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Emerging Markets
GEMS

Emerging Markets Macro and Strategy Outlook

What happens to EM when US short-term rates rise?

- How will EM be affected if short term US interest rates go up sooner rather than later? One important way of assessing the significance of rising short term US rates is to think about what impact it might have on the behavior of commercial banks in managing their cross-border exposure to EM. The reason for this is that, by and large, banks fund themselves at the front end of the yield curve, and so an upward shift at the front end of the curve might cause a 'second round' of capital outflows from EM, following the first round by portfolio investors that accompanied tapering fears in 2013.

- There are two arguments for EM not to worry about rising short term US rates. One is that EM has had time to get used to the idea. The current monetary cycle in the US is seeing an unusually long lag between the increase at the back end of the US curve and the increase at the front end, so EM has been given a chance to adjust in advance of a rise in short term US rates: currencies have weakened, current account deficits have shrunk. Another argument not to worry about rising short term US rates is that commercial banks are just less important these days as a supplier of cross-border funding to EM than was the case 10 or 20 years ago.

- But banks still play an important role in the supply of fx-denominated funding: the increase in banks' cross-border exposure to EM in the past five years has been roughly the same as the issuance of international debt securities by EM: around $1.2 trillion each. By far the biggest increase in banks' cross-border exposure has been to China. The BIS's 'consolidated' data show a $620 bn increase in exposure to China between early 2009 and late 2013; 80% of which was lent with maturities of less than 12 months.

- This raises the question of whether a rise in US rates could help precipitate a capital outflow from China. This question is particularly relevant given the likely currency mismatches that have been established in connection with foreign bank lending to China, and the recent increase in CNY volatility aimed at making those currency mismatches less profitable. In other words, the combination of higher US rates and a CNY that's no longer a one-way bet could lead to a bigger capital outflow from China.

- Capital outflows are not naturally conducive to strong domestic credit creation, and that might raise concern about GDP growth in an economy that has been as credit-hungry as China's has been in the past five years. So, if rising fx volatility and higher US rates suck capital out of China – just as low fx volatility and low US rates have pushed capital towards it - higher 'China risk' might be the most important consequence of higher short term US rates.

EM Economics and Strategy

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What happens to EM when US short-term rates rise?

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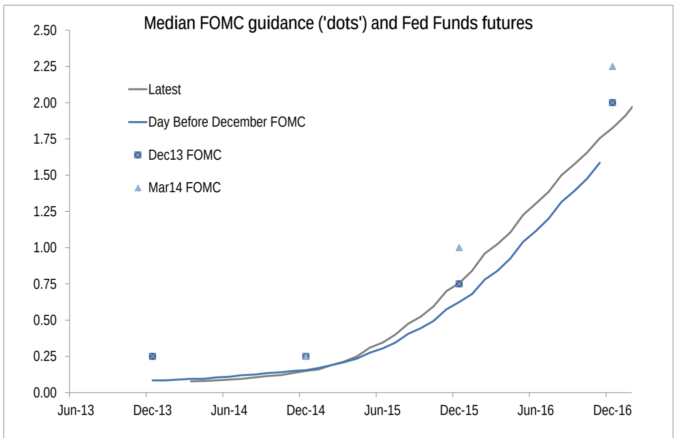
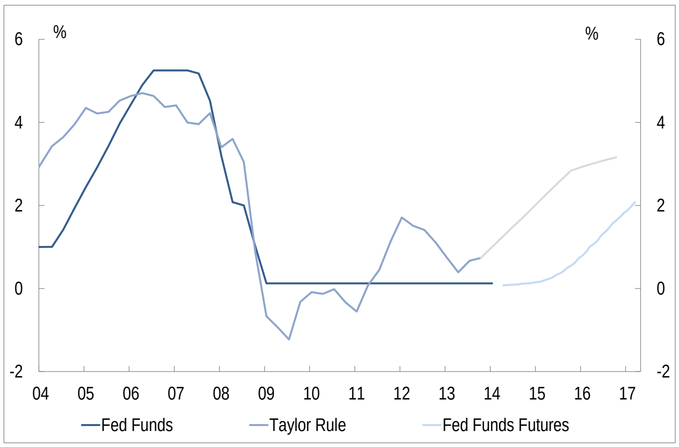
The prospect of an earlier-than-expected rise in short term US interest rates raises the question of how EM might be affected. Fed Chair Yellen's press conference on 19th March provided a reminder to investors that US short term rates might rise sooner rather than later. Yet even before Chair Yellen's defined the word 'considerable', it's been clear for some time that there has been a gap between the interest path implied by the Taylor Rule and that indicated by the FOMC's 'dots' – FOMC participants' judgments about the appropriate Fed funds rate in the future. Our view is that the large gap between officials' projections and the Taylor Rule rate creates upside rise to the US interest rate outlook (Figure 1). (U.S. Market and Policy Comments - Transparency ≠ Clarity). This should matter for EM: capital flows to EM have moved in cycles over the past 50 years, and those cycles seem to be linked to changes in US monetary conditions. And so the prospect of higher short-term US interest rates might be a new threat to the capital account of a number of EM economies.

Figure 1. A more hawkish Fed…



Notes: Diamonds represent FOMC participant's judgment of appropriate level of the target federal funds rate.
Sources: Federal Reserve Board, Bloomberg and Citi Research

Figure 2. ...and a Taylor Rule that suggests monetary tightening much earlier than the forward guidance



Source: Citi Research

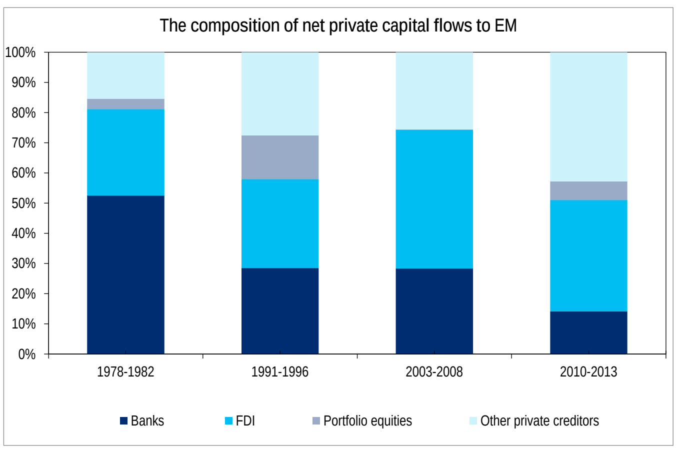
One way of assessing the significance of rising short term US rates is to think about what impact it might have on the behavior of *commercial banks* in managing their cross-border exposure to EM. The rise in US 10 year yields that we saw from May 2013 created uncertainty about portfolio flows to EM, mainly because portfolio investors are managing liabilities that lie across the whole of the US curve; so, a rising 'risk free' return on their longer term liabilities raises the chance that there might be less yield-seeking behavior among those investing longer-term liabilities. By contrast, the front end of the US curve is where commercial banks fund themselves, by and large. The risk here, then, is that rising short term rates in the US might cause commercial banks to shrink their risk-appetite towards EM, take repayments from EM borrowers, and thus create a 'second round' of capital outflows, following the first round that accompanied tapering fears in 2013.

There are two arguments for EM *not* to worry about rising short term US rates. One is that EM has had time to get used to the idea. The current monetary cycle in the US is seeing an unusually long lag between the increase at the back end of the US curve and the increase at the front end. What this means is that EM is being given space to adjust *before* the front end of the US curve actually shifts. As we've

seen in the past 10 months: currencies have depreciated, current account deficits have shrunk, and so fragile emerging economies should be much better-protected from the effect of rising short-term rates than they would have been if there was US monetary tightening 'out of the blue'; or if there had been a smaller gap between the rise at the back end of the US curve, and the rise at the front end.

Another argument not to worry about rising short term US rates is that commercial banks are less important these days as a supplier of cross-border funding to EM. This is absolutely true, as is evident from Figure 3. In the late 1970s and early 80s, banks were responsible for more than half of net private cross-border funding for emerging economies. In the past few years that has fallen to less than 15%, thanks to the extraordinary rise in the willingness of international investors to buy local markets debt in EM. So banks are much less important in overall terms. But they still play an important role in the supply of *fx-denominated* funding. This is illustrated in Figure 4, which compares the increase in the supply of international funding to EM that has come from banks with what has come from the issuance of international securities. The stock of banks' international claims in developing countries is around $3.5 trillion, more than $1 trillion greater than the stock of international debt securities issued by EM. In addition, the increase in the international claims of banks in EM has been just as sizeable as the increase in international securities issuance since early 2009: both have gone up by around $1.2 trillion each.

Figure 3. Banks are less important as a supplier of cross-border funding to EM than they used to be…



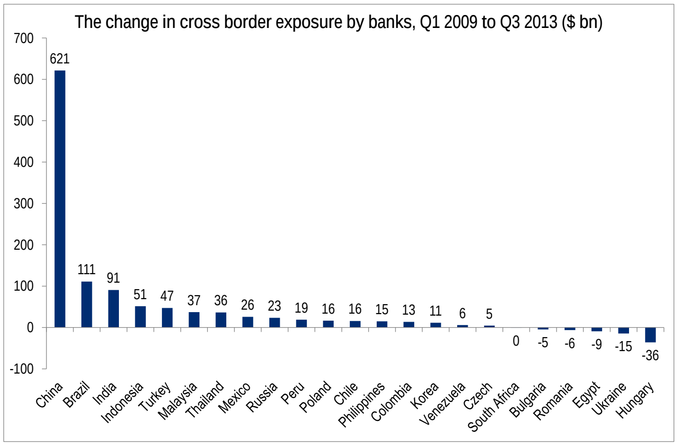
Source: IIF; Citi Research; note that 'other private' includes intra-company funding as well as inflows of fixed income investors.

Figure 4. …but banks have been more important than securities markets when it comes to the supply of fx-denominated funding

Source: BIS; Citi Research

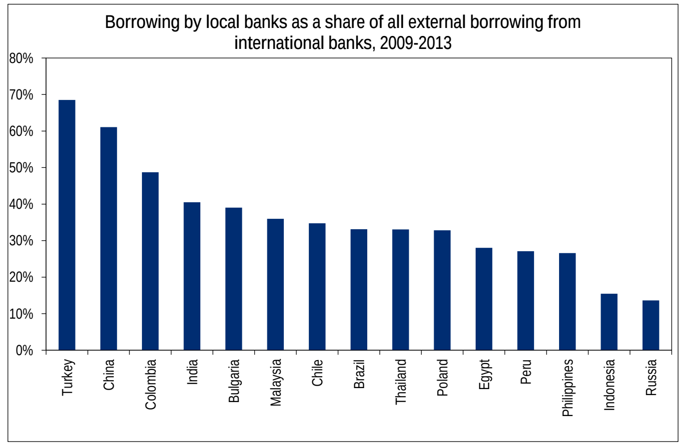
The supply of cross-border funding to EM by banks in recent years has been heavily oriented towards China. Net international borrowing from banks in the past five years by the 23 countries covered in Figure 5 amounts to around $1.1 trillion, but almost 60% of that borrowing has been done by China. While banks have been eager to 'de-lever' from eastern Europe – hence net repayments taken from Hungary, Ukraine, Romania, Bulgaria for example – risk appetite for China has been exceptionally robust; and to a lesser degree has risk appetite for some other 'big' EMs: Brazil, India, Indonesia and Turkey. Robust risk appetite by international lenders has helped to finance build-up of external debt by corporates in these countries, among other things.

Figure 5. Consolidated international claims by banks to EM went up by $1 trillion between early 2009 and late 2013; much of it lent to China…



Source: BIS; Citi Research

Figure 6. …and for a number of countries it is interbank lending that has dominated the flows.



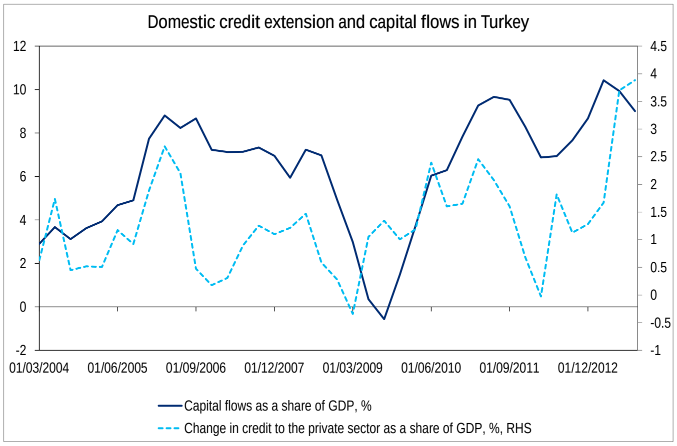
Source: Citi Research

There are three broad issues to consider in weighing up the risk of banks taking cross-border repayments from EM. The first is the extent to which banks have been an important marginal supplier of dollars to the economy. Aside from China – to which we'll return, below – this probably isn't an overwhelmingly important phenomenon. There is only a rather small group of countries – notably Brazil and India, Indonesia and Turkey - which have seen increases in offshore bank borrowing that could be large enough to create some threat to external stability.

A second issue to consider is the role of international banks as a source of funding to support the domestic credit cycle. Quite a few emerging economies are familiar with the idea that the availability of domestic credit is partly a function of the availability of external financing. In other words, when external funding conditions become constrained, that has a dampening effect on the availability of domestic credit. So, where EM banks have been relying on foreign banks as source of external funding, diminished risk appetite on the part of foreign banks could be a source of lower risk appetite among domestic banks. And since there aren't many countries in EM right now where domestic banks have very strong appetite to increase their balance sheets, a withdrawal of external funding from domestic banks could produce a squeeze on domestic spending growth. That's not necessarily the case. Central banks might find ways of substituting the withdrawal of external liquidity: the Central Bank of Russia for example has increased its own supply of funding to Russian banks fairly dramatically in the past couple of years to accommodate lower capital inflows. But this supply of central bank money may not be compatible with currency stability.

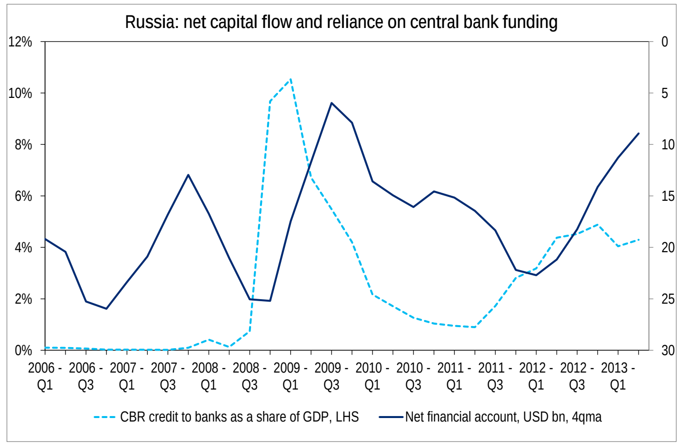
The third issue to consider is China. As Figure 5 makes clear, cross-border lending by international banks to China has dominated lending behavior in EM over the past five years. There are two additional factors to note about this lending. In the first place, it has been disproportionately short term. Figure 9 compares the maturity structure of BIS-reported consolidated loans to China during the past five years with other EMs, and it's clear that loans to China have been heavily concentrated in maturities of one year or less. The second factor to note is the acceleration of cross-border lending by banks into China that took place last year. This is particularly worth considering in the context of the PBOC's effort to increase exchange rate volatility recently.

Figure 7. Turkey's experience shows how the availability of domestic credit is somehow a function of the availability of external funding…



Source: Haver Analytics, Citi Research

Figure 8. …though Russia's experience shows how capital outflows can lead to greater reliance on the central bank to fund local banks



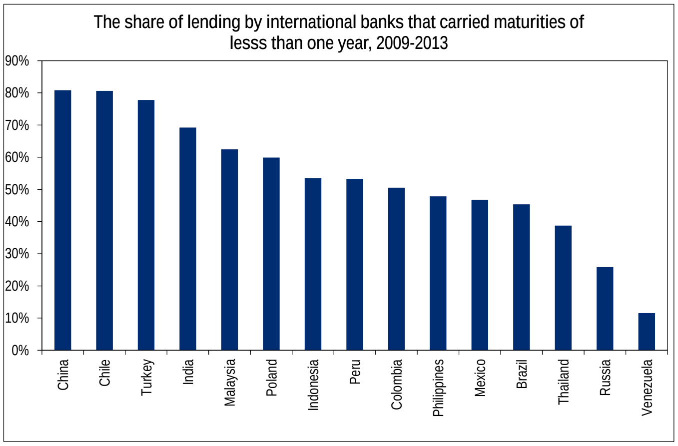
Source: Haver Analytics, Citi Research

China's big increase in short term offshore borrowing raises a question: is 'China risk' a function of US interest rate risk?[1] The steady appreciation of the RMB in recent years has, arguably, turned China into a magnet for speculative capital inflows. These flows seemed to grow dramatically during late 2012, 2013 and early this year, a growth that was reflected in the strength of the CNY within its trading band; and in the premium at which the offshore CNH traded against on the onshore CNY. And that growth is what, at least partly, is being illustrated in Figure 10. But it is probably true that during the whole post-Lehman era of exceptionally low US interest rates, the predictability of the RMB has attracted inflows aimed at established short USD, long RMB positions. In addition to the $620 bn of bank lending we've identified here, this period also saw international securities issuance of some $230 billion by Chinese borrowers, some of whom will have been motivated by the same desire. (It has to be said though that since the BIS data on banks includes their holdings of securities, there might be double-counting between these two numbers). There's a dangerous scenario, we think, in which the combination of rising US short term rates and more volatile RMB could lead to rather large capital outflow from China.

Chinese authorities have considered for some time the idea of making the RMB less of a one-way bet, and to erode the incentives for speculative positions in the currency. The reason is clear: a big wave of speculative capital inflows is unpleasant for any country because it can be the prelude to an even more unpleasant wave of speculative outflows. That's the background for the PBOC's efforts since mid-January to weaken the CNY fixing rate, and its mid-March decision to widen the CNY's daily trading band to +/- 2% from +/-1%. Complementary measures might include the introduction of taxes on various kinds of borrowing, in an effort to throw 'sand in the wheels' of speculative activity; and new measures to facilitate capital outflows. These might not be needed though, if volatility by itself breeds outflows.

[1] See "The Renminbi and Beijing's 'Chi-lemma'", David Lubin, 24 March 2014, Citi.

Figure 9. International bank lending to China has been overwhelmingly short-term in nature...



Source: BIS, Citi Research

Figure 10. ...and lending activity accelerated in 2013

Source: BIS, Citi Research

China's problem is that large capital inflows have helped to lubricate the engine of China's credit-driven growth model. As long as inflows have been plentiful, it's been easy for the PBOC to finance the creation of domestic liquidity: it buys the dollars that are coming in, and sells RMB. Of course that's not the only way the PBOC can create liquidity: the required reserves ratio (RRR) of Chinese banks is very high, for example, and cutting this could be a new source of domestic liquidity. But it is common enough for emerging economies to see weaker domestic liquidity conditions when capital flows out rather than in. And in China too: when 'tapering risk' first began to suck capital out of emerging markets last May, large outflows from China helped to set the stage for a nasty liquidity crunch in June 2013.

Capital outflows are not naturally conducive to strong domestic credit creation, and that might raise concern about GDP growth in an economy that has been as credit-hungry as China's has been in the past five years. So, one of China's challenges will be to make sure that more exchange rate volatility doesn't come at the expense of a sudden slowdown in credit growth that could squeeze the economy. That challenge will be particularly difficult at a time when the front end of the US yield curve might shift up in the next few months: rising short term interest rates in the US might erode banks' willingness to roll over their cross-border loans to borrowers in China, especially when there is more uncertainty about the path of the exchange rate. To that extent, higher 'China risk' might be the most important consequence of higher short term US rates.

Strategy: The Fed turns hawkish. Will EM tailspin?

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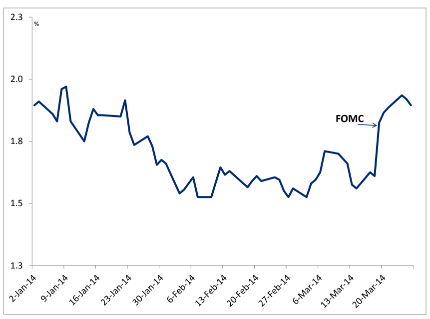
The Fed continues unabated its tapering of purchases of long-term assets. Market expectations are that only a large shock can turn the Fed away from its current pace of $10bn-a-meeting reduction in asset purchases. At the same time, in her first press conference as chair, Janet Yellen's Fed delivered a more hawkish message. The median FOMC forecast for policy rates in 2015 is now at 1% (25bp higher than in December) and for 2016, it is at 2.25% (50bp higher than three months ago). That is, not only the first hike in interest rates is gradually approaching (and it could happen earlier than previously thought), the path's slope is now forecasted to be steeper. US rates markets did not take long to respond. Within hours, 10y UST jumped 10bp and the December 2016 Fed Funds futures contract yield jumped 21.5bp. The adjustment continued in the following days and the Dec 2016 Fed Funds contract is now 30bp higher than pre-FOMC (Figure 11). Is this the first leg of another significant re-pricing in EM assets, as the one that followed the May 2013 initial "tapering" statements? We do not think so. Directionally, we think that EM will still accompany the normalization of US rates, but in our view, the magnitude of the adjustment is likely to be different and, in particular, could be quite different across asset classes.

Figure 11. Dec 2016 Fed Funds futures contract jumped 30bp after March FOMC.



Source: Bloomberg.

The 2013 May-September sell-off in EM assets was remarkable. From May 8 to September 5, local currency bond yields as measured in Citi's EMGBI index widened 154 bps (Figure 12), an equal-weighted portfolio of EM FX (spot) depreciated 7.7% (Figure 13), and EM CDX widened 112bp. If EM assets sold off this much when the announcements only implied less accommodative monetary policy, could conditions turn significantly worse when interest rates start moving? We think that the response is likely to be different across assets and countries. In the pages that follow, we will take a partial look at the potential dynamics at play. We will argue that it is important to look at the "betas" or asset price sensitivity to two different sources of external shocks: changes in term premia and changes in expected future policy rates. Our conclusions are:

- Local currency (lcy) bond betas are primarily a function of term premia in US Treasury yields. Changes in expectations of US policy rates matter, but revisions in expectations of term premia are significantly more impactful.

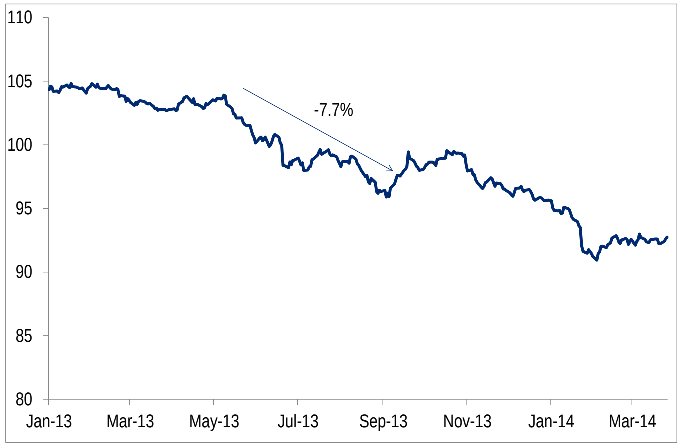
- The results for EM FX are less conclusive. On the one hand, economic fundamentals argue for continued weakness in EMFX. On the other, our statistical analysis suggests that within short periods (a month in our analysis) when expected future policy rates go up, EMFX can respond with tangible appreciations. We attribute this result to the fact that oftentimes increases in expected future rates are a product of current or expected economic conditions. In that light, we suggest that one needs to be careful about the drivers of expected future rates.

- EM credit is less sensitive to US rates, be it to term premia or expected future rates – as it should, since it reflects a spread. Like with EMFX, higher expected future policy rates can lead to tighter spreads, particularly if they stem from improving economic conditions. Term premia appears to be less relevant, and with mixed signs.

Figure 12. Local currency bonds (EMGBI) suffered a battering during the 2013 tapering episode and they have not recovered…

Source: Citi Research.

Figure 13. …neither has EM FX (equal-weighted index), despite some short-lived rebounds. Will the downward movement continue as Fed Funds normalize?



Source: Citi Research.

Why should we decompose UST yields?

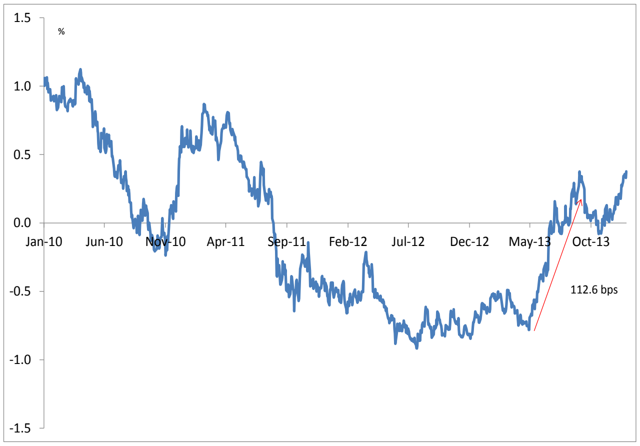
The term structure of US Treasury yields can be decomposed into two components: the expected path of short-term interest rates between now and a given point in the curve, and the term premia, or risk premia, associated with a longer duration instrument. Both components need not be independent. Indeed, they oftentimes co-move. However, the two can be separated, and yield an analytically tractable way to help us think through the drivers of the yield curve.

In the May-September tapering episode, the drastic move in 10-year US real yields (159bp) was larger than the move in nominal 10-year bonds (132bp) suggesting a real factor was behind the sell-off: term premia. In Figure 14, we show the Fed's estimate of the term premium in 10-year Treasury bonds.[2] According to this methodology, in May-September, the estimated term premium jumped 112.6bp, almost entirely explaining the move in nominal yields. Expected future rates (computed here as a residual) accounted for only 20bp (Figure 15). Calculating an independent measure of expected future rates is cumbersome. A noisy proxy could be computed by looking at the generic 24 month Fed Funds futures contract yield. As Figure 15 shows, both curves tend to co-move in episodes with large changes in expectations of future policy rates. Considering the tapering episode, expected future rates seemed to increase little, though with significant volatility.

How are US Treasuries likely to move in the future, particularly as we near the first hikes by the Fed? To begin with, Figure 14 suggests that term premia are still below the average levels (50bp) pre-Operation Twist and LSAP (QE3) (in both cases, the Fed retired large quantities of duration risk, significantly impacting its pricing). A full normalization of term premia would involve, perhaps, another increase of 20 or 30bp, though volatility cannot be ruled out. If 10-year US Treasurys trade today close to 2.7%, a post-LSAP level of 3.0% might not be unreasonable.

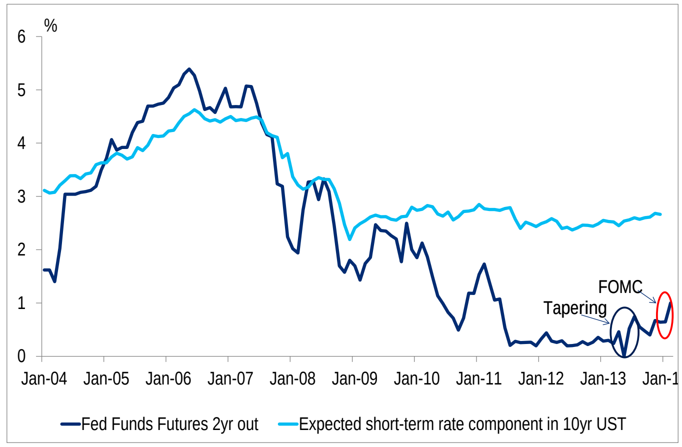
[2] Don H. Kim and Jonathan H. Wright, "An Arbitrage-Free Three-Factor Term Structure Model and the Recent Behavior of Long-Term Yields and Distant-Horizon Forward Rates," http://www.federalreserve.gov/pubs/feds/2005/200533/200533abs.html

Figure 14. Term premium in 10y UST. Operation Twist and QE3 delivered an abnormally negative level. Tapering produced a rapid normalization.



Source: Kim-Wright, Federal Reserve Board.

Figure 15. Expected future rates – two proxies. Both show significant stability at a low level since the GFC. The more volatile 2y Fed Funds futures suggests a pick-up of late.



Source: Citi Research, Federal Reserve Board, Bloomberg.

Besides the normalization in risk premia, towards the end of 2014, the Fed will be significantly closer to hiking interest rates. As markets slouch towards the first hike, front-end US Treasury yields will rise (bear-flattening).[3] As a first approximation, nine months from now, if the Fed median estimate of policy rates for year-end 2016 still holds (2.25%), then the 2-year Fed Funds futures contract ought to slide 125bp. Figure 15 suggests that 2yr Fed Funds futures are significantly more volatile than the full 10-year expected future rates (with no new information, just the passage of time should leave the 5y5y forward rate unchanged). Therefore, an additional 30-40bp move in 10-year expected future rates would seem reasonable. All in all, 10-year Treasury yields of 3.35-3.4% emerge as a likely forecast (in line with Citi US rates strategy forecasts).

How are EM assets likely to respond?

A useful way to think through the question is to consider the composition of EM assets' betas. If betas are driven primarily by US term premia, moderate optimism might not be out of place. If, on the other hand, betas respond mostly to the expectations of short-term rates, volatility and further re-pricing should be expected.

Economic theory makes some predictions about how betas ought to respond. In a world of perfectly floating exchange rates, a small open economy ought to find a high degree of monetary policy independence. Thus, if monetary policy tightens abroad, domestic interest rate could remain anchored by economic conditions at home and the exchange rate would absorb most of the difference in the policy path. If that was the case, local currency bonds, discounting local policy rates, ought to remain relatively unaffected and exchange rates ought to take the brunt of the adjustment. Naturally, monetary policy is never quite as independent. Central banks move their interest rates partly in response to changes in inflation, which is itself affected by exchange rates. Also, exchange rates overshoot and lead to policy responses by central banks with a dual mandate. Finally, exchange rates are seldom perfectly floating, and many countries tend to intervene (sometimes a lot). Intervention in response to moves in FX driven by monetary policy abroad often results in changes in expectations of future home policy rates. As a result, the more

[3] Notice that this is likely to materialize even if there are no further revisions in the Fed forecasts of the actual state of the economy.

moderate FX intervention is, the lower (higher) the local currency bond (FX) beta to changes in foreign interest rates (current or expected) will be. A powerful prediction relative to market concerns.

When term premium moves, it reflects varying risk factors that are bound to affect all global assets. In an integrated world capital market, with or without floating exchange rates, term premia ought to fully transmit (beta adjusted) across borders (i.e., higher US term premia ought to result in higher Mexico, Poland or Korea term premia). If the driving force is just an increase in risk aversion and movements in prices are nearly instantaneous, the impact on FX markets ought to be very limited. However, the risk component associated with term premia is inevitably a function of policy rates, inflation uncertainty and risk tolerance. Therefore, one would expect the beta of country *"i"* assets to be different from that of country *"j".* In all cases, however, one would expect to observe a higher response of local currency bonds to changes in US term premia than to expected future rates.

The driving force behind movements in expected future interest rates is also likely to matter a great deal. If US rates increase because of a strongly performing economy, it is possible that conditions will improve for EMs as well. As a result, EM FX may temporarily appreciate thanks to diminished risk aversion, and credit spreads could decline – the probability of default declines in a strongly performing global economy. On the other hand, if US rates are increased to fight inflation, weaker FX and wider spreads are to be expected. Regarding term premia, EM credit tends to have relatively long duration, thus increases in the price of duration risk ought to impact EM yields, but not necessarily credit spreads. This should be particularly true in the case of investment-grade and high-quality credit where beta is likely to be fairly low.

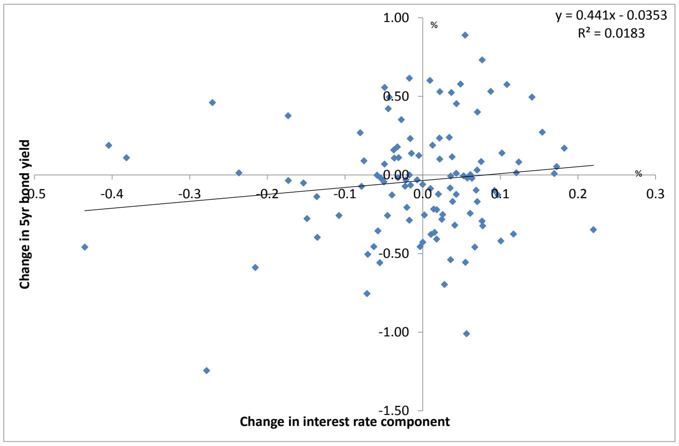
Interest rate and term premium betas

To decompose betas into interest rates and term premium betas, we run regressions of monthly changes in local currency bond yields, FX and spreads on monthly changes in the expected short-term rate and term premium components in 10-year US Treasury yields. We use the Federal Reserve Board's estimate of the term premium,[4] and subtract it from the 10-year Treasury yield to get the expected short-term rate component.

Figures 12 and 13 illustrate the results for Mexico's 5-year local currency bonds. Since Mexico is a country that has pursued a relatively clean float during the last decade, it offers an interesting test of the propositions presented above. As we can see in the graphs, Mexico's local bonds are significantly more responsive to changes in US term premia than to expectations of future Fed Fund rates.

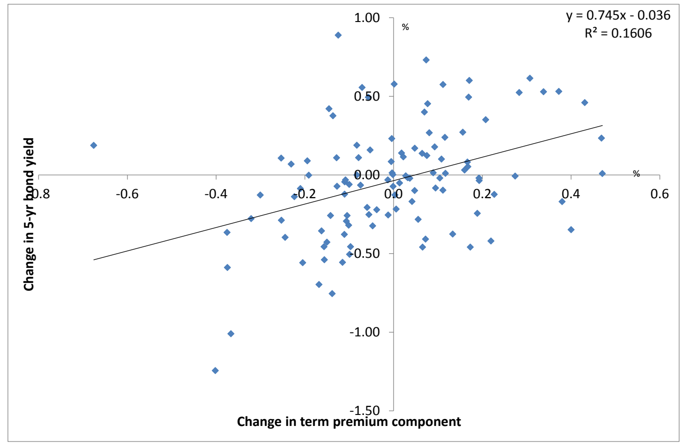
[4] Don H. Kim and Jonathan H. Wright, "An Arbitrage-Free Three-Factor Term Structure Model and the Recent Behavior of Long-Term Yields and Distant-Horizon Forward Rates," http://www.federalreserve.gov/pubs/feds/2005/200533/200533abs.html

Figure 16. Changes in 5yr MXN bond YTM do not seem to be too sensitive to changes in expected future US interest rates…



Source: Citi Research, Federal Reserve Board, Bloomberg.

Figure 17. … However, 5yr MXN bond yields seem quite responsive to changes in the term premium embedded in 10yr UST



Source: Citi Research, Federal Reserve Board, Bloomberg.

When we generalize the exercise to other EM, the results for local currency bonds seem broadly consistent with the view that expected future rates ought to be less significant (Figures 18 and 19). In most cases, the results show that term premia betas are statistically (and economically) significant, with the correct sign. On the other hand, only in a few cases are betas significantly different from zero for expected future rates. The most remarkable result emerges in Asia (Korea, Malaysia and Thailand) where expected future rates seem to be more significant than term premia. One plausible explanation, however, is that these are countries with heavily managed currencies where FX volatility has tended to be limited. Indeed, the results tend to suggest that in countries such as South Africa and Mexico, where the currency is allowed to float with greater flexibility, term premia betas are larger (a pattern also present in Hungary, Brazil, Turkey and Indonesia). While the results do not negate an impact of expected future rates, they suggest that it is bound to be somewhat more muted.

Figure 18. 5y EM local currency bonds' response to changes in expected future US interest rates.

	BRL	MXN	PEN	HUF	PLN	ZAR	TRY	IDR	KRW	MYR	PHP	THB
intercept	-0.11	-0.04	-0.02	-0.04	-0.01	-0.01	-0.06	-0.03	-0.01	0.01	-0.07	0.01
	(-1.34)	(-1.24)	(-0.27)	(-0.75)	(-0.48)	(-0.37)	(-0.93)	(-0.53)	(-0.70)	(-0.42)	(-1.96)	(-0.57)
beta	1.21	0.44	-0.10	-0.04	0.6	0.7	0.56	-0.42	0.72	0.56	0.10	1.28
	(-1.35)	(-2.13)	(-0.30)	(-0.09)	(-1.76)	(-1.13)	(-0.77)	(-0.58)	(4.75)	(-2.55)	(0.37)	(-4.00)
R^2	0.02	0.14	0.00	-0.01	0.03	0.04	0.01	0.00	0.11	0.11	0.00	0.17

Source: Citi Research.

Figure 19. 5y EM local currency bonds' response to changes in US 10y term premia.

	BRL	MXN	PEN	HUF	PLN	ZAR	TRY	IDR	KRW	MYR	PHP	THB
intercept	-0.1	-0.04	-0.02	-0.03	-0.01	-0.01	-0.07	-0.03	-0.02	0.01	-0.07	0.01
	(-1.40)	(-1.70)	(-0.32)	(-0.76)	(-0.51)	(-0.35)	(-1.17)	(-0.46)	(-0.85)	(-0.46)	(-1.94)	(-0.43)
beta	1.63	0.74	0.59	0.39	0.6	0.72	0.76	0.94	0.28	0.34	0.37	0.48
	(-4.09)	(-5.96)	(2.29)	(-1.02)	(-3.69)	(-4.60)	(-1.52)	(-1.20)	(2.98)	(-3.76)	(1.76)	(-4.06)
R^2	0.14	0.16	0.09	0.02	0.13	0.13	0.04	0.05	0.06	0.15	0.02	0.09

Source: Citi Research.

EMFX is more sensitive to expected future rates, though the sign deserves some discussion. Our regression results show that the FX beta relative to changes in expected future policy rates is, in absolute value, significantly larger than the beta

on term premia:[5] beta estimates are large and negative for BRL, MXN, ZAR, TRY, and KRW. A negative coefficient implies that when expected future interest rates abroad increase, EM FX tends to appreciate – the opposite direction our theory had suggested. We interpret these results to mean that, in short periods of time (one month in our empirical exercise), news about stronger US growth leads to an upward revision in expected future rates and a reduction in EM risk premia. Over time, we would expect that fundamental economic dynamics would prevail, driving EMFX weaker.

Figure 20. EM FX response to changes in expected future US interest rates.

	BRL	CLP	COP	MXN	CZK	HUF	ILS	RUB	ZAR	TRY	INR	IDR	KRW	MYR	PHP	THB
intercept	-0.34	-0.27	-0.32	0.10	-0.26	-0.06	-0.25	0.01	0.12	0.18	0.18	0.22	-0.11	-0.17	-0.15	-0.21
	-0.88	-0.85	-1.01	0.43	-0.73	-0.14	-1.13	0.02	0.32	0.50	0.78	0.88	-0.42	-0.89	-0.89	-1.38
beta	**-12.65**	-3.73	-1.71	**-10.51**	-3.74	-6.11	-0.42	**-5.59**	**-12.03**	**-6.63**	**-4.74**	**-5.42**	**-7.88**	-1.73	-1.25	-0.43
	-2.11	-0.75	-0.40	-2.43	-0.84	-1.15	-0.11	-2.17	-2.90	-1.95	-2.08	-2.25	-2.54	-0.65	-0.72	-0.30
R2	0.09	0.01	0.00	0.13	0.01	0.02	0.00	0.04	0.06	0.03	0.04	0.04	0.05	0.01	0.01	0.00

Source: Citi Research

Figure 21. EM FX response to changes in US 10y term premia.

	BRL	CLP	COP	MXN	CZK	HUF	ILS	RUB	ZAR	TRY	INR	IDR	KRW	MYR	PHP	THB
intercept	-0.30	-0.25	-0.31	0.14	-0.24	-0.03	-0.25	0.02	0.16	0.22	0.20	0.25	-0.08	-0.14	-0.14	-0.20
	-0.70	-0.77	-0.97	0.46	-0.68	-0.06	-1.13	0.08	0.38	0.60	0.84	0.95	-0.25	-0.70	-0.84	-1.35
beta	-0.40	2.14	1.25	0.37	0.86	2.29	-0.99	-0.22	0.11	**3.37**	0.45	1.05	0.82	0.70	0.92	**1.33**
	-0.20	1.13	0.67	0.24	0.38	0.92	-0.75	-0.16	0.04	1.97	0.39	0.85	0.81	0.59	1.31	1.90
R2	0.00	0.02	0.01	0.00	0.02	0.01	0.01	0.00	0.00	0.03	0.00	0.01	0.00	0.00	0.01	0.03

Source: Citi Research

As it stands, the notion that current rate tightening is not going to be as destabilizing for local currency bonds finds empirical support. Furthermore, in the short term, our results provide an explanation for why EM FX appreciated in response to the re-pricing in expected future US rates. For instance, if we arbitrarily assume that expected future rates moved by about one half the move in the 2y Fed Funds Future (+25bp since the FOMC statement) then, everything else the same, our regression results suggest an appreciation of 1.6% in BRL and ZAR, 1.3% in MXN and 0.8% in TRY and KRW. It is difficult to know in which direction expectations about future US growth will move in the next few months and, therefore, we should not anticipate changes in US rates driven by these forces. However, the sheer passage of time as we approach the first Fed Funds hike should lead to a slide in the expected future rates component in UST (we argued for 35-40bp before). We think that such “slide” in US rates should not be interpreted under the light of the regression analysis above. The regression captures “new information” rather than a gradual re-pricing of old news. For this reason, we think EMFX will tend to be driven more by fundamentals than the type of high frequency adjustment that the regression implies. Such trends continue to suggest EM FX will weaken through 2014.

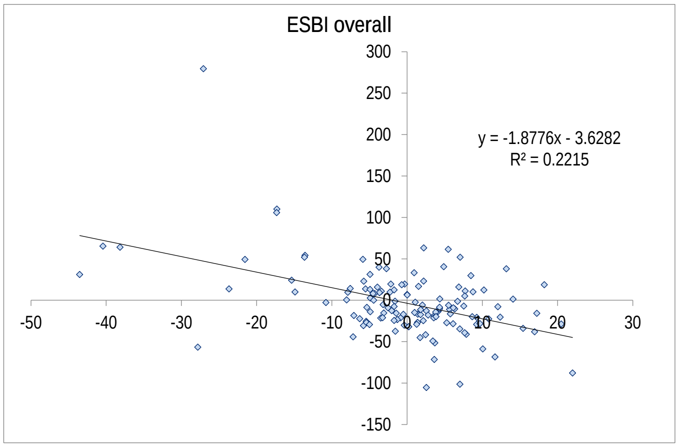
Could credit rally?

Unlike local rates, which have a positive beta to both the changes in term premium and the expectation of short rates, the regression coefficient for credit is negative. Also, unlike local rates which have noticeably higher beta to the term premia, for credit markets the beta is much larger for changes in the short rate (Figure 22 and 23). In fact, the beta for changes in expectation of the short rate is more than 8x that

[5] The beta relative to term premia are positive (higher term premia, weaker FX), though it is statistically significant in Turkey and Thailand only.

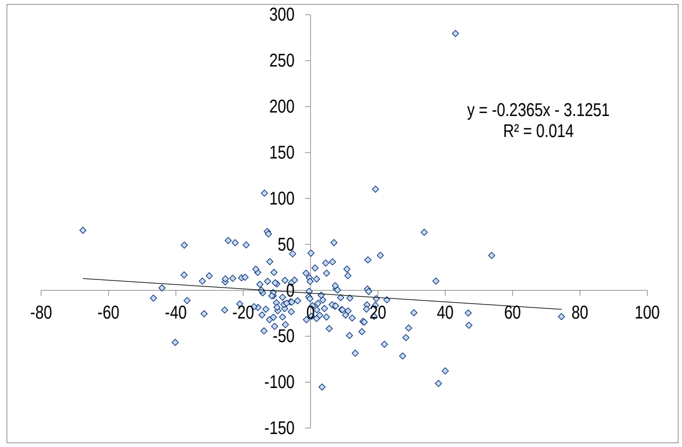
for changes in the term premium. As we argued above, this makes sense if expected future US rates increase because of an improving U.S. economic outlook. These periods usually imply lower default rates and increasing risk appetite, leading to tighter spreads. We see these type of events in the upper right quadrant of Figure 22 and 23 (though the very high point was during the global financial crisis).

Figure 22. Regression of 1-month changes in spread on the ESBI on 1-month changes in expectation of future US short rates



Source: Citi Research

Figure 23. Regression of 1-month changes in spread on the ESBI on 1-month changes in 10y UST term premia



Source: Citi Research

Since the overall ESBI is often driven by idiosyncratic factors in high beta names, we also consider the impact on just the investment grade portion. True to their name, the "low betas" do appear to have lower beta to changes in both the term premium and the expectation of future short rates than the overall ESBI (Figure 24).

When we look at individual countries, however, the picture becomes cloudier. Mexico, which has been investment grade throughout our sample, does have the lowest betas as we would expect based on our findings for the overall ESBI IG. However, Russia, which has been IG by two agencies since 2004, has the highest beta. Also Turkey, the most recent country to move to IG, sports a relatively low beta. In Turkey's case, its beta to the term premium is slightly positive.

Figure 24. Regressions of 1-month spread changes to changes in the term premium component and short-rate component

	ESBI	ESBI IG	Brazil	Mexico	Russia	Turkey
Beta to Term Premium	-0.236	-0.207	-0.068	-0.177	-0.454	0.104
	0.174	0.134	0.211	0.112	0.199	0.278
R^2	0.014	0.018	0.001	0.019	0.038	0.001
Beta to Short Rate	-1.878	-1.412	-1.115	-0.957	-2.336	-1.560
	0.309	0.240	0.409	0.209	0.349	0.538
R^2	0.221	0.210	0.054	0.139	0.256	0.061

Source: Citi Research

What should we make of the results?

Overall, the results present us with a varying picture across asset classes. If one accepts the assumption that expected future interest rates will increasingly be in the driving seat of how the market responds to US monetary policy, credit would stand to outperform, and even benefit. Local rates seem relatively immune, with only moderate impact on yields. The results suggest that EM FX ought to appreciate, yet our interpretation differs. We think that with no new information to change current growth (inflation) forecasts, movements in US rates will not result in the estimated appreciation of EM FX. We imagine, however, that exchange rates may not depreciate as much as originally feared. Since local currency bonds inevitably imply exposure to FX, a selective allocation would seem to be in order. The message is, nevertheless, somewhat comforting. Unless the revision in expected future interest rates (or in term premia) becomes very large, US monetary policy ought to be a less damaging force for EM assets than was the case with the tapering.

Annual Indicators

Figure 25. Emerging Markets – Economic Forecasts, 2013F-2015F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Asia	6.3	6.2	6.2	3.7	3.5	3.8	2.1	2.0	1.5	-2.3	-2.3	-2.1
China	7.7	7.3	7.0	2.6	2.6	3.2	2.0	2.0	1.5	-1.9	-2.1	-2.0
Hong Kong	2.9	3.4	3.8	4.3	3.9	4.0	2.1	3.1	3.9	0.8	1.3	0.7
India*	4.9	5.6	6.2	9.6	8.3	7.5	-2.0	-2.3	-2.5	-6.9	-6.7	-6.5
Indonesia	5.8	5.3	5.5	6.4	6.4	5.7	-3.3	-2.5	-2.1	-2.2	-2.2	-1.7
Korea	3.0	3.7	3.9	1.3	2.1	3.0	5.4	3.7	3.1	0.8	0.9	1.5
Malaysia	4.7	5.0	4.9	2.1	3.5	4.5	3.8	4.4	4.0	-3.9	-3.5	-3.0
Mongolia	11.7	10.0	9.0	10.5	13.4	12.0	-31.0	-22.2	-22.5	-4.0	-2.8	-2.3
Philippines	7.2	6.9	7.3	2.9	4.3	4.0	3.5	3.5	2.9	-1.4	-1.8	-1.6
Singapore	4.1	3.5	4.3	2.4	1.8	1.4	18.4	18.0	18.0	1.1	-0.3	0.2
Sri Lanka	7.3	7.2	7.4	6.9	5.4	6.5	-3.3	-2.5	-2.0	-5.9	-5.5	-5.2
Taiwan	2.1	3.2	3.8	0.8	1.3	1.9	11.7	11.0	10.2	-1.5	-1.4	-0.8
Thailand	2.9	1.8	4.1	2.2	2.3	2.8	-0.7	2.3	-1.1	-1.8	-1.2	-1.8
Vietnam	5.4	5.7	5.9	6.6	5.8	7.2	4.9	3.7	2.5	-5.3	-4.5	-4.0
Latin America	2.4	2.1	2.8	7.3	8.9	10.2	-2.6	-2.8	-2.5	-3.2	-3.6	-2.8
Argentina	4.9	1.0	1.5	10.6		30.5	-0.6	-0.5	-0.4	-2.4	-3.1	-2.3
Brazil	2.3	1.3	1.8	6.2	6.1	5.9	-3.7	-4.0	-4.1	-3.3	-3.7	-2.8
Chile	4.0	3.5	4.5	1.8	3.2	3.1	-3.5	-3.8	-4.0	-0.3	-0.4	-0.4
Colombia	4.3	4.6	5.0	2.0	2.3	3.4	-3.3	-3.5	-3.6	-1.4	-1.3	-0.7
Costa Rica	3.2	3.5	4.0	5.2	3.6	4.6	-5.5	-5.7	-5.9	-6.5	-7.0	-7.5
Dominican Republic	4.1	4.5	4.5	4.8	4.0	4.6	-4.4	-4.8	-5.0	-4.1	-4.0	-4.2
Ecuador	4.0	4.1	4.5	2.7	2.9	3.1	-1.8	-2.2	-1.5	-2.4	-1.9	-1.5
El Salvador	1.8	2.2	2.5	0.8	0.8	1.8	-6.1	-6.3	-5.7	-4.2	-4.1	-3.7
Mexico	1.1	3.3	4.0	3.8	4.2	3.6	-1.8	-2.1	-1.8	-2.4	-3.5	-2.5
Panama	8.4	6.2	5.5	4.0	2.7	2.8	-11.3	-9.0	-8.5	-3.0	-3.0	-3.0
Peru	5.0	5.7	6.2	2.8	2.7	2.5	-5.2	-5.6	-1.5	0.8	0.0	0.0
Venezuela	1.5	-1.0	1.9	38.5	62.5	82.1	3.3	4.0	5.1	-11.9	-11.1	-10.3
Europe	1.9	1.7	2.9	5.3	5.0	5.0	-1.3	-0.7	-1.1	-2.2	-2.4	-3.6
Bulgaria	0.9	1.5	2.5	0.9	-0.2	2.5	2.1	-0.8	-0.5	-1.9	-2.0	-1.2
Croatia	-1.0	0.7	1.5	2.2	0.6	2.8	0.2	0.0	-0.5	-5.5	-5.5	-5.0
Czech Republic	-0.9	1.9	2.5	1.4	0.8	2.0	-1.4	1.1	0.8	-2.4	-2.9	-2.9
Hungary	1.1	2.1	1.5	1.7	0.7	2.9	2.1	2.6	2.0	-2.6	-2.9	-2.9
Kazakhstan	6.0	5.0	6.0	5.7	6.0	5.7	-0.2	1.0	1.4	3.2	2.4	2.2
Poland	1.6	3.4	3.6	0.9	1.0	2.7	-1.5	-2.5	-3.6	-4.2	5.7	-2.3
Romania	3.5	3.0	3.4	4.0	2.4	3.4	-1.1	-2.5	-4.2	-2.5	-2.3	-2.3
Russia	1.3	1.0	2.3	6.8	6.0	5.2	1.6	1.8	1.2	-2.0	-4.4	-4.9
Serbia	2.5	1.2	2.0	7.9	4.9	6.3	-5.0	-4.9	-5.5	-7.2	-5.5	-5.0
Slovakia	0.9	2.0	2.5	1.4	0.3	1.5	2.4	2.8	2.6	-2.7	-3.3	-2.7
Turkey	4.0	2.3	3.5	7.5	7.7	7.4	-7.8	-5.2	-5.3	-1.2	-2.8	-3.2
Ukraine	-0.1	-2.4	2.1	-0.3	4.2	5.8	-9.3	-7.4	-5.2	-6.1	-4.1	-3.2
Africa/Mideast	3.8	4.6	5.3	4.3	4.4	5.0	12.7	10.7	8.4	1.6	1.0	-0.7
Bahrain	4.3	4.0	4.1	3.3	2.3	2.0	5.3	2.4	-1.5	-2.2	-3.3	-5.5
Egypt	2.0	2.9	3.4	9.5	9.2	7.1	-1.7	-1.3	-2.2	-11.6	-10.9	-9.4
Ghana	7.4	4.6	6.5	11.7	12.7	7.7	-12.7	-13.4	-13.3	-10.8	-8.9	-7.4
Iraq	3.1	10.4	11.6	1.9	3.4	6.0	13.5	13.8	12.8	-0.6	2.0	2.9
Israel	3.2	3.4	3.5	1.5	1.2	3.0	1.2	1.9	1.7	-2.7	-3.0	-2.5
Jordan	3.0	4.0	4.5	5.5	4.0	5.0	-15.2	-14.2	-11.9	-8.2	-10.1	-9.9
Kenya	5.1	5.5	6.1	5.4	7.1	6.7	-7.8	-7.6	-7.5	-7.0	-5.5	-4.5
Kuwait	4.3	3.9	3.9	2.6	3.1	4.5	51.0	49.5	47.8	26.8	27.0	21.0
Lebanon	1.4	2.0	2.4	2.1	4.4	5.0	-4.5	-5.3	-6.0	-10.0	-9.3	-8.7
Nigeria	6.5	6.6	6.4	8.5	8.8	10.6	7.0	4.4	2.6	-2.6	-2.9	-2.9
Oman	5.7	5.2	4.7	2.1	1.9	3.0	10.4	8.2	6.4	9.5	8.0	5.8
Qatar	5.6	5.9	6.1	3.1	2.5	3.5	30.1	25.8	20.9	8.2	4.3	1.2
Saudi Arabia	3.7	4.2	6.1	3.5	3.5	4.1	18.2	13.7	9.3	7.4	5.1	0.4
South Africa	1.9	2.4	2.8	5.8	6.5	6.1	-5.8	-5.1	-3.9	-4.3	-4.2	-4.2
Tanzania	6.8	7.0	8.1	7.9	6.6	6.8	-10.2	-14.1	-12.4	-5.0	-5.2	-5.9
UAE	3.7	4.0	4.0	1.5	1.3	1.6	26.2	21.4	17.0	NA	NA	NA
Uganda	5.0	5.2	5.5	5.5	6.0	6.1	-12.0	-13.9	-14.9	-3.4	-3.3	-3.5
Zambia	6.0	6.4	6.3	7.0	7.0	7.3	0.2	-1.0	-1.5	-7.1	-5.9	-5.1
Total	4.5	4.5	4.9	4.7	4.8	5.3	1.9	1.8	1.3	-2.1	-2.3	-2.3

Source: National sources, Citi Research forecasts

Economic Framework

Figure 26. Citi's Global Economic Forecasts

	GDP Growth (% YoY)			CPI Inflation (% YoY)			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F
Global	3.1	3.4	3.6	2.9	3.1	3.4	0.8	0.6	0.2	-3.0	-2.5	-2.3
Based on PPP weights	*3.5*	*3.8*	*4.0*	*3.3*	*3.5*	*3.9*	*0.5*	*0.3*	*0.0*	*-3.1*	*-2.7*	*-2.5*
Industrial Countries	2.1	2.4	2.4	1.6	1.6	1.5	0.0	0.1	0.0	-3.5	-2.7	-2.5
United States	2.8	3.1	3.2	1.4	1.7	2.2	-2.0	-1.5	-1.8	-3.9	-3.0	-3.4
Japan	0.9	1.0	1.2	2.9	1.6	1.6	0.4	0.3	0.6	-8.0	-6.2	-5.8
Euro Area	1.3	1.6	1.6	0.7	0.7	1.1	2.3	2.1	2.1	-2.4	-2.0	-1.6
Canada	2.3	2.7	2.7	1.9	1.8	2.0	-2.5	-2.4	-2.0	-0.1	0.3	0.4
Australia	2.9	3.0	3.1	3.1	2.5	2.4	-2.7	-2.5	-2.4	-3.0	-2.1	-1.4
New Zealand	3.2	2.7	2.4	2.1	2.2	2.2	-4.2	-5.4	-5.0	-1.6	-0.4	0.5
Germany	2.2	2.3	2.2	1.4	1.8	2.0	6.3	5.0	4.5	0.0	0.0	-0.1
France	1.0	1.2	1.5	1.1	1.2	1.3	-0.9	-0.3	0.2	-3.4	-2.8	-2.4
Italy	0.6	0.9	0.7	0.3	-0.4	0.1	1.1	1.2	1.3	-2.9	-2.5	-1.9
Spain	0.9	1.2	1.5	0.0	0.1	0.3	0.9	0.9	1.1	-5.9	-4.7	-3.5
Greece	-0.9	0.8	1.4	-1.9	-2.2	-1.4	1.8	2.3	2.7	-3.5	-2.4	-2.0
Ireland	1.3	2.9	2.6	0.8	1.0	1.1	9.2	9.6	9.0	-5.7	-3.3	-2.6
Portugal	1.5	1.7	1.4	-0.7	-0.8	-0.1	2.2	2.5	2.6	-4.1	-3.4	-2.8
Netherlands	1.2	1.3	1.6	0.6	1.2	1.4	10.1	9.8	9.5	-3.4	-2.5	-1.5
Belgium	1.3	1.4	1.5	0.7	1.0	1.1	-0.1	0.6	0.8	-2.5	-1.3	-0.6
Denmark	1.0	1.5	1.8	1.5	1.7	1.8	6.8	5.8	5.5	-1.3	-2.4	-1.4
Norway	1.9	2.1	2.4	2.0	2.1	2.1	11.2	11.5	11.9	11.9	11.0	10.0
Sweden	2.6	2.7	2.9	0.2	1.3	2.4	5.9	5.6	5.6	-1.6	-1.0	-0.3
Switzerland	1.7	1.9	2.1	-0.1	0.9	1.1	11.0	10.0	10.5	0.5	0.7	1.0
United Kingdom	3.5	3.6	2.5	1.6	1.8	2.1	-2.8	-3.2	-3.5	-5.4	-3.6	-1.6

Source: National sources and Citi Research

Figure 27. G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 26 March 2014

	2Q 14F	3Q 14F	4Q 14F	1Q 15F	2Q 15F	3Q 15F	4Q 15F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.75	1.00
10-Yr. Treasuries (Period Ave.)	2.85	3.10	3.35	3.50	3.60	3.70	3.75
Euro Area: US$/€	1.39	1.39	1.40	1.40	1.40	1.40	1.41
Euro Repo Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. Bunds (Period Average)	1.65	1.70	1.80	1.90	1.90	2.00	2.00
Japan: Yen/US$	106	106	107	109	110	112	114
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.55	0.70	0.85	0.95	1.05	1.15	1.10

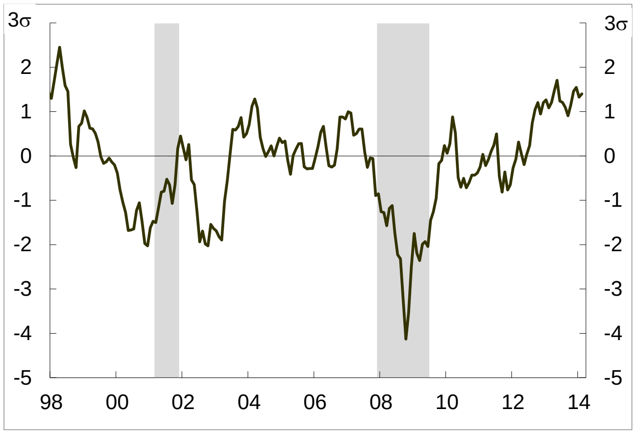
Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US$						Spread vs. Germany					
	Current	2Q 14	3Q 14	4Q 14	1Q 15	2Q 15	Current	2Q 14	3Q 14	4Q 14	1Q 15	2Q 15
United States	NA	NA	NA	NA	NA	NA	114	122	142	158	163	173
Japan	-217	-232	-242	-253	-258	-258	-103	-110	-100	-95	-95	-85
Euro Area	-114	-122	-142	-158	-163	-173	NA	NA	NA	NA	NA	NA
Canada	-26	-25	-20	-20	-10	-10	88	97	122	137	153	163
Australia	144	158	143	127	122	117	258	280	285	285	286	291
New Zealand	184	209	204	209	205	205	298	331	347	367	368	378
France	65	-57	-77	-93	-98	-108	52	65	65	65	65	65
Italy	65	58	28	2	-3	-23	177	180	170	160	160	150
Spain	57	53	18	-18	-23	-33	169	175	160	140	140	140
Netherlands	-82	-97	-117	-133	-138	-148	30	25	25	25	25	25
Belgium	-54	-47	-72	-88	-93	-103	58	75	70	70	70	70
Austria	-93	-92	-112	-128	-133	-143	19	30	30	30	30	30
Finland	-88	-97	-117	-133	-138	-148	24	25	25	25	25	25
Ireland	29	18	-22	-48	-63	-73	141	140	120	110	100	100
Portugal	140	138	103	72	57	37	252	260	245	230	220	210
Switzerland	-184	-187	-212	-233	-243	-253	-72	-65	-70	-75	-80	-80
United Kingdom	0	15	15	5	0	-5	112	137	158	163	163	168

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

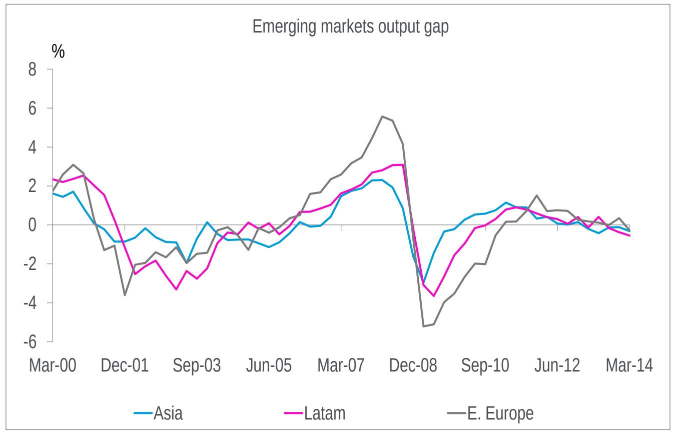
Regional Indicators

Figure 28. We continue to believe that the first FOMC rate hike will occur in the third quarter of 2015.



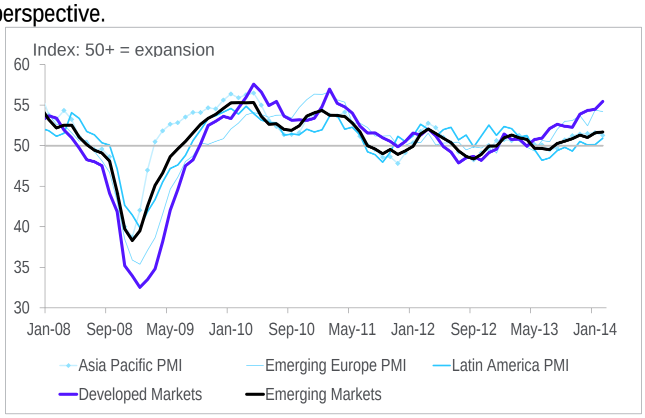
Source: Haver Analytics, Citi Research. Note: Shaded sections mark recession periods.

Figure 29. Output gap in EM is likely close to zero this quarter



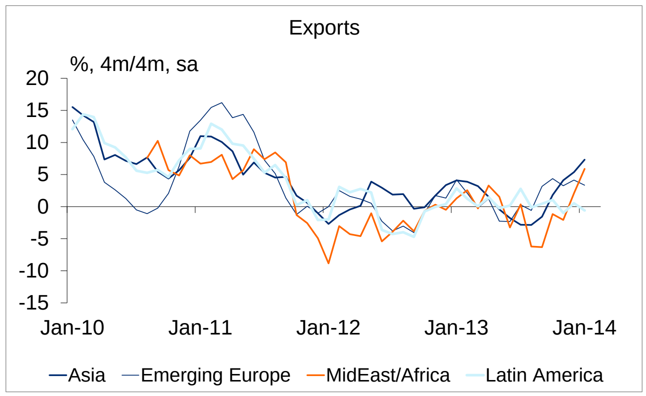
Source: Haver Analytics, Citi Research

Figure 30. PMIs give signs of an improving EM from a regional perspective.



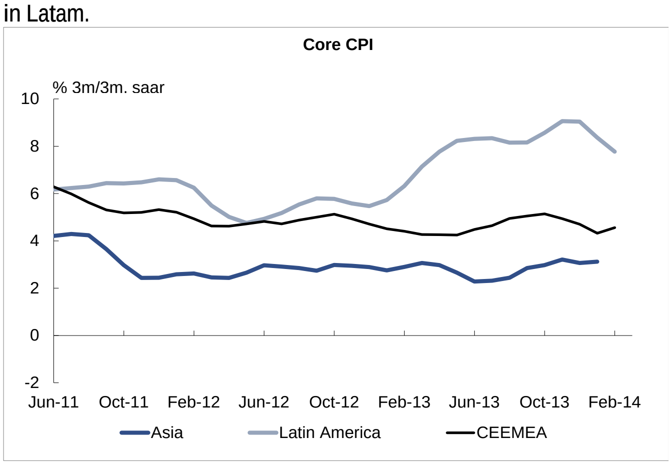
Source: Haver Analytics, Citi Research

Figure 31. That divergence is also reflected in exports growth.



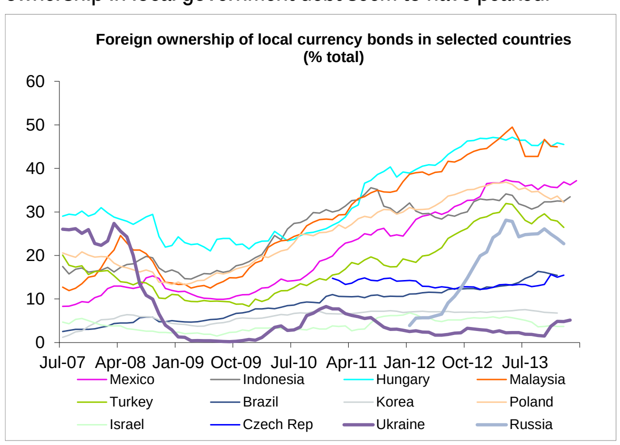
Source: Haver Analytics, Citi Research

Figure 32. Inflation is contained in most EM, but continues to build up in Latam.



Source: Haver Analytics, Citi Research

Figure 33. For many EMs, the sharp rise in the share of foreign ownership in local government debt seem to have peaked.



Source: Citi Research

Monetary Policy Watch

Figure 34. Asia Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2014
			Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	3.00	Jul-12	-25	2016	+25	3.00
India	Repo Rate	8.00	Jan-14	+25	FY16/17	-50	8.00
Indonesia	FasBI	5.75	Nov-13	+25	Jun-14	+25	6.00
Korea	BOK Policy Rate	2.50	May-13	-25	Mar-15	+25	2.50
Malaysia	Overnight Policy Rate	3.00	May-11	+25	Jul-14	+50	3.50
Philippines	Overnight Policy Rate	3.50	Oct-12	-25	Sep-14	+25	4.00
Taiwan	Discount Rate	1.875	Jun-11	+12.5	Mar-15	+12.5	1.88
Thailand	Overnight Repo Rate	2.00	Mar-14	-25	Mar-15	+25	2.00

Source: Bloomberg, Citi Research

Figure 35. CEEMEA Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2014
			Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.05	Nov-12	-20	4Q15	+20	0.05
Hungary	14-Day Repo Rate	2.70	Feb-14	-15	Apr-14	-10	3.00
Israel	Base Rate	0.75	Feb-14	-25	May-14	-25	0.50
Poland	7-Day Repo Rate	2.50	Jul-13	-25	Jan-15	+25	2.50
Romania	Refinancing Rate	3.50	Feb-14	-25	1Q15	+25	3.50
Russia	1 Week Repo Rate	7.00	Mar-14	+150	Jun-14	-50	5.50
S. Africa	Average Repo rate	5.50	Jan-14	+50	May-14	+50	6.50
Turkey*	Average Funding rate	10.20			by end-2014	+130	11.50
Ukraine	Discount Rate	6.50	Aug-13	-50	2015	-25	6.50

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

Figure 36. Latin America Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2014
			Date	Amount (bp)	Forecast	Amount (bp)	forecast
Brazil	SELIC	10.75	Feb-14	+25	Apr-14	+25	11.00
Chile	CAMARA (Overnight)	4.00	Mar-14	-25	Feb-16	+25	4.00
Colombia	Central Bank Repo Rate	3.25	Mar-13	-50	Jul-14	+25	4.00
Mexico	Official Overnight Rate	3.50	Oct-13	-25	Jun-15	+25	3.50
Peru	Reference Rate	4.00	Nov-13	-25	Jan-15	+25	4.00

Source: Bloomberg, Citi Research

FX Views

Figure 37. Asian Currencies Exchange Rates

		2Q14			3Q14			1Q15		
	26 Mar	**Forecast**	**Forward**	**Returns**	**Forecast**	**Forward**	**Returns**	**Forecast**	**Forward**	**Returns**
vs USD				(%)			(%)			(%)
China yuan	6.21	6.24	6.24	0.1	6.15	6.25	1.6	6.06	6.27	3.3
Hong Kong dollar	7.76	7.76	7.76	-0.1	7.76	7.75	-0.1	7.76	7.75	0.0
India rupee	60.17	61.95	61.26	-1.1	63.19	62.42	-1.2	64.01	64.59	0.9
Indonesia rupiah	11413	11658	11578	-0.7	11945	11769	-1.5	12156	n.a.	n.a.
Korea won	1075	1066	1080	1.3	1073	1085	1.0	1073	1092	1.7
Malaysia ringgit	3.30	3.35	3.32	-1.0	3.38	3.34	-1.2	3.39	n.a.	n.a.
Philippines peso	45.0	45.2	45.2	-0.1	45.5	45.3	-0.5	45.1	45.5	0.8
Singapore dollar	1.27	1.28	1.27	-0.8	1.29	1.27	-1.7	1.29	1.27	-1.8
Taiwan dollar	30.6	30.41	30.48	0.2	30.30	30.41	0.4	30.11	30.28	0.5
Thailand baht	32.6	33.43	32.73	-2.1	34.00	32.93	-3.3	34.17	n.a.	n.a.

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

Figure 38. CEEMEA Currencies Exchange Rates

		2Q14			3Q14			1Q15		
	26 Mar	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs EUR				(%)			(%)			(%)
Czech Republic koruna	27.4	27.5	27	-0.3	27.6	27.4	-0.8	27.4	27.3	-0.3
Hungary forint	312	319	315	-1.2	325	315	-3.0	330	315	-4.6
Poland zloty	4.18	4.24	4.18	-1.4	4.30	4.18	-2.8	4.27	4.18	-2.2
vs USD										
Israel shekel	3.49	3.46	3.49	1.0	3.53	3.49	-1.1	3.65	3.50	-4.5
Russia ruble	35.5	38.1	36.3	-5.1	38.8	37.1	-4.7	39.1	38.5	-1.5
Turkey new lira	2.19	2.33	2.25	-3.3	2.37	2.32	-2.1	2.42	2.44	0.8
S. Africa rand	10.69	11.34	10.85	-4.5	11.53	11.03	-4.6	11.66	11.89	2.0

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

Figure 39. Latin American Currencies Exchange Rates

		2Q14			3Q14			1Q15		
	26 Mar	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
Brazil reais	2.31	2.51	2.37	-5.9	2.58	2.43	-6.5	2.68	2.54	-5.6
Chile peso	554	579	559	-3.6	585	563	-3.9	590	571	-3.3
Colombia peso	1973	2086	1988	-4.9	2120	2005	-5.7	2150	2041	-5.3
Mexico new peso	13.1	13.3	13.1	-1.4	13.2	13.1	-0.6	13.0	13.1	0.9

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

Our Forecasts vs. Consensus

Figure 40. Citi vs Consensus Forecasts

	GDP Growth (%)				CPI Inflation (%)				Current Account Balance (US$ bn)			
	2014F	Consensus	2015F	Consensus	2014F	Consensus	2015F	Consensus	2014F	Consensus	2015F	Consensus
Asia	6.2%	6.3%	6.2%	—	3.5%	3.7%	3.8%	—	347	335	288	—
China	7.3	7.4	7.0	7.3	2.6	2.9	3.2	3.2	205	219	170	228
Hong Kong	3.4	3.5	3.8	3.6	3.9	3.9	4.0	3.6	9	5	12	6
India	5.6	5.4	6.2	—	8.3	8.0	7.5	—	-47	-55	-58	—
Indonesia	5.3	5.4	5.5	5.8	6.4	6.2	5.7	5.3	-21	-24	-19	-20
South Korea	3.7	3.5	3.9	3.7	2.1	2.1	3.0	2.6	52	55	47	49
Malaysia	5.0	5.1	4.9	5.0	3.5	3.2	4.5	3.5	14	14	13	16
Philippines	6.9	6.5	7.3	6.2	4.3	4.2	4.0	3.9	10	10	10	10
Singapore	3.5	3.8	4.3	4.0	1.8	2.7	1.4	2.8	55	54	59	55
Sri Lanka	7.2	7.2	7.4	7.0	5.4	6.2	6.5	6.8	-2	-3	-2	-3
Taiwan	3.2	3.3	3.8	3.7	1.3	1.3	1.9	1.8	56	55	56	53
Thailand	1.8	2.8	4.1	4.4	2.3	2.4	2.8	2.8	8	1	-4	3
Vietnam	5.7	5.6	5.9	5.9	5.8	6.9	7.2	7.2	7	4	5	3
Latin America	2.2%	2.2%	2.9%	2.9%	8.4%	10.3%	12.4%	9.0%	-134	-127	-123	-124
Argentina	1.0	-0.4	1.5	0.8	-	28.7	30.5	27.4	-2	-2	-2	-2
Brazil	1.3	1.8	1.8	2.1	6.1	6.0	5.9	5.6	-80	-74	-82	-70
Chile	3.5	3.6	4.5	4.3	3.2	3.1	3.1	3.0	-10	-9	-11	-8
Colombia	4.6	4.7	5.0	4.6	2.3	3.1	3.4	3.1	-13	-13	-13	-13
Mexico	3.3	3.0	4.0	4.0	4.2	4.1	3.6	3.5	-27	-24	-26	-29
Panama	6.2	6.8	5.5	6.0	2.7	3.6	2.8	3.4	-4	-4	-4	-4
Peru	5.7	5.4	6.2	5.7	2.7	2.7	2.5	2.6	-12	-10	-4	-9
Venezuela	-1.0	-0.9	1.9	1.3	62.5	52.0	82.1	40.5	15	9	18	11
Europe	1.8%	1.9%	2.9%	2.9%	4.9%	5.0%	4.9%	4.8%	-25	-38	-47	-56
Bulgaria	1.5	1.7	2.5	2.4	-0.2	0.9	2.5	2.2	0	0	0	-1
Croatia	0.7	0.0	1.5	1.2	0.6	1.4	2.8	2.3	0	0	0	0
Czech R	1.9	2.0	2.5	2.6	0.8	1.2	2.0	2.2	2	-2	2	-2
Hungary	2.1	2.1	1.5	2.1	0.7	1.1	2.9	2.9	3	3	3	3
Kazakhstan	5.0	5.6	6.0	6.4	6.0	6.3	5.7	6.6	2	2	3	3
Poland	3.4	3.0	3.6	3.5	1.0	1.6	2.7	2.3	-14	-11	-22	-15
Romania	3.0	2.8	3.4	3.4	2.4	2.4	3.4	3.1	-5	-3	-9	-4
Russia	1.0	1.3	2.3	2.1	6.0	5.8	5.2	5.1	33	27	24	15
Slovak Rep	2.0	2.3	2.5	3.0	0.3	1.0	1.5	1.9	3	3	3	3
Turkey	2.3	2.2	3.5	3.8	7.7	8.1	7.4	6.8	-39	-47	-42	-50
Ukraine	-2.4	-1.4	2.1	1.8	4.2	4.9	5.8	6.0	-11	-10	-8	-9
MEA	4.1%	4.1%	5.0%	4.5%	4.7%	4.7%	5.5%	5.0%	111	106	78	88
Israel	3.4	3.4	3.5	3.6	1.2	2.0	3.0	2.5	6	4	5	6
Nigeria	6.6	6.7	6.4	6.5	8.8	8.8	10.6	9.0	16	14	11	12
S. Africa	2.4	2.6	2.8	3.3	6.5	5.9	6.1	5.6	-17	-21	-14	-20
S. Arabia	4.2	4.1	6.1	4.6	3.5	3.5	4.1	3.9	106	108	76	91
Above Total	4.5%	4.6%	4.9%	—	4.8%	5.3%	5.8%	—	299	277	196	—

Source: Consensus Economics, National Sources, Citi Research forecasts

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Asia Pacific

China

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- **Summary view** – Given the string of weaker-than-expected economic data in Jan-Feb, we recently downgraded 1Q GDP growth forecast to 7.3%YoY but maintained our 2014 annual growth forecast unchanged at 7.3% assuming measured policy easing. We cut 2014 inflation forecast to 2.6% and no longer expect benchmark rate hikes (see *China Macro View - How Would the Government React to Economic Weakness?*).

- **Things to watch** – We expect China will continuously switch between growth and reform programs. The release of New Urbanization Plan and RMB trading band widening herald post-NPC reform initiatives. We expect reform to take place in a growth context, i.e., reforms won't compromise GDP growth.

- **Strategy** – The PBOC's doubling of the daily USDCNY trading band serves as one step further to let the market play a decisive role in allocating resources. We expect the RMB exchange rate to enter into a trading range between 6 and 6.3 this year, and revised our 6-12 month forecast to 6.08.

Possible measures of easing

GDP growth this year shall test the government's bottom-line in coming quarters. China's economy was hit by a string of negative news since the beginning of the year: weakening PMI readings; defaults involving trust loans and corporate bonds; RMB depreciation; negative export growth and trade deficit in Feb; intensifying PPI deflation; and weakness in real activity data. The economy has been moving in line with our expectation but the pace of slowdown is faster than expected. According to our estimate, even assuming a decent IP pick-up in Mar and stable growth of the service sector, GDP growth in 1Q may decelerate to 7.3%YoY, down from 7.7%YoY in 4Q2013. The credit condition index we compiled, which tends to lead GDP growth by 6 months, suggests growth may flirt around 7%YoY in 2Q. While it appears the government can tolerate growth below 7.5% this year, we think quarterly growth towards 7%YoY would still prompt policy easing.

The government may respond by fine-tuning macro policies and supporting demand. There are signs that weak demand has contributed to the recent fall in financing cost. The government may advance investment in select areas, including social housing, irrigation, railways in central and western regions, and energy saving and environment protection. Since budget revenue is no longer a binding task, revenue would be allowed to underperform and deficit could overshoot if the economy weakens further. In other words, fiscal policy may provide support even without revising the budget plan. PBOC may employ a range of tools to bring down cost of capital (cutting RRR is possible if there is capital outflow). If rising housing inventory in smaller cities poses investment risks, the government may act to boost demand, including easing of purchase restrictions and government buybacks.

We maintain 2014 annual growth forecast at 7.3% but cut inflation forecast. The export momentum has been stronger than what the headline suggests if data distortions are removed, and external demand may become a tailwind as the US steps out of the winter-related soft patch. But generally tighter fiscal and monetary policies this year (even considering possible policy easing) are expected to significantly slow down infrastructure and property investment. In light of weak growth and subdued inflation prospect, we cut annual inflation forecast for 2014 from 3.2% to 2.6%, and no longer expect benchmark rate hikes this year and next year, as the one-year deposit rate should mostly remain positive in real terms.

Urbanization revisited

The Chinese government has finally released the long-awaited New Urbanization Plan. If fully implemented, it would imply an addition of 110mn migrant workers to shore up the residency-based urbanization rate to 60% by 2020. The *hukou*-based urban population would be topped up by 150mn, to 45% of the total population. This implies an additional 2-4% urban annual population growth in the next seven years. Proposed reforms on *hukou*, land, and funding do not look ambitious, but should help unveil urbanization dividends gradually and boost sectors including urban infrastructure/commodity, property, services/consumption, agriculture, and environment protection.

What to expect next? We expect local governments to launch *hukou* reforms shortly. The collateralization of residential property should follow with a pilot. Longer-term financing instruments could be introduced, including possibly an infrastructure investment bank or a social housing investment bank to meet the demand for funding.

What's missing here? The core of the New Urbanization Plan should be a plan for reform, not a plan about how resources are to be allocated. We believe service sector deregulation, land monetization, fiscal support to urbanization, and removing administrative segmentation are necessary reforms before urbanization can take place at full speed.

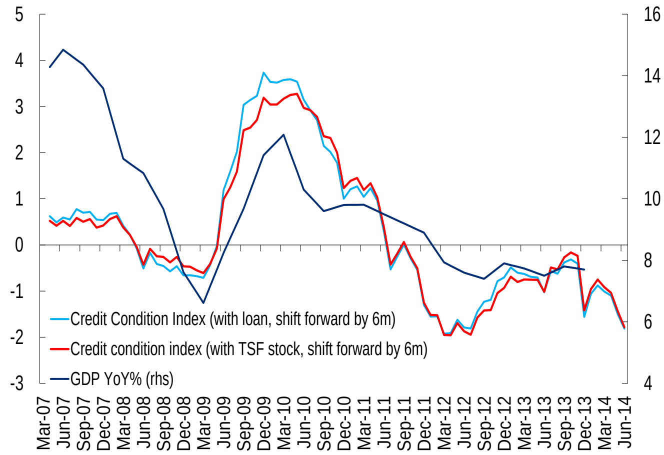
For details please see *China Macro View - Urbanization Revisited* (18-Mar)

RMB one-way appreciation ends after band widening

The PBOC decided to double the daily trading band of USDCNY to ±2% on Mar 14, signaling the end of the RMB's one-way appreciation. The RMB weakened in the spot market after the PBOC's announcement, in line with our expectation. This move aims at shaking out speculation and carry trade that had dominated the RMB appreciation recently. While the RMB depreciation may support exports, we think this is secondary unless PBOC is able to tolerate a much weaker RMB in the near term. In its announcement, the PBOC declared that there is no base to drive the dramatic move of the RMB exchange rate either way, and it has determined to intervene in the market if abnormal change occurs.

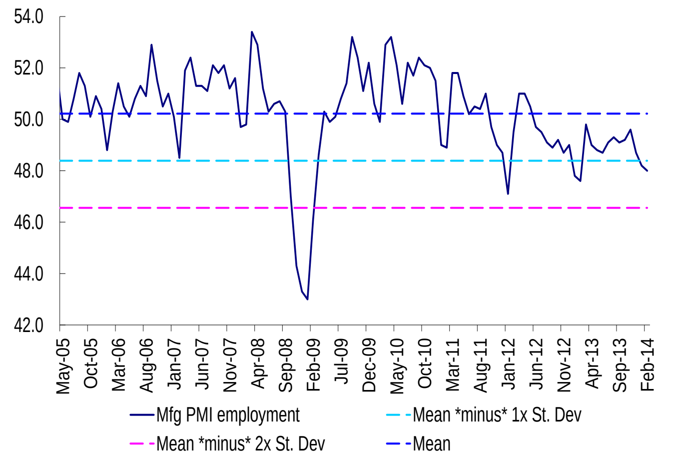
We expect the USDCNY to enter into a trading range of 6-6.3 this year, a range that allows volatility but not out of the tolerable levels of the PBOC. The near-term weakness of the RMB was partly initiated by the central bank's intension to introduce two-way trading into the system, and partly driven by capital outflows amid rising uncertainties in the FX market. More uncertainty in the FX market should discourage hot inflows that were active since 2H last year. Weak economic data in Jan-Feb might add concerns over financial market defaults and had exacerbated the worry of a weaker currency. The RMB may recover part of its losses in 2H this year if accommodative domestic policies ease the downside risk of the economy, export growth improves on better external demand, and incremental reforms lift the market sentiment. We forecast the spot rate of the USDCNY to finish at 6.08 this year, slightly stronger than 6.0969, the PBOC's fixing at the end of last year.

