

# Emerging Markets Macro and Strategy Outlook

## Bad news for commodities exporters?

- 'Sell deficits, buy surpluses' seemed a winning strategy for much of 2013, following an ancient pattern: when risk aversion takes hold, creditors lose enthusiasm for those who need to borrow. But the best guide for investors to discriminate among emerging economies changes over time, and now we think 'sell commodities, buy manufactures' could end up replacing 'sell deficits, buy surpluses'. Two of the 'Fragile 5' – India and Turkey – are essentially exporters of manufactured goods. If we're right about the idea that manufacturing exporters are going to be in better shape than commodities exporters, the 'Fragile 5' might be losing its usefulness now that there has been a degree of current account adjustment.
- The 'end of the commodities super-cycle' is by now a familiar idea, but it does seem as though its consequences have become more visible. Broad-based commodities price deflation seems well-established – notwithstanding the apparent rise in geopolitical risk – and this is causing commodities-exporters to suffer more than their manufacturing counterparts. To be sure, exports for EM as a whole are hardly encouraging, but there is divergence between commodity exporters and the rest.
- The export underperformance of commodities exporters relative to manufactured exporters has been evident for two years now, and is echoed by a general loss of global market share by this group. As a result of these trends, the current account balance of commodities exporters has been deteriorating much more markedly than in manufacturing economies. In a sense, manufacturing exporters now have some kind of competitiveness-advantage over commodities exporters; there was a huge divergence in the trend of each group's terms of trade over the past decade, leading to real exchange rate appreciation for the commodities group. That has been unwinding recently, and may have to continue.
- The relative economic weakness of commodities exporters is also clear from their higher inflation rates and their abrupt decline in the efficiency of their investment spending. All this suggests that, over time, a 'sell commodities, buy manufactures' strategy might be a theme worth watching.
- In the short run however, there is one big obstacle to implementing such a strategy: commodities exporters have considerably higher real interest rates, on average, than the rest. In a carry-seeking world, we find that EM over-weights are moderate and risk-taking is not excessive. So as long as the carry environment continues there is little threat of a technical correction driven by excessive risk unwinds. On the contrary, the pain trade seems to continue to be lower yields and tighter spreads. In other words: stay long.

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

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## Bad news for commodities exporters?

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The lesson for most of 2013 seemed to be 'sell deficits, buy surpluses', but what is the best way to discriminate among EM economies these days? Countries with current account deficits – the 'Fragile 5', for example – suffered for most of last year, while those with current account surpluses – Korea, Hungary, Israel, for example – did well. There is an ancient pattern here: when risk aversion grips markets, creditors lose enthusiasm for those who need to borrow. And when risk appetite suddenly increases – at the end of January 2014, for example – the reverse becomes true: the Brazilian real, Turkish lira, South African rand and Indian rupee were the world's best performing currencies between February and May this year. These big moves – risk aversion in May 2013, risk appetite in February 2014 – result in highly correlated moves among currencies that are most exposed to changes in risk appetite. Figure 1 shows the average daily fx correlations of the Fragile 5 during these periods.

Figure 1. 2013 saw a correlated sell-off among the Fragile 5, which was followed in February 2014 by a correlated rally...

Average daily fx correlation, May-July 2013

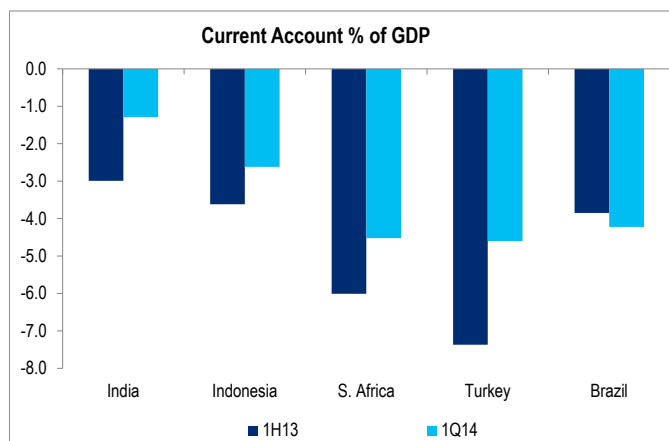
	BRL	INR	IDR	TRY	ZAR
BRL	100%	97%	83%	95%	81%
INR	97%	100%	79%	95%	82%
IDR	83%	79%	100%	74%	54%
TRY	95%	95%	74%	100%	88%
ZAR	81%	82%	54%	88%	100%
Average	83%				

Average daily fx correlation, Feb -June 2014

	BRL	INR	IDR	TRY	ZAR
BRL	100%	85%	59%	87%	93%
INR	85%	100%	54%	79%	85%
IDR	59%	54%	100%	29%	66%
TRY	87%	79%	29%	100%	85%
ZAR	93%	85%	66%	85%	100%
Average	72%				

Source: Citi Research

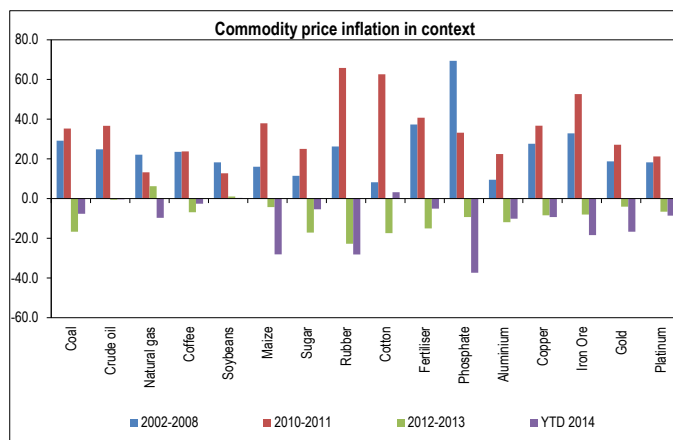
Figure 2. ...which partly reflects the evidence of current account adjustment that's taken place



Source: Haver Analytics, Citi Research

The best guide for investors to discriminate among emerging economies changes over time, and now we think 'commodities vs manufactures' might be replacing 'deficits vs surpluses'. It is unlikely that 'deficits vs surpluses' will *always* govern investor behavior towards emerging markets, especially now that this theme is becoming a little less relevant due to the current account adjustment that's taken place in some of the most vulnerable countries (Figure 2). But it is worth pointing out that some of the disappointments in the Fragile 5 adjustment process are explained by disappointing commodities markets. In Indonesia, for example, we have recently revised up our forecast for this year's current account deficit from 2.5% to 2.8% GDP thanks to a slide in the primary commodities trade balance. And in South Africa, the trade deficit continues to widen even though the current account deficit has been pushed down by large (and unrepeatabe?) net dividends inflows. Brazil, a commodities exporter, has seen its deficit *widen* in spite of very weak domestic spending growth. Meanwhile, India and Turkey – the two Fragile 5 members with the largest manufactured exports sectors – seem to be having better luck adjusting their trade balances. But is there a more general distinction worth making between 'commodities exporters' and 'manufactured goods exporters'? Should one be short the former and long the latter?

Figure 3. After substantial commodity price inflation both in the pre-Lehman period and 2010-11, commodity prices have deflated recently...



Source: Haver Analytics, Citi Research

Figure 4....which may not be surprising when set against the historically unprecedented rise in commodity prices after 2002



Source: David S Jacks, "From Boom to Bust: A Typology of Real Commodity Prices in the Long Run." National Bureau of Economic Research Working Paper 18874; Citi Research

**Commodity prices are not helping commodities exporters.** The 'end of the commodities super-cycle' is by now a familiar idea, but it does seem as though its consequences are becoming more visible. Figure 3 shows the breadth of the slide in commodities inflation in recent quarters. Of the sixteen commodities illustrated there, only cotton, soybeans and crude oil have seen a rise in prices YTD during 2014, and the past 2 years in general has seen commodity price deflation. Given the historic nature of the commodities boom after 2002 (Figure 4), perhaps this is not too surprising. And it does seem as though the biggest disappointments lie in the performance of commodity-exporting EM. To see this, we split EM between two groups: 'commodity exporters' and 'manufactured goods exporters'. The definition of these two groups is based on Standard International Trade Classification (SITC) categories: we define a country as a 'manufactured goods exporter' if SITC codes 5, 6, 7 and 8 account for more than 55% of total exports (Figure 5). This group includes China, Czech, Hungary, India, Israel, Korea, Mexico, Malaysia, Philippines, Poland, Romania and Turkey; while the group of commodities exporters includes Argentina, Brazil, Chile, Colombia, Indonesia, Peru, Russia, South Africa and Ukraine. Of course, this approach runs the risk of making insufficient distinctions among different commodities groups: energy accounts for 70% of Russian and Colombian exports, for example. But with apologies for the shortcomings of generalization, we proceed with this distinction to make some conclusions.

**EM as a whole has an 'export problem' but the problem is more concentrated among commodities exporters.** We've been emphasizing the idea that EM exports overall are not performing too well, and the general problem is illustrated in Figure 6: while the world has seen a recovery in real import growth since the middle of 2013, the performance of EM exports seems to be lagging this recovery.

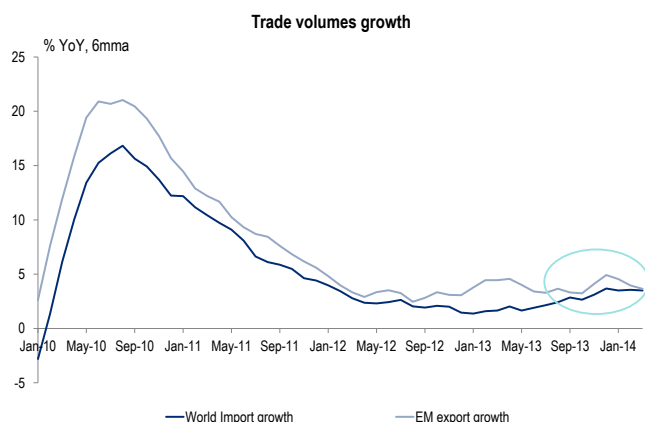
Figure 5. Export classifications (% of total exports)

Agriculture		Energy		Manufactures		Metals	
Argentina	53	Russia	71	Israel	92	Chile	57
Brazil	38	Colombia	67	China	92	Peru	38
Ukraine	29	Indonesia	31	Czech R.	85	Ukraine	33
Chile	27	Malaysia	22	Korea	81	S. Africa	33
Morocco	26	India	21	Hungary	80	Brazil	20
Indonesia	23	Bulgaria	16	Philippines	77	Bulgaria	20
Peru	18	Mexico	14	Poland	74	Turkey	11
Thailand	18	Peru	13	Thailand	72	Russia	8
Bulgaria	17	S. Africa	11	Romania	72	Indonesia	8
India	15	Korea	10	Mexico	71	Poland	7
Poland	14	Brazil	7	Turkey	69	Romania	7
Malaysia	13	Thailand	6	Morocco	63	Korea	7
Turkey	13	Argentina	6	Malaysia	60	Philippines	7
S. Africa	13	Morocco	6	India	56	India	6
Romania	12	Romania	5	Bulgaria	45	Argentina	6
Philippines	12	Poland	5	Indonesia	36	Czech R.	5
Colombia	11	Ukraine	5	S. Africa	36	Morocco	5
Hungary	10	Turkey	4	Ukraine	32	Mexico	5
Czech R.	7	Philippines	4	Brazil	32	Malaysia	4
Mexico	6	Hungary	4	Argentina	29	China	4
Russia	5	Czech R.	3	Colombia	15	Hungary	3
Israel	4	Israel	2	Chile	13	Colombia	3
China	3	China	2	Russia	12	Thailand	2
Korea	2	Chile	1	Peru	11	Israel	1

Source: Citi Research based on UNComtrade data

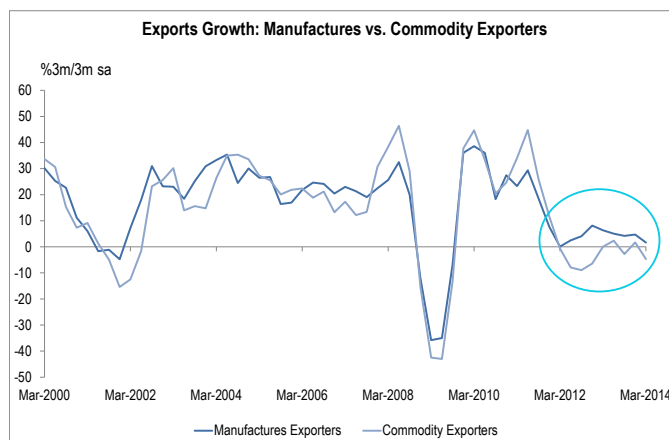
**The underperformance of the commodity exporters has become clear in the past two years.** Of the commodities exporters in our group, Figure 7 shows the underperformance of exports in commodity-producing economies. Of the commodity exporters in our group, there was only one country that hasn't experience negative export growth on a 3m/3m annualized basis on average during the past three quarters; and that was Russia. By contrast, the manufacturing exporters have been doing rather better: of this group, the only country to have suffered negative export growth on average in the past three quarters was Thailand. Of course, this group includes the central European economies whose exports performed exceptionally well in in late 2013 and early 2014. And for sure there have been some 'one-off' factors that may have helped the 'commodities' group look worse than the 'manufactures' group: Turkish exports, for example, were flattered in Q1 by a \$2 bn+ rise in gold exports, possibly a means of payment for Iranian energy; and South Africa's trade data was probably affected negatively by the long-running platinum strike. But the general pattern we're trying to identify – of underperformance by commodities exporters – is echoed in other data.

Figure 6. Emerging economies' export performance has lagged the recovery in global import volumes...



Source: CPB World Trade Monitor, Citi Research

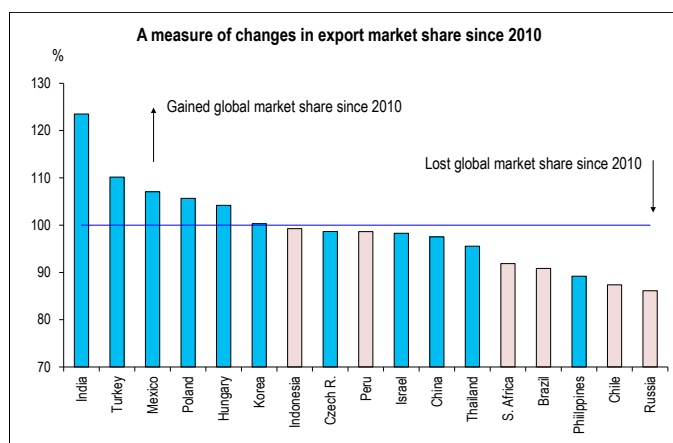
Figure 7. ...but it seems to be commodities exporters that are seeing the worst of the export underperformance



Source: Haver Analytics, Citi Research

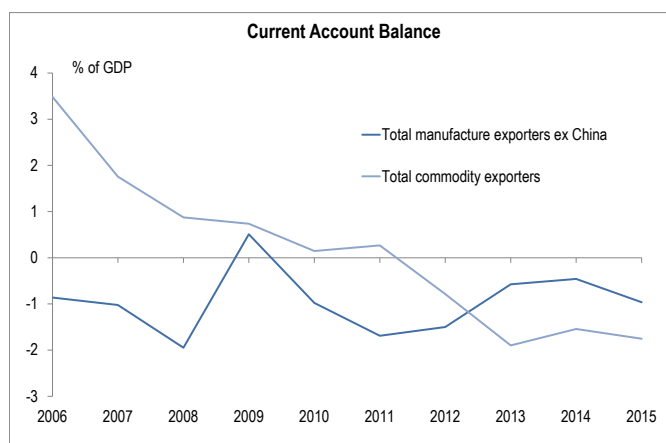
**Weak export performance by commodity exporters is also reflected in what's happening to their global market share.** Commodity exporters seem to be losing global market share at the expense of the manufacturers. This is tentatively illustrated in Figure 8, which shows that it's manufactured exporters (in blue) that have done rather better in increasing their share of trading partner imports. These trends, in turn, have helped to generate a gap in the current account performance of these two groups of countries (Figure 9): commodity-exporting EM has seen a reasonably sharp deterioration of its current account balance, moving from surplus to deficit, while the performance of the manufacturers has been more stable.

Figure 8. Commodities' exporting EM has had a tougher time in maintaining global market share than manufacturing exporters...



Source: Citi Research. The chart measures the change in each country's exports' share of trading partner imports

Figure 9. ...and this is reflected in a notably worse current account performance among the commodities exporters

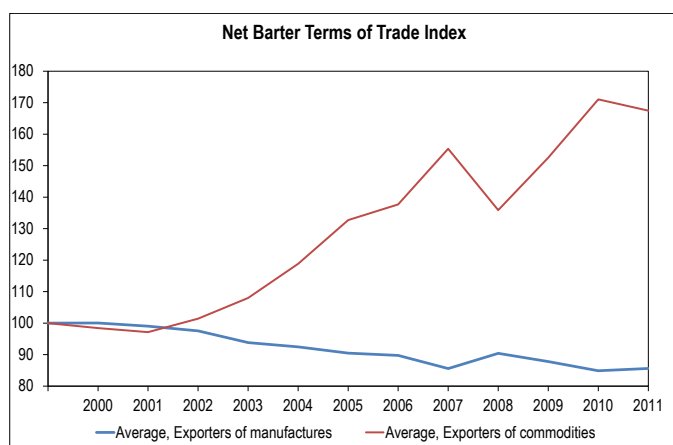


Source: Haver Analytics, Citi Research

**To some extent, what EM commodity exporters suffer from is an 'after the party' shock.** The commodities boom from 2002 on delivered huge terms of trade gains to EM commodities exporters. Figure 10 shows World Bank data on the 'net barter terms of trade' for our two groups of countries. While manufactured exporters suffered deterioration in their terms of trade, the commodities exporters enjoyed substantial gains. That in turn led to a much more marked appreciation of the real exchange rate among commodity-exporting EM (Figure 11). With commodity prices coming under pressure, this relative change in the terms of trade between commodities exporters and manufactured exporters seems likely to undergo some

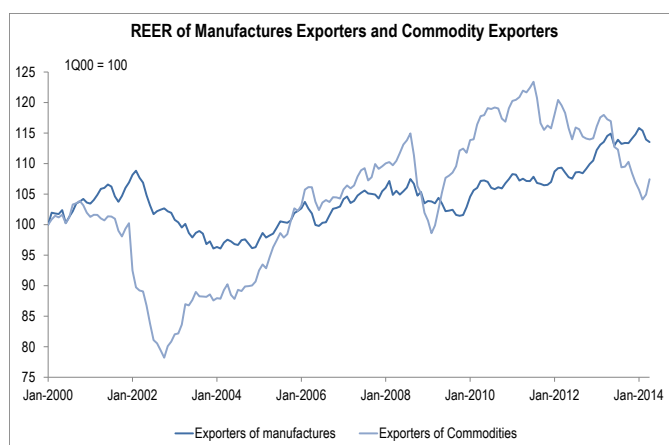
change. This change is already taking place through the real exchange rate – the underperformance of commodity currencies in real terms could be the beginning of an unwinding the relative outperformance of commodities exporters that began after 2002. Or to put it another way: while manufactured goods exporters failed to join the party - failed to enjoy dramatic terms of trade gains or improvements in their real purchasing power - they now enjoy a relative competitiveness advantage compared to commodity exporting economies. The important question is whether the underperformance of commodity exporting currencies that we've seen in the past two years has come to an end.

**Figure 10. The terms of trade exploded for commodities importers in the 2000s, while manufactured exporters suffered a negative TOT shock...**



Source: World Bank; Citi Research

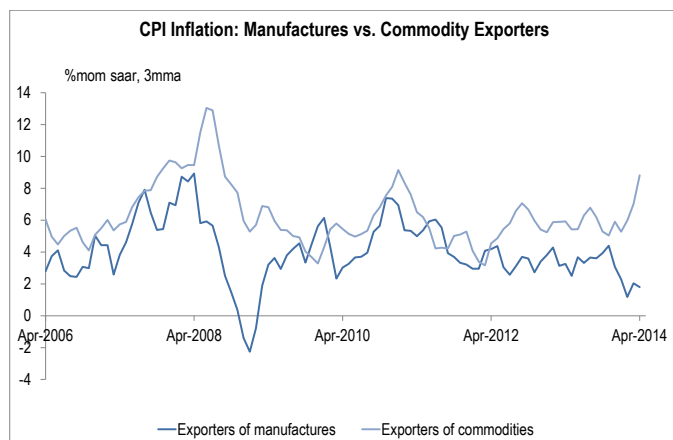
**Figure 11. ...which led to very substantial real exchange rate appreciation for commodities exporters, now going through adjustment**



Source: BIS, Citi Research

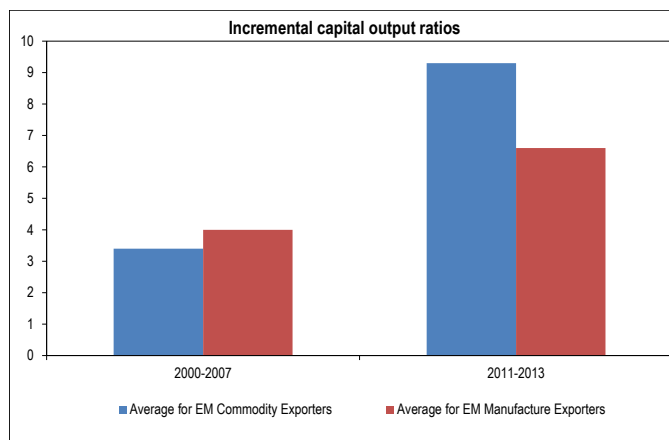
**The idea that commodities exporters are suffering now from a relative competitiveness disadvantage is echoed in their relative inflation performance, and in indicators of investment efficiency.** Figures 12 and 13 reinforce the picture of economic underperformance among commodity exporters: inflation is higher, and there has been a more marked loss of investment efficiency, measured by the incremental capital output ratio. As a longer-term theme, it seems to that the outperformance of EM's manufacturing economies is likely to remain worth watching.

**Figure 12. Commodities are suffering from higher inflation than exporters of manufactures...**



Source: Haver Analytics, Citi Research

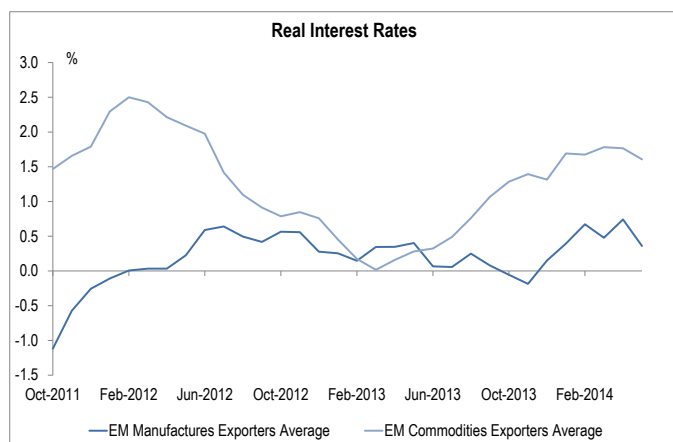
**Figure 13. ...and there has been a more marked loss of investment efficiency among the commodities exporters**



Source: Citi Research

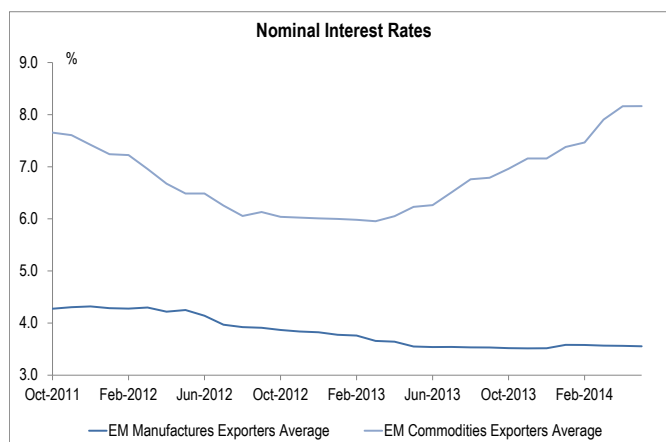
**But carry, for the time being, seems set to dominate investors' behavior, and the commodities exporters do have higher real interest rates than the rest.** If there does need to be a real exchange rate adjustment in commodity-exporting countries, the speed with which that adjustment could take place is heavily influenced by the fact that real and nominal interest rates are much higher on average in the commodity economies. Currency adjustment might have to follow on from interest rate declines. In the meantime then, yield-seeking behavior will trump the fundamentals in our view.

**Figure 14. Real interest rates are somewhat higher in commodity-producing EM, so their relative riskiness is somewhat priced...**



Source: Citi Research

**Figure 15. ...and nominal interest rates are considerably higher**



Source: Haver Analytics, Citi Research

## If carry is the game, have we stretched?

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**Reaching for the yield?** In the press conference that followed the June FOMC meeting, Janet Yellen stated that there was "some evidence of reach-for-yield behavior" in markets. There has been plenty of discussion of carry in EM, and the tightening of spreads in both EM credit and local currency bonds (LCY) observed since February has led many, including us, to wonder if markets have become over-stretched. In the analysis below we take a look at the behavior of EM real money funds and their relative positioning to conclude that, on the contrary, dedicated EM investors appear to have underweighted risk. In fact, our results suggest that, for index benchmarked funds, the "pain trade" is likely to be a continued grind tighter of spreads (both in LCY and credit).

**The global macro environment has been conducive for carry trades.** US Treasuries, a key force behind EM bonds, have tended to trade in a range. In fact, in the last two months, 10y UST have even rallied somewhat providing additional support for risk taking in EM (Figure 16). At the same time, the S&P has reached a new record and, more importantly, VIX – a forward looking indicator of asset market volatility – has been at very low and relatively stable levels (Figure 17). In such an environment, it is only natural that fixed income investors will reach for yield, and EM is an obvious candidate.

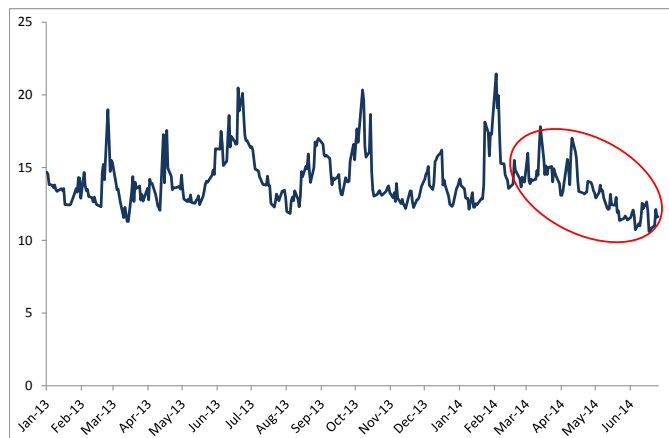


Figure 16. 10y UST have range traded, if not rallied, favoring fixed income risk assets...



Source: Bloomberg, Citi Research

Figure 17. ...while the sustained low levels of VIX and higher US equity valuations favored EM carry trades

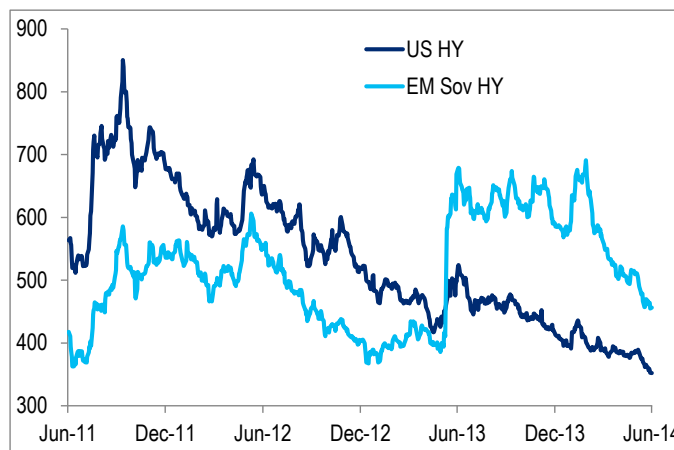


Source: Bloomberg, Citi Research

**The pro-carry global backdrop has favored EM credit** which has turned into one of the best performing asset classes of 2014. Following a difficult 2013 that left most of EM cheap to other credit markets, the bounce back this year has been somewhat remarkable with an 8% return through June. While a large component of the returns is due to the performance of U.S. interest rates – and the relatively long duration of EM bonds – we have also seen a significant amount of spread outperformance. US high yield spreads have also seen fairly steady compression since the second half of last year. However, the move tighter in EM spreads has accelerated since February of this year (Figure 18).

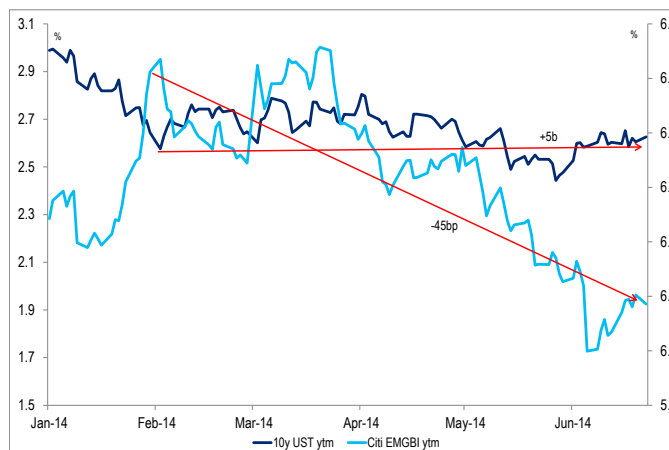
**In the local markets space, spreads have also tightened.** LCY bonds tend to track closely movements in long-term US treasuries. As Figure 19 shows, however, in recent months the relationship appears to have broken down. Since February, USTs have been largely unchanged while LCY bonds have rallied, with the yield on a Citi broad market index falling by about 45bp.

Figure 18. The compression in U.S. HY has driven more investors into EM credit... (bp)



Source: Bloomberg, Citi Research

Figure 19. ... while LCY bond yields tightened at a time when UST were range trading



Source: Bloomberg, Citi Research

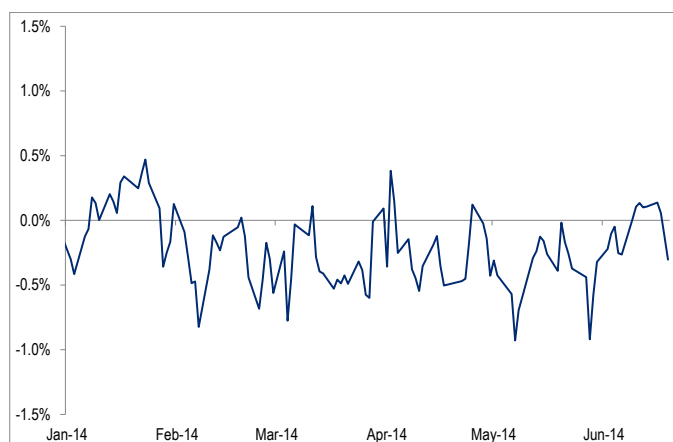
**What accounts for the tighter spreads?** EM bond yields are a function of global risk-free rates and risk premia. With no changes on the UST front, EM yields ought to have been driven by risk premia compression. While risk premia can fall as a result of improvement in EM fundamentals, “excessive demand” may also be a cause. We try to weigh in on the “which is it” question by looking at how investors are positioned. A priori, one would expect that if investors have stretched, they would have loaded up their portfolios with riskier assets and would, therefore, be susceptible to market corrections.

### Evaluating the performance of EM investors

**EM hard currency funds have on average underperformed the rally in the index.** Using a composite of 57 hard currency funds, we calculate that funds on average have underperformed the main EM sovereign bond index by -1.5% year-to-date (Figure 20). This underperformance likely has a number of factors. While fees have played a part, that can only explain a portion of the underperformance. Additionally, since we are not choosing funds exclusively that are benchmarked to a sovereign index, using that is somewhat unfair, especially as EM corporates have not seen quite as strong returns as sovereigns thus far (6.5% YTD for corporates versus 8.2% on sovereigns). Furthermore, we do not have a proper definition of the index that is used to benchmark each fund and thus compare returns to those of the standard EM index. Nevertheless, while there is no obvious value judgment on the performance, there is tentative evidence that EM funds have tended to hold less yieldy positions than that of the index - have been underweight.

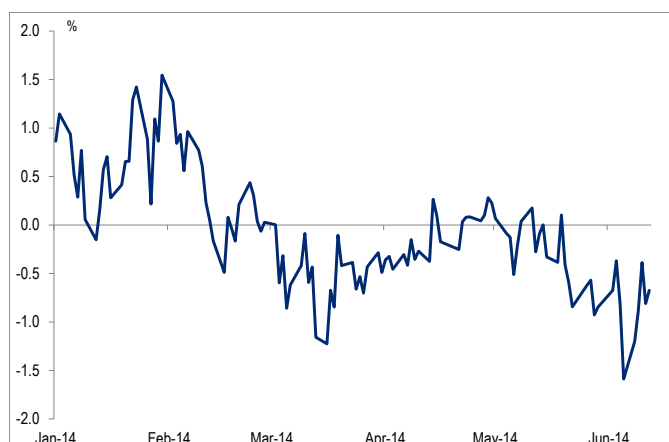
**The rally in LCY bonds does not appear to have lifted the performance of local currency funds.** On average, since the end of January, the 50 largest LCY funds have not been able to outperform their benchmarks. In May-June, excess returns even reached a year-to-date low. Although some recovery has taken place in June, LCY funds continue to stay in the red (Figure 21).

Figure 20. Excess returns of dedicated real money EM credit funds have, on average, been negative...



Source: Citi Research

Figure 21. ... LCY dedicated real money funds have also averaged slightly negative returns this year.



Source: Citi Research

**Average performance may conceal a number of factors** that, once disentangled, show that EM-dedicated investors were, in fact, stretching their risk taking. To avoid the pitfall that emerges from aggregating several changing factors driving the performance of funds, we conducted an empirical analysis that intends to attribute performance to different factors. The model attempts to explain the excess return of a fund by analyzing its beta relative to a number of variables. For instance, for credit funds we look at UST yields, EMHY sovereign and EMHG sovereign spreads and

also we consider the movement in EM Corporate spreads as funds have tended to use quasi-sovereign credits and corporates as a return enhancer. The empirical exercise constructs a panel with daily returns for the funds in each of the credit and LCY samples and runs rolling regressions over windows of 30 business days. The results is a set of time varying betas that we can analyze to determine if the average fund was overweight or underweight (relative to the benchmark) a particular component.

**The regressions have excess returns (for credit and LCY funds) as the dependent variable.** For the explanatory variables, we use change in yields or spreads, depending on the variable. In principle, the change in yield multiplied by the duration of the portfolio and the factor sensitivity ought to produce a good approximation to the fraction of the return that is explained by that portfolio component. Since the duration is unobservable to us, we use the change in yields and in spreads and assume that the duration (implicit in the estimated coefficient) is relatively constant. Therefore, a positive beta will typically imply that a widening of spreads (higher yields) illustrates an underweight position. Indeed, a widening of spreads in, say, EMHY suggests that the return from the HY portion of the portfolio is negative. Therefore, if the fund is underweight that segment of the asset class, the negative return in HY contributes positively to the excess return of the overall portfolio.

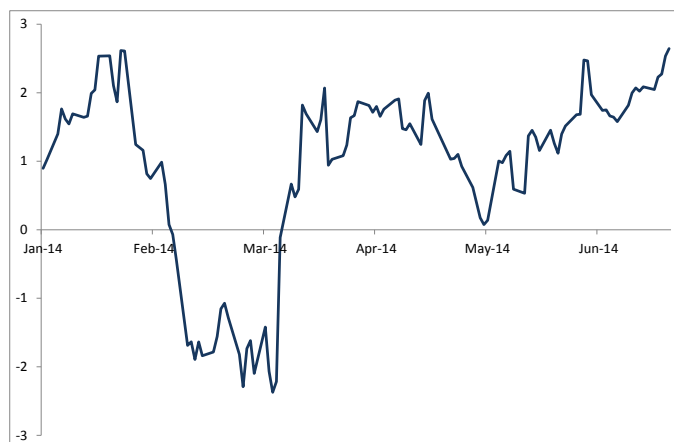
**Evidence of EM funds having stretched for yield requires that the betas to the riskier (higher yielding) components of the portfolio ought to be negative.**

Furthermore, if EM investors had been turning increasingly complacent towards risks, we would expect that the betas would be turning increasingly negative. If, on the other hand, the betas are relatively close to zero, the regression results would show that EM portfolio managers are holding positions close to neutral.

### **Stretched for yield in EM credit?**

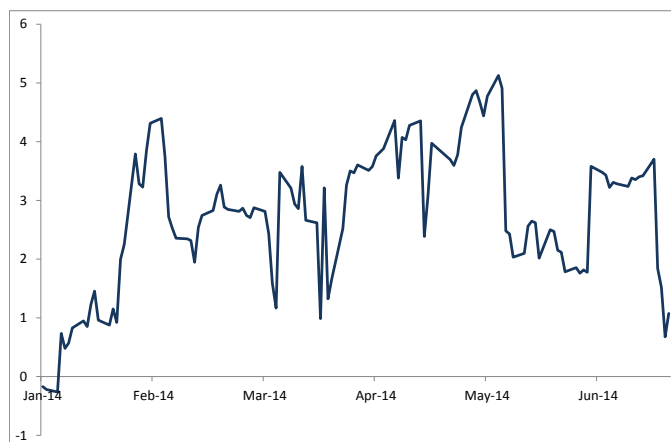
**We find little evidence that EM portfolio managers have reached for yield taking high levels of risk.** In fact, the evidence shows that EM investors have tended to be underweight high yielding sovereigns. As mentioned before, our performance attribution analysis of the excess returns ran a regression with four factors: U.S. 10y Treasury yields, EM IG Sovereign Spreads, EM HY Sovereign Spreads, and EM Corporate Yields. The results show that investors for the most part have maintained an overweight to EM corporates (Figure 25), along with a systematic underweight to HY Sovereigns (Figure 24). The result for corporates is unsurprising since many funds enhance their returns by holding some corporates which are excluded from the benchmark index. The results for sovereign holdings are less obvious: we find EM funds have been underweight the high yielders, with the underweight increasing in recent months. Despite the massive rally in Venezuela and Argentina spreads, EM real money has on average maintained underweight positions relative to these high-yielding credits. Interestingly, the regression analysis also suggests that portfolio managers have maintained underweight positions in high grade sovereign names. This result is probably explained by two factors. The first is the substitution of IG sovereign names for their quasi-sovereign or higher quality corporate equivalents. Second, portfolio managers may have maintained meaningful cash positions because they may be awaiting primary issuance, anticipating better entry levels, or out of concerns with potential redemptions. In any event, the empirical evidence shows, quite robustly, that dedicated EM portfolio managers have chased the rally and do not hold over-stretched positions in the sovereign credit space.

Figure 22. Hard currency excess return beta to U.S. 10YR yields



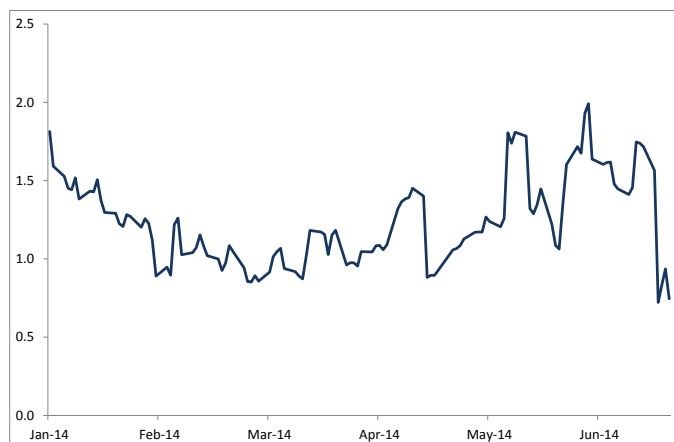
Source: Citi Research

Figure 23. Hard currency excess return beta to EM IG sovereign spreads



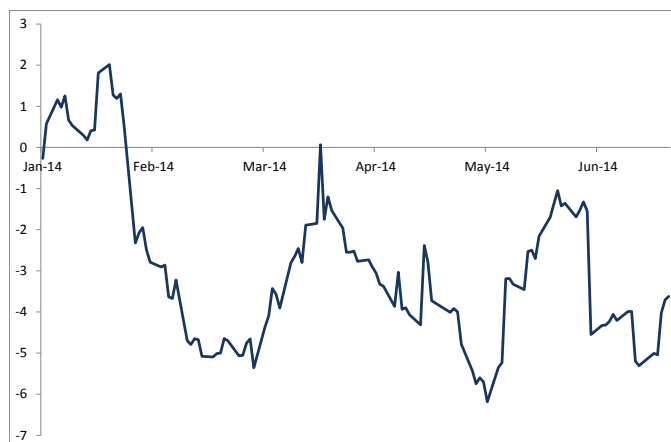
Source: Citi Research

Figure 24. Hard currency excess return beta to EM HY sovereign spreads



Source: Citi Research

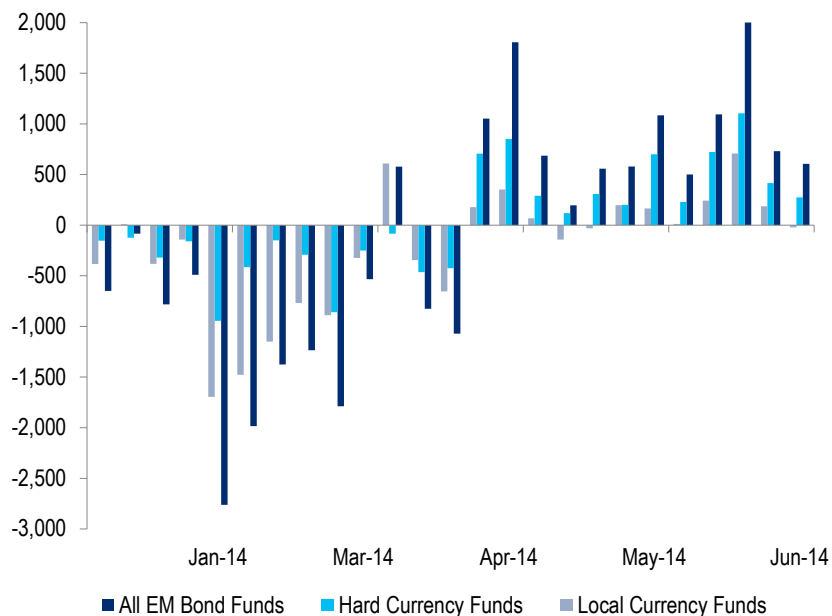
Figure 25. Hard currency excess return beta to EM corporate spreads



Source: Citi Research

**The sudden surge in inflows has likely played a role in explaining the portfolio underperformance and the estimated underweights as well.** EM flows have reversed from the 2013 trend, with hard currency funds seeing the bulk of the inflows. According to EPFR, over the last 12 weeks, hard currency funds have seen \$5.9 billion in net inflows (Figure 26). Since EPFR only tracks a small subsection of the EM fund universe, the actual amount of inflows has likely been much larger. It is likely that, given current valuations and availability of new issues, these inflows have left funds unable to invest the new assets quickly enough to catch the entire rally. A natural result of disproportionate inflows, therefore, tends to produce deeper underweights amongst dedicated managers. However, large inflows also may highlight that the "reach for yield" may be happening at a higher level than that of the dedicated EM portfolio manager. Retail investors and institutional money managers, by giving mandates to EM managers, could themselves be stretching for yield. If this was the case, the risk would be less one of excessive risk-taking by seasoned EM managers but more the risk of potential outflows. The silver-lining is that if such a scenario materialized, underweight positions amongst fund managers should mitigate the resulting price adjustment.

Figure 26. Funds may have had a difficult time investing the influx of new money, especially in recent weeks

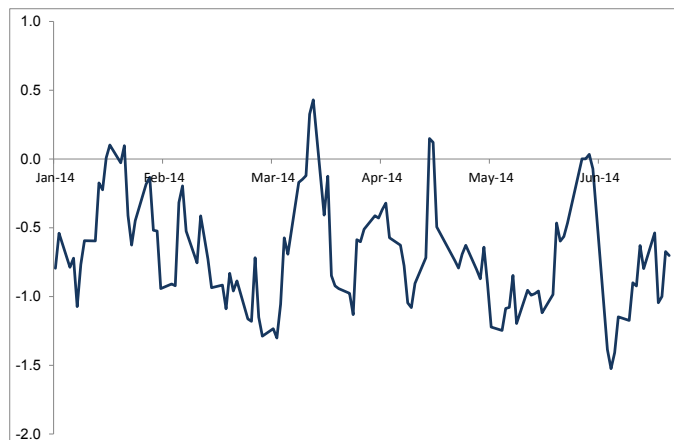


Source: EPFR

### Do LCY funds have riskier positions?

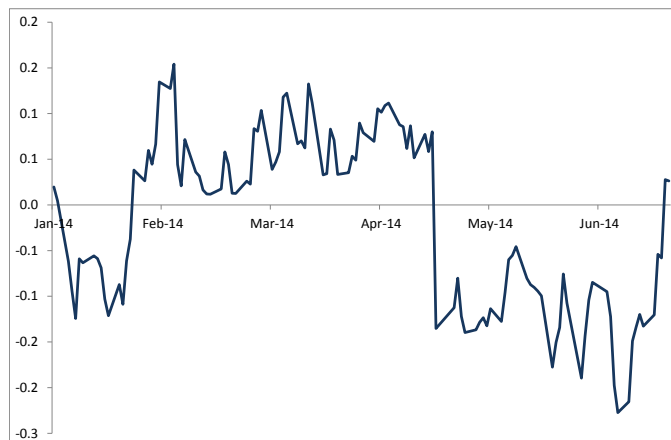
**Our performance attribution model for LCY funds** considers three basic factors: 10y UST yield (a proxy for duration risk); a subcomponent that captures the high yielding local currency names (those countries with 5y bonds that yield above 7%); and an index of EMFX (the equal-weighted average of the EMFX names included in the index). Based on our model estimates, active LCY funds have been long duration year-to-date. As Figure 27 suggests, the average beta to 10y UST (duration proxy) has been about -0.7. LCY funds appear to have been adding duration risk during April-May and have started reversing some of their longs in June. Our latest estimate suggests duration longs at about average levels (ytd).

Figure 27. LCY portfolio managers are long duration in their portfolios (returns are more negatively correlated with UST)



Source: Citi Research

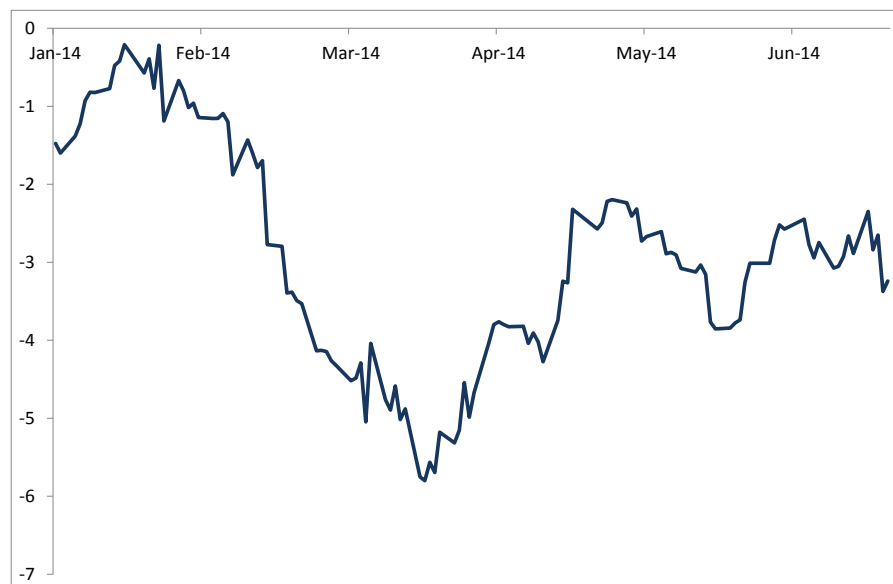
Figure 28. LCY funds carried FX underweights through April and are close to FX-neutral now



Source: Citi Research

**LCY fund managers seem to have been caught off-guard with the EM FX performance over the past few months.** From February to about mid-April, LCY funds were underweight EM FX (average beta of 0.2) suggesting that portfolios carried excessive FX hedges. As EM FX rallied into May, underweight FX positions were abandoned, and turned into overweights. With lackluster performance of EM FX in June, positioning now seems to be close to FX-neutral.

Figure 29. LCY funds built sizable high yield overweights after the January scare but have lately paired some risk



Source: Citi Research

**The results also show that LCY funds have been long high yielding countries in 2014.** After the January EM scare, the average beta has been around -3.4 while current beta is only slightly lower (around 3.0) (Figure 29) LCY funds appear to have been rapidly overweighting high yielding assets through February-March. After early April, however, when betas tripled relative to January, risk taking seems to have moderated. The trend since then has been to cut risk, yet maintain the overweight.

**Are LCY funds over-stretched?** When we take a somewhat longer historical view, our estimates show that, at their peak in March 2014, exposures were less than pre-Fed tapering levels. Currently, exposure is only about a half of that. The May-September 2013 sell-off was driven by tapering fears and poor EM fundamentals. If the Fed now, as seems likely, abstains from delivering similar shocks, and ECB implements QE, current exposures need not be excessive. Furthermore, unlike EM credit, (retail) inflows into the asset class, as illustrated in Figure 26, have been quite muted (though turning positive in the last couple of months). Therefore, the risk that "higher level" investors are the ones stretched, as opposed to EM dedicated portfolio managers, is not a concern in this instance. Nevertheless, combining the betas to EMFX and local yields suggests that there may be more evidence of reaching for yield.

**Stay long.** Our analysis suggests that yields may be lower, spreads tighter and there may be more money chasing few assets in EM. However, despite this, the revealed behavior by investors through the performance of EM funds suggests that overweights are moderate and risk taking is not excessive. If anything, we are driven to conclude that the carry environment continues without the menacing threat of a technical correction driven by excessive risk unwinds. On the contrary, the pain trade seems to continue to be lower yields and tighter spreads. In other words: stay long.

## Annual Indicators

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

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013	2014F	2015F	2013	2014F	2015F	2013	2014F	2015F	2013	2014F	2015F
<b>Asia</b>	<b>6.3</b>	<b>6.2</b>	<b>6.3</b>	<b>3.7</b>	<b>3.4</b>	<b>3.7</b>	<b>2.2</b>	<b>2.2</b>	<b>1.6</b>	<b>-2.3</b>	<b>-2.4</b>	<b>-2.2</b>
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	3.2	3.6	4.3	3.9	3.7	1.9	2.8	3.2	1.0	1.3	0.7
India*	4.7	5.6	6.5	9.5	8.0	6.5	-1.7	-1.9	-2.0	-6.9	-6.7	-6.5
Indonesia	5.8	5.3	5.5	6.4	6.5	6.7	-3.3	-2.8	-2.4	-2.2	-2.4	-2.2
Korea	3.0	3.9	4.0	1.3	1.9	2.9	6.1	4.7	3.0	1.0	0.9	1.5
Malaysia	4.7	5.4	5.6	2.1	3.2	4.0	4.0	4.4	4.0	-3.9	-3.5	-3.0
Mongolia	11.7	10.0	9.0	10.5	13.6	12.0	-30.9	-18.7	-20.0	-7.8	-7.5	-4.3
Philippines	7.2	6.7	7.2	2.9	4.4	4.0	3.5	3.5	3.1	-1.4	-1.8	-1.6
Singapore	3.9	3.5	4.1	2.4	1.4	1.1	18.3	18.0	18.0	1.1	-0.3	0.2
Sri Lanka	7.3	7.2	7.4	6.9	5.0	6.5	-3.9	-3.3	-3.1	-5.9	-5.6	-5.3
Taiwan	2.1	3.2	3.7	0.8	1.2	2.0	11.7	11.0	10.2	-1.4	-1.4	-0.8
Thailand	2.9	0.5	2.8	2.2	2.4	2.1	-0.7	2.3	-1.1	-1.8	-1.2	-1.8
Vietnam	5.4	5.4	5.7	6.6	5.0	6.8	6.0	4.9	3.9	-5.6	-6.4	-6.0
<b>Latin America</b>	<b>2.5</b>	<b>1.8</b>	<b>2.6</b>	<b>7.3</b>	<b>9.2</b>	<b>10.1</b>	<b>-2.6</b>	<b>-2.7</b>	<b>-2.8</b>	<b>-3.2</b>	<b>-3.7</b>	<b>-3.2</b>
Argentina	3.0	0.0	1.0	10.6		31.8	-0.7	-1.1	-1.2	-1.9	-2.4	-2.4
Brazil	2.3	0.9	1.2	6.2	6.4	6.4	-3.7	-3.8	-3.9	-3.3	-3.9	-3.4
Chile	4.1	3.0	4.0	1.9	4.0	3.0	-3.4	-2.6	-4.0	-0.3	-0.4	-0.4
Colombia	4.3	5.4	5.1	2.0	2.9	3.5	-3.4	-3.7	-3.6	-0.9	-1.6	-1.5
Costa Rica	3.5	3.1	2.2	5.2	4.4	4.6	-5.1	-7.4	-7.9	-6.5	-7.2	-7.7
Dominican Republic	4.1	5.0	4.5	4.8	3.4	4.2	-4.2	-4.5	-4.8	-4.1	-4.0	-4.2
Ecuador	4.5	4.5	4.5	2.7	3.5	2.5	-1.3	-1.1	-1.2	-5.9	-4.7	-3.7
El Salvador	1.7	2.2	2.5	0.8	1.0	1.7	-6.2	-6.4	-5.7	-4.2	-4.1	-3.7
Mexico	1.1	3.0	4.0	3.8	4.0	3.6	-2.1	-2.4	-2.2	-2.4	-3.5	-2.5
Panama	8.4	6.2	5.5	4.0	3.2	2.8	-11.3	-9.0	-8.5	-3.0	-3.0	-3.0
Peru	5.8	5.0	6.1	2.8	3.2	2.5	-4.8	-5.2	-4.8	0.8	0.0	0.0
Venezuela	1.3	-1.0	1.9	38.5	61.7	82.5	3.3	4.1	5.1	-11.9	-11.2	-10.3
<b>Europe</b>	<b>2.0</b>	<b>1.9</b>	<b>2.9</b>	<b>5.3</b>	<b>5.7</b>	<b>5.4</b>	<b>-1.3</b>	<b>-0.1</b>	<b>-0.7</b>	<b>-2.2</b>	<b>-2.4</b>	<b>-3.6</b>
Bulgaria	0.9	1.5	2.5	0.9	-0.8	2.5	1.9	-0.2	-0.5	-1.5	-2.0	-1.2
Croatia	-0.9	-0.6	1.2	2.2	0.3	2.7	1.3	0.5	-0.5	-4.9	-5.0	-3.5
Czech Republic	-0.9	2.4	2.7	1.4	0.7	2.0	-1.4	0.9	1.7	-1.5	-2.0	-2.5
Hungary	1.1	2.9	1.9	1.7	0.4	2.5	2.9	2.5	2.1	-2.2	-2.9	-2.9
Kazakhstan	5.9	5.0	6.0	5.7	6.5	5.9	-0.1	1.0	1.3	3.0	2.3	2.1
Poland	1.6	3.4	3.6	0.9	0.3	2.0	-1.3	-1.7	-2.7	-4.3	5.2	-2.7
Romania	3.5	3.0	3.4	4.0	1.8	3.3	-1.1	-2.5	-4.2	-2.5	-2.3	-2.3
Russia	1.3	1.0	2.3	6.8	7.1	6.1	1.5	2.7	1.9	-2.1	-4.4	-4.9
Serbia	2.5	1.2	2.0	7.9	2.9	6.2	-4.9	-5.0	-5.0	-5.7	-6.5	-6.5
Slovakia	0.9	2.2	2.7	1.4	0.1	1.0	2.1	1.6	2.7	-2.8	-3.0	-2.6
Turkey	4.0	3.5	3.5	7.5	8.6	7.9	-7.9	-5.3	-5.4	-1.2	-2.8	-3.2
Ukraine	0.0	-3.2	2.1	-0.3	7.2	7.3	-9.3	-4.7	-3.1	-6.7	-4.3	-3.4
<b>Africa/Mideast</b>	<b>3.9</b>	<b>4.6</b>	<b>5.2</b>	<b>4.2</b>	<b>4.3</b>	<b>5.0</b>	<b>11.0</b>	<b>9.7</b>	<b>7.4</b>	<b>1.3</b>	<b>1.2</b>	<b>-0.4</b>
Bahrain	5.3	4.0	4.0	3.3	2.5	2.0	6.8	5.5	1.3	-3.3	-4.5	-6.8
Egypt	1.5	2.4	3.2	9.5	7.9	6.5	-1.3	-2.5	-2.3	-13.7	-11.7	-9.0
Ghana	7.1	5.1	4.0	11.7	14.1	11.6	-12.7	-14.5	-14.3	-9.0	-8.7	-8.0
Iraq	3.1	10.4	11.6	1.9	2.5	5.0	13.3	13.6	12.6	-5.8	-2.3	-1.2
Israel	3.2	3.2	3.5	1.5	1.0	3.0	2.5	1.9	1.7	-2.7	-3.0	-2.5
Jordan	2.8	4.0	4.5	5.5	3.5	5.0	-11.3	-10.2	-7.9	-5.5	-9.6	-9.4
Kenya	4.7	5.5	6.1	5.4	7.5	6.6	-9.0	-7.6	-7.5	-7.8	-6.5	-6.0
Kuwait	5.7	3.8	3.9	2.6	3.0	4.0	37.9	40.4	38.3	28.8	32.2	26.5
Lebanon	1.4	2.0	2.4	2.1	3.5	5.0	-9.0	-9.8	-10.7	-9.3	-8.7	-8.0
Nigeria	6.8	6.5	6.4	8.5	8.7	10.6	1.8	1.5	0.7	-1.6	-2.0	-1.8
Oman	3.4	4.7	4.7	2.1	1.5	3.0	10.8	8.5	6.6	9.9	8.4	6.1
Qatar	6.5	5.9	6.2	3.1	3.0	3.5	30.9	29.4	25.1	8.2	4.2	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	2.0	2.8	5.8	6.5	5.8	-5.8	-4.9	-4.2	-4.3	-4.2	-4.2
Tanzania	7.0	7.1	7.2	7.9	6.6	6.1	-10.2	-14.1	-12.4	-6.0	-6.4	-6.5
UAE	3.7	4.0	4.0	1.1	2.0	2.4	26.2	21.4	17.0	NA	NA	NA
Uganda	6.0	6.1	6.5	5.5	5.3	7.4	-12.0	-13.9	-14.9	-3.7	-4.0	-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
<b>Total</b>	<b>4.5</b>	<b>4.5</b>	<b>5.0</b>	<b>4.7</b>	<b>4.9</b>	<b>5.2</b>	<b>1.8</b>	<b>1.9</b>	<b>1.2</b>	<b>-2.1</b>	<b>-2.3</b>	<b>-2.4</b>

Source: National sources, Citi Research forecasts



## Economic Framework

Figure 31. 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
<b>Global</b>	3.0	3.5	3.7	2.9	3.1	3.4	0.8	0.6	0.3	-3.7	-3.2	-2.9
<i>Based on PPP weights</i>	3.4	3.9	4.1	3.3	3.5	3.9	0.5	0.4	0.0	-3.7	-3.3	-3.0
<b>Industrial Countries</b>	2.0	2.5	2.5	1.6	1.7	1.5	0.0	0.1	0.0	-4.6	-3.8	-3.4
United States	2.2	3.2	3.2	1.6	1.9	2.2	-2.1	-1.5	-1.8	-6.4	-5.6	-5.6
Japan	1.5	0.9	1.2	2.8	1.7	1.6	-0.2	-0.3	0.0	-8.0	-6.2	-5.8
Euro Area	1.2	1.8	1.9	0.6	0.9	1.2	2.8	2.8	2.8	-2.6	-2.3	-1.7
Canada	2.3	2.7	2.7	2.0	2.0	2.0	-2.8	-2.8	-2.5	-0.1	0.3	0.4
Australia	3.4	3.0	3.1	2.7	2.5	2.4	-1.9	-2.2	-2.4	-3.1	-1.8	-1.0
New Zealand	3.5	2.9	2.4	2.1	2.2	2.2	-4.2	-5.4	-5.0	-1.6	-0.4	0.5
Germany	2.2	2.5	2.5	1.2	1.8	2.2	6.9	6.6	6.1	0.1	0.2	0.0
France	0.7	1.3	1.7	0.7	1.2	1.4	-0.7	-0.1	0.4	-4.2	-3.6	-2.8
Italy	0.2	1.1	1.1	0.3	-0.2	0.3	1.9	2.0	2.1	-3.0	-2.8	-2.1
Spain	1.3	1.9	2.2	-0.2	0.0	0.5	0.6	0.5	0.6	-5.7	-4.9	-3.9
Greece	-0.6	1.2	1.4	-1.6	-1.6	-1.0	2.1	2.4	2.4	-2.4	-2.7	-2.0
Ireland	2.8	3.4	2.8	0.8	1.0	1.1	9.6	10.3	9.4	-5.1	-2.5	-1.8
Portugal	1.2	2.0	1.9	-0.3	-0.7	-0.3	0.5	0.7	0.9	-4.2	-3.0	-2.4
Netherlands	0.6	1.4	1.7	0.3	1.1	1.5	10.9	10.3	9.8	-2.8	-2.2	-1.7
Belgium	1.3	1.5	1.6	0.6	1.1	1.8	1.0	1.7	1.8	-2.4	-1.9	-1.2
Denmark	1.3	1.6	1.8	1.0	1.5	1.8	6.8	5.7	5.4	-1.3	-2.7	-1.7
Norway	2.0	2.2	2.5	2.0	2.1	2.1	11.4	11.7	12.0	11.0	11.0	10.0
Sweden	2.4	2.7	2.8	-0.1	1.0	2.2	6.3	6.0	6.1	-1.6	-0.8	-0.3
Switzerland	2.1	2.6	2.7	-0.2	0.8	1.1	11.1	10.2	9.9	0.7	1.1	1.7
United Kingdom	3.5	3.6	2.8	1.6	1.9	2.1	-4.0	-4.0	-4.1	-5.6	-3.7	-1.5

Figure 32. G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 25 June 2014

	25-June	3Q 14F	4Q 14F	1Q 15F	2Q 15F	3Q 15F	4Q 15F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.75	1.00
10-Yr. Treasuries (Period Ave.)	2.59	2.70	2.90	3.00	3.05	3.15	3.20
Euro Area: US\$/€	1.36	1.38	1.36	1.35	1.36	1.37	1.39
Euro Repo Rate	0.15	0.15	0.15	0.15	0.15	0.15	0.15
10-Yr. Bunds (Period Average)	1.33	1.45	1.50	1.50	1.55	1.55	1.60
Japan: Yen/US\$	102	105	107	108	109	109	110
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.58	0.60	0.55	0.70	0.80	0.85	0.75

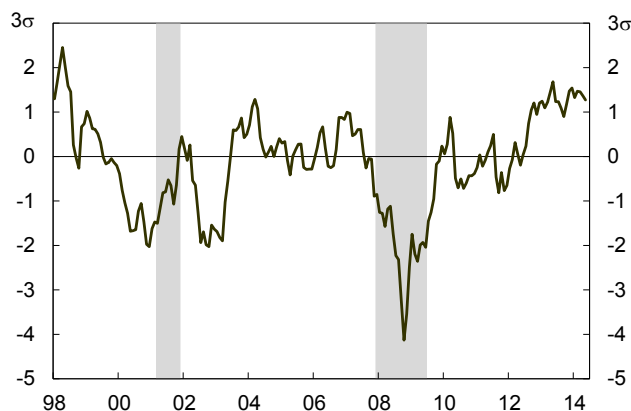
### Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US\$						Spread vs. Germany					
	Current	3Q 14	4Q 14	1Q 15	2Q 15	3Q 15	Current	3Q 14	4Q 14	1Q 15	2Q 15	3Q 15
<b>United States</b>	NA	NA	NA	NA	NA	NA	128	127	142	152	152	162
<b>Japan</b>	-203	-212	-237	-232	-227	-232	-75	-85	-95	-80	-75	-70
<b>Euro Area</b>	-128	-127	-142	-152	-152	-162	NA	NA	NA	NA	NA	NA
Canada	-31	-30	-25	-20	-15	-15	96	96	117	132	137	147
Australia	117	147	137	143	158	168	244	274	280	295	310	331
New Zealand	189	204	204	204	209	220	317	331	346	356	362	382
France	-84	-77	-102	-112	-112	-122	42	50	40	40	40	40
Italy	30	13	-22	-32	-32	-42	156	140	120	120	120	120
Spain	7	13	-22	-32	-32	-42	133	140	120	120	120	120
Netherlands	-104	-102	-117	-127	-127	-137	22	25	25	25	25	25
Belgium	-82	-72	-92	-102	-102	-112	44	55	50	50	50	50
Austria	-97	-97	-117	-127	-127	-137	29	30	25	25	25	25
Finland	-107	-97	-117	-127	-127	-137	19	30	25	25	25	25
Ireland	-21	-17	-62	-72	-72	-82	105	110	80	80	80	80
Portugal	86	63	8	-2	-2	-12	212	190	150	150	150	150
Greece	322	303	258	223	223	188	448	430	400	375	375	350
United Kingdom	11	20	15	15	10	5	137	147	157	167	162	168

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

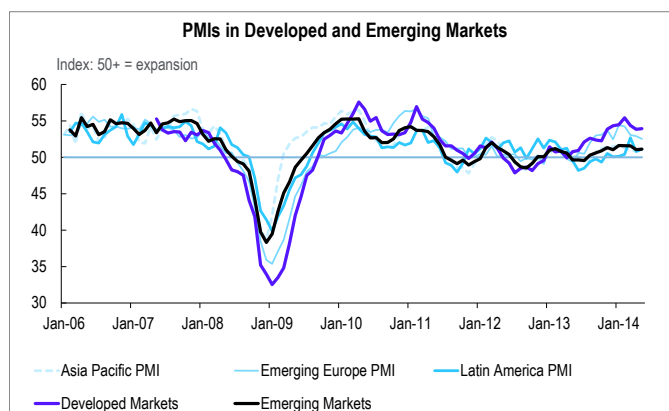
## Regional Indicators

**Figure 33.** We anticipate that solid US consumer spending gains will carry into next year. Consumer spending is supported by decent income gains and extremely favorable financial conditions (see chart).



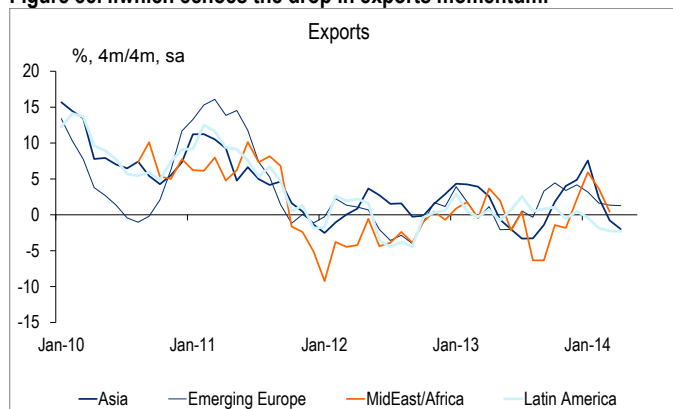
Source: Haver Analytics, Citi Research. Note: Shaded sections mark recession periods.

**Figure 34.** PMIs slowed in recent months...



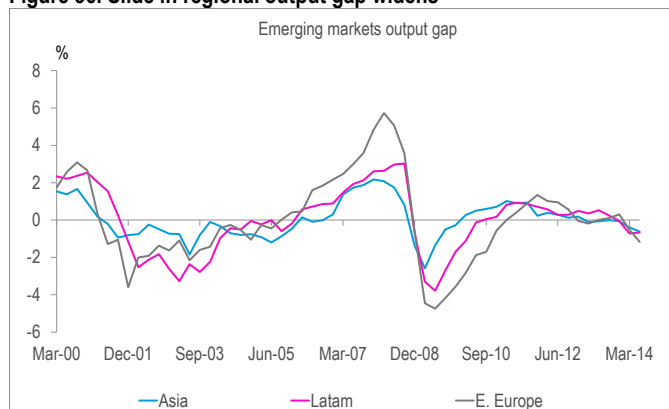
Source: Haver Analytics, Citi Research

**Figure 35.** ...which echoes the drop in exports momentum.



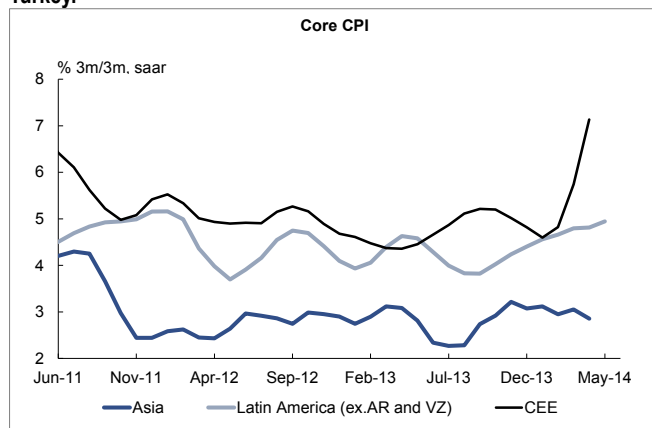
Source: Citi Research

**Figure 36.** Slide in regional output gap widens



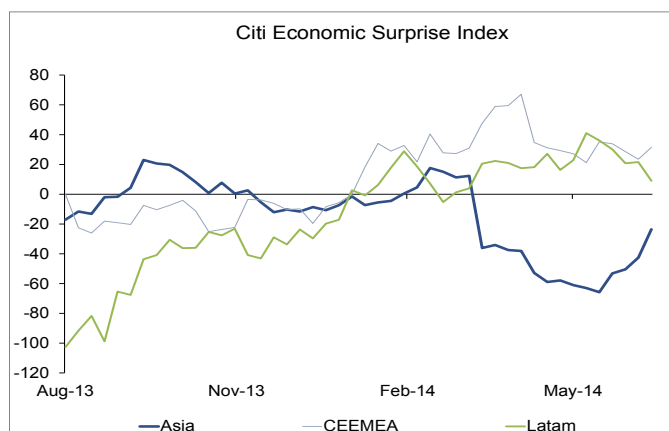
Source: Haver Analytics, Citi Research

**Figure 37.** Despite that, we see pressures on inflation, particularly in Turkey.



Source: Citi Research

**Figure 38.** Asia's performance continues to disappoint markets albeit less so



Source: Haver Analytics, Citi Research

## Monetary Policy Watch

Figure 39. Asia Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2014
			Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	3.00	Jul-12	-25	2016	+25	3.00
India	Repo Rate	8.00	Jan-14	+25	FY16/17	-50	8.00
Indonesia	FasBI	5.75	Nov-13	+25	Dec-14	+25	6.00
Korea	BOK Policy Rate	2.50	May-13	-25	Jun-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	Dec-14	+25	3.75
Taiwan	Discount Rate	1.875	Jun-11	+12.5	Mar-15	+12.5	1.875
Thailand	Overnight Repo Rate	2.00	Mar-14	-25	2016F	+150	2.00

Source: Bloomberg, Citi Research

Figure 40. CEEMEA Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2014
			Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.05	Nov-12	-20	4Q15	+20	0.05
Hungary	14-Day Repo Rate	2.30	Jun-14	-10	Jul-14	-10	2.10
Israel	Base Rate	0.75	Feb-14	-25	Jul-14	-25	0.50
Poland	7-Day Repo Rate	2.50	Jul-13	-25	Nov-15	+25	2.50
Romania	Refinancing Rate	3.50	Feb-14	-25	1Q15	+25	3.50
Russia	Refinancing Rate	7.50	Apr-14	+50	Oct-14	-50	7.00
S. Africa	Average Repo rate	5.50	Jan-14	+50	Jul-14	+25	6.00
Turkey*	Average Funding rate	9.50			by end-2014	+100	10.50
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 41. Latin America Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2014
			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	Jul-14	-25	3.50
Colombia	Central Bank Repo Rate	4.00	Jun-13	+25	Jul-14	+25	4.50
Mexico	Official Overnight Rate	3.00	Jun-13	-50	Jun-15	+25	3.00
Peru	Reference Rate	4.00	Nov-13	-25	Jul-14	-25	3.75

Source: Bloomberg, Citi Research

## FX Views

Figure 42. Asian Currencies Exchange Rates

		Sep-14			Dec-14			Dec-15		
	25-Jun	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
China yuan	6.23	6.14	6.27	2.1	6.09	6.29	3.2	6.02	6.35	5.3
Hong Kong dollar	7.75	7.75	7.75	0.0	7.75	7.75	0.0	7.75	7.75	0.0
India rupee	60.13	60.59	61.02	0.7	61.35	62.00	1.1	62.62	65.92	5.0
Indonesia rupiah	12090	11748	12270	4.3	11937	12480	4.3	11913	n.a.	n.a.
Korea won	1021	1025	1025	0.0	1025	1029	0.4	991	1040	4.8
Malaysia ringgit	3.22	3.27	3.24	-0.9	3.31	3.26	-1.5	3.36	n.a.	n.a.
Philippines peso	43.9	44.3	44.0	-0.8	44.7	44.0	-1.5	43.8	n.a.	n.a.
Singapore dollar	1.25	1.26	1.25	-0.8	1.26	1.25	-0.8	1.26	1.25	-0.8
Taiwan dollar	30.0	30.00	29.90	-0.3	30.00	29.81	-0.6	29.88	29.58	-1.0
Thailand baht	32.5	32.65	32.58	-0.2	32.84	32.70	-0.4	33.00	n.a.	n.a.

