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Emerging Markets Macro and Strategy Outlook

EM's 'stagflation puzzle'

- The broad picture these days is that DM is enjoying a low-inflation recovery, while EM is suffering a high-inflation slowdown. That's not technically 'stagflation' for EM, of course, but the combination of high inflation prints and disappointing activity data is notable for a number of countries across EM.
- EM GDP growth dynamism is being suppressed by a combination of i) creaky growth models in some countries (eg China, Brazil, Russia, South Africa); ii) the dampening effect on domestic spending growth that results from efforts to rein in current account deficits (India, Indonesia, Turkey, for example); iii) the relatively weak state of risk appetite within the financial sector of many EMs; and iv) the relatively constrained pick-up in exports that EM is enjoying.
- While the EM-DM growth differential is narrowing, the EM-DM inflation differential is widening. During the past six months the average EM-DM inflation differential has been around 450 basis points; high by historical standards, particularly in view of the fact that EM isn't being hit by a commodity price shock at the moment. Currency weakness, of course, has been an important culprit in driving up inflationary pressures across a number of EMs.
- The main consequence of rising inflationary pressure is that it has required a monetary policy response: EM central banks have raised rates. In fact, real interest rates in EM have risen markedly in the past few months, and the real interest rate differential between EM and DM is quite high now by historical standards.
- This doesn't do much to support growth optimism in EM: higher real interest rates will help to dampen private sector domestic spending, particularly given that EM credit aggregates have risen fairly sharply in the past few years. It is difficult these days to think of countries in EM where local banks are flush with risk appetite. In other words, the only solution to the 'stagflation puzzle' seems to be more downward pressure on economic activity.
- What that means is that in order for EM growth prospects to improve, either fiscal policy has to loosen, or exports have to grow. Brazil's experience is salutary: neither the market nor rating agencies are that tolerant of expansionary fiscal policy. And so, EM export growth will continue to have a decisive role in shaping the outlook for EM growth. While there are pockets of optimism here, the overall picture for EM exports isn't that encouraging.
- Meanwhile, the flipside of rising real rates and low growth is that 'carry' is governing investor behavior. We think this continues but investors should stay on guard.

EM Economics and Strategy

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

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EM's 'stagflation' puzzle

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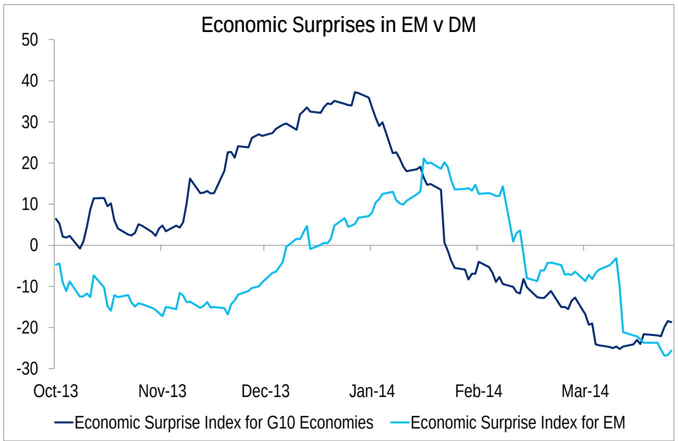
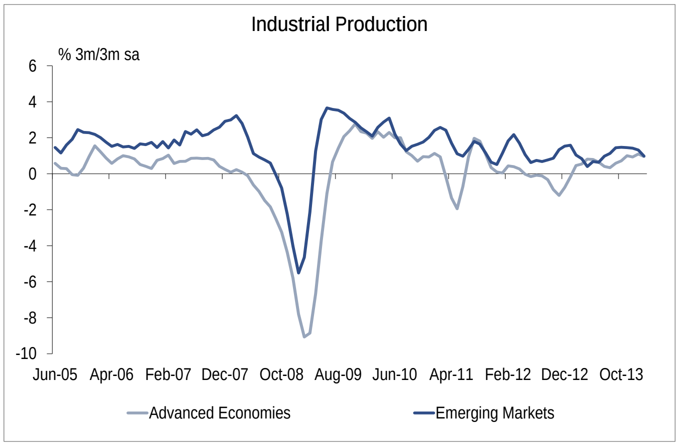
EM economic activity is generating little cheer these days. Economic surprises had seemed more negative for DM than for EM during most of early 2014, but that was driven largely by the negative weather shock that the US faced earlier in the year. If anything, recent 'surprise' data show some improvement in DM relative to EM: in other words, back to the story that had characterized much of late 2013 (Figure 1). In very broad terms, EM GDP growth dynamism is being suppressed by a combination of i) creaky growth models in some countries (eg China, Brazil, Russia, South Africa); ii) the dampening effect on domestic spending growth that results from efforts to rein in current account deficits (India, Indonesia, Turkey, for example); iii) the relatively weak state of risk appetite within the financial sector of many EMs (about which more below); and iv) the relatively constrained pick-up in exports that EM is enjoying. The combination of these factors means that we're in the unusual situation, illustrated in Figure 2, where there is barely any differential now between industrial production growth in EM and DM (at least on a 3m/3m SA basis).

Figure 1. Economic surprises are once again showing more dynamism in DM than in EM...



Source: Citi Research

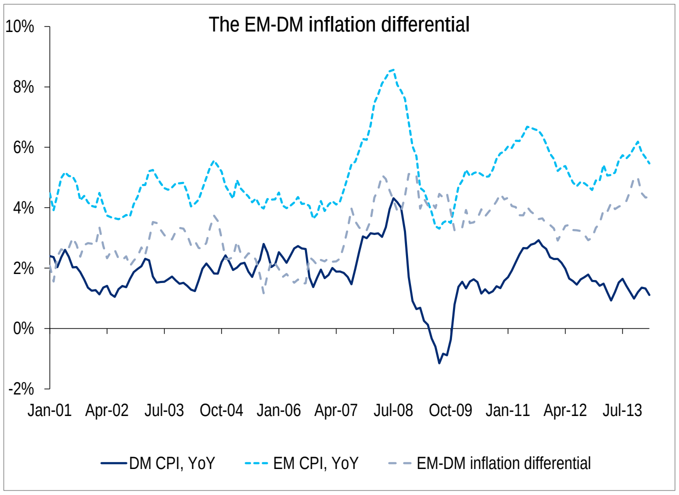
Figure 2. ...while this indicator of industrial activity is showing practically no growth differential between EM and DM anymore.



Source: Haver Analytics, Citi Research

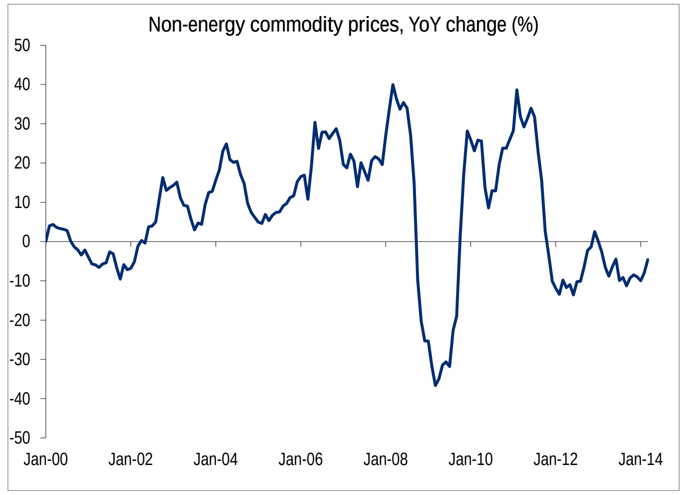
The idea of disappointing activity in EM is nothing new, but it sits awkwardly with high-ish EM inflation. Figure 2 suggests that there is more economic dynamism in DM than in EM; this is a familiar story. What is surprising though is that while the EM-DM growth differential is narrowing, the EM-DM inflation differential is widening. *While DM is enjoying a low-inflation recovery, EM is suffering a high-inflation slowdown*. Looking at the average of the last six months, the difference between EM consumer inflation and DM consumer inflation is around 4.5 percentage points: we haven't seen such a high inflation differential since 2008, when EM was hit was a significant commodity price shock (Figure 3). But there is no visible commodity price shock these days. On the contrary: non-energy commodity price inflation globally should be supporting a strong disinflationary tendency in EM. As Figure 4 shows, non-energy commodity inflation is currently negative, and has been negative for most of the period since Q4 2011. Of course, the big inflation differential between EM and DM is to a large degree the result of i) exceptionally low inflation in DM, where the average inflation rate is just 1%; and ii) the upward pressure on EM CPIs that has resulted from currency depreciation in many countries. But the implications might nevertheless be serious.

Figure 3. The gap between EM inflation and DM inflation is currently very high by historical standards...



Source: Citi Research

Figure 4. ...in spite of the fact that non-energy commodity price inflation has been negative for almost two and a half years.



Source: Citi Research

There is a relatively broad loss of inflation-fighting discipline in EM – largely thanks to currency weakness – and so real rates have had to rise. Figure 5 tries to illustrate this point by looking at countries with formal inflation targets. Based on our forecasts, it seems that six of the large inflation-targeters in EM will overshoot their targets in 2014 (we include Brazil in this, although we forecast Brazilian inflation to be at the target ceiling, not above it). This is a bigger number of 'inflation overshooters' than we have seen in recent years. On one level nothing is really surprising here: the common theme in these countries is currency depreciation. But one consequence of rising inflation threat is that real interest rates have had to rise: indeed, the gap between real interest rates in EM and those in DM is exceptionally high right now.

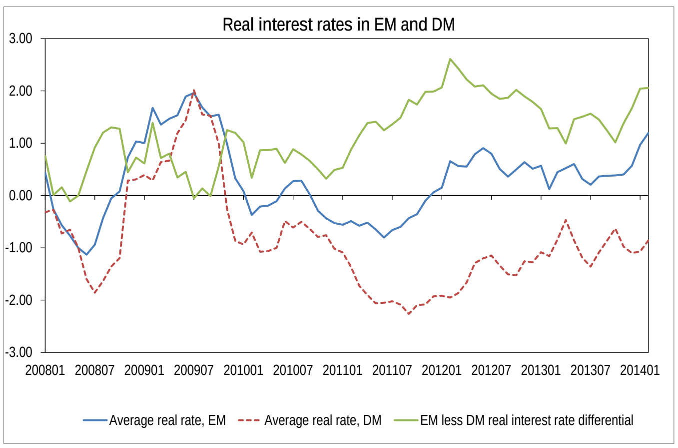
Figure 5. Inflation-targeters in EM: how many are overshooting their target?

	2014			2013			2012			2011		
	Average CPI (% YoY)	Inflation Target (mid)	Gap: Avg-year above Target?	Average CPI (% YoY)	Inflation Target (mid)	Gap: Avg-year above Target?	Average CPI (% YoY)	Inflation Target (mid)	Gap: Avg-year above Target?	Average CPI (% YoY)	Inflation Target (mid)	Gap: Avg-year above Target?
Brazil	6.5	4.50		6.2	4.50		5.4	4.50		6.6	4.50	Yes
Chile	3.4	3.00		1.8	3.00		3.0	3.00		3.3	3.00	
Colombia	2.6	3.00		2.0	3.00		3.2	3.00		3.4	3.00	
Mexico	4.1	3.00	Yes	3.8	3.00		4.1	3.00	Yes	3.4	3.00	
Hungary	0.7	3.00		1.7	3.00		5.7	3.00	Yes	3.9	3.00	
Israel	1.2	2.00		1.5	2.00		1.7	2.00		3.5	2.00	Yes
Poland	1.1	2.50		0.9	2.50		3.7	2.50	Yes	4.3	2.50	Yes
Russia	6.4	5.00	Yes	6.8	6.00	Yes	5.1	-	-	8.4	-	-
Turkey	8.1	5.00	Yes	7.5	5.00	Yes	8.9	5.00	Yes	6.5	5.00	
S. Africa	6.5	4.50	Yes	5.8	4.50		5.7	4.50		5.0	4.50	
India	8.0	8.00		5.9	5.00	Yes	7.5	5.00	Yes	8.8	-	-
Indonesia	6.4	4.50	Yes	6.4	4.50	Yes	4.0	4.50		5.3	4.50	
Korea	2.1	3.00		1.3	3.00		2.2	3.00		4.0	3.00	
Philippines	4.1	4.00		2.9	4.00		3.2	4.00		4.7	4.00	
Thailand**	1.6	1.75		1.0	1.75		2.1	1.75		2.4	1.75	

** Thailand targets the core CPI. Source: Haver Analytics, Citi Research.

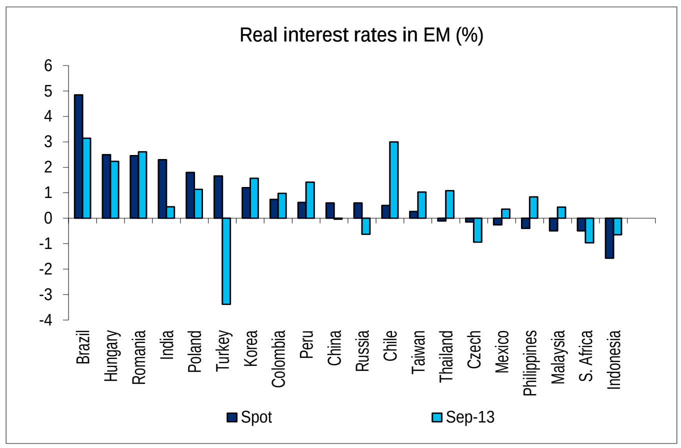
With real interest rates in EM now at rather high levels, the outlook for domestic spending growth may not be too bright. The problem with the coexistence of high inflation and weak growth in EM is that policymakers are inevitably drawn towards dealing with the inflation problem: and that means tight monetary policy, which makes the growth problem worse. Rate hikes at the start of the year by the likes of Turkey and South Africa – and subsequent tightening by others, including central banks in Russia and Colombia – have helped to push real interest rates up in EM. The average real interest rate in EM is currently just over 1%, higher than it has been for a considerable period of time, and sharply higher it was only a couple of years ago (Figure 6). As Figure 7 illustrates, real interest rates are higher now than six months ago in Brazil, Hungary, India, Poland, Turkey, China, Russia, South Africa and a number of others. The problem for EM is that while real interest rates are high by historical standards, growth is not. In 2011 – the last time the EM-DM real interest rate gap was as high as it is now – EM GDP growth was 6.3%. But EM growth is currently much weaker, and the problem is that this episode of high real rates is hitting EM at a time when private sector spending seems likely to suffer.

Figure 6. Real interest rates in EM are quite high by historical standards...



Source: Citi Research

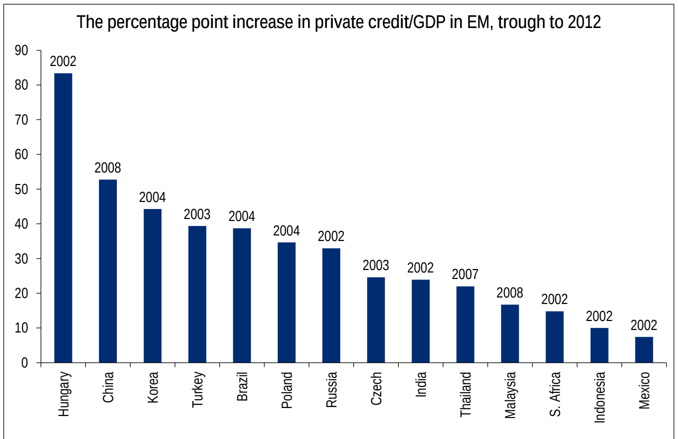
Figure 7. ...it is interesting to note how many EMs have seen an increase in their real interest rate



Source: Bloomberg, Haver Analytics, Citi Research

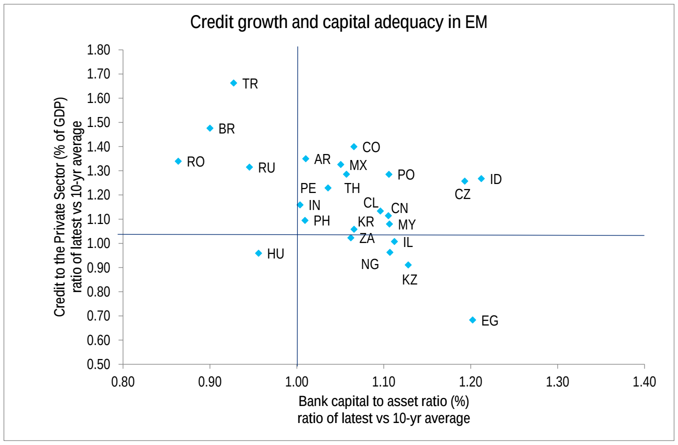
Private sector credit growth seems vulnerable in a number of countries. The immediate problem is that relatively tight monetary policy is hitting EM at a time when there is a notable decline in the willingness of banks in EM to lend. There are plenty of examples of countries these days where the level of risk appetite in the domestic banking system is pretty constrained, for a variety of reasons. **Indian** banks, for example, have been hurt by rapid increases in lending during the 'boom' years, and asset quality problems have begun to emerge on their portfolio of loans to infrastructure projects: both restructured loans and non-performing loans have risen fairly sharply in recent months. In **Brazil,** banks have been focused on 'de-risking' for some time, shying away from car loans, credit cards, personal loans and loans to SMEs. In **Indonesia**, credit growth is likely to continue decelerating under the burden of increased regulatory pressure as authorities remain focused on ensuring that the current account deficit is kept at a financeable level. In **Russia**, credit growth is decelerating thanks to regulatory effort to ensure that banks have adequate provisions and capital following a period of very sharp credit growth in 2012 and 2013. And in **Turkey**, credit growth is likely to continue decelerating under the weight of monetary tightening, since it will only be through declining credit growth that Turkey can reliably achieve a reduction in the current account deficit. All in all, there are few large EMs where financial sector risk appetite is strong.

Figure 8. Private sector credit extension has played an important role in EM…



Source: BIS; Citi Research. Year shows when credit/GDP ratio was at its lowest.

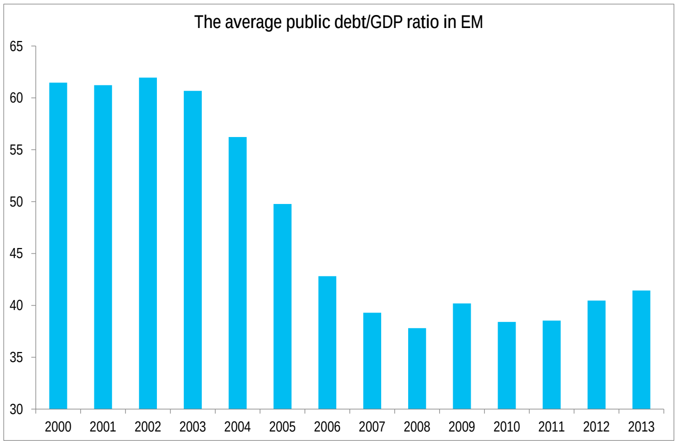
Figure 9. …and countries where credit growth has been strongest seem to have relatively weak capital buffers



Source: World Bank data; Citi Research

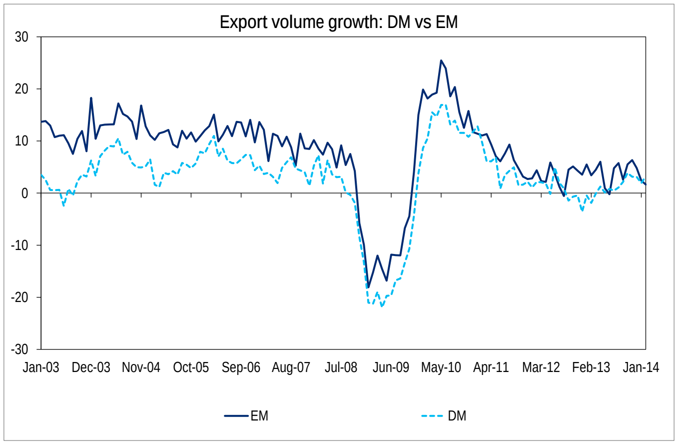
Real interest rates are rising against a background where domestic credit markets have become more fragile after some big increases in credit extension during the past few years. Figure 8 presents a very basic illustration of this point: it shows the percentage point increase in credit to the private sector during the few years to 2012: in each case, the data shows the rise in the private credit stock from its trough during the 2000s to its 2012 level. The point is that there are plenty of countries that have seen considerable increases in credit growth. So, one of the reasons why credit growth prospects are constrained in many emerging economies is because the credit booms have already happened. And Figure 9 confirms this by showing a relationship between credit growth and capital adequacy in the banking system. Capital adequacy is more likely to be weak when banks have pursued aggressive expansion of their balance sheets.

Figure 10. Public debt/GDP ratios are likely to rise mildly in the coming years, but fiscal expansion won't accelerate recovery in the near term…



Source: Citi Research

Figure 11. …and export dynamism looks a bit stronger in DM than EM: February export volume growth was 3.2% in DM, 1.6% in EM.



Source: Citi Research

So the question is: with high real interest rates and relatively weak prospects for domestic private credit growth, where will EM growth come from? In principle there are two possible answers: one is looser fiscal policy, and the other is exports. But the prospects of a marked fiscal loosening in EM seem low in the near term. Brazil has been punished both by markets and rating agencies for fiscal expansion, and it is likely that other countries would face similar consequences – although the market has been quite tolerant of recent news that the Turkish government aims to guarantee the debt of contractors on public-works projects. Over a longer time horizon, we do expect EM public sector balances to deteriorate: debt/GDP ratios are more likely to rise than fall over the next few years for example (Figure 10). But we don't expect significant stimulus to domestic spending in the near term.

Exports are the 'only hope'? Certainly there are pockets of EM that are showing relatively robust export growth: Korea for example, or central Europe. But in general, it still seems wrong to bank on an exceptionally strong export recovery in EM. Indeed, as Figure 11 shows export dynamism is recently a phenomenon more associated with DM than with EM. But muted growth prospects are not necessarily bad news for investors: high interest rates and low deficits can generate decent returns, even if growth is weak (or, perhaps, because growth is weak). That is the subject of our strategy section that follows:

Strategy: carry on; keep calm?

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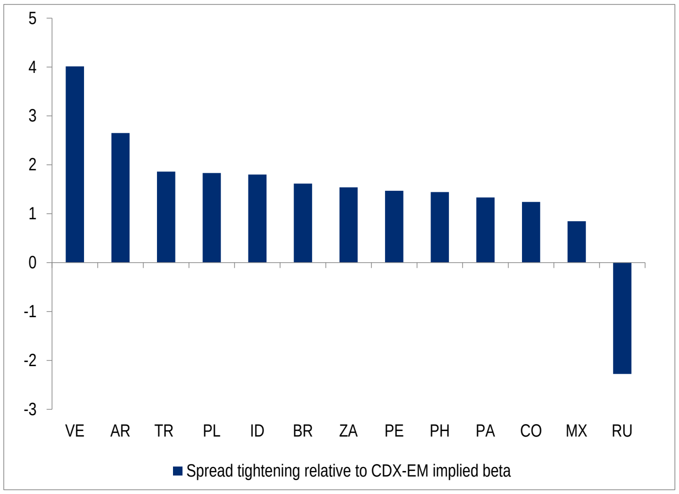
Carry on

Since February 2014 EM assets have been rallying. We now justify the improved performance in EM with a number of global and idiosyncratic factors, yet it is likely that the most important consideration is the relative stability in global bond markets. The stability in rates has created room for the resurrection of carry trades in credit and local bond markets. In fact, most EM investors reflect today some discomfort with the level of valuations in assets, but in the current scenario with no obviously hostile threats to stability, the choice remains to keep carry trades on. The question is, is this strategy likely to succeed? Or, will a prolonged carry period end in tears?

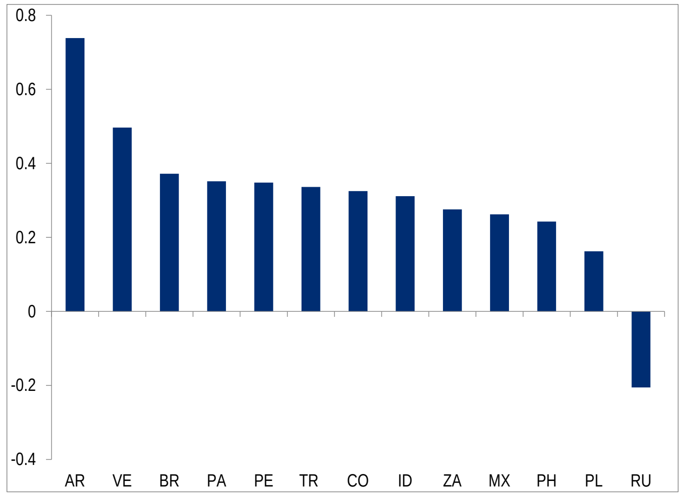
Despite the continuing Russian saga, EM spreads have rallied significantly over the last few months. While all markets have rallied, EM has done better than a simple beta analysis would imply. Figure 12 shows the ratio of the spread compression experienced by major EM sovereigns since the rally began relative to how much spread compression their historical betas would imply. We calculate the betas versus the CDX EM and unsurprisingly find that the biggest outperformers have been Venezuela and Argentina. Figure 13 presents a related exercise: in a world where the driver behind spread compression is a decline in risk-aversion one would expect spread tightening to be roughly proportional to the initial level of spreads. On the contrary, if changes in idiosyncratic conditions move most (say a lower probability of default or higher recovery rate) then we would expect non-uniform movements in relative spreads. In Figure 13 we observe that with the exception of Argentina (positive credit developments) and Russia (clearly negative changes), most EM spreads have moved roughly proportional to the initial levels. Both graphs suggest that in the credit space, carry has been a dominant force behind the rally.

Figure 12. EM has rallied more than their historic beta would suggest (ratio of spread tightening to beta-explained tightening)



Source: Bloomberg, Citi Research

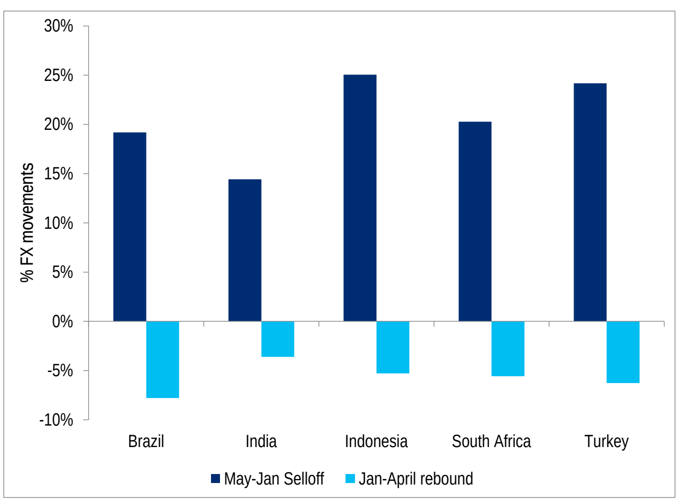
Figure 13. The ratio of spread tightening to the initial level of spread is relatively constant. Argentina and Russia are two clear exceptions.



Source: Bloomberg, Citi Research

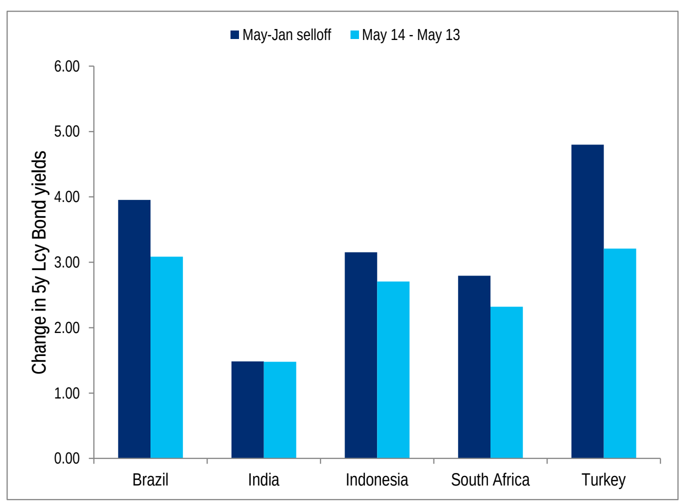
In the world of FX and local rates, the results share the same spirit, though they are somewhat less evident. In FX the recent appreciation has been roughly proportional to the depreciation that took place in May '13-Jan '14 (Figure 15). In local currency bonds (LCY), the evidence is less clear but the reduction in yields of the last few months bare some proportionality to the increase in yields that took place during the sell-off. It is natural that LCY bonds will be less attractive to pure carry trades as they tend to compound the risk, layering FX vulnerability on top of duration.

Figure 14. FX movement in the Fragile 5: recent rally has been roughly proportional to May-Jan depreciation. Evidence of carry trades?



Source: Citi Research

Figure 15. In local rates (5y) the evidence is less clear. However there is some proportionality in the fall in yields relative to the sell-off.



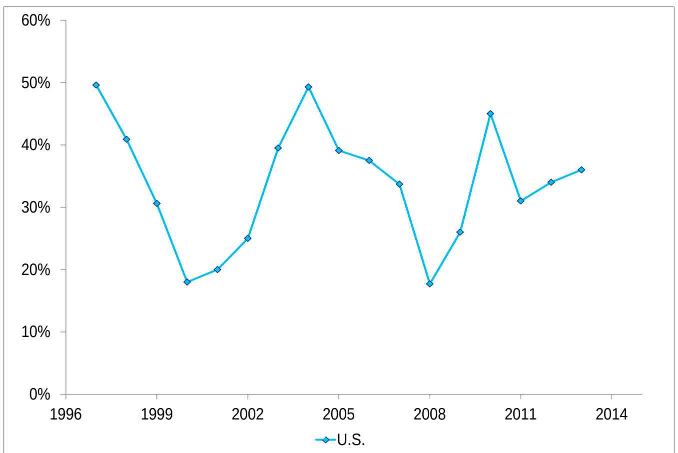
Source: Citi Research

Stay calm?

Carry episodes present a puzzle to the theory of finance. They provide positive excess return, something inconsistent with efficiently functioning markets. However, the recent literature finds that carry trades could emerge as compensation for bearing crash / peso-problem / rare event risk, and that returns are more (negatively) skewed - large risk of downside movements- at the time when carry trades appear most attractive.[1] Perhaps more importantly, the emergence of carry trades and build-up of speculative positions has received increased attention from policy-makers. For instance, Fed Governor Jeremy Stein has made several references recently to the risks embedded in such episodes arguing that they might be construed as signals of credit market overheating. From a practical point of view, both strands of analysis worry that carry trades may be followed by meaningful corrections or periods of negative returns.

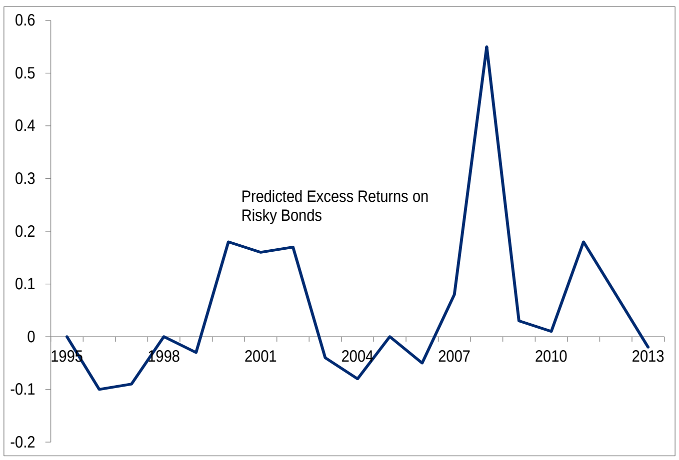
Prolonged periods dominated by the build-up of carry trades coincide with lower risk aversion and increased acceptance of lower quality securities. In a paper cited by Governor Stein, Greenwood and Hanson[2] find that this is indeed the case in the U.S. credit market. Their discussion introduces a framework for analyzing whether or not markets have become overextended: a peak in the portion of new corporate issues that are of low credit quality is a better indicator of an overextended market than the actual level of spreads. Perhaps more important, from our point of view, they find that when the proportion of new issuance that is from high-yield issuers peaks, a significant market sell-off follows within a couple of years. The steady rise in that ratio post-financial crisis would suggest, according to their model, that the market may be overextended and excess returns in 2014 could turn negative (Figures 16 and 17).

Figure 16. High yield debt issuance as a fraction of total debt issuance has been found to lead episodes of credit market corrections (Greenwood and Hanson).



Source: Atif Mian & Amir Sufi. Houseofdebt.org based on Greenwood and Hanson.

Figure 17. Recent high yield issuance (and current level of spreads) predicts slightly negative returns in risky bonds the following year.



Source: Atif Mian & Amir Sufi. Houseofdebt.org

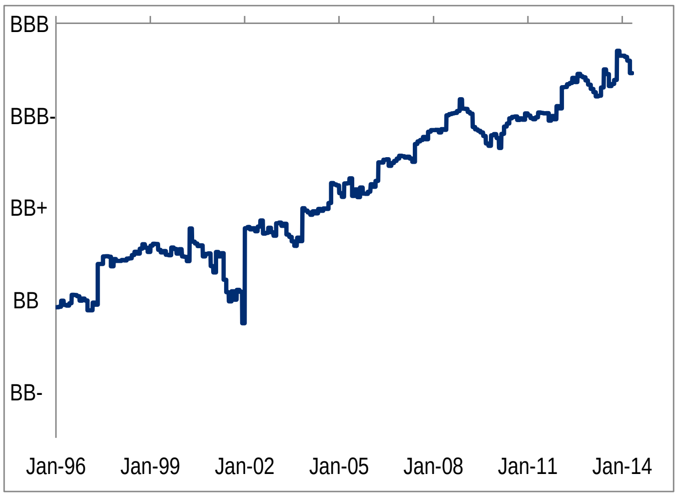
[1] See, for instance, M. Brunnermeier, S. Nagel, and L. Pedersen *"Carry Trades and Currency Crashes,"* NBER Macroeconomics Annual 2008, Volume 23, Cambridge, MA, p.313-347.

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

We adapted the analysis to emerging markets sovereign credit. We focus on EM sovereigns given the longer time horizon afforded relative to EM corporates or LCY bonds. An immediate challenge, however, is that the average credit quality of EM sovereigns has improved significantly over the past 2 decades (Figure 18). Because of this improvement, if we apply the same Greenwood-Hanson HY ratio to EM sovereigns we would find a consistently negative trend. To correct for this, we adapt the methodology and look at the portion of new issuance from the bottom 30% of the distribution of the existing universe of EM sovereign debt in a given year (measured by lowest credit ratings). This adjustment is consistent with the original paper since on average the high yield universe represents 30% of U.S. credit. Furthermore, the argument posits that an increase in the relative issuance of the lowest quality sovereigns is suggestive of increased risk tolerance and, potentially, of markets becoming over-extended. The adjustment notwithstanding, the increase in the quality of EM sovereign credits is so striking that the 30% cutoff threshold has drifted up quite notoriously (Figure 19).

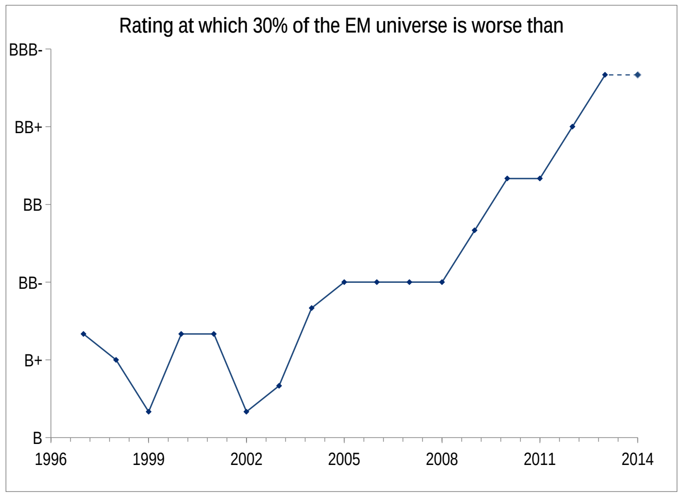
Figure 18. The average credit quality of EM sovereigns has increased significantly over time

Average rating of ESBI index



Source: Citi Research

Figure 19. ..causing the cutoff which 30% of the EM sovereign universe is below to move higher every year as well

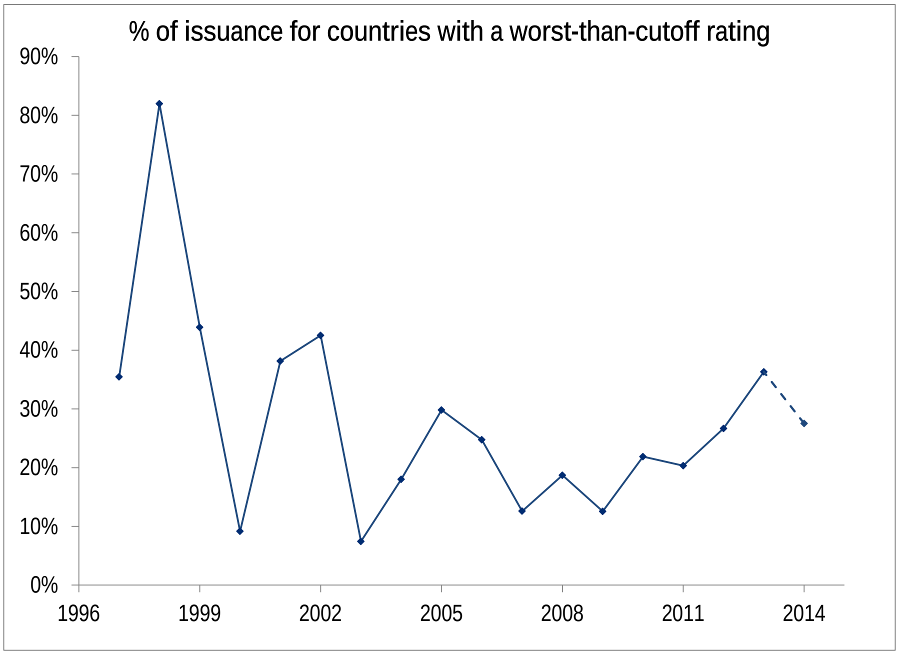


Source: Citi Research

Interestingly, EM sovereign credit shows a similar trend to the original U.S. credit market, although with different peak years. Figure 20 plots the proportion of EM issuance below the cutoff. While the peaks are similar in many cases to the U.S. we do see some differences. For example, while the U.S. had a peak in the high yield share in 2004, the peak in EM came a year later in 2005. Also, EM experienced an exceptionally large peak in 1998 as a result of the Russia default and the fact that the market was still highly concentrated at the time.

The proportion of EM issuance that has been below the threshold has steadily risen from 2009 through 2013. This in itself would suggest a market that is somewhat over-stretched – a result that those focused on excessive inflows / tourist money, are likely to find matches those concerns. If Greenwood and Hanson are correct, the results would seem to suggest that EM sovereign credit ought to anticipate deteriorating excess returns in the future. Nevertheless, it is notable that, despite the emergence of a new wave of carry trades, in the first four months of 2014 we have seen a meaningful drop in the ratio. While we are only one-third of the way through the year, EM sovereign issuance in 2014 ($57bn) is already more than half of the total for all of 2013 ($105bn), yet the high yield ratio is lower.

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



Source: Citi Research

All carry trade seasons (predictably) come to an end, though it is often difficult to find ahead of time the factor that triggers the correction. A popular candidate these days is to argue that it will emerge from a change in expectations of future US interest rates. Indeed, US Treasury rates have been a powerful stabilization force and an instigator of carry trades in 2014. Despite some increased uneasiness over the pace of tightening to be pursued by the Fed, as illustrated in the Dec '16 Fed-Funds Futures that fluctuated in a 50bp range, 10y UST have settled in a much narrower range. Nominal yields have fluctuated between 2.6% and 2.8%, while real yields (Tips) have range-traded between 45 and 65bp and implied inflation breakevens between 2.12% and 2.23%. The notorious stability in rates, and the firm degree of market conviction that tapering will continue at a consistent pace until its conclusion in September, has been an important contributor to appease anxieties in EM fixed income. However, the threat that as we approximate the first Fed hikes UST yields move again, is oftentimes taken as one of the most serious challenges to the carry trade.

We think that the type of movement in UST will be almost as important as the ultimate magnitude of the move in yields. In the March EMMSO we argued that movements in term-premia are more important for LCY bonds than the expected future interest rates component of UST yields. We add to that view the speculation that a gradual drift up in UST yields, driven by the passage of time towards the increase in rates, will be far less disruptive than the emergence of new macroeconomic information that could more suddenly produce a jump in yields. In other words, more important than reaching 3.30 or 3.40 in 10y yields by yearend will be wether we get there suddenly, or through a relatively smooth drift up of yields.

Are sudden moves in yields unavoidably positively skewed (resulting in negatively skewed EM returns)? Expectations of future interest rates are below the "Fed's dots" suggesting that the market holds a more dovish view than the median Fed governor forecast. Thus, it is plausible that news about a stronger than expected

economy/inflation could lead to sharper upward revisions in yields than the converse. However, the last few weeks have added a wild card to the discussion: The increased probability that the European Central Bank engages in large-scale unconventional monetary policies, which has now become Citi's baseline for the second half of 2014. Such an action could recreate a meaningful bid for duration and EM risk, adding significant new life to the EM carry trade.

Under current circumstances we think it is wise to "carry on, yet stay on guard."

Annual Indicators

Figure 21. Emerging Markets – Economic Forecasts, 2013-2015F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013	2014F	2015F	2013	2014F	2015F	2013	2014F	2015F	2013	2014F	2015F
Asia	6.3	6.2	6.3	3.7	3.5	3.9	2.2	2.1	1.5	-2.3	-2.4	-2.2
China	7.7	7.3	7.0	2.6	2.6	3.2	2.0	2.0	1.5	-1.9	-2.1	-2.0
Hong Kong	2.9	3.4	3.8	4.3	3.9	3.7	2.1	3.1	3.9	0.8	1.3	0.7
India*	4.9	5.6	6.2	9.5	8.0	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	7.2	-3.3	-2.4	-2.1	-2.2	-2.3	-1.7
Korea	3.0	3.9	4.0	1.3	2.1	3.0	6.1	3.8	3.0	1.0	0.9	1.5
Malaysia	4.7	5.0	5.0	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	13.3	12.0	-31.0	-13.8	-16.1	-7.8	-7.4	-4.3
Philippines	7.2	6.9	7.3	2.9	4.1	4.0	3.5	3.5	2.9	-1.4	-1.8	-1.6
Singapore	4.1	3.5	4.0	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	5.5	6.5	-3.9	-3.3	-3.1	-5.9	-5.6	-5.3
Taiwan	2.1	3.2	3.8	0.8	1.2	2.0	11.7	11.0	10.2	-1.4	-1.4	-0.8
Thailand	2.9	1.8	4.1	2.2	2.3	2.7	-0.7	2.2	-1.1	-1.8	-1.2	-1.8
Vietnam	5.4	5.7	5.9	6.6	5.4	6.8	5.3	4.1	2.9	-5.3	-5.3	-4.5
Latin America	2.4	2.1	2.8	7.5	9.1	10.1	-2.6	-2.8	-2.5	-3.2	-3.7	-3.1
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	6.5	6.3	-3.7	-4.1	-4.1	-3.3	-3.9	-3.4
Chile	4.1	3.5	4.5	4.5	0.9	2.9	-3.3	-3.4	-4.0	-0.3	-0.4	-0.4
Colombia	4.3	4.6	5.0	2.0	2.6	3.3	-3.4	-3.5	-3.6	-1.4	-1.3	-0.7
Costa Rica	3.5	3.1	2.2	5.2	3.9	5.0	-5.1	-7.5	-7.9	-6.5	-7.2	-7.7
Dominican Republic	4.1	4.5	4.5	4.8	4.0	4.6	-4.4	-4.8	-5.0	-4.1	-4.0	-4.2
Ecuador	4.5	4.5	4.5	2.7	3.6	2.4	-1.3	-1.5	-0.8	-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	4.1	3.7	-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	2.9	2.5	-5.2	-5.6	-1.5	0.8	0.0	0.0
Venezuela	1.3	-1.0	1.9	38.5	62.5	82.1	3.3	4.1	5.1	-11.9	-11.2	-10.3
Europe	2.0	1.7	2.9	5.3	5.3	5.1	-1.3	-0.5	-0.9	-2.2	-2.4	-3.6
Bulgaria	0.9	1.5	2.5	0.9	-0.4	2.5	1.9	-0.2	-0.5	-1.5	-2.0	-1.2
Croatia	-1.0	0.5	1.5	2.2	0.5	2.7	1.3	0.5	-0.5	-4.9	-4.8	-3.5
Czech Republic	-0.9	1.9	2.6	1.4	0.9	2.1	-1.4	0.2	0.8	-1.5	-2.0	-2.5
Hungary	1.1	2.3	1.7	1.7	0.7	2.9	2.9	3.1	2.2	-2.3	-2.9	-2.9
Kazakhstan	6.0	5.0	6.0	5.7	6.5	5.9	-0.1	1.0	1.3	3.2	2.3	2.2
Poland	1.6	3.4	3.6	0.9	1.1	2.7	-1.3	-2.5	-3.7	-4.3	5.2	-2.7
Romania	3.5	3.0	3.4	4.0	2.1	3.5	-1.1	-2.5	-4.2	-2.5	-2.3	-2.3
Russia	1.3	1.0	2.3	6.8	6.4	5.5	1.5	2.1	1.6	-2.1	-4.4	-4.9
Serbia	2.5	1.2	2.0	7.9	3.8	6.5	-4.8	-4.8	-5.0	-5.7	-7.0	-6.5
Slovakia	0.9	2.0	2.8	1.4	0.2	1.2	2.4	2.8	3.4	-2.8	-3.0	-2.5
Turkey	4.0	2.2	3.5	7.5	8.1	7.4	-7.9	-5.2	-5.3	-1.2	-2.8	-3.2
Ukraine	0.0	-3.2	2.1	-0.3	5.5	6.4	-9.3	-5.4	-3.7	-6.7	-4.3	-3.4
Africa/Mideast	3.8	4.6	5.2	4.2	4.4	5.0	11.9	10.1	7.6	1.7	1.1	-0.6
Bahrain	5.3	4.0	4.0	3.3	2.5	2.0	6.8	5.5	1.3	-2.3	-3.5	-5.9
Egypt	1.5	2.4	3.2	9.5	9.1	7.1	-1.4	-1.1	-1.9	-9.3	-9.5	-8.4
Ghana	7.4	4.6	6.5	11.7	13.3	10.0	-12.7	-14.4	-14.1	-10.8	-10.2	-9.0
Iraq	3.2	10.3	11.5	1.9	3.0	5.5	13.2	13.6	12.6	-5.8	-2.3	-1.2
Israel	3.2	3.4	3.5	1.5	1.2	3.0	2.5	1.9	1.7	-2.7	-3.0	-2.5
Jordan	2.8	4.0	4.5	5.5	4.0	5.0	-11.3	-10.2	-7.9	-5.5	-9.6	-9.4
Kenya	5.1	5.5	6.1	5.4	6.2	6.5	-7.8	-7.6	-7.5	-7.0	-5.5	-4.5
Kuwait	4.3	3.9	3.9	2.6	3.0	4.5	50.5	48.9	47.0	27.2	27.0	21.0
Lebanon	1.4	2.0	2.4	2.1	3.0	5.0	-9.0	-9.8	-10.7	-9.3	-8.7	-8.0
Nigeria	6.6	6.4	6.4	8.5	8.8	10.6	3.8	2.4	1.4	-1.4	-1.7	-1.6
Oman	3.4	4.7	4.7	2.1	1.2	3.0	10.5	8.4	6.5	9.7	8.2	5.9
Qatar	6.5	5.9	6.2	3.1	2.5	3.5	31.0	26.7	21.7	8.4	4.4	1.2
Saudi Arabia	3.8	4.8	5.9	3.5	3.5	4.1	18.2	14.8	8.9	7.4	6.2	1.3
South Africa	1.9	2.3	2.9	5.8	6.5	5.8	-5.8	-4.9	-4.2	-4.3	-4.2	-4.2
Tanzania	6.8	7.0	8.1	7.9	7.4	6.6	-10.2	-14.1	-12.4	-5.0	-5.2	-5.9
UAE	3.7	4.0	4.0	1.1	1.8	2.1	26.2	21.4	17.0	NA	NA	NA
Uganda	6.0	6.0	5.5	5.5	5.9	6.8	-12.0	-13.9	-14.9	-3.4	-3.3	-4.5
Zambia	6.2	6.4	6.3	7.0	7.8	8.0	0.2	-1.0	-1.5	-6.5	-6.1	-5.5
Total	4.5	4.5	5.0	4.7	4.9	5.3	1.9	1.9	1.3	-2.0	-2.3	-2.4

Source: National sources, Citi Research forecasts

Economic Framework

Figure 22. 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	3.5	3.7	2.9	3.1	4.2	0.7	0.6	0.2	-3.7	-3.2	-2.9
Based on PPP weights	*3.4*	*3.9*	*4.1*	*3.3*	*3.6*	*4.9*	*0.5*	*0.3*	*0.0*	*-3.7*	*-3.3*	*-3.0*
Industrial Countries	2.1	2.4	2.5	1.5	1.6	1.6	0.0	0.0	-0.1	-4.6	-3.7	-3.3
United States	2.6	3.2	3.2	1.4	1.8	2.2	-2.0	-1.5	-1.8	-6.4	-5.6	-5.6
Japan	0.9	1.0	1.2	3.0	1.6	1.6	-0.2	-0.3	0.0	-8.0	-6.2	-5.8
Euro Area	1.3	1.8	1.9	0.6	0.9	1.2	2.5	2.3	2.2	-2.6	-2.1	-1.6
Canada	2.3	2.7	2.7	1.8	2.0	2.0	-3.2	-2.8	-2.6	-0.1	0.3	0.4
Australia	2.9	2.9	3.1	2.7	2.5	2.4	-2.5	-2.4	-2.4	-3.0	-2.1	-1.4
New Zealand	3.2	2.7	2.4	2.1	2.2	2.2	-4.2	-5.4	-5.0	-1.6	-0.4	0.5
Germany	2.2	2.4	2.4	1.3	1.8	2.1	6.7	5.5	4.4	0.0	0.0	0.0
France	1.0	1.5	1.8	0.8	1.3	1.4	-0.6	0.1	0.5	-3.9	-3.2	-2.5
Italy	0.6	1.1	1.0	0.3	-0.2	0.2	1.3	1.2	1.6	-2.9	-2.7	-2.0
Spain	1.0	1.6	2.0	0.0	0.2	0.4	0.8	0.7	0.6	-5.8	-4.5	-3.5
Greece	-0.8	1.2	1.6	-1.6	-1.7	-1.0	1.9	2.4	2.4	-2.6	-2.6	-2.1
Ireland	1.8	3.1	2.8	0.8	1.0	1.1	8.7	9.0	8.3	-5.5	-3.0	-2.3
Portugal	1.5	2.0	1.7	-0.5	-0.7	0.0	2.2	2.5	2.6	-3.8	-2.8	-2.3
Netherlands	1.3	1.4	1.8	0.5	1.3	1.5	10.1	9.9	9.5	-3.0	-1.7	-0.9
Belgium	1.3	1.5	1.6	0.4	1.0	1.8	1.1	1.7	1.9	-2.3	-1.9	-0.9
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	0.1	1.3	2.2	5.9	5.6	5.6	-1.6	-1.0	-0.3
Switzerland	2.2	2.0	2.2	0.1	1.0	1.1	12.2	11.3	11.8	0.7	0.9	1.3
United Kingdom	3.5	3.6	2.5	1.7	1.9	2.1	-3.5	-3.6	-3.6	-5.6	-3.8	-1.7

Source: National sources and Citi Research

Figure 23. G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 30 April 2014

	30-Apr-14	2Q 14F	3Q 14F	4Q 14F	1Q 15F	2Q 15F	3Q 15F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.75
10-Yr. Treasuries (Period Ave.)	2.70	2.85	3.05	3.25	3.40	3.45	3.50
Euro Area: US$/€	1.38	1.40	1.37	1.35	1.35	1.37	1.38
Euro Repo Rate	0.25	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. Bunds (Period Average)	1.50	1.60	1.60	1.60	1.70	1.70	1.80
Japan: Yen/US$	102	104	105	107	108	110	111
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.61	0.55	0.70	0.85	0.95	1.05	1.15

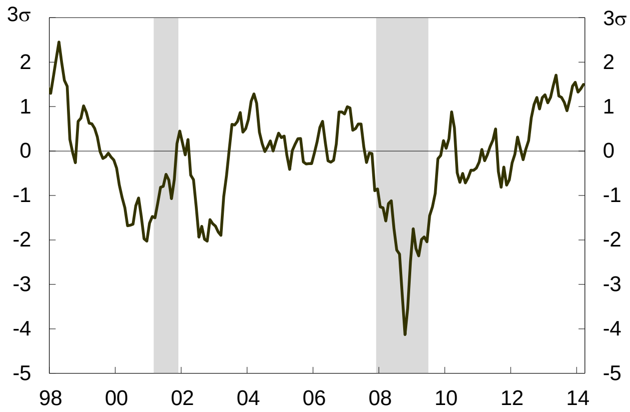
Industrialised Countries 10-Year Yield Spreads (Period Average)

	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	120	127	147	168	173	178
Japan	-208	-232	-237	-243	-248	-243	-88	-105	-90	-75	-75	-65
Euro Area	-120	-127	-147	-168	-173	-178	NA	NA	NA	NA	NA	NA
Canada	-26	-25	-20	-20	-10	-10	94	102	127	147	163	168
Australia	125	158	148	138	133	133	245	285	295	305	306	311
New Zealand	171	209	209	220	215	220	291	336	357	387	388	398
France	-70	-77	-97	-128	-133	-138	50	50	50	40	40	40
Italy	42	33	-7	-68	-73	-78	162	160	140	100	100	100
Spain	37	38	3	-48	-53	-58	157	165	150	120	120	120
Netherlands	-86	-102	-122	-143	-148	-153	34	25	25	25	25	25
Belgium	-57	-67	-87	-118	-123	-128	63	60	60	50	50	50
Austria	-96	-102	-122	-153	-158	-163	24	25	25	15	15	15
Finland	-90	-97	-117	-143	-148	-153	30	30	30	25	25	25
Ireland	14	13	-27	-88	-93	-98	134	140	120	80	80	80
Portugal	101	83	43	-18	-23	-28	221	210	190	150	150	150
Switzerland	-186	-192	-212	-233	-241	-246	-66	-65	-65	-65	-68	-68
United Kingdom	-1	0	15	5	10	10	119	127	163	173	183	188

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

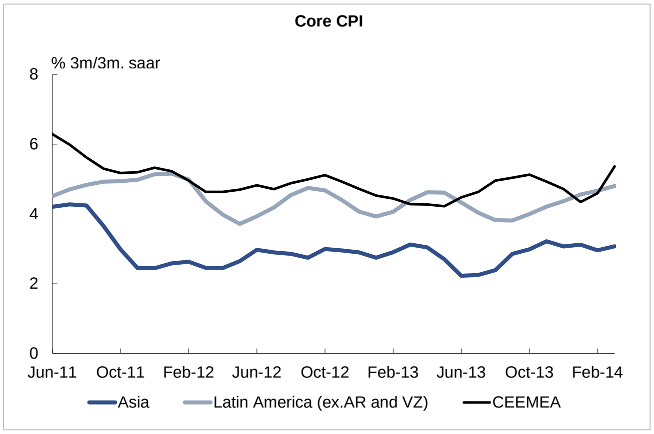
Regional Indicators

Figure 24. QE appears on target to end early this fall, and the latest refinement to forward guidance makes future short-term policy rates completely dependent on future economic developments.



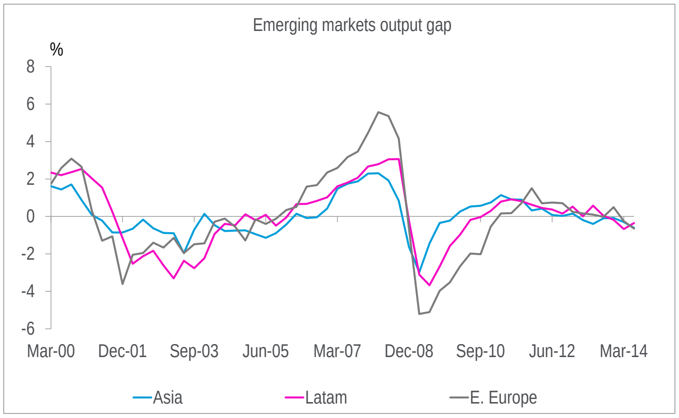
Source: Haver Analytics, Citi Research. Note: Shaded sections mark recession periods.

Figure 25. We see core CPI building up in CEEMEA and Latam



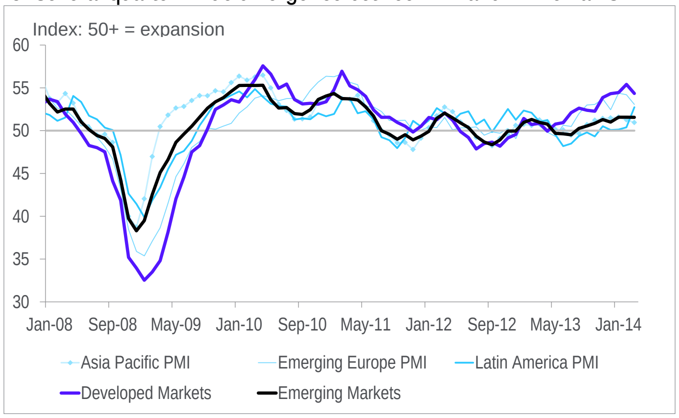
Source: Haver Analytics, Citi Research

Figure 26. Although output gap is still non-inflationary



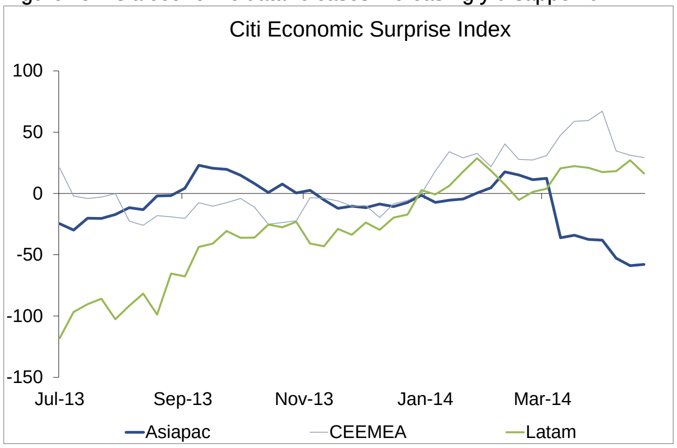
Source: Citi Research

Figure 27. Sharp pick in Latam PMI in March after lagging the rest of EM for several quarter. Wide divergence between EM and DM remains.



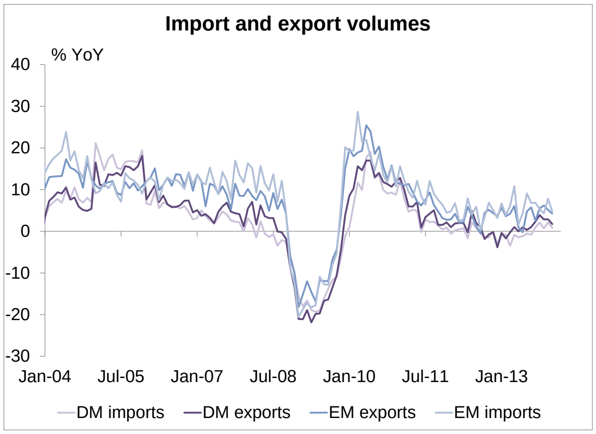
Source: Haver Analytics, Citi Research

Figure 28. Asia economic data releases increasingly disappoint.



Source: Citi Research

Figure 29. World trade remains sluggish



Source: Haver Analytics, Citi Research

Monetary Policy Watch

Figure 30. Asia Policy Rates and Movement

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

Source: Bloomberg, Citi Research

Figure 31. CEEMEA Policy Rates and Movement

			Last Move		Likely Next Move		End-2014
		Spot	Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.05	Nov-12	-20	4Q15	+20	0.05
Hungary	14-Day Repo Rate	2.50	Apr-14	-10	Dec-14	+25	2.75
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	Refinancing Rate	7.50	Apr-14	+50	Aug-14	-50	7.00
S. Africa	Average Repo rate	5.50	Jan-14	+50	May-14	+25	6.25
Turkey*	Average Funding rate	10.04			by end-2014	+146	11.50
Ukraine	Discount Rate	9.50	Apr-14	+300	2015	-25	9.50

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

Figure 32. Latin America Policy Rates and Movement

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

Source: Bloomberg, Citi Research

FX Views

Figure 33. Asian Currencies Exchange Rates

		2Q14			3Q14			2Q15		
	30-Apr	**Forecast**	**Forward**	**Returns**	**Forecast**	**Forward**	**Returns**	**Forecast**	**Forward**	**Returns**
vs USD				(%)			(%)			(%)
China yuan	6.26	6.27	6.29	0.4	6.19	6.32	2.1	6.05	6.36	4.8
Hong Kong dollar	7.75	7.76	7.75	-0.1	7.76	7.75	-0.1	7.76	7.75	-0.1
India rupee	60.31	60.59	61.09	0.8	62.09	62.12	0.1	63.66	64.32	1.0
Indonesia rupiah	11562	11588	11667	0.7	11813	11852	0.3	11997	n.a.	n.a.
Korea won	1033	1043	1037	-0.6	1050	1041	-0.9	1057	1049	-0.7
Malaysia ringgit	3.27	3.31	3.28	-1.1	3.35	3.30	-1.7	3.39	n.a.	n.a.
Philippines peso	44.6	45.0	44.6	-0.8	45.3	44.7	-1.3	44.8	44.9	0.3
Singapore dollar	1.26	1.27	1.26	-0.7	1.28	1.26	-1.9	1.29	1.26	-2.3
Taiwan dollar	30.2	30.46	30.21	-0.8	30.34	30.14	-0.7	30.06	30.02	-0.1
Thailand baht	32.4	32.60	32.47	-0.4	32.87	32.61	-0.8	33.13	n.a.	n.a.

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

Figure 34. CEEMEA Currencies Exchange Rates

		2Q14			3Q14			2Q15		
	30-Apr	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs EUR				(%)			(%)			(%)
Czech Republic koruna	27.5	27.4	27	0.0	27.6	27.4	-0.5	27.3	27.4	0.3
Hungary forint	308	316	311	-1.6	318	311	-2.2	322	311	-3.5
Poland zloty	4.20	4.21	4.20	-0.4	4.25	4.20	-1.2	4.20	4.20	0.1
vs USD										
Israel shekel	3.47	3.43	3.47	1.2	3.50	3.47	-0.9	3.69	3.48	-6.0
Russia ruble	35.7	36.9	36.3	-1.5	38.2	37.2	-2.6	39.2	38.9	-0.8
Turkey new lira	2.12	2.21	2.15	-3.0	2.25	2.20	-2.4	2.37	2.29	-3.2
S. Africa rand	10.55	10.86	10.66	-1.8	11.01	10.83	-1.6	11.06	11.67	5.2

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

Figure 35. Latin American Currencies Exchange Rates

		2Q14			3Q14			2Q15		
	30-Apr	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
Brazil reais	2.24	2.29	2.28	-0.5	2.38	2.34	-1.9	2.55	2.45	-4.0
Chile peso	562	567	565	-0.3	573	570	-0.4	583	579	-0.8
Colombia peso	1934	1965	1944	-1.1	2002	1963	-2.0	2084	2002	-4.1
Mexico new peso	13.1	13.2	13.1	-1.0	13.2	13.1	-0.5	13.0	13.1	1.1

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 36. Citi vs Consensus Forecasts

	GDP Growth (%)				CPI Inflation (%)				Current Account Balance (US$ bn)			
	2014F	Consensus	2015F	Consensus	2014F	Consensus	2015F	Consensus	2014F	Consensus	2015F	Consensus
Asia	6.2%	6.2%	6.2%	6.3%	3.4%	3.4%	3.9%	3.6%	345	341	285	335
China	7.3	7.3	7.0	7.2	2.6	2.6	3.2	3.0	201	214	169	216
Hong Kong	3.4	3.4	3.8	3.5	3.9	3.9	3.7	3.6	9	5	12	5
India	5.6	5.4	6.2	6.0	8.0	7.7	7.5	7.1	-47	-48	-58	-56
Indonesia	5.3	5.4	5.5	5.8	6.4	6.3	7.2	5.5	-21	-23	-19	-20
South Korea	3.9	3.5	4.0	3.7	2.1	1.9	3.0	2.6	55	58	47	52
Malaysia	5.0	5.1	5.0	5.0	3.5	3.3	4.5	3.6	14	14	13	16
Philippines	6.9	6.4	7.3	6.3	4.1	4.1	4.0	3.8	10	9	10	9
Singapore	3.5	3.8	4.0	4.0	1.8	2.5	1.4	2.7	56	54	59	56
Sri Lanka	7.2	7.2	7.4	7.0	5.5	6.2	6.5	6.7	-2	-3	-3	-3
Taiwan	3.2	3.3	3.8	3.6	1.2	1.2	2.0	1.7	55	54	55	54
Thailand	1.8	2.5	4.1	4.2	2.3	2.4	2.7	2.8	8	3	-4	3
Vietnam	5.7	5.7	5.9	5.9	5.4	6.0	6.8	6.9	7	5	6	4
Latin America	2.2%	2.1%	2.9%	2.8%	8.4%	10.9%	12.6%	9.4%	-136	-130	-126	-125
Argentina	1.0	-0.5	1.5	0.8	-	28.9	30.5	26.8	-2	-1	-2	-2
Brazil	1.3	1.8	1.8	2.0	6.5	6.3	6.3	5.8	-83	-78	-85	-73
Chile	3.5	3.3	4.5	4.1	0.9	3.4	2.9	3.0	-9	-9	-11	-8
Colombia	4.6	4.7	5.0	4.6	2.6	3.1	3.3	3.2	-13	-13	-14	-13
Mexico	3.3	3.0	4.0	3.9	4.1	4.0	3.7	3.5	-27	-24	-26	-26
Panama	6.2	6.8	5.5	6.1	2.7	3.6	2.8	3.4	-4	-4	-4	-5
Peru	5.7	5.4	6.2	5.7	2.9	2.8	2.5	2.6	-12	-10	-4	-9
Venezuela	-1.0	-1.4	1.9	1.1	62.5	59.2	82.1	45.9	15	10	18	11
Europe	1.7%	1.6%	2.9%	2.7%	5.2%	5.2%	5.1%	4.9%	-16.6	-30.4	-35.2	-49.3
Bulgaria	1.5	1.7	2.5	2.5	-0.4	0.9	2.5	2.3	-0.1	-0.1	-0.3	-0.7
Croatia	0.5	-0.2	1.5	1.1	0.5	1.1	2.7	2.2	0.3	0.3	-0.3	0.1
Czech R	1.9	2.1	2.6	2.6	0.9	1.0	2.1	2.2	0.3	-1.8	1.6	-2.3
Hungary	2.3	2.2	1.7	2.2	0.7	1.0	2.9	2.9	3.9	3.4	3.1	3.3
Kazakhstan	5.0	4.8	6.0	6.3	6.5	6.5	5.9	6.5	2.1	1.3	2.9	2.7
Poland	3.4	3.1	3.6	3.5	1.1	1.3	2.7	2.3	-13.9	-10.4	-21.8	-14.5
Romania	3.0	2.8	3.4	3.2	2.1	2.2	3.5	3.0	-5.0	-3.2	-9.1	-3.8
Russia	1.0	0.9	2.3	1.9	6.4	6.1	5.5	5.3	40.4	32.6	33.3	20.3
Slovak Rep	2.0	2.3	2.8	3.0	0.2	0.7	1.2	1.8	2.8	2.3	3.6	2.3
Turkey	2.2	2.3	3.5	3.7	8.1	8.1	7.4	6.7	-40.1	-47.6	-42.7	-49.4
Ukraine	-3.2	-3.9	2.1	1.3	5.5	6.6	6.4	6.7	-7.3	-7.2	-5.4	-7.3
MEA	4.3%	4.1%	4.9%	4.5%	4.7%	4.7%	5.5%	5.0%	121.0	104.7	74.1	92.6
Israel	3.4	3.3	3.5	3.6	1.2	1.9	3.0	2.4	5.9	5.7	5.2	6.5
Nigeria	6.4	6.7	6.4	6.6	8.8	8.7	10.6	9.1	15.8	12.5	10.7	10.0
S. Africa	2.3	2.5	2.9	3.3	6.5	6.1	5.8	5.7	-16.7	-19.5	-15.4	-18.1
S. Arabia	4.8	4.1	5.9	4.6	3.5	3.5	4.1	3.9	116.0	106.0	73.5	94.2
Above Total	4.5%	4.5%	4.9%	4.9%	4.8%	5.3%	5.9%	5.0%	312.9	284.9	197.5	253.5

Source: Consensus Economics, National Sources, Citi Research forecasts

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- **Summary view** – Chinese authorities have launched a set of targeted easing measures since late March. Barring strong rebound in exports, these policy supports are not likely to be enough to reverse the growth downturn. We expect growth to decelerate further to 7%YoY in Q2 after a Q1 slowdown.

- **Things to watch** – Better export growth and mild policy easing is a possible scenario in Q2. It's expected that the government may scale up its support policies, including more investment projects and monetary policy accommodation, conditioned on export growth recovery amid better US data.

- **Strategy** – Money market rates, which have fallen back from the recent peak after the Chinese New Year, may go lower to reflect slowdow of both credit supply and demand. The RMB has depreciated against the dollar by 3% year-to-date and may weaken a bit more before gaining support from the economy and policies.

Growth decelerated on weak demand

China recorded the slowest quarterly GDP growth since the global financial crisis. According to CEIC, the 1Q growth rate decelerated from 7.7%YoY in 4Q2013 to 7.357%YoY in 1Q2014, marginally higher than market's and our expectation of 7.3%YoY. Real activity indicators (industrial production, fixed asset investment and retail sales) were broadly weaker than expected. Better growth in the service sector partly explains the disparity between headline growth and real economic activities. However, the gap between nominal and real growth rates (0.43ppt in 1Q) appears the biggest discount relative to headline CPI since 2000. The preliminary reading of HSBC manufacturing PMI in April indicates production activities remain weak while export orders remain lackluster. We expect GDP growth in 2Q may decelerate further to 7%YoY.

Is China facing a negative output gap? China's CPI fell by 0.5% mom and PPI by 0.3% mom in Mar. While this deflationary trend of headline CPI could be seasonal, it is now 25 months since PPI deflation began, reflecting the intensified interaction between over-supply and weak demand. After removing the data distortions, we estimate export growth at around 7%YoY and import growth of roughly 5%YoY in 1Q. Both external and internal demand are unlikely to be growth drivers in the near-term. The deflation, if continues in following months, could mean a negative output gap, i.e., either China's potential GDP growth rate is higher or the actual GDP growth rate is lower than the officially reported number. However, this is inconsistent with reportedly positive job creation (above 300m) in 1Q, hinting at a positive output gap. We need more information and time to reconcile the inconsistency between negative PPI and positive job growth. If negative PPI is joined by CPI deflation, it could only mean job creation is a lagging indicator.

M2 undershooting creates room for easing. M2 growth fell sharply from 13.3% in Feb to 12.1% in Mar, the lowest YoY growth 1997, when the data were first made available. Commercial banks were hesitant to lend and money velocity was slowing down due to the fossilization of the real economy, meaning more credit was channeled to less productive sectors. Total social financing (TSF) rebounded in Mar, mainly driven by a falling risk appetite in the shadow banking sector. The M2 growth slowdown has created room for further policy easing.

Targeted easing to curb downside risks

Macro policy fine-tuning has gained momentum since late March, in line with our expectation. The government had introduced a set of targeted policy easing measures, e.g., extending SME tax cuts, investing more in social housing, railways, nuclear power and irrigation in the countryside, and cutting RRR for county-level rural banks. In the latest State Council regular meeting, the government plans to launch 80 pilot projects for the private sector to participate and invest in, including oil and gas exploration, public services, water conservation, infrastructure, and so on. We expect more targeted policies from the authorities to stabilize growth, such as removing purchase restrictions in the property market, employing FX purchases and open market operations to bring down borrowing costs, more fiscal spending, and possible adjustment of RRR and loan to deposit ratios in the banking sector.

