

# Asia Macro and Strategy Outlook

## What Now? Policy Outlook Amid Fed Confusion

- **Fed's prolonged accommodation eases EM pressures somewhat.** While this reduces near-term risks for the more taper-sensitive countries, primarily Indonesia, India, Sri Lanka, Malaysia and Thailand, we think it is important to assess countries making real adjustment to better insulate themselves from future Fed-related volatility and those that don't, especially as we think taper is just a matter of time.
- **India already showing real adjustment.** After two years of rupee depreciation and slower growth, we have seen sizeable improvement in India's goods & services trade balance. Credibility of adjustment is bolstered by a more structurally "CPI-hawkish" tilt at the RBI. However, we don't expect a major breakthrough any time soon in rules for the debt market leading to EM bond inclusion.
- **Malaysia is making the right noises, Thailand passive.** Both have less external imbalances, and thus the size of adjustment needed is not large. Malaysia is signaling fiscal tightening plans; we now shift our expectation of BNM's first rate hike to 2Q14 irrespective of the Fed's recent actions. Weaker domestic growth makes Thailand less likely to opt for policy tightening, and instead, we expect a bias toward THB weakness.
- **Indonesia policy adjustment has started, Sri Lanka is passive.** Indonesia has hiked rates by 150bps, raised subsidized fuel prices and let IDR weaken, but we think the size of adjustment needed is larger – current-account correction to a more 'sustainable' level could take longer. Fed taper delay could risk policy vigilance; we expect slower tightening from here. Sri Lanka's pro-growth bias remains largely unchanged so far, and the Fed's interim dovishness could reinforce more front-loaded offshore borrowing.
- **Broader DM recovery could make Asia's adjustment easier to varying degrees...** DM's higher hurdle to monetary "tightening" could be more supportive of broader domestic demand growth going forward and could ease EM adjustment via exports and a more constructive environment for equity flows. However, Asia's export bounce has been relatively subdued so far, and within Asia, the North Asian countries (CN, KR, TW) saw a much bigger bounce than some in Southeast Asia (MY, ID, TH). From an external liquidity standpoint, the latter needs it far more than the former.
- **...but China growth slowdown remains a risk.** While the near-term growth outlook has improved, prompting us to slightly upgrade our growth forecast, we are cautious over the longer-term sustainability of China's recent bounce given risks from financial imbalances and tighter financial conditions.

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

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## Citi Key Economic Forecasts

Figure 1. GDP forecasts (growth rate in percent)

	2012 GDP	2013 GDP Forecasts			2014 GDP Forecasts		
		Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	6.2	6.2	6.3	6.1	6.2	6.3	6.4
Asian NIEs*	1.7	2.9	3.0	2.6	3.7	3.8	3.5
SEAN-4**	6.3	5.4	5.6	5.2	5.3	5.8	5.5
China	7.7	7.6	7.4	7.5	7.2	7.1	7.4
Hong Kong	1.5	3.0	3.0	2.9	3.4	3.4	3.6
India***	5.0	4.8	5.4	4.9	5.6	6.2	5.9
Indonesia	6.2	5.7	5.8	5.7	5.3	5.6	5.9
Malaysia	5.6	4.8	5.2	4.4	5.0	5.8	5.1
Mongolia	12.4	13.8	13.8	—	11.0	11.0	—
Philippines	6.8	7.3	7.0	7.0	6.9	6.8	6.1
Singapore	1.3	3.2	3.2	2.8	4.0	4.4	3.7
South Korea	2.0	2.9	2.9	2.6	3.7	3.7	3.4
Sri Lanka	6.4	6.5	6.4	6.3	6.8	6.8	6.7
Taiwan	1.3	2.6	2.6	2.4	3.8	3.8	3.7
Thailand	6.5	4.0	4.0	3.6	4.4	4.4	4.5
Vietnam	5.3	5.1	5.1	5.2	5.4	5.4	5.5

Figure 2. CPI forecasts (growth rate in percent)

	2012 CPI	2013 CPI Forecasts			2014 CPI Forecasts		
		Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	3.9	3.6	3.5	3.7	3.7	3.7	3.9
Asian NIEs*	2.7	1.9	2.0	1.9	2.4	2.6	2.6
SEAN-4**	3.4	4.4	4.7	4.9	4.1	3.9	4.8
China	2.6	2.7	2.7	2.6	3.0	3.0	3.0
Hong Kong	4.1	4.3	4.3	4.1	3.6	3.6	3.8
India***	7.3	5.5	5.5	8.8	5.0	5.0	7.6
Indonesia	4.3	7.2	7.1	7.3	6.6	5.5	6.4
Malaysia	1.6	0.0	2.0	2.1	0.0	2.6	2.7
Mongolia	14.3	9.9	9.9	—	10.0	10.0	—
Philippines	3.2	2.7	2.8	3.0	3.2	3.2	3.8
Singapore	4.6	2.4	2.5	2.6	2.3	2.8	2.9
South Korea	2.2	1.5	1.5	1.5	2.5	2.6	2.6
Sri Lanka	7.5	7.3	8.1	7.6	7.0	7.0	6.9
Taiwan	1.9	1.2	1.5	1.2	1.7	1.9	1.8
Thailand	3.0	2.4	2.4	2.4	2.3	2.3	2.9
Vietnam	9.3	6.6	6.6	6.8	7.1	7.1	7.7

Figure 3. Current account forecasts (percent of GDP)

	2012 CAB	2013 CAB Forecasts			2014 CAB Forecasts		
		Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	1.8	1.7	1.6	0.8	1.5	1.4	0.8
Asian NIEs*	6.9	6.5	6.2	2.0	5.3	5.2	1.7
SEAN-4**	0.1	-0.9	-0.5	-0.6	-0.6	-0.5	-0.3
China	2.3	2.2	2.2	2.5	2.0	2.0	2.3
Hong Kong	1.1	2.2	2.2	1.2	3.7	3.7	1.0
India***	-4.8	-3.7	-4.1	-3.7	-2.6	-3.2	-3.1
Indonesia	-2.8	-3.5	-2.4	-2.7	-2.7	-2.2	-1.8
Malaysia	6.1	2.3	2.3	2.8	2.0	2.0	3.1
Mongolia	-31.2	-24.5	-23.3	—	-13.6	3.3	—
Philippines	2.8	3.6	2.5	2.7	3.3	2.1	2.4
Singapore	18.6	14.0	14.0	17.2	13.5	13.5	16.2
South Korea	3.8	4.3	4.0	4.4	2.4	2.2	3.6
Sri Lanka	-6.6	-5.3	-5.4	-4.9	-3.4	-4.0	-4.2
Taiwan	10.5	10.1	9.1	9.9	9.0	8.5	9.2
Thailand	0.0	-0.8	-0.1	0.0	-1.0	-0.4	0.6
Vietnam	6.3	4.2	3.3	0.0	3.0	1.5	0.0

Note: \* Asian NIEs are Hong Kong, Korea, Singapore, and Taiwan. \*\* SEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand. Asia-Pacific is Asian NIEs + SEAN-4 + China + India + Mongolia + Sri Lanka + Vietnam, GDP-weighted. \*\*\* India Fiscal year runs from April-March and inflation forecasts are Wholesale Price Index.

Source: CEIC Data Company Limited, Consensus Economics (September 9, 2013) and Citi Research estimates

## Macro Overview

### What Now? Policy Outlook Amid Fed Confusion

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**Fed surprised us not only with its “non-taper” decision but also its concerns over the “rapid tightening in financial conditions” and a more dovish language about taper timetable and Fed Funds forward guidance.**

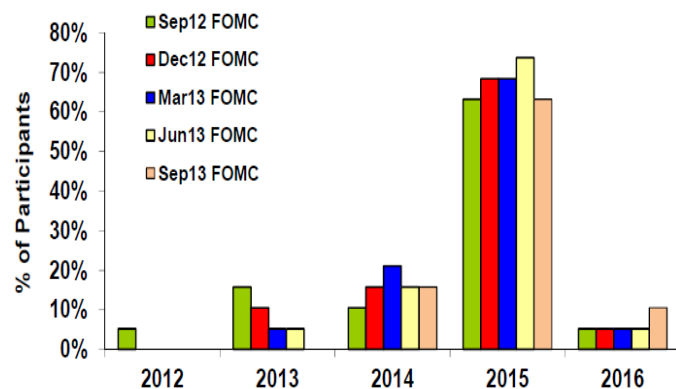
**We still expect Fed taper to likely start in December-January, but the delay of both taper and Fed Funds forward guidance supports easing of external funding conditions for EM.**

#### Fed’s Dovish Tilt Surprises the Market (and us)

**The Fed ended up being much more dovish than we expected.** The Fed’s September message has thrown markets off-course, and we believe alters the narrative impacting the timetable of Fed taper, and thus, performance of risk assets including those in EM. Aside from the “non-taper”, Fed expressing concerns about the “*rapid tightening in financial conditions in recent months*” suggests to us that the recent level and pace of US long-end yield back up was deemed inappropriate given the current state of the US economy. The Fed seems to now be acquiescing to the market perception that “tapering” is “tightening”— St. Louis Fed President Bullard said as such with his recent statement that “*the expected pace of asset purchases has conventional monetary policy effects*”, suggesting importance to the “flow” and not the “stock” of asset purchases. With emphasis that QE exit is data-dependent and having no pre-set timetable, we believe expectations that QE3 would end by mid-2014 have been notably altered. Fed’s forward guidance on the Fed Funds rate has also slightly tilted to the dovish side, both in Fed’s expectations about timing of policy (see Figure 4) as well as its emphasis on the unemployment rate being “thresholds”, not “triggers” for policy, saying “*Fed Funds rate increase might not occur until the unemployment rate is considerably below 6.5%*”.

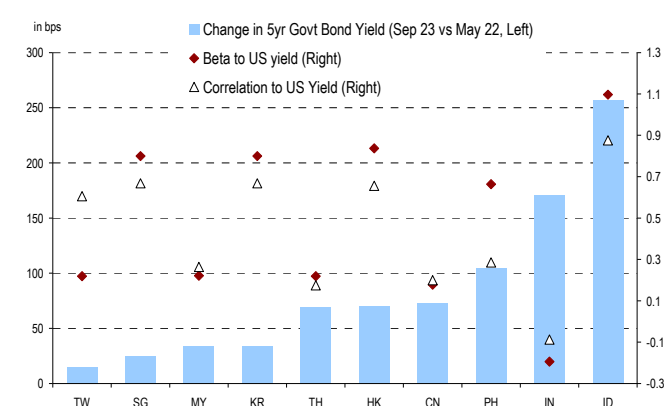
**While we still expect that Fed is more likely to start tapering by December-January** based on our more constructive view about fundamental trends in the US economy<sup>1</sup>, the change in new Fed Chairmanship and voting members still introduces uncertainty. Janet Yellen is now the perceived front-runner for Fed Chair, and whether justified or not, her dovish credentials loom large on market perception. Given the sharp sell-off in bond yields in the region (an average of 85bps sell-off in the 5yr since 22<sup>nd</sup> of May), and bear steepening in most curves (except in Indonesia, India and the Philippines where we saw bear-flattening), alongside FX sell-offs in the taper-sensitive parts of Asia, amid persistent fears of escalating EM fund outflows, we think the Fed’s surprise is a sufficient enough catalyst to give some reprieve to funding conditions for countries hit hardest – Indonesia and India.

Figure 4. US – Fed’s View of Appropriate Timing of Policy Firming



Source: FOMC, Citi Research (from [Chartpack Accompanying Weekly Views and Trade Ideas - 19 September 2013](#)).

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



Source: Bloomberg, Citi Research

<sup>1</sup> For discussion, see [U.S. Economics Weekly: Market and Policy Comments - Reassessing The Policy Path](#) (20 Sep 2013)

While this reduces near-term risks to taper-sensitive countries, we think the market should differentiate countries that are making real adjustment to insulate themselves from future Fed-related volatility and those that don't.

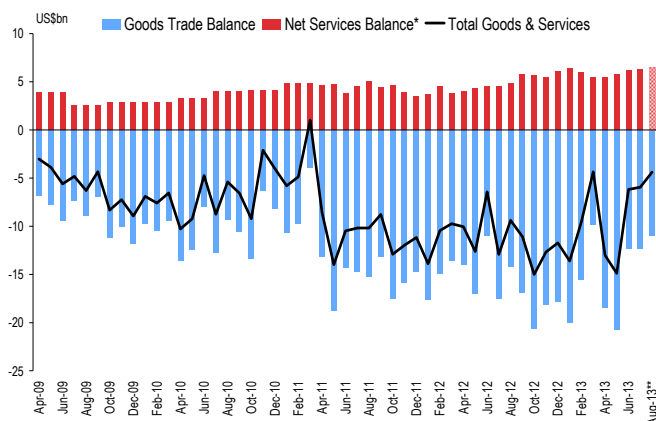
We think India is showing the biggest real adjustment in its external accounts, notably seeing a reduction in major components of its current-account deficit.

After the initial knee-jerk rally, we think it's important to step back and recognize which countries have taken longer lasting steps to insulate themselves from future Fed action-fueled volatility. We still expect Fed taper is a matter of time, and EM in the last 3+ months have essentially been given a "stress test" on what taper-led volatility would look like. We think the experience will provide lasting risk premium to countries that are ill-equipped from a fundamental standpoint to address risks associated with a shift in Fed policy, albeit delaying the realization of these risks. In many of our previous analysis, we have repeatedly cited that India, Indonesia, Malaysia and Thailand (Sri Lanka, if we include frontier) were likely going to be the more taper-sensitive, while North Asia and the Philippines (Vietnam, if we include frontier) are relatively more insulated.<sup>2</sup> We discuss below only the policy outlooks for the more vulnerable countries.

### India already showing real adjustment

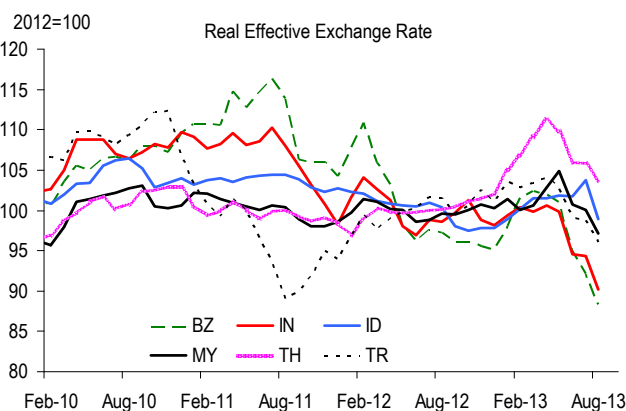
Among the taper-sensitive countries, we think India is showing the biggest real adjustment visibly seen in its major components of the current account (CA). After two years of REER depreciation, India's monthly trade deficit was cut by 45% in August versus the peak average monthly deficit in 4Q12, driven by both export outperformance (see Figure 18) and import compression, the latter from a decline of gold imports and sharply decelerating domestic demand. Monthly net services balance is also showing marked improvement, up 36% YoY to US\$23.7bn in Apr-Jul 2013 versus only 1.4% growth (BoP data) in FY 2013 (see Figure 6). On top of downgrading India's growth forecast to 4.8% for FY14, we revised down India's FY14 CA deficit forecast to US\$68bn (3.7% of GDP) from an earlier forecast of US\$83bn, translating to a 23% YoY decline.

Figure 6. India: Monthly Goods and Services Trade Balance (in US\$bn)



Source: RBI, CEIC Citi Research; Note: \*Monthly service balance data only started in April 2011, we use the average monthly services balance from the quarterly current account data prior to this; \*\*The August 2013 services data is not yet available, we assume the same YoY growth rate of services balance for Apr-July 2013 to August.

Figure 7. Real Effective Exchange Rate Trends, Feb 2010-Aug 2013



Source: BIS, Citi Research

Credibility of sustaining this external improvement is further bolstered by a more "hawkish"/ CPI-focused RBI.

**Credibility** of India's macro adjustment is further bolstered by a paradigm shift at the RBI. India is the first country in the region that (deliberately) conducted its monetary policy meeting right after the Fed this month and the verdict is clear – RBI Governor R. Rajan is no dove. While the RBI surprised the market with 75bp easing of the marginal standing facility (MSF) rate to 9.5% (MSF was always

<sup>2</sup> See [Asia Macro View - External Vulnerabilities in Historical Context](#) (28 Aug 2013), [Asia Macro and Strategy Outlook - Cyclical Bottoming despite Fed Taper and China Risk](#) (18 Jul 2013).

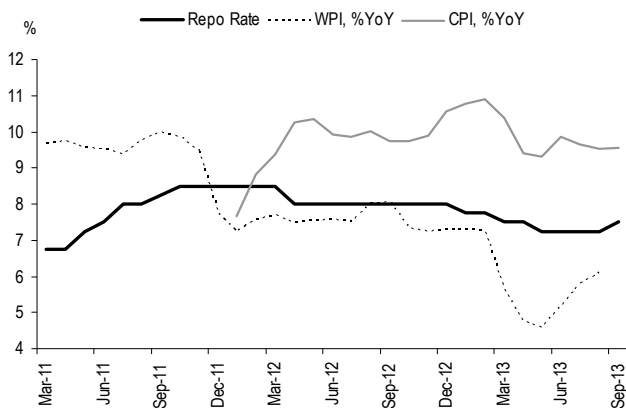
intended to be a temporary liquidity tightening tool), it also surprised us by hiking the repo rate by 25bps to 7.5%. We think Rajan's concerns over persistently high inflation expectations, weak domestic savings and high fiscal deficit, plus a shift towards CPI inflation as the nominal anchor for monetary policy, suggest there is a regime change in RBI's policy framework. While CPI inflation may trend gradually lower with the help of food prices (we assume it will average 8.1% in Sep 2013 to Mar 2013), we think the RBI is still going to hike the repo rate by another 25-50bps in 2H FY14 to correct distortions arising from very low real rates, but complement this move by another 50-75bps easing in the MSF rate so as to limit the impact on economic activity.<sup>3</sup> This should further reinforce external stability in India.

**We expect some incremental gains in easing access to debt-related foreign portfolio flows, but we are less convinced a breakthrough leading to EM bond index inclusion (via dismantling foreign bond quotas) will happen anytime soon.**

**India needs to diversify its foreign portfolio flow structure towards more debt-related flows, but we don't expect anything 'radical' happening here soon.**

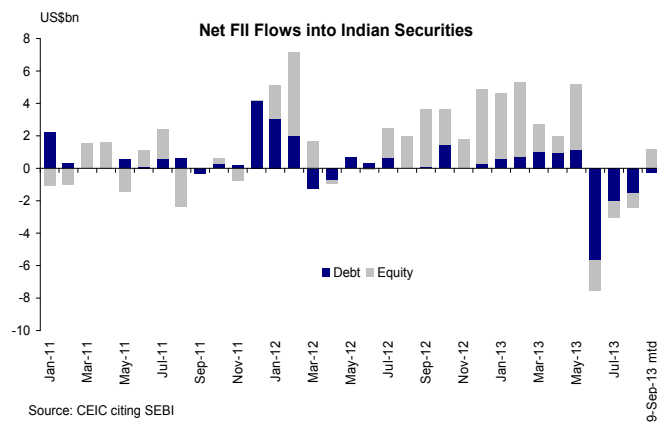
With growth unlikely to pick up significantly and election-related uncertainties looming large, there is greater need to diversify its capital flow structure towards less growth-sensitive debt flows. However, progress has only been incremental – SEBI recently relaxed KYC requirements and abolished the auction route for FII investment limits on G-secs until 90% of the quota limit is reached.<sup>4</sup> It could move to increase the quota to perhaps 5-10% of outstanding from the current 2%, but this will be non-binding as 49% of the existing quota on government bonds (for non-SWFs) is still un-utilized (as of 20<sup>th</sup> Sep). The biggest potential "game-changer" would be if India removes the quota system so INR government bonds could be included in major EM bond indices, raising at least US\$20bn of bond index-related flows.<sup>5</sup> However, we don't see this "politically-sensitive" policy hurdle being breached in the foreseeable future – it's not in our base case for FY14.

Figure 8. India – Repo Rate, WPI and CPI (%YoY)



Source: CEIC, Citi Research

Figure 9. Monthly Net FII flows into Indian Securities



Source: CEIC, SEBI, Citi Research

<sup>3</sup> See [India Macro Flash - New Governor, New Paradigm – Policy Rates Hiked by 25bps in Mid Quarter Policy](#) (20 September 2013).

<sup>4</sup> See [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1379070611774.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1379070611774.pdf) and [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1378989676484.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1378989676484.pdf)

<sup>5</sup> According to Ashmore, JP Morgan GBI-EM Global Diversified Index is followed by approx. \$200bn-\$225bn of bond investors. If we assume India will get 10% weighting and investors are neutral, India could get \$20-\$22.5bn of flows. [http://www.business-standard.com/article/markets/india-should-consider-opening-up-the-bond-market-tolga-ediz-and-jan-dehn-113091600652\\_1.htm](http://www.business-standard.com/article/markets/india-should-consider-opening-up-the-bond-market-tolga-ediz-and-jan-dehn-113091600652_1.htm)

## Malaysia & Thailand – Less adjustment needed, MY more proactive

**Malaysia is making more prudent fiscal and monetary policy noises, which should support external adjustment.**

**Malaysia is making the right policy noises on the fiscal and monetary fronts – we think this will continue regardless of Fed's delayed taper.** Malaysia saw a bigger deterioration in the current account than Thailand (2Q13 basic balance hit its first deficit since 3Q97), led by its goods trade balance – and July data show no major improvement yet (Figure 10). However, with elections over, PM Najib's position likely secure and Fitch sounding the alarm bells, Malaysia has signaled fiscal policy tightening plans starting with a 20sen/liter fuel price hike earlier this month. We expect more fuel hikes (at least another 20sen hike next year) on top of plans to stagger public sector projects with high import content, more administered price hikes and GST implementation (by 2015F).<sup>6</sup> BNM has also started to sound more hawkish, and we believe will remain vigilant about a second-round inflationary impact of the fuel price hikes. We moved our timetable for the first rate hike to 1H14 from 2H14, and expect fiscal tightening adjustment will be laid out in the October 25th budget speech (though off-budget spending plans are less clear) irrespective of the Fed's recent actions.

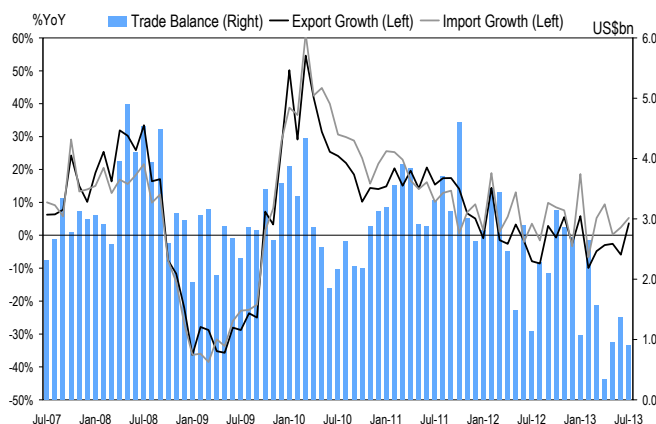
**Thailand remains relatively more passive; BoT will likely resist THB appreciation to support growth and we see limited appetite for monetary or fiscal tightening to raise domestic savings.**

**Thailand's policy approach is rather passive; expect BoT resistance to THB outperformance.** During the taper-led volatility, the BoT remained passive about THB depreciation to offset earlier outperformance. While the goods trade balance is tentatively improving, largely from slowing domestic demand as fiscal support weakens, export momentum is still lagging (Figure 18) and alongside the services deficit, the CA points to only very marginal improvement. In fact, over the medium term, we expect the CA deficit to increase on belated pursuit of public infrastructure investments. Unfortunately, Thai's net FDI flows have fallen *significantly* short of our earlier expectations to fund the CA gap – in fact, average foreign FDI inflows in Thailand in 2011-12 significantly underperformed China and ASEAN peers such as Indonesia (some auto-related Thai exports to Indonesia may have been cut by the shift of auto manufacturing facilities to Indonesia), Vietnam & Cambodia (lower labor costs) and Malaysia (better infrastructure) since the pre-GFC period. While upgrading transport infrastructure will be critical in boosting Thai productivity, the lack of sufficient domestic savings to fully fund this will expose Thailand to shifting external funding conditions, though coming from a strong position (high reserve buffer, low external debt). Given weaker domestic growth and benign inflation, we do not anticipate monetary or fiscal tightening in coming quarters to raise domestic savings. Instead, we think the BoT may have a persistent bias to keep the baht competitive.

<sup>6</sup> See [Malaysia Macro Flash - Fuel Subsidies Cut: Fiscal Consolidation Back on Track?](#) (3 Sep 2013).

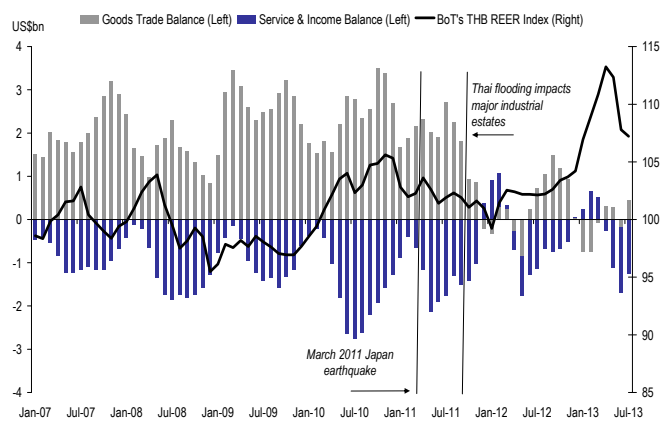


**Figure 10. Malaysia: Export & Import Growth (in US\$, %YoY) and Monthly Trade Balance (in US\$ bn)**



Source: CEIC, Citi Research

**Figure 11. Thailand: Goods and Services/Income Balance (rolling 3 Month Sum) and BoT's REER Index – Structural Deterioration?**



Source: CEIC, BOT, Citi Research

Indonesia has already begun to take corrective steps, but the size of policy adjustment needs to be bigger and more sustained as the current-account correction will likely take longer. There is risk Fed taper delay could make policymakers less vigilant with elections around the corner.

### Indonesia & Sri Lanka – Bigger adjustment needed; ID making a start

Indonesia has begun taking corrective steps to address its external imbalances via both monetary and fiscal policy tightening, but the size of adjustment needed is larger. Indonesia hiked subsidized fuel prices by an average of 33% in late June and hiked both BI & FASBI rates by 150bps since June to 7.25% and 5.75%, respectively, while recently downgrading growth forecasts to 5.5%-5.9% from 5.8%-6.2%. (We downgraded our forecasts for 2013F and 2014F to 5.7% and to 5.3%, respectively.) However, we think the impact of policy tightening alongside IDR weakness is going to have only a gradual impact on the CA, necessitating the BI to hike rates further (we expect a 2x25bps hike in 4Q13 to 1Q14), and there is a non-negligible risk that Fed's taper delay *could* make policymakers less vigilant. We cite four reasons for a possibly more gradual CA adjustment:

- *First*, more than half of exports are commodity-related, and prices of major commodities (coal, rubber and palm oil) remain subdued (plus China growth risks linger—see next section). Fuel price hike should eventually curb oil imports more than it has so far (oil imports were surprisingly strong in July);
- *Second*, raw materials form the bulk (75%) of Indonesia's total imports and the ability for weaker IDR to induce import substitution is hindered by the lack of domestic production capacity (Figure 12).<sup>7</sup>
- *Third*, while rising imported raw-material prices could curb investment, ongoing projects will likely continue plus two major drivers of raw-material demand – construction and vehicle production – may not see sufficient slowdown in the near-term – construction companies are enjoying historically high profit margins (Figure 14) and introduction of affordable cars that qualify for tax breaks could buffer consumer demand for autos<sup>8</sup>;

**Figure 12. Indonesia: Indicative market sizes and domestic production (mn tons) of selected basic industries**

	Domestic market	Domestic production
Steel*	9 - 10	6 - 6.5
Aluminium ingot*	0.6 - 0.8	0.3
Fertilizers*	24.2	16.6
Cement**	53	57
Asphalt*	1.2	0.6

Source: Reported estimates from Ministry of Industry estimates (2011-2012), \*\*Citi Research (2012)

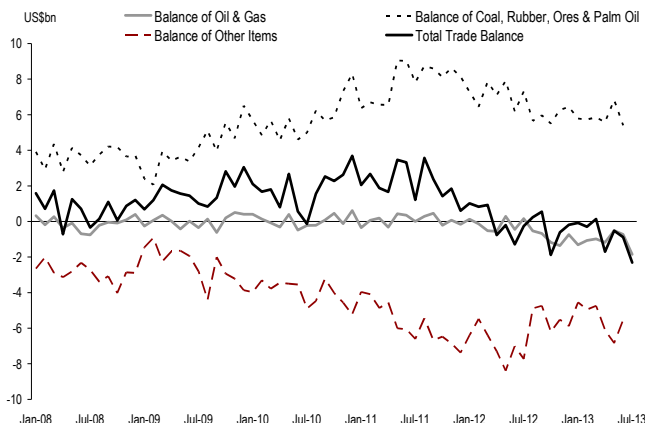
<sup>7</sup> [Indonesia Macro View - Assessing the Impact of IDR Depreciation](#) (30 July 2013).

<sup>8</sup> [Indonesia Macro View - How Strong Will the Forthcoming Growth Deceleration Be?](#) (16 Sep 2013)



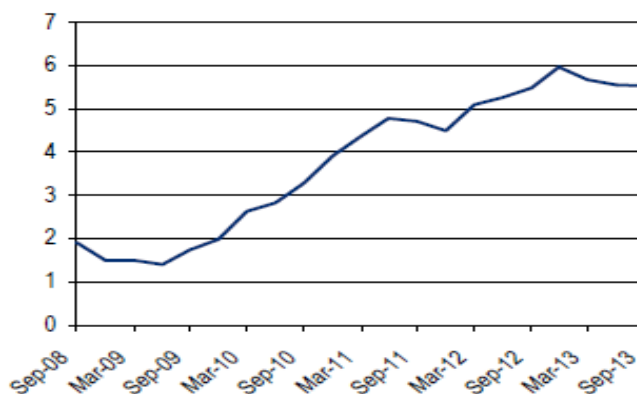
- *Last*, while credit growth is likely to slow as liquidity tightens and funding cost rises, our analysis shows that the impact on Indonesia's economy has a longer lag than others – may be due to much lower penetration of financial leverage.<sup>9</sup>

**Figure 13. Indonesia: Trade balance still deteriorating – oil and gas balance hasn't turned around yet**



Source: CEIC, Citi Research

**Figure 14. Indonesia: 12M trailing profit margin of major-listed construction companies**



Source: Bloomberg, Citi Research

**Sri Lanka's pro-growth bias remains largely unchanged even amid recent taper-led volatility, and Fed's interim "dovishness" could encourage more front-loaded offshore borrowing.**

**Fed's higher hurdle for "tightening" could ease EM Asia's external adjustment via export improvements and supportive backdrop for equity flows.**

**While exports in Asia have bounced in recent months, relative bounce still remains subdued.**

#### **We worry Sri Lanka doesn't yet see the need to make policy adjustments.**

After achieving better than expected 2Q13 real GDP growth of 6.8%, CBSL put out a press release reinforcing its 7.5% growth target for this year even as recent trade deficit figures show persistent stickiness amid strong import growth, FX reserves declined at the second-fastest pace in Asia in recent months (after Indonesia) and public debt/deficits remain persistently high. To be fair, exposure to portfolio flows is not as large given greater reliance on official loans, but that still exposes Sri Lanka to FX risk with very limited FX reserve buffer.<sup>10</sup> Sizeable external refinancing needs will make Sri Lanka sensitive to swings in global risk appetite. We think Fed's interim "dovishness" could reinforce CBSL's pro-growth bias and encourage more front-loaded offshore borrowing.

