

# Asia Macro and Strategy Outlook

## On the Lookout for Excessive Leverage

- **Monetary policy in AEs plus Asia's domestic policy responses are raising credit overheating risks in the region** — In fact, some studies show that it is domestic factors, especially monetary policy, that is historically more dominant than external factors in explaining rapid credit growth in Asia – and on average, EM Asia will now be in its third-and-a-half year of having below “normal” real interest rates.
- **Not all credit booms are created equally** — Some credit booms are associated with favorable economic outcomes, while others can be a function of excessive credit-fueled exuberance and/or lax lending standards leading to financial distress and/or subpar growth recovery. Some studies show “bad” credit booms tend to be larger and longer and start at a higher level of financial depth than “good” ones.
- **EM Asia's bank credit-to-GDP ratio has risen sharply, surpassing pre-Asian crisis highs on average** — The average EM Asia ratio has been on a rising uptrend for at least four years. The strongest bank credit boom in recent years has been in VN – this is now unraveling in a bad way – followed by very strong credit booms in CN (especially in 2009-2010) and HK (the latter may be distorted by growing CN-HK financial integration), and briefly in MY (in late mid 2009-early 2010), punctuated by BNM's move to tighten MP earliest on March 2010. However, recent data shows bank credit-to-GDP is now rising sharply in TH & SG. Despite strong nominal credit growth in recent years, increase in the bank credit-to-GDP ratio in ID, IN and PH looks more modest and coming from a low base, while KR's has been stagnant for years.
- **There are pockets of vulnerabilities, but no signs of systemic financial risks** — Asian banks look well capitalized, with comfortable liquidity position and relatively low NPL ratio (except VN & IN), and thus, no signs of systemic financial distress for most. Since 2007, household debt has risen significantly in CN, MY, SG and TH – we think MY looks the most vulnerable – while corporate leverage ratios rose most in PH, IN, TH and CN – and we worry more about it in CN and IN. Credit exuberance in the corporate bond market can also be detected by the sharply rising share of HY issuance to total issuance, reaching pre-Asia financial crisis highs. CN has added vulnerability stemming from the debt overhang of local governments.
- **Market Implications: EM Asia is going to be a loser of the “currency war”** — Less flexible exchange rates and prolonged low rates exacerbate credit booms – macroprudential policies help curb financial stability risks but are not a panacea. We think the case for Thailand and China to start “leaning against the wind” by tightening monetary conditions (partly via FX appreciation) is stronger than others – eventually Taiwan and Malaysia may need to do the same. The Philippines and Korea may be able to “gamble” with looser monetary policy for a little longer but given an already high level of household debt in the case of KR and gradually rising inflation risks, this window should narrow quickly.

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## Citi Key Economic Forecasts

Figure 1. GDP Forecasts (growth rate in percent)

	2012 GDP Estimates	2013 GDP Forecasts			2014 GDP Forecasts		
	Current	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	6.2	6.5	6.6	6.9	6.5	6.6	—
Asian NIEs*	1.7	3.1	3.0	3.1	4.0	4.0	—
SEAN-4**	6.2	5.7	5.7	5.7	6.0	5.9	—
China	7.8	7.8	7.8	8.2	7.3	7.3	8.2
Hong Kong	1.4	3.0	2.8	3.4	3.5	3.5	4.1
India***	5.0	5.7	6.2	6.3	6.4	6.9	—
Indonesia	6.2	6.2	6.1	6.2	6.3	6.3	6.3
Malaysia	5.6	5.5	5.5	5.0	6.0	6.0	5.3
Mongolia	12.3	13.8	13.8	—	11.0	11.0	—
Philippines	6.6	6.2	6.1	5.9	6.6	6.4	5.7
Singapore	1.3	2.0	2.0	2.7	4.0	4.0	3.9
South Korea	2.0	3.2	3.2	3.0	4.1	4.1	3.7
Sri Lanka	6.2	6.8	7.1	6.7	7.1	7.5	7.1
Taiwan	1.3	3.5	3.0	3.6	4.0	3.8	4.1
Thailand	6.4	4.7	4.5	4.6	4.8	4.8	4.8
Vietnam	5.0	5.4	5.4	5.5	5.8	5.8	5.9