Further weakness of the RMB towards 6.3 is possible in the near term. Commercial banks have shown some hesitation to lend recently while the shadow banking sector continues to be suppressed both due to rising credit risks, and the slow M2 growth, which could be a result of slower money velocity, all reducing the cost of capital. The RMB depreciation has deterred hot inflows in the near term though net capital outflow is not yet in sight. The RMB may gain some support before the Chine-US strategic and economic dialogue in June/July and possible export rebound in 2Q and beyond.

How great is the risk of capital outflow?

Exchange rate volatility and rising US yields may trigger capital outflow. The recent depreciation of CNY and continued QE tapering in the US will likely prompt the Chinese entities to cover their short FX positions, equivalent to a capital outflow. China's extensive capital controls make a rampant capital exodus unlikely, and we turn to the recent history to get a sense of possible size of capital outflow. Our base scenario envisages net non-FDI capital outflow of around $200bn this year, similar to that of 2012. Under this scenario, we expect USDCNY spot to rise in the near term but fall to around 6.08 by year-end following a volatile path. We estimate that PBOC will need to inject about Rmb1tn liquidity on a net basis for the rest of the year, or cut RRR by 50-100bps to achieve 13-14% M2 growth.

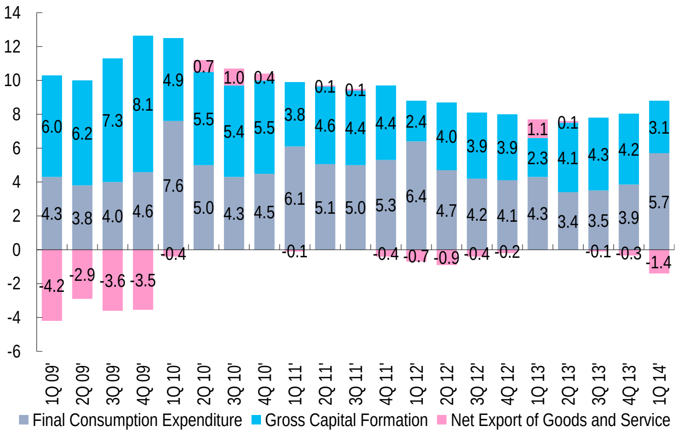
The size of capital outflow would affect currency movement and liquidity. While CAB surplus continues to support CNY appreciation, the size of surplus suggests CNY is only moderately undervalued, and large-scale capital outflow could overwhelm the market movements at least in the short run. In addition, capital outflow would slow down base money creation and drain liquidity. We have considered two additional scenarios apart from the base scenario.

- Balanced flow scenario: non-FDI capital outflow and inflow netting out each other. USDCNY may reach around 6.08 by year-end. PBOC can achieve M2 growth target without cutting RRR.

- Significant outflow scenario: non-FDI capital outflow of around $350bn. USDCNY may fluctuate around the current level. PBOC will have to cut RRR by about 200bps to achieve M2 growth target.

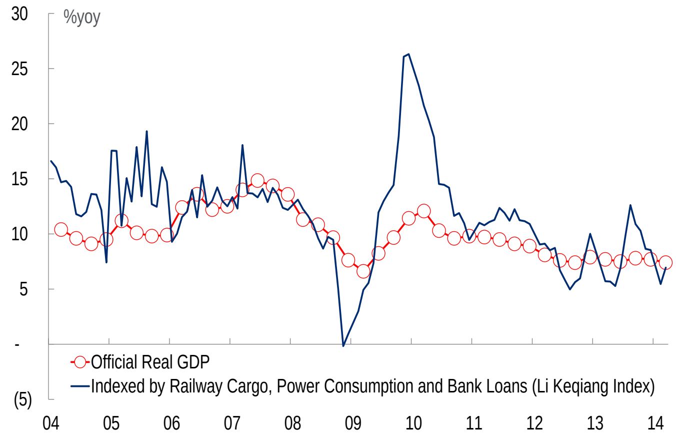
For details, please see *China Macro View - How Big Is the Risk of Capital Outflow?* (14-Apr)

Figure 37. GDP by contribution



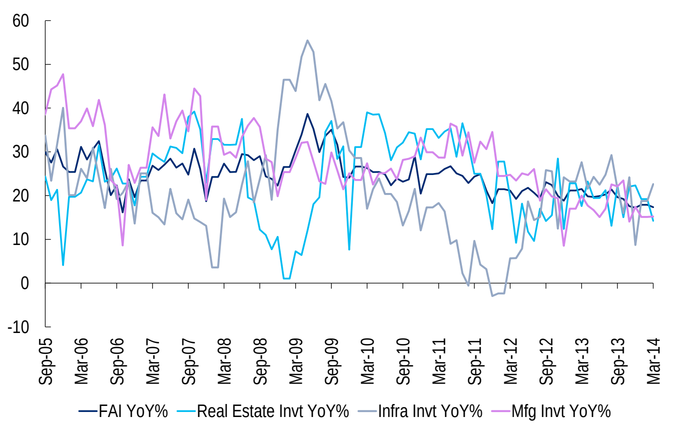
Source: CEIC and Citi Research

Figure 38. Li Keqiang Index vs. GDP growth



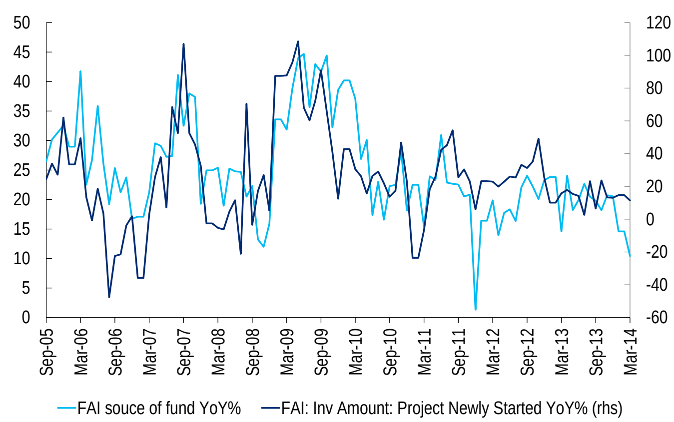
Source: CEIC and Citi Research

Figure 39. FAI by major sectors



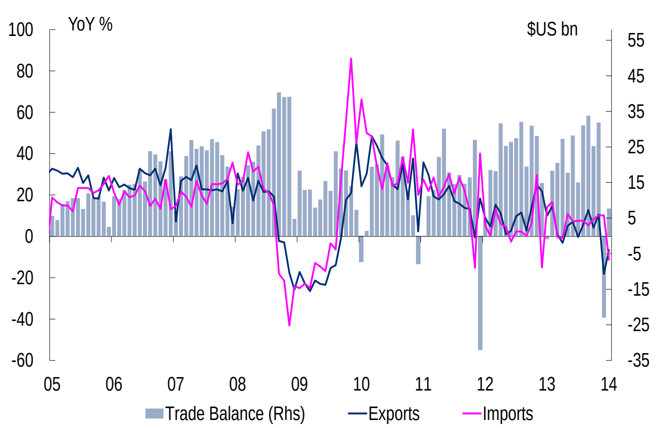
Source: CEIC and Citi Research

Figure 40. FAI source of funding and new projects started decelerating



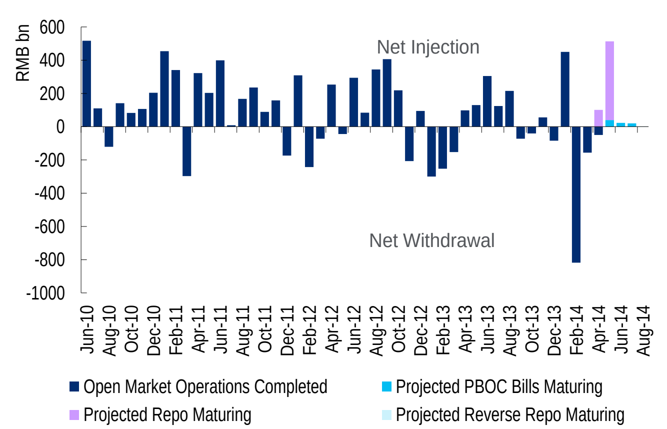
Source: CEIC and Citi Research

Figure 41. Trade balance turned to surplus on weak imports



Source: CEIC and Citi Research

Figure 42. Less liquidity withdrawal in Mar via OMO



Source: CEIC and Citi Research

Figure 43. China Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	3,494.5	4,544.0	5,070.5	5,932.5	7,319.0	8,238.5	9,244.8	10,063.1	11,256.4
Nominal GDP, local currency bn	26,583	31,490	34,632	40,151	47,310	51,894	56,881	62,138	67,988
GDP per capita, US$	2,645	3,422	3,800	4,424	5,432	6,084	6,794	7,366	8,218
Population, mn	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,360.7	1,366.2	1,369.7
Unemployment, % of labour force	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2	4.3
Economic Activity									
Real GDP, % yoy	14.2	9.6	9.2	10.4	9.3	7.7	7.7	7.3	7.0
Real investment growth % yoy	14.4	11.0	19.2	11.9	9.4	8.1	8.9	7.3	6.6
Real consumption growth % yoy	11.0	8.5	9.4	9.2	10.9	8.3	7.8	7.1	7.6
private consumption growth % yoy	11.1	9.2	10.3	8.5	18.2	8.5	8.0	7.3	7.8
Real export growth, % yoy	--	--	--	--	--	--	--	--	--
Real import growth, % yoy	--	--	--	--	--	--	--	--	--
Prices, Money & Credit									
CPI, % yoy	6.5	1.2	1.9	4.6	4.1	2.5	2.5	3.2	3.5
CPI, % avg	4.8	5.9	-0.7	3.3	5.4	2.6	2.6	2.6	3.2
Nominal wages, % yoy	18.5	16.9	11.6	13.3	14.4	11.9	9.6	9.2	9.4
Credit extension to private sector, % yoy	19.3	14.0	33.2	20.3	15.1	15.6	14.1	13.5	13.1
Policy interest rate, % eop	4.14	2.25	2.25	2.75	3.50	3.00	3.00	3.00	3.00
Short-term market rate, % eop	3.61	1.23	1.79	6.17	6.00	4.90	5.91	5.13	5.13
Long term yield, % eop	4.19	1.80	3.06	3.61	3.27	3.33	4.49	4.33	4.33
lc/US$, eop	7.30	6.82	6.83	6.59	6.29	6.23	6.05	6.10	6.02
lc/US$, avg	7.61	6.95	6.83	6.77	6.46	6.31	6.15	6.19	6.04
Balance of Payments, US$ bn									
Current account	353.2	420.6	243.3	237.8	136.1	215.4	182.8	201.3	168.8
% of GDP	10.1	9.3	4.8	4.0	1.9	2.6	2.0	2.0	1.5
Trade balance	264.3	298.1	195.7	181.5	154.9	230.3	259.2	291.4	298.4
Exports	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.7	2,209.5	2,328.7	2,484.1
Imports	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,818.4	1,950.3	2,037.3	2,185.7
Service balance	-7.9	-11.8	-29.4	-31.2	-61.6	-89.7	-124.5	-137.0	-150.7
Income balance	8.0	28.6	-8.5	-25.9	-70.3	-19.9	-43.8	-13.6	-19.2
FDI, net	139.1	114.8	87.2	185.7	231.7	176.3	185.0	170.3	118.1
International reserves	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,821.3	4,084.1	4,292.5
Total Amortisations	20.3	23.3	34.2	27.2	33.2	33.0	39.2	41.2	45.3
Public Finances, % of GDP									
Consolidated government balance	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-1.9	-2.1	-2.0
Consolidated gov primary balance	1.0	0.1	-1.8	-1.7	-0.9	-1.5	-1.4	-1.6	-1.5
Public debt	39.0	37.4	47.8	49.2	44.3	53.5	53.7	54.0	53.4
of which Domestic	38.0	36.6	47.0	48.6	43.7	53.1	53.3	53.6	53.0
Foreign Assets & Liabilities, US$ bn									
External debt	389.2	390.2	428.6	548.9	695.0	737.0	863.2	949.5	1,044.4
Private	354.3	356.9	391.8	510.1	657.6	700.4	828.8	911.7	1,002.9
Public	34.9	33.3	36.9	38.8	37.4	36.6	34.3	37.8	41.5
External debt / GDP	11.1	8.6	8.5	9.3	9.5	8.9	9.3	9.4	9.3
External debt / XGS	29.0	24.7	32.2	31.5	33.4	32.8	35.6	37.1	38.3
Short-term debt	235.7	226.3	259.3	375.7	500.9	540.9	676.6	744.3	818.7
Short-term debt/International Reserves (%)	15.4	11.6	10.8	13.2	15.7	16.3	17.7	18.2	19.1

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	7.8	7.7	7.4	7.0	7.1	7.4	7.4	7.2	6.8
CPI, % yoy	3.1	2.5	2.4	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	4.62	4.80	4.96	5.13	5.29	5.45	5.61
Long term yield, % eop	3.90	4.49	4.21	4.25	4.29	4.33	4.37	4.41	4.45
lc vs USD, eop	6.12	6.05	6.22	6.27	6.19	6.10	6.07	6.05	6.04

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

Hong Kong

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- **Summary view** – 1Q GDP growth is likely be sustained at 3.0%YoY. For 2Q, volatility in asset markets is likely to weigh on the economy. The new 'Shanghai-Hong Kong Stock Connect' looks a long-term positive. We see 2014 property prices to be on an easing (not falling) trend. Mild disinflation likely forming a trend.

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

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

Macro update

We expect 1Q GDP growth is likely to sustain at 3.0%YoY or 0.9%QoQ sa. Consensus also expects the economy to grow by 3.1%YoY in 1Q. Trade's contribution is likely to be small, but consumption from vibrant tourism and festive related spending is likely to help support growth. The many large-scale public infrastructure works and construction of private properties will likely continue to add to investment support to GDP in the quarter. Construction and service industry employment has kept the unemployment rate at a low level of 3.1% sa as of Mar14.

For 2Q, volatility in asset markets is likely to weigh on the economy, as markets digest continual positive signs from the US which may affect the pace of tapering and benefits from US/EU recovery will probably not be sufficient to offset China slowing impacts. These, however, are not our base case, as we think the hurdle of changing the pace of US$10bn per month tapering is higher now that it has done three rounds, and moderate easing would help stabilize the China economy to bottom at 7%YoY in 2Q14E. Nonetheless we think a China slowdown will still result in some degree of dampening in HK's recovery pace, as investments, tourist consumption and exports that are for China's domestic use would be affected. PMI for March dipped mildly into the contraction zone at 49.9, after five months of expansion, with mild contractions noted in both output and new orders in the month. Liquidity remains ample in the banking system thus far, but it will continue to have to weather the US Fed's QE3 exit in the coming months and the eventual normalization of interest rates. We maintain our full-year GDP growth at 3.4%YoY, lower than IMF's recently updated 3.8%YoY.

Property prices also deserve close monitoring. According to the IMF, "in the event of adverse China developments", "the main domestic risk is a disorderly correction in property prices, which could trigger an adverse feedback loop between economic activity, bank lending, household balance sheets, and the property market." For now, we view that property market cooling remains orderly and home prices are easing mildly amid low transaction volumes. The official property price index for the mass market has retreated by 3.5% as of Feb 14 since its last peak in Feb 13, and the Centa City Leading index for the mass market has also retreated by 4.8% as of Mar 14 since its peak in Mar 13. Against this backdrop we believe that the government's property cooling measures will likely be kept in place to buy time for interest rates to normalize and for supply to catch up. Our property analyst, Ken Yeung, thinks that property prices are showing signs of stabilization recently due to pent up demand (see *HK Property: Home Prices Showing Signs of Stabilization*).

Policymakers are closely monitoring HK bank's mainland exposure. HK, being an international financial center, will likely continue to increase its exposure to China; however, the pace of expansion needs to be in check. According to the HKMA,1Q credit grew 22.8%QoQ in annualized terms. The HKMA has stepped up oversight of banks including performing stress tests under various credit shock scenarios. In order to keep credit in check, the HKMA is currently reviewing banks' stable funding requirements – banks are required since 4Q13 to ensure deposit and loan tenors are matched. In addition, the HKMA published a recent note stating that HK bank's total mainland-related customer loans are properly managed. Such loans amounted to HK$2.3trn as of end-2013 and another HK$313bn are trade-finance loans. The HKMA hasn't detected any early signs of credit deterioration related to mainland-related loans; in particular, the classified loan ratio of bank's mainland-related lending portfolio stood at 0.29% (lower than that of the sector's total lending portfolio (0.48%)).

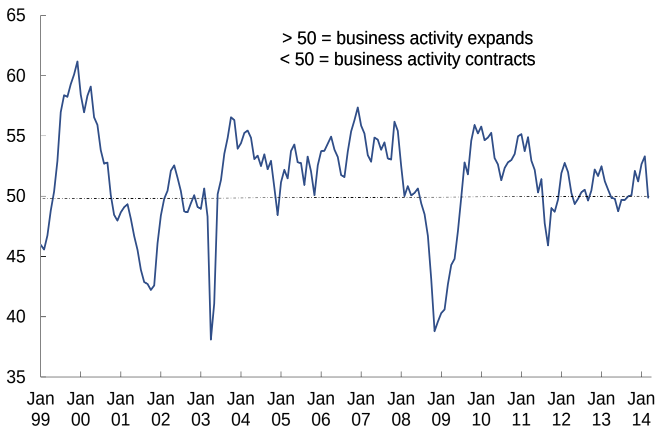
'Shanghai-HK Stock Connect' boosts HK's IFC status

Pilot scheme of cross-border stock-trading program to be launched in six months. The 'Shanghai-Hong Kong Stock Connect' scheme marks the beginning of QDII2 (qualified domestic individual investor program), and will be a positive for HK. The official announcement of this long-anticipated program will likely boost near-term sentiment and overall liquidity in the longer run for HK as mainland Chinese investors can invest in HK stocks (those in the Hang Seng big-cap and mid-cap indices and A+H stocks listed in HK). The total quota for purchasing Hong Kong-listed stocks by mainland investors is Rmb250bn, and daily quota is Rmb10.5bn. Having said that, this additional direct tie would bring both opportunities and risks to HK's stock market and further narrow any room for arbitrage of the difference between the A-H shares. This scheme will provide another remitting channel for the CNH pool accumulated in HK and help increase its multiplier, as foreign/HK investors can use this platform to invest in selected stocks (in Shanghai Stock Exchange 180 and 380, and A+H stocks listed in Shanghai). The total quota for purchasing Shanghai-listed stocks by HK investors is Rmb300bn, and the daily quota is Rmb13bn. Ultimately this announcement is a positive move to further strengthen HK's role as an international financial center, and it adds uniqueness to HK vs. other offshore RMB centers. See also our banking analyst Gary Lam's *Hong Kong Banks – Shanghai-Hong Kong Stock Connect Marks a Milestone* on its impact on HK banks.

Phase I of political consultation on electoral reforms ends

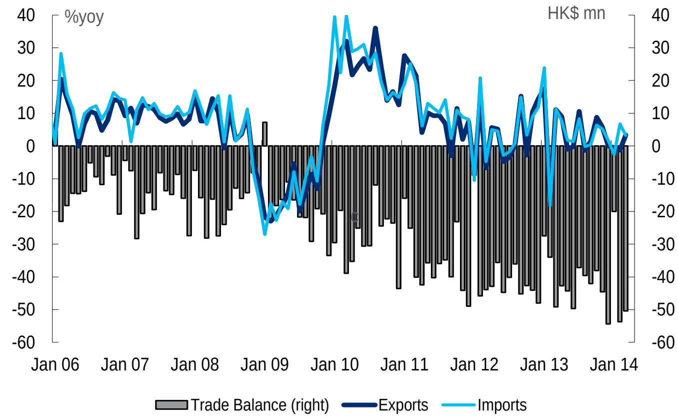
A few election mechanisms have been proposed publicly during this consultation period. This first round of five months of consultation on methods for selecting the CE in 2017 will end on 3 May, and a second round will be launched in 4Q14 after HKSAR government analysis and the Chinese government's opinions will be sought on the respective options. The political ice-breaker trip of the Legco delegation in mid-April kick-started direct discussions with Central Government officials on constitutional reforms. Despite the end of consultation, the dialogue will continue, as the Director of the Liaison Office of the Central People's Government in HKSAR, Mr. Zhang Xiaoming, has already said he will be meeting with Democratic Party members in the upcoming two months. However, large differences remain. Chinese officials have ruled out the option of public nomination of CE candidate as it is against the Basic Law and stressed the legal and security importance of nominating via the official committee. Of the publicly-proposed election mechanisms, the proposal by academics and the proposal by the DAB party incorporated public referral or recommendation for the nominating committee to officially nominate a Chief Executive Election candidate.

Figure 44. PMI in Mar edged back into contraction zone



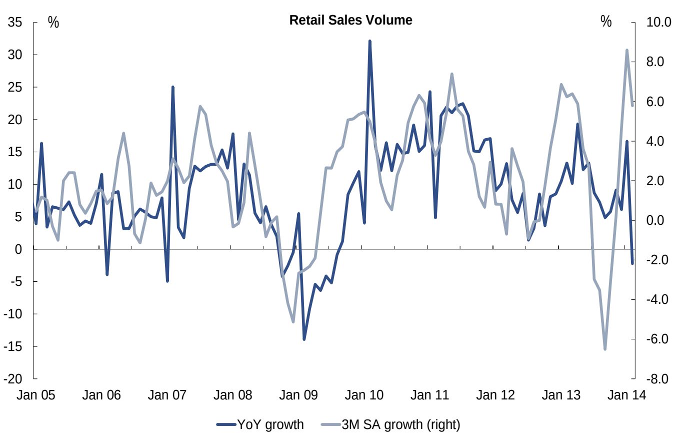
Source: CEIC, Citi Research

Figure 45. Trade recovery still rather weak



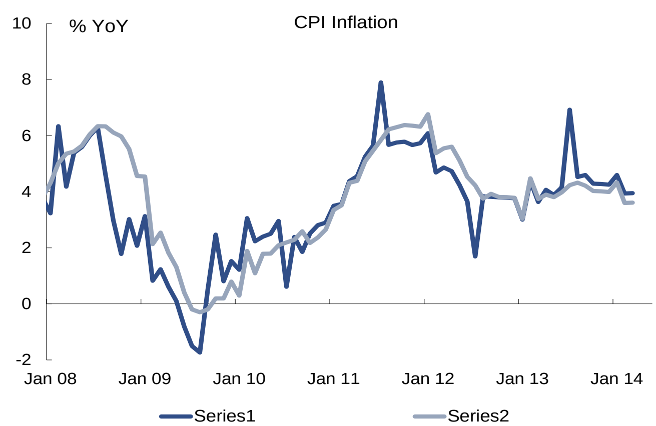
Source: CEIC, Citi Research

Figure 46. Retail sales softened post festive period



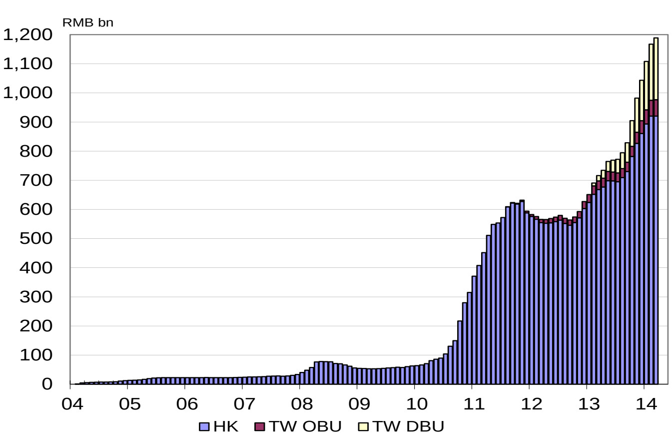
Source: CEIC, Citi Research

Figure 47. Disinflation likely in 2014E on slower rental pass-through



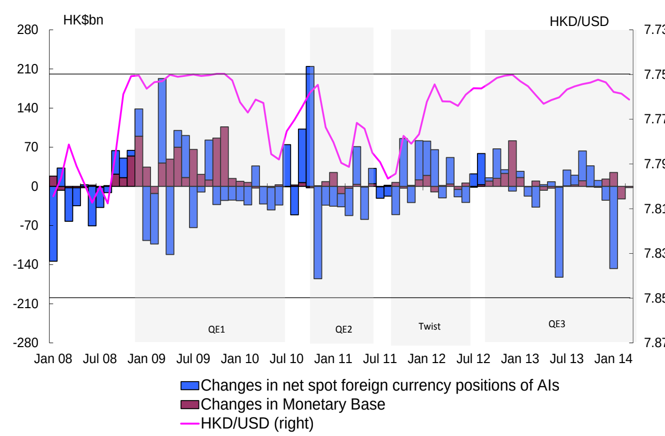
Source: CEIC, Citi Research

Figure 48. Offshore RMB Deposits in HK+TW to stay abundant



Source: CEIC, Citi Research

Figure 49. Net outflows recorded in Jan14; HKD easing from strong end



Source: CEIC, Citi Research

Figure 50. Hong Kong Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	211.6	219.3	214.1	228.7	248.5	262.6	273.6	285.5	302.3
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	39,431	41,623
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	3.4	3.4
CPI, % avg	2.0	4.3	0.6	2.3	5.3	4.1	4.3	3.9	3.7
Nominal wages, % yoy	2.4	4.0	-1.9	2.4	9.9	4.7	4.9	4.5	4.5
Credit extension to private sector, % yoy	15.2	11.0	-2.1	20.9	12.5	7.0	10.6	11.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	3.45	0.95	0.14	0.28	0.38	0.40	0.38	0.55	1.30
Long term yield, % eop	3.10	1.19	1.93	1.76	0.96	0.32	1.40	2.10	2.90
lc/US$, eop	7.80	7.75	7.75	7.77	7.77	7.75	7.75	7.76	7.75
lc/US$, avg	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.76	7.76
Balance of Payments, US$ bn									
Current account	27.6	32.9	21.2	16.0	13.8	4.1	5.6	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	3.9	3.8	6.1	3.4	4.0	3.5	3.4
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.39	0.38	0.38	0.45	0.50	0.55	0.60	0.90	1.10
Long term yield, % eop	1.15	1.39	1.45	1.60	1.80	2.10	2.30	2.50	2.70
lc vs USD, eop	7.76	7.75	7.76	7.76	7.76	7.76	7.76	7.76	7.75

India

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- **Summary view** – While recent macro data has been sluggish, we maintain our expectation of a modest recovery in FY15 GDP to 5.6%. A poor-bad monsoon could be a downside risk to our estimate but a decisive election outcome and consequent uptick in consumer and business activity could offset such risks.
- **Things to watch** – The exit poll on May 12 and election results on May 16 will be important to watch even though BJP-led NDA is widely considered to be the front runner. Besides, monsoon trends will also be key, considering that the Indian met department forecasts 60% chance of El Nino occuring this year.
- **Strategy** – We maintain our view of INR/$ trading in the 60-64 range amid a supportive BoP environment and the need to shore up fx reserves. On rates, we maintain our view of a prolonged pause in policy rates but given the elevated bond supply pipeline, we expect 10-year bond yields to stay in 8.70%-9% range.

Politics: high voter turnout suggests anti-incumbency

Anti-incumbency factor seems strong: With close to 60% of constituencies having already voted, all eyes remain fixed on the election results due to be announced on May 16. Opinion polls have predicted a high possibility of BJP victory (220+ seats). Going by the 8-12% increase in voter turnout in the current elections compared to the last, the anti-incumbency factor seems strong.

Markets on an optimistic note, watch out for exit poll on May 12: Equity and currency markets have been optimistic on opinion polls that show large gains for the BJP. Yet there remains a possibility of anti-incumbency votes getting divided in the wake of new frontiers such as the AAP (a new party) and Third front/regional party coalition. The markets will watch out for the result of exit polls, which should start coming in after polling ends on May 12, providing further indication for the final results on May 16.

FY15 growth estimated at 5.6%: Monsoon a risk factor

GDP growth to be affected by El Nino Effect and Monsoons: As mentioned in our latest *India Macroscope – Looking Beyond Elections,* we expect GDP growth to pick up to 5.6% in FY15 from 4.9% in FY14. However, our estimate for FY15 is predicated on agriculture growth at its long-term average of 3%YoY. Indian Meteorological Dept (IMD) predicts a 60% probability of El-Nino occurring in the current year, which could have an adverse effect on June-Sep rainfall and kharif crop production.

Investments “un-locking” continue but long road ahead: We continue to see incremental easing of bottlenecks on the investment side as (1) the PMG makes progress despite state level and viability issues; (2) iron ore mining has resumed in Goa, which bodes well for exports; (3) after flattish growth in FY14, Coal India is expecting double-digit growth in FY15. A decisive and positive election outcome would further revive business and consumer sentiments, in our view.

Inflation edges up: maintain view of extended pause

Easing trend in Inflation Reverses in March: Headline inflation picked up in March, with CPI rising to 8.3% from 8% last month and WPI up to 5.7%, from 4.7%. While the uptick in CPI was driven by higher food inflation, the rise in WPI was more broad-based. Going forward for FY15, we expect CPI and WPI to initially trend higher (Apr-May) and then, thanks to the favorable base effect, to ease toward sub-7% and sub-5% through November. We maintain our view of CPI and WPI averaging at 8% and 5.5% in FY15, respectively, vs 9.5% and 5.9% in FY14

Monetary Policy Outlook: With respect to monetary policy, we continue to expect an extended pause on rates through 2014 as the CPI follows the RBI's 'glide path'. Key risks to the inflation outlook: (1) interplay between commodity prices and currency, (2) El Nino, and (3) evolving fiscal trends post the elections. On rates, bond yields are likely to be range-bound despite a prolonged pause in interest rates largely due to elevated bond supply and lower recourse to OMOs. Consequently, we expect 10y bonds to trade in the 8.70-9% range in the next few months.

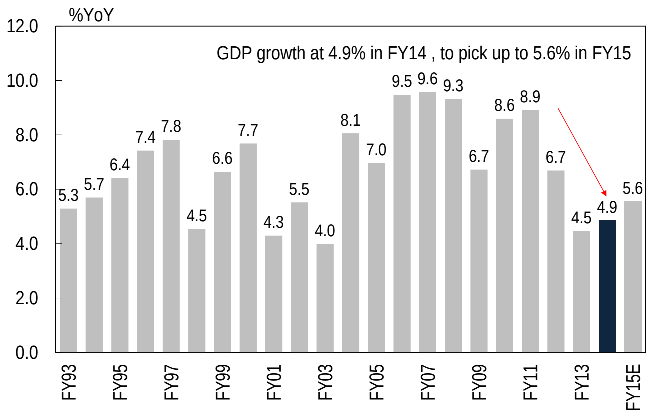
External front: INR range-bound, CAD under control

FY15E CAD marginally wider but comfortable: Notwithstanding a recent dip in exports, the full-year FY14 exports were up 4%YoY, to US$312.4bn, while imports fell 8.1%YoY, to US$451bn, with the deficit down to US$138.6bn from US$190.3bn in FY13. Going forward for FY15, we could see resumption in iron ore exports and potentially lower coal/metal scrap imports, but given the domestic recovery and possible relaxation in gold restrictions post elections, we maintain our view of the trade deficit widening to US$153bn. Consequently, we expect a higher CAD in FY15 at US$46.7bn, or 2.3% of GDP.

External debt rises to US$426bn, forward position at –ve US$31bn: India's external debt rose to US$426bn at the end of 3QFY14 vs US$404.9bn at end-FY13. While the increase was led almost entirely by NRI deposits, up by US$28bn, the overall level of external debt at 141% of FX reserves remains high. Additionally, while reserves have crossed US$311bn led by buoyant flows and oil swap unwind, it's key to note that the FCNR overhang remained elevated at US$31bn at end of Feb.

Rupee overvalued based on REER, to trade in 60-64 range: RBI recently released the monthly REER based on CPI, which indicates that INR was ~10% overvalued in March vs. 4% undervalued as per WPI. Taking into the account productivity differential, the equilibrium value of INR appears to be in the Rs60-62 range. From the current levels of 61/US$, a positive election outcome could cause INR to gap down, yet we do not expect the INR to be sustained below 60 levels for long as we believe the RBI would take the opportunity to shore up reserves. Overall we expect the unit to trade in the Rs60-64 range in FY15.

Figure 51. Trends in Real GDP growth (%YoY)



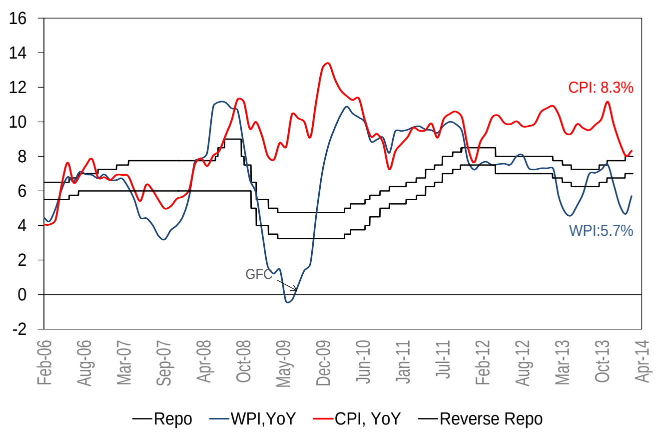
Source: CSO, Citi Research

Figure 52. 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

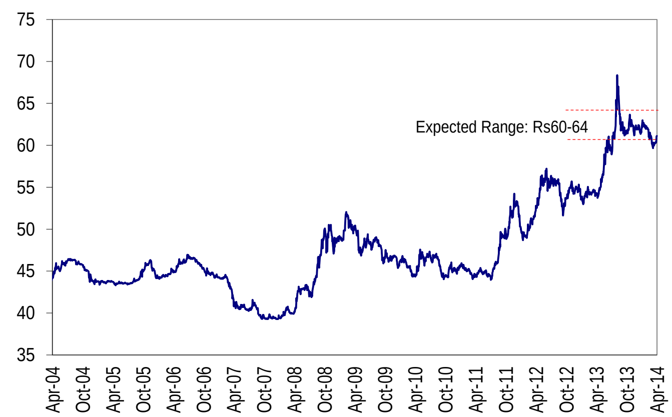
*info available as of 5th March; Source: News Reports (Times of India, ABP News, CNN)

Figure 53. Trends in Inflation and Policy Rates (%)



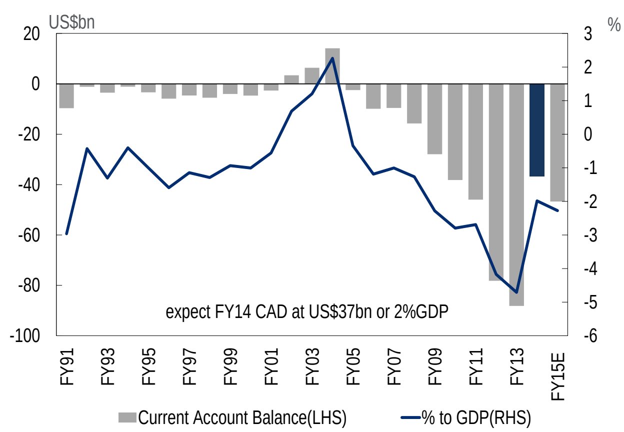
Source: CSO, Office of the Economic Advisor, RBI

Figure 54. Trends in the Rupee (US$ / INR)



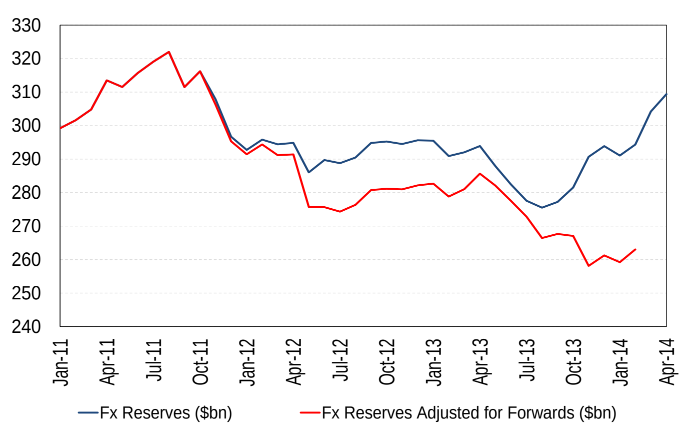
Source: CSO, Office of the Economic Advisor

Figure 55. Trends in Current Account Deficit (US$bn, %GDP)



Source: RBI, Citi Research

Figure 56. Trends in FX Reserves – spot & forwards adjusted (US$bn)



Source: RBI

Figure 57. 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	8.3	8.0	7.5
CPI, % avg	6.2	9.1	12.4	10.4	8.4	10.2	9.5	8.0	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$, eop	39.41	48.62	46.41	44.71	53.02	55.00	61.81	63.59	63.25
lc/US$, avg	41.18	43.42	48.30	45.68	46.63	53.38	58.57	61.54	63.56
Balance of Payments, US$ bn									
Current account	-15.7	-27.9	-38.2	-45.9	-78.2	-88.2	-36.8	-46.7	-58.1
% of GDP	-1.3	-2.3	-2.8	-2.7	-4.2	-4.7	-2.0	-2.3	-2.5
Trade balance	-91.5	-119.5	-118.2	-130.6	-189.8	-195.7	-148.7	-165.3	-181.8
Exports	166.2	189.0	182.4	250.5	309.8	306.6	323.4	349.3	384.3
Imports	257.6	308.5	300.6	381.1	499.5	502.2	472.1	514.6	566.1
Service balance	38.9	53.9	36.0	48.8	64.1	64.9	72.1	77.8	84.0
Income balance	-5.1	-7.1	-8.0	-17.3	-16.0	-21.5	-24.0	-24.0	-26.0
FDI, net	15.9	22.4	18.0	9.4	22.1	19.8	20.0	18.0	23.0
International reserves	299.1	241.6	252.8	273.7	260.9	264.7	278.0	294.8	314.2
Total Amortisations	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9	21.0
Public Finances, % of GDP									
Consolidated government balance	-4.0	-8.3	-9.3	-6.9	-8.1	-7.2	-6.9	-6.7	-6.5
Consolidated gov primary balance	-1.2	3.3	4.5	2.4	3.6	--	--	--	--
Public debt	76.1	76.8	75.5	70.2	69.7	69.8	69.5	68.1	66.3
of which Domestic	71.4	72.2	70.6	65.6	65.9	65.4	65.6	64.6	63.2
Foreign Assets & Liabilities, US$ bn									
External debt	224.4	224.5	260.9	317.9	360.8	404.9	426.0	441.0	456.0
Private	166.3	168.6	193.9	239.8	278.9	323.2	349.5	362.5	375.5
Public	58.1	55.9	67.1	78.1	81.9	81.7	76.4	78.4	80.4
External debt / GDP	18.1	18.3	19.1	18.6	19.3	21.6	23.1	21.9	19.6
External debt / XGS	88.5	77.7	95.2	84.7	80.7	90.1	92.3	84.4	73.6
Short-term debt	45.7	43.3	52.3	65.0	78.2	96.7	92.7	97.7	102.7
Short-term debt/International Reserves (%)	15.3	17.9	20.7	23.7	30.0	36.5	33.4	33.1	32.7

Quarterly Economic Indicators

	2013 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	8.4	8.5	7.5	7.0	8.5	8.0	7.6
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	8.36	8.25	8.25	8.10	8.10	8.10	8.10
Long term yield, % eop	8.28	8.80	8.78	8.75	8.50	8.50	8.50	8.50	8.50
lc vs USD, eop	62.59	61.81	60.02	60.59	62.09	63.59	63.86	63.66	63.46

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** – Amid the slowdown in domestic demand, momentum on import compression has been strong. Despite the IDR having pulled back from its lows, the risk of a quick reversal of the economic and import cycle looks contained. We expect a pause in the policy rate throughout 2Q and 3Q.

- **Things to watch** – The elections will influence the short-term outlook of policies such as subsidy reforms. The choice of running mates for the presidential contenders could determine whether the elections finish in one or two rounds, and also influence the strength of any future government coalition.

- **Strategy** – Any opposition quick win in the elections may still be taken positively by the markets, but appreciation pressure of the IDR in the near term (2Q) may have to be weighed against debt repayments and seasonally higher dividend repatriations.

Extended policy rate pause expected

Despite the IDR's pull-back in 1Q from recent lows, risk of an imminent resurgence of imports remains at bay. As of end March, the IDR retracted by 7% from the lows in January. However, the risk of import resurgence does not appear imminent in our view. The outlook for credit growth is still benign, amid structurally high loan to deposit ratios as well as moral suasion from policymakers to cut down loan growth. Imports of machinery related to the mining sector are also not too sensitive to IDR movements and is instead more dependent on the outlook for commodity exports (which remains muted). Thirdly, the decline in imports of vehicles and steel is not purely cyclical but was also due to substitution effects. For example, there has been a rise in sales of low-cost small cars at the expense of the higher-priced models.

Momentum on import compression has held up well; 1Q CA deficit could be lower than 2.5% of GDP. The downturn in the credit cycle continues as YoY local currency credit growth declined further to 18.6% in Feb, from 19.2% in Jan. (FCY credit growth nudged up to 6.4% from 4% but is still at a low base). Along with this, the decline in non-oil and gas imports has been persistent, although still mostly led by machinery and transport equipment. With the trade balance in March likely to have remained in surplus, the CA deficit in 1Q could be closer to 2% of GDP, versus our previous expectation of 2.5% GDP. Given these developments, and although the CA deficit could still see a hump shaped quarterly trajectory, the **policy rate pause is likely to be extended at least into 2Q and 3Q, in our view.**

High base effect on inflation forthcoming despite planned electricity tariff hikes for large industries. The government intends to proceed in raising electricity tariffs by up 38% - 65%, mostly for med-large industrial users and large households. Tariffs will be hiked on a bi-monthly basis starting from May and will eventually be allowed to float according to its economical price. This follows similarly gradual electricity tariff hikes last year, which contributed about 0.3pps to inflation. Our current CPI inflation forecast of 5.3% already takes into account the impact of the electricity tariff hike and we don't think any potential surprise is massive. Although some households are also likely to be subject to the tariff hike, it is only the large customers which make up a small percentage. We think the impact of the tariff hike would be felt more at the micro level and will vary across industries. Generally the tariff hike impact is likely to be more visible on the wholesale price index rather than the consumer price index.

Elections: VP choices will be crucial

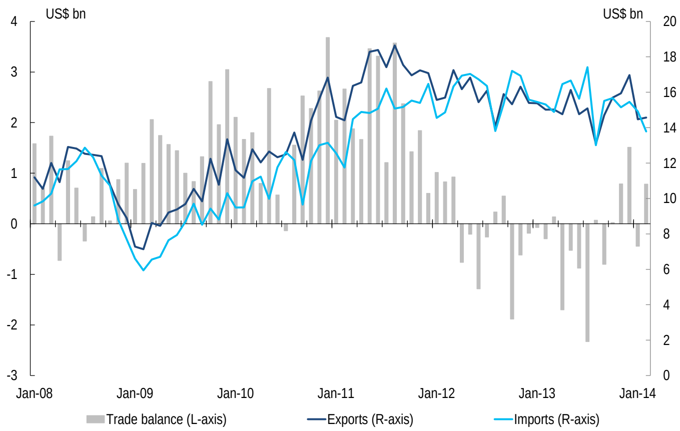
Coalitions for the presidential election still fluid; and postures can change thereafter. Following the 9-Apr elections, the presidential pairs must be formally registered on 18-20 May, after the parliamentary seats are formally designated on 9 May. The mapping of coalitions for the presidential candidates has yet to be finalized. Only Jokowi's PDIP has apparently fixed a coalition with Nasdem for the presidential race, in which the latter has suggested former VP Jusuf Kalla, as running mate for Jokowi. A number of political party officials have raised the possibility of mid-size political parties such as Demokrat, PAN, PKB, and PPP joining forces to put forward a totally new presidential candidate (outside of Aburizal Bakrie and Prabowo Subianto). Although in our view this is unlikely to materialize given the lack of popular presidential candidates, the position of Demokrat and PAN in any ensuing coalition should be closely watched. The head of PAN is currently the Coordinating Minister for Economic Affairs who must decide on fuel subsidy reforms that are being proposed this year by the Finance Ministry.

Lack of winning majority in parliamentary elections does not make the reform outlook gloomier, in our view. Post 1998, Indonesia's parliament has always been fragmented with no single party ever having majority seats. Therefore inter-party coalitions have always been a key feature of any government in the post Suharto era, although Indonesia officially adopts a presidential system for the cabinet as opposed to a parliamentary one. In our view even if the winning party had won stronger results, it still would not guarantee strong parliamentary support for its future president. Subsidy reform under President SBY's first term (2004-2009), for example, actually progressed faster in his first term in office, at a time when his Demokrat party controlled only 10% of the seats in parliament (vs. in his second term when Demokrat controlled 27% of parliamentary seats).

Quality of government coalition is more important than size. In our view, the key factor that will influence parliamentary support for the new presidency would be its ability to build a coalition of good quality. Note that the coalition posture post presidential elections is expected to be broader. Certain parties (e.g. Golkar) may eventually be invited into the winning coalition although they might have been in a different camp during the presidential race. The vice president is expected to play a crucial role in managing this extended coalition. The VP may have to be in the front seat socializing government policies and securing the backing of the coalition parties in parliament. Therefore, having a VP that has good relations with the second biggest political party in any forthcoming government coalition would be a strong advantage, in our view.

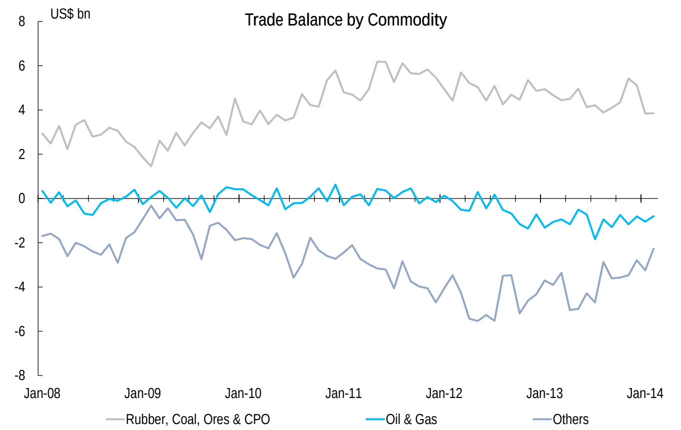
Debt repayments and seasonal repatriations may limit foreign reserve increase in 2Q. Further clarity on the presidential pairings could become a catalyst for capital inflows. However, we think the pace of reserve accumulations in 2Q could be limited by scheduled debt repayments and seasonal dividend repatriations. There are about $1.65bn in US$ denominated securities currencies maturing in 23 April and 4 May. Furthermore, dividend repatriations are seasonally higher in late 2Q and early 3Q, which may lead to a higher CA deficit in 2Q. This may cap the downside on the IDR in the near term and may also temporarily limit the magnitude of any increase in BI's foreign reserve position (which in March stood at $102.5bn), in our view.

Figure 58. Trade balance remains surplus in Feb and possibly Mar



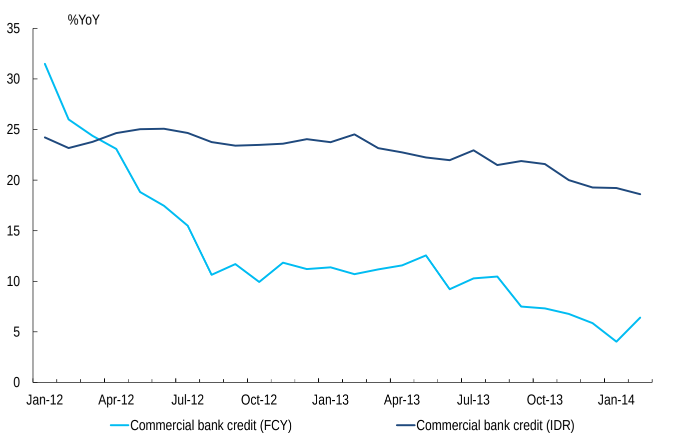
Source: CEIC, Citi Research

Figure 59. Improvement in non-commodity trade balance continues



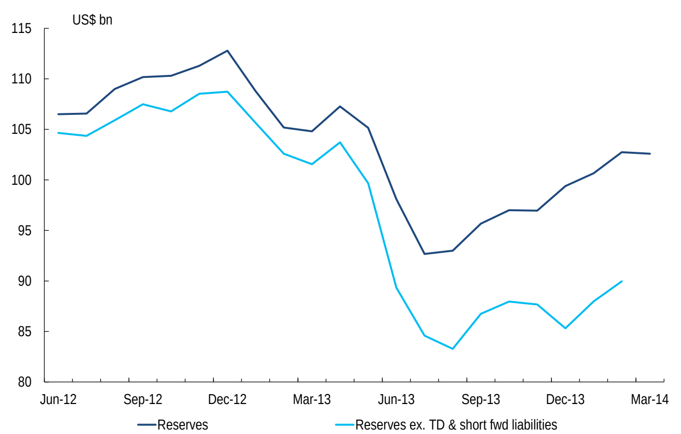
Source: CEIC, Citi Research

Figure 60. Downturn in credit cycle continues



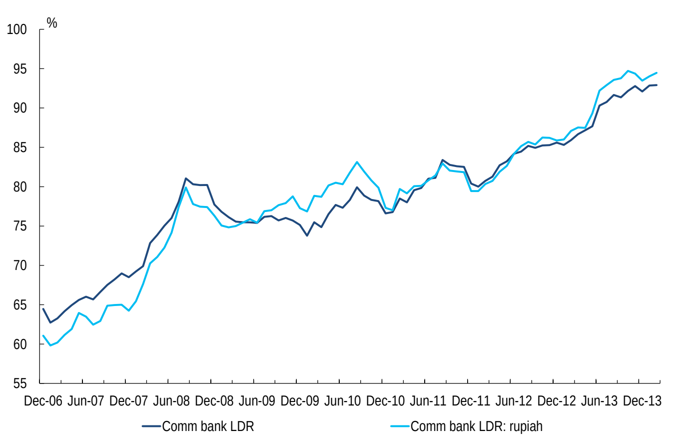
Source: CEIC, Citi Research

Figure 61. Reserve accumulation in 2Q may be slowed by repayments



Source: CEIC, Citi Research

Figure 62. Banking sector LDR above reg. threshold of 92%



Source: CEIC, Citi Research

Figure 63. Indonesia 9-Apr election "quick count" results

	Popular Votes %		
Party	2004	2009	2014E
Partai Demokrasi Indonesia Perjuangan (PDIP)	18.31	14.01	19.35
Partai Golongan Karya (Golkar)	21.62	14.45	14.69
Partai Gerakan Indonesia Merdeka (Gerindra)	0.00	4.46	11.91
Partai Demokrat	7.46	20.81	9.64
Partai Kebangkitan Bangsa (PKB)	10.61	4.95	9.08
Partai Amanat Nasional (PAN)	6.41	6.03	7.41
Partai Keadilan Sejahtera (PKS)	7.20	7.89	6.87
Partai Persatuan Pembangunan (PPP)	8.16	5.33	6.72
Partai Nasional Demokrat (NasDem)	0.00	0.00	6.66
Partai Hati Nurani Rakyat (Hanura)	0.00	3.77	5.28
Partai Bulan dan Bintang (PBB)	2.62	1.79	1.46
Partai Bintang Reformasi (PBR)	2.60	1.21	0.00
Partai Damai Sejahtera (PDS)	2.14	1.46	0.00
Partai Keadilan dan Persatuan Indonesia (PKPI)	1.26	0.90	0.95
Others (< 5 seats)	11.61	12.94	0.00
Total	100	100	100

Source: Kompas, Citi Research; 2014E is based on average of various quick count surveys

Figure 64. Indonesia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	432.2	510.7	538.6	709.5	845.4	876.9	868.5	857.7	933.7
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	3,439	3,699
Population, mn	225.6	228.5	231.4	237.6	242.6	244.2	247.4	249.4	252.4
Unemployment, % of labour force	9.1	8.4	7.9	7.1	6.6	5.8	5.8	6.5	6.3
Economic Activity									
Real GDP, % yoy	6.3	6.0	4.6	6.2	6.5	6.3	5.8	5.3	5.5
Real investment growth % yoy	1.9	12.4	2.4	8.8	10.1	16.3	4.9	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	7.2
CPI, % avg	6.3	9.9	4.8	5.1	5.3	4.0	6.4	6.4	7.2
Nominal wages, % yoy	4.9	7.6	5.3	12.2	3.4	20.4	11.5	17.1	15.0
Credit extension to private sector, % yoy	22.4	30.7	18.0	20.6	25.9	22.1	18.0	16.0	17.0
Policy interest rate, % eop	3.00	8.75	6.00	5.50	4.50	4.00	5.75	6.00	6.25
Short-term market rate, % eop	3.35	9.44	6.39	5.66	4.57	4.24	6.01	6.20	6.90
Long term yield, % eop	10.02	11.92	10.07	7.83	6.05	5.39	8.60	8.50	8.70
lc/US$, eop	9,393	10,900	9,425	9,010	9,068	9,638	12,170	12,039	11,876
lc/US$, avg	9,140	9,673	10,376	9,078	8,763	9,361	10,449	11,700	11,967
Balance of Payments, US$ bn									
Current account	10.5	0.1	10.6	5.1	1.7	-24.4	-28.5	-20.9	-19.3
% of GDP	2.4	0.0	2.0	0.7	0.2	-2.8	-3.3	-2.4	-2.1
Trade balance	32.8	22.9	30.9	30.6	34.8	8.6	6.2	11.0	13.3
Exports	118.0	139.6	119.6	158.1	200.8	188.5	183.5	190.6	201.9
Imports	85.3	116.7	88.7	127.4	166.0	179.9	177.4	179.6	188.6
Service balance	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-11.4	-10.7	-11.1
Income balance	-15.5	-15.2	-15.1	-20.8	-26.7	-26.8	-27.2	-25.4	-26.0
FDI, net	2.3	3.4	2.6	11.1	11.5	13.7	14.8	14.0	14.5
International reserves	56.9	51.6	66.1	96.2	110.1	112.8	99.4	107.9	113.6
Total Amortisations	18.8	16.7	20.4	24.0	25.2	29.4	41.0	42.0	42.0
Public Finances, % of GDP									
Consolidated government balance	-1.3	-0.1	-1.6	-0.7	-1.1	-1.9	-2.2	-2.3	-1.7
Consolidated gov primary balance	0.8	1.7	0.1	0.6	0.1	-0.6	-0.9	-1.0	-0.5
Public debt	34.1	29.3	31.4	26.4	23.6	23.3	23.5	26.0	25.0
of which Domestic	19.7	16.2	19.3	16.7	15.5	16.1	16.2	15.6	16.0
Foreign Assets & Liabilities, US$ bn									
External debt	141.2	155.1	172.9	202.4	225.4	252.4	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	32.3	31.1
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	7.3	6.9	4.7	5.3	6.9	8.1	7.9
Policy interest rate, % eop	5.50	5.75	5.75	5.75	5.75	6.00	6.25	6.25	6.25
Short-term market rate, % eop	5.70	6.01	5.86	6.10	6.10	6.20	6.20	6.20	6.20
Long term yield, % eop	8.54	8.60	8.21	8.25	8.40	8.50	8.60	8.70	8.70
lc vs USD, eop	11,580	12,170	11,360	11,588	11,813	12,039	12,057	11,997	11,937

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. With inflation pressures less pervasive into Mar, BNM remains in no hurry to hike, though 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] pervasiveness of inflation; [5] inflation expectations and wage growth; [6] progress on fiscal consolidation; [7] household credit growth; [8] guidance from Gov Zeti on monetary policy.
- **Strategy** – While a strong USD backdrop and heavy foreign positioning in bonds remain a headwind for MYR, this could be offset by an improving CA surplus and tightening bias in monetary policy, which may impute a bear flattening bias to the MGS curve near term.

Earlier Chinese New Year clouds 1Q14 GDP outlook

Chinese New Year distortions complicate interpretation of early 1Q14 data. The Jan-Feb IP data suggest a slow start to 1Q14 GDP – the official seasonally-adjusted data show average Jan-Feb levels are 0.4% below the 4Q13 average, dragged mainly by Mining which is 0.2% below 4Q13. Nonetheless Jan-Feb Manufacturing levels are about flat from 4Q13 while Jan-Feb Electricity levels are 0.4% higher. However, given possible swings in the seasonally-adjusted figures due to the moving holiday, we would not be surprised if the release of the Mar data shows a completely different picture.

Exports data continue to hint at improving underlying momentum. Despite a small 0.2%MoM SA decline in both headline (Jan: +2.1%) and E&E exports (Jan: +8.3%), average Jan-Feb seasonally-adjusted levels remain 3.1% and 3.7% above the 4Q13 average respectively. The E&E export improvement was also reflected in the E&E IP data (Feb: -0.7%MoM SA, Jan: +2.8%) where average Jan-Feb seasonally-adjusted levels are 3.8% above the 4Q13 average.

Jan-Feb intermediate goods imports point to improving manufacturing output. We estimate imports of intermediate goods saw a small 1.8%MoM SA decline that only partially offset the 9.2% surge in Jan, bringing average Jan-Feb seasonally-adjusted levels 4.7% above average 4Q13 levels, likely reflecting restocking by exporters catching up with improving external demand, which could foreshadow further strength in exports, as was the case in 1H13. We note that the surge in manufacturing sales growth (Feb: 16.1%YoY, Jan: 11.4%) has outstripped IP growth (Feb: 6.8%YoY, Jan: 3.7%) in recent months, suggesting production still has not caught up with demand, with inventories consequently drawn down.

Investments likely softened in Jan-Feb, but consumption bears watching. Imports saw a 1.4%MoM SA decline into Feb (Jan: +6.6%), but average Jan-Feb seasonally-adjusted levels remain 4.3% above the 4Q13 average. Our estimates suggest imports of capital goods continued to plunge sequentially (Feb: -10%MoM SA, Jan: -6.2%), bringing Jan-Feb seasonally-adjusted levels 0.1% below the 4Q13 average. We estimate however that consumption good imports continued to rise sequentially even in the face of the Chinese New Year distortion (Feb: 1.6%MoM SA, Jan: 4.3%), taking Jan-Feb levels 6.1% above 4Q13.

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

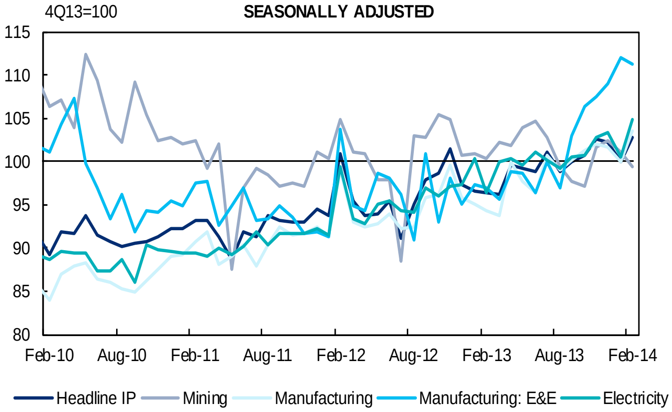
Inflation appears to have become less pervasive into Mar. Headline inflation remained stable into Mar at 3.5%YoY, though excluding food, alcoholic beverages and tobacco, transport, and electricity, our estimate of core inflation edged up to 2.1%YoY (Feb: 2.0%). Nonetheless there are signs that inflation became less pervasive – our inflation diffusion index suggests that the share of the CPI basket seeing MoM price increases declined into Mar, while our proxy's for BNM's inflation pervasiveness index indicates that a slightly smaller (unweighted) proportion of the CPI basket is now seeing above-2% inflation.

We do not think a May rate hike is in the cards. With headline inflation taking a pause after six straight months of increases (which BNM has attributed to supply-side pressures) and our estimate of BNM's pervasiveness index easing, this will likely fuel BNM's view that second-round effects remain contained and are less of a consideration for the interest rate outlook. In addition to Gov Zeti's recent comments downplaying inflation and indicating moderating demand – especially, a likely slowdown in consumption to below 7% – data do not give strong reasons for BNM to hike in May. Besides a possible small sequential GDP contraction in 1Q, with manufacturing labour productivity growth accelerating exceeding slower manufacturing wage growth in Jan-Feb, unit labour costs likely moderated, relieving pipeline inflation pressures – we note that PPI inflation (Jan, Feb: 2.6%YoY) has fallen back below CPI inflation after a brief spike above in Nov.

Nonetheless we think the bias is clearly towards higher rates, though the exact timing of the rate hike hinges on the evolution of growth data and the outlook. While a few months of data do not constitute a trend, we note that imports of consumption goods have continued to rise sequentially unabated for the four straight months up to Feb in spite of administered price adjustments, which may fuel BNM's confidence of resilient private consumption growth of 6.9% (vs the long-term average of 6.6%), which in itself already suggests a tightening bias. Should 1H14 GDP data prove comforting with private consumption growth coming in above the 7% threshold and external demand uncertainties recede in 2H14, this may warrant a resumption of policy rate normalization. We maintain our call for an initial hike in July (after an expected 20sen/litre fuel price hike) for now, but do not rule out a delay to Sep or even Nov after the release of 2Q or 3Q GDP data.

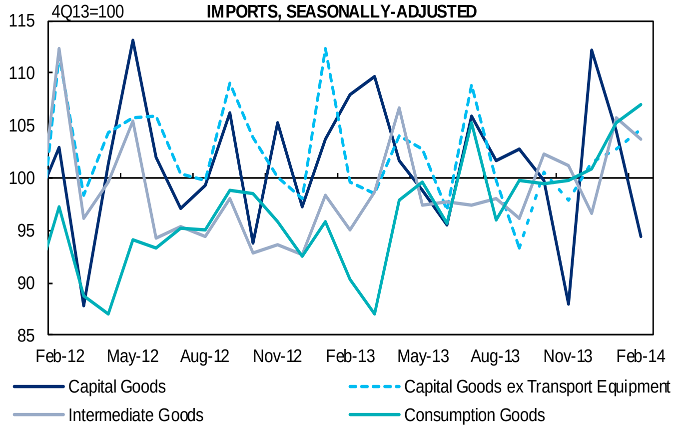
Financial stability risks also have to be watched – not just negative real interest rates but "destabilizing" financial imbalances (including excessive leverage and asset-price misalignments). Household and mortgage loan growth have moderated so far into Jan-Feb. BNM's latest Financial Stability and 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% amid 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 are 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.

Figure 65. Jan-Feb IP data suggest a slow start to 1Q14 GDP



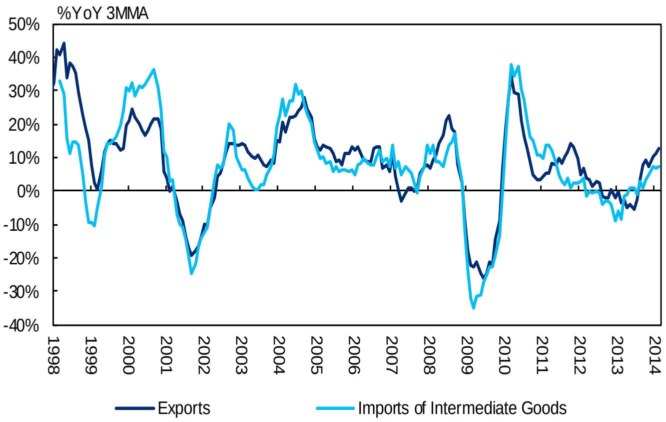
Source: CEIC, Citi Research

Figure 66. Investments likely softened, consumption bears watching



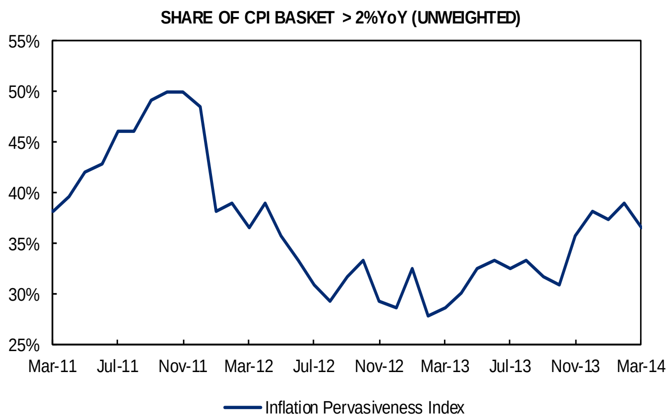
Source: CEIC, Citi Research

Figure 67. Intermediate good imports point to improving mfg output



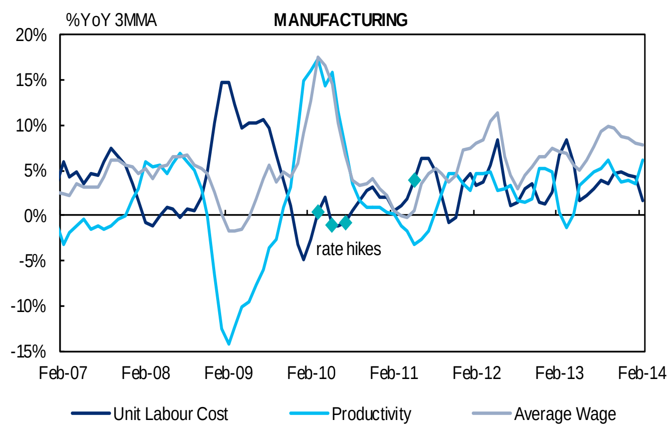
Source: CEIC, Citi Research

Figure 68. Inflation appears to have become less pervasive into Mar



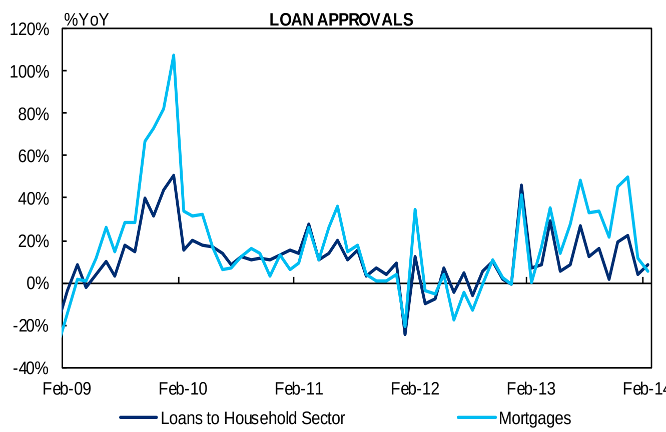
Source: Haver, Citi Research

Figure 69. Manufacturing unit labour cost growth has slowed



Source: BNM, CEIC, Citi Research

Figure 70. Household and mortgage loan growth have moderated



Source: CEIC, Citi Research

Figure 71. Malaysia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	193.7	231.1	202.4	247.7	289.3	305.0	312.6	317.4	329.9
Nominal GDP, local currency bn	665	770	713	797	884	941	984	1,057	1,118
GDP per capita, US$	7,123	8,393	7,255	8,664	9,987	10,398	10,520	10,408	10,641
Population, mn	27.2	27.5	27.9	28.6	29.0	29.3	29.7	30.5	31.0
Unemployment, % of labour force	3.2	3.3	3.7	3.4	3.1	3.0	3.1	2.9	2.9
Economic Activity									
Real GDP, % yoy	6.3	4.8	-1.5	7.4	5.1	5.6	4.7	5.0	5.0
Real investment growth % yoy	9.1	1.8	-9.4	25.3	2.3	22.3	7.2	1.8	7.7
Real consumption growth % yoy	9.7	8.4	1.4	6.2	8.6	7.1	7.3	6.0	3.6
private consumption growth % yoy	10.4	8.7	0.6	6.9	6.8	7.7	7.6	6.7	5.1
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	4.1	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$, eop	3.31	3.45	3.42	3.08	3.17	3.06	3.28	3.39	3.38
lc/US$, avg	3.44	3.33	3.52	3.22	3.06	3.09	3.15	3.33	3.39
Balance of Payments, US$ bn									
Current account	29.7	39.4	31.4	27.1	33.5	18.6	11.8	14.0	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	-16.2	-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	-1.8	-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	97.9	97.0	96.0
Private	37.8	41.5	41.9	44.7	53.7	55.6	69.2	67.0	67.0
Public	18.4	25.2	26.3	27.9	27.8	27.1	28.7	30.0	29.0
External debt / GDP	29.0	28.8	33.7	29.3	28.2	27.1	31.3	30.6	29.1
External debt / XGS	27.4	29.0	36.9	31.4	30.7	31.1	37.8	32.7	31.4
Short-term debt	16.3	22.5	22.7	25.4	32.8	30.4	39.4	42.0	42.0
Short-term debt/International Reserves (%)	16.1	24.6	23.5	23.8	24.6	21.8	29.2	31.1	30.0

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	5.0	5.1	5.0	4.9	5.5	4.5	4.4	5.2	4.8
CPI, % yoy	2.6	3.2	3.5	3.9	3.4	3.4	3.1	4.9	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	3.33	3.31	3.80	3.80	3.80	3.80	3.80
Long term yield, % eop	3.52	3.53	3.65	3.80	3.90	4.00	4.10	4.10	4.00
lc vs USD, eop	3.26	3.28	3.26	3.31	3.35	3.39	3.40	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** – Recent economic indicators support a 1Q14 GDP growth forecast of 6.8%YoY for an upbeat +3%QoQ SA. Spending catalysts would be led by strong exports, higher non-oil imports likely in tune with inventory build-up, remittance-driven consumption, and upbeat primary expenditures.

- **Things to watch** – Another bank reserve hike of 1% by MB when policymakers meet in May. BSP's imminent rate hike in 3Q14. Acceleration of rehabilitation/reconstruction activities and high infra spending targets. Awarding of another big-ticket PPP project following the new Cebu airport project. .

- **Strategy** – Qualifying as safe refuge within the short-duration bond space in the face of monetary tightening: 1) Series 5-72 that's at 3.25% or 98bp higher than policy intervention rate (PIR); 2) Series 3-20 — a 2-yr bond yielding 2.727% or 46bp higher than PIR while 'cheap' relative to the 1yr t-bill rate of 1.97%.

1Q14 GDP likely to probe growth of 3%QoQ SA or so

Initial set of economic indicators suggest 1Q14 GDP probably grew by 3%QoQ SA if not more. This may correspond to 1Q GDP growth of 6.5%YoY to 6.8%YoY (Citi: 6.8%YoY). Except in 2011, 1Q GDP during the years 2010-13 posted quarterly gains of 2%-3% QoQ SA . Over the 2012-13 period, industrial GDP with manufacturing and construction output leading the way, primarily elevated 1Q GDP growth. We sense industrial output was responding to favorable domestic demand (ex-inv) which posted gains 7%YoY-8%YoY in the first quarter of 2010-13. Key component of demand would be upbeat construction with an active infra spending. Strong 1Q GDP led the upbeat macro backdrop in recent years.

Likelihood of strong quarterly growth in 1Q14 was heightened by latest Customs trade export growth of 24.4%YoY in Feb (Jan-Feb: 16.5%YoY) driven by non-'chip' tech exports, non-tech manufactures and primary/unprocessed commodities. Meanwhile non-oil imports expanded 17.5%YoY in Jan-Feb in sync with upbeat domestic demand and export requirements. While net exports in 1Q14 GDP may be a lot more negative than earlier envisioned, the import build-up suggests inventory re-stocking of manufacturing and other sectors that bode well for uplifting GDP. Our current GDP forecast assumes inventory de-stocking equivalent to -3.1% of 1Q GDP. Raw material imports, which grew 31.6%YoY (Jan-Feb), suggest inventory de-stocking eased to 2.7% of GDP (or even less), supportive of a first quarter GDP growth forecast of 6.8%YoY.

OFW remittances (USD flows coursed through the banks) rose 5.8%YoY in Jan-Feb with purchasing power up 12%YoY over the two-month period. Weak PHP and dollar volume combined for higher real peso value of the remittances that probably supported 1Q consumption gains of at least 6%YoY.