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

Figure 43. CEEMEA Currencies Exchange Rates

		Sep-14			Dec-14			Dec-15		
	25Jun	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs EUR				(%)			(%)			(%)
Czech Republic koruna	27.4	27.5	27	-0.3	27.6	27.4	-0.8	27.0	27.3	1.2
Hungary forint	307	311	310	-0.5	313	310	-1.1	321	310	-3.6
Poland zloty	4.15	4.22	4.15	-1.6	4.26	4.15	-2.6	4.11	4.15	0.9
vs USD										
Israel shekel	3.44	3.53	3.43	-2.8	3.57	3.43	-3.9	3.76	3.43	-9.6
Russia ruble	33.7	35.8	34.4	-4.0	37.0	35.1	-5.5	37.5	35.1	-6.9
Turkey new lira	2.13	2.16	2.17	0.3	2.18	2.21	1.3	2.32	2.38	2.3
S. Africa rand	10.56	10.82	10.75	-0.7	10.97	10.92	-0.5	10.91	11.54	5.4

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

Figure 44. Latin American Currencies Exchange Rates

		Sep-14			Dec-14			Dec-15		
	25Jun	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
Brazil reais	2.20	2.36	2.26	-4.3	2.43	2.32	-5.1	2.59	2.53	-2.4
Chile peso	550	569	555	-2.6	575	560	-2.7	586	577	-1.6
Colombia peso	1884	1904	1907	0.2	1934	1926	-0.4	2016	2009	-0.4
Mexico new peso	13.0	13.0	13.0	-0.1	13.1	13.0	-0.4	12.9	13.0	1.3

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 45. 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
<b>Asia</b>	<b>6.1%</b>	<b>6.2%</b>	<b>6.2%</b>	<b>6.3%</b>	<b>3.4%</b>	<b>3.3%</b>	<b>3.7%</b>	<b>3.5%</b>	<b>370</b>	<b>363</b>	<b>302</b>	<b>353</b>
China	7.3	7.3	7.0	7.1	2.6	2.5	3.2	2.9	201	210	169	217
Hong Kong	3.2	3.3	3.6	3.5	3.9	3.9	3.7	3.6	8	6	10	7
India	5.6	5.4	6.5	6.2	8.0	7.8	6.5	7.0	-39	-47	-48	-58
Indonesia	5.3	5.3	5.5	5.7	6.5	6.2	6.7	5.7	-24	-23	-23	-21
South Korea	3.9	3.6	4.0	3.7	1.9	1.8	2.9	2.5	69	73	49	64
Malaysia	5.4	5.3	5.6	5.1	3.2	3.3	4.0	3.6	14	15	13	16
Philippines	6.7	6.4	7.2	6.3	4.4	4.2	4.0	3.9	10	10	10	9
Singapore	3.5	3.8	4.1	4.0	1.4	2.2	1.1	2.7	62	54	67	56
Sri Lanka	7.2	7.3	7.4	7.1	5.0	6.0	6.5	6.7	-2	-3	-3	-3
Taiwan	3.2	3.2	3.7	3.6	1.2	1.2	2.0	1.8	55	56	55	55
Thailand	0.5	1.3	2.8	4.1	2.4	2.4	2.1	2.8	8	7	-4	6
Vietnam	5.4	5.6	5.7	5.9	5.0	5.6	6.8	6.8	8	5	8	4
<b>Latin America</b>	<b>1.8%</b>	<b>1.8%</b>	<b>2.6%</b>	<b>2.7%</b>	<b>12.4%</b>	<b>11.5%</b>	<b>12.8%</b>	<b>10.1%</b>	<b>-142</b>	<b>-134</b>	<b>-146</b>	<b>-134</b>
Argentina	0.0	-1.0	1.0	0.8	31.8	32.5	35.0	31.8	-5	-4	-5	-4
Brazil	0.9	1.5	1.2	1.8	6.6	6.4	6.3	6.0	-85	-80	-86	-76
Chile	3.0	3.0	4.0	4.0	3.8	3.9	3.0	3.0	-7	-8	-11	-8
Colombia	5.4	4.6	5.1	4.6	3.4	3.3	3.5	3.1	-14	-14	-15	-13
Mexico	3.0	2.6	4.0	3.9	3.8	3.9	3.5	3.5	-31	-24	-32	-27
Panama	6.2	6.6	5.5	6.2	3.3	3.4	3.0	3.4	-4	-5	-4	-5
Peru	5.0	5.1	6.1	5.6	2.7	3.0	2.5	2.7	-11	-10	-11	-9
Venezuela	-1.0	-1.7	1.9	1.1	75.0	61.2	80.0	47.3	15	9	18	9
<b>Europe</b>	<b>1.9%</b>	<b>1.3%</b>	<b>2.9%</b>	<b>2.5%</b>	<b>5.6%</b>	<b>5.5%</b>	<b>5.4%</b>	<b>4.9%</b>	<b>0.4</b>	<b>-20.3</b>	<b>-25.6</b>	<b>-41.5</b>
Bulgaria	1.5	1.6	2.5	2.4	-0.8	-0.1	2.5	1.9	-0.1	0.2	-0.3	-0.6
Croatia	-0.6	-0.3	1.2	0.8	0.3	0.7	2.7	1.9	0.3	0.3	-0.3	0.1
Czech R	2.4	2.3	2.7	2.7	0.7	0.7	2.0	2.0	1.8	-1.8	3.7	-2.1
Hungary	2.9	2.7	1.9	2.3	0.4	0.5	2.5	2.6	3.3	3.2	2.9	2.9
Kazakhstan	5.0	4.7	6.0	5.4	6.5	6.8	5.9	6.5	2.1	3.7	2.9	4.8
Poland	3.4	3.2	3.6	3.6	0.3	0.7	2.0	2.1	-9.2	-10.3	-15.9	-14.6
Romania	3.0	3.0	3.4	3.3	1.8	2.1	3.3	3.0	-5.1	-2.8	-9.1	-3.5
Russia	1.0	0.2	2.3	1.6	7.1	6.5	6.1	5.3	54.9	37.6	39.2	24.0
Slovak Rep	2.2	2.5	2.7	3.1	0.1	0.4	1.0	1.7	1.6	2.5	2.8	2.5
Turkey	3.5	2.7	3.5	3.6	8.6	8.5	7.9	6.8	-42.8	-48.1	-46.9	-50.5
Ukraine	-3.2	-5.2	2.1	0.8	7.2	9.5	7.3	9.2	-6.5	-4.8	-4.6	-4.5
<b>MEA</b>	<b>4.2%</b>	<b>4.0%</b>	<b>4.9%</b>	<b>4.5%</b>	<b>4.7%</b>	<b>4.5%</b>	<b>5.5%</b>	<b>4.9%</b>	<b>113.4</b>	<b>115.5</b>	<b>67.9</b>	<b>90.4</b>
Israel	3.2	3.3	3.5	3.6	1.0	1.5	3.0	2.3	5.9	6.4	5.2	6.6
Nigeria	6.5	6.8	6.4	6.6	8.7	8.4	10.6	9.0	8.4	14.0	4.5	11.9
S. Africa	2.0	1.9	2.8	3.1	6.5	6.2	5.8	5.8	-16.9	-18.9	-15.4	-17.7
S. Arabia	4.8	4.1	5.9	4.7	3.5	3.2	4.1	3.7	116.0	114.0	73.5	89.6
<b>Above Total</b>	<b>4.4%</b>	<b>4.3%</b>	<b>4.9%</b>	<b>4.8%</b>	<b>5.7%</b>	<b>5.4%</b>	<b>5.8%</b>	<b>5.1%</b>	<b>342.0</b>	<b>323.5</b>	<b>197.9</b>	<b>268.5</b>

Source: Consensus Economics, National Sources, Citi Research forecasts



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## Asia Pacific

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- **Summary view** – Recent data point to stabilization of growth with property sector as an exception. Improving external demand and targeted policy easing will likely offset partially the downside from a property market correction, and we see upside risk to our 7.3% growth forecast for 2014.
- **Things to watch** – There has been a subtle change in policy tone in favor of easing. We expect monetary policy to remain accommodative. There could be targeted measures to prevent sharp property sector slowdown, but the government may put broad-based stimulus on hold for the moment.
- **Strategy** – USDCNY may have reached the turning point given the recent improvement of the headline export growth, although PBOC may continue to use every opportunity to instill volatility to deter hot money flows. We forecast USDCNY to reach 6.18 in 0-3 months, and 6.04 in 6-12 months.

### More signs of growth stabilization

**Data in May point to broad stabilization of growth momentum with the exception of the property sector.** Trade data normalized, pointing to recovery in the advanced economies and weakness in domestic investment. Widening trade surplus also led to some strengthening of the RMB. Better exports, stable retail sales and targeted policy support to infrastructure investment seem to have supported manufacturing activity, with PMI and IP growth edging higher. Power consumption growth also sped up to 5.3%YoY in May, and Jun HSBC manufacturing flash PMI entered into expansionary territory for the first time in six months on a production rebound and stronger domestic demand. However, property investment growth slid further, and average home prices started to drop month-on-month. We expect a sizable correction of the property market but see a market collapse as a tail risk.

**We see an easing bias in generally prudent monetary policy.** M2 growth edged up from 13.2% in Apr to 13.4% in May. RMB credit increased by Rmb871bn during the month, and credit outstanding growth accelerated slightly from 13.7% in Apr to 13.9%. Total social financing (TSF) reached Rmb1.4tn in May, with the share of off-balance-sheet financing falling further to 15%. While M2 growth does not deviate much from the annual target, PBOC appears to be implementing policies with an easing bias, including generous liquidity injection through OMOs, targeted RRR cuts for commercial banks with large exposure to agriculture and small and micro enterprises and reported lending to selected banks. With inflation staying below target, we expect monetary policy to remain accommodative to bring down the financing cost of the real economy.

**The government may put broad-based loosening on hold.** There has been a subtle change in policy tone. The premier has recently emphasized the growth target of 7.5% and called for more action in supporting economic growth, although the government seems to favor targeted easing relative to comprehensive stimulus. On the fiscal front, government spending in May accelerated to 25%YoY and the Ministry of Finance (MOF) has recently issued a notice calling for faster implementation of the budget expenditure. We think the government may resort to broad-based loosening only when there are signs of a sharp downturn.



**Improving external demand and targeted policy easing will likely offset partially the downside from a property market correction.** Exports may accelerate in the months ahead as the US bounces back from the 1Q weather-related hiccup. Meanwhile, more policy support is likely to be introduced to support the property sector, including PBOC re-lending to support social housing, higher loan quota for mortgages, and relaxation of the purchase restrictions at local levels. Data so far indicate 2Q growth would be higher than our current forecast of 7.0%YoY, and our credit condition index suggests growth may pick up in 2H. Barring a slump of the property market, we see some upside risk to our 7.3% growth forecast for 2014.

**The market is waiting for visible reforms.** The restart of China's reform process at the same time as a turning property cycle may challenge the government's strategy of an orderly transition. The authorities have so far avoided stimulating the economy in an old-fashioned way, and this may open room for proactive reforms of SOEs, hukou and fiscal policy in 2H. The Leading Group of Reform has reviewed schemes for fiscal and hukou reforms and may launch them in the coming quarters. SOEs will likely be divided into three groups: public, functional, and competitive, with differentiated state controls. As the fourth plenum is approaching, reforms will likely become more visible in 2H if downside risks to the economy are successfully curtailed.

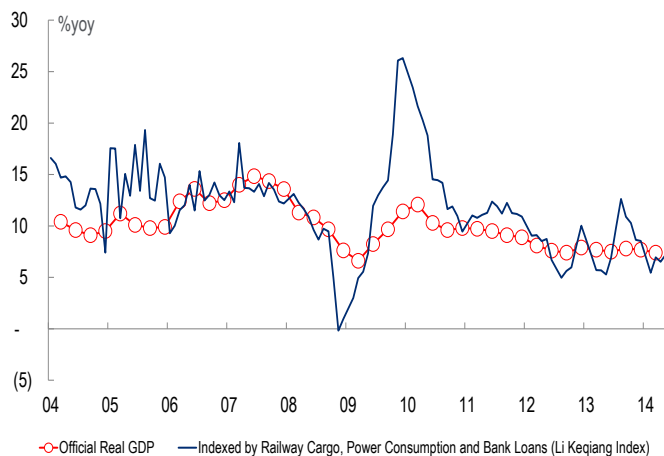
## **RMB may be turning stronger**

**We think the USDCNY has reached the turning point.** The RMB has depreciated against the US dollar by about 3% from Feb to May but the downward movement has stopped since June amid improving headline export growth. With the effect from distorted base fading out, exports may sustain relatively high growth in 2H on better US and Europe economic outlook. As a result, trade surplus is likely to increase for the rest of the year, adding pressure from not only the US but also the G20 on currency issues. The political pressure should be visible ahead of the China-US strategic and economic dialogue scheduled in July.

**Both Apr and May witnessed non-FDI capital outflows, suggesting RMB depreciation has reversed carry trade.** Net FX purchases by the banking system were only Rmb38.7bn in May, down 67% from Rmb116.9bn in Apr and down 80% from Rmb189.2bn in Mar, indicating a net non-FDI outflow of around US\$38bn based on our estimation. The outflow was to a large extent reflected in an increase in holdings of FX assets, instead of capital flight. Foreign currency deposits registered a record monthly increase of US\$36.6bn in May, possibly because RMB depreciation increased appetite for holding USD.

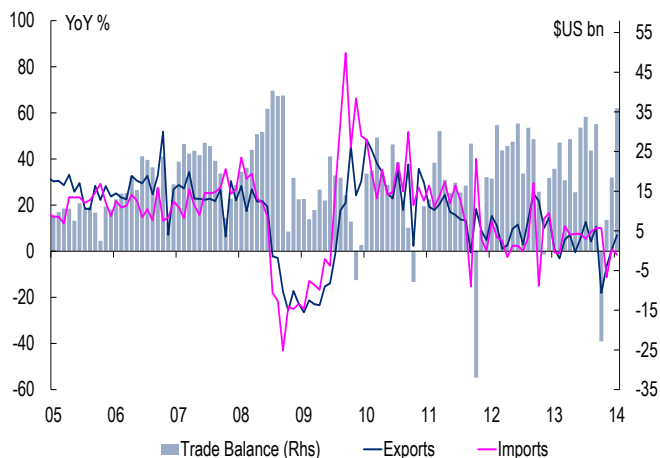
**We expect RMB to resume appreciation along a volatile path in 2H.** Although the property sector remains a downside risk for the economy, the economy has shown some signs of stabilization. The favorable growth momentum, along with widening trade surplus and mounting political pressures, supports stronger RMB. Meanwhile, anticipated capital outflow may moderate the pace of RMB appreciation. PBOC may use every opportunity to instill volatility to deter hot money flows. We forecast USDCNY to reach 6.18 in 0-3 months, and 6.04 in 6-12 months.

Figure 46. The economy has shown some stabilization after mild easing



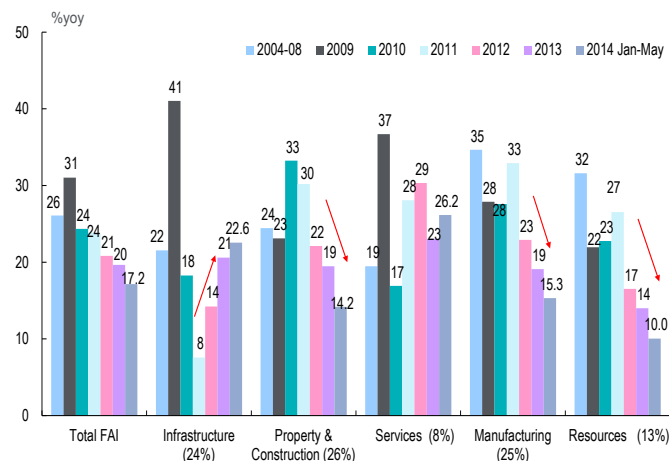
Source: CEIC and Citi Research

Figure 47. Trade data normalized in May



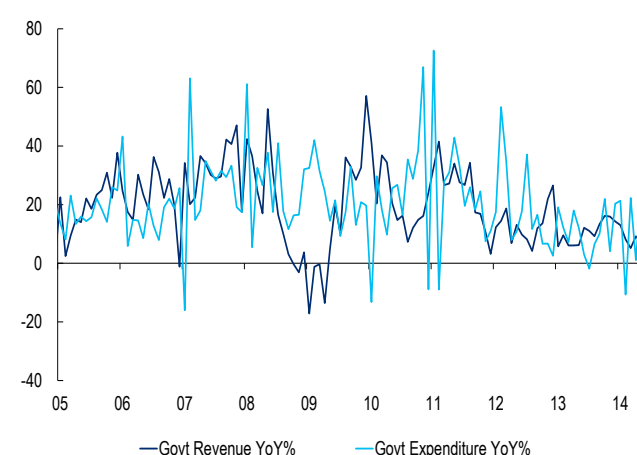
Source: CEIC, WIND and Citi Research

Figure 48. FAI by main sectors: Infrastructure investment took the lead



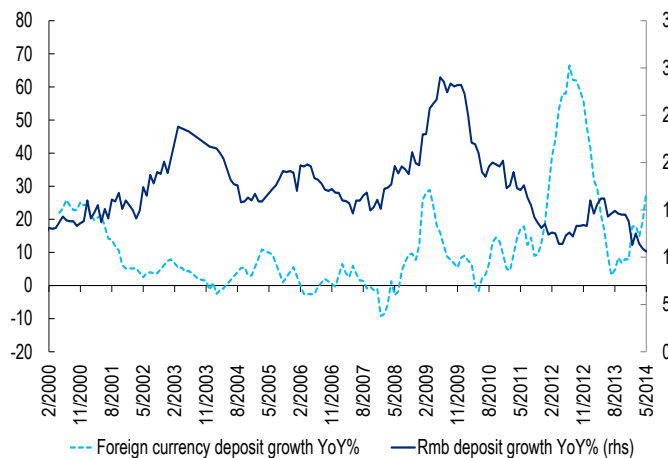
Source: CEIC and Citi Research

Figure 49. The gov't speeded up spending while fiscal revenue slowed



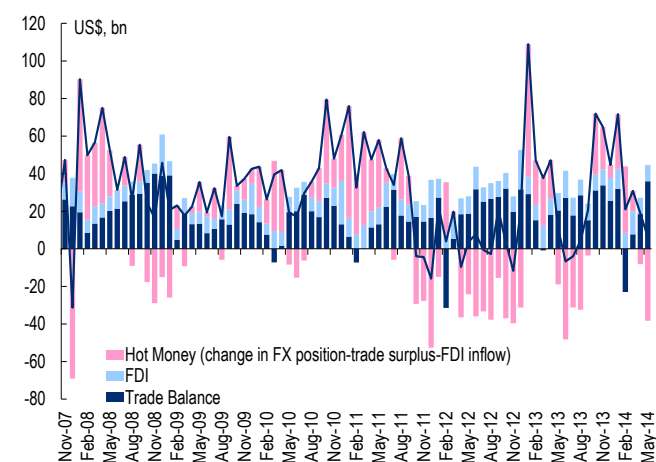
Source: CEIC and Citi Research

Figure 50. Jump in FX deposit growth possibly on RMB depreciation



Source: CEIC and Citi Research

Figure 51. Net capital outflow for the second consecutive month



Source: CEIC and Citi Research

Figure 52. China Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
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
<b>Economic Activity</b>									
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	--	--	--	--	--	--	--	--	--
<b>Prices, Money &amp; Credit</b>									
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	6.09	6.02
lc/US\$, avg	7.61	6.95	6.83	6.77	6.46	6.31	6.15	6.16	6.03
<b>Balance of Payments, US\$ bn</b>									
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
<b>Public Finances, % of GDP</b>									
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
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
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
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	7.7	7.4	7.0	7.1	7.4	7.4	7.2	6.8	6.7
CPI, % yoy	2.5	2.4	2.6	2.5	3.2	3.2	2.9	3.0	3.5
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	5.91	4.62	4.80	4.96	5.13	5.29	5.45	5.61	5.91
Long term yield, % eop	4.49	4.21	4.25	4.29	4.33	4.37	4.41	4.45	4.49
lc vs USD, eop	6.05	6.22	6.21	6.14	6.09	6.04	6.03	6.02	6.02

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

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

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## Hong Kong

- **Summary view** – We nudged down our 2Q GDP forecast to 2.6%YoY to reflect a near-term muddled exports and retail sales outlook. Consumption is now facing a big wild card with potential visa policy changes by the Chinese gov't to reduce the number of mainland tourists visiting HK. Political noise continues to escalate.
- **Things to watch** – 1) Liquidity concerns on taper and China's credit tightening; 2) Pace of trade recovery and property market adjustment; 3) Tourist shopping trends (volume vs. value/pax); 4) Electoral reforms; 5) Cooperating measures with Qianhai and Shanghai FTZ; 7) Changes to personal RMB conversion quota.
- **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 changed to expect mass market home prices to stay flat (vs. -10% previously) in 2014E. .

### 2Q GDP likely softened more than earlier expected

**We nudge down our 2Q GDP growth by -0.3ppt to 2.6%YoY.** The downgrade is mainly to reflect recent misses in trade and consumption data, as the unexpected relapse in April exports (-1.6%YoY) and sharp drop in April retail sales (-9.8%YoY) create a tough start for 2Q. We worry that May data would post further disappointments, especially with the exceptional gold rush phenomenon last year setting a high comparison base for multiple indicators.

### 2H outlook: Strained by both external and internal issues

**We think the HK economy will likely muddle through in 2H on external factors and domestic changes.** Having said that, we remain hopeful for better trade data in 2H14 from likely G3-led growth, China pulling over on targeted stimulus and interest in new tech gadgets; we are unsure if the consumption drivers would be in place for 2H. Our full-year GDP forecast remains at 3.2%YoY, with 2H growth expected to fare better at 3.7%YoY.

**The two main external worries** that we highlighted at the beginning of the year – the Fed's ultimate move to normalize interest rates and China policymakers' attempt to engineer a soft landing – can still materialize as prominent downside risks for 2H. Liquidity pattern is the benchmark to monitor for asset markets. According to our proxy of liquidity (tallying the changes in monetary base and in net spot foreign currency positions of banks) indicate that HK saw HK\$108.7bn of outflows in 1Q14, vs. the HK\$32.9bn of inflows we noted in 4Q13. Although FC positions data are not available for Apr/May yet, we think HK likely registered mild inflows in 2Q judging on the trends of the HKD and the HSI. For 2H, we still think the market remains in anxiety mode and would once again panic should we see a strong US recovery that may cause faster than expected Fed Fund Rates hike or China's domestic slowdown magnifies. In such an event, this again would feed back to consumer behavior via the wealth effect from asset market performances.

**List of domestic issues is actually growing.** This is rather unusual for a small open economy like HK, where we are seeing changes in tourists shopping behavior, and potential mainland tourist visa policies may take a toll on the already conservative local consumption pattern. Another growing issue is politics associated with the election process of the 2017 Chief Executive election, the recently issued white paper by State Council on The Practice of the "One Country, Two Systems" Policy in the Hong Kong Special Administrative Region and Occupy Central Referendum are taking HK political debates to unprecedented levels.

## Tourist consumption becoming the wildcard for 2H

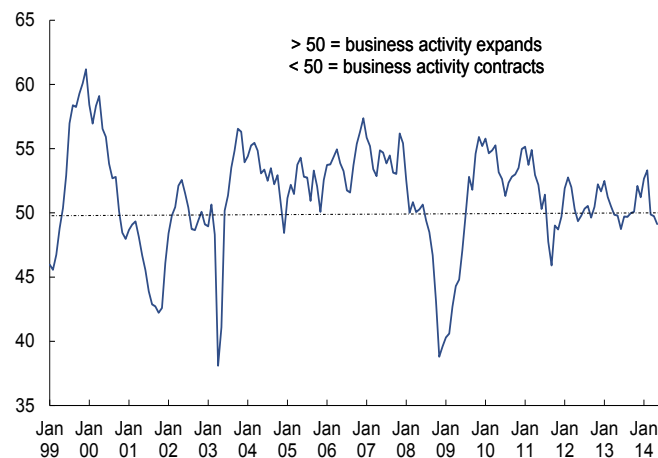
**Retail sales outlook clouded by potential change in mainland visitor visa scheme.** Tourism is one of HK's key economic pillars. According to the HK Tourism Board, HK tourist expenditure associated to inbound tourism accounted for HK\$343.1bn in 2013, equivalent to 16.1% of GDP. However, a surge in the number of visitor arrivals – a +11.7%YoY increase in 2013 to 54.3mn visitors, of which 75% of the visitors are from mainland China – has escalated opinions against hosting mainland tourists and discussions on HK's capacity to receive tourists.

**A review of the Individual Visitor Scheme (IVS)** – The IVS scheme was inceptioned in July 2013 and has expanded to allow 49 mainland cities, representing ~270mn mainland residents to visit HK in their individual capacity. In 2013, 27.5mn mainland visitors came to HK under the IVS scheme, which equals to 50.6% of total tourists or 77% of mainland tourism. Since Apr 2009, Shenzhen permanent residents can apply for a one-year multiple-entry visa to visit HK. According to the Commerce and Economic Development Bureau (CEDB) [report](#) on this topic published in Dec13, visitors with multiple entry endorsement account for 44.1% of IVS visitors.

**China and HK governments are now seeking to refine and enhance the IVS.** HK's Chief Executive CY Leung put forward the topic of a 20% cut of mainland Chinese IVS visitors to HK for public discussion. On 23 Jun, HK's Commerce Secretary Gregory So discussed with Beijing authorities on how to improve the IVS and in particular the multiple entry endorsement. Although China has not made its official decision yet, we expect a decision could come as early as in the fall as it seems in both the China and HK governments' interests to pacify social tensions between HK and mainland China by alleviating bottlenecks at immigration control points, the public transport system, tourist sites, hotels & lodging in the short term, and reduce shop rentals and commercial property prices in the medium to longer term. We believe administrative amendments to the multiple-entry scheme, such as the mentioned proposals (cited from Mr. So in his post-meeting press conference) to 'restrict multiple trips per day' and 'limiting the number of trips that a multiple entry visa holder can make' are both likely. We also think Chinese customs will step up to eliminate those taking advantage of the L-visa (a type of group tour visa) but in fact a one-person tour group to visit HK.

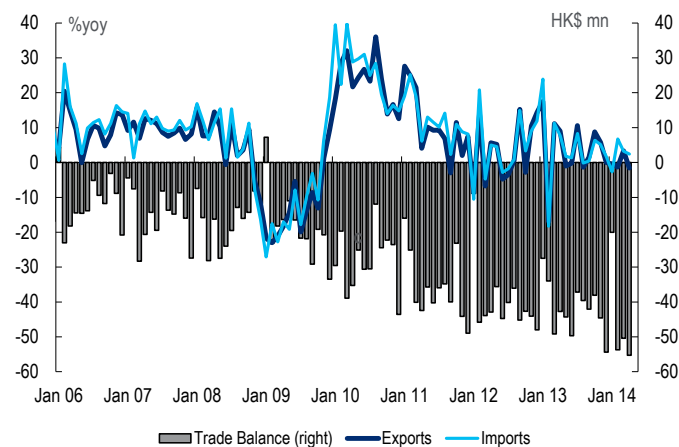
**Potential changes will take a short-term hit to tourism related sectors.** Such a potential visa scheme change is of added relevance to the retail sector nowadays, given two consecutive months of poor retail sales in March (-2.5%YoY) and April (-9.5%YoY), especially as retail sales grew on average at a double-digit pace in 2013. We have been arguing that the anti-corruption drive in China has already taken a toll on high-end retail shops in HK, tourist spending trend may be turning towards middle-to-low end shopping, and shops are making business via strategies that target volume rather than value. The potential visa scheme change would further reduce the volume of tourists and hence lower the volume of goods sold. Our back-of-the-envelope estimate of a hypothetical 20% decrease in IVS would cut 6mn tourists in 2014E. Given that approximately 90% of the multiple entry visa holders are day-trip visitors to HK from Shenzhen, and we estimate each of this type of visitor spends HK\$2,761/day; this would sum up to a loss of HK\$16.6bn tourism receipts or 0.7% of GDP. The hit to retail sales would be slightly smaller given that although these types of visitors do not spend on hotel & lodging, they still spend on restaurants and other services. It is also reasonable to assume that some of the impact could be mitigated too as multiple entry visa holders are likely to lengthen their stay from same-day trips to multiple-day stays in HK. To summarize, even without policy details, we believe there will be significant downside risks to our mid-single digit retail sales forecast growth for 2014E.

Figure 53. PMI in contraction zone for Apr-May14



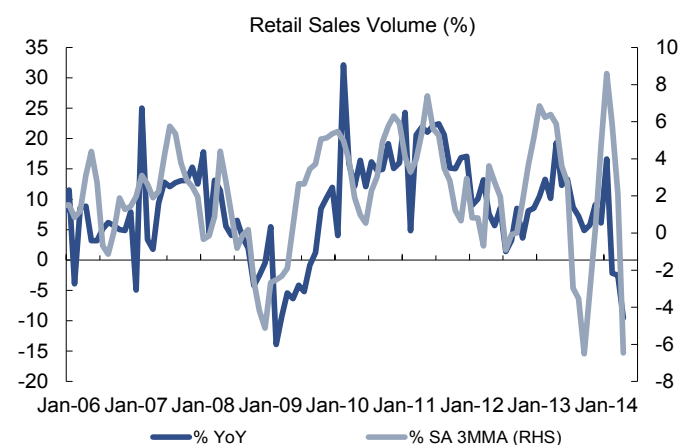
Source: Haver, Markit

Figure 54. Exports relapsed in Apr, recovery remains fragile



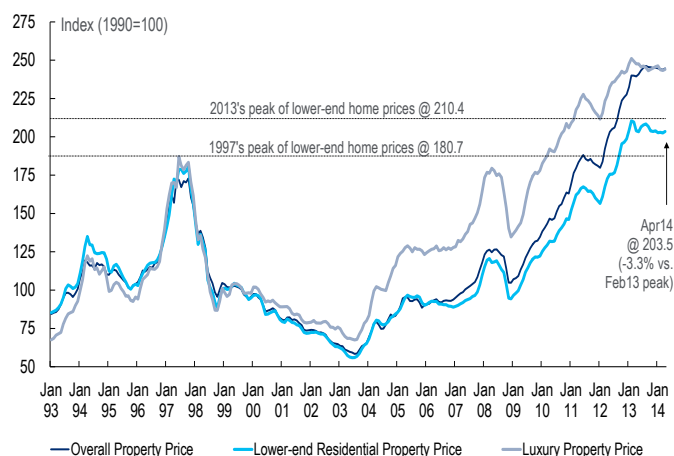
Source: CEIC, Citi Research

Figure 55. Retail sales slowdown may become trend



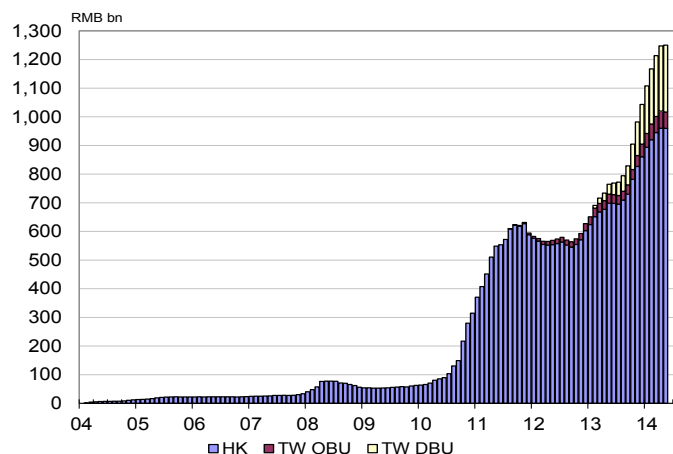
Source: CEIC, Citi Research

Figure 56. Price softening insufficient for bold property policy easing



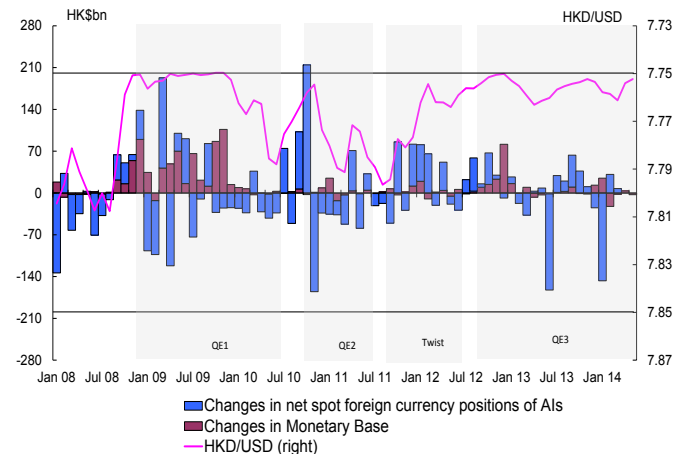
Source: CEIC, Citi Research

Figure 57. Offshore RMB Deposits in HK+TW to stay abundant



Source: CEIC, Citi Research

Figure 58. Net inflows recorded in Mar14; HKD heading to strong end



Source: CEIC, Citi Research

Note: Net FC positions data not available for Apr-May14 yet

Figure 59. Hong Kong Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	211.6	219.3	214.1	228.7	248.5	262.6	274.0	285.2	301.4
Nominal GDP, local currency bn	1,651	1,707	1,659	1,776	1,934	2,037	2,125	2,213	2,338
GDP per capita, US\$	30,495	31,491	30,595	32,424	34,941	36,587	37,953	39,390	41,503
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
<b>Economic Activity</b>									
Real GDP, % yoy	6.5	2.1	-2.5	6.8	4.8	1.5	2.9	3.2	3.6
Real investment growth % yoy	7.9	-0.3	1.0	11.1	2.3	3.5	3.7	4.6	2.7
Real consumption growth % yoy	7.9	1.9	0.5	5.8	7.6	4.0	4.0	2.0	2.3
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	4.1	6.3
Real import growth, % yoy	9.1	2.2	-9.0	17.4	4.6	2.9	6.9	3.9	5.7
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.8	2.1	1.5	2.9	5.7	3.8	4.3	3.3	3.6
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	7.75	7.75
lc/US\$, avg	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.75	7.75
<b>Balance of Payments, US\$ bn</b>									
Current account	27.6	32.9	21.2	16.0	13.8	4.1	5.1	8.1	9.6
% of GDP	13.0	15.0	9.9	7.0	5.6	1.6	1.9	2.8	3.2
Trade balance	-23.1	-25.8	-28.8	-43.0	-54.9	-61.6	-64.6	-68.1	-77.3
Exports	344.5	362.7	318.5	390.2	428.7	442.8	458.9	471.0	501.0
Imports	367.6	388.6	347.3	433.1	483.6	504.3	523.5	539.1	578.2
Service balance	-4.3	-2.7	3.6	10.1	17.0	21.9	28.5	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	--	--	--	--	--	--	--	--	--
<b>Public Finances, % of GDP</b>									
Consolidated government balance	7.3	0.0	1.5	4.1	3.8	3.1	1.0	1.3	0.7
Consolidated gov primary balance	7.4	0.0	1.6	4.2	3.8	3.2	1.0	1.3	0.7
Public debt	1.2	1.0	0.7	0.6	0.6	0.5	0.5	1.0	1.4
of which Domestic	0.4	0.2	0.1	0.0	0.0	0.0	0.0	0.1	0.1
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.9	2.5	2.9	3.3	3.9	3.1	3.6	3.9	3.8
CPI, % yoy	4.3	3.9	3.8	6.0	3.3	3.8	3.7	3.6	3.6
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.38	0.38	0.40	0.45	0.50	0.60	0.80	1.00	1.20
Long term yield, % eop	1.39	1.45	1.40	1.60	2.00	2.20	2.40	2.60	2.90
lc vs USD, eop	7.75	7.76	7.75	7.75	7.75	7.75	7.75	7.75	7.75

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

\*Note: Public debt is general government debt.



## India

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- **Summary view** – The Modi government has got a sweeping "change" mandate, surpassed only by expectations. The task for the BJP government is cut out: it needs to revive growth, bring down inflation, practice fiscal prudence and ensure an investor-friendly climate. Markets have cheered so far, but questions remain.
- **Things to watch** – July budget will be a key policy document – not only for the fiscal deficit roadmap, but also on major issues such as subsidies, GST timeline, disinvestment, public welfare programs and gold import controls. Also, monsoon and crude oil trends need to be followed for their impact on the economy.
- **Strategy** – Thanks to a supportive BoP and positive sentiment post-elections, we remain constructive on INR, but the crude spike could take a toll in the near term. We expect INR to trade close to its equilibrium value of Rs59-62. Notwithstanding a dovish RBI policy, bonds may struggle on inflation risks in the immediate term.

### Modi's mandate, mantra and more

**How will Mr. Modi change India?** As detailed in our latest [India Macroscope](#), Mr. Modi's 12-year track record as Gujarat's chief minister and his sharp early moves as PM suggest: a) High level of centralization; b) Bureaucratic empowerment; c) On-boarding state governments; and d) 'The buck stops with me' attitude.

**There's a lot that could happen, but there are also some risks:** While positive sentiment is a pre-requisite for growth to pick up and the new government has already delivered on that account, there's a lot to be done (backlog apart). Risks include El Nino, the global risk including geo-politics, a high inflation environment and towering expectations.

### Real economy: Gradual, investment-led recovery in FY16

**FY14 GDP prints at 4.7%, FY15 and FY16 outlook:** The new government takes charge at a time of weak growth, with FY14 GDP coming in at 4.7% vs. 4.5% in FY13. While global factors did add to woes, much of the decline was due to domestic factors – especially policy-related issues, which led to a collapse in investments. We retain our FY15 GDP estimate of 5.6% which factors in slower agri growth due to a sub-par monsoon, and also acknowledge downside risk of 50-90bps in the event of a drought. While the new political formation has already resulted in a much-needed change in sentiment, we expect a full-fledged recovery to be visible only in FY16/17E.

**Recovery rests on policy momentum:** We believe a sustainable recovery would only be possible by addressing issues on the investment and infrastructure front. Given the overwhelming mandate, there is now more than ever a need to bring project execution/implementation back in focus, in our view. The pick-up in growth may be a function of (1) pace of policy de-bottlenecking, (2) investment appetite of the corporate sector and (3) extent of the government's own role in capital formation. Furthermore, we believe in order to ensure that a pick-up in investments is financed largely by domestic savings, the key would be to revive domestic financial savings.



## Inflation: Monsoon, crude spike, rail fare hike in focus

**Inflation is now a Political Priority** – The NDA takes over at a time when inflation remains elevated, with the latest CPI reading at 8.3%. There is now a clear political intent to rein in inflation, particularly food inflation, with recently announced measures such as (1) setting a minimum export price on onions, (2) delisting fruits and vegetables from the APMC act and (3) releasing rice through PDS, which would help tackle food inflation from key items. Given continued government measures to [rein in food inflation](#) and the likely favorable base effect from June onwards we maintain our view of CPI and WPI trending toward an average of 8% and 5.5% in FY15.

**Upside risks from Monsoon, Crude, and Rail fare hike:** A combination of poor monsoons, sustained high crude prices and administered price hike poses an upside risk of 50-80bps on inflation. As detailed in our note [Macro muddle](#), a US\$10/bbl increase in crude prices could push up inflation by 30-90bps depending on the extent of pass-through in administered fuel products. Similarly the recent hike in rail tariff could push up inflation by 10-20 bps. As regards the monsoon, the relationship between rainfall and food inflation is not strong, yet lower agri production coupled with elevated inflation expectations could impact the projected path of disinflation.

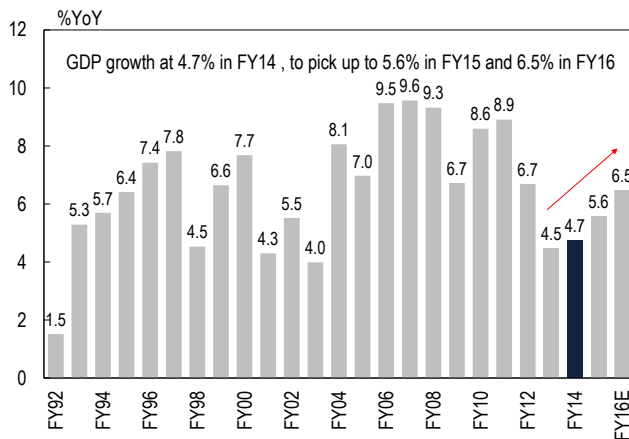
**Maintain view of Extended Pause:** We continue to expect an extended pause on rates through 2014 as CPI inflation roughly meets RBI's target of 8% by Jan'15 and 6% by Jan'16. Given upside risks to inflation from poor monsoons and global crude prices in the near term, the space to ease monetary policy could open up only in 2015 in the event the government takes definite measures to bring down food inflation.

## Fiscal indicators: watch out for Budget on 10<sup>th</sup> July

**Erstwhile Govt. maintains fiscal consolidation path:** Thanks to a record fiscal surplus of Rs910bn in Mar'14 achieved through a combination of (1) sharp cut in plan expenditure and (2) disinvestment/dividends overdrive, the erstwhile government restricted FY14 fiscal deficit to 4.5% of GDP, lower than its budget estimate of 4.8%. This was the second consecutive year of the govt. undershooting its budget estimate, leading to a cash build-up of Rs615bn in two years.

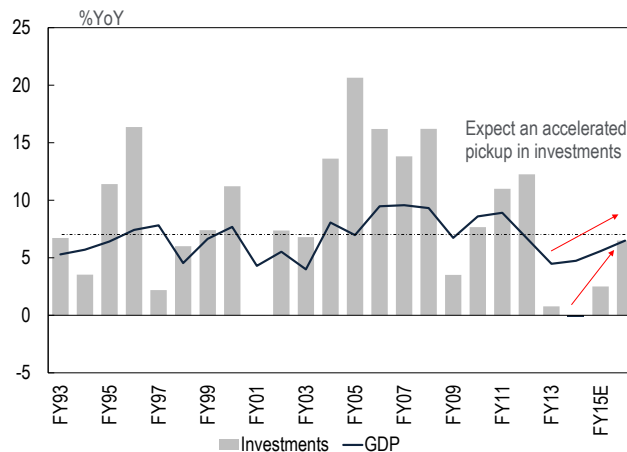
**Budget Preview: GST, subsidies, accounting norms** – On the revenues front, we expect some timeline on GST and Direct Tax code to provide necessary buoyancy to both direct and indirect taxes. Also given the favorable market condition, we could see higher PSU stake sales. On expenditure, subsidies would need to be rationalized from the current levels of 2.2%-2.5% of GDP. A recent spike in crude could push up fiscal costs, e.g., a US\$10/bbl increase in crude prices raises under-recoveries by Rs400bn, which could be offset through price increases and upstream sharing. Finally, the accounting norms may be changed to a modified cash basis. Overall, we expect the government to maintain trends of fiscal consolidation and restrict fiscal deficit within 4.4%.

Figure 60. Trends in Annual GDP growth (%YoY)



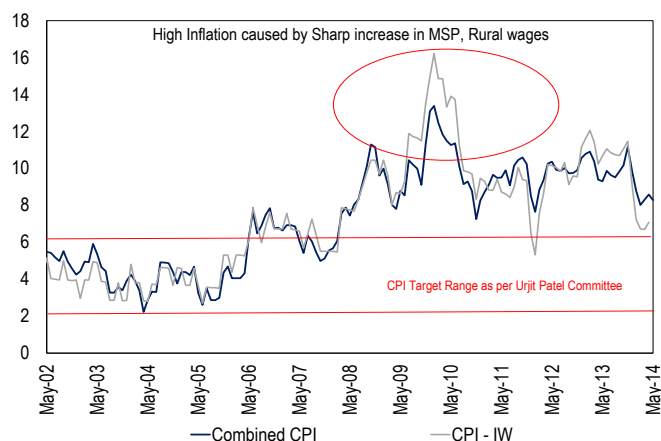
Source: CSO, Citi Research

Figure 61. Trends in Investments (%YoY)



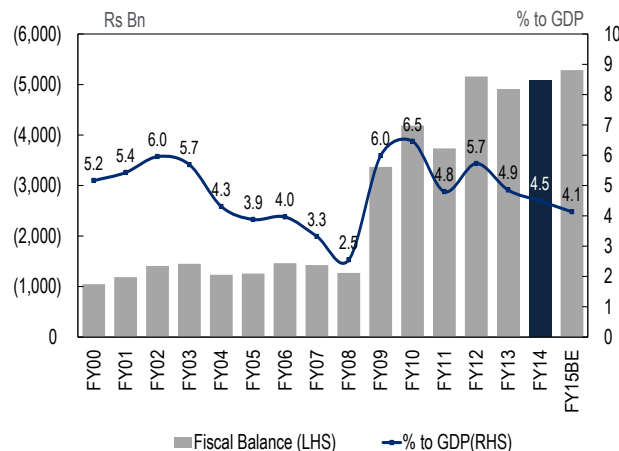
Source: CSO, Citi Research

Figure 62. Trends in CPI-Combined and CPI-IW (%YoY)



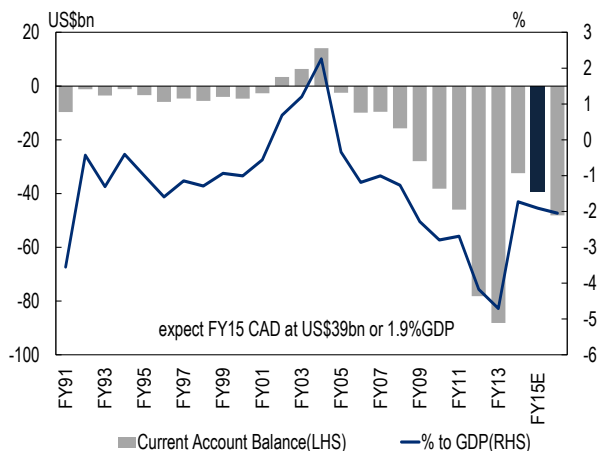
Source: CSO

Figure 63. Trends in Fiscal Deficit (Rs bn, % GDP)



Source: Budget Documents, CGA

Figure 64. Trends in Current Account Deficit (US\$bn, % GDP)



Source: RBI, Citi Research

Figure 65. Trends in US\$ / INR



Source: Bloomberg

Figure 66. India Economic Indicators

	FY08	FY09	FY10	FY11	FY12	FY13	FY14F	FY15F	FY16F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	1,240.6	1,223.9	1,366.6	1,707.8	1,873.1	1,872.8	1,880.0	2,069.6	2,359.3
Nominal GDP, local currency bn	49,871	56,301	64,778	77,841	90,097	101,133	113,205	127,921	146,276
GDP per capita, US\$	1,090	1,061	1,168	1,440	1,558	1,539	1,522	1,651	1,854
Population, mn	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,217.0	1,235.3	1,253.8	1,272.6
Unemployment, % of labour force	--	--	--	--	--	--	--	--	--
<b>Economic Activity</b>									
Real GDP, % yoy	9.3	6.7	8.6	8.9	6.7	4.5	4.7	5.6	6.5
Real investment growth % yoy	18.1	-5.2	17.3	14.1	3.9	4.9	-2.5	4.8	5.7
Real consumption growth % yoy	9.4	7.7	8.4	8.2	8.9	5.2	4.7	5.6	6.8
private consumption growth % yoy	9.4	7.2	7.4	8.7	9.3	5.0	4.8	5.5	7.0
Real export growth, % yoy	5.9	14.6	-4.7	19.6	15.6	5.0	8.4	11.0	9.3
Real import growth, % yoy	10.2	22.7	-2.1	15.6	21.1	6.6	-2.5	9.5	9.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	7.9	8.0	14.9	8.8	9.0	10.4	8.3	8.0	6.5
CPI, % avg	6.2	9.1	12.4	10.4	8.4	10.2	9.5	8.0	6.5
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	61.35	62.62
lc/US\$, avg	41.18	43.42	48.30	45.68	46.63	53.38	58.57	60.49	62.32
<b>Balance of Payments, US\$ bn</b>									
Current account	-15.7	-27.9	-38.2	-45.9	-78.2	-88.2	-32.4	-39.3	-48.1
% of GDP	-1.3	-2.3	-2.8	-2.7	-4.2	-4.7	-1.7	-1.9	-2.0
Trade balance	-91.5	-119.5	-118.2	-130.6	-189.8	-195.7	-147.6	-155.5	-171.1
Exports	166.2	189.0	182.4	250.5	309.8	306.6	318.6	343.8	378.2
Imports	257.6	308.5	300.6	381.1	499.5	502.2	466.2	499.3	549.2
Service balance	38.9	53.9	36.0	48.8	64.1	64.9	73.0	73.3	79.1
Income balance	-5.1	-7.1	-8.0	-17.3	-16.0	-21.5	-23.0	-24.0	-24.0
FDI, net	15.9	22.4	18.0	9.4	22.1	19.8	21.6	17.8	22.8
International reserves	299.1	241.6	252.8	273.7	260.1	259.7	276.4	309.4	340.7
Total Amortisations	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9	21.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-4.0	-8.3	-9.3	-6.9	-8.1	-7.2	-6.9	-6.7	-6.5
Consolidated gov primary balance	-1.2	3.3	4.5	2.4	3.6	--	--	--	--
Public debt	76.1	76.8	75.5	70.2	69.7	69.8	69.4	68.1	66.2
of which Domestic	71.4	72.2	70.6	65.6	65.9	65.4	65.4	64.6	63.1
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
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	22.7	21.3	19.3
External debt / XGS	88.5	77.7	95.2	84.7	80.7	90.1	90.6	82.3	72.7
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	30.1	37.2	33.5	31.6	30.1
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	4.6	4.6	5.2	5.6	5.8	5.8	6.5	6.6	6.0
CPI, % yoy	10.4	8.4	8.1	7.1	6.4	8.3	7.8	7.0	6.4
Policy interest rate, % eop	7.75	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00
Short-term market rate, % eop	9.00	8.36	8.25	8.25	8.10	8.10	8.10	8.10	8.10
Long term yield, % eop	8.80	8.78	8.75	8.50	8.50	8.50	8.50	8.50	8.50
lc vs USD, eop	61.81	60.02	60.13	60.59	61.35	62.02	62.22	62.42	62.62

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

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

## Indonesia

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- **Summary view** – The GDP growth slowdown may have bottomed but momentum remains relatively weak. Headline inflation may see base effects in coming months, but the likelihood of another fuel price hike occurring this year is growing in our view.
- **Things to watch** – The race among presidential candidates has tightened although Jokowi is still in the lead. A narrow victory risks prolonging the election process. Meanwhile on the balance of payments, concern is growing that commodity exports may still slip further.
- **Strategy** – Seasonal pressures on the IDR from dividend season has subsided, but the tight election has triggered concerns. A Jokowi win may be followed by a short-term relief rally, but the still high current account deficit would limit its extent in the longer term.

### Elections: not a clean sweep after all?

**Tighter presidential race sparking jitters.** A recent survey in early June from LSI shows only a 6% lead of Jokowi vs. Prabowo (45% vs. 38.7%). LSI's survey cited the impact of negative campaigns on Jokowi; meanwhile Prabowo benefited from perceptions of strong leadership. The tightening gap may raise uncertainty on the election timeline, in our view. We note that presidential election results have been disputed to the constitutional court in the past, for example in 2009. Although back then the charges were overruled, there have been other instances (such as in regional elections) whereby the court ruled in favor for a recount, which thereby prolongs the uncertainty. There is also still a regulatory loophole that may force a re-run of the election if the winner does not get more than 20% of the votes in >50% of the provinces, although the statistical probability of this happening is relatively small in our view.

**Immediate policy implication of a Prabowo win is not so straightforward.** In our view, it is hard to draw a strong distinction between the economic programs of both candidates. Each has their own dose of nationalism (for example, Jokowi favors shielding the banking sector against foreign ownership while Prabowo favors renegotiating mining contracts). And in issues such as mineral exports, both approve of upholding the 2009 mining law. Both are also in favor of subsidy reform although Jokowi's camp has been bolder in proposing fuel price hikes. Bloomberg recently reported that Prabowo's brother Hashim favors a rise in the public debt to GDP ratio toward 50%. But it is unclear whether this should be taken at face value: The official Prabowo-Hatta agenda actually states that they aim to reduce the budget deficit to 1% of GDP by 2017 and to fully repay official foreign debt by 2019.

**The key distinctions are in track record and perceived leadership ability, in our view.** No administration in the post-Suharto era has ever scored highly in implementing masterplans and grand policies. In our view, the key distinction between the candidates in this election is on their track records in policy delivery, as opposed to what is written in their policy agendas. We think that their expected abilities to minimize compromise and take bold policy actions are also a key distinction. Currently, the Prabowo coalition is supported by 5 political parties commanding 52% of parliament. Cabinet seat allocations were said to have been part of the discussions in forming the coalition.

## Growth contained but export weakness is a concern

### **Coincident economic indicators have stabilized but still lack momentum.**

Growth in the inflation-adjusted M1 money supply, which we use to track the business cycle, has bottomed but does not show strong rebound momentum. Flat trends are also seen in the YoY growth of investment indicators such as cement consumption, commercial vehicle sales and capital goods imports. Industrial property sales, which are used as a leading indicator of investments into the manufacturing sector, in 1Q14 were also weak. Furthermore the government is slashing capital expenditure in this year's budget to make way for more fuel subsidies. Admittedly consumption indicators are relatively more robust, but we also expect them to weaken as election campaigns cease in 3Q14.

### **We think imports will remain at bay although seasonal pressures may arise.**

Given still weak growth momentum, the underlying trend of imports will likely be kept at bay in the immediate future. Nonetheless forthcoming trade data may show seasonal import upticks, particularly in the months preceding the Ramadan fasting period and Eid festivity seasons, which span through July-August.

**Risk of further export slide: Palm oil and coal exports on the radar.** In April, exports of palm oil slid significantly (by almost half) and coal exports also weakened. This was attributed by supply factors, e.g., thick haze during the month. However, the prices in recent months have also been weak, suggesting that the demand side is also not rosy. With commodity exports potentially weaker than expected, concern on the current account deficit may escalate in coming months. We have downgraded our FY14 current account deficit forecast to around \$24bn (eq. to 2.8% GDP) from previously \$21bn.

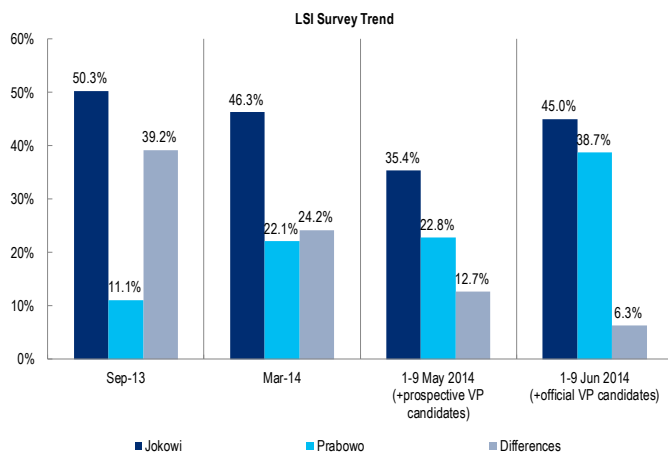
## Policy stance unchanged; but fuel hike increasingly likely

**Policy stance may not be changed too soon despite setback in the CA deficit expectation.** Despite the revision of expectations on the current account, we do not think BI will be in a hurry to further tighten its policy stance. The impact of previous policy rate hikes is still being channeled through the banking system. Bank deposit rates continue to see upward pressure as liquidity tightens (increasing on average by 20bps MoM in June). Meanwhile local currency credit growth also continues to slide (17.7% YoY in April vs. high of 24% in early 2013). Our baseline is that a further 25bps hike in the policy rate may occur but will be in response to a hike in fuel prices.

**Mid-year 2014 budget revision: Passed but with question marks.** The 2014 mid-year budget revision has been finalized with the budget deficit being slightly lower than initially proposed (2.4% GDP vs. 2.5%). However, we highlight the risk that the fuel subsidy budget and quota may be surpassed before year-end. The parliament only approved half of the proposed increase in the fuel subsidy budget, meaning that Rp46tn of subsidy payments will be deferred to the 2015 fiscal year. We continue to believe that fuel prices will have to be raised by the new government in the first few months in office to limit the strain on the 2015 government budget.

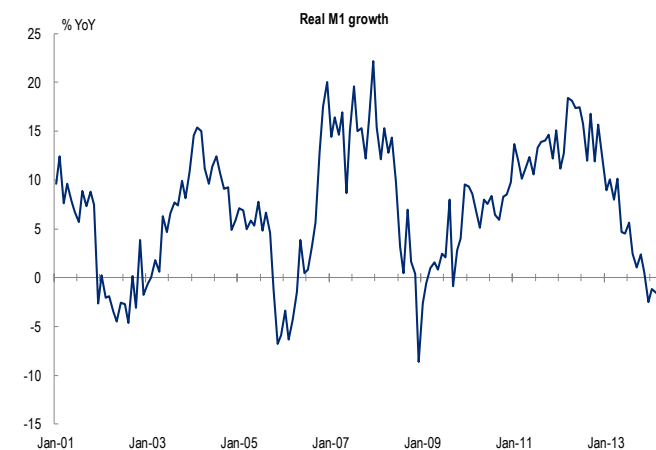
**IDR may see short-term relief under a Jokowi win, but CA deficit may weigh in on longer-term outlook.** Seasonal pressures on the IDR from the dividend season have subsided, but the tight election has triggered concerns. We think a win by Jokowi may be followed by a relief rally in the short term. However, we are still cautious on a 6-12M horizon; the still high current account deficit may keep any euphoria in check.

Figure 67. LSI shows Jokowi lead over Prabowo narrowing



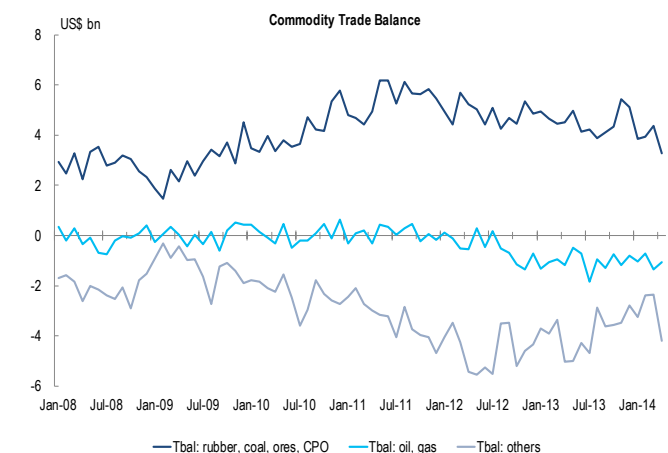
Source: LSI, Citi Research

Figure 68. Inflation adjusted money supply shows growth bottoming



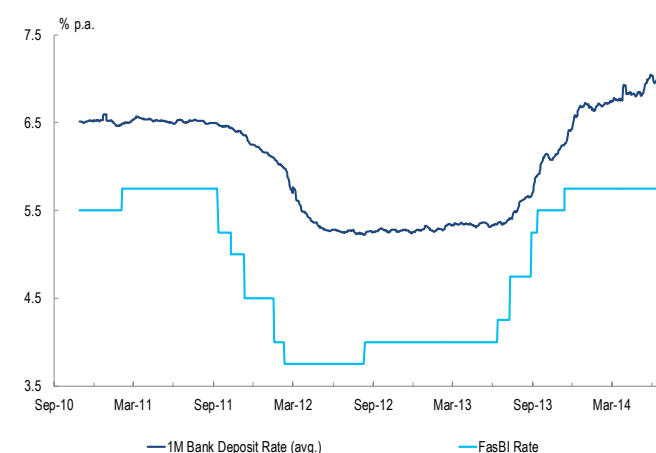
Source: CEIC, Citi Research

Figure 69. Commodity exports reached new low in April



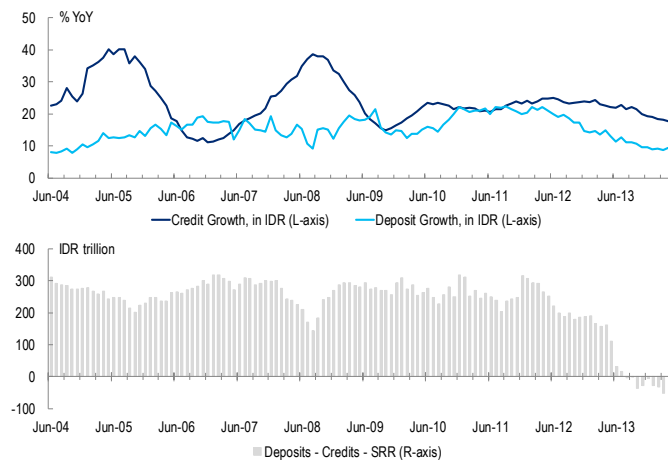
Source: CEIC, Citi Research

Figure 70. Bank deposit rates continue to see upward pressure



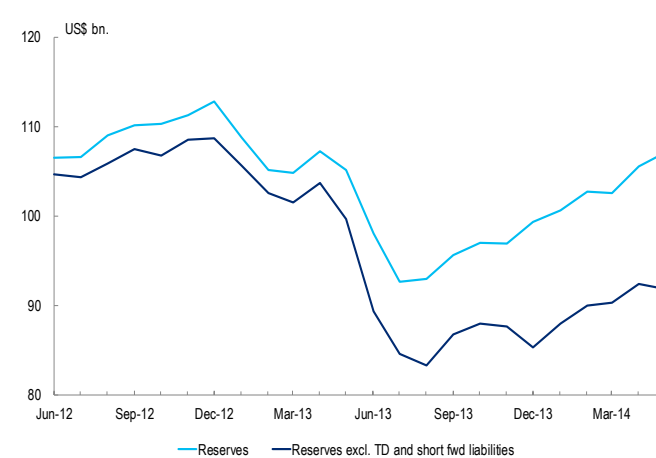
Source: CEIC, Citi Research

Figure 71. Credit growth slows as excess liquidity evaporates



Source: CEIC, Citi Research

Figure 72. Foreign reserves have stabilized



Source: Bank Indonesia, Citi Research

Figure 73. Indonesia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	432.2	510.7	538.6	709.5	845.4	876.9	868.5	863.8	932.6
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	3,464	3,695
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
<b>Economic Activity</b>									
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	4.7	6.0
Real consumption growth % yoy	4.9	5.9	6.2	4.1	4.5	4.8	5.2	4.7	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	1.1	5.7
Real import growth, % yoy	9.1	10.0	-15.0	17.3	13.3	6.7	1.2	-1.4	3.1
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	5.8	11.1	2.8	7.0	3.8	3.7	8.1	7.3	6.5
CPI, % avg	6.3	9.9	4.8	5.1	5.3	4.0	6.4	6.5	6.7
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	15.0	16.0
Policy interest rate, % eop	3.00	8.75	6.00	5.50	4.50	4.00	5.75	6.00	6.00
Short-term market rate, % eop	3.35	9.44	6.39	5.66	4.57	4.24	6.01	6.00	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	11,937	11,913
lc/US\$, avg	9,140	9,673	10,376	9,078	8,763	9,361	10,449	11,724	12,003
<b>Balance of Payments, US\$ bn</b>									
Current account	10.5	0.1	10.6	5.1	1.7	-24.4	-29.1	-24.0	-22.6
% of GDP	2.4	0.0	2.0	0.7	0.2	-2.8	-3.3	-2.8	-2.4
Trade balance	32.8	22.9	30.9	30.6	34.8	8.6	6.0	10.3	12.5
Exports	118.0	139.6	119.6	158.1	200.8	188.5	183.3	184.1	195.0
Imports	85.3	116.7	88.7	127.4	166.0	179.9	177.3	173.8	182.5
Service balance	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-12.1	-10.7	-11.1
Income balance	-15.5	-15.2	-15.1	-20.8	-26.7	-26.8	-27.0	-27.5	-28.0
FDI, net	2.3	3.4	2.6	11.1	11.5	13.7	13.7	14.0	14.5
International reserves	56.9	51.6	66.1	96.2	110.1	112.8	99.4	107.9	110.1
Total Amortisations	18.8	16.7	20.4	24.0	25.2	29.4	41.0	42.0	42.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-1.3	-0.1	-1.6	-0.7	-1.1	-1.9	-2.2	-2.4	-2.2
Consolidated gov primary balance	0.8	1.7	0.1	0.6	0.1	-0.6	-0.9	-1.2	-1.1
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
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	141.2	155.1	172.9	202.4	225.4	252.4	264.1	283.0	311.3
Private	60.6	68.5	73.6	83.8	106.7	126.2	140.5	153.5	175.8
Public	80.6	86.6	99.3	118.6	118.6	126.1	123.5	129.5	135.5
External debt / GDP	32.7	30.4	32.1	28.5	26.7	28.8	30.4	32.8	33.4
External debt / XGS	108.2	100.1	130.2	115.8	101.8	119.3	128.4	135.3	140.9
Short-term debt	18.7	20.5	24.0	31.6	36.6	43.4	46.6	46.0	49.0
Short-term debt/International Reserves (%)	32.8	39.7	36.4	32.8	33.2	38.4	46.9	42.6	44.5
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	5.7	5.2	5.2	5.3	5.3	5.4	5.3	5.6	5.6
CPI, % yoy	8.1	7.3	6.9	4.8	7.3	7.0	7.2	7.0	6.5
Policy interest rate, % eop	5.75	5.75	5.75	5.75	6.00	6.00	6.00	6.00	6.00
Short-term market rate, % eop	6.01	5.86	5.90	6.00	6.00	6.00	6.00	6.00	6.00
Long term yield, % eop	8.60	8.21	8.25	8.40	8.50	8.60	8.70	8.70	8.70
lc vs USD, eop	12,170	11,360	11,849	11,748	11,937	12,093	12,033	11,973	11,913

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.



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## Malaysia

- **Summary view** – Despite some near-term growth moderation, domestic demand is holding up better than expected and a G3-driven export recovery should support the investment cycle. We expect 25bps of hikes each in Jul and Sep, but do not rule out further hikes in 2015.
- **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** – Greater confidence over growth prospects, favourable interest differentials, stabilizing CA position (vis-à-vis Indo) should continue to support MYR in our view, though a key risk is unwinding of heavy foreign positioning in MGS and especially BNM bills

### Near-term moderation, but domestic demand resilient

**Domestic demand is holding up better than expected** despite likely near-term growth moderation. With the stronger-than-expected 1Q GDP setting the stage for the full year, policymakers now acknowledge that full-year growth is likely to come in at close to the upper end of Bank Negara's 4.5-5.5% official forecast, with possible upside risks. While less favourable effects may imply some moderation in YoY growth in the next 1-2 quarters – we note that the leading index fell into negative territory in Mar – the stronger-than-expected 1Q performance suggests that 2014 and 2015 growth should still be able to manage close to 5.4% and 5.6% respectively.

**The consumer should remain supported in the next few quarters.** Higher debt-service burdens remain an obstacle for the consumer, even as subsidy cuts may also erode the discretionary incomes of households – though a mitigating factor may be that rather than broad-based price hikes, which hurt lower-income groups that have the highest marginal propensity to consume (MPC), subsidy reductions may be increasingly accomplished via elimination/reduction of subsidy volumes to higher income groups that have a lower MPC. Offsets should also come from sustained income growth – BNM's previous studies had found income growth accounted for two-thirds of the growth in consumer spending – as well as front loaded spending ahead of the GST in Apr 2015, which could see consumer spending accelerating in 4Q14 and 1Q15 before decelerating in 2Q15.

**A G3-driven export recovery should support the investment cycle.** Headwinds to public investment from fiscal consolidation are evident, but private investments have been sustained, supported by implementation of previously-approved projects and externally-oriented FDI. While restocking momentum could take a near-term breather, this should not be a cause for concern if a G3 recovery offsets potential drag from China, particularly if a more import-intensive US capex recovery reverses declines in export sensitivity to US domestic demand. An export recovery should in turn drive FDI recovery into more productive tradables sectors, in turn improving investment efficiency and sustainability. Over the longer term, economic integration with Singapore may drive manufacturing capex in Johor, Penang and states along the west coast of the peninsula.



## Subsidy rationalization shifting towards volumes

**Authorities appear to be leaning towards subsidy volume reductions** rather than price hikes as a more politically expedient means to reduce subsidies. Such a targeted subsidy system could be announced around Sep or during the Budget itself on Oct 10th. Assuming measures to restrict subsidized fuel consumption by income levels or vehicle capacity kick in fully on 1 Sep 2014, the estimated 2014 savings from volume reductions could amount to RM3.3bn – equivalent to the savings from a 40sen/litre price hike on 1 Jul 2014. In the absence of broad-based fuel price hikes this may imply 2014-2015 headline inflation could be slightly lower by 0.3-0.4%pts vs. our previous baseline forecast of 3.5% and 4.5% respectively, falling from Sep 2014 on base effects, before a spike in Apr 2015 from the 6% GST Implementation

## Monetary policy focused on financial imbalances

### **Improving growth and financial imbalances should trigger rate normalization.**

With inflation not pervasive and wage pressures offset by productivity gains, inflation is not BNM's dominant concern now. Nonetheless the persistence of headline inflation may still be of concern for two reasons. First, above-potential growth of 5.5-6% could still stoke demand-pull pressures in 2015. Second, the mispricing of risks associated with negative real interest rates could fuel household leverage, excessive risk taking and financial disintermediation, besides hurting the purchasing power of middle-class depositors – this is evident in slowing deposit growth since 2012. Prior to commencement of BNM's rate hiking cycle in 2010, deposit growth also slowed sharply which, together with accelerating household loan growth, may have provided the trigger for rate normalization. Negative real rates could also have distributional consequences as it hurts the purchasing power of middle-income depositors who likely rely more heavily on interest incomes.

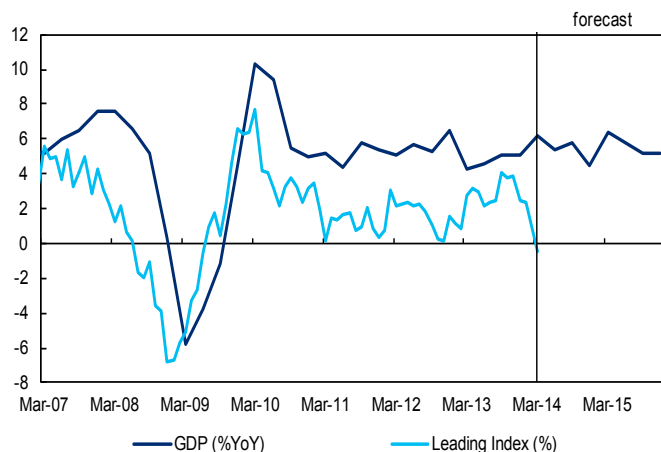
### **Overall, we maintain our call for 25bps of rate hikes each in Jul and Sep.**

Beyond Sep, with real policy rates still likely negative post GST even after a 50bps OPR adjustment in 2H14, we would not rule out further rate hikes by BNM in 2015 to further reduce the degree of monetary accommodation once there is greater clarity of the Fed's hiking cycle. Such a rate hike in tandem with the Fed would be justified on the grounds that Fed hikes are a reflection of an improving US outlook, which would in turn drive Malaysia's growth and inflation dynamics.

## Wither the MYR?

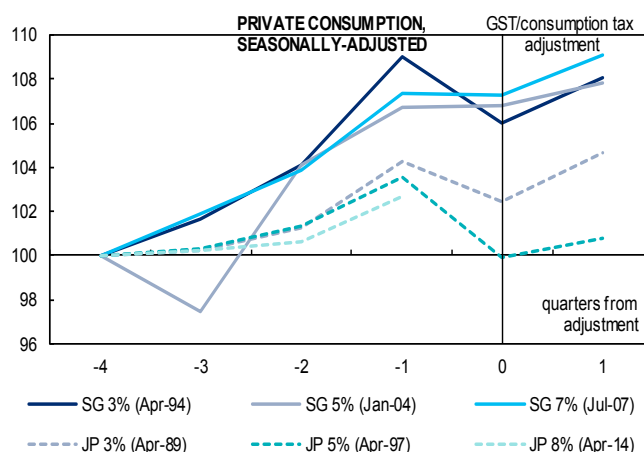
**Our overweight MYR call vs. the rest of ASEAN from Jan has largely played out**, evident in the recent decline in the SGD-MYR rate. Greater confidence over growth prospects, favourable interest differentials, stabilizing CA position (vis-à-vis Indo) should continue to support MYR in our view. Rising FX deposits suggests that the improving CA surplus may result in pent-up MYR demand if sentiment on the USD reverses. BNM intervention also suggests preference for a stronger MYR, perhaps to tighten monetary conditions and aid economic restructuring amid broader cost normalization pressures. Key risk to our view is unwinding of heavy foreign positioning in MGS and especially BNM bills – potential triggers for a sharp unwinding could come from [1] front-loaded expectations of Fed hikes, [2] disappointing CA surplus data, and [3] a more muted-than-expected BNM rate hiking cycle.

