

Asia Macro and Strategy Outlook

Is the Emerging Asia Growth Story Losing Its Luster?

- **Taper delay shifts focus from external imbalances to growth.** We've pushed back taper expectations to March 2014 and shaved off 0.4ppts from our US 2H13 growth forecasts to a muted 2%. Alongside lingering worries about diminishing tailwind from financial intermediation amid high leverage in some (most notably CN), IN and ID having to keep monetary policies tighter to reduce their current account deficits, the softer Sep exports from North Asia, and over the longer term, unfavorable demographic shifts in North Asia and potential growth challenges among NIEs already at/close to the technology frontier, there is a growing sense of malaise that Asia's growth story is running out of steam.
- **Short-term cyclical outlook looks weaker than before.** Financial conditions have meaningfully tightened vis-a-vis history for CN, IN and ID, which in CN's case is compounded by a more "structural" leverage problem in certain sectors. Slower short-term US growth outlook could be a drag to earlier expectations about the strength of Asia's export rebound.
- **However, some of the bearish growth views on Asia look exaggerated.** We think import-lite nature of recent US recovery is more due to the still historically weak and narrow nature of US domestic demand recovery, rather than the fears that Asia is meaningfully losing export competitiveness. If taper eventually comes alongside recovery in Advanced Economies, Asia would benefit.
- **Longer-term growth prospects still good for some, though China is a risk.** We think the story of capital accumulation and productivity gains, particularly in the South and Southeast Asian countries, has a long way to go, though IN and ID are constrained by low domestic savings (among other things) that policymakers are trying to address. CN slowdown concern is the most valid one, in our view, but there are some policy/growth offsets still available to CN's policymakers that argue a hard landing is not a foregone conclusion. If history is a guide (and it may not be), CN's track record of rapid labor productivity growth over the last few decades has been impressive.
- **Market outlook.** Carry/risk trades back on. On FX, we have a weak USD bias and like KRW, CNH, INR and MYR. On local debt, we like to add duration/risk in Thai, Indo and VND bonds, and on external debt, we are overweight Vietnam, and find relative value in NSBLK18s.

Note: For brevity, we use the following country abbreviations: CN=China, HK=Hong Kong; IN=India, ID=Indonesia, KR=Korea, MY=Malaysia, PH=Philippines, SG=Singapore, LK=Sri Lanka, TH=Thailand, TW=Taiwan, VN=Vietnam; JP= Japan, and EA=Euro Area

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

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Citi Key Economic Forecasts

Figure 1. GDP Forecasts (growth rate in percent)

	2012 GDP	2013 GDP Forecasts			2014 GDP Forecasts		
		Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	6.1	6.2	6.2	6.1	6.2	6.2	6.4
Asian NIEs*	1.7	2.9	2.9	2.7	3.7	3.7	3.5
SEAN-4**	6.3	5.3	5.4	5.1	5.2	5.3	5.3
China	7.7	7.6	7.6	7.6	7.2	7.2	7.4
Hong Kong	1.5	3.0	3.0	3.0	3.4	3.4	3.6
India***	5.0	4.8	4.8	4.6	5.6	5.6	5.7
Indonesia	6.2	5.7	5.7	5.6	5.3	5.3	5.5
Malaysia	5.6	4.4	4.8	4.3	5.0	5.0	5.1
Mongolia	12.4	12.3	13.8	—	11.0	11.0	—
Philippines	6.8	7.3	7.3	7.1	6.9	6.9	6.1
Singapore	1.3	3.6	3.2	2.9	3.5	4.0	3.6
South Korea	2.0	2.9	2.9	2.7	3.7	3.7	3.5
Sri Lanka	6.4	6.5	6.5	6.4	6.8	6.8	6.7
Taiwan	1.3	2.6	2.6	2.4	3.8	3.8	3.6
Thailand	6.5	3.5	4.0	3.5	4.2	4.4	4.4
Vietnam	5.3	5.2	5.1	5.2	5.5	5.4	5.5

Figure 2. CPI Forecasts (growth rate in percent)

	2012 CPI	2013 CPI Forecasts			2014 CPI Forecasts		
		Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	3.9	3.7	3.6	3.3	3.7	3.7	3.7
Asian NIEs*	2.7	1.8	1.9	1.8	2.4	2.4	2.5
SEAN-4**	3.4	4.7	4.4	4.8	4.7	4.1	4.8
China	2.6	2.7	2.7	2.6	3.0	3.0	3.1
Hong Kong	4.1	4.3	4.3	4.1	3.6	3.6	3.8
India***	7.3	6.0	5.5	6.2	5.0	5.0	6.0
Indonesia	4.3	7.1	7.2	7.3	6.6	6.6	6.4
Malaysia	1.6	2.0	2.0	2.2	3.7	3.1	2.9
Mongolia	14.3	10.3	9.9	—	12.0	10.0	—
Philippines	3.2	2.9	2.7	2.8	3.7	3.2	3.6
Singapore	4.6	2.5	2.4	2.5	2.6	2.3	2.9
South Korea	2.2	1.3	1.5	1.4	2.4	2.5	2.5
Sri Lanka	7.5	7.1	7.3	7.5	6.7	7.0	6.9
Taiwan	1.9	1.2	1.2	1.1	1.7	1.7	1.7
Thailand	3.0	2.1	2.4	2.3	2.2	2.3	2.8
Vietnam	9.3	6.7	6.6	6.9	7.1	7.1	8.0

Figure 3. Current Account Forecasts (percent of GDP)

	2012 CAB	2013 CAB Forecasts			2014 CAB Forecasts		
		Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	1.8	1.8	1.7	0.8	1.6	1.5	0.8
Asian NIEs*	6.9	7.0	6.5	2.1	5.8	5.3	1.8
SEAN-4**	0.1	-0.8	-0.9	-0.6	-0.3	-0.6	-0.5
China	2.3	2.2	2.2	2.6	2.0	2.0	2.4
Hong Kong	1.1	2.2	2.2	1.7	3.7	3.7	1.6
India***	-4.8	-3.7	-3.7	-3.3	-2.6	-2.6	-2.8
Indonesia	-2.8	-3.3	-3.5	-2.9	-2.7	-2.7	-2.2
Malaysia	6.1	3.0	2.3	2.6	2.5	2.0	2.8
Mongolia	-31.2	-24.8	-24.5	—	-13.6	-13.6	—
Philippines	2.8	3.6	3.6	3.0	3.3	3.3	2.7
Singapore	18.6	14.0	14.0	16.8	13.5	13.5	16.2
South Korea	3.8	5.1	4.3	4.8	3.2	2.4	3.7
Sri Lanka	-6.6	-4.6	-5.3	-4.6	-3.0	-3.4	-3.9
Taiwan	10.5	10.1	10.1	10.2	9.0	9.0	9.6
Thailand	0.0	-1.1	-0.8	-0.4	0.0	-1.0	0.2
Vietnam	6.3	4.2	4.2	0.0	3.0	3.0	0.0

Note: * Asian NIEs are Hong Kong, Korea, Singapore, and Taiwan. ** SEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand. Asia-Pacific is Asian NIEs + SEAN-4 + China + India + Mongolia + Sri Lanka + Vietnam, GDP-weighted. *** India Fiscal year runs from April-March and inflation forecasts are Wholesale Price Index. Source: CEIC Data Company Limited, Consensus Economics (October 14, 2013) and Citi Research estimates.

Macro Overview

Is the Emerging Asia Growth Story Losing Its Luster?

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EM Asia fared well in the aftermath of the global financial crisis, supported by strong economic fundamentals and use of counter-cyclical monetary and fiscal policies...

...but five years after the crisis, there are worries that growth engine is running out of steam, weighed by a sizeable leverage build-up in some, especially CN and policy constraints in a post-taper environment for CA deficit countries, the relatively import-“lite” nature of AE recovery (though we argue this is partly cyclical)....

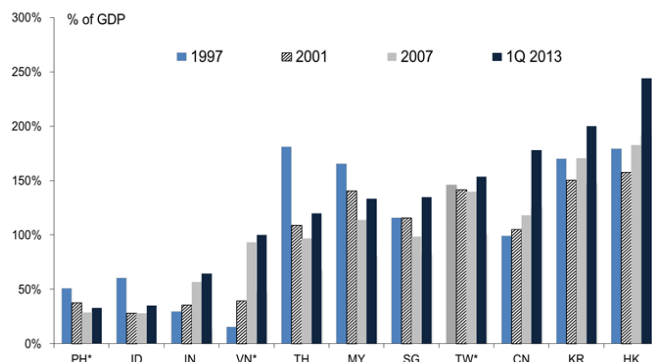
Emerging Asia withstood the Global Financial Crisis (GFC) remarkably well...

The region bounced back sharply, aided by very strong balance sheets of both private and public sectors, including the banks, and strong reserve buffers that helped shield the impact of the crisis and create space for accommodative (counter-cyclical) monetary, fiscal and quasi-fiscal policies, the latter particularly potent in CN, which in turn created significant positive spillovers to the rest of the region. Despite the deep recessions in developed countries, only five of the 10 major countries in Asia went through a “recession”, and those five recovered quickly¹, exceeding pre-crisis output levels within six quarters, on average, as opposed to developed countries like US which took 14 quarters to claw back to pre-output levels after two rounds of quantitative easing, or Japan and Euro Area whose real seasonal adjusted output remains below pre-crisis levels until now, the latter led by deep recessions in peripheral countries.

...but five years after the crisis, there is a growing sense of malaise that Asia's (& EM) growth story is running out of steam. There are five sources of concerns in the region, the first two having some cyclical components:

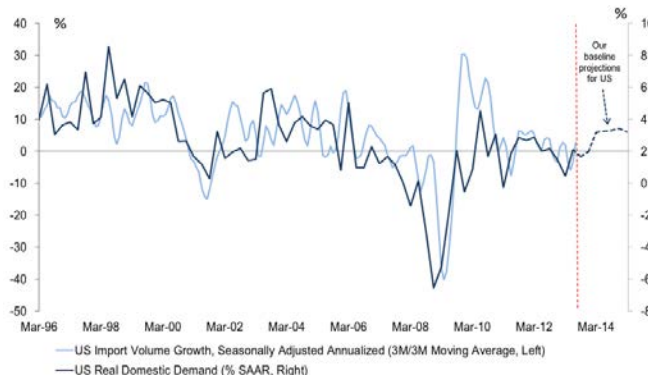
1. Efficacy of low real rates on financial intermediation is constrained by rising/high leverage, notably in CN, HK, SG, KR, MY & TH (see Figure 4). In fact taper fears (albeit now delayed to Mar 2014) are forcing CAD countries like IN & ID to tighten monetary conditions, and may still tighten further.
2. Even if eventual taper comes with a US-led recovery (though getting delayed), there are worries it may be less import-sensitive than in the past, and coupled with import-“lite” recovery in other AEs (Euro Area & JP) so far, would undermine Asia's export-driven recovery.² However, we believe this argument is partly a cyclical one given the relatively weak (& “narrow”) nature of AE growth. Our mid-term outlook, particularly on the US (to a lesser extent EA), hinges on domestic demand picking up to the 3-3.5% range in 2014F, which should provide more lift to US imports than what we've seen so far (Figure 5).

Figure 4. Emerging Asia – Credit to the Private Sector (% of GDP)



Source: BIS data on private sector debt, Haver, Citi Research
Note: *We use data only on “domestic banking” claims in the absence of BIS data.

Figure 5. US – Import Volume, %3M/3M SAAR, moving average, vs. Domestic Demand SAAR Growth (1Q 1996 to 1Q 2015F)



Source: Citi Research

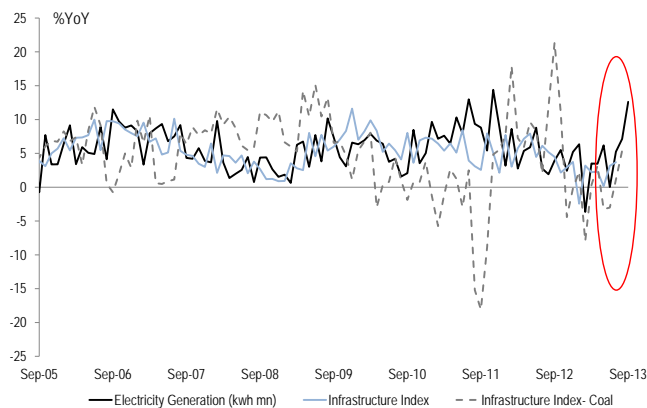
¹ The five that went into ‘recession’ were HK, Malaysia, Singapore, Taiwan and Thailand.

² See [Emerging Markets Macro and Strategy Outlook - Will DM's Recovery Be EM-friendly?](#) (27-Sep-2013).

...chronic supply bottlenecks specific to India, unfavorable demographic trends (especially in CN, KR, TW) and constraints to further innovation as some countries are already in the productivity frontier.

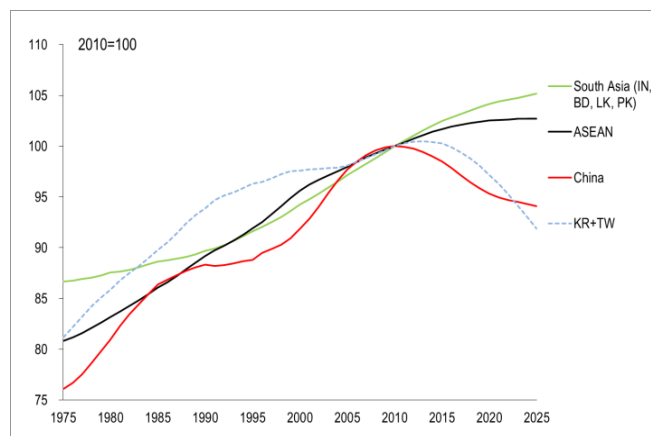
3. On a more country-specific level, supply bottlenecks in mining, energy and other infrastructure sectors in the region's second-largest economy, IN, remain complicated by election timetable and weak institutions. However, there are *tentative* signs some of these supply bottlenecks, at least on mining and power, are improving somewhat (see Figure 6). IN's regulatory issues act as supply-side constraints to potential growth, and while they are challenging, they are not "permanent" impediments. Resolving them depend more on a *qualitative* assessment of IN policymaking that is beyond our scope here.
4. Demographic trends are increasingly less favorable, with working age population growth slowing fast - CN, HK, KR & TW (>70% of the region's GDP) are expected to see an *absolute decline* in working age population by 2016-17 (this happened in JP in 1996), posing a growth challenge unless compensated by some combination of increased labor mobility, increased labor force participation rates (e.g. in KR) and/or rapid labor productivity growth.³
5. Some of EM Asia's NIEs (SG, KR and TW) are arguably on/close to the technology frontier, making it increasingly difficult to raise potential growth without more structural reforms (e.g. in KR's and TW's lagging services sector) and cutting-edge innovation. SG's per-capita income is already one of the highest in the world, while KR's and TW's output per capita has rapidly closed the per-capita income gap (at 75%) with Advanced Economies (AEs), vs. about two-thirds ratio a decade ago.

Figure 6. India Infrastructure Issues – Signs of life on power and coal



Source: CEIC, Citi Research

Figure 7. EM Asia – Working Age to Total Population Ratio, 2010=100



Source: UN Population Statistics, Taiwan CEPD, Citi Research

EM Asia will likely remain a dominant (though not as dominant) driver of global growth for years to come – blanket bearishness seem misplaced and differentiation is warranted.

We explore some of these short-to-medium factors influencing Asia's growth outlook in the region and argue that "*blanket*" bearishness about Asia's growth prospects is misplaced, that there is wide range of differentiation, and that the region will remain a dominant driver of global growth for years to come, though share of the region's contribution to global growth may come down at the margin (CN is a key variable).

³ See Nathan Sheets et al. [Perspectives - The Global Demographic Transition—What Role Are China & Other Emerging Asian Economies Likely to Play?](#) (21-Oct-2013).

Financial conditions in many Asian countries are still historically accommodative. Except for IN and ID, central banks will likely stay on prolonged hold until at least 1Q 2014F

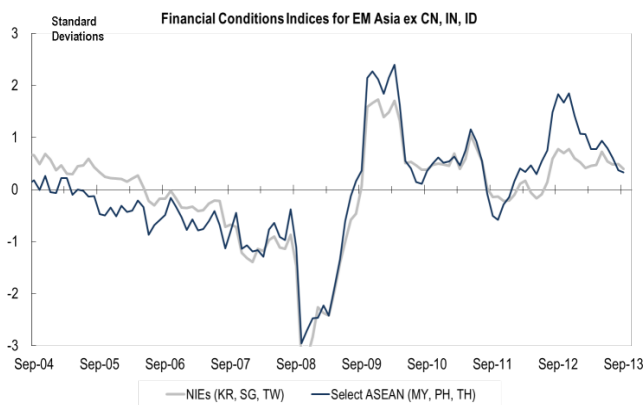
Tighter financial conditions are likely going to weigh more on the bigger countries – CN, IN & ID – but the growth impact is likely more “lasting” in CN as it coincides with a bigger structural issue on “excessive leverage”.

Financial conditions alongside leverage – Mixed support to growth

Real rates are still historically low for most countries in the region, and damage to financial conditions following recent market volatility is limited in many. In fact, financial conditions are still in accommodative territory for most (see Figure 8). Except for IN & ID, no one has hiked rates since mid-2011, nor have they had to reverse the cuts of 2012-13 or adjust policy significantly because of volatile capital flows partly because most of the region still has a current account surplus and strong external balance sheets that are somewhat indifferent (even tacitly supportive) to seeing currency depreciation. Except for IN and ID, everyone else will keep policy rates on hold until at least 2Q 2014F given still manageable inflation risks. Even BNM in MY, which had earlier sounded more hawkish, has become more dovish recently, and we have also pushed back our timetable for rate hikes in the PH by 1-2 quarters. In fact, frontier countries (LK & VN) may still cut – LK already surprised us with a 50bps cut.

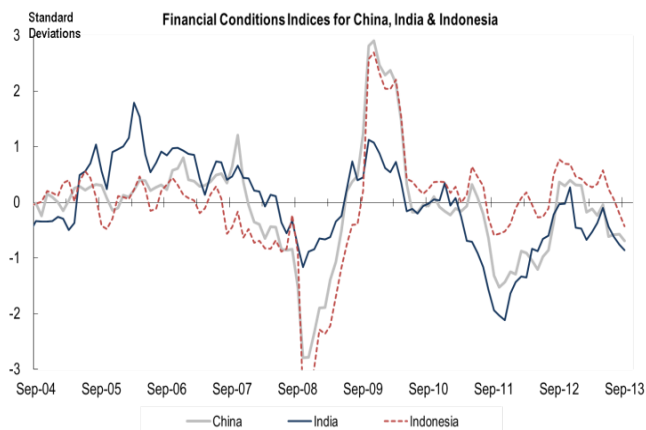
However, financial conditions have tightened in CN, IN and ID, and are likely to act as a constraint to growth. These three are much larger economies and could weigh more on the region. We think the impact of tighter financial conditions on growth will likely be more meaningful (and lasting) in CN given that this is also compounded by a more “structural” problem of over-leverage, especially in some of the corporate/SOE and local government sectors, which had been drivers of rapid investment-led growth with diminishing returns in the post-GFC years. Thus, we expect investment growth will decelerate over the medium term, and given that investment already accounts for 50% of GDP, will act as a more meaningful drag to growth.⁴ How rapid CN growth slows will also depend on policy stance and structural reforms to create offsetting growth drivers, though we still expect policymakers will use their policy space (and we think they still have space) to “defend” growth at the 7% in 2014F. Growth remains challenging in IN & ID as well, especially if taper-led volatility resurfaces in 2014F and policy will have to tighten further, but both countries have not over-invested nor have they over-levered (in fact, leverage ratios are very low in ID across corporate, households and government) and supply-side issues in IN could provide offsets to growth constraints on the demand side.

Figure 8. Financial Conditions are still on average quite accommodative for many Asian countries (especially the more “cyclical” ones)⁵



Source: Citi Research

Figure 9. However, China, India and Indonesia are facing historically tighter financial conditions



Source: Citi Research

⁴ See [China Macro Flash - Growth Rebound May Prove Transitory](#) (18 Oct 2013).

⁵ For details, see [Asia Macro View - Financial Conditions Present a Mixed Picture for EM Asia](#) (6-Sep-2013).

Short-term export outlook could be clouded by a weaker US recovery in 4Q

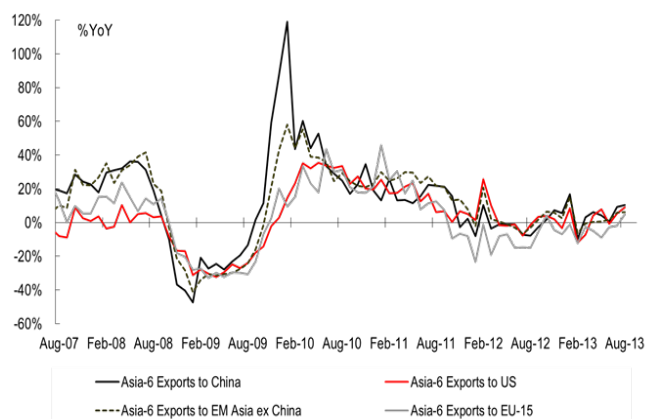
But there may be concerns about structural issues making DM's recovery less import friendly – but we would not exaggerate the impact – and this seems to only apply to US & JP (post Abenomics)...

Can Asia benefit from an eventual recovery in AE? Yes, but the problem is the *weakness of AE recovery* so far

US economic growth in the 2H 2014 has been clouded by the political budget and debt battle, and we have shaved off 0.4ppts to our 2H growth outlook. With US being the destination of about 14% of Asia's exports, and having been marginally supportive of the recent export upturn (Figure 10), this could provide some near-term drag. However, we think the impact is temporary – with strong bipartisan desire to overcome spending caps, impact of earlier fiscal restraint likely to fade, and cutbacks in 4Q13 activity to be made up in 1Q 2014, we expect US domestic demand will eventually pick up in 2014F.

However, there is evidence that the linkage between US real domestic demand and vis-à-vis import growth is weaker than it used to be (Figure 11), and a similar argument can be made with JP's demand revival since *Abenomics* (Figure 12), but we wouldn't exaggerate this point. US import weakness seems particularly notable in two sectors: autos & energy/petroleum related goods; the former is likely a byproduct of production relocation which may impact some in Asia, but the latter unlikely penalizes Asia. We think it's the absence of broader US consumer import recovery and the lack of business capex that is a bigger issue for Asia's exports. There may be a greater import substitution argument to be made in JP with a weaker yen, especially vis-à-vis KR, but we note that JP's domestic demand have historically never been very import sensitive, and if we exclude ID & MY whose exports to JP are likely commodity biased (and thus, very limited scope for import substitution), JP only accounts, on average, for about 6.5% of Asia's exports.

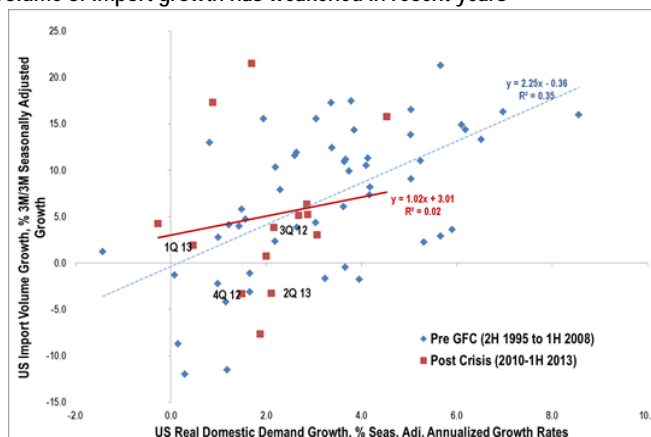
Figure 10. Select EM Asia's export growth (%YoY) have rebounded across geographies



Source: Haver, Citi Research.

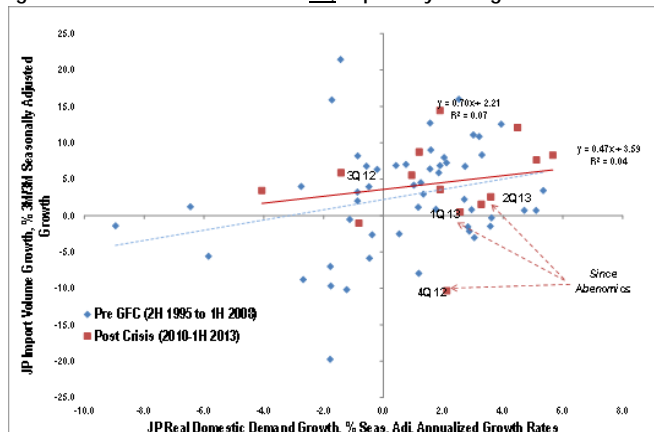
Note: *Asia 6 consist of those who report trade by country in a timely manner (KR, IN, MY, SG & TW) but we exclude CN given export over-invoicing distortions.

Figure 11. The linkage between US real domestic demand growth and volume of import growth has weakened in recent years



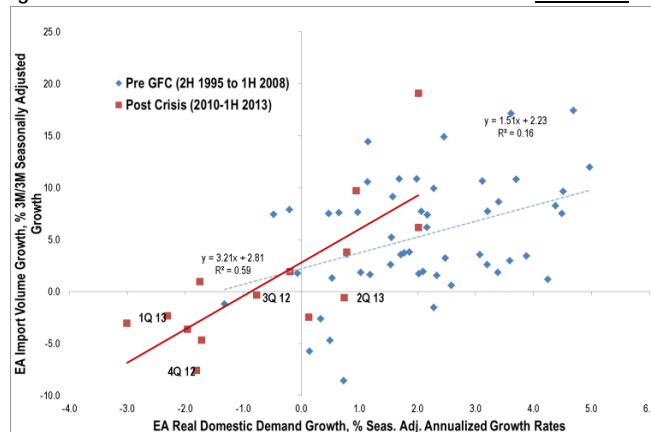
Source: CPB Netherlands World Trade Monitor, Citi Research

Figure 12. ...same can be said of JP, especially during Abenomics era



Source: CPB Netherlands World Trade Monitor, Citi Research

Figure 13. ...but there is little evidence that this is true in Euro Area



Source: CPB Netherlands World Trade Monitor, Citi Research

...but does not seem to hold for EA where import sensitivity appears to have even increased, but the problem is domestic demand growth is still weak.

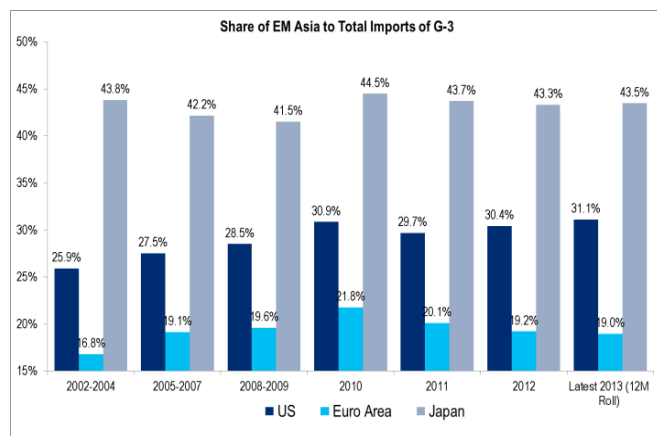
We think worries about EM Asia exports already losing competitiveness is overblown – aggregate data doesn't corroborate this, though it is natural to expect that market share gains will likely slow.

On a positive note, we find less compelling evidence Euro Area domestic demand growth is less import sensitive. In fact, the import sensitivity of EA's domestic demand seems to have increased in recent years (Figure 13), and while EA growth has been net export driven recently, our *forward-looking* assessment on EA growth dynamics envisions this shifting gradually towards domestic demand which had already begun to surface in 2Q 2013. Perhaps this *very marginally* explains why the sharpest export rebound in EM Asia in recent months have been from those whose export share to Euro Area is the highest (IN, VN & CN).

We find worries that EM Asia exports are losing competitiveness, on the back of more appreciated exchange rates and rising domestic cost pressures, are overblown.⁶ While there could clearly be some relative competitiveness loss in certain goods (and thus, production base moving mostly *within* EM), we think focusing just on exchange rate and domestic factor costs in Asia doesn't take into account significant productivity improvements and rising value added, some from the sheer scale of industrial upgrading via investments (e.g. in CN) as well as production agglomeration yielding supply chain networks that are costly to relocate. In aggregate, there is no compelling sign that Asia's export competitiveness is under serious threat, and that the region is less able to capitalize on a demand recovery in the major AEs (whenever that happens!). In the US, outside of energy-related industries where most countries in EM Asia are not global exporters, we see limited evidence of broad-based US manufacturing revival (we certainly don't see it in the US manufacturing jobs data). In fact, EM Asia's share of US imports has been rising even in the post GFC period (Figure 14). While we need to account for distortions from CN's export over-invoicing episode in late 2012 to 1Q13, EM Asia's export market share (in value terms) has been rising over a longer period, though we think the pace of gains we've seen the post-CN WTO period may be difficult to replicate given diminishing productivity gains from CN's earlier demographic dividends plus ongoing rebalancing pressures towards raising the labor share of income in order to support medium-term growth. After NIEs made impressive productivity improvements to maintain (and even raise) export market share in the last two decades, their accelerated per-capita income and productivity catch-up could make it look increasingly challenging to sustain (we are already seeing some pressure) though this could be offset by continued market share gains in lower-cost parts of South/Southeast Asia (Figure 15).

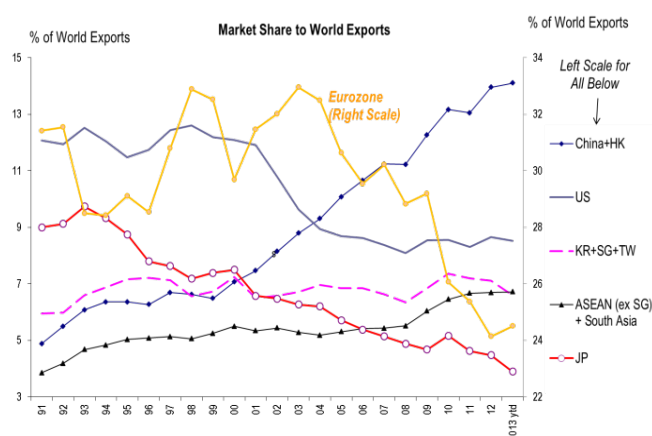
⁶ One example: Bloomberg's "Asia's Waning Competitiveness Seen in Trade Disconnect." (16 Oct 13).

Figure 14. Asia's market share of US total imports (in US\$) are rising while it is flat to pre-GFC levels for JP & Europe



Source: Haver, CEIC, Citi Research

Figure 15. Export Market Share for EM Asia is still rising as a whole, though the industrialized parts of Asia are seeing diminishing shares



Source: IMF Direction of Trade, Citi Research

The more valid concern for EM Asia's growth prospects is how much CN growth slows, though we take comfort that there is no obvious 'trigger' for CN to experience a rapid type of deleveraging accompanied by some sort of "financial crisis"

To us, the more valid concern for EM Asia's growth prospects, on top of the **disappointing** pace and breadth of US recovery so far, is how much CN growth slows down from here. We have extensively discussed the spillover impact of CN slowdown on EM Asia in past reports, likely hurting SG, TW, KR and MY more than others, but also complicating the current account adjustment for commodity reliant ID.⁷ One of the comforting features of CN's off-the-chart credit boom is that it has been largely funded by the domestic savings that are financially repressed, channeled through the domestic financial sector (though increasingly in the less regulated shadow banking sector), and capital account is still heavily regulated providing limited competition for the placement of domestic savings. CN's still sizeable current account surplus and massive FX reserves will likely keep it relatively insulated to Fed-induced capital flow volatility, while benign inflation so far do not give pressure for authorities to tighten monetary policy anytime soon. Thus, the timing to which "pressure" towards more rapid deleveraging in CN is hard to predict, but also needs to be counterbalanced, to some extent, by growth offsets from other potential policies/reforms.