#### **Will export bounce be a self-insulating adjustment for the region?**

If the Fed's relatively high hurdle to monetary "tightening" translates to a more positive growth outcome in the US and elsewhere, as it helps support looser financial conditions for longer (Figure 15), then EM Asia's external adjustment can be made easier via both export improvements buffering current accounts and a more positive environment for portfolio equity flows.

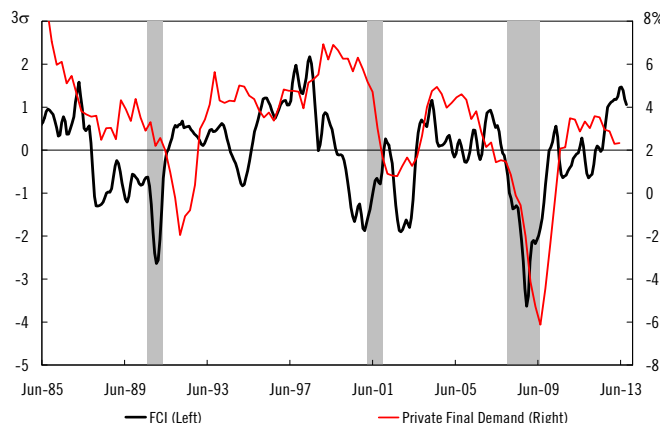
**Asia's export cycle has finally rebounded in recent months** (see Figure 16) with the help of the US and Europe. However, given that Eurozone recovery looks more fragile amid weak employment prospects and less accommodative financial conditions, we think US recovery will be a more important driver of global growth. However, US imports have so far lagged domestic economic activity, which partly explains why Asia's export rebound remains subdued. We think this is due to the nature of US recovery, narrowly concentrated in autos/vehicles, residential housing and mining sectors that tend to have a strong domestic production/non-tradable

<sup>9</sup> [Asia Macro View - Financial Conditions Present a Mixed Picture for EM Asia](#) (6 Sep 2013).

<sup>10</sup> [Sri Lanka Macro Flash - Relative Stability for a "Deficit" Country Probably Cannot Last](#) (21 Aug 2013)

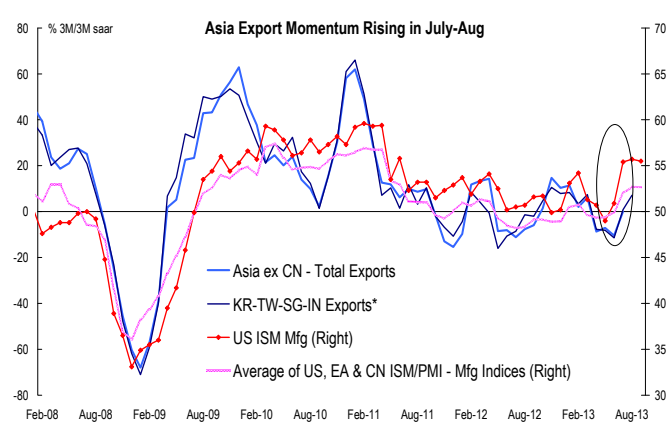
bias. Nonetheless, US import growth from Asia is outperforming overall US import growth and we think Asia would still be relatively well-positioned if US consumer spending broadens and other types of business capex pick up (Figure 17).

**Figure 15. US: Citi's Financial Conditions Index (3-Month Average) up to Sep 2013E vs. Real Private Domestic Demand (%YoY)**



Source: Bureau of Economic Analysis, Citi Research

**Figure 16. Asia: Export Momentum (%3M/3M SAAR) and Major Manufacturing Indices**

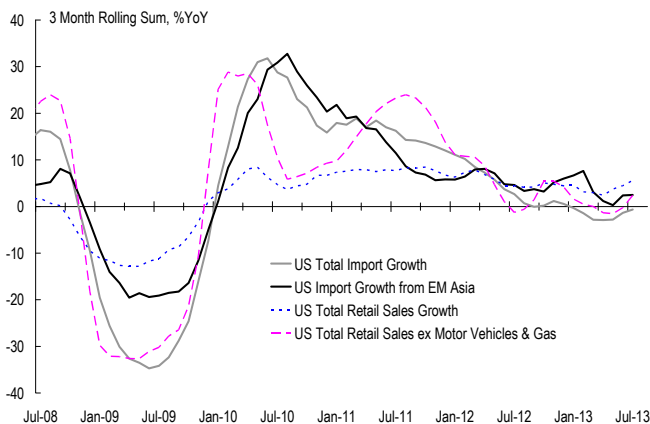


Source: CEIC, Bloomberg, Citi Research; Note: We exclude China's trade data whose momentum was significantly distorted by export overinvoicing in late 2012 to early 2013; we use Sep 2013 forecasts for CN PMI (ours) and US ISM (consensus)

**North Asia exports have generally outperformed Southeast Asia's exports and this may be partly explained by the divergent electronics product mix...**

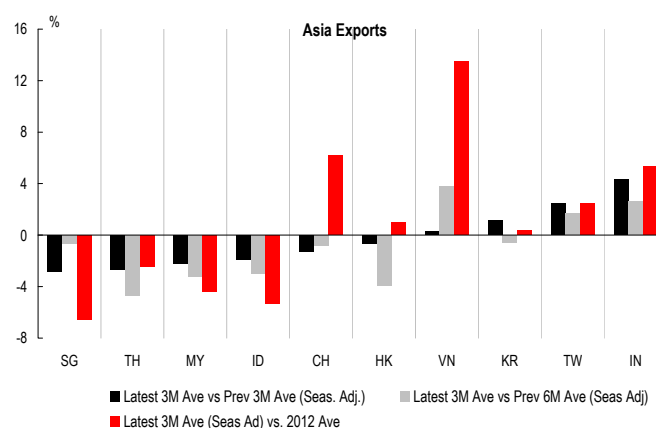
**Within Asia, there is still significant variation in export performance.** Exports of parts of South East Asia (ID-SG-MY-TH) have significantly underperformed the exports of North Asia (CN-KR-TW), India and Vietnam. While this may be partly explained by subdued commodity prices (impacting Malaysia & Indonesia), shifting supply chains (e.g. Samsung's assembly plants moving to Vietnam) and relative competitiveness (e.g. India), we also think this may have to do with the product mix.

**Figure 17. US: Growth of Total Imports, Imports from Asia, Retail Sales and Retail Sales ex Motor Vehicles & Gasoline Stations**



Source: CEIC, Citi research

**Figure 18. Asia: Significant differences in relative export performance**

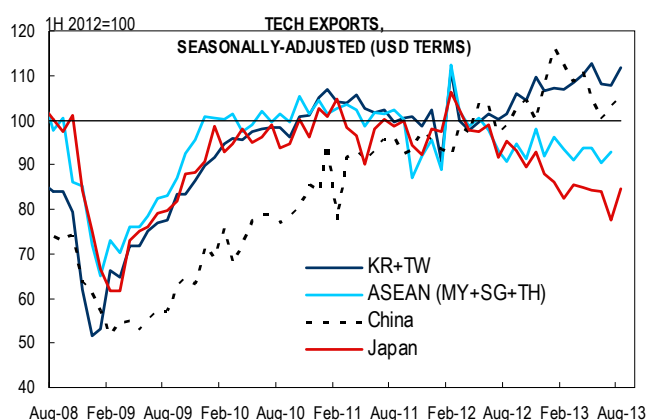


Source: CEIC, Citi Research

...particularly the bias of outperforming smartphone & tablet segments benefiting North Asia more.

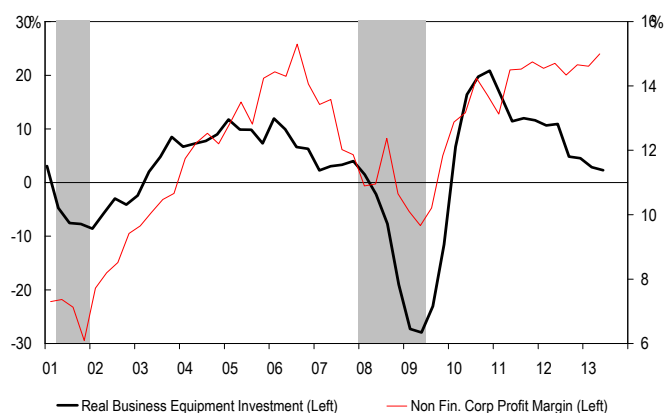
Electronics is an important driver of Asia's export/manufacturing cycle and we are seeing significant divergence between North Asia (ex Japan) and Southeast (SE) Asia (Figure 19). One explanation is the dramatic shift in consumer tastes towards smartphone and tablets whose components/major supply chains are likely dominated by North Asia (Samsung, Hon Hai/Foxconn & their mainland factories), supporting their already comfortable CA surpluses. SE Asia's tech sector may have a greater bias towards the underperforming PC market (e.g. the 2011 floods revealed Thailand's significant hard disk drive production base). We think the lack of broader US business capex (companies upgrading their PCs) may have exacerbated the divergent export performance (Figure 20). Thus, within the US, we may need broader recovery to benefit taper-sensitive countries more.

Figure 19. Asia's Tech Export Performance: Ongoing Divergence between Korea, Taiwan & China vs. the Rest



Source: CEIC, Citi Research

Figure 20. US: Real business investment (%YoY) remain weak despite historic high corporate profit margins (%), 2001-2Q13



Source: Bureau of Economic Analysis, Citi Research

We upgraded China growth following recent data bounce...

We recently upgraded our China growth forecasts on the back of recent data improvements – this bodes well for the region. In recent months, there has been a decisive shift in expectations about China's growth outlook following a positive turn in exports, PMI manufacturing indices, industrial production and investment, with China's economic surprise index sharply rebounding, allaying earlier fears that the outsized funding squeeze in May-June would prompt a sharper deleveraging. We upgraded our China growth forecast slightly to 7.6% (from 7.4%) for 2013F and 7.2% (from 7.1%) for 2014F.

...but sustainability of China's growth rebound over the medium term looks difficult amid the weight of very high leverage and tighter funding conditions.

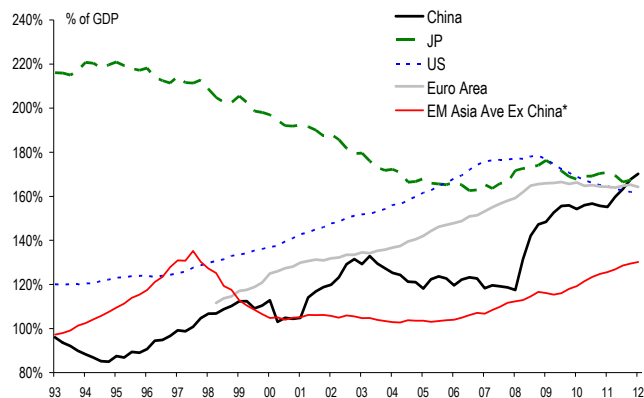
However, we would caution over the longer-term sustainability of China's recent bounce. We find that some of the drivers look unsustainable – in particular, FAI growth rebounded with the help of sufficient funding, especially from looser credit conditions earlier this year to support infrastructure projects. However, planned investments (newly started projects) and property investment growth are already decelerating, illustrating constraints to tighter funding.<sup>11</sup> Both private sector and local government debt rose rapidly in post-GFC years. In fact, local media reports that local government debt may have reached over RMB20trn or almost 40% of GDP in 2012 versus our earlier estimate of 25%.<sup>12</sup> We think tighter credit conditions persisting in 2H13 on top of already rapid build-up of leverage and financial imbalances will likely eventually weigh more on overall real GDP growth by

<sup>11</sup> See [China Macro View - Is the Recent Rebound the Beginning of an Uptrend](#) (11 Sep 2013).

<sup>12</sup> See <http://bond.hexun.com/2013-09-17/158079867.html>.

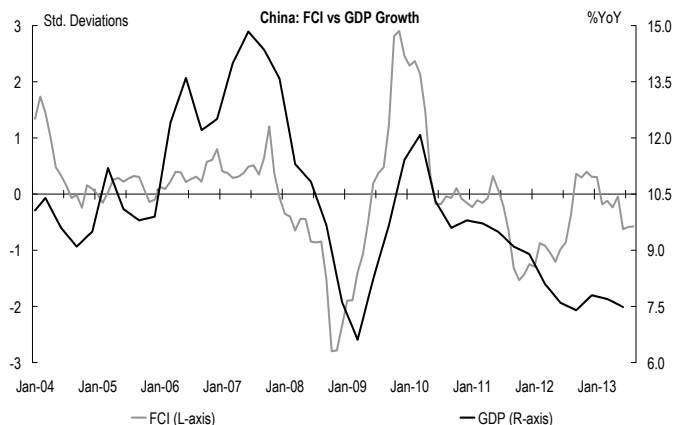
4Q13. Our China Financial Conditions is about 0.6x standard deviation tighter than average as of August amid higher real lending rates, slower credit and M2 growth and REER strength. (Figure 22).<sup>13</sup> Other data corroborate tighter credit conditions – corporate bond issuance has declined sharply (though buffered by government bond issuance), corporate bond yields have risen and the PBOC 3Q13 survey of loan approvals has declined.

**Figure 21. Comparing Credit to the Private Sector (% of GDP) – China has massively re-levered relative to the rest of the world.**



Source: BIS, Citi Research

**Figure 22. China – Citi's Financial Conditions Index updated until August 2013 & Real GDP Growth**



Source: Citi Research

**As long as China slowdown is managed within a range, shouldn't be too bad for risk appetite; equity bounce supportive to KR, IN, TW and to a lesser extent, MY.**

We think China's growth could start losing momentum by 4Q, though as long as growth deceleration remains managed within the 7-7.5% range (we think there are still sufficient policy flexibility to support this), the damage to overall risk appetite may not be too significant, and should continue to keep a lid on commodity prices. If EM equity flows can persist longer, countries in Asia that stand to benefit more are likely going to be where portfolio equity flows play a much larger role – we think this holds true in Korea, India, Taiwan, and to a lesser extent, Malaysia.<sup>14</sup>

## Market Outlook

**Within Asia FX, we would tactically overweight INR and MYR on the back of the taper-delay and progress (and expected progress) in their macro adjustment, but over the medium term, we think KRW and PHP have a more constructive fundamental story.**

**Asia FX:** With the Fed "taper" delay and more dovish guidance, we would be more positive currencies in the region that had sold off more during the "taper" fears and have shown signs of more real adjustment (or prospect for adjustment as discussed in earlier section) – INR and MYR. While we are neutral now, over the medium term, we would overweight KRW and PHP which can outperform down the line if export recovery advances for the former alongside equity flows, and if inflation picks up in the latter (our base case), making central banks in both countries eventually less sensitive to more FX gains. Despite the BoK intervention, we think KRW still looks historically cheap versus other main trading partners like JPY and CNY, and significant competitiveness in key export products (electronics, vessels) and conservative domestic policies curbing domestic demand will mean KR's large current-account surplus will persist for longer, keeping KRW appreciation pressures high. We would be short term neutral IDR and can see rationale to taking FX exposure via the short-term SBI bills (whose holding period has been reduced to 1M vs. 6M), but over the medium to longer term, still continue to expect further

<sup>13</sup> See [Asia Macro View - Financial Conditions Present a Mixed Picture for EM Asia](#) (6 Sep 2013).

<sup>14</sup> See Dirk Willer et al. "EM Focus- EM Equities to the Rescue" (19 September 2013), ([https://www.citilocity.com/menu/EM\\_OV?commentaryId=FXW1103906](https://www.citilocity.com/menu/EM_OV?commentaryId=FXW1103906))

While we may be in a period of some consolidation, we still generally expect steepening bias in local rates

Indonesia sovereign has outperformed and can rally a bit further, though there seems more juice with Indonesia quasi-sovereigns; we expect Mongolia outperformance to Sri Lanka to persist as there are positive developments on the policy front and less supply risk.

depreciating bias in IDR. We are near term underweight SGD with NEER well above the mid-point and may see less catalyst for near-term rally. We are neutral THB short term but slightly more wary over the medium term given our concern BoT will let THB bear much of the adjustment if our outlook of persistent and slight widening of the CA deficits persist over the medium term.

**Asia local debt:** With the big Fed surprise opening up accommodation for longer, we think this environment may be more conducive to some renewed yield-seeking behavior in parts of EM Asia, although with some caveats. Real money investors seem to have relatively elevated cash positions beyond the expected rate of redemption which could induce some catch-up buying, but we don't think yield levels and curves will snap back to pre-sell-off levels. Among the low yielders, we would prefer to add duration in both Korea and Thailand, more than we would add in Malaysia – Korea and Thailand have central banks that will likely remain on hold for awhile, inflation remains benign, fiscal policy prudent – Korea curve should get further support amid high surplus domestic savings while Thai curve has been higher beta to US in recent months and steepened more than Malaysia and latter still has much heavier positioning (though we like MYR more than THB). We would also turn a bit more neutral towards Indonesia bonds as have sold off the most in Asia and have room to retrace a bit given falling credit and term risk premium. Our earlier work shows IDR local bond valuations looking relatively attractive, although some of that cheapness will persist for much longer.<sup>15</sup>

However, technical factors would still argue bond yields aren't going to rally significantly; there is still a heavy Rp81.25trn of bond issuance left for this year (have completed 75.5% of issuance target) and foreigners may still have some pent up selling, especially if signs of BI tightening falter. Another way to seek yield with near term manageable FX risk is Sri Lanka 1yr bonds and adding more duration in Vietnam bonds where with base effect improving inflation optics and external position looking very resilient, SBV may cut rates again.

**External debt:** Indonesia has outperformed in the last month as bonds had significantly oversold, and we have always argued that despite some policy credibility gaps impacting external liquidity conditions, the fundamental creditworthiness of the country still remains intact (i.e. solvency is not seriously compromised) on the back of very low leverage and resilient growth. Indonesia's spread pick-up to Philippine dollar bonds has now come back to mid-August levels, and while we could still re-trace another 20bps if the "taper" delay and dovish rhetoric stabilizes EM debt fund flows, we could see bigger room for rally among Indonesia quasi-sovereigns which have significantly lagged the sovereign bond recovery. Two other countries that have become relatively vulnerable are Sri Lanka and Mongolia, and while both could recover on a credit risk-rally, we think Sri Lanka will continue to underperform Mongolia, and prefer adding exposure to the latter via the still relatively cheap quasi-sovereign (DBMMNs). As mentioned earlier in this overview, we think Sri Lanka has been more complacent about the need to make policy adjustments, maintaining its pro-growth bias and will likely use the Fed dovish guidance to do more front-loaded offshore borrowing that adds further to supply risk. Meanwhile, we think Mongolia has been much more proactive in making positive police noise – there is increasing chance that parliament will repeal the New investment Law which could help unlock much needed FDI, dollar bond issuance plans by DBMMN have now been replaced by samurai issuance, government has been talking about curbing fiscal spending and has also discussed

<sup>15</sup> See Alexander Demyanets. "[Emerging Markets Strategy - Local rates: looking for value](#)" (13 September 2013)

doubling the RMB swap line with China, which if it happens, would significantly strengthen its reserve coverage position.

**Asian Equities:** Our EM equity strategist, Markus Rosgen, thinks risk/reward of EM equities is very attractive at the moment, overweighting Asia and favoring current account surplus countries such as China, Korea and Taiwan while underweighting ASEAN and India. Post the Fed's decision not to start tapering QE, equity markets that had suffered the most, ie, those in economies with CAD, jumped the most, but we think this is a "get-out-of-jail-free" card. Long rates have moved higher and tapering will happen at some point. CAD will have to shrink, which is hardly positive for domestic consumption. Yet the surprise is how high the implied cost of equity is in EM, which signals the risk premium for EM equities. Whilst earnings growth rates are being revised down, relative to DM, EM earnings revisions are no longer getting worse and the operating stats (EBIT margins, ROE or ROA) are all higher in EM than in DM. Economic surprise indexes and liquidity indicators are all supportive for equities, and valuations in EM are at a discount to DM yet generate better ROE's. P/E and P/BV in EM are 1stdev below the mean and your upside vs downside return probabilities are biased to the upside.<sup>16</sup>

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<sup>16</sup> Markus Rosgen's [GEMS Strategy - Earnings Reconnection, the Cycle and the Implied Cost of Capital](#) (23-Sept-2013).



## Asian Currencies & Interest Rate Forecasts

Figure 23. Currency Forecasts and Forwards

	Mkt Data			Forecasts								
vs USD	26-Sep	3M Fwd	12M Fwd	0-3 Mos	6-12 Mos	Long-term	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Euro	1.35	1.35	1.35	1.37	1.36	1.40	1.37	1.36	1.36	1.37	1.38	1.38
Japanese Yen	98	98	98	99	105	110	101	103	105	106	107	108
Chinese Renminbi	6.12	6.15	6.19	6.10	6.18	6.00	6.12	6.15	6.18	6.14	6.10	6.07
Hong Kong Dollar	7.75	7.75	7.75	7.76	7.76	7.75	7.76	7.76	7.76	7.76	7.76	7.75
Indonesian Rupiah	11485	11670	12325	11000	11800	11000	11240	11537	11781	11620	11459	11301
Indian Rupee	62.4	63.9	67.3	61.0	64.0	58.0	61.9	63.0	63.9	62.6	61.4	60.3
Korean Won	1073	1080	1092	1050	1040	995	1047	1043	1039	1030	1021	1012
Malaysian Ringgit	3.22	3.24	3.28	3.15	3.27	3.05	3.19	3.23	3.26	3.22	3.18	3.13
Philippine Peso	43.3	43.2	43.3	42.0	42.5	40.8	42.2	42.3	42.5	42.1	41.8	41.4
Singapore Dollar	1.25	1.25	1.25	1.24	1.24	1.19	1.24	1.24	1.24	1.23	1.22	1.21
Sri Lanka Rupee	132.1	134.5	NA	133.0	130.1	125.0	133.0	135.0	133.0	130.0	130.0	130.0
Thai Baht	31.3	31.5	31.9	31.0	32.0	29.9	31.3	31.7	31.9	31.5	31.1	30.7
Taiwan Dollar	29.6	29.5	29.3	29.2	29.7	29.0	29.4	29.5	29.7	29.5	29.4	29.3
Vietnam Dong	21120	21510	23105	21150	21384	21600	21150	21229	21309	21388	21467	21467

\*Forecast as of Citi Foreign Exchange: Forecasts (September 19, 2013)

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

Figure 24. Interest rate forecasts (% period end)

	26-Sep	In 3M	In 6M	In 12M	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15
US* Fed Fund Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Year Treasuries	2.64	NA	NA	NA	2.70	2.80	3.00	3.15	3.25	3.40
EU* Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
10-Year Bunds	1.82	NA	NA	NA	1.70	1.80	1.80	1.80	1.90	2.00
JP* Call Money	0.07	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Year JGBs	0.68	NA	NA	NA	0.80	0.70	0.60	0.70	0.80	0.80
CN 1-Year Deposit rate	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50
1-Month Shibor	5.86	3.80	3.80	3.80	3.80	3.80	3.80	3.80	4.05	4.30
Government bond yield (5 -Year)	3.96	3.32	3.32	3.32	3.32	3.32	3.32	3.32	3.57	3.82
HK 3-Month Interbank Rate	0.39	0.45	0.59	0.80	0.45	0.60	0.70	0.80	0.90	1.00
5-Year Exchange Fund Note	1.21	1.30	1.49	1.89	1.30	1.50	1.70	1.90	2.10	2.30
IN Overnight Repo Rate	7.50	7.75	7.75	6.75	7.75	7.75	7.75	7.75	7.75	7.75
Overnight Reverse Repo Rate	6.50	6.75	6.75	5.75	6.75	6.75	6.75	6.75	6.75	6.75
91-Day T Bill	9.70	9.07	8.04	7.50	9.00	8.00	7.50	7.50	7.50	7.50
10-Year Gilt	8.79	8.50	8.26	8.25	8.50	8.25	8.25	8.25	8.25	8.25
ID BI Policy Rate	7.25	7.50	7.75	7.75	7.50	7.75	7.75	7.75	7.75	7.75
FasBI Rate	5.50	5.75	6.00	6.00	5.75	6.00	6.00	6.00	6.00	6.00
O/N Interbank Rate	5.66	6.64	6.89	6.90	6.65	6.90	6.90	6.90	6.90	6.90
10-Year Government Bond	8.06	8.49	8.26	8.01	8.50	8.25	8.25	8.00	8.00	8.00
MY Overnight Policy Rate	3.00	3.00	3.00	3.50	3.00	3.00	3.25	3.50	3.50	3.50
3-Month Interbank Rate	3.20	3.21	3.20	3.69	3.21	3.20	3.45	3.70	3.70	3.70
5-year MGS	3.54	3.59	3.70	3.90	3.60	3.70	3.80	3.90	4.00	4.10
PH O/N Rate	3.50	3.50	3.75	4.50	3.50	3.75	4.25	4.50	4.50	4.50
1-Month Reference Rate	0.33	0.43	1.22	1.98	0.50	1.25	1.50	2.00	2.75	2.75
5-Year T Bond	3.05	3.24	3.49	3.99	3.25	3.50	3.75	4.00	4.00	4.00
SG 3-Month Interbank Rate	0.37	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.45
10-Year SGS	2.35	2.50	2.60	2.89	2.50	2.60	2.75	2.90	3.00	3.00
KR BOK Policy Rate	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75
91-Day CD	2.66	2.70	2.75	2.75	2.70	2.75	2.75	2.75	2.75	2.90
5-Year Treasury	3.06	3.35	3.45	3.65	3.35	3.45	3.60	3.65	3.65	3.75
SL Reverse Repo Rate	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00
1-Month T-Bills	10.03	10.00	10.48	10.50	10.00	10.50	10.50	10.50	10.50	10.50
364-Day T-bill	10.57	10.50	10.50	10.50	10.50	10.50	10.50	10.50	10.50	10.50
TW Overnight Rate	0.39	0.41	0.43	0.48	0.41	0.43	0.45	0.48	0.51	0.54
Re-discount Rate	1.88	1.88	1.88	2.00	1.88	1.88	1.88	2.00	2.13	2.25
10-Year Government Bond	1.64	1.68	1.78	2.03	1.68	1.78	1.88	2.03	2.18	2.33
TH Overnight Repo Rate	2.50	2.50	2.50	2.75	2.50	2.50	2.50	2.75	3.00	3.00
1-Month interbank Rate	2.53	2.55	2.55	2.84	2.55	2.55	2.60	2.85	3.15	3.15
10-Year Government Bond	3.82	3.86	4.23	4.01	3.85	4.25	4.25	4.00	4.00	3.75
VN Refinance Rate	7.00	6.00	6.00	7.00	6.00	6.00	7.00	7.00	7.00	7.00
1-Month interbank Rate	4.42	3.00	3.96	5.93	3.00	4.00	4.50	6.00	6.00	6.00
5-Year Treasury	9.29	8.49	8.50	9.00	8.50	8.50	9.00	9.00	9.00	9.00

Note: \*Forecast as of Global Economic Outlook and Strategy (September 25, 2013)

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





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## Country Section

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## China

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- **Summary view** – Given better-than-expected real activity in Jul-Aug, we expect growth to rebound to 7.8%YoY in 3Q and hence upgrade 2013 GDP to 7.6%. But growth downturn may resume toward year end due to a less accommodative policy and a short-term negative impact from reform measures.
- **Things to watch** – Reform initiatives seem to be gaining momentum of late, featured by lending rate liberalization, the launch of the China (Shanghai) Free Trade Zone, and health-industry reforms. A reform agenda is likely to be introduced in the 3rd Plenary Session of the 18th Party Congress, but we remain cautiously constructive on the reform outlook.
- **Strategy** – Fed tapering, while delayed, could still weigh on financial market sentiment. Shadow banking gained some momentum in August, but eased liquidity conditions only at the margin. The cost of capital will likely inch up through the year-end unless exports and monetary policy surprise to the upside.

### Expecting a transitory growth rebound

**We revise up our growth forecast...**– We have upgraded our growth forecast on better-than-expected real activity in 3Q. Economic data released since the beginning of Jul have been generally positive, with industrial production and fixed-asset investment picking up speed on a YoY basis. If the positive momentum in the last two months is sustained in Sep, we may see a modest MoM pickup translate into more significant YoY improvement this quarter, partly due to the low base last year. We estimate that IP growth will reach about 10%YoY in 3Q. Based on the recent relationship between IP and GDP, we expect 3Q growth to be around 7.8%YoY, higher than our previous estimate of 7.4%YoY. Correspondingly, we upgrade 2013 growth from 7.4% to 7.6%, and 2014 growth from 7.1% to 7.2%.

**...but see the recent rebound as transitory.** The overall policy stance will likely be less accommodative in 2H. The current rebound has benefited from quite loose monetary and credit conditions in the first five months. Since Jun, credit conditions have already been tightened, as evidenced in the monetary data and the PBOC's 3Q survey of entrepreneurs and bankers. In this context, we see the total social financing rebound in Aug as a temporary deviation from a shift to a neutral policy stance. Recent remarks by the Premier and PBOC suggest little room for monetary loosening. In addition, the Minister of Finance has made it clear that the budget deficit for 2013 will not be increased. According to our estimate, fiscal policy will not be more expansionary than last year even if the budget is fully utilized. As a result, we think the current rebound is transitory, and growth may resume its downturn in 4Q.

### Reform prospects for next five years

**Reforms are gaining momentum in the context of stable growth.** The recent steps taken by the government, including the launch of the China (Shanghai) Free Trade Zone, VAT reform, and elimination of the lending rate floor, suggest the government is laying the groundwork for substantial reforms, and a comprehensive reform agenda is expected to be introduced during the Third Plenary Session of the Communist Party in November. The coming Third Plenary Session in Nov should mark the beginning of a brand new round of reform and opening up in China's history. The reforms are unlikely to be a 'big bang', and would be partly planned and partly forced. The next 3-5 years will be a critical window for reform, determining whether China can escape the middle-income trap and upgrade itself to an advanced economy.

**China's economic reforms aim to improve the quality of growth, invent new growth drivers.** Premier Li Keqiang has pledged to upgrade the Chinese economy by exploring reform dividend, domestic demand potential and innovative ability. But it is critical to prioritize the different parts of reform. We divide reforms into three key areas: boosting demand, enhancing productivity and de-leveraging. De-leveraging will likely pull down growth and is more likely to take place after domestic demand is boosted and productivity is enhanced. Following this order of reform, the economy may still weaken in the near-term, but a hard landing could be avoided.

## Boosting demand

**China has shifted from being a supply-constrained economy to a demand-constrained one,** and thus manufacturing output can't continue its rapid growth without additional external or domestic demand. External demand may remain weak due to de-globalization (e.g., US's re-industrialization, high jobless rate and prudential consumer spending in DM, and strong RMB), dragging down China's export growth to single digits. In order to keep growth in the manufacturing sector up, it needs to boost domestic demand including investment and consumption. On the one hand, investment is still needed, but the structure and efficiency of investment would have to be improved. On the other hand, consumption growth should stabilize through better income and wealth redistribution and consumption upgrades. Boosting demand can help create growth drivers and improve the quality of growth.

## Enhancing productivity

**The ultimate target of reform is to improve the productivity gains when China faces structurally funding constraints during the transition.** More importantly, China is gradually moving from industrialization to service-oriented growth. This could mean it is productivity-negative, a sharp reversal from the productivity gains while labor migrated from farming to manufacturing. Recent estimations show that productivity growth was falling nationwide but, during 2006-10, growth in the non-tradable sector was 2.8ppts lower than the tradable sector, which was mostly dominated by manufacturing goods. In the manufacturing sector alone, industrial upgrades and innovation are needed to increase productivity gains. The overall productivity gain in China is one way of escaping the middle-income trap.

## De-leveraging

**De-leveraging is needed to avoid a financial crisis in next few years.** Global experiences suggest that rising leverage ratios often end in a crisis and sharp economic adjustment. Two sectors highly leveraged in China are local govts and SOEs, but both have been key drivers of economic recovery in 2H12 and this year. De-leveraging would pressure China's growth, as shown in our CTI. This is likely to be a painful process and would involve bankruptcies (at least technically) of firms, local governments and financial institutions.