Figure 41. Citi CCI suggests growth deceleration may continue in 2Q



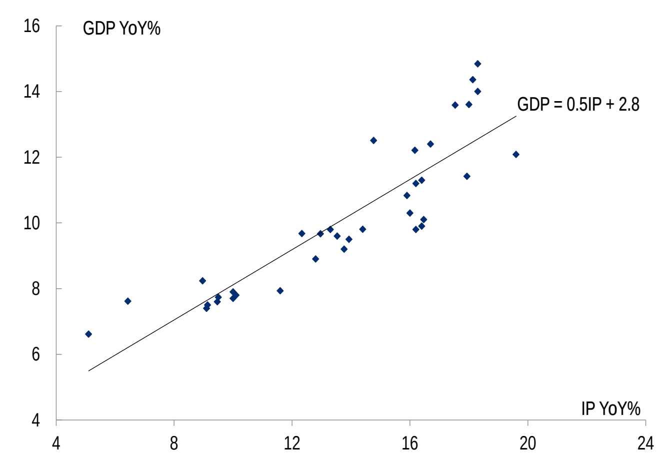
Source: WIND, CEIC and Citi Research

Figure 42. The PMI employment index



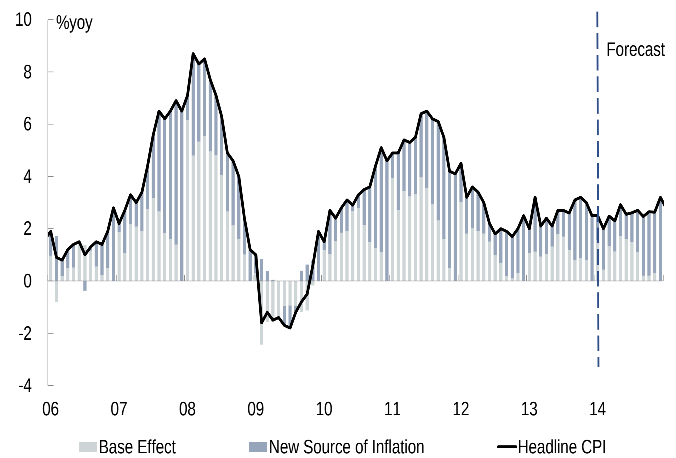
Source: CEIC and Citi Research

Figure 43. Relationship between GDP and IP



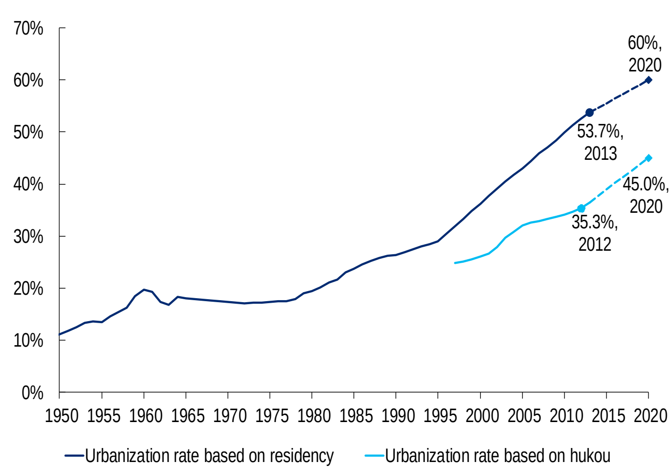
Source: CEIC and Citi Research

Figure 44. CPI inflation forecast



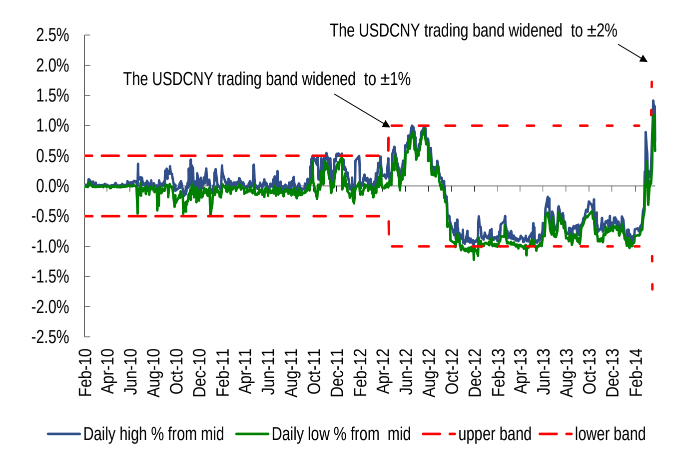
Source: CEIC and Citi Research

Figure 45. Urbanization rates until 2020



Source: CEIC and Citi Research

Figure 46. The daily move of the USDCNY from the PBOC fixing



Source: Bloomberg and Citi Research

Figure 47. China Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	3,494.5	4,544.0	5,070.5	5,932.5	7,319.0	8,238.5	9,244.9	10,241.3	11,316.8
Nominal GDP, local currency bn	26,583	31,490	34,632	40,151	47,310	51,894	56,881	62,029	67,901
GDP per capita, US$	2,645	3,422	3,800	4,424	5,432	6,084	6,794	7,496	8,262
Population, mn	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,360.7	1,366.2	1,369.7
Unemployment, % of labour force	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2	4.3
Economic Activity									
Real GDP, % yoy	14.2	9.6	9.2	10.4	9.3	7.7	7.7	7.3	7.0
Real investment growth % yoy	14.4	11.0	19.2	11.9	9.4	8.1	8.9	7.3	6.6
Real consumption growth % yoy	11.0	8.5	9.4	9.2	10.9	8.3	7.8	7.1	7.6
private consumption growth % yoy	11.1	9.2	10.3	8.5	18.2	8.5	8.0	7.3	7.8
Real export growth, % yoy	--	--	--	--	--	--	--	--	--
Real import growth, % yoy	--	--	--	--	--	--	--	--	--
Prices, Money & Credit									
CPI, % yoy	6.5	1.2	1.9	4.6	4.1	2.5	2.5	3.2	3.5
CPI, % avg	4.8	5.9	-0.7	3.3	5.4	2.6	2.6	2.6	3.2
Nominal wages, % yoy	18.5	16.9	11.6	13.3	14.4	11.9	9.6	9.1	9.5
Credit extension to private sector, % yoy	19.3	14.0	33.2	20.3	15.1	15.6	14.1	12.8	12.6
Policy interest rate, % eop	4.14	2.25	2.25	2.75	3.50	3.00	3.00	3.00	3.00
Short-term market rate, % eop	3.61	1.23	1.79	6.17	6.00	4.90	5.91	5.33	5.33
Long term yield, % eop	4.19	1.80	3.06	3.61	3.27	3.33	4.49	4.49	4.49
lc/US$, eop	7.30	6.82	6.83	6.59	6.29	6.23	6.05	6.08	6.01
lc/US$, avg	7.61	6.95	6.83	6.77	6.46	6.31	6.15	6.18	6.04
Balance of Payments, US$ bn									
Current account	353.2	420.6	243.3	237.8	136.1	193.1	188.6	204.8	169.8
% of GDP	10.1	9.3	4.8	4.0	1.9	2.3	2.0	2.0	1.5
Trade balance	264.3	298.1	195.7	181.5	154.9	230.3	259.2	279.1	285.7
Exports	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.7	2,209.6	2,347.8	2,504.7
Imports	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,818.4	1,950.4	2,068.7	2,219.0
Service balance	-7.9	-11.8	-29.4	-31.2	-61.6	-89.7	-98.7	-108.6	-119.5
Income balance	8.0	28.6	-8.5	-25.9	-70.3	-42.1	-0.6	-13.6	-23.7
FDI, net	139.1	114.8	87.2	185.7	231.7	191.1	147.1	99.9	47.8
International reserves	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,821.3	4,080.4	4,276.1
Total Amortisations	20.3	23.3	34.2	27.2	33.2	33.0	39.2	41.2	45.3
Public Finances, % of GDP									
Consolidated government balance	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-1.9	-2.1	-2.0
Consolidated gov primary balance	1.0	0.1	-1.8	-1.7	-0.9	-1.5	-1.4	-1.6	-1.5
Public debt	39.0	37.4	47.8	49.2	44.3	53.5	53.7	54.0	53.5
of which Domestic	38.0	36.6	47.0	48.6	43.7	53.1	53.2	53.6	53.0
Foreign Assets & Liabilities, US$ bn									
External debt	389.2	390.2	428.6	548.9	695.0	737.0	810.7	891.8	980.9
Private	354.3	356.9	391.8	510.1	657.6	700.4	770.4	847.4	932.2
Public	34.9	33.3	36.9	38.8	37.4	36.6	40.3	44.3	48.7
External debt / GDP	11.1	8.6	8.5	9.3	9.5	8.9	8.8	8.7	8.7
External debt / XGS	29.0	24.7	32.2	31.5	33.4	32.8	33.4	34.6	35.6
Short-term debt	235.7	226.3	259.3	375.7	475.7	504.4	554.8	610.3	671.4
Short-term debt/International Reserves (%)	15.4	11.6	10.8	13.2	15.0	15.2	14.5	15.0	15.7

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	7.8	7.7	7.3	7.0	7.1	7.4	7.4	7.2	6.8
CPI, % yoy	3.1	2.5	2.5	2.6	2.5	3.2	3.2	2.9	3.0
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Short-term market rate, % eop	5.30	5.91	4.95	5.09	5.21	5.33	5.45	5.57	5.69
Long term yield, % eop	3.90	4.49	4.49	4.49	4.49	4.49	4.49	4.49	4.49
lc vs USD, eop	6.12	6.05	6.25	6.24	6.15	6.08	6.06	6.05	6.03

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

Hong Kong

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- **Summary view** – We believe HK's economic outlook is contingent on a steady slowdown of the China economy and a gradual exit of the Fed's accomodation, raising specific questions like property risks and banks' exposure to China. Trade recovery still lackluster; financial market volatility appears inevitable near term.

- **Things to watch** – 1) Lingering liquidity concerns on taper and China's credit tightening; 2) Sustainability of trade recovery; 3) Property market adjustment; 4) Tourist shopping trends (volume vs. value/pax); 5) Political debate on electoral reforms; 6) Measures to enhance cooperation with Qianhai and Shanghai FTZ.

- **Strategy** – EFN yields have reacted post FOMC surprise and likely will continue to trend up with US yields as the Fed normalize policies. Our equity strategist's HSI target for 2014 year-end is 25,000, as few catalysts for a re-rating are visible. Citi's houseview is that home prices will drop 10% in 2014E.

External weakness vs. domestic resiliency

Two data surprises so far in Feb: Strong labor market and weak exports. Labor market, although considered a lagging indicator, continued to be strong sustaining a 3.1%sa unemployment rate even after the CNY (which usually hire a large amount of temporary jobs). Retail sales in Jan was boosted by CNY effects to grow at 16.8%YoY sa; although Feb data is likely to pay back some of the Jan gains, we expect overall consumption to remain steady with strong labor markets and vibrant tourism (but less luxury consumption and more medium/low end products).

Trade performance in Jan-Feb remains weak (exports at -0.8%YoY), implying weak advanced economies recovery thus far, and escalating China slowdown worries. While one can blame the cold weather to explain the decline in US demand, the declines seen in Germany and UK demand appear at odds with these countries' data strength. Moreover, Japanese yen depreciation will likely cause reduced demand for foreign goods, and likely will be more pronounced post their consumption tax hike. Overall, overseas shipment does indicate that AEs recovery is still fragile and AE consumers have once again turned selective after Christmas, making us worry about the expected US rebound post warming of weather in Mar.

CNH depreciation & China slowdown concerns affect HK

Recent RMB depreciation has spooked Asian FX markets and HKD has trended away from the strong end, especially vis-à-vis the strengthening USD. We think the HKD likely will stay softer at HK$7.76/USD for the next 12 months with China/RMB worries and choppy equity markets. However, given our house view that CNH depreciation is likely temporary, we do not expect a large contraction in RMB deposits in HK but future accumulation may grow at a slower pace. Also, HKMA analysis suggests that incentive for non-Mainland companies will increase for issuing dim sum bonds via USD/CNH cross-currency swap in the current stronger USD but lower RMB appreciation expectations environment. Lastly, our banking analyst, Gary Lam, expects RMB investment positions (including banks' proprietary books) however may be reduced. While cross-border lending would remain strong so long as onshore-vs-offshore rate differences remain substantial (See HK & Taiwan Bank). Meanwhile, the HK stock market, being H-share dominated, will continue to be affected by risk-hurting stories of China growth slowing and various cases of debt default/corporate bankruptcies. Over the last 4 weeks there have been continuous outflows from HK/China funds (US$3.1bn ytd). China ETFs alone had US$1.3bn of redemption from investors in the week of 19th Mar 14.

Cross border exposure in light of China slowdown is a growing concern. According to HKMA, non-bank Mainland exposure has risen to 19.7%YoY by YE2013 (vs. 18.6% in 1H13). The acceleration or enlarged share within half a year could be explained by HK's banks deploying more resources onshore to make profit from the funding tightness in China in 2H13. Market is also alarmed that external claims of HK banks to China has also risen to a 39% share (vs. 36.5% in 1H13) -- although recent rising external claims of HK banks to China include RMB funds for trade settlement purposes that HK banks placed with the Shenzhen PBOC. Policy-makers consider credit risks on their Mainland China-related exposure as a key risk for HK banks, despite much of the exposures likely backed by guarantees or collateralised. HKMA has been asking banks to step up risk control in view of recent acceleration in Mainland exposure (while scale of exposure is of lesser concern).

Hawkish FOMC adds pressure to HK's property market

Rising interest rates at both short and long end. The hawkish tone noted from Fed Chairwoman Yellen's first post FOMC speech have sent US short end rates pricing in earlier and more rate hikes. HK's short end interest rates, therefore, should follow given the linkage via the HKD peg. 5Y EFN yields have also jumped post FOMC surprise and likely will trend up with US yields as the Fed normalizes.

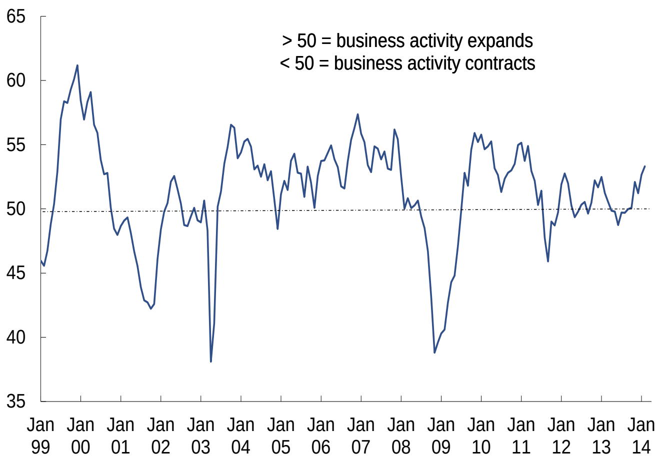
Growing household debt with rates normalizing is another property market risk. For now, HK's mortgage rates remain steady, as property transaction volumes are low and banks continue to keep mortgage rates low in order to compete for business. However, as HK short end rates also increase (either due to Fed's policy or spillover from China's funding tightness/macro slowdown), HK's rising household debt-to-GDP ratio will become another concern for the property market. According to the HKMA, the 2013-end ratio stands at 62%. Note, our house view is that home prices will likely fall on higher rate concerns and intact prudential controls, but our expected home price decrease is only 10% in 2014E, as we believe the supply of flats will still be unable to catch up with end-user demand in the upcoming years despite government's various supply increasing measures.

Political update

Electoral reform has yet to reach a breakthrough. Opinions remain scattered even after three months of high profile discussions on electoral reform – which is half the time of the six months long political consultation period. The sticking point being that the democratic party-raised idea of public nomination for Chief Executive does not appear to comply with the Basic Law, and high ranking Chinese officials continue to stress that only the official nomination committee is considered legal. In an attempt to break the ice, the Central Government has agreed to arrange a Shanghai visit for all Legislative Council members on April 12th and 13th, during which the visiting lawmakers would meet Basic Law Committee chairman Li Fei and the director of Beijing's Hong Kong and Macau Affairs Office, Wang Guangya to discuss the electoral reform.

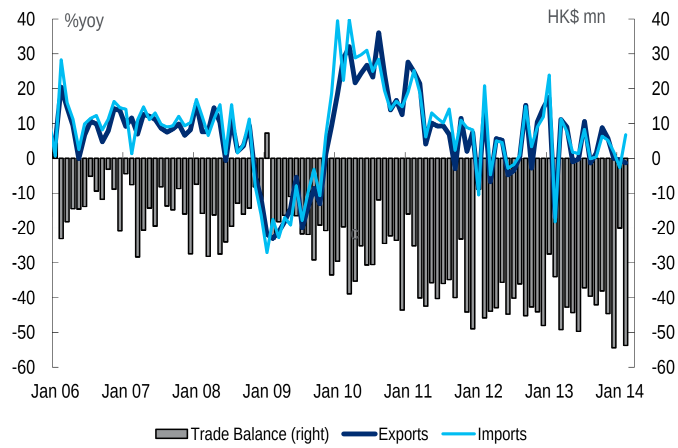
HK is also monitoring Taiwan's political fallout related to the service pact. Taiwan congress leader's unconventional handling of the opposition party's filibustering triggered local students to occupy government facilities. Such phenomenon could potentially fuel various pro-democratic bodies in Hong Kong to act similarly, especially with the incubating 'Occupy Central with Love and Peace' protest for universal suffrage. Although we do not expect such movement to materially affect HK's economy or reputation, as the HK Government has repeated its stance to eliminate any such 'unlawful act'; for the already delicate HK legislative process, we believe the Taiwan event inevitably adds difficulty to passing govt proposed measures, some of which are highly tangible to economic growth.

Figure 48. Further improvements in PMI in Feb



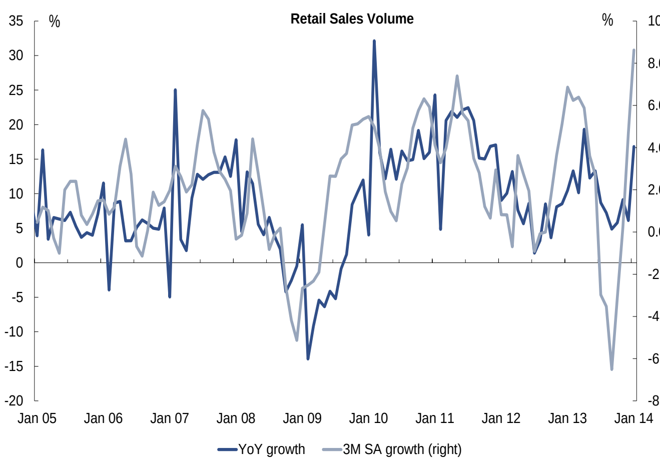
Source: CEIC, Citi Research

Figure 49. Trade recovery still rather weak



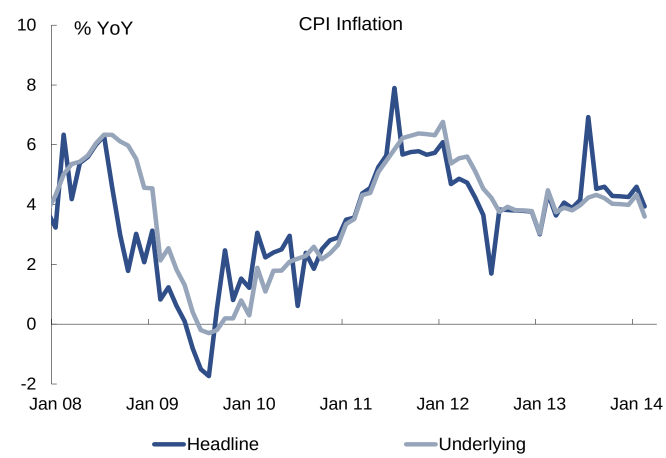
Source: CEIC, Citi Research

Figure 50. Retail sales rebounded on festive + tourist demand



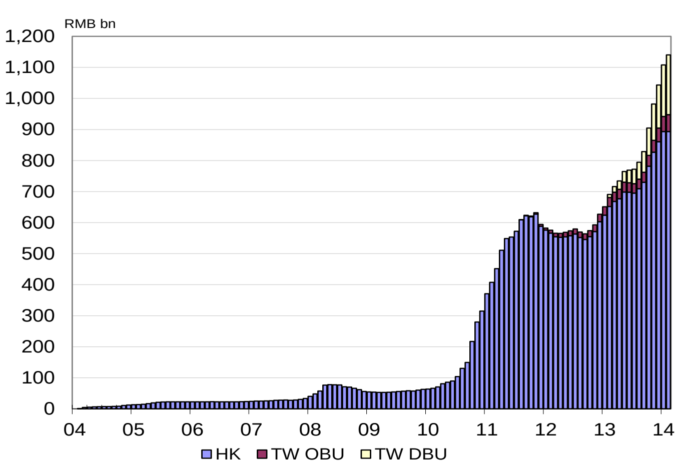
Source: CEIC, Citi Research

Figure 51. Inflation tames post festive period



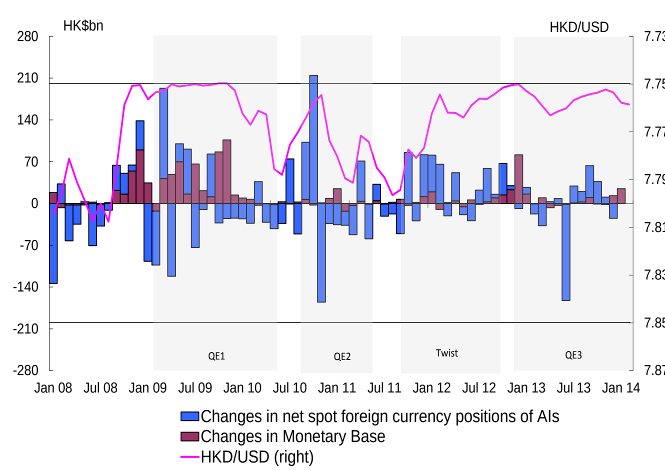
Source: CEIC, Citi Research

Figure 52. Offshore RMB Deposits in HK+TW to stay abundant



Source: CEIC, Citi Research

Figure 53. Net outflows recorded in Dec13; HKD easing from strong end



Source: CEIC, Citi Research

Figure 54. Hong Kong Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	211.6	219.3	214.1	228.7	248.5	262.6	273.6	285.6	302.4
Nominal GDP, local currency bn	1,651	1,707	1,659	1,776	1,934	2,037	2,122	2,216	2,344
GDP per capita, US$	30,495	31,491	30,595	32,424	34,941	36,588	37,902	39,439	41,639
Population, mn	6.9	7.0	7.0	7.1	7.1	7.2	7.2	7.2	7.3
Unemployment, % of labour force	4.0	3.5	5.3	4.3	3.4	3.3	3.4	3.1	3.1
Economic Activity									
Real GDP, % yoy	6.5	2.1	-2.5	6.8	4.8	1.5	2.9	3.4	3.8
Real investment growth % yoy	7.9	-0.3	1.0	11.1	2.3	3.5	3.7	3.5	3.7
Real consumption growth % yoy	7.9	1.9	0.5	5.8	7.6	4.0	4.0	2.0	2.2
private consumption growth % yoy	8.6	1.9	0.2	6.1	8.4	4.1	4.2	2.1	2.4
Real export growth, % yoy	8.3	2.5	-10.0	16.8	3.9	1.9	6.5	5.2	6.3
Real import growth, % yoy	9.1	2.2	-9.0	17.4	4.6	2.9	6.9	4.8	5.7
Prices, Money & Credit									
CPI, % yoy	3.8	2.1	1.5	2.9	5.7	3.8	4.3	3.3	3.9
CPI, % avg	2.0	4.3	0.6	2.3	5.3	4.1	4.3	3.9	4.0
Nominal wages, % yoy	2.4	4.0	-1.9	2.4	9.9	4.7	3.5	4.5	4.5
Credit extension to private sector, % yoy	15.2	11.0	-2.1	20.9	12.5	7.0	10.6	11.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	3.45	0.95	0.14	0.28	0.38	0.40	0.38	0.55	1.30
Long term yield, % eop	3.10	1.19	1.93	1.76	0.96	0.32	1.40	2.20	3.00
lc/US$, eop	7.80	7.75	7.75	7.77	7.77	7.75	7.75	7.76	7.75
lc/US$, avg	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.76	7.75
Balance of Payments, US$ bn									
Current account	27.6	32.9	21.2	16.0	13.8	4.1	5.6	9.0	11.6
% of GDP	13.0	15.0	9.9	7.0	5.6	1.6	2.1	3.1	3.9
Trade balance	-23.1	-25.8	-28.8	-43.0	-54.9	-61.6	-64.6	-62.7	-59.3
Exports	344.5	362.7	318.5	390.2	428.7	442.8	458.9	472.5	501.0
Imports	367.6	388.6	347.3	433.1	483.6	504.3	523.5	535.3	560.3
Service balance	-4.3	-2.7	3.6	10.1	17.0	21.9	29.1	29.7	30.3
Income balance	6.8	12.9	6.4	4.8	6.8	3.8	5.4	7.0	7.0
FDI, net	-19.0	-8.9	-6.4	-10.5	-8.7	-11.2	-10.9	-11.0	-12.0
International reserves	152.6	182.5	255.7	268.6	285.3	317.2	311.1	335.0	360.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	7.3	0.1	1.5	4.1	3.8	3.2	0.8	1.3	0.7
Consolidated gov primary balance	7.4	0.1	1.6	4.2	3.8	3.2	0.8	1.3	0.8
Public debt	1.2	1.0	0.7	0.6	0.6	0.5	0.6	1.0	1.4
of which Domestic	0.4	0.2	0.1	0.0	0.0	0.0	0.1	0.1	0.1
Foreign Assets & Liabilities, US$ bn									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	2.8	3.0	3.0	3.2	3.6	3.8	4.0	3.5	4.0
CPI, % yoy	4.6	4.3	4.5	4.2	4.3	3.3	3.6	3.6	5.6
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.39	0.38	0.40	0.45	0.50	0.55	0.60	0.90	1.10
Long term yield, % eop	1.15	1.39	1.50	1.70	1.90	2.20	2.40	2.60	2.80
lc vs USD, eop	7.76	7.75	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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- **Summary view** – As discussed in the latest ***India Macroscope - Looking Beyond Elections***, elections in Apr-May will be crucial. However beyond elections, it's still an uphill task for the economy. We believe a shallow recovery in FY15 GDP growth to 5.6% is dependent on 'unlocking investments' and managing NPLs

- **Things to watch** – The outcome of upcoming elections is the main event to watch out for. While recent opinion polls suggest higher possibility of a BJP-led alliance victory, the chances of the anti-incumbency votes getting divided among new frontiers can't be ruled out.

- **Strategy** – Given continued compression in CAD and supportive flows, we expect INR/$ to trade in 60-64 range after factoring in (1) Challeging EM environment and (2) a dip in forward adjusted reserves. On rates, we expect bond yields in 8.70%-9% range on tight liquidity and bond supply concerns.

Politics: the elections matter

India's elections will continue to be primetime till the 16 May results: India - the world's largest democracy with an electorate of 814mn will be going to polls to elect 543 members for its 16th Lok Sabha - the lower house of parliament. Polling begins on the 7th of April and will be held in nine phases, culminating on the 12th of May. Counting and results are scheduled for the 16th of May.

Expectations are up, and so are equity and currency markets: There appears to be a feel-good factor in the markets that have also been buoyed by the real gain on twin deficits, i.e. current account and fiscal. Based on recent assembly elections and trends in opinion polls, many believe that the anti-incumbency factor is strong and there exists a high possibility of BJP victory (220+ seats)...more so, since the BJP has made significant progress in battleground states such as UP and Bihar, which represent 120 seats of the total 543. While there is a possibility of the anti-incumbency votes getting divided in the wake of new frontiers such as AAP (a new party) and Third Front (a coalition of 11 regional parties, the consensus exists for the need of a stable formation at the centre which could revive the investment climate and growth.

Elections, investments, monsoons: key to FY15 growth

Elections: The upcoming elections are the event to watch out for. Political pundits at our Investor Conference alluded to recent opinion polls that indicate BJP-led alliance gaining ground (220+ seats). All-in-all, we believe a stable government is key, as the business cycle remains inter-linked with politics.

El Nino Effect and Monsoons: Recently, global weather agencies have reported an increased probability of 'weak El Nino conditions' developing in 2014. While we await the Indian Meteorological Dept (IMD) monsoon forecast due in April, occurrence of El Nino could lead to deficient rainfall in India and consequently, pose a downward risk to agricultural output. This could affect our FY15 GDP estimate of 5.6%YoY, which is contingent on agricultural growth at 3%.

Progress made by PMG: Since its inception in June 13, the Project Monitoring Group has resolved issues in 288 projects valued at ~US$89bn, or ~4.8% of GDP. While we believe the PMG is a positive step to improve investments, anecdotal evidence indicates that despite getting approvals, companies could be awaiting political clarity before commencing operations. Bottom line: In our view, a stable government post elections remains key to a capex revival.

Inflation eases: extended pause on rates

"Veggie" Shock Reversal results in inflation at ~2 year lows: On the monetary front, thanks to reversal of vegetable price shock, both the inflation indices surprised positively with the latest CPI coming in at 8.1% and WPI at 4.7%. This compares to the Nov high of CPI at 11.2% and WPI at 7.5% of which vegetables contributed ~200-300bps. Going forward, we expect some pressure on the food price front in the coming months due to (1) unseasonal rains and hailstorm in some agri producing states and (2) recent increase in dearness allowance for government employees. However, a stronger Rupee and softer global commodity prices could offset some pressure on the headline inflation. We maintain our view of WPI & CPI averaging 5.5% and 8.3% in FY15E.

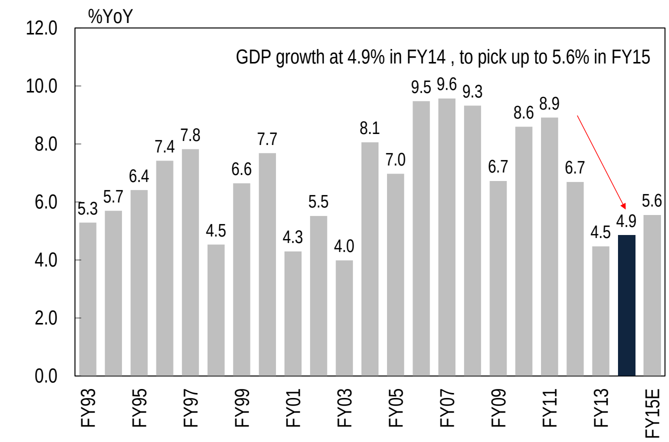
Monetary Policy Outlook: With inflation likely to trend in line with the "RBI's glide-path", we expect an extended pause in policy rates. On rates, despite the recent moderation in inflation, yields are likely to be range bound due to (1) Tight liquidity till the beginning of April due to an advance tax outflow of Rs700-800bn. (2) Increase in bond supply given the weekly auction of G-Secs that are scheduled to begin in April. An additional pressure point is the proposed maturity extension switch of Rs500bn in FY15. (3) Last but not the least, the slowing quantum of OMOs also adversely impact supply-demand for bonds. Consequently, we expect 10y bonds to trade in the 8.70-9% range in the next few months.

External front: CAD largely under control; INR stabilizes

CAD likely to be contained in the 2%-2.5% of GDP range: As is now well known, thanks to a series of policy measures, India's current account deficit (CAD) is likely to more than halve from US$88.2bn in FY13 to US$36.8bn in FY14E. A common question that we've been asked is whether the improvement in the CAD will be sustained at 2-2.5% of GDP or is this a one-off primarily due to the "squeeze" in gold imports. The short answer is yes, we expect the CAD in FY15 to be contained at US$46.7bn or 2.3% of GDP as the resumption of iron ore exports and potentially lower coal/metal scrap imports should partially offset a pick-up in gold and/or capital goods.

FX Outlook: The continued compression in CAD coupled with a pick-up in capital flows (FII flows in March ~ US$3bn so far), has created a constructive BoP environment for the INR. However, we do not expect the INR rally to extend beyond Rs60/US$ as RBI would step in to rebuild reserves and increase the FX import cover. Latest data indicate that RBI's short forward position remains elevated at US$32bn at the end of January. Thus despite an improvement in the CAD, we expect the INR to remain in the Rs60-64 range due to (1) challenging EM environment, and (2) a dip in forward-adjusted reserves.

Figure 55. Trends in real GDP growth (%YoY)



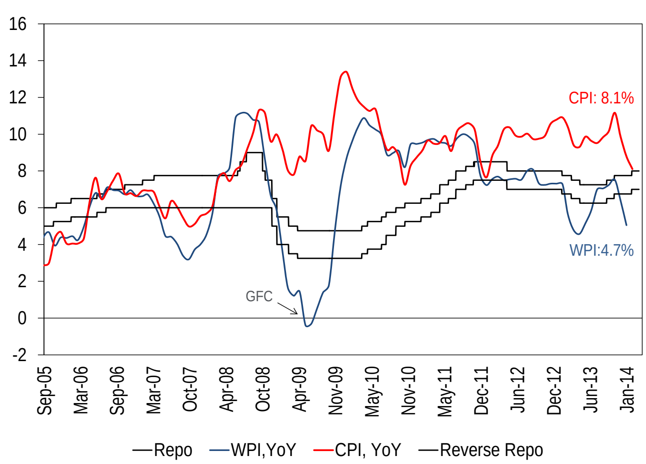
Source: CSO, Citi Research

Figure 56. 2014 elections - opinion polls*

	Times Now Cvoter	ABP News - Nielsen	CNN - IBN - Lokniti - CSDS
NDA (BJP + Allies)	227	236	211-231
UPA (Congress + Allies)	101	92	107-127
Others	215	215	205
Total	543	543	543

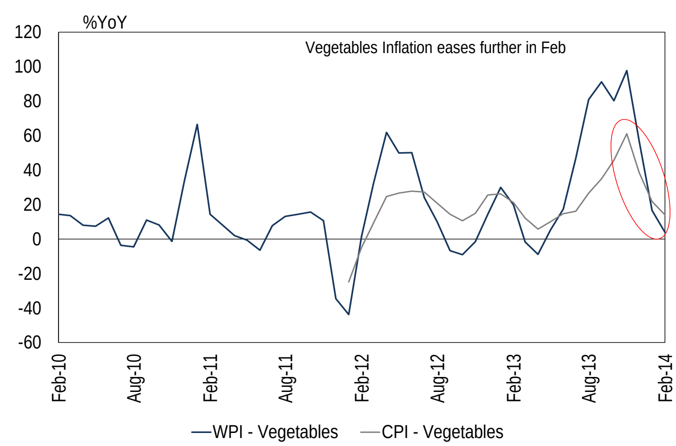
*info available as of 5th March; Source: News Reports (Times of India, ABP News, CNN)

Figure 57. Trends in inflation and policy rates (%)



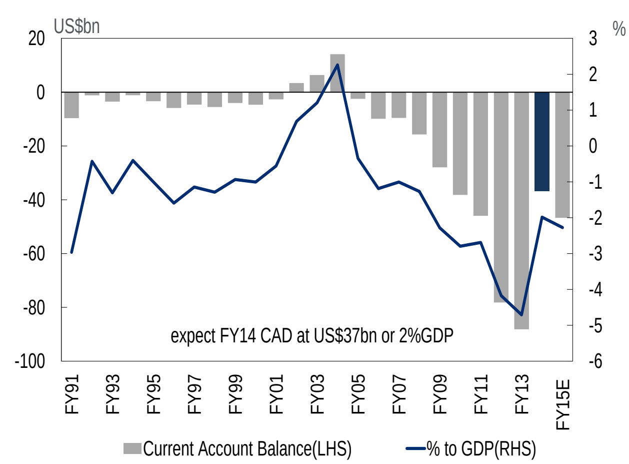
Source: CSO, Office of the Economic Advisor, RBI

Figure 58. Trends in vegetables inflation – WPI and CPI(%YoY)



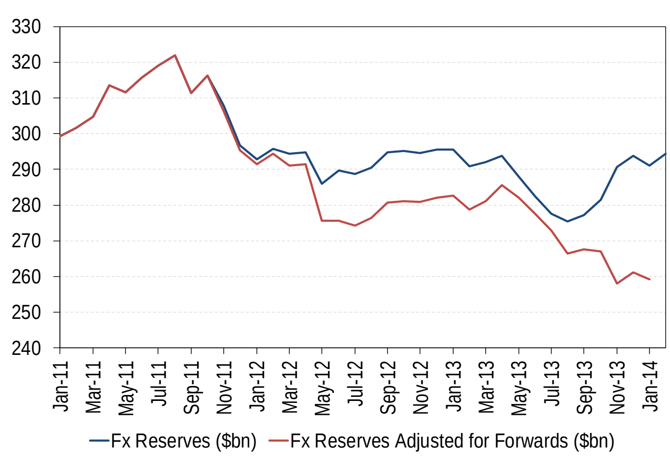
Source: CSO, Office of the Economic Advisor

Figure 59. Trends in current account deficit (US$bn, %GDP)



Source: RBI, Citi Research

Figure 60. Trends in FX reserves – spot & forwards adjusted (US$bn)



Source: RBI

Figure 61. India Economic Indicators

	FY08	FY09	FY10	FY11	FY12	FY13	FY14F	FY15F	FY16F
Summary Data									
Nominal GDP, US$ bn	1,240.6	1,223.9	1,366.6	1,707.8	1,873.1	1,872.8	1,840.7	2,012.1	2,325.8
Nominal GDP, local currency bn	49,871	56,301	64,778	77,841	90,097	101,133	113,205	127,921	145,830
GDP per capita, US$	1,090	1,061	1,168	1,440	1,558	1,539	1,490	1,605	1,828
Population, mn	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,217.0	1,235.3	1,253.8	1,272.6
Unemployment, % of labour force	--	--	--	--	--	--	--	--	--
Economic Activity									
Real GDP, % yoy	9.3	6.7	8.6	8.9	6.7	4.5	4.9	5.6	6.2
Real investment growth % yoy	18.1	-5.2	17.3	14.1	3.9	4.9	0.0	3.4	3.5
Real consumption growth % yoy	9.4	7.7	8.4	8.2	8.9	5.2	4.4	5.6	6.8
private consumption growth % yoy	9.4	7.2	7.4	8.7	9.3	5.0	4.1	5.5	7.0
Real export growth, % yoy	5.9	14.6	-4.7	19.6	15.6	5.0	8.0	11.0	9.0
Real import growth, % yoy	10.2	22.7	-2.1	15.6	21.1	6.6	-1.6	9.5	9.3
Prices, Money & Credit									
CPI, % yoy	7.9	8.0	14.9	8.8	9.0	10.4	9.6	8.3	7.5
CPI, % avg	6.2	9.1	12.4	10.4	8.4	10.2	9.6	8.3	7.5
Nominal wages, % yoy	--	--	--	--	--	--	--	--	--
Credit extension to private sector, % yoy	23.0	19.0	16.0	17.0	17.5	17.5	17.5	17.5	17.5
Policy interest rate, % eop	7.75	5.00	5.00	6.75	8.50	7.50	8.00	8.00	8.00
Short-term market rate, % eop	8.00	5.68	4.49	9.54	10.90	8.50	8.50	8.50	8.50
Long term yield, % eop	7.96	7.01	7.83	7.99	8.56	8.00	8.50	8.50	8.50
lc/US$, eop	39.41	48.62	46.41	44.71	53.02	55.00	61.81	64.27	63.23
lc/US$, avg	41.18	43.42	48.30	45.68	46.63	53.38	58.57	62.59	63.62
Balance of Payments, US$ bn									
Current account	-15.7	-27.9	-38.2	-45.9	-78.2	-88.2	-36.8	-46.7	-58.1
% of GDP	-1.3	-2.3	-2.8	-2.7	-4.2	-4.7	-2.0	-2.3	-2.5
Trade balance	-91.5	-119.5	-118.2	-130.6	-189.8	-195.7	-148.7	-165.3	-181.8
Exports	166.2	189.0	182.4	250.5	309.8	306.6	323.4	349.3	384.3
Imports	257.6	308.5	300.6	381.1	499.5	502.2	472.1	514.6	566.1
Service balance	38.9	53.9	36.0	48.8	64.1	64.9	72.1	77.8	84.0
Income balance	-5.1	-7.1	-8.0	-17.3	-16.0	-21.5	-24.0	-24.0	-26.0
FDI, net	15.9	22.4	18.0	9.4	22.1	19.8	20.0	18.0	23.0
International reserves	299.1	241.6	252.8	273.7	260.9	264.7	278.0	294.8	314.2
Total Amortisations	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9	21.0
Public Finances, % of GDP									
Consolidated government balance	-4.0	-8.3	-9.3	-6.9	-8.1	-7.2	-6.9	-6.7	-6.5
Consolidated gov primary balance	-1.2	3.3	4.5	2.4	3.6	--	--	--	--
Public debt	76.1	76.8	75.5	70.2	69.7	69.8	69.5	68.1	66.3
of which Domestic	71.4	72.2	70.6	65.6	65.9	65.4	65.6	64.6	63.2
Foreign Assets & Liabilities, US$ bn									
External debt	224.4	224.5	260.9	317.9	360.7	400.3	400.3	415.3	430.3
Private	166.3	168.6	193.9	239.8	278.8	318.6	321.9	334.9	347.9
Public	58.1	55.9	67.1	78.1	81.9	81.7	78.4	80.4	82.4
External debt / GDP	18.1	18.3	19.1	18.6	19.3	21.4	21.7	20.6	18.5
External debt / XGS	88.5	77.7	95.2	84.7	80.7	89.1	86.1	77.9	60.0
Short-term debt	45.7	43.3	52.3	65.0	78.2	96.7	94.8	99.8	104.8
Short-term debt/International Reserves (%)	15.3	17.9	20.7	23.7	30.0	36.5	34.1	33.8	33.3

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	4.8	4.7	5.0	5.2	5.6	5.8	5.8	6.5	6.6
CPI, % yoy	9.7	10.4	8.8	9.3	8.1	7.5	8.1	7.5	7.5
Policy interest rate, % eop	7.50	7.75	8.00	8.00	8.00	8.00	8.00	8.00	8.00
Short-term market rate, % eop	10.50	9.00	8.10	8.10	8.10	8.10	8.10	8.10	8.10
Long term yield, % eop	8.28	8.80	8.70	8.70	8.50	8.50	8.50	8.50	8.50
lc vs USD, eop	62.59	61.81	60.95	61.95	63.19	64.27	64.01	63.76	63.49

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** – The improving trend of the current account deficit, along with increased market transparency, has led to a decline in risk premia across Indonesian assets. This has been topped by the long awaited nomination of Jakarta Governor Joko Widodo as a presidential hopeful from the PDIP party.
- **Things to watch** – We still see challenges ahead. The reversing CA deficit has been mainly a result of a downturn in domestic demand. Meanwhile reforms are still urgently needed but haven't been fully implemented. We also would like to see a more solid recovery in manufacturing exports.
- **Strategy** – We believe a tight bias on monetary policy is still warranted (we still see another 25bps hike this year). We also doubt the sustainability of a continued strengthening of Indonesia's trade weighted exchange rate, as it may complicate efforts to achieve BI's current account deficit target of 2.5% of GDP.

Corrective actions bearing fruit

FX market turnover has recovered close to 2011 levels. Along with BI's drive to increase transparency in the FX market, daily turnover has been steadily rising and in recent weeks has exceeded US$500mn per day. This is still below the peaks in 2011 (during CA surplus and capital inflow era), but has improved significantly from the crunch periods in mid-2013 and end-2012. This rise in FX market turnover has apparently improved confidence among both exporters and foreign investors.

Current account trend has reversed toward improvement. The tightening of BI's policy mix in 2H13 (higher interest rates, weaker exchange rate and tighter macroprudential regulations) has also yielded results. Trade data in recent months has shown a sustained decline in non-oil and gas imports, which helped improve the trade balance and current account deficit. On the whole, imports of machinery, vehicles and steel, which altogether comprise around 30% of total imports, has contracted by 6% in 2013 compared to the previous year. This managed to offset the relatively strong growth of raw material imports such as fuel (+11% YoY volume growth in 2013) as well as plastics and chemicals.

Baseline is for yearly trend of CA deficit to improve further, **although hump-shaped trajectory expected on quarterly basis.** We expect the CA deficit to improve towards 2.5% GDP in 2014, from 3.3% in 2013. This is under our baseline of 5.3% GDP growth this year. On quarterly basis, however, we expect noise from the export side (i.e. commodity export fluctuations and temporary stimulus from election campaign spending) may result in a hump-shaped trajectory for the CA deficit. In 1H14 it may exceed 2.5% GDP by our estimates, from 2% in 4Q13.

General elections bring new sense of optimism. On 14-Mar, the PDIP party finally announced the nomination of Jakarta Governor Joko Widodo as a presidential hopeful. Widodo is expected to accelerate the pace of reform if elected to the presidency. This is given his track record on issues such as land acquisition, bureaucracy reform and development of public transportation in his tenures as Mayor of Solo (2005 – 2012) as well as Governor of Jakarta (2012-present). Going forward, upcoming milestones to be watched would be the nomination of the Vice Presidential candidate that will accompany Widodo. We think that a VP candidate from another sizeable coalition party would be regarded positively.

Stock-taking on the fundamental changes

Current account improvement so far mainly driven by downturn in investments. The turnaround of the current account has been mainly led by a sharp downturn in imports of machinery (i.e. both mining and non-mining). Exports of manufactured goods have not seen any game-changing increase. There has been 1-2 months of data showing a rise in growth of selected manufacturing exports (e.g. chemicals, machinery), but the magnitudes are still small in size vs. the monthly swings in commodity/resource exports.

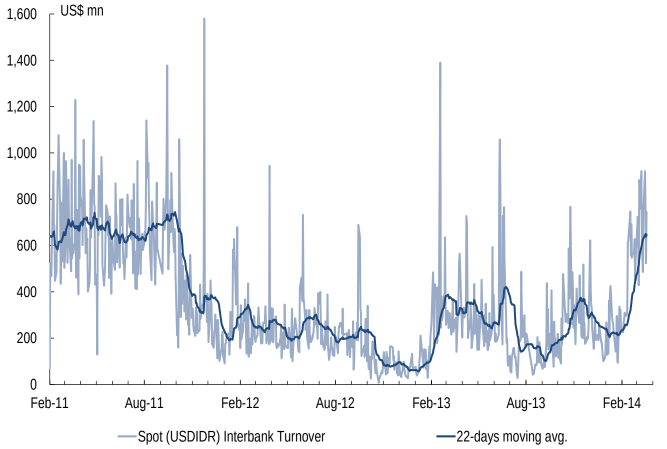
Badly needed reforms have yet to be fully implemented. Plans to raise electricity tariffs and LPG prices have been put forward. Furthermore the tender for the government's biodiesel program has recently seen better progress. But the oil trade deficit by volume has not seen any turnaround and remains unrestrained, given the decline in domestic oil output and insufficient efforts to curb domestic usage. The finance ministry has proposed a floating price mechanism for subsidized fuel which may be preceded by a one off fuel price hike (see *Indonesia Macro Flash - Subsidy Reform & Budget Revision: Options and What to Expect*). We view this positively, however no definite timeline has been set so far in this election year.

The medium term growth prospect of the economy is at stake. The current combination of suppressed investment and strong consumption growth do not make a good recipe for current account sustainability. Indonesia's last investment cycle commenced in 2010 and peaked in 2012, with many landmark factory constructions finishing in 2013. Indonesia historically has an investment cycle of around 3-4 years. Structural reforms need to be implemented in this short window. Otherwise the country risks not being able to "finance" its next investment upturn without triggering another round of serious balance of payments pressures. If reforms progress at a snail's pace, Indonesia may eventually have to settle for a lower medium term GDP growth rate.

Reduction in risk premia for Indonesian assets is partly justified, but must be weighed against sustainability of CA improvement. Given policymakers' consistency in maintaining a transparent market, we think that recent improvements in FX market turnover is generally here to stay. However, the economy still faces challenges ahead. The recent turnaround of the CA deficit appears more attributable to the cyclical downturn rather than result of structural reforms. Apart from higher import taxes and tighter regulations in some sectors, few structural changes have materialized. Manufacturing exports have only mild signs of recovery; and as we've seen in January, commodity exports can still cause major swings in the trade balance.

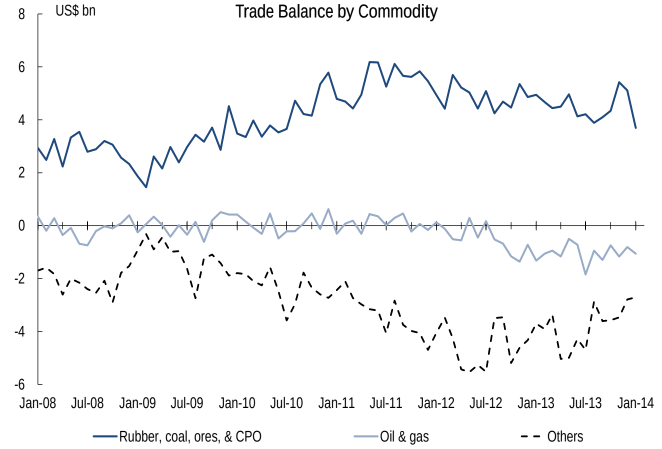
A too early reversal of tight policy now may risk derailing the CA deficit improvement. In our view, any premature resurgence in domestic demand may jeopardize the CA deficit improvement. It is not time yet to undo the tight policy bias. We do not think interest rates will decline this year although BI may not be too far away from an extended pause (we still expect one more 25bps policy rate hike to 7.75% in 2Q). We also doubt the sustainability of a continued strengthening of the IDR on a trade-weighted basis, as it may risk resurgence of imports which could complicate efforts to achieve BI's CA deficit target of around 2.5% GDP. We would be more comfortable going forward if the manufacturing exports recover on a more solid footing, and the next round of fuel subsidy reforms have been carried out. In the meantime, we think that IDR strengthening driven by portfolio inflows represents an opportunity for BI to replenish its foreign reserve position.

Figure 62. FX market turnover recovering towards 2011 levels



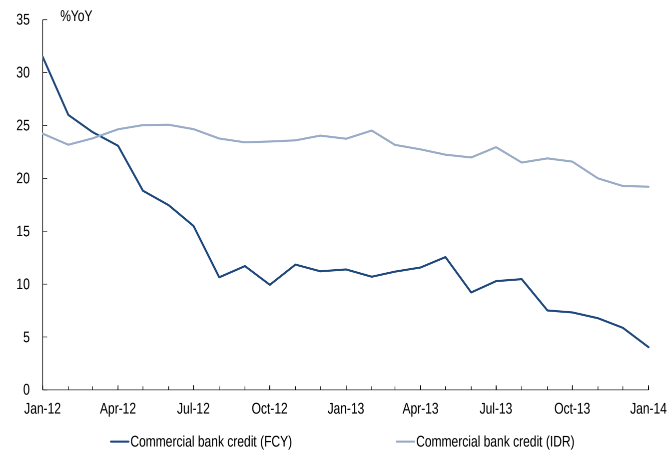
Source: CEIC, Citi Research

Figure 63. Non-commodity trade balance improve as imports shrink



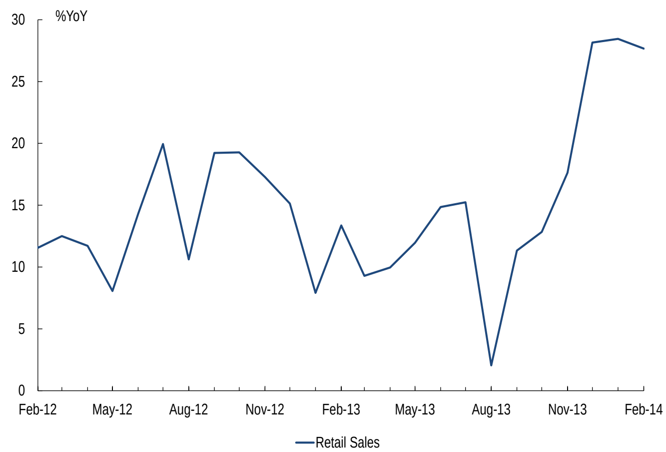
Source: CEIC, Citi Research

Figure 64. Credit growth continues to subside



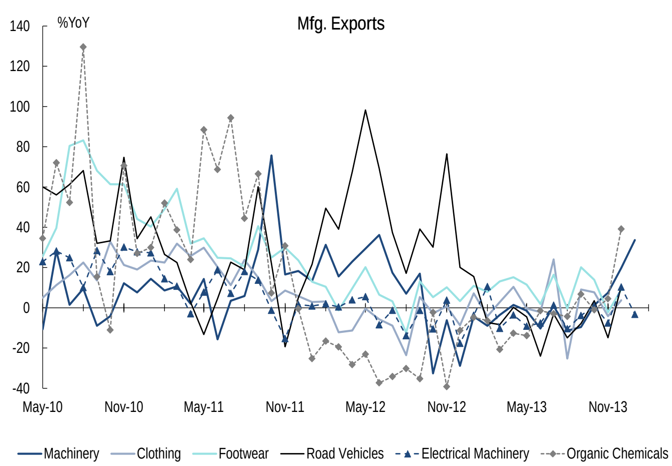
Source: CEIC, Citi Research

Figure 65. Retail sales growth undisturbed by policy adjustments



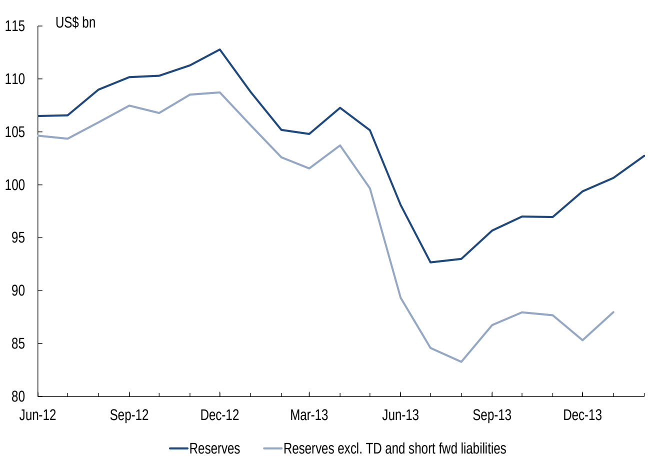
Source: CEIC, Citi Research

Figure 66. Manufacturing exports show nascent recovery



Source: CEIC, Citi Research

Figure 67. BI has incentive to reaccumulate foreign reserves



Source: Bank Indonesia, Citi Research

Figure 68. Indonesia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	432.2	510.7	538.6	709.5	845.4	876.9	868.5	849.9	923.7
Nominal GDP, local currency bn	3,950,893	4,948,688	5,606,203	6,446,852	7,419,187	8,229,439	9,083,972	10,035,224	11,173,188
GDP per capita, US$	1,915	2,235	2,328	2,986	3,484	3,591	3,510	3,408	3,660
Population, mn	225.6	228.5	231.4	237.6	242.6	244.2	247.4	249.4	252.4
Unemployment, % of labour force	9.1	8.4	7.9	7.1	6.6	6.1	6.3	6.5	6.3
Economic Activity									
Real GDP, % yoy	6.3	6.0	4.6	6.2	6.5	6.3	5.8	5.3	5.5
Real investment growth % yoy	1.9	12.4	2.4	8.8	10.1	16.3	4.9	3.3	6.0
Real consumption growth % yoy	4.9	5.9	6.2	4.1	4.5	4.8	5.2	5.4	3.9
private consumption growth % yoy	5.0	5.3	4.9	4.7	4.7	5.3	5.3	5.1	4.4
Real export growth, % yoy	8.5	9.5	-9.7	15.3	13.6	2.0	5.3	4.0	5.7
Real import growth, % yoy	9.1	10.0	-15.0	17.3	13.3	6.7	1.2	2.3	3.1
Prices, Money & Credit									
CPI, % yoy	5.8	11.1	2.8	7.0	3.8	3.7	8.1	5.3	6.4
CPI, % avg	6.3	9.9	4.8	5.1	5.3	4.0	6.4	6.4	5.7
Nominal wages, % yoy	4.9	7.6	5.3	12.2	3.4	20.4	21.2	17.1	15.0
Credit extension to private sector, % yoy	22.4	30.7	18.0	20.6	25.9	22.1	18.0	16.0	17.0
Policy interest rate, % eop	3.00	8.75	6.00	5.50	4.50	4.00	5.75	6.00	6.50
Short-term market rate, % eop	3.35	9.44	6.39	5.66	4.57	4.24	6.01	6.10	6.90
Long term yield, % eop	10.02	11.92	10.07	7.83	6.05	5.39	8.60	8.80	8.75
lc/US$, eop	9,393	10,900	9,425	9,010	9,068	9,638	12,170	12,196	12,036
lc/US$, avg	9,140	9,673	10,376	9,078	8,763	9,361	10,449	11,807	12,096
Balance of Payments, US$ bn									
Current account	10.5	0.1	10.6	5.1	1.7	-24.4	-28.5	-20.9	-19.3
% of GDP	2.4	0.0	2.0	0.7	0.2	-2.8	-3.3	-2.5	-2.1
Trade balance	32.8	22.9	30.9	30.6	34.8	8.6	6.2	11.0	13.3
Exports	118.0	139.6	119.6	158.1	200.8	188.5	183.5	190.6	201.9
Imports	85.3	116.7	88.7	127.4	166.0	179.9	177.4	179.6	188.6
Service balance	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-11.4	-10.7	-11.1
Income balance	-15.5	-15.2	-15.1	-20.8	-26.7	-26.8	-27.2	-25.4	-26.0
FDI, net	2.3	3.4	2.6	11.1	11.5	13.7	14.8	14.0	14.5
International reserves	56.9	51.6	66.1	96.2	110.1	112.8	99.4	107.9	113.6
Total Amortisations	18.8	16.7	20.4	24.0	25.2	29.4	41.0	42.0	42.0
Public Finances, % of GDP									
Consolidated government balance	-1.3	-0.1	-1.6	-0.7	-1.1	-1.9	-2.2	-2.2	-1.7
Consolidated gov primary balance	0.8	1.7	0.1	0.6	0.1	-0.6	-0.9	-1.0	-0.5
Public debt	34.1	29.3	31.4	26.4	23.6	23.3	23.5	26.0	25.0
of which Domestic	19.7	16.2	19.3	16.7	15.5	16.1	16.2	15.6	16.0
Foreign Assets & Liabilities, US$ bn									
External debt	141.2	155.1	172.9	202.4	225.4	252.4	265.0	277.0	290.0
Private	60.6	68.5	73.6	83.8	106.7	126.2	126.5	135.0	142.0
Public	80.6	86.6	99.3	118.6	118.6	126.1	138.5	142.0	148.0
External debt / GDP	32.7	30.4	32.1	28.5	26.7	28.8	30.5	32.6	31.4
External debt / XGS	108.2	100.1	130.2	115.8	101.8	119.3	128.6	128.5	127.2
Short-term debt	18.7	20.5	24.0	31.6	36.6	43.4	44.0	46.0	49.0
Short-term debt/International Reserves (%)	32.8	39.7	36.4	32.8	33.2	38.4	44.3	42.6	43.1

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	5.6	5.7	5.7	5.4	5.0	5.3	5.2	5.7	5.5
CPI, % yoy	7.9	8.1	7.4	7.2	5.0	5.3	5.9	6.9	6.7
Policy interest rate, % eop	5.50	5.75	5.75	6.00	6.00	6.00	6.25	6.50	6.50
Short-term market rate, % eop	5.70	6.01	6.00	6.10	6.10	6.10	6.40	6.70	6.70
Long term yield, % eop	8.54	8.60	8.10	8.25	8.75	8.80	8.75	8.75	8.75
lc vs USD, eop	11,580	12,170	11,430	11,658	11,945	12,196	12,156	12,116	12,076

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

Malaysia

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- **Summary view** – Chinese New Year distortions complicate the interpretation of early 1Q14 data and we forecast a continued if slower sequential expansion in 1Q14 GDP. BNM remains in no hurry to hike, but with inflation pressures more pervasive, the bias remains towards a tightening, perhaps in 2H14.
- **Things to watch** – [1] Private consumption growth; [2] improvements in external demand; [3] fuel price hikes and impact on inflation; [4] inflation expectations and wage growth; [5] progress on fiscal consolidation; [6] household credit growth; [8] guidance from Gov Zeti on monetary policy.
- **Strategy** – While a strong USD backdrop and heavy foreign positioning in bonds remain a headwind for MYR, this could be offset by an improving CA surplus and tightening bias in monetary policy, which may impute a bear flattening bias to the MGS curve near term.

Earlier Chinese New Year clouds 1Q14 GDP outlook

Chinese New Year distortions complicate interpretation of early 1Q14 data. The Jan IP data suggest a slow start to 1Q14 GDP – the official seasonally-adjusted data for the rebased IP series shows a sequential decline (Jan: -1.3%MoM SA, Dec: -0.8%) on broad-based declines across Manufacturing, Mining, and Electricity. This brings seasonally-adjusted Jan headline IP levels 1.3% below average 4Q13 levels with Manufacturing and Electricity IP levels 1.9% and 1.7% below 4Q respectively, though Mining IP is still 0.3% above. However given possible swings in the seasonally-adjusted figures due to the moving holiday, we would not be surprised to see major improvements in Feb/Mar.

The E&E data continues to hint at improving underlying export momentum. We estimate exports rose sequentially (Jan: 2.0%MoM SA, Dec: 1.5%), with E&E exports in particular surging 8.2%MoM SA (Dec: -7.5%), bringing seasonally-adjusted Jan E&E exports levels 3.8% above average 4Q13 levels. There is some evidence this was in fact reflected in the E&E IP data – we note that the *non*-seasonally adjusted MoM decline in E&E IP of 2.2% appears less severe vs Jan-2012 when it fell 4.9% under the previous series. While the lack of back data does limit the accuracy of our estimates, our seasonal adjustment process available data suggests Jan E&E IP rose 1.7%MoM SA (Dec: 1.5%), bringing Jan seasonally-adjusted levels 3.2% above average 4Q13 levels.

Jan intermediate goods imports point to improving manufacturing output. We estimate imports had surged sequentially (Jan: 6.2%MoM SA, Dec: 0%), led by intermediate goods which jumped 9.1%MoM SA (Dec: -4.7%) after recent weakness, bringing Jan seasonally-adjusted levels 5.3% above average 4Q13 levels, likely reflecting restocking by exporters catching up with improving external demand and could foreshadow further strength in exports, as was the case in 1H13.

Investments likely softened in Jan, but consumption bears watching. Our estimates suggest imports of capital goods fell 6.9%MoM SA, though the Dec jump of 30.4% leaves Jan seasonally-adjusted levels still 5.6% above average 4Q levels. We estimate however that consumption good imports rose 4.6%MoM SA (Dec: 0.8%), though this could have been boosted by the earlier Chinese New Year – Jan levels are 5.2% above 4Q.

BNM in no hurry to hike for now, but watch the signposts

BNM's signposts for policy action have put the spotlight on consumption. The last MPC statement suggests that private consumption growth coming in above its "long-term average" – which BNM has estimated at 6.6% – would be a sign of demand-pull inflation pressure, as opposed to strong headline GDP growth. BNM's own private consumption forecast of 6.9% for 2014 is higher than the long term average, and may suggest a tightening bias, especially if stronger than forecast.

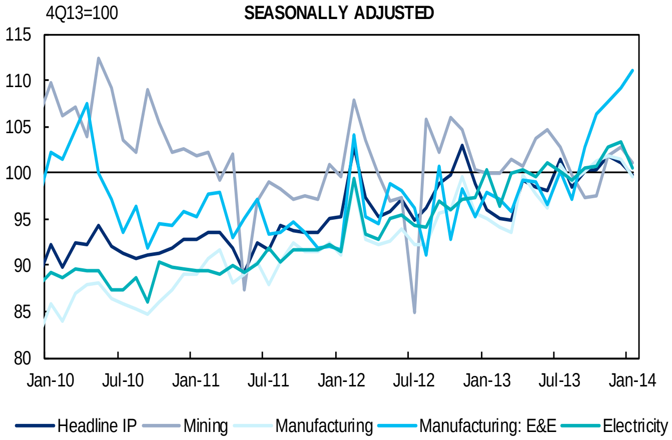
Recent upside surprises in inflation have thus far failed to prompt tightening. Headline inflation has risen to 3.5%YoY as of Feb (Jan: 3.4%) – excluding food, alcoholic beverages and tobacco, transport, and electricity, our estimate of core inflation is also now at 2.0%YoY (Jan: 1.7%). Inflation pressures have been turning more broad-based – our inflation diffusion index based on the most granular CPI data available suggests that the share of the CPI basket seeing MoM price increases continued to rise into Feb, while a rising proportion of the CPI basket is now seeing above-2% inflation.

BNM is watching the "persistence" and "pervasiveness" of cost pressures. While BNM has attributed the recent upward trajectory in inflation – which remains within its 2014 average forecast of 3-4% – to cost push pressures, it acknowledges the risk that inflation expectations become unhinged and lead to more "persistent and pervasive" inflation pressures, in turn driving excessive wage gains and/or greater willingness by firms to pass on rather than absorb cost increases.

Financial stability risks also have to be watched – not just negative real interest rates but "destabilizing" financial imbalances (including excessive leverage and asset-price misalignments). BNM's latest Financial Stability and Payment Systems Report shows household debt rose to 86.8% of GDP in 2013 (2012: 81.3%) – however BNM continues to view household debt as manageable and that risks to financial stability are well-contained. The aggregate household debt service ratio (DSR) edged down to 43.5% (2012: 43.9%), the DSR of new loans are below 40% amidst more stringent income documentation and assumptions for variable income, and only 27% of loans are to vulnerable groups earning less than RM3,000/month. Risks from a correction in property prices have been mitigated by limited borrowing for speculation, strengthened lending practices and sound buffers. Echoing the IMF Article IV, BNM expects domestic players, banks, pension funds and insurance funds to be able to absorb the shortfall if inflows from QE were to completely reverse.

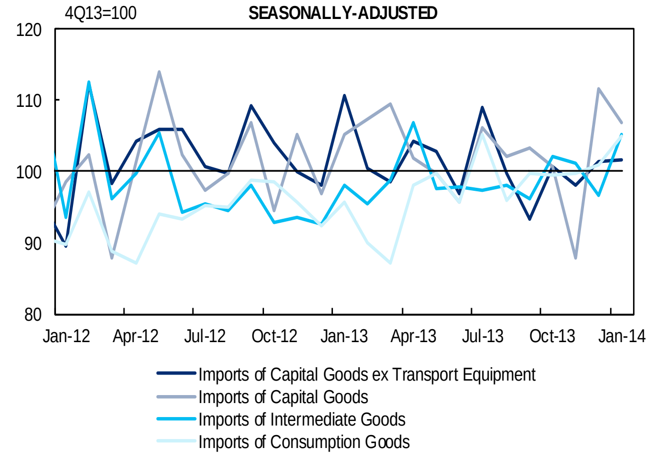
Overall, we think BNM's bias remains towards rate hikes, though more likely in 2H14. Recent uncertainty over China's growth outlook may also factor into standing pat for now, while manufacturing unit labour cost growth has plateaued. But while BNM may not hike in May, with monetary policy deemed "accommodative", we believe the bias clearly is towards higher rates. Price pressures have been turning more pervasive, and may worsen with fuel price hikes (likely Jun/July), which may also cause real interest rates to turn more negative. Should 1H14 GDP data prove comforting and external demand uncertainties recede in 2H14, coupled with BNM confidence of resilient private consumption growth of 6.9% (vs the long-term average of 6.6%), we see a greater risk that wage pressures would intensify and/or financial imbalances could worsen. In that case, arguments that inflation is merely cost push would be weakened. IMF studies also show the rise in debt service burdens from rate hikes would be small.

Figure 69. Jan IP data suggest a slow start to 1Q14 GDP



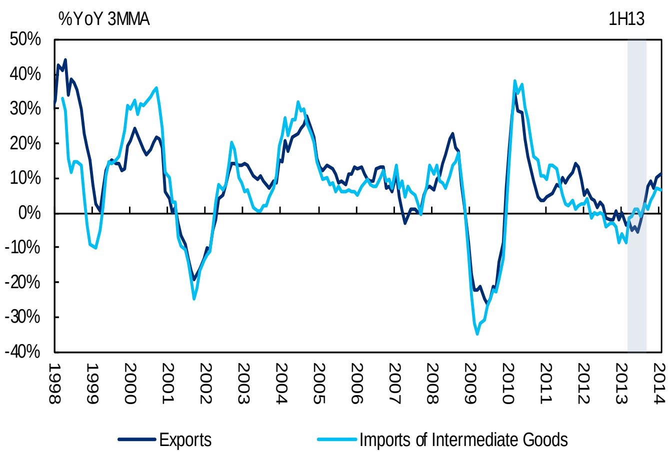
Source: CEIC, Citi Research

Figure 70. Investments likely softened, consumption bears watching



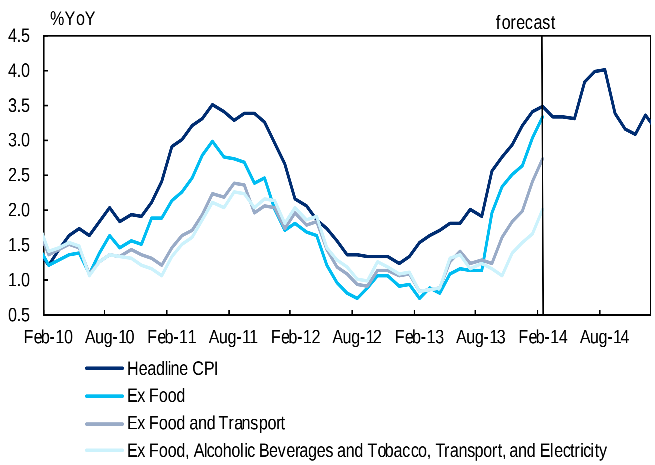
Source: CEIC, Citi Research

Figure 71. Intermediate good imports point to improving mfg output



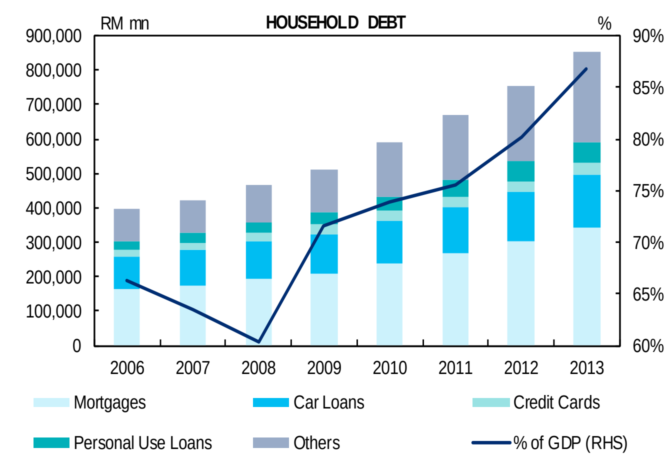
Source: CEIC, Citi Research

Figure 72. Upside surprises in inflation have failed to prompt tightening



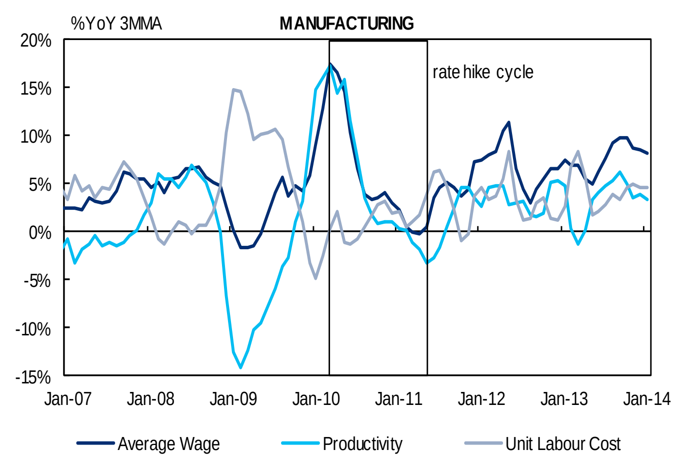
Source: Haver, Citi Research

Figure 73. Household debt rose to 86.8% of GDP in 2013 (2012: 81.3%)



Source: BNM, CEIC, Citi Research

Figure 74. Manufacturing unit labour cost growth has plateaued



Source: CEIC, Citi Research

Figure 75. Malaysia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	193.7	231.1	202.4	247.7	289.3	305.0	312.6	314.8	330.7
Nominal GDP, local currency bn	665	770	713	797	884	941	984	1,058	1,118
GDP per capita, US$	7,123	8,393	7,255	8,664	9,987	10,398	10,520	10,321	10,668
Population, mn	27.2	27.5	27.9	28.6	29.0	29.3	29.7	30.5	31.0
Unemployment, % of labour force	3.2	3.3	3.7	3.4	3.1	3.0	2.9	2.9	2.9
Economic Activity									
Real GDP, % yoy	6.3	4.8	-1.5	7.4	5.1	5.6	4.7	5.0	4.9
Real investment growth % yoy	9.1	1.8	-9.4	25.3	2.3	22.3	7.2	1.4	8.0
Real consumption growth % yoy	9.7	8.4	1.4	6.2	8.6	7.1	7.3	5.8	3.3
private consumption growth % yoy	10.4	8.7	0.6	6.9	6.8	7.7	7.6	6.5	4.7
Real export growth, % yoy	3.8	1.6	-10.9	11.1	4.6	-0.1	-0.3	4.4	3.3
Real import growth, % yoy	5.9	2.3	-12.7	15.6	6.1	4.7	1.9	3.8	3.0
Prices, Money & Credit									
CPI, % yoy	2.3	4.5	1.0	2.1	3.0	1.2	3.2	3.4	4.9
CPI, % avg	2.0	5.4	0.6	1.7	3.2	1.6	2.1	3.5	4.5
Nominal wages, % yoy	4.3	4.5	2.5	8.2	3.8	6.4	7.8	5.0	5.0
Credit extension to private sector, % yoy	9.2	10.2	6.8	10.6	12.3	12.1	11.0	11.0	11.0
Policy interest rate, % eop	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50	3.50
Short-term market rate, % eop	3.61	3.37	2.17	2.98	3.22	3.21	3.32	3.80	3.80
Long term yield, % eop	3.78	3.00	3.79	3.39	3.23	3.24	3.66	4.00	4.00
lc/US$, eop	3.31	3.45	3.42	3.08	3.17	3.06	3.28	3.40	3.38
lc/US$, avg	3.44	3.33	3.52	3.22	3.06	3.09	3.15	3.36	3.38
Balance of Payments, US$ bn									
Current account	29.7	39.4	31.4	27.1	33.5	18.6	11.8	13.9	13.2
% of GDP	15.4	17.1	15.5	10.9	11.6	6.1	3.8	4.4	4.0
Trade balance	38.1	51.1	39.8	42.5	49.6	40.7	32.6	34.0	35.0
Exports	176.5	198.9	157.0	199.2	228.8	227.9	219.4	257.4	265.0
Imports	138.5	147.7	117.1	156.7	179.2	187.2	186.8	223.4	230.0
Service balance	0.4	0.5	1.2	-0.4	-2.1	-4.5	-4.8	-3.8	-3.0
Income balance	-8.7	-12.2	-9.6	-15.0	-14.0	-17.6	-16.0	-16.3	-18.8
FDI, net	-2.7	-7.8	-6.3	-4.3	-3.1	-7.0	-1.3	-3.0	-1.0
International reserves	101.3	91.5	96.7	106.5	133.6	139.7	134.9	135.0	140.0
Total Amortisations	7.8	6.3	9.8	11.3	9.0	7.4	10.0	11.0	12.0
Public Finances, % of GDP									
Consolidated government balance	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-3.9	-3.5	-3.0
Consolidated gov primary balance	-1.2	-3.0	-4.7	-3.5	-2.8	-2.4	-1.7	-1.3	-0.9
Public debt	40.1	39.8	50.8	51.1	51.6	53.3	54.8	55.0	55.0
of which Domestic	37.1	37.2	48.9	49.0	49.5	51.5	53.1	53.5	53.5
Foreign Assets & Liabilities, US$ bn									
External debt	56.2	66.6	68.3	72.6	81.5	82.8	95.8	97.0	96.0
Private	37.8	41.5	41.9	44.7	53.7	55.6	67.8	67.0	67.0
Public	18.4	25.2	26.3	27.9	27.8	27.1	28.0	30.0	29.0
External debt / GDP	29.0	28.8	33.7	29.3	28.2	27.1	30.6	30.8	29.0
External debt / XGS	27.4	29.0	36.9	31.4	30.7	31.1	37.0	32.7	31.4
Short-term debt	16.3	22.5	22.7	25.4	32.8	30.4	38.6	42.0	42.0
Short-term debt/International Reserves (%)	16.1	24.6	23.5	23.8	24.6	21.8	28.6	31.1	30.0

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	5.0	5.1	5.6	4.6	5.5	4.4	4.0	5.2	4.8
CPI, % yoy	2.6	3.2	3.3	3.8	3.4	3.4	3.2	5.0	5.0
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.50	3.50	3.50	3.50	3.50
Short-term market rate, % eop	3.21	3.32	3.31	3.31	3.80	3.80	3.80	3.80	3.80
Long term yield, % eop	3.52	3.53	3.60	3.80	3.90	4.00	4.10	4.10	4.00
lc vs USD, eop	3.26	3.28	3.32	3.35	3.38	3.40	3.39	3.39	3.38

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

Philippines

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- **Summary view** – Our 2014 GDP growth forecast of 6.9% is unchanged although key indicators in Jan-Feb do not appear as robust. Real peso value of remittances should still buoy up 1Q consumption. FDI approvals remain elevated to offer upbeat private investment signals in support of strong growth.

- **Things to watch** – BSP's expected rate hike starting with SDA rate, if not in Mar, then likely in succeeding sessions. Strong primary fiscal expenditures in 1Q14 driven by rehabilitation/reconstruction activities and high infra spending targets. Core CPI uptrend still intact. Awarding and implementation of big-ticket PPP projects.

- **Strategy** – Within the short-duration bond space which could offer safe refuge to rate hikes, we like the 4yr-5yr segment preferably series 5-72 that's at 3.25% or 100bp higher than the PIR. Low interest rate setting supports a narrowing 2-yr rate differential conducive to PHP adrift vs USD.

While upbeat, 1Q14 momentum isn't as robust

Initial set of economic indicators while positive doesn't give the impression of robust contribution to 1Q14 growth. We start off with Jan exports (Customs trade data) that grew 9.3%YoY despite tech exports up 22.4%YoY. Against 4Q13 export growth of 16.1%YoY, the latest estimate has narrowed materially. In Dec, primary fiscal expenditures fell 16.8%YoY to round off a year of fiscal 'underspending' of Php95bn (0.8% of GDP) and lower than programmed 2013 fiscal deficit of Php164bn (1.4% of 2013 GDP). Manufacturing (mfg) production index grew 7.3%YoY in Jan—a pace much lower compared to its 4Q13 average growth of 22.4%YoY. Seasonally, mfg index fell 11.1%MoM SA (vs +4.2%MoM SA in Dec) to best capture mfg activity's easing pace to start 2014.

We estimate the real peso value of the remittances expanded 12%YoY in Jan for the third straight monthly 2-digit gain. PHP depreciation of 10%YoY, coupled with the $ volume, more than compensated for the elevated inflation effect (4.2%YoY). BSP reported OFW remittances (coursed through banking channels) in Jan of US$1.8bn for growth of 6%YoY. Strong purchasing power of the remittances driven by real PHP depreciation augurs well for a strong consumption lift.

Ensuing transport bottleneck if Manila city's truck ban were to persist could hostage roughly 1% (low) to 5% (high) of GDP coming mainly from non-tech, export commodities. Local/foreign locators in the PEZA zones of CALABARZON with their export-bound cargo requiring international shipping services are destined for the port of Manila (alternative port of Batangas doesn't have installed capacity to accommodate more container shipments). Cyclical risk from the truck ban may not be as severe as a collapse in external demand but over time, export delays that divert foreign buyers' interest could jeopardize production and jobs in CALABARZON. Tech producers that avail of airline services in shipping out their goods may be spared unlike non-tech manufacturers e.g. car parts, with their containerized shipments that exit through Manila's port, contribute 22.8% of GDP.

We expect a sanguine private investment outlook in 2014 despite financial market volatilities and soft external demand. Investment approvals—forward looking investment indicator fell by a sharp 28.6%YoY in 4Q13 owing to the base effect, but for 2013, investment approvals rose 8%. About Php346bn of planned power projects were booked in 2013 up 2.2x compared to 2012 approvals, likely instrumental in easing power constraints in 2016 onwards. For Feb, real estate and construction projects dominated approvals by Board of Investments up 139%YoY (Jan-Feb: -68.7%YoY).

4Q13 current account surplus failed to deter PHP's fall

Current account posted surplus of 5% of GDP (US$3.7bn) in 4Q13 for a full year surplus of 3.5% of GDP. Current account surplus (CAS) stood resilient despite natural disasters that derailed the macro momentum while external financial volatilities intensified owing to US Fed tapering, weak USD, and EM sell-off. 4Q13 CAS was a combination of narrowing trade deficit of US$4.4bn (-14.9%YoY) and familiar strengths, e.g. OFW remittances. Overall BOP surplus narrowed to 1.7% of GDP in 4Q13 as the BOP's financial accounts incurred a net outflow of US$1.6bn. BSP noted the 'surge in residents' acquisition of financial assets against a decline in residents' net incurrence of financial liabilities'. With global financial volatilities as backdrop, net outflows were posted in direct, portfolio (e.g. net outflow of US$500mn of equity securities and US$616mn of long-term bonds) and other investment accounts. FDI nonetheless expanded 35.8%YoY in 4Q13 to US$725mn (US$3.9bn in 2013) coincident with Moody's investment rating upgrade last Oct.

The current account/BOP surplus in 4Q13 implies additional liquidity into the market. CAS sustained strong broad money growth (>30%) largely due to compression of SDA balances. As such, CA probably contributed to policymakers' shift to a rate tightening bias soon. CAS of 5% of GDP could help ease negative sentiment against PHP with its external accounts stronger than other EM. But with rate differentials relatively low as US treasuries drift up, PHP remains vulnerable to US tapering risk, and portfolio exit risk in EM.

We expect CAS of 3.5% of GDP in 2014, easing to 3.3% of GDP in 2015. We assume modest exports gains of 6%-7% with alternating contributions from the tech and non-tech exports. Export and import gains likely underpin a trade deficit of US$19bn-US$20bn over the 2yr-forecast horizon. Resilient remittances should ensure net receipts of secondary income accounts at US$23bn-US$24.8bn over 2014-15. Last year's current account surplus was US$9.4bn for 3.5% of GDP.

Sequencing is equally as important as a rate hike

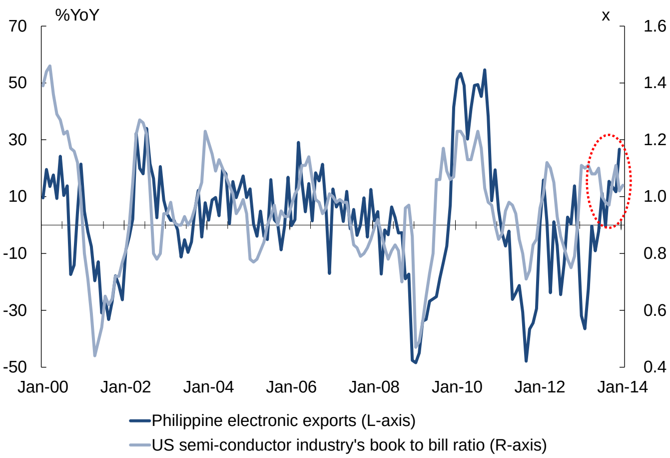
Hawkish signals ('early measured adjustments') were flagged by BSP Gov. Tetangco, a week or so before the scheduled MB meeting this month. We expect SDA rate hike of 25bp to kick off a sequence of rate tightening actions. We sense policymakers would find excess liquidity risk as sufficiently compelling to shift its tightening bias. SDA rate might be prioritized in their initial tightening move while leaving the overnight rate unchanged for now.