Historical Growth Drivers – A Cursory Look at Growth Accounting

To provide us a gauge of the track record of Asia's growth performance and its drivers, and to what extent demographic challenges will be a constraint to potential growth, we decompose the region's historical growth performance by looking at both growth in factors of production, namely labor and capital, weighed by their income shares in the economy, and the (Solow) residual used to capture "total factor productivity".⁸ We use the *Penn World Tables version 8.0*, and, mindful of the model and measurement caveats, we present results below.⁹

We decompose the region's historical growth by looking at the contribution from factor accumulation versus "productivity" growth

⁷ See [Asia Macro and Strategy Outlook - Cyclical Bottoming despite Fed Taper and China Risk](#) (18-Jul-2013).

⁸ We assume a Cobb Douglas production function: $Y_t = A_t F(K_t, L_t) = A_t K_t^\alpha L_t^{1-\alpha}$ with K for capital, L for labor, A capturing "total factor productivity" (TFP), and $0 < \alpha < 1$, or α capturing capital's share of income – the production function yields "constant returns to scale" (i.e. if you double L and K , you double Y). Reformulating the equation, one can estimate *TFP (or A)* growth as the residual of the growth rate of Y minus the weighted sum of the growth rate of L and K . For reference, see Robert Solow (1956). "A Contribution to the Theory of Economic Growth." *Quarterly Journal of Economics* 70: 65-94.

⁹ Robert C. Feenstra, Robert. Inklaar and Marcel Timmer (2013), "The Next Generation of the Penn World Table" available for download at www.ggdc.net/pwt

Figure 16. Emerging Asia – Historical Look at a Growth Accounting Exercise

		1970s	1980s	1990s	2000-11			1970s	1980s	1990s	2000-11			1970s	1980s	1990s	2000-11
CHN	Real GDP	6.67	9.74	10.00	10.20	KOR	Real GDP	10.08	8.62	6.68	4.51	SGP	Real GDP	9.44	7.81	7.31	5.93
	Labor	1.83	1.64	0.75	0.41		Labor	2.51	1.62	0.74	0.85		Labor	1.79	1.40	1.86	1.60
	Capital	3.47	3.31	4.35	6.25		Capital	4.11	4.36	4.81	2.58		Capital	7.08	5.11	4.57	2.99
	TFP	1.37	4.79	4.90	3.54		TFP	3.45	2.64	1.13	1.08		TFP	0.56	1.30	0.88	1.34
HKG	Real GDP	9.02	7.44	3.58	4.49	MYS	Real GDP	9.43	3.27	4.79	5.81	THA	Real GDP	10.12	7.26	5.35	4.19
	Labor	1.81	1.41	0.70	0.46		Labor	2.14	1.84	1.78	1.39		Labor	0.97	1.34	0.35	0.84
	Capital	3.81	3.72	3.39	1.76		Capital	3.77	4.04	4.76	2.21		Capital	5.00	4.19	5.42	1.53
	TFP	3.40	2.30	-0.51	2.28		TFP	3.52	-0.11	0.71	1.41		TFP	4.15	1.73	-0.42	1.82
IDN	Real GDP	7.76	3.27	4.79	5.81	PHL*	Real GDP	5.78	3.27	4.79	5.81	TWN	Real GDP	10.12	7.70	6.35	4.09
	Labor	1.30	1.76	0.81	0.71		Labor	2.68	2.32	1.74	1.54		Labor	2.13	1.44	0.69	0.45
	Capital	3.45	4.41	2.91	2.76		Capital	1.90	1.63	1.26	1.24		Capital	6.23	4.48	4.58	2.29
	TFP	3.01	0.22	-0.66	1.69		TFP	1.20	-1.93	-0.25	1.67		TFP	1.75	1.78	1.08	1.35
IND	Real GDP	2.94	5.58	5.84	7.30	LKA*	Real GDP	4.59	3.27	4.79	5.81	VNM*	Real GDP	4.76	4.73	7.42	7.11
	Labor	2.09	1.87	1.20	1.09		Labor	1.09	0.53	1.20	1.20		Labor	1.42	1.62	1.54	1.89
	Capital	1.12	1.42	2.16	4.34		Capital	1.52	1.44	1.13	1.71		Capital	0.70	1.13	3.32	3.20
	TFP	-0.26	2.30	2.48	1.87		TFP	1.99	2.27	2.95	2.22		TFP	2.65	1.97	2.56	2.08

Source: Penn World Table 8.0 and Citi Research

Note: We use actual labor share of income compiled in PWT8.0 which is not assumed to be constant, except for countries with (*) where data is unavailable or looks inaccurate, in which case we assume labor share of income is 70% as in D. Gollin, "Getting Income Shares Right" *Journal of Political Economy* 110, pp. 458-75 (2002)

Capital accumulation has been an important driver of the Asia growth experience

PH, TH and MY are in a stronger position to boost capital accumulation given that they are not (less) constrained by low domestic savings and excess capacity/low returns, CN may still need to deal with the latter. Meanwhile, VN has been too slow fix its banks, and IN, ID & LK are constrained by low domestic savings.

One of the remarkable features of the East Asia “miracle”, quite different from Latam’s experience¹⁰, is the strong role of capital accumulation in boosting labor productivity and generating impressive growth rates over the decades, especially among the more manufacturing/goods export-heavy countries of East Asia. While there were clearly excesses to this capital accumulation and questionable “exceptionalism” of Asia’s productivity gains in some,¹¹ as seen in the aftermath of the Asian financial crisis of 1997-98, a significant amount of real GDP growth in many countries (CN, HK, ID, IN, KR, MY, SG, TH, TW and VN) is still generated through capital accumulation going into the last decade, especially the strong investment revival in parts of ASEAN (Figure 18).

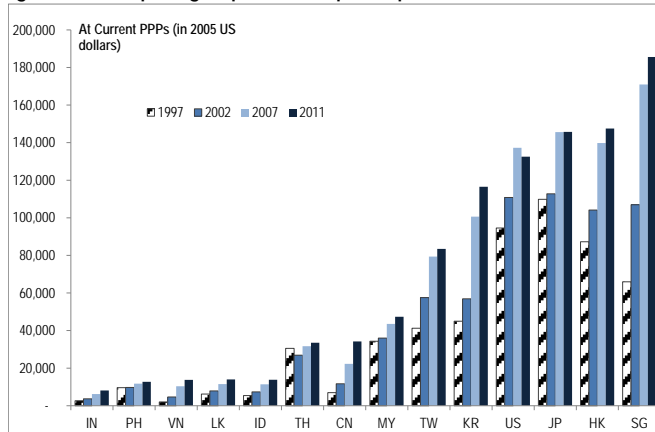
Can this be sustained? The picture is mixed. We have seen investment rates slow in some of the more industrialized NIEs, notably in KR, TW and SG as economies mature, though neither of the three see investment being constrained by lack of domestic savings (in fact, domestic savings are massive, but are exported). For others, the capital stock per capita is still relatively low, and thus, arguably, the convergence process for capital accumulation has more room to run (Figure 17). We think PH, TH and to a lesser extent MY, have an advantage in that neither of the three are constrained by either low domestic savings (though TH a bit more than the others), a weak banking system or “excessive” investment with rapidly diminishing returns. We think PH has the biggest advantage given the sheer scale of underinvestment and excess domestic savings, but institutional/ governance issues may be the more binding constraint. Both IN and ID have significant growth opportunities, but investment is constrained by low domestic savings which policymakers are now trying to address. While VN has built up rapidly rising savings as its export/FDI manufacturing sector boomed in recent years, the ability to intermediate savings through the financial sector has been broken by legacy NPL problems in the banking sector whose resolution has been painfully slow. Lastly, despite rapid investment fueled by credit in recent years, CN’s capital stock per capita is still low but returns are diminishing rapidly given the some “questionable”

¹⁰ See pp. 8-10 of [Latin America Macro & Strategy Outlook - Some \(Unpleasant\) Growth Decomposition](#) (4 Oct 2013).

¹¹ See Alwyn Young, “The Tyranny of Numbers: Confronting the Statistical Realities of the East Asia Growth Experience”, *The Quarterly Journal of Economics* Vol. 110, No. 3 (Aug., 1995), pp. 641-680

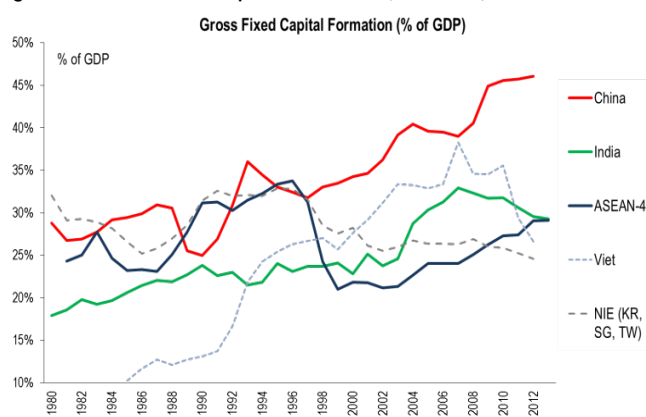
quality of capital accumulation during the post-GFC credit boom, and thus, there is risk of a more rapid slowdown in growth, which alongside diminishing working age population ratio, could significantly slow per-capita income gains.

Figure 17. Comparing Capital Stock per Capita



Source: Penn World Table 8.0, Citi Research

Figure 18. Gross Fixed Capital Formation (% of GDP)

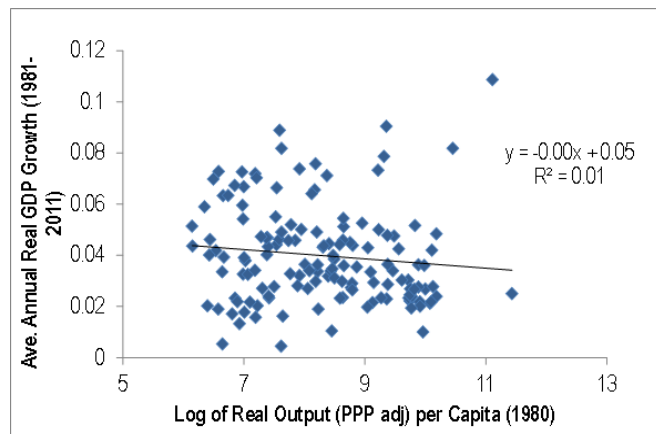


Source: Haver, CEIC, Citi Research

Meanwhile, there are some encouraging signs that labor productivity growth, backed other productivity gains outside of capital accumulation (i.e. TFP growth which could capture human capital gains, technological upgrading, improvements in institutions/regulations and quality of policymaking), is effectively boosting income per capita and generating a rising middle class in a number of key countries in Asia. If we assume away cyclical components to growth, “productivity” gains, by our measure, have been relatively high in a few countries – CN was the big story over the last decade, but ID, MY, PH, TH, TW (and KR in more recent years) have also seen progress.

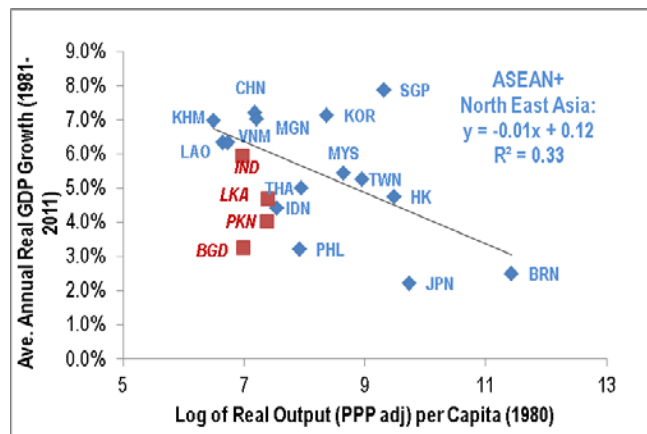
Going forward, we think lower-income countries operating well inside of the technological frontier, accompanied by appropriate investment, can achieve faster productivity gains to boost growth. The idea of “*absolute convergence*” in economic literature posits that, other things equal, poorer countries should grow more quickly than rich countries over the longer term, leading to a catch-up in living standards. The intuition behind this is simple – poorer countries can boost growth more easily by learning and adopting technologies of richer nations, as opposed to the latter having to do the tougher task of innovating to push out the technology frontier. In reality, when we look at over 140 countries, empirical evidence of absolute convergence is very weak, highlighting that all things are not created equally (Figure 19). However, one encouraging sign is that the evidence of *absolute convergence* is much stronger in East Asia (Figure 20).

Figure 19. Average Growth Rate is poorly correlated to starting levels of per capita income, i.e. absolute convergence doesn't hold globally



Source: Penn World Table 8.0, Citi Research

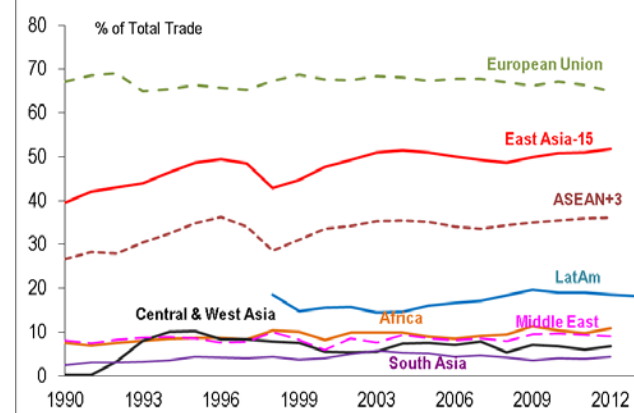
Figure 20. However, within East Asia, absolute convergence trends (i.e. catch-up) are more strongly visible (blue diamonds)



Source: Penn World Table 8.0, Citi Research

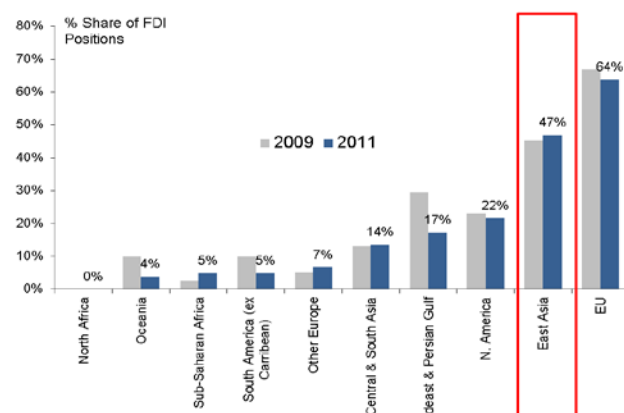
Globalization (including globalization of market reforms) has been an important driver of income convergence. We think East Asia's high trade and direct investment linkages is a clear advantage, and it is encouraging to see that not only are intra-Asia trade and direct investment flows high, but they are also rising (Figures 21-22), though rising in some more than others. The process of direct investment flows from the richer North Asians to the poorer South Asians helps catalyze productivity gains in the latter. This would suggest that there is still a lot more room for catch-up for CMLV (Cambodia, Myanmar, Laos and VN), ID, TH, MY and even CN, though at some point, the challenge of making a productivity leap to escape the "middle-income trap" still remains to be seen. In CN's case, there is still a lot of room to unlock growth potential in the underdeveloped services sector. PH and IN are less integrated to manufacturing supply chains and don't follow the typical East Asia industrialization model, but both have benefited from productivity gains and catch-up due to the rise of modern tradeable services, and could use more infrastructure investment to unlock opportunities in manufacturing as well.

Figure 21. East Asia's Intra-regional trade flows are high (& rising)



Source: ADB Regional Integration Center, Citi Research

Figure 22. East Asia's Intra-regional FDI Flows are also high (& rising)



Source: IMF Coordinated Direct Investment Survey, Citi Research

In summary, there is certainly some validity to fearing some cyclical headwinds to Asia's growth as leveraging off of low real rates is a story that is running out steam in some large countries amid financial imbalances (notably in

CN) and desire to curb external imbalances (IN and ID), plus US growth in the short term has been clouded by political standoffs in Washington. However, the view that the structural growth story for Asia is over, that CN growth will collapse, IN growth will never bounce and that Asia has seriously lost export competitiveness is, we believe, unfounded. If taper comes with a pickup in US domestic demand, as is our US colleagues' base case, EM Asia should benefit. Perhaps pace of CN slowdown concern is the most valid one, but there are some policy/growth offsets still available that leave us to believe "hard landing" is not a foregone conclusion. We also don't see sufficient evidence that Asia's dominance in global manufacturing has been seriously challenged in the last few years, certainly not by the US. We think the story of capital accumulation and productivity gains, particularly in the Southeast Asian countries, that are more integrated to trade and investment have a long way to go. The ability to channel capital from excess savers (North Asia including JP) to more savings-starved under-investors in the South will be an important, and track record on this has been encouraging so far in ASEAN. The issue is whether IN can heed lessons from East Asia and benefit as well.

Market Outlook

We are in a carry-seeking environment – we like KRW, CNH, INR & MYR relative to others; over the medium term, we are positive on PHP

Asia FX: A taper delay and weaker US data would argue for a weaker dollar bias, and alongside lower currency volatility, renews the appeal of carry trades. In Asia, we prefer currencies where fundamental drivers for appreciation are strong – KRW, CNH – and where central banks are less likely to fight you – INR, MYR (BI may use the risk rebound to rebuild FX reserves). We think PHP is another currency that has room to move, especially after still being about 4+% weaker than pre-taper levels, but BSP intervention incentive remains high for now while inflation is still manageable. We are forecasting PHP outperformance over the medium term. We are less keen on THB, where we think weaker domestic demand and underperforming exports will keep BoT on the defensive, and currencies that underperform in a carry-seeking environment – TWD and SGD.

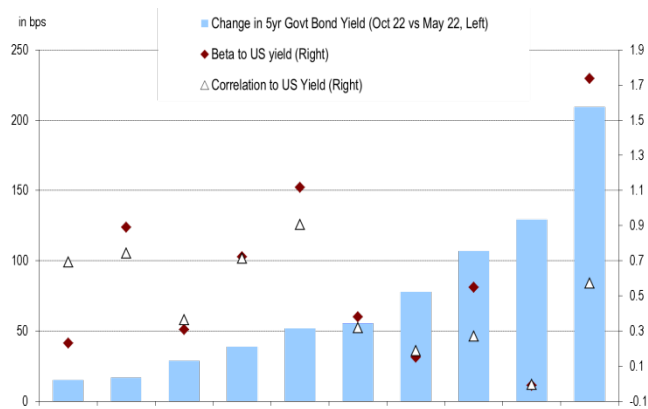
We are biased to be to add duration and exposure to local bonds, we like 5-year part of the Thai curve, we are now overweight on IDR bonds and like 5-year VND bonds

Asia local debt: We favor of adding duration and adding risk. Our strategists are now overweight IDR bonds as BI's improved policy credibility both on monetary and FX front should provide some support alongside yield-seeking flows. We also like Thai 5-year where the curve is still steep, has sold off more than what historical beta to US treasuries would imply, domestic demand growth remains subdued and exports relatively underperforming, plus BoT is relatively dovish and unlikely to signal a policy rate change anytime soon. We would also be long duration in Korea. We would be neutral Malaysia given more limited sell-off and inflation risks. On the frontier side, we outright recommend going long VND 5-year government bonds at ~8.35% – the curve remains very steep (2s5s at ~230bps), domestic liquidity remains flush (o/n rates have been at sub 4% range for the most part of the last 18 months) and could increase further when VAMC injects VND35trn (\$1.7bn) of 5-year zero-coupon bonds into the banks by year-end that the banks can repo. There are some devaluation worries after PM Dung mentioned his plans earlier this month, but we see little pressure, and at most, assume only 1% 'deval' by year-end. Meanwhile, we prefer to be in the shorter end (1-year) of Sri Lanka – curve is very flat, the 12.5% foreign quota will be made binding by year-end (no word about lifting quota), fiscal performance looks weak (though spending disbursements likely be pushed into arrears in 2014F) and a pro-growth policy stance by CBSL would keep external liquidity fears alive.

Taper delay should be risk positive for higher-yielding credits, but we argue for some differentiation – we like Vietnam 20s which has lagged the rally and after recommending DBMMNs last month, we now find more value in NSBLK18s which is still trading relatively wide to sovereign, even though we're not too keen on the sovereign.

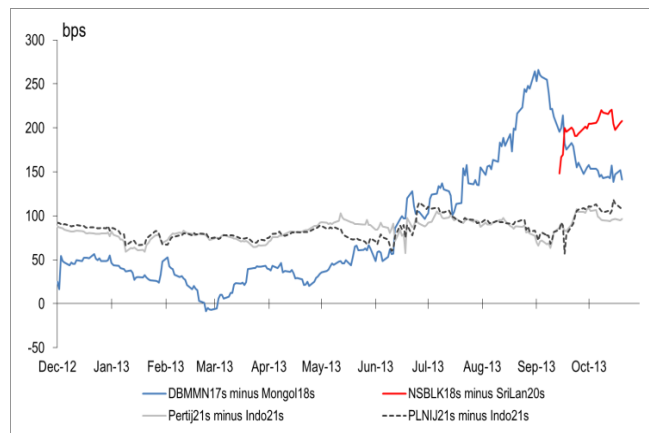
External Debt: The taper delay should be risk positive for credits, but we argue for differentiation. We view Vietnam and Indonesia as still solid credits (albeit latter being more externally vulnerable), with Indo benefiting from improved policy credibility from BI. However, as Indo bonds have already outperformed, we find more value in Vietnam20s which lagged (even lagging Sri Lanka), despite having no external refinancing need in sight. A Vietnam government guaranteed restructured Vinashin bond started trading this month (DATC 2025s with 1% coupon accruing at maturity), and this could gain interest amid scarcity of Vietnam paper. Last month, we had thought Mongolia would outperform Sri Lanka following some positive headlines (e.g. New Investment law) – this did not pan out. However, the cheaper quasi-sovereign (DBMMN's) spread pick-up has rallied nicely. While there is some hope on Mongolia's FDI progress following the legal change, and key to watch is how Rio Tinto OT Phase II negotiations pan out, we underestimated the weak macro policy management (via off-budget spending and, more recently, BoM's mortgage subsidy loan scheme that is tantamount to QE) is still putting pressure on its balance of payments and the tugriks. Thus, we are consequently neutral on Mongolia. Similarly, we believe Sri Lanka's pro-growth policy bias is risky given the country's high debt, low reserves and continued external refinancing needs – we are wary of the sovereign after recent outperformance, but see value in NSBLK '18s which is still trading substantially wide to the sovereign (see Figure 24).

Figure 23. Changes in 5r Government Bond Yields and Historical 6M Correlation and Beta to 5yr US Treasury yields (Weekly Changes)



Source: Bloomberg, Citi Research

Figure 24. Comparing Quasi-Sovereign Spreads of Higher Yields – NSBLK'18s spread pick-up looks too wide



Source: Bloomberg, Citi Research

Asian Equities: Our EM equity strategist, Markus Rosgen, remains constructive EM equities, and in particular, favors China, Korea and Taiwan. He believes they are consensus underweights among GEM funds manager, but their earnings revision have improved from three months ago as analysts finished their revisions post first half results. They are also the markets with surplus in current accounts and abundant reserves coverage ratio, and thus, very insulated from taper led volatility. Compared to developed markets, liquidity conditions in Asia remain supportive, much less so for those running CA deficits vs. surplus in the other regions. Judging by the PMI's, the world is slowly getting better, which, with a lag, has always helped emerging markets.¹²

¹² [GEMS Strategy - The model has spoken. It still likes Russia, China, Korea & Taiwan](#) (14-Oct-2013).

Asian Currencies & Interest Rate Forecasts

Figure 25. Currency Forecasts and Forwards

	Mkt Data			Forecasts								
vs USD	24-Oct	3M Fwd	12M Fwd	0-3 Mos	6-12 Mos	Long-term	Dec-13	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Euro	1.38	1.38	1.38	1.38	1.40	1.40	1.38	1.40	1.40	1.40	1.40	1.40
Japanese Yen	97	97	97	98	105	105	99	104	105	105	105	105
Chinese Renminbi	6.08	6.13	6.15	6.08	6.10	6.00	6.08	6.10	6.08	6.06	6.04	6.02
Hong Kong Dollar	7.75	7.75	7.75	7.76	7.76	7.75	7.76	7.76	7.76	7.76	7.75	7.75
Indonesian Rupiah	11155	11335	11940	11100	11700	11000	11207	11655	11587	11446	11308	11168
Indian Rupee	61.5	62.9	66.2	61.0	63.0	58.0	61.4	62.9	62.2	61.2	60.2	59.2
Korean Won	1061	1067	1080	1055	1030	995	1051	1032	1024	1017	1010	1003
Malaysian Ringgit	3.16	3.18	3.23	3.15	3.15	3.05	3.15	3.15	3.13	3.11	3.09	3.07
Philippine Peso	43.1	42.8	42.8	42.0	41.2	40.8	41.9	41.3	41.1	41.1	41.0	40.9
Singapore Dollar	1.24	1.24	1.24	1.24	1.24	1.19	1.24	1.24	1.23	1.22	1.21	1.20
Sri Lanka Rupee	130.6	133.0	NA	133.6	130.0	125.0	133.0	135.0	133.0	130.0	130.0	130.0
Thai Baht	31.1	31.3	31.8	31.0	31.2	29.9	31.0	31.2	31.0	30.7	30.5	30.2
Taiwan Dollar	29.4	29.3	29.1	29.2	29.0	29.0	29.2	29.0	29.0	29.0	29.0	29.0
Vietnam Dong	21100	21561	23164	21372	21611	21600	21350	21430	21510	21590	21670	21670

*Forecast as of Citi Foreign Exchange: Forecasts (October 18, 2013)

Source: Bloomberg, CEIC Data Company Limited, Reuters, and Citi Research estimates

Figure 26. Interest rate forecasts (% period end)

	24-Oct	In 3M	In 6M	In 12M	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15
US* Fed Fund Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Year Treasuries	2.50	NA	NA	NA	2.56	2.70	2.95	3.15	3.25	3.40
EU* Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
10-Year Bunds	1.77	NA	NA	NA	1.80	1.80	1.80	1.80	1.90	2.00
JP* Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Year JGBs	0.62	NA	NA	NA	0.65	0.60	0.50	0.60	0.70	0.90
CN 1-Year Deposit rate	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50
1-Month Shibor	5.40	5.30	5.30	5.37	5.30	5.30	5.30	5.30	5.55	5.80
Government bond yield (5 -Year)	4.02	3.90	3.90	3.96	3.90	3.90	3.90	3.90	4.15	4.40
HK 3-Month Interbank Rate	0.38	0.49	0.63	0.83	0.45	0.60	0.70	0.80	0.90	1.00
5-Year Exchange Fund Note	0.90	1.36	1.55	1.95	1.30	1.50	1.70	1.90	2.10	2.30
IN Overnight Repo Rate	7.50	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75
Overnight Reverse Repo Rate	6.50	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75
91-Day T Bill	8.77	8.72	8.00	8.00	9.00	8.00	8.00	8.00	8.00	8.00
10-Year Gilt	8.60	8.43	8.25	8.25	8.50	8.25	8.25	8.25	8.25	8.25
ID BI Policy Rate	7.25	7.50	7.75	7.75	7.50	7.75	7.75	7.75	7.75	7.75
FasBI Rate	5.50	5.75	6.00	6.00	5.75	6.00	6.00	6.00	6.00	6.00
O/N Interbank Rate	5.75	6.72	6.90	6.90	6.65	6.90	6.90	6.90	6.90	6.90
10-Year Government Bond	7.17	7.32	7.57	8.00	7.25	7.50	7.75	8.00	8.00	8.00
MY Overnight Policy Rate	3.00	3.00	3.00	3.50	3.00	3.00	3.25	3.50	3.50	3.50
3-Month Interbank Rate	3.21	3.21	3.27	3.70	3.21	3.20	3.45	3.70	3.70	3.70
5-year MGS	3.35	3.63	3.73	3.93	3.60	3.70	3.80	3.90	4.00	4.10
PH O/N Rate	3.50	3.50	3.50	3.75	3.50	3.50	3.50	3.75	4.00	4.00
1-Month Reference Rate	-1.26	-0.86	-0.36	1.76	-1.00	-0.50	0.00	1.50	2.50	3.00
5-Year T Bond	2.62	2.85	2.89	3.50	2.85	2.85	3.00	3.50	3.50	3.50
SG 3-Month Interbank Rate	0.39	0.35	0.35	0.36	0.35	0.35	0.35	0.35	0.40	0.45
10-Year SGS	2.11	2.53	2.64	2.93	2.50	2.60	2.75	2.90	3.00	3.00
KR BOK Policy Rate	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75
91-Day CD	2.66	2.71	2.75	2.75	2.70	2.75	2.75	2.75	2.75	2.90
5-Year Treasury	3.04	3.38	3.49	3.65	3.35	3.45	3.60	3.65	3.65	3.75
SL Reverse Repo Rate	8.50	8.50	8.00	8.50	8.50	8.00	8.00	8.50	8.50	9.00
1-Month T-Bills	9.47	9.36	9.14	10.00	9.50	9.00	9.50	10.00	10.00	10.50
364-Day T-bill	10.02	10.01	9.64	10.50	10.20	9.50	10.00	10.50	10.50	10.50
TW Overnight Rate	0.39	0.41	0.43	0.49	0.41	0.43	0.45	0.48	0.51	0.54
Re-discount Rate	1.88	1.88	1.88	2.00	1.88	1.88	1.88	2.00	2.13	2.25
10-Year Government Bond	1.60	1.71	1.81	2.07	1.68	1.78	1.88	2.03	2.18	2.33
TH Overnight Repo Rate	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00
1-Month interbank Rate	2.54	2.55	2.56	2.65	2.55	2.55	2.60	2.60	2.80	3.15
10-Year Government Bond	3.81	3.86	3.97	3.83	3.80	4.00	3.90	3.80	3.90	4.00
VN Refinance Rate	7.00	6.00	6.00	7.00	6.00	6.00	7.00	7.00	7.00	7.00
1-Month interbank Rate	5.38	3.28	4.14	6.00	3.00	4.00	4.50	6.00	6.00	6.00
5-Year Treasury	9.29	8.50	8.64	9.00	8.50	8.50	9.00	9.00	9.00	9.00

Note: *Forecast as of Global Economic Outlook and Strategy (October 23, 2013)

Source: Bloomberg, CEIC Data Company Limited, Reuters, and Citi Research estimates

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- **Summary view** – Growth rebounded in 3Q as widely expected, but signs of softening emerged in Sep. We expect GDP to moderate in 4Q under a tighter credit environment and local fiscal constraints, and maintain annual growth forecast of 7.6%.
- **Things to watch** – The upcoming local government debt audit result may lead to stricter control of debt while the 3rd Plenary Session of the 18th Party Congress next month will focus on economic reforms. Measures related to IR liberalization and administrative price increases would weigh on growth in the short term.
- **Strategy** – USDCNY could be slightly lower in the short term but we see limited CNY appreciation if trade surplus continues to narrow, and reserve accumulation and prudential measures would be used to tackle the uncertain capital flows. CNY trading band may be widened once market expectation is more balanced.

Growth rebound may prove transitory

Growth rebounded in 3Q as widely expected, but signs of softening emerged in Sep. China's GDP grew by 7.8%YoY in 3Q and 7.7%YoY in the first nine months, and the government annual growth target of 7.5% appears within reach. Growth remained unbalanced, with investment and consumption contributing 4.3ppts and 3.5ppts respectively, and net export contribution was negative 0.1ppt. Meanwhile, service industry continued to outperform manufacturing. However, both IP and FAI slowed on a YoY and MoM basis in Sep, suggesting the rebound may be losing steam. Manufacturing PMI in Sep suggests sequential growth of production is flattening. Disappointing exports in Sep also point to downside risks from external demand, although new export orders remained robust so far.

With inflation rising and job market stable, policies may become less accommodative. The ratio of job vacancies to job seekers rose to 1.08 in 3Q from 1.07 in 2Q, implying little slack in the job market in general. On the other hand, CPI inflation rose on a YoY and MoM basis in Sep, and the uptrend may continue in the near term, although inflation is expected to remain below the official target of 3.5%. The monetary data in Sep suggest sizable capital inflow, and money growth stayed above PBOC's annual target of 13%. The central bank's latest press conference indicates the overall monetary stance has yet to return to a more neutral position.