Figure 74. Leading index is in negative territory



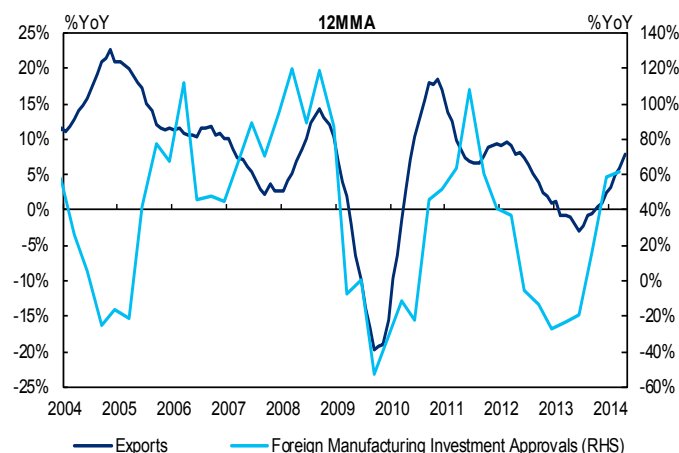
Source: CEIC, Citi Research

Figure 75. GST implementation could spur front loaded spending



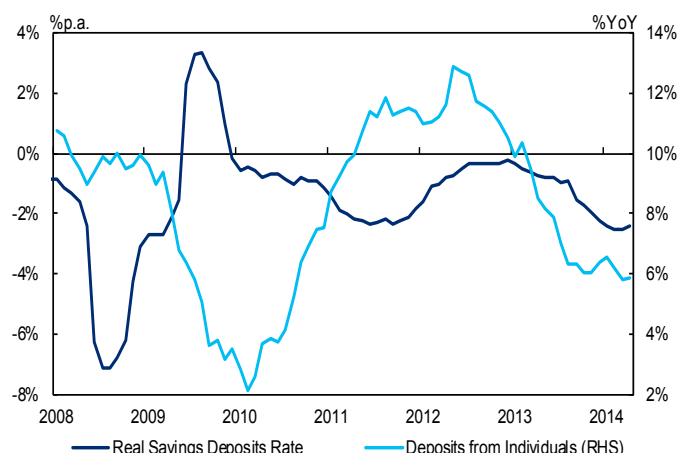
Source: CEIC, Citi Research

Figure 76. Export recovery should support the investment cycle



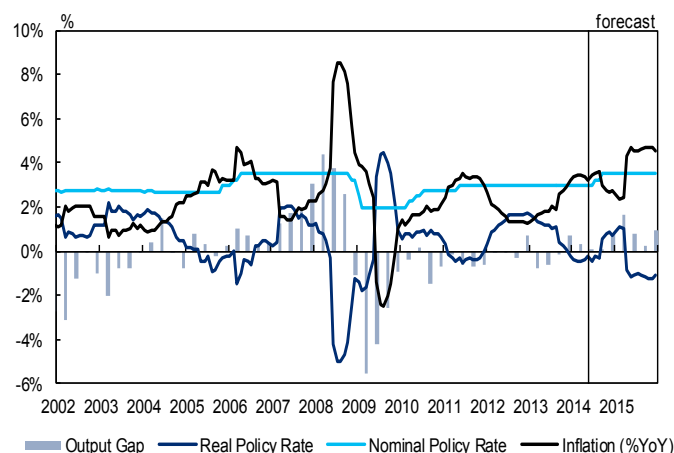
Source: CEIC, Citi Research

Figure 77. Deposit growth has slowed since 2012



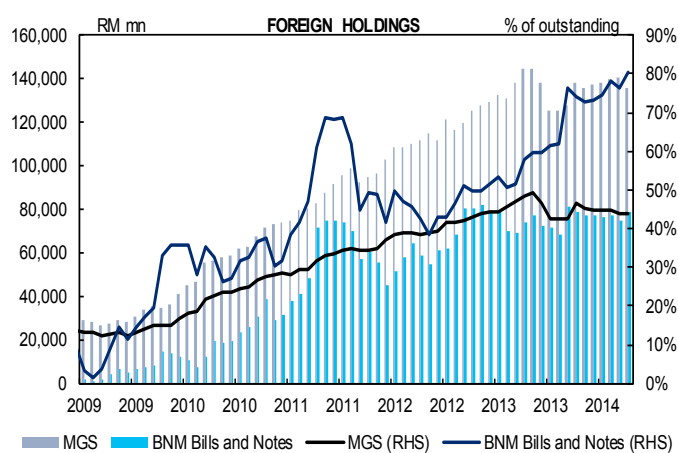
Source: CEIC, Citi Research

Figure 78. Real policy rates would likely remain negative post GST



Source: CEIC, Citi Research

Figure 79. Heavy foreign positioning in MGS, BNM bills a key MYR risk



Source: CEIC, Citi Research

Figure 80. Malaysia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	193.7	231.1	202.4	247.7	289.5	305.3	313.3	320.1	333.6
Nominal GDP, local currency bn	665	770	713	797	885	942	987	1,063	1,131
GDP per capita, US\$	7,123	8,393	7,255	8,664	9,997	10,405	10,544	10,495	10,763
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
<b>Economic Activity</b>									
Real GDP, % yoy	6.3	4.8	-1.5	7.4	5.2	5.6	4.7	5.4	5.6
Real investment growth % yoy	9.1	1.8	-9.4	25.3	2.3	22.3	7.2	-0.9	2.7
Real consumption growth % yoy	9.7	8.4	1.4	6.2	8.6	7.1	7.3	6.4	5.6
private consumption growth % yoy	10.4	8.7	0.6	6.9	6.8	7.7	7.6	6.9	6.3
Real export growth, % yoy	3.8	1.6	-10.9	11.1	4.6	-0.1	-0.3	6.0	7.1
Real import growth, % yoy	5.9	2.3	-12.7	15.6	6.1	4.7	1.9	4.5	6.3
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	2.3	4.5	1.0	2.1	3.0	1.2	3.2	2.7	4.6
CPI, % avg	2.0	5.4	0.6	1.7	3.2	1.6	2.1	3.2	4.0
Nominal wages, % yoy	4.3	4.5	2.5	8.2	3.8	6.4	7.8	5.0	5.0
Credit extension to private sector, % yoy	9.2	10.2	6.8	10.6	12.5	12.1	11.0	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	3.31	3.36
lc/US\$, avg	3.44	3.33	3.52	3.22	3.06	3.09	3.15	3.27	3.35
<b>Balance of Payments, US\$ bn</b>									
Current account	29.7	39.4	31.4	27.1	33.5	17.6	12.7	14.1	13.3
% of GDP	15.4	17.1	15.5	10.9	11.6	5.8	4.0	4.4	4.0
Trade balance	38.1	51.1	39.8	42.5	49.6	40.6	34.4	34.0	35.0
Exports	176.5	198.9	157.0	199.2	228.8	222.3	215.6	257.4	265.0
Imports	138.5	147.7	117.1	156.7	179.2	181.8	181.3	223.4	230.0
Service balance	0.4	0.5	1.2	-0.4	-2.1	-5.3	-5.3	-3.8	-3.0
Income balance	-8.7	-12.2	-9.6	-15.0	-14.0	-17.7	-16.4	-16.1	-18.7
FDI, net	-2.7	-7.8	-6.3	-4.3	-3.1	-7.9	-1.7	-3.0	-1.0
International reserves	101.3	91.5	96.7	106.5	133.6	139.7	134.9	135.0	140.0
Total Amortisations	7.8	6.3	9.8	11.3	9.0	7.4	10.0	11.0	12.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-3.9	-3.5	-3.0
Consolidated gov primary balance	-1.2	-3.0	-4.7	-3.5	-2.8	-2.4	-1.8	-1.3	-0.9
Public debt	40.1	39.8	50.8	51.1	51.5	53.3	54.7	55.0	55.0
of which Domestic	37.1	37.2	48.9	49.0	49.5	51.5	53.0	53.5	53.5
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	56.2	66.6	68.3	72.6	81.5	82.8	97.9	97.0	96.0
Private	37.8	41.5	41.9	44.7	53.7	55.6	69.2	67.0	67.0
Public	18.4	25.2	26.3	27.9	27.8	27.1	28.7	30.0	29.0
External debt / GDP	29.0	28.8	33.7	29.3	28.1	27.1	31.2	30.3	28.8
External debt / XGS	27.4	29.0	36.9	31.4	30.7	31.8	38.3	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
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	5.1	6.2	5.3	5.7	4.5	6.4	5.8	5.1	5.2
CPI, % yoy	3.2	3.5	3.4	2.9	2.7	2.4	4.6	4.7	4.6
Policy interest rate, % eop	3.00	3.00	3.00	3.50	3.50	3.50	3.50	3.50	3.50
Short-term market rate, % eop	3.32	3.33	3.31	3.80	3.80	3.80	3.80	3.80	3.80
Long term yield, % eop	3.53	3.65	3.80	3.90	4.00	4.10	4.10	4.00	4.00
lc vs USD, eop	3.28	3.26	3.23	3.27	3.31	3.34	3.35	3.35	3.36

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

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

## Philippines

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- **Summary view** – We maintain our GDP growth forecast of 6.7%YoY despite start of the rate tightening cycle. We believe the strong macro backdrop would stay resilient against rate tightening on the back of a strong investment trend, subdued impact of rate hikes on spending and long transmission effects.
- **Things to watch** – Moody's rating action (or inaction) in 3Q. As BSP pauses on bank reserve hikes, prospects for SDA rate adjustments and differential against the policy rate should drive near-term market sentiment. Uptrend of CPI and its peak in 3Q14 would be keenly watched. More PPP project awards anticipated.
- **Strategy** – Strong macro, upbeat credit rating outlook and rate hikes could sustain sub-44 for PHP in the near-term with the risk of a strong USD episode driving PHP to 44-45. Likelihood of more rate adjustments in 2H strengthen appeal of short-duration bonds although long bonds starting to offer better value.

### Rate tightening cycle begins but not a threat to growth

**Despite 1Q GDP growth easing to 5.7%YoY, the rate tightening cycle has begun with the recent SDA rate hike of 25bp to 2.25%.** The SDA hike complemented the cumulative bank reserve hike of 200bp since Mar. All these were meant to address excess liquidity morphing into strong bank lending that could fan inflation pressures following a CPI outturn of 4.5%YoY in May (vs 4.1%YoY in Jan).

**Will rate tightening curb potential of higher GDP growth?** We don't believe the rate tightening process poses a risk to growth. Our sanguine view of a macro backdrop that can withstand rate hikes rests primarily on the quality of 1Q growth that remains favorable as indicated by a real investments ex-inventory contributing 24% of GDP – a recent high. Key drivers of real investments, particularly construction and capital expenditures are rising incomes that support strong demand, outstanding supply deficiencies, e.g. housing demand backlog, tightening capacity, strong public investments, and competitive appeal to supply-chain FDI. Awarding of big ticket PPP projects also enhanced the investment outlook. The Apr labor survey reported manufacturing and construction jobs >100K attributed to higher investments, in our view, and supported a national jobless rate easing to 7%.

**Unlike the income variable, rising interest rates on average has subdued impact on domestic spending.** In a regression equation, we find that domestic demand ex-inventory that includes consumption and investments react strongly to net real GDP (net of taxes) rather than to our policy intervention rate measure (PIR - blended SDA and O/N policy rate). For a 1% increase in net real GDP, we obtain a 0.7% increase in domestic demand ex-inventory. A 1% increase in the PIR reduces domestic spending by 0.001%. Other variables like the change in real money supply (liquidity/credit variable) and inflation expectations were not statistically significant compared to the income and interest rate indicators.

**Negative real interest rate condition conducive to spending may take time to dissipate.** Inflation expectations (IE) continue to exceed nominal short-term rates to sustain negative real rates. A 1% rise in negative real rate would lower real bank loans by a modest 0.0007%. More policy rates adjustments would be needed to restore real rates and a meaningful impact may take time. In the BSP's 2Q consumer survey, IE eased to 6.1% (down from 8.4% in the 1Q survey) while consensus inflation forecasts remain in the 4% range. Upbeat consumer and business sentiment accompanied higher inflation and interest rate outlook although percentages of respondents expressing an elevated outlook may not be as high.

## 1Q current account surplus intact despite hefty BOP gap

**Current account surplus (CAS) of US\$2bn in 1Q14 (3.1% of 1Q GDP) held firm despite a hefty BOP deficit of US\$4.5bn.** The 1Q trade deficit of US\$4bn was offset by net receipts of US\$5bn in the secondary income accounts (+8.6% YoY), largely due to strong OFW remittance flows. The CAS however failed to cushion net outflows from the financial accounts. Net outflows were concentrated in portfolio (-US\$2bn) and other investments that coincided with the initiation of the Fed's QE tapering. Portfolio net outflows amounted to US\$2bn (vs net inflows of US\$783mn in 1Q13) with the national government's net redemption/repayment of US\$2.3bn of its short- and long-term bonds held by non-residents as the key contributor. We are keeping our 2014 forecast of a CAS of US\$9.9bn (~3.5% of 2014 GDP) since our 1Q current account surplus forecast (US\$2.1bn) was in line with the actual, which implies a quarterly path to a full year surplus of 3.5% still intact. Downside risk governs our 2014 CAS outlook largely due to the lackluster export trend based on our updated monthly extrapolation of Customs trade data.

**With the CAS buffer, any episode of strong USD and portfolio net outflows need not require higher interest rates in response.** We see less severe pressure on official reserves since its 'coverage' would be limited to net financial outflows. CAS condition would also free up monetary policy to focus on liquidity/inflation risk objectives as demonstrated by recent start of the local rate tightening cycle.

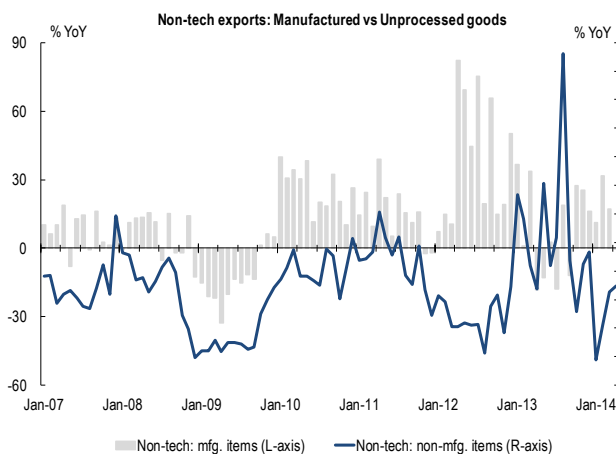
## Rate tightening cycle initiated with SDA hike

**According to BSP, the SDA rate hike of 25bp was meant to 'counter risks to price and financial stability** that could emanate from ample liquidity, noting that a modest upward adjustment in interest rates would be prudent amid robust credit growth'. Excess liquidity risk, which we flagged in our pre-MB meeting update, appears to be in the driver's seat of the rate tightening process. The SDA rate may now be the preferred instrument in restraining liquidity instead of higher bank reserves, with the reserve ratio intact at 20%. Keeping the policy rate at 3.5% implies upside inflation risk driven by elevated food prices still lack price 'contagion risk' since the pace of core CPI continues to lag food-driven headline inflation. MB also noted the future inflation path is likely to stay within target over the policy horizon as BSP's baseline CPI trajectory had been adjusted for a 'higher inflation outturn in May' and the inclusion of the potential impact of El Nino on food and utility prices'. The SDA hike nudged PIR to 2.52% in June from 2.27% in Jan. PIR's modest adjustment reflects initial phase of rate tightening but with a clear policy bias to operationally narrow the gap with the O/N by hiking SDA after the reserve hikes. Another 25bp SDA rate hike to 2.5% against an unchanged policy rate in July, would elevate PIR to 2.65% and result in a narrower rate gap of 100bp prior to potential simultaneous hikes of the SDA and O/N rate in 4Q14.

## PHP's 44-45 range intact with CAS and rate adjustments

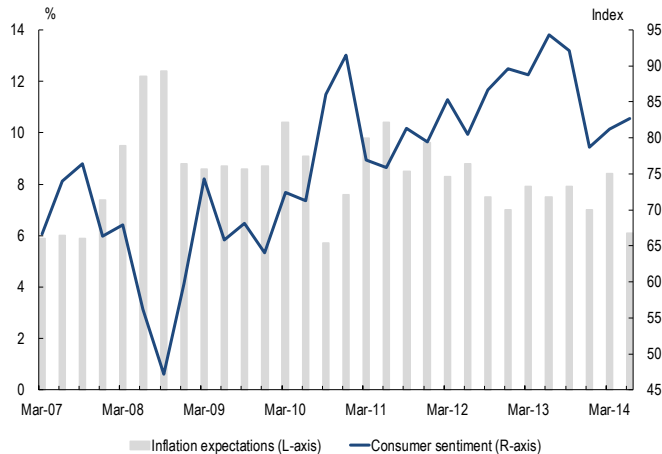
**Recent BOP surplus in May >US\$300mn suggests CAS intact and waning pressures on net financial outflows.** Coupled with an upbeat ratings outlook and rate tightening cycle, PHP's range of 43.50-44 may be the near-term outlook with BSP deterring further appreciation. Over 6-12 mos, we expect strong macro factors, including rate adjustments, would conspire to mitigate effects of a strong USD for a PHP range of 44-45. Coincident with peakish inflation, we expect a policy rate hike of 25bp hike in 4Q14 and in 1Q15 while the policy-SDA differential of 100bp is likely maintained. Likelihood of more rate hikes in 2H14 strengthens appeal of short-duration tenors although the long bonds are starting to look to offer better value with the tightening process underway.

Figure 81. Non-tech exports didn't fare well in Apr



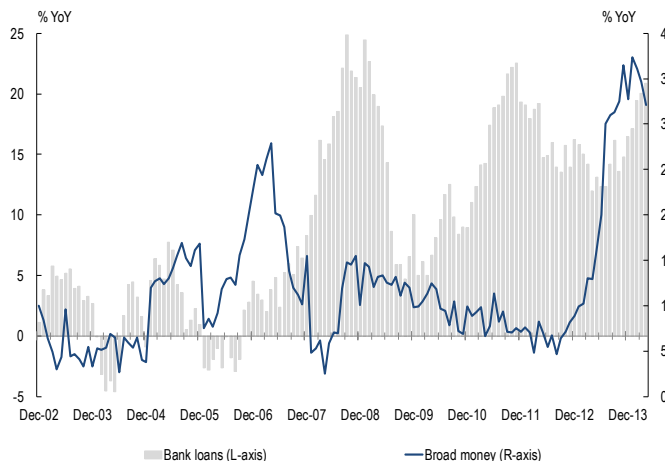
Source: CEIC, Citi Research

Figure 82. Consumer sentiment improves as inflation expectations ease



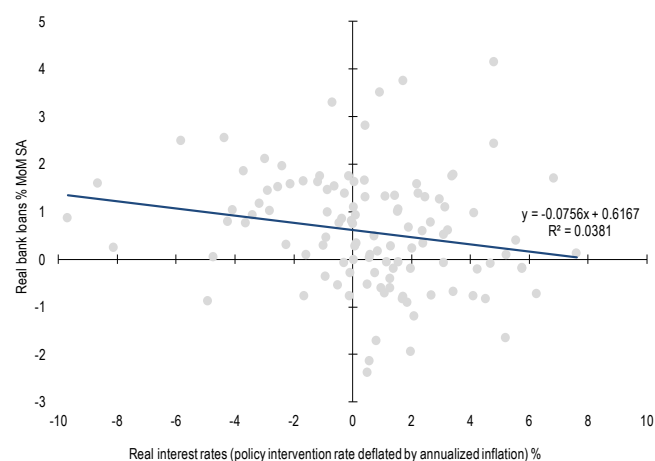
Source: CEIC, Citi Research

Figure 83. Excess liquidity gains vs 'excess' bank loan growth



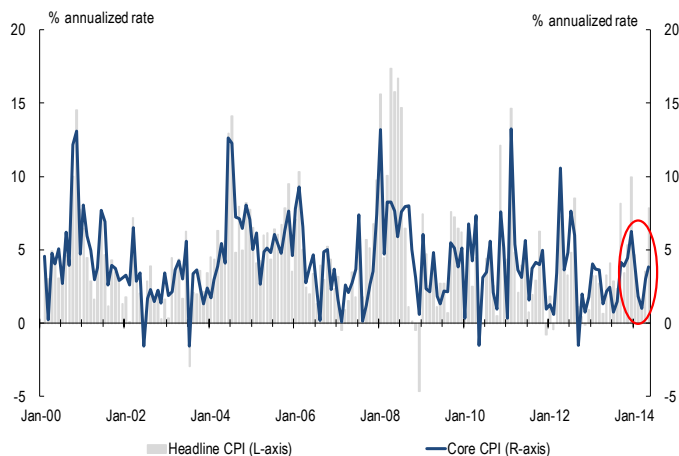
Source: CEIC, Citi Research

Figure 84. Modest impact on real bank loan growth from “-ve” real rates



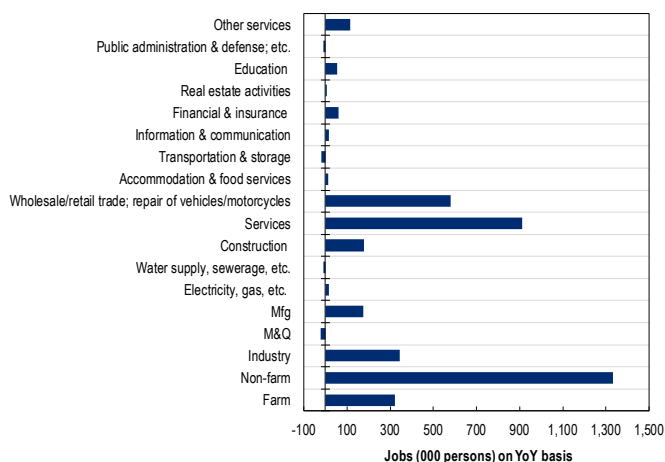
Source: CEIC, Citi Research

Figure 85. May headline CPI rose to 7.8% (annualized) vs 3.8% for core



Source: CEIC, Citi Research

Figure 86. Lower jobless rate in Apr on strong nonfarm job creation



Source: CEIC, Citi Research

Figure 87. Philippines Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	150.2	173.4	168.6	200.0	224.1	250.6	271.9	281.3	320.5
Nominal GDP, local currency bn	6,893	7,721	8,026	9,003	9,708	10,567	11,548	12,864	14,221
GDP per capita, US\$	1,693	1,917	1,829	2,127	2,339	2,568	2,736	2,779	3,108
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
<b>Economic Activity</b>									
Real GDP, % yoy	6.6	4.2	1.1	7.6	3.7	6.8	7.2	6.7	7.2
Real investment growth % yoy	-0.5	23.4	-8.7	31.6	2.8	-5.3	29.9	7.7	15.3
Real consumption growth % yoy	4.9	3.3	3.3	3.4	5.1	7.7	5.9	6.2	6.2
private consumption growth % yoy	4.6	3.7	2.3	3.4	5.6	6.6	5.7	6.0	6.2
Real export growth, % yoy	6.7	-2.7	-7.8	21.0	-2.5	8.5	-1.1	6.2	4.7
Real import growth, % yoy	1.7	1.6	-8.1	22.5	-0.6	4.9	5.4	5.8	6.7
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.9	8.0	4.3	3.6	4.2	3.0	4.1	4.2	3.8
CPI, % avg	2.8	9.3	3.2	4.1	4.7	3.2	2.9	4.4	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	3.75	4.00
Short-term market rate, % eop	6.03	5.20	4.11	0.75	1.68	-1.38	-0.15	2.50	3.50
Long term yield, % eop	5.70	6.55	6.25	4.78	4.21	3.70	2.91	4.25	4.50
lc/US\$, eop	41.23	47.47	46.50	43.65	43.84	41.06	44.39	44.67	43.75
lc/US\$, avg	46.05	44.48	47.56	45.06	43.29	42.22	42.46	44.41	44.35
<b>Balance of Payments, US\$ bn</b>									
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	3.1
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
<b>Public Finances, % of GDP</b>									
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
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
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	21.7	19.8
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
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	6.3	5.7	6.7	6.9	7.4	7.0	7.3	7.5	7.1
CPI, % yoy	4.1	3.9	4.4	4.8	4.2	4.1	4.0	3.9	3.8
Policy interest rate, % eop	3.50	3.50	3.50	3.50	3.75	4.00	4.00	4.00	4.00
Short-term market rate, % eop	-0.15	0.94	1.50	2.25	2.50	2.75	3.00	3.25	3.50
Long term yield, % eop	2.91	3.38	3.75	4.00	4.25	4.50	4.50	4.50	4.50
lc vs USD, eop	44.39	44.76	43.87	44.30	44.67	44.95	44.55	44.15	43.75

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 hoped-for external demand tailwind to growth has stalled, while domestic headwinds from restructuring, a housing downturn, household deleveraging remain formidable. The hurdle for MAS policy changes remains high and we continue to see a slight hawkish bias near term.
- **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** – Movements in the SGD NEER could reflect the tug of war between the MAS's hawkish bias, and trends in the headline CPI inflation, which may result in range trading in the upper half of the policy band. We remain alert for upward pressures on SOR on tighter banking liquidity and eventual Fed hikes.

### External tailwind stalled, domestic headwind formidable

**The hoped-for external tailwinds have yet to strengthen.** Growth accelerated to 5% in recent quarters (from 1-3% in 2011 and 2012), but momentum slowed in 2Q, hit by possible factory relocations and de-stocking, with exports underperforming. The underperformance of NODX is all the more stark considering that the re-export sector – and by extension trade related services – had up till Mar benefited from the upswing in global trade. This reinforces the notion that the weak manufacturing export performance was less a function of weak global demand, but more due to market share losses. Meanwhile the lift from regional trade to re-exports has waned, while other tradables services also weakened. Diminishing sensitivity to G3 demand notwithstanding, there are hopes manufacturing will turn around with a US capex recovery in 2H14, augmented by services exports.

**Domestic labour supply constraints will likely cap the pace of any expansion** even if external demand and exports do recover. Based on the end 2013 numbers, the top and bottom end of the income spectrum of foreign workers bore the brunt of tighter foreign worker policy. While the tightness in the labour market eased marginally in 1Q14, demand for workers far outstrips supply. While seasonally-adjusted job vacancies rose for the third quarter 62.5k (4Q: 60.7K), the ratio of job vacancies to unemployed persons moderated for the first time in two quarters to 1.33 from the record high of 1.43 in 4Q13. Labour constraints are already biting into growth in a visible way – in late May, PM Lee announced the deferment of S\$2bn worth of public construction projects due to the shortage of construction workers.

**Nonetheless consumer spending has been relatively sluggish** despite the tightness in the labour market. Private consumption has slowed to just 2.6% since early 2013, from 4.7% in 2010-2012. We see a few reasons for this, some of which could be more persistent, such that the consumer may still remain fairly subdued in the next 1-2 years: [1] higher home prices hurting discretionary spending, which may not reverse with falling home prices, as asset based borrowing has risen; [2] tighter credit conditions and the prospect of higher debt servicing burdens; [3] negative/low real wage growth in 2012 and 2013, though this is now reversing with disinflation; [4] reduced supply of COEs, though likely to reverse; and [5] domestic retail sales have been further hurt by the strong SGD, which has slowed tourism demand and diverted resident demand overseas.



## Housing on track for a soft landing, but risks remain

**So far, the decline in home prices has been relatively gradual** compared to past property down cycles. We think the main reason for this relatively slow slide in house prices is that the present housing down cycle is not accompanied by a macro shock to employment which impairs mortgage servicing capacity and leads to forced sales, with the tight labour market and low interest rate environment also providing some support to buyer sentiment. Good sales response to price cuts – monthly data shows that developers' sales of private homes nearly doubled in May as lower new launch prices appealed to more price sensitive buyers – points to pent-up demand, persistence of the slow slide in home prices, and smaller impact on GDP growth near term. This makes it less likely that property policies will be eased in 2014 – more likely closer to elections in 2015, when prices should have fallen sufficiently to improve home affordability (helped as well by rising income), yet not enough to bring buyers at the peak into negative equity. But policy relaxation may not fully arrest price declines, given the drag of higher supply on rental yields, which may not offset higher mortgage servicing burdens and may still induce selling amongst cash-strapped holders.

## Restructuring takes its toll

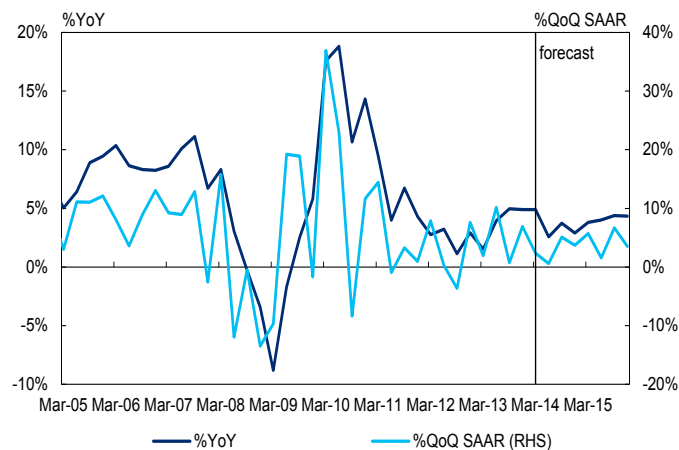
**The restructuring is taking its toll on growth and SME financial health.** Export underperformance, a recession in machinery and equipment investments, shelving of S\$2bn of public projects to ease labour shortage are all evidence of restructuring's toll on growth. At the firm level, this will likely translate into more pockets of financial stress, evident in delayed payment promptness by SMEs, higher companies liquidations. Redundancies have been edging up since 2011, but within the context of a tight labour market on aggregate, those made redundant due to restructuring have been able to find jobs fairly quickly, though whether this persists remains to be seen

## High hurdle for changes in MAS policy

**Rising core inflation imputes slight hawkish bias despite headline disinflation.** Within the context of a tight labour market, core inflation will likely continue on a steady uptrend, and plateau around 2-2.5% in 2H14 as the positive output gap gives companies more pricing power to pass through pent-up cost pressures and restore profit margins, especially in labour intensive services sectors. Nonetheless we do not see a runaway trend in core inflation beyond the initial pass through of pent-up cost pressures and we suspect that core inflation may plateau close to 2.5% around 2H14, before moderating to under 2% by 2H15. Outside of core, car prices and imputed rents should see disinflationary trends such that headline inflation should fall below 2% by Jul 2014, to reach the lower end of the MAS's 1.5-2.5% forecast for 2014, possibly staying below 1.5% through 2015.

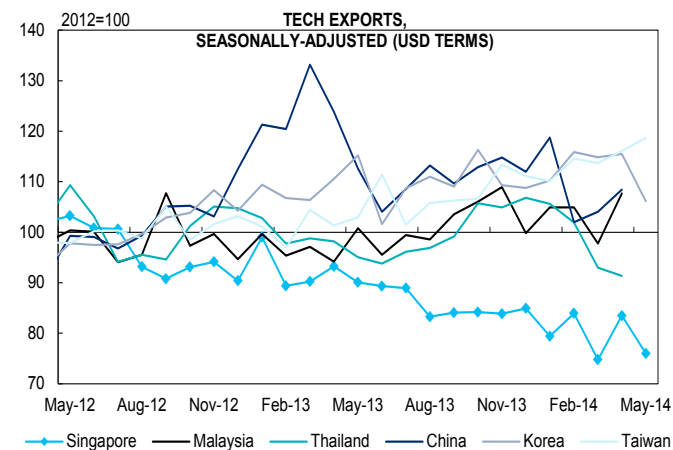
**The hurdle for MAS policy changes remains high, in our view.** With the job market still tight, output gap positive, and the MAS still expecting a “modest growth trajectory”, we continue to see a slight hawkish bias near term on the risk of core inflation breaching the 2-2.5% tolerance threshold, which alongside headline disinflation may imply range trading in the upper half of the SGD NEER policy band near term. But should growth expectations persistently disappoint, we would watch for potential knock-on effects on the jobs market and core inflation as a signpost for any shift in policy bias.

Figure 88. Composite Leading indicator fell into sequential decline



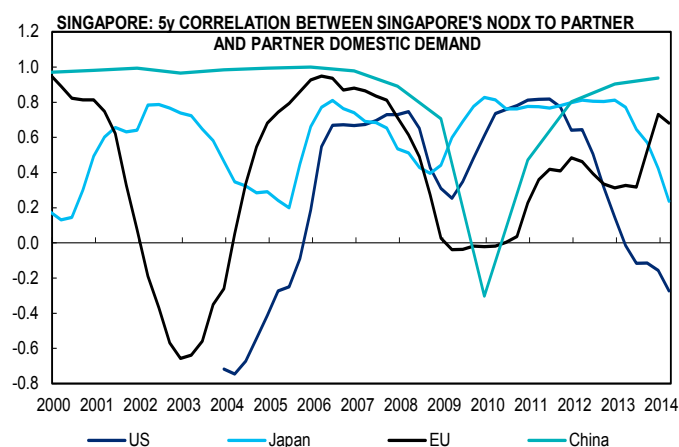
Source: CEIC, Citi Research

Figure 89. Singapore's tech exports have underperformed the region



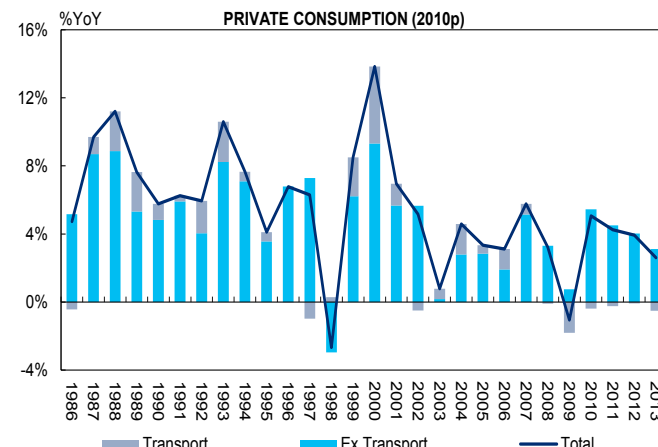
Source: CEIC, Citi Research

Figure 90. Declining linkage between G3 domestic demand and NODX



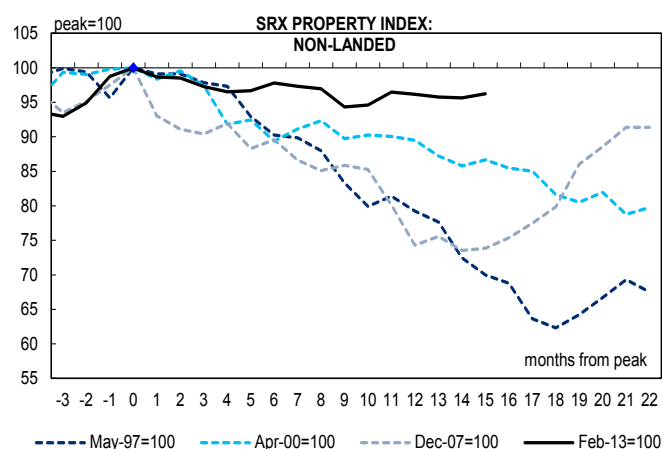
Source: CEIC, Citi Research

Figure 91. Private consumption has slowed



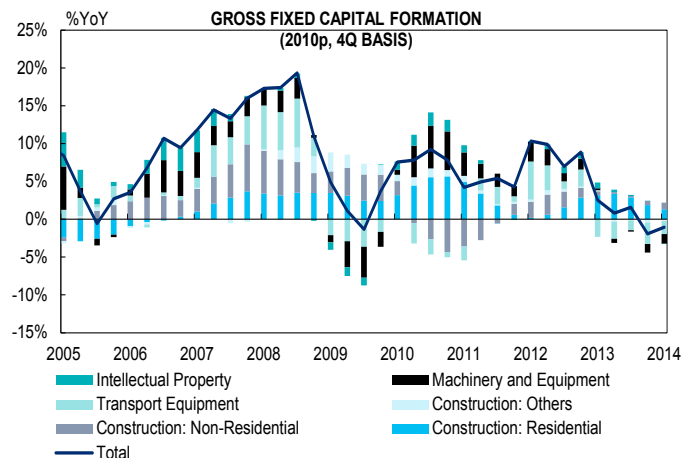
Source: CEIC, Citi Research

Figure 92. House price declines have been modest vs past down cycles



Source: Haver, Citi Research

Figure 93 Machinery, and transport equipment capex in recession



Source: CEIC, Citi Research

Figure 94. Singapore Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	180.3	192.5	193.0	236.9	274.3	287.2	298.0	342.1	370.3
Nominal GDP, local currency mn	271	272	280	322	345	359	373	431	467
GDP per capita, US\$	39,287	39,772	38,694	46,671	52,908	54,058	55,199	62,194	66,122
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
<b>Economic Activity</b>									
Real GDP, % yoy	9.1	1.8	-0.6	15.2	6.1	2.5	3.9	3.5	4.1
Real investment growth % yoy	12.1	29.6	-11.3	24.4	4.3	14.9	-2.2	3.1	0.9
Real consumption growth % yoy	5.4	4.0	0.0	6.9	3.1	3.1	4.1	0.4	0.2
private consumption growth % yoy	6.1	3.5	-1.1	5.9	4.3	3.9	2.6	2.5	0.8
Real export growth, % yoy	8.6	4.6	-7.5	17.4	4.6	1.5	3.6	4.4	3.9
Real import growth, % yoy	7.4	10.0	-10.4	16.2	3.2	3.1	3.1	3.7	2.3
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.7	5.5	-0.5	4.6	5.5	4.3	1.5	0.9	0.9
CPI, % avg	2.1	6.6	0.6	2.8	5.2	4.6	2.4	1.4	1.1
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	16.6	14.8	3.1	13.6	19.9	13.9	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	1.26	1.26
lc/US\$, avg	1.51	1.41	1.45	1.36	1.26	1.25	1.25	1.26	1.26
<b>Balance of Payments, US\$ bn</b>									
Current account	46.8	27.7	32.4	56.0	62.6	50.2	54.6	61.6	66.7
% of GDP	25.9	14.4	16.8	23.6	22.8	17.5	18.3	18.0	18.0
Trade balance	57.8	41.6	47.6	62.9	69.6	63.5	67.8	65.0	65.0
Exports	312.4	352.9	287.4	370.5	432.0	434.5	437.7	455.0	462.0
Imports	254.6	311.3	239.8	307.6	362.5	371.0	369.9	390.0	397.0
Service balance	-2.3	-1.5	-2.3	-0.4	2.8	0.9	0.8	1.0	2.0
Income balance	-8.7	-12.4	-12.9	-6.5	-9.8	-14.2	-14.0	-4.4	-0.3
FDI, net	10.8	5.4	-2.4	21.7	26.9	47.7	36.8	32.0	32.0
International reserves	163.0	174.2	187.8	225.8	237.7	259.3	273.1	280.0	290.0
Total Amortisations	--	--	--	--	--	--	--	--	--
<b>Public Finances, % of GDP</b>									
Consolidated government balance	2.8	0.1	-0.3	0.3	1.2	1.7	1.1	-0.3	0.2
Consolidated gov primary balance	2.7	1.1	-0.8	0.2	1.3	2.0	1.3	0.7	0.5
Public debt	86.3	93.9	104.2	99.6	102.7	107.4	104.7	110.0	110.0
of which Domestic	86.3	93.9	104.2	99.6	102.7	107.4	104.7	110.0	110.0
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	4.9	4.9	2.6	3.7	2.9	3.8	4.0	4.4	4.3
CPI, % yoy	1.5	1.2	2.1	1.1	0.9	0.9	0.9	1.3	1.5
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.40	0.41	0.40	0.40	0.40	0.45	0.50	0.60	0.80
Long term yield, % eop	2.56	2.49	2.75	2.90	3.00	3.00	3.10	3.20	3.20
lc vs USD, eop	1.26	1.26	1.25	1.26	1.26	1.26	1.26	1.26	1.26

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** – Subdued economic sentiment after the ferry sinking accident began to appear on domestic demand data. However, we think the contraction will be temporary and the recovery pace remains to attain economic growth of 3.9% in 2014. Meanwhile, sluggish exports in May seem to rebound in Jun.
- **Things to watch** – Slowdown in home sales transactions and concerns over economic recovery will likely lead to pro-growth policies, possibly including the relaxation of housing market regulations and supplementary budget.
- **Strategy** – Given that the BoK turned slightly dovish on sluggish domestic demand, we now expect the policy rate hike cycle to begin in 2Q15, instead of in 1Q15. USDKRW will likely linger around 1,025 before heading down again with the first rate hike.

### Ferry sinking impact kicks in albeit temporary

**Negative impacts of the ferry sinking incident (Apr 16<sup>th</sup>) materialized in Apr readings on service activities and retail sales.** Service production fell by 1.0% from the previous month and YoY growth weakened to 0.9% with sharp declines particularly seen in arts, sports & leisure, accommodation & food service activities, and whole sale & retail sales sectors. Following a rebound in Mar, retail sales shifted to decrease by 1.7%MoM sa and 0.1%YoY as durable goods and semi-durable goods fell. Given that flash estimates of sales performances of department stores and discount stores in May turned to post gains from a year ago, we think the impact of the ferry sinking disaster will be temporary. Yet the accident seems to have weighed on consumer and business sentiment and thus affected the anticipated path of economic recovery.

**IP and exports were weaker than expected while investments look favorable.** Apr industrial production (IP) grew by 0.1%MoM sa and 2.4%YoY, falling short of market expectations. Amid slower growth of production and shipment, inventories in the manufacturing sector further increased. In May, exports was distorted by fewer working days and fell by 1.0%YoY but exports to China (-9.5%) shifting to fall needs to be watched. However, export gains during the first 20 days in Jun (5.9%YoY) suggest a rebound of full-month exports from a fall in May. Favorable readings on equipment investment and its leading indicator, machinery orders received support our view of a rebound in facilities investment in 2Q14.

### More measures likely to sustain housing market recovery

**Housing market transactions and price shifted to decline.** After the government announced a series of measures to advance the local housing rental market in Feb, home sales transactions on a YoY basis slowed in growth and turned to decrease in May. Taxation on landlords' lease income included in the plan, mainly weakened confidence in the housing market and led households to refrain from buying homes. Housing price also shifted to fall sequentially in May. In concern of the housing market falling back into a slump, the government recently decided to adjust the taxation and seems to be considering relaxation of DTI and LTV ratios, abolishment of price ceiling on pre-sales, and easing aggregate income tax. Delay in the drawing up of boosting measures and the passage at the National Assembly are downside risks to private consumption and thus economic recovery.

## Pro-growth policies likely with the new finance minister

**Cabinet reshuffled to win back trust and revive the economy.** In the face of declining approval rating from 64.7% in Mar to below 50% in Jun (Realmeter's poll) and subdued economic sentiment after what was considered to be poor handling of the ferry disaster, president Park announced to replace nearly half of the cabinet members including the finance minister. Considering that the appointed finance minister nominee Kyung-hwan Choi is pro-growth and eager to revive the recovery pace of the economy, we think the odds for introducing stimulative measures on the economy, especially the housing market are high. He already hinted at lifting the DTI and LTV ratios on mortgage loans, and the Financial Services Commission (FSC), which has been conservative about the relaxation due to growing high household debt, may change its stance if Choi takes up the post. On the fiscal front, we think a small amount of a supplementary budget is possible. The government's advanced spending of KRW7.8trn in 2Q14 from 2H14 will likely result in a shortage of fiscal spending and thus growth loss from the government side in the second half. While the incumbent minister Hyun Oh-seok has been criticized for not being able to closely work with economic ministries, we expect the nominated Choi to have better control given his very close relationship with the president.

## BoK turns slightly dovish but we expect no rate cut

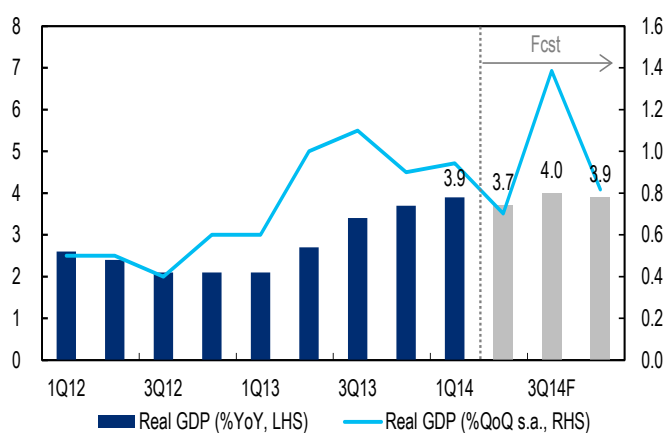
**We push back our timing of the first rate hike to 2Q15 from 1Q15.** Perceiving that domestic demand has slackened after the ferry incident, the MPC left the policy rate at 2.50%, considering the current rate as accommodative. As MPC members are concerned about domestic demand recovery, we think the BoK will lower 2014 economic growth forecast of 4.0% in July when it is scheduled to revise its outlook. We estimate the downward revision, if any, to be around -0.2%p at the most. However, the MPC is seeing the current policy rate low enough to support economic recovery. The BoK governor also maintained his view that the direction of policy rate change would be upward assuming economic recovery would continue amid gradual rise of CPI inflation. We now expect the rate hike cycle to begin in 2Q15, instead of previously expected 1Q15.

**CPI inflation will likely rise gradually.** Continued deflation of agricultural goods and oils, and KRW strength against USD remained as main downside pressures to CPI inflation. However, May headline inflation inched up further to 1.7%YoY on price increases of processed food and livestock products. We expect low base of a year ago and public tariff hikes likely in 2H14 to keep the uptrend of inflation going forward. Local governments after the local elections are reviewing lifting prices of city gas, water & sewage disposal charges, and public transportation fees. Yet we expect CPI inflation to rise gradually to around 3% by the year-end.

## USDKRW to move within a narrow range

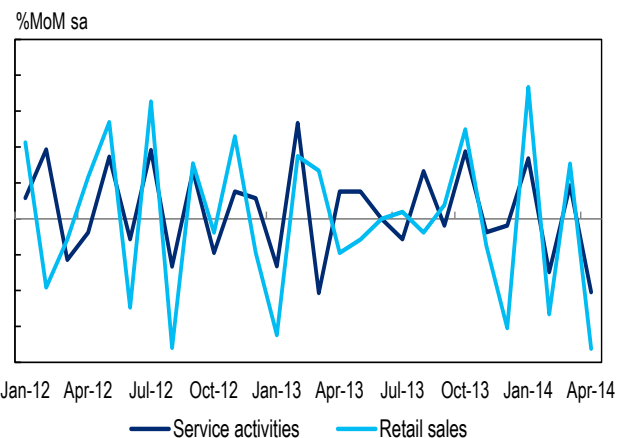
**Large trade surplus and foreign fund inflows continue to support KRW.** Despite verbal intervention by the FX authorities, KRW further appreciated against USD to reach 1,015.7 on Jun 11<sup>th</sup>, the lowest since in Aug 2008. Exporters' dollar selling and foreign fund inflows to local securities market continue to support KRW strength. During the first 20 days of Jun, foreigners net purchased US\$468.5mn of local stocks and US\$4.0bn of MSBs and KTBs. Given that USDKRW is already lower than the breakeven points for exporting firms, authorities are unlikely to allow sharp appreciation of KRW in order to secure export recovery. We expect USDKRW to range trade near 1,025 before falling with the start of the rate hike cycle in 2Q15.

Figure 95. Economic growth likely to have slowed in 2Q14



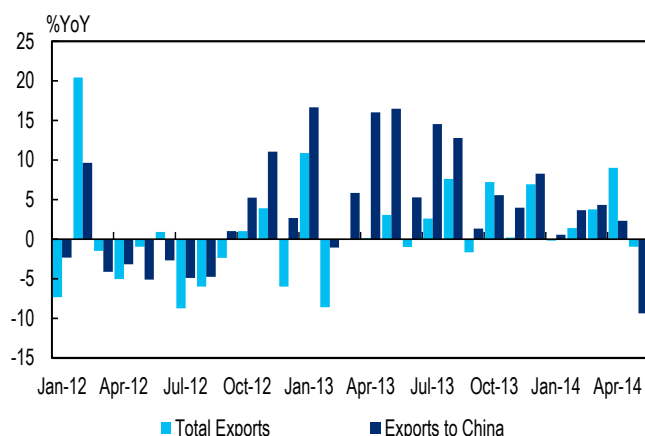
Source: Bank of Korea, Citi Research

Figure 96. Services activities / retail sales fell on ferry sinking impact



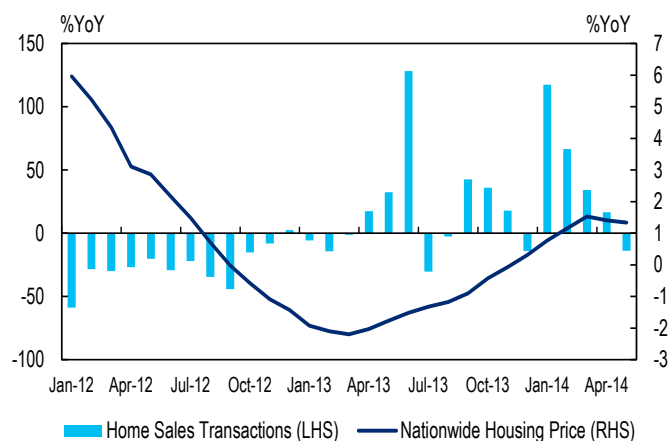
Source: Statistics Korea

Figure 97. May exports fell, led by a drop in exports to China



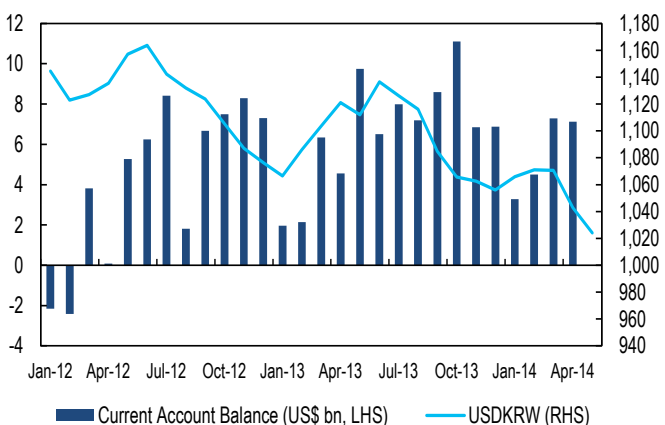
Source: Korea International Trade Association

Figure 98. Home sales transaction and price flagged



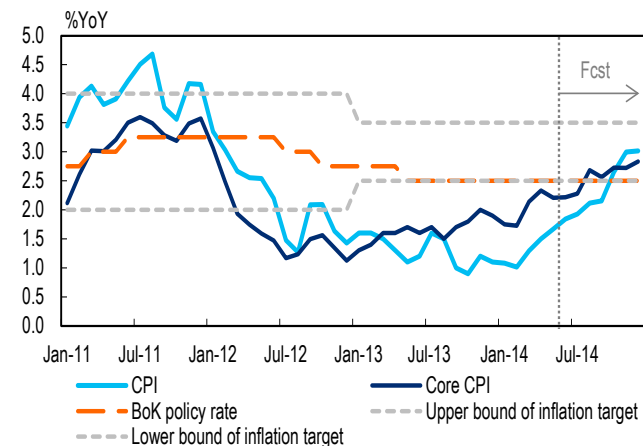
Source: Ministry of Land, Infrastructure and Transport, Korea Appraisal Board

Figure 99. Large current account continued to support KRW strength



Source: Bank of Korea

Figure 100. No rate change likely this year amid gradual rise in inflation



Source: Bank of Korea, Statistics Korea, Citi Research

Figure 101. Korea Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	1,121.3	999.7	902.6	1,094.6	1,202.8	1,222.5	1,304.3	1,466.2	1,607.5
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	1,516,299	1,618,774
GDP per capita, US\$	23,073	20,423	18,352	22,153	24,163	24,448	25,972	29,077	31,758
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
<b>Economic Activity</b>									
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	4.8	5.3
Real consumption growth % yoy	5.3	2.2	1.3	4.3	2.7	2.2	2.2	2.6	3.2
private consumption growth % yoy	5.1	1.4	0.2	4.4	2.9	1.9	2.0	2.6	3.3
Real export growth, % yoy	12.7	7.5	-0.3	12.7	15.1	5.1	4.3	5.6	6.9
Real import growth, % yoy	11.6	3.2	-6.8	17.3	14.3	2.4	1.6	5.4	6.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.6	4.1	2.7	3.1	4.2	1.4	1.1	3.0	2.9
CPI, % avg	2.5	4.7	2.8	3.0	4.0	2.2	1.3	1.9	2.9
Nominal wages, % yoy	5.6	-4.1	2.6	6.8	1.0	5.3	3.9	4.8	5.1
Credit extension to private sector, % yoy	12.5	14.9	5.0	4.0	6.5	3.2	4.7	5.7	7.9
Policy interest rate, % eop	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.50	3.25
Short-term market rate, % eop	5.73	4.68	2.82	2.80	3.55	2.89	2.66	2.65	3.50
Long term yield, % eop	5.78	3.77	4.92	4.08	3.46	2.97	3.23	3.30	3.95
lc/US\$, eop	936	1,263	1,166	1,121	1,159	1,064	1,051	1,025	991
lc/US\$, avg	929	1,102	1,275	1,156	1,108	1,127	1,095	1,034	1,007
<b>Balance of Payments, US\$ bn</b>									
Current account	11.8	3.2	33.6	28.9	18.7	50.8	79.9	69.4	48.9
% of GDP	1.1	0.3	3.7	2.6	1.6	4.2	6.1	4.7	3.0
Trade balance	14.6	-13.3	40.4	41.2	30.8	28.3	44.0	41.2	40.8
Exports	371.5	422.0	363.5	466.4	555.2	547.9	559.6	588.4	641.8
Imports	356.8	435.3	323.1	425.2	524.4	519.6	515.6	547.3	600.9
Service balance	-12.0	-5.7	-6.6	-8.6	-5.8	-5.2	-7.9	-3.7	-4.4
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	377.5	391.5
Total Amortisations	24.5	31.0	30.2	35.7	42.7	43.5	44.3	45.1	46.0
<b>Public Finances, % of GDP</b>									
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
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
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	28.7	26.7
External debt / XGS	75.0	61.9	79.1	65.0	61.3	62.1	61.8	59.1	55.2
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	27.5	27.6
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	3.7	3.9	3.7	4.0	3.9	3.8	4.2	4.0	4.2
CPI, % yoy	1.1	1.3	1.8	2.2	3.0	3.0	3.0	3.0	2.9
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	2.65	2.65	2.65	2.65	2.70	3.00	3.25	3.50
Long term yield, % eop	3.23	3.16	3.00	3.15	3.30	3.35	3.45	3.60	3.95
lc vs USD, eop	1,051	1,065	1,022	1,025	1,025	1,024	1,013	1,002	991

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** – Our call for mild exports recovery in 2014E still holds despite weaker than expected May exports. However ramping up of manufacturing in May previews activities could pick up more noticeably in 2H. Jan-May15 appears the only window for passing the oversight bill plus the ECFA for Services pact.
- **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) 4th nuclear plant referendum; 7) China impacts via exports, financials, RMB and geopolitics.
- **Strategy** – Policy rate likely stable till 2015; 10Y government bond yields likely on a gradual uptrend despite recent jump in global yields. Recent TWD strength likely to be maintained, on widening trade surplus, gradual economic recovery and expected RMB appreciation. Our house view on TAIEX is raised to 10,000

### 2H outlook: Gradual tech led recovery

**We expect 2H14 GDP to improve to 3.5%YoY from 1H14 forecast of 2.9%YoY.** Markit PMI remains in expansion zone for the third consecutive month at 56.2, while April Business Indicators compiled by the National Development Council also indicate that recovery is underway – especially with the composite leading index at 104.9 (+0.31% from previous month) and the overall monitoring indicator flashed the “green” signal for the third consecutive month.

**Our call for mild exports recovery in 2H14E still holds.** Although both May exports (+1.4%YoY) and export orders (+4.7%YoY) came in softer than expected, both appear, nonetheless, on a bumpy but recovering trend. These, coupled with the latest release in May industrial production data (which beat expectations) of 5.2%YoY, support our view that pace of improvements should pick up in 2H. We believe there could be further improvements in coming months given mass production of iPhone6 models likely to start in July, and downstream component suppliers in TW will be ramping up production. Other Apple and Mainland brand names smart device launches that are targeting the 2H festive demand would also stir up trade and manufacturing activities. Our equity strategist also recently raised TWSE index target from 9,200 on '[A Tech-Led Charge to 10,000](#)'.

**Consumption recovery will likely steadily push forward in 2H.** Retail sales grew above 4%YoY for three consecutive months up till May, while unemployment rate (a lagging indicator) also improved by 5bps in May to 3.99%sa. It is interesting that auto sales recorded double digit YoY growth every month since Nov13 (except for the CNY distorted Jan), suggesting that pent up demand is there and there is room for consumers to turn from very selective to more broad based if we can also see activities increasing wages moderately (note regular earnings on a 3MMA remain steady at 1.3-1.4%YoY for the past 8 months up to Apr14).

**The CBC likely to stay pat until early 2015 before hiking rates,** as we think, on the back of benign inflation outlook, CBC has more room to keep its maximum accommodation to foster more meaningful recovery in 2H14. The gradual Fed exit stance, most Asian central bank peers keeping policy rates unchanged also suggest that there is no urgency for CBC to hike either. Hiking rates could also further encourage recent TWD strength, and CBC is likely to prefer to foster meaningful exports recovery as opposed to current weak imports-led type of trade surplus widening. We believe Fed steady tapering and Taiwan's gradual recovery will slowly edge up 10Y government bond yields going forward, to 1.66% by year end.



**TWD likely to stay at 30.0/USD in the next 12 months; We maintain our long term forecast at 29.8/USD.** Our house view of near term RMB to restart appreciation will likely steady the TWD at the physiological level of 30/USD. Also, TWD appears well supported by foreign inflows into its stock market and trade surplus widening. As of May, trade surplus widening appears to be led by drop in imports, but we expect more visible export improvements in 2H.

### **Political window for x-strait deals pushed to Jan-May15**

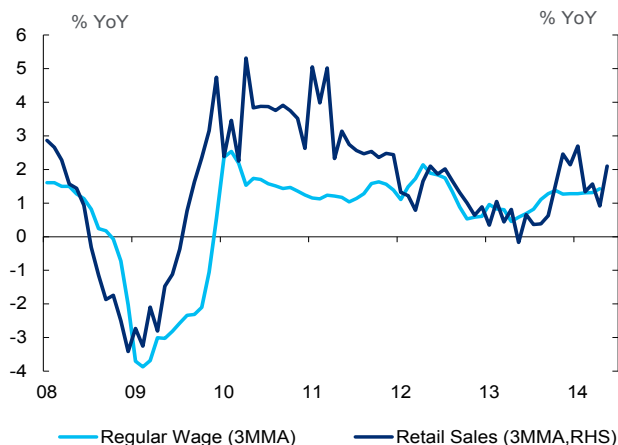
**The oversight bill is unlikely to be ready before local 7-in-1 elections in Dec-2014.** During the heat of the student 'Sunflower' protests against the ECFA for Services in mid-March, we argued that the pact is unlikely to be passed before year-end (See pg. 49 of [Asia Macro and Strategy Outlook - Hawkish Fed, China Risks – Old Issues, New Twist](#)). We now think it will also be difficult for the oversight bill for all cross-strait negotiations to be passed this summer Legislative Yuan (LY) session. The progress in drafting the bill has been noticeably slow, suggesting that both the Green and Blue political camps may now be waiting until after the year-end local election results to determine whether voters would support a more aggressive or a more restrictive approach to cross-strait negotiations.

**We see a tight 5-month window between Jan to May 2015 for a potential swift passing of the oversight bill plus the ECFA for Services pact.** However, several stars need to align for this to happen. [1] The current three term KMT Taichung City mayor, Jason Hu, will have to beat his popular DPP opponent, Lin Chia-lung. Taichung is the interface between the industrial and pro-KMT north and the agricultural, pro-DPP south. Agricultural imports from China, as a component of the cross-strait negotiations, are a hot button for the south of the island. [2] KMT needs to garner 50% control in local elections. [3] If KMT dominates by satisfying the first two criteria, we believe LY President Wang Jin-pyng would most likely support President Ma's policies. Wang is in general more pro-business and thus may choose to overcome his personal conflict with Ma to help get the oversight legislation and services agreement passed. Having said the above, we would like to point out that the window is a slim one, given that there will be the LY elections (likely in Jan-2016) and presidential election in Mar-2016. Based on historical experience, the presidential election campaign should begin heating up in May of 2015 and controversial cross strait bills will likely be put on hold again.

**We need to monitor two other local elections (New Taipei City and Taipei City) for their national implications.** Low poll ratings for President Ma are opening up an opportunity for a new generation of leaders to emerge within the KMT. The election results of these two cities will impact the success of these new leaders' ability to gain national office and KMT party influence. New Taipei City mayor Eric Chu has just declared that he will run for a re-election as mayor. Chu said he intends to stay for his full term as mayor, but many are wondering if this is only political talk as he remains one of the most likely KMT candidates to run for President in 2016. KMT candidate Sean Lien is perceived to be a political ally of Eric Chu and a counterweight to KMT Chairman and Taiwan President Ma. With Ma's lagging political popularity, these two individuals could come to the fore and reinvigorate support for improving cross-strait relations. Thus, the extent of Lien's electoral majority will determine his influence in the party.

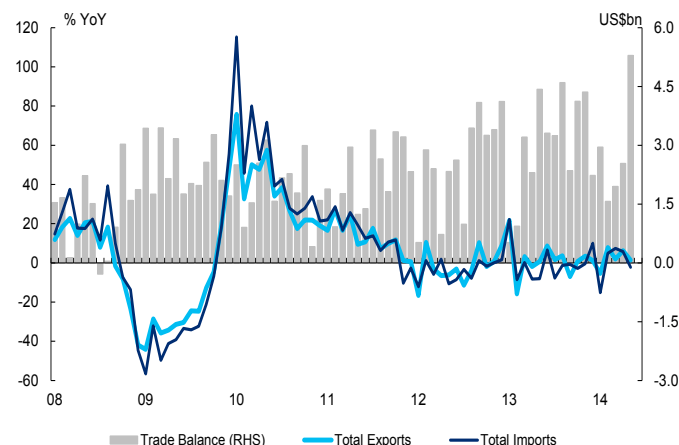
Please also see related report by Peter Kurz, [Taiwan Flavors - Politics: Cross-straits at Cross-roads](#) (23 May 2015).

Figure 102. Consumption improving more meaningfully



Source: CEIC, Citi Research

Figure 103. Gradual trade recovery likely to step up pace in 2H, ...



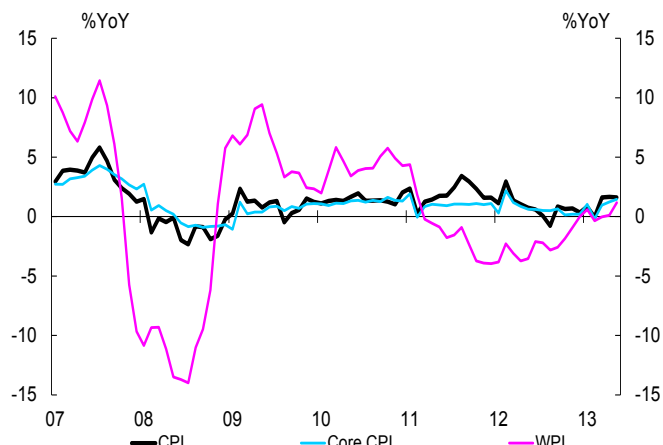
Source: CEIC, Citi Research

Figure 104.... together lifting orders and manufacturing in 2H



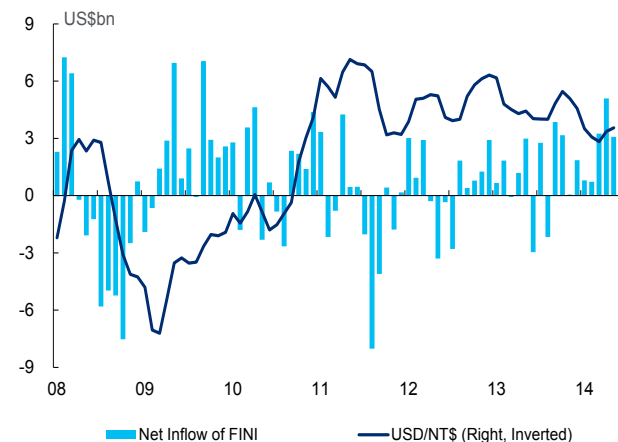
Source: CEIC, Citi Research

Figure 105. Benign inflation gives room for CBC's accommodation



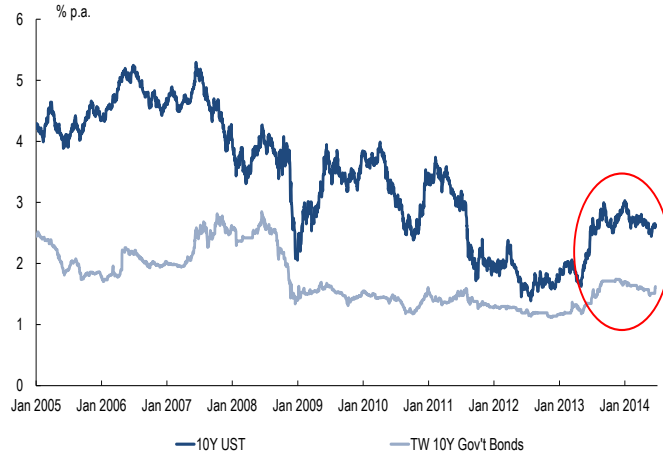
Source: CEIC, Citi Research

Figure 106. FINI inflows continued, pacifying TWD depreciation



Source: CEIC, Citi Research

Figure 107. 10Y govt bonds could rise again with US tapering



Source: CEIC, Citi Research

Figure 108. Taiwan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	393.0	400.2	378.0	430.3	466.5	476.3	490.8	500.7	536.2
Nominal GDP, local currency bn	12,911	12,620	12,481	13,552	13,709	14,077	14,564	15,207	16,082
GDP per capita, US\$	17,118	17,370	16,348	18,579	20,084	20,429	20,996	21,378	22,849
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
<b>Economic Activity</b>									
Real GDP, % yoy	6.0	0.7	-1.8	10.8	4.2	1.5	2.1	3.2	3.7
Real investment growth % yoy	-0.7	-7.9	-21.2	36.8	-6.8	-4.6	3.5	4.7	3.5
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	1.7	2.8
Real export growth, % yoy	9.6	0.9	-8.7	25.6	4.5	0.1	3.8	4.4	6.2
Real import growth, % yoy	3.0	-3.7	-13.1	27.7	-0.5	-2.2	4.0	3.6	5.2
<b>Prices, Money &amp; Credit</b>									
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	30.00	29.88
lc/US\$, avg	32.85	31.58	33.04	31.50	29.40	29.57	29.68	30.13	29.94
<b>Balance of Payments, US\$ bn</b>									
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	37.9	37.0
Exports	246.7	255.6	203.7	274.6	308.3	301.2	305.4	316.8	337.7
Imports	219.3	240.4	174.4	251.2	281.4	270.5	269.9	278.9	300.7
Service balance	-1.6	1.8	2.0	2.5	3.9	6.3	10.4	12.4	21.3
Income balance	10.1	10.0	12.5	13.6	13.2	15.3	14.1	17.0	19.0
FDI, net	-3.3	-4.9	-3.1	-9.1	-14.7	-9.9	-10.3	-10.0	-9.0
International reserves	270.3	291.7	348.2	382.0	385.5	403.2	416.8	440.0	460.0
Total Amortisations	8.8	2.5	3.2	6.8	3.4	2.9	3.1	3.2	3.2
<b>Public Finances, % of GDP</b>									
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	0.3	-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
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	94.5	90.4	82.0	101.6	122.5	130.8	170.4	175.4	180.4
Private	91.1	88.9	76.0	93.5	118.0	127.5	166.1	170.2	175.0
Public	3.5	1.5	5.9	8.0	4.5	3.3	4.3	5.3	5.4
External debt / GDP	24.1	22.6	21.7	23.6	26.3	27.5	34.7	35.0	33.7
External debt / XGS	33.4	30.9	34.7	32.0	34.6	37.4	47.6	47.4	44.5
Short-term debt	83.3	78.8	68.2	83.7	107.8	116.5	155.9	165.0	140.0
Short-term debt/International Reserves (%)	30.8	27.0	19.6	21.9	28.0	28.9	37.4	37.5	30.4
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.9	3.0	2.7	3.3	3.9	4.0	3.3	3.7	4.1
CPI, % yoy	0.3	1.6	0.6	0.7	2.5	0.9	1.7	2.3	2.8
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	2.00	2.13	2.25	2.38
Short-term market rate, % eop	0.87	0.87	0.87	0.87	0.93	0.99	1.05	1.11	1.17
Long term yield, % eop	1.68	1.56	1.58	1.61	1.66	1.74	1.84	1.94	2.04
lc vs USD, eop	29.83	30.45	30.02	30.00	30.00	30.00	29.96	29.92	29.88

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

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

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## Thailand

- **Summary view** – Consumer sentiment upturn in May—a favorable reaction to the coup, bode well for consumption recovery. Potential pent-up spending of Bt50bn-Bt60bn support consumption although HH debt>80% of GDP and widespread slack dampen prospects of a v-shaped recovery in the near-term.
- **Things to watch** – FY15 fiscal program particularly on infrastructure. Transition government's cabinet has yet to be identified and appointed. NCPO's policy reform agenda alongside the fiscal program. Disinflation signals starting with CPI prepared food. Upbeat durable goods demand recovery onshore.
- **Strategy** – MPC's dovish bias persisted but not as broad based with downside export risk cited. While awaiting the fiscal spending catalyst, policymakers remain wary of prematurely withdrawing accommodation. Dovish MPC against rising US treasuries sustain our 6-12 mo. forecast for USD/THB at 33.

### Consumer sentiment upturn hasten consumption recovery

**Consumer sentiment improved to 70.7% in May (+2.9ppt monthly jump) after 13 straight monthly downturns capped by the political crisis in 4Q13.** The sharp gain appears to be a positive reaction to the military coup in May. The futures index (next 3 months) incurred a larger gain of +3.9ppt in May while the current month's index improved by +1.7ppt. According to a Suan Dusit Poll (Bangkok Post), the public gave the National Council for Peace and Order (NCPO) a high approval rating of 8.82 out of 10 with 72.7% of respondents welcoming the return to a peaceful political environment. Consumer sentiment's upturn represents a turning point for consumer demand although a v-shaped spending recovery is unlikely.

**Key spending catalyst in 2H14 would be 'pent-up demand' that's likely to enable private consumption to rise by Bt50bn-Bt60bn or roughly 1%-1.2% of GDP.** Consistent with falling consumer sentiment in the recent past, we noted that the gross domestic savings (GDS) ratio rose sharply in excess of 40% of GDP in 4Q13-1Q14 that suggests consumption pull-back owing to households' fear of the political future, its economic implications as well as fiscal spending shackled by the internal crisis. As the crisis deepened in 1Q14 that led to domestic demand recession, we failed to see massive job cuts that could justify severe spending cuts mirrored by declining private consumption (-3%YoY) for the 3<sup>rd</sup> straight quarter.

**Mean reversion of savings propensity would easily unleash Bt50bn-Bt60bn in our estimate for basic and discretionary spending (e.g. cars).** As consumer fears' ease and enable savings propensity to head back to the long-term average GDS ratio of 37%-38%, households should be less tight with their budget decisions. Willingness index to spend on big-ticket consumer items in May picked up as well to preview consumption recovery. BoT's indicator of private car sales posted seasonally adjusted monthly gains since Feb rising by 9.3%MoM SA in Apr although motorcycle and commercial car sales continue to languish in negative territory.

**Pervasive capacity slack won't be remedied by consumption recovery alone.** The mfg capacity utilization rate (SA) probed the 60% lows recently amid persistent gains in the inventory to shipment index. As a result, mfg output has been trimmed consistently. Moreover Apr readings indicated only the export mfg cluster (46.2% share of mfg output) has shown signs of life with the vehicles & parts output still in limbo. Capacity slack would continue to deter strong private investment recovery that eases likelihood of v-shaped recovery in 2H14. NCPO's public investments agenda (~30% of real investments) should materialize in the FY15 budget program that starts 4Q14.

## More upside risk to 2015 growth forecast of 2.8%

**Even with potential of consumption and export recovery in 2H14, we believe there's higher upside risk to our 2015 GDP forecast in 2015 on the back of the fiscal spending catalyst.** This would begin in 4Q14 but stretches out over the next three quarters in 2015. NCPO has signaled a Bt2.5tn budget in FY15 with a budget deficit target of Bt250bn. While details have yet to be disclosed, reports of public investment projects that have been given a thorough due diligence e.g. necessary feasibility and impact studies, in the past would probably be pursued while laying the fiscal ground rules for the size of project activities requiring NCPO approval. NCPO has to ensure that fiscal underspending slippage is averted ('overpromise and underspend') that would serve to erode support. According to a senior government technocrat, NCPO advisers are carefully selecting infra projects under the FY15 budget to ensure that absorptive capacity risk is avoided. With the recent high ratings approval, NCPO has to fast-track its fiscal stimulus program to sustain broad based support in the near-term particularly if economy misses out on strong consumption and export recovery. Undertaking reforms to weed out corruption and cutback on populist programs, e.g. discontinue rice pledging scheme, may deny the rural poor their share of the budget. Options to Yingluck's fiscal transfers/subsidies that would NOT be as costly (or well-targeted) or done through off-budget channels (thus more transparent) could be considered ideal although the cash transfer impact may not be as 'generous'. Moreover the transition government's reform agenda and technical qualifications of the appointed cabinet members would be crucial to strengthening investor confidence and sustaining the consumer sentiment rally.

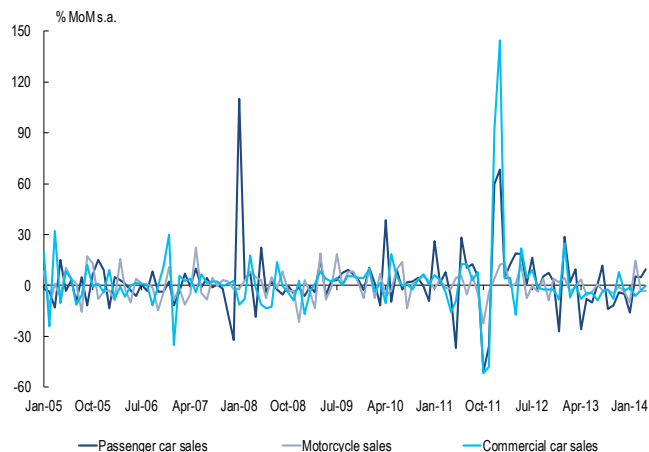
## Larger chunk of manufacturing on the recovery trail

**Over 40% of mfg output is on the recovery trail according to Apr data.** The export mfg cluster's output index grew 1.4%YoY (6.3%MoM SA) to snap out of nearly 15 months of shallow losses and gains. With flattish tech segment's output (-0.9%YoY), the estimated monthly gain in Apr was 10.2% (SA). Output on non-tech cluster grew by 3.7%YoY in Apr following 13 months of lackluster readings. If export demand for these industries has not firmed up entirely, we sense the inventory to shipment index (ISI) for key industries were less bloated suggesting subdued inventory overhang risk that may facilitate some production. Although low utilization rates persisted, the ISI of wearing apparel, luggage & handbags, furnitures, jewelry and related articles flagged potential re-stocking facilitating higher output. Updated monthly extrapolation of the export mfg cluster index suggests 2% growth in 2014. While the 2014 mfg estimate for this cluster implies less mfg slack, last year's average decline of 6.9% and 2012 average drop of 13% underscores the extent of unused capacity that would continue to downplay capex in the cluster. FDI approval has fallen by ~90%YoY as of May.