Despite upbeat exports and favorable domestic demand, manufacturing (mfg) index managed to rise by 1.2%YoY in Feb after a 5%YoY gain in Jan. Mfg output hasn't responded in a strong way to demand stimulus. This may suggests that hefty import gains may provide a lift to inventory for some but recent demand signals are probably not strong enough to prompt broad-base re-stocking for most mfg industries. BSP also reported a PMI mfg at 55% in Jan up from 50.9% in Dec as 10 out of 12 sectors were in an expansion mode. PMI inventories index rose sharply to 57.2% from below 50% in Dec while new orders were at 58.2%. Tightening capacity utilization rate (seas adjusted 83.3% in Feb) support new capex despite financial market volatility.

Primary expenditures back with double-digit gains

Primary fiscal expenditures grew 15%YoY in Jan-Feb to underscore the strong fiscal expansion bias. We sense a larger fiscal contribution to growth this quarter led by rehabilitation and reconstruction programs of the areas devastated. We noted that double-digit growth of primary expenditures implied strong real growth in public construction. Faster primary spending in Jan-Feb resulted in a 31.8%YoY decline in the primary fiscal surplus to Php28.3bn.

Customs revenues expanded 21.7%YoY in Jan-Feb to beat BIR collections. Weak PHP, faster import growth, and administrative reforms in play enabled Customs to buoy up its collections. Tax revenues as a whole grew 10.6%YoY In Jan-Feb—the slowest pace since Feb-Mar 2013, but prior to Apr when individual income tax filing and payment during the month elevates tax revenues.

The overall budget deficit was a Php43.9bn in Jan-Feb to account for 16.5% of the FY14 fiscal deficit target of Php266bn. In the government's cash budget report, roughly Php59bn was sourced locally, including the government's cash withdrawals. On the external side, it was net repayment of Php15bn in Jan-Feb. Sizeable external debt maturities of Php48.6bn in Jan-Feb exceeded gross foreign borrowings of Php32.7bn. Subdued debt supply risk implied more government cash withdrawals to mitigate risk of rising local bond yields.

Bank reserve hike of 1% backed up hawkish signals

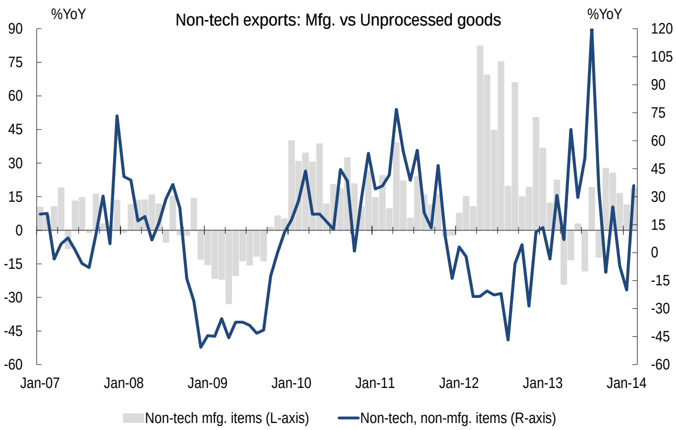
The Monetary Board (MB) started policy tightening by hiking the bank reserve ratio by 1% to drain roughly Php60bn of liquidity in the system while keeping the overnight policy rate and SDA rate still unchanged. Clearly the reserve hike signals a MB focus on excess liquidity risk gleaned from broad money growth exceeding 30% recently. We also estimate that MB action would drain 11.1% of the retail monies that were compelled to leave BSP's SDA facility last year. But the reserve hike impact on broad money would be to curb its growth by only 1.1%. If the persistent current account surplus condition aggravates "stock liquidity" (ex-SDA balances already in the system) is behind the prevailing 30% growth in money supply, the option to hike bank reserves may recur. Stronger loan growth, assuming banks deploy this liquidity in funding loans and acquisitions of other bank assets, could ease prospects for additional reserve hikes.

Given the initial liquidity impact estimates, we think the MB would opt for another 1% reserve hike to 20% in its scheduled meeting in May to fast-track a slowdown of broad money. Second time around may result in short-term rates starting to feel the liquidity pinch although front end rates have already risen since start of the year when inflation edged up to 4%. We continue to expect MB would hold back on SDA rate and overnight rate hikes until 3Q14 with the firm backdrop of strong USD and higher US treasuries. Sustaining a policy intervention rate (PIR) of 2.27% (weighted SDA and overnight rate), which is low by nominal and real rate standards, suggests a rate differential which is likely to handicap PHP prospects.

Safe refuge from monetary tightening

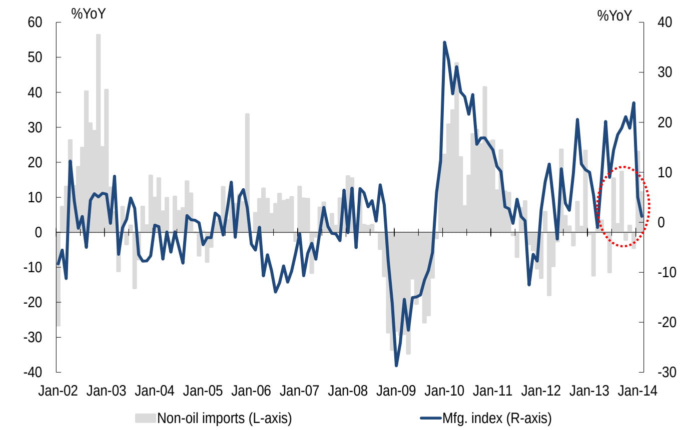
We reiterate the need to find safe haven from upcoming monetary tightening actions. Within the short-duration bond space, we continue to prefer the 4yr-5yr segment citing series 5-72, which at 3.25% exceeds PIR by 98bp. Same with the recently issued 2-yr government bond or series 3-20 with a yield of 2.727% or 46bp buffered from PIR while 'cheap' relative to the 1yr T-bill rate of 1.97%. Delays in rate adjustments while the MB's hawkish bias remains play well to the gallery, but it won't be sufficient to stall PHP weakness in case of strong USD pressures.

Figure 72. Non-tech exports continue to provide export upside



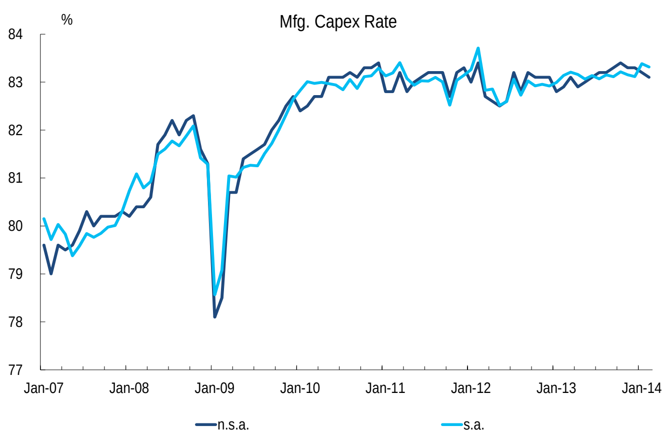
Source: CEIC, Citi Research

Figure 73. Hefty non-oil import gains as of Feb but not in sync with mfg



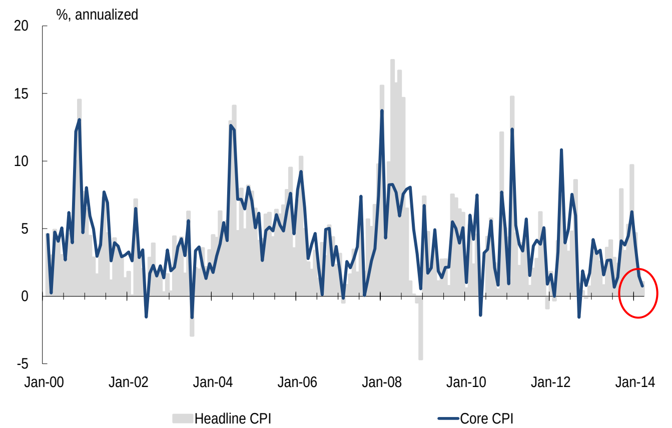
Source: CEIC, Citi Research

Figure 74. Capex appeal of capacity utilization rate staying firm at 83%



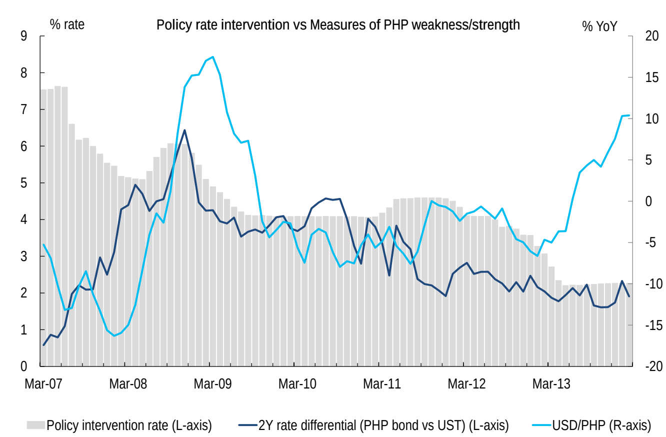
Source: CEIC, Citi Research

Figure 75. Easing annualized pace of inflation delayed rate hike to 2H



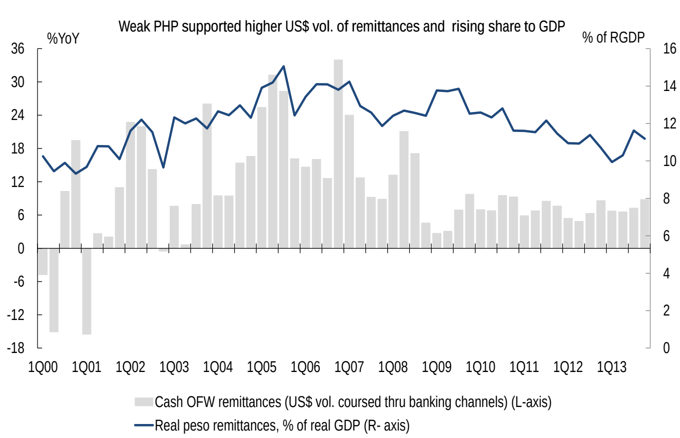
Source: CEIC, Citi Research

Figure 76. No 'rate differential' support for PHP



Source: CEIC, Citi Research

Figure 77. Higher contributions of remittances to GDP on weak PHP



Source: CEIC, Citi Research

Figure 78. Philippines Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	150.2	173.4	168.6	200.0	224.1	250.5	271.9	282.6	348.5
Nominal GDP, local currency bn	6,893	7,721	8,026	9,003	9,706	10,565	11,546	12,849	14,205
GDP per capita, US$	1,693	1,917	1,829	2,127	2,339	2,567	2,735	2,791	3,380
Population, mn	88.7	90.5	92.2	94.0	95.8	97.6	99.4	101.2	103.1
Unemployment, % of labour force	7.3	7.4	7.5	7.3	7.0	7.0	7.1	6.8	6.5
Economic Activity									
Real GDP, % yoy	6.6	4.2	1.1	7.6	3.6	6.8	7.2	6.9	7.3
Real investment growth % yoy	-0.5	23.4	-8.7	31.6	2.0	-3.2	18.2	10.6	15.0
Real consumption growth % yoy	4.9	3.3	3.3	3.4	5.2	7.3	6.0	6.3	6.2
private consumption growth % yoy	4.6	3.7	2.3	3.4	5.7	6.6	5.6	6.0	6.2
Real export growth, % yoy	6.7	-2.7	-7.8	21.0	-2.8	8.9	0.8	5.3	3.9
Real import growth, % yoy	1.7	1.6	-8.1	22.5	-1.0	5.3	4.3	5.6	4.9
Prices, Money & Credit									
CPI, % yoy	3.9	8.0	4.3	3.6	4.2	3.0	4.1	4.2	3.9
CPI, % avg	2.8	9.3	3.2	4.1	4.7	3.2	2.9	4.1	4.0
Nominal wages, % yoy	3.4	5.5	0.0	5.8	5.4	7.0	2.2	5.0	5.0
Credit extension to private sector, % yoy	10.6	12.8	4.3	13.8	16.2	14.1	10.0	13.5	15.0
Policy interest rate, % eop	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.00	4.50
Short-term market rate, % eop	6.03	5.20	4.11	0.75	1.68	-1.38	-0.15	2.25	3.25
Long term yield, % eop	5.70	6.55	6.25	4.78	4.21	3.70	2.91	4.00	4.50
lc/US$, eop	41.23	47.47	46.50	43.65	43.84	41.06	44.39	45.61	43.69
lc/US$, avg	46.05	44.48	47.56	45.06	43.29	42.22	42.46	45.17	44.50
Balance of Payments, US$ bn									
Current account	8.1	0.1	8.4	7.2	5.6	7.0	9.4	9.8	10.0
% of GDP	5.4	0.1	5.0	3.6	2.5	2.8	3.5	3.5	2.9
Trade balance	-14.0	-18.6	-13.9	-16.9	-20.4	-18.9	-18.5	-14.4	-15.1
Exports	32.8	34.7	29.1	36.8	38.3	46.4	44.7	51.7	55.5
Imports	46.8	53.3	43.0	53.6	58.7	65.3	63.3	66.0	70.5
Service balance	6.0	2.0	4.9	5.8	6.6	6.2	6.8	3.3	3.4
Income balance	16.1	16.8	17.4	18.3	19.5	19.7	21.1	20.8	21.7
FDI, net	2.5	0.6	-0.2	1.6	0.3	1.0	-0.2	3.0	3.0
International reserves (ex-gold)	33.8	37.6	44.2	62.4	75.3	83.8	83.2	83.5	90.0
Total Amortisations	4.7	7.0	5.7	8.3	6.3	2.7	9.3	9.7	10.0
Public Finances, % of GDP									
Consolidated government balance	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-1.4	-1.8	-1.6
Consolidated gov primary balance	3.7	2.6	-0.2	-0.2	0.8	0.7	1.4	1.1	1.1
Public debt	53.9	54.7	54.8	52.4	51.0	51.5	49.2	46.0	45.0
of which Domestic	31.9	31.3	30.8	30.2	29.6	32.8	32.3	30.0	29.5
Foreign Assets & Liabilities, US$ bn									
External debt	55.5	54.3	54.9	60.0	60.4	60.3	58.5	61.0	63.5
Private	17.5	13.7	11.6	13.9	14.1	15.2	18.0	18.0	18.5
Public	38.0	40.6	43.2	46.2	46.4	45.2	40.5	43.0	45.0
External debt / GDP	36.9	31.3	32.5	30.0	27.0	24.1	21.5	21.6	18.2
External debt / XGS	119.8	113.8	126.9	110.1	105.7	90.3	87.9	84.6	82.6
Short-term debt	7.1	7.0	4.0	6.3	7.0	8.5	11.2	11.1	12.0
Short-term debt/International Reserves (%)	21.0	18.6	9.0	10.1	9.3	10.1	13.5	13.3	13.3

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	6.9	6.5	6.6	7.1	6.8	7.1	6.6	6.7	7.5
CPI, % yoy	2.7	4.1	3.9	4.0	4.1	4.2	4.1	4.0	3.9
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	0.94	1.50	2.00	2.25	2.50	2.75	3.00
Long term yield, % eop	3.02	2.91	3.38	3.75	4.00	4.00	4.25	4.50	4.75
lc vs USD, eop	43.48	44.39	44.76	44.97	45.29	45.61	45.32	44.78	44.23

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 with a sequential slowdown – 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 for the time being.
- **Things to watch** – [1] Near-term export and production momentum; [2] house prices, which could trigger property policy easing; [3] household debt; [4] labour market and core inflation trends; [5] signs of financial stress in the SME sector.
- **Strategy** – MAS intervention could provide some support for the SGD near term, but further out SGD NEER movements should be driven more by broad DXY movements and expected disinflation trends. We remain alert for upward pressures on SOR on tighter banking liquidity and eventual Fed hikes.

2014 outlook still positive despite bouts of volatility

1Q GDP Advance Estimates showed expansion of 0.1%QoQ SAAR, 5.1%YoY (4Q: +6.1%QoQ SAAR, 5.5%YoY). Manufacturing rose 4.5%QoQ SAAR (+8%YoY) while Services fell 1.8%QoQ SAAR (+4.7%YoY), largely on trade-related and financial services, while Construction rose 10.7%QoQ SAAR (4Q: 1.4%). Ex-biomed, we estimate 1Q14 GDP rose 5.1%YoY and -5.7% QoQ SAAR. This GDP outcome remains within MAS's earlier expectations, with activity levels seen as "elevated", and MAS viewing that the "outlook for the global economy has brightened". We maintain our 2014 GDP forecast of 3.5%, which would bring end 2014 GDP levels to the upper half of the 2-4% official forecast range.

Mar IP data however suggests a possible upward revision. Our estimates suggest that 1Q seasonally-adjusted Electronics IP levels are now 6.1% above 4Q13 levels, while headline and ex Biomed IP are 4.1% and 4.7% above 4Q13 respectively. Taking into account the Mar IP figure and revisions in the backdata, 1Q14 headline IP is now +7%YoY vs the Manufacturing GDP Advance Estimate of +8%YoY. An upward revision in 1Q GDP is therefore possible – all else equal, our estimates suggest 1Q GDP growth could be revised up to +5.4%YoY, +0.8%QoQ SAAR.

NODX is showing signs of underperformance vs regional peers. NODX saw another large seasonally-adjusted swing (Mar: -8.9%MoM SA, Feb: +7%), likely due to the official seasonal adjustment process assuming the Chinese New Year fell entirely in Feb this year – as the start of the Chinese New Year fell at the end of Jan, this may have exaggerated the swings in the 1Q14 seasonally-adjusted data, making it hard to draw strong conclusions from the 1Q14 data this time. Nonetheless with 1Q14 seasonally-adjusted headline NODX levels 0.8% below 4Q13 levels even as 1Q14 NORX levels have climbed 1.2% above 4Q13, the growing divergence between NODX and NORX continues to suggest that the domestic manufacturing sector is underperforming regional peers, especially in tech. The downward trend in tech exports suggests capacity constraints are less to blame than possibly worsening cost competitiveness. That said, there are signs that exports could pick up in the coming months – the pick-up in non-oil retained imports of intermediate goods (NORI) since Nov suggests some re-stocking of parts in anticipation of a future pick-up in demand. We note that 1Q14 NORI levels are still 28.2% above 4Q13 despite declining again in Mar (Mar: -1.2%MoM SA, Feb: -10.2%).

MAS maintained monetary policy status quo as expected

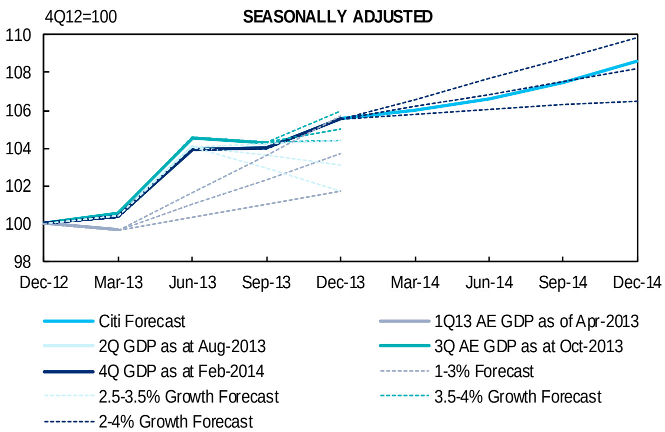
The MAS maintained the "modest and gradual appreciation" stance, with no change to the slope, width or centre. The continued positive output gap forms the basis of MAS' expectation that core inflation will rise in the next few quarters. The labour market remains tight, with the 4Q13 labour market data showing a stable unemployment rate of 1.8%s.a. even as a jump in job vacancies raised the ratio of job vacancies to unemployed persons (a measure of demand-supply balance in the labour market) for the second consecutive quarter to 1.44 (3Q: 1.41) – an all-time high since 1997. Indications are that the labour market will remain consistently tight given relatively stable hiring intentions indicated in the recent Manpower Inc. survey (2Q14 net employment outlook: +18%, 1Q: +16%) and the tightening in foreign worker supply forcing firms to further draw down the resident labour force. This is in line with MAS' view that pent-up domestic cost pressures could be passed through to core CPI inflation as economic conditions improve.

MAS thus maintained its 2-3% core inflation forecast despite cutting the headline forecast to 1.5-2.5% (prev: 2-3%). Both headline and core inflation rebounded in Mar to 1.2% and 2.0% respectively after dropping to 0.4% and 1.6% in Feb on base effects and, as if intending to discourage overly aggressive disinflationary expectations, the Mar MAS/MTI inflation statement noted that headline inflation will likely rise over the next few months, largely due to base effects associated with the fluctuations in COE premiums, before easing in 2H14. In line with our view of medium-term disinflationary undercurrents, MAS expects only a negligible inflation contribution from car prices for the year even as imputed rentals on owner-occupied accommodation are expected to stabilize as more housing supply hits the market. Imported inflation is also expected to be relatively benign for the rest of 2014.

We see the MAS core, rather than headline, inflation forecast as an indication of policy bias. Should inflation data and pipeline pressures suggest a risk that MAS' implicit 2-2.5% core inflation tolerance threshold is breached, we would not rule out a slope steepening to the "new normal" slope of 3% at some stage, though this is not our base case for now – MAS views the current policy stance as "appropriate" for ensuring medium-term price stability as the basis for sustainable growth. Three other factors also suggest a slight hawkish bias to policy: [1] a stronger SGD may also be viewed by policymakers as a tool to incentivize SMEs to raise productivity, [2] anchoring inflation expectations remains the key policy priority ahead of elections in 2015-16, and [3] likely Fed tightening in 2015 and the imposition of the TDSR will limit any unwanted decline in short-term interest rates in the event of slope steepening.

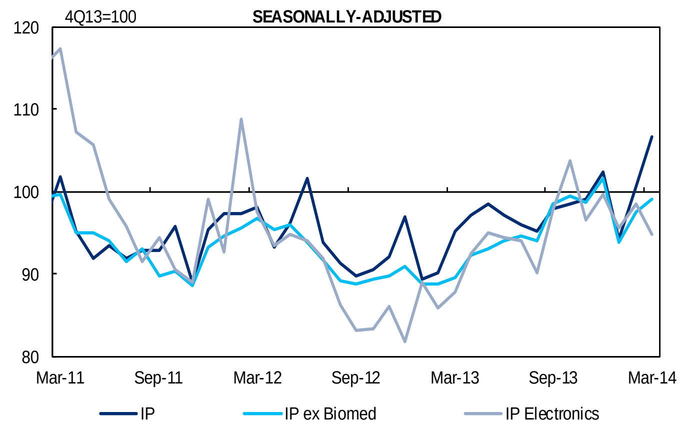
Headline disinflationary forces on the other hand will likely be welcomed after the recent years of high inflation – we maintain our 2014 headline inflation forecast of 1.8% as the correcting housing market and caps in car-price increases from higher COE supply gather steam, on top of disinflationary forces from lower industrial and commercial rentals, as well as the strong SGD and household deleveraging curbing demand-pull pressures. If necessary, any excessive disinflation will likely be tackled via sector-specific measures rather than monetary policy – slope reduction is likely only if the tradables to non-tradables productivity gap closes, either in a cyclical downturn or through a rise in non-tradables productivity, both of which would ease core inflation pressures.

Figure 79. Growth volatility likely remains within MAS expectations



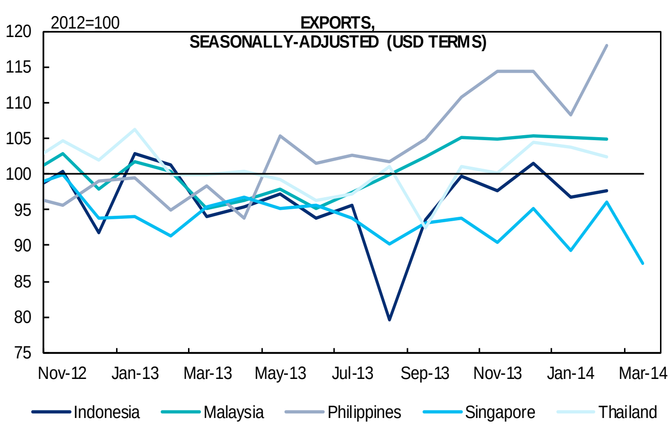
Source: CEIC, Citi Research

Figure 80. Mar IP data suggests a possible GDP upward revision



Source: CEIC, Citi Research

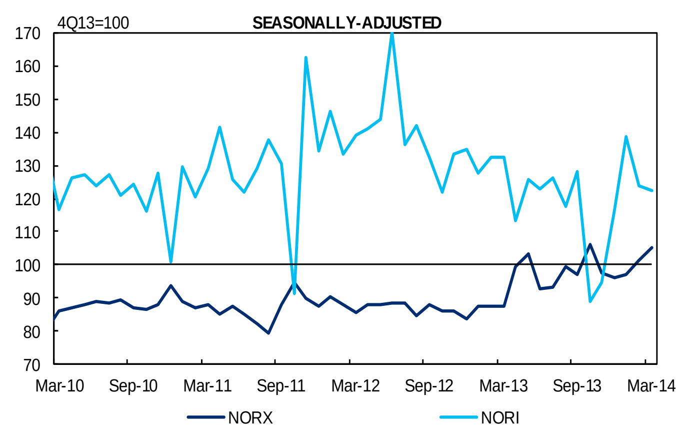
Figure 81. NODX is showing signs of underperformance



Note: We use NODX for Singapore.

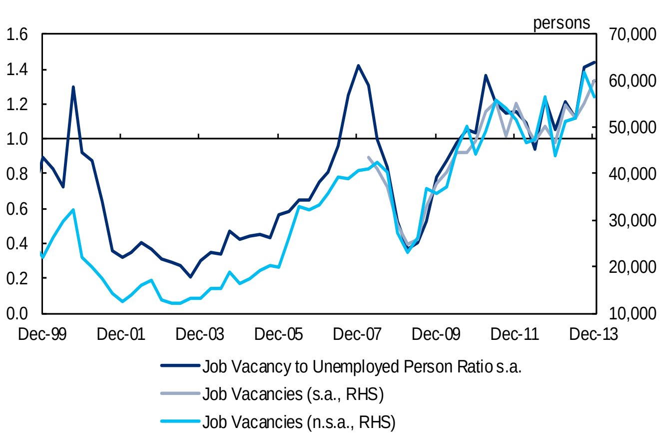
Source: CEIC, Citi Research

Figure 82. NORX and NORI have picked up into 1Q14



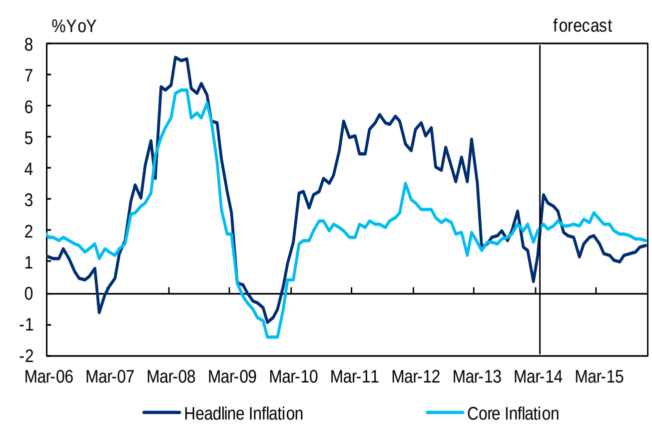
Source: CEIC, Citi Research

Figure 83. The labour market remains tight



Source: SMU-Mastercard, Citi Research

Figure 84. Headline inflation will likely rise before easing in 2H14



Source: CEIC, Haver, Citi Research

Figure 85. Singapore Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	178.6	190.6	190.7	233.8	270.8	284.6	295.8	309.8	326.5
Nominal GDP, local currency mn	269	269	277	318	334	355	370	397	418
GDP per capita, US$	38,913	39,379	38,243	46,058	52,234	53,564	54,791	56,335	58,302
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	4.3	3.5	4.1	3.5	4.0
Real investment growth % yoy	16.7	30.0	-19.1	12.5	10.0	23.4	-2.6	-3.7	0.6
Real consumption growth % yoy	6.0	3.6	0.3	7.4	3.4	2.8	4.4	3.9	2.9
private consumption growth % yoy	6.8	2.8	-0.7	6.4	4.5	4.0	2.7	2.0	2.3
Real export growth, % yoy	9.0	4.3	-7.1	18.3	3.3	1.0	3.6	3.5	3.2
Real import growth, % yoy	8.0	9.7	-11.1	16.1	2.8	3.9	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	1.6	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	17.8	16.4	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	1.28	1.28
Balance of Payments, US$ bn									
Current account	45.6	26.4	32.7	59.0	63.3	49.4	54.4	55.8	58.8
% of GDP	25.5	13.9	17.1	25.2	23.4	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	-10.2	-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	106.0	108.4	105.5	110.0	110.0
of which Domestic	87.1	94.9	105.4	101.0	106.0	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	5.6	2.2	3.6	2.9	3.5	3.3	4.6
CPI, % yoy	1.6	1.5	1.2	2.7	1.8	1.6	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	2.49	2.75	2.90	3.00	3.00	3.10	3.20
lc vs USD, eop	1.26	1.26	1.26	1.27	1.28	1.30	1.29	1.29	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 was intact in 1Q14 owing to an exports and construction investment rebound. We expect growth momentum to pick up in the coming quarters, with consumption recovery stirred up by job growth and export gains due to improvements of the US and EU economy.
- **Things to watch** – We believe a housing market recovery alongside a series of government boosting measures is critical to support recovery of consumption. Inflation is likely to trend up in the coming months on increases of service prices as well as base effects.
- **Strategy** – With downside risks to inflation, we still expect the BoK to hold the policy rate to the end of this year to bolster steady recovery of domestic demand. KRW will likely shift to weaken in 2H14 on uncertainties over the timing of Fed's rate hike and related EM stress.

Recovery pace retained despite weak domestic demand

We revise up 2014-15 GDP growth, reflecting better-than-expected 1Q14 data. Though weaker-than-expected exports and tepid industrial activities seemed to flag a slowdown in recovery pace, the economy maintained a sequential growth of 0.9% in 1Q14 and YoY growth rose to 3.9%, from 3.7% in 4Q13. Exports and construction investment were mainly behind the push while sequential growth of facilities investment and private consumption waned from the previous quarter. Exports were buoyed by electrical & electronic instruments and petroleum products. As imports shifted to fall, net exports contributed 1.2%p to the seasonally adjusted QoQ real GDP growth. Construction investment was lifted by residential construction, and intellectual property products also propelled GDP growth on the back of private spending for R&D. Reflecting stronger-than-expected 1Q14 GDP, we revise up our 2014-15 real GDP growth by 0.2%p and 0.1%p to 3.9% and 4.0% respectively.

Recovery of facilities investment seems to be delayed. Facilities investment in 1Q14 fell by 1.3%QoQ sa, after four consecutive quarters of increase. The YoY growth remained high due to a low base last year but slowed to 8.0% from 10.9% in 4Q13. We think firms have delayed facilities investment amid increased external uncertainties, such as Fed tapering and related EM growth risk, and China's structural slowdown. However, a continued rise of domestic machinery orders in Jan-Feb bodes well for a recovery of facilities investment ahead, which will likely add momentum to economic growth in the coming quarters.

Consumer spending is likely to pick up gradually despite a temporary setback. Despite increased sales of durable goods (especially cars) and services, private consumption in 1Q14 just grew 0.3%QoQ sa, half the pace of the growth in 4Q13. However, much of the deceleration in private consumption growth was attributable to lower tax returns or additional tax payments through the year-end tax adjustment, and to less household money spent on oil and electricity due to warm weather. Lukewarm housing market recovery also limited private consumption growth. We expect private consumption to pick up gradually, supported by job growth and housing market recovery. However, with sales declines seen in major retailers and firms refraining from marketing after the recent ferry disaster, we expect the incident to have some negative effect on consumer sentiment as well as on retail sales in Apr. Yet retailers and the travel industry are anticipating sales to revive in May on holiday demand and inflows of foreign tourists.

Services sector driving strong job growth. Against the backdrop of hefty construction investment and modest increases of exports and consumption last year, labor productivity of all industries in 2013 improved for the first time in three years, though nominal wage growth slowed to 3.9% from 5.3% in 2012. Labor productivity of the construction and services sectors rose by 3.1% and 1.4% respectively, while that of the manufacturing sector only grew by 0.1% and the improvement for all industries was 1.1%. The services sector not only saw a rise in labor productivity last year but also has mainly led the uptrend of total job growth. In particular, labor productivity and employed persons in human health & social work sector increased alongside rising demand for welfare and government support on childcare as well as its effort to lift the female participation rate. Despite a sequential decline in employed persons, YoY job growth in Mar stayed strong above 600K, with jobs in the services sector continuing to show strong growth of over 500K. Given resilient job growth and economic recovery is likely to continue, we expect average job growth of 470K for this year (vs. 386K in 2013), which should support consumption.

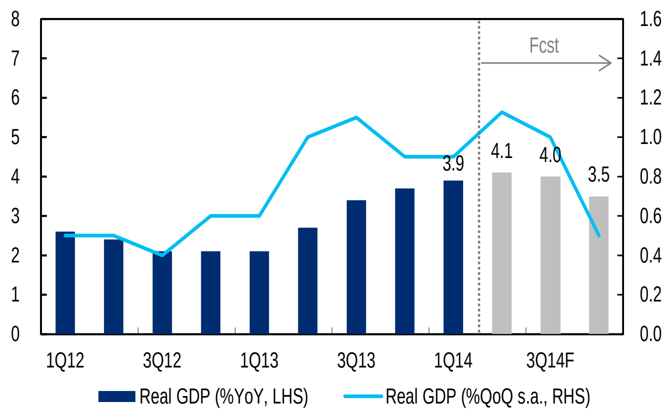
Policy rate hike unlikely despite rising inflation

We expect inflation to pick up but downside risks persisting. CPI inflation in Mar shifted to rise to 1.3%YoY, from 1.0% in Feb, mainly due to increases in livestock product prices and personal service fees, and dissipation of the effect of government subsidy for childcare. Excluding agricultural products and oils, which have been behind the low headline inflation in the past months, core CPI inflation rose to 2.1%YoY, from 1.7% in Feb. We expect CPI inflation to move upwards to the year-end, near 3%YoY in 2H, on service-price hikes and a low base last year. However, we see some downsides risks: 1) Import prices continue to fall short of te level of a year ago. Besides a low oil price, other manufacturing goods -- such as chemical products, and electrical & electronic equipment – led import prices to fall in Mar; 2) further hikes of public utility charges have been delayed. The BoK, in its recent downward revision of 2014 CPI inflation forecast, estimated delayed increases of public tariffs and tuition fees to lower inflation by 0.2%p. 3) A negative output gap will likely remain this year. Given such circumstances, the policy rate was unchanged at Apr MPC meeting, with the governor saying the BoK will raise the rate preemptively if inflationary pressures grow from the demand side which is unlikely in 2014. We expect no change in the policy rate this year.

Further KRW strength to be limited

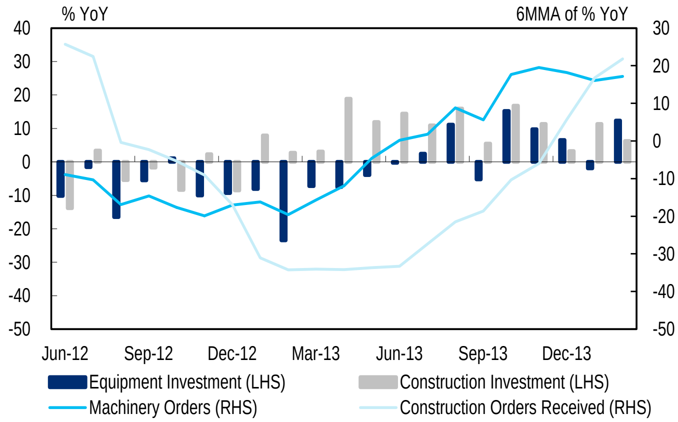
Return of risk appetite led the recent KRW appreciation. USDKRW dropped to 1,040 levels on 25 Apr from its last peak of near 1,080 on 25 Mar mostly in tandem with foreign fund inflows to local securities markets. Since the last peak of USDKRW, foreigners with a regained risk appetite net purchased US$3.9bn each from local stock and bond markets. As inferred from a sharp fall in domestic banks' foreign-currency deposits, exporters' USD selling also contributed to KRW appreciation. We expect continued current account surplus and economic recovery to further buttress the KRW. However, with USDKRW down at its lowest since mid-2008, we expect FX authorities to defend the 1,030 level via market intervention, though they have come under pressure from the IMF (in its assessment, the KRW remains undervalued by 2-8%) and the US Treasury Department noting in its recent reports Korea's active intervention to curb KRW appreciation. We have lowered our USDKRW forecast range to reflect the recent fall. We now expect 1040 on the 0-3m horizon and KRW to weaken against USD over 6-12m to 1,060, considering Fed tapering and its impact on EM.

Figure 86. Economic recovery trend continues



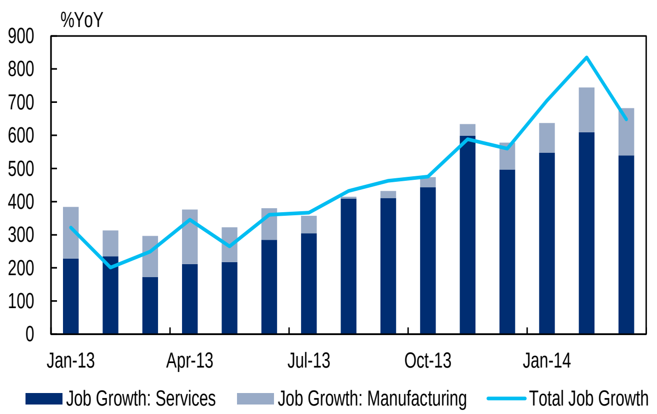
Source: Bank of Korea, Citi Research

Figure 87. Increase in orders bode well for investment



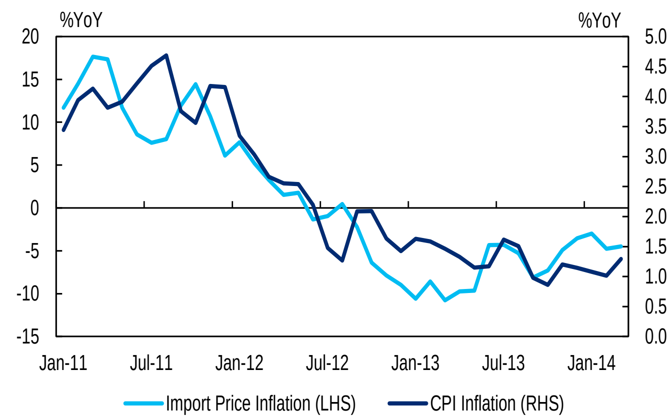
Source: Statistics Korea, Citi Research

Figure 88. Job growth has been led by services sector



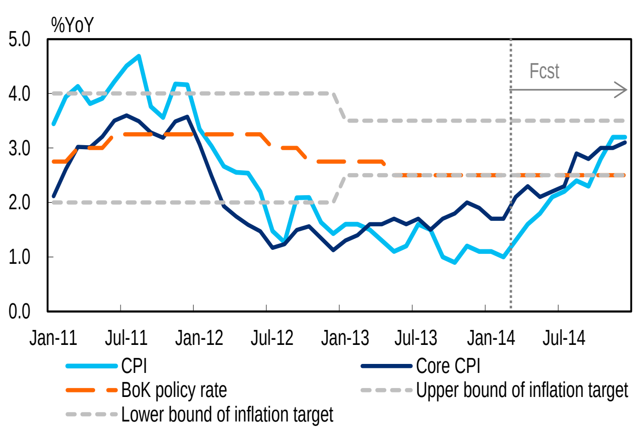
Source: Statistics Korea, Citi Research

Figure 89. Low import price poses downside risk to CPI inflation



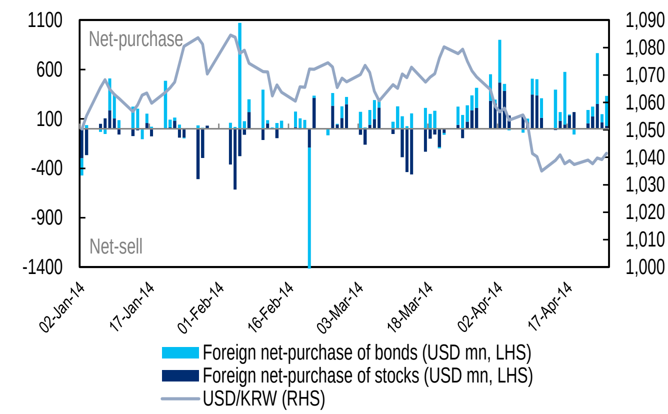
Source: Bank of Korea, Citi Research

Figure 90. We expect no policy rate hike despite rising inflation



Source: Bank of Korea, Statistics Korea, Citi Research

Figure 91. Foreign fund inflows to portfolio market led KRW strength



Source: Yonhap Infomax, Bank of Korea, Citi Research

Figure 92. Korea Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	1,121.3	999.7	902.6	1,094.6	1,203.0	1,222.0	1,304.0	1,439.0	1,534.0
Nominal GDP, local currency bn	1,043,258	1,104,492	1,151,708	1,265,308	1,332,681	1,377,457	1,428,295	1,516,883	1,619,556
GDP per capita, US$	23,073	20,423	18,352	22,153	24,167	24,438	25,966	28,538	30,306
Population, mn	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4	50.6
Unemployment, % of labour force	3.2	3.2	3.6	3.7	3.4	3.2	3.1	3.3	3.1
Economic Activity									
Real GDP, % yoy	5.5	2.8	0.7	6.5	3.7	2.3	3.0	3.9	4.0
Real investment growth % yoy	4.5	-1.0	-10.1	17.8	3.5	-2.3	0.0	6.0	5.7
Real consumption growth % yoy	5.3	2.2	1.3	4.3	2.7	2.2	2.2	2.5	3.2
private consumption growth % yoy	5.1	1.4	0.2	4.4	2.9	1.9	2.0	2.7	3.3
Real export growth, % yoy	12.7	7.5	-0.3	12.7	15.1	5.1	4.3	5.9	6.9
Real import growth, % yoy	11.6	3.2	-6.8	17.3	14.3	2.4	1.6	6.3	6.7
Prices, Money & Credit									
CPI, % yoy	3.6	4.1	2.7	3.1	4.2	1.4	1.1	3.2	2.9
CPI, % avg	2.5	4.7	2.8	3.0	4.0	2.2	1.3	2.1	3.0
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 rate, % eop	5.73	4.68	2.82	2.80	3.55	2.89	2.66	2.75	3.60
Long term yield, % eop	5.78	3.77	4.92	4.08	3.46	2.97	3.23	3.65	4.25
lc/US$, eop	936	1,263	1,166	1,121	1,159	1,064	1,051	1,058	1,053
lc/US$, avg	929	1,102	1,275	1,156	1,108	1,127	1,095	1,054	1,056
Balance of Payments, US$ bn									
Current account	11.8	3.2	33.6	28.9	18.7	50.8	79.9	54.6	46.7
% of GDP	1.1	0.3	3.7	2.6	1.6	4.2	6.1	3.8	3.0
Trade balance	14.6	-13.3	40.4	41.2	30.8	28.3	44.0	37.5	35.6
Exports	371.5	422.0	363.5	466.4	555.2	547.9	559.6	591.9	642.1
Imports	356.8	435.3	323.1	425.2	524.4	519.6	515.6	554.3	606.5
Service balance	-12.0	-5.7	-6.6	-8.6	-5.8	-5.2	-1.4	-0.8	-1.2
Income balance	-3.4	3.7	1.6	-2.1	0.3	6.6	7.2	0.5	-1.0
FDI, net	-17.9	-16.9	-14.9	-22.2	-16.4	-18.9	-13.1	-8.6	-4.3
International reserves	262.2	201.1	270.0	291.5	304.2	323.2	341.7	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	1.0	0.9	1.5
Consolidated gov primary balance	4.5	2.4	-0.2	2.6	2.7	2.5	2.3	2.2	2.7
Public debt	27.7	27.0	30.1	29.5	30.2	30.9	32.5	30.7	28.9
of which Domestic	26.7	26.1	29.1	28.7	29.4	30.1	31.7	29.9	28.2
Foreign Assets & Liabilities, US$ bn									
External debt	333.4	317.4	345.7	359.8	398.7	409.4	416.6	420.5	428.5
Private	279.8	264.9	277.9	280.1	314.7	311.2	312.3	314.6	319.8
Public	53.6	52.5	67.8	79.7	84.0	98.2	104.3	105.9	108.7
External debt / GDP	29.7	31.7	38.3	32.9	33.1	33.5	31.9	29.2	27.9
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	48.0	45.2	39.4	33.0	29.7	29.6

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	3.4	3.7	3.9	4.1	4.0	3.5	3.5	3.5	4.1
CPI, % yoy	1.0	1.1	1.3	2.1	2.3	3.2	3.1	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 rate, % eop	2.66	2.66	2.65	2.67	2.68	2.75	2.90	3.10	3.35
Long term yield, % eop	3.05	3.23	3.16	3.49	3.55	3.65	3.75	3.95	4.15
lc vs USD, eop	1,075	1,051	1,065	1,043	1,050	1,058	1,059	1,057	1,055

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

Taiwan

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- **Summary view** – We expect GDP growth to moderate to 2.7%YoY in 2Q on China concerns. Fund inflows have supported the equity market and helped eased depreciation. Taiwan will likely be affected by a China slowdown as well, and recent delays in ECFA have profund implcations.
- **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 students' demands 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 at 9,300.

2Q recovery momentum still affected by China

External uncertainties shifting. On the one hand, we think that a better US economy could come through to Taiwan, especially when new technology products launch. The persistent US$10bn Fed tapering per month and the continual stream of better US macro data lately are reinforcing this view. On the other hand, policy-engineered deceleration in China will have its ripple effects on Taiwan, especially on non-tech exports. The Chinese policy to rein in credit tightening, and the pushing ahead of other growth-hurting reforms, has led to 1Q GDP growth to slow by 0.3ppt to 7.4%YoY and we think GDP will likely slowdown further. Although we are seeing targeted policy easing (RRR cut for rural commercial banks, railway investment and extension of SMEs tax cut) being implemented in China, which in our view will likely prevent the economy from falling beyond 7% in 2QE; Taiwan trade data have already shown signs of percolating impact from the China slowdown.

Expected trade recovery likely to be dampened by slower demand from China. March exports indicated that demand from advanced economies indeed is picking up. US, Europe and Japan grew 10.3%YoY, 10% and 7.8%, respectively; the US purchased more machinery (+32.7%), Europe bought more minerals (+14%) and machinery (+25.1%), while Japan imported more chemicals (+36.6%). However, exports to China+HK fell 0.3%YoY in March, in line with other China indicators that are decelerating. This in turn weighed on non-tech exports, plastics, basic metals and chemicals, which all recorded growth declines in March.

A closer look at what percentage of Taiwanese exports is for China domestic use. Since China doesn't report re-export data, and it is difficult to track from a customs perspective which product group imported from one country was really used for additional processing and re-export; there really are no hard data to answer this very frequently-asked question. However, by examining the breakdown, we assess the products that are likely to be consumed in China, such as: perishable goods, prepared foodstuff/beverages, finished products of textile, iron/steel articles, electric appliances, vehicles, vessels, watches/clocks, games & sports, furniture; as well as mineral products and chemicals. As a result, we estimate that around 30% of what Taiwan exports to China would be consumed or used in China. What is left out of this list are mainly tech products (e.g. electronics, info/communication products, precision/optical instruments), machinery and electrical equipment – of which majority of these is likely to be processed and re-exported , suggesting there could be around 70% which could be used for re-exports. Using this rough guide, we believe a moderate and managed slowdown in China would therefore dampen but not derail Taiwan's export recovery.

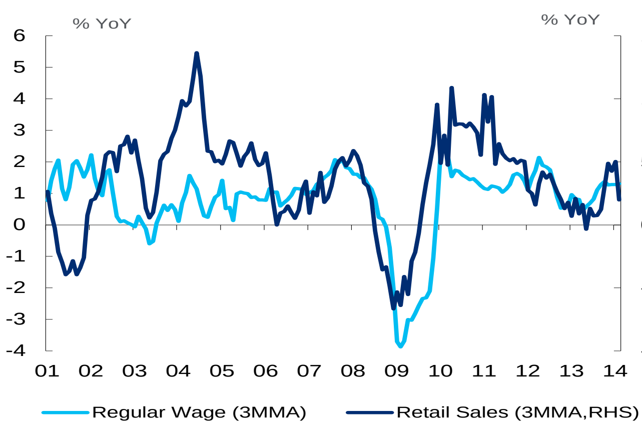
We think impact of a China slowdown on Taiwan's local/tourist consumption is small. Headline news in China could impact EM risk appetite and thus interest in Taiwan's asset market. Despite worries of China slowdown and its domestic political issues, Taiwan has outperformed Nasdaq by 7.1% and the S&P 500 by 4.6% since the beginning of the year, this in turn would be reflected in the consumer confidence index (which posted still a strong print of 81 in March) and could provide sentiment support for consumption. Moreover, nominal wage growth has recorded mild growth (of around 1.3%YoY) but steady improvement, and we think this trend is likely to be sustained as tech-related manufacturing activities and service sectors will likely keep employment growing. We therefore view that consumption would be incrementally supportive to GDP recovery in 2014. Tourism could also offer a material contribution to this year's consumption, although anti-corruption and growth moderation in China understandably would be negative for tourist spending, but we argue that a low comparison base and more first-time visits to Taiwan by Mainland Chinese tourists would still be a net boost (note that Tourism Bureau has recently raised the daily quota for Mainland Chinese individual visitors from 3,000 to 4,000). Of the total tourists that visited Taiwan in 1Q14, 40% were Mainland Chinese, and each Mainland tourist spends US$265/day (according to 2012 statistics, and it is reasonable to believe the daily per pax consumption amount has increased since).

The continual RMB depreciation will likely cause renewed depreciation of TWD. RMB has been the worst-performing EM currencies vs the USD since the end of January, and our forecasts suggest this should continue for the near term (6.30 in 0-3M). We believe fund inflows into the equity market was the main reason that have helped eased TWD depreciation in recent weeks, but our equity strategist Peter Kurz believes that some of the outperformance may be due to *Short Covering at a Peak* and 'very little short covering remaining for some of the leading stocks in the market'. For the near-term trend, we still see RMB weakness and still lukewarm recovery will likely continue to weigh on the TWD, allowing it to weaken to 30.5/USD in 0-3M. Longer term we believe China is likely to pull through this economic soft patch and growing trade surplus in China should allow the RMB to strengthen towards 6.08/USD in 6-12M, together with steady economic recovery in Taiwan, we see the TWD could move back to 30.2/USD in 6-12M.

Louder *Vox Populi* stalling policy implementation

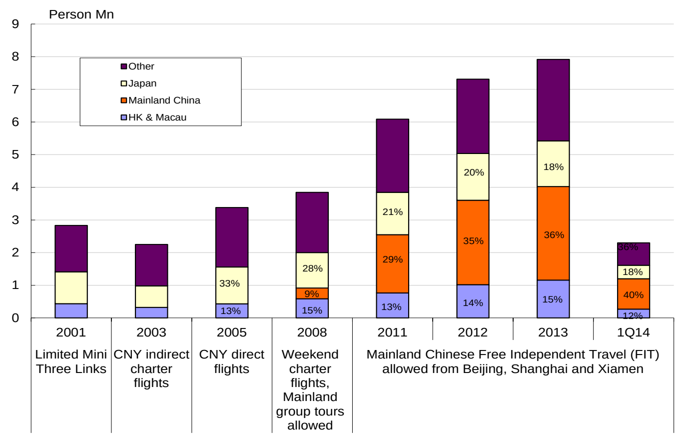
Pre-local elections tensions amid louder *Vox Populi* make policy implementation more difficult. As our political analyst Tina Fordham has pointed out, there is a growing 'taking it to the street' attitude in various EM countries, and 'protests often beat protests, and they become more common in the run-up to elections'. Taiwan has had its own versions recently, first with the 'Sunflower movement' (a 23-days student protest occupation of the legislative chamber and a related 500K-people rally) and the over 10K sit-ins and a protestor's hunger strike against the building of the fourth nuclear plant. Both protests have ended peacefully, but the remaining implication remains profound. The Sunflower movement has led to the need of passing of a new cross-strait agreements oversight legislation before the ECFA for Service agreement could be reviewed by the legislature on a clause-by-clause basis. We believe a meaningful review progress is unlikely before Nov local elections; thus there is likely to be a further delay in the signing of ECFA for goods to mid-2015, and this complicates applications for TPP and RECP. The safety of the fourth nuclear power plant that is currently under construction has met with public skepticism due to seismic hazards, and protests appear to have successfully make the ruling part agree to halt construction until a referendum on the issue is held later in the year. Although there is no immediate energy shortage in Taiwan till 2018, Taipower has warned that electricity price could increase by at least 10% if Taiwan decides to stop building the new nuclear plant.

Figure 93. Consumption (ex-CNY effects) on a general recovery path



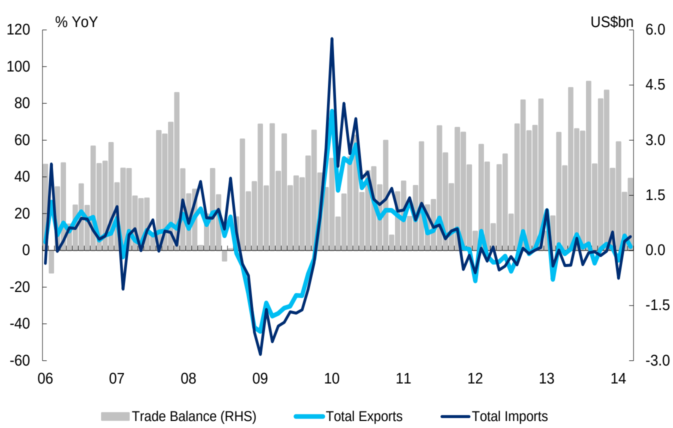
Source: CEIC, Citi Research

Figure 94. Rising Mainland tourists will add to consumption recovery



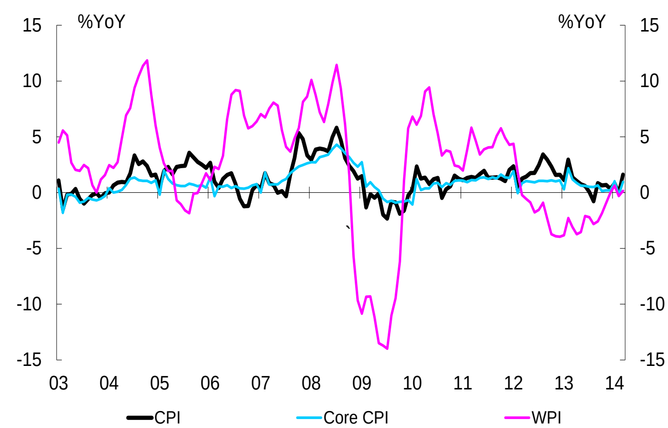
Source: CEIC, Citi Research

Figure 95. Gradual trade recovery likely to step up pace in 2H



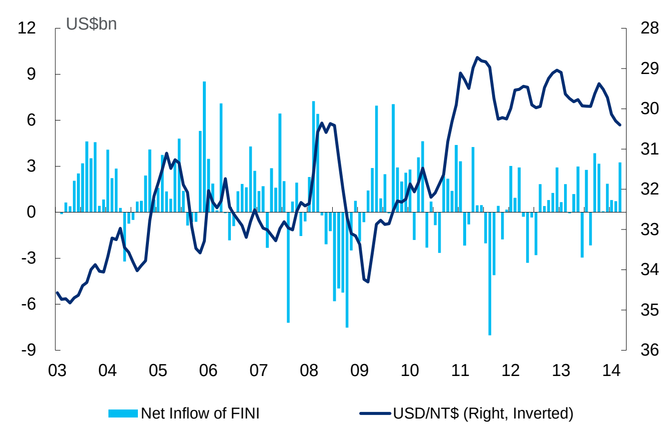
Source: CEIC, Citi Research

Figure 96. Benign inflation gives room for CBC's accommodation



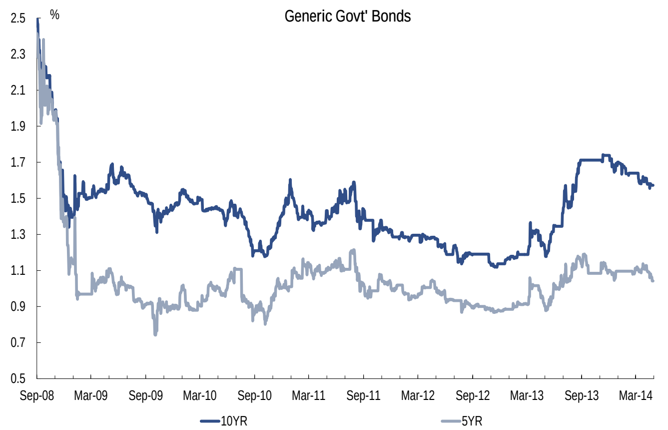
Source: CEIC, Citi Research

Figure 97. FINI inflows continued, pacifying TWD depreciation



Source: CEIC, Citi Research

Figure 98. 10Y govt bonds could rise again with US tapering



Source: CEIC, Citi Research

Figure 99. Taiwan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	393.0	400.2	378.0	430.3	466.5	476.3	490.8	500.9	536.6
Nominal GDP, local currency bn	12,911	12,620	12,481	13,552	13,709	14,077	14,564	15,214	16,094
GDP per capita, US$	17,118	17,370	16,348	18,579	20,084	20,429	20,996	21,388	22,866
Population, mn	23.0	23.0	23.1	23.2	23.2	23.3	23.4	23.4	23.5
Unemployment, % of labour force	3.9	4.1	5.8	5.2	4.4	4.2	4.2	4.0	3.9
Economic Activity									
Real GDP, % yoy	6.0	0.7	-1.8	10.8	4.2	1.5	2.1	3.2	3.8
Real investment growth % yoy	-0.7	-7.9	-21.2	36.8	-6.8	-4.6	3.5	5.0	3.6
Real consumption growth % yoy	2.1	-0.6	1.3	3.3	2.9	1.5	1.4	1.6	2.1
private consumption growth % yoy	2.1	-0.9	0.8	4.0	3.1	1.6	1.8	1.8	2.7
Real export growth, % yoy	9.6	0.9	-8.7	25.6	4.5	0.1	3.8	4.6	6.2
Real import growth, % yoy	3.0	-3.7	-13.1	27.7	-0.5	-2.2	4.0	3.7	5.2
Prices, Money & Credit									
CPI, % yoy	3.3	1.3	-0.2	1.2	2.0	1.6	0.3	2.5	2.8
CPI, % avg	1.8	3.5	-0.9	1.0	1.4	1.9	0.8	1.2	2.0
Nominal wages, % yoy	2.1	-0.1	-5.0	5.3	2.6	0.1	0.2	1.5	3.0
Credit extension to private sector, % yoy	3.9	2.7	-0.8	6.7	5.6	4.1	5.3	7.0	8.5
Policy interest rate, % eop	3.38	2.00	1.25	1.63	1.88	1.88	1.88	1.88	2.38
Short-term market rate, % eop	2.04	1.02	0.57	0.74	0.87	0.87	0.87	0.93	1.17
Long term yield, % eop	2.53	1.44	1.47	1.47	1.27	1.15	1.69	1.66	2.04
lc/US$, eop	32.43	32.78	32.23	29.17	30.29	29.06	29.83	30.23	29.90
lc/US$, avg	32.85	31.58	33.04	31.50	29.40	29.57	29.68	30.38	30.02
Balance of Payments, US$ bn									
Current account	35.2	27.5	42.9	39.9	41.7	50.7	57.4	55.1	54.7
% of GDP	8.9	6.9	11.4	9.3	8.9	10.6	11.7	11.0	10.2
Trade balance	27.4	15.2	29.3	23.4	26.8	30.7	35.5	38.7	51.0
Exports	246.7	255.6	203.7	274.6	308.3	301.2	305.4	320.9	352.0
Imports	219.3	240.4	174.4	251.2	281.4	270.5	269.9	282.2	301.1
Service balance	-1.6	1.8	2.0	2.5	3.9	6.3	10.4	11.0	6.7
Income balance	10.1	10.0	12.5	13.6	13.2	15.3	14.1	17.0	19.0
FDI, net	-3.3	-4.9	-3.1	-9.1	-14.7	-9.9	-10.3	-10.0	-9.0
International reserves	270.3	291.7	348.2	382.0	385.5	403.2	416.8	440.0	460.0
Total Amortisations	3.8	8.8	2.5	3.2	6.8	3.4	2.9	3.0	3.0
Public Finances, % of GDP									
Consolidated government balance	0.9	0.9	-2.2	-1.2	-0.5	-1.4	-1.4	-1.4	-0.8
Consolidated gov primary balance	1.9	1.9	-1.2	-0.3	0.4	-0.5	-0.5	-0.6	-0.5
Public debt	33.3	34.7	38.0	38.3	40.0	40.9	39.9	39.6	39.3
of which Domestic	33.3	34.7	38.0	38.2	40.0	40.8	39.9	39.6	39.3
Foreign Assets & Liabilities, US$ bn									
External debt	94.5	90.4	82.0	101.6	122.5	130.8	150.0	160.0	150.0
Private	91.1	88.9	76.0	93.5	118.0	127.5	146.3	156.0	146.0
Public	3.5	1.5	5.9	8.0	4.5	3.3	3.7	4.0	4.0
External debt / GDP	24.1	22.6	21.7	23.6	26.3	27.5	30.6	31.9	28.0
External debt / XGS	33.4	30.9	34.7	32.0	34.6	37.4	41.9	43.2	37.0
Short-term debt	83.3	78.8	68.2	83.7	107.8	116.5	125.0	130.0	120.0
Short-term debt/International Reserves (%)	30.8	27.0	19.6	21.9	28.0	28.9	30.0	29.5	26.1

Quarterly Economic Indicators

	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.3	2.9	3.0	2.7	3.3	3.9	4.0	3.3	3.7
CPI, % yoy	0.8	0.3	1.6	0.6	0.7	2.5	0.9	1.7	2.3
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	2.00	2.13	2.25
Short-term market rate, % eop	0.87	0.87	0.87	0.87	0.87	0.93	0.99	1.05	1.11
Long term yield, % eop	1.69	1.68	1.56	1.58	1.61	1.66	1.74	1.84	1.94
lc vs USD, eop	29.56	29.83	30.45	30.46	30.34	30.23	30.14	30.06	29.98

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 forecast at 1.8%, starting with a stagnant 1Q GDP. Another decline in domestic demand (-1%QoQ SA) underpins a 2.3%QoQ SA drop in 1Q GDP. Other than lackluster domestic demand, severe de-stocking probably accounted for an absence of 1Q GDP growth.

- **Things to watch** – Court decision on PM Yingluck's role in the removal of a senior NSC official. NACC's findings on PM Yingluck's role in the rice-pledging scheme. New date for elections. Core CPI's shift to disinflation. Whether export gains could provide a lift to mfg output in the near-term and firm up the capex rate.

- **Strategy** – MPC likely to talk dovishly during the period of prolonged drift but with overnight rates unchanged unless we see a marked deterioration in data. During a prolonged period of political drift, dovish a MPC amid strong USD pressures over the medium term, a THB closer to 33 remains a key risk.

Domestic demand shrunk with de-stocking risk in 1Q14

Political solution to the crisis of authority remains elusive. Past Songkran holidays, either Court intervention risk or the NACC'S decision could potentially change the head of the caretaker gov't at a time when the Election Commission has yet to determine the date for new general elections and obtain broad-based pledges from political parties to participate. War drums from the red-shirt group are likely to beat loudest if PM Yingluck is removed from office without a firm election date. Former PM Abhisit has 'volunteered' to end the political deadlock but the offer to help at this juncture may be interpreted as 'opportunistic' and a wee bit late.

Domestic demand weakness mirrored by double-digit import declines in Jan-Feb highlight the likelihood of absence of 1Q GDP growth. BoT's economic indicators during the first two months of the year featured an average 2%YoY drop in private consumption (same as our 1Q forecast) and an average 7.8%YoY decline in private spending. If we incorporate this into our forecasts, we obtain a 3.3%YoY collapse in domestic demand for the third straight quarter. Net exports probably grew by close to 50%YoY as imports plunged by double digits consistent with Jan-Feb trade data.

We believe that de-stocking intensified and, alongside domestic demand weakness, real GDP was stagnant (0%) in 1Q14 (vs 0.6%YoY growth in 4Q13). Drought affecting some farm areas, lack of recovery from shrimp disease and delayed rice payments to farmers, probably constrained farm production and inventory lift implications. Persistent softness of external demand in 1Q14 and a severe slump in local sentiment and onshore spending probably led to a significant reduction in inventory levels, particularly in manufacturing, only to facilitate slower production gains. The inventory to shipment ratio index of mfg continues to flag an excess inventory overhang as the index grew 11.3%YoY in Feb after a 16%YoY growth in Jan. Hefty re-stocking' of roughly 3.9% of real GDP in 4Q13 could spur 1Q14 de-stocking. We sense an unanticipated inventory increase in 4Q13 when GDP growth eased materially to 0.6%YoY. Potential de-stocking in 1Q14 could be as high as 2.8% of GDP.

We estimate seasonally-adjusted 1Q real GDP declined by 2.3%QoQ SA. Domestic demand ex-inv probably fell by a seasonally adjusted 1%QoQ SA during the quarter. If so, it's the third straight quarterly drop for domestic demand. With the collapse in imports, net exports probably grew 39%QoQ SA, roughly 24% of 1Q GDP.

Higher savings propensity as consumer sentiment slumps

If we manipulate the GDP accounts to determine what's compressing demand, **we see the sharp rise to 4Q13 gross domestic savings (GDS) to GDP could reflect consumer concerns on economic conditions, income and employment since 2Q13.** GDS to GDP stood at 42% in 4Q13 — the second highest ratio estimate. The savings to GDP trend stood at 38.9% in 2013 up from 37.8% in 2012. Simple scatter plot diagram indicated an inverse relationship between the GDS ratio and GDP QoQ growth. During quarters of declining quarterly gains particularly in the great recession of 2009 — highlighted by global trade collapse, the savings ratio (4Q rolling sum) rose sharply to nearly 40%, which we interpret as the average consumer's defensive reaction — stick to the basics (or slash discretionary spending) against macro uncertainty. Fiscal spending and rate cuts, even if we assume policy effectiveness, are unlikely to change the consumers' mindset until the fear triggers bedeviling consumption disappears. In 4Q13, the savings ratio uptrend mirrored consumer fears that higher political risk premia and weak global markets would take its toll on the economy. Our 1Q GDP forecast that assumes another consumption drop implied a GDS ratio edging up to 42.7% – a new high.

Still missing core's shift to disinflation

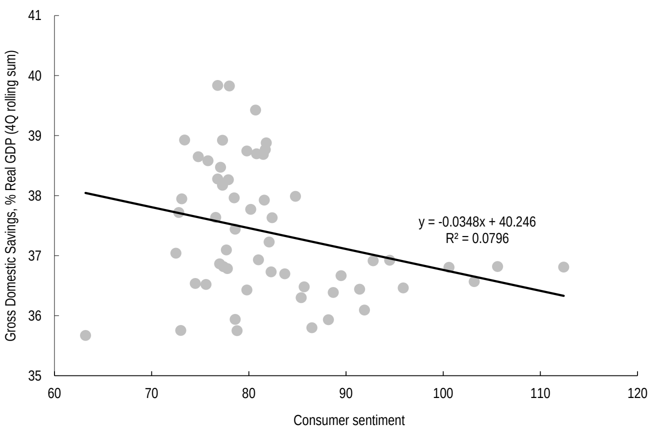
While not yet in print, we believe core's shift to disinflation may be coming soon to justify BoT's cumulative 50bp rate cut to 2%. Difficult to see how core inflation would persist edging up when the general macro — particularly consumer, backdrop is bearish. As of end-Mar, core stood at 1.31%YoY for a first quarter average of 1.2% up from last year's average of 1%. Among the components of core, CPI prepared food rose sharply in Mar-largely driven by prepared food outside the home. Costs of food preparation rose since raw food CPI had been rising led by rice, with imported foodstuffs more expensive due to weak THB. Excluding CPI prepared food in core CPI we noted the narrow core measure inched up in Mar. Contrast prepared food with non-food CPI that eased to sub-1%YoY in 1Q14 while posting seasonally adjusted monthly declines in Feb-Mar. Morever, we estimated an annualized rate for core CPI down sharply to 0.75% in Mar from 2% or more since Oct (except in Dec).

Inflation outlook (12M) however appear to be in sync with bearish macro as it's retreat persisted according to BoT's monthly survey. Inflation expectations eased to 3% in Feb — a consistent waning path since Aug 2013. The Feb estimate retraced the lows of inflation expectations in 2Q10. We sense expectations may be in sync with the lackluster demand backdrop and in tune with households/ consumers fears that the worst for the economy on the back of unresolved political crisis, has yet to come. While inflation print has yet to confirm disinflation, policymakers may have turned to retreating inflation expectations despite strong USD pressures, as a gauge of policy space to undertake rate easing.

THB's breakout to 33 remains a risk

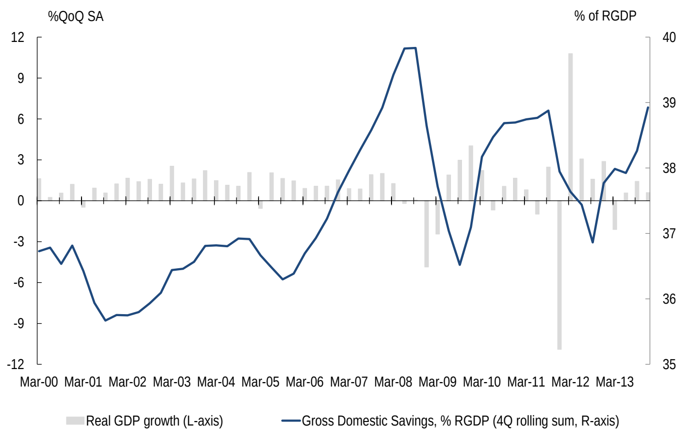
Lacking a political solution, we expect **MPC would persist in its dovish signals amid unchanged overnight rates unless forward looking data shows further macro deterioration.** We believe blaming the political crisis for higher downside risks to growth helps create realistic expectations on what monetary policy can accomplish when non-economic issues comprised the drag. As such, the rate differential doesn't bode well for THB. No political solution in sight as downside growth risk implications sustain market bias for bonds causing local bond yields to back up against tapering risk and rising UST. During a prolonged period of political drift, dovish MPC amid strong USD pressures over the medium-term, a THB closer to 33 remains a key risk.

Figure 100. Savings propensity surges on slumping consumer sentiment



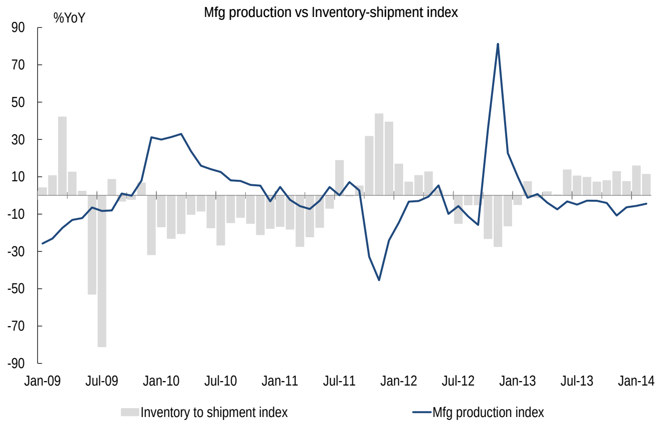
Source: CEIC, Citi Research

Figure 101. Savings propensity surge when quarterly GDP declines



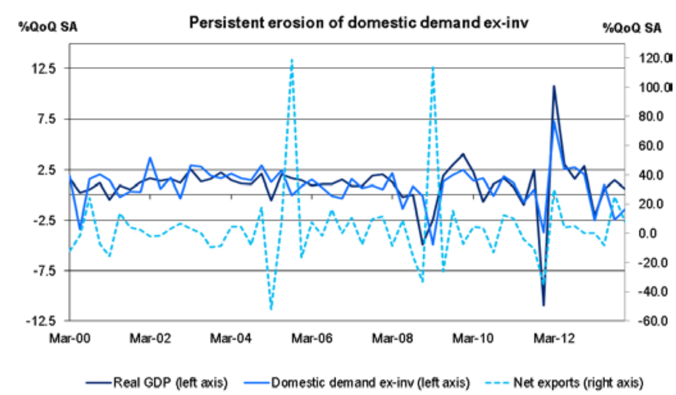
Source: CEIC, Citi Research

Figure 102. De-stocking to ease excess inventory likely to curb 1Q GDP



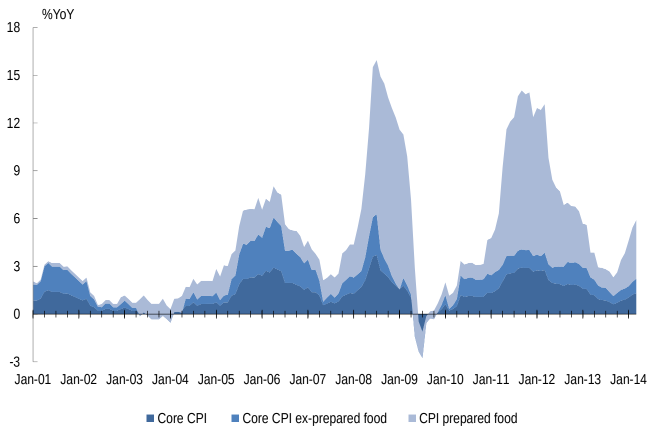
Source: CEIC, Citi Research

Figure 103. Domestic demand in 1Q14 probably declined 1%QoQ s.a.