Hiking SDA should have a larger impact in hiking BSP's policy intervention rate (PIR) currently at 2.26% (weighted average of SDA rate and overnight policy rate as of Feb) for a negative real rate compared to inflation expectations of 3.4%. Our policy intervention rate is the effective rate that mirrors an optimal benchmark for short-term rates after we take into account money parked in SDA & RRP accounts. A 100bp overnight rate hike could nudge PIR to 2.44% while an SDA rake hike of the same size could elevate PIR to 3.08%. This reflects strong SDA influence as preferred liquidity facility, as opportunity cost to other banking and investment products and as bank lending benchmark to premium clients.

Seeking safe refuge from rate hike prospects

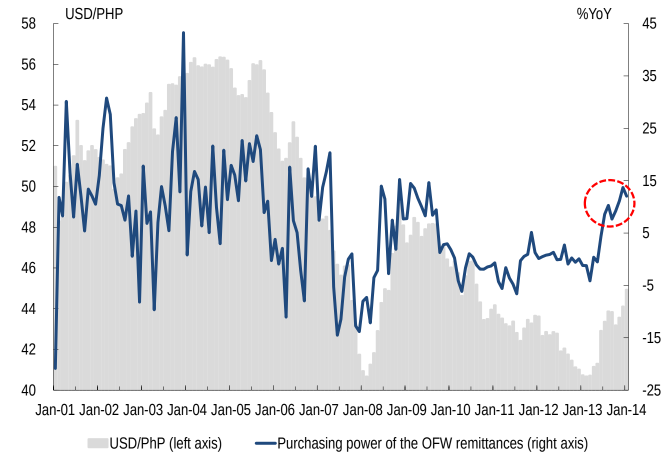
Assuming rate sequencing is in play implies an interest corridor in place. Within the short-duration bond space which could offer safe refuge to rate hikes, we like the 4yr-5yr segment preferably series 5-72 that's at 3.25% or 100bp higher than the PIR. The low interest rate setting mirrored by prevailing PIR supports a narrowing 2-yr rate differential (PH bond vs UST) conducive to PHP adrift vs USD.

Figure 76. Tech exports up 22.4%YoY in Jan



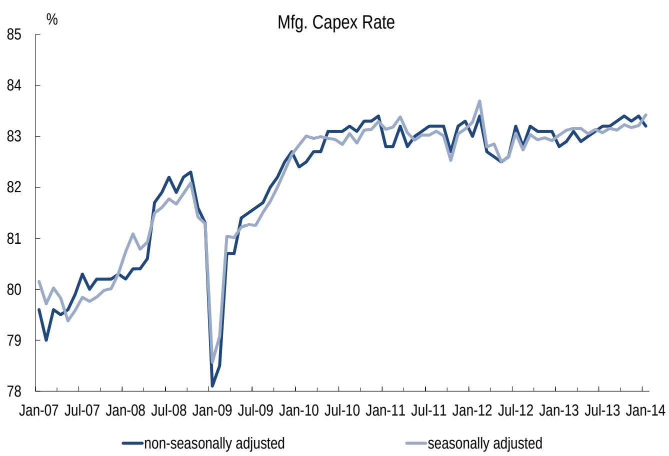
Source: CEIC, Citi Research

Figure 77. Purchasing power of the remittances still elevated in Jan



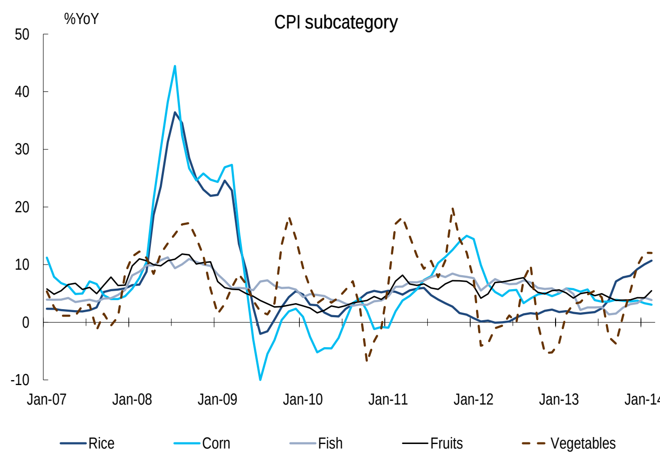
Source: CEIC, Citi Research

Figure 78. Capacity utilization rate remains firm >83% in Jan



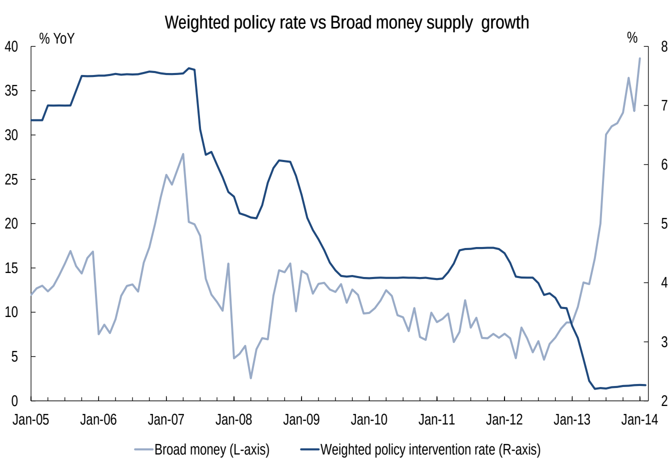
Source: CEIC, Citi Research

Figure 79. CPI rice and vegetables persistent in the 2-digit zone



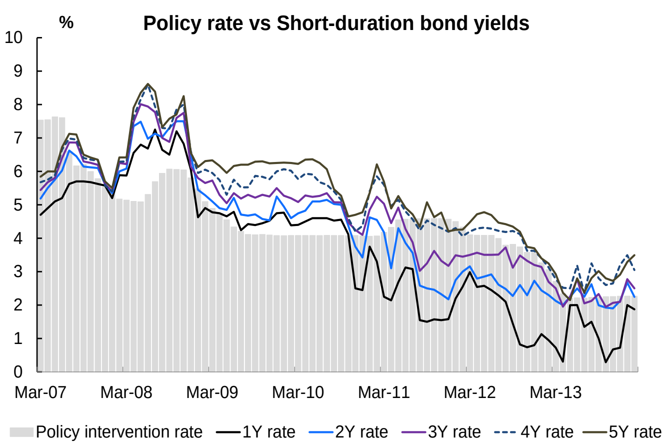
Source: CEIC, Citi Research

Figure 80. Effective policy intervention rate at 2.26% in Feb



Source: CEIC, Citi Research

Figure 81. Against rate hike prospects, we prefer the 4yr bond segment



Source: CEIC, Citi Research

Figure 82. Philippines Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	150.2	173.4	168.6	200.0	224.1	250.5	271.9	281.3	348.5
Nominal GDP, local currency bn	6,893	7,721	8,026	9,003	9,706	10,565	11,546	12,874	14,232
GDP per capita, US$	1,693	1,917	1,829	2,127	2,339	2,567	2,735	2,779	3,380
Population, mn	88.7	90.5	92.2	94.0	95.8	97.6	99.4	101.2	103.1
Unemployment, % of labour force	7.3	7.4	7.5	7.3	7.0	7.0	7.1	6.8	6.5
Economic Activity									
Real GDP, % yoy	6.6	4.2	1.1	7.6	3.6	6.8	7.2	6.9	7.3
Real investment growth % yoy	-0.5	23.4	-8.7	31.6	2.0	-3.2	18.2	10.6	15.0
Real consumption growth % yoy	4.9	3.3	3.3	3.4	5.2	7.3	6.0	6.3	6.2
private consumption growth % yoy	4.6	3.7	2.3	3.4	5.7	6.6	5.6	6.0	6.2
Real export growth, % yoy	6.7	-2.7	-7.8	21.0	-2.8	8.9	0.8	5.3	3.9
Real import growth, % yoy	1.7	1.6	-8.1	22.5	-1.0	5.3	4.3	5.6	4.9
Prices, Money & Credit									
CPI, % yoy	3.9	8.0	4.3	3.6	4.2	3.0	4.1	4.5	3.9
CPI, % avg	2.8	9.3	3.2	4.1	4.7	3.2	2.9	4.3	4.0
Nominal wages, % yoy	3.4	5.5	0.0	5.8	5.4	7.0	2.2	5.0	5.0
Credit extension to private sector, % yoy	10.6	12.8	4.3	13.8	16.2	14.1	10.0	13.5	15.0
Policy interest rate, % eop	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.00	4.50
Short-term market rate, % eop	6.03	5.20	4.11	0.75	1.68	-1.38	-0.15	2.50	3.25
Long term yield, % eop	5.70	6.55	6.25	4.78	4.21	3.70	2.91	4.00	4.50
lc/US$, eop	41.23	47.47	46.50	43.65	43.84	41.06	44.39	45.64	43.48
lc/US$, avg	46.05	44.48	47.56	45.06	43.29	42.22	42.46	45.38	44.30
Balance of Payments, US$ bn									
Current account	7.1	3.6	9.4	8.9	7.0	7.1	9.5	9.8	10.0
% of GDP	4.7	2.1	5.5	4.5	3.1	2.8	3.5	3.5	2.9
Trade balance	-10.4	-14.4	-9.7	-12.3	-17.0	-15.2	-13.2	-14.4	-15.1
Exports	34.1	35.2	29.8	37.6	38.3	46.3	48.4	51.7	55.5
Imports	44.4	49.5	39.4	49.9	55.2	61.5	61.6	66.0	70.5
Service balance	4.2	2.6	2.9	4.1	5.3	3.9	3.1	3.3	3.4
Income balance	13.3	15.4	16.1	17.2	18.7	18.4	19.6	20.8	21.7
FDI, net	0.6	-1.3	-1.6	-0.7	-1.3	-1.0	2.0	3.0	3.0
International reserves (ex-gold)	33.8	37.6	44.2	62.4	75.3	83.8	83.2	93.5	98.0
Total Amortisations	4.7	7.0	5.7	8.3	6.3	2.7	9.3	9.7	10.0
Public Finances, % of GDP									
Consolidated government balance	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-1.4	-1.8	-1.6
Consolidated gov primary balance	3.7	2.6	-0.2	-0.2	0.8	0.7	1.4	1.1	1.1
Public debt	53.9	54.7	54.8	52.4	51.0	51.5	49.2	46.0	45.0
of which Domestic	31.9	31.3	30.8	30.2	29.6	32.8	32.3	30.0	29.5
Foreign Assets & Liabilities, US$ bn									
External debt	55.5	54.3	54.9	60.0	60.4	60.3	60.0	61.0	63.5
Private	17.5	13.7	11.6	13.9	14.1	15.2	18.0	18.0	18.5
Public	38.0	40.6	43.2	46.2	46.4	45.2	42.0	43.0	45.0
External debt / GDP	36.9	31.3	32.5	30.0	27.0	24.1	22.1	21.7	18.2
External debt / XGS	120.9	117.0	131.8	113.3	107.7	93.0	88.4	84.6	82.6
Short-term debt	7.1	7.0	4.0	6.3	7.0	8.5	10.0	11.1	12.0
Short-term debt/International Reserves (%)	21.0	18.6	9.0	10.1	9.3	10.1	12.0	11.9	12.2

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	6.9	6.5	6.8	7.1	6.8	6.9	6.5	6.7	7.5
CPI, % yoy	2.7	4.1	4.1	4.3	4.3	4.5	4.3	4.0	3.8
Policy interest rate, % eop	3.50	3.50	3.50	3.50	3.75	4.00	4.25	4.50	4.50
Short-term market rate, % eop	-0.39	-0.15	1.20	2.00	2.25	2.50	2.75	3.00	3.25
Long term yield, % eop	3.02	2.91	3.50	3.75	4.00	4.00	4.25	4.50	4.75
lc vs USD, eop	43.48	44.39	45.20	45.20	45.46	45.64	45.11	44.57	44.02

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** – The economy started 2014 on a weak note, possibly flat at best on a sequential basis in 1Q14, but this GDP profile remains within MAS expectations and, along with an expected rise in core inflation within tolerance ranges, leaves no strong reason to change monetary policy stance in Apr.
- **Things to watch** – [1] Near-term export and production momentum; [2] house prices, which could trigger property policy easing; [3] household debt; [4] labour market and core inflation trends; [5] signs of financial stress in the SME sector.
- **Strategy** – The recent fall in SGD NEER may reflect the recent fall in headline inflation – this could reverse as headline inflation rises above 3% in 2Q14. While SOR and SIBOR have crept up, we would be alert for further pressures on tightening banking liquidity and eventual Fed hikes.

2014 outlook still positive despite bouts of volatility

The early 1Q14 data is rife with noise from Chinese New Year seasonal distortions. After plunging sequentially in Jan, NODX saw a large seasonally-adjusted swing upwards (Feb: +7.2%MoM SA, Jan: -5%) – a pattern which will likely be mirrored in the IP data which already plunged in Jan. The official seasonal adjustment process appears to be assuming the Chinese New Year fell entirely in Feb this year, but as the start of the Chinese New Year fell at the end of Jan, this may have exaggerated the swings in the Jan-Feb seasonally-adjusted data, making it hard to draw strong conclusions from the Jan-Feb data this time.

The growth volatility likely remains within MAS expectations. While monthly growth data since Oct have broadly surprised on the downside relative to market expectations, quarterly GDP data has consistently beat official forecasts, which was revised upwards twice in 2013. As a result, end-2013 GDP levels were at the upper end of implicit official forecasts (assuming constant QoQ SAAR growth for each remaining quarter of the year). Despite the likelihood that sequential growth may have been flat at best in 1Q14 or possibly negative (4Q13: 6.1%QoQ SAAR), this is broadly consistent with MAS's expectation of "some degree of fluctuation in momentum around a mild uptrend". We estimate the 2-4% official forecast for 2014 (Citi: 3.5%) implies constant QoQ SAAR growth rates of about 1-5% (2013: 3.7%).

External demand on a patchy upward trajectory. With average Jan-Feb seasonally-adjusted headline NODX levels above average 4Q13 levels, data does suggest that NODX remains on a patchy upward trajectory, especially in volume terms. That said, other data remain mixed, with domestic PMI data generally lackluster in Jan-Feb, pointing to soft manufacturing performance. Trade-related services has held up better than manufacturing, evident in the Jan-Feb sequential increases in NORX (Feb: 4.3%MoM SA, Jan: 0.9%), which may be linked to better trade data from regional peers. Divergence between manufacturing and trade related services suggest some degree of underperformance in Singapore's manufacturing sector vs regional peers. That said, there are signs that exports could pick up in the coming months – the pickup in non-oil retained imports of intermediate goods (NORI) since Nov suggests some re-stocking of parts in anticipation of future pickup in demand. We note that average Jan-Feb NORI levels are still 30.9% above 4Q levels despite plunging in Feb (Feb: -10.2%MoM SA, Jan: +18.4%MoM SA).

Inflation trends should not trigger MAS policy change

The disinflation in Feb headline and core was likely sharper than MAS's expectations in Oct, but not large enough to trigger a policy change. Indeed, MAS noted that the fall in Feb headline inflation had been anticipated in Jan, and as if to discourage overly aggressive disinflationary expectations, the MAS/MTI statement noted headline inflation will rise over the next few months, on base effects associated with the fluctuations in COE premiums. With the labour market tight in line with record high job vacancies to unemployed ratio and higher net employment outlook in the Manpower Inc. survey (2Q14: +18%, 1Q: +16%), MAS's guidance is for core inflation to rise "over the next few quarters". Compared to the Oct assessment that inflation would peak at 2.5% in 2Q14 or 3Q14, the more recent assessment has no reference to when or even whether core inflation will ease. At the risk of over-interpretation, we would see this as a subtle signal towards a hawkish bias, discouraging any expectations of policy easing in Apr.

Anchoring inflation expectations remains key challenge ahead of elections. Despite some moderation, inflation expectations remain at >3%, above tolerance thresholds. Public outcry sparked by surveys showing Singapore to be the most expensive city in the world sharpens the anti-inflation focus – even if such surveys measure price *levels* and costs of expatriates rather than locals. Maintaining a hawkish stance despite headline inflation undershoots would be the approach to managing down expectations, but the strong SGD is ironically a key contributor to REER strength, which is what such surveys effectively measure. Overall, we reiterate our view of no change to the slope, width, or centre of the band in Apr.

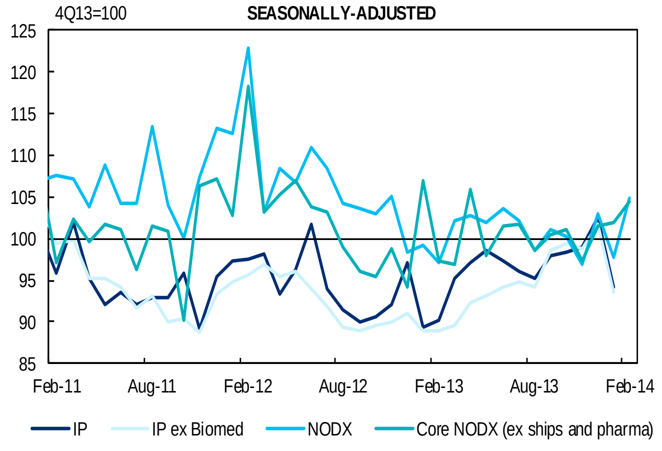
Medium-term domestic disinflationary forces building

We see a number of medium-term domestic disinflationary forces building. [1] The peak in private housing rentals in 3Q13 should pull down accommodation costs from 2H14. [2] Private road transport prices should fall in 2H14 onwards as the scrapping of cars purchased in 2004-2006 allows for more replacement COEs. [3] Pressure on industrial and commercial rentals could ease in line with growing supply. [4] The strong SGD and household de-leveraging may curb demand-pull pressures. [5] With productivity bottoming, the growth in unit labour costs could moderate.

As a result, we think core and headline inflation may fall below 2% in 2015. We expect a larger fall in headline inflation as private road transport and especially housing costs exert a larger drag as new supply comes in 2015. When and at what level core inflation will peak depends on the strength of the cyclical expansion and extent to which productivity gains – especially in non-tradables – can offset rising labour costs and ease the pressure on profit margins.

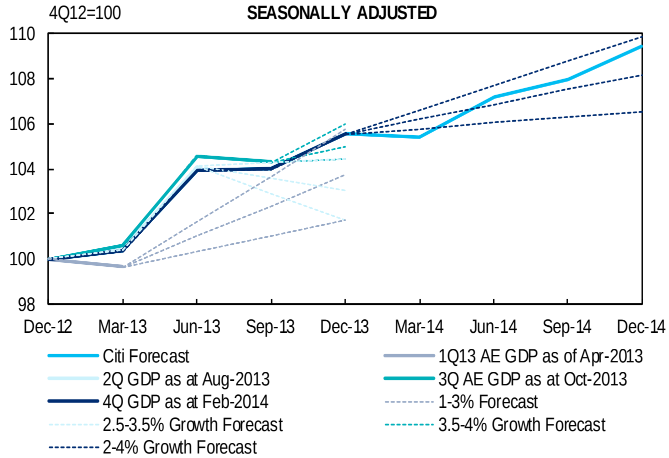
Whether MAS reduces the slope will depend on whether pressures for structural REER appreciation begin to ease, which could happen when the productivity gap between tradables and non-tradables closes. This gap could close either because of a decline in tradables productivity (during a cyclical export led recession for example) or an increase in non-tradables productivity, but MAS's expectation of a cyclical export-led recovery rules out the former at least in 2014. In the absence of a recession, whether Budget measures succeeds in raising construction and non-tradables services productivity may be key to watch as a signpost for MAS policy action.

Figure 83. Large NODX seasonally-adjusted swings in Jan-Feb



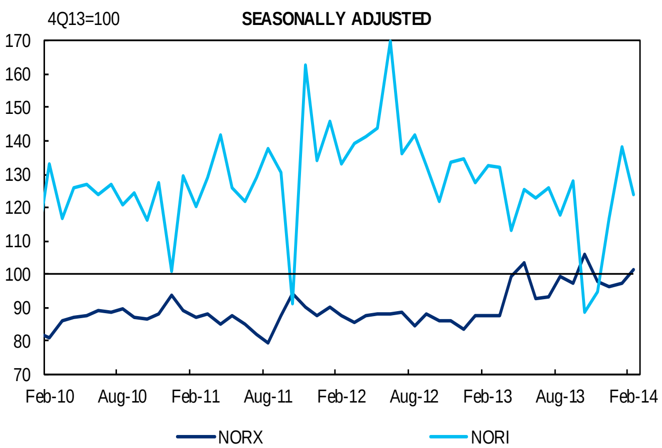
Source: CEIC, Citi Research

Figure 84. Growth volatility likely remains within MAS expectations



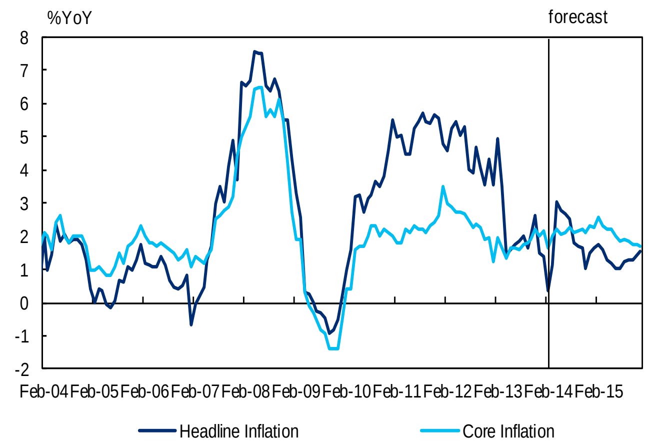
Source: CEIC, Citi Research

Figure 85. NORI and NORX have picked up



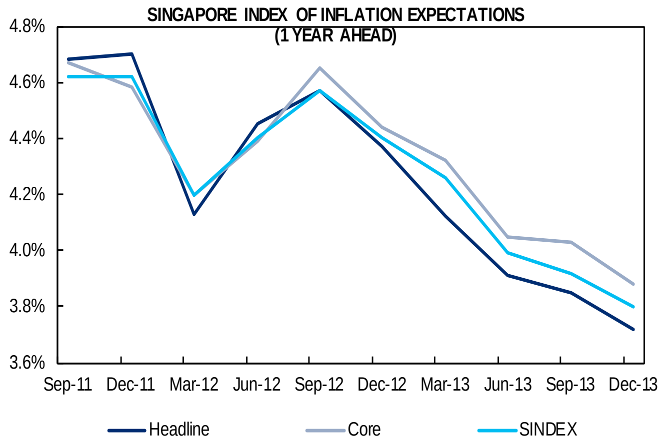
Source: IE Singapore, CEIC, Citi Research

Figure 86. Disinflation in Feb headline and core sharper than expected



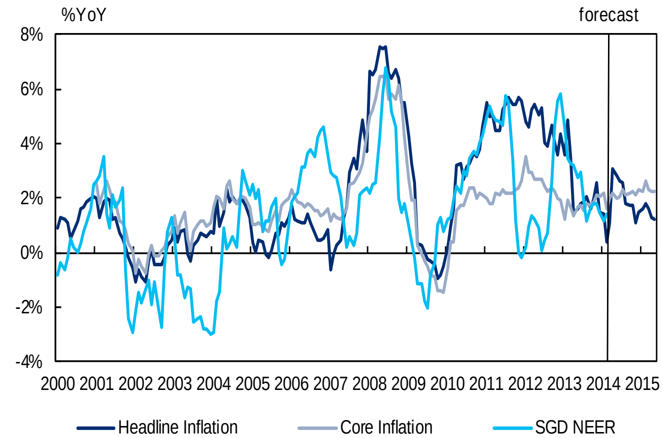
Source: CEIC, Citi Research

Figure 87. Despite some moderation, inflation expectations remain >3%



Source: SMU-Mastercard, Citi Research

Figure 88. Recent fall in SGD NEER may reflect fall in headline inflation



Source: CEIC, Haver, Citi Research

Figure 89. Singapore Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	178.6	190.6	190.7	233.8	272.5	284.6	295.8	306.9	326.8
Nominal GDP, local currency mn	269	269	277	318	343	355	370	396	418
GDP per capita, US$	38,913	39,379	38,243	46,058	52,572	53,564	54,791	55,804	58,355
Population, mn	4.6	4.8	5.0	5.1	5.2	5.3	5.4	5.5	5.6
Unemployment, % of labour force	2.1	2.3	3.0	2.2	2.0	1.9	1.9	1.8	1.8
Economic Activity									
Real GDP, % yoy	9.0	1.9	-0.6	15.1	6.0	1.9	4.1	3.5	4.3
Real investment growth % yoy	16.7	30.0	-19.1	12.5	14.3	18.8	-2.6	-3.7	0.6
Real consumption growth % yoy	6.0	3.6	0.3	7.4	3.5	2.8	4.4	3.9	3.4
private consumption growth % yoy	6.8	2.8	-0.7	6.4	4.4	4.1	2.7	2.0	2.9
Real export growth, % yoy	9.0	4.3	-7.1	18.3	3.0	1.4	3.6	3.5	3.2
Real import growth, % yoy	8.0	9.7	-11.1	16.1	2.8	4.0	3.0	2.7	2.8
Prices, Money & Credit									
CPI, % yoy	3.7	5.5	-0.5	4.6	5.5	4.3	1.5	1.5	1.6
CPI, % avg	2.1	6.6	0.6	2.8	5.2	4.6	2.4	1.8	1.4
Nominal wages, % yoy	6.2	5.4	-2.7	5.6	6.0	2.3	4.3	5.0	5.0
Credit extension to private sector, % yoy	16.9	14.8	2.9	13.4	20.8	13.6	12.0	10.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	2.38	1.00	0.69	0.44	0.38	0.38	0.40	0.40	0.80
Long term yield, % eop	2.68	2.05	2.66	2.71	1.63	1.30	2.56	3.00	3.20
lc/US$, eop	1.44	1.43	1.41	1.28	1.30	1.22	1.26	1.30	1.27
lc/US$, avg	1.51	1.41	1.45	1.36	1.26	1.25	1.25	1.29	1.28
Balance of Payments, US$ bn									
Current account	45.6	26.4	32.7	59.0	63.3	49.4	54.4	55.2	58.8
% of GDP	25.5	13.9	17.1	25.2	23.2	17.4	18.4	18.0	18.0
Trade balance	57.8	41.3	48.5	65.4	70.8	62.9	67.9	65.0	65.0
Exports	312.5	353.0	287.4	370.5	432.1	434.6	437.0	455.0	462.0
Imports	254.7	311.7	238.9	305.1	361.3	371.7	369.1	390.0	397.0
Service balance	-3.5	-2.5	-2.9	0.1	2.1	0.6	0.3	1.0	2.0
Income balance	-8.7	-12.4	-12.9	-6.5	-9.6	-14.1	-13.8	-10.8	-8.2
FDI, net	10.8	5.4	-2.4	21.7	26.9	47.6	36.9	32.0	32.0
International reserves	163.0	174.2	187.8	225.8	237.7	259.3	273.1	280.0	290.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	2.8	0.1	-0.3	0.3	1.2	1.7	1.1	-0.3	0.2
Consolidated gov primary balance	2.7	1.1	-0.8	0.2	1.3	2.0	1.3	0.7	0.5
Public debt	87.1	94.9	105.4	101.0	103.4	108.4	105.5	110.0	110.0
of which Domestic	87.1	94.9	105.4	101.0	103.4	108.4	105.5	110.0	110.0
Foreign Assets & Liabilities, US$ bn									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	5.8	5.5	5.0	2.2	3.7	3.0	4.4	3.5	4.7
CPI, % yoy	1.6	1.5	1.1	2.6	1.7	1.5	1.6	1.0	1.3
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.42	0.40	0.40	0.40	0.40	0.40	0.45	0.50	0.60
Long term yield, % eop	2.35	2.56	2.50	2.75	2.90	3.00	3.00	3.10	3.20
lc vs USD, eop	1.26	1.26	1.27	1.28	1.29	1.30	1.29	1.28	1.28

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** – The recovery pace of the economy remains intact though recent IP and trade fell below market expectations. We attribute these to data distortions due to the timing of the Lunar New Year holiday and the effects of a temporary retreat of the US economy due to the windstorm.
- **Things to watch** – We believe housing market recovery alongside a series of government boosting measures is critical to continued recovery of consumption. Inflation seems to have hit the bottom and will likely trend up gradually in 2Q14 on increases of public service tariffs and processed food as well as base effect.
- **Strategy** – We expect the KRW will remain weak this year amid uncertainties over the timing of Fed's rate hike and China growth. The likelihood of BoK's policy rate cut has been reduced significantly as the new governor said at the hearing that the current level of the rate is too accommodative to support economic recovery.

Domestic settings still positive while external risks grow

Weak export rebound in Feb but ICT and auto exports showed strong gains. Feb exports recorded a mere rebound of 1.5%YoY while a bigger swing was expected from the Jan dip caused by the Lunar New Year holidays falling earlier this year in Jan. Given fall in exports to US and Latin America, we attribute the lukewarm export growth partly to disappointing US macro readings and EM growth risks. Exports in Jan-Feb grew marginally by 0.7%YoY, slower than 4.7%YoY in 4Q13. While fewer working days this year mainly led Jan IP to fall by 3.8%YoY, we expect large export gains of ITC products and autos in Feb to have buoyed Feb IP growth. Upswing in ITC exports also increased import demand for ITC products and semiconductors, lifting total import growth in Feb to 3.9%YoY. Therefore, trade surplus in Feb fell to US$934mn, but slightly larger than US$778mn in Jan.

Inflation and job growth stabilized. CPI inflation in Feb slid down further by 0.1%p to 1.0%YoY from the previous month. While inflationary pressures from processed food rose, high base of agricultural products price last year and stabilizing oil price kept the CPI inflation low. Meanwhile, the seasonally adjusted jobless rate in Fed jumped to 3.9%, from 3.2% in Jan. With change in the timing of civil service examinations, the applicants as well as graduate job seekers led unemployed persons to increase rapidly. However, job growth remained strong (+835K YoY, + 113K MoM sa), especially with government effort to encourage female employment paying off and services sector in lead. Although job growth has improved since last year, nominal wage growth has slowed since 3Q13, suggesting increased supply of jobs, especially females and the youth, might limit wage growth.

We expect KRW to show near-term strength followed by modest weakness. USD/KRW has moved sideways within 1,060~1,080 range, though it rose to 1,080.3 on Mar 21st on favorable US macro data and Fed tapering. Despite continued trade surplus and foreign net purchase of local bonds (US$1.7bn during 1-21 Mar), foreigners' withdrawal from local stock markets have been pressuring the KRW. Amid weakened sentiments on EM, especially Ukraine and China, foreigners withdrew US$1.7bn from local stock markets during 1-21 Mar, including 10 consecutive business days of net-sell, and the Kospi market has leveled down from its previous peak near 1,980 at end-Feb. Considering uncertainties over EM risks as well as Fed tapering likely to end in Sep, and following noises on Fed's rate hike, we expect the KRW will remain within the range of 1,060~1,080 throughout this year.

Govt takes successive steps toward economic innovation

Government unveiled a 3-year economic plan for economic innovation. It was announced on President Park's first anniversary of her inauguration (Feb 25th), aiming to achieve an era of "People's Happiness". Taking account of inefficiency in the public sector, unfair practices in the private sector, weakening growth momentum, and imbalances between sectors, three strategies and nine tasks were drawn in the plan, which is expected to help the economy attain 4% growth potential and 70% employment, and to aim for per capita income of US$40K.

- **Fair and efficient economy** – 1) Public sector will be reformed, by disclosing all information on public institutions, eradicating unfair practices in contracts with private firms, and streamlining similar/overlapping projects. 2) Reforms will also be carried out in the private sector, by deterring unfair subcontracting practices and enhancing the protection of consumer/personal information. 3) Social safety net will be strengthened by making more workers eligible for unemployment benefits and by improving unemployment benefits and taxation support towards encouraging the unemployed to find jobs and the poor to escape from poverty.

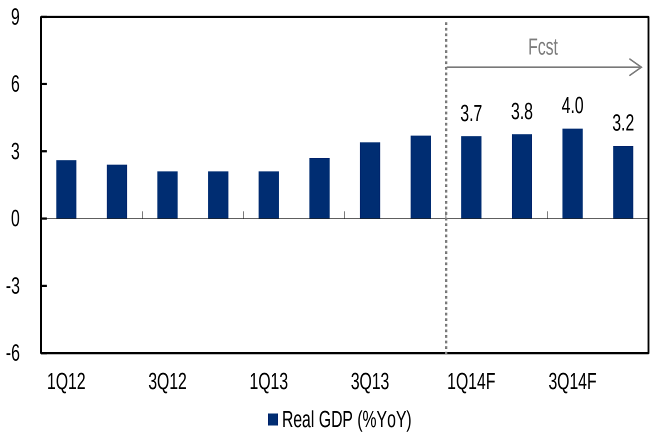
- **Growth through innovation**: 1) The government will promote a creative economy, by supporting business ventures & start-ups with programs/centers, Tech Bank, and financial aids. It also plans to invigorate M&A market and blend ICT into other industries. 2) Investment for the future – e.g. R&D, fellowship program – will be increased. Preparation for Emissions Trading will begin and eco-friendly energy industry will be fostered. 3) Efforts to develop overseas markets will be undertaken, by expanding FTA markets and financially supporting overseas construction business, plant exports, and content exports.

- **Balance between exports and domestic consumption**: 1) To boost investment, the government will introduce a cap on the total number of regulations and will foster services sector and regional economies. 2) To stimulate domestic consumption, the government aims to lower the ratio of household debt to disposable income by 5%p, improve household loan structure, increase supply of rental homes and reduce the burden of tenants. 3) Female and youth employment will be increased, by encouraging ability-based employment and by providing more flexible options of childcare and work-time.

Policy rate change unlikely in near-term

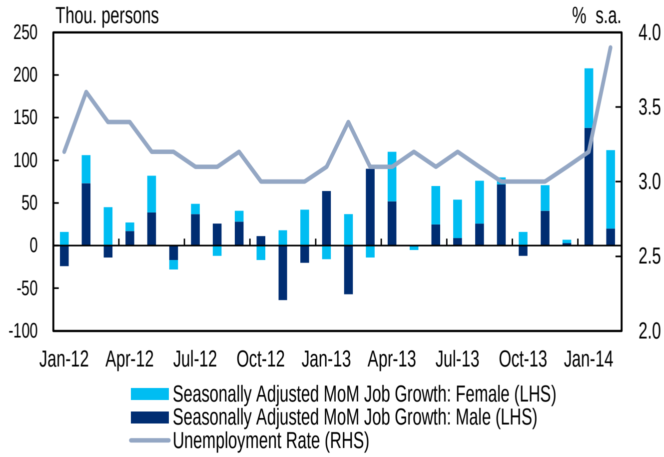
The BoK governor nominee passes the National Assembly hearing. At the confirmation hearing on Mar 19th, the BoK governor nominee, Lee Ju-yeol was questioned mainly on independence and the primary policy goal of the BoK, household debt issue, and the possibility of introducing a forward guidance. Inferred from his comments, he thinks the current level of the policy rate, 2.5%, is low enough to bolster economic recovery and deflation is unlikely in this economy. He also expects the BoK will seek a balanced combination of economic growth and inflation, and that high level of household leverage would not prevent the BoK from raising the policy rate when required. He added that household debt issues should be tackled with economic growth and job creation. His views on the economy and the policy rate lead us to reiterate our call of no policy rate change till the end of this year. We expect the first rate hike to come early next year when readings on data should confirm a fully settled down economic recovery, and some demand-side inflationary pressures may be witnessed.

Figure 90. We expect real GDP growth of 3.7% in 2014



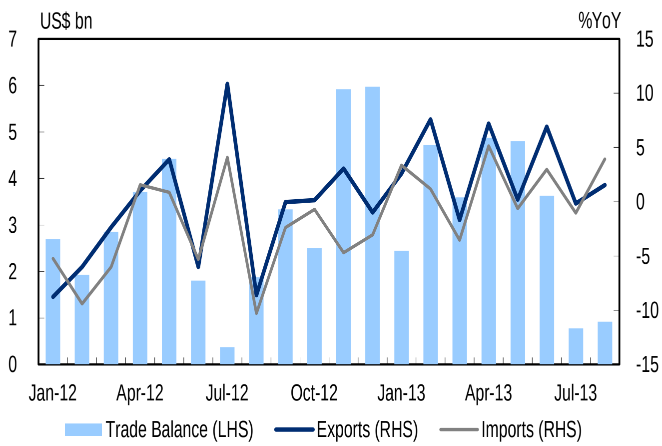
Source: Bank of Korea, Citi Research

Figure 91. Female workers mostly comprised total job growth in Feb



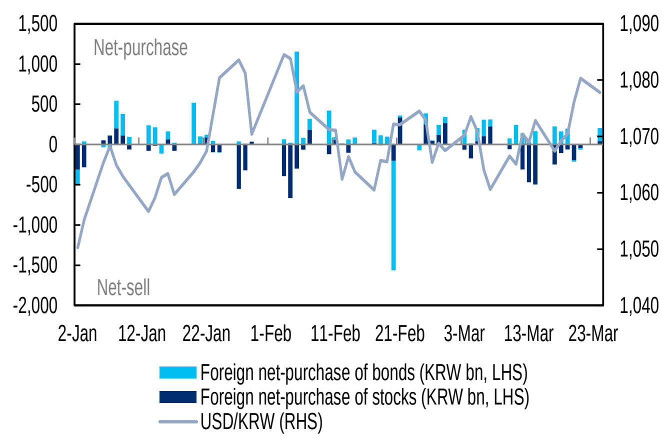
Source: Statistics Korea, Citi Research

Figure 92. Rebound in Feb trade was weaker than market expectations



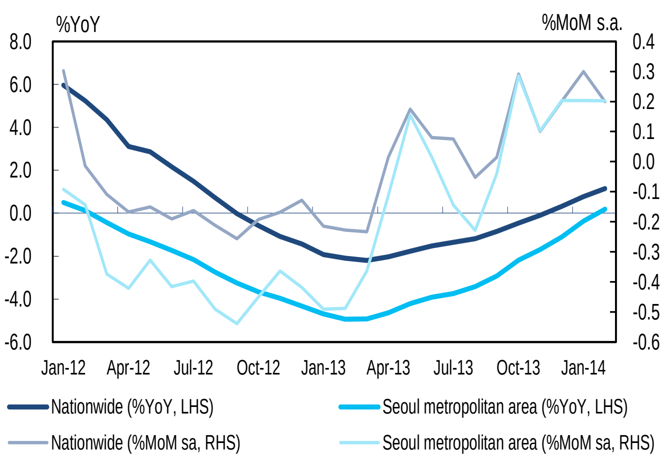
Source: Korea International Trade Association, Citi Research

Figure 93. USD/KRW and foreigners' portfolio net-purchase



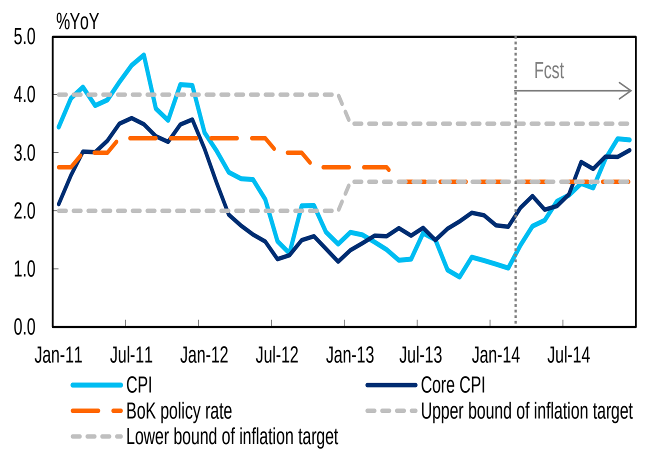
Source: Yonhap Infomax, Bank of Korea, Citi Research

Figure 94. Housing prices continue to rise on govt's boosting measures



Source: Korea Appraisal Board, Citi Research

Figure 95. Low inflation to allow the policy rate to be held this year



Source: Bank of Korea, Statistics Korea, Citi Research

Figure 96. Korea Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	1,121.3	999.7	902.6	1,094.6	1,202.8	1,222.5	1,304.3	1,410.5	1,517.1
Nominal GDP, local currency bn	1,043,258	1,104,492	1,151,708	1,265,308	1,332,681	1,377,457	1,428,295	1,513,477	1,614,157
GDP per capita, US$	23,073	20,424	18,352	22,153	24,163	24,448	25,972	27,973	29,971
Population, mn	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4	50.6
Unemployment, % of labour force	3.2	3.2	3.6	3.7	3.4	3.2	3.1	3.3	3.1
Economic Activity									
Real GDP, % yoy	5.5	2.8	0.7	6.5	3.7	2.3	3.0	3.7	3.9
Real investment growth % yoy	4.5	-1.0	-10.1	17.8	3.5	-2.3	0.0	6.1	5.4
Real consumption growth % yoy	5.3	2.2	1.3	4.3	2.7	2.2	2.2	2.6	3.2
private consumption growth % yoy	5.1	1.4	0.2	4.4	2.9	1.9	2.0	2.9	3.3
Real export growth, % yoy	12.7	7.5	-0.3	12.7	15.1	5.1	4.3	5.9	7.3
Real import growth, % yoy	11.6	3.2	-6.8	17.3	14.3	2.4	1.6	6.6	7.5
Prices, Money & Credit									
CPI, % yoy	3.6	4.1	2.7	3.1	4.2	1.4	1.1	3.2	2.9
CPI, % avg	2.5	4.7	2.8	3.0	4.0	2.2	1.3	2.1	3.0
Nominal wages, % yoy	5.6	-4.1	2.6	6.8	1.0	5.3	3.9	4.8	5.1
Credit extension to private sector, % yoy	12.5	14.9	2.6	4.0	5.0	1.9	5.3	7.0	8.9
Policy interest rate, % eop	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.50	3.50
Short-term market , % eop	5.73	4.68	2.82	2.80	3.55	2.89	2.66	2.75	3.60
Long term yield, % eop	5.78	3.77	4.92	4.08	3.46	2.97	3.23	3.65	4.25
lc/US$, eop	936	1,263	1,166	1,121	1,159	1,064	1,051	1,079	1,055
lc/US$, avg	929	1,102	1,275	1,156	1,108	1,127	1,095	1,073	1,064
Balance of Payments, US$ bn									
Current account	21.8	3.2	32.8	29.4	26.1	48.1	70.7	52.4	46.6
% of GDP	1.9	0.3	3.6	2.7	2.2	3.9	5.4	3.7	3.1
Trade balance	14.6	-13.3	40.4	41.2	30.8	28.3	44.0	35.8	35.6
Exports	371.5	422.0	363.5	466.4	555.2	547.9	559.6	591.4	642.1
Imports	356.8	435.3	323.1	425.2	524.4	519.6	515.6	555.6	606.5
Service balance	-12.0	-5.7	-6.6	-8.6	-5.8	5.7	9.8	11.0	11.8
Income balance	-3.4	3.7	1.6	-2.1	0.3	2.5	4.0	0.3	-1.0
FDI, net	-17.9	-16.9	-14.9	-22.2	-16.4	-18.9	-13.1	-8.6	-4.3
International reserves	262.2	201.1	270.0	291.5	304.2	323.2	341.7	350.7	364.5
Total Amortisations	24.5	31.0	30.2	35.7	42.7	43.5	44.3	45.1	46.0
Public Finances, % of GDP									
Consolidated government balance	3.2	1.1	-1.5	1.3	1.4	1.3	0.8	0.9	1.5
Consolidated gov primary balance	4.5	2.4	-0.2	2.6	2.7	2.5	2.1	2.2	2.7
Public debt	27.7	27.0	30.1	29.5	30.2	30.9	32.7	30.7	29.0
of which Domestic	26.7	26.1	29.1	28.7	29.4	30.1	31.9	30.0	28.3
Foreign Assets & Liabilities, US$ bn									
External debt	333.4	317.4	345.7	359.8	398.7	409.4	416.6	420.5	428.5
Private	279.8	264.9	277.9	280.0	314.7	311.2	312.3	314.6	319.8
Public	53.6	52.5	67.8	79.7	84.0	98.2	104.3	105.9	108.7
External debt / GDP	29.7	31.7	38.3	32.9	33.1	33.5	31.9	29.8	28.2
External debt / XGS	75.0	61.9	79.1	65.0	61.3	62.1	61.8	58.8	55.1
Short-term debt	160.3	149.9	149.2	139.8	137.4	127.2	112.8	104.0	108.0
Short-term debt/International Reserves (%)	61.1	74.5	55.3	47.9	45.2	39.4	33.0	29.7	29.6

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	3.4	3.7	3.7	3.8	4.0	3.2	4.0	4.0	3.7
CPI, % yoy	1.0	1.1	1.4	2.2	2.4	3.2	3.0	3.1	3.0
Policy interest rate, % eop	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.25
Short-term market , % eop	2.66	2.66	2.66	2.67	2.68	2.75	2.90	3.10	3.35
Long term yield, % eop	3.05	3.23	3.38	3.49	3.55	3.65	3.75	3.95	4.15
lc vs USD, eop	1,075	1,051	1,074	1,066	1,073	1,079	1,073	1,067	1,061

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** – Trade remains in a soft patch in 1Q14E, but should begin to gather momentum as global trade warms up. ECFA for service pact is likely delayed till year end, after Legislative Yuan was held up by the on-going student protest in the legislative yuan and political resistance.
- **Things to watch** – 1) Cross-strait momentum: Banks M&A, RMB swap line, ECFA for services and goods; 2) Pension reform; 3) 2014's local elections; 4) Liberalization efforts in FEZ; 5) Efforts to kickstart TPP and RECP talks mid-year; 6) The protesting student demand for rules to monitor agreements related to China.
- **Strategy** – Policy rate likely stable till 2015; 10Y government bond yields likely on a gradual uptrend despite recent jump in global yields. TWD likely to depreciate along with the CNH in the near term, but could appreciate mildly over time on macro recovery. Citi's TAIEX 2014 year-end target raised to 9,300.

Max accommodation: TWD depreciation & low policy rates

Trade and manufacturing recovery remains lukewarm after accounting for seasonality. The three related indicators (exports: 1.3%yoy; export orders: 1.5%yoy and IP: 2.1%yoy in Jan-Feb) confirm recovery is on the way in Jan-Feb (which average out the impact of CNY base effects). We believe there could be further improvements in March (especially post cold winter effects in the States and as hinted in the diffusion indicies. We think the diverging growth momentum in China and the AEs will likely determine Taiwan's 2Q export performance. The upcoming launches in tech products and recoveries in consumer buying power in the AEs will likely help lift tech exports further in 2Q and also by June, the high base statistical effect for optical and precision instruments will also have ended (as China's subsidy on energy saving goods, e.g. TVs, ended in May 2013). Meanwhile, our house view is that China's GDP could slow to 7%yoy growth in the 2Q14 (due to delayed effects of previous credit tightening); which in turn will affect Taiwan's non-tech exports (~30% of total exports), as China is a major buyer.

Currency depreciation help cushion the mild export growth. The TWD has been accelerated by the CNH/CNY depreciation and FOMC hawkish surprise and have touched a 29-month low of 30.638/USD. We think RMB weakness will remain in the short term which will keep the TWD soft too. The softer TWD in the near term (30.5/USD in 0-3M) should boost exports (both goods and services) competitiveness and cushion Taiwanese investors' losses from RMB positions. However, we expect the TWD could recover to around 30/USD in the medium term as macro economy gains a more solid footing and the RMB stabilizes from near term fluctuations.

Domestic demand also softened post CNY, bigger pickup expected in 2H14E. Jan-Feb retail sales recovery continued moderately at 3.5%yoy. However, consumer confidence reached a 27-month high of 82.9 led by investment prospects of the stock market and other steady recoveries in durable goods consumption, and employment opportunities. We expect wage growth would improve from the current three-month average of 1.3%yoy growth in 2H14 as the macro economy recovers.

CBC kept policy rates on hold for the 11th consecutive quarter as expected. The re-discount rate remains low at 1.875%, as further cutting of rates is unlikely to induce further lowering of the overnight rate which is already at 0.387%; while lukewarm growth momentum and benign inflation likely prevent any hike in interest rates. The very benign inflation (Jan-Feb: 0.4%yoy) is indicative of lackluster recovery, although recent currency depreciation should increase import prices and could lead to a mild increase in CPI and WPI (mainly due to commodity imports).

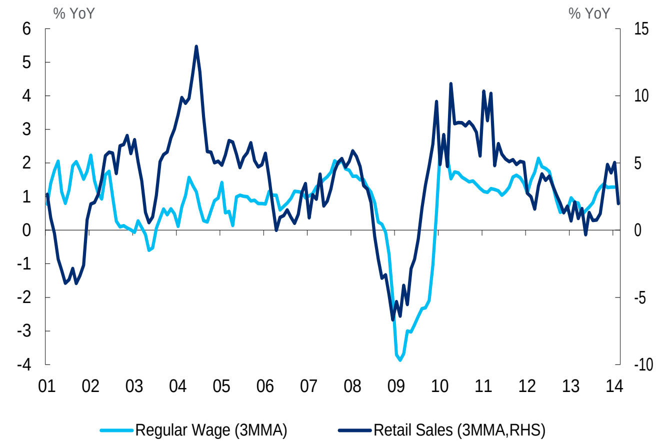
ECFA service pact likely delayed by protests and politics

Anti-ECFA service pact protests intensifying. The signed Economic Cooperation Framework Agreement (ECFA) for service pact with China has been pending review since its signing in Jun13. The Legislative Yuan was supposed to review the pact in the current LY session; however, the legislature was brought to a standstill as opposition party DPP insisted on a clause-by-clause review, while the ruling party KMT blocked the process. The ruling party has been criticized for pushing forward the agreement for submission to a plenary session final vote without a detailed review. To protest, a student group, known as Occupy Taiwan Legislature have occupied the Legislative chamber since 18th Mar; and other protestors forced into the Executive Yuan (EY) complex on the 23rd. Those in the EY were evicted by police using water cannons later in the night and multiple arrests were made. The students have accused the ruling party of not being transparent in the process. The students have also demanded rules to monitor negotiations of agreements related to China, and to retract the ECFA deal. The opposition party appears to back this student movement.

ECFA service pact approval may only come after Nov's local elections. No matter how the student protests come to an end, given that the ruling party has agreed to re-seek approval on each individual clause, the deliberation process will likely be prolonged and may be difficult to complete before the summer recess of LY in June. The next LY session runs from Sep-Dec. Also, it does not seem feasible that Taiwan can adopt or decline certain clauses within the already-negotiated pact. The process is especially complicated when both parties will likely stick to their stance in the run-up to local elections, which is scheduled at the end of Nov. The ruling party will have to convince the public that economic benefits from liberalization and broader China market access will outweigh economic and social costs. In particular, public fear regarding the service pact include: 1) hurting small and medium-sized businesses, 2) causing a large scale influx of foreign labor or immigration, 3) inducing M&As in various sectors with particular concern of Mainland Chinese gaining larger business control, and 4) perceived as making the nation more vulnerable to reunification pressures from Beijing.

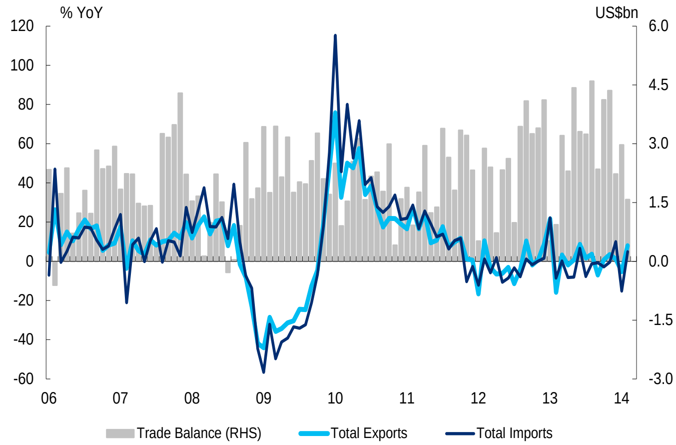
We continue to see the economic benefits and the need to clear ECFA for services. We believe the rectifying of the ECFA for services is a necessary prerequisite for the signing of ECFA for goods. We also envision that the selective liberalization and deregulation in the Free Economic Pilot Zone will help step up Taiwan's industry standards to meet international standards that fit the various free trade pacts in consideration. The narrowing of the labor cost advantage of producing in China, and steady high-quality labor availability/respect for intellectual property rights/free flow of funds on/off-shores in Taiwan will make Taiwan an attractive destination for foreign firms to set up plants, bringing in investments and jobs to Taiwan. Technological know-how and industry upgrade could potentially be achieved should foreign firms be willing to choose Taiwan as an FDI destination. The 'made of origin' requirement in most free-trade pacts should also be another attractive reason why foreign firms may set up manufacturing lines in Taiwan, especially targeting China as the end-consumer market being China using the potential ECFA for goods platform. Moreover, any tax incentives and government support being offered to the potential foreign firms to invest in the Free Economic Pilot Zone would help. The joining of TPP is technically difficult, as Taiwan will have to seek consent from all existing member countries (currently there are 12 country members, but future members that join before Taiwan will also have the right to veto Taiwan's application, and China is one of the potential joiners). In summary, we think ECFA for services is one of the initial steps of the Taiwan government's grand plan to expand Taiwan's export market and address the long cited hollowing out issue of the Taiwanese industry.

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



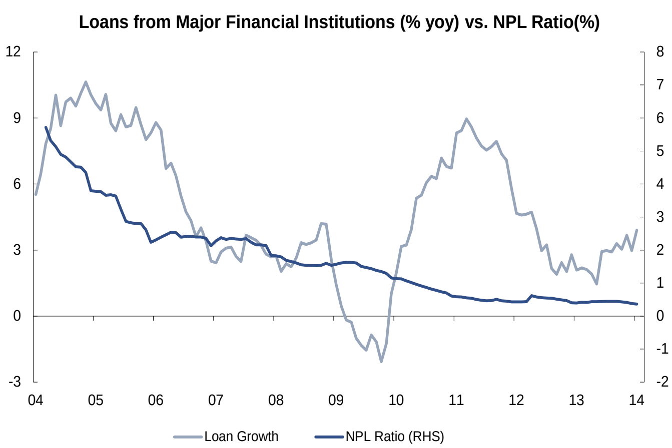
Source: CEIC, Citi Research

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



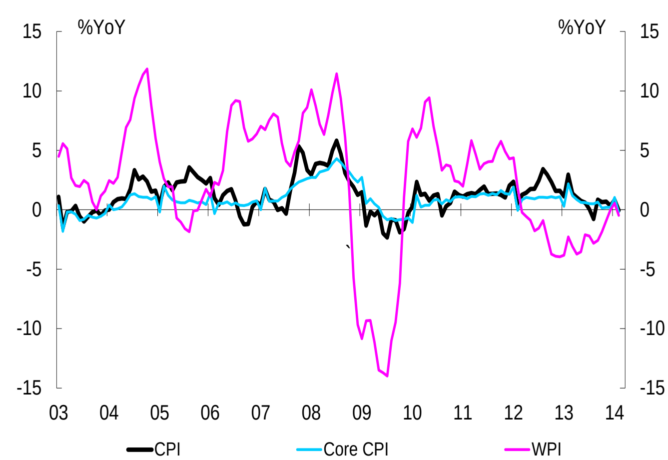
Source: CEIC, Citi Research

Figure 99. Loan growth continues uptrend on cross-border lending



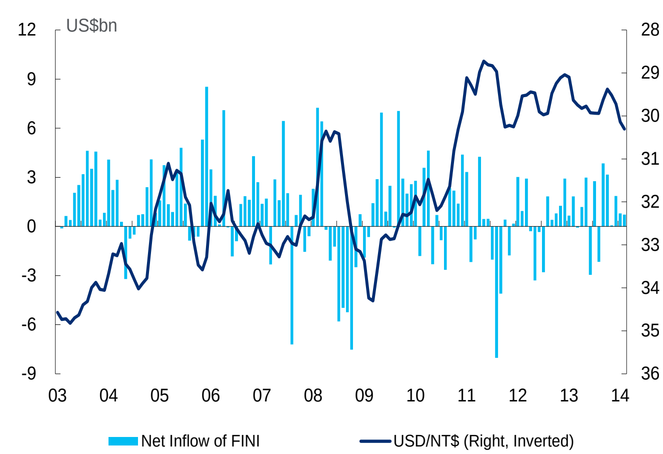
Source: CEIC, Citi Research

Figure 100. Benign inflation gives room for CBC's accommodation



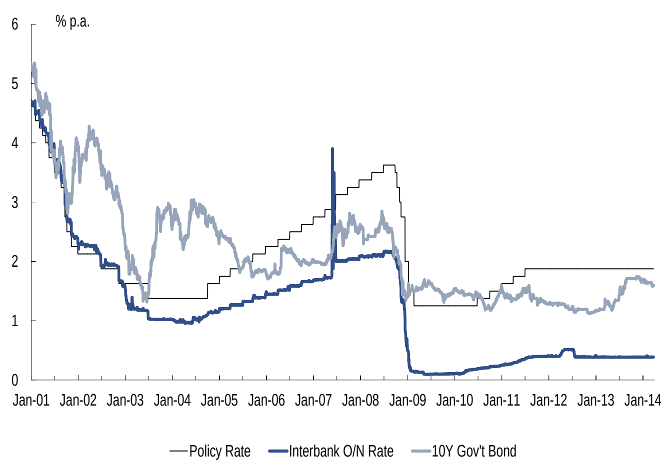
Source: CEIC, Citi Research

Figure 101. FINI inflows continued, but TWD depreciated with RMB



Source: CEIC, Citi Research

Figure 102. 10Y govt bonds could rise again with US tapering



Source: CEIC, Bloomberg, Citi Research

Figure 103. Taiwan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	393.0	400.2	378.0	430.3	466.5	476.3	490.8	513.0	551.1
Nominal GDP, local currency bn	12,911	12,620	12,481	13,552	13,709	14,077	14,564	15,214	16,076
GDP per capita, US$	17,118	17,370	16,348	18,579	20,084	20,429	20,996	21,906	23,482
Population, mn	23.0	23.0	23.1	23.2	23.2	23.3	23.4	23.4	23.5
Unemployment, % of labour force	3.9	4.1	5.8	5.2	4.4	4.2	4.2	4.0	3.9
Economic Activity									
Real GDP, % yoy	6.0	0.7	-1.8	10.8	4.2	1.5	2.1	3.2	3.8
Real investment growth % yoy	-0.7	-7.9	-21.2	36.8	-6.8	-4.6	3.5	5.5	3.5
Real consumption growth % yoy	2.1	-0.6	1.3	3.3	2.9	1.5	1.4	1.5	2.1
private consumption growth % yoy	2.1	-0.9	0.8	4.0	3.1	1.6	1.8	1.6	2.8
Real export growth, % yoy	9.6	0.9	-8.7	25.6	4.5	0.1	3.8	4.6	6.2
Real import growth, % yoy	3.0	-3.7	-13.1	27.7	-0.5	-2.2	4.0	3.9	5.2
Prices, Money & Credit									
CPI, % yoy	3.3	1.3	-0.2	1.2	2.0	1.6	0.3	2.5	2.8
CPI, % avg	1.8	3.5	-0.9	1.0	1.4	1.9	0.8	1.3	1.9
Nominal wages, % yoy	2.1	0.0	-4.9	5.5	2.7	0.3	0.5	1.5	3.0
Credit extension to private sector, % yoy	3.9	2.7	-0.8	6.7	5.6	4.1	5.4	7.0	8.5
Policy interest rate, % eop	3.38	2.00	1.25	1.63	1.88	1.88	1.88	1.88	2.38
Short-term market rate, % eop	2.04	1.02	0.57	0.74	0.87	0.87	0.87	0.93	1.17
Long term yield, % eop	2.53	1.44	1.47	1.47	1.27	1.15	1.69	1.77	2.27
lc/US$, eop	32.43	32.78	32.23	29.17	30.29	29.06	29.83	30.19	29.87
lc/US$, avg	32.85	31.58	33.04	31.50	29.40	29.57	29.68	30.37	29.99
Balance of Payments, US$ bn									
Current account	35.2	27.5	42.9	39.9	41.7	50.7	57.4	56.4	56.2
% of GDP	8.9	6.9	11.4	9.3	8.9	10.6	11.7	11.0	10.2
Trade balance	27.4	15.2	29.3	23.4	26.8	30.7	35.4	41.1	56.0
Exports	246.7	255.6	203.7	274.6	308.3	301.2	305.5	317.7	349.0
Imports	219.3	240.4	174.4	251.2	281.4	270.5	270.1	276.6	293.0
Service balance	-1.6	1.8	2.0	2.5	3.9	6.3	10.6	9.9	3.3
Income balance	10.1	10.0	12.5	13.6	13.2	15.3	14.1	17.0	19.0
FDI, net	-3.3	-4.9	-3.1	-9.1	-14.7	-9.9	-10.3	-10.0	-9.0
International reserves	270.3	291.7	348.2	382.0	385.5	403.2	416.8	440.0	460.0
Total Amortisations	3.8	8.8	2.5	3.2	6.8	3.4	2.9	3.0	3.0
Public Finances, % of GDP									
Consolidated government balance	0.9	0.9	-2.2	-1.2	-0.6	-1.6	-1.5	-1.4	-0.8
Consolidated gov primary balance	1.9	1.9	-1.2	-0.3	0.4	-0.7	-0.6	-0.6	-0.5
Public debt	33.3	34.7	38.0	38.3	40.0	40.9	39.9	39.6	39.3
of which Domestic	33.3	34.7	38.0	38.2	40.0	40.8	39.9	39.6	39.3
Foreign Assets & Liabilities, US$ bn									
External debt	94.5	90.4	82.0	101.6	122.5	130.8	150.0	160.0	150.0
Private	91.1	88.9	76.0	93.5	118.0	127.5	146.3	156.0	146.0
Public	3.5	1.5	5.9	8.0	4.5	3.3	3.7	4.0	4.0
External debt / GDP	24.1	22.6	21.7	23.6	26.3	27.5	30.6	31.2	27.2
External debt / XGS	33.4	30.9	34.7	32.0	34.6	37.4	41.9	42.2	36.0
Short-term debt	83.3	78.8	68.2	83.7	107.8	116.5	125.0	130.0	120.0
Short-term debt/International Reserves (%)	30.8	27.0	19.6	21.9	28.0	28.9	30.0	29.5	26.1

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.3	2.9	2.3	2.7	3.5	4.0	3.8	3.3	3.7
CPI, % yoy	0.8	0.3	1.9	0.8	0.7	2.5	0.7	1.4	2.3
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	2.00	2.13	2.25
Short-term market rate, % eop	0.87	0.87	0.87	0.87	0.87	0.93	0.99	1.05	1.11
Long term yield, % eop	1.69	1.68	1.62	1.64	1.69	1.77	1.87	1.97	2.12
lc vs USD, eop	29.56	29.83	30.59	30.41	30.30	30.19	30.11	30.03	29.95

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 maintain our 2014 GDP growth forecast of 1.8%. Macro backdrop in Jan highlight durable goods spending drag, tourism fall out and decline in private investments. Less daunting political newsflow bode well for tourism and consumer sentiment but spark to growth likely to stay modest.
- **Things to watch** – NACC decision on PM Yingluck's role in the rice pledging scheme in mid-Apr. Potential for a 'new' caretaker government in place and its political agenda prior to having a new set of elections. Trend of plunging FDI approvals. Size of 1Q GDP's QoQ decline. Core CPI's downside shift.
- **Strategy** – Following a cumulative 50bp cut to 2% since the crisis started, MPC will be on hold. Likelihood of further rate easing would depend on 1Q GDP's QoQ decline. Local bond market likely to outperform although a protracted crisis heightens risk of non-residents' unwinding their bond exposure.

Prolonged crisis likely to erode economy's resilience

Risk of political violence has abated with the lifting of the state of emergency decree (ED) in Bangkok and in other areas. Easing risk premia doesn't necessarily translate to recovery. Until we see an effective, functioning government and Parliament, hopefully through elections, less daunting politics is unlikely to translate into strong macro recovery. Looming risk is NACC/Court intervention that may 'remove' PM Yingluck on dereliction of duty in preventing corruption in the rice pledging scheme. Court recently 'voided' the Feb 2 election results on constitutional grounds, which Moody's claimed is 'credit-negative'. Against Court intervention risk, easing risk premia due to ED lifting isn't a sufficient condition for a clear trajectory of macro recovery to follow. Our sober 2014 outlook of 1.8% is unchanged which is materially less than BoT's revised growth forecast of 2.7% from the previous 3%.

Negatives continue to outweigh the positives in Jan. Macro 'casualties' in Jan due to the protracted crisis consist of plunging car sales (-50%YoY/-18.5%MoM SA), lackluster tourism (0.1%YoY), tanking consumer/business sentiment, declining fiscal revenues (-7.5%YoY), and 1-digit bank loan growth (9.2%YoY). Private consumption index improved 0.3%MoM SA in Jan for the 2nd straight month. Drag from car sales extended to Feb with a plunge exceeding 40%YoY. BoT's index of 'fast-moving consumer goods sale' fell 0.8%YoY—its first drop since the 4Q11 flooding event. Tourist arrivals fell to 2.3mn due to lower visitors from Asia. Weaker excise collections consistent with the macro slowdown and decline in personal income taxes due to new lower tax rates underpinned weaker fiscal receipts.

Broadening slack, soft export markets and weak business sentiment comprised the drag to private investments index in Jan. All key private investment indicators posted declines, led by commercial car sales (-36.2%YoY), real imports of capital goods (-7.9%YoY), and cement sales (-1.1%YoY). Construction indicators fell for the first time amid a prolonged crisis. Despite a mfg index gain of 0.1%MoM SA, the slack broadened with the inventory to shipment index up 8.6%MoM SA and capacity utilization rate inching down 61.5% SA. Notwithstanding weak private investments and political drift, FDI inflow was a hefty US$1.9bn in Jan that may start to fund roll out of last year's FDI approvals.

Macro weakness to start the year concentrated largely on private spending supports our view of a 1Q14 GDP decline of 2.3%QoQ SA that equates to lack of YoY gains. The expected resulting negative output gap could be larger than 2% from a positive output gap of 0.6% in 4Q13. Reversal to a negative output gap likely in 1Q14 supports MPC's recent rate easing.

Near-term upside from tourism and consumer sentiment

Tourism and consumer/business sentiment may start to improve with the ED lifting that could hoist near-term prospects. Positive outlook on these two key variables could ease the expected QoQ decline in 1Q14 but may not be enough to mitigate downside investment risk. Tourism recovery that we expect in a month or two that should recover lost Jan-Feb tourism earnings may contribute around Bt4-8bn (assuming 100,000-200,000 visitors) in tourism spending from hotel accommodation to restaurants and other retail services. This comprises 0.03%-0.07% of our 2014 GDP forecast. Consumer sentiment firming up bodes well for stability in durable goods demand (16% of 2013 consumption). In our regression analysis, a 1% increase in consumer sentiment would result in a 1%QoQ SA rise in durable goods consumption. Using this, our calculations lead us to a Bt4.1bn rise in durable goods demand on improving sentiment or roughly 0.16% of our 2014 consumption forecast. Real GDP and share of HH loans to GDP had material effects on durable goods demand but were not statistically significant unlike consumer sentiment. With HH debt at 80% of GDP, consumers may be unwilling to incur more debt to buy big-ticket items amid MPC's recent rate stimulus. Marginal gains from recovering tourism and durable goods demand lift may not provide a strong GDP spark.

Real investments not employment would bear the shock

FDI approvals shrank 61.3%YoY as of Feb with Japanese FDI approvals down 57.8%YoY despite JETRO survey results citing Thailand as a preferred Japanese operations base. Limited authority of the caretaker government to complete the cast of Board of Investments (BoI) contributed to this decline. Larger drag to FDI approvals came from lackluster export markets correlated with shallow mfg gains/losses and softening capacity utilization rates. We observed close correlation between FDI approvals as % GDP and export mfg growth. Declining FDI approvals would delay expansion in metal products and machinery (42.4% share of FDI approvals) and electronics sector (17.5% share).

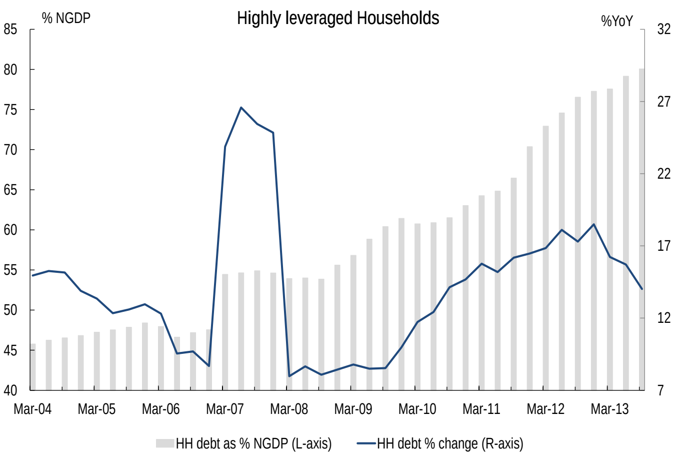
Plunging FDI approvals (weak investment outlook) comprised the main adjustment to the crisis and soft external markets while sparing employment. Coupled with investment delays in response to broadening slack, investment downside risk looks inevitable. Basic consumption may be spared if employment and wages are less vulnerable to downside risk. Considering tight labor markets as we entered the crisis, non-farm employment stood at 26mn in Jan (mfg employment at 6.3mn) vs the 'old' labor survey estimate of 24.7mn a year-ago. Facing cyclical weakness, MNCs probably have the financial capacity and flexibility to keep costs of headcount low amid a limited pool of productive labor.

However, a protracted political crisis would be unprecedented and heightens risk of an economy's resilience eventually being eroded, requiring deeper reforms to restore what may have been lost. This risk showed up in the mild erosion of investments contribution to real GDP at 21.7% as of end-2013 when prior to the crisis, the share was 22% or more. Post-great recession in 2010, we estimate +/-1% of investments' share would result in GDP gains/losses of roughly Bt46bn-Bt50bn.

Likelihood of another cut would depend on 1Q14 GDP

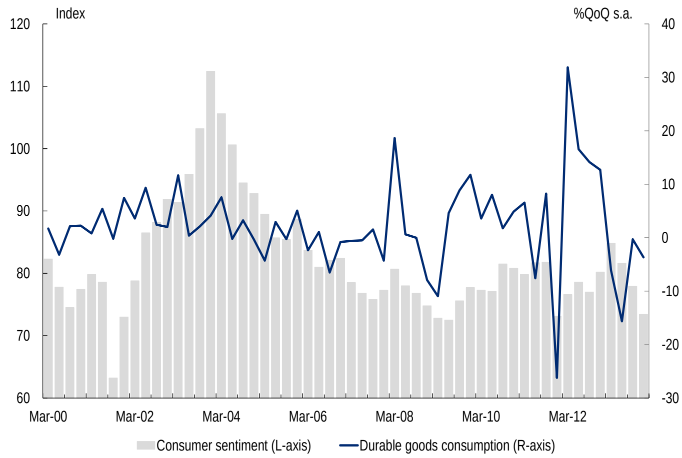
Risk of an overnight rate lower than 2% likely driven by 1Q14 GDP results (May). GDP decline probing 3%QoQ SA or more that mirrors broadening and deepening recession risk may heighten the odds of another 25bp cut—likely to be decided in the MPC's June meeting. We expect MPC to be on hold following a 50bp cut since the crisis started in 4Q13. Local bond market likely to outperform although a protracted crisis heightens risk of non-residents' unwinding their bond exposure.

Figure 104. Highly leveraged HH may curb impact of recent rate cuts



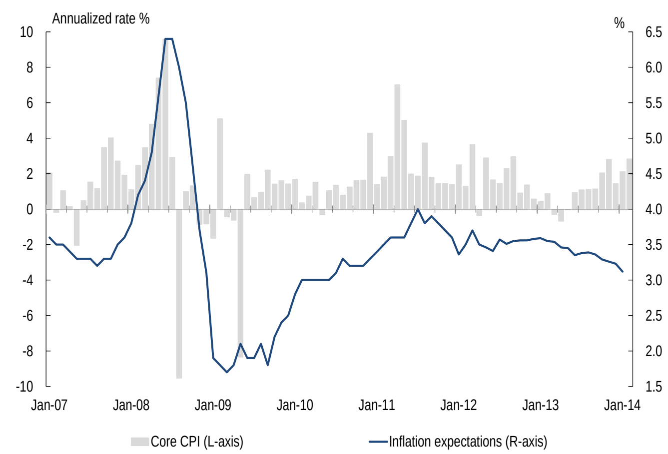
Source: CEIC, Citi Research

Figure 105. Waning consumer sentiment and durable goods demand



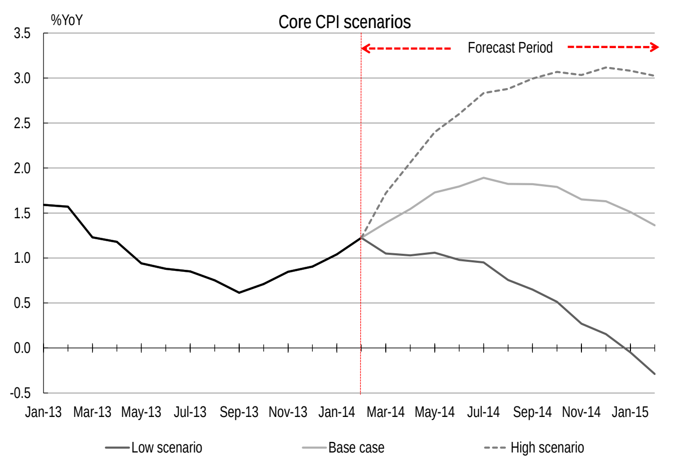
Source: CEIC, Citi Research

Figure 106. Easing inflation expectations vs elevated core CPI



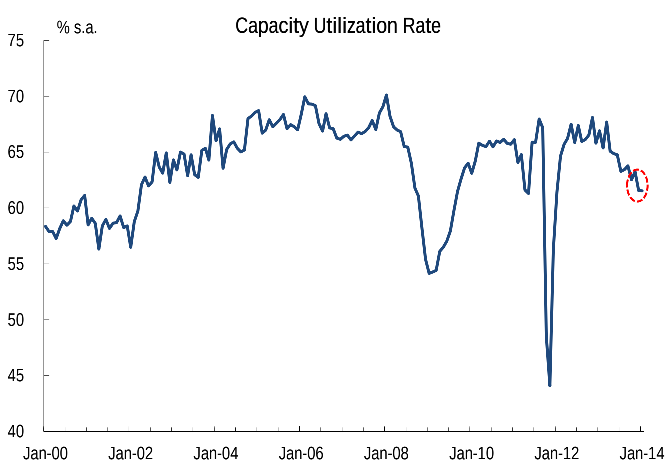
Source: CEIC, Citi Research

Figure 107. Core inflation trajectory likely to soften unexpectedly



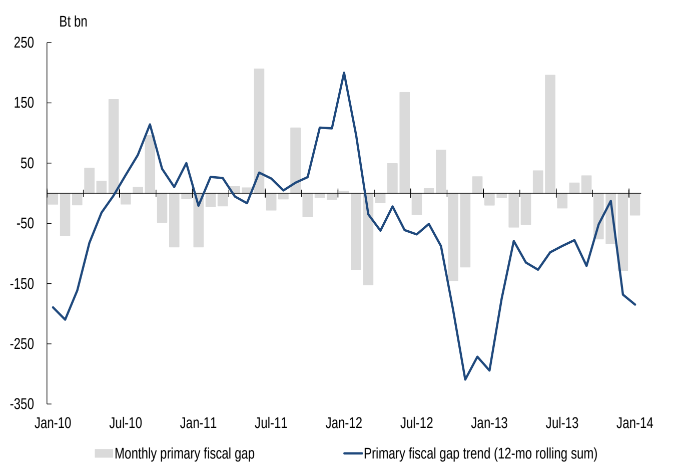
Source: Citi, CEIC Research

Figure 108. Seasonally adjusted utilization rate eased to 61.5% in Jan



Source: CEIC, Citi Research

Figure 109. Swelling primary fiscal deficit due to lackluster revenues



Source: CEIC, Citi Research

Figure 110. Thailand Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	265.2	276.1	263.8	319.3	346.1	366.4	387.8	364.9	387.5
Nominal GDP, local currency bn	8,525	9,080	9,042	10,105	10,540	11,375	11,897	12,450	13,314
GDP per capita, US$	4,207	4,355	4,153	4,998	5,401	5,685	5,987	5,605	5,922
Population, mn	63.0	63.4	63.5	63.9	64.1	64.5	64.8	65.1	65.4
Unemployment, % of labour force	1.4	1.4	1.5	1.0	0.7	0.7	0.9	0.8	0.8
Economic Activity									
Real GDP, % yoy	5.0	2.5	-2.3	7.8	0.1	6.5	2.9	1.8	4.1
Real investment growth % yoy	1.0	8.1	-25.2	28.7	0.1	16.8	2.2	-2.4	2.8
Real consumption growth % yoy	2.9	2.9	0.1	5.1	1.3	6.8	1.0	0.9	3.2
private consumption growth % yoy	1.8	2.9	-1.1	4.8	1.3	6.7	0.2	0.6	3.1
Real export growth, % yoy	7.8	5.1	-12.5	14.7	9.5	3.1	4.2	3.4	5.2
Real import growth, % yoy	4.4	8.9	-21.5	21.5	13.7	6.2	2.3	1.3	3.9
Prices, Money & Credit									
CPI, % yoy	3.1	0.4	3.5	3.1	3.5	3.6	1.7	2.5	3.0
CPI, % avg	2.2	5.5	-0.9	3.3	3.8	3.0	2.2	2.3	2.8
Nominal wages, % yoy	3.0	10.5	-1.9	5.8	7.2	11.9	7.9	4.0	3.5
Credit extension to private sector, % yoy	29.3	6.3	2.5	18.8	18.3	14.0	10.5	11.5	12.5
Policy interest rate, % eop	3.25	2.75	1.25	2.00	3.25	2.75	2.25	2.00	3.00
Short-term market rate, % eop	3.74	3.07	1.28	2.03	3.26	2.79	2.31	2.10	3.10
Long term yield, % eop	5.13	2.84	4.37	3.74	3.28	3.55	4.07	4.00	4.50
lc/US$, eop	30.05	34.79	33.36	30.07	31.57	30.60	32.70	34.47	33.27
lc/US$, avg	32.33	33.03	34.33	31.71	30.48	31.08	30.72	33.62	33.72
Balance of Payments, US$ bn									
Current account	15.7	2.2	21.9	10.0	4.1	-1.5	-2.8	8.3	-4.3
% of GDP	5.9	0.8	8.3	3.1	1.2	-0.4	-0.7	2.3	-1.1
Trade balance	26.6	17.3	32.6	29.8	17.0	6.0	6.4	16.2	2.5
Exports	151.3	175.2	150.8	191.6	219.1	225.9	225.4	233.7	246.5
Imports	124.6	157.9	118.2	161.9	202.1	219.9	219.0	217.4	244.1
Net service and Transfer accounts	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	3.8	-0.6	-0.8
Income balance	-3.0	-2.3	-4.4	-9.0	-2.3	-4.0	-13.0	-7.3	-6.0
FDI, net	8.3	4.4	0.7	4.5	5.0	-2.0	6.2	1.2	1.0
International reserves	87.5	111.0	138.4	172.1	175.1	181.6	167.2	170.0	180.0
Total Amortisations	20.3	15.4	11.3	9.4	8.8	9.5	18.0	19.0	20.0
Public Finances, % of GDP									
Consolidated government balance	-1.6	-1.0	-5.7	0.0	-1.0	-2.1	-1.8	-1.2	-1.8
Consolidated gov primary balance	-0.3	0.2	-4.5	1.1	-1.5	-1.6	-1.2	-0.3	-0.7
Public debt	38.3	37.3	45.2	42.6	41.7	45.4	45.9	47.2	48.1
of which Domestic	33.4	33.0	40.9	39.0	38.4	42.3	42.7	43.0	43.3
Foreign Assets & Liabilities, US$ bn									
External debt	74.4	76.1	75.3	100.6	104.3	130.7	132.3	135.0	140.0
Private	71.6	72.7	69.4	87.9	88.1	104.5	106.7	108.4	112.9
Public	2.8	3.4	5.9	12.7	16.2	26.2	25.6	26.6	27.1
External debt / GDP	28.1	27.6	28.5	31.5	30.1	35.7	34.1	37.0	36.1
External debt / XGS	41.0	36.5	41.6	44.5	40.0	47.5	46.5	45.5	44.6
Short-term debt	33.7	32.5	33.3	50.7	47.3	58.2	60.0	59.8	61.0
Short-term debt/International Reserves (%)	38.6	29.3	24.0	29.4	27.0	32.0	35.9	35.2	33.9

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	2.7	0.6	0.0	1.1	2.5	3.5	3.8	4.0	4.3
CPI, % yoy	1.4	1.7	2.1	2.3	2.4	2.5	2.6	2.7	2.8
Policy interest rate, % eop	2.50	2.25	2.00	2.00	2.00	2.00	2.25	2.50	2.75
Short-term market rate, % eop	2.55	2.55	2.10	2.10	2.10	2.10	2.30	2.60	2.80
Long term yield, % eop	4.21	4.07	3.85	4.00	4.10	4.00	4.00	4.25	4.35
lc vs USD, eop	31.24	32.70	32.58	33.43	34.00	34.47	34.17	33.87	33.57

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

Frontier Asia

Mongolia

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We now expect OT Phase II negotiations would take another quarter till June, as we draw close to the March 31 deadline of Rio-bank consortium project financing. According to Reuters, senior officials expressed the parliament will seek an OT resolution in the new parliamentary session in April-June. We believe the project financing would be extended, especially with supranational like IFC expressed that their loan pledge does not have an expiry date and other banks likely to have a longer investment horizon. With the anticipated delay of resolution, we have lowered the improvements assumed in our FDI and FX reserves forecasts, cutting GDP forecast to 10%yoy in 2014E and sustain depreciation for another quarter, but expect this year's current account forecast to improve to -2.7% of GDP and next year's to worsen to -3.5% as capital imports associated with Phase II are also expected to be delayed by a quarter, and the bulk of imports pushed to 2015.

There were a few positives since the beginning of the year: 1) Data of FX reserves, FDI and exports all improved (see Figures 90-91) in Jan/Feb on account of both mining and non-mining FDIs and copper/coal exports; imports drop also improved the trade deficit. 2) The Government has overcome the political hurdle to use the narrow gauge for the railroad to China (previous debate was to use the Russian standard broad gauge), and thus would meaningfully reduce transport cost of its coal exports. 3) BoM announced that its RMB swap line with PBOC will be doubled in May to RMB20bn, adding extra cushion to their USD FX reserves. 4) The Mining Minister expects that the Parliament will lift the moratorium on new exploration license (the ban has been in place in Jun10) in the Spring Parliament session which will help attract FDI (although insufficient to replace OT Phase II).

Policy tightening may be more effective at alleviating depreciation pressures and pacify foreign investors' worries. We think the 8% subsidized mortgage program (US$792mn as of 14th Mar) has been successful at stimulating the domestic economy amidst external weakness. However, fast liquidity expansion (Feb loan growth at 55.7%yoy and Jan M2 at 36.6%yoy) has intensified depreciation (7.2% YTD or 28% since end-2012) and inflation (Feb CPI of 12.2%yoy is above BOM target of 8% and trend is rising). We think the central bank would have to hike 50bps rate in 2H14 and end the subsidized mortgage loans program (at least cap its size), soon after any external/FDI improvements. The 2014 budget also needs to be updated to be compliant with the 2% FSL deficit requirement.