Growth may moderate in 4Q, and we maintain annual growth forecast of 7.6%. The local government debt audit result is expected to come out soon, which may lead to stricter control of the local debt. Growth momentum will likely soften under a tighter credit environment and local fiscal constraints, translating to lower YoY GDP growth in 4Q against a high base last year. Growth may fall to 7.4%YoY in 4Q. The expected reform measures, especially those related to interest rate liberalization and administrative price increases, would weigh on growth in the short term, although the recent expectation management of the new government helps to reduce the risks of a sharp downturn. We also maintain 2014 growth forecast at 7.2%.

Reform dividend: relaxing population policy

Population policy change is closer than ever. China has reached a turning point where the demographic dividend will become a liability. As working age population starts to decline, China's potential growth rate is set to fall, and the aging population would make the pension system unsustainable. Policy change discussion is gaining momentum recently. Late this year or early next year, the government may allow couples to have a second child if one of the parents has no siblings (单独二胎), and the government may adopt a blanket two-child policy in a few years. The main concern of the government is that new births might surge right after the policy relaxation, leading to a baby boom that could strain public facilities, such as hospitals and schools.

We expect policy relaxation to boost growth in the near and longer term. We have created a likely scenario and an aggressive scenario to assess the impact of policy changes relative to a base case of no policy change. We assume a phased relaxation (either age-based or region-based) that could avoid a bunching of new births. The likely/aggressive scenario, in which the TFR would rise to 1.8/2.0 immediately, envisages additional new births of 11 million/16 million in the next five years. In the near term, higher demand helps to absorb excess capacity and raise annual growth rates (0.1-0.2ppt in the likely scenario and 0.2-0.3ppt in the aggressive scenario during 2015-19). After 2030, as additional new births start to enter the labor force, potential growth could be lifted (0.05ppt per year in the likely scenario and 0.15ppt in the aggressive scenario during 2031-35).

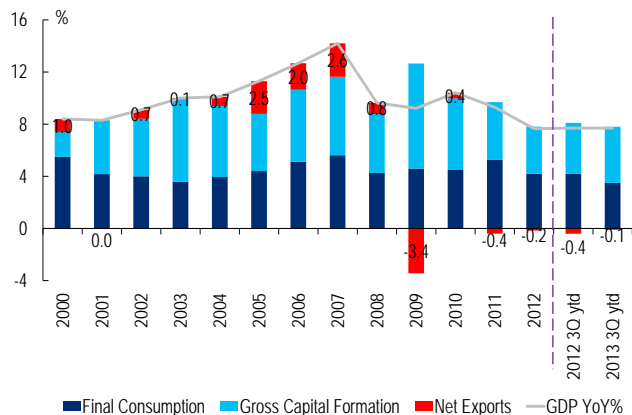
For more details, please see [China Macro View - Relaxing Population Policy: Overdue but Never Too Late](#) (16-Oct)

Limited CNY appreciation ahead

Limited CNY appreciation amid narrowing trade surplus coupled with accumulating reserve. We think the CNY fixing would be less affected by domestic political events (such as the party meeting) than BOP movements and international pressures. The recent strong CNY fixing could be a response to a big jump in FX reserves in Sep. Capital outflow is not an immediate threat yet due to the delay in US tapering, but trade surplus appears to be narrowing in recent months. Since the FX inflow is mainly caused by the volatile capital account transactions (or hot money), the authorities would be reluctant to appreciate the currency rapidly that could hurt the export sector. Therefore we expect limited CNY appreciation if trade surplus continues to narrow, and reserve accumulation and prudential measures would be used to tackle the uncertain capital flows. The widening of the band may take place when the market expectation is more balanced, i.e., when the spot gets closer to the fixing.

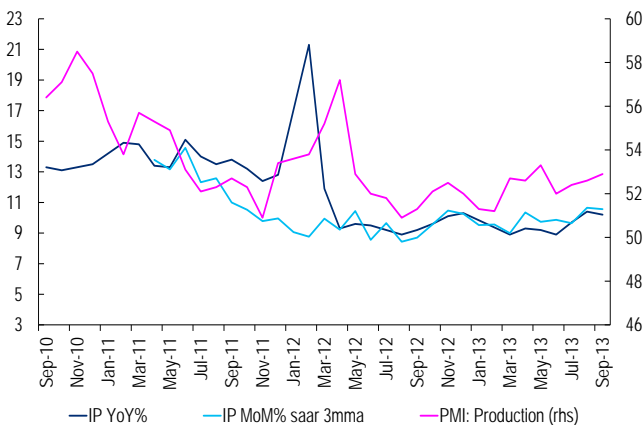
Mild CNY appreciation in the near term, but steadier in next 12 months. We believe USDCNY could head slightly lower towards 6.08 in 3m. In 12m period, as US tapering and diverging growth momentum relative to the US may lead to capital outflow, the authorities may respond by cutting FX reserves while keeping USDCNY relatively stable. We forecast USDCNY at 6.10 over the next 12 months.

Figure 27. Contribution to GDP



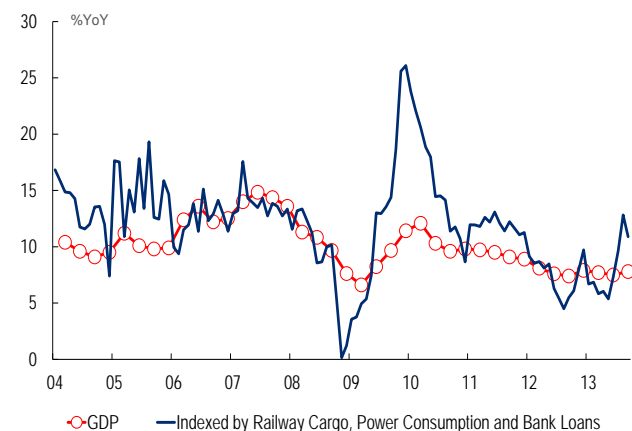
Source: NBS and Citi Research

Figure 29. IP decelerated in Sep following hot summer distortion



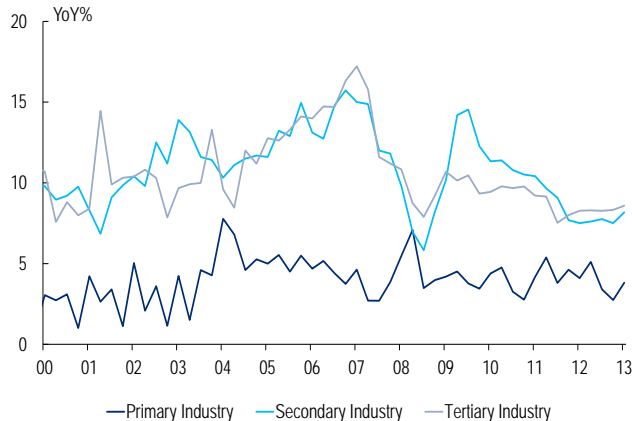
Source: NBS and Citi Research

Figure 31. Growth momentum appears to be softening



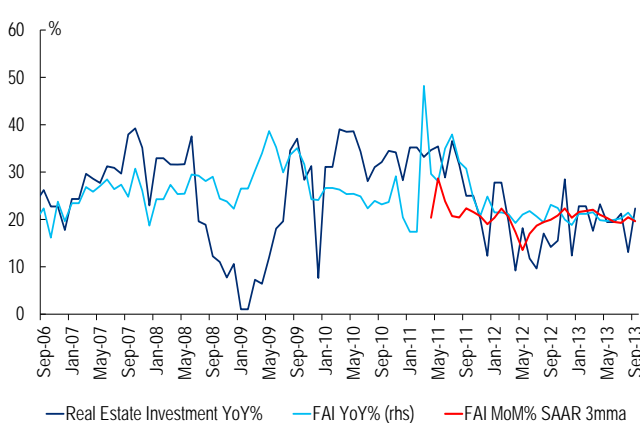
Source: NBS and Citi Research

Figure 28. Service industry continued to outperform



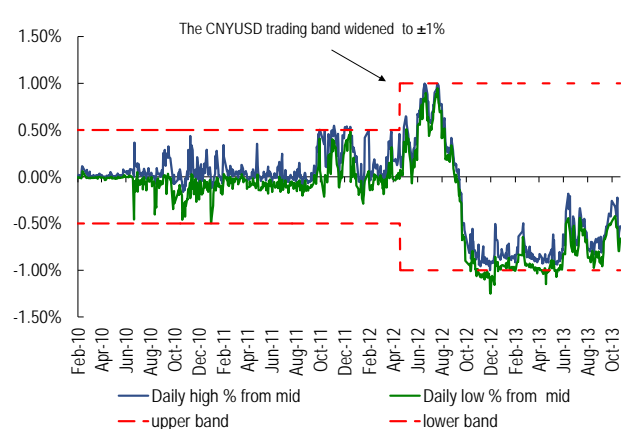
Source: NBS and Citi Research

Figure 30. FAI growth decelerated slightly



Source: NBS and Citi Research

Figure 32. Trading band may widen when outlook is more balance



Source: Bloomberg and Citi Research

Figure 33. China Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US\$ bn	2,787.2	3,494.5	4,544.0	5,070.5	5,932.5	7,319.0	8,238.5	9,259.6	10,237.4
Nominal GDP, local currency bn	22,224	26,583	31,490	34,632	40,151	47,310	51,894	57,002	62,320
GDP per capita, US\$	2,120	2,645	3,422	3,800	4,424	5,432	6,084	6,811	7,501
Population, mn	1,314.5	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,359.5	1,364.9
Unemployment, % of labour force	4.1	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2
Economic Activity									
Real GDP, % yoy	12.7	14.2	9.6	9.2	10.4	9.3	7.7	7.6	7.2
Real investment growth % yoy	13.3	14.4	11.0	19.2	11.9	9.4	8.1	8.5	6.9
Real consumption growth % yoy	9.8	11.0	8.5	9.4	9.2	10.9	8.3	7.1	7.3
private consumption growth % yoy	11.3	11.1	9.2	10.3	8.5	18.2	8.5	7.3	7.5
Prices, Money & Credit									
CPI, % yoy	2.8	6.5	1.2	1.9	4.6	4.1	2.5	3.0	3.5
CPI, % avg	1.5	4.8	5.9	-0.7	3.3	5.4	2.6	2.7	3.0
Nominal wages, % yoy	14.6	18.5	16.9	11.6	13.3	17.8	9.7	9.8	9.3
Credit extension to private sector, % yoy	14.3	19.3	14.0	33.2	20.3	15.1	14.8	14.8	13.7
Policy interest rate, % eop	2.52	4.14	2.25	2.25	2.75	3.50	3.00	3.00	3.25
1 month inter-bank rate, % eop	2.58	3.61	1.23	1.79	6.17	6.00	4.90	5.30	5.55
Long term yield, % eop	2.62	4.19	1.80	3.06	3.61	3.27	3.33	3.90	4.15
lc/US\$, eop	7.81	7.30	6.82	6.83	6.59	6.29	6.23	6.08	6.06
lc/US\$, avg	7.97	7.61	6.95	6.83	6.77	6.46	6.31	6.14	6.08
Balance of Payments, US\$ bn									
Current account	231.8	353.2	420.6	243.3	237.8	136.1	193.1	203.7	204.7
% of GDP	8.3	10.1	9.3	4.8	4.0	1.9	2.3	2.2	2.0
Trade balance	177.5	264.3	298.1	195.7	181.5	154.9	231.1	234.7	248.7
Exports	969.0	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.9	2,180.0	2,249.3
Imports	791.5	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,817.8	1,945.2	2,000.7
Service balance	-8.8	-7.9	-11.8	-29.4	-31.2	-61.6	-89.7	-98.7	-108.5
Income balance	-5.1	8.0	28.6	-8.5	-25.9	-70.3	-42.1	-0.6	-13.6
FDI, net	100.1	139.1	114.8	87.2	185.7	231.7	191.1	147.0	99.9
International reserves	1,066.3	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,734.9	3,923.4
Total Amortisations	17.9	20.3	23.3	34.2	27.2	33.2	38.8	41.8	46.0
Public Finances, % of GDP									
Consolidated government balance	-1.0	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-2.0	-2.0
Consolidated gov primary balance	-0.5	1.0	0.1	-1.8	-1.7	-0.9	-1.6	-1.6	-1.6
Public debt	18.6	39.0	37.4	47.8	49.2	44.3	45.0	45.1	45.3
of which Domestic	17.4	38.0	36.6	47.0	48.6	43.7	44.5	44.6	44.8
Foreign Assets & Liabilities, US\$ bn									
External debt	338.6	389.2	390.2	428.6	548.9	695.0	764.5	840.9	925.0
Private	304.2	354.3	356.9	391.8	510.1	657.6	723.4	795.7	875.3
Public	34.4	34.9	33.3	36.9	38.8	37.4	41.1	45.2	49.7
External debt / GDP	12.1	11.1	8.6	8.5	9.3	9.5	9.3	9.1	9.0
External debt / XGS	31.9	29.0	24.7	32.2	31.5	33.4	34.0	35.2	37.5
Short-term debt	199.2	235.7	226.3	259.3	375.7	475.7	523.2	575.5	633.1
Short-term debt/International Reserves (%)	18.7	15.4	11.6	10.8	13.2	15.0	15.8	15.4	16.1

Quarterly Economic Indicators

	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	7.7	7.5	7.8	7.4	7.2	7.0	7.1	7.5	7.2
CPI, % yoy	2.1	2.7	3.1	3.0	2.9	2.5	3.0	3.5	3.7
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50
1 month inter-bank rate, % eop	3.40	7.35	5.30	5.30	5.30	5.30	5.30	5.55	5.80
Long term yield, % eop	3.36	3.32	3.90	3.90	3.90	3.90	3.90	4.15	4.40
lc vs USD, eop	6.21	6.14	6.12	6.08	6.09	6.10	6.08	6.06	6.04

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

*Note: Public debt includes the debt of central, local govt and Ministry of Railway. Long term yield refers to 5Y Sovereign Bond yield. External debt is based on the residency of the holder of the debt (not by currency denomination).

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- **Summary view** – 3Q GDP likely to post a weak 0.2%QoQ sa growth (3.1%YoY). We expect a step up in poverty reduction measures as one-fifth of the population appears to be below the recently first-time defined poverty line. Financial reforms testing in Shanghai FTZ will provide both challenges and opportunities for HK.
- **Things to watch** – 1) The fragile trade recovery; 2) fund flows pattern in light of Fed would still taper before Jan14 and a managed China slowdown; 3) property market reactions; 4) tourist shopping trends following China's anti-graft measures; 5) political consultations to start end-2013 on electoral reforms.
- **Strategy** – EFN yields will lower near term along with their UST counterparts, with deferred Fed tapering and weak NFP release amidst further data uncertainties associated with government shutdown. Mild inflows were witnessed into China/HK funds since mid-Sep, Citi's HSI target for year-end is 24,000.

Recent data suggests 2H growth likely around 3%YoY

We expect 3Q GDP (to be released on 15 Nov) to grow at 3.1%YoY or 0.2%QoQ sa. The unexpected relapse of Aug trade data, the difficult base that Sep exports faces and a much more cautious exporter confidence index continue to highlight external fragilities which in turn will weigh on net exports contribution to GDP for the rest of the year. Retail sales data thus far also indicate that consumption continues to soften as Mainland Chinese tourists consumption appears to have dampened somewhat (although the arrivals volume remains strong but demand in large ticket items continues to decline). Together with selective local consumers, July and August retail data were on the low side. Even with the boost in new tech product launch in Sep, we expect 3Q consumption contribution to GDP will remain lukewarm only. Investment data, although continuing to be well supported by ongoing private construction and large-scale public infrastructure works, will see more difficult comparable base in 2H. Looking ahead to 4Q, the expected slowing of China GDP in the final quarter and our house latest downward revision to US' 4Q GDP to 2%QoQ saar (-0.7ppt) on the fiscal impasse suggest HK growth momentum is likely to be steady at best.

The need to tackle poverty

We expect a step up in poverty reduction measures as one-fifth of the population appears to be below the recently first-time defined poverty line. Commission of Poverty announced the poverty line for 2012 was set at 50% of median monthly household income (before tax and welfare transfers), for example, a four-person household with income below \$14,800. According to this standard, HK has a poor population of 1.02mn people or a poverty rate of 15.2%. The poverty line will become one of the key tools to measure success of poverty reduction policies going forward. However, to reduce this sizable portion of poor population and limited reduction, we believe the government in the current term will likely introduce more targeted measures to tackle poverty among the elderly and youth. However, the longer policy intention is to increase supply of public housing, which in turn would substantially reduce the financial burden of the poor. Any such measures will add to the fiscal burden; however, given that poverty reduction was one of the main policy aims of the current government, we believe further measures would likely be revealed (latest by Feb's Policy Address).

HK faces challenges & opportunities from Shanghai FTZ

Pilot zones are becoming the trend in Greater China... In a bid to test reforms, China and Taiwan are engaging in zones trials (Shanghai FTZ/Qianhai SEZ/Taiwan FEZ, etc.) to pursue financial innovations and modern service industries upgrades.

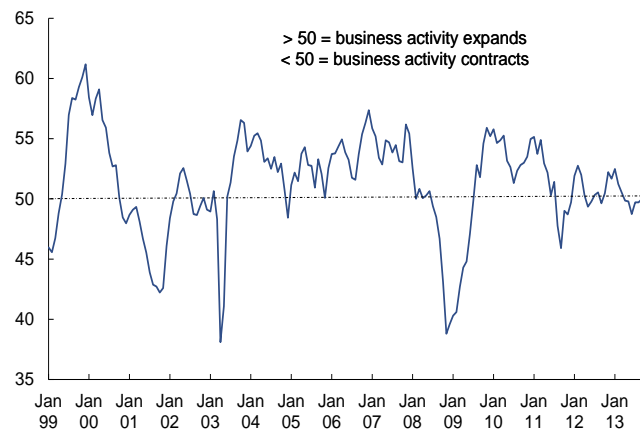
... Thus, providing both pros and cons for HK. Many warn the forthcoming competition from FTZs will marginalize HK in the long run. HK has always been a RMB offshore center, which contributed much to the internationalization of RMB in the past. The Shanghai FTZ is yet another important step for the Chinese government to further develop the RMB onshore market and test for capital account liberalization, which, when the model matures, can be rolled out to the nation. In our view, HK will continue to play an important role in China's capital account liberalization and RMB internationalization with HK's sound financial infrastructure, internationally compatible robust legal framework, open market architecture, talent pool and constant financial innovations, as well as its strong linkage between the mainland, other emerging markets and developed markets. Especially at current beginning stage of development, we see a limited time window for HK policymakers' and private sectors' quick actions to participate and cooperate with Shanghai FTZ other offshore RMB centers and create further first-mover advantages to entrench HK's status as a key offshore RMB banking center.

The need to stay competitive as imminent competition comes from many fronts. HK will need to play to its strengths and continue to innovate in order to reap this golden opportunity of RMB internationalization and become a leading RMB offshore center. HK is already working full throttle at RMB product engineering and deepening its role as regional asset management center (e.g., HK is currently the largest ETF center in the region). The next stage of development will likely focus on assisting mainland corporates and funds to invest abroad, in the form of RODI, RQDII and RQDII2. There will nevertheless be healthy competition among different markets, especially with keen interest from Singapore and London (which both were recently granted RQFII quotas by PBOC) and Taiwan (which is seeing fast pace of RMB accumulation and will benefit from large trade surplus vis-à-vis China). We think Hong Kong, with its unique strengths and circumstances, is well-positioned to play an important complementary role in the future development of RMB services. HKMA is seeking PBOC's approval to scrap the daily RMB20,000/person conversion quota, which if materialized, would accelerate the flow of RMB in HK and in turn facilitate further RMB products development.

Policy endorsement of the HKD peg at its 30th anniversary

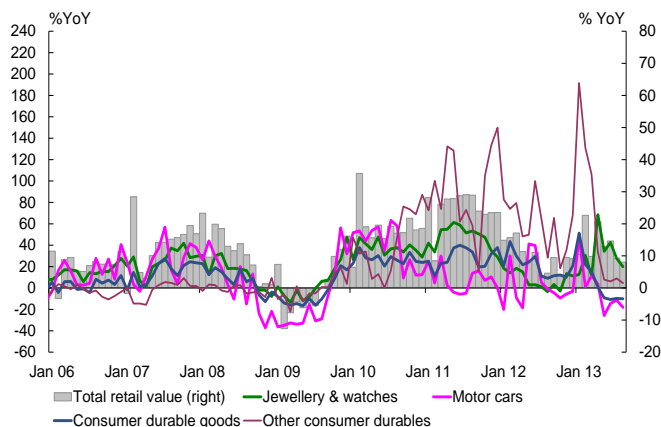
Senior government and HKMA officials reiterated their endorsement of the HKD peg's importance and the intention to maintain it status quo. HK's linked exchange rate system has provided immense stability to HK since 1983. HKMA Chief Norman Chan stressed the need for the HKD to be linked to a major international currency – the USD – especially when RMB convertibility and limited RMB assets remain the missing conditions for any potential switch, and stability is essential to help a small open economy like HK to weather through economic volatilities and to pursue further development as an IFC. Chan further refuted the possibility of a near-term peg to RMB by highlighting HK's exports (tourism is an export of service) competitiveness could be eroded and deflation and wage cuts would likely occur, as HK's productivity is insufficient to offset the growth differential HK has with China. Chan (similar to previous officials' views) reiterated the preference to use administrative measures to tackle asset price inflation. We think that property market stability and no relaxing of existing cooling measures remains the policy stance, even if more primary market supply gets launched.

Figure 34. PMI improving, but still in contraction zone



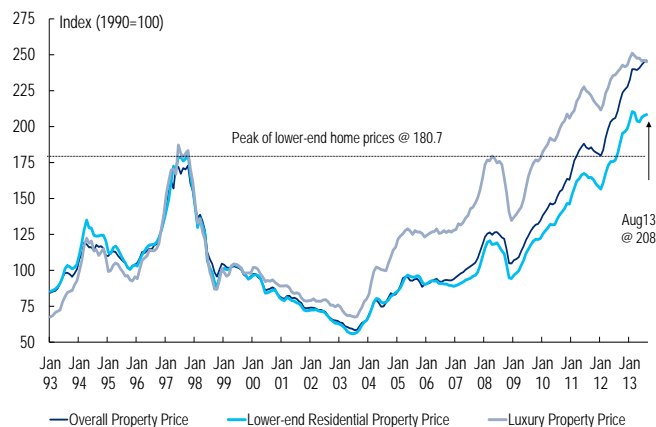
Source: Markit, Haver, Citi Research

Figure 36. Consumption slowing on selective local/foreign spending



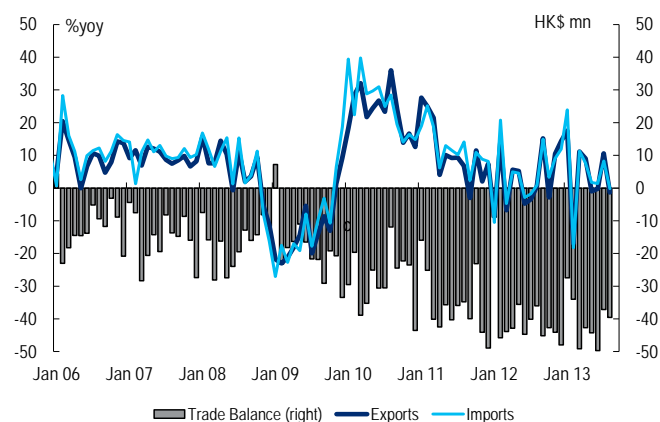
Source: CEIC, Citi Research

Figure 38. Lower-end home prices on a renewed rise trend



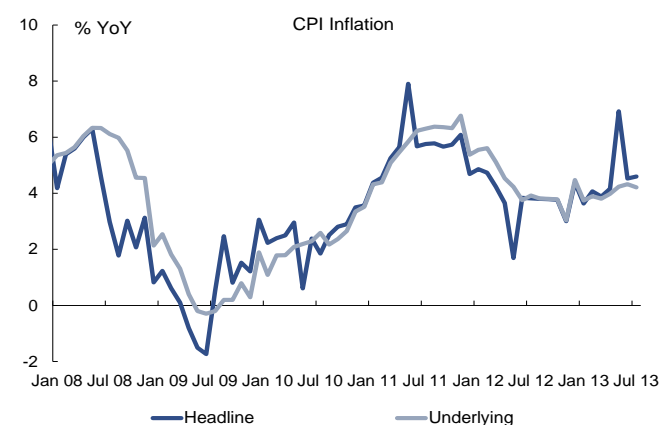
Source: CEIC, Citi Research

Figure 35. Aug data shows trade recovery fragilities



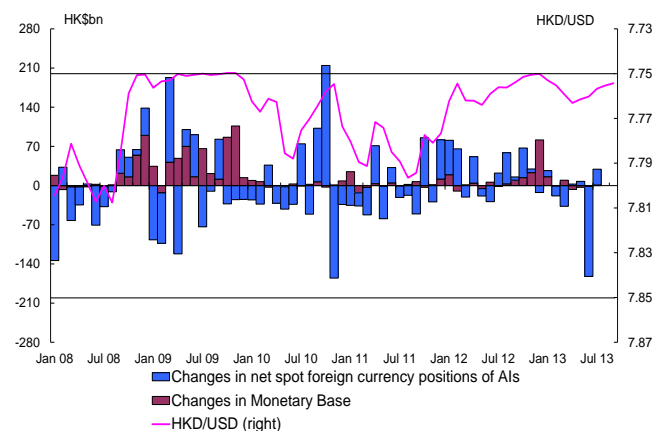
Source: CEIC, Citi Research

Figure 37. Mild price pressures as private housing pass-through slows



Source: CEIC, Citi Research

Figure 39. Back in mild inflows in Jul13



Source: HKMA, CEIC, Citi Research

Figure 40. Hong Kong Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US\$ bn	193.5	211.6	219.3	214.0	228.7	248.7	263.3	282.6	302.5
Nominal GDP, local currency bn	1,503	1,651	1,707	1,659	1,777	1,936	2,042	2,193	2,347
GDP per capita, US\$	28,031	30,497	31,488	30,594	32,429	34,971	36,697	39,081	41,497
Population, mn	6.9	6.9	7.0	7.0	7.1	7.1	7.2	7.2	7.3
Unemployment, % of labour force	4.8	4.1	3.4	5.2	4.4	3.5	3.3	3.4	3.2
Economic Activity									
Real GDP, % yoy	7.0	6.5	2.1	-2.5	6.8	4.9	1.5	3.0	3.4
Real investment growth % yoy	8.4	7.9	-0.3	1.0	11.1	2.2	5.2	3.1	3.6
Real consumption growth % yoy	5.4	7.9	1.9	1.0	5.9	8.2	3.2	3.8	2.1
private consumption growth % yoy	6.1	8.6	1.9	0.8	6.3	9.0	3.2	4.1	2.2
Real export growth, % yoy	9.4	8.3	2.5	-10.2	16.8	3.7	1.8	6.8	5.3
Real import growth, % yoy	9.1	9.1	2.2	-9.0	17.4	4.6	2.8	7.1	4.9
Prices, Money & Credit									
CPI, % yoy	2.3	3.8	2.1	1.5	2.9	5.7	3.8	4.1	3.6
CPI, % avg	2.1	2.0	4.3	0.6	2.3	5.3	4.1	4.3	3.6
Nominal wages, % yoy	2.1	2.4	4.0	-1.9	2.4	9.9	4.7	3.5	4.5
Credit extension to private sector, % yoy	2.3	15.2	11.0	-2.1	20.9	12.5	7.0	8.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	3.84	3.31	0.89	0.13	0.33	0.33	0.50	0.40	0.70
Long term yield, % eop	3.69	3.10	1.19	1.93	1.76	0.96	0.32	1.10	1.60
lc/US\$, eop	7.78	7.80	7.75	7.75	7.77	7.77	7.75	7.76	7.76
lc/US\$, avg	7.77	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.76
Balance of Payments, US\$ bn									
Current account	24.6	27.6	32.9	20.3	15.0	11.9	2.9	6.3	11.2
% of GDP	12.7	13.0	15.0	9.5	6.6	4.8	1.1	2.2	3.7
Trade balance	-17.9	-23.5	-25.9	-28.9	-43.1	-54.8	-61.6	-62.1	-60.5
Exports	316.8	344.7	363.0	318.7	390.4	429.2	443.1	464.3	505.6
Imports	334.7	368.2	388.9	347.6	433.5	484.0	504.7	526.4	566.1
Service balance	-9.3	-4.3	-2.7	3.4	10.1	16.3	22.8	23.0	23.4
Income balance	4.6	6.8	12.9	6.4	4.8	6.8	5.6	5.7	5.8
FDI, net	-15.5	-19.0	-8.9	-6.4	-10.5	-8.7	-9.0	-10.0	-11.0
International reserves	133.2	152.6	182.5	255.7	268.6	285.3	317.2	320.0	340.0
Public Finances, % of GDP									
Consolidated government balance	3.8	7.3	0.1	1.5	4.1	3.8	3.3	1.8	1.0
Consolidated gov primary balance	3.9	7.4	0.1	1.6	4.2	3.8	3.3	1.8	1.1
Public debt	1.4	1.2	1.0	0.7	0.6	0.6	0.5	1.0	1.3
of which Domestic	0.6	0.4	0.2	0.1	0.0	0.0	0.1	0.2	0.3
Quarterly Economic Indicators									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	2.9	3.3	3.1	3.0	3.2	3.4	3.4	3.6	3.7
CPI, % yoy	3.6	4.2	4.6	4.1	4.0	3.7	3.9	3.6	3.9
1 month inter-bank rate, % eop	0.21	0.21	0.21	0.23	0.25	0.35	0.45	0.55	0.65
Long term yield, % eop	0.51	1.12	1.15	1.10	1.30	1.50	1.40	1.60	2.10
lc vs USD, eop	7.76	7.76	7.76	7.76	7.76	7.76	7.76	7.76	7.75

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

*Note: Public debt is general government debt.

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India

- **Summary view** – With stability having returned to exchange rate markets, the focus has shifted back to the evolving growth inflation dynamics. Inflationary pressures have persisted despite a prolonged period of negative output gap. As a result, space for policy intervention remains severely constrained.
- **Things to watch** – A vegetable shock hit India almost at the same time as taper talk. Onion prices have been rising at a monthly rate of 33%MoM since June. Food prices are likely to soften from Oct/Nov arrivals but trends will be observed. State elections in Nov. will also be watched for leads on general elections.
- **Strategy** – After Fed's September policy, the RBI has been unwinding some of its exceptional tightening measures. The central bank reduced MSF rates by 125bps cumulatively and has hinted at a shift of operative rate to Repo gradually. However to contain inflationary pressure, RBI hiked repo rate by 25bps and is likely to hike repo by another 25-50bps in the remainder of 2HFY14.

Focus Shifting Towards Domestic Growth Inflation Mix

External risks have receded significantly, with the Rupee retracing over a third of its depreciation since May 22nd, i.e. beginning of taper talk. After an outflow of \$13bn in June-August period (debt \$9.2bn, equity \$3.8bn), portfolio flows have been positive \$1.3bn since September. Equity market has seen inflows of close to \$3.4bn since Sep, pushing the benchmark index close to its all-time high level.

Focus has shifted back to domestic growth inflation dynamics as market sentiment on exchange rate revived. The agriculture outlook remains strong and exports have seen an uptrend, but manufacturing output relapsed into contraction in August. Though activity remained sub-par, there was no let-up in inflation.

Headline inflation surges in September

Headline WPI inflation climbed to a 7-month high of 6.46%YoY in September. Food inflation at 18% YoY was the highest in 38 months, on back of a relentless rise in prices of perishables. Excluding vegetables, September WPI inflation would have printed at 4.7% vs. the headline 6.5%. Also the lagged pass-through of INR depreciation was seen in tradables, which could partly reverse with a pullback in the Rupee. September CPI was close to double digits at 9.84% with core CPI elevated at 8.4%. In contrast core WPI stood at a benign 2.1%.

We now estimate WPI to average at 6% and CPI at 9.2% in FY14 from our earlier estimate of 5.5% and 8.7%, respectively. Despite structural rigidities, we believe food prices, especially for vegetables, are likely to moderate on fresh arrivals from Oct/Nov. Easing food prices coupled with weak domestic demand conditions amid stable INR should lead to some moderation in headline inflation from current levels.