Source: Citi, CEIC Research

Figure 104. Higher CPI prepared food behind rising core



Source: CEIC, Citi Research

Figure 105. Softer inflation outlook in sync with lower utilization rate

Source: CEIC, Citi Research

Figure 106. Thailand Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	265.2	276.1	263.8	319.3	346.1	366.4	387.8	373.8	394.5
Nominal GDP, local currency bn	8,525	9,080	9,042	10,105	10,540	11,375	11,897	12,450	13,307
GDP per capita, US$	4,207	4,355	4,153	4,998	5,401	5,685	5,987	5,742	6,029
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	-7.9	2.9
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	3.3	5.1
Real import growth, % yoy	4.4	8.9	-21.5	21.5	13.7	6.2	2.3	-1.1	3.9
Prices, Money & Credit									
CPI, % yoy	3.1	0.4	3.5	3.1	3.5	3.6	1.7	2.5	2.7
CPI, % avg	2.2	5.5	-0.9	3.3	3.8	3.0	2.2	2.3	2.7
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	3.65	4.50
lc/US$, eop	30.05	34.79	33.36	30.07	31.57	30.60	32.70	33.13	33.05
lc/US$, avg	32.33	33.03	34.33	31.71	30.48	31.08	30.72	32.76	33.11
Balance of Payments, US$ bn									
Current account	15.7	2.2	21.9	10.0	8.9	-1.5	-2.8	8.3	-4.3
% of GDP	5.9	0.8	8.3	3.1	2.6	-0.4	-0.7	2.2	-1.1
Trade balance	26.6	17.3	32.6	29.8	17.0	6.0	6.4	16.2	2.5
Exports	151.3	175.2	150.8	191.6	219.1	225.9	225.4	233.7	246.5
Imports	124.6	157.9	118.2	161.9	202.1	219.9	219.0	217.4	244.1
Net service and Transfer accounts	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	3.7	-0.6	-0.8
Income balance	-3.0	-2.3	-4.4	-9.0	2.5	-4.0	-12.8	-7.3	-6.0
FDI, net	8.3	4.4	0.7	4.5	-2.8	-2.2	6.4	1.2	1.0
International reserves	87.5	111.0	138.4	172.1	175.1	181.6	167.2	170.0	180.0
Total Amortisations	20.3	15.4	11.3	9.4	8.8	9.5	18.0	19.0	20.0
Public Finances, % of GDP									
Consolidated government balance	-1.6	-1.0	-5.7	0.0	-1.0	-2.1	-1.8	-1.2	-1.8
Consolidated gov primary balance	-0.3	0.2	-4.5	1.1	-1.5	-1.6	-1.2	-0.3	-0.7
Public debt	38.3	37.3	45.2	42.6	41.7	45.4	45.9	47.2	48.1
of which Domestic	33.4	33.0	40.9	39.0	38.4	42.3	42.7	43.0	43.3
Foreign Assets & Liabilities, US$ bn									
External debt	74.4	76.1	75.3	100.6	104.3	130.7	139.9	135.0	140.0
Private	71.6	72.7	69.4	87.9	88.1	104.5	114.7	108.4	112.9
Public	2.8	3.4	5.9	12.7	16.2	26.2	25.2	26.6	27.1
External debt / GDP	28.1	27.6	28.5	31.5	30.1	35.7	36.1	36.1	35.5
External debt / XGS	41.0	36.5	41.6	44.5	40.0	47.5	49.2	45.5	44.6
Short-term debt	33.7	32.5	33.3	50.7	47.3	58.2	59.9	59.8	61.0
Short-term debt/International Reserves (%)	38.6	29.3	24.0	29.4	27.0	32.0	35.8	35.2	33.9

Quarterly Economic Indicators

	2013 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	2.55	2.10	2.10	2.10	2.30	2.60	2.80
Long term yield, % eop	4.21	4.07	3.80	3.60	3.60	3.65	3.85	4.00	4.25
lc vs USD, eop	31.24	32.70	32.43	32.60	32.87	33.13	33.17	33.13	33.09

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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Government turning proactive to boost economy. On the Oyu Tolgoi phase II, the government has passed the ball back to Rio's court and said Mongolia is willing to proceed with project financing. Project financing now aims for a Sep-end deadline, and local consensus believes that this date could be met. The Government is also actively seeking ways to boost other non-OT investments. It is widely expected that the parliament bills on amending the Minerals Law, Guidelines in Implementing the Minerals Law, Law on Specially Protected Lands, and annulling the ban on issuing explorations licenses will all be passed in the current parliament session (which ends in June). The government is also seeking to promote Tavan Tolgoi and railway related investments.

Naturally phasing out QE and fiscal plans to make DBM spending on-budget. We understand from BoM that it intends to gradually phase out its non-conventional spending programs, which includes the remaining 70% price stabilization program (total: MNT700bn) over the next 1.5-3 years, and by May14 the entire MNT900bn of liquidity injection (central bank placed time deposits at banks) will expire. The MNT1.5trn mortgage program (where BoM subsidized banks at 4% interest rate for the 8% affordable housing mortgages), however, will continue. We are also encouraged to learn from the MoF that they are planning to cut expenditure on all fronts to match revenues, update the 2014 budget latest by June to comply with FSL and make DBM spending on-budget by 2017E. We view these new developments positively, but urge both BoM and MoF to do the above mentioned ASAP. We also see room for interest rate hike in 2H14E as inflation is likely to rise further with MNT depreciation.

Balance of payment stress showing a turning point, but international reserves have yet to turn around. March trade balance has turned back into its first surplus since Dec 2010, FDI for the first two months were also remarkable. We believe the clearing of logistic bottleneck will clear copper & gold inventories at OT Phase I and thus growth of these commodity exports could accelerate till August. While with the MNT depreciated to 1800 record low will continue to constrain durable and consumer imports growth and previously accumulated diesel fuel will lower import needs for the remaining 1H of the year. International reserves has yet to turn around (Feb is at US$2.2bn, according to BoM). The buffer from the RMB swap line continues to act as the auxiliary reserves, and our understanding form the BoM is that less than 50% is used, and BoM is seeking to double its swap line to US$20bn in May when it extends it 3 year agreement.

Sri Lanka

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Improvement in external position not as strong as we had earlier expected. In our earlier investor trip, we understood from CBSL that the current account deficit (CAD) was going to be ~3% of GDP. However, the 2013 Report reveals that the CAD is larger at US$2.6bn or 3.9% of GDP, which is still a significant improvement from the revised CAD of US$4.0bn (6.7% of GDP) in 2012. Our main source of confusion was the services account – gross transport services was up only 9% YoY (and -13% YoY on net basis) and despite strong tourism receipts, surplus in net services balance in 2013 declined 6.5% YoY (first decline since 2009), contrary to indications we were getting. There was also a larger than expected net primary income deficit in 2013, which seems to have been driven by larger-than-expected repatriated dividends/earnings. *We still think that the CA improving story holds but now assume a more conservative path (3.3% and 3.1% of GDP in 2014F & 2015F, respectively).*

Net FDI is also a disappointment. We expected net FDI to break above US$1bn last year (CBSL reported that gross FDI inflows in Jan-Sep was up 41.5%yoy), but the actual BoP for net FDI (ex-loans) was a disappointing US$851mn in 2013 vs. revised US$871mn in 2012 (-3% YoY), covering only a third of the CAD last year.

We need to watch implications of a drought. Feb and Mar were particularly dry, and this not only impacts crop production (tea production down 1.2% YoY in Jan-Feb) but also hydropower supply. Ceylon Electricity Board (CEB) has been seeing rising losses – after a Rs24.6bn profit in 2013 (vs. Rs62.1bn loss in 2012), it has reportedly incurred a loss of Rs24.3bn in 1Q 2014 alone given its shift to more costly thermal power. Another electricity hike may be forthcoming, we slightly adjust inflation forecast upwards, and we think CBSL will pause for now.

No major surprises in the fiscal numbers; Weak revenues a problem – The 2013 budget deficit and public debt estimate of 5.9% of GDP and 78.3% of GDP, respectively, is in line with earlier guidance. Declining revenue- (and tax-) to GDP ratio remains a concern (Fig 4), but government has demonstrated ability to cut spending (recurrent and capital spending below target by 5% and 9%, respectively) to keep deficit in check. We expect them to exceed their deficit target this year. Sri Lanka increased its access to concessional borrowing in 2013 diversifying their funding, but this should reverse this year after it tapped the market with US$1.5bn of dollar bonds.

Vietnam

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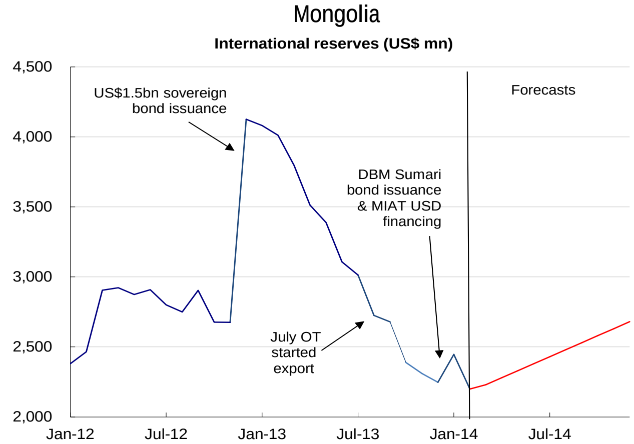
1Q real GDP growth off to a weak start — may have prompted the rate cut last month. 1Q14 real GDP growth of 5.0% is the fastest pace of 1Q expansion since 2010, but is still disappointing – we saw sharp contraction in mining (led by decline in coal, crude oil and gas production), and decelerating growth in manufacturing and construction (consistent with very weak credit growth, +1.35% ytd as of March 2014). With inflation being very subdued, this supports SBV's move to cut rates last month and we think we could see more. We expect economic activity will pick up led by exports, and spillover to domestic demand. However, while export growth should remain robust (HSBC PMI New Orders in March were the strongest in 5 months), the domestic value added looks low – spillovers on local firms linking up to the supply chains of foreign-invested companies remains limited, and thus, should hold back domestic demand.

Structural reforms are urgently needed. Unfortunately, the government delayed issuing a decree to ease foreign ownership limit in listed companies (to 60% from 49%). SOE privatization is very slow, one difficulty being the ability to properly evaluate SOE assets. There have been headlines on bank restructurings – e.g. Sacombank (5th largest lender) getting shareholder approval to merge with Southern Bank (PNB), BIDV (3rd largest lender) planning to sell up to 30% stake to a foreign investor & Vietcombank (4th largest lender) planning to acquire a bank, but timing and impact is unclear. Moody's recently noted, VAMC's operation boosted bank liquidity but failed to inject much needed capital, economic risks of problem loans still lying with the banks, and thus, haven't fundamentally resolved anything.

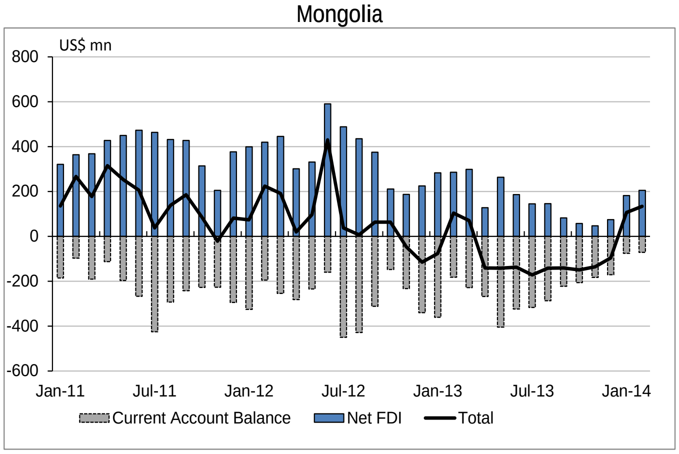
Pressure to provide more fiscal support remains high. The National Assembly late last year allowed fiscal budget deficit limit to widen to 5.3% of GDP, similar to the realized ratio in 2013, with plans to issue VND367trn ($14.5bn) of bonds (of which US$4.5bn will be foreign borrowings) this year vs. VND194.8trn in 2013 (but on a net basis, issuance will be half of that). While domestic liquidity has been able to absorb supply (helped further by VAMC's NPL purchases), the government's debt ratio continues to edge higher and could cap the rally in bond yields.

Figure 107. Mongolia – Reserves improvement has yet to come



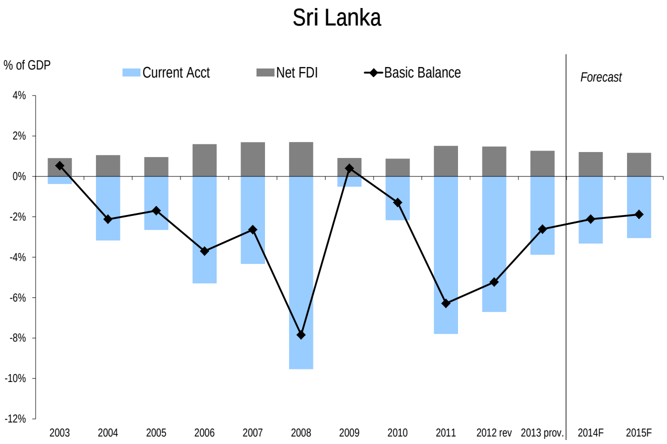
Source: BoM, CEIC and Citi Research

Figure 108. But FDI and trade balances are improving



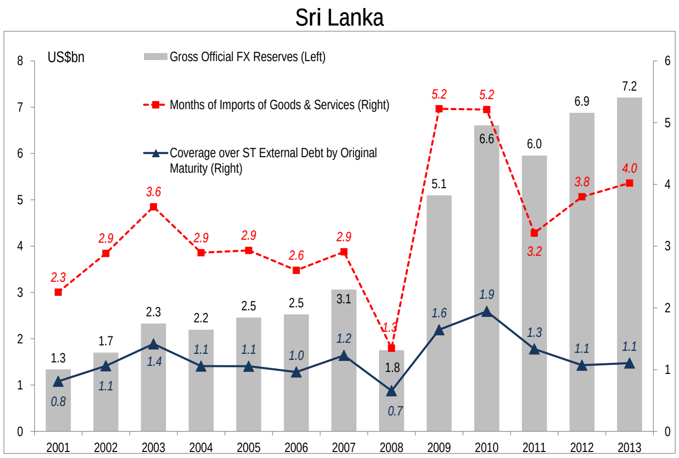
Source: BoM, CEIC and Citi Research

Figure 109. Sri Lanka – Basic balance deficit did not improve as much as we thought



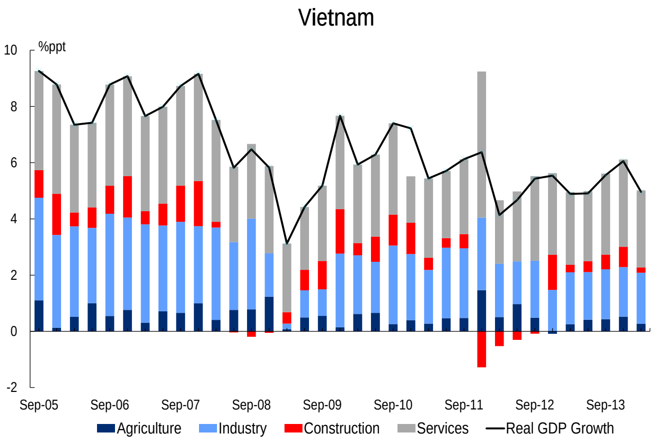
Source: CBSL, CEIC and Citi Research

Figure 110. External liquidity position didn't improve much when looking at ST external debt coverage



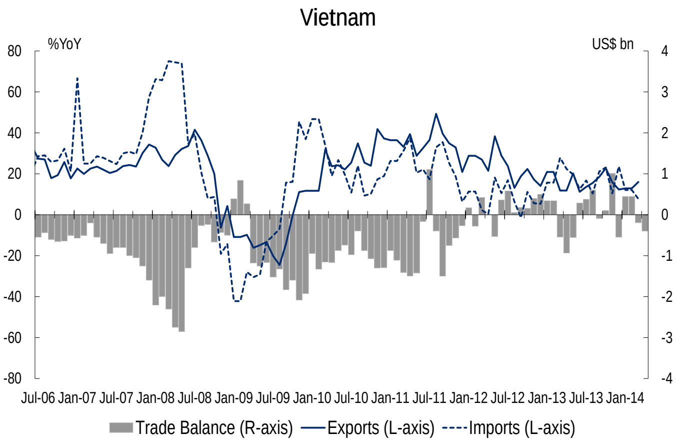
Source: CBSL, CEIC and Citi Research

Figure 111. Vietnam – Real GDP growth looks weak in 1Q14, led by sharp deceleration across most sectors except services



Source: CEIC, Citi Research

Figure 112. Despite strong export growth, the domestic value added still looks low, impeding its growth contribution



Source: CEIC, Citi Research

Figure 113. 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	15.6
GDP per capita, US$	1,629	2,138	1,717	2,287	3,186	3,595	3,525	4,131	5,173
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	13.3	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$, eop	1,172	1,275	1,433	1,233	1,378	1,378	1,660	1,719	1,651
lc/US$, avg	1,171	1,167	1,434	1,349	1,256	1,353	1,505	1,761	1,677
Current account (US$ bn)	0.3	-0.7	-0.4	-0.9	-3.4	-2.8	-3.2	-1.7	-2.5
% of GDP	6.3	-12.8	-8.9	-15.0	-38.4	-26.8	-31.0	-13.8	-16.1
Trade balance (US$ bn)	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-2.1	-0.1	-0.6
Exports (US$ bn)	1.9	2.5	1.9	2.9	4.8	4.4	4.3	4.7	5.5
Imports (US$ bn)	2.2	3.2	2.1	3.2	6.6	6.7	6.4	4.8	6.1
FDI, net (US$ bn)	0.4	0.8	0.6	1.6	4.6	3.9	-2.0	2.6	3.4
International reserves (US$ bn)	0.8	0.6	1.3	2.2	2.3	3.9	2.2	2.7	3.3
Consolidated government balance (% of GDP)	2.6	-4.5	-5.2	0.5	-6.9	-9.9	-7.8	-7.4	-4.3
Public debt (% of GDP)	36.0	30.6	44.2	28.7	28.9	42.1	67.3	69.4	69.3
Sri Lanka									
Nominal GDP, US$ bn	32.4	40.7	42.1	49.6	59.2	59.4	68.0	74.6	85.7
GDP per capita, US$	1,617	2,014	2,057	2,400	2,836	2,923	3,319	3,613	4,120
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	7.8	6.0
CPI, % avg	15.8	22.5	3.6	6.2	6.8	7.5	6.9	5.5	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	131.1	129.9
Current account (US$ bn)	-1.4	-3.9	-0.2	-1.1	-4.6	-4.0	-2.6	-2.5	-2.6
% of GDP	-4.3	-9.5	-0.5	-2.2	-7.8	-6.7	-3.9	-3.3	-3.1
Trade balance (US$ bn)	-3.7	-6.0	-3.1	-4.8	-9.7	-9.4	-7.6	-7.8	-8.3
Exports (US$ bn)	7.6	8.1	7.1	8.6	10.6	9.8	10.4	11.2	12.0
Imports (US$ bn)	11.3	14.1	10.2	13.5	20.3	19.2	18.0	19.0	20.3
FDI, net (US$ bn)	0.5	0.7	0.4	0.4	0.9	0.9	0.9	0.9	1.0
International reserves (US$ bn)	3.1	1.8	5.1	6.6	6.0	6.9	7.2	7.3	7.9
Consolidated government balance (% of GDP)	-6.9	-7.0	-9.9	-8.0	-6.9	-6.4	-5.9	-5.6	-5.3
Public debt (% of GDP)	85.0	81.4	86.1	81.9	78.5	79.2	78.3	77.0	76.0
Vietnam									
Nominal GDP, US$ bn	77.5	98.3	101.6	112.8	133.4	155.7	169.8	174.3	196.7
GDP per capita, US$	920	1,154	1,181	1,297	1,518	1,754	1,895	1,926	2,154
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	6.4	7.0
CPI, % avg	8.3	23.1	7.0	9.2	18.6	9.3	6.6	5.4	6.8
Policy interest rate, % eop	6.50	9.50	8.00	9.00	15.00	9.00	7.00	6.00	6.00
Long term yield, % eop	8.73	10.00	11.68	11.49	12.55	9.75	9.29	7.50	8.50
lc/US$, eop	16,028	17,483	18,474	19,498	21,034	20,840	21,095	21,036	21,036
lc/US$, avg	16,081	16,445	17,806	19,123	20,648	20,875	21,028	21,063	21,036
Current account (US$ bn)	-7.1	-10.8	-6.6	-4.3	0.2	9.1	8.9	7.1	5.6
% of GDP	-9.1	-11.0	-6.5	-3.8	0.2	5.8	5.3	4.1	2.9
Trade balance (US$ bn)	-10.4	-12.8	-7.6	-5.1	-0.5	9.5	9.4	8.6	6.9
Exports (US$ bn)	48.6	62.7	57.1	72.2	96.9	114.5	133.3	157.3	180.9
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	33.3	35.8	40.8
Consolidated government balance (% of GDP)	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-5.3	-5.3	-4.5
Public debt (% of GDP)	40.9	39.4	46.9	44.6	43.2	46.6	45.7	41.3	45.0

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

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CEEMEA

Czech Republic

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- **Summary view** — If we see continuous positive development in 2Q14, it would be a signal for us to raise our 2014 GDP forecast, which is currently overshadowed by the Ukraine crisis. However, we slightly increase our GDP forecast for 2015-16.

- **Things to watch** — First, CNB expects the adjusted core CPI to increase 0.4%YoY in 2Q14 after -0.2% in 1Q14. Second, the fiscal development and active finance management is likely to lead to a cut in 2014's MinFin's GBR.

- **Strategy** — We expect the CNB to start exiting its FX intervention in 2Q15 with a lower desired level of EURCZK from 27+ currently, but we see a risk that the hike in CNB policy rate occurs later than 4Q15.

We keep our 2014 forecast unchanged, 2015F slightly up

What has changed since last month? We see higher oil prices in USD terms, lower EURUSD on a 9-month horizon and better foreign demand outlook. Locally, we saw lower long-term yields, better real economic activity in first two months of 2014 and ongoing solid performance of the central state budget. We believe the April data do not point to a more hawkish CNB. First, eventually better fixed investment is probably disinflationary. Second, though both industrial and construction wage data suggest they will grow 4-5% in 1Q14, it would partly compensate for a negative surprise from 4Q13. Third, CPI was slightly below CNB´s forecast.

We maintain our 2014 growth forecast at 1.9%YoY, but increased 2015F and 2016F to 2.6% and 3% respectively (from 2.5% and 2.9%). Though below what the April confidence indicator suggests (2.1%), the indicator is below our forecast of 2.2% for 1H14. Though it is better than a month ago, this is not a signal for the CNB to start to think about tighter monetary policy as it is slightly below its forecast of 2.2% growth, but it could be a signal for the government to be more open to a cyclical improvement of the fiscal stance, in our view. We continue to expect average quarterly value-added growth of 0.6% in 2014. With better industrial activity, retail sales and higher manufacturing capacity utilisation, we continue to believe that strong fixed investment and private consumption were not temporary and will not be fully offset by the weaker 1Q reading. Moreover, the terms of trade have continued to improve, which is supportive for real domestic income and thus the demand side. If we see continuous positive development in industrial production and construction activity in 2Q14, it would be a signal for us to raise our GDP forecast, which is now overshadowed by the Ukraine crisis. However, we slightly increased our of GDP growth forecasts for 2015-16 owing to better foreign demand outlook and as both fiscal and monetary policy probably will be pro-cyclical.

An almost broad-based improvement in April confidence suggests ongoing positive data from the real economy in the near-term. Industrial confidence improved in April, supported by better assessment of orders, but foreign orders worsened after a weak improvement in 1Q14. While industrial confidence suggests only 3.8%YoY growth in industrial output, this is countered by the manufacturing PMI, which points to a 7% pace in growth: on balance, this points to around 5.8%YoY growth, which is below our forecast of 6.3% growth in 1H14. Construction confidence has improved as well, but still suggests that recent positive YoY growth in construction output has probably been weather-related; however, we also expect to see some improvement in this sector. Though consumer and retail confidence have improved, services sector confidence has worsened, and we see implied retail sales growth as solid at around 2-3%YoY.

Higher CPI outlook, smaller fiscal deficits

We have kept our inflation outlook unchanged, but there are asymmetric risks — disinflationary in short-term, offset by higher global oil prices owing to the Russia-Ukraine crisis and our lower forecast of EURUSD at 1.35 on a 9-month horizon (previously 1.4). Our CPI forecast remains below the CNB's projection for both 2014 and 2015, but with negligible monetary policy implications (there is upside risk to our 2015 forecast if our forecast of weaker USD does not materialise). In the near-term, we see a downside risk to our forecast for April inflation of 0.1%MoM, which would bring the YoY rate to 0.2%, as was the case in the previous three months. This reflects the disinflationary pressures from the non-core component and would increase the chance of inflation undershooting the CNB's February forecast, which looks for CPI growth of 0.4%YoY in 1Q14. While this CNB forecast is likely to be again undershot in 2Q14 (CNB forecasted 0.8%YoY) owing to lower regulated and fuel prices, all eyes will be on the core price segment, which the CNB expects to increase by 0.4%YoY in 2Q14 after -0.2% in 1Q14.

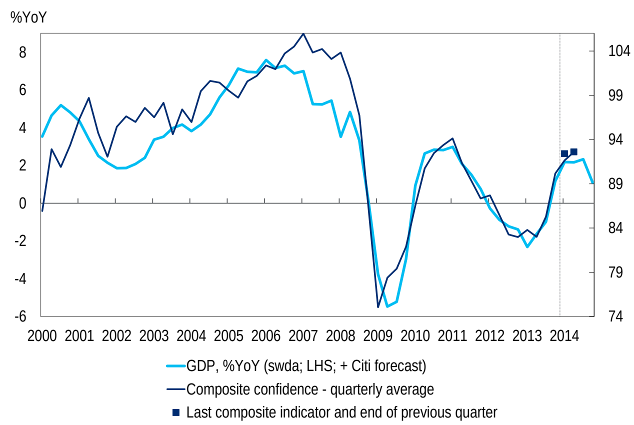
On the fiscal front, MinFin expects the general government deficit to widen to 1.8% in 2014 from -1.4% in the previous year. It expects the structural deficit will widen to -1.8% of GDP from -0.3% last year. More importantly, MiFin lowered its estimate of general government debt to 44% of GDP in 2014 from their previous forecast of 47.6%. This is below our forecast of 45%. This reflects three factors: i) narrower deficit in 2014 (-1.8% of GDP vs. -2.7% initially forecasted); ii) 1.2% larger nominal GDP level in 2014 than previously forecasted; iii) and an unspecified change in liquidity management of state debt.

FX forecast unchanged, but higher risk of higher volatility

We expect EURCZK at 27.5 on 3M, 27.7 on 9M and 26.5 on 2years. Our forecast still reflects a negative view on EM once the US Fed is closer to the end of tapering and closer to hiking its policy rate. Locally, for the time being, we see no reason to change our expectation that the CNB will start exiting its current intervention mode in 2Q15. However, this does not mean the end of FX intervention, but rather a gradual decrease in the CNB's desired level of EURCZK to 26 later in 2015 from 27+ currently. But we see a risk of hike in CNB's policy rate later than in 4Q15 owing to the possibility of more pronounced ECB easing. Our forecast looks dovish compared with the CNB's current forecast (both around 1Q15), which was found to be accompanied by slightly disinflationary risks at the last CNB meeting.

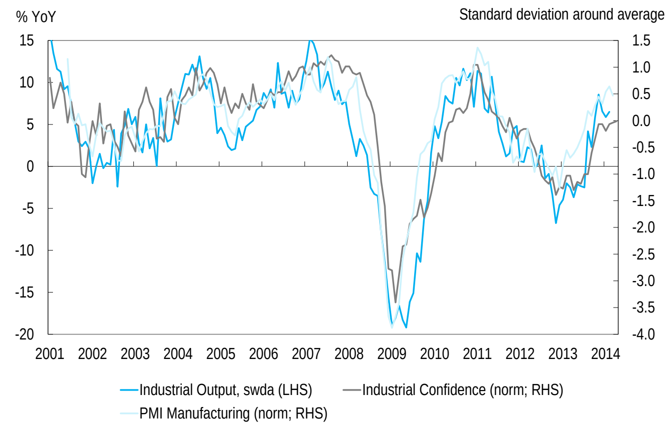
We see three risks in our forecast due to large-scale asset purchases both by the Fed and ECB. First, the koruna could be more volatile and stronger owing to liquidation of carry trades, if regional currencies are hit by Fed's tighter monetary policy. Second, ECB's QE could have asymmetric impact on the Czech koruna. While we expect it to be positive for EA GDP growth and thus for Czech exports, which could be CZK positive, it could, on the other hand, lead to more regional carry trades and as there is a clear floor for EURCZK at 27+, it could lead to a weaker koruna as the funding currency. Third, ECB QE could bring more volatility into EURCZK and Czech short-term rates, particularly if we see outperformance of Czech economy compared to its Western peers, which could reflect the outlook on both pro-cyclical fiscal and monetary policy. This could cause difficulties to the CNB to smoothly manage its commitment of no sharp FX appreciation after its exit strategy starts. Overall, if there are mostly positive impacts from eventual ECB QE, it would likely lead to lower EURCZK to 27.5 on 9m and to 26 on 2years, supported by better foreign demand.

Figure 114. Confidence suggests 2.1% GDP growth ...



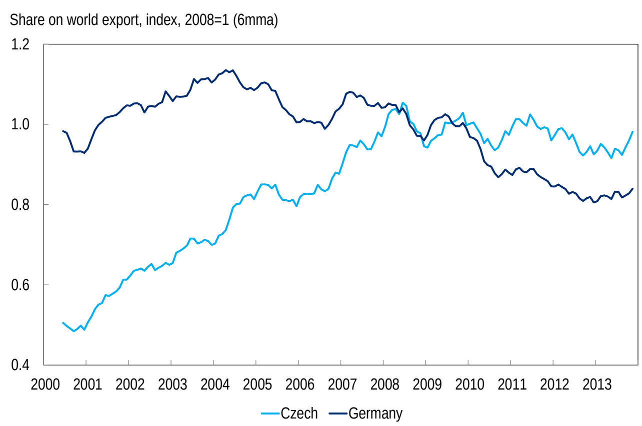
Source: CZSO, Citi Research

Figure 115. ... and points to almost 6% growth in industrial production



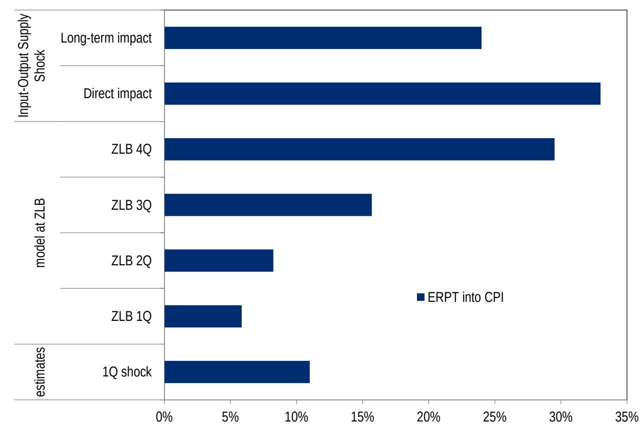
Source: CZSO, Haver Analytics, Citi Research calculation

Figure 116. Competitiveness of Czech exporters has improved



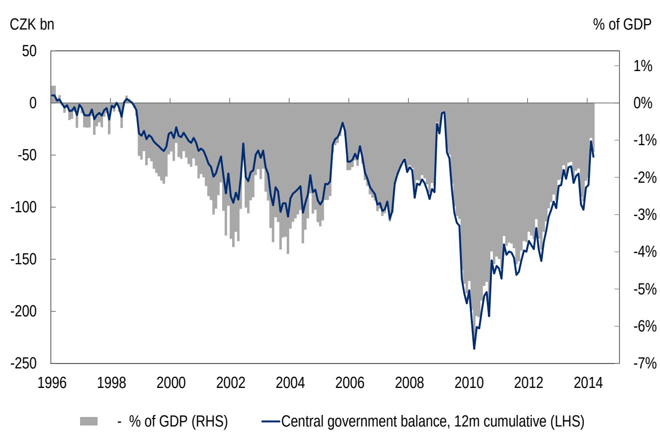
Source: Haver Analytics and Citi Research

Figure 117. Various exchange-rate pass-through coefficients



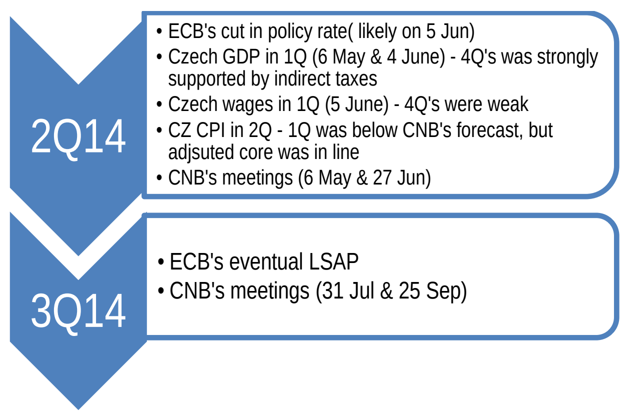
Source: Citi Research – based on CNB's sources: CNB – Meeting with analysts, November 2013 (page 21), CNB's Inflation Report 1/2014, CNB's RPN 1/2013.

Figure 118. March central cash state deficit still solid



Source: MinFin, CZSO, Citi Research calculation.

Figure 119. Schedule for the assessment of the CNB's policy



Source: Citi Research

Figure 120. Czech Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	180	225	197	198	216	196	198	206	212
Nominal GDP, local currency bn	3,663	3,848	3,759	3,791	3,823	3,846	3,884	4,041	4,226
GDP per capita, USD	17,484	21,614	18,795	18,873	20,584	18,693	18,881	19,626	20,143
Population, mn	10.3	10.4	10.5	10.5	10.5	10.5	10.5	10.5	10.5
Unemployment, % of labour force	5.3	4.4	6.7	7.3	6.7	7.0	7.0	7.0	6.8
Economic Activity									
Real GDP, yoy avg	5.7	3.1	-4.5	2.2	2.1	-1.0	-0.9	1.9	2.6
Real investment growth % yoy	15.5	1.9	-20.2	5.4	0.8	-5.0	-4.4	3.8	4.0
Real consumption growth % yoy	3.1	2.3	1.3	0.7	-0.4	-2.1	0.6	0.6	1.7
private consumption growth % yoy	4.2	2.8	0.2	0.9	0.5	-2.1	0.1	0.4	1.8
Real export growth, % yoy	11.2	4.0	-10.9	15.4	9.5	4.5	0.2	6.5	8.0
Real import growth, % yoy	12.8	2.7	-12.1	15.4	7.0	2.3	0.6	5.7	7.7
Prices, Money & Credit									
CPI, % yoy eop	5.5	3.6	1.0	2.3	2.4	2.4	1.4	1.8	2.0
CPI, % avg	2.9	6.3	1.0	1.5	1.9	3.3	1.4	0.9	2.1
Nominal wages, % yoy	7.2	7.9	3.4	2.2	2.5	2.7	0.1	2.1	3.6
Credit extension to private sector, % yoy	26.6	16.1	0.8	3.0	5.5	2.6	3.7	5.3	9.0
Policy Interest Rate, % eop	3.50	2.25	1.00	0.75	0.75	0.05	0.05	0.05	0.25
1 month inter-bank rate, %, eop	3.94	3.21	1.29	0.99	0.94	0.33	0.29	0.25	0.45
Long-term yield, %, eop	4.64	4.15	4.01	3.86	3.69	1.90	2.30	2.00	2.50
CZK/US$, eop	18.2	19.2	18.4	18.7	19.8	19.0	19.9	20.5	19.2
CZK/US$, avg	20.2	17.0	19.0	19.1	17.7	19.5	19.6	20.0	19.8
CZK/EUR, eop	26.5	26.8	26.4	25.0	25.6	25.1	27.3	27.7	26.8
CZK/EUR, avg	27.8	25.0	26.4	25.3	24.6	25.1	26.0	27.5	27.2
Balance of Payments, USD bn									
Current account	-7.9	-4.8	-4.8	-7.6	-6.3	-4.7	-2.9	0.3	1.6
% of GDP	-4.4	-2.1	-2.5	-3.8	-2.9	-2.4	-1.4	0.2	0.8
Trade balance	2.2	1.7	4.6	2.8	5.3	7.5	9.6	13.5	15.2
Exports	106.5	125.1	99.1	114.0	138.5	131.7	135.6	145.3	156.0
Imports	104.3	123.4	94.6	111.2	133.2	124.2	126.0	131.7	140.9
Service balance	2.9	4.4	3.9	3.9	3.8	2.5	2.7	3.5	4.0
Income balance	-12.7	-10.6	-13.2	-14.8	-15.6	-14.7	-16.0	-17.1	-18.1
FDI, net	9.0	2.3	2.0	4.9	4.2	9.2	1.7	6.0	6.4
International reserves	34.4	36.5	39.7	40.3	37.9	42.4	53.9	58.4	62.7
Total amortisations	4.0	4.2	6.2	5.4	8.6	5.4	7.4	7.1	7.1
Public Finances, % of GDP									
Consolidated government balance	-0.7	-2.2	-5.8	-4.7	-3.2	-4.2	-1.5	-2.0	-2.5
Consolidated gov primary balance	0.4	-1.2	-4.5	-3.3	-1.8	-2.7	-0.1	-0.2	-1.0
Public debt	27.9	28.7	34.6	38.4	41.4	46.2	46.0	44.8	45.2
of which Domestic	20.3	20.7	24.4	25.8	34.8	39.9	29.9	35.1	34.6
Foreign Assets & Liabilities, USD bn									
External debt	76.2	84.2	89.2	94.2	94.2	102.5	111.3	102.4	113.4
Public	15.0	15.3	19.8	24.0	22.6	28.3	30.2	23.4	29.4
External debt / GDP	42.2	37.4	45.3	47.5	43.6	52.2	56.1	49.6	53.5
External debt / XGS	61.5	57.3	75.3	69.8	58.3	66.7	70.5	60.6	62.4
Short-term debt	22.6	27.1	23.9	23.6	27.1	24.1	29.4	36.0	39.0
Short-term debt/International reserves (%)	65.5	74.2	60.2	58.5	71.5	56.8	54.6	61.6	62.2

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	-1.0	1.2	2.2	2.2	2.3	1.1	2.0	2.5	2.8
CPI, % yoy eop	1.0	1.4	0.2	0.6	1.6	1.8	2.3	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	1.94	1.97	2.00	2.13	2.25	2.38
CZK/EUR, eop	25.67	27.34	27.46	27.44	27.56	27.67	27.53	27.29	27.05

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 stabilise the exchange rate and eased, but not eliminated, foreign exchange shortages. But we don't see it as a long-term solution to the problems facing the economy or stabilising the EGP.

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

Greater political stability in 2014

Despite periodic upsurges in violence in early 2014, the holding of the constitutional referendum now means the military's political roadmap for Egypt is moving forward. The next important step in this will be the holding of presidential elections on May 26/27 to be followed by parliamentary elections, probably in July or August.

While the final list of presidential candidates is not due to be published until May 2, we would expect the former military leader, Abdelfattah el Sisi to be on it. Moreover, we think that the parliamentary vote will be quite widely split over a range of parties, meaning that a coalition government of some sort will have to be formed by the president, an outcome which is likely 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 political and economic lead in supporting Egypt's political transition, while US and European influence has diminished as they have struggled to react to political developments since June 2013.

The need to keep the Islamist political community on side

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

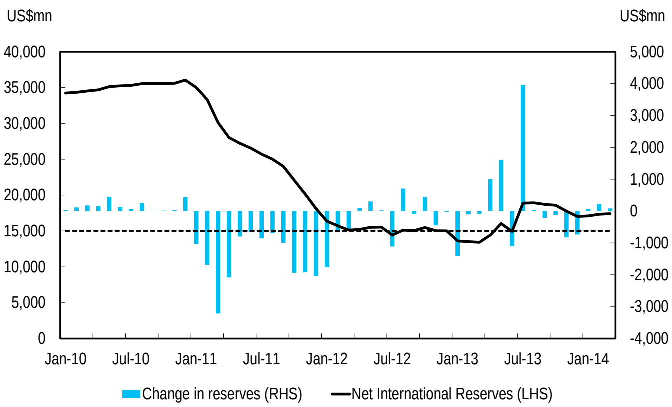
On a more positive note, with only modest EGP depreciation expected in 2014 and a still weak growth environment, we think that inflation is unlikely to rise sharply. While, it could be argued that the CBE's cuts in the Overnight Deposit Rate (ODR) in 2013 were premature given the rise in inflation in 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, in our view, however difficult. As such, while there may be a modest fall-back in the deficit going forward, the prospects for more fundamental fiscal consolidation seem unlikely for some time, in our view, given the current political agenda.

A homegrown reform programme

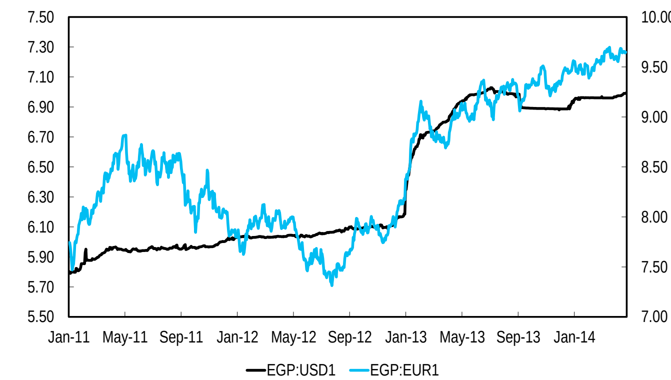
Having said that, the provision of Gulf support means that such difficult choices can be put off and the government can continue to operate in "muddle through" fiscal mode, probably well into 1H 2015. But at some point, the government will have to think about a more comprehensive reform programme. While 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 121. Reserves have stabilised since late 2013, but remain low



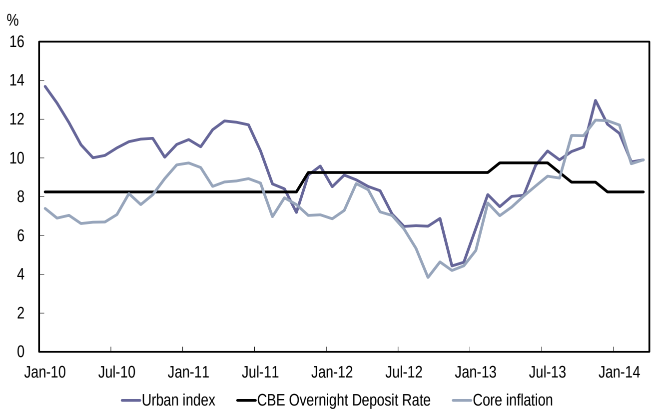
Source: Central Bank of Egypt, Haver Analytics

Figure 122. The EGP also starts to stabilise against USD since mid-2013



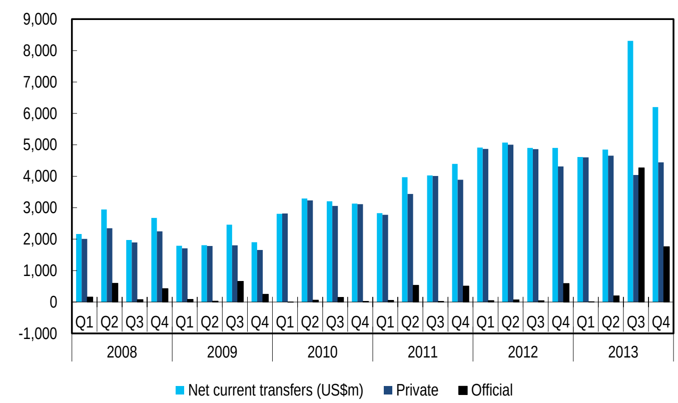
Source: Reuters

Figure 123. The CBE has cut rates, despite the rise in inflation in 2H 2013



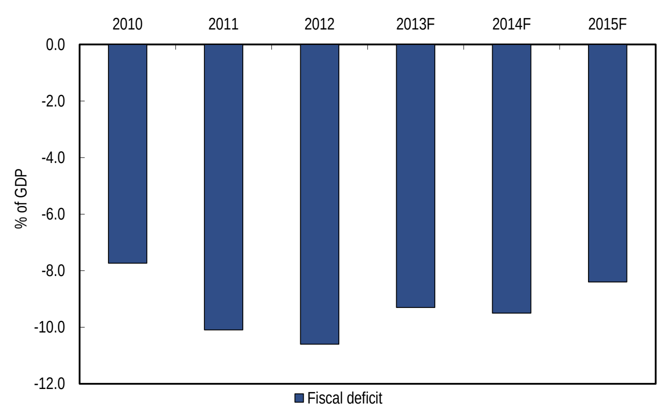
Source: Central Bank of Egypt, Haver Analytics and Citi forecasts for 2H 2013

Figure 124. Robust transfers have limited the deterioration in the current account and helped support consumption



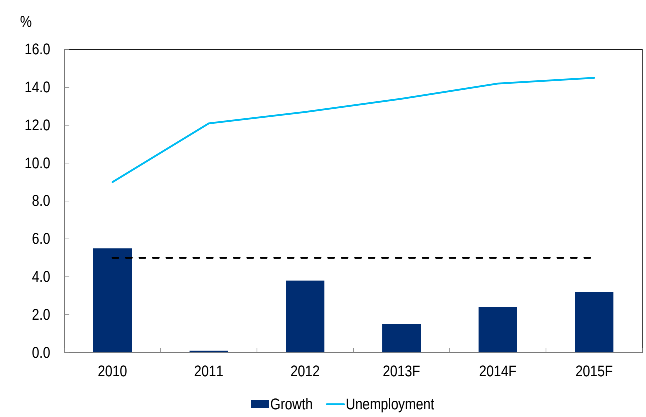
Source: Central Bank of Egypt, Haver Analytics

Figure 125. The fiscal deficit remains large and is a problem



Source: Haver Analytics and Citi forecasts for 2013-2015

Figure 126. A weak recovery may now be possible in 2014-15



Source: Haver Analytics and Citi forecasts for 2013-15

Figure 127. Egypt Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	132	165	188	214	231	260	255	275	285
Nominal GDP, local currency bn	745	896	1,042	1,207	1,371	1,576	1,753	1,950	2,151
GDP per capita, USD	1,783	2,187	2,454	2,755	2,920	3,233	3,114	3,305	3,379
Population, mn	74.1	75.4	76.6	77.8	79.1	80.4	81.7	83.1	84.4
Unemployment, % of labour force	8.9	8.7	9.4	9.0	12.0	12.7	13.4	14.2	14.5
Economic Activity									
Real GDP, yoy avg	-	6.0	4.6	5.5	0.1	3.8	1.5	2.4	3.2
Real investment growth % yoy	-	9.2	-10.0	12.2	-3.6	7.2	-10.8	9.5	12.1
Real consumption growth % yoy	-	5.4	4.7	4.9	4.3	4.6	3.8	2.0	2.4
private consumption growth % yoy	-	5.7	4.6	5.0	4.6	4.9	3.7	2.0	2.6
Real export growth, % yoy	-	14.1	-18.8	8.1	-12.5	-2.0	-6.3	2.2	5.6
Real import growth, % yoy	-	13.7	-24.0	10.5	-0.9	4.9	-3.4	4.7	7.2
Prices, Money & Credit									
CPI, % yoy eop	6.9	18.4	13.2	10.6	9.5	4.7	11.7	9.1	7.2
CPI, % avg	9.5	18.3	11.8	11.1	10.1	7.1	9.5	9.1	7.1
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	10.0	12.0	3.0	6.7	6.1	7.6	6.4	6.3	7.6
Policy Interest Rate, % eop	8.75	11.50	8.25	8.25	9.25	9.25	8.25	8.00	7.50
1 month inter-bank rate, %, eop	8.75	11.95	8.30	8.30	10.05	10.10	9.25	9.59	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	7.10	7.54
Balance of Payments, USD bn									
Current account	0.2	-1.3	-3.2	-5.6	-7.9	-10.7	-3.6	-2.9	-5.5
% of GDP	0.2	-0.8	-1.7	-2.6	-3.4	-4.1	-1.4	-1.1	-1.9
Trade balance	-20.8	-26.8	-22.5	-27.7	-28.5	-36.8	-30.2	-30.1	-30.1
Exports	24.5	29.8	23.1	25.0	27.9	23.2	25.1	26.1	27.3
Imports	45.3	56.6	45.6	52.7	56.5	59.9	55.3	56.2	57.4
Service balance	12.7	15.7	11.3	9.6	5.4	6.3	2.6	1.7	2.7
Income balance	-	-	-	-	-	-	-	-	-
FDI, net	10.9	7.6	6.1	5.2	-1.1	6.7	5.6	-0.1	3.0
International reserves	31.7	34.2	34.2	36.0	18.1	15.0	17.1	18.1	19.4
Total amortisations	2.3	1.8	2.4	2.0	2.1	2.3	2.3	2.6	2.4
Public Finances, % of GDP									
Consolidated government balance	-5.2	-6.4	-6.6	-7.7	-10.1	-10.6	-9.3	-9.5	-8.4
Consolidated gov primary balance	0.0	-1.8	-2.4	-2.6	-4.5	-4.7	-3.6	-3.1	-1.3
Public debt	64.2	53.5	54.0	59.8	69.0	77.7	78.6	78.2	77.8
of which Domestic	64.2	53.5	54.0	59.8	69.0	77.7	78.6	78.2	77.8
Foreign Assets & Liabilities, USD bn									
External debt	32.8	32.1	33.3	35.0	33.7	38.8	34.1	30.6	26.9
Public	21.6	26.0	27.2	28.3	27.4	32.8	31.5	31.5	31.5
External debt / GDP	24.8	19.5	17.7	16.3	14.6	14.9	13.4	11.2	9.4
External debt / XGS	68.8	55.6	73.0	70.9	71.1	85.9	78.2	69.9	57.7
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	36.7	34.3

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	1.4	1.5	1.8	3.0	3.2	3.0	3.2	3.0
CPI, % yoy eop	10.1	11.7	9.9	9.2	8.4	9.1	7.1	7.0	6.7
Policy interest rate, %, eop	8.75	8.25	8.25	8.25	8.25	8.00	8.00	7.50	7.50
Short-term market rate, % eop	10.15	9.25	9.25	9.68	8.83	9.59	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	6.97	7.00	7.30	7.35	7.50	7.60	7.60

Source: National Sources, Citi Research forecasts

GCC

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Saudi Arabia

Saudi crude oil production continued at an elevated level in excess of 9.7mbpd in March. Production has been in the 9.6mbpd-10mbpd range since mid-2013, while prices have held up in the US$106/bbl to US$110bbl. Interestingly, a large proportion of this increase has been directed towards exports to the United States, which, according to the US EIA, has increased imports from Saudi Arabia by over 500kbpd since early 2013. Some of this increase reflects an offset to declining Venezuelan imports by the US, and some is being directed towards Saudi Arabia's expanded refining capacity in the United States. Either way, these suggest a firm underpinning to the rise in Saudi production, in our view, which we believe will likely to be sustained in the near term. We are thus raising our expected average production for Saudi Arabia from 9.2mbpd to 9.5mbpd (on par with 2013).

As a result, we expect the public finances and external balances to remain robust in the near term: We are raising our current account surplus forecast for 2014 to 14.8% (from 13.7% previously), real GDP growth to 4.8% (from 4.2%) and the fiscal surplus to 6.2% (from 5.1%). 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 close to US$100 per barrel in 2015 and will continue to rise, resulting in forecast deficits as early as 2016. Although Saudi has ample resources to finance expected deficits from current cash reserves, the outlook does underscore the need for structural reform to set public finances on a long-term sustainable footing.

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

United Arab Emirates

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

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

Despite the differences, we also recognise 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.

We believe early indications of a cooling in the property sector are inconclusive at present. Specifically, there has been hardly any growth in property prices in the first three months of the year, according to data from Cluttons. Moreover, real estate sales have come down since their peak last May. We believe it is still too early to judge whether this is a lasting cooling in the property market, or a temporary lull. Indeed, while real estate transactions are down from their peak, they have been rising steadily in the past three months, suggesting a potential pass-through to future prices, in our view.

Qatar

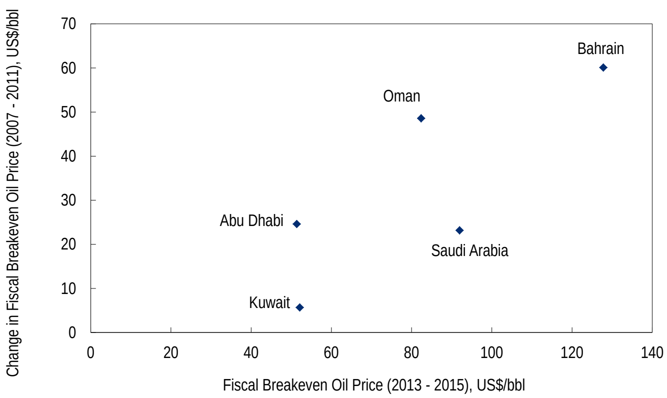
The Qatari economy continued to slow in 4Q with growth easing to 5.6%YoY from 6.9% reported in the 3Q. Despite this slowdown, growth for 2013 actually came in at 6.5%YoY, higher than our own expectations (5.9%). As was the case in 2012, the majority of growth in 2013 came from the non-mining and quarrying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

The diplomatic spat which erupted between Qatar and three of its GCC neighbours in March has been resolved. Last month, 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). Details of the Accord, signed in mid-April, resolving the rift have not been revealed.

Bahrain

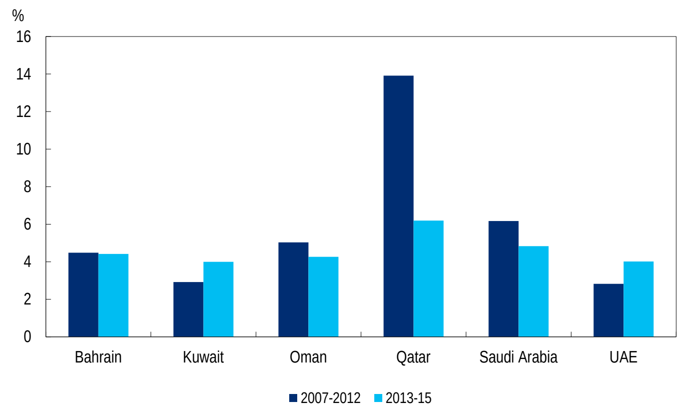
Unrest in Bahrain continues, with the Formula 1 race in April providing a focal point for protests, as expected. The race, a significant component in the country's bid to attract foreign tourism and investment, went ahead successfully, despite opposition marches and the explosion of a car bomb on the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

Figure 128. Fiscal breakeven oil prices on the rise



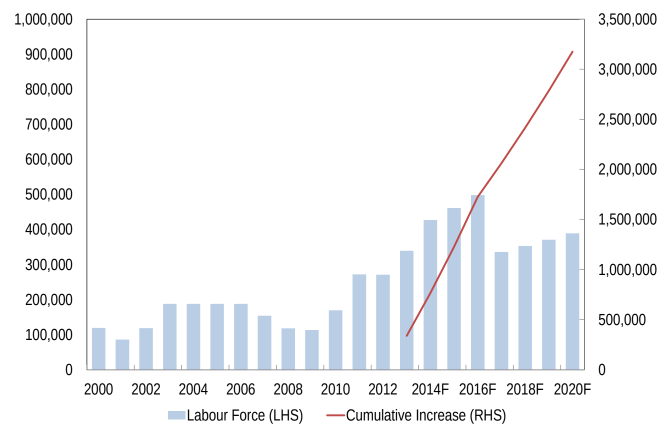
Source: Citi Research estimates

Figure 129. Economic growth will be uneven going forward



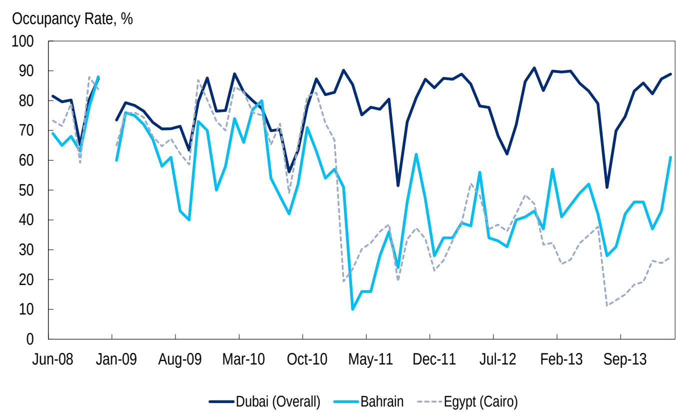
Source: Haver Analytics, Citi Research

Figure 130. 3.3 million entrants in Saudi job market by end of decade



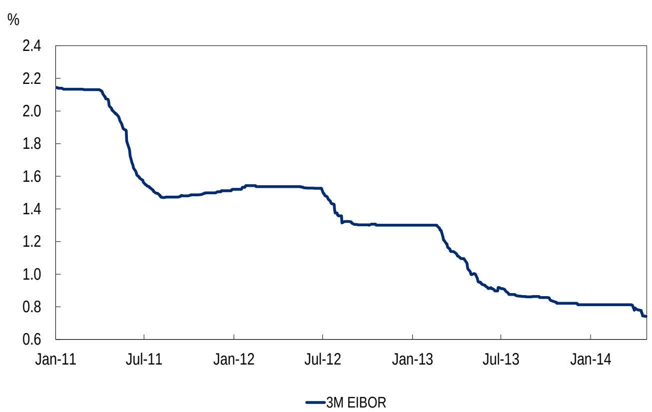
Source: Saudi Central Statistics Office, Citi Research

Figure 131. Dubai hotel occupancy continues to outperform its peers



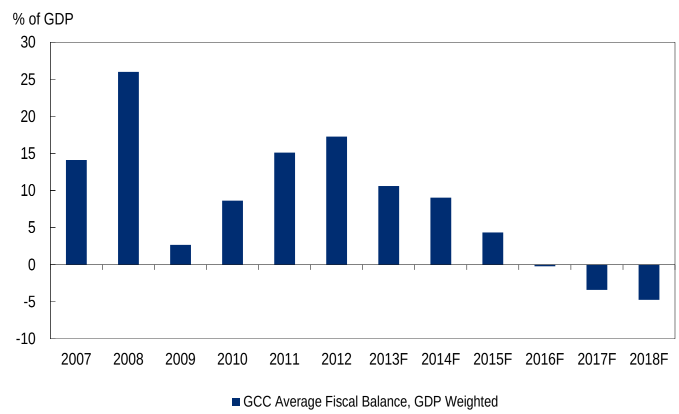
Source: Ernst & Young, Citi Research

Figure 132. EIBOR rates have begun to decline again



Source: Haver Analytics

Figure 133. High government expenditure will drive balances lower



Source: Haver Analytics, Citi Research estimates

Figure 134. GCC Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
BAHRAIN									
Nominal GDP, USD bn	21.7	25.6	22.9	25.6	29.1	30.3	32.7	35.0	37.4
GDP per capita, USD	21,072	22,983	19,192	20,482	22,489	22,969	23,856	24,563	25,193
Real GDP, yoy avg	8.3	6.2	2.5	4.3	2.1	3.4	5.3	4.0	4.0
CPI, % avg	3.3	3.5	2.8	1.9	-0.4	2.8	3.3	2.5	2.0
BHD/US$, avg	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
Current account, US$bn	2.8	2.1	0.4	0.6	3.0	2.0	2.2	1.9	0.5
% of GDP	12.7	8.1	1.7	2.3	10.3	6.4	6.8	5.5	1.3
Consolidated gov. balance, % of GDP	2.7	6.4	-4.3	-4.8	-0.3	-2.0	-2.3	-3.5	-5.9
KUWAIT									
Nominal GDP, USD bn	112.3	136.6	105.2	118.5	152.8	176.9	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	6.0	2.5	-7.1	-2.4	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	3.0	4.5
KWD/US$, avg	0.28	0.27	0.29	0.29	0.28	0.28	0.28	0.29	0.29
Current account, US$bn	41.9	57.8	29.1	37.8	66.2	78.8	102.1	101.4	98.1
% of GDP	37.3	42.3	27.6	31.9	43.3	44.6	50.5	48.9	47.0
Consolidated gov. balance, % of GDP	30.0	36.4	19.0	30.8	40.1	39.4	27.2	27.0	21.0
OMAN									
Nominal GDP, USD bn	42.0	59.9	53.4	53.4	53.4	53.4	85.9	91.6	96.7
GDP per capita, USD	15,326	20,887	18,015	17,438	16,881	16,180	24,841	25,358	25,617
Real GDP, yoy avg	4.5	8.2	6.1	4.8	0.9	5.8	3.4	4.7	4.7
CPI, % avg	5.9	12.5	3.6	3.2	4.0	2.9	2.1	1.2	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	10.5	8.4	6.5
Consolidated gov. balance, % of GDP	2.7	0.3	-0.1	3.1	-0.4	-0.3	9.7	8.2	5.9
QATAR									
Nominal GDP, USD bn	79.7	115.3	97.8	125.1	171.5	192.4	196.3	209.2	223.4
GDP per capita, USD	85,712	104,982	80,294	92,546	114,241	118,688	112,097	110,665	109,396
Real GDP, yoy avg	18.0	17.7	12.0	16.7	13.0	6.2	6.5	5.9	6.2
CPI, % avg	13.6	15.2	-4.9	-2.4	1.9	1.9	3.1	2.5	3.5
QAR/US$, avg	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64
Current account, US$bn	11.5	26.6	6.4	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	31.0	26.7	21.7
Consolidated gov. balance, % of GDP	10.9	9.8	13.4	2.7	7.7	11.9	8.4	4.4	1.2
SAUDI ARABIA									
Nominal GDP, USD bn	415.6	519.4	429.0	526.8	669.5	733.8	745.2	784.7	827.6
GDP per capita, USD	17,111	20,861	16,811	20,178	25,645	27,559	27,436	28,323	29,287
Real GDP, yoy avg	6.0	8.4	1.8	6.4	8.6	5.8	3.8	4.8	5.9
CPI, % avg	4.1	9.9	5.1	5.3	3.9	2.9	3.5	3.5	4.1
SAR/US$, avg	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Current account, US$bn	94.3	133.0	21.5	67.4	159.3	165.7	135.3	116.0	73.5
% of GDP	22.7	25.6	5.0	12.8	23.8	22.6	18.2	14.8	8.9
Consolidated gov. balance, % of GDP	12.2	30.8	-3.0	6.3	13.2	15.4	7.4	6.2	1.3
UNITED ARAB EMIRATES									
Nominal GDP, USD bn	257.9	315.5	254.8	287.4	348.6	383.8	409.8	439.1	470.4
GDP per capita, USD	57,467	66,205	51,915	56,858	66,946	70,678	72,074	73,830	75,673
Real GDP, yoy avg	3.2	3.2	-4.8	1.7	3.9	4.4	3.7	4.0	4.0
CPI, % avg	11.1	12.3	1.6	0.9	0.9	0.7	1.1	1.8	2.1
AED/US$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account, US$bn	15.5	22.7	7.9	7.4	74.3	108.6	107.3	93.8	80.0
% of GDP	6.0	7.2	3.1	2.6	21.3	28.3	26.2	21.4	17.0

Source: National Sources, Citi Research forecasts

Hungary

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- **Summary view** — Growth is benefiting from firming European demand. New monetary policy measures are helping to reduce local bond markets' external vulnerability, which may lead to higher tolerance towards FX weakness.
- **Things to watch** — Details of the NBH's new monetary policy instruments and changes in local bond supply may be key factors to watch.
- **Strategy** — New monetary policy instruments may provide permanent support to local bond markets and flatten the yield curve. Easing monetary conditions and squeeze-out of foreign investors from local markets point towards weaker FX.

Growth continues to surprise to the upside

We have lifted our GDP forecasts to 2.3%YoY in 2014 and 1.7%YoY in 2015 based on incoming data that provided positive inputs to the 2014 growth outlook: industrial output accelerated to 7.1% and retail sales also showed market acceleration to 4%YoY in the first two months of the year. Besides the improving export dynamics helped by firming European recovery that has lifted industrial output throughout the whole region (Figure 115), EU-fund inflows continue to add to a positive turnaround in domestic demand. Net inflows from EU funds have reached 5.5% of GDP in 2013 and may remain close to 5% of GDP this year thanks to accelerated absorption of un-utilised funds from the 2007-2013 EU budgets. Over the medium term EU inflows may stabilise around 4% of GDP, providing only marginal support to domestic sources of growth.

Rising net real wages and continuous improvement in consumer confidence have finally translated into household consumption recovery, as indicated by pickup in retail sales (Figure 116). In our view private investments are still too low (Figure 117) and remain a key hurdle to firmly improving long-term growth momentum as both corporate and household sector investments remain weak, with the exception of manufacturing investments related to car manufacturers and their suppliers. The utilization of the NBH's SME lending program (FGS) has slowed markedly since October so it remains questionable if this monetary policy measure will provide any significant stimulus to growth. The NBH expects a pickup in demand for the FGS in 2Q and 3Q14 as the second round of the FGS limits roll-over to 10% of total withdrawal and new investment loans eligible to participate may increase from the summer months when corporate investment activity typically picks up.

While short-term indicators confirm an improving growth outlook growth, we continue to see Hungary's long-term growth prospects weaker relative to the region. The renewal of the government for another 4-year term with 2/3rd parliamentary majority will likely not deliver any large twist in fiscal policy. The budget balance seems to remain under the 3% of GDP deficit threshold without any sizeable measure for 2014 and 2015. This suggests the tax environment may be more stable in the coming years but extraordinary taxes are unlikely to be phased out. Government communication suggests state intervention will be extended further with ownership changes in the energy sector and potential consolidation in the financial sector. Following the elections, the government's harsh and populist communication against foreign investors may soften, in our view, but FDI inflows are likely to remain weak after the large capacity expansions in the car industry run out.

External debt reduction, stagnating public debt

We expect the fiscal balance to remain within the government's 2.9% of GDP target this year with limited upside risks related to lower revenues, which we expect to be corrected by the government in 2H14, if needed. The 2013 fiscal deficit came out at 2.4% of GDP, undershooting the government's 2.7% original target for the second consecutive year. Public investments, consumption and wage bills widened relative to 2012 but this has been largely compensated by higher EU fund inflows, rising social security contributions and other revenues that have been introduced in 2013 (e-road tolls, financial transition tax). Despite the tight fiscal balance, Hungary's public debt ratio (down from 79.8% in 2012 to 79.0% of GDP in 2013) may increase slightly in 2014 due to FX weakening, given that close to 40% of public debt is FX-denominated. Over the long term the outlook for the public debt ratio remains stagnant or marginally rising if the government follows through with its nuclear power plant upgrade plans financed by central government loans.

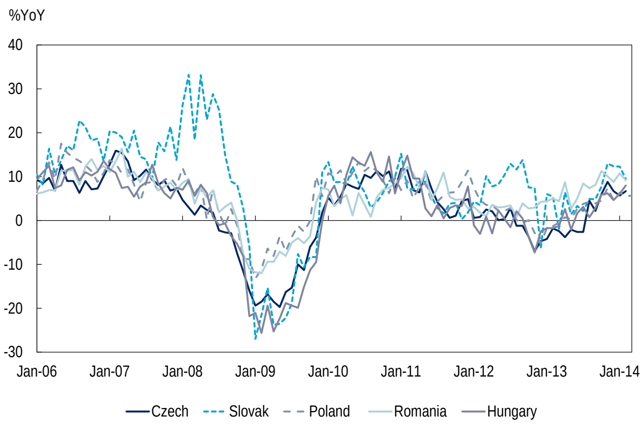
The acceleration in domestic demand may slightly narrow but is unlikely to fully erode Hungary's external surplus. We expect that barring additional domestic demand stimulus, exports may still outpace imports as external demand continues to recover. Net transfers from the EU may remain stable around €4bn annually over the next seven-year EU budgetary cycle. Given that EU funds are exchanged by the NBH, these inflows would add to FX reserves, unless utilised by the NBH. The NBH is likely to increase FX sales in the coming years as it sees no fundamental reasons to increase FX reserves further while external debt is declining and the current account remains in surplus. The NBH's new monetary policy instruments aim to channel more local funds into local currency-denominated government papers. The additional HUF liquidity may be exchanged by the NBH for the Debt Management Agency to repay maturing FX denominated external debt. This in turn may accelerate external debt deleveraging without delivering a sharp drop in FX reserves and may reduce the economy's sensitivity to FX weakness.

New monetary instruments and ECB QE may delay hikes

Inflation has continued to surprise to the downside. So far there are no signs of rising inflation pressures in core price trends, but accelerating household consumption and a weaker currency point towards the risk of core price acceleration over the next one- or two-year horizon. As the impacts of utility price cuts and negative food and fuel price indices fade out of the annual price index, CPI may rise slightly above the 3.0% official inflation target in 2H15, according to our expectations.

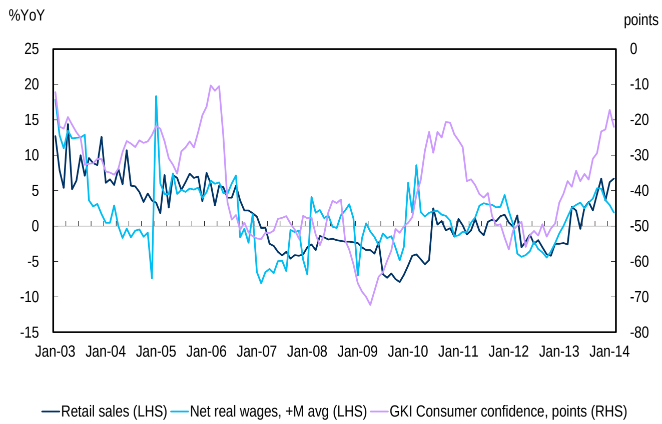
The switch from 2-week NBH bonds into deposits may provide permanent support to local bond markets and ease monetary conditions further by squeezing out excess HUF liquidity from NBH bonds. Additional new monetary instruments including an interest rate swap window may contribute to flattening in the yield curve up to 5-year tenor. In our view the MPC may turn less sensitive to higher FX volatility as the FX share of public debt declines over the long term. These factors in our view point towards a sustained low interest rate environment and further FX weakness as external financing conditions tighten. Our base-line scenario is that the NBH will halt with the rate cutting cycle at 2.50% and deliver one 25bp hike in December as headline inflation jumps in 4Q14. Nonetheless, increased possibility of ECB QE in 2H15 and the local bond market support provided by the new NBH instruments point towards the chances of rates remaining lower for longer.