Key messages from the Nov meeting could include: 1) Whether the gov't will accept short-term or longer-term pain. ST pain could mean GDP growth of 5-6%; LT pain could mean hard landing in the next 3-5 years with possible negative growth. 2) Whether GDP growth or jobs will be defended. Due to distorted growth, defending growth may not necessarily secure jobs. 3) Whether SOE reform is on the agenda.

**We highlight 10 most possible reforms in next 5 years:** 1) Relaxing the one-child policy to two children; 2) deposit rate liberalization; 3) hukou reform; 4) service sector deregulation; 5) securitization; 6) fiscal reform; 7) property tax; 8) negative list; 9) local government debt restructuring; and 10) land monetization.

Figure 25. Growth will likely rebound in 3Q

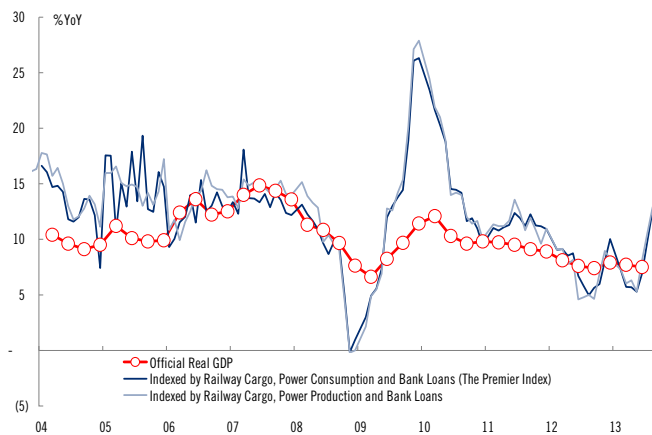


Figure 26. IP growth reached 17-month high

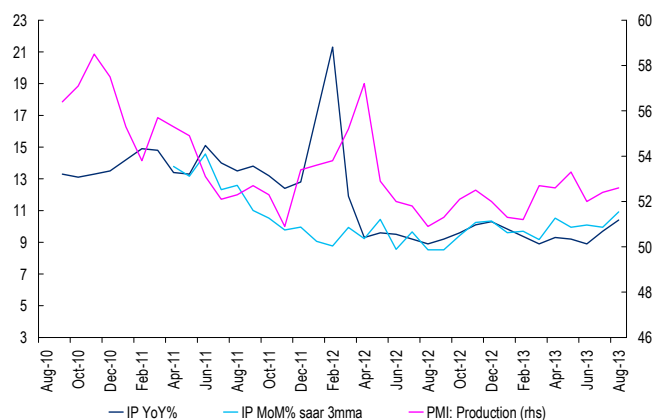
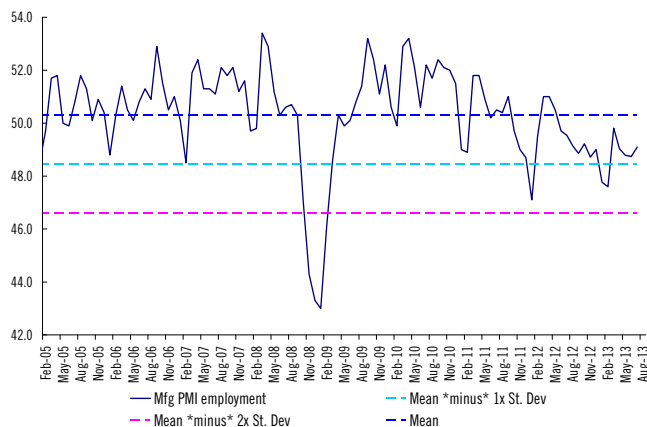


Figure 27. Downside risks reduced by improving external environment



Figure 28. PMI employment index indicates the job market is normal



Source: CEIC, Citi Research

Figure 29. Monthly TSF was much lower in Jun-Aug relative to Jan-May

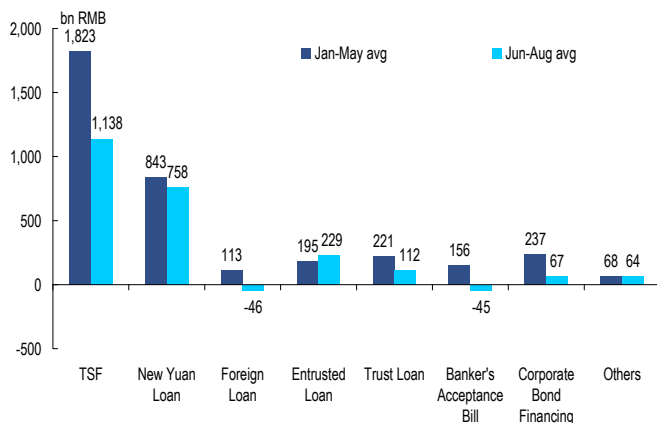
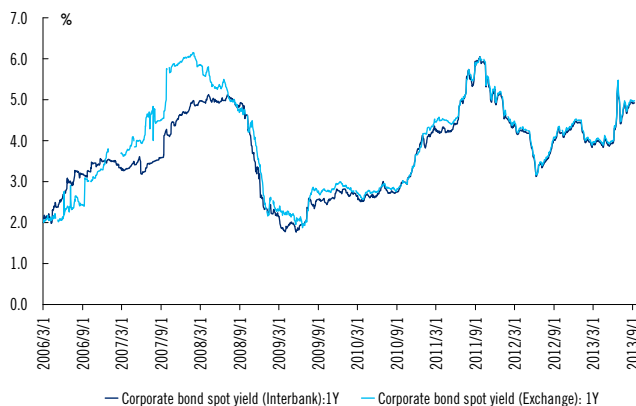


Figure 30. Rising cost of capital suggests tight liquidity



Source: CEIC, Citi Research

Source: WIND, Citi Research

Figure 31. China Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	2,787.2	3,494.5	4,544.0	5,070.5	5,932.5	7,319.0	8,238.5	9,243.1	10,278.8
Nominal GDP, local currency bn	22,224	26,583	31,490	34,632	40,151	47,310	51,894	56,976	62,289
GDP per capita, US\$	2,120	2,645	3,422	3,800	4,424	5,432	6,084	6,799	7,531
Population, mn	1,314.5	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,359.5	1,364.9
Unemployment, % of labour force	4.1	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2
<b>Economic Activity</b>									
Real GDP, % yoy	12.7	14.2	9.6	9.2	10.4	9.3	7.7	7.6	7.2
Real investment growth % yoy	13.3	14.4	11.0	19.2	11.9	9.4	8.1	7.4	7.0
Real consumption growth % yoy	9.8	11.0	8.5	9.4	9.2	10.9	8.3	7.1	7.3
private consumption growth % yoy	11.3	11.1	9.2	10.3	8.5	18.2	8.5	7.3	7.5
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	2.8	6.5	1.2	1.9	4.6	4.1	2.5	3.0	3.5
CPI, % avg	1.5	4.8	5.9	-0.7	3.3	5.4	2.6	2.7	3.0
Nominal wages, % yoy	14.6	18.5	16.9	11.6	13.3	17.8	9.7	9.8	9.3
Credit extension to private sector, % yoy	14.3	19.3	14.0	33.2	20.3	15.1	14.8	15.3	13.7
Policy interest rate, % eop	2.52	4.14	2.25	2.25	2.75	3.50	3.00	3.00	3.25
1 month inter-bank rate, % eop	2.58	3.61	1.23	1.79	6.17	6.00	4.90	3.80	4.05
Long term yield, % eop	2.62	4.19	1.80	3.06	3.61	3.27	3.33	3.32	3.57
lc/US\$, eop	7.81	7.30	6.82	6.83	6.59	6.29	6.23	6.16	6.09
lc/US\$, avg	7.97	7.61	6.95	6.83	6.77	6.46	6.31	6.17	6.14
<b>Balance of Payments, US\$ bn</b>									
Current account	231.8	353.2	420.6	243.3	237.8	136.1	193.1	203.3	205.6
% of GDP	8.3	10.1	9.3	4.8	4.0	1.9	2.3	2.2	2.0
Trade balance	177.5	264.3	298.1	195.7	181.5	154.9	231.1	276.9	293.0
Exports	969.0	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.9	2,224.6	2,296.4
Imports	791.5	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,817.8	1,947.8	2,003.4
Service balance	-8.8	-7.9	-11.8	-29.4	-31.2	-61.6	-89.7	-98.7	-108.5
Income balance	-5.1	8.0	28.6	-8.5	-25.9	-70.3	-42.1	-0.6	-13.6
FDI, net	100.1	139.1	114.8	87.2	185.7	231.7	191.1	147.0	99.9
International reserves	1,066.3	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,692.6	3,925.4
Total Amortisations	17.9	20.3	23.3	34.2	27.2	33.2	38.8	41.8	46.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-1.0	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-2.0	-2.0
Consolidated gov primary balance	-0.5	1.0	0.1	-1.8	-1.7	-0.9	-1.6	-1.6	-1.6
Public debt	18.6	39.0	37.4	47.8	49.2	44.3	45.0	45.1	45.3
of which Domestic	17.4	38.0	36.6	47.0	48.6	43.7	44.5	44.6	44.8
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	338.6	389.2	390.2	428.6	548.9	695.0	764.5	840.9	925.0
Private	304.2	354.3	356.9	391.8	510.1	657.6	723.4	795.7	875.3
Public	34.4	34.9	33.3	36.9	38.8	37.4	41.1	45.2	49.7
External debt / GDP	12.1	11.1	8.6	8.5	9.3	9.5	9.3	9.1	9.0
External debt / XGS	31.9	29.0	24.7	32.2	31.5	33.4	34.0	34.4	36.7
Short-term debt	199.2	235.7	226.3	259.3	375.7	475.7	523.2	575.5	633.1
Short-term debt/International Reserves (%)	18.7	15.4	11.6	10.8	13.2	15.0	15.8	15.6	16.1
<b>Quarterly Economic Indicators</b>									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	7.7	7.5	7.8	7.4	7.2	7.0	7.1	7.5	7.2
CPI, % yoy	2.1	2.7	2.7	3.0	2.9	2.5	3.0	3.5	3.7
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50
1 month inter-bank rate, % eop	3.40	7.35	3.80	3.80	3.80	3.80	3.80	4.05	4.30
Long term yield, % eop	3.36	3.32	3.32	3.32	3.32	3.32	3.32	3.57	3.82
lc vs USD, eop	6.21	6.14	6.15	6.16	6.17	6.16	6.13	6.09	6.05

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

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

## Hong Kong

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- **Summary view** – The economy is steadily recovering, with July trade improvement encouraging. Further cooperation between China and HK businesses granted with the signing of annex 10 of the CEPA trade pact. Policymakers reiterate intention to retain the cooling measures.
- **Things to watch** – 1) The pace of inflation pick-up; 2) pace of trade recovery; 3) fund flows pattern in light of Fed tapering before Jan14 and a managed China slowdown; 4) property market reactions; 5) tourist shopping trends following China's anti-graft measures.
- **Strategy** – EFN yields near term will likely closely follow their UST counterparts downwards, post Fed's surprised dovishness in the timing of tapering and its forward guidance. Citi's HSI target for year end is 24,000. HKD started moving higher post the Fed's surprise decision and signs of China stabilizing.

### Fund flows and macro trends amid global dynamics

**Global backdrop: deferred Fed tapering plus signs that China's growth is stabilizing.** We expect the Fed's decision to maintain peak accommodation will prevent any economic fallout from higher interest rates and fiscal tightening, which in turn will provide some near-term offset to the effects of a managed slowdown of the Chinese economy. Our China economists think that the rebound we see in China in 3Q is likely transitory, as the Chinese economy faces tighter funding impact in 4Q, along with the need to address past excesses and initiate structural reforms to sustain long-term growth by making short-term sacrifices.

**Fund flows trend:** We have seen sharper fund outflows since June (latest available data), as noted in the sizable drop in net spot foreign currency positions in the month, which reflects worries of China's slowdown and June's Shibor surge. This was also seen in equities' price drop, with the HSI and HSCEI down by 11.3% and 16.3%, respectively, during the first three weeks of June. Subsequently, with the equity market recovering sharply from June's bottom, fund outflows are likely to have calmed down. However, we think financial markets volatility in coming months is unavoidable given that the markets would continue to guess on the timing of the eventual start of Fed tapering.

**HKD:** The other indicator that we usually track for liquidity flows has made repeated attempts to strengthen since June, as initially banks increased demand for the HKD on stronger liquidity needs towards the half-yearly closing (according to HKMA) and interests in equity market returns. We expect this trend to prevail in the near term.

**Interest rate trend:** Given the HKD peg linkage with the USD, the likely move of the Fed to delay rate hikes till the US jobless rate is closer to 6% will in turn help keep HKD interest rates ultra low for an extended period of time. Such pass-on of extended accommodation should also defer HK's mortgage rate hikes. Our property analyst Ken Yeung thinks that "originally the market expected mortgage rate hikes to come in 2H14 with a cumulative 300-400bps rate increase towards 2016. Now, rate hike expectations have been deferred to 2015 with only a 200bps hike to 2016." As for EFN yields, after the recent repricing for the delayed Fed tapering schedule, we expect them to again start creeping up from 4Q onwards.



**The economy is steadily recovering, with July trade improvement particularly encouraging.** Headline export and import growth rose by 10.6%YoY and 8.3%YoY, respectively, with the trade deficit narrowing to HK\$37.2bn. Exports to China rebounded from negative growth to 14.5%YoY and 14.5%mom in Aug, which allayed previous worries of imminent economic fallout in China. Going forward, we expect trade recovery to be bumpy. For example, Aug data will face a difficult base effect, but we expect better overseas demand in developed countries coinciding with year-end new product launches, which could boost 4Q trade performance.

**Inflation likely to stay elevated** after the abnormal July surge to 6.9%YoY (due to a one-off statistical distortion). Aug headline and underlying CPI grew 4.5%YoY and 4.3%YoY, respectively, mainly reflecting continued pass-through of increases in private housing and package tour charges. Given upcoming taxi/tunnel fee hikes, general warming of economic activities and a tight labor market, our full-year average forecast remains 4.3%YoY.

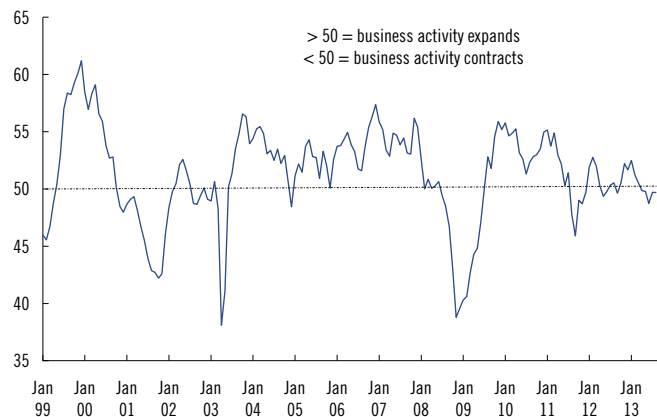
**Policymakers remain vigilant on property price rise.** The official property price index pointed to renewed increases in lower-end home prices in Jul 13, at 207.5 (much higher than 1997's peak of 180.7, although the more up-to-date Cenci City Leading Index indicated a mild pullback in Aug). The HKMA in its half-year report summarized that the HK "housing market is expected to see consolidation in the period ahead", "property valuations remain highly stretched, property market imbalances are still elevated and continue to entail macroeconomic and financial stability risks for HK". In particular the current price-to-income ratio (14.7 as of mid-2013) and income-gearing ratio at 65% (in June) were above peak levels of 1997 and long-term averages. The HKMA has warned that a 3%pt increase in mortgage rate would push the income-gearing ratio to 84%. This tone has been repeatedly echoed by the Chief Executive and other key senior officials, in particular aiming to quell recent hopes of near term lifting of the special stamp duty and property-related prudential measures. Especially in light of recent dovishness of the Fed officials both in terms of tapering and forward guidance for rates, HK policymakers will be vigilant to prevent any heating of market activities before supply can play catch-up.

## More incremental CEPA benefits

### **CEPA Supplement X to push for further business expansion into the Mainland.**

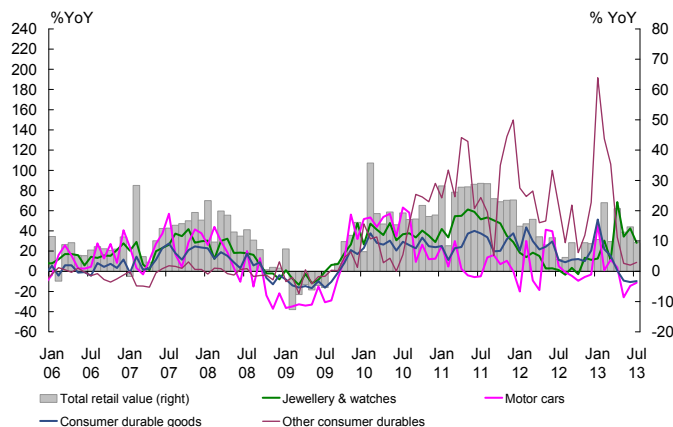
This CEPA supplement (effective in 1<sup>st</sup> Jan 2014) significantly expands scope, encourages labor mobility and upgrades benefits for HK businesses to tap the Pearl River Delta market. Several noteworthy amendments include: 1) allowing HK service suppliers to establish JVs in Guangdong Province of up to 55% equity ownership; 2) introduces a new concept of "contractual service providers" which allows HK service providers that do not have a commercial presence in the Mainland to send HK employees to work in the Mainland; 3) allowing HK banks subsidiaries in the Mainland to operate RMB businesses to serve HK enterprises and Mainland enterprises that are owned by HK investors; 4) granting HK fund houses to set up fully-licensed JV securities companies in Shanghai, Guangdong Province and Shenzhen, with a max 51% ownership; 5) expanding the scope of testing & certification services from food to other areas of voluntary product certification on a pilot basis in Guangdong Province; and 6) allowing HK's co-/solely-produced Cantonese films to be distributed and screened in the Mainland. [#3 and #4 are liberalization measures that Mainland had granted to Taiwan in late June and now also offered to HK.] According to official stats, CEPA in its 10 years lifetime thus far had granted 2700+ HK service suppliers certificates, allowed 4400+ HK residents to set up individually owned stores in the Mainland; and >\$52.4bn of goods exports enjoyed zero tariff and tariff savings amounted to RMB3.6bn.

Figure 32. PMI improved, but still in contraction zone



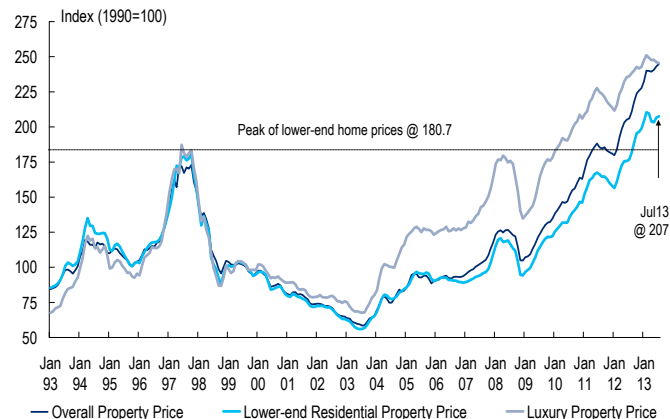
Source: Markit, Haver, Citi Research

Figure 34. Retail sales still weak as of Jul 13



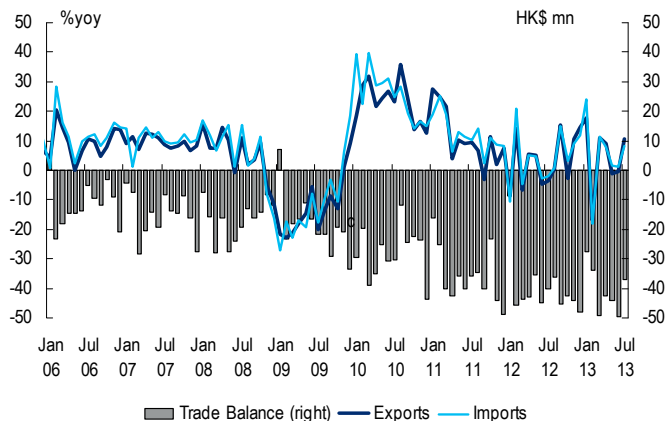
Source: CEIC, Citi Research

Figure 36. Property price for lower-end on a renewed rise as of Jul13



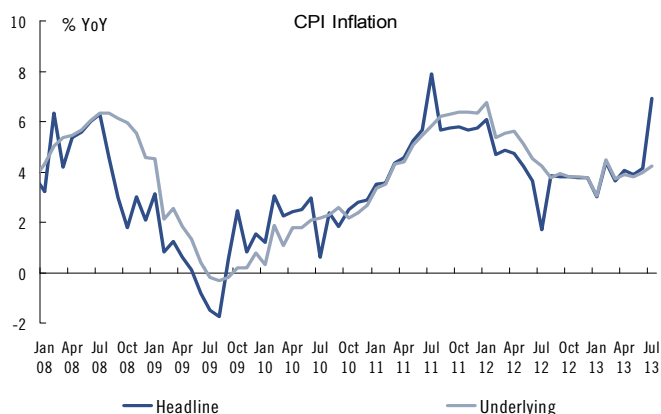
Source: CEIC, Citi Research

Figure 33. Exports rebounded in July



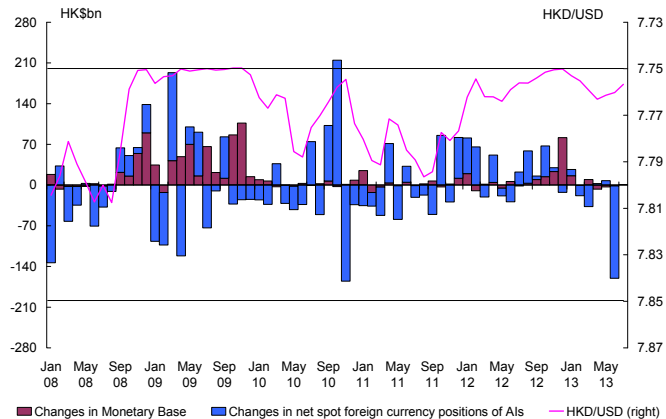
Source: CEIC, Citi Research

Figure 35. CPI likely peaked in July, but underlying on a gradual climb



Source: CEIC, Citi Research

Figure 37. HK saw sizeable capital outflows in Jul13



Source: HKMA, CEIC, Citi Research

Figure 38. Hong Kong Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	193.5	211.6	219.3	214.0	228.7	248.7	263.3	282.5	302.5
Nominal GDP, local currency bn	1,503	1,651	1,707	1,659	1,777	1,936	2,042	2,192	2,347
GDP per capita, US\$	28,031	30,497	31,488	30,594	32,429	34,971	36,697	39,067	41,499
Population, mn	6.9	6.9	7.0	7.0	7.1	7.1	7.2	7.2	7.3
Unemployment, % of labour force	4.8	4.1	3.4	5.2	4.4	3.5	3.3	3.4	3.2
<b>Economic Activity</b>									
Real GDP, % yoy	7.0	6.5	2.1	-2.5	6.8	4.9	1.5	3.0	3.4
Real investment growth % yoy	8.4	7.9	-0.3	1.0	11.1	2.2	5.2	3.1	3.6
Real consumption growth % yoy	5.4	7.9	1.9	1.0	5.9	8.2	3.2	3.8	2.1
private consumption growth % yoy	6.1	8.6	1.9	0.8	6.3	9.0	3.2	4.1	2.2
Real export growth, % yoy	9.4	8.3	2.5	-10.2	16.8	3.7	1.8	6.8	5.3
Real import growth, % yoy	9.1	9.1	2.2	-9.0	17.4	4.6	2.8	7.1	4.9
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	2.3	3.8	2.1	1.5	2.9	5.7	3.8	4.2	3.6
CPI, % avg	2.1	2.0	4.3	0.6	2.3	5.3	4.1	4.3	3.6
Nominal wages, % yoy	2.1	2.4	4.0	-1.9	2.4	9.9	4.7	3.5	4.5
Credit extension to private sector, % yoy	2.3	15.2	11.0	-2.1	20.9	12.5	7.0	8.0	8.0
1 month inter-bank rate, % eop	3.84	3.31	0.89	0.13	0.33	0.33	0.50	0.45	0.90
Long term yield, % eop	3.69	3.10	1.19	1.93	1.76	0.96	0.32	1.30	2.10
lc/US\$, eop	7.78	7.80	7.75	7.75	7.77	7.77	7.75	7.76	7.75
lc/US\$, avg	7.77	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.76
<b>Balance of Payments, US\$ bn</b>									
Current account	24.6	27.6	32.9	20.3	15.0	11.9	2.9	6.3	11.2
% of GDP	12.7	13.0	15.0	9.5	6.6	4.8	1.1	2.2	3.7
Trade balance	-17.9	-23.5	-25.9	-28.9	-43.1	-54.8	-61.6	-62.1	-60.5
Exports	316.8	344.7	363.0	318.7	390.4	429.2	443.1	464.3	505.6
Imports	334.7	368.2	388.9	347.6	433.5	484.0	504.7	526.4	566.1
Service balance	-9.3	-4.3	-2.7	3.4	10.1	16.3	22.8	23.0	23.4
Income balance	4.6	6.8	12.9	6.4	4.8	6.8	5.6	5.7	5.8
FDI, net	-15.5	-19.0	-8.9	-6.4	-10.5	-8.7	-9.0	-10.0	-11.0
International reserves	133.2	152.6	182.5	255.7	268.6	285.3	317.2	320.0	340.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	3.8	7.3	0.1	1.5	4.1	3.8	3.3	1.8	1.0
Consolidated gov primary balance	3.9	7.4	0.1	1.6	4.2	3.8	3.3	1.8	1.1
Public debt	1.4	1.2	1.0	0.7	0.6	0.6	0.5	1.0	1.3
of which Domestic	0.6	0.4	0.2	0.1	0.0	0.0	0.1	0.2	0.3
<b>Quarterly Economic Indicators</b>									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	2.9	3.3	3.1	3.0	3.2	3.4	3.4	3.6	3.7
CPI, % yoy	3.6	4.2	4.4	4.2	4.0	3.7	4.1	3.6	3.9
1 month inter-bank rate, % eop	0.21	0.21	0.21	0.30	0.50	0.55	0.65	0.75	0.85
Long term yield, % eop	0.51	1.12	1.19	1.30	1.50	1.70	1.90	2.10	2.30
lc vs USD, eop	7.76	7.76	7.76	7.76	7.76	7.76	7.76	7.75	7.75

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

\*Note: Public debt is general government debt.

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## India

- **Summary view** – India's economic activity has been decelerating for over two years on an investment slowdown and a slump in the industrial sector. The upheaval in financial markets that began with tapering talk and consequent monetary tightening has hurt recovery further. With neither monetary policy nor the fiscal policy having enough space to stimulate demand, we revise down our FY14 GDP estimate to 4.8%YoY from 5.4% earlier.
- **Things to watch** – After a US\$13bn portfolio outflow in June-August, flows are showing signs of stabilization with September flows a positive US\$1.8bn so far. But it may still be too early to say that it has turned a corner, as taper risks could resurface in 2H FY14. Domestically, with key state elections due in December, necessary fiscal adjustments may get delayed and influence business climate.
- **Strategy** – With a 25bps hike in the repo rate, the RBI in its September policy signaled a swift reversal of the easing cycle. We now expect the RBI to hike repo rates by 25-50bps in 2HFY14 on elevated CPI and high inflationary expectations. The central bank may simultaneously normalize money market conditions by reducing marginal standing facility rates by 50-75bps.

### Fallout of twin deficits

The capital outflows that began with taper talk exposed several of India's vulnerabilities, more importantly the twin deficits on current account and fiscal balances. The sharp rupee depreciation and a consequent rise in headline inflation led to swift reversal of monetary easing cycle even though GDP growth dropped to a 4-year low of 4.4% in 1QFY14. The RBI raised repo rates by 25bps in its [mid quarter policy](#), ending an interest rate cutting cycle that started in April 2012.

Besides monetary tightening, policy makers took other administrative measures to mitigate the heightened exchange rate volatility on both the current account and capital account fronts. The government clamped down on gold imports while the RBI offered swap concessions on NRI deposits and overseas borrowing. The delay in Fed taper provided further relief to currency markets. Due to these developments, INR reversed more than a third of its depreciation since May 22<sup>nd</sup>. But it may still be early to say that a corner has been turned as Fed taper has only been postponed and structural impediments such as twin deficits remain a concern.

### Downgrade GDP estimate to 4.8% in FY14

**GDP growth at a four-year low of 4.4%YoY:** The deceleration in activity continued into 1QFY14, with the industrial sector pulling the GDP growth down to 4.4%YoY. Since then there has been some improvement in industrial output and exports data (see [July IIP](#)). Combined with a pick-up in agriculture output on good monsoon, we see some acceleration in activity in upcoming quarters.

**Recovery slow in the absence of expansionary policy:** With neither monetary policy nor the fiscal front having enough space to stimulate demand, we expect recovery to be tepid, at best. Investment demand is likely to remain sluggish ahead of elections even though consumption could rise. On balance, we [forecast FY14 GDP](#) at factor cost to expand 4.8%YoY, down from our earlier estimate of 5.4%

## External sector rebalancing under way

**CAD to compress on policy measures:** The trade gap has narrowed in recent months due to a sustained policy focus to compress gold imports and improving export demand in developed markets. Gold imports may go up briefly on festive demand in coming months, but the soft patch will likely continue in FY14. We now expect the CAD to narrow to US\$68.4bn (3.7% GDP) in FY14.

**Exchange rate continues to dominate the market and policy focus:** Despite some narrowing in the current-account deficit, the rupee continues to face a challenging market environment. The financing need remains large amid volatile capital flows, and while the rupee is close to 10% below fair value in REER based on WPI inflation, it is still marginally overvalued based on CPI inflation. Also, the rupee has benefited temporarily from RBI support on account of swap concessions and the separate oil window, and the volatility could resurface when these measures are withdrawn

## Inflation: higher on food, fuel, rising importance of CPI

**Expect moderation in WPI & CPI:** The recent acceleration in WPI inflation to 6.1% and CPI to 9.5% has largely been on account of sharp increases in food and fuel prices. But we expect food inflation to turn soft with fresh crop arrivals in October; and after factoring in a decline in crude prices in rupee terms, the headline inflation is likely to trend lower towards an 8.7% average on CPI and 5.5% on WPI in FY14.

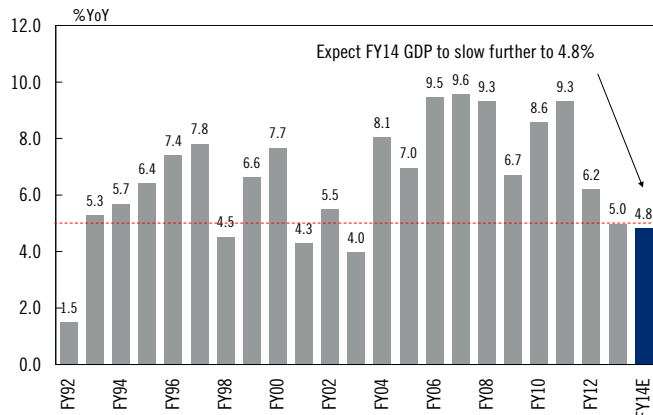
**Policy implications:** The trajectory of policy rates would depend on the choice of the nominal anchor going forward but clearly the governor has hinted at increasing importance of CPI in policy formulation. Still we expect the rate hike cycle to be short given a persistently large negative output gap and therefore we expect 1) 25-50bps hike in the repo rate in 2H FY14, and 2) MSF to come down by 50-75bps. Despite the hike in repo rates, interbank call money rates will likely progressively drift downwards towards the repo rate from the MSF rate of 9.5% currently

## Fiscal deficit: marginal slippage of 0.2% of GDP

**Lower revenue, higher subsidies:** We estimate marginal slippage in fiscal deficit to 5% of GDP due to a shortfall in revenue and an overshoot in subsidies and even after adjusting for cuts in plan expenditure. We estimate tax revenues to be lower by 0.5%GDP – at 10.4%GDP vs. 10.9% budgeted on account of shortfall in excise and services tax collections. The oil subsidies are likely to overshoot the budget estimate by ~Rs200bn due to large under-recoveries. The implementation of the food security bill can also put additional pressure on food subsidy to the tune of ~Rs100bn.

