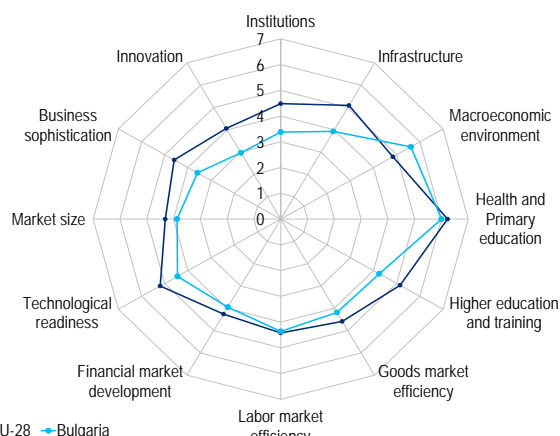
In our view, the medium-term growth outlook will be shaped by efforts to enhance competitiveness, which require a steady progress on structural reforms. According to the most recent WEF Competitiveness Report, Croatia ranks 75 among 148 countries, as it has a wide competitiveness gap in key areas such as goods market efficiency (ranks 111) and labor market efficiency (ranks 114). Regarding the latter, effect of taxation on incentives to work (ranks 143rd among 148 countries) remains one of the key development areas that could be addressed by government. It is true that various structural reforms have been implemented by the government (e.g., easing hiring restrictions, restructuring of several public owned enterprises). However, we think further steps are needed to increase labor market flexibility and strengthen the business climate for the country to attract sufficient investment and boost exports, and thereby seize its full growth potential.

Serbia

The recent data point to an acceleration in growth momentum with GDP growing by 3.2%YoY in 3Q compared with 0.2%YoY and 2.7%YoY in 2Q and 1Q, respectively. In addition to favorable base effects, this outcome is largely driven by exports and vibrant manufacturing activity. Notwithstanding the noted encouraging picture, weak domestic demand leads us to look for a moderation in GDP growth next year (2%) from an estimated 2.5% in 2013. Regarding price developments, the impressive decline in inflation from 12.2% in end-2012 to 2.2% in October 2013 is largely driven by benign food prices and the weak domestic demand. The sharp disinflation and a stable RSD have allowed the NBS to cut the policy rate to 10% in November from 11.75% in April 2013. Looking ahead, however, our analysis suggests that unfavorable base effects and increase in the reduced VAT rate to 10% from the current 8% starting in January 2014, will likely push inflation higher to above 6% in the second quarter of 2014. Consequently, we think that while the NBS is likely to continue easing in the next couple of months through lowering its policy rate to 9.0% by March 2014, further cuts will be harder to justify since inflation will likely rise above the Bank's tolerance band of 4%±1.5% thereafter.

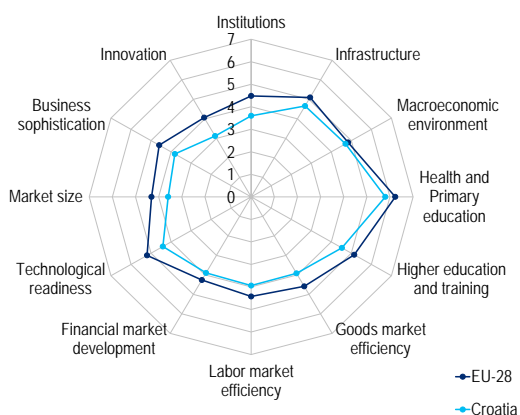
Despite recent favorable developments, we believe that further fiscal and structural reforms are required to put the country on a sustainable growth path. We think that the Government's recently announced fiscal austerity package, which includes actions such as raising VAT and lowering public sector wages, is a step in the right direction. However, we believe that additional consolidation measures – including pressing ahead with other structural reforms of pension system, public administration and health – would be needed to put the public finances on sustainable footing. In parallel, low savings rate (at 11% of GDP) and the wide competitiveness gap (Serbia ranks 101st among 148 countries, according to the WEF competitiveness index) continue to render the country vulnerable to shifts in investor sentiment, given wide current account deficit and the challenging external financing environment. In this respect, structural reforms to boost productivity and address key weaknesses (such as goods and labor market efficiency) will likely improve business climate and help country become more resilient to external shocks, in our view.

Figure 259. Bulgaria needs to make progress on reforming institutions, infrastructure and business sophistication...



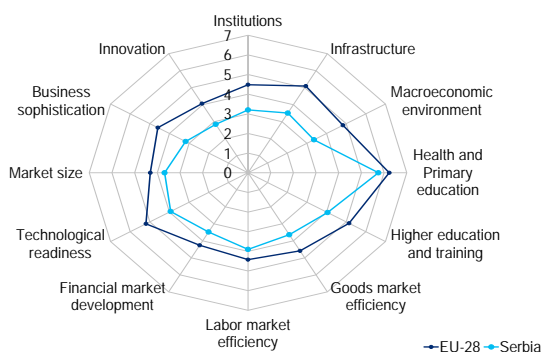
Source: World Economic Forum and Citi Research

Figure 261. Croatia's reform efforts will need to concentrate on innovation, institutions and technological readiness.....



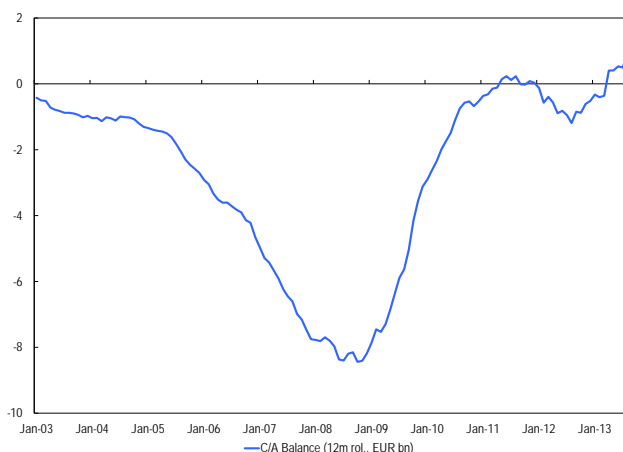
Source: World Economic Forum and Citi Research

Figure 263. Serbia, which ranks 101st among 148 countries, needs to tackle its competitiveness gap...



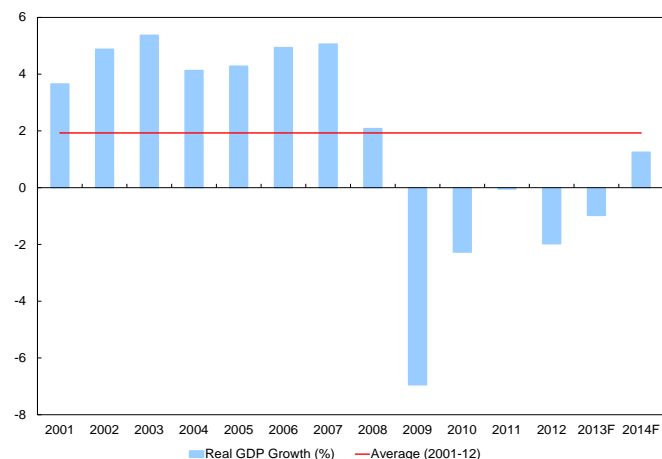
Source: World Economic Forum and Citi Research

Figure 260. ...in order to keep its external imbalance in check



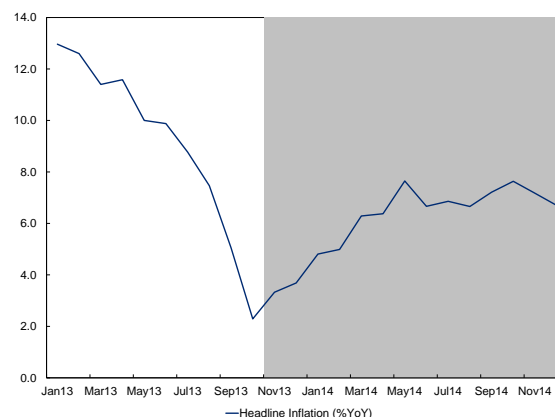
Source: Haver Analytics and Citi Research

Figure 262. ...to improve its growth potential



Source: Haver Analytics and Citi Research

Figure 264. ...to attract high quality inflows, as the disinflation process is likely to be reversed



Source: Haver Analytics, Citi Research

Figure 265. 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	53.7	58.9	62.3
GDP per capita, USD	5,512	6,812	6,421	6,360	7,307	6,997	7,409	8,173	8,692
Real GDP, yoy avg	6.4	6.2	-5.5	0.4	1.8	0.8	0.5	1.5	2.5
CPI, % avg	8.4	12.3	2.8	2.4	4.2	3.0	1.2	2.8	2.5
BGN/US\$, avg	1.43	1.33	1.40	1.47	1.40	1.52	1.48	1.41	1.40
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	0.0	-0.5	-0.9
% of GDP	-25.6	-23.0	-8.8	-1.6	0.3	-1.4	0.0	-0.8	-1.5
Consolidated gov. balance, % of GDP	3.3	2.9	-0.9	-4.0	-2.0	-0.5	-2.0	-2.0	-1.2
CROATIA									
Nominal GDP, USD bn	59.3	69.6	62.2	58.9	61.8	56.4	58.4	62.7	64.9
GDP per capita, USD	13,376	15,690	14,044	13,331	14,432	13,106	13,617	14,666	15,259
Real GDP, yoy avg	5.1	2.1	-6.9	-2.3	0.0	-2.0	-1.0	1.2	2.0
CPI, % avg	2.9	6.1	2.4	1.0	2.3	3.4	2.3	2.3	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	5.73	5.53	5.59
HRK/EUR, avg	7.34	7.23	7.34	7.29	7.43	7.51	7.57	7.69	7.83
Current account, US\$bn	-4.3	-6.1	-3.0	-0.8	-0.4	-0.1	-0.1	-0.3	-0.6
% of GDP	-7.3	-8.7	-4.9	-1.4	-0.7	-0.2	-0.1	-0.5	-1.0
Consolidated gov. balance, % of GDP	1.4	0.4	-2.0	-3.6	-3.6	-2.4	-5.5	-5.7	-5.0
SERBIA									
Nominal GDP, USD bn	39.0	47.8	40.2	37.1	43.7	38.5	43.9	47.1	48.4
GDP per capita, USD	5,277	6,497	5,496	5,085	6,026	5,303	6,048	6,487	6,670
Real GDP, yoy avg	5.4	3.8	-3.5	1.0	1.6	-1.7	2.5	2.0	2.2
CPI, % avg	556.4	1,194.4	868.6	614.1	1,098.4	776.1	8.3	6.6	5.9
Policy Interest Rate, % eop	10.00	17.75	9.50	11.50	9.75	11.25	9.50	9.00	8.50
RSD/US\$, avg	58.3	55.2	67.4	77.5	73.2	87.8	85.6	86.7	91.2
RSD/EUR, avg	80.0	81.4	94.0	102.9	102.0	112.9	113.1	120.5	127.7

Source: National Sources, Citi Research forecasts

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- **Summary view** — Plummeting international reserves, stagnant activity, a widening fiscal deficit and consistently high inflation combine to create a challenging mix for 2014. The most pressing issue authorities need to address is the drain in BCRA reserves. We expect international reserves to stand near USD31bn by the end of this year, down from USD43.3bn a year ago.
- **Things to watch** — The debt legal fluctuations and unfolding FX market imbalance. The drain in reserves, which peaked in 2013, threatens the sustainability of the economy.
- **Strategy** — While the current official growth accounting virtually ensures a GDP warrants payment, government officials have informed that they will revise the national accounts' base year and that the new series will be available in 1Q14. We see the USDARS at 6.25 and 8.45 by the end of 2013 and 2014, respectively.

The priority is to stop the drain in BCRA reserves

Central Bank (BCRA) reserves are falling faster than most analysts anticipated. We now see BCRA reserves at USD31bn by the end of this year, down from USD43.3bn one year ago, a drop roughly double the one from 2011, when the government introduced FX controls. A similar decline in reserves in 2014 would put them at nearly untenable levels, particularly given the big public and provincial debt payments in foreign currency forthcoming in 2015. Thus, we expect the government to further tighten FX restrictions.

Curbing the fall in reserves will not be easy. Lower agricultural commodity prices, particularly soybeans which Citi's commodities strategists expect to fall to close to USD400/tn in 2H14, could negatively affect exports by USD3bn. Additionally, the energy balance deficit is expected to continue widening to around USD8bn in 2014, up from USD6.5bn in 2013, as a result of lower exports – imports are unlikely to increase significantly given the low activity growth. Despite the tightening of FX controls, we expect BCRA reserves will drop an additional USD5bn in 2014 to USD26bn by year-end. It is important to note that our forecast assumes a GDP warrants payment in December 2014. Such disbursement may not take place if the new national accounts series, which will have 2004 as the base year and are expected to be released in early 2014, show GDP growing below 3.22% in 2013. Lastly, we see gross BCRA reserves at USD17.5bn by the end of 2015, after the maturity of the Boden 15. Net reserves could be significantly lower.

The cause of all evil: the fiscal deficit

Argentina is experiencing a classical balance of payment crisis. The monetary financing of the fiscal deficit creates an excess of pesos that leads the central bank to sell reserves as an auto sterilization mechanism. For instance, during the year ending October the BCRA sold USD1.1bn dollars in the FX market, the monetary base grew 26% YoY – i.e., in line with nominal GDP. However, in the meantime, peso transfers from the BCRA to the Treasury stood at ARS84.1bn, exceeding the overall increase in the monetary base which stood at ARS61.7bn.

The fiscal accounts demanded relatively moderate financing during the first eight months of 2013, but BCRA's pesos transfers to the Treasury soared in September and October suggesting there was a significant deterioration in the fiscal balance of late. As a result, we now expect the primary fiscal deficit to stand at 1% of GDP in 2013, up from 0.2% of GDP in 2012. However, the overall deficit should decrease slightly due to lower interest payments and stand at 2.3% of GDP. The widening in the primary fiscal deficit is worrisome as next year's public debt payments in pesos increase. Assuming that the primary deficit remains constant, with no access to debt markets, peso transfers from the BCRA to the Treasury could reach ARS130bn, or more than 30% of the monetary base at the end of 2013. Such pace of money printing would likely lead to: i) additional difficulties on the FX front; ii) increased inflationary pressures; and iii) a widening in the spread between the parallel exchange rate and the official one.

Inflation and exchange rate policy

High money growth plus tighter FX controls, particularly on imports, will likely lead to higher inflationary pressures. During the second semester of 2013, inflation already accelerated somewhat. During July-October, non-official monthly inflation averaged 2.3%, compared to 1.7% during the same four months of 2012. As a result, annual inflation has been trending up and stood at 26.3% in October, according to the local consultancy firm M&S. For next year, we expect non-official inflation to stand close to 30%, up from 26% at the end of 2013.

We also increase our forecasts for the official USDARS. We now see the USDARS at 6.25 at the end of 2013, up from 6.15 before. This change basically neutralizes the recent weakening in the BRL and the subsequent reaction from BCRA. For next year, a weaker BRL, higher inflation and lower terms of trade should prompt the authorities to accelerate further the ARS rate of crawl. We see the official USDARS increasing 35.2% to 8.45 by year-end. Additionally, according to press reports, the new BCRA Governor Juan Carlos Fábrega and the new Minister of Finance Axel Kicillof believe that the ARS is 10-15% overvalued. In that case, if the policy of a gradual rate of crawl is preserved, our FX and inflation forecasts may need to be revised upwards.

Activity growth

According to our preliminary estimates, economic activity rose 3% YoY in 3Q13, after increasing 5.8% YoY in 2Q13. This result is in line with our forecasts and, thus, we maintain our 2.7% GDP growth forecast for 2013. For next year, we continue to expect economic activity to increase only 0.5%. Also, we expect GDP growth to stand at only 1% in 2015. Our forecasts are based both on cyclical and structural factors. FX controls and the lower level of imports will in all likelihood negatively affect growth, as roughly ¾ of Argentina's imports are intermediate or capital goods. Also, the country's potential GDP growth has been trending down as a result of a low investment rate and its limited productivity (residential construction has been growing relative to reproductive investment during the last decade). In fact, average annual GDP growth has been only 2% in the last five years and roughly 0% in the past two years.

Official GDP growth, under the current methodology, implies a virtually guaranteed GDP warrants payment for 2014. Nevertheless, the authorities have announced a change to the national accounts' base year for early 2014, as well as a new inflation index. The change in statistical methodology could result in a meaningful downward revision to growth, eliminating the payment of GDP warrants.

Figure 266. BCRA reserves are plummeting as a result...

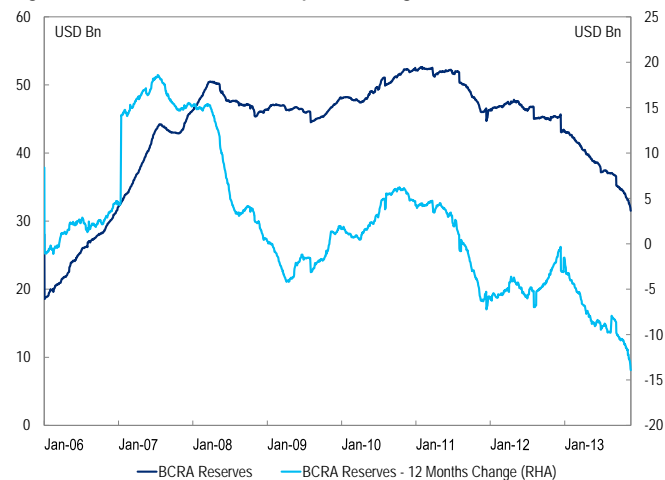


Figure 267. ... of the bank's inability to purchase foreign currency

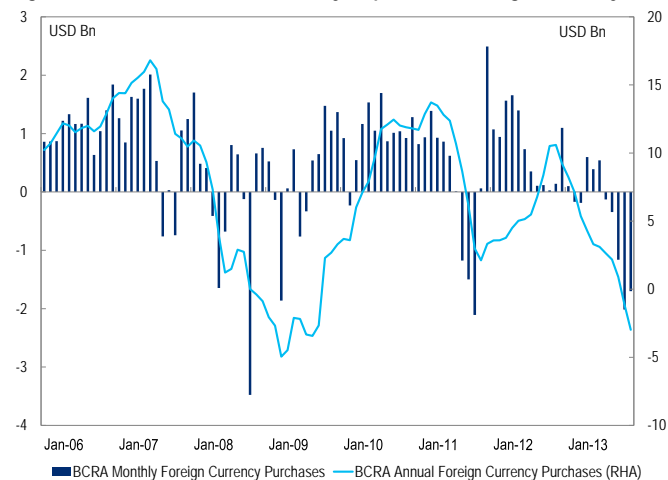


Figure 268. BCRA's peso transfers to the Treasury are on the rise...