Figure 135. Industrial output accelerated thought the CEE region



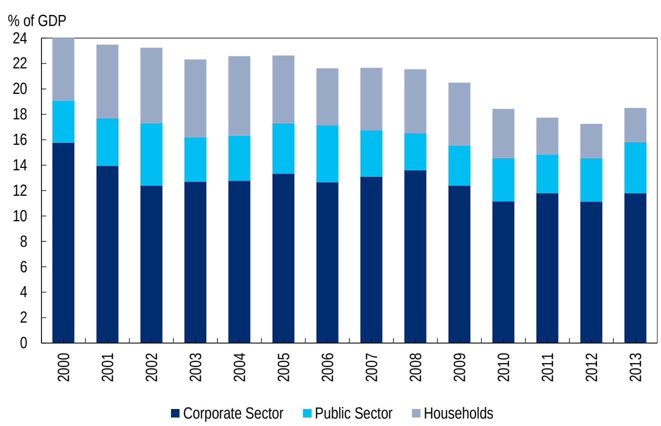
Source: Haver Analytics, Citi Research

Figure 136. Positive turnaround in retail sales



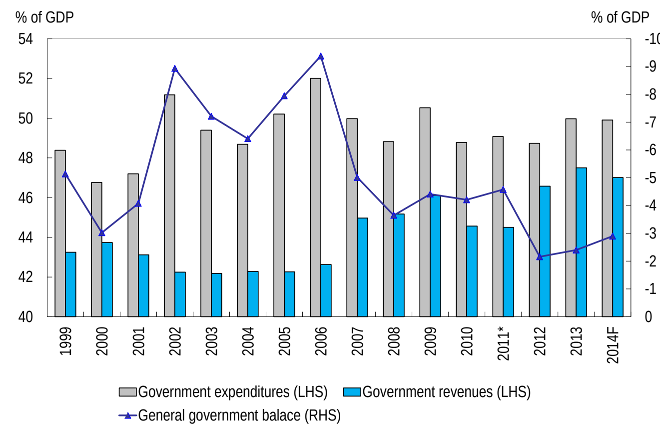
Source: CSO, Citi Research

Figure 137. Private sector investments still a hurdle to growth



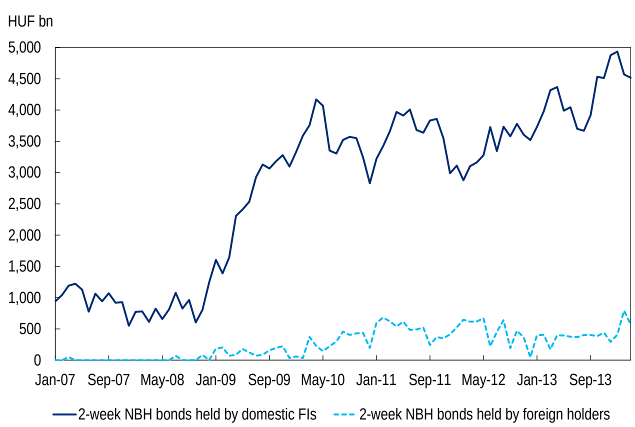
Source: CSO, Citi Research

Figure 138. Fiscal deficit to remain below 3% of GDP



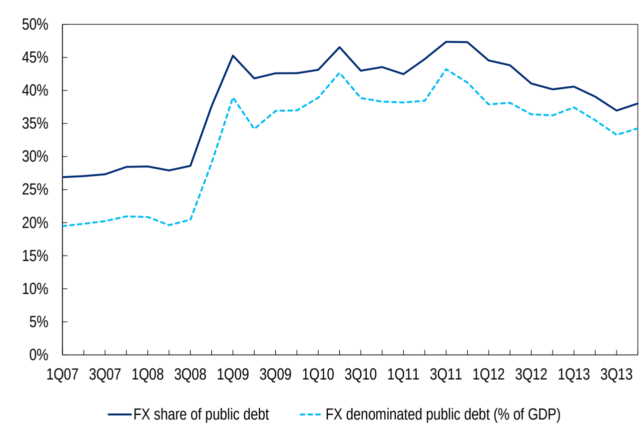
Source: Ministry of Finance, Citi Research Estimates

Figure 139. Switch from NBH bonds to bills to support reallocation to government papers…



Source: National Bank of Hungary, Citi Research

Figure 140. …and reduce the FX share of public debt



Source: National Bank of Hungary, Citi Research

Figure 141. Hungary Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	145	141	136	127	115	127	135	129	137
Nominal GDP, local currency bn	25,143	26,543	25,730	26,600	27,714	28,082	29,275	30,481	31,862
GDP per capita, USD	14,390	14,061	13,584	12,688	11,487	12,726	13,590	12,990	13,835
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	2.3	1.7
Real investment growth % yoy	-1.5	3.7	-29.6	11.5	-3.6	-11.2	2.1	2.2	0.0
Real consumption growth % yoy	-1.4	-0.2	-4.5	-2.5	0.3	-1.5	0.5	1.7	1.0
private consumption growth % yoy	1.1	-0.7	-6.6	-3.0	0.4	-1.6	0.2	1.7	1.5
Real export growth, % yoy	15.0	5.7	-10.2	11.3	8.4	1.7	5.3	5.8	6.0
Real import growth, % yoy	12.8	5.5	-14.8	10.9	6.4	-0.1	5.3	5.7	5.8
Prices, Money & Credit									
CPI, % yoy eop	7.4	3.4	5.4	4.6	4.1	5.1	0.6	2.4	3.0
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	4.6	3.8	4.4	4.2
Credit extension to private sector, % yoy	18.8	21.7	-2.7	4.1	-0.5	-10.1	-2.6	0.8	-0.9
Policy Interest Rate, % eop	7.50	10.00	6.25	5.75	7.00	5.75	3.00	2.75	4.00
1 month inter-bank rate, %, eop	7.50	10.00	6.25	5.75	7.08	5.75	3.00	2.75	4.00
Long-term yield, %, eop	7.08	8.28	7.99	7.97	9.75	6.11	5.61	6.00	6.20
HUF/US$, eop	173	190	189	208	244	221	216	236	232
HUF/US$, avg	183	171	201	208	201	225	223	229	234
HUF/EUR, eop	253	266	271	278	315	291	297	319	324
HUF/EUR, avg	251	252	280	275	279	289	297	315	322
Balance of Payments, USD bn									
Current account	-9.9	-11.4	-0.3	0.3	0.6	1.1	3.9	3.9	3.1
% of GDP	-6.8	-8.1	-0.2	0.2	0.5	0.8	2.9	3.1	2.2
Trade balance	-0.9	-1.8	3.3	3.2	4.3	4.5	5.7	6.0	4.8
Exports	93.0	106.1	80.0	88.8	103.7	97.3	103.4	109.8	114.6
Imports	93.9	107.9	76.7	85.5	99.4	92.8	97.7	103.8	109.8
Service balance	1.8	2.2	2.8	3.8	4.4	4.3	4.6	4.5	4.6
Income balance	-10.1	-11.0	-6.9	-7.3	-8.9	-8.2	-7.9	-7.9	-7.7
FDI, net	0.3	3.9	0.2	1.0	1.4	2.6	0.8	1.7	1.8
International reserves	23.2	33.2	41.1	43.1	45.4	43.5	47.3	50.3	56.8
Total amortisations	9.3	15.2	21.9	20.5	25.8	21.6	21.5	20.8	20.4
Public Finances, % of GDP									
Consolidated government balance	-5.1	-3.7	-4.6	-4.3	4.3	-2.0	-2.3	-2.9	-2.9
Consolidated gov primary balance	-1.0	0.5	0.0	-0.1	8.5	2.4	1.8	1.1	1.0
Public debt	66.5	72.3	78.1	79.9	81.9	79.8	78.8	81.4	80.1
of which Domestic	35.9	37.5	36.8	40.8	40.8	43.6	44.7	45.8	46.4
Foreign Assets & Liabilities, USD bn									
External debt	151.7	172.6	196.3	185.1	172.5	164.6	163.7	158.3	155.8
Public	47.4	51.8	62.1	59.6	58.4	63.8	62.5	63.0	63.5
External debt / GDP	104.8	122.2	144.1	145.7	150.3	129.6	121.3	122.8	113.6
External debt / XGS	137.7	136.5	199.2	171.2	137.3	139.7	131.1	119.3	112.7
Short-term debt	32.9	27.5	28.0	32.9	31.7	22.8	20.6	18.9	18.1
Short-term debt/International reserves (%)	141.7	82.8	68.2	76.1	69.9	52.4	43.6	37.6	31.9

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.8	2.7	3.2	2.3	1.8	1.6	1.4	1.5	1.5
CPI, % yoy eop	1.4	0.4	0.1	0.5	0.7	2.4	2.7	3.0	2.8
Policy interest rate, %, eop	3.60	3.00	2.60	2.50	2.50	2.75	3.50	4.00	4.00
Short-term market rate, % eop	3.60	3.00	2.60	2.50	2.50	2.75	3.50	4.00	4.00
Long-term yield, %, eop	5.83	5.61	5.54	5.80	6.00	6.00	6.20	6.20	6.20
HUF/EUR, eop	297	297	307	316	318	319	321	322	323

Source: National Sources, Citi Research forecasts

Israel

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

Some signs of recovery?

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

The external sector remains a focus for policymakers…

'Dutch disease' risks are still a concern. Like many other countries, Israel suffered a shock to export growth in 2012 and 2013, in spite of the fact that the shekel gained competitiveness over many other emerging economies. One of Israel's problems in this regard is that the destination of much of its exports remains the US and EU, with relatively little trade exposure to Asia (although this has been growing). So the Bank of Israel remains concerned about the need to maintain as competitive an exchange rate as possible, particularly because of the impact of gas production: Tamar, the smaller of two large gas fields being developed off Israel's northern coast, began production in April 2013. Gas from Tamar substituted some US$2.1bn of energy imports in 2013, with the result that Israel's current account has essentially disappeared, and there are good chances that Israel will sustain a long run of current account surpluses in the foreseeable future. Since these current account surpluses ($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 a an even stronger story than it is at the moment: the US Geological Survey estimates that the Levantine Basin – 40% of which is in Israeli waters –contains more than 3.4 trillion cubic meters of gas, suggesting that Israel might end up with twice the amount of gas that it has found to date.

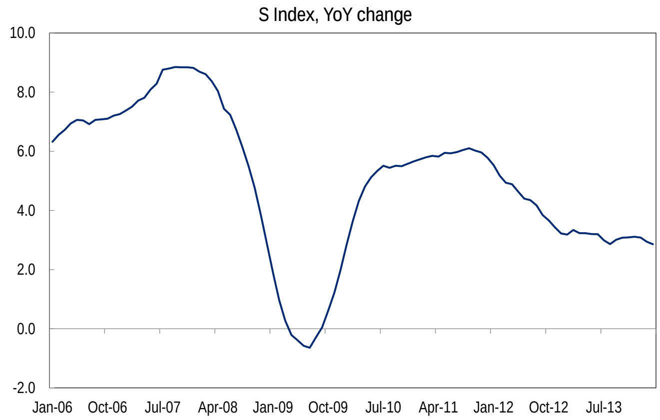
March interest rate cut makes sense

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

A better fiscal outlook

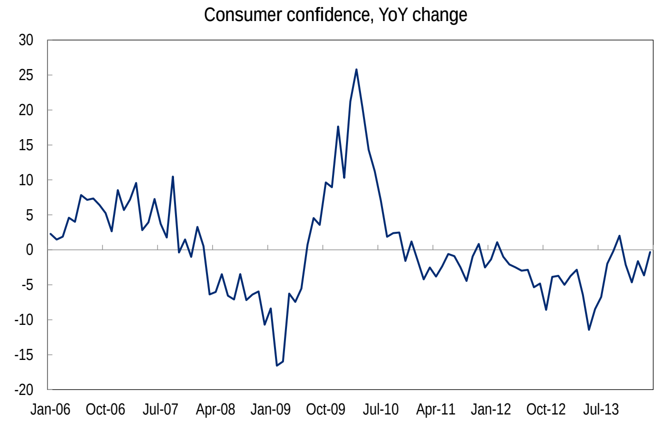
One of the factors that facilitated a more aggressive stance by the BOI is that fiscal uncertainties have eased somewhat. Due to some expenditure restraint and higher-than-expected revenues, the 2013 deficit was 3.2% GDP, compared to the 4.65% deficit that had been forecast earlier. In addition, changes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

Figure 142. Economic activity is stabilizing at a weak level, partly thanks to what the BOI describes as a 'virtual standstill' in world trade…



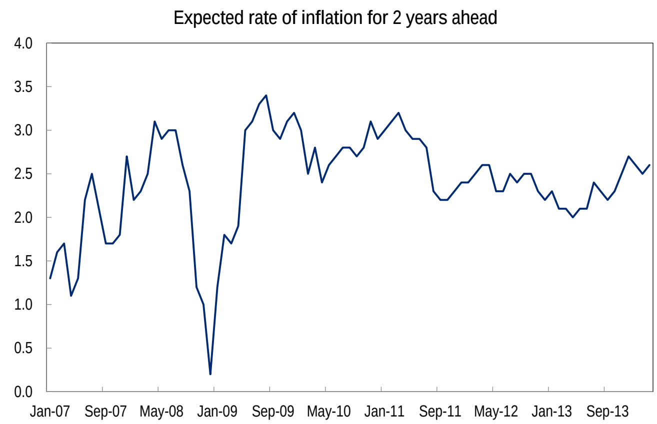
Source: Haver Analytics, Citi Research

Figure 143. …and consumer confidence is fragile even though household borrowing has been relatively robust



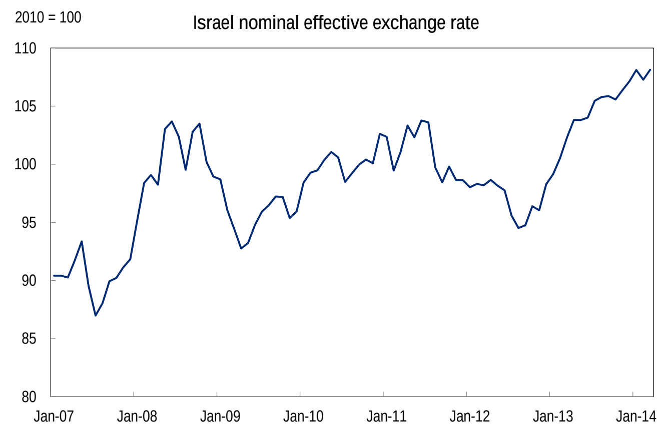
Source: Haver Analytics, Citi Research

Figure 144. Inflation expectations are more or less stable…



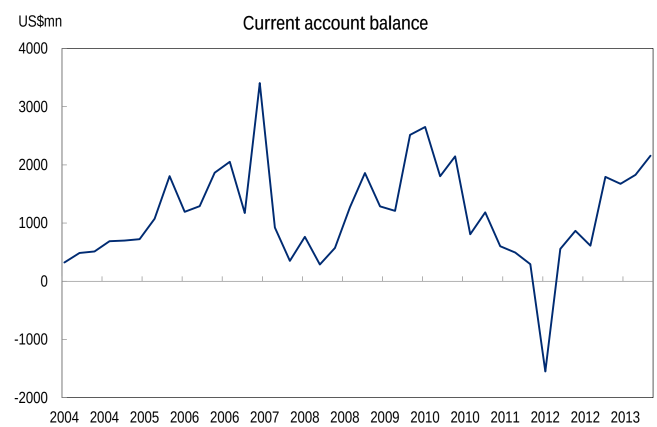
Source: Haver Analytics, Citi Research

Figure 145. …but the shekel has strengthened sharply in nominal terms in the past year…



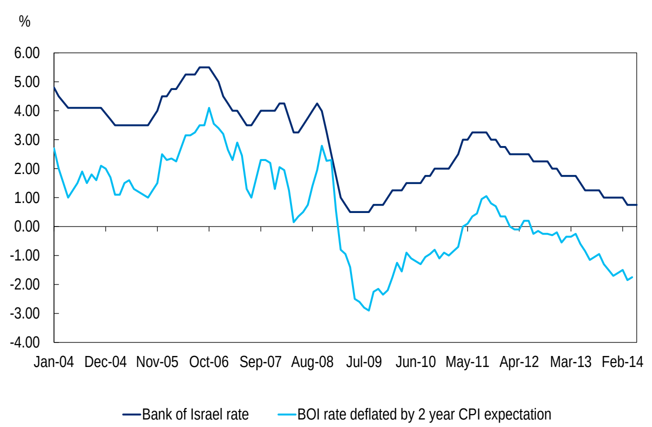
Source: Haver Analytics, Citi Research

Figure 146. …on the back of a sharply improving current account balance…



Source: Bloomberg, Citi Research

Figure 147. …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 148. Israel Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	175	213	206	232	258	258	292	315	316
Nominal GDP, local currency bn	719	765	809	866	924	993	1,053	1,101	1,172
GDP per capita, USD	25,248	29,990	28,289	31,273	34,236	33,702	37,704	40,210	39,891
Population, mn	6.9	7.1	7.3	7.4	7.5	7.6	7.7	7.8	7.9
Unemployment, % of labour force	9.2	7.7	9.4	8.3	7.1	6.9	6.3	6.0	5.8
Economic Activity									
Real GDP, yoy avg	6.8	5.0	1.0	5.2	4.7	3.5	3.2	3.4	3.5
Real investment growth % yoy	9.6	8.9	-4.4	9.4	15.6	3.6	1.3	5.6	3.6
Real consumption growth % yoy	6.6	1.6	2.5	4.4	3.6	3.2	3.5	3.0	-0.3
private consumption growth % yoy	8.1	1.5	2.4	4.9	4.0	3.1	3.8	3.0	-0.5
Real export growth, % yoy	11.2	6.6	-12.1	15.2	7.2	1.1	0.7	3.4	6.7
Real import growth, % yoy	10.6	2.3	-12.7	14.2	10.9	3.2	-1.6	1.6	5.4
Prices, Money & Credit									
CPI, % yoy eop	3.4	3.8	3.9	2.7	2.2	1.6	1.8	0.9	0.9
CPI, % avg	0.5	4.6	3.3	2.7	3.5	1.7	1.5	1.2	3.0
Nominal wages, % yoy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	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$, eop	3.86	3.78	3.79	3.52	3.81	3.73	3.47	3.58	3.79
ILS/US$, avg	4.11	3.58	3.93	3.73	3.58	3.85	3.61	3.50	3.71
Balance of Payments, USD bn									
Current account	5.6	3.1	7.9	7.2	3.3	0.8	7.2	5.9	5.2
% of GDP	3.2	1.4	3.8	3.1	1.3	0.3	2.5	1.9	1.7
Trade balance	-5.2	-6.4	0.7	-2.0	-8.2	-9.3	-9.4	-5.0	-2.3
Exports	50.8	58.0	46.8	56.4	64.3	62.3	61.7	71.0	75.3
Imports	56.0	64.4	46.1	58.4	72.5	71.7	71.1	76.0	77.5
Service balance	3.7	5.0	5.0	6.0	6.9	9.8	12.9	9.0	12.0
Income balance	-0.2	-4.0	-5.1	-5.2	-4.4	-8.0	-5.5	-6.1	-4.5
FDI, net	17.4	18.1	6.1	14.6	16.1	11.8	16.7	4.0	6.0
International reserves	28.6	42.5	60.6	70.9	74.9	76.0	81.8	87.0	95.0
Total amortisations	5.6	4.7	4.5	5.0	5.0	4.0	3.8	4.2	3.0
Public Finances, % of GDP									
Consolidated government balance	0.5	-1.2	-4.2	-2.8	-2.5	-3.5	-2.7	-3.0	-2.5
Consolidated gov primary balance	6.1	4.1	1.0	2.3	2.5	1.4	2.1	3.0	3.0
Public debt	72.8	71.5	73.8	74.5	73.8	72.5	71.7	70.5	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	95.6	104.0	105.0
Public	32.0	28.2	31.2	40.3	36.5	37.0	38.0	40.0	42.0
External debt / GDP	52.8	42.0	46.0	46.5	40.8	37.6	32.8	33.1	33.2
External debt / XGS	127.9	108.1	136.4	132.8	114.8	104.0	100.8	99.0	94.4
Short-term debt	39.9	40.3	42.2	54.4	49.6	44.0	45.0	45.0	45.0
Short-term debt/International reserves (%)	139.6	94.7	69.7	76.7	66.2	57.9	55.0	51.7	47.4

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	3.1	2.9	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	0.6	1.2	1.0
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	0.73	0.50	0.50	0.50	1.00	1.00	1.00
Long-term yield, %, eop	3.20	3.50	2.07	4.75	4.75	4.75	4.75	4.75	4.75
ILS/US$, eop	3.53	3.47	3.48	3.43	3.50	3.58	3.64	3.69	3.74

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 favourable 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 behaviour 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. Inflation should, however, increase this year on the weaker tenge, reaching 6.0% in 2014. This, in our view, will lead in 2015 to a 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 will create some headwinds for the economy. Industrial production has already started the year on a downbeat note, growing by only 0.8%YoY in January, but contracting by 0.6% in February and 1.0% in March. Consumption should remain a key driver, although the pace of expansion will likely moderate. A slowdown in China would 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$2.5bn in 4Q12, the current account went into a surplus of US$2.2bn in 1Q13, before transitioning to a small deficit in 2Q13 (US$0.01bn) and plunging into a much bigger deficit in 3Q (US$2.2bn). 4Q13 current account was almost flat at -US$0.06bn. Correspondingly, the annual current account surplus dipped from 5.5% of GDP in 2011 to only 0.5% in 2012 and a deficit of 0.1% in 2013.

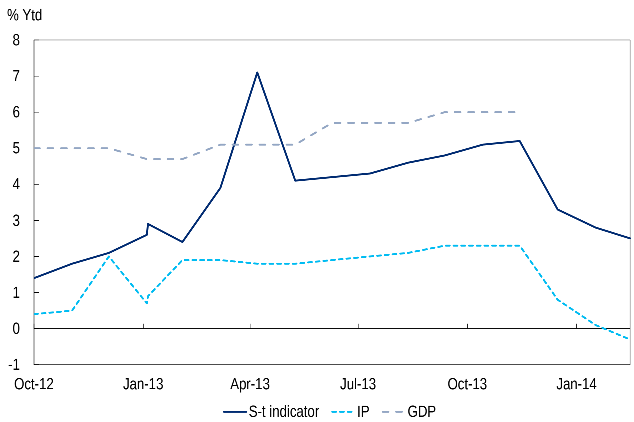
The recent deterioration of the external position has also led to a decline in foreign reserves. Gross foreign reserves have followed current account's performance, falling from US$35.5bn in February 2012 to US$26.5bn in March 2014. This has become the key indicator that has focused market concerns in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

This led to the National Bank of Kazakhstan (NBK) to devalue the tenge by 20% in early February, citing concerns of a loss of external competitiveness. The new central level for the USDKZT is 185, with the tenge being allowed to fluctuate between 182 and 188. The NBK has a history of adjusting the tenge to sizable moves in the RUB (early 2009 a prime example) and the NBK's statement explicitly cites concerns about the RUB and, more generally, about potential loss of competitiveness. Devaluation fears had also been growing in the country with the FX share of deposits rising rapidly from 29.8% in December 2012 to 39.6% in January 2014. The share rose sharply to 47.2% in February.

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.

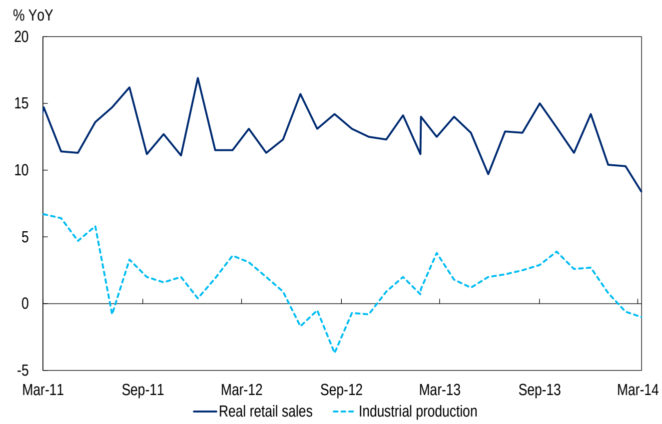
The magnitude of the currency adjustment looks too large. According to the REER (a measure of external competitiveness that the NBK has always referred to), the tenge does not look too strong. The slight loss of competitiveness observed since early 2012 when the REER rose was offset by allowing the tenge 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 149. Growth is still strong, but some weakness is evident…



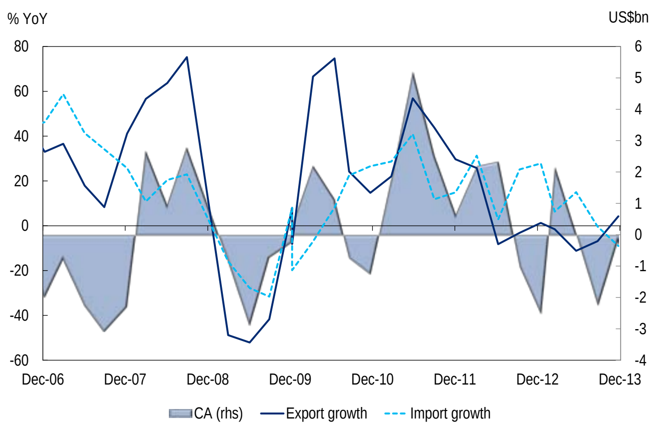
Source: Kazstat, Citi Research

Figure 150. It is mainly consumption driven as production struggles



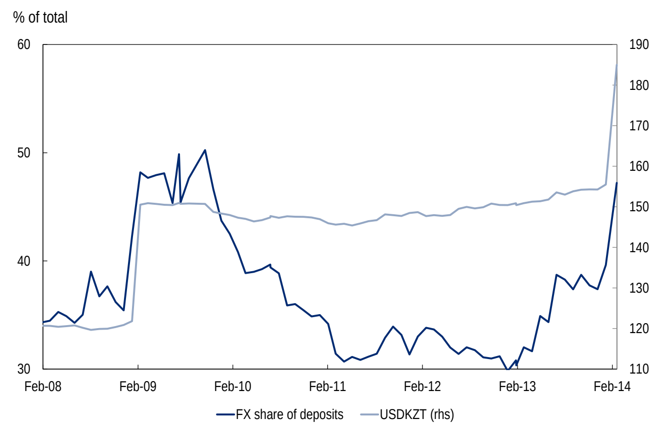
Source: Kazstat, Citi Research

Figure 151. Current account decline led by lower exports…



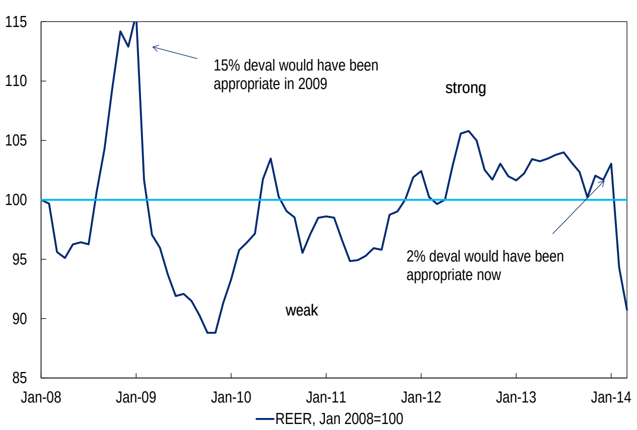
Source: NBK, Citi research

Figure 152. … led to the central bank devaluing the tenge



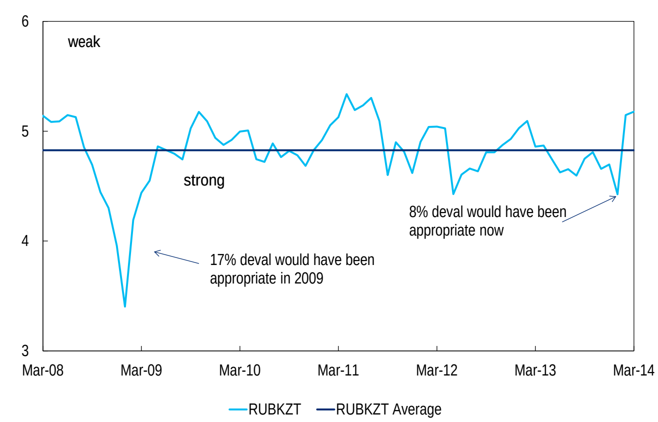
Source: NBK, Citi Research

Figure 153. The magnitude of the devaluation appears too big on REER…



Source: NBK, Citi Research

Figure 154. …and RUBKZT basis



Source: Bloomberg, Citi Research

Figure 155. Kazakhstan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	105	133	115	146	186	202	222	219	227
Nominal GDP, local currency bn	12,529	16,053	17,008	20,554	27,279	30,093	33,717	37,529	41,940
GDP per capita, USD	6,810	8,572	7,324	9,171	11,557	12,403	13,460	13,120	13,446
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	6.1	4.5	6.9	5.6
CPI, % avg	10.8	17.1	7.3	7.1	8.3	5.2	5.7	6.5	5.9
Nominal wages, % yoy	28.1	16.2	10.8	14.9	15.9	13.5	6.8	7.0	8.0
Credit extension to private sector, % yoy	55.2	5.2	7.3	0.3	15.8	12.1	12.8	12.0	12.0
Policy Interest Rate, % eop	11.00	10.50	7.00	7.00	7.50	5.50	-0.65	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	172	185
Balance of Payments, USD bn									
Current account	-8.4	6.3	-4.1	1.4	10.2	1.1	-0.1	2.1	2.9
% of GDP	-8.0	4.7	-3.6	0.9	5.5	0.5	-0.1	1.0	1.3
Trade balance	15.2	33.6	15.0	28.5	44.8	38.1	33.7	35.7	39.1
Exports	48.3	72.0	43.9	61.4	85.2	86.9	83.4	88.4	95.5
Imports	33.1	38.4	28.9	32.9	40.3	48.8	49.7	52.7	56.4
Service balance	-8.4	-6.9	-6.0	-7.2	-6.6	-7.9	-6.9	-6.0	-7.0
Income balance	-12.9	-19.4	-12.4	-19.4	-27.7	-28.1	-25.3	-26.6	-28.2
FDI, net	-8.0	-13.1	-10.1	-3.7	-8.6	-11.8	-7.8	-6.0	-8.6
International reserves	17.6	19.9	22.7	27.7	28.8	27.7	20.0	23.1	26.3
Total amortisations	25.5	31.8	30.5	21.1	22.5	23.7	13.2	9.8	9.8
Public Finances, % of GDP									
Consolidated government balance	4.5	-9.3	-9.4	2.7	5.9	0.9	3.2	2.3	2.2
Consolidated gov primary balance	4.8	-8.9	-9.0	3.1	6.3	1.3	3.8	3.0	2.7
Public debt	5.3	6.3	9.5	10.3	10.1	12.1	12.8	13.9	14.6
of which Domestic	4.0	5.1	7.6	7.8	7.6	9.6	10.4	11.6	12.3
Foreign Assets & Liabilities, USD bn									
External debt	66.8	67.7	63.2	65.9	64.8	70.6	77.2	78.7	80.0
Public	1.6	1.7	3.2	4.8	5.1	5.5	4.1	5.6	6.9
External debt / GDP	63.7	50.8	54.8	45.2	34.8	35.0	34.8	36.0	35.3
External debt / XGS	129.0	88.8	131.7	100.7	72.4	76.9	87.0	89.0	83.7
Short-term debt	11.5	9.5	7.0	8.9	8.8	9.3	10.2	10.5	10.6
Short-term debt/International reserves (%)	65.4	47.7	30.8	31.9	30.4	33.7	51.3	45.7	40.4

Quarterly Economic Indicators

	2013 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	4.5	6.2	6.9	6.9	6.9	5.7	5.7	5.8
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	5.00	3.48	3.48	3.48	3.48	3.98	3.98
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	154	154	182	185	185	185	185	185	185

Source: National Sources, Citi Research forecasts

Levant

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Iraq

Campaigning kicked off this month for the parliamentary elections, which take place April 30. The elections take place against a backdrop of increased sectarian violence and a highly divisive and fractured political scene. Following the disintegration of political alliances that formed in the 2010 elections, the number of candidates and political groupings has proliferated, with it being highly unlikely, in our view, that any single party will emerge with the ability to form a majority government.

The formation of the next government is therefore likely to be, yet again, the result of a prolonged period of horse-trading among the competing groupings, a process that took almost 10 months after the 2010 elections. Going into this next round of negotiations, the outcome is highly uncertain and the deals made between parties to facilitate their political co-operation are likely to be more binding in nature than the Erbil agreement, which allowed the formation of a government under PM Nouri al Maliki in 2010 (which was never even published and was subsequently not implemented).

In our view, the weaker the position of the dominant political parties after the votes are counted, and thus the greater the need to piece together another wide-reaching coalition, the higher the chance of conciliatory deals being reached. Of these, one of the most important from an investment perspective will be any potential deal that would allow the Kurdish parties to support a new government. It is conceivable, in our opinion, that this could act as a catalyst for a relatively robust agreement between Baghdad and Erbil on Kurdish oil exports.

For the time being, however, the dispute between the KRG and Baghdad continues, precluding the passing of the 2014 budget. The announcement last month by the KRG that it would resume pumping 100,000 bpd of oil through the Iraq-Turkey Pipeline (ITP) never came into fruition, but talks between the parties have continued. In a recent sign of potential co-operation (and perhaps a foreshadow of a future oil deal in post-electoral horsetrading), officials from both sides have agreed in principle to allow the Baghdad-controlled Northern Oil Company (NOC) to export crude to Ceyhan though the newly completed Kurdish export pipeline (Iraq Oil Report, April 25). Baghdad is seeking ways to bypass the existing Iraq-Turkey Pipeline (ITP), which has been out of action in March due to continued sabotage and terrorist activity.

Recent data show a significant weakening in Iraq's fiscal position, although we expect a rebound on the back of higher crude oil exports this year. Crude exports (which account for over 90% of government revenues) declined by around 4% in 2013 vis-à-vis the previous year, as volumes stagnated at the 2.4mbpd mark and prices softened. At the same time, expenditures rose by around 5% of GDP, resulting in a deficit which we estimate at 5.8% of GDP, as opposed to a surplus of 4.1% last year. This deficit is likely to narrow substantially going forward, in our view, given the expected progress in the country's crude sector in the coming years.

Lebanon

In its scheduled annual review of Lebanon, rating agency Standard & Poor's revised its outlook on the country's long-term foreign currency ratings from negative to stable, holding them at B-. S&P's report echoed our own view that the stability of the sovereign risk profile rests on the robustness of the Lebanese banking sector and its ability to continue funding the government.

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

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

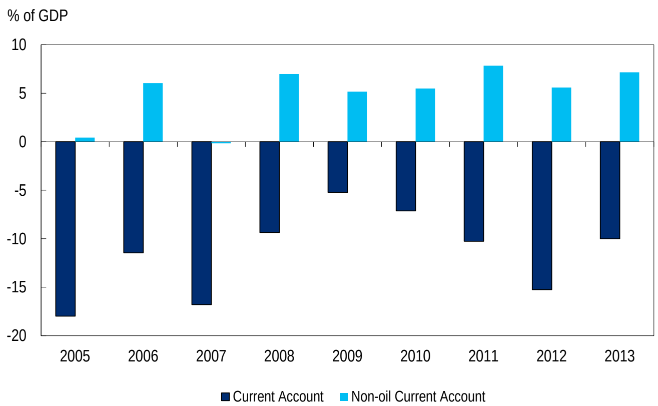
At the same time, banking sector indicators remain robust. Overall deposit growth was 7% yoy in February, with non-resident deposit growth remaining in the double-digits (11%). The dollarisation ratio remained stable at under 60%, and the risk premium on Lebanese Lira deposits has likewise hardly moved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

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

Its second task is to manage the upcoming election schedule. Presidential elections have begun, with the first round of voting by parliamentarians having taken place on 23 April. As expected, no clear consensus candidate emerged in this first round, with a large number of deputies submitting blank votes to oppose the attempt by Lebanese Forces (and March 14) candidate Samire Geagea from garnering the requisite two-thirds majority. Widespread concern persists 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 until Michel Sleiman assumed office, and in the interim the country teetered on the brink of civil war, with fighting in the streets between Hizbollah and the Sunni Future Movement.

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

Figure 156. Jordan current account dominated by oil imports ...

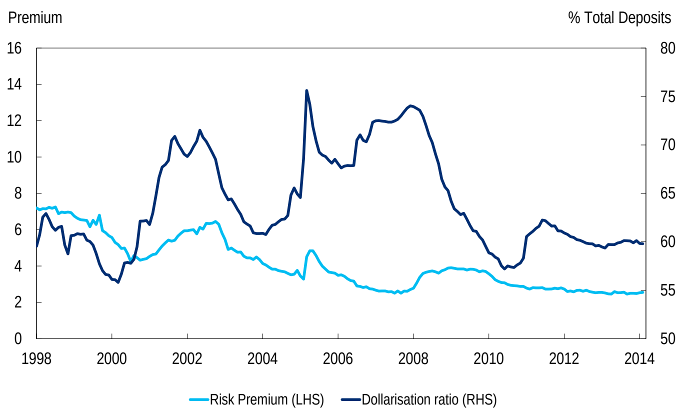


Source: Haver Analytics, Citi Research

Figure 157. Without grants Jordan's fiscal situation would be worse

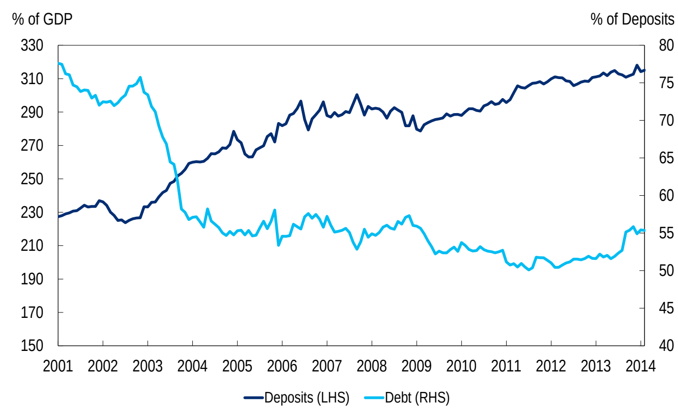
Source: Haver Analytics, Citi Research

Figure 158. Lebanon dollarization has gone up, but risk premium stable



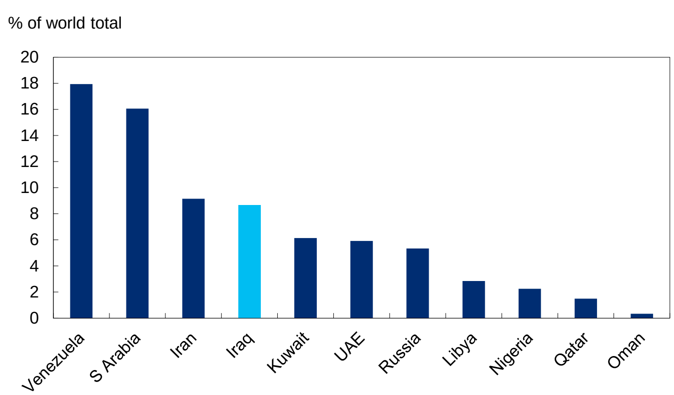
Source: Haver Analytics, Citi Research

Figure 159. Deposit growth slows, but still plenty of capacity



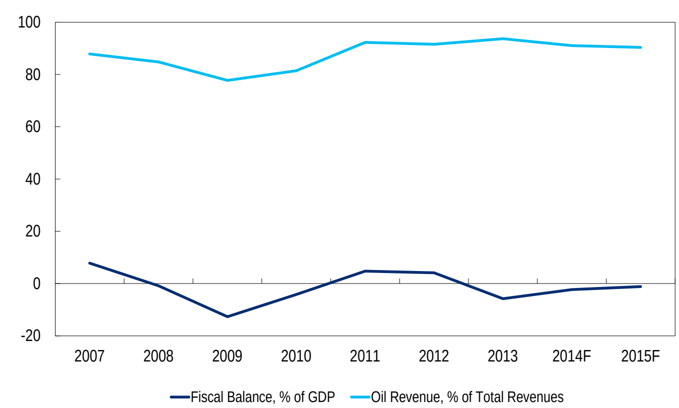
Source: Haver Analytics, Citi Research

Figure 160. Iraq has world's fourth largest proven oil reserves and ...



Source: BP, Citi Research

Figure 161. ... public finances should strengthen as a result



Source: Haver Analytics, Citi Research

Figure 162. Levant Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
IRAQ									
Nominal GDP, USD bn	91.7	135.6	113.6	138.9	186.3	216.6	234.8	271.9	318.4
GDP per capita, USD	3,190	4,607	3,766	4,487	5,871	6,655	7,032	7,942	9,068
Real GDP, yoy avg	1.4	6.6	5.8	5.5	10.2	10.3	3.2	10.3	11.5
CPI, % avg	32.6	2.8	-2.8	2.4	5.6	6.1	1.9	3.0	5.5
IQD/US$, avg	1,253	1,189	1,156	1,167	1,171	1,164	1,162	1,162	1,162
Current account, US$bn	20.0	28.4	-1.3	6.3	26.2	38.0	31.1	36.9	40.2
% of GDP	21.9	20.9	-1.1	4.6	14.1	17.5	13.2	13.6	12.6
Consolidated gov. balance, % of GDP	7.8	-0.9	-12.7	-4.2	4.7	4.1	-5.8	-2.3	-1.2
JORDAN									
Nominal GDP, USD bn	17.1	22.0	23.9	26.5	28.8	30.9	33.6	35.8	38.5
GDP per capita, USD	3,026	3,722	3,866	4,104	4,284	4,404	4,593	4,699	4,848
Real GDP, yoy avg	8.2	7.2	5.5	2.3	2.6	2.7	2.8	4.0	4.5
CPI, % avg	4.7	13.9	-0.7	5.0	4.4	4.8	5.5	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	-3.8	-3.6	-3.0
% of GDP	-16.8	-9.3	-5.2	-7.1	-12.0	-17.4	-11.3	-10.2	-7.9
Consolidated gov. balance, % of GDP	-5.1	-4.4	-8.9	-5.6	-6.8	-8.3	-5.5	-9.6	-9.4
LEBANON									
Nominal GDP, USD bn	24.6	28.8	35.1	38.0	40.1	43.0	45.3	48.1	51.1
GDP per capita, USD	6,538	7,572	9,111	9,726	10,126	10,647	11,006	11,441	11,936
Real GDP, yoy avg	9.3	9.1	10.3	8.0	2.0	2.5	1.4	2.0	2.4
CPI, % avg	4.1	10.8	1.2	4.0	5.0	6.6	2.1	3.0	5.0
LBP/US$, avg	1,512	1,507	1,504	1,502	1,506	1,504	1,507	1,508	1,508
Current account, US$bn	-1.4	-4.1	-6.7	-7.6	-4.4	-3.5	-4.1	-4.7	-5.5
% of GDP	-5.6	-14.4	-19.2	-20.0	-10.9	-8.2	-9.0	-9.8	-10.7
Consolidated gov. balance, % of GDP	-10.4	-10.1	-8.4	-7.6	-5.8	-9.1	-9.3	-8.7	-8.0

Source: National Sources, Citi Research forecasts

Nigeria

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- **Summary view** — Although political uncertainty is set to rise towards the February 2015 elections, we still expect growth to remain robust at over 6% in 2014-15. But the fiscal picture could deteriorate, notably in 2H 2014 if supplementary budgets are passed or there is no recovery in oil production.
- **Things to watch** — MPC meetings during 2H 2014 will start to provide an insight into the policy thinking of the new governor of the Central Bank of Nigeria (CBN), Godwin Emefiele, notably in terms of naira policy.
- **Strategy** —The finance minister, Ngozi Okonjo-Iweala, will seek to maintain fiscal discipline despite the approaching elections. But this should become increasingly difficult, while progress with structural reform is likely to stall.

Africa's largest economy heads to the polls

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

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

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

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

But growth should remain robust

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

Macroeconomic and naira stability for now

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

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

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

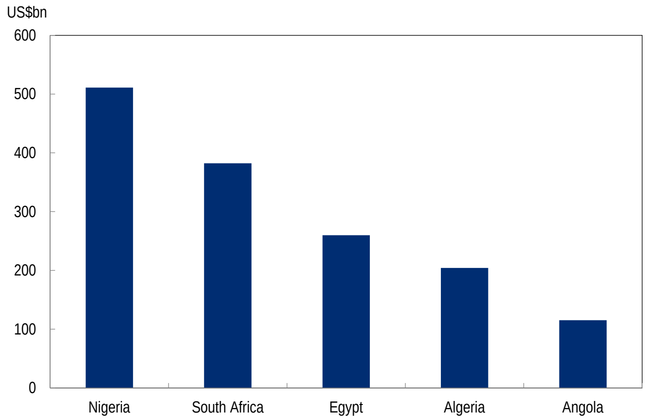
The fate of the naira is in the government's own hands

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

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

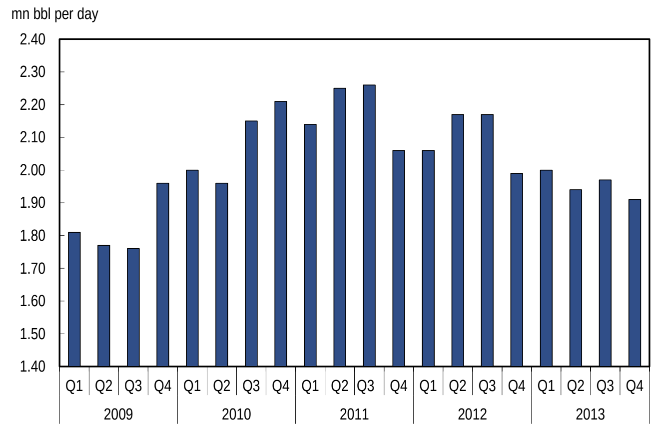
But, while we would not expect any significant change in monetary policy under the acting governor, Sarah Alade, the new governor, Godwin Emefiele, will be under the spotlight in 2H 2014 and certainly in 2015. In particular, even if the CBN can maintain broad naira stability up to the elections, the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

Figure 163. Nigeria is now Africa's largest economy



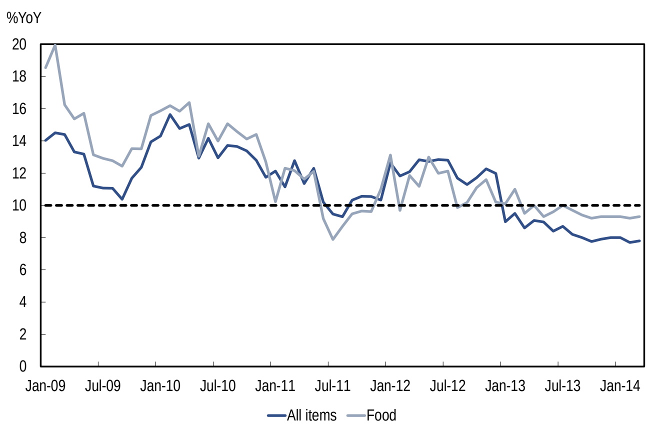
Source: National Bureau of Statistics, Citi and IMF

Figure 164. Even though oil production has been on a downward trend since mid-2012



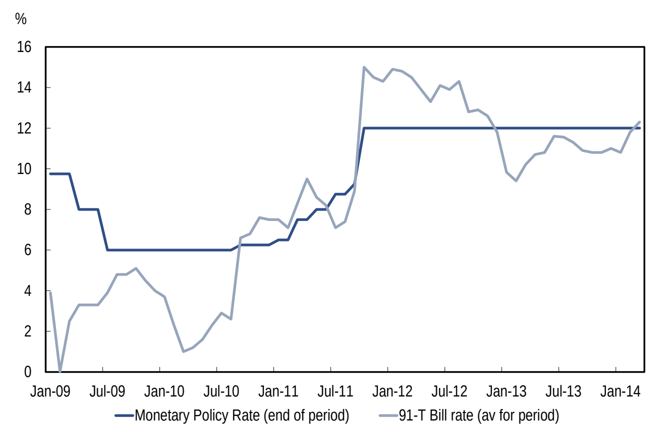
Source: International Energy Agency

Figure 165. Inflation has remained in single digits throughout 2013 and into 2014



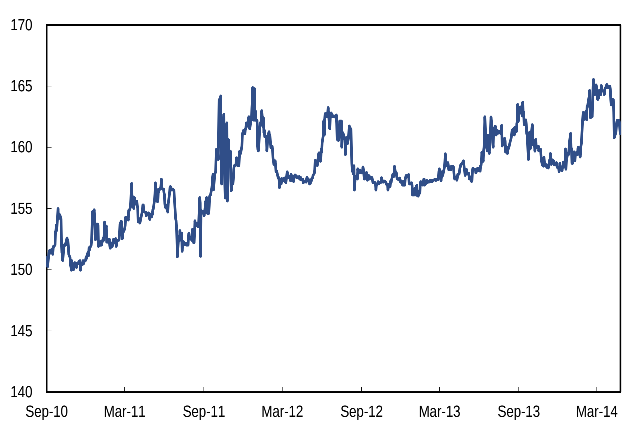
Source: National Bureau of Statistics and Citi forecasts from October 2013

Figure 166. The MPR has been left unchanged since October 2011



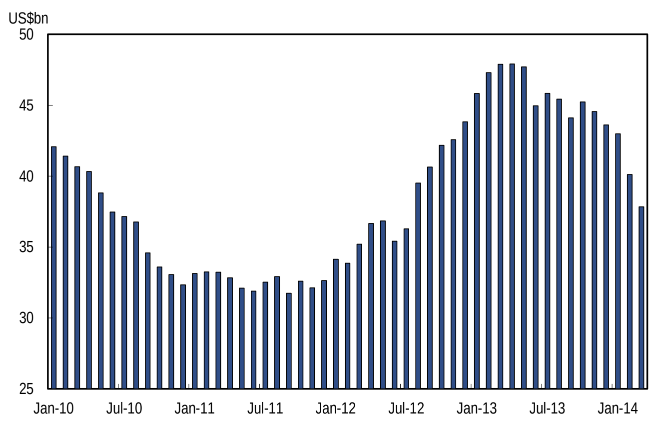
Source: Central Bank of Nigeria

Figure 167. Pressure on the naira has resurfaced in 2014



Source: Reuters

Figure 168. Reserves have been rebuilt, but come under pressure again in 2H 2013 and into 2014



Source: Haver Analytics and Central Bank of Nigeria

Figure 169. Nigeria Economic Forecasts

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

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	7.8	8.8	9.5	10.1
Policy interest rate, %, eop	12.0	12.0	12.0	12.0	12.0	12.0	12.5	12.5	12.0
Short-term market rate, % eop	13.0	10.9	11.0	11.4	11.1	0.0	12.0	14.0	14.0
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** — The recovery continues thanks to an improved labour market and we expect 2014 GDP growth to reach 3.4%. However risks to this forecast are skewed to the downside.
- **Things to watch** — The Russia-Ukraine crisis remains probably one of most important risk factors that deserve careful monitoring in coming months, as it might affect Polish exports and output growth.
- **Strategy** — The prospect of QE by the ECB is likely to be supportive for Polish government bonds in the near term, especially given the better-than-planned funding situation of the Polish budget.

No sign of negative impact of Russia crisis, so far

1Q economic growth probably exceeded 3%YoY, mostly thanks to stronger domestic demand. Monthly retail sales data, as well as labour market data, suggest private consumption is recovering quickly after a relatively weak 2013. Nominal wage growth rose by 4.8%YoY, which implies over 4% real growth, the fastest pace since January 2009. Despite the Russia-Ukraine conflict, data published in April shows no sign of deteriorating consumer confidence, while firms from the manufacturing and construction sectors appear more optimistic in their predictions of new orders. This suggests that so far the actual impact of the geopolitical crisis on economic activity in Poland has been limited and hasn't changed near-term growth forecasts. However, we wouldn't downplay geopolitical risks and although we believe they are generally manageable for the Polish economy, the intensification of the crisis could lead to some moderate downward revisions of growth forecasts. All the more so given that even without the Ukraine crisis, GDP growth is likely to have lost some momentum in first months of 2014 (Figure 144).

Although our GDP growth forecasts have been above the consensus for a long time, the gap has narrowed recently. We expect the economy to expand by around 3.4% in 2014, while the consensus is at 3.2% (Reuters survey). Although we believe internal factors are highly supportive for Poland's growth, their impact is now largely offset by rising uncertainty regarding the consequences of Russia-Ukraine crisis. Having said this, we see risks to our GDP growth forecasts as slightly skewed to the downside, at least in 2H 2014. We believe these risks could materialise in case of more serious US/EU sanctions against Russia and Russian sanctions against the West.

Rates on hold until year end

The Monetary Policy Council (MPC) probably feels very comfortable with the current macroeconomic situation. On the one hand, recent comments from several MPC members point to an even more optimistic growth forecast than ours, while on the other hand inflation is so benign that the central bank doesn't treat it as an obstacle for keeping rates at the current, very low, level. According to our forecasts, consumer price inflation will remain muted in the coming months and will only rise gradually in 2H 2014 to reach 1.7-1.8% by the end of the year and 2.5% in 1Q 2015. Low CPI and above-potential GDP growth suggest the MPC will probably stick to its policy of stable rates throughout this year and will probably start the tightening cycle only early next year. We expect in this scenario interest rates could be raised by around 100bp in 2015 and the base rate would reach 3.50%.

The biggest risk for this scenario is a possibility of zloty strengthening after the beginning of quantitative easing (QE) by the ECB. QE in the euro zone has become a part of our base-case scenario and although it is unlikely to have direct impact on NBP decisions, we believe it could affect MPC decisions if it leads to excessive currency appreciation. We believe the strong zloty probably wouldn't lead to rate cuts in Poland but it could postpone the beginning of the rate hike cycle quite substantially, especially if appreciating zloty is accompanied by intensification of the Russia-Ukraine crisis.

Strong fiscal performance continues

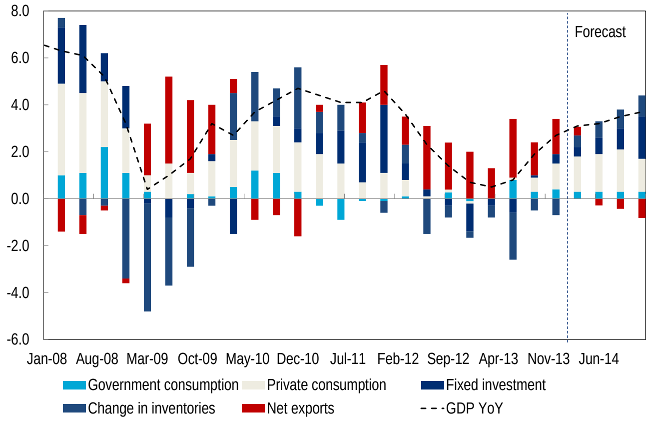
The budget deficit in first three months of the year remained well below levels that could be expected based on seasonal and historical patterns. The deficit reached 36.8% of the annual plan, while the five-year average was 11.4 points higher. Looking at the more detailed breakdown, the impressive deficit performance was a result of both relatively low spending, as well as strong tax revenues. In particular VAT revenues appear stronger than in 2013 and although this may be partly due to one-off factors, the impressive recovery in domestic demand is likely to have played an important role as well. Furthermore personal income tax revenues are likely to benefit from improvement in the labour market, though the effects will probably be seen only later this year.

According to our estimates, based on recent trends the budget deficit for the whole of 2014 is likely to reach approximately PLN 39bn, thus undershooting the official target of the government (47.5bn). This implies that even in case of external shocks, for example related to intensification of the geopolitical crisis in Ukraine, the risk of forced budget revision during the fiscal year is low, unlike in 2013. Furthermore, the lower-than-planned deficit also suggests the actual borrowing needs this year will be at least PLN8-9bn lower than assumed in the Budget Bill. According to our forecasts, total borrowing needs will be fully covered by June/July and therefore the Finance Ministry will have flexibility to reduce supply and will use 2H to prefund next year's borrowing needs. All in all, this means the general government deficit (adjusted for the impact of a one-off transfer of pension fund assets) should reach around 3.5% of GDP this year and fall below 3% in 2015.

Bonds to benefit from good fiscal position

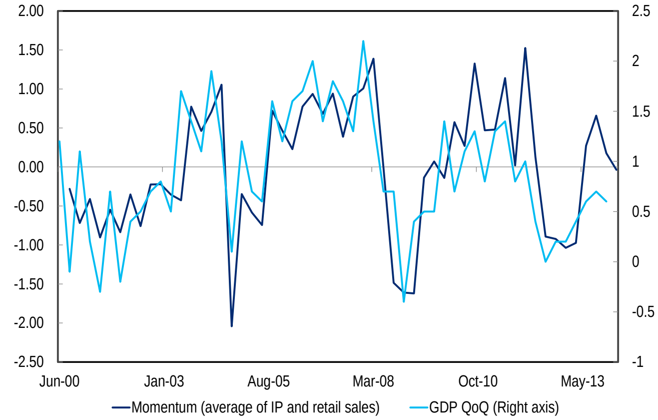
Relatively fast realisation of borrowing needs will likely act as a stabilising factor for local currency bonds. Given relatively dovish MPC comments, strong fiscal performance as well as hopes for the QE in the euro zone, we expect yields in Poland to remain close to current levels or even fall in the coming months. However, in the medium term we expect the GDP recovery and gradually rising inflation to push longer-term yields higher, thus leading to steeper curve. Given the more dovish tone of the ECB, we are now slightly more optimistic about the zloty but the base-case forecast still assumes some depreciation over next 6-12 months. The mix of outflows from EM markets and uncertainty regarding the geopolitical situation in Eastern Europe may weigh on the PLN, pushing the EUR/PLN towards 4.30.

Figure 170. Ongoing recovery supported by stronger domestic demand



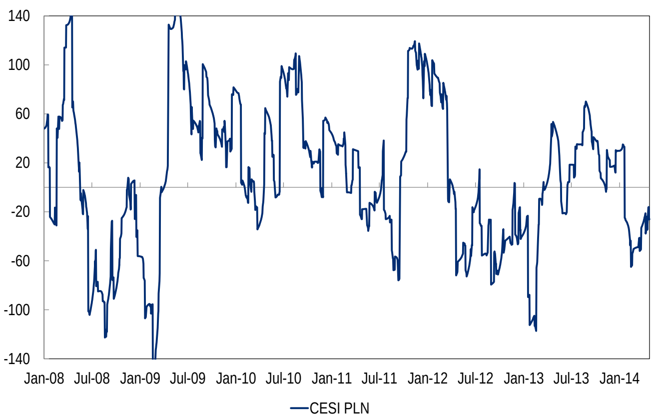
Source: CSO, Citi Research estimates

Figure 171. ..but growth momentum is somewhat weaker



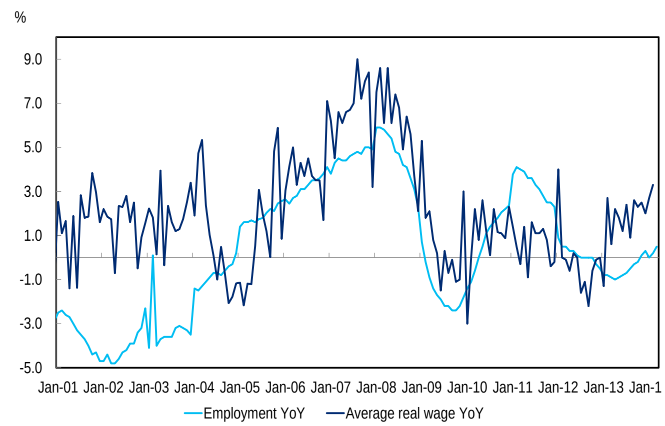
Source: Citi Research estimates based on GUS and Eurostat data. Note: The momentum indicator shows trends in QoQ GDP growth in Poland and is calculated based on monthly industrial output and retail sales data.

Figure 172. Also some 1Q data releases were weaker than expected



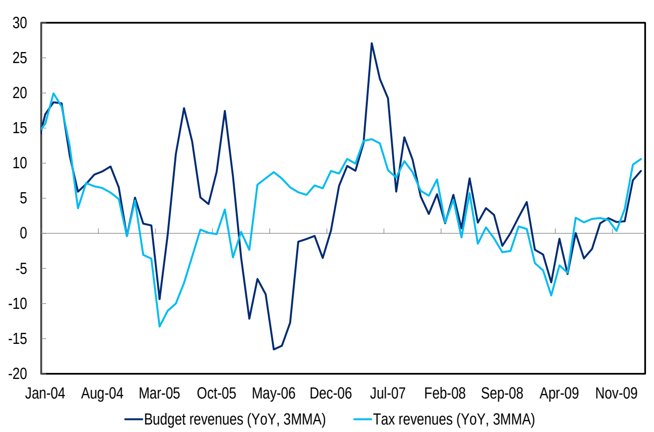
Source: Bloomberg, Citi Research

Figure 173. But labour market shows recovery is not short lived ...



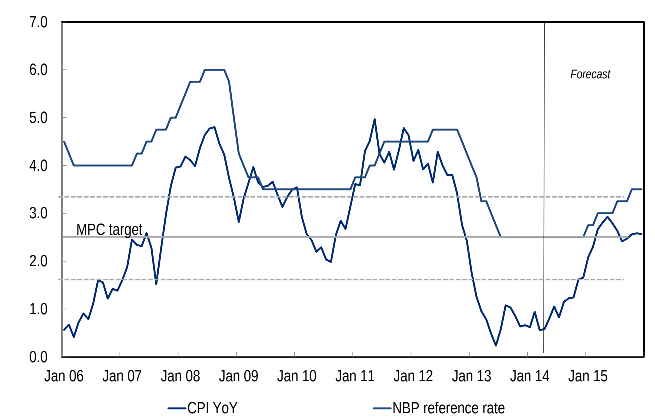
Source: CSO, Citi Research

Figure 174. ... and seems to be confirmed by rebound in tax revenues



Source: Ministry of Finance, Citi Research

Figure 175. The MPC is in no hurry to raise interest rates



Source: CSO, NBP, Citi Research forecasts

Figure 176. Poland Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	426	534	433	470	517	490	516	552	592
Nominal GDP, local currency bn	1,175	1,275	1,343	1,414	1,525	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	14,331	15,408
Population, mn	38.1	38.1	38.2	38.5	38.5	38.5	38.5	38.5	38.5
Unemployment, % of labour force	11.2	9.5	12.1	12.4	12.5	13.4	13.4	12.4	11.7
Economic Activity									
Real GDP, yoy avg	6.8	5.1	1.6	3.9	4.5	2.0	1.6	3.4	3.6
Real investment growth % yoy	24.3	4.0	-11.5	9.3	11.2	-4.0	-4.7	8.3	4.5
Real consumption growth % yoy	4.6	6.1	2.0	3.4	1.6	1.0	1.2	2.5	3.0
private consumption growth % yoy	4.9	5.7	2.1	3.2	2.6	1.3	0.8	2.7	3.2
Real export growth, % yoy	9.1	7.1	-6.8	12.1	7.7	3.9	4.6	5.9	6.5
Real import growth, % yoy	13.7	8.0	-12.4	13.9	5.5	-0.7	1.2	6.7	7.5
Prices, Money & Credit									
CPI, % yoy eop	3.9	3.4	3.7	3.2	4.6	2.6	0.8	1.8	2.7
CPI, % avg	2.5	4.2	3.5	2.6	4.3	3.7	0.9	1.1	2.7
Nominal wages, % yoy	9.1	10.5	4.2	3.6	4.9	3.5	2.6	4.5	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	4.40	4.90
PLN/US$, eop	2.47	2.97	2.87	2.97	3.45	3.09	3.02	3.17	2.93
PLN/US$, avg	2.76	2.39	3.10	3.01	2.96	3.25	3.16	3.08	3.03
PLN/EUR, eop	3.60	4.15	4.10	3.97	4.47	4.08	4.15	4.29	4.08
PLN/EUR, avg	3.78	3.52	4.32	3.99	4.12	4.18	4.20	4.23	4.17
Balance of Payments, USD bn									
Current account	-26.5	-34.9	-17.3	-24.1	-25.8	-18.1	-6.6	-13.9	-21.8
% of GDP	-6.2	-6.5	-4.0	-5.1	-5.0	-3.7	-1.3	-2.5	-3.7
Trade balance	-19.1	-30.7	-7.6	-11.8	-14.1	-6.7	3.1	2.1	-2.3
Exports	145.3	178.7	142.1	165.9	195.2	191.0	207.2	233.2	269.9
Imports	164.4	209.4	149.7	177.7	209.3	197.7	204.2	231.1	272.1
Service balance	4.8	5.0	4.8	3.1	5.7	6.0	7.0	6.1	6.2
Income balance	-16.4	-12.8	-16.6	-19.1	-23.6	-22.6	-21.7	-27.8	-32.6
FDI, net	18.0	10.4	8.5	6.9	12.3	5.2	5.2	4.0	6.0
International reserves	54.6	57.2	69.7	81.4	86.8	96.1	94.0	87.5	89.2
Total amortisations	43.0	44.0	46.9	43.4	42.8	44.5	49.3	46.9	45.7
Public Finances, % of GDP									
Consolidated government balance	-1.9	-3.7	-7.5	-7.9	-5.0	-3.9	-4.3	5.2	-2.7
Consolidated gov primary balance	0.4	-1.5	-4.9	-5.2	-2.3	-1.1	-1.7	7.3	-0.5
Public debt	44.8	46.9	49.8	52.8	53.4	52.7	53.9	47.5	46.6
of which Domestic	34.3	34.8	36.7	38.4	36.5	36.1	36.7	29.4	29.6
Foreign Assets & Liabilities, USD bn									
External debt	233.3	244.8	280.2	317.1	323.3	365.7	379.3	367.3	361.3
Public	86.8	69.4	92.2	116.5	121.0	155.9	161.1	156.0	153.4
External debt / GDP	54.7	45.9	64.7	67.4	62.6	74.6	73.4	66.6	61.0
External debt / XGS	133.9	114.2	163.8	159.6	138.9	159.8	153.3	132.3	112.5
Short-term debt	60.9	65.9	70.0	77.2	71.9	70.5	75.5	73.5	72.5
Short-term debt/International reserves (%)	111.4	115.1	100.4	94.9	82.8	73.3	80.3	83.9	81.2

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	2.0	2.3	3.1	3.2	3.5	3.7	3.3	3.3	3.7
CPI, % yoy eop	1.0	0.7	0.7	1.2	1.3	1.8	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	2.61	2.61	2.62	2.80	3.17	3.30	3.57
Long-term yield, %, eop	4.52	4.42	4.27	4.20	4.25	4.40	4.55	4.70	4.80
PLN/EUR, eop	4.22	4.15	4.17	4.21	4.25	4.29	4.26	4.20	4.14

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, the available data provide mixed signals for the much-need recovery in domestic demand.
- **Things to watch** — Political stability ahead of the November 2014 presidential election and the implementation of the IMF-EU supported economic programme 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.

Data give mixed signals on domestic demand recovery

The evidence on the expected recovery in domestic demand remains mixed. The upward trend in seasonally adjusted monthly import growth, the moderate improvement in the economic sentiment index and the recent retail turnover data offer some hope for the much-needed recovery in domestic demand. However, the absence of a meaningful pick-up in lending activity and stagnant consumer confidence warrant concern. Moreover, there is some evidence suggesting that the robust industrial production may be losing steam. Despite the noted backdrop, we continue to look for a pick-up in non-agricultural growth and expect this year's GDP growth at around 3%. In our view, better absorption of EU funds is likely to support a gradual recovery in investment. Private consumption is expected to pick up with a rise in real disposable income following the recent policy easing, record low inflation and higher minimum wages.

We recognise that there are important risks clouding the growth outlook. In our view, household, corporate, and foreign-parent bank deleveraging — coupled with rising non-performing loans — could continue to constrain credit growth and thwart the recovery in domestic demand. In addition, monetary policy tightening in advanced economies could lead to capital outflows as investors reassess portfolio risks and return, which would aggravate depreciation pressures. Given the large volume of foreign-currency lending, a sharp depreciation in the exchange rate could lead to further deterioration in bank and private sector balance sheets, thereby hindering the recovery process.

Food drives March inflation lower

At 1.0%YoY, the inflation outturn in March came in lower than the consensus (1.2%MoM). Lower-than-expected food prices, which dropped by 0.12%MoM, and turned out to be considerably lower than the seasonal average of an increase of about 0.4%MoM (Figure 5). Using seasonally adjusted data, the March print translates into a rise of about 0.13%MoM compared with an increase of around 0.3%MoM in February and 0.5%MoM in January. In our view, the better-than-expected March inflation reading doesn't change the big picture as service and nonfood prices remain sticky. Specifically, with service and non-food inflation (SA, 6-month moving average annualised) standing at around 4.2% and 2.8%, respectively, coupled with our expectations of a reversal in food prices, we keep our year-end inflation forecast at around 4.0%. In our view, the possibility of a sharper reversal in food inflation and a weaker leu emerge as the key risk factors that require close monitoring. By contrast, additional reductions in the VAT rate for certain products could lead to a lower inflation reading than we currently envisage.

NBR needs a more clear-cut operational framework

We are yet to see evidence suggesting that the NBR's accommodative stance has been effective in terms of stimulating credit activity. Concurrently, 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%. Shrugging off the IMF's suggestion, the NBR continues to keep money market rates well below the policy rate of 3.5%. As was underlined by the IMF, prolonged periods of divergence between interbank rates and the policy rate as well as excessive interbank rate volatility risk run the risk of undermining the monetary policy transmission.

Looking ahead, investors are wondering whether the NBR will carry out further cuts in RRRs. Given the already low money market rates, we believe that the NBR isn't very likely to lower RRR in the near future. Where do we go from here? The risks on the inflation front and the possibility of a weaker-than-expected leu lead us to believe that the NBR will keep rates steady at 3.5% for the remainder of the year.

Budget gap remains in check, for now

Standing at around RON 3.1 billion, the budget gap in the first two months of the year is somewhat wider than the deficit seen in the same period of 2013 (around RON 2.4bn). This outcome is largely driven by expenditures, which were up by almost 6%YoY. The government approved a budget consistent with a deficit target of 2.2% of GDP for 2014. Under the umbrella of the existing programme, the authorities intend to continue fiscal adjustment in 2015 with a view to attaining a structural deficit of 1% of GDP, while also accommodating expected further increases in co-financing of projects supported by the EU

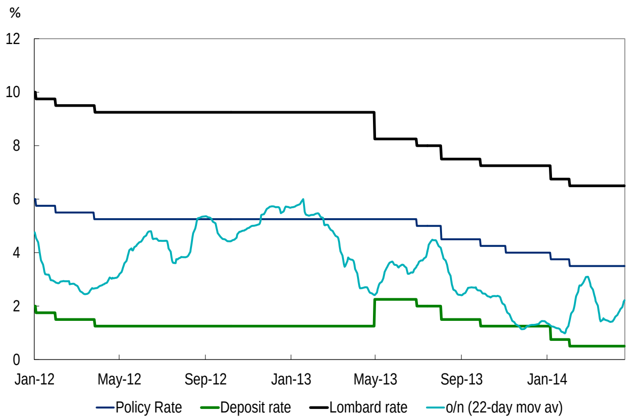
Current account gap is on track to widen moderately

Romania's current account balance printed a deficit of EUR0.1bn in the first two months of 2014 compared with a surplus of about EUR0.2bn in the same months of 2013. 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.

Subsiding inflows and NBR's strategy cloud leu outlook

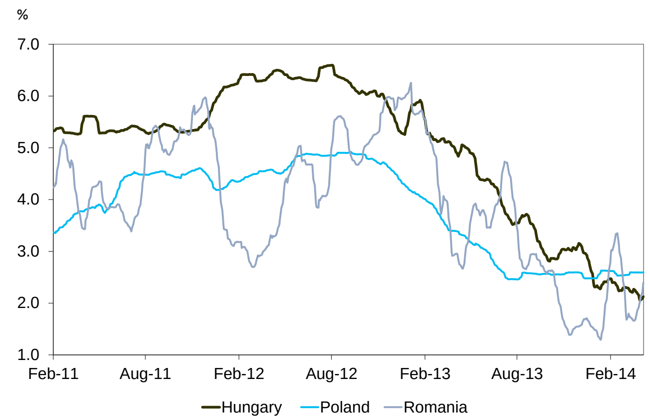
We believe that the NBR's decision to drive money markets below the policy rate remains a cause for concern. Specifically, Romania has the lowest interbank o/n interest rate when compared with its peers in the region. Moreover, we also observe an increase in the volatility of the leu, which probably 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 attract more attention going forward, in our view.