Central Bank to stay on guard

Even though sources of inflation are largely supply side, the recent surge in headline inflation is likely to keep central bank on guard nevertheless. Excluding the fuel and food items, core WPI and core CPI were relatively lower at 2.1%YoY and 8.4%YoY in Sep. However due to rising influence of CPI and diminishing role of core WPI inflation in the policy formulation exercise, we expect the central bank to hike repo rates by 25-50bps in 2HFY14, with 25bps hike in October 29th policy itself.

The rollback of exceptional liquidity conditions is likely to continue, and therefore even after 25-50 bps repo hikes, the interbank call money rates could likely drift towards 7.75%-8% from current 9% level.

Easing bottlenecks to support recovery

We maintain our GDP growth estimate at 4.8%YoY in FY14 as some early signs of recovery have emerged especially in the infrastructure sector. We expect economic activity to pick up as 1) coal, electricity production has been strengthening steadily; 2) exports have been growing at a double-digit level in the last two months; 3) agriculture production is likely to be robust; and 4) profitability has returned to the corporate sector in 2QFY14 as noted by our India equity strategists.

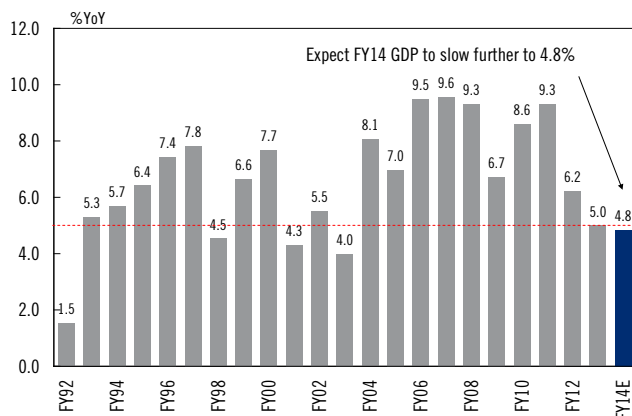
The biggest relief for the economy has come on the external front with trade deficit compressing to a monthly average of \$10.1bn in 2QFY14 from \$16.8bn in 1QFY14. In the last two months, exports have grown at double-digit rates and gold imports are down close to 80%YoY. Note that gold imports alone contributed to more than half of the \$88.2bn current account deficit in FY13. The rebalancing of external sector is likely to bring down FY14 CAD to \$68.4bn or 3.7% of GDP with a likelihood that CAD could improve further if gold imports do not pick up in the festival season.

Fiscal deficit to overshoot budget aim

Lower revenue, higher subsidies: We estimate marginal slippage in fiscal deficit to 5% of GDP due to a shortfall in revenue and an overshoot in subsidies, even after adjusting for cuts in plan expenditure. We estimate tax revenues to be lower by 0.5%GDP – at 10.4%GDP vs. 10.9% budgeted on account of a shortfall in excise and services tax collections. The oil subsidies are likely to overshoot the budget estimate by ~200bn due to large under-recoveries. The implementation of a food security bill could also put additional pressure on food subsidy to the tune of ~100bn.

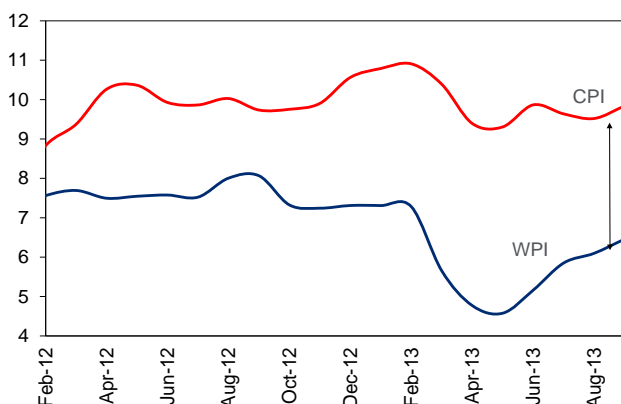
Savings likely in plan expenditure: Similar to last fiscal, there is room for plan expenditure to be pruned by close to 600bn this year. The savings arising from plan expenditure is likely to restrict slippage to 0.2% of GDP. Despite a marginal slippage this year, the chances of sovereign downgrade is low as long as the government sticks to its fiscal consolidation roadmap in the context of strong medium-term growth outlook

Figure 41. GDP: expect FY14 GDP at 4.8%YoY



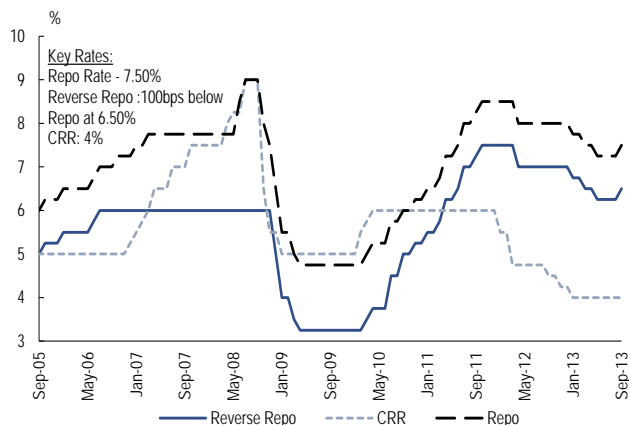
Source: CSO; Citi Research

Figure 43. Trends in WPI and CPI inflation (% YoY)



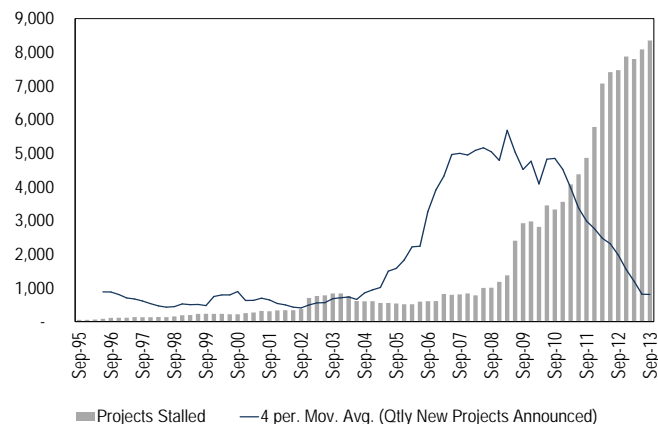
Source: Office of the Economic Advisor

Figure 45. Rate cycle reverses on rupee volatility and inflation outlook



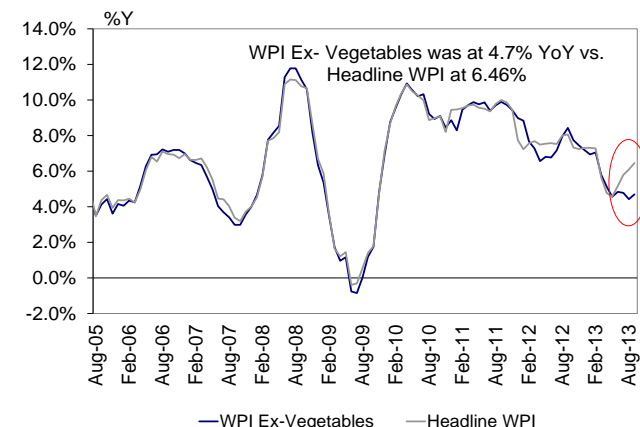
Source: RBI; Citi Research

Figure 42. Trend in projects stalled + new projects announced (Rs bn)



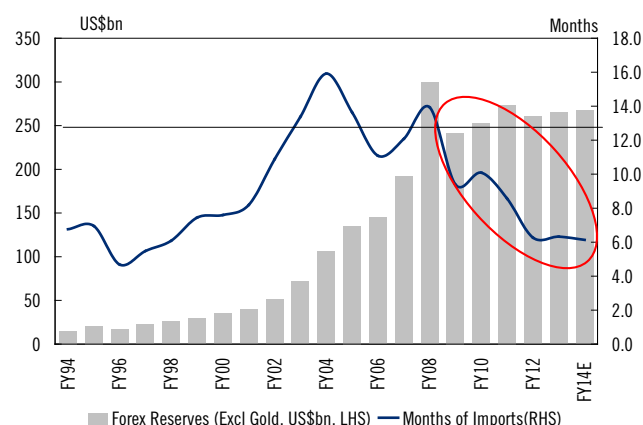
Source: CMIE

Figure 44. Headline WPI inflation led primarily by vegetables



Source: Office of the Economic Advisor

Figure 46. Trends in Forex reserves and import cover (US\$bn, Months)



Source: RBI; Citi Research

Figure 47. India Economic Indicators

	FY07	FY08	FY09	FY10	FY11	FY12F	FY13F	FY14F	FY15F
Summary Data									
Nominal GDP, US\$ bn	950.2	1,240.6	1,223.9	1,366.6	1,710.2	1,865.9	1,855.7	1,836.3	2,299.0
Nominal GDP, local currency bn	42,947	49,871	56,301	64,778	77,953	89,749	100,206	112,932	128,743
GDP per capita, US\$	847	1,090	1,061	1,168	1,442	1,552	1,521	1,483	1,829
Population, mn	1,122.0	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,220.0	1,238.3	1,256.9
Economic Activity									
Real GDP, % yoy	9.6	9.3	6.7	8.6	9.3	6.2	5.0	4.8	5.6
Real investment growth % yoy	13.4	18.1	-5.2	16.7	16.2	1.5	5.1	1.9	4.5
Real consumption growth % yoy	7.9	9.3	7.6	8.2	8.1	8.1	3.9	5.6	6.4
private consumption growth % yoy	8.7	9.2	7.1	7.1	8.6	8.0	4.0	5.3	6.5
Real export growth, % yoy	19.9	5.9	15.2	-4.7	19.7	15.3	3.0	5.2	11.0
Real import growth, % yoy	21.3	10.2	23.0	-2.1	15.8	21.5	6.8	5.0	9.5
Prices, Money & Credit									
WPI, % yoy	6.8	7.7	1.5	10.6	9.7	7.7	6.0	6.0	5.0
WPI, % avg	6.5	4.8	8.1	3.8	9.6	8.9	7.3	6.0	5.0
Credit extension to private sector, % yoy	28.5	23.0	19.0	16.0	17.0	17.5	17.5	17.5	17.5
Policy interest rate, % eop	7.50	7.75	5.00	5.00	6.75	8.50	7.50	7.75	7.75
1 month inter-bank rate, % eop	9.43	8.00	5.68	4.49	9.54	10.90	8.50	8.50	8.50
Long term yield, % eop	7.98	7.96	7.01	7.83	7.99	8.56	8.00	8.25	8.25
lc/US\$, eop	44.12	39.41	48.62	46.41	44.71	53.02	55.00	61.36	61.18
lc/US\$, avg	45.19	41.18	43.42	48.30	45.68	46.63	53.38	59.41	62.08
Balance of Payments, US\$ bn									
Current account	-9.6	-15.7	-27.9	-38.2	-48.1	-78.2	-88.2	-68.4	-60.4
% of GDP	-1.0	-1.3	-2.3	-2.8	-2.8	-4.2	-4.8	-3.7	-2.6
Trade balance	-61.8	-91.5	-119.5	-118.2	-127.3	-189.8	-195.7	-173.8	-173.2
Exports	128.9	166.2	189.0	182.4	256.2	309.8	306.6	323.4	368.7
Imports	190.7	257.6	308.5	300.6	383.5	499.5	502.2	497.2	542.0
Service balance	29.5	38.9	53.9	35.8	44.1	64.1	64.9	63.6	69.1
Income balance	-7.3	-5.1	-7.1	-8.0	-18.0	-16.0	-21.5	-24.0	-24.0
FDI, net	7.7	15.9	19.8	18.0	11.8	22.1	19.8	21.0	18.0
International reserves	191.9	299.1	241.6	252.8	273.7	260.9	264.7	259.8	274.9
Total Amortisations	11.4	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9
Public Finances, % of GDP									
Consolidated government balance	-5.4	-4.0	-8.3	-9.4	-8.0	-8.1	-7.0	-6.7	-6.4
Consolidated gov primary balance	0.0	-1.1	3.4	4.6	2.7	2.2	--	--	--
Public debt	79.9	76.1	76.8	75.8	70.7	69.9	67.6	66.8	66.2
of which Domestic	74.7	71.4	72.2	70.8	66.0	65.9	63.2	63.0	62.8
Foreign Assets & Liabilities, US\$ bn									
External debt	172.4	224.4	224.5	260.9	305.9	345.8	392.1	388.5	403.5
Private	123.0	166.3	168.6	193.9	227.8	263.9	310.5	310.2	323.2
Public	49.4	58.1	55.9	67.1	78.1	81.9	81.7	78.4	80.4
External debt / GDP	18.1	18.1	18.3	19.1	17.9	18.5	21.1	21.2	17.6
External debt / XGS	86.1	88.5	77.7	95.2	81.5	77.6	88.7	85.5	69.1
Short-term debt	28.1	45.7	43.3	52.3	65.0	78.2	96.7	96.8	101.8
Short-term debt/International Reserves (%)	14.7	15.3	17.9	20.7	23.7	30.0	36.5	37.2	37.0

Quarterly Economic Indicators

	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	4.8	4.4	4.6	5.0	5.2	5.2	5.6	5.8	5.8
WPI, % yoy	5.7	4.8	6.1	6.6	6.5	5.3	5.1	5.0	5.0
Policy interest rate, % eop	7.50	7.25	7.50	7.75	7.75	7.75	7.75	7.75	7.75
1 month inter-bank rate, % eop	9.30	8.05	10.50	9.00	8.00	8.00	8.00	8.00	8.00
Long term yield, % eop	8.00	7.50	8.40	8.50	8.25	8.25	8.25	8.25	8.25
lc vs USD, eop	54.29	59.53	62.59	61.36	62.10	62.85	62.19	61.18	60.20

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** – FX market transparency and trading volumes improved over the past month as intervention is toned down. Foreign reserves have begun to stabilize in Sep and risk perceptions have subsided. Aug showed a turnaround in the trade deficit though we doubt that the pace going forward will be as swift.
- **Things to watch** – Broadly, incoming economic data show signs of slowing growth but do not uniformly point to a sharp downturn. We stick to our view that the forthcoming adjustment to the current account deficit (CAD) will take time, and there may still be volatility along the way.
- **Strategy** – We think the IDR could see relative strength under a 0-3M horizon under a theme of Fed taper delay and domestically better policy clarity. However we are less constructive under a 6-12M horizon. On rates, we still expect BI to raise rates 25bps by YE13 and 25bps in 1Q14.

What has changed over the month?

Policy clarity has improved. After repeatedly under-guiding the market on current account and inflation forecasts, BI's tone has become more cautious. We also sense a clearer recognition among policymakers that commodity prices probably won't rebound anytime soon. FX intervention has been scaled back significantly compared to during the pre-10,000 levels. This has led to an improvement in foreign reserve levels, or at least a slowing pace of reserve decline if BI's short-term borrowings from domestic banks are excluded from the data. As the rupiah is no longer held at artificial levels, the risk of an abrupt correction of the currency has also been significantly reduced in our view. Interbank spot transaction volumes also appear to be recovering, as policymakers have in recent weeks allowed for more price transparency in the market. The Jakarta Interbank Spot Dollar Reference (JISDOR) now more accurately reflects the actual trades in the market.

Trade and current account data has turned around? Apart from positive sentiment from Fed taper delay, worries on the IDR subsided as the trade data for August showed a small surplus (from a record high deficit in July). And the YoY inflation number for September showed a decline, following the reversal of volatile spice prices, e.g. onions and chili. Exchange rate pass-through from non-food items hasn't been too noticeable in the Sep CPI data, although we observe anecdotally that some high import-content items such as electronics and cars have seen a nudge up in prices. Among the non-foods, import inflation has been most visible through the rise in gold prices, which helped pushed up the core inflation from 4.4% to 4.7%. Despite this, we think core could probably be pushed further towards 5% by YE13.

Change in CPI base year delayed to January 2014. Previously the statistics office had planned to introduce the latest CPI based on the 2012 cost of living survey, sometime in 4Q13. The new CPI was to have higher weightings on food, which by our calculation probably would have brought up the YoY inflation number by up to 0.2 percentage points. However the statistics office has rescheduled the new base year introduction to January 2014 and has also revised again the CPI weightings on food. Food will have similar weight to the current 2007 base year CPI. Although it is difficult to pinpoint the impact of this base year change to the YoY inflation number, we think it could push it slightly lower. This is because the weighting of fuel and public transport will be smaller.

Are CAD concerns really a thing of the past?

In our view, the overall incoming data does not contradict our expectation that the growth deceleration and current account turnaround will be gradual.

Consumer confidence and retail sales growth for September do show signs of weakness. However car sales for September rebounded to 14% YoY, after a weaker 2% YoY in August, following the introduction of tax breaks for small cars. Cement sales also bounced back up to positive territory (+3% YoY) concurrently. A further look at interbank clearing data also showed that the value of transactions through the system were up 30% YoY in September. (This same data set showed negative YoY growth in end-2008, following the sharp depreciation of the IDR).

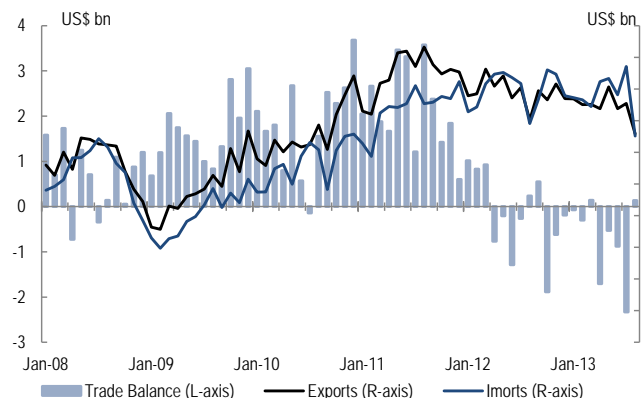
We maintain our view that the current account will improve, but the pace of the improvement will be gradual. We expect the general trend of imports to weaken in coming months following the IDR depreciation and higher interest rates. Our baseline now expects the current account deficit to improve towards 3.7% and 3.1% of GDP in 3Q and 4Q this year. Although this may be a significant improvement from the record high 4.4% in August, it is still above sustainable levels, which we think should be between 2-2.5% of GDP (assuming net FDI in the region of 1.5% of GDP).

Accordingly, volatility may still happen along the way. For example trade data has historically been very erratic, and we are not convinced that forthcoming trade balance numbers will consistently remain in surplus. A number of structural misalignments haven't been fully addressed. For example in regard to the oil trade deficit, the gap between the market price and subsidized price of fuel has increased again towards the pre-June levels (i.e., Rp 4,000 – 4,500 per liter by our estimates, from around Rp5,000 per liter before the price hikes), following the IDR depreciation. We would need to see progress in implementation of promised structural reforms, such as the government's plan to reduce the imports of diesel by raising the mandatory biodiesel usage to 10%, before being comfortable with the trajectory of the oil trade deficit. Going forward, volatile trade balance data may act to keep risk appetite in check, in our view.

We maintain our forecast of 50bps more interest rate hikes in the current cycle. The debate among policymakers has apparently focused on how to bring down the CAD back to sustainable levels (i.e., 2.5% GDP according to BI officials); this is as opposed to during the pre-taper era whereby the focus was on the overall BOP. (That is, a rising CA deficit was tolerable for as long as projected portfolio inflows were sufficient to cover the short fall). Therefore given our baseline projection of no swift current account deficit improvement, we think BI may still raise its benchmark policy rate by a further 50bps. We think their moves going forward will be data dependent. Apart from raising rates, the central bank has also further tightened regulations on property sector lending which will take time to implement.

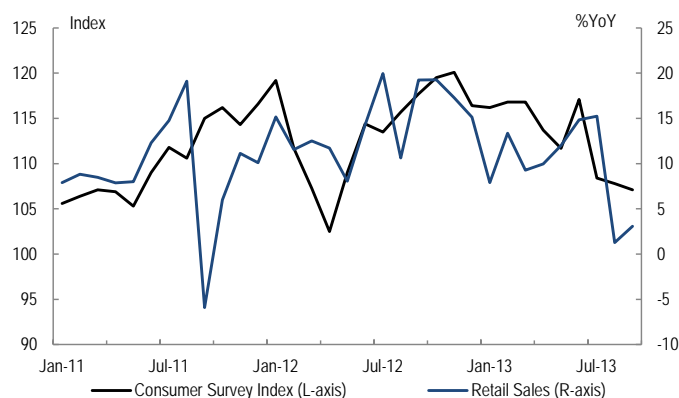
We see IDR still trading in a wide range in the forthcoming 12M. We think the IDR could see relative strength under a 0-3M horizon under a theme of Fed taper delay and domestically better policy clarity. We have also revised down our YE13 forecasts for the 10-yr yield, as investors reduce their underweights to reflect the recent positive developments. However we are less constructive under a 6-12M horizon, as the Fed tapering will eventually come to fruition and the current account improvement still may or may not be rapid enough to position the balance of payments in a comfortable surplus.

Figure 48. Trade balance slipped to small surplus in Aug



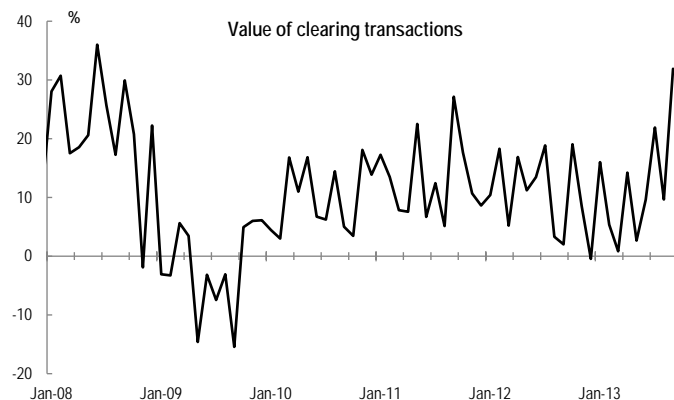
Source: CEIC, Citi Research

Figure 50. Consumer confidence and retail sales weakened



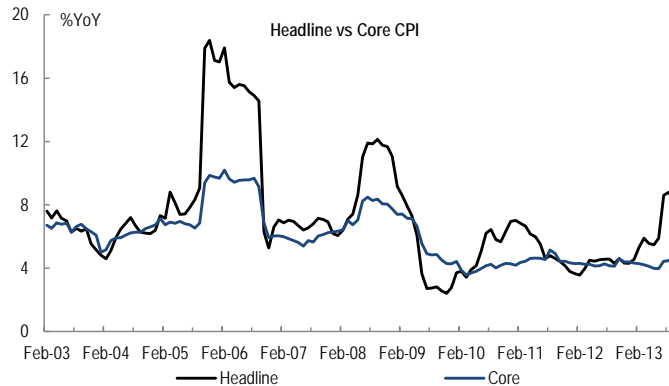
Source: CEIC, Citi Research

Figure 52. Value of bank transactions (clearing) haven't yet dropped



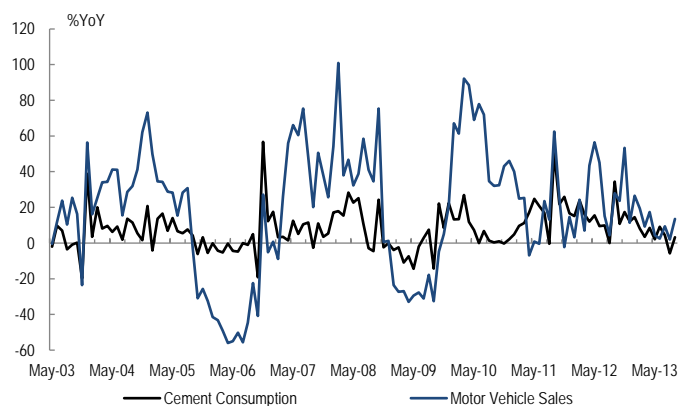
Source: BI, Citi Research

Figure 49. CPI inflation: headline has moderated, but core still rising



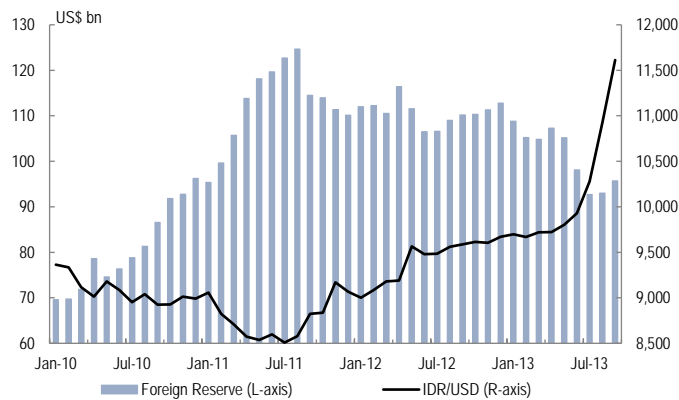
Source: CEIC, Citi Research

Figure 51. Car and cement sales rebounded in Sep



Source: CEIC, Citi Research

Figure 53. Foreign reserves have started to stabilize



Source: CEIC, Citi Research

Figure 54. Indonesia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US\$ bn	364.4	432.2	510.7	538.6	709.5	845.8	878.3	888.5	921.3
Nominal GDP, local currency bn	3,339,217	3,950,893	4,948,688	5,606,203	6,446,852	7,422,781	8,241,864	9,365,180	10,621,769
GDP per capita, US\$	1,636	1,915	2,235	2,328	2,986	3,486	3,596	3,605	3,694
Population, mn	222.8	225.6	228.5	231.4	237.6	242.6	244.2	246.5	249.4
Unemployment, % of labour force	10.3	9.1	8.4	7.9	7.1	6.6	6.1	5.9	5.9
Economic Activity									
Real GDP, % yoy	5.5	6.3	6.0	4.6	6.2	6.5	6.2	5.7	5.3
Real investment growth % yoy	1.3	1.9	12.4	2.4	8.8	10.5	16.9	4.5	3.5
Real consumption growth % yoy	3.9	4.9	5.9	6.2	4.1	4.5	4.8	4.7	4.9
private consumption growth % yoy	3.2	5.0	5.3	4.9	4.7	4.7	5.3	5.0	4.7
Real export growth, % yoy	9.4	8.5	9.5	-9.7	15.3	13.6	2.0	4.2	6.0
Real import growth, % yoy	8.6	9.1	10.0	-15.0	17.3	13.3	6.6	0.6	4.1
Prices, Money & Credit									
CPI, % yoy	6.6	5.8	11.1	2.8	7.0	3.8	4.3	8.8	4.9
CPI, % avg	13.1	6.3	9.9	4.8	5.1	5.4	4.3	7.1	6.6
Nominal wages, % yoy	6.2	4.9	7.6	5.3	12.2	3.4	20.6	28.0	15.0
Credit extension to private sector, % yoy	12.1	22.4	30.7	18.0	20.6	25.9	22.1	18.0	16.0
Policy interest rate, % eop	4.75	3.00	8.75	6.00	5.50	4.50	4.00	5.75	6.00
1 month inter-bank rate, % eop	5.75	3.35	9.44	6.39	5.66	4.57	4.24	6.65	6.90
Long term yield, % eop	10.18	10.02	11.92	10.07	7.83	6.05	5.39	7.25	8.00
Ic/US\$, eop	8994	9393	10900	9425	9010	9068	9638	11207	11446
Ic/US\$, avg	9171	9140	9673	10376	9078	8763	9361	10588	11529
Balance of Payments, US\$ bn									
Current account	10.9	10.5	0.1	10.6	5.1	1.7	-24.4	-29.3	-24.6
% of GDP	3.0	2.4	0.0	2.0	0.7	0.2	-2.8	-3.3	-2.7
Trade balance	29.7	32.8	22.9	30.9	30.6	34.8	8.6	3.9	5.5
Exports	103.5	118.0	139.6	119.6	158.1	200.8	188.5	177.4	192.8
Imports	73.9	85.3	116.7	88.7	127.4	166.0	179.9	173.4	187.3
Service balance	-9.9	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-10.1	-9.6
Income balance	-13.8	-15.5	-15.2	-15.1	-20.8	-26.7	-26.7	-25.3	-24.0
FDI, net	2.2	2.3	3.4	2.6	11.1	11.5	14.0	12.7	12.0
International reserves	42.6	56.9	51.6	66.1	96.2	110.1	112.8	96.4	91.4
Total Amortisations	16.4	18.8	16.7	20.4	24.0	25.1	40.3	41.0	42.0
Public Finances, % of GDP									
Consolidated government balance	-0.9	-1.3	-0.1	-1.6	-0.7	-1.1	-1.9	-2.1	-1.8
Consolidated gov primary balance	1.5	0.8	1.7	0.1	0.6	0.1	-0.6	-1.1	-0.2
Public debt	39.6	34.1	29.3	31.4	26.4	23.6	23.6	25.0	26.0
of which Domestic	22.6	19.7	16.2	19.3	16.7	15.5	16.1	15.6	15.6
Foreign Assets & Liabilities, US\$ bn									
External debt	132.6	141.2	155.1	172.9	202.4	225.4	252.4	270.0	297.0
Private	56.8	60.6	68.5	73.6	83.8	106.7	126.2	131.5	155.0
Public	75.8	80.6	86.6	99.3	118.6	118.6	126.1	138.5	142.0
External debt / GDP	36.4	32.7	30.4	32.1	28.5	26.6	28.7	30.4	32.2
External debt / XGS	115.3	108.2	100.1	130.2	115.8	101.8	119.3	134.2	136.4
Short-term debt	12.2	18.7	20.5	24.0	31.6	36.6	43.4	44.0	47.0
Short-term debt/International Reserves (%)	28.7	32.8	39.7	36.4	32.8	33.2	38.4	45.6	51.4
Quarterly Economic Indicators									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	6.0	5.8	5.5	5.6	5.2	5.1	5.3	5.6	5.4
CPI, % yoy	5.9	5.9	8.4	8.8	7.4	7.4	5.3	4.9	5.2
Policy interest rate, % eop	4.00	4.25	5.50	5.75	6.00	6.00	6.00	6.00	6.00
1 month inter-bank rate, % eop	4.18	4.45	5.70	6.65	6.90	6.90	6.90	6.90	6.90
Long term yield, % eop	5.74	7.21	8.54	7.25	7.50	7.75	8.00	8.00	8.00
Ic vs USD, eop	9718	9925	11580	11207	11430	11655	11587	11446	11308

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).

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Malaysia

- **Summary view** – Downside risks to growth alongside subdued inflation suggest BNM remains in no hurry to hike, though growth disappointments could result in slight slippages to the 4% of GDP fiscal deficit target. Incoming data suggests a temporary improvement in the CA surplus in 2H13.
- **Things to watch** – (1) Fiscal reforms in the Oct 25th Budget; (2) Deferral of public sector projects; (3) Guidance from BNM on rate hikes.
- **Strategy** – Amidst Fed taper delay, CA stabilization, likely reforms in the Budget and a fall in foreign MGS holdings to 42.7% of outstanding (from a peak of 49.5% in May), we turn more neutral on the MYR near term.

Downside risks to growth even as CA stabilizes

The disappointing Aug IP has raised downside risks to growth. Despite a sequential expansion in Aug exports, Aug IP saw a broad-based 4.6%MoM SA decline (Jul: +1.8%), with Manufacturing declining 5.4%MoM SA (Jul: +2.4%), which we estimate was led by a 4.0%MoM SA contraction in Electrical & Electronics (E&E). Overall, average Jul-Aug seasonally-adjusted Manufacturing IP levels are now 1.1% below their 2Q average, while Mining is 2.7% below and Electricity also 1.6% below. However downside risks are likely more a reflection of manufacturers keeping inventories lean amidst uncertainty resulting in choppy growth rather than a slowdown that results in job losses. With inventories not particularly bloated at this stage, we don't see further dramatic drops in production either.