Sri Lanka

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Surprisingly strong growth in 4Q13 – we nudge our growth forecasts a bit higher led by service sector expansion. The real GDP growth acceleration in 4Q13, while partly fueled by a sharp manufacturing sector rebound, doesn't tally well with import contraction in the same period, sluggish private sector credit growth and likely fiscal restraint in order to achieve the deficit targets. Nonetheless, we think prospect for services sector growth – led by tourism-related and transport/logistic services – look promising, and we nudge our 2014F & 2015F growth higher at 7.2% and 7.4%, respectively (versus earlier forecast of 7%). In the near term, the strength of the 4Q13 manufacturing rebound could soften if US weather related issues hit Sri Lanka garment orders with a lag.

Improvements in external position look sustainable – this is the bright spot. The current account deficit appears to have narrowed more sharply than what we (and the government) earlier projected. Net FDI flows have also improved to help fund half of the CAD and the government and some SOEs seem to have access to relatively cheaper external loan financing.

Despite larger debt repayments (to the IMF), CBSL forecasts FX reserves could still gradually rise by another US$700-800mn – even though international bond issuance doesn't seem to be in the imminent pipeline (not in 1H 2014), and the foreign quota on LKR Treasury securities will likely remain unchanged (assuming no outflows).

Monetary policy on a wait-and-see mode— we postpone our rate cut call in 3Q14, but odds of easing have receded. CBSL is facing opposition from pensioners/retirees reliant on deposit-based savings and have no safety nets. However, given benign inflation, CBSL has not closed doors for easing but will be monitoring M2b growth, as well as likely watching whether early signs of a drought are sustained, which would not only impact food prices but likely prompt electricity rate hikes. For now, we still pencil in a 50bps cut in 3Q14 to 7.5% but this assumes weather conditions normalize. Otherwise, in order to maintain their commitment to containing SOE losses, another round of electricity price adjustment will be pending (fuel prices will not need to be hiked unless oil prices well exceed their assumption of US$110/bbl) which will likely make CBSL cautious. Fiscal consolidation is ongoing with MoF projecting the 2013 budget deficit hit 5.9% of GDP versus 5.8% target, but in the absence of major tax reforms, the process is likely to be gradual, and we think they will miss their ambitious 5.2% of GDP deficit reduction plan this year.

Vietnam

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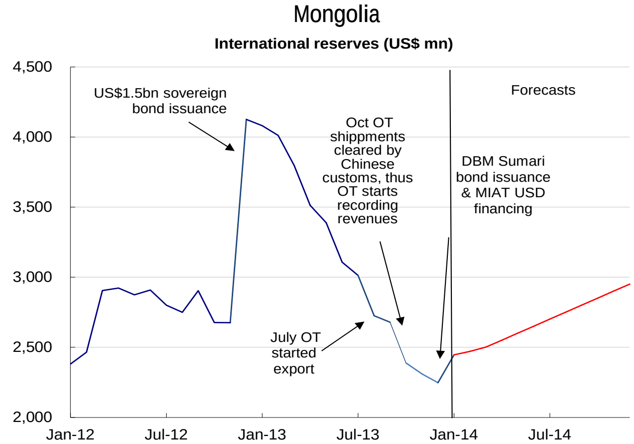
SBV cuts refinancing rates by 50bps (depo rates up to 100bps) and we think this may not be the last. The State Bank of Vietnam cut its key policy rates by 50 bps (refinancing rate to 6.5%, O/N rate to 7.5%, and discount rate to 4.5%). It also cut caps on the bank lending rate, now down to 8% from 9% for some sectors, and various ceilings for both VND and USD deposit rates. In the previous monthly, we hinted that the risk of monetary easing has increased after SBV had been on hold since May given that both inflation had been surprisingly benign during Tet season (+1.24% Feb ytd), but more surprisingly, credit growth seems to have deteriorated (-1.05% ytd as of March) after rebounding late last year. Resolving bank sector NPL remains very slow and will likely remain a drag on the banking system for a while. The VAMC has nearly bought VND 39trilllion (US$1.9bn) since Sep 2013 but has only recovered about VND200bn (US$9.4mn) with legal framework to dispose of bad debt still an issue. Moreover, lack of clarity on the balance sheet of the banks, who reported that NPL ratio declined to only 3.8% by end of 2013, also means the potential pool of NPLs that VAMC will purchase is likely grossly inadequate. SBV recently delayed again by another 6 months the implementation of new standard loan classification system. While bank liquidity is very flush, appetite to lend continues to remain problematic, and we think SBV may cut rates another 50bps.

SOE privatizations off to a slow start – still awaiting implementation. We are still waiting for the final decree on plans to increase foreign ownership on listed companies to 60% (from 49%), which we thought was a more imminent policy change last month – nonetheless, VN equity markets continue to climb to more than 4-year high. Government is targeting to restructure about 432 companies in 2014-15, a draft decree relating to accelerating SOE equitization is planned for April, and there is an aggressive timetable for a number of large-scale SOE IPOs this year – progress would be credit positive, but we are still awaiting implementation.

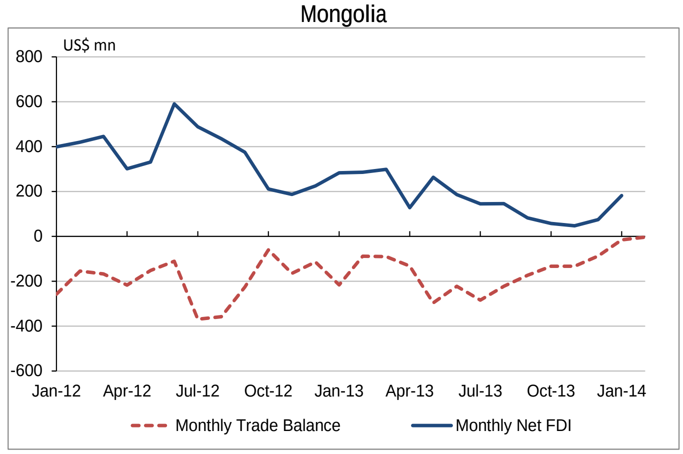
While FDI in manufacturing remain a bright spot, creating jobs and boosting exports, the domestic value added still remains very low and ability of local businesses to provide supporting industries/components to the large MNCs, especially in the high tech sector, still looks limited. Thus, despite the positive net export contribution to growth, we think Vietnam's economy will continue to expand below potential at about 5.7% in 2014F vs. 5.4% in 2013.

Figure 111. Mongolia – Reserves started to improve in 2014…



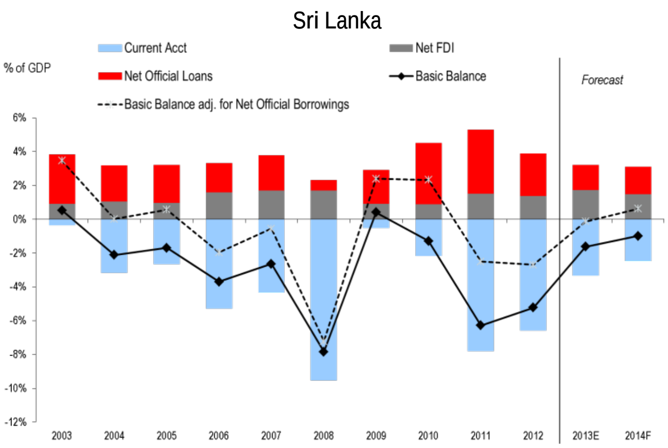
Source: BoM, CEIC and Citi Research

Figure 112. … driven by improvements in trade deficit and FDI inflows



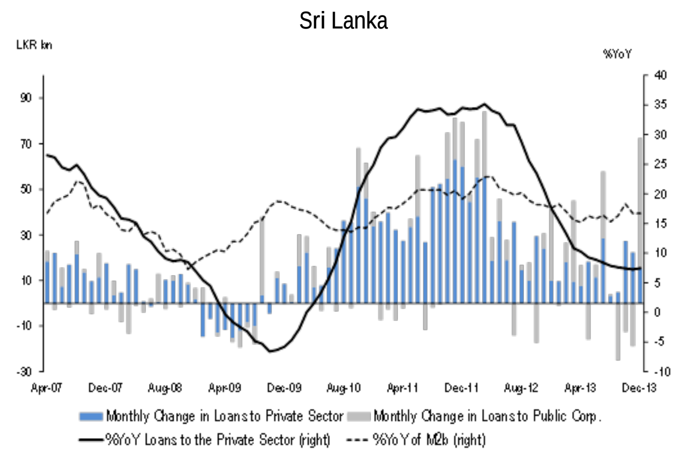
Source: BoM, CEIC and Citi Research

Figure 113. Sri Lanka – Outlook for CA deficit is better than earlier expected – net FDI and official loans seem able to fully cover it



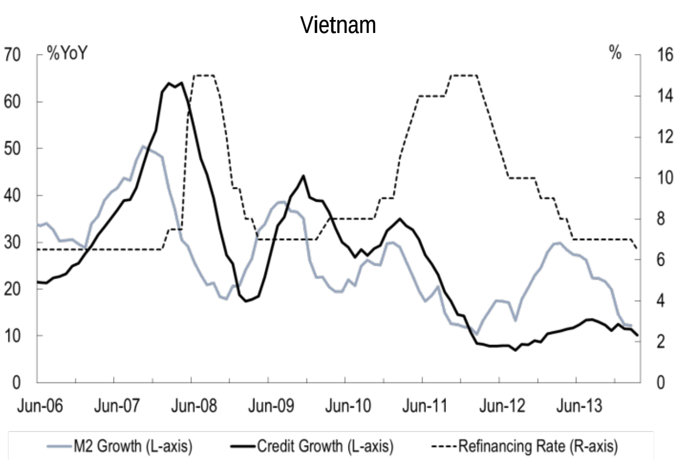
Source: CBSL and Citi Research

Figure 114. Private Sector Credit Growth has been subdued but the spike in lending to public sector in Dec bears some watching



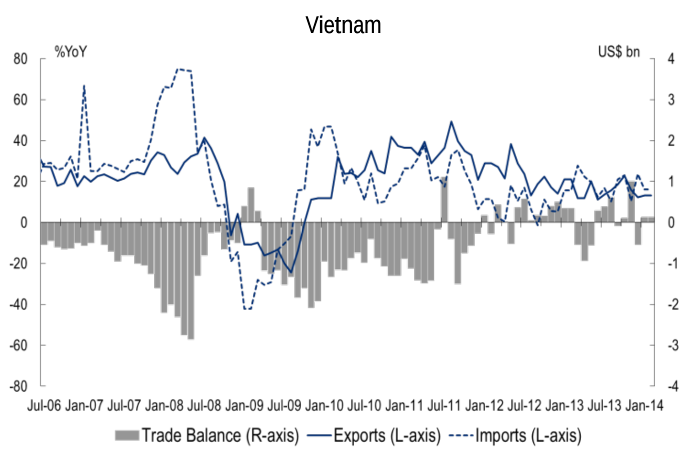
Source: CBSL, CEIC, and Citi Research

Figure 115. Vietnam – Credit growth appears to be losing momentum



Source: CEIC, Citi Research

Figure 116. Despite strong export growth, the domestic value added still looks low, impeding its growth contribution



Source: CEIC, Citi Research

Figure 117. Asia Frontier Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Mongolia									
Nominal GDP, US$ bn	4.2	5.6	4.6	6.2	8.8	10.3	10.3	12.3	15.7
GDP per capita, US$	1,629	2,138	1,717	2,287	3,186	3,595	3,525	4,135	5,184
Population, mn	2.6	2.6	2.7	2.7	2.8	2.9	2.9	3.0	3.0
Real GDP, % yoy	10.2	8.9	-1.3	6.4	17.5	12.4	11.7	10.0	9.0
CPI, % yoy	15.1	22.1	4.2	13.0	10.2	14.0	12.5	14.0	11.5
CPI, % avg	--	28.0	8.0	10.1	9.2	14.3	10.5	13.4	12.0
Policy interest rate, % eop	8.40	9.75	10.00	11.00	12.25	13.25	10.50	11.00	11.50
Long term yield, % eop	21.83	20.58	21.67	20.07	16.61	18.11	17.40	18.60	20.00
lc/US$, eop	1,172	1,275	1,433	1,233	1,378	1,378	1,660	1,716	1,648
lc/US$, avg	1,171	1,167	1,434	1,349	1,256	1,353	1,505	1,760	1,674
Current account (US$ bn)	0.3	-0.7	-0.4	-0.9	-3.4	-2.8	-3.2	-2.7	-3.5
% of GDP	6.3	-12.8	-8.9	-15.0	-38.4	-26.8	-31.0	-22.2	-22.5
Trade balance (US$ bn)	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-2.1	-1.3	-1.9
Exports (US$ bn)	1.9	2.5	1.9	2.9	4.8	4.4	4.3	4.3	5.0
Imports (US$ bn)	2.2	3.2	2.1	3.2	6.6	6.7	6.4	5.6	6.9
FDI, net (US$ bn)	0.4	0.8	0.6	1.6	4.6	3.9	-2.0	2.6	3.3
International reserves (US$ bn)	0.8	0.6	1.3	2.2	2.3	3.9	2.2	3.0	3.6
Consolidated government balance (% of GDP)	2.6	-4.5	-5.2	0.5	-6.9	-8.1	-4.0	-2.8	-2.3
Public debt (% of GDP)	36.0	30.6	44.2	28.7	28.9	42.1	50.0	58.1	64.5
Sri Lanka									
Nominal GDP, US$ bn	32.4	40.7	42.1	49.6	59.2	59.4	67.9	74.4	85.5
GDP per capita, US$	1,617	2,014	2,057	2,400	2,836	2,923	3,314	3,605	4,110
Population, mn	20.0	20.2	20.5	20.7	20.9	20.3	20.5	20.6	20.8
Real GDP, % yoy	6.8	5.9	3.5	8.0	8.2	6.3	7.3	7.2	7.4
CPI, % yoy	18.8	13.9	5.0	6.8	4.9	9.2	4.7	7.4	6.0
CPI, % avg	15.8	22.5	3.6	6.2	6.8	7.5	6.9	5.4	6.5
Policy interest rate, % eop	12.00	12.00	9.75	9.00	8.50	9.50	8.50	7.50	8.00
Long term yield, % eop	19.96	19.20	11.50	9.24	10.00	11.81	9.91	9.50	9.00
lc/US$, eop	108.7	113.0	114.4	110.9	113.9	127.7	130.8	131.0	129.0
lc/US$, avg	110.6	108.3	114.9	113.0	110.5	127.2	129.1	131.0	129.9
Current account (US$ bn)	-1.4	-3.9	-0.2	-1.1	-4.6	-3.9	-2.3	-1.8	-1.7
% of GDP	-4.3	-9.5	-0.5	-2.2	-7.8	-6.6	-3.3	-2.5	-2.0
Trade balance (US$ bn)	-3.7	-6.0	-3.1	-4.8	-9.7	-9.4	-8.4	-8.6	-9.4
Exports (US$ bn)	7.6	8.1	7.1	8.6	10.6	9.8	10.4	11.3	12.3
Imports (US$ bn)	11.3	14.1	10.2	13.5	20.3	19.2	18.8	19.9	21.7
FDI, net (US$ bn)	0.5	0.7	0.4	0.4	0.9	0.8	1.2	1.1	1.2
International reserves (US$ bn)	3.1	1.8	5.1	6.6	6.0	6.9	7.2	8.0	9.4
Consolidated government balance (% of GDP)	-6.9	-7.0	-9.9	-8.0	-6.9	-6.4	-5.9	-5.5	-5.2
Public debt (% of GDP)	85.0	81.4	86.1	81.9	78.4	79.1	78.6	77.0	76.0
Vietnam									
Nominal GDP, US$ bn	77.5	98.3	101.6	112.8	121.7	141.5	156.6	175.0	198.2
GDP per capita, US$	920	1,154	1,181	1,297	1,385	1,594	1,747	1,935	2,171
Population, mn	84.2	85.1	86.0	86.9	87.8	88.8	89.6	90.5	91.3
Real GDP, % yoy	7.1	5.7	5.4	6.4	6.2	5.2	5.4	5.7	5.9
CPI, % yoy	12.6	19.9	6.5	11.8	18.1	6.8	6.0	7.0	7.3
CPI, % avg	8.3	23.1	7.0	9.2	18.6	9.3	6.6	5.8	7.2
Policy interest rate, % eop	6.50	9.50	8.00	9.00	15.00	9.00	7.00	6.00	6.00
Long term yield, % eop	8.73	10.00	11.68	11.49	12.55	9.75	9.29	8.50	8.50
lc/US$, eop	16,028	17,483	18,474	19,498	21,034	20,840	21,095	21,036	21,036
lc/US$, avg	16,081	16,445	17,806	19,123	20,648	20,875	21,028	21,063	21,036
Current account (US$ bn)	-7.1	-10.8	-6.6	-4.3	0.2	9.1	7.7	6.5	4.9
% of GDP	-9.1	-11.0	-6.5	-3.8	0.2	6.4	4.9	3.7	2.5
Trade balance (US$ bn)	-10.4	-12.8	-7.6	-5.1	-0.5	9.5	8.9	8.0	6.2
Exports (US$ bn)	48.6	62.7	57.1	72.2	96.9	114.5	132.8	156.7	180.2
Imports (US$ bn)	59.0	75.5	64.7	77.4	97.4	105.0	123.9	148.7	174.0
FDI, net (US$ bn)	6.5	9.3	6.9	7.1	6.5	7.2	7.3	7.6	7.7
International reserves (US$ bn)	23.5	23.9	16.0	12.1	13.5	25.6	34.8	37.3	42.3
Consolidated government balance (% of GDP)	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-5.3	-4.5	-4.0
Public debt (% of GDP)	35.9	34.5	42.8	44.9	43.3	43.0	44.5	44.6	45.0

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

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CEEMEA

Czech Republic

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- **Summary view** — Despite stronger 4Q GDP data we left our 2014 GDP growth forecast unchanged at 1.9%YoY owing to less benign carry-over effect along with mixed implications from 4Q13 data.
- **Things to watch** — First, CPI data, particularly if the adjusted core CPI meets the CNB forecast. Second, the Finance Minister's tax proposal, though it is line with the Government statement and it does not represent a game-changer.
- **Strategy** — We still expect the CNB to start its exit strategy in 2Q15, but we moved the first hike earlier to 4Q15 reflecting a weaker koruna in our forecast. We expect the total MinFin's primary issuance in cash of CZK130bn in 1H14 that would cover its gross borrowing requirements for 2014 at 55%.

We keep our 2014 forecast unchanged, 2015 slightly up

There are several mixed implications from 4Q13's GDP data. Czech GDP surged by 1.9%QoQ after 0.3%QoQ in 3Q13, which turned the YoY growth to positive 1.3% in 4Q13 after -1%YoY a quarter ago. This eased the average annual contraction in 2013 to –0.9%. Despite stronger 4Q's GDP data, we kept our forecast for 2014's GDP growth unchanged at 1.9%YoY owing to less benign carry-over effect from milder contraction in 2013 accompanied with several mixed implications from 4Q13's data. *First*, forward buying of tobacco contributed 1.4%pts to 1.9%QoQ GDP growth (the contribution was much stronger than in previous years). We expect this to negatively influence the GDP by 0.9%pts in 2014. However, the value added increased by healthy 0.6%QoQ in 4Q13 and we assume this growth to continue also in 2014. *Second*, there was stronger private consumption and fixed investment that likely partly reflected the FX interventions. However, our analysis does not suggests that these were only driven by forward buying as fixed investments seems to were driven by machinery and equipment (and not by vehicles), which we assume to be driven rather by higher utilization of production capacities (lower utilisation of industrial production capacities in January disappointed, but lower assessment of current production capacities could be supportive for investment activity in 1Q14). The private consumption was driven by semi-durable goods in 4Q13, not by durable goods (moreover, the confidence survey suggest still high intensions of consumers to buy new cars). *Third*, despite there was larger forward buying of tobacco and strong industrial activity in 4Q13, it was not accompanied with increase in inventories, which limits the downside risk for 2014. *Fourth*, the GDP growth was weaker than real gross domestic income (we estimate it at 2.7%YoY in 4Q13, almost double compared to GDP growth). *Fifth*, Russia-Ukrainian crisis is a risk that we have not incorporated in our forecast. Czech exports to Russia represent some 2.6% of GDP through their 3.3% share on total goods exports.

March's confidence indicator improved to a three-year high, after being unchanged for the previous three months, pointing to 2%YoY GDP growth. On a quarterly basis, the confidence indicator points to 0.5%QoQ GDP growth, which is a tick below our forecast of an average 0.6% quarterly gain in value added. We found the level of Czech PMI consistent with around 8%YoY growth in industrial production, which represents an upside risk to our forecast of its 5.4%YoY growth in 1Q14 and average 5% in 2014 after 7% in 4Q13 and 0.7% in 2013. This risk is, however, offset by a weaker industrial confidence.

Lower inflation forecast is likely to be policy neutral

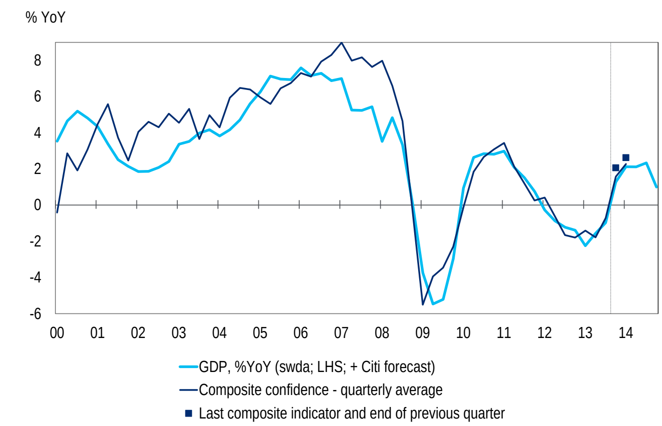
Lower CPI has not been a pain for CNB now. We expect a further easing of CPI growth to 0-0.1%YoY in March (higher food prices offset by lower alcohol and fuel prices) after 0.2%YoY in previous two months that was below CNB's forecast of 0.4%. However, the CNB said the factors behind its forecast error are almost the same as January, when the CNB was satisfied with the exchange rate pass-through (ERPT) to consumer prices (slightly lower adjusted core CPI reflects drop in non-tradable segment). The verification of the ERPT could start in 2Q14 as the carry-over effect suggests adjusted core CPI of -0.1%YoY, while the CNB expects 0.4%YoY. Price expectations have been mixed in February suggesting limited upward pressure in the near term and hence we are likely to see a similar CPI growth in March, followed by acceleration to, but below 2%YoY by end-2014.

We revised downward the consumer price forecast owing to a larger fall in energy and fuel prices in 1Q14, slightly lower outlook on oil prices and likely new lower 3rd VAT rate (we assume 8% rate with impact of -0.1%pts in 2015). We also do not expect as strong wage growth as the CNB does, but this is offset by our higher EURCZK forecast over 6-12months. By contrast, food prices have increased in the previous two months and - though the global index is still below 1H13's CZK values – we included in our forecast a small supply shock. We also incorporated another tobacco tax hike in 2016 (0.2%pts to CPI growth). However, the food and oil prices are lower than consensus and CNB expect due our higher EUR/USD forecast at 1Y and 2Y horizon. Our forecast is below the CNB one, for both 2014 and 2015. However, we do not think it has some strong (disinflationary) policy implications as the difference is mainly pro-inflationary owing to lower regulated and fuel prices. There is upside risk to our forecast if weaker USD does not materialize.

CNB likely in wait-and-see approach until mid-2014

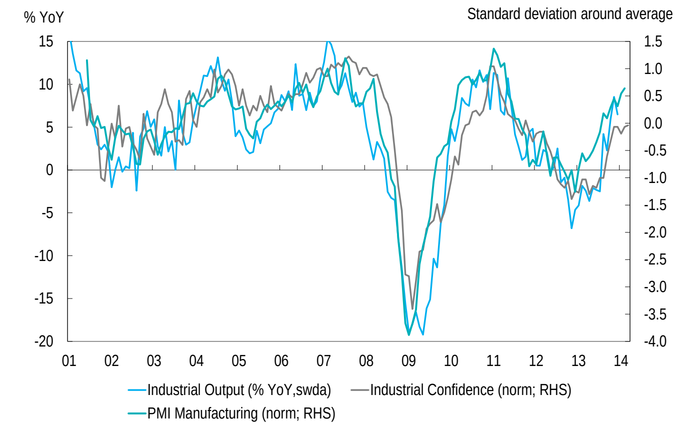
We keep our forecast of EURCZK broadly unchanged, but now an earlier hike in the CNB policy rate (4Q15 vs. 1Q16 initially), though still later than CNB forecasts (1Q15). The CNB is happy with current monetary conditions. While the CNB assumes EURCZK to gradually fall to 27 in 2Q-4Q14, we expect the koruna to get weaker to around 27.7 on 9m owing to our bearish EM FX view after 24.4 on 3M when we expect the koruna to be supported by the ECB's cut. Nevertheless, our EURUSD and commodity forecast and our somewhat more skeptic view of positive impact of weaker koruna into the domestic demand points to lower CPI growth compared to the CNB forecast. Therefore, we expect the CNB exit strategy from the current FX intervention cycle in around 2Q15 (one quarter later than the CNB envisages) which also reflects our forecast of later ECB tightening. Moreover, this also keeps our forecast of a first CNB hike behind CNB's forecast that assumes 1Q15. We not expect the first hike in the policy rate in 4Q15, a quarter earlier than we thought previously that reflects a weaker koruna. We expect a gradual koruna's appreciation once the CNB will announce the exit strategy, but the CNB is likely to remain vigilant to avoid a stronger koruna appreciation with renewed deflationary or recessionary pressures. We understand that the CNB expects the koruna to return to its appreciation, but at a milder pace (1.5%YoY), in line with a milder real convergence process. There is a downside risk to our EURCZK forecast of 2Y horizon, if there is a stronger recovery of Czech economy resulting into a stronger real convergence process. We assume that during the exit strategy the CNB will follow its rule of thumb – no hike in policy rate, if there are interventions against the koruna value.

Figure 118. Confidence suggests 2% GDP growth ...



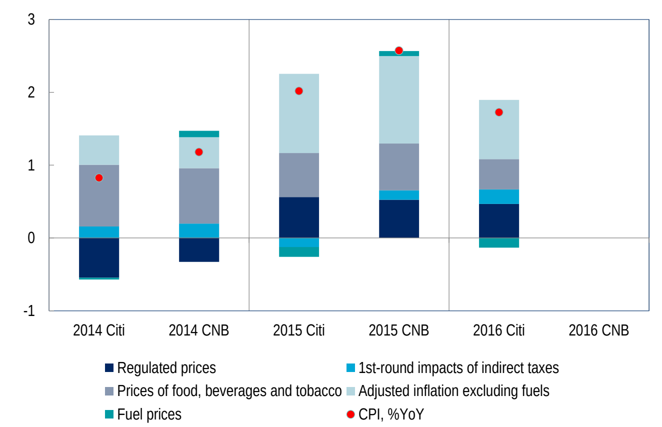
Source: CZSO, Citi Research

Figure 119. ...and points to around 6% growth in industrial production



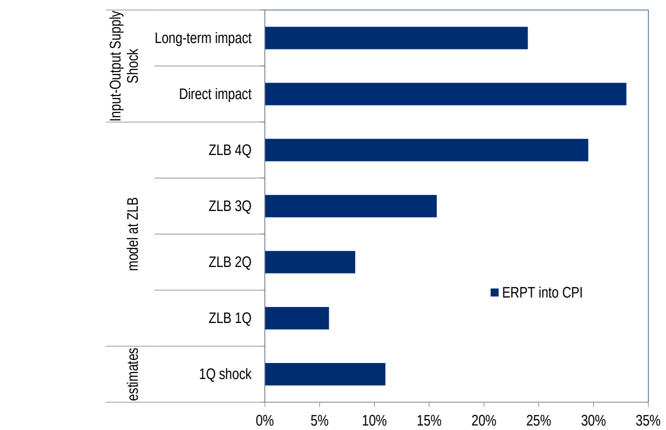
Source: CZSO, Haver Analytics, Citi Research calculation

Figure 120. Our CPI outlook is lower due to regulated, fuel prices, VAT



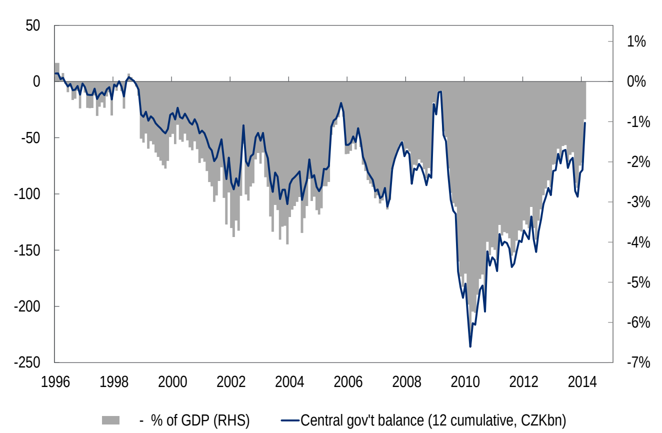
Source: CNB and Citi Research forecast

Figure 121. Various exchange-rate pass-through coefficients



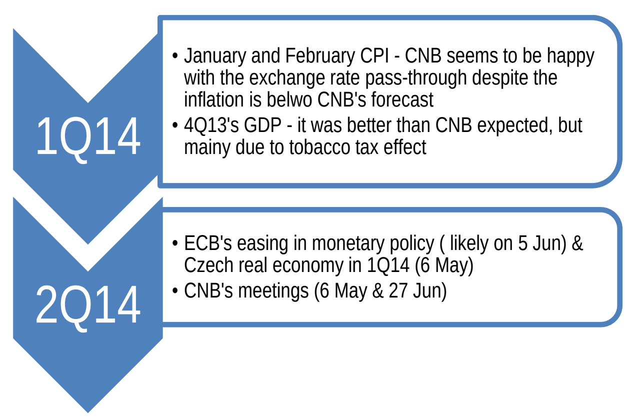
Source: Citi Research – based on CNB's sources: CNB – Meeting with analysts, November 2013 (page 21), CNB's Inflation Report 1/2014, CNB's RPN 1/2013.

Figure 5. Another positive surprise in state budget in February



Source: MinFin, CZSO, Citi Research calculation.

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



Source: Citi Research

Figure 123. Czech Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	180	225	197	198	216	196	198	207	212
Nominal GDP, local currency bn	3,663	3,848	3,759	3,791	3,823	3,846	3,881	4,043	4,219
GDP per capita, USD	17,484	21,614	18,795	18,873	20,584	18,693	18,865	19,634	20,154
Population, mn	10.3	10.4	10.5	10.5	10.5	10.5	10.5	10.5	10.5
Unemployment, % of labour force	5.3	4.4	6.7	7.3	6.7	7.0	7.0	6.3	5.5
Economic Activity									
Real GDP, yoy avg	5.7	3.1	-4.5	2.2	2.1	-1.0	-0.9	1.9	2.5
Real investment growth % yoy	15.5	1.9	-20.2	5.4	0.8	-5.0	-3.9	3.4	4.6
Real consumption growth % yoy	3.1	2.3	1.3	0.7	-0.4	-2.1	0.4	0.6	1.7
private consumption growth % yoy	4.2	2.8	0.2	0.9	0.5	-2.1	-0.1	0.5	1.8
Real export growth, % yoy	11.2	4.0	-10.9	15.4	9.5	4.5	0.1	6.5	6.4
Real import growth, % yoy	12.8	2.7	-12.1	15.4	7.0	2.3	0.5	5.7	6.4
Prices, Money & Credit									
CPI, % yoy eop	5.5	3.6	1.0	2.3	2.4	2.4	1.4	1.8	2.0
CPI, % avg	2.9	6.3	1.0	1.5	1.9	3.3	1.4	0.8	2.0
Nominal wages, % yoy	7.2	7.9	3.4	2.2	2.5	2.7	0.1	2.3	3.5
Credit extension to private sector, % yoy	26.6	16.1	0.8	3.0	5.5	2.6	3.7	5.3	9.0
Policy Interest Rate, % eop	3.50	2.25	1.00	0.75	0.75	0.05	0.05	0.05	0.25
1 month inter-bank rate, %, eop	3.94	3.21	1.29	0.99	0.94	0.33	0.29	0.25	0.45
Long-term yield, %, eop	4.64	4.15	4.01	3.86	3.69	1.90	2.30	2.50	2.50
CZK/US$, eop	18.2	19.2	18.4	18.7	19.8	19.0	19.9	19.8	19.0
CZK/US$, avg	20.2	17.0	19.0	19.1	17.7	19.5	19.6	19.8	19.3
CZK/EUR, eop	26.5	26.8	26.4	25.0	25.6	25.1	27.3	27.7	26.7
CZK/EUR, avg	27.8	25.0	26.4	25.3	24.6	25.1	26.0	27.6	27.1
Balance of Payments, USD bn									
Current account	-7.9	-4.8	-4.8	-7.6	-6.3	-4.7	-2.9	2.3	1.7
% of GDP	-4.4	-2.1	-2.5	-3.8	-2.9	-2.4	-1.4	1.1	0.8
Trade balance	2.2	1.7	4.6	2.8	5.3	7.5	9.6	13.9	15.0
Exports	106.5	125.1	99.1	114.0	138.5	131.7	135.6	145.8	156.7
Imports	104.3	123.4	94.6	111.2	133.2	124.2	126.0	131.9	141.7
Service balance	2.9	4.4	3.9	3.9	3.8	2.5	2.7	3.6	4.1
Income balance	-12.7	-10.6	-13.2	-14.8	-15.6	-14.7	-16.0	-15.9	-18.1
FDI, net	9.0	2.3	2.0	4.9	4.2	9.2	1.7	4.5	5.9
International reserves	34.4	36.5	39.7	40.3	37.9	42.4	53.9	60.2	63.4
Total amortisations	4.0	4.2	6.2	5.4	8.6	5.4	7.8	7.7	7.6
Public Finances, % of GDP									
Consolidated government balance	-0.7	-2.2	-5.8	-4.7	-3.2	-4.4	-2.4	-2.9	-2.9
Consolidated gov primary balance	0.4	-1.2	-4.5	-3.3	-1.8	-2.9	-0.7	-1.2	-1.7
Public debt	27.9	28.7	34.6	38.4	41.4	46.2	46.5	46.1	47.0
of which Domestic	20.3	20.7	24.1	25.5	28.6	31.6	31.6	31.6	32.1
Foreign Assets & Liabilities, USD bn									
External debt	76.2	84.2	89.2	94.2	94.2	101.9	95.6	103.1	109.6
Public	15.0	15.3	19.8	24.0	22.6	28.3	29.6	33.1	36.6
External debt / GDP	42.2	37.4	45.3	47.5	43.6	51.9	48.2	49.9	51.6
External debt / XGS	61.5	57.3	75.3	69.8	58.3	66.3	60.5	60.8	59.9
Short-term debt	22.6	27.1	23.9	23.6	27.1	26.2	26.0	27.0	28.0
Short-term debt/International reserves (%)	65.5	74.2	60.2	58.5	71.5	61.7	48.2	44.9	44.2

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	-1.0	1.3	2.1	2.1	2.3	1.0	1.8	2.3	2.7
CPI, % yoy eop	1.0	1.4	0.0	0.5	1.5	1.8	2.2	1.9	1.9
Policy interest rate, %, eop	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Short-term market rate, % eop	0.31	0.29	0.27	0.27	0.25	0.25	0.25	0.25	0.25
Long-term yield, %, eop	2.47	2.30	2.18	2.21	2.24	2.50	2.50	2.50	2.50
CZK/EUR, eop	25.67	27.34	27.46	27.49	27.60	27.67	27.44	27.20	26.96

Source: National Sources, Citi Research forecasts

Egypt

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- **Summary view** — Following the holding of the constitutional referendum, the military's political roadmap to a new political dispensation will continue to unfold in 1H 2014. Even with periodic upsurges in violence, we still expect the political transition to be completed by year end.

- **Things to watch** — Gulf support has helped stabilize the exchange rate and eased, but not eliminated, foreign exchange shortages. But it is not a long-term economic solution to the problems facing the economy or stabilizing the EGP.

- **Strategy** — As the political situation stablises in 2014, the government plans to use Gulf support to part fund a big push in capital spending. But a more coherent economic policy remains elusive, notably a medium- to long-term strategy to reduce the fiscal deficit.

Greater political stability in 2014

Despite periodic upsurges in violence in early 2014, the holding of the constitutional referendum now means the military's political roadmap for Egypt is moving forward. With a reasonable turnout and a strong "yes" vote, the outcome of the referendum seems to have persuaded Field Marshall Abdelfattah el Sisi to stand in presidential elections, which are now likely to be held in April.

This would then allow parliamentary elections to be held in early 2H 2014, completing the political transition. But while the vote for the president could potentially coalesce around Mr Sisi if he chooses to run, we expect that the parliamentary vote will be quite widely split over a range of parties. This would mean that a coalition government of some sort will have to be formed by the president, an outcome which is likely to lead to a strong presidency.

This outcome is also likely to be supported by most foreign governments. But it is clear that the political environment has changed in recent months, with the Gulf States now taking the lead in supporting Egypt's political transition while Western powers have apparently lost influence as they took their time in deciding the position they should take over political developments since June.

The need to keep the Islamist political community on side

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

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

The re-emergence of a fragile economic stability…

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

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

…but more comprehensive reform programme still needed

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

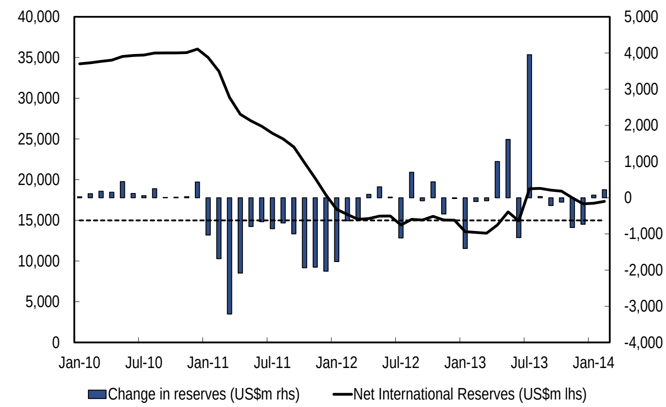
On a more positive note, with only modest EGP depreciation expected in 2014 and a still weak growth environment we think that inflation is unlikely to rise sharply. While, it could be argued that the CBE's cuts in the Overnight Deposit Rate (ODR) in 2013 were premature given the rise in inflation in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

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

A homegrown reform programme

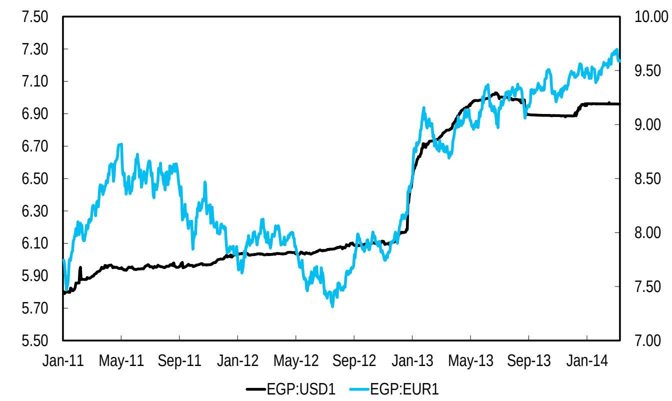
Having said that, the provision of Gulf support means that such difficult choices can be put off and the government can continue to operate in "muddle through" fiscal mode, probably well into 1H 2015. But at some point, the government will have to think about a more comprehensive reform programme. While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

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



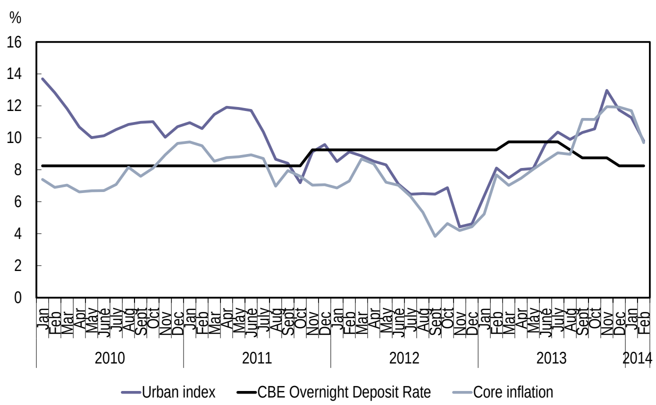
Source: Central Bank of Egypt, Haver Analytics

Figure 125. The EGP also starts to stabilise against USD since mid-2013



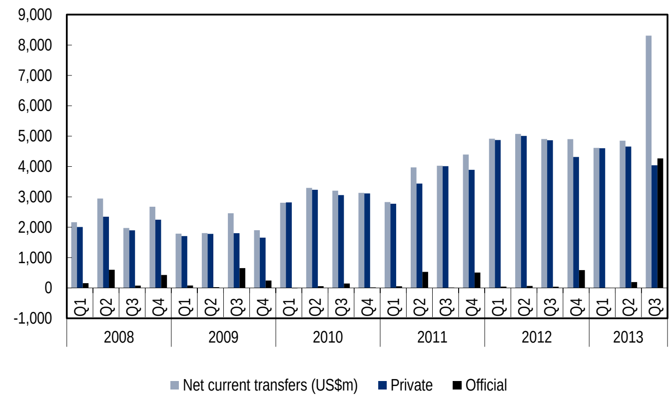
Source: Reuters

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



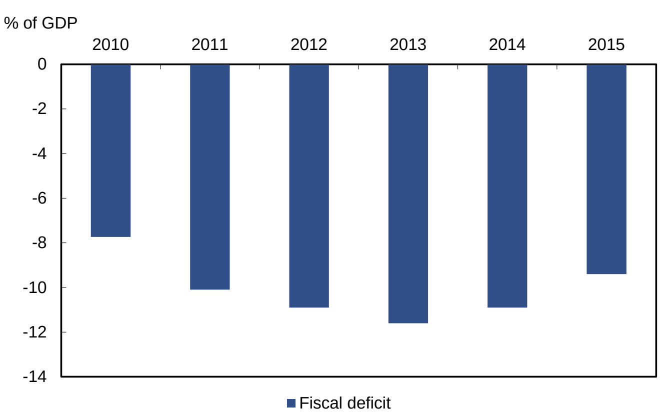
Source: Central Bank of Egypt, Haver Analytics and Citi forecasts for 2H 2013

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



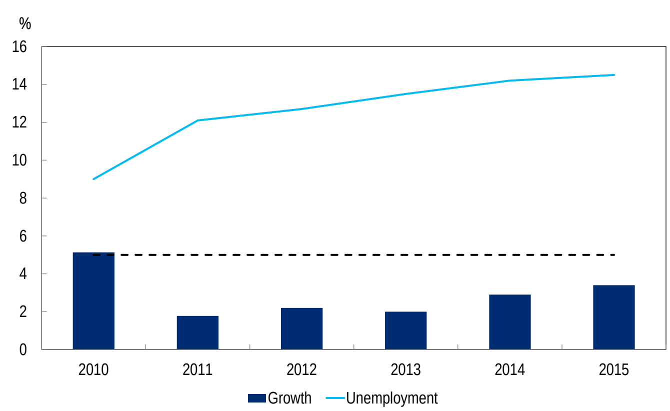
Source: Central Bank of Egypt, Haver Analytics

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



Source: Haver Analytics and Citi forecasts for 2013

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



Source: Haver Analytics and Citi forecasts for 2013-14

Figure 130. Egypt Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	132	165	188	214	231	254	249	271	283
Nominal GDP, local currency bn	745	896	1,042	1,207	1,371	1,542	1,719	1,927	2,131
GDP per capita, USD	1,783	2,187	2,454	2,755	2,919	3,164	3,042	3,265	3,347
Population, mn	74.1	75.4	76.6	77.8	79.1	80.4	81.7	83.1	84.4
Unemployment, % of labour force	8.9	8.7	9.4	9.0	12.0	12.7	13.5	14.2	14.5
Economic Activity									
Real GDP, yoy avg	7.1	7.2	4.7	5.1	1.8	2.2	2.0	2.9	3.4
Real investment growth % yoy	23.7	15.5	-9.1	8.0	-2.1	8.0	-3.8	5.6	10.1
Real consumption growth % yoy	7.6	5.2	5.7	4.2	5.3	5.5	3.2	3.3	5.1
private consumption growth % yoy	8.8	5.7	5.7	4.1	5.5	5.9	2.7	3.5	5.1
Real export growth, % yoy	20.2	28.8	-14.5	-3.0	1.2	-2.3	2.9	2.0	6.0
Real import growth, % yoy	30.5	26.3	-17.9	-3.2	8.4	10.8	2.3	4.7	13.4
Prices, Money & Credit									
CPI, % yoy eop	6.9	18.4	13.2	10.6	9.5	4.7	11.7	9.2	7.2
CPI, % avg	9.5	18.3	11.8	11.1	10.1	7.1	9.5	9.2	7.1
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	10.0	12.0	3.0	6.7	6.1	7.6	7.1	6.3	7.6
Policy Interest Rate, % eop	8.75	11.50	8.25	8.25	9.25	9.25	8.25	7.50	7.00
1 month inter-bank rate, %, eop	8.75	11.95	8.30	8.30	10.05	10.10	12.14	9.69	7.68
Long-term yield, %, eop	9.50	9.00	9.00	9.00	9.50	10.00	13.50	11.00	10.00
EGP/US$, eop	5.53	5.50	5.48	5.81	6.03	6.36	6.95	7.35	7.65
EGP/US$, avg	5.64	5.44	5.55	5.63	5.94	6.07	6.87	7.11	7.54
Balance of Payments, USD bn									
Current account	0.2	-1.3	-3.2	-5.6	-7.6	-7.6	-4.2	-3.5	-6.2
% of GDP	0.2	-0.8	-1.7	-2.6	-3.3	-3.0	-1.7	-1.3	-2.2
Trade balance	-20.8	-26.8	-22.5	-27.7	-28.2	-33.8	-31.6	-31.2	-31.2
Exports	24.5	29.8	23.1	25.0	27.9	25.9	24.9	26.3	27.6
Imports	45.3	56.6	45.6	52.7	56.1	59.7	56.5	57.4	58.8
Service balance	12.7	15.7	11.3	9.6	5.4	6.4	2.9	2.1	3.1
Income balance	-	-	-	-	-	-	-	-	-
FDI, net	10.9	7.6	6.1	5.2	-1.1	3.5	5.7	2.0	5.0
International reserves	31.7	34.2	34.2	36.0	18.1	15.0	17.1	18.4	19.6
Total amortisations	2.3	1.8	2.4	2.0	2.1	2.3	2.3	2.6	2.4
Public Finances, % of GDP									
Consolidated government balance	-5.2	-6.4	-6.6	-7.7	-10.1	-10.9	-11.6	-10.9	-9.4
Consolidated gov primary balance	0.0	-1.8	-2.4	-2.6	-4.5	-4.8	-5.7	-4.4	-2.3
Public debt	64.2	53.5	54.0	59.8	69.0	79.4	79.9	79.1	78.6
of which Domestic	64.2	53.5	54.0	59.8	69.0	79.4	79.9	79.1	78.6
Foreign Assets & Liabilities, USD bn									
External debt	32.8	32.1	33.3	35.0	33.7	38.8	40.0	40.5	40.7
Public	21.6	26.0	27.2	28.3	27.4	32.8	31.5	31.5	31.5
External debt / GDP	24.8	19.5	17.7	16.3	14.6	15.3	16.1	14.9	14.4
External debt / XGS	68.8	55.6	73.0	70.9	71.1	81.1	91.8	91.5	86.4
Short-term debt	2.2	2.8	2.6	3.1	3.0	6.7	6.7	6.7	6.7
Short-term debt/International reserves (%)	7.0	8.3	7.5	8.7	16.7	44.3	38.8	36.2	33.9

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.0	1.1	1.5	1.8	3.0	3.2	3.0	3.2	3.0
CPI, % yoy eop	10.1	11.7	10.0	9.3	8.5	9.2	7.1	7.0	6.7
Policy interest rate, %, eop	8.75	8.25	8.00	7.50	7.50	7.50	7.00	7.00	7.00
Short-term market rate, % eop	10.15	12.14	10.42	9.78	8.94	9.69	7.57	7.46	7.15
Long-term yield, %, eop	11.00	13.50	13.50	13.50	13.00	12.50	12.00	11.50	11.50
EGP/US$, eop	6.89	6.95	7.00	7.00	7.30	7.35	7.50	7.60	7.60

Source: National Sources, Citi Research forecasts

GCC

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A diplomatic spat has erupted within the GCC. Following a meeting of GCC foreign ministers in March, Saudi Arabia, the UAE and Bahrain announced a unilateral withdrawal of their ambassadors from Qatar to protest the latter's alleged non-compliance with the terms of a recent GCC security agreement. Further details on how Qatar was allegedly non-compliant were not given, although reference was made to Qatar's alleged failure to stop 'support for anyone who threatens the security and stability of GCC countries' (Bloomberg, 5 March).

Since the late 1990s under the leadership of former Emir Hamad bin Khalifa al Thani, Qatar has pursued an active regional foreign policy that has often led to frictions with its Gulf partners. The recent support offered to the Muslim Brotherhood-dominated government of former President Mohamed Morsi in Egypt is a case in point. Moreover, its hosting of the Al Jazeera news network, which is perceived by GCC neighbours as airing views that are critical of them, including those of Islamist preacher Yusuf al-Qaradawi, has also on several occasions led to accusations that Qatar is meddling in the internal affairs of its neighbours.

In the weeks prior to the withdrawal of ambassadors, such tensions escalated significantly. A sermon delivered by Al Qaradawi in January led to a very public dispute between the UAE and Qatar, in which the Chairman of the GCC, Dr Adullatif al Zayani, publicly condemned comments made by the cleric; legal proceedings against Al Qaradawi were instigated within the UAE, and the Qatari Ambassador to Abu Dhabi was summoned to hear an official protest (The National, 4 February). Another sermon in February drew the ire of Saudi, which went so far as to threaten to close its borders and airspace to Qatar (Middle East Monitor, 20 February).

The current escalation is not likely, in our view, to have significant regional implications. We do not expect a further escalation in the dispute. Moreover, the economies of the region operate largely independently of one another: we estimate non-hydrocarbons trade between Qatar and its GCC partners to be around 1% of Qatar's total trade by value. We therefore see few economic implications to the current diplomatic rift.

That said, we do note the significance of the Dolphin Energy project in the economic ties between Qatar and the UAE. We estimate that the gas exports to the UAE via the pipeline account for around 5% of Qatar's total export earnings, and the Abu Dhabi Council for Economic Development estimated in 2010 that the emirate was reliant on the Dolphin pipeline for 50%-60% of its total gas requirements, while electricity generation was almost entirely dependent on gas. We do not anticipate any disruption to the gas flows at this point, but any escalation, however unlikely, could be harmful if it were to affect this key regional project.

Saudi Arabia

Fitch upgraded its ratings on Saudi Arabia by one notch to AA in March, putting it one notch above the ratings of S&P and Moody's. We believe the rating action is warranted given Saudi Arabia's fiscal and external strength, and closes the (in our view) unjustified gap between the ratings on the Kingdom and those on Qatar, Abu Dhabi and Kuwait. However, we do also consider the timing to be questionable given our view that the Kingdom, like the other GCC oil producers, is facing a tightening in fiscal conditions in the medium term. We expect public finances and external balances will remain robust in the near term: the current account surplus looks set to remain in double digits in 2014, while we expect the fiscal surplus will narrow from around 10% this year to a still healthy 5% in 2014. That said, we think rising expenditures and an expected leveling off in oil revenues and production present a challenge in the medium- to long-term. We forecast the

fiscal breakeven oil price will rise to over US$90 per barrel in 2014 and will continue to rise, resulting in forecast deficits as early as 2016. Although Saudi has ample resources to finance expected deficits from current cash reserves, the outlook does underscore the need for structural reform to set public finances on a long-term sustainable footing.

United Arab Emirates

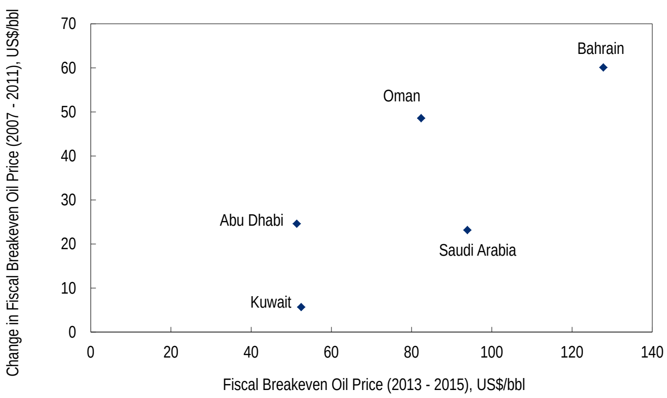
As Dubai's property market booms and large-scale projects are announced, parallels are emerging with the property bubble that affected the emirate six years ago. According to Cluttons Data, average house prices rose by 42% in the course of 2013. This is on the back of a buoyant economy that is thriving on a resurgence of regional trade and liquidity, as well as tourism.

While we have for some time been highlighting our concerns regarding the sustainability of asset price inflation, we consider Dubai to be more resilient to exogenous shocks than it was at the height of the previous cycle in mid-2008, for three main reasons. The first of these is a more sound and liquid banking system. In contrast to mid-2008, bank liquidity is less vulnerable to exogenous shocks and is likely to remain supportive of local asset markets. The second is the progress Dubai has made on deleveraging and smoothing debt maturities. Refinancing risk among some of Dubai's most significant Government Related Entities (GREs) has been significantly reduced. Finally, the rise in property prices has not, to date, led to a significant rise in construction and leverage.

We would also note that there are emerging signs that the acceleration in housing prices has tempered somewhat in the past couple of months. Indeed, Cluttons data show hardly any rise in average house prices since the start of the year. Whether this is the beginning of a sustained cooling in the real estate market remains to be seen. We believe that a slowdown in the growth of house prices at this juncture would greatly reduce the risk of future volatility in the real estate sector.

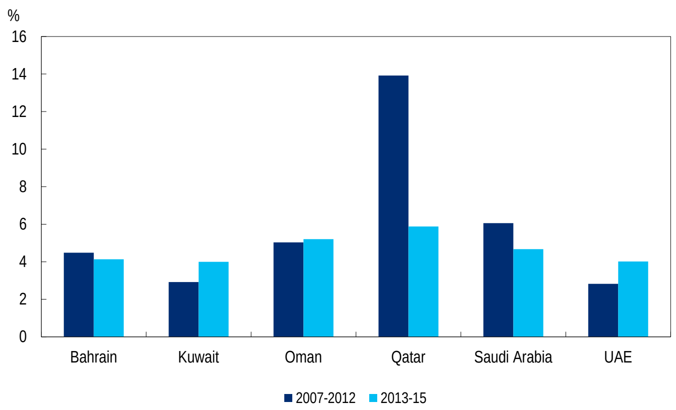
Despite the differences, we also recognize that Dubai's is a dynamic and fast-changing economic landscape. Signs may emerge that construction activity is responding to potential speculative demand in the real estate market, and that this is leading to oversupply issues and rising corporate sector leverage.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

Figure 131. Fiscal breakeven oil prices on the rise



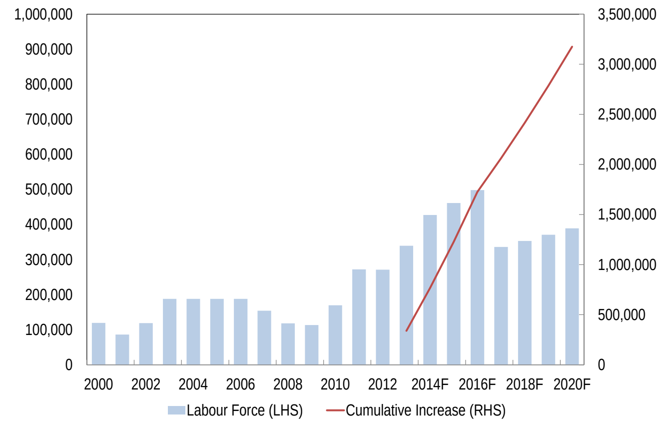
Source: Citi Research estimates

Figure 132. Economic growth will be uneven going forward



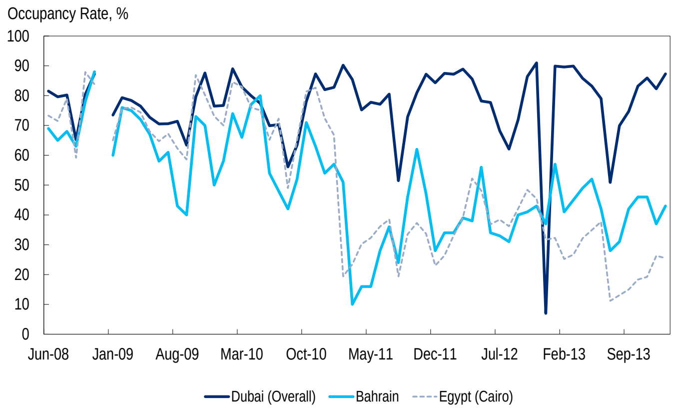
Source: Haver Analytics, Citi Research

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



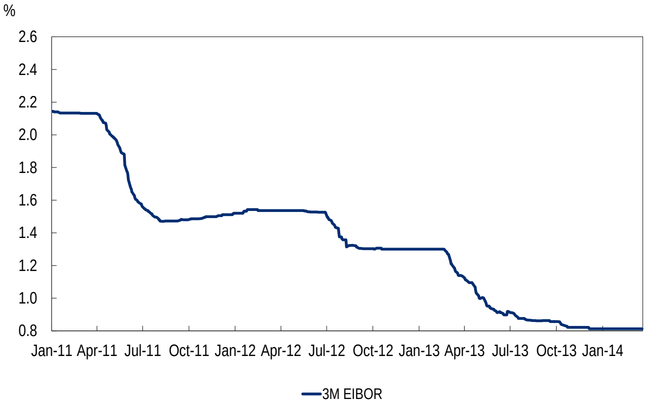
Source: Saudi Central Statistics Office, Citi Research

Figure 134. Dubai hotel occupancy continues to outperform its peers



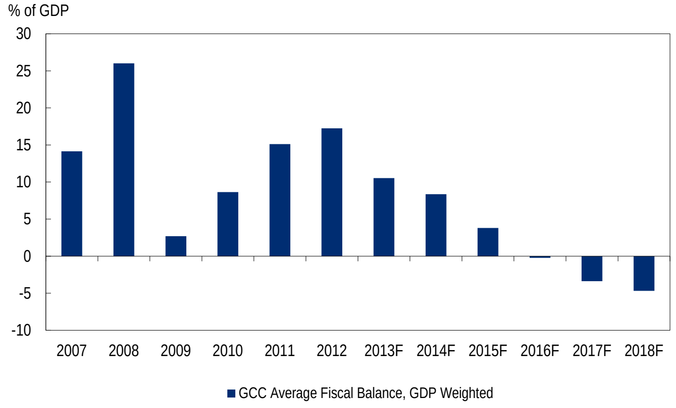
Source: Ernst & Young, Citi Research

Figure 135. EIBOR rates have begun to decline again



Source: Haver Analytics

Figure 136. High government expenditure will drive balances lower



Source: Haver Analytics, Citi Research estimates

Figure 137. GCC Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
BAHRAIN									
Nominal GDP, USD bn	21.7	25.6	22.9	25.6	29.0	30.3	34.9	37.6	40.3
GDP per capita, USD	21,072	22,983	19,192	20,482	22,401	22,973	25,486	26,370	27,202
Real GDP, yoy avg	8.3	6.2	2.5	4.3	2.1	3.4	4.3	4.0	4.1
CPI, % avg	3.3	3.5	2.8	1.9	-0.4	2.8	3.3	2.3	2.0
BHD/US$, avg	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
Current account, US$bn	2.8	2.1	0.4	0.6	3.0	2.0	1.8	0.9	-0.6
% of GDP	12.7	8.1	1.7	2.3	10.3	6.4	5.3	2.4	-1.5
Consolidated gov. balance, % of GDP	2.7	6.4	-4.3	-4.8	-0.3	-2.0	-2.2	-3.3	-5.5
KUWAIT									
Nominal GDP, USD bn	112.3	136.6	105.2	118.5	152.8	176.9	202.2	207.3	208.7
GDP per capita, USD	43,971	50,563	36,898	39,610	48,908	54,947	60,992	60,696	59,346
Real GDP, yoy avg	-	-	-	-	10.2	8.3	4.3	3.9	3.9
CPI, % avg	5.5	10.6	4.0	4.0	4.7	2.9	2.6	3.1	4.5
KWD/US$, avg	0.28	0.27	0.29	0.29	0.28	0.28	0.28	0.29	0.29
Current account, US$bn	41.9	57.8	29.1	37.8	66.2	79.2	103.1	102.7	99.7
% of GDP	37.3	42.3	27.6	31.9	43.3	44.8	51.0	49.5	47.8
Consolidated gov. balance, % of GDP	30.0	36.4	19.0	30.8	40.1	39.4	26.8	27.0	21.0
OMAN									
Nominal GDP, USD bn	42.0	59.9	53.4	53.4	53.4	53.4	87.0	93.3	98.6
GDP per capita, USD	15,326	20,887	18,015	17,438	16,881	16,180	25,157	25,831	26,121
Real GDP, yoy avg	4.5	8.2	6.1	4.8	0.9	5.8	5.7	5.2	4.7
CPI, % avg	5.9	12.5	3.6	3.2	4.0	2.9	2.1	1.9	3.0
OMR/US$, avg	0.38	0.38	0.38	0.38	0.39	0.39	0.38	0.39	0.39
Current account, US$bn	2.5	5.0	-0.5	5.0	9.0	8.1	9.1	7.7	6.3
% of GDP	5.8	8.4	-0.9	9.4	16.8	15.2	10.4	8.2	6.4
Consolidated gov. balance, % of GDP	2.7	0.3	-0.1	3.1	-0.4	-0.3	9.5	8.0	5.8
QATAR									
Nominal GDP, USD bn	79.7	115.3	97.8	125.1	171.5	192.4	202.2	216.2	231.6
GDP per capita, USD	85,712	104,982	80,294	92,546	114,241	118,688	115,512	114,352	113,414
Real GDP, yoy avg	18.0	17.7	12.0	16.7	13.0	6.2	5.6	5.9	6.1
CPI, % avg	13.6	15.2	-4.9	-2.4	1.9	1.9	3.1	2.5	3.5
QAR/US$, avg	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64
Current account, US$bn	11.5	26.6	6.4	23.8	52.0	61.6	60.9	55.8	48.5
% of GDP	14.4	23.1	6.5	19.0	30.3	32.0	30.1	25.8	20.9
Consolidated gov. balance, % of GDP	10.9	9.8	13.4	2.7	7.7	11.8	8.2	4.3	1.2
SAUDI ARABIA									
Nominal GDP, USD bn	415.6	519.4	429.0	526.8	669.5	733.8	739.3	773.5	818.8
GDP per capita, USD	17,111	20,861	16,811	20,178	25,645	27,559	27,220	27,921	28,976
Real GDP, yoy avg	6.0	8.4	1.8	6.4	8.6	5.1	3.7	4.2	6.1
CPI, % avg	4.1	9.9	5.1	5.3	3.9	2.9	3.5	3.5	4.1
SAR/US$, avg	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Current account, US$bn	94.3	133.0	21.5	67.4	159.3	165.7	134.5	106.4	75.8
% of GDP	22.7	25.6	5.0	12.8	23.8	22.6	18.2	13.7	9.3
Consolidated gov. balance, % of GDP	12.2	30.8	-3.0	6.3	13.2	15.4	7.4	5.1	0.4
UNITED ARAB EMIRATES									
Nominal GDP, USD bn	257.9	315.5	254.8	287.4	348.6	383.8	409.8	439.1	470.4
GDP per capita, USD	57,467	66,205	51,915	56,858	66,946	70,678	72,074	73,830	75,673
Real GDP, yoy avg	3.2	3.2	-4.8	1.7	3.9	4.4	3.7	4.0	4.0
CPI, % avg	11.1	12.3	1.6	0.9	0.9	0.7	1.5	1.3	1.6
AED/US$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account, US$bn	15.5	22.7	7.9	7.4	74.3	108.6	107.3	93.8	80.0
% of GDP	6.0	7.2	3.1	2.6	21.3	28.3	26.2	21.4	17.0

Source: National Sources, Citi Research forecasts

Hungary

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- **Summary view** — The outlook of weak domestic demand and low inflation is likely to persist, which leaves the NBH more tolerant towards FX weakness amidst continued pressure on EMFX as global yields normalize.
- **Things to watch** — Details about the FX mortgage aid scheme, impact of interventionist policies in the energy sector and monetary policy response to tightening external conditions will be key factors to watch.
- **Strategy** — We expect the HUF to remain on a weakening path as outflows from local bonds may continue. The NBH is likely to follow with slower rate hikes than market expectations, citing a low inflationary environment.

Growth continues to firm in 1Q14

Improvement in external demand has been confirmed by incoming European indicators and acceleration in Hungarian industrial output (6.1%YoY in Jan). The accelerated absorption of EU funds is likely to continue in 1H14, which provides boost to constructions while private sector investment recovery remains weak. The intensity of infrastructure investments may slow in 2H14 partly due to base effects and increased public investments in the run up to elections in April. This may be offset by the positive impacts of the NBH's Funding for Growth Scheme. Although utilization since October has been weak, the NBH expects accelerating utilization in the next quarters given that 90% of the loans distributed under the 2nd phase of the scheme is new lending, thus in a larger part investment related.

Household consumption has remained weak but shows signs of acceleration with 0.4% QoQ growth in 4Q13 and a 3.9% YoY increase in January retail sales. Given the household sector's FX debt exposure and the sluggish increase in private sector employment we expect a recovery in consumption to remain a slow process as consumers remain burdened by BS adjustment. Considering the improved euro zone growth outlook and positive surprise in 4Q13 consumption we have upped our 2014 GDP forecast to 2.1% YoY from 1.9% YoY previously.

April elections may renew Fidesz supermajority

Recent polls show that the governing party has widened its support and has good chances to win 2/3rd majority for another 4 year term on the Apr 6 parliamentary elections. We do not expect a major change in policies following the elections, given the stable political landscape and the absence of fiscal adjustment need. Comments from PM Orban suggest that during the next term the government may consider lowering the PIT rate further, extend public work programs further to sharply reduce official unemployment and carry on the reorganization of the energy sector with further nationalizations and reduction in energy prices potentially extended to the wholesale sector. We do not expect sharp change in banking sector extra burdens due to the need to preserve fiscal stability. Any additional fiscal room created by rising growth may be used to PIT tax reduction as key priorities.

We remain bearish about long-term growth prospects as the sustainability of energy price cuts seems questionable - especially if nuclear power plant capacity will be increased. Moreover, interventionist government policies may discourage a private sector investments supported by FDI. We do not expect and radical one-off burden on banks from the FX mortgage aid scheme but measures may permanently weigh in on banking sector from the revenue side.

External surplus to remain, public debt may stagnate

The composition of growth suggests that that Hungary's external balance is unlikely to disappear in the coming years. Hungary's external surplus (current and capital account plus net errors) peaked at around 7% of GDP in 2013 and may decline slightly towards 6% this year as domestic demand picks up. The external surplus has been offset by outflows on the financing account, primarily driven by bank deleveraging. Therefore the external surplus is only supportive to the HUF as long as there are no additional outflows from existing stock of external debt, which does not seem to be the case for this year. The most vulnerable part of external debt financing seems to be portfolio investments in government papers that have increased by 8-9% of GDP from post crises lows until mid-2013 but suffered outflows since.

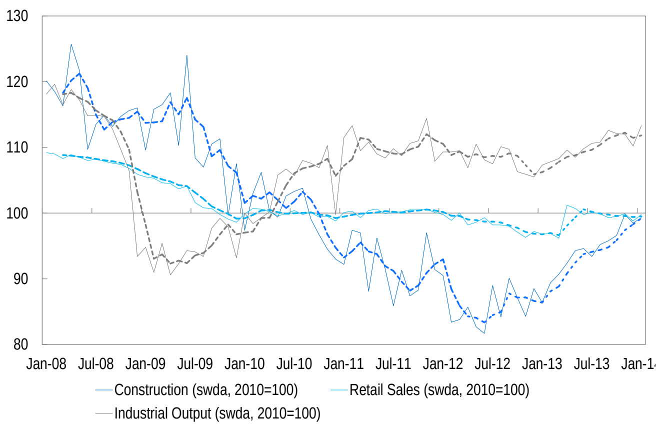
FX weakening and weak medium term growth outlook and the realization of the planned nuclear power plant upgrade may add to the public debt ratio. Although the fiscal balance is under control and Hungary is running a primary surplus, due to the low nominal GDP growth the reduction in public debt ratio is likely to be a slow and temporary offset by the impact of FX weakening. Based on the stock of 34% of GDP FX denominated government debt, every 5% rise in EUR/HUF (all FX exposure is swapped to EUR) increases the public debt ratio by 1.5ppts from an already elevated 80% of GDP level. Our baseline scenario does not calculate with the government loan agreement with Russia to finance the new nuclear power plant investment. Based on the size of the loan agreement (~10% of GDP), without any offsetting fiscal tightening public debt ratio may remain around the current 80% level in ten years' time. The nuclear power plant project also poses risk to the long term fiscal outlook, as the debt service may burden the central budget in order to avoid a sharp increase in electricity production costs.

NBH tolerates FX weakness amidst soft inflation outlook

The NBH remains confident about the sustainability of low inflation, as incoming data has continued to surprise to the downside over the past few months. The recent slowdown in household inflation expectations, measured private sector wage growth and an easing in tax filtered core inflation suggest that the 3% official CPI target remains within reach even after the impacts of utility price cuts fade out from the annual index. We expect headline CPI to remain below 0.5% YoY until August and rise towards 2.3% YoY by December 2014, with the sharpest rise coming in November as the impact of former utility price cuts fall out of the index. Inflation may rise to 2.5-3.0% over the 12m horizon, with upside risks related to further FX weakness and food prices and downside risks related to additional regulated energy price cuts.

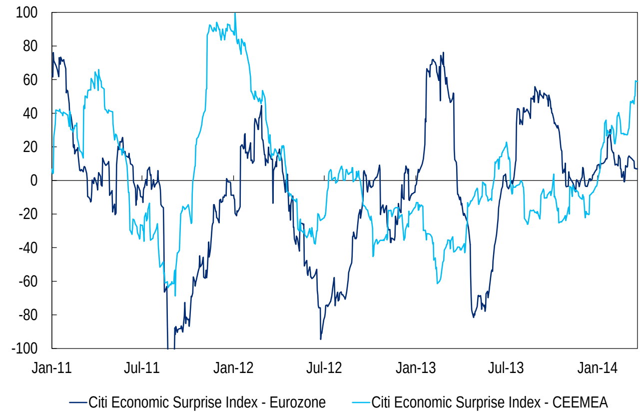
FX weakening does not seem to concern the MPC from an inflationary point, given soft underlying inflation measures and the low imported inflation outlook. The pass-through from FX to CPI has been around 20% on a 6-8 quarter horizon but the total pass-through may be longer than a year, muting the impact to the annual price index to around 13%. Given the sharp moderation in underlying inflation trends and poor growth outlook the MPC seems to be more tolerant towards FX weakening, citing also the improved shock resistance of the banking sector as a result of the FX debt deleveraging since the beginning of the crises. In our view outflows from local assets may continue amidst sustained pressure on EMFX, which in turn may force the NBH to gradually hike rates in late 2014, but likely at a slower pace than current market expectations given the bearish growth and soft inflation outlook.

Figure 138. Industrial output pick up in January…



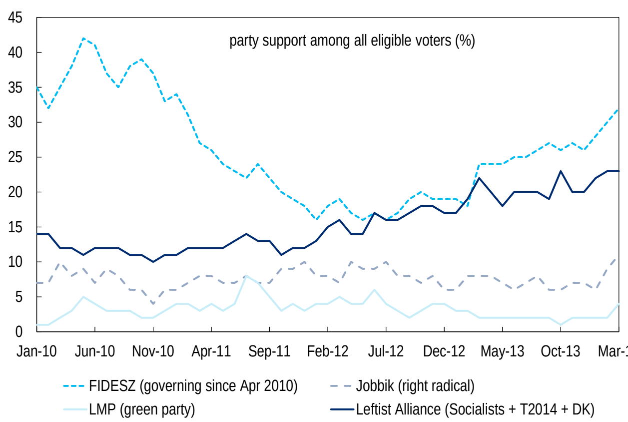
Source: Hungarian CSO, Citi Research

Figure 139. … in line with improved Euro Zone and regional outlook



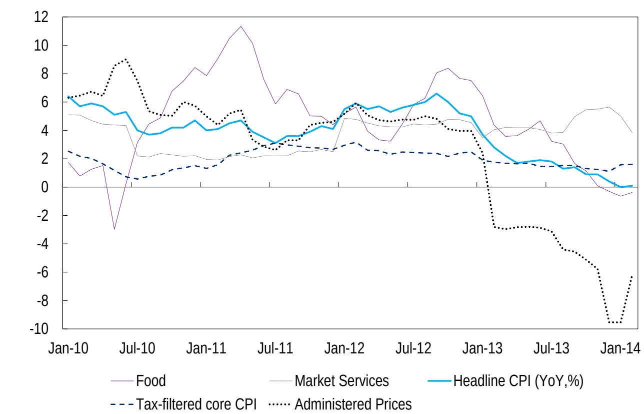
Source: Bloomberg, Citi Research

Figure 140. Governing Fidesz has widened its lead in polls



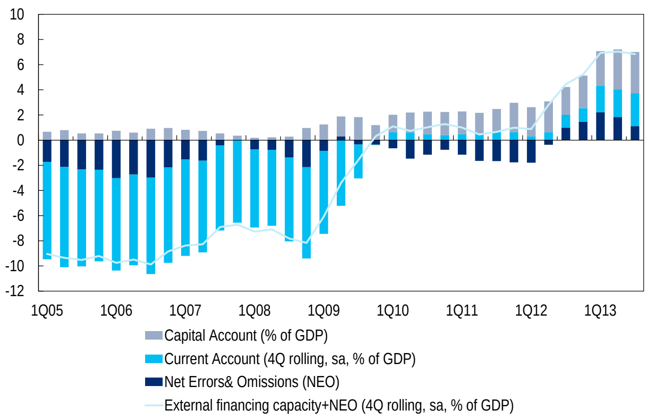
Source: Szonda-Ipsos, Citi Research

Figure 141. Food and utility prices pull down headline CPI but tax-filtered core inflation also moderated



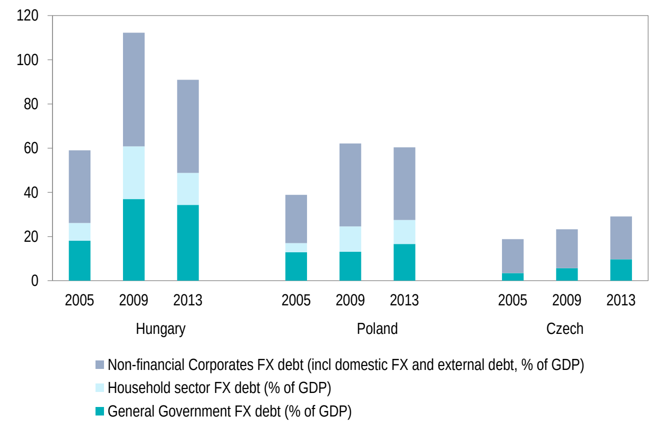
Source: National Bank of Hungary, Citi Research

Figure 142. External surplus likely peaked but not to disappear…



Source: National Bank of Hungary, Citi Research

Figure 143. …but FX sensitivity remains as deleveraging not over yet



Source: National Banks, Citi Research estimate

Figure 144. Hungary Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	145	141	136	127	115	127	135	130	136
Nominal GDP, local currency bn	25,143	26,543	25,730	26,599	27,714	28,082	29,179	30,554	31,872
GDP per capita, USD	14,390	14,061	13,584	12,688	11,487	12,726	13,620	13,060	13,718
Population, mn	10.1	10.0	10.0	10.0	10.0	10.0	9.9	9.9	9.9
Unemployment, % of labour force	7.7	8.0	10.5	10.8	10.7	10.7	9.1	8.6	8.5
Economic Activity									
Real GDP, yoy avg	0.1	0.9	-6.8	1.1	1.6	-1.7	1.1	2.1	1.5
Real investment growth % yoy	-1.5	3.7	-29.6	11.5	-3.6	-11.2	5.9	3.0	0.0
Real consumption growth % yoy	-1.4	-0.2	-4.5	-2.5	0.3	-1.5	0.5	1.1	0.6
private consumption growth % yoy	1.1	-0.7	-6.6	-3.0	0.4	-1.6	-0.1	0.7	1.0
Real export growth, % yoy	15.0	5.7	-10.2	11.3	8.4	1.7	5.3	4.8	4.6
Real import growth, % yoy	12.8	5.5	-14.8	10.9	6.4	-0.1	5.3	4.6	4.1
Prices, Money & Credit									
CPI, % yoy eop	7.4	3.4	5.4	4.6	4.1	5.1	0.6	2.3	3.1
CPI, % avg	7.9	6.0	4.0	4.7	3.9	5.7	1.7	0.7	2.9
Nominal wages, % yoy	8.0	7.4	0.5	1.3	5.2	4.7	3.8	4.4	4.2
Credit extension to private sector, % yoy	18.8	21.7	-2.7	4.1	-0.5	-10.1	-2.6	2.1	-1.3
Policy Interest Rate, % eop	7.50	10.00	6.25	5.75	7.00	5.75	3.00	3.00	4.00
1 month inter-bank rate, %, eop	7.50	10.00	6.25	5.75	7.08	5.75	3.00	3.00	4.00
Long-term yield, %, eop	7.08	8.28	7.99	7.97	9.75	6.11	5.61	6.60	6.50
HUF/US$, eop	173	190	189	208	244	221	216	236	234
HUF/US$, avg	183	171	201	208	201	225	223	232	235
HUF/EUR, eop	253	266	271	278	315	291	297	330	330
HUF/EUR, avg	251	252	280	275	279	289	297	322	330
Balance of Payments, USD bn									
Current account	-9.9	-11.4	-0.3	0.3	0.6	1.3	2.9	3.3	2.7
% of GDP	-6.8	-8.1	-0.2	0.2	0.5	1.0	2.1	2.6	2.0
Trade balance	-0.9	-1.8	3.3	3.2	4.3	4.6	5.4	6.3	5.4
Exports	93.0	106.1	80.0	88.8	103.7	97.3	104.8	112.0	116.7
Imports	93.9	107.9	76.7	85.5	99.4	92.7	99.4	105.7	111.2
Service balance	1.8	2.2	2.8	3.8	4.4	4.4	4.8	4.8	5.0
Income balance	-10.1	-11.0	-6.9	-7.3	-8.9	-8.2	-8.5	-8.6	-8.5
FDI, net	0.3	3.9	0.2	1.0	0.9	2.6	2.0	1.8	1.6
International reserves	23.2	33.2	41.1	43.1	45.4	43.5	48.4	51.9	56.5
Total amortisations	9.3	15.2	21.9	20.5	25.8	21.6	21.5	21.1	20.6
Public Finances, % of GDP									
Consolidated government balance	-5.1	-3.7	-4.6	-4.3	4.3	-2.0	-2.6	-2.9	-2.9
Consolidated gov primary balance	-1.0	0.5	0.0	-0.1	8.5	2.4	1.5	1.1	1.0
Public debt	66.5	72.3	78.1	79.9	81.9	79.8	79.1	81.2	80.1
of which Domestic	35.9	37.5	36.8	40.8	40.8	43.6	44.8	45.7	46.3
Foreign Assets & Liabilities, USD bn									
External debt	151.7	172.6	196.3	185.1	171.7	163.9	163.7	160.5	156.5
Public	47.4	51.8	62.1	59.6	58.4	63.8	62.5	63.0	63.5
External debt / GDP	104.8	122.2	144.1	145.7	149.6	129.1	121.0	123.8	115.0
External debt / XGS	137.7	136.5	199.2	171.2	136.6	139.3	129.4	118.6	111.1
Short-term debt	32.9	27.5	28.0	32.9	31.7	22.8	20.6	19.6	18.3
Short-term debt/International reserves (%)	141.7	82.8	68.2	76.1	69.9	52.4	42.6	37.8	32.4

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.8	2.4	2.7	2.2	1.7	1.6	1.4	1.5	1.5
CPI, % yoy eop	1.4	0.4	0.0	0.5	0.7	2.3	2.8	3.0	2.9
Policy interest rate, %, eop	3.60	3.00	2.60	2.50	2.50	3.00	3.75	4.00	4.00
Short-term market rate, % eop	3.60	3.00	2.60	2.50	2.50	3.00	3.75	4.00	4.00
Long-term yield, %, eop	5.83	-	6.00	6.30	6.50	6.60	7.00	7.00	6.50
HUF/EUR, eop	297	297	313	319	325	330	330	330	330

Source: National Sources, Citi Research forecasts

Israel

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

Some signs of recovery?

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

The external sector remains a focus for policymakers…

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

…and the problem won't go away

In the medium term, the outlook for Israel's balance of payments is exceptionally good, due to very large offshore gas discoveries in the past couple of years which could add around 2% GDP per year to Israel's balance of payments (both through import-substitution as well as exports). The government is in the process of creating a Sovereign Wealth Fund to capture the net income from gas production, and it reckons that the Fund will reach over US$80bn by 2040 (Israel's GDP this year is around US$230bn). We think it's worth assuming that more gas and oil will be discovered in the Eastern Mediterranean, and so Israel's emergence as an energy exporter is likely to become an even stronger story than it is at the moment: the US Geological Survey estimates that the Levantine Basin – 40% of which is in Israeli waters –contains more than 3.4 trillion cubic meters of gas, suggesting that Israel might end up with twice the amount of gas that it has found to date.

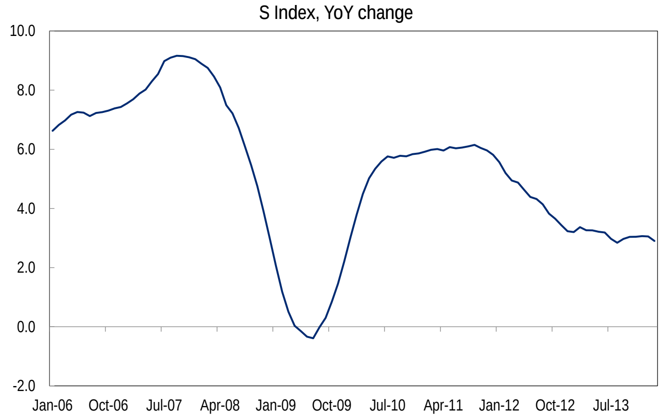
March interest rate cut makes sense

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

A better fiscal outlook

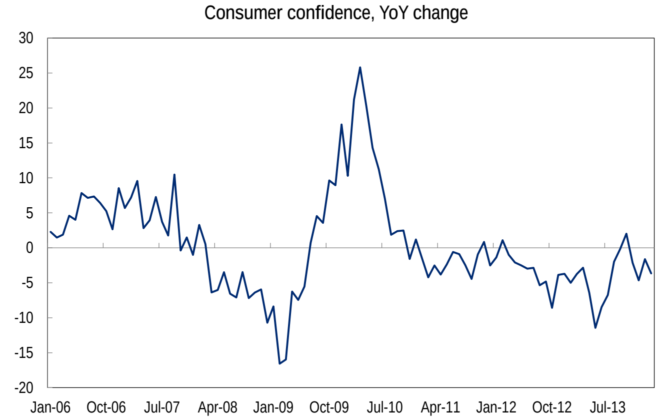
One of the factors that facilitated a more aggressive stance by the BOI is that fiscal uncertainties have eased somewhat. Due to some expenditure restraint and higher-than-expected revenues, the 2013 deficit was 3.2% GDP, compared to the 4.65% deficit that had been forecast earlier. In addition, changes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

Figure 145. Economic activity is stabilizing at a weak level, partly thanks to what the BOI describes as a 'virtual standstill' in world trade...