Figure 177. Divergence between interbank rates and the policy rate…



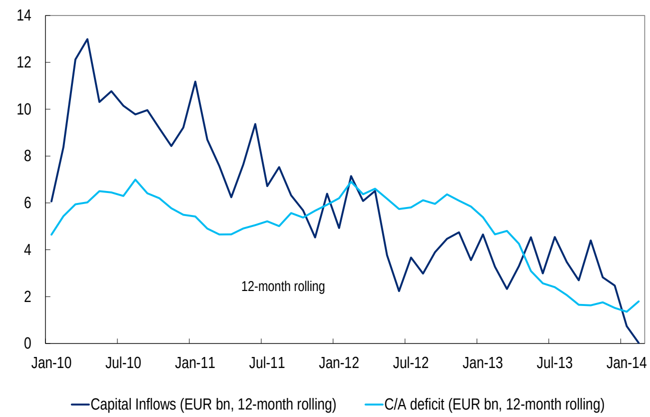
Source: Haver Analytics and Citi Research

Figure 178. …low money market rates…



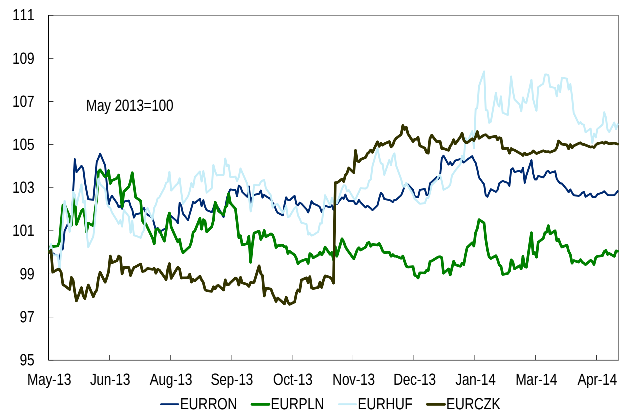
Source: Haver Analytics and Citi Research Note: 22-day moving average

Figure 179. …and subsiding capital inflows…



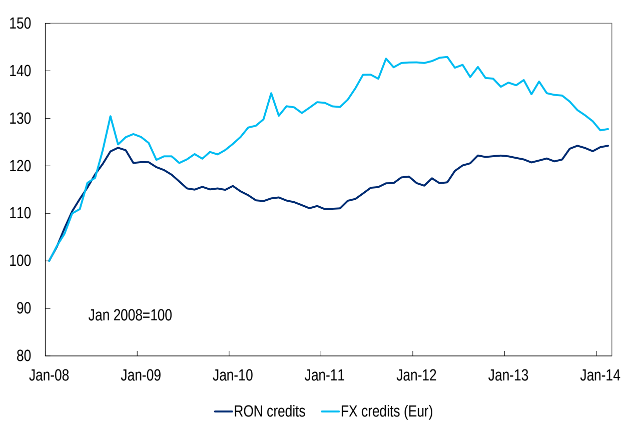
Source: Haver Analytics and Citi Research

Figure 180. …cloud the leu outlook…



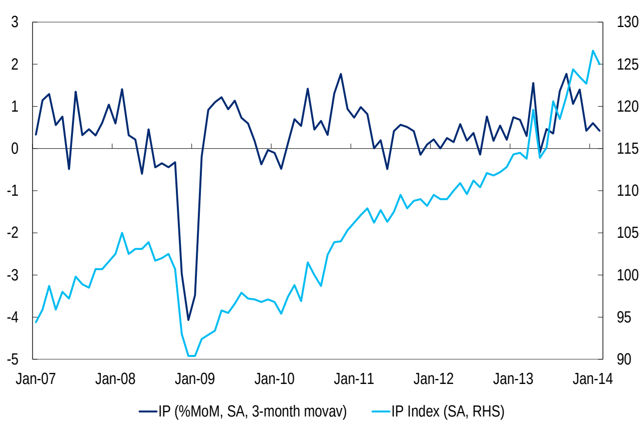
Source: Haver Analytics and Citi Research

Figure 181. …as lending activity is yet to pick-up



Source: Haver and Citi Research

Figure 182. …and the robust IP growth may be losing steam



Source: Haver and Citi Research

Figure 183. Romania Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	171	204	165	165	183	169	189	202	217
Nominal GDP, local currency bn	416	515	501	524	557	587	629	661	708
GDP per capita, USD	7,653	9,176	7,397	7,413	8,246	7,642	8,550	9,139	9,831
Population, mn	22.3	22.3	22.2	22.2	22.2	22.1	22.1	22.1	22.0
Unemployment, % of labour force	4.3	4.0	6.3	7.6	5.4	5.1	5.3	5.5	5.5
Economic Activity									
Real GDP, yoy avg	6.3	7.5	-6.6	-1.2	2.4	0.5	3.5	3.0	3.4
Real investment growth % yoy	42.6	3.0	-34.3	8.9	12.1	-0.3	-8.7	3.1	1.9
Real consumption growth % yoy	10.6	9.3	-9.0	-0.8	1.4	1.4	1.0	1.5	3.3
private consumption growth % yoy	12.0	9.5	-10.4	-0.3	1.5	1.4	1.3	1.5	3.5
Real export growth, % yoy	7.7	7.6	-6.3	14.2	12.0	-1.8	13.1	5.5	4.5
Real import growth, % yoy	27.8	7.6	-21.4	12.5	10.6	-0.3	2.3	3.0	4.0
Prices, Money & Credit									
CPI, % yoy eop	6.6	6.3	4.7	8.0	3.1	5.0	1.6	4.0	3.0
CPI, % avg	4.8	7.9	5.6	6.1	5.8	3.3	4.0	2.1	3.5
Nominal wages, % yoy	22.6	23.6	8.4	2.5	4.9	5.0	5.0	5.0	4.5
Bank credit extension to private sector, % yoy	60.4	33.7	0.9	4.7	6.6	1.3	-3.3	4.7	8.3
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
RON/US$, eop	2.47	2.89	2.96	3.17	3.33	3.37	3.25	3.37	3.19
RON/US$, avg	2.43	2.50	3.04	3.17	3.04	3.46	3.33	3.28	3.27
RON/EUR, eop	3.61	4.03	4.24	4.24	4.32	4.45	4.46	4.55	4.45
RON/EUR, avg	3.33	3.68	4.24	4.21	4.24	4.46	4.42	4.51	4.49
Balance of Payments, USD bn									
Current account	-22.9	-23.8	-6.8	-7.3	-8.2	-7.5	-2.0	-5.0	-9.1
% of GDP	-13.4	-11.6	-4.2	-4.4	-4.5	-4.4	-1.1	-2.5	-4.2
Trade balance	-24.4	-28.1	-9.6	-10.1	-10.3	-9.5	-4.6	-7.3	-11.5
Exports	40.5	49.6	40.5	49.6	63.0	57.9	65.8	67.7	71.9
Imports	64.9	77.7	50.1	59.6	73.3	67.4	70.4	75.0	83.3
Service balance	0.6	1.0	-0.4	0.5	0.5	1.5	3.6	0.6	0.6
Income balance	-5.7	-5.4	-2.6	-2.5	-3.1	-3.9	-6.1	-3.0	-3.2
FDI, net	9.7	13.7	5.0	3.0	2.6	2.9	3.5	2.0	2.6
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

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	5.4	3.9	4.2	2.9	1.9	2.2	2.7	3.1
CPI, % yoy eop	1.9	1.6	1.1	1.5	3.0	4.0	3.9	3.6	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
RON/EUR, eop	4.46	4.46	4.46	4.50	4.52	4.55	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 downgrade our 2014 GDP forecast from 2.6% to 1.0%
- **Things to watch** — Uncertainty should remain elevated at least until the end-May elections in Ukraine. The central bank has a very difficult task navigating between the need to maintain financial stability and the desire to support flagging growth. Risks to our new growth forecast are slanted to the downside.
- **Strategy** — The expected transition from a current account surplus to current account deficit over the next couple of years will put structural pressure on the currency. Cyclical pressures will also weigh on the currency as tapering fears and may weaken the RUB basket to 47.0 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 in 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% (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 is the only bright spot in Russian macro, it has been on a downtrend recently as fears of a consumer boom turning into a bubble have led to more restrictive regulatory behaviour (Is there more room to consume?). Now broader uncertainty will further weigh on real private consumption spending, which we cut 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

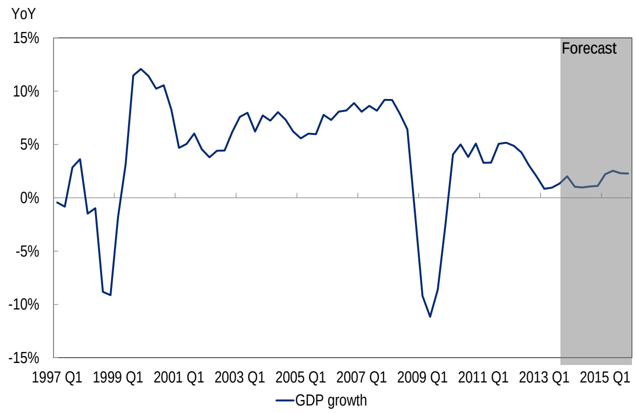
In a refreshing, if belated, recognition of Russia's dimmed economic potential, the Ministry of Economy has significantly downgraded its long-term growth forecasts. On 6 November 2013, the Ministry of Economy revised its long-term macroeconomic forecast until 2030. Average GDP growth for 2013-2030 is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

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

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

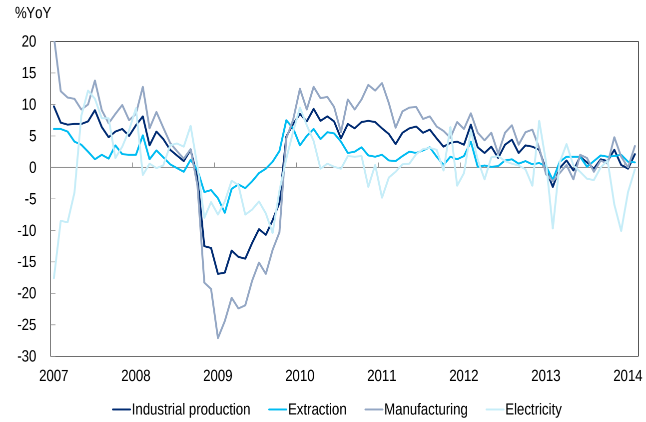
Cyclical developments are also rouble negative. The Central Bank of Russia reported that 2013 current account surplus came in at US32.8bn, or 1.5% of GDP. This is significantly less than the US$71.3bn (3.6% of GDP) surplus that was posted in 2012. In addition, net capital outflows came in at USD50bn in 1Q14 vs USD 59.7bn for the whole of 2013. Against that background, the Ukraine contagion risks have served to expose Russia as a proxy for expressing bearish views on the region, with equity and fixed income markets coming under severe market pressure. As a result, we see the rouble basket weakening towards 47 by the end of the year.

Figure 184. Growth will continue to struggle into 2014



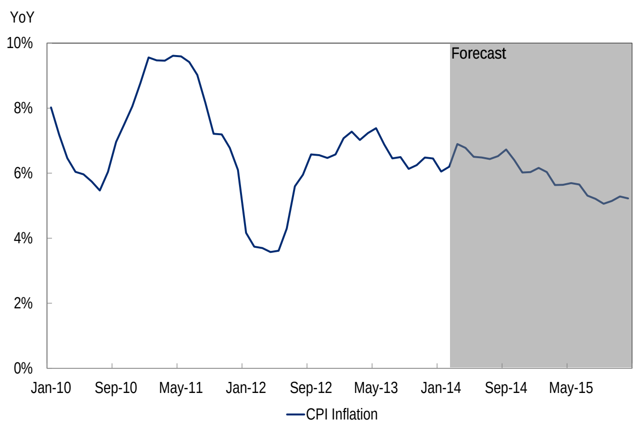
Source: Rosstat, Citi Research

Figure 185. Industrial activity is still weak



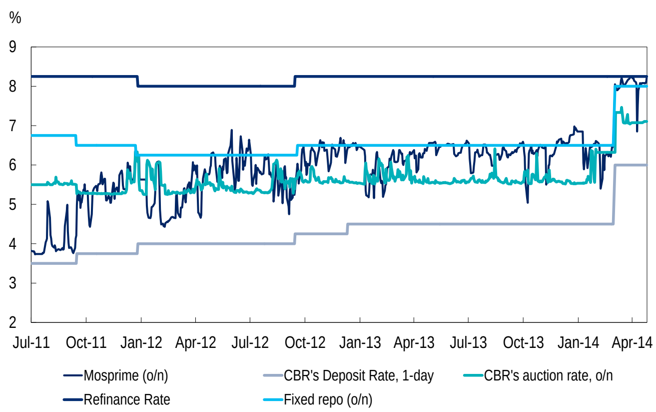
Source: Rosstat, Citi Research

Figure 186. CBR will miss its 5.0% end-2014 target...



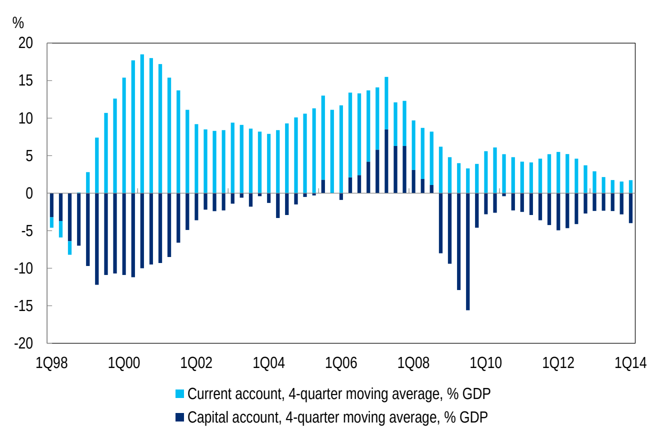
Source: Rosstat, Citi Research

Figure 187. ...despite raising policy rate by 150bpts in early March



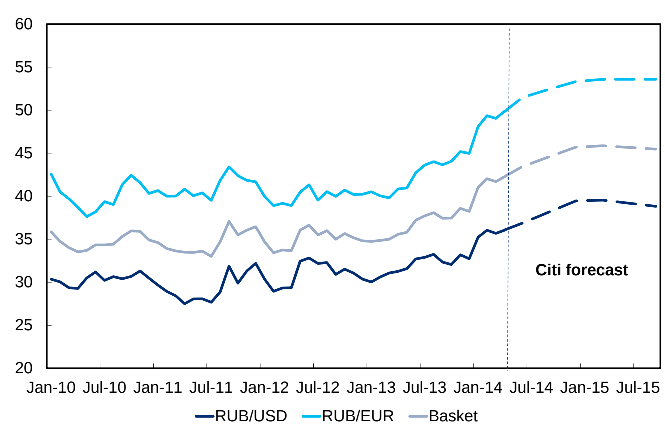
Source: Bloomberg, Citi Research

Figure 188. The gradual disappearance of the current account...



Source: CBR, Citi Research

Figure 189. ...should keep the ruble under pressure during 2014



Source: Bloomberg, Citi Research

Figure 190. Russia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,304	1,665	1,229	1,524	1,903	2,000	2,114	1,933	2,021
Nominal GDP, local currency bn	33,248	41,277	38,807	46,309	55,967	62,218	67,293	72,351	78,825
GDP per capita, USD	9,081	11,585	8,554	10,611	13,267	13,969	14,798	13,571	14,223
Population, mn	143.7	143.7	143.7	143.6	143.4	143.2	142.8	142.5	142.1
Unemployment, % of labour force	6.1	6.4	8.4	7.5	6.6	5.5	5.5	5.7	5.8
Economic Activity									
Real GDP, yoy avg	8.5	5.2	-7.8	4.5	4.3	3.4	1.3	1.0	2.3
Real investment growth % yoy	22.0	10.5	-41.0	28.5	22.6	6.6	-0.3	0.0	3.3
Real consumption growth % yoy	10.7	8.4	-3.9	3.5	4.8	5.0	3.3	2.5	2.4
private consumption growth % yoy	14.2	10.4	-5.1	5.5	6.3	6.7	4.3	3.2	3.1
Real export growth, % yoy	6.3	0.6	-4.7	7.0	0.3	1.4	1.5	2.0	2.1
Real import growth, % yoy	26.2	14.8	-30.4	25.8	20.3	9.5	5.5	4.5	5.0
Prices, Money & Credit									
CPI, % yoy eop	11.9	13.3	8.8	8.8	6.1	6.6	6.5	6.0	5.2
CPI, % avg	9.0	14.1	11.6	6.8	8.4	5.1	6.8	6.4	5.5
Nominal wages, % yoy	26.0	27.4	9.1	12.8	11.7	13.3	12.3	13.5	12.7
Credit extension to private sector, % yoy	49.3	37.2	2.6	12.9	28.1	19.4	17.2	15.0	15.0
Policy Interest Rate, % eop	6.50	9.50	6.00	5.00	5.25	5.50	5.50	7.00	5.50
1 month inter-bank rate, %, eop	6.09	20.20	6.32	3.78	6.37	6.90	6.81	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$, eop	24.6	30.5	30.3	30.6	32.2	30.6	32.9	39.5	38.5
RUB/US$, avg	25.6	24.9	31.7	30.4	29.4	31.1	31.9	37.4	39.0
RUB/EUR, eop	35.9	42.7	43.4	40.9	41.7	40.3	45.2	53.3	53.6
RUB/EUR, avg	35.1	36.6	44.2	40.3	41.0	40.0	42.3	51.4	53.6
Balance of Payments, USD bn									
Current account	72.2	103.9	50.4	67.5	97.3	71.3	32.8	40.4	33.3
% of GDP	5.5	6.2	4.1	4.4	5.1	3.6	1.5	2.1	1.6
Trade balance	123.4	177.6	113.2	147.0	196.9	191.7	180.3	181.4	172.6
Exports	346.5	466.3	297.2	392.7	515.4	527.4	523.3	536.4	552.5
Imports	223.1	288.7	183.9	245.7	318.6	335.8	343.0	355.0	379.8
Service balance	-16.7	-20.4	-17.6	-26.1	-33.5	-46.6	-58.6	-63.0	-59.9
Income balance	-28.8	-46.5	-39.7	-47.1	-60.4	-67.7	-79.8	-69.0	-70.5
FDI, net	11.1	19.1	-6.7	-9.4	-11.8	-18.1	12.4	-5.0	10.0
International reserves	466.4	410.7	405.8	432.9	441.2	473.1	492.6	478.0	486.3
Total amortisations	28.5	47.2	49.9	40.8	52.0	90.5	139.0	103.1	105.3
Public Finances, % of GDP									
Consolidated government balance	6.7	5.1	-5.6	-3.2	2.1	-0.7	-2.1	-4.4	-4.9
Consolidated gov primary balance	5.8	4.4	-5.4	-3.4	1.2	0.6	1.6	1.8	0.8
Public debt	6.6	5.2	7.3	7.6	8.2	7.7	6.7	9.5	13.3
of which Domestic	3.8	3.4	4.7	5.3	6.3	5.9	4.6	7.2	10.8
Foreign Assets & Liabilities, USD bn									
External debt	471.2	480.6	467.3	488.9	538.9	636.4	727.1	714.0	728.7
Public	37.4	29.5	31.3	34.5	34.7	38.1	43.1	43.4	50.6
External debt / GDP	36.1	28.9	38.0	32.1	28.3	31.8	34.4	36.9	36.1
External debt / XGS	120.7	91.8	136.3	110.7	94.0	107.9	122.6	121.0	121.2
Short-term debt	99.7	73.6	52.7	60.2	68.2	81.5	84.0	88.2	91.9
Short-term debt/International reserves (%)	21.4	17.9	13.0	13.9	15.5	17.2	17.1	18.5	18.9

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.3	2.0	1.0	1.0	1.1	1.1	2.2	2.5	2.3
CPI, % yoy eop	6.1	6.5	6.9	6.5	6.7	6.0	5.6	5.7	5.1
Policy interest rate, %, eop	5.50	5.50	7.00	7.50	7.00	7.00	6.50	6.00	5.50
Short-term market rate, % eop	6.53	6.83	8.74	6.63	6.48	6.43	6.31	6.31	6.27
Long-term yield, %, eop	7.62	7.88	8.80	8.13	7.98	7.93	7.92	7.81	7.77
RUB/US$, avg	32.8	32.6	35.0	36.9	38.2	39.5	39.6	39.2	38.8

Source: National Sources, Citi Research forecasts

Slovakia

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- **Summary view** — We leave our 2014 GDP forecast unchanged at 2%YoY, which is below consensus and official forecasts. Risks look balanced, with a possible positive surprise in construction activity on one side vs. large errors in the BoP and the Ukraine-Russia crisis on the other. We raise 2015-16 growth forecasts.
- **Things to watch** — Debt breached another level in the debt-brake rule despite a narrower deficit. Though the government has prepared relatively sizeable measures to avoid a debt-to-GDP ratio of 57% of GDP, an eventual downward revision to GDP would put this level at risk.
- **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's gross borrowing requirements of €6bn for 2014 are 62% covered.

We still see reasons to be not overoptimistic this year

Economic activity remains supportive for 1Q GDP despite weaker industry. Foreign trade dynamics look better and the trade surplus larger both in QoQ and YoY terms in 1Q14. Industrial activity and retail sales are also improving, while only construction activity contracted in February after a strong recovery in 4Q13. Overall, we keep our forecast of GDP growth of 0.5%QoQ in 1Q14, which should lift annual growth to 2%YoY, from 1.6% in 4Q13. We estimate the seasonally adjusted rate slightly decreased, but remained virtually unchanged around 13.1% in March (14.5% a year ago). However, the central bank also noted there was an increase in the number of unemployed who were not seeking employment (and thus not part of unemployment market statistics), which helped to reduce the unemployment rate. In any case, unemployment decreased by 7.9%YoY to 358k or 349k seasonally adjusted, which is the lowest number since mid-2011. The March outcome was better than our forecast, which suggests that our forecast of GDP growth of 2% in 2014 is accompanied with upside risk.

March confidence improved, but most sectors remain below January, pointing to some risks for 2Q14. The total confidence indicator has continued to improve slightly, to an almost 20-month high in March. The improvement was apparent in almost all sectors, with the largest improvement in consumer and service sectors, followed by industry and construction. However, the first three aforementioned sectors remained below January levels. In other words, the recent increase in total confidence has been driven mainly by construction. The March outturn represents a downside risk to our forecast of 7.7%YoY growth in industrial output in 1H14, but remained supportive for construction output at around 3-5%YoY.

We have kept our GDP growth forecast unchanged for 2014, but increased it for 2015. We believe March confidence levels support our less optimistic forecast of 2%YoY GDP growth in 2014 compared to 2.3%-2.4% forecast by the MinFin, NBS, EC, and IMF. We see asymmetric risks to our forecast, with a possible positive surprise in construction activity on one side vs. large errors in the BoP and the Ukraine-Russia crisis on the other, as we think Slovak export exposure to this region (3.5% of exports and 2.9% of GDP) could be understated by the trade statistics. Moreover, fiscal policy is unlikely to become more pro-cyclical this year owing to the debt brake rule. However, better euro area GDP outlook and more ECB easing lead us to raise 2015 GDP growth forecast to 2.8%YoY from 2.5% initially and to 3.1% in 2016 from 3%, but fiscal policy probably represents a downside risk.

Prospect for lower CPI growth

Current sources of deflation are located in four main groups — falls in energy, durable goods and telco services prices and disinflation in food prices. March consumer prices decreased by 0.2%YoY after -0.1% a month ago. This reflects another 0.1% monthly fall owing to lower food and transport prices. Disinflation in total consumer prices to -0.2%YoY in March from 2.1% a year ago mainly reflects a drop in housing energy prices, lower food prices, and the prices of Other Goods and Services. As a result the core measure of CPI (non-regulated prices) eased its growth to 0.2%YoY from 1.8% a year ago and the net measure of CPI (excl. food and tax changes) eased its growth to 0.1%YoY from 1.1% a year ago. If we look at the more "demand-pulled" segments, the disinflation is mainly driven by durable goods (HICP showed -2.5%YoY in February) and communication services (-1.4%YoY owing to drops in prices in summer last year).

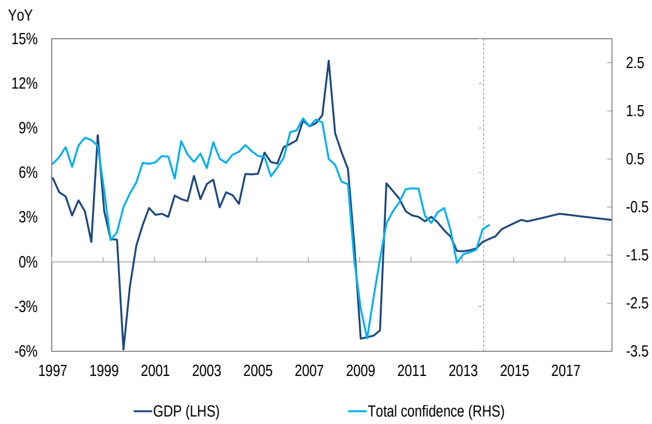
We cut our inflation forecast to 0.2% in 2014 and 1.2% in 2015 after lower March data, followed by 2% in 2016. In the near-term, we expect the base effect to lead to a weakening deflation in energy prices in April, while the deflation of food prices is likely to ease around the middle of this year, but fuel prices are likely to continue to fall unless we see a larger increase in oil prices. Hence, we expect consumer price growth to become positive in 2H14. Our forecast is below both the MinFin and the central bank reflecting our view on lower oil prices and a relatively stronger euro, which should result in lower energy and fuel prices compared to these forecasts. MinFin forecasts the CPI to decelerate to 0.8%YoY in 2014, followed by stronger growth of 2.1% in 2015 and 2.3-2.4% in following next two years — this acceleration should be broad-based. Central bank expects a stronger disinflation to 0.2%YoY in 2014, followed by a weaker pace in inflation of 1.9-2% in 2015-16.

Knocking on debt-brake rule door

Debt breached another level in the debt-brake rule despite a narrower deficit. The government deficit significantly fell to 2.8% of GDP in 2013 from -4.5% a year ago owing to larger revenues, which increased 2.2%pt to 35.9% of GDP. However, it was insufficient to stop an increase in the government debt-to-GDP ratio, which increased to 55.4% of GDP in 2013 (we expected 54.5%) from 52.7% in 2012 (revised up from 52.4%). 2013 debt is 1.1% of GDP higher than the government expected, which could jeopardise the government's plan of debt at 56.8% of GDP in 2014. Hence, the government has to freeze expenditures now to narrow the deficit below the planned -2.8% in 2014 and -2.5% in 2015. The government agreed on around €470mn of measures (0.6% of GDP) for 2015 and assumes a change in management of state oil reserve, which increased debt by €500mn (0.7% of GDP). Moreover, the government plans privatisation of 49% of a telecom company (€1bn). So together, this is about 2.6% of GDP, plus an eventual 0.3% from the real estate tax.

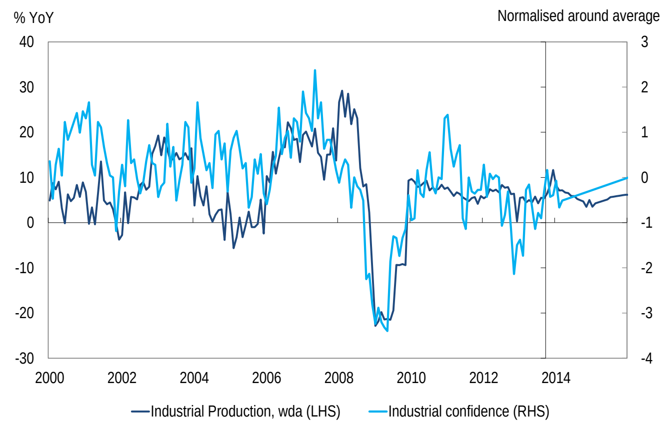
However, the new ESA2010 and in particular eventual downward revision in nominal GDP (owing to large error item in the balance of payments) could take debt above 57% of GDP in 2014, which would require a balanced fiscal budget in 2016. We see several ways how to avoid this situation: i) the most plausible — to cooperate with the opposition (as we talk about the Constitutional law) to apply the debt-brake rule on net debt (gross less the financing reserve or Single treasury account); ii) to cooperate and increase the levels in the rule, which we do not see as constructive as it would be another increase in levels; iii) to ignore the substance of law and to reconstruct the government, which would provide more time to decrease the debt below 57% of GDP without balancing the budget.

Figure 191. March confidence remains supportive for the recovery



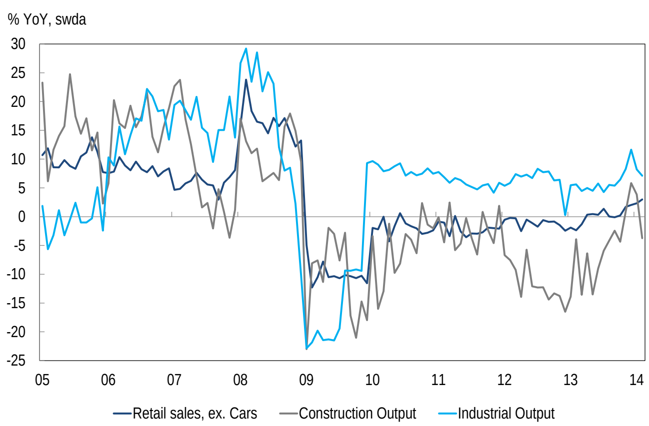
Source Statistical Office of the Slovak Republic, Citi Research estimates

Figure 192. but industrial confidence was weaker than is our outlook



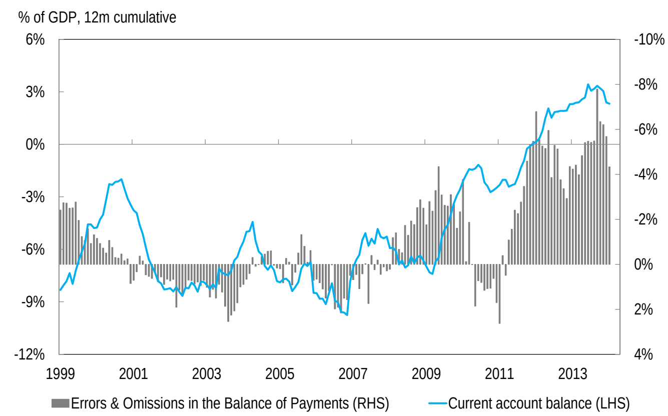
Source: Statistical Office of the Slovak Republic, Citi Research estimates

Figure 193. February data from real economy were weaker, but solid



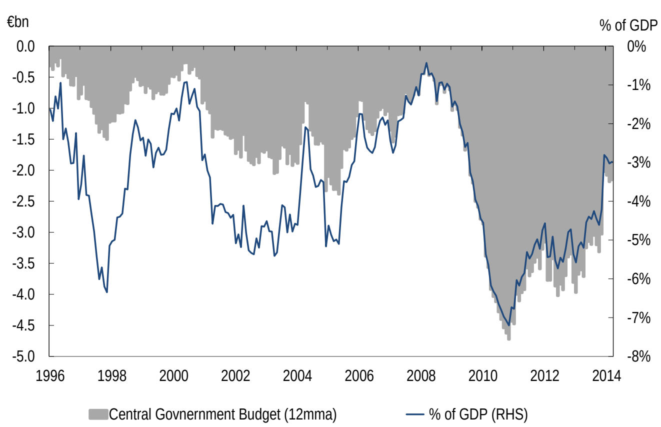
Source: Statistical Office of the Slovak Republic, Eurostat, Citi Research

Figure 194. Large errors in the BoP represent a risk of GDP revision



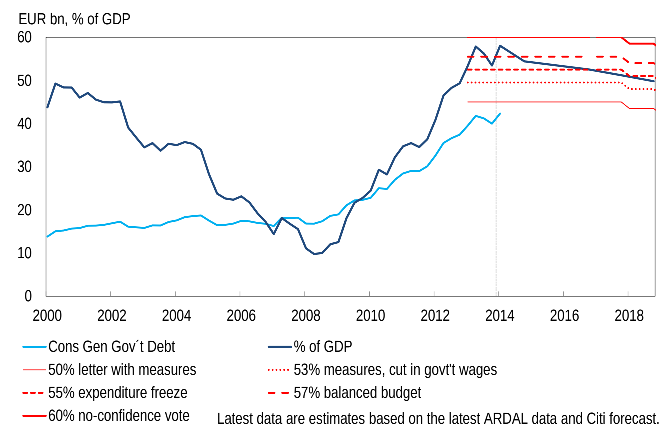
Source: Haver Analytics, Citi Research calculations

Figure 195. Central government budget was mixed in March



Source: Haver Analytics and Citi Research calculations

Figure 196. Knocking on debt-brake rule door



Source: ARDAL, Eurostat, Haver Analytics and Citi Research

Figure 197. Slovakia Economic Indicators

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

Quarterly Economic Indicators

	2013 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	2.6	2.8	2.7
CPI, % yoy eop	1.0	0.4	-0.2	0.1	0.4	0.6	1.1	1.2	1.3
Short-term market rate, % eop	0.13	0.21	0.23	0.14	0.06	0.06	0.06	0.25	0.25
Long-term yield, %, eop	2.83	2.78	2.49	2.28	2.33	2.32	2.42	2.42	2.52

Source: National Sources, Citi Research forecasts

South Africa

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- **Summary view** — The debate on the magnitude, timing and increments of rate hikes remains given the trade-off between high inflation and low GDP growth.
- **Things to watch** — Upcoming elections leaves political risk higher than usual while the ZAR is key to monetary policy decisions.
- **Strategy** — Risk of ZAR volatility and weakness remains. Another sovereign ratings downgrade is minimised but still cannot be ruled out entirely.

A necessary rebalancing

South Africa's macro outlook has changed significantly since the start of the year. Following the surprising 50bp rate hike by the SA Reserve Bank in January, we continue to expect a total 150bp in this interest rate cycle. A weaker ZAR leaves inflation trending higher and that this will erode real disposable income growth. But tighter monetary policy will also weigh down on consumer spending given that it will take some time to result in lower inflation. Higher rates and the expectation of rising rates dampens corporate earnings, corporate credit take-up and likely boosts corporate savings. Alongside electricity troubles and labour disruptions, this is sufficient reason to expect less from private sector fixed investment. We continue to expect below-consensus GDP growth of 2.3% in 2014 with some downside risk from electricity shortages and labour unrest. The platinum sector continues to grapple with strike-related production stoppages, which isn't too surprising given its highly unionised labour force and 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. As seen in recent GDP data, rebalancing from consumption to production is taking place and we expect this to express through the current account deficit this year. The Q1 14 current account deficit may see a slight setback from electricity outages in March (which also brought about greater oil imports) but we think something in line with its narrowing to 5.1% in Q4 13 is still likely. Local limits (labour unrest, high wages, rising costs of production and inefficient logistics) have dampened exports ability to respond to a weaker currency, but some improvement is starting to emerge. Concurrently more significant import compression has emerged in direct relation to a loss of momentum in gross domestic expenditure (falling 3.5% in Q4). It is obvious now that the consumer and the private sector are importing less. But government's price inelastic infrastructure roll-out will dampen the ability for a more significantly drop in imports. Unfortunately, Q2 14 may also prove problematic for the trade deficit. The 13-week long platinum strikes appear to have compromised platinum exports from April onwards. Finally, a metals manufacturing strike in July would also not help exports. Nevertheless, aside these once-offs, we expect a year-end ratio of 4.5% of GDP and an annual average current account deficit of 4.9% which is an improvement on 5.8% in 2013. For the ZAR this still requires about R180bn in financing which is difficult in a global environment that lacks liquidity. What's more, questions remain as to the make-up of unrecorded transactions (3% of GDP currently), which is key to why the ZAR remains undervalued through the year.

It's all about vulnerabilities

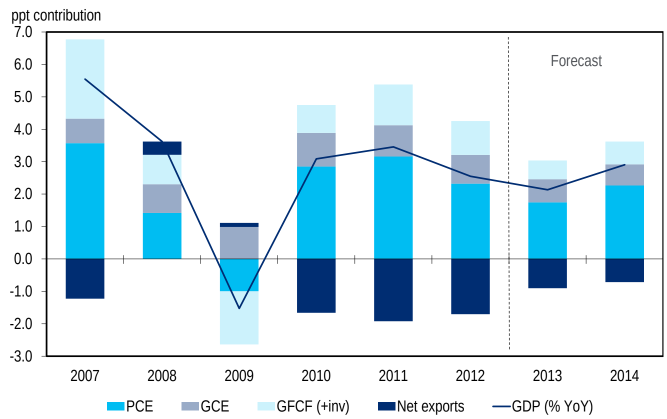
We see more ZAR pass-through to inflation this year. Company margins are under pressure in the face of rising costs and low domestic demand leaving retailers with no other choice but to try pass-through more currency weakness than before. Anecdotal evidence from surveys and the listed retail sector affirms 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 far higher by Q3 14. Finally, the coupling of above inflation wages and low productivity keeps unit labour costs elevated and a certain upside risk to the inflation outlook. Despite the many upside price pressures, inflation variance remains low, which we believe is due to the opposing forces of limited consumer appetite and rising cost push pressures. As a result, the downside risk of a still-negative output gap (particularly if one takes 150bp in rate hikes into account) should keep headline CPI from rising more than 6.8% in Q4 14 however, the many upside risks keep inflation out the target range from Q2 14 through to Q1 15.

Monetary policy faces another year of fierce debate. Following the surprise 50bp rate hike in January, lower ZAR variance and downside GDP growth risks have allowed for a more dovish monetary policy debate. This aligns to the SARB's communication that a slow and moderate hiking cycle is its preferred option when normalising policy rates and was conducive to its decision to keep the repo rate unchanged in March. That said, upside risks to inflation expectations (the ZAR, food and wages mostly) and the prolonged 4-quarter period that the SARB expects CPI to remain above-target still justifies additional tightening, but smaller increments are now more likely. We have adjusted our base case and now look for a 25bp rate hike in May (from 50bp previously). This aligns to the current FRAs. For timing, we believe it is still critical to hike in May for the SARB's credibility as, after pausing in March, it needs to communicate its intention to still normalizing policy rates. Thereafter, we have split our previous 50bp July rate hike between July (+25bp) and September (+25bp) but attach a lower probability to the September MPC meeting given how data-dependent the SARB would be at that point. Our year-end level for the repo rate is 6.25%. Fatefully for rates markets, the monetary policy debate is likely to remain rather fierce given its data dependency on both global and local factors — many of which are highly unpredictable. In our view, this keeps a degree of market volatility in the near-term.

Looking to the national elections

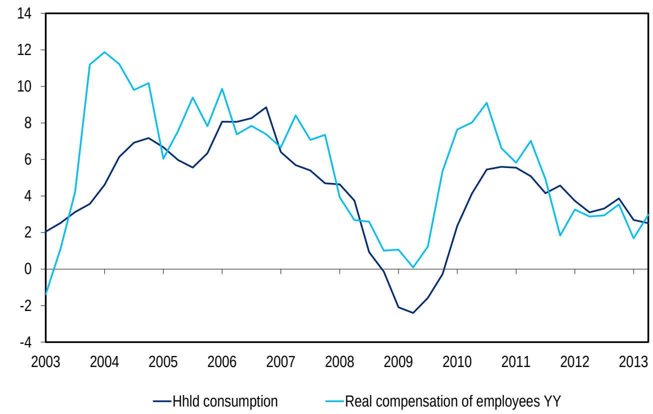
The 2014 national elections should be a turning point for South Africa politics. On 7 May 2014 the country will face its national elections. This time the current ruling party, the African National Congress (ANC), faces more voter challenge than before. The ANC's tripartite alliance with Cosatu (the 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 198. GDP to remain lackluster in 2013 and 2014



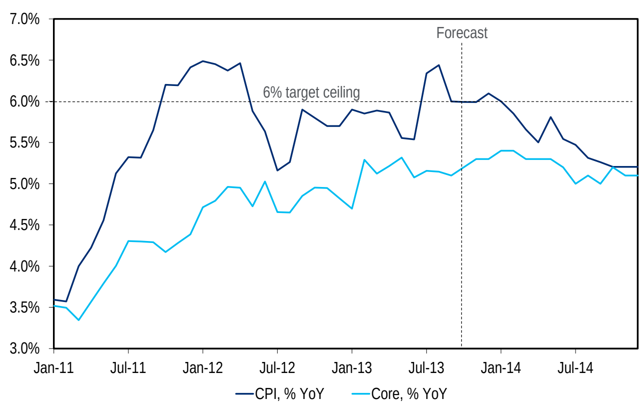
Source: SARB, Citi Research Projections

Figure 199. Consumption is slowing as real incomes decelerate



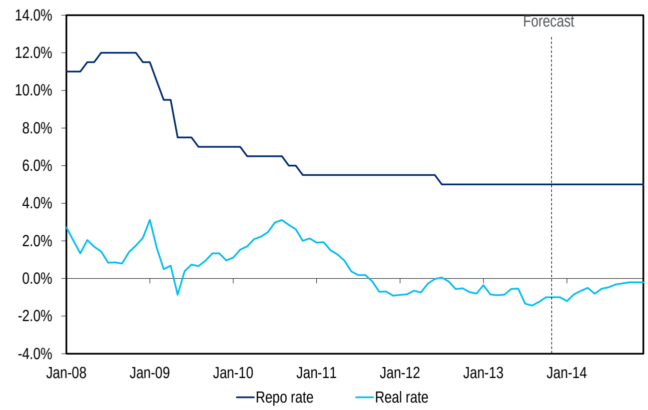
Source: SARB, Citi Research calculations

Figure 200. The CPI will remain at the top of the SARB ceiling in 2H 2013



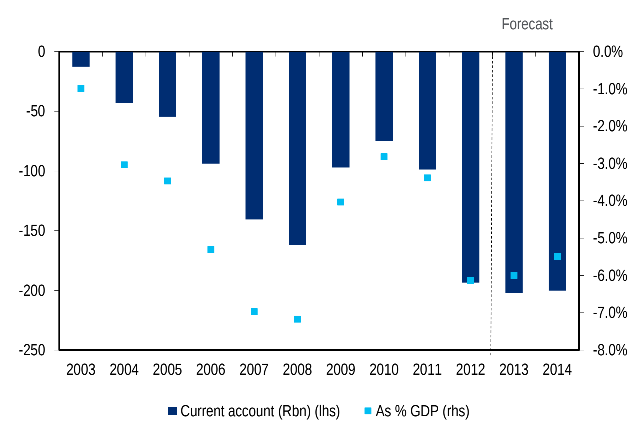
Source: Stats SA, Citi Research projections

Figure 201. Rand volatility suggests further Repo rates cuts are unlikely



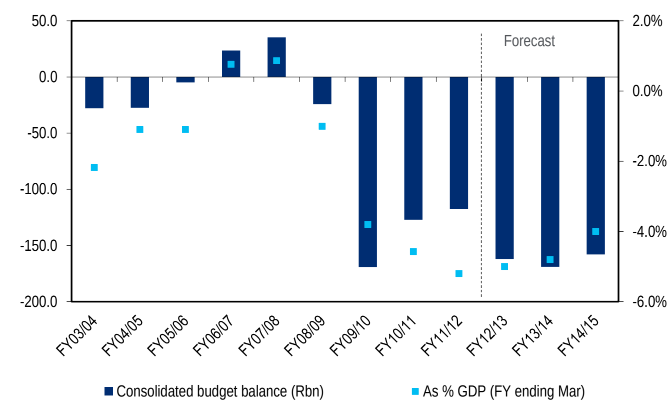
Source: SARB. Stats SA

Figure 202. No meaningful narrowing in the current account deficit



Source: SARB, Citi Research projections

Figure 203. Fiscal consolidation will likely be slow



Source: National Treasury, Haver Analytics, Citi Research projections

Figure 204. South Africa Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	286	273	287	366	404	382	351	340	370
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	6,752	7,334
Population, mn	49.6	48.7	49.3	50.0	50.0	50.0	50.2	50.3	50.4
Unemployment, % of labour force	-	22.5	23.7	24.9	24.8	24.9	24.7	25.0	24.6
Economic Activity									
Real GDP, yoy avg	5.5	3.6	-1.5	3.1	3.6	2.5	1.9	2.3	2.9
Real investment growth % yoy	12.0	4.4	-8.6	4.3	7.0	4.9	2.4	1.1	8.0
Real consumption growth % yoy	5.2	2.8	-0.1	4.4	4.7	3.7	2.5	2.4	3.0
private consumption growth % yoy	5.5	2.2	-1.6	4.4	4.9	3.5	2.6	2.4	3.1
Real export growth, % yoy	6.6	1.8	-19.5	9.0	6.8	0.4	4.2	6.6	5.5
Real import growth, % yoy	9.0	1.5	-17.4	11.0	10.0	6.0	4.7	4.0	6.8
Prices, Money & Credit									
CPI, % yoy eop	7.6	9.3	6.0	3.4	6.4	5.7	5.3	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
Bank credit extension to private sector, % yoy	21.5	13.6	-0.1	5.5	6.2	10.1	6.2	8.2	9.0
Policy Interest Rate, % eop	11.00	11.50	7.00	5.50	5.50	5.00	5.00	6.50	7.50
1 month inter-bank rate, %, eop	11.18	11.35	6.94	5.44	5.47	5.02	5.10	6.60	7.60
ZAR/US$, eop	6.87	9.49	7.41	6.62	8.09	8.46	10.50	11.16	10.90
ZAR/US$, avg	7.05	8.27	8.41	7.32	7.26	8.21	9.65	10.89	11.02
Balance of Payments, USD bn									
Current account	-19.9	-19.6	-11.6	-7.2	-9.4	-20.0	-20.4	-16.7	-15.4
% of GDP	-7.0	-7.2	-4.0	-2.0	-2.3	-5.2	-5.8	-4.9	-4.2
Trade balance	-5.2	-4.3	0.3	6.8	6.5	-4.8	-7.6	-4.3	-3.6
Exports	76.2	85.3	66.4	89.8	108.8	99.2	95.1	91.9	95.9
Imports	81.4	89.6	66.1	83.0	102.3	104.0	102.7	96.1	99.4
Service balance	-2.7	-4.1	-2.8	-4.4	-4.7	-2.5	-2.2	-1.8	-2.3
Income balance	-9.8	-8.9	-6.4	-7.2	-9.2	-8.9	-7.4	-7.8	-6.8
FDI, net	3.6	12.3	6.4	3.7	4.5	1.6	2.6	2.2	2.1
International reserves	29.6	30.6	35.3	38.2	42.6	44.0	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

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	2.0	2.3	2.0	2.6	2.3	2.6	2.8	3.2
CPI, % yoy eop	6.1	5.3	6.1	6.9	6.7	7.0	6.5	6.1	5.7
Policy interest rate, %, eop	5.00	5.00	5.50	6.00	6.50	6.50	7.00	7.00	7.50
Short-term market rate, % eop	5.08	5.10	5.63	6.10	6.60	6.60	7.10	7.10	7.60
ZAR/US$, eop	10.03	10.50	10.53	10.86	11.01	11.16	11.14	11.06	10.98

Source: National Sources, Citi Research forecasts

Turkey

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- **Summary view** — A sub-par growth performance remains our base case, as we expect GDP growth to decelerate to 2.2% from 4% in 2013.
- **Things to watch** — Political developments, as we approach the first round of the presidential election on August 10, forward-looking growth indicators and the CBT's resolve to avoid premature easing need to be monitored closely.
- **Strategy** — The recent steepening of the xCCY swap curve is in line with our expectations. Looking ahead, however, we don't see much room for further steeping in the xCCY.

Delivering 4% GDP growth per annum will get harder

At 4.4%YoY, GDP growth in the fourth quarter of 2013 came in stronger than the consensus (4.1%), bringing the full-year GDP growth to 4%. Standing at 0.5%QoQ (SWDA), the recent GDP data also suggests that economic activity in 4Q 2013 has lost momentum when compared with 3Q (0.8%QoQ) and 2Q (2.0%QoQ). Although Turkey's 4%YoY GDP growth in 2013 can be considered a successful outcome given the difficult global and domestic backdrop, its composition warrants concern for at least two reasons. First, standing at 1.6pp, the contribution of the public sector to GDP growth in 2013 is well above its 2002-12 average of 0.6pp. Such a boost from the government cannot continue without raising questions about the fiscal health of the country. Second, the contribution of private consumption and investment (combined) to GDP growth in 2013 was 3.2pp, which is well below its 2002-12 average of 5.3pp. Given the presence of more stretched corporate and household balance sheets, coupled with a more hostile external environment, we expect the noted sub-par contribution to continue going forward, which leads us to look for a below-average growth of about 2.2% in 2014.

February current account backs external adjustment story

We expect the current account deficit to narrow this year to 5.2% of GDP from 7.9% 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 February is about US$0.8bn 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% and the possibility of a sharper-than-expected reversal in net gold exports. A closer look at the capital account suggests that external financing continues to be highly tilted toward shorter term inflows and more stable sources of funding like FDI remain rather unimpressive.

March inflation: A reminder of the difficult road ahead

At 8.4%YoY, the March inflation reading came in higher than the consensus (8.1%). Using seasonally adjusted data, the March inflation print translates into a rise of around 1.0%MoM, compared with a rise of 0.5%MoM in February and 1.4%MoM in January. We see a marked deterioration in underlying inflation indicators, which, coupled with the worsening in forward-looking expectations, paints a challenging outlook for the CBT. Specifically, with core measures (SA, 3-month moving average annualized) standing at around 11.5%-12.5%, the CBT's forecast of inflation reaching 5% by mid-2015 looks unrealistic. Against this backdrop, we see inflation at 8.5% by the end of 2014, with the risks tilted toward a higher print.

Monetary policy easing is back on the table…

The recent developments, including the PM's recent comments on interest rates, have revived expectations of a relaxation in the monetary policy stance. Specifically, the PM recently stated that: "As soon as the local election results were announced, markets started to react positively. The stock exchange climbed above 70,000. Yields are falling. In line with this, the central bank will probably convene an extraordinary Monetary Policy Committee meeting, and this time it should lower interest rates" (Reuters, April 4, 2013). In response, Governor Basci argued there was no need to hold an extraordinary meeting to lower rates, while signaling any cuts will come in gradual and measured steps (Bloomberg, April 8, 2014).

Given the difficult inflation outlook and the country's large external financing needs, we believe an outright rate cut in the near-term is not very likely. At the April MPC, the CBT reiterated that the tight monetary policy stance will be sustained until there is a significant improvement in the inflation outlook. In our view, the unwinding of certain macro-prudential measures put forward by the BRSA and the CBT would be the first line of defense against the economic slowdown. Looking ahead, however, pressure on the CBT is likely to intensify as we approach the August presidential elections. In this respect, we believe the combination of a further appreciation of the lira and more signs of economic weakness would raise the likelihood of a premature easing. This would, in turn, undermine efforts to stabilise the lira and undo the salutary impact of the January rate hike in bolstering investor confidence and in supporting the external adjustment process (Turkey Macro Flash - Can the CBT afford policy easing?).

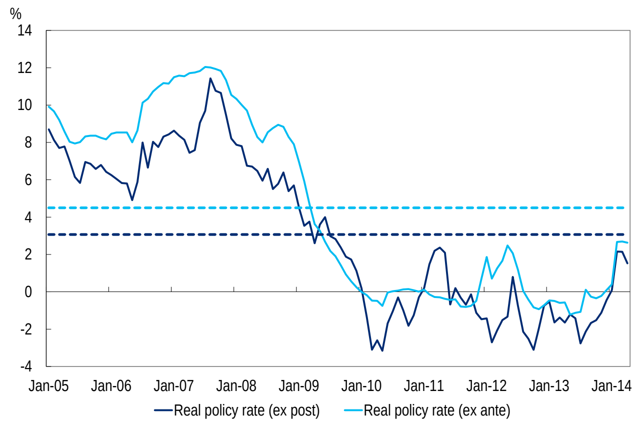
…which complicates the lira outlook

The decline in political noise after the March local elections and the increased buffer for downside risks following the January rate hike played an important role in the recovery of the lira. Nonetheless, we believe 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 on portfolio debt and short-term bank flows to meet the country's hefty external financing needs. Second, policy slippages that could hurt fiscal discipline (such as the new guarantee scheme) and rising pressures on the CBT, which probably led the CBT to bring money market rate from around 12% closer to 10% before raising it back to about 11.4%, warrant concern. While we think an actual reduction of the policy rates is unlikely in the short-term owing to the Bank's massive credibility gap and the possibility of a market backlash, one cannot rule out surprises ahead of the presidential elections.

xCCY swap curve is set to flatten

The recent steepening of the xCCY swap curve is in line with our expectations. Looking ahead, however, we don't see much room for further steeping in the xCCY. In fact, if anything, one can make a case for a moderate flattening. First, we believe that an outright rate cut in the near-term is not very likely owing to the difficult inflation outlook and the country's large external financing needs. Second, evidence suggests that the recent sharp drop in interest rates was incommensurate with the improvement in Turkey's relative performance in credit markets. These, coupled with our model estimates for the 1s5s, lead us to believe that the recent steepening has probably run its course and that a moderate flattening in the xCCY cannot be ruled out.

Figure 205. It is difficult to reconcile rate cut expectations...

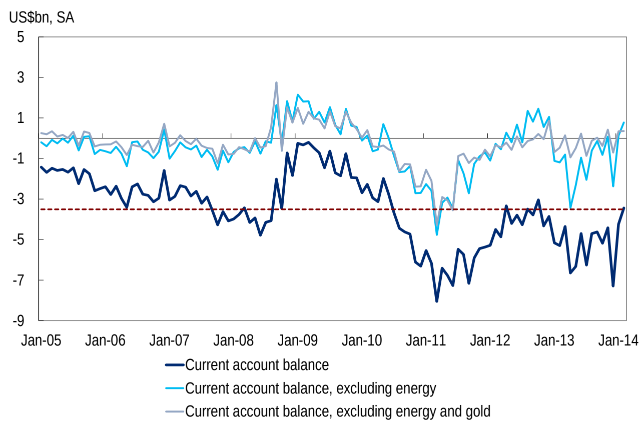


Source: Haver Analytics, Citi Research

Figure 206. ... with the marked deterioration in underlying inflation

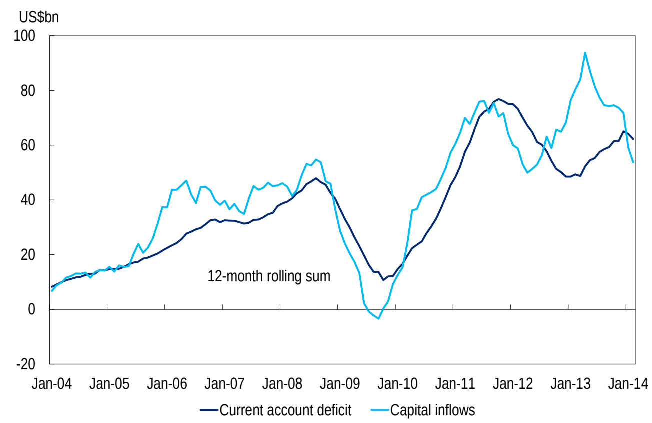
Source: CBT, Citi Research Note (12-month rolling)

Figure 207 External adjustment is gaining momentum...



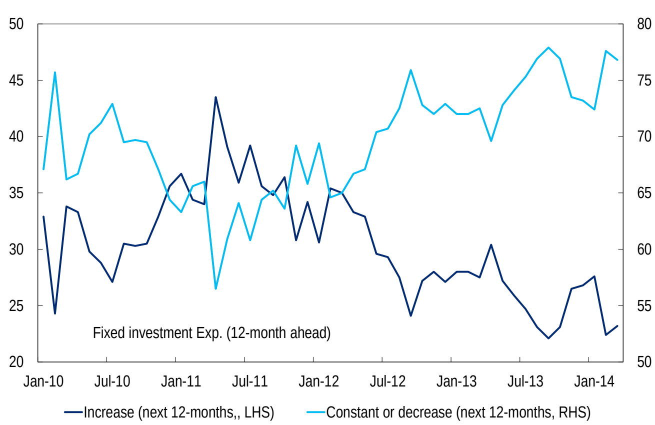
Source: Bloomberg, Citi Research

Figure 208. ... but subsiding capital inflows warrant concern...



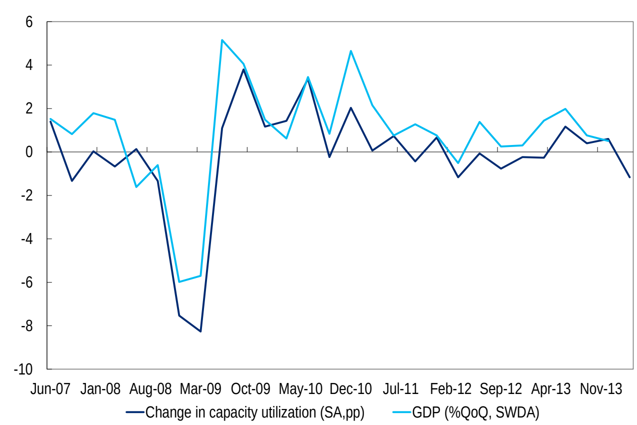
Source: Haver Analytics, Citi Research. Note:12-month rolling sum.

Figure 209. Private investment remains weak...



Source: CBT, Citi Research

Figure 210. ... pointing to softer activity in 1Q



Source: CBT, Haver Analytics, Citi Research

Figure 211. Turkey Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	646	731	615	731	775	789	820	776	803
Nominal GDP, local currency bn	843	951	953	1,099	1,298	1,417	1,562	1,726	1,918
GDP per capita, USD	9,207	10,282	8,530	10,016	10,473	10,531	10,721	10,039	10,275
Population, mn	70.2	71.1	72.1	73.0	74.0	74.9	76.5	77.3	78.2
Unemployment, % of labour force	10.3	11.0	14.0	12.0	9.8	9.2	9.8	9.5	9.5
Economic Activity									
Real GDP, yoy avg	4.7	0.7	-4.8	9.2	8.8	2.1	4.0	2.2	3.5
Real investment growth % yoy	5.8	-4.8	-28.6	48.4	16.8	-8.5	11.4	-11.3	4.0
Real consumption growth % yoy	5.6	-0.1	-1.0	6.0	7.3	0.4	4.8	-0.5	3.2
private consumption growth % yoy	5.5	-0.3	-2.3	6.7	7.7	-0.5	4.6	-1.5	3.2
Real export growth, % yoy	7.3	2.7	-5.0	3.4	7.9	16.3	0.1	11.0	4.4
Real import growth, % yoy	10.7	-4.1	-14.3	20.7	10.7	-0.4	8.5	-8.6	4.0
Prices, Money & Credit									
CPI, % yoy eop	8.4	10.1	6.5	6.4	10.4	6.2	7.4	8.5	7.0
CPI, % avg	8.8	10.4	6.3	8.6	6.5	8.9	7.5	8.1	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$, eop	1.17	1.54	1.50	1.54	1.89	1.78	2.15	2.29	2.45
TRY/US$, avg	1.31	1.31	1.55	1.51	1.68	1.80	1.91	2.22	2.39
TRY/EUR, eop	1.70	2.15	2.15	2.06	2.44	2.35	2.95	3.09	3.41
TRY/EUR, avg	1.79	1.92	2.17	2.00	2.34	2.32	2.53	3.06	3.28
Balance of Payments, USD bn									
Current account	-37.8	-40.4	-12.1	-45.4	-75.1	-48.5	-65.0	-40.1	-42.7
% of GDP	-5.8	-5.5	-2.0	-6.2	-9.7	-6.1	-7.9	-5.2	-5.3
Trade balance	-46.9	-53.0	-24.9	-56.4	-89.1	-65.3	-79.9	-59.3	-64.5
Exports	115.4	140.8	109.6	120.9	143.4	163.2	163.4	181.5	194.4
Imports	162.2	193.8	134.5	177.3	232.5	228.6	243.3	240.8	258.8
Service balance	14.0	18.9	18.6	16.7	20.2	22.6	23.1	26.6	28.7
Income balance	-7.1	-8.4	-8.3	-7.2	-7.9	-7.2	-9.3	-8.7	-8.3
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	38.7	37.7	36.7
of which Domestic	30.3	28.9	34.6	32.1	28.4	27.3	25.8	25.3	25.0
Foreign Assets & Liabilities, USD bn									
External debt	250.4	281.1	269.1	292.0	304.4	337.5	391.2	407.8	425.8
Public	89.3	92.4	96.6	100.6	90.0	101.8	116.8	122.3	127.3
External debt / GDP	38.7	38.5	43.8	39.9	39.3	42.8	47.7	52.5	53.0
External debt / XGS	172.4	158.1	185.1	185.8	165.4	163.6	186.5	175.9	171.4
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	4.3	4.4	3.3	0.3	1.1	4.2	3.0	3.6	3.8
CPI, % yoy eop	7.9	7.4	8.4	7.8	7.7	8.5	7.6	7.3	7.3
Policy interest rate, %, eop	6.45	7.10	10.27	10.00	11.00	11.50	11.00	10.50	10.50
Short-term market rate, % eop	7.34	8.66	12.28	11.20	12.20	12.70	12.20	11.70	11.70
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	2.02	2.15	2.14	2.21	2.25	2.29	2.33	2.37	2.41

Source: National Sources, Citi Research forecasts

Ukraine

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

IMF deal, but at what price?

The 27 March announcement of a new IMF deal should alleviate, at least for the time being, market concerns of an imminent sovereign default. The confluence of unsustainable external position, overvalued exchange rates, and fast declining reserves have kept markets fully aware of the possibility of Ukraine being unable to meet its upcoming external obligations. However, the two-year Stand-By Arrangement announced on 27 March aimed at unlocking US$27bn, including US$14-18bn from the IMF, has significantly reduced fears of an imminent sovereign default.

We expect the first tranche of IMF money to be disbursed before the May Presidential elections on Ukraine implementing some prior actions. We believe that the agreement will be approved by the IMF's Executive Board in April and the first tranche of around USD$3-4bn will be disbursed before the end-May Presidential elections. However, this will be critically dependent on the government adopting and implementing some prior actions, including passing an amended 2014 Budget, a package of anti-crisis measures and raising gas tariffs for the households by 50% from 1 May. The first two measures were already passed by the Rada on 27 March.

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

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

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

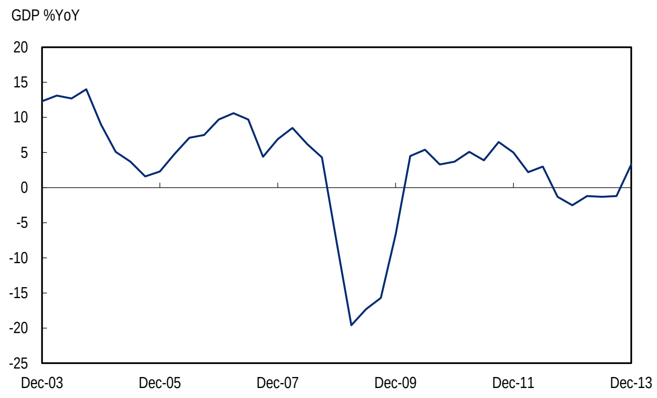
The adoption of the anti-crisis package on 27 March after very long discussions and only on the second attempt serves to underscore the potency of the implementation risk. The anti-crisis package includes freezing profit and VAT tax rates at 18% and 20%, respectively (versus previous plans to have them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

Risk of military escalation remains

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

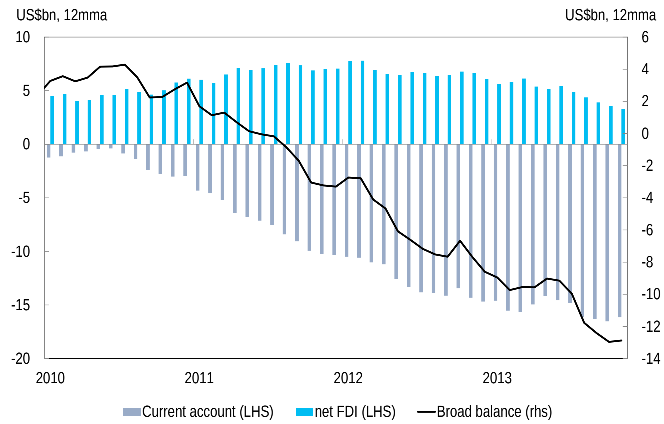
What is Ukraine's new political math without Crimea? The next critical signpost for the Ukraine crisis is the snap presidential election on 25 May. The vote will take place in a highly charged domestic political environment and amid ongoing civil disturbances and tensions with Russia. One hard fact we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

Figure 212. Economy struggles...



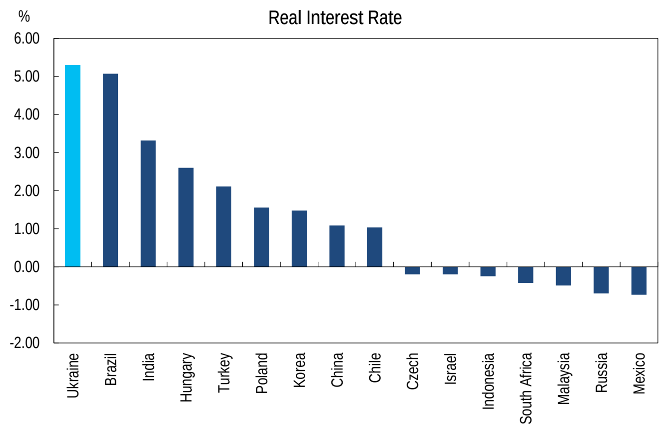
Source: UKR Statistics, Citi Research

Figure 213. ... and external position remains challenging



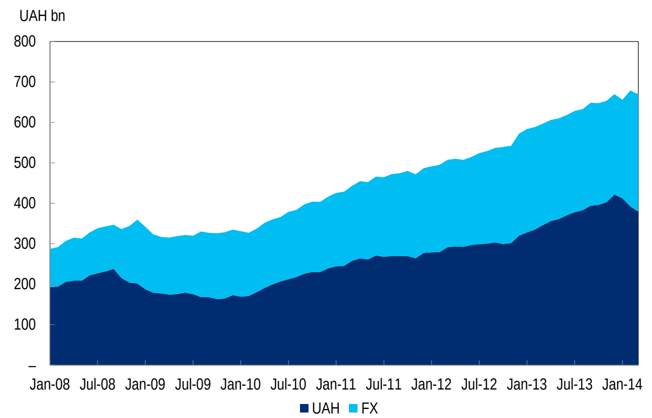
Source: UKR Statistics, Citi Research

Figure 214. Despite very high real interest rates...



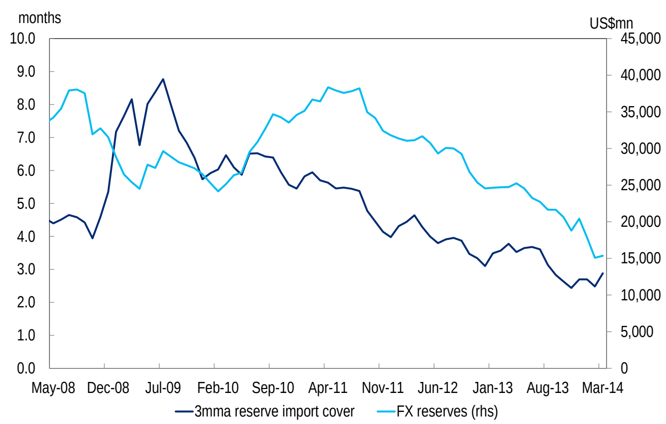
Source: Citi Research

Figure 215. ...population has started to reduce UAH deposits



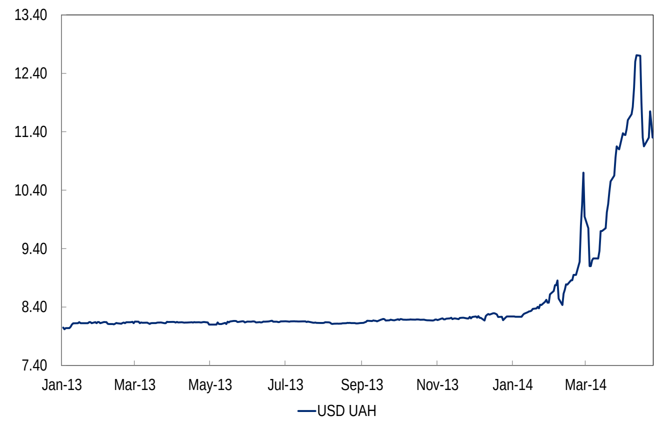
Source: UKR Statistics, Citi Research

Figure 216. Reserves are below 3 months of imports ...



Source: UKR Statistics, Citi Research

Figure 217. ...as the exchange rate has started to weaken



Source: Haver Analytics

Figure 218. Ukraine Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	143	180	117	136	163	177	176	137	146
Nominal GDP, local currency bn	715	946	913	1,080	1,292	1,409	1,455	1,437	1,560
GDP per capita, USD	3,059	3,875	2,536	2,964	3,566	3,872	3,877	3,030	3,248
Population, mn	46.7	46.5	46.2	46.0	45.8	45.6	45.4	45.2	45.0
Unemployment, % of labour force	6.4	6.4	8.8	8.1	7.9	7.5	7.7	7.7	7.5
Economic Activity									
Real GDP, yoy avg	7.6	2.3	-14.8	4.1	5.2	0.3	0.0	-3.2	2.1
Real investment growth % yoy	26.6	1.8	-57.1	15.9	18.0	-7.5	-23.6	-21.3	13.2
Real consumption growth % yoy	13.1	10.1	-12.3	6.4	11.3	7.9	5.8	-3.3	2.2
private consumption growth % yoy	17.0	12.8	-14.9	7.1	15.5	8.8	7.9	-4.0	2.5
Real export growth, % yoy	2.8	5.7	-22.0	3.9	4.3	-7.2	-8.8	1.0	2.0
Real import growth, % yoy	23.9	17.0	-38.9	11.3	17.7	1.8	-5.9	0.0	6.0
Prices, Money & Credit									
CPI, % yoy eop	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	8.1	5.3
CPI, % avg	12.8	25.2	15.9	9.4	8.0	0.6	-0.3	5.5	6.4
Nominal wages, % yoy	29.7	33.7	5.5	17.7	17.5	14.9	8.0	9.7	8.5
Credit extension to private sector, % yoy	73.7	67.1	-4.2	0.7	8.9	2.8	13.8	10.0	10.0
Policy Interest Rate, % eop	8.00	12.00	10.25	7.75	7.75	7.50	6.50	9.50	9.00
1 month inter-bank rate, %, eop	8.41	23.78	19.10	10.75	20.25	25.00	16.25	15.00	11.25
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US$, eop	5.05	8.05	8.05	7.97	8.01	8.05	8.24	10.50	10.80
UAH/US$, avg	5.03	5.16	8.06	7.97	7.99	8.08	8.15	10.49	10.68
UAH/EUR, eop	7.37	11.25	11.53	10.66	10.37	10.62	11.33	14.70	15.21
UAH/EUR, avg	6.89	7.60	11.21	10.55	11.11	10.39	10.83	14.43	14.99
Balance of Payments, USD bn									
Current account	-5.3	-12.8	-1.7	-3.0	-10.2	-14.3	-16.4	-7.3	-5.4
% of GDP	-3.7	-7.1	-1.5	-2.2	-6.3	-8.1	-9.3	-5.4	-3.7
Trade balance	-10.6	-16.1	-4.3	-8.4	-16.3	-19.5	-19.6	-14.7	-11.2
Exports	49.8	67.7	40.4	52.2	69.4	70.2	65.0	68.2	71.6
Imports	60.4	83.8	44.7	60.6	85.7	89.7	84.6	82.9	82.9
Service balance	2.4	1.7	2.4	4.4	6.1	5.2	4.1	6.0	5.5
Income balance	-0.7	-1.5	-2.4	-2.0	-3.8	-3.0	-3.0	-2.0	-3.0
FDI, net	9.2	9.9	4.7	5.8	7.0	6.6	3.4	0.0	6.8
International reserves	32.5	31.5	26.4	34.6	31.8	24.5	21.3	27.7	35.9
Total amortisations	8.5	13.9	17.9	23.5	23.6	20.1	20.5	18.0	22.1
Public Finances, % of GDP									
Consolidated government balance	-0.8	-1.2	-7.3	-8.8	-3.9	-5.6	-6.7	-4.3	-3.4
Consolidated gov primary balance	-0.3	-0.7	-6.2	-7.6	-2.9	-4.7	-5.8	-3.0	-2.2
Public debt	10.8	14.4	25.5	31.5	28.3	29.0	34.0	50.5	55.4
of which Domestic	2.5	4.7	10.0	13.1	12.4	13.5	17.8	19.5	19.3
Foreign Assets & Liabilities, USD bn									
External debt	80.0	101.7	103.4	117.3	126.2	135.1	142.5	147.8	154.9
Public	12.3	16.7	24.0	32.5	33.4	32.2	31.7	36.5	37.3
External debt / GDP	56.0	56.5	88.2	86.0	77.2	76.5	81.0	107.9	106.0
External debt / XGS	124.9	118.7	190.6	169.4	142.1	150.0	167.1	161.7	216.2
Short-term debt	20.7	20.3	19.0	23.5	30.7	33.2	37.6	38.0	35.3
Short-term debt/International reserves (%)	63.7	64.4	72.0	68.1	96.7	135.2	176.4	137.3	98.3

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	-2.9	-2.8	-2.2	-1.5	2.3	2.2	2.1
CPI, % yoy eop	-0.5	0.5	3.4	5.8	7.9	8.1	7.7	5.9	5.4
Policy interest rate, %, eop	6.50	6.50	6.50	9.50	9.50	9.50	9.00	9.00	9.00
Short-term market rate, % eop	5.97	16.25	23.00	18.00	15.00	15.00	11.25	11.25	11.25
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US$, eop	8.19	8.24	11.12	11.00	10.50	10.50	10.60	10.70	10.75

Source: National Sources, Citi Research forecasts

Other Africa

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Ghana

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

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

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

Kenya

- A steady pick-up in growth towards 6% looks set to continue in 2014-15, but the pick-up will likely 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 remaining at the top end of its inflation target (5%, +/- 2.5pp) we think it will act cautiously. Moreover, a too rapid cut in rates could spill over into more substantial KES depreciation than the CBK may be comfortable with.