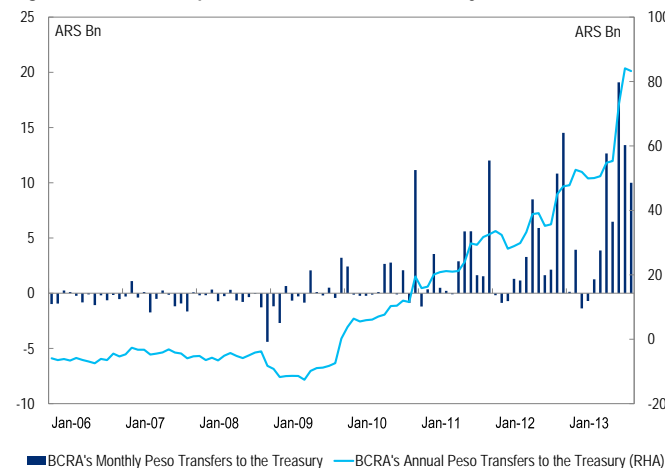


Figure 269. ... leading to strong monetary aggregates growth

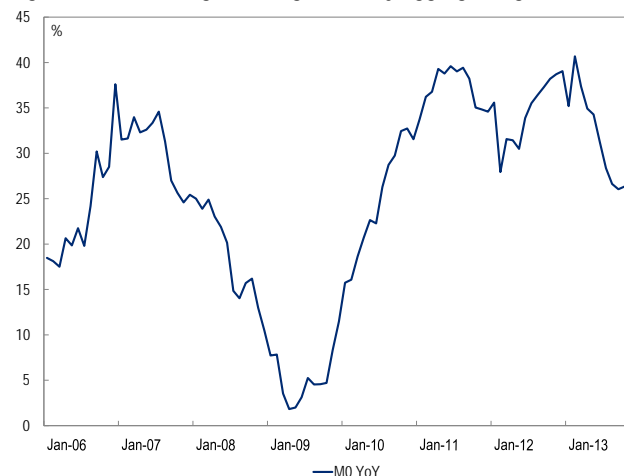


Figure 270. Annual inflation has been trending up in 2H13

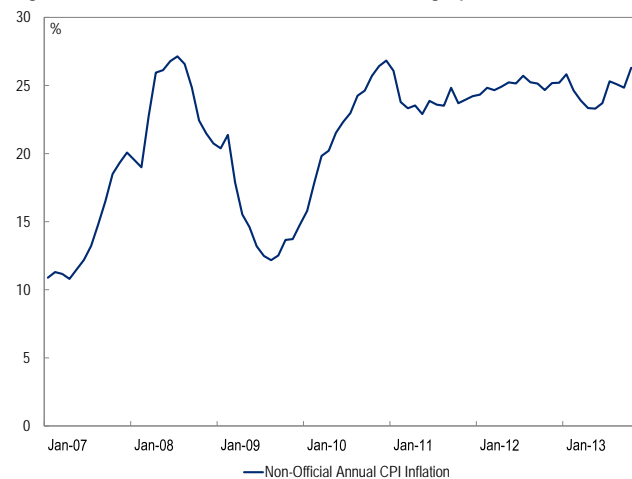


Figure 271. Economic activity growth ceased in 2H13

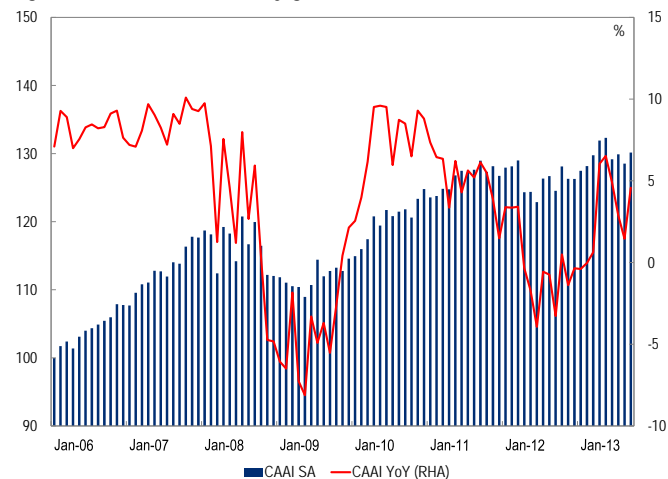


Figure 272. Argentina Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	262	329	308	370	448	477	490	450	418
Nominal GDP, local currency bn	812	1,033	1,145	1,443	1,842	2,164	2,685	3,348	4,200
GDP per capita, USD	6,666	8,271	7,683	9,131	10,948	11,541	11,741	10,695	9,846
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	7.5	7.8	7.8
Economic Activity									
Real GDP, yoy avg	8.6	3.0	-4.0	7.5	5.1	-0.3	2.7	0.5	1.0
Real investment growth % yoy	14.8	15.4	-9.1	19.6	10.7	-7.7	5.2	1.3	0.1
Real consumption growth % yoy	8.8	6.6	1.5	9.1	10.7	4.8	6.4	3.2	2.6
private consumption growth % yoy	9.0	6.5	0.5	9.0	10.7	4.4	6.3	3.3	2.3
Real export growth, % yoy	9.1	1.2	-6.4	14.6	4.3	-6.6	-0.4	-1.6	-1.5
Real import growth, % yoy	20.5	14.1	-19.0	34.0	17.8	-5.2	8.3	-1.9	0.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	20.1	20.7	14.8	26.8	24.2	25.2	26.0	30.0	30.0
CPI, % avg	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	20.3	22.4	20.0	21.7	27.5	27.1	24.7	26.7	28.5
Credit extension to private sector, % yoy	25.4	10.5	11.5	31.6	34.6	39.0	27.0	35.0	-
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	13.63	19.75	10.00	11.25	17.19	15.44	20.00	24.00	28.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	3.15	3.45	3.80	3.97	4.30	4.92	6.25	8.45	11.40
ARS/USD, avg	3.12	3.16	3.73	3.91	4.13	4.54	5.52	7.44	10.04
Balance of Payments, USD bn									
Current account	7.4	6.8	11.0	1.4	-2.4	-0.1	-2.5	-1.9	-1.6
% of GDP	2.8	2.1	3.6	0.4	-0.5	0.0	-0.5	-0.4	-0.4
Trade balance	13.5	15.4	18.5	14.3	12.9	15.4	12.0	11.9	10.6
Exports	56.0	70.0	55.7	68.1	84.1	80.9	84.4	82.0	83.2
Imports	42.5	54.6	37.1	53.9	71.1	65.6	72.4	70.1	72.6
Service balance	-0.5	-1.3	-1.3	-1.2	-2.2	-3.6	-2.2	-0.7	1.6
Income balance	-5.9	-7.6	-9.0	-11.3	-12.6	-11.5	-11.8	-12.3	-13.1
FDI, net	6.5	9.7	4.0	7.8	9.9	12.1	10.2	10.0	10.0
International reserves	46.2	46.4	48.0	52.2	46.4	43.3	31.0	26.0	17.5
Total amortisations	5.2	4.7	11.2	10.7	12.0	11.9	11.4	11.4	11.4
Public Finances, % of GDP									
Consolidated government balance	1.1	1.4	-0.6	0.2	-1.7	-2.6	-2.3	-3.1	-2.3
Consolidated gov primary balance	3.1	3.1	1.5	1.7	0.3	-0.2	-1.0	-1.1	-1.1
Public debt	55.2	44.4	47.7	44.4	40.0	42.2	39.6	43.7	50.0
of which Domestic	28.2	24.8	27.7	25.6	23.6	27.1	26.5	29.6	33.8
Foreign Assets & Liabilities, USD bn									
External debt	124.5	124.9	115.6	129.3	141.1	140.9	134.0	127.9	127.7
Public	70.8	64.4	61.8	69.5	73.2	71.6	64.2	63.8	68.2
External debt / GDP	47.5	38.0	37.5	35.0	31.5	29.6	27.4	28.4	30.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	5.8	3.0	1.8	1.2	0.0	0.6	0.3	0.8	1.0
CPI, % yoy	23.7	24.8	26.0	28.1	30.2	30.0	30.0	30.0	30.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	17.13	17.19	20.00	20.00	21.00	22.40	24.00	24.00	24.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	5.39	5.79	6.25	6.80	7.35	7.90	8.45	9.19	9.93

Source: National Sources, Citi Research

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Summary view — We have extended our call of monetary policy adjustment. We now expect the Selic rate to be raised to 10.75% in February 2014, remaining at this level until year-end. We continue to see Copom resuming the tightening cycle in 2015, hiking interest rate by an additional 125bps to 12%. On the FX front, the steady deterioration in domestic fiscal fundamentals combined with expectations for FOMC tapering continue to weaken the BRL, motivating upward revisions in our USD/BRL forecasts.

Things to watch — The timing of FOMC tapering and potential changes in government FX interventions will be closely monitored, given their impacts on the USD/BRL. The fiscal accounts will also be closely monitored due to the risk of a downgrade in sovereign rating, in case of further fiscal deterioration.

Strategy — On the FX front, the steady deterioration in domestic fundamentals and the approaching FOMC tapering suggest an opportunity to short the BRL when USD/BRL falls below the 2.30 level. On rates, even after considering the revisions to our forecasts for the Selic, we see value in receiving the short-end of the curve.

A longer adjustment of monetary conditions

We now expect Copom to raise the Selic rate to 10.75% in 2014 (from 10.25% previously). Assuming that Copom increases the Selic rate by 50bps on November 27 and keeps the same statement released in the previous meeting, we change our monetary policy call adding a 50bps hike on January 15, followed by a final rise of 25bps on February 26. After that, we believe the monetary authority will stay on hold throughout the remainder of 2014. Looking ahead, we believe the Copom will try to bring inflation down from the 6% level, thus resuming the tightening cycle in 2015 with an additional 125bps hike to the Selic rate in the first meetings of the year.

We forecast 2014 CPI inflation at 5.9%, despite the tighter monetary policy. We expect market-prices inflation to decelerate next year, reflecting the smaller BRL depreciation and tighter monetary policy. On the other hand, monitored price increases should be higher than this year – when they were helped by the sharp reduction in consumers' energy fees. However, monitored prices should continue to increase at a slower pace than the rest of the CPI basket, reflecting the likely small increases in urban transportation fares. Therefore, we forecast CPI inflation to reach 5.9% in 2014, still above the mid-point target of 4.5%, but below the target band's 6.5% upper bound. For 2015, we expect CPI inflation to stand at 5.5%, given our expectation of even tighter monetary conditions and some reduction in fiscal stimuli (i.e., a higher primary surplus).

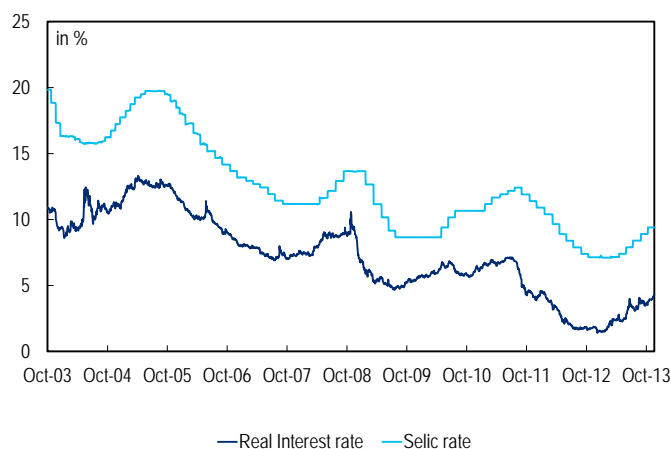
We continue to expect GDP growth of 2% in 2014 and also in 2015. After the significant deceleration in 3Q13 GDP growth (data not released at the time of writing), we do not expect a meaningful recovery ahead, given the increasing forces from higher domestic real interest rates. Therefore, quarterly GDP growth will likely stay in the 0.4-0.6% range, slightly below our estimate of potential GDP growth. It's important to emphasize that domestic demand will likely continue to disappoint, as a result of higher domestic real interest rate, while external demand should strengthen (stronger global growth amid weaker real exchange rate). Regarding the labor market, we expect the unemployment rate to initiate a slight upward trend, reflecting insufficient employment growth and a normalization in labor force expansion.

We do not expect an improvement in fiscal fundamentals. The 2014 Budget Law proposal does not represent a change in the conduction of fiscal policy. It sets a target for the primary fiscal surplus of 2.1% of GDP, which is lower than the 2.3% figure established for 2013. In addition, the proposal likely overestimates both revenues and the regional governments' surplus and thus we do not expect this target to be fulfilled. Therefore, we continue to forecast a primary surplus of 1.5% of GDP in 2014. However, we expect a significant fiscal adjustment in 2015, signaling the new government's commitment of putting the net-public-debt-to-GDP ratio on a downward trend. Because of that, we expect the 2015 primary surplus to reach 2.5% of GDP, the highest figure since 2011. In this scenario, both gross and net public debt to GDP ratios should remain roughly flat (around 60% and 35%, respectively).

Deterioration in domestic fiscal fundamentals and the approach of FOMC tapering imply a weaker BRL, reinforcing the view of improving external accounts ahead. Government intervention in FX markets through the swaps contracts instrument was not enough to avoid a rebound of the USD/BRL to levels around 2.30. For us, the steady deterioration in domestic fiscal fundamentals continues to increase the risks of a sovereign rating downgrade in the near term, another fact that points toward a weaker BRL. In the meantime, the signs of US recovery suggest that FOMC tapering is closer, favoring capital flows from emerging countries to US, reinforcing the trend of a higher USD/BRL. Under this scenario of a weaker currency (USD/BRL at 2.46 in 2014 year-end) and disappointing domestic growth, external accounts are likely to improve and the current account deficit should narrow to around 3.2% of GDP in 2014 (3.5% in 2013).

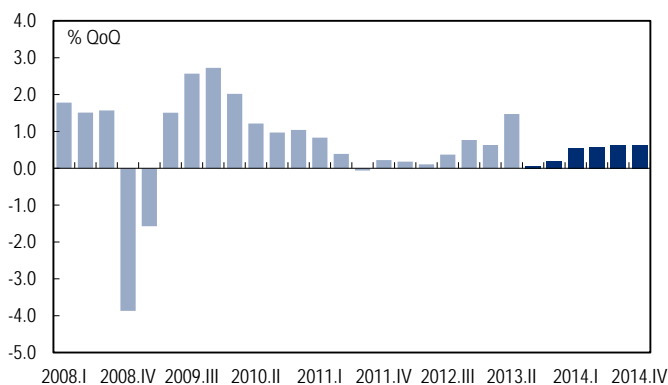
On the political front, President Dilma Rousseff's approval remains fairly stable at a level that suggests her re-election is the most likely outcome. President Dilma's popularity remains slightly below the 40% "threshold" level, which is inside the range reached by Fernando Henrique Cardoso in June 1997 and Lula da Silva in August 2005, one year before their re-elections. For us, if Dilma were able to maintain this level of popularity until the October 2014 presidential election, then she would be re-elected. Considering that we do not anticipate any significant deterioration in the key macroeconomic variables (GDP growth, inflation and labor markets conditions) between now and October 2014, we continue to assume her re-election in our base case scenario. However, there are several risks associated with this assumption, especially the possibility of the World Cup in June/July next year bringing public demonstrations back and the potential effects of them on President Dilma's popularity, only three months before the presidential ballot.