Full-year growth could fall short of the official 4.5-5% forecast range. While we had previously expected a 2H13 pick-up to bring full-year 2013 growth to 4.8%, the surprisingly weak Sep IP figure poses downside risks to this forecast. While Sep could see a technical rebound as sentiment may have stabilized out, this may not be strong enough to keep full-year growth from falling out of the government's 4.5-5% forecast range into the 4-4.5% zone – we now expect full-year 2013 growth of 4.4%. Nonetheless domestic demand should continue to anchor 3Q GDP – we estimate Jul-Aug capital goods imports are 5% above 2Q while Jul-Aug consumption goods imports are 1.8% above 2Q, though there are some hints of slowing momentum.

The Aug trade data continues to substantiate our view of an exports recovery given the earlier 1H13 surge in imports of intermediate goods. Our estimates suggest exports continued to pick up into Aug, bringing average Jul-Aug seasonally-adjusted exports 7.6% above 2Q. In line with upbeat E&E exports, most tech leading indicators remain fairly supportive with 6 out of 9 indicators in Aug showing MoM increases – into Sep, 2 out of 3 available indicators rose MoM. Nonetheless the recent softening of intermediate goods imports and the substantial Jul-Aug contribution of commodities exports do warrant some caution – we estimate Jul-Aug intermediate goods imports are now 3.1% below 2Q after the 2Q surge.

Overall, we could see a possible stabilization in the trade and current account balance in 2H13 – the trade surplus widened in Aug to RM7.1bn (Jul: RM2.9bn). With a likely exports recovery and some slowdown in domestic demand alongside possible delays to some public sector projects with high import content, we now expect the current account surplus for the full-year 2013 to come in at 3% of GDP (prev: 2.3%), though the magnitude of any improvement will likely be capped by still robust domestic demand and capital goods imports.

BNM likely remains in no hurry to hike

We expect Sept CPI inflation of 2.6%YoY (Aug: 1.9%). The 20sen/litre hikes in RON95 and diesel prices in early Sep should impute a direct 0.6%MoM shock to Sep CPI. But taking a cue from the second-round effects from the June 2008 80sen/litre hike on food, transport and other services costs and adjusting proportionately, we think the overall impact could be larger at 0.9%MoM. Hence Sep CPI inflation could rise to 2.6%YoY and further second-round effects could push the inflation figure to approach 3% by early 2014, hovering at these levels in 1H14 until a likely 10sen/litre hike in June pushes inflation higher to 3.3-3.5% in 2H14.

Overall, the data continues to suggest rate hikes are not yet in the picture. BNM Governor Zeti recently commented that she is focused “mostly on growth” over the next 6-12 months as global growth should remain “subdued” while inflation is stable given steady demand growth and significant capacity additions. With BNM seeing the balance of risks as tilted towards growth rather than inflation, uncertainties over the outlook suggest that BNM will not be in a hurry to hike. Zeti’s comments that credit growth has moderated to a sustainable pace and that there are no asset bubbles forming also suggest that rates are unlikely to be hiked on financial stability concerns – macro-prudential measures likely remain the preferred response for such issues.

Our forecast is still for a first rate hike in 2Q14, though this remains highly data dependent. Apart from the Sept CPI figure and the extent of second-round price effects, our interest rate path is also dependent on the timing of further subsidy rationalization – we assume another two 10sen RON95 fuel price hikes in June and December next year. To prevent the real OPR rate from turning negative, we expect BNM to hike in 2Q14 in anticipation of a further RON95 price hike in June 2014 which would push headline inflation decisively above 3%.

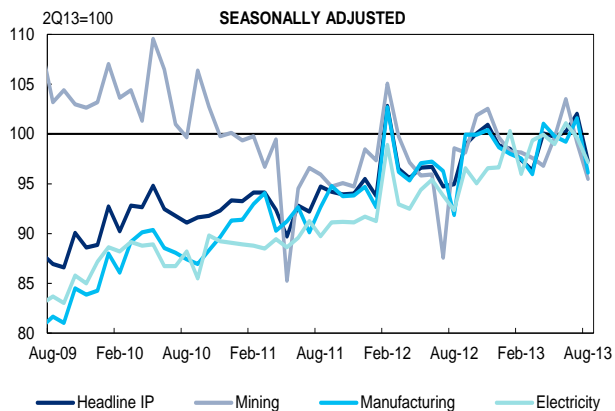
All eyes on the Oct 25th Budget

The UMNO vice-presidential elections have further cemented PM Najib’s position. Datuk Seri Ahmad Zahid Hamidi, Datuk Seri Shafie Apdal and Datuk Seri Hishammuddin Hussein – all aligned to the PM – retained their UMNO vice-presidencies and fended off a challenge from Datuk Mukhriz Mahathir, son of former PM Mahathir. This suggests the fiscal reform agenda should remain insulated from challenge, though the swing back to affirmative action is unlikely to be reversed (and likely contributed to the vice-presidential status quo).

GST implementation for 2015 will likely be announced, though timeline for fuel price hikes could prove elusive. There are concerns that a detailed and concrete timeline for subsidy rationalization could lead to hoarding and raise inflation expectations, though it remains to be seen if a blank commitment will be sufficient to convince ratings agencies. However we continue to expect a GST rate of 4-5% to be announced, which could be accompanied by a timeline for personal and corporate income tax cuts.

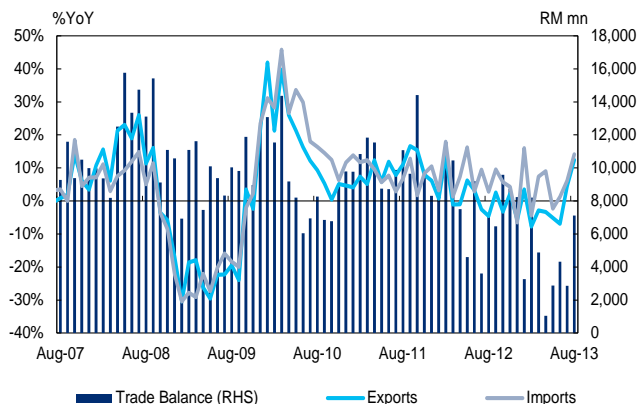
Growth disappointments could also raise questions about whether the 4% of GDP fiscal deficit target is achievable. While the 4% target will likely be reiterated along with the official 4.5-5% growth forecast, we do not rule out the possibility of small fiscal slippage in the actual deficit if growth disappoints in 2H13. The 2014 deficit target will likely be cut to 3.5% of GDP, in line with the target to reduce it to 3% of GDP by 2015.

Figure 55. Disappointing Aug IP has raised downside risks to growth



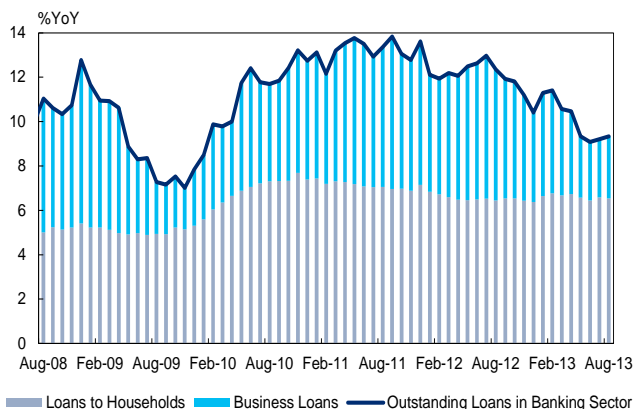
Source: CEIC, Citi Research

Figure 57. The trade surplus widened in Aug



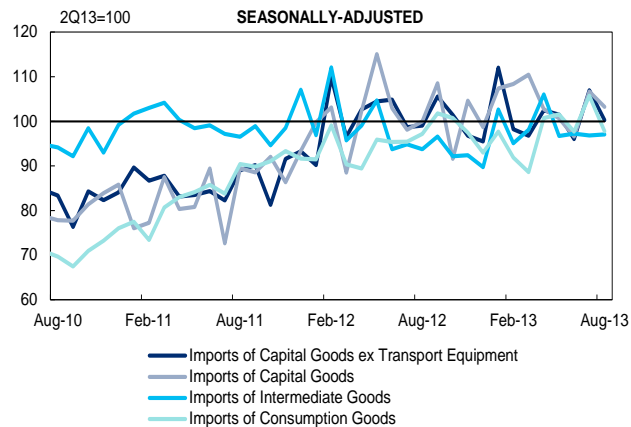
Source: CEIC, Citi Research

Figure 59. Credit growth has moderated



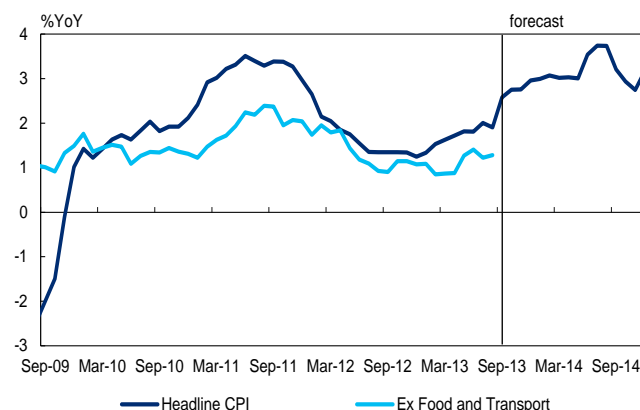
Source: CEIC, Citi Research

Figure 56. Domestic demand should continue to anchor 3Q GDP



Source: CEIC, Citi Research

Figure 58. We expect Sept CPI inflation of 2.6%YoY



Source: Haver, Citi Research

Figure 60. We expect a 2Q14 rate hike to keep the real OPR positive



Note: Prior to April 2004, BNM used the Intervention Rate to affect the Base Lending Rate; however since Apr 2004 it has used the Overnight Policy Rate.

Source: CEIC, Citi Research

Figure 61. Malaysia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US\$ bn	162.8	193.7	231.1	202.4	247.7	289.3	305.0	314.8	335.8
Nominal GDP, local currency bn	597	665	770	713	797	884	941	998	1,054
GDP per capita, US\$	6,067	7,123	8,393	7,255	8,664	9,987	10,398	10,529	11,009
Population, mn	26.8	27.2	27.5	27.9	28.6	29.0	29.3	29.9	30.5
Unemployment, % of labour force	3.3	3.2	3.3	3.7	3.2	3.1	3.0	2.9	2.9
Economic Activity									
Real GDP, % yoy	5.6	6.3	4.8	-1.5	7.4	5.1	5.6	4.4	5.0
Real investment growth % yoy	8.6	9.1	1.8	-9.4	25.3	2.3	22.3	9.6	4.6
Real consumption growth % yoy	6.4	9.7	8.4	1.4	6.2	8.6	7.1	5.8	4.8
private consumption growth % yoy	6.6	10.4	8.7	0.6	6.9	6.8	7.7	6.9	6.2
Real export growth, % yoy	6.7	3.8	1.6	-10.9	11.1	4.6	-0.1	-1.1	4.3
Real import growth, % yoy	8.2	5.9	2.3	-12.7	15.6	6.1	4.7	1.2	3.9
Prices, Money & Credit									
CPI, % yoy	3.1	2.3	4.5	1.0	2.1	3.0	1.2	3.0	3.2
CPI, % avg	3.6	2.0	5.4	0.6	1.7	3.2	1.6	2.0	3.7
Nominal wages, % yoy	2.1	4.3	4.5	2.5	8.2	3.8	6.4	5.0	5.0
Credit extension to private sector, % yoy	6.8	9.2	10.2	6.8	10.9	12.4	12.1	11.0	11.0
Policy interest rate, % eop	3.50	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50
3 month inter-bank rate, % eop	3.71	3.61	3.37	2.17	2.98	3.22	3.21	3.21	3.70
Long term yield, % eop	3.70	3.78	3.00	3.79	3.39	3.23	3.24	3.60	4.00
lc/US\$, eop	3.53	3.31	3.45	3.42	3.08	3.17	3.06	3.15	3.11
lc/US\$, avg	3.67	3.44	3.33	3.52	3.22	3.06	3.09	3.17	3.14
Balance of Payments, US\$ bn									
Current account	26.2	29.7	39.4	31.4	27.1	33.5	18.6	9.4	8.4
% of GDP	16.1	15.4	17.1	15.5	10.9	11.6	6.1	3.0	2.5
Trade balance	38.0	38.1	51.1	39.8	42.5	49.6	40.7	26.2	27.0
Exports	161.5	176.5	198.9	157.0	199.2	228.8	227.9	236.2	242.0
Imports	123.5	138.5	147.7	117.1	156.7	179.2	187.2	210.0	215.0
Service balance	-2.6	0.4	0.5	1.2	-0.4	-2.1	-4.5	-1.0	-3.0
Income balance	-9.3	-8.7	-12.2	-9.6	-15.0	-14.0	-17.6	-15.8	-15.6
FDI, net	0.0	-2.7	-7.8	-6.3	-4.3	-3.1	-7.0	-2.0	-1.0
International reserves	82.5	101.3	91.5	96.7	106.5	133.6	139.7	151.0	157.0
Total Amortisations	5.3	7.8	6.3	9.8	11.3	9.0	9.3	10.0	10.0
Public Finances, % of GDP									
Consolidated government balance	-3.2	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-4.0	-3.5
Consolidated gov primary balance	-1.1	-1.2	-3.0	-4.7	-3.5	-2.8	-2.4	-2.0	-2.0
Public debt	40.6	40.1	39.8	50.8	51.1	51.6	53.3	53.7	53.0
of which Domestic	36.4	37.1	37.2	48.9	49.0	49.5	51.5	52.0	51.5
Foreign Assets & Liabilities, US\$ bn									
External debt	52.0	56.2	66.6	68.3	72.6	81.5	82.8	94.7	98.5
Private	30.8	37.8	41.5	41.9	44.7	53.7	55.6	89.0	93.0
Public	21.2	18.4	25.2	26.3	27.9	27.8	27.1	5.7	5.5
External debt / GDP	32.0	29.0	28.8	33.7	29.3	28.2	27.1	30.1	29.3
External debt / XGS	28.5	27.4	29.0	36.9	31.4	30.7	31.1	33.9	34.3
Short-term debt	12.1	16.3	22.5	22.7	25.4	32.9	30.4	40.0	42.0
Short-term debt/International Reserves (%)	14.6	16.1	24.6	23.5	23.8	24.6	21.8	26.5	26.8
Quarterly Economic Indicators									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	4.1	4.3	4.9	4.2	7.5	4.8	4.2	3.7	5.1
CPI, % yoy	1.6	1.8	2.6	3.0	3.0	3.5	3.2	3.2	3.0
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.50	3.50
3 month inter-bank rate, % eop	3.21	3.20	3.21	3.21	3.20	3.45	3.70	3.70	3.70
Long term yield, % eop	3.22	3.20	3.35	3.60	3.70	3.80	3.90	4.00	4.10
lc vs USD, eop	3.09	3.16	3.26	3.15	3.15	3.15	3.13	3.11	3.09

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** – Upside risk surrounds our 3Q GDP forecast of 6.9%YoY due to positive export surprise in Aug, strong purchasing power of remittances and buoyant fiscal spending. Downside risk likely to come from weak farm output due to monsoon/typhoon shocks. Upside inflation risk in place although still benign.
- **Things to watch** – Faster primary fiscal spending due to spate of flooding and typhoon damage in Aug-Sep, rehab and relief aid following military conflict in Zamboanga city and Bohol earthquake. 3Q GDP growth may probe 8%YoY despite these shocks, when money supply eases following 30%YoY rise in Aug.
- **Strategy** – Lacking monetary tightening, BSP may relent to a PHP below 43 in response to CPI upticks coincident with the end-year remittance season. Tightening risk and unabated fiscal debt supply conspire to weaken sentiment for long duration.

Identifying the spending catalysts and downside risks

We retain our 2013 GDP growth forecast of 7.3% although recent economic indicators in 3Q13 underscore upside risk. Following strong Aug exports (20.2%YoY), we see 3Q13 exports could rise by 7.3%YoY to snap out of two straight quarterly declines. Higher net export contribution to 3Q GDP of 2.4% (vs our base case estimate of 0.7%) could be the potential GDP impact. Lacking upside symmetry for imports, the higher net export contribution could yield 3Q GDP growth of 8.8%YoY. This hefty Aug export gain is unlikely to recur for the rest of the year but it marks a good turning point for exports.

Strong non-tech exports of manufactures (Aug. +18.7%YoY) and unprocessed goods including agro-based products (+118%YoY) underpinned upbeat exports. Ignition wiring sets (12.2%YoY) and woodcrafts & furniture (68.7%YoY), chemicals (128.9%YoY), processed food & beverages (191.67%YoY) were among the non-tech mfg exports that fared well. Semiconductor devices/components fell 9.6%YoY but non-chip, tech products, e.g., electronic data processing equipment, expanded 35.2%YoY to ease semi-conductor weakness.

Another GDP stimulus in 3Q13 would be the strong purchasing power of the OFW remittances likely to uplift HH consumption. Weak PHP in July-Aug coupled with sustained disinflation in 3Q13 enabled the real peso value of OFW remittances to rise by 9.1%YoY in Aug after a 7.5%YoY rise in July. For 3Q13, the real peso value of remittances probably elevated its share of real HH consumption to 16.9% from 14%-15% share in 1H13. This higher ratio in 3Q13 strongly suggests basic and discretionary spending can be given a stronger lift by OFW remittances.

Primary fiscal spending stimulus was evident as well when this expanded by 18.8%YoY in July-Aug. Public outcry against alleged misuse/diversion of the presidential development assistance fund of key Senators have led to a broader investigation of lump sum funds in the budget. Petitions filed in the High Court to stop pork barrel fund releases could slow down budgetary disbursements.

Downside growth risk would come from farm output that was affected by strong monsoons/typhoons during the quarter as well as the conflict between the military and Muslim armed gunmen in Zamboanga city. As the military flushed out the Muslim armed group that hostaged coastal residential communities in the city, business activities ground to a halt while inflicting damage to private property and infrastructure. Close to Php4bn of budget resources were pledged for rehabilitation/relief in the affected areas to partially offset foregone regional GDP.

Blurring tightening signals as CPI upticks begin

A Monetary Board (MB) member signaled unchanged policy and SDA rates for the rest of the year. According to Bloomberg, the MB member (Dr. Felipe Medalla) highlighted: 1) inflation slightly below target but can inch up a bit (Sep CPI: 2.7%YoY vs Aug CPI: 2.1%YoY); 2) unchanged policy rate and SDA rate until 1Q14; 3) US debt deal buys time but markets to remain volatile; 4) no need for a change in policy settings; and 5) ensure there's enough liquidity in the markets.

How long can the MB delay tightening signals/actions amid robust GDP prospects and inflation upticks likely to be aggravated in the near-term by recent typhoon shocks? **If policy settings would not be adjusted in the next quarter with the new inflation cycle of monthly CPI at 3%YoY or more in full swing, we can only think of BSP relenting to a stronger PHP starting 3Q13 to help anchor rising inflation expectations.** We sense BSP's 'pro-remittance peso bias' remains strong as it defends the line in the sand of 43 through spot market purchases and by keeping the onshore swap market rate negative to partially narrow any PHP arb opportunity against a heavily discounted offshore PHP NDF rate. Lacking monetary tightening signals/actions amid an EM risk-on environment (after a US fiscal crisis was averted), we expect PHP would be allowed to breach downside of 43 in Nov-Dec coincident with a strong end-year remittance season and seasonal import slack. Rising BOP surplus of US\$3.8bn as of Sep presumably from the remittance-driven current account surplus, that sustained official reserves of US\$83.5bn, also argues for a strong PHP. We forecast PHP strengthening close to the 42 range by end-Dec although BSP's 'market guidance' would determine the actual levels.

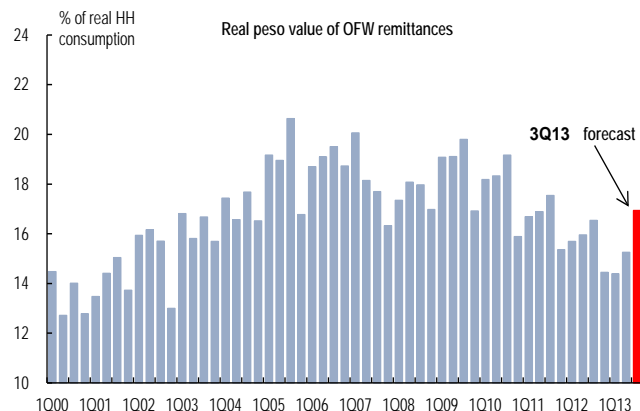
2-digit money supply gains failed to weaken PHP

We should abandon any hope that persistent 2-digit money supply gains would 'weaken' PHP. The peso yield curve particularly the long bond yields refused to flatten (shifts in US treasuries affect USD) despite money supply growth of 30.9%YoY (Aug) as SDA investors compelled to move out of BSP's SDA facility prefer to park bulk of their monies with the banks in savings/time deposits instead of the long bonds. Unabated debt supply risk could also be a reason with planned peso bond sales of Php80bn this quarter vs. Php45bn in 4Q12 soon after generating Php150bn proceeds in retail treasury bond sales. Additional liquidity arising from an expected Php107bn in maturities (series 5-67 matures on Jan 27th) may also spur new debt supply (5yr debt sale of Php30bn in Dec). Rising inflation outlook despite its benign character would lead to tightening signals/actions at some point in time that could cause the entire yield curve to eventually shift up coincident with the new inflation cycle. Lacking a weak fiscal position often considered as the 'macro weakness in the belly of the system' would enable the inflation uptrend to stay fairly benign and thus won't require rapid and severe monetary tightening adjustments.

Likely to take its time in making the rate adjustments

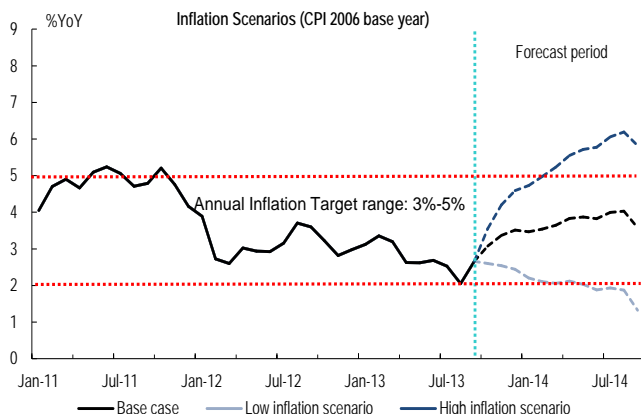
BSP would probably respond to upside inflation risk primarily using macro prudential measures to deter spill over into a stronger PHP. BSP could start with a hike in SDA rate (25bp) or bank reserve requirement perhaps in 2Q14 post-US tapering. In 3Q14 when the inflation cycle may start to peak in the 4% range, overnight rate adjustments could be initiated with a 25bp hike (SDA rate following suit). Policy rate hikes will be 'reactive' rather than pro-active with inflation still within the BSP's target range of 3%-5% next year while BSP remains averse to strong PHP appreciation. We probably will end 2014 with an overnight rate at 4% and another 50bp hike in 2015 assuming inflation probes 5%. Tightening risk and unabated fiscal debt supply conspire to weaken sentiment for long duration.

Figure 62. OFW remittances in real terms elevated 3Q13 consumption



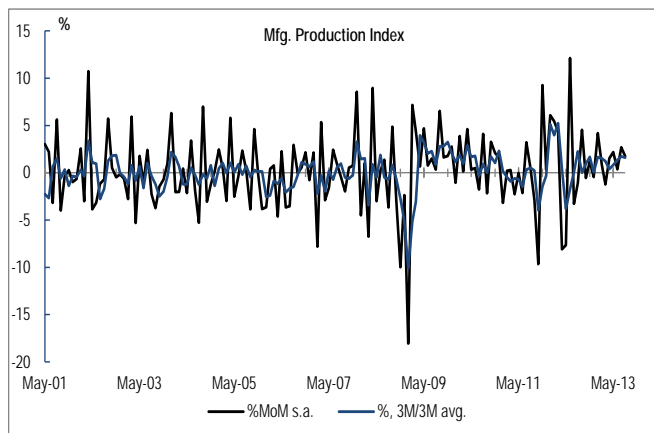
Source: CEIC, Citi Research

Figure 64. CPI upticks expected following Sep CPI of 2.7%YoY



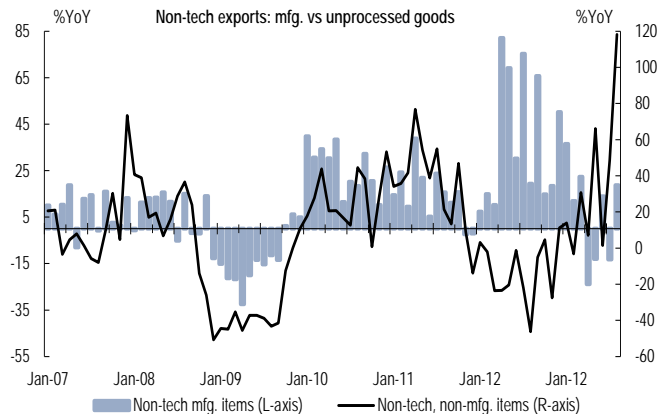
Source: CEIC, Citi Research

Figure 66. Mfg index SA in Aug posted a 5th straight monthly gain



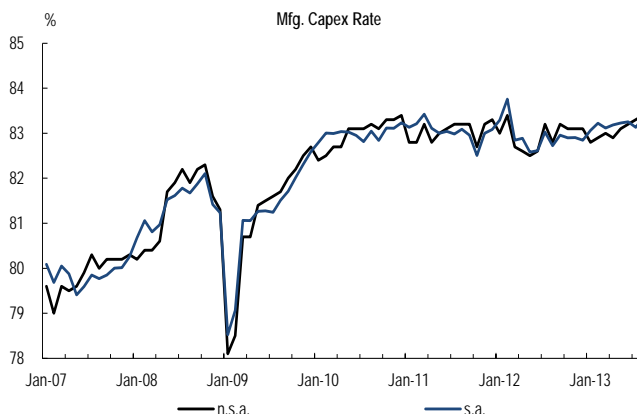
Source: CEIC, Citi Research

Figure 63. Non-tech mfg and unprocessed goods uplifted Aug exports



Source: CEIC, Citi Research

Figure 65. Capacity utilization rate SA set a new high of 83.3% in Aug



Source: Bangko Sentral ng Pilipinas, CEIC, Citi Research

Figure 67. Official reserves in Sep can still cover 1yr worth of imports



Source: CEIC, Citi Research

Figure 68. Philippines Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US\$ bn	122.4	150.2	173.4	168.6	200.0	224.1	250.5	273.5	310.0
Nominal GDP, local currency bn	6,271	6,893	7,721	8,026	9,003	9,706	10,565	11,663	12,929
GDP per capita, US\$	1,408	1,693	1,917	1,829	2,127	2,339	2,567	2,752	3,064
Population, mn	87.0	88.7	90.5	92.2	94.0	95.8	97.6	99.4	101.2
Unemployment, % of labour force	8.0	7.3	7.4	7.5	7.3	7.0	7.0	6.5	6.0
Economic Activity									
Real GDP, % yoy	5.2	6.6	4.2	1.1	7.6	3.6	6.8	7.3	6.9
Real investment growth % yoy	-15.1	-0.5	23.4	-8.7	31.6	2.0	-3.2	18.7	7.8
Real consumption growth % yoy	4.9	4.9	3.3	3.3	3.4	5.2	7.3	6.7	6.3
private consumption growth % yoy	4.2	4.6	3.7	2.3	3.4	5.7	6.6	5.7	6.0
Real export growth, % yoy	12.6	6.7	-2.7	-7.8	21.0	-2.8	8.9	-3.8	3.1
Real import growth, % yoy	3.5	1.7	1.6	-8.1	22.5	-1.0	5.3	-0.6	2.5
Prices, Money & Credit									
CPI, % yoy	4.3	3.9	8.0	4.3	3.6	4.2	3.0	3.5	3.7
CPI, % avg	6.3	2.8	9.3	3.2	4.1	4.7	3.2	2.9	3.7
Nominal wages, % yoy	7.7	3.4	5.5	0.0	5.8	5.4	7.0	2.0	6.0
Credit extension to private sector, % yoy	9.0	10.6	12.8	4.3	13.8	15.8	14.4	10.0	13.5
Policy interest rate, % eop	7.50	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.00
1 month Philippine Reference rate, % eop	6.35	6.03	5.20	4.11	0.75	1.68	-1.38	-1.00	2.50
Long term yield, % eop	5.99	5.70	6.55	6.25	4.78	4.21	3.70	2.85	3.50
lc/US\$, eop	49.05	41.23	47.47	46.50	43.65	43.84	41.06	41.86	41.05
lc/US\$, avg	51.28	46.05	44.48	47.56	45.06	43.29	42.22	42.32	41.25
Balance of Payments, US\$ bn									
Current account	5.3	7.1	3.6	9.4	8.9	7.0	7.1	10.0	10.1
% of GDP	4.4	4.7	2.1	5.5	4.5	3.1	2.8	3.6	3.3
Trade balance	-9.0	-10.4	-14.4	-9.7	-12.3	-17.0	-15.2	-12.8	-14.0
Exports	32.4	34.1	35.2	29.8	37.6	38.3	46.3	48.2	51.6
Imports	41.4	44.4	49.5	39.4	49.9	55.2	61.5	61.0	65.6
Service balance	2.4	4.2	2.6	2.9	4.1	5.3	3.9	3.3	3.3
Income balance	11.9	13.3	15.4	16.1	17.2	18.7	18.4	19.0	20.4
FDI, net	-2.8	0.6	-1.3	-1.6	-0.7	-1.3	-1.0	2.0	3.0
International reserves (ex-gold)	23.0	33.8	37.6	44.2	62.4	75.3	83.8	88.0	93.5
Total Amortisations	9.4	6.3	8.2	6.4	9.5	7.3	8.5	9.3	9.7
Public Finances, % of GDP									
Consolidated government balance	-1.0	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-2.3	-2.0
Consolidated gov primary balance	3.9	3.7	2.6	-0.2	-0.2	0.8	0.7	0.7	1.0
Public debt	61.4	53.9	54.7	54.8	52.4	51.0	51.5	50.0	49.5
of which Domestic	34.3	31.9	31.3	30.8	30.2	29.6	32.8	32.5	32.0
Foreign Assets & Liabilities, US\$ bn									
External debt	53.9	55.5	54.3	54.9	60.0	60.4	60.3	65.0	68.7
Private	16.5	17.5	13.7	11.6	13.9	14.1	15.2	17.0	21.2
Public	37.4	38.0	40.6	43.2	46.2	46.4	45.2	48.0	47.5
External debt / GDP	44.0	36.9	31.3	32.5	30.0	27.0	24.1	23.8	22.2
External debt / XGS	131.0	120.9	117.0	131.8	113.3	107.7	93.0	96.0	95.5
Short-term debt	5.0	7.1	7.0	4.0	6.3	7.0	8.5	10.5	11.8
Short-term debt/International Reserves (%)	21.8	21.0	18.6	9.0	10.1	9.3	10.1	11.9	12.6
Quarterly Economic Indicators									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	7.7	7.5	6.9	7.1	6.8	7.3	7.0	6.6	6.5
CPI, % yoy	3.2	2.7	2.7	3.5	3.6	3.8	3.8	3.7	3.6
Policy interest rate, % eop	3.50	3.50	3.50	3.50	3.50	3.50	3.75	4.00	4.00
1 month Philippine Reference rate, % eop	-0.36	0.26	-0.39	-1.00	-0.50	0.00	1.50	2.50	3.00
Long term yield, % eop	2.93	2.80	3.02	2.85	2.85	3.00	3.50	3.50	3.50
lc vs USD, eop	40.85	43.10	43.48	41.86	41.56	41.26	41.14	41.05	40.98

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

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

Singapore

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- **Summary view** – We raised our full-year growth forecast after the 3Q GDP Advance Estimates surprised on the upside. While the upward trajectory for core inflation suggests slope steepening in Apr 2014 cannot be ruled out, our base case remains for MAS to stay on hold in Apr 2014.
- **Things to watch** – (1) Near-term export momentum, especially electronics; (2) trajectory of COE premiums which could influence headline; (3) housing market developments; (4) labour market developments; (5) household leverage.
- **Strategy** – SGD NEER movements should be driven by broad DXY trends. While slope steepening in Apr 2014 cannot be ruled out, our base case remains for MAS to stay on hold in Apr 2014.