Tanzania

- Over the next two years Tanzanian politics should 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, especially if the government does issue a Eurobond in 2014.

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

Uganda

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

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

- 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.

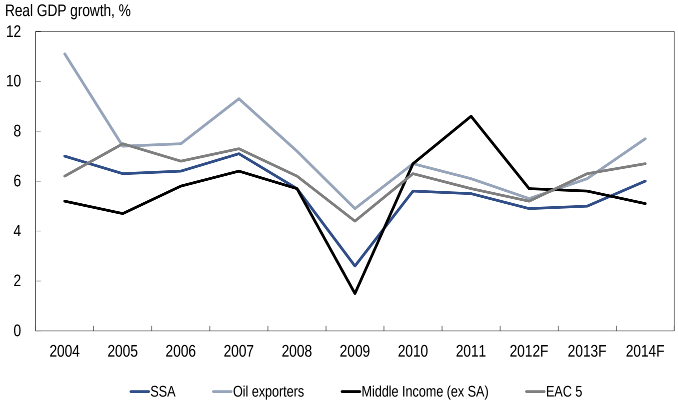
Zambia

- 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 should 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.

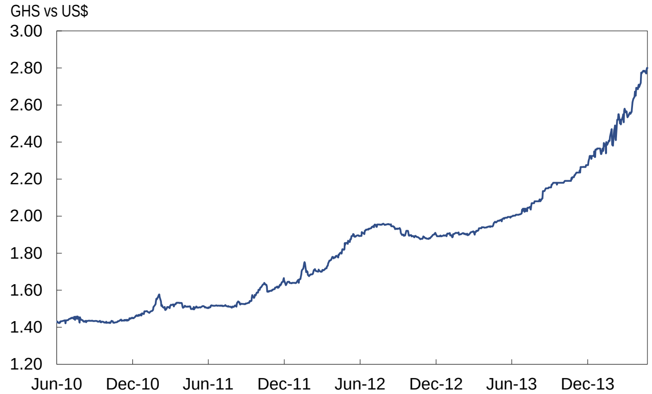
- These developments should provide considerable support for the kwacha, with only modest depreciation going forward once the current bout of weakness has run its course. And it should allow the Bank of Zambia (BoZ) to rebuild foreign exchange reserves, which are low by regional standards.

Figure 219. Growth should be robust in 2014-15



Source: IMF

Figure 220. How quickly can the cedi reach the GHS3:US$1 level?



Source: Haver Analytics

Figure 221. A very gradual weakening of the Kenyan shilling in 2014

Source: Haver Analytics

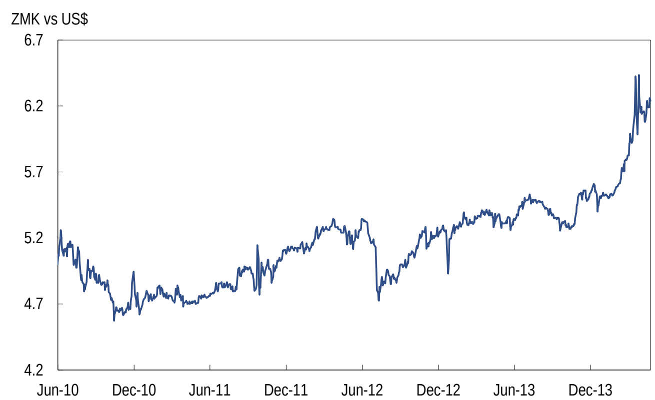
Figure 222. Is the Tanzanian shilling now too strong?

Source: Haver Analytics

Figure 223. A stable Ugandan shilling in 1H 2014

Source: Haver Analytics

Figure 224. The kwacha is volatile, with a sharp weakening in 2014



Source: Haver Analytics

Figure 225. Other Africa Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
GHANA									
Nominal GDP, USD bn	24.8	28.5	26.0	32.2	39.6	40.7	41.0	34.6	35.5
GDP per capita, USD	1,099	1,234	1,096	1,326	1,594	1,605	1,582	1,309	1,314
Real GDP, yoy avg	6.5	8.4	4.0	8.0	15.0	7.9	7.4	4.6	6.5
CPI, % avg	10.7	16.5	19.3	10.7	8.7	9.2	11.7	13.3	10.0
Policy Interest Rate, % eop	13.5	17.0	18.0	13.5	12.5	15.0	16.0	19.0	16.0
GHS/US$, avg	0.95	1.07	1.43	1.43	1.55	1.85	2.06	2.94	3.40
Current account, US$bn	-2.1	-3.5	-1.6	-2.6	-2.5	-4.9	-5.2	-5.0	-5.0
% of GDP	-8.6	-12.4	-6.2	-8.2	-6.3	-12.1	-12.7	-14.4	-14.1
Consolidated gov. balance, % of GDP	-5.6	-8.4	-7.0	-9.4	-5.5	-9.3	-10.8	-10.2	-9.0
KENYA									
Nominal GDP, USD bn	27.2	30.5	30.6	32.2	34.3	40.7	44.1	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	6.2	6.5
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	7.4	6.6
TZS/US$, avg	1,237	1,198	1,324	1,439	1,582	1,586	1,617	1,646	1,730
Current account, US$bn	-2.3	-3.2	-2.5	-2.7	-4.6	-3.5	-3.3	-4.9	-4.6
% of GDP	-13.9	-15.2	-11.5	-11.9	-19.1	-11.9	-10.2	-14.1	-12.4
Consolidated gov. balance, % of GDP	-1.9	-2.6	-6.0	-6.5	-5.0	-5.4	-5.0	-5.2	-5.9
UGANDA									
Nominal GDP, USD bn	13.5	16.4	16.5	17.2	18.2	21.2	22.6	24.7	26.8
GDP per capita, USD	441	515	503	506	518	584	601	636	668
Real GDP, yoy avg	8.1	10.4	4.1	6.2	6.2	2.8	6.0	6.0	5.5
CPI, % avg	6.1	12.0	13.0	4.0	18.7	14.0	5.5	5.9	6.8
UGX/US$, avg	1,723	1,714	2,025	2,173	2,511	2,501	2,584	2,555	2,735
Current account, US$bn	-0.6	-1.3	-1.1	-1.7	-2.1	-1.9	-2.7	-3.4	-4.0
% of GDP	-4.8	-7.8	-6.7	-10.0	-11.7	-9.0	-12.0	-13.9	-14.9
Consolidated gov. balance, % of GDP	-1.1	-2.8	-2.4	-6.7	-3.2	-3.6	-3.4	-3.3	-4.5
ZAMBIA									
Nominal GDP, USD bn	11.5	14.6	12.8	16.2	19.2	20.6	22.3	22.7	25.4
GDP per capita, USD	953	1,175	998	1,225	1,408	1,465	1,530	1,514	1,638
Real GDP, yoy avg	6.2	5.7	6.4	7.6	6.8	7.3	6.2	6.4	6.3
CPI, % avg	10.6	12.4	13.4	8.5	6.4	6.6	7.0	7.8	8.0
ZMK/US$, avg	3,992	3,702	5,020	4,791	4,861	5,139	5,195	6	6
Current account, US$bn	-0.8	-1.1	0.5	1.1	0.7	0.0	0.0	-0.2	-0.4
% of GDP	-6.5	-7.2	4.2	7.1	3.7	0.1	0.2	-1.0	-1.5
Consolidated gov. balance, % of GDP	-1.3	-0.8	-2.5	-3.0	-2.2	-3.1	-6.5	-6.1	-5.5
Quarterly Economic Indicators									
	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GHS/US$, eop	2.18	2.37	2.69	3.00	3.20	3.20	3.30	3.40	3.50
KES/US$, eop	86.40	86.45	86.40	87.50	88.00	89.50	90.00	92.00	92.00
TZS/US$, eop	1,605	1,587	1,638	1,640	1,660	1,680	1,700	1,725	1,750
UGX/US$, eop	2,550	2,523	2,547	2,550	2,580	2,600	2,700	2,700	2,800
ZMK/US$, eop	5,195.00	5,195.00	5,195.00	6.10	6.10	6.10	6.10	6.15	6.20

Source: National Sources, Citi Research forecasts

Other Europe

Bulgaria

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Recent high frequency data suggest that domestic demand is likely to recover in 2014. The retail trade index rose by 1.0%MoM (SA, excluding motor vehicles) in February, following another strong increase in January (2.1%MoM). With this outcome, the three month average rise in retail trade index stands at 1.1%MoM — the highest since March 2012. In parallel, the recent confidence indicators signal a more upbeat economic outlook with economic sentiment index rising to 101.30 in March — the highest reading since December 2010 — from 99.9 in February. Concurrently, we expect investment activity to remain strong this year thanks to a higher absorption rate of EU funds and good export performance owing to the likely pick-up in growth in the Euro zone. Against this backdrop, we expect the GDP growth to accelerate to 1.5% in 2014 from 0.9% in 2013.

Turning to price developments, at -2.3%YoY, deflationary pressures eased slightly in March when compared with February (-2.6%). The rise in inflation was mainly driven by base effects associated with the March 2013 electricity price cut, while deflationary pressures from food prices capped the rise in headline inflation. Looking ahead, while the deflationary environment is likely to prevail in the short-term, we expect inflation to rise to about 2.0% by end of the year on the back of stronger economic activity and base effects, as the impact of the latter will be more evident after August 2014. Regarding external developments, the current account deficit came in at €107mn in February, compared with a deficit of about €416mn in the same month of 2013. With the February data, the current account deficit in the first two months of the year stood at €384mn and represents an improvement of €119mn over the same period in 2013. Going forward, our expectation of stronger domestic demand this year lead us to look for a current account gap of about 0.2% of GDP in 2014, compared with a surplus of 2% of GDP in 2013. On the fiscal front, according to the most recent Eurostat estimates, the general government budget deficit stood at BGN1.2bn or 1.5% of GDP in 2013, compared with October 2013 estimate of 2.0% of GDP thanks mainly to higher-than-estimated surplus in local government. Looking ahead, we expect the fiscal situation to deteriorate slightly and record a deficit of about 2.0% of GDP in 2014, which is broadly in line with the 2014 budget target.

Croatia

While the recent data show that domestic demand remains weak, there are nascent signs of a recovery in exports. The country's retail trade continued to fall in February (0.4%MoM, sa, value) following 0.1%MoM drop in January. Similarly, lending activity doesn't offer much hope with the annual domestic credit growth standing at -1.6%YoY in February. Turning to manufacturing activity, February's industrial production fell by 2.8%MoM (SA), partially reversing the strong pick-up in January (5.4%MoM, SA). Similarly, export growth, which accelerated strongly to 21%YoY in January from 3.6%YoY in December, softened considerably in February (6.0%YoY). The noted backdrop, in turn, leads us to revise down our GDP forecast for this year to 0.5% from 0.7%. In parallel, our expectations of the continued weakness in domestic demand and a relatively strong export outlook lead us to revise our current account balance forecast to a surplus of 0.5% of GDP (from 0.2% earlier), which represents a smaller surplus compared with 2013 (1.3% of GDP).

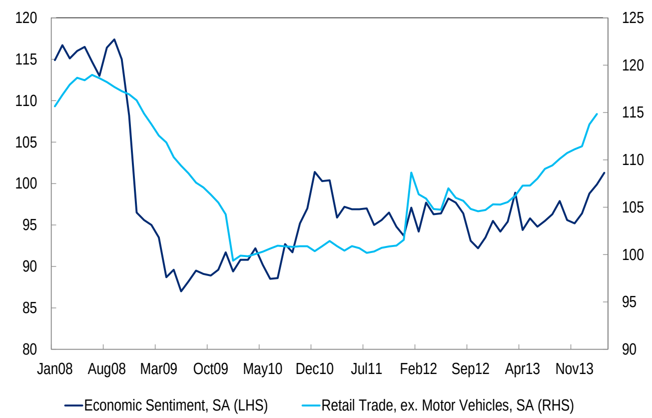
Regarding price developments, consumer prices rose 0.57%MoM in March, bringing the annual inflation to -0.37%YoY from -0.57%YoY in February. The noted outcome was mainly driven by a relatively strong pick up in clothing prices (10.6%MoM vs. seasonal average of about 5.4%MoM). Looking ahead, while weak domestic demand is likely to keep inflationary pressures in check, we think that inflation is likely to rise gradually to about 1% by the end of second quarter and to about 1.8% by end-2014 owing to base effects and unwinding of cyclical factors. On the fiscal front, the country's the public debt rose markedly to 67.1% of GDP in 2013 from 55.9% in 2012, according to the latest Eurostat data. In parallel, at 4.9% of GDP, Eurostat's new estimate of the fiscal gap for 2013 was significantly wider than that of the October 2013 estimate of 3.6% of GDP. Looking ahead, owing to weak domestic demand, we expect the budget gap in 2014 to remain at around 5.0% of GDP, somewhat above the government's new target of 4.5%.

Serbia

Following the formation of the new SNS-led government, the authorities are widely expected to revive the reform agenda. Based on the recent statements of PM Vucic and recommendations of the international financial institutions, we think that the upcoming fiscal and structural reforms would likely address key areas such as bloated public sector, tax system and administration, pension system, labour law and healthcare system, while also stepping up efforts aimed at entering into the EU. We think that the relatively strong support for the new government in the recent elections, as demonstrated by their strong presence in Parliament (158 out of 250 seats), could speed up its reform agenda, thereby improving the medium-term growth outlook. Turning to the near-term economic outlook, the recent high frequency indicators paint a mixed picture. While February's industrial production fell by 1.1%MoM (SA), retail trade rose by 2.6%MoM (SA) — the strongest monthly increase since April 2013. All in all, we maintain our view that domestic demand will gain some traction in 2014. This, coupled with the expected euro area recovery and the start of negotiations on EU accession, will likely play a critical role in driving growth this year. Nevertheless, we expect unfavorable base effects in agricultural production and automobile industry to 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.

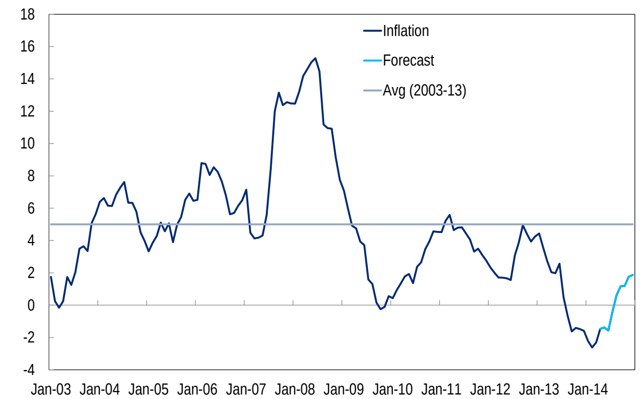
Turning to price developments, inflation dropped to 2.3%YoY in March from 2.6%YoY in February owing to the continued softness in food prices. While price developments in the first three months of the year have been more favourable than our expectations, we think that a reversal in cyclical factors and unfavorable base effects will likely push inflation closer to 5.5% by end of this year, compared with 2.2% in 2013. In light of our inflation forecast trajectory and a more hostile global environment, we continue to think that there is not much room left for additional easing. The April rate decision of NBS corroborates this view, as the Bank noted that "instability in international financial markets and heightened uncertainties surrounding the current geopolitical tensions" were the main factors in keeping the rates on hold in April. Regarding external developments, we see a marked adjustment in the current account balance, which narrowed from a deficit of 11% of GDP in 2012 to about 5.0% 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. Against this backdrop, we expect the current account deficit to remain broadly unchanged in 2014, at around 5% of GDP.

Figure 226. Bulgaria: Recent high frequency data suggest that domestic demand is likely to recover in 2014...



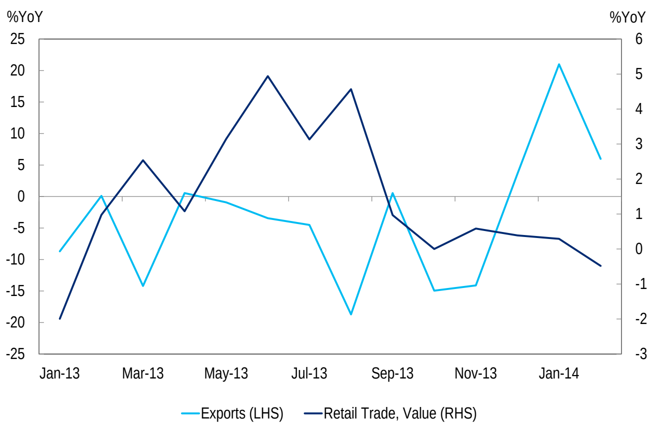
Source: Haver Analytics and Citi Research

Figure 227. ...as we expect deflationary pressures to fade away in the coming months due to a reversal in food inflation and base effects



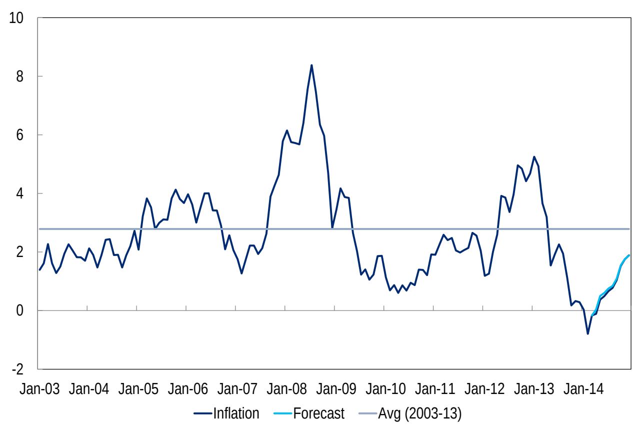
Source: Haver Analytics and Citi Research

Figure 228. Croatia: While domestic demand remains weak, there are nascent signs of a recovery in exports...



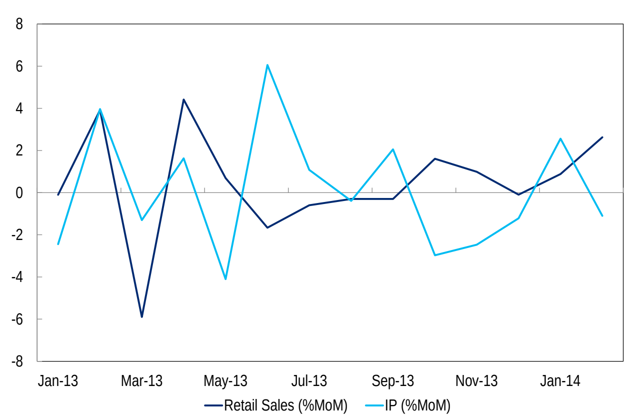
Source: Haver Analytics and Citi Research

Figure 229. ... as unfavorable base effects are likely to drive inflation closer to its norm



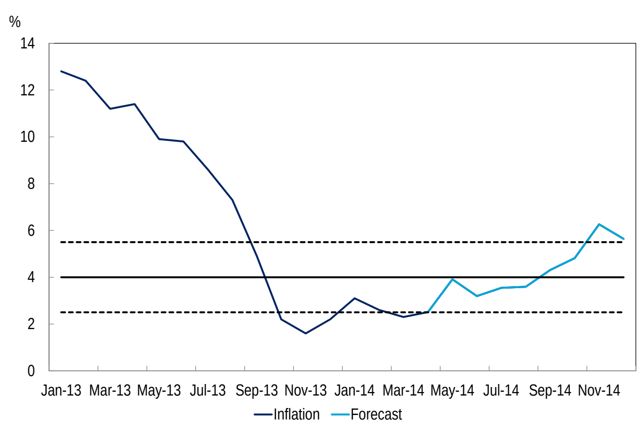
Source: Haver Analytics and Citi Research

Figure 230. Serbia: Recent high frequency growth indicators paint a mixed picture ...



Source: Haver Analytics and Citi Research

Figure 231....as inflation is set to rise on the back of a reversal in cyclical factors and unfavorable base effects



Source: Haver Analytics and Citi Research

Figure 232. Other Europe Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
BULGARIA									
Nominal GDP, USD bn	42.1	51.8	48.6	47.7	53.5	51.0	53.9	56.4	59.2
GDP per capita, USD	5,512	6,812	6,421	6,360	7,307	6,997	7,446	7,825	8,260
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	-0.4	2.5
BGN/US$, avg	1.43	1.33	1.40	1.47	1.40	1.52	1.47	1.43	1.43
BGN/EUR, avg	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
Current account, US$bn	-10.8	-11.9	-4.3	-0.8	0.1	-0.7	1.0	-0.1	-0.3
% of GDP	-25.6	-23.0	-8.8	-1.6	0.3	-1.4	1.9	-0.2	-0.5
Consolidated gov. balance, % of GDP	1.2	1.7	-4.3	-3.1	-2.0	-0.8	-1.5	-2.0	-1.2
CROATIA									
Nominal GDP, USD bn	59.3	69.6	62.2	58.9	61.8	56.4	57.6	59.4	61.2
GDP per capita, USD	13,376	15,690	14,044	13,331	14,432	13,106	13,418	13,898	14,388
Real GDP, yoy avg	5.1	2.1	-6.9	-2.3	0.0	-2.0	-1.0	0.5	1.5
CPI, % avg	2.9	6.1	2.4	1.0	2.3	3.4	2.2	0.5	2.7
Policy Interest Rate, % eop	9.00	9.00	9.00	9.00	7.00	7.00	7.00	7.00	7.00
HRK/US$, avg	5.35	4.91	5.26	5.49	5.34	5.84	5.70	5.58	5.64
HRK/EUR, avg	7.34	7.23	7.34	7.29	7.43	7.51	7.58	7.68	7.75
Current account, US$bn	-4.3	-6.1	-3.0	-0.8	-0.4	-0.1	0.7	0.3	-0.3
% of GDP	-7.3	-8.7	-4.9	-1.4	-0.7	-0.2	1.3	0.5	-0.5
Consolidated gov. balance, % of GDP	-	-	-5.3	-6.4	-7.8	-5.0	-4.9	-4.8	-3.5
SERBIA									
Nominal GDP, USD bn	39.0	47.8	40.2	37.1	43.7	38.5	43.5	45.7	47.7
GDP per capita, USD	5,277	6,497	5,496	5,085	6,026	5,348	6,039	6,354	6,619
Real GDP, yoy avg	5.4	3.8	-3.5	1.0	1.6	-1.5	2.5	1.2	2.0
CPI, % avg	5.6	11.9	8.7	6.1	11.0	7.8	7.9	3.8	6.5
Policy Interest Rate, % eop	10.00	17.75	9.50	11.50	9.75	11.25	9.50	9.00	8.50
RSD/US$, avg	58.3	55.2	67.4	77.5	73.2	87.8	85.1	85.0	88.7
RSD/EUR, avg	80.0	81.4	94.0	102.9	102.0	112.9	113.1	116.8	121.8
Current account, US$bn	-6.9	-10.4	-2.9	-2.8	-4.0	-4.1	-2.1	-2.2	-2.4
% of GDP	-17.7	-21.9	-7.1	-7.5	-9.1	-10.6	-4.8	-4.8	-5.0
Consolidated gov. balance, % of GDP	0.6	-1.8	-3.5	-3.5	-4.1	-5.7	-5.7	-7.0	-6.5

Source: National Sources, Citi Research forecasts

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Latin America

Argentina

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- **Summary view** — The FX market remains calm. However, the flipside of this stability is a combination of downward pressures on activity, a repressed FX demand and continued monetization of an unrelenting fiscal deficit.
- **Things to watch** — Watch for much needed fiscal announcements. Also, keep an eye on monetary printing, as the scarcity of foreign currency is the flipside of an excess supply of domestic currency. Finally, confidence indicators (e.g., consumer) have shown a marked deterioration recently.
- **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.

Is this all?

The "stabilization" that followed the devaluation and drop in reserves of the first two months of 2014, mostly in January, was based on three pillars: i) a more depreciated nominal exchange rate; ii) some money absorption by the BCRA and higher interest rates; iii) regulatory changes limiting banks' FX positions, short-term FX inflows and tighter controls on import payments, together with the seasonal pickup in exports in 2Q. In this monthly update, we look at these three points in order to assess if the recent stabilization is sustainable and will continue in 2H14. As the title suggests, further actions are needed, particularly in the fiscal front, to prevent a new round of turbulence once agricultural exports begin to decline in Q3.

Argentina has also made some progress in its relationship with creditors. The macroeconomic strategy seems to be to try to facilitate a quick return to external financing, to minimize the magnitude of fiscal adjustments before the 2015 presidential transition. Negotiations with the Paris Club are under way and the country settled its differences with Repsol. Furthermore, a new price index and national income statistics were announced to appease the IMF (and prevent payment of the warrants). However, given the pace of monetization of the fiscal deficit, these actions alone are unlikely to provide an anchor to the domestic money and FX markets later in the year.

i) Is 8 an "equilibrium" USDARS?

As we have explained in past writings, the Argentina's problems are monetary in essence, and can be divided in two: a stocks problem and a flows one. The level of the exchange rate is crucial for the first problem: the one about stocks. Currently, the economy faces an excess of domestic currency, which puts pressure on reserves as individuals and corporations try to reduce their holdings of pesos. In this context, the "equilibrium" exchange rate can be defined as the one that results in high enough prices to dilute the excess of local currency in real term.

According to our estimates, the excess of transactional currency stood at around 40% in March. While it has decreased from 45/46% in the end of 2013, it is still high. Basically, this means that the nominal depreciation of the ARS that took place in January has only marginally eliminated the excess of ARS. The monetary overhang has decreased only marginally as: i) monetary aggregates growth remains strong, particularly in the case of broader aggregates; and ii) the lower activity negatively affects the demand for local currency. Because the pass-through of the exchange rate to prices is less than one, the increase in the official USDARS that would equilibrate the FX market would probably need to be higher than 40%.

ii) Money printing in the absence of fiscal adjustment

According to the latest official data, which goes up to April 16, the central bank (BCRA) has reduced the monetary base by ARS18.2bn year-to-date (YTD). Aggressive sterilization has resulted in M0 contracting YTD despite foreign currency purchases by the BCRA for USD2.1bn (or ARS17.5bn) and peso transfers to the Treasury for ARS11.1bn. It is worth noting that peso transfers to the Treasury were only ARS2bn in the same period of 2013. Conversely, the BCRA has absorbed ARS41.7bn through the issuance of short-term notes and ARS9.3bn through the repo window.

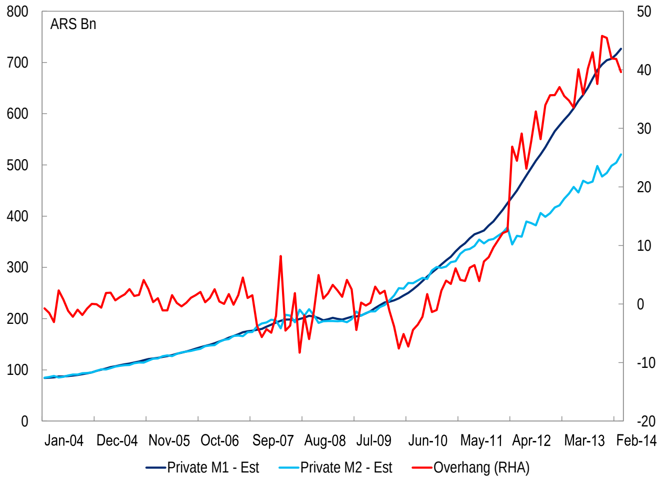
High fiscal needs translate into less credit for the private sector and/or fast money printing. In the absence of fiscal moderation, containing monetary aggregates requires the BCRA to issue short-term debt at a fast pace to offset the peso transfers to the Treasury. As a result, credit to the private sector shrinks with sizable effects. For instance, year-to-date credit to the private sector in ARS (94% of the total stock) grew 0.3% in nominal terms yet it dropped around 10% in real terms, as a result of the higher “sterilization” by the authorities. Peso transfers to the Federal Government (ARS103.3bn in the last 12 months) are very high relative to banks’ credit to the private sector in ARS (approximately ARS475bn). As a result, the tradeoff faced by the BCRA is not an easy one: tightening credit to finance increasing fiscal needs adds a thick extra layer of downward pressure to the already weak activity. But, relaxing monetary policy to avoid this “crowding out” would put FX stability at risk.

iii) On BCRA’s recent foreign currency purchases

The BCRA has purchased USD2.1bn of foreign currency in the FX market YTD (as of April 16), compared to USD115mn during the same period of 2013. However, this improvement in official FX purchases looks poor given that it was based on: i) one-off regulatory changes; ii) repressing roughly 40% of the import payments in the last two months; iii) short-term dollar inflows. First, the BCRA issued a regulatory change limiting banks’ holdings of FX assets (to 30% of their net worth), including their spot positions. According to Ámbito Financiero on April 24, banks have sold USD2.3bn in the FX spot market as a result of this regulatory change. Additionally, Secretary of Commerce Augusto Costa has implemented a system requiring big importers to provide financing to pay for imports. In practice, the government has repressed import payments significantly since then. According to Ámbito Financiero (April 14), there are USD4.5bn in pending import payments, as a result of this action. The press also reports that grain exporters have sold foreign currency in advance of their exports for more than USD2bn in recent months.

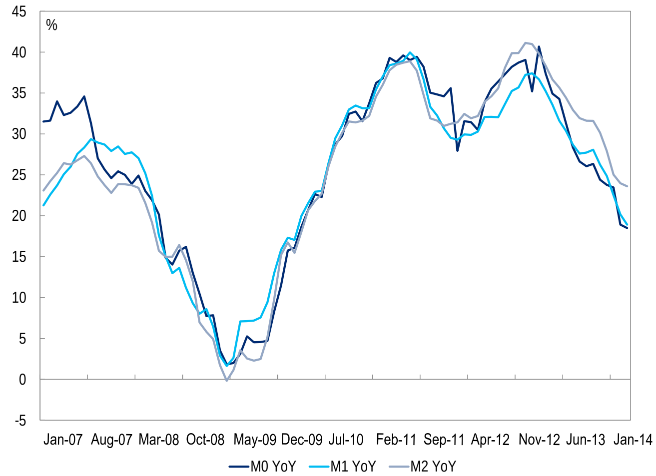
Despite the heterodox policies, the BCRA was a net seller of foreign currency in the last 12 months: USD3.4bn. With net and liquid reserves at levels close to the public debt payments in foreign currency until the end of 2015, and given the short term initiatives used to temporarily boost the supply of foreign currency and limit its demand, the situation looks unsustainable without further macroeconomic corrections. We anticipate 2Q to remain calm, as a bumper crop is exported, but the scarcity of foreign currency continues to be large once seasonal and one-off factors are left aside. More sustainable fiscal initiatives are badly needed.

Figure 233. The monetary overhang continues to be high



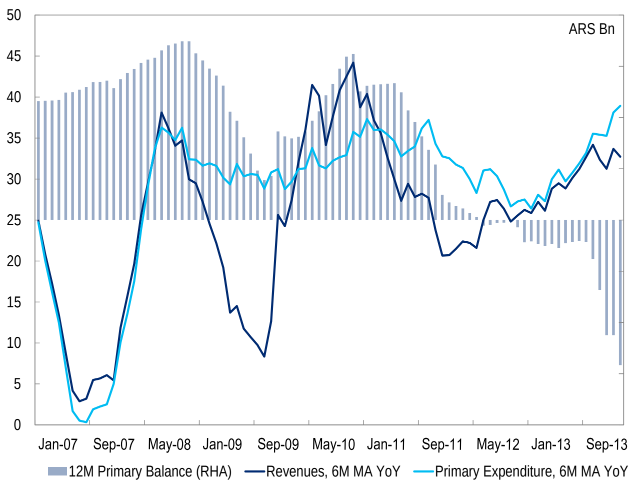
Source: BCRA and Citi Research

Figure 234. M2 growth has decelerated less than in the case of the M0



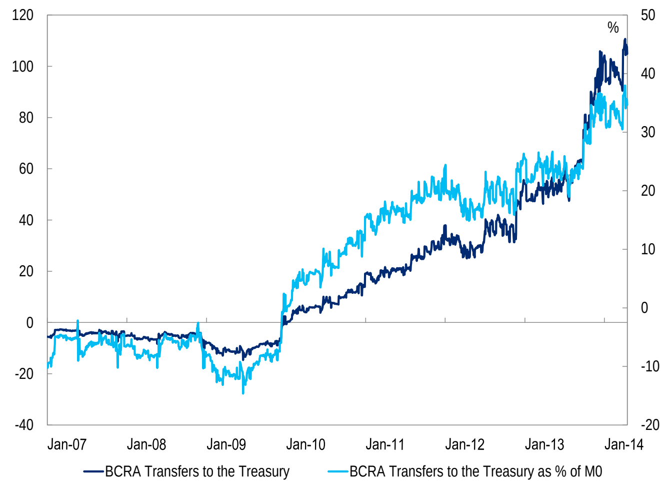
Source: BCRA and Citi Research

Figure 235. The fiscal accounts have been deteriorating leading…



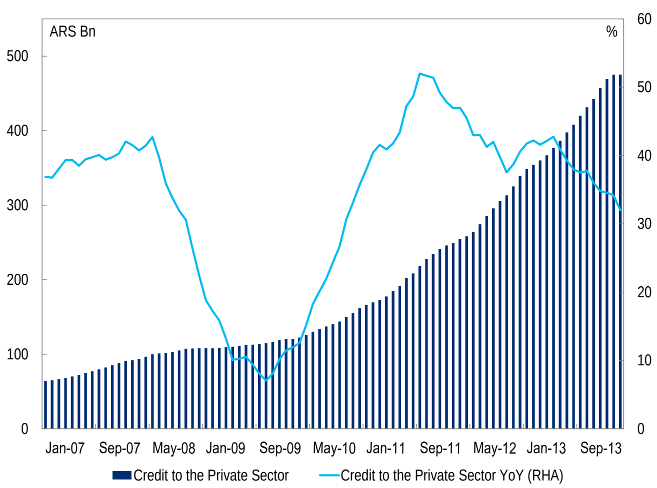
Source: MECON and Citi Research

Figure 236. … to more assistances from the BCRA to the Treasury



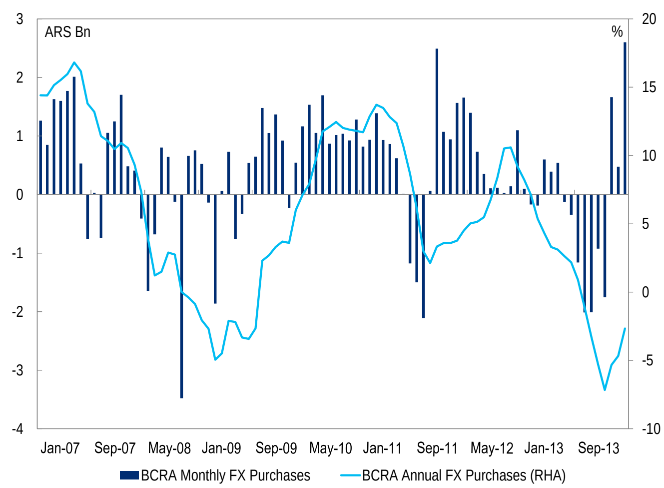
Source: BCRA and Citi Research

Figure 237. Credit growth has decelerated markedly



Source: BCRA and Citi Research

Figure 238. The BCRA remains as a FX seller in the last 12M



Source: BCRA and Citi Research

Figure 239. 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	37.4	39.0	39.5	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	8.00	-	9.50	10.00	10.78	11.62	12.52

Source: National Sources, Citi Research

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- **Summary view** — Dilma Rouseff's government is losing steam even before energy rationing was announced, turning the election result into a close call. We still believe that President Rousseff is the favorite, but the chances of the two opposition candidates (Aecio Campos from PSDB, and Eduardo Campos from PSB) are on the rise. We have increased our CPI inflation forecast for 2014 to 6.6%, up from 6.1% and above the upper limit of the inflation target (6.5%). We have also raised our CPI inflation expectation for 2015 (to 6.3% from 5.8%). Regarding activity, we expect the better performance of activity indicators in February to be reversed in March. Thus, we are keeping our GDP growth forecast for this year unchanged at 1.3%. Regarding monetary policy, we expect no more hikes to the Selic rate in 2014, but we assume 150bps of hikes next year. In terms of the fiscal policy, and based on the budget guidelines, we have reduced our 2015 primary surplus forecast to 2% of GDP (from 2.5% previously). We have lowered our USDBRL forecasts to 2.47 and to 2.61 at 2014 and 2015 yearend, respectively (from USDBRL 2.65 and 2.77).

- **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 continue in the spotlight as the fiscal accounts are still under a lot of scrutiny due to the weak results so far this year.

- **Strategy** — Unless we see further improvements in global conditions, our model suggests that USD/BRL close to 2.20 has already adjusted to the new levels of commodity prices/risk aversion. This being the case and considering our bearish view concerning domestic fundamentals, we see value at staying long USD/BRL at the levels close to 2.20. On rates, our scenario of persistent inflation pressures and the CB on hold until yearend suggests the yield curve tends to steepen.

We Expect CPI Inflation to Surpass the Target This Year

On the political front, President Dilma Rousseff's approval rates are moving consistently to the south turning the election result a close call. President Dilma's popularity (excellent and good evaluation) has shrank to 34%, below the levels exhibited by Fernando Henrique Cardoso and Lula da Silva in the year of their reelections. We still believe that President Rousseff is the favorite, but the chances of the two opposition candidates (Aecio Campos from PSDB, and Eduardo Campos from PSB) are on the rise. Moreover, the current energy situation (which continues to be denied by the authorities), the possibility of new demonstrations during the World Cup in June/July and increasing inflation pose serious risks for Dilma Rousseff's reelection.

We have increased our CPI inflation forecasts for both 2014 (to 6.6% from 6.1%) and 2015 (6.3% from 5.8%). If our forecasts materialize, 2014 would be the first year since 2003 in which the CB fails to keep inflation within the 2.5-6.5% target band. The main reason behind our upward revision to the 2014 forecast was 1Q14 inflation outcome: prices rose 2.2%, compared to our forecast of 1.9%. Another reason for increasing our inflation forecast this year are monitored prices, which we now expect to increase 5% from 4.2% previously. The increase in next year's CPI forecast to 6.3% is almost fully explained by monitored prices, especially the effect of the higher use of thermal power plants for energy generation (which are markedly more expensive than hydro power). We see a 12% increase in housing energy prices and also significant realignments in gasoline prices and bus fares. Therefore, we now forecast monitored prices increasing 6.4% instead of 4.5% in 2015, adding 50bps to CPI inflation.

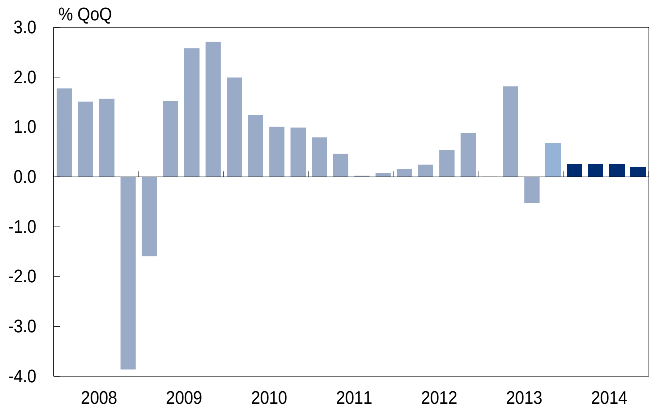
Better performances of activity indicators in February will likely be reversed in March; thus, we are keeping our GDP growth forecast for 2014 at 1.3%. In February, industrial production increased 0.4% MoM, while core retail sales expanded 0.2% MoM. However, we believe that part of the monthly increase seen in February will likely be reversed in following month, reflecting the unusual Carnival holiday in March (instead of February). All in all, we maintain our 2014 and 2015 GDP growth forecasts unchanged at 1.3% and 1.8%, respectively, both below consensus estimates (1.6% and 2.0%). Regarding the labor market, the unemployment rate reached a new all-time low in March: 4.7% seasonally adjusted. However, this drop was driven by lower labor force participation (instead of employment growth), suggesting the labor market is already weakening, though gradually, at the margin.

We expect no more hikes to the Selic rate in 2014, but we assume 150bps rise next year. For 2014, we are keeping our call for no more hikes, because we believe part of the current food price (perishable items) shock may reverse soon. However, we recognize the possibility of another 25bp rise in the Selic rate in May 28, given the data-dependent mode of the central bank. For 2015, we believe the Copom will resume the tightening cycle in order to fight the persistent inflation problem. Because of that, we expect 150bps of hikes to the Selic rate in the first meetings of the year, putting the Selic rate at 12.50% 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.

Budget guidelines led us to lower our 2015 primary surplus forecast to 2% of GDP. Government sent to Congress its proposal for the 2015 Budget Law Guidelines. It sets the target for the public sector primary surplus at 2.5% of GDP. However, investments in the growth acceleration program (PAC) could be discounted from this target up to 0.5% of GDP. Thus, we have decided to reduce our 2015 primary surplus forecast to 2% of GDP, down from 2.5% before but still above our 1.5% of GDP estimate for this year. It is worth noting that the aforementioned 2015 target is above the 1.9% of GDP primary surplus target set by the government for this year. As result, gross public sector debt would reach 57.7% of GDP in 2015 increasing slightly thereafter and likely reaching 58.4% in 2018.

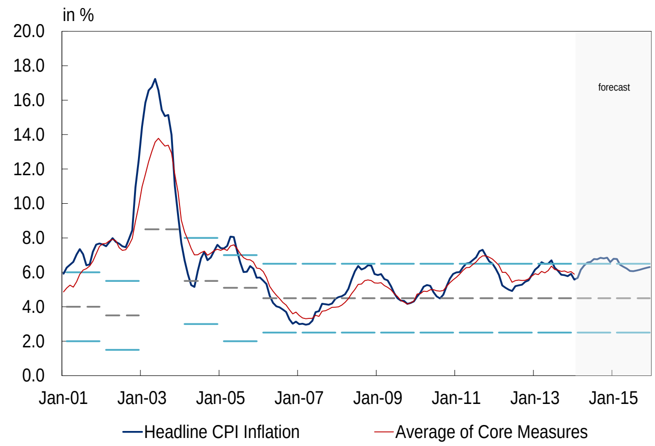
Better global conditions support a stronger BRL in the near term. Since February, commodity prices rose over 8%, while global risk aversion dropped more than 20%. According to our models, both developments favored BRL, explaining the bulk of the recent appreciation of domestic currency which approached the USDBRL 2.20 level (see Brazil Macro View – April 16, 2014). Assuming that part of these global movements will last for some time, we have reduced our USDBRL forecasts to 2.47 and to 2.61 at 2014 and 2015 yearend (from USDBRL 2.65 and 2.77 previously). Overall, depite acknowledging better global conditions in the near term, we continue seeing domestic fundamentals deteriorating ahead, especially the fiscal accounts. This prognosis, combined with a scenario of higher political uncertainty in domestic front (presidential election in October) and steadiness in FOMC tapering, continues to point to some depreciation of BRL in the medium term. In terms of external accounts, we continue to think that current account will show a deficit slightly higher than USD80 billion this year. Finally, as emphasized previously, the risk of a power rationing continues to rise, putting additional bias toward a more depreciated BRL in the medium/long term.

Figure 240. We expect 2014 GDP growth to reach 1.3%



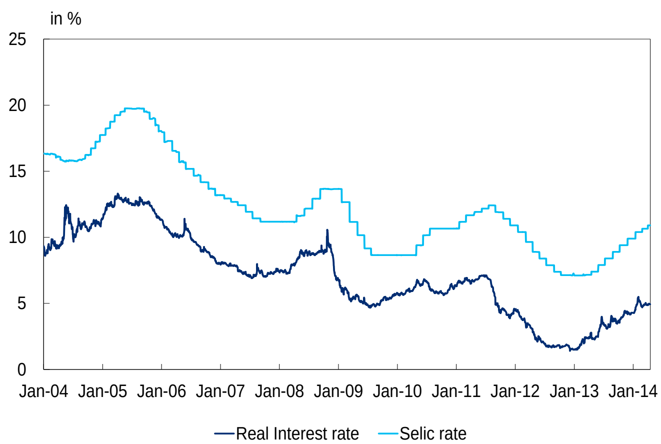
Sources: Citi Research and IBGE

Figure 241. CPI Inflation will likely breach the 6.5% upper bound of target



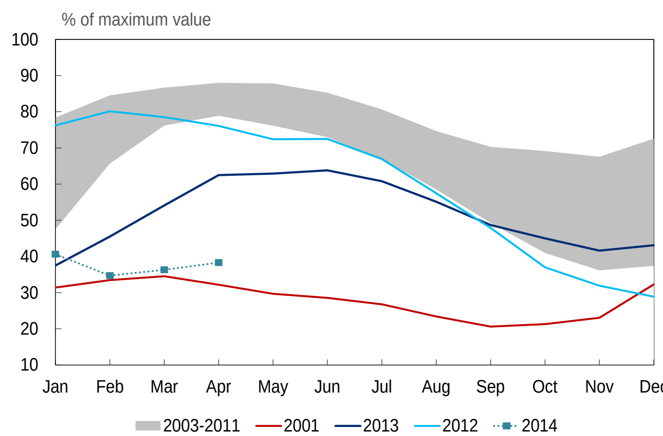
Sources: Citi Research, BCB and IBGE

Figure 242. We expect Copom to keep Selicrate at 11% until 2014 year end



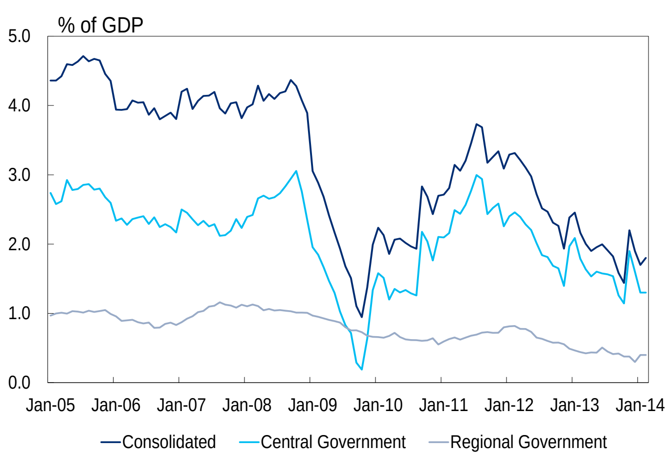
Sources: Citi Research and Bloomberg

Figure 243. Low resevoir levels point to risks of a power rationing



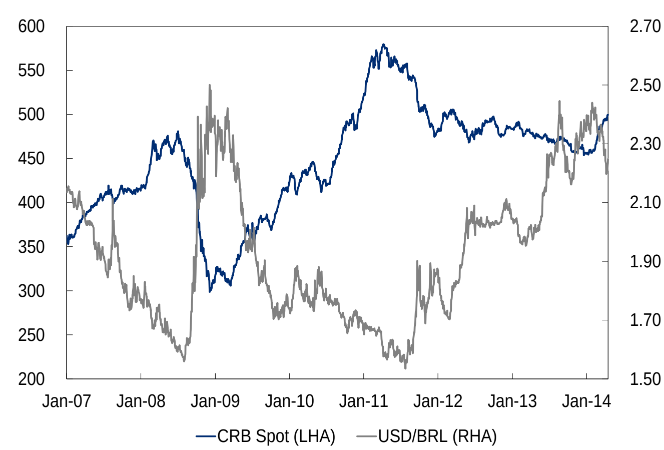
Sources: Citi Research and BCB

Figure 244. The primary fiscal surplus continues below 2% of GDP



Sources: Citi Research and BCB

Figure 245. Commodity prices and USD/BRL: a negative correlation



Sources: Citi Research and Bloomberg

Figure 246. Brazil Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	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	6.6	6.3
CPI, % avg	3.6	5.7	4.9	5.0	6.6	5.4	6.2	6.5	6.3
Nominal wages, % yoy	7.0	10.4	4.8	12.7	8.9	10.7	10.8	11.5	11.0
Credit extension to private sector, % yoy	-	30.9	15.1	20.6	19.0	16.4	14.8	14.2	14.5
Policy Rate (eop)	11.25	13.75	8.75	10.75	11.00	7.25	10.00	11.00	12.50
1 month inter-bank rate, %, eop	11.11	13.49	8.61	10.64	10.87	6.59	9.78	11.00	12.50
Long-term yield, %, eop	12.95	12.27	12.25	12.24	10.66	7.96	12.00	13.41	13.91
BRL/USD, eop	1.78	2.31	1.76	1.66	1.86	2.05	2.36	2.47	2.61
BRL/USD, avg	2.09	1.84	1.80	1.73	1.67	1.95	2.16	2.35	2.57
Balance of Payments, USD bn									
Current account	1.6	-28.2	-24.3	-47.3	-52.5	-54.2	-81.4	-83.3	-84.7
% of GDP	0.1	-1.6	-1.5	-2.2	-2.1	-2.4	-3.7	-4.1	-4.1
Trade balance	40.0	24.8	25.3	20.1	29.8	19.4	2.6	5.2	8.9
Exports	160.6	197.9	153.0	201.9	256.0	242.6	242.2	249.3	265.1
Imports	120.6	173.1	127.7	181.8	226.2	223.2	239.6	244.1	256.2
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	-3.9	-3.4
Consolidated gov primary balance	3.8	3.9	2.0	2.7	3.1	2.4	1.9	1.5	2.0
Public debt	55.0	55.9	60.9	53.4	54.2	58.8	56.8	57.2	57.7
of which Domestic	50.9	51.2	57.5	50.5	51.5	55.9	53.8	54.2	54.7
Foreign Assets & Liabilities, USD bn									
External debt	193.6	198.3	198.2	256.8	298.2	312.9	322.0	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	6.4	6.8	6.6	6.4	6.1	6.2
Policy interest rate, %, eop	9.00	10.00	10.75	11.00	11.00	11.00	12.00	12.50	12.50
Short-term market rate, % eop	8.72	9.78	10.56	11.00	11.00	11.00	12.00	12.50	12.50
Long-term yield, %, eop	8.91	8.57	12.88	12.91	13.41	13.41	13.91	13.91	13.91
BRL/USD, eop	2.22	2.36	2.27	2.29	2.38	2.47	2.52	2.55	2.58

Source: National Sources, Citi Research

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- **Summary view** — In our view, the May 4 elections in Panama are almost a nonmarket event. We expect growth to slow down in Costa Rica as a result of the partial exit of Intel from the country. In the Dominican Republic, the economy had a strong start during January-February 2014.
- **Things to watch** — The stock of Letes (short-term debt) is rising again in El Salvador. 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
- **Strategy** — We think that Intel's announcement is negative for Costa Rica's asset prices. We think that this announcement is a major change for the country's balance of payments (BoP) and, as such, it would exert pressure on the local currency. The likely slowdown in growth would lower (even more) the political incentives to undertake the much needed fiscal adjustment, thereby affecting external debt prices.

Panama holds elections

In our view, the May 4 elections in Panama are almost a nonmarket event. Panama will hold presidential, congressional and municipal elections next month. In our view, in Panama we can hardly expect major swings in economic policy, regardless of who wins the presidential election. We think this is not a country in which an economic "model" is at stake. Polls show that the presidential race among Jose Domingo Arias (CD), Juan Carlos Varela (PPA) and Juan Carlos Navarro (PRD) has tightened. The polls conducted by Dichter & Neira have consistently put the ruling party's candidate (Mr. Arias) ahead of everyone else — notwithstanding that his lead over other candidates (particularly against Mr. Varela) has decreased. However, a different poll by Ipsos (April 14), shows a tie between Mr. Arias and Mr. Navarro. The last day to publish polls was April 24.

We continue to expect a slowdown in growth in Panama. This slowdown would be driven by modest traffic in the Panama Canal, the temporary halt in works in the Panama Canal expansion in 1Q14, and potential weak data in the Colon Free Zone (ZLC). The recent diplomatic conflict with Venezuela could work against the ZLC, as that country continues to be a major destination of its "re-exports". We expect real GDP growth to slow down to 6.2% in 2014 from 8.4% in 2013.

Intel's partial exit from Costa Rica

We expect growth to slow down as a result of the partial exit of Intel from Costa Rica. Intel is considered to be the main exporter in Costa Rica. Intel's production in Costa Rica is regarded as a Zona Franca — meaning that it can import virtually anything without paying duties, as long as it exports its output. Zonas Francas are the main driver of growth in both manufacturing output and exports, and given the importance of Intel within this sector we think that the partial exit of Intel from the country will pull down growth. Local newspaper *El Financiero* (April 8, 2014) quotes an analysis made by Intel, showing that this company accounts for 6% of Costa Rica's GDP and 20% of the country's exports.

After this announcement, we downgraded our 2014 real GDP growth forecast to 3.1% from 3.5% and our 2015 estimate to 2.2% from 4%. Given the weight that Intel has on output, a slowdown in growth seems inevitable. We expect a fall in exports in 2014-15 accompanied by a decline in imports. We think that the fall in exports would dominate and therefore we also expect a widening in the current account deficit. Spillover effects could also affect consumption and investment. The effect on foreign direct investment (FDI) could be minor if compared to the potential swings in trade. Given the kind of adjustment that Intel has announced, there should be no negative effect on the balance of services. Lower growth could also affect tax revenues (for more details please see Costa Rica Macro View - The Macro Effect of a Microprocessor, April 9, 2014).

Overall, we think that Intel's announcement is negative for Costa Rica's asset prices. We think that this announcement is a major change for the country's balance of payments (BoP) and, as such, it would exert pressure on the local currency. Regarding external debt prices, in previous comments we have expressed our concerns about the likely absence of meaningful reforms to turnaround the fiscal deficit (see Costa Rica Macro View - Throwing in the Towel, March 6, 2014). The likely slowdown in growth would lower (even more) the political incentives to undertake the much needed fiscal adjustment, thereby affecting external debt prices.

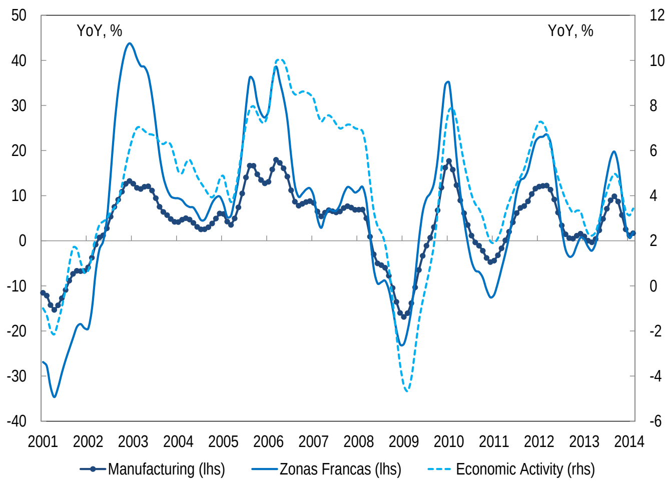
Decent start in the Dominican Republic

The economy had a strong start during January-February 2014. A press release (March 27) published by the Central Bank of the Dominican Republic (BCRD), quotes Central Bank Governor Hector Valdez Albizu saying that the trend-cycle monthly indicator of economic activity (IMAE) increased 5% in January-February (2014). According to Mr. Valdez Albizu, the main drivers of this growth rate were agriculture, mining, construction and tourism (hotels, bars and restaurants). These results make us feel comfortable with our view that real GDP growth will likely increase 4.5% in 2014.

Letes in El Salvador

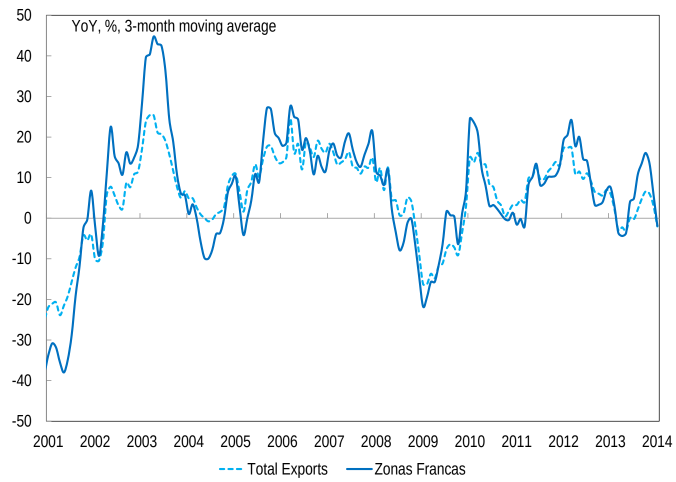
The stock of Letes is rising again in El Salvador. According to the data published by the Reserve (Central) Bank of El Salvador (BCRES), the stock of Letes (short-term debt) increased to almost USD719mn in February 2014. This shows that the country continues to rely heavily on short-term financing. Usually, when the stock of short-term debt breaches a certain threshold, the government ends up issuing longer-dated debt to face the Letes amortizations.

Figure 247. Intel's exit is expected to affect manufacturing in Costa Rica



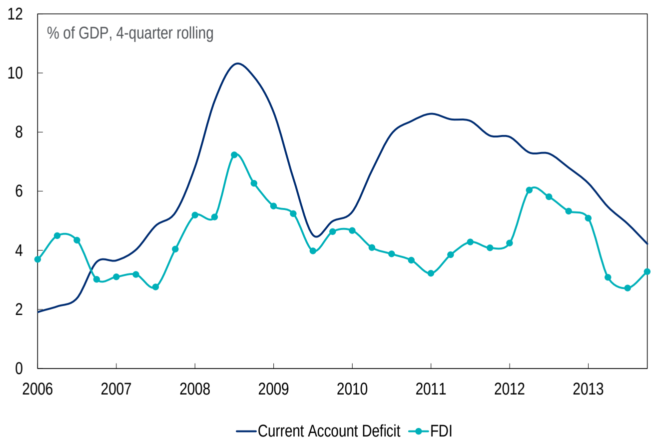
Source: BCCR, Haver and Citi Research

Figure 248. Intel was a driver of exports from Zonas Francas in Costa Rica



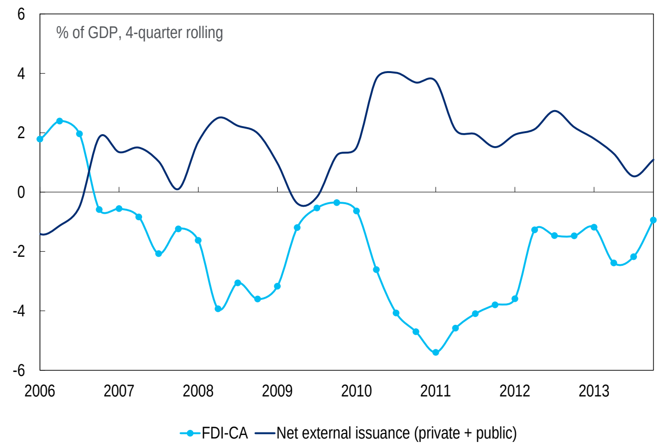
Source BCCR, Haver and Citi Research

Figure 249. The current account deficit has been falling in DomRep



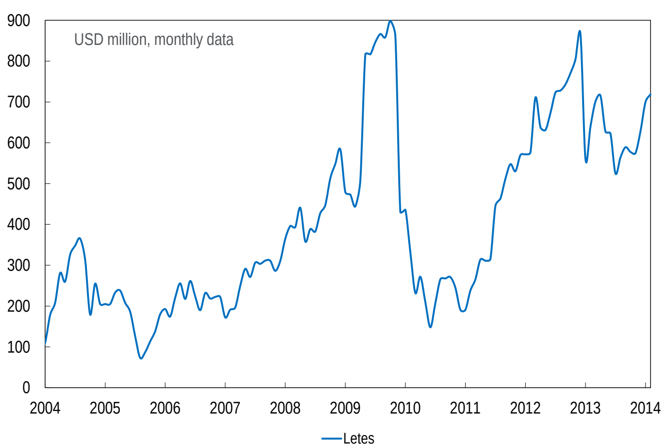
Source: BCRD, Haver and Citi Research

Figure 250. External issuance is expected to increase in DomRep



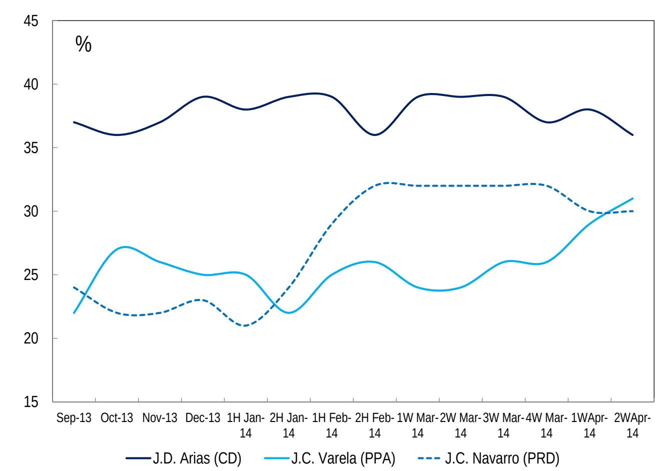
Source: BCRD, Haver and Citi Research

Figure 251. The stock of Letes is increasing again in El Salvador



Source: BCRES and Citi Research

Figure 252. The ruling party's candidate is ahead in the polls in Panama



Source: Dichter & Neira and Citi Research

Figure 253. CCA Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Costa Rica									
Nominal GDP, USD bn	26.3	29.8	29.4	36.3	41.2	45.4	49.6	47.3	47.9
GDP per capita, USD	5,925	6,583	6,359	7,955	8,964	9,654	10,557	9,846	9,974
Real GDP, yoy avg	7.9	2.7	-1.0	5.0	4.5	5.1	3.5	3.1	2.2
CPI, % avg	9.4	13.4	7.8	5.7	4.9	4.5	5.2	3.9	5.0
CRC/US$, avg	517	525	570	521	502	503	501	562	595
CRC/US$, eop	496	560	555	504	506	513	501	585	610
Current account	-1.6	-2.8	-0.6	-1.3	-2.2	-2.4	-2.5	-3.6	-3.8
% of GDP	-6.3	-9.3	-2.0	-3.5	-5.3	-5.3	-5.1	-7.5	-7.9
Consolidated government balance	0.8	0.5	-3.9	-6.0	-5.6	-5.7	-6.5	-7.2	-7.7
	2007	2008	2009	2010	2011	2012	2013	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	2013	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$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.2	-1.5	-0.3	-0.6	-1.1	-1.3	-1.5	-1.6	-1.5
% of GDP	-6.1	-7.1	-1.5	-2.7	-4.6	-5.3	-6.1	-6.3	-5.7
Consolidated government balance	-1.9	-2.8	-5.5	-4.4	-4.0	-3.5	-4.2	-4.1	-3.7
	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Panama									
Nominal GDP, USD bn	21.1	24.9	25.9	28.8	33.3	38.0	42.6	46.5	50.4
GDP per capita, USD	6,318	7,312	7,482	8,170	9,242	10,543	11,668	12,575	13,274
Real GDP, yoy avg	12.1	9.1	4.0	5.9	10.8	10.2	8.4	6.2	5.5
CPI, % avg	4.2	8.8	2.4	3.5	5.9	5.7	4.0	2.7	2.8
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
PAB/US$, 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
% of GDP	-6.7	-10.9	-0.7	-9.6	-15.0	-10.1	-11.3	-9.0	-8.5
Consolidated government balance	3.5	0.4	-1.0	-1.9	-2.2	-1.5	-3.0	-3.0	-3.0

Source: National Sources, Citi Research forecasts

Chile

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- **Summary view** — Activity continues to lack "dynamism", while inflation is accelerating on the back of a weaker CLP and higher fuel prices. Despite higher inflation, we now expect 50bps of additional cuts to the policy rate, starting in June. President Bachelet sent to Congress the fiscal reform bill. The Bachelet administration expects it to be approved by May 21 by the Lower House.

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

- **Strategy** — We are calling for a weaker local currency. Our view on the CLP is consistent with additional monetary policy easing. We expect two additional consecutive 25bps cuts to the policy rate, starting in June. However, we acknowledge that the timing of the next move is a close call--monetary policy easing could begin as soon as in May.

Activity growth: still well below potential

Activity continues growing below potential. According to the Central Bank of Chile's (BCCh) IMACEC (monthly GDP proxy), activity grew 2.9% YoY in February, up from 1.6% YoY in January. As a result, annual activity growth came below 3% for the fifth month in a row. In seasonally-adjusted terms, the IMACEC grew 0.2% MoM in February. As a result, the IMACEC increased 2.3% in SA annualized terms (SAAR) in the quarter ending in February, while it rose 2% SAAR in the last six months, in both cases well below potential.

Domestic demand growth has decelerated in line with overall activity. For instance, private consumption, approximated by real retail sales, the sector which had shown the stronger "dynamism" recently, has been cooling down significantly. According to the National Statistics Institute (INE), real retail sales annual growth has decelerated to 5.3% in February, down from 9.4% in 4Q13. Trend-cycle real retail sales' growth has decelerated significantly in the last months, with them increasing only 0.4% in SAAR in the first two months of 2014.

External accounts: what can they tell us?

External accounts show an improvement, but not due to "good reasons". According to the latest available data from the BCCh, the trade surplus stood at USD2.7bn in 1Q14, up from USD0.6bn in the same period of last year. However, the improvement of the trade balance was driven by a marked drop in imports, which suggest that domestic demand continues under pressure. Exports increased 4.5% YoY in during 1Q14, while imports shrunk 7% YoY.

Composition also matters. While the different types of exports have behaved relatively homogeneously so far this year, the case of imports is quite different. Final goods imports dropped "only" 1.3% YoY in 1Q14 and intermediate goods imports dropped 5.9% YoY, while imports of capital goods plummeted 18.1% YoY. Needless to say, these results suggest that investment continued to be the underperformer on the demand side. However, there are some signs that this may be reverting. Capital goods imports dropped 6.7% YoY in March, significantly less than in the two previous months. In the case of imports of intermediate goods, they actually posted a 2.7% YoY rise. Conversely, final goods imports dropped 6.4% YoY in March. As a consequence, overall imports shrank by1.4% YoY in March, after dropping 9.5% YoY in the first two months of 2014.

Inflation: It will increase further before dropping

Do not worry too much about inflation. Consumer prices rose 0.8% MoM in March, after increasing 0.5% in February. As a result, annual inflation accelerated to 3.5%, up from 3.2% in February and 3% in January. However, despite the recent strong inflation prints, we continue to believe that the inflation risks faced by the Chilean economy are still moderate. In the case of March's big jump in prices, it is worth noting that it was driven by a few sub-indices that typically show large seasonality and volatility. The sub-index which increased the most in March was Education, which rose 4.9% MoM adding 0.39 percentage points (pp) to overall monthly inflation, followed by Foods and Non-Alcoholic Beverages and Clothes and Shoes, which increased 0.8% MoM and 1.4% MoM and added 0.15pp and 0.06pp to the overall print, respectively. The increase in education is explained by the fact that March is the month in which schools open their doors in the southern cone after the (austral) summer holidays.

Inflation will likely increase moving forward. However, this should not be surprising, given the weakening of the CLP. We expect annual inflation to peak in May, reaching 4.1% and surpassing the upper bound of BCCh's target band, and to start decelerating onwards, though gradually.

Monetary policy: a difficult situation for authorities?

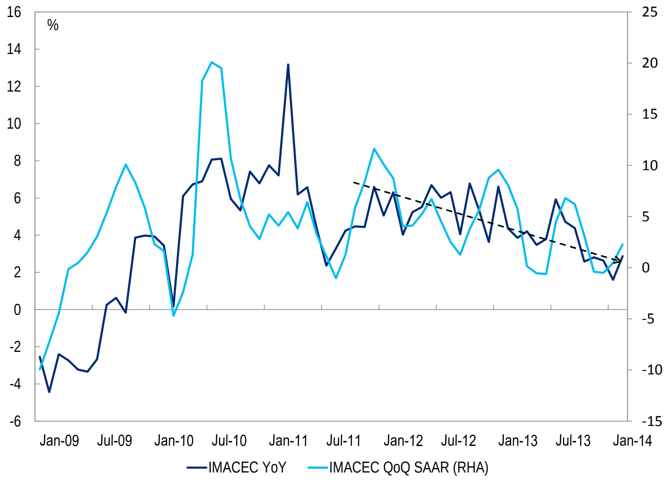
At a first glance, it may seem that the current situation of decelerating growth and accelerating inflation may be challenging for the authorities; however, we think it is not. We believe that the authorities will resume monetary policy easing as soon as next June, and we acknowledge that there are some risks of sooner-than-expected easing. The reason why we think that the BCCh will extend for one additional month (i.e., May) the pause it started in April is twofold: i) while inflation expectations remain well anchored, it may opt to wait for a "calmer" inflation outlook; and ii) it may want to collect some additional information on the activity-inflation outlook, in line with its recent communiqués. In a nutshell, we are changing our call on the policy rate, and we now expect two additional and consecutive 25bps cuts to the policy rate, starting in June. The recent statements from BCCh's Rodrigo Vergara and Pablo García reaffirm our prognosis for additional policy rate cuts.

First steps in the agenda

On Monday, March 31, President Michelle Bachelet presented the main guidelines of her fiscal reform proposal. At the same time, her administration sent to Congress the fiscal reform bill for its approval. The proposal is in line with President Bachelet announcements during her campaign last year. This bill is the first step towards the education reform, a reform that according to the Finance Minister Arenas should imply a fiscal effort of 1.5-2% of GDP.

