31 October 2014 │ 172 pages

Emerging Markets Macro and Strategy Outlook

Commodities and EM: a quick tour

- 'Sellers lose and buyers win'; is that all that's worth saying when commodity prices fall? In a sense, yes: in recent quarters it has become clear that the more commodity-dependent a country is, the weaker its export growth is likely to have been. Manufacturing economies have generally delivered better returns to investors than commodity economies.

- But there is a sense in which all EM 'loses' when commodity prices fall. EM is a commodity-exporting asset class, to the tune of about 5% of aggregate GDP. That's ex-China, but one important factor explaining the weakness of commodity prices recently is the fall in Chinese import growth. What seems to be happening in China these days is that i) there is indeed evidence of a domestic rebalancing process in China, given the growing gap between services sector growth and the growth rate of GDP; but ii) this rebalancing isn't proving to be very EM-friendly: China's trade surplus is rising, not falling, and the growth of consumer goods imports is significantly exceeding the growth of capital goods imports.

- And there is another way in which all EM 'loses' when commodity prices fall, especially when that is associated with a strong dollar: weak commodity prices are associated with declining risk appetite. One consequence of this is that falling oil prices affect oil exporters and importers *asymmetrically*: oil exporters lose more than oil importers win. Turkey, for example, wins on the current account when oil prices fall, but loses on the capital account due to greater risk aversion. That's probably why the lira fails, historically, to rally when oil prices go down.

- But equally there is a way in which all EM 'wins' when commodity prices fall, and that is in the fight against inflation. Weaker oil prices are unambiguously disinflationary, and we suspect that the market may in for some downside inflation surprises if oil and other commodity prices stay weak in the coming months. There are only a few countries – India, China, Israel, Poland, for example – where inflation expectations have really shifted down in recent months. What that means is that expectations might have some catching up to do. That could mean fewer rate hikes for countries struggling with above-target inflation rates. But equally it means that countries suffering very below-target inflation might have more-than-expected easing ahead of them.

- Our results suggests that a 10% decline in oil leads to 70-90bp lower rates in Brazil, Chile, Turkey, Korea and Thailand. Meanwhile, 10% lower oil results in 50-80bp higher rates in Hungary, Indonesia and Russia. But since lower oil leads to weaker EM exchange rates by and large.

EM Economics and Strategy

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Commodities and EM: a quick tour

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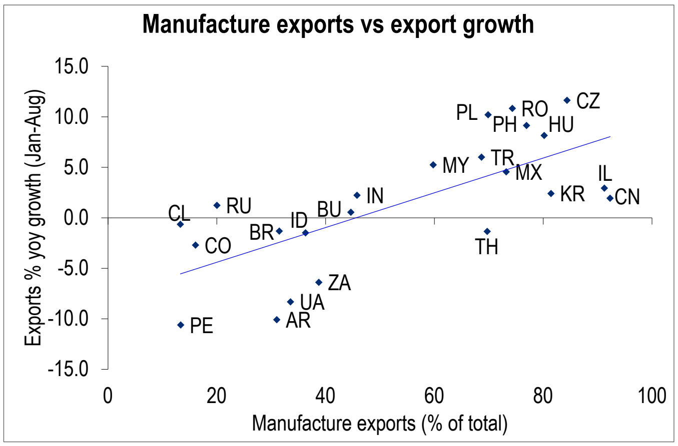
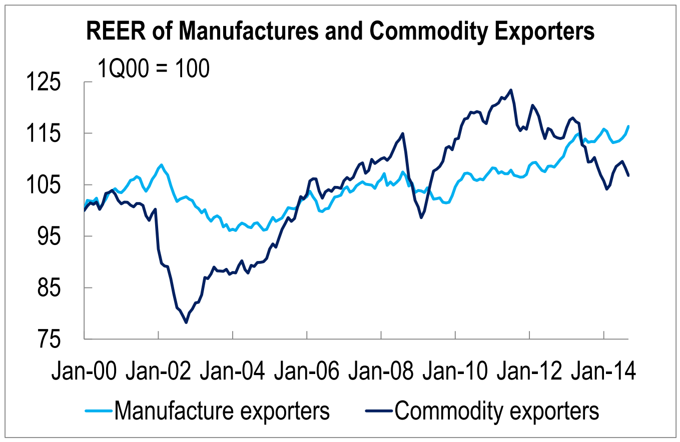
'Sellers lose and buyers win'; is that all that's worth saying when commodity prices fall? To some degree this was the simple argument that we presented in a couple of recent monthly publications (Time for another tantrum?; and Bad news for commodities exporters?). The bulk of the argument is illustrated in Figures 1 and 2. Falling prices have eroded the export growth rate of commodity producers (Fig 1), and it seems clear that the currencies of commodity-exporting EMs have been dramatically underperforming those of the manufacturing-exporters within EM (Fig 2). In a way this is a zero-sum game: since many manufacturing economies in EM are also net commodity importers, a fall in commodity prices amounts to a transfer of resources from exporters to importers, which helps to generate the outcome for FX described in Figure 2; and a similar conclusion would be generated in other asset classes.

Figure 1. Export growth seems negatively correlated with a country's degree of commodity-dependence…



Source: Citi Research

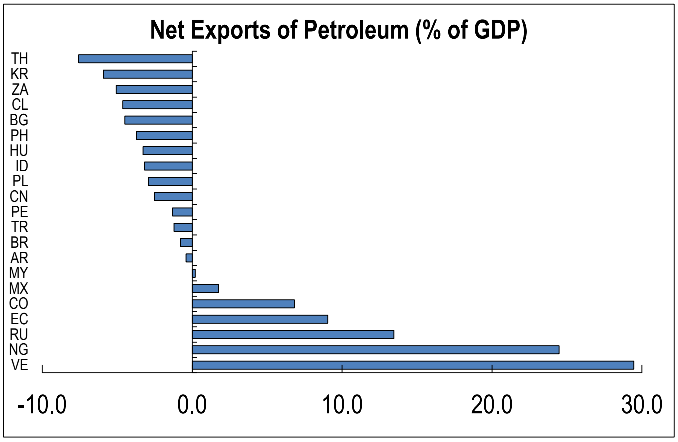
Figure 2. …and commodity exporters as a whole have suffered sharp currency depreciation compared to manufacturing economies in EM



Source: Citi Research

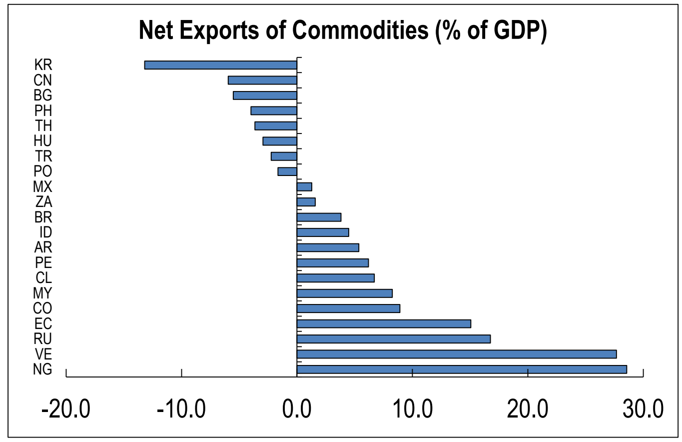
While it's true that 'sellers win, buyers lose' when prices fall, there is also a sense in which all EM suffers when commodity prices go down. This may not be self-evident, but the most obvious way of supporting this claim is to point out that EM is, ex-China, a commodity-exporting asset class, to the tune of 4.8% GDP last year. After 2002 in particular, it was Chinese demand that created a *'China-commodities complex',* in which rapid Chinese growth supported commodity-exporting EMs. And for sure one of the factors that has been depressing commodity prices is the weakening of Chinese import growth. The correlation between weaker Chinese import growth and weaker commodities price inflation is clear enough. One hope for EM used to be that a 'domestic rebalancing' of the Chinese economy might create opportunities for manufacturing industries across EM – by providing more scope to sell consumer goods to China. But that seems like it might be a forlorn hope. What seems to be happening in China these days is that i) there is indeed evidence of a domestic rebalancing process in China, given the growing gap between services sector growth and the growth rate of GDP; but ii) this rebalancing isn't proving to be very EM-friendly: China's trade surplus is rising, not falling, and the growth of consumer goods imports is significantly exceeding the growth of capital goods imports. All in all: a weaker China is not likely to be good news in the short run for any EMs, neither commodity exporters nor importers.

Figure 3. EM probably has more oil importers than exporters, and the oil exporters do not account for the bulk of EM GDP…



Source: Citi Research, UN Comtrade. Note: Using SITC code 33, Rev 3: Petroleum, petroleum products and related materials

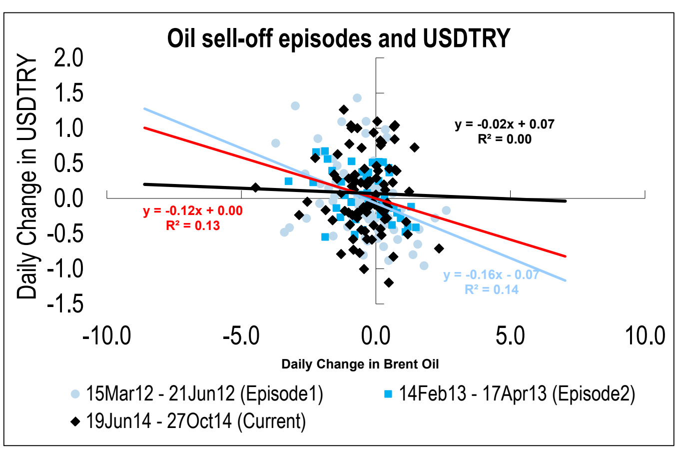
Figure 4. …but it is certainly true that EM (ex China) is a net exporter of commodities, to the tune of around 5% of GDP



Source: Citi Research, UN Comtrade. Note: Using SITC codes 0-4.

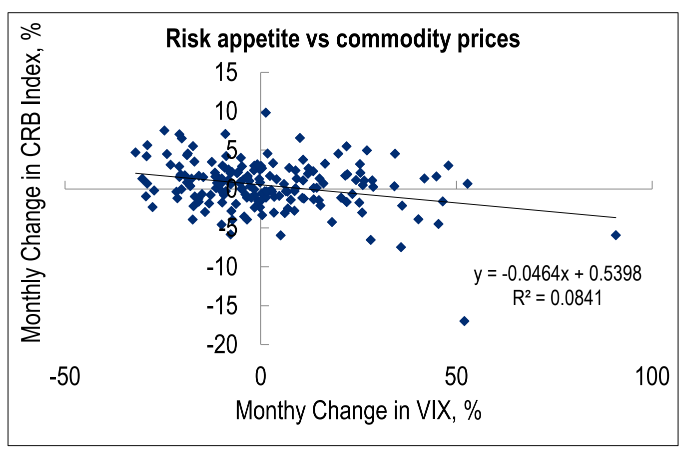
Another way of seeing that all EM might suffer from weaker commodity prices comes from the link between commodities and risk appetite. Consider Figure 5, for example, which shows the link between TRY/USD and oil prices. Since we know that Turkey is an important oil importer, it might make sense to conclude that the lira should strengthen when oil prices fall, as it implies a smaller current account deficit. Yet that's not all the case; there is no discernable relationship between the TRY and the oil price. And that's true across the board in EM: risk premia for oil importers don't fall when oil prices do. A broader way of stating this point is contained in Figure 6, which shows the relationship CRB-measured commodity prices and the VIX, which we take as a proxy for 'risk appetite'. Our inclination is to conclude that lower commodity prices in general – and lower oil prices in particular – tend to be associated with weaker risk appetite, not stronger risk appetite.

Figure 5. The Turkish lira shows no real sign of strengthening in response to weaker oil prices, nor vice versa…



Source: Citi Research, Bloomberg

Figure 6. …and as a general rule there is some evidence that falling commodity prices are positively associated with risk aversion

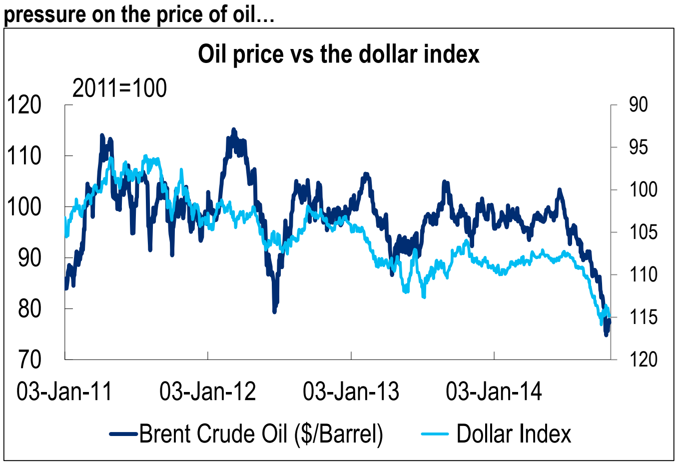


Source: Citi Research, Bloomberg

Why weaker oil is associated with lower risk appetite is a bit of a mystery. As Figure 3 shows, it isn't just Turkey that is a net importer of oil, but a majority of emerging economies – certainly those that make up major bond and equity indicies – are also oil importers. The reason why asset prices for these economies don't neatly rise when oil prices fall probably has something to do with the recycling of Petrodollars. (It is worth bearing in mind that the accumulated current account surplus of OPEC-plus-Russia since 1980 is $4.8 trillion - not including returns on assets – which is equivalent to around a third of the US government debt stock). If there are fewer globally investible surpluses when oil prices go down – thanks to the downward pressure on oil exporters' revenues – that could reinforce a tendency towards global risk aversion when oil prices fall. No matter how you try to measure risk appetite – the term premium, VIX, or Citi's own proprietary measure – risk appetite seems to fall when oil prices do. And equally, risk appetite seems to fall when a broader measure of commodity prices – CRB, for example – does.

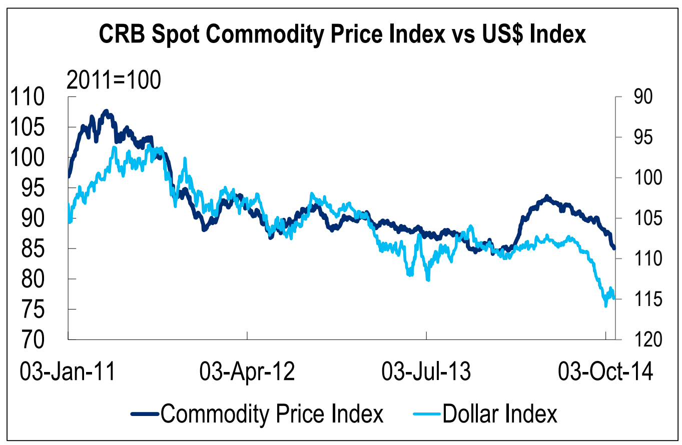
And the negative relationship between risk aversion and commodity prices is reinforced by the dollar. Figures 7 and 8 make it clear that dollar appreciation – which Citi expects to continue – has the effect of putting downward pressure on dollar-denominated commodity prices. So in that sense the dollar's appreciation can also have the effect of putting downward pressure on risk appetite, through its impact on commodity prices.

Figure 7. A strengthening dollar is usually associated with downward pressure on the price of oil…



Source: Citi Research, Haver Analytics. Using Wall Street Journal Dollar Index

Figure 8. …and commodities in general

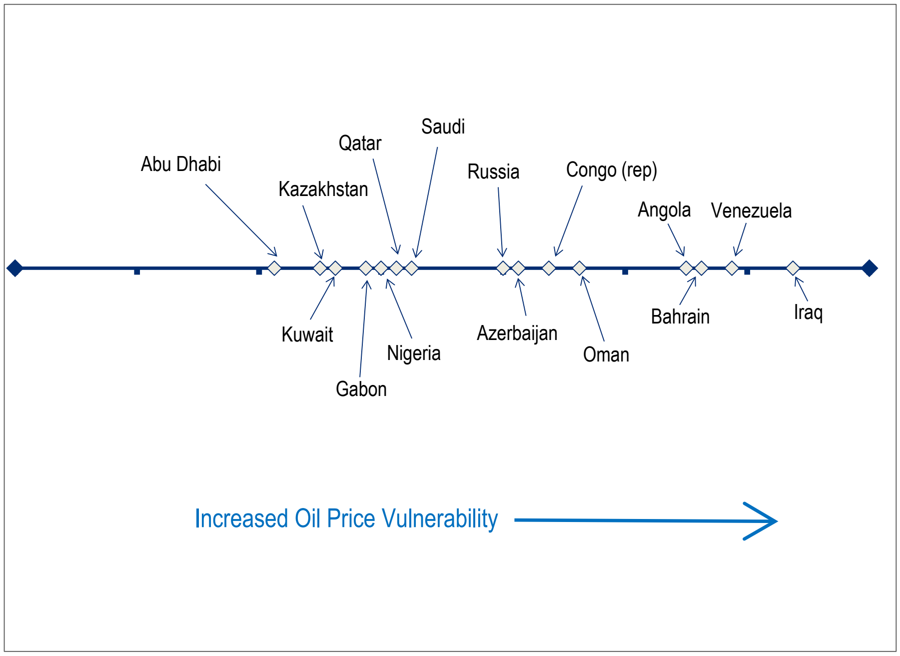


Source: Citi Research, Haver Analytics. Using Wall Street Journal Dollar Index

So, before considering any country-by-country analysis of the effects of lower commodity prices on EM, the headline effect on EM as a whole is not friendly. Our feeling is that commodity prices affect EM *asymmetrically*. For example, when oil prices go up, exporters benefit more than importers lose. This is the 'Turkey effect' discussed earlier: Turkey gains on the capital account when oil prices rise - due to rising risk appetite - just as it loses on the current account, and so Turkey loses out less than an oil exporter gains. Equally, when oil prices go down, oil exporters lose more than oil importers gain.

How big are the risks for oil exporters? To try to answer this question we've created a 'fiscal vulnerability indicator' for oil exporters based on four variables: the change in the budget balance from a $10 move in the price of oil; an assessment of what the budget balance would be with oil at $60/bbl; the public debt/GDP ratio; and the ratio of fiscal reserves to total public spending. The first two variables try to capture gross fiscal vulnerability, while the second try to capture balance sheet resilience. Figure 9 shows the results of a simple scoring exercise based on each country's ranking across these variables. Iraq and Venezuela seem to us to have the greatest sensitivity to falling oil prices among the exporters.

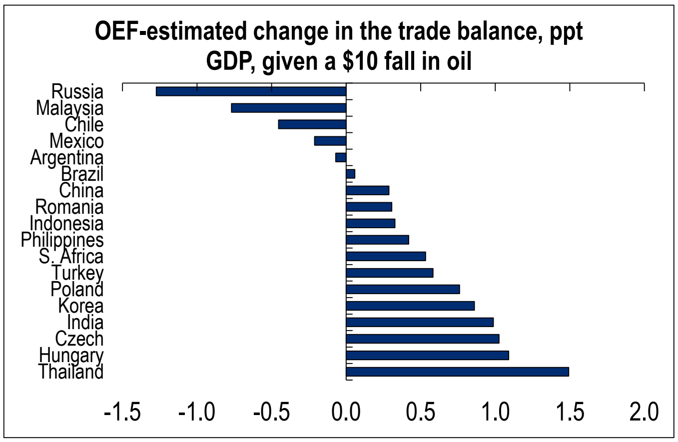
Figure 9. Our ranking of vulnerability to falling oil prices among the oil exporters suggests that Iraq and Venezuela are at the greatest risk



Source: Citi Research

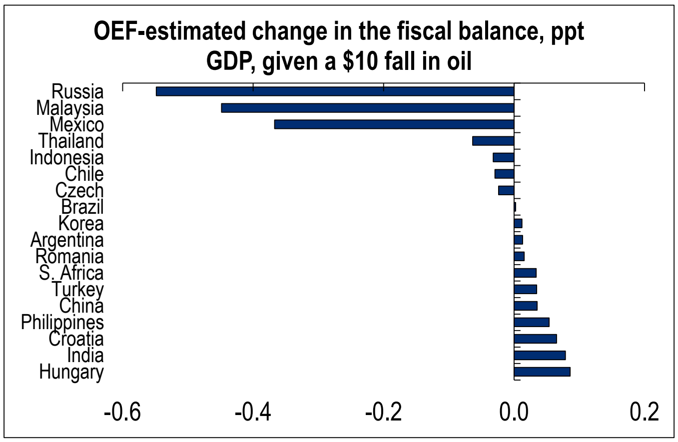
For EM as a whole, the most obvious country-specific questions when oil prices fall are about the impact on the trade and fiscal balances, and on inflation. As for the first two of these issues, the sensitivities are intuitive enough: oil exporters lose, importers gain. Figure 10 presents some outputs of the Oxford Economic Forecasting model, which are more or less consistent with the analysis of Citi's own economists; and Figure 11 shows equivalent analysis for the (much smaller) effects on budget balances of a $10/bbl fall in oil prices. So, we're back to the original, obvious observation: commodity sellers lose and buyers gain when prices fall – with the important proviso that the effect on risk appetite of weaker commodity prices acts as a kind of overlay to the country-by-country analysis.

Figure 10. "Sellers-lose-buyers-win" when it comes to the impact of weaker oil prices on the trade balance…



Source: Citi Research using the OEF global model

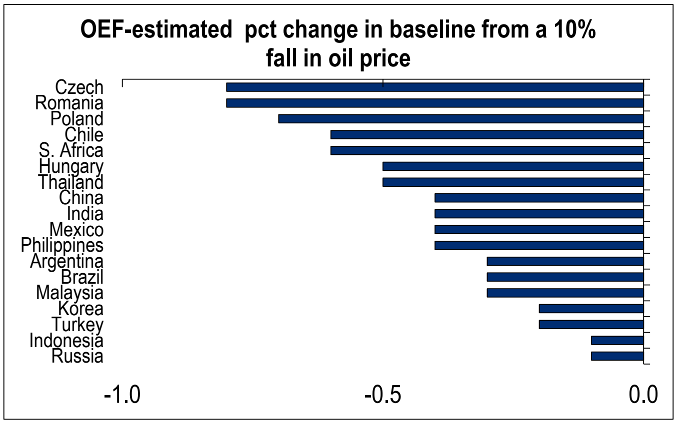
Figure 11. …and on the fiscal balance too, albeit with much smaller effects



Source: : Citi Research using the OEF global model

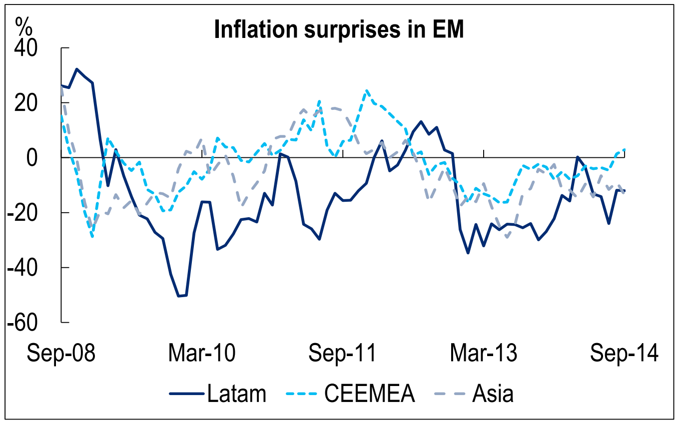
When it comes to inflation, the whole of EM is a winner as commodity prices fall. So, we've argued that if weak commodity prices dent risk appetite then, in some ways, all EM *loses* when commodities are weak. But there is one area in which all EM *gains*, and that's inflation. As Figure 12 shows, there are disinflationary effects all over EM when oil prices fall. What's significant about this is that it hasn't quite come through in the data. Figure 13 shows our inflation surprise indices for the three main EM regions, and it is only in Asia where inflation surprises have been meaningfully to the downside in recent months. That conclusion is echoed in Figure 14, which shows the evolution of 12-months-ahead inflation expectations across a range of EM economies. Although inflation expectations have fallen in a number of economies, the declines – with the exception of India, Israel and China, for example – have been relatively low. It is probably worth anticipating that we are in for a period of further declines in inflation expectations if commodity prices stay relatively subdued. Of course there are pressures pulling in the other direction, particularly in countries vulnerable to currency depreciation in an environment of weakening commodity prices. But the combination of an unambiguously disinflationary move in oil prices is hitting EM at a time when demand pressures are relatively weak. All in all then, we are in a monetary policy environment that is reasonably benign across the board.

Figure 12. Lower oil prices should push inflation lower across the board…



Source: : Citi Research using the OEF global model

Figure 13. …but so far inflation surprises have only been meaningfully to the downside in Asia…



Source: Citi Research

Figure 14. There is still room for inflation expectations to fall in many countries if oil prices stay low or keep declining, especially when demand pressures are relatively weak.

	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14	Sep-14	Jan-Sep Change
India	8.3	8.4	8	7.6	7.5	7.6	7.6	7.5	7.6	-0.7
Israel	1.7	1.6	1.6	1.6	1.5	1.4	1.3	1.2	1.1	-0.6
China	3.1	3.1	3	2.8	2.7	2.7	2.7	2.7	2.7	-0.4
Poland	0.5	0.6	0.5	0.5	0.5	0.2	0.1	0.2	0.2	-0.3
Czech R.	2.3	2.3	2.4	2.3	2.1	2.2	2.1	2	2	-0.3
Mexico	3.7	3.6	3.6	3.6	3.7	3.6	3.6	3.5	3.5	-0.2
Korea	2.9	2.9	2.8	2.9	2.8	2.8	2.8	2.8	2.8	-0.1
Malaysia	3.1	3.2	3.3	3.4	3.5	3.4	3.5	3.5	3.5	-0.1
Philippines	4	4.2	4.1	4	4	4	4.1	4	4	-0.1
Thailand	2.5	2.5	2.5	2.6	2.6	2.6	2.6	2.6	2.5	-0.1
Indonesia	6.1	6	6	6	6	5.9	5.9	5.9	6	-0.1
Hungary	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	0.0
S. Africa	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	0.0
Brazil	6	5.9	6	5.8	5.9	5.8	5.7	6	6	0.1
Chile	3	3	3	3	3.1	3	3	3	3.2	0.2
Colombia	2.9	2.9	3	3.1	3.2	3.2	3.2	3.1	3.2	0.3
Turkey	7	7.1	7.3	7.3	7.3	7.2	7.3	7.4	7.5	0.5
Romania	3.2	3.2	3.2	3.1	3.1	3.1	3.5	3.9	4.3	1.1

Source: Haver Analytics, Citi Research

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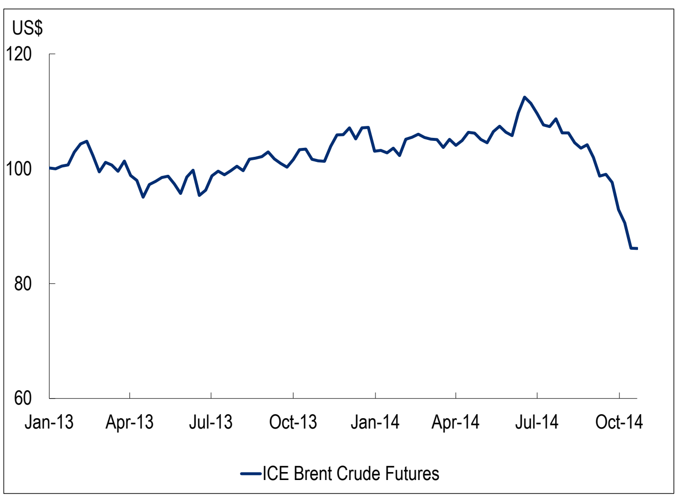
Oil, risk premia and correlation breakdown

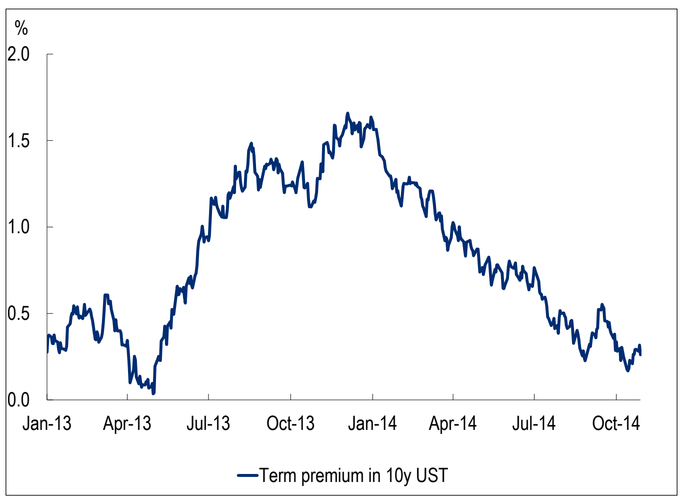
The month of October brought a fair number of surprises. In the realm of market prices, perhaps the two most shocking moves have been the 9.75% collapse in oil prices and the resurgent volatility in US Treasuries term premia. Indeed, in October, Brent escaped from what had been the stable range between $95 and 110 since mid-2012 (Figure 15). 10y UST term premia, which had steadily declined since January 2014, giving rise to the 2014 vintage EM carry trade, broke the trend in September and picked up significant volatility in October (Figure 16). Consensus trades in EM broke apart (the carry trade had turned into strong USD/EM) and correlations went haywire. In these pages, we take a look at potential reasons behind the correlation breakdown and ponder what might happen to rates and FX in the next few months.

Figure 15. Oil prices abandoned their narrow corridor and turned into a sizable (negative) shock in August 2014.



Source: Citi Research

Figure 16. After 2013's taper tantrum, term premia in 10y UST had gradually declined until September.

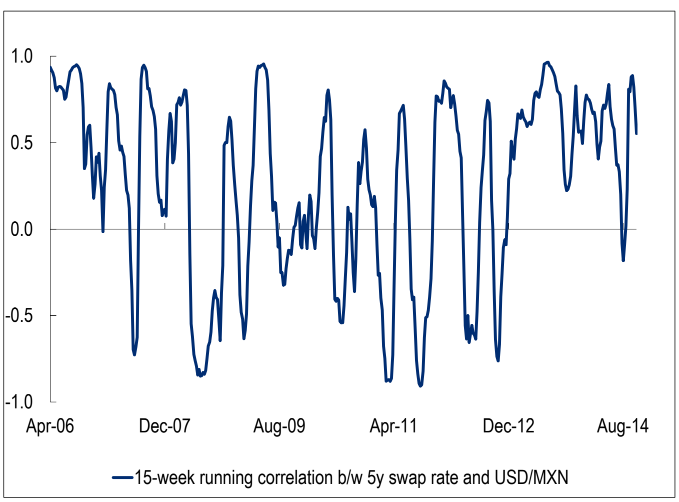


Source: Citi Research

Correlations in EM are usually very unstable and, this time around, they proved to remain unsteady. A typical view amongst many investors is that rates (as in five year local currency yields) and FX co-move positively in EM. Two of the most popular explanations are that depreciating currencies lead to higher inflation and, through that, to higher future policy rates; or that investors reduce FX and LCY bond exposures in response to higher risk aversion. That pattern of response does not seem to have materialized in the last few weeks, however. With the benefit of hindsight, conditions for the LCY carry trade seem to have started changing in early July, when several EM currencies began to depreciate. In that period, FX and 5y LCY bond yields moved without a clear common pattern. In Colombia, South Africa, South Korea and Indonesia 5y LCY yields and FX moved in opposite directions (-40bps and 10.2%; -54bps and 2.16%; -42bps and 4.39%; and -33bps and 1.9% respectively). On the other hand, in Turkey, Mexico and Brazil, 5y LCY yields and FX moved in the "traditional" way (10bps and 3.75%; 29bps and 3.76%; and 67bps and 8.64%). Notice that if risk premia had been the driving force behind the move, all countries should have responded in a similar pattern. On the other hand, if the problem was credibility of monetary policy, whereby countries with less credibility have a higher positive correlation, we would expect a different ordering across countries. While Turkey and Brazil appear to warrant a (strong?) positive correlation, there are few reasons to think that South Africa and Indonesia should be fundamentally different. Therefore, the explanations seem to be lacking, and something else, such as an outside shock (or shocks) may have driven the movement in EM asset prices.

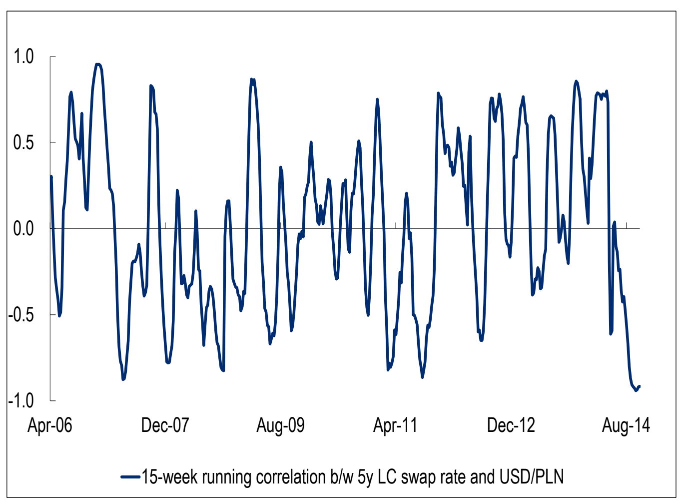
There is nothing unusual about unstable correlations between 5y LCY and FX in EM. In fact, if instead of considering a set episode we consider correlations over time for a few countries, we find that they move a great deal and, on average, are not too different from zero. Take for instance the case of Mexico and Poland, two countries with mature LCY markets, abundant presence of foreign investors, and where inflation expectations are relatively well anchored. In Mexico (Figure 17) the correlation has been highly unstable, though on average it is marginally positive. Also, in line with our findings above, the correlation in the last few weeks has been positive. On the other hand in Poland, where the correlation is also very unstable and on average nil, the recent correlation was fairly negative. These results suggest that the nature of the shocks affecting these markets is far richer than the simplistic reasoning above and it seems worth exploring the response of these (and other) markets to a variety of shocks.

Figure 17. Mexico, 5y LCY yields - FX correlation is highly unstable, on average marginally positive, and positive in last few weeks.



Source: Citi Research

Figure 18. Poland, 5y LCY yields - FX correlation is highly unstable, on average zero, and negative in last few weeks.



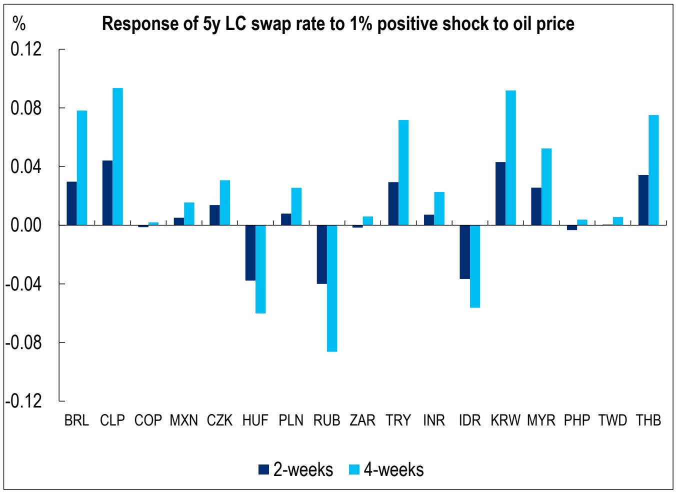
Source: Citi Research

A changing combination (and intensity) of external and internal shocks can lead to different patterns of response across countries and over time. For this reason, we decided to explore how LCY and spot FX respond to a few different shocks. We hope that doing so may help to discover if oil prices and their differential impact across countries, UST term premia, VIX and domestic shocks provide some guidance over how rates and LCY yields moved and, importantly, how they could move in the months to come.

We estimate a simple econometric model to uncover the pattern of response over time and to see if the shocks to Brent, VIX and 10y UST term premia might explain recent movements. The model we run is a simple VAR(1) estimated with weekly data (hoping to capture high frequency co-movements yet with some predictive capabilities over the next few months) for the period covering H2 2009 until now. The model includes the change in Brent, VIX, 10y UST term premia (ACM model as measured by the NY Fed), 5y LCY swap yields, and the change in FX. To "identify" the shocks, we choose the following ordering which embeds a particular logic. We treat weekly oil prices as exogenous, recognizing that they reflect current and expected demand-supply imbalances and past (last week's) financial conditions. We assume that VIX responds to the information about growth included in oil prices, but that otherwise it is an exogenous variable. We propose that 10y UST term premium responds to contemporaneous oil prices (as they reflect information in current and future activity and inflation risk) and to risk aversion, but is largely independent from the idiosyncratic country shocks that drive local rates and FX. We order local variables by assuming that FX markets are the fastest to respond to all the information contained in global variables and local yields, as well as other FX-specific shocks. Therefore, the ordering of variables we use treats oil prices as the most "exogenous" global variable followed by VIX and term premia. Spot FX is the most responsive to current information or "endogenous" variable in our system. Notice that our model allows for oil prices and global risk premia in their two versions for fixed income and equities (term premia and VIX) to be correlated. Therefore, an oil shock may change the domestic inflation outlook but also might affect global risk aversion and our model would pick the summary response to all.

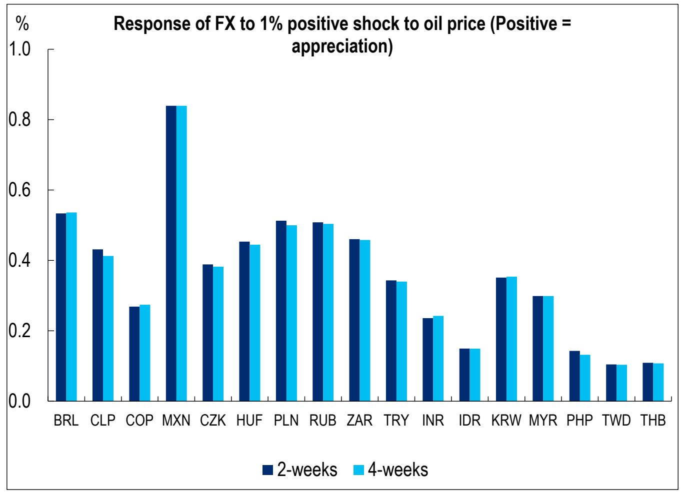
Our estimates allow the identification of shocks and of LCY yields and FX sensitivities over time. Naturally, at a given point in time, the particular combination of shock variables will determine the correlation pattern between yields and FX. We report the estimated cumulative sensitivities for two and four weeks. We also report some of the more interesting graphs, to avoid boring the reader with details. Nevertheless, it is important to note that despite the instability in LCY-FX correlations (and near zero averages) highlighted above, the sensitivities are oftentimes statistically different from zero. This suggests that the reason behind the instability in correlations is more due to a changing mix of shocks, and that the transmission mechanisms are relatively stable and significant.

Figure 19. Standardized sensitivities of 5y LCY yields to 1% shock in oil prices.



Source: Citi Research

Figure 20. Surprising sensitivity of spot FX to 1% shock in oil prices: appreciation. Is it that higher oil has typically implied good news?

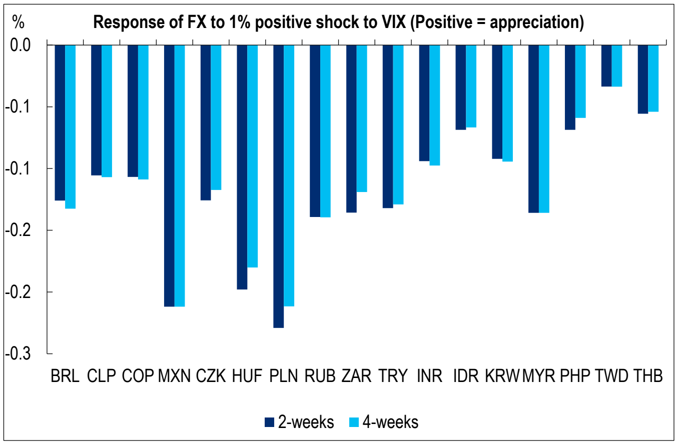


Source: Citi Research

A 10% oil price decline, like the one observed in October, has a different impact on rates and in FX markets. As Figure 19 illustrates, a 10% decline in oil leads to 70-90bp lower rates in Brazil, Chile, Turkey, Korea and Thailand. Meanwhile, 10% lower oil results in 50-80bp higher rates in Hungary, Indonesia and Russia. A move down in oil leads, counterintuitively, to depreciated exchange rates! Ex-ante, one would have expected that lower oil prices would result in more depreciated FX in oil exporting countries such as Russia and Colombia and stronger FX in oil importing nations. We think that the remarkably uniform (and significant) result is the product of several important forces. First, lower oil prices may suggest a weakening global economy which, in turn, hurts all EM nations one way or another. Second, lower oil prices also seem to coincide with higher risk aversion, a force that may affect FX negatively. Finally, the results may well be the outcome of estimating the model in very short frequencies while the correlation between oil prices and FX changes when we allow for more time. We will explore these hypotheses next.

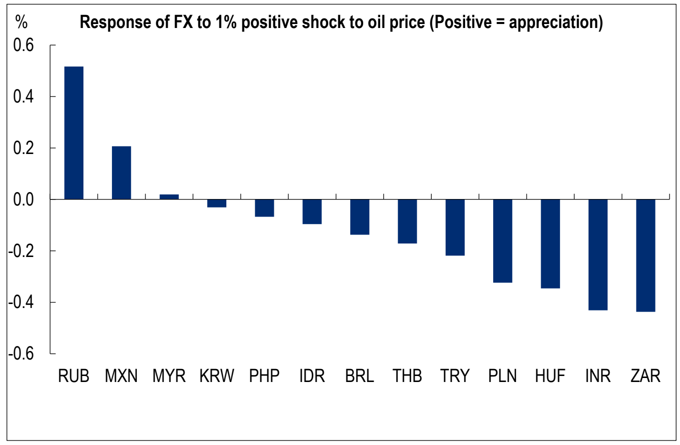
Higher risk premia, as captured by VIX, lead to depreciated exchange rates. Figure 21 shows that when there is a positive shock to VIX, EM exchange rates depreciate across the board, as experience suggests. Interestingly, strong macro countries' FX, such as MXN and PLN, are amongst those most sensitive to risk aversion. Also, Asian currencies tend to be less sensitive, in line with the perception that they are low-beta. The fragile-5 currencies have a relatively high sensitivity, though they are not alone in that range. As we argued before, lower oil prices tend to correlate with higher risk permia as measured by VIX. Therefore, it is highly plausible that the estimated appreciation of FX in response to higher oil is more an indirect response to risk aversion than to any fundamental economic force linking oil to exports or imports. Yet, it also suggests that the depreciation observed in EMFX since July is less the response to oil and more a move associated with risk premia.

Figure 21. FX uniformly depreciates when risk aversion (VIX) is higher



Source: Citi Research

Figure 22. The estimated sensitivity of FX to a 1% positive oil shock four quarters ahead. Lower oil leads to appreciating MXN and RUB (-).

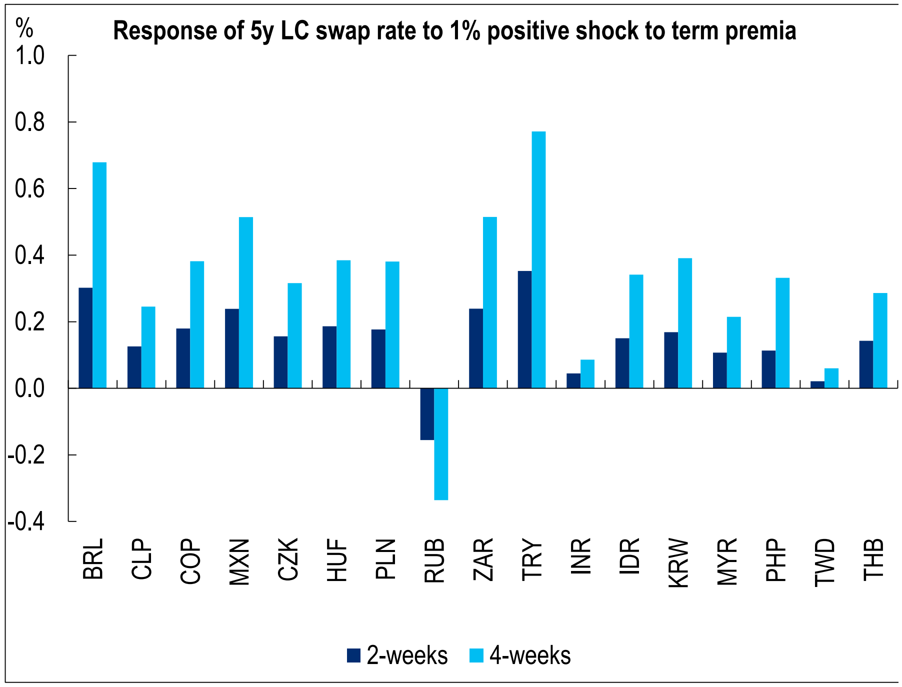


Source: Citi Research

We also estimate a model of LCY yields and FX with quarterly data considering longer horizons and controlling for G10 growth. The lower frequency model attempted to evaluate the impact on EM yields and FX of a pure oil shock, once we control for potential changes in industrialized country demand. It also allows for economic forces to play a greater role over time in driving FX. The logic of the model structure is similar, except that it treats G10 growth as exogenous and considers oil as affected directly by G10 growth. The cumulative FX response four quarters ahead to a positive oil shock is presented in Figure 22. The results suggest that a 10% drop in oil prices would lead to a 4% appreciation of the ZAR and INR, 2% for TRY and 5% depreciation for RUB. Mexico's cumulative response has the anticipated negative sign, but it is not too big. This version of the model suggests that the frequency of estimation matters when identifying economic sensitivities and that a weakening global economy could explain the weaker oil prices and, through them, the depreciating currencies that our high frequency model picked up.

Fixed income assets are more likely to respond to term premia than to proxies for risk aversion, such as VIX (or, at least, theory suggests that should be the case). For that matter, and given the sharp change in behavior observed in the last two months in UST yields, and in term premia in particular, we included this concept in our model. A positive shock to term premia should spread across fixed income Figure 23 move higher in term premia, after controlling for oil prices and VIX leads, after four weeks, to 70-80bp higher BRL and TRY yields; 50bp higher MXN and ZAR; and 40bp higher COP, HUF, PLN, IDR, KRW, PHP and THB rates. Given the 45bp decline in term premia observed since July, the model suggests EM yields should have dropped between 18-35bp, in response to this factor.

Figure 23. LCY yields increase when term premia move up



Source: Citi Research

The recent breakdown in correlations is probably explained by a combination of shocks with their differentiated impact on countries and yields/FX. Oil prices, per-se, seem to play a limited role in explaining the pattern of correlations observed. Rather, they probably were a proxy for expectations of lower global growth and higher risk aversion which, together with heightened VIX, explain the larger part of the move in EMFX. On the other hand, it appears that the move in UST term premia is a more powerful global force behind changes in local rates. Naturally, local shocks also matter. However, we think the pattern of correlations is more likely explained by these global forces.

What should we expect happens to FX and LCY yields in the next few months? Using the estimated sensitivities and Citi's house views for some of the key variables, we can conjecture how these asset prices will evolve. In particular, Citi expects that the seasonal winter tightness in oil markets will bring a moderate but noticeable increase in Brent oil prices to $92 by year-end, or nearly 7% above current prices, only to fade briskly in the spring. At the same time, Citi's US rates strategists expect 10y UST to be at 2.35% towards the end of 2014, which would imply a nearly unchanged term premia. Our model predicts that an unchanged term premia results in more or less stable LCY yields. The sensitivities discussed here also suggest that stronger oil, when not driven by either global growth or lower risk aversion, is likely to leave EMFX largely unchanged, if not produce a small appreciation. Therefore, stable and still high yields and unchanging FX re-creates an environment prone to re-kindle small carry trades and "risk-on" positioning.

Monetary Policy Watch

Figure 24. Asia Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2015
			Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	3.00	Jul-12	-25	Dec-14	-25	2.25
India	Repo Rate	8.00	Jan-14	+25	Mar-16	-25	8.00
Indonesia	FasBI	5.75	Nov-13	+25	2016	+25	5.75
Korea	BOK Policy Rate	2.00	Aug-14	-25	Dec-15	+25	2.25
Malaysia	Overnight Policy Rate	3.25	Jul-14	+25	Jul-15	+25	3.50
Philippines	Overnight Policy Rate	4.00	Sep-14	+25	2016	+50	4.00
Taiwan	Discount Rate	1.875	Jun-11	+12.5	Sep-15	+12.5	2.125
Thailand	Overnight Repo Rate	2.00	Mar-14	-25	2016	+50	2.00

Source: Bloomberg, Citi Research

Figure 25. CEEMEA Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2015
			Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.05	Nov-12	-20	3Q16	+20	0.05
Hungary	14-Day Repo Rate	2.10	Jul-14	-20	Dec-15	+25	2.35
Israel	Base Rate	0.25	Jul-14	-25	Nov-14	-25	0.25
Poland	7-Day Repo Rate	2.00	Jul-13	-25	Nov-14	-25	1.75
Romania	Refinancing Rate	3.00	Sep-14	-25	Nov-14	-25	3.50
Russia	Refinancing Rate	8.00	Jul-14	+50	Oct-14	+50	7.50
S. Africa	Average Repo rate	5.75	Jul-14	+25	May-15	+25	6.75
Turkey*	Average Funding rate	8.44			by end-2014	+56	9.50
Ukraine	Discount Rate	12.50	Jul-14	+300	2015	+200	12.00

Source: Bloomberg, Citi Research.

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

Figure 26. Latin America Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2015
			Date	Amount (bp)	Forecast	Amount (bp)	forecast
Brazil	SELIC	11.00	Apr-14	+25	Jan-15	+50	11.00
Chile	CAMARA (Overnight)	3.00	Oct-14	-25	Apr-16	+25	3.00
Colombia	Central Bank Repo Rate	4.50	Aug-14	+25	Mar-16	-25	4.50
Mexico	Official Overnight Rate	3.00	Jun-14	-25	Jun-15	+25	3.75
Peru	Reference Rate	3.50	Sep-14	-25	Jun-16	+25	3.50

Source: Bloomberg, Citi Research

FX Views

Figure 27. Asian Currencies Exchange Rates

		Dec-14			Jun-15			Dec-15		
	29-Oct	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
China yuan	6.11	6.09	6.12	0.4	6.05	6.17	2.0	6.03	6.22	3.2
Hong Kong dollar	7.75	7.76	7.75	-0.1	7.75	7.75	0.0	7.75	7.75	0.1
India rupee	61.36	61.55	61.91	0.6	62.30	63.80	2.4	62.61	65.53	4.5
Indonesia rupiah	12083	11946	12212	2.2	12170	12648	3.8	12130	n.a.	n.a.
Korea won	1047	1052	1050	-0.2	1059	1055	-0.4	1046	1057	1.1
Malaysia ringgit	3.27	3.27	3.29	0.6	3.30	3.32	0.7	3.33	n.a.	n.a.
Philippines peso	44.7	45.0	44.8	-0.4	45.0	44.9	-0.2	44.8	n.a.	n.a.
Singapore dollar	1.28	1.28	1.28	-0.5	1.30	1.28	-1.6	1.31	1.28	-2.9
Taiwan dollar	30.4	30.27	30.33	0.2	30.12	30.20	0.3	29.92	30.07	0.5
Thailand baht	32.5	32.74	32.64	-0.3	32.79	32.94	0.5	32.87	n.a.	n.a.

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

Figure 28. CEEMEA Currencies Exchange Rates

		Dec-14			Jun-15			Dec-15		
	29-Oct	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs EUR				(%)			(%)			(%)
Czech Republic koruna	27.7	27.6	28	0.6	28.0	27.7	-1.1	27.6	27.7	0.1
Hungary forint	310	312	313	0.2	324	313	-3.4	325	313	-3.9
Poland zloty	4.23	4.25	4.23	-0.5	4.29	4.23	-1.6	4.23	4.23	-0.1
vs USD										
Israel shekel	3.77	3.77	3.77	-0.1	3.89	3.76	-3.4	3.90	3.74	-4.2
Russia ruble	42.8	42.2	n.a.	n.a.	44.6	n.a.	n.a.	45.3	n.a.	n.a.
Turkey new lira	2.21	2.28	2.25	-1.5	2.43	2.34	-4.0	2.50	2.43	-3.1
S. Africa rand	10.95	11.15	11.06	-0.8	11.37	11.41	0.4	11.40	11.65	2.2

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

Figure 29. Latin American Currencies Exchange Rates

		Dec-14			Jun-15			Dec-15		
	29-Oct	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
Brazil reais	2.47	2.57	2.51	-2.3	2.64	2.63	-0.5	2.70	2.76	1.9
Chile peso	575	592	579	-2.2	599	588	-1.9	597	596	0.0
Colombia peso	2045	2050	2060	0.5	2050	2099	2.3	2059	2139	3.8
Mexico new peso	13.5	13.5	13.5	0.1	13.3	13.5	1.2	13.2	13.5	2.4

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

Global Assumptions

Macroeconomic Forecasts

	GDP Growth (% YoY)			CPI Inflation (% YoY)			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F
Global	2.7	3.2	3.6	2.7	2.6	3.1	0.8	0.8	0.6	-3.5	-3.0	-2.8
Industrial Countries	1.7	2.2	2.5	1.4	1.4	1.6	-0.1	0.2	0.3	-4.2	-3.3	-3.2
United States	2.2	3.2	3.2	1.4	1.4	2.2	-2.0	-1.2	-1.0	-5.5	-4.4	-4.7
Japan	0.8	0.9	1.2	2.8	1.6	1.6	0.1	0.5	1.0	-8.0	-6.2	-5.8
Euro Area	0.8	1.1	1.7	0.5	0.9	1.4	2.7	2.9	2.9	-2.6	-2.5	-2.0
Germany	1.4	1.2	1.7	0.9	1.4	2.0	7.3	7.5	6.9	0.1	0.0	0.0
United Kingdom	3.0	3.2	3.3	1.5	1.5	1.9	-4.9	-5.1	-5.6	-4.1	-3.4	-2.1

G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 29 October 2014

		4Q 14F	1Q 15F	2Q 15F	3Q 14F	4Q 15F	1Q 16F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.75	1.00	1.25
10-Yr. Treasuries (Period Ave.)	2.29	2.35	2.55	2.80	2.95	3.05	3.10
Euro Area: US$/€	1.27	1.22	1.19	1.16	1.14	1.13	1.12
Euro Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05	0.05
10-Yr. Bunds (Period Average)	0.88	0.65	1.00	1.00	1.25	1.25	1.50
Japan: Yen/US$	108	110	112	114	116	117	118
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.46	0.45	0.55	0.75	0.85	0.75	0.85

Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US$						Spread vs. Germany					
	Current	4Q 14	1Q 15	2Q 15	3Q 15	4Q 15	Current	4Q 14	1Q 15	2Q 15	3Q 15	4Q 15
United States	NA	NA	NA	NA	NA	NA	142	171	157	182	172	182
Japan	-184	-191	-202	-207	-212	-232	-42	-20	-45	-25	-40	-50
Euro Area	-142	-171	-157	-182	-172	-182	NA	NA	NA	NA	NA	NA
United Kingdom	-6	-10	-5	5	-5	-10	135	161	152	187	167	172

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

Commodities Price Outlook

		3M	6-12M	LT
Metals and Bulks				
Gold Price	US$/oz	1200	1240	1050
Silver Price	US$/oz	18.30	18.70	16.50
Platinum Price	US$/oz	1400	1500	1763
Energy				
WTI Oil Price	US$/bbl	83	86	81
Brent Oil Price	US$/bbl	92	94	85
Henry Hub Gas Price	US$/MMbtu	3.90	3.80	5.50
Agriculture				
CBOT Corn - North America	US¢/bu	310	390	
CBOT Wheat - North America	US¢/bu	475	500	
CBOT Soybeans - North America	US¢/bu	900	1000	
CBOT Rice - North America	US¢/cwt	13.00	14.00	

Source: Citi Research

EM: Key Forecasts

Figure 30. Emerging Markets – Economic Forecasts, 2013-2015F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013	2014F	2015F	2013	2014F	2015F	2013	2014F	2015F	2013	2014F	2015F
Asia	**6.2**	**6.2**	**6.2**	**3.7**	**3.1**	**3.0**	**2.1**	**2.4**	**2.2**	**-2.4**	**-2.4**	**-2.3**
China	7.7	7.3	6.9	2.6	2.1	2.2	2.0	2.3	2.3	-1.9	-2.1	-2.0
Hong Kong	2.9	2.3	2.6	4.3	4.1	3.6	1.9	2.6	3.6	1.0	1.3	0.7
India*	4.7	5.6	6.5	9.5	7.8	6.2	-1.7	-1.8	-1.9	-6.9	-6.7	-6.5
Indonesia	5.8	5.1	5.1	6.4	6.2	6.7	-3.3	-3.2	-2.9	-2.2	-2.4	-1.9
Korea	3.0	3.6	3.8	1.3	1.4	2.2	6.1	5.4	4.0	1.0	0.9	0.4
Malaysia	4.7	5.7	5.6	2.1	3.2	4.1	4.0	5.4	5.0	-3.9	-3.5	-3.0
Mongolia	11.7	6.5	9.0	10.5	13.4	13.0	-30.9	-15.8	-24.0	-7.8	-7.9	-6.9
Pakistan	4.4	5.4	4.5	7.4	8.6	7.5	-1.1	-1.2	-0.9	-8.2	-5.5	-6.2
Philippines	7.2	6.3	6.5	2.9	4.3	3.5	3.5	3.6	3.4	-1.4	-1.6	-0.9
Singapore	3.9	2.9	3.0	2.4	1.1	0.7	18.3	18.0	18.0	1.1	-0.3	0.2
Sri Lanka	7.3	7.7	7.5	6.9	3.7	5.5	-3.9	-2.7	-2.5	-5.9	-5.4	-5.0
Taiwan	2.1	3.7	4.0	0.8	1.5	2.0	11.7	11.0	10.2	-1.3	-1.4	-0.8
Thailand	2.9	1.1	3.9	2.2	2.0	1.5	-0.6	4.1	3.1	-1.8	-1.2	-1.8
Vietnam	5.4	5.7	5.9	6.6	3.3	5.8	6.1	5.0	4.0	-5.6	-6.4	-6.0
Latin America	**2.6**	**0.9**	**1.8**	**6.8**	**7.6**	**7.6**	**-2.6**	**-2.7**	**-2.7**	**-2.6**	**-3.9**	**-3.4**
Argentina	2.9	0.0	-1.0	10.6		29.0	-0.7	-1.2	-1.1	-1.9	-3.7	-4.7
Brazil	2.5	0.1	1.0	6.2	6.3	6.6	-3.7	-3.8	-4.0	-3.3	-5.1	-3.7
Chile	4.1	1.8	3.0	1.9	4.2	3.3	-3.4	-2.0	-2.8	-0.6	-2.0	-1.6
Colombia	4.7	4.8	4.5	2.0	2.8	3.0	-3.4	-3.7	-3.8	-0.9	-1.6	-1.5
Costa Rica	3.5	3.1	2.2	5.2	4.8	5.0	-5.1	-6.4	-6.5	-6.5	-7.2	-7.7
Dominican Republic	4.6	6.8	4.5	4.8	3.3	3.8	-4.0	-3.7	-3.8	-4.1	-4.0	-4.0
El Salvador	1.7	2.2	2.5	0.8	1.4	2.1	-6.2	-6.4	-5.7	-4.2	-3.1	-3.0
Mexico	1.1	2.4	3.9	3.8	4.0	3.5	-2.1	-2.2	-2.0	-2.3	-3.6	-3.5
Panama	8.4	6.2	5.5	4.0	2.8	2.2	-11.3	-9.0	-8.6	-3.0	-4.0	-3.0
Peru	5.8	2.5	3.8	2.8	3.2	2.5	-4.4	-5.6	-5.0	12.5	9.0	9.0
Venezuela	1.3	-4.0	-2.2	38.5	61.3	70.3	3.3	4.5	6.2	-11.9	-12.3	-12.6
Europe	**2.0**	**1.4**	**2.2**	**5.2**	**6.0**	**5.7**	**-1.2**	**0.1**	**-0.2**	**-2.2**	**-3.4**	**-3.6**
Bulgaria	1.1	1.5	2.5	0.9	-1.3	2.2	2.1	0.5	-1.0	-1.5	-2.7	-2.0
Croatia	-0.9	-0.7	0.7	2.2	0.0	2.2	0.9	1.0	0.3	-4.9	-5.0	-4.0
Czech Republic	-0.7	2.4	2.4	0.0	0.4	1.3	-1.4	0.0	-0.8	-1.3	-1.9	-2.3
Hungary	1.1	3.1	2.2	1.7	0.2	2.1	4.1	4.4	3.6	-2.2	-2.9	-3.0
Kazakhstan	5.9	4.4	5.0	5.8	6.7	6.4	-0.1	1.1	1.5	3.0	2.4	2.1
Poland	1.6	3.0	3.4	0.9	0.1	1.2	-1.4	-2.0	-3.4	-4.3	-3.0	-2.3
Romania	3.5	2.0	3.4	4.0	1.3	2.7	-0.8	-1.2	-2.0	-2.5	-2.3	-2.3
Russia	1.3	0.7	1.0	6.8	7.4	7.0	1.6	3.2	3.0	-2.1	-4.4	-4.9
Serbia	2.5	-1.0	2.3	7.9	2.5	6.4	-4.9	-5.3	-5.8	-5.7	-6.0	-5.5
Slovakia	1.4	2.3	2.6	1.4	0.0	1.3	2.1	1.0	1.0	-2.6	-2.9	-2.7
Turkey	4.1	3.1	3.5	7.5	9.0	6.9	-7.9	-5.3	-5.3	-1.2	-2.8	-3.2
Ukraine	0.2	-7.7	0.7	-0.3	11.6	13.8	-9.1	-3.9	-2.4	-6.6	-6.0	-4.1
Africa/Mideast	**4.3**	**3.9**	**4.6**	**4.5**	**4.5**	**5.0**	**11.3**	**9.4**	**6.8**	**1.7**	**0.6**	**-1.3**
Bahrain	5.5	4.8	4.4	3.3	4.2	4.6	6.8	6.6	2.2	-3.3	-3.7	-5.4
Egypt	1.5	2.4	3.2	9.5	10.4	11.1	-1.3	-2.7	-3.4	-13.7	-11.7	-9.5
Ghana	7.1	5.1	4.0	11.7	15.2	13.2	-11.5	-8.9	-8.4	-10.0	-8.7	-7.0
Iraq	6.8	0.1	8.9	1.9	2.5	5.0	14.1	10.7	9.5	-5.9	-5.9	-4.3
Israel	3.1	2.3	2.2	1.5	0.5	0.3	2.4	2.0	1.8	-2.7	-3.0	-3.3
Jordan	2.8	3.6	3.8	5.5	2.8	3.1	-10.0	-11.7	-12.9	-5.5	-4.9	-4.2
Kenya	5.7	5.4	6.0	5.7	7.3	7.3	-8.7	-7.6	-7.5	-5.7	-6.0	-5.8
Kuwait	5.7	3.8	3.9	2.6	3.0	3.5	40.7	38.4	35.0	31.6	26.7	15.1
Lebanon	0.7	0.4	2.5	2.1	1.9	2.6	-16.4	-15.0	-14.0	-9.6	-9.8	-9.8
Nigeria	5.5	6.4	6.4	8.5	8.2	9.5	4.0	2.1	1.5	-1.6	-2.0	-2.1
Oman	3.4	4.7	4.7	2.1	1.0	0.9	6.1	7.7	4.9	0.8	-1.4	-4.5
Qatar	6.5	5.5	6.9	3.1	3.0	3.5	30.9	28.8	23.7	15.6	13.0	9.5
Saudi Arabia	4.0	4.8	4.2	3.5	2.9	3.0	17.9	14.8	9.2	8.7	6.0	0.9
South Africa	1.9	1.4	2.6	5.8	6.2	5.7	-5.6	-5.3	-4.7	-4.1	-4.1	-4.1
Tanzania	7.0	7.1	7.2	7.9	6.4	6.2	-10.2	-13.9	-12.9	-5.9	-6.2	-6.5
UAE	5.2	4.0	4.0	1.1	2.0	2.4	28.4	23.7	19.1	NA	NA	NA
Uganda	4.7	6.1	6.5	5.5	4.6	4.9	-8.3	-9.5	-10.1	-4.5	-5.3	-5.6
Zambia	6.2	6.2	6.3	7.0	7.9	6.5	0.7	1.5	1.2	-6.7	-5.3	-4.4
Total	**4.6**	**4.2**	**4.6**	**4.6**	**4.5**	**4.4**	**1.8**	**2.0**	**1.6**	**-1.9**	**-2.5**	**-2.5**

Source: National sources, Citi Research forecasts

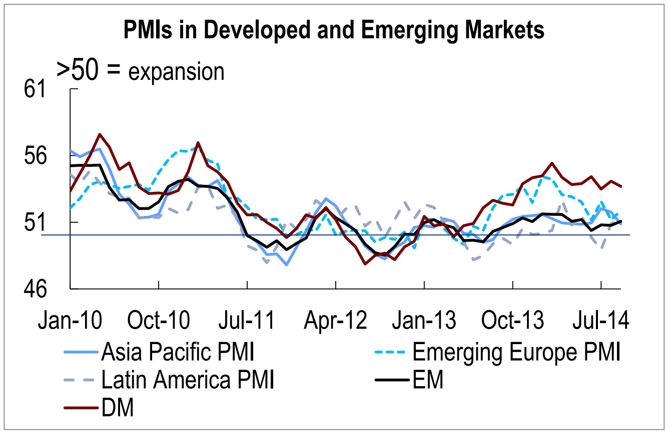
Our Forecasts vs. Consensus

Figure 31. Citi vs Consensus Forecasts

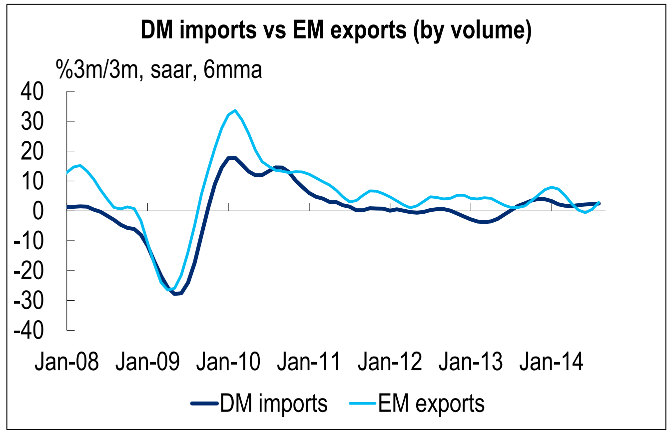
	GDP Growth (%)				CPI Inflation (%)				Current Account Balance (US$ bn)			
	2014F	Consensus	2015F	Consensus	2014F	Consensus	2015F	Consensus	2014F	Consensus	2015F	Consensus
Asia	**6.2%**	**6.2%**	**6.2%**	**6.3%**	**3.0%**	**3.2%**	**3.0%**	**3.4%**	**415**	**412**	**422**	**393**
China	7.3	7.3	6.9	7.1	2.1	2.3	2.2	2.7	231	236	255	237
Hong Kong	2.3	2.3	2.6	3.0	4.1	3.9	3.6	3.5	7	4	11	6
India	5.6	5.6	6.5	6.3	7.8	7.7	6.2	6.8	-37	-40	-44	-50
Indonesia	5.1	5.2	5.1	5.6	6.2	6.1	6.7	6.0	-28	-26	-27	-23
South Korea	3.6	3.5	3.8	3.7	1.4	1.5	2.2	2.2	78	81	62	69
Malaysia	5.7	5.7	5.6	5.2	3.2	3.2	4.1	3.9	18	18	17	17
Philippines	6.3	6.3	6.5	6.3	4.3	4.3	3.5	3.9	10	10	11	10
Singapore	2.9	3.2	3.0	3.7	1.1	1.5	0.7	2.1	58	56	64	57
Sri Lanka	7.7	7.3	7.5	7.1	3.7	5.3	5.5	6.3	-2	-3	-2	-4
Taiwan	3.7	3.6	4.0	3.6	1.5	1.4	2.0	1.8	56	58	56	57
Thailand	1.1	1.3	3.9	4.3	2.0	2.2	1.5	2.5	15	11	12	7
Vietnam	5.7	5.6	5.9	5.8	3.3	5.1	5.8	6.2	8	8	7	7
Latin America	**0.9%**	**1.0%**	**1.9%**	**2.0%**	**11.3%**	**11.7%**	**12.1%**	**10.7%**	**-140**	**-135**	**-141**	**-135**
Argentina	0.0	-1.6	-1.0	-0.7	26.3	28.2	37.0	28.0	-6	-5	-5	-6
Brazil	0.1	0.3	1.0	1.0	6.4	6.4	6.8	6.3	-85	-80	-88	-76
Chile	1.8	1.9	3.0	3.1	4.4	4.5	3.0	2.8	-5	-4	-7	-5
Colombia	4.8	4.9	4.5	4.6	3.2	3.3	3.0	3.2	-14	-15	-15	-15
Mexico	2.4	2.5	3.9	3.8	3.9	3.9	3.3	3.5	-28	-25	-28	-28
Panama	6.2	6.6	5.5	6.3	2.4	3.2	2.6	3.5	-4	-5	-4	-5
Peru	2.5	3.3	3.8	5.0	3.1	3.0	2.5	2.7	-12	-10	-11	-10
Venezuela	-4.0	-3.0	-2.2	-0.6	64.0	67.9	75.0	67.6	15	10	18	10
Europe	**1.5%**	**1.2%**	**2.1%**	**1.8%**	**5.9%**	**6.2%**	**5.7%**	**5.3%**	**9.6**	**3.1**	**-5.8**	**-14.2**
Bulgaria	1.5	1.6	2.5	2.2	-1.3	-0.8	2.2	1.4	0.3	0.3	-0.5	-0.4
Croatia	-0.7	-0.6	0.7	0.4	0.0	0.0	2.2	1.5	0.6	0.6	0.2	0.3
Czech R	2.4	2.5	2.4	2.5	0.4	0.5	1.3	1.8	0.0	-0.4	-1.7	-0.4
Hungary	3.1	3.1	2.2	2.2	0.2	0.1	2.1	2.3	5.3	4.0	4.0	3.3
Kazakhstan	4.4	4.4	5.0	5.2	6.7	7.3	6.4	6.1	2.3	2.8	3.3	0.7
Poland	3.0	3.1	3.4	3.3	0.1	0.2	1.2	1.3	-10.7	-6.5	-15.9	-10.5
Romania	2.0	2.2	3.4	3.1	1.3	1.4	2.7	2.6	-2.3	-2.6	-3.6	-3.4
Russia	0.7	0.2	1.0	0.4	7.4	8.0	7.0	6.2	60.3	53.3	53.3	46.4
Slovak Rep	2.3	2.5	2.6	2.9	0.0	0.1	1.3	1.4	1.1	2.1	0.9	1.9
Turkey	3.1	2.9	3.5	3.4	9.0	8.9	6.9	7.1	-42.2	-46.3	-42.5	-48.6
Ukraine	-7.7	-7.7	0.7	-1.1	11.6	11.0	13.8	11.1	-5.0	-4.2	-3.3	-3.5
MEA	**3.7%**	**3.6%**	**3.8%**	**4.0%**	**5.0%**	**5.0%**	**5.2%**	**5.4%**	**105.4**	**108.8**	**57.8**	**83.0**
Egypt	2.4	2.3	3.2	3.0	10.4	10.1	11.1	10.6	-7.6	-5.3	-10.5	-8.0
Israel	2.3	2.5	2.2	3.2	0.5	0.8	0.3	1.5	5.9	6.8	5.2	7.5
Nigeria	6.4	6.4	6.4	6.4	8.2	8.4	9.5	9.0	12.0	13.4	9.7	12.2
S. Africa	1.4	1.5	2.6	2.8	6.2	6.2	5.7	5.7	-17.7	-18.1	-16.6	-16.0
S. Arabia	4.8	4.3	4.2	4.2	2.9	2.9	3.0	3.4	112.8	112.0	70.0	87.3
Above Total	**4.2%**	**4.2%**	**4.6%**	**4.6%**	**5.2%**	**5.5%**	**5.3%**	**5.2%**	**398.1**	**394.7**	**344.1**	**334.6**

Source: Consensus Economics, National Sources, Citi Research forecasts

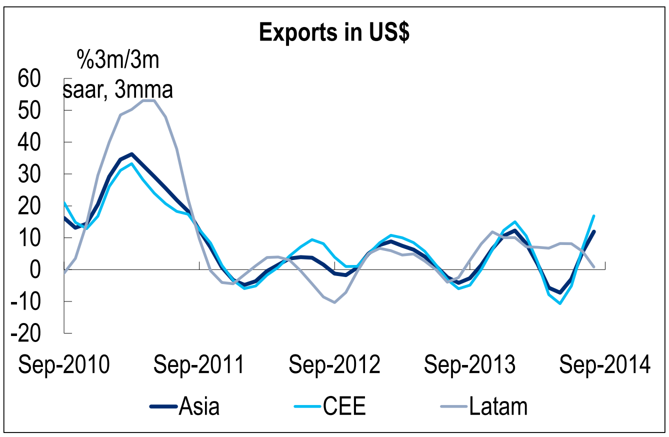
EM most requested regional charts



Source: Haver Analytics, Citi Research



Source: Haver Analytics, Citi Research



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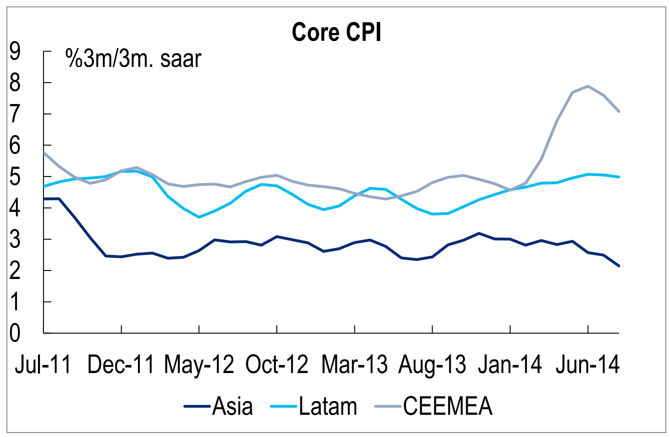

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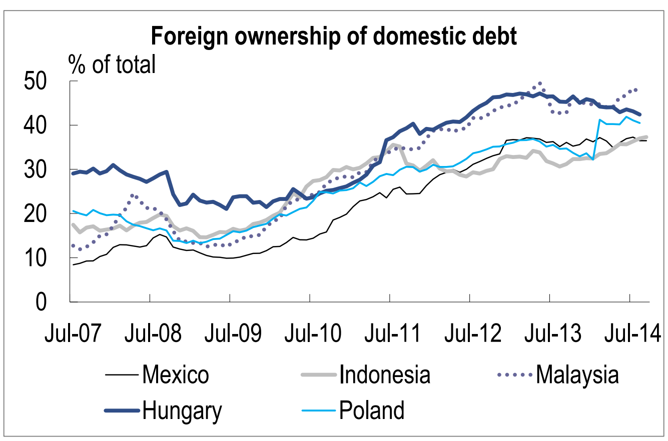

Source: Haver Analytics, Citi Research

<table>
<tr><th></th><th colspan="2">Potential GDP</th></tr>
<tr><th></th><th>Current</th><th>5-10 yr (LT)</th></tr>
<tr><td>Brazil</td><td>1.8 - 2.0</td><td>2.5</td></tr>
<tr><td>Chile</td><td colspan="2">4.0</td></tr>
<tr><td>Colombia</td><td colspan="2">4.5</td></tr>
<tr><td>Mexico</td><td>2.8</td><td>4.5</td></tr>
<tr><td>Peru</td><td colspan="2">4.8</td></tr>
<tr><td>Czech</td><td>1.2</td><td>2.8</td></tr>
<tr><td>Hungary</td><td>1.4</td><td>1.9</td></tr>
<tr><td>Poland</td><td colspan="2">2.8</td></tr>
<tr><td>Romania</td><td>3.3</td><td>3.0</td></tr>
<tr><td>Russia</td><td>1.5 - 2.0</td><td>2.5 - 3.0</td></tr>
<tr><td>Turkey</td><td>3.7</td><td>3.5</td></tr>
<tr><td>Israel</td><td colspan="2">2.5</td></tr>
<tr><td>S. Africa</td><td colspan="2">3.0</td></tr>
<tr><td>Indonesia</td><td colspan="2">5.4</td></tr>
<tr><td>Korea</td><td>3.6</td><td>3.5</td></tr>
<tr><td>Malaysia</td><td colspan="2">5.0</td></tr>
<tr><td>Philippines</td><td colspan="2">5.5</td></tr>
<tr><td>Thailand</td><td colspan="2">4.0</td></tr>
</table>

Source: Central banks, Haver Analytics, Citi Research

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China

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- **Summary view** – Growth downtrend continued in 3Q due to a property-led slowdown. We keep our annual GDP growth forecasts at 7.3% for 2014, and lower our CPI inflation forecast from 2.3% to 2.1%. In light of downside risks to growth and inflation, we continue to anticipate a 25bps rate cut by the year-end.
- **Things to watch** – The property measures introduced in late Sep should help in stabilizing home sales and avoiding a market collapse. However, we do not expect a quick turnaround of the property investment momentum due to over-supply, and we believe that the external demand will likely contribute less to China's growth going forward.
- **Strategy** – Strong net exports so far has been supportive to the appreciation bias of the RMB. Due to falling commodity prices and weak domestic demand, the trade surplus will likely last until 2015. We forecast a mild RMB appreciation against a strong USD, with USDCNY spot at 6.09 by year-end and 6.03 by end-2015.

Downside risks to growth and inflation call for rate cuts

Growth downtrend continued despite strong support from external demand – Growth decelerated from 7.5%YoY in 2Q to 7.3%YoY in 3Q, and net exports contributed 2.5ppts to the quarterly growth. Domestically, property investment growth fell from 9.9%YoY in Aug to 8.6%YoY in Sep. The impact of property market correction is spilling over to the broader economy, with infrastructure investment and housing-related retail sales (home appliances, furniture and construction materials) slowing further. While IP growth improved from 6.9%YoY in Aug to 8.0%YoY in Sep, it was the second slowest level of growth since 2009. The real activity data suggest strong exports and targeted policy easing were not sufficient to offset the property drag.

Falling inflation is creating conditions for broad rate cuts – CPI inflation dropped to 1.6%YoY in Sep, and PPI deflation intensified to -1.8%YoY. In particular, non-food inflation fell to 1.3%YoY, the lowest level since Mar 2010, suggesting the negative output gap may be enlarging, as a result of weak domestic demand. With one-year deposit rate at roughly 3.3%, the interest rate is increasingly positive in real terms. Actually, the real deposit rate is now higher than the level in mid-2012 when PBOC cut benchmark rates last time. Weak domestic demand and falling import prices may continue to depress inflation in the foreseeable future. We cut average inflation forecast from 2.3% to 2.1% for 2014, and from 2.6% to 2.2% for 2015, and continue to expect three policy rate cuts, 25bps each, by mid-2015. The first rate cut is likely to take place by end-2014.

We keep our growth forecast at 7.3% for 2014. The mortgage loosening measures introduced in late Sep, together with relaxation of home purchase restrictions in most cities (except for the first-tier cities), should help in stabilizing home sales and in avoiding a market collapse. However, we do not expect a quick turnaround of the property investment momentum, due to over-supply. Stagnating land sales revenue would weigh on investment late this year and early next year. Negative economic news from Europe has clouded the global outlook, and external demand will likely contribute less to China's growth going forward. The expected rate cuts may only lift the economy towards the middle of next year, due to a lag effect. Growth will likely decelerate further to 7.1%YoY in 4Q, and below 7% in 1H 2015.

Reform progress: Budget law revision & the 4th Plenum

The revision of the budget law marks a breakthrough in fiscal reform – Since last fall, the reform has quickly progressed in fiscal and financial areas as well as investment deregulation. The new budget law, effective early next year, promises to make the budgeting process more transparent and fiscal policy counter-cyclical. In particular, local governments will be allowed to issue bonds on their own under a quota system, to finance capital expenditure and refinance existing debt. Based on the 2013 audit, the government debt will be screened and confirmed through negotiations between creditors and debtors. The confirmed local government debt will be incorporated into the budget management process.

The envisaged fiscal reform is expected to have major impact on macro management, bond market and banking business.

- The multi-year budget balancing mechanism allows fiscal policy to become an automatic stabilizer, helping reduce economic volatility.
- The stock of government bonds may reach Rmb27-29tn by 2019, on the basis of debt refinance need and conservative assumptions on debt growth.
- Bond market may expand at the expense of loan growth, depressing banks' interest income growth while boosting bond-related income. Clarity on local government debt may lift valuations of banks.

Political reform centers on rule of law – The communique of the Communist Party's Fourth Plenum released on 23 Oct highlights principles and proposes some changes to enhance the rule of law. It emphasizes on governance according to the Constitution under the Party's leadership, and that rule of law starts with enactment of laws. This suggests that major reform measures in the future will need to have a legal base. The revised budget law passed in late Aug was an example. Going ahead, legislation will be needed for the introduction of the property tax and environment protection tax.

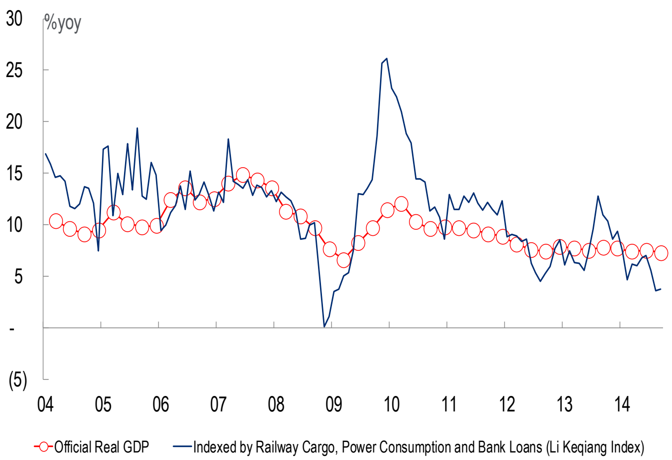
Proposals and changes to enhance the rule of law include:

1. **The launch of circuit courts and cross-region courts**. To reduce interference of the local governments, the Supreme Court will set up circuit courts to hear cases around the country. For the same purpose, cross-region courts will be set up. It is also likely, although not explicit in the communique, that the courts will be separated from the local administration, and will report directly to the Supreme Court, with fiscal appropriations and personnel issues determined by the latter.