Source: Haver Analytics, Citi Research

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

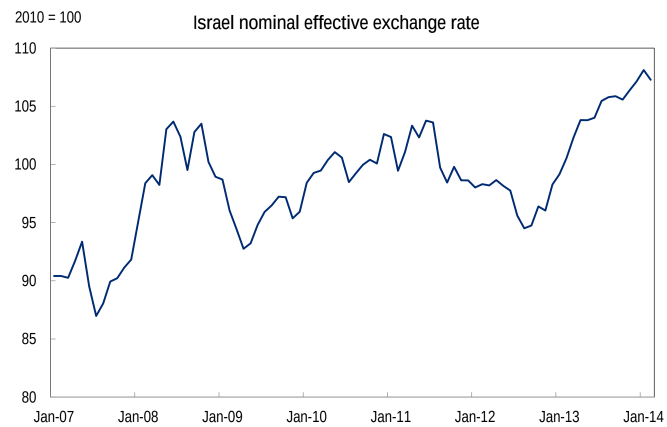


Source: Haver Analytics, Citi Research

Figure 147. Inflation expectations are more or less stable...

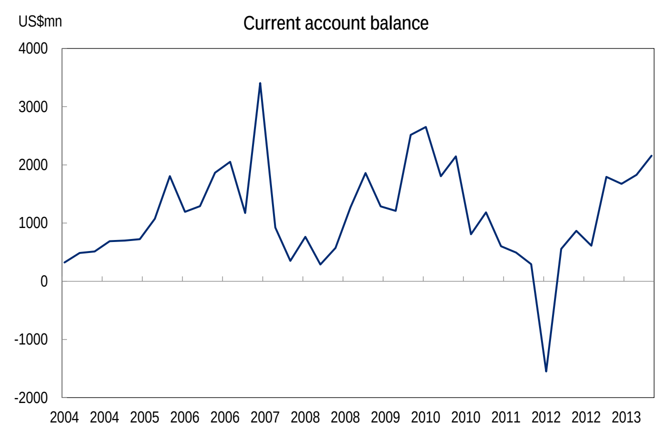
Source: Haver Analytics, Citi Research

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



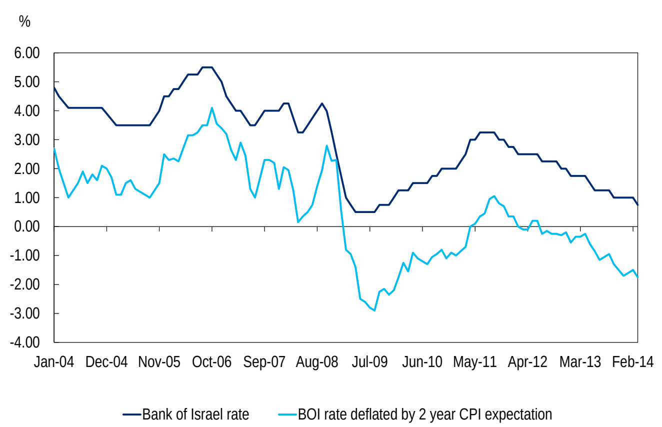
Source: Haver Analytics, Citi Research

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



Source: Bloomberg, Citi Research

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



Source: Bloomberg, Citi Research

Figure 151. Israel Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	175	213	206	232	258	258	292	314	314
Nominal GDP, local currency bn	719	765	809	866	924	993	1,053	1,101	1,173
GDP per capita, USD	25,248	29,990	28,289	31,273	34,236	33,702	37,718	40,092	39,700
Population, mn	6.9	7.1	7.3	7.4	7.5	7.6	7.7	7.8	7.9
Unemployment, % of labour force	9.2	7.7	9.4	8.3	7.1	6.9	6.3	6.0	5.8
Economic Activity									
Real GDP, yoy avg	6.8	5.0	1.0	5.3	4.7	3.4	3.2	3.4	3.5
Real investment growth % yoy	9.7	8.8	-4.4	9.4	15.6	3.6	1.6	5.6	3.6
Real consumption growth % yoy	6.6	1.6	2.5	4.4	3.6	3.2	3.5	3.0	-0.3
private consumption growth % yoy	8.1	1.5	2.4	4.9	4.0	3.1	3.7	3.0	-0.5
Real export growth, % yoy	11.2	6.6	-12.1	15.2	7.2	1.1	0.9	3.4	6.7
Real import growth, % yoy	10.6	2.3	-12.7	14.2	10.9	3.2	-1.1	1.6	5.4
Prices, Money & Credit									
CPI, % yoy eop	3.4	3.8	3.9	2.7	2.2	1.6	1.8	0.9	1.0
CPI, % avg	0.5	4.6	3.3	2.7	3.5	1.7	1.5	1.2	3.0
Nominal wages, % yoy	4.1	-0.2	1.7	4.7	3.1	4.4	1.5	5.0	5.0
Credit extension to private sector, % yoy	10.8	-0.5	6.5	7.0	5.0	3.4	2.0	4.0	4.5
Policy Interest Rate, % eop	4.25	2.50	1.00	2.00	2.75	2.00	1.00	0.50	1.25
1 month inter-bank rate, %, eop	4.50	1.90	1.31	2.06	2.74	1.75	0.99	1.50	1.25
Long-term yield, %, eop	6.17	4.72	5.11	4.75	4.24	3.62	3.65	4.20	4.50
ILS/US$, eop	3.86	3.78	3.79	3.52	3.81	3.73	3.47	3.61	3.81
ILS/US$, avg	4.11	3.58	3.93	3.73	3.58	3.85	3.61	3.51	3.73
Balance of Payments, USD bn									
Current account	5.6	3.1	7.9	7.2	3.3	0.8	3.5	5.9	5.2
% of GDP	3.2	1.4	3.8	3.1	1.3	0.3	1.2	1.9	1.7
Trade balance	-5.2	-6.4	0.7	-2.0	-8.2	-9.3	-13.0	-5.0	-2.3
Exports	50.8	58.0	46.8	56.4	64.3	62.3	61.0	71.0	75.3
Imports	56.0	64.4	46.1	58.4	72.5	71.7	74.0	76.0	77.5
Service balance	3.7	5.0	5.0	6.0	6.9	9.8	12.0	9.0	12.0
Income balance	-0.2	-4.0	-5.1	-5.2	-4.4	-8.0	-3.0	-6.1	-4.5
FDI, net	17.4	18.1	6.1	14.6	16.1	11.8	2.5	4.0	6.0
International reserves	28.6	42.5	60.6	70.9	74.9	76.0	81.8	87.0	95.0
Total amortisations	5.6	4.7	4.5	5.0	5.0	4.0	3.8	4.2	3.0
Public Finances, % of GDP									
Consolidated government balance	0.5	-1.2	-4.2	-2.8	-2.5	-3.5	-2.7	-3.0	-2.5
Consolidated gov primary balance	6.1	4.1	1.0	2.3	2.5	1.4	2.1	3.0	3.0
Public debt	72.9	71.5	73.8	74.5	73.8	72.5	71.7	70.5	67.4
of which Domestic	56.5	57.3	60.1	57.7	57.4	56.4	55.1	53.6	51.2
Foreign Assets & Liabilities, USD bn									
External debt	92.3	89.6	94.6	107.8	105.3	96.9	102.0	104.0	105.0
Public	32.0	28.2	31.2	40.3	36.5	37.0	38.0	40.0	42.0
External debt / GDP	52.8	42.0	46.0	46.5	40.8	37.6	35.0	33.2	33.4
External debt / XGS	127.9	108.1	136.4	132.8	114.8	104.0	112.1	99.0	94.4
Short-term debt	39.9	40.3	42.2	54.4	49.6	44.0	45.0	45.0	45.0
Short-term debt/International reserves (%)	139.6	94.7	69.7	76.7	66.2	57.9	55.0	51.7	47.4

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	3.2	2.8	3.2	3.0	3.0	3.0	3.5	4.5	4.5
CPI, % yoy eop	1.3	1.8	1.2	0.8	1.4	0.9	0.7	1.3	1.1
Policy interest rate, %, eop	1.25	1.00	0.75	0.50	0.50	1.25	1.00	1.00	1.00
Short-term market rate, % eop	1.00	0.99	0.75	0.50	0.50	0.50	1.00	1.00	1.00
Long-term yield, %, eop	3.20	3.50	4.75	4.75	4.75	4.75	4.75	4.75	4.75
ILS/US$, eop	3.53	3.47	3.45	3.46	3.53	3.61	3.65	3.70	3.76

Source: National Sources, Citi Research forecasts

Kazakhstan

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- **Summary view** — We see GDP growth decelerating to 5% in 2014 on the back of heightened uncertainty in the CIS region and a China slowdown. Still, prospects remain favorable in the medium term, as the Kashagan oil field should finally start making a positive contribution to economic activity.
- **Things to watch** — The only macro concern recently has been the deterioration of the CA position, which has been driven by a steady decline in exports related to sluggish global growth. The CA should be structurally supported by Kashagan-related trade flows, although the effect will be felt more strongly only from 2015.
- **Strategy** —The National Bank of Kazakhstan (NBK) effectively devalued the tenge by 20% by announcing a new central level for the USDKZT of 185. The tenge will be allowed to fluctuate between 182 and 188. The NBK has the resources to maintain this new level of the exchange rate, in our view.

Growth has been strong, but will moderate in 2014

GDP growth has been on a broad uptrend since 2010. Kazakhstan recovered strongly from the recession in 2009, posting above 7% GDP growth rates in 2010 and 2011. The pace of economic activity moderated in 2012 in line with more challenging global conditions, with GDP expanding at 5%, and picked up pace to 5.7%YoY year-to-date in the first three quarters of 2013. Sequentially, the economy has accelerated for a fourth consecutive quarter from 4.3%YoY in 3Q12 to 7.3% in 3Q13.

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

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

Inflation has remained within the NBK's 6-8% target. CPI inflation continued its downtrend, moderating to 4.8%YoY in December from a high of 7.0% in February 2013. The decline is broad-based, although driven mainly by lower growth in food and services prices. We estimate inflation will, however, increase this year on the weaker tenge, reaching 6.0% in 2014. This, in our view, will lead in 2015 to 50bpts hike in the policy rate from its current 5.50% level.

2014 GDP will likely decelerate to 5% on heightened regional uncertainty and a China slowdown. Events in Ukraine and Russia should create some headwinds for the Kazakh economy. Industrial production has already started the year on a downbeat note, growing by only 0.8%YoY in January and contracting by 0.6% in February. We believe consumption will remain a key driver, although the pace of expansion will likely moderate from its current strong growth rates. A slowdown in China could also bite.

Weaker external position leads to a currency devaluation

While the broader macro-economy has been healthy, the worsening current account position has been one key reason for concern. The current account was in deficit in 4 out of the last 6 quarters. After posting deficits of US$1.0bn in 3Q12 and US$2.9bn in 4Q12, the current account went into a surplus of US$1.9bn in 1Q13, before transitioning to a small deficit in 2Q13 (US$0.2bn) and plunging into a much bigger deficit in 3Q (US$31.5bn). 4Q13 current account was almost flat at US$0.3bn. Correspondingly, the annual current account surplus dipped from 5.5% of GDP in 2011 to only 0.3% in 2012 and an estimated deficit of 0.2% in 2013.

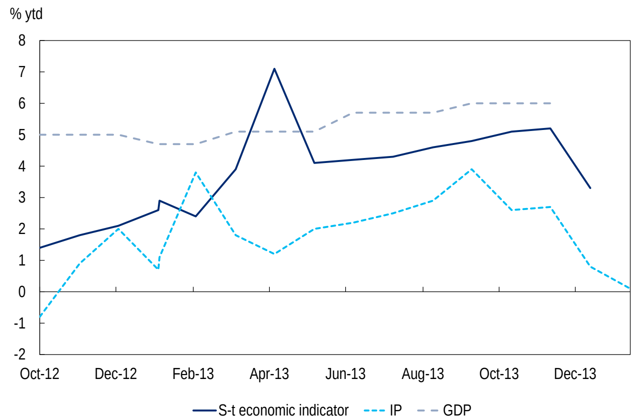
The recent deterioration of the external position has also led to a decline in foreign reserves. Gross foreign reserves have followed current account's performance, falling from US$35.5bn in February 2012 to US$24.5bn in January 2014. This has become the key indicator that has focused market concerns in Kazakhstan.

This led to the National Bank of Kazakhstan (NBK) to devalue the tenge by 20% in early February, citing concerns of a loss of external competitiveness. The new central level for the USDKZT is 185, with the tenge being allowed to fluctuate between 182 and 188. The NBK has a history of adjusting the tenge to sizable moves in the RUB (early 2009 a prime example) and the NBK's statement explicitly cites concerns about the RUB and, more generally, about potential loss of competitiveness. Devaluation fears have also been growing in the country with the FX share of deposits rising rapidly from 29.8% in December 2012 to 37.7% in December 2013.

The NBK had been following a crawling depreciation policy against the US dollar since mid-2011 in line with the worsening current account position. In August 2013, the NBK moved to a currency basket similar to Russia to ensure against changes in USDEUR and USDRUB and to give the NBK more freedom to weaken the KZT via the EUR and RUB.

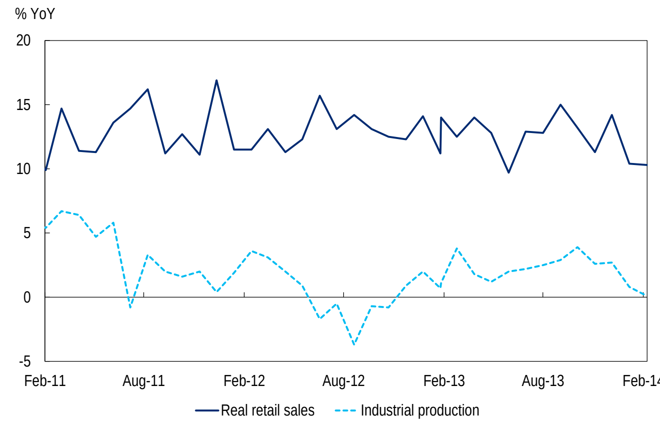
The magnitude of the currency adjustment looks too large. According to the REER (a measure of external competitiveness that the NBK has always referred to), the tenge does not look too strong. The slight loss of competitiveness observed since early 2012 when the REER rose was offset by allowing the tenge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

Figure 152. Growth is still strong…



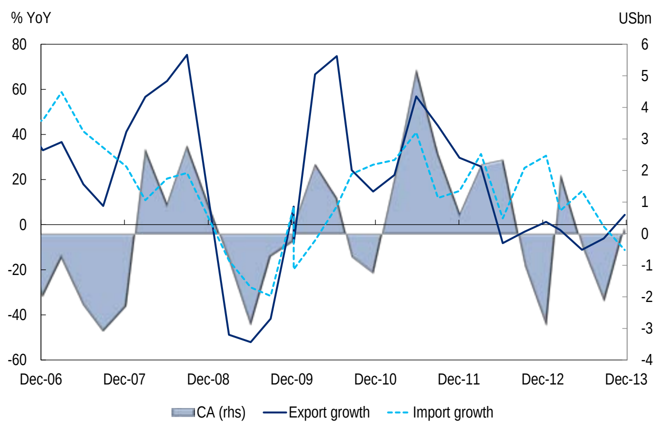
Source: Kazstat, Citi Research

Figure 153. …but is mainly consumption driven as production struggles



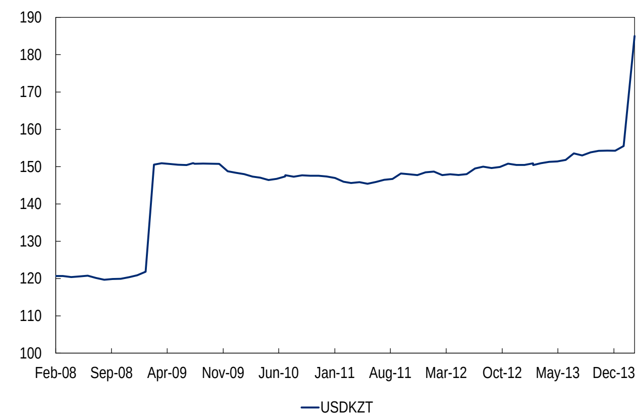
Source: Kazstat, Citi Research

Figure 154. Current account decline led by lower exports…



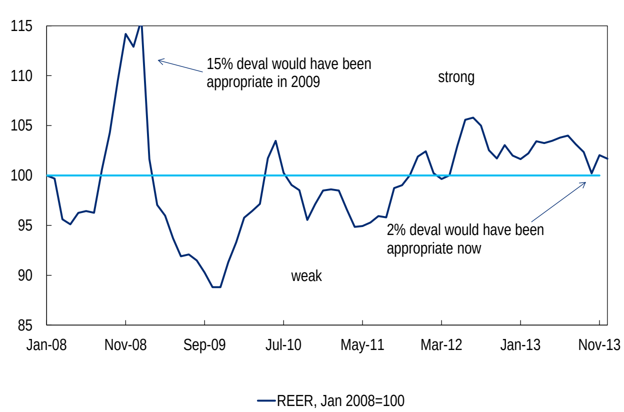
Source: NBK, Citi research

Figure 155. … led to the central bank devaluing the tenge



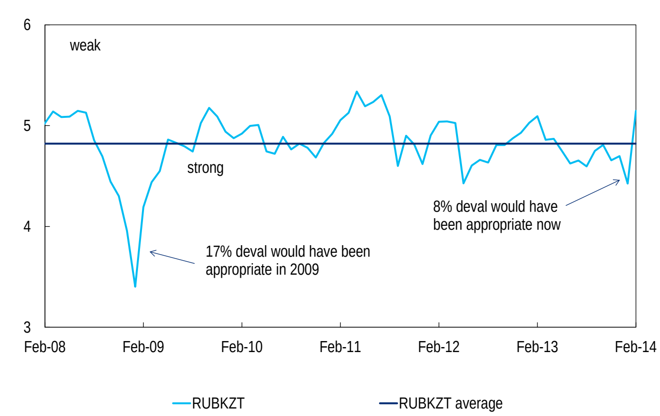
Source: NBK, Citi Research

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



Source: NBK, Citi Research

Figure 157. …and RUBKZT basis



Source: Bloomberg, Citi Research

Figure 158. Kazakhstan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	105	133	115	146	186	202	222	220	225
Nominal GDP, local currency bn	12,528	16,053	17,008	20,557	27,279	30,081	33,705	37,356	41,675
GDP per capita, USD	6,810	8,572	7,324	9,171	11,557	12,404	13,461	13,197	13,358
Population, mn	15.4	15.6	15.7	15.9	16.1	16.3	16.5	16.7	16.9
Unemployment, % of labour force	7.3	6.6	6.6	5.8	5.4	5.3	5.3	5.3	5.3
Economic Activity									
Real GDP, yoy avg	9.2	3.6	0.8	6.9	7.4	4.9	6.0	5.0	6.0
Real investment growth % yoy	23.4	-12.8	2.3	2.1	5.6	6.8	-1.7	3.2	3.2
Real consumption growth % yoy	11.4	5.2	0.7	9.4	11.0	11.2	9.6	7.0	5.9
private consumption growth % yoy	11.1	5.3	0.7	10.2	11.0	11.2	10.3	7.0	6.0
Real export growth, % yoy	9.0	0.8	-11.6	1.9	3.5	4.1	-2.0	4.0	6.0
Real import growth, % yoy	25.8	-11.5	-16.0	0.9	6.9	17.2	7.0	7.0	8.0
Prices, Money & Credit									
CPI, % yoy eop	18.8	9.5	6.2	7.8	7.4	6.0	4.7	6.3	5.5
CPI, % avg	10.8	17.1	7.3	7.1	8.3	5.1	5.7	6.0	5.7
Nominal wages, % yoy	28.1	16.2	10.8	14.9	15.9	13.5	7.0	7.0	8.0
Credit extension to private sector, % yoy	55.2	5.2	7.3	0.3	15.8	12.1	13.6	12.0	12.0
Policy Interest Rate, % eop	11.00	10.50	7.00	7.00	7.50	5.50	5.50	5.50	6.00
1 month inter-bank rate, %, eop	11.50	9.00	4.00	1.50	1.50	1.50	5.50	3.48	3.98
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	121	121	149	147	148	150	154	185	185
KZT/US$, avg	123	120	147	147	147	149	152	170	185
Balance of Payments, USD bn									
Current account	-8.4	6.3	-4.1	1.4	10.2	0.6	-0.4	2.3	3.2
% of GDP	-8.0	4.7	-3.6	0.9	5.5	0.3	-0.2	1.0	1.4
Trade balance	15.2	33.6	15.0	28.5	44.8	37.9	36.6	40.6	44.4
Exports	48.3	72.0	43.9	61.4	85.2	86.9	88.7	95.8	103.4
Imports	33.1	38.4	28.9	32.9	40.3	49.1	52.0	55.1	59.0
Service balance	-8.4	-6.9	-6.0	-7.2	-6.6	-8.0	-5.8	-6.0	-7.0
Income balance	-12.9	-19.4	-12.4	-19.4	-27.7	-28.2	-29.8	-31.3	-33.2
FDI, net	-8.0	-13.1	-10.1	-3.7	-8.6	-11.7	-6.0	-6.0	-8.6
International reserves	17.6	19.9	22.7	27.7	28.8	27.7	23.4	26.6	30.2
Total amortisations	25.5	31.8	30.5	21.1	22.5	23.7	13.2	9.8	9.8
Public Finances, % of GDP									
Consolidated government balance	4.5	-9.3	-9.4	2.7	5.9	0.9	3.2	2.4	2.2
Consolidated gov primary balance	4.8	-8.9	-9.0	3.1	6.3	1.3	3.8	3.0	2.8
Public debt	5.3	6.3	9.5	10.3	10.1	12.1	12.8	13.9	14.7
of which Domestic	4.0	5.1	7.6	7.8	7.6	9.6	10.4	11.7	12.4
Foreign Assets & Liabilities, USD bn									
External debt	66.8	67.7	63.2	65.9	64.8	70.6	77.2	78.7	80.0
Public	1.6	1.7	3.2	4.8	5.1	5.5	4.1	5.6	6.9
External debt / GDP	63.7	50.8	54.8	45.2	34.8	35.0	34.8	35.8	35.5
External debt / XGS	129.0	88.8	131.7	100.7	72.4	76.9	87.0	82.1	77.3
Short-term debt	11.5	9.5	7.0	8.9	8.8	9.3	10.2	10.5	10.6
Short-term debt/International reserves (%)	65.4	47.7	30.8	31.9	30.4	33.7	43.9	39.6	35.2

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	6.9	7.0	4.8	5.1	5.6	4.6	6.5	5.9	5.5
CPI, % yoy eop	5.1	4.7	5.7	6.4	6.4	6.3	5.6	5.6	5.7
Policy interest rate, %, eop	5.50	5.50	5.50	5.50	5.50	5.50	5.50	6.00	6.00
Short-term market rate, % eop	3.00	5.50	3.48	3.48	3.48	3.48	3.48	3.98	3.98
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	154	154	185	185	185	185	185	185	185

Source: National Sources, Citi Research forecasts

Levant

Iraq

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The dispute between the KRG and Baghdad continues, precluding the passing of the 2014 budget. The recent announcement by the KRG that they would resume pumping 100,000 bpd of oil through the Iraq-Turkey Pipeline (ITP) as of 1 April is a welcome gesture of goodwill but, for us, does not signal an imminent breakthrough in ongoing negotiations between the two parties over oil sovereignty and the budget. The KRG export offer is limited and temporary, in that exports will proceed only while negotiations over wider oil sovereignty and the budget are proceeding in a ‘positive direction’.

It is not clear whether any new oil will be physically pumped from the Kurdish North in the near term, given the stockpiling of over 1 million barrels of KRG crude in the port of Ceyhan since the start of the year (Platts, 5 March). The KRG has been unable to sell this stockpile in the absence of Turkish agreement to do so.

We believe a deal on KRG exports is a necessary precondition for the 2014 budget to be approved, given the implications on revenue sources and allocations. In the meantime, the federal government is making monthly disbursements equal to one-twelfth of the previous year’s budget, although the legality of such disbursements is the subject of ongoing legal proceedings.

In our view, the Kurdish gesture to resume exports in part reflects the weakening negotiating position of the KRG as Ankara continues to withhold its consent for independent Kurdish exports, and Baghdad’s non-disbursement of monthly allocations has pushed the Kurdish north to the brink of an economic crisis. However, we believe it also reflects the desire of the KRG to demonstrate that it has done everything it can to ensure a successful outcome to the negotiations (including bowing to external pressure that has been applied to come to a deal), and that any failure to arrive at a final settlement will reflect primarily the intransigence of the Maliki government. In other words, we think this gesture should be seen within the broader context of a Kurdish bid for independent exports, and is in part directed towards Turkey and the United States to secure future support for such exports if negotiations fail.

We do not believe that Baghdad has a strong incentive to make concessions to the Kurds ahead of April elections, reducing the likelihood of a breakthrough prior to that date. PM Maliki’s image as a Shia strongman has been bolstered by his handling of the Anbar crisis and his tough stance on the KRG, and thus his need to secure KRG backing ahead of elections is limited. Indeed, a deal is more likely during post-election maneuvering by political leaders to form a new government, in our view, once parliamentary standings are known and relative bargaining power established, although this is likely to be a drawn-out process.

We remain sanguine about the likelihood of the sectarian violence that has engulfed the Anbar province and parts of the North escalating into all-out civil war, and thus remain optimistic regarding the trajectory of Iraq’s oil production and exports. February saw a surge in exports to record highs, and while March numbers are likely to be down given the extent of sabotage to the ITP in recent weeks, we anticipate the trend will be positive.

That said, we continue to highlight the risk to production from any potential instability in the south: Violence targeted against foreign oil workers last November is a reflection of growing frustration of the local community in the south with a stagnant standard of living, in our view. This frustration is the driving force behind calls for greater regional autonomy in the south, something which may gather momentum following national elections in April. This is because a strong showing for PM Al Maliki and his State of Law coalition may motivate political rivals with strong support bases in the Shia south to attempt to restrict and dilute the PM's increasing executive powers through a push for decentralization and devolution. This is a potential threat to the relative political stability and security the south has enjoyed in recent years, and could have consequences for oil exports. While this risk remains relatively remote for the time being, we believe it is one worth watching going forward.

Lebanon

Prime Minister Tammam Salam's government of 'national interest' has won its vote of confidence in parliament. The government is formed of eight "March 14" ministers, eight "March 8" ministers, and eight neutral ministers aligned with PM Salam and President Sleiman. Its formation was made possible after Mr. Salam reached a compromise deal with Michel Aoun's Free Patriotic Movement on the issue of cabinet rotations. Former Energy Minister Gibran Bassil will move to the foreign ministry, while retaining some responsibilities within the energy ministry. The Energy Minister's role will also go to an MP from within the change and reform bloc (Arthur Nazarian), headed by Aoun. This could indicate greater continuity at the energy ministry, which is in charge of dealing with the pending oil and gas auctions, but we remain cautious on the prospects of this and other economic policy progress in the current political environment.

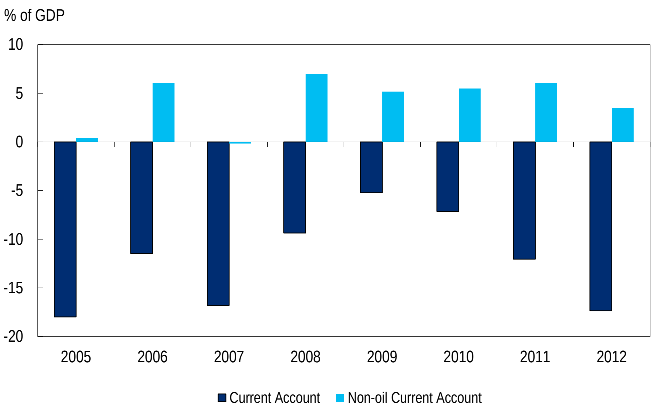
Given the general elections in November, the current government's term will be short-lived and likely focus on two key tasks.

First, it is to prevent the country from sliding further into sectarian strife by filling the leadership vacuum and providing a forum for inter-sectarian dialogue. Violence continued across the country in February, and included another twin suicide bombing targeting Iranian interests in South Beirut in which eight people were killed. We believe the cabinet will have limited success in this, in view of the challenges it faces.

Its second task is to manage the upcoming presidential succession (May) and parliamentary elections (November), after which point it will be disbanded and replaced with a new government (reflecting the results of the latter). Debate over candidates for the presidency has begun, and there is widespread concern regarding the possibility of a presidential vacuum. This happened in the last presidential succession, after Emile Lahood stepped down at the end of 2007 with no successor appointed. It was another six months before Michel Sleiman assumed office, and in the interim the country teetered on the brink of civil war, with fighting in the streets between Hezbollah and the Sunni Future Movement.

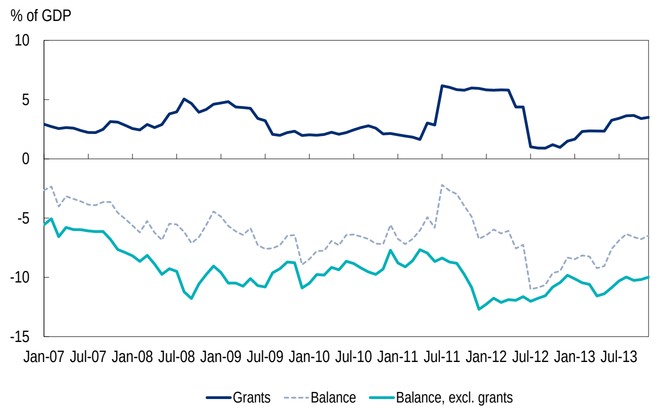
As for the parliamentary elections, disagreement between the various political groupings over the law that will govern the elections was one of the factors behind the collapse of the previous government of Najib Mikati. As far as we can see, there has been no progress in closing the gap between the different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

Figure 159. Jordan current account dominated by oil imports ...



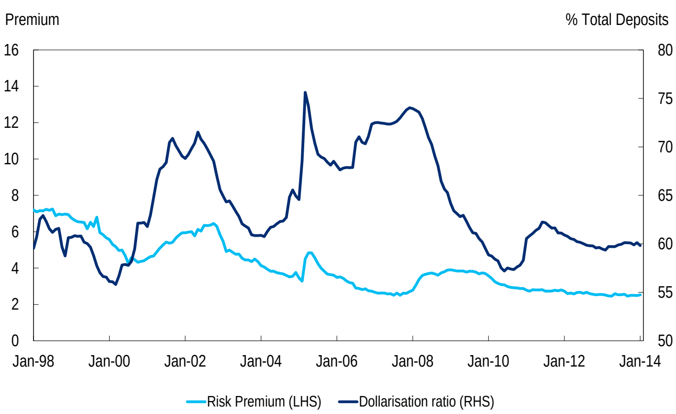
Source: Haver Analytics, Citi Research

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



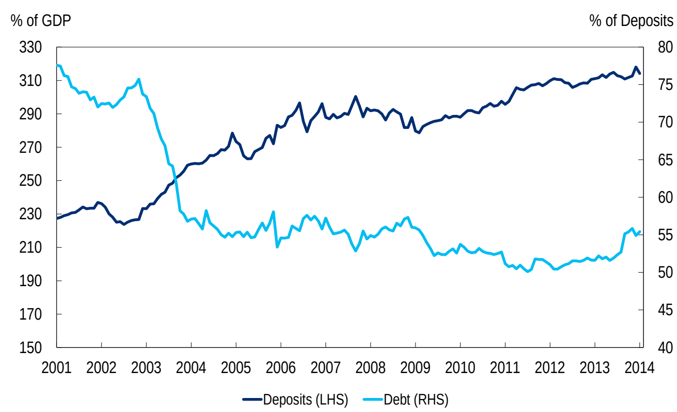
Source: Haver Analytics, Citi Research

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



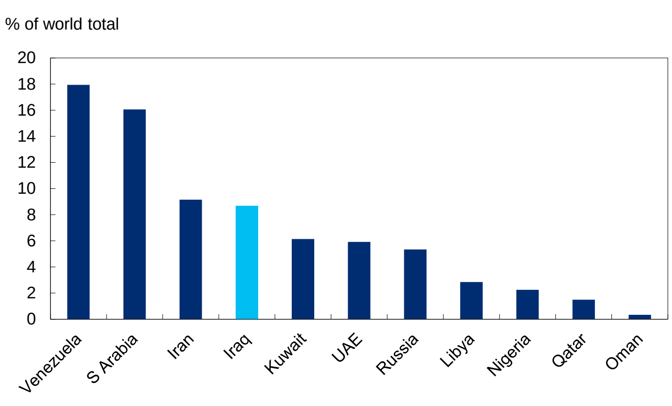
Source: Haver Analytics, Citi Research

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



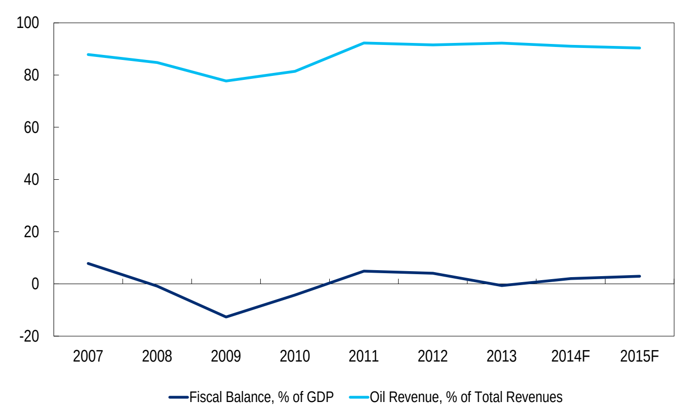
Source: Haver Analytics, Citi Research

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



Source: BP, Citi Research

Figure 164. ... public finances to strengthen on greater oil revenues



Source: Haver Analytics, Citi Research

Figure 165. Levant Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
IRAQ									
Nominal GDP, USD bn	91.7	135.6	113.6	135.9	181.2	213.0	230.8	267.6	313.7
GDP per capita, USD	3,190	4,607	3,766	4,389	5,708	6,545	6,914	7,818	8,936
Real GDP, yoy avg	1.4	6.6	5.8	5.9	8.6	8.4	3.1	10.4	11.6
CPI, % avg	32.6	2.8	-2.8	2.4	5.6	6.1	1.9	3.4	6.0
IQD/US$, avg	1,253	1,189	1,156	1,167	1,171	1,164	1,162	1,162	1,162
Current account, US$bn	20.0	28.4	-1.3	6.3	26.2	38.0	31.1	36.9	40.2
% of GDP	21.9	20.9	-1.1	4.7	14.5	17.8	13.5	13.8	12.8
Consolidated gov. balance, % of GDP	7.8	-0.9	-12.7	-4.3	4.9	4.1	-0.6	2.0	2.9
JORDAN									
Nominal GDP, USD bn	17.1	22.0	23.9	26.5	28.8	30.9	32.8	35.0	37.6
GDP per capita, USD	3,026	3,722	3,866	4,104	4,284	4,404	4,490	4,594	4,739
Real GDP, yoy avg	8.2	7.2	5.5	2.3	2.6	2.7	3.0	4.0	4.5
CPI, % avg	4.7	13.9	-0.7	5.0	4.4	4.8	5.5	4.0	5.0
JOD/US$, avg	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71
Current account, US$bn	-2.9	-2.1	-1.2	-1.9	-3.5	-5.4	-5.0	-5.0	-4.5
% of GDP	-16.8	-9.3	-5.2	-7.1	-12.0	-17.4	-15.2	-14.2	-11.9
Consolidated gov. balance, % of GDP	-5.1	-4.4	-8.9	-5.6	-6.8	-8.3	-8.2	-10.1	-9.9
LEBANON									
Nominal GDP, USD bn	24.6	28.8	35.1	38.0	40.1	43.0	45.3	48.1	51.1
GDP per capita, USD	6,538	7,572	9,111	9,726	10,126	10,647	11,006	11,441	11,936
Real GDP, yoy avg	9.3	9.1	10.3	8.0	2.0	2.5	1.4	2.0	2.4
CPI, % avg	4.1	10.8	1.2	4.0	5.1	6.4	2.1	4.4	5.0
LBP/US$, avg	1,512	1,507	1,504	1,502	1,506	1,504	1,507	1,508	1,508
Current account, US$bn	-1.4	-4.1	-6.7	-7.6	-4.9	-1.7	-2.1	-2.5	-3.1
% of GDP	-5.6	-14.4	-19.2	-20.0	-12.1	-3.9	-4.5	-5.3	-6.0
Consolidated gov. balance, % of GDP	-10.4	-10.1	-8.4	-7.6	-5.8	-9.1	-10.0	-9.3	-8.7

Source: National Sources, Citi Research forecasts

Nigeria

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

- **Things to watch** — The suspension of Lamido Sanusi as central bank governor means that the naira is likely to remain under pressure in March. How the CBN responds to this will be crucial in understanding its overall commitment to naira stability going forward.

- **Strategy** — The finance minister, Ngozi Okonjo-Iweala, will seek to maintain fiscal discipline despite the approaching elections. But this will become increasingly difficult, while progress with structural reform is likely to be limited as the year progresses.

2014 is a pre-election year

With Nigeria set to hold presidential and parliamentary elections in February 2015, 2014 is a pre-election year. This is already clear from the recent very public divisions within the ruling People's Democratic Party (PDP), with a significant number of its existing governors and National Assembly representatives switching their political allegiance to the opposition All Progressives Congress (APC) in recent months. This highlights how tense the political scene is likely to become in the coming 12 months, although it is still far too early to be sure how the politics will eventually play out.

Meanwhile, the rise in political tension is already driving a deeply partisan debate over the 2014 budget in the National Assembly. Ms Okonjo-Iweala is pushing hard to maintain a tight fiscal stance, but this is already running up against political demands for higher spending. Given the major political battle over the budget, the reality is that a final version may not approved until well into 1H 2014. But whatever the projections in the budget eventually passed, the real key to the fiscal stance in 2014 may be the nature of supplementary budgets passed in 2H 2014 and the overall oil production level achieved, making forecasting complicated.

We also expect only very limited progress with structural reform this year. This includes the passage of the proposed Petroleum Industry Bill (PIB) and Sovereign Wealth Fund (SWF). However, there could be some further progress with electricity sector reform as this is a crucial platform for President Goodluck Jonathan if he intends to seek re-election in 2015, providing a concrete sign of what he has achieved while in office.

But growth should remain robust

But while a deteriorating political environment is not good for growth, we expect it to remain over 6%. But overall we still think that growth will be constrained by only limited increases in oil production given recent problems with production and with the approaching elections raising political tensions in the Niger Delta. The growth picture will also be complicated by the fact that the National Bureau of Statistics is planning to implement a GDP rebasing exercise in 1H 2014. This is likely to result in the value of GDP being increased around 40% and the overall trend of greater service sector driven growth further confirmed with the importance of the oil sector downgraded.

Change and continuity at the CBN

From late 2011 to late 2013 the Central Bank of Nigeria (CBN) was able to maintain a stable naira on the back of strong portfolio inflows. But at times the naira still came under pressure meaning that even though inflation has fallen sharply throughout 2013, the CBN has shown little inclination to loosen monetary policy. But the situation has become more complicated in early 2014 as the slow but steady fall in reserves has continued due to investor outflows. Initially these seemed to mirror the general EM sell off, but the decision to suspend the CBN governor in February also increased investor uncertainty about CBN independence a move which clearly increased pressure on the naira in the short term.

All eyes will now be on the next MPC meeting to be chaired by the acting governor, Sarah Alade. While she is unlikely to change naira policy significantly it will be interesting to see if the MPC votes for a rise in the MPR. This would confirm its commitment to maintain naira stability, with further justification coming from concerns about the potential for rising inflation in 2H 2014 and a possible deterioration in the fiscal position (or the ongoing running down of savings in the excess crude account (ECA)).

While a further tightening of monetary policy should help achieve naira stability, we still think the naira will be under pressure for much of 2014. Given this, much will now depend on who replaces Mr Sanusi, with Godwin Emefiele, the name put forward to the Senate by the president. Although his economic policy views are not known, unless he seeks to fundamentally review the current naira policy, what we expect is periodic bouts of weakness throughout the year driven by myriad factors, but often domestic capital outflows. But it should still bounce back, with overall only relatively modest depreciation expected for the year as a whole.

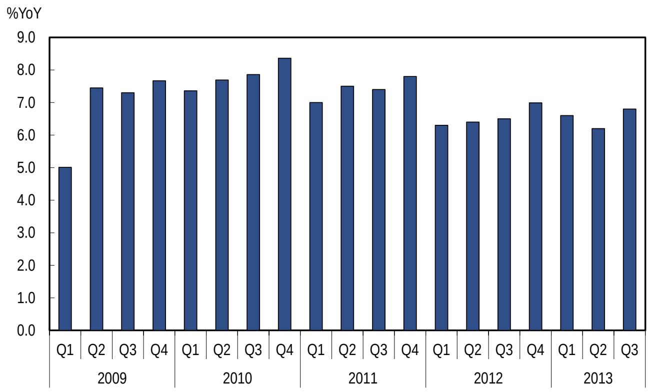
The oil price-production question and reserves

The other variables to consider when thinking about the naira outlook and policy are the oil price and the level of production. In 2013, production has been under pressure, but this has been offset by a high oil price of well over US$100/ barrel. This equation could be reserved as 2014 progresses with rising oil production offsetting an easing price, but if either, or both, were to come under more sustained pressure, the current governor has made it clear that the CBN would have to revisit its exchange rate policy. We also think the CBN's response to naira pressure will be driven by the rate of reserve burn and the potential emergence of differential between the parallel and official exchange rates. In particular, we think that once reserves fall towards around the US$34bn level, the CBN would have to more actively consider the prospects of devaluing the naira.

Macroeconomic and naira stability for now

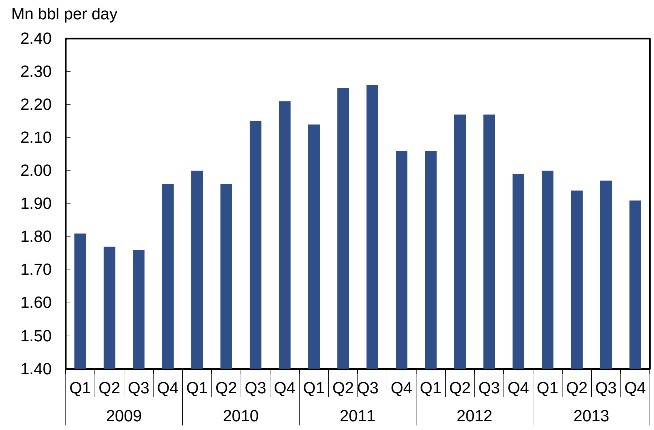
We expect that the current economic management team will be able to maintain macroeconomic and naira stability in 1H 2014. But in 2H the overall macroeconomic and political outlook will become distinctly more complicated as the pace of electioneering is bound to gather pace. But while this would imply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

Figure 166. Growth, although robust, has been under some pressure since 2012



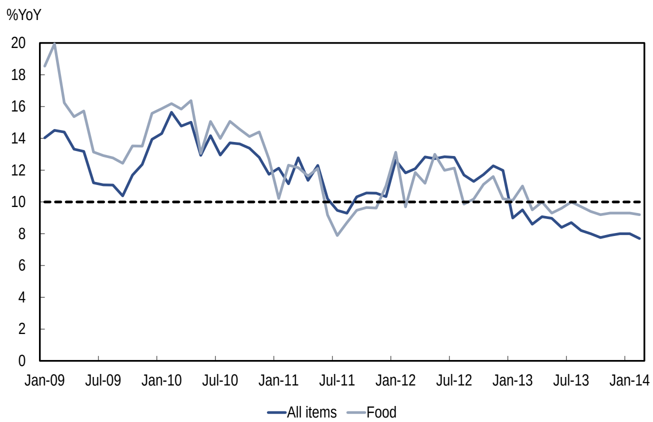
Source: National Bureau of Statistics

Figure 167. Oil production has been on a downward trend since mid-2012



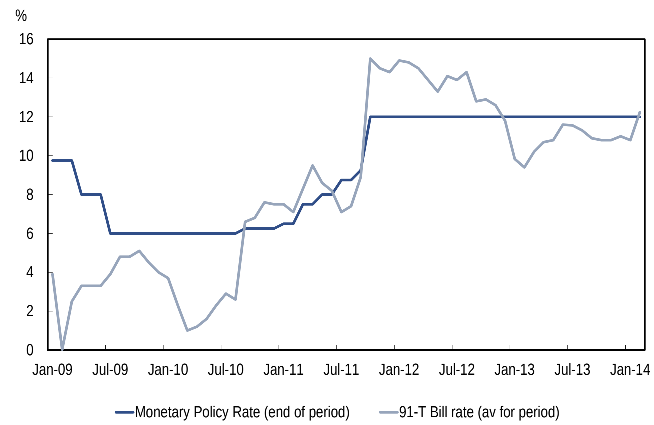
Source: International Energy Agency

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



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

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

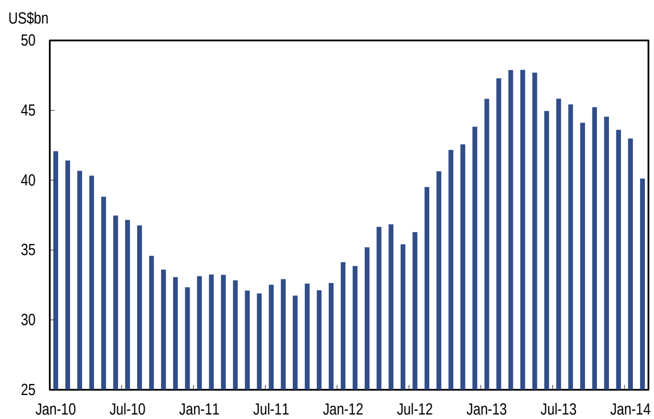


Source: Central Bank of Nigeria

Figure 170. The pressure on the naira has resurfaced since late 2013

Source: Reuters

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



Source: Haver Analytics and Central Bank of Nigeria

Figure 172. Nigeria Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	164	204	166	225	240	255	322	360	410
Nominal GDP, local currency bn	20,657	24,296	24,794	33,985	37,410	40,544	46,861	54,356	63,923
GDP per capita, USD	1,119	1,356	1,072	1,421	1,478	1,533	1,887	2,053	2,284
Population, mn	146.8	150.6	154.4	158.4	162.4	166.6	170.8	175.2	179.7
Unemployment, % of labour force	-	-	-	-	-	-	-	-	-
Economic Activity									
Real GDP, yoy avg	6.4	6.0	7.0	8.0	7.4	6.6	6.5	6.6	6.4
Real investment growth % yoy	41.7	-0.7	34.7	18.3	-10.8	-19.9	-	-	-
Real consumption growth % yoy	42.4	-7.5	20.3	-2.5	8.4	-11.7	-	-	-
private consumption growth % yoy	37.6	-19.4	31.7	-9.0	8.9	-11.3	-	-	-
Real export growth, % yoy	-17.7	28.8	-30.7	53.5	32.4	2.7	-	-	-
Real import growth, % yoy	85.5	-11.3	11.7	12.7	22.7	-38.5	-	-	-
Prices, Money & Credit									
CPI, % yoy eop	6.6	15.1	13.9	11.7	10.3	12.0	8.0	10.0	10.1
CPI, % avg	5.4	11.6	12.5	13.7	10.8	12.2	8.5	8.8	10.6
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	97.1	59.4	26.8	-3.8	44.3	6.8	12.0	11.0	19.0
Policy Interest Rate, % eop	9.50	9.75	6.00	6.25	12.00	12.00	11.75	11.75	12.50
1 month inter-bank rate, %, eop	12.50	18.00	15.79	13.07	17.17	14.39	15.00	14.00	13.00
Long-term yield, %, eop	9.25	9.25	11.80	8.50	8.00	12.01	13.26	12.00	13.50
NGN/US$, eop	118	138	150	152	162	156	160	168	172
NGN/US$, avg	126	119	150	151	156	159	159	165	169
Balance of Payments, USD bn									
Current account	27.6	29.1	14.0	14.5	12.6	20.4	22.4	15.8	10.7
% of GDP	16.8	14.3	8.5	6.4	5.2	8.0	7.0	4.4	2.6
Trade balance	37.8	45.9	25.7	31.7	35.0	42.4	43.6	39.4	36.9
Exports	66.1	85.7	56.8	78.5	97.2	96.0	95.4	93.2	93.8
Imports	28.3	39.8	31.1	46.8	62.2	53.6	51.8	53.8	56.9
Service balance	-16.9	-22.1	-16.7	-18.5	-21.4	-21.7	-22.5	-24.4	-25.6
Income balance	-11.8	-15.1	-14.6	-19.7	-23.0	-22.3	-20.1	-19.6	-21.3
FDI, net	-	-	-	-	-	-	-	-	-
International reserves	51.3	53.0	42.4	32.3	32.9	43.8	43.6	37.8	39.2
Total amortisations	0.9	0.6	0.5	0.5	0.4	0.3	0.3	0.3	0.3
Public Finances, % of GDP									
Consolidated government balance	-0.6	-0.2	-3.3	-3.3	-3.1	-2.2	-2.6	-2.9	-2.9
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	10.9	8.5	13.0	13.3	14.5	14.8	14.2	14.4	14.2
Foreign Assets & Liabilities, USD bn									
External debt	3.4	3.7	4.6	4.6	5.7	6.5	8.3	9.4	13.0
Public	3.0	3.2	3.9	4.4	5.0	6.0	6.8	7.2	10.0
External debt / GDP	2.1	1.8	2.8	2.0	2.4	2.6	2.6	2.6	3.2
External debt / XGS	5.0	4.2	7.7	5.6	5.6	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2015 Q3F
GDP, % yoy	7.0	6.6	6.2	6.8	6.8	6.2	6.3	6.4	6.9
CPI, % yoy eop	12.0	8.6	8.4	7.9	7.9	7.6	8.8	9.5	10.1
Policy interest rate, %, eop	12.0	12.0	12.0	12.0	12.0	12.0	12.5	12.5	12.0
Short-term market rate, % eop	13.0	10.9	11.0	11.4	11.1	15.0	12.0	14.0	14.0
Long-term yield, %, eop	12.0	11.0	13.6	13.3	13.3	13.7	13.1	12.6	13.1
NGN/US$, eop	156	159	163	161	160	165	163	166	169

Source: National Sources, Citi Research forecasts

Poland

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- **Summary view** — We keep our forecast of 3.4% growth in 2014 and recently published data seems to support this view, with domestic demand being an important driver behind the current recovery.
- **Things to watch** — Due to its geographical proximity to Russia the Polish economy may be potentially affected by developments in Crimea and Ukraine. A deep drop in exports to CIS might prompt some revision of growth forecasts.
- **Strategy** — We still assume an increase in yields due to Fed's QE and stronger growth though it will come more slowly due to low inflation and extended forward guidance signaling flat rates for longer. Zloty not likely to escape the weakness of other EM FX.

Growth despite increased Russia-Ukraine uncertainty

All data releases for the domestic economy point to an unabated recovery in Poland, driven by both domestic demand and net exports. Industrial output rose by 5.6% YoY (adjusted for working days), while construction output jumped by an impressive 14.2% YoY, partly thanks to improved weather conditions after a very weak January. This was accompanied by further gradual improvement in the labour market, as real wages increased by 3.3%. The data is consistent with further acceleration in GDP growth in 1Q, probably above 3%, and we believe this trend will continue later this year.

The key risk factor for the scenario of continued strong growth is related to external factors and in particular uncertain geopolitical situation due to the Crimea situation. Poland's direct trade links with Ukraine are relatively small but exports to Russia are more important as the Russian market absorbs approximately 5% of Polish exports. This means that even in the case of a substantial slowdown in the CIS Poland's growth should remain relatively strong, especially in that external shocks can be offset by strong domestic demand. However, in the case of full scale sanctions that could lead to a collapse in Poland-Russia trade (not our base-case scenario), Poland's export structure suggests that GDP growth could be lowered by 2.0-2.5 percentage points vs. our current estimate (3.4%). Even if no serious sanctions are imposed, the geopolitical uncertainty could negatively affect economic sentiment and thus weigh on consumer and/or investment demand. However, so far we haven't seen any signs of confidence being seriously affected.

Stubbornly low inflation

January and February inflation data once again brought a downward surprise. The consumer price inflation in February reached 0.7% YoY and was again below not only the inflation target of 2.5% but also the floor of the +/-1ppt bank around the target. Clearly core inflation is very low and there are no signs of inflation pressures in Poland. Additionally, in the short term food prices are likely to grow slower than seasonal patterns would suggest, mostly due to a ban on Polish pork exports to several countries. Our current forecasts suggest the CPI will fluctuate below or close to 1% until July and will start rising thereafter, eventually reaching 1.5% by the end of the year and 2.5% in early 2015. Given the Ukraine-Russia crisis, there is a large risk related to both energy and food prices in the coming months and for the time being we assume a scenario of food prices changing generally consistent with long-term averages.

Rates on hold for longer

Although the Monetary Policy Council left rates steady at its March meeting it surprised us and the market by extending quasi forward guidance. The MPC said rates would remain steady at least until the end of 3Q14 (previously 2Q) while Central Bank Governor Belka emphasized in a Q&A session that rates might remain stable even longer. The key reason behind this change was the publication of a inflation projection showing that the central bank's target of 2.5% would be hit only in late 2016. At the same time the GDP projection was revised up and showed substantial acceleration in economic growth, above 3.5% in 2014, thus beating our already above-consensus GDP forecast.

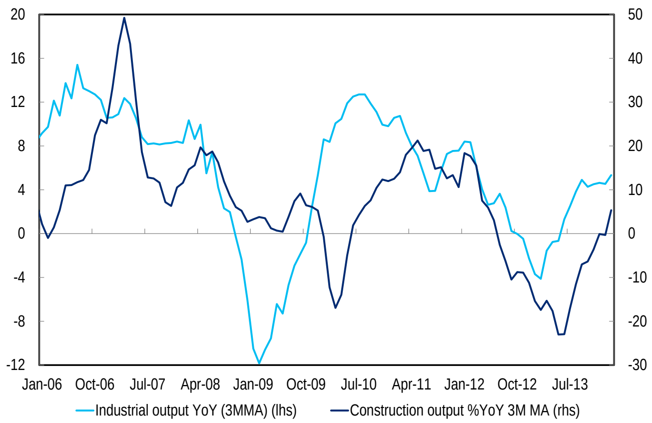
Taking into account the change in forward guidance we now expect the tightening cycle in Poland will begin in 1Q 2015, with some chance of an earlier hike if inflation surprises to the upside. We expect that the first increase will be followed by a series of rate hikes (by 25bps every two or three months) and the tightening cycle will finish with the base rate at around 4%, still below the medium term average. The biggest risk to the scenario is planned changes in the MPC, as the government wants to appoint additional three new members, thus temporarily expanding the MPC to 13 members. This is to be done in order to implement staggered terms and we believe this change will be beneficial for the quality of policymaking in Poland but one consequence will be greater uncertainty regarding the direction of monetary policy in 2015. The impact on the MPC may be significant depending on who is appointed to the Council.

Slower increase in yields and zloty weakening

We expect an increase in yields on less dovish Fed policy and GDP growth acceleration, although it will be more gradual due to a dovish MPC and low inflation. We still expect further QE tapering and also above-consensus and above-potential GDP growth will likely lead to higher yields in the next quarters. However, as the MPC extended the forward guidance signaling rates will stay flat at least until the end of 3Q and inflation data surprised to the downside, we currently expect the monetary policy prospects will limit potential for yields increase over the short term. Especially, as some Council members' suggest that rates could stay unchanged even in the whole horizon of the NBP projection. Therefore, we expect that the yield curve is likely to be lower in the next few months than we assumed earlier, even despite the upward revision in GDP growth. The pressure on yields from higher economic growth and core yield will be also limited by high advancement in realization of borrowing needs, which currently amounts to around 70%, i.e. much more than in the same period of time in the previous years. Consequently, we expect yield curve flattening to start only near the moment of first interest rate hike, i.e. at the turn of the year.

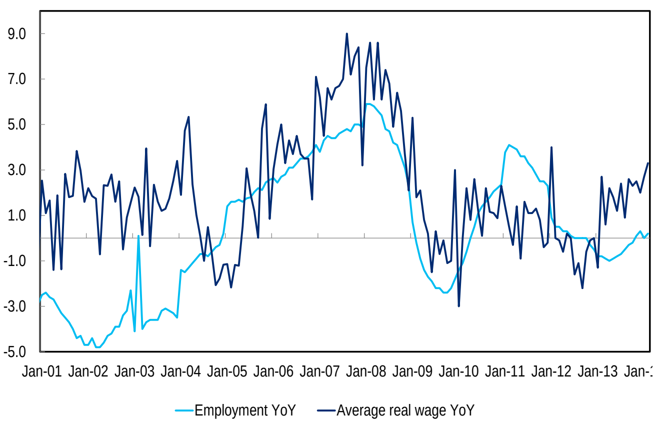
The zloty will not escape the expected EM FX weakening trend. We assume that the less dovish Fed policy and gradually commencing interest rate hikes in the US will likely lead to EM weakness, which will also hurt the zloty. Moreover, the PLN is likely to be under negative impact of any further escalation of situation in the Ukraine, which would likely lead to higher geopolitical risk, risk aversion and negative effect on GDP growth. Relatively high real rates amid slow increase in inflation will likely be not enough to offset negative factors for the zloty. Although strong economic growth can have positive impact on the FX, it will also result in the widening of the current account deficit.

Figure 173. Output growth improves in construction and manufacturing



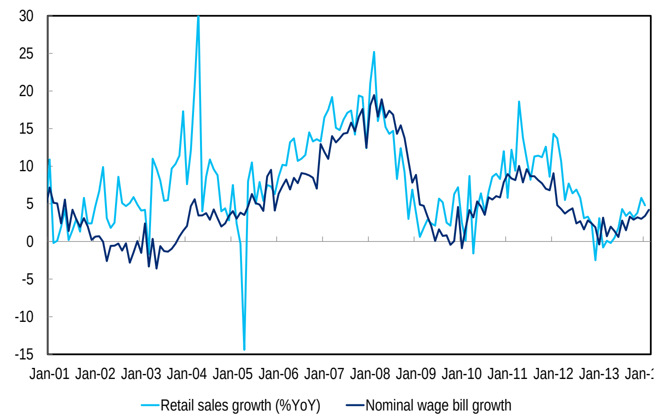
Source: CSO, Citi Research

Figure 174. Rising employment and moderate wage growth amid very low inflation supports real wage bill growth



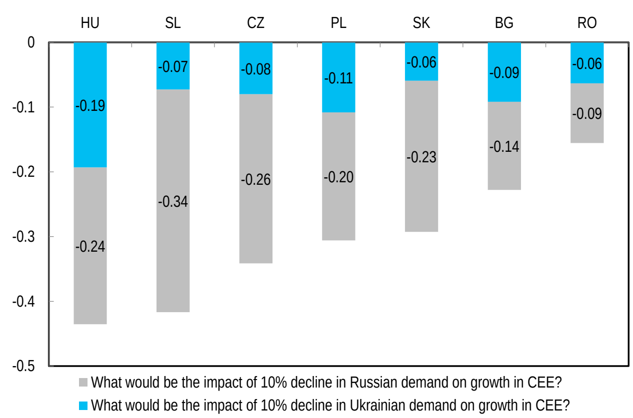
Source: CSO

Figure 175. Labour market recovery supports private consumption



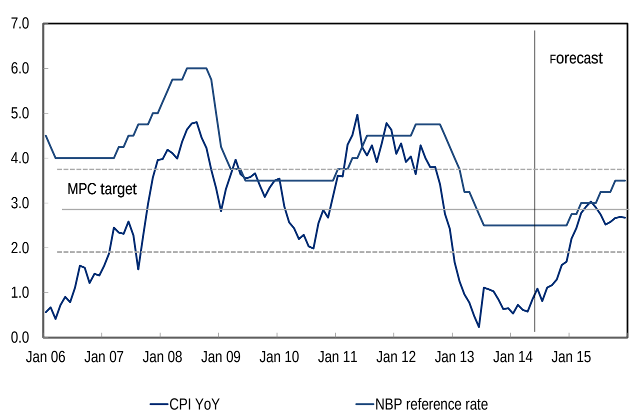
Source: CSO

Figure 176. Intensification of situation in Ukraine will likely have a negative impact on GDP growth



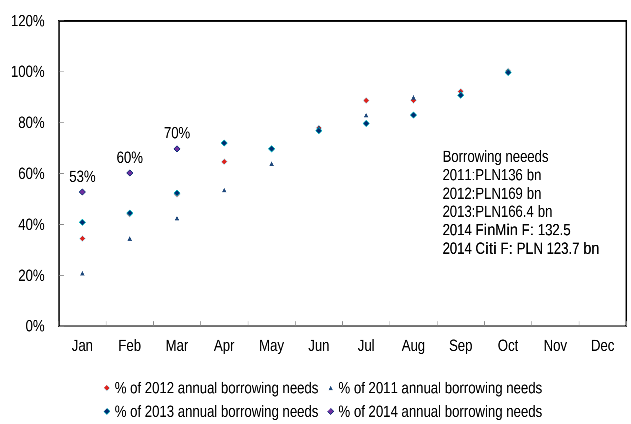
Source: Citi Research estimates

Figure 177. Inflation to increase slowly with first rate hike in 2015



Source: CSO, Citi Research estimates

Figure 178. Expected yield increases in coming months will likely slow



Source: Ministry of Finance

Figure 179. Poland Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	426	534	433	470	517	490	516	553	606
Nominal GDP, local currency bn	1,175	1,275	1,343	1,414	1,526	1,594	1,632	1,698	1,796
GDP per capita, USD	11,185	13,994	11,347	12,210	13,404	12,721	13,416	14,353	15,752
Population, mn	38.1	38.1	38.2	38.5	38.5	38.5	38.5	38.5	38.5
Unemployment, % of labour force	11.2	9.5	12.1	12.4	12.5	13.4	13.4	12.4	11.7
Economic Activity									
Real GDP, yoy avg	6.8	5.1	1.6	3.9	4.5	1.9	1.6	3.4	3.6
Real investment growth % yoy	24.3	4.0	-11.5	9.3	11.2	-4.2	-4.9	8.3	4.5
Real consumption growth % yoy	4.6	6.1	2.0	3.4	1.6	1.0	1.1	2.5	3.0
private consumption growth % yoy	4.9	5.7	2.1	3.2	2.6	1.2	0.8	2.7	3.2
Real export growth, % yoy	9.1	7.1	-6.8	12.1	7.7	2.8	4.3	5.9	6.5
Real import growth, % yoy	13.7	8.0	-12.4	13.9	5.5	-1.8	0.7	6.7	7.5
Prices, Money & Credit									
CPI, % yoy eop	3.9	3.4	3.7	3.2	4.6	2.6	0.8	1.7	2.7
CPI, % avg	2.5	4.2	3.5	2.6	4.3	3.7	0.9	1.0	2.7
Nominal wages, % yoy	9.1	10.5	4.2	3.6	4.9	3.5	2.6	3.9	4.8
Credit extension to private sector, % yoy	31.5	36.4	7.0	8.5	13.9	2.4	4.5	8.0	12.0
Policy Interest Rate, % eop	5.00	5.00	3.50	3.50	4.50	4.25	2.50	2.50	3.50
1 month inter-bank rate, %, eop	5.52	5.61	3.76	3.66	4.77	4.21	2.61	2.80	3.77
Long-term yield, %, eop	5.93	5.46	6.24	6.07	5.91	3.73	4.34	4.65	5.05
PLN/US$, eop	2.47	2.97	2.87	2.97	3.45	3.09	3.02	3.10	2.88
PLN/US$, avg	2.76	2.39	3.10	3.01	2.96	3.25	3.16	3.07	2.97
PLN/EUR, eop	3.60	4.15	4.10	3.97	4.47	4.08	4.15	4.34	4.06
PLN/EUR, avg	3.78	3.52	4.32	3.99	4.12	4.18	4.20	4.27	4.17
Balance of Payments, USD bn									
Current account	-26.5	-34.9	-17.3	-24.1	-25.8	-18.1	-7.8	-13.9	-21.8
% of GDP	-6.2	-6.5	-4.0	-5.1	-5.0	-3.7	-1.5	-2.5	-3.6
Trade balance	-19.1	-30.7	-7.6	-11.8	-14.1	-6.7	2.6	2.1	-2.3
Exports	145.3	178.7	142.1	165.9	195.2	191.0	206.0	233.2	269.9
Imports	164.4	209.4	149.7	177.7	209.3	197.7	203.4	231.1	272.1
Service balance	4.8	5.0	4.8	3.1	5.7	6.0	6.6	6.1	6.2
Income balance	-16.4	-12.8	-16.6	-19.1	-23.6	-22.6	-22.2	-27.8	-32.6
FDI, net	18.0	10.4	8.5	6.9	12.3	5.2	0.4	4.0	6.0
International reserves	54.6	57.2	69.7	81.4	86.8	96.1	94.0	86.2	87.1
Total amortisations	43.0	44.0	46.9	43.4	42.8	44.5	47.2	44.9	43.6
Public Finances, % of GDP									
Consolidated government balance	-1.9	-3.7	-7.5	-7.9	-5.0	-3.9	-4.2	5.7	-2.3
Consolidated gov primary balance	0.4	-1.5	-4.9	-5.2	-2.3	-1.1	-1.5	8.2	0.2
Public debt	44.8	46.9	49.8	52.8	53.5	52.7	54.4	46.6	45.9
of which Domestic	34.3	34.8	36.7	38.4	36.5	36.1	37.2	28.4	29.0
Foreign Assets & Liabilities, USD bn									
External debt	233.3	244.8	280.2	317.1	323.3	365.7	363.0	351.0	345.0
Public	86.8	69.4	92.2	116.5	120.2	137.6	136.5	132.0	129.8
External debt / GDP	54.7	45.9	64.7	67.4	62.6	74.6	70.3	63.5	57.0
External debt / XGS	133.9	114.2	163.8	159.6	138.9	159.8	147.4	126.5	107.4
Short-term debt	60.9	65.9	70.0	77.2	71.9	70.5	75.4	73.4	72.4
Short-term debt/International reserves (%)	111.4	115.1	100.4	94.9	82.8	73.3	80.2	85.1	83.1

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	2.0	2.3	3.2	3.2	3.5	3.7	3.3	3.3	3.7
CPI, % yoy eop	1.0	0.7	0.6	1.1	1.2	1.7	2.8	2.9	2.6
Policy interest rate, %, eop	2.50	2.50	2.50	2.50	2.50	2.50	3.00	3.00	3.25
Short-term market rate, % eop	2.59	2.61	2.62	2.62	2.62	2.80	3.17	3.30	3.57
Long-term yield, %, eop	4.52	4.42	4.30	4.40	4.50	4.65	4.80	4.95	5.00
PLN/EUR, eop	4.22	4.15	4.20	4.24	4.30	4.34	4.27	4.20	4.13

Source: National Sources, Citi Research forecasts

Romania

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- **Summary view** — While we expect growth drivers to gradually switch from net exports to domestic demand this year, domestic demand has yet to display a meaningful pick up.
- **Things to watch** — Political stability ahead of the November 2014 presidential election and the implementation of the IMF-EU supported economic program deserve close monitoring.
- **Strategy** — The NBR's decision to relax RON liquidity again is likely to revive concerns about the leu outlook, in our view.

Still waiting for a pick-up in private investment

Detailed data on the 4Q GDP outturn suggests that domestic demand has yet to display a meaningful recovery. Specifically, while a quick look at seasonally adjusted data points to a moderate pick-up in consumer spending, private investment still remains subdued. Consequently, domestic demand as a whole continues to be weak, as net exports remain the main engine of growth. The noted composition, in turn, casts doubt on the sustainability of the upward momentum for the recovery. In this respect, it is worth reiterating that Romania's demand recovery remains considerably behind its regional peers since the deleveraging process continues to be a significant drag on private consumption and investment spending.

Recent growth indicators paint a relatively upbeat picture for the growth outlook. Specifically, standing at 2.3% (SWA, %MoM), the January IP reading suggests that exports remain strong. In parallel, retail sales figures in January also paint an encouraging picture for the first quarter. Against this backdrop, we look for a moderate pick-up in domestic demand this year. Specifically, we expect growth drivers to switch from net exports to domestic demand—private investment in particular, owing to the likely acceleration in the absorption of EU funds—with GDP growth reaching 3.0% in 2014. We note that the balance of risks to the outlook appear tilted to the downside since the banking system remains heavily dependent on parent funding, exposing the economy to spillover risks from the euro area, and is vulnerable to currency depreciation given substantial FX lending.

The best of inflation is probably behind us

At 1.1% YoY, the inflation outturn in February came in higher than the consensus (1.0%YoY). Using seasonally adjusted data, the February print translates into a rise of about 0.1% MoM compared with an increase of around 0.4% MoM in January and a rise of around 0.3% MoM in December. Developments to date seem to confirm our expectation that last year's inflation performance will be hard to repeat in 2014. Specifically, a quick glance at the CPI components suggests that service and non-food prices remain sticky, while there are signs suggesting that a reversal on food inflation may be under way. The noted backdrop, coupled with higher excise duties, led us to look for a year-end inflation of 4.0%, which is more pessimistic than the NBR's most recent projection of 3.5%. In our view, the possibility of a sharper reversal in food inflation, which cannot be ruled out, and a weaker leu emerge as the key risk factors that require close monitoring.

Will NBR opt for additional RRR cuts?

We find it difficult to reconcile the NBR's 25bp rate cut at the February Board meeting with the upward revision of the Bank's year-end forecast to 3.5% from 3.0%, which brings the real policy rate to 0%. In fact, since money market rates are fluctuating below the policy rate, the monetary policy stance is even more accommodative in practice. In this regard, we are puzzled by the NBR's decision to relax RON liquidity again after pushing money market rates close to the policy rate in the first half of February.

Looking ahead, we believe that the focus will be on two issues. First, whether there will be additional reductions in the VAT rate for certain products. Second, whether the NBR will carry out further cuts in RRRs. Given the already low money market rates, we believe that the NBR is unlikely to lower RRR in the near future. Regarding the possibility of the VAT rate cut, while we have to wait and see the reaction of the IMF, we realize that this is a very popular measure and may go through. Nonetheless, the risks on the inflation front and the possibility of a weaker than widely expected leu lead us to believe that the NBR will keep rates steady at 3.5% for the remainder of the year.

Strong revenues bolster January budget performance

Standing at around RON 1.5 billion, the budget surplus in January is considerably stronger than the surplus observed in the same month of 2013 (around RON 1.0bn). This outcome is largely driven by robust revenues, which were up by over 10%YoY. The government approved a budget consistent with a deficit target of 2.2% of GDP for 2014. Under the umbrella of the existing program, the authorities intend to continue fiscal adjustment in 2015 with a view to attaining a structural deficit of 1% of GDP, while also accommodating expected further increases in co-financing of projects supported by the EU

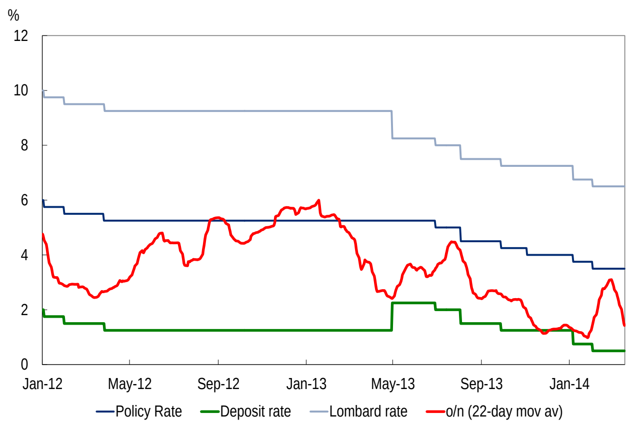
Current account gap is on track to widen moderately

Romania's current account balance printed a stronger surplus in January (EUR 0.4bn) in January when compared with the same month of 2013 (EUR 0.3bn). This outcome was mainly driven by a narrower trade deficit and a moderate improvement in services balance. In line with our expectations of a moderate pick up in domestic demand and private credit growth, we expect the current account deficit to widen to around 2.5% of GDP this year from 1.1%. Despite the encouraging backdrop, signs of a secular decline in the level of capital inflows are becoming more evident.

NBR relaxes RON liquidity, again

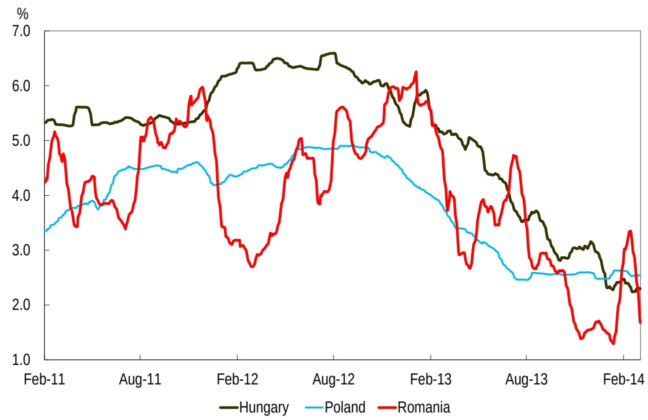
The recent developments have alleviated concerns about the political outlook and the fate of the EU-IMF supported economic program. However, we believe that the NBR's decision to drive money markets below the policy rate again is a source of concern. Specifically, Romania has the lowest interbank o/n interest rate when compared with its peers in the region. Moreover, we also observe a marked increase in the volatility of the leu, which probably reflects the NBR's increased pain threshold for FX volatility. All in all, we believe that the NBR's policy stance is hard to square with the difficult global environment and domestic risks. Against this backdrop, the issue of whether Romania's interest rate provides adequate buffer is likely to receive greater attention going forward, in our view.

Figure 180. NBR relaxes RON liquidity, again...



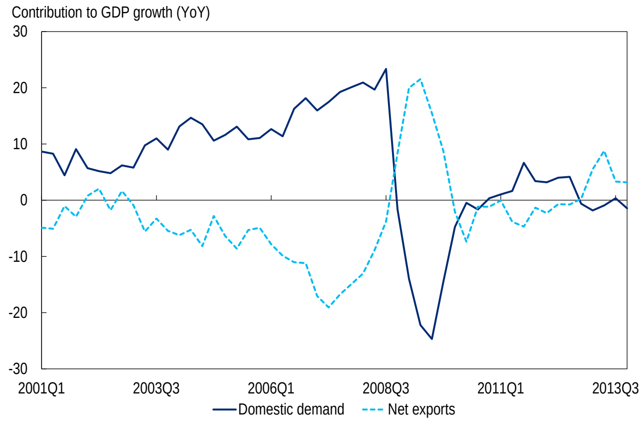
Source: Haver Analytics and Citi Research

Figure 181. ...driving money market rates lower...



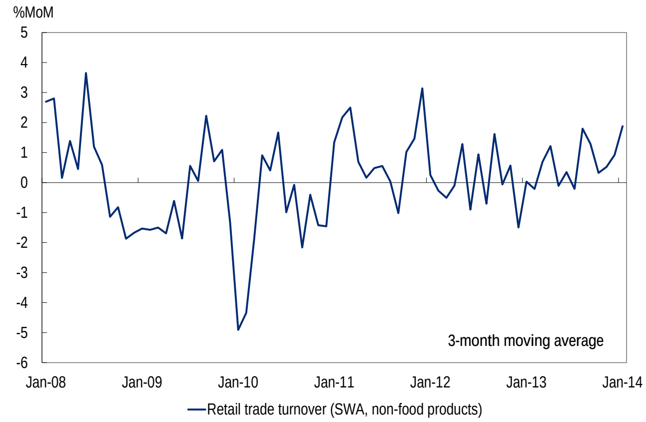
Source: Haver Analytics and Citi Research Note: 22-day moving average

Figure 182. Low rates are yet to stimulate domestic demand...



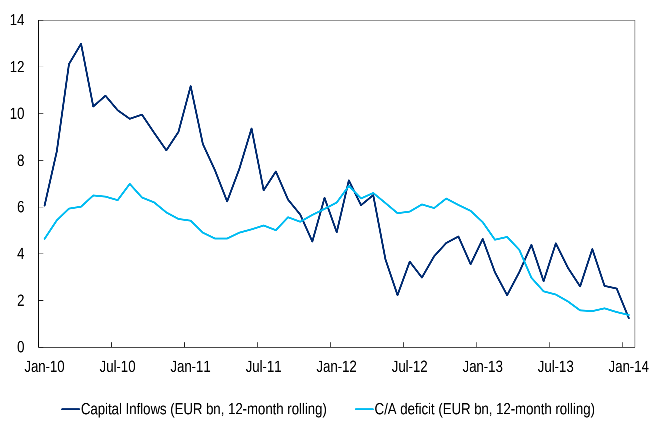
Source: Haver Analytics and Citi Research

Figure 183. ...but there are encouraging signs



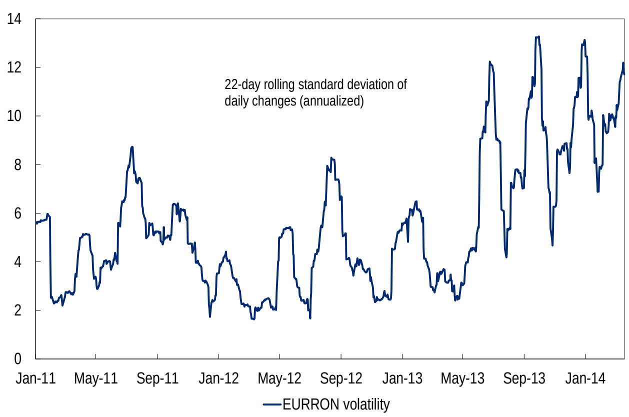
Source: Haver Analytics and Citi Research

Figure 184. Subsiding capital inflows...



Source: Haver and Citi Research

Figure 185. ...raises concerns about the leu, which has become more volatile



Source: Haver and Citi Research

Figure 186. Romania Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	171	204	165	165	183	171	190	204	222
Nominal GDP, local currency bn	416	515	501	524	557	594	631	665	711
GDP per capita, USD	7,653	9,176	7,397	7,413	8,246	7,738	8,588	9,238	10,103
Population, mn	22.3	22.3	22.2	22.2	22.2	22.1	22.1	22.1	22.0
Unemployment, % of labour force	4.3	4.0	6.3	7.6	5.4	5.1	5.3	5.5	5.5
Economic Activity									
Real GDP, yoy avg	6.3	7.5	-6.6	-1.2	2.4	0.5	3.5	3.0	3.4
Real investment growth % yoy	42.6	3.0	-34.3	8.9	12.1	-0.3	-7.1	3.0	1.3
Real consumption growth % yoy	10.6	9.3	-9.0	-0.8	1.4	1.4	0.7	1.5	3.3
private consumption growth % yoy	12.0	9.5	-10.4	-0.3	1.5	1.4	1.4	1.5	3.5
Real export growth, % yoy	7.7	7.6	-6.3	14.2	12.0	-1.8	12.4	5.5	4.5
Real import growth, % yoy	27.8	7.6	-21.4	12.5	10.6	-0.3	2.2	3.0	4.0
Prices, Money & Credit									
CPI, % yoy eop	6.6	6.3	4.7	8.0	3.1	5.0	1.6	4.0	3.2
CPI, % avg	4.8	7.9	5.6	6.1	5.8	3.3	4.0	2.4	3.4
Nominal wages, % yoy	22.6	23.6	8.4	2.5	4.9	5.0	5.0	5.0	4.5
Credit extension to private sector, % yoy	60.4	33.7	0.9	4.7	6.6	1.3	-3.3	5.4	8.1
Policy Interest Rate, % eop	7.50	10.25	8.00	6.25	6.00	5.25	4.00	3.50	4.50
1 month inter-bank rate, %, eop	8.24	15.35	10.60	4.05	5.72	6.04	4.60	4.10	5.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/US$, eop	2.47	2.89	2.96	3.17	3.33	3.37	3.25	3.26	3.16
RON/US$, avg	2.43	2.50	3.04	3.17	3.04	3.46	3.33	3.27	3.20
RON/EUR, eop	3.61	4.03	4.24	4.24	4.32	4.45	4.46	4.57	4.45
RON/EUR, avg	3.33	3.68	4.24	4.21	4.24	4.46	4.42	4.54	4.49
Balance of Payments, USD bn									
Current account	-22.9	-23.8	-6.8	-7.3	-8.2	-7.5	-2.0	-5.1	-9.3
% of GDP	-13.4	-11.6	-4.2	-4.4	-4.5	-4.4	-1.1	-2.5	-4.2
Trade balance	-24.4	-28.1	-9.6	-10.1	-10.3	-9.5	-4.5	-7.4	-11.7
Exports	40.5	49.6	40.5	49.6	63.0	57.9	65.8	68.8	73.2
Imports	64.9	77.7	50.1	59.6	73.3	67.4	70.4	76.2	84.9
Service balance	0.6	1.0	-0.4	0.5	0.5	1.5	3.4	0.6	0.7
Income balance	-5.7	-5.4	-2.6	-2.5	-3.1	-3.9	-5.8	-3.1	-3.3
FDI, net	9.7	13.7	5.0	3.0	2.6	2.9	3.5	2.0	2.6
International reserves	37.3	36.5	39.4	42.3	42.4	41.8	45.7	48.6	51.1
Total amortisations	12.2	18.1	17.7	19.7	19.6	25.0	34.1	35.7	37.3
Public Finances, % of GDP									
Consolidated government balance	-2.3	-4.8	-7.3	-6.4	-4.3	-2.2	-2.5	-2.3	-2.3
Consolidated gov primary balance	-1.5	-3.9	-5.7	-4.9	-2.6	-0.4	-0.3	-0.1	-0.1
Public debt	19.8	21.3	29.4	37.1	40.1	40.5	42.6	42.0	41.0
of which Domestic	10.2	12.6	15.4	19.8	21.9	18.2	18.9	16.8	15.7
Foreign Assets & Liabilities, USD bn									
External debt	80.3	105.8	113.0	122.4	137.3	129.7	140.5	146.8	155.7
Public	13.9	14.2	19.6	24.8	28.9	34.2	40.3	46.2	50.7
External debt / GDP	47.0	51.8	68.7	74.3	75.1	75.7	74.0	72.0	70.0
External debt / XGS	160.8	169.4	224.4	209.7	187.7	188.7	176.6	174.4	173.6
Short-term debt	28.7	28.5	22.5	26.2	29.5	28.0	26.8	28.0	29.6
Short-term debt/International reserves (%)	77.1	78.1	57.0	61.9	69.7	66.9	58.6	57.6	57.9

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	4.2	5.2	3.7	4.1	2.8	1.9	2.2	2.7	3.1
CPI, % yoy eop	1.9	1.6	1.3	1.9	3.3	4.0	3.5	3.4	3.3
Policy interest rate, %, eop	4.25	4.00	3.50	3.50	3.50	3.50	4.25	4.50	4.75
Short-term market rate, % eop	4.75	4.50	4.00	4.00	4.00	4.00	4.75	5.00	5.25
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/EUR, eop	4.46	4.46	4.50	4.53	4.55	4.57	4.55	4.50	4.47

Source: National Sources, Citi Research forecasts

Russia

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- **Summary view** — The rising tensions in Ukraine make for a challenging backdrop to the economy. The combination of more subdued investment and consumption spending related to heightened uncertainty and tighter monetary policy lead us to sharply lower our 2014 GDP forecast from 2.6% to 1.0%

- **Things to watch** — Uncertainty will remain elevated at least until the end-May elections in Ukraine. The central bank has a very difficult task navigating between the need to maintain financial stability and the desire to support flagging growth. Risks to our new growth forecast are to the downside.