Figure 273. We expect Copom to increase the Selic until 10.75% in 2014



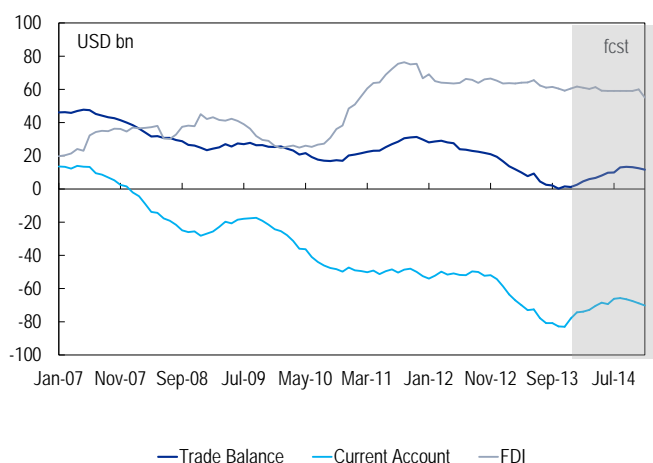
Source: Citi Research and Bloomberg

Figure 275. We do not expect a marked growth acceleration ahead



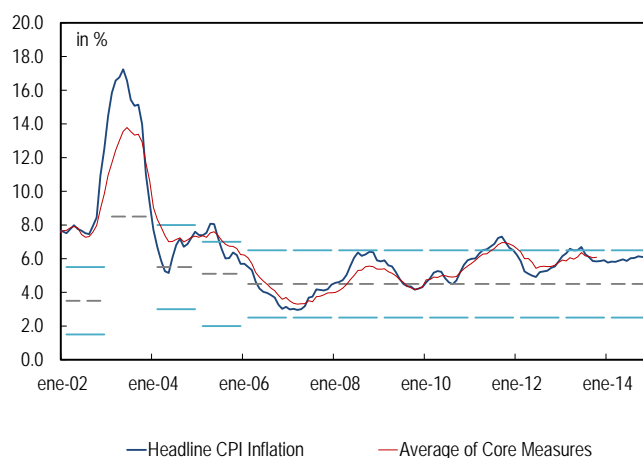
Source: Citi Research and IBGE

Figure 277. Trade balance/current account will likely improve ahead



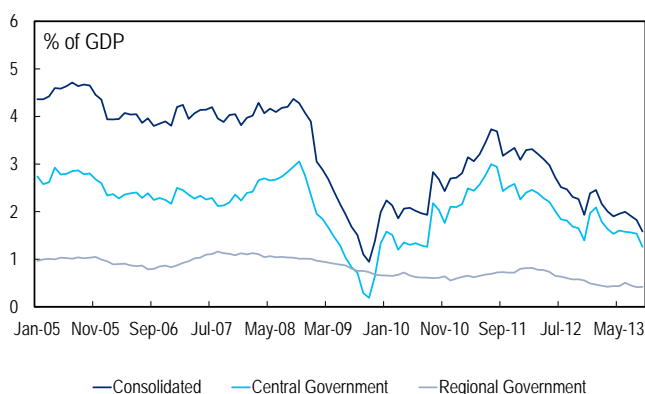
Source: Citi Research, MDIC and BCB

Figure 274. CPI Inflation will likely remain above the mid-point target of 4.5%



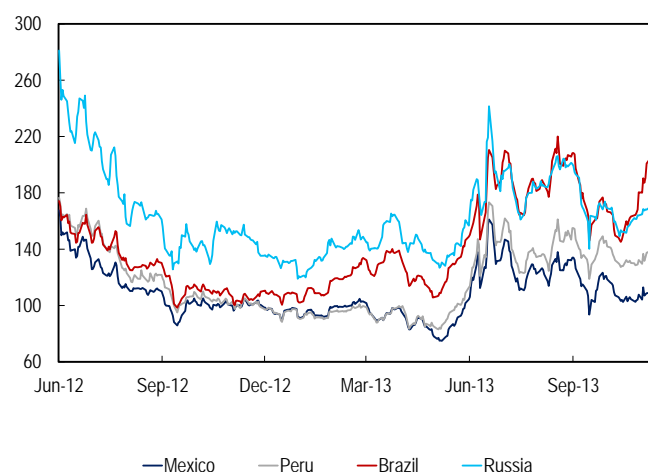
Source: Citi Research, BCB and IBGE

Figure 276. The primary fiscal surplus continues below 2% of GDP



Source: Citi Research and BCB

Figure 278. Brazil's 5Y CDS have underperformed its peers since Nov 12



Source: Citi Research and Bloomberg

Figure 279. Brazil Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,375	1,678	1,622	2,142	2,475	2,252	2,210	2,134	2,248
Nominal GDP, local currency bn	2,661	3,032	3,239	3,770	4,143	4,403	4,778	5,160	5,563
GDP per capita, USD	7,258	8,760	8,379	10,955	12,536	11,305	10,991	10,523	10,985
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	6.0
Economic Activity									
Real GDP, yoy avg	6.1	5.2	-0.3	7.5	2.7	0.9	2.6	2.0	2.0
Real investment growth % yoy	16.9	16.4	-16.0	33.4	4.0	-8.1	9.9	0.4	1.1
Real consumption growth % yoy	5.8	5.1	4.1	6.3	3.6	3.1	2.1	2.2	2.1
private consumption growth % yoy	6.1	5.7	4.4	6.9	4.1	3.1	1.9	1.9	1.9
Real export growth, % yoy	6.2	0.5	-9.1	11.5	4.5	0.5	1.9	6.3	6.8
Real import growth, % yoy	19.9	15.4	-7.6	35.8	9.7	0.2	8.0	3.9	4.4
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	4.5	5.9	4.3	5.9	6.5	5.8	5.9	5.9	5.5
CPI, % avg	3.6	5.7	4.9	5.0	6.6	5.4	6.2	6.0	5.7
Nominal wages, % yoy	7.0	10.4	4.8	12.7	8.9	10.7	10.8	10.8	10.5
Credit extension to private sector, % yoy	-	30.9	15.1	20.6	19.0	16.4	15.4	14.2	-
Policy Rate (eop)	11.25	13.75	8.75	10.75	11.00	7.25	10.00	10.75	12.00
1 month inter-bank rate, %, eop	11.11	13.49	8.61	10.64	10.87	6.59	10.00	10.75	12.00
Long-term yield, %, eop	12.95	12.27	12.25	12.24	10.66	7.96	11.50	14.00	14.50
BRL/USD, eop	1.78	2.31	1.74	1.66	1.86	2.05	2.31	2.46	2.49
BRL/USD, avg	1.95	1.84	2.00	1.76	1.67	1.95	2.19	2.42	2.49
Balance of Payments, USD bn									
Current account	1.6	-28.2	-24.3	-47.3	-52.5	-54.2	-77.5	-71.6	-70.6
% of GDP	0.1	-1.7	-1.5	-2.2	-2.1	-2.4	-3.5	-3.4	-3.1
Trade balance	40.0	24.8	25.3	20.1	29.8	19.4	1.2	9.6	12.6
Exports	160.6	197.9	153.0	201.9	256.0	242.6	242.2	256.9	268.9
Imports	120.6	173.1	127.7	181.8	226.2	223.2	241.0	247.2	256.2
Service balance	-13.2	-16.7	-19.2	-30.8	-37.9	-41.0	-47.0	-44.8	-45.8
Income balance	-29.3	-40.6	-33.7	-39.5	-47.3	-35.4	-35.2	-40.0	-41.0
FDI, net	34.6	45.1	25.9	48.5	66.7	64.7	58.2	60.0	60.0
International reserves	180.3	206.8	239.1	288.6	352.0	378.6	376.9	376.9	376.9
Total amortisations	38.2	22.4	30.1	33.8	29.8	35.8	41.8	47.8	49.8
Public Finances, % of GDP									
Consolidated government balance	-2.8	-2.0	-3.3	-2.6	-2.6	-2.5	-3.6	-3.9	-2.7
Consolidated gov primary balance	3.8	3.9	2.0	2.7	3.1	2.4	1.5	1.5	2.5
Public debt	55.0	55.9	60.9	53.4	54.2	58.7	59.5	59.9	59.8
of which Domestic	50.9	51.2	57.5	50.5	51.5	55.8	56.5	56.9	56.8
Foreign Assets & Liabilities, USD bn									
External debt	193.6	198.3	198.2	256.8	298.2	312.9	316.0	321.1	327.1
Public	86.0	84.2	93.7	103.7	102.3	112.9	113.6	115.8	117.9
External debt / GDP	14.1	11.8	12.2	12.0	12.1	13.9	14.3	15.0	14.6
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	38.9	36.4	31.0	57.3	40.1	37.2	40.0	42.0	-
Short-term debt/International reserves (%)	21.6	17.6	13.0	19.9	11.4	9.8	10.6	11.1	-
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	3.3	3.0	2.4	2.2	1.3	2.0	2.4	2.2	2.0
CPI, % yoy	6.7	5.9	5.9	5.8	5.9	6.0	5.9	5.8	5.6
Policy interest rate, %, eop	8.00	9.00	10.00	10.75	10.75	10.75	10.75	11.75	12.00
Short-term market rate, % eop	7.72	8.72	10.00	10.75	10.75	10.75	10.75	10.07	11.40
Long-term yield, %, eop	8.68	8.91	8.57	12.00	13.50	14.00	14.00	14.50	14.50
BRL/USD, eop	2.23	2.22	2.31	2.36	2.42	2.45	2.46	2.47	2.48

Source: National Sources, Citi Research

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- **Summary view** — Fiscal topics will again be in the spotlight. We do not expect too much fiscal progress in El Salvador and Panama, while in Costa Rica we are skeptical about the possibility of a thorough fiscal reform. We expect the Dominican Republic to keep the fiscal deficit at a level that prevents debt ratios from rising.
- **Things to watch** — Costa Rica, El Salvador and Panama will hold presidential elections next year. The election in El Salvador is, by far, the one that has the highest political risk attached.
- **Strategy** — In the Dominican Republic, we expect the BCRD to hold a stronger grip on the DOP. Larger-than-usual net external issuance by the government could lend a hand to the BCRD to calm the FX market. In Costa Rica, we expect moderate appreciation pressures in the CRC to remain intact, and thus the BCCR would continue defending the floor of the FX band.

The “election” year

Costa Rica, El Salvador and Panama will hold presidential elections next year.

In Costa Rica, Johnny Araya (PLN) seems to face little opposition in the presidential race. The opposition continues to be fragmented and therefore we expect Mr. Araya to become Costa Rica's next president. In Panama, the candidate from the ruling party is also ahead in the polls. Jose Domingo Arias from the CD party has roughly a 10 percentage point lead over Juan Carlos Varela (PPA).⁴ Juan Carlos Navarro (PRD) was ahead in the polls not so long ago, but is now in third place. In both Costa Rica and Panama, we regard the elections as a non-market event, with virtually no political risk. In Costa Rica, the first round of the election will be held on February 2, while in Panama on May 4.

In El Salvador, the election has a different flavor than those in Costa Rica and Panama.

Unlike in Panama or Costa Rica, we think there is political risk attached to the election in El Salvador. We consider opposition candidate Norman Quijano (ARENA) to be significantly more market friendly than Salvador Sanchez Ceren (FMLN). Mr. Sanchez Ceren is regarded as part of the “old” FMLN. In the most recent poll (see graph at the end of the CCA section), the ruling FMLN party is slightly ahead of ARENA in the presidential race. Nonetheless, we think that in a likely second round ARENA would defeat the ruling party, as Mr. Quijano would garner most of the constituency that voted in favor of former president Antonio “Tony” Saca (UNIDAD) in the first round. We must note, however, that the most recent advance by the FMLN has not been at the expense of ARENA losing votes to UNIDAD. Although we expect Mr. Quijano to prevail in a second round, we still think it would be untimely to take his victory for granted.

Fiscal concerns to persist

We are skeptical about Costa Rica's final attempt to deliver some kind of fiscal reform. The outgoing government is expected to send Congress a fiscal reform proposal in February – right after the presidential election. The government has been trying to get feedback from businessmen, academics and other stakeholders. It seems the government is trying to build a strong consensus about the main features of the aforementioned reform. This is consistent with the fact that the Costa Rican society likes to build a strong consensus around major issues.

⁴ Source: Dichter & Neira (November 18, 2013)

Our skepticism is associated with the traditional slowness of Congress in Costa Rica, and the poor political capital of an outgoing administration. As an example, the capital controls bill was sent to Congress by the government in early 2013 and has not yet been approved. That bill had a strong consensus and is far less politically complicated than a fiscal reform. In our view, the outgoing administration lacks the political capital to push for the approval of any reform – let alone a fiscal reform. We have yet to see how much political capital the incoming administration would commit to the reform.

Panama seems to be parked in a comfort zone of a 3% NFPS deficit. The essence of the fiscal responsibility law has been forgotten for some time. We do not see any sign that either the outgoing or incoming administrations would try to revive the aforementioned essence and reduce the non-financial public sector deficit (NFPS). In our view, a 3% deficit is manageable for Panama as long as it continues to grow at high rates. However, as the economy is slowing, we get closer to the completion of the Panama Canal expansion, one thing that will come up is the missed opportunity of putting fiscal accounts in check when the economy was outperforming everyone else in Latin America.

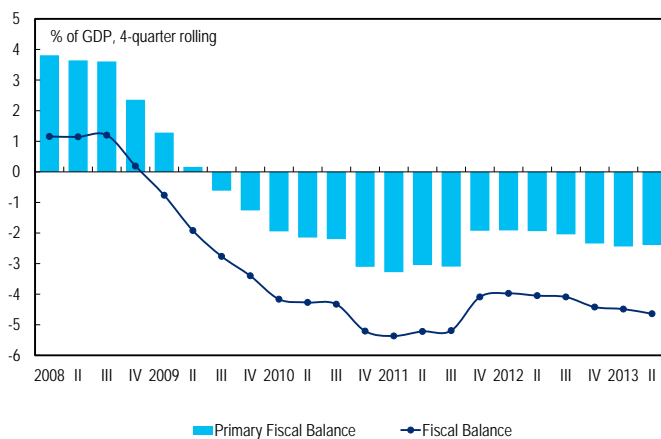
“Fiscal” reform fatigue could become evident in El Salvador. The outgoing administration undertook fiscal reforms and hiked taxes but in the end it did not deliver the narrowing in the fiscal deficit it was expecting. Low growth prevented the government from getting the necessary revenues to be successful in lowering the deficit. After so many years of low growth and many attempts to narrow the fiscal deficit, we think the incoming administration – regardless of who wins – is unlikely to have the will to tighten the government’s belt severely or undertake a thorough fiscal reform.

Dominican Republic is expected to behave relatively well on the fiscal side. The Dominican Republic made significant progress in lowering the deficit during 2013. We think that next year, the central government deficit would be below 3% of GDP. In our view, a deficit below this threshold keeps debt ratios stable. Of course, we do not expect too much progress in reducing the subsidy to electricity, but we do not expect the subsidy to get out of control – provided that oil prices do not increase substantially (like in 2008).

Two different FX policies

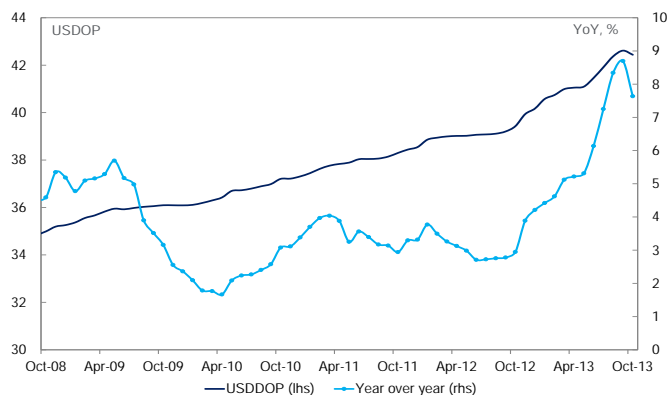
We expect the BCRD to hold a stronger grip on the DOP, while the BCCR will likely be unsuccessful in weakening the CRC. We expect higher net external financing in 2014 to lend a hand to the Central Bank of the Dominican Republic to calm the FX market in the country. Through the government’s external issuance, the BCRD would be able to push up international reserves. These reserves could be used more actively in case the USDDOP moves beyond the BCRD parameters. In Costa Rica, the central bank (BCCR) will most likely continue to buy hard currency to prevent the USDCRC from moving below the floor of the FX band. We expect FDI and exports to continue bringing enough hard currency to keep intact the current moderate appreciation pressures in the *Colón*. Needless to say, we do not expect any kind of modification to the FX band.

Figure 280. The fiscal deficit is widening again in Costa Rica



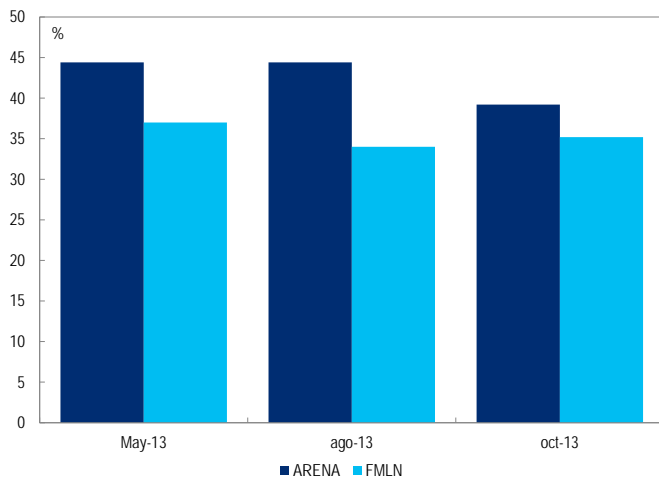
Source: Hacienda, BCCR and Citi Research

Figure 282. Domrep's authorities will try to hold a stronger grip on the FX



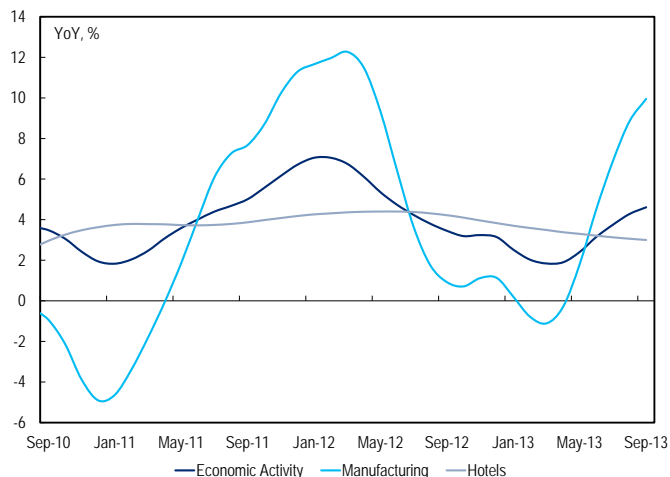
Source: BCRD, Haver and Citi Research

Figure 284. ARENA is still ahead in a likely second round in El Salvador



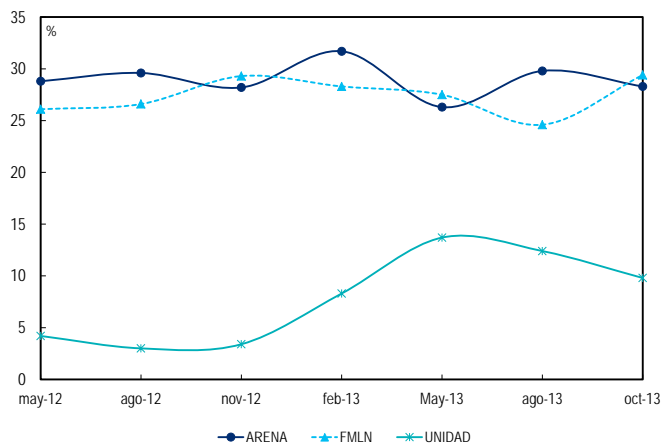
Source: LPG Datos, La Prensa Grafica and Citi Research