2. **To improve decision-making procedures and accountability**, the communique calls for a transparent list of government powers. The major administrative decisions will need to go through public hearings, expert evaluations, risk assessments, and compliance reviews. Officials will be held accountable, throughout their lifetime, for the decisions they make.

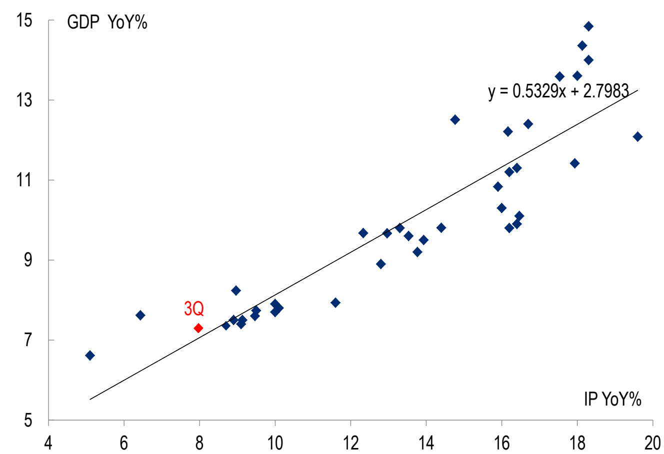
These proposals, if implemented forcefully, should help increase the independence of the judicial system from local influence and improve the business environment.

Figure 32. Citi Li Keqiang Index vs. GDP



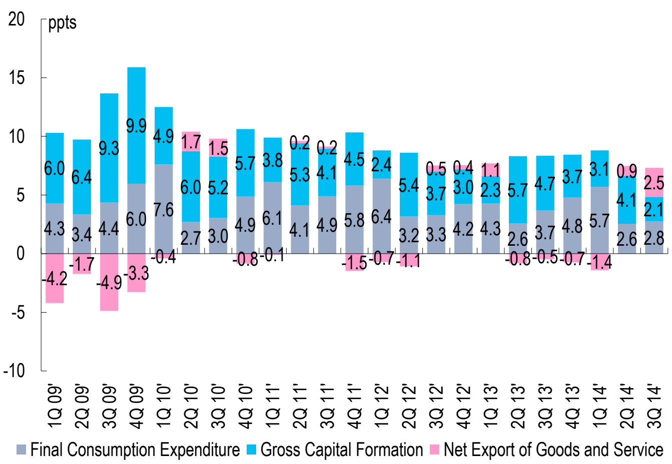
Source: CEIC and Citi Research

Figure 33. IP downturn was more significant than GDP slowdown in 3Q



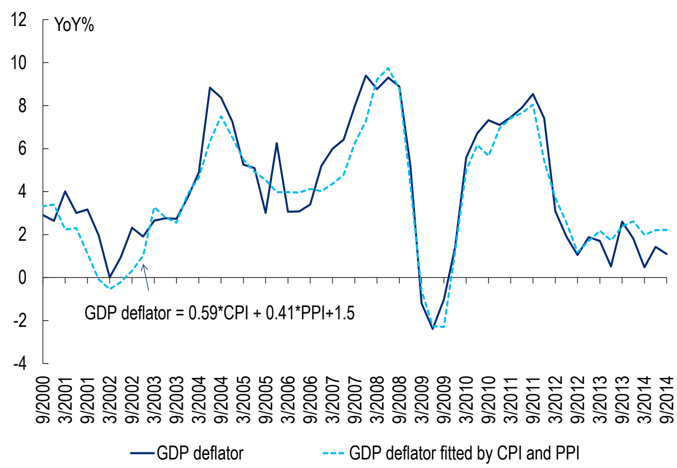
Source: CEIC and Citi Research

Figure 34. Net exports contributed 2.5ppts to GDP growth in 3Q



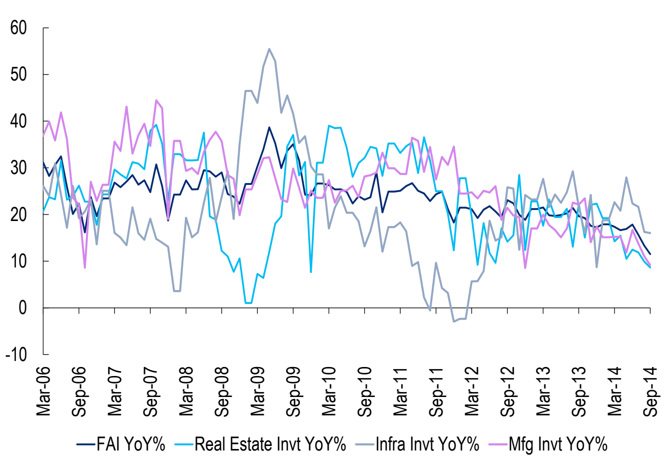
Source: NBS, CEIC and Citi Research

Figure 35. GDP deflator fell to 1.1%YoY in 3Q



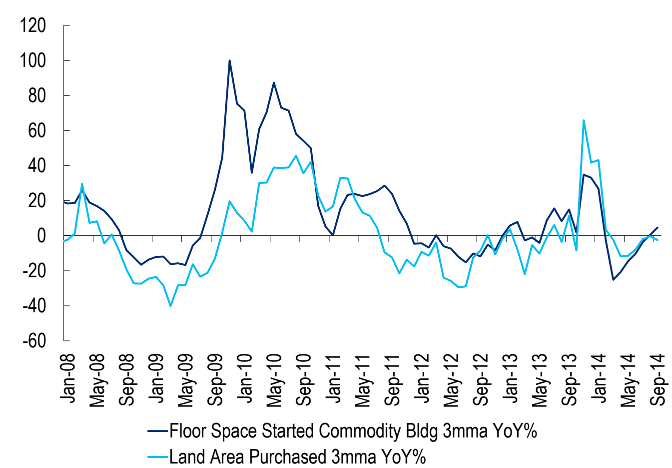
Source: WIND, CEIC and Citi Research

Figure 36. FAI slowdown became broad based



Source: WIND, CEIC and Citi Research

Figure 37. New home starts and land sales remained sluggish



Source: CEIC and Citi Research

Figure 38. China Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	3,494.5	4,544.0	5,070.5	5,932.5	7,319.0	8,246.9	9,245.4	10,041.3	11,098.9
Nominal GDP, local currency bn	26,583	31,490	34,632	40,151	47,310	51,947	56,885	61,785	66,995
GDP per capita, US$	2,645	3,422	3,800	4,424	5,432	6,091	6,794	7,350	8,103
Population, mn	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,360.7	1,366.2	1,369.7
Unemployment, % of labour force	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2	4.2
Economic Activity									
Real GDP, % yoy	14.2	9.6	9.2	10.4	9.3	7.7	7.8	7.3	6.9
Real investment growth % yoy	14.4	11.0	19.2	11.9	9.4	8.1	8.9	6.4	6.3
Real consumption growth % yoy	11.0	8.5	9.4	9.2	10.9	8.3	7.9	7.1	7.0
private consumption growth % yoy	11.1	9.2	10.3	8.5	18.2	7.8	7.2	7.3	7.2
Real export growth, % yoy	--	--	--	--	--	--	--	--	--
Real import growth, % yoy	--	--	--	--	--	--	--	--	--
Prices, Money & Credit									
CPI, % yoy	6.5	1.2	1.9	4.6	4.1	2.5	2.5	2.1	2.5
CPI, % avg	4.8	5.9	-0.7	3.3	5.4	2.6	2.6	2.1	2.2
Nominal wages, % yoy	18.5	16.9	11.6	13.3	14.4	11.9	9.5	8.6	8.4
Credit extension to private sector, % yoy	19.3	14.0	33.2	20.3	15.1	15.6	14.1	13.4	13.1
Policy interest rate, % eop	4.14	2.25	2.25	2.75	3.50	3.00	3.00	2.75	2.25
Short-term market rate, % eop	3.61	1.23	1.79	6.17	6.00	4.90	5.91	4.69	4.19
Long term yield, % eop	4.19	1.80	3.06	3.61	3.27	3.33	4.49	3.24	4.09
lc/US$, eop	7.30	6.82	6.83	6.59	6.29	6.23	6.05	6.09	6.03
lc/US$, avg	7.61	6.95	6.83	6.77	6.46	6.31	6.15	6.16	6.04
Balance of Payments, US$ bn									
Current account	353.2	420.6	243.3	237.8	136.1	215.4	182.8	231.0	255.3
% of GDP	10.1	9.3	4.8	4.0	1.9	2.6	2.0	2.3	2.3
Trade balance	264.3	298.1	195.7	181.5	154.9	230.3	259.2	353.9	412.1
Exports	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.7	2,209.5	2,339.5	2,496.9
Imports	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,818.4	1,950.3	1,985.6	2,084.9
Service balance	-7.9	-11.8	-29.4	-31.2	-61.6	-89.7	-124.5	-137.0	-150.7
Income balance	8.0	28.6	-8.5	-25.9	-70.3	-19.9	-43.8	-13.6	-19.2
FDI, net	139.1	114.8	87.2	185.7	231.7	176.3	185.0	157.4	106.5
International reserves	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,821.3	4,007.6	4,286.1
Total Amortisations	20.3	23.3	34.2	27.2	33.2	33.0	39.2	41.2	45.3
Public Finances, % of GDP									
Consolidated government balance	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-1.9	-2.1	-2.0
Consolidated gov primary balance	1.0	0.1	-1.8	-1.7	-0.9	-1.5	-1.4	-1.6	-1.5
Public debt	39.0	37.4	47.8	49.2	44.3	53.5	53.7	54.3	54.2
of which Domestic	38.0	36.6	47.0	48.6	43.7	53.0	53.3	53.9	53.8
Foreign Assets & Liabilities, US$ bn									
External debt	389.2	390.2	428.6	548.9	695.0	737.0	863.2	949.5	1,044.4
Private	354.3	356.9	391.8	510.1	657.6	700.4	828.8	911.7	1,002.9
Public	34.9	33.3	36.9	38.8	37.4	36.6	34.3	37.8	41.5
External debt / GDP	11.1	8.6	8.5	9.3	9.5	8.9	9.3	9.5	9.4
External debt / XGS	29.0	24.7	32.2	31.5	33.4	32.8	35.6	37.0	38.1
Short-term debt	235.7	226.3	259.3	375.7	500.9	540.9	676.6	744.3	818.7
Short-term debt/International Reserves (%)	15.4	11.6	10.8	13.2	15.7	16.3	17.7	18.6	19.1

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	7.4	7.5	7.3	7.1	6.7	6.8	7.0	7.1	7.0
CPI, % yoy	2.4	2.3	1.6	2.1	2.0	1.8	2.2	2.5	2.5
Policy interest rate, % eop	3.00	3.00	3.00	2.75	2.50	2.25	2.25	2.25	2.25
Short-term market rate, % eop	4.62	5.00	4.00	4.69	4.12	4.35	4.03	4.68	3.95
Long term yield, % eop	4.21	3.84	3.90	3.24	3.66	3.49	4.03	4.09	4.41
lc vs USD, eop	6.22	6.20	6.14	6.09	6.07	6.05	6.03	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).

Hong Kong

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- **Summary view** – We cut out HK GDP forecast further to 2.3%YoY and 2.6% for 2014 & 2015, on consumption slowdown. The delayed launch of Shanghai-HK Stock Connect, if prolonged, will again hurt confidence. The umbrella movement is turning into a drag out event, disrupting businesses and daily lives.
- **Things to watch** – 1) Liquidity concerns on end of taper; 2) Trade recovery and property market adjustment; 3) Tourist shopping (lower volume & value/pax); 4) Electoral reforms and protests; 5) Co-operating measures with Qianhai and Shanghai FTZ/stock exchanges; 7) Changes to personal RMB conversion quota.
- **Strategy** – Pressure for interest rate increase would resurface with the end of tapering. HKD is expected to stay around HK$7.76/USD (away from its strong trading band) on prolonged poltiical discussions. Citi's house view is that the mass market home prices would stay flat in 2014E; and the HSI target for 2014 year-end is 25,000.

Politics take the center stage since late Sep

The umbrella movement is turning into a drag out event – A month has passed since the start of the movement. Major road blockages remain; posing a serious inconvenience to people's daily lives, disrupting business and deterring local spending. Several affected business groups/companies have turned to the Supreme Court to issue injunctions against occupying various streets, and the hearings of these temporary injunctions continues with occupants defending their case of civil disobedience. The already fragile working relationship between the executive and the legislative gov't bodies has worsened due to the movement, as democratic LegCo members have launched non-cooperative exercises at the LegCo meetings.

Little room for the gov't to concede to the student leader's demands, in our view – The first of the several dialogues between the student activists and the gov't was broadcasted live on 21 Oct, and both sides reiterated their stance, as expected. The students demanded the gov't to come up with electoral reform timetable, and methods to deliver a genuine CE election in 2017 with civil nomination. The demands also include getting rid of functional group members of the LegCo election in 2016, which will require persuading the China's State council to amend its 31 Aug decision and possibly to amend the Basic Law. The gov't reiterated that there is room for negotiation on the composition of the nomination committee and on the election methodologies, during the second round of electoral consultation, and that 2017 isn't the end game as further reforms can be considered for later elections. The gov't proposed to submit a supplementary report to Beijing reflecting the latest public sentiment, and is considering establishing a multi-dimension discussion platform on constitutional developments. We will likely see both pro and against groups launching more polls/signature collections in order to provide more statistics for the potential supplementary report.

Stock Connect may also be hindered – Any delay of the Stock Connect program beyond the planned October start is likely to re-ignite worries as to whether the Chinese Gov't has changed its stance towards supporting HK's financial developments in the long run, taking toll in business sentiment and investment plans. We believe the delay will be only temporary, given that the pilot program is a critical part of China's RMB internationalization goal, which would allow offshore RMB to flow back onshore and higher yields. HK would continue to play an essential role of an international financing facilitator for China in the years to come, for remitting international funding onshore and Chinese ODI offshore, in our view. A delay in the pilot program by a few months may not be a bad thing, given the initial scale expectations and short-term deliverable benefits have been hyped.

Further GDP downgrade

We downgrade our GDP forecast for 2014 and 2015 on lower consumption – China's decision to halt group tours to HK is likely to last till year end (at least in our view) and would further weigh on retail sales, at a time when tourists are already spending less. According to 2013 statistics and a gov't sample, Chinese tour groups is approximately 10% of HK's total tourist arrivals, and each of these group tour visitors on average spends ~HK$1,810 per day and stays around 5.1 days. Our back of the envelope calculation suggests that HK GDP would decline by 0.6ppt if the ban on these tour groups remains till year end. Back in August, we lowered 2014 GDP on lower tourism receipts as we noted a trend of lower tourist arrivals and lesser spending per tourist. We further downgrade our consumption forecasts because both Mainland tourist arrivals and local consumption is affected by sentiment and inconvenience.

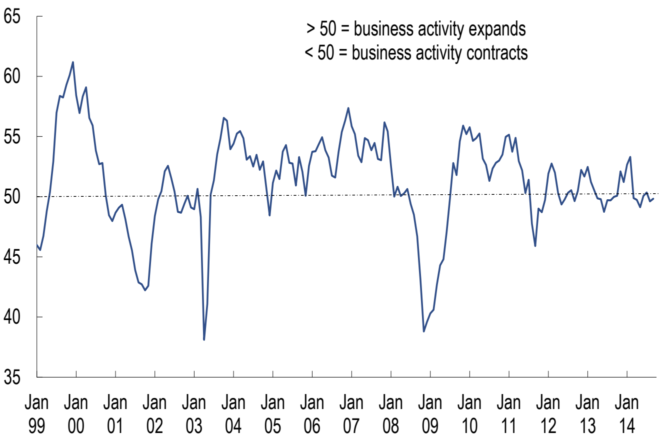
Economic cost will only be reflected over time – HK risk premium is set to rise longer-term as businesses & investors are increasingly building in a higher perception of operational risks in HK, factoring in risks that future protests could escalate in size, frequency or disruptive potential. Further electoral reform debate is scheduled to continue till mid-2015. Rule of law & business operating stability ultimately are key pillars that underscore business confidence in HK.

Retailers immediately affected – Sales volume at affected areas took a big hit given lesser human traffic. According to the financial secretary, credit card spending has markedly declined during the protest period. The retail management association claims that the store sales dropped by 30-50%YoY since the occupying movement started. The gov't is looking into offering loan guarantees to affected businesses which face liquidity problems. Our property analyst has highlighted that shop rents in prime areas such as Mong Kok, Causeway Bay, Wan Chai and Central have dropped by an average 20% (sourcing real estate agent Centaline Commercial). The agency expects buying and selling of retail stores in 4Q14 to slide 10% qoq. See Home Thoughts: Prolonged Occupy Central - A Blow to Shop Rents for details. Moreover, some street level shops may face a double whammy of higher rents if their leases are due for renewal in the near term (as renewed leases are likely to reflect the previous rental increase cycle); and thus some shops closures or relocations can be expected. A prolonged ban on Mainland tour group and overall lower tourist receipts will likely prompt tourist related industries to adjust staffing plans. Jobless rate related to retail rose 0.7ppt to 4.6% over the past 9 months, even before the protest. We reiterate our forecast that the unemployment rate is likely to edge up to 3.5% s.a. by year end, as 17% of HK's employment is tourism related.

Leading indicators support our near term moderation call – Markit PMI continues to show that overall service sector is contracting (at 49.8 in Sep, below the expansion threshold of 50). The PMI sub-indices show that firms are cutting jobs at a faster pace, while input cost continues to rise despite marginal expansion of output. A more worrisome point is that the new work intakes from Mainland China declined for the second month, echoing the softer Chinese economic data seen lately. These points support our more conservative call on HK's outlook.

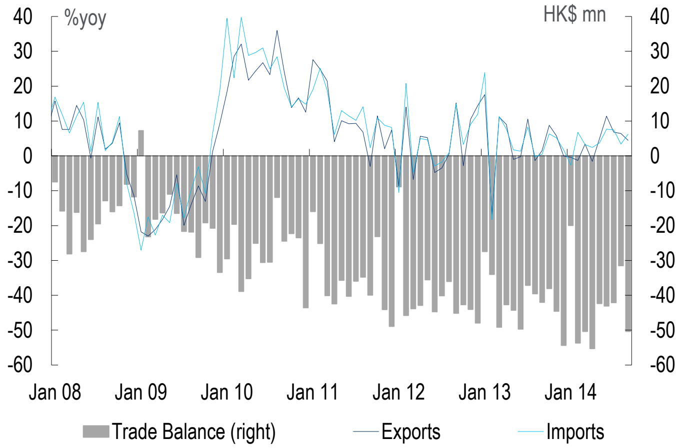
Markets appear to be functioning properly despite road blocks – From the height of the event, when 44 bank branches/offices/ATMs were closed, banks operation normalized with bank branches operating in affected areas shutting only temporarily during protestors/police clashes. Liquidity remains flush with steady overnight HIBOR. HKD forward is a little bid and the HKD spot is slightly away from the strong end of the trading band reflecting the political anxiety.

Figure 39. PMI still in contraction zone in Sep



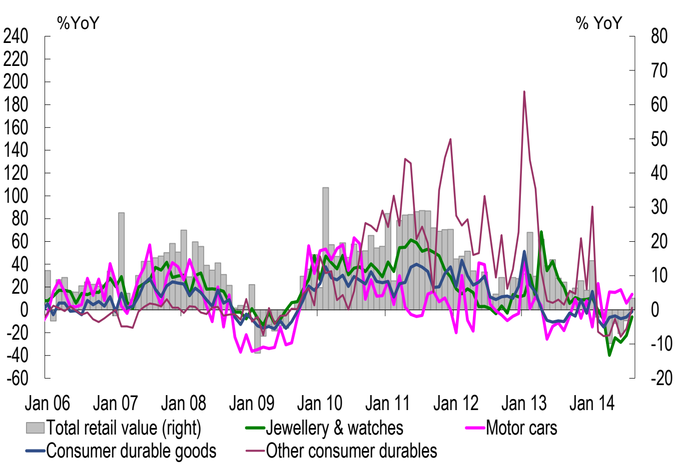
Source: Markit, Haver, Citi Research

Figure 40. Trade recovery likely to improve mildly in 2H



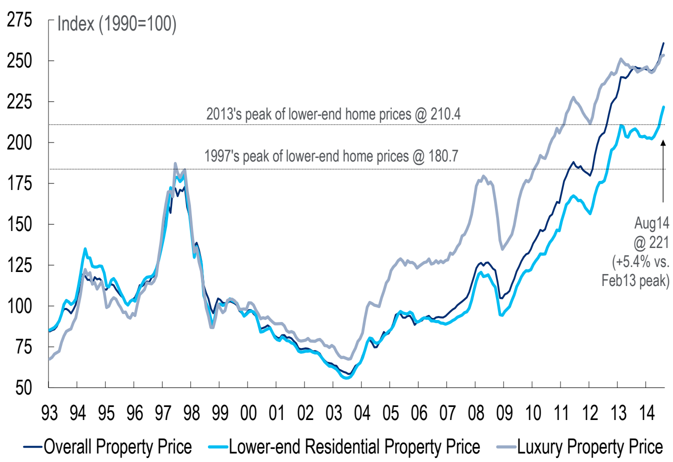
Source: CEIC, Citi Research

Figure 41. Retail sales may slow again in Oct with protests



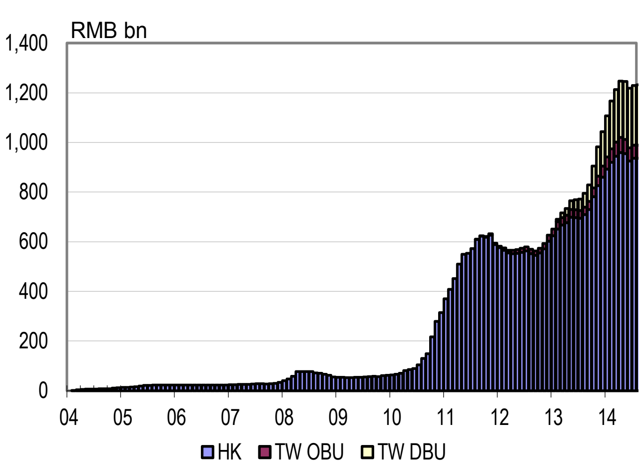
Source: CEIC, Citi Research

Figure 42. Price re-climbing for mass market residential property



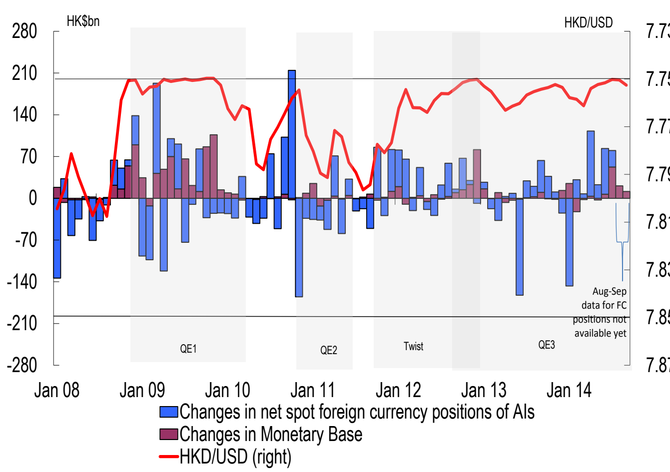
Source: CEIC, Citi Research

Figure 43. Offshore RMB deposits in HK+TW stays abundant



Source: CEIC, Citi Research

Figure 44. Net inflows continued in Jul14; HKD weakened mildly



Source: CEIC, Citi Research

Figure 45. Hong Kong Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	211.6	219.3	214.1	228.7	248.5	262.6	274.0	283.2	296.1
Nominal GDP, local currency bn	1,651	1,707	1,659	1,776	1,934	2,037	2,125	2,195	2,295
GDP per capita, US$	30,495	31,491	30,595	32,424	34,941	36,587	37,942	39,097	40,762
Population, mn	6.9	7.0	7.0	7.1	7.1	7.2	7.2	7.2	7.3
Unemployment, % of labour force	4.0	3.5	5.3	4.3	3.4	3.3	3.4	3.3	3.5
Economic Activity									
Real GDP, % yoy	6.5	2.1	-2.5	6.8	4.8	1.5	2.9	2.3	2.6
Real investment growth % yoy	7.9	-0.3	1.0	11.1	2.3	3.5	3.7	4.1	-0.1
Real consumption growth % yoy	7.9	1.9	0.5	5.8	7.6	4.0	4.0	1.8	1.6
private consumption growth % yoy	8.6	1.9	0.2	6.1	8.4	4.1	4.2	1.8	1.7
Real export growth, % yoy	8.3	2.5	-10.0	16.8	3.9	1.9	6.5	2.6	5.2
Real import growth, % yoy	9.1	2.2	-9.0	17.4	4.6	2.9	6.9	2.6	4.6
Prices, Money & Credit									
CPI, % yoy	3.8	2.1	1.5	2.9	5.7	3.8	4.3	3.7	3.2
CPI, % avg	2.0	4.3	0.6	2.3	5.3	4.1	4.3	4.1	3.6
Nominal wages, % yoy	2.4	4.0	-1.9	2.4	9.9	4.7	4.9	4.5	4.5
Credit extension to private sector, % yoy	15.2	11.0	-2.1	20.9	12.5	7.0	10.6	11.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	3.45	0.95	0.14	0.28	0.38	0.40	0.38	0.38	1.00
Long term yield, % eop	3.10	1.19	1.93	1.76	0.96	0.32	1.40	1.50	2.60
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	16.0	13.8	4.1	5.1	7.5	10.6
% of GDP	13.0	15.0	9.9	7.0	5.6	1.6	1.9	2.6	3.6
Trade balance	-23.1	-25.8	-28.8	-43.0	-54.9	-61.6	-64.6	-64.3	-63.3
Exports	344.5	362.7	318.5	390.2	428.7	442.8	458.9	485.2	518.3
Imports	367.6	388.6	347.3	433.1	483.6	504.3	523.5	549.5	581.6
Service balance	-4.3	-2.7	3.6	10.1	17.0	21.9	28.5	28.6	28.1
Income balance	6.8	12.9	6.4	4.8	6.8	3.8	5.4	5.4	5.4
FDI, net	-19.0	-8.9	-6.4	-10.5	-8.7	-11.2	-10.9	-11.0	-12.0
International reserves	152.6	182.5	255.7	268.6	285.3	317.2	311.1	330.0	355.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	7.3	0.0	1.5	4.1	3.8	3.1	1.0	1.3	0.7
Consolidated gov primary balance	7.4	0.0	1.6	4.2	3.8	3.2	1.0	1.3	0.7
Public debt	1.2	1.0	0.7	0.6	0.6	0.5	0.5	1.0	1.4
of which Domestic	0.4	0.2	0.1	0.0	0.0	0.0	0.0	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

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	2.6	1.8	2.6	2.3	2.1	2.0	2.9	3.1	4.0
CPI, % yoy	3.9	3.6	6.6	3.7	3.9	3.9	3.1	3.2	3.2
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.38	0.38	0.38	0.38	0.50	0.60	0.80	1.00	1.20
Long term yield, % eop	1.45	1.36	1.47	1.50	1.90	2.20	2.40	2.60	2.80
lc vs USD, eop	7.76	7.75	7.77	7.76	7.75	7.75	7.75	7.75	7.75

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

India

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- **Summary view** – India's reform momentum got a boost following the success of the Modi-led BJP party in recent state elections. While macro-stabilization continues, global factors such as lower commodity prices further improve India's prospects. We maintain our view of GDP growth improving to 5.6% in FY15.
- **Things to watch** – The winter session of parliament which begins in end-Nov will be key as legislative changes could be introduced in the area of GST, objectives for monetary policy framework and other reforms. In addition, the progress on divestments also needs to be monitored for fiscal trends.
- **Strategy** – With inflation continuing to surprise on the downside, rates market has begun to rally. S&P upgrade of India ratings outlook has also helped. We maintain our view that the window to ease rates could open in 2015 and expect 10year yield to soften to 8.25-8.5%, and INR to trade in 59-62 range.

Modi momentum continues; BJP largest party in state elections; fuel reforms implemented

Maharashtra & Haryana state elections: Modi shines again – BJP emerged as the single largest party in both Maharashtra and Haryana state elections. While anti-incumbency was a factor, the popularity of PM Modi and his development agenda have kept the momentum going for BJP. The success in assembly elections paves the way for BJP to have larger representation in the Rajya Sabha (Upper house) where it continues to have a minority status.

Fuel reforms: Diesel de-regulation, natural gas pricing, LPG – Immediately after state elections, the Modi government swung into action on fuel reforms. Key decisions were (1) Diesel prices now market-determined, similar to Petrol (deregulated in Jun 2010) (2) Natural Gas prices raised from US$4.2 to US$5.6 per unit (3) Roll out of modified direct benefit transfer for LPG in 54 districts in Nov and all India from 1st Jan. While these measures will reduce fuel subsidy (by 0.5% of GDP) and moderate inflation, they are also aimed to spur investments and competition in the energy sector.

Labor reforms – several administrative steps – As an enabler for his "Make in India" initiative, PM Modi recently made further inroads on labor reforms that aim to ease compliance and improve transparency. These bode well for the manufacturing sector and for the ease of doing business in India. (See Modi Momentum: State Elections, Fuel Reforms, Labor and More)

Real economy: on track to recovery… but still a long way to go

Positive Macro Momentum…But Still a Long Way to Go: After the pick-up in 1Q GDP to 5.7%, trends have been subdued in 2Q. Factory output slowed to 0.4% in July-August compared to 4.4% in 1Q. There were data one-offs in Jul-Aug but overall trends remain a concern.

On the investment front, there are some rays of light that indicate things could pick up. These include (1) rebound in new project announcements by both gov't and private sector in 2Q – possibly a consequence of faster project clearances (2) bilateral investment commitments ~US$100bn (Japan, China and US) following PM

Modi's visits (3) fuel and labor reforms. Efforts to improve India's ease of doing business rank from currently 134 to targeted 50 (among 189 countries) will be gradual as government continues to focus on execution, easing policy clearances, removing bureaucratic bottlenecks.

Bottom line, India is largely a 'self-help' story, aided by the new political will coupled with an active central bank. While there are jitters on the global front, India is holding out relatively better. We thus maintain our FY15 GDP growth of 5.6% (agri: 0.5%; industry: 3.9%; services: 7.5%). One could debate pace and timing, but we re-iterate that India is on its way back to 7% growth by FY17.

Inflation: surprises on downside; RBI's target achievable

Inflation eases, further decline likely – Following a 7.7% print last month, Sep CPI inflation fell to 6.5%, a six-year low. The decline was broad-based with both food and core CPI declining to 7.6% and 5.9% respectively. In the near term, we expect the CPI to ease below 6% by Nov; however as the base effect reverses, CPI could edge towards 7% while staying below RBI's Jan-15 target of 8%.

Lower Crude to Help – As per RBI's monetary policy report, a 10% change in the price of crude could affect CPI inflation by 20bps (crude assumption US$100/bbl); the sensitivity for WPI is likely to be higher (tradables account for 57% in WPI vs. 33% in CPI). The impact on WPI could be 30-90bps depending on the extent of pass-through in administered fuel products.

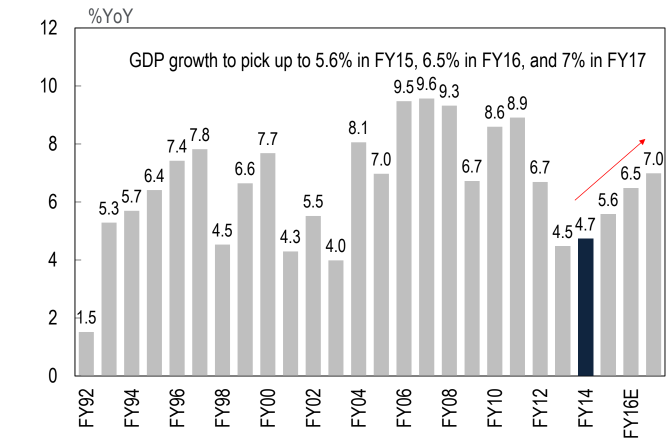
Possibility of easing exists in 2015 – While the RBI maintains its view of an upside risk to its 6% CPI target (albeit lower in Sept policy), we believe that the upside risks have subsided materially given the (1) benign outlook on global commodities, (2) stable trends in INR, (3) drop in core CPI momentum and (4) continued supply-side efforts to contain food inflation. As a result, we reiterate our view that the window to ease rates could open up in 2015.

Twin deficits outlook: India's commodity cushion helps

Current account deficit to remain in check – As discussed in our recent trip notes, India's Commodity Cushion, a decline of crude price by US$1/bbl reduces trade balance by US$0.9bn given India's large energy dependency. We expect the CAD trends to remain stable in FY15 at US$36.7bn (1.8% of GDP) as a recent decline in crude could offset the subdued trends seen in exports.

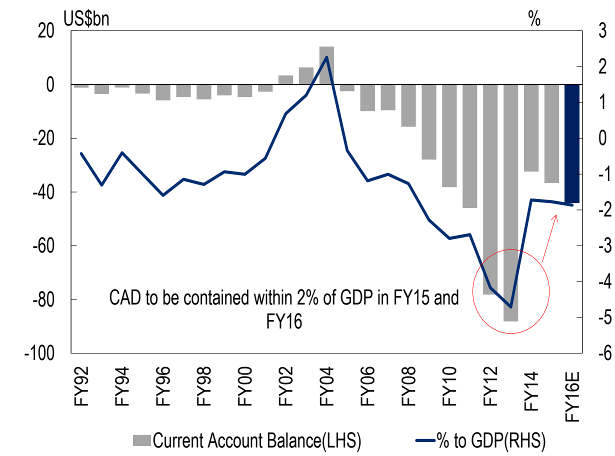
Fiscal deficit to come off on diesel de-regulation – Note that US$1/bbl decline in crude prices tends to reduce under-recoveries by US$700mn. With diesel de-regulation, the fuel subsidy is likely to come down by 0.5% of GDP. The implementation of direct benefit transfer for LPG and Kerosene could also help plug leakages. As a result of improving fiscal trends, the S&P revised India's sovereign rating outlook to 'Stable' from 'Negative' which bodes well for India's government bonds.

Figure 46. Trends in Annual GDP growth (%YoY)



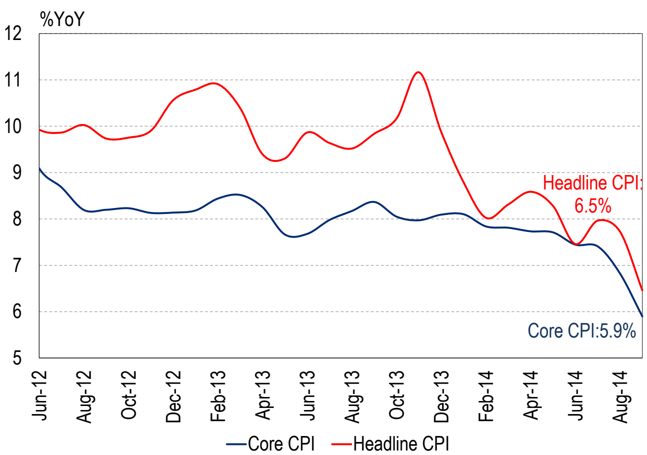
Source: CSO, Citi Research

Figure 47. Trends in Current Account Deficit (US$bn, %GDP)



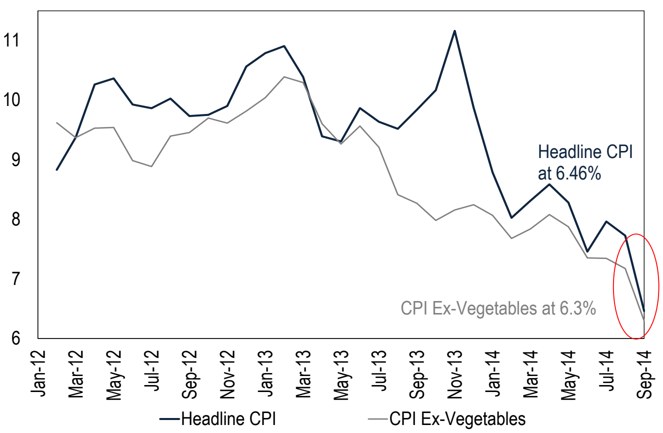
Source: CSO, Citi Research

Figure 48. Trends in Headline CPI and Core CPI (%YoY)



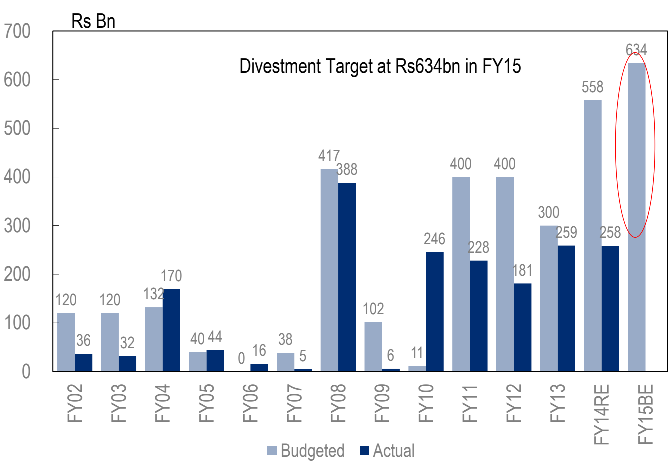
Source: CSO

Figure 49. Trends in Headline CPI and CPI Ex-Vegetables



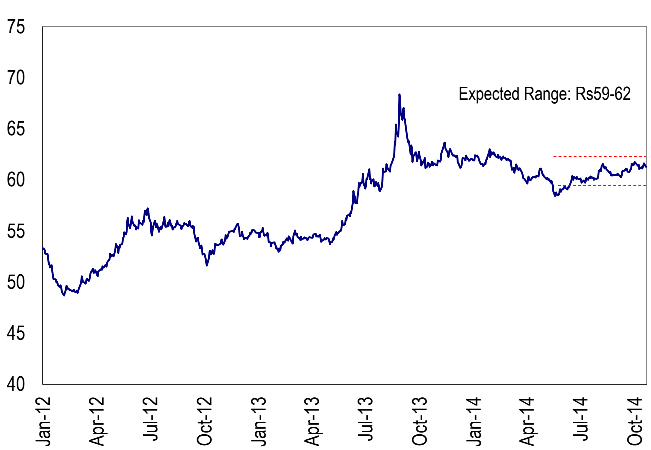
Source: Budget Documents, CGA

Figure 50. Trends in Divestments – Budgeted vs Actual (Rs bn)



Source: Budget Documents

Figure 51. Trends in US$ / INR



Source: Bloomberg

Figure 52. India Economic Indicators

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F
Summary Data									
Nominal GDP, US$ bn	1,240.6	1,223.9	1,366.6	1,707.8	1,873.1	1,872.8	1,880.0	2,069.6	2,359.3
Nominal GDP, local currency bn	49,871	56,301	64,778	77,841	90,097	101,133	113,551	128,312	146,276
GDP per capita, US$	1,090	1,061	1,168	1,440	1,558	1,539	1,522	1,651	1,854
Population, mn	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,217.0	1,235.3	1,253.8	1,272.6
Unemployment, % of labour force	--	--	--	--	--	--	--	--	--
Economic Activity									
Real GDP, % yoy	9.3	6.7	8.6	8.9	6.7	4.5	4.7	5.6	6.5
Real investment growth % yoy	18.1	-5.2	17.3	14.1	3.9	4.9	-2.5	4.8	5.7
Real consumption growth % yoy	9.4	7.7	8.4	8.2	8.9	5.2	4.7	5.6	6.8
private consumption growth % yoy	9.4	7.2	7.4	8.7	9.3	5.0	4.8	5.5	7.0
Real export growth, % yoy	5.9	14.6	-4.7	19.6	15.6	5.0	8.4	11.0	9.3
Real import growth, % yoy	10.2	22.7	-2.1	15.6	21.1	6.6	-2.5	9.5	9.0
Prices, Money & Credit									
CPI, % yoy	7.9	8.0	14.9	8.8	9.0	10.4	8.3	8.0	6.2
CPI, % avg	6.2	9.1	12.4	10.4	8.4	10.2	9.5	7.8	6.2
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	7.75
Short-term market rate, % eop	8.00	5.68	4.49	9.54	10.90	8.50	8.50	8.50	8.50
Long term yield, % eop	7.96	7.01	7.83	7.99	8.56	8.00	8.50	8.50	8.25
lc/US$, eop	39.41	48.62	46.41	44.71	53.02	55.00	61.81	61.55	62.61
lc/US$, avg	41.18	43.42	48.30	45.68	46.63	53.38	58.57	60.85	62.33
Balance of Payments, US$ bn									
Current account	-15.7	-27.9	-38.2	-45.9	-78.2	-88.2	-32.4	-36.7	-44.0
% of GDP	-1.3	-2.3	-2.8	-2.7	-4.2	-4.7	-1.7	-1.8	-1.9
Trade balance	-91.5	-119.5	-118.2	-130.6	-189.8	-195.7	-147.6	-147.5	-162.2
Exports	166.2	189.0	182.4	250.5	309.8	306.6	318.6	342.5	376.8
Imports	257.6	308.5	300.6	381.1	499.5	502.2	466.2	490.0	539.0
Service balance	38.9	53.9	36.0	48.8	64.1	64.9	73.0	72.6	78.4
Income balance	-5.1	-7.1	-8.0	-17.3	-16.0	-21.5	-23.0	-28.0	-28.0
FDI, net	15.9	22.4	18.0	9.4	22.1	19.8	21.6	24.6	27.6
International reserves	299.1	241.6	252.8	273.7	260.1	259.7	276.4	315.3	352.8
Total Amortisations	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9	21.0
Public Finances, % of GDP									
Consolidated government balance	-4.0	-8.3	-9.3	-6.9	-8.1	-7.2	-6.9	-6.7	-6.5
Consolidated gov primary balance	-1.2	3.3	4.5	2.4	3.6	--	--	--	--
Public debt	76.1	76.8	75.5	70.2	69.7	69.8	69.4	68.1	66.2
of which Domestic	71.4	72.2	70.6	65.6	65.9	65.4	65.4	64.6	63.1
Foreign Assets & Liabilities, US$ bn									
External debt	224.4	224.5	260.9	317.9	360.8	409.4	442.2	457.2	472.2
Private	166.3	168.6	193.9	239.8	278.9	327.8	360.6	373.6	386.6
Public	58.1	55.9	67.1	78.1	81.9	81.7	81.7	83.7	85.7
External debt / GDP	18.1	18.3	19.1	18.6	19.3	21.9	23.5	22.1	20.0
External debt / XGS	88.5	77.7	95.2	84.7	80.7	91.1	94.8	86.0	75.9
Short-term debt	45.7	43.3	52.3	65.0	78.2	96.7	89.2	94.2	99.2
Short-term debt/International Reserves (%)	15.3	17.9	20.7	23.7	30.1	37.2	32.3	29.9	28.1

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	4.6	5.7	5.2	5.4	5.8	5.8	6.6	6.0	6.1
CPI, % yoy	8.4	8.1	7.4	6.3	7.8	7.2	6.3	6.5	6.0
Policy interest rate, % eop	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	7.75
Short-term market rate, % eop	8.36	8.25	8.25	8.10	8.10	8.10	8.10	8.10	7.85
Long term yield, % eop	8.78	8.75	8.50	8.50	8.50	8.50	8.50	8.50	8.25
lc vs USD, eop	60.02	60.06	61.94	61.55	61.92	62.30	62.49	62.61	62.73

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** – We still expect a stable GDP growth trajectory of 5.1% for 2014 and 2015. Domestic demand has not shown signs of resurgence and the weakening of credit growth continues. Leading indicators of investment point to a modest instead of strong rebound in 2015.
- **Things to watch** – The magnitude of decline in oil prices has outpaced the drop in coal and palm oil prices since October. Persistence of this trend may lead to modest improvements in the trade balance. We also expect that the political news flow will be more positive, given the recent enlargement of Jokowi's coalition.
- **Strategy** – We have turned slightly positive IDR short term, lowering our 0-3M projection to 11,900/US$ in 0-3M from 12,200 previously. However, we still maintain our 6-12M forecast at 12,200 given Fed hike expectations. We do not expect a policy rate rise although inflation may rise after the fuel price hike.

Domestic demand has not yet shown signs of resurgence – Coincident indicators show mixed signs. Car sales were down 11% YoY in September, while cement consumption growth was relatively stable (6% YoY). Credit growth also continues to slide, with latest reading at 13.8% YoY in August, which is already below the 15-17% guidance mentioned by central bank officials earlier in the year. Retail sales growth remains at double digit levels YoY. However we think this stands on shaky ground as the forthcoming fuel price hike may erode household purchasing power. Until the time this report was written, there had been no official decision from the President regarding the timing and magnitude of the fuel price hike. (We still expect a Rp2,000/l or 30% average price hike in November, with a possibility of a higher magnitude of a price increase for diesel).

We still expect investment growth to rebound in 2015, but momentum may be moderate – Industrial land sales in 3Q14 grew positively, however it is still far lower compared to the levels seen in the 2010 – 2012 boom years. Capex spending data from the BKPM also shows a YoY growth rebound in 3Q but at modest rate of 7% YoY. Manufacturing capacity utilization is higher compared to a year ago for industries such as food & beverages and textiles. Although the export outlook is still relatively dim, we still expect a stable growth of 5.1% for both 2014 and 2015. We do not expect the central bank to raise the policy rate following a fuel price hike.

Recent oil price slide has outpaced other commodities; positive net impact expected – According to the 2015 budget note, the sensitivity of the budget deficit to a US$1/bl change in the assumption of oil prices is Rp4.0-4.3tn (0.04% GDP). Meanwhile a uniform across-the-board drop in commodity prices negatively impacts the trade balance. Indonesia's trade surplus of coal, palm and rubber combined is larger than the trade deficit of oil. Furthermore the impact of a given change in oil prices to the oil trade deficit is offset by an inverse move in gas surplus. (Overall we estimate that a uniform 10% decline in oil, coal, palm, rubber and ore prices may shave the primary commodity trade surplus by about 0.3% of GDP annually). However the oil price decline in October has outpaced that of coal, CPO and rubber. Persistence of this trend may improve the trade balance, possibly by around US$100 - $200m per month, on our estimates.

Cabinet: not free from questions, but still a step forward

Politically affiliated personnel present, but not dominant – President Jokowi has unveiled the cabinet formation for 2014-2019 and there are at least 14 of 34 ministers with clear political party affiliations. Several of them hold senior party positions; and it is unclear whether or not the ministers will relinquish them later on. That said, the number of politician ministers now is fewer compared to 19 in the previous government. Furthermore, several names linked to high profile cases have been written off, following the input from the Corruption Commission in screening of the candidates.

Where does the key difference lie vs. the previous cabinet? – The posts previously manned by politicians are now entrusted to non-partisans, which include Economic Coordinator, Energy, Transportation, Communications and Agriculture. We reiterate the importance of the first three ministries with regard to subsidy reform and infrastructure development. Indeed even from the pool of non-partisans, not all are free from question marks. However, generally we see better background/skill matching, or at least a clearer track record, underlying many of the appointments.

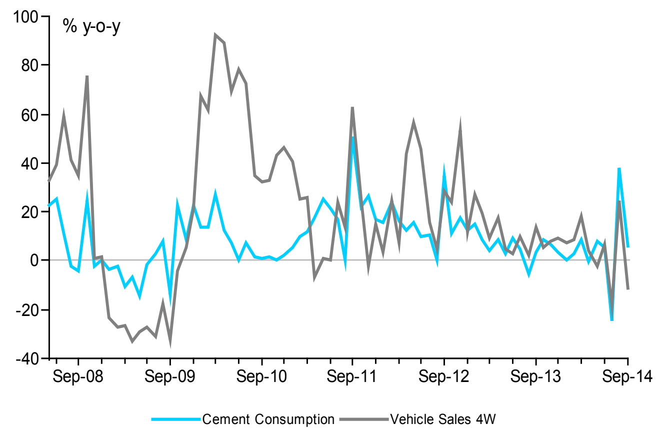
Finance and Economic Coordinator likely can hit the ground running – The finance minister and coordinating economic minister are two pivotal positions. (Please see Indonesia Macro Flash - Pre-Cabinet Announcement: What to Look for?). We don't see a dice rolled here, as the appointees have a professional background and have served in previous cabinets, therefore should be familiar with the bureaucracy and meticulous budgeting processes. We expect the November fuel price hike to go through (+30% for petrol) the fiscal policy to remain on a relatively prudent path in the next five years.

Bottom line: albeit not free from question marks, new cabinet does host pockets of optimism – It remains to be seen, whether or not the Jokowi cabinet can be called a "dream team" formation. The steepness of the learning curve of certain political appointees, especially those tasked to head fat-structured ministries, is unknown. Risks such as conflicts of interest and dual loyalty (i.e. not loyal to the President but to party boss or sponsor) have also not fallen to zero, in our view. Nonetheless we do see a number of pockets in the cabinet that host optimism in terms of accelerating the reform momentum.

What's next in the political calendar? – Indonesia's political temperature has receded lately, though still prone to abrupt swings. However, we are quite encouraged by the addition of PPP into the Jokowi coalition, which boosts parliamentary support from 37% to 44%. Parliament will early next year decide on whether or not to accept the Government Regulation in Lieu of Law 1/2014 which repealed the power of regional parliaments to select governors and district heads. We see better odds now for the Jokowi camp to permanently reinstall direct elections for regional leaders, thereby recouping some lost ground.

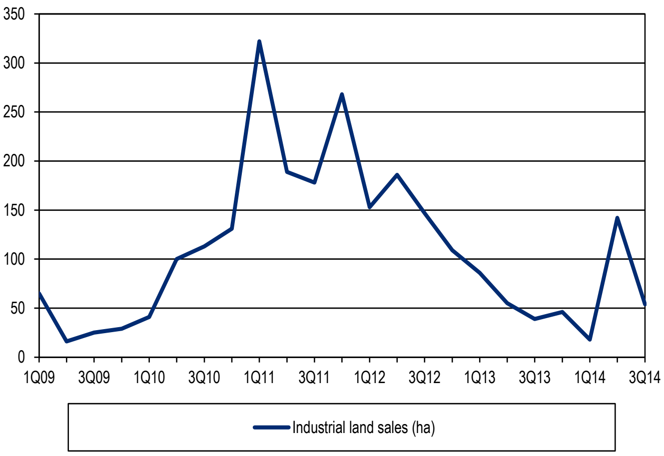
We see breathing room for IDR near term, though 6-12M forecast unchanged – We have lowered our short term (3M) IDR forecast to 11,900/US$, from Rp12,200/US$ previously, following the decline in oil prices relative to non-oil commodities, as well as improvement in the political news flow. Further out, we maintain our 6-12M forecast at 12,200/US$. We still expect a Fed tightening and higher UST yields weighing on IDR.

Figure 53. Coincident indicators do not show strong demand rebound



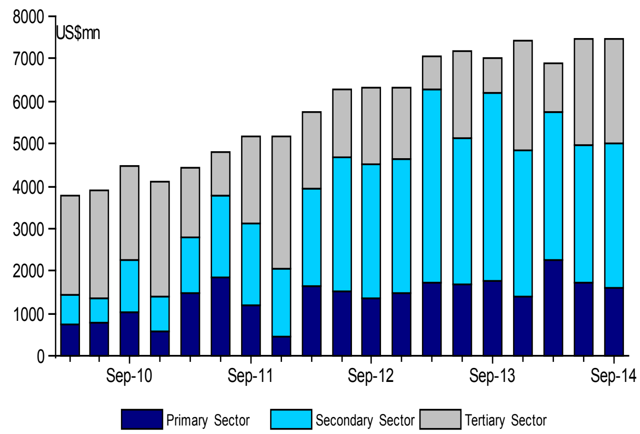
Source: CEIC, Citi Research

Figure 54. Industrial land sales recovering but modestly



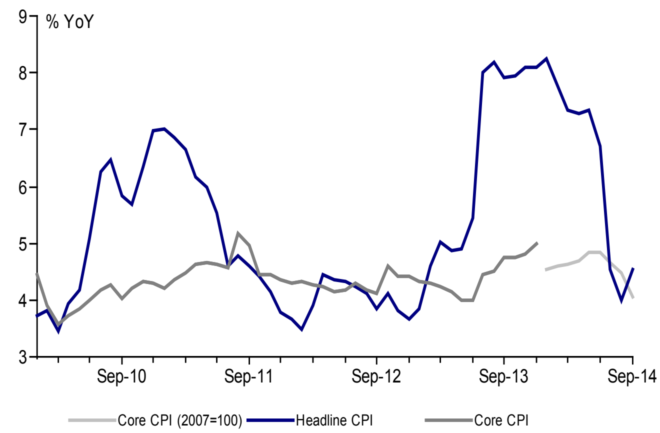
Source: CEIC, Citi Research

Figure 55. FDI capital investment seeing single digit YoY growth



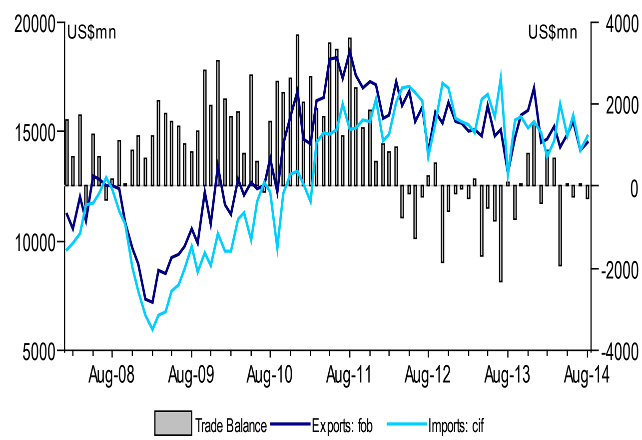
Source: CEIC, Citi Research

Figure 56. Inflation kept at bay, but may rise towards 7% under fuel hike



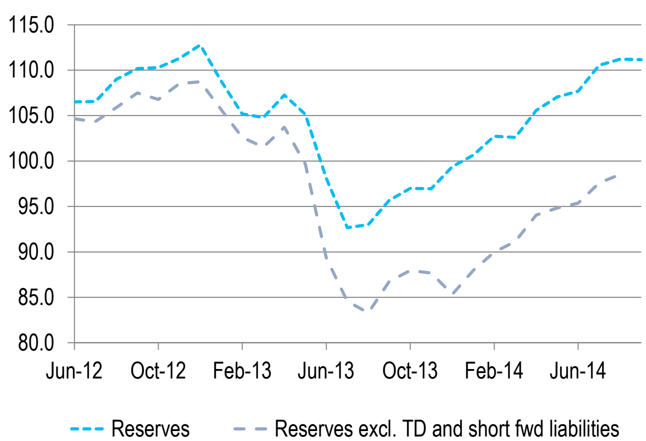
Source: CEIC, Citi Research

Figure 57. Trade deficit in Aug, may improve if oil falls further



Source: CEIC, Citi Research

Figure 58. Foreign reserves steadily rising



Source: Bank Indonesia, Citi Research

Figure 59. Indonesia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	432.2	510.7	538.6	709.5	845.4	876.9	868.5	866.3	934.5
Nominal GDP, local currency bn	3,950,893	4,948,688	5,606,203	6,446,852	7,419,187	8,229,439	9,083,972	10,064,314	11,196,463
GDP per capita, US$	1,896	2,207	2,292	2,975	3,493	3,573	3,491	3,435	3,658
Population, mn	228.0	231.4	235.0	238.5	242.0	245.4	248.8	252.2	255.5
Unemployment, % of labour force	9.1	8.4	7.9	7.1	6.6	5.8	5.8	6.5	6.3
Economic Activity									
Real GDP, % yoy	6.3	6.0	4.6	6.2	6.5	6.3	5.8	5.1	5.1
Real investment growth % yoy	1.9	12.4	2.4	8.8	10.1	16.3	4.9	4.8	5.7
Real consumption growth % yoy	4.9	5.9	6.2	4.1	4.5	4.8	5.2	4.5	4.2
private consumption growth % yoy	5.0	5.3	4.9	4.7	4.7	5.3	5.3	5.1	4.1
Real export growth, % yoy	8.5	9.5	-9.7	15.3	13.6	2.0	5.3	-1.4	4.8
Real import growth, % yoy	9.1	10.0	-15.0	17.3	13.3	6.7	1.2	-4.4	3.5
Prices, Money & Credit									
CPI, % yoy	5.8	11.1	2.8	7.0	3.8	3.7	8.1	7.0	6.3
CPI, % avg	6.3	9.9	4.8	5.1	5.3	4.0	6.4	6.2	6.7
Nominal wages, % yoy	9.7	5.0	6.3	18.2	-2.9	20.0	12.4	17.1	13.0
Credit extension to private sector, % yoy	22.4	30.7	18.0	20.6	25.9	22.3	18.0	15.0	16.0
Policy interest rate, % eop	3.00	8.75	6.00	5.50	4.50	4.00	5.75	5.75	5.75
Short-term market rate, % eop	3.35	9.44	6.39	5.66	4.57	4.24	6.01	5.85	5.85
Long term yield, % eop	10.02	11.92	10.07	7.83	6.05	5.39	8.60	8.25	8.75
lc/US$, eop	9,393	10,900	9,425	9,010	9,068	9,638	12,170	11,946	12,130
lc/US$, avg	9,140	9,673	10,376	9,078	8,763	9,361	10,449	11,842	12,132
Balance of Payments, US$ bn									
Current account	10.5	0.1	10.6	5.1	1.7	-24.4	-29.1	-28.1	-26.7
% of GDP	2.4	0.0	2.0	0.7	0.2	-2.8	-3.3	-3.2	-2.9
Trade balance	32.8	22.9	30.9	30.6	34.8	8.6	6.0	5.8	9.0
Exports	118.0	139.6	119.6	158.1	200.8	188.5	183.3	176.4	183.4
Imports	85.3	116.7	88.7	127.4	166.0	179.9	177.3	170.6	174.4
Service balance	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-12.1	-10.4	-11.1
Income balance	-15.5	-15.2	-15.1	-20.8	-26.7	-26.8	-27.0	-27.5	-28.5
FDI, net	2.3	3.4	2.6	11.1	11.5	13.7	13.7	15.0	17.0
International reserves	56.9	51.6	66.1	96.2	110.1	112.8	99.4	110.0	120.8
Total Amortisations	18.8	16.7	20.4	24.0	25.2	29.4	41.0	42.0	42.0
Public Finances, % of GDP									
Consolidated government balance	-1.3	-0.1	-1.6	-0.7	-1.1	-1.9	-2.2	-2.4	-1.9
Consolidated gov primary balance	0.8	1.7	0.1	0.6	0.1	-0.6	-0.9	-1.2	-0.9
Public debt	34.1	29.3	31.4	26.4	23.6	23.3	23.5	26.0	25.0
of which Domestic	19.7	16.2	19.3	16.7	15.5	16.1	16.2	15.6	16.0
Foreign Assets & Liabilities, US$ bn									
External debt	141.2	155.1	172.9	202.4	225.4	252.4	265.6	290.0	327.7
Private	60.6	68.5	73.6	83.8	106.7	126.2	142.0	160.5	192.2
Public	80.6	86.6	99.3	118.6	118.6	126.1	123.5	129.5	135.5
External debt / GDP	32.7	30.4	32.1	28.5	26.7	28.8	30.6	33.5	35.1
External debt / XGS	108.2	100.1	130.2	115.8	101.8	119.3	129.1	144.0	156.5
Short-term debt	18.7	20.5	24.0	31.6	36.6	43.4	44.6	50.0	55.0
Short-term debt/International Reserves (%)	32.8	39.7	36.4	32.8	33.2	38.4	44.9	45.5	45.5

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	5.2	5.1	5.0	5.0	5.0	4.7	5.2	5.3	5.3
CPI, % yoy	7.3	6.7	4.3	7.0	6.5	6.8	6.8	6.3	5.9
Policy interest rate, % eop	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75
Short-term market rate, % eop	5.86	5.85	5.85	5.85	5.85	5.85	5.85	5.85	5.85
Long term yield, % eop	8.21	8.35	8.10	8.25	8.40	8.50	8.60	8.75	8.75
lc vs USD, eop	11,360	11,855	12,185	11,946	12,057	12,170	12,170	12,130	12,090

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** – A growth slowdown is likely in 3Q. Budget 2015's gradual approach to austerity dilutes fiscal gains from GST, even as it reduces inflation impact and facilitates rebalancing towards investments. We see the next rate hike in Sep 2015, after BNM has sufficient time to gauge the impact of the GST.

- **Things to watch** – [1] Data on external developments to understand growth risks; [2] news flow on targeted subsidy mechanism [3] Loans and deposit indicators to gauge financial imbalances; [4] Domestic consumption indicators.

- **Strategy** – With the reduction of speculative positioning in anticipation of front loaded policy rate hikes and given the stronger USD backdrop, we remain neutral on MYR in the near term, but remain positive vs. regional currencies in the medium term given positive FDI and CA dynamics.

Jul-Aug data points to 3Q GDP slowdown

Output and domestic demand are expected to slow down in 3Q – Aug IP rose 6.5% YoY and increased sequentially (3.4% MoM SA) but could not offset the July slump, leaving seasonally adjusted Jul-Aug IP still 1.5% below average 2Q14 levels. The Jul-Aug IP data points to a 3Q14 GDP slowdown to +5.5% YoY (2Q: +6.4% YoY). The Aug IP uptick was accompanied by a sequential increase in exports (1.7% YoY, 1.9% MoM SA) on broad-based increases across LNG, petroleum products and electric and electronic products exports. Even so, seasonally adjusted Jul-Aug exports are still 4.3% below 2Q14 levels and the Jul-Aug trade surplus is still 39.2% below 2Q, suggesting a net export drag to 3Q GDP. Importantly, the increased momentum in exports in Aug outpaced the uptick in IP, suggesting softer domestic demand. The domestic demand slowdown is corroborated by slowing consumer credit and passenger vehicles sales, and imports of consumer goods also showed weakness in 3Q. That said, the bottoming of the Composite Leading Indicator and imports of intermediate goods, points to a small export led growth pick up in 4Q14.

Budget 2015: growth rebalancing amid gradual austerity

Budget 2015 facilitates a rebalancing from consumption towards investments – The government's 2015 fiscal target is 3.0% of GDP and we believe it is achievable. The government showed resolve in improving Malaysia's fiscal health by reiterating the establishment of GST and various subsidy cuts. However, the enlarged BR1M transfers and expanded list of GST exemptions suggest a gradual move towards austerity. Corporate tax cuts and other measures including the provision of a capital tax allowance for automation related expenditures should encourage investments and improve competitiveness, rebalancing domestic demand from consumption to investments.

A fall in Tapis crude prices would reduce the fiscal deficit – Applying the elasticity of the prices of RON97 and RON95 to crude Tapis prices, we estimate that a drop in Tapis crude price to $85/bbl would completely eliminate the fuel subsidy. Elasticity of revenues to crude prices is lower; however assuming unit elasticity of revenues to crude prices (despite historical data suggesting that a 1% change in Tapis crude price is consistent with a 0.7% change in oil revenues), we estimate that at $90/bbl, there would be a positive net fiscal impact of oil that could cut the deficit to 2.1-2.5% of GDP, all else being equal.

Recent press reports suggest a three-tiered system for fuel subsidy rationalization – Malaysians with a monthly income of less than RM5K will be fully subsidized, between RM5K-10K will be partially subsidized and higher than RM10 will pay market price. While the diesel subsidy rationalization will be implemented using fleet cards in Jan 2015, the government is considering using MyKad for the RON95 subsidy rationalization, starting Jun 2015. Once a company is selected (of the 77 being currently reviewed) to develop the RON95 mechanism, it will be given four months to carry out pilot tests. The programmes implemented by the government will impact 18 million petrol vehicles and 780,000 diesel vehicles. The new system for diesel is expected to save the government RM5-6 billion annually, with around RM1 billion in potential annual savings from the reduction in diesel smuggling on 2013 levels.

Inflation forecasts revised on policy changes

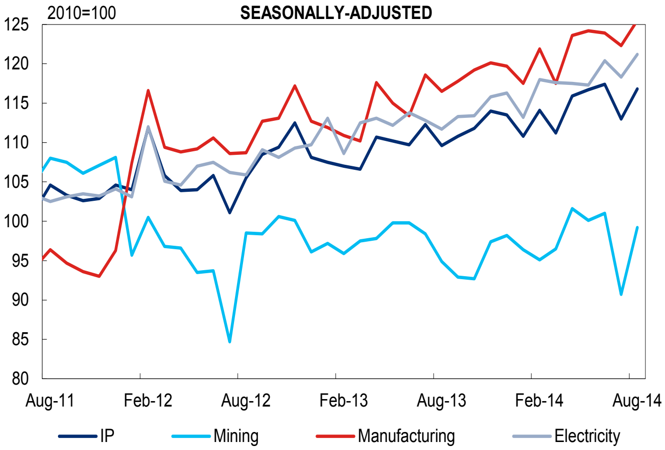
The 20sen/litre hike to RON95 and diesel prices, effective 2nd October 2014, is likely to increase transport costs by 4.2% MoM in Oct 2014 but the impact of the fuel price hike on 2015 inflation will be tempered by the expansion in GST exemptions – The additional GST exempted items have a weight of 12% in the CPI basket. The bulk of the items not covered under the SST, thus would face a full 6% increase in prices due to GST. We estimate that the enlarged exemption list could reduce the direct inflation impact from GST to 1.1-1.5%pt, from the government's previous estimate of 1.8% based on the earlier GST exempt list. In a recent statement Malaysia's GST director, said that the estimated impact of GST would reduce to 1%, close to our own estimate. Risks to these revised *direct* inflation impact estimates may still be skewed to the upside as a positive output gap may increase second round effects, while menu costs may cause businesses to raise prices more than those caused by GST. Factoring in the fuel hike and the enlarged list of GST exemptions, we expect headline inflation to rise to 4.5% in 2Q15, from 2.7% in 1Q15, falling to 4.2% by end 2015. On the whole, we have revised our inflation forecast to 3.2% for 2014 and 4.1% for 2015 (from 3.0% in 2014 and 3.9% in 2015).

BNM likely to delay rate normalization

Zeti's recent comments suggest a dovish policy bias – In a recent Bloomberg interview, BNM Gov Zeti expressed concerns over global growth risks while re-iterating that the BNM is "not concerned" about inflation as the inflation spike is likely to be "temporary" (returning to its long run average by 2016), and would not affect "well-anchored" inflation expectations. She also re-iterated the BNM's focus on maintaining an "accommodative" monetary policy. We interpret Zeti's new emphasis on growth risks as being dovish.

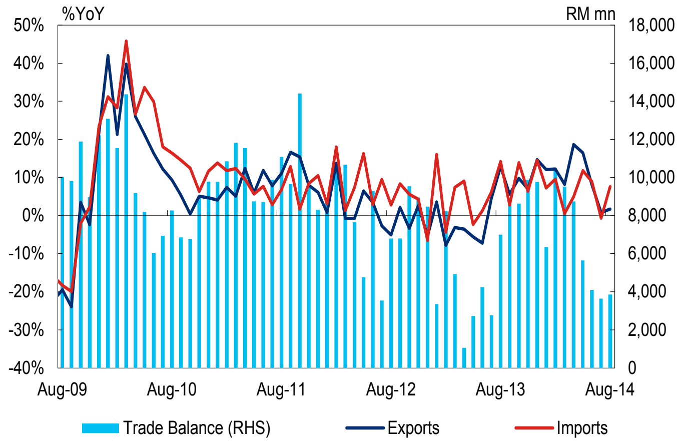
Growth and financial imbalance data supports delayed rate normalization – While the projected 2015 growth of 5-6% remains slightly above potential, weakness exists in domestic consumption, a metric the BNM places greater emphasis on. A slowdown in consumer vehicle sales, consumer credit and imports of consumption goods points to softening domestic demand. While the improvement in financial imbalance data on mortgage loan approvals and deposit growth in Jul did not extend into Aug, broader measures such as loan growth have slowed. The domestic consumption weakness, marginally improving financial imbalances and the BNM's limited concern about inflation make a Nov rate pause likely. We push back our call for the next hike to Sep 2015 when there is sufficient 2Q15 and 3Q15 data to assess the impacts of GST, especially on consumption, and when Fed starts hiking rates. The situation remains fluid however, with two way risks to this call depending on the evolution of external environment and private consumption data.

Figure 60. Industrial Production Index, Seasonally-Adjusted



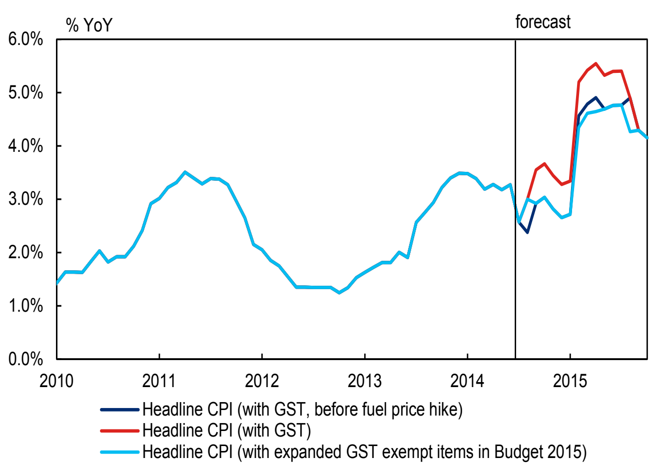
Source: CEIC, Citi Research

Figure 61. Export & Import Growth (%YoY), Trade Balance



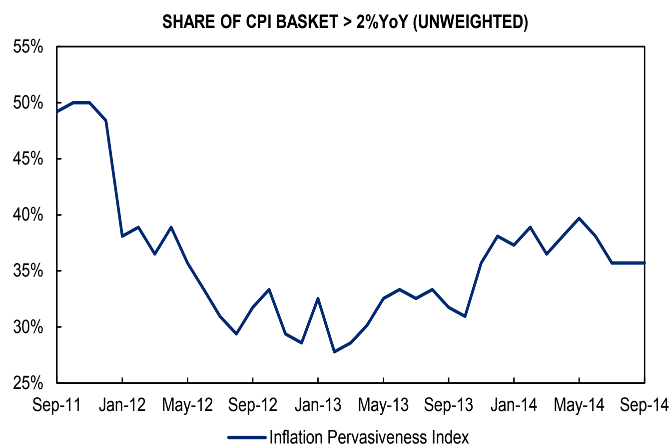
Source: CEIC, Citi Research

Figure 62. Headline CPI is expected to rise on recent fiscal measures



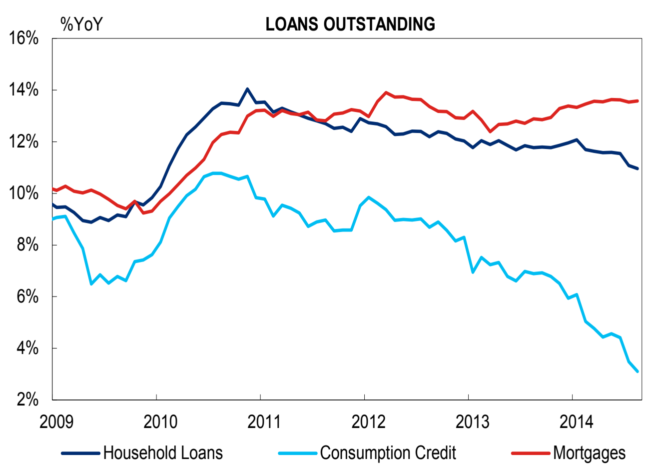
Source: CEIC, Citi Research

Figure 63. BNM's inflation pervasiveness index has remained flat



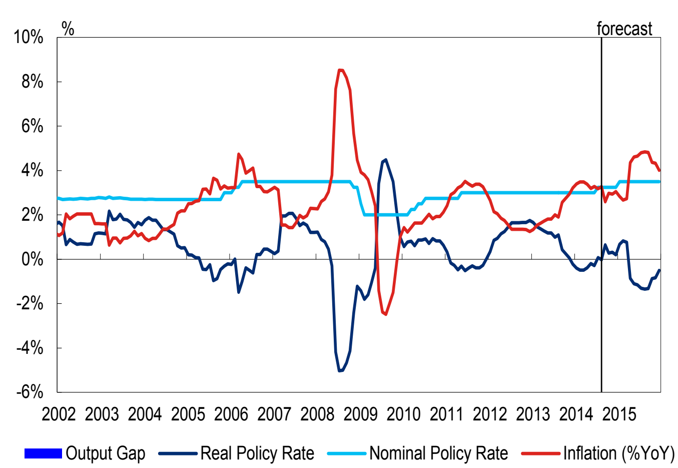
Source: CEIC, Citi Research

Figure 64. Household loan growth slowing, led by consumption credit



Source: CEIC, Citi Research

Figure 65. OPR are expected to be held until Sep 2015



Source: CEIC, Citi Research

Figure 66. Malaysia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	193.7	231.1	202.4	247.7	289.5	305.3	313.3	328.4	342.7
Nominal GDP, local currency bn	665	770	713	797	885	942	987	1,066	1,134
GDP per capita, US$	7,123	8,393	7,255	8,664	9,997	10,405	10,544	10,768	11,056
Population, mn	27.2	27.5	27.9	28.6	29.0	29.3	29.7	30.5	31.0
Unemployment, % of labour force	3.2	3.3	3.7	3.4	3.1	3.0	3.1	2.9	2.9
Economic Activity									
Real GDP, % yoy	6.3	4.8	-1.5	7.4	5.2	5.6	4.7	5.7	5.6
Real investment growth % yoy	9.1	1.8	-9.4	25.3	3.0	20.3	4.9	1.0	5.2
Real consumption growth % yoy	9.7	8.4	1.4	6.2	8.8	7.5	7.0	5.7	5.0
private consumption growth % yoy	10.4	8.7	0.6	6.9	6.9	8.2	7.2	6.3	5.9
Real export growth, % yoy	3.8	1.6	-10.9	11.1	4.5	-1.8	0.6	6.6	6.8
Real import growth, % yoy	5.9	2.3	-12.7	15.6	6.2	2.5	2.0	5.1	6.3
Prices, Money & Credit									
CPI, % yoy	2.3	4.5	1.0	2.1	3.0	1.2	3.2	3.0	4.0
CPI, % avg	2.0	5.4	0.6	1.7	3.2	1.6	2.1	3.2	4.1
Nominal wages, % yoy	4.3	4.5	2.5	8.2	3.8	6.4	7.8	5.0	5.0
Credit extension to private sector, % yoy	9.2	10.2	6.8	10.6	12.5	12.1	11.0	10.0	10.0
Policy interest rate, % eop	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.25	3.50
Short-term market rate, % eop	3.61	3.37	2.17	2.98	3.22	3.21	3.32	3.80	3.80
Long term yield, % eop	3.78	3.00	3.79	3.39	3.23	3.24	3.66	4.00	4.00
lc/US$, eop	3.31	3.45	3.42	3.08	3.17	3.06	3.28	3.27	3.33
lc/US$, avg	3.44	3.33	3.52	3.22	3.06	3.09	3.15	3.26	3.30
Balance of Payments, US$ bn									
Current account	29.7	39.4	31.4	27.1	33.5	17.6	12.7	17.8	17.0
% of GDP	15.4	17.1	15.5	10.9	11.6	5.8	4.0	5.4	5.0
Trade balance	38.1	51.1	39.8	42.5	49.6	40.6	34.4	37.7	41.2
Exports	176.5	198.9	157.0	199.2	228.8	222.3	215.6	234.7	270.4
Imports	138.5	147.7	117.1	156.7	179.2	181.8	181.3	197.0	229.2
Service balance	0.4	0.5	1.2	-0.4	-2.1	-5.3	-5.3	-5.5	-6.8
Income balance	-8.7	-12.2	-9.6	-15.0	-14.0	-17.7	-16.4	-14.4	-17.4
FDI, net	-2.7	-7.8	-6.3	-4.3	-3.1	-7.9	-1.7	-3.0	-1.0
International reserves	101.3	91.5	96.7	106.5	133.6	139.7	134.9	135.0	140.0
Total Amortisations	7.8	6.3	9.8	11.3	9.0	7.4	10.0	11.0	12.0
Public Finances, % of GDP									
Consolidated government balance	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-3.9	-3.5	-3.0
Consolidated gov primary balance	-1.2	-3.0	-4.7	-3.5	-2.8	-2.4	-1.8	-1.3	-0.9
Public debt	40.1	39.8	50.8	51.1	51.5	53.3	54.7	55.0	55.0
of which Domestic	37.1	37.2	48.9	49.0	49.5	51.5	53.0	53.5	53.5
Foreign Assets & Liabilities, US$ bn									
External debt	56.2	66.6	68.3	72.6	81.5	82.8	97.9	97.0	96.0
Private	37.8	41.5	41.9	44.7	53.7	55.6	69.2	67.0	67.0
Public	18.4	25.2	26.3	27.9	27.8	27.1	28.7	30.0	29.0
External debt / GDP	29.0	28.8	33.7	29.3	28.1	27.1	31.2	29.5	28.0
External debt / XGS	27.4	29.0	36.9	31.4	30.7	31.8	38.3	35.4	30.7
Short-term debt	16.3	22.5	22.7	25.4	32.8	30.4	39.4	42.0	42.0
Short-term debt/International Reserves (%)	16.1	24.6	23.5	23.8	24.6	21.8	29.2	31.1	30.0

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	6.2	6.4	5.4	5.0	6.4	5.8	4.6	5.7	5.3
CPI, % yoy	3.5	3.3	2.6	3.0	2.7	4.7	4.8	4.0	4.1
Policy interest rate, % eop	3.00	3.00	3.25	3.25	3.25	3.25	3.50	3.50	3.50
Short-term market rate, % eop	3.33	3.55	3.80	3.80	3.80	3.80	3.80	3.80	3.80
Long term yield, % eop	3.65	3.70	3.90	4.00	4.10	4.10	4.00	4.00	4.00
lc vs USD, eop	3.26	3.21	3.28	3.27	3.28	3.30	3.31	3.33	3.34

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** – Our GDP forecasts of 6.3% in 2014 and 6.5% in 2015 remain unchanged. Indicators of consumption, exports and manufacturing flagged upside gains in July-Aug. Soft oil price readings support disinflation and weak PHP uplift near-term purchasing power bodes well for demand.

- **Things to watch** – [1] Government strategy/initiatives towards averting 2Q15 power crisis, [2] Moody's rating action (or inaction) in 4Q14, [3] 2H reconstruction in typhoon devastated areas, that may resume strong fiscal spending, [4] legal/corruption allegations faced by top presidential contender VP Jejomar Binay.

- **Strategy** – Increase duration exposure, as disinflation ends policy rate tightening coupled with falling oil prices and limited long bond supply. BSP to use FX reserves, tighten import compliance and moral suasion tactics to manage PHP weakness. Expect PHP to stay adrift in the range of 45 in 4Q14.

Exports, consumption and mfg. lead 3Q macro gains

July-Aug exports and manufacturing indicators suggest a 3Q macro backdrop that's likely to be as exciting as 2Q14 GDP – 3Q exports are likely to post a double-digit gain (July-Aug: 11.4%YoY) driven by improving tech, upbeat non-tech manufactures and rising contribution of farm/unprocessed goods. 3Q non-tech manufactures probably expanded by 18%YoY to sustain their outstanding July-Aug performance (18.1%YoY). Non-tech manufactures continue to surprise positively from ignition wiring sets, machinery & equipment, woodcrafts & furniture to familiar garment exports. Base effect probably softened Aug non-tech manufactured exports although tech exports started to show improvement with semi-conductor shipments having a solid run since June. New export capacities since 2012-13, particularly on non-tech side, have diversified 'upside' from manufactures exports.

Manufacturing is the key beneficiary of upbeat exports – While strong base effect would dampen YoY comparison, mfg index is still capable of favorable gains of 6%YoY in 3Q14 (July-Aug: 7.7%YoY). Manufacturing output would likely witness a strong boost from exports of manufactures. Our composite index for non-food mfg in July-Aug grew by 13.5%YoY. Other than external demand benefiting furniture & fixtures and electrical machinery, upbeat private construction also supported basic metals, fabricated metal products, and machinery other than electrical in 3Q14. Lean inventory bias would deny excessive mfg output gains. Capacity utilization rate >83%SA for 19 straight months enhance investment prospects.

We continue to miss strong fiscal spending in July-Aug although primary expenditures may surprise in Sep – Primary expenditures including infra spending fell 7.5%YoY in Jul-Aug. With 'lapsing rule', we suspect implementing agencies will report a surge in end-3Q disbursements similar to last June. 3Q typhoon/monsoon season might restrain strong infra contribution during the quarter.

Upside from consumption spending due to resilient remittances and BPO activities, stable inflation expectations and declining jobless rate during the quarter could firm up domestic demand – Resumption of weak PHP late Sep coupled with disinflation as food inflation weakens enhanced real peso value of remittances and HH consumption outlook going into 4Q14. Construction job creation of 178K together with wholesale/retail trade & repair services of 183.7K support upbeat 3Q consumption. Car sales up 37.6%YoY in 3Q14 support strong durable goods demand that confirm upbeat consumption during the period.

Potential for soft oil prices to lower the trade deficit

In our regression results, a 10% decline (hike) in oil prices cuts (raises) the trade deficit ratio to GDP by 1% translating into billions of dollars 'saved' presumably due to lower import costs – Including PHP, our results show 1% depreciation (appreciation) can improve (worsen) the trade deficit ratio by 0.6%. Combination of weak PHP and softer oil prices can lower the trade deficit ratio by an average of 1.6%. Since 2007, price catalysts: PHP, inflation expectations, wage rate and labor productivity, other than oil prices have had a larger impact on core inflation. PHP effect on core of roughly 0.05% exceeded the oil price effect of 0.006% on core. Daily wage rate impact of 0.05%-0.07% on core dominated the results but offset by a labor productivity effect of -0.05% to -0.06% on core. With electricity's oil-based dependence down to 5.8% in 2012 from 20.3% in 2000 due to more indigenous energy sources, oil price effects on core may not be as huge.