- **Strategy** — The expected transition from a current account surplus to current account deficit over the next couple of years will put structural pressure on the currency. Cyclical pressures will also weigh on the currency as tapering fears and may weaken the RUB basket to 45.0 by the end of the year.

Growth is very weak, but should get even weaker in 2014

GDP grew by only 1.3% in 2013. Preliminary estimates from Rosstat point to 4Q13 GDP growth of 1.3% YoY (1.2% in 3Q13), implying full-year GDP of 1.3% (2012 GDP of 3.4%). The slowdown was driven by contracting investment and net exports, with consumption providing the only bright spot in the economy. We think 3Q13 marked the bottom of the cycle, with a fragile recovery starting to take place from 4Q13 and firming up in 2014. 3Q13 GDP marked the bottom of the current cycle, which had seen five consecutive quarters of decelerating growth. More granular data paint a similar picture with industrial production broadly flat and investment spending growth down by almost a percent YoY during Jan-Dec 2013. Consumer spending remains the one bright spot in the economy, with real disposable incomes and real retail sales expanding by 3.7% YoY and 5.5% during Jan-Dec 2013, respectively.

We forecast further growth moderation, to 1.0% in 2014. The rising tensions over Ukraine make for a very challenging backdrop to the Russian economy, creating substantial downside risks to economic performance. The combination of more subdued investment and consumption spending related to heightened uncertainty, and tighter monetary policy, lead us to downgrade our 2014 GDP forecast from 2.6% to 1.0% (vs 1.3% in 2013).

Investment spending will be the key avenue via which market volatility will affect growth performance. The sectoral breakdown of last year's investment suggested that private-sector consumption-related investment has been growing, while it was oil and gas investment that was holding back overall investment activity. Our more positive view on 2014 GDP was critically dependent on the assumption that government-led oil and gas investment would come out of its 2013 doldrums, with new projects coming on stream. However, given the uncertain backdrop, we now have much less confidence about this scenario playing out, even if, in principle, the government may feel more pressure to 'take control' of SOE investment plans. We, therefore, cut our real investment growth forecast to zero from 3.8% previously.

Consumer spending will also feel the pain. While consumption has been the only bright spot, it has been on a downtrend recently as fears of a consumer boom turning into a bubble have led to more restrictive regulatory behavior (Is there more room to consume?). Now broader uncertainty will likely further weigh on real private consumption spending, and we cut our 2014 forecast to 3.2% from 4.2% previously.

CBR's rate hike will further constrain growth. The Central Bank of Russia raised the one-week REPO rate by 150bpts to 7.00% on March 3rd. The CBR argued that the decision was driven by a desire to ensure financial stability and ward off the build-up of inflationary expectations against the backdrop of heightened market volatility. The CBR was right, in our view, to hike rates, but this will also come at the cost of stronger headwinds to growth even if the CBR fully unwinds the hike by year-end.

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

Long-term potential has been downgraded

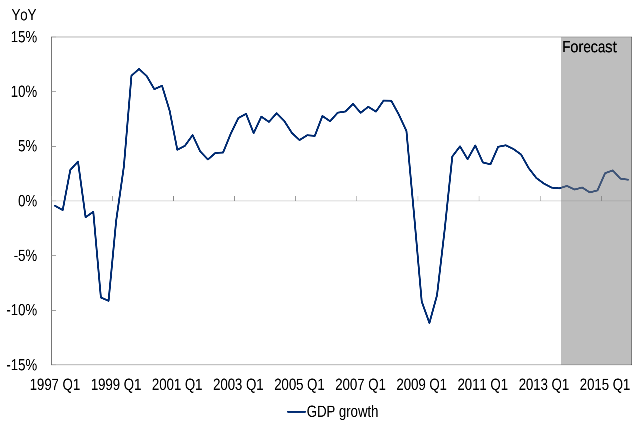
In a refreshing, if belated, recognition of Russia's dimmed economic potential, the Ministry of Economy has significantly downgraded its long-term growth forecasts. On 6 November 2013, the Ministry of Economy revised its long-term macroeconomic forecast through 2030. Average GDP growth for 2013-2030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

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

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

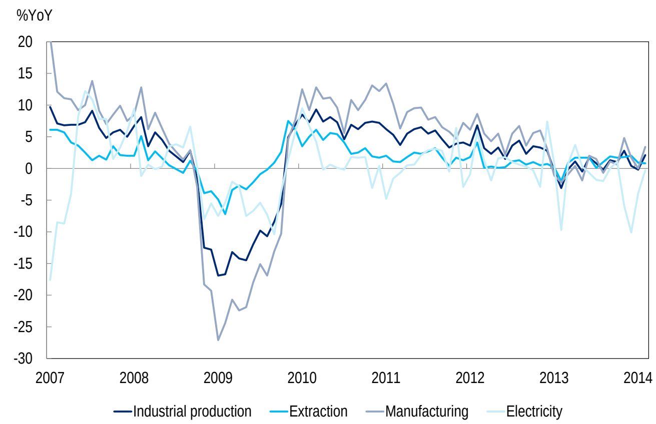
Cyclical developments are also rouble negative. The Central Bank of Russia reported that 4Q13 current account surplus came in at US5bn, bringing full-year current account surplus to US$33bn (1.6% of GDP). This is significantly less than the US$72bn (3.6% of GDP) surplus that was posted in 2012. Against that background, the Ukraine contagion risks have served to expose Russia as a proxy for expressing bearish views on the region, with equity and fixed income markets coming under severe market pressure. As a result, we see the rouble weakening against the basket towards 43.5 by the end of the year.

Figure 187. Growth will continue to struggle into 2014



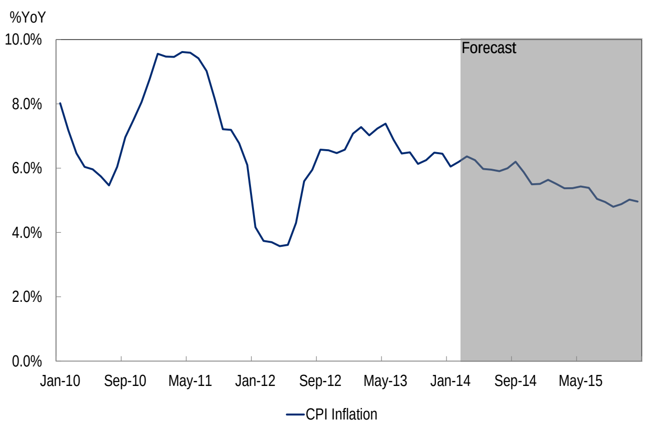
Source: Rosstat, Citi Research

Figure 188. Industrial activity is still weak



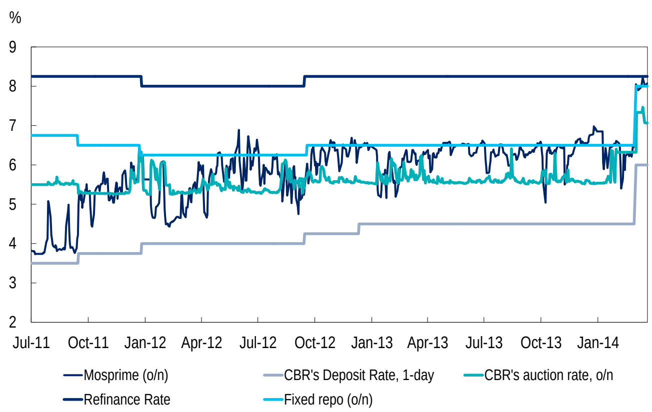
Source: Rosstat, Citi Research

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



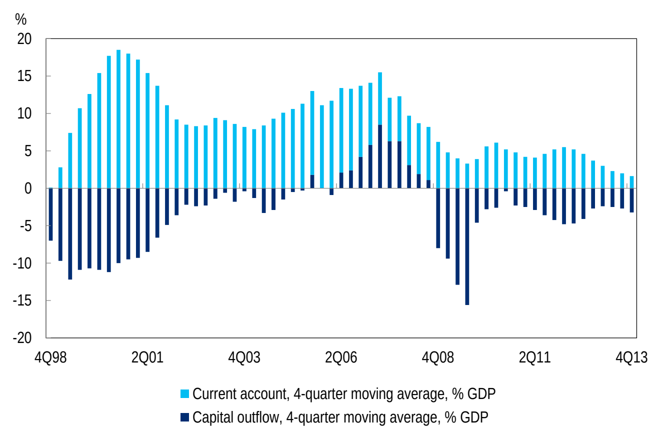
Source: Rosstat, Citi Research

Figure 190. ...despite raising policy rate by 150bpts in early March



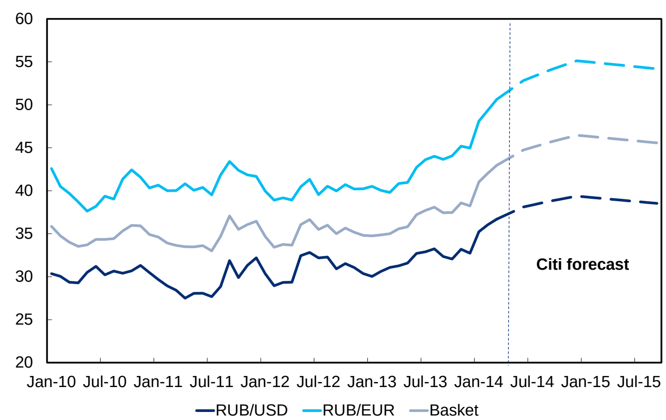
Source: Bloomberg, Citi Research

Figure 191. The gradual disappearance of the current account...



Source: CBR, Citi Research

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



Source: Bloomberg, Citi Research

Figure 193. Russia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,304	1,665	1,229	1,524	1,897	2,012	2,127	1,896	2,037
Nominal GDP, local currency bn	33,248	41,277	38,807	46,309	55,644	61,811	67,710	72,498	78,759
GDP per capita, USD	9,081	11,585	8,554	10,611	13,227	14,055	14,890	13,306	14,332
Population, mn	143.7	143.7	143.7	143.6	143.4	143.2	142.8	142.5	142.1
Unemployment, % of labour force	6.1	6.4	8.4	7.5	6.6	5.5	5.5	5.7	5.8
Economic Activity									
Real GDP, yoy avg	8.5	5.2	-7.8	4.5	4.3	3.4	1.3	1.0	2.3
Real investment growth % yoy	22.0	10.5	-41.0	28.5	22.6	6.6	-0.3	0.0	3.3
Real consumption growth % yoy	10.7	8.4	-3.9	3.5	4.8	5.0	3.3	2.5	2.4
private consumption growth % yoy	14.2	10.4	-5.1	5.5	6.3	6.7	4.3	3.2	3.1
Real export growth, % yoy	6.3	0.6	-4.7	7.0	0.3	1.4	1.5	2.0	2.1
Real import growth, % yoy	26.2	14.8	-30.4	25.8	20.3	9.5	5.5	4.5	5.0
Prices, Money & Credit									
CPI, % yoy eop	11.9	13.3	8.8	8.8	6.1	6.6	6.5	5.5	5.0
CPI, % avg	9.0	14.1	11.6	6.8	8.4	5.1	6.8	6.0	5.2
Nominal wages, % yoy	26.0	27.4	9.1	12.8	11.7	13.3	12.3	13.5	12.7
Credit extension to private sector, % yoy	49.3	37.2	2.6	12.9	28.1	19.4	17.2	15.0	15.0
Policy Interest Rate, % eop	6.50	9.50	6.00	5.00	5.25	5.50	5.50	5.50	5.25
1 month inter-bank rate, %, eop	6.09	20.20	6.32	3.78	6.37	6.90	6.81	6.43	6.23
Long-term yield, %, eop	6.58	10.90	9.45	8.23	8.77	7.04	7.88	7.93	7.73
RUB/US$, eop	24.6	30.5	30.3	30.6	32.2	30.6	32.9	39.4	38.2
RUB/US$, avg	25.6	24.9	31.7	30.4	29.4	31.1	31.9	38.2	38.7
RUB/EUR, eop	35.9	42.7	43.4	40.9	41.7	40.3	45.2	55.1	53.9
RUB/EUR, avg	35.1	36.6	44.2	40.3	41.0	40.0	42.3	53.1	54.3
Balance of Payments, USD bn									
Current account	72.2	103.9	50.4	67.5	97.3	72.0	34.0	33.3	24.3
% of GDP	5.5	6.2	4.1	4.4	5.1	3.6	1.6	1.8	1.2
Trade balance	123.4	177.6	113.2	147.0	196.9	192.3	168.6	169.3	159.7
Exports	346.5	466.3	297.2	392.7	515.4	528.0	523.6	536.7	552.8
Imports	223.1	288.7	183.9	245.7	318.6	335.7	355.0	367.4	393.1
Service balance	-16.7	-20.4	-17.6	-26.1	-33.5	-46.5	-63.0	-63.0	-59.9
Income balance	-28.8	-46.5	-39.7	-47.1	-60.4	-67.7	-67.6	-69.0	-70.5
FDI, net	11.1	19.1	-6.7	-9.4	-11.8	-18.1	12.4	-5.0	10.0
International reserves	466.4	410.7	405.8	432.9	441.2	473.1	468.3	446.6	445.9
Total amortisations	28.5	47.2	49.9	40.8	52.0	90.5	139.0	103.1	105.3
Public Finances, % of GDP									
Consolidated government balance	6.7	5.1	-5.6	-3.2	2.1	-0.7	-2.0	-4.4	-4.9
Consolidated gov primary balance	5.8	4.4	-5.4	-3.4	1.2	0.6	1.6	1.8	0.8
Public debt	6.6	5.2	7.3	7.6	8.2	7.7	6.6	9.5	13.3
of which Domestic	3.8	3.4	4.7	5.3	6.4	5.8	4.5	7.2	10.8
Foreign Assets & Liabilities, USD bn									
External debt	471.2	480.6	467.3	488.9	538.9	636.4	697.4	684.3	699.0
Public	37.4	29.5	31.3	34.5	34.7	38.1	43.1	43.6	51.0
External debt / GDP	36.1	28.9	38.0	32.1	28.4	31.6	32.8	36.1	34.3
External debt / XGS	120.7	91.8	136.3	110.7	94.0	107.8	120.3	115.9	116.2
Short-term debt	99.7	73.6	52.7	60.2	68.2	81.5	76.8	81.0	84.7
Short-term debt/International reserves (%)	21.4	17.9	13.0	13.9	15.5	17.2	16.4	18.1	19.0

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.2	1.4	1.0	1.2	0.8	1.0	2.5	2.8	2.0
CPI, % yoy eop	6.1	6.5	6.4	6.0	6.2	5.5	5.4	5.4	4.8
Policy interest rate, %, eop	5.50	5.50	7.00	6.50	6.00	5.50	5.25	5.25	5.25
Short-term market rate, % eop	6.53	6.83	7.38	6.63	6.48	6.43	6.31	6.31	6.27
Long-term yield, %, eop	7.62	7.88	8.88	8.13	7.98	7.93	7.92	7.81	7.77
RUB/US$, avg	32.8	32.6	36.7	38.1	38.8	39.4	39.1	38.8	38.5

Source: National Sources, Citi Research forecasts

Slovakia

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- **Summary view** — We leave our 2014 GDP forecast unchanged at 2% YoY after strong GDP in 4Q13 owing to possible destocking of inventories. Our forecast is below the MinFin of 2.3%. The risks look balanced – with a possible positive surprise in construction activity on one side vs. large errors in the BoP and Ukraine-Russia crisis on the other.

- **Things to watch** — The presidential election could influence economic policy in the long-term if PM Fico loses. Mr. Kiska seems to be the candidate who could beat him in the second round, which take place on 29 March.

- **Strategy** — Better than expected fiscal deficit in 2013, solid financing reserve and the pressure from the debt-brake rule limits negative pressure on bonds. For the time being the government gross borrowing requirements of €6bn for 2014 are covered by 51%.

PM Fico has strong opponent to become president

PM Robert Fico in delicate position after 1st round of presidential elections. Though PM Fico (left-wing SMER-SD) won the first round of the presidential election, he got only 28% of the votes. Unaffiliated candidate and philanthropist Andrej Kiska obtained 24%, followed by opposition candidates Prochazka with 21% and Knazko with 13%. The first round participation rate stood at 43.4%, almost the same as in 2009, when participation reached 52% in the second round. We think the participation rate and particularly the endorsements from Prochazka and Knazko will be important for the outcome of second round on 29 March. And both Mr. Prochazka and Mr. Knazko supported Mr. Kiska. We believe the first round results reduce the chances of PM Fico winning the presidential elections. However, if there is a larger voters' participation at the second round, we think it would increase the chance of PM Fico to win the election. We view the decision of PM Fico (SMER-SD) to run for the presidency as unsurprising, despite the fact that he still has two years to run of a one-party majority government. We argue that, although GDP has recovered to 5.6%, above the pre-crisis level, private consumption is 1% below. Moreover, fiscal policy is likely to be even more complicated until the economic recovery becomes stronger, especially as the government's current debt limit of 50%-60% of GDP is only temporary and will be gradually lowered by 1% every year going forward, reaching 40%-50% in 2027. Moreover, the new national account numbers in autumn this year may complicate the situation further. If Mr Fico were to continue as PM he might have to enact tighter and hence more unpopular fiscal policies (though he has already introduced some market-unfriendly measures which are, however, relatively mild) that might harm his ability to run for the positions of President or PM in the future. All in all, whether or not PM Fico wins; we see the likely outcomes as negative for the SMER party – as it would lose its leader in the first instance (leading to possible internal tensions) or probably see its policy undermined by a new president in the second, which could influence economic policy in the long term. The new president will then take office on 15 June 2014. We would expect that if PM Fico becomes president, there will be an effort to increase his power as we feel that PM Fico get a lesson from the recently elected Czech President, who tried to extensively used his power.

Solid GDP growth in 4Q13, solid growth ahead

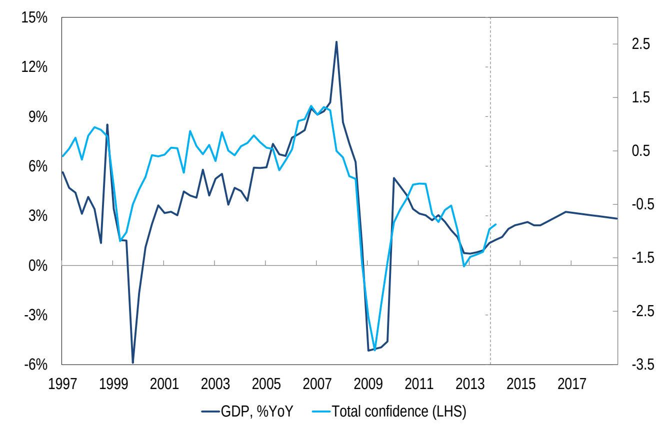
Investment activity supported GDP in late 2013. Slovakia's Statistical office confirmed that GDP expanded by 0.4% QoQ in 4Q13, or 1.3% YoY (swda). This compares to the 0.8% YoY growth in 1Q-3Q13. The economy was driven by domestic demand, which increased 2.2% YoY on stronger fixed investment activity (+4%) and restocking of inventories (total investment increased 7.7%). This compares to previous quarters when investment activity growth was negative. The ongoing 2.5% growth in public consumption and mild increase in private consumption of 0.4% accelerated import growth 3ppts, to 7.4%. Export activity eased 1.6ppt, to 6.6%. The weakness in private consumption reflects a weak labour market, which has started to stabilize since end-2013. We think there is also likely to be some destocking of inventories in 1Q14 and though capacity utilization in manufacturing slightly increased in early in 1Q14, some setback is likely as well.

We left our 2014 forecast unchanged after we raised by 0.1ppts, to 2%, in mid-February. This is still below MinFin's expectation of 2.3%. The risks look balanced –possible positive surprises could come from construction activity and slightly better foreign demand outlook on the one hand, vs. a potential downward GDP revision on the other due to a larger error in the BoP, which reached around 6% of GDP in 2013. We hope that this issue will be solved with the national accounts based on the new ESA 2010 methodology that will be published in September 2014. If we assume that these errors from BoP will cut the GDP by 5ppts (for example the Czech Republic has 12 months cumulative errors of 1% of GDP in its BoP) and new ESA2010 will increase the GDP by 1.5%, the total impact could be of -3.5% of GDP. If this materializes, it could increase the debt-to-GDP ratio by 2ppts and jeopardize the debt-brake rule with adverse fiscal tightening. By contrast, further improvement of the labour market would be another factor that would further improve our GDP growth forecast. While the Ukraine-Russia crisis represents a risk due to possible outage of gas delivery, the almost 3-4 months storage, benign weather conditions, and improved pipeline infrastructure should help to avoid a gas-related drop in economic activity as was the case in 1Q09.

Mixed fiscal in February, but solid pre-financing of GBR

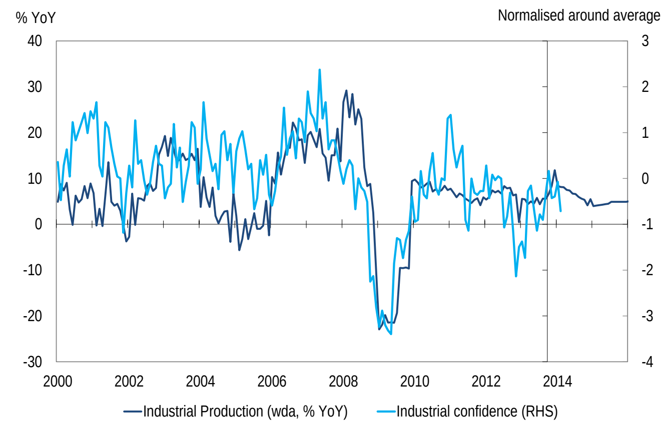
The February central government cash budget showed a deficit of €0.88bn YTD, wider then the €-0.71bn a year ago, reflecting larger expenditure that offset solid revenue dynamics. We estimate the 12m cumulative deficit reached 3% of GDP, slightly wider than 2.9% a month ago, but narrower than 5.2% a year ago (the primary deficit likely reached 1.2% of GDP, compared to -3.4% a year ago). Recent performance suggests to us mixed implications as the seasonal performance of both expenditure and revenue suggest an annual deficit around 7.7% of GDP in 2014, which is wider than the planned 4.7%. This is, however, too negative, owing to the different seasonality of interest rate expenditure. After this adjustment, the seasonal performance suggests a risk of a deficit that is wider by 1.7% of GDP. By contrast, recent dynamics in revenues and expenditures suggest a deficit of around 2.8% in 2014, which seems to us too optimistic owing to an ongoing larger increase in expenditure in early 2014 (this holds also for a primary expenditure) and because 2013's better-than-expected budget reflected not only lower current expenditure and larger tax revenue, but also a larger EU fund inflow. For the time being the government gross borrowing requirements of €6bn for 2014 are covered by 51%. The fiscal risk is somewhat limited by the debt-brake rule (there is still a risk in our view that government debt will breach the 57% ratio due to the ESA2010 methodology as we showed above).

Figure 194. February confidence remains supportive for the recovery



Source Statistical Office of the Slovak Republic, Citi Research Forecasts

Figure 195. but industrial confidence was weaker than is our outlook

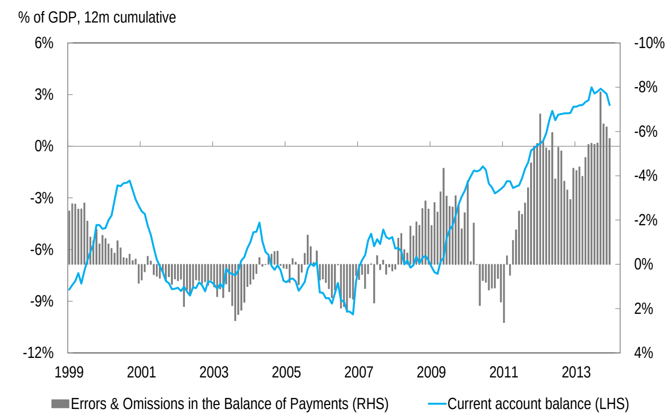


Source: Statistical Office of the Slovak Republic, Citi Research forecast

Figure 196. January data from real economy were weaker, but solid

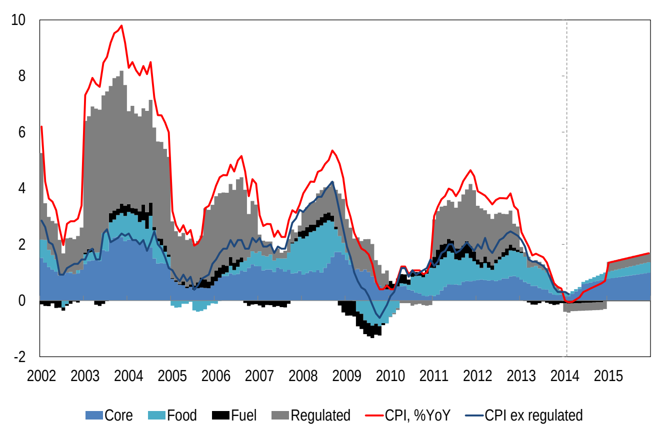
Source: Statistical Office of the Slovak Republic, Eurostat, Citi Research

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



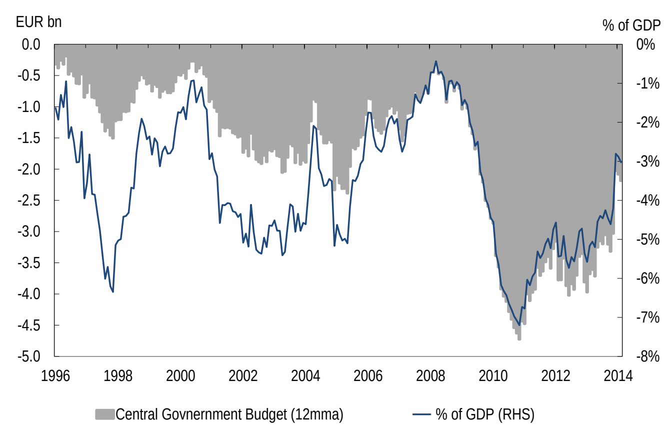
Source: Haver Analytics, Citi Research calculations

Figure 198. Recovery should lead to higher core CPI in our outlook



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

Figure 199. Central government budget was mixed in February



Source: Haver Analytics and Citi Research calculations

Figure 200. Slovakia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	75	95	88	87	96	91	96	102	107
Nominal GDP, local currency bn	61	67	62	66	69	71	72	74	77
GDP per capita, USD	13,936	17,493	16,156	16,087	17,654	16,781	17,577	18,685	19,664
Population, mn	5.4	5.4	5.4	5.4	5.4	5.4	5.5	5.5	5.5
Unemployment, % of labour force	8.4	7.7	11.4	12.5	13.2	13.6	14.1	13.3	12.7
Economic Activity									
Real GDP, yoy avg	10.5	5.8	-4.9	4.4	3.0	1.8	0.9	2.0	2.5
Real investment growth % yoy	9.7	4.7	-31.5	20.0	9.5	-16.0	-5.1	5.2	3.6
Real consumption growth % yoy	5.1	6.1	1.6	-0.3	-1.4	-0.4	0.3	1.1	1.6
private consumption growth % yoy	6.8	6.1	0.2	-0.7	-0.5	-0.2	-0.1	1.0	1.8
Real export growth, % yoy	14.3	3.1	-16.3	16.0	12.2	9.9	4.5	6.2	6.8
Real import growth, % yoy	9.2	3.1	-18.9	14.9	9.7	3.3	2.9	6.4	6.7
Prices, Money & Credit									
CPI, % yoy eop	3.4	4.4	0.5	1.3	4.4	3.2	0.4	0.7	1.7
CPI, % avg	2.8	4.6	1.6	1.0	3.9	3.6	1.4	0.3	1.5
Nominal wages, % yoy	7.5	8.2	3.0	3.3	2.2	2.5	2.5	2.3	3.1
Credit extension to private sector, % yoy	23.4	16.3	0.9	4.8	8.6	2.8	1.5	2.2	3.9
Balance of Payments, USD bn									
Current account	-4.1	-5.9	-2.3	-3.3	-3.6	2.0	2.3	2.8	2.8
% of GDP	-5.4	-6.2	-2.6	-3.7	-3.8	2.2	2.4	2.8	2.6
Trade balance	-1.0	-1.1	1.3	1.0	1.4	4.6	5.9	4.1	2.5
Exports	64.9	72.9	55.4	64.0	79.0	79.9	85.7	93.5	100.3
Imports	65.9	74.0	54.1	63.0	77.6	75.4	79.8	89.4	97.8
Service balance	0.5	-0.7	-1.4	-1.0	-0.5	0.4	0.2	2.2	4.3
Income balance	-3.2	-2.8	-1.2	-2.7	-4.0	-2.1	-2.4	-2.9	-3.4
FDI, net	3.0	4.3	-0.9	0.8	2.8	2.9	1.2	1.0	1.5
Total amortisations	1.7	1.7	1.8	2.1	2.1	2.3	2.5	2.6	2.7
Public Finances, % of GDP									
Consolidated government balance	-1.6	-2.0	-8.0	-7.7	-5.1	-4.5	-2.7	-3.3	-2.7
Consolidated gov primary balance	-0.4	-0.8	-6.6	-6.3	-3.5	-3.1	-1.2	-1.8	-1.2
Public debt	26.6	27.9	35.7	40.6	43.4	52.4	54.4	57.0	56.4
of which Domestic	18.1	19.0	20.4	25.2	30.6	49.4	41.6	45.8	46.9
Foreign Assets & Liabilities, USD bn									
External debt	44.3	52.5	65.3	65.8	68.5	76.3	80.8	84.8	87.8
Public	9.5	10.3	11.4	13.3	15.5	17.7	19.7	20.8	21.8
External debt / GDP	58.8	55.5	74.5	75.3	71.3	83.5	84.3	83.1	81.7
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	17.4	20.1	30.3	29.9	29.8	34.6	34.9	36.7	37.5

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	0.9	1.4	1.5	1.7	2.2	2.4	2.5	2.6	2.4
CPI, % yoy eop	1.0	0.4	0.1	0.3	0.5	0.7	1.4	1.5	1.6
Short-term market rate, % eop	0.13	0.21	0.22	0.04	0.06	0.06	0.06	0.25	0.25
Long-term yield, %, eop	2.83	2.78	2.63	2.52	2.52	2.51	2.61	2.61	2.63

Source: National Sources, Citi Research forecasts

South Africa

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- **Summary view** — The question of rate hikes dominates as the trade-off between high inflation and low growth remains a feature of monetary policy.
- **Things to watch** — Upcoming elections leaves political risk higher than usual while the ZAR determines inflation expectations and the pace of rate hikes.
- **Strategy** — Joint global and local forces leave ZAR volatility alive. Another sovereign ratings downgrade is minimized but still cannot be ruled out entirely.

A necessary rebalancing

South Africa's macro outlook has changed significantly since the start of the year. A surprising but proactive 50bp rate hike by the SA Reserve Bank has led us to expect a total 150bp in total hikes this year. A weaker ZAR leaves inflation trending higher and that this will erode real disposable income growth. But unfortunately tighter monetary policy will also weigh down on consumer spending given that it will take some time to result in lower inflation. Tighter monetary policy or even the expectation of it, also dampens corporate earnings, corporate credit take-up and often boosts corporate savings. Together with electricity troubles, low business confidence and continued labour disruptions this is sufficient reason to expect less from private sector fixed investment. We still expect below-consensus GPD growth of 2.4% in 2014 but acknowledge increased downside risk from electricity shortages and potential labour unrest. The platinum continues to grapple with strike-related production stoppages, which isn't too surprising as it is highly unionized and rocked by increasing union rivalry. The metals manufacturing sector is also at risk of labour strikes mid-year given that its wage agreement is up for negotiation and its union, NUMSA, has publically dissociated itself with the rest of Cosatu. In our view this may make NUMSA more desperate to retain members and defy Cosatu. Fortunately, the risk of a public sector service strike this year is diminished now that higher CPI should leave public sector workers with a wage increase that matches the increase of the previous two years.

The current account deficit is starting to narrow. The Q4 13 current account deficit shrank to 5.1% from 6.4% previously. Though local limits (labour unrest, high wages, rising costs of production and inefficient logistics) have dampened export's ability to respond to a weaker currency, some improvement is starting to emerge. Aside from this, a big change in the data was the degree of import compression in Q4. Despite government's price inelastic infrastructure roll-out, a loss of momentum in gross domestic expenditure (falling 3.5% in Q4) meant that consumer and the private sector are importing less. Expectations of lower GDP, higher inflation and higher interest rates, suggests that import compression should continue. Unfortunately, Q1 14 is likely to prove problematic for the trade deficit. Despite our view that import compression continues, the collective effect of platinum strikes and oil demand given the lack of electricity will mean a temporary worsening in the Q1 current account deficit. Nevertheless, once this passes, we expect narrowing to continue to a year-end ratio of 4.7% of GDP. For the year as a whole, an average current account deficit of 5.1% is an improvement on 5.8% in 2013 but unfortunately, still requires about R190bn in financing which is difficult in a global environment that lacks liquidity. This is a key reason as to why we expect the ZAR to remain undervalued through the year.

It's all about vulnerabilities

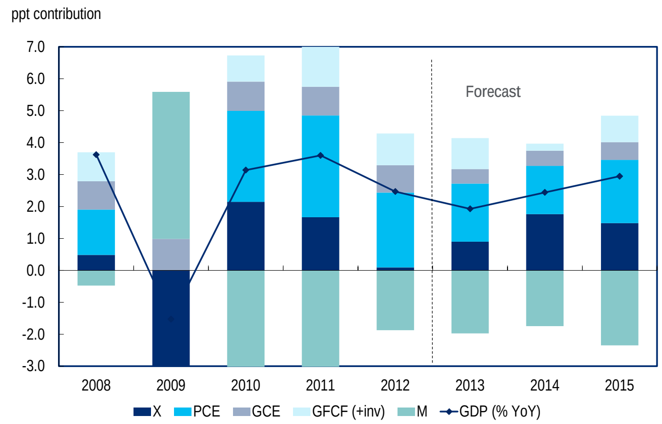
We see more ZAR pass-through to inflation this year. Company margins are under pressure in the face of rising costs and low domestic demand leaving retailers with no other choice but to try pass-through more currency weakness than before. Anecdotal evidence from surveys and the listed retail sector affirms this. We also expect upside pressure form rental inflation given the rapid fall in housing supply which is significant in the CPI basket. Despite global food deflation, droughts have cost South Africa's maize market dearly since December and local grain prices are up. This takes 9 months to filter through the food supply chain, leaving CPI food close to double-digits by Q4 14. Finally, the coupling of above inflation wages and low productivity keeps unit labour costs elevated and a certain upside risk to the inflation outlook. Despite the many upside price pressures, inflation variance remains low, which we believe is due to the opposing forces of limited consumer appetite and rising cost push pressures. As a result, the downside risk of a still-negative output gap (particularly if one takes 150bp in rate hikes into account) should keep headline CPI from rising more than 6.6% in Q4 14, but the many upside risks keep inflation out the target range from Q2 14 until Q1 15.

Monetary policy faces another year of fierce debate. Following the surprise 50bp rate hike in January the macro backdrop has become more dovish. We continue to believe that because the economy is weak, the SARB prefers a slow and moderate hiking cycle in its process of normalizing policy rates. A more dovish backdrop in March allows the SARB to keep the repo rate unchanged but upside risks to inflation expectations (the ZAR, food and wages mostly) and the prolonged 5-quarter period that the SARB expects CPI to remain above-target will mean additional tightening. We have thus factored in a 50bp hike in May and another 50bp hike in July. May is critical for the SARB's credibility as after pausing in March, it will need to communicate its intention to still normalizing policy rates. We attach a lower probability to a July rate hike given that right now there may be sufficient data to justify it, but the many features of the global and local backdrop make it ever more data-dependent. Aside timing, forecast risk is also high for the increments of this hiking cycle. Our case for a slow and moderate cycle is that the SARB may pause between meeting but another option would be to hike at 25bp increments at each consecutive meeting. We think this is less likely because the SARB does not want to surprise markets. However, one cannot rule it out completely. Fatefully for rates markets, there remains strong debate swing between upside inflation risk and downside GDP risk which again, breeds a degree of market volatility in the near-term.

Looking to the national elections

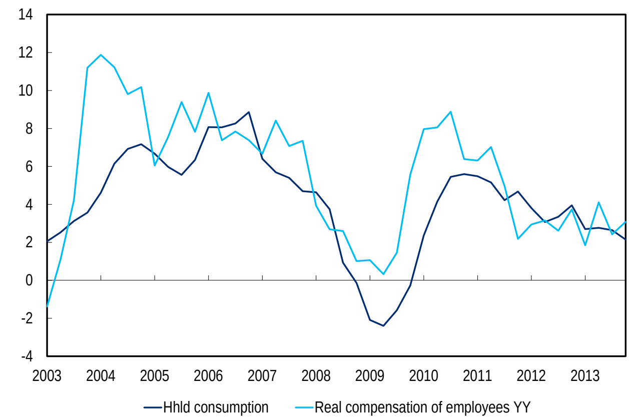
The 2014 national elections is a turning point for South Africa politics. On 7 May 2014 the country will face its national elections. This time the current ruling party, the African National Congress (ANC), faces more voter challenge than before. The ANC's tripartite alliance with Cosatu (the largest trade union) has weakened now that Numsa (one of Cosatu's largest unions) has denounced support for President Zuma in this election. What's more, the ANC has disappointed greatly on service delivery and leadership capability which adds to the emergence of stronger opposition parties. We are keeping a close watch on newcomer opposition party, the Economic Freedom Fighters (EFF) led by ex-ANCYL president, Julius Malema. Though the EFF has proven more popular by public impression, its true merits will be tested in coming elections in the bid for funding. Our baseline is that the ANC drops from 65.9% in votes to around 60%. But no matter the outcome, we believe the current political backdrop is setting in motion a turning point for South Africa politics.

Figure 201. GDP to remain lackluster in 2013 and 2014



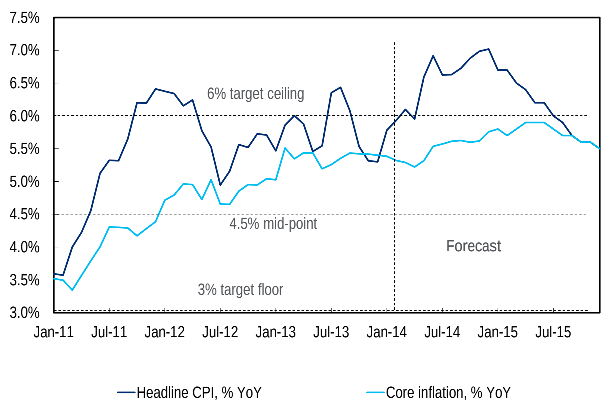
Source: SARB, Citi Research Estimates

Figure 202. Consumption is slowing as real incomes decelerate



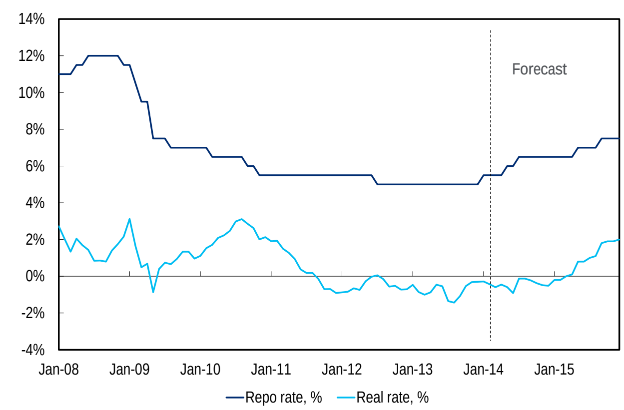
Source: SARB, Citi Research calculations

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



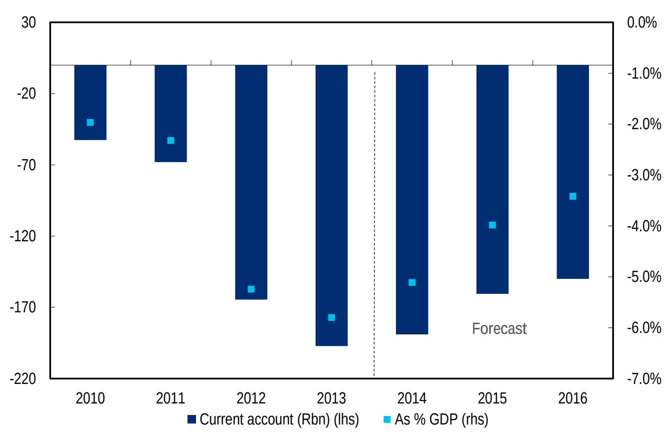
Source: Stats SA, Citi Research projections

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



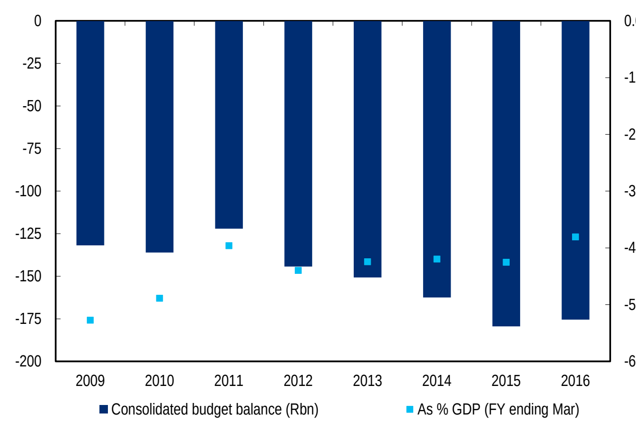
Source: SARB. Stats SA

Figure 205. No meaningful narrowing in the current account deficit



Source: SARB, Citi Research projections

Figure 206. Fiscal consolidation will likely be slow



Source: National Treasury, Haver Analytics, Citi Research projections

Figure 207. South Africa Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	286	273	287	366	404	382	351	325	351
Nominal GDP, local currency bn	2,016	2,256	2,408	2,674	2,933	3,139	3,385	3,697	4,074
GDP per capita, USD	5,763	5,613	5,825	7,312	8,081	7,646	6,986	6,456	6,971
Population, mn	49.6	48.7	49.3	50.0	50.0	50.0	50.2	50.3	50.4
Unemployment, % of labour force	-	22.5	23.7	24.9	24.8	24.9	24.7	25.0	24.6
Economic Activity									
Real GDP, yoy avg	5.5	3.6	-1.5	3.1	3.6	2.5	1.9	2.4	2.8
Real investment growth % yoy	12.0	4.4	-8.6	4.3	7.0	4.9	2.4	4.3	4.0
Real consumption growth % yoy	5.2	2.8	-0.1	4.4	4.7	3.7	2.5	2.2	2.9
private consumption growth % yoy	5.5	2.2	-1.6	4.4	4.9	3.5	2.6	2.3	3.0
Real export growth, % yoy	6.6	1.8	-19.5	9.0	6.8	0.4	4.2	6.5	5.6
Real import growth, % yoy	9.0	1.5	-17.4	11.0	10.0	6.0	4.7	6.5	6.8
Prices, Money & Credit									
CPI, % yoy eop	7.6	9.3	6.0	3.4	6.4	5.7	5.3	7.0	5.5
CPI, % avg	6.2	10.0	7.2	4.1	5.0	5.7	5.8	6.5	6.1
Nominal wages, % yoy	7.9	12.8	11.8	13.5	7.2	7.5	8.1	9.2	9.7
Credit extension to private sector, % yoy	21.5	13.6	-0.1	5.5	6.2	10.1	6.1	8.2	9.0
Policy Interest Rate, % eop	11.00	11.50	7.00	5.50	5.50	5.00	5.00	6.50	7.50
1 month inter-bank rate, %, eop	11.18	11.35	6.94	5.44	5.47	5.02	5.10	6.58	7.58
Long-term yield, %, eop	8.58	7.33	9.05	8.14	7.93	6.39	7.91	7.90	8.00
ZAR/US$, eop	6.87	9.49	7.41	6.62	8.09	8.46	10.50	11.70	11.54
ZAR/US$, avg	7.05	8.27	8.41	7.32	7.26	8.21	9.65	11.39	11.60
Balance of Payments, USD bn									
Current account	-19.9	-19.6	-11.6	-7.2	-9.4	-20.0	-20.4	-16.6	-13.8
% of GDP	-7.0	-7.2	-4.0	-2.0	-2.3	-5.2	-5.8	-5.1	-3.9
Trade balance	-5.2	-4.3	0.3	6.8	6.5	-4.8	-7.6	-5.7	-3.3
Exports	76.2	85.3	66.4	89.8	108.8	99.2	95.1	85.6	91.2
Imports	81.4	89.6	66.1	83.0	102.3	104.0	102.7	91.3	94.5
Service balance	-2.7	-4.1	-2.8	-4.4	-4.7	-2.5	-2.2	-1.8	-2.2
Income balance	-9.8	-8.9	-6.4	-7.2	-9.2	-8.9	-7.4	-6.5	-5.8
FDI, net	3.6	12.3	6.4	3.7	4.5	1.6	2.6	2.1	2.0
International reserves	29.6	30.6	35.3	38.2	42.6	44.0	47.0	49.8	52.0
Total amortisations	2.5	2.7	2.1	1.7	2.4	7.4	4.8	6.4	4.5
Public Finances, % of GDP									
Consolidated government balance	0.9	-1.0	-5.3	-4.9	-4.0	-4.4	-4.3	-4.2	-4.2
Consolidated gov primary balance	3.3	2.4	-3.1	-2.7	-1.7	-1.9	-1.6	-1.6	-1.6
Public debt	28.3	27.8	31.3	35.6	39.4	42.5	46.1	47.3	48.3
of which Domestic	24.5	23.4	27.7	32.3	35.6	38.8	42.2	43.8	44.8
Foreign Assets & Liabilities, USD bn									
External debt	63.0	60.4	63.8	80.6	89.7	113.7	91.6	97.9	102.7
Public	19.5	18.1	22.6	35.8	41.5	55.9	-	55.7	55.7
External debt / GDP	22.0	22.1	22.2	22.1	22.2	29.7	26.1	30.1	29.2
External debt / XGS	70.0	61.6	81.4	77.7	72.6	99.4	83.9	98.6	97.4
Short-term debt	24.0	25.5	21.3	21.7	20.5	27.9	28.4	29.0	29.5
Short-term debt/International reserves (%)	81.2	83.2	60.4	56.9	48.2	63.3	60.3	58.2	56.7

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.7	2.4	2.4	2.7	3.9	1.5	2.6	2.7	2.9
CPI, % yoy eop	6.1	5.3	6.1	6.9	6.7	7.0	6.5	6.2	5.7
Policy interest rate, %, eop	5.00	5.00	5.50	6.00	6.50	6.50	6.50	7.00	7.50
Short-term market rate, % eop	5.08	5.10	5.58	6.08	6.58	6.58	6.58	7.08	7.58
Long-term yield, %, eop	7.58	7.91	7.70	7.70	7.80	7.90	8.00	8.05	8.00
ZAR/US$, eop	10.03	10.50	10.97	11.34	11.53	11.70	11.66	11.62	11.58

Source: National Sources, Citi Research forecasts

Turkey

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- **Summary view** — A more hostile global environment and the marked increase in political noise have further complicated growth dynamics, raising downside risks associated with our 2014 GDP growth projection of 2.3%.
- **Things to watch** — Political developments in the run-up to the March 30th local elections and thereafter, forward-looking growth indicators and the CBT's resolve to maintain its tight stance need to be monitored closely.
- **Strategy** — While the CBT's bold rate hike at the emergency MPC meeting has provided some respite to the lira, tighter external financing conditions and a higher political risk premium overshadow the FX outlook.

Headwinds to growth persist

It is true that the main production indicators such as industrial production and the PMI appear resilient. It is also true that the likely moderate pick up in the Euro zone and the depreciation of the lira should help boost exports. Nonetheless, we still remain concerned about the growth outlook owing to the sharp drop in consumer confidence, which coupled with a tighter monetary policy stance and the lira depreciation, leads us to look for a significant drop in consumer spending. Forward looking sentiment indicators for private investment also continue to paint a similar picture, suggesting that domestic demand is on track to soften considerably. Against this backdrop, we expect growth to decelerate to 2.3% this year from an estimated 4% in 2013. Global and political headwinds suggest that the balance of risks associated with our growth forecast is tilted to the downside.

Data point to a sharp capital account shock in January

We expect the current account deficit to narrow this year to 5.2% of GDP from an estimated 7.8% in 2013 thanks to the lira depreciation and weaker domestic demand. A quick glance at the seasonally adjusted data also suggests that an adjustment is underway, as the current account gap in January is about US$2bn narrower than the previous month. In our view, the possibility of a narrower deficit than we envision cannot be ruled out given downside risks associated with our 2014 GDP growth forecast of 2.3%. A closer look at the capital account suggests that Turkey experienced a strong capital account shock in January. It looks like reserves (US$5.8bn) and errors and omissions (US$2.2bn) covered almost 95% of the country's external financing needs (current account gap and external debt service payments) in January.

Underlying inflation continues to deteriorate

At 7.9% YoY, the February inflation reading came in close to the consensus (7.8% YoY). Using seasonally adjusted data, the February inflation print translates into a rise of around 0.5% MoM, compared with a rise of 1.3% MoM in January and 0.7% MoM in December. We see a marked deterioration in underlying inflation indicators which, coupled with the worsening in forward-looking inflation expectations, paints a challenging outlook for the CBT. Specifically, with core measures (SA, 3-month moving average annualized) standing at around 9%-10%, we believe that the 5% target by the end of the year is getting out of reach. Against this backdrop, we see inflation at 8.2% by the end of 2014 with the risks tilted toward a higher print.

Is the CBT off the hook?

Developments to date suggest to us that there has been an improvement in the relative performance of the lira and the country's risk premium since the CBT's emergency rate hike. In our view, the CBT's decision to normalize monetary policy and keep money market rates closer to the upper band of the interest rate corridor (12%) instead of the one-week repo rate (10%) have also played an important role in supporting Turkish assets.

Looking ahead, if politics and global markets stabilize, the CBT may not need to carry out additional tightening since under these two assumptions, acute BOP pressures would subside. This would mean the CBT could get away with real policy rates at around 4-5%, ex-ante, i.e. a money market rate of around 11.5-12%, on average, less the 12-month ahead inflation expectations of little over 7%. On the other hand, we do not think the CBT can afford to ease rates even in this relatively benign scenario, simply because we very much doubt that inflation will begin to decelerate to 5% anytime soon.

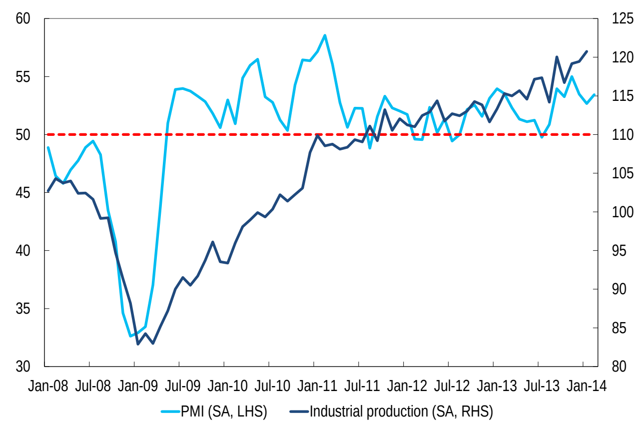
Lira: CBT's saves the day but…

We acknowledge that the CBT's rate hike at the emergency meeting has improved the near-term outlook for the lira. The absence of valuation problems and the increased buffer for downside risks should help reduce concerns about the lira, at least in the near term. Nonetheless, we believe that the lira continues to face a challenging outlook for at least two reasons. First, Turkey's large external financing needs will continue to overshadow the outlook. Due to a more hostile global environment, it will be more difficult to rely heavily on portfolio debt and short-term bank flows to meet the country's hefty external financing needs. Second, the sharp increase in the corporate sector's currency mismatch, which overshadows macroeconomic and financial stability, could aggravate the adverse impact of FX shocks.

The going is likely to get tougher for bonds

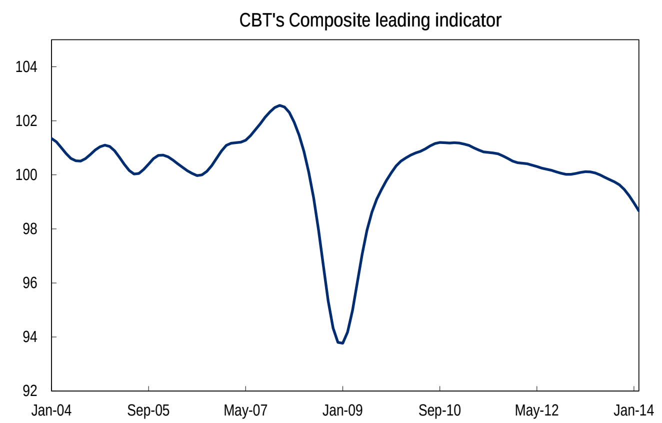
Upward pressures on bond yields seem to have intensified, **with the 10-year bond yields moving closer to its historical peak of about 11.40%.** In our view, the fixed income outlook remains challenging for several reasons. *First*, there has been a marked decline in the carry (the spread between bond yields and the cost of funding). *Second*, our analysis suggests that, under our base case, Turkey's real rates should be at around 4.5% this year, which under our base case, implies that the 2-year bond yields should be at around 12% to provide adequate buffer for downside risks. *Third*, we observe a meaningful change in the composition of capital inflows away from bonds and equity towards swaps since May 2013. This trend is likely to gain traction on the back of the Fed's decision to taper its QE program. *Fourth*, we believe that hedging through cross-currency swaps may not be as effective as it was in the past. We believe that the current level of the spread between the benchmark yield and the 2-year xCCY swap yield is unsustainable. In our view, the bulk of the adjustment in the noted spread will come from the 2 year benchmark bond yields, as front-end xCCY swap yields have already risen considerably due, in part, to investors' endeavor to hedge their position during the recent market volatility. Consequently, this leads us to believe that bonds would be more sensitive to adverse shocks when compared with swaps.

Figure 208. While IP and PMI seem to be resilient...



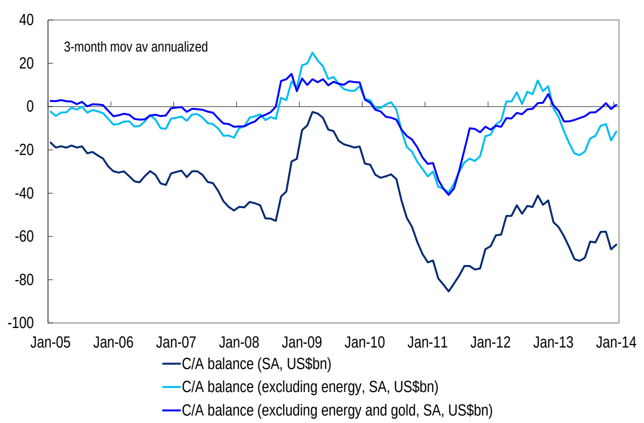
Source: Haver Analytics and Citi Research

Figure 209. ... leading indicators point to softer activity going forward



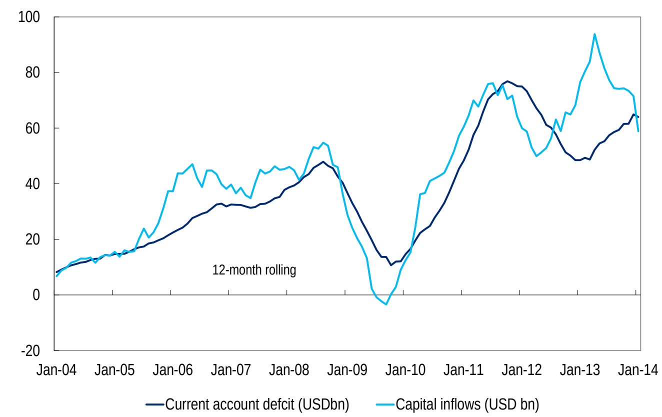
Source: CBT and Citi Research Note (12-month rolling)

Figure 210 It is true that external adjustment is set to gain traction...



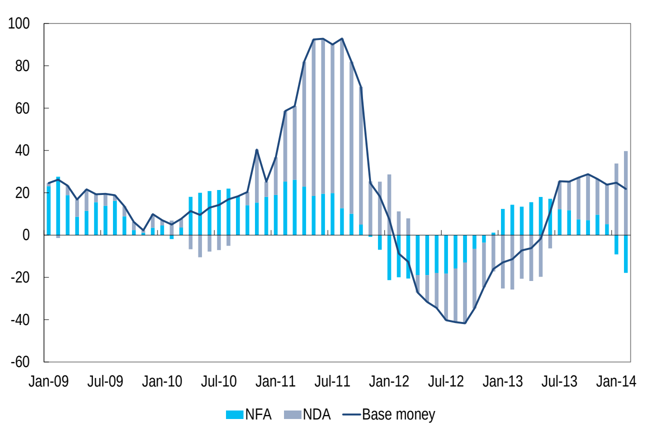
Source: Bloomberg and Citi Research

Figure 211. ... but subsiding capital inflows warrant concern...



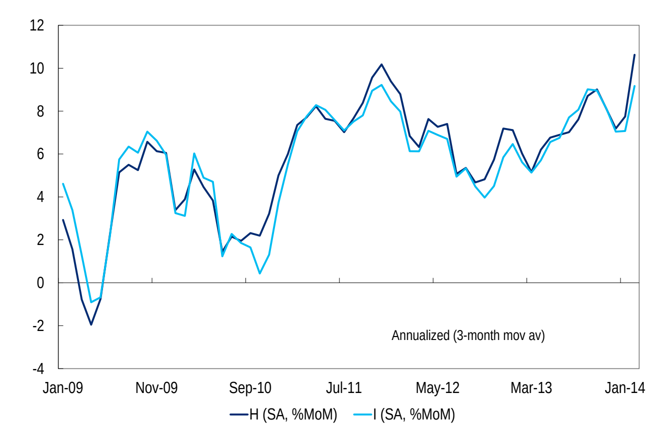
Source: Haver and Citi Research Note:12-month rolling sum.

Figure 212. ... as the CBT's ability to create permanent TRY liquidity is weakening...



Source: Bloomberg and Citi Research

Figure 213. ...against the backdrop of a sharp deterioration in underlying inflation dynamics



Source: CBT, Haver and Citi Research

Figure 214. Turkey Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	646	731	615	731	775	788	831	745	790
Nominal GDP, local currency bn	843	951	953	1,099	1,298	1,416	1,582	1,743	1,937
GDP per capita, USD	9,207	10,282	8,530	10,016	10,473	10,523	10,864	9,639	10,109
Population, mn	70.2	71.1	72.1	73.0	74.0	74.9	76.5	77.3	78.2
Unemployment, % of labour force	10.3	11.0	14.0	12.0	9.8	9.2	9.8	9.5	9.5
Economic Activity									
Real GDP, yoy avg	4.7	0.7	-4.8	9.2	8.8	2.2	4.0	2.3	3.5
Real investment growth % yoy	5.8	-4.8	-28.6	48.4	16.8	-8.3	9.3	-11.8	4.1
Real consumption growth % yoy	5.6	-0.1	-1.0	6.0	7.3	0.3	4.6	-0.5	3.2
private consumption growth % yoy	5.5	-0.3	-2.3	6.7	7.7	-0.6	4.6	-1.5	3.2
Real export growth, % yoy	7.3	2.7	-5.0	3.4	7.9	16.7	1.9	9.6	4.4
Real import growth, % yoy	10.7	-4.1	-14.3	20.7	10.7	-0.3	8.1	-10.4	4.0
Prices, Money & Credit									
CPI, % yoy eop	8.4	10.1	6.5	6.4	10.4	6.2	7.4	8.2	7.0
CPI, % avg	8.8	10.4	6.3	8.6	6.5	8.9	7.5	7.7	7.4
Nominal wages, % yoy	9.5	11.6	9.9	11.8	9.7	11.5	8.5	7.5	7.5
Credit extension to private sector, % yoy	27.8	22.4	13.4	40.4	32.8	19.8	33.5	15.0	15.0
Policy Interest Rate, % eop	15.75	15.00	6.50	6.50	5.75	5.55	7.10	11.50	10.50
1 month inter-bank rate, %, eop	17.21	17.16	7.20	6.89	11.54	5.80	8.66	12.70	11.70
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	1.17	1.54	1.50	1.54	1.89	1.78	2.15	2.40	2.48
TRY/US$, avg	1.31	1.31	1.55	1.51	1.68	1.80	1.91	2.34	2.45
TRY/EUR, eop	1.70	2.15	2.15	2.06	2.44	2.35	2.95	3.36	3.50
TRY/EUR, avg	1.79	1.92	2.17	2.00	2.34	2.32	2.53	3.25	3.45
Balance of Payments, USD bn									
Current account	-37.8	-40.4	-12.1	-45.4	-75.1	-48.5	-64.9	-39.1	-42.0
% of GDP	-5.8	-5.5	-2.0	-6.2	-9.7	-6.2	-7.8	-5.2	-5.3
Trade balance	-46.9	-53.0	-24.9	-56.4	-89.1	-65.3	-79.9	-58.3	-63.8
Exports	115.4	140.8	109.6	120.9	143.4	163.2	163.4	176.0	192.1
Imports	162.2	193.8	134.5	177.3	232.5	228.6	243.2	234.3	255.8
Service balance	14.0	18.9	18.6	16.7	20.2	22.6	23.1	26.5	28.6
Income balance	-7.1	-8.4	-8.3	-7.2	-7.9	-7.2	-9.3	-8.5	-8.2
FDI, net	19.9	17.2	7.1	7.6	13.8	9.2	9.8	9.5	10.0
International reserves	73.3	71.0	70.7	80.7	78.5	99.9	109.8	114.8	109.3
Total amortisations	37.6	41.1	47.4	45.0	37.9	33.5	36.4	44.0	50.0
Public Finances, % of GDP									
Consolidated government balance	-1.6	-1.8	-5.5	-3.6	-1.3	-2.0	-1.2	-2.8	-3.2
Consolidated gov primary balance	4.1	3.5	0.1	0.8	1.8	1.4	0.9	0.3	0.3
Public debt	40.4	41.2	47.7	44.4	41.2	38.8	38.2	37.7	36.7
of which Domestic	30.3	28.9	34.6	32.1	28.4	27.3	25.5	25.3	25.0
Foreign Assets & Liabilities, USD bn									
External debt	250.4	281.1	269.1	292.0	304.4	337.5	391.4	408.0	426.0
Public	89.3	92.4	96.6	100.6	90.0	101.8	117.3	122.8	127.8
External debt / GDP	38.7	38.5	43.8	39.9	39.3	42.8	47.1	54.7	53.9
External debt / XGS	172.4	158.1	185.1	185.8	165.4	163.6	186.5	180.6	173.2
Short-term debt	43.2	52.5	49.0	77.3	81.9	100.8	129.1	131.1	136.1
Short-term debt/International reserves (%)	58.9	74.0	69.3	95.8	104.4	100.9	117.5	114.2	124.5

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	4.4	4.0	3.4	1.5	1.5	3.0	3.0	3.6	3.8
CPI, % yoy eop	7.9	7.4	7.3	7.3	7.4	8.2	7.6	7.3	7.3
Policy interest rate, %, eop	6.45	7.10	10.20	11.00	11.50	11.50	11.00	10.50	10.50
Short-term market rate, % eop	7.34	8.66	11.40	12.20	12.70	12.70	12.20	11.70	11.70
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	2.02	2.15	2.26	2.33	2.37	2.40	2.42	2.44	2.46

Source: National Sources, Citi Research forecasts

Ukraine

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- **Summary view** — Tensions have flared again in Ukraine and political infighting has intensified. Economics has now taken a back seat to politics with street clashes leading to casualties. While the probability of a sovereign default has risen, signs are emerging that a political solution may materialize.
- **Things to watch** — The focus of attention will continue to be on external sustainability and political maneuvering in the run-up to the May Presidential elections. We think it will be hard to avoid a deepening recession in 2014 even in our baseline case of a relatively speedy resolution of the political crisis.
- **Strategy** — The NBU devalued the hryvnia by 10% in early Feb, but has since moved closer to its fair value of USD/UAH around 10. Irrespective of the way the political situation evolves, currency pressures look set to continue despite prospects of an imminent IMF Program.

Ukraine fell into a recession in 2013

Economic growth was lifted in 4Q13 on better agricultural harvest and higher steel prices. According to Ukrstat, 4Q13 GDP expanded at 3.3% YoY, well ahead of the market consensus, which anticipated a much more modest pace of expansion at 1.1% YoY. While there is no breakdown of GDP components, we think the faster-than-anticipated GDP growth may have been driven by agricultural output, which performed well into year-end, and some export-boosting recovery in steel prices.

This ensured that the economy fell into a mild recession in 2013 against a very challenging external backdrop. The 4Q13 economic expansion ensured that, following five quarters of contracting growth, GDP finally posted some recovery. Still, full-year 2013 GDP contracted by -0.1 % on the back of a 0.2% GDP growth in 2012. Trade with Russia has been badly hit by Ukraine's pursuit of an Association Agreement with the EU, while the Eurozone's shift towards a large current account surplus is not conducive to Ukrainian export growth. The cumulative current account deficit reached US$16bn in 2013E, up from US$14.8bn in 2012.

The second consecutive year of broadly flat growth has not helped improve the gaping current account deficit. The traditional positive effect of slowing economic performance on the external position has failed to materialize in the case of UKR as subdued domestic demand has been matched by contracting export growth to a still recessionary Europe and struggling Russia.

The hryvnia was devalued by 10% in early Feb in recognition of worsening external position, but the currency has continued to slide to around 10 against the USD. The NBU officially moved the USD/UAH fix to 8.7 from 7.99 in recognition of the fact that currency pressures cannot be contained against the backdrop of continued political and economic uncertainty. It also imposed some currency restrictions, including a waiting period of six days for foreign currency purchases for companies and individuals and a monthly limit of UAH50000 on individuals' non-trade related FX purchases. The hryvnia has subsequently moved to around 10 against the USD. Although the depreciation of UAH might pose some challenges for the economy, given the private sector still has large net FX liabilities, we believe that a weaker currency should be interpreted positively from a macro perspective. This is because it represents an equilibrium move to a value that is much more in line with economic fundamentals.

FX reserves have been running below 3 months of imports for a couple of months now. Although Ukrainian borrowers had plenty of capacity to borrow internationally in early 2013, that access to capital markets is no longer readily available and capital outflows are now threatening FX reserves. As of February, foreign reserves amounted to US$15.3bn or about 2.4 months of imports. This is driven not only by the worsening current account deficit, but also by the steady decline in net FDIs on the back of heightened political uncertainty.

We see deepening recession in 2014

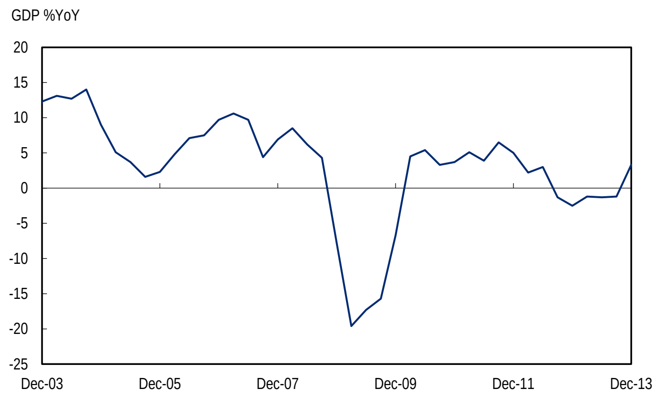
Our baseline scenario assumes that the new government will embark on resuming relationships with the IMF. It is of critical importance now for Ukraine to secure a financial package that would ensure avoidance of a sovereign default. Russia has already indicated that, at this juncture, it is likely to discontinue its financial support, which suggests that Ukraine's external financing gap of around US$30 billion will need to be met by other sources in order to avoid a default on the June sovereign Eurobond and the September Naftogaz Eurobond. It is most likely, in our view, that such support will come from a new IMF Program.

IMF conditionality will likely lead to a painful recession in 2014. The IMF program will include significant fiscal consolidation, a more flexible currency and higher gas tariffs for the households. These will lead to the contraction in investment spending continuing this year, with consumer spending also declining for the first time in five years and some improvement in export growth on better economic prospects for Europe. We thus forecast a GDP of contraction of 2.4% in 2014.

An IMF-type of public debt sustainability analysis reveals that Ukraine faces problems of illiquidity rather than insolvency. In our debt sustainability analysis we assume that Ukraine negotiates a new IMF/EU program that disburses US$30bn over the next few years under the conditions of a more flexible exchange rate (USD/UAH 10), tighter fiscal policy that brings the consolidated fiscal balance from -6% of GDP in 2013 to -1.5% of GDP by 2019, and higher gas tariffs for the households. Under these conditions, we compute that the public debt to GDP ratio would rise from 41.6% in 2013 to 54.2% in 2014, reaching a peak of 59.7% in 2015 and moderating to 55.9% by 2018. This analysis suggests that, in our view, the IMF will likely find that Ukraine suffers from illiquidity rather than insolvency, as the profile of the public debt to GDP ratio looks sustainable to us under realistic macro-economic assumptions.

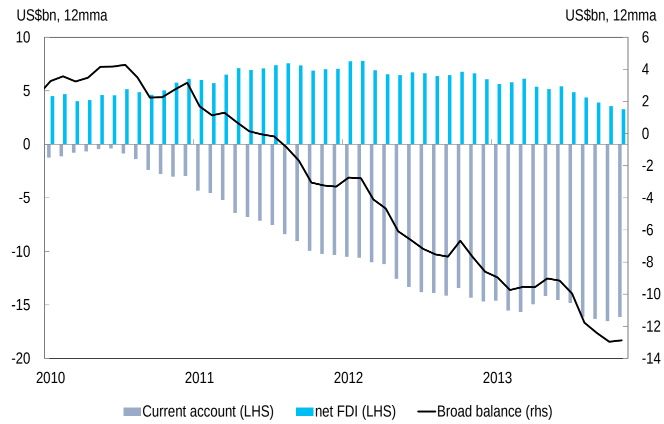
Currency pressures may continue, but we see the hryvnia trading range-bound around our estimated fair value of 10 against the USD. Using the so-called external sustainability approach, which estimates the potential exchange-rate misalignment as the required change in the real effective exchange rate that would remove the discrepancy between the current value of the current account and the level required to stabilize net foreign assets, we calculate that the hryvnia is about 25-30% overvalued relative to its end-2013 value of 7.99. Our approach suggests a fair value for the hrvyvnia of about 10 against the US dollar. With the currency already trading around these levels and assuming an IMF Program materializing in 2014, we see the hryvnia remaining broadly range-bound by end of 2014.

Figure 215. Economy struggles...



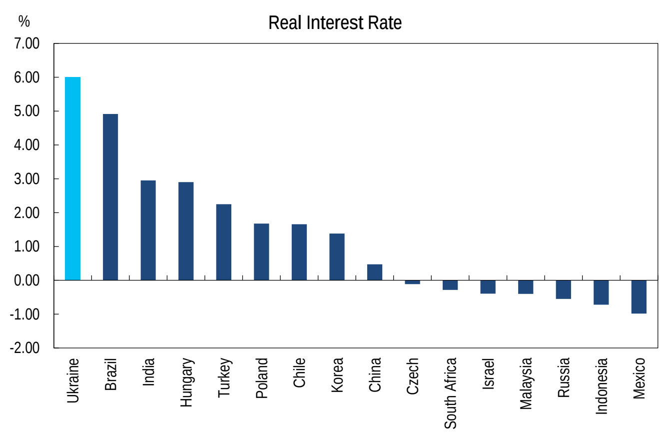
Source: UKR Statistics, Citi Research

Figure 216. ... and external position remains challenging



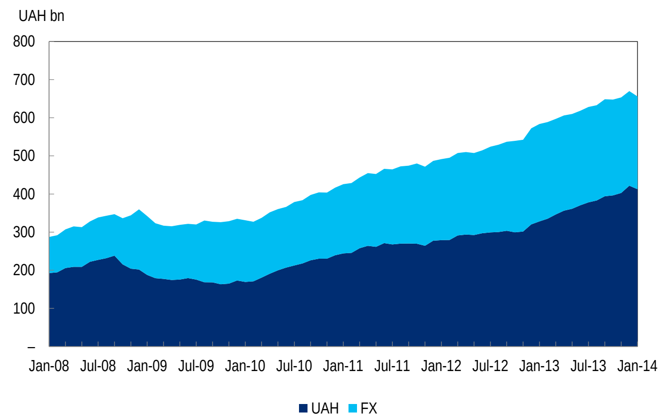
Source: UKR Statistics, Citi Research

Figure 217. Despite very high real interest rates...



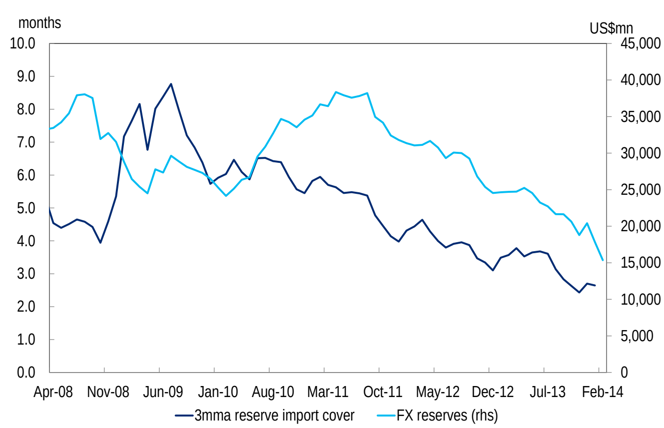
Source: Citi Research

Figure 218. ...population has started to reduce UAH deposits



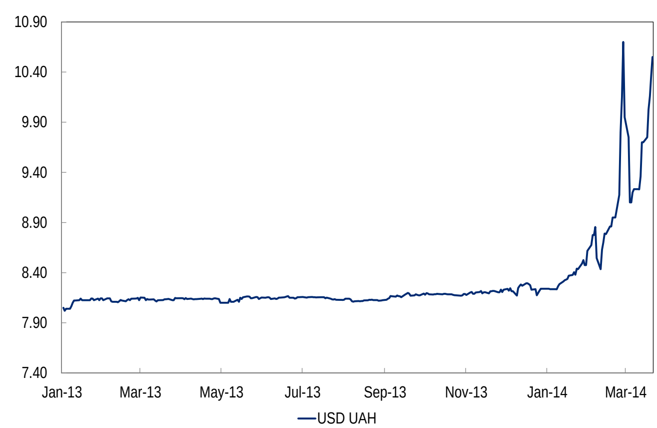
Source: UKR Statistics, Citi Research

Figure 219. Reserves are below 3 months of imports ...



Source: UKR Statistics, Citi Research

Figure 220. ...as the exchange rate has started to weaken



Source: Haver Analytics

Figure 221. Ukraine Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	143	180	117	136	163	177	172	146	152
Nominal GDP, local currency bn	715	946	913	1,080	1,294	1,408	1,406	1,431	1,545
GDP per capita, USD	3,059	3,875	2,536	2,964	3,566	3,872	3,795	3,238	3,378
Population, mn	46.7	46.5	46.2	46.0	45.8	45.6	45.4	45.2	45.0
Unemployment, % of labour force	6.4	6.4	8.8	8.1	7.9	7.5	7.7	7.7	7.5
Economic Activity									
Real GDP, yoy avg	7.6	2.3	-14.8	4.1	5.2	0.2	-0.1	-2.4	2.1
Real investment growth % yoy	26.6	1.8	-57.1	15.9	18.0	-13.9	-10.0	-8.3	13.2
Real consumption growth % yoy	13.1	10.1	-12.3	6.4	11.3	9.7	3.3	-1.6	2.2
private consumption growth % yoy	17.0	12.8	-14.9	7.1	15.5	11.6	4.0	-2.0	2.5
Real export growth, % yoy	2.8	5.7	-22.0	3.9	4.3	-7.7	-8.8	1.0	2.0
Real import growth, % yoy	23.9	17.0	-38.9	11.3	17.7	1.9	-5.8	0.0	6.0
Prices, Money & Credit									
CPI, % yoy eop	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	6.5	5.0
CPI, % avg	12.8	25.2	15.9	9.4	8.0	0.6	-0.3	4.2	5.8
Nominal wages, % yoy	29.7	33.7	5.5	17.7	17.5	14.9	9.1	9.7	8.5
Credit extension to private sector, % yoy	73.7	67.1	-4.2	0.7	8.9	2.8	7.0	10.0	10.0
Policy Interest Rate, % eop	8.00	12.00	10.25	7.75	7.75	7.50	6.50	6.50	6.75
1 month inter-bank rate, %, eop	8.41	23.78	19.10	10.75	20.25	25.00	16.25	8.50	8.13
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US$, eop	5.05	8.05	8.05	7.97	8.01	8.05	8.24	10.00	10.30
UAH/US$, avg	5.03	5.16	8.06	7.97	7.99	8.08	8.15	9.78	10.16
UAH/EUR, eop	7.37	11.25	11.53	10.66	10.37	10.62	11.33	14.00	14.50
UAH/EUR, avg	6.89	7.60	11.21	10.55	11.11	10.39	10.83	13.45	14.27
Balance of Payments, USD bn									
Current account	-5.3	-12.8	-1.7	-3.0	-10.2	-14.3	-16.1	-10.8	-7.8
% of GDP	-3.7	-7.1	-1.5	-2.2	-6.3	-8.1	-9.3	-7.4	-5.2
Trade balance	-10.6	-16.1	-4.3	-8.4	-16.3	-19.5	-21.1	-17.0	-13.7
Exports	49.8	67.7	40.4	52.2	69.4	70.2	64.2	67.4	70.8
Imports	60.4	83.8	44.7	60.6	85.7	89.7	85.3	84.4	84.4
Service balance	2.4	1.7	2.4	4.4	6.1	5.2	4.6	6.0	5.5
Income balance	-0.7	-1.5	-2.4	-2.0	-3.8	-3.0	-2.9	-3.0	-3.0
FDI, net	9.2	9.9	4.7	5.8	7.0	9.4	3.0	0.0	6.8
International reserves	32.5	31.5	26.4	34.6	31.8	24.5	17.9	20.9	26.7
Total amortisations	8.5	13.9	17.9	23.5	23.6	20.1	20.5	18.0	22.1
Public Finances, % of GDP									
Consolidated government balance	-0.8	-1.2	-7.3	-8.8	-3.9	-5.6	-6.1	-4.1	-3.2
Consolidated gov primary balance	-0.3	-0.7	-6.2	-7.6	-2.9	-4.7	-4.5	-2.7	-1.9
Public debt	10.8	14.4	25.5	31.5	28.3	29.0	33.4	49.8	54.8
of which Domestic	2.5	4.7	10.0	13.1	12.4	13.5	17.1	18.8	18.5
Foreign Assets & Liabilities, USD bn									
External debt	80.0	101.7	103.4	117.3	126.2	135.1	137.5	150.6	154.9
Public	12.3	16.7	24.0	32.5	33.4	32.2	30.5	35.2	37.3
External debt / GDP	56.0	56.5	88.2	86.0	77.2	76.5	79.8	102.9	101.9
External debt / XGS	124.9	118.7	190.6	169.4	142.1	150.0	159.1	166.3	218.8
Short-term debt	20.7	20.3	19.0	23.5	30.7	33.2	33.6	34.0	35.3
Short-term debt/International reserves (%)	63.7	64.4	72.0	68.1	96.7	135.2	187.2	162.8	132.1

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	-1.2	3.3	-3.0	-3.0	-2.3	-1.6	2.3	2.1	2.1
CPI, % yoy eop	-0.5	0.5	2.2	4.3	6.4	6.5	7.1	5.5	5.0
Policy interest rate, %, eop	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.50
Short-term market rate, % eop	5.97	16.25	15.00	9.00	8.50	8.50	8.13	8.13	8.13
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US$, eop	8.19	8.24	9.95	10.00	10.00	10.00	10.10	10.20	10.20

Source: National Sources, Citi Research forecasts

Other Africa

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Ghana

- The next two years are set to be a crucial period of fiscal consolidation for the government if it is not to see further pressure on the cedi which will potentially undermine the government's credibility as it heads to elections in December 2016. Fiscal consolidation, however, will be tough, with the reality being that the government will need to significantly boost revenue collection which is well below the levels of other middle income governments in Africa.

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

- Without more concerted efforts at fiscal consolidation, there is a chance that the government could lose wider loss of investor confidence in Ghanaian debt with few investors willing to roll their maturing cedi bonds while struggling to issue a new Eurobond. Given this, signing of a new agreement with the IMF at some point in 2014 may be an absolute necessity to restore confidence.

Kenya

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

- Meanwhile, the twin fiscal and current account deficits have started to fall as the practical difficulties of implementing the new constitution have constrained government spending, while import growth seems to have eased. The current account is also likely be substantial revised in 2014 with the current capital inflows, both official and short term, revised as current account transactions. But with both deficits falling, we think that Kenyan shilling (KES) depreciation will be limited in 2014-15.

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

Tanzania

- Over the next two years Tanzanian politics will be dominated by the battle to succeed current president, Jakaya Kikwete, and adopting a new constitution. A revised draft was released in December, but, given various contentious issues, could distract the government's much needed focus on economic reform. The most immediate pressing priority is resolving the ongoing power sector crisis, which has negatively impacted growth, pushed up imports and made bringing down the inflation rate a much slower process than elsewhere in East Africa, although it is now firmly in single digits.

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

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

Uganda

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

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

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

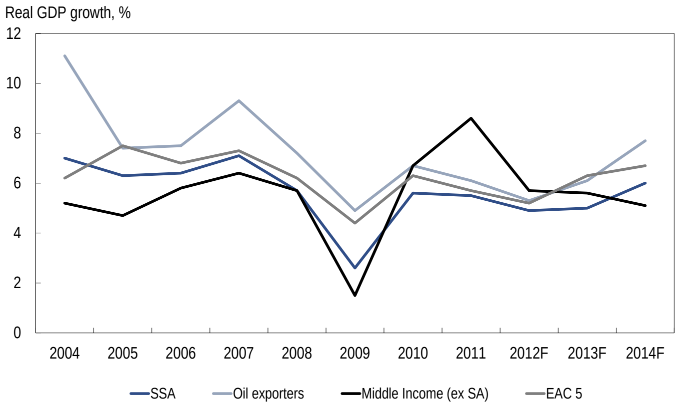
Zambia

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

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

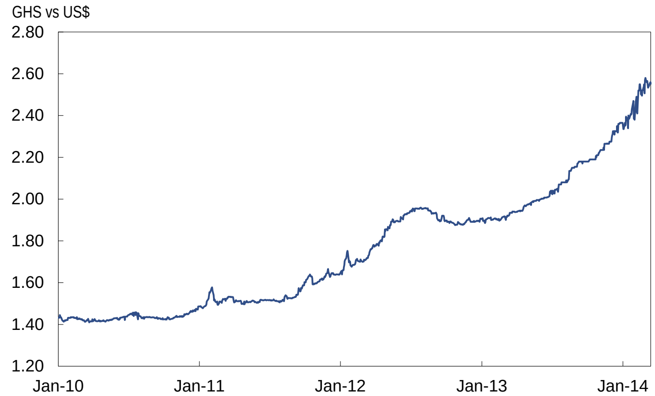
- These developments should provide considerable support for the kwacha, with only modest depreciation going forward once the current bout of weakness has run its course. And it should allow the Bank of Zambia (BoZ) to rebuild foreign exchange reserves which are low by regional standards.