Figure 281. Manufacturing is pushing up growth again in Costa Rica



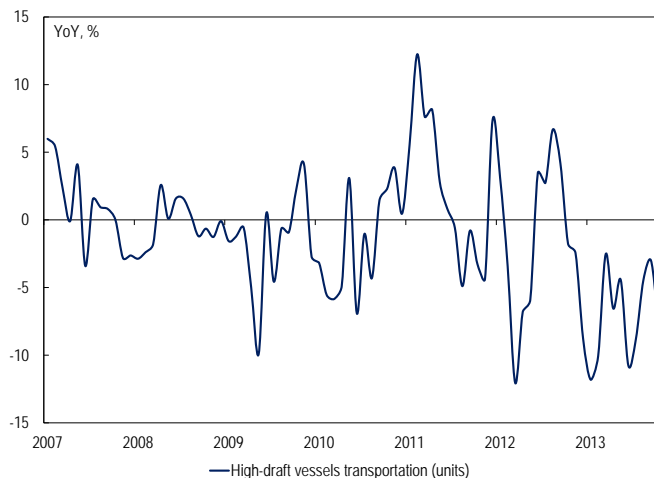
Source: BCCR, Haver and Citi Research

Figure 283. Polls show the FMLN is gaining momentum in El Salvador



Source: LPG Datos, La Prensa Grafica and Citi Research

Figure 285. Traffic in the Panama Canal continues to disappoint



Source: ACP, Bloomberg, Haver and Citi Research

Figure 286. CCA Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Costa Rica									
Nominal GDP, USD bn	26.4	29.8	29.4	36.4	40.9	45.1	49.5	53.0	57.7
GDP per capita, USD	5,941	6,582	6,366	7,988	8,892	9,602	10,523	11,045	12,014
Real GDP, yoy avg	7.9	2.7	-1.0	5.0	4.4	5.1	3.5	4.0	4.5
CPI, % avg	9.4	13.4	7.8	5.7	4.9	4.5	5.3	3.1	4.1
CRC/US\$, avg	517	525	570	521	502	503	499.8	500.0	500.0
Current account	-1.6	-2.8	-0.6	-1.3	-2.2	-2.3	-2.7	-2.7	-2.9
% of GDP	-6.2	-9.3	-2.0	-3.5	-5.4	-5.2	-5.5	-5.1	-5.0
Consolidated government balance	0.8	0.5	-3.9	-6.0	-5.6	-5.7	-6.0	-6.7	-7.0
Dominican Republic									
Nominal GDP, USD bn	41.3	45.8	46.8	51.8	55.8	59.0	60.3	63.9	67.3
GDP per capita, USD	4,414	4,807	4,822	5,241	5,544	5,770	5,852	6,202	6,530
Real GDP, yoy avg	8.5	5.3	3.5	7.8	4.5	3.9	3.0	4.0	4.5
CPI, % avg	6.1	10.6	1.4	6.3	8.5	3.7	5.1	5.1	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	41.6	42.9	44.5
Current account	-2.2	-4.5	-2.3	-4.3	-4.4	-4.2	-3.1	-3.4	-3.4
% of GDP	-5.2	-9.9	-5.0	-8.4	-7.9	-7.2	-5.1	-5.3	-5.1
Consolidated government balance	-1.7	-4.3	-4.8	-3.7	-3.8	-7.9	-4.2	-4.0	-4.2
El Salvador									
Nominal GDP, USD bn	20.1	21.4	20.7	21.4	23.1	23.8	24.4	25.4	-
GDP per capita, USD	3,500	3,705	3,548	3,653	3,912	4,001	4,063	4,228	-
Real GDP, yoy avg	3.8	1.3	-3.1	1.4	2.0	1.6	1.5	2.0	2.5
CPI, % avg	4.6	7.3	0.5	1.2	5.1	1.8	1.0	2.0	-
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
SVC/US\$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.2	-1.5	-0.3	-0.6	-1.1	-1.3	-1.3	-1.3	-
% of GDP	-6.1	-7.1	-1.5	-2.7	-4.6	-5.3	-5.3	-5.1	-
Consolidated government balance	-1.9	-2.8	-5.5	-4.4	-4.0	-3.5	-3.6	-3.4	-3.0
Panama									
Nominal GDP, USD bn	19.8	23.0	24.2	27.1	31.3	36.3	40.4	44.2	48.0
GDP per capita, USD	5,921	6,759	6,973	7,670	8,699	10,070	11,063	11,958	12,622
Real GDP, yoy avg	12.1	10.1	3.9	7.6	10.6	10.7	7.2	6.5	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	-3.8	-3.3	-5.8	-6.0	-4.4
% of GDP	-7.2	-11.8	-0.7	-10.2	-12.2	-9.0	-14.3	-13.6	-9.2
Consolidated government balance	3.5	0.4	-1.0	-1.9	-2.2	-2.1	-3.5	-3.0	-3.0

Source: National Sources, Citi Research

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- **Summary view** — Below-potential GDP growth and a benign inflation outlook should give enough room for the BCCh to continue easing monetary policy in 2014. Michelle Bachelet is expected to push for an ambitious social agenda in his likely second term.
- **Things to watch** — The country will hold the second round of the presidential election on December 15. Mrs Bachelet is widely expected to win, but she might try to boost as much as possible her political capital in this second round to get support for her economic and social agenda.
- **Strategy** — We expect 50bps of additional cuts to the policy rate in 2014. In addition, we expect more interest from offshore investors in Chile as a result of the approval of the Ley Unica de Fondos.

Flat growth with no inflation worries

We expect growth in 2014 to be 4% – unchanged from 2013. GDP growth has been decelerating through 2013, as we were expecting. As a result, we continue to see real GDP at 4% in 2013, a slightly below-consensus forecast. Our forecast is at the lower end of the Central Bank of Chile's (BCCh) forecast (4.0-4.5%). For 2014, we reduce our real GDP growth forecast to 4%, down from 4.5%. This forecast is both below market and BCCh expectations, and would put annual growth below potential for the second year in a row. In our view, potential growth is closer to 5% than to 4%. Maybe more important than lower GDP growth is our view that domestic demand growth should also begin to grow at more "normal" levels. As a result, the current account deficit should stop widening and remain within comfortable levels.

On the inflation front, we are not seeing potential short-term pressures.

Besides the fact that headline inflation is currently below the lower bound of BCCh's target band (2-4%), alternative indicators suggest a benign inflation outlook. The two core inflation measures, the IPCX and IPCX1, have increased 1.7% and 2.1% during the last 12 months, well below the BCCh's midpoint target. Also, the sticky non-tradable inflation has been trending down and currently stands at 3.5% in annual terms. Moreover, year-to-date non-tradable inflation stood at 2.5% as of October. Interestingly, despite the weaker CLP, tradable inflation is well contained and came in at 0% YoY and 1.6% YTD, also in October. There is always a risk that commodity prices could drive up inflation, but our baseline scenario assumes that commodities are unlikely to give headaches in 2014.

Implications for monetary policy

The absence of inflationary pressures and below-potential GDP growth should lead the BCCh to further cut the policy rate by 50bps in 2014 to 4%.

Following the two 25bps cuts to the policy rate in October and November, we expect the BCCh to remain on hold in December but continue cutting the policy rate in 2014. In particular, we expect two additional 25bps cuts – most likely beginning in 1Q13. Our prognosis is also based on lower inflation expectations. After remaining remarkably anchored at BCCh's midpoint target for a long period of time despite the low inflation readings, BCCh's surveys suggest expectations have started to trend down. For instance, economists see annual inflation at 2.8% in the next 12 months, while traders expect prices to rise only 2.4%. Regarding this last figure, it is worth noting that it is the lowest since January 2010.

Bachelet's second term

Michelle Bachelet (Nueva Mayoría) is widely expected to become president.

Mrs. Bachelet is much better positioned than Evelyn Matthei (Alianza) to win the second round on December 15. Not only was Mrs. Bachelet relatively close to getting 50% of the votes in the first round, but she also enjoys a much higher popularity (or a much lower unpopularity) than Mrs. Matthei. The relevant question seems to be how big the difference between Bachelet and Matthei will be. If the difference is big, then the chances of Mrs. Bachelet being successful in pushing her ambitious social agenda will increase. Although Mrs. Bachelet's Nueva Mayoría does not have the necessary qualified majorities in Congress to pass the educational reform and the modification of the binomial electoral system, if she gets some momentum her party may get support from the independent lawmakers. This scenario cannot be ruled out as Nueva Mayoría is very close to gathering the 4/7 of each chamber's members necessary to get congressional approval of the reforms: 21 out of the 30 members of the Senate and 68 out of the 120 members of the House of Representatives (i.e., in both cases, Nueva Mayoría is one seat short from controlling 4/7 of the chambers). In the case of the tax reform, which aims to boost tax collection by 3% of GDP in order to finance the 1.5-2.0% of GDP increase in public spending resulting from the educational reform and to eliminate the 1% of GDP structural deficit Mrs. Bachelet will inherit from the current administration, a simple majority in both Congress chambers is necessary.

There are other topics that are raising concerns among local and offshore

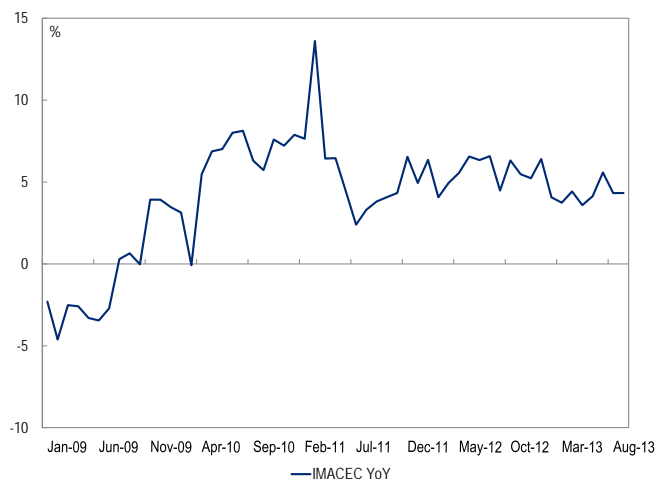
investors. The first is the appointment of key cabinet posts – particularly the selection of the Minister of Finance. In our view, there is a high probability that Mrs. Bachelet will not choose a Minister of Finance from the traditional elite of Chilean economists. This opens the door for guesswork if the next Minister of Finance will have the will or the muscle to stop policies that could be regarded as market unfriendly or potentially inconvenient for the stability of public finances – such as the expansion of welfare-state programs. Another concern is the possible creation of a state-owned AFP (pension fund), thereby bringing the unnecessary discomfort that surrounds a state-owned agency participating actively in local markets. Even if the regulatory structure surrounding the new state-owned AFP were to be well designed, there would likely be suspicions about how fairly this pension fund will compete against private firms. Issues of moral hazard, different incentive structures of participants, and potentially having the state as a large shareholder in private companies could generate uncertainty and have an impact on market valuations.

Exporter of services

The approval of the Ley Unica de Fondos is opening a new opportunity for

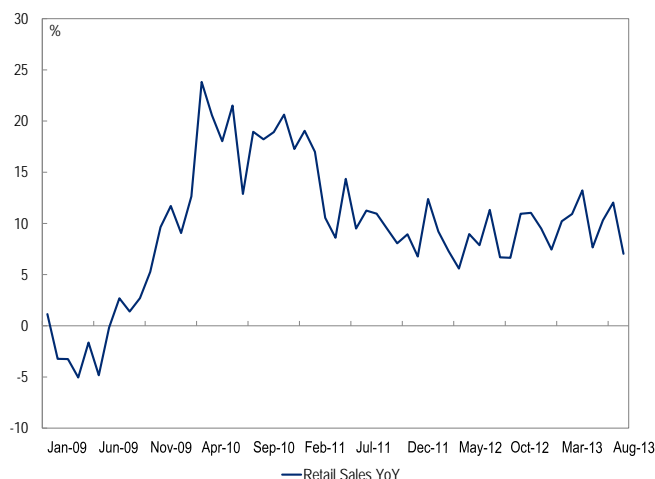
Chile. On November 20, the Lower House approved the Ley Unica de Fondos. The Senate had already approved earlier this year. The main purpose of this new law is to make Chile an “exporter” of financial services. As a result, it will be easier for offshore investors to access the local bond market. We expect it to expand local issuers' investor base.

Figure 287. Activity annual growth has remained stable...



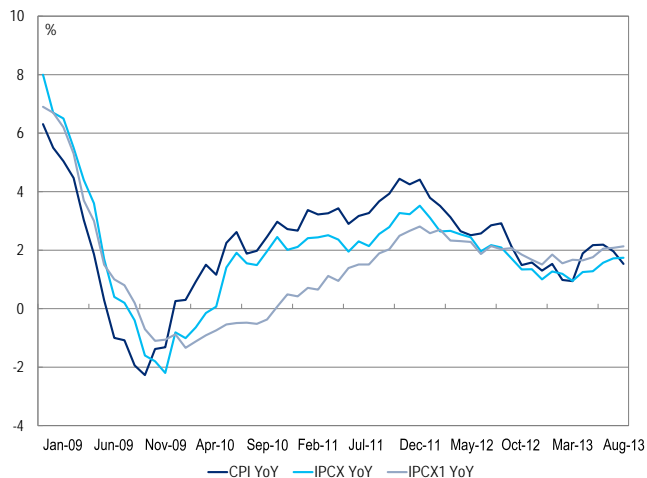
Source: BCCh and Citi Research

Figure 289. Retail sales growth has also slowed



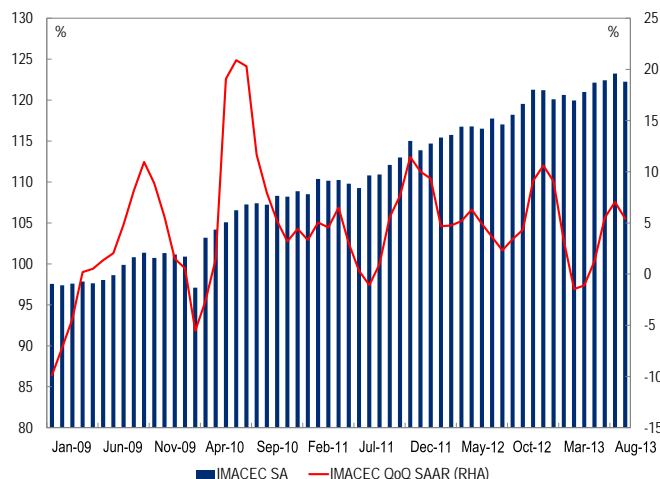
Source: INE and Citi Research

Figure 291. Inflationary pressures look contained



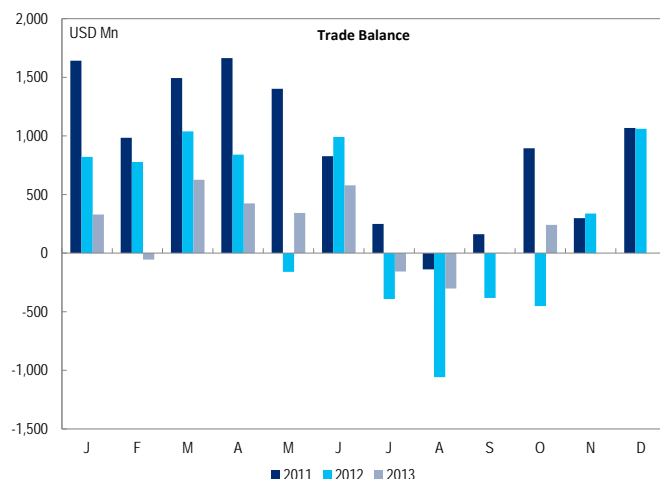
Source: INE and Citi Research

Figure 288. ... but seasonally-adjusted figures show a deceleration



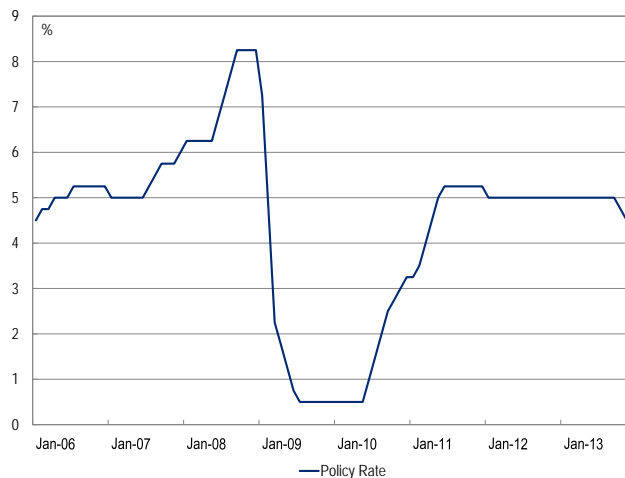
Source: BCCh and Citi Research

Figure 290. The trade balance has stopped deteriorating



Source: BCCh and Citi Research

Figure 292. BCCh has started to ease monetary policy



Source: Bloomberg and Citi Research

Figure 293. Chile Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	173	183	173	218	251	268	281	290	314
Nominal GDP, local currency bn	90	94	96	111	121	131	139	149	160
GDP per capita, USD	10,414	10,876	10,199	12,861	14,649	15,509	16,055	16,433	17,618
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	6.0	6.0	6.0
Economic Activity									
Real GDP, yoy avg	5.2	3.3	-1.0	5.8	5.9	5.6	4.0	4.0	4.5
Real investment growth % yoy	6.4	20.8	-23.5	33.4	10.9	12.6	2.6	3.3	6.3
Real consumption growth % yoy	7.5	4.4	0.8	9.8	7.9	5.8	5.3	4.7	4.8
private consumption growth % yoy	7.6	5.2	-0.8	10.8	8.9	6.1	5.6	4.9	4.9
Real export growth, % yoy	7.2	-0.7	-4.5	2.3	5.2	1.0	5.9	3.8	4.2
Real import growth, % yoy	14.3	11.2	-16.2	25.9	14.5	4.9	5.1	4.1	6.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	7.8	7.1	-1.5	3.0	4.4	1.5	2.2	2.8	3.0
CPI, % avg	4.4	8.7	1.5	1.4	3.3	3.0	1.7	2.6	2.9
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	4.00	4.00
1 month inter-bank rate, %, eop	5.93	8.24	0.45	3.13	5.23	4.99	4.50	4.00	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	520	510	509
CLP/USD, avg	522	524	559	510	484	486	501	512	510
Balance of Payments, USD bn									
Current account	7.1	-5.8	3.5	3.2	-3.3	-9.5	-9.8	-11.1	-12.5
% of GDP	4.1	-3.2	2.0	1.5	-1.3	-3.5	-3.5	-3.8	-4.0
Trade balance	24.1	6.1	15.4	15.6	10.5	3.4	1.6	1.4	0.5
Exports	68.6	64.5	55.5	71.1	81.5	78.3	77.5	82.8	88.4
Imports	44.4	58.4	40.1	55.5	70.9	74.9	76.0	81.4	87.9
Service balance	-1.3	-1.2	-2.0	-2.1	-2.6	-2.4	-2.7	-0.5	-0.2
Income balance	-18.9	-13.6	-11.4	-14.7	-14.1	-12.7	-11.2	-14.3	-15.4
FDI, net	12.6	15.5	12.9	15.4	22.9	30.3	19.4	17.7	12.4
International reserves	16.9	23.2	25.4	27.9	42.0	41.6	41.7	43.1	46.7
Total amortisations	14.3	14.3	16.4	12.3	12.8	22.4	22.7	22.8	23.5
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	122.1	126.1	136.6
Public	4.0	3.3	4.0	5.6	7.1	7.9	4.3	4.3	4.7
External debt / GDP	30.8	34.9	41.5	38.7	39.3	43.9	46.8	43.5	43.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	9.0	14.0	15.8	16.2	19.6	22.8	21.8	22.2	23.9
Short-term debt/International reserves (%)	53.4	60.6	62.4	58.3	46.6	54.9	52.4	51.4	51.3
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	4.0	4.7	2.7	2.5	3.7	4.1	5.5	5.1	4.2
CPI, % yoy	1.9	2.0	2.2	2.2	2.7	2.5	2.8	2.8	2.9
Policy interest rate, %, eop	5.00	5.00	4.50	4.00	4.00	4.00	4.00	4.00	4.00
Short-term market rate, % eop	5.00	5.00	4.50	4.00	4.00	4.00	4.00	4.00	4.00
Long-term yield, %, eop	5.24	5.13	5.10	5.00	5.00	5.00	5.00	5.00	5.00
CLP/USD, eop	508	505	520	516	512	510	510	510	510

Source: National Sources, Citi Research

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- **Summary view** — After the deceleration phase that started at the end of 2011, it seems the economy will be reaching its business cycle trough at the end of 2H13. Nonetheless, the recovery has not been homogenous across sectors, with industrial production still lagging. We expect this mild recovery phase to continue in 2014, taking GDP growth to 4.6%. The evolution of civil works spending should pose the major downside risk for activity. This is the result of the country's legal restrictions on new government spending during political campaigns.
- **Things to watch** — In our view, the presidential race and the evolution of the peace process will be the center of the attention during the first half of next year.
- **Strategy** — In the context of a mild economic recovery, we expect the central bank to start normalizing the repo rate, which could negatively affect the fixed rate TES curve next year.