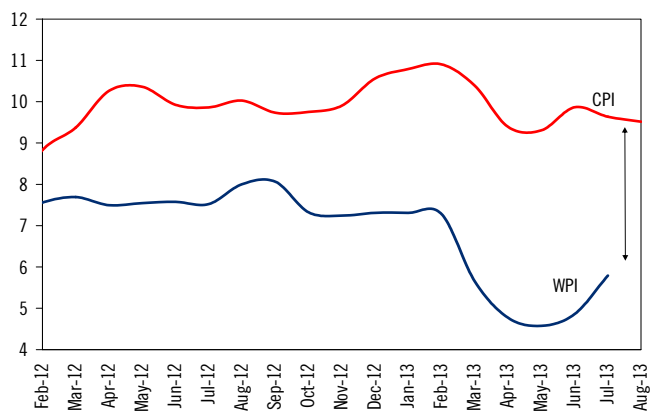
**Savings likely in plan expenditure:** Similar to the last fiscal, there is room for plan expenditure to be pruned by close to Rs600bn this year. The savings arising from plan expenditure is likely to restrict slippage to 0.2% of GDP. Despite a marginal slippage this year, the chances of sovereign downgrade are low as long as government sticks to the fiscal consolidation roadmap in the context of a strong medium-term growth outlook.

Figure 39. GDP – Expect FY14 GDP at 4.8%YoY



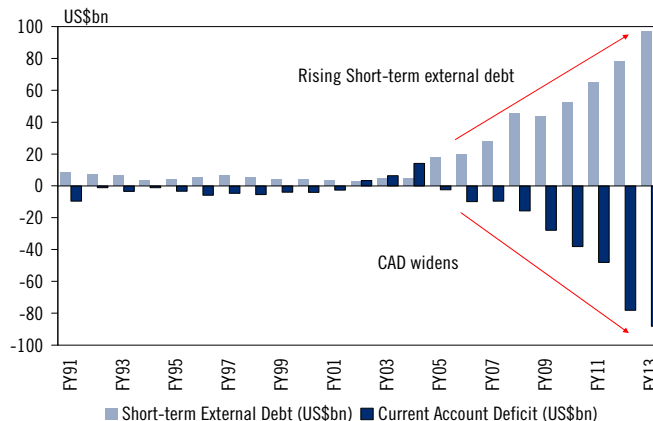
Source: CSO; Citi Research

Figure 41. Trends in headline and core inflation (% YoY)



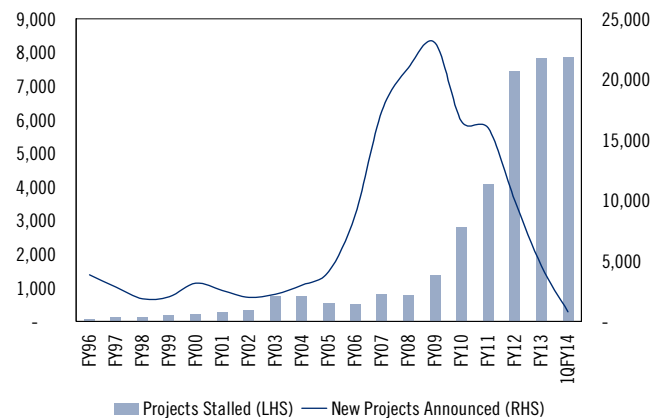
Source: Office of the Economic Advisor

Figure 43. External financing requirements remain high



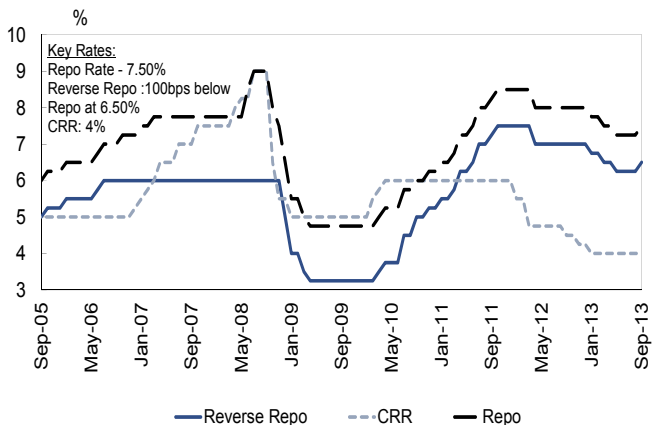
Source: Budget Documents; Citi Research

Figure 40. Trends in investment projects remain dismal (Rs bn)



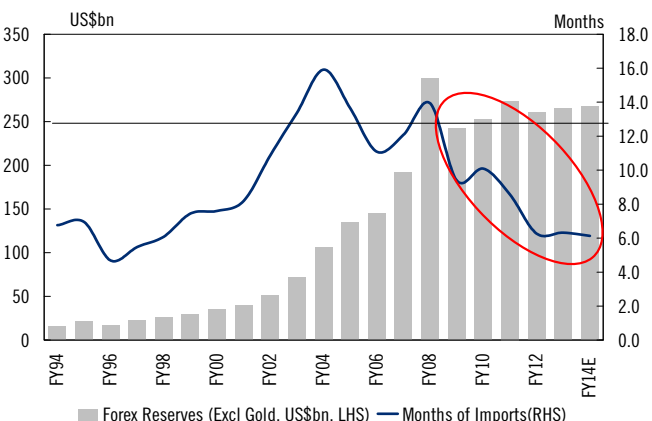
Source: CMIE

Figure 42. Rupee volatility leads to reversal of rate easing cycle



Source: Bloomberg

Figure 44. Trends in forex reserves and import cover (US\$bn, Months)



Source: RBI; Citi Research

Figure 45. India Economic Indicators

	FY07	FY08	FY09	FY10	FY11	FY12F	FY13F	FY14F	FY15F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	950.2	1,240.6	1,223.9	1,366.6	1,710.2	1,865.9	1,855.7	1,836.3	2,299.0
Nominal GDP, local currency bn	42,947	49,871	56,301	64,778	77,953	89,749	100,206	112,932	128,743
GDP per capita, US\$	847	1,090	1,061	1,168	1,442	1,552	1,521	1,483	1,829
Population, mn	1,122.0	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,220.0	1,238.3	1,256.9
<b>Economic Activity</b>									
Real GDP, % yoy	9.6	9.3	6.7	8.6	9.3	6.2	5.0	4.8	5.6
Real investment growth % yoy	13.4	18.1	-5.2	16.7	16.2	1.5	5.1	1.9	4.5
Real consumption growth % yoy	7.9	9.3	7.6	8.2	8.1	8.1	3.9	5.6	6.4
private consumption growth % yoy	8.7	9.2	7.1	7.1	8.6	8.0	4.0	5.3	6.5
Real export growth, % yoy	19.9	5.9	15.2	-4.7	19.7	15.3	3.0	5.2	11.0
Real import growth, % yoy	21.3	10.2	23.0	-2.1	15.8	21.5	6.8	5.0	9.5
<b>Prices, Money &amp; Credit</b>									
WPI, % yoy	6.8	7.7	1.5	10.6	9.7	7.7	6.0	5.5	5.0
WPI, % avg	6.5	4.8	8.1	3.8	9.6	8.9	7.3	5.5	5.0
Credit extension to private sector, % yoy	28.5	23.0	19.0	16.0	17.0	17.5	17.5	17.5	17.5
Policy interest rate, % eop	7.50	7.75	5.00	5.00	6.75	8.50	7.50	7.75	7.75
1 month inter-bank rate, % eop	9.43	8.00	5.68	4.49	9.54	10.90	8.50	8.50	8.50
Long term yield, % eop	7.98	7.96	7.01	7.83	7.99	8.56	8.00	8.25	8.25
lc/US\$, eop	44.12	39.41	48.62	46.41	44.71	53.02	55.00	63.88	61.49
lc/US\$, avg	45.19	41.18	43.42	48.30	45.68	46.63	53.38	60.17	63.33
<b>Balance of Payments, US\$ bn</b>									
Current account	-9.6	-15.7	-27.9	-38.2	-48.1	-78.2	-88.2	-68.4	-60.4
% of GDP	-1.0	-1.3	-2.3	-2.8	-2.8	-4.2	-4.8	-3.7	-2.6
Trade balance	-61.8	-91.5	-119.5	-118.2	-127.3	-189.8	-195.7	-173.8	-173.2
Exports	128.9	166.2	189.0	182.4	256.2	309.8	306.6	323.4	368.7
Imports	190.7	257.6	308.5	300.6	383.5	499.5	502.2	497.2	542.0
Service balance	29.5	38.9	53.9	35.8	44.1	64.1	64.9	63.6	69.1
Income balance	-7.3	-5.1	-7.1	-8.0	-18.0	-16.0	-21.5	-24.0	-24.0
FDI, net	7.7	15.9	19.8	18.0	11.8	22.1	19.8	21.0	18.0
International reserves	191.9	299.1	241.6	252.8	273.7	260.9	264.7	259.8	274.9
Total Amortisations	11.4	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-5.4	-4.0	-8.3	-9.4	-8.0	-8.1	-7.0	-6.7	-6.4
Consolidated gov primary balance	0.0	-1.1	3.4	4.6	2.7	2.2	--	--	--
Public debt	79.9	76.1	76.8	75.8	70.7	69.9	67.6	66.8	66.2
of which Domestic	74.7	71.4	72.2	70.8	66.0	65.9	63.2	63.0	62.8
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	172.4	224.4	224.5	260.9	305.9	345.5	390.0	405.0	420.0
Private	123.0	166.3	168.6	193.9	227.8	263.6	308.4	321.4	334.4
Public	49.4	58.1	55.9	67.1	78.1	81.9	81.7	83.7	85.7
External debt / GDP	18.1	18.1	18.3	19.1	17.9	18.5	21.0	22.1	18.3
External debt / XGS	86.1	88.5	77.7	95.2	81.5	77.5	88.2	89.2	72.0
Short-term debt	28.1	45.7	43.3	52.3	65.0	78.2	96.7	101.7	106.7
Short-term debt/International Reserves (%)	14.7	15.3	17.9	20.7	23.7	30.0	36.5	39.1	38.8
<b>Quarterly Economic Indicators</b>									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	4.8	4.4	4.6	5.0	5.2	5.2	5.6	5.8	5.8
WPI, % yoy	5.7	5.2	6.0	5.6	5.5	5.3	5.1	5.0	5.0
Policy interest rate, % eop	7.50	7.25	7.50	7.75	7.75	7.75	7.75	7.75	7.75
1 month inter-bank rate, % eop	9.30	8.05	10.50	9.00	8.00	8.00	8.00	8.00	8.00
Long term yield, % eop	8.00	7.50	8.40	8.50	8.25	8.25	8.25	8.25	8.25
lc vs USD, eop	54.29	59.53	63.12	63.88	64.62	64.31	62.90	61.49	60.11

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** – Our GDP growth forecast has been further lowered to 5.3% for 2014 from 5.6%. FX volatility since August has cast more clouds on the near term growth outlook. However, we generally think that the sensitivity of growth to IDR/USD depreciation could be milder this time compared to 2008.
- **Things to watch** – We expect YoY inflation to still rise towards 9.2% by YE13, before receding towards 4.9% in YE14. Although credit growth deceleration is already under way, we think current-account adjustment will not be swift and the risk of growth overkill from monetary policy is not alarmingly high.
- **Strategy** – In recent weeks, policy variables have taken a turn in the right direction with the FasBI and BI rate having been raised to 5.5% and 7.25%, respectively. We see the possibility of a further 25bp interest rate hike in 4Q13 and another 25bps in 1Q14 (bringing the total rate hike in the cycle to 200bps).

### IDR depreciation: Impact creeping through

**Overall GDP growth outlook has undoubtedly weakened but no free fall expected.** This month we further downgraded our FY13 and FY14 GDP growth forecasts to 5.7% and 5.3%, respectively (prev. 5.8% and 5.6%). We expect the weaker IDR to impact growth of household consumption and also fixed investments. With rising prices of e.g. construction materials and capital goods, the cost of business investment will undoubtedly increase while the revenue projections for domestic market sales will be declining or at best stable. We expect therefore many companies will have to review their upcoming expansion plans, leading to project delays and a slowdown in fixed investments in coming quarters. However, we do not expect the 2008 widespread halts to ongoing expansion projects.

**Trade-weighted exchange rate depreciation finally occurring.** As of Aug, Indonesia's nominal effective exchange rate saw further depreciation, after appreciating from Jan-May. It is not too far off from the lows seen in 4Q08. Note that we prefer now to look at the nominal instead of real trade weighted exchange rate (NEER vs. REER) because since the June fuel price hikes, the latter has been distorted by public bus tariffs and spice price increases which have little to do with trade competitiveness. However, anecdotally we also estimate the IDR prices of various imports using sectoral producer price indexes in the origin countries. It can be seen that some imports from Japan e.g. steel and general machinery may not have become far too expensive compared to a year ago, given the depreciation of the Yen against the IDR in late 2012 - early 2013.

**FX depreciation impact has started to creep through to domestic prices.** Following the increased FX depreciation momentum since July, the wholesale price index of imported goods rose 7.6% YoY in July, up from just 3% in May. Our indicators show rising momentum in the rupiah prices of various Chinese imports such as metals, electrical machinery, telecom equipment, garments etc. Meanwhile data as of August also shows prices of key construction materials on the rise, although still milder vs. that seen in 2008. We have also seen the exchange rate impact creeping through to the consumer price index, through prices of e.g. imported foods and gold. Further adjustments are probably on the way on durable goods prices. We expect inflation to rise towards 9.2% by YE13, before subsiding back to 4.9% by YE14.

## Current-account adjustment may take time

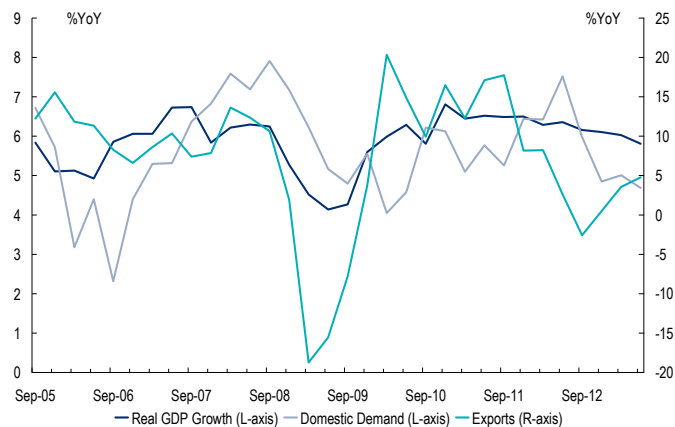
**Growth in high import content industries should be closely watched as a leading indicator for imports.** In [Indonesia Macro View - Assessing the Impact of IDR Depreciation](#), we identified the industries with high import content but which sell their products mainly to the domestic market. Among them are heavy industries such as vehicle, metals, chemicals and pharmaceuticals manufacturing. We also identified the building construction and automotive sectors as key users of steel (which is the second largest raw material import after petroleum and has been stubbornly growing).

**In 2008 growth in high import sectors immediately collapsed after IDR depreciation, but can it now be stickier?** In 2008, the rise in construction material prices was very strong, reaching a high of 32% YoY. Apart from FX depreciation, it was also amplified by rising prices of global commodities such as oil, coal and iron ore. The latter pressures are now less profound. Furthermore, net profit margins of major construction companies, especially the privately owned, appear to be higher in recent quarters compared to 2008. This means that there could be a longer lag before the rise in construction material prices is passed through to selling prices and affects final demand. Separately the launch of affordable car line-ups can also cushion the decline in auto sales. In Aug, 4W vehicle sales already dropped by about 6% YoY. But a number of Japanese carmakers have already started introducing their line ups of affordable small-cars, qualifying for tax breaks under the government's "low cost green car (LCGC)" program. This may be able to cushion the drop. Whereas in 2008 car sales volume growth dipped 20%, Citi still expects positive growth of car sales in 2014, supported by the LCGC. **Given the lower elasticity of growth to FX depreciation, we think the adjustment in the current account will probably be gradual and not coming in a straight-line. In this regard, we think the exchange rate will still be prone to two-way volatility.**

**Monetary policy needs to continue playing a role in restoring the external imbalance; and the risk of growth overkill is not dramatically high in our view.** In order to reduce imports and restore the external balance, we think that economic growth would have to slow further. Tighter monetary policy (i.e. both interest rates and macroprudential regulations) has a role to play because if the adjustment is left mainly to the exchange rate alone, the necessary magnitude may have to be larger. And a too strong adjustment in the exchange rate risks weakening corporate balance sheets by inflating the value of foreign debt. We think this is a costlier option in the longer term because strong balance sheets are needed to allow for a faster growth recovery when the time comes.

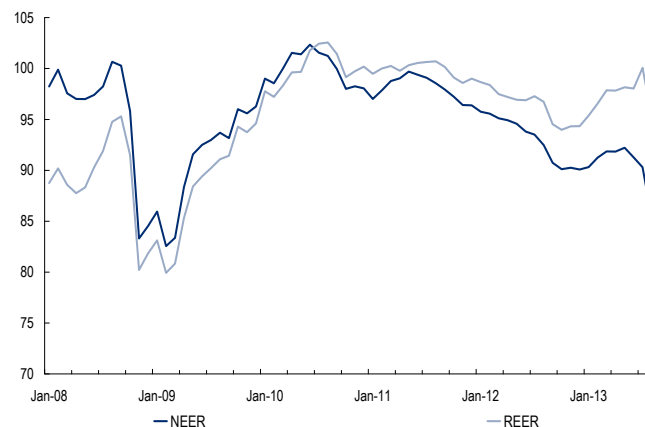
**Policy implication: September rate hike probably not the last.** Year to date, the BI rate and FasBI rate have been raised by 150bps, while the repo rate has only been increased by 50bps. Policymakers have been mindful of financial sector stability, in regard to previous experiences whereby liquidity can move towards larger banks during volatile times. Yet in spite of this, anecdotally we sense that the degree of risk aversion among banks so far has not been as high as in 2008. From current levels of 5.75% and 7.25% in the FasBI and BI rates, we expect another 2 x 25bps policy rate hikes in 4Q13 and 1Q14, bringing the total rate hike in the cycle to 200bps. This will come along with further intensification of macro-prudential measures to slow loans growth to high-import sectors e.g. property.

Figure 46. GDP growth is decelerating



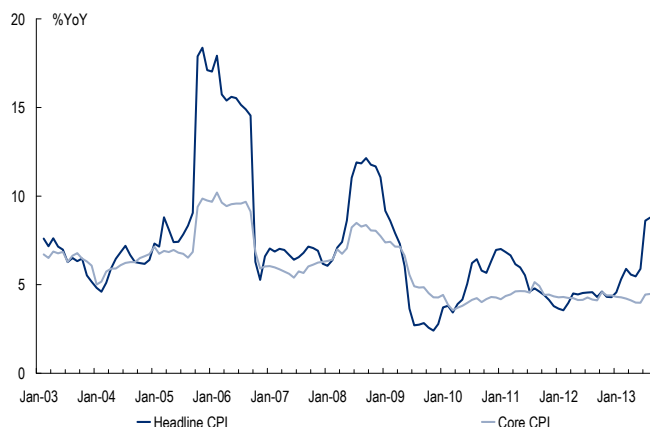
Source: CEIC, Citi Research

Figure 47. IDR has started to weaken on a trade weighted basis



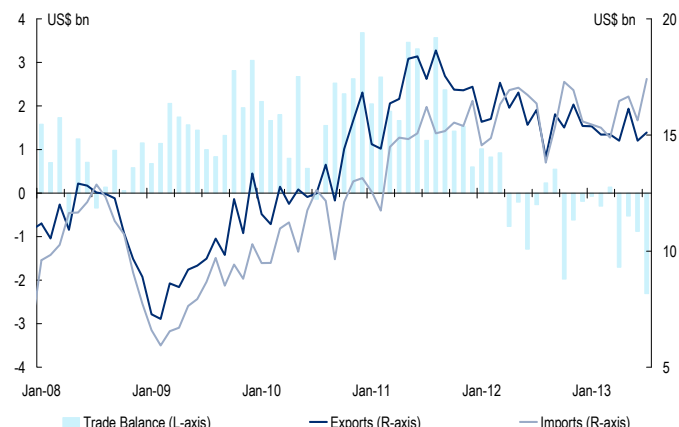
Source: CEIC, Citi Research

Figure 48. Headline inflation jumped, but rise in core has been milder



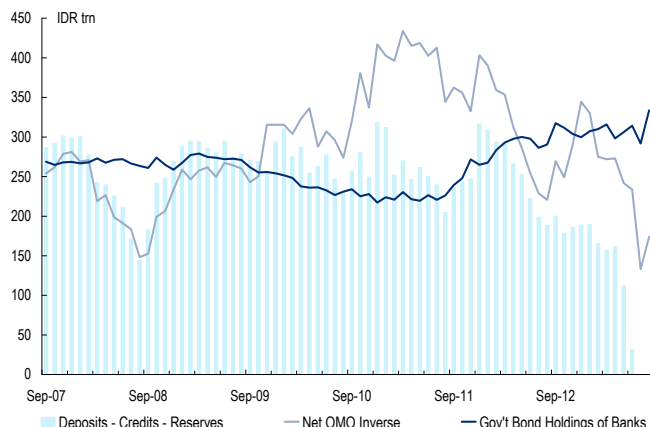
Source: CEIC, Citi Research

Figure 49. Record trade deficit in Jul



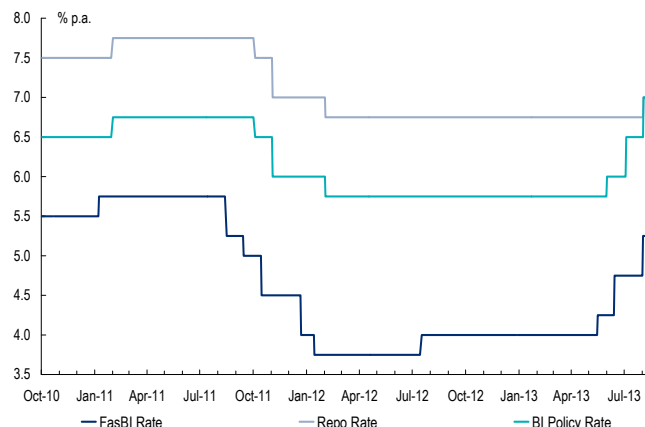
Source: CEIC, Citi Research

Figure 50. Pool of excess liquidity has been shrinking



Source: CEIC, Citi Research

Figure 51. BI rate has been raised 150bps in the cycle



Source: CEIC, Citi Research

Figure 52. Indonesia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	364.4	432.2	510.7	538.6	709.5	845.8	878.3	898.5	915.7
Nominal GDP, local currency bn	3,339,217	3,950,893	4,948,688	5,606,203	6,446,852	7,422,781	8,241,864	9,365,180	10,621,769
GDP per capita, US\$	1,636	1,915	2,235	2,328	2,986	3,486	3,596	3,645	3,672
Population, mn	222.8	225.6	228.5	231.4	237.6	242.6	244.2	246.5	249.4
Unemployment, % of labour force	10.3	9.1	8.4	7.9	7.1	6.6	6.1	5.9	5.9
<b>Economic Activity</b>									
Real GDP, % yoy	5.5	6.3	6.0	4.6	6.2	6.5	6.2	5.7	5.3
Real investment growth % yoy	1.3	1.9	12.4	2.4	8.8	10.5	16.9	4.5	3.5
Real consumption growth % yoy	3.9	4.9	5.9	6.2	4.1	4.5	4.8	4.7	4.9
private consumption growth % yoy	3.2	5.0	5.3	4.9	4.7	4.7	5.3	5.0	4.7
Real export growth, % yoy	9.4	8.5	9.5	-9.7	15.3	13.6	2.0	4.2	6.0
Real import growth, % yoy	8.6	9.1	10.0	-15.0	17.3	13.3	6.6	0.6	4.1
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	6.6	5.8	11.1	2.8	7.0	3.8	4.3	9.2	4.9
CPI, % avg	13.1	6.3	9.9	4.8	5.1	5.4	4.3	7.2	6.6
Nominal wages, % yoy	6.3	4.2	7.6	5.3	12.2	3.4	12.7	28.0	15.0
Credit extension to private sector, % yoy	12.1	22.4	30.7	18.0	20.6	25.9	22.1	18.0	16.0
Policy interest rate, % eop	4.75	3.00	8.75	6.00	5.50	4.50	4.00	5.75	6.00
1 month inter-bank rate, % eop	5.75	3.35	9.44	6.39	5.66	4.57	4.24	6.65	6.90
Long term yield, % eop	10.18	10.02	11.92	10.07	7.83	6.05	5.39	8.50	8.00
lc/US\$, eop	8994	9393	10900	9425	9010	9068	9638	10438	10375
lc/US\$, avg	9171	9140	9673	10376	9078	8763	9361	10135	10462
<b>Balance of Payments, US\$ bn</b>									
Current account	10.9	10.5	0.1	10.6	5.1	1.7	-24.4	-31.3	-24.6
% of GDP	3.0	2.4	0.0	2.0	0.7	0.2	-2.8	-3.5	-2.7
Trade balance	29.7	32.8	22.9	30.9	30.6	34.8	8.6	2.2	5.5
Exports	103.5	118.0	139.6	119.6	158.1	200.8	188.5	178.1	192.8
Imports	73.9	85.3	116.7	88.7	127.4	166.0	179.9	175.9	187.3
Service balance	-9.9	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-10.1	-9.6
Income balance	-13.8	-15.5	-15.2	-15.1	-20.8	-26.7	-26.7	-25.3	-24.0
FDI, net	2.2	2.3	3.4	2.6	11.1	11.5	14.0	12.0	11.0
International reserves	42.6	56.9	51.6	66.1	96.2	110.1	112.8	90.9	84.9
Total Amortisations	16.4	18.8	16.7	20.4	24.0	25.1	40.3	41.0	42.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.9	-1.3	-0.1	-1.6	-0.7	-1.1	-1.9	-2.1	-1.8
Consolidated gov primary balance	1.5	0.8	1.7	0.1	0.6	0.1	-0.6	-1.1	-0.2
Public debt	39.6	34.1	29.3	31.4	26.4	23.6	23.6	25.0	26.0
of which Domestic	22.6	19.7	16.2	19.3	16.7	15.5	16.1	15.6	15.6
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	132.6	141.2	155.1	172.9	202.4	225.4	252.4	270.0	297.0
Private	56.8	60.6	68.5	73.6	83.8	106.7	126.2	131.5	155.0
Public	75.8	80.6	86.6	99.3	118.6	118.6	126.1	138.5	142.0
External debt / GDP	36.4	32.7	30.4	32.1	28.5	26.6	28.7	30.1	32.4
External debt / XGS	115.3	108.2	100.1	130.2	115.8	101.8	119.3	133.7	136.4
Short-term debt	12.2	18.7	20.5	24.0	31.6	36.6	43.4	44.0	47.0
Short-term debt/International Reserves (%)	28.7	32.8	39.7	36.4	32.8	33.2	38.4	48.4	55.4
<b>Quarterly Economic Indicators</b>									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	6.0	5.8	5.5	5.6	5.2	5.1	5.3	5.6	5.4
CPI, % yoy	5.9	5.9	9.0	9.2	7.8	7.7	5.1	4.9	5.2
Policy interest rate, % eop	4.00	4.25	5.50	5.75	6.00	6.00	6.00	6.00	6.00
1 month inter-bank rate, % eop	4.18	4.45	6.40	6.65	6.90	6.90	6.90	6.90	6.90
Long term yield, % eop	5.74	7.21	8.25	8.50	8.25	8.25	8.00	8.00	8.00
lc vs USD, eop	9718	9925	10362	10438	10512	10516	10445	10375	10306

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

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

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## Malaysia

- **Summary view** – An export-led recovery in 3Q GDP suggests the CA surplus could stabilize at 1-1.5% of GDP. Fuel price hikes should push inflation to above 3% by 2H14, and we tentatively expect BNM to hike 50bps starting 2Q14.
- **Things to watch** – (1) UMNO General Assembly; (2) Fiscal reforms in the Oct 25<sup>th</sup> Budget; (3) Deferral of public sector projects; (4) Sept CPI.
- **Strategy** – Amidst Fed taper delay, CA stabilization, likely reforms in the Budget and some fall in foreign MGS holdings to 42.8% of outstanding (from a peak of 49.5% in May), we turn more neutral on the MYR near term.

### Strong start to 3Q GDP

**Jul-Aug data hint at strong start to 3Q GDP on manufacturing restocking.** Corroborating a strong 5.2%MoM SA (Jun: -1.7%) rise in exports, Jul IP rose 1.9%MoM SA (Jun: 0.5%) led by Manufacturing on Petroleum, Chemical, Rubber and Plastic Products; Food, Beverages and Tobacco, and Transport Equipment and Other Manufactures; as well as Electrical & Electronics (E&E). These offset sequential declines in Mining and Electricity IP. Overall, Jul headline and manufacturing IP seasonally-adjusted levels are now 2.1% and 1.7% above the 2Q13 averages respectively, though Mining and Electricity IP levels at 0.9% and 0.4% below 2Q13 could provide small drags. Jul-Aug Bursa Malaysia turnover volumes remain elevated while the decline in gross fundraising in capital markets eased sharply in Jul, suggesting a boost from financial services, while outstanding loans to the construction sector have been climbing since the start of the year.

**Signs of re-stocking in E&E.** E&E production rose sequentially for the first time in three months, confirming the sequential gain in Jul E&E exports, which we estimate rose 5.3%MoM SA in Jul. Jul seasonally-adjusted E&E IP levels are 1.8% above the 2Q13 average. Tech indicators also remain fairly supportive – in Jul, 4 out of 9 tech indicators showed MoM increases while 2 out of 3 available tech indicators for Aug expanded. There are also further signs of re-stocking in anticipation of further pick-up in exports for 2H13.

**3Q GDP growth of above 5% looks possible.** Overall, the turnaround in Jul IP and trade data substantiates BNM's slightly more confident assessment of the external environment in the Sept MPC statement, and is also consistent with earlier signals of a bottoming in exports from the surge in intermediate goods imports in 2Q. With the positive Jul IP and trade data, 3Q GDP growth of 5%YoY looks possible, supported by export-led manufacturing re-stocking. With election uncertainties behind us, a post-election rebound in housing and construction activities also is likely, as housing approvals for construction by private developers (leading indicator) rebounded strongly in May-Jun, after falling to 4-year low in Apr.

**CA surplus could improve marginally in 3Q in line with better exports,** but full year 2013 surplus will likely still be substantially narrower at 2.7% of GDP (2012: 5%). The magnitude of any improvement will likely be capped by still robust domestic demand and capital goods imports. A key development to watch would be the deferring of public sector construction projects with high import content, which could be announced in the Budget and may reduce the sensitivity of imports to domestic demand. Together with a substantial fall in foreign MGS holdings to 42.8% of outstanding and a delay in Fed tapering, we turn near term neutral on the MYR.