## MPC pauses in June as downside export risk a concern

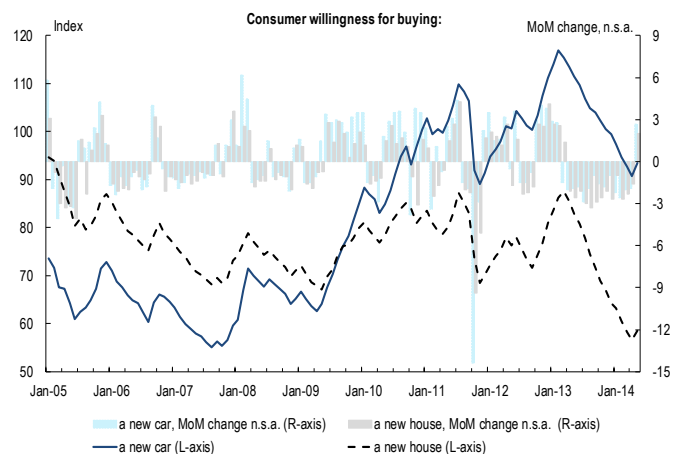
**MPC's dovish bias persisted although the basis for the view was not as broad-based as in previous meetings.** Slow recovery of exports of goods and tourism pose downside risk to growth according to MPC. Until there's empirical proof of strong export recovery and domestic demand's full upturn, accommodation looks set to stay. Post-coup, the MPC cited 'significant reduction of political uncertainties' that augur well for 'improving public and private spending' likely to benefit the domestic economy. Despite this upbeat view, the committee remains wary of prematurely sending the signal of phasing out monetary accommodation. Against long-term rates in the US climbing higher, THB would come under pressure although our average forecast over 6-12 months at 33 remains unchanged from last month.

Figure 109. Pre-coup, upbeat gains on passenger car sales since Feb



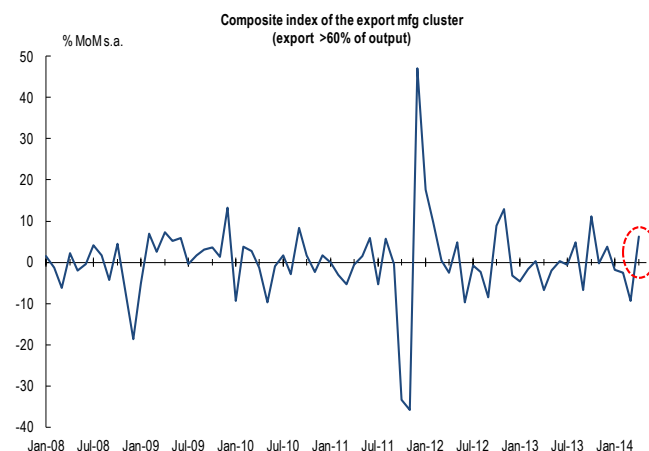
Source: CEIC, Citi Research

Figure 110. Consumer sentiment upturn in May in reaction to coup



Source: CEIC, Citi Research

Figure 111. Sharp monthly uptick of the export mfg cluster in Apr



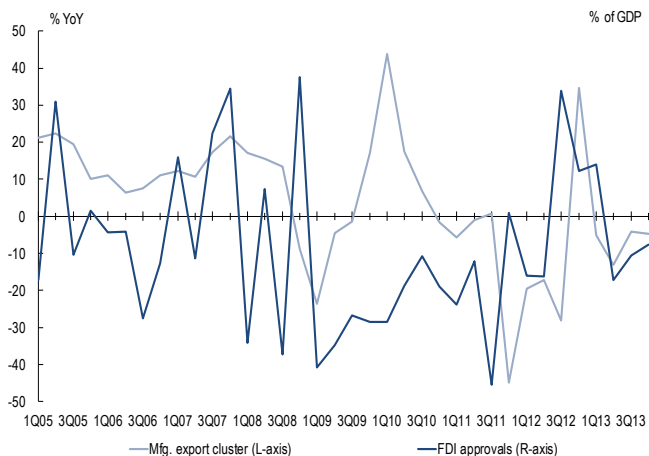
Source: CEIC, Citi Research

Figure 112. Slumping FDI approval with broad based capacity slack



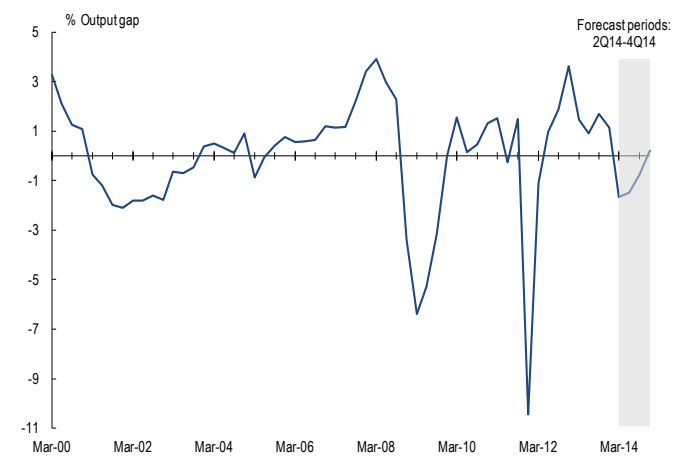
Source: CEIC, Citi Research

Figure 113. FDI approval ratio tracking mfg export cluster's output



Source: CEIC, Citi Research

Figure 114. We expect the negative output gap to close in 2H14



Source: CEIC, Citi Research

Figure 115. Thailand Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	265.2	276.1	263.8	319.3	346.1	366.4	387.8	369.7	385.3
Nominal GDP, local currency bn	8,525	9,080	9,042	10,105	10,540	11,375	11,899	12,246	12,850
GDP per capita, US\$	4,207	4,355	4,153	4,998	5,401	5,685	5,987	5,678	5,888
Population, mn	63.0	63.4	63.5	63.9	64.1	64.5	64.8	65.1	65.4
Unemployment, % of labour force	1.4	1.4	1.5	1.0	0.7	0.7	0.7	0.8	0.8
<b>Economic Activity</b>									
Real GDP, % yoy	5.0	2.5	-2.3	7.8	0.1	6.5	2.9	0.5	2.8
Real investment growth % yoy	1.0	8.1	-25.2	28.7	0.1	16.8	2.2	-2.2	0.0
Real consumption growth % yoy	2.9	2.9	0.1	5.1	1.3	6.8	1.1	-0.3	2.5
private consumption growth % yoy	1.8	2.9	-1.1	4.8	1.3	6.7	0.3	-1.0	2.2
Real export growth, % yoy	7.8	5.1	-12.5	14.7	9.5	3.1	4.2	1.0	3.4
Real import growth, % yoy	4.4	8.9	-21.5	21.5	13.7	6.2	2.3	-0.7	2.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.1	0.4	3.5	3.1	3.5	3.6	1.7	2.3	2.3
CPI, % avg	2.2	5.5	-0.9	3.3	3.8	3.0	2.2	2.4	2.1
Nominal wages, % yoy	3.0	10.5	-1.9	5.8	7.2	11.9	7.9	4.0	3.5
Credit extension to private sector, % yoy	29.3	6.3	2.5	18.8	18.3	14.0	10.5	8.5	10.0
Policy interest rate, % eop	3.25	2.75	1.25	2.00	3.25	2.75	2.25	2.00	2.00
Short-term market rate, % eop	3.74	3.07	1.28	2.03	3.26	2.79	2.31	2.05	2.10
Long term yield, % eop	5.13	2.84	4.37	3.74	3.28	3.55	4.07	3.85	3.80
lc/US\$, eop	30.05	34.79	33.36	30.07	31.57	30.60	32.70	32.84	33.00
lc/US\$, avg	32.39	33.21	34.33	31.71	30.48	31.08	30.72	32.60	33.00
<b>Balance of Payments, US\$ bn</b>									
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	2.3	-1.1
Trade balance	26.6	17.3	32.6	29.8	17.0	6.0	6.4	16.2	2.5
Exports	151.3	175.2	150.8	191.6	219.1	225.9	225.4	233.7	246.5
Imports	124.6	157.9	118.2	161.9	202.1	219.9	219.0	217.4	244.1
Net service and Transfer accounts	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	3.7	-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
<b>Public Finances, % of GDP</b>									
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
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
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	36.5	36.3
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
<b>Quarterly Economic Indicators</b>									
	2013 Q4F	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	0.6	-0.6	0.0	0.7	1.8	2.3	3.0	2.8	3.0
CPI, % yoy	1.7	2.1	2.5	2.6	2.3	2.1	1.9	2.2	2.3
Policy interest rate, % eop	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Short-term market rate, % eop	2.32	2.08	2.10	2.08	2.05	2.08	2.10	2.10	2.10
Long term yield, % eop	4.07	3.80	3.80	3.80	3.85	4.00	3.85	3.85	3.80
lc vs USD, eop	32.70	32.43	32.47	32.65	32.84	33.00	33.00	33.00	33.00

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

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



# Frontier Asia

## Mongolia

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**We are turning cautious on Mongolia's near term outlook, mainly as previous signs of BOP strains easing are being reversed.** Incremental good news of the newly signed US\$1.3bn combined heat & power plant (CHP5) project with intentional energy consortium, and other supranational's aid to the various private sectors look insufficient to pacify investors' concerns (especially some have already enjoyed a good run on the Mongolia sovereign play and may prefer to take profit).

**First, previous improvements seen in 1Q FDI has been substantially revised downwards**, with the revised data at US\$163.7mn vs. the previous released US\$541.6mn. The April FDI is also weak at US\$54.1mn. We therefore have significantly adjusted down our full year FDI estimate to US\$1.4bn.

**Second, we are concerned about the central bank's delay in release of its FX reserves data.** The latest update is for Feb which stands at US\$2.2bn, and we estimate the reserves have fallen further to about US\$1.7bn by June. Given that Bank of Mongolia is still in talks with China's PBOC to double its RMB swap line to RMB20bn, we think the central banks have no option than to use part of its reserves to help stabilize the MNT (which recently improved slightly to MNT1819/USD as of 24 June). Recent rise in CPI to 13.7%yoy in May, vs. BoM's target of 8%, adds pressure for the central bank to cushion its currency depreciation.

**Third, the likely passing of the new Debt Management Law (DML) should pave way to more public and sovereign guaranteed debt.** The new DML received even votes at its parliament review and was sent back for committee discussion. The bill will be resubmitted after some technical (classification of regulatory body) amendments. We believe the bill will still be passed in this Spring session or in the extraordinary session. This will likely facilitate higher concessionary borrowings in 2H14E and additional sovereign guaranteed debt supply in 2015E.

**Fourth, the OT Phase II negotiations between Rio Tinto and the Government ran into fresh dispute** with Mongolia's Tax Authority's latest audit report claiming that OT has US\$130mn of unpaid tax and penalties. Turquoise Hill announced it will enter a 60-day negotiation period to resolve the issue; and would seek international arbitration if unresolved. The feasibility study is hence delayed. We see room for negotiation on this new tax claim at the cabinet level, but such obstacles to the negotiation process will likely make wary investors concerned that OT will again not be able to make the 30 Sep project financing deadline set by the banks consortium.

## Sri Lanka

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**CBSL maintains a neutral tone, supporting our view of prolonged hold on rates.** May inflation was very benign, driven largely by a favorable base effect and extremely benign non-food inflation even as food inflation has picked up sharply on deficient water. We expect inflation will gradually rise -- food price pressures may rise amid mounting harvest losses in 1H2014 and there is still risk of another electricity tariff hike this year. While growth in credit and monetary aggregates remain very subdued, we are seeing signs of pick-up of consumer goods imports and export rebound has been surprisingly strong led by a sharp growth of textile and garment exports. 1Q14 Real GDP growth was robust at 7.6% (we nudge our 2014F growth forecast higher to 7.4% vs. 7.2%) led by services, construction and steady manufacturing growth. CBSL's last two policy statements were more neutral, with the last one citing that "growth momentum is likely to continue during the remainder of the year", that the current level of policy rate is "appropriate", and they are leaning more on moral suasion for banks to lower market lending rates. We maintain our view that CBSL will be on a prolonged hold.



**External position still well supported and the Sri Lankan rupee has been on a strengthening path.** Recent international bond issuances have helped buffer FX reserves to historic high of US\$8.9bn in Apr, and we have also seen contained trade deficit and buoyant tourism revenues (led by a sharp growth in Chinese visitor arrivals). We had been forecasting some rupee weakness this year to be made up next year in expectation of a broader based EMFX weakness as US rates rise, but we now think that the “carry trade” appeal and Sri Lanka’s greater insulation from portfolio flows will likely keep US\$DKR on a more stable to slightly lower bias, and adjust both our currency and longer term bond yield forecasts.

**Will parliament allow a UNHRC inquiry into war crimes into the country?**

March decision by the UNHRC to investigate Sri Lanka for war crimes during the violence leading up to May 2009 is a sensitive political flashpoint, and the Rajapakse-controlled parliament is due to decide whether it would let a UN-appointed individual leading the inquiry to enter the country (at best, we expect only very limited cooperation)—latest proposal is to hold a referendum. The government has protested the split UNHRC decision (23 in favor, 12 against, 12 abstained). We don’t see this as having a significant and lasting impact on the economy – serious sanctions look unlikely to us.

## Vietnam

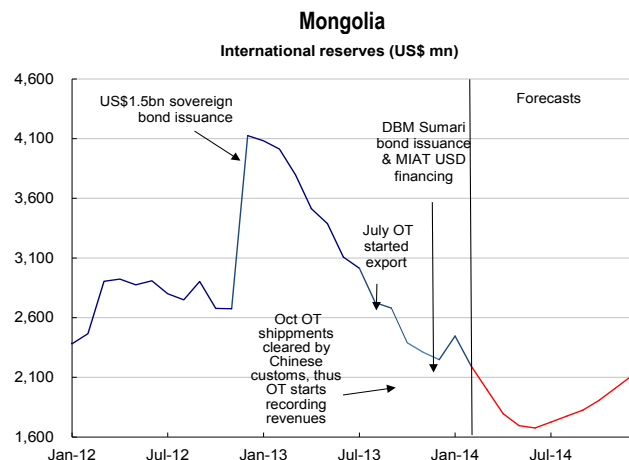
**Downgrading growth forecast to 5.5% (vs 5.7% prev) in 2014F on spillover from Sino-Vietnam tensions and weak credit growth.** Heightened geopolitical tensions with China will have adverse impact on both service related flows (e.g. around 26.5% of tourist arrivals come from China; Chinese government has temporarily stopped Chinese SOEs from bidding for fresh contracts in Vietnam) and FDI, especially from China (which isn’t large on a cumulative basis, but has risen in importance in recent years). We expect less disruption from cross-border goods trade where much of it is driven by supply chains and raw goods (e.g. rice) that are likely less susceptible to boycotts. Protracted problems in the banks have continued to undermine credit, which rose only 1.31% ytd as of May (vs. 3% a year ago), and would remain a significant drag to domestic demand growth. However, we still believe broader FDI impact from recent anti-China riots will be contained as the domestic security situation has normalized somewhat. We take some comfort following Samsung’s recent announcement that it will build a third plant worth US\$1bn in HCM, as well Vietnam’s plans to complete FTA negotiations with EU by year-end.

**Structural reforms still lagging significantly.** VAMC has made limited progress on NPL disposal and the legal difficulty to transfer title of real estate collateral remains a hurdle. Continued delay of banks’ loss recognition (via tighter accounting rules), lack of government’s willingness to inject capital and significant restriction on foreign capital (because of onerous foreign ownership limits) will mean bank sector resolution will remain painfully slow, in our view. SOE privatization is also way behind the 432 targeted SOEs privatizations in 2014-15. One encouraging progress has been the new regulation that would allow SOEs to equitize/privatize assets at below par or at a loss, but with majority stakes of all the SOEs residing with the government, this will likely impede real structural reforms.

**A lingering concern is Vietnam’s weakening public finances.** Slow growth and expansionary fiscal policies in the last two years have led to rising public debt of ~54% of GDP in 2013 – could rise to 57-58% of GDP this year. A legal limit of 65% of GDP should safeguard fiscal discipline but also illustrates reduced fiscal space to provide countercyclical policy support to growth.

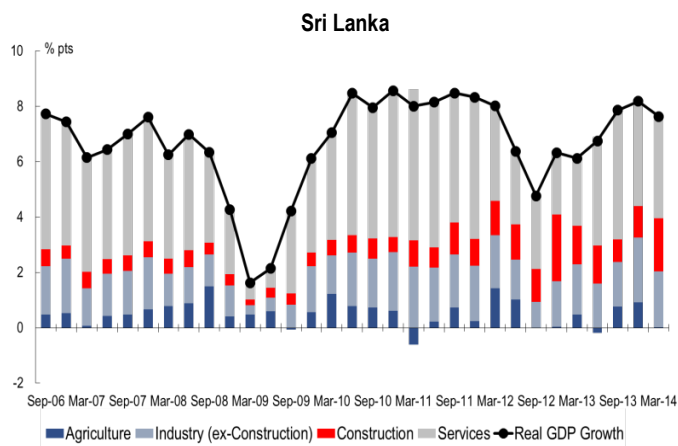
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Figure 116. Mongolia – More reserves likely drained with MNT weakness



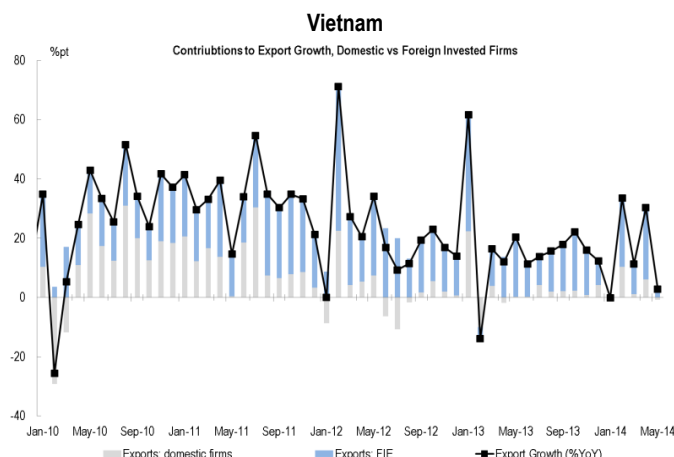
Source: BoM, CEIC and Citi Research

Figure 118. Sri Lanka – 1Q14 real GDP growth stayed elevated, buoyed by resilient services and expansion of construction activity



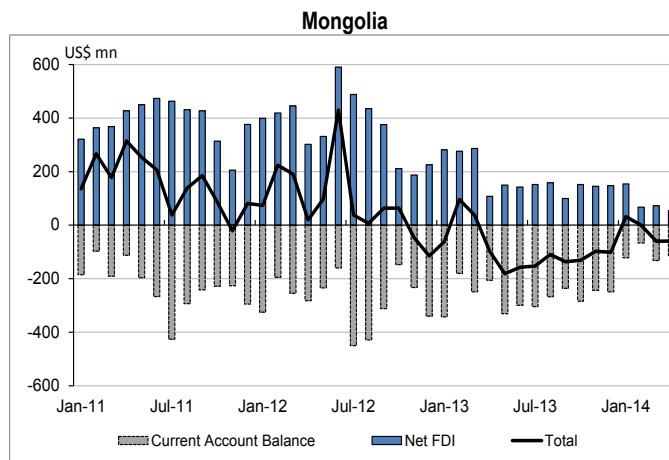
Source: CBSL, CEIC and Citi Research

Figure 120. Vietnam – Domestic firms' contribution to export growth has collapsed in recent years



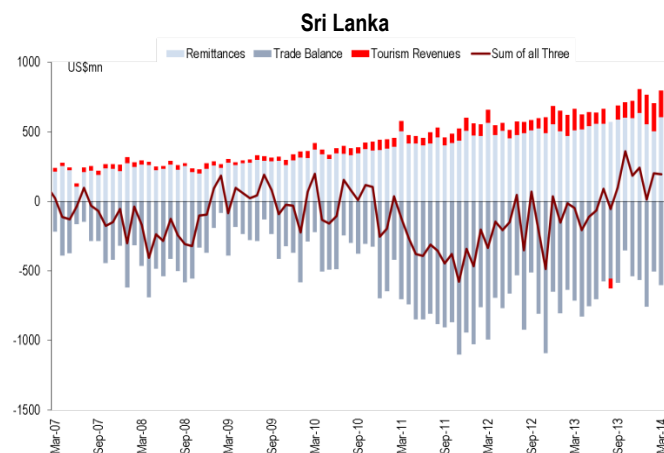
Source: CEIC, Citi Research

Figure 117. Basic balance back in negative after 1Q BOP revisions



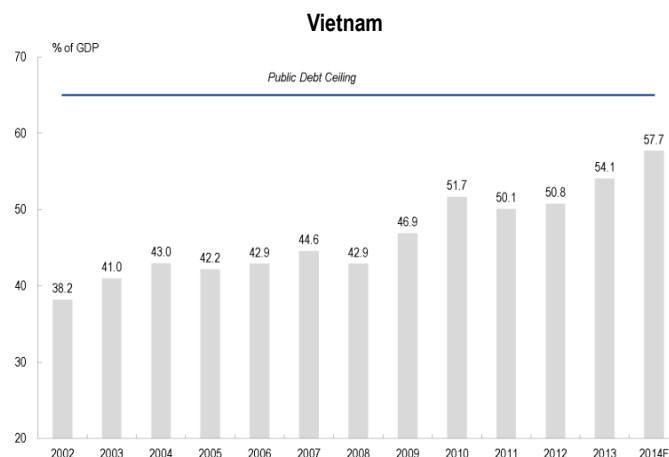
Source: BoM, CEIC and Citi Research

Figure 119. Sum of three major current account components – trade balance, tourism revenues and remittances – is improving



Source: CBSL, CEIC, and Citi Research

Figure 121. Public and publicly guaranteed debt ratio on a rising trend



Source: IMF, WB, Various news articles, Citi Research

Figure 122. Asia Frontier Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Mongolia</b>									
Nominal GDP, US\$ bn	4.2	5.6	4.6	6.2	8.8	10.3	10.3	12.0	15.1
GDP per capita, US\$	1,629	2,138	1,717	2,287	3,186	3,595	3,525	4,020	4,986
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	13.6	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	18.48	19.68	21.08
lc/US\$, eop	1,172	1,275	1,433	1,233	1,378	1,378	1,660	1,787	1,717
lc/US\$, avg	1,171	1,167	1,434	1,349	1,256	1,353	1,505	1,813	1,743
Current account (US\$ bn)	0.3	-0.7	-0.4	-0.9	-3.4	-3.2	-3.2	-2.2	-3.0
% of GDP	6.3	-12.8	-8.9	-15.0	-38.4	-31.1	-30.9	-18.7	-20.0
Trade balance (US\$ bn)	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-2.1	-0.7	-1.1
Exports (US\$ bn)	1.9	2.5	1.9	2.9	4.8	4.4	4.3	6.0	7.5
Imports (US\$ bn)	2.2	3.2	2.1	3.2	6.6	6.7	6.4	6.7	8.6
FDI, net (US\$ bn)	0.4	0.8	0.6	1.6	4.6	3.9	-2.1	1.4	3.4
International reserves (US\$ bn)	0.8	0.6	1.3	2.2	2.3	3.9	2.2	2.1	3.2
Consolidated government balance (% of GDP)	2.6	-4.5	-5.2	0.5	-6.9	-9.9	-7.8	-7.5	-4.3
Public debt (% of GDP)	36.0	30.6	44.2	28.7	28.9	42.1	67.3	73.5	74.6
<b>Sri Lanka</b>									
Nominal GDP, US\$ bn	32.4	40.7	42.1	49.6	59.2	59.4	67.2	74.7	85.7
GDP per capita, US\$	1,617	2,014	2,057	2,400	2,836	2,923	3,281	3,616	4,118
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	7.1	6.0
CPI, % avg	15.8	22.5	3.6	6.2	6.8	7.5	6.9	5.0	6.5
Policy interest rate, % eop	12.00	12.00	9.75	9.00	8.50	9.50	8.50	8.00	8.00
Long term yield, % eop	19.96	19.20	11.50	9.24	10.00	11.81	9.91	8.50	8.75
lc/US\$, eop	108.7	113.0	114.4	110.9	113.9	127.7	130.8	130.0	129.0
lc/US\$, avg	110.6	108.3	114.9	113.0	110.5	127.2	129.1	130.4	129.4
Current account (US\$ bn)	-1.4	-3.9	-0.2	-1.1	-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
<b>Vietnam</b>									
Nominal GDP, US\$ bn	77.5	98.3	101.6	112.8	121.7	141.7	157.9	171.5	190.3
GDP per capita, US\$	920	1,154	1,181	1,297	1,385	1,596	1,762	1,895	2,085
Population, mn	84.2	85.1	86.0	86.9	87.8	88.8	89.6	90.5	91.3
Real GDP, % yoy	7.1	5.7	5.4	6.4	6.2	5.3	5.4	5.4	5.7
CPI, % yoy	12.6	19.9	6.5	11.8	18.1	6.8	6.0	5.9	7.0
CPI, % avg	8.3	23.1	7.0	9.2	18.6	9.3	6.6	5.0	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	21,407	21,621
lc/US\$, avg	16,081	16,445	17,806	19,123	20,648	20,875	21,028	21,276	21,567
Current account (US\$ bn)	-7.1	-10.8	-6.6	-4.3	0.2	9.3	9.5	8.5	7.5
% of GDP	-9.1	-11.0	-6.5	-3.8	0.2	6.5	6.0	4.9	3.9
Trade balance (US\$ bn)	-10.4	-12.8	-7.6	-5.1	-0.5	9.9	8.7	11.3	9.8
Exports (US\$ bn)	48.6	62.7	57.1	72.2	96.9	114.6	132.1	152.0	170.2
Imports (US\$ bn)	59.0	75.5	64.7	77.4	97.4	104.7	123.4	140.7	160.4
FDI, net (US\$ bn)	6.5	9.3	6.9	7.1	6.5	7.2	6.9	6.5	7.0
International reserves (US\$ bn)	23.5	23.9	16.4	12.5	13.5	25.6	25.9	32.7	35.2
Consolidated government balance (% of GDP)	-5.3	-2.2	-7.2	-3.0	-3.2	-4.8	-5.6	-6.4	-6.0
Public debt (% of GDP)	40.9	39.4	46.9	44.6	43.2	46.6	41.8	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

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## Czech Republic

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- **Summary view** — We upgraded our GDP growth forecast to 2.4% in 2014 and 2.7% in 2015 from 1.9% and 2.5% respectively as industrial production surprised positively in April and domestic demand is likely to remain in recovery.
- **Things to watch** — We think June's CPI will come in at -0.3%YoY on lower food prices. Hence, it will be interesting to watch the CNB's reaction as underlying core CPI has so far grown a bit faster than the CNB expected. Recent volatility in global price expectations is unlikely to force CNB into action and we think the Board will wait for 2H14 data to see the impact of domestic demand.
- **Strategy** — We think the CNB will retain the EURCZK floor despite lower CPI trajectory unless we see an eventual drop in export competitiveness or in foreign demand. Our view of tightening of monetary conditions in late 2H15 looks likely.

### Upward GDP revision in forecast reflects mainly better 1Q

**We view recently published data from local economy as representing an inflationary risk to CNB's forecast, but the external environment is rather mixed.** GDP growth was revised upward to 2.5%YoY in 1Q14 from the flash estimate of 2%, which is now much closer to CNB's forecast of 2.7% growth. Moreover, real average wage growth of 3.1%YoY in 1Q14 was above the CNB's 2.5% expectation. Meanwhile, the government approved a 3.5% increase in public sector wages and return to a more generous pension valorization by full CPI and 1/3 of real wage growth in 2015. The inflationary impact on the CNB's forecast from the consumption and wage data is partly offset by stronger investment activity. However, April data from the real economy suggests the recovery is set to continue, though both retail sales and construction activity is likely to decelerate, but the first is likely to be supported by consumer confidence. By contrast, oil prices have increased, with inflationary implications on the 3-year horizon, which is partly offset by a lower outlook for global food prices. We think more importantly is the ECB has started another round of monetary easing, which has been, however, reflected in higher consensus forecast on Euro Area GDP growth in 2015, which has mixed implications for the CNB.

**June confidence indicator increased to highest level since February 2011 and points to 2.5%YoY and 0.6%QoQ GDP growth** (the average 2Q confidence points to 2.3%YoY and 0.5%QoQ). Overall we remain confident in a recovery of the Czech economy as export order book data and investment plans are supportive. Conversely, we think there needs to be a rise in the Czech PMI indicator (which materialised in May) to realize further gains in an export-led recovery in order to see a more tangible recovery in the labour market — a necessity for further gains in domestic demand, as retail sales growth (as suggested by the confidence indicator) seems to be close to its peak. However, we see also some issues. The weaker koruna was not reflected in cross-border consumption data in 1Q14 and fixed investments were supported by all main segments excluding dwellings, but the confidence indicator suggests weaker car registrations and thus this part of investment is likely to weaken later in 2Q14. However, value-added dynamics in industry undershot monthly industrial output in 1Q14, which could be offset by better value-added in 2Q14. We expect a deceleration of industrial production growth to around 8.2%YoY in May-June after 9.1% in April, followed by 5.6% in 2H14, but June Czech industrial confidence and Euroarea PMI represent a downside risk. Moreover, terms of trade improved further in April, which should support domestic demand and Czech exporters have avoided a larger fall in their foreign pricing.

## Inflation provides mixed signals and outlook is also mixed

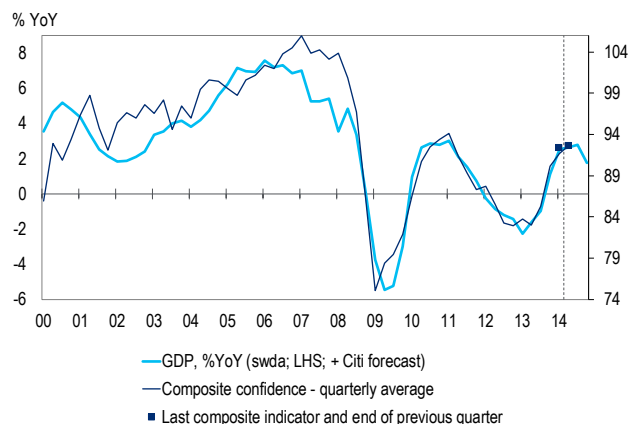
**We forecast the CPI growth to reach 0.7%YoY this year, followed by 2% in 2015.** We estimate CPI inflation will fall 0.3%YoY in June on the back of lower food prices, particularly potatoes. We estimate food, alcohol, tobacco and fuel are likely to cut 0.3%pt from CPI growth in June to -0.3%MoM; on a YoY basis, well below the CNB's forecast of +0.5%YoY. For the time being, it is difficult to say whether it reflects a change in seasonal impact (there is usually large fall in July) or if it is a correction of recently higher Czech food prices compared to peers. However, we think that it is the first option due to a big increase in potatoes prices a year ago, which is likely to happen later this year. Though May producer prices increased less than we expected (we estimate 0.2%YoY), they provide support for higher consumer prices. The market service prices suggest the growth of the non-tradable part of the CPI basket will accelerate later this year, which should also be supported by higher real wage growth. Moreover, we see a gradual continuous increase of price expectations in the core retail component (ex. food, tobacco, fuel and cars). This should be benign for the CNB, which assumes domestic demand will support CPI growth from 2H14 after the koruna's impulse through import prices diminishes in late 2014. Our CPI forecast does not significantly differ to CNB's but we assume milder GDP growth, whose impact on CPI is offset by our view of weaker koruna.

## CNB will tighten policy later

**We see a risk of somewhat dovish CNB during summer, but the expected recovery should keep the EURCZK floor unchanged.** Lower inflation could persuade the CNB to discuss a higher EURCZK floor, particularly if retail sales decelerate more strongly later in 2Q14. While CNB's economists survey points to a somewhat lower forecasted level of the CNB's policy rate in our calculation, it is still above the current CNB's policy rate of 0.05%. Moreover, this pressure has been partly offset by another positive growth of adjusted core CPI (0.3%YoY in May). We think the composition of CPI development and strong data from the domestic economy are unlikely to persuade the CNB Board to vote a higher level of EURCZK floor. We think the CNB will keep the EURCZK floor despite a lower CPI trajectory unless we see an eventual drop in export competitiveness or in foreign demand. However, we do not rule out the possibility the Board may start to think about a slightly negative policy rate if there is pressure on the EURCZK floor after the expected easing in ECB monetary policy. Overall, our view of a later tightening of monetary conditions (in late 2H15) looks more likely. Vicegovernor Hampl assumes — indicated in his presentation — a trade-off between the smoothness of the exit and likelihood of departing from the ZLB. He believes the earlier the CNB starts exiting, the smoother the process will likely be, while a later exit would increase the likelihood the CNB would not return to ZLB again. CNB has a clear definition of "exit" as "a return to standard inflation targeting framework with interest rates as key instrument, combined with managed floating", without an explicit FX floor.

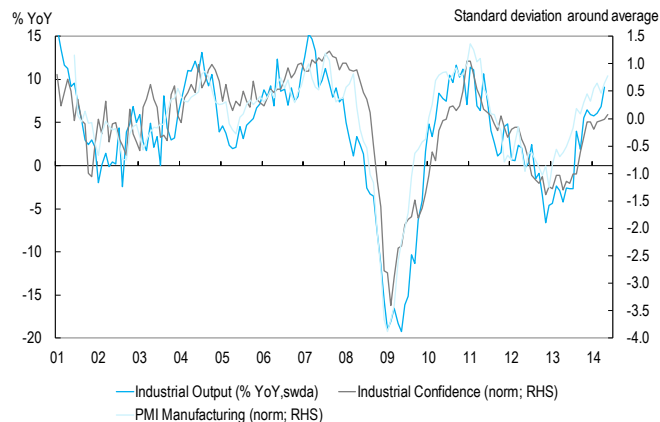
**Ministry of Finance prepared proposals to cut cash central government deficits to CZK100bn in 2015-2016** (CZK95bn in 2017) from CZK120bn suggested by previous government, which is on average around 2.4% of GDP compared to -2.8% initially. The plan assumes only a mild increase in expenditure limits (expenditures excl. EU funds related expenditures) of 1% in 2015 and 2.2% in 2016-17. We expect the MinFin to issue CZK30-40bn of local marketable bonds in 2H14 if there is a demand for buybacks and switch auctions or CZK20bn excluding these operations as there was low demand for retail bonds. Overall, this plan suggests to us coverage of this year's local issuance at 80% or 92% if there are no buybacks and switches.

Figure 123. 2Q's confidence suggests 2.3% GDP growth ...



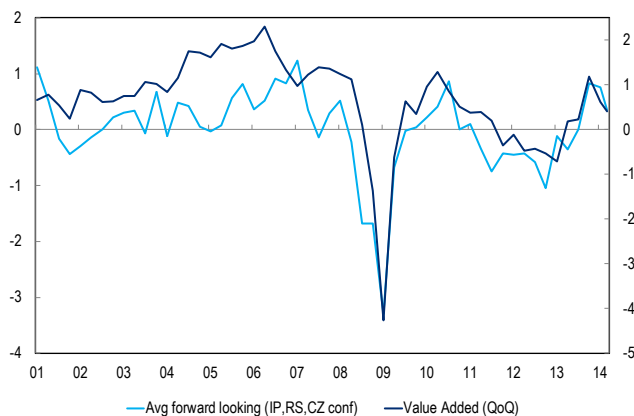
Source: CZSO, Citi Research forecast

Figure 124. ... industrial production surprised positively in April ...



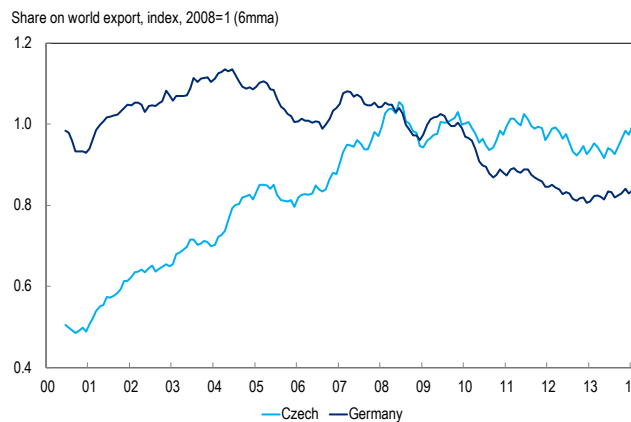
Source: CZSO, Haver Analytics, Citi Research calculation

Figure 125. ... but momentum indicator decelerated in Apr-May



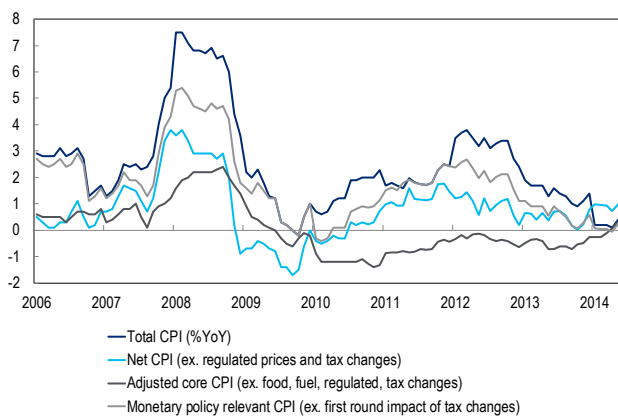
Source: CZSO, Haver Analytics, Citi Research calculation

Figure 126. Czech competitiveness has improved ...



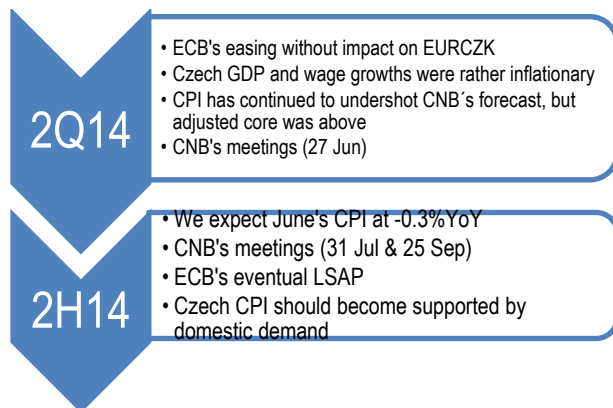
Source: Haver Analytics and Citi Research

Figure 127. Core CPI above CNB's forecast, though total is below



Source: CNB, CZSO, Citi Research calculation.

Figure 128. Schedule for the assessment of the CNB's policy



Source: Citi Research



Figure 129. Czech Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	180	225	197	198	216	196	198	207	212
Nominal GDP, local currency bn	3,663	3,848	3,759	3,791	3,823	3,846	3,884	4,059	4,244
GDP per capita, USD	17,484	21,614	18,795	18,873	20,584	18,693	18,881	19,713	20,141
Population, mn	10.3	10.4	10.5	10.5	10.5	10.5	10.5	10.5	10.5
Unemployment, % of labour force	5.3	4.4	6.7	7.3	6.7	7.0	7.0	6.8	6.5
<b>Economic Activity</b>									
Real GDP, yoy avg	5.7	3.1	-4.5	2.2	2.1	-1.0	-0.9	2.4	2.7
Real investment growth % yoy	15.5	1.9	-20.2	5.4	0.8	-5.0	-4.4	1.0	3.2
Real consumption growth % yoy	3.1	2.3	1.3	0.7	-0.4	-2.1	0.6	1.3	1.8
private consumption growth % yoy	4.2	2.8	0.2	0.9	0.5	-2.1	0.1	1.2	2.2
Real export growth, % yoy	11.2	4.0	-10.9	15.4	9.5	4.5	0.2	9.7	8.1
Real import growth, % yoy	12.8	2.7	-12.1	15.4	7.0	2.3	0.6	8.3	7.7
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	5.5	3.6	1.0	2.3	2.4	2.4	1.4	1.6	1.9
CPI, % avg	2.9	6.3	1.0	1.5	1.9	3.3	1.4	0.7	2.0
Nominal wages, % yoy	7.2	7.9	3.4	2.2	2.5	2.7	0.1	2.7	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	20.3	19.4
CZK/US\$, avg	20.2	17.0	19.0	19.1	17.7	19.5	19.6	20.1	20.0
CZK/EUR, eop	26.5	26.8	26.4	25.0	25.6	25.1	27.3	27.6	27.0
CZK/EUR, avg	27.8	25.0	26.4	25.3	24.6	25.1	26.0	27.5	27.3
<b>Balance of Payments, USD bn</b>									
Current account	-7.9	-4.8	-4.8	-7.6	-6.3	-4.7	-2.9	1.8	3.7
% of GDP	-4.4	-2.1	-2.5	-3.8	-2.9	-2.4	-1.4	0.9	1.7
Trade balance	2.2	1.7	4.6	2.8	5.3	7.5	9.6	13.6	15.5
Exports	106.5	125.1	99.1	114.0	138.5	131.7	135.6	148.1	159.1
Imports	104.3	123.4	94.6	111.2	133.2	124.2	126.0	134.5	143.7
Service balance	2.9	4.4	3.9	3.9	3.8	2.5	2.7	4.8	5.5
Income balance	-12.7	-10.6	-13.2	-14.8	-15.6	-14.7	-16.0	-17.6	-17.9
FDI, net	9.0	2.3	2.0	4.9	4.2	9.2	1.7	5.9	6.3
International reserves	34.4	36.5	39.7	40.3	37.9	42.4	53.9	58.9	62.4
Total amortisations	4.0	4.2	6.2	5.4	8.6	5.4	7.4	7.1	7.1
<b>Public Finances, % of GDP</b>									
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	44.6	45.0
of which Domestic	20.3	20.7	24.4	25.8	34.8	39.9	29.9	34.9	34.5
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	76.2	84.2	89.2	94.2	94.2	102.5	111.3	102.2	113.3
Public	15.0	15.3	19.8	24.0	22.6	28.3	30.2	23.2	29.3
External debt / GDP	42.2	37.4	45.3	47.5	43.6	52.2	56.1	49.3	53.4
External debt / XGS	61.5	57.3	75.3	69.8	58.3	66.7	70.5	58.9	60.6
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	61.1	62.5
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.1	2.5	2.6	2.7	1.7	2.0	2.5	2.9	3.2
CPI, % yoy eop	1.4	0.2	-0.3	1.1	1.6	2.0	2.1	1.8	1.9
Policy interest rate, %, eop	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.25
Short-term market rate, % eop	0.29	0.27	0.27	0.25	0.25	0.25	0.25	0.25	0.45
Long-term yield, %, eop	2.30	2.18	1.54	1.66	2.00	2.13	2.25	2.38	2.50
CZK/EUR, eop	27.34	27.46	27.43	27.49	27.60	27.67	27.43	27.19	26.95

Source: National Sources, Citi Research forecasts

## Egypt

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

### Consolidating political power

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

**Part of this should be the ongoing clampdown on the Muslim Brotherhood (MB).** But pushing the MB underground raises the risk of returning to the low level insurgency of the 1990s. And despite the clampdown, the president is keen to keep significant elements of the Islamist political community on side during the transition to preserve his wider political legitimacy.

**This also ties in with his second goal, to build a wider political power base capable of performing well in parliamentary elections, which will probably be held in September.** Given the weak and fragmented nature of the current political parties, none looks as if it can mount a successful campaign to secure a parliamentary majority. But with a couple of new parties being formed by supporters of the president and his ability to appoint 27 MPs, the goal will be to construct a supportive parliamentary alliance.

**Even if the security clampdown is at the expense of some democratic values, the eventual political outcome is also likely to be supported by most foreign governments.** But it is clear that the political environment has changed markedly in the last year, 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.

### A technocratic government to start with

**Despite the vagueness of his policy pronouncements to date, the third goal of the president will be to kick start the economy.** In this respect, he seems keen on keeping a technocratic government and eschewing pressure to appoint more populist ministers. In fact, by keeping Ibrahim Mahleb as prime minister and Hani Kadri Dimian as finance minister, the government does seem to have strong echoes of those from the late Mubarak period. Moreover, it is now possible to identify some potential broad policy themes that the president's first government will pursue which also have echoes of the end of Mubarak era.

**First, we are all in this together.** So an important strand of policy should be to raise taxes on the richer segments of society, notably through a wealth tax, capital gains and property taxes. But those paying may also be given the ability to stress where they want them spent in a broad sense — from a list of hospitals or schools for example. This would be supported by the implementation of a full VAT tax.

**The second is growth with social justice.** While the government is still formally only forecasting growth of 3.2% in the coming fiscal year, it will be hoping for a higher rate. But publicly it will also argue that it is interested in more than just the headline rate of growth. Instead, the government's growth-oriented agenda should also have a strong emphasis on social justice. Again, this reinforces our view that the government will only warily tackle the issue of food subsidies.

**Third, Gulf support and the military.** Although the 2014/15 budget is unlikely to include high levels of Gulf support, to meet its ambitious growth agenda, it would need major Gulf government financial support and private investment. This should be focussed on projects such as the building of low-cost housing or improving health and education facilities in the country. Another key agent that we think will be used to drive the investment agenda in coming years will be the army, which is one of the few institutions in the country, which has the logistical capacity to support the ambitious investment agenda.

## **A formal reform programme may emerge**

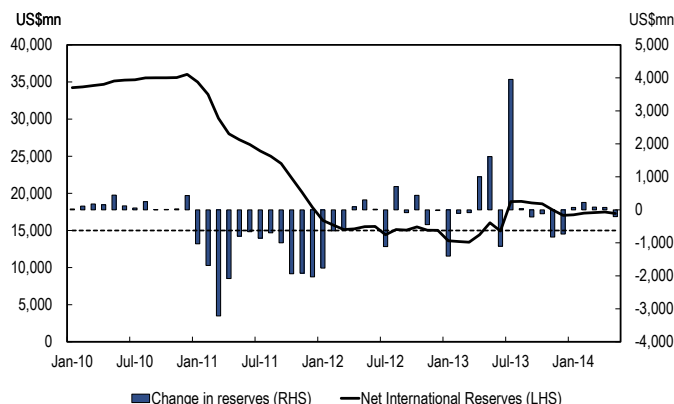
**Over time, many of these themes could potentially be brought together in a more formal home-grown economic programme.** Essentially, this should be a programme of technocratic reform, with bringing down the fiscal deficit and subsidy reform at the heart of it. But with additional underpinning themes: the involvement of the military; growth yes, but with social justice; the need for many to make a sacrifice to support growth; and finally, probably a strong anti-corruption strand.

**And while Gulf states may push for greater non-Gulf involvement in this programme, with a potential donor conference on the cards, we think other pledges of support will be harder to drum up.** However, when this full home-grown reform programme has been running for some time government, the government will probably open negotiations with the IMF to crowd in wider financial support. In the meantime, it will likely continue to use the IMF to help technical aspects of reform such as the introduction of VAT or subsidy reform.

## **The need for reality**

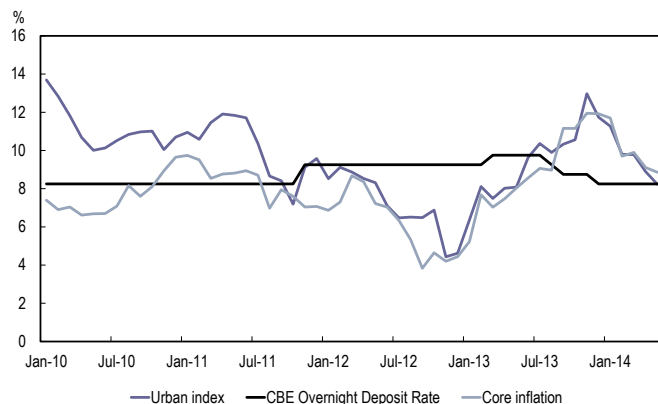
**But the need for reality must also remain paramount.** Even if an ambitious reform agenda along these lines is put in place, the reality remains that the state of the economy is still precarious, as shown by the weakening of the EGP since early April. Moreover, the government could face a major test in the coming months in the form of an energy crunch this summer: the usual air conditioning demand surge will highlight how power demand growth has risen much faster than investment in the sector in the last decade and the need to reform the sector, notably the role of subsidies. These potential mini-crises, coupled with a weak civil service and a politically divided country, mean that the realities of running the country should also quickly take hold as the success of the president's election victory fades away.

Figure 130. Reserves have stabilised since late 2013, but remain low



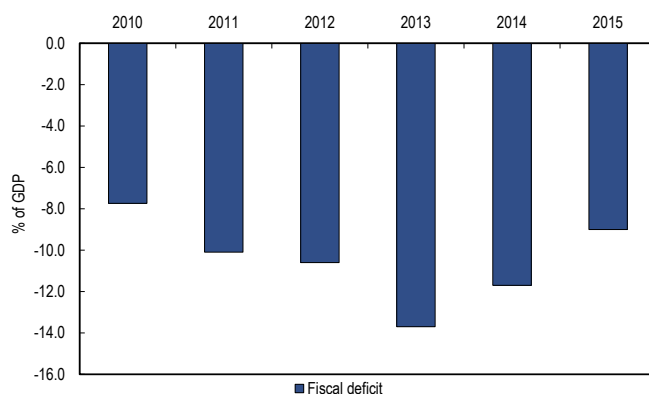
Source: Central Bank of Egypt, Haver Analytics

Figure 132. Inflation has moved back in line with monetary policy in 1H 2014



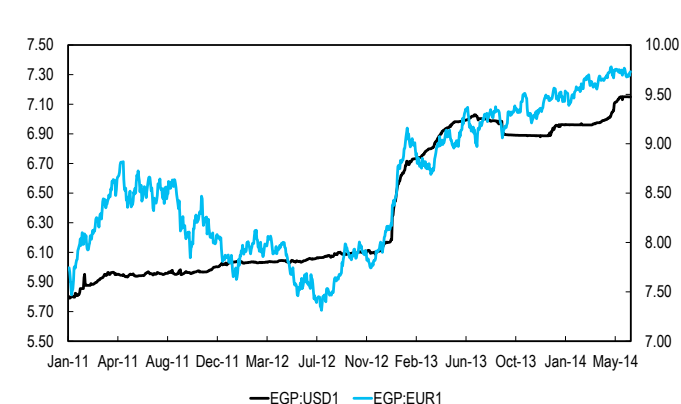
Source: Central Bank of Egypt, Haver Analytics and Citi forecasts for 2H 2013

Figure 134. The fiscal deficit remains large and is a problem



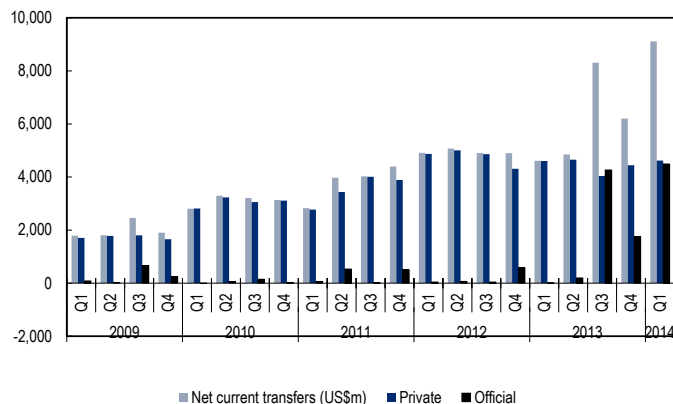
Source: Haver Analytics and Citi forecasts for 2013-2015

Figure 131. EGP – Downward steps against the US dollar



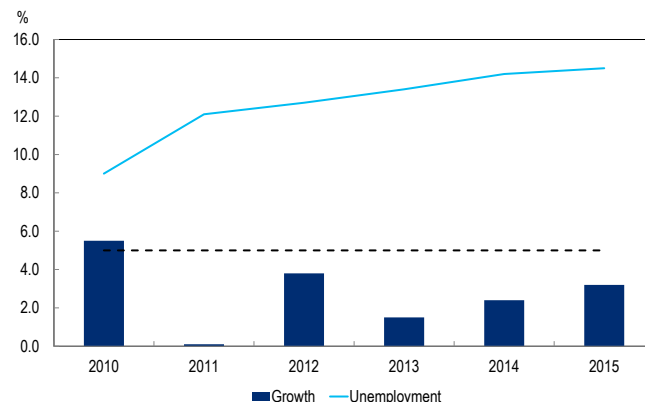
Source: Reuters

Figure 133. Robust transfers have limited the deterioration in the current account and helped support consumption



Source: Central Bank of Egypt, Haver Analytics

Figure 135. A slow recovery may now be possible in 2014-15



Source: Haver Analytics and Citi forecasts for 2013-15

Figure 136. Egypt Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	132	165	188	214	231	260	255	271	281
Nominal GDP, local currency bn	817	977	1,124	1,308	1,461	1,663	1,887	1,929	2,116
GDP per capita, USD	1,783	2,187	2,454	2,755	2,920	3,233	3,114	3,260	3,334
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
<b>Economic Activity</b>									
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
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	6.9	18.4	13.2	10.6	9.5	4.7	11.7	7.3	7.2
CPI, % avg	9.5	18.3	11.8	11.1	10.1	7.1	9.5	7.9	6.5
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	7.74	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	7.30	7.65
EGP/US\$, avg	5.64	5.44	5.55	5.63	5.94	6.07	6.87	7.12	7.52
<b>Balance of Payments, USD bn</b>									
Current account	0.2	-1.3	-3.2	-5.6	-7.9	-10.7	-3.3	-6.8	-6.4
% of GDP	0.2	-0.8	-1.7	-2.6	-3.4	-4.1	-1.3	-2.5	-2.3
Trade balance	-20.8	-26.8	-22.5	-27.7	-28.5	-36.8	-30.2	-33.2	-31.7
Exports	24.5	29.8	23.1	25.0	27.9	23.2	25.1	25.9	27.5
Imports	45.3	56.6	45.6	52.7	56.5	59.9	55.3	59.1	59.2
Service balance	12.7	15.7	11.3	9.6	5.4	6.3	2.9	2.5	3.5
Income balance	-	-	-	-	-	-	-	-	-
FDI, net	10.9	7.6	6.1	5.2	-1.1	6.7	5.3	-0.1	3.0
International reserves	31.7	34.2	34.2	36.0	18.1	15.0	26.5	27.5	28.8
Total amortisations	2.3	1.8	2.4	2.0	2.2	2.3	2.5	2.8	3.1
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-5.2	-6.4	-6.6	-7.7	-10.1	-10.6	-13.7	-11.7	-9.0
Consolidated gov primary balance	0.0	-1.8	-2.4	-2.6	-4.5	-4.7	-6.0	-2.5	0.9
Public debt	64.2	53.5	54.0	59.8	69.0	77.7	78.6	79.0	79.1
of which Domestic	64.2	53.5	54.0	59.8	69.0	77.7	78.6	79.0	79.1
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	32.8	32.1	33.3	35.0	33.7	38.8	45.8	39.3	35.6
Public	21.6	26.0	27.2	28.3	27.4	32.8	40.5	31.5	31.5
External debt / GDP	24.8	19.5	17.7	16.3	14.6	14.9	18.0	14.5	12.6
External debt / XGS	68.8	55.6	73.0	70.9	71.1	85.9	105.1	89.2	75.4
Short-term debt	2.2	2.8	2.6	3.1	3.0	6.7	2.8	2.8	2.8
Short-term debt/International reserves (%)	7.0	8.3	7.5	8.7	16.7	44.3	10.6	10.2	9.8
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.4	1.5	1.8	3.0	3.2	3.0	3.2	3.0	3.5
CPI, % yoy eop	11.7	9.8	7.4	6.5	7.3	5.4	7.0	6.7	7.2
Policy interest rate, %, eop	8.25	8.25	8.25	8.25	8.00	8.00	7.50	7.50	7.50
Short-term market rate, % eop	9.25	9.25	7.83	7.00	7.74	5.84	7.46	7.15	7.68
Long-term yield, %, eop	13.50	13.50	13.50	13.00	12.50	12.00	11.50	11.50	11.00
EGP/US\$, eop	6.95	6.97	7.15	7.20	7.30	7.45	7.55	7.60	7.65

Source: National Sources, Citi Research forecasts

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## GCC

### Saudi Arabia

**As the advance of ISIS in Iraq poses a theoretical (but small) risk of disruption in global oil supplies, the focus has turned on Saudi Arabia's ability to make up any potential shortfall in Iraqi exports.** Saudi oil production has been in the 9.6mbpd-10mbpd range since mid-2013, while capacity remains at around 12.5 mbpd. The Kingdom has never pumped more than 10mbpd on a sustained basis, and the ease with which it can cover any Iraqi crude losses is thus uncertain. That said, heightened concerns about global supply risks suggest a firm underpinning to Saudi production, in our view, which we believe is likely to be sustained in the near term.

**We recently raised our expected average 2014 production for Saudi Arabia from 9.2mbpd to 9.5mbpd (on par with 2013) as a result.** We expect public finances and external balances to remain robust in the near term, with a likely current account surplus of 14.8% this year, real GDP growth of 4.8%, and a fiscal surplus of 6.2%. That said, we think rising expenditures and an expected levelling 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 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 is 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.

**There are mixed signals regarding the trajectory of house prices and the real estate market at present.** Cluttons data suggest there has been a levelling off in residential prices in 2014, with the international property consultancy arguing that measures taken by the authorities, particularly the cap on mortgage values, having been successful in cooling the market. But data from Jones Lang Lasalle's Q1 Dubai property market report suggests that prices continue their upward trajectory, albeit at a somewhat reduced pace. Either way, rates are up around a third on average across Dubai, with some areas seeing prices in excess of the 2008 peak. The number of announced projects and the sharp rise in land transactions over the past year and during the first quarter (value of transactions rose 57%YoY) suggest to us that the momentum remains driven by strong investor confidence, and we expect further gains in future.

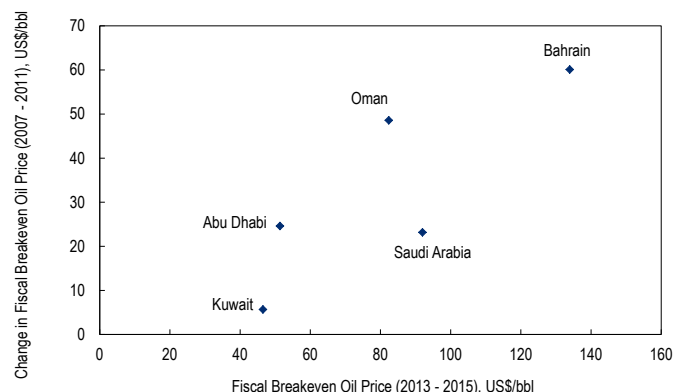
## **Qatar**

**In recent weeks, Qatar's hosting of the World Cup in 2022 has been brought into doubt by rising calls for FIFA to rehold the vote, following revelations of alleged irregularities in the bidding process and concerns regarding possible corruption among FIFA officials.** We do not have a view on the likelihood of the tournament being awarded elsewhere. However, were this to happen, we believe the impact on the Qatari economy would be limited. In the near term, construction activity may experience some decline as ongoing projects are potentially curbed. In the longer term, however, we have always been unconvinced about the economic benefits to Qatar of hosting the World Cup. Were it awarded elsewhere, we consider the long-term loss to the economy to be limited, with the potential upside that capital that would have been allocated to World Cup-related projects could be put to better use elsewhere in the economy.

**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 [Middle East Macro 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%.

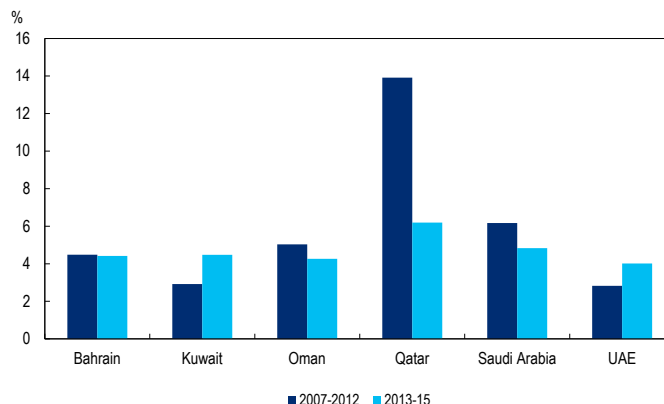


Figure 137. Fiscal breakeven oil prices on the rise



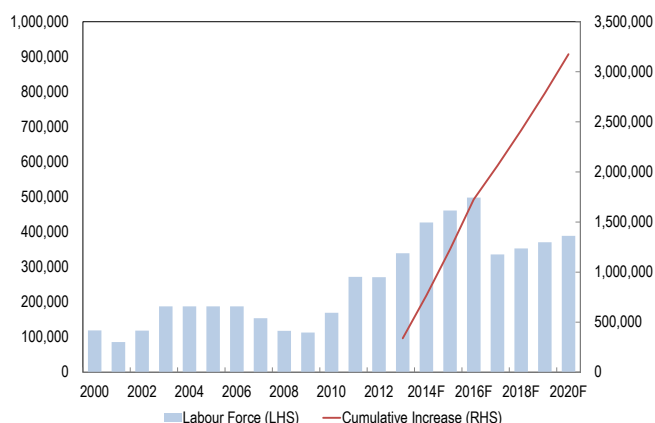
Source: Citi Research estimates

Figure 138. Economic growth will be uneven going forward



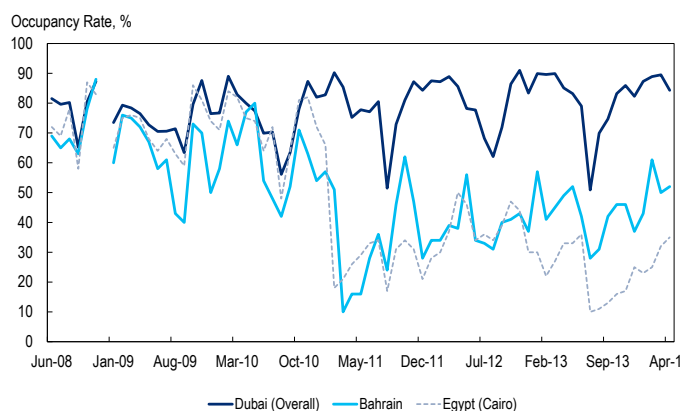
Source: Haver Analytics, Citi Research

Figure 139. 3.3 million entrants in Saudi job market by end of decade



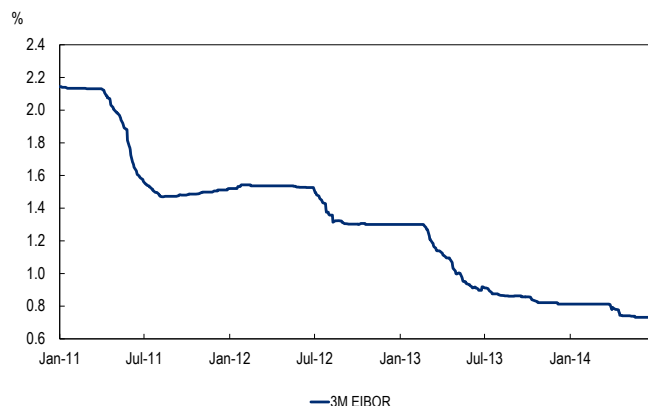
Source: Saudi Central Statistics Office, Citi Research

Figure 140. Dubai hotel occupancy continues to outperform its peers



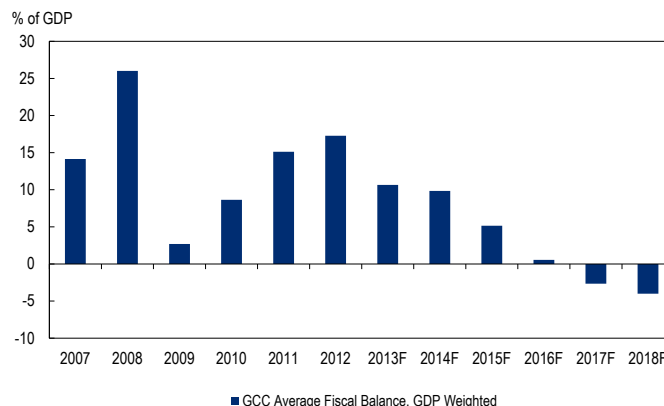
Source: Ernst & Young, Citi Research

Figure 141. EIBOR rates stabilise at low levels



Source: Haver Analytics

Figure 142. High government expenditure will drive balances lower



Source: Haver Analytics, Citi Research estimates

Figure 143. GCC Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>BAHRAIN</b>									
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	-3.3	-4.5	-6.8
<b>KUWAIT</b>									
Nominal GDP, USD bn	112.3	136.6	105.2	118.5	152.8	176.9	191.3	210.4	211.8
GDP per capita, USD	43,971	50,563	36,898	39,610	48,908	54,947	57,706	61,608	60,218
Real GDP, yoy avg	6.0	2.5	-7.1	-2.4	10.2	8.3	5.7	3.8	3.9
CPI, % avg	5.5	10.6	4.0	4.0	4.7	2.9	2.6	3.0	4.0
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	72.6	85.0	81.2
% of GDP	37.3	42.3	27.6	31.9	43.3	44.6	37.9	40.4	38.3
Consolidated gov. balance, % of GDP	30.0	36.4	19.0	30.8	40.1	39.4	28.8	32.2	26.5
<b>OMAN</b>									
Nominal GDP, USD bn	42.0	59.9	53.4	53.4	53.4	53.4	84.3	89.8	94.8
GDP per capita, USD	15,326	20,887	18,015	17,438	16,881	16,180	24,363	24,858	25,097
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	1.5	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	10.8	8.5	6.6
Consolidated gov. balance, % of GDP	2.7	0.3	-0.1	3.1	-0.4	-0.3	9.9	8.4	6.1
<b>QATAR</b>									
Nominal GDP, USD bn	79.7	115.3	97.8	125.1	171.5	192.4	202.5	216.1	231.1
GDP per capita, USD	85,712	104,982	80,294	92,546	114,241	118,688	115,635	114,314	113,188
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	3.0	3.5
QAR/US\$, avg	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64
Current account, US\$bn	11.5	26.6	6.4	24.0	52.0	62.0	62.6	63.5	58.0
% of GDP	14.4	23.1	6.5	19.1	30.3	32.2	30.9	29.4	25.1
Consolidated gov. balance, % of GDP	10.9	9.8	13.4	2.7	7.8	11.9	8.2	4.2	1.2
<b>SAUDI ARABIA</b>									
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
<b>UNITED ARAB EMIRATES</b>									
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	2.0	2.4
AED/US\$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account, US\$bn	15.5	22.7	7.9	7.4	74.3	108.6	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 continues to surprise to the positive side in 2Q14 but may slow from 2H14. Soft inflation supports further minor rate cuts amidst a supportive external environment.
- **Things to watch** — Details related to the long-awaited FX mortgage aid scheme is likely to be the key market moving local event in the coming months, which we do not expect to conclude before September.
- **Strategy** — Further monetary loosening and uncertainties related to the resolution of FX loan problem may keep the HUF vulnerable to tightening global monetary conditions.

### Inflation risks muted despite positive growth momentum

**Growth indicators continue to beat expectations.** Following the upbeat (1.1%QoQ and 3.5%YoY) 1Q14 GDP print, incoming indicators signal sustained strong growth momentum in 2Q14. Positive growth surprise has been largely driven by accelerated EU fund absorption fuelling public investments and export-driven industrial output primarily related to new capacity in car manufacturing. Industrial output data from April (2.4%MoM) suggest growth may accelerate further in 2Q14, driven by manufacturing exports benefiting from the European recovery. While retail sales continue to signal a fast expansion in consumption, we note retail sales overestimate household consumption growth due to methodological changes and the whitening of the economy. Household consumption expenditures grew by a moderate 1.5%YoY in 1Q14 against the 7.1% growth in retail sales during the same period, which signals a continuation of a gradual consumption recovery but given that consumption has been just catching up to pre-crisis levels, it is unlikely to deliver unexpected sharp acceleration in inflation.

**We expect a slowdown in growth in 2H14 due to base effects** as new car plant capacities have been fully utilized and EU fund absorption has likely peaked in 2H14-1H14, thus the positive growth impacts related to a pickup in investments may fade. Moreover, we believe agricultural output (-5.8%YoY in 1Q14 based on CSO estimate) may contribute more negatively to growth following last year's record high crops. Based on the incoming strong 2Q14 indicators, we have upgraded our 2014 GDP growth forecast to 2.9%YoY but keep our 1.9%YoY 2015 GDP forecast unchanged due to the expected slowdown from 2H14.

### FX mortgage legislation key domestic factor to watch

**There has been no major change in fiscal policy following the renewal of the government** as the fiscal deficit is likely to remain within the 2.9% of GDP which would deliver 1.4% loosening in the structural deficit as fiscal stimulus. Further extension of state ownership in the energy sector and cuts in the 16% flat Personal Income Tax (PIT) have been set as medium-term targets by the government while extraordinary sectoral taxes would remain in place.

**Solving the FX mortgage is at the top of the political agenda** as the 16 June Supreme Court decision opens the door for legislative changes in loan conditions such as applied FX margins and increases in client interest rates that were set without benchmarks in most FX loan contracts. The government is looking for a solution to ultimately fix installments in HUF but has set as a principle that FX debtors should not benefit over HUF borrowers, thus extreme haircuts on outstanding FX mortgage debt seem unlikely.

**The finalisation of the long-awaited FX bail-out scheme is unlikely before September**, which may add to uncertainty fuelled by harsh political talk. We believe the final solution is likely to shift bulk of the burden on banks, which have been already loss making since 2011 at a consolidated level. We do not expect a major threat to banks' stability as the government has been focusing on solutions where the losses are not upfront but incurred gradually during the remaining lifetime of the loans. The retrospective change in loan conditions however may be adverse to business confidence, which together with remaining constraints to credit supply may continue to hold back private investments and domestic sources of growth.

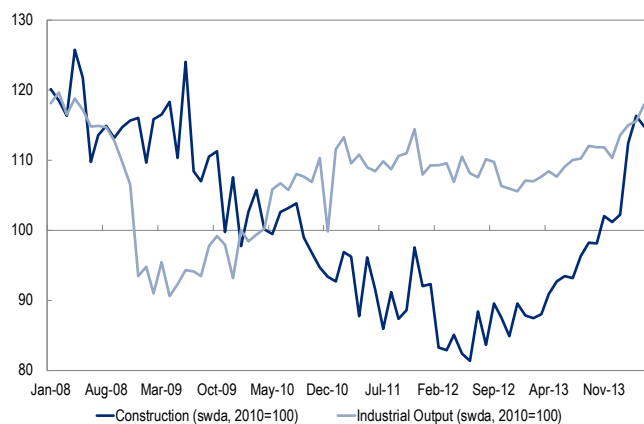
### **Soft inflation and ECB steps create room for more cuts**

**April-May CPI prints (-0.1%YoY) confirmed the continuing moderation in underlying inflation** as, besides the large disinflationary impact of regulated utility price cuts, the tax-filtered core inflation index has also slowed, reflecting low imported inflation and the still large slack in domestic demand. Based on the soft incoming inflation surprises, we have once again reduced our CPI forecasts to 0.4% and 2.5% for 2014 and 2015 respectively. Recent comments from MPC members confirm the soft inflation surprises and the benign external risk environment supported by the ECB's steps provide room for further gradual rate cuts.

**We expect that the MPC will deliver three more 10bp cuts by August** and stop rate cuts at 2.10% in September when domestic noises related to the FX loan aid scheme and a potentially more hawkish Fed rhetoric may add to market volatility. The NBH is also placing increased emphasis on the communication of future interest rate guidance, arguing that the continued low global inflation environment and the announced ECB steps may help to keep monetary conditions loose. In our view, ECB QE — expected around year-end by Citi economists — may help to postpone the beginning of rate hikes to 2Q15. Given that ex-post real rates may turn negative by mid-2015 (Figure 141), we believe the NBH may start gradual rate hikes around mid-2015 and expect the base rate to reach 3.50% by end-2015.

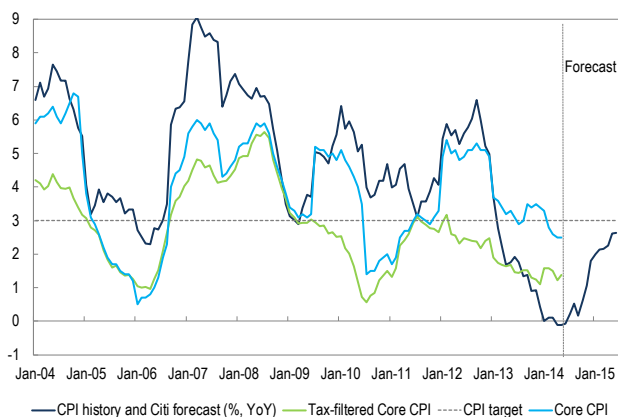
**The currency may be increasingly exposed to shifts in global sentiment** as the carry on the HUF continues to erode further while inflation rises. Considering the final FX mortgage ruling may also include conversion into local currency, we expect the HUF to become more volatile during the autumn months and weaken towards 315 (vs the euro) levels by year-end.