Figure 222. Growth should be robust in 2014-15



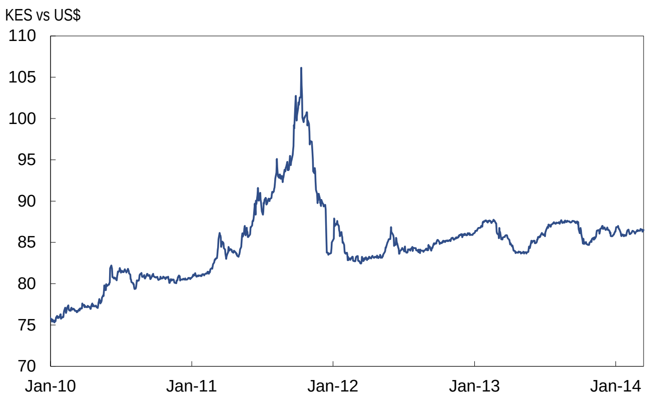
Source: IMF

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



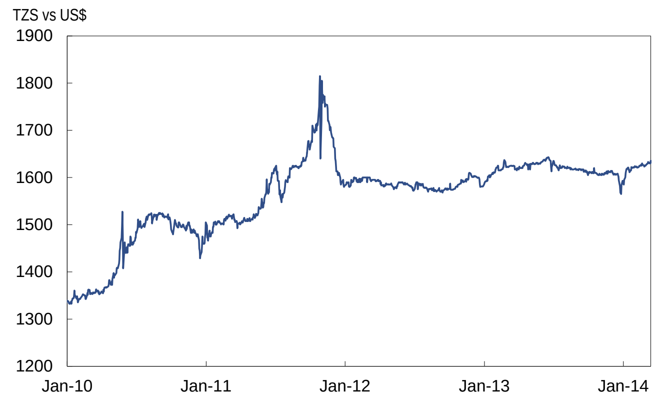
Source: Haver Analytics

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



Source: Haver Analytics

Figure 225. Is the Tanzanian shilling now too strong?

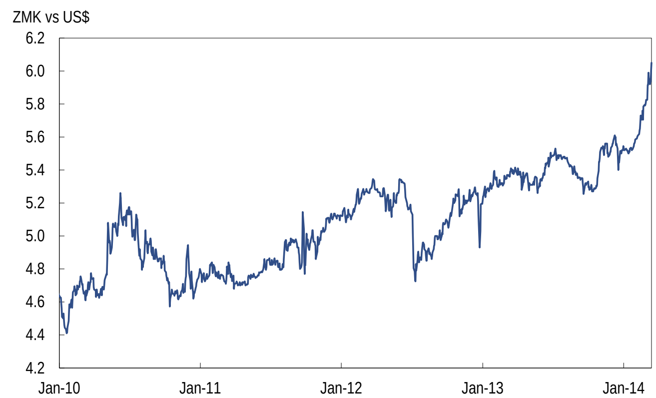


Source: Haver Analytics

Figure 226. A stable Ugandan shilling in 2013 and early 2014

Source: Haver Analytics

Figure 227. The kwacha is volatile, with a sharp recent drop



Source: Haver Analytics

Figure 228. Other Africa Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
GHANA									
Nominal GDP, USD bn	24.8	28.5	26.0	32.2	39.6	40.7	41.0	37.4	37.6
GDP per capita, USD	1,099	1,234	1,096	1,326	1,594	1,605	1,582	1,413	1,393
Real GDP, yoy avg	6.5	8.4	4.0	8.0	15.0	7.9	7.4	4.6	6.5
CPI, % avg	10.7	16.5	19.3	10.7	8.7	9.2	11.7	12.7	7.7
Policy Interest Rate, % eop	13.5	17.0	18.0	13.5	12.5	15.0	16.0	19.0	16.0
GHS/US$, avg	0.95	1.07	1.43	1.43	1.55	1.85	2.06	2.71	3.13
Current account, US$bn	-2.1	-3.5	-1.6	-2.6	-2.5	-4.9	-5.2	-5.0	-5.0
% of GDP	-8.6	-12.4	-6.2	-8.2	-6.3	-12.1	-12.7	-13.4	-13.3
Consolidated gov. balance, % of GDP	-5.6	-8.4	-7.0	-9.4	-5.5	-9.3	-10.8	-8.9	-7.4
KENYA									
Nominal GDP, USD bn	27.2	30.5	30.6	32.2	34.3	40.7	44.1	51.1	56.8
GDP per capita, USD	721	786	768	788	817	943	995	1,121	1,216
Real GDP, yoy avg	7.0	1.5	2.7	5.8	4.4	4.6	5.1	5.5	6.1
CPI, % avg	4.3	15.1	10.6	4.3	14.0	9.4	5.4	7.1	6.7
Policy Interest Rate, % eop	8.8	8.5	7.0	6.0	18.0	11.0	8.5	8.5	8.0
KES/US$, avg	67.3	68.8	77.3	79.2	88.4	84.5	86.1	87.6	92.4
Current account, US$bn	-1.1	-2.0	-1.8	-2.1	-3.3	-3.8	-3.4	-3.9	-4.3
% of GDP	-4.0	-6.6	-5.8	-6.5	-9.6	-9.3	-7.8	-7.6	-7.5
Consolidated gov. balance, % of GDP	-4.2	-3.5	-6.2	-4.7	-5.5	-9.0	-7.0	-5.5	-4.5
TANZANIA									
Nominal GDP, USD bn	16.8	20.7	21.4	22.9	23.9	29.1	31.9	34.9	37.5
GDP per capita, USD	409	489	490	509	515	609	648	689	717
Real GDP, yoy avg	7.1	7.4	6.0	7.0	6.4	6.9	6.8	7.0	8.1
CPI, % avg	7.0	10.3	12.1	7.2	12.7	16.0	7.9	6.6	6.8
TZS/US$, avg	1,237	1,198	1,324	1,439	1,582	1,586	1,617	1,646	1,730
Current account, US$bn	-2.3	-3.2	-2.5	-2.7	-4.6	-3.5	-3.3	-4.9	-4.6
% of GDP	-13.9	-15.2	-11.5	-11.9	-19.1	-11.9	-10.2	-14.1	-12.4
Consolidated gov. balance, % of GDP	-1.9	-2.6	-6.0	-6.5	-5.0	-5.4	-5.0	-5.2	-5.9
UGANDA									
Nominal GDP, USD bn	13.5	16.4	16.5	17.2	18.2	21.2	22.6	24.7	26.8
GDP per capita, USD	441	515	503	506	518	584	601	636	668
Real GDP, yoy avg	8.1	10.4	4.1	6.2	6.2	2.8	5.0	5.2	5.5
CPI, % avg	6.1	12.0	13.0	4.0	18.7	14.0	5.5	6.0	6.1
UGX/US$, avg	1,723	1,714	2,025	2,173	2,511	2,501	2,584	2,563	2,735
Current account, US$bn	-0.6	-1.3	-1.1	-1.7	-2.1	-1.9	-2.7	-3.4	-4.0
% of GDP	-4.8	-7.8	-6.7	-10.0	-11.7	-9.0	-12.0	-13.9	-14.9
Consolidated gov. balance, % of GDP	-1.1	-2.8	-2.4	-6.7	-3.2	-3.6	-3.4	-3.3	-3.5
ZAMBIA									
Nominal GDP, USD bn	11.5	14.6	12.8	16.2	19.2	20.6	22.2	22.8	25.1
GDP per capita, USD	953	1,175	998	1,225	1,408	1,465	1,528	1,515	1,619
Real GDP, yoy avg	6.2	5.7	6.4	7.6	6.8	7.3	6.0	6.4	6.3
CPI, % avg	10.6	12.4	13.4	8.5	6.4	6.6	7.0	7.0	7.3
ZMK/US$, avg	3,992	3,702	5,020	4,791	4,861	5,139	5,195	6	6
Current account, US$bn	-0.8	-1.1	0.5	1.1	0.7	0.0	0.0	-0.2	-0.4
% of GDP	-6.5	-7.2	4.2	7.1	3.7	0.1	0.2	-1.0	-1.5
Consolidated gov. balance, % of GDP	-1.3	-0.8	-2.5	-3.0	-2.2	-3.1	-7.1	-5.9	-5.1

Quarterly Economic Indicators	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GHS/US$, eop	2.18	2.37	2.50	2.70	2.80	3.05	3.00	3.10	3.20
KES/US$, eop	86.40	86.45	86.80	87.50	88.00	89.50	90.00	92.00	92.00
TZS/US$, eop	1,605	1,587	1,620	1,640	1,660	1,680	1,700	1,725	1,750
UGX/US$, eop	2,550	2,523	2,525	2,570	2,580	2,615	2,700	2,700	2,800
ZMK/US$, eop	5,195.00	5,195.00	6.10	6.00	6.00	6.00	6.10	6.10	6.20

Source: National Sources, Citi Research forecasts

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GDP expanded 1.2% YoY in 4Q 2013, topping the flash estimate of 1.0% YoY, and bringing growth for the whole year to 0.9%YoY. The detailed national accounts data suggest that the relative strength in 4Q was mainly driven by an increase in fixed capital formation and a positive contribution of net exports, as consumption expenditures remain subdued. More specifically, individual and collective consumption expenditures fell 03% QoQ (SA) and 0.6% QoQ (SA) in 4Q, respectively, failing to offer hope for a meaningful recovery. Nevertheless, gross fixed capital formation rose strongly by 1.5% QoQ (SA), following an even stronger rise in 3Q (1.8% QoQ, SA). Finally, while sequential export growth fell in 4Q (-0.3% QoQ) in 4Q, the contribution of net exports remained in positive territory due to an even larger drop in imports of -1.5%QoQ (SA). Looking ahead, we expect to see a more of the same this year, as growth is likely to be driven by continued strength in investment activity—thanks to a higher absorption rate of EU funds—and net exports on the back of the likely pick-up in growth in the Euro zone. However, it is worth noting that risks associated with our 2014 GDP forecast are tilted to downside since the recent developments in Ukraine can undermine economic activity through a reduction in exports and tourism revenues and the possibility of higher oil prices.

Turning to price developments, at -2.6%YoY, deflationary pressures accelerated in February when compared with January (-2.2%). The drop in inflation was mainly driven by services and particularly by transport prices, which contributed about 0.33ppt to the noted drop of 0.4ppt. Food inflation, which, together with utility price adjustments, has been the main driver of the sharp drop in inflation since mid-2013, shows signs of a reversal. While the deflationary environment is likely in the short-term, we expect inflation to rise to about 2.0% by end of the year. Regarding external developments, the current account deficit came in at EUR282mn in January, compared with a deficit of about EUR88mn in the same month of 2013. The noted EUR194mn deterioration over a year ago was driven by a drop in exports (-EUR192mn) and a rise in imports (EUR98mn). While we expect to see a pick-up in exports in the coming months on the back of a stronger European growth, spillovers from the Ukraine crisis represents an important headwind in the short-term.

Croatia

The 4Q national account data point to a marked drop in private consumption and investment activity. Particularly, household consumption and fixed capital formation fell by 3.1% QoQ (SA) and 3.9% QoQ (SA) in the fourth quarter, respectively, leading GDP to contract by 1.2% QoQ (SA) in 4Q. We acknowledge that the recent data offers some hope with industrial production increasing by 5.4% MoM (SA) in January—the strongest MoM rise since September 2011. Nevertheless, the continued weakness in domestic demand (as is evidenced by the 0.10% MoM decline in retail sales in January) and anemic lending activity (-1.6% YoY in January) and poor labor market conditions led us to revise our growth forecast for 2014 considerably to 0.7% from 1.2%.

Regarding price developments, inflation fell to -0.6% YoY in February from 0.1% in January on the back of benign food prices and clothing prices. However, our analysis suggests that inflation is likely to rise gradually to about 1% by the end of second quarter and further to about 2.0% by end-2014 as favorable cyclical factors dissipate. Turning to external developments, we currently look for a deficit of 0.2% of GDP compared with 0.2% of surplus in 2013. On the fiscal front, following the opening of an excessive deficit procedure (EDP) for Croatia by EC on

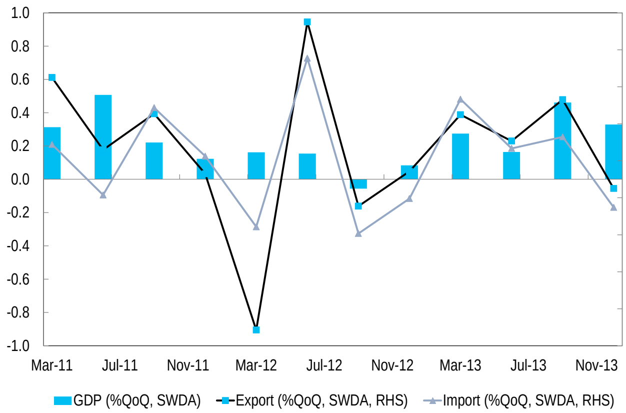
January 28, the government announced that it revised its fiscal deficit target for 2014 to 4.5% of GDP from 5.5% of GDP on March 5. Against this backdrop, we expect the budget gap in 2014 to remain at around 5.5% of GDP, above the government's new target.

Serbia

According to preliminary results based on about 99% of counted votes, the coalition led by the Serbian Progressive Party (SNS) won 48.3% of votes and absolute majority of 158 seats in the assembly. Development to date lead us believe that the new government is likely to be established before May 1 and that Mr. Krstic will remain Finance Minister. We think that the focus will now shift to needed structural reforms and cuts in public spending. To this end, we think that securing a three-year precautionary with the IMF may help anchor expectations given the weak fiscal situation and the envisioned drop in growth. Turning to the economic outlook, recent high frequency indicators paint a relatively upbeat picture. For example, the industrial production rose by 2.6% MoM (SA) in January following a 1.2% drop in December. Similarly, retail sales growth accelerated to 0.9% MoM (SA) in January compared with a flat reading in December, corroborating our view that domestic demand will gain some traction in 2014. In addition, we think that the expected euro area recovery and the start of negotiations on EU accession will play a critical role in driving growth this year. Nevertheless, we expect that unfavorable base effects in agricultural production and automobile industry will overshadow the growth outlook in the short-term. Against this backdrop, we look for a moderation in GDP growth this year to 1.2% from 2.5% in 2013.

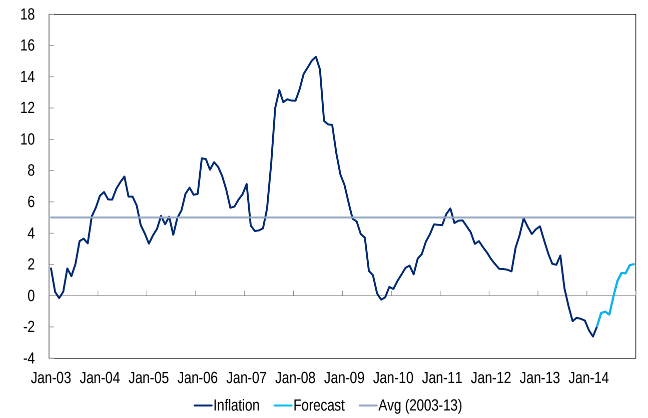
Turning to price developments, inflation dropped to 2.5% YoY in February from 3.1% YoY in January owing to the continued softness in food inflation and lower than-expected transport prices. Looking ahead, however, our analysis suggests that a reversal in cyclical factors, coupled with unfavorable base effects, will likely push inflation above the Bank's tolerance band of 4%±1.5% in May. Against this backdrop, we expect inflation to end the year at around 6.5%, compared with 2.2% in 2013. In light of our inflation forecast trajectory and a more hostile global environment, we believe that there is not much room left for additional easing. Our view is supported by the NBS's recent decisions to keep rates on hold in the last three Board meetings. Against this backdrop, we think that while an additional 50bp cut may be still on the table in the coming months—particularly, if the RSD remains stable and the EM sell-off eases—with inflation is set to exceed the Bank's tolerance band, the NBS is likely to err on the side of caution. Regarding the external balance, we see a marked adjustment in the current account balance, which narrowed from a deficit of 11% of GDP in 2012 to an estimated 5% in 2013, thanks to the strong export performance and the subdued domestic demand. Looking ahead, however, we think that further external adjustment will be much harder since we expect favorable base effects to dissipate and domestic demand to pick up moderately. All in all, we expect that the current account deficit will remain broadly unchanged in 2014, at around 5% of GDP.

Figure 229. Bulgaria: Net exports will likely be the driving force of growth in 2014...



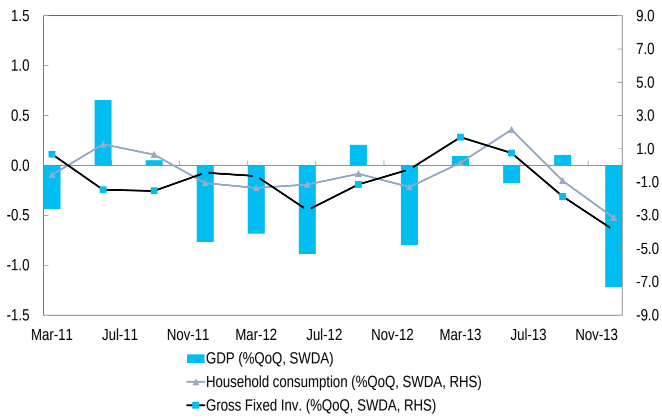
Source: Haver Analytics and Citi Research

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



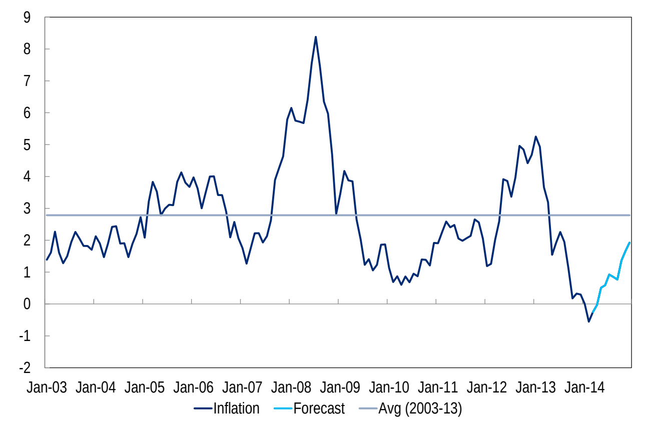
Source: Haver Analytics and Citi Research

Figure 231. Croatia: Continued weakness in domestic demand led us to revise our growth forecast to 0.7% from 1.2%...



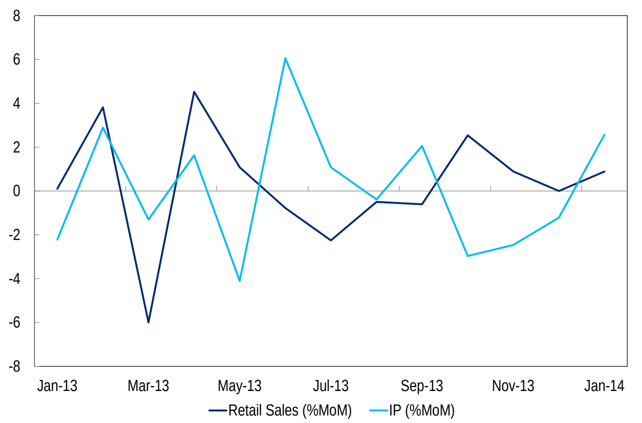
Source: Haver Analytics and Citi Research

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



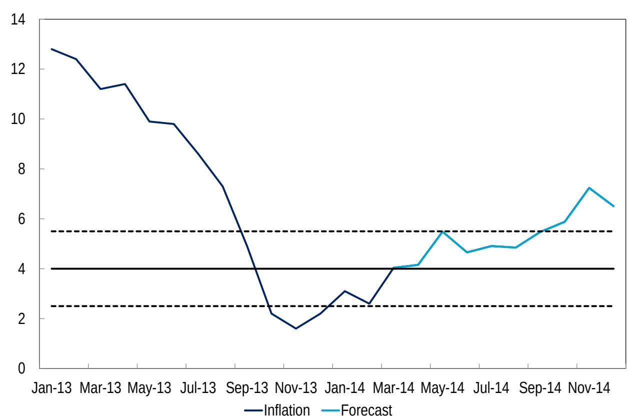
Source: Haver Analytics and Citi Research

Figure 233. Serbia: recent high frequency indicators paint a relatively upbeat picture ...



Source: Haver Analytics and Citi Research

Figure 234....as inflation is set to go above the NBS' tolerance band



Source: Haver Analytics and Citi Research

Figure 235. Other Europe Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
BULGARIA									
Nominal GDP, USD bn	42.1	51.8	48.6	47.7	53.5	51.0	53.9	57.1	60.7
GDP per capita, USD	5,512	6,812	6,421	6,360	7,307	6,997	7,437	7,924	8,460
Real GDP, yoy avg	6.4	6.2	-5.5	0.4	1.8	0.8	0.9	1.5	2.5
CPI, % avg	8.4	12.3	2.8	2.4	4.2	3.0	0.9	-0.2	2.5
BGN/US$, avg	1.43	1.33	1.40	1.47	1.40	1.52	1.47	1.41	1.39
BGN/EUR, avg	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
Current account, US$bn	-10.8	-11.9	-4.3	-0.8	0.1	-0.7	1.1	-0.5	-0.3
% of GDP	-25.6	-23.0	-8.8	-1.6	0.3	-1.4	2.1	-0.8	-0.5
Consolidated gov. balance, % of GDP	3.3	2.9	-0.9	-4.0	-2.0	-0.5	-1.9	-2.0	-1.2
CROATIA									
Nominal GDP, USD bn	59.3	69.6	62.2	58.9	61.8	56.4	58.3	61.0	63.7
GDP per capita, USD	13,376	15,690	14,044	13,331	14,432	13,106	13,586	14,268	14,977
Real GDP, yoy avg	5.1	2.1	-6.9	-2.3	0.0	-2.0	-1.0	0.7	1.5
CPI, % avg	2.9	6.1	2.4	1.0	2.3	3.4	2.2	0.6	2.8
Policy Interest Rate, % eop	9.00	9.00	9.00	9.00	7.00	7.00	7.00	7.00	7.00
HRK/US$, avg	5.35	4.91	5.26	5.49	5.34	5.84	5.70	5.53	5.52
HRK/EUR, avg	7.34	7.23	7.34	7.29	7.43	7.51	7.58	7.68	7.75
Current account, US$bn	-4.3	-6.1	-3.0	-0.8	-0.4	-0.1	0.1	0.0	-0.3
% of GDP	-7.3	-8.7	-4.9	-1.4	-0.7	-0.2	0.2	0.0	-0.5
Consolidated gov. balance, % of GDP	1.4	0.4	-2.0	-3.6	-3.6	-2.4	-5.5	-5.5	-5.0
SERBIA									
Nominal GDP, USD bn	39.0	47.8	40.2	37.1	43.7	38.5	43.5	46.6	49.1
GDP per capita, USD	5,277	6,497	5,496	5,085	6,026	5,303	5,987	6,425	6,767
Real GDP, yoy avg	5.4	3.8	-3.5	1.0	1.6	-1.7	2.5	1.2	2.0
CPI, % avg	5.6	11.9	8.7	6.1	11.0	7.8	7.9	4.9	6.3
Policy Interest Rate, % eop	10.00	17.75	9.50	11.50	9.75	11.25	9.50	9.00	8.50
RSD/US$, avg	58.3	55.2	67.4	77.5	73.2	87.8	85.1	84.3	86.7
RSD/EUR, avg	80.0	81.4	94.0	102.9	102.0	112.9	113.1	117.1	121.8
Current account, US$bn	-6.9	-10.4	-2.9	-2.8	-4.0	-4.1	-2.2	-2.3	-2.7
% of GDP	-17.7	-21.9	-7.1	-7.5	-9.1	-10.6	-5.0	-4.9	-5.5
Consolidated gov. balance, % of GDP	0.6	-1.8	-3.5	-3.5	-4.1	-5.7	-7.2	-5.5	-5.0

Source: National Sources, Citi Research forecasts

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Latin America

Argentina

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- **Summary view** — The authorities' intervention has temporarily stopped the drain in international reserves. However, this was mainly the consequence of regulatory changes limiting banks' FX positions and increased FX pressure on exporters and importers. The authorities anticipate that the second quarter export pickup will contribute to restoring stability. However, macroeconomic conditions remain unsustainable, in our view.

- **Things to watch** — Watch for fiscal announcements. Also, keep an eye on monetary printing, as the scarcity of foreign currency is the flipside of an excess of domestic currency. Lastly, confidence indicators (e.g., consumer) have shown a marked deterioration recently, which could suggest increased pressure on activity.

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

International Reserves: On the Razor's Edge

International reserves continue to be the key variable to be monitored in Argentina. The authorities' actions have been increasingly driven by a concern over the level and future prospects for international reserves. Today, gross reserves stand at USD27.2bn, having fallen USD3.4bn year-to-date. To stabilize reserves, the authorities have resorted to a combination of actions: a devaluation of the currency; tighter limits on bank's FX holdings; a request to exporters to bring forward export revenues; and sharp restrictions on imports.

Net reserves are at a critical level. A frequent calculation in the local market nets out of the stock of reserves the very short term FX liabilities of the central bank. Netting out FX-denominated deposits (USD7.8bn) and Banque de France repo lines (according to the press, they have been reduced to approximately USD 1.5bn) yields USD17.9bn of net reserves. Since not all reserves are liquid (there are SDR's and gold held in Buenos Aires) it is possible to estimate that net and liquid reserves stand today at less than USD15bn: a level dangerously close to the international obligations until December 2015 (the end of the term of the current administration).

From deleveraging to re-leveraging, the government is attempting a radical change in strategy. Aware that the current FX calm is fragile, the government is attempting to regain access to international lines of credit. The first steps include a (partial) resolution of some ICSID claims and an agreement with REPSOL over the nationalization of YPF that were settled through issuance of bonds. The authorities have also approached the Paris Club where they are scheduled for a debt work-out session in late May. There are also several press reports that there are attempts to re-engage the Inter-American Development Bank and the World Bank, trying to expedite the approval of credit lines.

Fiscal Adjustment: Where, When and How?

The large fiscal imbalance (for a country with no access to credit) is at the heart of Argentina's problem. Peso transfers from the BCRA to the Treasury remain unabated. In the year ending on March 14, the BCRA transferred ARS94.9bn to the Treasury, or 31.8% of the M0 a year ago. The latest officially published fiscal accounts (January) illustrate the magnitude of the fiscal problem. In the last semester, primary expenditure has increased 38.1% YoY, compared to a 33.1% YoY rise in revenues.

Since the cabinet reshuffle of late 2013 the authorities have repeatedly argued that energy and transportation subsidies will be cut to strengthen fiscal accounts. However, so far, only bus fares in the Buenos Aires metropolitan area have been (partially) increased - the bulk of subsidies being in the energy sector. Announcements over the date, magnitude and scope of any changes to the subsidy policy remain elusive.

External Accounts: Will They Come to the Rescue?

The fiscal imbalance has generated a monetary overhang. Argentina has an excess of pesos in circulation (relative to demand) which, despite the selling of foreign currency by the BCRA and the FX devaluation, has not been eliminated. In order to reduce the pressure on international reserves resulting from this imbalance, the authorities have introduced tight restrictions on capital outflows, on dividend payments abroad and on other flows. However, when tight capital controls are in place, a monetary overhang typically yields a deteriorating current account.

The recently published central bank cash-basis FX balance shows a large current account deficit: 13.3bn for 2013 (which compares to USD3.9bn surplus in 2012). The deterioration in the current account was the consequence of deteriorating trade and service balances. The cash trade balance posted an USD1.8bn surplus, compared to an USD14.7bn surplus in 2012. Regarding the service deficit, it widened from USD3.8bn in 2012 to USD9.4bn in 2013, mainly driven by tourism.

In 2014, external accounts continue to show a worrisome pattern. YTD, the trade balance posted an USD79mn surplus, compared to USD800mn during the first two months of 2013. On the side of exports, primary goods exports have plummeted 38% YoY during January-February, while industrial manufacturers have decreased 7% YoY. Conversely, exports of agricultural manufactures and fuels have increased 10% YoY and 18% YoY, respectively.

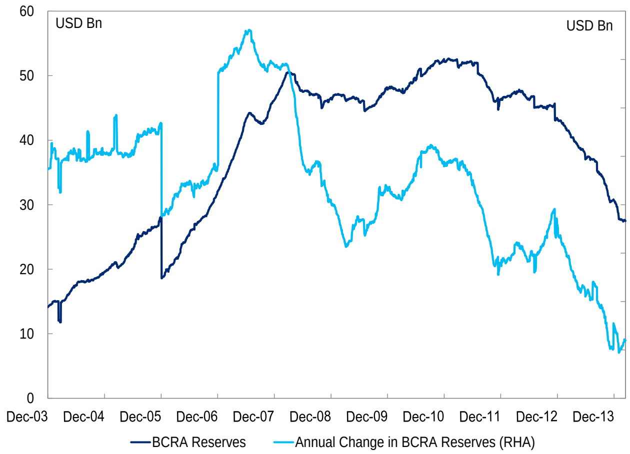
The government's short term strategy is critically dependent on primary goods exports picking up pace in Q2. A strong crop and very high soy prices feed the government's optimism. Furthermore, the weaker ARS and higher interest rates also add to the view that farmers will choose to sell their exports, rather than stockpile them (current technology allows the stockpiling of the crop for a few years at extraordinarily low costs). We remain concerned that incentives remain tilted in the direction of inducing farmers to hoard the crop. If that is the case, the sale of dollars may not shore up international reserves strongly enough in Q2 to ward off a seasonally challenging Q3 and Q4 in terms of the demand for USD.

Economic Activity and Inflation: Stagflation^2

Non-official estimations suggest activity has flat-lined during the first two months of 2014. According to the local consultancy firm OJF, in February its General Activity Index (IGA) showed a 0% change in seasonally-adjusted terms when compared to December 2013. In annual terms, the IGA rose 1.3% in January and 0.7% in February. Private estimates suggest economic activity has been flat since 2H13. We continue to expect non-official GDP to drop 1% this year.

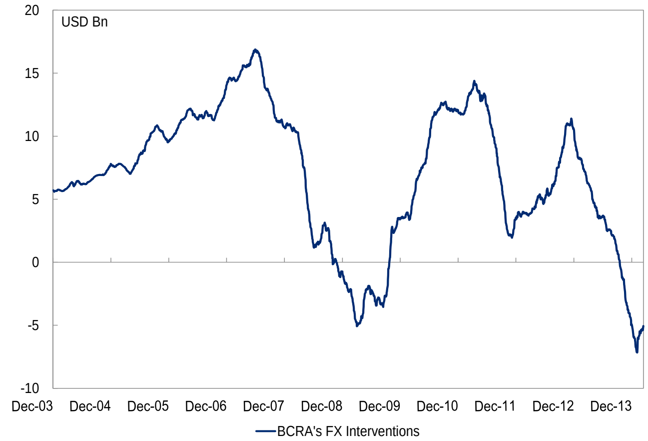
Inflation is also an important challenge. Annual inflation has accelerated markedly during the past few months. According to opposition congressmen, prices rose 34.8% YoY in February. Even if inflation decelerates on a month on month basis, we expect annual inflation will surpass 40% in April/May. We see annual non-official inflation at 38% by the end of 2014, roughly 9 percentage points higher than in 2013.

Figure 236. BCRA reserves drop…



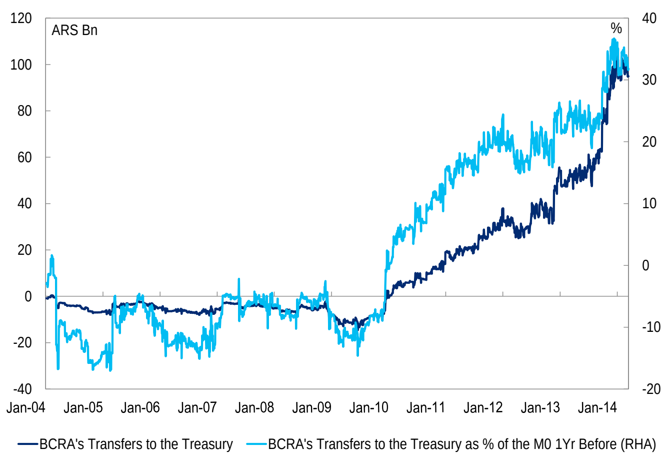
Source: BCRA and Citi Research

Figure 237. … partially as a result of its interventions in the FX market



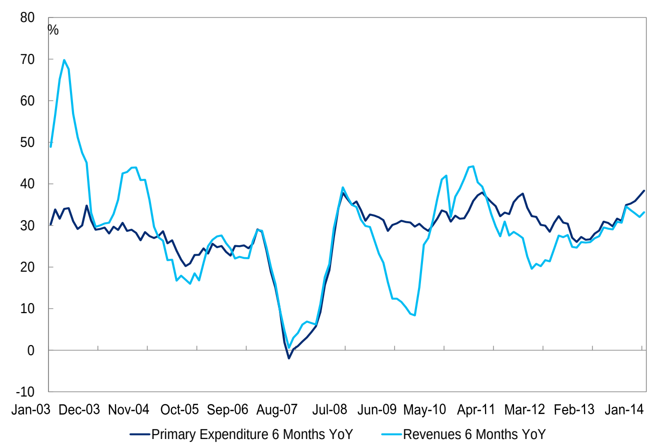
Source: BCRA and Citi Research

Figure 238. BCRA peso transfers to the Treasury continue unabated…



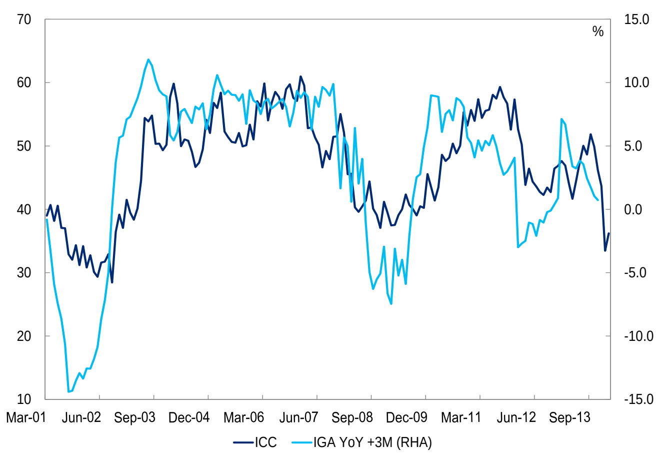
Source: BCRA and Citi Research

Figure 239. … in the absence of any fiscal moderation



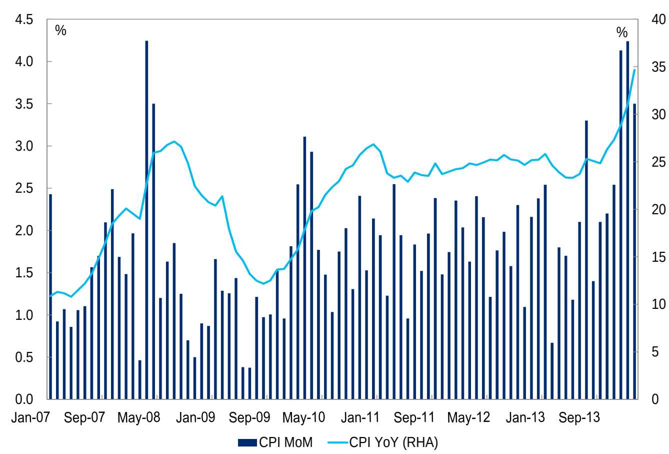
Source: MECON and Citi Research

Figure 240. Lower consumer confidence may negatively affect activity



Source: UTDT and Citi Research

Figure 241. (Non-official) inflation is all over the place



Source: MyS and Citi Research

Figure 242. Argentina Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	262	329	308	370	448	477	485	390	375
Nominal GDP, local currency bn	812	1,033	1,145	1,443	1,842	2,164	2,680	3,458	4,422
GDP per capita, USD	6,666	8,271	7,683	9,131	10,948	11,541	11,644	9,259	8,817
Population, mn	39.4	39.7	40.1	40.5	40.9	41.3	41.7	42.1	42.5
Unemployment, % of labour force	8.5	7.9	8.7	7.8	7.2	7.2	7.1	7.7	8.1
Economic Activity									
Real GDP, yoy avg	8.4	2.6	-3.9	7.7	5.1	-0.3	2.8	-1.0	0.0
Real investment growth % yoy	14.8	15.4	-9.1	19.6	10.7	-7.7	5.3	-3.9	-0.3
Real consumption growth % yoy	8.8	6.6	1.5	9.1	10.7	4.8	6.1	2.1	2.1
private consumption growth % yoy	9.0	6.5	0.5	9.0	10.7	4.4	6.0	2.1	2.1
Real export growth, % yoy	9.1	1.2	-6.4	14.6	4.3	-6.6	-0.1	-1.6	-1.5
Real import growth, % yoy	20.5	14.1	-19.0	34.0	17.8	-5.2	8.6	-1.9	0.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	20.1	20.7	14.8	26.8	24.2	25.2	28.8	38.0	35.0
CPI, % avg	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	20.3	22.4	20.0	21.7	27.5	27.1	24.7	29.8	32.0
Credit extension to private sector, % yoy	25.4	10.5	11.5	31.6	34.6	39.0	22.0	35.0	30.0
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	13.63	19.75	10.00	11.25	17.19	15.44	21.63	33.00	37.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	3.15	3.45	3.80	3.97	4.30	4.92	6.52	10.00	13.50
ARS/USD, avg	3.12	3.16	3.73	3.91	4.13	4.54	5.45	8.89	11.81
Balance of Payments, USD bn									
Current account	7.4	6.8	11.0	1.4	-2.4	-0.1	-2.9	-1.9	-1.6
% of GDP	2.8	2.1	3.6	0.4	-0.5	0.0	-0.6	-0.5	-0.4
Trade balance	13.5	15.4	18.5	14.3	12.9	15.4	12.0	11.9	10.6
Exports	56.0	70.0	55.7	68.1	84.1	80.9	84.4	82.0	83.2
Imports	42.5	54.6	37.1	53.9	71.1	65.6	72.4	70.1	72.6
Service balance	-0.5	-1.3	-1.3	-1.2	-2.2	-3.6	-3.2	-0.7	1.6
Income balance	-5.9	-7.6	-9.0	-11.3	-12.6	-11.5	-11.3	-12.3	-13.1
FDI, net	6.5	9.7	4.0	7.8	9.9	12.1	9.9	10.0	10.0
International reserves	46.2	46.4	48.0	52.2	46.4	43.3	30.6	26.0	17.5
Total amortisations	5.2	4.7	11.2	10.7	12.0	11.9	11.3	11.3	11.3
Public Finances, % of GDP									
Consolidated government balance	1.1	1.4	-0.6	0.2	-1.7	-2.6	-2.4	-3.1	-2.3
Consolidated gov primary balance	3.1	3.1	1.5	1.7	0.3	-0.2	-0.8	-1.1	-1.1
Public debt	55.2	44.4	47.7	44.4	40.0	42.2	39.7	47.7	56.3
of which Domestic	28.2	24.8	27.7	25.6	23.6	27.1	26.6	32.6	37.8
Foreign Assets & Liabilities, USD bn									
External debt	124.5	124.9	115.6	129.3	141.1	140.9	132.8	114.4	122.4
Public	70.8	64.4	61.8	69.5	73.2	71.6	63.6	58.9	69.1
External debt / GDP	47.5	38.0	37.5	35.0	31.5	29.6	27.4	29.3	32.7
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators									
	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	3.0	1.8	-0.1	-1.5	-1.5	-0.8	-0.3	0.2	0.0
CPI, % yoy	24.8	28.8	37.2	42.2	41.8	38.0	32.9	31.5	32.9
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	17.19	21.63	27.00	29.00	31.00	33.00	33.00	34.00	35.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	5.79	6.52	8.30	8.30	9.50	10.00	10.78	11.62	12.52

Source: National Sources, Citi Research

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- **Summary view** — The energy situation is becoming more serious, with chances of rationing increasing significantly. This can curb the likelihood of President Rousseff being reelected in the first round. Her victory is still assumed in our base case scenario. We keep our GDP growth forecast at 1.3% in 2014, despite the better-than-expected 0.7% QoQ growth in 4Q13. Regarding monetary policy, we expect another 25bps hike in April, driving the interest rate to 11%. We forecast CPI to increase 6.1% in 2014 and 5.8% in 2015. As for fiscal policy, we don't expect a significant adjustment this year and, thus, the primary surplus should remain below the 2013's level (1.5% against 1.9% of GDP in 2013) even after the downgrade by S&P. On external accounts, we expect current account deficit to be around USD80bn, despite an improvement in the trade balance, reflecting the weaker BRL and the improvement in global growth scenario.

- **Things to watch** — Besides inflation and activity, the level of the hydropower reservoirs should be closely monitored given the threat of energy shortages. Monthly fiscal results will remain in the spotlight as the fiscal accounts were probably the main reasons for the downgrade by S&P.

- **Strategy** — On the FX front, the steady deterioration in domestic fundamentals and the strong activity data in US suggest opportunity to stay short BRL when USD/BRL falls below the 2.40 level. On rates, the scenario of weaker currency and softer Selic rate hikes suggest a sharper rise of the long end of the yield curve.

We Continue to Expect 2014 GDP Growth of 1.3%

In spite of the stronger than expected 4Q13 figure, we keep our 2014 and 2015 GDP growth estimates at 1.3% and at 1.8%, respectively. In particular, and besides signs of deceleration in labor and credit markets, the higher real interest rate (which has increased from 1.5% in Dec/12 to above 5% nowadays) will likely constrain domestic demand growth, especially private consumption and investment. While we recognize potential improvement in external demand performance this year compared to last year (given the weaker domestic currency and stronger global growth), high industrial real unit labor costs (around 10% above equilibrium) will likely partially offset it. Overall, our 2014 and 2015 GDP growth estimates are on the bearish side of the street, with consensus estimating annual expansions of 1.7% and 2.0%, respectively. It's worth emphasizing that under an alternative scenario of power rationing, our GDP growth forecasts would hardly be affected, given the significant GDP elasticity relative to energy and the likely lack of sufficient alternatives sources of energy (thermoelectric power plants are operating at virtually full capacity).

We keep our 2014 and 2015 CPI inflation forecasts at 6.1% and 5.8%, respectively. Food prices may generate upward pressures with both agriculture commodities and perishable food shocks affecting CPI inflation in the short run —in line with March's IPCA preview, which showed food monthly inflation already above 1%. Agriculture wholesale inflation is expected to get close to 6% in March, the highest level since 2007 and it should continue to pass through to CPI inflation in the next couple of months. However, we believe this shock may be temporary and, therefore, we are keeping our forecast for 2014 year-end at 6.1% —although we acknowledge an upward risk. The higher cost of generating energy from thermo power plants should eventually be passed through to monitored prices, putting pressure on next year's inflation. Nonetheless, we are keeping our 2015 inflation forecast at 5.8%, as we see a slightly less depreciated domestic currency next year.

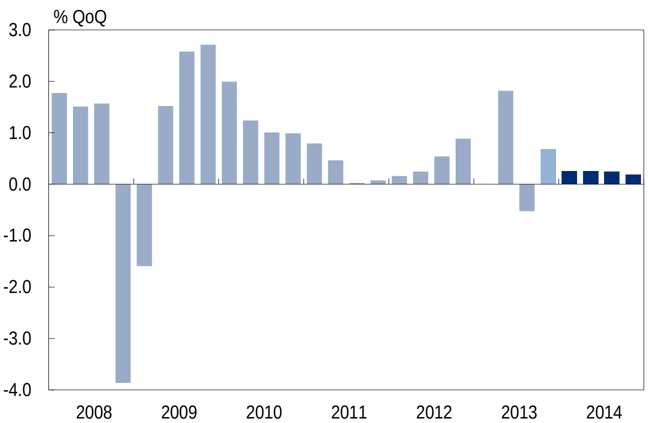
We expect Copom to raise the Selic rate up to 11% in 2014. After the decision to reduce the pace of Selic rate hikes to 25bps from 50bps in the February 26 meeting, we think the Central Bank will hike the policy rate by a further 25 bps in the next Copom meeting (April 2). We still see this hike as the last one, but we acknowledge that the chances of the central bank continuing the tightening cycle are increasing as the near-term inflation prints might bring 12-month inflation above 6% as soon as March. For 2015, we believe the Copom will resume the tightening cycle in order to fight the persistent inflation problem. Because of that, we expect 100bps of hikes to the Selic rate in the first meetings of the year, putting the Selic rate at 12% by the end of the monetary tightening process. Even so, we do not see inflation converging to the mid-point of the target in 2015.

S&P has downgraded Brazil's long-term foreign currency sovereign rating to BBB- from BBB with stable outlook. The decision was motivated by a combination of factors that had negative implications for fiscal accounts, coupled with a subdued growth outlook over the next two years. S&P recognized the difficulty of the public sector's achieving the formal primary fiscal surplus target of 1.9% the GDP without recurring "one-off adjustments," in line with our view that the public sector will deliver a primary surplus of 1.5% of GDP in 2014. Despite S&P's recognition of several downside risks for the Brazilian economy in the near term, we note that, in particular, the rising risks of facing energy scarcity/power rationing and their impacts on activity were not embedded in the S&P's GDP growth forecast of 1.8% for 2014. Although S&P authorities sounded comfortable with the new Brazil sovereign rating, we believe the risk of additional deterioration remains significant.

Steady deterioration in domestic fiscal fundamentals and FOMC tapering point to a BRL weakening this year. Even with the government intervening in FX markets, the USD/BRL remained above the 2.30 level. For us, the steady deterioration in domestic fiscal fundamentals continues to pressure risk premiums upward, explaining the worse performance of Brazilian sovereign 5 years CDS compared to some Latin peers like Mexico, Colombia and Peru. Meanwhile, the FOMC decision to continue tapering may fuel capital outflows from emerging countries to US, reinforcing the forecast for a higher USD/BRL. Under this scenario of a weaker currency (USD/BRL at 2.65 at 2014 year-end) and disappointing domestic growth, the trade balance should improve. However, we continue to see the current account deficit roughly stable in relation to the previous year's figure: at around USD80bn. It's important to emphasize that under an alternative scenario of power rationing, additional factors adding upward pressure on the USD/BRL would emerge. Firstly, lower growth prospects are usually associated with smaller capital inflows. Secondly, assuming power rationing as a typical adverse supply shock, such a development would likely imply a larger current account deficit, requiring a weaker domestic currency to fill in the gaps in the BoP.

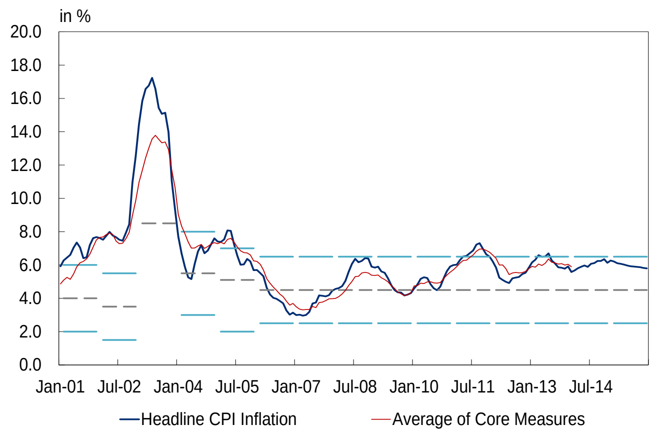
On the political front, President Dilma Rousseff's approval remains at a level that suggests she will be reelected, but the energy situation is deteriorating significantly. President Dilma's popularity (excellent and good evaluation) has been stable at 40%, above the levels exhibited by Fernando Henrique Cardoso and Lula da Silva in the year ahead of their reelections. Our view is that if President Rousseff is able to maintain this level of popularity until October's presidential election, she would be reelected. However, the energy situation is becoming more serious, with chances of rationing increasing significantly. This can reduce the probability of President Rousseff being reelected in the first round, if the government is forced to announce some measures to save energy. Another important risk is the possibility of the World Cup in June/July bringing demonstrators back to the streets, and the potential effects of them on President Dilma's popularity only three months before the presidential ballot.

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



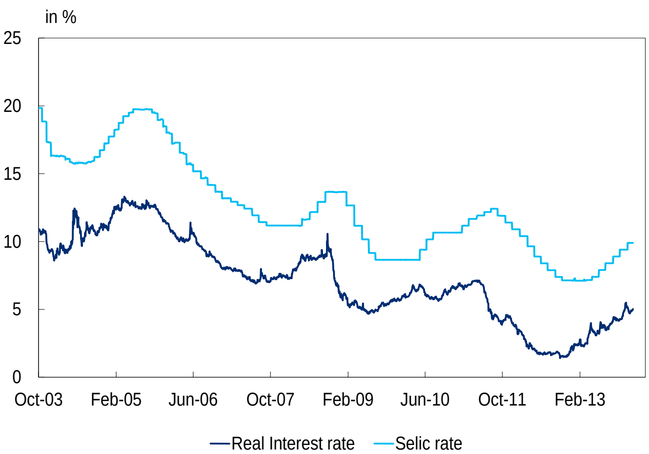
Sources: Citi Research and IBGE

Figure 244. CPI Inflation will likely remain close to 6.5% (upper bound)



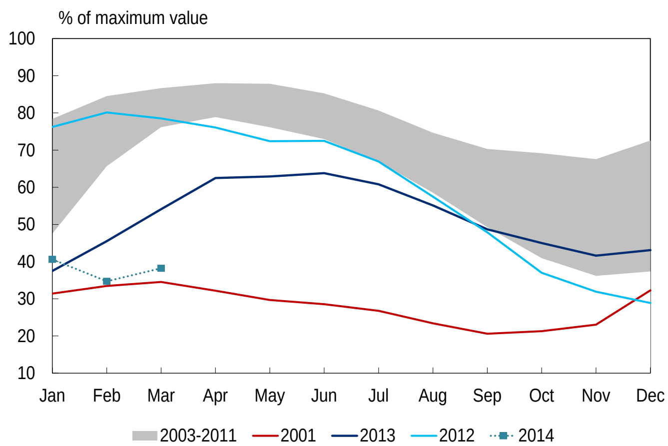
Sources: Citi Research, BCB and IBGE

Figure 245. We expect Copom to increase the Selic until 11% in 2014



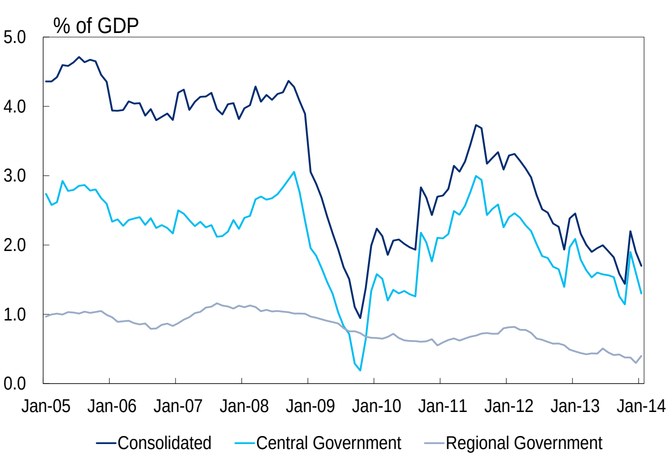
Sources: Citi Research and Bloomberg

Figure 246. Risks of facing a power rationing arise



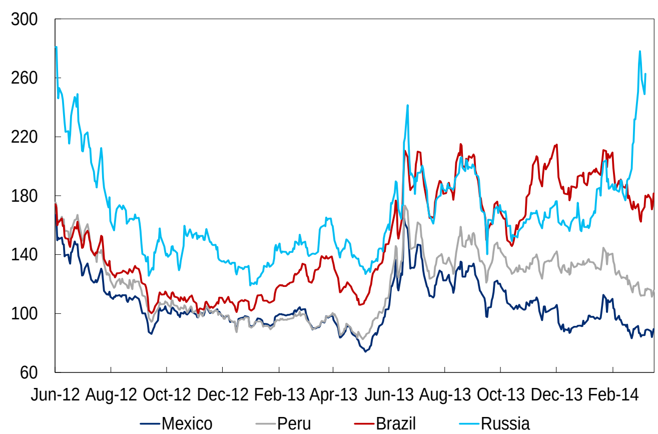
Sources: Citi Research and BCB

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



Sources: Citi Research and BCB

Figure 248. Brazil's 5Y CDS have underperformed its Latam peers



Sources: Citi Research and Bloomberg

Figure 249. Brazil Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,317	1,746	1,622	2,142	2,475	2,247	2,212	2,056	2,052
Nominal GDP, local currency bn	2,661	3,032	3,239	3,770	4,143	4,392	4,808	5,163	5,562
GDP per capita, USD	6,950	9,114	8,379	10,955	12,536	11,278	11,002	10,141	10,032
Population, mn	189.5	191.5	193.5	195.5	197.4	199.2	201.0	202.8	204.6
Unemployment, % of labour force	9.3	7.9	8.1	6.7	6.0	5.5	5.5	5.8	6.0
Economic Activity									
Real GDP, yoy avg	6.1	5.2	-0.3	7.5	2.7	1.0	2.3	1.3	1.8
Real investment growth % yoy	16.9	16.4	-16.0	33.4	4.0	-7.9	8.0	-0.8	0.9
Real consumption growth % yoy	5.8	5.1	4.1	6.3	3.6	3.2	2.2	1.7	1.8
private consumption growth % yoy	6.1	5.7	4.4	6.9	4.1	3.2	2.3	1.7	1.9
Real export growth, % yoy	6.2	0.5	-9.1	11.5	4.5	0.5	2.5	2.5	6.8
Real import growth, % yoy	19.9	15.4	-7.6	35.8	9.7	0.2	8.4	2.3	4.4
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	4.5	5.9	4.3	5.9	6.5	5.8	5.9	6.1	5.8
CPI, % avg	3.6	5.7	4.9	5.0	6.6	5.4	6.2	6.1	5.9
Nominal wages, % yoy	7.0	10.4	4.8	12.7	8.9	10.7	10.8	11.0	10.7
Credit extension to private sector, % yoy	-	30.9	15.1	20.6	19.0	16.4	14.8	13.4	13.6
Policy Rate (eop)	11.25	13.75	8.75	10.75	11.00	7.25	10.00	11.00	12.00
1 month inter-bank rate, %, eop	11.11	13.49	8.61	10.64	10.87	6.59	9.78	11.00	12.00
Long-term yield, %, eop	12.95	12.27	12.25	12.24	10.66	7.96	12.00	13.67	14.17
BRL/USD, eop	1.78	2.31	1.74	1.66	1.86	2.05	2.36	2.65	2.77
BRL/USD, avg	1.95	1.84	2.00	1.76	1.67	1.95	2.16	2.53	2.73
Balance of Payments, USD bn									
Current account	1.6	-28.2	-24.3	-47.3	-52.5	-54.2	-81.4	-82.5	-83.9
% of GDP	0.1	-1.6	-1.5	-2.2	-2.1	-2.4	-3.7	-4.0	-4.1
Trade balance	40.0	24.8	25.3	20.1	29.8	19.4	2.6	6.0	9.7
Exports	160.6	197.9	153.0	201.9	256.0	242.6	242.2	251.2	267.2
Imports	120.6	173.1	127.7	181.8	226.2	223.2	239.6	245.2	257.5
Service balance	-13.2	-16.7	-19.2	-30.8	-37.9	-41.0	-47.5	-54.3	-58.1
Income balance	-29.3	-40.6	-33.7	-39.5	-47.3	-35.4	-39.8	-37.8	-39.1
FDI, net	34.6	45.1	25.9	48.5	66.7	65.3	64.0	60.0	60.0
International reserves	180.3	193.8	238.5	288.6	352.0	373.1	375.8	375.8	375.8
Total amortisations	38.2	22.4	30.1	33.8	29.8	35.8	41.8	47.8	49.8
Public Finances, % of GDP									
Consolidated government balance	-2.8	-2.0	-3.3	-2.6	-2.6	-2.5	-3.3	-3.7	-2.8
Consolidated gov primary balance	3.8	3.9	2.0	2.7	3.1	2.4	1.9	1.5	2.5
Public debt	55.0	55.9	60.9	53.4	54.2	58.8	57.2	57.6	57.5
of which Domestic	50.9	51.2	57.5	50.5	51.5	55.9	54.2	54.6	54.5
Foreign Assets & Liabilities, USD bn									
External debt	193.6	198.3	198.2	256.8	298.2	312.9	322.0	321.8	327.8
Public	86.0	84.2	93.3	103.6	102.1	113.7	119.5	116.4	118.6
External debt / GDP	14.7	11.4	12.2	12.0	12.1	13.9	14.6	15.6	16.0
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	38.9	36.4	31.0	57.3	40.1	37.2	40.0	42.0	44.0
Short-term debt/International reserves (%)	21.6	18.8	13.0	19.9	11.4	10.0	10.6	11.2	11.7

Quarterly Economic Indicators									
	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	2.2	1.9	2.1	0.6	1.6	1.0	1.3	1.6	1.9
CPI, % yoy	5.9	5.9	5.6	6.1	6.2	6.1	5.9	5.8	5.8
Policy interest rate, %, eop	9.00	10.00	10.75	11.00	11.00	11.00	12.00	12.00	12.00
Short-term market rate, % eop	8.72	9.78	10.75	11.00	11.00	11.00	12.00	12.00	12.00
Long-term yield, %, eop	8.91	8.57	12.88	13.17	13.67	13.67	14.17	14.17	14.17
BRL/USD, eop	2.22	2.36	2.37	2.51	2.58	2.65	2.68	2.71	2.74

Source: National Sources, Citi Research

CCA

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- **Summary view** — In Costa Rica, we are expecting the incoming administration to postpone any meaningful attempt to turnaround the fiscal deficit. In El Salvador, it will take some time before the wounds of the election begin to heal. Overall, we do not expect any major improvement on the fiscal side across the region.

- **Things to watch** — Panama will hold elections on May 4. In El Salvador, the main event would be the appointment of the incoming administration's new Minister of Finance. The election in Costa Rica has now become a formality.

- **Strategy** — We expect Costa Rica and the Dominican Republic to "defend" their currencies. The BCCR announced that intervention will no longer be constrained to the floor and ceilings of the FX band. We expect the BCRD to try to keep this year's increase in the USDDOP at about 5%

The Aftermath of the Elections

Elections are shaping up El Salvador and Costa Rica in a much different way than originally expected. El Salvador already declared Salvador Sanchez Ceren (FMLN) as president elect, after defeating Norman Quijano (ARENA) in a "photo finish" second round. Mr. Quijano almost overcame the 10 percentage point difference that the FMLN got in the first round. Costa Rica will hold a second round on April 6, in which Luis Guillermo Solis (PAC) will most likely be the winner after his rival (Johnny Araya, PLN) abandoned the race, thereby implicitly conceding defeat. Mr. Solis was virtually out of the radar just a few months ago.

In Costa Rica, the most direct implication of the election outcome is on the fiscal outlook. We expect the potential Solis administration to postpone any meaningful attempt to turn around the weak fiscal stance. In our view, Mr. Solis is not overly worried about the fiscal outlook. He will likely undertake some moderate expenditure cuts during the first couple of years of his administration but without complementing them with fiscal reform to generate more revenues. In our view, Costa Rica needs to address the weak fiscal stance from both the revenue and the expenditure sides.

El Salvador needs to heal the wounds from this election if it wants to restore its lost creditworthiness. Low growth and a weak fiscal outlook are unlikely to be reversed as long as the rivalry between the FMLN and the local business establishment persists. The aftermath of this election complicates such settlement as we expect the country to remain virtually divided as we begin to move into the political cycle ahead of the 2015 congressional election. It will take some time for the local business establishment to start to feel comfortable with the incoming government.

In Panama, unlike its neighbors, the presidential election is unlikely to shape things differently in the country. Polls continue to show that Jose Domingo Arias (CD) remains the frontrunner in the presidential race. His running mate is no other than First Lady Marta Linares de Martinelli. We expect outgoing President Ricardo Martinelli to remain an influence in the ruling party and the incoming administration as he should continue to have a strong voice. The presidential and congressional elections will be held on May 4, 2014.

Under this political outlook, we expect real GDP growth in Costa Rica and El Salvador to underperform that in the Dominican Republic and Panama. In the cases of Costa Rica and El Salvador, we think uncertainty would linger for a while, resulting in a few months' extension of the moderate slowdown in growth. In the Dominican Republic, the first hints from economic activity lead us to think that growth remained strong in 1Q14.[6] In Panama, we continue to expect a slowdown in growth. This slowdown would be driven by modest growth in traffic in the Panama Canal, the temporary halt in works in the Panama Canal expansion during 1Q14, and potential weak data in the Colon Free Zone (ZLC). The recent diplomatic conflict with Venezuela could work against the ZLC, as Venezuela continues to be a major destination of its "re-exports". Nonetheless, growth in Panama would still be higher than in the other three countries.

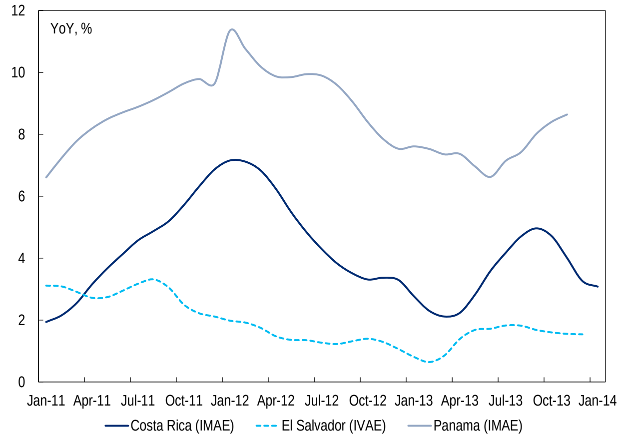
We do not expect any major improvement on the fiscal side across the region. In the case of Panama, what we would expect from the new administration is to keep running deficits in the nonfinancial public sector (NFPS) of around 3% of GDP. For quite a long time, the spirit of the original fiscal responsibility law has been buried, and we do not see any major driver (in both politics and economics) that could revive it. In our view, the country lost a unique opportunity during these years of high growth to migrate permanently to a lower fiscal deficit. The Dominican Republic complied with its quest to return to a more manageable fiscal deficit in 2013, after the spending spree associated with the 2012 election. We do not expect any attempt to undertake any kind of fiscal reform in the remainder of this administration. Since elections should not take place until 2016, we would expect the deficit to remain slightly below 3% of GDP in 2014-15.

In contrast to Panama and the Dominican Republic, in Costa Rica and El Salvador it is a little more disappointing that no progress is made. As we mentioned earlier in this piece, Costa Rica needs to turn around its weakening fiscal stance. In our view, the likely lack of progress on the fiscal side would translate into deficits of above 6% of GDP in the near future. This would open the door to prospective downgrades by rating agencies. In the case of El Salvador, the country continues to rely heavily on short-term financing (Letes). Usually when the stock of short-term debt breaches a certain threshold, the government ends up issuing longer-dated debt to face the Letes amortizations. Low growth also exerts more pressure on the government to increase fiscal spending.

We expect Costa Rica and the Dominican Republic to "defend" their currencies. The Central Bank of Costa Rica (BCCR) announced a "widening" of its FX intervention policy: intervention will no longer be constrained to the floor and ceilings of the FX band. The central bank could intervene to lessen volatility or when the BCCR believes the USDCRC has drifted away from its medium- and long term trend. The Central Bank of the Dominican Republic (BCRD) will likely use international reserves to prevent a sharp depreciation of the local currency. We would expect the BCRD to try to keep this year's increase in the USDDOP at about 5%. The BCRD needs to beef up its international reserves to be able to accomplish this, and that is why we think the government has budgeted higher-than-usual external debt issuance. This issuance would bring the muscle that the BCRD currently lacks.

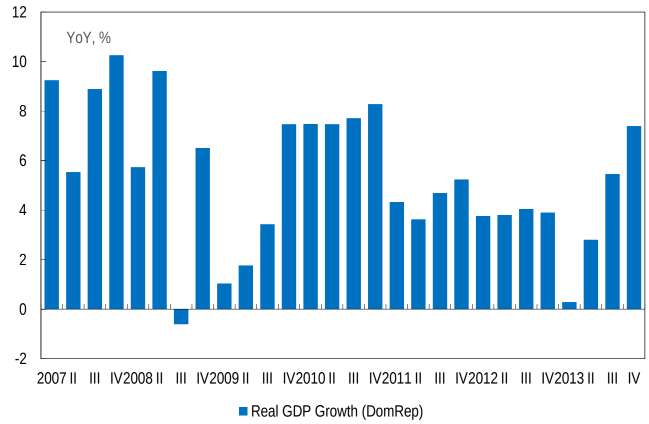
[6] Central Bank Governor Hector Valdez Albizu was quoted by Listin Diario (March 12, 2014) saying that the economy grew more than 5% in January 2014.

Figure 250. Politics may extend the slowdown in Costar and ElSalv



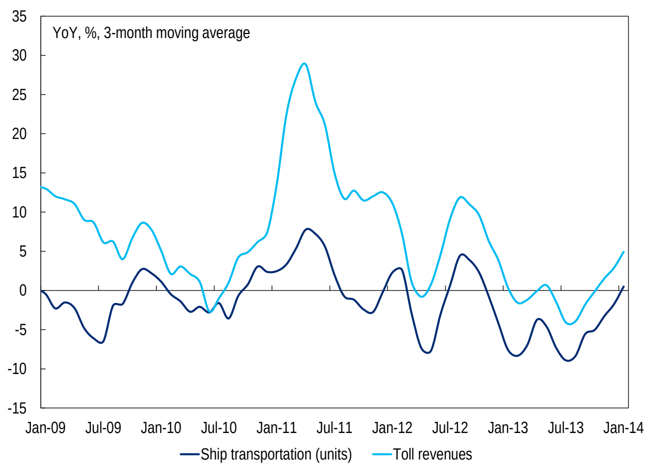
Source: BCCR, BCRES, Contraloria, Haver and Citi Research

Figure 251. Growth is back on track in the Dominican Republic



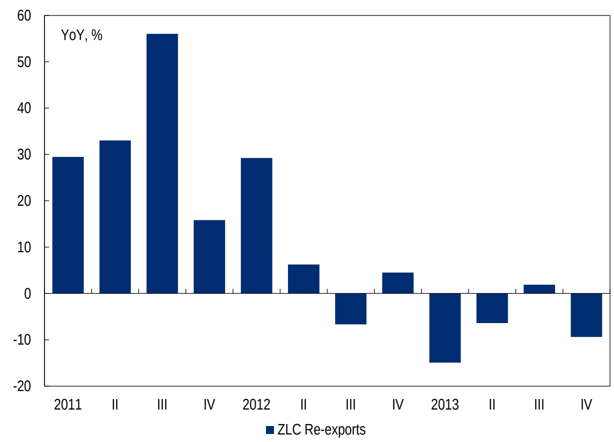
Source BCRD, Haver and Citi Research

Figure 252. Modest growth in the Panama Canal's traffic



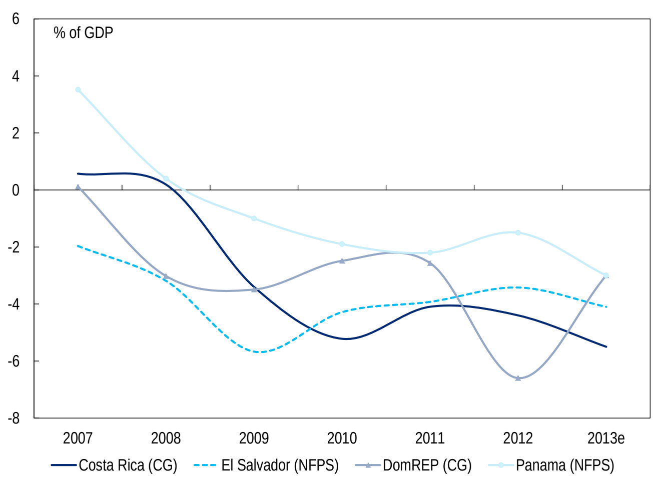
Source: ACP, Haver and Citi Research

Figure 253. Conflicts with Venezuela would affect Panama's ZLC



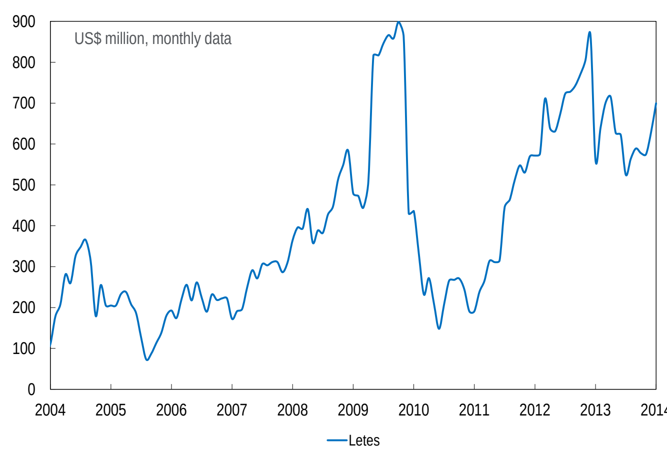
Source: Contraloria, Globalsource and Citi Research

Figure 254. DomRep is the only one that did a fiscal effort last year



Source: National Sources, IMF, Haver and Citi Research

Figure 255. El Salvador: Letes are once again increasing



Source: BCRES, Hacienda and Citi Research

Figure 256. CCA Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Costa Rica									
Nominal GDP, USD bn	26.3	29.8	29.4	36.3	41.0	45.1	49.3	47.1	48.8
GDP per capita, USD	5,925	6,583	6,359	7,955	8,919	9,597	10,489	9,810	10,176
Real GDP, yoy avg	7.9	2.7	-1.0	5.0	4.4	5.1	3.2	3.5	4.0
CPI, % avg	9.4	13.4	7.8	5.7	4.9	4.5	5.2	3.6	4.6
CRC/US$, avg	517	525	570	521	502	503	501	561	589
CRC/US$, eop	496	560	555	504	506	513	501	575	600
Current account	-1.6	-2.8	-0.6	-1.3	-2.2	-2.3	-2.7	-2.7	-2.9
% of GDP	-6.3	-9.3	-2.0	-3.5	-5.4	-5.2	-5.5	-5.7	-5.9
Consolidated government balance	0.8	0.5	-3.9	-6.0	-5.6	-5.7	-6.5	-7.0	-7.5
	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Dominican Republic									
Nominal GDP, USD bn	41.3	45.8	46.8	51.8	55.8	59.0	60.6	62.7	65.2
GDP per capita, USD	4,414	4,807	4,822	5,241	5,544	5,770	5,888	6,091	6,335
Real GDP, yoy avg	8.5	5.3	3.5	7.8	4.5	3.9	4.1	4.5	4.5
CPI, % avg	6.1	10.6	1.4	6.3	8.5	3.7	4.8	4.0	4.6
Policy Interest Rate, % eop	7.00	9.50	4.00	5.00	6.75	5.00	6.25	6.25	5.00
DOP/US$, avg	32.8	34.4	35.9	36.8	38.0	39.2	41.7	43.8	46.1
DOP/US$, eop	33.0	35.4	36.2	37.4	38.7	40.4	42.7	44.8	47.0
Current account	-2.2	-4.5	-2.3	-4.3	-4.4	-4.2	-2.7	-3.0	-3.3
% of GDP	-5.2	-9.9	-5.0	-8.4	-7.9	-7.2	-4.4	-4.8	-5.0
Consolidated government balance	-1.7	-4.3	-4.8	-3.7	-3.8	-7.9	-4.1	-4.0	-4.2
	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
El Salvador									
Nominal GDP, USD bn	20.1	21.4	20.7	21.4	23.1	23.9	24.5	25.2	26.3
GDP per capita, USD	3,500	3,705	3,548	3,653	3,919	4,014	4,079	4,203	4,385
Real GDP, yoy avg	3.8	1.3	-3.1	1.4	2.0	1.6	1.8	2.2	2.5
CPI, % avg	4.6	7.3	0.5	1.2	5.1	1.8	0.8	0.8	1.8
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
SVC/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.2	-1.5	-0.3	-0.6	-1.1	-1.3	-1.5	-1.6	-1.5
% of GDP	-6.1	-7.1	-1.5	-2.7	-4.6	-5.3	-6.1	-6.3	-5.7
Consolidated government balance	-1.9	-2.8	-5.5	-4.4	-4.0	-3.5	-4.2	-4.1	-3.7
	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Panama									
Nominal GDP, USD bn	21.1	24.9	25.9	28.8	33.3	38.0	42.6	46.5	50.4
GDP per capita, USD	6,318	7,312	7,482	8,170	9,242	10,543	11,668	12,575	13,274
Real GDP, yoy avg	12.1	9.1	4.0	5.9	10.8	10.2	8.4	6.2	5.5
CPI, % avg	4.2	8.8	2.4	3.5	5.9	5.7	4.0	2.7	2.8
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
PAB/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.4	-2.7	-0.2	-2.8	-5.0	-3.8	-4.8	-4.2	-4.3

Source: National Sources, Citi Research

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- **Summary view** — The slowdown in growth is broad based, but the fall in investment is deepening it. We would expect growth to begin recovering in the second half of 2014 and, perhaps, Codelco could be a force in turning around investment.
- **Things to watch** — The Bachelet administration is expected to present its fiscal reform proposal on March 31. The cornerstone of the fiscal proposal will probably seek to raise the corporate tax rate.
- **Strategy** — We expect a weak CLP; however, that does not seem to be an obstacle for the BCCh to keep an easing bias

Blame It on Investment

The slowdown in growth is broad based, but the fall in investment is deepening it. The recently-released fourth-quarter GDP data confirmed the fears about a substantial slowdown that had been lingering for a while. Real GDP slowed down to 2.7% YoY in 4Q13 from 5% in 3Q13. Seasonally adjusted figures show a small fall in output during the last quarter of 2013. Everything slowed down at the end of last year (private consumption, government consumption and exports), but nothing compares to the fall in investment and, particularly, to that of gross fixed capital formation in machinery and equipment. In our view, the main drivers of this trend in investment are associated with the fall in copper prices, the weaker outlook in China, and uncertainty around the incoming administration's fiscal reform.

We would expect growth to begin recovering in 2H14. In our view, the drivers of the slowdown would remain intact or could even deepen in the remainder of 1H14. March was a particularly bad time for copper prices, and that would most likely take its toll on growth in 1Q14 and part of 2Q14. The Bachelet administration is expected to present its fiscal reform proposal on March 31, and only after that date could the private sector begin figuring out what to do with some of its investment plans. In addition, it seems reasonable to expect that some public investment decisions could be delayed with the change of administration that took place on March.

Codelco could be a force in turning around investment later this year. Although copper prices are unlikely to work as an incentive to increase investment, there are other things that weigh heavily on investments associated with this sector. Our understanding is that copper production is becoming more costly in Chile as Codelco has to excavate deeper as time goes by. In that vein, Codelco has an ambitious investment plan[7] for the next four years—otherwise copper production and the contributions that the company makes to the national treasury would decline over time.

Mining revenues are falling at a time in which the government wants to raise more money for the social agenda. Both copper and mining revenues have been falling during the past couple of years, while non-mining tax revenue has been relatively stable over that period of time. In turn, the Bachelet administration cannot rely on current trends in public finances to finance the educational reform and the rest of the social agenda. From what she proposed even before her presidential campaign officially began, we would expect the fiscal reform to seek to raise tax collection by 2.5% of GDP and reduce tax evasion by 0.5% of GDP.

[7] Source: La Tercera (February 6, 2014).

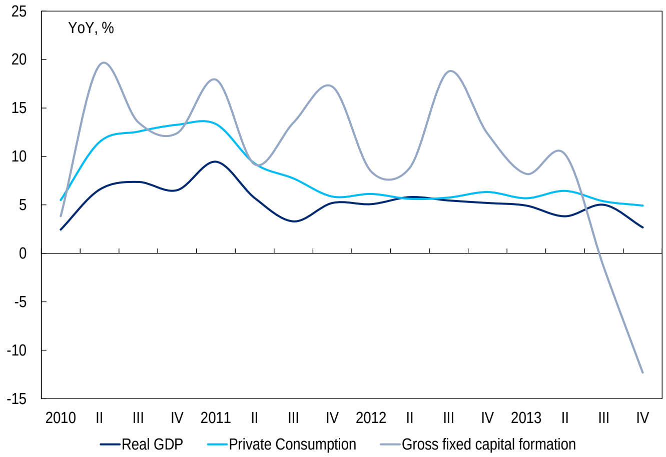
The cornerstone of the fiscal proposal will probably seek to raise the corporate tax rate to 25% from 20% over a period of four years. A reduction to the ceiling on the income tax rate to 35% from 40% could also be part of the proposal. The combination of these two tax changes could translate into a net increase in revenues of 1.92% of GDP, or ¾ of the aforementioned increase in tax collection. Perhaps some elements could change in the proposal, but from what we saw before and during the presidential campaign, the aforementioned tax changes are likely to be included in the bill proposal.

Lower copper exports are unlikely to translate into a significant widening of the current account. Copper prices affect export performance significantly, but that does not necessarily mean that the country gets immediately into a current account deficit problem. The flexible FX regime and the second round effects that lower copper prices have on other sectors of economic activity (domestic demand) have allowed Chile to accommodate the shocks to its terms of trade. This said, the main risk that we see to the current account would be associated with a surge in import growth not associated with copper prices or investment. The first thing that inevitably pops up is a rise in fiscal spending that is not supported by higher tax collection. In turn, if the tax reform were to be insufficient for the social agenda, we would have to adjust our balance of payments outlook. For the time being, we keep our view that the current account deficit will remain at manageable levels.

Although the current account deficit would remain on manageable levels, we expect a weak CLP. FDI is still higher than the current account deficit, but not as much as it was a year ago. In our view, the combination of low copper prices and a more challenging global environment would reduce the surplus of FDI over the current account deficit. In addition, it is unlikely that portfolio inflows will increase substantially in Chile, to compensate for the trend in the balance of payments, to turn around pressures on the FX.

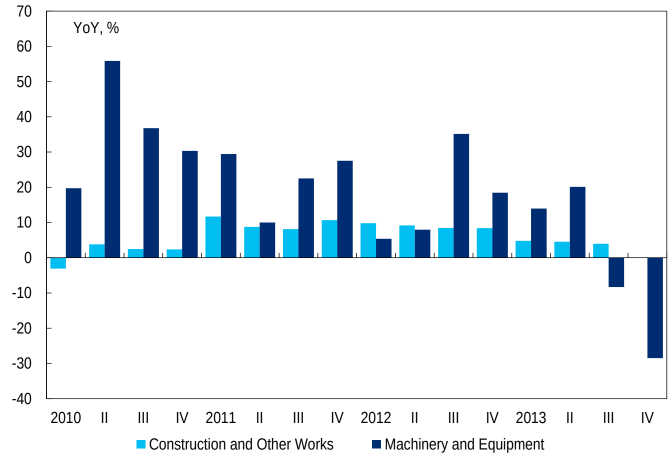
A weak FX does not seem to be an obstacle for the BCCh to maintain an easing bias. The BCCh has highlighted in its statements that inflation remains anchored around the midpoint of the inflation target. The BCCh said in its most recent statement that it will consider adding further monetary stimuli, depending on the evolution on domestic and external variables. In our view, the wording suggests that the authorities continue to have an easing bias, but they are not as convinced as one month ago that they should continue to cut the policy rate and will act in an extremely “data-dependent” mode. In other words, they will likely need additional evidence that activity is decelerating further and that inflationary pressures remain subdued.

Figure 257. Investment is deepening the slowdown in growth



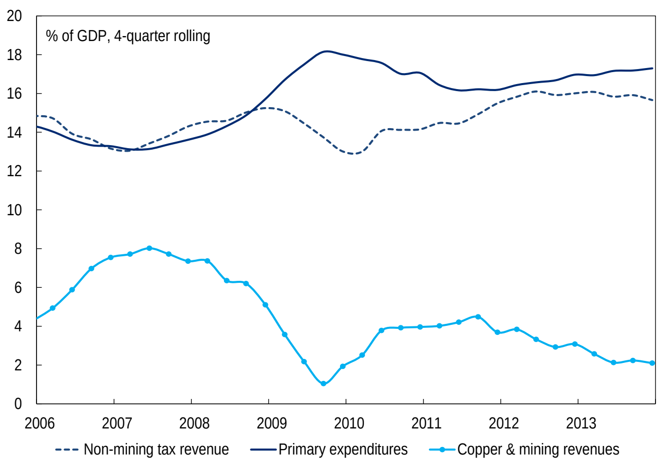
Source: : BCCh, Haver and Citi Research

Figure 258. Investment in machinery is underperforming



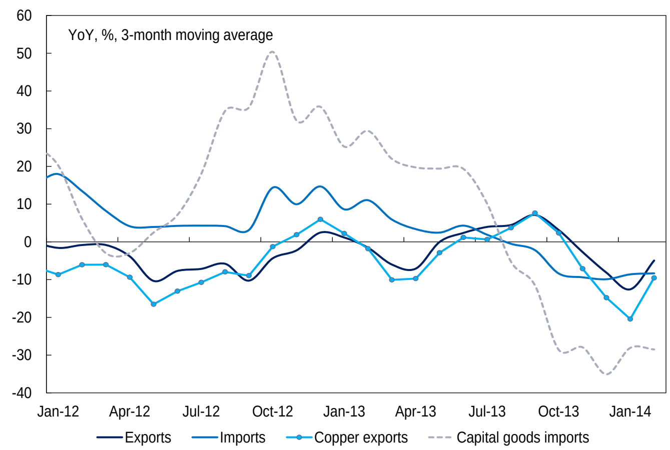
Source: BCCh, Haver and Citi Research

Figure 259. Copper and mining revenues are falling



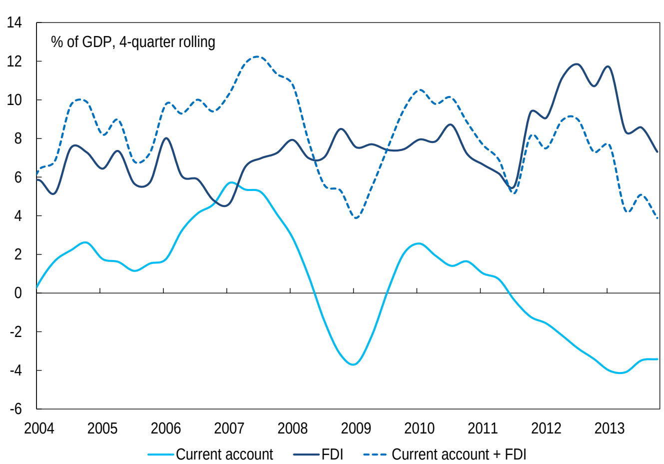
Source: Hacienda, BCCh, Haver and Citi Research

Figure 260. Capital goods imports have been falling sharply



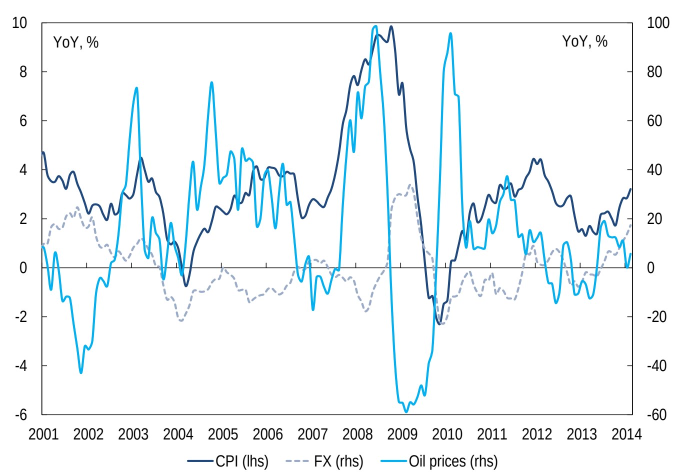
Source: BCCh, Haver and Citi Research

Figure 261. The surplus from FDI is not as high as one year ago



Source: : BCCh, Haver and Citi Research

Figure 262. The BCCh is not overly worried about inflation



Source: BCCh, INE, Haver and Citi Research

Figure 263. Chile Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	173	183	173	218	251	267	277	255	267
Nominal GDP, local currency bn	90	94	96	111	121	130	137	147	158
GDP per capita, USD	10,414	10,876	10,199	12,861	14,639	15,398	15,863	14,442	14,989
Population, mn	16.6	16.8	17.0	17.0	17.1	17.3	17.5	17.7	17.8
Unemployment, % of labour force	7.1	7.8	10.8	8.2	7.1	6.4	5.9	6.1	6.4
Economic Activity									
Real GDP, yoy avg	5.2	3.3	-1.0	5.8	5.8	5.4	4.1	3.5	4.5
Real investment growth % yoy	6.4	20.8	-23.5	33.4	10.7	12.5	1.3	3.4	6.3
Real consumption growth % yoy	7.5	4.4	0.8	9.8	7.8	5.6	5.4	4.6	4.6
private consumption growth % yoy	7.6	5.2	-0.8	10.8	8.9	6.0	5.6	4.6	4.7
Real export growth, % yoy	7.2	-0.7	-4.5	2.3	5.5	1.1	4.3	1.7	4.2
Real import growth, % yoy	14.3	11.2	-16.2	25.9	15.6	5.0	2.2	-0.3	6.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	7.8	7.1	-1.5	3.0	4.4	1.5	3.0	3.0	3.0
CPI, % avg	4.4	8.7	1.5	1.4	3.3	3.0	1.8	3.4	3.1
Nominal wages, % yoy	7.1	8.5	5.8	3.5	5.8	6.3	5.0	4.5	4.5
Credit extension to private sector, % yoy	21.0	18.7	-1.4	7.1	16.9	12.1	6.4	7.3	6.5
Policy Rate (eop)	6.00	8.25	0.50	3.25	5.25	5.00	4.50	4.00	4.00
1 month inter-bank rate, %, eop	5.93	8.24	0.45	3.13	5.23	4.99	4.50	4.00	4.00
Long-term yield, %, eop	6.30	5.93	5.38	5.81	4.92	5.45	5.10	5.00	5.00
CLP/USD, eop	498	638	507	468	520	479	525	590	590
CLP/USD, avg	522	524	559	510	484	486	496	580	590
Balance of Payments, USD bn									
Current account	7.1	-5.8	3.5	3.2	-3.3	-9.5	-9.1	-8.8	-10.6
% of GDP	4.1	-3.2	2.0	1.5	-1.3	-3.6	-3.3	-3.4	-4.0
Trade balance	24.1	6.1	15.4	15.6	10.5	3.4	2.6	2.2	0.5
Exports	68.6	64.5	55.5	71.1	81.5	78.3	77.2	70.5	75.2
Imports	44.4	58.4	40.1	55.5	70.9	74.9	74.7	68.3	74.8
Service balance	-1.3	-1.2	-2.0	-2.1	-2.6	-2.4	-3.1	-0.5	-0.1
Income balance	-18.9	-13.6	-11.4	-14.7	-14.1	-12.7	-10.8	-12.6	-13.1
FDI, net	12.6	15.5	12.9	15.4	22.9	30.3	20.8	15.6	14.0
International reserves	16.9	23.2	25.4	27.9	42.0	41.6	42.0	37.9	39.7
Total amortisations	14.3	14.3	16.4	12.3	12.8	22.4	22.7	22.8	23.3
Public Finances, % of GDP									
Consolidated government balance	8.4	4.3	-4.3	-0.3	1.4	0.6	-0.3	-0.4	-0.4
Consolidated gov primary balance	9.0	4.8	-3.8	0.2	2.0	1.1	0.2	0.0	0.0
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	2.0	2.4	4.9	7.4	7.7	6.3	5.5	5.4	6.2
Foreign Assets & Liabilities, USD bn									
External debt	53.4	63.7	71.9	84.5	98.7	117.8	120.7	110.9	116.2
Public	4.0	3.3	4.0	5.6	7.1	7.9	4.2	3.8	4.0
External debt / GDP	30.8	34.9	41.5	38.7	39.3	44.2	43.5	43.5	43.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	9.0	14.0	15.8	16.2	19.6	22.8	21.8	19.7	20.6
Short-term debt/International reserves (%)	53.4	60.6	62.4	58.3	46.6	54.9	51.8	51.9	51.8

Quarterly Economic Indicators	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	5.0	2.7	2.8	4.0	3.0	4.1	5.2	4.2	4.6
CPI, % yoy	2.0	3.0	3.4	3.4	3.3	3.0	2.6	3.2	3.2
Policy interest rate, %, eop	5.00	4.50	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Short-term market rate, % eop	5.00	4.50	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Long-term yield, %, eop	5.13	5.10	5.00	5.00	5.00	5.00	5.00	5.00	5.00
CLP/USD, eop	505	525	566	579	585	590	590	590	590

Source: National Sources, Citi Research

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- **Summary view** — Recent data on economic activity confirm our view of a gradual recovery in GDP growth throughout 2014. That being said, we believe that the Central Bank still has leeway to keep its policy interest rate on hold until the July meeting. The attention during the next two months will be centered on the evolution of the presidential race. Recent polls show President Santos as the most likely candidate to win the presidency, but still he does not have enough votes to win in the first round. Nonetheless, it is important to note that all candidates that have a chance to be possible contenders in an eventual second round do not represent changes to the country's conservative macroeconomic policy tradition.