## Bringing forward rate hikes amidst subsidy cuts

### **Inflation could approach 3% by early 2014 after Sept fuel price hike**

Notwithstanding the lower than expected Aug headline CPI inflation print of 1.9% (consensus: 2.0%), core inflation ticked up to 1.3% YoY (Jul 1.2%). The 20sen/litre hikes in RON95 and diesel prices in early Sep should impute a direct 0.6%MoM shock to Sep CPI. But taking cue of the second round effects from the Jun 2008 80sen/litre hike and adjusting proportionately, we think the overall impact could be larger at 0.9%MoM. Hence Sep CPI inflation could rise to 2.6% YoY and further second-round effects could push inflation figure to approach 3% by early 2014

**We tentatively bring forward our rate hike forecast to 2Q14 for now (prev: 2H14),** though this is contingent upon a number of assumptions. Apart from the magnitude of the Sept fuel price hike inflation impact and the extent of second round price effects, our interest rate path is also dependent on the timing of further subsidy rationalization – we assume another two 10sen RON95 fuel price hikes in June and December next year. While the Sept MPC statement took a less dovish tone, we suspect the MPC is in no hurry to hike – the external environment has yet to turn convincingly, and with inflation hovering around 3% in 1H14, the current 3% OPR would still not turn negative in real terms through 1H14. To prevent the real OPR rate from turning negative, we however expect BNM to hike in 2Q14 in anticipation of a further RON95 price hike in Jun 2014 which would push headline inflation decisively above 3%. The MPC will likely be watching the Sept CPI figure and the Budget announcement on further price hikes for greater clarity on the inflation profile going forward before making a decision on rate hikes

## Oct 25<sup>th</sup> Budget focused on fiscal reform

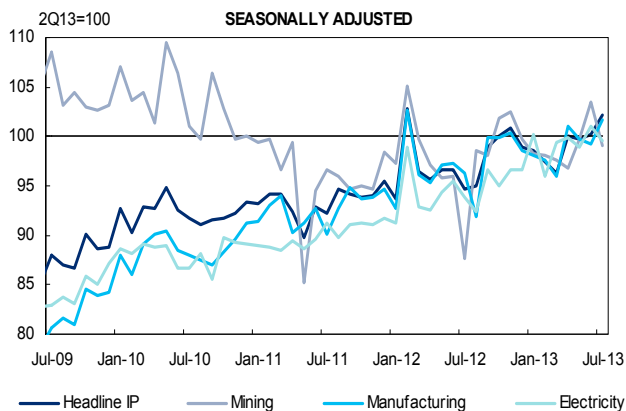
**With Najib's position as UMNO president unchallenged, the overriding priority of the Budget will be to fend off the threat of credit rating downgrades.** The 2013 fiscal deficit will likely come in at 4.2% of GDP, slightly above the Budget target of 4%, as revenue overshoots may be insufficient to cover election related operating expenditure overshoots. In line with the target of cutting the deficit to 3% of GDP by 2015, the 2014 deficit target could be cut to 3.5% of GDP, assuming efficiency gains in corporate and personal tax collections, cuts in fuel subsidies and development expenditure

**Given the political sensitivities, GST will likely be initially implemented after 14 months at a rate of 4-5% and with exemptions of essential items.** As GST will replace the 5% sales and service tax, the net fiscal impact in 2015 will be only around RM3-5bn. Given the minimal net revenue impact from 4-5% GST rate, and given pressure on sovereign ratings, personal tax cuts could be deferred for now.

**Fuel subsidy rationalization timeline and BR1M details to be announced.** A timetable closer to the original Pemandu plan for hikes of around 10sen/litre every six months is likely, starting in Jun 2014. To offset the impact on the lower income groups, BR1M handouts will likely be increased. Our sense is that BR1M handouts could be around RM2bn, and with the earlier 20sen/litre hike generating RM3.3bn of savings, further fuel price hikes in 2014 are likely for savings to be meaningful.

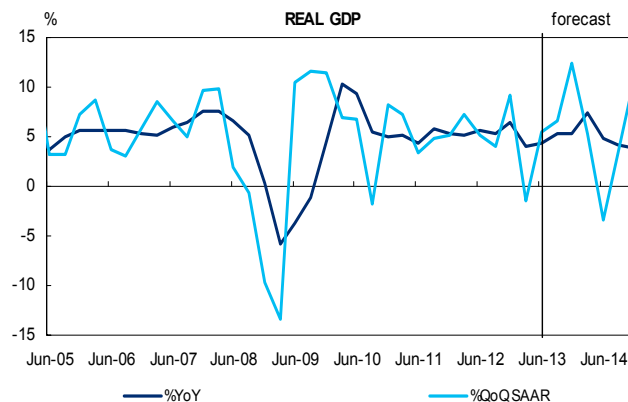
**We also expect hikes in sin taxes with further property tightening measures** on the demand side – including RPGT and/or credit measures could be announced to curb speculative demand. However, given the supply shortage, demand side measures are more likely politically expedient rather than economically effective.

Figure 53. Strong start to 3Q GDP on manufacturing restocking



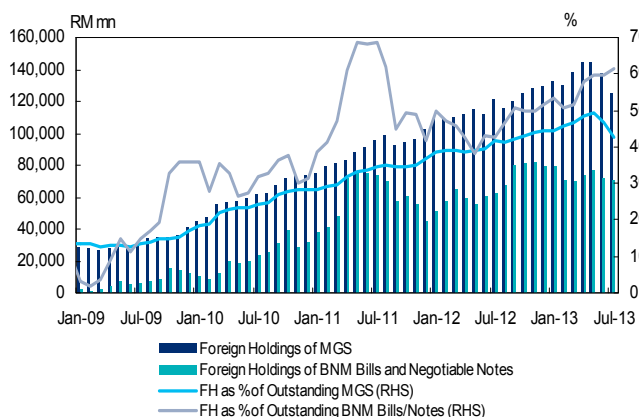
Source: CEIC, Citi Research

Figure 54. 3Q GDP growth of above 5% looks possible



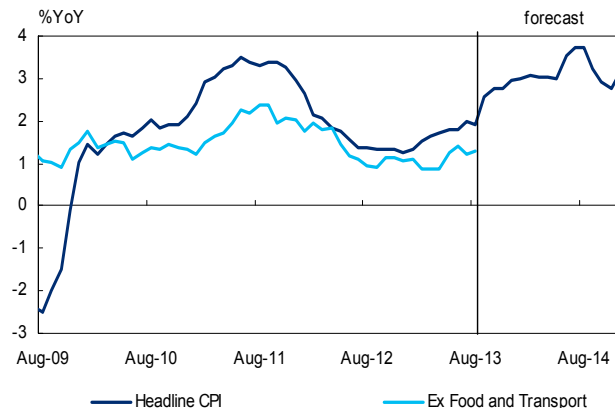
Source: CEIC, Citi Research

Figure 55. Foreign MGS holdings have fallen to 42.8% of outstanding



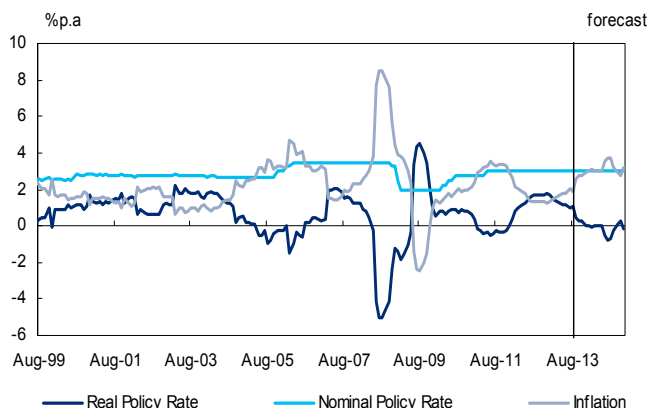
Source: CEIC, Citi Research

Figure 56. Inflation could approach 3% by early 2014



Source: CEIC, Citi Research

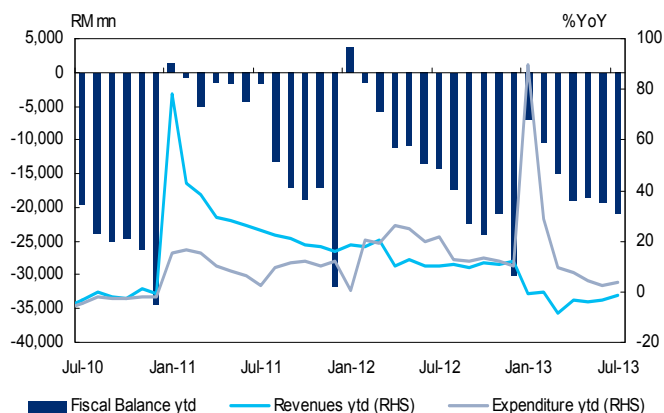
Figure 57. Real OPR would turn negative in 2Q14 unless rates are hiked



Source: CEIC, Citi Research

Note: The chart shows the real OPR if rates are not hiked (our forecast is for a hike in 2Q14). Prior to April 2004, BNM used the Intervention Rate to affect the Base Lending Rate; however since Apr 2004 it has used the Overnight Policy Rate.

Figure 58. Revenue overshoots may be insufficient to cover spending



Source: CEIC, Citi Research



Figure 59. Malaysia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	162.8	193.7	231.1	202.4	247.7	289.3	305.0	313.1	328.9
Nominal GDP, local currency bn	597	665	770	713	797	884	941	986	1,059
GDP per capita, US\$	6,067	7,123	8,393	7,255	8,664	9,987	10,398	10,472	10,783
Population, mn	26.8	27.2	27.5	27.9	28.6	29.0	29.3	29.9	30.5
Unemployment, % of labour force	3.3	3.2	3.3	3.7	3.2	3.1	3.0	2.9	2.9
<b>Economic Activity</b>									
Real GDP, % yoy	5.6	6.3	4.8	-1.5	7.4	5.1	5.6	4.8	5.0
Real investment growth % yoy	8.6	9.1	1.8	-9.4	25.3	2.3	22.3	10.6	4.6
Real consumption growth % yoy	6.4	9.7	8.4	1.4	6.2	8.6	7.1	6.0	4.8
private consumption growth % yoy	6.6	10.4	8.7	0.6	6.9	6.8	7.7	7.0	6.2
Real export growth, % yoy	6.7	3.8	1.6	-10.9	11.1	4.6	-0.1	-1.4	4.3
Real import growth, % yoy	8.2	5.9	2.3	-12.7	15.6	6.1	4.7	0.8	3.9
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.1	2.3	4.5	1.0	2.1	3.0	1.2	3.0	3.2
CPI, % avg	3.6	2.0	5.4	0.6	1.7	3.2	1.6	0.0	0.0
Nominal wages, % yoy	2.1	4.3	4.5	2.5	8.2	3.8	6.4	5.0	5.0
Credit extension to private sector, % yoy	6.8	9.2	10.2	6.8	10.9	12.4	12.1	11.0	11.0
Policy interest rate, % eop	3.50	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50
3 month inter-bank rate, % eop	3.71	3.61	3.37	2.17	2.98	3.22	3.21	3.21	3.70
Long term yield, % eop	3.70	3.78	3.00	3.79	3.39	3.23	3.24	3.60	4.00
lc/US\$, eop	3.53	3.31	3.45	3.42	3.08	3.17	3.06	3.28	3.15
lc/US\$, avg	3.67	3.44	3.33	3.52	3.22	3.06	3.09	3.21	3.21
<b>Balance of Payments, US\$ bn</b>									
Current account	26.2	29.7	39.4	31.4	27.1	33.5	18.6	7.2	6.6
% of GDP	16.1	15.4	17.1	15.5	10.9	11.6	6.1	2.3	2.0
Trade balance	38.0	38.1	51.1	39.8	42.5	49.6	40.7	26.2	27.0
Exports	161.5	176.5	198.9	157.0	199.2	228.8	227.9	236.2	242.0
Imports	123.5	138.5	147.7	117.1	156.7	179.2	187.2	210.0	215.0
Service balance	-2.6	0.4	0.5	1.2	-0.4	-2.1	-4.5	-1.0	-3.0
Income balance	-9.3	-8.7	-12.2	-9.6	-15.0	-14.0	-17.6	-18.0	-17.4
FDI, net	0.0	-2.7	-7.8	-6.3	-4.3	-3.1	-7.0	-2.0	-1.0
International reserves	82.5	101.3	91.5	96.7	106.5	133.6	139.7	151.0	157.0
Total Amortisations	5.3	7.8	6.3	9.8	11.3	9.0	9.3	10.0	10.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-3.2	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-4.2	-3.5
Consolidated gov primary balance	-1.1	-1.2	-3.0	-4.7	-3.5	-2.8	-2.4	-2.2	-2.2
Public debt	40.6	40.1	39.8	50.8	51.1	51.6	53.3	53.7	53.0
of which Domestic	36.4	37.1	37.2	48.9	49.0	49.5	51.5	52.0	51.5
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	52.0	56.2	66.6	68.3	72.6	81.5	82.8	94.7	98.5
Private	30.8	37.8	41.5	41.9	44.7	53.7	55.6	89.0	93.0
Public	21.2	18.4	25.2	26.3	27.9	27.8	27.1	5.7	5.5
External debt / GDP	32.0	29.0	28.8	33.7	29.3	28.2	27.1	30.2	29.9
External debt / XGS	28.5	27.4	29.0	36.9	31.4	30.7	31.1	33.9	34.3
Short-term debt	12.1	16.3	22.5	22.7	25.4	32.9	30.4	40.0	42.0
Short-term debt/International Reserves (%)	14.6	16.1	24.6	23.5	23.8	24.6	21.8	26.5	26.8
<b>Quarterly Economic Indicators</b>									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	4.1	4.3	5.4	5.3	7.5	4.8	4.2	3.8	5.1
CPI, % yoy	1.6	1.8	2.6	3.0	3.0	3.5	3.2	3.2	3.0
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.50	3.50
3 month inter-bank rate, % eop	3.21	3.20	3.21	3.21	3.20	3.45	3.70	3.70	3.70
Long term yield, % eop	3.22	3.20	3.35	3.60	3.70	3.80	3.90	4.00	4.10
lc vs USD, eop	3.09	3.16	3.30	3.28	3.26	3.23	3.19	3.15	3.11

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** – In Aug, we upgraded our 2013 GDP growth forecast to 7.3% due to stronger 1H growth (7.6%). Fiscal spending is still the primary catalyst. Weak PHP firmed up purchasing power of remittances. Weak consumer sentiment driven by higher inflation expectations and unemployment remains an issue.
- **Things to watch** – Whether primary spending eases on public outcry for scrapping of 'pork barrel' funds. Negative impact of Zamboanga city conflict on regional gains. Whether disinflation cycle ends in 3Q13 and corresponding BSP signals. BSP's sterilization bias likely to intensify and stall rapid PHP appreciation.
- **Strategy** – PHP in the 42.20 range by end-Dec on resilient but lower current account surplus, declining external debt stock and ratios, favorable growth momentum in 2H although not as robust, and end to disinflation cycle. Duration risk preference would be determined by end to disinflation and monetary signals.

### Identifying the spending catalysts and downside risks

**Our forecast of 2013 GDP growth of 7.3% rests largely on strong 1H13 growth (7.6%YoY) while assuming easing 2H gains (7%YoY).** Primary fiscal spending remains the undisputed growth catalyst as it posted 30%YoY growth in July. Government released Php1bn in Aug to support 175 project loans under the Social Housing Financing Corp's community mortgage program. Investigation of the Php10bn 'pork barrel scam' and the military conflict in Zamboanga city may be a distraction to fiscal spending although the latter event would suggest increased public spending particularly infra rehabilitation in the beleaguered city, when the conflict ends and stability returns. Real purchasing power of OFW remittances rose 7.5%YoY in July (vs +3.3%YoY in June)—a product of weak PhP and disinflation. Both these catalysts bode well for basic consumption and construction in 3Q13.

**Exports continue to post subdued gains in June-July that doesn't seem to bother manufacturing activity.** Exports grew 2.3%YoY in July following 4.1%YoY gain in June. We may be in the midst of mild export recovery particularly for tech exports since it has posted 5 straight seasonally adjusted monthly gains since Feb although the YoY comparison remains bland. Semi-con exports in July languished in negative territory (-12.6%YoY) while non, semi-con tech exports grew by 26.6%YoY with its uptrend intact. Non-tech exports eg ignition wiring sets, face base effects in 2H13 but expected monthly earnings could still fall in the high range of US\$1.7bn-US\$2bn. Despite mixed export readings, the mfg index grew by 12%YoY in July due to 11 out of 20 industries posting gains consistent with upbeat sales (+23%YoY). If the mfg trend for Jan-July remains intact, 2-digit gains may be in store for the index in 2H to confirm favorable domestic demand and a few export industries performing well, benefiting from real exchange rate weakness.

**Consumer sentiment retreating in 3Q coupled with an elevated jobless rate at 7.3% in July poses a challenge to prospects.** Job creation amounted to 620K but failed to lower the unemployment rate. Farm sector contributed 173K jobs with industrial jobs at 63K and services jobs at 384K. Mfg (-32K) and mining (-9K) shed jobs coincident with lackluster exports. Construction jobs of +96.5K remain lackluster compared to previous quarters' job creation (>100K). Consumer sentiment in 3Q13 fell to -7.9% from -5.7% in 2Q with a higher share of respondents (43.4%) expecting higher unemployment. Inflation expectations edged up to 7.9% from 7.5% in 2Q that may have been triggered by weak PHP. A lower share of survey respondents expects higher interest rates (30.6%) and PHP appreciation (3.6%).

## Expecting benign price upticks in Dec as disinflation ends

**CPI at 2.1%YoY in Aug may be the bottom of the disinflation cycle.** One potential upside risk – though more a one-off knock-on effect – is higher raw food CPI in Sep from logistical bottlenecks due to recent flooding in Metro Manila. Hefty fuel price adjustments recently exceeding PHP1/liter on average were undertaken due to the weak PHP and oil prices edging up due to geopolitical risks in Syria. Policymakers noted the ‘balance of risk to the inflation outlook shifted slightly toward the upside as oil prices have become more volatile amid ongoing Middle East geopolitical tensions’. A sustained softer oil price outlook may no longer be a safe assumption with the US and Japan’s prospects firming up, the Eurozone recession at an end and China’s Aug PMI surprising on the upside. BSP’s business sentiment survey flagged inflation expectations in excess of 3% in 4Q13 consistent with higher inflation expectations in the consumer survey. Our updated monthly extrapolation also indicated inflation of 2.7-2.8%YoY by Dec which, while benign, would be on an upswing. The macro backdrop may not be as robust as in 1Q13 but it could nurture a faster cost-push pass-through environment.

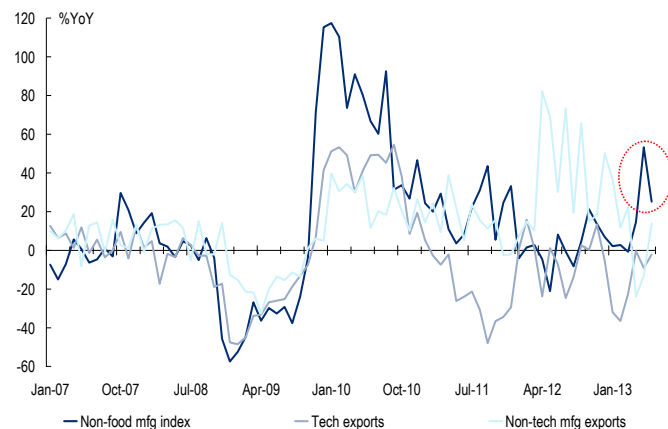
## Waning BSP losses enhanced its sterilization capacity

Compression of BSP’s losses (Php19bn as of July down 61%YoY) implies a stronger sterilization capacity. BSP can intervene materially in the spot market and neutralize liquidity created by its forex operations particularly on USD buying without resulting in significant costs. Having a positive bottom line after monetary operations is ideal for any central bank, though this ideal has to be neither pursued aggressively nor prioritized over inflation and monetary stability. Even with modest losses, BSP is better poised now to manage the exchange rate post-FOMC’s non-tapering decision which has already spawned EM currency rallies against USD. Costs associated with FX/monetary operations should not be significant, unlike those incurred in 2011-12. Between FX losses & sterilization costs, we believe the latter remains key to ensuring financial pressures do not handicap BSP’s FX operations and monetary management. BSP’s FX losses associated with FX rate fluctuations are paper losses while interest expenses in servicing SDA and its forward book result in actual payments which could lead to money creation, if not erode BSP’s retained cash holdings. Between a lower SDA rate and collapsed SDA balances, the latter would have a larger impact on BSP’s interest expense. A plot of both variables indicated declining SDA yields (from 7.74% in 2006 to 3.58% in 2012) against rising SDA balances. This pattern resulted in waning BSP income prior to FX losses in 2011, only to deteriorate to a net loss of Php45bn in 2012.

## Expecting PHP at 42 in 0-3 months

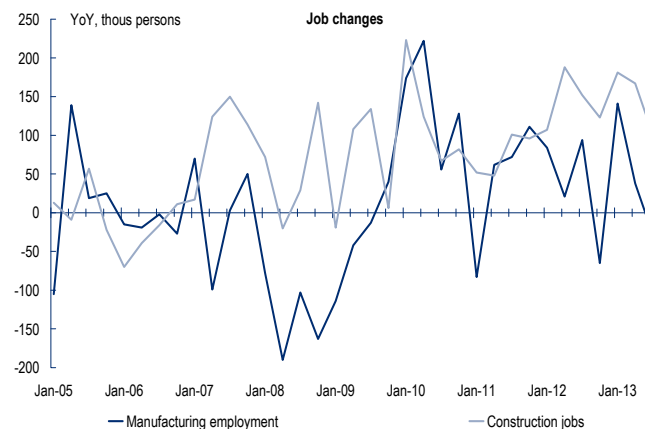
**Despite the Fed taper risk in 4Q13, we believe the following factors underpin a stronger PHP average at 42.20 by YE 2013:** Current account surplus likely intact due to resilient remittance flows, domestic demand upbeat although not as robust, declining external debt stock and ratios that affirm less dependence on external funding, and end to disinflation cycle. These factors also underpin Moody’s credit rating upgrade event in 4Q13. Net debt repayments and negative revaluations due to a weak JPY led to US\$3.2bn contraction in the external debt stock to US\$58bn as of end-June (21.8% of GDP). Declining stock and ratio of external debt confirms limited dependence of the domestic economy on external financing for imports and growth while there’s abundant ‘bottled up’ onshore liquidity that can be availed of for working and investment capital at affordable rates. BSP may relent to USD’s retreat with an end to the disinflation cycle. PHP’s recent rally to 43.05 with QE3 still in place firmed up bond market sentiment. Duration risk preference would be determined by disinflation cycle ending and monetary tightening signals to follow.

Figure 60. Correlation of non-food mfg with tech exports persisted



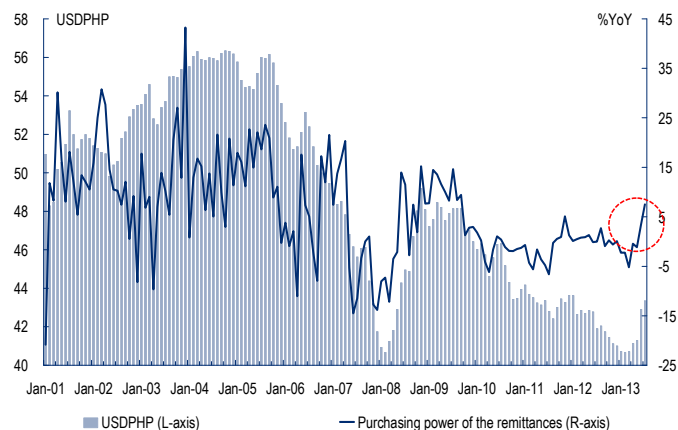
Source: CEIC, Citi Research

Figure 61. Construction jobs were <100K in Jul while mfg jobs declined



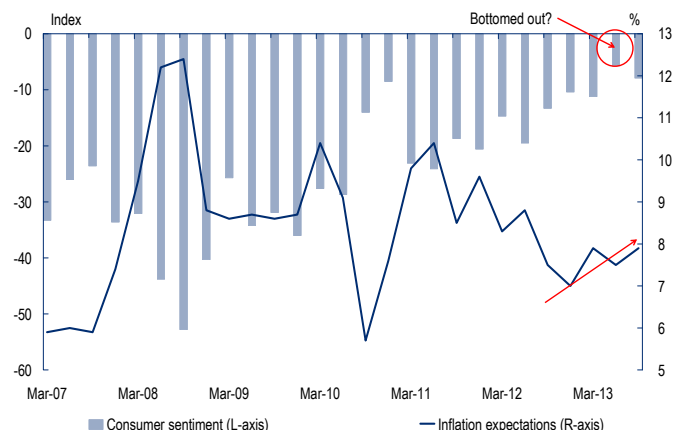
Source: CEIC, Citi Research

Figure 62. Real appreciation strengthened peso value of remittances



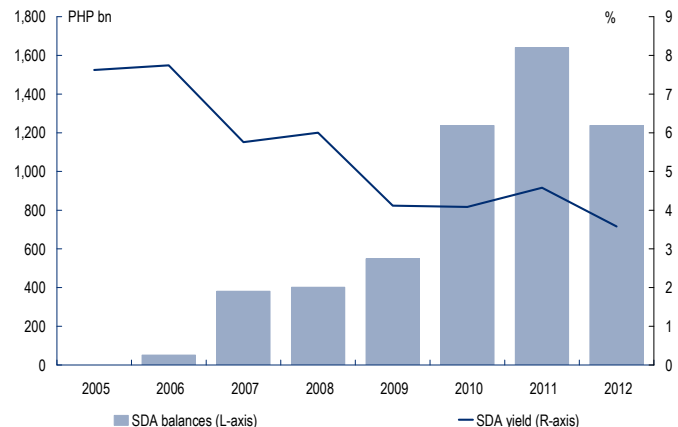
Source: CEIC, Citi Research

Figure 63. Rising inflation outlooks weighed on consumer sentiment



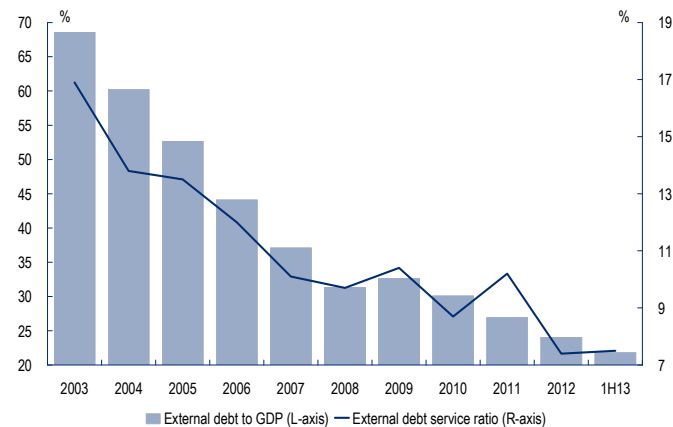
Source: BSP, CEIC, Citi Research

Figure 64. BSP's financial losses driven by expanding SDA balances



Source: CEIC, Citi Research

Figure 65. Declines in the external debt stock and ratios in June



Source: CEIC, Citi Research

Figure 66. Philippines Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	122.4	150.2	173.4	168.6	200.0	224.1	250.5	274.1	303.3
Nominal GDP, local currency bn	6,271	6,893	7,721	8,026	9,003	9,706	10,565	11,636	12,834
GDP per capita, US\$	1,408	1,693	1,917	1,829	2,127	2,339	2,567	2,759	2,999
Population, mn	87.0	88.7	90.5	92.2	94.0	95.8	97.6	99.4	101.2
Unemployment, % of labour force	8.0	7.3	7.4	7.5	7.3	7.0	7.0	6.5	6.0
<b>Economic Activity</b>									
Real GDP, % yoy	5.2	6.6	4.2	1.1	7.6	3.6	6.8	7.3	6.9
Real investment growth % yoy	-15.1	-0.5	23.4	-8.7	31.6	2.0	-3.2	18.7	7.8
Real consumption growth % yoy	4.9	4.9	3.3	3.3	3.4	5.2	7.3	6.7	6.3
private consumption growth % yoy	4.2	4.6	3.7	2.3	3.4	5.7	6.6	5.7	6.0
Real export growth, % yoy	12.6	6.7	-2.7	-7.8	21.0	-2.8	8.9	-3.8	3.1
Real import growth, % yoy	3.5	1.7	1.6	-8.1	22.5	-1.0	5.3	-0.6	2.5
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	4.3	3.9	8.0	4.3	3.6	4.2	3.0	2.7	3.5
CPI, % avg	6.3	2.8	9.3	3.2	4.1	4.7	3.2	2.7	3.2
Nominal wages, % yoy	7.7	3.4	5.5	0.0	5.8	5.4	7.0	6.5	6.0
Credit extension to private sector, % yoy	9.0	10.6	12.8	4.3	13.8	15.8	14.4	11.3	15.0
Policy interest rate, % eop	7.50	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.50
1 month Philippine Reference rate, % eop	6.35	6.03	5.20	4.11	0.75	1.68	-1.38	0.50	2.75
Long term yield, % eop	5.99	5.70	6.55	6.25	4.78	4.21	3.70	3.25	4.00
lc/US\$, eop	49.05	41.23	47.47	46.50	43.65	43.84	41.06	43.34	41.65
lc/US\$, avg	51.28	46.05	44.48	47.56	45.06	43.29	42.22	42.80	42.19
<b>Balance of Payments, US\$ bn</b>									
Current account	5.3	7.1	3.6	9.4	8.9	7.0	7.1	10.0	10.1
% of GDP	4.4	4.7	2.1	5.5	4.5	3.1	2.8	3.6	3.3
Trade balance	-9.0	-10.4	-14.4	-9.7	-12.3	-17.0	-15.2	-12.8	-14.0
Exports	32.4	34.1	35.2	29.8	37.6	38.3	46.3	48.2	51.6
Imports	41.4	44.4	49.5	39.4	49.9	55.2	61.5	61.0	65.6
Service balance	2.4	4.2	2.6	2.9	4.1	5.3	3.9	3.3	3.3
Income balance	11.9	13.3	15.4	16.1	17.2	18.7	18.4	19.0	20.4
FDI, net	-2.8	0.6	-1.3	-1.6	-0.7	-1.3	-1.0	2.0	3.0
International reserves (ex-gold)	23.0	33.8	37.6	44.2	62.4	75.3	83.8	88.0	93.5
Total Amortisations	9.4	6.3	8.2	6.4	9.5	7.3	8.5	9.3	9.7
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-1.0	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-2.3	-2.0
Consolidated gov primary balance	3.9	3.7	2.6	-0.2	-0.2	0.8	0.7	0.7	1.0
Public debt	61.4	53.9	54.7	54.8	52.4	51.0	51.5	50.0	49.5
of which Domestic	34.3	31.9	31.3	30.8	30.2	29.6	32.8	32.5	32.0
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	53.9	55.5	54.3	54.9	60.0	60.4	60.3	65.0	68.7
Private	16.5	17.5	13.7	11.6	13.9	14.1	15.2	17.0	21.2
Public	37.4	38.0	40.6	43.2	46.2	46.4	45.2	48.0	47.5
External debt / GDP	44.0	36.9	31.3	32.5	30.0	27.0	24.1	23.7	22.6
External debt / XGS	131.0	120.9	117.0	131.8	113.3	107.7	93.0	96.0	95.5
Short-term debt	5.0	7.1	7.0	4.0	6.3	7.0	8.5	10.5	11.8
Short-term debt/International Reserves (%)	21.8	21.0	18.6	9.0	10.1	9.3	10.1	11.9	12.6
<b>Quarterly Economic Indicators</b>									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	7.7	7.5	6.9	7.1	6.8	7.3	7.0	6.6	6.5
CPI, % yoy	3.2	2.7	2.2	2.6	2.8	3.1	3.3	3.5	3.6
Policy interest rate, % eop	3.50	3.50	3.50	3.50	3.75	4.25	4.50	4.50	4.50
1 month Philippine Reference rate, % eop	-0.36	0.26	-1.00	0.50	1.25	1.50	2.00	2.75	2.75
Long term yield, % eop	2.93	2.80	3.00	3.25	3.50	3.75	4.00	4.00	4.00
lc vs USD, eop	40.85	43.10	43.91	43.34	42.79	42.33	41.99	41.65	41.31

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

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

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## Singapore

- **Summary view** – Upside growth surprises and downside inflation surprises (though bottomed) leave little reason to change MAS policy. Domestic disinflationary risks will likely be tackled largely with non-monetary measures, unless triggered by a broader macro downturn.
- **Things to watch** – (1) Near-term export momentum, especially electronics; (2) trajectory of COE premiums which could influence headline; (3) housing market developments; (4) labour market developments; (5) household leverage.
- **Strategy** – The upward trajectory of core inflation amidst a delay in Fed tapering would favour the NEER staying in the upper half of the policy band near term. With the Fed still expected to start tapering by Dec, we would be cautious in chasing the recent rally in 10Y SGS.