Back in the sweet spot as disinflation emerges in Sep

Sep CPI receded to 4.4%YoY from 4.9%YoY in July-Aug to highlight materially easing food inflation particularly CPI rice – Seasonally adjusted CPI implied an annualized rate of 1.8% (vs recent high of 6.9% in July). Weak PHP in Sep coupled with recent typhoons failed to spoil disinflation. CPI's waning pace support a pause in BSP's rate tightening cycle for the rest of 2014 with strong likelihood of inflation <4% by end-Dec that's likely to sustain a 12-month trajectory below the 4% range.

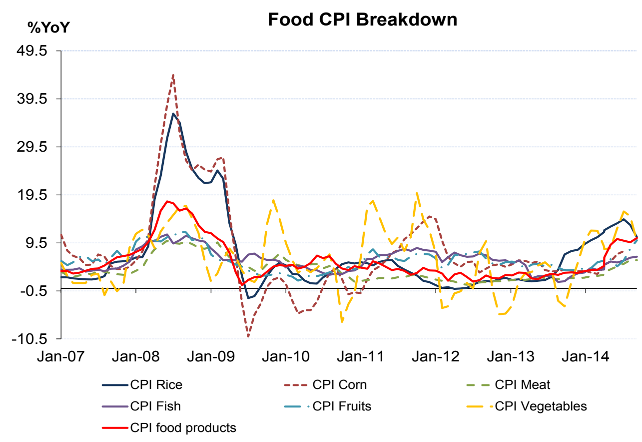
What if it's 'dim lights' in 2Q15 due to a power crisis?

Absent government intervention in a 2Q15 power shortfall (government¡¦s estimate of 700MW-900MW) concentrated in Luzon grid, our tests using 2006 Input-Output (I/O) table suggests downside output risk: 1) -0.3% to -0.4% in a 300MW shortage scenario; 2) -0.6% to -0.8% assuming 600MW shortfall; and 3) -1% to -1.4% in a 1,000MW deficiency – Opportunity loss estimates on aggregate output clouds 1H15 outlook. Power shortage impact is distributed 'unevenly', with those 'high' on electricity inputs and on intermediate 'consumption' most vulnerable. Manufacturers of intermediate goods, coal mining, crude oil and natural gas aside from those directly generating/distributing electricity and steam make the top-ten list of highly vulnerable industries. Unable to buy necessary inputs and short of electricity to process such inputs, most industries might operate below capacity. Meralco's Interruptible Load Program (ILP) — securing commitments from large captive customers with their own stand-by power sources e.g. heavy duty gensets, to use these during peak demand hours in 2Q15 and ease power demand in the Luzon grid, has obtained 133MW. Meralco's residential customers will shoulder these costs. One-off tariff hikes, modest weight of Metro Manila's CPI electricity and a soft oil price outlook eases upside inflation risk. Investment-driven growth could persist if construction stays unaffected and if Pres. Aquino is in a 'legacy' mode, implying strong 2015 fiscal spending.

Shift to neutral bias amid disinflation and soft oil prices

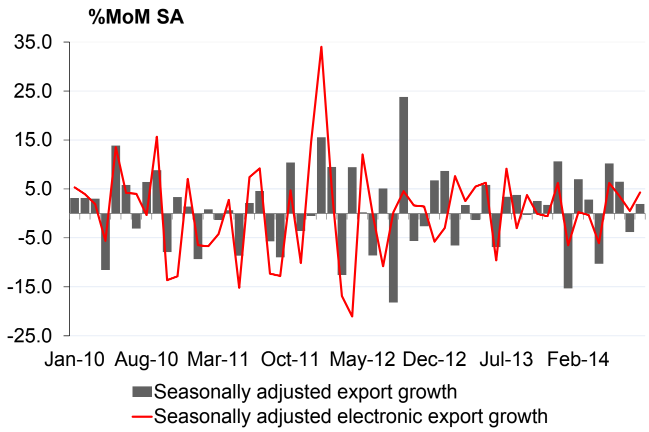
'Nominal' impacts of softer oil prices on the current account and inflation would sustain the recent shift in policy bias to neutral – Statistically, low oil prices support disinflation that can help temper BSP's hawkish signals consistent with an anticipated power crisis in 2Q15. Bond market sentiment would be given a lift by slumping oil prices and downside risk to growth from an expected 2Q power shortfall. Under our 'dim lights' macro scenario that potentially softens non-oil import demand, our 2Q15 average PHP forecast at 45 may not be as firm.

Figure 67. Hefty correction of CPI rice & veggie in led easing food CPI



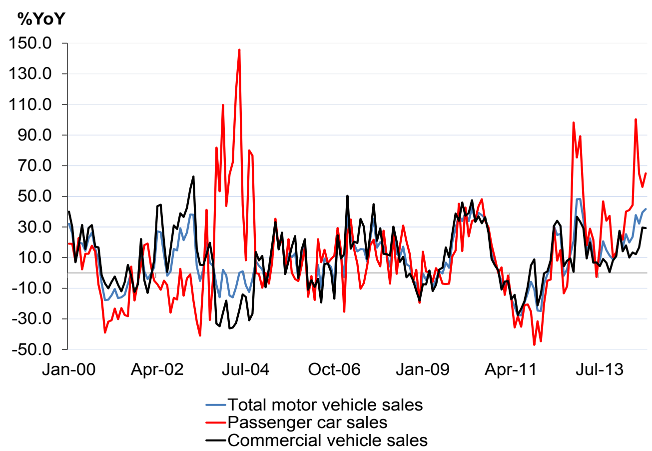
Source: CEIC, Citi Research

Figure 68. Overall export gains in Aug tracked upbeat tech exports



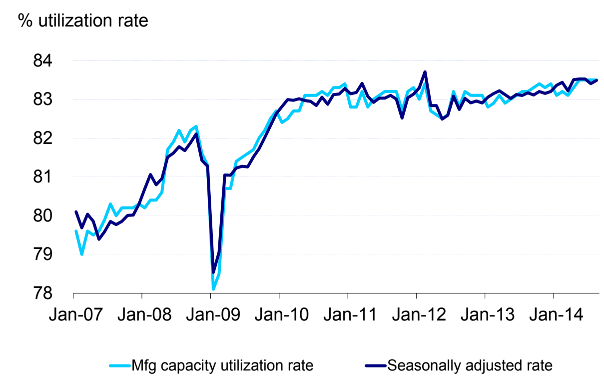
Source: CEIC, Citi Research

Figure 69. Car sales in 3Q14 soared by 37.6%YoY



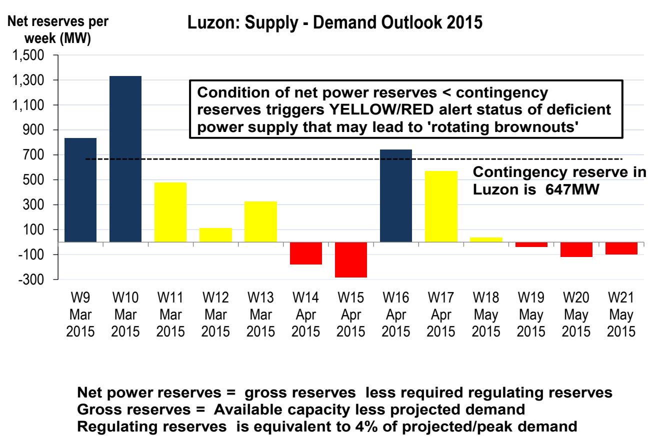
Source: CEIC, Citi Research

Figure 70. Capacity utilization rate SA >83% for the past 19 months



Source: CEIC, Citi Research

Figure 71. Low power reserves in Apr-May anticipated



Source: Energy Department (Philippines Power Sector Update, 8/18/2014), Citi Research

Figure 72. Which sectors are most/least vulnerable to a power crisis?

Most Vulnerable			
Generation, collection and distribution of electricity	-10.76%	-21.51%	-35.86%
Steam and hot water supply	-10.76%	-21.51%	-35.85%
Coal mining	-7.78%	-15.56%	-25.94%
Crude oil and natural gas	-4.90%	-9.81%	-16.35%
Manufacture of accumulators, primary cells and primary batteries	-4.33%	-8.66%	-14.43%
Manufacture of insulated wires and cables	-2.69%	-5.39%	-8.98%
Manufacture of electricity distribution and control apparatus	-1.36%	-2.72%	-4.53%
Collection, purification and distribution of water	-1.21%	-2.41%	-4.02%
Research and Development	-1.14%	-2.28%	-3.80%
Manufacture of other chemical products, n.e.c.	-0.82%	-1.64%	-2.73%
Least Vulnerable			
Ownership of Dwellings	0.0000%	0.0000%	0.0000%
Manufacture of other transport equipment, n.e.c.	0.0000%	0.0000%	0.0000%
Manufacture of jewelry and related articles	-0.0004%	-0.0007%	-0.0012%
Manufacture of wood carvings	-0.0005%	-0.0009%	-0.0016%
Other service activities, nec	-0.0005%	-0.0010%	-0.0016%
Other animal including dairy production	-0.0014%	-0.0027%	-0.0045%
Manufacture of cigars and chewing and smoking tobacco, snuff	-0.0015%	-0.0029%	-0.0048%
Custom tailoring and dressmaking and articles of fur	-0.0022%	-0.0045%	-0.0074%
Manufacture of watches and clocks	-0.0027%	-0.0055%	-0.0091%
Construction	-0.0030%	-0.0059%	-0.0098%
TOTAL	**-0.42%**	**-0.83%**	**-1.38%**

Source: CEIC, Citi Research

Figure 73. Philippines Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	150.2	173.4	168.6	200.0	224.1	250.6	271.9	279.7	312.1
Nominal GDP, local currency bn	6,893	7,721	8,026	9,003	9,708	10,567	11,548	12,644	13,891
GDP per capita, US$	1,693	1,917	1,829	2,127	2,364	2,595	2,764	2,792	3,059
Population, mn	88.7	90.5	92.2	94.0	94.8	96.6	98.4	100.2	102.0
Unemployment, % of labour force	7.3	7.4	7.5	7.3	7.0	7.0	7.1	6.8	6.5
Economic Activity									
Real GDP, % yoy	6.6	4.2	1.1	7.6	3.7	6.8	7.2	6.3	6.5
Real investment growth % yoy	-0.5	23.4	-8.7	31.6	2.8	-5.3	29.9	2.8	11.7
Real consumption growth % yoy	4.9	3.3	3.3	3.4	5.1	7.7	5.9	5.9	6.2
private consumption growth % yoy	4.6	3.7	2.3	3.4	5.6	6.6	5.7	6.0	6.2
Real export growth, % yoy	6.7	-2.7	-7.8	21.0	-2.5	8.5	-1.1	7.5	4.8
Real import growth, % yoy	1.7	1.6	-8.1	22.5	-0.6	4.9	5.4	5.0	6.7
Prices, Money & Credit									
CPI, % yoy	3.9	8.0	4.3	3.6	4.2	3.0	4.1	4.1	3.3
CPI, % avg	2.8	9.3	3.2	4.1	4.7	3.2	2.9	4.3	3.5
Nominal wages, % yoy	3.4	5.5	0.0	5.8	5.4	7.0	2.2	0.0	2.5
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	4.00
Short-term market rate, % eop	6.03	5.20	4.11	0.75	1.68	-1.38	-0.15	0.85	1.00
Long term yield, % eop	5.70	6.55	6.25	4.78	4.21	3.70	2.91	3.75	4.25
lc/US$, eop	41.23	47.47	46.50	43.65	43.84	41.06	44.39	44.95	44.83
lc/US$, avg	46.05	44.48	47.56	45.06	43.29	42.22	42.46	44.60	44.93
Balance of Payments, US$ bn									
Current account	8.1	0.1	8.4	7.2	5.6	7.0	9.4	10.0	10.7
% of GDP	5.4	0.1	5.0	3.6	2.5	2.8	3.5	3.6	3.4
Trade balance	-14.0	-18.6	-13.9	-16.9	-20.4	-18.9	-18.5	-19.7	-20.7
Exports	32.8	34.7	29.1	36.8	38.3	46.4	44.7	47.4	50.9
Imports	46.8	53.3	43.0	53.6	58.7	65.3	63.3	67.1	71.6
Service balance	6.0	2.0	4.9	5.8	6.6	6.2	6.8	7.2	7.5
Income balance	16.1	16.8	17.4	18.3	19.5	19.7	21.1	22.5	23.9
FDI, net	2.5	0.6	-0.2	1.6	0.3	1.0	-0.2	2.0	3.0
International reserves (ex-gold)	33.8	37.6	44.2	62.4	75.3	83.8	83.2	83.5	90.0
Total Amortisations	4.7	7.0	5.7	8.3	6.3	2.7	9.3	9.7	10.0
Public Finances, % of GDP									
Consolidated government balance	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-1.4	-1.6	-0.9
Consolidated gov primary balance	3.7	2.6	-0.2	-0.2	0.8	0.7	1.4	1.1	1.1
Public debt	53.9	54.7	54.8	52.4	51.0	51.5	49.2	46.0	45.0
of which Domestic	31.9	31.3	30.8	30.2	29.6	32.8	32.3	30.0	29.5
Foreign Assets & Liabilities, US$ bn									
External debt	55.5	54.3	54.9	60.0	60.4	60.3	58.5	61.0	63.5
Private	17.5	13.7	11.6	13.9	14.1	15.2	18.0	18.0	18.5
Public	38.0	40.6	43.2	46.2	46.4	45.2	40.5	43.0	45.0
External debt / GDP	36.9	31.3	32.5	30.0	27.0	24.1	21.5	21.8	20.3
External debt / XGS	119.8	113.8	126.9	110.1	105.7	90.3	87.9	86.8	84.7
Short-term debt	7.1	7.0	4.0	6.3	7.0	8.5	11.2	11.1	12.0
Short-term debt/International Reserves (%)	21.0	18.6	9.0	10.1	9.3	10.1	13.5	13.3	13.3

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	5.6	6.4	6.5	6.6	6.2	6.5	6.7	6.6	6.7
CPI, % yoy	3.9	4.4	4.8	4.1	3.7	3.6	3.4	3.3	3.5
Policy interest rate, % eop	3.50	3.50	4.00	4.00	4.00	4.00	4.00	4.00	4.50
Short-term market rate, % eop	0.94	0.79	0.98	0.85	0.70	0.80	0.85	1.00	2.00
Long term yield, % eop	3.38	3.50	4.00	3.75	3.65	3.85	4.00	4.25	4.50
lc vs USD, eop	44.76	43.63	44.97	44.95	44.97	44.99	44.93	44.83	44.73

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).

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- **Summary view** – Following the subdued uptick in 3Q GDP from depressed levels in 2Q, we trimmed our GDP growth (2014: 2.9%, 2015: 3.0%) and inflation forecasts (2014: 1.1%, 2015: 0.7%). Despite deepening disinflationary undercurrents, we do not expect the MAS to shift policy stance in Apr.

- **Things to watch** – [1] Near–term export and production momentum, [2] house prices and sale volumes, [3] household debt, [4] labor market and core inflation trends and [5] signs of financial stress in the SME sector.

- **Strategy** – While we do not see MAS shifting its policy stance at the next meeting, further downside surprises in the data amid a stronger USD outlook may still pressure the NEER lower vs the band, though we would be wary of MAS intervention closer to the midpoint.

Trimming 2014 and 2015 growth and inflation forecasts

3Q GDP growth likely revised upwards, but still at low levels – Advanced estimates for 3Q GDP (3Q: 2.4%YoY, 1.2% QoQ SAAR) suggest a shallow uptick in GDP after a sequential contraction in 2Q (2.4 % YoY, -0.1 QoQ SAAR). The sequential increase was led by Manufacturing (1.2% QoQ SAAR) and Services (1.3% QoQ SAAR) but tempered by a fall in Construction (-2.7% QoQ SAAR). Manufacturing output was held back by a fall in biomedical output in 3Q, as anticipated by the EDB's Economic Survey of Business Expectations. With 3Q IP data suggesting a rise in manufacturing output of 1.8% YoY, higher than the advance estimate of +1.4% YoY, we expect 3Q GDP growth to be revised marginally upwards from 2.4% YoY to 2.5% YoY.

Apart from manufacturing, construction is bearing the brunt of the slowdown – On the demand side, construction demand is weakening from the private sector, in particular the private residential segment as the housing market softens. On the supply side, tighter foreign worker restrictions are slowing construction employment at a time when construction labour productivity has plateaued, with project delays and higher foreign worker levies squeezing the cash flow of subcontractors. Already, worker shortages have forced deferments of public sector projects, which is likely to slow construction GDP in the coming quarters, based on the past experience in 2007/08, when public sector projects were deferred.

The housing market remains in a slow but persistent slide – Monthly data till Sep suggest that non-landed house prices have fallen just 5.8%, around 18 months after the peak in house prices, vs a price decline of >20% at similar stages in past cycles. We see that the earliest window for a policy relaxation could be in 2H15. During the past cycles, relaxation of property measures occurred only after prices fell between 11% and 25%. History suggests that it would take at least another 5-10% in price declines before property cooling measures are relaxed, which may not happen till 2H15 at the earliest.

We trimmed our 2014 and 2015 GDP growth forecasts on downward revisions to historical data – The release of the 3Q GDP advanced estimates was accompanied by a revision in 1H14 GDP growth from 3.6% YoY to 3.5% YoY. Consequently, we nudged our 2014 GDP growth forecast to 2.9% from 3.1% and the 2015 GDP growth forecast from 3.2% to 3.0%. These forecasts anticipate a fairly strong 6.4% QoQ SAAR expansion in 4Q.

We are trimming our inflation forecast on the introduction of "one-off" medical subsidies in Sep – Sep headline inflation (0.6% YoY) and core inflation (1.9% YoY) came below consensus expectations on the introduction of medical subsidies, that caused a one-off step down in healthcare services cost levels. We have consequently cut our headline inflation forecast for 2014 to 1.1% YoY from 1.2% and for 2015 to 0.7% from 0.9%. We expect core inflation at 2% YoY in 2014 and 1.7% in 2015.

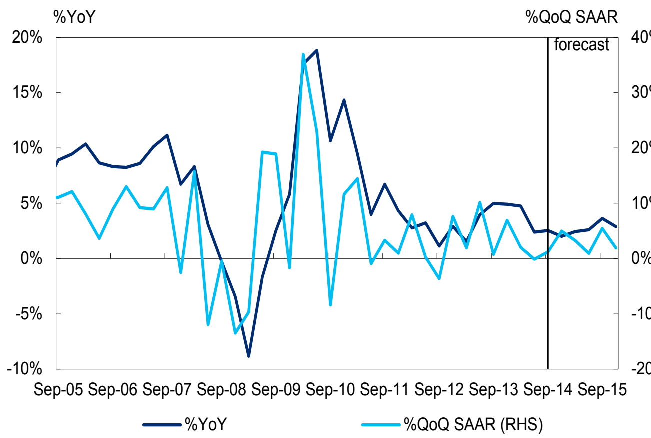
Intensifying pipeline disinflationary forces not just on headline but also core – [1] Private road transport is expected to drag down inflation. COE supply is expected to increase 5.3% from November 2014 to January 2015 on increasing vehicle de-registrations, causing COE premiums to fall and pull down private road transport prices. In addition, base effects will drag down private transport inflation. [2] Accommodation rentals are also likely to drag inflation. The slowdown in housing accommodation prices has accelerated recently, falling 0.6% in Sep after a 0.2% fall in Aug (Jul: 0.0%). Going forward, the rising pipeline in private housing completions from 2014 (28% of existing stock) onwards will likely push up vacancy rates, especially in the context of slower population growth. The turning demand-supply balance is likely to place downward pressures even on HDB rentals. [3]. Weakness in private consumption in the context of negative wealth effects from lower house prices and deleveraging could hurt pricing power and limit the upside to core CPI despite higher costs. [4] Weak consumption and tourist arrivals have hurt retail sales, limiting landlords' ability to raise retail rents, which have essentially been flat since 2010 despite falling vacancy rates. The weak retail environment has already been reflected in the contraction in tenant traffic and sales of the major retail REITS.

What could be signposts for a policy shift?

The MAS is likely to stand pat for now but we should look out for signposts for a policy shift – Notwithstanding the likely slight upward revision in the 3Q GDP data and the slight recovery in electronics output, manufacturing output remains at fairly depressed levels. Indeed, with the external demand recovery yet to materialize and private consumption at its weakest in five years, we suspect core inflation to possibly stay near or slightly under 2% in the coming months, contrary to MAS expectations for core inflation to rise into early 2015. Should growth remain weak and core fall significantly below 2%, we would watch for cracks in the labour market as a signpost for any shift in policy bias, which may be signalled by the MAS allowing the SGD NEER to fall lower vs the band. While the labour market remains tight for now, we would keep an eye on falling fixed investment spending as a leading indicator for a potential easing of labour demand.

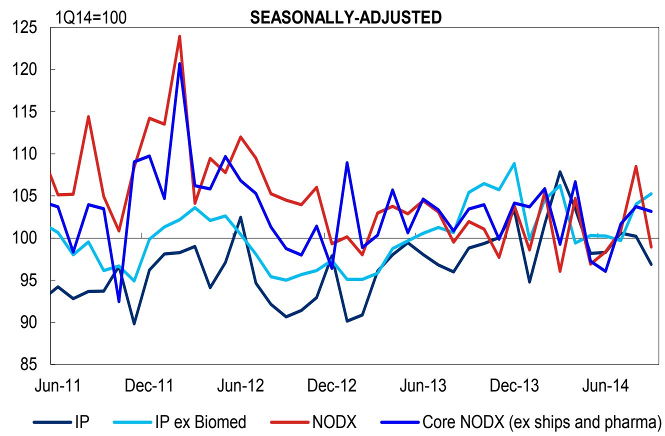
We recently revised our band parameter estimates to a slope of +2% p.a. with an unchanged width of +/-2% – If the band slope is 2% instead of our previous "slightly steeper" estimate of 2.5%, it may suggest somewhat less scope (or perhaps a higher hurdle) for slope reduction than previously thought, with any reduction in the pace of structural REER appreciation borne initially via lower inflation vs trading partners, and then only subsequently via a gentler pace NEER appreciation. However, with the SGD NEER now firmly in the upper half of the band under our new estimate, this may provide more scope for the NEER to trade weaker vs the band if data continues to surprise on the downside, although we would be wary of MAS intervention to defend to SGD closer to the mid-point.

Figure 74. We trimmed our GDP forecasts to 2.9% (2014), 3.0% (2015)



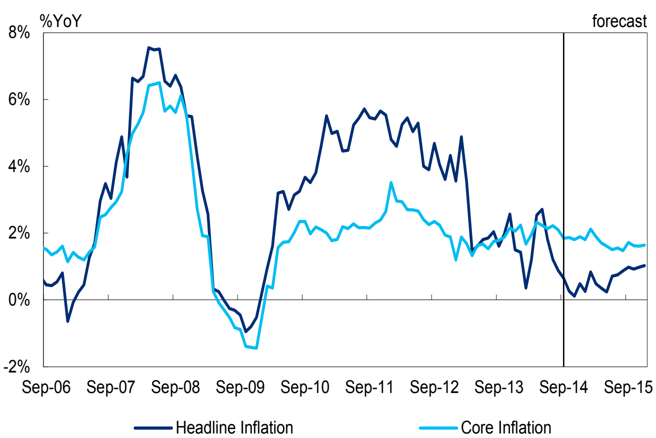
Source: CEIC, Citi Research

Figure 75. 3Q NODX and IP data provided evidence of de-stocking



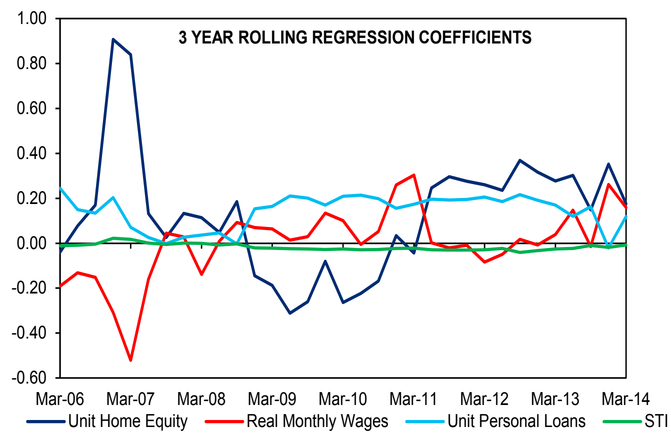
Source: CEIC, Citi Research

Figure 76. Trimming our inflation forecasts to 1.1% (2014), 0.7%(2015)



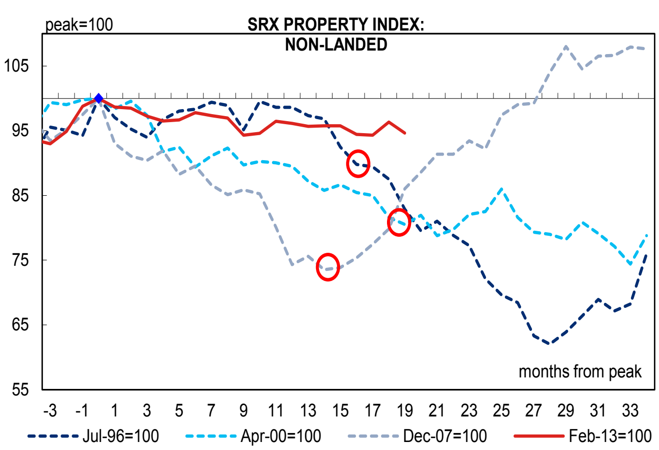
Source: CEIC, Citi Research

Figure 77. The wealth effect of home equity has turned positive



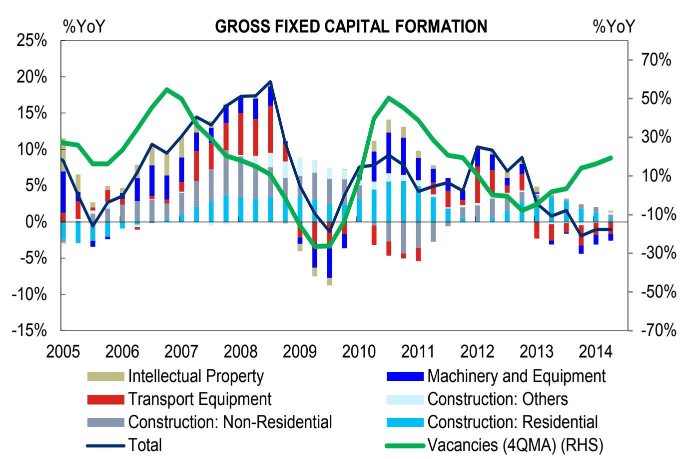
Note: Regression: Private Consumption/person growth = a* (Monthly Wages growth) + b*(Personal Loans/per person growth) + c*(Home Equity/per person growth) + d*(STI).
Source: CEIC, Citi Research

Figure 78. Timing of policy relaxation in property cycles



Note: Red circles represent the timing of policy relaxation
Source: CEIC, Citi Research

Figure 79. We must look at the labour market for signs of distress



Source: CEIC, Citi Research

Figure 80. Singapore Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	180.3	192.5	193.0	236.9	274.3	287.2	298.0	324.2	357.4
Nominal GDP, local currency mn	271	272	280	322	345	359	373	409	453
GDP per capita, US$	39,287	39,772	38,694	46,671	52,908	54,058	55,199	58,938	63,815
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	2.0	2.1
Economic Activity									
Real GDP, % yoy	9.1	1.8	-0.6	15.2	6.1	2.5	3.9	2.9	3.0
Real investment growth % yoy	12.1	29.6	-11.3	24.4	4.3	14.9	-2.2	-1.9	-1.3
Real consumption growth % yoy	5.4	4.0	0.0	6.9	3.1	3.1	4.1	1.2	1.4
private consumption growth % yoy	6.1	3.5	-1.1	5.9	4.3	3.9	2.6	1.3	0.5
Real export growth, % yoy	8.6	4.6	-7.5	17.4	4.6	1.5	3.6	3.8	3.6
Real import growth, % yoy	7.4	10.0	-10.4	16.2	3.2	3.1	3.1	3.2	2.4
Prices, Money & Credit									
CPI, % yoy	3.7	5.5	-0.5	4.6	5.5	4.3	1.5	0.5	1.0
CPI, % avg	2.1	6.6	0.6	2.8	5.2	4.6	2.4	1.1	0.7
Nominal wages, % yoy	6.2	5.4	-2.7	5.6	6.0	2.3	4.3	3.5	3.5
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	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	2.38	1.00	0.69	0.44	0.38	0.38	0.40	0.40	0.80
Long term yield, % eop	2.68	2.05	2.66	2.71	1.63	1.30	2.56	3.00	3.20
lc/US$, eop	1.44	1.43	1.41	1.28	1.30	1.22	1.26	1.28	1.31
lc/US$, avg	1.51	1.41	1.45	1.36	1.26	1.25	1.25	1.27	1.30
Balance of Payments, US$ bn									
Current account	46.8	27.7	32.4	56.0	62.6	50.2	54.6	58.3	64.3
% of GDP	25.9	14.4	16.8	23.6	22.8	17.5	18.3	18.0	18.0
Trade balance	57.8	41.6	47.6	62.9	69.6	63.5	67.8	65.0	70.0
Exports	312.4	352.9	287.4	370.5	432.0	434.5	437.7	440.0	450.0
Imports	254.6	311.3	239.8	307.6	362.5	371.0	369.9	375.0	380.0
Service balance	-2.3	-1.5	-2.3	-0.4	2.8	0.9	0.8	1.0	2.0
Income balance	-8.7	-12.4	-12.9	-6.5	-9.8	-14.2	-14.0	-7.7	-7.7
FDI, net	10.8	5.4	-2.4	21.7	26.9	47.7	36.8	32.0	32.0
International reserves	163.0	174.2	187.8	225.8	237.7	259.3	273.1	280.0	290.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	2.8	0.1	-0.3	0.3	1.2	1.7	1.1	-0.3	0.2
Consolidated gov primary balance	2.7	1.1	-0.8	0.2	1.3	2.0	1.3	0.7	0.5
Public debt	86.3	93.9	104.2	99.6	102.7	107.4	104.7	110.0	110.0
of which Domestic	86.3	93.9	104.2	99.6	102.7	107.4	104.7	110.0	110.0
Foreign Assets & Liabilities, US$ bn									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	4.8	2.4	2.4	2.1	2.5	2.7	3.8	2.9	3.9
CPI, % yoy	1.2	1.8	0.6	0.5	0.5	0.7	1.0	1.0	1.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.41	0.40	0.40	0.40	0.45	0.50	0.60	0.80	1.00
Long term yield, % eop	2.49	2.75	2.90	3.00	3.00	3.10	3.20	3.20	3.30
lc vs USD, eop	1.26	1.25	1.28	1.28	1.29	1.30	1.31	1.31	1.32

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** – 3Q GDP growth on a YoY basis slowed despite stimulus measures. Weaker than expected readings on exports and facilities investment in 3Q illustrate that the economy's recovery pace is still vulnerable to external risks. If external risks deteriorate further, additional stimulus is more likely in 1H15.

- **Things to watch** – The BoK has cut a total of 50bps to 2.00% during Aug-Oct14. Our base line call is that there would be no additional rate change till 4Q15, when the BoK starts the rate-hike cycle. However, we do not rule out an extra rate cut in early 2015, as it might take place in case the economic recovery is not strong enough to grow at c1.0%QoQ sa.

- **Strategy** – Over the 0-3m horizon, USDKRW is likely to stay around 1050. However, 6-12 months out, broad USD strength from Fed's gradual policy normalization and the BoK's easing stance on monetary policy has led us to bump up our USDKRW forecast up to 1060.

Weak growth continued despite stimulus in 3Q

The economy slowed further on YoY terms in 3Q14 as expected – The GDP growth in 3Q14 registered 0.9%QoQ sa and 3.2%YoY (vs. 2Q14: 0.5%QoQ sa and 3.5%YoY). Market and Citi expected the economy to rebound from a slowdown in 2Q14, due to the aftermath of the ferry incident in Apr. In particular, despite expansionary fiscal measures and the BoK's Aug rate cut, the decline in growth (YoY) was widely expected on the back of lukewarm exports and sharp contraction in Aug IP, amid delayed improvement in economic sentiment. Domestic demand contributed 1.9%p QoQ and 3.4%p YoY to 3Q GDP growth**.** Private consumption growth rebounded as the ferry incident's effect waned. Government expanded its expenditure substantially with a KRW31trn stimulus package in 2H14. Construction growth improved but facilities investment growth turned into negative territory on a QoQ basis. Meanwhile, net exports resulted in the deterioration of overall growth rate as it contributed -1.0%p QoQ and -0.1%p YoY to GDP growth. Exports and imports both contracted QoQ sa.

Only gradual recovery is expected in exports and facilities investment – A continued recovery is expected alongside the improvement in global economy, mostly driven by the US, but the pace of recovery is likely to be limited by two major factors; [1] slow-down of major trade partners, China (25% of export share) and Euro area (9.5% of export share), [2] further weakening of the JPY against the KRW. Exports are expected to increase ~~slowly~~ by 3.8% in 2014 (vs 2013: 2.1%). Given the external risks, the prospects for corporate investments are not so bright, in our view; however a slow but steady recovery of domestic demand is like to support overall improvement of investment spending.

Low inflation and subdued job growth expected – We cut our inflation forecast for 2014 and 2015 to 1.4% and 2.2%, respectively. We expect that supply-side deflationary pressure is going to continue for a while, widening negative output gap. Headline inflation, in particular is likely to remain below 2% to the end of 1H15. Separately, the employment figures decreased by 54.0K in Sep on a MoM sa basis after increasing for three consecutive months (avg. of Jun-Aug: +126.5K). We expect that job growth in the coming quarters will remain below 100K MoM and 500K YoY, on the back of a slow economic recovery and base effect. We also expect the jobless rate to fall to 3.3% sa at the end of this year as the improvement in labor participation is likely to be limited.

If external risks worsen, another stimulus is likely

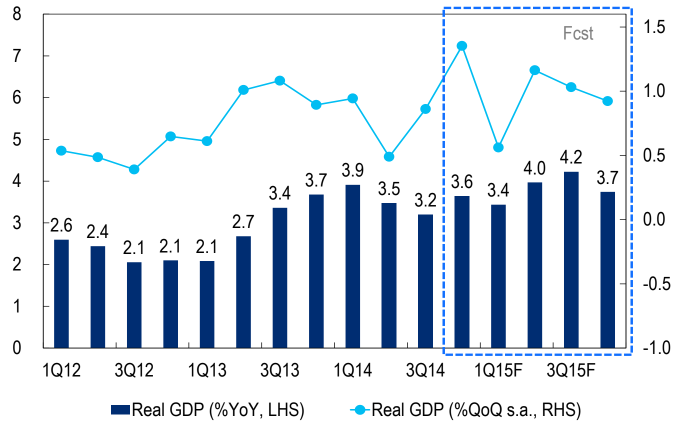
We have cut our growth forecasts, but external risks could dampen growth further – In early Oct, we adjusted 2014 and 2015 growth forecasts by 0.3%p and 0.2%p to 3.6% and 3.8%, respectively - see Weak Recovery Increases Likelihood of Further Monetary Easing. Downward adjustments to growth reflected slower than expected pace of recovery in 3Q14 and delayed effects of fiscal stimulus. The BoK has also revised down its 2014-15 growth by 0.3%p and 0.1%p to 3.5% and 3.9%. - see BoK Sees Slower Growth as Domestic Demand Remains Weak. However, risks to exports and facilities investment could dampen growth even further, lower than the recently revised forecasts. Weaker than expected readings on exports and facilities investment in 3Q illustrate that the economy's recovery pace is still vulnerable to external risks. We see further slowdowns in the euro area and China, negative impact from oil price decline to EM growth, and further weakening of JPY; these would be the main downside risks to growth going forward, in our view.

Additional fiscal stimulus in 2015 depends on severity of the external risks – For now, the government is likely to wait and see the impacts of the measures put in place in Jul-Oct 14. Owing to a growing concern of a further decline in growth, both in terms of cyclical and structural, the government allocated KRW41trn towards stimulus measures in Jul. It had also allocated KRW5trn in Oct and had planned to spend a total of KRW31trn in 2H14, as the economic activity and sentiments remained in the doldrums. In Sep, the government raised its spending growth forecast for 2015 to 5.7% from previous 3.4% to intensify the fiscal role towards supporting the economic recovery during the next year. The spending increase is mostly likely to center on welfare (including subsides on education) and employment, supporting SMEs, social safety and SOC. These expansionary fiscal measures during 2014-15E will end up deteriorating fiscal soundness, even if they are better than those taken in major OECD countries', in our view.

The BoK lowered its policy rate in Oct, but another cut in 1H15 is possible – On top of government pressure, continuing low inflation at ~1% and weaker-than-expected recovery in 3Q14 have led the BoK to cut rates at Oct MPC meeting, as expected. The Bok has cut a total of 50bps to 2.00% during Aug-Oct14. The BoK's governor has said that the BoK's rate cuts in Aug and Oct could help economic recovery along with the recent fiscal stimulus; these measures are expected to increase real GDP growth by 0.2%p. The Oct MPC added in the monetary policy statement that it would closely monitor capital flows and financial stability because the rate cuts could provoke capital outflows in bond markets amid the current KRW weakness and could also accelerate household debt growth. Our base line call for the policy rate is no additional rate change till 3Q15, after which the BoK is likely to start a rate-hike cycle by raising rates by 25bps. However, we do not rule out an extra rate cut in early 2015 in case the economic recovery is not strong enough to grow at c1.0%QoQ sa on external risks. In our view, the BoK and the government is likely to put economic growth as its first policy priority for 2015, rather than financial stability.

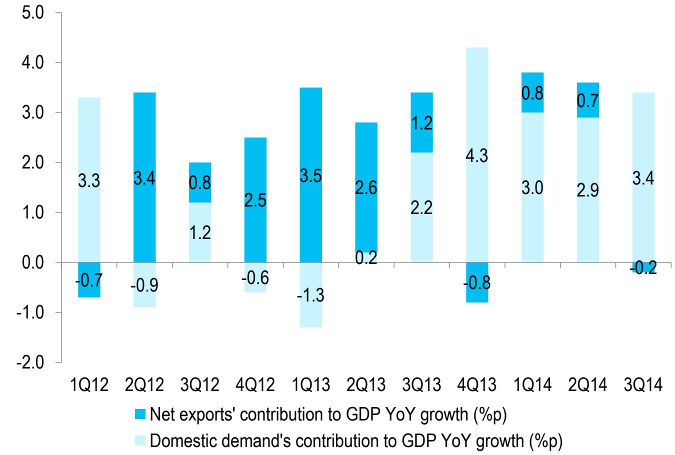
We revised upward our USDKRW forecast to 1060 in 6-12 months out – Over the 0-3m horizon, USDKRW is likely to stay around 1050**.** 6-12m out, however, broad USD strength from Fed's gradual normalization of policy and the BoK's easing stance on monetary policy have led us to bump up our USDKRW forecast up to 1060. Additional depreciation pressure from the expected BoJ QE is also a concern. We believe that KRW is expected to appreciate only slowly in the long term, reaching to 1046 in 4Q15 and 1018 in 4Q16.

Figure 81. We lowered our 2014 and 2015 growth forecast



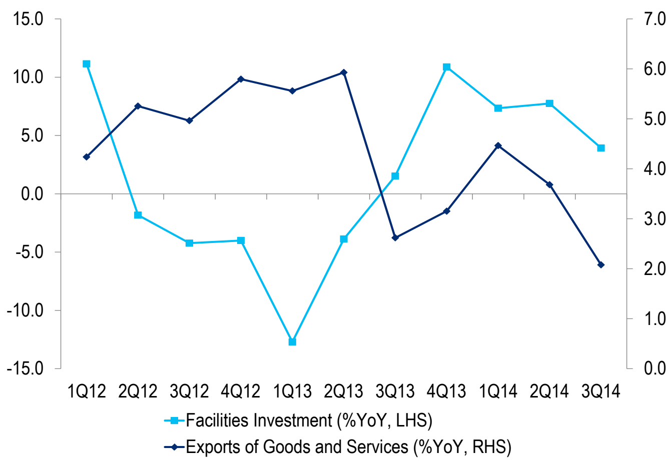
Source: Bank of Korea, CEIC, Citi Research

Figure 82. Domestic demand improved but net exports contracted in 3Q



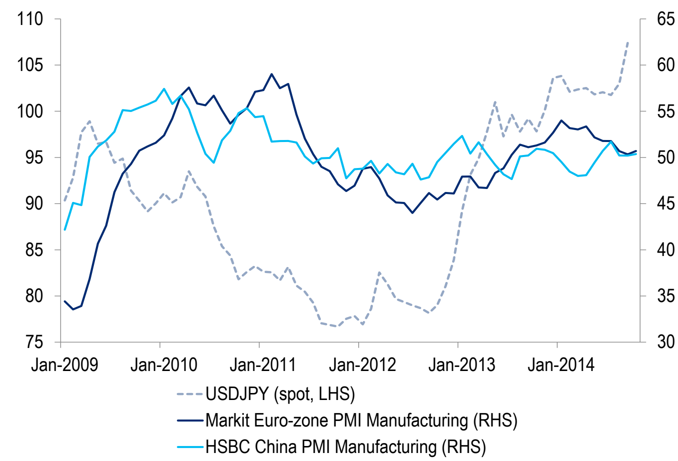
Source: Bank of Korea, CEIC, Citi Research

Figure 83. Growth of exports and facilities investment weakened in 3Q



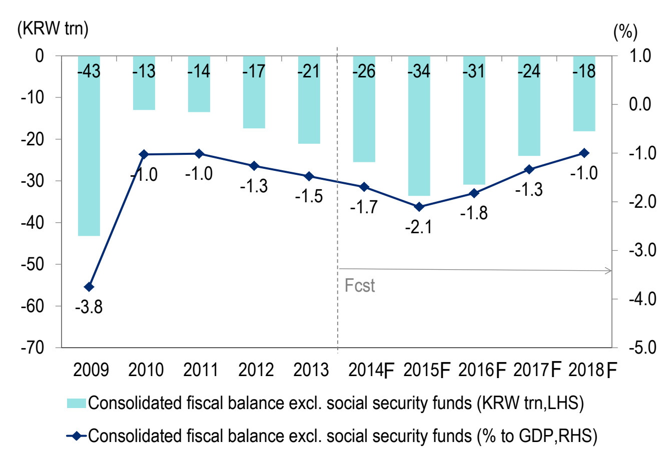
Source: Bank of Korea, CEIC, Citi Research

Figure 84. China Manu PMI, Euro-zone Manu PMI, and USDJPY



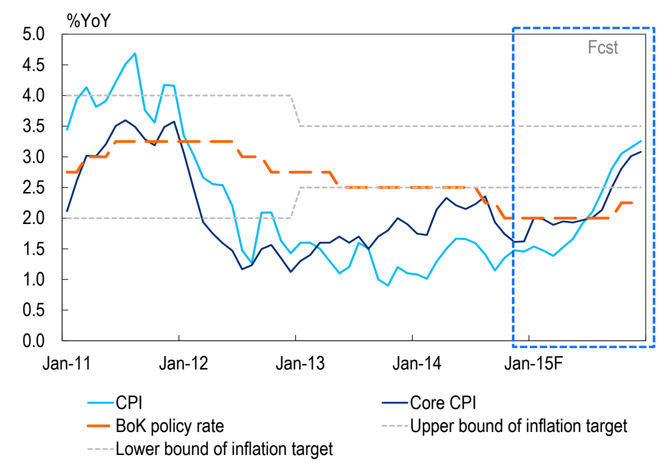
Source: KITA, Markit, CEIC, Haver, Citi Research

Figure 85. Fiscal balance deteriorated to support stimulus measures



Source: Ministry of Strategy and Finance's estimates, Citi Research

Figure 86. We expect the BoK to hold till 4Q15



Source: Bank of Korea, CEIC, Citi Research

Figure 87. Korea Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	1,121.3	999.7	902.6	1,094.6	1,202.8	1,222.5	1,304.3	1,445.6	1,531.3
Nominal GDP, local currency bn	1,043,258	1,104,492	1,151,708	1,265,308	1,332,681	1,377,457	1,428,295	1,491,861	1,576,094
GDP per capita, US$	23,073	20,424	18,352	22,153	24,163	24,448	25,972	28,669	30,253
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	3.5	3.3
Economic Activity									
Real GDP, % yoy	5.5	2.8	0.7	6.5	3.7	2.3	3.0	3.6	3.8
Real investment growth % yoy	4.5	-1.0	-10.1	17.8	3.5	-2.3	0.0	5.8	3.2
Real consumption growth % yoy	5.3	2.2	1.3	4.3	2.7	2.2	2.2	2.2	3.6
private consumption growth % yoy	5.1	1.4	0.2	4.4	2.9	1.9	2.0	2.0	3.4
Real export growth, % yoy	12.7	7.5	-0.3	12.7	15.1	5.1	4.3	3.4	6.9
Real import growth, % yoy	11.6	3.2	-6.8	17.3	14.3	2.4	1.6	3.1	6.7
Prices, Money & Credit									
CPI, % yoy	3.6	4.1	2.7	3.1	4.2	1.4	1.1	1.5	3.3
CPI, % avg	2.5	4.7	2.8	3.0	4.0	2.2	1.3	1.4	2.2
Nominal wages, % yoy	5.6	-4.1	2.6	6.8	1.0	5.3	3.9	4.8	5.1
Credit extension to private sector, % yoy	12.5	14.9	5.0	4.0	6.5	3.2	4.7	5.7	7.9
Policy interest rate, % eop	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.00	2.25
Short-term market rate, % eop	5.73	4.68	2.82	2.80	3.55	2.89	2.66	2.10	2.40
Long term yield, % eop	5.70	4.22	5.39	4.52	3.79	3.16	3.58	2.90	3.30
lc/US$, eop	936	1,263	1,166	1,121	1,159	1,064	1,051	1,052	1,046
lc/US$, avg	929	1,102	1,275	1,156	1,108	1,127	1,095	1,046	1,054
Balance of Payments, US$ bn									
Current account	11.8	3.2	33.6	28.9	18.7	50.8	79.9	77.8	61.7
% of GDP	1.1	0.3	3.7	2.6	1.6	4.2	6.1	5.4	4.0
Trade balance	14.6	-13.3	40.4	41.2	30.8	28.3	44.0	39.6	34.0
Exports	371.5	422.0	363.5	466.4	555.2	547.9	559.6	580.8	623.7
Imports	356.8	435.3	323.1	425.2	524.4	519.6	515.6	541.2	589.7
Service balance	-12.0	-5.7	-6.6	-8.6	-5.8	-5.2	-7.9	-9.5	-10.8
Income balance	-3.4	3.7	1.6	-2.1	0.3	6.6	7.2	3.4	-1.0
FDI, net	-17.9	-16.9	-14.9	-22.2	-16.4	-18.9	-13.1	-8.6	-4.3
International reserves	262.2	201.1	270.0	291.5	304.2	323.2	341.7	362.5	372.3
Total Amortisations	24.5	31.0	30.2	35.7	42.7	43.5	44.3	45.1	46.0
Public Finances, % of GDP									
Consolidated government balance	3.2	1.1	-1.5	1.3	1.4	1.3	1.0	0.9	0.4
Consolidated gov primary balance	4.5	2.4	-0.2	2.6	2.7	2.6	2.1	2.0	1.6
Public debt	28.7	28.0	31.2	31.0	31.6	32.2	34.3	35.3	36.2
of which Domestic	26.7	26.1	29.1	30.2	29.4	31.4	33.5	34.5	35.4
Foreign Assets & Liabilities, US$ bn									
External debt	333.4	317.4	345.7	359.8	398.7	409.4	416.6	420.5	428.5
Private	279.8	264.9	277.9	280.0	314.7	311.2	312.3	314.6	319.8
Public	53.6	52.5	67.8	79.7	84.0	98.2	104.3	105.9	108.7
External debt / GDP	29.7	31.7	38.3	32.9	33.1	33.5	31.9	29.1	28.0
External debt / XGS	75.0	61.9	79.1	65.0	61.3	62.8	63.0	61.3	57.9
Short-term debt	160.3	149.9	149.2	139.8	137.4	127.2	112.8	104.0	108.0
Short-term debt/International Reserves (%)	61.1	74.5	55.3	47.9	45.2	39.4	33.0	28.7	29.0

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.9	3.5	3.2	3.6	3.4	4.0	4.2	3.7	3.9
CPI, % yoy	1.3	1.7	1.1	1.5	1.4	1.9	2.8	3.3	3.0
Policy interest rate, % eop	2.50	2.50	2.25	2.00	2.00	2.00	2.00	2.25	2.50
Short-term market rate, % eop	2.65	2.65	2.35	2.10	2.10	2.10	2.15	2.40	2.65
Long term yield, % eop	3.52	3.17	2.85	2.90	2.95	3.05	3.20	3.30	3.50
lc vs USD, eop	1,065	1,012	1,055	1,052	1,055	1,059	1,054	1,046	1,038

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** – We expect the economy to grow steadily in 3Q and 4Q at 3.8%YoY and 3.9%YoY, but with a diverging trend of tech and non-tech exports. Trade recovery is still expected to be only at a moderate level. Cheaper oil import bill likely has a modest impact on CPI but it is positive for current account.
- **Things to watch** – 1) Cross-strait momentum: banks M&A, RMB swap line, ECFA for services and goods; 2) pension reforms; 3) 2014's local elections; 4) liberalization efforts in FEZ; 5) TPP and RECP talks; 6) 4th nuclear plant refrendum; 7) China impacts via exports, financials, RMB and geopolitics.
- **Strategy** – Policy rate is likely to be stable untill 2H15, CBC prefers to use NCD for liquidity managment; 10Y government bond yields likely to be on a gradual uptrend. TWD strength gave way to USD strength, we maintain our 0-3M forecast to 30.3/USD . Our house view on TAIEX has recently been updated to 9,500 from 10,000 previously for end 2014.

Taiwan's recent data outperformance vs. region

Taiwan's PMI outperformance in the region is most notable – Taiwan's (Markit) PMI index has been improving from April's 52.3 to August's 56.1 this year. It had performed much better than other tech countries in the region, like Japan, Korea and Singapore. (Figure 88) We believe that this tech theme was earlier reflected in other leading indicators such as the equity market; as the tech cycle theme played out well in 1H14. However, the Sep US ISM and Taiwan PMI readings suggest that both economies are seeing near term headwinds, with the US ISM at 56.6 (-2.4ppt vs. Aug) and Taiwan's PMI at 53.3 (-2.7ppt vs. Aug). We see 4Q Taiwan's export outlook for 4Q14 and 1H15 highly dependent on the strength of the US recovery. A manageable slowdown in Chinese economy with some help from conventional monetary easing remains our base case.

Better Sep data is something to cheer, but not a game changer – Export orders and IP for Sep beat expectations and grew sharply at 12.7%YoY and 10.3%YoY, respectively. We think Oct readings will also be impressive, and respective diffusion indices do support our call – in particularly likely more production of autos, electronics and chemicals, along with more orders of info/communication products.

Oct exports may not be able to follow through with such stellar performance – We have noted that export orders and exports have very loose correlations lately. It is because Taiwanese tech firms take orders in Taiwan but assemble the products in China and therefore the exports are registered in China and not Taiwan (iPhones being the typical example). Actually this mild export and manufacturing recovery is one for which we have waited for all year, as Taiwan observes a typical tech production cycle ahead of the festive shopping season at year end. We, thus, are sticking with our mid-single digit exports growth forecast for 2014E.

Market begins searching for 2015 themes: Tech themes likely to drive economic performance near term, but the question of export outperformance follow through in 2015 is being raised as the novelty of new tech product wanes. From export orders and production data, we begin to note small themes emerging. Machineries and autos have been reviving and likely to be driven by advanced economies engaging in production chain expansion and global consumer demand recovery. Trends of these two subsectors deserve close monitoring given our US-led global recovery call remains intact. Just to add some quantitative reference, these are small themes given that machineries account for ~5% share of export orders and industrial production, while autos account for ~2% of IP in Jan-Sep 14.

Market update and elections watch

Lowering YE2014 index target to 9,500; MY2015 set at 10,000 – Our equity strategist, Peter Kurz, have lowered our 2014-end target to 95,000 given the recent sharp market pullback, but he remains confident that the index will challenge the 10,000 level over the course of the next three quarters. He argues that Taiwan has been spoiled by recent cyclical recovery, but growth drivers remain intact. Peter recommends a re-weighting back into Tech (semiconductor sectors, which includes the Display sector as well as Foundry, OSATs and IC Design), reversing the rotation into Financials over the summer (driven by wealth-management business, insurance FYP, and a removal of the TMU restrictions), and considers positioning into the large-cap sector Telecom. See *Taiwan Equity Strategy - Heavy Cash Calls May Soon Abate.*

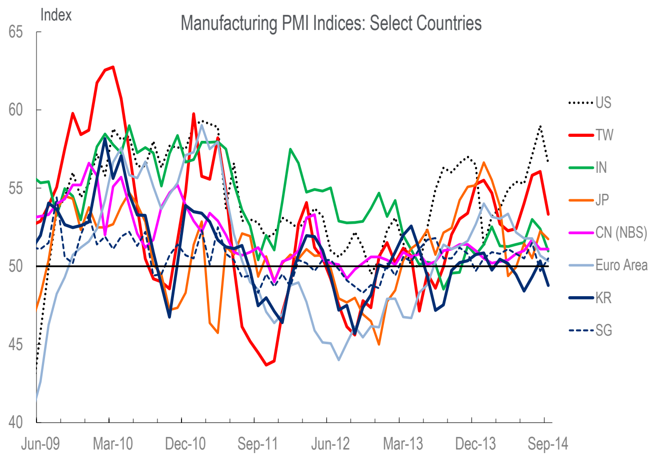
CBC to stand pat till 3Q15E – We continue to believe CBC re-discount rate hike need not front-run the Fed's (our house view of first Fed policy rate hike of 25bps in 3Q15 remains), given benign inflation in Taiwan. Sep headline CPI dropped back to 0.75%YoY, on temporary factors associated with high typhoon damaged vegetable prices last year; but core CPI only retreated a little to 1.6%YoY in Sep. More notable is the retreat of WPI inflation into negative (-0.75YoY) in Sep, due to lower prices of oil products, computers, electronics and optical instruments. We believe recent fall in global oil price will lower WPI more than CPI, given that petroleum and petrochemicals weigh ~10% in WPI basket, while electricity and fuels weigh ~5.7% in CPI basket. Of course lower WPI will have second round impact on consumer prices with a lag, and thus contributes to our overall benign inflation call.

We maintain our mild appreciation call for the TWD – We believe data surprises likely will be offset by weaker regional (KRW, JPY) and strong USD currency trends. Thus we are maintaining our 0-3M TWD forecast at 30.3/USD. From a current account perspective, earlier in the year we already saw large CA surplus, but this was only led by imports compression. Now we are seeing some pickup in exports and it is only making the CA surplus healthier but not a dramatic increase in CA surplus (besides imports have increased alongside exports recovery too). A lower oil import bill will also be supportive to Taiwan's current account surplus.

Property curbs continue to yield results – The property cooling measures that were launched in June are dampening the property price rise in metropolitan areas, especially notable in Taipei City and Taipei area (Figure 91).

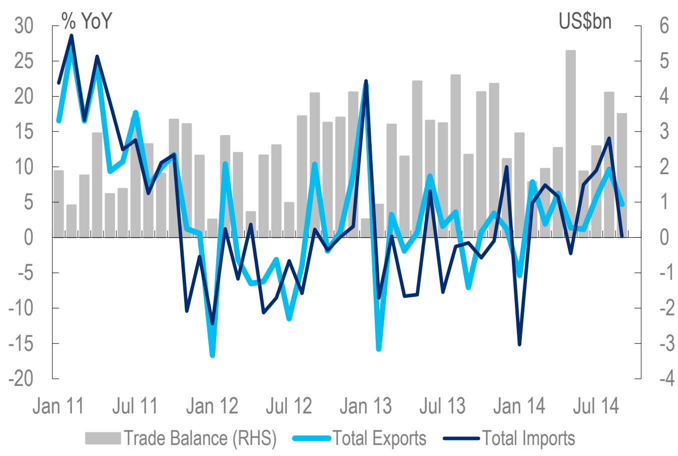
Local elections only a month away (scheduled for 29 Nov) – Year-end local elections are important as they consolidate seven separate elections of mayors/municipal leaders into one. Therefore they would be more influential on the financial markets than usual. Foreign equity investors will be keen to see if there is a shift away from the ruling party to the opposition party. In this regard, we also see election uncertainty as one of the factors that may offset some of the data strength near term for TWD performance. Our equity strategist also believes that ongoing pro-democracy demonstrations in Hong Kong may benefit the DPP insofar as it underscores the risks of increasing dependency on China, and that there is the possibility that close races in the cities of Taipei and Taichung could lean further in support of the pro-Green candidates. More importantly, the victory of the incumbent KMT candidate, Eric Chu, in the New Taipei City elections by a convincing margin will have significant implications on his potential to run for the 2016 presidential elections. We think that the results of the local elections will set the tone for 2015 policies (especially in relation with cooperation with China) and upcoming legislative elections (Dec15) and presidential elections (Mar16).

Figure 88. TW PMI still outperforming despite Sep's retreat



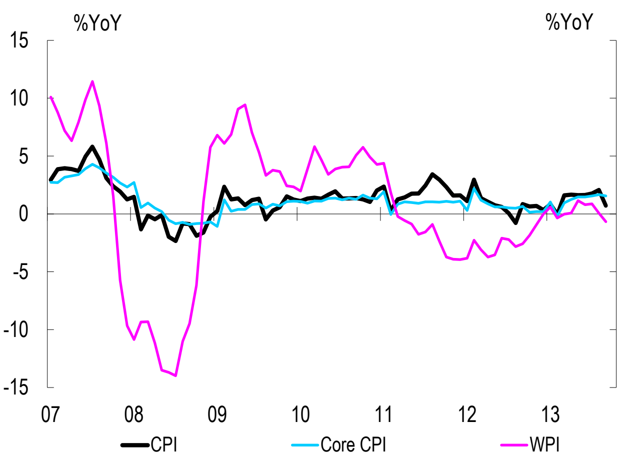
Source: CEIC, Citi Research

Figure 89. Our mild trade recovery call for 2H remains intact



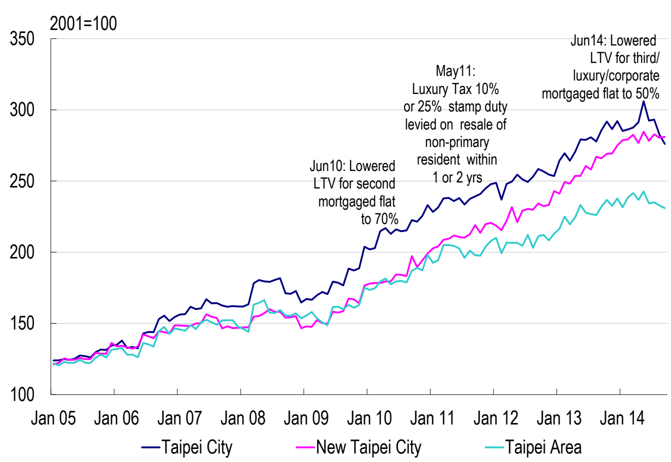
Source: CEIC, Citi Research

Figure 90. Benign inflation gives room for CBC's accommodation



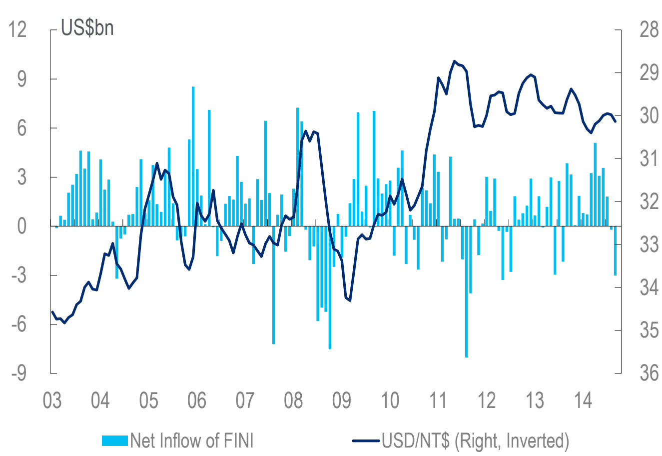
Source: CEIC, Citi Research

Figure 91. Sinyi price index retreated post new ppt measures



Source: CEIC, Citi Research

Figure 92. FINI outflow lowered support for TWD amidst strong USD



Source: CEIC, Citi Research

Figure 93. 10Y govt bonds likely will rise, but more gradual than UST

Source: CEIC, Citi Research

Figure 94. Taiwan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	393.0	400.2	378.0	430.3	466.5	476.3	490.6	509.4	545.4
Nominal GDP, local currency bn	12,911	12,620	12,481	13,552	13,709	14,077	14,561	15,316	16,234
GDP per capita, US$	17,118	17,370	16,348	18,579	20,084	20,429	20,991	21,749	23,241
Population, mn	23.0	23.0	23.1	23.2	23.2	23.3	23.4	23.4	23.5
Unemployment, % of labour force	3.9	4.1	5.8	5.2	4.4	4.2	4.2	4.0	3.9
Economic Activity									
Real GDP, % yoy	6.0	0.7	-1.8	10.8	4.2	1.5	2.1	3.7	4.0
Real investment growth % yoy	-0.7	-7.9	-21.2	36.8	-6.8	-4.6	2.2	5.7	2.6
Real consumption growth % yoy	2.1	-0.6	1.3	3.3	2.9	1.5	1.6	2.2	2.6
private consumption growth % yoy	2.1	-0.9	0.8	4.0	3.1	1.6	2.0	2.4	3.0
Real export growth, % yoy	9.6	0.9	-8.7	25.6	4.5	0.1	3.8	4.6	6.3
Real import growth, % yoy	3.0	-3.7	-13.1	27.7	-0.5	-2.2	3.9	3.8	5.2
Prices, Money & Credit									
CPI, % yoy	3.3	1.3	-0.2	1.2	2.0	1.6	0.3	2.5	2.7
CPI, % avg	1.8	3.5	-0.9	1.0	1.4	1.9	0.8	1.5	2.0
Nominal wages, % yoy	2.1	-0.1	-5.0	5.3	2.6	0.1	0.2	1.5	3.0
Credit extension to private sector, % yoy	3.9	2.7	-0.8	6.7	5.6	4.1	5.3	7.0	8.5
Policy interest rate, % eop	3.38	2.00	1.25	1.63	1.88	1.88	1.88	1.88	2.13
Short-term market rate, % eop	2.03	1.07	0.27	0.49	0.79	0.76	0.64	0.84	0.98
Long term yield, % eop	2.53	1.44	1.47	1.47	1.27	1.15	1.69	1.80	2.00
lc/US$, eop	32.43	32.78	32.23	29.17	30.29	29.06	29.83	30.27	29.92
lc/US$, avg	32.85	31.58	33.04	31.50	29.40	29.57	29.68	30.27	30.07
Balance of Payments, US$ bn									
Current account	35.2	27.5	42.9	39.9	41.7	50.6	57.3	56.0	55.6
% of GDP	8.9	6.9	11.4	9.3	8.9	10.6	11.7	11.0	10.2
Trade balance	27.4	15.2	29.3	23.4	26.8	30.7	35.5	39.9	46.1
Exports	246.7	255.6	203.7	274.6	308.3	301.2	305.4	320.8	347.5
Imports	219.3	240.4	174.4	251.2	281.4	270.5	269.9	280.8	301.4
Service balance	-1.6	1.8	2.0	2.5	3.9	6.3	10.4	11.2	13.4
Income balance	10.1	10.0	12.5	13.6	13.2	15.3	14.3	17.0	19.0
FDI, net	-3.3	-4.9	-3.1	-9.1	-14.7	-9.9	-10.7	-10.0	-9.0
International reserves	270.3	291.7	348.2	382.0	385.5	403.2	416.8	420.0	450.0
Total Amortisations	8.8	2.5	3.2	6.8	3.4	2.9	3.1	3.2	3.2
Public Finances, % of GDP									
Consolidated government balance	0.9	0.9	-2.2	-1.2	-0.5	-1.4	-1.3	-1.4	-0.8
Consolidated gov primary balance	1.9	1.9	-1.2	-0.3	0.3	-0.5	-0.5	-0.6	-0.5
Public debt	33.3	34.7	38.0	38.3	40.0	41.0	39.9	39.3	39.0
of which Domestic	33.3	34.7	38.0	38.2	40.0	41.0	39.9	39.3	39.0
Foreign Assets & Liabilities, US$ bn									
External debt	94.5	90.4	82.0	101.6	122.5	130.8	170.1	175.4	180.4
Private	91.1	88.9	76.0	93.5	118.0	127.5	165.8	170.2	175.0
Public	3.5	1.5	5.9	8.0	4.5	3.3	4.3	5.3	5.4
External debt / GDP	24.1	22.6	21.7	23.6	26.3	27.5	34.7	34.4	33.1
External debt / XGS	33.4	30.9	34.7	32.0	34.6	37.4	47.6	46.8	44.0
Short-term debt	83.3	78.8	68.2	83.7	107.8	116.5	155.6	165.0	140.0
Short-term debt/International Reserves (%)	30.8	27.0	19.6	21.9	28.0	28.9	37.3	39.3	31.1

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.2	3.7	3.6	3.7	3.6	3.6	4.1	4.2	4.0
CPI, % yoy	1.6	1.6	0.7	2.5	1.3	1.3	2.5	2.7	2.3
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	2.00	2.13	2.25
Short-term market rate, % eop	0.83	0.83	0.83	0.86	0.89	0.95	1.01	1.07	1.13
Long term yield, % eop	1.56	1.58	1.72	1.80	1.85	1.90	1.95	2.00	2.08
lc vs USD, eop	30.45	29.87	30.43	30.27	30.19	30.12	30.02	29.92	29.83

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** – Our growth forecasts of 1.1% in 2014 and 4% in 2015 are unchanged. Capacity slack bottomed out in July due to tech output gains while missing out on upbeat domestic demand. Lift to HH incomes from easing oil prices may be undermined by subsidized diesel prices and elevated HH debt.
- **Things to watch** – Roll out of the FY15 budget particularly on infrastructure. Start of energy price reforms on CPI with oil prices on the wane. Whether pursuit of strong governance affects the pace of infra budget disbursements. Sustained improvements in utilization rate despite lack of broad-based mfg output gains.
- **Strategy** – Lacking firm recovery signals, BoT's accommodation would stay and remain consistent with a relatively weak THB range. Potential trade surplus effect from soft oil prices would ease THB weakness in case of a strong USD episode. We sense lower risk of overshooting our end-Dec THB forecast of 32.70.

Initial signs of diminishing slack due to tech export gains

We maintain our GDP forecast at 1.1% for 2014 and 4% for 2015 – We continue to think fiscal spending stimulus contained in FY15 budget would figure prominently in recovery prospects together with consumption and tourism recovery. However recovery will be gradual and unlikely to see a v-shaped pattern similar to previous recoveries because: 1) lacking strong and durable export recovery implies capacity slack (export mfg cluster accounts for 46% of total mfg output) disappear quickly and de-stocking bias likely to persist; 2) NCPO's reforms that frown at wasteful, populist spending programs while trimming energy price subsidies will not help uplift near-term HH incomes that support consumption surprises; and 3) pursuit of strong governance would lead to deliberate but cautious implementation of infra projects.

In Aug, we noted preliminary signs of capacity slack bottoming out as tech exports and corresponding output turn upbeat – Seasonally adjusted utilization rate improved from 59.3% in July to 60.7% in Aug. The inventory to shipment index (3.3%YoY) and inventory index (-1.9%YoY) narrowed as well. Aug jobless rate improved to 0.8% SA from 1.1% SA in July. Hotel occupancy rate rose to 55% in Aug (vs. <50% in July/2Q14) with improving tourist arrivals (+3.7%MoM SA). Narrowing slack in Aug suggests worst of the crisis may be over.

Shipments of electronics (+4.5%MoM SA), autos & parts (+6.6%MoM SA), petroleum products (+2.5%MoM SA) in Aug posted monthly gains according to BoT – Select export gains probably lifted mfg output (3.8%MoM SA). Manufactures of HDD & integrated circuits (+7.9%MoM SA), electrical appliances (+1.8%MoM SA), petroleum (+15.1%MoM SA), apparel (+3.7%MoM SA) and chemicals (+2.7%MoM SA) led the industry winners.

Onshore private spending on the other hand, remains lackluster in Aug – The weakness was indicated by a fall private consumption index -0.8%YoY (-0.2%MoM SA) in tandem with persistent weakness of the private investment index (-5.6%YoY/-1.2%MoM SA). Passenger car sales fell 41.3%YoY to lead lackluster consumption. Resilient slack has restrained private investments. FDI approvals, a forward looking investment indicator rose 12.1%YoY in 3Q14 although for Sep alone, approvals gained 5.4%YoY. Disbursements for infrastructure spending fell 9.5%YoY to Bt210.6bn over the period Oct-Aug of FY14 against an FY14 target of Bt441bn. Missing several local catalysts, domestic demand has yet to materially contribute to easing slack.

Potential gains from softer oil price readings

Softer oil prices could boost trade surplus ratio to GDP but in our empirical tests there's more lift from THB and global demand – Trade surplus ratio to GDP could gain up to +2.2% for a 10% drop in crude oil prices. This translates to about US$119mn per quarter in 'import savings', or US$476mn a year. However, other determinants, THB and world trade indicators, offer a larger trade surplus impact. A 10% THB depreciation that cheapens exports potentially elevates trade surplus ratio by 8.6%, translating into a quarterly additional net surplus of US$466mn. A 10% rise in the world export volume on the other hand expands trade surplus ratio by 4.2%, or potentially a quarterly net surplus of US$230mn. Windfall gain brought about by soft oil prices on current account remains modest compared to impact of a weak THB or shifts in external demand. Still lower oil price effects on trade gap contribute to easing THB's vulnerability to strong USD.

Oil price impact on core inflation modest compared to other factors – Our regression shows an oil price effect of 0.005% on core, lesser than THB's impact of 0.03% on core. 10% drop in oil prices lowers core by 0.05%, or an annualized 0.2% decline; THB appreciation of 10% (parallel slumping oil prices) reduces core by 0.34%, or an annualized 1.4% drop. Inflation expectations (0.005%), liquidity indicator (money supply to real GDP ratio) (0.045%) and average compensation (0.044%) displayed impacts that matched or exceeded oil-price effects. Softening oil price amid subdued oil-price effect on core would keep MPC's neutral bias.

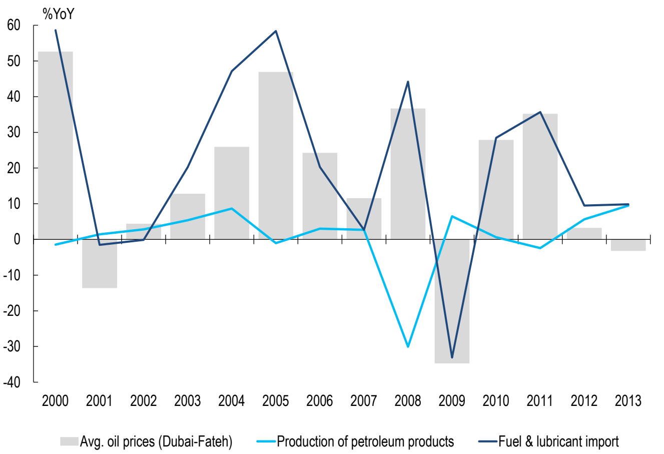
Real effects of declining oil prices

Based on household (HH) budget allocations (measured by CPI weights) for energy-related expenditures, we estimate windfall income gains of Bt64bn (1.3% of 2014 real GDP) to Bt103.7bn (2% of 2014 real GDP) from a 10% decline in oil prices – CPI weights that reflect HH expenditure priorities enable 'weighting' of oil price changes relevant for HH budget priorities and re-alignments. At the macro level, this consumer-weighted oil price change offers an estimate of how much of the HH budget would be freed up (or curtailed) in the event of an oil price decline (increase). The real impact of softer oil price outlook becomes largely relevant because slightly >20% of HH budgets are deployed for energy-related expenditures. However actual consumption impact may be less than what windfall income gains suggest as oil prices soften due to the following: 1) Because diesel is subsidized (now priced at ~Bt30/liter despite recent excise tax rebalancing and reduction in OPSF contribution) and accounts for >40% of petroleum production, retail diesel prices are unlikely to change as oil prices soften that undermine windfall income gains and effects; 2) Elevated household (HH) debt to GDP may compel deployment of a portion of windfall income gains to paying maturing debt. Persistent low interest rate setting amid a lofty HH debt stock may sustain severe dilution of HH net interest receipts (down to <1% of GDP starting 2007) and, as such, future debt service would compete with consumption in the HH budget allocation.

Declining oil prices ease THB overshooting risk past 32.70

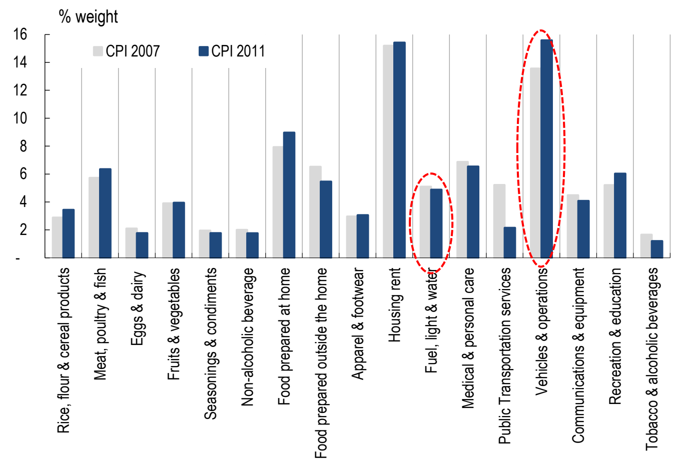
Among windfall macro gains expected in the current account, core CPI and real incomes due to softer oil prices, the potential trade surplus benefit would probably appeal more to market sentiment and thus curb THB's vulnerability to a strong USD – Windfall 'surplus' from lower oil prices helps relieve pressure on GIR in the event of strong USD demand and reduces risk of overshooting our Dec THB forecast of 32.70.

Figure 95. Fuel imports driven by oil prices rather than energy demand



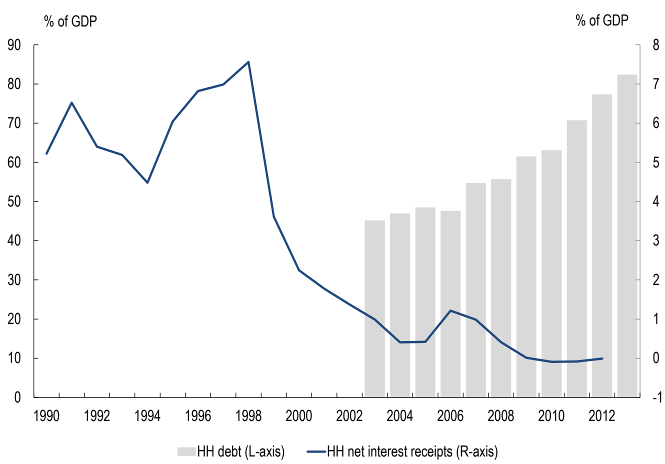
Source: CEIC, Citi Research

Figure 96. HH deploy >20% of their budget on energy



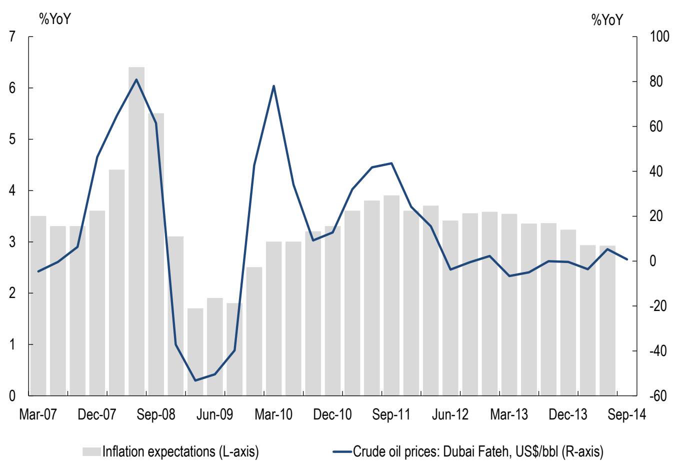
Source: CEIC, Citi Research

Figure 97. HH net interest receipts on the wane amid an elevated debt



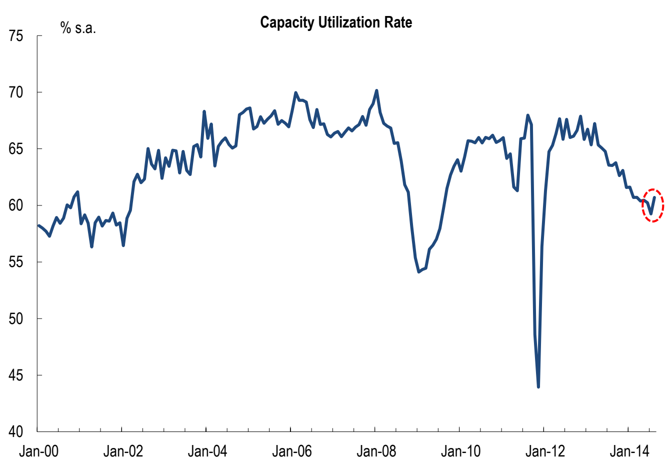
Source: CEIC, Citi Research

Figure 98. Inflation expectations tracking crude oil price movements



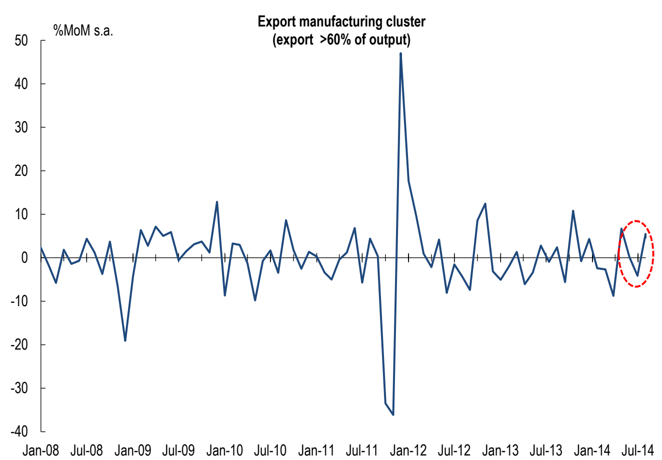
Source: CEIC, Citi Research

Figure 99. Capacity slack probably bottomed out in July



Source: CEIC, Citi Research

Figure 100. Mfg. exports posted MoM gains in Jul-Aug driven by tech



Source: CEIC, Citi Research

Figure 101. Thailand Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	265.2	276.1	263.8	319.3	346.1	366.4	387.8	376.1	396.2
Nominal GDP, local currency bn	8,525	9,080	9,042	10,105	10,540	11,375	11,899	12,270	12,944
GDP per capita, US$	4,207	4,355	4,153	4,998	5,401	5,685	5,987	5,777	6,056
Population, mn	63.0	63.4	63.5	63.9	64.1	64.5	64.8	65.1	65.4
Unemployment, % of labour force	1.4	1.4	1.5	1.0	0.7	0.7	0.7	0.8	0.8
Economic Activity									
Real GDP, % yoy	5.0	2.5	-2.3	7.8	0.1	6.5	2.9	1.1	3.9
Real investment growth % yoy	1.0	8.1	-25.2	28.7	0.1	16.8	2.2	-12.0	3.5
Real consumption growth % yoy	2.9	2.9	0.1	5.1	1.3	6.8	1.1	0.7	3.6
private consumption growth % yoy	1.8	2.9	-1.1	4.8	1.3	6.7	0.3	0.3	3.3
Real export growth, % yoy	7.8	5.1	-12.5	14.7	9.5	3.1	4.2	-0.2	3.8
Real import growth, % yoy	4.4	8.9	-21.5	21.5	13.7	6.2	2.3	-5.9	2.8
Prices, Money & Credit									
CPI, % yoy	3.1	0.4	3.5	3.1	3.5	3.6	1.7	1.3	2.0
CPI, % avg	2.2	5.5	-0.9	3.3	3.8	3.0	2.2	2.0	1.5
Nominal wages, % yoy	3.0	10.5	-1.9	5.8	7.2	11.9	7.9	4.0	3.5
Credit extension to private sector, % yoy	29.3	6.3	2.5	18.8	18.3	14.0	10.5	8.5	10.0
Policy interest rate, % eop	3.25	2.75	1.25	2.00	3.25	2.75	2.25	2.00	2.00
Short-term market rate, % eop	3.74	3.07	1.28	2.03	3.26	2.79	2.31	2.05	2.10
Long term yield, % eop	5.13	2.84	4.37	3.74	3.28	3.55	4.07	3.15	3.75
lc/US$, eop	30.05	34.79	33.36	30.07	31.57	30.60	32.70	32.74	32.87
lc/US$, avg	32.39	33.21	34.33	31.71	30.48	31.08	30.72	32.51	32.81
Balance of Payments, US$ bn									
Current account	15.7	2.2	21.9	10.0	8.9	-1.5	-2.5	15.5	12.4
% of GDP	5.9	0.8	8.3	3.1	2.6	-0.4	-0.6	4.1	3.1
Trade balance	26.6	17.3	32.6	29.8	17.0	6.0	6.7	24.5	21.6
Exports	151.3	175.2	150.8	191.6	219.1	225.9	225.4	221.4	230.3
Imports	124.6	157.9	118.2	161.9	202.1	219.9	218.7	196.9	208.7
Net service and Transfer accounts	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	3.7	-0.4	-0.8
Income balance	-3.0	-2.3	-4.4	-9.0	2.5	-4.0	-12.8	-8.6	-8.5
FDI, net	8.3	4.4	0.7	4.5	-2.8	-2.2	6.1	3.6	5.0
International reserves	87.5	111.0	138.4	172.1	175.1	181.6	167.3	170.0	180.0
Total Amortisations	20.3	15.4	11.3	9.4	8.8	9.5	18.0	19.0	20.0
Public Finances, % of GDP									
Consolidated government balance	-1.6	-1.0	-5.7	0.0	-1.0	-2.1	-1.8	-1.2	-1.8
Consolidated gov primary balance	-0.3	0.2	-4.5	1.1	-1.5	-1.6	-1.2	-0.3	-0.7
Public debt	38.3	37.3	45.2	42.6	41.7	45.4	45.9	47.2	48.1
of which Domestic	33.4	33.0	40.9	39.0	38.4	42.3	42.7	43.0	43.3
Foreign Assets & Liabilities, US$ bn									
External debt	74.4	76.1	75.3	100.6	104.3	130.7	139.8	151.9	156.8
Private	71.6	72.7	69.4	87.9	88.1	104.5	114.5	121.9	121.5
Public	2.8	3.4	5.9	12.7	16.2	26.2	25.2	30.0	35.3
External debt / GDP	28.1	27.6	28.5	31.5	30.1	35.7	36.0	40.4	39.6
External debt / XGS	41.0	36.5	41.6	44.5	40.0	47.5	49.1	55.9	55.4
Short-term debt	33.7	32.5	33.3	50.7	47.3	58.2	59.9	64.7	69.8
Short-term debt/International Reserves (%)	38.6	29.3	24.0	29.4	27.0	32.0	35.8	38.0	38.8

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	-0.6	0.4	1.8	2.8	3.4	3.9	4.1	4.3	4.4
CPI, % yoy	2.1	2.2	1.7	1.3	1.1	1.5	1.9	2.0	2.1
Policy interest rate, % eop	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.50
Short-term market rate, % eop	2.08	2.10	2.08	2.05	2.08	2.10	2.10	2.10	2.60
Long term yield, % eop	3.80	3.78	3.47	3.15	3.25	3.50	3.65	3.75	4.00
lc vs USD, eop	32.43	32.44	32.43	32.74	32.76	32.79	32.83	32.87	32.91

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

Frontier Asia

Mongolia

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A few noteworthy developments have taken place since we published our long trip notes, *UB Takeaways: Fixing the Economy with a Political Mandate*:

Mongolia to adopt gauge standards that suit its commodities customers – After six years of debate, the Parliament has decided that railroads that lead to the Chinese borders will be built on the Chinese narrow gauge track, while the horizontal & northbound tracks on broad gauge track. This decision took enormous political compromise as Mongolia's law requires all rails to use the broad gauge, but cost savings in transportation of coal to China could be as high as 50% if narrow gauge is used in southbound routes. The decision is good news to the Mongolian coal exporters and is FDI positive. The 267km railway currently being built between Tavan Tolgoi and Gashuun Sukhait is pending for this decision; and Mongolia seeks the remaining US$600-$800mn funding needed. Private investors (who have expressed initial interests) and bilateral funding would be willing to fund this rail, only if the investment makes economic sense (i.e. narrow gauge).