- **Things to watch** — Watch for the evolution of the presidential race and the peace process.

- **Strategy** — We expect to see some positive behavior of the TES and FX market during April. Nonetheless, there could be some volatility episodes arising from the challenging outlook for emerging market economies.

Economic Outlook

GDP grew at a yearly 4.9% rate in 4Q13 taking 2013's GDP growth to 4.3%. The print for 2013 stood slightly above market expectations and our own forecast. The quarter-over-quarter seasonally adjusted growth was 0.8%. On the supply side, the best performers for 2013's growth were: construction (9.8% YoY), social services (5.3% YoY), agriculture (5.2% YoY) and oil & mining (4.9% YoY). The worst performer in 2013 was manufacturing (-1.2% YoY). On the demand side, consumption (consumer and government) grew by a yearly 4.7%. Gross fixed capital formation increased 4.9% year over year. Finally, real exports posted a 5.3% annual change while imports increased 2.1%. These results confirmed our view our view of a gradual recovery in GDP growth throughout 2014.

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

Infrastructure projects and their impact on growth. One of the most important opportunities that Colombia will have during the next years will be centered on the infrastructure projects that the country needs. The first round of this projects should be starting during 2H14, and according to the government will be focused initially on 9 transportation projects, materialized in what the government has called public-private partnerships.

The initial investment in these projects could be around USD5bn while, according to the government forecasts, over the medium term all the infrastructure projects could add up to USD25bn in investments. In our view, most of the impact of these projects will be felt during 2015 and 2016; however, our optimism regarding the construction sector in 2014 is based on ongoing projects. In our view, these projects could imply an increase in Colombia's potential GDP growth and could provide an important buffer for economic activity during 2014 and 2015, given that the expected external outlook is not as favorable as before.

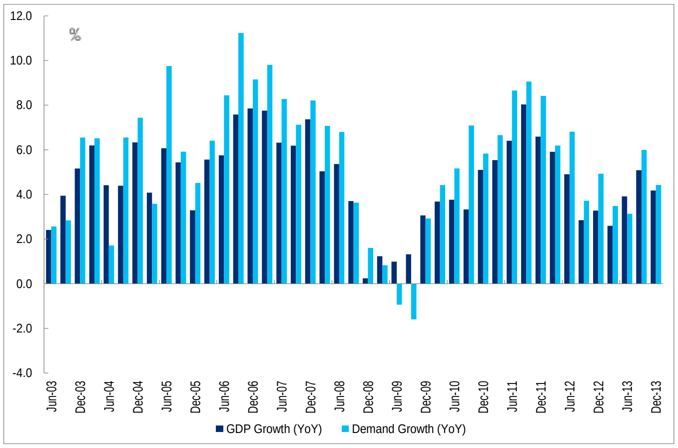
No major surprises in the inflation front are expected. Inflation is expected to normalize this year as a result of the reversal of the supply-side positive shocks observed last year. For 2014, we expect CPI to converge in a gradual way up to 2.8% by year-end. The main risk for the inflation outlook in Colombia could be adverse weather shocks (e.g., an eventual El Niño phenomenon), but still it seems this is not a likely scenario for the time being.

Monetary policy. The low inflation prints along with a moderate economic recovery during the year should provide Banrep enough leeway to keep its policy rate on hold at 3.25% for some additional time. We expect to see the first hike to the repo rate for July. In recent minutes and communiqués, Banrep has kept a relatively neutral tone and has not provided major indications regarding future monetary policy stance. By year-end, we expect the repo rate to sit at 4.0%. On the FX front, the recent behavior of the exchange rate led the Board to extend its international reserves accumulation program up to USD1bn during 2Q14, with a wording that provides enough flexibility in case FX intervention needs to be fine-tuned. In our view, the recent dynamics of the USDCOP and the expected inflows for big corporations' tax payments in April could take them to be somewhat more active in the FX market, but with a normalization afterwards.

The Presidential Race

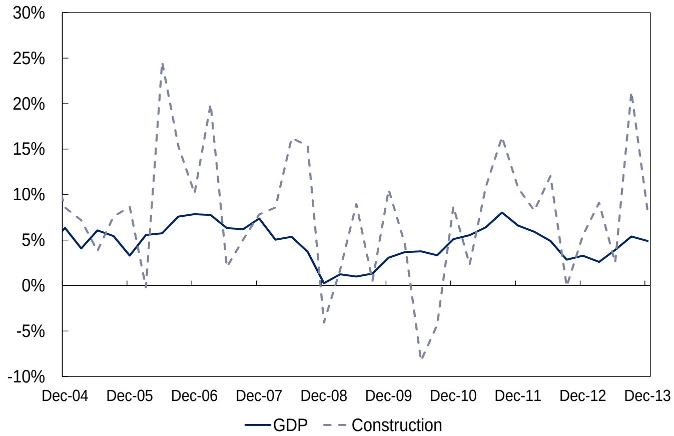
The presidential election can be expected to be the center of attention and main source of headlines during the rest of 1H14. March's Congressional elections did not represent major changes in the political map. After the Congressional elections, the presidential campaign is starting to heat up. For the time being, and according to all pollsters, it seems that President Santos continues to be the most likely winner in the presidential election, but he still does not have enough votes to ensure election in the first round (May), so there would have to be a runoff (June). The main challengers of President Santos will be former president Uribe's Centro Democrático candidate, Oscar Ivan Zuluaga, and the Green Party's candidate Enrique Peñalosa. Nonetheless, both of these alternative candidates still need to significantly increase their vote intentions to guarantee a chance in the second round. In our view, none of the candidates with higher vote intentions would represent a change in the overall macroeconomic policy.

Figure 264. An mild recovery is expected in 2014



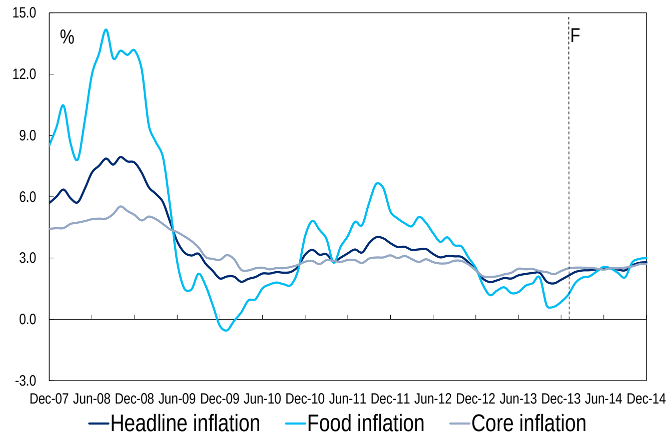
Source: Dane and Citi Research

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



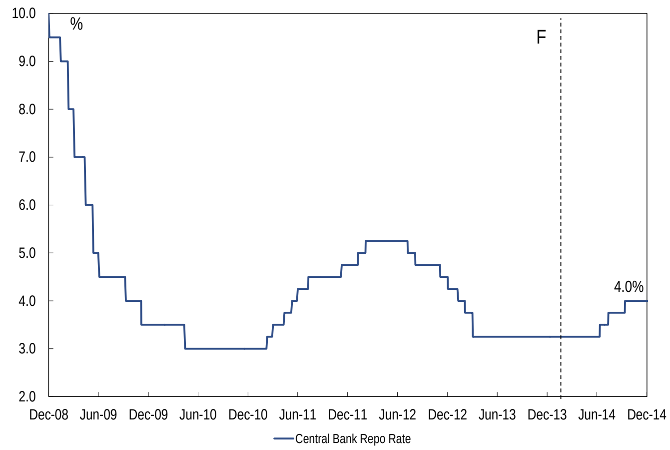
Source: Dane and Citi Research

Figure 266. Inflation should normalize, but still below the 3% mid-target



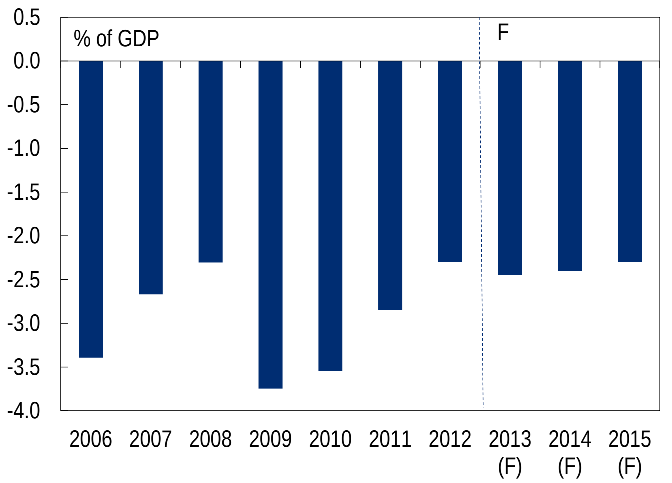
Source: Dane and Citi Research

Figure 267. We expect the repo rate to start increasing only in 2H14



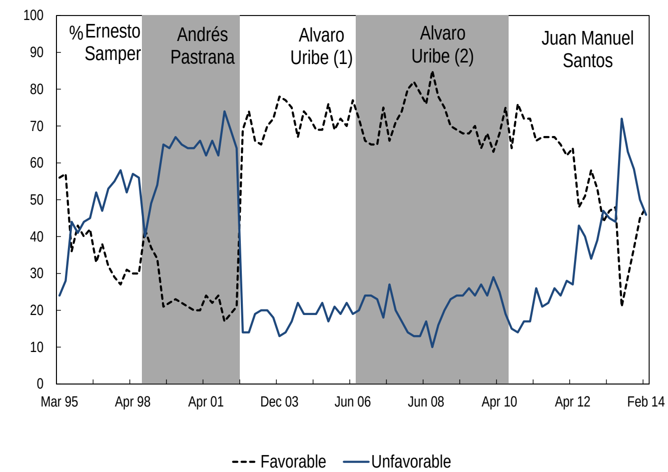
Source: Banrep and Citi Research

Figure 268. Central government deficit should continue relatively stable



Source: Ministry of Finance and Citi Research

Figure 269. Politics in the frontline



Source: Gallup and Citi Research's rendering

Figure 270. Colombia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	208	242	231	285	335	370	373	367	376
Nominal GDP, local currency bn	431	480	505	544	616	673	732	762	824
GDP per capita, USD	4,726	5,447	5,136	6,262	7,289	7,956	7,921	7,709	7,827
Population, mn	43.9	44.5	45.0	45.5	46.0	46.5	47.1	47.6	48.1
Unemployment, % of labour force	11.4	11.5	13.0	12.4	11.5	11.2	10.6	10.1	9.6
Economic Activity									
Real GDP, yoy avg	6.9	3.5	1.7	4.0	6.6	4.0	4.3	4.6	5.0
Real investment growth % yoy	12.8	9.0	-3.9	7.7	18.5	4.6	4.9	4.6	3.3
Real consumption growth % yoy	7.0	3.5	1.6	5.1	5.5	4.7	4.8	4.4	5.5
private consumption growth % yoy	7.3	3.5	0.6	5.0	6.0	4.4	4.5	4.2	5.5
Real export growth, % yoy	6.9	4.5	-2.8	1.3	11.8	6.1	5.3	3.1	4.5
Real import growth, % yoy	14.0	10.5	-9.1	10.8	21.5	8.9	2.1	5.0	4.6
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	5.7	7.7	2.0	3.2	3.7	2.4	1.9	2.8	3.5
CPI, % avg	5.5	7.0	4.2	2.3	3.4	3.2	2.0	2.3	3.4
Nominal wages, % yoy	5.4	19.1	3.0	4.1	4.2	4.3	4.4	4.5	4.6
Credit extension to private sector, % yoy	19.9	14.3	6.8	9.8	18.3	10.0	13.7	14.0	15.9
Policy Rate (eop)	9.50	9.50	3.50	3.00	4.75	4.25	3.25	4.00	5.00
1 month inter-bank rate, %, eop	9.35	8.87	3.10	3.00	4.81	4.27	3.30	4.02	4.77
Long-term yield, %, eop	10.27	12.76	8.47	7.70	7.60	5.86	6.78	8.02	8.77
COP/USD, eop	2,018	2,249	2,043	1,920	1,939	1,767	1,930	2,150	2,150
COP/USD, avg	2,076	1,968	2,154	1,898	1,848	1,798	1,869	2,093	2,150
Balance of Payments, USD bn									
Current account	-6.0	-6.9	-5.1	-8.9	-9.8	-12.1	-12.2	-13.0	-13.5
% of GDP	-2.9	-2.8	-2.2	-3.1	-2.9	-3.3	-3.3	-3.5	-3.6
Trade balance	-0.6	1.0	2.5	2.4	6.1	4.8	3.7	2.8	5.7
Exports	30.6	38.5	34.0	40.8	58.3	61.5	61.5	61.3	64.7
Imports	31.2	37.6	31.5	38.5	52.2	56.7	57.7	58.5	58.9
Service balance	-2.6	-3.1	-2.9	-3.7	-4.7	-5.5	-4.9	-7.8	-10.3
Income balance	-8.0	-10.2	-9.3	-12.0	-16.0	-16.0	-15.7	-12.9	-14.1
FDI, net	9.0	10.6	7.1	6.7	13.4	15.7	17.1	17.5	17.9
International reserves	20.9	24.0	25.4	28.5	32.3	37.5	44.1	47.7	51.3
Total amortisations	5.7	5.1	5.8	6.5	6.3	12.1	6.8	7.5	7.5
Public Finances, % of GDP									
Consolidated government balance	-0.6	-0.1	-2.7	-3.3	-2.9	0.3	-1.4	-1.3	-0.7
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	32.9	34.0	36.7	37.2	34.5	32.5	32.3	30.8	29.1
of which Domestic	21.9	22.6	24.9	26.3	24.2	23.6	23.3	22.2	21.1
Foreign Assets & Liabilities, USD bn									
External debt	44.6	46.4	53.7	64.1	75.9	78.8	90.2	93.5	97.5
Public	28.8	29.4	37.1	38.9	42.8	46.1	51.2	55.2	59.2
External debt / GDP	21.5	19.1	23.2	22.5	22.6	21.3	24.2	25.5	25.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	5.1	5.7	3.9	8.1	10.8	9.8	9.9	9.7	9.5
Short-term debt/International reserves (%)	24.6	23.5	15.6	28.3	33.4	26.2	22.4	20.4	18.6

Quarterly Economic Indicators									
	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	5.4	4.9	5.0	4.2	4.1	5.3	4.9	4.9	5.0
CPI, % yoy	2.3	1.9	2.0	2.1	2.2	2.8	3.2	3.4	3.5
Policy interest rate, %, eop	3.25	3.25	3.25	3.25	3.75	4.00	4.25	4.50	4.75
Short-term market rate, % eop	3.29	3.30	3.27	3.27	3.77	4.02	4.02	4.27	4.52
Long-term yield, %, eop	6.87	6.78	7.27	7.27	7.77	8.02	8.02	8.27	8.52
COP/USD, eop	1,912	1,930	2,015	2,086	2,120	2,150	2,150	2,150	2,150

Source: National Sources, Citi Research

Ecuador

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- **Summary view** — The latest data on economic activity show that the economy started to rebound during 3Q13. In fact, Ecuador's economic growth accelerated in 3Q13 to 4.9%, after standing at around 3.5% for two consecutive quarters. That being said, we maintained our GDP growth forecast of 4% for both 2014 and 2015. Amid relatively favorable inflation results observed in January and February, together with an economy which is expected to continue to grow on the back of consumption and government spending, the main goal of the government is to guarantee enough inflows of FDI to finance the new oil production projects. In addition, we expect a marginal deterioration of the current account balance in 2014.

- **Things to watch** — With the Yasuni referendum closer, some doubts regarding the type of question that could be asked have emerged. That being said, watch for the evolution and comments by the Constitutional Court on this matter.

Inflation and Activity Outlook

With no major data releases, we maintain our GDP forecast of 4% for both 2013 and 2014. Last year, economic growth in Ecuador could have closed at around 4% for the year as a whole, driven by the dynamism observed in consumption and government spending growth. The latest GDP data available for 3Q13 showed a 4.9% YoY expansion, driven by the behavior of the non-oil sector, which expanded at a 4.9% annual rate. On the other hand, the oil-sector grew 3.8% YoY, posting positive growth for the first time in the year. We expect the pickup observed in 3Q13 to continue for the rest of the year, which should take GDP growth to 4.0% for the year as a whole.

We expect GDP growth to continue exhibiting positive results in 2014, coming in at 4%. That print is based on a 5.1% rise in government consumption and a 4.9% expansion in household consumption. The main risk, in our view, arises from the external front, namely the evolution of oil prices. This is why our GDP growth forecast for this year is more conservative than the government's 4.5%–5.1% forecast. Exports, investment, and household consumption should continue to be the sectors with higher growth in 2013 and 2014. We expect the government to continue to increase fiscal spending to boost activity growth as long as oil revenues permit. Having said that, we acknowledge that there are questions regarding the sustainability of current oil production levels going forward, something that adds one more reason for the government to back the Yasuni project.

Inflationary pressures continue to be subdued, but we expect a moderate increase in inflation in 2014. Annual inflation has displayed a significant decline starting in June 2013, mostly driven by the evolution of foodstuff prices. However, the latest inflation results showed that, although inflation pressures remained relatively muted, there could be some slight pressures coming from non-tradable prices going forward. The latest CPI data for February showed that inflation stood around 2.9% for a second consecutive month. According to February's inflation data, restaurants and hotels were the main drivers of the rise in consumer prices, followed by clothing and footwear and utilities.

External accounts will rely heavily on the evolution of oil prices. According to our commodity strategist (see Commodities Brief - March Madness – geopolitics and weather risks upset the bears), commodities have outperformed most other asset markets by a wide margin in the first quarter of the year. Nonetheless, Citi Research has a neutral-to-bullish view for WTI into the summer, though 2Q14 could see a period of weakness as crude stocks hit new record highs. If these expectations materialize, the pressure on Ecuador's external accounts should continue. Given this outlook, we expect Ecuador's terms of trade to remain relatively flat this year (although with a downward risk). Also, as a result of the increase in oil derivatives purchases, imports should continue to negatively weight the current account balance. Thus, our baseline scenario contemplates a deterioration in the current account deficit in 2014, which should only start to improve in 2015.

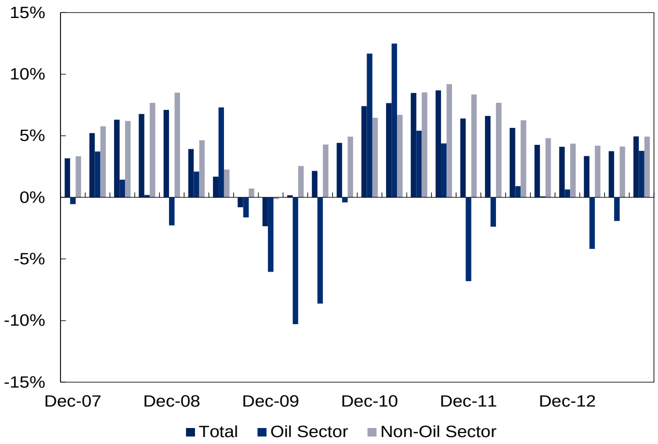
The trade balance deficit is the flipside of domestic growth, but its financing poses medium-term concerns. The trade balance showed a deficit of USD1084mn during 2013 versus a deficit of USD440.6mn in 2012. In particular, the deficit was explained by higher raw materials and oil derivatives' imports. Growth in raw materials and capital goods imports are usually correlated with higher real GDP growth, at least as long as they are financed through capital inflows. The increase in oil derivatives imports has to do with the overhang concerning the Esmeraldas refinery, the biggest in the country. It is expected to be fully completed and reach its maximum processing capacity (110 thousand barrels per day) by 2015. In the meantime, the lower local refinement capacity will have to be substituted by imports.

We expect a marginal deterioration of the current account balance in 2014. As we have mentioned in our previous reports, and based on the recent trends observed in the balance of payments, we anticipate that 2014's current account deficit will stand at -0.9% of GDP.

Political Update: Of Regional Elections, Social Security Reform, and Other Demons

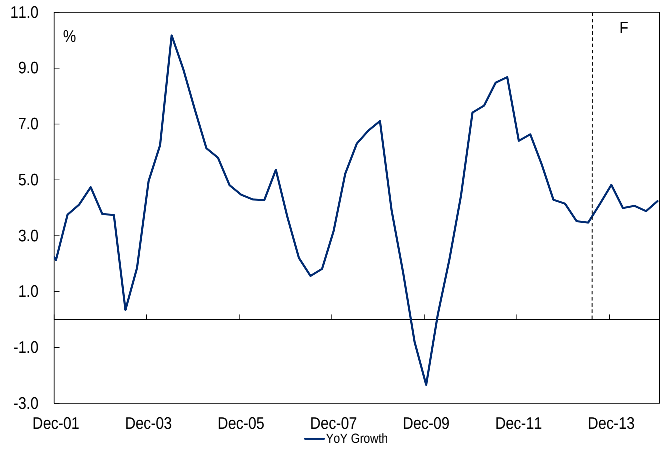
Throughout the quarter, we saw the announcement by president Correa considering an amendment to the 2008 Constitution in order for him to run for reelection. This came as a consequence of the regional elections held in February in which *Alianza Pais* (president Correa's political party) lost six of the most important mayoral races and some more regional governorships (*prefecturas*) as well. After what Mr. Correa considered to be a quick acceleration of the opposition in the political space, he announced that he would reconsider the idea of not presenting himself again for reelection, in which case a constitutional amendment would be needed as currently a president can serve only two terms in office. At the same time, discussions over a project to modify social security enrollment by independent workers in order to make it mandatory created a lot of uncertainty and discomfort within the population, obliging the government to backtrack in the measure (i.e., leaving enrollment as voluntary).

Figure 271. 3Q13 GDP growth breakdown



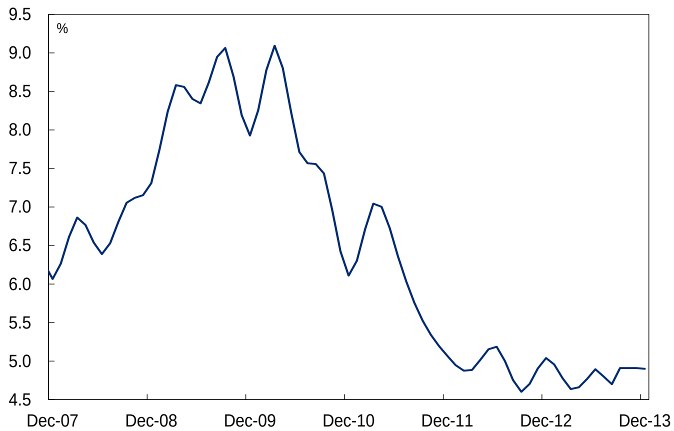
Source: Central Bank of Ecuador and Citi Research

Figure 272. GDP is expected to rebound in 2H13



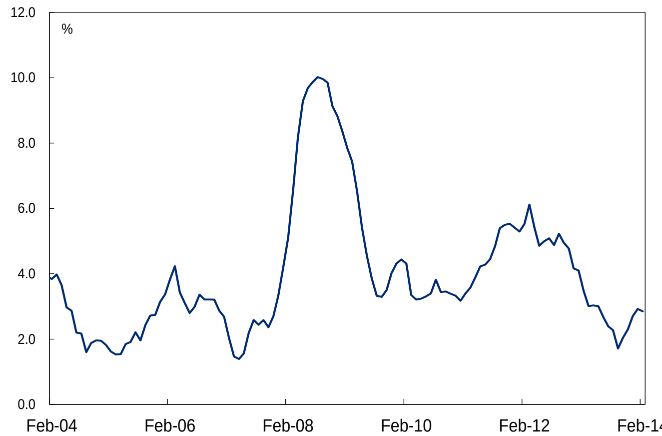
Source: Central Bank of Ecuador and Citi Research

Figure 273. Unemployment rate



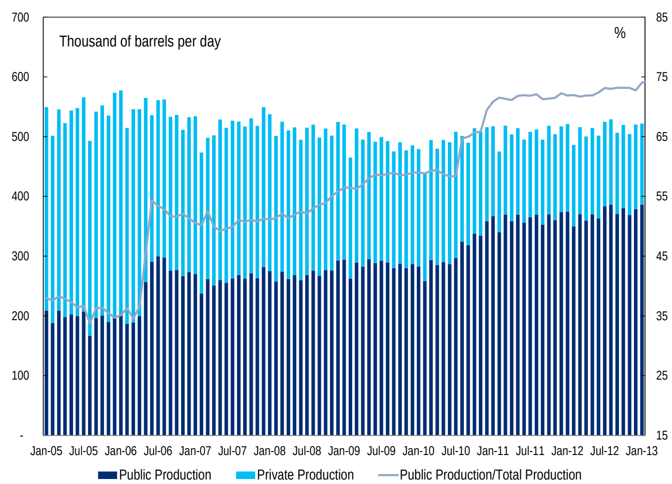
Source: Central Bank of Ecuador and Citi Research

Figure 274. Inflation rate



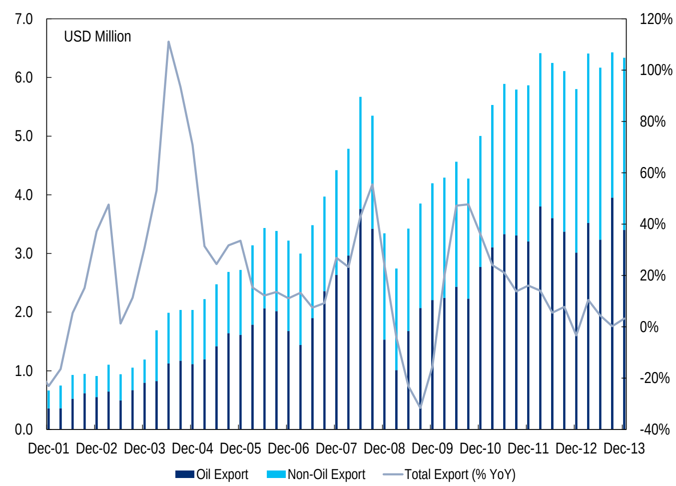
Source: Central Bank of Ecuador and Citi Research

Figure 275. Oil production



Source: Central Bank of Ecuador and Citi Research

Figure 276. Exports breakdown



Source: Central Bank of Ecuador and Citi Research

Figure 277. Ecuador Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	51	62	63	70	80	88	93	99	106
Nominal GDP, local currency bn	51	62	63	70	80	88	93	99	106
GDP per capita, USD	1,856	2,211	2,203	4,637	5,233	5,648	5,881	6,146	6,496
Population, mn	27.5	27.9	28.4	15.0	15.2	15.5	15.8	16.1	16.4
Unemployment, % of labour force	6.1	7.3	7.9	6.1	5.1	5.0	4.9	5.0	5.0
Economic Activity									
Real GDP, yoy avg	2.2	6.4	0.6	3.5	7.8	5.1	4.0	4.1	4.5
Real investment growth % yoy	4.2	22.5	-7.3	10.5	12.5	4.7	5.1	5.1	6.4
Real consumption growth % yoy	4.4	6.2	0.9	7.2	5.8	4.8	3.9	4.9	4.5
private consumption growth % yoy	4.2	5.4	-1.0	7.7	5.9	4.3	4.0	4.9	4.3
Real export growth, % yoy	0.0	3.0	-4.8	-0.2	4.6	2.7	3.4	4.5	4.8
Real import growth, % yoy	7.1	14.4	-9.9	14.8	3.9	1.9	4.1	7.6	6.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.3	8.8	4.3	3.3	5.4	4.2	2.7	3.0	3.1
CPI, % avg	2.3	8.4	5.2	3.6	4.5	5.1	2.7	2.9	3.1
Nominal wages, % yoy	6.3	17.6	9.0	10.1	10.0	10.6	8.0	8.5	11.7
Credit extension to private sector, % yoy	-	34.3	13.0	7.9	12.4	19.2	22.0	21.9	21.9
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	-	5.09	0.20	0.20	0.20	0.20	0.20	0.20	0.20
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ECD/USD, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Balance of Payments, USD bn									
Current account	1.6	1.3	-0.3	-1.6	-0.2	-0.3	-1.7	-2.1	-1.6
% of GDP	3.1	2.1	-0.5	-2.3	-0.3	-0.3	-1.8	-2.2	-1.5
Trade balance	1.8	1.4	-0.1	-1.5	-0.2	0.0	-1.1	-1.5	-1.0
Exports	14.9	19.1	14.2	18.1	23.1	24.6	25.0	24.7	24.7
Imports	13.0	17.8	14.3	19.6	23.2	24.5	26.0	26.3	25.7
Service balance	-1.4	-1.6	-1.3	-1.5	-1.6	-1.5	-1.7	-1.7	-1.7
Income balance	-2.0	-1.5	-1.4	-1.0	-1.2	-1.3	-1.3	-1.4	-1.4
FDI, net	0.2	1.0	0.3	0.2	0.6	0.6	0.7	1.5	2.5
International reserves	3.5	4.5	3.8	2.6	3.0	2.5	4.4	4.2	4.2
Total amortisations	11.8	9.5	8.6	7.5	7.4	6.9	6.4	6.4	6.4
Public Finances, % of GDP									
Consolidated government balance	-0.1	-1.0	-4.2	-1.6	-1.5	-1.9	-2.4	-1.9	-1.5
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	27.2	22.2	16.4	19.2	18.3	21.3	21.8	20.8	20.1
of which Domestic	6.4	5.9	4.5	6.7	5.6	8.9	8.8	8.4	7.9
Foreign Assets & Liabilities, USD bn									
External debt	17.5	16.9	13.4	13.9	15.3	16.0	17.5	17.7	18.8
Public	10.6	10.1	7.4	8.7	10.1	10.9	12.1	12.3	13.0
External debt / GDP	34.3	27.4	21.5	19.9	19.2	18.3	18.8	17.9	17.7
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	4.9	4.1	4.0	4.1	3.9	4.2	4.3	4.4	4.7
CPI, % yoy	1.7	2.7	2.3	3.3	3.3	3.0	3.0	3.1	3.1
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-

Source: National Sources, Citi Research

Mexico

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- **Summary view —** A softer beginning for activity in 2014 lead us to revise our GDP growth forecast for this year to 3.3% from 3.8% before. We nonetheless believe signs of an economic rebound will grow stronger in 2Q14 and, along with progress on the structural reform front, should lead to better sentiment about Mexico and growing differentiation vs. other EM countries.
- **Things to watch —** Secondary laws for several constitutional reforms, including the key energy reform, should be ready before the end of the current period of legislative sessions, on 30 April.
- **Strategy—** We examine in detail local prospects as normalization takes place in the US. The interaction between this "pull" factor and local "push" factors — a consistent macro framework, rebound in activity, progress on reform — will determine the performance of Mexican assets, particularly the MXN

Economic Rebound: Are We There Yet?

A harsh winter in the US had an impact on activity south of the border, but the "NAFTA link "still appears to be safe and sound. Total Mexican non-oil exports rose 2%YoY in January, below the 4.8% we had anticipated. This contrasts with the performance at the end of last year, when no traces of a meaningful deceleration were evident. In December, for example, non-oil exports rose 5.4%, not far from the 5.9% average registered for the second half of last year. This was indeed associated with fewer shipments to the US, as non-oil Mexican exports to this destination rose 3.8%YoY in January, well below the 8.2% average for the second half of 2013. However, we found that 96% of the acceleration of non-oil exports in the second half of 2013 — when their annual growth rate averaged 5.9% — was explained by the US: the crucial "NAFTA link" appears to be in good shape. Good economic prospects for the US should thus benefit Mexico, and we expect total export growth this year to average 8.7%, above the 2.6% rate registered in 2013.

On the internal front, we think that the net effect of fiscal policy in January was still weak. The indirect effect is the easiest to gauge, as it involves the impact of tax changes over inflation: We calculate this effect at 54bp. It was slightly more frontloaded than what we had originally anticipated, with most of these impacts materializing in the first half January, but it also dissipated faster, as suggested by inflation results for the second half of that month. Meanwhile, the fiscal reform also involves increased tax revenues, implying less spending power for the private sector, but since the public sector will run a deficit worth 1.4% of GDP this year, the net direct effect should be expansionary. January, however, was less expansionary than anticipated, as revenues were MXN 17.4 billion above projections while spending was also above projections, but by a smaller amount of MXN 6.4 billion. While this probably contributed to a soft beginning of the year, fiscal revenues are rising, thus validating increases in fiscal expenditure: even by January, paid fiscal expenditure rose 28%YoY in real terms.

All in all, we see a weaker 1Q14 and, accordingly, have revised our 2014 forecast to 3.3% from 3.8% before. The YoY growth rate in 1Q14 will benefit from a low comparison base in 1Q13, and thus our new forecast of 3.3% annual growth would imply a 2.7%YoY growth rate in 1Q14. On a quarterly, seasonally-adjusted basis though, the rate will be a more modest 0.7%; still an improvement over 4Q13 at 0.2%QoQ. In 2Q14, the Easter Holiday effect will imply fewer working days than in the same quarter of 2013 and thus a relatively modest 2.5%YoY rate will actually mask a gain in momentum as the quarterly, seasonally adjusted rate will go up to 1.6%.

Reforms About to Enter Implementation Phase

After a year of political breakthroughs, attention turns to the details. The first period of congressional sessions — from 1 February to 30 April — already has legislators at full throttle, as significant progress in the passage of constitutional reforms last year now has to be followed by the approval of enabling legislation. In the case of the bills referred to competition and telecommunications, the details to be clarified by enabling legislation are important enough so as to ultimately determine investment decision. This also applies to several of the rulings that the institutions that were set up — or modified — by the reforms have to make.

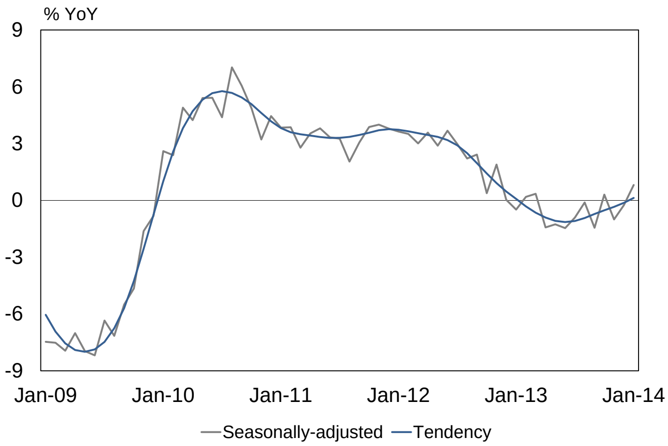
When it comes to the energy reform bill, we believe that enabling legislation is unlikely to generate surprises. The main challenge in this respect probably involves time restrictions; transitory articles in the constitutional energy reform require secondary legislation to be ready by April 20, and as we have already seen, congressional workloads are quite heavy. Moreover, the profound transformation of this sector will be just beginning. We revised several “top down” approaches to the potential investment flows generated by the reform, and our estimates suggest that starting in 2015, we could see additional investment inflows into the “energy ecosystem” worth around USD 10 billion. Those estimates also suggest that these flows could peak at around 2017 at levels of about USD 30 billion, averaging USD 20 billion in the first years of the reform.

Activity + Reforms – Fed = Differentiation?

In terms of financial flows, we will have a “pull” factor common to all EMs (Fed normalization) and “push” factors that are more Mexico-specific. Moreover, Mexico benefits from an internally consistent macro policy framework. At the outset, there are no major imbalances: (1) the fiscal deficit authorized for this year will result in a still reasonable debt-to-GDP ratio of 38%; (2) the level of indebtedness of the private sector is also manageable, as bank lending to the private sector has risen by an average of 8%YoY in real terms during 2011–13; (3) the current account deficit closed last year at 1.8% of GDP, and we project it will stand at 2.1% of GDP this year. Moreover, a strong commitment to a free-floating exchange rate, along with increased reputation in terms of anti-inflation credentials, means Mexico has overcome the “fear of floating”: FX volatility is unlikely to have significant balance-sheet effects, and since nominal exchange rate movements are almost wholly translated into real exchange rate movements, a weaker/stronger peso is consistent with looser/tighter monetary conditions.

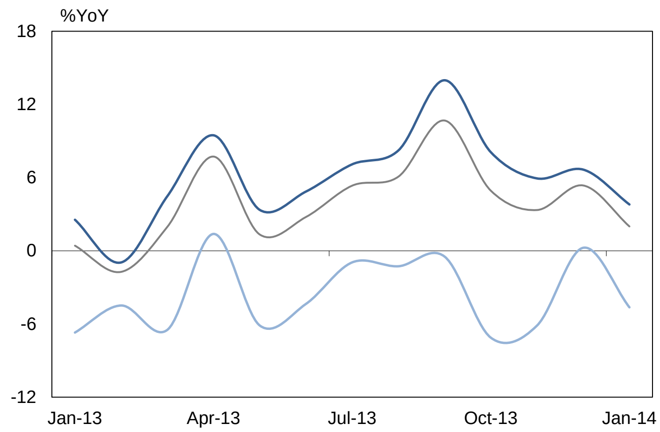
All things considered, the exchange rate is the variable to follow in the near term. As an example, if “push” factors could overcome the “pull” effect of Fed normalization, exchange rate appreciation would take place, the real exchange rate would strengthen, and thus monetary conditions would get tighter, thus reducing the need for rate hikes by Banxico. Provided inflation remains under control, as appears to be the case, we revise our year-end annual inflation forecast down to 4.0% from 4.2% previously. What is left to define is what, in our view, is the net balance between “pull” and “push” factors. We think that a gradual improvement in “push” factors will lead to a broadly balanced position between them. Accordingly, we currently expect the USD/MXN to trade at levels of around 13.30 in a three-month horizon and close the year at 13.10. This will be consistent with Banxico remaining on hold at 3.5% throughout this year and to start a hiking cycle in second quarter 2015 that would place the policy rate at 4.75% by the end of that year. In sum, relative to other EMs, we expect Mexico to start to differentiate in terms of performance.

Figure 278. IP growth is still weak, but is picking up



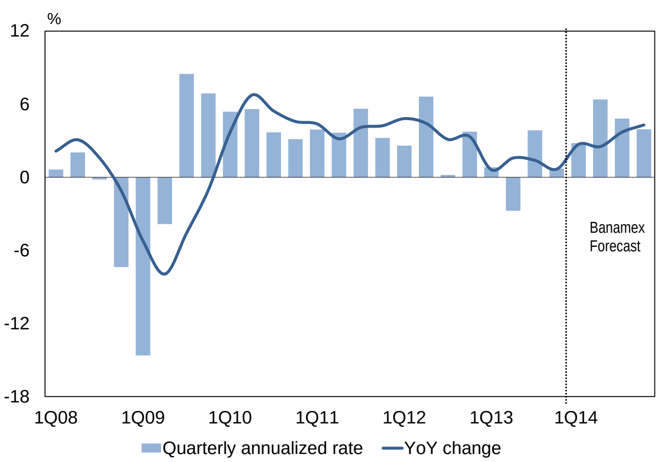
Sources: INEGI and Banamex

Figure 279. Non-oil exports to US outperformed those the ROW



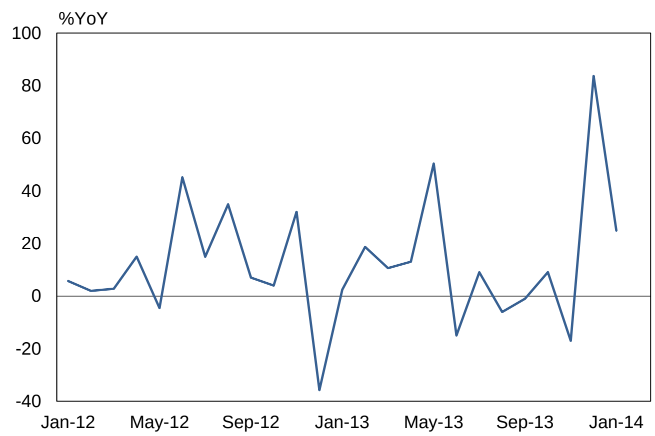
Sources: INEGI and Banamex

Figure 280. GDP Growth rates set to accelerate



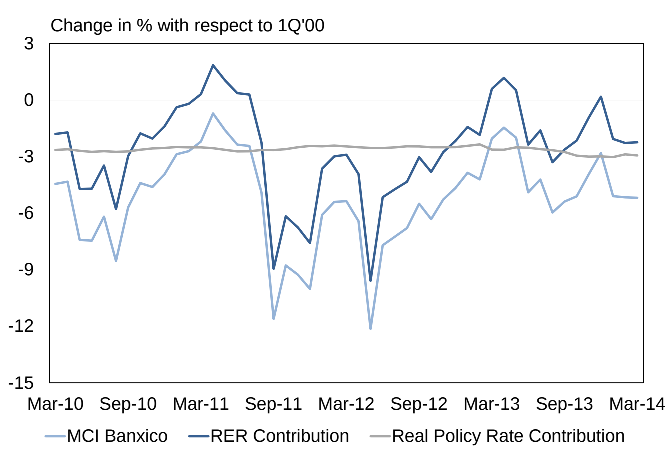
Sources: INEGI and Banamex

Figure 281. Tax reform boosts fiscal revenues



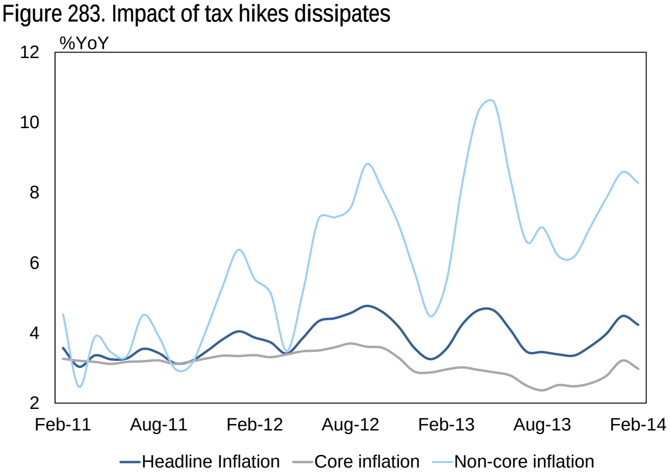
Sources: INEGI and Banamex

Figure 282. Monetary conditions are responsive to the RER



Sources: INEGI and Banamex

Figure 283. Impact of tax hikes dissipates



Sources: INEGI and Banamex.

Figure 284. Mexico Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,044	1,109	897	1,052	1,170	1,184	1,259	1,304	1,445
Nominal GDP, local currency bn	11,403	12,257	12,094	13,282	14,531	15,588	16,077	17,254	18,668
GDP per capita, USD	9,507	9,967	7,952	9,206	10,117	10,130	10,659	10,934	12,001
Population, mn	109.8	111.3	112.9	114.3	115.6	116.9	118.1	119.3	120.4
Unemployment, % of labour force	3.7	4.0	5.5	5.4	5.2	5.0	5.0	4.8	4.8
Economic Activity									
Real GDP, yoy avg	3.1	1.4	-4.7	5.1	4.0	3.9	1.1	3.3	4.0
Real investment growth % yoy	3.7	6.2	-13.3	4.5	5.4	5.7	-2.3	2.6	5.8
Real consumption growth % yoy	3.0	2.1	-5.2	4.7	4.6	4.5	2.3	3.2	3.7
private consumption growth % yoy	3.0	1.9	-6.5	5.3	4.9	4.7	2.5	3.4	4.1
Real export growth, % yoy	3.6	-1.3	-11.8	20.5	8.2	5.9	1.4	7.4	8.6
Real import growth, % yoy	5.9	4.4	-17.6	20.5	8.0	5.4	1.2	7.1	8.6
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.8	6.5	3.6	4.4	3.8	3.6	4.0	4.0	3.6
CPI, % avg	4.0	5.1	5.3	4.2	3.4	4.1	3.8	4.2	3.6
Nominal wages, % yoy	5.4	5.3	4.2	3.0	5.4	4.4	4.6	4.2	4.3
Credit extension to private sector, % yoy	12.0	9.6	0.6	5.6	7.4	6.8	6.7	8.5	9.8
Policy Rate (eop)	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.50	4.75
1 month inter-bank rate, %, eop	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.50	4.75
Long-term yield, %, eop	8.03	8.35	7.99	6.95	6.51	5.38	6.45	7.12	7.61
MXN/USD, eop	10.91	13.67	13.06	12.36	13.95	12.87	13.04	13.09	12.77
MXN/USD, avg	10.93	11.16	13.50	12.63	12.44	13.16	12.76	13.22	12.89
Balance of Payments, USD bn									
Current account	-14.3	-19.6	-7.7	-2.7	-11.4	-12.0	-22.3	-27.4	-25.8
% of GDP	-1.4	-1.8	-0.9	-0.3	-1.0	-1.0	-1.8	-2.1	-1.8
Trade balance	-10.1	-17.3	-4.7	-3.0	-1.5	0.0	-1.0	-4.6	-3.2
Exports	271.9	291.3	229.7	298.5	349.4	370.7	380.2	413.1	466.2
Imports	281.9	308.6	234.4	301.5	350.8	370.8	381.2	417.7	469.4
Service balance	-7.6	-8.2	-10.0	-9.9	-14.1	-14.0	-11.7	-12.6	-12.3
Income balance	-23.0	-19.5	-14.6	-11.3	-18.8	-20.5	-31.4	-32.1	-33.1
FDI, net	31.6	27.9	16.7	22.6	23.8	15.6	35.0	22.5	26.5
International reserves	78.0	85.4	90.8	113.6	142.5	163.5	176.5	192.0	205.6
Total amortisations	37.3	46.0	79.0	57.0	47.7	52.9	50.5	43.3	39.9
Public Finances, % of GDP									
Consolidated government balance	0.0	-0.1	-2.3	-2.8	-2.5	-2.6	-2.4	-3.5	-2.5
Consolidated gov primary balance	2.2	1.8	-0.1	-0.9	-0.6	-0.6	-0.4	-1.3	-1.3
Public debt	33.7	36.5	40.3	38.8	39.6	39.5	38.2	38.1	37.9
of which Domestic	22.1	24.8	26.8	24.0	23.9	18.9	17.8	18.3	18.8
Foreign Assets & Liabilities, USD bn									
External debt	196.8	205.3	195.0	247.9	282.1	346.9	381.1	399.3	415.3
Public	121.0	129.3	120.9	155.1	183.0	242.6	259.7	275.8	290.9
External debt / GDP	18.9	18.5	21.7	23.6	24.1	29.3	30.3	30.6	28.8
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	26.1	25.1	21.3	21.3	22.8	22.4	21.3	22.0	22.7
Short-term debt/International reserves (%)	33.4	29.4	23.5	18.8	16.0	13.7	12.1	11.4	11.1

Quarterly Economic Indicators	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.4	0.7	2.7	2.5	3.7	4.3	4.3	4.1	4.1
CPI, % yoy	3.4	4.0	3.8	4.1	4.4	4.0	3.6	3.7	3.8
Policy interest rate, %, eop	3.75	3.50	3.50	3.50	3.50	3.50	3.50	3.75	4.25
Short-term market rate, % eop	3.75	3.50	3.50	3.50	3.50	3.50	3.50	3.75	4.25
Long-term yield, %, eop	6.10	6.45	6.35	6.72	6.94	7.12	7.26	7.36	7.46
MXN/USD, eop	13.09	13.04	13.29	13.31	13.20	13.09	13.01	12.93	12.85

Source: National Sources, Citi Research

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- **Summary view** — Economic activity should show some improvement at the same time that inflation should get closer to the 2% mid-point target during 2014. Domestic absorption should also show some resilience with household consumption, and gross capital formation is expected to post better numbers than those observed in 2013. The main risk for the economic outlook will continue to be the evolution of commodity prices and eventual depreciation pressures in the FX market.

- **Things to watch** — Watch for the BCRP's meeting.

- **Strategy** — We expect the USDPEN to be affected by the behavior of FX flows and commodity prices. That being said, the BCRP will likely continue intervening in the FX market to decrease volatility.

Economic Activity: Looking for Growth Drivers

After exhibiting average growth of 6.5% throughout the past decade, the Peruvian economy is feeling the headwinds associated with a weaker outlook for commodities. Although the country is not alone and most of LatAm economies are going through the same reality, for Peru this situation brings up the question of the sustainability of those extremely positive growth rates observed in the past. The domestic view seems to be aligned in the sense that the current deceleration in economic activity is seen as transitory, and hence in 2014 and 2015 the economy should begin to pick up once again, mostly thanks to expected significant increases in FDI and to the beginning of operation of new mining projects, which should translate into higher exports.

In particular, monthly activity indicators showed growth continues to hover around the 5% mark. The National Statistics Institute (INEI) reported that in January, annual growth of economic activity stood at 4.2%, a number below market expectations. Financial services (13.9%), mining (5.6%), retail (4.7%) and transportation services (4.3%) accounted for 50% of the growth observed in January.

With stable or even weaker terms of trade in the horizon, it is difficult to build the case for exports-led growth. We acknowledge that the terms of trade having remained relatively stable since 2011 does not bode well for the external sector as a main driver of economic growth going forward. Having said that, the fact that new mining projects should begin early production by 2015 does matter for GDP determination, and we believe this should have a positive impact on the country's exports in the future.

When external driven growth is not available, domestic-driven factors should replace them. Given our view that external factors will likely fail to boost growth in Peru at the margin, we believe it is important to look at the health of domestic drivers: i.e., consumption and investment. Household consumption has been increasing recently, and we expect these dynamics to continue throughout 2014, as credit conditions remain favorable even despite recent increases in non-performing loans. On the investment side, the government and the private sector are expected to continue with infrastructure and residential construction projects, something that should help to back growth.

Inflation: If the Output Gap Is Negative, Why Is Inflation Still High?

Over the past few months we have been hearing from the central bank that the recent inflation prints are stubbornly high due to supply shocks. In particular, foodstuffs are considered to be the main upward drivers of inflation, and the central bank has repeatedly stated that these prices should begin to fall sooner rather than later. However, when core prices are considered, price increases are not only high, but they are outside of the 1%–3% inflation target range (3.8% as of February 2014). Hence, one question that is worth asking is why, if economic growth is below potential, inflation has not only remained high but has also increased at the margin even when food prices are excluded from the analysis. We consider one possible answer: If the numbers continue to hover around the inflation target's upper boundary, maybe the economy's output gap is not as high as it used to be. We acknowledge that only time will confirm or reject this hypothesis. We currently expect inflation of 2.45% in 2014, which implies a deceleration when compared to 2013.

Monetary Policy: The Conundrum

No room for cuts. Even though economic activity is growing below what is locally accepted as potential, the event of inflation reaching the upper bound of the target, together with the depreciation pressures on the PEN stemming from an adverse external environment, limit the central bank's room to cut its policy rate. However, the monetary authority could continue with the reduction of reserve requirements if conditions permit.

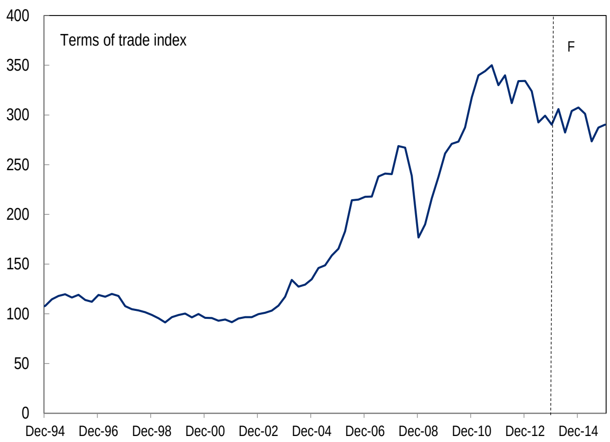
Political Update: New Cabinet Passes Confidence Vote but Its Political Capital Grows Thin

Confidence vote passes, but not without consequences. Only a few weeks after the last cabinet shuffle done by president Humala, Congress held a vote of confidence that passed after several attempts in which abstention was higher than the actual number of casted votes. While the government finally was able to get a majority, we think the political capital of this cabinet is low and that it will have to work hard in order to increase it going forward.

The confidence motion took place thanks to, according to some opposition congressmen, the direct influence of First Lady Nadine Heredia in government matters. In particular, the recent discussion over the minimum wage increase, which ended with the resignation of prime minister Cesar Villanueva and the appointment of Rene Cornejo after comments of Mr. Villanueva were contradicted by Mrs. Heredia, has brought up the question of how significant the influence of the first lady on this administration is. At the same time, some opposition members have voiced their outrage following the recent increase in wages of the cabinet, which were doubled.

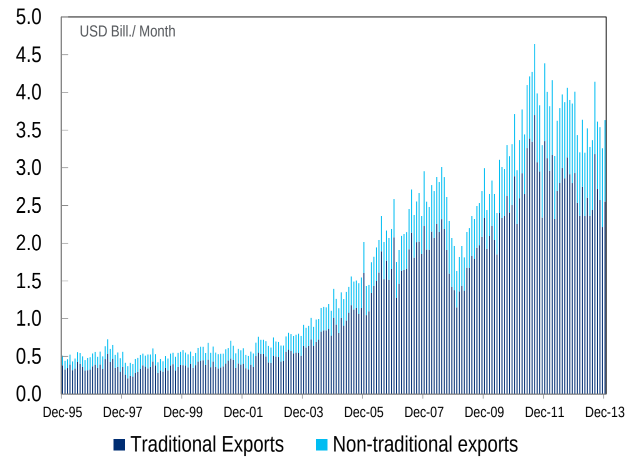
The situation seems under control for the time being, but the government will have to work harder in order to pass any new legislation by Congress. We do not expect this to be last time a confidence vote on the cabinet is held; as we get closer to the next round of elections, the likelihood of this event will only get higher in our view. This situation will put the new cabinet to test, particularly as health, pension, and labor reforms make their way to Congress.

Figure 285. Terms of trade dynamics...



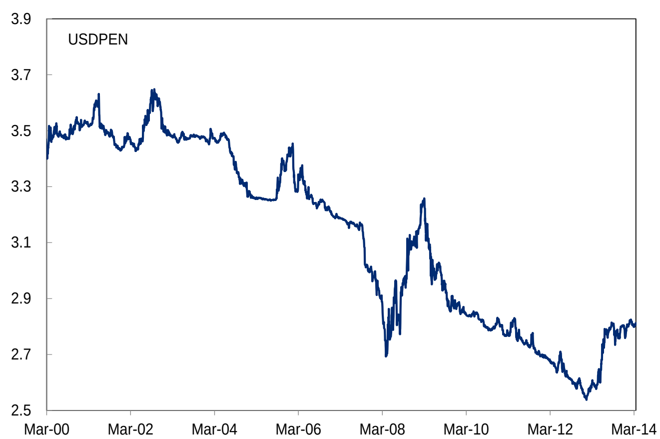
Source: Bloomberg and Citi Research

Figure 286. Could translate into weaker traditional exports...



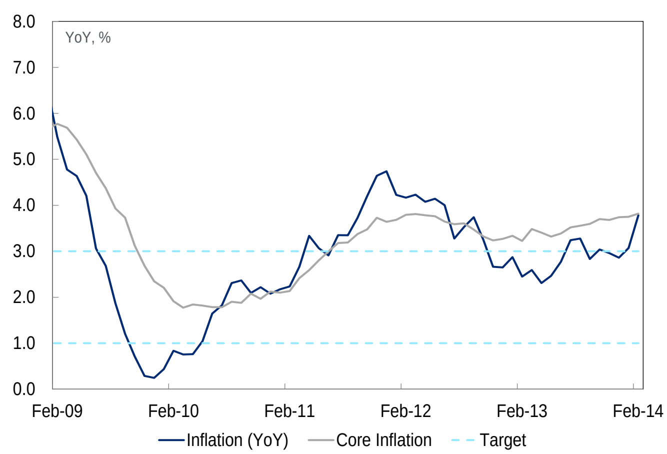
Source: BCRP and Citi Research

Figure 287. And a weaker exchange rate



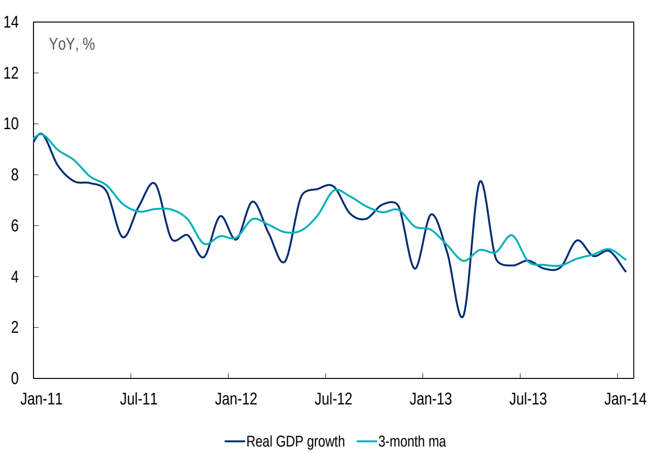
Source: Bloomberg and Citi Research

Figure 288. Inflation dynamics



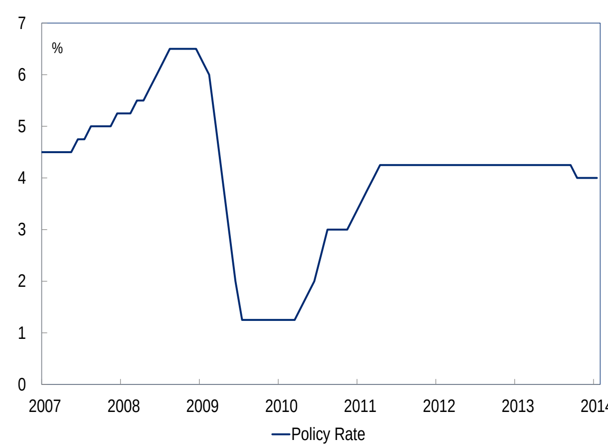
Source: BCRP, Haver and Citi Research

Figure 289. Output is expected to pick up...



Source: INEI, Haver and Citi Research

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



Source: BCRP, Haver and Citi Research

Figure 291. Peru Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	107	127	127	153	176	199	208	217	238
Nominal GDP, local currency bn	336	371	382	435	486	526	566	613	668
GDP per capita, USD	3,906	4,562	4,482	5,344	6,033	6,709	6,902	7,101	7,691
Population, mn	27.4	27.8	28.3	28.7	29.2	29.7	30.1	30.6	31.0
Unemployment, % of labour force	8.4	8.4	8.4	7.9	7.7	6.8	5.8	5.7	5.6
Economic Activity									
Real GDP, yoy avg	8.9	9.8	0.9	8.8	6.9	6.3	5.0	5.7	6.2
Real investment growth % yoy	25.8	25.8	-20.6	35.9	9.6	10.1	7.5	5.0	4.9
Real consumption growth % yoy	7.9	8.0	3.9	6.5	6.2	6.3	5.4	6.3	6.5
private consumption growth % yoy	8.3	8.7	2.4	6.3	6.2	5.8	5.2	5.9	6.7
Real export growth, % yoy	6.9	8.2	-3.2	1.3	8.8	5.4	0.6	4.9	4.5
Real import growth, % yoy	21.4	20.1	-18.6	24.0	9.8	10.4	6.2	6.1	4.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.9	6.7	0.2	2.1	4.7	2.6	2.9	2.5	2.5
CPI, % avg	1.8	5.8	2.9	1.5	3.4	3.7	2.8	2.7	2.5
Nominal wages, % yoy	5.0	12.8	23.1	-8.8	15.1	5.4	5.0	5.0	0.0
Credit extension to private sector, % yoy	29.9	14.3	10.4	20.1	14.2	13.8	11.0	11.0	5.0
Policy Rate (eop)	5.00	6.50	1.25	3.00	4.25	4.25	4.00	4.00	4.50
1 month inter-bank rate, %, eop	5.51	6.68	1.28	3.20	4.17	4.22	4.60	4.10	4.60
Long-term yield, %, eop	6.44	7.69	6.31	6.34	6.16	4.24	5.40	5.30	4.50
PEN/USD, eop	3.00	3.13	2.89	2.81	2.70	2.55	2.80	2.85	2.80
PEN/USD, avg	3.13	2.92	3.01	2.82	2.75	2.64	2.70	2.82	2.80
Balance of Payments, USD bn									
Current account	1.5	-5.3	-0.7	-3.8	-3.3	-6.8	-10.9	-12.2	-3.6
% of GDP	1.4	-4.2	-0.6	-2.5	-1.9	-3.4	-5.2	-5.6	-1.5
Trade balance	8.5	2.6	6.0	6.8	9.3	4.8	-0.8	-0.8	-0.9
Exports	28.1	31.0	27.0	35.6	46.3	45.9	41.5	41.6	44.8
Imports	19.6	28.4	21.0	28.8	37.0	41.1	42.3	42.5	45.7
Service balance	-1.2	-2.1	-1.2	-2.3	-2.1	-2.3	-1.9	-2.2	-2.3
Income balance	-8.3	-8.7	-8.4	-11.2	-13.7	-12.7	-11.3	-12.5	-13.2
FDI, net	5.5	6.9	6.4	8.5	8.2	12.2	12.1	13.0	13.4
International reserves	27.7	31.2	33.1	44.1	48.8	64.0	67.5	70.2	75.3
Total amortisations	6.8	3.3	2.2	4.1	1.4	4.0	4.1	4.3	4.5
Public Finances, % of GDP									
Consolidated government balance	2.6	2.3	-1.6	-0.3	1.8	1.9	0.8	0.0	0.0
Consolidated gov primary balance	4.4	3.8	-0.3	0.8	2.9	2.9	1.9	1.1	1.1
Public debt	29.8	24.1	27.2	23.5	21.8	19.9	17.4	17.4	17.0
of which Domestic	11.1	9.0	10.9	10.5	10.3	10.3	8.9	8.9	8.7
Foreign Assets & Liabilities, USD bn									
External debt	31.8	34.0	35.5	40.6	43.9	51.5	52.9	55.3	57.9
Public	20.1	19.2	20.6	19.9	20.2	19.0	17.5	18.4	19.3
External debt / GDP	29.8	26.8	28.0	26.4	24.9	25.9	25.4	25.4	24.3
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	20.6	19.5	20.1	22.9	24.2	26.3	25.9	26.7	28.6
Short-term debt/International reserves (%)	74.2	62.5	60.7	52.0	49.6	41.1	38.4	38.0	38.0

Quarterly Economic Indicators	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	4.4	5.2	5.9	5.5	5.7	5.7	6.5	6.1	5.9
CPI, % yoy	2.8	2.9	3.0	2.6	2.5	2.5	2.0	2.4	2.1
Policy interest rate, %, eop	4.25	4.00	4.00	4.00	4.00	4.00	4.50	4.50	4.50
Short-term market rate, % eop	4.70	4.60	4.10	4.10	4.10	4.10	4.35	4.60	4.60
Long-term yield, %, eop	5.65	5.40	5.30	5.30	5.30	5.30	5.70	5.70	5.70
PEN/USD, eop	2.79	2.80	2.80	2.82	2.83	2.85	2.85	2.85	2.85

Source: National Sources, Citi Research

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- **Summary view** —Throughout February and most of March, social unrest continued to affect the country, with violent events adding to the already challenging economic environment. While we believe that the peak of this bout of politically motivated social unrest was reached, we cannot rule out additional social unrest driven by the challenging economic situation experienced by Venezuelans: namely, high levels of inflation and scarcity. The main economic development continues to be associated with the announcement of SICAD II (complementing SICAD I auctions). While we think this alternative mechanism could release some of the pressure on fiscal accounts for the government and PDVSA, the uncertainty associated with the sources of USD to be offered in this market and its ability to reduce USD shortages in the country lead us to maintain our -1% GDP growth forecast and the 75% annual inflation expectation.

- **Things to watch** — Watch for the evolution of SICAD II operations.

- **Strategy** — In our view, the evolution of oil prices and USD-denominated resources will continue to be the main risk indicators to assess macroeconomic and external vulnerabilities.

Economic outlook: Tumbling Dice

Unfortunately, uncertainty regarding macroeconomic management continues to take its toll on economic performance. The recent deceleration in consumption and government spending growth should continue this year, causing GDP to contract 1% for the year as a whole. On the demand side, we forecast consumption and government spending will grow 0.1% and 0.2%, respectively, this year. The worst performers will be investment and real exports, which we expect to fall 7.5% and 3.8%, respectively.

As we mentioned in our previous report, inflation and scarcity should continue increasing this year. The Central Bank of Venezuela reported that the national inflation gauge stood at 2.4% MoM in February, lower than market expectations (consensus 4.5%, Citi 3.5% MoM). This result took the yearly inflation print up to 57.3%, one percentage point higher than January's print. According to the report, inflation in Caracas stood at 2.6% MoM. Inflation was driven by entertainment (4.1% MoM), healthcare (4.1% MoM), and restaurant and hotels (3.9% MoM). Food inflation stood at 1.7% MoM.

Despite the lower-than-expected monthly print, the inflation outlook in Venezuela continues to be challenging. We expect yearly inflation and scarcity to increase during the year as a result of the delays in USD disbursements, local production bottlenecks, and the ample liquidity in local currency. The scarcity of goods and its inflationary consequences will continue to be the main problem faced by the government —-a situation the government has called "*the economic war.*" In our view, the government's approach to inflation as a byproduct of the "war" will continue, translating into more price controls and regulations with limited, or even harmful, effects. That being said, we still expect inflation to accelerate up to 75% by year-end.

Assessing the sustainability of Venezuela's economy. Using the BoP approach, we found threshold levels of USD90.9 per barrel, USD84.2 per barrel, and USD77.6 per barrel on average for the year as whole, for different stressed scenarios in the BoP.

Using the FXSU approach we found a minimum threshold price of USD83.8 per barrel for the Venezuelan oil basket. In our view, the evolution of oil prices and USD-denominated resources (international reserves and special funds) will continue to be the main risk indicators for external vulnerabilities. For a detailed analysis see our Venezuela Macro View - Tight on cash?.

SICAD II and Debt Issuance: Can You Hear Me Knocking

The main economic development continues to be associated with the announcement of SICAD II (complementing SICAD I auctions). While we think this alternative mechanism could release some of the pressure on fiscal accounts for the government and PDVSA, the uncertainty associated with the sources of USD to be offered in this market and its ability to reduce USD shortages continues.

What are some of the implications of SICAD II? To measure the impact of SICAD 2 on the economy, its effect has to be divided in three parts: i) its impact on the private sector; ii) its effect in government and PDVSA accounts; and iii) its implications for USD-denominated debt issuances. Although the creation of an alternative mechanism of USD supply to the private sector is positive, the constant changes in FX regulations create unnecessary additional costs and uncertainty when doing business in Venezuela. Also, with the appearance of SICAD II, the economy will be back to a three-tier FX scheme (four if we include the black market), which could create further price distortions. All in all, if SICAD II is able to effectively provide more USD in a faster way, the result for the private sector should be positive. We believe this is the reason why the market reaction to the announcements has been positive. However, we think that it is on the delivery on the promise where the new market will face issues.

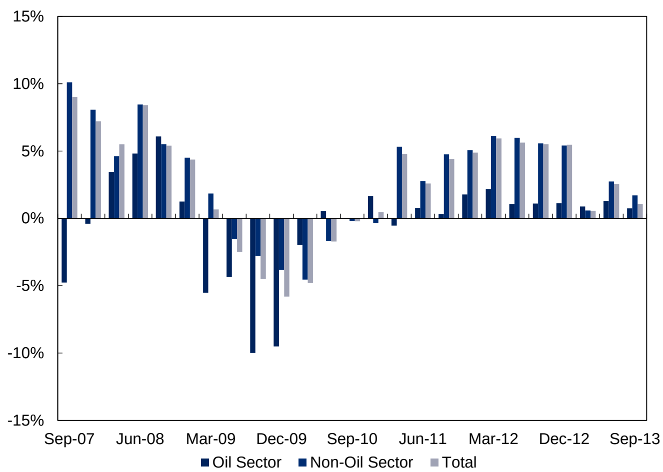
Impact on the oil sector and fiscal accounts. In general, the possibility of offering USD at a higher rate will be beneficial for the oil sector and the government. For the government, the projected fiscal deficit could be reduced if USD inflows are monetized at a higher rate. Nonetheless, the fact that the government is presenting systematic fiscal deficits which are mostly monetized by the BCV does not lead us to think that inflation will recede.

Implications on bond supply: Is issuance coming? In our view, some of the supply that will be given in SICAD II will come from USD-denominated bonds in the hands of the government and public entities. Although there is no detailed information on how much that would be, the pattern in SICAD I auctions leads us to think there is a low level of USD-denominated debt available for sale. We thus believe the only mechanism to “normalize” the USD supply in the country is to issue additional debt. We think that the USD-denominated issuance will more likely come from the sovereign first and in an amount that could be around USD3-4 billion (around half of the yearly allocations made by the extinct SITME system).

Political outlook

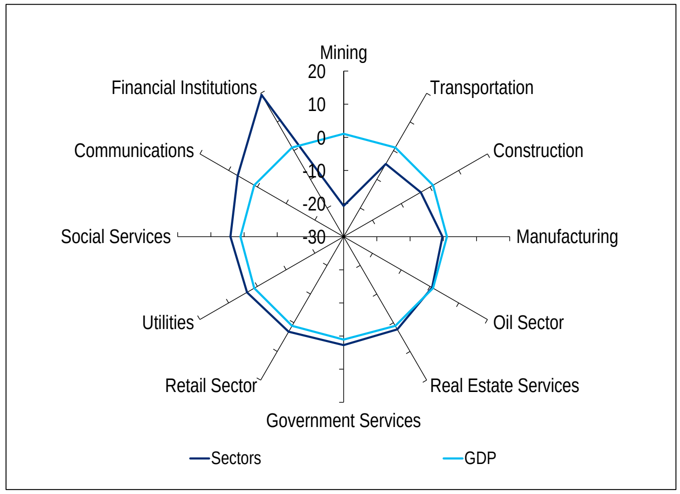
The political outlook continues to be challenging but the peak of the protest seems to be over. Throughout February and most of March, social unrest continued to affect the country, with violent events adding to the already challenging economic environment. While we believe that the peak of this bout of politically motivated social unrest was reached, we cannot rule out additional social unrest driven by the challenging economic situation experienced by Venezuelans. Nonetheless, we do not see any changes in the political arena over the short term that allow the opposition to gain additional political leverage.

Figure 292. GDP growth should continue decelerating



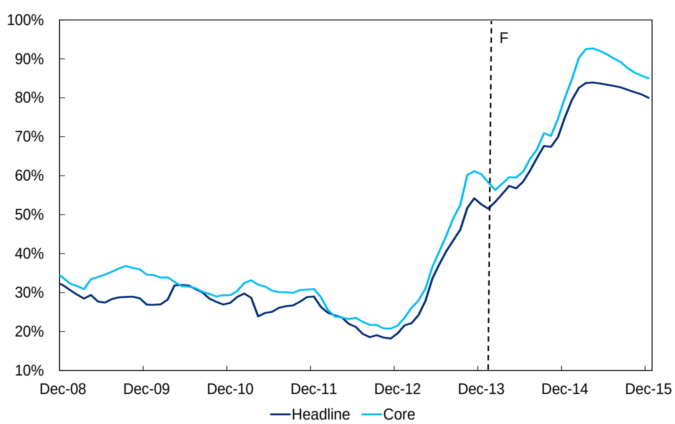
Source: BCV and Citi Research

Figure 293. GDP growth by sector in 3Q13



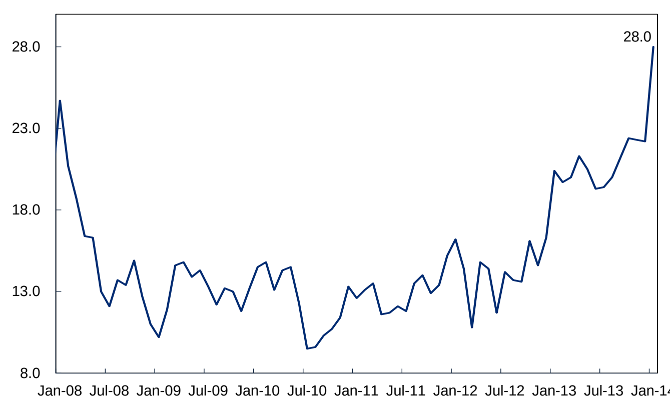
Source: BCV and Citi Research

Figure 294. Inflation should accelerate despite the week GDP growth



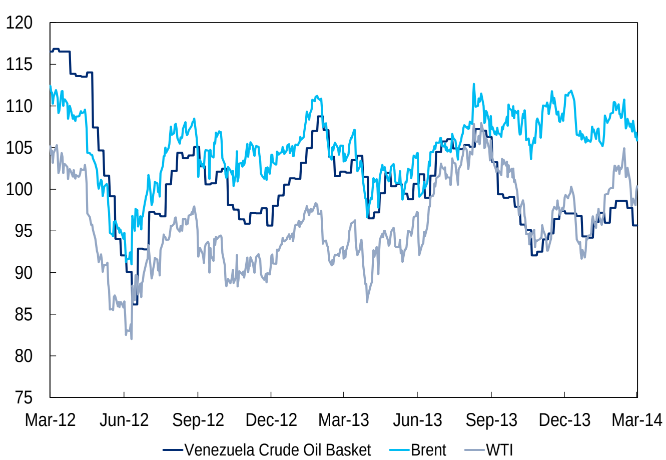
Source: BCV and Citi Research

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



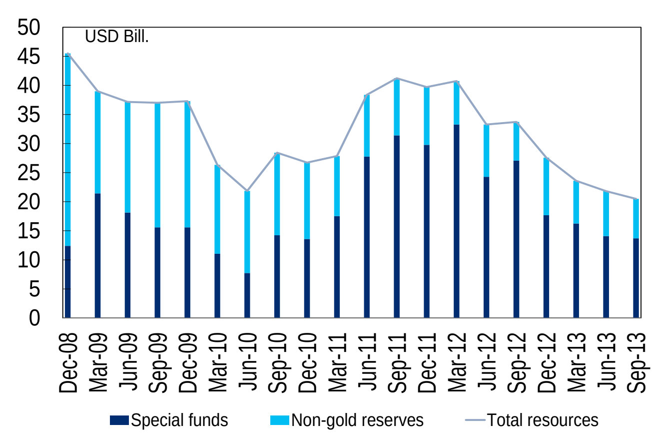
Source: BCV and Citi Research

Figure 296. Venezuelan oil basket prices and WTI prices



Source: BCV and Citi Research

Figure 297. Could total liquid resources continue its downtrend?



Source: BCV and Citi Research

Figure 298. Venezuela Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	213	298	284	257	298	361	373	368	360
Nominal GDP, local currency bn	495	678	707	1,017	1,357	1,642	2,595	4,152	6,778
GDP per capita, USD	7,738	10,683	9,996	8,925	10,188	12,141	12,355	12,038	11,592
Population, mn	27.5	27.9	28.4	28.8	29.3	29.7	30.2	30.6	31.0
Unemployment, % of labour force	6.2	6.1	6.6	6.5	6.5	5.9	5.6	5.7	5.8
Economic Activity									
Real GDP, yoy avg	8.8	5.3	-3.2	-1.5	4.2	5.6	1.5	-1.0	1.9
Real investment growth % yoy	28.2	2.2	-19.1	1.0	15.2	24.1	-7.5	-3.6	1.5
Real consumption growth % yoy	16.3	6.0	-2.1	-1.1	4.4	6.9	3.6	0.1	0.3
private consumption growth % yoy	16.9	6.3	-2.9	-1.9	4.0	7.0	3.8	0.1	0.3
Real export growth, % yoy	-7.6	-1.0	-13.7	-12.9	4.7	1.6	-3.8	1.3	4.2
Real import growth, % yoy	33.0	1.4	-19.6	-2.9	15.4	24.4	-4.6	-0.7	-1.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	22.5	31.9	26.9	27.4	29.0	19.5	52.7	75.0	80.0
CPI, % avg	18.7	31.4	28.6	29.1	27.1	21.1	38.5	62.5	82.1
Nominal wages, % yoy	20.7	25.0	23.7	24.5	27.0	30.0	45.0	60.0	60.0
Credit extension to private sector, % yoy	43.3	30.6	18.0	27.6	36.8	55.3	65.8	80.0	80.0
Policy Rate (eop)	18.00	28.10	14.00	12.50	-	-	-	-	-
1 month inter-bank rate, %, eop	18.00	28.10	11.30	12.30	14.50	14.50	14.50	14.50	14.50
Long-term yield, %, eop	12.00	12.00	14.38	13.02	13.93	9.18	12.88	15.20	16.88
VEF/USD, eop	2.15	2.15	2.15	4.29	4.29	4.29	6.29	12.00	19.80
VEF/USD, avg	2.15	2.15	2.15	4.20	4.29	4.29	5.99	10.58	19.80
Balance of Payments, USD bn									
Current account	18.1	37.4	8.6	12.1	27.3	11.0	12.2	14.9	18.2
% of GDP	8.5	12.5	3.0	4.7	9.1	3.1	3.3	4.0	5.1
Trade balance	23.0	45.7	19.2	27.1	46.4	38.0	36.7	33.5	36.8
Exports	69.0	95.1	57.6	65.7	92.7	97.3	89.2	83.5	88.9
Imports	46.0	49.5	38.4	38.6	46.2	59.3	52.4	50.0	52.0
Service balance	-7.0	-8.4	-7.6	-9.2	-10.7	-16.0	-13.8	-7.7	-7.8
Income balance	2.5	0.7	-2.7	-5.3	-7.9	-10.0	-9.8	-9.8	-9.8
FDI, net	1.0	-0.9	-4.9	-1.5	5.1	0.8	2.4	0.8	0.8
International reserves	34.3	43.1	35.8	30.3	29.9	26.5	25.0	23.5	22.0
Total amortisations	4.0	7.5	4.3	6.9	11.0	4.1	6.8	4.5	0.1
Public Finances, % of GDP									
Consolidated government balance	-2.8	-3.5	-8.7	-10.4	-11.6	-15.0	-11.9	-11.1	-10.3
Consolidated gov primary balance	-1.2	-2.0	-7.2	-8.6	-9.4	-12.3	-9.3	-8.9	-8.2
Public debt	25.5	21.6	31.3	42.0	44.2	43.4	41.9	40.7	40.2
of which Domestic	7.3	4.5	7.5	8.9	11.4	14.1	12.3	9.5	7.2
Foreign Assets & Liabilities, USD bn									
External debt	56.3	66.4	81.9	97.1	110.7	118.9	124.3	128.5	132.7
Public	38.7	50.9	67.4	85.3	98.0	105.8	110.5	114.5	118.5
External debt / GDP	26.5	22.2	28.9	37.7	37.1	33.0	33.4	34.9	36.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	18.1	19.9	17.4	16.8	16.7	21.1	21.8	21.5	21.0
Short-term debt/International reserves (%)	52.8	46.1	48.4	55.3	55.8	79.6	87.1	91.6	95.5

Quarterly Economic Indicators									
	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.1	1.5	-1.5	-0.9	-1.1	-0.4	2.6	1.4	2.0
CPI, % yoy	46.2	52.7	55.3	58.5	67.6	75.0	83.8	83.4	82.1
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	11.71	12.88	13.73	14.81	14.71	15.88	14.73	15.81	15.71
VEF/USD, eop	6.29	6.29	6.30	12.00	12.00	12.00	19.80	19.80	19.80

Source: National Sources, Citi Research

Notes

Appendix A-1

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