Raising forecasts on 3Q GDP upside surprise

The 3Q GDP Advance Estimates surprised on the upside with a smaller than expected sequential decline (3Q: -1%QoQ SAAR, +5.1%YoY; 2Q: +16.9%QoQ SAAR, +4.2%YoY). The sequential decline in headline GDP was narrowed by a 1%QoQ SAAR expansion in services on trade-related and financial services even as Construction fell 8.8%QoQ SAAR and Manufacturing fell 3.4%QoQ SAAR.

The 2013 official GDP forecast was maintained at 2.5-3.5%, with the MAS statement noting that growth is “unlikely to be significantly different in 2014, as externally-oriented sectors see a “modest uplift” while domestic-driven sectors “remain resilient”. At face value, the assessment of continued expansion despite some volatility in growth rates is not significantly different from the Apr assessment that growth will be “confronted by intermittent bouts of external volatility.” Into 2014, MAS expects the cyclical expansion to continue, with growth similar to the 2.5-3.5% expected in 2013 (Citi: 3.5%).

We nudged up our 2013 GDP forecast to 3.6% (prev 3.2%), which still implies technical recession as 4Q GDP would still have to fall 0-1%QoQ SAAR. Even so, any technical recession in 2H13 would take place from elevated levels in 2Q – suggesting that the output gap remains positive – and would remain within implied official expectations of a 2-16%QoQ SAAR decline for 4Q. Importantly, we note that the year-end level of GDP implied by the upper half of the current official forecast range of 2.5-3.5% remains well within year-end levels implied by the earlier forecast of 1-3% which prevailed at the time of the Apr policy decision. With the lower half of the forecast range unlikely to materialize barring the realization of tail risks, the starting point for 2014 GDP is unlikely to be significantly different from earlier expectations.

MAS expects the labour market to remain at “full employment” on supply constraints. Recent data continued to paint the picture of a generally tight labour market despite the uptick in the unemployment rate to 2.1% s.a. in 2Q (1Q: 1.9%). Seasonally-adjusted job vacancies eased to 52K in 2Q (1Q: 54.8K), lowering the ratio of job vacancies to unemployed persons (a measure of demand-supply balance in the labour market) to 1.12 (1Q: 1.21), which is still above 1. Looking ahead, the recent Manpower Inc. survey continued to point to improving hiring intentions (3Q/4Q13 net employment outlook: +15/+21%, 2Q13: +17%) amid further tightening in foreign worker supply after latest round of tightening on July 1st.

Low risk of Apr 2014 tightening despite rising core

The MAS decision to stand pat was justified by the rise in core inflation in line with earlier expectations despite downside surprises in historical headline inflation data having prompting an earlier 1%pt cut in MAS's headline inflation forecasts in July. This confirms our earlier view that a lowering of inflation forecasts – especially if due to historical disappointments – is not necessarily a precursor to policy easing. Out of now 11 episodes when inflation forecasts were lowered since 2001, MAS only eased in four and even tightened in one.

MAS narrowed its forecasts for headline CPI to 2.5-3% and core inflation 1.5-2% for 2013. With greater clarity over the COE premium trajectory after the recent announcement of COE recategorization – average car COE premiums have picked up strongly in Sep and Oct (though MAS does not expect increases to be sustained) which could push 4Q headline up to 2.4%YoY and we edge up our full-year forecast to 2.5% (prev: 2.4%) – MAS narrowed its 2013 headline inflation forecast to the upper half of the previous 2-3% forecast range. But with core inflation remaining well-behaved such that the official 2013 core forecast was narrowed to the lower half of the previous 1.5-2.5% range, there remains no urgency to tighten policy. Inflation expectations have also continued to edge down.

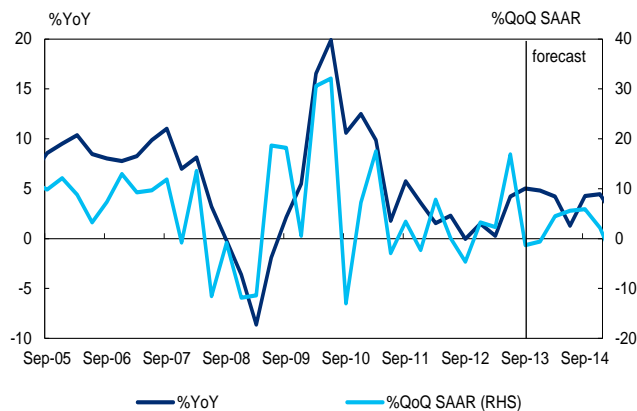
With 2014 core inflation likely to stay in lower half of MAS's 2-3% forecast, we see lower risk of tightening. MAS expects core inflation to rise over the next few quarters on rising cost pressures from labour costs, business rentals and COE premiums for commercial vehicles – all symptoms of a continuing positive output gap. While the official forecast implies core inflation may breach the MAS's implicit 2-2.5% tolerance threshold in 2014 and slope steepening in Apr 2014 cannot be ruled out, our forecasts suggest that notwithstanding the upward trajectory, core inflation will likely remain in the lower half of the official forecast range and thus our base case remains for MAS to stay on hold in Apr 2014.

Medium-term disinflationary/deflationary pressures

Beyond the next 6-12 months, we earlier noted three medium-term disinflationary forces: [1] Cost competitiveness strains and supply constraints from economic restructuring could potentially temper the pace of recovery and core inflation as FDI slows and the SME sector consolidates. [2] Significant pipeline of housing supply from 2014 onwards may pressure property prices and rentals downwards. [3] Deleveraging in certain over-indebted segments of households could slow consumption spending, especially when interest rates rise (likely in 2015).

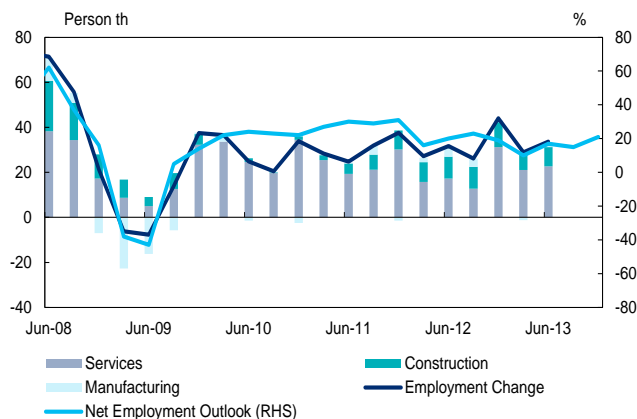
These forces could have a larger bearing on the outlook from late 2014 and 2015, though only the first risk is likely to directly trigger a monetary policy response and only in the event of an external demand shock. The latter two risks have in recent times coincided with periods of recessions and MAS easing, but if broader growth holds up this time, these will likely be tackled via sector-specific administrative and supply side measures. Any further delay of QE tapering may weaken the argument for MAS easing, as it could add to domestic liquidity risks amidst a tide of capital inflows. Indeed, a firmer recovery in external demand that offsets these domestic forces may even provide flexibility for MAS to tighten if core inflation breaches tolerance thresholds, more so that financial conditions remain accommodative while the recent imposition of TDSR will limit unintended consequences of low short-term rates from slope steepening.

Figure 69. 3Q GDP Advance Estimates surprised on the upside



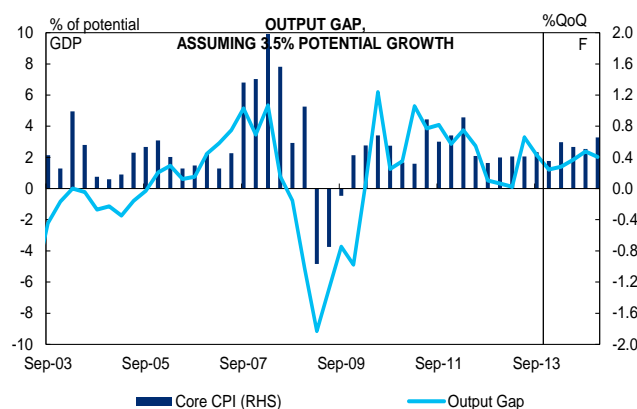
Source: CEIC, Citi Research

Figure 71. The labour market is expected to remain at full employment



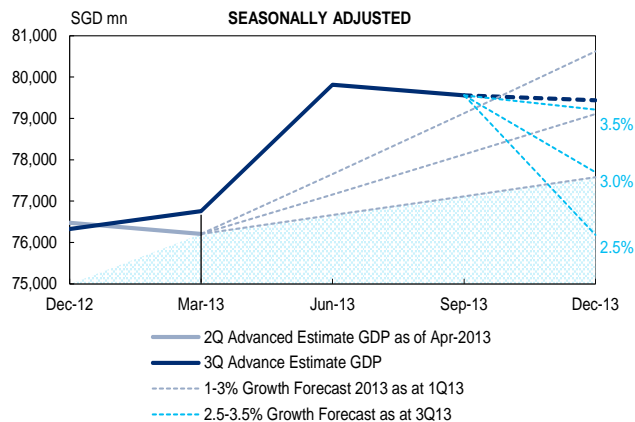
Source: Manpower Inc, CEIC, Citi Research

Figure 73. The output gap likely remains positive



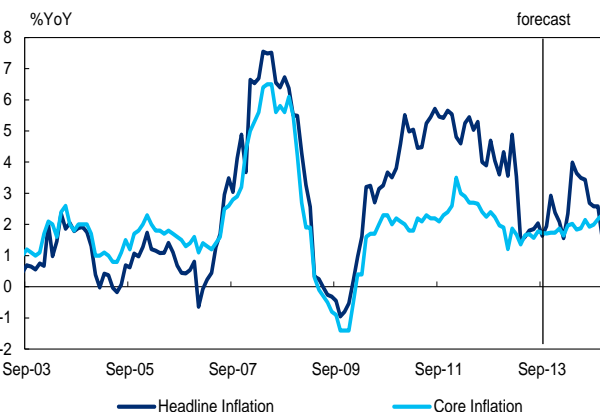
Source: CEIC, Citi Research

Figure 70. A technical recession is likely be within official expectations



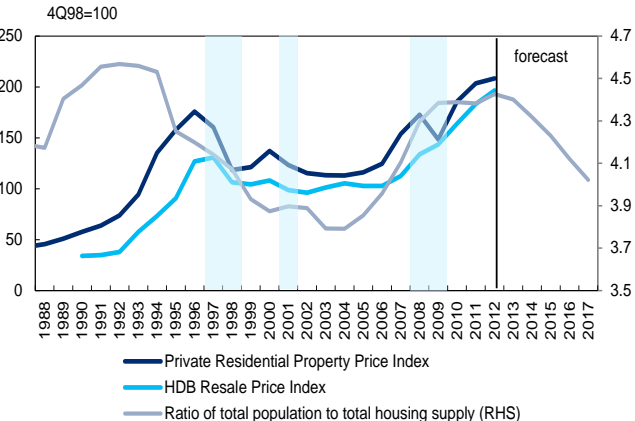
Source: CEIC, Citi Research

Figure 72. 2014 core inflation likely to stay in lower half of MAS forecast



Source: CEIC, Citi Research

Figure 74. A tempered approach to property-specific measures is likely



Source: CEIC, Citi Research

Figure 75. Singapore Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US\$ bn	145.8	178.2	190.8	189.4	232.2	265.8	276.8	290.9	316.6
Nominal GDP, local currency mn	231	268	270	275	316	334	346	364	389
GDP per capita, US\$	33,131	38,828	39,434	37,970	45,741	51,275	52,099	53,883	57,563
Population, mn	4.4	4.6	4.8	5.0	5.1	5.2	5.3	5.4	5.5
Unemployment, % of labour force	2.7	2.1	2.3	3.0	2.2	2.0	1.9	1.9	1.8
Economic Activity									
Real GDP, % yoy	8.6	9.0	1.7	-0.8	14.8	5.2	1.3	3.6	3.5
Real investment growth % yoy	17.2	16.8	28.5	-21.0	5.4	12.7	26.8	1.8	-3.2
Real consumption growth % yoy	4.5	5.9	3.6	0.5	7.2	3.7	0.9	3.9	2.6
private consumption growth % yoy	4.5	6.7	2.9	-0.5	6.2	4.6	2.2	1.8	1.9
Real export growth, % yoy	10.8	9.0	5.0	-7.6	18.6	3.5	0.3	1.4	3.8
Real import growth, % yoy	11.1	8.1	9.6	-11.2	15.9	3.6	3.2	1.6	2.9
Prices, Money & Credit									
CPI, % yoy	0.8	3.7	5.5	-0.5	4.6	5.5	4.3	2.4	1.3
CPI, % avg	1.0	2.1	6.6	0.6	2.8	5.2	4.6	2.5	2.6
Nominal wages, % yoy	3.2	6.2	5.4	-2.7	5.6	6.0	2.3	5.0	5.5
Credit extension to private sector, % yoy	4.9	16.9	15.2	2.0	13.4	18.6	13.2	12.0	11.0
3 month inter-bank rate, % eop	3.44	2.38	1.00	0.69	0.44	0.38	0.38	0.35	0.40
Long term yield, % eop	3.05	2.68	2.05	2.66	2.71	1.63	1.30	2.50	3.00
lc/US\$, eop	1.53	1.44	1.43	1.41	1.28	1.30	1.22	1.24	1.22
lc/US\$, avg	1.59	1.51	1.41	1.45	1.36	1.26	1.25	1.25	1.23
Balance of Payments, US\$ bn									
Current account	36.1	46.4	28.8	33.5	62.1	65.4	51.5	40.7	42.7
% of GDP	24.8	26.0	15.1	17.7	26.7	24.6	18.6	14.0	13.5
Trade balance	50.6	57.8	42.8	49.3	66.0	72.7	61.0	59.8	66.0
Exports	281.0	312.5	354.5	288.6	371.2	434.4	436.0	443.9	456.0
Imports	230.4	254.7	311.7	239.3	305.2	361.7	375.1	384.1	390.0
Service balance	-7.3	-2.7	-1.6	-1.7	2.3	0.7	0.4	1.4	2.0
Income balance	-7.2	-8.7	-12.4	-14.1	-6.3	-8.0	-9.9	-18.7	-24.0
FDI, net	18.1	10.1	5.4	0.9	28.3	29.7	33.6	33.0	32.0
International reserves	136.3	163.0	174.2	187.8	225.8	237.7	259.3	260.0	270.0
Public Finances, % of GDP									
Consolidated government balance	0.0	2.8	0.1	-0.3	0.3	1.2	1.1	0.7	0.5
Consolidated gov primary balance	0.6	2.7	1.1	-0.8	0.2	1.3	1.5	0.4	1.0
Public debt	89.2	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0
of which Domestic	89.2	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0
Quarterly Economic Indicators									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	0.3	4.2	5.0	4.8	4.2	1.3	4.3	4.5	2.1
CPI, % yoy	3.5	1.8	1.6	2.4	2.3	3.5	2.6	1.3	0.4
1 month inter-bank rate, % eop	0.38	0.38	0.42	0.35	0.35	0.35	0.35	0.40	0.45
Long term yield, % eop	1.54	2.51	2.35	2.50	2.60	2.75	2.90	3.00	3.00
lc vs USD, eop	1.24	1.27	1.26	1.24	1.24	1.24	1.23	1.22	1.21

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

*Note: Public debt is general government debt.

South Korea

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- **Summary view** – Macro data in hand implies that the economy maintained a mild recovery pace over the 3Q though investment needs to be further watched. CPI inflation came in lower than expected in Sep but we expect it to head up given narrowing negative output gap and upside potentials.
- **Things to watch** – Housing market transactions and purchase price improved on the back of additional boosting measures. However, delay in implementation of the measures could dampen sentiment. The BoK will likely further expand its FX safety net to strengthen vulnerability of FX market.
- **Strategy** – While foreigners could shift away from consecutive buying at stock market, we expect KRW appreciation trend to be supported by continued current account surplus. The BoK is likely to keep policy rate unchanged till the end of 1H14 at the least to secure economic recovery.

Macro trends hint at continued recovery

Economic recovery trend likely remained intact in 3Q13. Aug data showing a rapid rebound in industrial production (IP) and steady recovery in retail sales support our view that economic growth of around 1%QoQ sa continued in the third quarter. Despite constraints from the nationwide electricity conservation policy, IP grew 2.0%YoY in Jul-Aug vs. -0.7% in 2Q, with production increase in IT products driven by smartphone demand. Retail sales in Jul-Aug grew 1.8%YoY vs. 1.1% in 2Q, with broad-based gains seen in durables, semi-durables, and non-durables sales. However, investment looks uncertain and should be further watched. Construction work completed improved in Aug but Jul-Aug growth weakened to 14.1% vs. 15.6% in 2Q while construction orders received remained sluggish. Equipment investment reversed to grow on a monthly basis in Aug and recorded a positive YoY growth, at 4.6%, for the first time since Apr 2012. Yet this was largely attributable to purchase of a large aircraft and investment in machineries continued to fall, despite mild recovery of exports and increase in capital goods imports. Export growth rose to 2.8%YoY in 3Q, up from 0.7% in 2Q, with upswings in vessel and semiconductors persisted during the quarter. Import growth during the period also rose to 0.1%YoY, from -2.7% in previous quarter.

Housing market rebounds but we stay cautious. After the government unveiled measures to stabilize the Jeonse/rental market on Aug 28th, housing sales transactions picked up again and YoY decline in housing purchase price narrowed in Sep. However, with uncertainties about passage and the time of enforcement of the measures, Jeonse prices continued to rise and the ratio of Jeonse to purchase price, especially for the Seoul metropolitan area, remained on an uptrend. Given that many people purchased homes after the government proposed the permanent cut in property acquisition tax rate in its second round housing market stimulus package, the cut could become effective this year and be applied retroactively from Aug 28th. The government will also have to decide on ways to make up for the expected tax revenue shortfall caused by the acquisition tax cut. However, if implementation of boosting measures is delayed, it could weigh on market sentiments and lead potential homebuyers to defer purchases in the meantime.

Benign inflation with upside potentials

We expect inflation to head up till next year. Sep CPI inflation came in lower than expected at 0.8%YoY, a 14-year low, mainly as agricultural products and oil prices declined. Reflecting the downside surprise, we now forecast CPI inflation for 2013-14 at 1.3% and 2.4% respectively. While deflationary pressures from the supply side has kept CPI inflation subdued recently, we expect headline inflation to trend up till next year as negative output gap narrows with economic recovery and as effect of government support on childcare wears off next March. Moreover, taxi fares in Seoul metropolitan area were raised this month and more public service charges, e.g., electricity rates for industries, are waiting to be hiked. Yet, we think further strengthening of KRW against USD could partially offset upside risks from volatile agricultural products and oil prices. We expect CPI inflation to approach the midpoint of the BoK's inflation target band of 2.5~3.5% at the end of 2014.

Expect further KRW gains and expansion of FX safety net

KRW strengthened on continued current account surplus and foreign inflows to stock markets. Current account surplus, maintained for 19 straight months in Aug, continues to back KRW strengthening against USD. More recently, foreign buying of domestic stocks has led gain in KRW. As of Oct 21st, foreign investors recorded a net purchase for 37 consecutive business days at the Kospi market, the longest period ever and totaling US\$11.5bn. During the period, USD/KRW slid from 1,116.90 to 1,062.20. Though uncertainties over the Fed tapering impact and US fiscal issues could cap KRW gains, we expect continued current account surplus (2014: US\$43.9bn of 3.2% of GDP) to mainly support further appreciation of KRW, bringing USD/KRW down to 1,055 in 0-3 months and to 1,030 in 6-12 months.

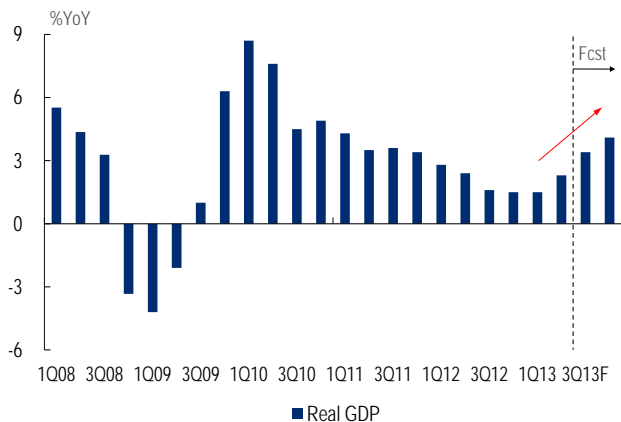
BoK expands currency swap arrangements to enhance FX market stability.

The BoK agreed on bilateral, three-year currency swap deals with Indonesia, UAE, and Malaysia this month. In addition to the record high FX reserves (US\$336.9bn as of end-Sep), Korea now has swap lines worth US\$128.5bn in total and according to Yonhap Infomax, a swap arrangement with Australia is also being discussed. Swap lines will likely increase trade settlements between the countries and, in turn, reduce US dollar demand when FX market risk heightens.

Policy rate to remain on hold

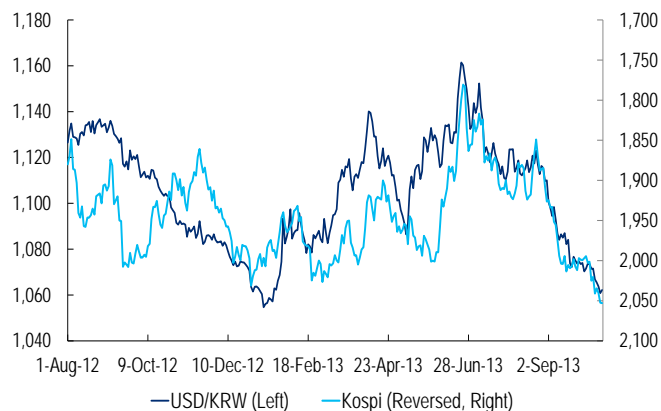
BoK cuts 2014 growth by 0.2%p to 3.8%. The policy rate was left unchanged at 2.50% at the MPC meeting on Oct 10th as the BoK viewed the economy recovering gradually amid increased external uncertainties. While the BoK maintained 2013 GDP growth forecast at 2.8%, it lowered 2014 growth to 3.8% from previous 4.0% alongside downward adjustments in world economic growth and trade growth, and upward revision of crude oil price forecast. Its revised forecasts are broadly in line with our 2013-14 forecasts of 2.9% and 3.7% respectively. Although imminent downside risks from US debt ceiling has receded, we think the BoK will not hike its policy rate till the end of 1H14, at the least, in order to secure the economy from falling into recession. On the other hand, we do not think the BoK will cut the rate to induce KRW weakness as the effect will not be significant or lasting.

Figure 76. Economy will likely remain on recovery track



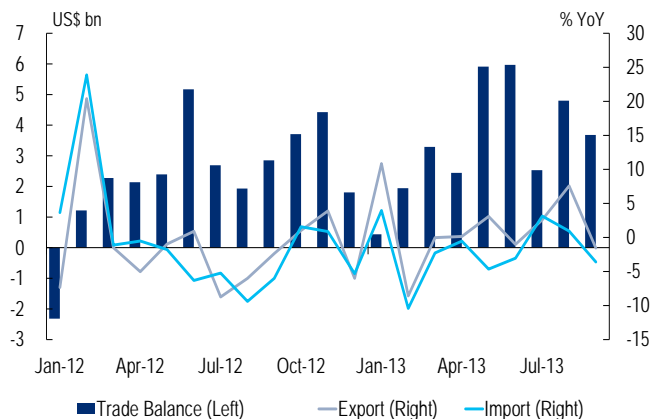
Source: Bank of Korea, Citi Research

Figure 77. KRW strength recently backed by inflows to Kospi market



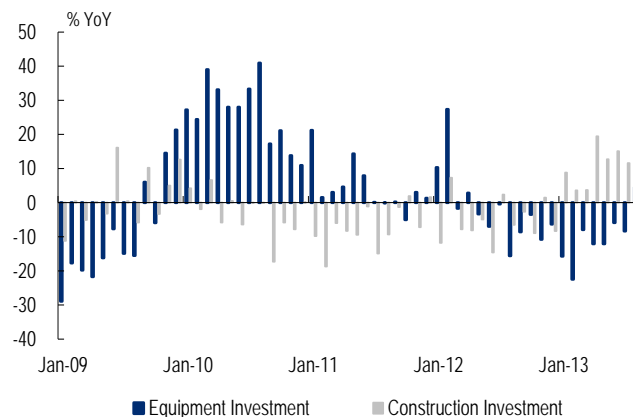
Source: Bank of Korea, Citi Research

Figure 78. Exports fell in Sep but 3Q growth showed a mild recovery



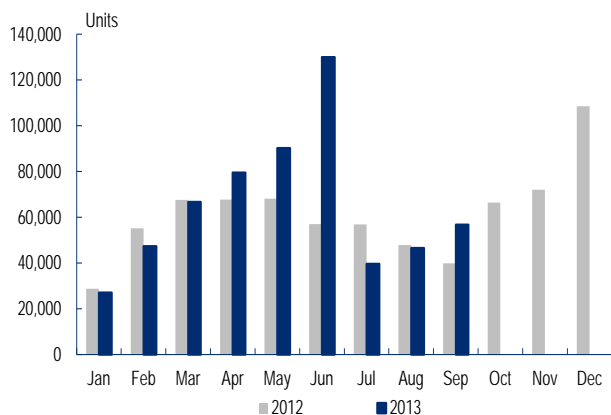
Source: Korea International Trade Association, Citi Research

Figure 79. Investment shows an improving trend



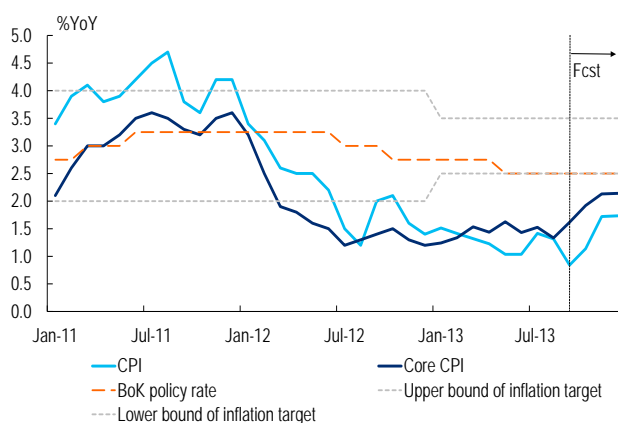
Source: Statistics Korea, Citi Research

Figure 80. Housing transactions picks up again in Sep



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

Figure 81. Policy rate was kept on hold amid benign inflation



Source: Bank of Korea, Statistics Korea, Citi Research

Figure 82. Korea Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US\$ bn	954.0	1,048.0	929.1	834.7	1,014.9	1,114.8	1,129.3	1,208.0	1,363.5
Nominal GDP, local currency bn	908,744	975,013	1,026,452	1,065,037	1,173,275	1,235,161	1,272,460	1,322,724	1,402,360
GDP per capita, US\$	19,722	21,565	18,981	16,972	20,540	22,395	22,584	24,054	27,041
Population, mn	48.4	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4
Unemployment, % of labour force	3.5	3.2	3.2	3.6	3.7	3.4	3.2	3.1	3.1
Economic Activity									
Real GDP, % yoy	5.2	5.1	2.3	0.3	6.3	3.7	2.0	2.9	3.7
Real investment growth % yoy	4.4	3.5	0.0	-13.5	15.8	1.4	-1.8	1.0	2.5
Real consumption growth % yoy	5.1	5.1	2.0	1.2	4.1	2.3	2.2	2.2	2.9
private consumption growth % yoy	4.7	5.1	1.3	0.0	4.4	2.4	1.7	1.7	3.0
Real export growth, % yoy	11.4	12.6	6.6	-1.2	14.7	9.1	4.2	5.7	6.1
Real import growth, % yoy	11.3	11.7	4.4	-8.0	17.3	6.1	2.5	4.2	5.5
Prices, Money & Credit									
CPI, % yoy	2.1	3.6	4.1	2.8	3.0	4.2	1.4	1.7	3.0
CPI, % avg	2.2	2.5	4.7	2.8	3.0	4.0	2.2	1.3	2.4
Nominal wages, % yoy	5.7	5.6	-4.1	2.6	6.8	1.0	5.3	4.3	5.2
Credit extension to private sector, % yoy	14.7	12.4	15.0	2.3	3.6	5.1	1.9	5.3	7.0
Policy interest rate, % eop	4.50	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.50
91-Day CD Rate, % eop	4.76	5.73	4.68	2.82	2.80	3.55	2.89	2.70	2.75
Long term yield, % eop	5.00	5.78	3.77	4.92	4.08	3.46	2.97	3.35	3.65
lc/US\$, eop	930	936	1263	1166	1121	1159	1064	1051	1017
lc/US\$, avg	955	929	1102	1275	1156	1108	1127	1095	1029
Balance of Payments, US\$ bn									
Current account	14.1	21.8	3.2	32.8	29.4	26.1	43.1	62.1	43.9
% of GDP	1.5	2.1	0.3	3.9	2.9	2.3	3.8	5.1	3.2
Trade balance	16.1	14.6	-13.3	40.4	41.2	30.8	28.3	37.6	23.5
Exports	325.5	371.5	422.0	363.5	466.4	555.2	547.9	559.7	587.4
Imports	309.4	356.8	435.3	323.1	425.2	524.4	519.6	522.0	564.0
Service balance	-13.3	-12.0	-5.7	-6.6	-8.6	-5.8	2.7	6.8	10.1
Income balance	-4.0	-3.4	3.8	1.6	-2.1	0.3	2.1	3.1	0.3
FDI, net	-7.6	-17.9	-16.9	-14.9	-22.2	-16.4	-18.6	-12.5	-8.6
International reserves	238.9	262.2	201.1	270.0	291.5	304.2	323.2	334.1	343.1
Total Amortisations	17.7	43.8	42.9	43.6	40.0	42.0	46.0	44.0	41.0
Public Finances, % of GDP									
Consolidated government balance	0.4	3.5	1.2	-1.7	1.4	1.5	1.5	0.9	2.3
Consolidated gov primary balance	1.7	4.9	2.6	-0.2	2.8	2.9	2.7	2.3	3.7
Public debt	30.1	29.7	29.0	32.5	31.9	32.6	33.0	35.0	33.0
of which Domestic	28.9	28.6	28.1	31.4	31.0	31.8	32.6	34.4	32.3
Foreign Assets & Liabilities, US\$ bn									
External debt	225.2	333.4	317.4	345.7	359.8	398.7	413.6	426.0	441.8
Private	225.0	333.1	317.1	345.4	359.4	358.3	373.4	384.8	399.6
Public	0.2	0.3	0.3	0.3	0.4	40.4	40.2	41.2	42.2
External debt / GDP	23.6	31.8	34.2	41.4	35.5	35.8	36.6	35.3	32.4
External debt / XGS	58.9	75.0	61.9	79.1	65.0	61.3	63.0	63.2	61.7
Short-term debt	113.8	160.3	149.9	149.2	139.8	137.4	126.7	130.3	140.4
Short-term debt/International Reserves (%)	47.6	61.1	74.5	55.3	48.0	45.2	39.2	39.0	40.9
Quarterly Economic Indicators									
	2013 Q1	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	1.5	2.3	3.3	4.1	3.9	3.8	3.8	3.4	3.7
CPI, % yoy	1.3	1.0	0.8	1.7	1.7	2.4	2.9	3.0	3.3
Policy interest rate, % eop	2.75	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75
91-Day CD Rate, % eop	2.81	2.69	2.66	2.70	2.75	2.75	2.75	2.75	2.90
Long term yield, % eop	2.58	3.14	3.05	3.35	3.45	3.60	3.65	3.65	3.75
lc vs USD, eop	1111	1142	1075	1051	1041	1032	1024	1017	1010

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** – Mild recovery in trade still expected, selective consumer behaviour likely to support Oct sales but overall recovery remains weak, capex recovery story likely to get pushed into 2014E given political delays. CBC likely to maintain neutral stance to keep property prices apace and support GDP growth.
- **Things to watch** – 1) Political gridlock remains and delay ECFA of services, 2014 budget & key policies; 2) Potential revisions on the luxury tax; 3) Cross-strait momentum: Banks M&A, RMB swap line, ECFA for the broader goods; 4) FTA signing with Singapore; 5) Pension reform; 6) 2014's "7-in-1" local elections.
- **Strategy** – We expect 10Y government bond yields will resume a gradual upward trend when Fed tapering talks reignite in Dec13/Jan14. Recent returning interests of foreign investors into the local equity market and strong RMB are adding to currency appreciation pressure. Citi's TAIEX year-end target at 8,500.