Activity, inflation, and monetary and fiscal policy

A mild recovery, but still a recovery. The available GDP data and several leading indicators (with the notable exception of industrial production) suggest the business cycle trough will be reached at the end of 2H13, and the economy should start rising beyond that point. Nonetheless, the local characteristics – namely the performance of the industrial sector, the moderation in growth in the oil and mining sectors, and the uncertainty regarding the construction sector – along with the upcoming presidential elections lead us to expect a mild recovery next year, with GDP growth standing at 4.6% in 2014, after an expected expansion of 3.9% in 2013. In general terms, 2014 should be characterized by the growth heterogeneity between sectors. Our 4.6% GDP growth forecast implies that construction (8.5% YoY), financial services (5.3% YoY), retail (5.2% YoY), and oil and mining (5.0%) will be the best performers next year. On the other hand, agriculture (2.6%) and the industrial sector (3.4% YoY) should continue displaying growth levels below the overall GDP figure. Regarding the expected behavior for the industrial sector, we expect to see some moderate recovery by the end of 2013 and the beginning of 2014, as a result of the low base of comparison, but still we see overall poor results extending to 1Q14. We expect the construction sector to be the best performer next year; however, we 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 think that most of the fundamental problems (corruption scandals, microeconomic bottlenecks, and coordination among ministries) have taken their toll on the growth figures, we expect to see a significant improvement in the overall construction sector next year driven by ongoing civil works projects, spending at the regional level and private sector works.

The presidential campaign could have two potential negative effects in economic performance. On the one hand, local regulations impose important restrictions on government contracts when the president is running for a second term (*Ley de Garantías*). This could create an additional source of uncertainty regarding the spending on civil works programs. On the other hand, the analysis of political and business cycles, at both national and local level, tends to point to lower levels of spending and public works execution during the first year of government. Nevertheless, our central scenario assumes that a significant amount of the already approved civil works projects would be unaffected, taking the construction sector to be the best performer sector next year.

Inflation: Down is the new up. The inflation outlook has been favorable in 2013, with some months' prints even standing below the lower band of the CB's inflation target. This behavior has been mostly driven by foodstuffs and some regulated prices, particularly gasoline. In that sense, the discussion of a new formula which could imply lower retail gasoline prices will be an important element to assess the future dynamics of prices in Colombia. That said, we have modified our 2013 year-end inflation forecast down to 2.0%. For next year, we expect a moderate increase in inflation to 2.8% by year-end, still below the CB's midpoint target.

Monetary policy. Although the low headline inflation prints may concern some CB Board members, next year's inflation is expected to be driven by a moderate pick-up in core inflation, which would take the CB to start normalizing the repo rate. We expect two rounds of repo rate increases: 50bps between March and May, and 75bps after the presidential election results between September and November, taking the repo rate to 4.50% by the end of 2014.

No major surprises expected on the fiscal front. We expect fiscal prints to stay relatively in line with expectations in 2013, and the government to finish the fiscal year with some of the resources needed for next year's external financing. That said, the main variable to analyze will be tax collections, which we expect to be relatively in line with the Fiscal Plan's target of COP102 trillion (USD56.6 billion). In 2014, we also expect the government to stay in line with the official budget and with no major pressures on the fiscal front. Nonetheless, we think there are two important risks that will have to be followed closely. First, Citi's commodity strategists have a bearish outlook for oil prices which could affect tax collections, particularly in 2015. Second, there is the cost of the peace process – which will depend on the final agreement reached between the government and FARC – something that we have not included in our 2014 forecasting exercise.

Political outlook

Politics on the frontline. The presidential and congressional elections scheduled for 2014 will be the center of attention and main source of headlines during 1H14. There are three elements that make these elections particularly challenging and will likely cause the political parties to take a more aggressive-than-usual approach during the campaigns. First, the low levels of popularity of Mr. Santos will have to be reversed drastically. Second, the government announced that the peace process will continue during the presidential race, with any advance made in Cuba affecting favorably Mr. Santos' image, but with any setback being costly in political terms. Last but not least, former President Uribe will be running for Congress and he will be supporting Mr. Santos' main rival in the presidential race, former finance Minister Oscar Iván Zuluaga. Our base case scenario assumes that Mr. Santos continues in power after a victory in the second round. Nevertheless, apart from the difference in treatment to the current negotiation with FARC, we do not believe the main contenders in the upcoming presidential election will have major differences in economic agenda.

Figure 294. A mild recovery is expected in 2014

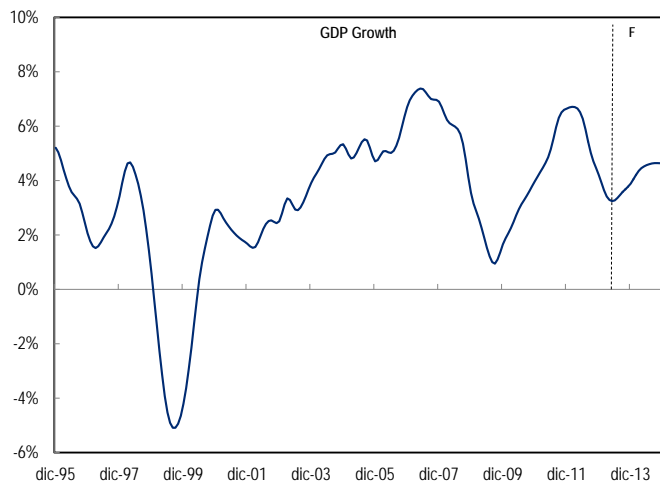


Figure 296. Inflation should normalize, but still below the 3% mid-target

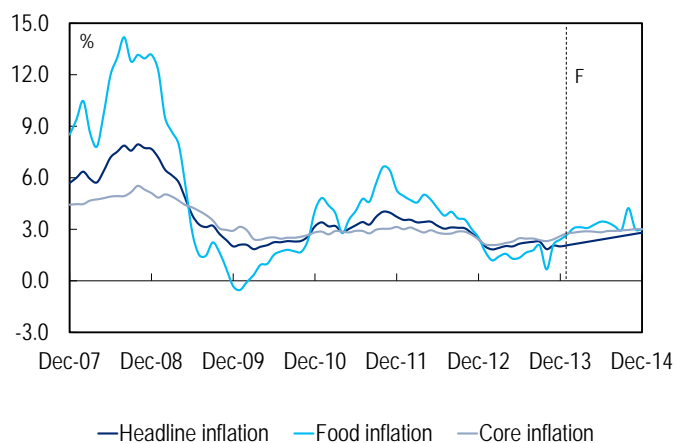


Figure 298. No major short-run surprises are expected in the fiscal front

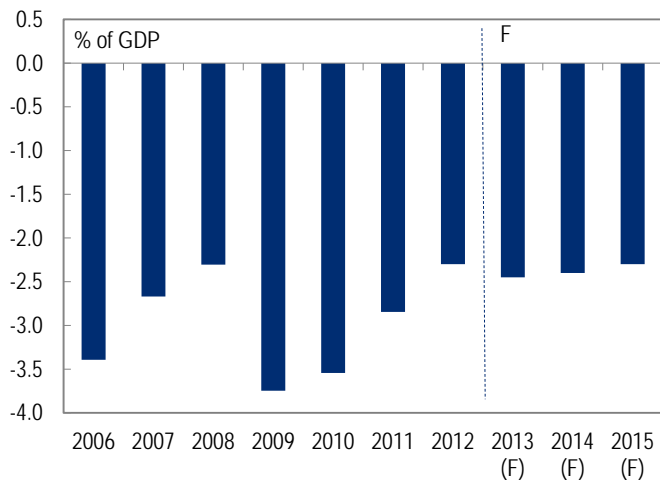


Figure 295. The construction sector is the main source of uncertainty

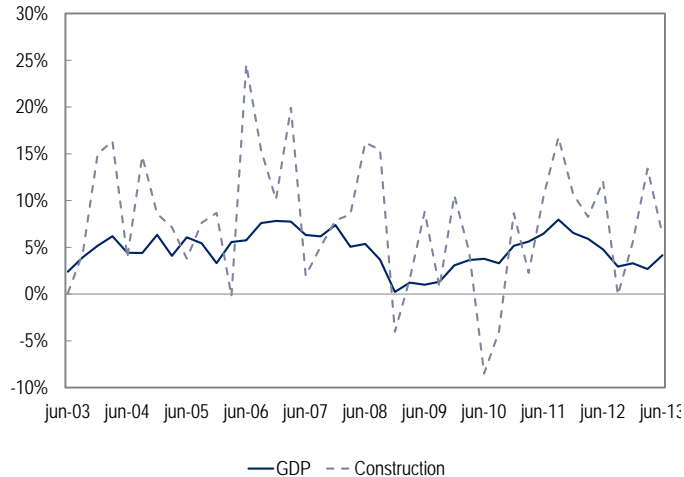


Figure 297. We expect the repo rate to be increased next year

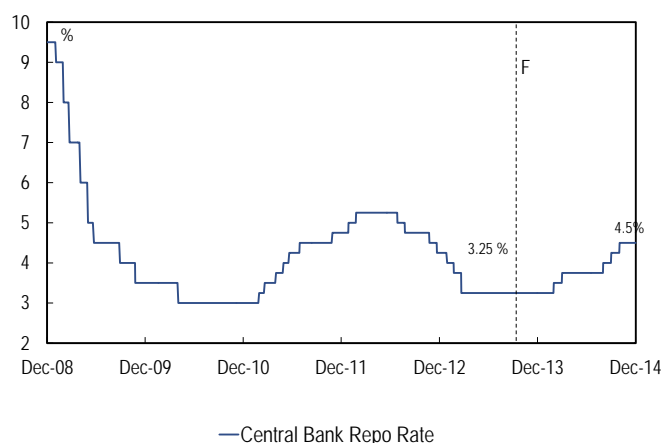


Figure 299. Politics on the frontline

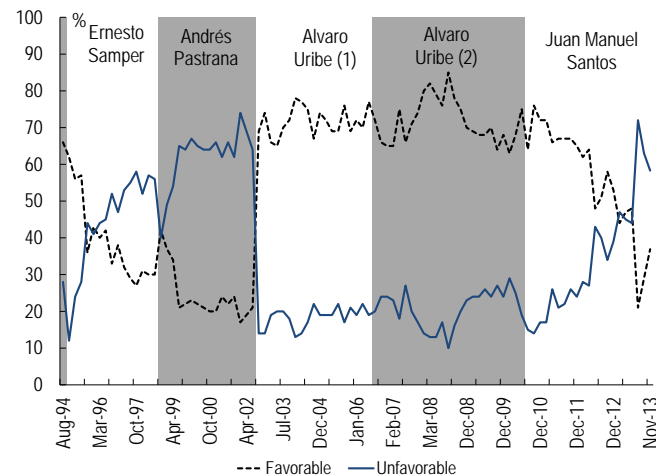


Figure 300. Colombia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	208	242	231	285	332	374	389	397	421
Nominal GDP, local currency bn	431	480	505	544	616	673	732	762	824
GDP per capita, USD	4,726	5,447	5,136	6,248	7,220	8,048	8,255	8,357	8,755
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	9.8	9.4
Economic Activity									
Real GDP, yoy avg	6.9	3.5	1.7	4.0	6.6	4.2	3.9	4.6	5.0
Real investment growth % yoy	12.8	9.0	-3.9	7.7	18.2	7.3	3.1	4.6	3.3
Real consumption growth % yoy	7.0	3.5	1.6	5.1	5.4	4.8	4.1	4.8	5.6
private consumption growth % yoy	7.3	3.5	0.6	5.0	5.9	4.7	4.1	4.8	5.5
Real export growth, % yoy	6.9	4.5	-2.8	1.3	12.9	5.4	4.7	7.8	11.0
Real import growth, % yoy	14.0	10.5	-9.1	10.8	21.2	9.1	3.3	7.4	9.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	5.7	7.7	2.0	3.2	3.7	2.4	2.0	2.8	3.5
CPI, % avg	5.5	7.0	4.2	2.3	3.4	3.2	2.0	2.4	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	12.8	14.0	15.9
Policy Rate (eop)	9.50	9.50	3.50	3.00	4.75	4.25	3.25	4.50	5.50
1 month inter-bank rate, %, eop	9.35	8.87	3.10	3.00	4.81	4.27	3.30	4.52	5.52
Long-term yield, %, eop	10.27	12.76	8.47	7.70	7.60	5.86	6.20	7.42	8.42
COP/USD, eop	2,018	2,249	2,043	1,920	1,939	1,767	1,901	1,936	1,969
COP/USD, avg	2,076	1,968	2,154	1,898	1,848	1,798	1,889	1,921	1,960
Balance of Payments, USD bn									
Current account	-6.0	-6.7	-5.0	-8.8	-9.8	-12.2	-11.9	-12.8	-14.8
% of GDP	-2.9	-2.8	-2.1	-3.1	-3.0	-3.3	-3.1	-3.2	-3.5
Trade balance	-0.6	1.0	2.5	2.4	6.1	4.8	4.7	3.2	4.7
Exports	30.6	38.5	34.0	40.8	58.3	61.5	62.0	61.3	64.7
Imports	31.2	37.6	31.5	38.5	52.2	56.7	57.3	58.1	60.0
Service balance	-2.6	-3.1	-2.8	-3.6	-4.7	-5.5	-4.4	-7.0	-9.6
Income balance	-8.0	-10.2	-9.3	-12.0	-16.0	-16.0	-16.7	-13.9	-15.1
FDI, net	9.0	10.6	7.1	6.8	13.4	15.6	16.0	16.4	16.8
International reserves	20.9	24.0	25.4	28.5	32.3	37.5	44.1	47.7	51.3
Total amortisations	5.7	5.1	5.8	6.5	6.3	12.1	7.7	7.8	7.9
Public Finances, % of GDP									
Consolidated government balance	-0.6	-0.1	-2.7	-3.3	-2.9	0.3	-1.1	-0.7	-0.7
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	32.9	34.0	36.7	37.3	34.9	32.1	31.0	30.3	28.4
of which Domestic	21.9	22.6	24.9	26.4	24.5	23.3	22.4	21.9	20.6
Foreign Assets & Liabilities, USD bn									
External debt	44.6	46.4	53.7	64.1	75.9	79.1	81.5	81.9	81.9
Public	28.8	29.4	37.1	38.9	42.8	46.4	46.5	46.5	46.5
External debt / GDP	21.5	19.1	23.2	22.5	22.8	21.1	20.9	20.6	19.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	5.1	5.7	3.9	8.1	10.8	9.8	10.2	10.4	10.6
Short-term debt/International reserves (%)	24.6	23.5	15.6	28.3	33.4	26.2	23.2	21.8	20.7
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	4.2	4.2	4.5	4.6	5.0	4.5	4.5	4.8	4.9
CPI, % yoy	2.2	2.3	2.0	2.3	2.4	2.4	2.8	3.1	3.3
Policy interest rate, %, eop	3.25	3.25	3.25	3.50	3.75	4.00	4.50	4.75	5.00
Short-term market rate, % eop	3.17	3.29	3.30	3.27	3.77	3.77	4.52	4.52	5.02
Long-term yield, %, eop	6.42	6.87	6.20	6.17	6.67	6.67	7.42	7.42	7.92
COP/USD, eop	1,922	1,912	1,901	1,908	1,916	1,925	1,936	1,947	1,958

Source: National Sources, Citi Research

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- **Summary view** — Ecuador's economy is expected to start accelerating in 2H13 after two consecutive quarters growing at 3.5%. That said, we expect 2013 GDP growth of 4% and to continue at the same pace next year. Amid favorable inflation results and an economy which is expected to continue to grow on the back of consumption and government spending, the main goal of the government is to guarantee enough inflows of FDI to finance the new oil production projects. The widening of the trade balance deficit and its financing concerns are, in our view, the main reason for the government to look for the development of the oil exploration at the Yasuni National Park to increase oil production.
- **Things to watch** — On the political side, the campaigns for the mayoral elections have begun and the dispute over Guayaquil is expected to take center stage at the beginning of 2014.