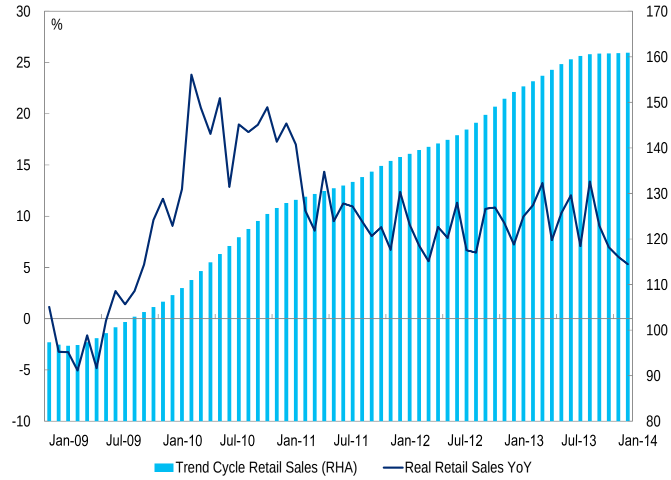
The purpose of the fiscal reform is to increase tax collection by 3% of GDP (US$8.2 billion). To get this amount, the government is seeking to reduce tax evasion and elusion by around 0.5% of GDP through some legal changes that would strengthen government agencies that handle taxes. The bill proposes to gradually raise the corporate tax rate to 25% from 20%, to eliminate the FUT (Taxable Profits Fund) and of the DL600, and to increase some taxes (stamps, some beverages). The tax reform would also translate into some revenue decreases as the government is looking to reduce the income tax rate to 35% from 40% in the highest bracket. Small- and medium-size companies (PYMES) would benefit from some measures (instant depreciation) and the modifications to the way they pay the value added tax (VAT).

Figure 254. Activity growth has decelerated more-than-expected



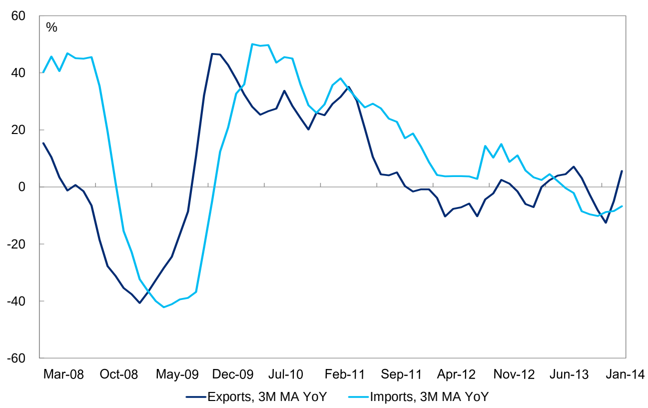
Source: BCCh and Citi Research

Figure 255. Retail sales growth has lost “dynamism”



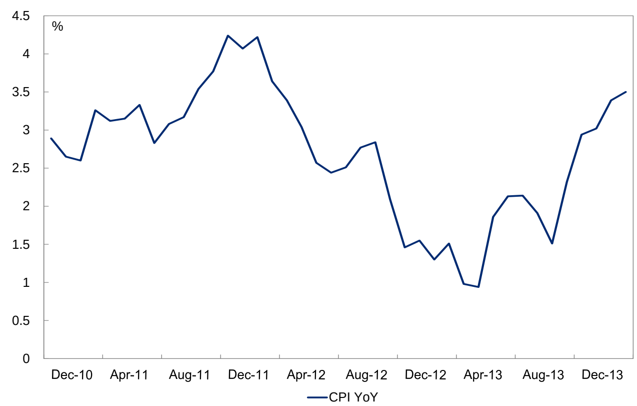
Source: INE and Citi Research

Figure 256. Exports improve, but imports remain under pressure



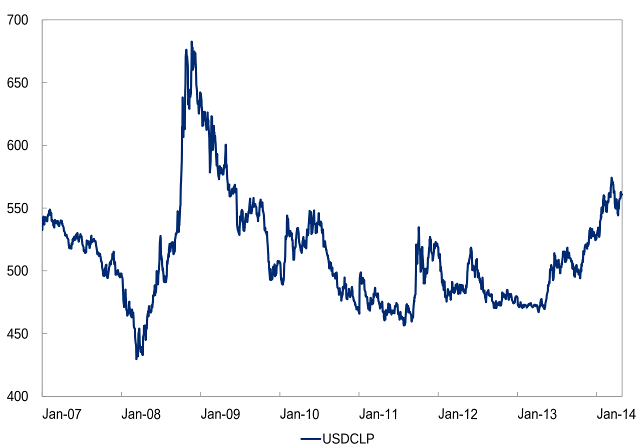
Source: BCCh and Citi Research

Figure 257. Consumer inflation has accelerated…



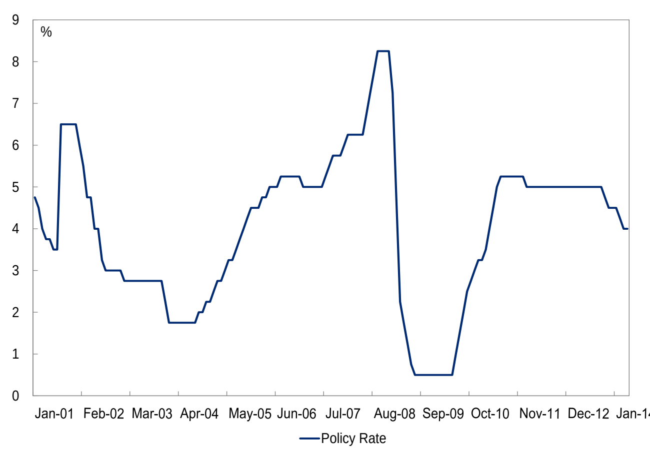
Source: INE and Citi Research

Figure 258. … on the back of a weaker CLP



Source: Bloomberg and Citi Research

Figure 259. The BCCh took a (temporary?) pause in April



Source: Bloomberg and Citi Research

Figure 260. Chile Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	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	13.3	3.3	3.0
CPI, % avg	4.4	8.7	1.5	1.4	3.3	3.0	4.5	0.9	2.9
Nominal wages, % yoy	7.1	8.5	5.8	3.5	5.8	6.3	5.0	4.5	4.5
Credit extension to private sector, % yoy	21.0	18.7	-1.4	7.1	16.9	12.1	6.4	7.3	6.5
Policy Rate (eop)	6.00	8.25	0.50	3.25	5.25	5.00	4.50	4.00	4.00
1 month inter-bank rate, %, eop	5.93	8.24	0.45	3.13	5.23	4.99	4.50	4.00	4.00
Long-term yield, %, eop	6.30	5.93	5.38	5.81	4.92	5.45	5.10	5.00	5.00
CLP/USD, eop	498	638	507	468	520	479	525	578	587
CLP/USD, avg	522	524	559	510	484	486	496	567	584
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	13.3	3.5	3.8	3.4	3.3	2.5	2.7	3.2
Policy interest rate, %, eop	5.00	4.50	4.00	3.75	3.50	3.50	3.50	3.75	4.00
Short-term market rate, % eop	5.00	4.50	4.00	3.75	3.50	3.50	3.50	3.75	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	549	567	573	578	581	583	585

Source: National Sources, Citi Research

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- **Summary view** — The presidential election will garner all the attention during May, being the main source of headlines. Recent polls continue to show President Santos as the most likely winner, but given the low levels of vote intention, a run off in June continues to be our base-case. We do not expect politics to have a significant impact in local markets and macroeconomic performance. Enrique Peñalosa, a recognized technocrat and former major of Bogota has been gaining momentum recently but, although he has chances to go to the second round, we think it will be hard for him to defeat Mr. Santos.
- **Things to watch** — Watch for the presidential election to be held on May 25.
- **Strategy** — The recent behavior of offshore investors (TES holdings by offshore investors increased around COP2.6 trillion in March) are supportive for the local curve, mitigating the effect of monetary policy normalization in longer tenors and causing a "bear-flattening".

Economic outlook

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

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

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. Nonetheless, 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.

Inflation and monetary policy

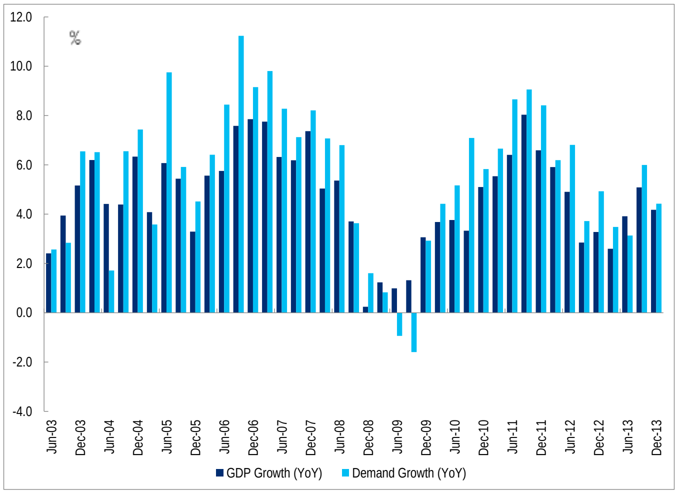
The recent behavior of inflation may indicate that the positive supply shocks that kept inflationary pressures at bay last year could be vanishing earlier-than-expected, leading to an unwanted decrease in real interest rates. In particular, March's inflation print came above expectation, as a result of both food and non-food items. Regarding food inflation, the outcome was driven by perishable food prices (3.37% MoM), while in the non-food inflation field upward pressures came from communications and healthcare (1.54% and 0.58% MoM, respectively). In addition, it is important to note that inflation of regulated goods and services continued increasing in annual terms. All in all, throughout the year inflation has been surprising on the upside and hence it is now expected to move closer to the mid-point of the inflation target range this year, mainly as a result of the reversal of the supply-side positive shocks observed last year and a gradual acceleration in non-food inflation. Our models now show that, given 1Q14 dynamics, a 3% inflation forecast for 2013 is more likely than our previous 2.8%.

An outlook of accelerating inflation together with a steady recovery in GDP growth will likely lead to monetary policy normalization throughout the remainder of 2014. GDP growth expectations along with some leading indicators – particularly the latest industrial production and retail sales results – signal a positive behavior of GDP activities and domestic demand in 1Q14, and that the economy has already entered in a recovery phase. Thus, using our GDP forecast of 4.6% for the year as a whole and our new inflation path, we have updated our Taylor Rule model, which now predicts increases in the policy rate starting in 2Q14. Given that the inflation-GDP outlook seems to be in line with a higher interest rate, we now see 100bps of hikes during the remainder of 2014, implying a 4.25% repo rate by yearend.

The presidential race

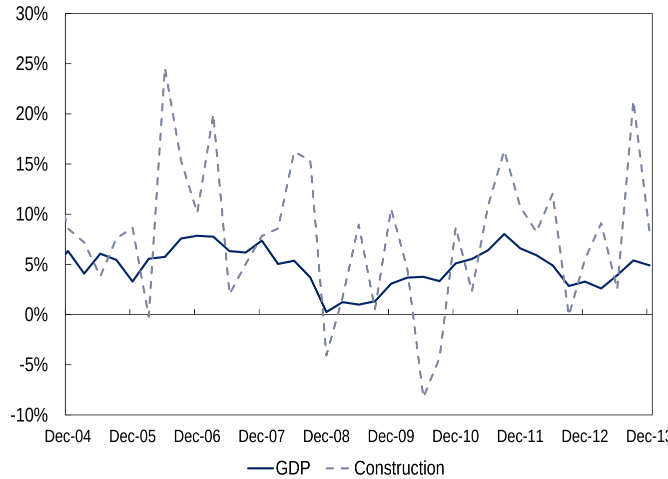
The presidential election will be the center of attention and main source of headlines during May. For the time being, and according to all pollsters, it seems that President Santos continues to be the most likely winner in the presidential election, but still does not have enough votes to assure the 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 Green Party's candidate Enrique Peñalosa. Nonetheless, both of these alternative candidates still need to increase significantly their vote intention 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 261. An mild recovery is expected in 2014



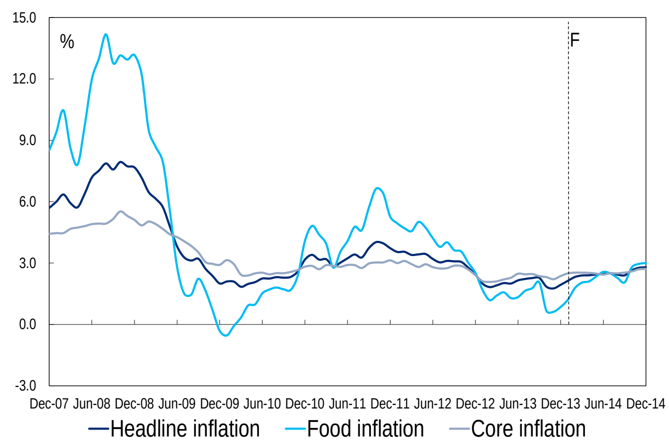
Source: Dane and Citi Research

Figure 262. The construction sector is the main source of uncertainty



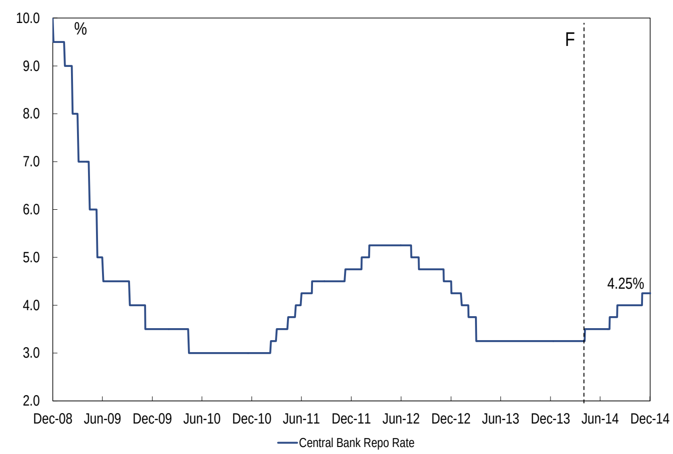
Source: Dane and Citi Research

Figure 263. Inflation should normalize at 3%



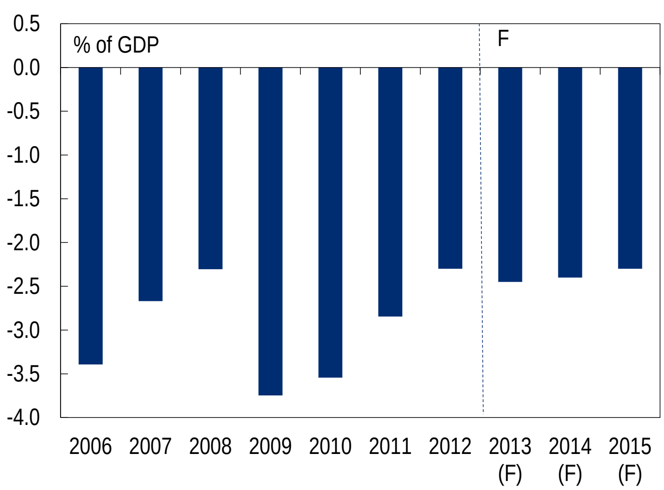
Source: Dane and Citi Research

Figure 264. We expect the repo rate to continue increasing in 2H14



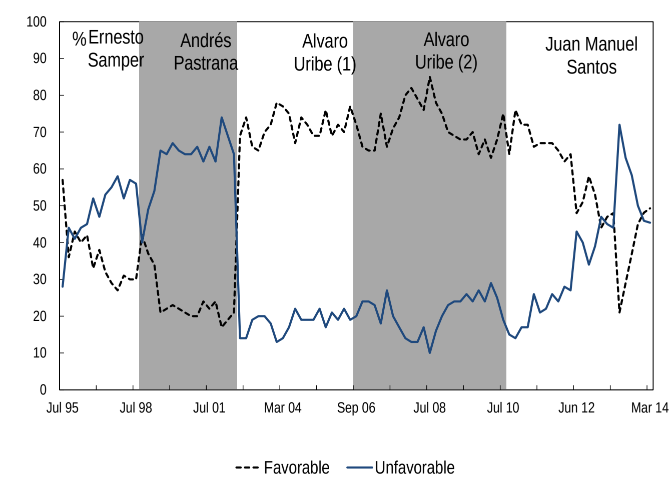
Source: Banrep and Citi Research

Figure 265. Central government deficit should continue relatively stable



Source: Ministry of Finance and Citi Research

Figure 266. Politics in the frontline



Source: Gallup and Citi Research's rendering

Figure 267. Colombia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	208	242	231	285	334	370	376	378	391
Nominal GDP, local currency bn	431	480	505	544	616	673	732	762	824
GDP per capita, USD	4,726	5,447	5,136	6,262	7,269	7,954	7,979	7,948	8,119
Population, mn	43.9	44.5	45.0	45.5	46.0	46.5	47.1	47.6	48.1
Unemployment, % of labour force	11.4	11.5	13.0	12.4	11.5	11.2	10.6	9.5	8.4
Economic Activity									
Real GDP, yoy avg	6.9	3.5	1.7	4.0	6.6	4.0	4.3	4.6	5.0
Real investment growth % yoy	12.8	9.0	-3.9	7.7	18.5	4.6	4.9	4.6	3.3
Real consumption growth % yoy	7.0	3.5	1.6	5.1	5.5	4.7	4.8	4.4	5.5
private consumption growth % yoy	7.3	3.5	0.6	5.0	6.0	4.4	4.5	4.2	5.5
Real export growth, % yoy	6.9	4.5	-2.8	1.3	11.8	6.1	5.3	3.1	4.5
Real import growth, % yoy	14.0	10.5	-9.1	10.8	21.5	8.9	2.1	5.0	4.6
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	5.7	7.7	2.0	3.2	3.7	2.4	1.9	3.0	3.5
CPI, % avg	5.5	7.0	4.2	2.3	3.4	3.2	2.0	2.6	3.3
Nominal wages, % yoy	5.4	19.1	3.0	4.1	4.2	4.3	4.4	4.5	4.6
Credit extension to private sector, % yoy	19.9	14.3	6.8	9.8	18.3	10.0	13.7	14.0	15.9
Policy Rate (eop)	9.50	9.50	3.50	3.00	4.75	4.25	3.25	4.25	5.00
1 month inter-bank rate, %, eop	9.35	8.87	3.10	3.00	4.81	4.27	3.30	4.27	5.02
Long-term yield, %, eop	10.27	12.76	8.47	7.70	7.60	5.86	6.75	7.07	7.82
COP/USD, eop	2,018	2,249	2,043	1,920	1,939	1,767	1,930	2,040	2,125
COP/USD, avg	2,076	1,968	2,154	1,898	1,848	1,798	1,869	1,994	2,094
Balance of Payments, USD bn									
Current account	-6.0	-6.9	-5.1	-8.9	-9.9	-11.8	-12.7	-13.3	-14.0
% of GDP	-2.9	-2.8	-2.2	-3.1	-2.9	-3.2	-3.4	-3.5	-3.6
Trade balance	-0.6	1.0	2.5	2.3	6.1	4.7	2.8	2.3	5.1
Exports	30.6	38.5	34.0	40.8	58.3	61.4	60.0	61.2	64.7
Imports	31.2	37.6	31.5	38.5	52.2	56.7	57.2	58.9	59.5
Service balance	-2.6	-3.1	-2.9	-3.7	-4.7	-5.5	-5.5	-8.7	-11.2
Income balance	-8.0	-10.2	-9.3	-12.0	-16.0	-15.7	-14.7	-11.9	-13.1
FDI, net	9.0	10.6	7.1	6.7	13.4	15.5	16.8	17.2	17.6
International reserves	20.9	24.0	25.4	28.5	32.3	37.5	43.6	47.2	50.8
Total amortisations	5.7	5.1	5.8	6.5	6.3	12.1	6.8	7.5	7.5
Public Finances, % of GDP									
Consolidated government balance	-0.6	-0.1	-2.7	-3.3	-2.9	0.3	-1.4	-1.3	-0.7
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	32.9	34.0	36.7	37.2	34.6	32.5	32.1	30.6	28.9
of which Domestic	21.9	22.6	24.9	26.3	24.3	23.6	23.2	22.1	20.9
Foreign Assets & Liabilities, USD bn									
External debt	44.6	46.4	53.7	64.1	75.9	78.8	90.2	93.5	97.5
Public	28.8	29.4	37.1	38.9	42.8	46.1	51.2	55.2	59.2
External debt / GDP	21.5	19.1	23.2	22.5	22.7	21.3	24.0	24.8	25.0
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	5.1	5.7	3.9	8.1	10.8	9.8	10.0	10.0	10.1
Short-term debt/International reserves (%)	24.6	23.5	15.6	28.3	33.4	26.2	22.8	21.2	19.8

Quarterly Economic Indicators									
	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	5.4	4.9	5.0	4.2	4.1	5.3	4.9	4.9	5.0
CPI, % yoy	2.3	1.9	2.5	2.7	2.6	3.0	3.1	3.2	3.4
Policy interest rate, %, eop	3.25	3.25	3.25	3.50	4.00	4.25	4.50	4.50	4.75
Short-term market rate, % eop	3.29	3.30	3.27	3.52	4.02	4.27	4.27	4.52	4.77
Long-term yield, %, eop	6.87	6.75	6.93	6.32	6.82	7.07	7.07	7.32	7.57
COP/USD, eop	1,912	1,930	1,972	1,965	2,002	2,040	2,064	2,084	2,104

Source: National Sources, Citi Research

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- **Summary view** — The latest data on economic activity suggest that the economy started to rebound during 2H13. In fact, Ecuador's economic growth accelerated importantly after standing around 3.5% during the first half of last year. That being said, we have increased our GDP growth forecast for 2014 up to 4.5%. In our view, the main goal of the government continues to be centered in guaranteeing 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** — Watch for the release of the 1Q14 trade balance prints.

Inflation and activity outlook

In 2013 GDP growth stood at 4.5%. According to the Central Bank of Ecuador, GDP growth displayed an important recovery during 2H14. According to the report, GDP growth during 4Q13 was 5.6%, taking the GDP print for the year as a whole up to 4.5%. The main drivers of the result for the year as a whole were investment (gross capital formation) and real exports, even despite the slow increase in oil production. Investment rose 6.6% in 2013, while exports expanded 4.5%. Government spending decelerated in 2013 standing at 4.3%, while imports increased 4.2%. Regarding consumption, while it rose "only" 3.4% in 2013 as a whole, it showed some improvement during 2H13. On the supply side, construction was the main driver of the result, contributing with 87bps to the total annual GDP print, followed by oil and mining with a 51bps contribution. According to the report, the ongoing projects in Esmeraldas refinery negatively affected growth, reducing GDP growth by 33bps in the oil refining sector.

We expect activity growth to remain healthy in 2014, and real GDP to rise 4.5%. Given the results of 4Q13 we updated our forecast for 2014, and we now expect GDP to expand 4.5% this year. That print is based on a 5.5% rise in government consumption and a 5.4% expansion in household consumption. The main risk, in our view, arises from the external front, namely the evolution of oil prices. This is why our GDP growth forecast for this year continues to be somewhat conservative. Exports, investment and household consumption should be the sectors with higher growth in 2014. Nonetheless, we expect real imports to offset some these figures, as the maintenance of the Esmeraldas refinery will imply higher oil derivatives imports. We expect the government to continue increasing fiscal spending to boost activity growth as long as oil revenues permit. Having said that, we acknowledge that there are questions regarding the sustainability of the current oil production levels going forward, providing an additional reason for the government to back the Yasuni project as we have mentioned before.

External accounts will continue to rely on commodity price evolution. According to our commodity strategist, commodities have outperformed most other asset markets by a wide margin in the first quarter of the year. In our view, in 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 negatively weighting on the current account balance. Thus, our baseline scenario contemplates a deterioration in the current account deficit in 2014, which should only start improving 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 related with higher real GDP growth, at least as long as they are financed through capital inflows.

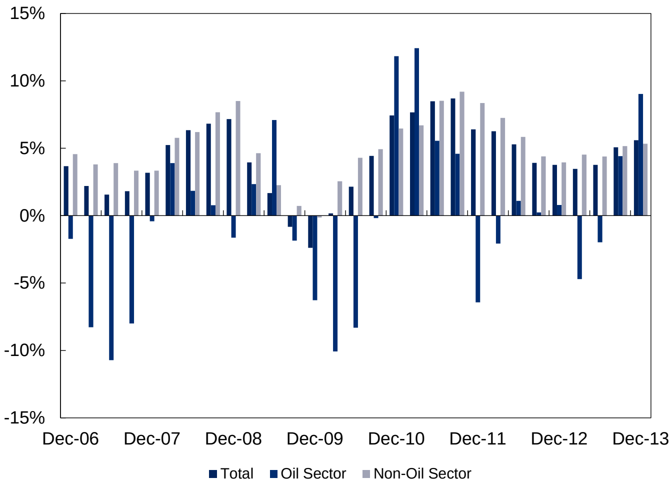
Imports should continue to be the main driver behind the deterioration of the trade balance. The increase in oil derivatives imports has to do with the Esmeraldas refinery overhang, the biggest in the country and which is expected to be fully completed and reach its maximum processing capacity (110 thousand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

We continue to 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 -1.5% of GDP after displaying a 1.3% of GDP deficit in 2013.

Ecuador-EU free-trade talks continued at very slow speed. The advances during the second round of-trade talks between Ecuador and the EU were modest; we therefore think that the likelihood of a quick agreement is relatively low. In our view, is important for Ecuador to continue in this process, in order to add an additional important market for its non-oil exports (particularly tuna and bananas).

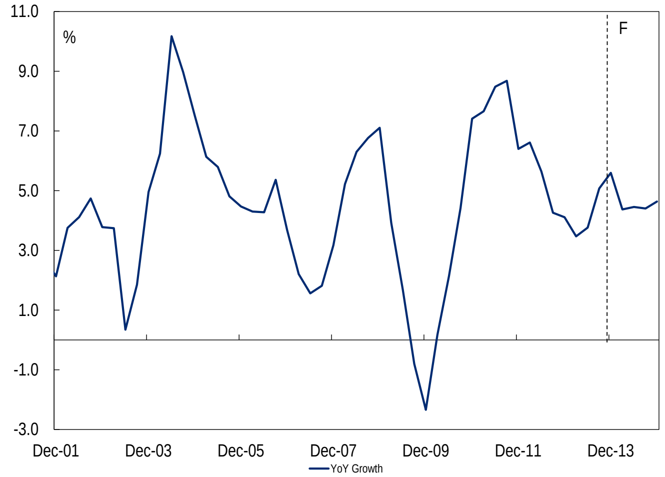
A return to the markets? In early April, President Rafael Correa said that the government plans to issue around USD700mn in global bonds in 2014. The relations of Ecuador with international markets were affected by the 2008 government decision of declaring "illegitimate" USD3.2 billion in sovereign bonds. Although the amount announced by Mr. Correa is relatively low, the issuance (if materialized) will represent an important advance for the country, in our view.

Figure 268. 4Q13 GDP growth breakdown



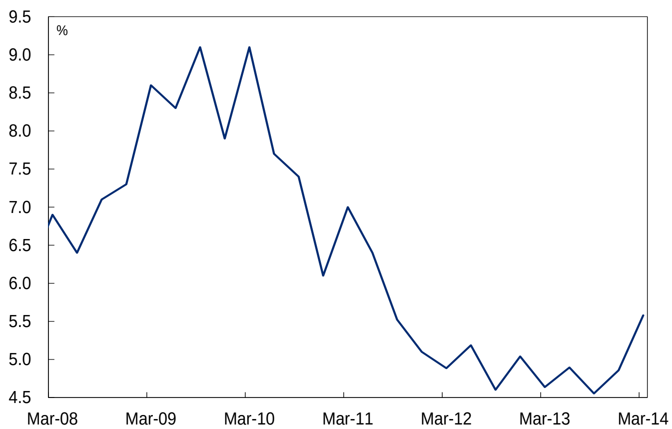
Source: Central Bank of Ecuador and Citi Research

Figure 269. GDP is expected to rebound in 2H13



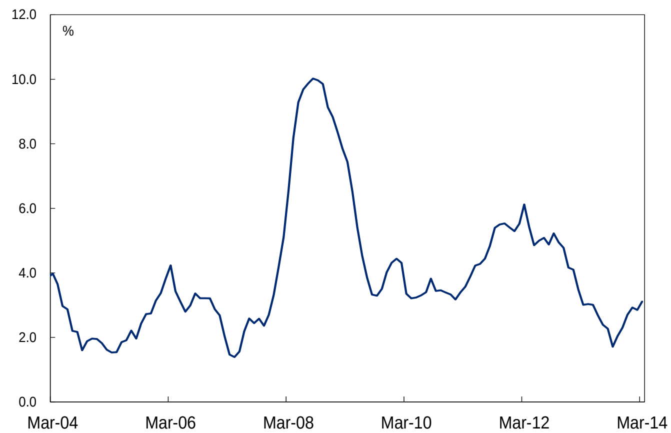
Source: Central Bank of Ecuador and Citi Research

Figure 270. Unemployment rate



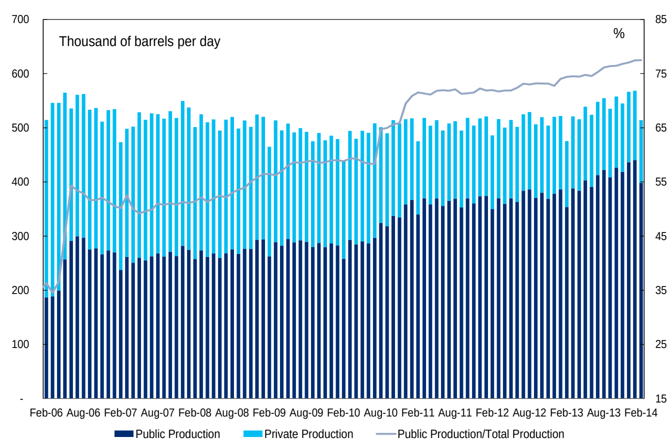
Source: Central Bank of Ecuador and Citi Research

Figure 271. Inflation rate



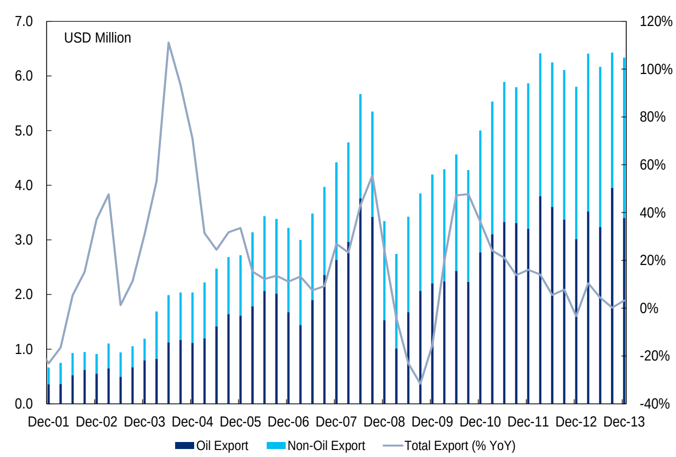
Source: Central Bank of Ecuador and Citi Research

Figure 272. Oil production



Source: Central Bank of Ecuador and Citi Research

Figure 273. Exports breakdown



Source: Central Bank of Ecuador and Citi Research

Figure 274. Ecuador Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	51	62	63	70	80	88	93	100	107
Nominal GDP, local currency bn	51	62	63	70	80	88	93	100	107
GDP per capita, USD	1,856	2,211	2,203	4,637	5,233	5,648	5,903	6,196	6,549
Population, mn	27.5	27.9	28.4	15.0	15.2	15.5	15.8	16.1	16.4
Unemployment, % of labour force	6.1	7.3	7.9	6.1	5.1	5.0	4.9	5.0	5.0
Economic Activity									
Real GDP, yoy avg	2.2	6.4	0.6	3.5	7.8	5.1	4.5	4.5	4.5
Real investment growth % yoy	4.2	22.5	-7.3	10.5	12.5	4.7	6.9	5.1	6.4
Real consumption growth % yoy	4.4	6.2	0.9	7.2	5.8	4.8	3.5	5.4	4.5
private consumption growth % yoy	4.2	5.4	-1.0	7.7	5.9	4.3	3.4	5.4	4.3
Real export growth, % yoy	0.0	3.0	-4.8	-0.2	4.6	2.7	4.5	4.5	4.8
Real import growth, % yoy	7.1	14.4	-9.9	14.8	3.9	1.9	4.2	7.5	6.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.3	8.8	4.3	3.3	5.4	4.2	2.7	3.0	3.1
CPI, % avg	2.3	8.4	5.2	3.6	4.5	5.1	2.7	3.6	2.4
Nominal wages, % yoy	6.3	17.6	9.0	10.1	10.0	10.6	8.0	8.5	11.7
Credit extension to private sector, % yoy	-	34.3	13.0	7.9	12.4	19.2	22.0	21.9	21.9
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	-	5.09	0.20	0.20	0.20	0.20	0.20	0.20	0.20
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ECD/USD, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Balance of Payments, USD bn									
Current account	1.6	1.3	-0.3	-1.6	-0.2	-0.3	-1.2	-1.5	-0.9
% of GDP	3.1	2.1	-0.5	-2.3	-0.3	-0.3	-1.3	-1.5	-0.8
Trade balance	1.8	1.4	-0.1	-1.5	-0.2	0.0	-0.6	-0.9	-0.3
Exports	14.9	19.1	14.2	18.1	23.1	24.6	25.7	25.8	25.9
Imports	13.0	17.8	14.3	19.6	23.2	24.5	26.3	26.7	26.1
Service balance	-1.4	-1.6	-1.3	-1.5	-1.6	-1.5	-1.5	-1.5	-1.5
Income balance	-2.0	-1.5	-1.4	-1.0	-1.2	-1.3	-1.4	-1.4	-1.5
FDI, net	0.2	1.0	0.3	0.2	0.6	0.6	0.7	1.6	2.5
International reserves	3.5	4.5	3.8	2.6	3.0	2.5	4.4	4.2	4.2
Total amortisations	11.8	9.5	8.6	7.5	7.4	6.9	6.4	6.4	6.4
Public Finances, % of GDP									
Consolidated government balance	-0.1	-1.0	-4.2	-1.6	-1.5	-1.9	-2.4	-1.9	-1.5
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	27.2	22.2	16.4	19.2	18.3	21.3	23.2	21.5	20.6
of which Domestic	6.4	5.9	4.5	6.7	5.6	8.9	9.4	8.6	8.0
Foreign Assets & Liabilities, USD bn									
External debt	17.5	16.9	13.4	13.9	15.3	16.0	18.3	18.3	19.4
Public	10.6	10.1	7.4	8.7	10.1	10.9	12.9	12.9	13.5
External debt / GDP	34.3	27.4	21.5	19.9	19.2	18.3	19.6	18.4	18.0
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	5.1	5.6	4.4	4.5	4.4	4.6	4.3	4.4	4.7
CPI, % yoy	1.7	2.7	3.1	4.1	4.1	3.0	2.2	2.3	2.3
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 —** Exports are picking up, with manufacturing shipments to the US up 9.6% YoY in February. As the export glitch is left behind, attention shifts to the internal market which remains tepid. We now see 1Q14 GDP growth at 2.4%YoY down from 2.7%YoY before, while keeping our whole-year forecast at 3.3%. Better-than-expected inflation readings led us to revise our yearend forecast to 4%. Our call for Banxico remaining on hold throughout 2014 remains unchanged.

- **Things to watch —** Congress is likely to call for an extraordinary period of sessions as it will find difficult to process all the remaining legislative workload in the ordinary period that ends April 30. The extraordinary period could be called as early as May, with the secondary legislation on the energy reform likely being the main item in the agenda.

- **Strategy—** Holders of linkers should take into account that seasonal drops in electricity prices during April and May are likely to lead to negative monthly changes in headline inflation. However, this effect should have vanished by June and, given a low comparison base, annual headline inflation should rise to levels slightly above Banxico´s variability range.

External demand reacts; Internal market still tepid

Recent data support the view that the deceleration of exports observed early in the year was temporary. Trade figures for February show manufacturing exports to the US up 9.6% YoY, the best print since September and way above the modest 3.8% YoY growth rate registered in January. Moreover, auto exports in March (in unit terms) stood at 230.8k, with annual growth rates at a solid 12% clip for a second consecutive month. These results are consistent with our view that modest export performance in January was temporary and mostly explained by harsh weather conditions in the US. We therefore believe that the Mexican economy will benefit from the activity rebound in the US via manufacturing and, particularly, the auto sector, where new production capacity is coming into line.

Meanwhile, the internal market is taking longer to react. Retail sales remain in the doldrums, with same-store sales reported by ANTAD – a retailers´ association – at -2.4% YoY in March, having dropped for four months in a row. This, together with several other indicators, has raised concerns about the ability of the internal market to exhibit a rebound. Therefore, it is important to put things in perspective by looking at aggregate demand figures. Private consumption is equivalent to 68% of GDP, a large proportion, but its trajectory depends on exogenous factors. The most important one is net exports, but it operates in a peculiar way. During 2012-2013 exports and imports were equivalent to 31.4% and 31.5% of GDP and they grew at very similar rates, bringing the contribution of *net* exports to GDP close to nil on *average*. However, when there is a turning point in the cycle, the difference between exports and imports increases temporarily, and quite substantially: this is what pushes the “private consumption” ship in a certain direction. In 2Q13 for example, when exports decelerated ahead of imports, net exports posted a -5.9% YoY change. In 4Q13 – when exports began to accelerate again – next exports printed a 7.1% YoY growth rate. This momentum was temporarily interrupted early this year, but with renewed export dynamism, we would expect the internal market to start showing better numbers ahead.

A similar lag may apply to public spending, up 19% YoY during the first two months of the year. In this case though, assessing the net effect of fiscal policy also has to take into account the recessionary effect of tax changes associated to

the fiscal reform as well as their effects over investment and consumption decisions, where we had likely underestimated the reaction that these changes generated in the private sector. Still, the net effect of fiscal policy this year should be expansionary, given a projected fiscal deficit worth 1.5% of GDP.

All in all, we now expect GDP growth of 2.4%YoY in 1Q14, while we are keeping our estimate for the year as a whole constant at 3.3%. Weaker growth in 1Q14 (our previous estimate was 2.7%YoY) is perceived as driven by temporary factors. The fact that private consumption remained tepid in 1Q14 also helps to explain inflation falling back to Banxico´s target range faster than originally expected, as in March headline inflation stood at 3.8% YoY, from 4.2% YoY in February. We nonetheless believe that inflation will rise a bit in the second half of the year and will close 2014 at 4.0%.

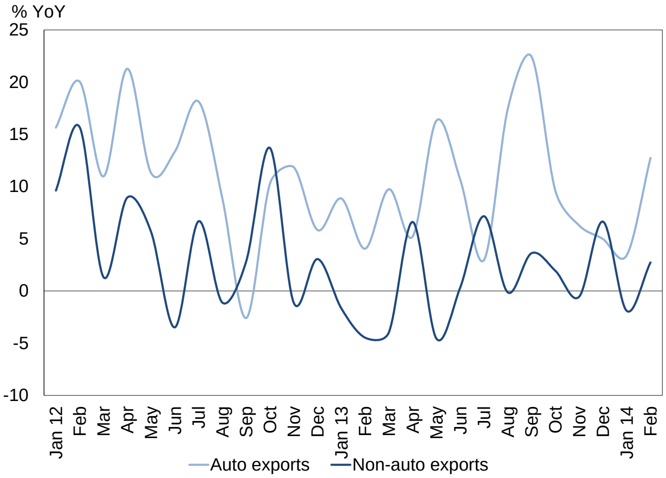
Meanwhile, Banxico is positioned for waiting for Fed normalization while keeping its overnight rate unchanged during 2014. With activity being the main concern in the short term, the question is whether Banxico could consider additional rate cuts. At the outset, we thought this was unlikely and recent communication by policymakers reinforces our perception. While the minutes corresponding to the last policy meeting in March shows policymakers more concerned about activity, it also shows them reluctant to send a message that could be interpreted as opening the door to policy moves. We think Banxico is comfortable with the current 3.5% level for the policy rate, as along with a weaker real exchange rate, it has contributed to ease financial conditions, but it is only slightly negative in real terms (if long term inflation expectations are used, it is close to zero in real terms). We think this is important for local policymakers as the Fed normalizes. We still see the first rate hike in June 2015 but now expect a more gradual hiking cycle, with the o/n rate closing 2015 at 4.25%.

Congress to call for an extraordinary period of sessions

We now think that Congress will call for an extraordinary period of sessions. The ordinary period of sessions ends on April 30 and there are several important pieces of legislation that are still pending after a hectic period of legislative work. The enacting laws accompanying the constitutional reforms on Competition and Telecommunications have generated an intense discussion – particularly the latter – and while passage before the end of the month is feasible, we think the Senate may choose to set priorities. This is particularly the case since legislation on the electoral reform is also pending, and deadlines should be met for these new rules to apply in the 2015 federal elections.

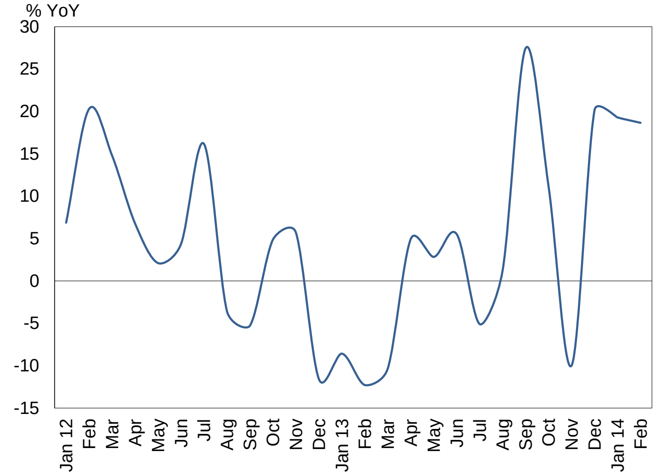
The secondary legislation of the energy reform is likely to be one of the issues to be addressed in the extraordinary period. The main reason for this is the fact that the proposal of the government was not sent to the Senate before the Easter holiday, thus limiting the number of sessions available for its approval. While it is still feasible for the relevant commissions to have this bill ready before the end of the month, a vote on the floor both of the Senate and the Lower House would still be pending, suggesting it is better to consider such an important piece of legislation in an extraordinary period, that could take place as early as in May.

Figure 275. Exports rebounding, driven by the auto sector



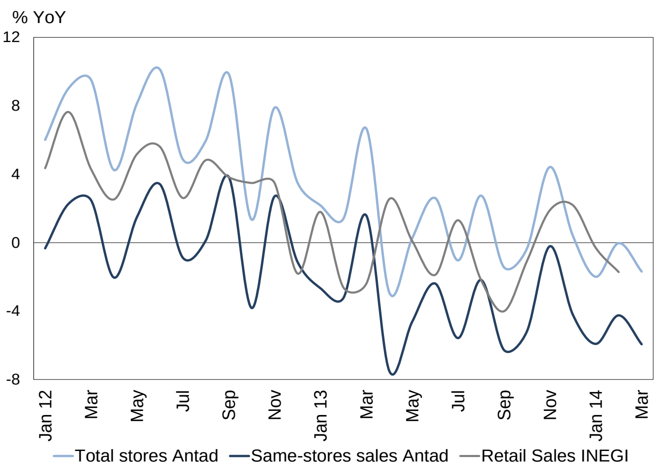
Sources: INEGI and Banamex

Figure 276. Activity supported by solid public spending



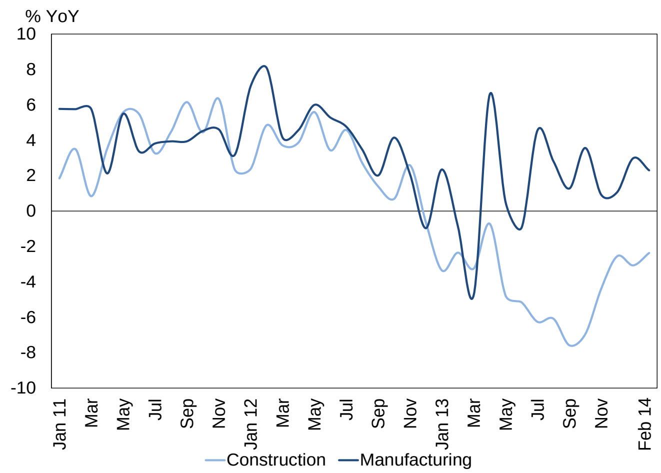
Sources: SHCPI and Banamex

Figure 277. But, a still lagging internal market



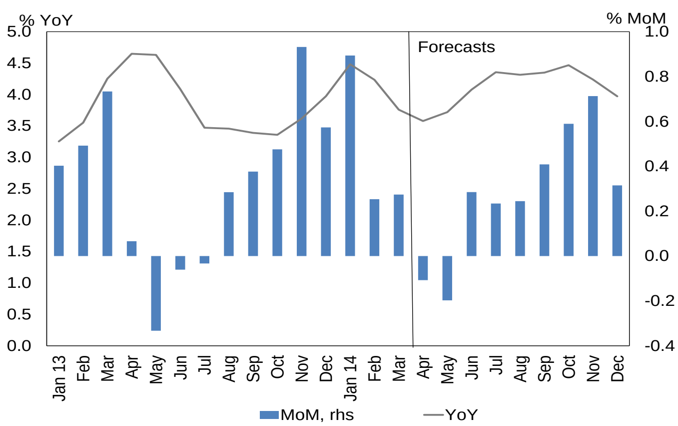
Sources: ANTAD, INEGII and Banamex

Figure 278. In a two-speed economy



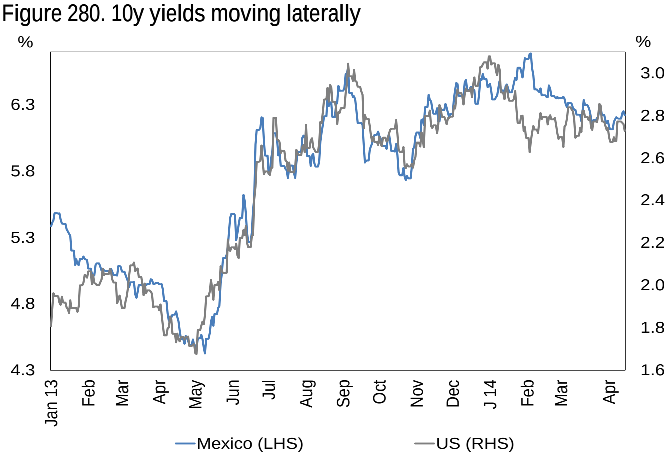
Sources: INEGI and Banamex

Figure 279. Annual Inflation reaches a trough in April



Sources: INEGI and Banamex

Figure 280. 10y yields moving laterally



Sources: Bloomberg and Banamex.

Figure 281. Mexico Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,044	1,109	897	1,052	1,170	1,184	1,259	1,305	1,444
Nominal GDP, local currency bn	11,403	12,257	12,094	13,282	14,531	15,588	16,077	17,251	18,665
GDP per capita, USD	9,507	9,967	7,952	9,206	10,117	10,130	10,659	10,935	11,999
Population, mn	109.8	111.3	112.9	114.3	115.6	116.9	118.1	119.3	120.4
Unemployment, % of labour force	3.7	4.0	5.5	5.4	5.2	5.0	5.0	4.8	4.5
Economic Activity									
Real GDP, yoy avg	3.1	1.4	-4.7	5.1	4.0	3.9	1.1	3.3	4.0
Real investment growth % yoy	3.7	6.2	-13.3	4.5	5.4	5.7	-2.3	2.5	5.4
Real consumption growth % yoy	3.0	2.1	-5.2	4.7	4.6	4.5	2.3	3.0	3.6
private consumption growth % yoy	3.0	1.9	-6.5	5.3	4.9	4.7	2.5	3.1	4.0
Real export growth, % yoy	3.6	-1.3	-11.8	20.5	8.2	5.9	1.4	6.9	5.5
Real import growth, % yoy	5.9	4.4	-17.6	20.5	8.0	5.4	1.2	6.6	7.4
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	4.1	3.7
Nominal wages, % yoy	5.4	5.3	4.2	3.0	5.4	4.4	4.6	4.2	4.3
Credit extension to private sector, % yoy	12.0	9.6	0.6	5.6	7.4	6.8	6.7	8.5	9.8
Policy Rate (eop)	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.50	4.25
1 month inter-bank rate, %, eop	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.50	4.25
Long-term yield, %, eop	8.03	8.35	7.99	6.95	6.51	5.38	6.45	7.27	7.70
MXN/USD, eop	10.91	13.67	13.06	12.36	13.95	12.87	13.04	13.12	12.80
MXN/USD, avg	10.93	11.16	13.50	12.63	12.44	13.16	12.76	13.14	12.92
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	2.4	2.5	3.8	4.5	4.6	4.0	4.0
CPI, % yoy	3.4	4.0	3.8	4.0	4.3	4.0	3.6	3.8	3.8
Policy interest rate, %, eop	3.75	3.50	3.50	3.50	3.50	3.50	3.50	3.75	4.00
Short-term market rate, % eop	3.75	3.50	3.50	3.50	3.50	3.50	3.50	3.75	4.00
Long-term yield, %, eop	6.10	6.45	6.20	6.47	6.71	7.27	7.58	7.62	7.66
MXN/USD, eop	13.09	13.04	13.06	13.23	13.17	13.12	13.04	12.96	12.88

Source: National Sources, Citi Research

Peru

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- **Summary view** — The outlook for the Peruvian economy improves. In particular, we saw a pickup in economic activity during February, which ratifies our view that Peru will remain as one of the best performing economies in the region, despite a challenging external outlook and the important risks associated to it. That being said, we think the analysis of the balance of payments and the trade balance will be the main variables to assess eventual vulnerabilities during 2014 and 2015.

- **Things to watch** —Watch for 1Q14 GDP result. Also the National Statistics Office (INEI) will update the national accounts base year.

- **Strategy** — We expect the BCRP to keep its interest rate unchanged during the month. FX policy will likely continue to be the tool to absorb external shocks, if they materialize.

Economic activity

Economic activity is gaining momentum. During February we saw economic activity gaining momentum - after some relatively weak figures - growing 5.7% YoY during the month. Although this can be partly explained by a low comparison base, the behavior across sectors is positive and supportive of a gradual recovery during the year. The latter means that the weakest activity prints, which took place in December-January, are probably behind us. In February the main performing sectors were fisheries (18.2%), financial services (13.9%), and construction (9.8%). On the other hand, the agricultural sector displayed the worst performance (and the only negative print across sectors) decreasing by 0.6% YoY. Although economic activity is growing below what is locally accepted as potential, we expect to see a favorable evolution going forward. Nonetheless, it is important to keep in mind that this recovery should not be a straight line and some volatility in the monthly economic activity index should be expected.

Commodity prices continue to be the main concern for GDP growth. We acknowledge that the fact that terms of trade have slightly fell 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 its early production by 2015 does matter for GDP determination and we believe this should have a positive impact on the country's exports in the future. In addition, and as mentioned by our commodity strategists (see Global Economic Outlook and Strategy - March 2014), growing Chinese macro concerns over the past month have impacted the prices for industrial metals, particularly copper. Although the copper's selloff observed in March was partially reversed in April, we expect copper to remain below the $7,000 per ton mark over the short term.

Domestic-driven growth should support economic performance in 2014 and 2015. Given our view that external factors will likely fail to boost growth in Peru, we believe it is important to look at the health of domestic drivers: consumption and investment. Household consumption has been increasing recently and we expect these dynamics to continue throughout 2014, as credit conditions remain favorable even despite the recent increases in non-performing loans.

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

Inflation and monetary policy

During 1Q14 inflation continued above the inflation target range. During 1Q14 inflation stood above the inflation target range of 1-3%. Inflation has been mostly driven by supply shocks associated with foodstuffs, and thus we expect inflation to gradually converge to the inflation target. We continue to expect inflation to stand at 2.5% by yearend, slightly below market expectations (2.8% YoY).

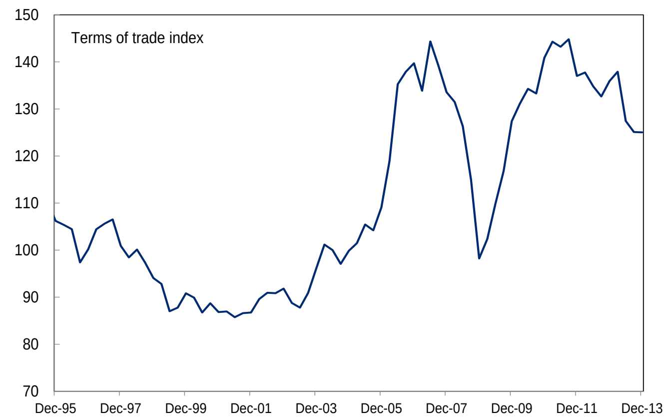
Monetary policy. Although economic activity is growing below what is locally accepted as potential, the fact that inflation is on the upper bound of the target limits the central bank's room to cut its policy rate, in our view. However, the monetary authority could continue using reserve requirements as an alternative tool to boost economic activity if conditions permit. According to a previous BCRP's communiqué, reduction in reserve requirements have had a positive impact on loans in local currency, which were growing at an annual rate close to 25% by the end of 1Q14.

External sector

Falling metal prices and the overall appetite for emerging market risk could create some pressures in the exchange rate. Last year we observed an important depreciation of the exchange rate as a result of: i) the expectations of Fed's tapering; and ii) less appetite for emerging market risk. While we do not expect such abrupt movements to repeat, we recognize that the overall outlook for commodity prices continue to be challenging. Therefore, we expect the USDPEN to increase to 2.85 by yearend. In our view, levels beyond that mark would lead to aggressive interventions by the BCRP in the FX market, as it occurred back in February.

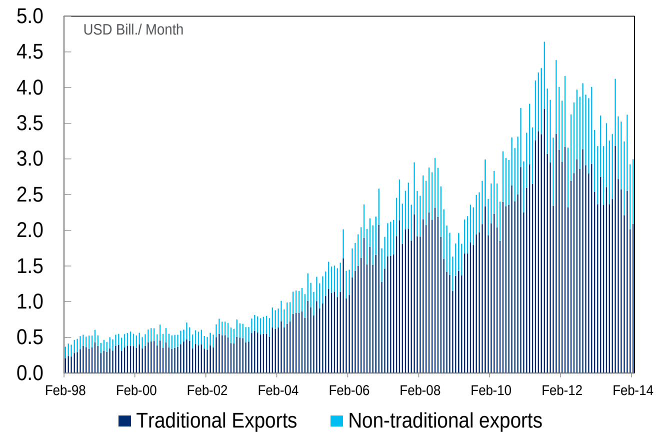
Balance of payments. During 2013, the current account deficit stood at 4.9% of GDP, increasing 1.6 percentage points versus the previous year. This increase in the current account deficit was mostly driven by the deterioration of the trade balance, which went from 2.6% of GDP surplus to a 0.2% of GDP deficit. For 2014, we expect the current account to further deteriorate to 5.4% of GDP, on the back of stagnant exports and lower commodity prices. For the time being, the current account deficit continued to be comfortably financed by strong inflows of foreign direct investment, something that has explained the significant increases in international reserves. Nonetheless, we expect a slower reserves accumulation moving forward.

Figure 282. Terms of trade dynamics...



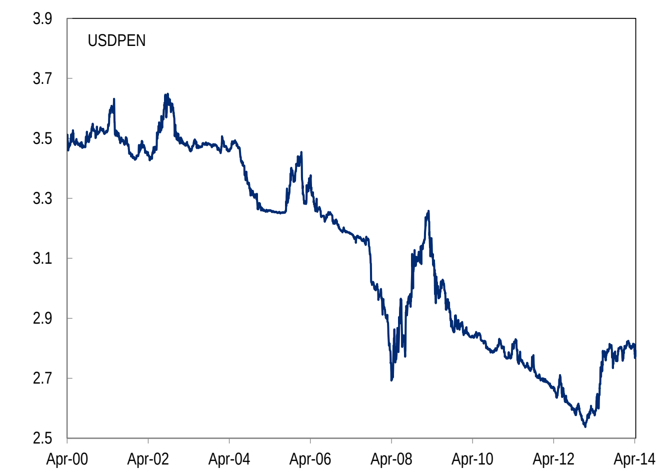
Source: Bloomberg and Citi Research

Figure 283. Could translate into weaker traditional exports...



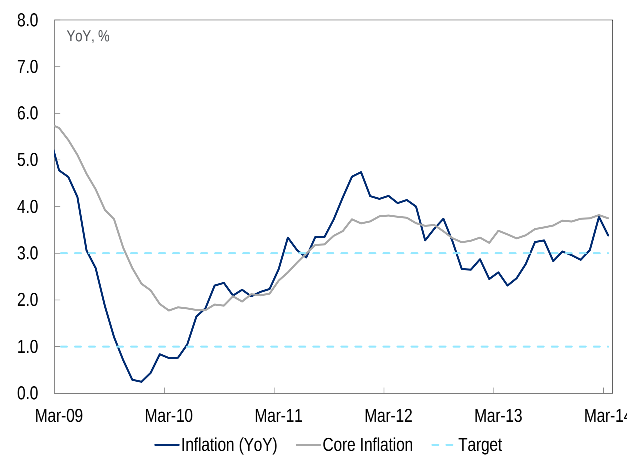
Source: BCRP and Citi Research

Figure 284. And a weaker exchange rate



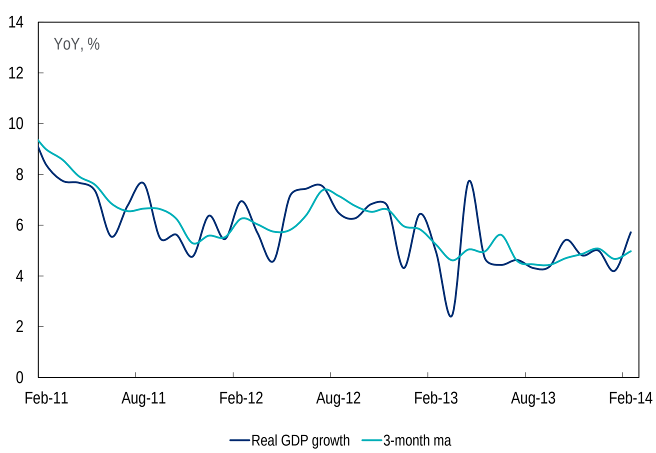
Source: Bloomberg and Citi Research

Figure 285. Inflation dynamics



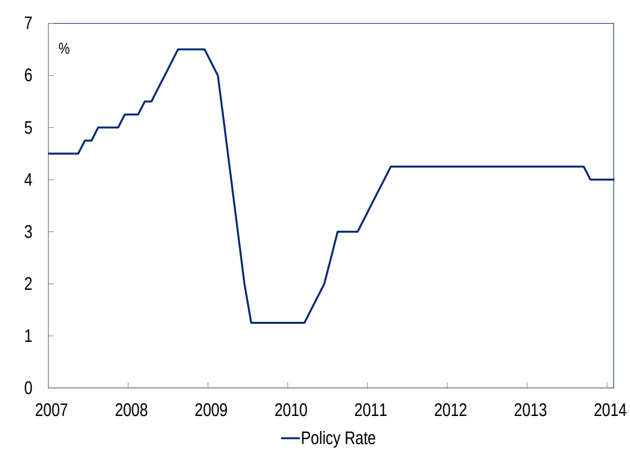
Source: BCRP, Haver and Citi Research

Figure 286. Output is expected to pick up...



Source: INEI, Haver and Citi Research

Figure 287. The BCRP is expected to keep the interest rate on hold



Source: BCRP, Haver and Citi Research

Figure 288. Peru Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, USD bn	107	127	127	153	176	199	208	218	239
Nominal GDP, local currency bn	336	371	382	435	486	526	567	614	668
GDP per capita, USD	3,906	4,562	4,482	5,344	6,033	6,712	6,909	7,116	7,699
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	9.7	6.8	5.0	4.9
Real consumption growth % yoy	7.9	8.0	3.9	6.5	6.2	6.3	5.3	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	5.9	1.0	4.9	4.5
Real import growth, % yoy	21.4	20.1	-18.6	24.0	9.8	10.4	5.1	6.1	4.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.9	6.7	0.2	2.1	4.7	2.6	2.9	2.5	2.5
CPI, % avg	1.8	5.8	2.9	1.5	3.4	3.7	2.8	2.9	2.5
Nominal wages, % yoy	5.0	12.8	23.1	-8.8	15.1	5.4	5.0	5.0	0.0
Credit extension to private sector, % yoy	29.9	14.3	10.4	20.1	14.2	13.8	11.0	11.0	12.0
Policy Rate (eop)	5.00	6.50	1.25	3.00	4.25	4.25	4.00	4.00	4.50
1 month inter-bank rate, %, eop	5.51	6.68	1.28	3.20	4.17	4.22	4.60	4.10	4.60
Long-term yield, %, eop	6.44	7.69	6.31	6.34	6.16	4.24	5.40	5.30	5.00
PEN/USD, eop	3.00	3.13	2.89	2.81	2.70	2.55	2.80	2.85	2.80
PEN/USD, avg	3.13	2.92	3.01	2.82	2.75	2.64	2.70	2.82	2.80
Balance of Payments, USD bn									
Current account	1.5	-5.3	-0.7	-3.8	-3.3	-6.8	-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	-0.9	-0.9
Exports	28.1	31.0	27.0	35.6	46.3	45.9	41.5	41.7	44.8
Imports	19.6	28.4	21.0	28.8	37.0	41.1	42.3	42.6	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	-12.6	-13.2
FDI, net	5.5	6.9	6.4	8.5	8.2	12.2	11.3	12.5	12.9
International reserves	27.7	31.2	33.1	44.1	48.8	64.0	67.5	70.3	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	55.4	58.0
Public	20.1	19.2	20.6	19.9	20.2	19.0	17.6	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	4.5	5.1	5.9	5.5	5.7	5.7	6.5	6.1	5.9
CPI, % yoy	2.8	2.9	3.4	3.1	2.3	2.5	1.7	1.9	2.2
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	2.81	2.81	2.82	2.85	2.85	2.85	2.85

Source: National Sources, Citi Research

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- **Summary view** —With the loosening of political tensions, partly due to the ongoing conversations between the government and the opposition, economic policy has taken center stage. On this ground, the opening of the SICAD II market has disappointed, as the approved volumes (which have not been officially informed) have been too low to reverse the scarcity of foreign currency faced by the private sector. In this context, we see inflation increasing to 75% by yearend, while activity dropping 1% this year. Given the deterioration in economic fundamentals, we do not rule out additional episodes of social unrest. Going forward, the way the government handles the economy in order to boost local production and reduce goods' scarcity will be crucial; reducing scarcity and increasing production would imply eliminating some of the restrictions and caps previously imposed by the authorities. In our view, whether the government is willing or not to do such changes will have important implication for the evolution of the economic situation in the upcoming months and the likelihood of future social unrest.

- **Things to watch** — Watch for the evolution of SICAD II operations and possible debt issuance announcements.

- **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: hope of deliverance

Throughout the year, economic activity and inflation have continued to deteriorate and the government is realizing that it needs to unwind some of the previously implemented measures to (try to) turnaround the situation. For instance, the general sense is that the Central Bank has stopped to prove the complete dataset for activity and inflation as a result of the significant deterioration in these indicators. Even more important is the fact that with the peak of the political crisis behind us, main-street Venezuelans are now facing a reduction in economic activity coupled with increases in prices, clearly an ugly mix. If this situation is left unattended, it could create a new wave of social unrest but one which would not be politically but economically motivated. In our view, the government understands this and, as a result, is looking at alternatives to improve conditions without having to sacrifice much of its "XX1 Century Socialism". This is the main reason behind the recent announcements of a new wave of economic measures including, among other things, simplification of procedures associated with imports, price increases on many basic goods as well as vehicles, and offering of additional US dollars for producers.

We believe that it will be important to see how fast can the government implement (or not) the announced measures, as we are in a context in which economic variables are quickly deteriorating. In particular, we expect consumption and government spending to continue decelerating this year, causing GDP to contract 1%. 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. It is worth noting that we see a downward bias for our activity forecasts, as it is still unclear how effective will the recent announced policies be in boosting growth.

As we mentioned in our previous report, inflation and scarcity should continue increasing this year. The Central Bank of Venezuela reported that the national inflation gauge stood at 4.1% MoM in March, in line with market expectations (consensus 4.1%, Citi 3.5% MoM). This result took the yearly inflation print up to 59.3%, above February's print. The Central Bank avoided informing on scarcity in the report, a course of action that suggests that the situation continued aggravating in March.

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 have to change, as thia strategy has fueled scarcity instead of solving it. All in all, we still expect inflation to accelerate up to 75% by yearend.

SICAD II and debt issuance: someone is knocking at the door?

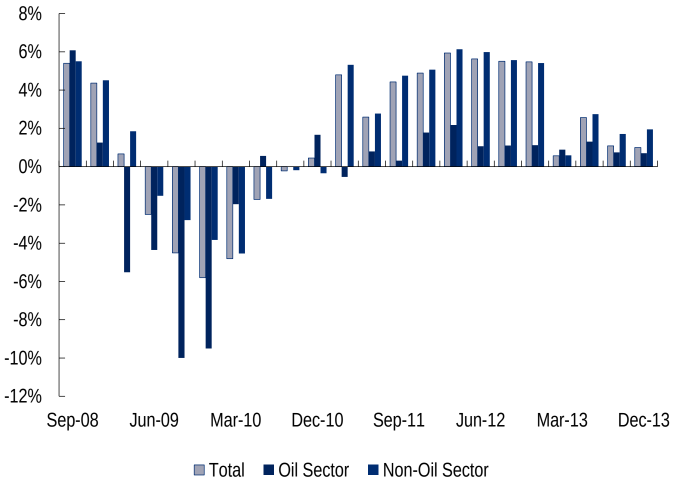
A lot of expectations built up around the new SICAD II, and its ability to supply foreign currency. However, following the first month of SICAD II operations, we believe that, despite the drop in the black market exchange rate which took place during this period of time, the average traded volume in this market (SDUSD47mn per day, according to local think tank Ecoanalitica) is not enough to provide any significant economic relief.

What are some of the implications of SICAD II after its first month? To measure the impact of SICAD II on the economy, its effects have 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 was initially seen as positive, the high burden of operative costs by the companies and the fact volumes have been perceived as relatively low have created more questions regarding the usefulness of this mechanism to provide a solution to the bottlenecks observed in the production chain of the private sector.

Impact on the oil sector and fiscal accounts. In general, the possibility of offering USD at a higher rate should be beneficial for both 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 and the growth of monetary aggregates has not fell (currently the monetary base is growing at a rate higher than 70%)..

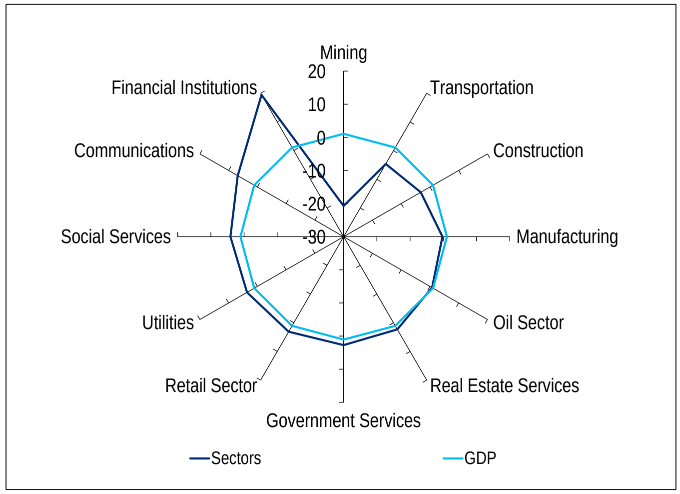
Implications on bond supply: Is issuance coming? So far most of the supply in the SICAD II has been in the form of bonds, raising questions on the stock of bonds available for sale in the market and for how much time can the new mechanism work given that stock. Although there is no detailed information to answer any of these questions, we believe the current levels of USD-denominated debt available for sale are not enough and hence we expect issuance of additional debt. In particular, we think that the USD-denominated issuance will more likely come from PDVSA in an amount that could be around USD3-4bn (around half of the annual allocations made by the extinct SITME system).

Figure 289. GDP growth performance in 4Q13



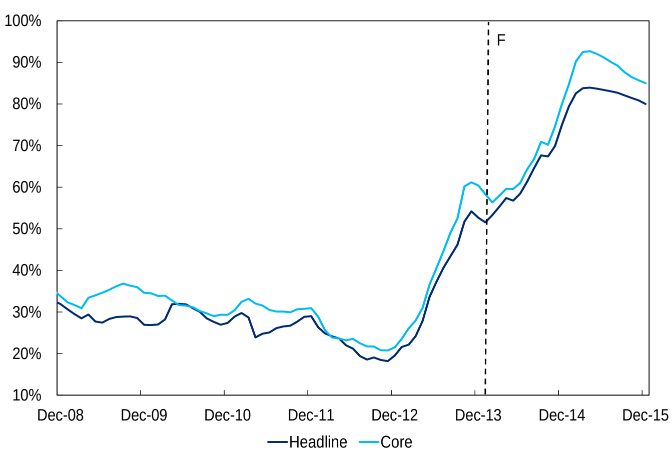
Source: BCV and Citi Research

Figure 290. GDP growth by sector 3Q13



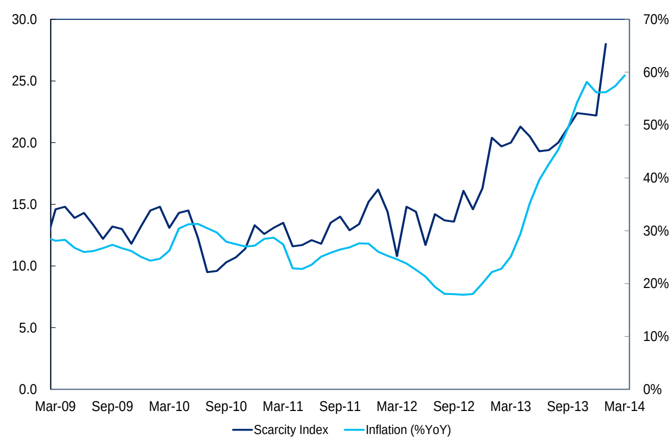
Source: BCV and Citi Research

Figure 291. Inflation should accelerate despite the week GDP growth



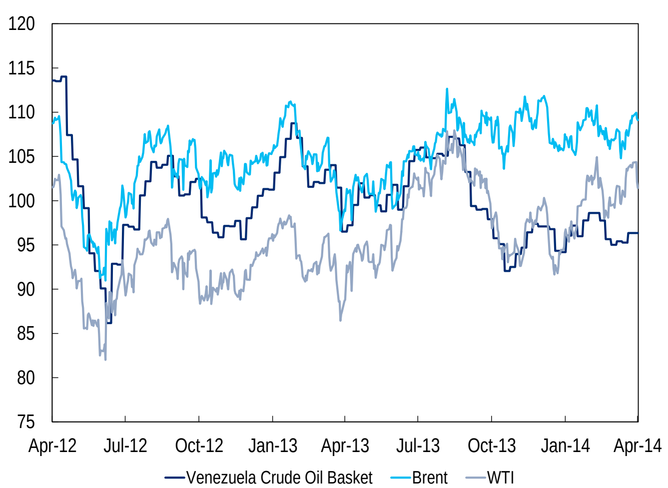
Source: BCV and Citi Research

Figure 292 Scarcity continues to be one of the drivers of inflation



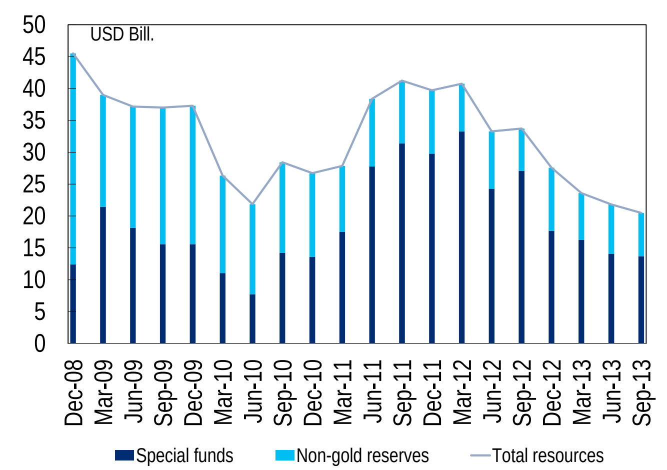
Source: BCV and Citi Research

Figure 293. Venezuelan oil basket prices and WTI prices



Source: BCV and Citi Research

Figure 294. Could total liquid resources continue its downtrend?



Source: BCV and Citi Research

Figure 295. Venezuela Economic Indicators

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

Quarterly Economic Indicators									
	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F
GDP, % yoy	1.1	1.1	-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	13.53	14.81	14.71	15.88	14.53	15.81	15.71
VEF/USD, eop	6.29	6.29	6.29	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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