Figure 2. CPI Forecasts (growth rate in percent)

	2012 CPI	2013 CPI Forecasts			2014 CPI Forecasts		
	Current	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	3.7	3.8	3.5	3.9	4.1	3.9	—
Asian NIEs*	2.7	2.8	2.8	2.7	2.9	2.9	—
SEAN-4**	3.4	3.7	3.7	4.1	4.0	4.1	—
China	2.6	2.8	2.8	3.2	3.6	3.6	3.5
Hong Kong	4.1	4.3	4.0	4.0	3.7	3.7	3.7
India***	7.5	7.0	7.0	7.5	6.0	6.0	—
Indonesia	4.3	4.7	4.7	5.2	4.7	4.7	5.2
Malaysia	1.6	1.7	1.7	2.3	2.4	2.4	2.9
Mongolia	14.3	12.0	12.0	—	10.0	10.0	—
Philippines	3.1	3.5	3.5	3.6	3.8	3.8	4.0
Singapore	4.6	4.0	4.0	3.8	3.4	3.4	3.3
South Korea	2.2	2.6	2.6	2.5	3.0	3.0	2.9
Sri Lanka	7.5	7.1	7.1	7.7	6.5	6.5	6.8
Taiwan	1.9	1.7	2.0	1.8	2.0	1.8	2.0
Thailand	3.0	3.3	3.3	3.3	3.5	4.0	3.4
Vietnam	9.3	7.6	7.2	8.1	7.2	7.0	8.2

Figure 3. Current Account Forecasts (percent of GDP)

	2012 CAB Estimates	2013 CAB Forecasts			2014 CAB Forecasts		
	Current	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	2.0	1.4	1.5	0.8	1.1	1.2	—
Asian NIEs*	7.3	5.0	5.0	1.4	5.0	5.1	—
SEAN-4**	0.4	0.2	-0.1	-0.1	0.1	-0.2	—
China	2.6	2.0	2.0	2.4	1.5	1.5	2.0
Hong Kong	5.0	5.6	5.6	1.9	6.2	6.2	2.0
India***	-4.7	-4.3	-3.5	-3.7	-3.7	-3.0	—
Indonesia	-2.8	-2.1	-2.0	-1.5	-1.7	-1.5	-1.0
Malaysia	6.4	5.0	4.0	5.6	4.0	3.3	5.8
Mongolia	-31.3	-22.5	-22.1	—	3.1	3.1	—
Philippines	3.9	3.2	2.2	3.1	2.2	1.1	2.6
Singapore	18.6	14.0	13.9	15.4	13.5	13.3	15.8
South Korea	3.8	1.4	1.4	2.6	1.6	1.8	2.2
Sri Lanka	-5.5	-4.7	-4.7	-4.7	-4.0	-4.0	-3.7
Taiwan	10.5	8.4	8.4	8.3	8.0	8.0	7.8
Thailand	0.7	-0.3	-0.4	1.1	-0.5	-0.7	1.3
Vietnam	3.2	2.4	2.4	0.0	0.7	0.7	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 (February 11, 2013) and Citi Research estimates.

# Macro Overview

## On the Lookout for Excessive Leverage

### Post G7/G20 – A Race to the Bottom?

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One key takeaway from the G7/G20 meeting is to see little resistance to advanced economies (AE) pursuing a more accommodative monetary policy if it suits domestic policy objectives, regardless of the currency weakening implications.<sup>1</sup> For example, the G7 communique says “our fiscal and monetary policies have been and will remain oriented towards meeting our respective domestic objectives using domestic instruments, and that we will not target exchange rates”. The G20 communique – with varying and often conflicting objectives between AE vs. EM countries – had an even more bland statement saying “In all policy areas, we commit to minimize the negative spillovers on other countries of policies implemented for domestic purposes”. Where does this leave EM Asia?

We shift our focus on the “currency war” theme by looking at the consequence of both AE monetary accommodation and Asia’s own policy responses to potentially creating further risks to financial stability via excessive leverage.