Figure 144. Industry and construction catch up to pre-crisis levels



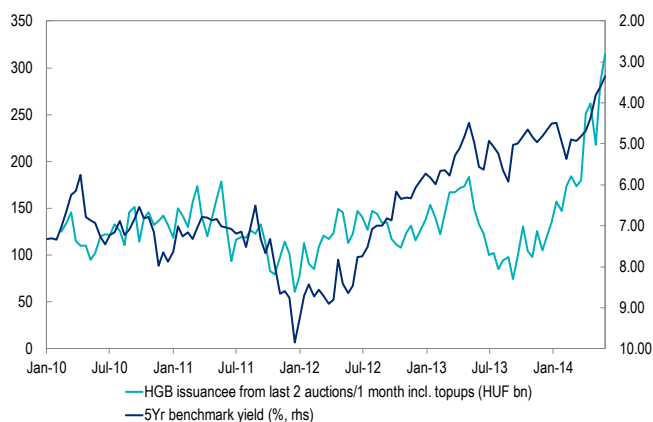
Source: Haver, Citi Research

Figure 146. Core price moderation suggests soft inflation outlook...



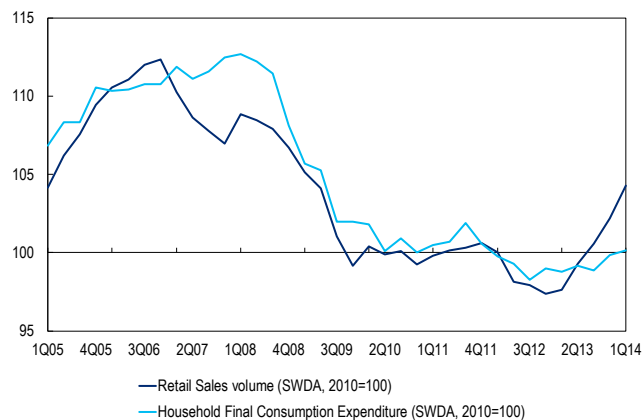
Source: National Bank of Hungary, Citi Research

Figure 148. NBH steps support demand for local bonds



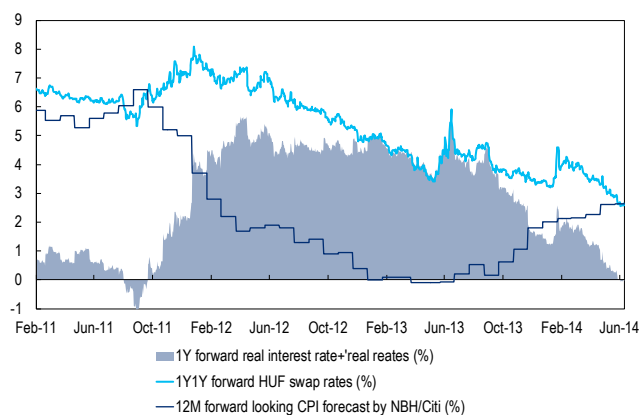
Source: GDMA, Bloomberg, Citi Research

Figure 145. Household consumption still depressed despite recent pick up



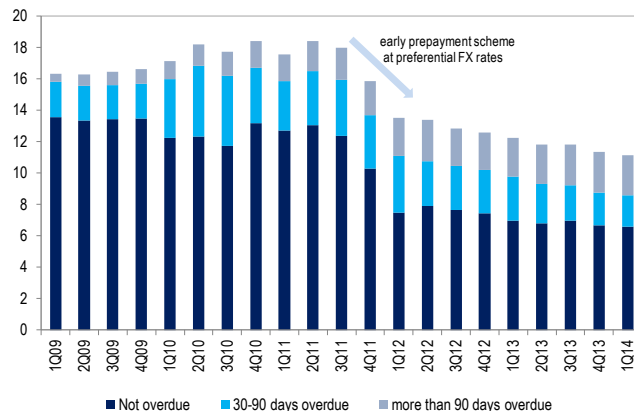
Source: Haver, Citi Research

Figure 147. ...but NBH is unlikely to avoid rate hikes as real rates turn negative by mid-2015



Source: National Bank of Hungary, Bloomberg, Citi Research

Figure 149. FX mortgage loans by delays in payment (EUR bn)



Source: National Bank of Hungary, Citi Research

Figure 150. Hungary Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	145	141	136	127	115	127	135	134	139
Nominal GDP, local currency bn	25,143	26,543	25,730	26,600	27,714	28,082	29,275	30,785	32,241
GDP per capita, USD	14,390	14,061	13,584	12,688	11,487	12,726	13,590	13,459	14,028
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
<b>Economic Activity</b>									
Real GDP, yoy avg	0.1	0.9	-6.8	1.1	1.6	-1.7	1.1	2.9	1.9
Real investment growth % yoy	-1.5	3.7	-29.6	11.5	-3.6	-11.2	2.1	4.5	0.0
Real consumption growth % yoy	-1.4	-0.2	-4.5	-2.5	0.3	-1.5	0.5	1.8	1.5
private consumption growth % yoy	1.1	-0.7	-6.6	-3.0	0.4	-1.6	0.2	1.8	1.9
Real export growth, % yoy	15.0	5.7	-10.2	11.3	8.4	1.7	5.3	5.9	6.0
Real import growth, % yoy	12.8	5.5	-14.8	10.9	6.4	-0.1	5.3	5.8	5.9
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	7.4	3.4	5.4	4.6	4.1	5.1	0.6	1.8	2.8
CPI, % avg	7.9	6.0	4.0	4.7	3.9	5.7	1.7	0.4	2.5
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	0.1	-0.5
Policy Interest Rate, % eop	7.50	10.00	6.25	5.75	7.00	5.75	3.00	2.10	3.50
1 month inter-bank rate, %, eop	7.50	10.00	6.25	5.75	7.08	5.75	3.00	2.10	3.50
Long-term yield, %, eop	7.08	8.28	7.99	7.97	9.75	6.11	5.61	5.60	6.00
HUF/US\$, eop	173	190	189	208	244	221	216	230	232
HUF/US\$, avg	183	171	201	208	201	225	223	226	233
HUF/EUR, eop	253	266	271	278	315	291	297	313	321
HUF/EUR, avg	251	252	280	275	279	289	297	310	318
<b>Balance of Payments, USD bn</b>									
Current account	-9.9	-11.4	-0.3	0.3	0.6	1.1	3.9	3.3	2.9
% of GDP	-6.8	-8.1	-0.2	0.2	0.5	0.8	2.9	2.5	2.1
Trade balance	-0.9	-1.8	3.3	3.2	4.3	4.5	5.7	6.5	5.8
Exports	93.0	106.1	80.0	88.8	103.7	97.3	103.4	110.1	114.7
Imports	93.9	107.9	76.7	85.5	99.4	92.8	97.7	103.6	108.9
Service balance	1.8	2.2	2.8	3.8	4.4	4.3	4.6	4.4	4.6
Income balance	-10.1	-11.0	-6.9	-7.3	-8.9	-8.2	-7.9	-9.0	-8.8
FDI, net	0.3	3.9	0.2	1.0	1.4	2.6	0.8	1.6	1.8
International reserves	23.2	33.2	41.1	43.1	45.4	43.5	47.3	50.0	55.8
Total amortisations	9.3	15.2	21.9	20.5	25.8	21.6	21.5	20.9	20.4
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-5.1	-3.7	-4.6	-4.3	4.3	-2.0	-2.2	-2.9	-2.9
Consolidated gov primary balance	-1.0	0.5	0.0	-0.1	8.5	2.4	2.2	1.1	1.0
Public debt	66.5	72.3	78.1	79.9	81.9	79.8	78.8	79.8	79.5
of which Domestic	35.9	37.5	36.8	40.8	40.8	43.6	44.6	47.5	47.9
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	151.7	172.6	196.3	185.1	172.5	164.9	164.4	159.3	156.1
Public	47.4	51.8	62.1	59.6	58.4	63.8	62.5	63.0	63.5
External debt / GDP	104.8	122.2	144.1	145.7	150.3	129.9	121.8	119.3	112.3
External debt / XGS	137.7	136.5	199.2	171.2	137.3	140.0	131.6	119.8	113.0
Short-term debt	32.9	27.5	28.0	32.9	31.7	22.8	22.9	21.3	20.3
Short-term debt/International reserves (%)	141.7	82.8	68.2	76.1	69.9	52.4	48.3	42.5	36.3
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.7	3.5	3.7	2.1	2.3	1.7	1.8	1.8	2.1
CPI, % yoy eop	0.4	0.1	-0.1	0.2	1.8	2.2	2.6	2.6	2.8
Policy interest rate, %, eop	3.00	2.60	2.30	2.10	2.10	2.10	2.40	2.80	3.50
Short-term market rate, % eop	3.00	2.60	2.30	2.10	2.10	2.10	2.40	2.80	3.50
Long-term yield, %, eop	5.61	5.54	5.00	5.40	5.60	6.00	6.00	6.00	6.00
HUF/EUR, eop	297	307	307	311	313	315	317	319	321

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 the coming months, in spite of the Bank's rather hawkish tone recently. 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, but it is hardly convincing.** The PMI has been rising impressively in Q2, reaching 55.6 in May, but other indicators paint a more mixed picture of Israel's strength. Manufacturing output growth has been negative in the past two months, for example, and so has export growth. Partly thanks to developments like these, the Bank of Israel has revised down its 2014 growth forecast from 3.1% to 2.9% (while the forecast for 2015 remained unchanged). At the same time, the Bank's inflation forecast for 2014 fell 50 bp to 0.4%. In view of all these developments, we think the Bank of Israel will indeed end up cutting its interest rate once more this year, in spite of the fact that the MPC's body language seems relatively hawkish right now.

### The external sector remains a focus for policymakers...

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



## ...and the problem won't go away

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

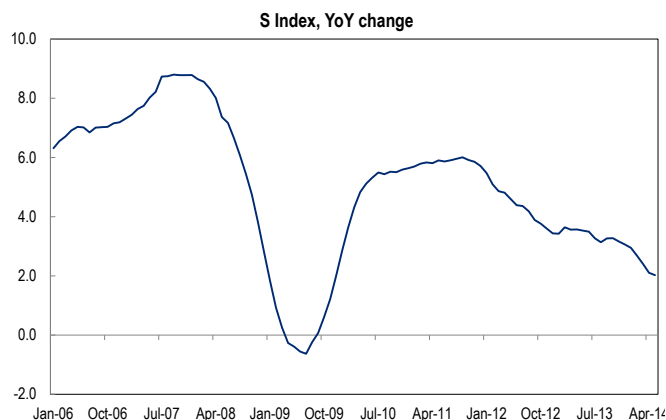
## Another interest rate cut is coming, we think

**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 Q3 – particularly given the relative weakness of exports and manufacturing. Moreover, inflation expectations continue to fall: 2-year ahead inflation expectations have fallen 100 bp in the past two months to 1.5%.

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



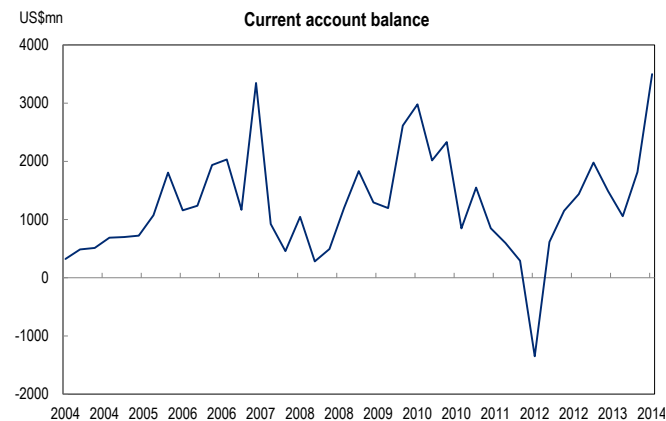
Source: Haver Analytics, Citi Research

**Figure 153. Inflation expectations are more or less stable...**



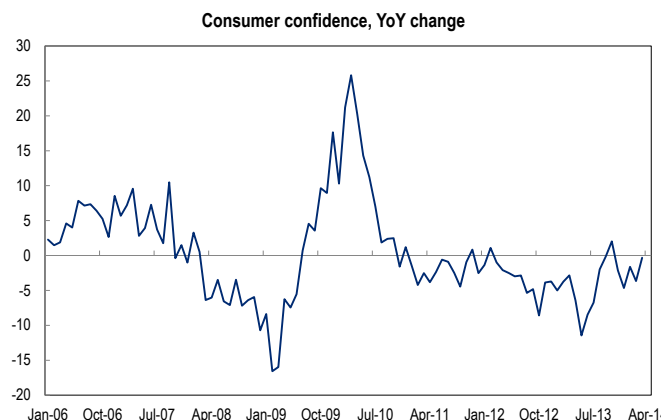
Source: Haver Analytics, Citi Research

**Figure 155. ...on the back of a sharply improving current account balance...**



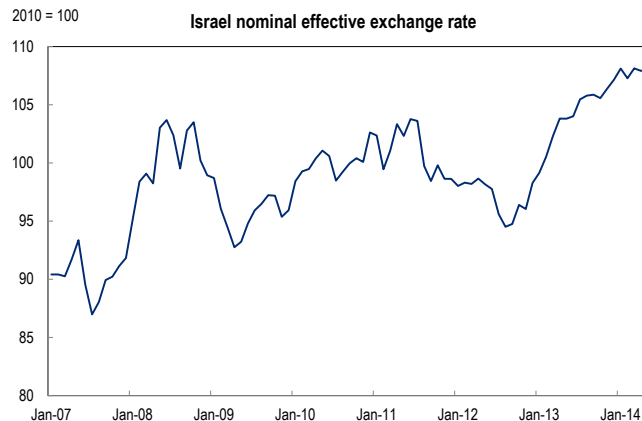
Source: Bloomberg, Citi Research

**Figure 152. ...and consumer confidence is fragile even though household borrowing has been relatively robust**



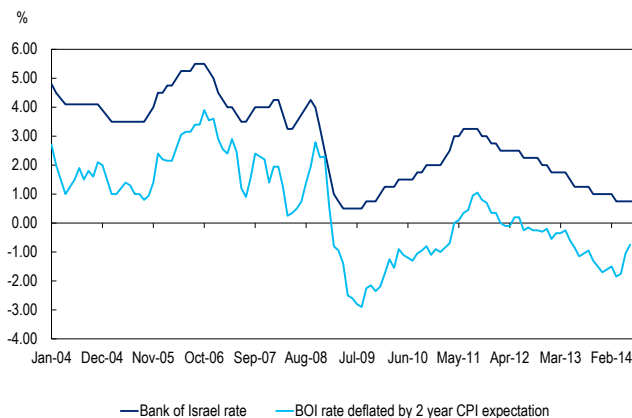
Source: Haver Analytics, Citi Research

**Figure 154. ...but the shekel has strengthened sharply in nominal terms in the past year...**



Source: Haver Analytics, Citi Research

**Figure 156. ...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 157. Israel Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	175	213	206	232	258	258	291	312	317
Nominal GDP, local currency bn	719	765	809	866	924	993	1,052	1,096	1,167
GDP per capita, USD	25,248	29,990	28,289	31,273	34,236	33,702	37,677	39,884	40,030
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
<b>Economic Activity</b>									
Real GDP, yoy avg	6.8	5.0	1.0	5.3	4.7	3.5	3.2	3.2	3.5
Real investment growth % yoy	9.5	9.0	-4.5	9.2	15.8	3.6	0.9	5.6	3.6
Real consumption growth % yoy	6.6	1.7	2.5	4.4	3.6	3.2	3.3	2.6	-0.3
private consumption growth % yoy	8.1	1.5	2.4	4.8	4.1	3.2	3.5	2.6	-0.5
Real export growth, % yoy	11.2	6.6	-12.1	15.2	7.3	1.1	0.9	3.4	6.7
Real import growth, % yoy	10.6	2.3	-12.7	14.1	11.0	3.2	-1.7	1.6	5.4
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	3.4	3.8	3.9	2.7	2.2	1.6	1.8	0.6	1.1
CPI, % avg	0.5	4.6	3.3	2.7	3.5	1.7	1.5	1.0	3.0
Nominal wages, % yoy	2.2	3.8	0.7	3.4	3.8	2.6	2.3	5.0	5.0
Credit extension to private sector, % yoy	10.8	-0.5	6.5	7.0	5.0	3.4	1.7	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	3.57	3.76
ILS/US\$, avg	4.11	3.58	3.93	3.73	3.58	3.85	3.61	3.51	3.68
<b>Balance of Payments, USD bn</b>									
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
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.5	-1.2	-4.2	-2.8	-2.5	-3.5	-2.7	-3.0	-2.5
Consolidated gov primary balance	6.1	4.1	1.0	2.3	2.5	1.4	2.1	3.0	3.0
Public debt	72.9	71.5	73.8	74.5	73.8	72.5	71.8	70.8	67.7
of which Domestic	56.5	57.3	60.1	57.7	57.4	56.4	55.1	53.8	51.4
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
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	33.3	33.1
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
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.9	3.1	3.0	3.0	3.0	3.5	4.5	4.5	4.5
CPI, % yoy eop	1.8	1.3	0.5	1.1	0.6	0.9	1.4	1.1	1.1
Policy interest rate, %, eop	1.00	0.75	0.75	0.50	1.25	1.00	1.00	1.00	1.25
Short-term market rate, % eop	0.99	0.73	0.75	0.50	0.50	1.00	1.00	1.00	1.25
Long-term yield, %, eop	3.50	2.07	4.75	4.75	4.75	4.75	4.75	4.75	4.75
ILS/US\$, eop	3.47	3.48	3.47	3.53	3.57	3.61	3.66	3.71	3.76

Source: National Sources, Citi Research forecasts

## Kazakhstan

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- **Summary view** — We see GDP growth decelerating to 5% in 2014 on the back of heightened uncertainty in the CIS region and a China slowdown. Still, prospects remain 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 was 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 2017.
- **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.

**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 will remain a key driver, although the pace of expansion should moderate. A slowdown in China would also bite.

**First quarter GDP data already showed some fragility.** Preliminary data showed that 1Q14 GDP grew only at 3.8%YoY, confirming our view that Kazakhstan will not be able to emerge unscathed from the broader EM malaise and the regional geopolitical uncertainty. The short-term economic indicator, which captures around two thirds of the economy, expanded by a mere 2.8% during Jan-May on an YoY basis, while industrial production increased by 0.1% during the same time period.

## 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.

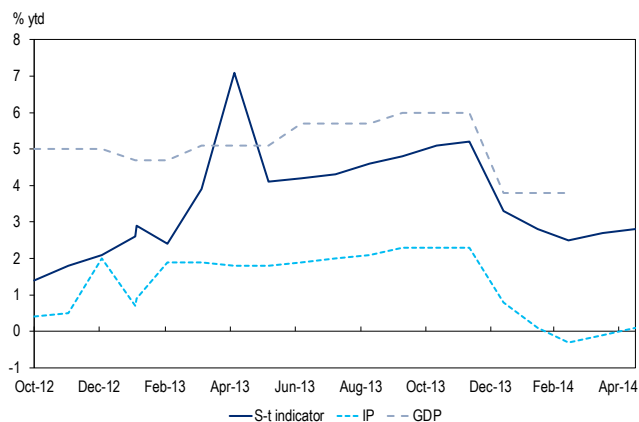
**The recent deterioration of the external position has also led to a decline in foreign reserves.** Gross foreign reserves have followed the current account's performance, falling from US\$35.5bn in February 2012 to US\$26.5bn in March 2014. This has become the key indicator that has focused market 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 47.7% in March 2014.

**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 that emerging market currencies may continue to be under pressure, thus necessitating further devaluations in the future, which the central bank wanted to avoid.

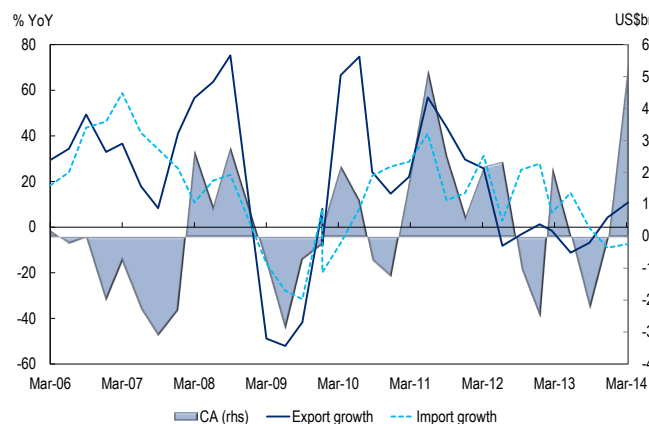
**However, softer growth and currency devaluation have boosted CA in 1Q.** 1Q14 CA surplus came in very strong at US\$5.5bn. This was driven by a significant 7.4%YoY drop in import growth on the back of slowing internal demand and a healthy 10.8% increase in export growth related to the weaker currency. Correspondingly, foreign reserves also benefited, rising to US\$27.6bn in May from US\$24.7bn in December.

Figure 158. Growth is still strong, but some weakness is evident



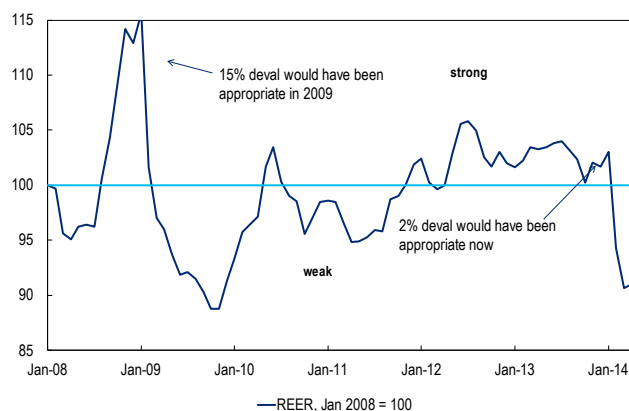
Source: Kazstat, Citi Research

Figure 160. Current account improved in 1Q



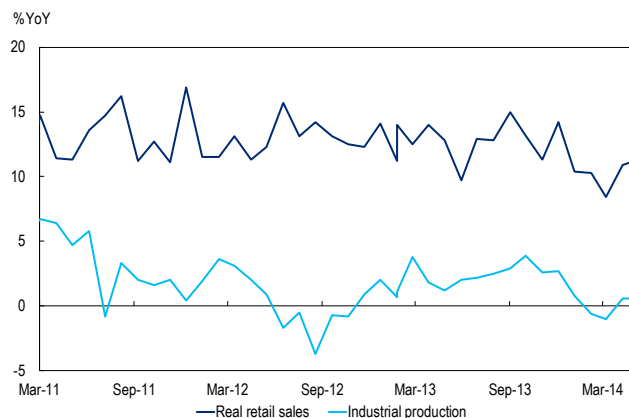
Source: NBK, Citi research

Figure 162. The magnitude of the devaluation appears too big on REER...



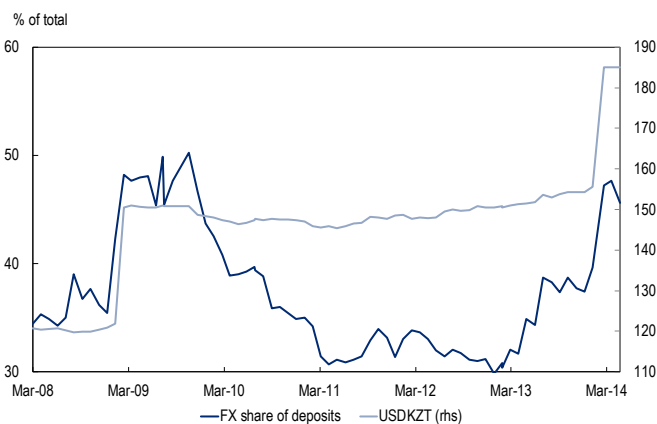
Source: NBK, Citi Research

Figure 159. It is mainly consumption driven as production struggles



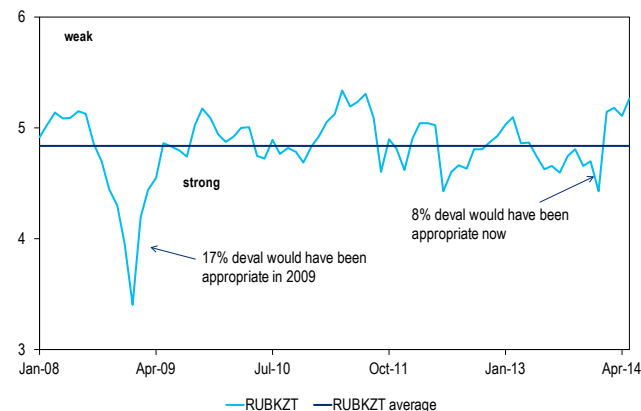
Source: Kazstat, Citi Research

Figure 161. FX share of deposits have started to stabilize after the Feb devaluation



Source: NBK, Citi Research

Figure 163. ...and RUBKZT basis



Source: Bloomberg, Citi Research

Figure 164. Kazakhstan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	105	133	115	146	186	202	222	215	227
Nominal GDP, local currency bn	12,547	16,053	17,008	20,540	27,305	30,147	33,760	37,593	42,020
GDP per capita, USD	6,810	8,572	7,324	9,171	11,568	12,426	13,477	12,910	13,479
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
<b>Economic Activity</b>									
Real GDP, yoy avg	9.2	3.6	0.8	7.3	7.5	5.0	5.9	5.0	6.0
Real investment growth % yoy	23.4	-12.8	2.3	2.0	5.9	12.2	10.7	2.3	3.1
Real consumption growth % yoy	11.4	6.0	0.7	10.0	10.9	11.4	8.2	5.2	5.9
private consumption growth % yoy	11.1	6.4	0.7	10.9	10.9	11.2	9.0	5.5	6.0
Real export growth, % yoy	9.1	0.9	-11.9	3.1	1.5	4.2	-0.2	2.0	6.0
Real import growth, % yoy	26.1	-11.5	-15.7	2.9	3.5	22.5	5.2	2.0	8.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	18.8	9.5	6.2	7.8	7.4	6.1	4.6	7.0	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	-0.55	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	175	185
<b>Balance of Payments, USD bn</b>									
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	28.8	34.1	39.0	25.4	29.6	31.9	31.9	10.5	11.1
<b>Public Finances, % of GDP</b>									
Consolidated government balance	4.5	-9.3	-9.4	2.7	5.9	3.9	3.0	2.3	2.1
Consolidated gov primary balance	4.8	-8.9	-9.0	3.1	6.3	4.4	3.5	3.0	2.7
Public debt	5.3	6.3	9.5	10.3	10.0	12.0	12.7	13.8	14.6
of which Domestic	4.0	5.1	7.6	7.8	7.6	9.6	10.4	11.6	12.3
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
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	34.9	34.8	36.6	35.2
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
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	6.4	3.8	5.5	4.5	6.1	7.7	5.9	6.0	4.7
CPI, % yoy eop	4.6	6.1	7.0	7.0	7.0	5.8	5.7	5.8	5.6
Policy interest rate, %, eop	5.50	5.50	5.50	5.50	5.50	5.50	6.00	6.00	6.00
Short-term market rate, % eop	5.50	5.00	3.48	3.48	3.48	3.48	3.98	3.98	3.98
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US\$, eop	154	182	185	185	185	185	185	185	185

Source: National Sources, Citi Research forecasts



## Levant

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**The fall of Mosul and other advances made by the Islamic State in Iraq and Sham (ISIS) in the past fortnight represent a significant escalation in militant activity and presage what is likely to be a heightened and sustained level of military conflict between Iraqi security forces and Sunni insurgents in the days and weeks to come.** The economic and political significance of some of the territories claimed by ISIS, including most recently the Baiji oil refinery, the country's main source of refined petroleum products, mean that prompt efforts to recapture lost ground are likely to be a priority for the Iraqi government in the near future. Moreover, regional and international powers have expressed alarm given the unexpected military success of the al-Qaeda-affiliated group and the threat it poses to regional stability.

**In our view, the ISIS advance has likely run its course in terms of territorial gain, and we consider the likelihood that Baghdad and the South of the country will be overrun by the extremist Sunni group to be minute.** The reasons for this include 1) the fact that the territories that have fallen to ISIS/Islamist control are where the Shia population make up a small percentage of the total, whereas in Baghdad and the South they are the vast majority, 2) security forces and militia in Baghdad and the South are much stronger than was the case in the areas where insurgents have seen recent success, 3) the scale of operations that would be required to take a city like Baghdad, a city five times the size of Mosul, would be enormous, and 4) there is clear international support for Baghdad and likely concerted effort to prevent ISIS from making any progress in its capture.

**Going forward, the real question in our view is whether the Islamists have the ability to consolidate the territorial gains they have recently made, both from the point of view of administering captured territories and in terms of resisting the likely military counteroffensive.** On the former, we believe the lack of independent income sources from most of the conquered areas means that their economic viability outside of the framework of the Iraqi federal structure is doubtful. Moreover, ISIS' extreme and harsh governing style has been seen to alienate local populations in Syria, and the same may well prove true of Iraq.

**In terms of the military counteroffensive, aimed at pushing ISIS back from territories gained, we believe the prospects are much more uncertain.** Baghdad must ensure that the conflict does not escalate into an all-out civil war, and thus is wary of employing Shia militias and foreign reinforcements against ISIS. At the same time, Baghdad will likely need the support of Sunni tribal leaders and militias in its fight against ISIS, something that is likely to prove a significant challenge in the current politically divisive atmosphere.

**While it is important to note that the advance of ISIS and other Sunni militias in recent weeks does not represent a broader uprising by the Sunni community, grievances with Baghdad within this community run deep and it appears unlikely that Sunnis will mobilise in large numbers against ISIS until some of these are met.**

**Consequently, we believe the Maliki government has been greatly weakened by the crisis, and we believe that PM al Maliki is now less likely to emerge as the head of the new Iraqi government, following April elections.** This is because 1) Maliki is himself being held partly responsible for creating the divisive atmosphere in which ISIS has thrived, or at the very least that Maliki is unlikely to be the figure that can build bridges with the alienated Sunni community, 2) Maliki's image as a strong-man is greatly tarnished given the military's spectacular failure to secure key cities, and 3) international support for Maliki appears to have diminished significantly for the above reasons.

**Indeed, the rise of Sunni militant extremism underscores the need for the Shia-led Iraqi government to engage more constructively with the Sunni community. Such engagement was a key element of the 'Sunni Awakening' strategy that, alongside the 'surge' by the US military, helped end Iraq's civil war in 2008.**

**In short, we believe that confronting ISIS requires Baghdad to seek the support of a broad spectrum of Iraqi society, something that is likely to have a bearing on the ongoing coalition politics and efforts to form a government following recent inconclusive elections.**

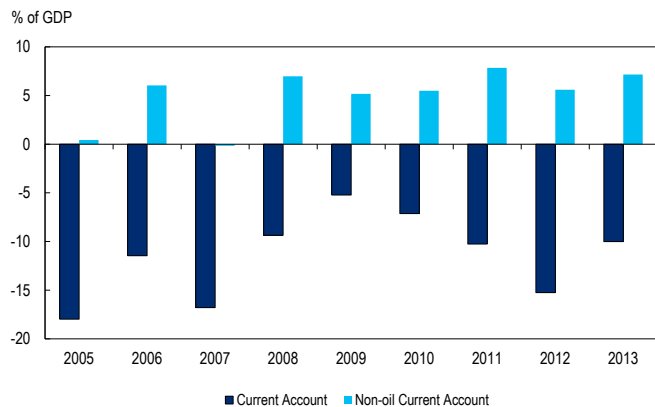
**Despite the gravity of the situation from a security perspective, we do not believe these events materially affect Iraqi sovereign creditworthiness.** We maintain our view that the fighting will remain limited to the North and is unlikely to lead to the disintegration of Iraq. Importantly, it is also unlikely to affect Iraq's Southern oil infrastructure (see Iraq Macro View - The Economic Consequences of Conflict in Iraq and Middle East Macro Monthly - Staying bullish on Iraq). Although we cannot discount the threat of terrorist attacks on infrastructure, a sustained shut-down of oil production appears unlikely at this point. Oil revenues continue to grow in line with recent gains in production and export capacity, bolstering debt servicing capacity. There is no reason, in our view, to believe that recent developments will otherwise affect the federal government's ability or willingness to service its debt.

**We do believe, however, that the prospects for Kurdish independence have increased markedly as a result of recent developments.** Not only has this process gained significant momentum in recent months with the initiation of independent oil exports from the Kurdish region, but the territorial gains made by the KRG in disputed territories have moved the facts on the ground in favour of the Kurds significantly in terms of their bargaining power with Baghdad. While this may be used to arrive at a permanent deal with Baghdad over such things as oil exports and the budget, we believe it has also given added momentum to the drive towards full independence, as evidenced by recent comments made by the KRG leadership to that effect.

**We do not consider Kurdish independence a threat to the federal government's ability or willingness to repay its debt.** The KRG contributes nothing to the Iraqi budget at present, and its de facto independence since 1991 reinforces our view that the federal debt is a responsibility which Baghdad has taken on fully, and will continue to do so.

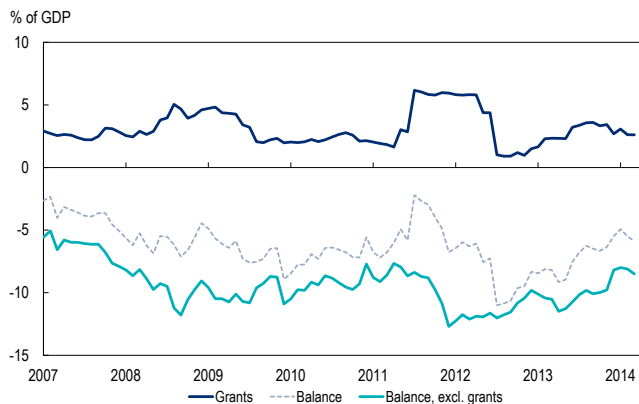
**We are wary of the wider risks to the Levant and the region as a whole.** The flow of refugees to Jordan and Lebanon presents challenges to these countries, as does the deterioration in border security. Moreover, the risk that sectarian tensions are roused beyond current levels across the region is particularly problematic for Lebanon, given its more volatile ethnic mix and history.

Figure 165. Jordan current account dominated by oil imports ...



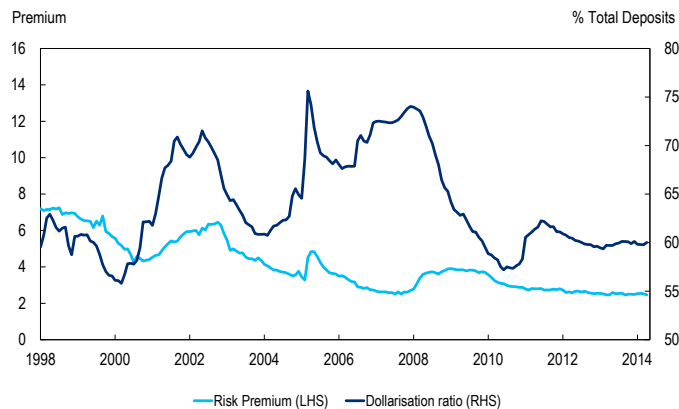
Source: Haver Analytics, Citi Research

Figure 166. Without grants Jordan's fiscal situation would be worse



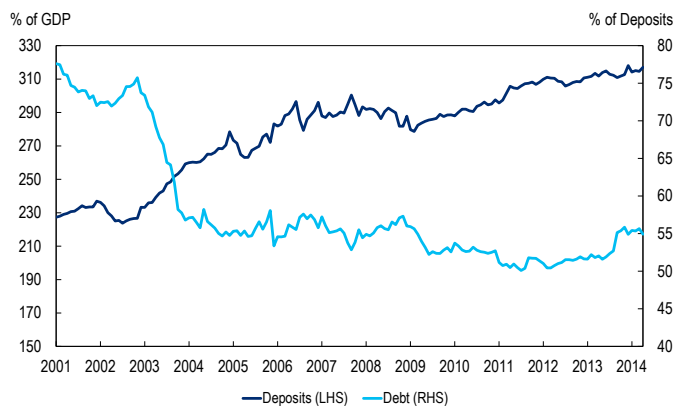
Source: Haver Analytics, Citi Research

Figure 167. Lebanon dollarization has gone up, but risk premium stable



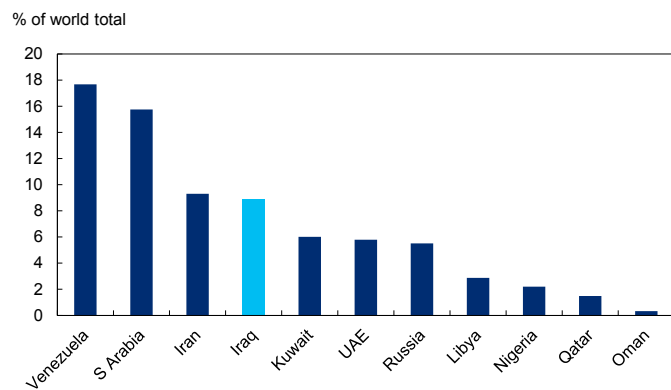
Source: Haver Analytics, Citi Research

Figure 168. Deposit growth slows, but still plenty of capacity



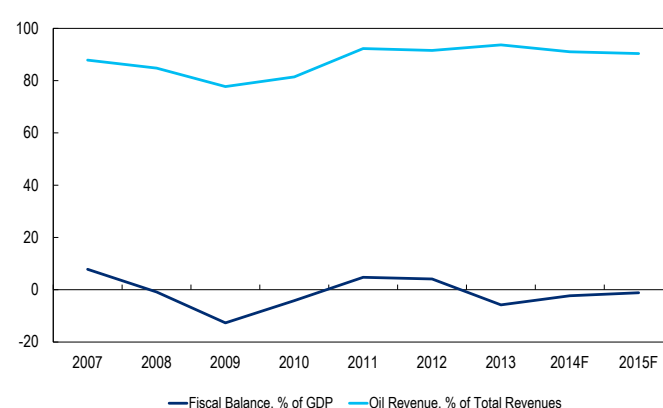
Source: Haver Analytics, Citi Research

Figure 169. Iraq has world's fourth largest proven oil reserves and ...



Source: BP, Citi Research

Figure 170. ... public finances should strengthen as a result



Source: Haver Analytics, Citi Research

Figure 171. Levant Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>IRAQ</b>									
Nominal GDP, USD bn	91.7	135.6	113.6	138.9	186.3	216.6	234.8	272.0	318.7
GDP per capita, USD	3,190	4,607	3,766	4,487	5,871	6,655	7,032	7,946	9,076
Real GDP, yoy avg	1.4	6.6	5.8	5.5	10.2	10.3	3.1	10.4	11.6
CPI, % avg	20.8	2.7	-2.2	2.4	5.6	6.1	1.9	2.5	5.0
IQD/US\$, avg	1,253	1,189	1,156	1,167	1,171	1,164	1,162	1,162	1,162
Current account, US\$bn	20.0	28.4	-1.3	6.3	26.2	38.0	31.1	36.9	40.2
% of GDP	21.9	20.9	-1.1	4.6	14.1	17.5	13.3	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
<b>JORDAN</b>									
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	3.5	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
<b>LEBANON</b>									
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	3.5	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 going into 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** — Comments by the new governor of the Central Bank of Nigeria (CBN), Godwin Emefiele, at his maiden press conference that he would like lower interest rates at some point have put the naira under some pressure. All eyes are now on the CBN's July MPC meeting.
- **Strategy** — The finance minister, Ngozi Okonjo-Iweala, will seek to maintain fiscal discipline despite the approaching elections. But this will become increasingly difficult, while progress with structural reform is likely to 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) and published in early April, Nigeria's economy is now estimated at US\$510bn in 2013.** This makes it the largest in Africa, although it does not change the myriad 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 legislative elections set for February 2015.** Not only is political tensions within the political elite likely to rise sharply as the polls approach, but the elections will be set against the background of the on-going conflict with Boko Haram in the north and potential terrorist incidents in other parts of the country, although probably only in the north.

**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 select 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 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 stabilizing, 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.

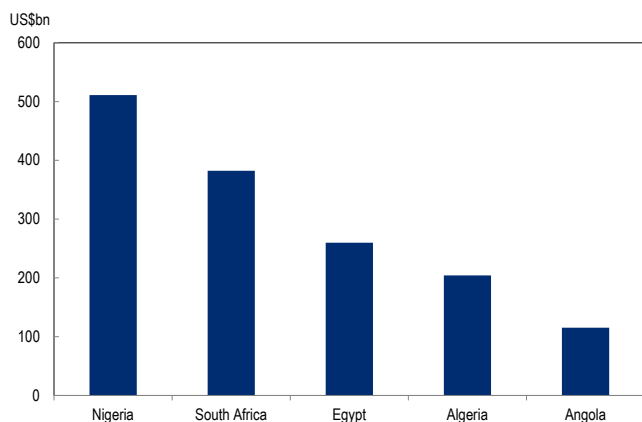
## The fate of the naira is in the government's own hands

**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 2.2m 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\$35bn-US\$40bn level, pressure on the naira should be less intense than in early 2014 even with the approach of the elections.

**Under Mr Sanusi, we would also have been confident of the CBN's willingness to tighten monetary policy further to defend the naira.** But it is not so clear whether this would be the case under Mr Emezie. Having said that, we think inflation will start to trend back up again in 2H 2014, and if fiscal spending pressures were to rise, this would mean he is under no pressure to lower interest rates until after the elections. But, since the departure of Mr Sanusi, the CBN has not mopped up liquidity as aggressively. And given our expected inflation and fiscal trends, and rising political uncertainty this could put the naira under significant pressure again at some point in 2H 2014.

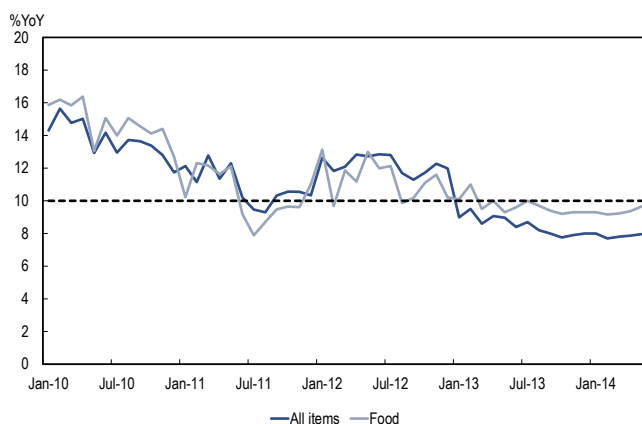
**This may pose a major challenge to the new governor if he is committed to maintaining broad naira stability up to the elections. In fact, in this case he may have to make up monetary policy as he goes along.** But once the elections are passed the more fundamental question will have to be asked about whether the current policy of naira stability is sustainable without a significant increase in the ECA and reserves.

**Figure 172. Nigeria is now Africa's largest economy**



Source: National Bureau of Statistics, Citi and IMF

**Figure 174. Inflation has remained in single digits so far in 2014**



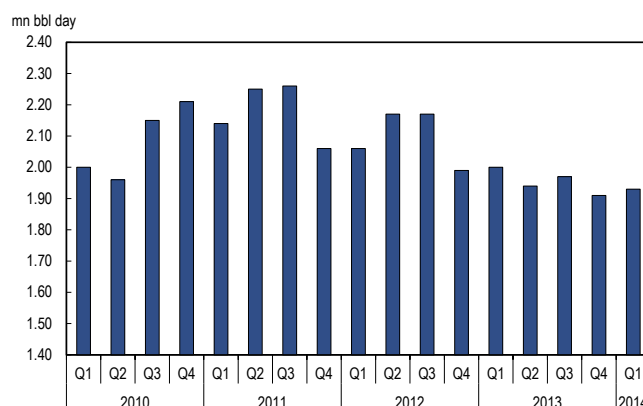
Source: National Bureau of Statistics and Citi forecasts from October 2013

**Figure 176. Pressure on the naira has resurfaced in 2014**



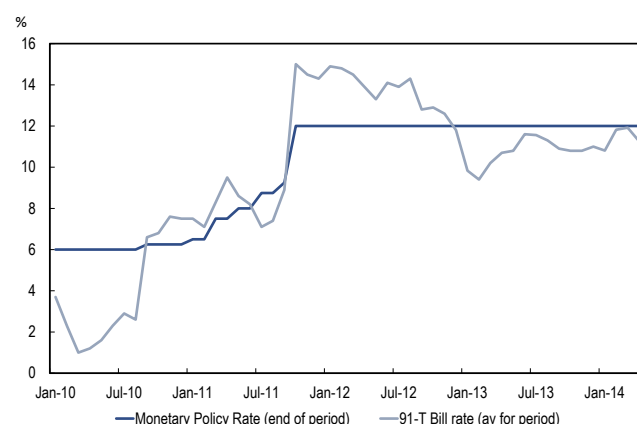
Source: Reuters

**Figure 173. Oil production has been stagnant since mid-2012**



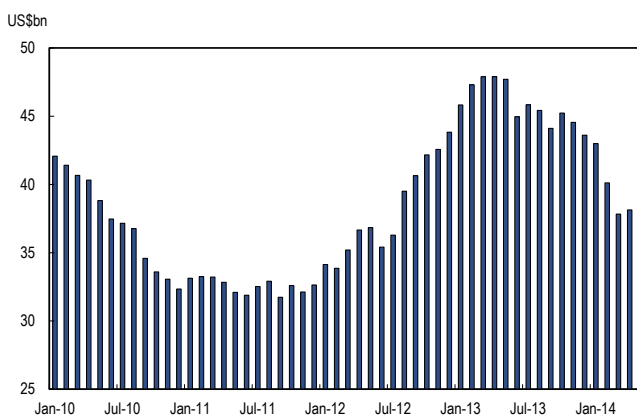
Source: International Energy Agency

**Figure 175. The MPR has been left unchanged since October 2011**



Source: Central Bank of Nigeria

**Figure 177. Reserves have remained under pressure in 2014**



Source: Haver Analytics and Central Bank of Nigeria



Figure 178. Nigeria Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	-	-	-	359	406	448	509	571	651
Nominal GDP, local currency bn	-	-	-	54,205	63,259	71,187	82,497	95,519	112,479
GDP per capita, USD	-	-	-	2,266	2,499	2,692	2,983	3,261	3,621
Population, mn	146.8	150.6	154.4	158.4	162.4	166.6	170.8	175.2	179.7
Unemployment, % of labour force	-	-	-	-	-	-	-	-	-
<b>Economic Activity</b>									
Real GDP, yoy avg	-	-	-	-	5.1	6.7	6.8	6.5	6.4
Real investment growth % yoy	-	-	-	-	-	-	-	-	-
Real consumption growth % yoy	-	-	-	-	-	-	-	-	-
private consumption growth % yoy	-	-	-	-	-	-	-	-	-
Real export growth, % yoy	-	-	-	-	-	-	-	-	-
Real import growth, % yoy	-	-	-	-	-	-	-	-	-
<b>Prices, Money &amp; Credit</b>									
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	8.7	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	12.00	12.00	11.75
1 month inter-bank rate, %, eop	12.50	18.00	15.79	13.07	17.17	14.39	15.00	14.00	13.00
Long-term yield, %, eop	9.25	9.25	11.80	8.50	8.00	0.00	0.00	12.00	13.50
NGN/US\$, eop	118	138	150	152	162	156	160	167	172
NGN/US\$, avg	126	119	150	151	156	159	159	164	169
<b>Balance of Payments, USD bn</b>									
Current account	27.6	29.1	14.0	13.4	8.7	20.4	9.2	8.4	4.5
% of GDP	-	-	-	3.7	2.1	4.6	1.8	1.5	0.7
Trade balance	37.8	45.9	25.7	30.6	31.1	42.4	36.6	32.0	30.7
Exports	66.1	85.7	56.8	77.4	93.3	96.0	93.8	93.2	93.8
Imports	28.3	39.8	31.1	46.8	62.2	53.6	57.2	61.2	63.1
Service balance	-16.9	-22.1	-16.7	-18.5	-21.4	-21.7	-28.7	-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	34.5	32.4
Total amortisations	0.9	0.6	0.5	0.5	0.4	0.3	0.3	0.3	0.3
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.4	-0.1	-1.8	-2.0	-1.8	-1.4	-1.6	-2.0	-1.8
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	7.0	5.5	7.1	8.2	8.4	9.2	8.8	8.9	8.8
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	3.4	3.7	4.6	4.6	5.7	6.5	8.8	9.2	12.3
Public	3.0	3.2	3.9	4.4	5.0	6.0	7.3	7.7	10.0
External debt / GDP	-	-	-	1.3	1.4	1.5	1.7	1.6	1.9
External debt / XGS	5.0	4.2	7.7	5.7	5.9	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	7.7	6.2	6.3	6.4	7.0	5.2	6.2	6.9	7.4
CPI, % yoy eop	7.9	7.8	8.5	9.5	10.0	11.5	10.9	10.1	10.1
Policy interest rate, %, eop	12.0	12.0	12.5	12.5	12.5	12.3	12.0	12.0	12.0
Short-term market rate, % eop	11.1	11.4	12.0	14.0	14.0	16.0	16.0	14.0	13.0
Long-term yield, %, eop	13.3	14.0	12.7	12.2	12.0	12.4	12.8	13.1	13.5
NGN/US\$, eop	160	165	163	166	167	168	168	169	172

Source: National Sources, Citi Research forecasts

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- **Summary view** — Growth has lost some of momentum in 2Q but still remains above potential and is driven by robust domestic demand. However, in the short term, inflation is likely to stay low, possibly even below 0%.
- **Things to watch** — The political scandal resulting from publications of secret recordings of Polish politicians has the potential to roil the political stage and possibly could even lead to early elections (though not our base case).
- **Strategy** — Higher political risk premium and prospects of tighter monetary policy in the US are likely to be negative for Polish assets.

### Dovish MPC but rates on hold

**In June the Monetary Policy Council softened its rhetoric and for the first time has suggested that additional monetary policy easing cannot be ruled out.**

This significant shift in communication strategy suggests the central bank does not want to close the door on any policy action, especially given the non-standard measures taken by the ECB. However, despite more dovish communiqué the comments from various MPC members suggest they are still far from the decision to reduce interest rates and for example, according to governor Belka such a scenario “has a low probability”.

**Indeed, the most serious and probably the only argument justifying policy easing in Poland is that extremely low inflation may even temporarily fall slightly below 0% in July and August.** However, this drop is driven by transitory factors, including a deep slide in food prices, partly due to the Russian ban on Polish meat exports, while we expect the CPI to return to above 2% around May 2015. Also, economic growth is running above potential, which should lead to a gradual rise in demand side pressures in the coming quarters. Taking the above factors into account the safest strategy for the MPC probably would be to refrain from any policy changes and wait for the gradual rebound in inflation. This is exactly why although we believe there is some risk of a rate cut after the summer (30%). Our base case scenario is for stable interest rates until late 2015. We differ from the market, which is currently pricing in one rate cut by 25bps in early 2015.

### Weaker growth momentum

**The biggest risk to our no-cut scenario is the possibility of an additional economic slowdown.** After an impressive acceleration in previous quarters the Polish economy probably lost some momentum in 2Q. The published data on industrial output and the PMI index repeatedly surprised to the downside, partly reflecting the delayed impact of weaker demand from the CIS countries. If this trend continues it may force the MPC to re-think its policy strategy. However, based on various indicators – in particular improving labour market, rising lending activity and consumer confidence indicators – we expect that growth will nevertheless remain at a relatively strong level. We forecast growth to reach around 3%YoY in 2Q and accelerate again in 2H. This means that although our forecasts are less optimistic than central bank’s, as the latter look for around 4% growth by the end of 2014, we generally believe the economy will keep expanding at an above-potential pace.

## Political risk rises substantially

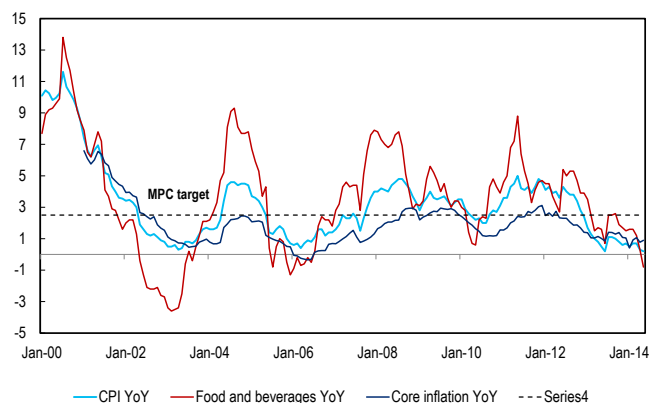
**The most important political event in Poland in recent weeks was the publication of several recordings of conversations of Polish politicians.** Local press says that new recordings will be revealed in the coming weeks, increasing pressure on the government and somewhat increasing the risk of early elections (see our note [Poland Macro Flash - What you should know about the new political crisis](#), dated 19 June 2014). According to local political analysts, the published recordings may substantially increase the chances of the biggest opposition party PiS taking a large share of votes. We believe this also creates the risk of more significant shifts in government policies after the elections. Additionally, one of persons involved in “tapes scandal” is NBP governor Belka, who was recorded discussing conditions under which the central bank could theoretically start an asset purchase program ahead of elections, potentially in order to boost chances of the incumbent government’s re-election. According to Polish law the NBP head has complete independence from the Parliament and therefore cannot be easily removed from the office. Also, comments from Mr. Belka suggest that he has no plans to step down. Nevertheless, we believe the scandal raises some of previously absent political risk that may affect the market in the coming months.

## Increased political risk premium negative for assets

**In our view despite a very low inflation path the prospects of a potential rate cut are limited by the increased political risk hitting NBP credibility, and, in our opinion, this is likely to affect bond yields, at least temporarily.** However, taking into account our current inflation estimates and relatively long period of stable rates, we expect that bond yields will increase very slowly until year-end and larger increase in yields will start in 2015, in line with a rise in inflation. Low yields should also be supported by a lower bond supply, as by mid-June the Finance Ministry has already realized as much as 95% of borrowing needs and in the second half of the year the average size of bond supply at auctions used for pre-financing of 2015 will most likely be much smaller than in 1H. This should limit the expected increase in bond yields similar to any further monetary policy easing by the ECB.

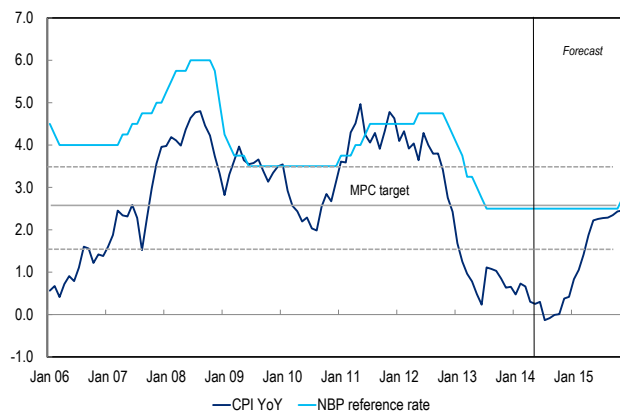
**Despite the improving external position we believe the zloty is likely to weaken over next 6-12 months, partly due to a prospect of tighter policy in the US and partly due to rising domestic political risks.** In case of intensification of the political crisis in Poland or realization of early election scenario or resignation of the NBP governor, the political risk premium could negatively impact the zloty, especially as the market may start discounting a scenario that the new government might conduct less market friendly policies. However, in our opinion zloty weakening will be limited by strong economic fundamentals, i.e. accelerating economic growth and still improving current account balance.

Figure 179. We expect inflation to drop below zero in July-August



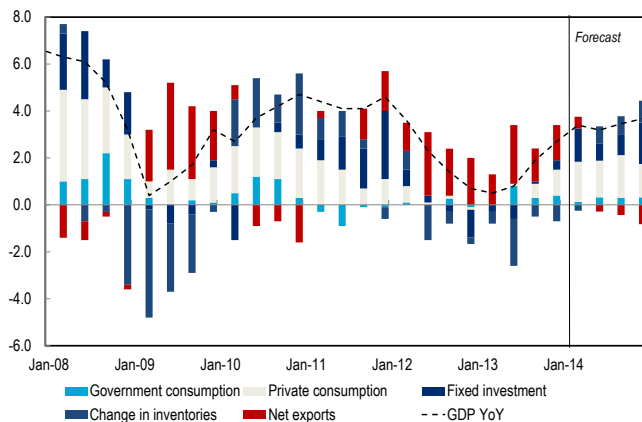
Source: CSO, Citi Research

Figure 180. The MPC will likely delay first rate hike till 4Q15



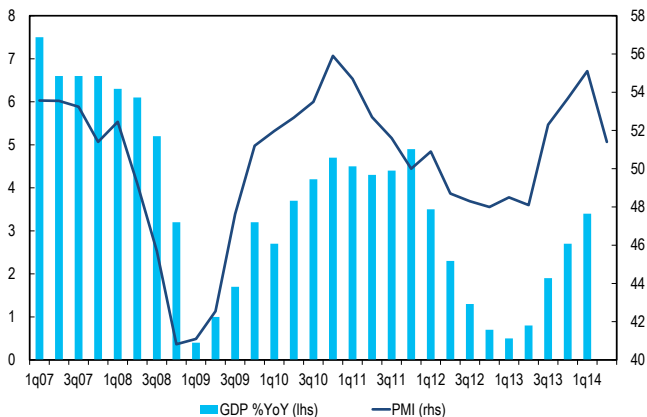
Source: CSO, Citi Research estimates

Figure 181. Recovery supported by stronger domestic demand



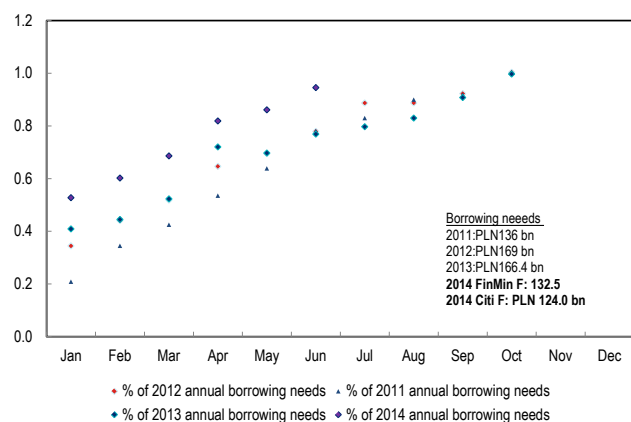
Source: CSO, Citi Research estimates

Figure 182. Weak PMI poses some risk to GDP growth recovery



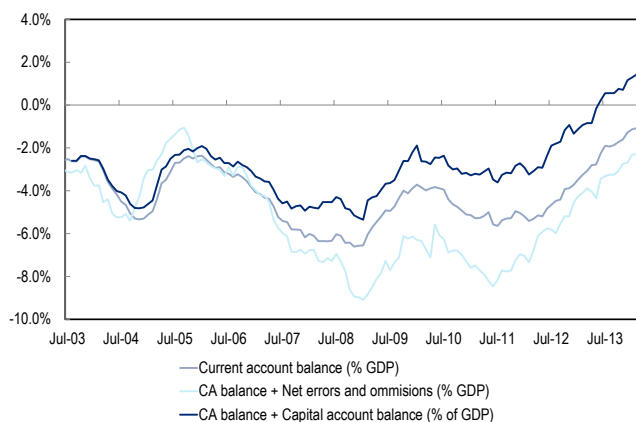
Source: Eurostat, CSO, Reuters, Citi Research

Figure 183. MinFin has nearly finalized realization of borrowing needs



Source: Ministry of Finance

Figure 184. Gradual current account improvement limits zloty sensitivity



Source: NBP, CSO, Citi Research

Figure 185. Poland Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	426	534	433	470	517	490	516	553	584
Nominal GDP, local currency bn	1,177	1,276	1,345	1,417	1,528	1,596	1,632	1,698	1,797
GDP per capita, USD	11,185	13,994	11,347	12,210	13,404	12,721	13,416	14,376	15,196
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
<b>Economic Activity</b>									
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	8.4	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	2.8	3.2
Real export growth, % yoy	9.1	7.1	-6.8	12.1	7.7	3.9	4.6	6.6	6.5
Real import growth, % yoy	13.7	8.0	-12.4	13.9	5.5	-0.7	1.2	7.5	7.5
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	3.9	3.4	3.7	3.2	4.6	2.6	0.8	0.4	2.4
CPI, % avg	2.5	4.2	3.5	2.6	4.3	3.7	0.9	0.3	2.0
Nominal wages, % yoy	9.1	10.5	4.2	3.6	4.9	3.5	2.6	4.8	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	2.75
1 month inter-bank rate, %, eop	5.52	5.61	3.76	3.66	4.77	4.21	2.61	2.62	2.85
Long-term yield, %, eop	5.93	5.46	6.24	6.07	5.91	3.73	4.34	3.95	4.55
PLN/US\$, eop	2.47	2.97	2.87	2.97	3.45	3.09	3.02	3.13	2.97
PLN/US\$, avg	2.76	2.39	3.10	3.01	2.96	3.25	3.16	3.07	3.08
PLN/EUR, eop	3.60	4.15	4.10	3.97	4.47	4.08	4.15	4.26	4.11
PLN/EUR, avg	3.78	3.52	4.32	3.99	4.12	4.18	4.20	4.20	4.20
<b>Balance of Payments, USD bn</b>									
Current account	-26.5	-34.9	-17.3	-24.1	-25.8	-18.1	-6.6	-9.2	-15.9
% of GDP	-6.2	-6.5	-4.0	-5.1	-5.0	-3.7	-1.3	-1.7	-2.7
Trade balance	-19.1	-30.7	-7.6	-11.8	-14.1	-6.7	3.1	3.0	-1.2
Exports	145.3	178.7	142.1	165.9	195.2	191.0	207.2	233.5	264.6
Imports	164.4	209.4	149.7	177.7	209.3	197.7	204.2	230.4	265.8
Service balance	4.8	5.0	4.8	3.1	5.7	6.0	7.0	6.3	6.4
Income balance	-16.4	-12.8	-16.6	-19.1	-23.6	-22.6	-21.7	-24.6	-28.2
FDI, net	18.0	10.4	8.5	6.9	12.4	5.3	-1.3	4.0	6.0
International reserves	54.6	57.2	69.7	81.4	86.8	96.1	94.0	92.3	99.9
Total amortisations	43.0	44.0	46.9	44.1	38.3	47.5	48.7	49.2	51.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-1.9	-3.7	-7.5	-7.8	-5.1	-3.9	-4.3	5.2	-2.7
Consolidated gov primary balance	0.4	-1.5	-4.9	-5.1	-2.4	-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	37.6	30.4	30.2
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
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	66.4	61.8
External debt / XGS	133.9	114.2	163.8	159.6	138.9	159.8	153.3	133.0	115.4
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	79.6	72.5
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.3	3.8	3.0	3.3	3.8	3.4	3.3	3.7	3.9
CPI, % yoy eop	0.7	0.7	0.3	0.0	0.4	1.4	2.3	2.3	2.4
Policy interest rate, %, eop	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75
Short-term market rate, % eop	2.61	2.61	2.61	2.62	2.62	2.62	2.62	2.62	2.85
Long-term yield, %, eop	4.42	4.27	3.55	3.80	3.95	4.10	4.25	4.40	4.55
PLN/EUR, eop	4.15	4.17	4.17	4.22	4.26	4.29	4.23	4.17	4.11

Source: National Sources, Citi Research forecasts

## Romania

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- **Summary view** — Growth drivers seem to be switching from net exports to domestic demand this year. In this respect, the recent data provide some hope that private consumption is probably gaining some traction, as investment recovery continues to lag behind.
- **Things to watch** — Political stability ahead of the November 2014 presidential election and the implementation of the IMF-EU supported economic program deserve close monitoring.
- **Strategy** — Despite the favorable relative performance of Romanian assets so far, we find it hard to get excited about the leu, as we question whether the bond market rally has more legs.

### Does domestic demand recovery have more legs?

**The observed pick-up in private consumption, which is in line with our expectations of growth drivers switching from net exports to domestic demand, is encouraging.** However, we believe that there are reasons to be more cautious on the growth outlook. First, the marked slowdown in the growth momentum warrants concern. Standing at 0.06%QoQ (SWA), the 1Q print represents a considerable slowdown when compared with the last two quarters of 2013 (1.4% in 4Q and 1.6% in 3Q). Second, preliminary data for the second quarter—such as industrial production and retail trade turnover—don't suggest that economic activity is gaining traction after a soft patch in 1Q. Third, the outstanding issues on the IMF-EU program, if prolonged, could hurt investor sentiment, thereby thwarting the recovery process. Against this backdrop we keep our 2014 GDP growth forecast at 3.0%, although we have become more cognizant of downside risks.

### A reversal in food prices in 2H is likely

**At 0.9%YoY, the May inflation reading came in lower than the consensus projection (1.2%) thanks to benign food prices.** Using seasonally adjusted data, the May print translates into a flattish inflation, compared with an increase of 0.3% MoM in April and a flattish inflation in March. We still think the better-than-expected inflation readings since the beginning of the year doesn't change the big picture given sticky service and non-food prices as well as the important contribution of downward administrative price adjustments to the disinflation process so far this year. More importantly, our analysis leads us to expect higher food prices in the second half unless there is a major structural change.

**Looking ahead, we believe that the possibility of a sharper reversal in food inflation, uncertainties related to the timetable for the deregulation of natural gas/electricity markets 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. All in all, with service and non-food inflation (SA, 6-month moving average annualized) standing at around 4.1% and 4.2%, respectively—coupled with our expectations of a reversal in food prices—we have a slightly more pessimistic year-end forecast (3.5%) compared with the NBR (3.3%).

## **NBR is set to keep rates steady at 3.5%**

**At the May Board meeting, the NBR kept its policy rate unchanged at 3.5%.**

According to the NBR, external risks associated with investors' risk appetite over the short and medium term and the ongoing cross-border deleveraging across the banking system require close monitoring. The noted backdrop and the risks on the inflation front lead us to believe that the NBR will keep rates on hold at 3.50% for the remainder of the year.

**Contrary to the IMF's recommendation, the NBR continues to keep money market rates below the policy rate.**

Our empirical findings suggest that low interest rates alone may not be sufficient to bolster credit growth. Specifically, our results demonstrate that real GDP and the exchange rate play a more important role in affecting RON-denominated lending activity. Consequently, we remain skeptical about the effectiveness of this approach, which involves keeping money market rates below the policy rate, in stimulating lending activity and thus in promoting growth.

## **Budget gap is in check but structural reforms move slowly**

**Standing at around RON 2.0 billion, the budget gap in the first four months of the year was considerably narrower than the deficit seen in the same period of 2013 (RON 7.5bn).**

While revenues during the period under consideration increased by about 4.4%YoY, expenditures were down by about 3.8%. While we think the 2014 budget deficit target of 2.2% of GDP is attainable, compared with a deficit of 2.5% in 2013, the progress on reforming SOEs—one of the key challenges in the fiscal sphere—has been slower than desired.

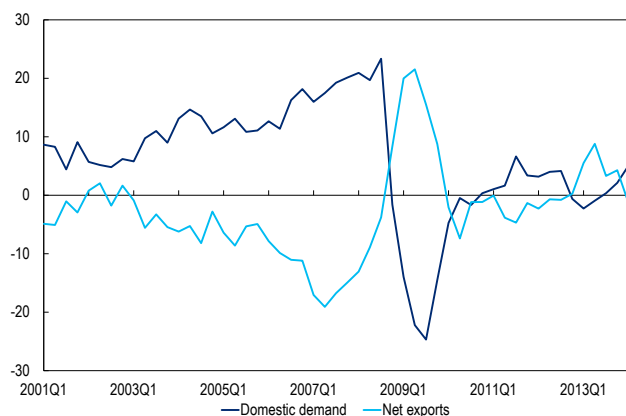
## **It is hard to get excited about EUR/RON...**

We concur that the leu has performed better than its peers in the region (HUF, PLN, CZK and HRK) so far this year. However, low yields and weak capital inflows—coupled with the NBR's inclination to keep money market rates below the policy rate and its increased pain threshold for FX volatility—cloud the outlook for the leu. Against this backdrop, we expect the EUR/RON to be around 4.50 by the end of 2014.

## **...as we question whether bond market rally has more legs**

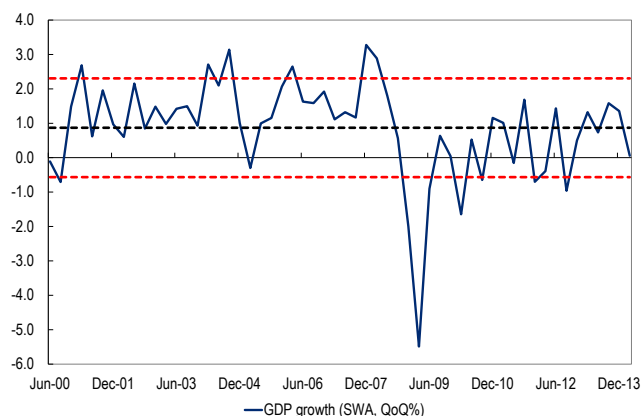
The above-noted factors overshadowing the leu outlook, coupled with the increased risk associated with the EU-IMF supported program and higher political noise ahead of the upcoming presidential elections lead us to turn more cautious about the sustainability of the rally in the bond market. Our empirical analysis suggests that the 1-year and 3-year bond yields are about 60bp below their fitted values. Consequently, we are inclined to believe that there isn't much room left for further bond price appreciation.

**Figure 186. While growth drivers are switching from external to domestic demand...**



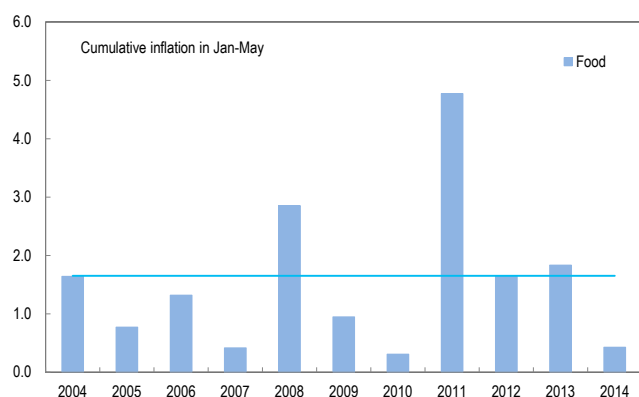
Source: Haver Analytics and Citi Research

**Figure 187. ...slowing growth momentum warrants concern.**



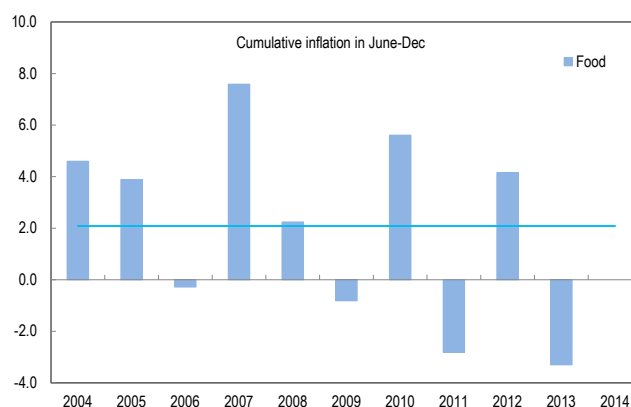
Source: Haver Analytics and Citi Research

**Figure 188. Historically low food prices in the Jan-May period...**



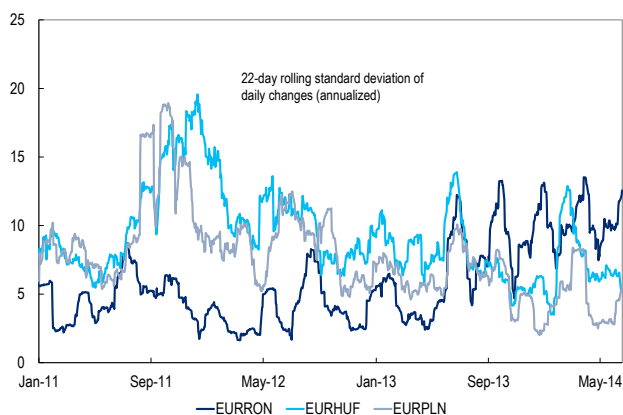
Source: Haver Analytics and Citi Research

**Figure 189. ...suggest to us that a reversal is likely**



Source: Haver Analytics and Citi Research

**Figure 190. Increased FX volatility...**



Source: Haver and Citi Research

**Figure 191. ...and low yields overshadow the leu outlook**



Source: Haver and Citi Research



Figure 192. Romania Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
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	659	704
GDP per capita, USD	7,653	9,176	7,397	7,413	8,246	7,642	8,550	9,162	9,848
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
<b>Economic Activity</b>									
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
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	6.6	6.3	4.7	8.0	3.1	5.0	1.6	3.5	3.0
CPI, % avg	4.8	7.9	5.6	6.1	5.8	3.3	4.0	1.8	3.3
Nominal wages, % yoy	22.6	23.6	8.4	2.5	4.9	5.0	5.0	5.0	4.5
Credit extension to private sector, % yoy	60.4	33.7	0.9	4.7	6.6	1.3	-3.3	4.4	6.5
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	1.88	2.50	5.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/US\$, eop	2.47	2.89	2.96	3.17	3.33	3.37	3.25	3.31	3.18
RON/US\$, avg	2.43	2.50	3.04	3.17	3.04	3.46	3.33	3.26	3.25
RON/EUR, eop	3.61	4.03	4.24	4.24	4.32	4.45	4.46	4.50	4.40
RON/EUR, avg	3.33	3.68	4.24	4.21	4.24	4.46	4.42	4.47	4.44
<b>Balance of Payments, USD bn</b>									
Current account	-22.9	-23.8	-6.8	-7.3	-8.2	-7.5	-2.0	-5.1	-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	67.9	72.0
Imports	64.9	77.7	50.1	59.6	73.3	67.4	70.4	75.2	83.5
Service balance	0.6	1.0	-0.4	0.5	0.5	1.5	3.6	0.6	0.7
Income balance	-5.7	-5.4	-2.6	-2.5	-3.1	-3.9	-6.1	-3.0	-3.3
FDI, net	9.7	13.7	5.0	3.0	2.6	2.9	3.5	2.0	2.6
International reserves	37.3	36.5	39.4	42.3	42.4	41.8	45.7	47.2	50.3
Total amortisations	12.2	18.1	17.7	19.7	19.6	25.0	34.1	34.7	36.7
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-2.3	-4.8	-7.3	-6.4	-4.3	-2.2	-2.5	-2.3	-2.3
Consolidated gov primary balance	-1.5	-3.9	-5.7	-4.9	-2.6	-0.4	-0.3	-0.1	-0.1
Public debt	19.8	21.3	29.4	37.1	40.1	41.0	42.5	41.9	40.9
of which Domestic	10.2	12.6	15.4	19.8	21.9	18.5	18.8	20.3	19.3
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	80.3	105.8	113.0	122.4	137.3	128.1	127.6	145.5	151.8
Public	13.9	14.2	19.6	24.8	28.9	34.2	40.3	38.8	41.6
External debt / GDP	47.0	51.8	68.7	74.3	75.1	75.7	67.5	72.0	70.0
External debt / XGS	160.8	169.4	224.4	209.7	187.7	186.4	159.2	173.9	171.0
Short-term debt	28.7	28.5	22.5	26.2	29.5	28.0	26.3	26.5	28.1
Short-term debt/International reserves (%)	77.1	78.1	57.0	61.9	69.7	66.9	57.7	56.2	55.9
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	5.4	3.8	3.2	3.0	2.4	3.0	2.9	3.2	3.5
CPI, % yoy eop	1.6	1.1	1.1	2.5	3.5	3.4	3.5	3.3	3.0
Policy interest rate, %, eop	4.00	3.50	3.50	3.50	3.50	4.25	4.50	4.75	4.50
Short-term market rate, % eop	1.88	2.23	2.50	2.50	2.50	3.75	4.50	5.25	5.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/EUR, eop	4.46	4.46	4.45	4.47	4.50	4.47	4.45	4.43	4.40

Source: National Sources, Citi Research forecasts

## Russia

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- **Summary view** — The lingering tensions in Ukraine make for a challenging backdrop to the economy. The combination of more subdued investment and consumption related to heightened uncertainty, and tighter monetary policy, led us to downgrade our 2014 GDP forecast from 2.6% to 1.0%.
- **Things to watch** — Uncertainty will remain elevated at least until the end of the year. 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 may weaken the RUB basket to 44.0 by the end of the year.