### Upside surprises in GDP levels despite 3Q pullback

**Since Apr, 1H13 growth has been better than expected**, led by stronger than expected G3 (and more recently Chinese) demand offsetting weaker demand from Asia, amid MAS's upbeat assessment of G3 and IT demand in its latest *Recent Economic Developments* released on Sep 5<sup>th</sup>. While the MAS expects only a "mild expansion" path in 2H13 after "strong" growth in 1H13, the full-year growth forecast was upgraded to 2.5-3.5% in Aug, from 1-3% previously.

**Thus, GDP levels are higher than implied in MAS's Apr expectations of a "gradual" recovery.** Despite an expected sequential deceleration in 2H13 to just -5.0 to 0%QoQ SAAR on average implied by the new full-year GDP forecast range of 2.5-3.5%, the stronger than expected growth in 2Q13 implies that the *level* of economic activity has been higher – and could stay higher – than that expected in Apr. Qualitatively, MAS's Sep 5<sup>th</sup> assessment of the domestic economy is also more upbeat than in Apr.

**Overall, despite a likely pullback in 3Q13 GDP at 1-2%QoQ SAAR, this comes from elevated levels in 2Q.** Up to Aug, NODX has seen two straight months of sequential decline, bringing average Jul-Aug seasonally-adjusted NODX to 3.5% below average 2Q levels; Jul IP also contracted sequentially to 2.7% below 2Q levels. But even this sequential contraction would still put 3Q GDP levels higher than the earlier forecast range of 1-3%. Further considering the possibility that GDP levels may overshoot the official forecast if 4Q GDP rebounds, this would suggest that GDP levels in 2H13 could be higher than initially anticipated. This should keep the output gap positive with the labour market still tight into early 2014.

### Historical inflation downside surprises (have bottomed)

**Headline inflation has been lower than expected since Apr.** With 1H13 inflation already at 2.8%, 2H13 inflation would have had to average 3.2% to hit the lower end of MAS's previous forecast range of 3-4% – a highly unlikely scenario – culminating in a 1%pt cut in the forecast to 2-3% in Jul. With the new lower bound of the MAS forecast range implying 2H13 inflation of just 1.2% and with Jul-Aug inflation already averaging 1.9%YoY, assuming a gradual rise in private road transport prices for the rest of the year, we expect full-year headline inflation to fall in the middle of the forecast range at 2.5%.



**Meanwhile MAS core inflation has been largely within Apr expectations.** 1H13 core averaged 1.6%, consistent with the MAS's expectation for core to stay "slightly above 1.5%", while Jul-Aug core averaged 1.7%, still within the expectations to rise to around 2% by the end of the year. ,

### **...Leave little reason to change MAS Policy**

**Two conditions have to be met before the MAS would ease policy.** First, realized *historical* inflation data must surprise on the downside relative to MAS's earlier expectations. Second, there must be strong reasons for the MAS to downgrade its *forward*-looking inflation forecast, including a sharper than expected growth contraction that causes the output gap to turn negative. Similar to the situation in Apr, while the first condition of historical disappointments has been met for headline inflation, the second condition has not been met, with a likely rise especially in core inflation in line with Apr expectations.

**While the first condition has been met, the second has not and thus MAS could stand pat in Oct.** Even as pressures from housing prices and COE remain under control, core inflation could climb to 2-2.5% in 2014, partly driven by cyclical output gap dynamics but also possibly the lagged impact of recent SGD weakness on import prices. Despite the cut in MAS's inflation forecast on historical downside surprises, aiming for downside inflation surprises relative to upwardly biased inflation forecasts appears to be part of MAS's strategy to anchor inflation expectations and thus should not trigger policy easing. While we expect core inflation to rise to 2-2.5% by early 2014 on the cyclical expansion, this rise is expected and still falls within the range of MAS (higher) tolerance thresholds. Alongside near term disinflationary forces from softer housing rentals, headline inflation should stay at 2-2.5% range through early 2014. Out of ten episodes when inflation forecasts were lowered since 2001, MAS only eased in four and even tightened in one.

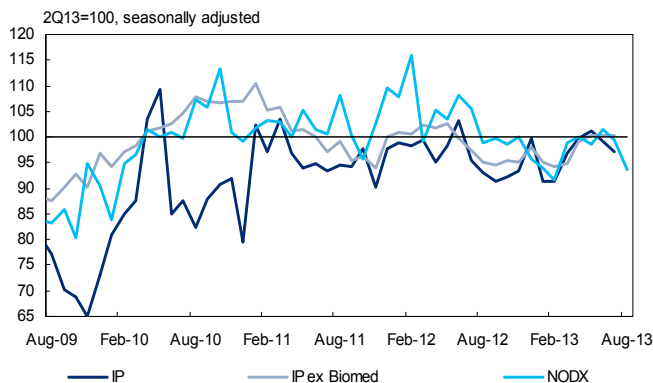
### **Medium-term domestic disinflationary risks**

**We see three potential sources of medium-term disinflationary or even deflationary risks** that need to be watched. [1] Cost competitiveness strains and supply constraints from economic restructuring could potentially temper the pace of recovery and core inflation as FDI slows and the SME sector consolidates. [2] Significant pipeline of housing supply from 2014 onwards may pressure property prices and rentals downwards. [3] Deleveraging in certain over-indebted segments of households could slow consumption spending, especially when interest rates rise (likely in 2015).

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

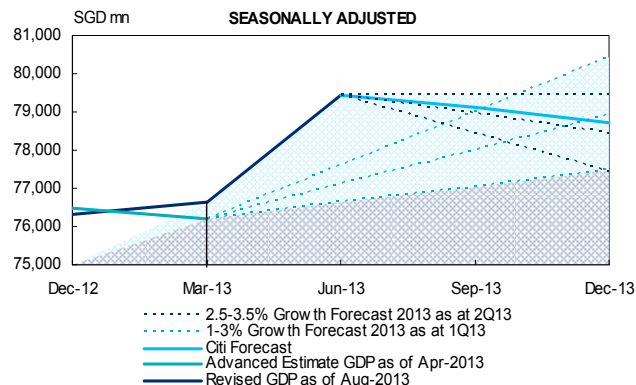


Figure 67. Despite a likely pullback in 3Q13 GDP...



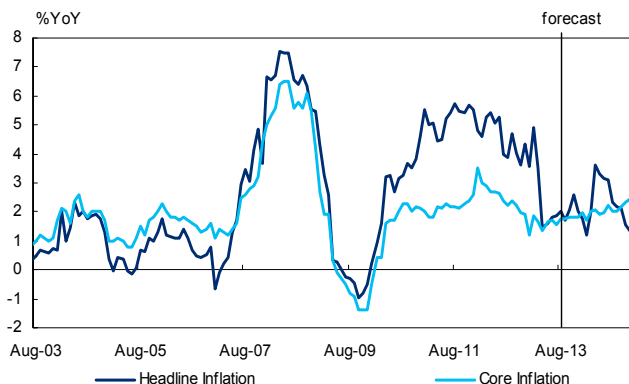
Source: CEIC, Citi Research

Figure 68. ...this comes from elevated levels in 2Q



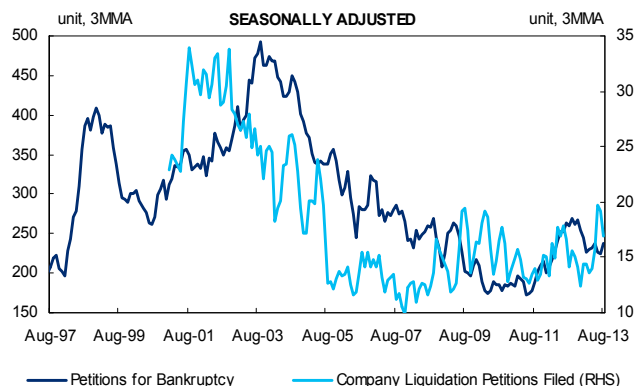
Source: CEIC, MTI, Citi Research. Note: MAS had projected 1-3% full-year 2013 growth as of Apr-2013 – we estimate the implied 1Q13 GDP levels based on GDP data as of 4Q12 adjusted by 1Q13 Advance Estimates. GDP data was subsequently revised as of 2Q13 and we estimate the implied straight-line GDP level projections to achieve the revised 2.5-3.5% full-year growth target in 2013.

Figure 69. Core inflation likely remains on an upward trajectory



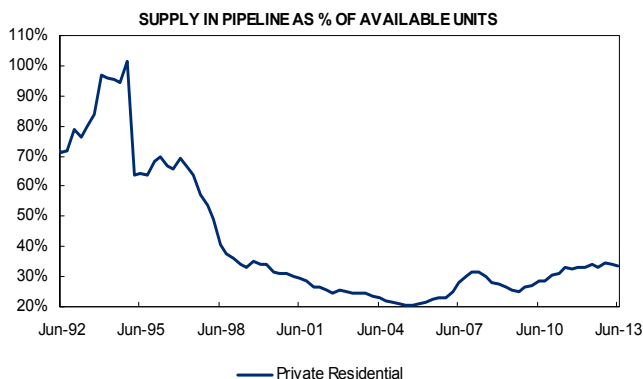
Source: CEIC, Citi Research

Figure 70. Strains from economic restructuring are showing



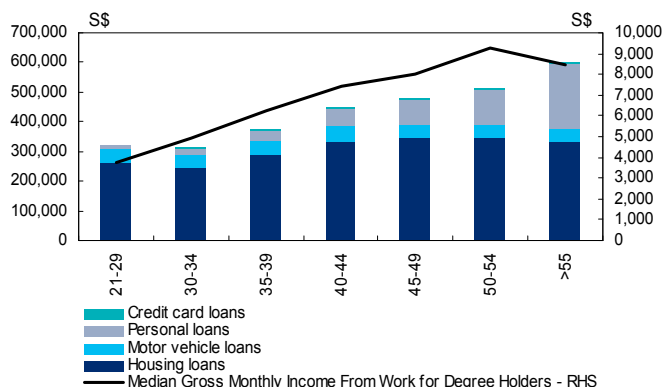
Source: CEIC, Citi Research

Figure 71. Potential supply of private residential property has risen



Source: CEIC, Citi Research

Figure 72. Certain segments of the population may be over-indebted



Source: Credit Bureau, Citi Research. Note: The graph depicts the relative size of the four major types of loans (using average loan value for each loan type) for each age group, and an average individual may not be exposed to all four types of loans. The median gross monthly income excludes employer CPF and sample only includes full-time employed residents, as of June 2012. For age group between 21-29, median income for degree holders aged 25-29 is used. For age group >55, median income for degree holders aged 55-59 is used.

Figure 73. Singapore Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	145.8	178.2	190.8	189.4	232.2	265.8	276.8	290.1	315.7
Nominal GDP, local currency mn	231	268	270	275	316	334	346	363	388
GDP per capita, US\$	33,131	38,827	39,434	37,970	45,741	51,275	52,098	53,695	57,400
Population, mn	4.4	4.6	4.8	5.0	5.1	5.2	5.3	5.4	5.5
Unemployment, % of labour force	2.7	2.1	2.3	3.0	2.2	2.0	1.9	1.9	1.8
<b>Economic Activity</b>									
Real GDP, % yoy	8.6	9.0	1.7	-0.8	14.8	5.2	1.3	3.2	4.0
Real investment growth % yoy	17.2	16.8	28.5	-21.0	5.4	12.7	26.8	1.9	-3.2
Real consumption growth % yoy	4.5	5.9	3.6	0.5	7.2	3.7	0.9	4.0	2.6
private consumption growth % yoy	4.5	6.7	2.9	-0.5	6.2	4.6	2.2	1.8	1.9
Real export growth, % yoy	10.8	9.0	5.0	-7.6	18.6	3.5	0.3	1.5	3.8
Real import growth, % yoy	11.1	8.1	9.6	-11.2	15.9	3.6	3.2	1.7	2.9
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	0.8	3.7	5.5	-0.5	4.6	5.5	4.3	2.0	1.4
CPI, % avg	1.0	2.1	6.6	0.6	2.8	5.2	4.6	2.4	2.3
Nominal wages, % yoy	3.2	6.2	5.4	-2.7	5.6	6.0	2.3	5.0	5.5
Credit extension to private sector, % yoy	4.9	16.9	15.2	2.0	13.4	18.6	13.3	12.0	11.0
3 month inter-bank rate, % eop	3.44	2.38	1.00	0.69	0.44	0.38	0.38	0.35	0.40
Long term yield, % eop	3.05	2.68	2.05	2.66	2.71	1.63	1.30	2.50	3.00
lc/US\$, eop	1.53	1.44	1.43	1.41	1.28	1.30	1.22	1.27	1.23
lc/US\$, avg	1.59	1.51	1.41	1.45	1.36	1.26	1.25	1.26	1.25
<b>Balance of Payments, US\$ bn</b>									
Current account	36.1	46.4	28.8	33.5	62.1	65.4	51.5	40.6	42.6
% of GDP	24.8	26.0	15.1	17.7	26.7	24.6	18.6	14.0	13.5
Trade balance	50.6	57.8	42.8	49.3	66.0	72.7	61.0	59.8	66.0
Exports	281.0	312.5	354.5	288.6	371.2	434.4	436.0	443.9	456.0
Imports	230.4	254.7	311.7	239.3	305.2	361.7	375.1	384.1	390.0
Service balance	-7.3	-2.7	-1.6	-1.7	2.3	0.7	0.4	1.4	2.0
Income balance	-7.2	-8.7	-12.4	-14.1	-6.3	-8.0	-9.9	-18.7	-24.0
FDI, net	18.1	10.1	5.4	0.9	28.3	29.7	33.6	33.0	32.0
International reserves	136.3	163.0	174.2	187.8	225.8	237.7	259.3	260.0	270.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.0	2.8	0.1	-0.3	0.3	1.2	1.1	0.7	0.5
Consolidated gov primary balance	0.6	2.7	1.1	-0.8	0.2	1.3	1.5	0.4	1.0
Public debt	89.2	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0
of which Domestic	89.2	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0
<b>Quarterly Economic Indicators</b>									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	0.2	3.8	4.9	3.9	4.2	2.2	4.7	4.9	3.4
CPI, % yoy	3.5	1.8	1.7	2.0	2.0	3.1	2.2	1.4	0.4
1 month inter-bank rate, % eop	0.38	0.38	0.35	0.35	0.35	0.35	0.35	0.40	0.45
Long term yield, % eop	1.54	2.51	2.50	2.50	2.60	2.75	2.90	3.00	3.00
lc vs USD, eop	1.24	1.27	1.27	1.27	1.27	1.26	1.25	1.23	1.21

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

\*Note: Public debt is general government debt.

## South Korea

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- **Summary view** – Resilient job growth and a steady rise in nominal wage have been supporting a recovery in consumption. On the back of continued smartphone demand, exports outperformed expectations and imports of durable goods increased, sending a positive signal to investment.
- **Things to watch** – Housing market measures should be carried out without delay to secure the improving trend of the market. Besides cutbacks in welfare plans, the government could face more struggles between boosting the economy and keeping its pledges amid tax revenue deficiency.
- **Strategy** – While concerns over Fed tapering impact will likely continue, we expect the KRW to further gain against the USD to 1,050 in 0-3 months and to 1,040 in 6-12 months. Expecting continued economic rebound and subdued inflation, the BoK will likely keep the policy rate unchanged this year at the least.

### Signs of consumption and investment recovery

**Resilient job growth supports consumption pickup.** Year-on-year job growth in Aug reached up to over 400K in eleven months, with the number of employed persons increasing sequentially for three consecutive months. The 3-month moving average of seasonally adjusted MoM job growth stayed in positive terrain since Feb this year. The services sector has been at the forefront of resilient job growth recently. In particular, jobs in human health and social work activities have shown a steady increase in tandem with government support on welfare such as childcare. We think solid job growth along with a steady rise in nominal wage gave momentum to consumption recovery. With broad-based gains in durables (especially autos), semi-durables, and non-durables, retail sales growth in July accelerated on MoM sa and YoY terms.

**Aug trade data bode well for investment.** Aug export growth came in stronger than expected at 7.7%YoY, up from 2.6% in Jul. Exports of IT goods continued to be driven by smartphone demand and auto and shipbuilding exports surged albeit partly on low base of a year ago. Amid concerns about the Fed tapering impact on Asian EM countries, exports to ASEAN rather saw a positive turnaround. Meanwhile, low raw materials price played the main role in slowing import growth to 1.0%YoY from 3.2% in Jul. However, imports of capital goods – e.g. machineries and semiconductor manufacturing equipment – and consumer goods maintained positive growth, hinting at recovery of investment and consumption.

**KRW to strengthen on sound economic fundamentals and external position.** Despite worries over Fed tapering, the KRW has strengthened against the USD by about 4.5%, sliding down to 1,070 levels on 23 Sep from its previous peak of 1,123 on Aug 22nd. KRW even outperformed other EM currencies though some of them also gained against the USD. The main backdrop for the outperformance of KRW appears to be a continued large current account surplus, foreign net-purchase at stock markets (US\$7.5bn during Aug 23<sup>rd</sup>-Sep 23<sup>rd</sup>), recent macro data confirming an economic recovery trend, and changes in composition of external debt (decreasing share of short-term debt and increasing share of long-term debt). We expect the recent trend to continue, with USD/KRW falling to 1,050 over the next three months and further to 1,040 in 6-12 months. However, the BoK may intervene via smoothing operation especially when USD/JPY rises further to over 100.

## Housing market recovery riding government measures

**Housing prices rising again on additional measures.** Following the first round of government measures introduced on Apr 1st to normalize the housing market, housing prices and transactions picked up but retreated in Jul-Aug after the termination of acquisition tax cut at the end of Jun. Amid fear of housing price declines, potential homebuyers have delayed purchases of homes and their preference for Jeonse – Korea's unique type of home lease which requires to put down a lump-sum deposit which will be paid back when lease contract expires - has further pushed up Jeonse prices. On top of this, low interest rates leading landlords to switchover from Jeonse to monthly rent has exacerbated the shortage of Jeonse. However, since the government drew up a plan to stabilize the Jeonse/rental market on Aug 28th, housing prices recovered in the first two weeks of Sep, with increased transactions of first-time homebuyers.

**Government plan should be carried out without setbacks to secure recovery.**

The outline of the bill proposed in late Aug includes carrying out market stabilizing measures to convert Jeonse demand to purchasing demand, increasing supply of public/private rental housing, reducing financial burdens of leaseholders, and resolving difficulties of tenants during the moving season in autumn. However, potential homebuyers are waiting for approval by the National Assembly on some of the stimulus measures proposed in Apr, e.g. vertical extensions of apartment buildings, and the permanent cut in property acquisition tax rate proposed in the additional plan. Though the government's introduction of additional measures had a positive impact on housing price recently, the National Assembly needs to pass the related laws as soon as possible to avoid setbacks and delays in implementation.

## We continue to expect no policy rate change this year

**Prospect of continued economic rebound and low inflation back rate hold.**

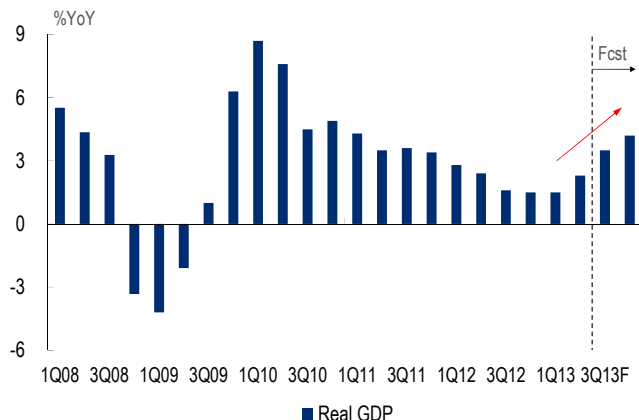
Despite heightened concerns over Fed tapering impact on market volatility and the Middle East geopolitical risk, the BoK left the policy rate unchanged at 2.50% for the fourth month in Sep, maintaining its view of continued economic recovery and subdued inflation going forward. CPI rose faster in Aug at 0.3%MoM but YoY inflation eased to 1.3%, and inflationary pressures from planned public tariff hikes in 2H – e.g. taxi and city bus fares, and electricity rates – will likely be offset by disinflationary pressures from commodities due to low raw materials price and strong KRW. We expect inflation to stay below the lower level of BoK's inflation target band (2.5-3.5%) and resilient job growth and steady, albeit gradual, rebound of exports to continue to maintain recovery in 2H. We maintain our view that the BoK will leave the policy rate unchanged for the remainder of the year.

## Government confronts tax revenue shortfall

**Tax revenue shortfall leads the government to scale back its welfare pledges.**

Tax revenues in 1H13 were down by KRW10.1trn compared to 1H12, with a fall in corporate tax and VAT revenues. As debate on corporate tax increases reignited, Finance Minister and Deputy Prime Minister Hyun Oh-seok asserted that tax increases could dampen economic recovery. Instead, while the government is drawing up a budget plan for 2014 assuming real GDP growth of 3.9%, the budget for education and welfare – particularly basic pension benefits for the elderly and full coverage of four major diseases – is to be trimmed to cope with the tax revenue deficiency. The government may face more struggles to keep its pledges if downside risks weigh on economic recovery.

Figure 74. We expect economic rebound to continue in 2H at 3.8%YoY



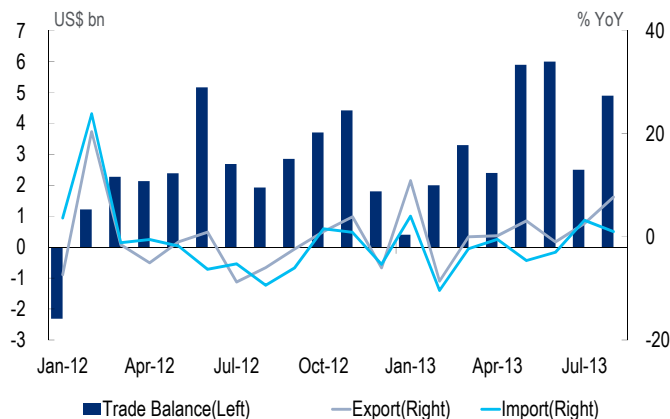
Source: Bank of Korea, Citi Research

Figure 75. KRW gained against USD on large current account surplus



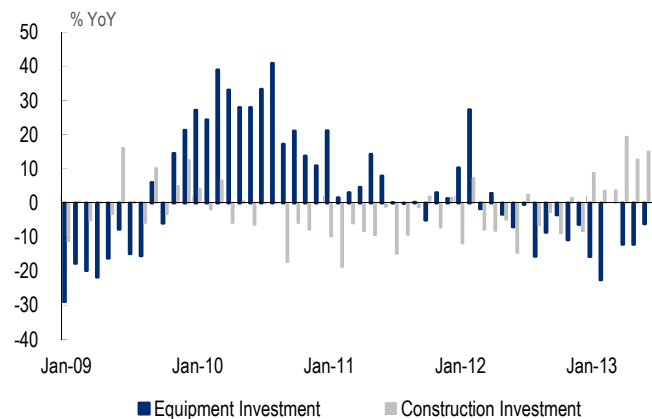
Source: Bank of Korea, CEIC, Citi Research

Figure 76. Better than expected exports bode well for investment



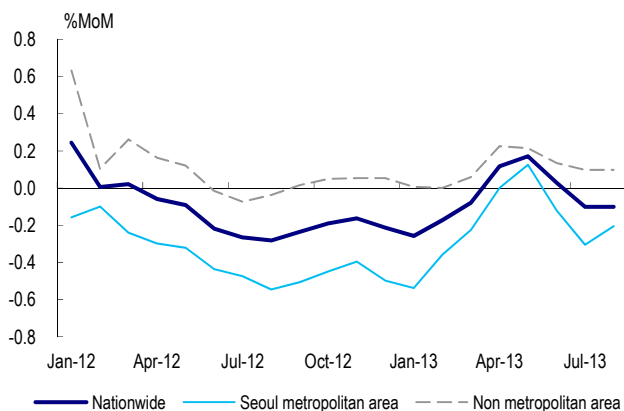
Source: Korea International Trade Association, Citi Research

Figure 77. Equipment investment sluggish but construction expanded



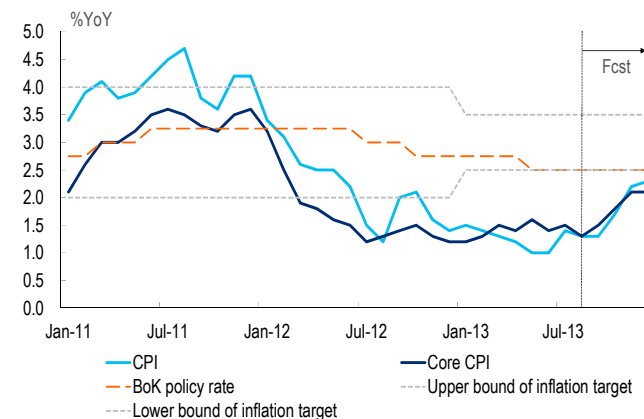
Source: Statistics Korea, Citi Research

Figure 78. Nationwide housing price fell after acquisition tax cut ended



Source: Korea Appraisal Board, Citi Research

Figure 79. Subdued inflation and policy rate to be on hold this year



Source: Bank of Korea, Citi Research Estimates

Figure 80. Korea Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	954.0	1,048.0	929.1	834.7	1,014.9	1,114.8	1,129.3	1,213.1	1,357.6
Nominal GDP, local currency bn	908,744	975,013	1,026,452	1,065,037	1,173,275	1,235,161	1,272,460	1,323,260	1,402,706
GDP per capita, US\$	19,722	21,565	18,981	16,972	20,540	22,395	22,584	24,156	26,924
Population, mn	48.4	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4
Unemployment, % of labour force	3.5	3.2	3.2	3.6	3.7	3.4	3.2	3.2	3.2
<b>Economic Activity</b>									
Real GDP, % yoy	5.2	5.1	2.3	0.3	6.3	3.7	2.0	2.9	3.7
Real investment growth % yoy	4.4	3.5	0.0	-13.5	15.8	1.4	-1.8	1.6	3.5
Real consumption growth % yoy	5.1	5.1	2.0	1.2	4.1	2.3	2.2	2.2	2.8
private consumption growth % yoy	4.7	5.1	1.3	0.0	4.4	2.4	1.7	1.7	2.9
Real export growth, % yoy	11.4	12.6	6.6	-1.2	14.7	9.1	4.2	5.7	6.2
Real import growth, % yoy	11.3	11.7	4.4	-8.0	17.3	6.1	2.5	4.6	6.1
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	2.1	3.6	4.1	2.8	3.0	4.2	1.4	2.3	2.6
CPI, % avg	2.2	2.5	4.7	2.8	3.0	4.0	2.2	1.5	2.5
Nominal wages, % yoy	5.7	5.6	-4.1	2.6	6.8	1.0	5.3	4.3	5.2
Credit extension to private sector, % yoy	14.7	12.4	15.0	2.3	3.6	5.1	1.9	5.3	7.0
Policy interest rate, % eop	4.50	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.50
91-Day CD Rate, % eop	4.76	5.73	4.68	2.82	2.80	3.55	2.89	2.70	2.75
Long term yield, % eop	5.00	5.78	3.77	4.92	4.08	3.46	2.97	3.35	3.65
lc/US\$, eop	930	936	1263	1166	1121	1159	1064	1127	1052
lc/US\$, avg	955	929	1102	1275	1156	1108	1127	1130	1086
<b>Balance of Payments, US\$ bn</b>									
Current account	14.1	21.8	3.2	32.8	29.4	26.1	43.1	51.9	32.7
% of GDP	1.5	2.1	0.3	3.9	2.9	2.3	3.8	4.3	2.4
Trade balance	16.1	14.6	-13.3	40.4	41.2	30.8	28.3	31.5	17.9
Exports	325.5	371.5	422.0	363.5	466.4	555.2	547.9	557.9	587.4
Imports	309.4	356.8	435.3	323.1	425.2	524.4	519.6	526.4	569.5
Service balance	-13.3	-12.0	-5.7	-6.6	-8.6	-5.8	2.7	5.9	7.8
Income balance	-4.0	-3.4	3.8	1.6	-2.1	0.3	2.1	3.1	0.3
FDI, net	-7.6	-17.9	-16.9	-14.9	-22.2	-16.4	-18.6	-12.5	-8.6
International reserves	238.9	262.2	201.1	270.0	291.5	304.2	323.2	331.1	345.7
Total Amortisations	17.7	43.8	42.9	43.6	40.0	42.0	46.0	44.0	41.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.4	3.5	1.2	-1.7	1.4	1.5	1.5	0.9	2.3
Consolidated gov primary balance	1.7	4.9	2.6	-0.2	2.8	2.9	2.7	2.3	3.7
Public debt	30.1	29.7	29.0	32.5	31.9	32.6	33.0	35.0	33.0
of which Domestic	28.9	28.6	28.1	31.4	31.0	31.8	32.6	34.4	32.3
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	225.2	333.4	317.4	345.7	359.8	398.7	413.6	426.0	441.8
Private	225.0	333.1	317.1	345.4	359.4	358.3	373.4	384.8	399.6
Public	0.2	0.3	0.3	0.3	0.4	40.4	40.2	41.2	42.2
External debt / GDP	23.6	31.8	34.2	41.4	35.5	35.8	36.6	35.1	32.5
External debt / XGS	58.9	75.0	61.9	79.1	65.0	61.3	63.0	63.4	61.7
Short-term debt	113.8	160.3	149.9	149.2	139.8	137.4	126.7	130.3	140.4
Short-term debt/International Reserves (%)	47.6	61.1	74.5	55.3	48.0	45.2	39.2	39.4	40.6
<b>Quarterly Economic Indicators</b>									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	1.5	2.3	3.5	4.2	4.0	3.7	3.7	3.4	3.7
CPI, % yoy	1.3	1.0	1.3	2.3	2.1	2.7	2.6	2.6	3.0
Policy interest rate, % eop	2.75	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75
91-Day CD Rate, % eop	2.81	2.69	2.70	2.70	2.75	2.75	2.75	2.75	2.90
Long term yield, % eop	2.58	3.14	3.30	3.35	3.45	3.60	3.65	3.65	3.75
lc vs USD, eop	1111	1142	1138	1127	1116	1099	1076	1052	1030

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** – Recovery momentum could pick up in 4Q on the back of stronger semiconductor sales. Fed postponing tapering and China stabilization are positive for Taiwan exports. August deflation print likely to be a temporary phenomenon but inflation will be kept benign with nascent macro recovery.
- **Things to watch** – 1) September political fallout could delay ECFA of services & key policies; 2) Potential revisions on the luxury tax; 3) Cross-strait momentum: Banks M&A, RMB swap line, ECFA for the broader goods; 4) FTA signing with Singapore; 5) Pension reform; 6) 2014's "7-in-1" local elections.
- **Strategy** – Recent foreign equity interests in the local stock market and reversal in EM FX weakness likely to provide near term support to the TWD. 10Y gvt bond yields retreated in the latest auction and higher risk appetite post US's delay in tapering. Our equity strategist has a TAIEX year end target of 8,500.