We focus on analyzing risks associated with sustained capital inflows in Asia, **PLUS** risks associated with Asia’s own domestic policy responses to the “currency war”. Not only could EM Asia face global liquidity injection (or potential liquidity injection) from AEs, but also inherent risks associated with EM Asia’s various policy responses to this currency war, namely, escalating currency intervention and prolonged low real rates (see [Asia Macro and Strategy Outlook - Currency Wars? More Like Currency Skirmishes](#)) in fuelling further expansion of risk-taking and leverage. In fact, a recent IMF study shows that domestic factors, especially monetary policy, are historically *more dominant* than external factors in driving rapid credit growth in EM Asia.<sup>2</sup>

We think the outlook for further capital inflows fueling further liquidity expansion is likely

**Capital inflows have waned from the January highs, but we think this may prove temporary.** EPFR data show fund flows into EM Asian equity and bond funds have tempered vis-à-vis recent months, likely due to growing concern about adverse repercussions of “currency wars” as well as worries over premature withdrawal of global liquidity, especially amid more hawkish than expected statements from the Fed (**Figure 4**). However, we expect these concerns will fade over time amid underlying strength in growth momentum in EM (especially in Asia), improving growth prospects in parts of AEs, especially in the US, and still ample liquidity.

...for one thing, Japanese investors don’t seem to be adding to global liquidity injection via overseas portfolio investments yet.

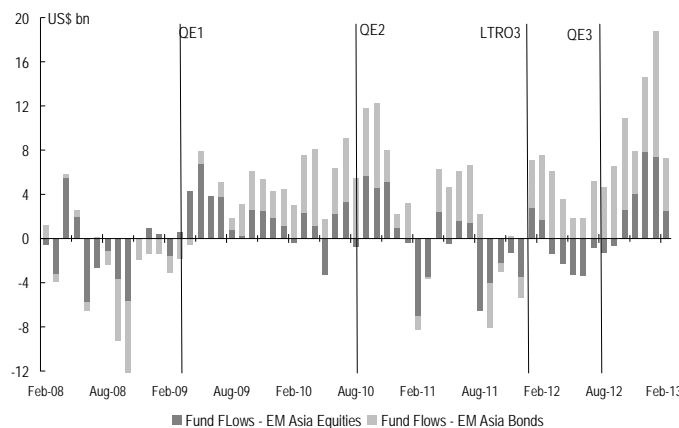
Moreover, one interesting aspect of the global portfolio flow story is that, **despite Yen weakness, there is still no sign that local Japanese investors are adding to this global liquidity injection by shifting out of the Yen into purchasing overseas securities.** A recent IMF study indicates Japanese investors have actually been “taking profit” on overseas portfolio investments following the recent FX gains. In other words, the weak Yen period since last year ironically was accompanied by net portfolio investments into (rather than out of) Japan (**Figure 4**).<sup>3</sup> However, if JPY weakness persists awhile longer (we are forecasting USD-JPY at 95-96 range on both 0-3M and 6-12M horizon) and remains embedded in Japanese investors’ expectations, we think this net portfolio flow into Japan should eventually reverse.

<sup>1</sup> For a discussion on G7, see W. Buiter & E. Rahbari. [“Global Economics View - More Expansionary Monetary Policy Weakens the Currency: Get Used to It”](#) (15-Feb-2013).

<sup>2</sup> See S. Elekdag & F. Han. “What Drives Credit Growth in Emerging Asia?” IMF Working Paper No. 12/43 (February 2012). See: <http://www.imf.org/external/pubs/ft/wp/2012/wp1243.pdf>.