### Growth slows in early 2014

**First-quarter GDP grew at 0.9%YoY.** Preliminary estimates from Rosstat point to economic growth slowing to 0.9%YoY, down from the 2.0% expansion posted in 4Q13. While on a downtrend, GDP grew better than the consensus estimate of 0.7%YoY.

**Investment spending was the key avenue via which heightened geopolitical uncertainty weighed on growth performance.** Investment contracted by an estimated 5.0%YoY in 1Q, as business confidence struggled in the face of higher uncertainty and rising borrowing costs. This disappointing performance is much more broad-based relative to what we saw last year when the sectoral breakdown of investment suggested that private-sector consumption-related investment had been growing, while it had been oil and gas investment holding back overall investment activity. A broader lack of visibility has now led to private and public investment losing steam.

**Consumer spending was, however, resilient as households shifted spending forward.** In contrast to investment, consumer spending performed well, with real retail sales increasing by 3.5%YoY, broadly on par with that in 4Q13. This was chiefly driven by households drawing on savings to shift spending forward as the weaker currency and rising inflation were signaling less robust spending power in the future. However, we think that this is only a temporary factor that will fade away over the next couple of quarters. More importantly, consumer spending faces medium-term challenges as fears of a consumer boom turning into a bubble have led to more restrictive regulatory behavior.

**Still, the risks to our 1.0% 2014 GDP growth are squarely slanted to the downside.** Despite our belief that the geopolitical uncertainty will start to dissipate gradually in the aftermath of the May 25<sup>th</sup> Presidential elections in Ukraine, headwinds to Russian growth will continue to batter the economy, in our view. Policy is also limited in its scope to provide some respite. The fiscal rule implies a conservative fiscal stance while the two emergency rate hikes by the CBR, which brought policy rates 200bps higher to 7.50%, have made it increasingly more expensive for corporates to access credit, thus further weighing on growth expectations. This all implies downside risks to our 1.0% GDP forecast for 2014 (1.3% in 2013).

**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 3<sup>rd</sup> and a further 50bpts to 7.50% on April 25<sup>th</sup>. 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, including because of the S&P downgrade.

**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

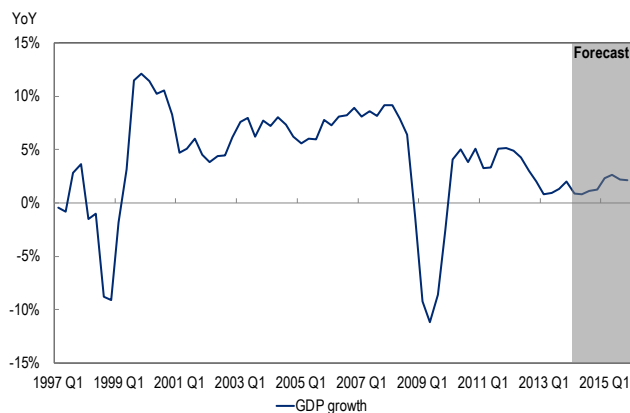
**In a refreshing, if somewhat belated, recognition of Russia's dimmed economic potential, the Ministry of Economy has significantly downgraded its long-term growth forecasts.** On 6 November 2013, the Ministry revised its long-term macroeconomic forecast until 2030. Average GDP growth for 2013-2030 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.

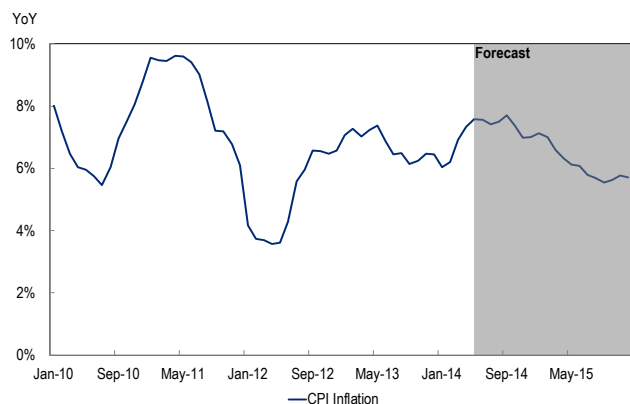
**Cyclical developments are also rouble negative.** The Central Bank of Russia reported that the 2013 current account surplus came in at US\$32.8bn, or 1.5% of GDP. This is significantly less than the US\$71.3bn (3.6% of GDP) surplus that was posted in 2012. In addition, net capital outflows came in at US\$50bn in 1Q14 vs US\$59.7bn for 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 44 by the end of the year.

Figure 193. Growth continues to struggle in early 2014



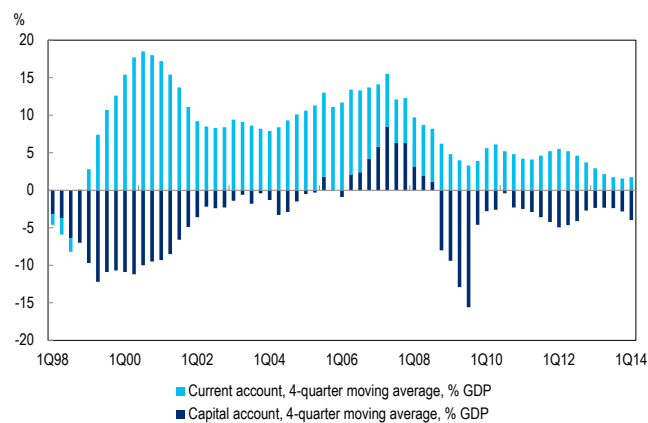
Source: Rosstat, Citi Research

Figure 195. CBR will miss its 5.0% end-2014 target...



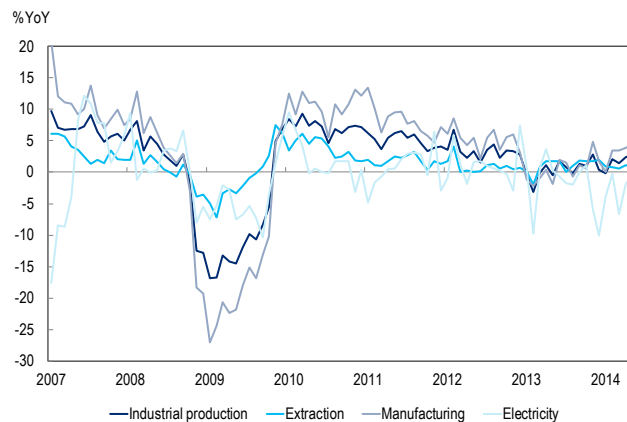
Source: Rosstat, Citi Research

Figure 197. The gradual disappearance of the current account...



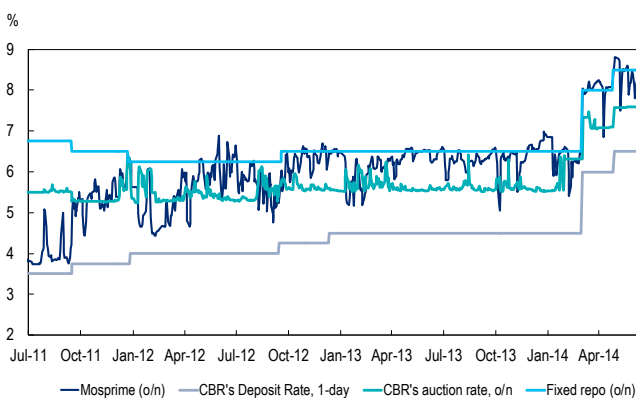
Source: CBR, Citi Research

Figure 194. Industrial activity is also weak



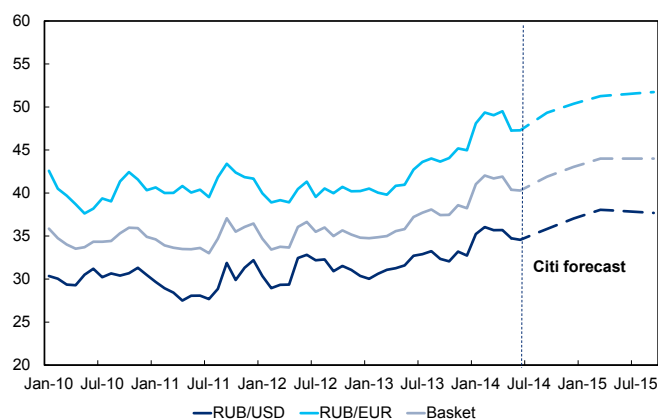
Source: Rosstat, Citi Research

Figure 196. ...despite raising policy rate by 200bpts since early March



Source: Bloomberg, Citi Research

Figure 198. ...should keep the ruble under pressure during 2014



Source: Bloomberg, Citi Research

Figure 199. Russia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	1,304	1,665	1,229	1,524	1,903	2,000	2,114	2,042	2,112
Nominal GDP, local currency bn	33,248	41,277	38,807	46,309	55,967	62,218	66,755	72,801	79,780
GDP per capita, USD	9,081	11,585	8,554	10,611	13,267	13,969	14,799	14,333	14,862
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
<b>Economic Activity</b>									
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	21.0	1.5	-6.1	-2.1	3.1
Real consumption growth % yoy	10.7	8.4	-3.9	3.5	5.3	7.0	3.6	2.3	2.3
private consumption growth % yoy	14.2	10.4	-5.1	5.5	6.7	7.9	4.7	3.0	3.0
Real export growth, % yoy	6.3	0.6	-4.7	7.0	0.3	1.4	4.2	2.0	2.1
Real import growth, % yoy	26.2	14.8	-30.4	25.8	20.3	8.8	3.7	4.5	5.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	11.9	13.3	8.8	8.8	6.1	6.6	6.5	7.0	5.7
CPI, % avg	9.0	14.1	11.6	6.8	8.4	5.1	6.8	7.1	6.1
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	5.75
1 month inter-bank rate, %, eop	6.09	20.20	6.32	3.78	6.37	6.90	6.81	7.48	6.59
Long-term yield, %, eop	6.58	10.90	9.45	8.23	8.77	7.04	7.88	8.98	8.09
RUB/US\$, eop	24.6	30.5	30.3	30.6	32.2	30.6	32.9	37.0	37.5
RUB/US\$, avg	25.6	24.9	31.7	30.4	29.4	31.1	31.9	35.7	37.8
RUB/EUR, eop	35.9	42.7	43.4	40.9	41.7	40.3	45.2	50.4	52.0
RUB/EUR, avg	35.1	36.6	44.2	40.3	41.0	40.0	42.3	48.9	51.6
<b>Balance of Payments, USD bn</b>									
Current account	72.2	103.9	50.4	67.5	97.3	71.3	32.8	54.9	39.2
% of GDP	5.5	6.2	4.1	4.4	5.1	3.6	1.5	2.7	1.9
Trade balance	123.4	177.6	113.2	147.0	196.9	191.7	180.3	186.9	178.5
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	349.5	374.0
Service balance	-16.7	-20.4	-17.6	-26.1	-33.5	-46.6	-58.6	-54.0	-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	457.5	471.6
Total amortisations	28.5	47.2	49.9	40.8	52.0	90.5	139.1	163.1	81.4
<b>Public Finances, % of GDP</b>									
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	13.1
of which Domestic	3.8	3.4	4.7	5.3	6.3	5.9	4.6	7.2	10.7
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	471.2	480.6	467.3	488.9	538.9	636.4	727.1	654.1	692.6
Public	37.4	29.5	31.3	34.5	34.7	38.1	43.1	45.8	51.3
External debt / GDP	36.1	28.9	38.0	32.1	28.3	31.8	34.4	32.0	32.8
External debt / XGS	120.7	91.8	136.3	110.7	94.0	107.9	122.6	110.9	115.2
Short-term debt	99.7	73.6	52.7	60.2	68.2	81.5	84.0	73.2	82.9
Short-term debt/International reserves (%)	21.4	17.9	13.0	13.9	15.5	17.2	17.1	16.0	17.6
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.0	0.9	0.8	1.1	1.3	2.3	2.6	2.2	2.1
CPI, % yoy eop	6.5	6.9	7.6	7.7	7.0	6.6	6.1	5.5	5.7
Policy interest rate, %, eop	5.50	7.00	7.50	7.50	7.00	6.50	6.00	5.75	5.75
Short-term market rate, % eop	6.83	8.74	8.04	7.57	7.48	6.68	6.59	6.59	6.59
Long-term yield, %, eop	7.88	8.80	9.54	9.07	8.98	8.71	8.09	8.09	8.09
RUB/US\$, avg	32.6	35.0	34.6	35.8	37.0	38.1	37.9	37.7	37.5

Source: National Sources, Citi Research forecasts

## Slovakia

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- **Summary view** — We are lifting our 2014 and 2015 GDP growth forecast by 0.1%pt to 2.2%YoY and 2.7%, respectively, due to better domestic demand, though our forecast remains below MinFin.
- **Things to watch** — Ukraine crisis and large errors in the BoP represent a downside risk to our outlook. Though the government has prepared relatively sizeable measures to avoid a debt-to-GDP ratio of 57%, an eventual downward revision to GDP would put this level at risk. The planned privatisation of a telco company will be watched to avoid the 57% debt-brake trigger.
- **Strategy** — Activated trigger in debt-brake rule – which is now reflected in partly frozen expenditures and at risk of enforced balance budget – are likely, together with monetary policy to provide support for bonds. The government gross borrowing requirements of €6bn for 2014 are 69% covered in June.

### Mild rise forecast; domestic demand supportive

**Statistical office confirmed its flash estimate of GDP growth of 0.6%QoQ in 1Q14, which together with upward revision in 2Q-4Q13 accelerated YoY growth to 2%swda (2.4% nsa).** Annual GDP growth was mainly driven by domestic demand, where private and public consumption accelerated to 3.3%YoY from 1.2% a quarter ago and to 4% from 2.8%, respectively. This was supported by ongoing solid 4.8%YoY growth in fixed investment. Though exports accelerated to 10%YoY, imports grew more, by 10.7%, reflecting the acceleration of domestic demand. This was already signaled by monthly foreign trade goods data, where the surplus stabilized at around 6% of GDP in 1Q14. Overall, GDP is 5% above its pre-crisis peak, domestic demand is 7% below as although government and private consumption recovered (+4% and -1% respectively), fixed investment is 8% below its pre-crisis level and the stable assessment of capacity utilization in manufacturing does not provide a reason to see some stronger acceleration ahead. Moreover, the expected foreign demand in manufacturing decreased in 2Q14, but overall confidence is supportive.

**Domestic demand on recovery path due to better labour market.** We estimate the seasonally adjusted rate negligibly increased to 13.08% in May and registered unemployment, after seasonal adjustment, has stabilized at around 390k since mid-2011. The lower unemployment reflects a solid increase in private sector employment, which accelerated to 2.5%YoY in April from -0.6% a year ago. This growth has been supported by other services sector, excl. retail and car repairs (4.8%YoY) and industry (2.1%). Employment expectations from the business survey do not suggest a turnaround in the labour market. Strong dynamics in services sector employment has been reflected in wage dynamics that together with industry and the public sector led to a 4.1% increase in average nominal wages (supported by bonuses), which – in a mildly deflationary environment – boosted real wage growth to 4.1%YoY, compared to 0.9%YoY in 2013 and -1.4% in 2011-12.

**We raise our 2014E and 2015E GDP growth forecast by 0.1%pt to 2.2% and 2.7% respectively, followed by c.3.1% growth in 2016-18,** which is below the MinFin's 2.4% this year, 3% in 2015 and 3.5% in 2016-17. The Ukraine crisis remains a key downside risk, but no gas interruptions have been reported. The central bank's scenario – including 20% drop in EU exports to Russia and c25% increase in oil price – could cut 1.4%pt from real GDP in 2014, 2.9%pt in 2015 and 1.8% in 2016.

## Deflation should be limited by stronger domestic demand

**Annual deflation in consumer price growth eased in May, but the 12-month moving average reached the historical lows of 0.6%YoY**, which is below lows of 0.8% seen in the previous disinflation cycle in 3Q10. This easing particularly reflects an acceleration of fuel prices, milder monthly fall in the core segment compared to previous months and milder contraction in food prices. Though deflation has become more widespread across CPI segments, the share of the segments in deflation is still lower compared to 2006 or 2009-10, when around 17% of service items (mainly telcos) saw deflation, according to the MinFin. Looking forward, we expect food prices to further ease their contraction around mid-year and to show positive growth later in 2H14. Also fuel prices are likely to reflect a recent increase in global oil prices in forthcoming months and our forecast of weaker EUR on a 9-month horizon. For later years we assume domestic demand will create inflationary pressures, however, this will likely be muted by a stronger EUR. Overall, our forecast assumes CPI growth of 0.2%YoY in 2014 (with upside risk from stronger wage growth in 1Q14 and eventual further increases in global oil prices), with 1.3% in 2015, followed by 2% growth in 2016. Recent disinflation has been reflected in the MinFin's outlook, which envisages CPI growth at 0.3%YoY this year and 1.6% in 2015 (both lower by 0.5%pt compared to its previous forecast) before accelerating to around 2.2% in 2016-17. MinFin assumes the acceleration in CPI to be reflected in all segments.

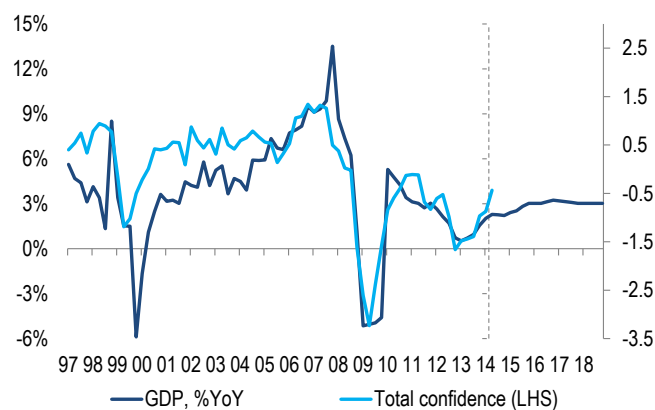
## A lot of measures in play to avoid another debt-rule trigger

**Deficit worsened in May and it will be worth watching tax collection developments.** The central government deficit widened to €1.8bn ytd in May (annual deficit at 3.2% of GDP), compared to €1.6bn a year ago, tax revenues and EU fund inflows worsened this year after their strong performance in 2013 and larger current expenditures are only partly offset by stronger non-tax revenues (larger dividends and sale of telco frequencies). As 2013 government debt reached 55.4% of GDP, and in the process breached the 55% rule trigger, the government has to freeze 3% of total expenditures excluding social, natural disasters and debt related expenditures. Hence, MinFin announced it froze €305mn on the expenditure side, the equivalent of 0.4% of GDP in 2014. However, only part of it will have a negative impact on real expenditures, as €200mn is taken from the reserve and the remainder should be cut from operational expenditures.

**Moreover, in order to decrease the debt ratio, the government plans to change the management of state oil reserves** – a recent change in their management increased debt by €500mn (0.7% of GDP) in 2013. The government is also planning to privatize 49% of a telecom company, which should raise €1bn. So together, this is about 2.6% of GDP, plus a further 0.3% should come from a real estate tax. There is also a risk that the large Error and Omissions component of the Slovak balance of payments could result in a 4-5% drop in nominal GDP levels. At least this could be partly offset by a potential upward revision as a result of the recalculation of GDP from moving to ESA 2010 methodology. The Stability Programme suggests – as has been approved by government – measures of €470mn (0.6% of GDP) for 2015 (from lower expenditure and slightly higher taxes). The government further weakened its plan for fiscal consolidation with a 2.6% of GDP deficit this year (risk of wider deficit by 0.2%) and 2.5% next year, but this scenario without any new measures suggests a deficit of 3.7% of GDP in 2015 and 3% in 2017. Additional measures in range of 0.3-0.7% of GDP will have to be introduced to reach the planned deficit of 0.5% of GDP in 2017, according to the MinFin, to comply with the EU's requirement of 0.5% of GDP annually in fiscal consolidation efforts.

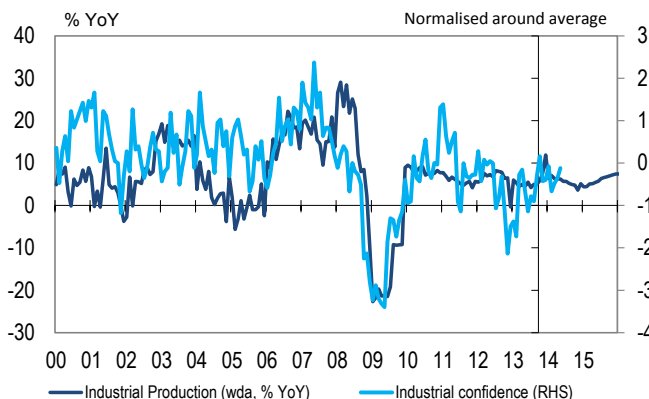


Figure 200. May confidence points to stronger domestic demand



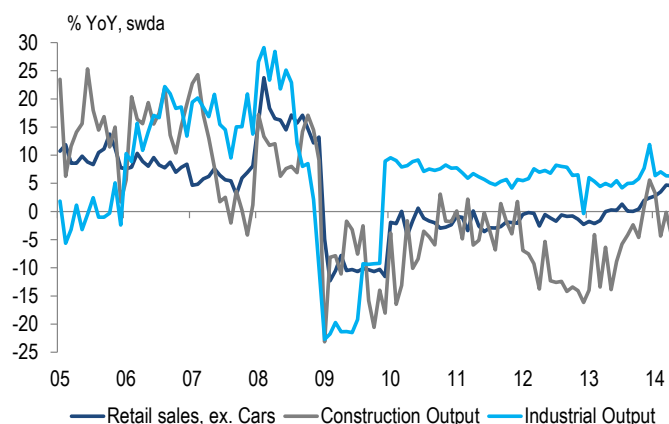
Source: Statistical Office of the Slovak Republic, Citi Research estimates

Figure 201. Industrial confidence has erased its recent losses



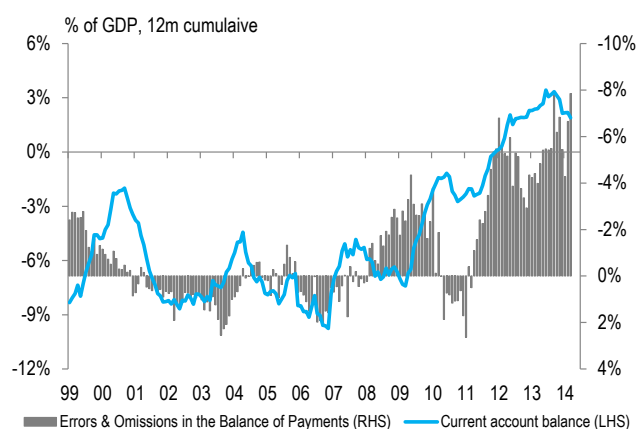
Source: Statistical Office of the Slovak Republic, Citi Research estimates

Figure 202. Construction output worsened, but retail and industry better



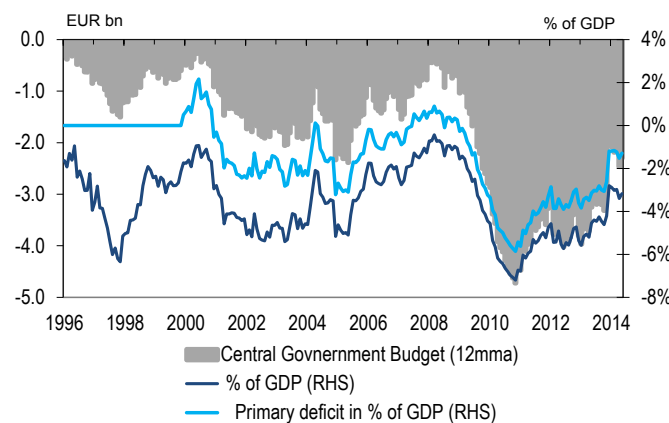
Source: Statistical Office of the Slovak Republic, Eurostat, Citi Research

Figure 203. BoP's errors surged and are likely to offset upward revision of GDP after implementation of ESA2010 this autumn



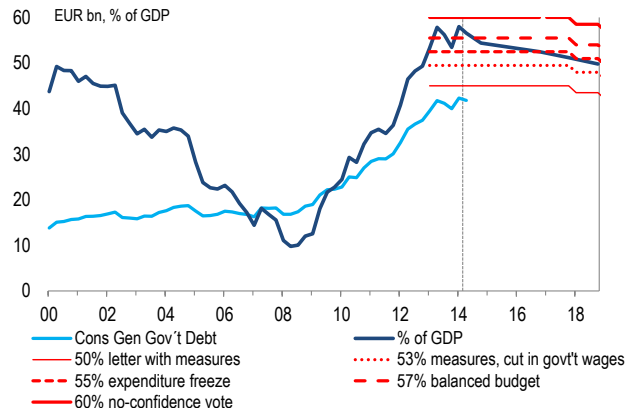
Source: Haver Analytics, Citi Research calculations

Figure 204. Central gov't budget worsened in May



Source: Haver Analytics and Citi Research calculations

Figure 205. Knocking on debt-brake rule door, but privatization revenues should provide a relief



The latest data are estimates based on the latest ARDAL data and Citi forecast.

Source: ARDAL, Eurostat, Haver Analytics and Citi Research



Figure 206. Slovakia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	75	95	88	87	96	91	96	101	104
Nominal GDP, local currency bn	61	67	62	66	69	71	72	73	76
GDP per capita, USD	13,936	17,493	16,156	16,087	17,654	16,781	17,577	18,470	19,040
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
<b>Economic Activity</b>									
Real GDP, yoy avg	10.5	5.8	-4.9	4.4	3.0	1.8	0.9	2.2	2.7
Real investment growth % yoy	9.7	4.7	-31.5	20.0	9.5	-16.0	-5.1	6.9	1.6
Real consumption growth % yoy	5.1	6.1	1.6	-0.3	-1.4	-0.4	0.3	2.0	0.7
private consumption growth % yoy	6.8	6.1	0.2	-0.7	-0.5	-0.2	-0.1	2.1	1.4
Real export growth, % yoy	14.3	3.1	-16.3	16.0	12.2	9.9	4.5	7.6	7.8
Real import growth, % yoy	9.2	3.1	-18.9	14.9	9.7	3.3	2.9	8.8	6.7
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	3.4	4.4	0.5	1.3	4.4	3.2	0.4	0.2	1.3
CPI, % avg	2.8	4.6	1.6	1.0	3.9	3.6	1.4	0.1	1.0
Nominal wages, % yoy	7.5	8.2	3.0	3.3	2.2	2.5	2.4	3.1	2.9
Credit extension to private sector, % yoy	23.4	16.3	0.9	4.8	8.6	2.8	1.5	1.8	3.7
<b>Balance of Payments, USD bn</b>									
Current account	-4.1	-5.9	-2.3	-3.3	-3.6	2.0	2.0	1.6	2.8
% of GDP	-5.4	-6.2	-2.6	-3.7	-3.8	2.2	2.1	1.6	2.7
Trade balance	-1.0	-1.1	1.3	1.0	1.4	4.6	5.7	5.1	6.5
Exports	64.9	72.9	55.4	64.0	79.0	79.9	85.5	93.2	100.5
Imports	65.9	74.0	54.1	63.0	77.6	75.4	79.9	88.1	93.9
Service balance	0.5	-0.7	-1.4	-1.0	-0.5	0.4	0.2	0.2	0.3
Income balance	-3.2	-2.8	-1.2	-2.7	-4.0	-2.1	-2.4	-3.2	-3.5
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	2.2	2.6	2.9	2.9
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-1.6	-2.0	-8.0	-7.5	-4.8	-4.5	-2.8	-3.0	-2.6
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	55.7
of which Domestic	18.1	19.0	20.4	25.2	30.8	49.6	93.1	60.5	66.5
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	44.3	52.5	65.3	65.8	68.5	70.9	82.3	93.1	93.7
Public	9.5	10.3	11.4	13.3	15.5	25.9	34.2	37.2	36.2
External debt / GDP	58.8	55.5	74.5	75.3	71.3	77.6	85.9	92.3	90.0
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	23.6	27.1	37.4	36.3	36.7	28.1	25.0	32.3	32.5
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.6	2.0	2.3	2.3	2.2	2.4	2.5	2.8	3.0
CPI, % yoy eop	0.4	-0.2	0.1	0.1	0.2	0.8	1.0	1.1	1.3
Short-term market rate, % eop	0.21	0.23	0.19	0.06	0.06	0.06	0.25	0.25	0.25
Long-term yield, %, eop	2.78	2.47	1.87	1.90	1.83	1.93	2.03	2.13	2.15

Source: National Sources, Citi Research forecasts

## South Africa

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- **Summary view** — 2014 GDP downgrades have been significant. Coupled with above-target inflation this adds to the monetary policy debate.
- **Things to watch** — The July MPC will signal the SARB's intention on policy rate normalization. A potential manufacturing strike in July looms.
- **Strategy** — ZAR volatility and weakness remains a threat to inflation, GDP and is unlikely to narrow the current account deficit meaningfully.

### 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, GDP downgrades have been significant. We reduced our 2014 GDP outlook to 2.0% while the current Reuters consensus lies at 1.9%. The SARB expects 2.1%. This is from previous expectations for 2.8-3.0% GDP growth this year. A key culprit here is the almost-six month long strikes in the platinum mining sector, which pushed Q1 GDP growth negative, raising concern of a recession. The platinum strikes officially ended the week of 23 June 2014 however, the up- and downstream manufacturing supply chain have already been negatively affected by our findings. Adding to the downside risk in manufacturing is a looming metals strike in July. If this goes ahead the deduction to GDP would be far greater than that of platinum mining, in our view. Exports are under strain as a result of lost production and would take a further hit if the metals strike occurs. This, together with rising inflation, reduces national nominal income. This means less disposable income for consumers and lower earnings potential for corporates. A final setback for an economy trying to rebalance towards production is electricity constraints, particularly now the first unit of the Medupi power station has been delayed to Q1 15.

**The current account deficit narrowed in Q1 but is unsustainable.** Even though the market perceived Q1's 4.5% current account deficit as a positive sign (the ZAR strengthened on the news) we caution that behind the headline figure, the narrowing only took place because of a significant, and likely one-off, inflow of dividends. In contrast, the Q1 trade deficit widened, signaling a generalized weakness in the export sector. Our analysis shows that Q1 platinum exports were not compromised due to sufficient inventories (as witnessed by a relatively stable platinum price) however, the manufacturing supply chain came under pressure and electricity outages in March also took a toll. Looking ahead, we note that dividend inflows are always erratic and, as a result, are unlikely to be available to compensate for the loss of Q2 exports. Though platinum stockpiles remained intact through Q2, a greater negative impact to its manufacturing supply chain started to take effect. Finally, we see substantial downside risk to the Q3 current account deficit given that (1) platinum inventories should run out by mid-July and therefore platinum production must recommence within a month now that the strikes have ended (some mines have indicated this may take longer), and (2) if a metals strike occurs, the just-in-time nature of processing in the sector means exports are likely to fall quickly. Put together, we expect a current account deficit 'stuck' just below 6.0% of GDP through Q2 and Q3 before reducing to 5.0% of GDP by year-end. Unfortunately, this still demands around R200bn in financing which, against a volatile global liquidity environment, should keep pressure on the ZAR. We are also concerned that the main sources of financing – portfolio flows and unrecorded transactions – remain questionable.

## It's all about vulnerabilities

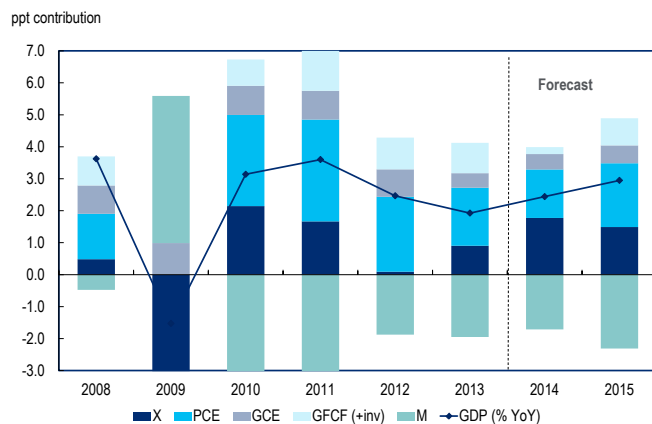
**We see more ZAR pass-through to inflation this year.** Company margins are under pressure in the face of rising costs and low domestic demand, leaving retailers with no other choice but to try pass-through more currency weakness than before. Anecdotal evidence from surveys and the listed retail sector affirms this. We also expect upside pressure from rental inflation given the rapid fall in housing supply, which is significant in the CPI basket. The lag of January's local maize price spike should take 8-9 months to filter through the food supply chain, leaving CPI for food far higher by Q3 14. Finally, the coupling of above-inflation wages and low productivity keeps unit labour costs elevated and presents a real 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 GDP downgrades are taken into account) should keep headline CPI peaking at 6.8% in June and trending downwards from there on. Nevertheless, the many upside risks should keep inflation out the target range until Q1 15, in our view.

**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 less hawkish monetary policy debate. This aligns with the SARB's communication that a slow and moderate hiking cycle is its preferred option when normalizing policy rates and was conducive to its decision to keep the repo rate unchanged in March and May. That said, we believe upside risks to inflation expectations (the ZAR, food and wages mostly) and the prolonged period that the SARB expects CPI to remain above-target still justifies additional tightening but, in smaller increments. As we see the SARB as intent on signaling that it is tough on inflation, we continue to forecast a 25bp rate hike in July and another 25bp hike in September. This brings our total 2014 rate cycle to 100bp from a total of 150bp previously. The caveat to a September rate hike is where the ZAR is trading at the time – a difficult call if the Fed moves to a more hawkish stance. This is unfortunate for rates markets, as the monetary policy debate is likely to remain rather fierce given its data dependency on global and local factors – many of which are highly unpredictable. Further out, we believe the 2015 rates cycle will start in reaction to market pricing of Fed hiking.

## Cabinet reshuffle and ratings downgrade

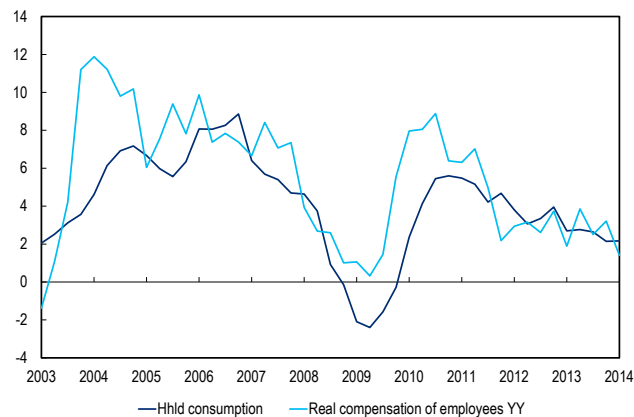
**Following a relatively uneventful national election in May, the ruling party, the ANC, has selected a new Cabinet.** Unfortunately for sentiment, the general perception is that new the Ministers of key industries are not as conducive to structural reform as the market had hoped. This was raised as a concern in both Fitch and S&P's recent country review on South Africa. Together with the labour strike and resulting GDP downgrades, this contributed to why Fitch moved South Africa's outlook to negative and why S&P downgraded the local (BBB+) and foreign (BBB-) currency ratings. Though both moves are a negative for the economy, the ZAR has remained relatively stable given that S&P also moved the outlook to stable. Essentially this means that unless S&P moves to a negative outlook again, which would imply the foreign currency was at risk of moving to speculative grade, the worst would appear to be over. If Moody's or Fitch were to downgrade the foreign currency rating to align with that of S&P, the market would mostly have priced for this.

Figure 207. GDP to remain lackluster in 2014



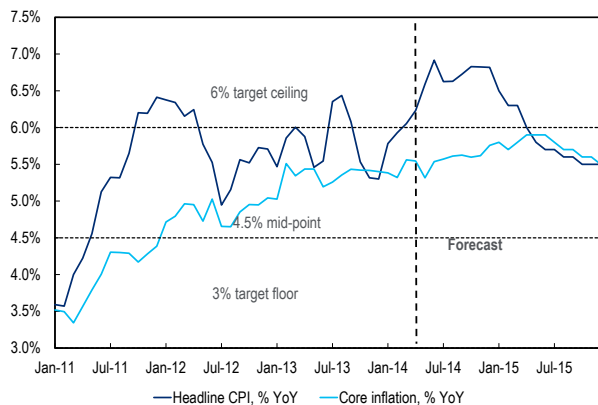
Source: SARB, Citi Research Projections

Figure 208. Consumption is slowing as real incomes decelerate



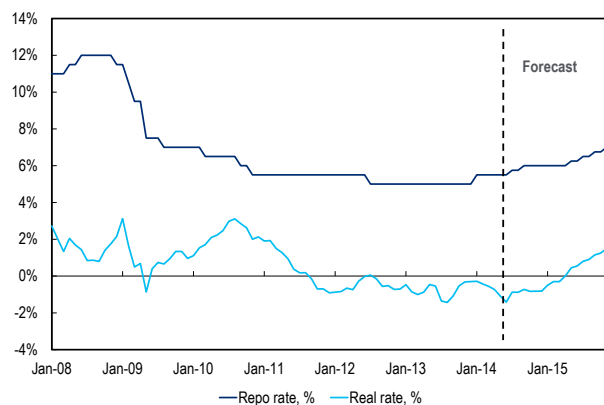
Source: SARB, Citi Research calculations

Figure 209. Inflation likely to be above the SARB ceiling in 2014



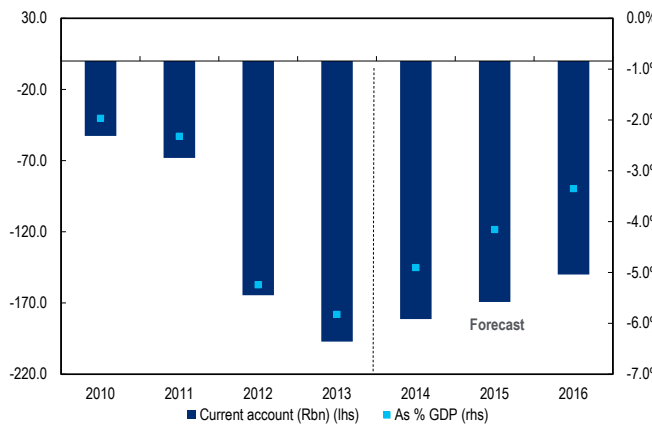
Source: Stats SA, Citi Research projections

Figure 210. Rand volatility suggests further Repo rates cuts are unlikely



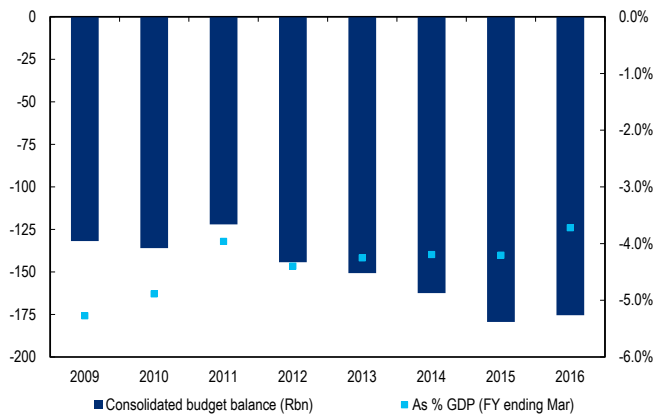
Source: SARB, Stats SA

Figure 211. No meaningful narrowing in the current account deficit



Source: SARB, Citi Research projections

Figure 212. Fiscal consolidation will likely be slow



Source: National Treasury, Haver Analytics, Citi Research projections

Figure 213. South Africa Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	286	273	287	366	404	382	351	344	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	6,835	7,347
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
<b>Economic Activity</b>									
Real GDP, yoy avg	5.5	3.6	-1.5	3.1	3.6	2.5	1.9	2.0	2.8
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
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	7.6	9.3	6.0	3.4	6.4	5.7	5.3	6.8	5.5
CPI, % avg	6.2	10.0	7.2	4.1	5.0	5.7	5.8	6.5	5.8
Nominal wages, % yoy	7.9	12.8	11.8	13.5	7.2	7.5	8.1	9.2	9.7
Credit extension to private sector, % yoy	21.5	13.6	-0.1	5.5	6.2	10.1	6.2	8.2	9.0
Policy Interest Rate, % eop	11.00	11.50	7.00	5.50	5.50	5.00	5.00	6.00	7.00
1 month inter-bank rate, %, eop	11.18	11.35	6.94	5.44	5.47	5.02	5.10	6.18	7.18
Long-term yield, %, eop	8.58	7.33	9.05	8.14	7.93	6.39	7.91	7.90	8.00
ZAR/US\$, eop	6.87	9.49	7.41	6.62	8.09	8.46	10.50	10.97	10.91
ZAR/US\$, avg	7.05	8.27	8.41	7.32	7.26	8.21	9.65	10.75	11.00
<b>Balance of Payments, USD bn</b>									
Current account	-19.9	-19.6	-11.6	-7.2	-9.4	-20.0	-20.4	-16.9	-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	93.0	96.0
Imports	81.4	89.6	66.1	83.0	102.3	104.0	102.7	97.3	99.6
Service balance	-2.7	-4.1	-2.8	-4.4	-4.7	-2.5	-2.2	-1.9	-2.3
Income balance	-9.8	-8.9	-6.4	-7.2	-9.2	-8.9	-7.4	-7.9	-6.8
FDI, net	3.6	12.3	6.4	3.7	4.5	1.6	2.6	2.3	2.2
International reserves	29.6	30.6	35.3	38.2	42.6	44.0	44.8	46.4	47.2
Total amortisations	2.5	2.7	2.1	1.7	2.4	7.4	4.0	5.5	2.8
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.9	-1.0	-5.3	-4.9	-4.0	-4.4	-4.3	-4.2	-4.2
Consolidated gov primary balance	3.3	2.4	-3.1	-2.7	-1.7	-1.9	-1.6	-1.6	-1.6
Public debt	28.3	27.8	31.3	35.6	39.4	42.5	46.1	47.3	48.3
of which Domestic	24.5	23.4	27.7	32.3	35.6	38.8	42.2	43.8	44.8
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	63.0	60.4	63.8	80.6	89.7	113.7	108.6	101.3	106.8
Public	19.5	18.1	22.6	35.8	41.5	55.9	52.8	55.7	55.7
External debt / GDP	22.0	22.1	22.2	22.1	22.2	29.7	31.0	29.5	28.8
External debt / XGS	70.0	61.6	81.4	77.7	72.6	99.4	99.4	94.3	96.2
Short-term debt	24.0	25.5	21.3	21.7	20.5	27.9	27.2	28.7	29.2
Short-term debt/International reserves (%)	81.2	83.2	60.4	56.9	48.2	63.3	60.9	61.9	61.9
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.0	1.6	1.8	2.3	2.3	2.8	2.7	2.8	2.9
CPI, % yoy eop	5.3	6.1	6.9	6.7	6.8	6.3	5.7	5.6	5.5
Policy interest rate, %, eop	5.00	5.50	5.50	6.00	6.00	6.00	6.25	6.75	7.00
Short-term market rate, % eop	5.10	5.63	5.67	6.18	6.18	6.18	6.43	6.93	7.18
Long-term yield, %, eop	7.91	8.30	7.70	7.80	7.90	8.00	8.05	8.00	8.00
ZAR/US\$, eop	10.50	10.53	10.71	10.82	10.97	11.09	11.03	10.97	10.91

Source: National Sources, Citi Research forecasts

## Turkey

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- **Summary view** — We revise our 2014 GDP growth forecast to 3.5% from 2.2% in light of recent developments.
- **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 lira isn't out of the woods yet, owing to the country's large external financing needs, the possibility of an increase in political noise given the election-heavy calendar and the risk of premature monetary policy easing.

### Government spending and net export drive 1Q GDP...

**At 4.3%YoY, GDP growth in the first quarter of 2014 came in somewhat stronger than the consensus and our projection (both 4.2%YoY).** The contribution of private consumption and investment to GDP growth in the first quarter stood at 2.1pp and -0.3pp, respectively. In parallel, net exports contributed positively (2.7pp) unlike changes in stock, which shaved 1.2pp off GDP growth in 1Q. As has been the case in recent years, standing at 1.0pp, the contribution of the public sector to GDP growth in 1Q was above its 2002-12 average of 0.6pp.

**Standing at 1.7%QoQ (SWDA), the 1Q GDP outturn also suggests that economic activity in 1Q has gained momentum when compared with 4Q 2013 (0.9%QoQ) and 3Q 2013 (0.4%QoQ).** According to the SWA official data, the noted 1.7%QoQ growth was driven largely by agriculture (0.45pp), finance and insurance (0.43pp) and manufacturing (0.40pp). Developments to date—coupled with the increased likelihood of a more accommodative policy stance going forward—lead us to revise our 2014 GDP growth forecast to 3.5% from 2.2%.

### ...as the external adjustment remains in line with the script

**At US\$4.8 billion, the current account deficit in April was slightly narrower than the consensus (US\$4.9bn).** With the April data, the current account gap in the first four months of the year is about US\$8.3bn, narrower than the deficit seen in the same period of 2013. The magnitude of the correction during the same period still remains significant in the case of the underlying deficit excluding energy and gold (around US\$4.2bn). We expect the current account gap to narrow from 7.9% of GDP in 2013 to about 5% this year, owing to a weaker lira, sub-par growth and a marked reversal in net gold exports. While the overall financing picture warrants concerns, there are some encouraging signs suggesting that residents are reducing their reliance on short-term external borrowing in the first four months of the year when compared with the same period of 2013.

### Inflation probably peaked but remains too high for comfort

**At 9.7%YoY, the May inflation reading came in somewhat lower than the consensus (9.9%YoY).** Our analysis suggests that inflation probably peaked in May at 9.7%YoY and is on track to ease during the summer months on the back of favorable base effects. However, we think that inflation will likely remain elevated owing to the recent deterioration in inflation expectations, delayed effects of pass-through, and the likely energy price hikes later in the year. We believe that the possibility of a relatively poor harvest year further complicates the outlook. Against this backdrop, we believe that year-end inflation is likely to be around 9.0%.

## Shrugging off risks, CBT is on track to deliver further cuts

**We struggle to find a good justification for the CBT's 125bp rate cuts at the May and June MPC meetings combined** – particularly if one remembers how the CBT was forced to hike rates aggressively not so long ago. More importantly, we maintain our view that the CBT doesn't have much room to ease without hurting the performance of the lira. Consequently, we think the CBT's recent rate cuts were premature and further easing could reverse the salutary impact of the January rate hike in stabilizing the lira and bolstering investor sentiment.

**Looking ahead, we don't rule out additional easing thereafter as long as global markets permit.** As a result, we remain concerned with the possibility of the CBT getting carried away with the easing cycle – particularly if growth indicators disappoint. The fact that external factors can easily become less benign – coupled with other domestic risk factors – leads us to believe that the CBT risks repeating past mistakes.

## Goldilocks Scenario...

**With growth turning out to be more resilient than expected and the current account gap narrowing more aggressively than envisaged by the consensus, is Turkey heading for a "Goldilocks" scenario?** We don't think so for at least two reasons. First, there hasn't been any meaningful progress on tackling Turkey's structural challenges and placing the foundations of a new growth strategy. In our view, the country needs a new credible story to buttress its investment-grade status and escape the middle-income trap.

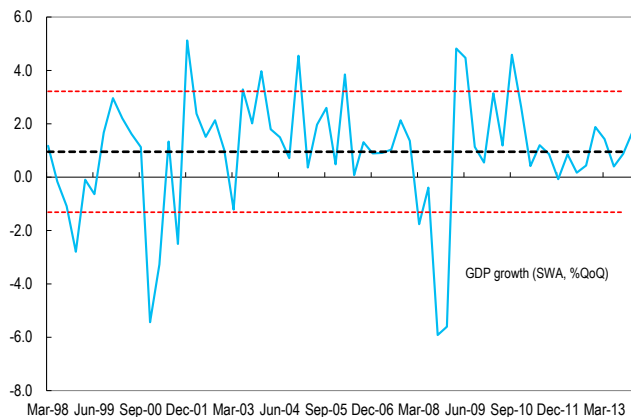
Second, while one may argue that there is fiscal space to support growth, the marked rise in non-interest spending and the sharp decline in the primary balance warrant concern. The combination of a prolonged period of softer growth and normalization of interest rates could change the fiscal picture drastically, thereby adversely affecting investor sentiment. In terms of the external adjustment, as we argued before, the likely improvement in the current account balance is largely cyclical, driven mainly by the sharp reversal in net gold exports. Consequently, it is hard to talk about a secular improvement in the country's current account balance – particularly in the absence of reforms aimed at bolstering competitiveness and changing Turkey's growth strategy.

## ...for Turkish assets?

**All in all, we argue that, while Turkish assets can benefit from a favorable global environment in the near term, there is no solid evidence suggesting that Turkey is heading for a "Goldilocks" scenario.** This is because the majority of the country's structural challenges remain unattended and large external financing needs leave the economy vulnerable to sudden shifts in investor sentiment. We also recognize that the increased likelihood of the CBT getting carried away with the easing cycle – coupled with the emergence geopolitical risks – cloud the outlook for Turkish assets.

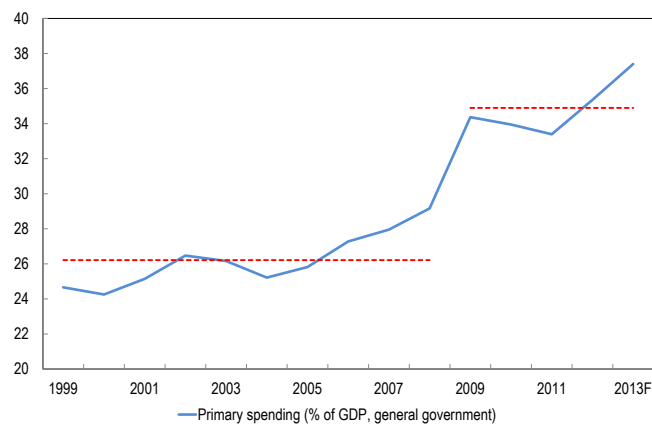


Figure 214. Despite the relative resilience of economic activity...



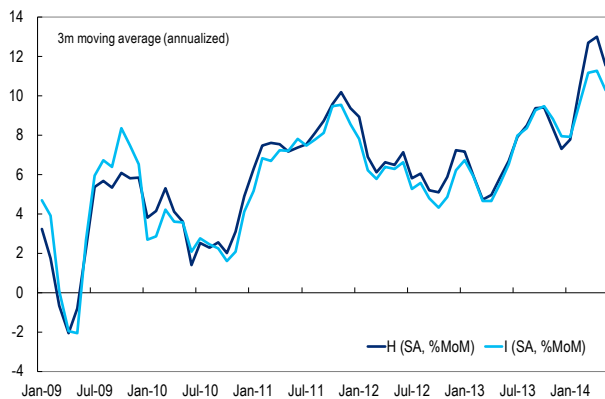
Source: Haver Analytics and Citi Research Note: 3-month mov av, annualized.

Figure 216 ...and the strong contribution of public spending...



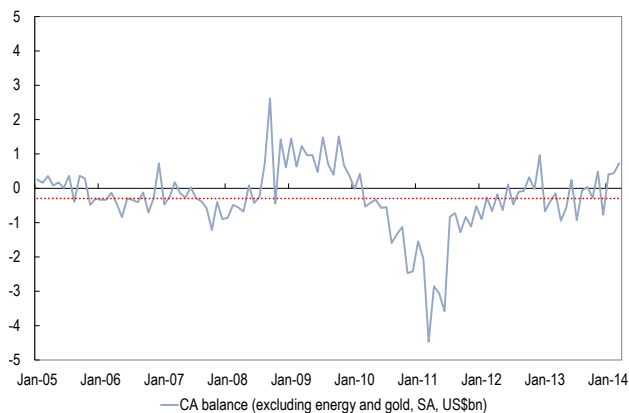
Source: Ministry of Development. F = Ministry of Development forecast

Figure 218. ...as inflation remains too high for comfort...



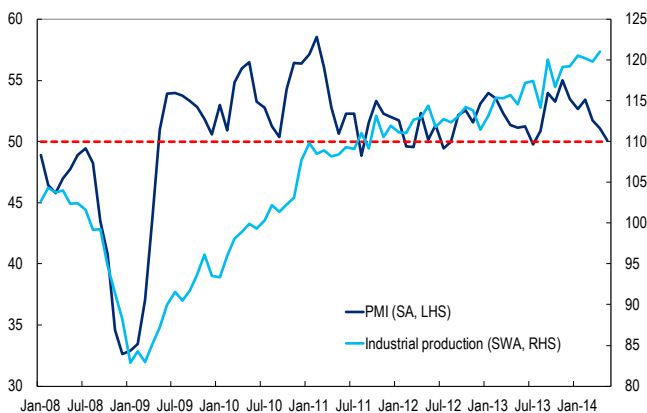
Source: CBT and Citi Research

Figure 215. ...the cyclical nature of the external adjustment...



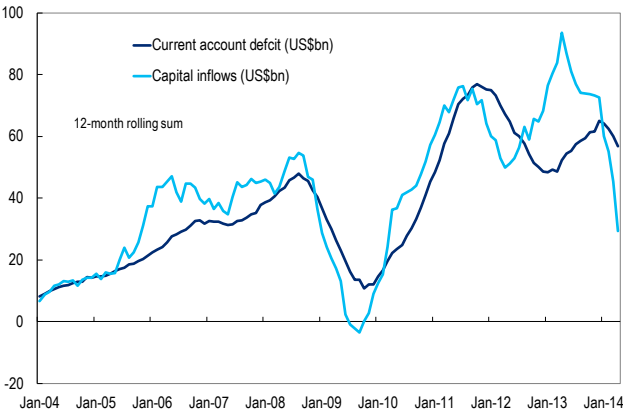
Source: CBT and Citi Research

Figure 217. ...raise questions about the sustainability of the momentum...



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

Figure 219. ... and capital inflows lose steam



Source: CBT, Haver and Citi Research



Figure 220. Turkey Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	646	731	615	731	775	789	820	813	865
Nominal GDP, local currency bn	843	951	953	1,099	1,298	1,417	1,562	1,755	1,959
GDP per capita, USD	9,207	10,282	8,530	10,016	10,473	10,531	10,721	10,510	11,068
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
<b>Economic Activity</b>									
Real GDP, yoy avg	4.7	0.7	-4.8	9.2	8.8	2.1	4.0	3.5	3.5
Real investment growth % yoy	5.8	-4.8	-28.6	48.4	16.8	-8.5	11.4	-9.1	4.0
Real consumption growth % yoy	5.6	-0.1	-1.0	6.0	7.3	0.4	4.8	3.3	3.2
private consumption growth % yoy	5.5	-0.3	-2.3	6.7	7.7	-0.5	4.6	2.4	3.2
Real export growth, % yoy	7.3	2.7	-5.0	3.4	7.9	16.3	0.1	9.8	4.4
Real import growth, % yoy	10.7	-4.1	-14.3	20.7	10.7	-0.4	8.5	-2.3	4.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	8.4	10.1	6.5	6.4	10.4	6.2	7.4	9.0	7.4
CPI, % avg	8.8	10.4	6.3	8.6	6.5	8.9	7.5	8.6	7.9
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	10.50	11.00
1 month inter-bank rate, %, eop	17.21	17.16	7.20	6.89	11.54	5.80	8.66	11.30	11.80
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US\$, eop	1.17	1.54	1.50	1.54	1.89	1.78	2.15	2.18	2.32
TRY/US\$, avg	1.31	1.31	1.55	1.51	1.68	1.80	1.91	2.16	2.26
TRY/EUR, eop	1.70	2.15	2.15	2.06	2.44	2.35	2.95	2.97	3.22
TRY/EUR, avg	1.79	1.92	2.17	2.00	2.34	2.32	2.53	2.96	3.09
<b>Balance of Payments, USD bn</b>									
Current account	-37.8	-40.4	-12.1	-45.4	-75.1	-48.5	-65.1	-42.8	-46.9
% of GDP	-5.8	-5.5	-2.0	-6.2	-9.7	-6.1	-7.9	-5.3	-5.4
Trade balance	-46.9	-53.0	-24.9	-56.4	-89.1	-65.3	-80.0	-61.9	-68.4
Exports	115.4	140.8	109.6	120.9	143.4	163.2	163.4	185.6	198.5
Imports	162.2	193.8	134.5	177.3	232.5	228.6	243.4	247.6	266.9
Service balance	14.0	18.9	18.6	16.7	20.2	22.6	23.1	26.8	28.8
Income balance	-7.1	-8.4	-8.3	-7.2	-7.9	-7.2	-9.3	-8.9	-8.6
FDI, net	19.9	17.2	7.1	7.6	13.8	9.2	9.8	10.5	11.0
International reserves	73.3	71.0	70.7	80.7	78.5	99.9	109.8	116.3	114.3
Total amortisations	37.6	41.1	47.4	45.0	37.9	33.5	36.4	44.0	50.0
<b>Public Finances, % of GDP</b>									
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
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	250.4	281.1	269.1	292.0	304.4	337.5	391.3	411.5	429.5
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	50.6	49.7
External debt / XGS	172.4	158.1	185.1	185.8	165.4	163.6	186.3	174.0	169.6
Short-term debt	43.2	52.5	49.0	77.3	81.9	100.8	129.1	129.1	134.1
Short-term debt/International reserves (%)	58.9	74.0	69.3	95.8	104.4	100.9	117.5	111.0	117.3
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	4.4	4.3	3.7	3.6	2.5	3.0	3.6	3.7	4.4
CPI, % yoy eop	7.4	8.4	8.4	8.2	9.0	8.2	7.8	7.8	7.4
Policy interest rate, %, eop	7.10	10.27	8.75	10.00	10.50	10.50	10.50	11.00	11.00
Short-term market rate, % eop	8.66	12.28	9.25	10.80	11.30	11.30	11.30	11.80	11.80
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US\$, eop	2.15	2.14	2.15	2.16	2.18	2.20	2.24	2.28	2.32

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 program. The first tranche was disbursed in early May.
- **Things to watch** — Despite the fact that May Presidential elections went relatively peacefully, the geopolitical backdrop remains challenging. We think it will be hard to avoid a deepening recession in 2014 even in the face of rising economic costs related to the IMF program.
- **Strategy** — The NBU devalued the hryvnia by 10% in early February, but the USD:UAH 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.

**The first tranche of IMF money was disbursed in early May.** The Executive Board of the IMF approved the SBA on April 30<sup>th</sup> with the immediate disbursement of US\$3.2bn as the first tranche of the agreement. The second and third disbursements will be based on bi-monthly reviews and performance criteria, and the remainder of the program period will be subject to standard quarterly reviews and performance criteria. The government has already adopted and implemented 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.

**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 will 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 law for public purchases, speeding up VAT refunds to business and implementing an independent quarterly audit of Naftogas accounts.

**These IMF conditions will impose significant economic pain on Ukraine.** The above conditions should force the economy back into recession, and we forecast a GDP 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\$14-18bn provided by the IMF, the government's ability to press ahead with the painful reforms is a significant concern.

**The adoption of the anti-crisis package on 27 March after 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 MPs 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 MPs felt quite uncomfortable with the 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.

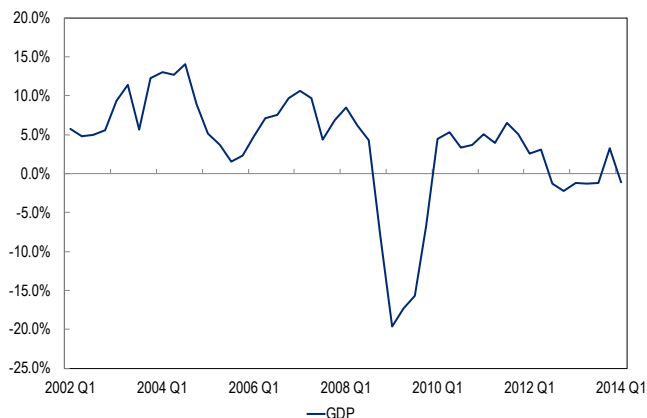
**On the positive side, external adjustment has started to take place.** The current account deficit has decreased to only US\$0.4bn during Jan-Apr vs US\$4.2bn for the same period last year. This is of course mainly driven by the fast-weakening economy and collapsing internal demand. We forecast that the current account deficit will halve to 4.7% of GDP in 2014 vs 9.3% of GDP last year.

**Similarly, deposit withdrawals have broadly stabilized.** Hryvnia deposits fell by 10% in the first quarter of the year, but have since broadly stabilized during April and May. Similarly, after a 15% fall in FX deposits at the start of the year, currency deposits have also reached some kind of an equilibrium level.

## Risk of military escalation remains

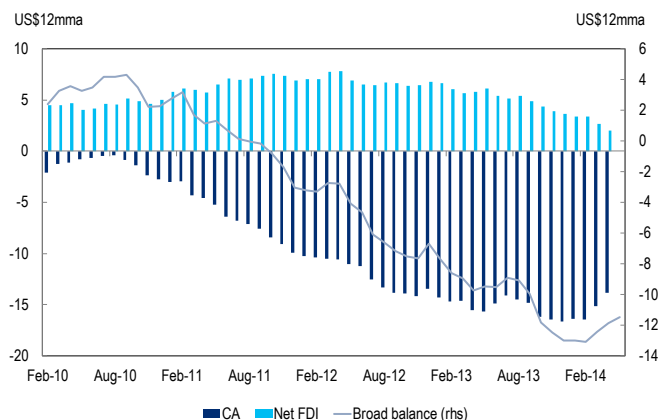
**With Russian troops still massed on the border, the risk of further military action is non-negligible.** While Russian troops have withdrawn deeper into Russian territory, they remain massed along Ukraine's eastern border. Post-election tail risks remain: civil disturbances could still prompt some form of military action, and Russia's halting its gas exports to Ukraine may aggravate economic pain.

Figure 221. Economy struggles...



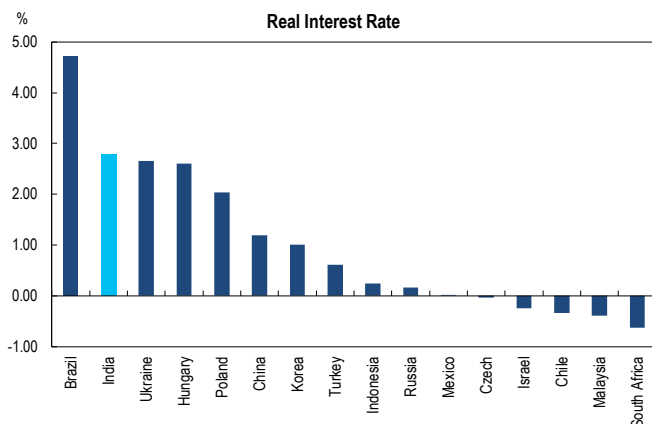
Source: UKR Statistics, Citi Research

Figure 222. ... but external position has started to improve



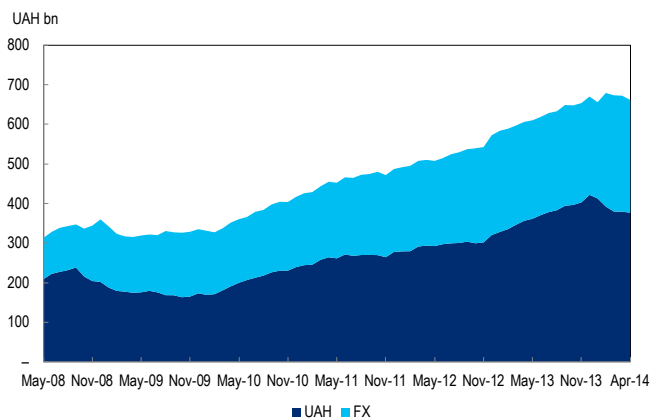
Source: UKR Statistics, Citi Research

Figure 223. Despite very high real interest rates...



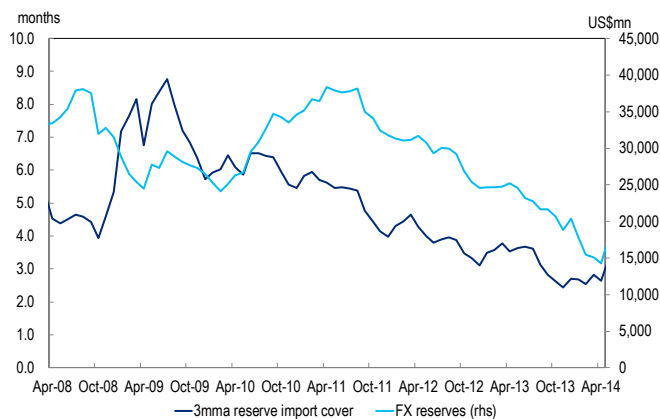
Source: Citi Research

Figure 224. ...population has started to reduce UAH deposits



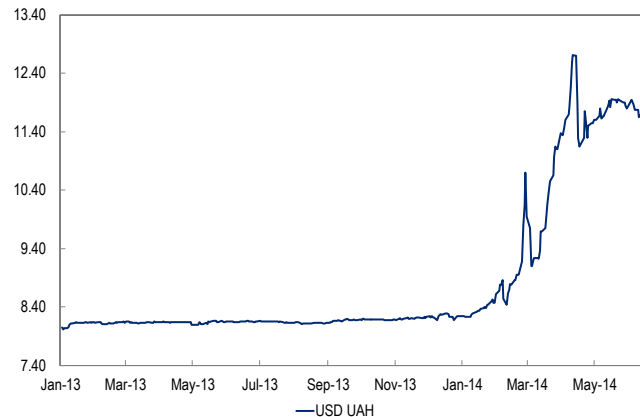
Source: UKR Statistics, Citi Research

Figure 225. Reserves are now slightly above 3 months of imports as IMF money has come in ...



Source: UKR Statistics, Citi Research

Figure 226. ...as the exchange rate has been weakening



Source: Haver Analytics

Figure 227. Ukraine Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	143	180	117	136	163	177	176	139	150
Nominal GDP, local currency bn	715	946	913	1,080	1,292	1,409	1,455	1,461	1,600
GDP per capita, USD	3,059	3,875	2,536	2,964	3,566	3,872	3,877	3,075	3,331
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
<b>Economic Activity</b>									
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
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy eop	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	10.5	5.8
CPI, % avg	12.8	25.2	15.9	9.4	8.0	0.6	-0.3	7.2	7.3
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	10.51	10.68
UAH/EUR, eop	7.37	11.25	11.53	10.66	10.37	10.62	11.33	14.28	14.97
UAH/EUR, avg	6.89	7.60	11.21	10.55	11.11	10.39	10.83	14.29	14.55
<b>Balance of Payments, USD bn</b>									
Current account	-5.3	-12.8	-1.7	-3.0	-10.2	-14.3	-16.4	-6.5	-4.6
% of GDP	-3.7	-7.1	-1.5	-2.2	-6.3	-8.1	-9.3	-4.7	-3.1
Trade balance	-10.6	-16.1	-4.3	-8.4	-16.3	-19.5	-19.6	-13.8	-10.4
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	82.0	82.0
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	20.4	27.6	36.7
Total amortisations	8.5	13.9	17.9	23.5	23.6	20.1	20.5	18.0	22.1
<b>Public Finances, % of GDP</b>									
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	49.7	54.2
of which Domestic	2.5	4.7	10.0	13.1	12.4	13.5	17.8	19.3	19.0
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
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	106.3	103.4
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	184.1	137.5	96.1
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	3.3	-1.1	-2.7	-4.1	-4.4	-0.1	1.5	2.8	3.6
CPI, % yoy eop	0.5	3.4	8.1	10.3	10.5	10.1	6.4	5.9	5.8
Policy interest rate, %, eop	6.50	6.50	9.50	9.50	9.50	9.00	9.00	9.00	9.00
Short-term market rate, % eop	16.25	23.00	18.00	15.00	15.00	11.25	11.25	11.25	11.25
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US\$, eop	8.24	11.12	11.00	10.50	10.50	10.60	10.70	10.75	10.80

Source: National Sources, Citi Research forecasts

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## Other Africa

### 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 so far in 2014, and inflation creeping up, the Bank of Ghana (BoG) tightened monetary policy at an emergency MPC meeting in February. 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.
- While the government may be able to muddle through in the next year, there is a chance that it 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 see a 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 be constrained by ongoing political uncertainty, sporadic terrorist incidences, periodic drought and infrastructure bottlenecks.
- Proposed revisions to the GDP and balance of payments statistics in 2H 2014 should reduce the twin fiscal and current account deficits and provide a more logical explanation of only gradual Kenyan shilling depreciation in recent years and the ability of the CBK to build foreign exchange reserves. But the government will have to avoid the temptation of using the lower fiscal deficit's debt stock as an excuse for not continuing with its programme of gradual mid-election fiscal consolidation.
- Although the Central Bank of Kenya (CBK) is likely to be 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 gradual depreciation that the CBK seems comfortable with.

### Tanzania

- Tanzanian politics will be dominated by the battle to succeed current president, Jakaya Kikwete, and adopting a new constitution, although it is now touch and go whether the constitution can be agreed upon and approved prior to the polls scheduled to be held in October 2015. Both issues will detract from the need for economic reform, notably the pressing need to resolve the ongoing power sector crisis, which has negatively affected growth, pushed up imports and made lowering the inflation rate a much slower process than elsewhere in East Africa, although it is now firmly in single digits.

- Given political developments, the prospects for rapid progress towards gas production are now very limited. But growth should continue to be robust at around 7%. The current account deficit is set to remain substantial, but with donor support and FDI inflows remaining high, the balance of payments will remain in surplus.
- While strong capital inflows coupled with capital controls and the Bank of Tanzania's (BoT) tight monetary policy has 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.

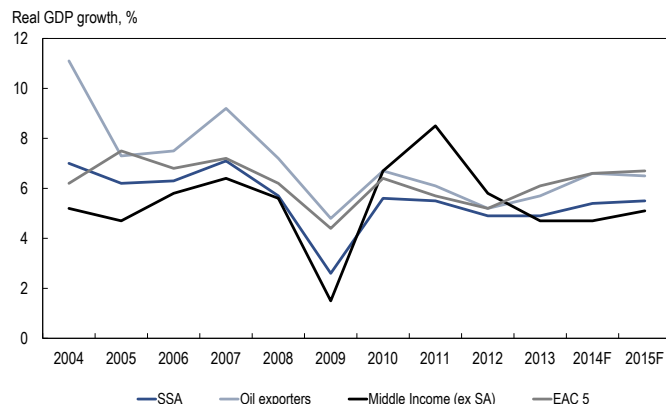
## Uganda

- The decision by the Bank of Uganda (BoU) to cut the Central Bank Rate (CBR) to 11% in June reflects its confidence in the inflation outlook in 2H 2014. Further cuts may be possible during this time but they will depend on the extent to which the BoU is worried about an inflation pick up in 2015 and potential Ugandan shilling (UGX) weakness.
- In particular, we expect the government to move into a period of more expansionary fiscal policy, driven by the elections in early 2016 and its plans to push ahead with various major infrastructure projects. Moreover, at a time when relations with traditional donors are strained, these projects are likely to be financed by either domestic borrowing, Chinese borrowing or even issuing a debut Eurobond. The combination of these trends means that after several years of Uganda shilling (UGX) stability it could be under more pressure in 2H 2014 and into 2015.
- At some point in the next five years, Uganda should become an oil producer. But this is still a long-term promise, and its impact on growth and government revenue will, initially, be minimal. While the development of the fields will push up the current account deficit, it should be largely funded through FDI.