### Trade sponsored recovery intact for rest of the year

**GDP recovery likely to pick up pace in 2H**, especially with 4Q potentially benefiting from a more meaningful trade recovery, against the backdrop of China's economy stabilizing somewhat and the Fed's extended accommodation. Net trade recovery in 3Q appears associated with chemical exports and imports slowdown due to falling commodity prices, but 4Q recovery is likely to be more driven by an increase in tech exports. Aug exports and export orders data only show very mild growth. We think exports of components of the various new tech products will increase in coming months, especially as Taiwanese firms have won a larger mandate for semiconductor production at year-end. Also recent stabilization of the Chinese economy (albeit 3Q outperformance has been boosted by favorable base) adds some comfort to near term Taiwanese exports to China; however, as we maintain our house view that 4Q Chinese economy could see more downside risk, we will need to monitor closely whether 4Q could see better prospects beyond just the semiconductor boost. Meanwhile, TIER's July survey indicated that petroleum/coal production, securities, retails, transportation and storage businesses are more optimistic on outlook.

### Politics could delay pro-investment policies

**September's political struggle.** In early September, President Ma, in his capacity as KMT chairman, had demanded that the KMT disciplinary committee to revoke Wang Jin-pyng's party membership, and hence remove him from the post of the legislative yuan speaker. The denunciation was based on Wang's alleged influence peddling in the court proceedings in a case involving a prominent opposition legislator. A subsequent court injunction was granted to Wang to temporarily allow him to stay as a KMT member and speaker of the legislature, which the injunction would undergo high-court hearing this week.

**Politics instability adds challenges to cross-strait cooperation.** The immediate impact of this series of political events was the delay in the debate between the two parties on ECFA of services (an agreement that was signed back in June, but implementation is pending this debate and approval by Legislative Yuan). If serious further delays were to happen for the implementation of ECFA of services, this could in turn weigh on the timing of cross-strait agreement on ECFA for the broader goods list (although cross-strait negotiations are still ongoing). Other key policies initiatives to invigorate the economy, namely the free economic zone (FEZ), could subsequently be postponed. These together could put Taiwanese businesses' expansion plans on hold, as the anticipated larger customer base post ECFA tariff reduction and liberalization in FEZ are now further in reach.



## New FSC chairman pro financial liberalization stance

**Positive market reaction towards Mr. Tseng Ming-chung as new FSC chairman.** In the latest cabinet reshuffle, previous vice finance minister Tseng replaced Mr. Chen Yuh-chang as chairman of the FSC. This move boosted hopes that Tseng will be more aggressive than Chen in pushing for financial market liberalization and allowing more market friendly practices in Taiwan. Indeed, Tseng, at his swearing-in ceremony, said he aims to push for consolidation in the local banking industry to strength the sector's competitive edge. Since Tseng took office, the FSC has unveiled three de-regulating measures to help spur stock market activity: 1) allow same day trading starting early Jan14; 2) allow eligible securities to be shorted lower than their previous closing prices; 3) install a temporary measure till Mar 8, 2014 for brokerage firms to trade securities on their own account at +/-7% previous closing prices. In addition, FSC has disclosed that they will allow insurance companies to sell RMB denominated life insurance policies before year end. Proactive policy changes by the FSC and the continual theme of RMB banking and greater business opportunities in China for Taiwanese banks and brokerages appear to be generating foreign interest in Taiwanese financial equities. See also our banking analyst Bradford Ti's note: [Taiwan Financials - FINI Buy & Sell: Inflows Resume MTD Sep, but Select Names Benefit More than Most](#).

## Fund flows with China's tightening and Fed's non-tapering

**Taiwanese bank providing offshore funding to China:** Loan growth picked up in June and July at 2.9%YoY and 3%YoY, respectively, higher than the 2% average seen in the first five months of the year, as much more loans were made out in June (NT\$106.3bn) and July (NT\$175.1bn). We note that this coincides with funding tightness seen in China which was amplified in June with the Shibor surge.

**Portfolio fund flows:** Since late August we have seen US\$3.7bn of foreign net purchase in Taiwan equities, which brings the YTD net buy to US\$4.1bn. This has come as Fed tapering speculation led money out of countries in ASEAN and India, to places with high foreign reserves like Taiwan and Korea.

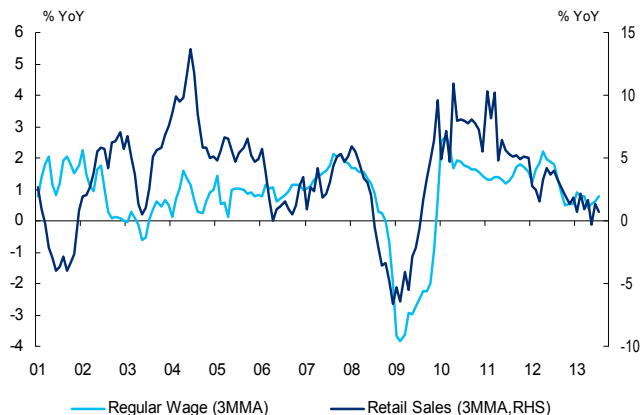
**Near term NTD could strengthen to 29.2/USD in 0-3 months** given better 2H economic prospects, China economy stabilizing, Fed's non-tapering, some reversal in EM weakness, plus foreign interests in Taiwanese equity market.

**10Y government bond yield still on a gradual uptrend, despite recent pullback.** We have adjusted downwards our forecasts to reflect spot started coming off since latest 10Y bond auction, and further retreated with surprise FOMC result; however, with Fed tapering still likely before Jan14 and better domestic economic fundamentals market rates will again start to edge up in our forecast horizon.

## Low inflation (but no deflation) prospects

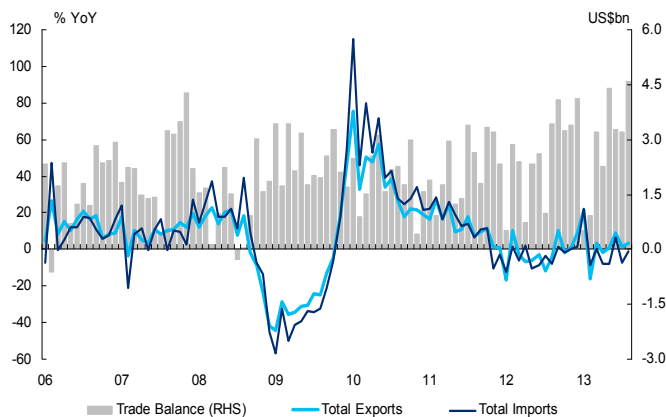
**Aug CPI deflation likely temporary.** Aug CPI inflation posted a drop of -0.79% YoY, on lower food and electronics prices. The unexpected deflation print was due to a weather-related distortion to fruits and vegetable prices as damage from last year's typhoons had a worse impact on crop prices. However, intense competition of electronics vendors has led to continuous discounts/promotions for many electronics and this will likely continue to drive disinflation. With the upcoming launches of various new electronics products, the trend can be reversed. Looking at the core CPI (which is ex-food and energy), inflation is relatively stable as it only mildly retreated by 0.02ppt in Aug to 0.48%YoY from 0.5%YoY in Jul. The second phase of electricity hike (+8.49% on average) will add 0.19ppt to the inflation bill in Oct and 0.05ppt in 2013, according to DGBAS estimate.

Figure 81. Wage growth improving gently, consumption lags



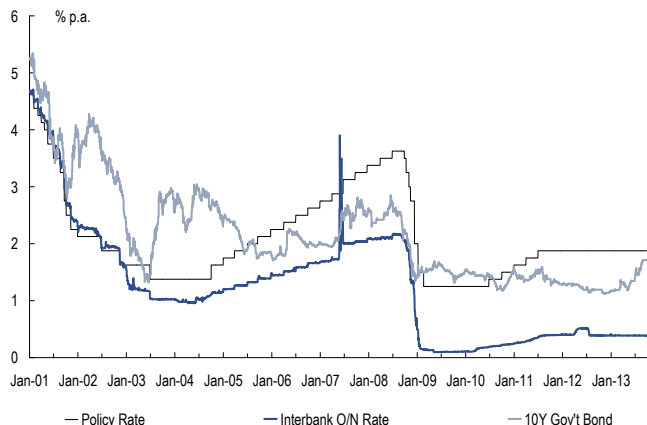
Source: CEIC, Citi Research

Figure 83. Trade is on a bumpy but recovering ride



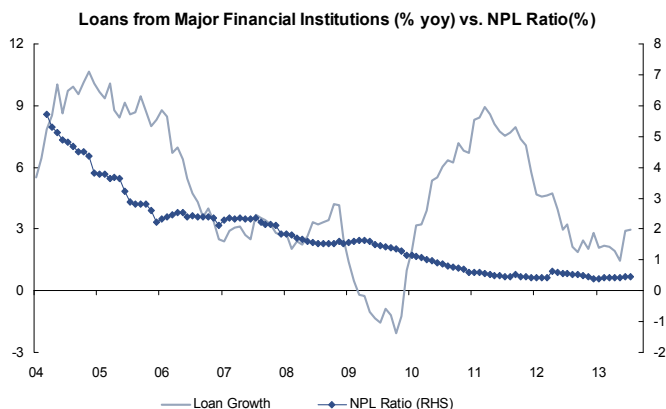
Source: CEIC, Citi Research

Figure 85. 10Y gvt bonds lowered post auction & Fed no-tapering



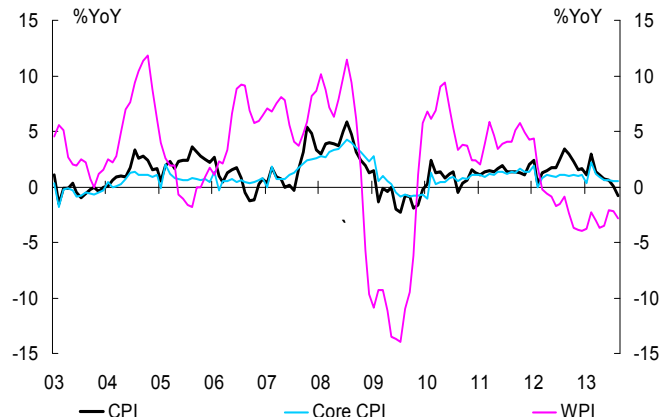
Source: CEIC, Citi Research

Figure 82. Loan growth picking up since June Shibor surge in China



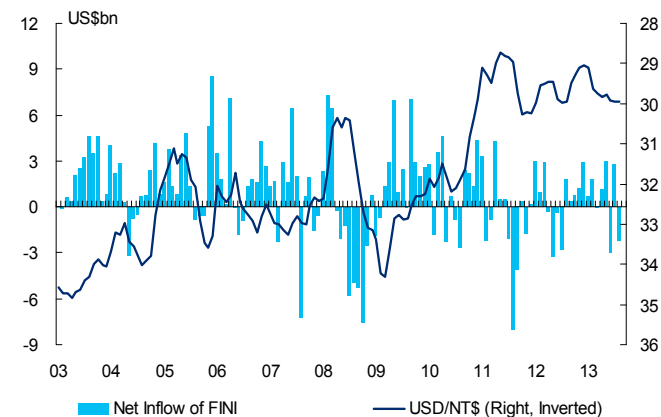
Source: CEIC, Citi Research

Figure 84. Deflation seen in Aug likely temporary



Source: CEIC, Citi Research

Figure 86. TWD seeing support from FINI inflows in Sep



Source: CEIC, Citi Research

Figure 87. Taiwan Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	376.3	393.1	400.2	377.6	428.2	464.0	474.0	491.5	520.3
Nominal GDP, local currency bn	12,243	12,911	12,620	12,481	13,552	13,674	14,037	14,569	15,369
GDP per capita, US\$	16,513	17,191	17,444	16,404	18,574	20,078	20,437	21,151	22,345
Population, mn	22.8	22.9	22.9	23.0	23.1	23.1	23.2	23.2	23.3
Unemployment, % of labour force	3.9	3.9	4.1	5.8	5.2	4.4	4.2	4.1	4.0
<b>Economic Activity</b>									
Real GDP, % yoy	5.4	6.0	0.7	-1.8	10.8	4.1	1.3	2.6	3.8
Real investment growth % yoy	0.5	-0.7	-7.9	-21.2	36.8	-7.5	-4.2	2.9	5.0
Real consumption growth % yoy	1.1	2.1	-0.6	1.3	3.3	3.0	1.3	1.5	2.3
private consumption growth % yoy	1.5	2.1	-0.9	0.8	4.0	3.1	1.5	1.7	2.7
Real export growth, % yoy	11.4	9.6	0.9	-8.7	25.6	4.4	0.1	5.2	4.8
Real import growth, % yoy	4.6	3.0	-3.7	-13.1	27.7	-0.5	-1.9	4.9	3.8
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	0.7	3.3	1.3	-0.2	1.2	2.0	1.6	2.3	1.7
CPI, % avg	0.6	1.8	3.5	-0.9	1.0	1.4	1.9	1.2	1.7
Nominal wages, % yoy	0.8	2.1	0.0	-4.9	5.5	2.7	0.3	1.8	3.0
Credit extension to private sector, % yoy	4.7	3.9	2.7	-0.8	6.7	5.7	4.2	5.5	7.0
Policy interest rate, % eop	2.75	3.38	2.00	1.25	1.63	1.88	1.88	1.88	2.13
1 month inter-bank rate, % eop	1.69	2.04	1.02	0.57	0.74	0.87	0.87	0.87	1.05
Long term yield, % eop	1.99	2.53	1.44	1.47	1.47	1.27	1.15	1.68	2.18
lc/US\$, eop	32.59	32.43	32.78	32.23	29.17	30.29	29.06	30.07	29.45
lc/US\$, avg	32.52	32.85	31.58	33.04	31.50	29.40	29.57	30.01	29.71
<b>Balance of Payments, US\$ bn</b>									
Current account	26.3	35.2	27.5	42.9	39.9	41.2	49.9	49.6	46.8
% of GDP	7.0	8.9	6.9	11.4	9.3	8.9	10.5	10.1	9.0
Trade balance	11.6	16.8	4.4	20.3	11.0	11.3	14.4	27.2	48.2
Exports	213.2	235.1	243.8	193.8	261.6	291.9	284.2	294.4	317.3
Imports	201.6	218.2	239.5	173.5	250.5	280.6	269.8	267.2	269.1
Service balance	-3.5	-1.6	1.9	2.0	2.5	3.9	6.1	11.2	-3.6
Income balance	9.6	10.1	10.0	12.5	13.6	13.2	15.3	17.5	19.0
FDI, net	0.0	-3.3	-4.9	-3.1	-9.1	-14.7	-9.8	-8.5	-7.0
International reserves	266.1	270.3	291.7	348.2	382.0	385.5	403.2	420.0	440.0
Total Amortisations	5.8	3.8	8.8	2.5	3.2	6.8	3.4	2.9	3.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	0.1	0.3	-0.5	-3.5	-2.3	-1.9	-1.6	-1.2	-1.3
Consolidated gov primary balance	1.2	1.3	0.5	-2.5	-1.5	-1.0	-0.7	-0.4	-0.6
Public debt	34.2	33.3	34.7	38.0	38.3	40.1	40.9	41.1	41.0
of which Domestic	34.1	33.3	34.7	38.0	38.2	40.1	40.9	41.1	41.0
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	85.8	94.5	90.4	82.0	101.6	122.5	130.8	132.8	134.3
Private	75.2	91.1	88.9	76.0	93.5	118.0	127.5	129.1	130.3
Public	10.6	3.5	1.5	5.9	8.0	4.5	3.3	3.7	4.0
External debt / GDP	22.8	24.0	22.6	21.7	23.7	26.4	27.6	27.0	25.8
External debt / XGS	33.5	33.4	30.9	34.7	32.1	34.7	37.5	35.8	33.9
Short-term debt	74.2	83.3	78.8	68.2	83.7	107.8	116.5	115.0	110.0
Short-term debt/International Reserves (%)	27.9	30.8	27.0	19.6	21.9	28.0	28.9	27.4	25.0
<b>Quarterly Economic Indicators</b>									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	1.6	2.5	2.9	3.4	3.1	4.7	3.9	3.7	4.0
CPI, % yoy	1.8	0.8	1.3	2.3	2.6	1.6	1.4	2.4	3.7
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	2.00	2.13	2.25
1 month inter-bank rate, % eop	0.87	0.87	0.87	0.93	0.99	0.99	1.05	1.05	1.11
Long term yield, % eop	1.31	1.41	1.63	1.68	1.78	1.88	2.03	2.18	2.33
lc vs USD, eop	29.83	29.96	30.18	30.07	29.96	29.81	29.63	29.45	29.27

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** – Our GDP forecasts of 4.1% in 2013 and 4.4% in 2014 are unchanged. Strong pressure on public investments to deliver in 2H13. Roll out of hefty FDI approvals timed with export recovery could be another upside. Car sales growth of 6.3%MoM SA in Aug may signal durable goods demand upturn.
- **Things to watch** – Core disinflation still has room to go. Accommodative policy rate to stay as well as preference for weak THB. Sizeable FDI approvals but roll-out still awaited. Whether the legal challenge following approval of Bt2tn public investment program would delay public investments.
- **Strategy** – Lackluster THB prospects to stay unless downside growth risk eases and export recovery mitigates current account deficit risk. Likely peak of THB weakness is 2Q14 close to 32. Benign FY14 fiscal deficit outlook provides bond market relief although wary of SBI debt flare up and fiscal funding implications.

### Persistent downside risk to 2H growth

**We are maintaining our FY13 GDP growth forecast of 4.1% and our FY14 GDP forecast of 4.4%.** With exports continuing to underperform, there is more pressure on the fiscal side and other domestic demand components to uplift 2H growth. Downside risk to growth would probably extend in 3Q13 although not as severe as in 2Q13 when central government spending appeared lost amid a primary fiscal surplus that ballooned to Bt171bn. Fiscal expenditures seasonally ease (or primary surpluses built up in the 2H of government's fiscal year. Extending the 10-month fiscal data trend, we obtain primary fiscal spending growth of 8.9%YoY in 3Q13 (4QFY13) probably be dominated by cash transfers/subsidies.

**Further scrutiny of fiscal data indicated likelihood that the cash disbursements under the FY13 budget probably depicted infra 'underspending' coupled with current expenditures 'overshooting' the FY13 target.** Using the existing Oct-July FY13 fiscal data and comparing this with the published annual program targets, cash disbursements for infra spending probably fell short of the FY13 infra spending target of Bt450bn by Bt200bn. Admittedly capex of state owned enterprises (SOE) may be included in this infra spending target but bulk of this should be central government. SOE may be the saving grace if we base it on 2Q13 GDP accounts that highlighted 50% growth of SOE capex that uplifted public investments by 14.8%YoY. SOE's construction expanded 12%YoY while central/local governments' construction expenditures fell 2.6%YoY in 2Q13.

**Rather than allow this to translate into a FY surplus, available resources due to slippage on fiscal investments in FY13 may have been diverted to current expenditures ex-interest.** This net fiscal item could swell past the FY13 program by Bt304bn in our estimate although there are strong indications that government may want to phase out/down some of these costly stimulus programs eg rice subsidy/rubber subsidies. This still highlights fiscal preference in FY13 to downplay infra spending for quick disbursing current expenditures, eg 'economic grants'.

**Underperforming exports reinforced much of de-stocking bias in manufacturing.** Broad manufactured exports fell 1.2%YoY in July, led by a 3.1%YoY decline in industrial exports. The mfg output of the export cluster declined by 8.1%YoY in July or more than the export drop to highlight severe inventory adjustments rather than cut labor for now. Lacking material improvement in external demand amid fiscal spending on the current expenditures probably close to being maxed out, downside risk to our 2H13 forecasts remains elevated.

## Car sales up 6.3%MoM SA in Aug that may signal recovery

**Consumer backdrop doesn't appear as upbeat if one were to consider downbeat consumer sentiment in Aug for the 5<sup>th</sup> straight month alongside car sales decline by over 20%YoY for the 2<sup>nd</sup> straight month in Aug.** In the survey consumer respondents expressed deteriorating future expectations (-1.2ppt) compared to the current period (-0.7ppt), which has been a firm trend since Apr. Lackluster sentiment was coincident with a technical recession in 2Q13 driven by declining real consumption (-1.9%QoQ SA) that extended 1Q weakness (-1.3%QoQ SA). Behind declining consumption was a 16.6%QoQ SA contraction in durable goods demand. However in Aug, we estimated seasonally adjusted car sales rose sharply 6.3%MoM SA to snap out of 4 straight monthly declines. Despite phase out of government's first car, tax rebate program amid BoT's warning of rising HH debt, consumer credit still posted 13.6%YoY growth in July although at a slower pace, that can support fledgling recovery in car demand.

## FDI approvals at Bt349bn as of Aug

FDI approvals continue to climb as of Aug although down only by 1.6%YoY from last year's record pace. Current FDI approvals did not shrink materially after last year's record high (~5% of GDP) owing to the post-deluge spending to rehabilitate damaged production capacity. Problem is that roll out of these FDI approvals appear to be at a slow pace largely due to export slack in our view. Export recovery could be coincident with faster capex. Alongside private construction flagged by buoyant cement sales and construction permits that bucked the capex slowdown, we sense upside risk to 2H13 investment outlook.

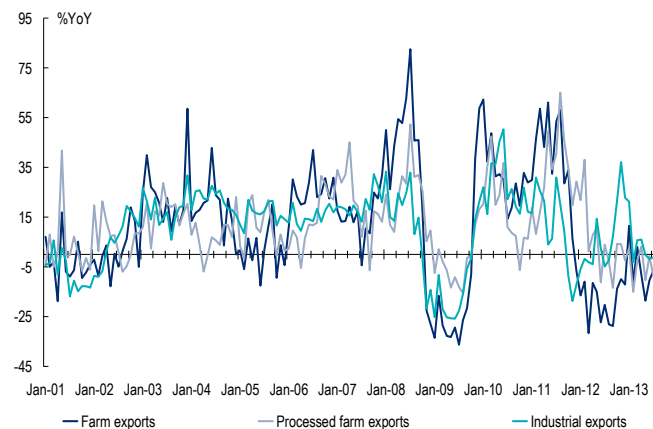
## Benign fiscal deficit outlook in FY14

**We expect to see an FY13 budget deficit at Bt308bn (2.6% of FY13F GDP) likely to breach the FY13 fiscal gap target of Bt251bn (ex-repayments).** The planned FY14 budget entails a lower fiscal deficit target of Bt250bn. Ex-principal payments, the fiscal deficit target narrows to Bt184bn, down 26.7%. Benign FY14 fiscal deficit target could signal gradual 'expensing out' of potential fiscal losses from the off-budget spending. Government expenditures ex-repayment would be expanding (4.6%) by less than the planned revenue target (8.3%). The capital outlay target of Bt442bn would be 2% less than the FY13 infra spending target. We don't expect to see a repeat of overspending in the current expenditures coupled with infra underspending with government's planned shift to more public investments over the medium-term (Bt2tn public investment program). Lacking 'off-budget' spending dynamics with more emphasis on public investments that's in the soon to be approved budget, would help improve market sentiment on fiscal debt.

## Maintaining lackluster THB view

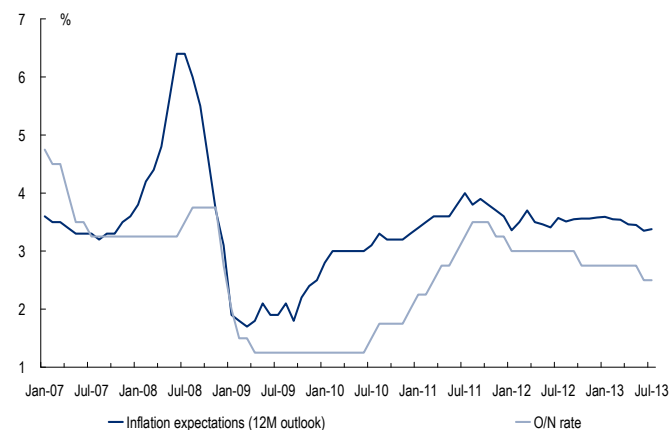
**Unless growth headwinds dissipate and export recovery mitigates current account funding risk, THB could stay vulnerable to strong USD/Fed taper risk.** We expect THB weakness to peak at 31.90 in 2Q14 before correction to the 30-31 range materializes. While current account funding risk is not due to trade deterioration but steady net outflows from services and income accounts traced to familiar freight payments and profit/divided repatriation owing to Thailand's huge multinational base, THB remains handicapped by the twin deficit risk during a period of tightening global liquidity. Amid fiscal dynamics of infra underspending and current expenditures overshooting in FY13, government resorted to cash drawdowns in funding the fiscal gap while curbing fiscal borrowings (-51%YoY for Oct-July). Benign FY14 fiscal deficit outlook provides near-term market relief while wary of SFI debt (+98.9%YoY as of June) due to effects of off-budget spending.

Figure 88. Exports still mired in negative territory despite its diversity



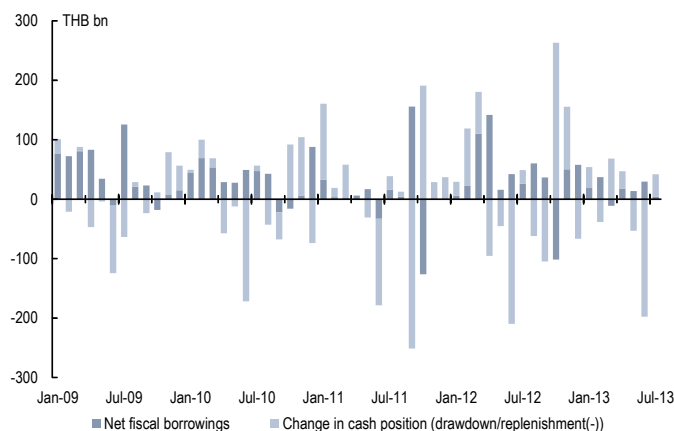
Source: CEIC, Citi Research

Figure 90. Inflation outlooks inched up in Jul to disrupt waning trend



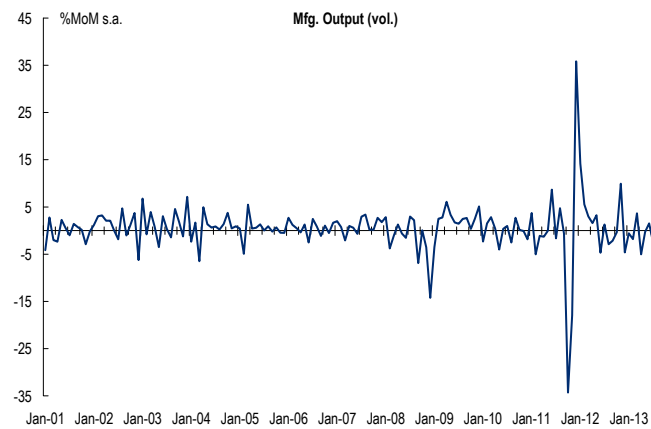
Source: CEIC, Citi Research

Figure 92. Net fiscal borrowings fell 51%YoY in the ten months to Jul



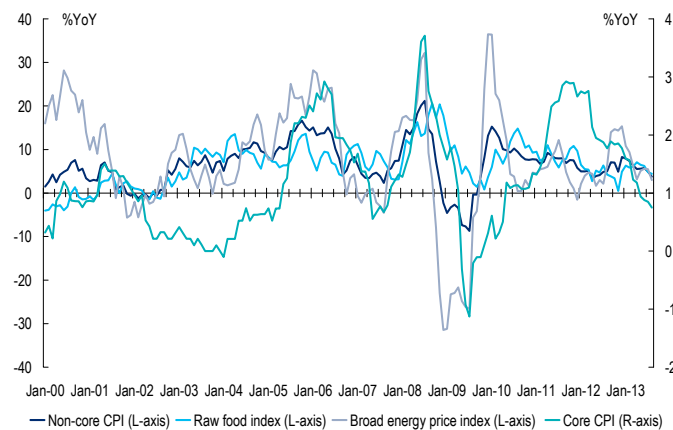
Source: CEIC, Citi Research

Figure 89. ...as such, mfg. index continues to flag shallow weakness



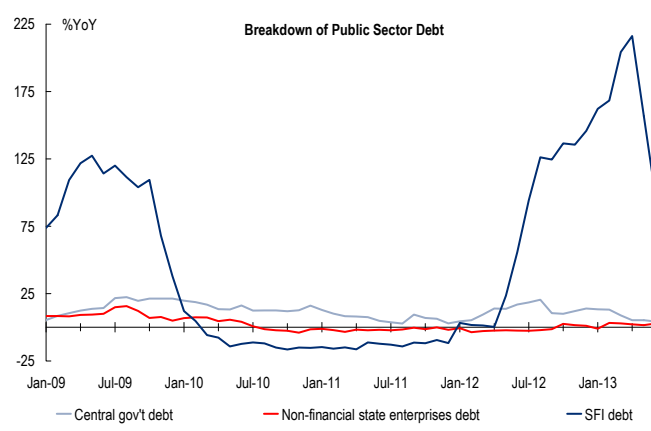
Source: CEIC, Citi Research

Figure 91. Resilient Aug core disinflation despite non-core CPI upticks



Source: CEIC, Citi Research

Figure 93. SFI debt explosion behind rising public sector debt



Source: CEIC, Citi Research

Figure 94. Thailand Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	207.4	265.2	276.1	263.8	319.3	346.1	366.4	390.7	404.9
Nominal GDP, local currency bn	7,845	8,525	9,080	9,042	10,105	10,540	11,375	12,120	12,942
GDP per capita, US\$	3,301	4,207	4,355	4,153	4,998	5,401	5,685	6,031	6,219
Population, mn	62.8	63.0	63.4	63.5	63.9	64.1	64.5	64.8	65.1
Unemployment, % of labour force	1.5	1.4	1.4	1.5	1.0	0.7	0.7	0.8	1.0
<b>Economic Activity</b>									
Real GDP, % yoy	5.1	5.0	2.5	-2.3	7.8	0.1	6.5	4.0	4.4
Real investment growth % yoy	-3.6	1.0	8.1	-25.2	28.7	0.1	16.8	5.4	13.3
Real consumption growth % yoy	3.0	2.9	2.9	0.1	5.1	1.3	6.8	3.2	3.4
private consumption growth % yoy	3.2	1.8	2.9	-1.1	4.8	1.3	6.7	3.1	3.3
Real export growth, % yoy	9.1	7.8	5.1	-12.5	14.7	9.5	3.1	5.8	5.4
Real import growth, % yoy	3.3	4.4	8.9	-21.5	21.5	13.7	6.2	5.8	8.2
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.6	3.1	0.4	3.5	3.1	3.5	3.6	2.1	2.6
CPI, % avg	4.6	2.2	5.5	-0.9	3.3	3.8	3.0	2.4	2.3
Nominal wages, % yoy	5.8	3.0	10.5	-1.9	5.8	7.2	11.9	5.5	4.0
Credit extension to private sector, % yoy	4.5	29.3	6.3	2.5	18.9	18.2	13.7	13.5	11.5
Policy interest rate, % eop	5.00	3.25	2.75	1.25	2.00	3.25	2.75	2.50	3.00
1 month inter-bank rate, % eop	5.22	3.74	3.07	1.28	2.03	3.26	2.79	2.55	3.15
Long term yield, % eop	5.04	5.13	2.84	4.37	3.74	3.28	3.55	3.85	4.00
lc/US\$, eop	35.45	30.05	34.79	33.36	30.07	31.57	30.60	31.55	30.95
lc/US\$, avg	37.93	32.33	33.03	34.33	31.71	30.48	31.08	30.78	31.49
<b>Balance of Payments, US\$ bn</b>									
Current account	2.3	15.7	2.2	21.9	10.0	5.9	0.2	-3.3	-4.2
% of GDP	1.1	5.9	0.8	8.3	3.1	1.7	0.0	-0.8	-1.0
Trade balance	13.7	26.6	17.3	32.6	29.8	17.0	6.0	1.8	-0.3
Exports	127.9	151.3	175.2	150.8	191.6	219.1	225.9	233.8	253.2
Imports	114.3	124.6	157.9	118.2	161.9	202.1	219.9	232.0	253.5
Net service and Transfer accounts	-8.0	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	-2.5	-3.0
Income balance	-3.4	-3.0	-2.3	-4.4	-9.0	-0.5	-2.4	-2.6	-0.9
FDI, net	8.5	8.3	4.4	0.7	4.5	-0.4	-4.9	-0.7	2.2
International reserves	67.0	87.5	111.0	138.4	172.1	175.1	181.6	185.0	197.8
Total Amortisations	12.8	20.5	15.0	10.7	9.4	8.9	17.3	18.0	19.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	-0.7	-1.6	-1.0	-5.7	0.0	-1.0	-2.1	-2.6	-2.3
Consolidated gov primary balance	0.9	-0.3	0.2	-4.5	1.2	0.2	-0.8	-1.7	-1.3
Public debt	40.3	37.4	38.2	43.9	42.4	40.8	43.6	47.5	48.0
of which Domestic	34.3	32.7	33.7	39.7	38.8	37.5	40.5	41.2	42.3
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	70.0	74.4	76.1	75.3	100.6	104.6	133.2	132.3	135.0
Private	64.7	71.6	72.7	69.4	87.9	88.4	107.0	106.7	108.4
Public	5.2	2.8	3.4	5.9	12.7	16.2	26.2	25.6	26.6
External debt / GDP	33.7	28.1	27.6	28.5	31.5	30.2	36.4	33.9	33.3
External debt / XGS	45.9	41.0	36.5	41.6	44.5	40.1	48.4	46.0	43.4
Short-term debt	27.2	34.0	33.6	33.1	50.7	47.3	60.6	60.0	59.8
Short-term debt/International Reserves (%)	40.7	38.9	30.3	23.9	29.4	27.0	33.4	32.4	30.2
<b>Quarterly Economic Indicators</b>									
	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	5.4	2.8	3.8	4.2	3.9	4.2	4.6	4.8	5.0
CPI, % yoy	2.7	2.3	2.2	2.1	2.1	2.3	2.4	2.6	2.8
Policy interest rate, % eop	2.75	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.00
1 month inter-bank rate, % eop	2.79	2.53	2.55	2.55	2.55	2.60	2.85	3.15	3.15
Long term yield, % eop	3.54	3.78	4.00	3.85	4.25	4.25	4.00	4.00	3.75
lc vs USD, eop	29.29	31.14	31.25	31.55	31.85	31.79	31.37	30.95	30.53

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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**Five pending breakthroughs:** Mongolia is at a crossroads now. Since our last update ([Mongolia Macro View - Takeaways from Ulaanbaatar: Need to Unlock Bottlenecks Quickly](#)), the government seems to have picked up pace at addressing key issues at hand. First, the special parliament session will repeal the New Investment Law (allowing equal treatment to foreign investment as local's; simplified approval process by Ministry of Economic Development that involves foreign SOEs; and requiring 2/3 of parliament to change this law in the future); update the 'Long Name Law' to allow legal (gold) mining activities near rivers, forests and protected areas; and decide to keep using the existing mining law (i.e. no re-draft and new exploration licenses could be issued). Second, secure funding for its investment needs by an expected samurai bond issuance by DBM. Third, Finance Minister to cut spending to reduce structural deficit to 2% of GDP for this year. Four, PBOC grants BoM's request to double its 10bn RMB swap line. Fifth, to reach an agreement with Rio to restart OT Phase II development. We ranked these five items in descending order of the likelihood of accomplishing in the near term.