OT2 progresses – We continue to factor an OT2 deal in early 2015 and FDI in 4Q15E, in our base case. Rio Tinto has publicly expressed that the ball is now in the government's hands; the sticking point remains the same: shareholder issues, Phase I cost overrun and the US$30mn tax dispute. We see that economic hardship and closing-in of political timeline would pressure the government to close the deal. Small signs of good faith/governance from the government side have been seen: MoF repaid US$115mn matured treasury bills to Turquoise Hill in mid-Oct and MIGA documents (if signed would allow OT2 project financers to tap MIGA guarantees) were submitted for Parliament ratification late Oct.

Political scene is simmering ahead of Jun 2016 parliamentary elections – The merger of ministries and internal alignment of personnel may cause delays in actions such as the re-submitting of the 2015 fiscal budget (partly due to UB mayor's opposition), re-tendering of mining licenses and approval for mineral explorations.

Figure 102. Mongolia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	4.2	5.6	4.6	6.2	8.8	10.3	10.3	11.6	14.6
GDP per capita, US$	1,629	2,138	1,717	2,287	3,186	3,595	3,525	3,910	4,841
Population, mn	2.6	2.6	2.7	2.7	2.8	2.9	2.9	3.0	3.0
Real GDP, % yoy	10.2	8.9	-1.3	6.4	17.5	12.4	11.7	6.5	9.0
CPI, % yoy	15.1	22.1	4.2	13.0	10.2	14.0	12.5	14.0	12.5
CPI, % avg	--	28.0	8.0	10.1	9.2	14.3	10.5	13.4	13.0
Policy interest rate, % eop	8.40	9.75	10.00	11.00	12.25	13.25	10.50	13.00	13.50
Long term yield, % eop	21.83	20.58	21.67	20.07	16.61	18.11	18.48	19.70	21.10
lc/US$, eop	1,172	1,275	1,433	1,233	1,378	1,378	1,660	1,800	1,729
lc/US$, avg	1,171	1,167	1,434	1,349	1,256	1,353	1,505	1,808	1,755
Current account (US$ bn)	0.3	-0.7	-0.4	-0.9	-3.4	-3.2	-3.2	-1.8	-3.5
% of GDP	6.3	-12.8	-8.9	-15.0	-38.4	-30.9	-30.9	-15.8	-24.0
Trade balance (US$ bn)	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-2.1	-0.2	-1.6
Exports (US$ bn)	1.9	2.5	1.9	2.9	4.8	4.4	4.3	5.4	5.8
Imports (US$ bn)	2.2	3.2	2.1	3.2	6.6	6.7	6.4	5.6	7.4
FDI, net (US$ bn)	0.4	0.8	0.6	1.6	4.6	3.9	-2.1	1.1	2.6
International reserves (US$ bn)	0.8	0.6	1.3	2.2	2.3	3.9	2.2	1.9	3.6
Consolidated government balance (% of GDP)	2.6	-4.5	-5.2	0.5	-6.9	-9.9	-7.8	-7.9	-6.9
Public debt (% of GDP)	36.0	30.6	44.2	28.7	28.9	42.1	67.3	71.9	74.7
External debt (% of GDP)	41.1	38.8	65.1	95.7	109.9	149.2	184.1	175.4	149.9

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

Pakistan

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Some positive momentum in Pakistan this month as the Nawaz al Sharif's government moves forward on energy tariff reform, raising expectations of a simultaneous release of the fourth and fifth review tranches of the IMF $6.7bn loan – Having backed down from raising energy tariffs in August amid heightened political turmoil, the government quietly relented to IMF demands in October. This removes a key sticking point with the IMF, which had led to the delay of the fourth review in September. We currently expect the combined fourth and fifth review discussions to take place in Dubai in the coming days, with an announcement to be made some time around November 7, which is when the discussions are scheduled to end (The Nation, October 24).

Also positive was the announced end of the Tahirul Qadri's PAT sit-in in Islamabad – Although both Imran Khan's PTI and the PAT plan to carry out protests across the country, the announcement has contributed to a sense that the political crisis is receding. It remains to be seen, however, whether the decision to raise electricity tariffs (which will only be felt by consumers when they receive their November bills) will stoke further anti-government sentiment, which can be capitalized by the PAT and, especially, the PTI, which has made electricity rates a central theme of its protests.

We think the State Bank of Pakistan will keep interest rates at 10% for some time – Despite the pick-up of inflation in FY14, it remains relatively stable, and we expect it to ease in FY15. Notwithstanding recent uncertainties, real economic activity is gradually gaining traction and the external position is on an improving trajectory. While the SBP somewhat reluctantly raised rates in November 2013 to curb inflationary pressures and to relieve exchange rate pressure, the current political environment would not argue for a rate cut in the foreseeable future.

Figure 103. Pakistan Economic Indicators

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F
Summary Data									
Nominal GDP, US$ bn	152.4	169.7	167.1	176.7	212.4	221.7	229.6	243.1	258.0
GDP per capita, US$	964	1,031	994	1,029	1,211	1,239	1,258	1,305	1,357
Population, mn	158.2	164.7	168.2	171.7	175.3	178.9	182.5	186.3	190.1
Real GDP, % yoy	4.8	1.7	2.8	1.6	2.7	3.5	4.4	5.4	4.5
CPI, % yoy	7.0	21.5	11.0	11.8	13.3	11.3	5.9	8.2	8.0
CPI, % avg	7.8	12.0	19.6	10.1	13.7	11.0	7.4	8.6	7.5
Policy interest rate, % eop	9.50	12.00	14.00	12.50	14.00	12.00	9.00	10.00	10.00
Long term yield, % eop	--	--	--	--	--	--	--	--	--
lc/US$, eop	61.7	79.1	84.4	85.7	89.9	97.3	105.4	98.8	103.6
lc/US$, avg	60.8	69.9	81.5	85.2	86.4	93.3	101.4	103.2	104.5
Current account (US$ bn)	-6.9	-13.9	-9.3	-3.9	0.2	-4.7	-2.5	-3.0	-2.3
% of GDP	-4.5	-8.2	-5.5	-2.2	0.1	-2.1	-1.1	-1.2	-0.9
Trade balance (US$ bn)	-9.6	-14.8	-12.5	-11.5	-10.4	-15.7	-15.4	-16.5	-17.3
Exports (US$ bn)	17.3	20.4	19.1	19.7	25.4	24.7	24.8	25.2	25.9
Imports (US$ bn)	26.9	35.3	31.7	31.1	35.8	40.4	40.2	41.7	43.2
FDI, net (US$ bn)	-5.0	-5.3	-3.7	-2.1	-1.6	-0.7	-1.3	-1.5	2.9
International reserves (US$ bn)	15.2	11.1	11.6	15.1	17.7	14.2	8.0	11.2	11.2
Consolidated government balance (% of GDP)	-4.1	-7.3	-5.2	-6.2	-6.6	-6.9	-8.2	-5.5	-6.2
Public debt (% of GDP)	50.9	53.9	51.6	51.7	56.1	60.3	63.0	65.3	67.8
External debt (% of GDP)	26.5	27.2	31.3	34.8	31.2	29.5	26.5	27.0	28.0

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

Sri Lanka

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Growth will likely be strong in the run-up to the next Presidential snap polls – Domestic liquidity remains ample, further boosted by CBSL's recent action to limit the access to its Standing Deposit Facility (SDF), which we think would further support expansion of private sector credit. Last month's fuel and electricity cut, on top of already very benign inflation, should continue to underpin consumption, and *eventually* lead CBSL to cut rates by 50bps in the coming months to be in line with already collapsing market rates. Investment still looks relatively strong, with FDI (inflows) up substantially (+55%YoY in Jan-Aug). Trade data show a very pronounced rebound in non-oil imports led by consumer and intermediate goods.

After a sharp CA deficit reduction in 2Q14, trade deficit begun to widen recently – The rupee has been under some modest pressure both due to a sharp rise in import demand since July (with widening trade deficit) and about US$200mn of unwind in foreign holdings of rupee Treasury securities prompted by profit-taking. With FX reserve coverage still below 1x ST debt by remaining maturity, Sri Lanka's external liquidity position is the weakest among EM Asia, but a much narrower CA deficit this year (further aided by lower oil prices), persistently lower US rates and diversified external funding sources should help contain the damage.

The 2015F budget speech had strong pre-election overtones – It aims to reduce the budget deficit to 4.6% of GDP (vs. 5.2% of GDP target in 2014F) but we again think this relies on optimistic revenue growth and real GDP growth assumption, and government will have to rely on spending cutbacks to keep the deficit contained, as what happened in Jan-Sep fiscal numbers. There were limited revenue enhancement measures for 2015F, while a host of more "populist" on-budget (and off-budget) spending plan was announced, including a minimum public servant salary hike, interest free loans for public servants, providing pension scheme and raising paddy price support for farmers, providing a fixed 12% deposit rate for senior citizens at state banks, raising EPF contributions from employers by 2ppts to 14%, a 10% cut in water rates for households, extending the 25% electricity cut to SMEs, and a 15% cut for other industries effective Nov 2014.

Figure 104. Sri Lanka Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	32.4	40.7	42.1	49.6	59.2	59.4	67.2	74.1	84.4
GDP per capita, US$	1,615	2,011	2,055	2,400	2,836	2,920	3,281	3,590	4,055
Population, mn	20.0	20.2	20.5	20.7	20.9	20.3	20.5	20.6	20.8
Real GDP, % yoy	6.8	6.0	3.5	8.0	8.2	6.3	7.3	7.7	7.5
CPI, % yoy	18.7	13.9	5.0	6.8	4.9	9.2	4.7	4.1	5.9
CPI, % avg	15.8	22.6	3.6	6.2	6.7	7.5	6.9	3.7	5.5
Policy interest rate, % eop	11.50	12.00	12.00	9.75	9.00	8.50	9.50	8.00	8.00
Long term yield, % eop	19.96	19.08	19.20	11.54	9.24	10.00	11.93	9.50	9.00
lc/US$, eop	108.7	113.0	114.4	110.9	113.9	127.7	130.8	130.0	129.0
lc/US$, avg	110.6	108.3	114.9	113.0	110.5	127.2	129.1	130.4	129.4
Current account (US$ bn)	-1.4	-3.9	-0.2	-1.4	-4.6	-4.0	-2.6	-2.0	-2.1
% of GDP	-4.3	-9.5	-0.5	-2.8	-7.8	-6.7	-3.9	-2.7	-2.5
Trade balance (US$ bn)	-3.7	-6.0	-3.1	-5.2	-9.7	-9.4	-7.6	-7.4	-7.8
Exports (US$ bn)	7.6	8.1	7.1	8.3	10.6	9.8	10.4	11.7	12.6
Imports (US$ bn)	11.3	14.1	10.2	13.5	20.3	19.2	18.0	19.0	20.4
FDI, net (US$ bn)	0.5	0.7	0.4	0.4	0.9	0.9	0.9	1.1	1.0
International reserves (US$ bn)	3.1	1.8	5.1	6.6	6.0	6.9	7.2	8.8	10.1
Consolidated government balance (% of GDP)	-246.4	-309.6	-476.2	-446.0	-450.2	-489.0	-5.9	-5.4	-5.0
Public debt (% of GDP)	85.0	81.4	86.1	81.9	78.5	79.2	78.3	75.9	74.0
External debt (% of GDP)	50.9	43.6	49.7	50.1	55.3	62.5	59.1	55.8	56.9

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

Vietnam

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Growth in the third quarter surprised strongly – we nudge our forecast slightly higher – Real GDP expanded to a surprisingly strong 6.4% YoY in the 3Q (5.6% ytd) with exports and (foreign) investments boosting industrial sector while services rebounded following 2Q slump. Industrial production has been improving steadily since April, driven by external demand and improved production capacity amid resilient foreign investment, which now accounts for about 70% of export growth ytd. Easing Sino-Vietnam tensions, prolonged macro stability as well as competitive cost base should continue to make Vietnam attractive for manufacturing-based FDI. However, amid entry of foreign firms, bank sector challenges and lingering SOE inefficiencies, domestic firms are facing a tough environment, contributing to a still anemic domestic demand and rising bankruptcies. Nonetheless, this dual-track economy should still be able to achieve about 5.7% and 5.9% growth in 2014F and 2015F respectively.

The conclusion of two major Free Trade Agreements (FTAs) will be key growth drivers – Vietnam is in the middle of finalizing a FTA with EU and Korea, its 2nd and 4th largest trading partner (with Korea being among its fastest growing trading partners amid production relocation activities), with the aim of concluding negotiations by year-end. We see this as further catalysts for attracting FDI, facilitating more supply chain networks and making Vietnam more competitive.

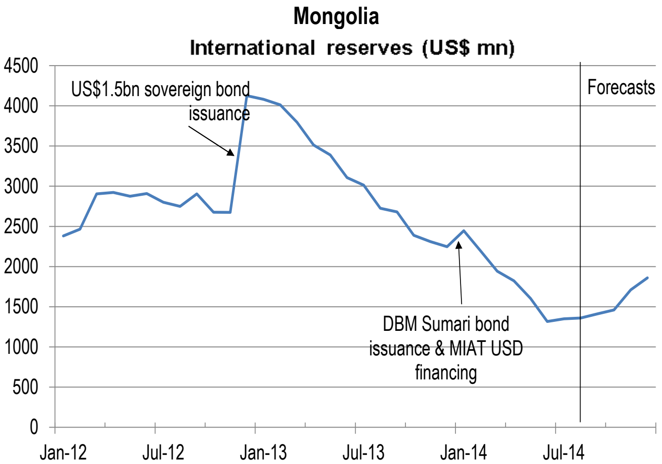
Eroding fiscal space and slow structural reforms could inhibit positive spillovers to the domestic economy – Weak tax revenues are causing deficits to exceed their targets and public debt to rise steadily. NPL resolution remains slow as ability of VAMC to dispose of bad loans face legal hurdles. The delayed implementation of tougher bank loan classification and provisioning requirements (Circular 02) to April 2015 will be key to watch. SOE equitizations have picked up in recent months and large SOE IPOs have begun with Vinatex in Sep (Vietnam Airlines in Nov), but with only partial/minority stake divestments, limited foreign participation and lack of transparency, catalyst for significant and transformational improvement in SOE performance is still lacking.

Figure 105. Vietnam Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	71.1	90.3	93.1	103.5	122.8	141.4	154.6	166.8	184.1
GDP per capita, US$	844	1,061	1,083	1,191	1,398	1,592	1,723	1,843	2,016
Population, mn	84.2	85.1	86.0	86.9	87.8	88.8	89.7	90.5	91.3
Real GDP, % yoy	7.1	5.7	5.4	6.4	6.2	5.2	5.4	5.7	5.9
CPI, % yoy	12.6	19.9	6.5	11.8	18.1	6.8	6.0	3.5	6.3
CPI, % avg	8.3	23.1	7.0	9.2	18.6	9.3	6.6	3.3	5.8
Policy interest rate, % eop	6.50	9.50	8.00	9.00	15.00	9.00	7.00	6.50	6.00
Long term yield, % eop	8.73	10.00	11.68	11.49	12.55	9.75	9.29	5.25	6.50
lc/US$, eop	16,028	17,483	18,474	19,498	21,034	20,840	21,095	21,334	21,547
lc/US$, avg	16,081	16,445	17,806	19,123	20,648	20,875	21,028	21,248	21,494
Current account (US$ bn)	-7.1	-10.8	-6.6	-4.3	0.2	9.3	9.5	8.3	7.4
% of GDP	-10.0	-12.0	-7.1	-4.1	0.2	6.6	6.1	5.0	4.0
Trade balance (US$ bn)	-10.4	-12.8	-7.6	-5.1	-0.5	8.7	8.7	11.1	9.7
Exports (US$ bn)	48.6	62.7	57.1	72.2	96.9	114.5	132.1	149.3	167.2
Imports (US$ bn)	59.0	75.5	64.7	77.4	97.4	105.8	123.4	138.2	157.6
FDI, net (US$ bn)	6.5	9.3	6.9	7.1	6.6	7.2	6.9	7.0	7.2
International reserves (US$ bn)	23.5	23.9	16.4	12.5	13.5	25.6	25.9	37.4	48.3
Consolidated government balance (% of GDP)	-3.6	-2.2	-7.2	-3.0	-3.2	-4.8	-5.6	-6.4	-6.0
Public debt (% of GDP)	40.9	39.4	46.9	41.2	39.7	38.2	41.4	44.6	46.3
External debt (% of GDP)	37.6	33.8	39.9	41.5	41.8	41.9	42.4	42.3	--

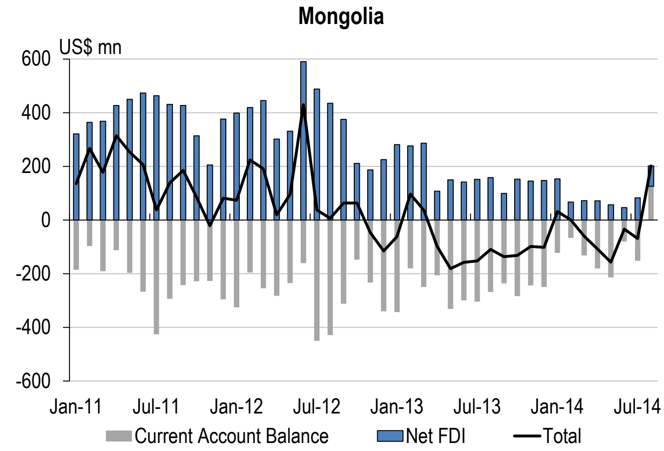
Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and Citi Research estimates

Figure 106. Mongolia – FX reserves to rise on foreign borrowings



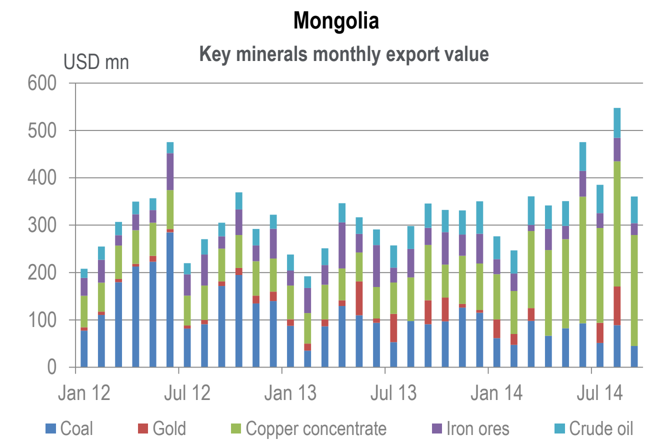
Source: BoM, CEIC and Citi Research

Figure 107. Net FDI and CA improvements lowers BOP concerns



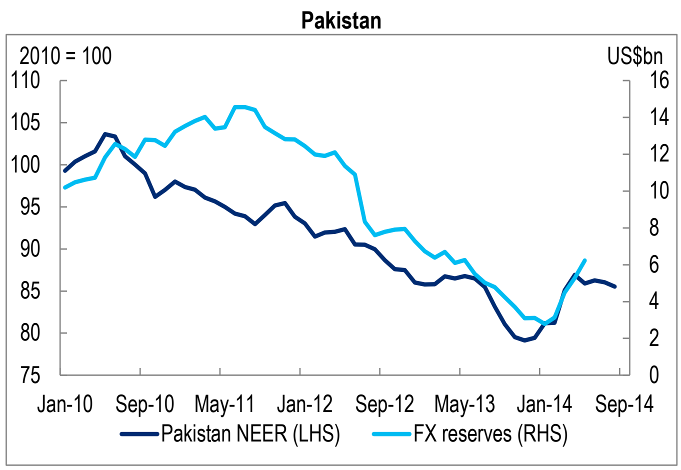
Source: BoM, CEIC and Citi Research

Figure 108. Copper exports driving CA improvements



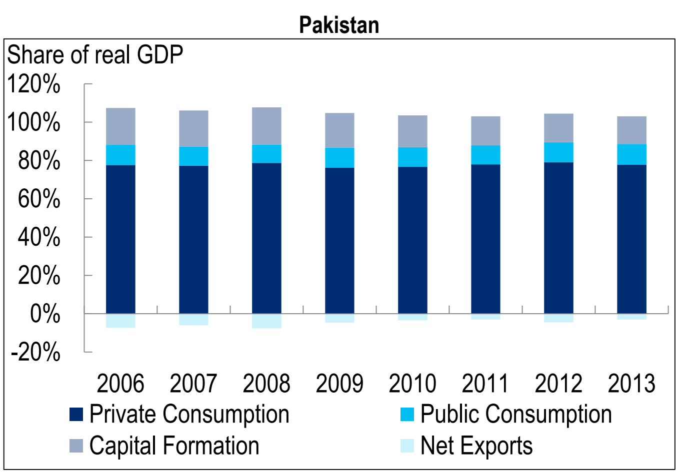
Source: CEIC and Citi Research

Figure 109. Pakistan – Reserves rebuilding on back of rupee strength



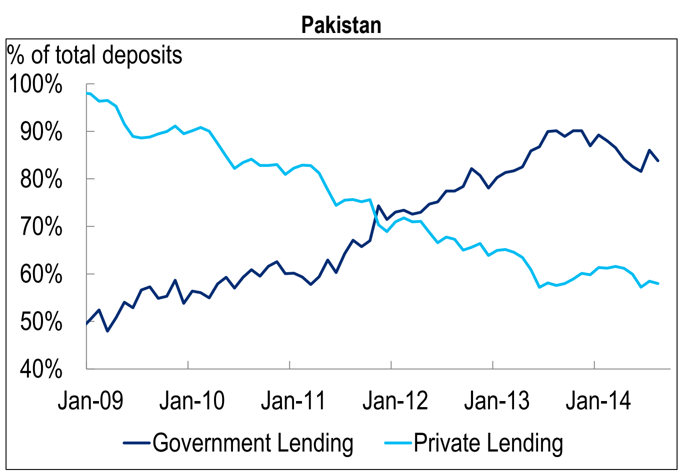
Source: Haver Analytics, Citi Research

Figure 110. While the private sector drives economic growth



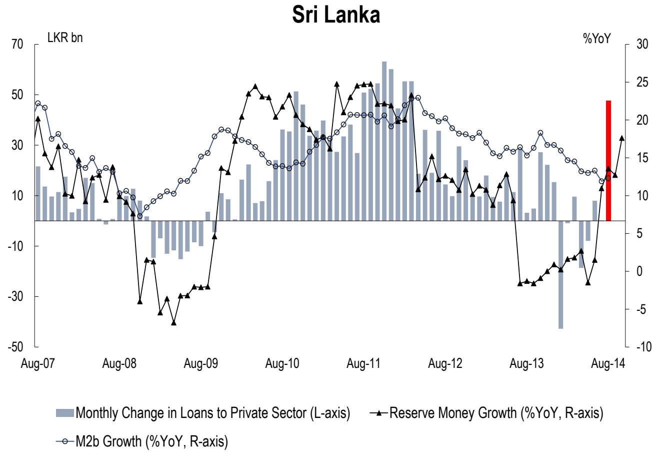
Source: Haver Analytics, Citi Research

Figure 111. The government has been crowding out private sector credit



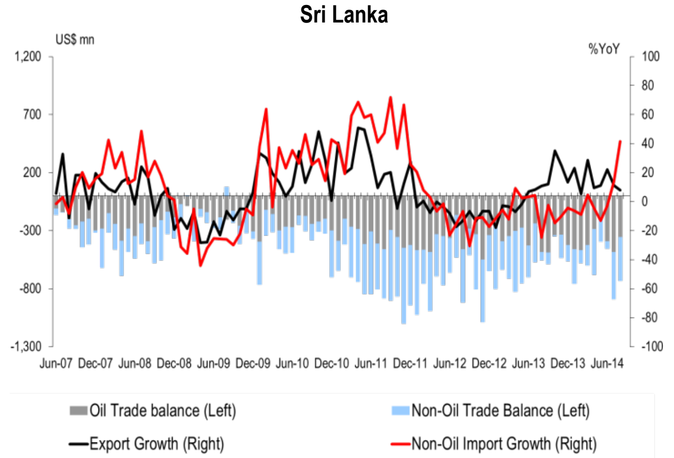
Source: Haver Analytics, Citi Research

Figure 112. Sri Lanka – Early signs of a private sector credit revival amid very abundant liquidity



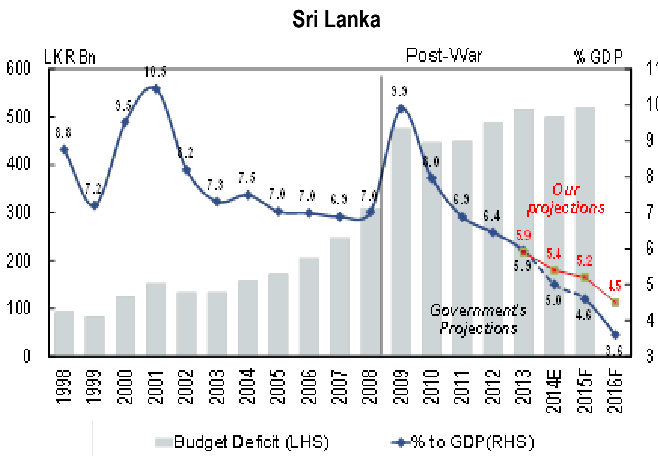
Source: CBSL, CEIC, Citi Research

Figure 113. Sharp pick-up in non-oil imports amid strong demand bears some watching



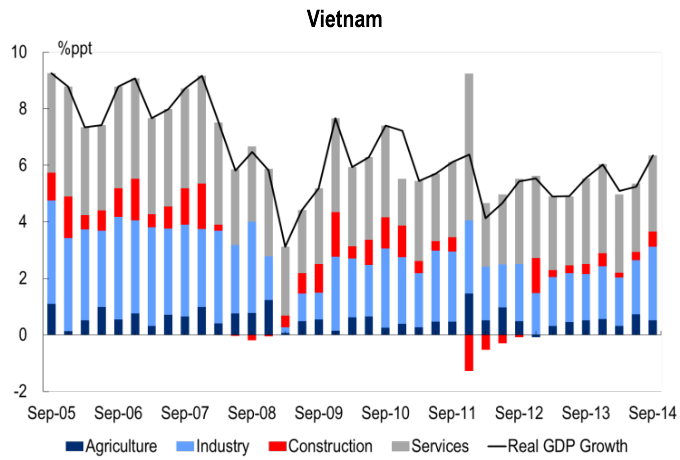
Source: CEIC, Citi Research

Figure 114. Fiscal consolidation plan of the government



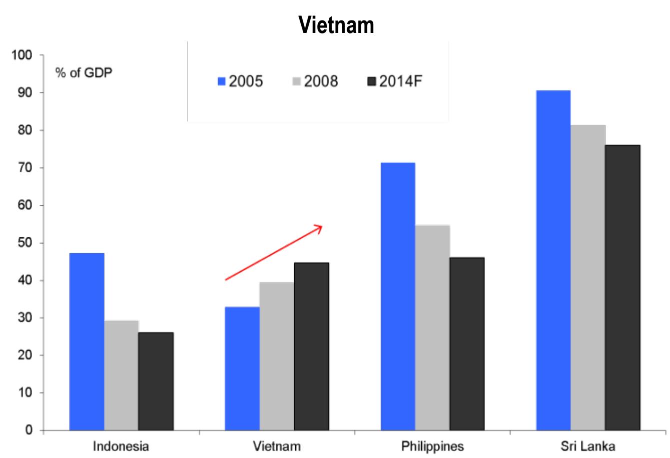
Source: Ministry of Finance, CEIC, Citi Research

Figure 115. Vietnam – Real GDP Growth is rebounding steadily



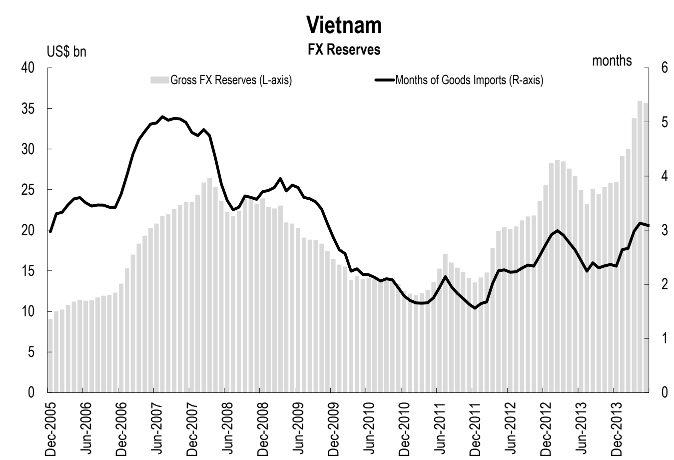
Source: CEIC, Citi Research

Figure 116. Rising government debt ratio (% of GDP)



Source: CEIC, Citi Research

Figure 117. Rising trend of FX reserves



Source: CEIC, Citi Research

CEEMEA

Czech Republic

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- **Summary view** — Western European demand is proving to be a larger risk for Czech recovery than Ukraine-Russia conflict. However, Czech confidence indicators have continued to outperform peers and October confidence reached a 3¾-year high, which is consistent with GDP growth at 2.7%YoY in 4Q14 after an implied 2.4% in 3Q14. Despite this, we keep our GDP growth forecast at 2.4%YoY in 2014 and 2015 due to different reasons. However, weaker economic activity and lower oil prices lead to cuts in our CPI forecast for 2015.

- **Things to watch** — August drop in industrial production was most likely related to holiday effect, as car production recovered in September. The impact of current external disinflationary risks on CNB's policy will depend on resilience of local inflationary pressures that should intensify in 4Q14 according to the latest CNB's forecast. We do not expect meaningful changes to fiscal budget proposal for 2015 in the Lower House.

- **Strategy** — EURCZK is likely to be virtually unchanged on 0-3m, but we expect to be more volatile. Outlook on lower Bund yield is likely to move the Czech bond 10y yield below 1% in 4Q14, though we assume slightly wider benchmark spread due to liquidity premium. We see a risk of later CNB's exit from its FX intervention mode vs. our expectation of mid-2016 with the first hike in 3Q16.

Growth miracle or just a temporary mirage?

Though downside risks increased, the Czech economic recovery is likely to continue. Though Czech industry showed a similar drop in industrial production as regional peers in August, there are signs that the drop in production was more related to holidays in the car sector (Aug-14 vs. Jul-13). First, the reported car production has returned to 20%YoY in September from -22% a month ago. Second, the cars' export sales accelerated during summer months. Hence, this suggests to us that Czech industry is likely continue to grow as also indicated by outperforming confidence indicators. Moreover, despite the drop in industrial production, our momentum indicator remained stable in August and is consistent with a mild increase in GDP, which is in line with our forecast of 0.3%QoQ in 3Q14. However, this would require ongoing improvement in September retail sales after they posted solid outturn in August, mainly in the core segment.

We keep our forecast GDP growths at 2.4%YoY in both 2014 and 2015 due to different reasons. Though we assume a weaker outlook on foreign demand in the rest of 2014 and in 2015, it is somewhat compensated by a slightly weaker outlook on Czech koruna. However, and more important, the Czech domestic consumption has been stronger due to new ESA 2010 than previously believed. Moreover, the quarterly dynamics – with 0.5%QoQ in the value added in 2Q14 – remained solid. For 2015, while the foreign demand outlook is weaker, a more benign base effect from 1H14 represented an upside risk to our previous forecast. Having said this we cut both 2014 and 2015 export growth forecast, which we, however, assume to accelerate in 2016 and onwards, though it is likely to remain below double-digit growth. But it will be enough to support industrial production growth close to 5%YoY and be supportive for the investment activity. This we expect to be also supported by government spending, but this we see a downside risk here if Czech Republic continues to disappoint in the utilization of the EU funds also in new EU budget period.

Growth and commodities disinflationary, FX inflationary

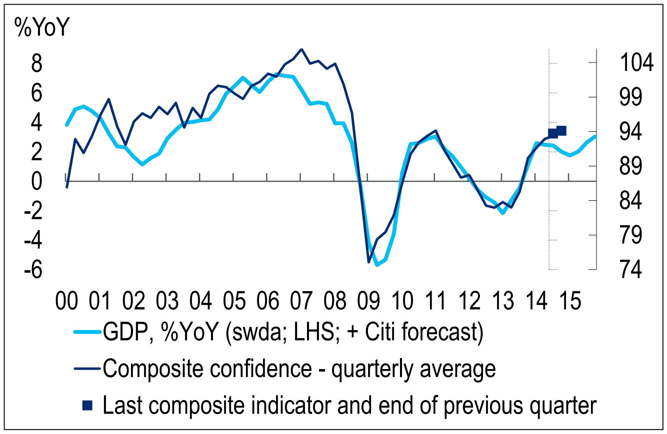
Larger disinflation in the Euro area, ECB behind a curve and lower foreign demand outlook are likely to make the CNB more nervous though it has been so far happy with its EURCZK floor. While the previous forecast showed the growth outlook as disinflationary, it is now accompanied with lower oil prices, while food price outlook somewhat increased and koruna forecast has remained weak. This combination, and further decrease on power electricity prices, lead to us to lower CPI forecast to 1.3%YoY in 2015 from 1.6% previously. If the disinflationary pressures from the Euro area continue and the recovery in domestic demand is not enough, the CNB is likely to talk and thing more about another round of monetary easing. However, this will be a function of local fiscal policy (proposed to be expansionary, but actually designed to be somewhat less expansionary) and ECB policy. If ECB delivers more QE, CNB is likely to keep current policy that means if there are new mild disinflationary pressures, the CNB's reaction equals to the later exit from the FX intervention mode (we forecast mid 2016). If ECB does not deliver, the CNB would have to deliver something. For the time being the FX intervention remain the first option as QE and qualitative easing does not look reasonable for them. The Bank Board does not have a sympathy for the negative policy rate (though, they do not usually rule out this option as a tool for fine tuning to ease the pressure on the FX intervention programme if there are appreciation pressures on koruna if the ECB delivers more QE). Overall, we see a risk of later CNB's exit from its FX intervention mode vs. our expectation of mid-2016 with the first hike in 3Q16.

Though we assume the EURCZK to be virtually unchanged in the short-run, we do not rule out its volatility. On the one hand, disinflationary risks to CNB's inflation forecast seem to be rising reflecting both lower oil prices and lower foreign demand outlook, of which the second could lead to further postponement of the exit from the CNB's FX intervention mode. This could increase market expectations of a hike in the EURCZK floor from current 27+. On the other hand, our expectation of ECB's QE in 4Q14/1Q15 should be supportive for the koruna. Nevertheless, our outlook on tighter US monetary policy in 2H15 in combination with an upward pressure on koruna from the USD leg, suggest the koruna to weaken on mid-term horizon. While we assume the koruna to be stronger on 2year outlook due to a stronger economic recovery and particularly to the CNB's exit from the FX intervention mode in mid-2016, our forecast of further strength of US dollar represents a risk to this view.

MinFin's supply of bonds in 2015 will be supportive

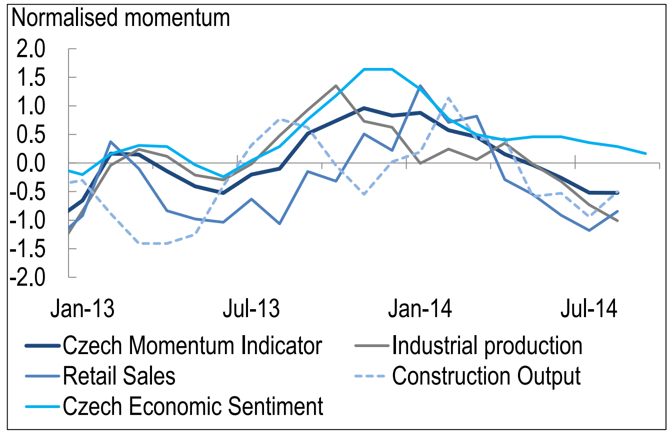
MinFin does plan to issue any bonds in November 2014. This suggests the MinFin expects a narrower state cash deficit than CZK80bn in 2014, while September data suggests to us to expect the central government deficit e between CZK73-97bn in 2014. December issuance seems to be unlikely unless we see a strong demand of investor to continue in the buyback programme. Our September clients' meeting with MinFin confirms its plan to cover the deficit in 2015 (proposed at CZK100bn) by the sources from the Single Treasury Account, maybe also (at least partly) in 2016 if MinFin manages to enlarge the Single treasury account by more public entities to be obliged to participate or by more effective cash pooling. MinFin bond redemption will reach CZK140bn in 2015, of which 86% are local bonds (CZK59bn in Apr15 and CZK61bn in Sep15), followed by local euro denominated bonds (CZK8bn in Oct15) and retail bonds (CZK12bn in Dec). Though we assume lower retail issuance in 2015, any Eurobond issuance in 2015 larger than CZK15bn could make local tradable issuance negative in net terms, if the MinFin's plan to use cash from the STA materializes.

Figure 118. October confidence represents an upside risk to our GDP forecast



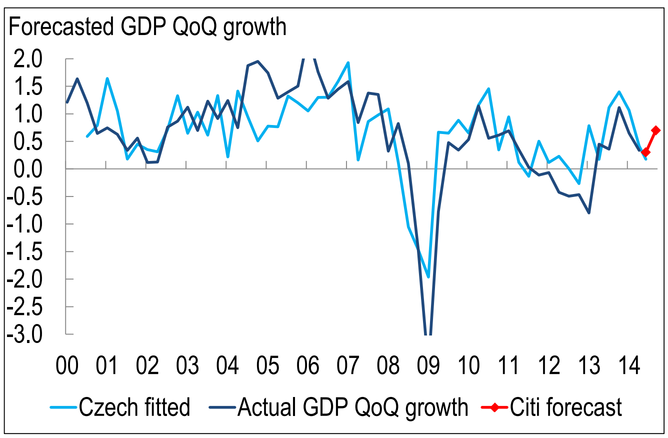
Source: CZSO, Citi Research forecast

Figure 119. Momentum indicator has stabilized in August …



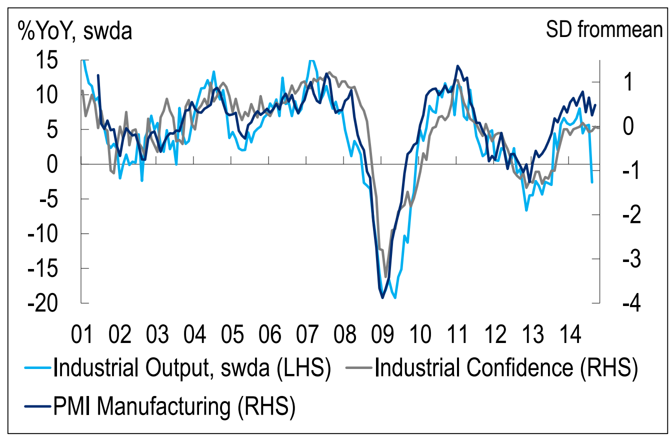
Source: CZSO, Eurostat, Citi Research calculation

Figure 120. … and seems to be in line with our GDP forecast



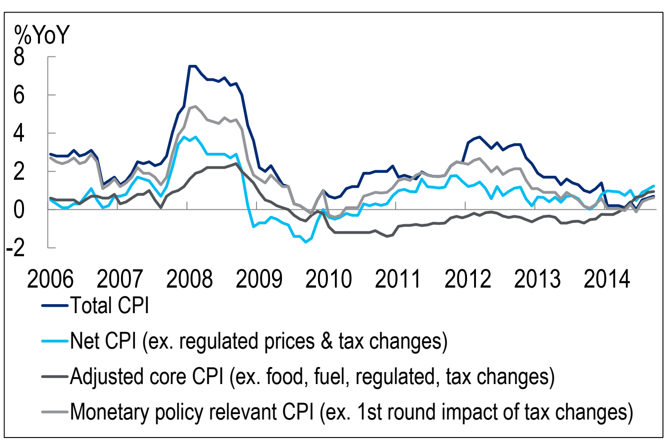
Source: CZSO, Eurostat, Citi Research calculation and forecast

Figure 121. Confidence still suggests around 5-6% industrial growth



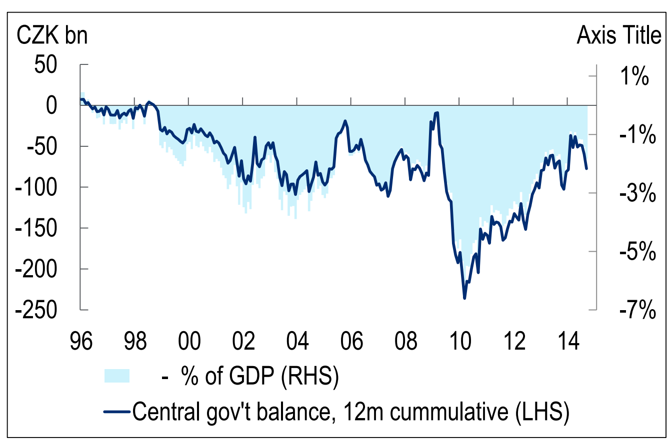
Source: CZSO, Haver Analytics, Citi Research calculation

Figure 122. Headline inflation is above the CNB forecast, core was just a tick below in September



Source: CNB, CZSO, Citi Research calculation

Figure 123. September data suggests to us to expect the central government deficit e between CZK73-97bn in 2014



Source: Haver Analyitcs, Citi Research calculation

Figure 124. Czech Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	189	235	206	207	227	207	209	219	217
Nominal GDP, local currency bn	3,832	4,015	3,922	3,954	4,022	4,048	4,086	4,290	4,482
GDP per capita, USD	18,292	22,552	19,609	19,684	21,655	19,673	19,865	20,834	20,573
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	6.9	6.3	6.1
Economic Activity									
Real GDP, yoy avg	5.5	2.7	-4.8	2.0	2.2	-0.8	-0.7	2.4	2.4
Real investment growth % yoy	14.4	1.2	-18.1	4.4	1.9	-3.7	-5.1	5.4	5.4
Real consumption growth % yoy	3.0	2.4	0.4	0.8	-0.7	-1.5	0.9	1.7	2.0
private consumption growth % yoy	4.1	2.9	-0.7	1.0	0.2	-1.8	0.4	1.9	2.2
Real export growth, % yoy	11.0	4.2	-9.8	14.8	9.3	4.1	0.3	8.5	5.6
Real import growth, % yoy	12.8	3.2	-11.0	14.9	6.7	2.4	0.3	9.1	6.3
Prices, Money & Credit									
CPI, % yoy eop	5.5	3.6	1.0	2.3	2.4	2.4	1.4	0.7	1.6
CPI, % avg	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.4	1.3
Nominal wages, % yoy	7.2	7.9	3.4	2.2	2.5	2.5	0.0	3.1	3.5
Credit extension to private sector, % yoy	26.6	16.1	0.8	3.0	5.5	2.6	3.7	4.4	8.8
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	0.29	0.25	0.25
Long-term yield, %, eop	4.64	4.15	4.01	3.86	3.69	1.90	2.30	0.90	1.40
CZK/US$, eop	18.2	19.2	18.4	18.7	19.8	19.0	19.9	22.7	24.4
CZK/US$, avg	20.2	17.0	19.0	19.1	17.7	19.5	19.6	21.0	24.1
CZK/EUR, eop	26.5	26.8	26.4	25.0	25.6	25.1	27.3	27.6	27.6
CZK/EUR, avg	27.8	25.0	26.4	25.3	24.6	25.1	26.0	27.5	27.8
Balance of Payments, USD bn									
Current account	-7.9	-4.8	-4.8	-7.6	-6.3	-2.5	-2.9	0.0	-1.7
% of GDP	-4.2	-2.0	-2.4	-3.7	-2.8	-1.2	-1.4	0.0	-0.8
Trade balance	2.2	1.7	4.6	2.8	5.3	7.6	9.6	11.7	11.3
Exports	106.5	125.1	99.1	114.0	138.5	132.7	135.6	147.1	138.2
Imports	104.3	123.4	94.6	111.2	133.2	125.1	126.0	135.4	126.9
Service balance	2.9	4.4	3.9	3.9	3.8	3.2	2.7	3.4	3.2
Income balance	-12.7	-10.6	-13.2	-14.8	-15.6	-13.2	-16.0	-16.1	-15.7
FDI, net	9.0	2.3	2.0	4.9	4.2	6.2	1.7	7.1	5.3
International reserves	34.4	36.5	39.7	40.3	37.9	42.4	53.9	52.9	52.7
Total amortisations	4.0	4.2	6.2	5.4	8.6	5.4	7.4	7.3	7.2
Public Finances, % of GDP									
Consolidated government balance	-0.7	-2.1	-5.5	-4.4	-2.9	-4.0	-1.3	-1.9	-2.3
Consolidated gov primary balance	0.4	-1.1	-4.3	-3.1	-1.5	-2.5	0.0	-0.2	-1.4
Public debt	27.8	28.7	34.1	38.2	41.0	45.5	45.7	43.8	42.0
of which Domestic	18.4	18.5	20.3	23.2	24.3	32.9	29.8	28.8	28.4
Foreign Assets & Liabilities, USD bn									
External debt	76.2	84.2	89.2	94.2	94.2	102.5	111.3	104.9	113.9
Public	15.0	15.3	19.8	24.0	22.6	28.3	30.2	25.9	29.9
External debt / GDP	40.4	35.8	43.4	45.5	41.4	49.6	53.3	47.9	52.6
External debt / XGS	61.5	57.3	75.3	69.8	58.3	65.9	70.5	60.9	70.1
Short-term debt	22.6	27.1	23.9	23.6	27.1	24.1	29.4	36.0	39.0
Short-term debt/International reserves (%)	65.5	74.2	60.2	58.5	71.5	56.8	54.6	68.1	74.1

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	2.7	2.9	2.8	2.0	1.7	2.0	2.6	3.0	3.3
CPI, % yoy eop	0.2	0.0	0.8	0.7	1.0	1.3	1.6	1.6	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	0.27	0.27	0.27	0.25	0.25	0.25	0.25	0.25	0.25
Long-term yield, %, eop	2.18	1.55	1.20	0.90	1.09	1.21	1.34	1.40	0.53
CZK/EUR, eop	27.46	27.45	27.50	27.59	27.80	28.02	27.89	27.63	27.38

Source: National Sources, Citi Research forecasts

Egypt

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- **Summary view** — The new president will push ahead with three major goals: improving the security situation; consolidating his power base prior to the parliamentary elections; and putting in place policies to kick start the economy.
- **Things to watch** — Gulf support has helped stabilize the exchange rate and eased, but not eliminated, foreign exchange shortages. But the fragility of the exchange rate is clear from the weakening of EGP in April and May 2014.
- **Strategy** — The broad outlines of a new policy direction are now possible to discern, but a key element will remain the level of Gulf support available to part fund a big push in capital spending. This could morph into a more coherent economic policy with a medium term strategy to reduce the fiscal deficit.

Improving security, consolidating political power

Following his victory in the May presidential election, Abdelfattah el Sisi will now focus his attention on three issues. The first, which draws mostly on his military background, will be to restore the security situation in the country, notably in the Sinai. This is arguably not only important as part of the country's economic recovery, but a key plank in maintaining popularity.

Part of this will be the ongoing clampdown on the Muslim Brotherhood (MB). But pushing the MB underground raises the risk of returning to the low level insurgency of the 1990s. But the clampdown will also be wider, against all forms of dissent, although the president is keen to keep some elements of the Islamist political community on side to preserve his wider political legitimacy.

The president also seems to be building a wider political power base capable of performing well in parliamentary elections. Given the weak and fragmented nature of the current political parties, none looks as if it can mount a successful campaign to secure a parliamentary majority. But with a new parties being formed by supporters of the president, and ex-military figures, coupled with his ability to appoint MPs, he should be able to construct a supportive parliamentary alliance when elections are held in late 2014, or more likely 1H 2015.

A technocratic approach to policy too start with

Since his election, there have been increasing indications on the overall direction on economic policy, with the third goal of the president being the need to kick-start the economy. The initial thrust in this respect has been relatively technocratic, with the president insisting on greater fiscal consolidation than proposed in the initial 2014/15 budget and also making an early start on addressing the thorny questions of subsidies, by increasing fuel prices for both petrol and industries on July 5.

This step is clearly a medium term positive, and seems to have had faced little political backlash to date. But it is clear it also has short term costs, as shown by the sharp jump in inflation in July. We expect inflation to remain elevated in the 10-13% range until mid-2015 as a result. But this level is probably insufficient to push the CBE into a further rate rise after the 100 basis point rise in the overnight deposit rate to 9.25% in July. The CBE still seems quite comfortable with negative real interest rates given the weak growth and investment environment, although this stance would probably change if the economy showed greater signs of recovery.

Boosting growth, with social justice

But while fiscal reform is a medium term positive for the economy, despite the shorter term economic consequences, the real challenge for the government is to boost growth. And while an improvement in the security environment and the end of political uncertainty will help this, it will not be sufficient. Instead, the government will have to push ahead with a more ambitious growth agenda.

This is likely to focus on both large domestic mega projects, such as around the Suez canal, while stressing the need for growth with social justice. This latter element is likely to have symbolic elements, such as raising taxes on the richer segments of society, although only a more significant implementation of VAT is likely to have a major impact on the revenue side. And it will also have a practical side with some focus on projects such as the building of low-cost housing or improving health and education facilities in the country.

The key questions in this respect are who will fund the programme and will it boost job creation? Certainly initially, we expect ongoing support from Gulf states to be important. But it will not be open ended and we expect the Saudi Arabia and the Egyptian government to continue to push for a much wider investor and donor conference – this is currently expected to be held in February 2015. It is also not clear to what extent the investment push will boost job creation directly given that army is one of the few institutions in the country which has the logistical capacity to support the ambitious investment agenda.

A formal reform programme may emerge

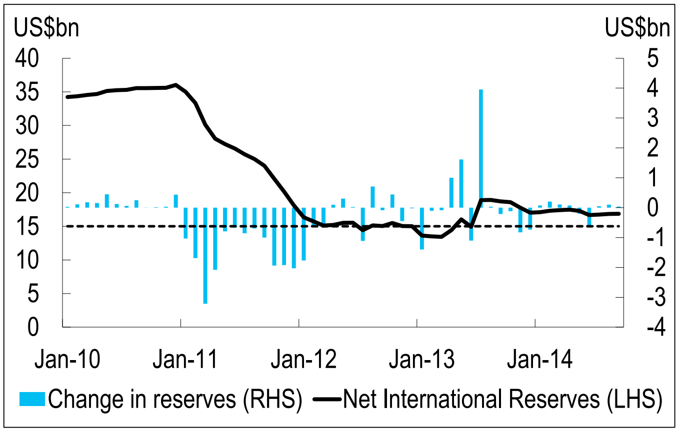
What we would also expect, is that over time these broad themes could potentially be brought together in a more formal home-grown economic reform programme. Essentially, this will be a programme of gradual fiscal consolidation, based around subsidy reform and raising more revenue. But with additional underpinning themes: the involvement of the military; growth yes, but with social justice; the need for many to make a sacrifice to support growth; and finally, probably a strong anti-corruption strand.

Only when this full home-grown reform programme has been running for some time, do we think that the government will open negotiations with the IMF to possibly agree on a more formal programme. And given the political constraints even a formal programme may be too controversial, with the IMF only providing a stamp of approval to the home grown programme through a Precautionary and Liquidity Line (PLL) as was the case with Morocco in 2012. In the meantime, the government will continue to use the IMF to help technical aspects of reform such as the introduction of VAT or subsidy reform.

The need for reality

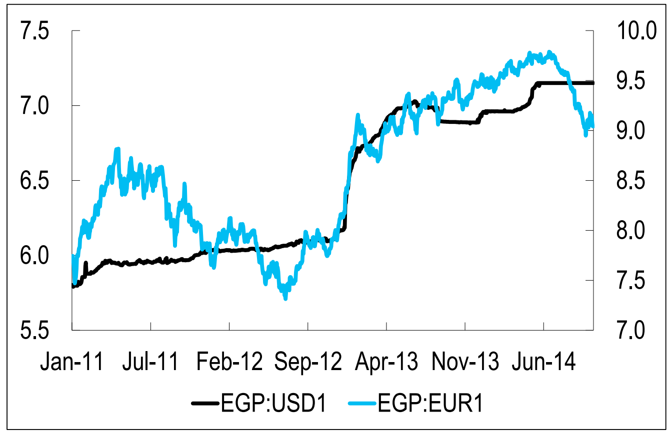
But the need for reality must also remain paramount. Even if an ambitious reform agenda along these lines is put in place, the reality remains that the state of the economy is still precarious, as shown by bouts of EGP weakness in 2014. Moreover, the current fragile stability is still heavily dependent on the current high levels of Gulf support. When set against the background of longer term structural issues, such as a weak civil service, a poor education system and a politically divided country, the realities of running the country while boosting growth and job creation will quickly become apparent to the new president in 2015, even as political stability improves.

Figure 125. Reserves have stabilised since late 2013, but remain low



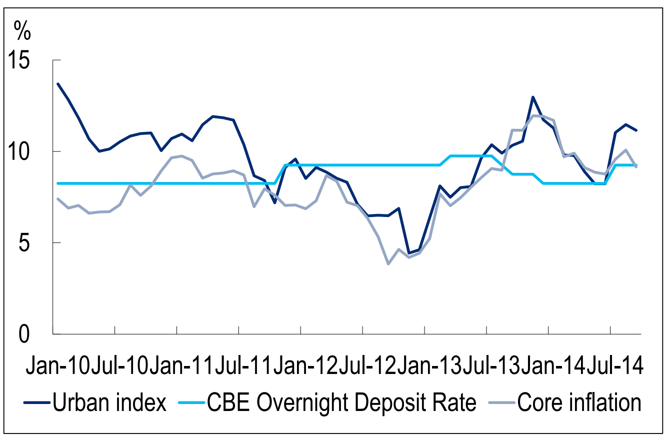
Source: Central Bank of Egypt, Haver Analytics

Figure 126. EGP – Downward steps against the US dollar



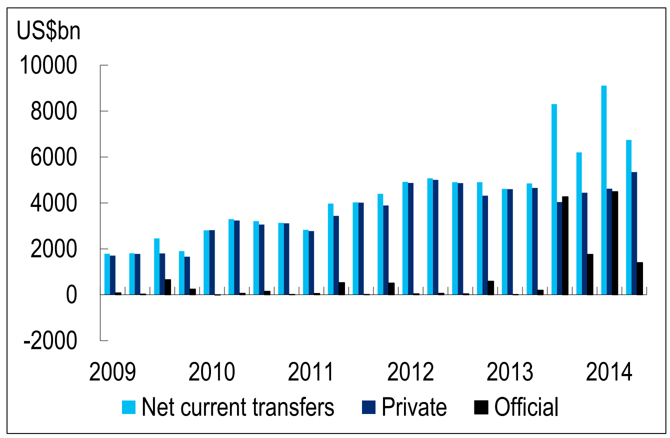
Source: Reuters

Figure 127. Inflation has picked up following subsidy cuts in July, forcing a response from the CBE



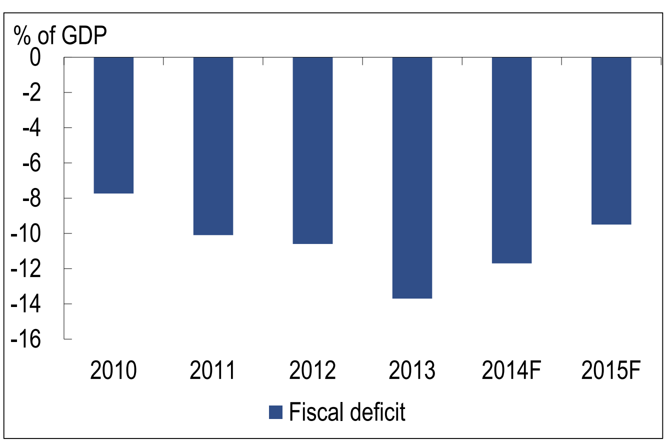
Source: Central Bank of Egypt, Haver Analytics and Citi forecasts for 2H 2013

Figure 128. Robust transfers have limited the deterioration in the current account and helped support consumption



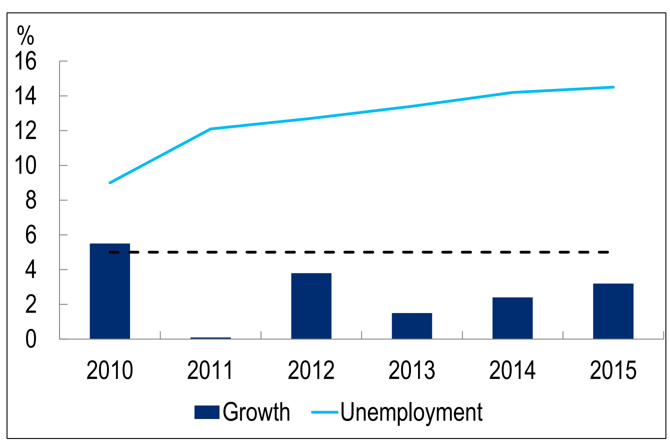
Source: Central Bank of Egypt, Haver Analytics

Figure 129. Modest fiscal consolidation is likely going forward



Source: Haver Analytics and Citi forecasts for 2013-2015

Figure 130. A slow recovery may now be possible in 2014-15



Source: Haver Analytics and Citi forecasts for 2013-15

Figure 131. Egypt Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	132	165	188	214	231	260	255	279	310
Nominal GDP, local currency bn	817	977	1,124	1,308	1,461	1,663	1,887	1,973	2,255
GDP per capita, USD	1,783	2,187	2,454	2,755	2,920	3,233	3,114	3,354	3,670
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	13.2	14.2	14.5
Economic Activity									
Real GDP, yoy avg	-	6.0	4.6	5.5	0.1	3.8	1.5	2.4	3.2
Real investment growth % yoy	-	9.2	-10.0	12.2	-3.6	7.2	-10.8	9.5	12.1
Real consumption growth % yoy	-	5.4	4.7	4.9	4.3	4.6	3.8	2.0	2.4
private consumption growth % yoy	-	5.7	4.6	5.0	4.6	4.9	3.7	2.0	2.6
Real export growth, % yoy	-	14.1	-18.8	8.1	-12.5	-2.0	-6.3	2.2	5.6
Real import growth, % yoy	-	13.7	-24.0	10.5	-0.9	4.9	-3.4	4.7	7.2
Prices, Money & Credit									
CPI, % yoy eop	6.9	18.4	13.2	10.6	9.5	4.7	11.7	12.8	9.5
CPI, % avg	9.5	18.3	11.8	11.1	10.1	7.1	9.5	10.4	11.1
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	10.0	12.0	3.0	6.7	6.1	7.6	6.4	6.3	7.6
Policy Interest Rate, % eop	8.75	11.50	8.25	8.25	9.25	9.25	8.25	9.25	8.50
1 month inter-bank rate, %, eop	8.75	11.95	8.30	8.30	10.05	10.10	9.25	13.27	9.93
Long-term yield, %, eop	9.50	9.00	9.00	9.00	9.50	10.00	13.50	11.00	10.00
EGP/US$, eop	5.53	5.50	5.48	5.81	6.03	6.36	6.95	7.15	7.35
EGP/US$, avg	5.64	5.44	5.55	5.63	5.94	6.07	6.87	7.08	7.28
Balance of Payments, USD bn									
Current account	0.2	-1.3	-3.2	-5.6	-7.9	-10.7	-3.3	-7.6	-10.5
% of GDP	0.2	-0.8	-1.7	-2.6	-3.4	-4.1	-1.3	-2.7	-3.4
Trade balance	-20.8	-26.8	-22.5	-27.7	-28.5	-36.8	-30.2	-37.6	-34.9
Exports	24.5	29.8	23.1	25.0	27.9	23.2	25.1	26.5	27.4
Imports	45.3	56.6	45.6	52.7	56.5	59.9	55.3	64.0	62.2
Service balance	12.7	15.7	11.3	9.6	5.4	6.3	2.9	1.4	2.5
Income balance	-	-	-	-	-	-	-	-	-
FDI, net	10.9	7.6	6.1	5.2	-1.1	6.7	5.3	-0.1	3.0
International reserves	31.7	34.2	34.2	36.0	18.1	15.0	17.1	17.9	20.4
Total amortisations	2.3	1.8	2.4	2.0	2.2	2.3	2.5	2.8	3.1
Public Finances, % of GDP									
Consolidated government balance	-5.2	-6.4	-6.6	-7.7	-10.1	-10.6	-13.7	-11.7	-9.5
Consolidated gov primary balance	0.0	-1.8	-2.4	-2.6	-4.5	-4.7	-6.0	-2.7	-0.2
Public debt	64.2	53.5	54.0	59.8	69.0	77.7	78.6	77.3	74.3
of which Domestic	64.2	53.5	54.0	59.8	69.0	77.7	78.6	77.3	74.3
Foreign Assets & Liabilities, USD bn									
External debt	32.8	32.1	33.3	35.0	33.7	38.8	45.8	39.4	35.6
Public	21.6	26.0	27.2	28.3	27.4	32.8	40.5	31.5	31.5
External debt / GDP	24.8	19.5	17.7	16.3	14.6	14.9	18.0	14.1	11.5
External debt / XGS	68.8	55.6	73.0	70.9	71.1	85.9	105.1	87.5	75.1
Short-term debt	2.2	2.8	2.6	3.1	3.0	6.7	2.8	2.8	2.8
Short-term debt/International reserves (%)	7.0	8.3	7.5	8.7	16.7	44.3	16.5	15.8	13.8

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	1.5	1.8	3.0	3.2	3.0	3.2	3.0	3.5	4.0
CPI, % yoy eop	9.8	8.2	11.2	12.8	11.6	12.4	10.5	9.5	10.6
Policy interest rate, %, eop	8.25	8.25	9.25	9.25	9.25	9.25	9.00	8.50	8.00
Short-term market rate, % eop	9.25	9.25	9.25	13.27	12.04	12.87	10.91	9.93	11.02
Long-term yield, %, eop	13.50	13.50	13.00	12.50	12.00	11.50	11.50	11.00	11.00
EGP/US$, eop	6.97	7.15	7.15	7.15	7.20	7.30	7.35	7.35	7.40

Source: National Sources, Citi Research forecasts

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GCC

Saudi Arabia

As oil prices continue to tumble, Saudi Arabia has confounded our expectations that it would cut production in order to support the market. Saudi officials have instead been signaling their willingness to live with lower oil prices, although their tolerance threshold remains unclear. We believe that Saudi's reluctance to cut makes good economic sense: in the absence of a coordinated move in that direction with other global suppliers, it is not clear that Saudi would achieve much with a cut other than reduced revenues and market share. Lower oil prices are also supportive of global demand and will restrict future uncompetitive supply, helping balance the market outlook.

Saudi budget revenues will come under pressure during our forecast horizon, and put a strain on public finances. We calculate the fiscal breakeven oil price for the Kingdom at around $88 per barrel in 2014, rising to the mid-90s next year. This implies deficits at current oil prices sooner than we had been expecting (our projections were for the Saudi budget to go into deficit in 2016). While Saudi has ample fiscal reserves to fund such deficits, as well as plenty of capacity to raise debt, we do expect that the Saudi authorities will seek to put public finances on a sustained footing over the medium term. This implies an accelerated timetable for fiscal consolidation and economic reform.

In August, the CMA published the draft rules for would-be foreign investors in the Tadawul, which are highly restrictive and limit the actual access opportunities for foreign funds. The rules introduce the concept of Qualified Foreign investors, which must be a) a bank, b) a brokerage or securities firm, c) an asset manager, or c) an insurance company. The QFI must have assets under management of at least $5bn (or $3bn at the discretion of the CMA), and must have been in operation for over 5 years. This means that only the largest, most established international investors will have access to the Saudi Market.

Moreover, the CMA has proposed significant limits on foreign ownership that are likely to restrict diversification opportunities, further limit access and could keep the Tadawul out of the MSCI emerging markets index. QFIs may not hold more than 20% of any given company, foreign investors (including p-note holders) may not hold more than 49% of any company, and total foreign investment in the Tadawul cannot exceed 10% of the market capitalization. Such rules clearly restrict access to the stock market and could create significant sectoral biases – consider, for example, that the largest company (by market cap) in the Tadawul is almost 20% of the index, meaning that once the foreign ownership limit is reached in this company, it is all but reached in the index as a whole. QFIs maximizing their holdings of the top two companies would breach the aggregate investment limit by 20%. This brings into question the availability of foreign investment for all but the largest, most established Saudi companies, in our view.

United Arab Emirates

The UAE economy is also vulnerable to the drop in oil prices witnessed in recent weeks. Abu Dhabi's fiscal breakeven oil price is just below $80 per barrel, meaning the room for expenditure growth is limited, and expenditure rationalization may be required should the oil price fall further. While Abu Dhabi, like Saudi, has ample fiscal space to fund deficits in the medium term, we believe that the Abu Dhabi authorities are less likely to do so and will prefer to curtail expenditure. We believe this is in keeping with Abu Dhabi's past track record, and reflects the emirate's conservative approach and lower expenditure pressures.

Dubai may well be the ultimate regional success story in terms of diversification, with hydrocarbons contributing less than 1.5% to GDP in 2013, but this does not insulate the emirate from the effects of lower oil prices, especially when this reflects weaker global demand. Dubai has successfully pursued a 'hub and spoke' model, attracting businesses and people on the basis that it is the ideal spot from which businesses can capitalize on regional growth opportunities. If these opportunities diminish on the back of falling oil prices, so does Dubai's attractiveness as a business destination. Moreover, Dubai's trade and logistics business, another pillar of its economy, is highly dependent on global trade prospects, which have also declined in recent weeks.

That said, we remain bullish regarding Dubai's growth prospects in the medium- to long-term as we see significant growth in non-traditional regional markets. These include Iraq, Pakistan, East Africa and Iran. The latter, in particular, could prove a significant near-term fillip to Dubai's growth prospects should a deal between the P5+1 materialise, resulting in the rolling back of sanctions against Iran in the coming years. We believe Dubai would be well-placed to serve as a base for foreign investors looking to access opportunities in the newly opened market.

On the all-important real estate market, there are signs that housing prices in Dubai have begun to moderate. Cluttons' data show that the price of mid-range villas (per square foot) rose 42% in 2013, around the same amount as mid-range apartments. By contrast, thus far in 2014, mid-range villa prices have fallen by an annualized rate of 7%, and, while apartment rates continue to rise, the pace has moderated to 8% (annualized).

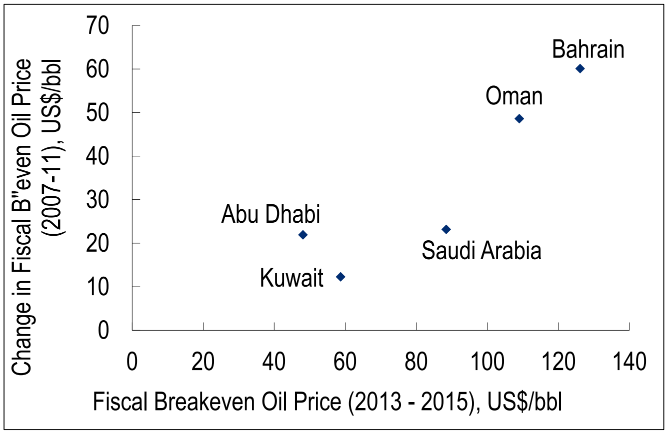
This does not mean, however, that the risks to the real estate market have subsided. Indeed, our concerns regarding signs of overheating in the real estate market have not been focused on prices, but on construction activity and leverage. Here, the lack of hard data makes analytical judgment much more difficult, but anecdotal evidence suggests that Dubai is beginning to experience something of a revival in construction activity. The future balance of supply and demand, the extent to which construction and real estate begin to dominate economic growth, and the level of leverage in the construction and real estate sectors are all things that we believe merit close monitoring.

Qatar

The report to the ethics committee on alleged corruption in the bidding process for the 2018 and 2022 World Cups was completed in September, but FIFA has raised considerable controversy in insisting that it should remain secret. Despite the debate, we believe the bottom line is that FIFA is highly unlikely to take sanctions against Qatar. Sources close to the investigation told the Sunday Times (28 September) that the report made recommendations of further action against individuals, but not against the Russia (2018) or Qatar (2022) bids.

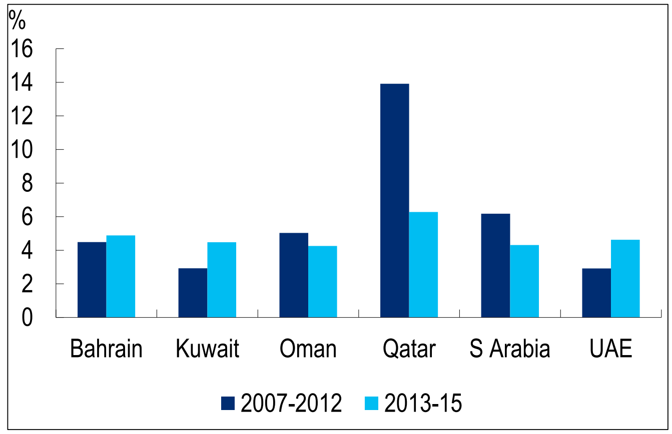
This does not mean that uncertainty surrounding Qatar's hosting of the World Cup has gone away, though. Other issues, such as the weather conditions in the Qatari summer, labour conditions in the build-out of World Cup infrastructure, Qatar's alleged support for Jihadi groups across the Middle East, and any escalation in blowback by FIFA's sponsors and/or members could yet derail plans to host the event, in our view.

Figure 132. Fiscal breakeven oil prices on the rise



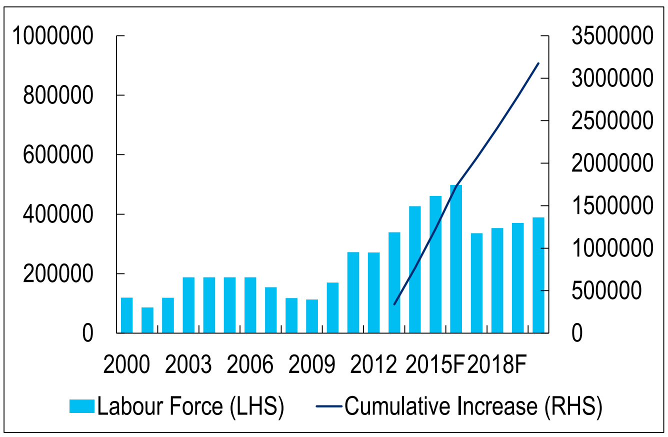
Source: Citi Research estimates

Figure 133. Economic growth will be uneven going forward



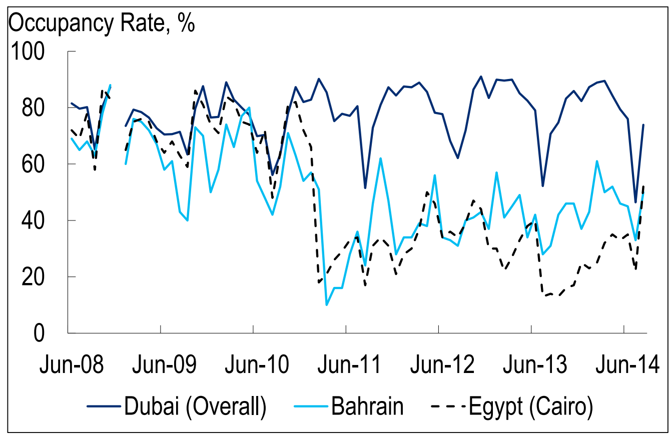
Source: Haver Analytics, Citi Research

Figure 134. 3.3 million entrants in Saudi job market by end of decade



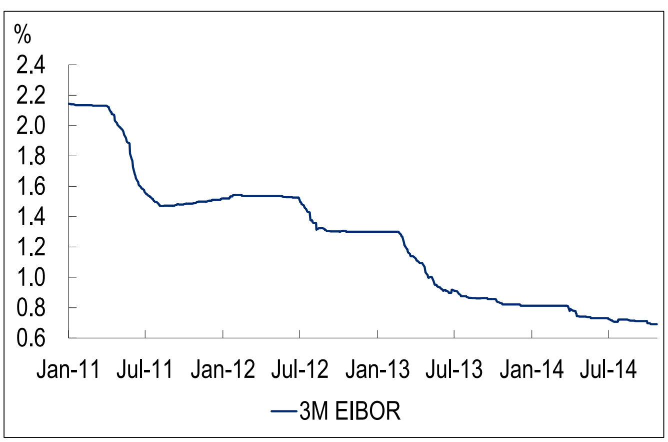
Source: Saudi Central Statistics Office, Citi Research

Figure 135. Dubai hotel occupancy continues to outperform its peers



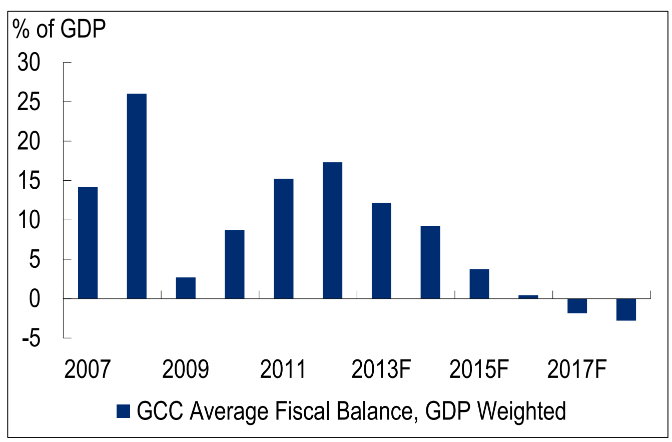
Source: Ernst & Young, Citi Research

Figure 136. EIBOR rates stablise at low levels



Source: Haver Analytics

Figure 137. High government expenditure will drive balances lower



Source: Haver Analytics, Citi Research estimates

Figure 138. 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	30.7	32.8	35.0	37.2
GDP per capita, USD	21,072	22,983	19,192	20,482	22,401	23,272	23,931	24,582	25,088
Real GDP, yoy avg	8.3	6.2	2.5	4.3	2.1	3.4	5.5	4.8	4.4
CPI, % avg	3.3	3.5	2.8	1.9	-0.4	2.8	3.3	4.2	4.6
BHD/US$, avg	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
Current account, US$bn	2.8	2.1	0.4	0.6	3.0	2.0	2.2	2.3	0.8
% of GDP	12.7	8.1	1.7	2.3	10.3	6.4	6.8	6.6	2.2
Consolidated gov. balance, % of GDP	2.7	6.4	-4.3	-4.8	-0.3	-2.0	-3.3	-3.7	-5.4
KUWAIT									
Nominal GDP, USD bn	112.3	136.6	105.2	114.1	146.6	168.0	174.2	176.0	174.7
GDP per capita, USD	43,971	50,563	36,898	38,122	46,908	52,196	52,532	51,544	49,662
Real GDP, yoy avg	6.0	2.5	-7.1	-2.4	10.2	8.3	5.7	3.8	3.9
CPI, % avg	5.5	10.6	4.0	4.0	4.7	2.9	2.6	3.0	3.5
KWD/US$, avg	0.28	0.27	0.29	0.29	0.28	0.28	0.28	0.29	0.29
Current account, US$bn	41.9	57.8	29.1	37.8	66.2	78.7	70.9	67.5	61.1
% of GDP	37.3	42.3	27.6	33.2	45.2	46.9	40.7	38.4	35.0
Consolidated gov. balance, % of GDP	30.0	36.4	19.0	32.0	41.9	41.4	31.6	26.7	15.1
OMAN									
Nominal GDP, USD bn	42.0	59.9	53.4	53.4	53.4	53.4	84.3	88.9	92.9
GDP per capita, USD	15,326	20,887	18,015	17,438	16,881	16,180	24,363	24,608	24,604
Real GDP, yoy avg	4.5	8.2	6.1	4.8	0.9	5.8	3.4	4.7	4.7
CPI, % avg	5.9	12.5	3.6	3.2	4.0	2.9	2.1	1.0	0.9
OMR/US$, avg	0.38	0.38	0.38	0.38	0.39	0.39	0.38	0.39	0.39
Current account, US$bn	2.5	5.0	-0.5	5.0	8.9	7.8	5.1	6.8	4.6
% of GDP	5.8	8.4	-0.9	9.4	16.7	14.6	6.1	7.7	4.9
Consolidated gov. balance, % of GDP	2.7	0.3	-0.1	3.1	-0.4	-0.3	0.8	-1.4	-4.5
QATAR									
Nominal GDP, USD bn	79.7	115.3	97.8	125.1	171.5	192.4	202.5	213.4	227.5
GDP per capita, USD	85,712	104,982	80,294	92,546	114,241	118,688	115,635	112,836	111,419
Real GDP, yoy avg	18.0	17.7	12.0	16.7	13.0	6.1	6.5	5.5	6.9
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	24.0	52.0	62.0	62.6	61.5	54.0
% of GDP	14.4	23.1	6.5	19.1	30.3	32.2	30.9	28.8	23.7
Consolidated gov. balance, % of GDP	10.9	9.8	13.4	2.7	7.8	11.4	15.6	13.0	9.5
SAUDI ARABIA									
Nominal GDP, USD bn	415.6	519.4	429.0	526.8	669.5	733.8	748.4	763.6	763.4
GDP per capita, USD	17,111	20,861	16,811	20,178	25,645	27,559	27,553	27,561	27,016
Real GDP, yoy avg	6.0	8.4	1.8	6.4	8.6	5.8	4.0	4.8	4.2
CPI, % avg	4.1	9.9	5.1	5.3	3.9	2.9	3.5	2.9	3.0
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	133.6	112.8	70.0
% of GDP	22.7	25.6	5.0	12.8	23.8	22.6	17.9	14.8	9.2
Consolidated gov. balance, % of GDP	12.2	30.8	-3.0	6.3	13.2	15.4	8.7	6.0	0.9
UNITED ARAB EMIRATES									
Nominal GDP, USD bn	257.9	315.5	253.5	286.0	347.4	372.3	402.3	431.0	461.8
GDP per capita, USD	57,467	66,205	51,659	56,586	66,727	68,563	70,757	72,478	74,285
Real GDP, yoy avg	3.2	3.2	-5.2	1.6	4.9	4.7	5.2	4.0	4.0
CPI, % avg	11.1	12.3	1.6	0.9	0.9	0.7	1.1	2.0	2.4
AED/US$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account, US$bn	15.5	22.7	7.9	7.4	74.3	108.8	114.1	102.2	88.3
% of GDP	6.0	7.2	3.1	2.6	21.4	29.2	28.4	23.7	19.1

Source: National Sources, Citi Research forecasts

Hungary

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- **Summary view** — Growth is likely to slow in 2H14 amidst slowing external demand and on base effects. Tighter structural fiscal balance may be offset by the positive impact of FX debt burden reduction on household consumption.

- **Things to watch** — Details of the 2015 budget and the FX mortgage loan conversion plans will be most important domestic events to watch.

- **Strategy** — Soft inflation surprises, downside risks to growth and ECB policy action point towards permanently low interest rate outlook. We expect gradual weakening in the HUF as monetary conditions remain loose and inflation rises.

Growth is likely to slow significantly in 2H15

A large part of the August industrial output slowdown is likely to be related to seasonal factors that may prove temporary, base effects and slowing German manufacturing orders point towards downside risks to the outlook. We expect GDP growth to slow from 3.5% in 1H14 to the range of 2.2-2.5% in 2H14 and reach 3.1% in annual average. A tightening in the structural fiscal balance and external demand both pose downside risks to our 2.1% GDP forecast in 2015.

The government is likely to adjust the structural balance in the 2015 budget. The government is likely to address the EC's concerns about the 1.4% of GDP structural balance loosening in 2014 and present lower deficit plan than the former official deficit target of 2.8% of GDP for 2015. While the government already revealed new smaller taxes that should help increase the revenue side, public expenditure cuts may also be on the table, which we believe may improve the odds of credit rating upgrades. In our view, fiscal tightening plans may dampen the risk of reopening the EDP and thereby the EURHUF spot exchange rate on Dec 31st, influencing the end-2014 public debt ratio should be less critical issue for the authorities to watch.