## Zambia

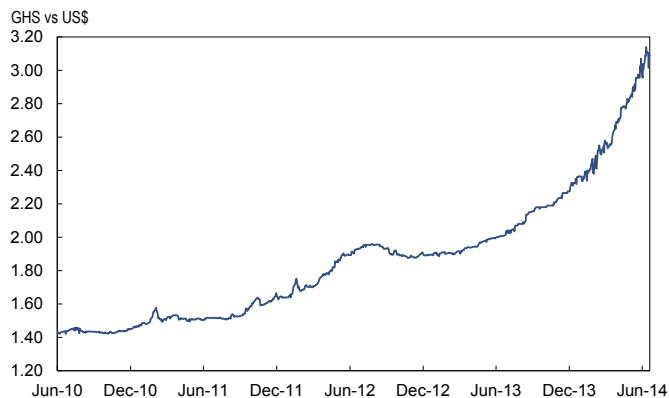
- The widening fiscal deficit in 2013 meant higher government wages spilled over into strong demand for imports in early 2014. Combined with disruptions to flows from the copper sector onto the market this drove significant kwacha depreciation.
- While the current account is likely to move into a small deficit in 2014, we expect it to be largely funded by FDI inflows. In addition, we expect an improvement in the fiscal deficit in 2014-15 as the government freezes government wages. 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 and push it into signing a new agreement with the IMF in late 2014. Although inflationary pressures look set to remain in 2H 2014, we think inflation will moderate towards the end of year. We also expect a modest recovery in growth on the back of rising agricultural and copper production in 2014.
- These developments, coupled with the sharp tightening of monetary policy in early 2014, 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 228. Growth across SSA should be robust in 2014-15**



Source: IMF

**Figure 229. The cedi charges through the GHS3:US\$1 level**



Source: Haver Analytics

**Figure 230. A gradual depreciation of the Kenyan shilling in 2014**



Source: Haver Analytics

**Figure 231. Is the Tanzanian shilling now too strong?**



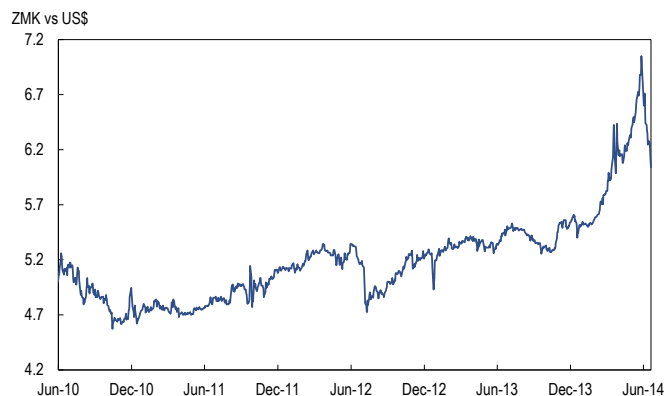
Source: Haver Analytics

**Figure 232. The Ugandan shilling is now coming under more pressure**



Source: Haver Analytics

**Figure 233. Has kwacha weakening in 1H 2014 now run its course?**



Source: Haver Analytics



Figure 234. Other Africa Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>GHANA</b>									
Nominal GDP, USD bn	24.8	28.5	26.0	32.2	39.6	40.7	41.0	34.6	35.0
GDP per capita, USD	1,099	1,234	1,096	1,326	1,594	1,605	1,582	1,307	1,295
Real GDP, yoy avg	6.5	8.4	4.0	8.0	15.0	8.8	7.1	5.1	4.0
CPI, % avg	10.7	16.5	19.3	10.7	8.7	9.2	11.7	14.1	11.6
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	2.97	3.46
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	-14.5	-14.3
Consolidated gov. balance, % of GDP	-5.6	-8.4	-7.0	-9.4	-5.5	-9.3	-9.0	-8.7	-8.0
<b>KENYA</b>									
Nominal GDP, USD bn	27.2	30.5	30.6	32.2	34.3	40.7	44.0	51.1	56.8
GDP per capita, USD	721	786	768	788	817	943	992	1,121	1,216
Real GDP, yoy avg	7.0	1.5	2.7	5.8	4.4	4.6	4.7	5.5	6.1
CPI, % avg	4.3	15.1	10.6	4.3	14.0	9.4	5.4	7.5	6.6
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	-4.0	-3.9	-4.3
% of GDP	-4.0	-6.6	-5.8	-6.5	-9.6	-9.3	-9.0	-7.6	-7.5
Consolidated gov. balance, % of GDP	-4.2	-3.5	-6.2	-4.7	-5.5	-9.0	-7.8	-6.5	-6.0
<b>TANZANIA</b>									
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	7.0	7.1	7.2
CPI, % avg	7.0	10.3	12.1	7.2	12.7	16.0	7.9	6.6	6.1
TZS/US\$, avg	1,237	1,198	1,324	1,439	1,582	1,586	1,617	1,648	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	-6.0	-6.4	-6.5
<b>UGANDA</b>									
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	6.1	6.5
CPI, % avg	6.1	12.0	13.0	4.0	18.7	14.0	5.5	5.3	7.4
UGX/US\$, avg	1,723	1,714	2,025	2,173	2,511	2,501	2,584	2,559	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	-3.1	-3.5	-3.7	-4.0	-4.5
<b>ZAMBIA</b>									
Nominal GDP, USD bn	11.5	14.6	12.8	16.2	19.2	20.6	22.3	22.2	24.4
GDP per capita, USD	953	1,175	998	1,225	1,408	1,465	1,530	1,478	1,575
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
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GHS/US\$, eop	2.37	2.69	3.00	3.20	3.35	3.40	3.40	3.50	3.60
KES/US\$, eop	86.45	86.40	87.50	88.00	89.50	90.00	92.00	92.00	93.50
TZS/US\$, eop	1,587	1,638	1,640	1,660	1,680	1,700	1,725	1,750	1,785
UGX/US\$, eop	2,523	2,547	2,550	2,580	2,650	2,700	2,700	2,800	2,825
ZMK/US\$, eop	5,195.00	5,195.00	6.30	6.30	6.30	6.40	6.40	6.45	6.45

Source: National Sources, Citi Research forecasts

## Other Europe

### Bulgaria

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**While we maintain our view that economic activity will rebound this year, the ongoing political tension suggests to us that domestic demand recovery may face major hurdles in the short term.** It is true that the 0.27%QoQ (WD) rise in GDP in the first quarter was mainly driven by a 1.3%QoQ pick up in individual consumption, which corroborated our view that this year's growth will be mainly shaped by domestic demand recovery. Although we still see such a domestic-demand driven recovery as our baseline case, we believe that downside risk to growth is intensifying on the back of the recent developments, including the elevated political noise and the uncertainty regarding the early general elections later this year. In fact, several high-frequency data have already provided early signs of softer domestic demand while real sector activity has been holding up relatively well, thanks to strong exports. Against this backdrop, while we maintain our 1.5% GDP growth forecast for 2014, we think that risks associated with our forecast are tilted to the downside.

**Turning to price developments, at -2.0%YoY, deflationary pressures accelerated in May compared with April (-1.6%).** Our analysis suggests that the deflationary pressures were wide-spread with eight of the 12 CPI components now standing in deflationary territory. Looking ahead, we expect the deflationary environment to prevail in the short term. However, we project inflation to rise to about 1.5% by end of the year on the back of stronger economic activity and base effects, with the impact of the latter becoming more evident after August 2014. Regarding external developments, the current account balance recorded a deficit of €212mn in April, compared with a surplus of about €466mn in the same month of 2013. With the April data, the current account deficit in the first four months of the year stood at €212mn, compared with a surplus of €54mn in the same period of 2013. Going forward, our expectation of stronger domestic demand this year leads 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.

### Croatia

**According to the flash estimate, GDP contracted by 0.4%YoY in the first quarter of the year, which represents the 10th consecutive negative reading in annual GDP growth.** In parallel, seasonally adjusted GDP, which rose by 0.59%QoQ in 1Q, paints a more upbeat picture of the first quarter, as it represents the strongest sequential growth since 2Q 2011. The noted strength in QoQ growth was driven by a surge in household consumption expenditures, which, at 1.32%QoQ, was the highest quarterly growth since 3Q 2010. Turning to higher frequency data, retail trade and industrial production data in April paint a mixed picture. The retail trade volume, which rose by 1.36%MoM (SA) in April, compared with 1Q average of 0.21%MoM, signals that household consumption in the second quarter remains strong. However, industrial production, which fell by 2.86%MoM in April – notably below the first quarter average of a rise of 1.32%MoM – suggests that real sector activity has been much softer in early 2Q. Against the noted backdrop, we continue to look for a moderate contraction of 0.6% this year compared with a 0.9% drop in GDP in 2013.

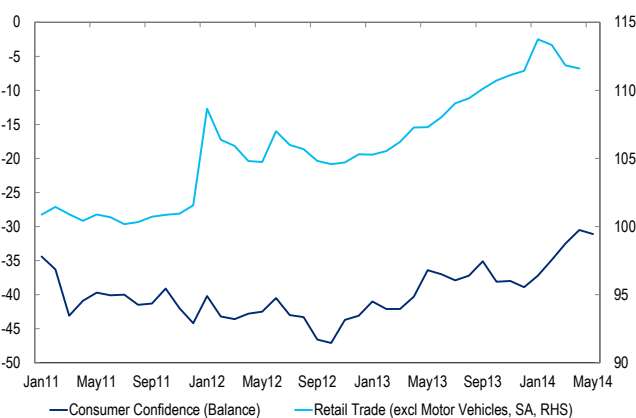
**Regarding price developments, consumer prices rose 0.3%MoM in May, bringing the annual inflation to -0.18%YoY from -0.46%YoY in April.** The monthly inflation print in May was markedly lower than its seasonal average (0.55%MoM) – an outcome mainly driven by below-average readings in food, clothing and utilities inflation. Looking ahead, while weak domestic demand is likely to keep inflationary pressures in check, we think that inflation is likely to rise gradually to about 1.5% by end-2014 owing to base effects and the unwinding of cyclical factors. In parallel, our expectations of the continued sub-par growth in domestic demand and a relatively strong export outlook lead us to look for a current account surplus of 0.5% of GDP, compared with a surplus 1.3% of GDP in 2013.

## Serbia

**Recent developments suggest that the pace of economic activity will likely be softer in the coming quarters.** Specifically, the unprecedented floods in mid-May have caused significant stress in agriculture, energy and transportation sectors, which will likely cause a loss in output in the short term. According to Deputy PM and Construction Minister, Zorana Mihajlovic, the direct damage from the flood on infrastructure and energy sector are estimated at more than €600mn. Moreover, according to her, indirect damages (such as loss in production, impact on environment, etc.) will amount to more than €2bn. Even before the floods, high-frequency data were signaling softer economic activity, as suggested by the retail trade data, which stood at only 0.2%MoM (SA) in the first four months of the year, compared with 0.83%MoM in the last quarter of 2013. The noted backdrop, in turn, leads us to look for weaker economic activity in 2014, as we revise our GDP growth forecast to 1.0% from 1.2%. Regarding external developments, we revise our 2014 current account deficit forecast marginally to 5% of GDP (from 4.8%) due to the likely adverse impact of the recent flooding on Serbia's external balance.

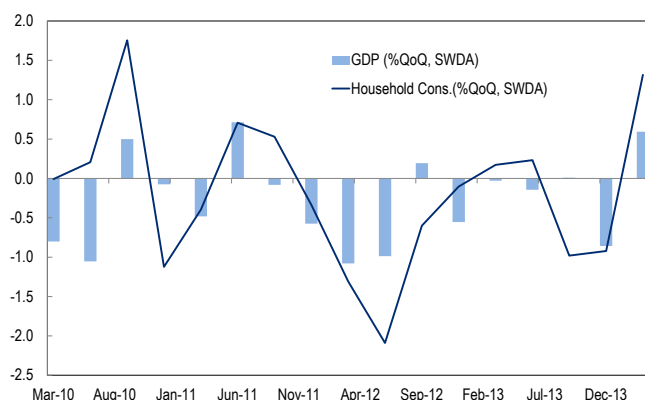
**At the June meeting, the NBS cut the policy rate by 50bp to 8.5%.** The Bank's assessment that inflation would continue to fluctuate around the lower-band of the target and that flooding will not lead to inflationary pressures, coupled with more favorable international environment, were the main drivers of Bank's decision to cut. It is true that price developments in the first five months of the year have been markedly more favorable than our expectations, as inflation stood at 2.1% in May. However, our analysis suggests that the lower-than-expected inflation was mainly driven by a relatively sharp drop in unprocessed food prices, which fell 5.0%YoY in the first five months of the year compared with the same period in 2013. Despite the noted favorable developments to date, we believe that there are reasons to be concerned about the inflation outlook, as, excluding food, inflation remains relatively high. Moreover, industrial goods, energy and services inflation, which stood at 5.3%, 5.3% and 4.0% in May, respectively, stand at or above the inflation target. Second, we expect to see a relatively sharp reversal in unprocessed food prices in the second half of the year. Against this backdrop, we expect inflation to rise at around 5% by end of this year. Looking ahead, we think that the emerging backdrop – softer domestic demand, lower inflation outturn, the likely IMF arrangement in the coming months and lower risk premium – strengthen the NBS's hand to carry out further easing in the short term. Against this backdrop and the improved policy environment following the elections, we expect to see an additional 50bp cut in the policy rate by end of the year.

**Figure 235. Bulgaria: Domestic demand recovery may face major hurdles in the short-term ...**



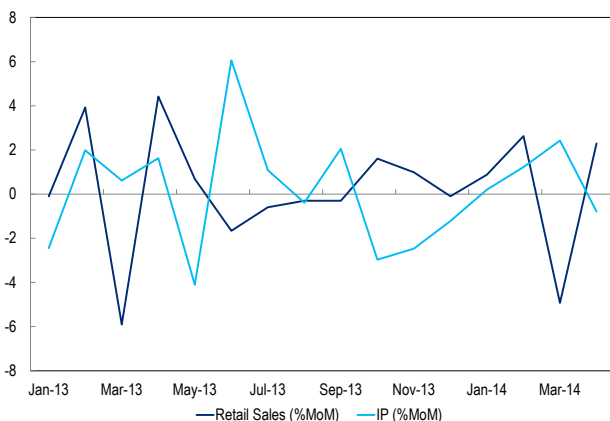
Source: Haver Analytics and Citi Research

**Figure 237. Croatia: Thanks to a surge in consumption, GDP rose by 0.59%QoQ (SA) in 1Q, the strongest sequential growth since 2Q 2011...**



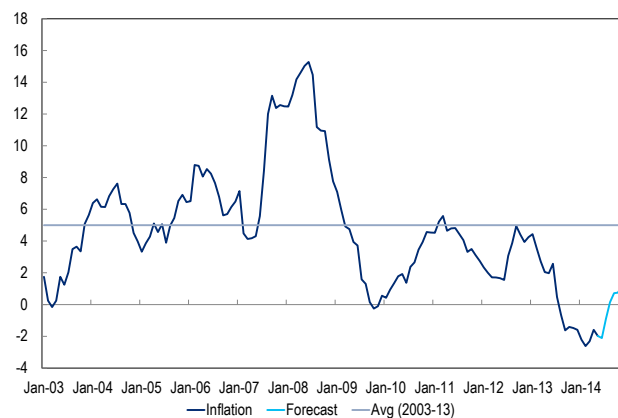
Source: Haver Analytics and Citi Research

**Figure 239. Serbia: Recent high frequency data continue to paint a mixed picture...**



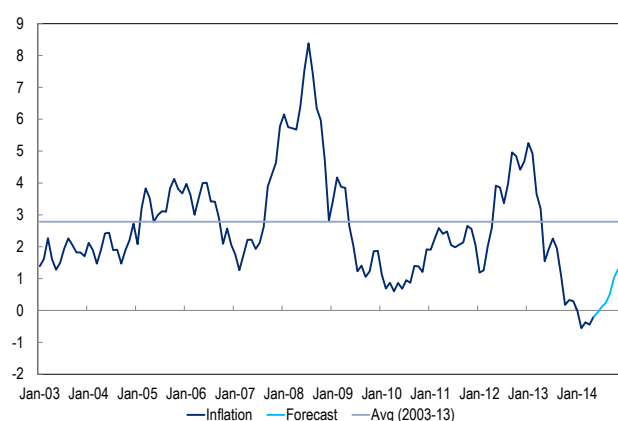
Source: Haver Analytics and Citi Research

**Figure 236. ...as we expect deflationary pressures to fade away in the coming months due to a reversal in food inflation and base effects**



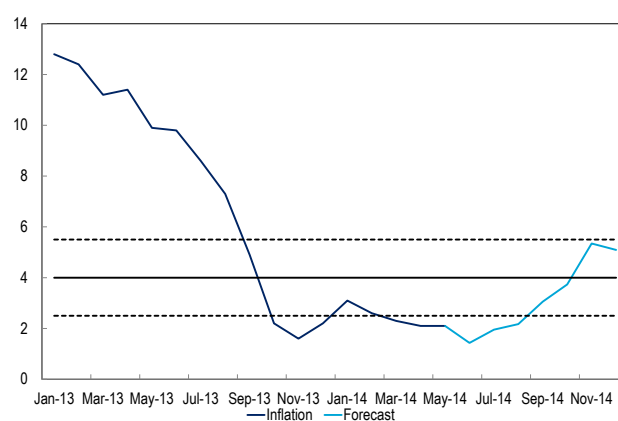
Source: Haver Analytics and Citi Research

**Figure 238. ... as we think that inflation is likely to rise to about 1.5% by end-2014 owing to base effects and the unwinding of cyclical factors**



Source: Haver Analytics and Citi Research

**Figure 240....as we expect inflation to rise at around 5% on the back of a reversal in food prices**



Source: Haver Analytics and Citi Research

Figure 241. Other Europe Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>BULGARIA</b>									
Nominal GDP, USD bn	42.2	52.1	48.7	47.8	53.6	51.3	53.9	56.1	58.8
GDP per capita, USD	5,521	6,849	6,435	6,374	7,314	7,040	7,446	7,787	8,205
Real GDP, yoy avg	6.4	6.2	-5.5	0.4	1.8	0.6	0.9	1.5	2.5
CPI, % avg	8.4	12.3	2.8	2.4	4.2	3.0	0.9	-0.8	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	-10.6	-12.0	-4.3	-0.7	0.0	-0.4	1.0	-0.1	-0.3
% of GDP	-25.2	-23.1	-8.9	-1.5	0.1	-0.8	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
<b>CROATIA</b>									
Nominal GDP, USD bn	59.3	69.6	62.2	58.9	61.5	56.4	57.3	58.4	59.8
GDP per capita, USD	13,581	15,960	14,299	13,577	14,227	13,106	13,361	13,682	14,058
Real GDP, yoy avg	5.1	2.1	-6.9	-2.3	-0.2	-2.2	-0.9	-0.6	1.2
CPI, % avg	2.9	6.1	2.4	1.0	2.3	3.4	2.2	0.3	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	5.57	5.66
HRK/EUR, avg	7.34	7.23	7.34	7.29	7.43	7.51	7.58	7.65	7.75
Current account, US\$bn	-4.3	-6.2	-3.2	-0.7	-0.5	-0.1	0.7	0.3	-0.3
% of GDP	-7.3	-8.9	-5.1	-1.1	-0.9	-0.1	1.3	0.5	-0.5
Consolidated gov. balance, % of GDP	-	-	-5.3	-6.4	-7.8	-5.0	-4.9	-5.0	-3.5
<b>SERBIA</b>									
Nominal GDP, USD bn	39.0	47.8	40.2	37.1	43.7	38.1	42.5	44.5	46.0
GDP per capita, USD	5,277	6,497	5,496	5,086	6,047	5,288	5,903	6,181	6,396
Real GDP, yoy avg	5.4	3.8	-3.5	1.0	1.6	-1.5	2.5	1.2	2.0
CPI, % avg	6.0	12.5	8.2	6.2	11.2	7.3	7.9	2.9	6.2
Policy Interest Rate, % eop	10.00	17.75	9.50	11.50	9.75	11.25	9.50	8.00	8.00
RSD/US\$, avg	58.3	55.2	67.4	77.5	73.2	87.8	85.1	84.7	88.7
RSD/EUR, avg	80.0	81.4	94.0	102.9	102.0	112.9	113.1	116.2	121.4
Current account, US\$bn	-6.9	-10.5	-2.9	-2.8	-4.0	-4.1	-2.1	-2.2	-2.3
% of GDP	-17.7	-21.9	-7.2	-7.6	-9.2	-10.9	-4.9	-5.0	-5.0
Consolidated gov. balance, % of GDP	-1.4	-2.0	-3.9	-3.9	-4.3	-7.2	-5.7	-6.5	-6.5

Source: National Sources, Citi Research forecasts



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## Latin America

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# Argentina

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- **Summary view** — The *pari passu* case has gotten more difficult, after the SCOTUS denied hearing the Republic's appeal. Now, the stay has been lifted, and the authorities will need to work against the clock to get to a solution. The increased legal risk adds to already-weak economic fundamentals: a widening fiscal deficit, continued pressures on the FX market, shrinking activity, and an accelerating inflation rate. The second half is set to be challenging.
- **Things to watch** — Besides the *pari passu* case, keep a close eye on the fiscal situation and the evolution of the FX and money markets, particularly as we enter the second semester.
- **Strategy** — We remain bearish on the country's credit. We believe prices do not properly reflect sovereign debt risk.

## The *pari passu* saga heats up

**The Supreme Court of the United States denied hearing the Republic's appeal in the *pari passu* case.** Following this development, the Second Circuit Court of Appeals lifted the stay. In response to the judicial developments, the Argentine authorities and their legal representatives presented a long list of contradictory statements. The gist of the message is that Argentina will attempt to enter negotiations with the holdouts (though the government has said that it intends to do so under a court umbrella that, at the time of this writing, does not exist).

**Among the many contradictory announcements made, Minister Kicillof said that the Republic will begin to work on the implementation of a foreign-to-local law exchange.** Judge Griesa reiterated during the week, too, that such an exchange like the one announced would be a violation of his anti-evasion order, yet the authorities have reiterated their intention to continue their work on this alternative. However, such a transaction is likely to be fraught with significant difficulties.

**Argentina has also announced it will seek to negotiate under the court's umbrella.** Judge Griesa has, as of this writing, failed to provide such an arrangement (or even a stay). Any negotiation with holdouts is likely to be quite complex. To begin with, there should be some basic agreements over what, how, and how much will be negotiated. The "what" is critical since Argentina has litigation that goes far beyond the current *pari passu* case. To restore market access and make the settlement a policy success, it would seem important to negotiate a solution to all claims held by holdouts. Several of the funds litigating with Argentina have indicated their intention to discuss the whole package, not just the *pari-passu* claims. The "how" also matters because Argentina does not have disagreements with just one creditor. Finally, agreeing on the amounts that Argentina would actually need to settle requires also significant sharpening. While the *pari passu* case entails approximately USD1.5bn in claims, we estimate total claims on Argentina to be roughly USD16.5bn (please see [Argentina: Is its liability \\$1.5 billion or \\$15 billion?](#)).

**The Kirchner administration also faces two legal obstacles to successfully negotiate the case: the RUFO clause and the debt restructuring law approved in 2013.** The RUFO clause in the 2005 exchange offered any bondholder that participated the right to receive similar treatment as that offered in any voluntary negotiation with holdouts before December 2014. The law passed last year by Congress reopening the 2005 and 2010 exchanges, thereby superseding some of the articles of the "lock law," prohibits the government from offering better conditions to holdouts than the ones offered in the previous exchanges (article 2).



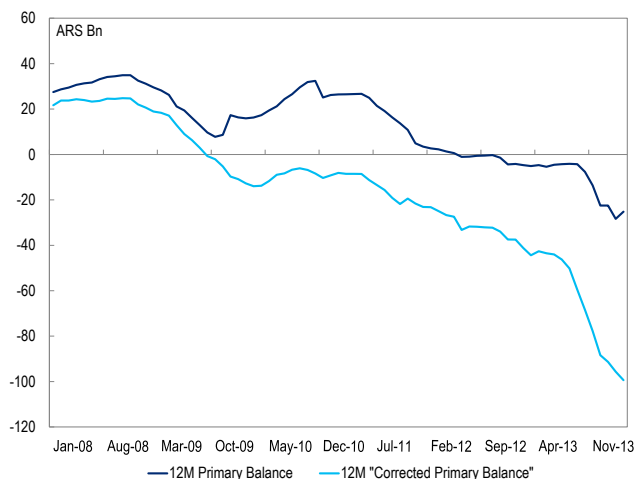
## Economic fundamentals show no improvement

**Fiscal accounts: all that glitters is not gold.** The higher primary surplus was the consequence of a 41.4% YoY rise in revenues and a 35.7% YoY increase in primary expenditure. However, Fiscal accounting has changed significantly in the last decade. Now, the Federal Government accounts as revenue, in the proprietary income line, BCRA's paper-profits and the returns from the FGS — the fund created following the nationalization of the private pension funds — as “proprietary income.” Regarding BCRA's paper-profits, they imply plain money printing. In the case of FGS' returns, they tend to create a double accounting issue, which leads to an overestimation of the primary balance, although they do not affect the overall balance. The “corrected primary balance” (i.e., leaving aside BCRA's paper-profits and the returns from the FGS) showed a marked deterioration in 1Q14 and also in March. Interestingly, the improvement in the “primary balance” in March was the result of much higher proprietary income, particularly from the Treasury (which accounts for BCRA's paper-profits transfers). Proprietary income stood at ARS12.9bn in March, up from ARS6.4bn one year ago (i.e., an ARS6.5bn difference). Similarly, proprietary income also increased markedly in 1Q14 as a whole, standing at ARS17.8bn, compared to ARS9.8bn in 1Q13. In other words, the “corrected primary balance” showed a marked deterioration in 1Q14, posting an ARS19bn deficit, vs. an ARS8.3bn deficit in 1Q13 (i.e., more than doubling). For further details, see our [Argentina Macro Flash - All That Glitters is not Gold](#).

**External accounts: get ready for 2H.** The BCRA has significantly increased its foreign currency purchases after the January devaluation, but remains a net seller in the last 12 months. According to its data, it has purchased USD4.1bn in the FX market year-to-date (as of June 13). However, despite the strong FX purchases, international reserves have decreased USD1.8bn during the same period of time. This is partially explained by the fact that it bought USD3bn from local banks, as a result of regulatory changes. Those holdings of foreign currency were already deposited at the BCRA and, thus, accounted for as reserves. Also, it has been limiting the supply of foreign exchange to companies to pay for their imports. Companies are allowed to import, but in many cases they do not get the necessary foreign currency to pay for them. According to some market estimates, the import payments have decreased around 40%. Needless to say, extending this strategy moving forward will be extremely costly in terms of activity. Despite these “heterodox” measures, the BCRA had to sell USD2.3bn of foreign currency in the last 12 months, to prevent the official exchange rate from depreciating even further. This fact proves that the stabilization accomplished in 1H14 may have “feet of clay.”

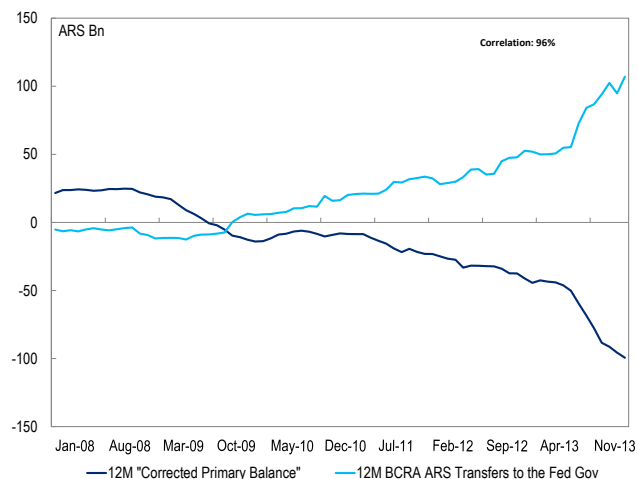
**Stagflation aggravates.** Even official statistics recognize the economy is in recession. Official real GDP shrank 0.8% QoQ seasonally adjusted (SA) in 1Q14. As a result, official GDP posted its second consecutive quarterly drop, after decreasing 0.5% QoQ SA in 4Q13. GDP also dropped in annual terms, posting a 0.2% YoY contraction. Gross capital formation rose 1.9% YoY, public consumption increased 3.4% YoY, and private consumption dropped 1.2% YoY, all in real terms. Also, exports of goods and services shrank 6.4% YoY, while imports also dropped, by 3.8% YoY. Lastly, 2013 real GDP growth was revised down to 2.9%, compared to 3% previously. Meanwhile, official consumer prices increased 13.5% during the first five months of the year. Private estimates show higher consumer inflation. According to local consultancy firm MyS, consumer prices have increased 17.2% year to date. As a result, annual inflation has accelerated to 39.6%, up from 28.8% in December 2013.

Figure 242. The "corrected primary balance" ...



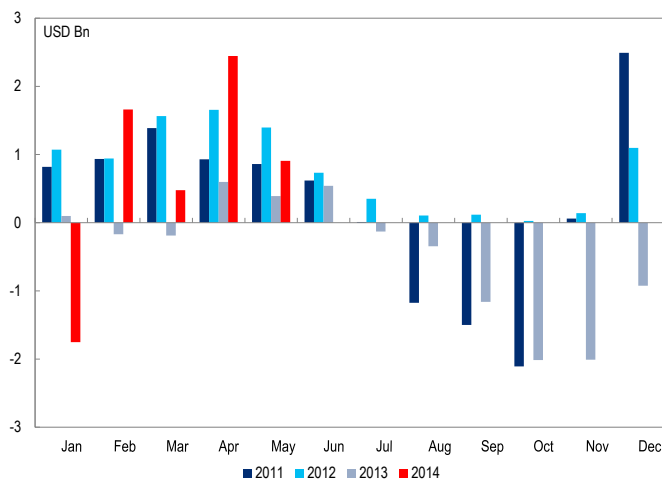
Source: MECON and Citi Research

Figure 243. ... drives fiscal money printing



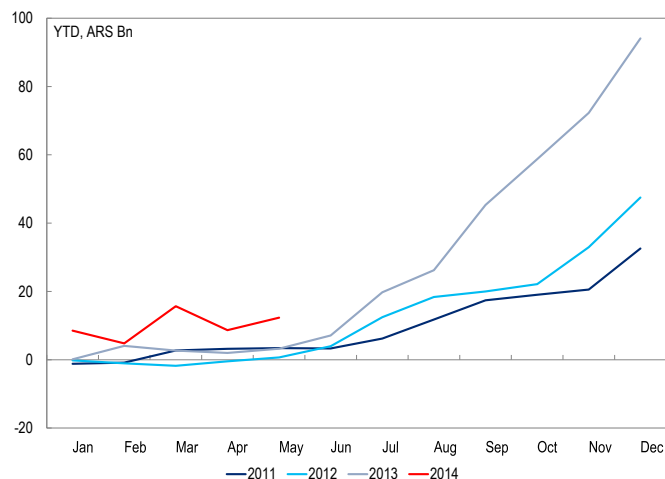
Source: BCRA, MECON and Citi Research

Figure 244. BCRA's FX purchases drop in the second semester...



Source: BCRA and Citi Research

Figure 245. ... while fiscal money printing soars



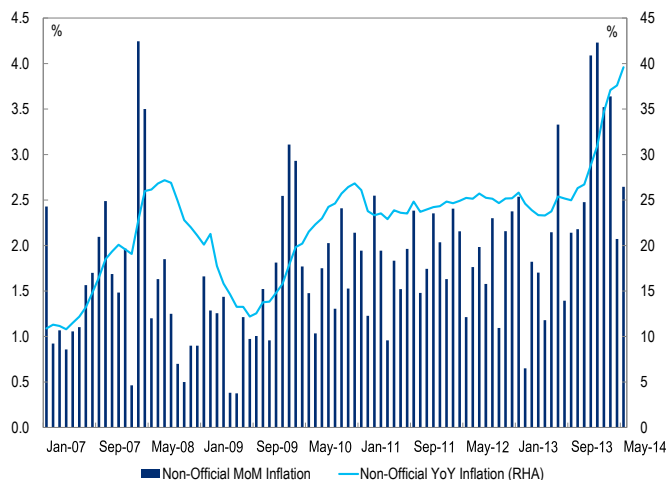
Source: CEC and Citi Research

Figure 246. Official real GDP dropped in annual terms in 1Q14...



Source: INDEC and Citi Research

Figure 247. ... while consumer inflation soared



Source: MyS and Citi Research

Figure 248. Argentina Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	332	409	380	464	560	604	605	477	450
Nominal GDP, local currency bn	1,027	1,284	1,412	1,810	2,303	2,745	3,347	4,178	5,315
GDP per capita, USD	8,428	10,281	9,470	11,456	13,684	14,628	14,519	11,324	10,584
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
<b>Economic Activity</b>									
Real GDP, yoy avg	8.4	2.6	-3.9	7.7	5.1	-0.3	2.8	-1.5	0.0
Real investment growth % yoy	16.3	6.2	-24.0	38.4	15.6	-11.5	1.6	-4.5	-0.3
Real consumption growth % yoy	8.9	5.5	4.1	7.2	10.5	4.5	4.7	0.8	1.5
private consumption growth % yoy	9.0	5.6	3.5	7.1	10.8	4.2	4.3	0.6	1.4
Real export growth, % yoy	8.0	0.8	-8.7	14.4	4.9	-5.9	-5.3	-1.5	-1.5
Real import growth, % yoy	21.9	13.5	-19.3	35.0	19.8	-4.7	1.6	-2.0	0.0
<b>Prices, Money &amp; Credit</b>									
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	30.00	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	8.75	11.81
<b>Balance of Payments, USD bn</b>									
Current account	7.4	6.8	11.0	-0.8	-2.3	0.1	-4.3	-5.0	-5.3
% of GDP	2.2	1.7	2.9	-0.2	-0.4	0.0	-0.7	-1.1	-1.2
Trade balance	13.5	15.4	18.5	14.3	12.9	15.4	12.2	12.1	12.6
Exports	56.0	70.0	55.7	68.1	84.1	80.9	83.0	81.5	82.3
Imports	42.5	54.6	37.1	53.9	71.1	65.6	70.9	69.4	69.7
Service balance	-0.5	-1.3	-1.3	-1.2	-2.2	-3.4	-5.1	-4.1	-4.1
Income balance	-5.9	-7.6	-9.0	-13.5	-12.4	-11.5	-10.7	-12.3	-13.1
FDI, net	6.5	9.7	4.0	11.3	10.7	12.1	9.1	10.0	10.0
International reserves	46.2	46.4	48.0	52.2	46.4	43.3	30.6	26.0	17.5
Total amortisations	5.2	4.7	11.2	10.7	12.0	9.7	9.3	9.3	9.3
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.9	1.1	-0.5	0.2	-1.3	-2.0	-1.9	-2.4	-2.4
Consolidated gov primary balance	2.5	2.5	1.2	1.4	0.2	-0.2	-0.7	-1.1	-1.1
Public debt	43.6	35.7	38.7	35.4	32.0	31.7	31.3	38.1	46.0
of which Domestic	22.3	20.0	22.4	20.4	18.9	19.7	19.8	25.0	29.7
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	124.5	124.9	115.6	129.3	141.1	142.2	137.6	116.1	124.1
Public	70.8	64.4	61.8	69.5	73.2	72.0	70.1	62.2	73.1
External debt / GDP	37.5	30.6	30.4	27.9	25.2	23.5	22.7	24.4	27.6
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.8	-0.5	-1.7	-2.2	-1.4	-0.9	-0.2	0.3	0.6
CPI, % yoy	28.8	37.2	39.0	39.9	38.0	32.8	34.5	34.7	35.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	21.63	26.40	25.00	27.00	30.00	33.00	34.00	35.00	37.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	6.52	8.00	8.30	9.20	10.00	10.78	11.62	12.52	13.50

Source: National Sources, Citi Research

## Brazil

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- **Summary view** — We are revising down our growth forecasts for 2014 and 2015 to 0.9% and 1.2%, respectively. We expect the policy interest rate (Selic) to remain flat at 11% until year-end, although the risks are now skewed to the downside. We still see CPI inflation at 6.6% at year-end. On FX, we still see higher USD/BRL in the medium/long term, reflecting a steady deterioration in domestic fundamentals amid the process of normalization of US monetary policy. We continue to expect President Dilma Rousseff to be re-elected, even though her approval rating has fallen below 35%.
- **Things to watch** — CPI inflation seems to be moderating, so the relevance of activity indicators will tend to increase. Rousseff's approval rate should be closely monitored as it is already at a critical level. Monthly fiscal results will remain in the spotlight because the fiscal accounts are still under heavy scrutiny.
- **Strategy** — Given our skepticism about domestic fundamentals, we continue to see opportunity in staying long USDBRL in the medium/long term. We also see the yield curve steepening in coming months. It's worth mentioning that our trade strategies are conditioned on our political outlook, which has Dilma Rousseff's re-election as the base-case scenario.

### Economic growth outlook spooks Dilma Rousseff

**We are reducing our 2014 and 2015 GDP growth forecasts to 0.9% and 1.2%, respectively.** The low growth registered in 1Q14 (0.2% QoQ SA) combined with an upward revision in the 2013 figure (to 2.5% from 2.3%, implying a smaller carry-over this year) indicated to us our previous growth forecasts for 2014 and 2015 (1.3% and 1.8%, respectively) were on the "too optimistic" side. Moreover, April's activity indicators (industrial production, civil construction, and retail sales) were disappointing as well, reinforcing our skepticism about future growth. Overall, based on our Brazilian Leading Indicator model and our view for the agriculture/livestock sector, we forecast GDP will remain flat in 2Q14, with additional contraction in industrial production. For the quarters ahead, our structural models are suggesting neither higher potential GDP growth (which we estimate between 2% to 2.5%) nor a rebound in the output gap, suggesting quarterly growth will be hovering around 0.2%–0.3% QoQ. It's worth emphasizing that we are not forecasting any quarterly contraction ahead. However, we recognize that the risks have been increasing lately, given the deceleration in labor/credit markets, the sticky higher-than-equilibrium real-unit labor cost in the industrial sector, and the collapse in confidence indicators. All in all, our new 2014 and 2015 GDP growth estimates will likely stay on the bearish side of the street.

**We expect the Selic interest rate to be flat at 11% until the end of the year, but risks are now slightly skewed to the downside.** Copom will likely stay on hold for the rest of the year, given it is more comfortable on the inflation front while more concerned about economy activity. The risk of rising volatility during an election year is another reason for Copom to stay put. However, in case of a major negative surprise in economic growth, we cannot rule out a cut of the Selic rate even before the election. For 2015, we believe Copom will resume monetary tightening in order to bring CPI inflation to lower levels. Because of that, we still forecast 150bps of additional hikes to the policy rate during the first meetings of 2015, putting the reference interest rate at 12.50% by the end of the monetary-tightening process. Once again, if economic activity continues to deteriorate, our call for further tightening may be revised.

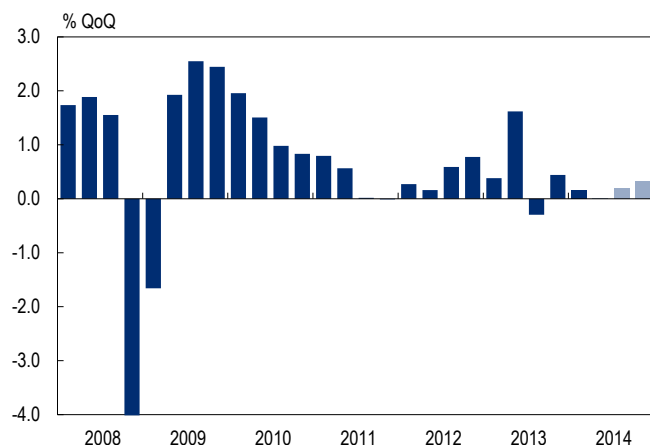
**The World Cup's impact on inflation has been milder than expected, and commodity prices shock is fading away.** The near-term Inflation outlook has been showing some improvement, especially at the agriculture wholesale level. In addition, upward price pressures linked to the World Cup event have been milder than anticipated. On the other hand, core measures (hovering around 7% in annualized terms) and service inflation (sticky at 9%) are still at uncomfortable levels. Therefore, we maintain our 2014 year-end CPI inflation forecast at 6.6%, but the risks of a breach in the upper limit of the target (6.5%) are somehow smaller than last month. For 2015, we expect a reduction in market-price inflation to 6% (from 6.3%) as a result of soft economic growth, but pressures surrounding monitored prices are rising. Thus, we now expect monitored price inflation to reach 7.2% in 2015 (from 6.4%), given the distortions in energy cost, gasoline prices, and bus fares. All in all, we are keeping our 2015 CPI inflation forecast at 6.3% for now, but risks seem tilted to the upside.

**Negative surprises to economic activity might be a liability to the incumbent candidate.** So far, the World Cup has not hurt President's Rousseff's voting intention, which is still close to 40%. However, her approval rate has been falling since February and is now close to 30%. This level is significantly below the 35% threshold, where re-election has been proven to be difficult. We still have her re-election as our base case scenario, because she still has plenty of time to react in the TV campaign. Negative surprises in economic activity might be also a significant risk for the incumbent candidate. The campaign of the Eduardo Campos seems to be losing steam, and the most plausible opponent in the second round is Aécio Neves from PSDB.

**The government is maintaining a loose fiscal policy.** The government has even announced measures that point to a looser fiscal policy. Among these is a renewal of PSI (a subsidized credit line through BNDES), an export incentive program (REINTEGRA), and more benefits for companies that opt for a debt refinancing program known as REFIS. Furthermore, the government is continuing to count on one-off revenues to achieve its fiscal target. All in all, we continue to expect a primary surplus of 1.5% of GDP in 2014. Looking ahead, we do not see a meaningful fiscal adjustment in 2015 (whatever the result of the election) and continue to expect a primary surplus of 2.0% of GDP for that 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.

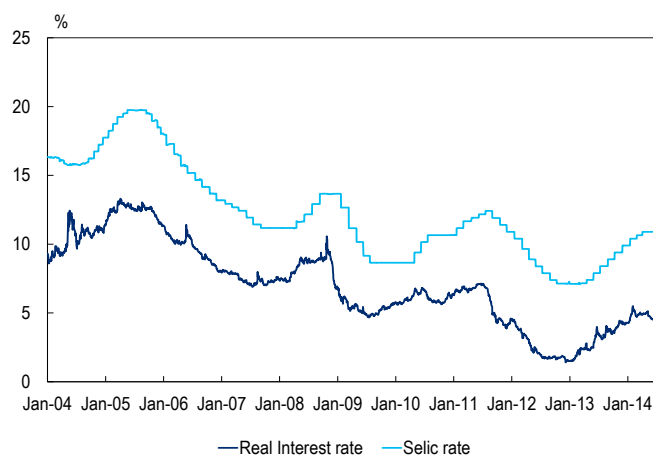
**Global conditions continue to support the BRL in the near term, even though deteriorating domestic fundamentals point to some depreciation over longer horizons.** Global risk aversion and commodity prices have remained at favorable levels justifying the current level of the USDBRL, slightly above 2.20. However, President Rousseff's government continues to indicate just a slight (if any) fiscal policy tightening next year amid a deteriorating outlook for domestic growth. Overall, apart from the process of US monetary policy normalization, we believe worse domestic fundamentals will likely support a weaker domestic currency, leading us to set our USDBRL forecasts at 2.43 and at 2.59 for the 2014 and 2015 year-ends, respectively. With these estimates, we do not envision significant adjustments in external accounts, but rather a rough stabilization of current account deficits at levels close to 4% of GDP.

Figure 249. We expect 2014 GDP growth to reach 0.9%



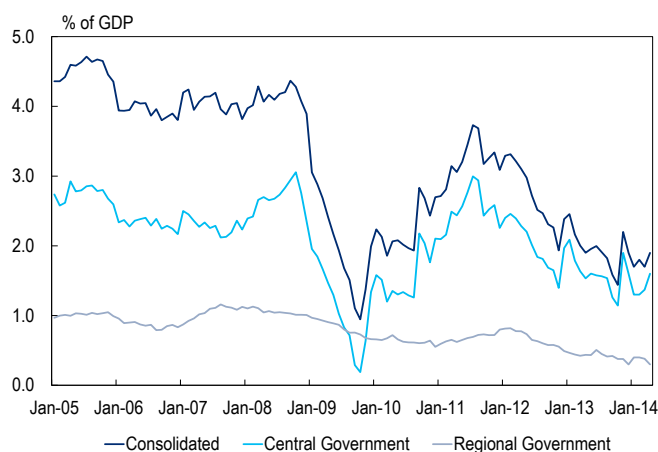
Source: Citi Research and IBGE

Figure 251. We expect the Selic rate to remain at 11% until 2014 year-end



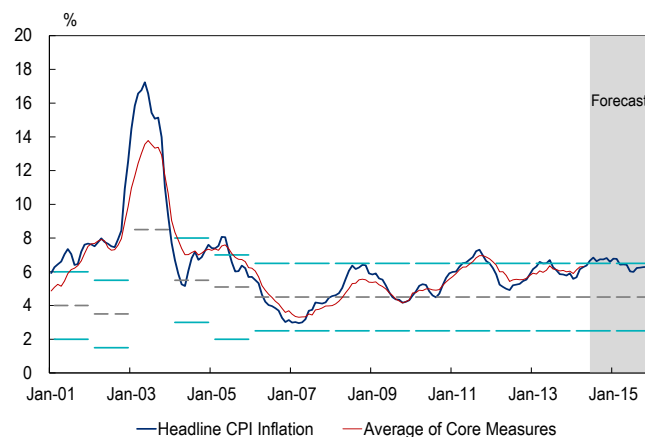
Source: Citi Research and Bloomberg

Figure 253. The primary fiscal surplus remains below 2% of GDP



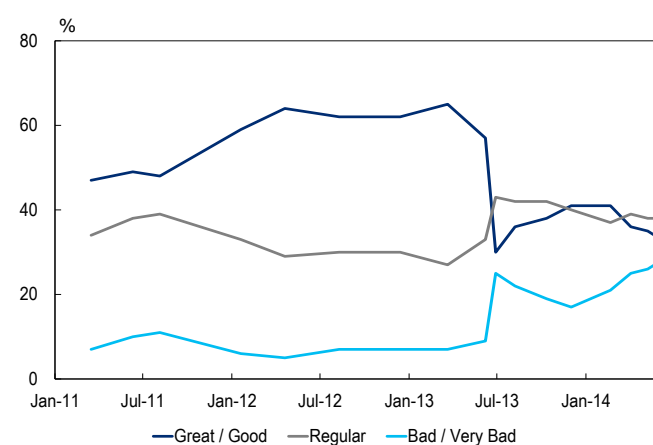
Source: Citi Research and BCB

Figure 250. Inflation may breach the target's 6.5% upper band



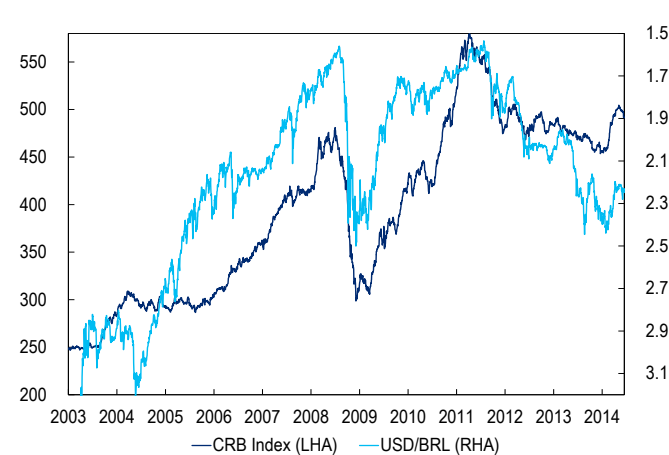
Source: Citi Research, BCB and IBGE

Figure 252. President Rousseff's negative assessment surpassed positive



Source: Citi Research and DataFolha

Figure 254. Commodity prices and USD/BRL: a negative correlation



Source: Citi Research and Bloomberg

Figure 255. Brazil Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	1,317	1,746	1,622	2,142	2,475	2,247	2,212	2,212	2,200
Nominal GDP, local currency bn	2,661	3,032	3,239	3,770	4,143	4,392	4,808	5,166	5,554
GDP per capita, USD	6,950	9,114	8,379	10,955	12,536	11,278	11,002	10,910	10,751
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	5.9
<b>Economic Activity</b>									
Real GDP, yoy avg	6.1	5.2	-0.3	7.5	2.7	1.0	2.3	0.9	1.2
Real investment growth % yoy	16.9	16.4	-16.0	33.4	4.0	-7.9	8.0	-3.0	1.3
Real consumption growth % yoy	5.8	5.1	4.1	6.3	3.6	3.2	2.2	2.0	1.3
private consumption growth % yoy	6.1	5.7	4.4	6.9	4.1	3.2	2.3	1.6	1.9
Real export growth, % yoy	6.2	0.5	-9.1	11.5	4.5	0.5	2.5	2.2	6.8
Real import growth, % yoy	19.9	15.4	-7.6	35.8	9.7	0.2	8.4	2.6	4.4
<b>Prices, Money &amp; Credit</b>									
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	6.4	6.4
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	14.7	13.5	13.5
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	11.66	12.16
BRL/USD, eop	1.78	2.31	1.74	1.66	1.86	2.05	2.36	2.43	2.59
BRL/USD, avg	1.95	1.84	2.00	1.76	1.67	1.95	2.16	2.33	2.55
<b>Balance of Payments, USD bn</b>									
Current account	1.6	-28.2	-24.3	-47.3	-52.5	-54.2	-81.4	-84.6	-86.2
% of GDP	0.1	-1.6	-1.5	-2.2	-2.1	-2.4	-3.7	-3.8	-3.9
Trade balance	40.0	24.8	25.3	20.1	29.8	19.4	2.6	3.9	7.4
Exports	160.6	197.9	153.0	201.9	256.0	242.6	242.2	245.0	260.6
Imports	120.6	173.1	127.7	181.8	226.2	223.2	239.6	241.1	253.1
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	53.8
<b>Public Finances, % of GDP</b>									
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
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	193.6	198.3	198.2	256.8	298.2	312.9	322.8	318.6	312.0
Public	86.0	84.2	93.3	103.6	102.1	113.7	119.5	116.4	114.0
External debt / GDP	14.7	11.4	12.2	12.0	12.1	13.9	14.6	14.4	14.2
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	38.9	36.4	31.0	57.3	40.1	37.2	40.0	42.0	44.0
Short-term debt/International reserves (%)	21.6	18.8	13.0	19.9	11.4	10.0	10.6	11.2	11.7
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.9	1.9	0.2	0.9	0.6	0.9	1.1	1.3	1.4
CPI, % yoy	5.9	5.6	6.3	6.8	6.6	6.4	6.1	6.3	6.3
Policy interest rate, %, eop	10.00	10.75	11.00	11.00	11.00	12.00	12.50	12.50	12.50
Short-term market rate, % eop	9.78	10.56	11.00	11.00	11.00	12.00	12.50	12.50	12.50
Long-term yield, %, eop	8.57	12.88	12.24	11.66	11.66	12.16	12.16	12.16	12.16
BRL/USD, eop	2.36	2.27	2.26	2.36	2.43	2.50	2.53	2.56	2.59

Source: National Sources, Citi Research



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- **Summary view** — The dust from the busy political cycle has settled, and governments are beginning to shape up policies. Costa Rica and El Salvador are beginning to talk about fiscal reform, while in Panama and the Dominican Republic there is nothing in the pipeline.
- **Things to watch** — The government is “reaching out” to the private sector in El Salvador. This is the only way in which the country can increase private investment and begin thinking about moving toward a higher potential growth rate.
- **Strategy** — In our view, the BCCR’s priority is to lessen FX volatility.

### The dust settles... time to work

**The dust from the busy political cycle has settled, and governments are beginning to shape up policies.** Luis Guillermo Solis and Salvador Sanchez Ceren have already been inaugurated as presidents of Costa Rica and El Salvador, respectively, while Juan Carlos Varela is about to begin his term in Panama. As the dust from this year’s busy political calendar seems to be settling, we are beginning to see a few signs of how these politicians would like to guide their countries.

**Costa Rica and El Salvador are beginning to talk about fiscal reform.** In the case of Costa Rica, the plan seems to be to work in a fiscal reform proposal that would most likely be sent to Congress in early 2015. The reform will likely target an increase in taxes of around 2% of GDP. Another objective would be that the reform becomes effective in 2016. In turn, the first half of the Solis administration is unlikely to see a turnaround in the widening fiscal deficit. In the case of El Salvador, the government is working to try to get approval of the bill sent by Mauricio Funes (when he was still in office) that aims to raise USD200 million (around 0.8% of GDP) in new taxes. The government has committed to “fiscal austerity” but, together with the ruling FMLN party, has been unable, so far, to gather enough votes to move forward with this bill. In our view, the bill could be approved if the government concedes some watering down of the reform.

**In Panama and the Dominican Republic, there are no fiscal reform plans in the pipeline.** Juan Carlos Varela will take office on July 1, and he has already given some indications on who might be cabinet members, including the announcement of Dulcidio de la Guardia as Economy and Finance Minister. Mr. de la Guardia has already said that there are no plans to increase taxes, as this was a campaign promise from Mr. Varela. We must note that our view is that there is a possibility that the Varela administration becomes more fiscally prudent than the outgoing Martinelli administration. The Dominican Republic has already raised taxes (and lowered expenditures) to reverse the fiscal slippage associated with the previous election. It seems that the Medina administration has no further plans to increase taxes or implement some kind of fiscal reform for the remainder of the term.

**There is not much in the pipeline in the Dominican Republic, which seems to be on autopilot, but this could change in about 1½ years.** The country has already made its fiscal adjustment, gold exports are working in favor of growth, and the loosening of reserve requirements has pushed credit growth. All this comes at a time in which President Danilo Medina has a high approval rating (89.3% according to Gallup-Hoy<sup>1</sup>). We not expect major policy changes over the next 1½ years, but this might change when politics begin heating up again in late 2015 or early 2016, when we move into the electoral cycle.

<sup>1</sup> The survey was published by *El Diario de Hoy* on May 21, 2014.



**Idiosyncratic factors could begin playing a role in Dominican Republic when we get closer to the 2016 election.** We think that during the next 18 months, the risks to our baseline scenario will come mostly from overseas. After that period of time, the risks will likely shift to idiosyncratic factors. The most notorious spikes in primary expenditures in previous years have taken place during election years. We see no reason why 2016 should be different. The tighter the election becomes, the higher the incentives to increase — at least temporarily — primary expenditures. President Danilo Medina has high popularity, but he cannot run for re-election. The only option for him to run for office in 2016 is to make a constitutional amendment. Without a constitutional amendment, the ruling PLD party loses its strongest name and could face a harder election in 2016. If that were the case, it is natural to think that the incentives for fiscal expansionism will pop up again.

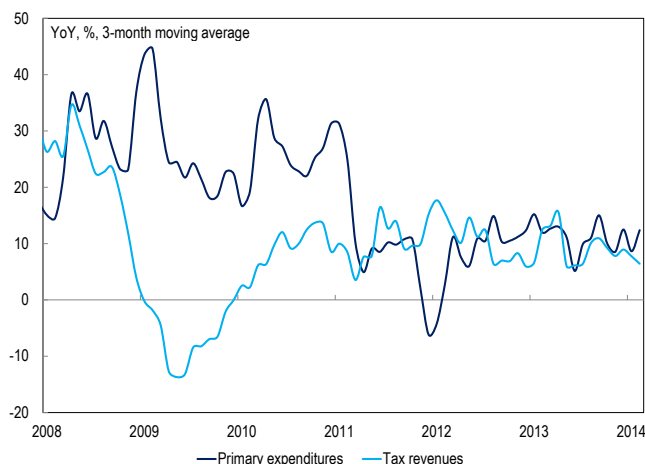
**El Salvador is trying to “reach out” to the private sector, while Costa Rica is still adjusting to the departure of Intel.** The Sanchez Ceren administration seems to be trying to have a less confrontational approach to the private sector than the previous one. In our view, this is the only way in which the country can increase private investment and begin thinking about moving toward a higher potential growth rate. In the case of Costa Rica, the partial departure of Intel will likely translate into a deceleration of growth. This slowdown will probably become more evident in the second half of the year.

**In Panama, growth is slowing down, but it should continue to be high.** The temporary halt in works in the Panama Canal expansion and the fall in re-exports from the Colon Free Zone (ZLC) would remain the main drivers of the slowdown. We are noticing, however, that toll revenues have begun to recover slightly. Nonetheless, traffic in the Panama Canal continues to be affected by stronger competition from the Suez Canal and soft global trade.

**In our view, the Dominican Republic would use rate cuts as a tool to push up growth only after currency risk is perceived to have diminished substantially.** For now, the looser reserve requirements have been working in favor of growth, but a lower overnight rate could be even better for credit growth. We think that now, the BCRD is willing to allow a move in the USDDOP of 5%–6% per year, but we also believe it is committed to prevent moves beyond that. That a rate cut when managing the FX seems to be a priority would sound odd, but we think that unwinding last year’s 200bps rate hike (August 2014) is something that may not be entirely off the table. If the BCRD is effective in keeping the USDDOP crawling rate within the 5%–6% range, we would not be surprised if it would be tempted to begin thinking about returning the overnight rate to a level closer to 5%–5.5%. For now, this is not a topic that will begin making headlines anytime soon, but it certainly is something that could pop up again in late 2014 or early 2015 — depending also on how expectations on global rates (United States and Europe) evolve.

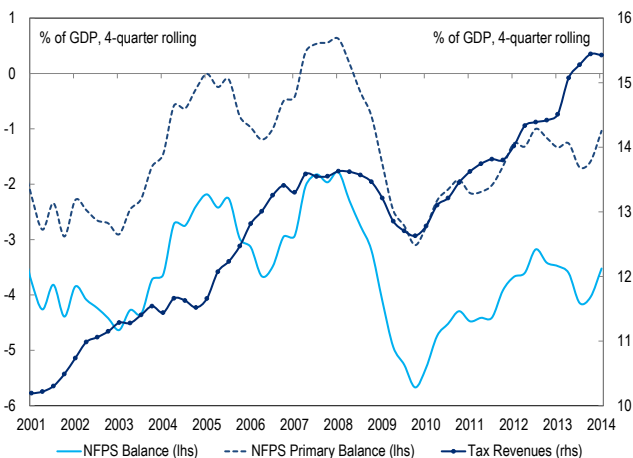
**In the case of Costa Rica, FX policy can be expected to seek to diminish volatility.** In our view, the Central Bank of Costa Rica’s (BCCR) priority is to lessen volatility in the FX market — particularly after the wild swings of early 2014. We expect the BCCR to continue to intervene, without forcing a change in a particular trend. We think that this announcement is a major change for the country’s balance of payments (BoP). Accordingly, it would exert pressure on the local currency.

**Figure 256. Costa Rica: Expenditures are growing faster than revenues**



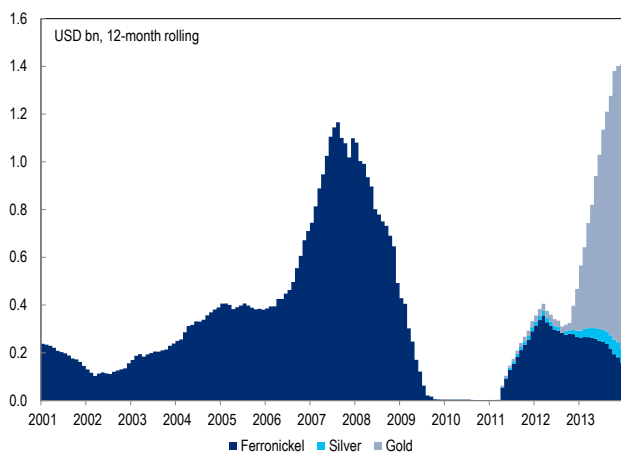
Source: BCRD, Hacienda and Citi Research

**Figure 257. El Salvador: The fiscal deficit narrowed in 1Q14**



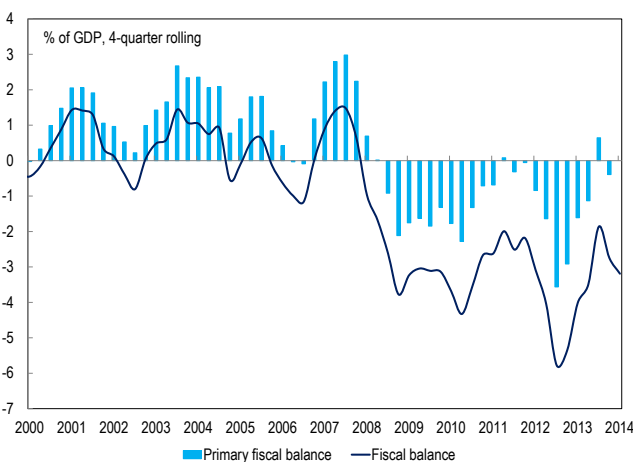
Source: BCRES, Hacienda and Citi Research

**Figure 258. DomRep: Gold exports have soared**



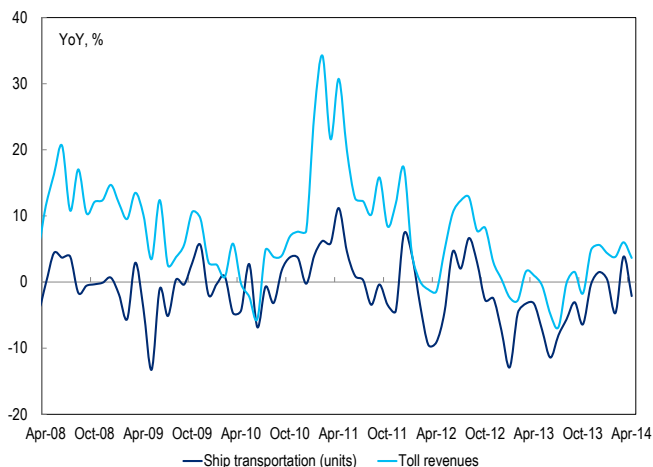
Source: BCRD and Citi Research

**Figure 259. DomRep: The fiscal deficit has widened in election years**



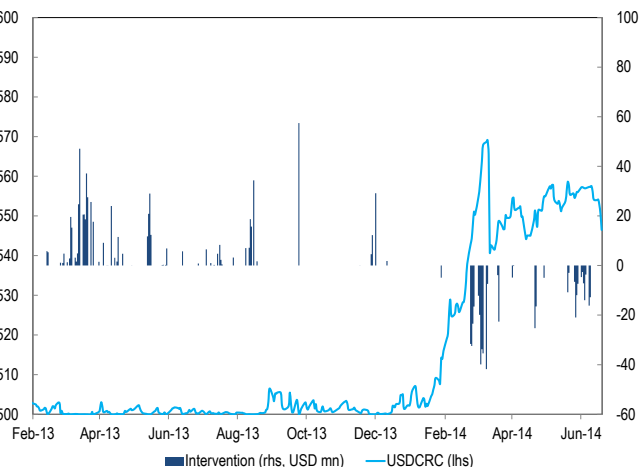
Source: BCRD, Hacienda, Haver and Citi Research

**Figure 260. Panama: Traffic in the canal has been falling in 2014**



Source: ACP, Haver and Citi Research

**Figure 261. Costa Rica: The BCCR has intervened in the FX market**



Source: BCCR and Citi Research

Figure 262. CCA Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Costa Rica</b>									
Nominal GDP, USD bn	26.3	29.8	29.4	36.3	41.2	45.4	49.6	48.1	48.0
GDP per capita, USD	5,925	6,583	6,389	7,955	8,964	9,654	10,557	10,017	9,995
Real GDP, yoy avg	7.9	2.7	-1.0	5.0	4.5	5.1	3.5	3.1	2.2
CPI, % avg	9.4	13.4	7.8	5.7	4.9	4.5	5.2	4.4	4.6
CRC/US\$, avg	517	525	570	521	502	503	501	555	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	-7.4	-7.9
Consolidated government balance	0.8	0.5	-3.9	-6.0	-5.6	-5.7	-6.5	-7.2	-7.7
<b>Dominican Republic</b>									
Nominal GDP, USD bn	41.3	45.8	46.8	51.8	55.8	59.0	60.8	62.9	65.0
GDP per capita, USD	4,414	4,807	4,822	5,241	5,544	5,770	5,901	6,108	6,315
Real GDP, yoy avg	8.5	5.3	3.5	7.8	4.5	3.9	4.1	5.0	4.5
CPI, % avg	6.1	10.6	1.4	6.3	8.5	3.7	4.8	3.4	4.2
Policy Interest Rate, % eop	7.00	9.50	4.00	5.00	6.75	5.00	6.25	5.50	5.00
DOP/US\$, avg	32.8	34.4	35.9	36.8	38.0	39.2	41.7	43.7	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	-4.0	-2.6	-2.8	-3.1
% of GDP	-5.2	-9.9	-5.0	-8.4	-7.9	-6.8	-4.2	-4.5	-4.8
Consolidated government balance	-1.7	-4.3	-4.8	-3.7	-3.8	-7.9	-4.1	-4.0	-4.2
<b>El Salvador</b>									
Nominal GDP, USD bn	20.1	21.4	20.7	21.4	23.1	23.8	24.3	25.1	26.1
GDP per capita, USD	3,500	3,705	3,548	3,653	3,919	4,006	4,043	4,176	4,352
Real GDP, yoy avg	3.8	1.3	-3.1	1.4	2.2	1.9	1.7	2.2	2.5
CPI, % avg	4.6	7.3	0.5	1.2	5.1	1.8	0.8	1.0	1.7
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
SVC/US\$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.2	-1.5	-0.3	-0.6	-1.1	-1.3	-1.5	-1.6	-1.5
% of GDP	-6.1	-7.1	-1.5	-2.7	-4.6	-5.3	-6.2	-6.4	-5.7
Consolidated government balance	-1.9	-2.8	-5.5	-4.4	-4.0	-3.5	-4.2	-4.1	-3.7
<b>Panama</b>									
Nominal GDP, USD bn	21.1	24.9	25.9	28.8	33.3	38.0	42.6	46.8	50.7
GDP per capita, USD	6,318	7,312	7,482	8,170	9,242	10,543	11,668	12,639	13,352
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	3.2	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** — The slowdown in domestic demand seems to be the most worrisome topic right now. There are several factors that would continue to work against domestic demand and consumer confidence. Under this outlook, the BCCh has kept an easing bias.
- **Things to watch** — If inflation proves to be temporary, the BCCh would ease further to put the policy rate at 3.5%. We expect the next big question in Chile to be whether the country is transitioning to a lower potential growth rate.
- **Strategy** — The BCCh's easing cycle has been so far of 100bps, but its statements (and minutes) suggest there is room to deepen it. We expect the central bank to cut the policy rate by an additional 50bps this year — thereby putting it at 3.5%.

### The slowdown goes on

**The slowdown in domestic demand seems to be the most worrisome topic in Chile right now.** For quite some time, we have been discussing how investment has been working against growth. Investment in machinery and equipment has been disappointing and has inevitably taken its toll on growth. Concerns about growth began with the fall in copper prices in 2013 and then moved to investment. It seems that the sources of worry about growth in Chile are now refocusing on private consumption, as it looks to be slowly heading to lower growth rates.

**There are several factors that would continue to work against domestic demand.** We are still in a low-copper-price environment that has eroded the outlook in Chile, but in our view, this was not the only factor that has lowered expectations about the country. We think President Michelle Bachelet's fiscal reform proposal — particularly the potential elimination of the FUT (*Fondo de Utilidades Tributables*, or Taxable Profits Fund) — has affected private investment plans. Potentially higher corporate tax rates do not help the investment outlook either. We think that copper prices and weaker investment began to erode confidence among Chilean consumers at the first stage, but that the tax reform has fueled it further. We think it would take some time to turn around this erosion in confidence.

**The slowdown in domestic demand would translate into a narrower current account deficit.** The slowdown in domestic demand is even more evident if we take a look to the trade balance. Imports have been consistently falling since last year. This fall has been led by capital goods imports, but consumer goods are beginning to fall at double-digit rates. In our view, lower import growth, together with a slight recovery in exports, would translate into a narrower current account deficit. A recovery in exports has already begun, as copper prices are recovering from recent lows and the depreciation of the local currency seems to be working in favor of other exports.

**The narrowing in the current account would not necessarily mean a higher surplus in the Balance of Payments (BoP).** Foreign direct investment (FDI) as a percentage of GDP has been trending down. The aforementioned concerns associated with investment among locals (fiscal reform) could also undermine some inflows in foreign direct investment. In turn, the surplus from FDI and the current account will likely be lower.

**With this outlook, we expect the next big question in Chile to be whether the country is transitioning to a lower potential growth rate.** In our view, the language from the statements of the central bank and from its officials suggests that authorities are still working under the assumption that the country's potential growth rate is around 5%. We think this assumption is the anchor that has allowed the Central Bank of Chile (BCCh) to cut rates and to keep an easing bias. However, if growth continues to disappoint or if copper prices do not rebound (or even fall), the country will most likely begin asking itself if potential growth is lower than the aforementioned 5%.

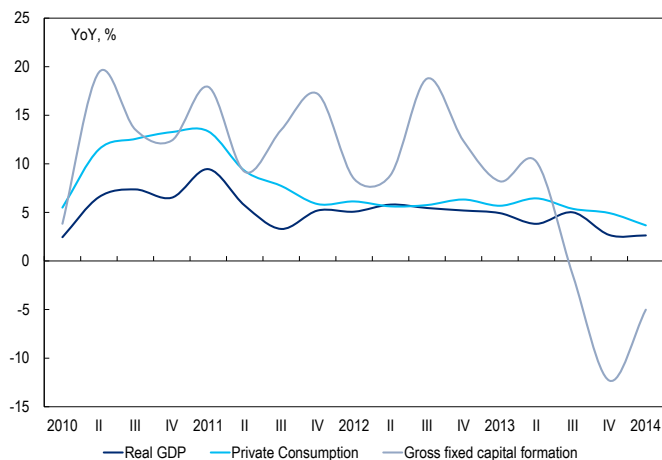
**Since authorities seem to have kept intact their views on potential growth, there is still more room for rate cuts.** The BCCh's easing cycle has so far been of 100bps, but its statements (and minutes) suggest that there is room to deepen it. In our view, the central bank will cut the policy rate by an additional 50bps this year — thereby putting it at 3.5%. The central bank recently cut its 2014 real GDP growth outlook to 2.5%–3.5% (from 3%–4%), but it has to wait for a window of opportunity to undertake another round of easing.

**The only headwind against rate cuts is the recent rebound in inflation, but the BCCh expects it to recede.** The weakening in the local currency has been one of the main feeders of the rebound in inflation of tradable goods. Other items that have pushed up inflation are energy and food prices. We share the central bank's view that the rebound in inflation should prove to be temporary and that inflation will come back to the target range ( $3\pm 1\%$ ). In our view, the central bank is waiting to gather more evidence that the rebound in inflation is temporary. As soon as it finds that evidence, we would expect it to resume the easing cycle. Moreover, if growth remains below potential, rate cuts would not translate into serious demand-side inflationary pressures.

**Our views on growth, the BoP, and monetary policy are behind our currency outlook.** We see a higher USDCLP in the months ahead, but we do not expect the BCCh to intervene in the FX market to defend a certain USDCLP level or to alter the trend in this currency. The central bank has not intervened in a long time, and although the FX has caused some (temporary) trouble to inflation, we think that intervention is not considered an option by the BCCh.

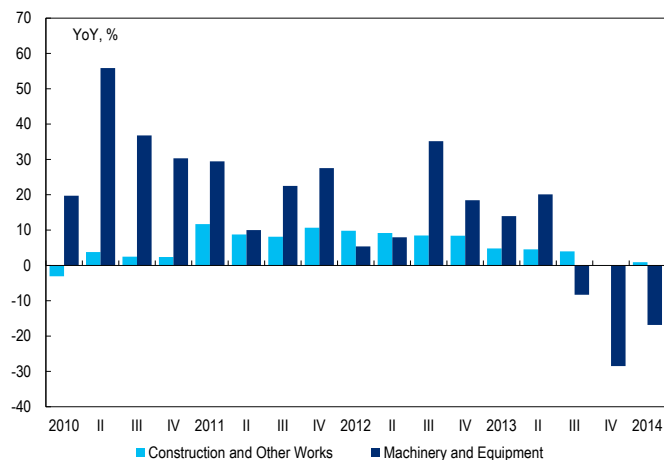
**Finally, we must note that fiscal accounts are weakening.** The 4-quarter rolling fiscal deficit was around 1% of GDP in 1Q14, while a year ago the government was running a surplus of 0.8% of GDP. The fall in copper revenues has contributed to that, but primary expenditures have been increasing constantly during the past couple of years. One of the current administration's targets is to reduce the structural fiscal deficit to 0% of GDP. However, we do not see how this could be possible in the near term. The fiscal reform could provide more resources, but we would expect that the new revenue would be committed to permanent expenditures associated with the social agenda.