**Market sentiment improved slightly in light of these potential breakthroughs:** The MNT has recovered ~5% (after reaching 1712/USD on 11 Sep (-23.1% YTD)), and Z-spreads of the 10Y sovereign and 5Y quasi-sovereign bond have also recovered ~80bps and ~170bps to 461bps and 651bps (as of Sep 23), respectively.

**Macro data wise,** exports on a YoY grew 4.9% in Aug but an increase in copper exports from OT production was noted. Still low FDI and a decline in FX reserves as of Aug continue to catch attention. CPI started to edge up from its low of 8.3% to 9.4% in Aug, as import prices (petrol and food, especially) are rising with MNT depreciation, suggesting BoM may need to enhance its price stabilization program if BoM is determined to maintain its 8% inflation target for the year.

## Sri Lanka

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**Growth surprised to the upside in 2Q13; slight nudge higher to our growth forecast.** Sri Lanka's 2Q13 growth accelerated to 6.8%, beating expectations, driven by a rebound in industry and services, with the former driven by surprisingly strong construction activity even as manufacturing growth remained tepid, decelerating alongside lackluster exports. We think this pick-up in construction is likely dominated by public sector related investment projects since private sector loan pick-up remained very subdued in 2Q13. We don't think public spending, especially the portion that is on-budget (NSB's \$750mn issuance, half of which to fund government related projects is likely going to be off-budget) is sustainable given the sharp deterioration in revenue collection that is challenging its deficit target this year. We slightly upgrade our growth forecast for this year to 6.5% (from 6.4%) and expect headline growth to pick up above 7% in 3Q13 on the back of a favorable base effect before coming off in 4Q13.

**CBSL on hold for now, but should be on guard to FX pressures.** Inflation has been well contained with core inflation pressures being subdued for the most part of last year despite periodic supply-side administered adjustment to energy prices. However, we expect headline inflation has already bottomed as favorable base effect reverses. Lagged impact of monetary easing and the recent liquidity injection via SLR cut had a material impact on private sector loans in July, and thus, alongside subdued export performance, external imbalances will likely remain a challenge. We expect CBSL to remain on hold this year, but do not preclude the possibility that CBSL could tighten monetary policy by 1H14 if FX stability is challenged by renewed taper-led volatility impacting portfolio flows.

**Sri Lanka's external funding picture still looks challenging over the medium term.** We expect the current account deficit to stay above 5% of GDP this year with rising income deficit and sticky goods trade deficit offsetting improving balance on services and transfers. While net FDI is up 20%YoY in 1H13, and there seems to be some stepped up effort to mobilize "official" funding sources, Sri Lanka remains exposed to global risk sentiment impacting portfolio flows. The FX reserve coverage ratio looks low and very reliant on pursuing continued debt-related inflows. While we may have some short-term risk bounce on EM credits after Sri Lanka dollar bonds underperformed on new supply, the longer term external refinancing pressure will likely keep spreads wide to the likes of Vietnam. LKR bonds still have some support given the yield buffer, but we remain biased on the short-end.

## Vietnam

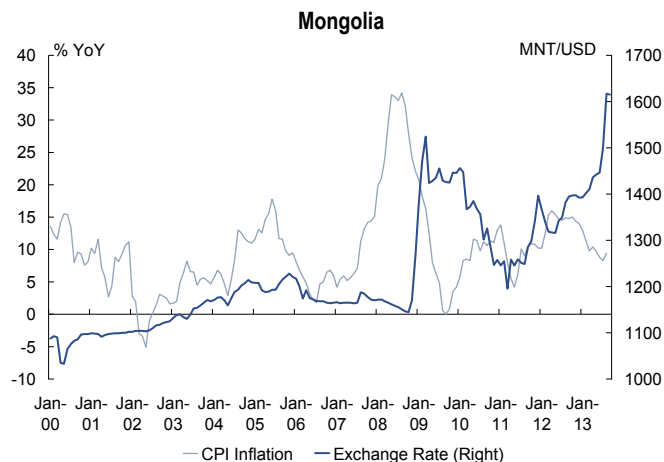
**We expect only a very limited economic rebound in 2H13.** After very subdued growth of 4.9% in 1H13 and PMI hitting a trough in June, this has started to rise gradually, but looking at high-frequency data like (real) retail sales, industrial production and trade, it does not seem to show much pick-up though PMI had started to rise very gradually (though still at 49.4 in Aug). The main driver of our expectation of a slight pick-up in 2H13 is on both net exports and impact of lagged monetary accommodation. After 800bps of cuts since early last year, pace of bank deleveraging seems to be slowing somewhat with credit growth picking up above our earlier expectations – we revise up our credit growth forecast by year-end to 12% from 8%, but we are somewhat disappointed by the slow pace of export pick-up. We maintain our GDP growth forecast at 5.1% this year, lower than the government's "downwardly adjusted" 2013 forecast of 5.4%.

**Inflation remains a concern, but we don't think this precludes one more rate cut.** Headline inflation eased to 6.3%YoY in September (vs Aug: 7.5%) due to a favorable base effect and normalizing transportation costs after two rounds of fuel price adjustments in June and July, as well as reversal of healthcare increase in Aug. Despite the lower YoY inflation, MoM inflation stayed elevated (Sep: 1.06%; Aug: 0.83%) amid seasonal spikes in education costs, and persistent inflation on food. We think Vietnam could still ease monetary policy further given anemic domestic demand, lack of credit intermediation, and comfortable external balance sheet. We revised up our current account surplus estimate in 2012, hitting about 6% of GDP after IMF released its latest data, and we expect this to narrow to 4.2% of GDP in 2013F. With limited external vulnerabilities, we slightly adjust our VND forecast towards more stability.

**Bank sector problems continue to fester for awhile.** After the Vietnam Asset Management Company (VAMC) was set up in July, it has yet to be operational (targeted to start this month) in buying bad debts. The government has an unrealistic goal that VAMC can purchase at least VND30trillion (\$1.4bn) of bad debt this year, or 19-20% of SBV's estimated outstanding NPLs in the banking system – SBV reported recently that the NPL ratio is at 4.68% of total loans in July, a much smaller figure than outside estimates and their earlier estimate of 8.8% in September 2012. However, we still remain skeptical that we will get quick resolution – banks' participation in offloading NPLs to VAMC is voluntary and feedback seems very mixed, banks still have to provision for 20% of the bad debts exchanged every year (so only buys banks time), recovery rate is unclear and we are still missing a crucial fresh capital injection in the banking system which the government remains very hesitant to do. Thus, subpar domestic growth will likely persist for awhile, in contrast to a more buoyant export-manufacturing sector.

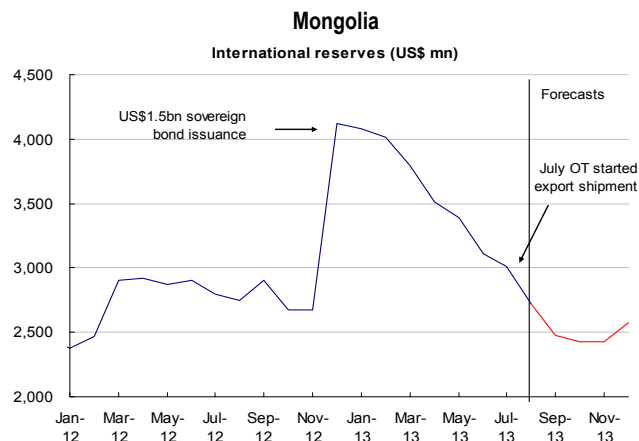
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Figure 95. Mongolia – MNT depreciation will add inflation pressures



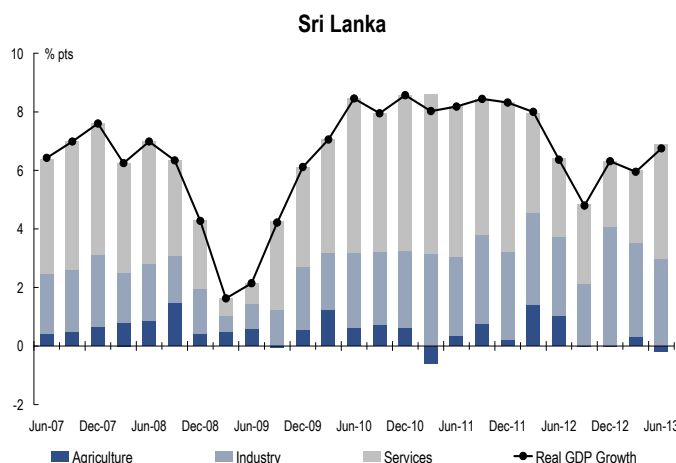
Source: BoM, CEIC and Citi Research

Figure 96. FX reserves decline would not arrest till sizeable FDI returns



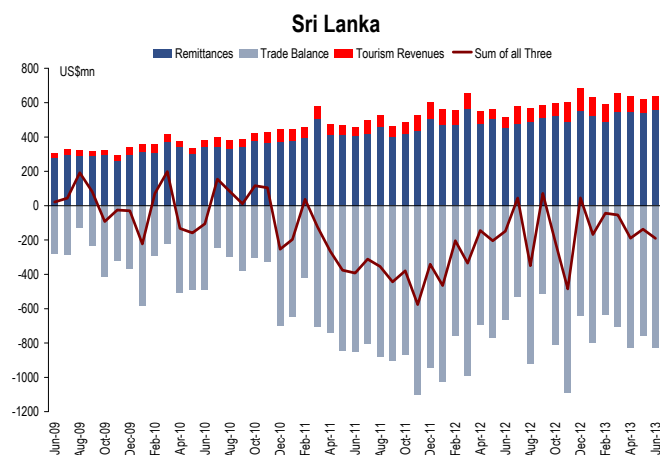
Source: BoM, CEIC and Citi Research

Figure 97. Sri Lanka – Real GDP growth in 2Q13 surprised to the upside



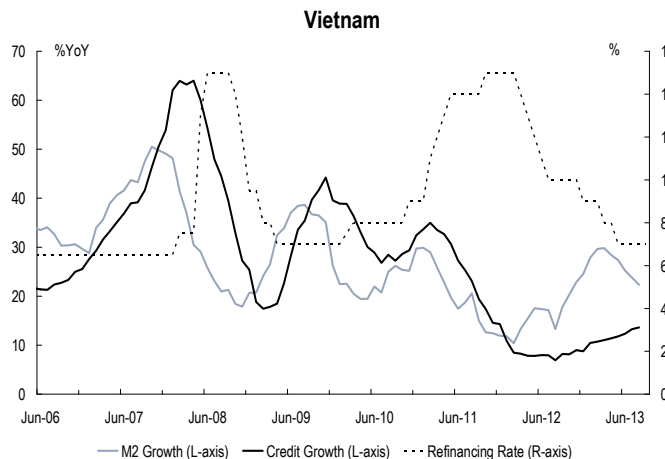
Source: CBSL, CEIC, Citi Research

Figure 98. High frequency data still show a challenging backdrop to the current account



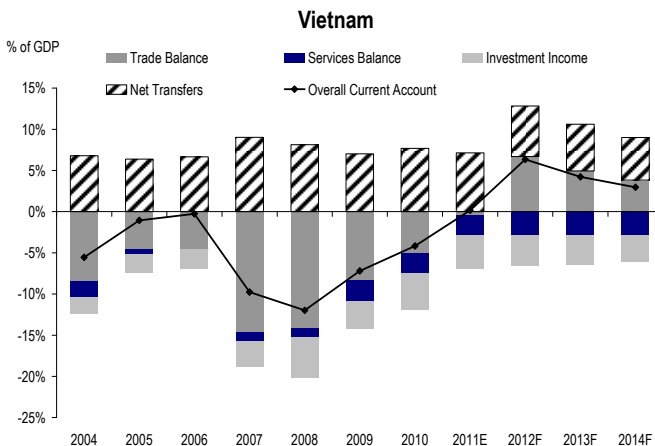
Source: CBSL, CEIC, Citi Research

Figure 99. Vietnam – Bank credit very modestly showing signs of life; deleveraging is slowing



Source: CEIC, GSO, SBV, Citi Research

Figure 100. Current account surplus remains at comfortable levels



Source: CEIC, IMF, Citi Research

Figure 101. Asia Frontier Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
<b>Mongolia</b>									
Nominal GDP, US\$ bn	3.4	4.2	5.6	4.6	6.2	8.8	10.3	11.3	13.2
GDP per capita, US\$	1334	1629	2138	1717	2287	3186	3593	3889	4481
Population, mn	2.6	2.6	2.6	2.7	2.7	2.8	2.9	2.9	3.0
Real GDP, % yoy	8.6	10.2	8.9	-1.3	6.4	17.5	12.4	13.8	11.0
CPI, % yoy	8.1	15.1	22.1	4.2	13.0	10.2	14.0	10.0	10.0
CPI, % avg	4.5	--	28.0	8.0	10.1	9.2	14.3	9.9	10.0
Policy interest rate, % eop	--	8.40	9.75	10.00	11.00	12.25	13.25	10.00	10.50
Long term yield, % eop	26.93	21.83	20.58	21.67	20.07	16.61	18.11	15.61	16.81
lc/US\$, eop	1164	1172	1275	1433	1233	1378	1378	1630	1560
lc/US\$, avg	1181	1171	1167	1434	1349	1256	1353	1530	1583
Current account (US\$ bn)	0.2	0.3	-0.7	-0.4	-0.9	-2.8	-3.2	-2.8	-1.8
% of GDP	6.5	6.3	-12.8	-8.9	-15.0	-31.5	-31.2	-24.5	-13.6
Trade balance (US\$ bn)	0.1	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-1.5	-0.4
Exports (US\$ bn)	1.5	1.9	2.5	1.9	2.9	4.8	4.4	5.0	6.5
Imports (US\$ bn)	1.5	2.2	3.2	2.1	3.2	6.6	6.7	6.6	6.8
FDI, net (US\$ bn)	--	0.4	0.8	0.6	1.6	4.6	3.9	3.0	3.5
International reserves (US\$ bn)	0.6	0.8	0.6	1.3	2.2	2.3	3.9	2.7	3.2
Consolidated government balance (% of GDP)	7.6	2.6	-4.5	-5.2	0.5	-6.9	-8.3	-7.8	-5.8
Public debt (% of GDP)	40.6	36.0	30.6	48.7	42.1	55.0	47.8	50.0	40.0
<b>Sri Lanka</b>									
Nominal GDP, US\$ bn	28.3	32.4	40.7	42.1	49.6	59.2	59.4	66.1	75.6
GDP per capita, US\$	1422	1615	2014	2057	2400	2836	2816	3099	3504
Population, mn	19.9	20.0	20.2	20.5	20.7	20.9	21.1	21.3	21.6
Real GDP, % yoy	7.7	6.8	5.9	3.5	8.0	8.2	6.4	6.5	6.8
CPI, % yoy	13.5	18.8	13.9	5.0	6.8	4.9	9.2	6.3	7.8
CPI, % avg	10.0	15.8	22.5	3.6	6.2	6.8	7.5	7.3	7.0
Policy interest rate, % eop	11.50	12.00	12.00	9.75	9.00	8.50	9.50	8.75	9.00
Long term yield, % eop	12.98	19.96	19.12	9.33	7.55	9.31	11.54	10.50	10.50
lc/US\$, eop	107.5	108.7	113.0	114.4	110.9	113.9	127.7	133.0	130.0
lc/US\$, avg	103.9	110.6	108.3	114.9	113.0	110.5	127.2	130.6	130.0
Current account (US\$ bn)	-1.5	-1.4	-3.9	-0.2	-1.1	-4.6	-3.9	-3.5	-2.6
% of GDP	-5.3	-4.3	-9.5	-0.5	-2.2	-7.8	-6.6	-5.3	-3.4
Trade balance (US\$ bn)	-3.4	-3.7	-6.0	-3.1	-4.8	-9.7	-9.4	-9.7	-11.0
Exports (US\$ bn)	6.9	7.6	8.1	7.1	8.6	10.6	9.8	10.1	11.0
Imports (US\$ bn)	10.3	11.3	14.1	10.2	13.5	20.3	19.2	19.8	21.9
FDI, net (US\$ bn)	0.5	0.5	0.7	0.4	0.4	0.9	0.8	1.0	1.0
International reserves (US\$ bn)	2.5	3.1	1.8	5.1	6.6	6.0	6.9	6.6	7.7
Consolidated government balance (% of GDP)	-7.0	-6.9	-7.0	-9.9	-8.0	-6.9	-6.4	-6.2	-5.7
Public debt (% of GDP)	87.9	85.0	81.4	86.1	81.9	78.4	79.1	78.0	76.0
<b>Vietnam</b>									
Nominal GDP, US\$ bn	60.9	71.2	90.0	91.9	102.4	121.7	141.5	156.2	173.8
GDP per capita, US\$	724	836	1044	1054	1163	1367	1572	1718	1893
Population, mn	84.1	85.2	86.2	87.2	88.1	89.0	90.0	90.9	91.8
Real GDP, % yoy	7.0	7.1	5.7	5.4	6.4	6.2	5.3	5.1	5.4
CPI, % yoy	6.6	12.6	19.9	6.5	11.7	18.1	6.8	6.6	8.1
CPI, % avg	7.5	8.5	23.2	7.0	9.2	18.6	9.3	6.6	7.1
Policy interest rate, % eop	6.50	6.50	9.50	8.00	9.00	15.00	9.00	6.00	7.00
Long term yield, % eop	8.29	8.73	10.00	11.68	11.50	12.55	9.75	8.50	9.00
lc/US\$, eop	16056	16028	17483	18474	19498	21034	20840	21150	21388
lc/US\$, avg	15990	16081	16445	17806	19123	20648	20875	21104	21348
Current account (US\$ bn)	-0.2	-7.0	-10.7	-7.2	-4.3	0.2	9.0	6.6	5.2
% of GDP	-0.3	-9.8	-11.9	-7.8	-4.2	0.2	6.3	4.2	3.0
Trade balance (US\$ bn)	-2.8	-10.4	-12.8	-8.3	-5.1	-0.5	9.5	7.7	6.7
Exports (US\$ bn)	39.8	48.6	62.7	57.1	72.2	96.9	114.5	131.6	155.3
Imports (US\$ bn)	42.6	58.9	75.5	65.4	77.4	97.4	105.0	123.9	148.7
FDI, net (US\$ bn)	2.3	6.6	9.3	6.9	7.1	7.3	7.0	7.0	7.0
International reserves (US\$ bn)	13.4	23.5	23.9	16.4	12.5	13.5	25.6	35.8	38.3
Consolidated government balance (% of GDP)	-1.1	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-4.8	-4.0
Public debt (% of GDP)	37.5	39.0	34.9	40.0	45.5	45.9	43.1	41.0	41.5

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

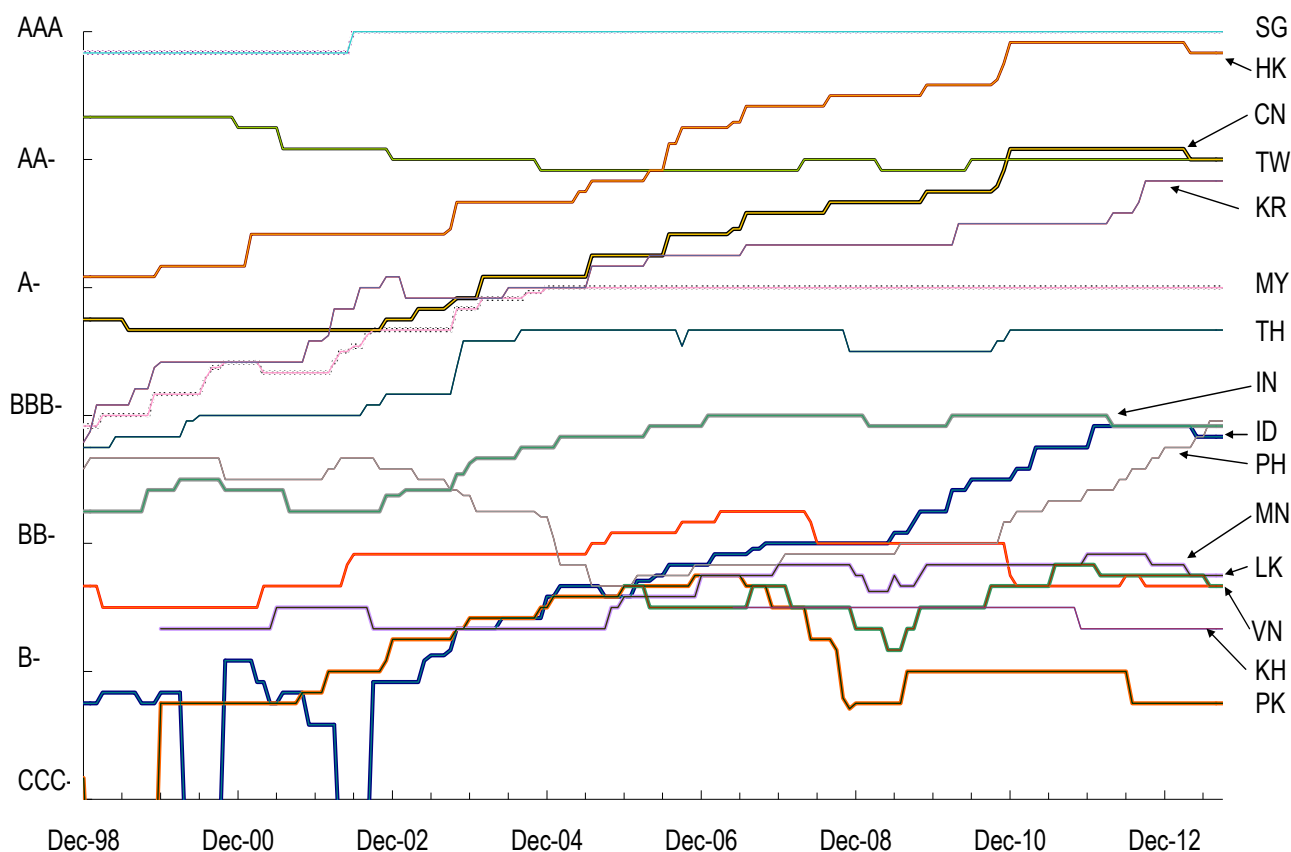
## Appendix: Sovereign Risk Ratings Summary

Figure 102. Long-Term Foreign Currency Ratings

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

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

Figure 103. Ratings History (Average of S&P and Moody's Ratings), December 1998- September 2013



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

## Global Assumptions

	2013 Q1E	2013 Q2E	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2012E	2013F	2014F	2015F	2016F	2017F
<b>Global Indicators</b>														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	2.6	2.5	3.2	3.4	3.7	3.7
CPI Inflation (average, y/y %)	—	—	—	—	—	—	—	—	2.9	2.6	3.0	3.2	3.2	3.2
Current Account (% of GDP)	—	—	—	—	—	—	—	—	0.5	0.7	0.6	0.3	0.1	0.0
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-4.4	-3.5	-3.0	-2.6	-2.4	-2.3
<b>Industrial Countries*</b>														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	1.4	1.2	2.0	2.2	2.3	2.3
CPI Inflation (average, y/y %)	—	—	—	—	—	—	—	—	1.8	1.3	1.9	1.5	1.4	1.5
Current Account (% of GDP)	—	—	—	—	—	—	—	—	-0.6	-0.1	-0.1	-0.1	-0.1	-0.1
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-6.0	-4.4	-3.6	-2.9	-2.6	-2.4
<b>United States</b>														
GDP Growth (SAAR %)	1.1	2.8	2.0	2.7	2.7	2.9	3.1	3.2	—	—	—	—	—	—
GDP Growth (y/y %)	1.3	1.7	1.5	2.2	2.5	2.6	2.8	3.0	2.8	1.7	2.7	3.2	3.2	3.0
CPI Inflation (average, y/y %)	1.4	1.1	1.2	1.2	1.5	2.0	2.1	2.1	1.8	1.2	1.9	2.1	2.1	2.1
Current Account (% of GDP)	-2.6	-2.4	-2.6	-2.7	-2.7	-2.7	-2.7	-2.7	-2.7	-2.8	-2.8	-3.0	-3.0	-3.0
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-8.1	-4.8	-4.3	-3.8	-3.8	-3.8
S&P 500 EPS (y/y %)	5.0	5.0	6.3	4.2	7.6	6.2	5.6	7.0	6.1	5.5	6.2	—	—	—
Business Investment (y/y %)	2.4	2.4	3.3	2.0	4.3	4.3	4.6	4.9	7.3	2.5	4.5	—	—	—
Imports (y/y %)	0.1	1.1	1.9	4.0	5.5	5.5	6.1	6.4	2.2	1.8	5.9	—	—	—
<b>Japan</b>														
GDP Growth (SAAR %)	3.8	3.8	2.3	3.9	4.6	-4.6	2.1	0.8	—	—	—	—	—	—
GDP Growth (y/y %)	0.1	1.3	2.8	3.5	3.6	1.5	1.5	0.7	2.0	2.0	1.8	1.0	1.2	1.2
CPI Inflation (y/y %)	-0.6	-0.3	0.6	0.8	0.8	2.9	2.7	2.5	0.0	0.0	2.1	0.7	0.5	0.7
Current Account (% of GDP)	0.7	1.7	1.8	1.7	2.1	2.5	2.6	2.5	1.1	1.5	2.4	1.8	1.5	1.3
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-10.7	-9.8	-8.0	-6.2	-5.8	-5.4
<b>Euro Area</b>														
GDP Growth (SAAR %)	-1.1	1.2	0.6	0.9	0.7	0.6	0.8	0.7	—	—	—	—	—	—
GDP Growth (y/y %)	-1.1	-0.5	-0.2	0.5	0.8	0.7	0.7	0.7	-0.6	-0.3	0.7	1.0	1.3	1.5
CPI Inflation (y/y %)	1.9	1.4	1.4	1.5	1.4	1.7	1.5	1.5	2.5	1.5	1.5	1.4	1.4	1.4
Current Account (% of GDP)	—	—	—	—	—	—	—	—	1.2	2.5	2.3	2.3	2.3	2.3
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-3.7	-2.9	-2.5	-2.0	-1.7	-1.2
<b>Exchange Rates</b>														
US\$ vs. Euro (eop)	1.33	1.31	1.30	1.31	1.33	1.33	1.34	1.35	1.28	1.33	1.37	1.39	1.40	1.40
US\$ vs. JPY (eop)	103	108	110	110	110	110	110	110	81	98	105	109	110	110
JPY vs. Euro (eop)	137	141	144	145	146	147	148	149	104	131	144	152	154	154
<b>Short Interest Rates (eop)**</b>														
United States	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	1.60	2.70
Japan	0.09	0.09	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Euro Area	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.88	0.56	0.50	0.50	0.56	0.81
<b>10-Yr Yield Forecasts (Period Avg.)</b>														
United States	1.85	2.49	2.60	2.70	2.80	3.00	3.15	3.25	1.80	2.35	3.05	3.50	3.75	4.00
Japan	0.55	0.85	0.90	0.80	0.70	0.60	0.70	0.80	0.85	0.72	0.60	0.90	1.25	1.50
Euro Area***	1.29	1.73	1.55	1.70	1.80	1.80	1.80	1.90	1.57	1.62	1.83	2.00	2.25	2.50
<b>Emerging Markets</b>														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	4.6	4.7	5.0	5.2	5.5	5.6
CPI Inflation (eop, y/y %)	—	—	—	—	—	—	—	—	4.6	4.7	4.6	4.7	4.6	4.6
Current Account (% of GDP)	—	—	—	—	—	—	—	—	2.1	1.8	1.5	0.8	0.3	0.0
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-1.6	-2.1	-2.1	-2.1	-2.2	-2.1
<b>Commodities</b>														
WTI Oil price (US\$/bbl)	94.4	94.2	108.0	107.0	108.0	103.0	108.0	102.0	94.1	100.9	105.3	99.3	—	—
Copper (Average, USD/MT)	7,964	7,188	7,060	6,900	6,700	6,600	6,400	6,500	7,945	7,280	6,550	6,800	—	—
Gold (Average, US\$/oz)	1,632	1,429	1,315	1,250	1,220	1,230	1,260	1,280	1,669	1,405	1,250	1,350	—	—

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

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## Asia-Pacific Economics and Market Analysis

Figure 104. Citi Global Economics Team *For informational purposes only*

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Source: Citi Research.



## Appendix A-1

### Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

### IMPORTANT DISCLOSURES

Rohini Malkani is on a three months leave of absence for the period July 15 2013 to October 14 2013. During this period, she will be working for the Ministry of Finance, India and she will cease all normal course business activity as an Economist at Citi.

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