The NBH's participation in loan conversion mutes FX risks

The NBH's participation to cover banks' FX hedging needs related to FX loan settlements eliminates a mayor risk to the HUF. There is no decision on FX mortgage conversion yet, which may be still connected with the settlement of unilateral loan condition changes taking place in Feb-Apr 2015 to avoid an increase in installments due to higher HUF mortgage rates. A conversion at spot or 5-10% below spot exchange rate seems the most likely outcome, thus the conversion is unlikely to put significant additional losses on banks on the top of the estimated HUF700bn net losses related to the settlements of loan condition changes.

The utilization of FX reserves via swap and forward FX facilities for mortgage loan conversion will lower FX reserves but due to declining short term external debt, FX reserve coverage may remain adequate. Considering inflows from EU funds and assuming the sovereign FX debt redemptions will be mostly covered by HUF issuance next year, we estimate that the NBH's FX reserves may decline to the range of €28-30 by end-2015 after the mortgage loan conversion. Parallel with the FX reserve utilization the excess HUF liquidity is likely to tighten as the NBH's balance sheet shrinks. This, in our view may close the gap between the short-end of the yield curve and the base rate over time. Downside risks to growth suggest that the NBH may extend the FGS further as long as there is demand from SMEs for cheap lending, which may partly offset the contraction in HUF liquidity.

Inflation outlook may shift lower

Inflation outlook may undershoot the NBH's latest forecast from September. The NBH's tax-filtered core CPI that excludes the impacts of all administrative measures slowed to 1.2%YoY in September, down from 1.5%YoY in August. The recent decline in energy prices and downward revision in global growth forecasts also suggests that imported inflation may be lower. FX pass-through has weakened since the crises and impact of lower imported inflation has been more influential in domestic price trends. Considering the base effects in utility prices we expect CPI to rebound to 1% in December and rise to 2% by 3Q15 and to around 2.4% by end-2015. This is lower than the NBH's forecast, which sees inflation reaching the 3% target by late 2015.

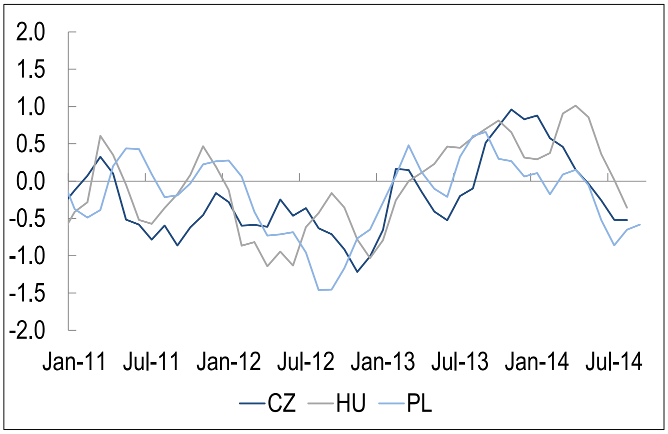
Further evidence of CPI undershooting the NBH's forecast in the coming months could increase the chance of minor cuts but likely not before year-end. The downward shift in external rates outlook and more dovish central banks in the region may increase the room for the NBH to ease further if growth disappoints. However, recent communication from MPC members shows cautious assessment of the downside risks to inflation given the narrowing in the output gap and to ongoing consumption recovery. Considering the importance of avoiding HUF weakness at year-end in order to keep the public debt ratio on a declining path, we do not expect any change in the NBH's stance before early 2015. .

We expect low yields, gradually weaker HUF

The beginning of gradual rate hikes may shift out to Dec 2015 or early 2016. Soft inflation outlook, downward shift in the forward global yield expectations and potential credit spread compression helped by ECB asset purchased will likely allow the NBH to keep rates low for longer. In our baseline scenario we have pushed out the first 25bp hike to Dec 2015, whereas if Fed tightening will be delayed, NBH rate hikes may be shifted out further. Given the NBH's dovish bias, the improvement in Hungary's external vulnerability since the beginning of the crises and local banks ability of absorb local government bonds we expect that the rate hiking cycle is likely to be gradual, starting in 25bp steps.

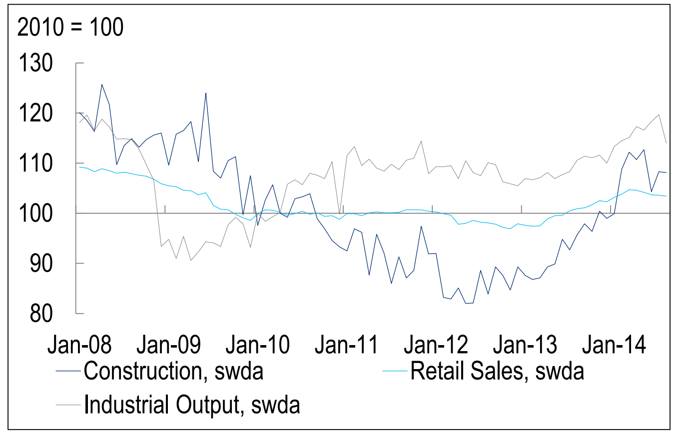
We expect gradually weaker HUF as the NBH will keep monetary conditions loose. The downward risks to external demand and the likely elimination of households sensitivity to FX weakness through the FX debt conversion suggests that the NBH may prefer to keep monetary conditions loose and tolerate some FX weakness to support economic growth. Hungary's external surplus has likely peaked in 2013-2014 as domestic demand has started to recover. Nonetheless, the current account surplus is unlikely to disappear in the medium term, muting the risks of permanent and significant FX depreciation. We expect that the HUF will weaken gradually against the EUR as positive ex-post real rates disappear with the pickup in headline CPI throughout 2015 while short term FX volatility may be primarily driven by the impacts of Fed policy expectations on EMFX.

Figure 139. Our Hungarian growth momentum indicator has been slowing sharply in line with the region…



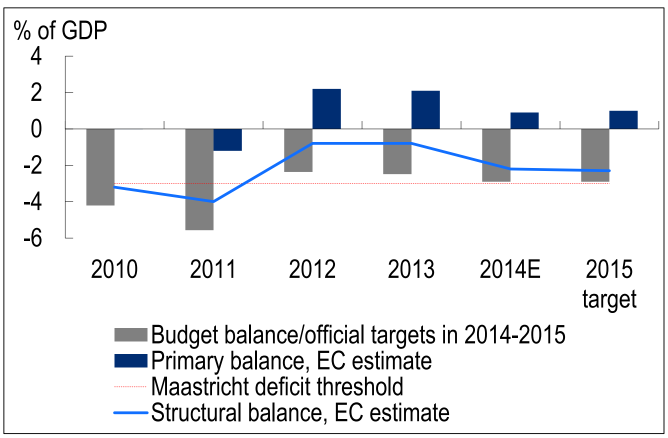
Source: Haver Analytics, Citi Research estimates

Figure 140….as industry, construction and retails sales in Hungary all lost momentum



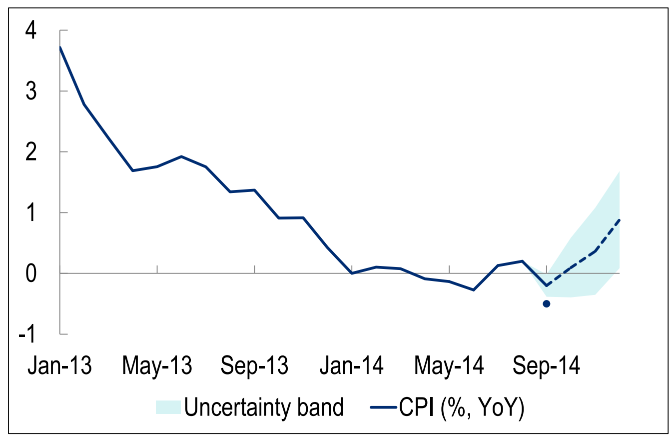
Source: Haver Analytics, Hungarian CSO, Citi Research

Figure 141. The government may adjust the structural balance in 2015



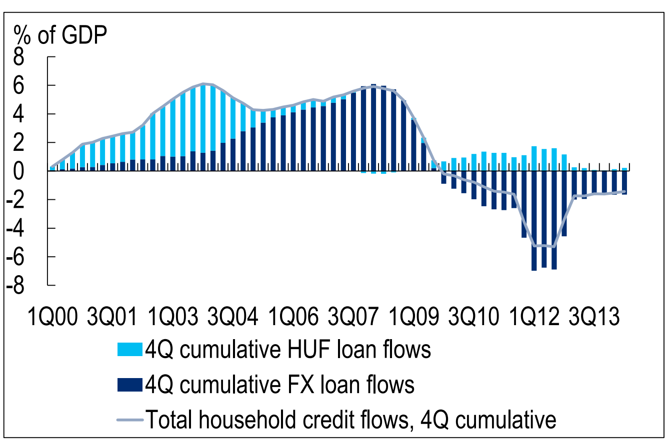
Source: Hungarian CSO, European Commission, Citi Research

Figure 142. September CPI undershot the NBH's projections



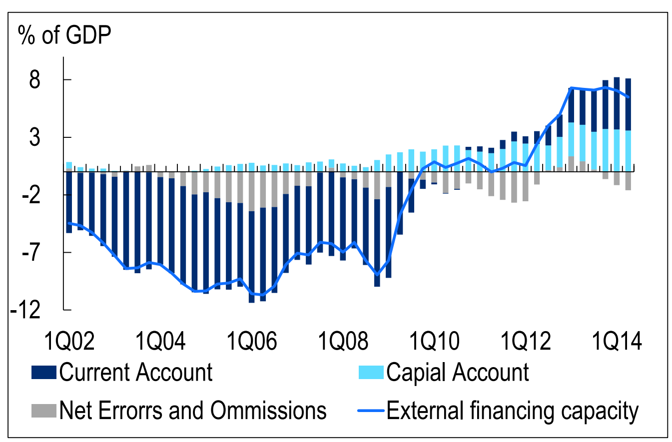
Source: National Bank of Hungary, Citi Research

Figure 143. FX credit measures to shrink the burden of debt deleveraging on households in 2015



Source: National Bank of Hungary, Citi Research

Figure 144. External surplus still strong but has peaked as domestic demand picks up and exports slow



Source: National Bank of Hungary, Citi Research. Note: External financing capacity = Current Account + Capital Account + Net Errors and Omissions.

Figure 145. Hungary Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	145	141	136	127	115	127	135	119	112
Nominal GDP, local currency bn	25,167	26,554	25,743	26,612	27,727	28,109	29,262	30,585	32,080
GDP per capita, USD	14,390	14,061	13,584	12,688	11,487	12,726	13,543	12,015	11,275
Population, mn	10.1	10.0	10.0	10.0	10.0	10.0	10.0	9.9	9.9
Unemployment, % of labour force	7.7	8.0	10.5	10.8	10.7	10.7	9.1	8.6	8.1
Economic Activity									
Real GDP, yoy avg	0.1	0.9	-6.8	1.1	1.6	-1.7	1.1	3.1	2.2
Real investment growth % yoy	-1.5	3.7	-29.6	11.5	-3.6	-11.2	1.9	10.0	3.5
Real consumption growth % yoy	-1.4	-0.2	-4.5	-2.5	0.3	-1.5	0.5	1.4	1.6
private consumption growth % yoy	1.1	-0.7	-6.6	-3.0	0.4	-1.6	0.3	1.8	2.0
Real export growth, % yoy	15.0	5.7	-10.2	11.3	8.4	1.7	5.3	6.8	6.0
Real import growth, % yoy	12.8	5.5	-14.8	10.9	6.4	-0.1	5.3	7.2	6.2
Prices, Money & Credit									
CPI, % yoy eop	7.4	3.4	5.4	4.6	4.1	5.1	0.6	1.4	2.5
CPI, % avg	7.9	6.0	4.0	4.7	3.9	5.7	1.7	0.2	2.1
Nominal wages, % yoy	8.0	7.4	0.5	1.3	5.2	4.6	3.4	4.4	4.2
Credit extension to private sector, % yoy	18.8	21.7	-2.7	4.1	-0.5	-12.5	-5.7	0.7	0.6
Policy Interest Rate, % eop	7.50	10.00	6.25	5.75	7.00	5.75	3.00	2.10	2.35
1 month inter-bank rate, %, eop	7.50	10.00	6.25	5.75	7.08	5.75	3.00	2.10	2.35
Long-term yield, %, eop	7.08	8.28	7.99	7.97	9.75	6.11	5.61	4.80	5.30
HUF/US$, eop	173	190	189	208	244	221	216	256	287
HUF/US$, avg	183	171	201	208	201	225	223	237	279
HUF/EUR, eop	253	266	271	278	315	291	297	312	325
HUF/EUR, avg	251	252	280	275	279	289	297	310	323
Balance of Payments, USD bn									
Current account	-9.9	-11.2	-1.1	0.4	1.0	2.4	5.5	5.3	4.0
% of GDP	-6.8	-7.9	-0.8	0.3	0.9	1.9	4.1	4.4	3.6
Trade balance	-0.6	-1.4	3.7	3.5	4.1	3.9	4.8	4.5	3.1
Exports	89.5	105.7	79.3	87.7	100.0	90.4	96.2	98.2	90.7
Imports	90.1	107.1	75.6	84.3	95.9	86.5	91.4	93.7	87.5
Service balance	1.2	1.9	1.6	3.5	4.6	4.9	5.4	5.8	5.3
Income balance	-9.0	-9.9	-6.0	-6.1	-6.8	-5.4	-3.9	-4.3	-3.7
FDI, net	0.4	-3.5	-0.2	-1.0	-1.4	-2.6	-0.5	1.2	1.2
International reserves	23.2	33.2	41.1	43.1	45.4	43.5	47.0	38.0	30.8
Total amortisations	9.3	15.2	21.9	20.5	25.8	21.6	21.5	20.0	19.0
Public Finances, % of GDP									
Consolidated government balance	-5.1	-3.7	-4.7	-4.6	4.3	-2.0	-2.2	-2.9	-3.0
Consolidated gov primary balance	-1.0	0.4	-0.1	-0.4	8.5	2.7	2.5	0.9	0.8
Public debt	66.5	72.3	78.0	79.9	81.8	79.7	78.8	78.9	78.0
of which Domestic	35.8	37.5	36.8	40.7	40.8	43.5	44.6	48.9	48.9
Foreign Assets & Liabilities, USD bn									
External debt	151.7	172.6	196.3	185.1	172.5	164.9	164.4	152.9	144.9
Public	47.4	51.8	62.1	59.6	58.4	63.8	62.5	63.0	63.5
External debt / GDP	104.8	122.2	144.1	145.7	150.3	129.9	121.9	128.2	129.6
External debt / XGS	142.4	136.7	200.7	172.7	141.1	148.3	138.7	125.4	129.1
Short-term debt	32.9	27.5	28.0	32.9	31.7	22.8	22.9	19.0	16.6
Short-term debt/International reserves (%)	141.7	82.8	68.2	76.1	69.9	52.4	48.6	50.1	53.8

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.7	3.9	2.6	2.4	2.0	2.1	2.3	2.5	1.9
CPI, % yoy eop	0.1	-0.3	-0.2	1.4	1.8	2.2	2.2	2.5	3.0
Policy interest rate, %, eop	2.60	2.30	2.10	2.10	2.10	2.10	2.10	2.35	3.10
Short-term market rate, % eop	2.60	2.30	2.10	2.10	2.10	2.10	2.10	2.35	3.10
Long-term yield, %, eop	5.54	4.39	4.63	4.80	4.90	5.00	5.30	5.30	4.55
HUF/EUR, eop	307	310	311	312	318	324	325	325	325

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 growth in domestic spending.
- **Things to watch** — Israeli price deflation is now a reality, and it is difficult to see why inflation will move back up to the 1-3% target range without further action by the Bank of Israel. This will require a) a further cut in the policy rate to zero, followed by b) aggressive action in the fx market, either by increasing the central bank's dollar-purchases or announcing a 'Minimum Exchange Rate'.
- **Strategy** — The shekel is likely to stay very weak. Not only is the market primed to expect the kind of central bank action outlined above, but there is also evidence that Israeli portfolio managers are less inclined to fx-hedge their purchases of foreign securities.

Growth prospects turn sour

The data coming in over the summer shows a deterioration in the pace of economic activity. While the PMI had been rising impressively in Q2, reaching 55.6 in May, it has fallen back below 50 in the subsequent four months. Manufacturing growth also returned to negative territory in June and July, and the Israeli construction sector is effectively in recession, partly thanks to uncertainty about the prospects for a zero VAT rate on couples' first purchase of newly built homes: builders are holding off to be sure of what specifications would attract the zero-rating, and buyers are holding off in case the VAT measure is passed. GDP growth fell to 1.5% annualized in Q2, the lowest rate since the aftermath of the 2008 financial crisis. Gross fixed capital formation and net exports are creating the biggest drag on economic activity.

The shekel is part of the problem…

Israeli gas production set to grow. Tamar, the smaller of two large gas fields being developed off Israel's northern coast, began production in April 2013. Gas from Tamar (around 300 bcm) substituted some US$2.1bn of energy imports in 2013. A larger field, Leviathan (around 600 bcm), will commence production in 2017 or just after. 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$300bn). 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, suggesting that Israel might end up with twice the amount of gas that it has found to date.

Partly as a result of these developments, the shekel has been one of the strongest currencies in the world in 2013 and H1 2014: the real effective exchange rate appreciated by 10% during this period alone. The appreciation of the shekel might have something to do with the weakening performance of Israeli exports, but the Bank of Israel is unwilling to 'bail out' the corporate sector by artificially depreciating the shekel. However, the shekel's strength is a critical concern for the Bank because it is driving Israeli inflation way below the Bank's 1-3% inflation target. And since cutting the interest rate is no longer much use in creating inflation pressure, the Bank's only remaining tool is the currency.

…and disinflation looks like it's here to stay

The exchange rate's impact on CPI is evident from the collapse of tradeables inflation. Tradeables inflation has been negative every month this year, reaching -2.6% in September. That is dragging down overall CPI, and in turn that is pushing inflation expectations down. Moreover, it is not only the exchange rate that is creating disinflationary pressure in Israel. First, the government's efforts to increase workforce participation among the ultra-Orthodox and Arab Israelis seem likely to increase labour supply, possibly putting downward pressure on wages. Second, in the wake of a recent government commission to increase competition and reduce concentration of ownership in the economy, efforts are being made to increase competition in the retail food sector, in telecoms, TV services and in auto retail. The 'cost of living' remains a major focus in Israeli political debate.

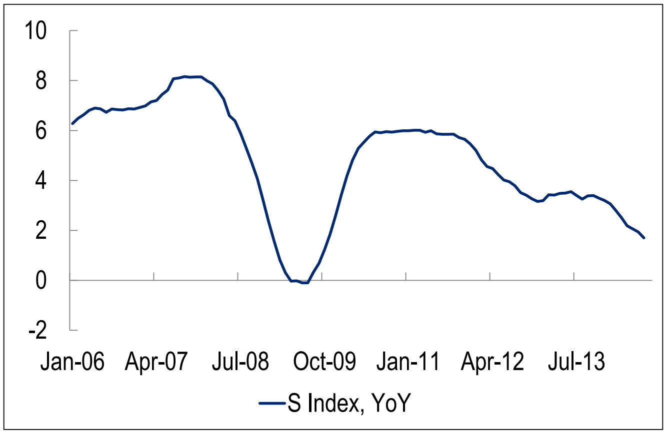
Time for radical thinking about the exchange rate?

The central bank is now close to running out of traditional policy tools. The BOI's policy rate has fallen from 1% at the start of this year, and now having nearly reached the zero lower bound the central bank will be forced to consider alternative ways of delivering monetary stimulus. In our view, that stimulus is most likely to come from the fx market: since Israel's low inflation problem is largely currency-induced, it follows that the solution should be currency-oriented. In that case, it might not be long before the Bank considers something like a 'Minimum Exchange Rate' along the lines pursued by the Czech and Swiss National Banks. An alternative to this would be simply for the Bank to pursue aggressive intervention in the fx market. Either way, the consequence is likely to be a weaker nominal exchange rate. The next couple of months' worth of inflation data will be particularly important in shaping the outlook for an unconventional exchange rate policy. The Bank of Israel has expressed uncertainty about the wisdom of a Minimum Exchange Rate, arguing that a) it is practically very tough to establish the right level for the MER, and b) that it only gives a one-off boost to the price-level, rather than a sustained boost to inflation.

Fiscal and political noise rising

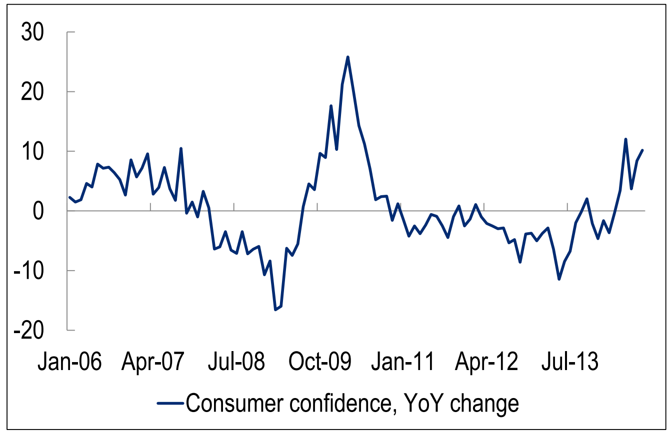
A dispute over fiscal policy might act as a constraint on the central bank's willingness to loosen monetary policy. The finance ministry has proposed a temporary departure from Israel's fiscal rules for 2015, ending up with a proposed deficit for next year of 3.4% GDP compared to the original target of 2.5%. While the Bank of Israel sympathises with the need for some leniency on next year's deficit – up to 3% of GDP, partly in acknowledgement of the costs of the 2014 conflict in Gaza – the Bank remains concerned about the consequences of excessively loose fiscal policy. This is relevant to the Bank's decision-making, since the looser fiscal policy is, the harder it will be to justify extraordinary measures on the monetary side. At the same time, the Bank will also need to consider the impact of tighter monetary policy in the US: the 10 year Israeli shekel bond yield is now at a record-low spread to the US 10 year yield, and so there could be some tightening of financial conditions if Israeli yields rise on the back of a shock from the US. If higher US rates and a strong dollar help to suck capital out of Israel and generate a weaker shekel, that might suit the Bank of Israel's effort to find a way to push inflation up.

Figure 146. Economic activity is stabilizing at a weak level, partly due to what the BOI describes as a 'virtual standstill' in world trade…



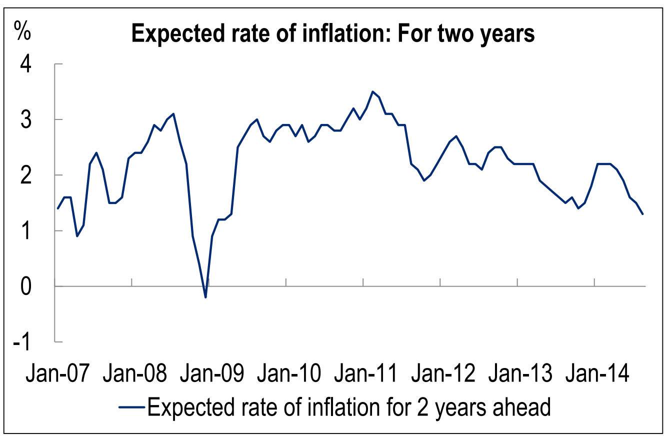
Source: Haver Analytics, Citi Research

Figure 147. ...and consumer confidence is fragile even though household borrowing has been relatively robust



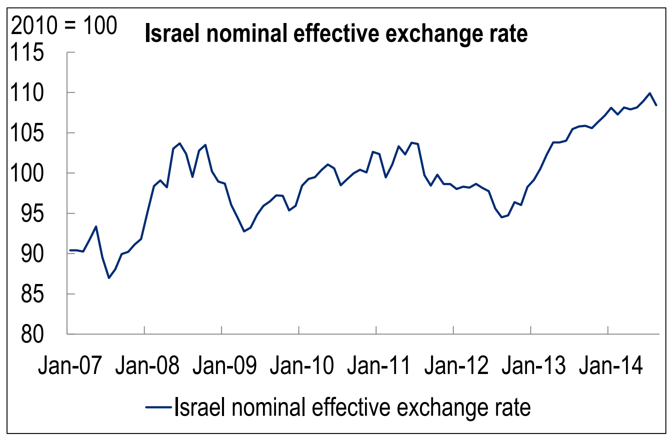
Source: Haver Analytics, Citi Research

Figure 148. Inflation expectations have fallen sharply…



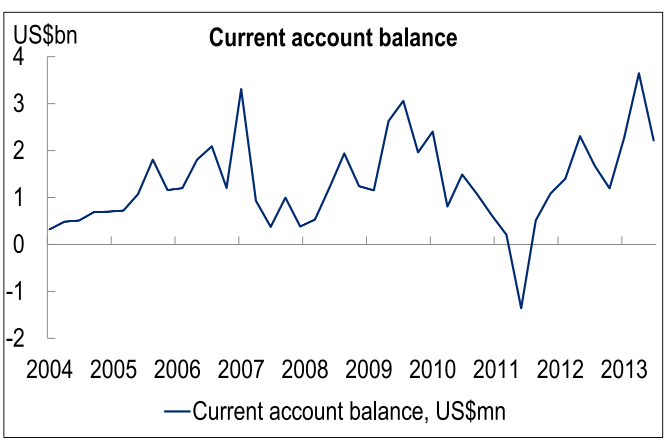
Source: Haver Analytics, Citi Research

Figure 149. …largely thanks to the appreciation of the shekel…



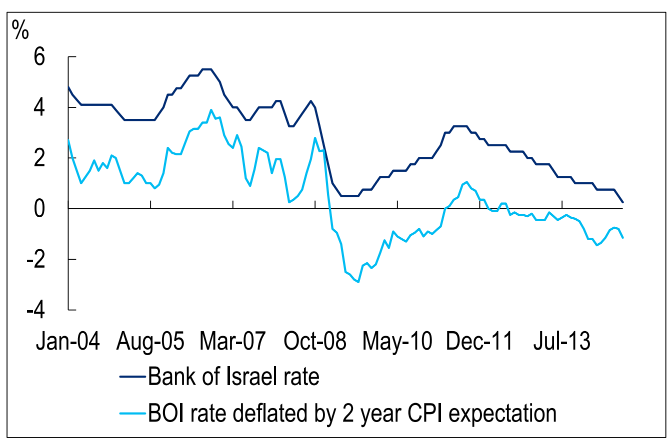
Source: Haver Analytics, Citi Research

Figure 150. …on the back of a sharply improving current account balance…



Source: Bloomberg, Citi Research

Figure 151. …giving room for the BOI to cut rates, and, probably, increase its effort to weaken the shekel.



Source: Bloomberg, Citi Research

Figure 152. Israel Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	177	214	206	233	258	257	291	300	285
Nominal GDP, local currency bn	726	768	812	871	925	992	1,049	1,079	1,106
GDP per capita, USD	25,494	30,101	28,383	31,440	34,263	33,648	37,573	38,386	35,997
Population, mn	6.9	7.1	7.3	7.4	7.5	7.6	7.7	7.8	7.9
Unemployment, % of labour force	9.2	7.7	9.4	8.3	7.1	6.9	6.3	6.0	5.8
Economic Activity									
Real GDP, yoy avg	6.0	4.0	1.7	5.5	4.4	3.1	3.1	2.3	2.2
Real investment growth % yoy	10.7	4.8	-2.6	9.9	14.7	3.1	1.1	4.5	6.5
Real consumption growth % yoy	6.1	1.4	2.6	4.0	3.0	3.3	3.4	2.0	2.1
private consumption growth % yoy	7.5	1.3	2.4	4.4	3.1	3.0	3.4	2.1	2.4
Real export growth, % yoy	10.7	7.4	-12.4	16.2	6.2	1.0	2.0	3.0	4.0
Real import growth, % yoy	10.6	2.2	-12.8	14.1	11.2	3.3	-1.4	1.6	3.5
Prices, Money & Credit									
CPI, % yoy eop	3.4	3.8	3.9	2.7	2.2	1.6	1.8	0.6	0.2
CPI, % avg	0.5	4.6	3.3	2.7	3.5	1.7	1.5	0.5	0.3
Nominal wages, % yoy	2.2	3.8	0.7	3.4	3.8	2.6	2.5	5.0	5.0
Credit extension to private sector, % yoy	10.8	-0.4	6.4	7.1	4.9	3.4	1.9	4.0	4.5
Policy Interest Rate, % eop	4.25	2.50	1.00	2.00	2.75	2.00	1.00	0.00	0.25
1 month inter-bank rate, %, eop	4.50	1.90	1.31	2.06	2.74	1.75	0.99	0.00	0.25
Long-term yield, %, eop	6.17	4.72	5.11	4.75	4.24	3.62	3.65	2.40	3.00
ILS/US$, eop	3.86	3.78	3.79	3.52	3.81	3.73	3.47	3.77	3.90
ILS/US$, avg	4.11	3.58	3.93	3.73	3.58	3.85	3.61	3.59	3.88
Balance of Payments, USD bn									
Current account	5.6	3.2	8.0	7.9	3.9	2.1	6.9	5.9	5.2
% of GDP	3.1	1.5	3.9	3.4	1.5	0.8	2.4	2.0	1.8
Trade balance	-5.2	-6.4	0.7	-1.9	-8.1	-9.7	-9.3	-5.0	-2.3
Exports	50.8	58.0	46.8	56.4	64.3	62.0	62.0	71.0	75.3
Imports	56.0	64.4	46.1	58.3	72.4	71.8	71.3	76.0	77.5
Service balance	3.7	5.2	5.1	6.7	6.8	10.2	13.5	9.0	12.0
Income balance	-0.2	-4.0	-5.1	-5.2	-3.6	-6.5	-6.3	-6.1	-4.5
FDI, net	-0.2	-3.7	-2.7	3.6	0.1	-4.8	-7.1	4.0	6.0
International reserves	28.6	42.5	60.6	70.9	74.9	76.0	81.8	87.0	95.0
Total amortisations	10.6	4.1	4.7	5.2	16.2	7.8	7.3	4.2	3.0
Public Finances, % of GDP									
Consolidated government balance	0.4	-1.2	-4.2	-2.8	-2.5	-3.5	-2.7	-3.0	-3.3
Consolidated gov primary balance	6.1	4.0	1.0	2.3	2.5	1.4	2.1	1.6	3.0
Public debt	72.2	71.2	73.5	74.1	73.8	72.6	72.0	71.9	71.4
of which Domestic	55.9	57.1	59.9	57.4	57.3	56.5	55.3	54.7	54.3
Foreign Assets & Liabilities, USD bn									
External debt	92.3	89.6	94.6	107.8	105.6	97.5	95.4	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	52.3	41.9	45.8	46.2	40.9	37.9	32.8	34.6	36.8
External debt / XGS	127.9	107.9	136.4	131.9	115.1	104.6	99.7	99.0	94.4
Short-term debt	39.9	40.3	42.2	55.7	51.0	43.3	42.2	45.0	45.0
Short-term debt/International reserves (%)	139.6	94.7	69.7	78.6	68.1	56.9	51.6	51.7	47.4

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.3	2.4	0.2	3.0	2.8	2.4	2.0	1.6	3.0
CPI, % yoy eop	1.3	0.5	-0.3	0.2	0.0	0.3	0.6	0.2	1.7
Policy interest rate, %, eop	0.75	0.75	0.25	0.00	0.00	0.00	0.00	0.25	0.25
Short-term market rate, % eop	0.73	0.74	0.23	0.00	0.00	0.00	0.00	0.25	0.25
Long-term yield, %, eop	2.07	1.72	1.36	4.75	4.75	4.75	4.75	4.75	4.75
ILS/US$, eop	3.48	3.43	3.68	3.77	3.83	3.89	3.90	3.90	3.90

Source: National Sources, Citi Research forecasts

Kazakhstan

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- **Summary view** — Growth remains subdued with preliminary 2Q GDP expanding at 4.0%YoY (3.8% in 1Q). We downgrade our 2014 and 2015 GDP growth to 4.4% and 5.0% (vs. 5.0% and 6.0%) on heightened uncertainty in the CIS region and a China slowdown.
- **Things to watch** — One recent key macro concern has been the deterioration of the current account position, driven by a steady decline in exports related to sluggish global growth. The current account, however, improved in 1H and should be supported longer-term by the Kashagan oil field coming on stream.
- **Strategy** — The National Bank of Kazakhstan (NBK) devalued the tenge by 20% in Feb by announcing a new central level for the USDKZT of 185 within a 182-188 band. The NBK widened the corridor to 170-188 on 11 September. The NBK has the ability and resources to support the KZT at current levels.

Growth loses momentum in 2014

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

We now estimate that 2014 GDP will decelerate to 4.4% on heightened regional uncertainty and a China slowdown with downside risks. Events in Ukraine and Russia already act as some headwinds for the economy. Industrial production has started the year on a downbeat note, contracting 0.3%YoY in 1Q14 and by a further 0.4% in 2Q14. Consumption will remain a key driver in 2014, although the pace of expansion will moderate. A slowdown in China will also bite.

First half GDP data already showed some fragility. 1Q14 GDP grew only at 3.8%YoY while preliminary 2Q14 data points to a 4.0%YoY growth, confirming our view that Kazakhstan will not be able to emerge unscathed from the broader EM malaise and the regional geopolitical uncertainty. The short-term economic indicator, which captures around two thirds of the economy, expanded by a mere 2.6% during Jan-Sep on a YoY basis.

Growth is mainly driven by consumption as production struggles. This is best exemplified by the diverging behavior of retail sales and industrial production. Real retail sales grew at 12.8%YoY during 2013, broadly on par with its pace over 2011 and 2012. At the same time, industrial production has faced some headwinds, increasing by only 2.3%YoY during 2013. The same divergence has remained in place for the first half of 2014, with retail sales growing by 11.6%YoY, while industrial production contracting by 0.4%.

Consumption itself is increasingly led by robust retail loan growth. While consumption was initially supported by disposable incomes, which were growing at double digits in real terms, retail loans have taken over since about mid-2011. Real retail loan growth turned positive around that time, but has since accelerated to almost 27%YoY as of December 2013 (corporate loans grow at about 10%). This may be at least partly related to catching-up with post-crisis times as consumers deleveraged during 2009. Growth has moderated to 19.0%YoY in August this year, but remains robust enough to provide decent support for consumption spending.

Weaker current account leads to a currency devaluation

While the broader macro-economy has been healthy, the worsening current account position has been one key reason for concern. The current account was in deficit in 4 out of the last 6 quarters. After posting deficits of US$1.0bn in 3Q12 and US$2.5bn in 4Q12, the current account went into a surplus of US$2.2bn in 1Q13, before transitioning to a small deficit in 2Q13 (US$0.01bn) and plunging into a much bigger deficit in 3Q (US$2.2bn). 4Q13 current account was almost flat at -US$0.06bn. Correspondingly, the annual current account surplus dipped from 5.5% of GDP in 2011 to only 0.5% in 2012 and a deficit of 0.1% in 2013. Current account improved to US$6.2bn in 1Q and US$0.4bn in 2Q.

The deterioration of the external position has also led to a decline in foreign reserves. Gross foreign reserves have followed current account's performance, falling from US$35.5bn in February 2012 to US$26.5bn in March 2014. Foreign reserves have more recently improved, rising to US$28.0bn in August.

This led to the National Bank of Kazakhstan (NBK) to devalue the tenge by 20% in early February. The new central level for the USDKZT is 185, with the tenge being allowed to fluctuate between 182 and 188. The NBK has a history of adjusting the tenge to sizable moves in the RUB (early 2009 a prime example) and the NBK's statement explicitly cites concerns about the RUB and, more generally, about potential loss of competitiveness. Devaluation fears had also been growing in the country with the FX share of deposits rising rapidly from 29.8% in December 2012 to 39.6% in January 2014. The share rose sharply to 47.7% in March 2014, although it dropped to 45.5% in August.

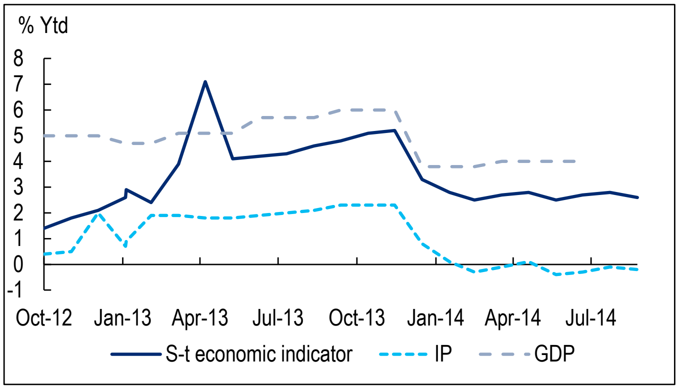
NBK widens USDKZT corridor in September

It has always been our view that the original 20% devaluation was too large. According to the REER, the tenge actually looks now too weak rather than too strong. The tenge was only about 2% stronger in Jan relative to its 2008-2013 REER average. For comparison, in Jan 2009 the REER was about 15% overvalued, which is mostly consistent with the 20% devaluation implemented in Feb 2009. The same can be gleaned from looking directly at the RUBKZT, which also does not indicate levels of stress that existed around early 2009. While in Jan 2009, the RUBKZT was 17% stronger relative to its long-term average, justifying a 20% devaluation, in Jan 2014, the RUBKZT was only 8% stronger relative to its long-term average.

The current decision to widen the corridor on the downside should, thus, be taken, as a way to bring the exchange rate to levels more in line with macro fundamentals. NBK's actions may suggest that the NBK is explicitly acknowledging some mistakes in weakening the KZT too much. This may be related to concerns that the larger-than-warranted devaluation is contributing to accelerating CPI inflation, which accelerated from only 4.5%YoY in January to 7.4% in Sep. The proposed lower band of the corridor (170 vs 182 before) would in fact amount to exactly 10% devaluation relative to the original (pre-February) 155 USDKZT.

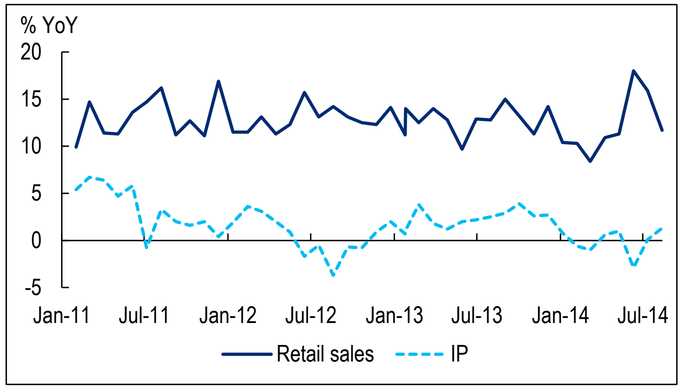
Still, given that the RUBKZT has now reached levels at which the tenge was devalued back in Feb, concerns have again emerged that another devaluation may be in store. Despite the level of the RUBKZT, the REER is still running at levels that suggest that the tenge is weak rather than strong. In addition, we doubt that the authorities will authorize a second devaluation in a single year for fear of creating unwanted social disruptions similar to those happening in Feb.

Figure 153. Growth is still strong, but some weakness is evident



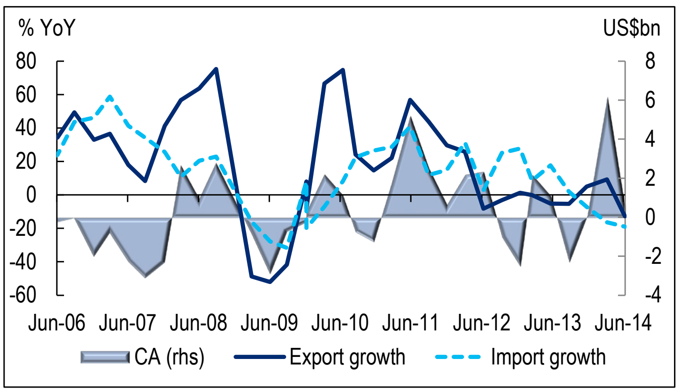
Source: Kazstat, Citi Research

Figure 154. Growth is mainly consumption driven as production struggles



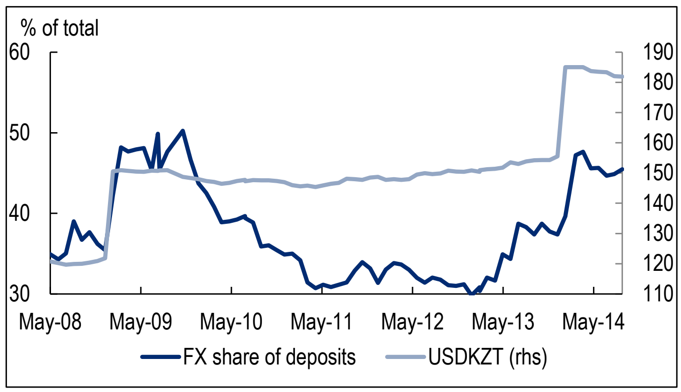
Source: Kazstat, Citi Research

Figure 155. Current account improved in 1H



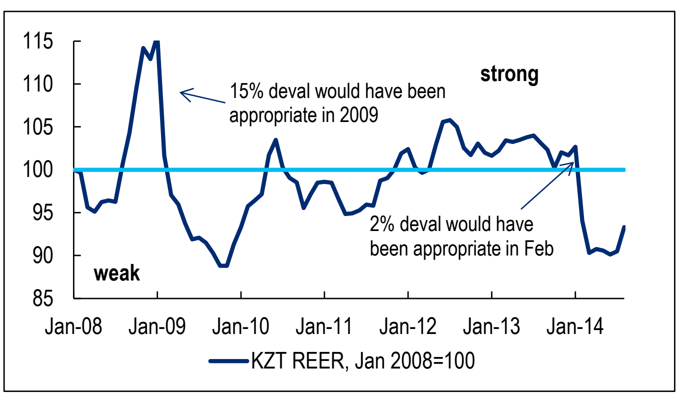
Source: NBK, Citi research

Figure 156. FX share of deposits have started to stabilize after the Feb devaluation



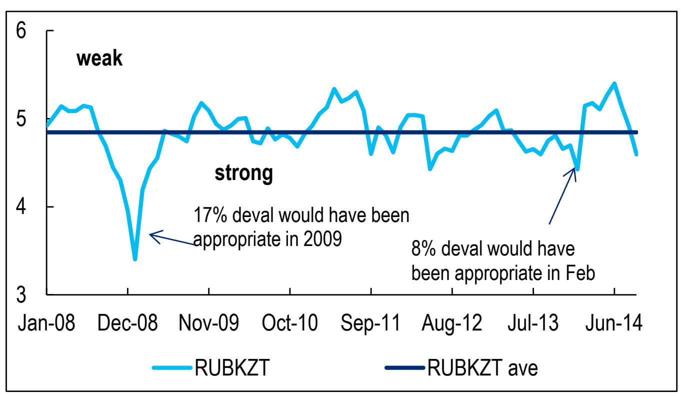
Source: NBK, Citi Research

Figure 157. Tenge is still too weak when judged by the REER…



Source: NBK, Citi Research

Figure 158. …although it has now reached levels against the RUB at which the KZT was devalued in Feb



Source: Bloomberg, Citi Research

Figure 159. Kazakhstan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	105	133	115	146	186	202	222	209	226
Nominal GDP, local currency bn	12,547	16,053	17,008	20,540	27,305	30,147	33,767	37,417	41,594
GDP per capita, USD	6,810	8,572	7,324	9,171	11,568	12,426	13,501	12,583	13,395
Population, mn	15.4	15.6	15.7	15.9	16.1	16.3	16.4	16.6	16.8
Unemployment, % of labour force	7.3	6.6	6.6	5.8	5.4	5.3	5.2	5.2	5.2
Economic Activity									
Real GDP, yoy avg	9.2	3.6	0.8	7.3	7.5	5.0	5.9	4.4	5.0
Real investment growth % yoy	23.4	-12.8	2.3	2.0	5.9	12.2	10.7	2.3	3.1
Real consumption growth % yoy	11.4	6.0	0.7	10.0	10.9	11.4	8.2	4.6	5.9
private consumption growth % yoy	11.1	6.4	0.7	10.9	10.9	11.2	9.0	5.0	6.0
Real export growth, % yoy	9.1	0.9	-11.9	3.1	1.5	4.2	-0.2	2.0	2.0
Real import growth, % yoy	26.1	-11.5	-15.7	2.9	3.5	22.5	5.2	3.0	8.0
Prices, Money & Credit									
CPI, % yoy eop	18.8	9.5	6.2	7.8	7.4	6.1	4.6	7.6	5.7
CPI, % avg	10.8	17.1	7.3	7.1	8.3	5.2	5.8	6.7	6.4
Nominal wages, % yoy	28.1	16.2	10.8	14.9	15.9	13.5	6.8	7.0	8.0
Credit extension to private sector, % yoy	55.2	5.2	7.3	0.3	15.8	12.1	12.8	12.0	12.0
Policy Interest Rate, % eop	11.00	10.50	7.00	7.00	7.50	5.50	5.50	5.50	6.00
1 month inter-bank rate, %, eop	11.50	9.00	4.00	1.50	1.50	1.50	5.50	3.48	3.98
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	121	121	149	147	148	150	154	185	185
KZT/US$, avg	123	120	147	147	147	149	152	179	184
Balance of Payments, USD bn									
Current account	-8.4	6.3	-4.1	1.4	10.2	1.1	-0.1	2.3	3.3
% of GDP	-8.0	4.7	-3.6	0.9	5.5	0.5	-0.1	1.1	1.5
Trade balance	15.2	33.6	15.0	28.5	44.8	38.1	33.7	35.7	39.1
Exports	48.3	72.0	43.9	61.4	85.2	86.9	83.4	88.4	95.5
Imports	33.1	38.4	28.9	32.9	40.3	48.8	49.7	52.7	56.4
Service balance	-8.4	-6.9	-6.0	-7.2	-6.6	-7.9	-6.9	-6.0	-7.0
Income balance	-12.9	-19.4	-12.4	-19.4	-27.7	-28.1	-25.3	-26.5	-27.8
FDI, net	-8.0	-13.1	-10.1	-3.7	-8.6	-11.8	-7.8	-6.0	-8.6
International reserves	17.6	19.9	22.7	27.7	28.8	27.7	24.1	27.4	31.1
Total amortisations	28.8	34.1	39.0	25.4	29.6	31.9	31.9	10.5	11.1
Public Finances, % of GDP									
Consolidated government balance	4.5	-9.3	-9.4	2.7	5.9	3.9	3.0	2.4	2.1
Consolidated gov primary balance	4.8	-8.9	-9.0	3.1	6.3	4.4	3.5	3.0	2.7
Public debt	5.3	6.3	9.5	10.3	10.0	12.0	12.7	13.9	14.7
of which Domestic	4.0	5.1	7.6	7.8	7.6	9.6	10.4	11.7	12.4
Foreign Assets & Liabilities, USD bn									
External debt	66.8	67.7	63.2	65.9	62.7	69.3	76.1	86.7	88.0
Public	1.6	1.7	3.2	4.8	5.1	5.5	5.7	7.3	8.6
External debt / GDP	63.7	50.8	54.8	45.2	33.7	34.3	34.3	41.4	39.0
External debt / XGS	129.0	88.8	131.7	100.7	70.1	75.6	85.8	98.1	92.2
Short-term debt	11.5	9.5	7.0	8.9	7.9	9.1	9.4	9.8	9.9
Short-term debt/International reserves (%)	65.4	47.7	30.8	32.0	27.3	32.8	38.9	35.7	31.8

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	4.0	3.2	4.2	5.9	6.0	6.2	4.6	3.4	3.3
CPI, % yoy eop	6.0	6.8	7.6	7.6	6.5	6.4	6.0	5.7	5.9
Policy interest rate, %, eop	5.50	5.50	5.50	5.50	5.50	6.00	6.00	6.00	6.00
Short-term market rate, % eop	5.00	4.00	5.50	3.48	3.48	3.98	3.98	3.98	3.98
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	182	184	182	185	185	185	185	185	185

Source: National Sources, Citi Research forecasts

Levant

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The recent confirmation of the Iraqi Defence and Interior ministers is a significant step towards bolstering the government of Prime Minister Haider al-Abadi. We believe the most urgent task of the new government is to pave the way toward some sort of reconciliation or accommodation between the country's polarized sectarian populations, and in particular to reduce the sense of disenfranchisement and marginalization among the Sunni population that has enabled the rise of extremist insurgency in Sunni-dominated areas.

In this regard, the appointment of Khaled al-Obeidi, a prominent Sunni politician from the fallen city of Mosul, is a significant step forward. The Iraqi military is perceived as being Shia-dominated and overtly sectarian by the country's Sunni population, adding to a sense of distrust of Baghdad. We think appointing a prominent Sunni at the helm may go some way to allaying these suspicions.

Perhaps more importantly, however, the control of the military by a member of the Sunni leadership brings with it the promise of reversing the decade-old process of de-baathification. This policy purged the army of huge numbers of experienced Saddam-era soldiers and officers, and contributed to the advance of ISIS in two key ways. First, it severely weakened the battle-readiness of the Iraqi army, aggravating problems of incompetence and corruption within military ranks. Second, it fuelled the resentment of the Sunni population, and lead to the radicalization of many experienced (and now unemployed) Saddam-era soldiers which have aided, either explicitly or implicitly, ISIS's rise.

It remains to be seen the extent to which Mr al-Obeidi will be able to extend his influence over the Army and military policy. His predecessor was another respected Sunni politician, Saadoun al Dulaimi, who failed to exert control. This failure was largely due to previous PM Nouri al Maliki's authoritarian leadership style and disregard for the Iraqi constitution, which led him to go so far as to set up direct commands in the field that reported directly to the Prime Minister, bypassing the chains of command and severely eroding the authority of the ministry. Dismantling these direct commands and re-establishing the authority of the ministry over the armed forces will be a key early hurdle for Mr Obeidi, in our view.

That said, we believe the appointment of Mr Obeidi will help bolster the bridge-building credentials of Mr Abadi's government, something which is less obvious of his choice of interior minister. The Iraqi police are arguably more powerful a force than the military and certainly have a greater impact on the day-to-day lives of civilians, with whom they have more contact. The Sunni population has complained about the sectarian nature of the police, including harassment, torture and alleged extra-judicial killings. The appointment of Mohammed Salem al-Ghabban, a member of the Badr Organisation, will likely do little to allay these concerns, in our view. Al-Ghabban is subordinate to the organisation's head Hadi al-Amiri, who led the Shia militia during Iraq's civil war of 2006-2008, establishing its reputation as one of the most active and violent of that time.

Overall, however, we believe that the political climate in Iraq is gradually improving, a sentiment reinforced by the decision of the Kurdish leadership to participate in the new government despite a number of outstanding points of contention between Erbil and Baghdad (Iraq Oil Report, October 14). We believe that establishing a political accommodation between Iraq's Sunni, Kurdish and Shia communities is a critical pre-requisite to marginalizing and eventually defeating extremist insurgents such as ISIS.

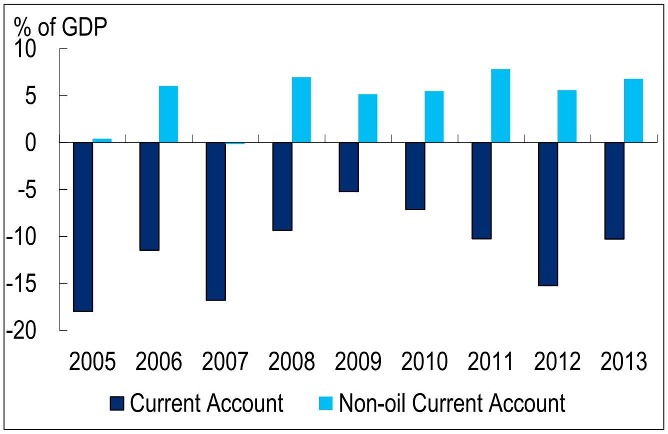
Militarily, the fight against ISIS appears to be bearing fruit. US-led airstrikes in Iraq and Syria have been decisive in halting ISIS's advance and have turned the military balance against the extremist group. In the past month, the Syrian Kurdish border-town of Kobani has become the focal point of the conflict, as ISIS have striven and failed to gain control of the strategic border-crossing at great loss of life (481 fighters, according to the Syrian Observatory for Human Rights). Their failure is in large part due to the intensity of US-led aerial bombardment, and the story is repeated numerous times across northern Syria and Iraq. Kurdish and Iraqi security forces have made headway in recapturing strategic towns.

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

The prolonging of the conflict in Syria spells risks for neighbouring Lebanon, in our view. Not only has the Lebanese economy been overwhelmed by the arrival of over 1 million displaced Syrians (20% of the Lebanese population), the Syrian civil war has also threatened to flare up already heightened sectarian tensions within Lebanon. A spate of bombings in Beirut in the summer appears to have subsided, but after the attack and capture of Arsal by JAN militants in August, the northern city of Tripoli has in recent days seen fighting between government troops and forces linked with JAN. The Jihadi group has responded by threatening to execute 30 Lebanese soldiers it has been holding since the fighting in Arsal in the summer, and shelling Hizbollah positions in the Bekaa Valley.

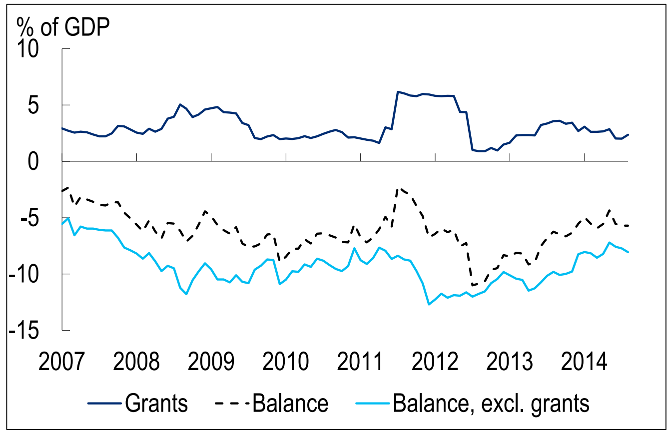
While the fiscal, economic and political picture looks difficult, our view remains that the slide in country risk does not necessarily signal a slide in Lebanese sovereign risk. This is because we believe the stability of the sovereign risk profile rests on the robustness of the Lebanese banking sector and its ability to continue funding the government. Banking sector indicators remain robust. Overall deposit growth was 7% yoy in February, with non-resident deposit growth remaining in the double digits (11%). The dollarisation ratio remained stable at under 60%, and the risk premium on Lebanese Lira deposits has likewise hardly moved in recent months. In our view, the banking sector remains sound and liquid and retains significant capacity to continue financing the Lebanese sovereign through the purchase of government securities. This keeps sovereign risk in check, despite an evidently deteriorating country risk profile (see Lebanon Macro View - The gap widens between country and sovereign risk).

Figure 160. Jordan current account dominated by oil imports …



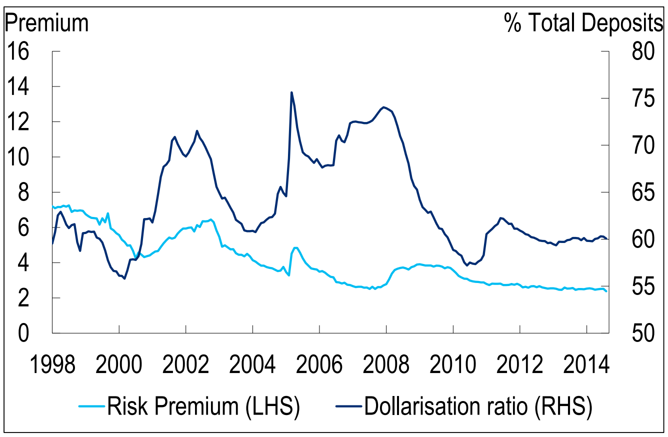
Source: Haver Analytics, Citi Research

Figure 161. Without grants Jordan's fiscal situation would be worse



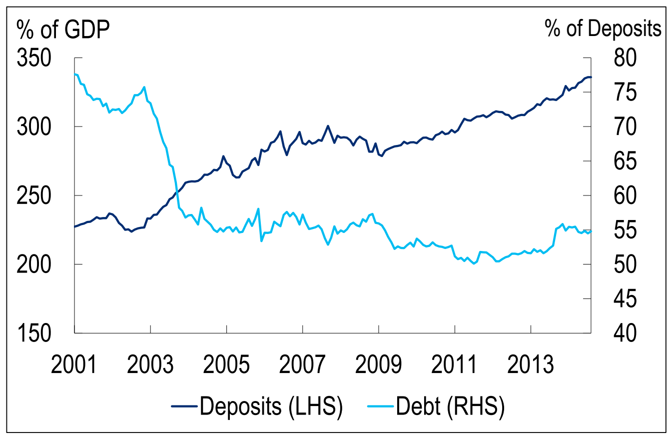
Source: Haver Analytics, Citi Research

Figure 162. Lebanon dollarization has gone up, but risk premium stable



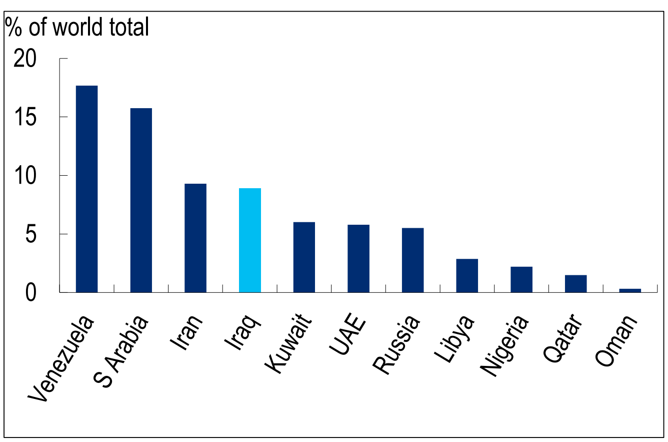
Source: Haver Analytics, Citi Research

Figure 163. Deposit growth slows, but still plenty of capacity



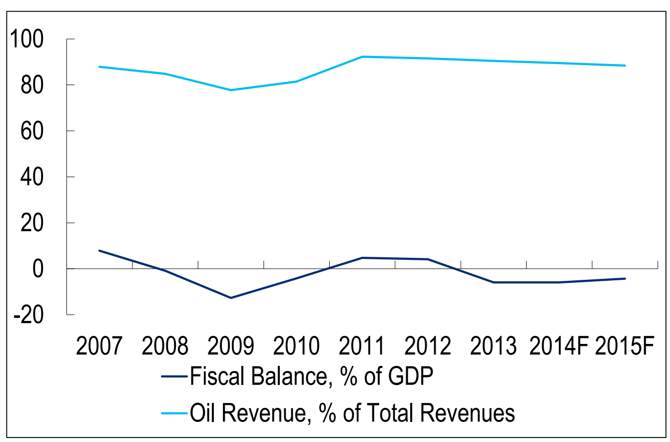
Source: Haver Analytics, Citi Research

Figure 164. Iraq has world's fourth largest proven oil reserves and …



Source: BP, Citi Research

Figure 165. … public finances should strengthen as a result



Source: Haver Analytics, Citi Research

Figure 166. Levant Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
IRAQ									
Nominal GDP, USD bn	91.7	135.6	113.6	138.9	186.3	216.6	230.1	229.5	248.6
GDP per capita, USD	3,190	4,607	3,766	4,487	5,871	6,655	6,892	6,705	7,080
Real GDP, yoy avg	1.4	6.6	5.8	5.5	10.2	10.3	6.8	0.1	8.9
CPI, % avg	20.8	2.7	-2.2	2.4	5.6	6.1	1.9	2.5	5.0
IQD/US$, avg	1,253	1,189	1,156	1,167	1,171	1,164	1,162	1,162	1,162
Current account, US$bn	20.0	28.4	-1.3	6.3	26.2	39.6	32.4	24.5	23.5
% of GDP	21.9	20.9	-1.1	4.6	14.1	18.3	14.1	10.7	9.5
Consolidated gov. balance, % of GDP	7.8	-0.9	-12.7	-4.2	4.7	4.1	-5.9	-5.9	-4.3
JORDAN									
Nominal GDP, USD bn	17.1	22.0	23.9	26.5	28.8	30.9	33.6	35.7	38.1
GDP per capita, USD	3,026	3,722	3,866	4,104	4,284	4,404	4,615	4,712	4,839
Real GDP, yoy avg	8.2	7.2	5.5	2.3	2.6	2.7	2.8	3.6	3.8
CPI, % avg	4.7	13.9	-0.7	5.0	4.4	4.8	5.5	2.8	3.1
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	-3.0	-4.7	-3.4	-4.2	-4.9
% of GDP	-16.8	-9.3	-5.2	-7.1	-10.3	-15.3	-10.0	-11.7	-12.9
Consolidated gov. balance, % of GDP	-5.1	-4.4	-8.9	-5.6	-6.8	-8.3	-5.5	-4.9	-4.2
LEBANON									
Nominal GDP, USD bn	24.6	28.8	35.1	38.0	40.1	43.0	43.8	45.1	47.4
GDP per capita, USD	6,538	7,572	9,111	9,726	10,126	10,647	10,626	10,744	11,059
Real GDP, yoy avg	9.3	9.1	10.3	8.0	2.0	2.5	0.7	0.4	2.5
CPI, % avg	4.1	10.8	1.2	4.0	5.0	6.6	2.1	1.9	2.6
LBP/US$, avg	1,512	1,507	1,504	1,502	1,506	1,504	1,507	1,508	1,508
Current account, US$bn	-1.8	-3.2	-4.4	-5.1	-6.3	-6.7	-7.2	-6.8	-6.6
% of GDP	-7.2	-11.1	-12.5	-13.3	-15.7	-15.6	-16.4	-15.0	-14.0
Consolidated gov. balance, % of GDP	-10.4	-10.1	-8.4	-7.6	-5.8	-9.1	-9.6	-9.8	-9.8

Source: National Sources, Citi Research forecasts

Nigeria

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- **Summary view** — Although political uncertainty is set to rise towards the February 2015 elections, we still expect growth to remain robust at just over 6% in 2014-15 and overall macroeconomic stability to deteriorate only marginally.
- **Things to watch** — The weakening of the oil price has increased pressure on the naira since early October. But the CBN and policy makers have a number of policy options to limit naira weakness, including tightening monetary policy, and no major break in the currency, as in late 2008, seems imminent.
- **Strategy** —The finance minister, Ngozi Okonjo-Iweala, will seek to maintain fiscal discipline despite the approaching elections, while progress with structural reform is likely to stall. All eyes will then focus on the outcome of the elections and the policy choices the new government makes in 2H 2015.

Africa's largest economy heads to the polls

Following the GDP rebasing exercise completed in early 2014, Nigeria is now Africa's largest economy, with an estimated GDP of US$510bn in 2013. But the revisions have also led changes in the pattern or growth and a downward revision to the growth rate in the 2011-12 period to levels of around 4-5%, rather than the previous levels of 7%, although economic growth has picked up in 1H 2014.

Even though Nigeria is now the largest economy in Africa, it does not change the myriad challenges facing the government. These include the need to reduce high levels of poverty, boost electricity production or re-build savings in the excess crude account (ECA). Moreover, given the likely rise of political tensions as the country heads towards presidential and legislative elections set for mid-February 2015 we only expect very limited progress with key, but long overdue, structural reforms, notably in the electricity sector.

Not only do we expect political tensions within the elite to rise sharply as the polls approach, but the elections will be set against the background of the on-going conflict with Boko Haram in the north. The likelihood of this spreading to other parts of the country still seems limited, but if it was to occur it would potentially much more significantly impact on the economic outlook.

In terms of the elections, we expect that the ruling People's Democratic Party (PDP) will take the lead in selecting its presidential candidate. At present, this is likely to be the incumbent president, Jonathan Goodluck, who is expected to declare his intention to stand in the coming months. The battle to be the candidate for the opposition All Progressives Congress (APC) is likely to be more closely contested, but should be decided by early December. But with only a few months to polling day, the nominee may struggle to build enough momentum to defeat the PDP candidate.

But growth should remain robust

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

Broad naira stability, but bouts of pressure

Despite positive macroeconomic data, in recent years, the government has struggled to save into the ECA or SWF despite the oil price being over US$100/barrel. While a tight monetary policy and portfolio inflows has allowed the CBN to re-build reserves, these are not savings. Moreover, when foreign exchange demand has risen, foreign exchange reserves have quickly come under pressure. This has created a number of self-fulfilling cycles of rising demand for foreign exchange and greater naira pressure, the latest having been triggered by the falling world oil price in early October.

But it is not always helpful just to focus on the oil price when thinking about the naira outlook: the level of oil production and foreign reserves are also crucial. Our rule of thumb is that a US$90/barrel oil price with production over 2m b/d and with reserves above US$30bn allows the CBN to maintain broad naira stability. But if 2 out of 3 indicators are breeched for a sustained period of time, the pressure on the naira will grow rapidly, especially if it foreign exchange reserves are moving towards what we think is the CBN's cut-off point of US$30bn.

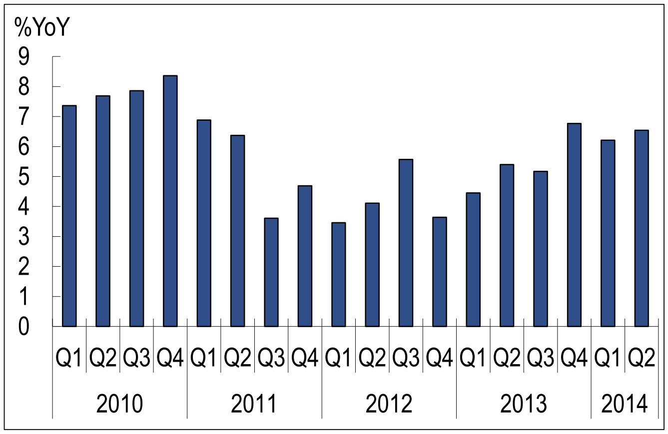
Beyond this point, the CBN will probably have to revisit its policy of maintaining naira stability, or allow a devaluation of the currency. But it is likely to hold the line for some time before reacting, depending on the rate of reserve burn and the potential emergence of differential between the parallel and official exchange rates. It should also be noted that the CBN has been ambiguous about what it considers a suitable level of foreign exchange reserves. If, for example, it uses the internationally acceptable level of cover of three months of goods and services this would indicate an ultimate cut off level of around US$20.5bn on our data forecasts, at which point the supply of foreign currency, and support for the naira, would need to be comprehensively re-evaluated.

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

Even if the naira does come under further pressure in the run up to the elections, there are still a number of policy options that the CBN and policy makers can pursue to limit any depreciation. Moreover, with the elections approaching, the political pressure not to devalue the naira is likely to be substantial. The easiest solution would be to push oil production back up towards the 2.5m b/d level, boosting revenue and foreign exchange inflows, while keeping a tighter rein on disbursements from the ECA than in recent years. It should then be able to slowly, if only very modestly rebuild its savings. And if this means that it can keep reserves in the US$35-US$40bn level, pressure on the naira will probably be containable even with the approach of the elections.

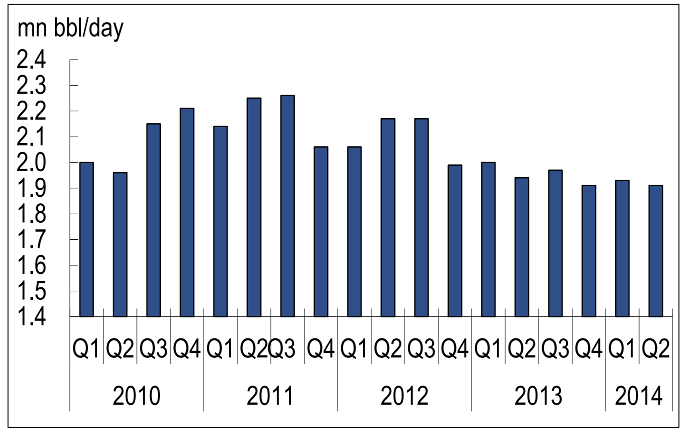
The CBN could also further tighten monetary policy to defend the naira. Not only can it more aggressively mop under liquidity, but we expect that inflation will start to trend back up again in early 2015, and if fiscal spending pressures were to rise, the CBN would be under no real pressure to lower interest rates until after the elections. In fact, it could probably justify a rate rise which would also provide support to the naira. But while such measures will limit any depreciation, they are arguably only temporary solutions. Therefore, once the elections are passed the more fundamental question will have to be asked about whether the current policy of naira stability is sustainable without a significant increase in the ECA and reserves.

Figure 167. New growth data shows economic weakness in 2011-12, with a recovery since 2H 2013



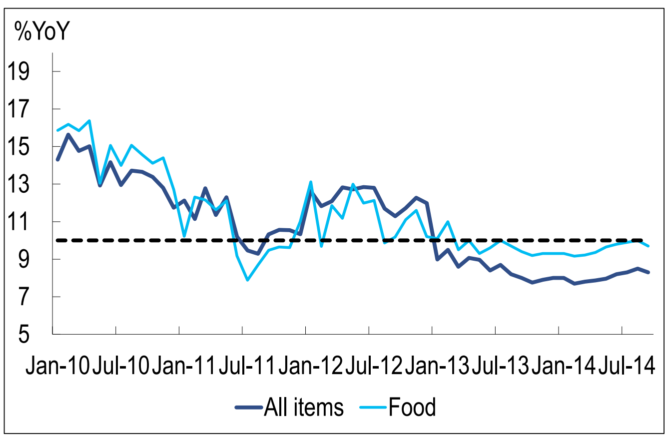
Source: National Bureau of Statistics

Figure 168. Oil production seems to have stabilized since late 2013



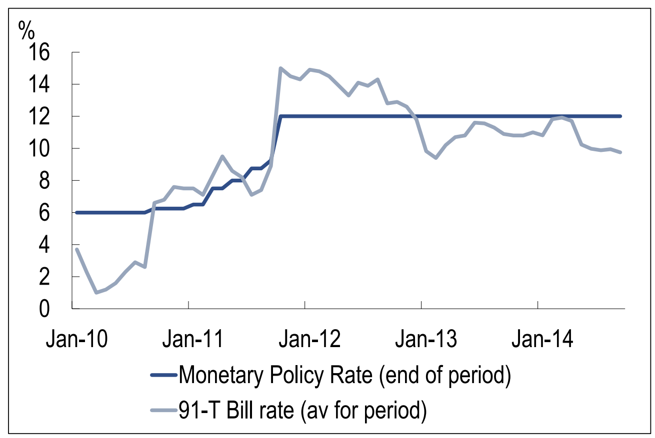
Source: International Energy Agency

Figure 169. Inflation has remained in single digits so far in 2014, but has started to edge up



Source: National Bureau of Statistics

Figure 170. The MPR has been left unchanged since October 2011

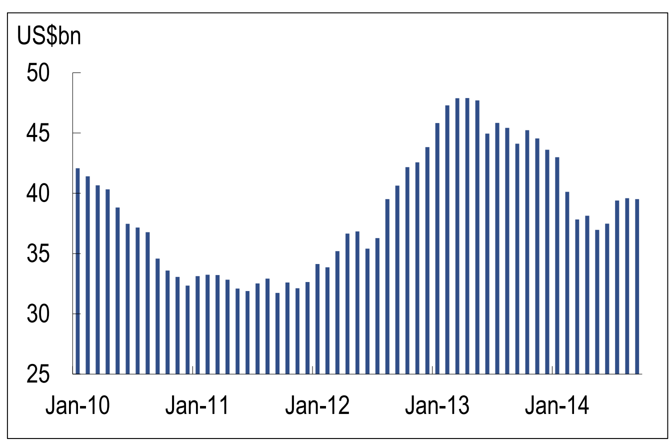


Source: Central Bank of Nigeria

Figure 171. Pressure on the naira has come and gone in 2014, and is currently on

Source: Reuters

Figure 172. Reserves have not come under pressure, yet, despite the weakening in the global oil price



Source: Haver Analytics and Central Bank of Nigeria

Figure 173. Nigeria Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	-	-	-	361	404	452	509	566	638
Nominal GDP, local currency bn	-	-	-	54,612	62,980	71,714	80,093	92,200	107,425
GDP per capita, USD	-	-	-	2,283	2,488	2,712	2,983	3,230	3,553
Population, mn	146.8	150.6	154.4	158.4	162.4	166.6	170.8	175.2	179.7
Unemployment, % of labour force	-	-	-	-	-	-	-	-	-
Economic Activity									
Real GDP, yoy avg	-	-	-	-	5.3	4.2	5.5	6.4	6.4
Real investment growth % yoy	-	-	-	-	-	-	-	-	-
Real consumption growth % yoy	-	-	-	-	-	-	-	-	-
private consumption growth % yoy	-	-	-	-	-	-	-	-	-
Real export growth, % yoy	-	-	-	-	-	-	-	-	-
Real import growth, % yoy	-	-	-	-	-	-	-	-	-
Prices, Money & Credit									
CPI, % yoy eop	6.6	15.1	13.9	11.7	10.3	12.0	7.9	8.7	9.4
CPI, % avg	5.4	11.6	12.5	13.7	10.8	12.2	8.5	8.2	9.5
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	97.1	59.4	26.8	-3.8	44.3	6.8	9.0	10.1	15.0
Policy Interest Rate, % eop	9.50	9.75	6.00	6.25	12.00	12.00	12.00	12.00	11.75
1 month inter-bank rate, %, eop	12.50	18.00	15.79	13.07	17.17	14.39	12.61	13.00	13.00
Long-term yield, %, eop	11.00	12.45	8.32	7.15	16.50	11.90	11.77	12.00	13.50
NGN/US$, eop	118	138	150	152	162	156	160	165	169
NGN/US$, avg	126	119	150	151	156	159	159	163	167
Balance of Payments, USD bn									
Current account	27.6	29.1	14.0	14.5	12.6	18.9	20.6	12.0	9.7
% of GDP	-	-	-	4.0	3.1	4.2	4.0	2.1	1.5
Trade balance	37.8	45.9	25.7	31.7	35.0	40.9	43.7	36.2	32.9
Exports	66.1	85.7	56.8	78.5	97.2	94.3	95.1	89.4	89.0
Imports	28.3	39.8	31.1	46.8	62.2	53.4	51.4	53.2	56.1
Service balance	-16.9	-22.1	-16.7	-18.5	-21.4	-21.7	-20.1	-21.8	-21.6
Income balance	-11.8	-15.1	-14.6	-19.7	-23.0	-22.3	-25.2	-25.4	-24.8
FDI, net	-	-	-	-	-	-	-	-	-
International reserves	51.3	53.0	42.4	32.3	32.9	43.8	43.6	37.5	40.4
Total amortisations	0.9	0.6	0.5	0.5	0.4	0.3	0.3	0.3	0.3
Public Finances, % of GDP									
Consolidated government balance	-0.4	-0.1	-1.8	-2.0	-1.8	-1.4	-1.6	-2.0	-2.1
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	7.0	5.5	7.1	8.2	8.4	9.2	8.8	9.0	9.0
Foreign Assets & Liabilities, USD bn									
External debt	3.4	3.7	4.6	4.6	5.7	6.5	8.8	9.2	12.3
Public	3.0	3.2	3.9	4.4	5.0	6.0	7.3	7.7	10.0
External debt / GDP	-	-	-	1.3	1.4	1.4	1.7	1.6	1.9
External debt / XGS	5.0	4.2	7.7	5.6	5.6	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2016 Q1F
GDP, % yoy	6.8	6.2	6.5	6.1	6.7	5.2	6.2	6.9	6.3
CPI, % yoy eop	7.9	7.8	8.2	8.3	8.7	9.9	9.8	9.4	9.0
Policy interest rate, %, eop	12.0	12.0	12.0	12.0	12.0	12.0	12.0	11.8	11.8
Short-term market rate, % eop	11.1	11.4	12.1	12.8	13.0	13.5	13.5	13.0	12.5
Long-term yield, %, eop	13.3	14.0	12.2	11.7	12.0	12.4	12.8	13.1	13.0
NGN/US$, eop	160	165	163	164	165	165	168	169	170

Source: National Sources, Citi Research forecasts

Poland

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- **Summary view** — Recently published data surprised to the upside but we expect relatively stable growth in the near term followed by GDP acceleration to 3.4% in 2015.
- **Things to watch** — Interest rate decision in November deserves attention as the MPC is split on whether monetary policy should be eased further or not.
- **Strategy** — External environment, including asset purchases by the ECB, are likely to support Polish bonds in the coming months.

Growth stabilizing?

After substantial slowdown in prior months the most recent set of data seems to suggest the stabilization in economic activity. Positive surprises in case of manufacturing PMI, industrial production and construction output in September were moderate but sufficient to lift our momentum indicator a bit, thus suggesting that QoQ GDP growth is about to bottom out. It is too early to call a turnaround in economic growth, especially given weak performance of the euro zone, but if the October data confirms this signal we would be more constructive about next year's growth outlook.

The data published so far suggest the GDP growth decelerated to 2.7-2.8% in 3Q. If confirmed this would be much lower than 3.3% in 2Q, though still a bit higher than our last month's estimates were suggesting. Although, we expect some acceleration in QoQ terms in the coming quarters, the year-on-year growth will most likely stay subdued, at around 2.5%, until 1Q 2015, mostly due to statistical factors (high base effect). More significant acceleration would be possible only later in 2015 and we expect growth in full 2015 to reach 3.4%.

Our forecast assumes that the clearly negative impact of external environment on Polish growth will be offset by more favourable domestic factors. There is no single factor that could boost GDP growth but we expect several small impulses coming from different sources. First, 2015 will be a year when EU-financed investments will cumulate, which should be supportive for private and public investment. Second, the budget already assumes noticeably acceleration in public spending and given much better than expected fiscal performance so far we believe the government will have sufficient space to ease fiscal policy if such a need arises. Third, a drop in commodity prices proved much deeper than weakening of the zloty and given that Poland is energy importer this should be a positive factor for growth. According to central bank's estimates each 10% decline in energy prices can raise GDP growth by 0.2% points (after two years). The biggest and probably underestimated risk to our scenario is potential further slowdown in the euro zone, including rising tensions in peripheral economies. If this risk materializes the growth in Poland would stay lower for longer.

Bigger than expected rate cut

Although in September the inflation surprised to the upside it is expected to stay below zero until the year end. The consumer price inflation remained at -0.3%YoY as food prices surprised to the upside, even despite the implementation of the Russian embargo on Polish food. However, given low crude oil prices we keep our inflation forecast and expect the CPI to remain in deflationary territory until the end of the year.

In response to low inflation the MPC cut the reference rate by 50bp, to 2%, in October. The reduction was bigger than expected but the actual surprise to us was a 100bps cut in the Lombard rate (upper limit of the rates corridor around the base rate). Since, according to Polish anti-usury law, the maximum level of interest rates charged on consumer lending is four times the Lombard rate, the reduction has led to a 400bps drop in the interest rate ceiling (from 16% to 12%). This implies a substantial lowering of borrowing costs for less risky borrowers but we see a risk that with such a significant change some of more risky ones may actually lose access to bank lending. All in all, given that local currency mortgage loans are already rising at a double-digit pace we believe interest rate reductions are unlikely to have significant impact on household spending. A potentially more successful policy option would be to allow for moderate zloty depreciation in order to offset negative export shocks. We believe this aim can be achieved only indirectly, as the central bank probably would not like to get involved in market interventions to weaken PLN (at least at this stage). The NBP and Finance Ministry could use verbal interventions while a bigger share of EU funds could be converted in the central bank, instead of doing this in the market. Our reading of policymakers comments is that the NBP does not like the idea of increasing FX reserves and therefore could agree to a higher limit for FX conversion only in the case of further deterioration in growth and inflation outlook.

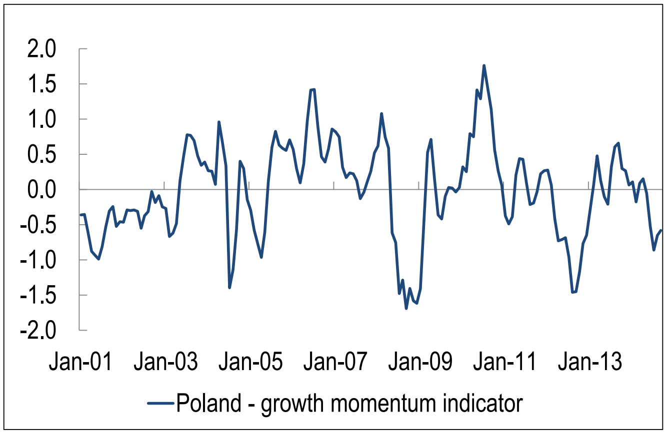
Deficit undershoots earlier forecasts

Despite weaker growth the budget deficit is likely to undershoot the 2014 official limit by a wide margin. Relatively fast tax revenues growth and a revision of historical data suggest the general government deficit could reach 3% of GDP this year and we see even a chance of it falling below the 3% mark. Next year the deficit is unlikely to exceed 2.5%, which means there is a chance the European Commission could lift the excessive deficit procedure already in 2015 or 2016 at the latest. The key advantage is that the Finance Ministry will have sufficient room of up to 0.5% point to provide fiscal stimulus if growth and inflation don't start picking up soon. This is one of reasons why we are constructive when it comes to 2015 growth outlook in Poland. The strong fiscal performance means also that the Finance Ministry should be able to prefund approximately 20% of next year's borrowing needs through December. In October the Ministry has already funded 15% of PLN 154.8bn borrowing needs for 2015. Very comfortable funding position suggests the FinMin will be able to adjust bond supply in the next months in order to stabilize the market.