Inflation and activity outlook

On the activity outlook, we continue to expect growth of 4% in 2013, fueled by strong consumption and government spending growth. The latest GDP data available for 2Q13 showed a 3.5% YoY expansion, driven by the behavior of the non-oil sector which expanded at a 4% annual rate. On the other hand, the oil-sector contracted 2.2% YoY, completing two consecutive quarters of negative growth. Nonetheless, we expect an important pick-up in economic activity during 2H13, which should take GDP growth to 4.0% for the year as a whole. We expect consumption growth to be 4.7% and government spending to expand 5.5%, both in 2013. 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, one more reason for the government to back the Yasuni project.

We expect GDP growth to continue exhibiting positive results in 2014, and to stand at 4%. That print is based on a 5% rise in government consumption and a 4.9% expansion in consumption. The main risk, in our view, arises from the external front, namely the evolution of oil prices. This is why our GDP growth forecast for next year is more conservative than the government's 4.5%-5.1% forecast.

Inflationary pressures continue to be subdued, but we expect a moderate increase in inflation in 2014. Annual inflation has displayed an important reduction starting in June 2013, mostly driven by the evolution of foodstuff prices. However, the latest inflation results showed that, despite inflation pressures remaining relatively muted, there could be some slight pressure from non-tradable prices going forward.

External accounts

Trade deficit is the flipside of domestic growth, but its financing poses medium-term concerns.

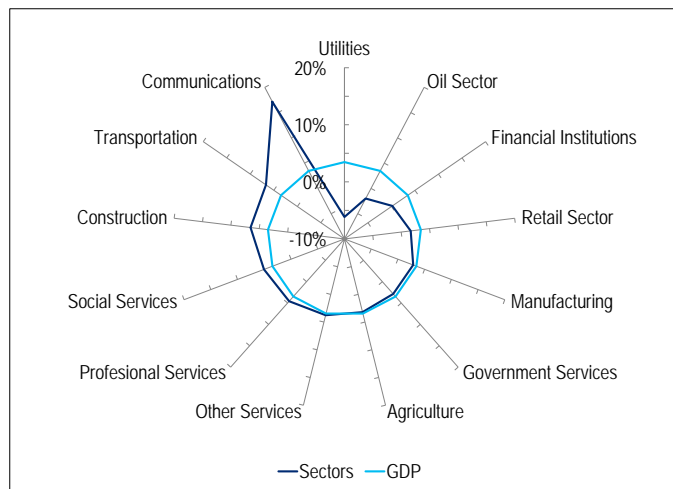
The trade balance showed a deficit of USD787.9mn during January-September versus a surplus of USD118.4mn during the same period last year. In particular, the deficit was explained by higher raw materials and oil derivatives imports. Growth in raw materials and capital goods imports are usually related with higher real GDP growth, at least as long as they are financed through capital inflows. The increase in oil derivatives imports is related to 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.

We expect a marginal deterioration of the current account balance in 2014.

Based on the recent trend observed in the balance of payments, we anticipate that 2013's current account deficit will widen to -0.7% of GDP. In addition, Citi's commodities strategists expect that global macroeconomic factors should continue to mute global demand for commodities for at least another year, so the outlook for 2014 remains neutral-to-bearish regarding oil prices. That being said, we expect Ecuador's terms of trade to remain flat next year. As a result, the aforementioned increase in oil derivatives imports should continue deteriorating the current account balance. Thus, our baseline scenario suggests a current account deficit of -0.9% of GDP in 2014 and it to only start improving in 2015.

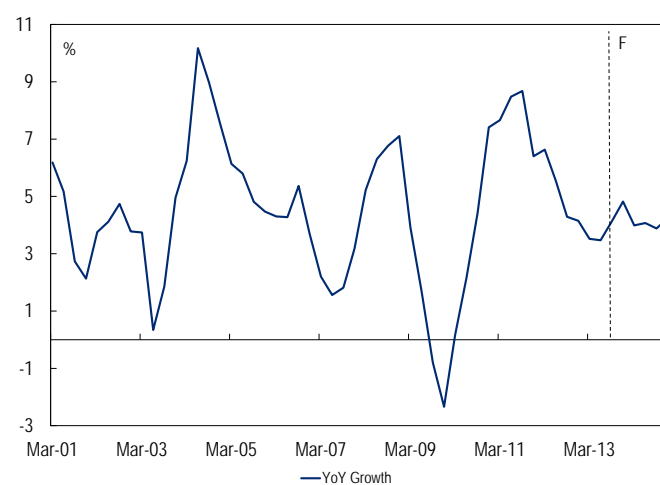
In our view, the medium-term financing of the trade deficit is what has pushed forward the agenda of exploration at the Yasuni National Park. In order to finance its trade deficit, the country needs to increase exports or attract foreign direct investment (FDI). This is the reason why we consider the exploration at the Yasuni National Park and attracting investors in the oil potential from this region has turned into a priority for the government. It was not surprising then that, early in October, the National Assembly granted permission to begin oil exploration at the Yasuni National Park.

Figure 301. 2Q13 GDP growth breakdown



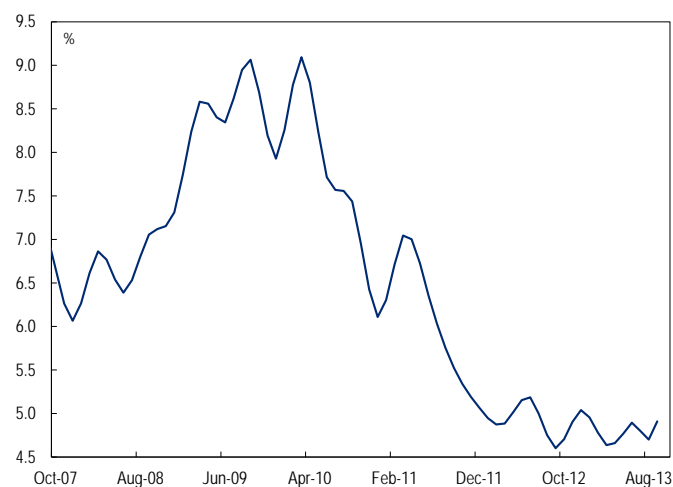
Source: Central Bank of Ecuador and Citi Research

Figure 302. GDP is expected to rebound in 2H13



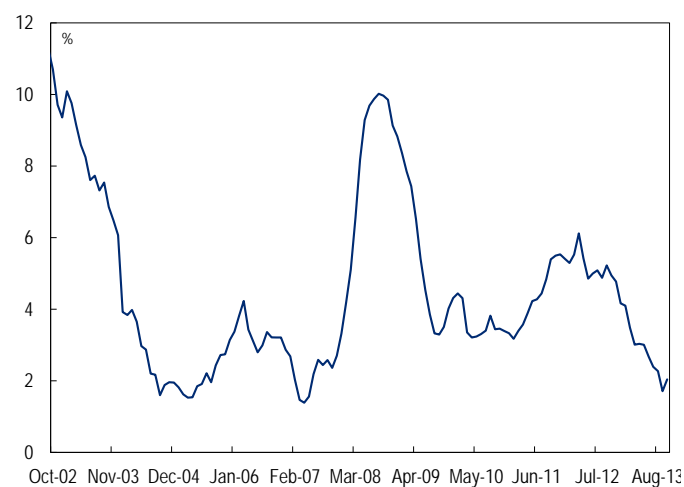
Source: Central Bank of Ecuador and Citi Research

Figure 303. Unemployment rate



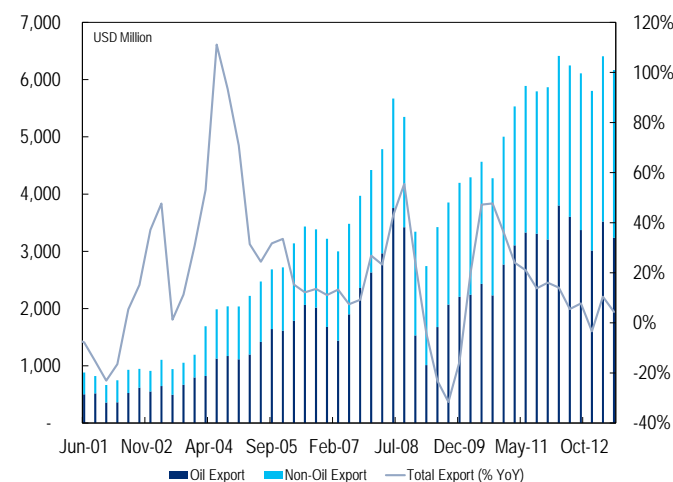
Source: Central Bank of Ecuador and Citi Research

Figure 304. Inflation rate



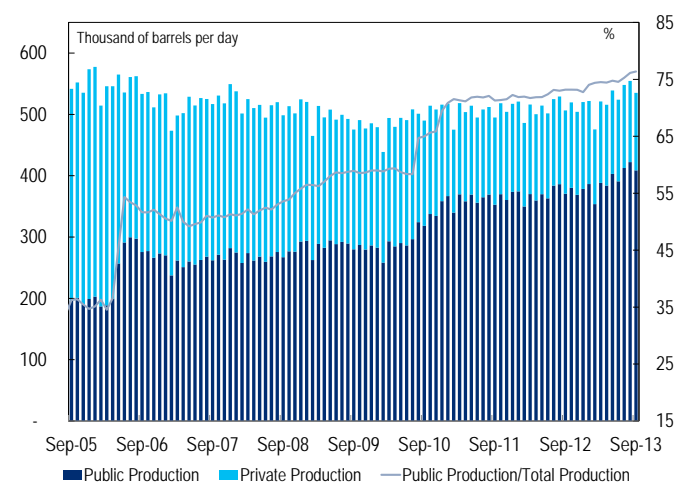
Source: Central Bank of Ecuador and Citi Research

Figure 305. Exports breakdown



Source: Central Bank of Ecuador and Citi Research

Figure 306. Oil production



Source: Central Bank of Ecuador and Citi Research

Figure 307. Ecuador Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	51	62	63	70	80	87	93	99	107
Nominal GDP, local currency bn	51	62	63	70	80	87	93	99	107
GDP per capita, USD	1,856	2,211	2,203	4,637	5,233	5,648	5,905	6,167	6,517
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	5.2	5.0	5.0
Economic Activity									
Real GDP, yoy avg	2.2	6.4	0.6	3.5	7.8	5.1	4.0	4.0	4.5
Real investment growth % yoy	4.2	22.5	-7.3	10.5	12.5	4.7	3.9	5.1	6.4
Real consumption growth % yoy	4.4	6.2	0.9	7.2	5.8	4.8	4.9	4.9	4.5
private consumption growth % yoy	4.2	5.4	-1.0	7.7	5.9	4.3	4.7	4.9	4.3
Real export growth, % yoy	0.0	3.0	-4.8	-0.2	4.6	2.7	2.2	4.5	4.8
Real import growth, % yoy	7.1	14.4	-9.9	14.8	3.9	1.9	4.5	7.6	6.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.3	8.8	4.3	3.3	5.4	4.2	2.0	3.0	3.1
CPI, % avg	2.3	8.4	5.2	3.6	4.5	5.1	2.6	2.3	3.1
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	-0.7	-0.9	-0.3
% of GDP	3.1	2.1	-0.5	-2.3	-0.3	-0.3	-0.7	-0.9	-0.3
Trade balance	1.8	1.4	-0.1	-1.5	-0.2	0.0	-0.1	-0.2	0.3
Exports	14.9	19.1	14.2	18.1	23.1	24.6	26.3	26.6	26.7
Imports	13.0	17.8	14.3	19.6	23.2	24.5	26.4	26.9	26.4
Service balance	-1.4	-1.6	-1.3	-1.5	-1.6	-1.5	-1.7	-1.7	-1.7
Income balance	-2.0	-1.5	-1.4	-1.0	-1.2	-1.3	-1.3	-1.4	-1.4
FDI, net	0.2	1.0	0.3	0.2	0.6	0.6	0.8	1.7	2.6
International reserves	3.5	4.5	3.8	2.6	3.0	2.5	3.7	3.9	3.9
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	-	-	-	-	-	-	-	-	-
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	27.2	22.2	16.4	19.2	18.3	21.3	21.7	20.8	20.0
of which Domestic	6.4	5.9	4.5	6.7	5.6	8.9	8.8	8.4	7.8
Foreign Assets & Liabilities, USD bn									
External debt	17.5	16.9	13.4	13.9	15.3	16.0	17.5	17.7	18.8
Public	10.6	10.1	7.4	8.7	10.1	10.9	12.1	12.3	13.0
External debt / GDP	34.3	27.4	21.5	19.9	19.2	18.3	18.7	17.9	17.6
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	3.5	3.5	4.1	4.8	4.0	4.1	3.9	4.2	4.3
CPI, % yoy	3.0	2.7	1.7	2.0	1.6	2.6	2.6	3.0	3.0
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** — GDP growth in 3Q13 was practically in line with our forecast. Inflation remains in check, and low inflationary risks allowed a second and last cut in Banxico's policy rate.
- **Things to watch** — The constitutional reform is expected to be approved before year-end, while the secondary laws could be ready during 1H2014. On activity, the evolution of the manufacturing sector in the U.S. will be a key driver of growth in Mexico next year.
- **Strategy** — Relatively light positioning and the approval of the energy constitutional reform could lead to a stronger MXN against the USD in the next few months.

Economic activity likely to continue recovering

Activity started to recover in the third quarter. Manufacturing exports rebounded (7.8%YoY in dollars terms during 3Q13 versus 3.9%YoY in 2Q13), supported by the recovery of U.S. manufacturing output. Our outlook remains unchanged: external demand will likely continue rising driving local activity in the next few months. As a result, GDP growth in 3Q stood at 1.3% YoY, slightly higher than our forecast of 1.0% YoY (or 3.4% saar versus our 4.5% saar forecast). However, growth dynamics appear to have weakened a little towards the end of 3Q13: industrial production surprised on the downside in September, falling by 1.6%YoY, despite the impulse of the manufacturing sector (1.2%YoY, equal to the January-September average), and mostly due to a deeper decline in construction (-8.3%YoY versus an average of -4.5%YoY from January to September).

The available data points to a slight fall in economic activity at the beginning of the fourth quarter. During October, automotive production grew by just 1.0% YoY in unit terms and total ANTAD sales fell by 0.4% YoY. On the other hand, our positive view regarding the recovery in U.S. manufacturing remains a key factor for growth in Mexico. We forecast that GDP growth will accelerate in 4Q13, but slightly softer than what we were anticipating. Therefore, we still expect GDP growth at 1.5%YoY in 2H13 and 1.2% for 2013 as a whole. The statistical carry-over for 2014 should be slightly lower than previously forecast, but it should be compensated by the moderate impact we estimate from the structural reforms (their most visible effects will begin in 2015-16). Thus, for 2014 and 2015, we forecast that GDP growth will remain at 3.8%YoY and 4.0%YoY, respectively.

Everything quiet on the monetary front

Inflation remains under control. Headline inflation in October stood at 3.4%YoY, close to Banxico's permanent target of 3%. Core inflation remains an important anchor for inflation (2.5%YoY in October). Several factors ensure a good performance for inflation, including: 1) the weakness of domestic demand; 2) low international prices for basic foods; and, 3) a sharp fall in local prices for farm goods. Our short-term perspective is that inflation will remain under control, with low inflationary risks, although we estimate that the effects of the fiscal reform will lead to a moderate rebound in inflation in 2014, though this should be short-lived. All in all, we see headline inflation at 4.2% in 2014 and returning to 3.6% in 2015.

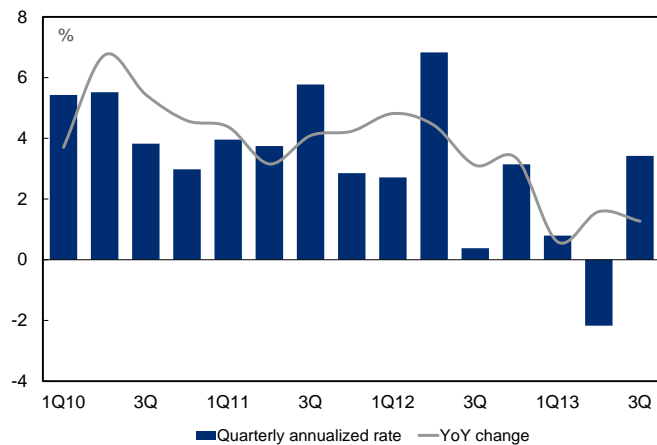
Banxico cuts and bows. Economic weakness and inflation under control provided room for Banxico to implement a mini-easing cycle. The central bank reduced its overnight interbank rate by 25 basis points in October, the second consecutive cut, although it stated clearly that it was the end of the easing cycle, noting that “further reductions in the reference rate would not be convenient in the foreseeable future”. Therefore, we expect the central bank to hold its reference rate at the present level (3.5 %) until 2015.

Structural reforms: Constitutional changes in the energy sector expected to be approved before year-end

We expect Congress to discuss and approve the constitutional changes encompassed in the energy reform during the next few weeks. The Senate has received three Bills aiming to reform the energy sector submitted by each of the main political parties – PRI, PAN and PRD. The PRI's and PAN's Bills are the most ambitious proposals to liberalize the oil, gas and electricity industries and involve constitutional amendments. The procedure for a constitutional amendment is as follows: the reform will need to be approved first in the Senate by a qualified majority (i.e. two thirds of the attending quorum); then, in the House in the same terms; and, finally, the Bill will be sent to the 31 local legislatures, where at least 16 will have to approve it. Our expectation is that both chambers of the Federal Congress will have passed it before year-end, while approval by local congresses could take some weeks into 2014. This would mean that President Peña would be able to publish the constitutional reform by the end of January.

With this schedule in mind, we expect the secondary laws to be ready in 1H2014. After publication of the constitutional reform, the secondary laws will need to be adjusted to reflect changes in the Constitution. The Bills in the Senate provide 365 days after publication for secondary laws to be ready. However, we believe that Congress will attempt to complete this process during the next ordinary session (February-April 2014) or in an extraordinary period before the end of 1H2014.