Figure 263. Investment is falling and consumption is slowing down



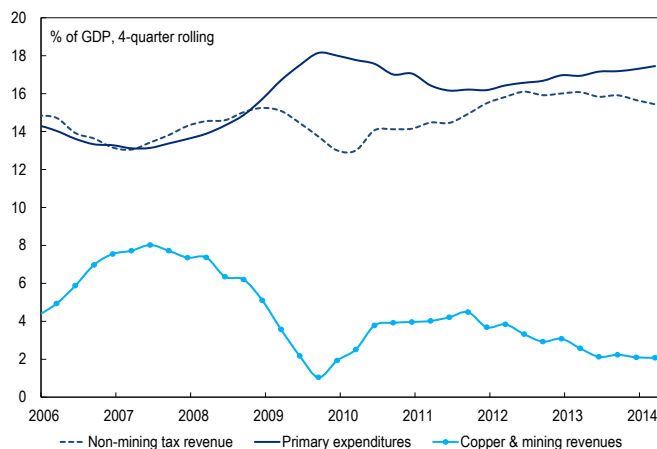
Source: : BCCh, Haver and Citi Research

Figure 264. Investment in machinery is pulling down growth



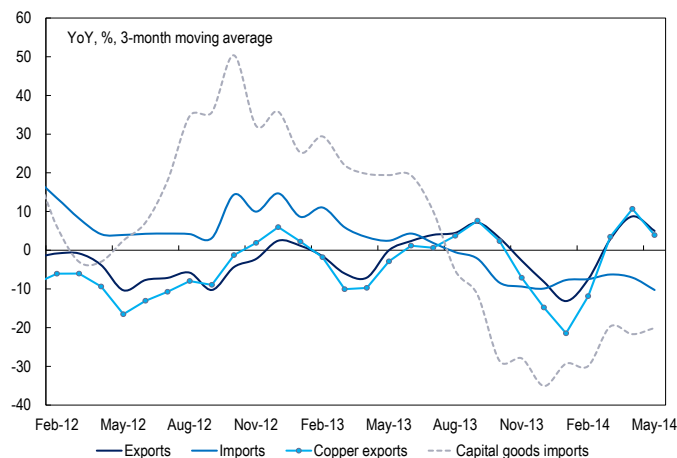
Source: BCCh, Haver and Citi Research

Figure 265. Mining revenues are stabilizing



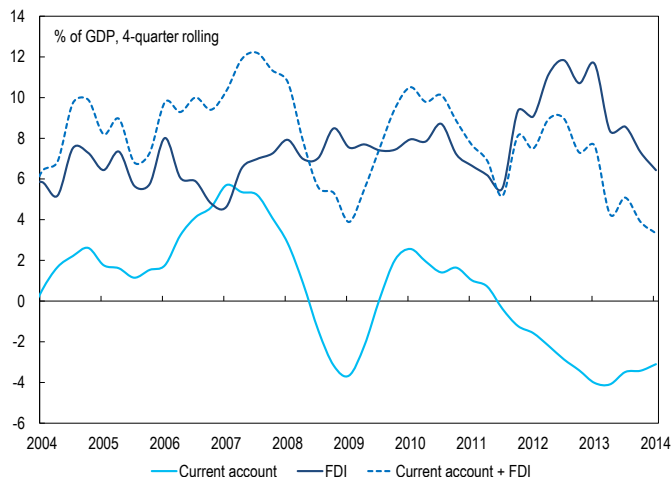
Source: Hacienda, BCCh, Haver and Citi Research

Figure 266. Capital goods imports continue underperforming



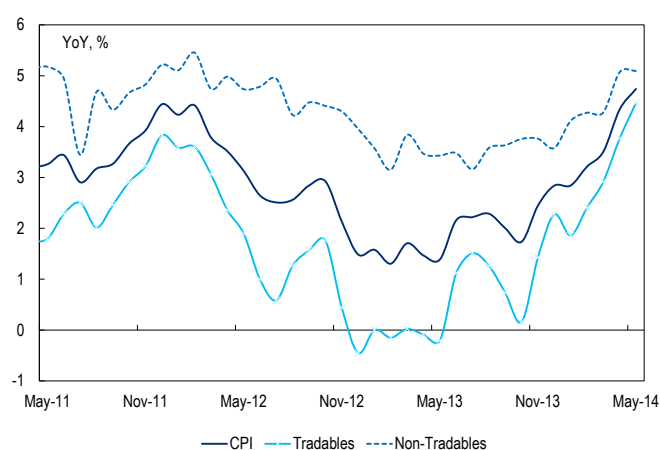
Source: BCCh, Haver and Citi Research

Figure 267. The BoP surplus is not as high as in the last two years



Source: : BCCh, Haver and Citi Research

Figure 268. Inflation breached the 4% threshold



Source: INE, Haver and Citi Research

Figure 269. Chile Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	173	183	173	218	251	267	277	261	268
Nominal GDP, local currency bn	90	94	96	111	121	130	137	146	156
GDP per capita, USD	10,414	10,876	10,199	12,861	14,639	15,398	15,863	14,764	15,049
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
<b>Economic Activity</b>									
Real GDP, yoy avg	5.2	3.3	-1.0	5.8	5.8	5.4	4.1	3.0	4.0
Real investment growth % yoy	6.4	20.8	-23.5	27.3	14.2	11.0	-2.5	-5.2	5.0
Real consumption growth % yoy	7.5	4.4	0.8	9.8	7.8	5.6	5.4	3.7	4.0
private consumption growth % yoy	7.6	5.2	-0.8	10.8	8.9	6.0	5.6	3.3	4.1
Real export growth, % yoy	7.2	-0.7	-4.5	2.3	5.5	1.1	4.3	3.6	3.1
Real import growth, % yoy	14.3	11.2	-16.2	25.9	15.6	5.0	2.2	-2.8	3.8
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	7.8	7.1	-1.5	3.0	4.4	1.5	2.9	3.8	3.0
CPI, % avg	4.4	8.7	1.5	1.4	3.3	3.0	1.9	4.0	3.0
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	3.50	4.00
1 month inter-bank rate, %, eop	5.93	8.24	0.45	3.13	5.23	4.99	4.50	3.50	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	575	586
CLP/USD, avg	522	524	559	510	484	486	496	563	583
<b>Balance of Payments, USD bn</b>									
Current account	7.1	-5.8	3.5	3.6	-3.1	-9.1	-9.5	-6.7	-10.7
% of GDP	4.1	-3.2	2.0	1.6	-1.2	-3.4	-3.4	-2.6	-4.0
Trade balance	24.1	6.1	15.4	15.7	11.0	2.5	2.1	4.5	0.5
Exports	68.6	64.5	55.5	71.1	81.4	78.0	76.7	74.2	75.5
Imports	44.4	58.4	40.1	55.4	70.4	75.5	74.6	69.7	75.1
Service balance	-1.3	-1.2	-2.0	-1.9	-3.1	-2.3	-2.9	-0.9	-0.1
Income balance	-18.9	-13.6	-11.4	-14.7	-13.9	-11.5	-11.1	-12.4	-13.1
FDI, net	12.6	15.5	12.9	15.7	23.4	28.5	20.3	15.9	14.0
International reserves	16.9	23.2	25.4	27.9	42.0	41.6	41.1	38.7	39.9
Total amortisations	14.3	14.3	16.4	12.3	12.8	22.4	22.7	22.9	23.3
<b>Public Finances, % of GDP</b>									
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	1.2	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
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	53.4	63.7	71.9	84.5	98.7	117.8	120.7	113.3	116.7
Public	4.0	3.3	4.0	5.6	7.1	7.9	4.2	3.9	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	21.9	20.2	20.8
Short-term debt/International reserves (%)	53.4	60.6	62.4	58.3	46.6	54.9	53.3	52.3	52.2
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	2.7	2.6	2.8	2.7	3.7	4.5	4.7	3.7	3.2
CPI, % yoy	2.9	3.5	4.4	4.0	3.8	2.9	2.5	3.0	3.0
Policy interest rate, %, eop	4.50	4.00	4.00	3.50	3.50	3.50	3.75	4.00	4.00
Short-term market rate, % eop	4.50	4.00	4.00	3.50	3.50	3.50	3.75	4.00	4.00
Long-term yield, %, eop	5.10	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
CLP/USD, eop	525	549	560	569	575	580	582	584	586

Source: National Sources, Citi Research

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- **Summary view** — Throughout the first quarter of the year, economic activity pointed toward a better-than-expected recovery, leading us to change our GDP growth forecast to 5% for 2014 and 5.5% for 2015. Having said that, we expect economic activity to exhibit some mild deceleration during the second quarter. Although inflation currently stands well contained within the inflation target band of 2%–4%, throughout the first five months of the year the actual inflation print has surprised the market on the upside in four consecutive months, leading to a revision of inflation expectations.
- **Things to watch** — Watch for changes to the government cabinet as well as for announcements associated with reforms the government should be presenting to Congress throughout the second half of the year.
- **Strategy** — We now expect a faster monetary normalization with additional interest rate increases in Banrep's July and August meetings.

### Activity recovery amid inflation acceleration

**Economic activity continues to signal a recovery is under way.** The print for 1Q14 stood above market consensus and our own forecast. Quarter-over-quarter seasonally adjusted growth was 2.3%, while annual growth reached 6.4%. On the supply side, the best performers in 1Q14 were construction (17.2% YoY), social services (6.3%), agriculture (6.1%), and financial services (6.0%). The weakest performer in 1Q14 was manufacturing (3.3% YoY), although it showed positive growth for the first time in many quarters. Although the results show the economy is in recovery mode, we expect growth to decelerate to 5% on an annual basis in the second quarter. Nevertheless, we have revised up our GDP growth forecasts for this year and next, and we now expect growth of 5% and 5.5%, respectively.

**Although the second quarter should not be as good as the first, activity should continue to exhibit growth consistent with 5% for the year as a whole.** In particular, we continue to expect construction, financial services, retail, and oil and mining to remain among the top performers of the year. On the other hand, we expect the industrial sector to continue to display growth levels below the overall GDP figure. We forecast some moderate recovery for it this year, but mostly as a result of a low base of comparison. Also, we expect the construction sector to be the best performer; but we also acknowledge its performance is the major source of uncertainty, for during the past two years the construction sector and particularly civil works projects have shown significant volatility. While we think that most of the fundamental problems (corruption scandals, microeconomic bottlenecks, and coordination among ministries) have taken their toll on growth, we expect to see a significant improvement in the aggregate construction sector in 2014, mostly driven by private construction, spending at the regional level, and ongoing civil works projects. Having said that, most of the impacts of the civil works projects known as fourth generation are expected to materialize in 2015.

**On a positive note, the auction process for the first nine projects of the so-called fourth generation infrastructure projects continued, despite the fact that presidential elections were taking place.** It is the first time in recent history that processes worth USD5.5 billion were not halted by the election, demonstrating that preparation was good and that infrastructure is seen as a priority that goes beyond politics. At the time of this writing, bids for seven of the nine projects have been received, and three auction winners have been announced.



**As for inflation, we have observed upward surprises in four out of the five months of data released by DANE this year.** Most of the inflation surprise has to do with increases in foodstuffs inflation, which last year was falling due to excellent weather conditions that translated into production oversupply. But because the situation has reversed this year, we have seen a normalization of foodstuffs inflation. For 2014, we expect CPI to end at 3.4%. For 2015, the main risk for the inflation outlook in Colombia could be adverse weather shocks (e.g., an eventual El Niño phenomenon). However, any that arise should be of a transitory nature.

**Monetary policy.** Back in April, the central bank decided to begin its policy normalization by increasing the interest rate by 25bps and stating that it preferred to make a gradual adjustment rather than an abrupt one. This is the reason we still believe Banrep will continue with its 25bps increases until the repo rate gets to 4.5%, a situation that should occur in August. At this point, we believe Banrep will declare a pause in order to assess the effects of the first round of interest-rate increases. Going forward, monetary policy should continue to be determined by the interaction of both activity and inflation.

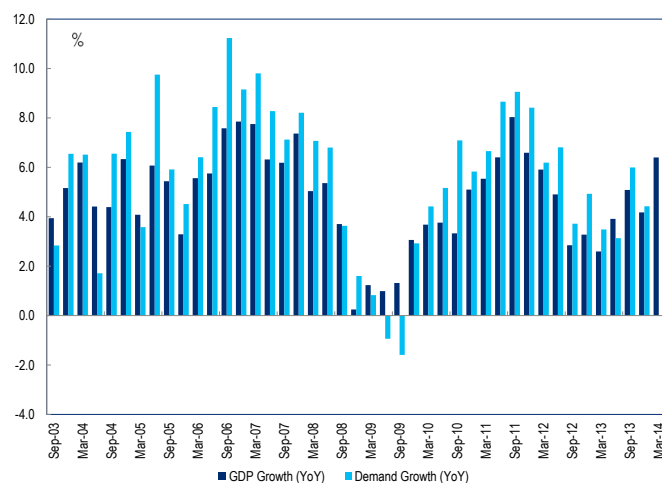
### **The TES market: Is it ALL about fiscal?**

**Throughout the quarter, we saw the local TES curve reacted favorably to offshore inflows originated by the rebalancing of the GBI index, although recent fiscal announcements triggered a sell-off.** In particular, the amount of inflows between mid-March and April was USD2.5 billion according to our own calculations. Nevertheless, most recently the government decided to modify its schedule of debt auctions by increasing local auctions by COP1 trillion and COP2 trillion more on issuances that go to public institutions. Although only COP500 billion of this additional issuance is associated with (marginally) higher fiscal spending (the rest will be used as 2015 pre-financing according to the Ministry of Finance), the market did not take the announcement well, and we saw a sell-off of all references throughout the curve. Going forward, we do not think the fiscal announcements should have any further effect. Thus, we continue to expect a bear-flattening to occur, as increases in the short-end due to monetary policy rate hikes should be larger than any expected movements in the long-end.

### **Elections aftermath**

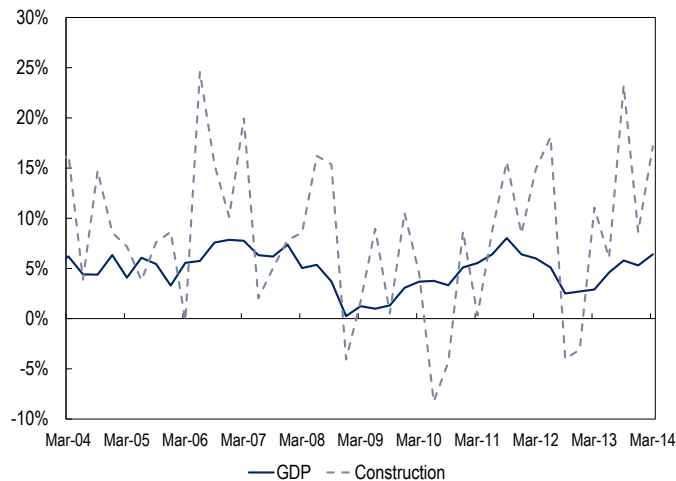
**With the re-election of President Juan Manuel Santos, the country can now focus on the peace process with FARC and ELN as well as on the reforms the government promised to implement as part of its re-election campaign.** In particular, we expect the government to announce a reform to the Judiciary system, where a simplification of procedures is well overdue; healthcare reform, as people want to have improvement in the efficiency of the system; education reform; and pension reform in order to cut loopholes that are extending the life of the pay-as-you-go system. In addition, we expect the peace negotiations with FARC to last at least until 1Q15, when there will have to be a referendum in which people will vote against or in favor of the agreements signed in La Havana. Only then we will know what the cost of peace will be. That is the moment when we expect for the government to announce tax reform aimed at increasing tax revenues on a permanent basis to pay for peace. This year, however, we could see minor tax reform take place to extend the wealth tax, which is scheduled to expire in 2014. Our view, however, is that the next set of structural changes to the tax system will take place only after peace negotiations have come to an end.

Figure 270. A surprising 1Q14 GDP result



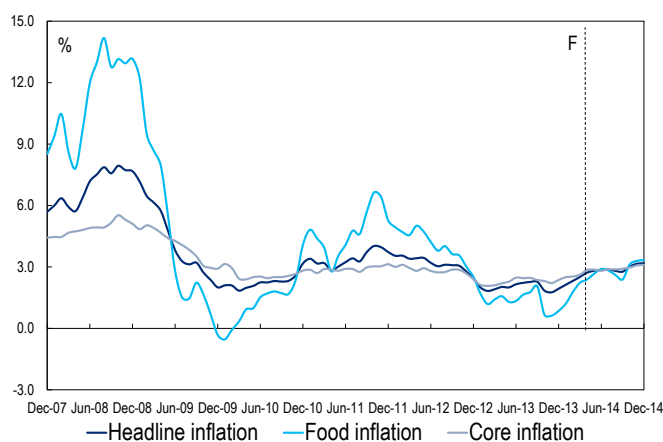
Source: Dane and Citi Research

Figure 271. The construction sector is the main source of uncertainty



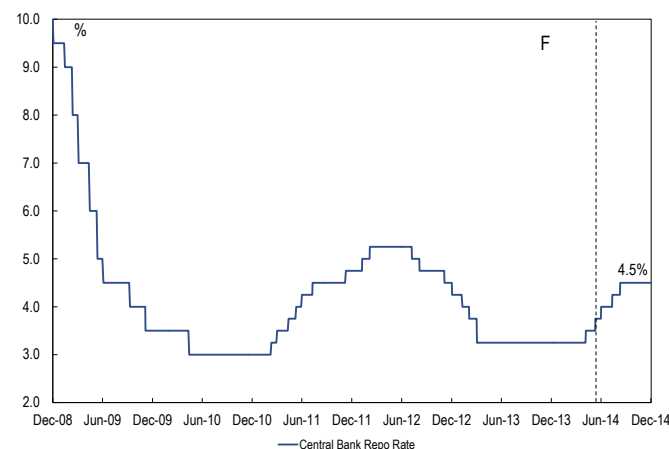
Source: Dane and Citi Research

Figure 272. Inflation should continue increasing



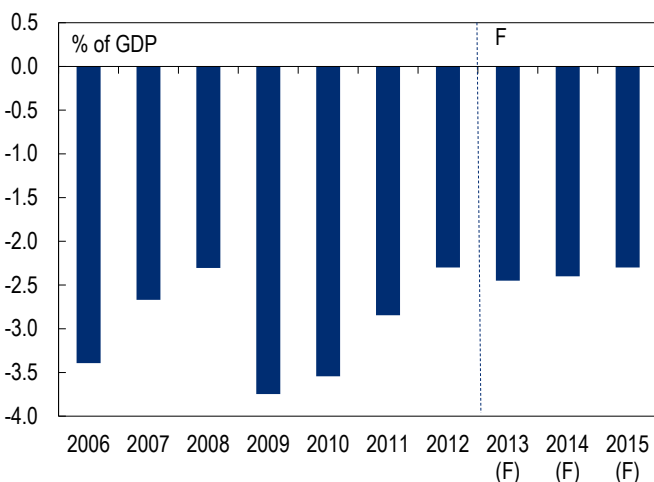
Source: Dane and Citi Research

Figure 273. We expect the repo rate to continue increasing



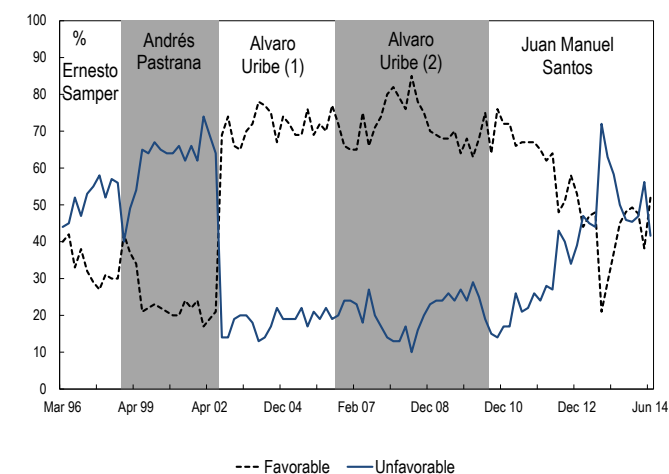
Source: Banrep and Citi Research

Figure 274. Central government deficit



Source: Ministry of Finance and Citi Research

Figure 275. Political image volatility



Source: Gallup and Citi Research's rendering

Figure 276. Colombia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	208	242	231	285	334	370	376	393	416
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	8,273	8,643
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	9.3	7.8
<b>Economic Activity</b>									
Real GDP, yoy avg	6.9	3.5	1.7	4.0	6.6	4.0	4.3	5.4	5.1
Real investment growth % yoy	12.8	9.0	-3.9	7.7	18.5	4.6	4.9	5.1	3.3
Real consumption growth % yoy	7.0	3.5	1.6	5.1	5.5	4.7	4.8	5.3	5.5
private consumption growth % yoy	7.3	3.5	0.6	5.0	6.0	4.4	4.5	5.4	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	5.2	4.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	5.7	7.7	2.0	3.2	3.7	2.4	1.9	3.4	3.5
CPI, % avg	5.5	7.0	4.2	2.3	3.4	3.2	2.0	2.9	3.5
Nominal wages, % yoy	5.4	19.1	3.0	4.1	4.2	4.3	4.4	4.5	4.6
Credit extension to private sector, % yoy	19.9	14.3	6.8	9.8	18.3	10.0	13.7	14.0	15.9
Policy Rate (eop)	9.50	9.50	3.50	3.00	4.75	4.25	3.25	4.50	5.00
1 month inter-bank rate, %, eop	9.35	8.87	3.10	3.00	4.81	4.27	3.30	4.52	5.02
Long-term yield, %, eop	10.27	12.76	8.47	7.70	7.60	5.86	6.75	7.32	7.82
COP/USD, eop	2,018	2,249	2,043	1,920	1,939	1,767	1,930	1,934	2,016
COP/USD, avg	2,076	1,968	2,154	1,898	1,848	1,798	1,869	1,923	1,989
<b>Balance of Payments, USD bn</b>									
Current account	-6.0	-6.9	-5.1	-8.9	-9.9	-11.8	-12.7	-14.4	-15.0
% of GDP	-2.9	-2.8	-2.2	-3.1	-2.9	-3.2	-3.4	-3.7	-3.6
Trade balance	-0.6	1.0	2.5	2.3	6.1	4.7	2.8	1.2	4.1
Exports	30.6	38.5	34.0	40.8	58.3	61.4	60.0	61.2	64.7
Imports	31.2	37.6	31.5	38.5	52.2	56.7	57.2	60.0	60.6
Service balance	-2.6	-3.1	-2.9	-3.7	-4.7	-5.5	-5.5	-8.7	-11.2
Income balance	-8.0	-10.2	-9.3	-12.0	-16.0	-15.7	-14.7	-11.9	-13.1
FDI, net	9.0	10.6	7.1	6.7	13.4	15.5	16.8	17.2	17.6
International reserves	20.9	24.0	25.4	28.5	32.3	37.5	43.6	47.2	50.8
Total amortisations	5.7	5.1	5.8	6.5	6.3	12.1	6.8	7.5	7.5
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.6	-0.1	-2.7	-3.3	-2.9	0.3	-0.9	-1.6	-1.5
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	32.9	34.0	36.7	37.2	34.6	33.7	34.8	35.0	33.8
of which Domestic	21.9	22.6	24.9	26.3	24.3	23.6	25.6	24.9	23.7
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
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	23.8	23.4
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	5.1	5.7	3.9	8.1	10.8	9.8	10.0	10.4	10.9
Short-term debt/International reserves (%)	24.6	23.5	15.6	28.3	33.4	26.2	22.8	22.1	21.4
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	4.9	6.7	4.9	5.0	5.1	5.3	4.9	5.1	5.1
CPI, % yoy	1.9	2.5	2.9	2.9	3.4	3.5	3.5	3.5	3.5
Policy interest rate, %, eop	3.25	3.25	4.00	4.50	4.50	4.75	4.75	5.00	5.00
Short-term market rate, % eop	3.30	3.27	4.00	4.52	4.52	4.52	4.77	5.02	5.02
Long-term yield, %, eop	6.75	6.93	6.60	7.32	7.32	7.32	7.57	7.82	7.82
COP/USD, eop	1,930	1,972	1,884	1,904	1,934	1,962	1,980	1,998	2,016

Source: National Sources, Citi Research

## Ecuador

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- **Summary view** — Thanks to investment driven by the government, Ecuador was able to grow 4.5% in 2013. We expect a similar pattern of economic activity this year on the back of ongoing infrastructure projects. Inflation is under control and should end the year at 3.5%, with the risk at this moment being the materialization of an El Niño phenomenon, which could create some transitory but upward pressures on foodstuffs and energy generation. Going forward, we expect the government to continue to approach offshore investors in order to increase FDI inflows.
- **Things to watch** — Watch for announcements of new bilateral agreements with friendly countries, especially China. Also, the referendum on the Yasuni project should take place in 3Q

### Inflation and activity outlook

**Throughout the quarter, we did not get economic activity releases for the year, so we maintained our GDP forecast of 4.5% for both 2014 and 2015.** Last year, economic growth in Ecuador was 4.5% for the year as a whole, driven by strong dynamics in consumption and growth in government spending. The latest GDP data available for 4Q13 showed a 5.6% YoY expansion, driven by the oil sector, which expanded at a 9.1% annual rate, posting positive growth for the second time in 2013. On the other hand, the non-oil sector grew 5.3% in the quarter. For 2014, we expect the non-oil sector to continue to exhibit strong growth. We also expect this sector to remain highly volatile. All in all, we forecast GDP growth for this year will be 4.5%.

**Inflationary pressures continue to be subdued, but we expect a moderate increase in inflation in 2014.** Annual inflation has registered an important reduction starting in June 2013, mostly driven by foodstuff prices. However, the latest inflation results showed that even though inflation pressures remained relatively muted, some slight pressures may come from non-tradable prices going forward. The latest CPI data for April showed that inflation stood at around 3.2%. According to April's inflation data, alcoholic beverages and tobacco products were the main drivers of the rise in consumer prices, followed by restaurants and hotels, and education.

**On the external front, the first quarter showed a trade balance surplus, after a series of deficits in the past.** In the first quarter of 2014, the trade balance showed a surplus of USD437.7mn, versus a deficit of USD90.1mn a year ago. In particular, we believe the result had to do with the restrictions the government imposed on sectors it considered to be non-priority. These restrictions came in preparation of an expected increase in imports of oil derivatives due to the Esmeraldas refinery overhang: Esmeraldas is the biggest refinery in the country, and it is expected to be fully completed and reach its maximum processing capacity (110,000 barrels/day) by 2015. In the meantime, lower local-refinement capacity will have to be compensated for by imports.

**We expect the current account to post a new deficit deficit 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 will continue to post a deficit, which we expect to stand at -1.1% of GDP.

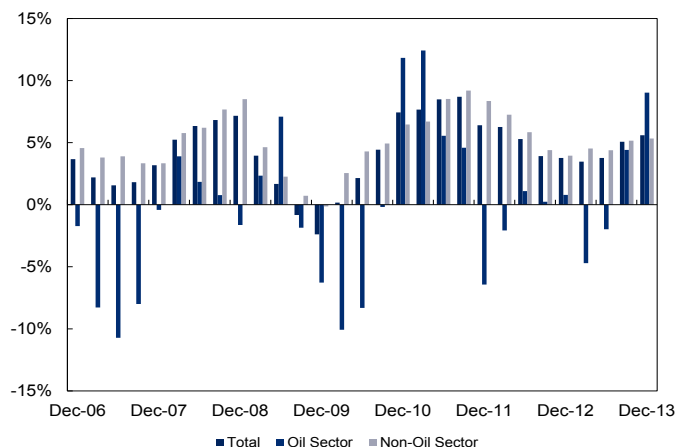
## **What is the next set of measures that will support Ecuador's growth going forward?**

**Throughout the past decade, the government has been the main player behind investment in the country, but can this be supported in the years to come?** There is no doubt that the biggest share of investment in Ecuador in recent years has come from the government, either directly or through its intermediation with foreign countries such as China. Through a policy of increasing contributions from the private sector, the government was able to carry important projects throughout the nation, which explains the good performance of the Ecuadorean economy. Having said that, we note government officials have stated that there are pending projects in healthcare, education, and infrastructure, but at the same time the country is running a fiscal deficit, which means that new sources of income are needed. This is the main reason we believe the government will look at ways of attracting new investment into the country, which will require providing guarantees in terms of stability and rules of the game for foreign investors.

## **A quick comment on the electronic money initiative**

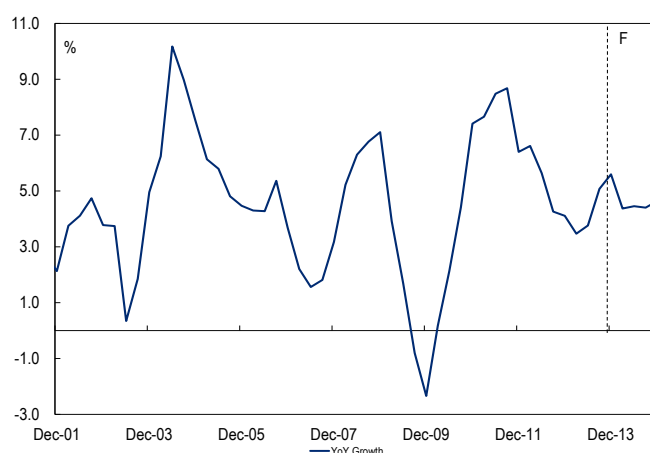
**This quarter, we saw an announcement by the government on the implementation of a new electronic payment system that will use cellphones.** After many questions raised by the local financial system, it was finally made clear by the government that this mechanism is not expected to reach high volumes when compared to conventional payments systems and that the idea of the government is to use it as a way to increase the overall state of financial deepening in the country, given that the penetration rates of cellphones in the country are high. The main concern of local analysts was that this system could be used as a source of financing by the government, but our view is that due to the expected low volumes to be traded and the observed experience in other countries where such systems are in place, it should be extremely difficult for the government to use this system as a permanent source of resources.

Figure 277. 4Q13 GDP growth breakdown



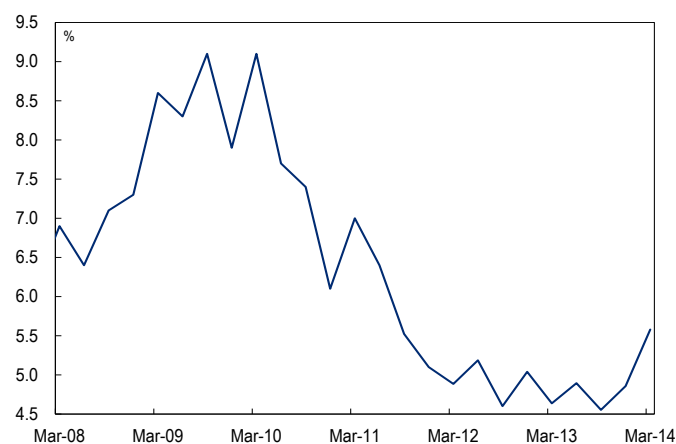
Source: Central Bank of Ecuador and Citi Research

Figure 278. GDP is expected to keep a good momentum



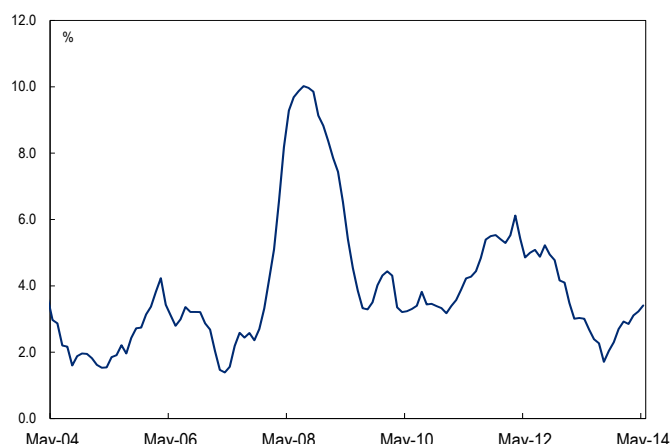
Source: Central Bank of Ecuador and Citi Research

Figure 279. Unemployment rate



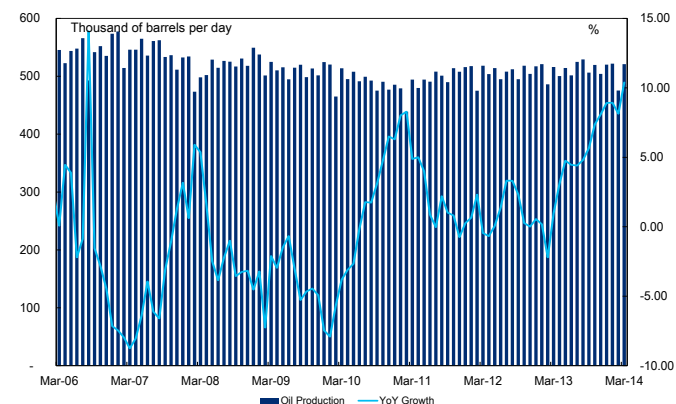
Source: Central Bank of Ecuador and Citi Research

Figure 280. Inflation rate



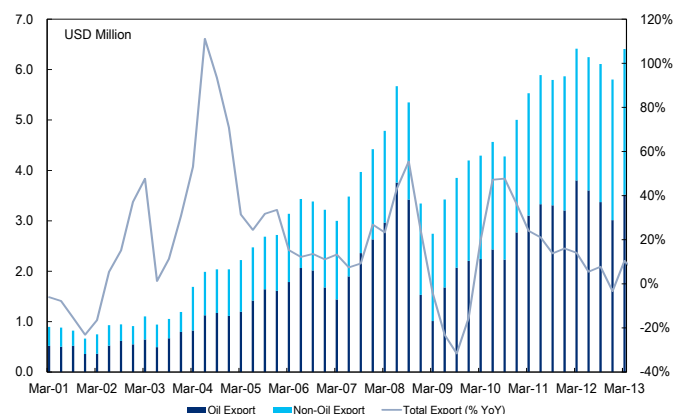
Source: Central Bank of Ecuador and Citi Research

Figure 281. Oil production



Source: Central Bank of Ecuador and Citi Research

Figure 282. Exports breakdown



Source: Central Bank of Ecuador and Citi Research

Figure 283. Ecuador Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
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
<b>Economic Activity</b>									
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
<b>Prices, Money &amp; Credit</b>									
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	3.5	2.5
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
<b>Balance of Payments, USD bn</b>									
Current account	1.6	1.3	-0.3	-1.6	-0.3	-0.3	-1.2	-1.1	-1.3
% of GDP	3.1	2.1	-0.5	-2.3	-0.4	-0.4	-1.3	-1.1	-1.2
Trade balance	1.8	1.4	-0.1	-1.5	-0.2	0.0	-0.6	-0.5	-0.7
Exports	14.9	19.1	14.2	18.1	23.1	24.6	25.7	26.0	26.0
Imports	13.0	17.8	14.3	19.6	23.2	24.5	26.3	26.5	26.7
Service balance	-1.4	-1.6	-1.3	-1.5	-1.6	-1.4	-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	4.1	4.1
Total amortisations	11.8	9.5	8.6	7.5	7.4	6.9	6.4	6.4	6.4
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.1	-1.0	-4.2	-1.6	-1.5	-1.9	-5.9	-4.7	-3.7
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	27.2	22.2	16.4	19.2	18.3	21.3	23.2	23.7	22.0
of which Domestic	6.4	5.9	4.5	6.7	5.6	8.9	9.4	8.6	8.0
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	17.5	16.9	13.4	13.9	15.3	16.0	18.3	20.5	20.9
Public	10.6	10.1	7.4	8.7	10.1	10.9	12.9	15.0	15.0
External debt / GDP	34.3	27.4	21.5	19.9	19.2	18.3	19.6	20.5	19.4
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
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	3.8	3.8	3.0	2.2	2.5	2.5
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** — The latest data suggest that activity growth started to accelerate in 2Q14 as we had expected, though gradually. We are therefore holding our GDP growth forecasts at 3.0% for 2014 and at 4.0% for 2015.
- **Things to watch** — Legislative calendars on the processing of pending secondary legislation were modified, but it is still targeted for the end of June.
- **Strategy** — We think the USD/MXN story will revolve around two opposing forces: higher UST yields, on the one hand, and more supportive idiosyncratic factors, on the other. With this in mind, we forecast a relatively flat path for USD/MXN: 13.0 for the 0–3m horizon and 13.1 for the 6–12m horizon, respectively.

### The economic recovery is under way

The economic weakness registered in 1Q14 was related to faint growth in domestic demand, with a fall in investment standing out. Meanwhile, exports of goods and services improved, despite the negative effect of adverse weather in the United States. The outlook for the second quarter remains positive, as the adverse weather factors have been left behind and a rebound in U.S. manufacturing output is evident. Thus, external demand should help to drive Mexican manufacturing activity higher. In fact, one Mexican manufacturing segment that is strengthening its position in the U.S. market is the auto industry: Its exports grew (in unit terms) by an average of 16% YoY in April–May, versus 8.4% YoY in 1Q14. We expect auto exports to grow by 14% YoY in 2014, becoming one of the main drivers of the expected recovery, along with a pronounced increase in public spending.

**We therefore reiterate our GDP growth forecasts of 3.0% and 4.0% for 2014 and 2015, respectively.** Overall, the recovery we have anticipated now seems to be materializing; the latest data for activity in the second quarter are consistent with our outlook that gradual economic recovery is under way. Industrial output grew by 0.6% MoM in April, posting its fourth monthly increase in a row. Perhaps more important is the fact that, adjusting for calendar effects, it grew by 2.5% YoY in April, the fastest pace in the last 19 months (when calendar adjustments are left aside, it fell by 0.6% YoY). Construction activity also shows signs of recovery, but more gradually. However, we should be cautious of: i) relatively low government spending; ii) lower-than-expected economic growth for United States, given its impact on the growth of exports from non-auto sectors; and iii) less-dynamic household consumption, which is still showing a downtrend. Thus, we do not rule out the view that some downside risks remain for our 2014 GDP.

### Banxico surprised the markets by lowering its policy rate

**Annual inflation continues to move as we expected.** In May, headline prices increased 3.5% in annual terms, while the core measure rose 3%. We therefore reiterate our estimate of 3.8% for headline inflation at year-end. With inflation under control and no visible risks, along with slow economic growth, Banxico surprised everyone by lowering its policy rate 50 basis points, to 3.0%, in June. The communiqué stated further easing was not feasible, especially for the following reasons: a) regarding external conditions, Banxico continues to talk about volatility risks, though to a lesser extent, given the messages from central banks in the developed countries that they will maintain liquidity for a prolonged period; b) with weaker economic activity, it is possible that Banxico has a more negative output gap projection and one with a longer period so that inflation will finally converge on 3% toward the end of 2015.



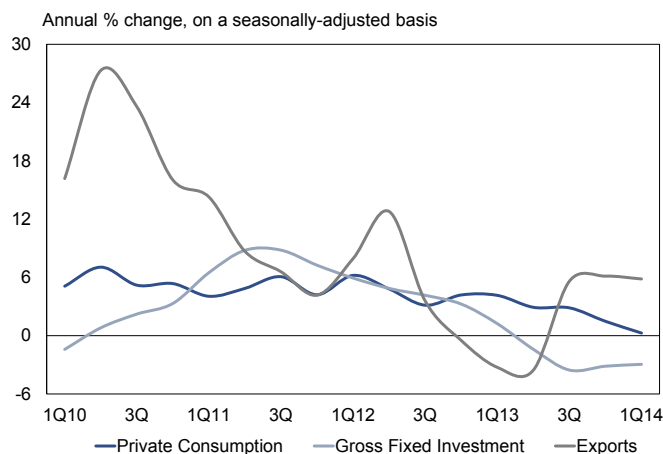
**In this context, Banxico has a view to a scenario in which it meets its inflation target, so it will seek to bring the monetary policy rate into line with that inflation expectation.** In essence, its central scenario points to a real interest rate of zero, not a negative one. Thus, the new interest-rate level will have a new equilibrium with inflation at 3%. Under the new monetary conditions, we agree with Banxico that it would not be a good idea to make further reductions in the target interest rate. Thus, we expect the policy rate to close 2014 at its current level (3.0%).

### **Congress has made progress on secondary telecommunications and energy laws**

**Congress has made progress on the secondary telecommunications and energy laws.** Four reports involving secondary energy laws are currently up for discussion. The first of these is the Law on Hydrocarbons and the reforms to the Foreign Investment, Mining, and Public-Private Association laws. The second report refers to laws on the Electricity Industry and Geothermal Energy. The third involves laws on Petróleos Mexicanos, laws on the Federal Electricity Commission (CFE), and reforms to the laws on State Corporations and Acquisitions, Leasing, and Public Sector Services. The last one addresses laws on the Coordinated Regulatory Organs on Energy and the National Agenda on Industrial Security and Environmental Protection, as well as changes to the Organic Law on Federal Public Administration. The calendar proposes that these bills should be voted on jointly on the same day, which should be either June 23 or 24, and that once approved there should be an extraordinary period after June 25 when a full plenum should vote on them in the Senate. The opposition parties are effectively in favor of greater controls on accountability and anti-corruption mechanisms for the allocation of contracts. The reforms to the secondary laws on Telecommunications are also expected to be enacted at the end of June or the beginning of July, as according to party leaders the report is now almost ready.

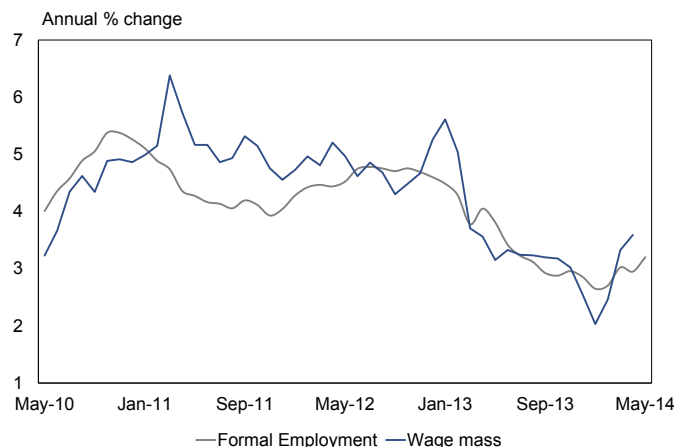
**The approval of the secondary laws on energy and telecommunications has led to various negotiations between the parties.** The opposition parties, especially the PRD and the PAN, have left the negotiating tables several times. At the beginning, the PRD wanted to delay the discussion, but it could not obtain re-entry to the committees. The PAN first quit because the secondary political-electoral reforms were not being approved by the local Congresses as fast as required for them to be enacted before the end of June. Then, it left again because of the lack of agreement to modify the Article 87 of the General Law on Parties, which would favor the small parties. Although the PRI-PVEM alliance and the PANAL need very few votes to approve the secondary laws, inter-party negotiations imply that these will be approved with a substantial number of votes because the structural changes will have a sharp repercussion throughout the country and will need the consensus of a large number of political parties.

**Figure 284. Local demand remained weak in 1Q14**



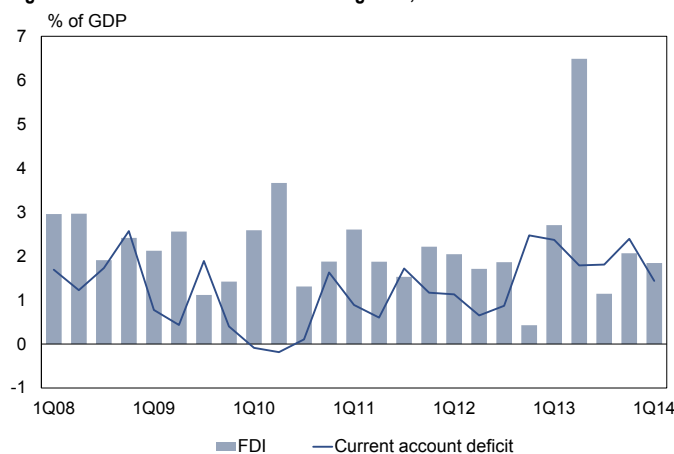
Sources: INEGI and Banamex

**Figure 286. Conditions in the labor market are improving**



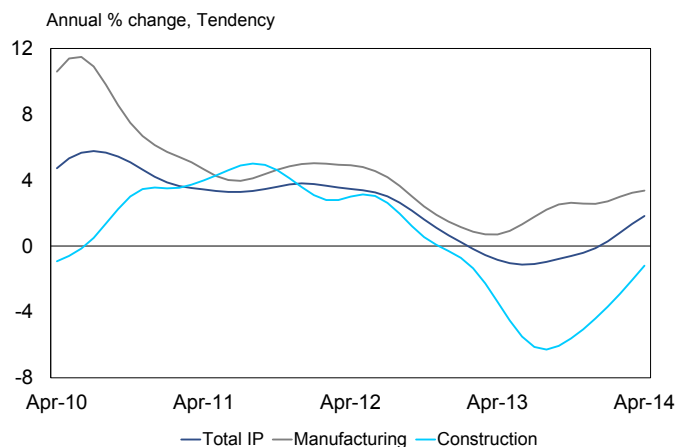
Sources: Banamex, based on data from IMSS

**Figure 288. External deficit remains manageable, below FDI flows**



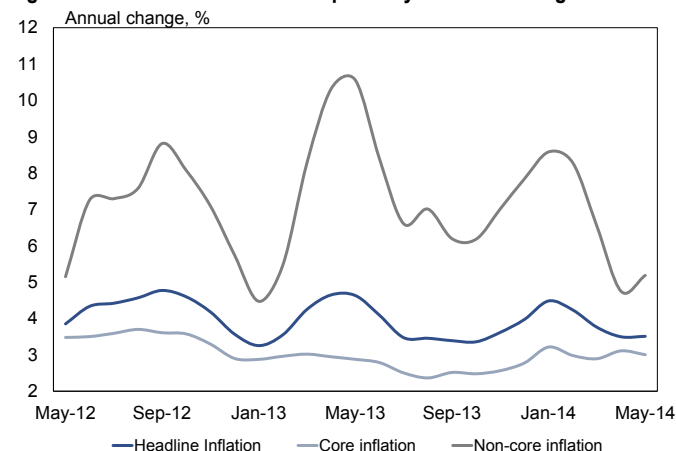
Source: Banamex, based on data from IMSS.

**Figure 285. Industrial production pointing to recovery**



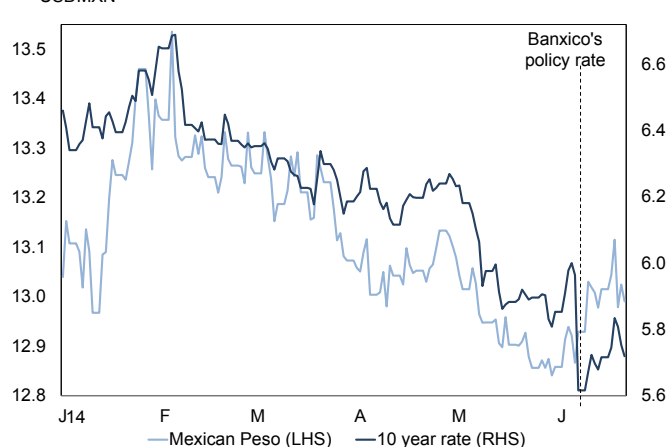
Sources: INEGI and Banamex

**Figure 287. The annual inflation is probably now in its trough**



Sources: INEGI and Banamex.

**Figure 289. FX and FI responding to Banxico's policy rate cut surprise**



Sources: Bloomberg and Banamex.

Figure 290. Mexico Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	1,044	1,109	897	1,052	1,170	1,184	1,259	1,299	1,438
Nominal GDP, local currency bn	11,403	12,257	12,094	13,282	14,531	15,588	16,077	17,173	18,584
GDP per capita, USD	9,507	9,967	7,952	9,206	10,117	10,130	10,659	10,886	11,946
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
<b>Economic Activity</b>									
Real GDP, yoy avg	3.1	1.4	-4.7	5.1	4.0	3.9	1.1	3.0	4.0
Real investment growth % yoy	3.7	6.2	-13.3	4.5	5.4	5.5	-2.4	2.3	5.1
Real consumption growth % yoy	3.0	2.1	-5.2	5.1	4.5	4.6	2.3	2.7	3.7
private consumption growth % yoy	3.0	1.9	-6.5	5.7	4.8	4.9	2.5	2.7	4.0
Real export growth, % yoy	3.6	-1.3	-11.8	20.5	8.2	5.9	1.2	6.4	5.5
Real import growth, % yoy	5.9	4.4	-17.6	20.5	8.0	5.5	1.5	6.6	7.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	3.8	6.5	3.6	4.4	3.8	3.6	4.0	3.8	3.5
CPI, % avg	4.0	5.1	5.3	4.2	3.4	4.1	3.8	4.0	3.6
Nominal wages, % yoy	5.4	5.3	4.2	3.0	5.4	4.4	4.6	4.2	4.3
Credit extension to private sector, % yoy	12.0	9.6	0.6	5.6	7.4	6.8	6.7	8.5	9.8
Policy Rate (eop)	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.00	3.75
1 month inter-bank rate, %, eop	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.00	3.75
Long-term yield, %, eop	8.03	8.35	7.99	6.95	6.51	5.38	6.45	6.84	7.23
MXN/USD, eop	10.91	13.67	13.06	12.36	13.95	12.87	13.04	13.07	12.85
MXN/USD, avg	10.93	11.16	13.50	12.63	12.44	13.16	12.76	13.04	12.97
<b>Balance of Payments, USD bn</b>									
Current account	-14.3	-19.6	-7.7	-2.7	-11.4	-12.0	-25.9	-30.6	-31.6
% of GDP	-1.4	-1.8	-0.9	-0.3	-1.0	-1.0	-2.1	-2.4	-2.2
Trade balance	-10.1	-17.3	-4.7	-3.0	-1.5	0.0	-1.0	-9.6	-10.4
Exports	271.9	291.3	229.7	298.5	349.4	370.7	380.2	401.8	452.0
Imports	281.9	308.6	234.4	301.5	350.8	370.8	381.2	411.4	462.4
Service balance	-7.6	-8.2	-10.0	-9.9	-14.1	-14.0	-11.7	-13.1	-12.8
Income balance	-23.0	-19.5	-14.6	-11.3	-18.8	-20.5	-34.9	-30.3	-31.1
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	194.7	208.5
Total amortisations	37.3	46.0	79.0	57.0	47.7	52.9	50.5	43.3	39.9
<b>Public Finances, % of GDP</b>									
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
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
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	30.7	28.9
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	11.3	10.9
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	0.7	2.1	2.0	3.4	4.3	5.0	4.3	3.8	3.1
CPI, % yoy	4.0	3.8	3.9	4.1	3.8	3.4	3.7	3.7	3.5
Policy interest rate, %, eop	3.50	3.50	3.00	3.00	3.00	3.00	3.25	3.50	3.75
Short-term market rate, % eop	3.50	3.50	3.50	3.50	3.50	3.00	3.25	3.50	3.75
Long-term yield, %, eop	6.45	6.20	5.75	6.20	6.84	7.14	7.17	7.20	7.23
MXN/USD, eop	13.04	13.06	13.01	13.03	13.07	13.09	13.01	12.93	12.85

Source: National Sources, Citi Research

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- **Summary view** — Economic activity remained very sluggish during April, bringing the government to announce a series of measures to boost investment. According to the government, these measures will add between 1.5 and 3 percentage points to GDP growth, but in our view the impact during this year will be limited. Also, we expect BCRP to weight GDP growth more, leading it to reduce its reference interest rate during 3Q14. As we have mentioned previously, analysis of the balance of payments and the trade balance can be expected to remain the main variables in assessing eventual vulnerabilities during 2014 and 2015.
- **Things to watch** — Inflation and monthly economic activity will be important in assessing the future evolution of monetary policy.
- **Strategy** — The relatively weak economic activity displayed so far in 2014 could lead the BCRP to reduce its policy rate during 3Q14.

### Economic activity

**The economic activity index displayed 2.0% YoY growth in April, a print below both market (3.0%) and our own-in-house expectations (3%), taking economic annual growth during the first four months of the year to 4.2% and 12-month accumulated growth to 5.2%.** According to the National Statistics Institute (INEI), core activities displayed a weak performance. According to the report, mining fell 6.1% YoY, construction contracted 8.9% YoY, retail advanced a weak 3.5% YoY, and manufacturing rose but marginally 0.4% YoY. Although we continue to expect Peru to be one of the best-performing economies in the region, the recent results, along with the change in the base of GDP (which imply an upward revision of 2013 growth to 5.8%), lead us once again to reduce our GDP growth forecast for the year as a whole, to 5.0% from 5.4%.

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

**Nonetheless, a rebound in economic activity could be seen in 2015.** Given our view that external factors will likely fail to boost growth in Peru, we believe it is important to look at the health of domestic drivers. Household consumption has been increasing recently, and we expect these dynamics to continue throughout 2014 as credit conditions remain favorable, despite the recent increases in non-performing loans.

## Inflation and monetary policy

**Inflation remained above the target range in May.** During 2014, inflation has consistently stood above the 1%–3% target-range. Inflation has been mostly driven by supply shocks associated with foodstuffs. Thus, we expect inflation to gradually converge to the inflation target. Nonetheless, for the time being we keep our inflation forecast for 2014 at 2.7%, given the recent dynamics of consumer prices. This forecast still incorporates an important deceleration of prices during 2H14, which should have crucial importance in the evolution of monetary policy.

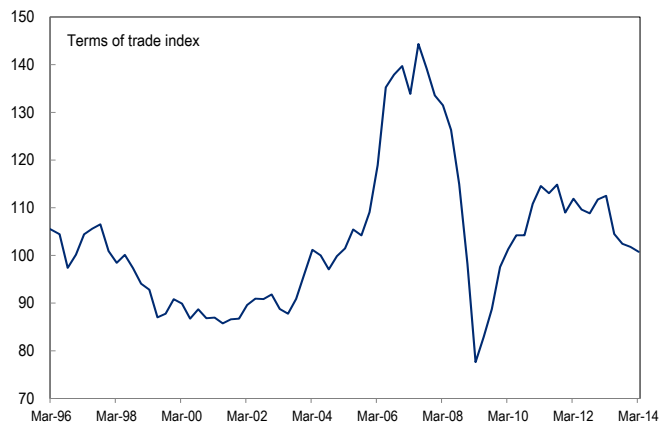
**Monetary policy.** In its last monthly meeting, the Central Bank of Peru (BCRP) decided to keep its reference rate at 4.0%, as expected by the consensus and us. According to the communiqué the Board took into account that (i) inflation expectations continue to be anchored; (ii) recent below-potential GDP growth is expected to be temporary; (iii) the external outlook continues to display mixed signals; and (iv) supply-side inflation pressures seem to be receding. The Board mentioned that inflation is expected to remain above the upper bound of the inflation target range, given the effect of supply-side pressures mostly associated with foodstuffs. However, inflation is still expected to be within the target range by year-end and to converge to 2% in 2015. The BCRP highlighted that economic activity has been weak, mostly driven by lower dynamics in investment and exports. As in previous statements, the Board mentioned that it will be vigilant of the inflation outlook and its drivers so as to take further easing measures if necessary.

**Switching to “dovish mode.”** In our view, the fact that the BCRP mentioned that the supply shocks associated with inflation could be receding in coming months, together with its recent discussion on economic activity, could signal the beginning of a more dovish stance going forward. Since economic activity has already posted weak results (something that has also led the Ministry of Finance to make some announcements with a view to boosting economic activity), we would expect the evolution of inflation (and particularly the June inflation print that will be released on July 1) to be crucial in determining future policy actions. That being said, our new scenario contemplates a 25bps reduction in BCRP’s policy rate during 3Q14.

## External sector

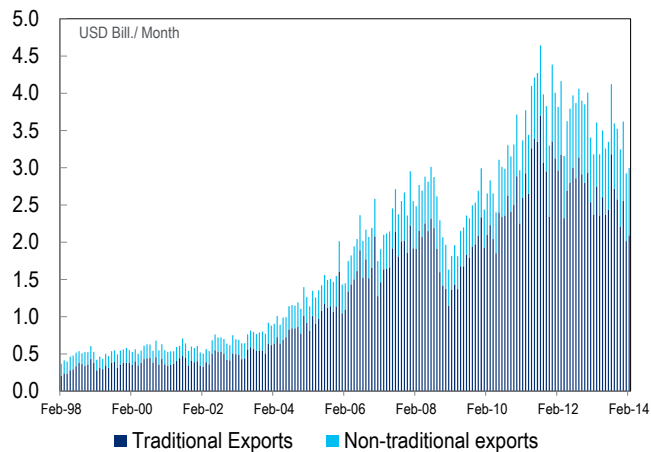
**Balance of payments.** During 2013, the current account deficit stood at 4.8% of GDP, increasing 1.6 percentage points versus the previous year. This increase in the current account deficit was mostly driven by the deterioration of the trade balance, a situation we anticipate will continue this year. This month, we have marginally revised our forecasts, and we now expect the current account to further deteriorate and post a deficit of 5.2% of GDP this year, on the back of stagnant exports and lower commodity prices. For the time being, the current account deficit continues to be financed by inflows of foreign direct investment, something that has led to significant increases in international reserves. Nonetheless, we expect a slower accumulation of reserves moving forward.

Figure 291. Terms of trade dynamics...



Source: Bloomberg and Citi Research

Figure 292. Could translate into weaker traditional exports...



Source: BCRP and Citi Research

Figure 293. And a weaker exchange rate



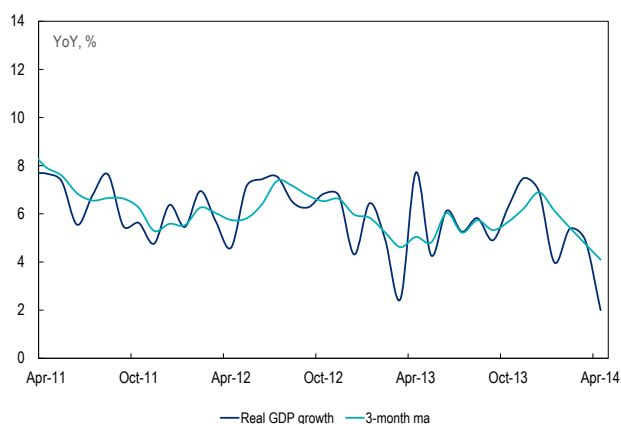
Source: Bloomberg and Citi Research

Figure 294. Inflation dynamics



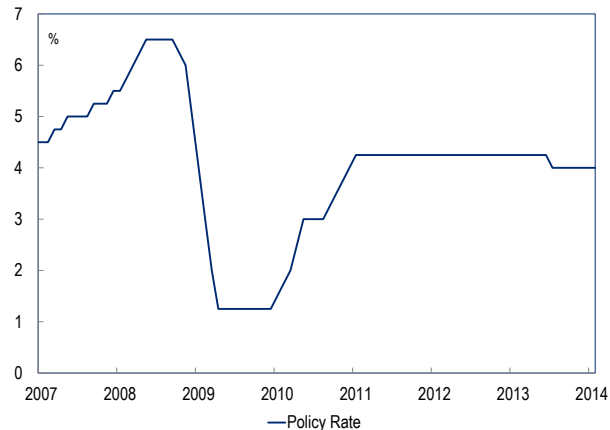
Source: BCRP, Haver and Citi Research

Figure 295. GDP Dynamics



Source: INEI, Haver and Citi Research

Figure 296. The latest BCRP's communiqué came with a dovish tone



Source: BCRP, Haver and Citi Research

Figure 297. Peru Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
Nominal GDP, USD bn	107	127	127	153	176	199	210	219	239
Nominal GDP, local currency bn	336	371	382	435	486	526	571	614	668
GDP per capita, USD	3,906	4,562	4,482	5,344	6,033	6,712	6,960	7,140	7,696
Population, mn	27.4	27.8	28.3	28.7	29.2	29.7	30.1	30.6	31.0
Unemployment, % of labour force	8.4	8.4	8.4	7.9	7.7	6.8	5.9	6.1	6.0
<b>Economic Activity</b>									
Real GDP, yoy avg	8.5	9.1	1.0	8.5	6.5	6.0	5.8	5.0	6.1
Real investment growth % yoy	31.3	29.4	-22.9	38.8	12.9	12.3	10.5	3.6	4.9
Real consumption growth % yoy	8.0	8.6	4.1	8.2	5.8	6.4	5.6	5.6	6.5
private consumption growth % yoy	8.6	8.9	2.8	8.7	6.0	6.1	5.4	5.0	6.7
Real export growth, % yoy	4.3	7.1	-0.7	1.3	6.9	3.7	-0.9	0.9	4.5
Real import growth, % yoy	20.2	24.1	-16.7	26.1	11.6	11.3	3.6	1.3	4.3
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy (Citi estimates)	3.9	6.7	0.2	2.1	4.7	2.6	2.9	2.7	2.5
CPI, % avg	1.8	5.8	2.9	1.5	3.4	3.7	2.8	3.2	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	3.75	4.50
1 month inter-bank rate, %, eop	5.51	6.68	1.28	3.20	4.17	4.22	4.58	4.10	4.60
Long-term yield, %, eop	6.44	7.69	6.31	6.34	6.16	4.24	6.16	5.30	5.00
PEN/USD, eop	3.00	3.13	2.89	2.81	2.70	2.55	2.80	2.85	2.80
PEN/USD, avg	3.13	2.92	3.01	2.82	2.75	2.64	2.70	2.81	2.80
<b>Balance of Payments, USD bn</b>									
Current account	1.5	-5.3	-0.7	-3.8	-3.3	-6.5	-10.2	-11.3	-11.5
% of GDP	1.4	-4.2	-0.6	-2.5	-1.9	-3.3	-4.8	-5.2	-4.8
Trade balance	8.5	2.6	6.0	6.8	9.3	5.1	-0.4	-0.1	0.0
Exports	28.1	31.0	27.0	35.6	46.3	46.2	41.8	42.6	45.8
Imports	19.6	28.4	21.0	28.8	37.0	41.1	42.2	42.7	45.7
Service balance	-1.2	-2.1	-1.2	-2.3	-2.1	-2.3	-1.8	-2.2	-2.2
Income balance	-8.3	-8.7	-8.4	-11.2	-13.7	-12.7	-11.2	-12.5	-13.0
FDI, net	5.5	6.9	6.4	8.5	8.2	12.2	10.2	11.8	11.6
International reserves	27.7	31.2	33.1	44.1	48.8	64.0	65.7	70.0	74.5
Total amortisations	6.8	3.3	2.2	4.1	1.4	4.0	4.1	4.3	4.5
<b>Public Finances, % of GDP</b>									
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
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	31.8	34.0	35.5	40.6	43.9	51.5	53.3	55.6	58.0
Public	20.1	19.2	20.6	19.9	20.2	19.0	17.7	18.5	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	26.1	26.8	28.6
Short-term debt/International reserves (%)	74.2	62.5	60.7	52.0	49.6	41.1	39.8	38.2	38.4
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	6.9	4.8	4.6	5.0	5.5	6.4	6.0	5.8	6.1
CPI, % yoy	2.9	3.4	3.4	3.0	2.7	1.9	1.8	1.8	2.6
Policy interest rate, %, eop	4.00	4.00	4.00	3.75	3.75	4.00	4.50	4.50	4.50
Short-term market rate, % eop	4.58	5.08	4.99	4.10	4.10	4.35	4.60	4.60	4.60
Long-term yield, %, eop	6.16	6.30	5.70	5.30	5.30	5.70	5.70	5.70	5.70
PEN/USD, eop	2.80	2.81	2.80	2.81	2.85	2.85	2.85	2.85	2.90

Source: National Sources, Citi Research

## Venezuela

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■ **Summary view** — The first half of the year was marked by a reduction in economic activity and an acceleration of inflation. In addition, despite being produced, data are not being released on a timely basis. We believe the delay in releasing data may be related to negative outcomes, a situation that is not benefiting the government. This is the reason, despite our continued expectations of a contraction of 1% in economic activity and of 75% inflation by year-end, we now believe there are risks of a deeper slide in economic activity and of even-higher inflation going forward.

■ **Things to watch** — Watch for the convergence of the CENCOEX 6.3 exchange rate toward the SICAD I rate. Also, watch for possible increases in prices of gasoline and public services.

**Strategy** — For the rest of the year, we believe the government will shift the 6.3 CENCOEX exchange rate toward the SICAD I rate of 10, at the same time that it will attempt to increase prices of gasoline as well as some regulated public services.

### Economic outlook: Oh data where art ye

**Throughout the first half of the year, uncertainty about macroeconomic management continues to take its toll on economic performance.** The overall sentiment is that of an economy that is weakening on the back of a reduction in supply due to several bottlenecks affecting the production process for local companies. At the same time, there are no new investments, either public or private. Hence, we forecast consumption and government spending will grow 0.1% and 0.2%, respectively, this year. Investment and real exports should be the worst performers, falling 7.5% and 3.8%, respectively. Having said that, we acknowledge that the observed pattern of economic activity has created a downward bias to our economic activity forecast for this year, which currently stands at –1.0%.

**Unfortunately, delays in the publication of both activity and inflation data are fueling uncertainty about the performance of the economy in the first half of the year.** Until early June, the last published inflation print by the Central Bank of Venezuela was released in March, and since December, there have been no disaggregated data for CPI or economic activity. Finally by mid-June the central bank released inflation data for April and May, with monthly inflation standing at 5.7% in each of the two months and annual inflation in May standing at 60.9%. Foodstuffs, restaurants and hotels, and transportation were the sectors exhibiting the highest monthly variations. The fact the data are not being released on a regular basis is raising questions about inflation and activity patterns.

**We continue to expect annual inflation to reach 75% by year-end, as we do not foresee a reduction in scarcity and we now see evidence of a wage spiral.** Using data from the Ministry of Finance, we can now say that most of the growth in fiscal spending is related to increases in expenditures associated with payroll. This can be interpreted as evidence of increasing indexation of wages, a factor that leads to higher persistency of inflation.



## **SICAD II: One swallow does not a summer make**

**SICAD II was introduced back in March as a way of reducing the excess liquidity in the system at the same time that it was aimed at improving the scarcity of USD in the country.** Around the time SICAD II was announced, the government increased reserve requirements, which, coupled with the seasonal effect associated with tax collections, created a significant reduction in excess liquidity around the end of March and early April. However, after that initial effect, excess liquidity has remained around VEF80-100 billion, following an upward trend that shows monetary conditions remain loose despite the two months of continual activity of SICAD II.

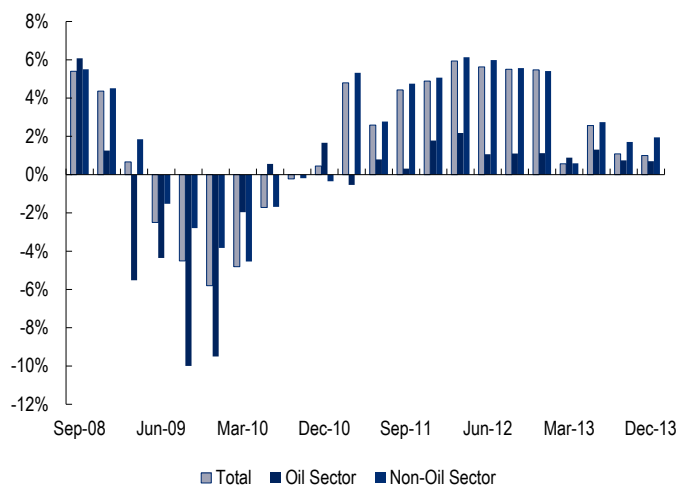
**With sales of USD being estimated at USD1.8 billion, since its inception, SICAD II has improved availability of the USD but not to the levels seen in previous years.** When combined with Cencorex and SICAD I, total USD disbursements in 1Q14 represented USD6.9 billion, which is still below the USD7.4 billion quarterly average disbursed in 2013. This means that the country continues to reduce approvals of imports. This is affecting the availability of goods and the generation of output, reducing GDP and accelerating inflation.

**Data show that fiscal spending has accelerated mostly due to increases in salaries for public workers.** In our view, this wage spiral is one of the most important inflation boosters. The low approval rates of the current government will likely make it very difficult for the administration to freeze wages moving forward.

**We believe we are close to a new change to the FX system: elimination of the 6.3 exchange rate, with only the SICAD I and SICAD II rates being left.** With this fix, the government will be able to buy some time, especially when thinking about 2015, when elections for the National Assembly will take place. We think the initial rates that will remain will be the 10 exchange rate for SICAD I and the 50 exchange rate for the SICAD II. Although President Maduro has already mentioned that he was expecting a faster reduction of the SICAD II rate and hence of the black market rate, we believe at this point the only way of reducing that exchange rate will be to increase supply at that market, something that we do not think the government is willing to do because it will imply additional debt issuance by PDVSA.

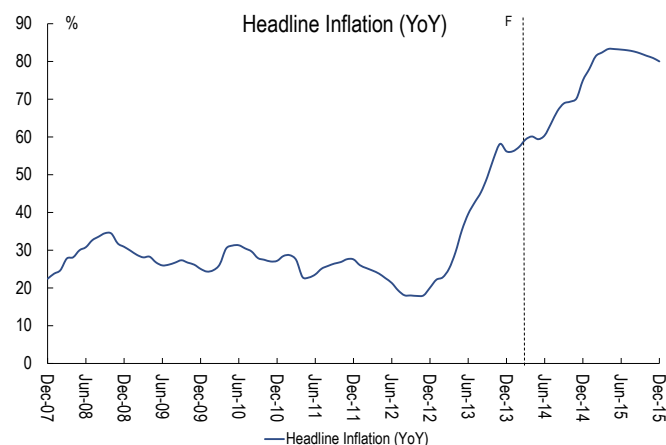
**On the FX front, the country will likely move back to a two-tier system, but the reduction of the black market rate from its current levels will be difficult to achieve.** As we already mentioned, we expect the FX system to go back to a two-tier system where the SICAD I and II rates will be the official rates of the country. Having said that, we note the reduction in the overall availability of USD in the country should continue, which will make it very difficult for the government to further reduce the black market rate from its current levels.

Figure 298. GDP growth performance in 4Q13



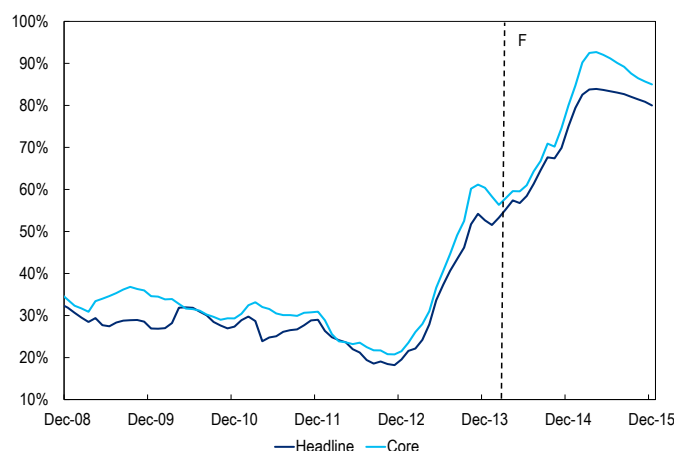
Source: BCV and Citi Research

Figure 299. Inflation should accelerate despite the week GDP growth



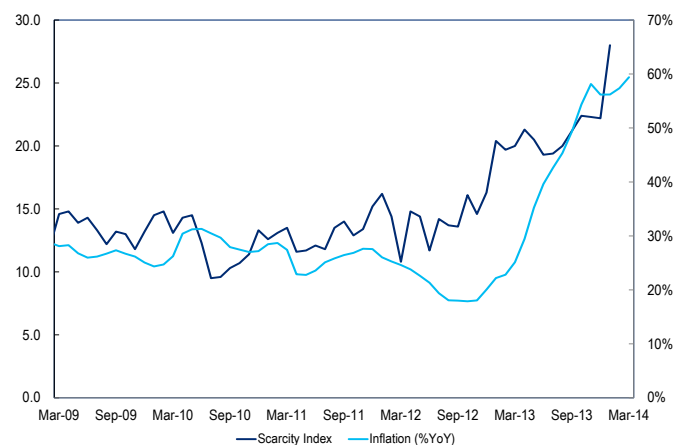
Source: BCV and Citi Research

Figure 300. Caracas inflation



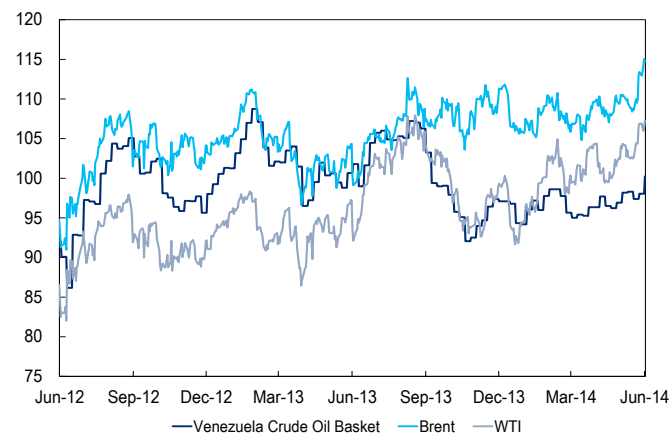
Source: BCV and Citi Research

Figure 301. Scarcity continues to be one of the drivers of inflation



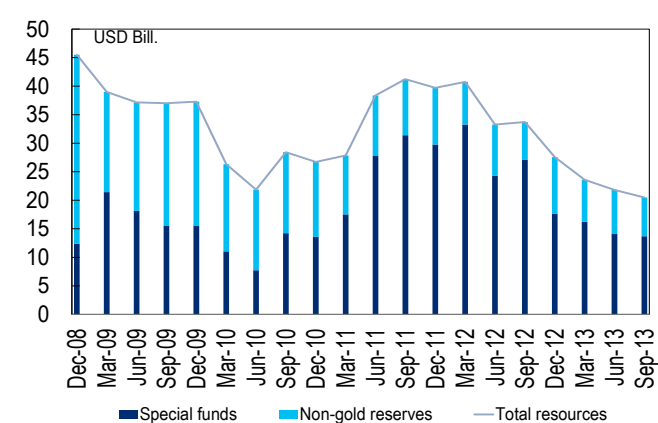
Source: BCV and Citi Research

Figure 302. Venezuelan oil basket prices and WTI prices



Source: BCV and Citi Research

Figure 303. Could total liquid resources continue its downtrend?



Source: BCV and Citi Research

Figure 304. Venezuela Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
<b>Summary Data</b>									
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	4.8	4.0
<b>Economic Activity</b>									
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
<b>Prices, Money &amp; Credit</b>									
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	61.7	82.5
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	9.15	19.80
<b>Balance of Payments, USD bn</b>									
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
<b>Public Finances, % of GDP</b>									
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	41.5	40.2	39.7
of which Domestic	7.3	4.5	7.5	8.9	11.4	14.1	12.3	9.6	7.2
<b>Foreign Assets &amp; Liabilities, USD bn</b>									
External debt	56.3	66.4	81.9	97.1	110.7	118.9	123.3	127.5	131.7
Public	38.7	50.9	67.4	85.3	98.0	105.8	108.8	112.8	116.8
External debt / GDP	26.5	22.2	28.9	37.7	37.1	33.0	33.1	34.7	36.7
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
<b>Quarterly Economic Indicators</b>									
	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F
GDP, % yoy	1.1	-1.5	-0.9	-1.1	-0.4	2.6	1.4	2.0	1.8
CPI, % yoy	52.7	54.8	56.8	66.9	75.0	83.8	84.4	82.4	80.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	12.88	13.53	11.80	14.71	15.88	14.53	12.80	15.71	16.88
VEF/USD, eop	6.29	6.29	6.30	12.00	12.00	19.80	19.80	19.80	19.80

Source: National Sources, Citi Research



## Appendix A-1

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