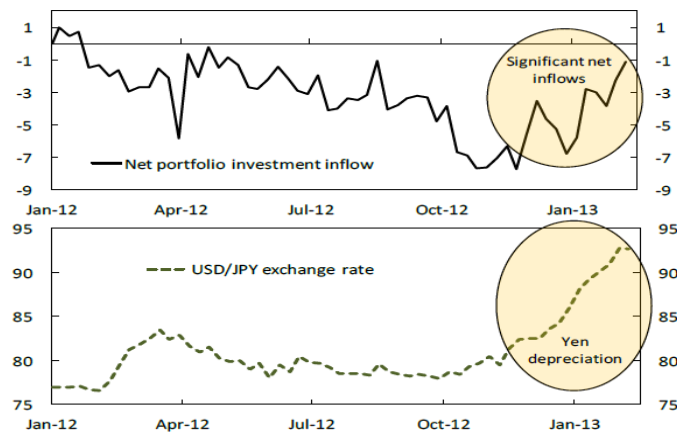
<sup>3</sup> See “Special Feature: Portfolio Flows to Japan and the Yen – What Do the Data Say?” published in *IMF Global Markets Monitor* (20 February 2013).

Figure 4. Fund Flows into Asia ex-Japan Bonds and Equity Funds



Source: EPFR, Citi Research

Figure 5. Japan's Cumulative Portfolio Investment since End 2011 vs. USD-JPY Rate



Source: IMF Global Markets Monitor (20 Feb 2013)

## Risks to Asia's Policy Responses to the "Currency War"

**Monetary accommodation of AEs and the weaker FX consequences (notably in JPY) pose important influences on some of Asia's CB behavior, inducing a bias towards more aggressive FX intervention and keeping rates low for longer.**

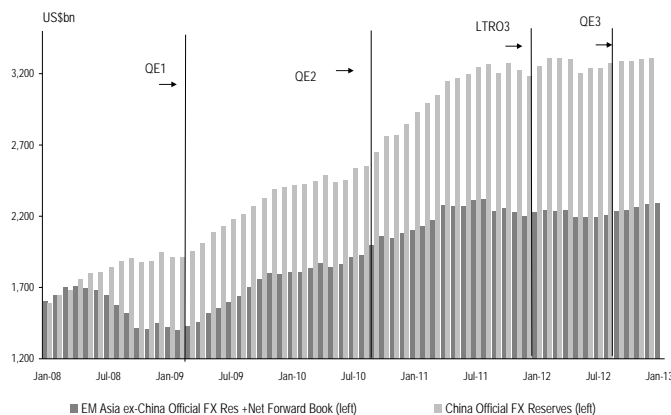
**Lagged impact of prolonged low real rates potentially jeopardizing financial stability remains to be seen.**

We argued previously that two likely policy responses of some Asian countries to currency debasement in AEs, particularly the JPY, is to see escalating FX intervention and a bias to keep rates low for longer (and possibly even cut further). Notwithstanding some portfolio revaluation effect, the gradually rising trend in official FX reserves and net forward positions of Asian central banks give us an indication that intervention has picked in some countries (Figure 6). One cost to intervention is clearly risks to exacerbating financial instability, asset price and overall inflation risks (although inflation momentum has remained benign so far for most). With the exception of Indonesia and Singapore, recent inflation readings have remained close to or below expectations.

On average, EM Asia will now be in its *third-and-a-half* year of having below "normal" (i.e. vis-à-vis its standardized 8-year mean) **real short interest rates** (Figure 7), with the most extreme being in the case of HK and Singapore. The lagged impact of very low real rates on risk-taking, yield-seeking, leverage-inducing behavior, and implications to long term financial stability in the region remain unclear. One can clearly mitigate the risks to prolonged low real rates by counteracting this with tighter or more restrictive macroprudential policies, with the aim of reducing the pro-cyclicality of lending, especially in sensitive areas like mortgages. However, as Singapore's *seventh* round and Hong Kong's *sixth* round of property tightening measures clearly illustrate – the effectiveness of these policies when both domestic and global monetary conditions remain persistently accommodative, can prove to be frustratingly inadequate, requiring repeated rounds of tightening with broader regulatory coverage to avert leakages.<sup>4</sup>

<sup>4</sup> See: [Singapore Property - 7th Round of Measures: Bringing Out The Big Guns This Time](#) and [Hong Kong Macro Flash - Broad-based and Steep Property Cooling Measures Announced](#).