Stronger bonds and weaker zloty

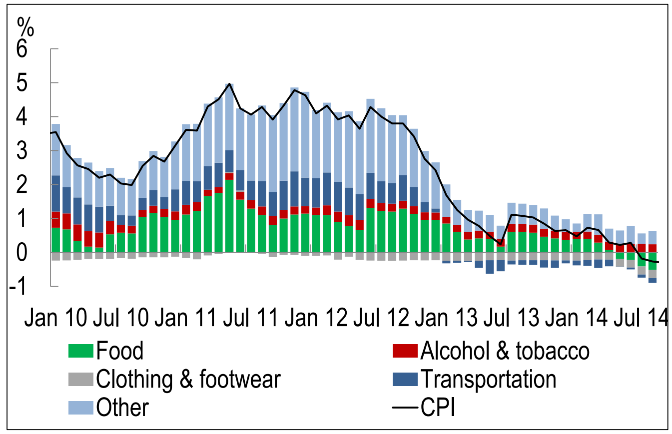
Prospects of deflation and monetary policy easing by the MPC as well as asset purchases by ECB should be supportive for domestic bonds. We see some additional room for a further decline in bond yields this year, barring another wave of risk aversion. It seems the situation in the core market will still be a key factor for domestic yields and investors are also likely to focus on rising uncertainty regarding the situation in euro zone peripheries. Although the zloty could slightly recover on drop in global volatility in the short term, we continue to expect further weakness of the zloty on still relatively weak growth in 2H14 and lower interest rates in the 3M horizon. We also see negative impact of expectations for rate hikes in the US on EM currencies in the 6-12M perspective.

Figure 174. After a sharp deceleration, QoQ growth appears to be stabilizing



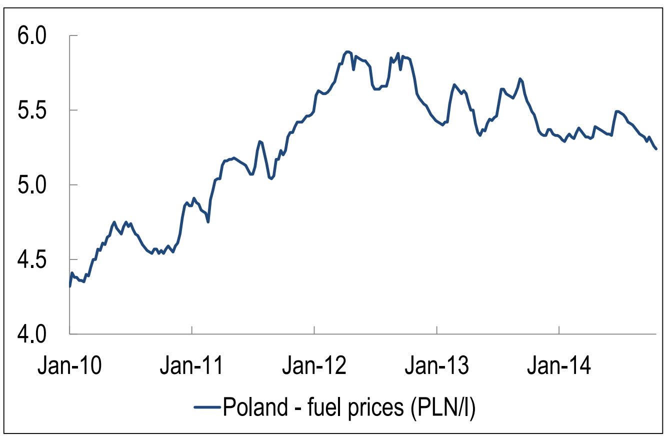
Source: Citi Research estimates based on Eurostat and GUS data.

Figure 175. Deflation is largely driven by low food and fuel prices



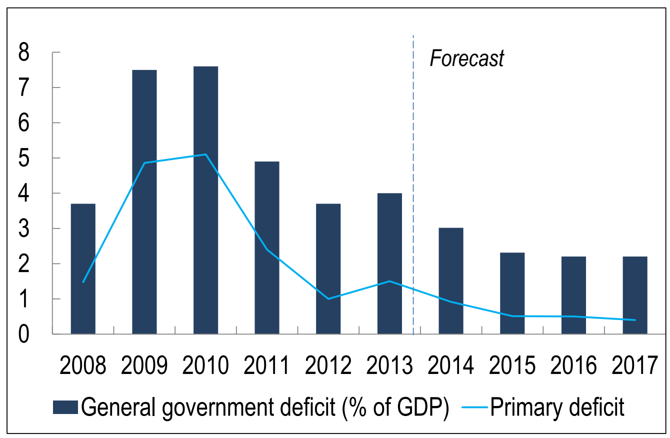
Source: Citi estimates based on GUS data

Figure 176. Commodity price decline partly offset by weaker zloty



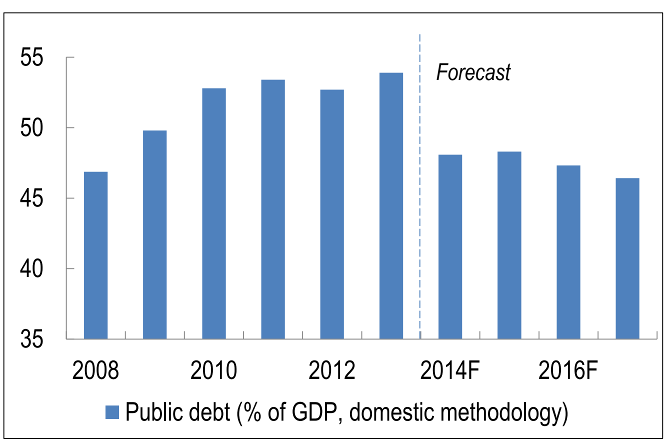
Source: Reflex, PAP

Figure 177. Deficit is expected to fall well below 3% of GDP in 2015



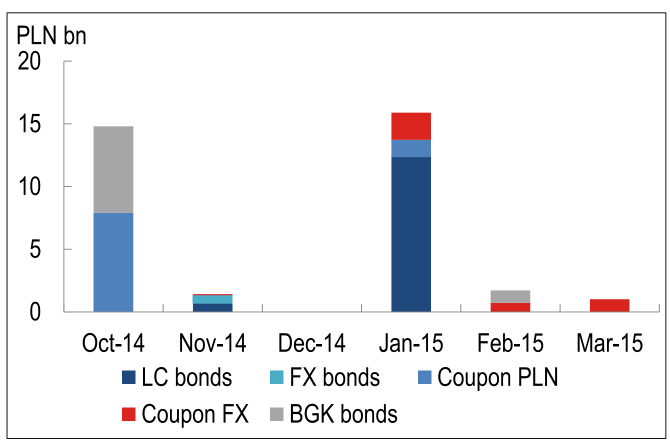
Source: Eurostat, Citi Research Estimates

Figure 178. Public debt pressure is expected to decline



Source: Ministry of Finance, Citi Research estimates

Figure 179. Bond principal redemptions and coupon payments



Source: of Finance, Bloomberg, Citi Research. Note: Gov PLN&FX principal and coupon payments (excl BGK bonds): 4Q14: PLN 9.4 bn (including PLN 7.9bn coupon on 27th Oct) 1Q15: PLN 17.6 bn

Figure 180. Poland Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	426	534	433	470	517	490	516	523	474
Nominal GDP, local currency bn	1,177	1,276	1,345	1,417	1,528	1,596	1,632	1,678	1,749
GDP per capita, USD	11,185	13,994	11,347	12,210	13,404	12,721	13,416	13,596	12,318
Population, mn	38.1	38.1	38.2	38.5	38.5	38.5	38.5	38.5	38.5
Unemployment, % of labour force	11.2	9.5	12.1	12.4	12.5	13.4	13.4	12.1	11.3
Economic Activity									
Real GDP, yoy avg	6.8	5.1	1.6	3.9	4.5	2.0	1.6	3.0	3.4
Real investment growth % yoy	24.3	4.0	-11.5	9.3	11.2	-4.0	-4.7	10.0	6.3
Real consumption growth % yoy	4.6	6.1	2.0	3.4	1.6	1.0	1.2	2.2	2.5
private consumption growth % yoy	4.9	5.7	2.1	3.2	2.6	1.3	0.8	2.5	2.8
Real export growth, % yoy	9.1	7.1	-6.8	12.1	7.7	3.9	4.6	3.5	4.7
Real import growth, % yoy	13.7	8.0	-12.4	13.9	5.5	-0.7	1.2	5.4	4.6
Prices, Money & Credit									
CPI, % yoy eop	3.9	3.4	3.7	3.2	4.6	2.6	0.8	-0.1	2.0
CPI, % avg	2.5	4.2	3.5	2.6	4.3	3.7	0.9	0.1	1.2
Nominal wages, % yoy	9.1	10.5	4.2	3.6	4.9	3.5	2.6	3.8	4.8
Credit extension to private sector, % yoy	31.5	36.4	7.0	8.5	13.9	2.4	4.5	6.5	8.0
Policy Interest Rate, % eop	5.00	5.00	3.50	3.50	4.50	4.25	2.50	1.75	1.75
1 month inter-bank rate, %, eop	5.52	5.61	3.76	3.66	4.77	4.21	2.61	1.78	1.82
Long-term yield, %, eop	5.93	5.46	6.24	6.07	5.91	3.73	4.34	2.50	3.20
PLN/US$, eop	2.47	2.97	2.87	2.97	3.45	3.09	3.02	3.49	3.74
PLN/US$, avg	2.76	2.39	3.10	3.01	2.96	3.25	3.16	3.21	3.69
PLN/EUR, eop	3.60	4.15	4.10	3.97	4.47	4.08	4.15	4.25	4.23
PLN/EUR, avg	3.78	3.52	4.32	3.99	4.12	4.18	4.20	4.19	4.27
Balance of Payments, USD bn									
Current account	-26.5	-34.9	-17.3	-24.1	-27.1	-17.6	-7.0	-10.7	-15.9
% of GDP	-6.2	-6.5	-4.0	-5.1	-5.2	-3.6	-1.4	-2.0	-3.4
Trade balance	-19.1	-30.7	-7.6	-11.8	-17.4	-9.2	0.9	0.0	-4.6
Exports	145.3	178.7	142.1	165.9	184.2	181.1	197.8	205.9	201.3
Imports	164.4	209.4	149.7	177.7	201.6	190.3	196.9	206.0	205.8
Service balance	-	-	-	-	7.3	8.0	10.6	8.7	7.7
Income balance	-16.4	-12.8	-16.6	-19.1	-18.0	-16.1	-18.0	-20.1	-20.1
FDI, net	-	-	-	-	-13.8	-6.6	-3.7	-12.0	-18.0
International reserves	54.6	57.2	69.7	81.4	86.8	96.1	94.0	76.9	36.9
Total amortisations	43.0	44.0	46.9	44.1	38.3	47.5	48.7	49.2	51.0
Public Finances, % of GDP									
Consolidated government balance	-1.9	-3.7	-7.5	-7.8	-5.1	-3.9	-4.3	-3.0	-2.3
Consolidated gov primary balance	0.4	-1.5	-4.9	-5.3	-2.6	-1.2	-1.8	-0.9	-0.5
Public debt	44.8	46.9	49.8	52.8	53.4	52.7	53.9	48.0	48.5
of which Domestic	34.3	34.8	36.7	38.4	36.5	36.1	37.6	30.0	30.1
Foreign Assets & Liabilities, USD bn									
External debt	233.6	245.0	280.5	318.6	323.4	366.7	382.1	380.1	360.1
Public	86.8	69.4	92.2	117.9	121.2	156.8	163.9	163.0	154.4
External debt / GDP	54.8	45.9	64.8	67.7	62.6	74.8	74.0	72.6	76.0
External debt / XGS	-	-	-	-	143.7	165.0	157.4	151.4	146.8
Short-term debt	44.9	51.3	54.3	48.4	44.8	42.4	46.3	44.3	40.3
Short-term debt/International reserves (%)	82.2	89.6	77.8	59.4	51.6	44.1	49.2	57.6	109.2

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.8	3.3	2.8	2.6	2.5	3.0	3.7	4.3	3.8
CPI, % yoy eop	0.7	0.3	-0.3	-0.1	0.5	1.3	1.6	2.0	2.8
Policy interest rate, %, eop	2.50	2.50	2.50	1.75	1.75	1.75	1.75	1.75	2.00
Short-term market rate, % eop	2.61	2.61	2.40	1.78	1.85	1.85	1.87	1.82	2.32
Long-term yield, %, eop	4.27	3.56	3.07	2.50	2.65	2.80	3.00	3.20	3.80
PLN/EUR, eop	4.17	4.16	4.18	4.25	4.27	4.29	4.27	4.23	4.19

Source: National Sources, Citi Research forecasts

Romania

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- **Summary view** — Growth indicators fail to show signs of a pick-up in economic activity. This, coupled with the likely downward revision of the NBR's inflation forecast trajectory, leads us to believe that a 25bp rate cut at the November Board meeting is now highly likely.

- **Things to watch** —The November presidential election and developments regarding the IMF-EU supported economic program deserve close monitoring.

- **Strategy** — Despite the presence of a fixed income friendly macroeconomic backdrop, we question whether the bond market rally has further legs following the marked downward move in yields since end-September.

Growth indicators paint a grim picture

High frequency indicators continue to paint a bleak picture for economic recovery. The recent industrial production and retail sales data fail to offer hope for a pick-up in economic activity in 3Q after the disappointing 2Q GDP reading. Concurrently, sentiment indicators remain stagnant, which doesn't bode well for the much-needed recovery in domestic demand. In our view, the ongoing weakness in investment spending is discouraging if one considers the improvement in the absorption of EU funds and the low interest rate environment, among other things. Against the noted backdrop—in particular, the absence of a pick-up in investment spending, the anemic recovery in private consumption, the deterioration in the growth outlook in the Eurozone—we expect GDP growth to soften this year to 2% from 3.5% in 2013.

Inflation has begun to normalize

At 1.5%YoY, the inflation print in September came in between our projection (1.6%) and the consensus (1.4%). It is worth noting that the inflation outturn turned out to be higher than the consensus for the first time since February 2014. Our forecast error stems largely from softer than expected service inflation, which, at 0.14%MoM, came in below its seasonal average of about 0.9% (2004-13). Using seasonally adjusted data, the September print translates into a rise of 0.1%MoM compared with a flattish inflation reading in August.

Low food inflation has been the key driver of the country's better-than-expected inflation performance this year. The noted backdrop, along with the recent softening in non-food and service inflation, leads us to expect inflation to be around 2.5% by the end of the year, though a lower print cannot be ruled out. Looking ahead, however, we believe that the pace of disinflation in non-food and food components is unsustainable, as we expect inflation to pick up next year, rising to 3%.

In our view, the possibility of a sharp reversal in food prices and strong base effects overshadow price dynamics in 2015. A weaker-than-expected leu and uncertainties related to the timetable for the deregulation of natural gas/electricity markets also emerge as additional risk factors that require close monitoring. Another important factor, which is worth highlighting, is whether the government will carry out VAT cuts for vegetables, fruit and meat in 2015. In this respect, the likely difficult negotiations over the 2015 Budget suggests to us that such VAT cuts—or similar policy actions—in 2015 aren't very likely.

What will NBR do at the final meeting of the year?

The recent price developments in Romania suggest to us that the NBR is likely to revise its 2014 and 2015 inflation forecasts lower. This, coupled with the disappointing growth indicators, further raises the likelihood of a 25bp rate cut at the last Board meeting of the year in November. Against this backdrop, we now see the policy rate at 2.75% by the end of the year. Our more cautious inflation forecast trajectory, unimpressive capital inflows and our expectations of no further VAT cuts in 2015 lead us to believe that there isn't much room left for further easing in 2015.

We remain skeptical about the NBR's ability to stimulate lending activity through lowering rates. Our empirical results suggest that real GDP and the exchange rate play a more important role in affecting RON-denominated lending activity. Consequently, keeping money market rates below the policy rate may not be effective in promoting lending activity and thus economic growth.

What is the status of the IMF-EU supported program?

We believe that the fate of the IMF-EU supported program, which is currently frozen, will become clearer after the November Presidential election. In our base case, we assume that the authorities will take actions to put the IMF-EU program back on track following the Presidential election. In our view, the negotiations over the 2015 budget will be particularly challenging as whether the IMF-EU will display flexibility about revising next year's target remains to be seen.

Turning to the recent fiscal developments, standing at around RON 1.6 billion, the budget gap in the first eight months of the year was considerably narrower than the deficit seen in the same period of 2013 (RON 7.9bn). While revenues during the period under consideration increased by about 4.3%YoY, expenditures were down by about 0.5%YoY. Based on the available data, it looks like the 2014 budget deficit target of 2.2% of GDP looks attainable.

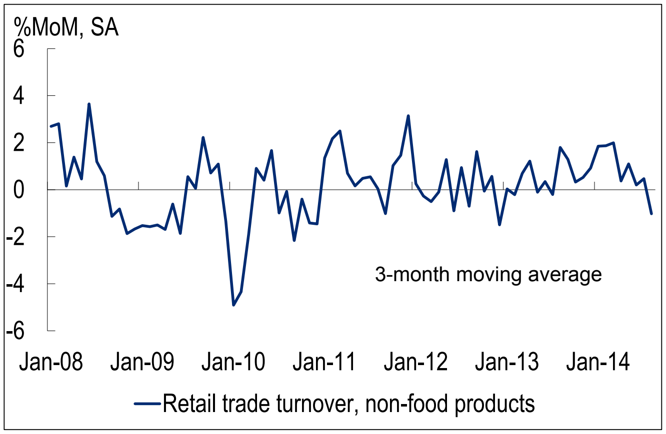
Current account gap is set to widen moderately

Romania's current account balance printed a deficit of about €0.95 billion in the first eight months of 2014, which is wider than the deficit seen in the same period of 2013 (about €0.49 billion). This outcome was mainly driven by a wider deficit in in the income balance. In line with our expectations of a moderate pick up in domestic demand and private credit growth, we expect the current account deficit to widen to around 1.2% of GDP this year from 0.8% in 2013. On the capital account front, we are yet to see a meaningful recovery in inflows, which warrants concern.

EUR/RON seems to be underperforming since end-August

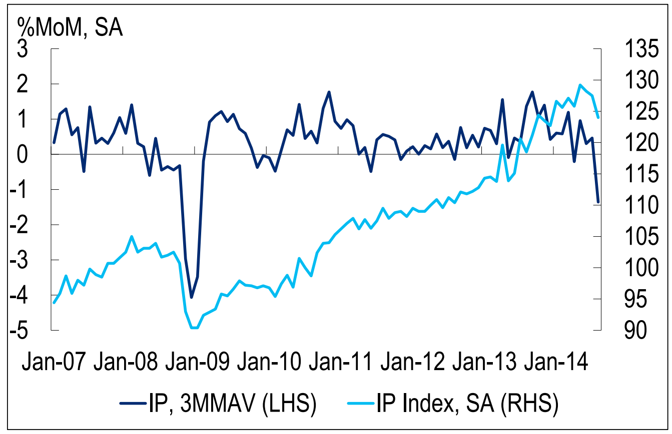
We observe a moderate deterioration in the leu's relative performance with respect to its regional peers (HUF, PLN, CZK) since end August. In our view, low yields and weak capital inflows—coupled with the NBR's inclination to keep money market rates below the policy rate—cloud the outlook for the leu. Against this backdrop, we expect the EUR/RON to be around 4.45 by the end of 2014.

Figure 181. Retail sales and…



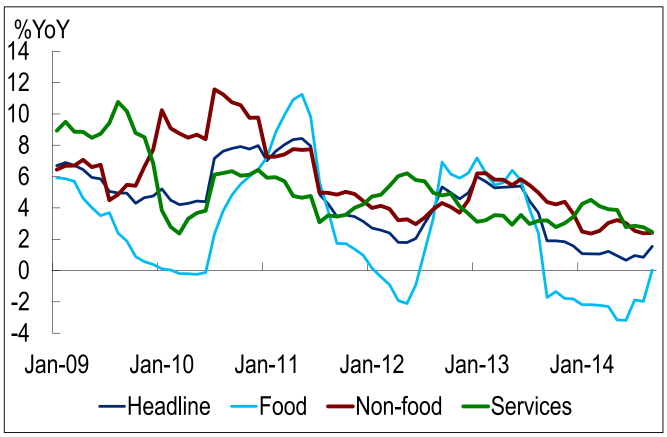
Source: Haver Analytics, Citi Research

Figure 182. …IP data paint a grim picture for economic recovery…



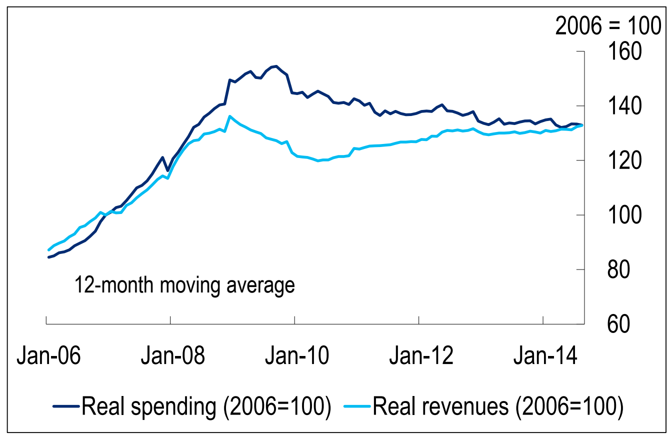
Source: Haver Analytics, Citi Research

Figure 183. …as inflation is beginning to normalize



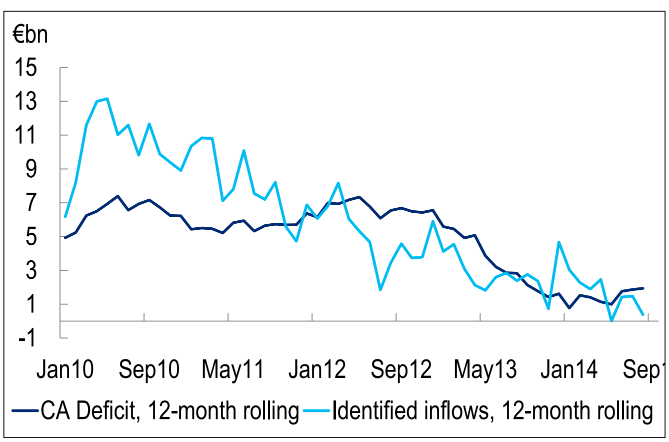
Source: Haver Analytics, Citi Research

Figure 184. While fiscal performance remains strong…



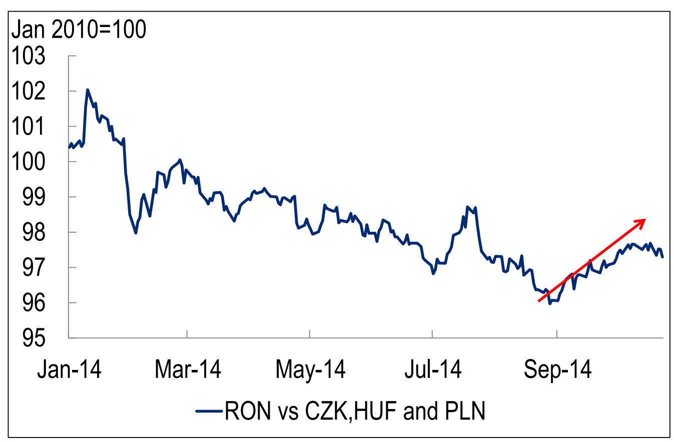
Source: Haver Analytics, Citi Research

Figure 185. … subdued capital inflows…



Source: Haver Analytics, Citi Research

Figure 186. … overshadow the performance of the leu



Source: Haver Analytics, Citi Research. Note: A rise in this index represents a deterioration in the leu' s relative performance vis a vis these currencies

Figure 187. Romania Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	171	204	165	165	183	169	189	191	180
Nominal GDP, local currency bn	416	515	501	524	557	587	629	650	690
GDP per capita, USD	7,653	9,176	7,397	7,413	8,246	7,642	8,550	8,662	8,157
Population, mn	22.3	22.3	22.2	22.2	22.2	22.1	22.1	22.1	22.0
Unemployment, % of labour force	4.3	4.0	6.3	7.6	5.4	5.1	5.3	5.5	5.5
Economic Activity									
Real GDP, yoy avg	6.3	7.5	-6.6	-1.2	2.4	0.5	3.5	2.0	3.4
Real investment growth % yoy	42.6	3.0	-34.3	8.9	12.1	-0.3	-8.7	-2.7	1.8
Real consumption growth % yoy	10.6	9.3	-9.0	-0.8	1.4	1.4	1.0	3.7	3.3
private consumption growth % yoy	12.0	9.5	-10.4	-0.3	1.5	1.4	1.3	4.0	3.5
Real export growth, % yoy	7.7	7.6	-6.3	14.2	12.0	-1.8	13.1	9.5	4.5
Real import growth, % yoy	27.8	7.6	-21.4	12.5	10.6	-0.3	2.3	7.5	4.0
Prices, Money & Credit									
CPI, % yoy eop	6.6	6.3	4.7	8.0	3.1	5.0	1.6	2.4	3.0
CPI, % avg	4.8	7.9	5.6	6.1	5.8	3.3	4.0	1.3	2.7
Nominal wages, % yoy	22.6	23.6	8.4	2.5	4.9	5.0	5.0	5.0	4.5
Credit extension to private sector, % yoy	60.4	33.7	0.9	4.7	6.6	1.3	-3.3	2.9	5.9
Policy Interest Rate, % eop	7.50	10.25	8.00	6.25	6.00	5.25	4.00	2.75	3.50
1 month inter-bank rate, %, eop	8.24	15.35	10.60	4.05	5.72	6.04	1.88	2.25	3.30
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/US$, eop	2.47	2.89	2.96	3.17	3.33	3.37	3.25	3.65	3.89
RON/US$, avg	2.43	2.50	3.04	3.17	3.04	3.46	3.33	3.40	3.84
RON/EUR, eop	3.61	4.03	4.24	4.24	4.32	4.45	4.46	4.45	4.40
RON/EUR, avg	3.33	3.68	4.24	4.21	4.24	4.46	4.42	4.44	4.44
Balance of Payments, USD bn									
Current account	-22.9	-23.8	-6.8	-7.3	-8.2	-7.5	-1.5	-2.3	-3.6
% of GDP	-13.4	-11.6	-4.2	-4.4	-4.5	-4.4	-0.8	-1.2	-2.0
Trade balance	-24.4	-28.1	-9.6	-10.1	-10.3	-9.5	-7.2	-7.3	-8.3
Exports	40.5	49.6	40.5	49.6	63.0	57.9	58.3	59.6	56.9
Imports	64.9	77.7	50.1	59.6	73.3	67.4	65.5	66.9	65.2
Service balance	0.6	1.0	-0.4	0.5	0.5	1.5	6.2	7.1	5.9
Income balance	-5.7	-5.4	-2.6	-2.5	-3.1	-3.9	-4.1	-5.5	-4.8
FDI, net	9.7	13.7	5.0	3.0	2.6	2.9	3.9	4.6	4.1
International reserves	37.3	36.5	39.4	42.3	42.4	41.8	45.7	38.9	36.7
Total amortisations	12.2	18.1	17.7	19.7	19.6	25.0	34.1	31.1	30.0
Public Finances, % of GDP									
Consolidated government balance	-2.3	-4.8	-7.3	-6.4	-4.3	-2.2	-2.5	-2.3	-2.3
Consolidated gov primary balance	-1.5	-3.9	-5.7	-4.9	-2.6	-0.4	-0.3	-0.1	-0.1
Public debt	19.8	21.3	29.4	37.1	40.1	41.0	42.5	41.9	40.9
of which Domestic	10.2	12.6	15.4	19.8	21.9	18.5	18.4	19.7	19.6
Foreign Assets & Liabilities, USD bn									
External debt	80.3	105.8	113.0	122.4	137.3	128.1	127.6	137.6	125.7
Public	13.9	14.2	19.6	24.8	28.9	34.2	41.0	37.8	34.0
External debt / GDP	47.0	51.8	68.7	74.3	75.1	75.7	67.5	72.0	70.0
External debt / XGS	160.8	169.4	224.4	209.7	187.7	186.4	167.6	175.7	168.6
Short-term debt	28.7	28.5	22.5	26.2	29.5	28.0	26.3	23.1	22.7
Short-term debt/International reserves (%)	77.1	78.1	57.0	61.9	69.7	66.9	57.7	59.5	61.8

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.9	1.2	1.3	2.2	2.9	4.6	3.4	2.8	3.2
CPI, % yoy eop	1.1	0.7	1.5	2.4	2.3	2.8	3.2	3.0	2.7
Policy interest rate, %, eop	3.50	3.50	3.00	2.75	2.75	3.00	3.50	3.50	4.00
Short-term market rate, % eop	2.23	2.08	3.22	2.25	2.55	2.80	3.30	3.30	3.80
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/EUR, eop	4.46	4.39	4.41	4.45	4.47	4.45	4.43	4.40	4.42

Source: National Sources, Citi Research forecasts

Russia

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- **Summary view** — The Russian economy may be near recession with little prospect for a substantial near-term improvement. The impact of sanctions on the Russian economy will become clearer over time, but it will probably be quite difficult to unpack the effect of sanctions from the many other factors that help to explain Russia's slowdown.

- **Things to watch** — Uncertainty should remain elevated at least until the end of the year. The possibility that yet further sanctions are imposed may impose additional costs to the economy and endanger our 1.0% 2015 GDP forecast. The monetary hiking cycle could continue, creating more headwinds for the economy.

- **Strategy** — While the current account surplus has been performing better than expected this year, it has been overcome by larger capital account outflows, thus putting pressure on the RUB. Continued tapering should also weigh on the currency and we see the RUB basket weakening to 44.0 by the end of the year.

Russia avoids recession, for now

Second-quarter GDP grew at 0.8%YoY and Russia avoided recession. Preliminary estimates from Rosstat pointed to economic growth slowing marginally to 0.8%YoY, down from the 0.9% expansion posted in 1Q14. While on a downtrend, GDP grew better than the consensus estimate of 0.7%YoY. More importantly, Russia avoided recession. We estimate that after the 1.1% seasonally-adjusted QoQ contraction in 1Q14, the economy expanded by 0.3% on a seasonally-adjusted QoQ basis in 2Q14. The quarterly expansion is very modest, yet it is just enough to avoid a technical recession.

The breakdown of 2Q GDP points to a continued decline in investment spending and a larger-than-anticipated deceleration in consumption spending. Rosstat also released the breakdown of 2Q GDP. The key takeaway is that while investment spending continued to contract, albeit by a smaller magnitude than in 1Q, it was consumption spending – the main driver of the economy recently – that almost ground to a halt.

Private consumption's deceleration stands out in particular. Private consumption spending sputtered, growing by only 0.8%YoY in 2Q vs 3.7% in 1Q (and vs close to 9%YoY in mid-2012). Consumption spending remained resilient in 1Q, as households shifted spending forward in anticipation of currency-driven inflation acceleration. However, this strength was only temporary and as inflation was indeed boosted in 2Q, consumers sharply reduced their purchases.

This cyclical softness in consumption only adds to structural weaknesses that have been building up recently. While consumption had been the only bright spot in Russian macro in recent years, it has already been on a downtrend recently as fears of a retail lending-driven consumer boom turning into a bubble led to more restrictive regulatory behaviour and a significant cooling-off in retail lending.

As a result, for the first time since mid-2010, consumption subtracted from GDP growth on a QoQ basis. While consumption is still making a positive, albeit declining, contribution to GDP growth on a YoY basis, it delivered a large negative surprise (-2.0%) to growth on a QoQ basis. This contrasts starkly with the 0.9% positive contribution of consumption to1Q GDP growth**.**

We see little reason to expect a turnaround in consumption over the next couple of quarters as the steady RUB weakening and still rising inflation should continue to weigh on consumer confidence and, more broadly, on GDP. This creates substantial downside risks to growth, given that private consumption accounts for almost half of GDP. Thus, consumption risks to our 2014 (0.7%) and 2015 (1.0%) GDP forecasts seem squarely slanted to the downside.

The only component of GDP that can currently provide a positive surprise to growth is net exports. The significant RUB weakening is providing a much welcome boost to exports while at the same time crimping imports. Exports grew by 1.3%YoY in 1Q (1.6% in 2Q) while import contraction strengthened from 4.5%YoY in 1Q to 7.7% in 2Q. As a result, net exports are now providing a very substantial contribution to GDP growth both on a YoY and QoQ basis. In our view, policy-makers may have now taken a position of benign neglect of the weaker currency in the hope that this may provide a much-needed fillip to import substitution against the current sanctions-based backdrop.

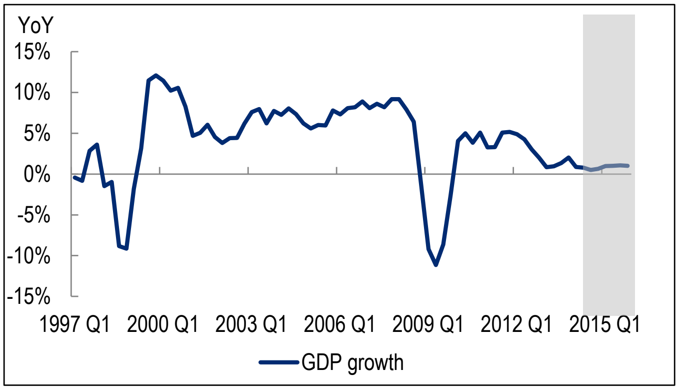
We recently downgraded 2015 GDP growth on heightened uncertainty. The newly imposed sanctions by the US and EU will make for a more challenging backdrop to the Russian economy, creating additional risks to growth. The combination of more subdued investment and consumption spending related to heightened uncertainty, and tighter monetary policy, led us to downgrade our 2015 GDP forecast from 2.3% to 1.0% (1.3% in 2013).

CBR's rate hikes will further constrain growth. The Central Bank of Russia raised the one-week REPO rate by 150bp to 7.00% on 3 March and a further 50bp to 8.00% on 25 April and 25 July. The CBR argued that the recent decisions were driven by a desire to ensure financial stability and ward off the build-up of inflationary expectations against the backdrop of heightened market volatility

The confluence of slowing growth and elevated inflation are fuelling tensions between the central bank and the Ministry of Economy. These tensions apparently manifested themselves in a renewed fashion on 28 August when the Minister of Economy announced that President Putin had approved the creation of a mechanism for the CBR, MinFin and MinEcon to jointly determine inflation objectives. This may impinge on the CBR's ability to conduct monetary policies in an independent way and endanger the definitive progress that the central bank has achieved during the last five years on the road to inflation targeting.

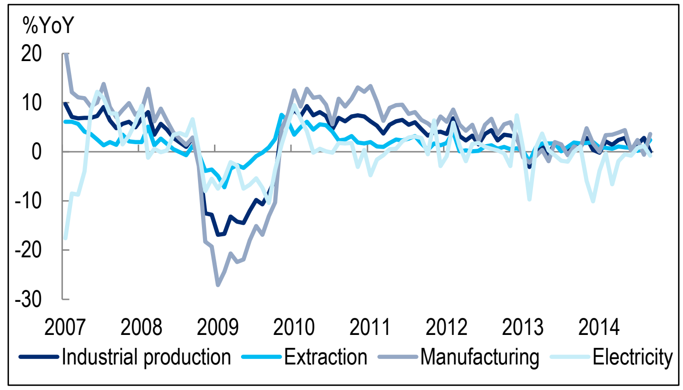
Structural challenges pose medium-term risks for the rouble. Russia is likely to gradually transition from a twin-surplus to a twin-deficit economy over the next couple of years – a phenomenon that historically has been associated with downward pressure on EM currencies. While Russia already runs (admittedly small) budget deficits, the positive current account balance still provides some currency cover during periods of market turbulence. However, we project its disappearance in the not too distant future will constitute a drag on the rouble. In addition, the expected medium-term deterioration in the public sector balance sheet may also weigh on medium-term rouble prospects. Against that background, Ukraine contagion risks have served to expose Russia as a proxy for expressing bearish views on the region, with equity and fixed income markets coming under pressure. As a result, we see the rouble basket weakening towards 44 by the end of the year.

Figure 188. Growth is very subdued



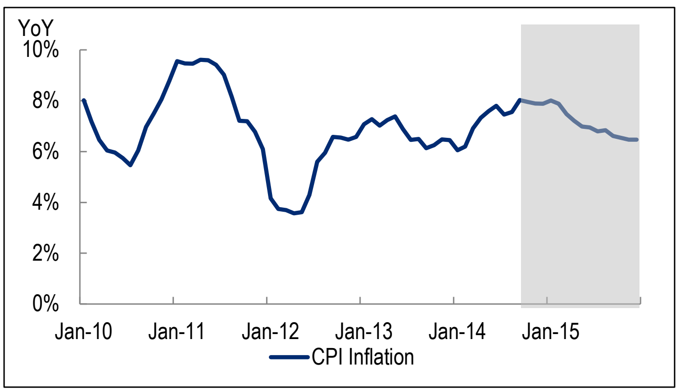
Source: Rosstat, Citi Research (shaded area is Citi forecast)

Figure 189. Industrial activity is also weak



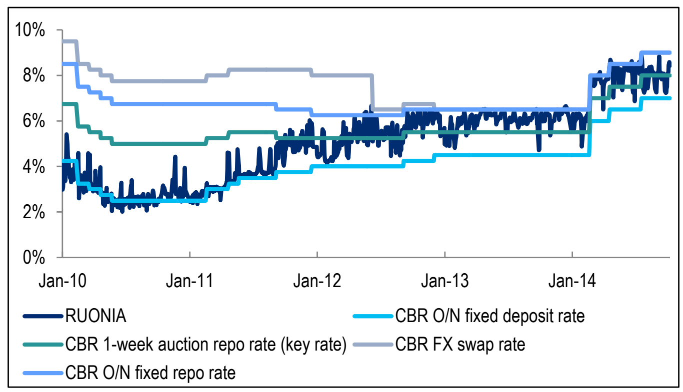
Source: Rosstat, Citi Research

Figure 190. CBR will miss its 2014 inflation target of 5-6%...



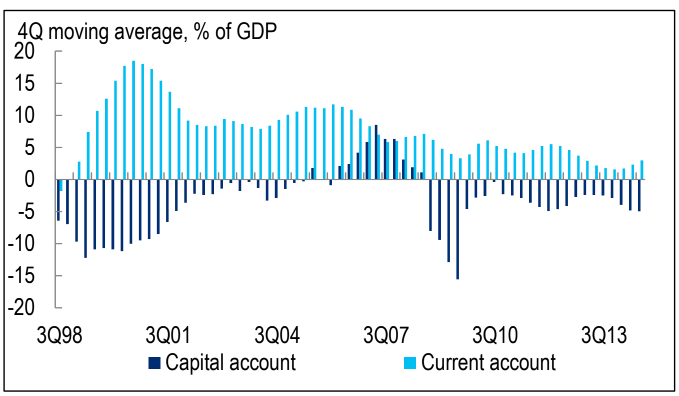
Source: Rosstat, Citi Research (shaded area is Citi forecast)

Figure 191. …and likely do one more rate hike until end-2014



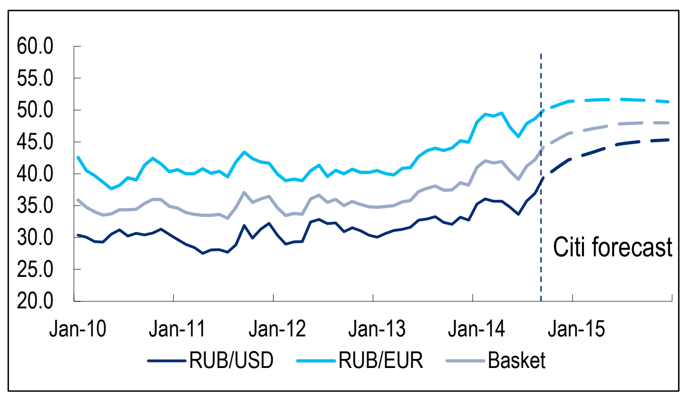
Source: Bloomberg, Citi Research

Figure 192. The gradual disappearance of the current account…



Source: CBR, Citi Research

Figure 193. …poses risks for the ruble



Source: Bloomberg, Citi Research

Figure 194. Russia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,304	1,665	1,229	1,524	1,903	2,000	2,093	1,913	1,766
Nominal GDP, local currency bn	33,248	41,277	38,807	46,309	55,967	62,218	66,755	72,191	78,781
GDP per capita, USD	9,081	11,585	8,554	10,611	13,267	13,969	14,656	13,428	12,427
Population, mn	143.7	143.7	143.7	143.6	143.4	143.2	142.8	142.5	142.1
Unemployment, % of labour force	6.0	6.2	8.2	7.4	6.5	5.5	5.5	5.7	5.8
Economic Activity									
Real GDP, yoy avg	8.5	5.2	-7.8	4.5	4.3	3.4	1.3	0.7	1.0
Real investment growth % yoy	22.0	10.5	-41.0	28.5	21.0	1.5	-6.1	-2.8	1.6
Real consumption growth % yoy	10.7	8.4	-3.9	3.5	5.3	7.0	3.6	1.4	0.8
private consumption growth % yoy	14.2	10.4	-5.1	5.5	6.7	7.9	4.7	1.9	1.0
Real export growth, % yoy	6.3	0.6	-4.7	7.0	0.3	1.4	4.2	2.0	2.0
Real import growth, % yoy	26.2	14.8	-30.4	25.8	20.3	8.8	3.7	2.5	2.0
Prices, Money & Credit									
CPI, % yoy eop	11.9	13.3	8.8	8.8	6.1	6.6	6.5	7.9	6.5
CPI, % avg	9.0	14.1	11.6	6.8	8.4	5.1	6.8	7.4	7.0
Nominal wages, % yoy	26.0	27.4	9.1	12.8	11.7	13.3	12.3	13.5	12.7
Credit extension to private sector, % yoy	49.3	37.2	2.6	12.9	28.1	19.4	17.2	15.0	8.0
Policy Interest Rate, % eop	6.50	9.50	6.00	5.00	5.25	5.50	5.50	8.50	7.50
1 month inter-bank rate, %, eop	6.09	20.20	6.32	3.78	6.37	6.90	6.81	7.94	6.59
Long-term yield, %, eop	6.58	10.90	9.45	8.23	8.77	7.04	7.88	9.44	8.09
RUB/US$, eop	24.6	30.5	30.3	30.6	32.2	30.6	32.9	42.2	45.3
RUB/US$, avg	25.6	24.9	31.7	30.4	29.4	31.1	31.9	37.7	44.6
RUB/EUR, eop	35.9	42.7	43.4	40.9	41.7	40.3	45.2	51.4	51.3
RUB/EUR, avg	35.1	36.6	44.2	40.3	41.0	40.0	42.3	49.3	51.5
Balance of Payments, USD bn									
Current account	72.2	103.9	50.4	67.5	97.3	71.3	34.1	60.3	53.3
% of GDP	5.5	6.2	4.1	4.4	5.1	3.6	1.6	3.2	3.0
Trade balance	123.4	177.6	113.2	147.0	196.9	191.7	181.9	192.3	192.7
Exports	346.5	466.3	297.2	392.7	515.4	527.4	523.3	536.4	547.1
Imports	223.1	288.7	183.9	245.7	318.6	335.8	341.3	344.1	354.4
Service balance	-16.7	-20.4	-17.6	-26.1	-33.5	-46.6	-58.3	-54.0	-59.9
Income balance	-28.8	-46.5	-39.7	-47.1	-60.4	-67.7	-80.2	-69.0	-70.5
FDI, net	11.1	19.1	-6.7	-9.4	-11.8	-18.1	12.4	-5.0	0.0
International reserves	466.4	410.7	405.8	432.9	441.2	473.1	456.4	406.7	425.1
Total amortisations	28.5	47.2	49.9	40.8	52.0	90.5	139.1	163.1	81.4
Public Finances, % of GDP									
Consolidated government balance	6.7	5.1	-5.6	-3.2	2.1	-0.7	-2.1	-4.4	-4.9
Consolidated gov primary balance	5.8	4.4	-5.4	-3.4	1.2	0.6	1.6	1.8	0.8
Public debt	6.6	5.2	7.3	7.6	8.2	7.7	6.7	9.6	13.3
of which Domestic	3.8	3.4	4.7	5.3	6.3	5.9	4.6	7.2	10.7
Foreign Assets & Liabilities, USD bn									
External debt	471.2	480.6	467.3	488.9	538.9	636.4	728.9	655.9	694.4
Public	37.4	29.5	31.3	34.5	34.7	38.1	43.1	40.6	43.7
External debt / GDP	36.1	28.9	38.0	32.1	28.3	31.8	34.8	34.3	39.3
External debt / XGS	120.7	91.8	136.3	110.7	94.0	107.9	122.8	111.2	116.5
Short-term debt	99.7	73.6	52.7	60.2	68.2	81.5	85.3	74.5	84.2
Short-term debt/International reserves (%)	21.4	17.9	13.0	13.9	15.5	17.2	18.7	18.3	19.8

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	0.9	0.8	0.5	0.7	1.0	1.0	1.1	1.0	1.4
CPI, % yoy eop	6.9	7.8	8.0	7.9	7.5	6.9	6.6	6.5	6.5
Policy interest rate, %, eop	7.00	7.50	8.00	8.50	8.50	8.00	8.00	7.50	7.00
Short-term market rate, % eop	8.74	9.20	9.45	7.94	6.68	6.59	6.59	6.59	5.42
Long-term yield, %, eop	8.80	8.53	9.44	9.44	8.71	8.09	8.09	8.09	7.67
RUB/US$, avg	35.0	35.0	36.3	42.2	43.4	44.6	45.1	45.3	45.5

Source: National Sources, Citi Research forecasts

Slovakia

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- **Summary view** — We have kept GDP forecast virtually unchanged at 2.3%YoY in 2014 and 2.6% in 2015 reflecting several contradictory reasons. Our momentum indicator improved in August, which – together with weaker currency outlook – limits downside risks from lower foreign demand. Our forecast is accompanied with a risk owing to new ESA 2010 data and August retail sales and September confidence suggest a risk to domestic demand.

- **Things to watch** — First, the statistical office has so far published only annual data. Hence, we did not fully reflect new ESA 2010 in our GDP forecast (but we did in the annual GDP ratios) as new quarterly data will be published later, partly in mid-November and fully in early December. Second, lower fiscal debt could tempt the government to spend its fiscal buffer earlier. Third, we still have concerns over the national account revisions, as a narrower trade surplus seems insufficient to substantially reduce the previous errors in the balance of payments.

- **Strategy** — A combination of utilisation of cash from the single treasury account, potential fiscal buffer after partly escaping the debt-brake triggers and likely further loosening by the ECB should bode well for Slovak bonds.

Economy has so been far resilient to foreign slowdown

The performance of the real economy in August surprised positively though retail sales fell. Industrial production did not follow regional peers and increased 0.3%MoM in August, though there was downward revision to previous data. This resulted into a mild deceleration of YoY growth to 5% from 5.6% a month earlier. However, trade dynamics have continued to disappoint with -2.4%YoY nsa in August. By contrast construction confidence improved and this led to an easing of the YoY contraction to -2.6% from -5.5% a month ago. Retail sales excluding cars showed a fall of 0.6%MoM after a cumulative gain of 0.7% in previous two months. This resulted into a milder YoY growth of 1:8% vs. 2.5% a month ago. Overall, our momentum indicator improved in August in contrast to regional peers and suggests upside risk to our forecast of 0.4%QoQ GDP growth in 3Q14 after 0.6% in 2Q14 (still using the previous methodology).

September sentiment data showed some risks for domestic demand. Economic sentiment deteriorated in September, but remains above 2Q14. While industrial confidence remained virtually unchanged and construction confidence improved to 0.4 s.d. above its long-term average (even higher than industrial confidence), both services and consumer confidence have worsened for two months in a row. Despite lower September sentiment, there is upside risk to our forecast. Analysis of time series suggests upside risks to our forecast of milder GDP growth of 0.4%QoQ and 2.3%YoY swda in 3Q14 after 0.6% and 2.4% respectively in 2Q14. In more detail, the business survey showed weaker foreign order books in manufacturing, with a resilient car industry, but weaker electronics. Though foreign orders decreased slightly, order books remained supportive for total industrial confidence, which suggests upside risk to our forecasts for industrial production and export activity in 2H14. By contrast, a drop in services and consumer confidence provides a risk to domestic demand due to lower employment expectations.

Some relief from debt-brake rule creates fiscal buffer

Dividends narrow central government deficit in September. Deficit is likely to return to recent annual levels as dividend inflow for the rest of 2014 is likely to be modest. The central government cash deficit narrowed to €1.84bn YTD in September from -€2.4bn a month earlier. Hence it narrowed by €0.14bn vs. the same period of 2013, though it was wider by €0.5bn YoY a month ago. As result the 12 month cumulative deficit narrowed to -2.6% of GDP (still in ESA1995) in September 2014 from -3.5% a month ago and -4.6% a year ago (the primary deficit reached 0.7% of GDP in September, the smallest since March 2009). The improvement mainly reflects a surge in September revenues (+11% YY YTD vs. +3.4% reported in August), while expenditures slightly decelerated to 7.1% YY.

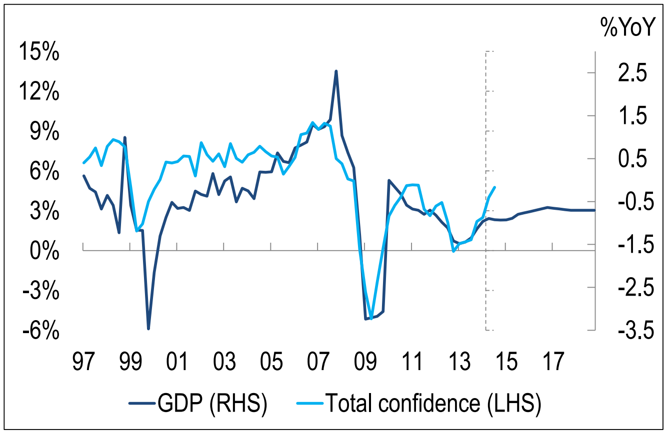
Higher GDP brings government debt ratio below 55% trigger. Methodological changes, mainly the new ESA 2010, increased the level of nominal GDP on average by 1.8% in 1995-2013 (2% in 2013). This has helped to lower general government debt to 54.6% of GDP in 2013 vs. the 55.4% reported before the changes. However, the decline in debt-to-GDP ratio is apparent only in 2012 and 2013 as the impact of higher GDP was largely offset by an increase in absolute debt levels before.

A larger fiscal stimulus is unlikely in the near term. We argue that the central cash deficit has worsened this year (September improvement was driven by dividend inflow), as evidenced by the government's increased expectation of a larger accrual deficit to 2.9% of GDP this year from 2.8% initially expected. This reflects a larger central government cash deficit at €2.6bn (3.5% of GDP), €220m wider in 2014 (0.3% of GDP) compared with the MinFin's August plan. Hence, any fiscal stimulus or unfreezing of expenditures this year would have a negative impact on the 3% limit on fiscal deficit.

However, we estimate a potential a fiscal buffer of c.1% of GDP to the 55% debt-brake rule trigger in 2015 reflecting the government's proposed budget deficit, which assumes larger tax revenues (to which we see partly downside risks), combined with its conservative estimate of debt dynamics. The government assumes a more benign debt-to-GDP ratio, and expects it to fall by 0.5%pt to 54.1% of GDP in 2014, as suggested by the 2015 budget proposal from mid-October. MinFin had assumed the debt at 54.9% in 2014, when it sent data to Eurostat at end September. First, this reflects a loan repayment for "Agency of oil stock emergency management" from state assets (without this the debt ratio would be 54.8% of GDP in 2014). Second, MinFin's outlook on debt dynamics assumes wider deficits than government plans. Third, the government assumes general government deficits at 2% and 1% of GDP in 2015-16, which is 0.5%-0.4% narrower vs. the initial plan. This is supported by larger tax revenues. However, we see a risk here as it assumes a budget surplus of 1% in the rest of the government sector, as the state's deficits are expected at -3% and -2% in 2015-16. We also remind that the lower outlook on debt reflects MinFin's plan to cover its financing needs by the utilisation of cash from the Single Treasury Account of 1.2% and 1.6% of GDP in 2015-16 after 2.4% of GDP in 2014 (utilisation in 2015 is 0.2% of GDP larger than initially expected).

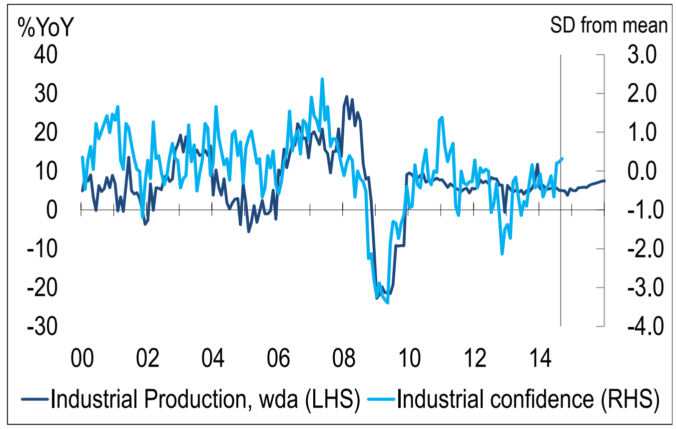
We still have concerns on the revision. Although the statistical office narrowed the trade surplus by an average 1.5% of GDP in 2011-13, we do not think this is enough to substantially decrease the previous errors in the balance of payments that reached an average 5.1% of GDP in 2011-13 or 5.7% in July 2014.

Figure 195. September confidence remained supportive



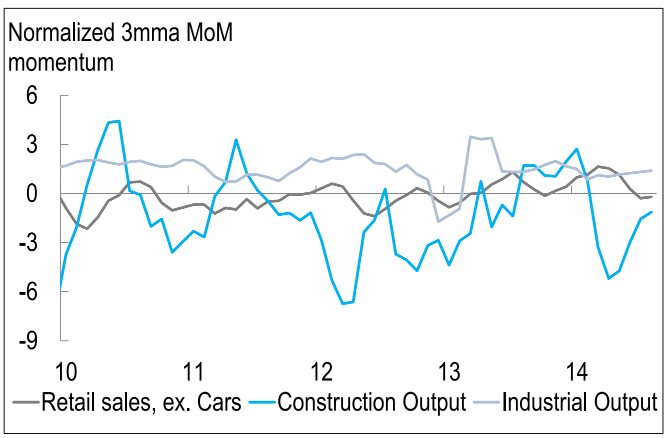
Source: Statistical Office of the Slovak Republic, Citi Research estimates

Figure 196. Industrial production did not fell in August as peers in region



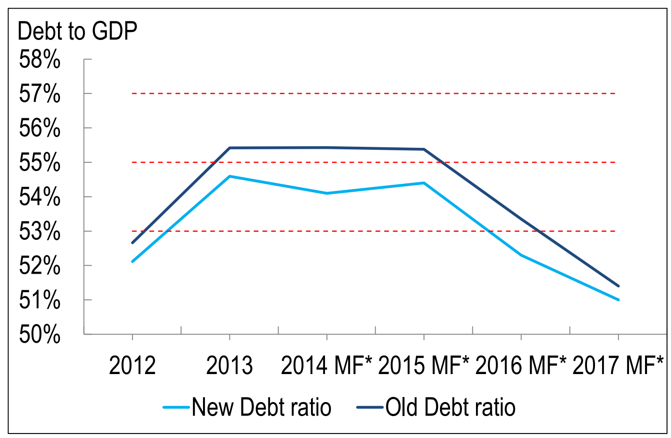
Source: Statistical Office of the Slovak Republic, Citi Research estimates

Figure 197. August performance of real economy surprised positively though retail sales fell



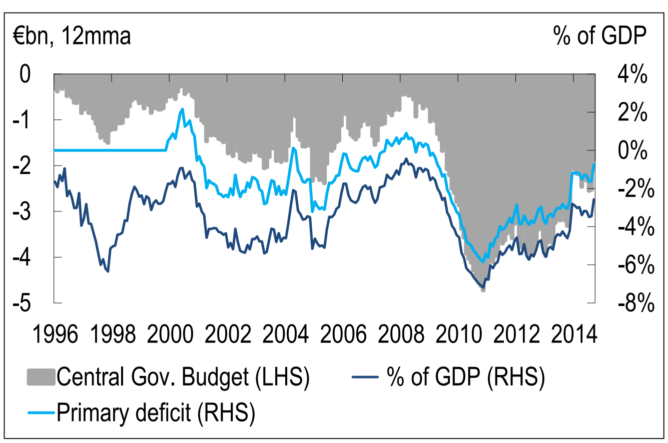
Source: Statistical Office of the Slovak Republic, Haver Analytics, Citi Research

Figure 198. Lower fiscal debt-to-GDP ratio creates room for fiscal stimulus if necessary compared to previous MinFin outlook on debt



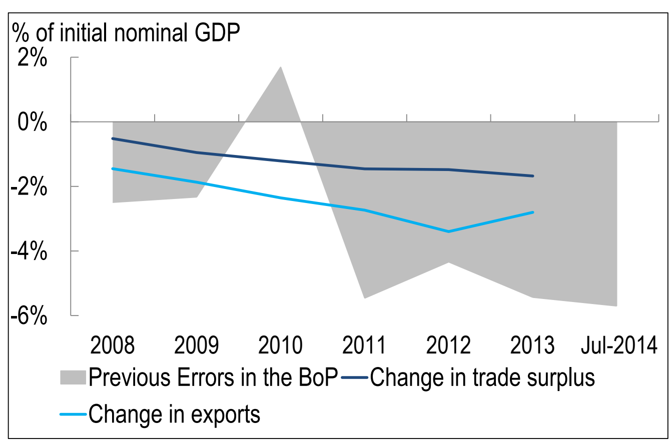
Source: MinFin, Citi Research calculation.

Figure 199. but not in the short-term as deficit is still close 3% level despite September improvement owing to dividends



Source: Haver Analytics and Citi Research calculations

Figure 200. Errors in the Balance of payments remained close to 3-4% of GDP if we assume the foreign trade to be the only change in the BoP



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

Figure 201. Slovakia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	75	95	88	87	96	91	96	100	93
Nominal GDP, local currency bn	61	67	62	66	70	72	74	75	79
GDP per capita, USD	13,936	17,493	16,156	16,087	17,654	16,781	17,577	18,387	16,962
Population, mn	5.4	5.4	5.4	5.4	5.4	5.4	5.5	5.5	5.5
Unemployment, % of labour force	8.4	7.7	11.4	12.5	13.2	13.6	14.1	12.9	12.4
Economic Activity									
Real GDP, yoy avg	10.7	5.4	-5.3	4.8	2.7	1.6	1.4	2.3	2.6
Real investment growth % yoy	9.4	5.8	-29.2	18.8	7.6	-14.0	-0.1	10.6	4.4
Real consumption growth % yoy	5.5	5.9	1.2	0.5	-1.0	-0.8	0.0	3.1	2.1
private consumption growth % yoy	7.5	6.0	-0.5	0.1	-0.7	-0.4	-0.7	2.8	2.0
Real export growth, % yoy	14.6	3.0	-17.0	15.7	12.0	9.3	5.2	5.5	5.7
Real import growth, % yoy	9.4	3.6	-19.1	14.7	9.7	2.6	3.8	7.1	6.0
Prices, Money & Credit									
CPI, % yoy eop	3.4	4.4	0.5	1.3	4.4	3.2	0.4	0.3	1.9
CPI, % avg	2.8	4.6	1.6	1.0	3.9	3.6	1.4	0.0	1.3
Nominal wages, % yoy	7.5	8.2	3.0	3.3	2.2	2.5	2.4	5.0	2.4
Credit extension to private sector, % yoy	23.4	16.3	0.9	4.8	8.6	2.8	5.6	3.0	4.7
Balance of Payments, USD bn									
Current account	-4.1	-5.9	-2.3	-3.3	-3.6	2.0	2.0	1.1	0.9
% of GDP	-5.4	-6.2	-2.6	-3.7	-3.8	2.2	2.1	1.0	1.0
Trade balance	-1.0	-1.1	1.3	1.0	1.4	4.6	5.6	4.6	4.3
Exports	64.9	72.9	55.4	64.0	79.0	79.9	85.3	87.8	83.3
Imports	65.9	74.0	54.1	63.0	77.6	75.4	79.6	83.2	79.1
Service balance	0.5	-0.7	-1.4	-1.0	-0.5	0.4	0.2	0.1	0.1
Income balance	-3.2	-2.8	-1.2	-2.7	-4.0	-2.1	-2.4	-3.1	-3.0
FDI, net	3.0	4.3	-0.9	0.8	2.8	2.9	1.0	1.0	1.5
Total amortisations	1.7	1.7	1.8	2.1	2.1	2.2	2.6	2.6	2.6
Public Finances, % of GDP									
Consolidated government balance	-1.7	-2.3	-7.9	-7.5	-4.1	-4.2	-2.6	-2.9	-2.7
Consolidated gov primary balance	-0.4	-0.8	-6.6	-6.3	-3.5	-3.2	-1.7	-2.1	-1.8
Public debt	27.5	28.8	36.7	41.6	43.5	52.1	54.6	54.4	54.1
of which Domestic	18.6	19.6	21.0	25.8	30.7	49.1	91.8	58.4	64.7
Foreign Assets & Liabilities, USD bn									
External debt	44.3	52.5	65.3	65.8	68.5	70.9	82.3	83.5	85.7
Public	9.5	10.3	11.4	13.3	15.5	25.9	34.2	37.3	36.2
External debt / GDP	58.8	55.5	74.5	75.3	71.3	77.6	85.9	83.2	92.4
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	23.6	27.1	37.4	36.3	36.7	28.1	25.0	23.0	24.4

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	2.2	2.4	2.3	2.3	2.3	2.4	2.7	2.8	2.9
CPI, % yoy eop	-0.2	-0.1	-0.1	0.3	0.8	1.3	1.6	1.9	2.5
Short-term market rate, % eop	0.23	0.15	0.02	0.02	0.02	0.02	0.02	0.02	0.02
Long-term yield, %, eop	2.47	2.05	1.51	1.14	1.24	1.39	1.49	1.59	0.55

Source: National Sources, Citi Research forecasts

South Africa

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(On Maternity Leave)

- **Summary view** — The South African economy is currently flirting with stagflation as real GDP growth remains weak and inflation is stuck around the top end of the SARB's target band of 3-6%.
- **Things to watch** — With limited scope to significantly alter fiscal and monetary policy, the main mechanism for adjustment will continue to be the rand. This could remain highly volatile, especially at times of emerging market turmoil.
- **Strategy** —. The SARB is committed to policy normalisation, or to raising its key repo rate, but we think its actions will remain very much data-dependent

GDP growth looks weak

Following a number of downgrades, we now expect real GDP growth of only 1.4% in 2014. This compares to a Reuters consensus of just above 2.0% at the start of the year. As well as the impact of various prolonged strikes on the growth outlook, more worryingly the rebalancing of the economy away from consumption as an engine of growth towards production, as may have seemed to be happening in early 2014 due to earlier rand weakness, does not seem to gained momentum.

In addition, not only has the consumption side of the economy proved weaker than our initial expectations, but headwinds remain. Going into 2015, the combination of still relatively high inflation, tight lending standards, high consumer indebtedness and lacklustre consumer confidence, all point to a sub-par purchasing power environment. In fact, we don't expect any significant rebound in consumer spending in 2015 given rising electricity tariffs and continued policy rate normalisation by the SARB.

For the rest of the economy, potential labour unrest will likely rear its head again in mid-year when the coal and gold sectors start wage negotiations. At the same time, electricity constraints will keep a lid on investment intentions as, although the first unit of the Medupi power station will be fully operational by Q2 15, the additional electricity supply will be offset by increased maintenance.

Rebalancing is some way off and the ZAR under pressure

A widening current account deficit so far in 2014 also reflects the lack of rebalancing in the economy. Despite the narrowing of the deficit in Q1 2014 to 4.5% of GDP, this was never sustainable given that it was driven by a large once-off dividend inflow while the trade deficit continued to widen. With dividend inflows slowing in Q2, and the negative impact of strikes on exports, the Q2 2014 current account deficit widened considerably to 6.2% of GDP. Though platinum stockpiles remained relatively intact through Q2, a greater negative impact to its manufacturing supply chain started to take effect.

Furthermore, we see the current account deficit remaining wide in 2H 2014. Overall this will mean that we expect the 2014 current account deficit will remain 'stuck' at 5.3% of GDP, compared to 5.6% in 2013. This is a large deficit given the extent of recent currency weakness. It also means that the government needs to attract around ZAR200bn a year to fund the deficit. And with financial account flows still relatively unpredictable, notably portfolio flows and unrecorded transactions, we continue to expect the ZAR to remain on the back foot, weakening to R11.25/USD on a 6-12 month basis.

Monetary policy remains highly data-dependent

We think that inflation peaked at 6.6% YoY in June. And while CPI is generally expected to slowly trend downwards, the trajectory will prove slow and sticky due to contradictory forces. For example, downward pressures in food prices being offset by upward pressure from ZAR pass-through in the form of higher core inflation, even if incredibly muted versus previous cycles. The lack of a more significant ZAR pass-through to-date is not surprising given the efforts of the listed retail sector to push volumes while absorbing cost push pressures. This is affirmed by both the BER retail survey and financial statements of the listed retail sector. Put together, this allows CPI to move back within the 3-6% target band by the end of Q1 2015 however, is only likely to get as low as 5.7% before upside inflation risks associated with Fed hiking in Q2 2015 starts to become a greater concern for the SARB MPC.

This slow decline in inflation, coupled with weak GDP growth leaves monetary policy walking a tightrope. The SARB has so far hiked twice this year: first by 50bp in January and then by 25bp in July raising the policy rate at 5.75%. The reason for a slow moderate hiking cycle thus far has been the trade-off between downside GDP growth risk and upside inflation risk – this was the reason why the SARB kept the policy rate unchanged in March, May and September and the reason why we expect no further change until Q2 15. What's more, the SARB has moved to smaller incremental hikes of 25bp as a way of signalling that it remains tough on inflation risks, but remains concerned about GDP prospects.

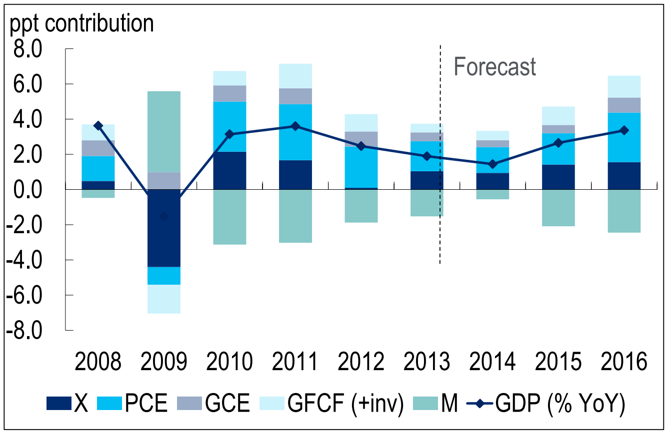
But given downward revisions to the GDP growth outlook, we believe that the SARB probably prefers to push the remainder of this hiking to Q2 2015 when US monetary policy is likely to be tightened. We further believe that the SARB will be able to justify this by the fact that inflation is now only expected to remain outside the target band for two more quarters, before trending back below 6.0% in Q2 2015. The risks to this outlook however, lie in the data-dependent nature of monetary policy decisions and specifically, how the ZAR reacts to changing market expectations of Fed monetary policy. As such, we would only expect the SARB to move earlier than Q2 2015 if ZAR weakness was substantial enough to push its inflation outlook back above 6.0% for three or more quarters. This data-dependency of monetary policy decisions is unfortunate for rates markets, as it makes the timing of rate hikes difficult to forecast.

Tough structural policy decisions

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

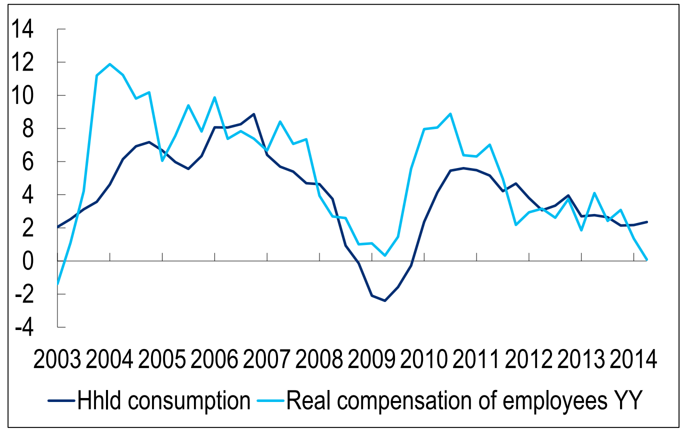
While Mr Nene explicitly stated that the tax increases outlined in the budget will be based on the current Davis Tax Committee review, our research points to a higher VAT rate as the most obvious tax policy shift. But we also acknowledge how difficult it will be for National Treasury to find an acceptable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

Figure 202. GDP to remain lackluster in 2013 and 2014



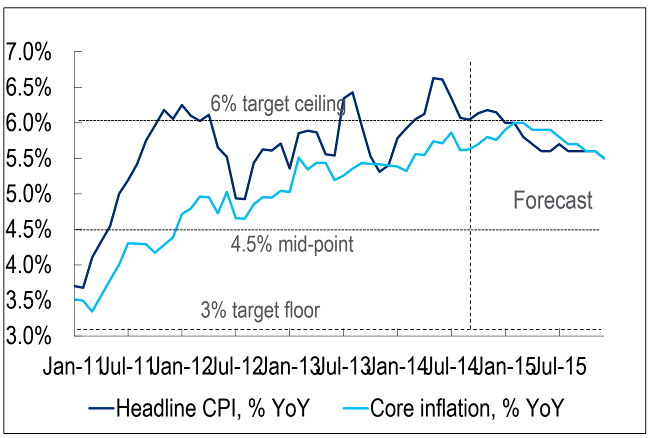
Source: SARB, Citi Research Projections

Figure 203. Consumption is slowing as real incomes decelerate



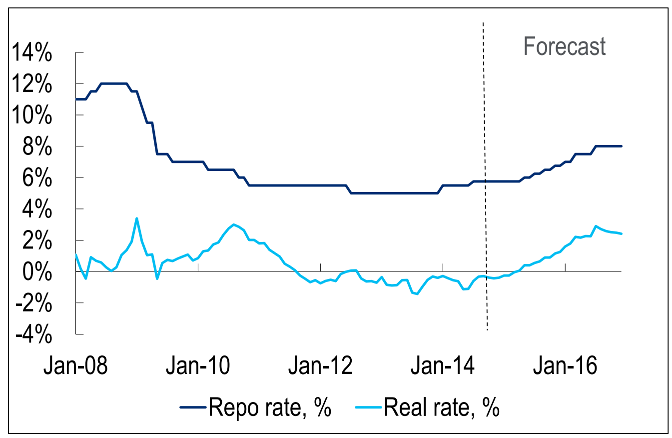
Source: SARB, Citi Research calculations

Figure 204. The CPI will remain at the top of the SARB ceiling in 2H 2013



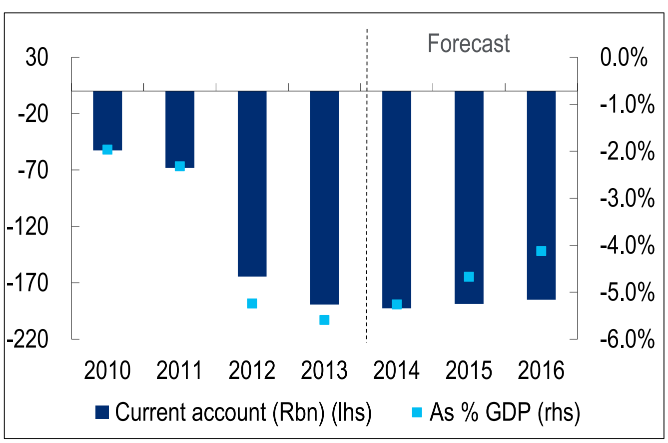
Source: Stats SA, Citi Research projections

Figure 205. Rand volatility suggests further Repo rates cuts are unlikely



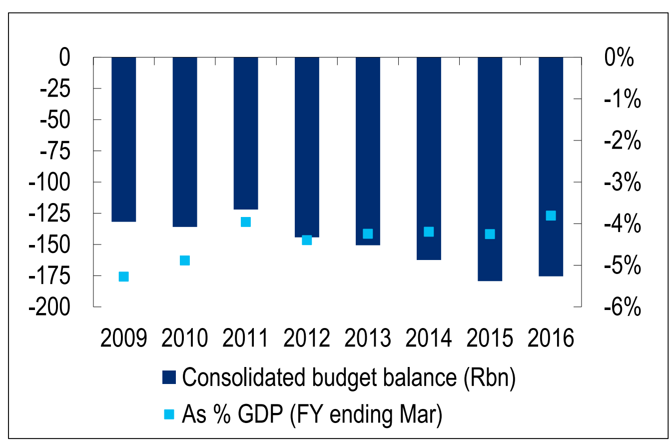
Source: SARB. Stats SA

Figure 206. No meaningful narrowing in the current account deficit



Source: SARB, Citi Research projections

Figure 207. Fiscal consolidation will likely be slow



Source: National Treasury, Haver Analytics, Citi Research projections

Figure 208. South Africa Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	286	273	287	366	404	382	351	336	356
Nominal GDP, local currency bn	2,016	2,256	2,408	2,674	2,933	3,139	3,385	3,661	4,038
GDP per capita, USD	5,763	5,613	5,825	7,312	8,081	7,646	6,986	6,680	7,055
Population, mn	49.6	48.7	49.3	50.0	50.0	50.0	50.2	50.3	50.4
Unemployment, % of labour force	-	22.5	23.7	24.9	24.8	24.9	24.7	25.0	24.6
Economic Activity									
Real GDP, yoy avg	5.5	3.6	-1.5	3.1	3.6	2.5	1.9	1.4	2.6
Real investment growth % yoy	12.0	4.4	-8.6	4.3	7.0	4.9	2.4	2.6	5.0
Real consumption growth % yoy	5.2	2.8	-0.1	4.4	4.7	3.7	2.5	2.1	2.5
private consumption growth % yoy	5.5	2.2	-1.6	4.4	4.9	3.5	2.6	2.2	2.7
Real export growth, % yoy	6.6	1.8	-19.5	9.0	6.8	0.4	4.2	3.7	5.5
Real import growth, % yoy	9.0	1.5	-17.4	11.0	10.0	6.0	4.7	1.7	6.3
Prices, Money & Credit									
CPI, % yoy eop	7.6	9.3	6.0	3.4	6.4	5.7	5.3	6.1	5.5
CPI, % avg	6.2	10.0	7.2	4.1	5.0	5.7	5.8	6.2	5.7
Nominal wages, % yoy	7.9	12.8	11.8	13.5	7.2	7.5	8.1	8.5	8.7
Credit extension to private sector, % yoy	21.5	13.6	-0.1	5.5	6.2	10.1	6.1	8.2	9.0
Policy Interest Rate, % eop	11.00	11.50	7.00	5.50	5.50	5.00	5.00	5.75	6.75
1 month inter-bank rate, %, eop	11.18	11.35	6.94	5.44	5.47	5.02	5.10	5.99	6.99
Long-term yield, %, eop	8.58	7.33	9.05	8.14	7.93	6.39	7.91	7.90	8.00
ZAR/US$, eop	6.87	9.49	7.41	6.62	8.09	8.46	10.50	11.15	11.40
ZAR/US$, avg	7.05	8.27	8.41	7.32	7.26	8.21	9.65	10.90	11.36
Balance of Payments, USD bn									
Current account	-19.9	-19.6	-11.6	-7.2	-9.4	-20.0	-19.6	-17.7	-16.6
% of GDP	-7.0	-7.2	-4.0	-2.0	-2.3	-5.2	-5.6	-5.3	-4.7
Trade balance	-5.2	-4.3	0.3	6.8	6.5	-4.8	-7.6	-7.7	-6.3
Exports	76.2	85.3	66.4	89.8	108.8	99.2	95.1	91.6	94.1
Imports	81.4	89.6	66.1	83.0	102.3	104.0	102.7	99.3	100.4
Service balance	-2.7	-4.1	-2.8	-4.4	-4.7	-2.5	-2.2	-1.6	-2.2
Income balance	-9.8	-8.9	-6.4	-7.2	-9.2	-8.9	-6.6	-5.5	-5.4
FDI, net	3.6	12.3	6.4	3.7	4.5	1.6	2.6	2.2	2.1
International reserves	29.6	30.6	35.3	38.2	42.6	44.0	44.8	46.4	47.2
Total amortisations	2.5	2.7	2.1	1.7	2.4	7.4	4.0	5.5	2.8
Public Finances, % of GDP									
Consolidated government balance	0.9	-1.0	-5.1	-4.9	-3.9	-4.5	-4.1	-4.1	-4.1
Consolidated gov primary balance	3.4	2.4	-3.0	-2.7	-1.6	-2.0	-1.5	-1.4	-1.4
Public debt	28.3	27.8	31.3	35.6	39.4	42.5	46.1	49.6	50.8
of which Domestic	24.5	23.4	27.7	32.3	35.6	38.8	41.9	45.6	46.7
Foreign Assets & Liabilities, USD bn									
External debt	63.0	60.4	63.8	80.6	89.7	113.7	108.6	101.3	106.8
Public	19.5	18.1	22.6	35.8	41.5	55.9	52.8	55.7	55.7
External debt / GDP	22.0	22.1	22.2	22.1	22.2	29.7	31.0	30.2	30.0
External debt / XGS	70.0	61.6	81.4	77.7	72.6	99.4	99.4	95.7	98.3
Short-term debt	24.0	25.5	21.3	21.7	20.5	27.9	27.2	28.7	29.2
Short-term debt/International reserves (%)	81.2	83.2	60.4	56.9	48.2	63.3	60.9	61.9	62.0

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	1.6	1.0	1.5	1.6	2.3	2.8	2.7	2.8	-3.9
CPI, % yoy eop	6.0	6.6	5.9	6.1	5.8	5.6	5.6	5.5	5.3
Policy interest rate, %, eop	5.50	5.50	6.00	5.75	5.75	6.00	6.50	6.75	7.50
Short-term market rate, % eop	5.63	5.73	6.03	5.99	5.99	6.24	6.74	6.99	7.74
Long-term yield, %, eop	8.30	8.17	8.13	7.90	8.00	8.05	8.00	8.00	8.10
ZAR/US$, eop	10.53	10.64	11.29	11.15	11.26	11.37	11.40	11.40	11.40

Source: National Sources, Citi Research forecasts

Turkey

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- **Summary view** — Due to a string of weaker than expected growth indicators in 3Q, we decided to revise our 2014 growth forecast to 3.1% from 3.5%, which, coupled with the already difficult inflation outlook, will further complicate the CBT's task.
- **Things to watch** — The CBT's new Inflation Report (to be released on October 31) and geopolitical developments require close monitoring.
- **Strategy** — Our empirical findings suggest that lower oil prices alone shouldn't be taken as a signal for a stronger lira.

Underlying growth dynamics remain weak…

Growth indicators since the release of the weaker-than-expected 2Q GDP data fail to suggest that the economy is doing a lot better in the third quarter. Specifically, forward looking indicators for fixed investment display no signs of improvement. A similar picture emerges when we review the recent sentiment indicators, capacity utilisation and industrial production prints. In short, we believe that the available indicators regarding 3Q aren't strong enough to suggest that a meaningful rebound in domestic demand has taken place. Against this backdrop, we decided to revise our 2014 growth forecast to 3.1% from 3.5%, as another sub-par growth in 2015 is likely.

...as the pace of external adjustment loses steam

At US$2.8 billion, the current account deficit in August came in narrower than the consensus estimate (US$3.1bn). With the August outturn, the current account gap in the first eight months of the year stands at US$29.6bn, which is considerably narrower than the deficit seen in the same period of 2013 (US$45.8bn). At around US$8.6bn, the magnitude of the correction in Turkey's underlying deficit excluding energy and gold during the same period points to a less aggressive but still meaningful adjustment.

On the capital account front, standing at US$4.6bn in the first eight months of the year, FDI inflows are weaker than they were in the same period of 2013 (US$6.1bn). During the same period, we saw a sharp increase in errors and omissions (to US$9.1bn from US$0.2bn), as portfolio inflows (equity net) remain in line with 2013. Marked declines in currency and deposits as well as short-term debt are noteworthy when compared with the same period of 2013. All in all, while the overall financing picture warrants concerns, there are some encouraging signs suggesting that residents are reducing their reliance on short-term external borrowing when compared with the same period of 2013.

Administrative adjustments complicate inflation dynamics

At 8.9%YoY, the September inflation reading came in lower than the consensus (9.4%). While seasonally adjusted underlying inflation measures suggest that inflationary momentum is softening, standing at around 8.2% and 7.5% (SA, 3-month moving average annualised H and I, respectively), core measures remain too high for comfort, leading us to believe that lowering inflation to 5% by the end of 2015 as is currently envisaged by the CBT looks difficult. Developments to date, including the recent administrative price adjustments and the deterioration in forward looking expectations, lead us to expect year-end inflation at around 9.3%.

CBT appears to have become more cautious but…

In our view, the CBT did the right thing at the October meeting by keeping all rates unchanged. Since the previous MPC meeting, the CBT's average funding rate and money market rates have been hovering around 8.5% and 11%, respectively. The CBT's decision to increase the daily FX sale amount to US$40 million from US$10 million suggest to us that the Bank became uneasy with the depreciation of the lira during the recent bout of volatility. The noted backdrop, coupled with the difficult inflation outlook and subdued capital inflows, leads us to believe that the CBT is likely to refrain from easing during the remainder of the year. Despite the challenging external and domestic backdrop, however, we believe the CBT will look for opportunities to ease if the lira and global conditions permit. Consequently, while the CBT's relatively cautious stance is encouraging, there remain questions about its predictability and determination to maintain a tight policy stance.

Is the New Medium-Term Program ambitious enough?

The authorities revealed the much-awaited Medium Term Program (MTP) on 8 October. When compared with the previous one, the 2015-2017 MTP envisages less optimistic trajectories for growth and inflation in 2014 and 2015 (*Turkey Macro Flash - Does the New Medium-Term Program Go Far Enough?*). The government forecasts GDP growth to come in at 3.3% (vs. 4% before) and 4.0% (vs. 5% before) for 2014 and 2015, respectively. Following the revisions in the new MTP, the government's growth projections are more in line with our forecasts (3.1% for 2014 and 3.5% for next year).

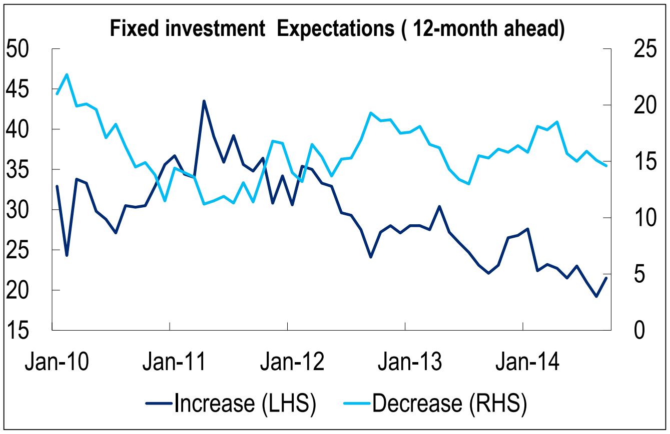
In the fiscal sphere, the new MTP contains narrower budget deficit targets for 2014 (1.4% of GDP) and 2015 (1.1% of GDP). Nonetheless, the envisaged improvement in the government's underlying fiscal stance stops short of representing a meaningful tightening in terms of reducing the external imbalance and alleviating pressure on monetary policy. Moreover, steady upward revisions in the government's spending projections in recent years and the 2015 general elections lead us to remain sceptical about the envisaged decline in primary spending to 21.5% of GDP in 2015 from about 22.6% in 2014.