Very gradual trade recovery in the making

Sep manufacturing and trade data infer a rather soft trade recovery. On first look, dismal exports growth of -7%yoy and export orders of +2%yoy and IP growth of +1.1%yoy appear contradicting. However, we think these suggest that trade recovery thus far has been bumpy on a monthly basis and tepid overall; weak manufacturing production of only 0.73%yoy confirms this; while there are some mild recovery signs noted in export orders and diffusion indicies. We continue to note drags from slower Chinese and ASEAN demand, but orders from Europe and US appear to be recovering somewhat. We think upcoming festive shopping season, which coincides with recent tech product launches, will help tech exports and related manufacturing in 4QE. In particular, Dec figures could be boosted by the larger mandate for semiconductor production that Taiwanese manufacturers have won this year. However, evidence of a China slowdown are noted in Taiwan's trade data, as categories of Taiwanese non-tech imports that China usually imports (i.e., chemicals and basic metals) are seeing softening trends. Our recent downgrade to US' 4Q GDP to 2%qoq saar (-0.7ppt) on fiscal impasse suggest US consumption would further dampen recovery hopes vs. our earlier expectation.

Imports trend suggests a near-term drag to GDP but conducive for longer-term economic growth. Imports declined less than expected at -0.7%yoy in Sep. Raw materials imports continue to be negative as global commodity prices remain soft, and this import weakness was the reason for previous trade surplus widening. However, the pickup in capital imports (+13.2%yoy in Sep) will likely have reduced Taiwan's 3Q trade surplus, but in a longer perspective, such construction/capital expenditures are positive for further growth. We think Taiwan has pent-up need of investment; after all, it has suffered from 2 years of negative investment growth. However, we believe a more material increase in capex is being hindered by the current political gridlock -- the implementation of ECFA for services suffers a 5-month delay post signing as it still lacks legislative backing. Although the 'Sep political struggle' has come to an end with President Ma and legislative yuan speaker Wang appearing to have called a truce, and Premier Jiang Yi-huah also surviving a no-confidence vote launched by opposition lawmakers, unfortunately the implementation of the trade service pact is still on hold as a previously planned debate between President Ma and DPP Chairman Su on this topic was postponed.

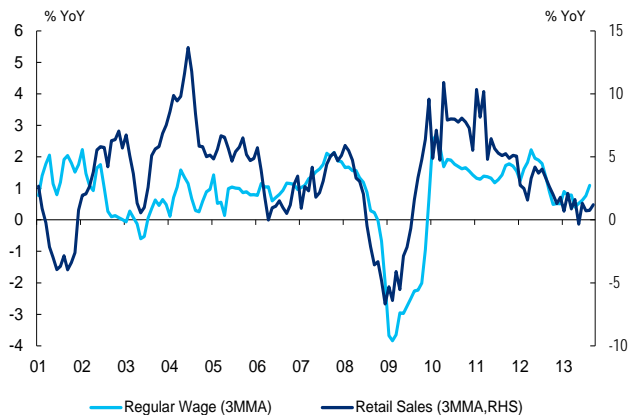
Free Economic Zone (FEZ) plans are however making progress. Although we anticipate the implementation of the pilot project of Free Economic Zone will also unfortunately suffer from political delays, we believe FEZ will be the next policy focus and we also noted more meaningful progress has been made recently, especially in light of new competition from Shanghai Free Trade Zone. President Ma in his national day speech, continued to stress the importance of liberalization for Taiwan's economic reform, and ECFA, FTAs and FEZs are all important puzzle pieces that will fulfill his vision to make Taiwan a free economic island. As mentioned in our last monthly report, the new FSC chairman is allowing more financial liberalization in Taiwan, the latest news (by Bloomberg) says that the FSC will announce by end-Nov a further lifting of restrictions allowing Overseas Banking Units (OBUs) to operate in the FEZ to offer non-TWD denominated products and fixed income services. We believe this is a crucial step for the next wave of financial market deepening in Taiwan and this would help lure money that has been sent to offshore markets back to Taiwan.

Fund flows trends

Taiwanese banks to step up in funding Taiwanese entrepreneurs in Kunshan, China. We pointed out in our last monthly that there is rising correlation of Taiwanese loan growth pickup with China's funding tightness. Here we further explore this discussion with details from an August launched pilot RMB lending program in Kunshan (a city in Jiangsu where many Taiwanese businesses have operations) and a CBC circular issued in Sep specifying instructions and requirements for interested participants. The program intends to promote two-way RMB lending into and out of Kunshan and Taiwan, as a mini-test trial for China's capital account liberalization. In fact a high profile two-way RMB loan transaction was completed in Sep. But given funding tightness in China, we believe the near-term trend for this program is that it will attract more interest for Taiwanese firms that have operations in Kunshan to borrow RMB from Taiwan's RMB pool, by having the parent company make a TWD loan from a Taiwan bank and after FX conversion, transfer the RMB into Kunshan as an inter-company loan. This trial program appears to be providing much needed and cheaper capital for Taiwanese corporates in Kunshan and also creates large business opportunities for Taiwanese banks to mobilize their idle RMB cash in Taiwan.

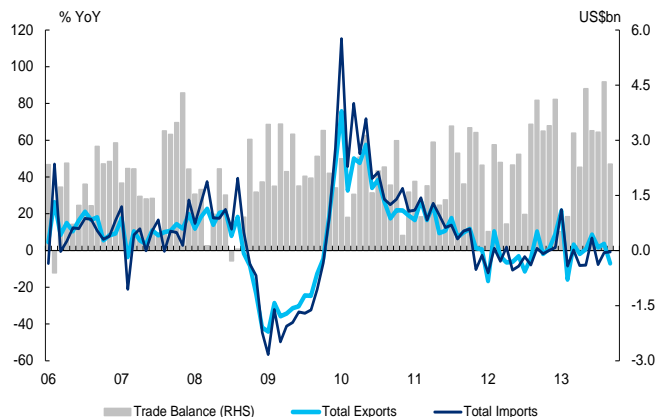
Recent foreign interest in Taiwan continues, supporting equities and TWD. Foreigners' net purchase of Taiwan equities has been increasing rapidly since the end of August. It has already reached US\$6.7bn, surpassing the peak in set in May. Since late Aug, the TWD has appreciated ~2% and the TAIEX has moved up by 7.3%. The actual inflows in the local equity market appear to have further strengthened with extended Fed accommodation. This, together with the endorsement of Taiwan's current account surplus, recent record low RMB fixing and KRW appreciation, all appear to help the mild TWD appreciation continue. Note that the CBC chief in a recent legislative yuan briefing confirmed that Taiwan's FX reserves contains RMB (bought via the market), endorsing our view that the rising currency in the region is also gaining influence in the direction of the TWD, after all China is a key trading partner of Taiwan (~40% of Taiwan's exports goes to China + HK). We forecast USD/TWD falling to 29.2 in the next three months and to 29.0 medium term.

Figure 83. Wage growth and consumption improving gently



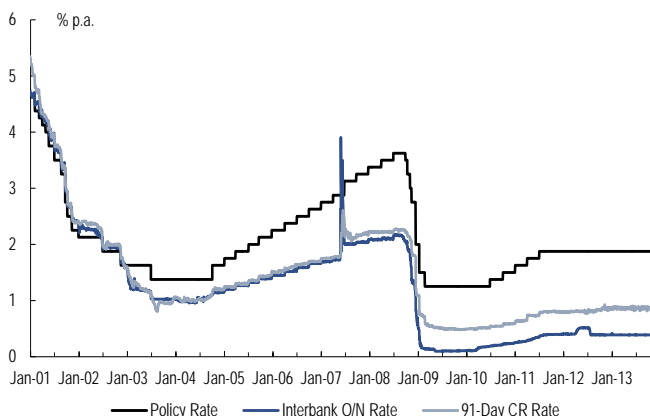
Source: CEIC, Citi Research

Figure 85. Trade is on a bumpy but recovering ride



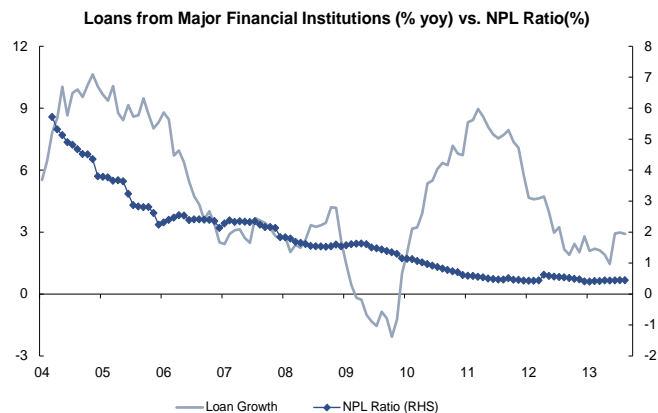
Source: CEIC, Citi Research

Figure 87. 10Y gvt bonds lowered Fed no-tapering and gvt. shutdown



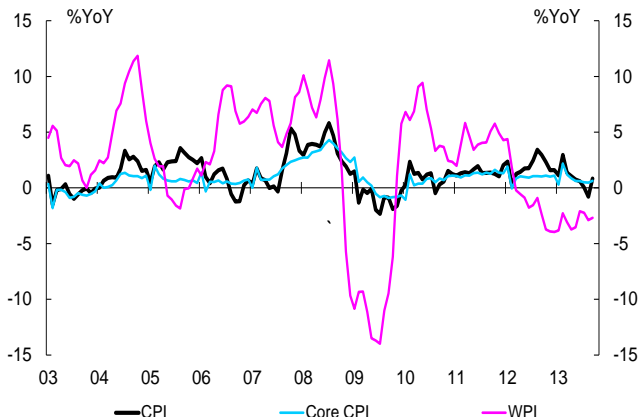
Source: CEIC, Citi Research

Figure 84. Loan growth likely to pick up with China's funding tightness



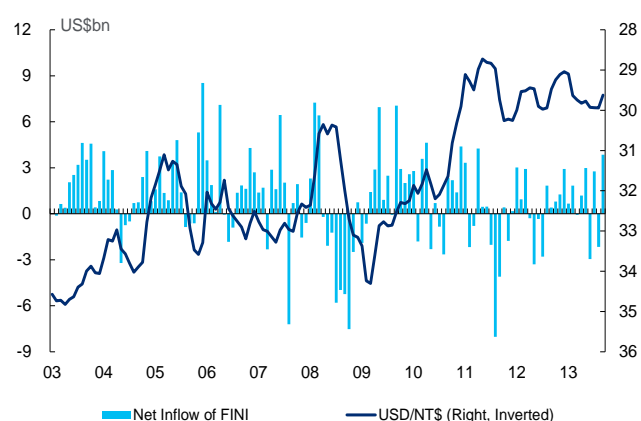
Source: CEIC, Citi Research

Figure 86. Benign inflation gives room for CBC's accommodation



Source: CEIC, Citi Research

Figure 88. TWD continues to see support from FINI inflows



Source: CEIC, Citi Research

Figure 89. Taiwan Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US\$ bn	376.3	393.1	400.2	377.6	428.2	464.0	474.0	491.0	529.1
Nominal GDP, local currency bn	12,243	12,911	12,620	12,481	13,552	13,674	14,037	14,559	15,356
GDP per capita, US\$	16,513	17,191	17,444	16,404	18,574	20,078	20,437	21,130	22,721
Population, mn	22.8	22.9	22.9	23.0	23.1	23.1	23.2	23.2	23.3
Unemployment, % of labour force	3.9	3.9	4.1	5.8	5.2	4.4	4.2	4.1	4.0
Economic Activity									
Real GDP, % yoy	5.4	6.0	0.7	-1.8	10.8	4.1	1.3	2.6	3.8
Real investment growth % yoy	0.5	-0.7	-7.9	-21.2	36.8	-7.5	-4.2	2.9	5.0
Real consumption growth % yoy	1.1	2.1	-0.6	1.3	3.3	3.0	1.3	1.4	2.3
private consumption growth % yoy	1.5	2.1	-0.9	0.8	4.0	3.1	1.5	1.7	2.7
Real export growth, % yoy	11.4	9.6	0.9	-8.7	25.6	4.4	0.1	3.2	4.8
Real import growth, % yoy	4.6	3.0	-3.7	-13.1	27.7	-0.5	-1.9	2.4	3.7
Prices, Money & Credit									
CPI, % yoy	0.7	3.3	1.3	-0.2	1.2	2.0	1.6	2.3	1.7
CPI, % avg	0.6	1.8	3.5	-0.9	1.0	1.4	1.9	1.2	1.7
Nominal wages, % yoy	0.8	2.1	0.0	-4.9	5.5	2.7	0.3	1.8	3.0
Credit extension to private sector, % yoy	4.7	3.9	2.7	-0.8	6.7	5.7	4.2	5.5	7.0
Policy interest rate, % eop	2.75	3.38	2.00	1.25	1.63	1.88	1.88	1.88	1.97
1 month inter-bank rate, % eop	1.69	2.04	1.02	0.57	0.74	0.87	0.87	0.87	1.05
Long term yield, % eop	1.99	2.53	1.44	1.47	1.47	1.27	1.15	1.66	1.94
lc/US\$, eop	32.59	32.43	32.78	32.23	29.17	30.29	29.06	29.16	29.00
lc/US\$, avg	32.52	32.85	31.58	33.04	31.50	29.40	29.57	29.65	29.03
Balance of Payments, US\$ bn									
Current account	26.3	35.2	27.5	42.9	39.9	41.2	49.9	49.6	47.6
% of GDP	7.0	8.9	6.9	11.4	9.3	8.9	10.5	10.1	9.0
Trade balance	11.6	16.8	4.4	20.3	11.0	11.3	14.4	27.2	48.2
Exports	213.2	235.1	243.8	193.8	261.6	291.9	284.2	294.4	317.3
Imports	201.6	218.2	239.5	173.5	250.5	280.6	269.8	267.2	269.1
Service balance	-3.5	-1.6	1.9	2.0	2.5	3.9	6.1	11.2	-3.6
Income balance	9.6	10.1	10.0	12.5	13.6	13.2	15.3	17.5	19.0
FDI, net	0.0	-3.3	-4.9	-3.1	-9.1	-14.7	-9.8	-8.5	-7.0
International reserves	266.1	270.3	291.7	348.2	382.0	385.5	403.2	420.0	440.0
Total Amortisations	5.8	3.8	8.8	2.5	3.2	6.8	3.4	2.9	3.0
Public Finances, % of GDP									
Consolidated government balance	0.1	0.3	-0.5	-3.5	-2.3	-1.9	-1.6	-1.2	-1.3
Consolidated gov primary balance	1.2	1.3	0.5	-2.5	-1.5	-1.0	-0.7	-0.4	-0.6
Public debt	34.2	33.3	34.7	38.0	38.3	40.1	40.9	41.2	41.0
of which Domestic	34.1	33.3	34.7	38.0	38.2	40.1	40.9	41.1	41.0
Foreign Assets & Liabilities, US\$ bn									
External debt	85.8	94.5	90.4	82.0	101.6	122.5	130.8	132.8	134.3
Private	75.2	91.1	88.9	76.0	93.5	118.0	127.5	129.1	130.3
Public	10.6	3.5	1.5	5.9	8.0	4.5	3.3	3.7	4.0
External debt / GDP	22.8	24.0	22.6	21.7	23.7	26.4	27.6	27.0	25.4
External debt / XGS	33.5	33.4	30.9	34.7	32.1	34.7	37.5	35.8	33.9
Short-term debt	74.2	83.3	78.8	68.2	83.7	107.8	116.5	115.0	110.0
Short-term debt/International Reserves (%)	27.9	30.8	27.0	19.6	21.9	28.0	28.9	27.4	25.0
Quarterly Economic Indicators									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	1.6	2.5	2.6	3.4	3.1	4.7	3.8	3.7	4.0
CPI, % yoy	1.8	0.8	1.3	2.3	2.6	1.6	1.4	2.4	3.7
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	2.00	2.13	2.25
1 month inter-bank rate, % eop	0.87	0.87	0.87	0.87	0.93	0.93	0.99	0.99	1.05
Long term yield, % eop	1.31	1.41	1.69	1.66	1.71	1.76	1.84	1.94	2.09
lc vs USD, eop	29.83	29.96	29.56	29.16	29.09	29.01	29.00	29.00	29.00

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

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

Thailand

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- **Summary view** – We revise lower our FY13 GDP forecast to 3.5% and FY14 GDP outlook to 4.2%. The GDP downgrade was driven by slower 3Q pace of growth on the back of lackluster consumption and investments. Despite the downgrade, 3Q GDP probably posted QoQ SA gains to end technical recession.
- **Things to watch** – Seasonally adjusted 3Q GDP gains. Decline in 3Q durable goods demand on a YoY basis but up on a seasonally adjusted QoQ. Pace of recovery of infra spending in 1QFY14 (4Q13). Whether tech export recovery will persist in 4Q13. Impact of the high base effect on 4Q13 exports.
- **Strategy** – Unchanged overnight policy rate of 2.5% for the rest of the year will be consistent with weak THB at 31 or more. Benign inflation backdrop facilitates the combination of low rates and weak THB in support of growth. Coupled with modest fiscal gaps in FY13 and FY14, long duration risk is appealing.

Downgrade 2013-14 growth forecasts

We revised lower our 2013 GDP growth forecast to 3.5% (previously 4.1%) and our 2014 GDP forecast to 4.2% (previously 4.4%). We downgraded 3Q GDP growth to 2.8%YoY (previously above 3%YoY) on the back of lackluster private consumption and slower investments. In 4Q13, start of FY14 budget expenditures coupled with recovering consumption support 4Q13 GDP growth of 3.2%YoY. Despite expected mild gains, technical recession would end in 3Q13. Seasonally adjusted GDP probably grew 1.6%QoQ SA in 3Q13 and 3.2%QoQ SA in 4Q13.

Growth lift would come from higher net exports contribution to 3Q GDP of 14.1% up from a 13.3% share in 1H13. Combination of upbeat tourism, shallow merchandise export volume gains (+1%YoY growth in 3Q13) and waning imports as domestic demand (ex-inv) eases, elevated the net export ratio. Tech exports led by HDD probably uplifted export-oriented mfg cluster. Despite exports firming up, the net exports' share of GDP would be restrained by the high base effect in 4Q13.

Domestic demand (ex-inv) likely to post slower growth of 2.3%YoY in 3Q13, underpinned much of the 3Q GDP forecast downgrade. HH consumption in our forecasts probably bottomed out with growth of 1.8%YoY in 3Q13 with non-durable good demand posting 3.2%YoY and durable goods demand down 7.6%YoY with base effect constraints. Seasonally adjusted HH consumption (+2.3%QoQ SA) probably recorded a quarterly gain due to upbeat non-durables demand (+2%QoQ SA). Amid slumping consumer sentiment, HH deleveraging started easing off in 3Q13 stabilizes consumption. Car sales rose 6.3%MoM SA in Aug to snap out of 4 straight monthly declines although in Sep car sales fell 3.4%MoM SA.

Total fiscal spending probably grew 4.4%YoY in 3Q13 (vs. 8.2%YoY in 1H13) with public investments contributing 33%-34% of total fiscal spending. 3Q public investments (include SOE capex) probably grew 8.8%YoY after 4 quarters of 2-digit gains. Fiscal consolidation in 3Q13 as populist measures were faded and government shifts to public investments, probably led to slower infra spending in 3Q13 (-26%YoY). Sustained slack in the export markets contributed to slower private investments (1.8%YoY vs. 1.9%YoY in 2Q13) with capex likely the drag and construction providing the lift.

Current account deficit at 1.1% of GDP in FY13

Likely to be a current account deficit (CAD) year as the 2Q CAD of US\$6.7bn won't be offset by improving trade gaps in 2H13. We estimate a trade surplus of US\$5.5bn in 3Q13 and a near trade balance in 4Q13 mainly on the back of waning imports and exports firming up. Profit/dividend remittances of multinationals and trade-driven freight payments bloat the net outflows in the non-merchandise trade segment of the current account (-US\$6.2bn in 2Q13) although it's likely to narrow in 2H13 as imports ease. Upbeat tourism revenues probably mitigated the outflows. The CAD would put pressure on reserve accumulation although in real terms, lackluster imports would augur for a larger net export volume contribution to GDP.

Disinflation has more room to go

From 0.61%YoY in Sep, we anticipate core inflation to probe 1%YoY by end 1Q14. Near-term, core inflation would remain benign consistent with sharply narrowing output gap from +4% in 4Q12 to +0.1% in 2Q13. Our forecast of improving quarterly GDP growth implies a larger positive output gap but perhaps not in the magnitude of 4Q12. In short, there's room for core inflation to remain benign at less than 1%YoY prior to upside risk as core breaches upside of 1%YoY either in late 1Q14 or 2Q14. From a high of 67.6% in Mar, the seasonally adjusted average mfg capacity utilization rate eased to 63.6% in Aug to reflect less pressure for cost-push pass-through environment from the manufacturing side. Despite a relatively weak THB in 2Q13, soft oil and commodity prices would probably mitigate imported inflation consistent with subdued cost-push pressures and ongoing disinflation.

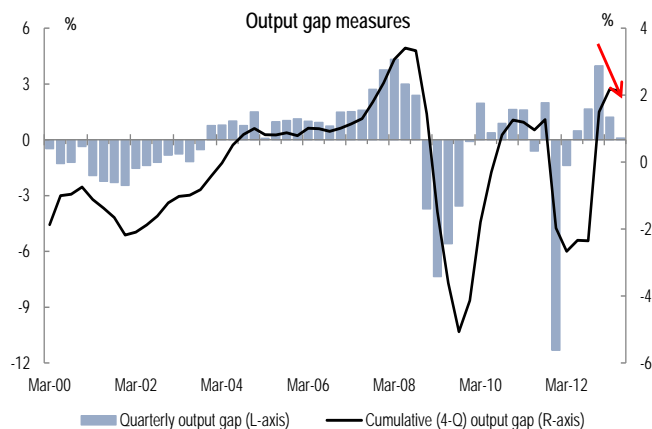
Trending towards a FY13 fiscal deficit of Bt256bn

The latest cash budget figures for the central government which excluded off-budget spending, e.g., rice pledging scheme, appears to be trending towards a FY13 fiscal deficit estimate of Bt256bn that's lower than our FY13 deficit forecast of Bt308bn (2.6% of FY13 GDP) or the government's FY13 deficit target of Bt300bn. However the emerging cash budget deficit seems in line with the fiscal deficit target ex-repayment of Bt250.8bn. This modest fiscal deficit estimate was primarily due to restrained infra spending (acquisitions of non-financial assets) in 2H FY13 that fell 18.1%YoY in our estimate following an 80.2%YoY expansion in 1H FY13. Overall infra spending for FY13 stood at Bt253.8bn in our estimate (+10.5%YoY) that fell short of the FY13 capital expenditure target of Bt450bn. Total current operating expenditures trended towards Bt2.1tn versus an FY13 target of Bt1.9tn for a program slippage of Bt201.4bn to mitigate the shortfall in capital expenditures exceeding Bt195bn. Fiscal position in FY13 looks benign despite populist measures in 1H FY13. Losses incurred due to the rice pledging scheme and other subsidy programs would be 'expensed' in the next fiscal years.

Unchanged overnight rates at 3.5% alongside THB at 31

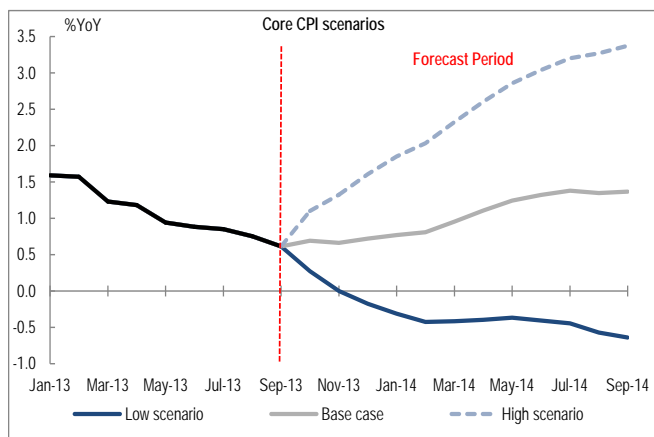
Fundamentals support a policy rate unchanged at 2.5% perhaps up to 2Q14 until demand headwinds ease and disinflation cycle wanes. BoT's preference for a relatively weak THB at 31 or more would persist in the near term amid benign inflation and consistent with low interest rates in support of export recovery and tourism. With benign fiscal deficit estimate in FY13 and next year's deficit target of Bt250bn (less than Bt200bn ex-debt repayments), market sentiment remains upbeat long duration risk.

Figure 90. Tech recession risk in 2013 cut the output gap



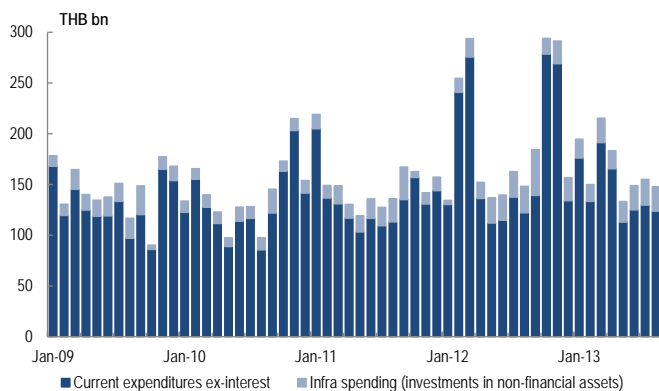
Source: CEIC, Citi Research

Figure 92. Base case core CPI upticks >1%YoY starting in 2014



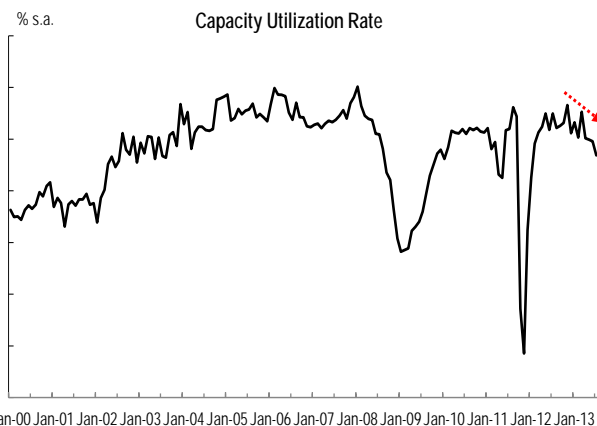
Source: CEIC, Citi Research using EViews

Figure 94. 2HFY13 infra spending fell after 80%YoY growth in 1HFY13



Source: CEIC, Citi Research

Figure 91. Weak capex rate suggesting muted cost-push pass-through



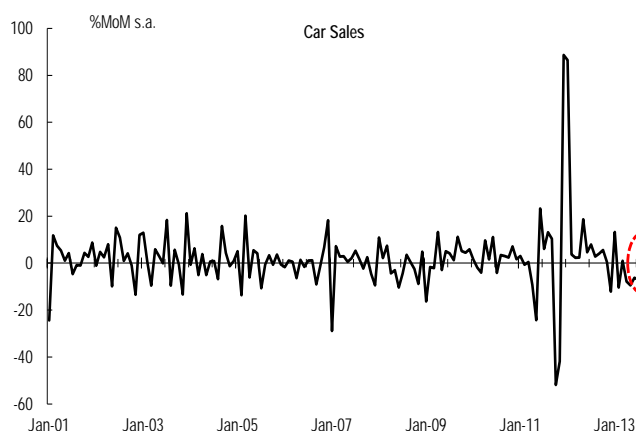
Source: CEIC, Citi Research

Figure 93. 5th straight monthly drop for the mfg index in Aug (-3.1%YoY)



Source: CEIC, Citi Research

Figure 95. Car sales fell by 3.4%MoM s.a. in Sep after the Aug rebound



Source: CEIC, Citi Research

Figure 96. Thailand Economic Indicators

2006 2007 2008 2009 2010 2011 2012 2013F 2014F

Summary Data									
Nominal GDP, US\$ bn	207.4	265.2	276.1	263.8	319.3	346.1	366.4	390.8	408.6
Nominal GDP, local currency bn	7,845	8,525	9,080	9,042	10,105	10,540	11,375	12,025	12,801
GDP per capita, US\$	3,301	4,207	4,355	4,153	4,998	5,401	5,685	6,032	6,276
Population, mn	62.8	63.0	63.4	63.5	63.9	64.1	64.5	64.8	65.1
Unemployment, % of labour force	1.5	1.4	1.4	1.5	1.0	0.7	0.7	0.9	0.8
Economic Activity									
Real GDP, % yoy	5.1	5.0	2.5	-2.3	7.8	0.1	6.5	3.5	4.2
Real investment growth % yoy	-3.6	1.0	8.1	-25.2	28.7	0.1	16.8	4.4	6.9
Real consumption growth % yoy	3.0	2.9	2.9	0.1	5.1	1.3	6.8	2.9	3.2
private consumption growth % yoy	3.2	1.8	2.9	-1.1	4.8	1.3	6.7	2.7	3.1
Real export growth, % yoy	9.1	7.8	5.1	-12.5	14.7	9.5	3.1	4.3	4.2
Real import growth, % yoy	3.3	4.4	8.9	-21.5	21.5	13.7	6.2	4.1	4.2
Prices, Money & Credit									
CPI, % yoy	3.6	3.1	0.4	3.5	3.1	3.5	3.6	1.3	2.5
CPI, % avg	4.6	2.2	5.5	-0.9	3.3	3.8	3.0	2.1	2.2
Nominal wages, % yoy	5.8	3.0	10.5	-1.9	5.8	7.2	11.9	5.5	4.0
Credit extension to private sector, % eop	4.5	29.3	6.3	2.5	18.9	18.2	13.7	10.5	11.5
Policy interest rate, % eop	5.00	3.25	2.75	1.25	2.00	3.25	2.75	2.50	2.75
1 month inter-bank rate, % eop	5.22	3.74	3.07	1.28	2.03	3.26	2.79	2.55	2.80
Long term yield, % eop	5.04	5.13	2.84	4.37	3.74	3.28	3.55	3.80	3.90
lc/US\$, eop	35.45	30.05	34.79	33.36	30.07	31.57	30.60	31.04	30.73
lc/US\$, avg	37.93	32.33	33.03	34.33	31.71	30.48	31.08	30.65	31.00
Balance of Payments, US\$ bn									
Current account	2.3	15.7	2.2	21.9	10.0	5.9	0.2	-4.2	0.2
% of GDP	1.1	5.9	0.8	8.3	3.1	1.7	0.0	-1.1	0.0
Trade balance	13.7	26.6	17.3	32.6	29.8	17.0	6.0	4.3	4.1
Exports	127.9	151.3	175.2	150.8	191.6	219.1	225.9	228.6	238.9
Imports	114.3	124.6	157.9	118.2	161.9	202.1	219.9	224.3	234.8
Net service and Transfer accounts	-8.0	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	-2.5	-0.6
Income balance	-3.4	-3.0	-2.3	-4.4	-9.0	-0.5	-2.4	-6.0	-3.3
FDI, net	8.5	8.3	4.4	0.7	4.5	-0.4	-4.9	-0.7	1.2
International reserves	67.0	87.5	111.0	138.4	172.1	175.1	181.6	175.0	182.5
Total Amortisations	12.8	20.5	15.0	10.7	9.4	8.9	17.3	18.0	19.0
Public Finances, % of GDP									
Consolidated government balance	-0.7	-1.6	-1.0	-5.7	0.0	-1.0	-2.1	-2.6	-2.3
Consolidated gov primary balance	0.9	-0.3	0.2	-4.5	1.2	0.2	-0.8	-1.7	-1.3
Public debt	40.3	37.4	38.2	43.9	42.4	40.8	43.6	45.2	46.0
of which Domestic	34.3	32.7	33.7	39.7	38.8	37.5	40.5	41.2	42.3
Foreign Assets & Liabilities, US\$ bn									
External debt	70.0	74.4	76.1	75.3	100.6	104.6	133.2	132.3	135.0
Private	64.7	71.6	72.7	69.4	87.9	88.4	107.0	106.7	108.4
Public	5.2	2.8	3.4	5.9	12.7	16.2	26.2	25.6	26.6
External debt / GDP	33.7	28.1	27.6	28.5	31.5	30.2	36.4	33.9	33.0
External debt / XGS	45.9	41.0	36.5	41.6	44.5	40.1	48.4	46.8	45.5
Short-term debt	27.2	34.0	33.6	33.1	50.7	47.3	60.6	60.0	59.8
Short-term debt/International Reserves (%)	40.7	38.9	30.3	23.9	29.4	27.0	33.4	34.3	32.8
Quarterly Economic Indicators									
	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	5.4	2.8	2.8	3.2	3.7	4.1	4.3	4.5	4.4
CPI, % yoy	2.7	2.3	1.7	1.4	1.5	2.2	2.4	2.5	2.8
Policy interest rate, % eop	2.75	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00
1 month inter-bank rate, % eop	2.79	2.53	2.55	2.55	2.55	2.60	2.60	2.80	3.15
Long term yield, % eop	3.54	3.78	3.94	3.80	4.00	3.90	3.80	3.90	4.00
lc vs USD, eop	29.29	31.14	31.24	31.04	31.11	31.19	30.99	30.73	30.47

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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New Investment Law (NIL) and warming of foreign relations to entice FDI. The NIL offers equal treatment to both foreign and domestic investors, and guarantees tax stabilization to help repair damaged foreign investor confidence. This is a crucial positive move, in our view, as it removes a key obstacle to foreign investment into Mongolia (see also [Mongolia Macro Flash](#)). Incremental positive news from Rio/GOM talks over the Oyu Tolgoi project is offering hopes that phase II can be restart by the end of the year. The recent start of clearing by Chinese customs for OT copper delivery to Chinese customers (after a four-month delay) will finally allow OT to start recording revenue and to contribute to foreign reserves. We also note Mongolia's recent step up in foreign interactions with China, G3, UK, Canada, HK, Taiwan, North Korea, etc. are helping to foster economic ties and FDI opportunities.