Figure 308. GDP growth rebounded during 3Q13



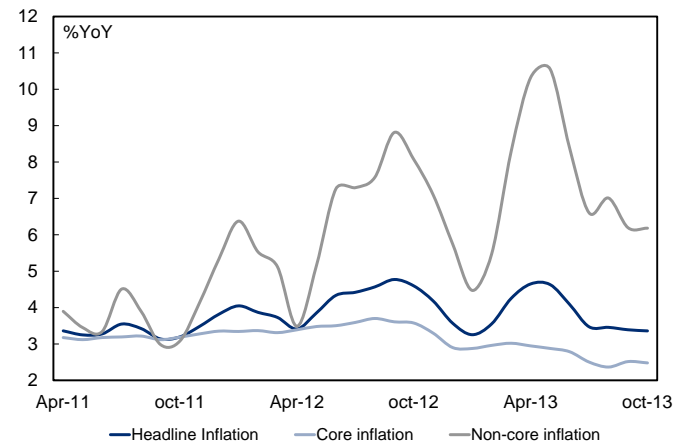
Source: INEGI and Banamex

Figure 310. Manufacturing exports up its share in the U.S. imports



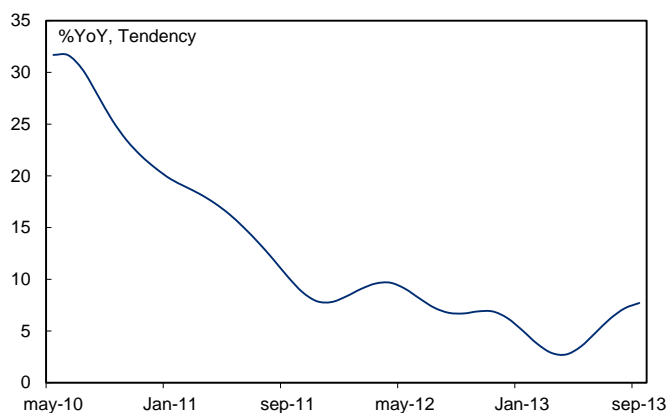
Source: U.S. Department of Commerce and Banamex

Figure 312. Annual inflation is probably at its trough



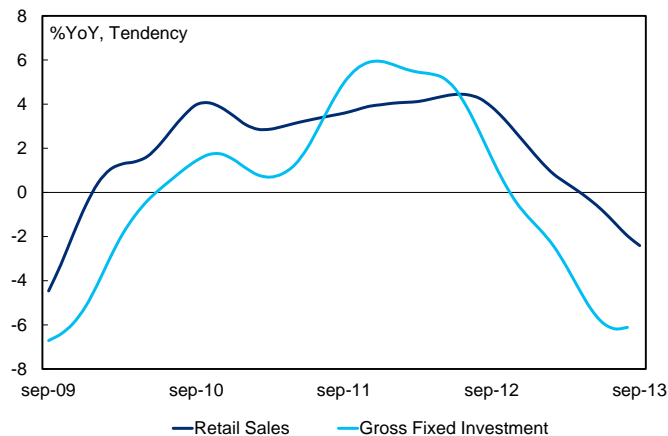
Source: INEGI and Banamex

Figure 309. Manufacturing exports are gaining momentum



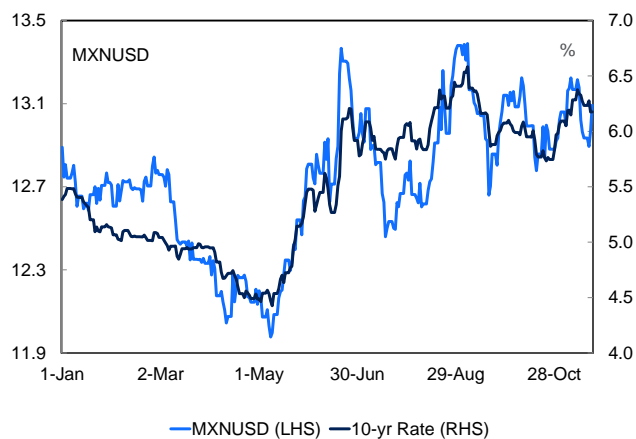
Source: INEGI and Banamex

Figure 311. Local demand remains as the laggard



Source: INEGI and Banamex

Figure 313. Long-term rates and FX in the wait for directionality



Source: Bloomberg and Banamex

Figure 314. 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	1,270	1,383	1,520
Nominal GDP, local currency bn	11,403	12,257	12,094	13,282	14,531	15,588	16,147	17,403	18,827
GDP per capita, USD	9,507	9,967	7,952	9,206	10,117	10,130	10,753	11,593	12,624
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	4.8
Economic Activity									
Real GDP, yoy avg	3.1	1.4	-4.7	5.1	4.0	3.9	1.2	3.8	4.0
Real investment growth % yoy	3.7	6.2	-13.3	4.5	5.4	4.6	0.0	6.0	6.9
Real consumption growth % yoy	3.0	2.1	-5.2	5.1	4.5	4.3	2.1	3.6	3.5
private consumption growth % yoy	3.0	1.9	-6.5	5.6	4.8	4.6	2.4	4.0	3.9
Real export growth, % yoy	3.6	-1.3	-11.8	20.5	8.2	4.2	2.6	8.0	7.6
Real import growth, % yoy	5.9	4.4	-17.6	20.5	8.0	6.0	3.0	8.5	8.4
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.8	6.5	3.6	4.4	3.8	3.6	3.6	4.2	3.6
CPI, % avg	4.0	5.1	5.3	4.2	3.4	4.1	3.8	4.0	3.7
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	7.0	7.9	9.8
Policy Rate (eop)	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.50	4.75
1 month inter-bank rate, %, eop	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.50	4.75
Long-term yield, %, eop	8.03	8.35	7.99	6.95	6.51	5.38	6.15	6.90	7.30
MXN/USD, eop	10.91	13.67	13.06	12.36	13.95	12.87	12.60	12.51	12.30
MXN/USD, avg	10.93	11.16	13.50	12.63	12.44	13.16	12.76	12.57	12.37
Balance of Payments, USD bn									
Current account	-14.3	-19.6	-7.7	-2.7	-11.4	-13.9	-21.2	-26.4	-25.1
% of GDP	-1.4	-1.8	-0.9	-0.3	-1.0	-1.2	-1.7	-1.9	-1.7
Trade balance	-10.1	-17.3	-4.7	-3.0	-1.5	0.0	-5.3	-9.3	-8.3
Exports	271.9	291.3	229.7	298.5	349.4	370.7	383.8	417.0	470.6
Imports	281.9	308.6	234.4	301.5	350.8	370.8	389.1	426.3	478.9
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	-22.4	-25.8	-26.5	-27.2
FDI, net	31.6	27.7	16.6	22.6	23.6	15.5	38.6	22.1	24.0
International reserves	78.0	85.4	90.8	113.6	142.5	163.5	179.9	197.0	212.3
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	30.0	28.9	27.3
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	11.9	11.2	10.7
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	1.6	1.3	1.5	4.4	3.1	4.2	3.4	3.7	3.9
CPI, % yoy	4.1	3.4	3.6	3.6	3.9	4.2	4.2	3.6	3.8
Policy interest rate, %, eop	4.00	3.75	3.50	3.50	3.50	3.50	3.50	3.50	3.75
Short-term market rate, % eop	4.00	3.75	3.50	3.50	3.50	3.50	3.50	3.50	3.75
Long-term yield, %, eop	5.92	6.10	6.15	6.34	6.53	6.71	6.90	7.00	7.10
MXN/USD, eop	12.95	13.09	12.60	12.60	12.60	12.57	12.51	12.45	12.39

Source: National Sources, Citi Research

Peru

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- **Summary view** — We now expect Peru to grow slightly below the 5% psychological threshold over the next couple of years. This growth outlook would open the door for the BCRP to cut its policy rate by an additional 50bps to 3.5% in early 2014 and keep an easing bias in 2015.
- **Things to watch** — President Ollanta Humala's approval rates are worth monitoring. In our view, the president's political capital has reached a point in which it would be difficult to undertake a serious reform agenda, probably for the remainder of his administration.
- **Strategy** — The BCRP will likely continue intervening in the FX market to lower volatility. The high dollarization in the country prevents the BCRP from taking a much looser stance towards the FX. If the PEN were to underperform other Latam currencies, we would expect the BCRP to intervene in the FX market.

The 5% psychological threshold

We now expect Peru to grow slightly below 5% over the next couple of years.

A few months ago, we began talking about the perception that potential growth in Peru was no longer close to 7%, but rather 6%. However, recent growth prints below 5% have raised concerns again about the country's potential growth. It seems that growth below 5% is unable to translate into an improvement in standards of living, and therefore this level has become some kind of psychological threshold. During the past few years, households have got used to seeing an increase in their well-being and an expansion of the middle-class in Peru. In previous notes, we have said that the country is transitioning into a new phase. In this phase, potential output would be lower as a result of a more moderate impulse from external demand and lower terms of trade. Under such an environment, domestic demand would be a much more important driver of economic growth.

We do not expect a likely pick-up in mining export volumes to be able to push growth back above 5%. As we have mentioned before, our understanding is that export volumes could pick up as a result of previous investments in mining. This pick-up would not necessarily be large enough to compensate for the less favorable terms of trade, but could lend a hand to growth. A look at the latest data suggests that exports are not falling as much as they were a few months ago. In addition, imports are growing less rapidly. However, it seems that domestic demand is unlikely to grow as much as we originally expected.

Easing bias

In November, the Central Bank of Peru (BCRP) cut its policy rate by 25bps to 4%. In its statement, the BCRP said that the new policy rate level is compatible with an inflation forecast of 2% for 2014-15. In addition, it takes into account that growth is slowing below its potential, that global growth is lower, that inflation expectations remain well anchored, and that temporary supply-side inflation shocks would revert. The BCRP also says that the decision to cut rates has "a preventive nature and does not imply a sequence of policy rate reductions". We read this sentence as a sign that a rate cut in December should not be taken for granted.

In our view, the room to continue using reserve requirements as the main policy tool has narrowed. Our reading from November's rate cut is that in some ways it acknowledges that the room to make the reserve requirement regime more flexible has narrowed substantially. During the past few months, the BCRP had favored taking actions on reserve requirements rather than on the policy rate. Now it seems that the main tool will be, once again, the policy rate. The tone of the latest statement by the BCRP is more bearish on growth than previous ones.

We think the BCRP could cut its policy rate in early 2014 by an additional 50bps to 3.5%. As we mentioned earlier, the potential rebound in exports would probably not be enough to push real GDP growth above the 5% threshold. This could open the door for the BCRP to undertake a deeper easing cycle. Domestic demand would need a hand to compensate weak external demand. Due to the aforementioned preventive nature of the cut, we do not expect an additional rate cut in December, but as growth continues to disappoint (for Peruvian standards) we expect more rate cuts in early 2014.

The BCRP's main concern is growth. In our view, growth continues to be the primary concern within authorities, including the BCRP. Headline inflation is running close the ceiling of the target band (1-3%). Even if inflation in tradable goods were to increase due to a higher USDPEN, we think it would be compensated by a likely decrease in inflation non-tradable goods. In our view, domestic demand growth is unlikely to generate inflationary pressures.

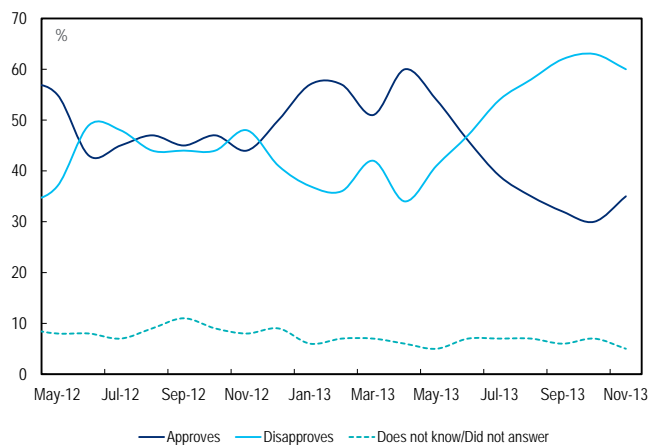
Humala's popularity to remain at low levels

President Ollanta Humala's popularity recovered in November, but will likely remain at low levels for quite some time. President Humala's approval rate increased to 35% in November, up from 30% in October. Mr. Humala's approval rate had reached a high of 60% in April 2013. We think the recent political noise that led to a reshuffle in the Ministry of the Interior and in the Police will prevent Mr. Humala's approval rates from recovering. In our view, the president's political capital has reached a point in which it would be difficult to undertake a serious reform agenda, probably for the remainder of his administration.

BCRP to manage volatility

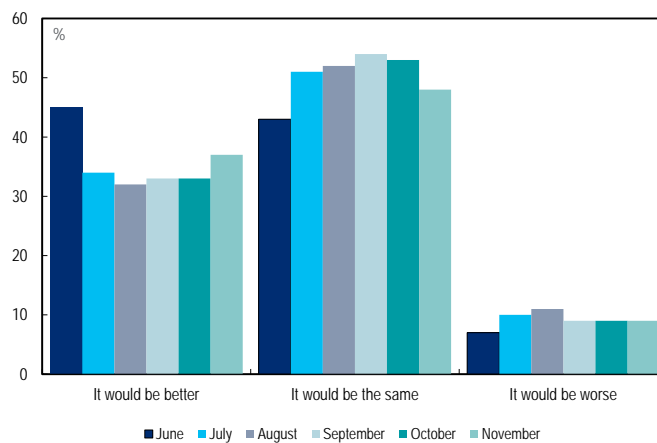
The BCRP will likely continue intervening in the FX market to lower volatility. The high dollarization in the country prevents the BCRP from taking a much looser stance towards the FX. If the PEN were to underperform other Latam currencies, we would expect the BCRP to intervene in the FX market.