All in all, we believe that the new MTP doesn't go far enough in terms of bolstering national savings and supporting monetary policy to meet the inflation target. The macroeconomic targets/projections underpinning the new MTP suggest to us that Turkey's sub-par growth performance, wide current account gap and elevated inflation will continue to overshadow the performance of Turkish assets. In this respect, the government's much-awaited reform programme will be of particular importance.

Will lower oil prices boost the lira's performance?

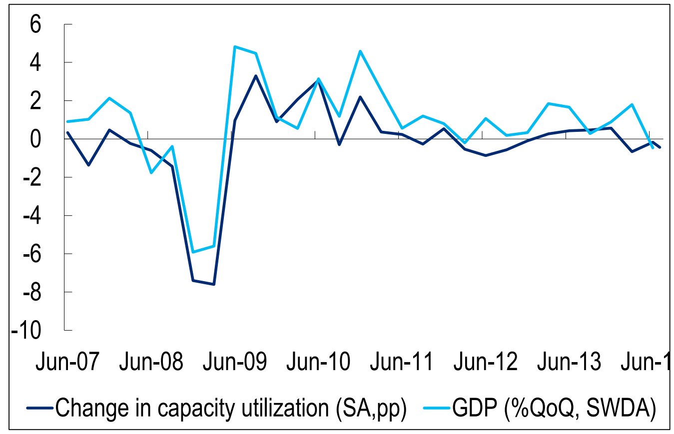
Given Turkey's high energy dependency, the marked downward trend in oil prices has revived investors' interest in Turkish assets. We acknowledge that lower oil prices may render Turkish assets more attractive and lead to cyclical opportunities. However, our empirical findings (see *Turkey Macro View - Should we get excited about lower oil prices?*) suggest that: (i) lower oil prices alone shouldn't be taken as a signal for a stronger lira, as the underlying factors behind the decline matter; and (ii) as far as external vulnerability is concerned, lower oil prices won't change Turkey's relative standing significantly in the EM universe.

Figure 209. The outlook for investment spending remains bleak…



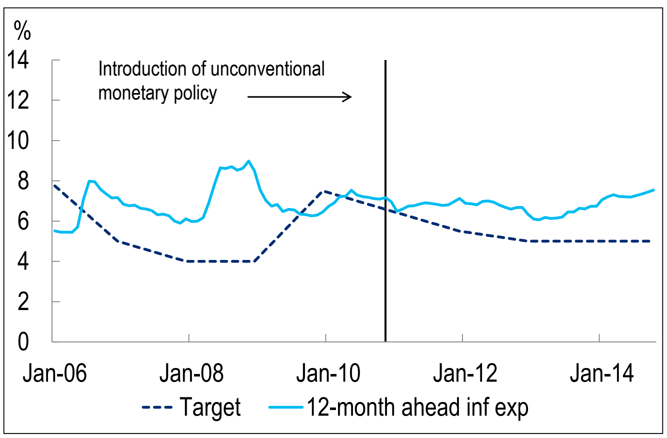
Source: Haver Analytics and Citi Research

Figure 210. …as economic activity in 3Q doesn't look particularly strong



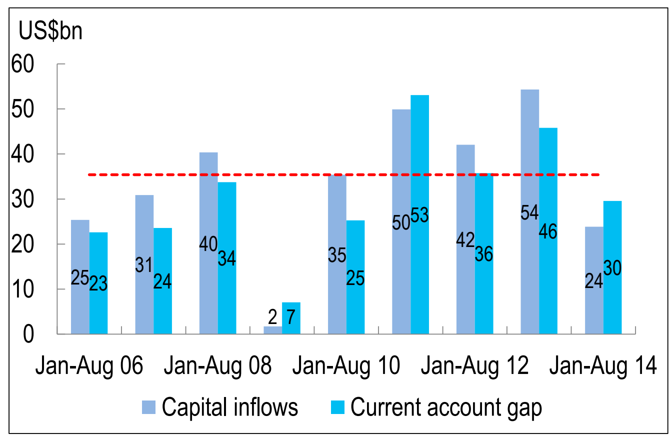
Source: Haver and Citi Research

Figure 211 The challenging inflation outlook…



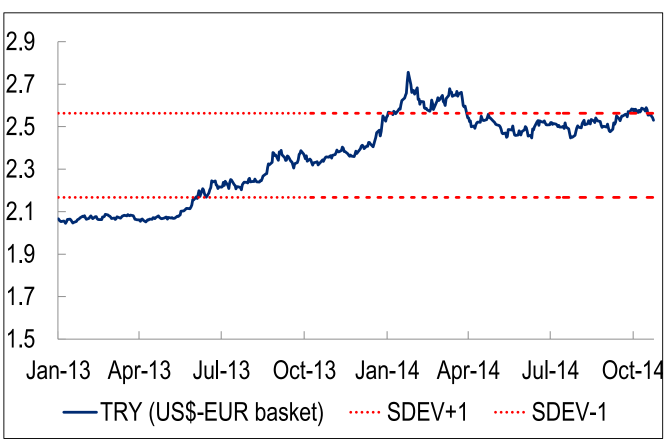
Source: CBT and Citi Research

Figure 212. …the disappointing inflows



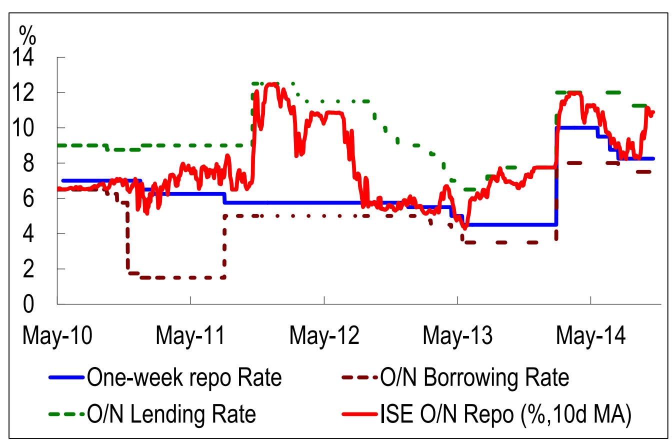
Source: Haver and Citi Research

Figure 213. …and the lira's performance…



Source: Haver and Citi Research

Figure 214. …lead the CBT to maintain a tight stance, for now



Source: Bloomberg and Citi Research

Figure 215. Turkey Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	646	731	615	731	775	789	822	798	797
Nominal GDP, local currency bn	843	951	953	1,099	1,298	1,417	1,565	1,759	1,946
GDP per capita, USD	9,207	10,282	8,530	10,016	10,473	10,531	10,746	10,320	10,204
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	10.0	13.0	11.2	9.1	8.5	9.1	9.5	9.5
Economic Activity									
Real GDP, yoy avg	4.7	0.7	-4.8	9.2	8.8	2.1	4.1	3.1	3.5
Real investment growth % yoy	5.8	-4.8	-28.6	48.4	16.8	-8.5	11.3	-1.4	4.0
Real consumption growth % yoy	5.6	-0.1	-1.0	6.0	7.3	0.4	5.3	1.9	3.2
private consumption growth % yoy	5.5	-0.3	-2.3	6.7	7.7	-0.5	5.1	1.3	3.2
Real export growth, % yoy	7.3	2.7	-5.0	3.4	7.9	16.3	-0.3	5.2	4.4
Real import growth, % yoy	10.7	-4.1	-14.3	20.7	10.7	-0.4	9.0	-2.0	4.0
Prices, Money & Credit									
CPI, % yoy eop	8.4	10.1	6.5	6.4	10.4	6.2	7.4	9.3	7.0
CPI, % avg	8.8	10.4	6.3	8.6	6.5	8.9	7.5	9.0	6.9
Nominal wages, % yoy	9.5	11.6	9.9	11.8	9.7	11.5	12.4	16.0	14.0
Credit extension to private sector, % yoy	27.8	22.4	13.4	40.4	32.8	19.8	33.5	15.0	15.0
Policy Interest Rate, % eop	15.75	15.00	6.50	6.50	5.75	5.55	7.10	9.00	9.50
1 month inter-bank rate, %, eop	17.21	17.16	7.20	6.89	11.54	5.80	8.66	10.50	10.50
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	1.17	1.54	1.50	1.54	1.89	1.78	2.15	2.28	2.50
TRY/US$, avg	1.31	1.31	1.55	1.51	1.68	1.80	1.91	2.20	2.44
TRY/EUR, eop	1.70	2.15	2.15	2.06	2.44	2.35	2.95	2.78	2.83
TRY/EUR, avg	1.79	1.92	2.17	2.00	2.34	2.32	2.53	2.88	2.82
Balance of Payments, USD bn									
Current account	-37.8	-40.4	-12.1	-45.4	-75.1	-48.5	-65.1	-42.2	-42.5
% of GDP	-5.8	-5.5	-2.0	-6.2	-9.7	-6.1	-7.9	-5.3	-5.3
Trade balance	-46.9	-53.0	-24.9	-56.4	-89.1	-65.3	-80.0	-61.3	-64.2
Exports	115.4	140.8	109.6	120.9	143.4	163.2	163.4	182.8	191.9
Imports	162.2	193.8	134.5	177.3	232.5	228.6	243.4	244.1	256.1
Service balance	14.0	18.9	18.6	16.7	20.2	22.6	23.1	26.7	28.6
Income balance	-7.1	-8.4	-8.3	-7.2	-7.9	-7.2	-9.4	-8.8	-8.2
FDI, net	19.9	17.2	7.1	7.6	13.8	9.2	9.8	10.2	11.0
International reserves	73.3	71.0	70.7	80.7	78.5	99.9	109.8	114.8	119.8
Total amortisations	37.6	41.1	47.4	45.0	37.9	33.5	36.7	39.0	41.0
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

Quarterly Economic Indicators	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	4.7	2.1	2.4	3.3	2.9	3.6	3.8	4.4	3.8
CPI, % yoy eop	8.4	9.2	8.9	9.3	7.4	6.6	6.7	7.0	7.1
Policy interest rate, %, eop	10.27	8.82	8.72	9.00	8.50	8.25	9.00	9.50	10.00
Short-term market rate, % eop	12.28	9.19	10.95	10.50	10.00	9.00	9.80	10.50	10.80
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	2.14	2.12	2.28	2.28	2.35	2.43	2.47	2.50	2.53

Source: National Sources, Citi Research forecasts

Other Africa

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Ghana

- Following on from its September Eurobond issuance, investors will now focus on the 2015 budget presentation in November for whether the government can agree a deal with the IMF. Both need to outline a credible plan for fiscal consolidation before the country moves into a period of intensive cedi bond repayments in 2H 2015 and into 2016. But, fiscal consolidation will be tough, with the government needing to significantly boost revenue collection which is well below the levels of other middle income governments in Africa.

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

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

Kenya

- A steady pick-up in growth towards 6% by 2015 seems underway, but the recovery is being constrained by ongoing political uncertainty, sporadic terrorist incidences, periodic drought and infrastructure bottlenecks.

- The recent GDP revision, plus a proposed revision to the balance of payments statistics, should reduce the twin fiscal and current account deficits and provide a more logical explanation of only gradual Kenyan shilling depreciation in recent years and the ability of the CBK to build foreign exchange reserves. But we believe the government will have to avoid the temptation of using the lower fiscal deficits debt stock as an excuse for not continuing with its programme of gradual mid-election fiscal consolidation.

- Although the Central Bank of Kenya (CBK) will be sorely tempted to cut rates to support the economic pick-up, with inflation remaining either above or at the top end of its inflation target (5%, +/- 2.5pp), for the rest of 2014 and into early 2015, we think it will act cautiously. Especially as rate cuts could spill over into more substantial KES depreciation than the gradual depreciation the CBK seems comfortable with.

Tanzania

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

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

- After two years of relative stability, the substantial fiscal and current account deficits have started to translate into more significant shilling weakness in 2014. Whether this picks up pace next year could well depend on the extent of fiscal slippage in the run-up to the 2015 elections. But with revenue collection behind targets and arrears a mounting concern, pressure could increase, limiting the scope of the Bank of Tanzania (bOT) to loosen monetary policy.

Uganda

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

- In this environment, the Bank of Uganda (BoU) will face a difficult balancing act. While it probably wants to cut the Central Bank Rate (CBR) in 2H 2014 in line with its inflation outlook, this may well spill over into potential Ugandan shilling (UGX) weakness given the fiscal stance, especially if the government bows to raising recurrent spending in 2015 as the February 2016 elections loom closer. So we expect it will opt for a more cautious approach limiting depreciation.

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

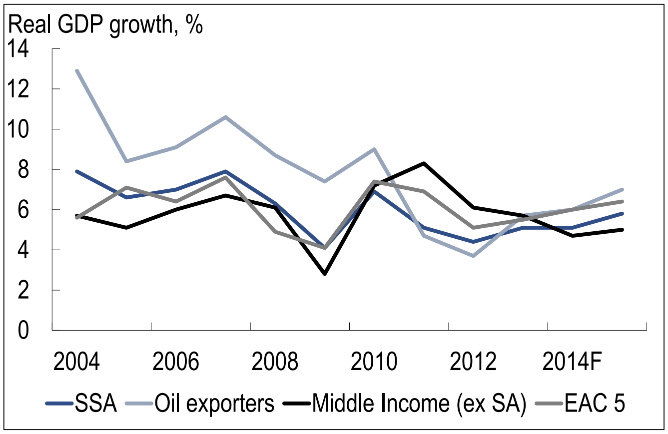
Zambia

- A sharp tightening of monetary policy, coupled with a more gradual tightening of fiscal policy, has meant there has been considerable kwacha stability since the middle of 2014, although it has come under some pressure since October.

- With the 2015 budget outlining still further fiscal consolidation next year, coupled with the current account now expected to remain in a small surplus and strong FDI inflows, we expect the current bout of kwacha weakness to be relatively limited and further kwacha stability in 2015 (especially if the government can agree a new programme with the IMF in early 2015 and growth remains robust as we expect). These trends should also allow the Bank of Zambia (BoZ) to rebuild foreign exchange reserves which are low by regional standards

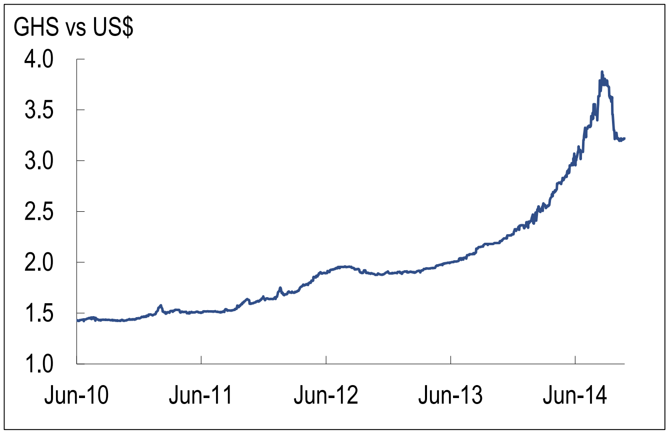
- The death of President Sata on October 29 means that elections will now be held in Zambia within 90 days. These are likely to be closely contested between the three main parties, but orderly as were the elections in 2008 under the same circumstance. While the political uncertainty may lead to short term pressure on the kwacha, we expect no major change in monetary or fiscal policy, or a return to kwacha stability once the political uncertainty dies away.

Figure 216. Growth should be robust in 2014-15



Source: IMF

Figure 217. A temporary cedi stabilization

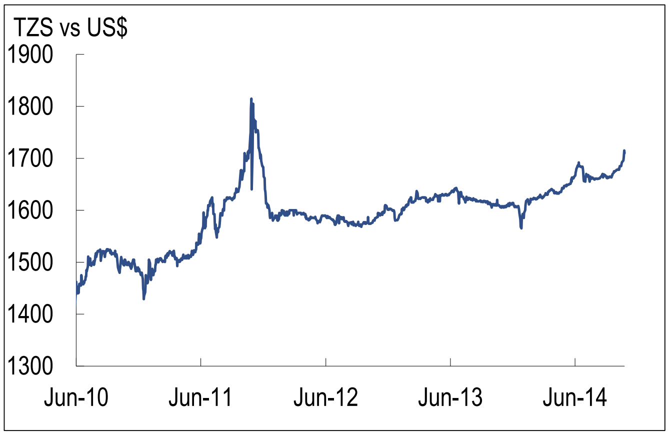


Source: Haver Analytics

Figure 218. A gradual depreciation of the Kenyan shilling in 2014

Source: Haver Analytics

Figure 219. The Tanzanian shilling has eventually started to weaken

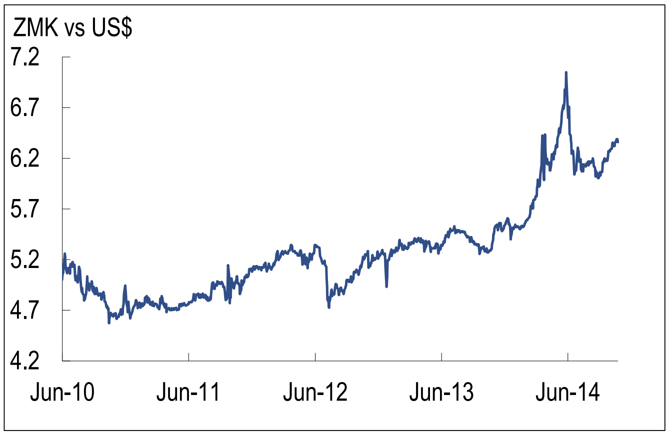


Source: Haver Analytics

Figure 220. The Ugandan shilling is now coming under more pressure

Source: Haver Analytics

Figure 221. The kwacha remains under only moderate pressure



Source: Haver Analytics

Figure 222. Other Africa Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
GHANA									
Nominal GDP, USD bn	24.8	28.5	26.0	32.2	39.6	41.7	45.2	39.1	34.3
GDP per capita, USD	1,099	1,234	1,096	1,326	1,594	1,646	1,744	1,480	1,273
Real GDP, yoy avg	6.5	8.4	4.0	8.0	15.0	8.8	7.1	5.1	4.0
CPI, % avg	10.7	16.5	19.3	10.7	8.7	9.2	11.7	15.2	13.2
Policy Interest Rate, % eop	13.5	17.0	18.0	13.5	12.5	15.0	16.0	19.0	16.0
GHS/US$, avg	0.95	1.07	1.43	1.43	1.55	1.85	2.06	2.92	3.97
Current account, US$bn	-2.1	-3.5	-1.6	-2.6	-2.5	-4.9	-5.2	-3.5	-2.9
% of GDP	-8.6	-12.4	-6.2	-8.2	-6.3	-11.8	-11.5	-8.9	-8.4
Consolidated gov. balance, % of GDP	-5.4	-8.4	-7.0	-9.4	-5.2	-12.1	-10.0	-8.7	-7.0
KENYA									
Nominal GDP, USD bn	32.0	35.9	37.0	40.0	42.0	50.3	55.2	51.8	59.2
GDP per capita, USD	848	926	929	978	999	1,165	1,245	1,138	1,266
Real GDP, yoy avg	6.9	0.2	3.3	8.4	6.1	4.5	5.7	5.4	6.0
CPI, % avg	4.3	15.1	10.6	4.3	14.0	9.4	5.7	7.3	7.3
Policy Interest Rate, % eop	8.8	8.5	7.0	6.0	18.0	11.0	8.5	8.5	8.0
KES/US$, avg	67.3	68.8	77.3	79.2	88.4	84.5	86.1	87.7	92.6
Current account, US$bn	-1.0	-1.9	-1.7	-2.4	-3.7	-4.2	-4.8	-3.9	-4.4
% of GDP	-3.2	-5.4	-4.6	-5.9	-8.9	-8.4	-8.7	-7.6	-7.5
Consolidated gov. balance, % of GDP	-2.4	-3.3	-4.4	-4.4	-4.0	-5.0	-5.7	-6.0	-5.8
TANZANIA									
Nominal GDP, USD bn	16.8	20.7	21.4	22.9	23.9	28.2	32.5	36.6	40.8
GDP per capita, USD	409	489	490	509	515	590	661	721	781
Real GDP, yoy avg	7.1	7.4	6.0	7.0	6.4	6.9	7.0	7.1	7.2
CPI, % avg	7.0	10.3	12.1	7.2	12.7	16.0	7.9	6.4	6.2
TZS/US$, avg	1,237	1,198	1,324	1,439	1,582	1,586	1,617	1,656	1,730
Current account, US$bn	-1.8	-2.1	-2.1	-2.1	-3.5	-4.5	-3.3	-5.1	-5.3
% of GDP	-11.0	-10.2	-9.8	-9.3	-14.5	-16.0	-10.2	-13.9	-12.9
Consolidated gov. balance, % of GDP	-1.9	-2.6	-6.0	-6.5	-5.0	-5.7	-5.9	-6.2	-6.5
UGANDA									
Nominal GDP, USD bn	13.5	16.4	16.5	17.2	18.2	21.2	23.1	25.6	27.2
GDP per capita, USD	441	515	503	506	518	584	613	659	678
Real GDP, yoy avg	8.1	10.4	4.1	6.2	6.4	3.6	4.7	6.1	6.5
CPI, % avg	6.1	12.0	13.0	4.0	18.7	14.0	5.5	4.6	4.9
UGX/US$, avg	1,723	1,714	2,025	2,173	2,511	2,501	2,584	2,583	2,735
Current account, US$bn	-0.6	-1.2	-1.1	-1.7	-2.1	-1.6	-1.9	-2.4	-2.7
% of GDP	-4.2	-7.5	-6.4	-9.7	-11.4	-7.7	-8.3	-9.5	-10.1
Consolidated gov. balance, % of GDP	-2.7	-2.7	-1.6	-6.6	-3.9	-3.8	-4.5	-5.3	-5.6
ZAMBIA									
Nominal GDP, USD bn	14.1	17.9	15.3	20.3	23.7	25.0	26.9	27.0	29.2
GDP per capita, USD	1,161	1,438	1,195	1,533	1,740	1,774	1,853	1,795	1,883
Real GDP, yoy avg	6.2	5.7	6.4	7.6	6.8	7.3	6.2	6.2	6.3
CPI, % avg	10.6	12.4	13.4	8.5	6.4	6.6	7.0	7.9	6.5
ZMK/US$, avg	3,992	3,702	5,020	4,791	4,861	5,139	5,195	6	6
Current account, US$bn	-0.8	-1.0	0.6	1.2	0.7	0.8	0.2	0.4	0.4
% of GDP	-5.4	-5.6	3.8	5.9	3.0	3.1	0.7	1.5	1.2
Consolidated gov. balance, % of GDP	-1.3	-0.8	-2.5	-3.0	-2.2	-3.9	-6.7	-5.3	-4.4

Quarterly Economic Indicators

	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GHS/US$, eop	2.69	3.33	3.29	3.40	3.60	4.00	4.30	4.30	4.30
KES/US$, eop	86.40	87.65	89.25	89.50	90.00	92.00	92.00	93.50	95.00
TZS/US$, eop	1,638	1,658	1,677	1,680	1,700	1,725	1,750	1,785	1,810
UGX/US$, eop	2,547	2,600	2,645	2,650	2,700	2,700	2,800	2,825	2,900
ZMK/US$, eop	5,195.00	5,195.00	5,195.00	6.30	6.30	6.45	6.45	6.45	6.50

Source: National Sources, Citi Research forecasts

Other Europe

Bulgaria

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Centre-right GERB party won the 5 October snap election by receiving 32.7% of the vote but fell short of an outright majority. GERB was followed by the BSP (socialist party, 15.4%) and the MRF (a party representing mostly ethnic Turks, 14.8%). Moreover, five additional parties were able to clear the 4% threshold, leading to a more fragmented parliament structure compared with the previous one in which there were only four parties. It remains to be seen whether GERB will team up with the Reformist Bloc to form a coalition government. We note that since such a coalition would have only 107 seats in the 240-member assembly, concerns over political stability may continue to overshadow economic sentiment. Turning to economic activity, we believe that political uncertainty has probably played an important role in the deterioration in confidence indicators in recent months. The consumer confidence stood at -39.8% (balance, SA) in September, which represents the lowest reading since April 2013. In parallel, industrial production, which has been falling MoM (SA) since April, suggests that economic activity is losing momentum. Looking ahead, we expect to see a moderate recovery in domestic demand in the coming months on the back of a partial recovery in consumer confidence following the formation of the new government. Against this backdrop, we maintain our view that GDP growth will accelerate to 1.5% in 2014 from 0.9% in 2013.

Regarding price developments, we note that, at -0.8%YoY, deflationary pressures accelerated in September, compared with -0.6% (August). Lower-than-expected readings in key components (food, health, communication and transport) in September suggest to us that deflationary pressures are stronger than we envisioned earlier. Consequently, we now project inflation to reach only 0.2% by end of 2014 compared with our earlier forecast of about 1%. Concerning external developments, the current account balance in the first eight months of the year printed a surplus of €809m, compared with a surplus of €1.259bn in the same period of 2013. Our expectations of stronger domestic demand this year leads us to look for a current account surplus of about 0.5% of GDP in 2014, compared with a surplus of 2.1% in 2013.

Croatia

Recent data continue to paint a relatively bleak picture for the near-term growth prospects. Domestic demand remains relatively weak with retail sales falling 0.5%MoM (SA) on average in the first two months of 3Q, compared with 0.6%MoM average increase in 1H. The elevated unemployment rate (16.5%, SA) and weak lending activity (credit growth in August is -3.2%YoY) suggest to us that a meaningful rebound in private consumption is unlikely in the coming months. Gross fixed investment, which contracted 4.5%YoY in 1H, subtracted about 1pp from 1H growth. Nevertheless, we expect to see a gradual rebound in investment activity in the coming months thanks to EU-funded projects. Finally, we expect that government spending, which fell by 2.8%YoY in 1H, will likely remain subdued owing to constrains to meet the EDP targets. Turning to net foreign demand, which contributed about 2pp to the annual growth in 2Q, we think that export growth is likely to lose traction in the rest of the year on the back of slowing Eurozone growth. In fact, the most recent data have started showing signs of stress with annual growth in exports slowing to 7.8%YoY (3-month average) in July from 19.4%YoY (3-month average) in June. The noted backdrop leads us believe that GDP will contract by 0.7% this year, compared with a contraction of 0.9% in 2013.

Regarding inflation, consumer prices rose by 0.7%MoM in September, bringing the annual inflation rate to -0.2%YoY from -0.4%YoY in August. The monthly inflation print in September was about 0.2pp higher than its seasonal average (0.56%MoM) – an outcome mainly driven by above-average readings in clothing and recreation/culture components despite the below-average outturn in transport inflation. Looking ahead, while weak domestic demand is likely to keep inflationary pressures in check, we think that inflation is likely to rise gradually to about 1.0% by end-2014 owing to base effects and the unwinding of cyclical factors. Turning to external developments, the trade balance in the first seven months of the year printed a surplus of €4.2bn, which is slightly less than the surplus observed in the same period of 2013 (€4.4bn). Looking ahead, we expect the current account balance to remain in positive territory this year on the back of subdued domestic demand, the strong export performance in 1H and a solid tourism season. Against this backdrop, we look for a current account surplus of 1.0% of GDP this year, compared with a surplus 0.9% in 2013.

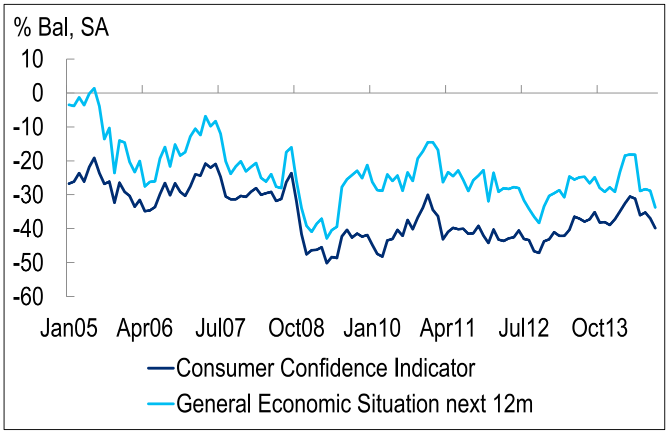
Serbia

Recent data suggest that economic activity remained subdued in 3Q following a dismal 2Q, which was adversely affected by severe flooding. For example, retail trade growth averaged 0.5%MoM (SA) in the first two months of 3Q following an average increase of 0.7%MoM (SA) in 1H. In parallel, we were expecting that industrial production, which plunged 11.8%MoM (SA) in May, would recover relatively strongly afterwards. However, following a 2.8%MoM (SA) rise in June, industrial production continued to fall in July and August by about 0.7%MoM (SA) combined, suggesting to us that the recovery will likely be slower than we envisioned earlier. Against this backdrop, we now expect the economy to contract by 1% this year compared with our previous GDP growth forecast of -0.5%.

Turning to price developments, annual inflation rose to 2.1%YoY in September from 1.5% in August due mainly to base effects associated low food inflation in 2013. Particularly, a base effect-related jump in annual inflation contributed almost the entire 0.6pp rise in September inflation. In parallel, the September outturn also provided signs of a partial reversal in food inflation, which came in at 2.3%MoM, above its seasonal average of about 2%. Looking ahead, we now assume that the hike in gas and electricity prices will not take place by end of this year, which led us to revise our year-end inflation forecast to 4%YoY from 4.5%. We note that while inflation continued to hover below the target tolerance band of the NBS (4±1.5%), the Bank opted to keep rates on hold at the October MPC meeting on the back of continued uncertainties in the domestic and international environment. Particularly, the Bank drew attention to the ongoing geopolitical tensions and the monetary policy normalisation process in the US. We acknowledge that softer domestic demand, relatively low inflation outturn, and the likely IMF arrangement[1] by end-of year as recently stated by PM Vucic should strengthen the NBS's hand to cut the rates by 25bp, bringing the policy rate to 8.25% by the end of 2014. In the event of a stronger RSD than we envision, a more aggressive easing cannot be ruled out.

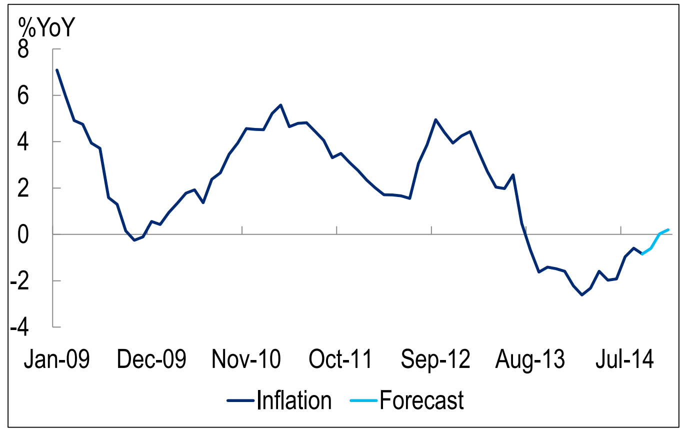
[1]According Finance Minister Vujovic, the government is likely to sign a precautionary agreement with the IMF by the end of 2014 (Bloomberg, October 22, 2014). In this respect, it is worth noting that the recent revision of the 2014 budget foresees a wider deficit of 5.7% of GDP (vs.4.6%) and envisions retrenchment in public sector wages, among other things. The noted revision, coupled with the 2015 budget, will play an important role during the upcoming negotiations in November.

Figure 223. Bulgaria: We expect to see an improvement in sentiment indicators in the coming months…



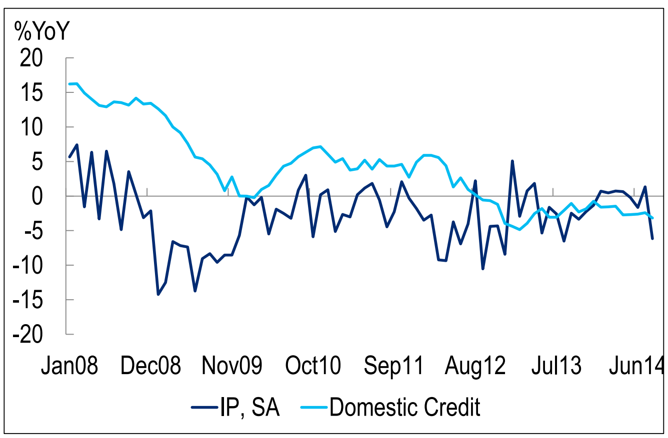
Source: Haver Analytics and Citi Research

Figure 224. …as deflationary pressures are likely to soften—albeit gradually.



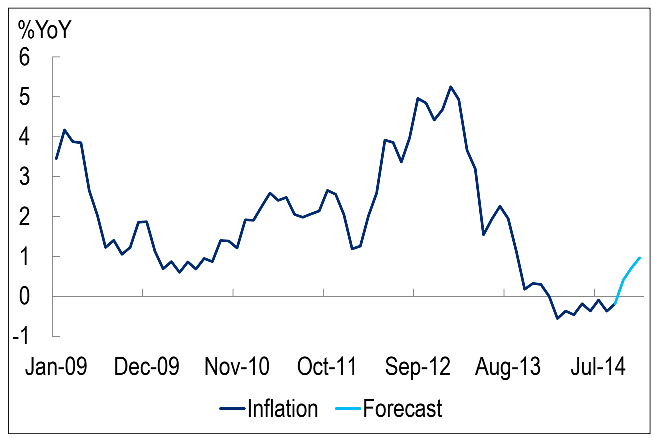
Source: Haver Analytics and Citi Research

Figure 225. Croatia: Recent data continue to paint a relatively bleak picture for the near-term growth prospects …



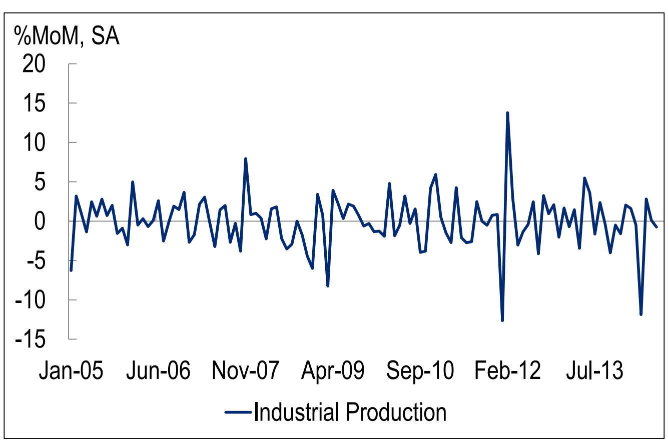
Source: Haver Analytics and Citi Research

Figure 226. … but inflation is likely to rise on the back of base effects



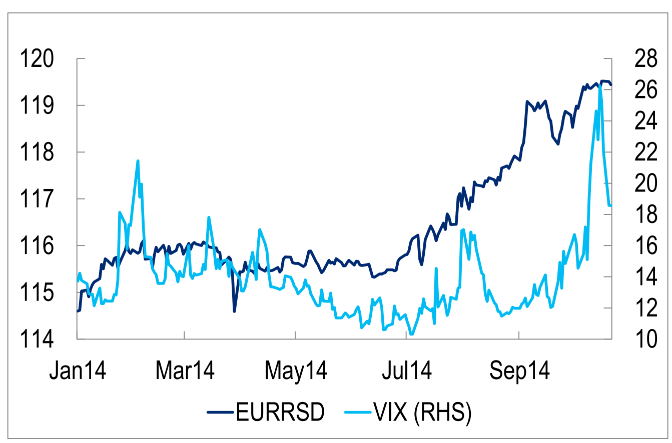
Source: Haver Analytics and Citi Research

Figure 227. Serbia: The bounce-back in IP following the May flooding has so far been relatively subdued…



Source: Haver Analytics, NBS and Citi Research

Figure 228. … as the NBS kept rates on hold owing to global risks and the underperformance of EURRSD



Source: Bloomberg, Reuters and Citi Research

Figure 229. Other Europe Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
BULGARIA									
Nominal GDP, USD bn	43.7	53.6	50.3	48.8	55.8	52.6	54.5	53.7	49.8
GDP per capita, USD	5,720	7,047	6,646	6,500	7,617	7,225	7,532	7,462	6,946
Real GDP, yoy avg	6.4	6.2	-5.5	0.4	1.8	0.6	1.1	1.5	2.5
CPI, % avg	8.4	12.3	2.8	2.4	4.2	3.0	0.9	-1.3	2.2
BGN/US$, avg	1.43	1.33	1.40	1.47	1.40	1.52	1.47	1.50	1.70
BGN/EUR, avg	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
Current account, US$bn	-10.6	-12.0	-4.3	-0.7	0.0	-0.6	1.1	0.3	-0.5
% of GDP	-24.3	-22.4	-8.6	-1.4	0.1	-1.1	2.1	0.5	-1.0
Consolidated gov. balance, % of GDP	1.2	1.7	-4.3	-3.1	-2.0	-0.8	-1.5	-2.7	-2.0
CROATIA									
Nominal GDP, USD bn	59.3	69.6	62.2	58.9	61.5	55.9	57.9	56.1	50.3
GDP per capita, USD	13,581	15,960	14,299	13,577	14,227	12,978	13,495	13,133	11,812
Real GDP, yoy avg	5.1	2.1	-6.9	-2.3	-0.2	-2.2	-0.9	-0.7	0.7
CPI, % avg	2.9	6.1	2.4	1.0	2.3	3.4	2.2	0.0	2.2
Policy Interest Rate, % eop	9.00	9.00	9.00	9.00	7.00	7.00	7.00	7.00	7.00
HRK/US$, avg	5.35	4.91	5.26	5.49	5.34	5.84	5.70	5.84	6.71
HRK/EUR, avg	7.34	7.23	7.34	7.29	7.43	7.51	7.58	7.63	7.75
Current account, US$bn	-4.3	-6.2	-3.2	-0.7	-0.5	-0.1	0.5	0.6	0.2
% of GDP	-7.2	-8.8	-5.1	-1.1	-0.9	-0.2	0.9	1.0	0.3
Consolidated gov. balance, % of GDP	-	-	-5.3	-6.4	-7.8	-5.0	-4.9	-5.0	-4.0
SERBIA									
Nominal GDP, USD bn	40.3	49.3	42.6	39.5	46.5	40.7	42.5	41.0	37.6
GDP per capita, USD	5,458	6,701	5,819	5,413	6,399	5,660	5,903	5,693	5,227
Real GDP, yoy avg	5.4	3.8	-3.5	1.0	1.6	-1.5	2.5	-1.0	2.3
CPI, % avg	6.0	12.5	8.2	6.2	11.2	7.3	7.9	2.5	6.4
Policy Interest Rate, % eop	10.00	17.75	9.50	11.50	9.75	11.25	9.50	8.25	8.00
RSD/US$, avg	58.3	55.2	67.4	77.5	73.2	87.8	85.1	89.6	106.2
RSD/EUR, avg	80.0	81.4	94.0	102.9	102.0	112.9	113.1	117.1	122.7
Current account, US$bn	-6.9	-10.5	-2.9	-2.8	-4.0	-4.4	-2.1	-2.2	-2.2
% of GDP	-17.1	-21.2	-6.8	-7.2	-8.6	-10.9	-4.9	-5.3	-5.8
Consolidated gov. balance, % of GDP	-0.9	-2.0	-3.9	-3.9	-4.4	-7.2	-5.7	-6.0	-5.5

Source: National Sources, Citi Research forecasts

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- **Summary view** — The recession continued in 3Q14, deeper than expected. Thus, we reduce our (non-official) growth forecast for this year to -2.3%, down from -1.5% before. Based on the announced baseline of no-settlement with creditors, we expect output to fall an additional 2.5% in 2015. Meanwhile, the gap between government expenditure and revenues continues to grow. We believe that worsening fiscal accounts, if it continues, could have destabilizing effects.

- **Things to watch** — The external front is the battleground. The next few months will be, in all likelihood, challenging. Market expectations are that an agreement with holdouts is forthcoming. If it fails to materialize, conditions could worsen.

- **Strategy** — We believe that the high and sticky inflation has pushed the government to slow the pace of depreciation of the official FX rate. Yet, we continue to believe that eventually the ARS will have to depreciate faster.

Activity down, inflation up…

Activity shrank more-than-expected during the third quarter, according to private estimates. Local consultancy firm OJF reported that its General Activity Index (IGA), a real GDP proxy, dropped 4.2% YoY in September. The drop was a consequence of a 0.4% month-over-month seasonally-adjusted contraction (the third in a row). As a result, their measure of activity decreased 2.2% QoQ seasonally-adjusted and 3.7% YoY in 3Q14. Year-to-date activity has shrunk 2%, when compared to the first nine months of 2013. As a result, we are now reducing our growth forecast for this year. We now expect (non-official) real GDP to drop 2.3% in 2014, compared to -1.5% before. The reasons behind the contraction are several: the scarcity of foreign currency and the resulting controls on imports, lower terms of trade and activity in Brazil, an increasingly overvalued exchange rate, crowding-out due to the widening of the fiscal deficit and a deterioration in business and consumer sentiment.

A settlement with holdouts in early 2015 could help, but is unlikely to outweigh other macro forces. The local press speculates that come January 2015, the government will negotiate with the holdouts. Such a settlement could produce a bout of fresh air for a country faced with significant dollar scarcity. However, the financing constraint is not the only negative force besetting the country. Terms of trade have suffered significantly. Soy prices have fallen nearly 18% from the average reached during the last crop and are likely to stay low. Brazil remains mired in recession and Citi's forecast for next year only envisages a modest recovery in H2. Business investment is likely to stay subdued awaiting the results of the October 2015 elections. And, the exchange rate is likely to suffer even further real appreciation in the event of a settlement. All those forces would compound with further negative sentiment and dollar scarcity if, as the authorities have promised, there is no negotiations with the holdouts. In this scenario, we expect output to decrease another 2.5%.

Meanwhile, (non-official) consumer inflation trends up. According to local consultancy firm MyS, consumer prices rose 2.9% MoM in September. As a result, annual inflation accelerated to 41.2%, up from 40.2% the previous month. The persistence of inflation is linked to un-anchored expectations. Universidad Torcuato Di Tella reported that median 12 months ahead annual expected inflation came in at 35% (all-time high) in October. We expect year-on-year inflation to stand at 38% by the end of the year (the deceleration resulting from base effects), and to accelerate to 45% in 2015.

… and fiscal policy is not helping

A disorderly fiscal policy implies strong destabilizing forces. The widening fiscal deficit and its monetary financing leads to excessive money printing adding pressure to external accounts. According to data from the Ministry of Finance, primary expenditure rose 48.9% YoY in August, while revenues rose 48.1% YoY. However, revenues growth was strongly boosted by transfer of paper profits from the Central Bank (BCRA), which rose from ARS1.7bn in August 2013 to ARS16.5bn last August. Unfortunately, the BCRA's profits emerge from marking-to-market their asset holdings that, when translated into ARS after the large January depreciation, can only be paid through money printing. If the "inflation profits" are left aside, then genuine revenues rose 25.0% YoY, nearly half the pace of expenditure growth! When compared to previous months, the picture that emerges is one of rapidly deteriorating fiscal accounts. Year-do-date, primary expenditure has increased 44.4% YoY, while "genuine" (i.e., excluding paper profits transfers from the BCRA) revenues rose 35.8%.

Money printing is, mostly, the result of a wider fiscal deficit. According to the latest available data from the BCRA, the latter has transferred ARS88.2bn to the Treasury (in the form of paper profits and transitory loans) year-to-date (as of October 17), compared to ARS49.5bn during the same period of 2013 or ARS94.1bn during 2013 as a whole. We expect fiscal money printing to further increase and reach ARS180bn in 2014 as a whole (or roughly 50% of the monetary base at the end of 2013). If fiscal accounts continue to deteriorate, money printing will likely rise further in 2015. Assuming a "low" 10 percentage points gap between expenditure and revenues growth for 2015, transfers from the BCRA to the Treasury could reach ARS310bn in 2015, or nearly 70% of the monetary base at the end of this year!

What about the FX?

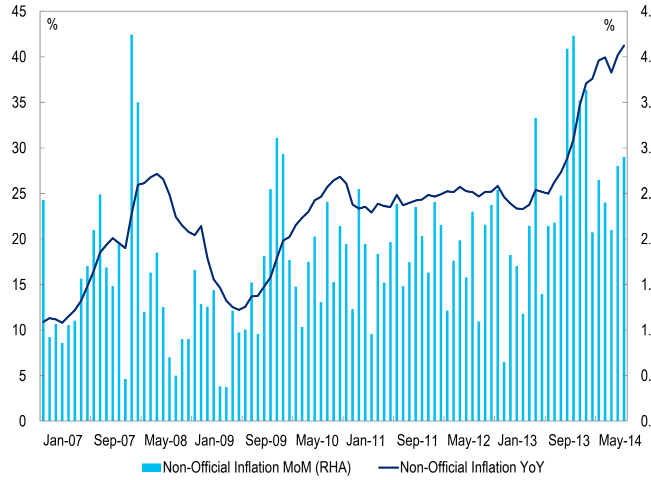
During the second semester, the BCRA has been using the exchange rate as the economy's nominal anchor. However, the pace of money printing has built pressure in the parallel market driving expectations of a large future devaluation. When expectations become un-anchored, activity ends up suffering and the fiscal deficit suffers even further, creating a vicious circle. A devaluation, therefore, seems almost inevitable, be it early or late in 2015. However, in the very short term, we expect the authorities will keep the pace of depreciation contained in the next couple of months to avoid fueling social unrest as we get closer to December. The eventual depreciation of the peso, when it arrives, may happen as a faster pace of crawl or as a step-devaluation. We expect the official USDARS to stand at 8.9 by the end of 2014, and to increase to 13.5 by the end of 2015.

Will the "calm" in the parallel FX market last? The ARS has appreciated in the blue chip market since Alejandro Vanoli was appointed as BCRA's Governor, after several weeks under strong pressure. We believe that this reversal is the result of tighter controls, but that the underlying imbalances remain unattended. For instance, the monetary base rose 6.6% so far in October (ARS25.2bn), faster than any other month in 2014. Similarly, implicit USDARS that results from dividing M0 by international reserves, which has a good record tracking the parallel market's implied FX rate, has increased further.

Figure 230. Activity shrank more than expected in 3Q14

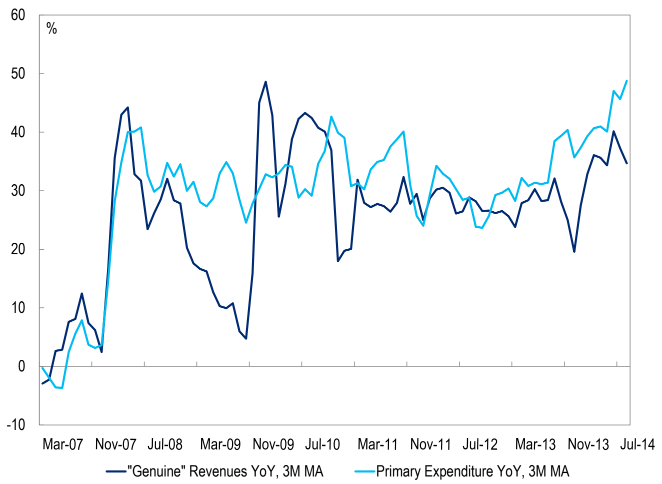
Source: OJF and Citi Research

Figure 231. Inflation has accelerated in recent months



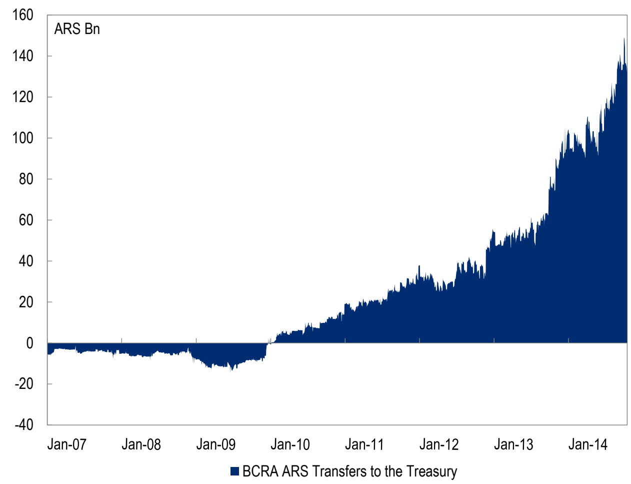
Source: MyS and Citi Research

Figure 232. The gap between expenditure and revenues growth widens



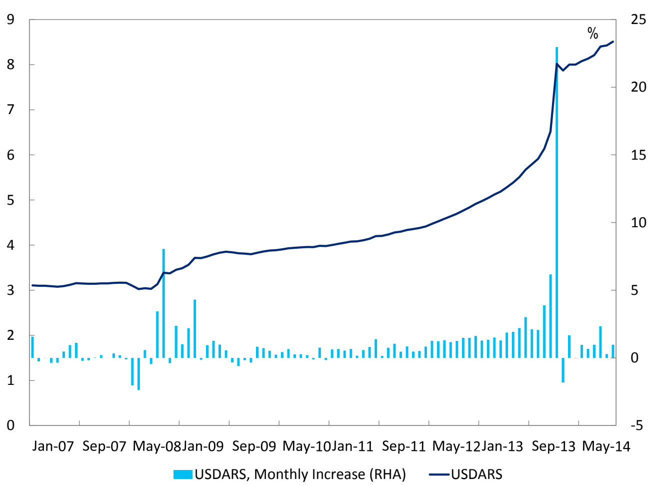
Source: MECON and Citi Research

Figure 233. Leading to higher fiscal money printing



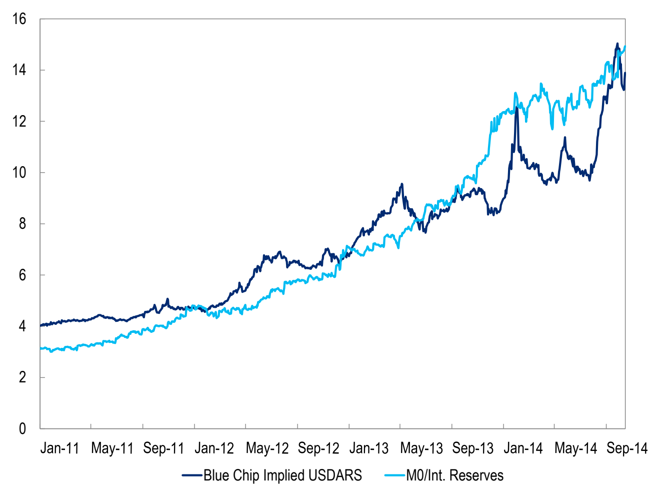
Source: BCRA and Citi Research

Figure 234. The FX rate is being used as nominal anchor



Source: Bloomberg and Citi Research

Figure 235. The M0, reserves and the BCS are very related



Source: BCRA, Bloomberg and Citi Research

Figure 236. Argentina Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	332	409	380	464	560	604	605	511	473
Nominal GDP, local currency bn	1,027	1,284	1,412	1,810	2,303	2,745	3,346	4,242	5,287
GDP per capita, USD	8,428	10,281	9,470	11,456	13,684	14,628	14,517	12,143	11,133
Population, mn	39.4	39.7	40.1	40.5	40.9	41.3	41.7	42.1	42.5
Unemployment, % of labour force	8.5	7.9	8.7	7.8	7.2	7.2	7.1	7.6	8.9
Economic Activity									
Real GDP, yoy avg (Citi estimates)	8.4	2.3	-3.9	7.5	5.0	-0.1	2.9	-2.3	-2.5
Real investment growth % yoy	16.3	6.2	-24.0	38.4	15.6	-11.5	1.5	-2.4	-5.9
Real consumption growth % yoy	8.9	5.5	4.1	7.2	10.5	4.5	4.5	0.2	-0.3
private consumption growth % yoy	9.0	5.6	3.5	7.1	10.8	4.2	4.3	-0.3	-0.8
Real export growth, % yoy	8.0	0.8	-8.7	14.4	4.9	-5.9	-3.8	-4.8	-2.5
Real import growth, % yoy	21.9	13.5	-19.3	35.0	19.8	-4.7	1.9	-5.1	-3.5
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	20.1	20.7	14.8	26.8	24.2	25.2	28.8	38.0	45.0
CPI, % yoy eop (reported)	8.5	7.2	7.7	10.9	9.5	10.8	10.9	26.3	37.0
Nominal wages, % yoy	20.3	22.4	20.0	21.7	27.5	27.1	24.7	29.8	32.0
Credit extension to private sector, % yoy	25.4	10.5	11.5	31.6	34.6	39.0	23.8	26.0	36.0
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	13.63	19.75	10.00	11.25	17.19	15.44	21.63	25.00	39.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	3.15	3.45	3.80	3.97	4.30	4.92	6.52	8.90	13.50
ARS/USD, avg	3.12	3.16	3.73	3.91	4.13	4.54	5.45	8.29	11.23
Balance of Payments, USD bn									
Current account	7.4	6.8	11.0	-0.8	-2.3	0.1	-4.3	-6.2	-5.3
% of GDP	2.2	1.7	2.9	-0.2	-0.4	0.0	-0.7	-1.2	-1.1
Trade balance	13.5	15.4	18.5	14.3	12.9	15.4	12.2	10.9	12.5
Exports	56.0	70.0	55.7	68.1	84.1	80.9	83.0	76.3	72.3
Imports	42.5	54.6	37.1	53.9	71.1	65.6	70.9	65.4	59.8
Service balance	-0.5	-1.3	-1.3	-1.2	-2.2	-3.4	-5.1	-4.1	-4.1
Income balance	-5.9	-7.6	-9.0	-13.5	-12.4	-11.5	-10.7	-12.3	-13.1
FDI, net	6.5	9.7	4.0	11.3	10.7	12.1	9.1	10.0	10.0
International reserves	46.2	46.4	48.0	52.2	46.4	43.3	30.6	25.0	17.5
Total amortisations	5.2	4.7	11.2	10.7	12.0	9.7	9.3	9.3	9.3
Public Finances, % of GDP									
Consolidated government balance	0.9	1.1	-0.5	0.2	-1.3	-2.0	-1.9	-3.7	-4.7
Consolidated gov primary balance	2.5	2.5	1.2	1.4	0.2	-0.2	-0.7	-2.0	-3.0
Public debt	43.6	35.7	38.7	35.4	32.0	31.7	31.3	37.3	44.9
of which Domestic	22.3	20.0	22.4	20.4	18.9	19.7	19.8	24.4	29.2
Foreign Assets & Liabilities, USD bn									
External debt	124.5	124.9	115.6	129.3	141.1	142.2	137.6	123.4	127.8
Public	70.8	64.4	61.8	69.5	73.2	72.0	70.1	65.6	74.2
External debt / GDP	37.5	30.6	30.4	27.9	25.2	23.5	22.7	24.2	27.0
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	-0.5	-1.7	-3.0	-3.9	-2.9	-3.9	-2.2	-0.9	-0.1
CPI, % yoy	37.0	39.9	40.7	38.0	35.5	38.6	41.3	45.0	42.4
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	26.40	22.75	21.38	25.00	27.00	30.00	35.00	39.00	43.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	8.00	8.13	8.43	8.90	9.88	10.96	12.16	13.50	14.42

Source: National Sources, Citi Research

Brazil

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- **Summary view** — The incumbent Dilma Rousseff was reelected with a margin narrower than that suggested by the main polls. Her second term effectively has already started. Mr Rousseff has to continue governing and must make important decisions immediately. The challenging domestic and international environment amid the open wounds of the election process are indicating that Rousseff's second term is likely to have a very difficult first year with tough political and economic choices. We expect some fiscal consolidation, although the forecast of a primary fiscal surplus of 2% of GDP embedded in the 2015 budget law is a very ambitious objective, in our view. An inflation rate still close to the upper bound of the target and anemic growth worsen the central bank's trade off. The first steps of monetary policy are difficult to forecast, though we maintain our view that the central bank will attempt two more hikes to curb the inflationary pressures. External conditions (commodity prices and dollar strength) have turned against the BRL, and this trend is likely to proceed in the long run.

- **Things to watch** — US economic data has been shown to be a relevant driver of domestic forward interest rates and the exchange rate. On domestic front, we expect the announcement of the new Minister of Finance to minimize any volatility that follows the electoral results. Apart from that, domestic activity and inflation indicators keep having an important role in fine tuning next steps for monetary and fiscal policy.

- **Strategy** — Assuming that the new economic team/Minister of Finance wil not modify the perception about the conduct of economic policy, especially on the fiscal front, we see additional room for an increase in long term interest rates relative to shorter maturities, supporting further steepening in the yield curve. On FX front, apart from the domestic scenario, the recent decline in commodity prices together with rising global risk aversion point to weaker a domestic currency.

Addressing the macroeconomic imbalances

Dilma Rousseff, the incumbent president, was reelected with a narrower margin than that suggested by the main polls. The incumbent president obtained 51.6% of the valid votes, while the opposition candidate, Aecio Neves, got the remaining 48.4%. For us, Rousseff's staff was competent in increasing president popularity during the campaign, spinning the election back in her direction. For instance, and according to Datafolha, while in July 31% of interviewers considered Rousseff's government good or great, this figure rose to 44% on the eve of the second round run-off. This level of popularity is even higher than that reached by FHC during his re-election in 1998. In the meantime, Neves' rejection surpassed Rousseff's (42% against 41%), undermining the argument that a high rejection rate was the main weakness of the incumbent.

Dilma Rousseff's second term has already effectively started. While the formal inauguration of her second 4-year term is scheduled for January 1st, Mrs Rousseff has to continue governing and must make important decisions immediately. The challenging domestic and international environment amid the open wounds of the election process are indicating that Rousseff's second term is likely to have a very difficult first year with tough political and economic choices, especially with regard to fiscal and monetary policies.

We see the next administration pursuing a tighter fiscal policy next year. Monthly fiscal results continue to disappoint and one-off revenues (like those linked to the REFIS scheme) have not been enough to make up for poor recurrent revenues that result from a faltering economy. Moreover, expenditures have accelerated, and we now forecast a primary surplus of 0.4% of GDP at end-2014 (from 1.0% previously). In our view, the next administration will have to tighten the fiscal accounts in 2015 and keep the trajectory of sustainable debt in check. A primary surplus of 2.0% of GDP, as a 2015 target embedded in the budget bill, still looks ambitious though. But if the new administration does not respond quickly with concrete signals of fiscal restraint, there is an impending risk of a sovereign rating downgrade.

We still expect Copom to raise the Selic rate in 1Q15, bringing it back to 11% by 2H15. Inflation hovering around the target's upper bound and the anemic growth worsen the central bank trade off. Furthermore, during the earlier part of the campaign, president Rousseff undermined the credibility of the central bank, which needs to restore its autonomy. Although CB's next moves are hard to predict, we maintain our view that the central bank will attempt two hikes in the first two meetings of next year (50bps in each) to curb the inflationary pressures.

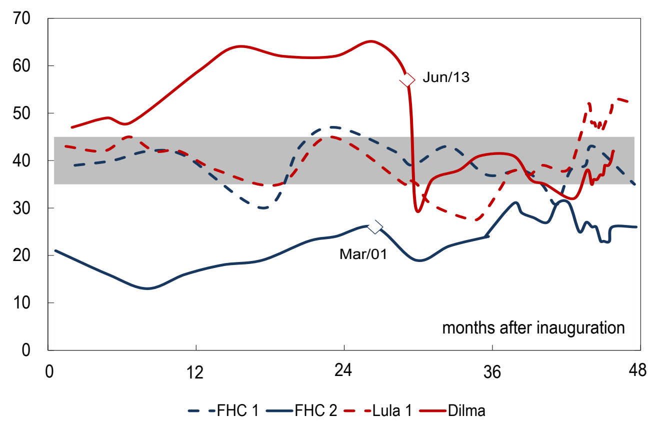
We continue expecting GDP growth of 0.1% this year, below market consensus of around 0.3%. Despite the better performance of some activity indicators in August we have not seen a reversion in demand to a decelerating trend yet. Because of that, despite recognizing the higher risk of 3Q14 GDP surpassing our forecast of a flat figure (on QoQ basis), we cannot underestimate the possibility of a weaker-than-expected growth figure in 4Q14 given the likely correction in inventories ahead. Overall, we keep our estimate that 2014 GDP will expand 0.1%, slighty below consensus estimate.

Fundamentals point to another frustrating GDP performance next year. Looking ahead, we see fundamentals supporting a scenario of sluggish growth. In particular, all confidence indicators have continued declining, reaching their lowest levels since 1H09 when the economy was in recession. Moreover, the labor market keeps weakening, with the unemployment rate rising only mildly because of the decline in labor force participation. In addition, given the high levels of loan interest rates and the depressed confidence, credit growth should keep decelerating in coming months. Taking all together, we do not see 2015 GDP growth accelerating markedly. On the contrary, fundamentals are suggesting that the risks are tilted toward a softer expansion than our current estimate of 1.0% for 2015.

We expect seasonal headwinds to prop up year-end headline inflation. Over the next few months, we expect seasonality to prevail and the headline CPI inflation prints to notch up to levels similar to the ones observed in 1H2014. Our 2014 year-end CPI inflation forecast still is 6.4%, as monitored prices increase less than the rest of prices. For 2015, we see an increase in headline inflation slightly above the upper bound of the target: 6.8%. We expect a correction in monitored-price inflation to reach 9.0% in 2015 —e.g. a 22.3% hike in regulated energy bills—which should help address the price repression issue in Brazil.

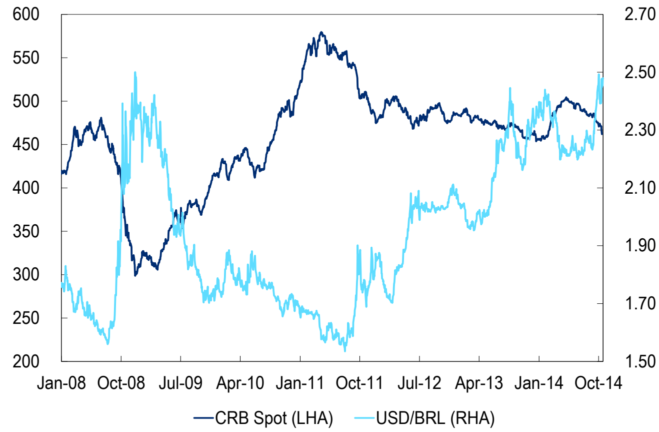
Global and domestic fundamentals support weaker domestic currency. On the FX front, the current account deficit of around 3.7% of GDP and the approach of US monetary policy normalization will likely pressure BRL downward in the medium and long term. In the near term, market analysts will focus their attention on the announcement of the MoF to gauge the likelihood of reversing the deteriorating macroeconomic fundamentals. All in all, we expect the USDBRL to stand at 2.57 at 2014 by yearend, and USDBRL 2.70 at the end of 2015.

Figure 237. Dilma's popularity rose significatnyl during the campaing



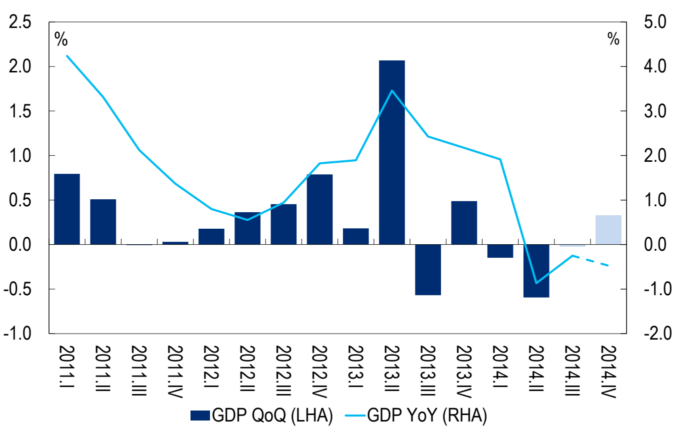
Source: Citi Research and Datafolha

Figure 238. Lower commodity prices has been pressuring BRL downward



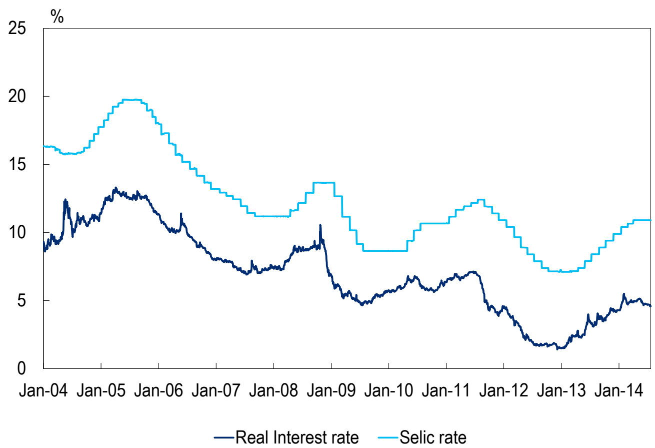
Source: Citi Research, BCB and Bloomberg

Figure 239. We see no meaningful GDP recovery ahead



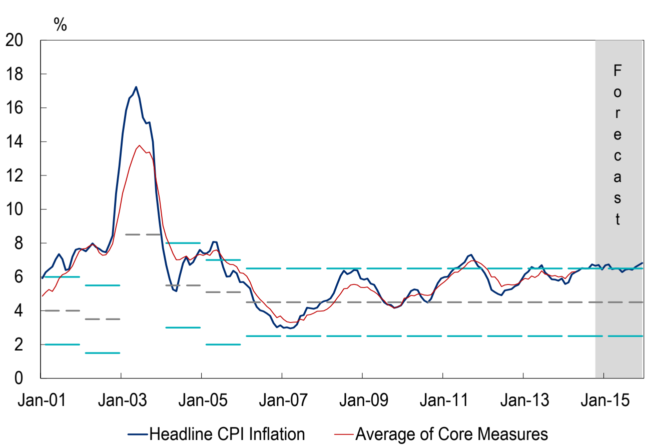
Source: Citi Research and IBGE

Figure 240. We expect Copom to keep Selic rate stable until 2014 year end



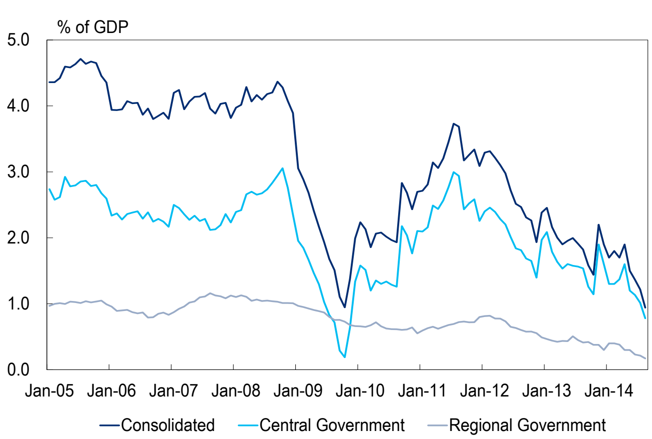
Source: Citi Research and BCB

Figure 241. CPI inflation will stay close to the upper limit of the target



Source: Citi Research, IBGE and BCB

Figure 242. Primary fiscal surplus continues markedly below 2% of GDP



Source: Citi Research and BCB

Figure 243. Brazil Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,317	1,746	1,622	2,142	2,475	2,247	2,215	2,224	2,192
Nominal GDP, local currency bn	2,661	3,032	3,239	3,770	4,143	4,392	4,815	5,116	5,505
GDP per capita, USD	6,950	9,114	8,379	10,955	12,536	11,278	11,019	10,969	10,713
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	4.9	5.3
Economic Activity									
Real GDP, yoy avg (Citi estimates)	6.1	5.2	-0.3	7.5	2.7	1.0	2.5	0.1	1.0
Real investment growth % yoy	16.9	16.4	-16.0	33.4	4.0	-7.9	7.9	-6.7	2.4
Real consumption growth % yoy	5.8	5.1	4.1	6.3	3.6	3.2	2.4	1.5	0.8
private consumption growth % yoy	6.1	5.7	4.4	6.9	4.1	3.2	2.6	1.2	1.3
Real export growth, % yoy	6.2	0.5	-9.1	11.5	4.5	0.5	2.5	2.3	2.4
Real import growth, % yoy	19.9	15.4	-7.6	35.8	9.7	0.2	8.3	0.2	2.8
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	4.5	5.9	4.3	5.9	6.5	5.8	5.9	6.4	6.8
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	7.0	10.4	4.8	12.7	8.9	10.7	10.8	11.3	11.7
Credit extension to private sector, % yoy	-	30.9	15.1	20.6	18.8	16.4	14.7	11.7	14.1
Policy Rate (eop)	11.25	13.75	8.75	10.75	11.00	7.25	10.00	11.00	11.00
1 month inter-bank rate, %, eop	11.11	13.49	8.61	10.64	10.87	6.59	9.78	11.00	11.00
Long-term yield, %, eop	12.95	12.27	12.25	12.24	10.66	7.96	12.00	12.27	12.77
BRL/USD, eop	1.78	2.31	1.74	1.66	1.86	2.05	2.36	2.57	2.70
BRL/USD, avg	1.95	1.84	2.00	1.76	1.67	1.95	2.16	2.37	2.65
Balance of Payments, USD bn									
Current account	1.6	-28.2	-24.3	-47.3	-52.5	-54.2	-81.1	-85.2	-88.0
% of GDP	0.1	-1.6	-1.5	-2.2	-2.1	-2.4	-3.7	-3.8	-4.0
Trade balance	40.0	24.8	25.3	20.1	29.8	19.4	2.6	0.9	4.3
Exports	160.6	197.9	153.0	201.9	256.0	242.6	242.2	239.3	254.5
Imports	120.6	173.1	127.7	181.8	226.2	223.2	239.6	238.4	250.3
Service balance	-13.2	-16.7	-19.2	-30.8	-37.9	-41.0	-47.2	-50.9	-56.7
Income balance	-29.3	-40.6	-33.7	-39.5	-47.3	-35.4	-39.8	-37.9	-39.1
FDI, net	34.6	45.1	25.9	48.5	66.7	65.3	64.0	60.3	60.0
International reserves	180.3	193.8	238.5	288.6	352.0	373.1	375.8	380.5	380.5
Total amortisations	38.2	22.4	30.1	33.8	37.7	39.7	60.1	67.0	73.0
Public Finances, % of GDP									
Consolidated government balance	-2.8	-2.0	-3.3	-2.6	-2.6	-2.5	-3.3	-5.1	-3.7
Consolidated gov primary balance	3.8	3.9	2.0	2.7	3.1	2.4	1.9	0.4	2.0
Public debt	55.0	55.9	60.9	53.4	54.2	58.8	56.7	59.4	59.9
of which Domestic	50.9	51.2	57.5	50.5	51.5	55.9	53.8	56.5	56.9
Foreign Assets & Liabilities, USD bn									
External debt	193.6	198.3	198.2	256.8	298.2	312.9	322.8	318.6	312.0
Public	86.0	84.2	93.3	103.6	102.1	113.7	119.5	116.2	113.8
External debt / GDP	14.7	11.4	12.2	12.0	12.1	13.9	14.6	14.3	14.2
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	38.9	36.4	31.0	57.3	40.1	37.2	40.0	42.0	44.0
Short-term debt/International reserves (%)	21.6	18.8	13.0	19.9	11.4	10.0	10.6	11.0	11.6

Quarterly Economic Indicators	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	1.9	-0.9	-0.3	-0.5	-0.1	0.9	1.4	1.9	2.5
CPI, % yoy	5.6	6.3	6.5	6.4	6.5	6.3	6.4	6.8	6.6
Policy interest rate, %, eop	10.75	11.00	11.00	11.00	12.00	12.00	11.50	11.00	10.75
Short-term market rate, % eop	10.56	10.80	10.82	11.00	11.95	12.00	11.51	11.00	10.51
Long-term yield, %, eop	12.88	12.24	11.50	12.27	12.77	12.77	12.77	12.77	13.27
BRL/USD, eop	2.27	2.21	2.45	2.57	2.60	2.64	2.67	2.70	2.73

Source: National Sources, Citi Research

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- **Summary view** — We are upgrading our 2014 real GDP growth forecast to 6.8% from 6% for the Dominican Republic. This upgrade implies that we expect a real GDP growth rate of 6% in 4Q14.
- **Things to watch** — The countries across the region are in the process of fine tuning and approving their 2015 budgets.
- **Strategy** — The fate of the Dominican Republic's relative value remains critically dependent on the amount of hard-currency debt supply brought to market over the next year.

DomRep continues to grow at a fast rate

Central Bank Governor Héctor Valdez Albizu said that real GDP grew 7% YoY during January-September 2014. He made this announcement during his speech at the 67th anniversary of the Central Bank of the Dominican Republic (BCRD). Mr. Valdez Albizu highlighted that the sectors that contributed the most to growth were mining, construction, and tourism related activities. The 7% YoY growth rate during January-September 2014 implies that real GDP increased about 6.6% YoY during 3Q14 — virtually unchanged from that of 2Q14 (6.7%). We assume that there are no revisions to previously released data of the new National Accounts.

After the 3Q14 results, we are upgrading our 2014 growth outlook. We are revising our 2014 real GDP growth forecast to 6.8% from 6%. This upgrade implies that we expect a real GDP growth rate of 6% in 4Q14. We originally thought that growth was going to remain high, but around 5% during 2H14. After Mr. Valdez Albizu's announcement, it seems that growth in 2H14 could be above 6%.

DomRep and Petrocaribe

The recent fall in oil prices is benefitting the Dominican Republic, as it is a net oil importer, but could also accelerate changes in Petrocaribe — namely, should Venezuela trim the amount of financing it offers through this agreement. The most recent data published by the Central Bank of the Dominican Republic (BCRD) shows that the country imported 31 million barrels of crude oil and refined products during the last 12 months (July 2013 to June 2014). These oil imports amounted to USD3.4 billion. If we include liquefied petroleum gas (LPG) and natural gas, the "energy bill" goes to almost USD4.2 billion. A permanent drop of USD10/bbl in the price of the WTI could translate into a reduction in the trade deficit of 0.5% of GDP. If we were to extend some equivalent fall in LPG and natural gas prices, the benefit on the trade balance would be slightly higher.

An end to Petrocaribe financing would be negative for the credit, but the extent of the damage depends on the oil price outlook. Our longstanding view has been that an exit from Petrocaribe would translate into higher external debt issuance by the Dominican Republic. For example, the government is budgeting USD650 million in Petrocaribe financing. If that financing were to cease, as a result of the continuous economic deterioration in Venezuela (we are downgrading our growth forecasts markedly for this country in this edition), the first reaction would be to expect that the Dominican Republic would raise that money through bonds. However, since the actual Petrocaribe financing moves together with the actual price of oil, current and expected oil prices, would determine the size of the actual financing that is lost. It is not the same Petrocaribe financing under an USD100/bbl environment as it would be in an USD80/bbl world.

The net damage to the Balance of Payments (BoP) from the potential exit from Petrocaribe decreases as we move into a low oil price environment. In an USD100/bbl environment the net outflow of dollars associated with oil would be around USD2.35 billion (oil imports minus Petrocaribe financing). If we assume that an USD80/bbl environment could trigger changes to Petrocaribe, the net outflows (only oil imports in this case) would still be higher, but not that different from those of a high oil price world in which Petrocaribe is still alive. Not having Petrocaribe under a USD75/bbl environment would be virtually the same (in terms of outflows) as having the membership in an USD100/bbl environment.

The government could have some initial flexibility to accommodate the shock from Petrocaribe in the capital account. The public debt law (or bill at this moment) gives total flexibility to the government to decide not only the currency (USD or DOP), but also address (external or local law) bond financing. This means that the government could easily decide if the full amount of bond financing needs to be in dollars. This could give it at least initial flexibility to come up with the dollars that usually come through Petrocaribe to prevent a hard currency hole in the capital account.

A spending adjustment could decelerate growth. Gauging how much a loss of Petrocaribe could impact the economy is difficult at this time, but we think it would undermine confidence (among consumers and businesses) as so far the country has not been explicit on what it would do in the absence of Petrocaribe

Slowdown begins in Costa Rica

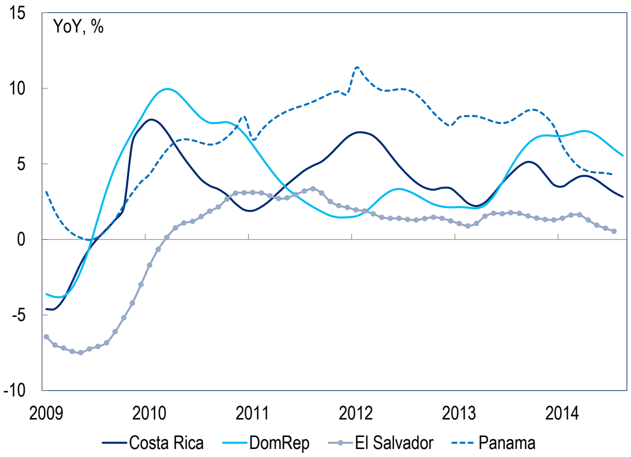
Intel's exit is beginning to show up in Costa Rica's activity figures. It is worth remembering that in April Intel announced a partial exit from Costa Rica by saying (among other things) that it would reallocate its assembly and test operation to Asia. Given the importance of Intel to exports and in manufacturing output, we argued some time ago that a slowdown in growth seemed inevitable. In our view, that exit is beginning to show up in activity figures.

Both the trade balance and manufacturing output suggest that Intel's exit is beginning to affect the economy. Exports and imports are falling and, according to the most recent data published by the Central Bank of Costa Rica (BCCR), it seems that the slowdown comes from *Zonas Francas*. It is worth remembering that Intel's manufacturing operations in Costa Rica were regarded as *Zona Franca* — meaning that it can import virtually anything without paying duties, as long as it exports its output. Exports from Zonas Francas fell during most of 2Q14 and 3Q14, while imports of raw material and intermediate goods for Zonas Francas also decreased. This strongly suggests that downsizing of Intel is affecting activity in Zonas Francas. If we connect that with the actual slowdown in manufacturing output, it seems that the exit of Intel is beginning to pull down growth.

Panama Canal with low traffic

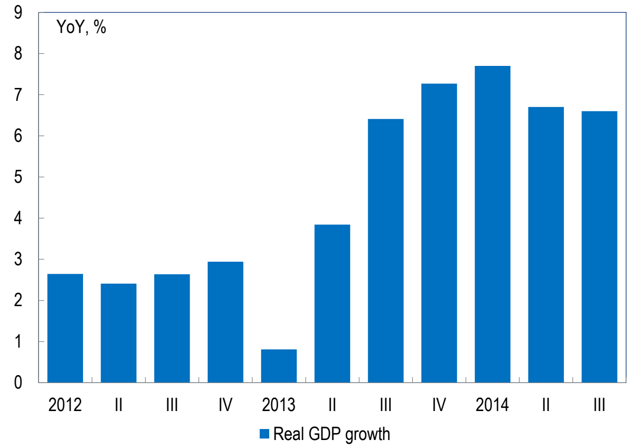
Traffic in the Panama Canal continues to show low traffic. Traffic in the Panama Canal has been falling during most of 2014. Toll revenues have increased, but the low traffic levels are preventing the Canal from pushing growth up a little bit. It is worth remembering that the temporary halt in the Panama Canal expansion at the beginning of the year worked against growth.