We lowered our real GDP growth forecast for 2013E to 12.3%yoy (-1.5ppt).

Although we recognize policymakers recent stepped efforts to ratify various contentious issues, near-term growth will still unavoidably be dampened, on: the slow recovery in exports (despite OT copper addition), pickup in imports on local infrastructure building needs, the shock to the domestic economy by MNT depreciation (which revisited MNT1692/USD on Oct 23) and delayed investment plans caused by previous politics/policies uncertainties. Of slight comfort is FX reserves, although continues to fall (Sep: \$2680mn), the rate of decline appears to have slowed. Market will watch fiscal efforts to comply 2013 budget deficit to FSL.

Sri Lanka

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CBSL surprises market with 50bps, more easing possible if inflation remains manageable. The move comes after real GDP growth in 2Q13 surprised to the upside, SRR was already cut by 200bps to 6% effective 1st of July and private sector growth had picked up a bit. This move reinforces our concerns that Sri Lanka does not see any need to make policy adjustments despite recent taper-led volatility, and that Fed's "dovishness" would reinforce CBSL's "pro-growth bias". In fact, CBSL said that it cut rates "to harness Sri Lanka's full economic potential, and stimulate the economy to reach a higher growth trajectory in 2014". Benign inflation has likely been the major driver of CBSL's decision after seeing two months (Aug-Sep) of deflation led by declining food prices (Sep inflation of 6.2%YoY), alongside benign core readings (3% range since July). We downgrade our 2013F & 2014F (ave) inflation forecast to 7.1% & 6.8%, respectively. Given that we under-estimated CBSL's "dovishness", we now think CBSL might cut another 50bps again if inflation readings stay manageable.

Officials downplayed risks from external imbalances, which is a source of our concern. While tourism, remittances and FDI flows have improved, the goods trade deficit in Jan-Aug 2013 is down only 5.5% from last year, highlighting risk of a slow external adjustment and loss of goods export competitiveness (though service exports are improving). When coupled with fiscal issues and external refinancing risks, albeit the latter now being mitigated by the more protracted timetable for Fed taper, we think policymakers are too complacent. The 2Q current account data out and the high frequency data showing improvements, and we cut our CAD forecast this year to \$3.1bn or 4.7% of GDP (vs. \$3.5bn), but we still expect net FDI will only finance a third of this. We are concerned LK's relatively low FX reserve buffer is being built up primarily via external borrowings, even though external debt is relatively high and majority now on commercial terms. While LK is not as exposed to portfolio flows as other CAD countries, e.g. IN & ID, we do note that foreign ownership of Treasury securities are being gradually pared down.

We are neutral on Sri Lanka vis-a-vis the EM hard currency bond index, and find value in NSB '18s. While we are in a near-term EM risk-positive environment, we find the government's pro-growth stance as risky and would lead to regular supply, capping outperformance of sovereign – we are neutral Sri Lanka for yield, but prefer to play it via NSB '18s, still trading ~240bps wider than sovereign on a duration-adjusted basis.

Vietnam

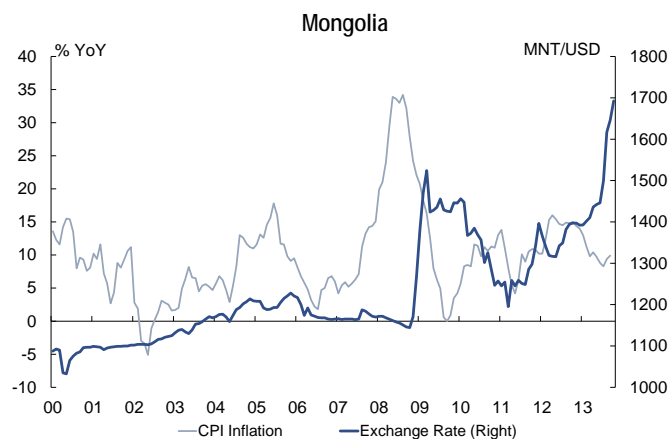
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We nudge our growth forecast slightly higher. Shortly after the last monthly, Vietnam released its 3Q2013 real GDP growth with a surprising uptick of 5.4% vs. 4/9% growth in 1H) led by a broad-based rebound across sectors, not just industry but also services, agriculture and construction sectors – the latter is giving some signs that the weight of bank deleveraging is slowing and credit is marginally picking up. We nudge our GDP growth forecast at 5.2% this year, still lower than the government's "downwardly adjusted" 2013 forecast of 5.3-5.4%, and also nudge our 2014F forecast to 5.5%. We think bank deleveraging is slowing down, parts of the economy continue to show some positive momentum from the spillover of strong manufacturing/FDI-invested sectors, growth of informal lending channels and three years of relative macro stability. However, Vietnam continues to grow below its potential due to painfully slow progress in restructuring its banks and state-owned enterprises. Both the Prime Minister and SBV reiterated plans to raise cap on foreign ownership of local banks to as much as 49% in the "near future" (versus current cap at 30% and 15% for single strategic investor), which may help mobilize some foreign capital though likely not sufficient to rehabilitate the weaker banks.

While government has signaled its commitment to macro stability, we think the temptation to ease both monetary and fiscal policy will persist. While MoM inflation has been elevated in recent months on the back of non-food items (e.g., house utilities, health, education), the muted second-round inflationary impact and favorable base effect could see headline inflation edging slightly lower towards the 6% handle (6.3% in Sep) in the near term, which could be tempting for policy makers to cut rates further (possibly another 50-100bps) in order to support growth. In fact, there are also plans to lift the fiscal deficit cap to 5.5% of GDP from an earlier target of 4.8% of GDP which would mean public debt to GDP will likely stay sticky in the 50% of GDP range.

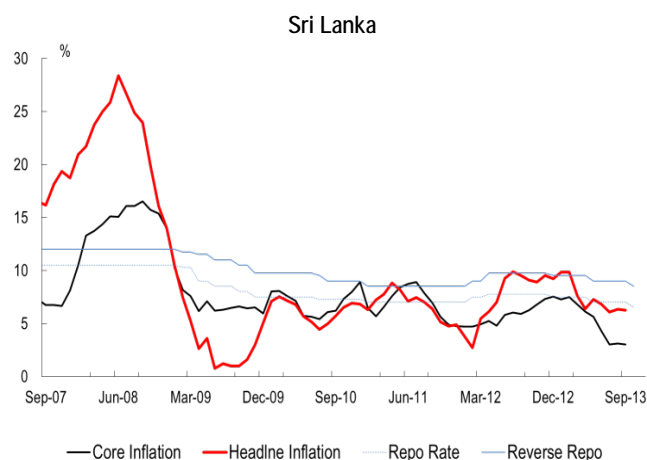
We also think risk to a deliberate modest devaluation by year-end is high. We slightly revised our dong forecast about 0.9% weaker by year-end, which impacts our 2014 forecasts assuming another 1.5% annual depreciation. This weakness is not driven by fundamental factors, wherein USD liquidity remains ample supported by a still comfortable current account surplus. We think this is a policy-induced weakness after Prime Minister Dung signaled early this month his intention to devalue the dong again to boost the economy under his view that the dong was "overvalued" (following post-Taper weakness in other EM currencies). With inflation likely to remain relatively manageable amid limits to fiscal flexibility, we think the PM's statement carries some weight, and we are thus forecasting another mid-point devaluation in 4Q 2013, which will also influence the market FX rate at an equal magnitude.

Figure 97. Mongolia – Depreciation will add to price pressures



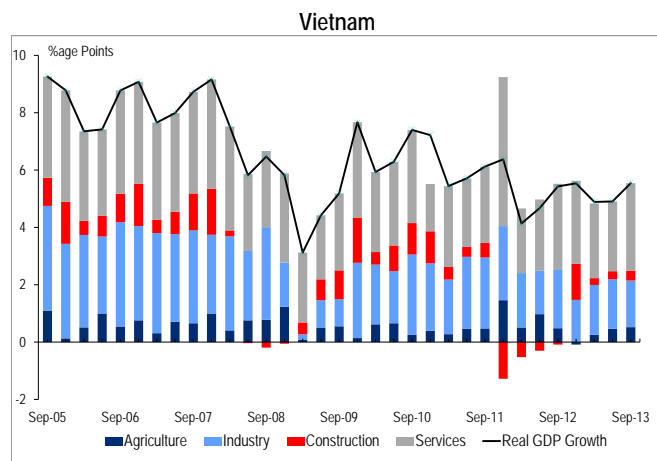
Source: BoM, CEIC and Citi Research

Figure 99. Sri Lanka – Benign inflation prompts CBSL to cut further



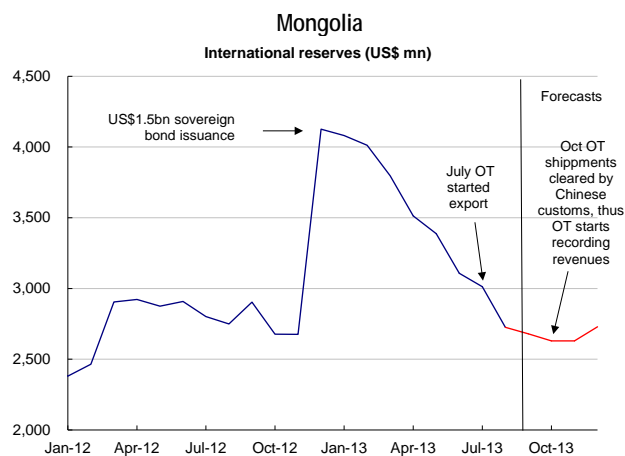
Source: CBSL, CEIC, Citi Research

Figure 101. Vietnam – Real GDP growth is rebounding broadly across sectors



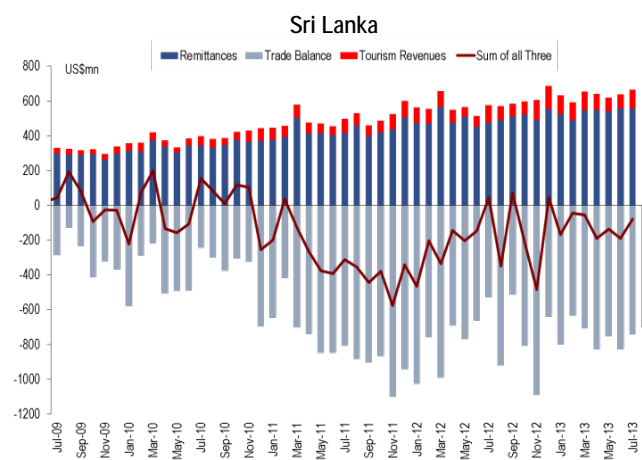
Source: CEIC, GSO, Citi Research

Figure 98. Pace of FDI reserves decline appears slowing



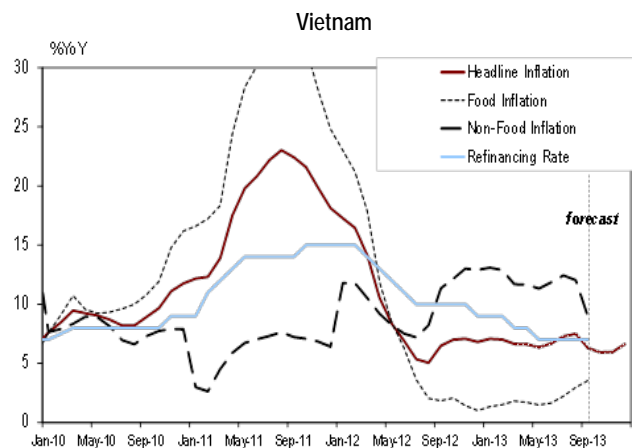
Source: BoM, CEIC and Citi Research

Figure 100. High frequency data show improvement to the current account



Source: CBSL, CEIC, Citi Research

Figure 102. Manageable inflation could still leave some room for a residual rate cut



Source: IMF, CEIC, Citi Research

Figure 103. Asia Frontier Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Mongolia									
Nominal GDP, US\$ bn	3.4	4.2	5.6	4.6	6.2	8.8	10.3	11.2	13.2
GDP per capita, US\$	1334	1629	2138	1717	2287	3186	3595	3833	4475
Population, mn	2.6	2.6	2.6	2.7	2.7	2.8	2.9	2.9	3.0
Real GDP, % yoy	8.6	10.2	8.9	-1.3	6.4	17.5	12.4	12.3	11.0
CPI, % yoy	8.1	15.1	22.1	4.2	13.0	10.2	14.0	11.5	12.0
CPI, % avg	4.5	--	28.0	8.0	10.1	9.2	14.3	10.3	12.0
Policy interest rate, % eop	--	8.40	9.75	10.00	11.00	12.25	13.25	10.00	10.50
Long term yield, % eop	26.93	21.83	20.58	21.67	20.07	20.07	18.11	15.61	16.81
lc/US\$, eop	1164	1172	1275	1433	1233	1378	1378	1647	1574
lc/US\$, avg	1181	1171	1167	1434	1349	1256	1353	1540	1598
Current account (US\$ bn)	0.2	0.3	-0.7	-0.4	-0.9	-2.8	-3.2	-2.8	-1.8
% of GDP	6.5	6.3	-12.8	-8.9	-15.0	-31.5	-31.2	-24.8	-13.6
Trade balance (US\$ bn)	0.1	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-1.5	-0.4
Exports (US\$ bn)	1.5	1.9	2.5	1.9	2.9	4.8	4.4	5.0	6.5
Imports (US\$ bn)	1.5	2.2	3.2	2.1	3.2	6.6	6.7	6.6	6.8
FDI, net (US\$ bn)	--	0.4	0.8	0.6	1.6	4.6	3.9	2.8	3.5
International reserves (US\$ bn)	0.6	0.8	0.6	1.3	2.2	2.3	3.9	--	--
Consolidated government balance (% of GDP)	7.6	2.6	-4.5	-5.2	0.5	-6.9	-8.3	-7.8	-5.8
Public debt (% of GDP)	40.6	36.0	30.6	43.3	38.5	50.6	59.2	58.7	57.3
Sri Lanka									
Nominal GDP, US\$ bn	28.3	32.4	40.7	42.1	49.6	59.2	59.4	66.0	75.2
GDP per capita, US\$	1422	1615	2014	2057	2400	2836	2816	3093	3487
Population, mn	19.9	20.0	20.2	20.5	20.7	20.9	21.1	21.3	21.6
Real GDP, % yoy	7.7	6.8	5.9	3.5	8.0	8.2	6.4	6.5	6.8
CPI, % yoy	13.5	18.8	13.9	5.0	6.8	4.9	9.2	5.6	7.9
CPI, % avg	10.0	15.8	22.5	3.6	6.2	6.8	7.5	7.1	6.7
Policy interest rate, % eop	11.50	12.00	12.00	9.75	9.00	8.50	9.50	8.50	8.50
Long term yield, % eop	12.98	19.96	19.12	9.33	7.55	9.31	11.54	10.20	10.50
lc/US\$, eop	107.5	108.7	113.0	114.4	110.9	113.9	127.7	133.0	130.0
lc/US\$, avg	103.9	110.6	108.3	114.9	113.0	110.5	127.2	130.6	130.0
Current account (US\$ bn)	-1.5	-1.4	-3.9	-0.2	-1.1	-4.6	-3.9	-3.0	-2.3
% of GDP	-5.3	-4.3	-9.5	-0.5	-2.2	-7.8	-6.6	-4.6	-3.0
Trade balance (US\$ bn)	-3.4	-3.7	-6.0	-3.1	-4.8	-9.7	-9.4	-9.3	-10.7
Exports (US\$ bn)	6.9	7.6	8.1	7.1	8.6	10.6	9.8	10.1	10.8
Imports (US\$ bn)	10.3	11.3	14.1	10.2	13.5	20.3	19.2	19.3	21.5
FDI, net (US\$ bn)	0.5	0.5	0.7	0.4	0.4	0.9	0.8	1.0	1.0
International reserves (US\$ bn)	2.5	3.1	1.8	5.1	6.6	6.0	6.9	7.0	8.4
Consolidated government balance (% of GDP)	-7.0	-6.9	-7.0	-9.9	-8.0	-6.9	-6.4	-6.2	-5.7
Public debt (% of GDP)	87.9	85.0	81.4	86.1	81.9	78.4	79.1	78.0	76.0
Vietnam									
Nominal GDP, US\$ bn	60.9	71.2	90.0	91.9	102.4	121.7	141.5	156.0	172.5
GDP per capita, US\$	724	836	1044	1054	1163	1367	1572	1716	1879
Population, mn	84.1	85.2	86.2	87.2	88.1	89.0	90.0	90.9	91.8
Real GDP, % yoy	7.0	7.1	5.7	5.4	6.4	6.2	5.3	5.2	5.5
CPI, % yoy	6.6	12.6	19.9	6.5	11.7	18.1	6.8	6.6	8.1
CPI, % avg	7.5	8.5	23.2	7.0	9.2	18.6	9.3	6.7	7.1
Policy interest rate, % eop	6.50	6.50	9.50	8.00	9.00	15.00	9.00	6.00	7.00
Long term yield, % eop	8.29	8.73	10.00	11.68	11.50	12.55	9.75	8.50	9.00
lc/US\$, eop	16056	16028	17483	18474	19498	21034	20840	21350	21590
lc/US\$, avg	15990	16081	16445	17806	19123	20648	20875	21154	21550
Current account (US\$ bn)	-0.2	-7.0	-10.7	-7.2	-4.3	0.2	9.0	6.6	5.2
% of GDP	-0.3	-9.8	-11.9	-7.8	-4.2	0.2	6.3	4.2	3.0
Trade balance (US\$ bn)	-2.8	-10.4	-12.8	-8.3	-5.1	-0.5	9.5	7.7	6.7
Exports (US\$ bn)	39.8	48.6	62.7	57.1	72.2	96.9	114.5	131.6	155.3
Imports (US\$ bn)	42.6	58.9	75.5	65.4	77.4	97.4	105.0	123.9	148.7
FDI, net (US\$ bn)	2.3	6.6	9.3	6.9	7.1	7.3	7.0	7.0	7.0
International reserves (US\$ bn)	13.4	23.5	23.9	16.4	12.5	13.5	25.6	35.8	38.3
Consolidated government balance (% of GDP)	-1.1	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-4.8	-4.0
Public debt (% of GDP)	37.5	39.0	34.9	40.0	45.5	45.9	43.1	41.0	41.5

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

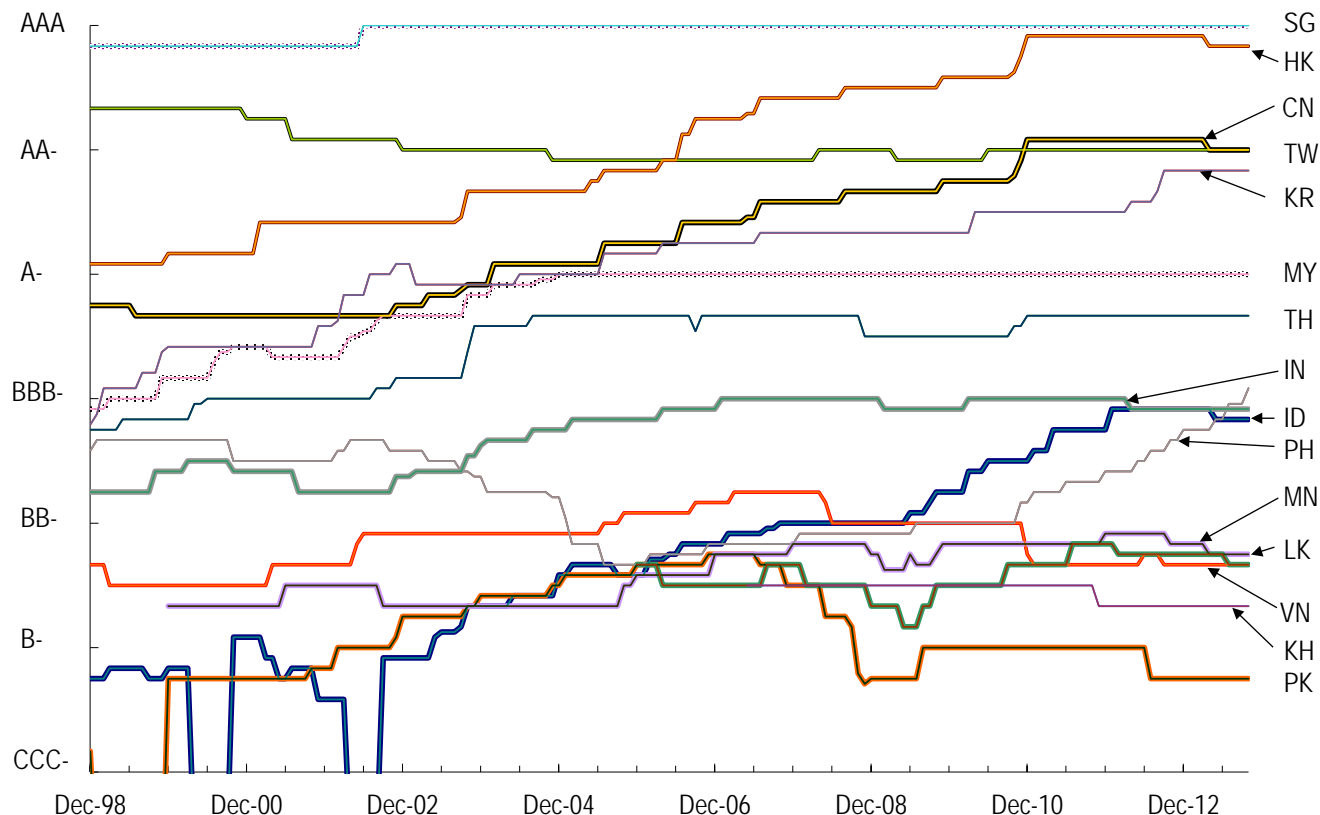
Appendix: Sovereign Risk Ratings Summary

Figure 104. Long-Term Foreign Currency Ratings

	S&P	Moody's	Fitch
AAA/Aaa	Hong Kong (stable) Singapore (stable)	Singapore (stable)	Singapore (stable)
AA+/Aa1	—	Hong Kong (stable)	Hong Kong (stable)
AA/Aa2	—	—	—
AA-/Aa3	China (stable) Taiwan (stable)	China (stable) Korea (stable) Taiwan (stable)	Korea (stable)
A+/A1	Korea (stable)	—	China (stable) Taiwan (stable)
A/A2	—	—	—
A-/A3	Malaysia (stable)	Malaysia (stable)	Malaysia (negative)
BBB+/Baa1	Thailand (stable)	Thailand (stable)	Thailand (stable)
BBB-/Baa2	—	—	—
BBB-/Baa3	India (negative) Philippines (stable)	India (stable) Indonesia (stable) Philippines (positive)	India (stable) Indonesia (stable) Philippines (stable)
BB+/Ba1	Indonesia (stable)	—	—
BB/Ba2	—	—	—
BB-/Ba3	Bangladesh (stable) Mongolia (negative) Vietnam (stable)	Bangladesh (stable)	Sri Lanka (stable)
B+/B1	Sri Lanka (stable)	Fiji (stable) Mongolia (stable) Sri Lanka (stable)	Mongolia (stable) Vietnam (stable)
B/B2	Cambodia (stable) Fiji (stable)	Cambodia (stable) Vietnam (stable)	—
B-/B3	Pakistan (stable)	—	—
CCC+/Caa1	—	Pakistan (negative)	—
CCC/Caa2	—	—	—
CC+/Ca1 & Below	—	—	—

Source: S&P, Moody's, Fitch, Bloomberg

Figure 105. Ratings History (Average of S&P and Moody's Ratings), December 1998-October 2013



Source: S&P, Moody's, and Citi Research

Global Assumptions

	2013 Q2E	2013 Q3E	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2012E	2013F	2014F	2015F	2016F	2017F
Global Indicators														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	2.6	2.5	3.2	3.4	3.6	3.6
CPI Inflation (average, y/y %)	—	—	—	—	—	—	—	—	2.9	2.6	2.9	3.3	3.2	3.2
Current Account (% of GDP)	—	—	—	—	—	—	—	—	0.5	0.7	0.7	0.4	0.1	-0.1
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-4.4	-3.5	-3.0	-2.6	-2.4	-2.2
Industrial Countries*														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	1.4	1.1	2.0	2.2	2.3	2.2
CPI Inflation (average, y/y %)	—	—	—	—	—	—	—	—	1.9	1.3	1.8	1.6	1.6	1.5
Current Account (% of GDP)	—	—	—	—	—	—	—	—	-0.5	0.0	0.0	-0.1	-0.2	-0.2
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-6.0	-4.4	-3.6	-2.9	-2.6	-2.3
United States														
GDP Growth (SAAR %)	2.5	1.9	2.0	2.9	3.0	3.1	3.1	3.0	—	—	—	—	—	—
GDP Growth (y/y %)	1.6	1.4	1.9	2.3	2.5	2.8	3.0	3.1	2.8	1.6	2.6	3.2	3.2	3.0
CPI Inflation (average, y/y %)	1.1	1.2	1.2	1.5	2.1	2.1	2.1	2.1	1.8	1.2	1.9	2.1	2.1	2.1
Current Account (% of GDP)	-2.4	-2.5	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6	-2.7	-2.5	-2.6	-2.7	-2.7	-2.7
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-8.1	-4.8	-4.3	-3.8	-3.8	-3.8
S&P 500 EPS (y/y %)	5.8	4.2	7.6	6.2	5.6	7.0	5.9	NA	6.1	5.5	6.2	—	—	—
Business Investment (y/y %)	2.4	3.3	1.8	4.1	4.2	4.5	5.0	5.2	7.3	2.4	4.4	—	—	—
Imports (y/y %)	1.2	1.9	3.9	5.4	5.3	6.0	6.3	6.3	2.2	1.8	5.7	—	—	—
Japan														
GDP Growth (SAAR %)	3.8	2.0	4.2	4.7	-5.2	2.5	0.6	0.5	—	—	—	—	—	—
GDP Growth (y/y %)	1.3	2.7	3.5	3.7	1.4	1.5	0.6	-0.4	2.0	1.9	1.8	1.0	1.2	1.2
CPI Inflation (y/y %)	-0.3	0.7	0.8	0.8	2.8	2.5	2.4	2.4	0.0	0.1	2.1	1.5	1.5	0.7
Current Account (% of GDP)	0.4	0.3	0.3	0.5	0.6	0.6	0.5	0.5	1.1	1.5	2.4	1.8	1.5	1.3
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-10.7	-9.8	-8.0	-6.2	-5.8	-5.4
Euro Area														
GDP Growth (SAAR %)	1.2	0.8	0.9	0.8	0.7	0.8	0.8	1.1	—	—	—	—	—	—
GDP Growth (y/y %)	-0.5	-0.2	0.6	0.9	0.8	0.8	0.8	0.8	-0.6	-0.3	0.8	1.0	1.3	1.5
CPI Inflation (y/y %)	1.4	1.3	1.2	1.2	1.4	1.3	1.4	1.4	2.5	1.4	1.3	1.4	1.4	1.4
Current Account (% of GDP)	—	—	—	—	—	—	—	—	1.3	2.6	2.5	2.5	2.5	2.5
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-3.7	-2.8	-2.3	-1.8	-1.4	-0.9
Exchange Rates														
US\$ vs. Euro (eop)	1.30	1.35	1.38	1.39	1.40	1.40	1.40	1.40	1.28	1.33	1.40	1.40	1.40	1.40
US\$ vs. JPY (eop)	99	98	99	102	104	105	105	105	81	98	104	105	105	105
JPY vs. Euro (eop)	129	133	137	142	146	147	147	147	104	130	145	147	147	147
Short Interest Rates (eop)**														
United States	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	1.60	2.70
Japan	0.09	0.08	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Euro Area	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.88	0.56	0.50	0.50	0.56	0.81
10-Yr Yield Forecasts (Period Avg.)														
United States	2.49	2.61	2.70	2.78	2.98	3.15	3.25	3.40	1.80	2.30	3.00	3.50	3.75	4.00
Japan	0.85	0.69	0.65	0.60	0.50	0.60	0.70	0.80	0.85	0.72	0.60	0.90	1.25	1.50
Euro Area***	1.73	1.78	1.80	1.80	1.80	1.80	1.90	2.00	1.57	1.62	1.83	2.00	2.25	2.50
Emerging Markets														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	4.6	4.6	5.0	5.2	5.4	5.5
CPI Inflation (eop, y/y %)	—	—	—	—	—	—	—	—	4.6	4.7	4.6	4.8	4.6	4.7
Current Account (% of GDP)	—	—	—	—	—	—	—	—	2.1	1.9	1.6	1.0	0.4	0.1
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-1.6	-2.0	-2.1	-2.0	-2.0	-2.0
Commodities														
WTI Oil price (US\$/bbl)	94.2	108.0	107.0	108.0	103.0	108.0	102.0	102.0	94.1	100.9	105.3	99.3	—	—
Copper (Average, USD/MT)	7,188	7,060	6,900	6,700	6,600	6,400	6,500	6,500	7,945	7,280	6,550	6,800	—	—
Gold (Average, US\$/oz)	1,429	1,315	1,250	1,220	1,230	1,260	1,280	1,280	1,669	1,405	1,250	1,350	—	—

Note: *It includes: US, Japan, Germany, France, Italy, Spain, Netherlands, Belgium, Finland, Denmark, Norway, Sweden, Switzerland, United Kingdom, Canada, Australia, and New Zealand. **Average from 2008 on. ***Ten-year Bond yield. Sources: National authorities and Citi Research estimates.

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Country/Region	Topic	Author	Date
Global	<u>Cross-Currents and Risks</u>	Willem Buiter, Michael Saunders	22-Oct-13
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Asia-Pacific Economics and Market Analysis

Figure 106. Citi Global Economics Team *For informational purposes only*

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Rohini Malkani was on a three months leave of absence for the period July 15 2013 until October 14 2013. During this period, she worked for the Ministry of Finance, India and she ceased all normal course business activity as an Economist at Citi.

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