Figure 315. Humala's approval rate stopped falling in November



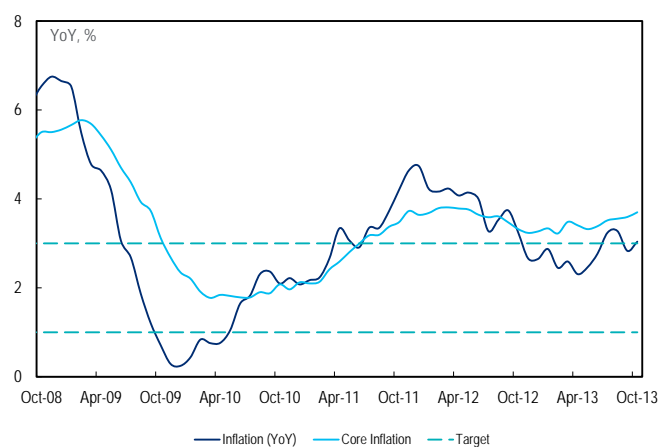
Source: Datum and Citi Research

Figure 316. Confidence in the economy has stabilized



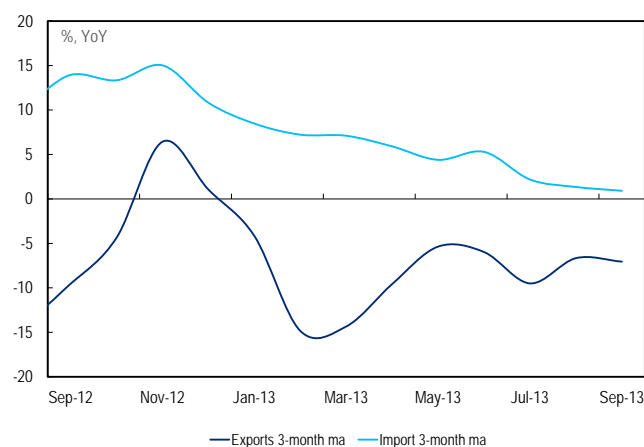
Source: Datum and Citi Research

Figure 317. Headline inflation is running close to the target's ceiling



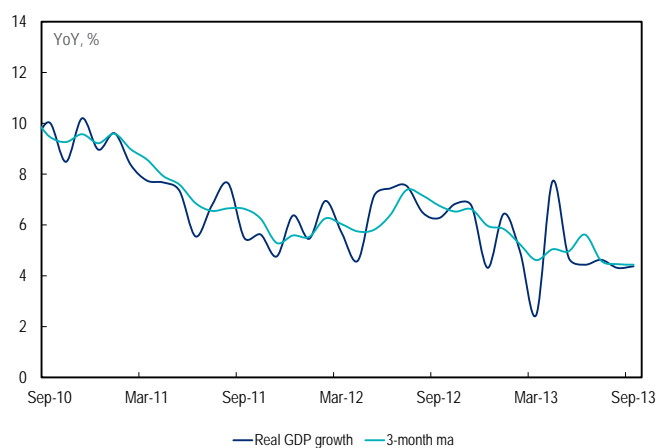
Source: INEI, Haver and Citi Research

Figure 318. Import growth is decelerating



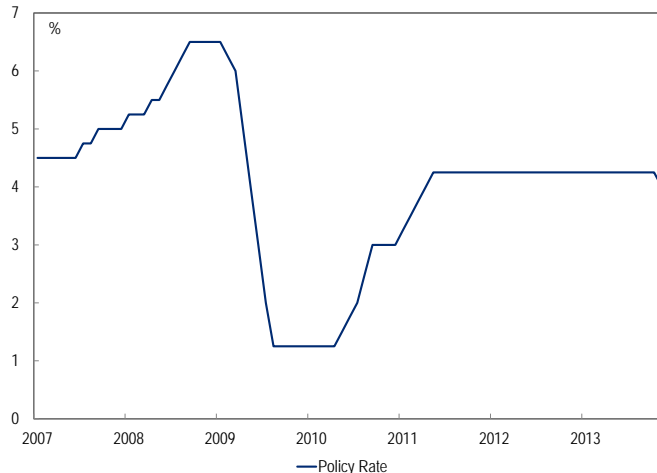
Source: BCRP, Haver and Citi Research

Figure 319. Output is growing below 5%



Source: INEI, Haver and Citi Research

Figure 320. The BCRP cut its policy rate in November



Source: BCRP, Haver and Citi Research

Figure 321. Peru Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	107	127	127	154	176	199	208	220	251
Nominal GDP, local currency bn	336	371	382	435	486	526	566	608	653
GDP per capita, USD	3,906	4,562	4,482	5,344	6,034	6,720	6,896	7,194	8,100
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	6.0	5.8	7.0
Economic Activity									
Real GDP, yoy avg	8.9	9.8	0.9	8.8	6.9	6.3	4.9	4.8	4.8
Real investment growth % yoy	25.8	25.8	-20.6	36.3	9.3	10.1	7.4	4.9	4.9
Real consumption growth % yoy	7.9	8.0	3.9	6.4	6.3	6.4	5.4	5.3	4.7
private consumption growth % yoy	8.3	8.7	2.4	6.0	6.4	5.8	5.1	4.9	4.7
Real export growth, % yoy	6.9	8.2	-3.2	1.3	8.8	4.8	0.6	4.9	4.5
Real import growth, % yoy	21.4	20.1	-18.6	24.0	9.8	10.4	6.3	6.4	4.4
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.9	6.7	0.2	2.1	4.7	2.6	3.5	2.6	2.5
CPI, % avg	1.8	5.8	2.9	1.5	3.4	3.7	2.9	3.4	2.5
Nominal wages, % yoy	5.0	12.8	23.1	-8.8	15.1	5.4	5.0	5.0	-
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	3.50	3.00
1 month inter-bank rate, %, eop	5.51	6.68	1.28	3.20	4.17	4.22	4.60	4.10	4.00
Long-term yield, %, eop	6.44	7.69	6.31	6.34	6.16	4.24	5.40	5.20	5.00
PEN/USD, eop	3.00	3.13	2.89	2.81	2.70	2.55	2.81	2.72	2.60
PEN/USD, avg	3.13	2.92	3.01	2.82	2.75	2.64	2.72	2.76	2.60
Balance of Payments, USD bn									
Current account	1.5	-5.3	-0.7	-3.8	-3.3	-7.1	-11.4	-12.3	-3.8
% of GDP	1.4	-4.2	-0.6	-2.5	-1.9	-3.6	-5.5	-5.6	-1.5
Trade balance	8.5	2.6	6.0	6.8	9.3	4.5	-1.7	-2.6	-2.4
Exports	28.1	31.0	27.0	35.6	46.3	45.6	39.3	41.8	45.3
Imports	19.6	28.4	21.0	28.8	37.0	41.1	41.1	44.4	47.7
Service balance	-1.2	-2.1	-1.2	-2.3	-2.1	-2.3	-1.9	-2.0	-2.1
Income balance	-8.3	-8.7	-8.4	-11.2	-13.7	-12.7	-10.8	-11.0	-11.9
FDI, net	5.5	6.9	6.4	8.5	8.2	12.2	12.8	13.5	14.9
International reserves	27.7	31.2	33.1	44.1	48.8	64.0	68.8	81.7	98.0
Total amortisations	6.8	3.3	2.2	4.1	1.4	3.9	4.1	4.3	4.6
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	43.5	51.1	52.8	56.0	59.1
Public	20.1	19.2	20.6	19.9	20.2	19.0	17.5	18.6	19.7
External debt / GDP	29.8	26.8	28.0	26.4	24.7	25.7	25.4	25.4	23.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	20.6	19.5	20.1	22.9	24.2	26.3	25.9	27.0	29.2
Short-term debt/International reserves (%)	74.2	62.5	60.7	52.0	49.6	41.1	37.7	33.1	29.8
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	5.6	4.4	5.1	5.0	4.8	4.7	4.7	5.0	4.7
CPI, % yoy	2.8	2.8	3.5	3.8	3.5	3.3	2.6	2.3	2.7
Policy interest rate, %, eop	4.25	4.25	4.00	3.50	3.50	3.50	3.50	3.50	3.50
Short-term market rate, % eop	4.31	4.70	4.60	4.10	4.10	4.10	4.10	4.10	4.10
Long-term yield, %, eop	5.73	5.65	5.40	5.20	5.20	5.20	5.20	5.20	5.20
PEN/USD, eop	2.78	2.79	2.81	2.80	2.77	2.75	2.72	2.72	2.75

Source: National Sources, Citi Research

Venezuela

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- **Summary view** — The political and economic outlook continues to deteriorate. The recent announcements of Mr. Maduro regarding further price and FX controls have created additional uncertainty regarding future macroeconomic management, particularly since the severe inflation, scarcity and external misalignments are yet to be addressed by the government. That said, we now expect an important deceleration in economic activity, from 5.6% GDP growth in 2012 to 2.0% in 2013 and 0% in 2014. In our view, the deceleration in economic activity will not translate into lower inflation prints, since the inflationary dynamics in the country continue to be driven by ample liquidity, scarcity and bottlenecks in local production. In addition, we contemplate in our central scenario a devaluation of the CADVI rate from VEF6.3 to VEF10 and expect SICAD's or other government alternative rate to stand around VEF17.
- **Things to watch** — New FX and price regulations. Also, the announcement of a VEF devaluation at the beginning of 2014.
- **Strategy** — The main variables to assess Venezuela performance in the short term will continue to be the evolution of oil prices, international reserves and special funds' holdings.

Activity and inflation outlook

For 2014, GDP growth should continue decelerating, standing at 0% for the year as a whole. We expect a continuation of the deceleration in overall economic activity with GDP growth of 2% in 2013 and 0% in 2014. For 2014, our projection includes a government consumption growth forecast of 0.5% YoY after an expected 2.8% annual expansion in 2013. Households' consumption should decelerate together with lower public spending. In particular, we anticipate consumption to expand a timid 0.3% next year, while investment should decrease 2.7% in 2014 after the 1.3% poor expansion we forecast for 2013. Thus, our central scenario contemplates an important deceleration in domestic demand which we expect to fall -0.7% next year, leaving the external sector (i.e. oil exports and restricted imports) bearing the burden of sustaining economic activity.

Venezuelan inflation should accelerate next year, and is at a point in which it could turn into a hyperinflationary environment. When talking about inflation, it is always important to remember that price dynamics are more of a supply- than demand-driven phenomenon in Venezuela. The worst-than-expected performance in inflation throughout this year has been driven by the scarcity of foodstuffs, medicines and raw materials, local production bottlenecks and ample liquidity. That said, we expect year-end inflation to sit at 55% in 2013 and increase to 60% next year. While we think this situation is not sustainable for the government, for the time being is hard to foresee policy changes that can mute the ongoing inflationary process unless drastic changes take place (e.g., dollarization or a severe economic contraction).

FX and external accounts

Our central scenario contemplates that the CADIVI rate will be increased to VEF10 and SICAD's or a new FX rate for an alternative mechanism to be set at VEF17. It is important to point out that previous devaluation episodes have been announced during the last days of December or the first days of January.

The recent behavior of the balance of payments (BoP) suggests that Venezuela could still obtain current account surpluses, although in lower magnitudes than in the past. In fact, we expect the CA surplus will stand at 3.6% of GDP this year and 3.8% of GDP in 2014. Nonetheless, this figure per se cannot be read as favorable as much of the improvement is due to restrictions on imports. Also, given the current policy framework and the imbalances in some macroeconomic and BoP figures, the best way in our view to assess Venezuela's performance in the short/medium term will be two additional elements – the availability of liquid resources and the ability to generate cash flows.

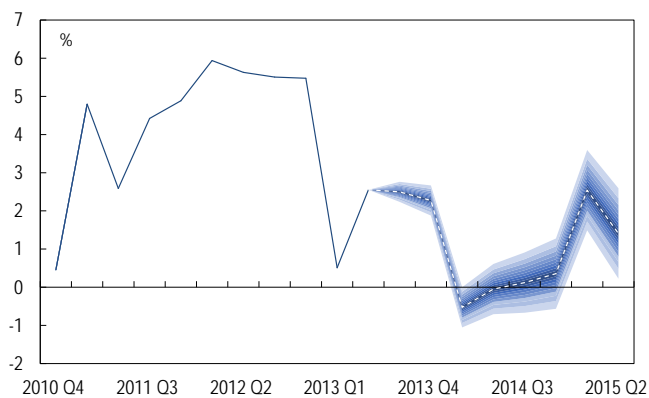
In order to explore what minimum oil price level would lead to an unbalance in Venezuela's external accounts, we analyzed what happened in the 2008/09 international crisis. One of the fundamental characteristics of the Venezuelan economy is that capital account outflows are determined by current account surpluses. Since the current account surplus is almost completely driven by oil exports, the sharp decline in oil price during the 2008/09 international financial crisis created a deep current account contraction and consequently the capital account deficit closed. In that episode, the Venezuelan basket oil price plunged, reaching a minimum value of US\$33.93 per barrel in February 2009 bringing the average balance of payment surplus in 2009 to 3.0% of GDP. In our view, the 3% of GDP figure can be used as a first threshold for external account pressures. The next critical levels for oil prices were calculated with current account surpluses of 1.8% of GDP (half of this year's estimate) and a 0% of GDP surplus. The projections start from our baseline in which we anticipate a current account surplus of 3.6% in 2013 and a 3.8% surplus in 2014.

We found that the three aforementioned levels of balance of payments give threshold levels of USD91.4 per barrel, USD86.8 per barrel and USD80 per barrel on average for the year as whole. Assuming constant elasticity of GDP and imports to oil prices, we found three threshold average oil prices for 2014 that could imply significant deterioration of the CA surplus. It is important to note that these thresholds correspond to average prices for the year as whole. According to our computations, the first threshold is USD91.4 per barrel for the Venezuelan basket. This average price could take the CA surplus to 3% of GDP and would be a first signal of deterioration in CA balances. The second threshold corresponds to an average oil price of USD86.8 per barrel, which could take the CA surplus to 1.8% of GDP. Lastly, the oil price that could eliminate CA surpluses is USD80 per barrel on average, which would signal an extreme external shock if it materializes.

Political outlook

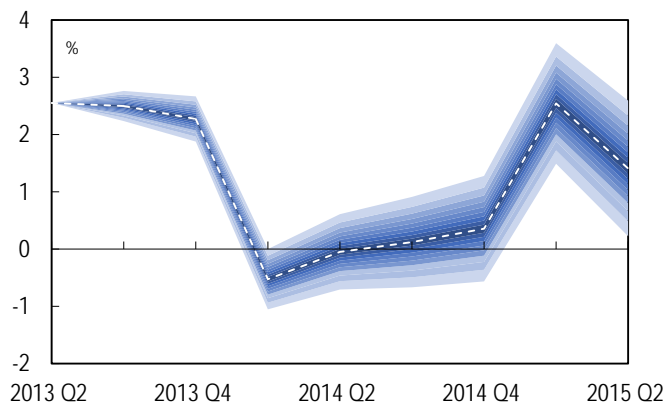
With less than a year in power, President Maduro's approval has fallen sharply. In particular, the insecurity and the economic situation have taken their toll on President Maduro's approval rating which now stands at 44.7%, according to local political pollster IVAD. Mr. Maduro gets a positive mark for the "government on the streets" campaign but high inflation and the weakening of economic activity more than compensate bringing down his overall approval. The latter has led the government to announce a fight against corruption and speculation with the goal of reaching out to the population as an advocate of better living conditions for main street Venezuelans. However, we believe the lack of improvement in the economic situation should continue to affect President Maduro's approval ratings, a situation that could lead to some people taking to the streets and protesting.

Figure 322. Venezuela: GDP forecast (2010-2015)



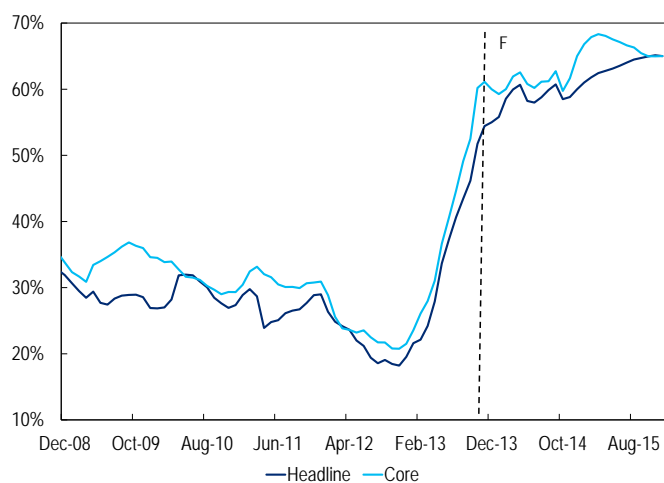
Source: BCV and Citi Research

Figure 323. Venezuela: GDP forecast (2013-2015)



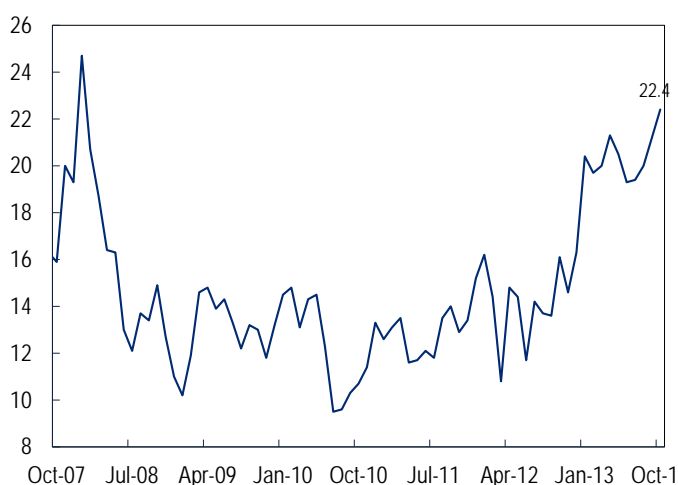
Source: BCV and Citi Research

Figure 324. Inflation: Likely to increase further moving forward



Source: BCV and Citi Research

Figure 325. Scarcity: It has climbed rapidly during 2013



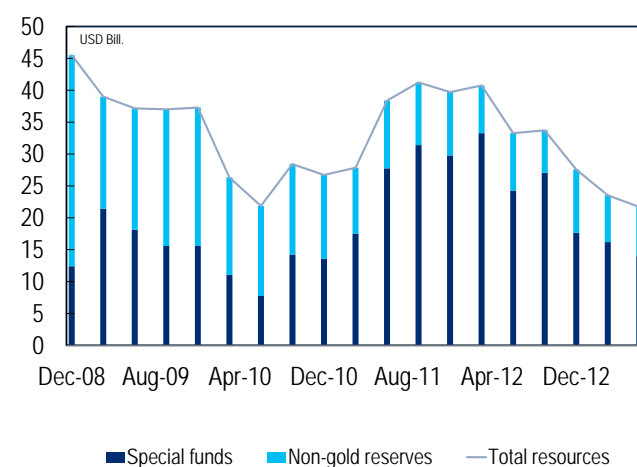
Source: BCV and Citi Research

Figure 326. Average threshold prices for the Venezuelan oil basket in 2014



Source: BCV and Citi Research

Figure 327. Could total liquid resources continue their downtrend?



Source: BCV and Citi Research

Figure 328. Venezuela Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	213	298	284	257	298	361	380	353	350
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	12,608	11,554	11,272
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	5.9	6.5	6.7
Economic Activity									
Real GDP, yoy avg	8.8	5.3	-3.2	-1.5	4.2	5.6	2.0	0.0	2.0
Real investment growth % yoy	28.2	2.2	-19.1	1.0	15.2	24.1	-2.8	-2.7	1.6
Real consumption growth % yoy	16.3	6.0	-2.1	-1.1	4.4	6.9	3.6	0.4	0.3
private consumption growth % yoy	16.9	6.3	-2.9	-1.9	4.0	7.0	3.8	0.3	0.3
Real export growth, % yoy	-7.6	-1.0	-13.7	-12.9	4.7	1.6	0.0	1.3	4.2
Real import growth, % yoy	33.0	1.4	-19.6	-2.9	15.4	24.4	-0.3	-1.5	-1.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	22.5	31.9	26.9	27.4	29.0	19.5	55.0	60.0	65.0
CPI, % avg	18.7	31.4	28.6	29.1	27.1	21.1	38.8	59.0	63.8
Nominal wages, % yoy	20.7	25.0	23.7	24.5	27.0	30.0	35.0	30.0	25.0
Credit extension to private sector, % yoy	43.3	30.6	18.0	27.6	36.8	55.3	61.5	67.5	66.5
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	9.30	9.19	8.90	9.23
VEF/USD, eop	2.15	2.15	2.15	4.29	4.29	4.29	6.30	10.00	16.50
VEF/USD, avg	2.15	2.15	2.15	4.20	4.29	4.29	6.13	10.00	16.50
Balance of Payments, USD bn									
Current account	18.1	37.4	8.6	12.1	27.3	11.0	13.7	13.5	11.4
% of GDP	8.5	12.5	3.0	4.7	9.1	3.1	3.6	3.8	3.3
Trade balance	23.0	45.7	19.2	27.1	46.4	38.0	36.9	32.6	30.6
Exports	69.0	95.1	57.6	65.7	92.7	97.3	91.0	89.1	89.5
Imports	46.0	49.5	38.4	38.6	46.2	59.3	54.1	56.6	58.8
Service balance	-7.0	-8.4	-7.6	-9.2	-10.7	-16.0	-12.0	-7.7	-7.8
Income balance	2.5	0.7	-2.7	-5.3	-7.9	-10.0	-10.3	-10.5	-10.5
FDI, net	1.0	-0.9	-4.9	-1.5	5.1	0.8	2.1	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	-11.7	-11.8	-11.9
Consolidated gov primary balance	-1.2	-2.0	-7.2	-8.6	-9.4	-12.3	-9.1	-9.4	-9.5
Public debt	25.5	21.6	31.3	42.0	44.2	43.4	41.1	42.5	42.3
of which Domestic	7.3	4.5	7.5	8.9	11.4	14.1	12.0	10.1	8.4
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	32.7	36.4	38.0
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	18.1	19.9	17.4	16.8	16.7	21.1	22.2	20.7	20.4
Short-term debt/International reserves (%)	52.8	46.1	48.4	55.3	55.8	79.6	88.9	87.9	92.9
Quarterly Economic Indicators									
	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	2.6	2.5	2.3	-0.5	0.0	0.1	0.4	2.5	1.4
CPI, % yoy	37.3	46.2	55.0	60.0	58.0	60.7	60.0	62.4	63.5
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	11.61	11.69	14.50	15.50	15.50	15.50	15.50	16.83	17.50
VEF/USD, eop	6.29	6.29	6.30	10.00	10.00	10.00	10.00	16.50	16.50

Source: National Sources, Citi Research

Notes

Notes

Notes

Appendix A-1

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