Figure 244. CCA: DomRep's IMAE is growing at the fastest rate



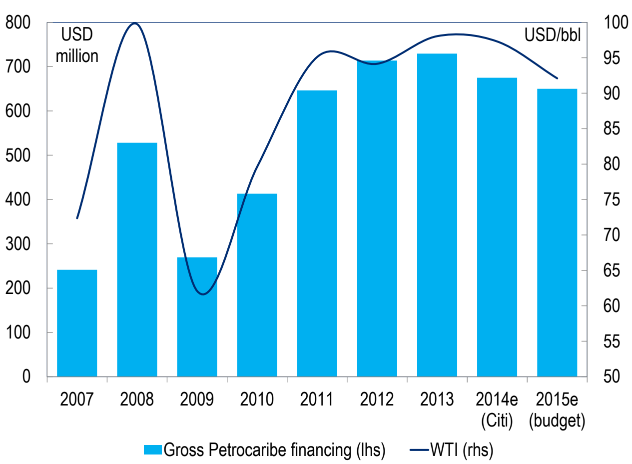
Source: BCCR, BCRD, BCRES, INEC, Haver and Citi Research

Figure 245. DomRep: Real GDP grew 6.6% YoY in 3Q14



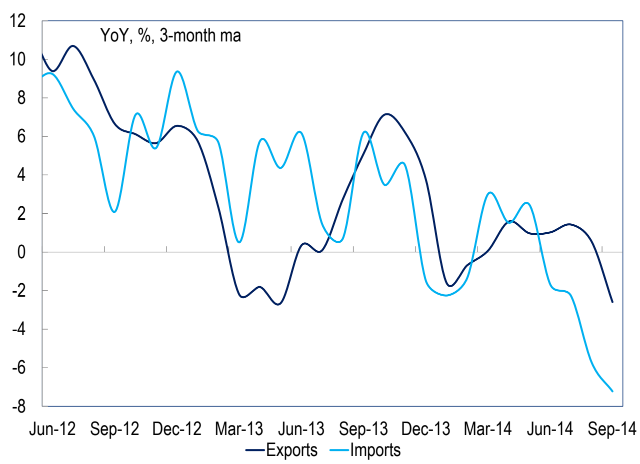
Source: BCRD and Citi Research

Figure 246. DomRep : Oil prices drive Petrocaribe financing



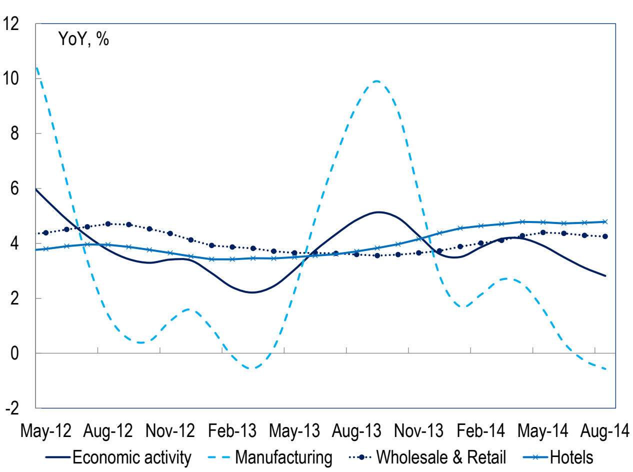
Source: Ministry of Finance (Hacienda), Bloomberg and Citi Research

Figure 247. Costa Rica: Exports and Imports are falling



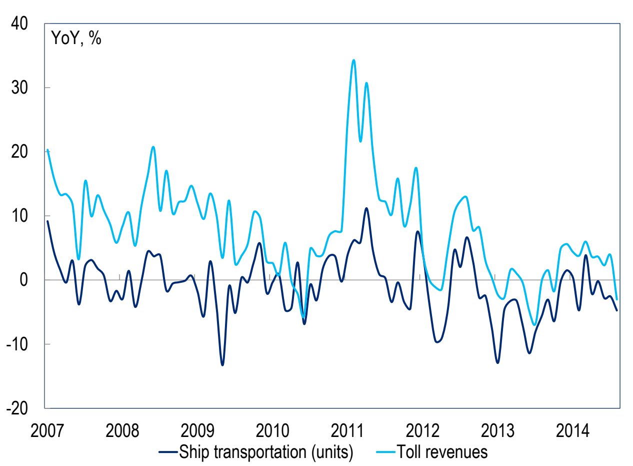
Source: BCCR, Haver and Citi Research

Figure 248. Costa Rica: Manufacturing is pulling down growth



Source: BCCR, Haver and Citi Research

Figure 249. Panama: Traffic in the Canal is falling



Source: ACP, Haver and Citi Research

Figure 250. CCA Economic Research Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Costa Rica									
Nominal GDP, USD bn	26.3	29.8	29.4	36.3	41.2	45.4	49.6	49.5	51.1
GDP per capita, USD	5,925	6,583	6,359	7,955	8,964	9,654	10,557	10,307	10,636
Real GDP, yoy avg	7.9	2.7	-1.0	5.0	4.5	5.1	3.5	3.1	2.2
CPI, % avg	9.4	13.4	7.8	5.7	4.9	4.5	5.2	4.8	5.0
CRC/US$, avg	517	525	570	521	502	503	501	541	562
Real GDP, yoy avg (Citi estimates)	496	560	555	504	506	513	501	550	570
Current account	-1.6	-2.8	-0.6	-1.3	-2.2	-2.4	-2.5	-3.2	-3.3
% of GDP	-6.3	-9.3	-2.0	-3.5	-5.3	-5.3	-5.1	-6.4	-6.5
Consolidated government balance	0.8	0.5	-3.9	-6.0	-5.6	-5.7	-6.5	-7.2	-7.7

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Dominican Republic									
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
GDP per capita, USD	4,708	5,053	4,967	5,454	5,816	5,909	5,955	6,309	6,639
Real GDP, yoy avg	8.5	3.1	0.9	8.3	2.9	2.7	4.6	6.8	4.5
CPI, % avg	6.1	10.6	1.4	6.3	8.5	3.7	4.8	3.3	3.8
Policy Interest Rate, % eop	7.00	9.50	4.00	5.00	6.75	5.00	6.25	6.25	6.25
DOP/US$, avg	32.8	34.4	35.9	36.8	38.0	39.2	41.7	43.4	44.7
DOP/US$, eop	33.0	35.4	36.2	37.4	38.7	40.4	42.7	44.0	45.5
Current account	-2.2	-4.5	-2.3	-4.0	-4.4	-4.0	-2.5	-2.4	-2.6
% of GDP	-4.9	-9.4	-4.8	-7.4	-7.5	-6.6	-4.0	-3.7	-3.8
Consolidated government balance	-1.7	-4.3	-4.8	-3.7	-3.8	-7.9	-4.1	-4.0	-4.0

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
El Salvador									
Nominal GDP, USD bn	20.1	21.4	20.7	21.4	23.1	23.8	24.3	25.2	26.3
GDP per capita, USD	3,500	3,705	3,548	3,653	3,919	4,006	4,043	4,192	4,385
Real GDP, yoy avg	3.8	1.3	-3.1	1.4	2.2	1.9	1.7	2.2	2.5
CPI, % avg	4.6	7.3	0.5	1.2	5.1	1.8	0.8	1.4	2.1
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
SVC/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.2	-1.5	-0.3	-0.6	-1.1	-1.3	-1.5	-1.6	-1.5
% of GDP	-6.1	-7.1	-1.5	-2.7	-4.6	-5.3	-6.2	-6.4	-5.7
Consolidated government balance	-1.9	-2.8	-5.5	-4.4	-4.0	-3.5	-4.2	-3.1	-3.0

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Panama									
Nominal GDP, USD bn	21.1	24.9	25.9	28.8	33.3	38.0	42.6	46.6	50.2
GDP per capita, USD	6,318	7,312	7,482	8,170	9,242	10,543	11,668	12,589	13,222
Real GDP, yoy avg	12.1	9.1	4.0	5.9	10.8	10.2	8.4	6.2	5.5
CPI, % avg	4.2	8.8	2.4	3.5	5.9	5.7	4.0	2.8	2.2
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
PAB/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.4	-2.7	-0.2	-2.8	-5.0	-3.8	-4.8	-4.2	-4.3
% of GDP	-6.7	-10.9	-0.7	-9.6	-15.0	-10.1	-11.3	-9.0	-8.6
Consolidated government balance	3.5	0.4	-1.0	-1.9	-2.2	-1.5	-3.0	-4.0	-3.0

Source: National Sources, Citi Research forecasts

Chile

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- **Summary view** — The BCCh removed the easing bias and adopted a neutral stance. Business confidence and the government's approval rates remain at low levels.

- **Things to watch** — Discussions about education reform in the local congress are worth monitoring. The government could begin gearing up labor reform for early 2015.

- **Strategy** — We expect the central bank to remain on hold for a long period of time, as growth remains below potential and inflation is expected to begin slowing down.

Easing cycle comes to an end

The Central Bank of Chile (BCCh) removed its easing bias and adopted a neutral stance. In its October meeting, the Central Bank of Chile (BCCh) reduced its policy rate by 25bps, to 3%, following the three previous consecutive 25bps cuts. The easing bias incorporated in previous statements, when the BCCh used to say that it would continue to analyze the possibility of additional easing, was completely eliminated. In the October statement, the central bank said that "future changes to the monetary policy rate will depend on the implications from domestic and external conditions on the inflation outlook." This fragment is similar to the text in the communiqués from the first half of 2013, when the BCCh used to be on hold. The fact that the communiqué does not provide any guidance on the future direction of monetary policy likely makes evident that the authorities have adopted a neutral stance, in our view.

We expect the BCCh to remain on hold for a long period of time. Below trend growth during the next year is behind that view. In addition, inflation is expected to slow down. Inflation surprised on the upside in September, as consumer prices rose 4.9% YoY. However, the BCCh continues to expect annual inflation to fall back into its target-band, after remaining above the upper bound of it for some additional months. In our view, the recent downturn in commodity prices (particularly in oil) could lend a hand to pull down inflation. We must note that during the rebound in inflation, expectations (other than short-term) remained around 3% (BCCh's midpoint target). Even though monetary conditions in the United States could tighten next year, we do not expect the BCCh to begin feeling peer pressure to hike rates. The reason why we think the BCCh would stay on hold during 2015 is because we think that China's business cycle has become more important for Chile than the U.S. cycle.

Labor markets are beginning to weaken, thereby providing room for staying on hold. During this year, the unemployment rate has been slowly moving up — nonetheless, it remains at relatively low levels. The rise in wages accelerated during most of 2014. However, growth in wages began to slowdown In August. In our view, the likely further weakening of labor markets are key for the inflation outlook, which assumes that inflation would slow down. As we mentioned before, the expected slowdown in inflation would provide room to remain on hold for a long period of time.

The BCCh seems to be assuming that growth will begin recovering next year. That does not mean that growth would return to its potential growth rate, but simply recover from the below-trend growth of 2014. We consider this also a main assumption by the central bank; otherwise it would have left intact its easing bias. If the economy were to refrain from showing signs of recovery in early 2015, the central bank would probably begin opening the door for another round of cuts. Of course, this is not our baseline scenario, but we have to acknowledge that we should not totally rule out that possibility.

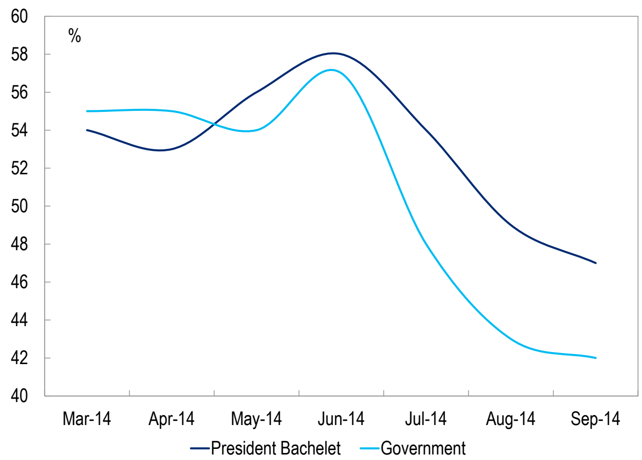
The final reason why we think that there is room for the central bank to stay on hold for a while is the behavior of the trade balance. Imports continue to fall, while exports are beginning to post positive growth rates. Under these trends, the current account would remain at manageable levels, thereby putting away concerns of the effect that a low (real) interest rate environment could have on the current account.

Confidence in authorities and the economy is still low

Business confidence remains at low levels, despite the improvement in September. In previous comments we underscored how confidence had been heading down in Chile. We attributed that trend to the combination of low commodity prices, tax reform and weaker economic activity. However, the September print of the IMCE (monthly indicator of business confidence) shows a slight recovery in confidence. A breakdown of that indicator suggests that the uptick stems from a rebound in the construction and mining sub-indexes. Nonetheless, the IMCE remains at low levels.

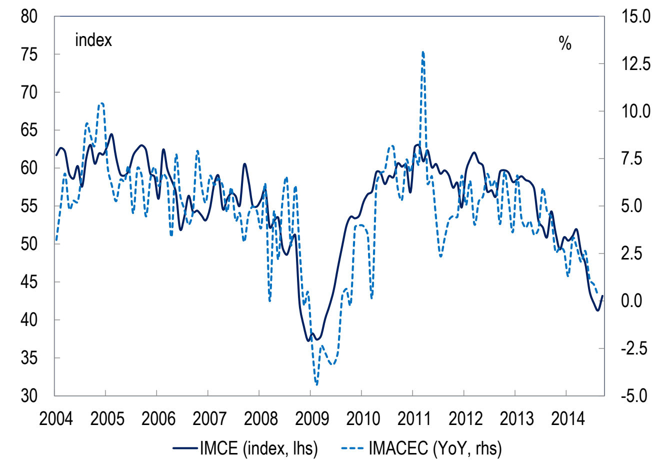
The government's approval rates fell again in September. Approval rates for both President Michelle Bachelet and her government fell again in September. That fall was small if compared to that of the previous months. The decrease in approval rates suggest that the Bachelet administration would have to use even more political capital if it wants to make progress on its reform agenda.

Figure 251. Approval rates declined further in September



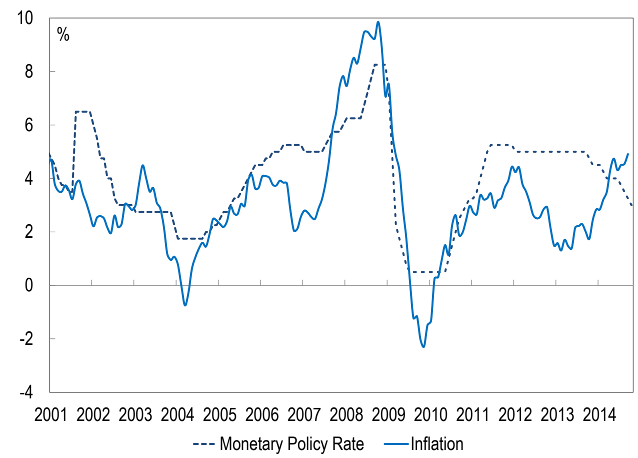
Source: GFK Adimar and Citi Research

Figure 252. Confidence (IMCE) is low, but picked up slightly in September



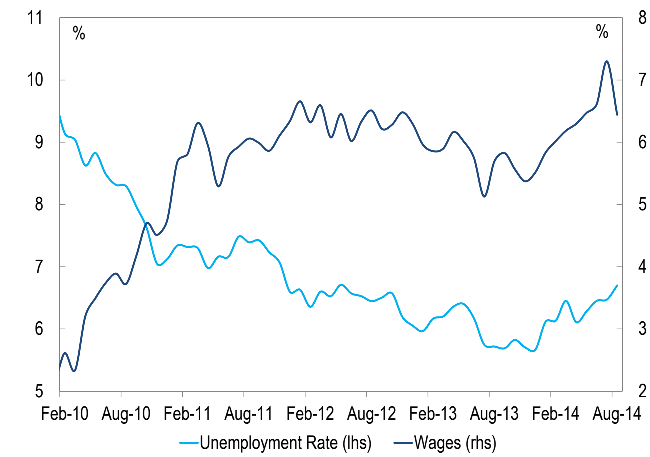
Source: ICARE, Haver and Citi Research

Figure 253. Short-term real interest rates seem to be in negative territory



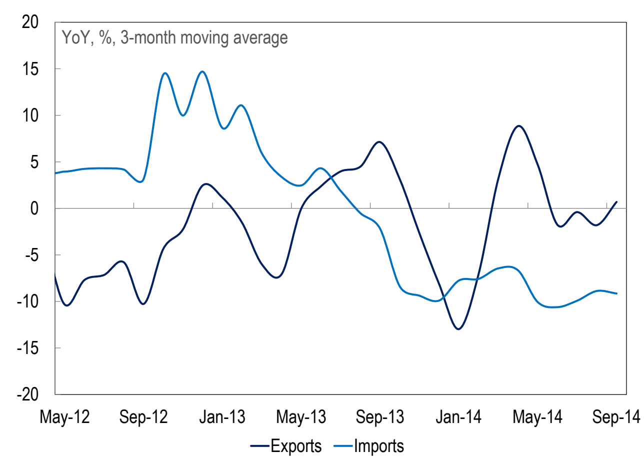
Source: BCCh, INE, Haver and Citi Research

Figure 254. Labor markets begin to show some signs of weakness



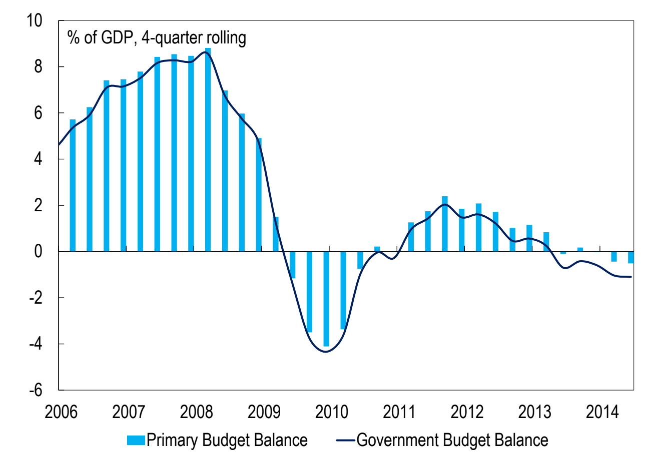
Source: INE, Haver and Citi Research

Figure 255. Imports are falling more than exports



Source: BCCh, Haver and Citi Research

Figure 256. The fiscal deficit is widening



Source: Hacienda, Haver, BCCh and Citi Research

Figure 257. Chile Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	173	183	173	218	251	267	277	253	247
Nominal GDP, local currency bn	90	94	96	111	121	130	137	144	153
GDP per capita, USD	10,414	10,876	10,199	12,861	14,639	15,398	15,863	14,306	13,840
Population, mn	16.6	16.8	17.0	17.0	17.1	17.3	17.5	17.7	17.8
Unemployment, % of labour force	7.1	7.8	10.8	8.2	7.1	6.4	5.9	6.4	7.2
Economic Activity									
Real GDP, yoy avg (Citi estimates)	5.2	3.3	-1.0	5.8	5.8	5.4	4.1	1.8	3.0
Real investment growth % yoy	6.4	20.8	-23.5	33.4	10.7	10.6	-3.7	-8.6	2.0
Real consumption growth % yoy	7.5	4.4	0.8	9.8	7.8	5.6	5.4	2.4	3.7
private consumption growth % yoy	7.6	5.2	-0.8	10.8	8.9	6.0	5.6	2.0	3.5
Real export growth, % yoy	7.2	-0.7	-4.5	2.3	5.5	1.1	4.3	1.1	2.6
Real import growth, % yoy	14.3	11.2	-16.2	25.9	15.6	5.0	2.2	-5.8	3.8
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	7.8	7.1	-1.5	3.0	4.4	1.5	2.9	4.4	3.0
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	7.1	8.5	5.8	3.5	5.8	6.3	5.8	6.0	4.9
Credit extension to private sector, % yoy	21.0	18.7	-1.4	7.1	16.9	12.1	9.7	5.2	6.5
Policy Rate (eop)	6.00	8.25	0.50	3.25	5.25	5.00	4.50	3.00	3.00
1 month inter-bank rate, %, eop	5.93	8.24	0.45	3.13	5.23	4.99	4.50	3.00	3.00
Long-term yield, %, eop	6.30	5.93	5.38	5.81	4.92	5.45	5.10	5.00	5.00
CLP/USD, eop	498	638	507	468	520	479	525	592	597
CLP/USD, avg	522	524	559	510	484	486	496	573	597
Balance of Payments, USD bn									
Current account	7.1	-5.8	3.5	3.6	-3.1	-9.1	-9.5	-5.1	-6.9
% of GDP	4.1	-3.2	2.0	1.6	-1.2	-3.4	-3.4	-2.0	-2.8
Trade balance	24.1	6.1	15.4	15.7	11.0	2.5	2.1	6.3	3.3
Exports	68.6	64.5	55.5	71.1	81.4	78.0	76.7	73.5	69.4
Imports	44.4	58.4	40.1	55.4	70.4	75.5	74.6	67.2	66.1
Service balance	-1.3	-1.2	-2.0	-1.9	-3.1	-2.3	-2.9	-1.7	-0.1
Income balance	-18.9	-13.6	-11.4	-14.7	-13.9	-11.5	-11.1	-11.7	-12.1
FDI, net	12.6	15.5	12.9	15.7	23.4	28.5	20.3	15.1	14.0
International reserves	16.9	23.2	25.4	27.9	42.0	41.6	41.1	37.5	40.0
Total amortisations	14.3	14.3	16.4	12.3	12.8	22.4	22.7	22.7	23.6
Public Finances, % of GDP									
Consolidated government balance	8.4	4.3	-4.3	-0.3	1.4	0.6	-0.6	-2.0	-1.6
Consolidated gov primary balance	9.0	4.8	-3.8	0.2	2.0	1.2	0.0	-1.4	-1.0
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	2.0	2.4	4.9	7.4	7.7	9.9	10.2	5.8	6.7
Foreign Assets & Liabilities, USD bn									
External debt	53.4	63.7	71.9	84.5	98.7	117.8	130.7	129.3	127.1
Public	4.0	3.3	4.0	5.6	7.1	7.9	7.5	7.3	7.4
External debt / GDP	30.8	34.9	41.5	38.7	39.3	44.2	47.1	51.2	51.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	9.0	14.0	15.8	16.2	19.6	22.8	21.9	19.6	19.1
Short-term debt/International reserves (%)	53.4	60.6	62.4	58.3	46.6	54.9	53.3	52.3	47.8

Quarterly Economic Indicators	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	2.4	1.9	0.9	2.0	2.2	2.9	3.4	3.3	3.3
CPI, % yoy	3.5	4.4	4.6	4.4	3.6	3.1	3.0	3.0	3.0
Policy interest rate, %, eop	4.00	4.00	3.25	3.00	3.00	3.00	3.00	3.00	3.25
Short-term market rate, % eop	4.00	4.00	3.25	3.00	3.00	3.00	3.00	3.00	3.25
Long-term yield, %, eop	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
CLP/USD, eop	549	552	598	592	595	599	599	597	595

Source: National Sources, Citi Research

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- **Summary view** — Data for the first half of the year depicts an economy that is being driven by domestic sectors such as construction, the financial sector, and retail. That being said, the country is also suffering from weak external demand, with the expectations for external factors such as oil prices only raising questions about how long local activity can continue to outperform. These questions are behind our call for Banrep to remain on hold throughout 2015.
- **Things to watch** — Watch for the tax reform bill and the discussion that this proposal should have in Congress.
- **Strategy** — With the pause by Banrep already priced-in by the market, we believe the steepening or flattening of the local curve will depend on the reaction of the long-end to USDCOP and US Treasuries. On the FX, although the observed speed of the recent COP depreciation was not expected, fundamentals always pointed toward a depreciated currency by yearend.

Economic activity: Of oil and other demons

Over the past decade the Colombian economy has gone through significant positive developments in both its institutional and economic framework. Among the biggest changes, the country decided to concentrate efforts in the development of the oil and mining sector. This decision proved to be positive as Colombia embarked in the opening of its energy sector in 2003 at a moment when it was uncertain what was about to happen to the oil price. By 2007, the country produced 530 thousand barrels per day (tbpd); thanks to the increase in oil prices production reached the 900 tbpd in 2011, and over the past three years it has touched at times the 1 million bpd rate.

The increase in oil prices led to a windfall which was used by the country to propel investment to one of the highest levels among its LatAm peers. The country decided to finance increases in investment with the additional revenues taking its investment to GDP ratio from 14% back in 2007 to 28% currently.

Currently, oil represents 55% of exports, 15% of government revenues, 48% of FDI according to the balance of payments on a cash basis and the oil and mining sector represents 7% of GDP. Hence the question is, now that the oil price has move dramatically to lower levels, what impact could this have on the main macroeconomic variables for Colombia?

We have calculated that a sustained USD10 reduction in the price of WTI translates into a reduction of USD3.3 billion in exports, a USD2.1 billion decrease in fiscal revenues, and a 0.5% fall in economic activity. The effect on the current account is somewhat mitigated thanks to the reduction in imports (USD2 billion) and of factor income (USD700 million) leading to a deterioration of the current account of USD600 million.

At the same time, weaker oil prices translate into a weaker COP, which is one of the main forces helping to stabilize the economy. We believe there is an asymmetry in the FX policy in the country in the sense that policy makers do not suffer from fear of floating when talking about depreciation of the currency and are willing to let the COP weaken as much as necessary, something that did not necessarily happen in the past when the country suffered from COP appreciation and the central bank decided to intervene in the market by performing USD outright purchases.

With the already observed COP depreciation against the USD, the question on the pass-through to inflation becomes relevant. For Colombia, pass-through estimates range between 15-17% which is a number relatively low and which over the past few years has remained even lower thanks to the reduction of international prices of raw materials and intermediate goods. We believe this situation partially explains the positive behavior of inflation in Colombia and the fact it is one of the few countries in the region with anchored inflation as well as inflation expectations.

On the back of these results we have reduced our growth and inflation expectations for 2015 to 4.5% and 3%, respectively. Although most of the drivers supporting GDP growth are of a domestic nature and we do not expect this to change going forward, we do expect a reduction in investment as a consequence of the fall in oil prices. The latter should reduce inflationary pressures which should help to keep prices at bay.

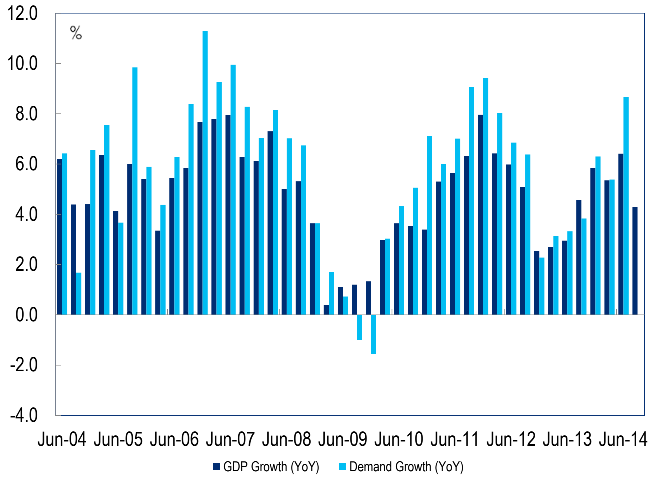
Under this new scenario for activity and inflation, Banrep will not have the need to increase its repo rate further. Hence we have changed our call for the repo rate to reach 5% in 2015, and now we do not expect changes to the 4.5% policy rate next year. With activity growing at what we believe is its potential and inflation expectations under control, Banrep will now be able to remain on hold for 2015. Going forward, it is worth mentioning that monetary policy will continue being determined by the interaction of both activity and inflation and that the biggest threats to our call comes from weaker-than-expected economic activity from one side and inflation surprises that end up affecting inflation expectations on the other.

On the fiscal front, although there is an effect associated with the reduction of oil prices, the government already incorporated a USD2.7 billion reduction in oil revenues next year. Hence, although the reduction in oil revenues due to the decrease in oil prices is relatively new, part of the reasons why the government is currently pursuing tax reform in Congress has to do with the expectation of a reduction in oil revenues next year. This is why we believe that, for the government 2015 should not be as complicated as what happens in the following years given the fact that going forward it will have to face the reality of a permanent reduction of its revenues which will pose the question of adjusting to it by reducing spending or looking for alternative sources of income by increasing taxes.

The TES market: between the USDCOP and Treasuries. Over the past few weeks we have observed that the local curve has followed movements in the USDCOP more than movements in US Treasuries, a situation which has translated at times into a steepening of the curve when the COP depreciates and a flattening when it appreciates. Having said that, we continue to believe the relationship with US treasuries is important as well, and the local curve has not fully reacted to the appreciation we observed on Treasuries over the past month. In our view, with the end of Banrep increases already priced-in by the market, the steepening or flattening of the curve will depend on the reaction of the long-end, which seems to be moving between the behavior of the USDCOP and US Treasuries.

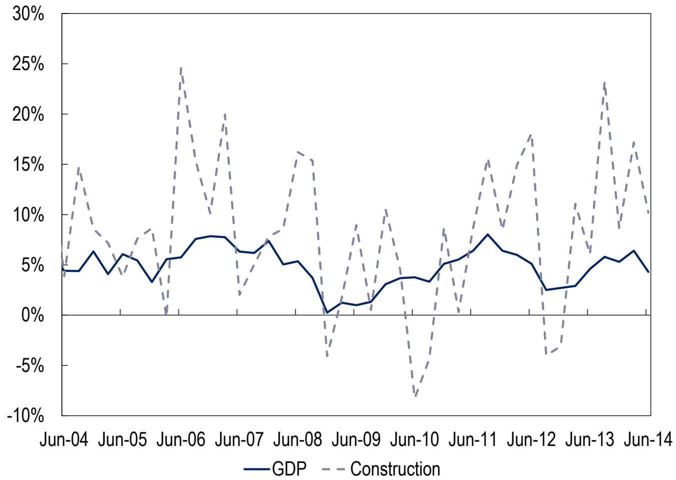
USDCOP: Too fast, too soon? On the FX front we continued seeing some depreciation of the COP against the USD. In particular we were always of the view that most of the flows associated to the GBI rebalancing were going to be over by the third quarter and that afterwards, fundamentals should begin to act causing the COP to depreciate. Our in-house calculations continue to point towards an equilibrium exchange rate with corresponding nominal exchange rate between 1950 and 2050, so we expect the USDCOP to end the year at 2,050. Nonetheless, we believe risks for this call are on the upside given the recent dynamics in oil prices.

Figure 258. Down to earth 2Q14 GDP growth



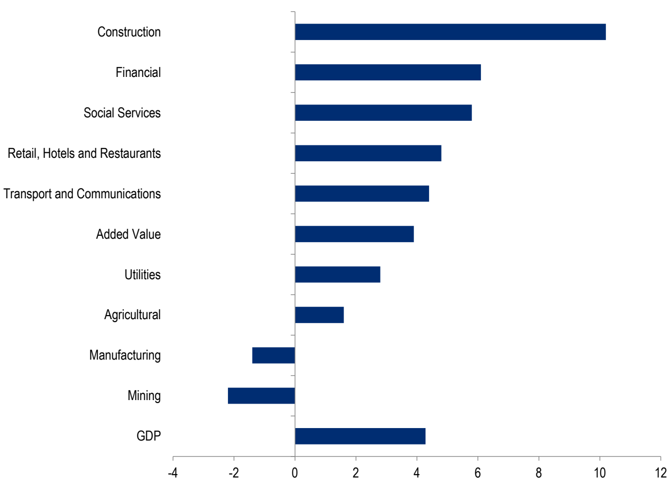
Source: Dane and Citi Research

Figure 259. The construction sector is the main source of uncertainty



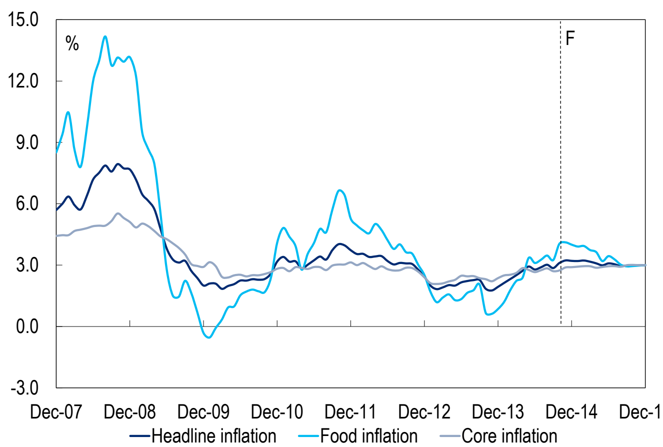
Source: Dane and Citi Research

Figure 260. Oil & Mining and Manufacturing posted negative growth



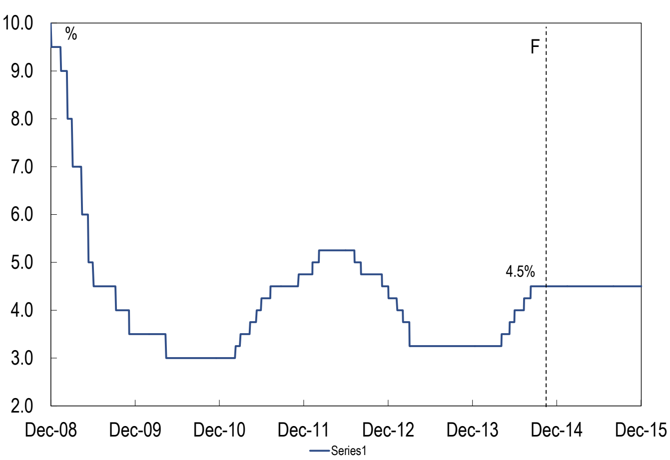
Source: Dane and Citi Research

Figure 261. Foodstuffs to remain as the main cause of inflation



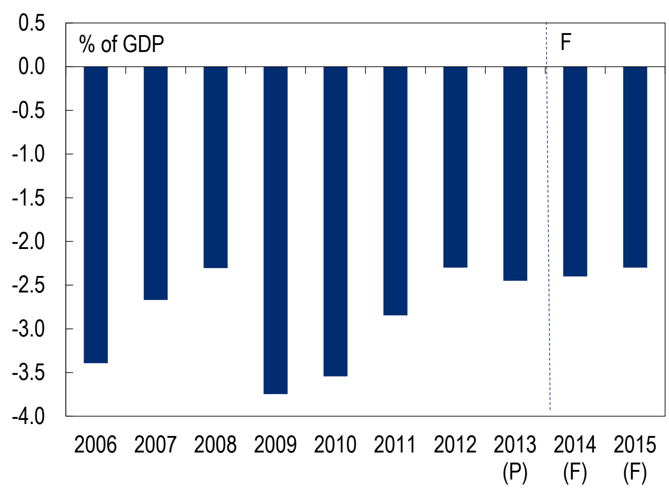
Source: Dane and Citi Research

Figure 262. We expect for Banrep to pause for the rest of the year



Source: Banrep and Citi Research

Figure 263. Central government deficit requires a tax reform



Source: Ministry of Finance and Citi Research

Figure 264. Colombia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	208	242	231	285	334	370	376	384	397
Nominal GDP, local currency bn	431	480	505	544	616	673	732	762	824
GDP per capita, USD	4,726	5,447	5,136	6,262	7,269	7,954	7,985	8,071	8,249
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	9.0
Economic Activity									
Real GDP, yoy avg (Citi estimates)	6.9	3.5	1.7	4.0	6.6	4.0	4.7	4.8	4.5
Real investment growth % yoy	12.8	9.0	-3.9	7.7	18.5	4.6	5.1	12.1	5.6
Real consumption growth % yoy	7.0	3.5	1.6	5.1	5.5	4.7	4.5	5.6	5.0
private consumption growth % yoy	7.3	3.5	0.6	5.0	6.0	4.4	4.2	5.2	4.9
Real export growth, % yoy	6.9	4.5	-2.8	1.3	11.8	6.1	5.4	-3.5	1.0
Real import growth, % yoy	14.0	10.5	-9.1	10.8	21.5	8.9	4.5	8.1	4.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	5.7	7.7	2.0	3.2	3.7	2.4	1.9	3.2	3.0
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	5.4	19.1	3.0	4.1	4.2	4.3	4.4	4.5	4.6
Credit extension to private sector, % yoy	19.9	14.3	6.8	9.8	18.3	10.0	13.7	14.0	15.9
Policy Rate (eop)	9.50	9.50	3.50	3.00	4.75	4.25	3.25	4.50	4.50
1 month inter-bank rate, %, eop	9.35	8.87	3.10	3.00	4.81	4.27	3.30	4.52	4.52
Long-term yield, %, eop	10.27	12.76	8.47	7.70	7.60	5.86	6.75	7.32	7.32
COP/USD, eop	2,018	2,249	2,043	1,920	1,939	1,767	1,930	2,050	2,059
COP/USD, avg	2,076	1,968	2,154	1,898	1,848	1,798	1,869	1,981	2,053
Balance of Payments, USD bn									
Current account	-6.0	-6.9	-5.1	-8.9	-9.9	-11.8	-12.7	-14.4	-15.0
% of GDP	-2.9	-2.8	-2.2	-3.1	-2.9	-3.2	-3.4	-3.7	-3.8
Trade balance	-0.6	1.0	2.5	2.3	6.1	4.7	2.8	1.2	4.1
Exports	30.6	38.5	34.0	40.8	58.3	61.4	60.0	61.2	64.7
Imports	31.2	37.6	31.5	38.5	52.2	56.7	57.2	60.0	60.6
Service balance	-2.6	-3.1	-2.9	-3.7	-4.7	-5.5	-5.5	-8.7	-11.2
Income balance	-8.0	-10.2	-9.3	-12.0	-16.0	-15.7	-14.7	-11.9	-13.1
FDI, net	9.0	10.6	7.1	6.7	13.4	15.5	16.8	17.2	17.6
International reserves	20.9	24.0	25.4	28.5	32.3	37.5	43.6	47.2	50.8
Total amortisations	5.7	5.1	5.8	6.5	6.3	12.1	6.3	7.2	8.1
Public Finances, % of GDP									
Consolidated government balance	-0.6	-0.1	-2.7	-3.3	-2.9	0.3	-0.9	-1.6	-1.5
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	32.9	34.0	36.7	37.2	34.6	33.7	34.8	34.9	34.0
of which Domestic	21.9	22.6	24.9	26.3	24.3	23.6	25.5	25.4	24.4
Foreign Assets & Liabilities, USD bn									
External debt	44.6	46.4	53.7	64.1	75.9	78.8	91.9	98.7	102.7
Public	28.8	29.4	37.1	38.9	42.8	46.1	52.1	58.6	62.6
External debt / GDP	21.5	19.1	23.2	22.5	22.7	21.3	24.4	25.7	25.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	5.1	5.7	3.9	8.1	10.8	9.8	10.0	10.2	10.4
Short-term debt/International reserves (%)	24.6	23.5	15.6	28.3	33.4	26.2	22.8	21.5	20.4

Quarterly Economic Indicators	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	6.5	4.3	3.9	4.5	3.5	4.6	4.9	5.1	4.6
CPI, % yoy	2.5	2.9	2.9	3.2	3.2	2.9	3.0	3.0	3.0
Policy interest rate, %, eop	3.25	4.00	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Short-term market rate, % eop	3.27	3.53	4.52	4.52	4.52	4.52	4.52	4.52	4.52
Long-term yield, %, eop	6.93	6.60	7.32	7.32	7.32	7.32	7.32	7.32	7.32
COP/USD, eop	1,972	1,880	2,025	2,050	2,050	2,050	2,054	2,059	2,064

Source: National Sources, Citi Research

Mexico

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- **Summary view —** We revised our GDP growth forecast for this year to 2.4% from 2.6% before, on the back of a disappointing activity figure for August. A broader set of indicators suggest this is a soft patch though and we still see activity gaining momentum ahead.
- **Things to watch —** The abduction of 43 students in the state of Guerrero has unexpectedly shifted the national agenda away from reforms and towards addressing issues of law and order. The way that the political class responds to this crisis is, in our view, as important for the modernization of the country as the economic reforms.
- **Strategy—** We now see the USD/MXN closing at 13.50 as dollar strength is likely to be the underlying global theme: on crosses though we still expect the Mexican currency to perform better.

Activity goes through a soft patch in August

Manufacturing exports consolidate as the main driver of the recovery in activity. Manufacturing exports during January-August were up 5.7% over the same period of 2013. A core factor behind the expansion of manufacturing exports is the auto industry: output in September (in unit terms) was up 10.7% YoY and so far this year 2.4 million units have rolled out from the factories. As a result, Mexico´s share of total US manufacturing imports rose to 12.8% in January-August, a record high which suggests Mexico's competitiveness should allow it to keep benefiting from stronger demand conditions in the US.

In the internal market, signs of a pickup in demand are somewhat undermined by a weak reading for IGAE in August. Private consumption growth stood at 2.4% YoY in July, while retail sales grew 4.4% YoY in August, albeit in the second case a methodological change was also involved. Construction posted a more encouraging growth rate in August (4.5%YoY), against a backdrop of a bit softer-than-expected manufacturing activity. In this respect, the result for IGAE, the monthly proxy for GDP, in August constituted a negative surprise as the 1.3% annual growth rate was well below our 2.1% estimate on the back of weaker-than-expected services – the contrast with the improving performance of retail sales was confusing. We believe this is not a change of trend, as several early indicators for September suggest renewed momentum: formal employment during that month rose 4% YoY, when we calculate that 76.5 thousand new jobs were created, the highest print in 28 months. All in all, we think the IGAE reading is indicative of a soft patch, rather than of a change of trend.

All in all, we are doing a slight adjustment to our GDP growth forecast. The effect of the lower than expected IGAE in terms of our quarterly growth rate estimate is relevant and we have decided to make a downward adjustment, to 2.5% YoY growth in 3Q14 from 3.0% YoY previously, and to 2.4% for the whole of 2014 from 2.6% before. For 2015, we keep our GDP growth estimate at 3.9%.

Steady macro policy mix, emphasis on fiscal trends

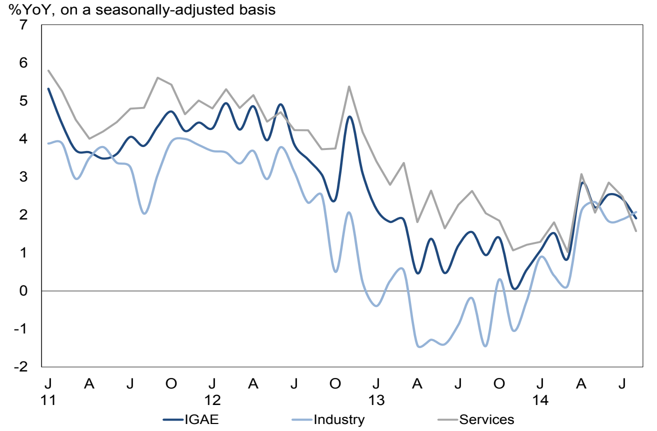
The MXN is likely to continue acting as a cushion to global volatility, particularly as FX pass-through is limited. We still see the level of the USD/MXN as a compromise between good fundamentals and global conditions, where directionality depends on risk-off/on episodes. The latter is currently having the upper hand and translates into a strengthening of the greenback across the board that has led us to modify our end-year forecast for the USD/MXN to 13.50 from 13.30 before. Thus, the free-floating exchange rate is likely to continue acting as the main cushion to global volatility, given the limited effects of a weaker peso over local inflation. On this front, annual headline inflation in the first half of October, at 4.32%, should probably mark the peak before declining to levels of 3.93% by year end. Banxico will probably keep its anti-inflation rhetoric, but we still believe that conditions should allow it to wait until the second half of next year for a first rate hike. Naturally, the factor to watch will be the process of policy normalization in the US.

On the fiscal front, the approval of the 2015 budget is underway. The Ministry of Finance proposed to Congress a reduction of the fiscal deficit in its narrow definition, to 1% of GDP In 2015 from 1.5% this year. This is consistent with the original schedule of fiscal consolidation passed as part of the fiscal reform last year. However, under a PSBR definition, the effort is more modest, as this gauge would pass to 4% of GDP in 2015 from 4.2% this year. The difference is explained by an effort to keep high Capex levels at PEMEX and CFE, a reasonable goal particularly while the implementation of energy reform takes place.

The main modifications by Congress to the 2015 budget are prompted by the oil outlook. The Lower Chamber has already passed the expenditure side of the budget, with a reduction in the assumed average price of the Mexican oil mix during 2015 to USD 81 per barrel vs. an original proposal of USD 82. We think that the fiscal risks associated with lower prices are limited, as: (a) although volatility had some impact on the hedging program that the government implements every year, we think put contracts should still limit downside risks significantly: (b) resources in the oil stabilization front should help to cover eventual shortfalls. It should also be taken into account that a growing amount of imports of oil byproducts (e.g. gasoline) implies a lower *net* effect of a one-dollar drop in the price of a barrel of oil – we currently estimate this net effect at USD300 million. Last but not least, since government expenditure is peso denominated, a weaker exchange rate helps to offset the effect of lower oil revenues. Congress actually took advantage of this “natural hedge”, as it altered the assumption of the average FX in 2015 to MXN 13.40 per dollar from 13.0 originally, thereby ending up with total fiscal revenues in 2015 at MXN 4.03 trillion instead of the MXN 4.00 trillion in the original proposal. This is another reason for closely monitoring of fiscal trends in coming years.

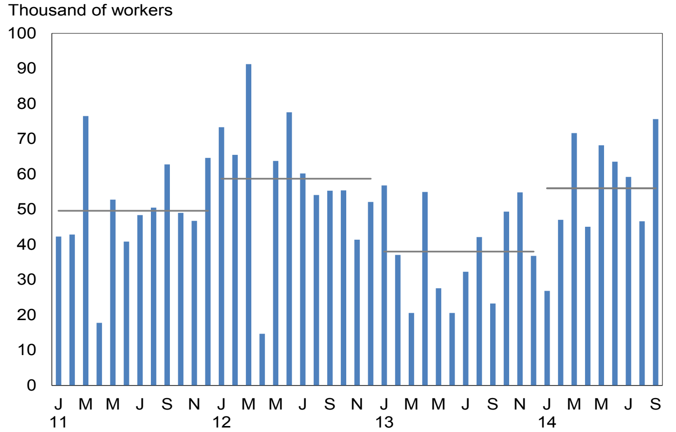
Reform implementation is moving as expected, but the political agenda shifts –rightly – to rule of law issues. The timeline of the reform agenda – energy in particular – is moving as expected but the abduction and disappearance of 43 students in the state of Guerrero, on orders by the now fugitive major of the capital, has unexpectedly shifted the national agenda away from reforms and towards addressing issues of law and order. The response of the Peña Nieto administration – and the political class at large – to this crisis is the main item in the national agenda, and rightly so: development is a holistic concept and the ambitious reform program Mexico is implementing has to be complemented, and reinforced, by efforts at combating impunity, insecurity and corruption.

Figure 265. Slowdown in services brought total activity down in August



Sources: INEGI and Banamex

Figure 266. … but, formal job creation remains strong.



Sources: INEGI and Banamex

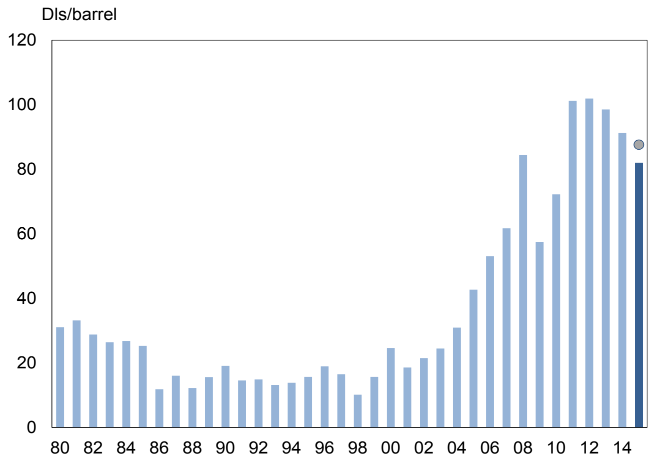
Figure 267. Fiscal spending will continue to support growth…

	% of GDP		
	2014*	Programmed 2015	Approved by Lower House 2015
Total Revenues	**22.3**	**21.6**	**21.7**
Oil related	**7.3**	**6.3**	**0.1**
PEMEX	2.5	2.4	2.4
Non-oil	**15.1**	**15.2**	**15.2**
Federal Government	11.3	11.5	11.6
Tax Revenues	10.3	10.6	10.6
ISR, IETU & IDE	5.6	5.7	5.7
VAT	3.8	3.8	3.8
Production and Services	0.6	0.8	0.8
Gasoline and diesel		0.1	0.1
Other		0.7	0.7
Imports	0.2	0.2	0.2
Other Taxes	0.1	0.1	0.1
Non tax revenues	1.0	0.9	1.0
Organismos y empresas	3.8	3.7	3.7
Total Expenditure	**26.0**	**25.1**	**25.2**
Programmed	20.3	19.4	19.4
Non programmed	5.7	5.6	5.6
Balance	**-3.6**	**-3.5**	**-3.5**

* Forecast

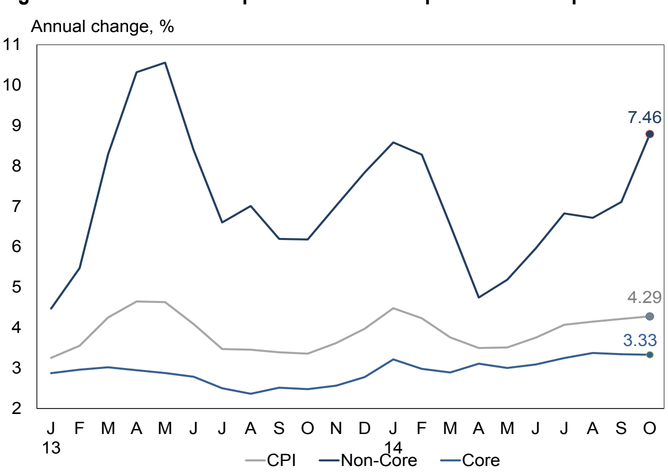
Sources: IMSS and Banamex

Figure 268. A lower Mexican Oil Mix price will affect fiscal revenues.



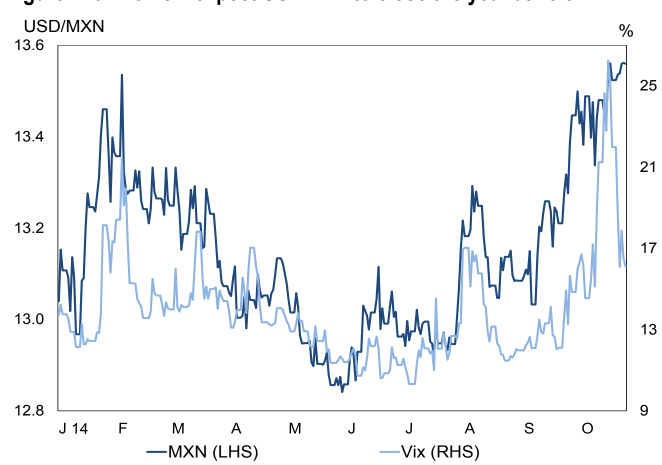
Sources: Ministry of Finance and Banamex

Figure 269. Non-core component continue to push inflation upwards



Source: INEGI and Banamex

Figure 270. We now expect USDMXN to close the year at 13.5



Sources: Bloomberg and Banamex.

Figure 271. 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	1,171	1,186	1,261	1,268	1,402
Nominal GDP, local currency bn	11,403	12,257	12,094	13,282	14,550	15,615	16,104	17,122	18,500
GDP per capita, USD	9,507	9,967	7,952	9,209	10,124	10,135	10,653	10,595	11,582
Population, mn	109.8	111.3	112.9	114.3	115.7	117.1	118.4	119.7	121.0
Unemployment, % of labour force	3.7	4.0	5.5	5.4	5.2	5.0	5.0	4.8	4.5
Economic Activity									
Real GDP, yoy avg (Citi estimates)	3.1	1.4	-4.7	5.1	4.0	4.0	1.1	2.4	3.9
Real investment growth % yoy	3.7	6.2	-13.3	4.5	5.4	5.5	-2.4	2.0	4.9
Real consumption growth % yoy	3.0	2.1	-5.2	5.1	4.5	4.6	2.3	2.1	3.3
private consumption growth % yoy	3.0	1.9	-6.5	5.7	4.8	4.9	2.5	2.1	3.6
Real export growth, % yoy	3.6	-1.3	-11.8	20.5	8.2	5.9	1.2	6.2	7.2
Real import growth, % yoy	5.9	4.4	-17.6	20.5	8.0	5.5	1.5	5.6	8.5
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.8	6.5	3.6	4.4	3.8	3.6	4.0	3.9	3.3
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	5.4	5.3	4.2	3.0	5.4	4.4	4.6	4.2	4.3
Credit extension to private sector, % yoy	12.0	9.6	0.6	5.6	7.4	6.8	6.7	8.5	9.8
Policy Rate (eop)	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.00	3.75
1 month inter-bank rate, %, eop	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.00	3.75
Long-term yield, %, eop	8.03	8.35	7.99	6.95	6.51	5.38	6.45	6.08	6.95
MXN/USD, eop	10.91	13.67	13.06	12.36	13.95	12.87	13.04	13.47	13.16
MXN/USD, avg	10.93	11.16	13.50	12.63	12.44	13.16	12.76	13.23	13.28
Balance of Payments, USD bn									
Current account	-14.7	-20.2	-8.3	-3.5	-12.3	-15.0	-26.5	-28.3	-28.3
% of GDP	-1.4	-1.8	-0.9	-0.3	-1.1	-1.3	-2.1	-2.2	-2.0
Trade balance	-10.1	-17.3	-4.7	-3.0	-1.4	0.0	-1.2	-3.7	-3.1
Exports	271.9	291.3	229.7	298.5	349.4	370.8	380.0	397.4	441.7
Imports	281.9	308.6	234.4	301.5	350.8	370.8	381.2	401.1	444.8
Service balance	-7.6	-8.2	-10.0	-9.9	-14.1	-14.0	-11.7	-12.6	-12.8
Income balance	-23.4	-20.2	-15.2	-12.1	-19.7	-23.6	-35.7	-35.0	-36.1
FDI, net	32.3	28.3	17.3	23.4	23.4	17.6	38.3	22.7	27.1
International reserves	78.0	85.4	90.8	113.6	142.5	163.5	176.5	198.0	211.6
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	-24.0	-2.6	-2.3	-3.6	-3.5
Consolidated gov primary balance	2.2	1.8	-0.1	-0.9	-0.6	-0.6	-0.4	-1.5	-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	196.2	204.7	194.4	260.0	298.0	367.7	413.3	433.5	449.0
Public	121.0	129.3	120.9	167.1	198.9	263.6	292.8	306.8	335.6
External debt / GDP	18.8	18.5	21.7	24.7	25.4	31.0	32.8	34.2	32.0
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	26.1	25.1	21.3	21.3	22.8	22.4	21.9	22.9	23.7
Short-term debt/International reserves (%)	33.4	29.4	23.5	18.8	16.0	13.7	12.4	11.5	11.2

Quarterly Economic Indicators	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	1.9	1.6	2.5	3.7	4.5	4.1	3.9	3.2	3.8
CPI, % yoy	3.8	3.8	4.2	3.9	3.4	3.8	3.6	3.3	3.4
Policy interest rate, %, eop	3.50	3.00	3.00	3.00	3.00	3.25	3.50	3.75	4.00
Short-term market rate, % eop	3.50	3.00	3.00	3.00	3.00	3.25	3.50	3.75	4.00
Long-term yield, %, eop	6.20	5.68	6.05	6.08	6.25	6.49	6.72	6.95	7.11
MXN/USD, eop	13.06	12.97	13.43	13.47	13.40	13.32	13.24	13.16	13.08

Source: National Sources, Citi Research

Peru

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- **Summary view** — Economic activity continued to perform poorly during August, with setbacks in the mining and manufacturing sectors. On the back of these latest numbers we have updated our GDP growth numbers for this year and next. We expect growth of 2.5% in 2014 and 3.8% in 2015. With the government announcing a series of measures to boost investment and the central bank reducing by 50bps its policy rate in the last quarter, the country is following the standard recipe to counteract an adverse economic environment. As we have mentioned before, the analysis of the balance of payments and the trade balance will continue to be the main variables to assess eventual vulnerabilities during 2014 and 2015.
- **Things to watch** — Inflation and the monthly economic activity will be important to assess the future evolution of monetary policy.
- **Strategy** — The relatively weak economic activity displayed during 2014 could prompt the BCRP to further reduce its policy rate going forward.

Economic activity

The economic activity index displayed a 1.2% YoY growth in August, a print slightly higher than our own in-house expectations (1%), taking economic annual growth during the first 8 months of the year to 2.8% and 12-month accumulated growth to 4.1%. According to the National Statistics Institute (INEI), core activities displayed a weak performance. According to the report, mining fell 3.5% YoY, construction contracted 5.1% YoY, retail advanced a weak 3.2% YoY and manufacturing fell 3.2% YoY. Although we continue to expect Peru to be one of the best performing economies in the region, the recent results along with the change in the base of GDP (which implies an upward revision of 2013 growth to 5.8%) lead us to reduce once again our GDP growth forecast for the year as a whole to 2.5%, from 3.5%.

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

Nonetheless, economic activity growth should be around 3.8% in 2015. Given our view that external factors will likely fail to boost growth in Peru, we believe it is important to look at the health of domestic drivers. Household consumption has been increasing recently although mildly and we expect these dynamics to continue throughout 2014 as credit conditions remain favorable, even despite the recent increases in non-performing loans. This is why we expect for GDP growth to be 3.8% next year.

Inflation and monetary policy

Inflation continued below the target-range in September. During most of 2014 inflation has systematically stood above the 1-3% target-range although the September inflation print was the second consecutive print below 3%. Inflation has been mostly driven by supply shocks associated with foodstuffs and, thus, we expect inflation to gradually converge to the inflation target. Nonetheless, for the time being we keep our inflation forecast for 2014 at 3.1%, given the recent dynamics of consumer prices. This forecast still incorporates an important deceleration of core inflation during 4Q14, which should be of crucial importance in the evolution of monetary policy.

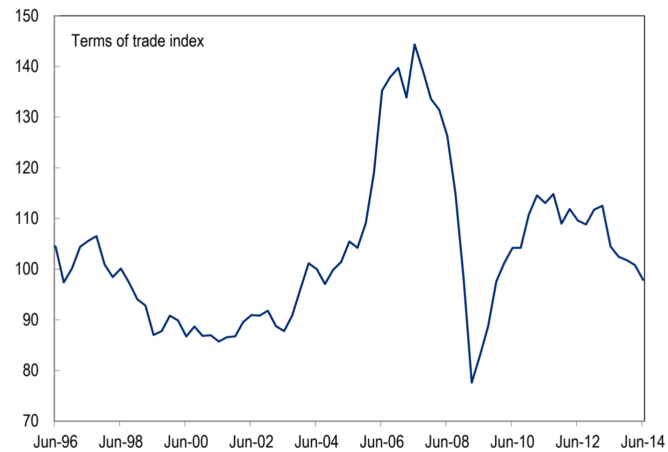
Monetary policy. In its last monthly meeting, the Central Bank of Peru (BCRP) decided to remain on hold at 3.5%, as expected by the consensus and us. According to the communiqué, the Board considered that: (i) inflation expectations continued to be anchored; (ii) the recent below-potential GDP growth is expected to be temporary; (iii) the external outlook continues displaying mixed signals; and (iv) supply-side inflation pressures seem to be receding. The Board mentioned that even after the September print, inflation is expected to continue above the upper bound of the inflation target range, given the effect of supply-side pressures mostly associated with foodstuffs. However, inflation is still expected to be within the target range by yearend and to converge to 2% in 2015. The BCRP highlighted that economic activity has shown weak results, mostly driven by lower dynamics in investment and exports. As in previous statements, the Board mentioned that it will be vigilant over the inflation outlook and its drivers to take further easing measures if necessary.

Waiting for the effects of fiscal and monetary policy. In our view, the reaction of both monetary and fiscal policy amid an environment of weakness in economic activity was the correct one with the government announcing increases in government spending as well as reforms to improve investment and the central bank reducing its policy rate. Although the effects of fiscal policy should be felt first, due to the lag of monetary policy, we are optimistic about the reaction of the Peruvian economy to these measures and hence we expect GDP growth to recover in 2015 to 3.8%. Having said that, we do not rule out additional reductions of the policy rate going forward if the economy continues underperforming and if inflation falls within the 1-3% inflation target range.

External sector

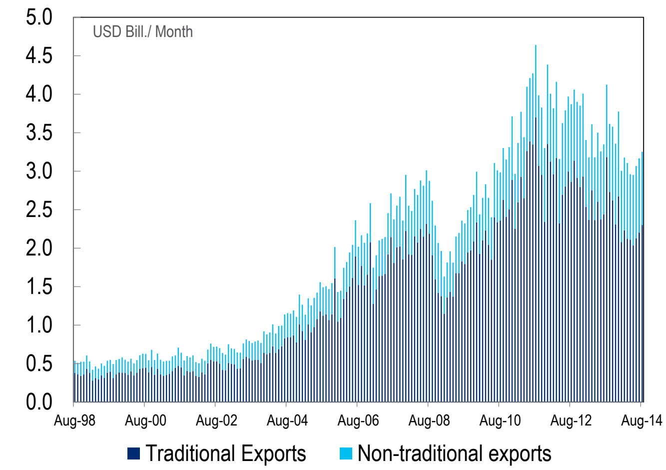
Balance of payments. During 2013, the current account deficit stood at 4.8% of GDP, increasing 1.6 percentage points versus the previous year. This increase in the current account deficit was mostly driven by the deterioration of the trade balance, a situation we anticipate to continue this year. This month we have marginally revised our forecasts and we now expect the current account to further deteriorate and post a 5.6% GDP deficit this year, on the back of stagnant exports and lower commodity prices. For the time being, the current account deficit continues to be financed by foreign direct investment inflows, something that has led to significant increases in international reserves. Nonetheless, we expect a slower reserves accumulation moving forward.

Figure 272. Terms of trade dynamics…



Source: Bloomberg and Citi Research

Figure 273. Could translate into weaker traditional exports…



Source: BCRP and Citi Research

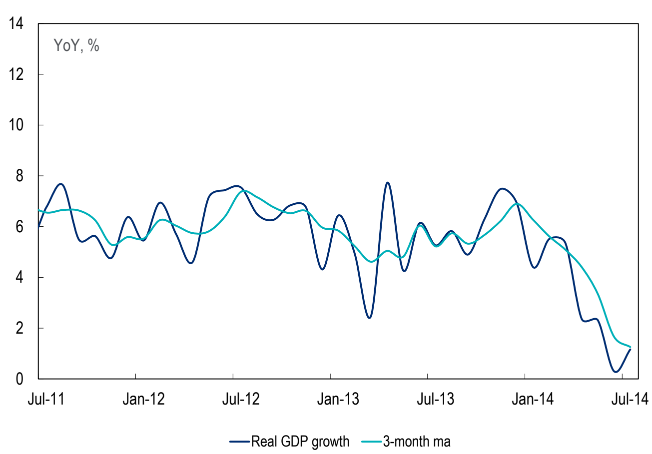
Figure 274. And a weaker exchange rate

Source: Bloomberg and Citi Research

Figure 275. Inflation dynamics

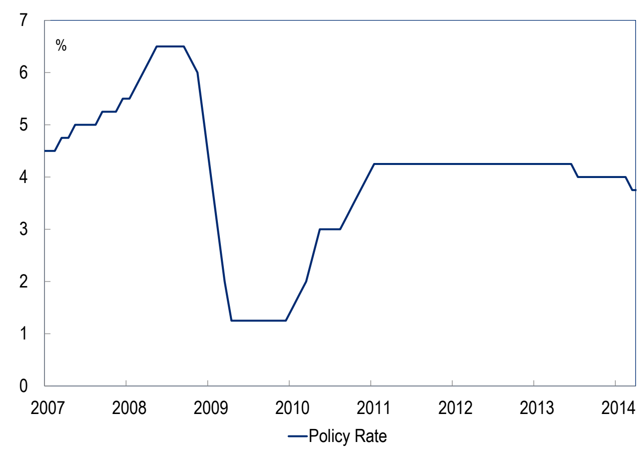
Source: BCRP, Haver and Citi Research

Figure 276. GDP Dynamics



Source: INEI, Haver and Citi Research

Figure 277. The latest BCRP's communiqué came with a dovish tone



Source: BCRP, Haver and Citi Research

Figure 278. Peru Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	107	127	127	153	176	199	208	205	220
Nominal GDP, local currency bn	336	371	382	435	486	526	563	578	615
GDP per capita, USD	3,906	4,562	4,482	5,344	6,033	6,712	6,909	6,701	7,083
Population, mn	27.4	27.8	28.3	28.7	29.2	29.7	30.1	30.6	31.0
Unemployment, % of labour force	8.4	8.4	8.4	7.9	7.7	6.8	5.9	6.1	6.0
Economic Activity									
Real GDP, yoy avg (Citi estimates)	8.5	9.1	1.0	8.5	6.5	6.0	5.8	2.5	3.8
Real investment growth % yoy	31.3	29.4	-22.9	38.8	12.9	12.3	10.5	-2.3	0.9
Real consumption growth % yoy	8.0	8.6	4.1	8.2	5.8	6.4	5.5	4.7	4.4
private consumption growth % yoy	8.6	8.9	2.8	8.7	6.0	6.1	5.3	4.4	4.3
Real export growth, % yoy	4.3	7.1	-0.7	1.3	6.9	3.7	-0.9	-1.9	1.5
Real import growth, % yoy	20.2	24.1	-16.7	26.1	11.6	11.3	3.6	-1.1	0.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.9	6.7	0.2	2.1	4.7	2.6	2.9	3.1	2.5
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	5.0	12.8	23.1	-8.8	15.1	5.4	5.0	5.0	0.0
Credit extension to private sector, % yoy	29.9	14.3	10.4	20.1	14.2	13.8	12.4	11.0	12.0
Policy Rate (eop)	5.00	6.50	1.25	3.00	4.25	4.25	4.00	3.50	3.50
1 month inter-bank rate, %, eop	5.51	6.68	1.28	3.20	4.17	4.22	4.58	4.00	4.00
Long-term yield, %, eop	6.44	7.69	6.31	6.34	6.16	4.24	6.16	5.30	5.00
PEN/USD, eop	3.00	3.13	2.89	2.81	2.70	2.55	2.80	2.90	2.80
PEN/USD, avg	3.13	2.92	3.01	2.82	2.75	2.64	2.70	2.82	2.80
Balance of Payments, USD bn									
Current account	1.5	-5.3	-0.6	-3.5	-3.2	-6.3	-9.1	-11.5	-10.9
% of GDP	1.4	-4.2	-0.5	-2.3	-1.8	-3.2	-4.4	-5.6	-5.0
Trade balance	8.5	2.6	6.1	7.0	9.2	5.2	0.0	-2.5	-1.8
Exports	28.1	31.0	27.1	35.8	46.4	46.4	42.2	37.0	38.8
Imports	19.6	28.4	21.0	28.8	37.2	41.1	42.2	39.5	40.6
Service balance	-1.2	-2.1	-1.2	-2.4	-2.2	-2.4	-1.8	-1.8	-1.8
Income balance	-8.3	-8.7	-8.4	-11.2	-13.4	-12.4	-10.6	-10.7	-10.8
FDI, net	5.5	6.9	6.4	8.5	7.7	11.9	9.3	9.9	9.4
International reserves	27.7	31.2	33.1	44.1	48.8	64.0	65.7	65.9	67.7
Total amortisations	6.8	3.3	2.2	4.1	1.4	4.0	4.2	4.0	4.1
Public Finances, % of GDP									
Consolidated government balance	2.6	2.3	-1.6	-0.3	1.8	1.9	12.5	9.0	9.0
Consolidated gov primary balance	4.4	3.8	-0.3	0.8	2.9	3.0	13.5	10.1	10.0
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	44.0	51.9	54.3	52.2	52.5
Public	20.1	19.2	20.6	19.9	20.2	19.0	17.5	17.3	17.5
External debt / GDP	29.8	26.8	28.0	26.4	25.0	26.1	26.1	25.4	23.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	20.6	19.5	20.1	22.9	24.2	26.5	24.0	23.8	24.7
Short-term debt/International reserves (%)	74.2	62.5	60.7	52.0	49.6	41.3	36.6	36.2	36.5

Quarterly Economic Indicators	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	5.1	1.7	1.7	1.9	3.3	3.9	4.0	4.0	4.6
CPI, % yoy	3.4	3.4	2.9	3.1	2.3	2.2	2.3	2.6	2.3
Policy interest rate, %, eop	4.00	4.00	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Short-term market rate, % eop	5.08	4.99	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Long-term yield, %, eop	6.30	5.70	5.30	5.30	5.70	5.70	5.70	5.70	5.70
PEN/USD, eop	2.81	2.80	2.89	2.90	2.90	2.90	2.90	2.90	2.90

Source: National Sources, Citi Research

Venezuela

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- **Summary view** — To an already negative outlook in terms of economic activity, high inflation, and overall low availability of US dollars, it is necessary to add the uncertainty that lower oil prices create for revenues going forward. In particular we have estimated that for every USD10 drop in the Venezuelan oil price, the country faces a reduction of USD7.5 billion in revenues. In an environment where US dollar low availability was already in place, the potential effects of a further reduction in the supply of the greenback should add more pressure on the government. In particular, the government should be forced to announce measures it has postponed until now which include a depreciation of the CENCOEX exchange rate which currently stands at 6.3 to a level closer to the SICAD 1 rate of 12. At the same time, the government could look at selling some of the gold it currently holds as part of international reserves, it could renegotiate the Petrocaribe arrangement which costs USD8 billion per year, or it could increase gasoline prices in order to eliminate a subsidy which costs USD12 billion per year. It is clear the government still has options, but at the same time the current negative shock in oil prices is showing an economy that is vulnerable and not well prepared to withstand a structural correction in commodities.

- **Things to watch** — Watch for ratings agencies Fitch and Moody's which could follow Standard & Poors' decision to downgrade the country's rating and put it on negative watch.

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

Economic outlook:

Throughout the year, uncertainty regarding macroeconomic management continues to take its toll on economic performance. The overall sentiment is that of an economy that is weakening on the back of a reduction in supply due to several bottle necks affecting the production process for local companies. At the same time there are no new investments, either public or private. Hence, we forecast consumption and investment to fall 4% and 6.2%, respectively, this year. This is the reason why we now expect economic activity to fall 4% this year and 2.2% next.

We now expect annual inflation to reach 64% by yearend and 75% next year, as we do not foresee a reduction in scarcity and we now see evidence of a wage spiral. Using data from the Ministry of Finance we can now say that most of the growth in fiscal spending has to do with increases in expenditures associated with government payrolls. This fact can be interpreted as evidence of increasing wage indexation, a factor that leads to higher inflation persistency.

To an already negative outlook in terms of economic activity, high inflation, and overall low availability of US dollars, it is necessary to add the uncertainty that lower oil prices create for revenues going forward. In particular we have estimated that for every USD10 drop in the Venezuelan oil price, the country faces a reduction of USD7.5 billion in revenues. In an environment where US dollar low availability was already in place, the potential effects of a further reduction in the supply of the greenback should add more pressure on the government.

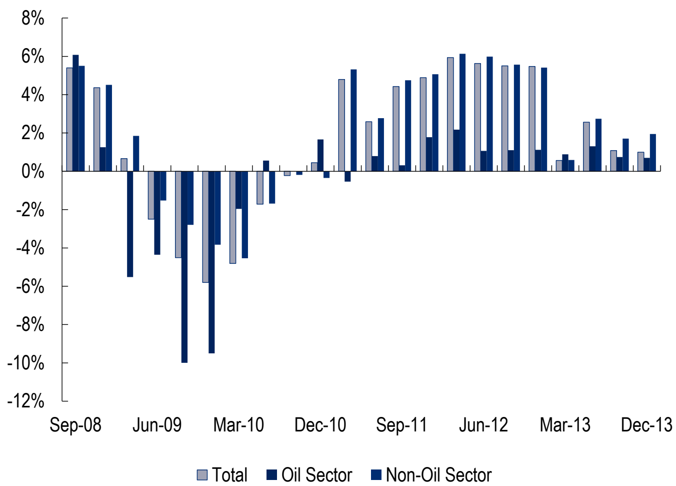
The government should be forced to announce measures it has postponed until now, which include a depreciation of the CENCOEX exchange rate which currently stands at 6.3 to a level closer to the SICAD I rate of 12. We believe under the current situation the adjustment is inevitable and the 6.3 exchange rate will be eliminated with only the SICAD I and SICAD II rates being left unchanged. With this fix, which could be announced before yearend or in early 2015, the government will be able to buy some time especially when in 2015, when elections for the National Assembly are expected to take place. We think that the initial rates that will be in place should be a 12 exchange rate for SICAD I and a 50 exchange rate for the SICAD II, although we do not completely discard the likelihood of an increase of the SICAD I exchange rate to a level of 15 to 17. Having said that, we do not expect for CENCOEX to be eliminated but rather for its exchange rate to be adjusted, meaning that the procedures necessary to access the preferential exchange rate will remain.

At the same time, the government can also announce additional measures aimed at improving its cash flow. In particular, it could look at selling some of the gold it currently holds as part of international reserves, it could renegotiate the Petrocaribe arrangement which costs USD8 billion per year, or it could increase gasoline prices in order to eliminate a subsidy which costs USD12 billion per year. All of these measures have been in the pipeline of possible adjustments the government could implement, and we believe the government will now be forced to decide which of these measures it should take.

Although it is clear the government still has options the current negative shock in oil prices is showing an economy that is vulnerable and not well prepared to withstand a structural correction in commodities. With international reserves slightly below USD21 billion and its cash position significantly reduced due to the bond payment the sovereign had to do early in October, the question that remains is how the cash flow of the country could be affected now that the price of the Venezuelan basket of oil has fallen to USD75. This becomes more relevant given the fact PDVSA has made payments of USD3.3 billion this month, and next year there will be pressures around March and October.

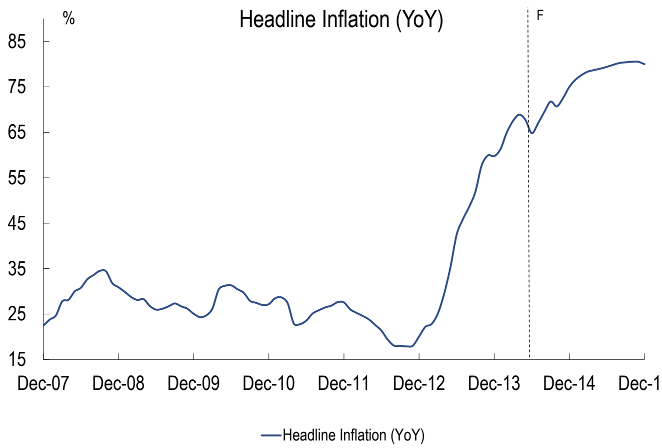
For the time being, import restrictions continue as the main tool used to manage the overall reduction in USD availability. According to the National Statistics Institute, between January and June, imports by the private sector represented USD10.2 billion, which represents a reduction of 32% when compared to the same period a year ago when imports were USD15 billion. A simple extrapolation shows that if this trend continues, by yearend the reduction in imports could be close to USD10 billion, which explains most of the weakness in economic activity. Along with these results for the private sector, imports by the public sector have not been increased, as the data shows that in the first half of the year the government imported USD7.1 billion, which stands practically unchanged to the USD7.2 billion imported by the government in 1H13. Normally, the reduction in imports could be considered as an adjustment tool, but in our view, this only works if the country uses the “savings” stemming from this restriction to fix the balance of payments misalignments; in other words, to improve the level of international reserves or funds available at special funds, a situation which is not happening as both international reserves and balances at special funds have been falling throughout the year.

Figure 279. GDP growth performance in 4Q13



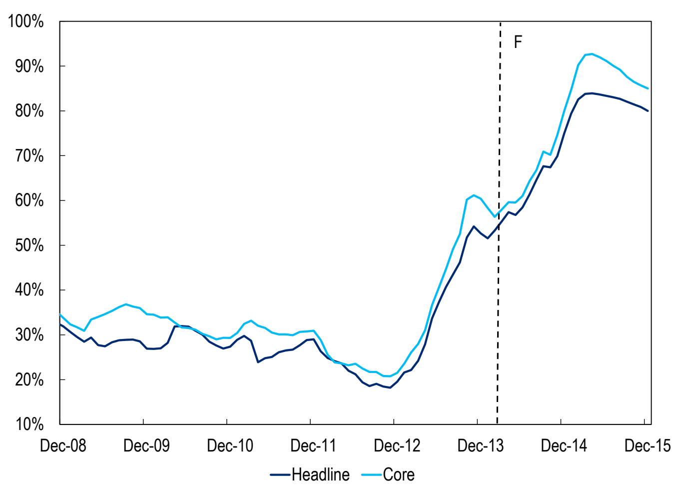
Source: BCV and Citi Research

Figure 280. Inflation should accelerate despite the weak GDP growth



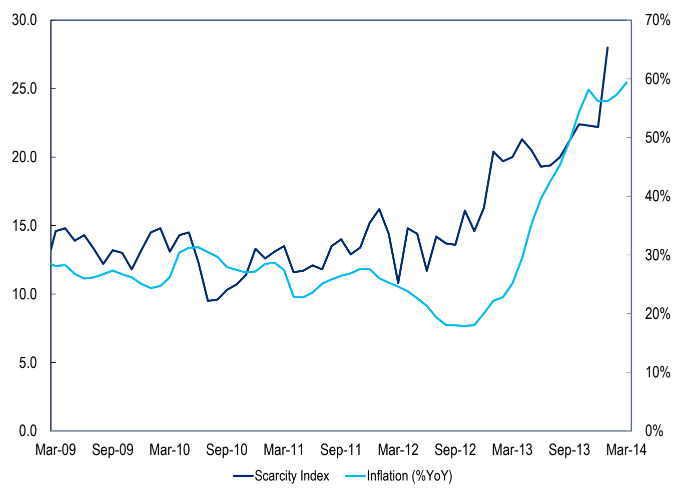
Source: BCV and Citi Research

Figure 281. Caracas inflation



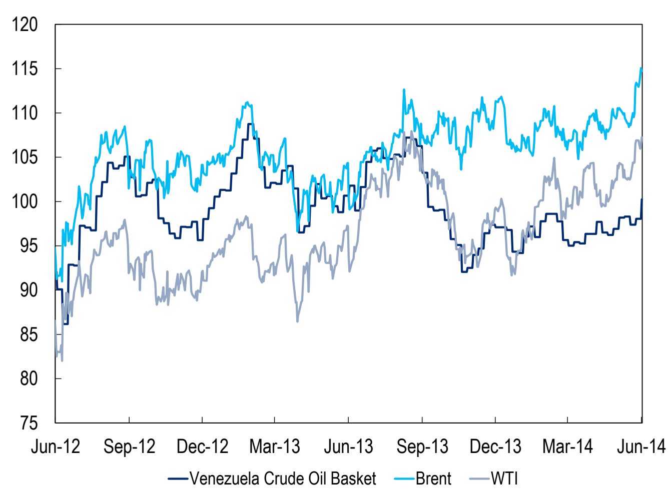
Source: BCV and Citi Research

Figure 282 Scarcity continues to be one of the drivers of inflation



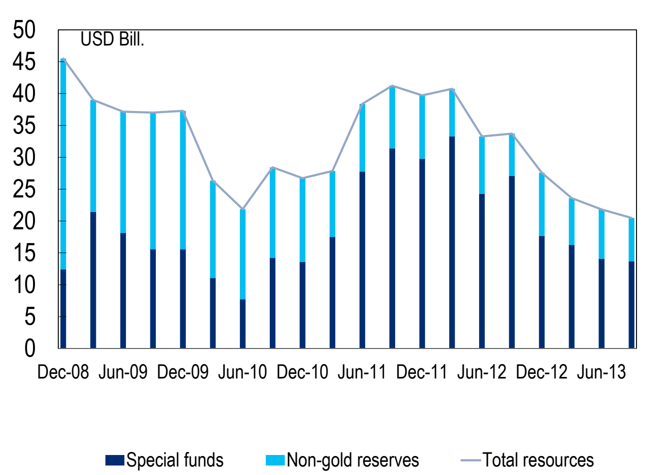
Source: BCV and Citi Research

Figure 283. Venezuelan oil basket prices and WTI prices



Source: BCV and Citi Research

Figure 284. Could total liquid resources continue its downtrend?



Source: BCV and Citi Research

Figure 285. Venezuela Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	213	298	284	257	298	361	372	334	293
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	12,343	10,926	9,449
Population, mn	27.5	27.9	28.4	28.8	29.3	29.7	30.2	30.6	31.0
Unemployment, % of labour force	6.2	6.1	6.6	6.5	6.5	5.9	5.6	4.8	4.0
Economic Activity									
Real GDP, yoy avg (Citi estimates)	8.8	5.3	-3.2	-1.5	4.2	5.6	1.3	-4.0	-2.2
Real investment growth % yoy	28.2	2.2	-19.1	1.0	15.2	24.1	-14.0	-6.2	0.6
Real consumption growth % yoy	16.3	6.0	-2.1	-1.1	4.4	6.9	4.4	-4.0	-3.0
private consumption growth % yoy	16.9	6.3	-2.9	-1.9	4.0	7.0	4.7	-5.0	-4.0
Real export growth, % yoy	-7.6	-1.0	-13.7	-12.9	4.7	1.6	-6.2	-1.0	-1.0
Real import growth, % yoy	33.0	1.4	-19.6	-2.9	15.4	24.4	-9.7	-5.0	-1.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	22.5	31.9	26.9	27.4	29.0	19.5	52.7	64.0	75.0
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	20.7	25.0	23.7	24.5	27.0	30.0	45.0	60.0	60.0
Credit extension to private sector, % yoy	43.3	30.6	18.0	27.6	36.8	55.3	65.8	69.0	69.0
Policy Rate (eop)	18.00	28.10	14.00	12.50	-	-	-	-	-
1 month inter-bank rate, %, eop	18.00	28.10	11.30	12.30	14.50	14.50	14.50	14.50	14.50
Long-term yield, %, eop	12.00	12.00	14.38	13.02	13.93	9.18	12.88	15.20	16.88
VEF/USD, eop	2.15	2.15	2.15	4.29	4.29	4.29	6.29	12.00	19.80
VEF/USD, avg	2.15	2.15	2.15	4.20	4.29	4.29	5.99	9.15	19.80
Balance of Payments, USD bn									
Current account	18.1	37.4	8.6	12.1	27.3	11.0	12.2	14.9	18.2
% of GDP	8.5	12.5	3.0	4.7	9.1	3.1	3.3	4.5	6.2
Trade balance	23.0	45.7	19.2	27.1	46.4	38.0	36.7	33.5	36.8
Exports	69.0	95.1	57.6	65.7	92.7	97.3	89.2	83.5	88.9
Imports	46.0	49.5	38.4	38.6	46.2	59.3	52.4	50.0	52.0
Service balance	-7.0	-8.4	-7.6	-9.2	-10.7	-16.0	-13.8	-7.7	-7.8
Income balance	2.5	0.7	-2.7	-5.3	-7.9	-10.0	-9.8	-9.8	-9.8
FDI, net	1.0	-0.9	-4.9	-1.5	5.1	0.8	2.4	0.8	0.8
International reserves	34.3	43.1	35.8	30.3	29.9	29.9	25.0	23.5	22.0
Total amortisations	4.0	7.5	4.3	6.9	11.0	4.1	6.8	4.5	0.1
Public Finances, % of GDP									
Consolidated government balance	-2.8	-3.5	-8.7	-10.4	-11.6	-15.0	-11.9	-12.3	-12.6
Consolidated gov primary balance	-1.2	-2.0	-7.2	-8.6	-9.4	-12.3	-9.3	-9.8	-10.1
Public debt	25.5	21.6	31.3	42.0	44.2	43.4	41.5	44.3	48.7
of which Domestic	7.3	4.5	7.5	8.9	11.4	14.1	12.3	10.5	8.9
Foreign Assets & Liabilities, USD bn									
External debt	56.3	66.4	81.9	97.1	110.7	118.9	123.3	127.5	131.7
Public	38.7	50.9	67.4	85.3	98.0	105.8	108.8	112.8	116.8
External debt / GDP	26.5	22.2	28.9	37.7	37.1	33.0	33.1	38.2	44.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	18.1	19.9	17.4	16.8	16.7	21.1	21.8	19.5	17.1
Short-term debt/International reserves (%)	52.8	46.1	48.4	55.3	55.8	70.6	87.0	83.1	77.9

Quarterly Economic Indicators	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	-4.1	-4.2	-4.1	-3.8	-2.3	-2.3	-2.3	-2.1	1.8
CPI, % yoy	59.3	60.5	63.6	64.0	68.8	68.6	71.6	75.0	71.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	13.53	11.80	14.71	15.88	14.53	12.80	15.71	16.88	16.88
VEF/USD, eop	6.29	6.29	6.29	12.00	19.80	19.80	19.80	19.80	19.80

Source: National Sources, Citi Research

Appendix A-1

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