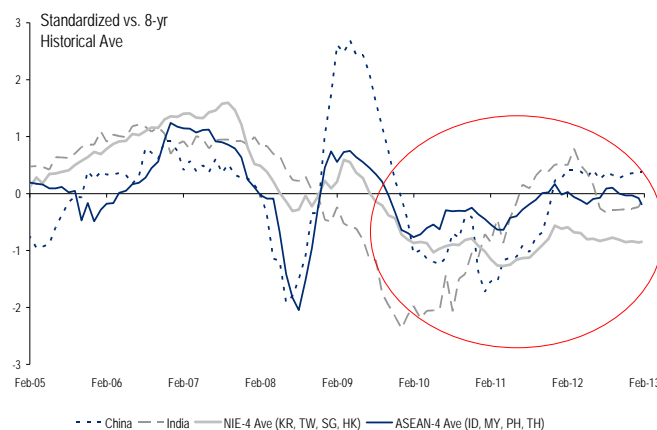
Figure 6. Asian Central Banks- Official FX Reserves and Net Forward Positions (where applicable), Jan 2008 to Jan 2013\*



Source: Citi Research

Note: With the exception of Thailand, all net forward positions of Asian central banks have data available only up to Dec 2012. We assume constant net forward position in January to build the EM Asia ex-China chart.

Figure 7. Asia's Real Short Term/Policy Interest Rates (Nominal Rate minus 12M- Forward Consensus Inflation Forecast)



Source: Bloomberg, Consensus Economics, Citi Research

## Not All Credit Booms Are Created Equally

**Not all credit booms end up leading to a banking crisis or weaker growth outcome weighed by deleveraging – in fact, many credit booms are associated with financial deepening and benign economic outcomes – i.e. good booms**

**Are we seeing financial deepening or seeds of a financial crisis?** Periods associated with rapid credit growth and an above-trend rise in credit-to-GDP ratio do not always lead to some form of systemic banking crisis. Empirical studies show that while credit booms often precede a banking crisis, the reverse is often not true – i.e. credit booms do not always lead to a financial crisis. In fact, most studies show that a financial crisis is the minority event post a credit boom. For example, a 2002 study of 39 middle income countries in 1980-99 found that the probability of a banking crisis in a given country year, conditional on a lending boom, is only 6%, while another 2007 study looking at a broader set of 100 countries from 1980-2004 identifying 137 episodes of credit booms found that only about 23% of these end up in some form of financial distress (16% in some form of systemic banking crisis).<sup>5</sup> A more recent IMF study by Dell'Ariccia et al (2012) looking at 170 countries from the 1960s to 2010 and citing 175 episodes of “credit booms” found that about 40% of those episodes are associated with episodes where credit-to-GDP ratio “*shifts permanently to a new higher ‘equilibrium’ level*”, and that these are also associated with higher cumulative real per capita GDP growth rates.<sup>6</sup>

The latter is not altogether surprising – there is long and extensive research on both theoretical and empirical underpinnings linking financial development (often proxied by private credit to GDP ratio) and growth, arguing, for example, that financial development reduces information & transaction costs, improves allocation of capital, facilitates risk-diversification and, *therefore*, boosts economic outcomes.<sup>7</sup>

<sup>5</sup> A. Tornell & F. Westermann. “Boom-Bust Cycles in Middle Income Countries: Facts and Explanation” *IMF Staff Papers* Vol 49. Special Issue (2002); and, A. Barajas, G. Dell'Ariccia and A. Levchenko. “Credit Booms: the Good, the Bad, and the Ugly”. Unpublished manuscript, IMF (2007)

<sup>6</sup> G. Dell'Ariccia, D. Igan, L. Laeven, H. Tong, B. Bakker & J. Vandeussche. “Policies for Macroeconomic Stability: How to Deal with Credit Booms.” *IMF Staff Discussion Note*, (June 2012).

<sup>7</sup> A literature review can be found in R Levine. “Finance and Growth: Theory and Evidence,” *Handbook of Economic Growth*, 1. Elsevier (2005).

...while other studies show that credit booms beyond a certain point can lead to bad macro outcomes – i.e. a banking crisis and/or slower growth.

But there are also many studies linking credit booms to a financial crisis, and even without a full blown crisis, a subpar economic recovery. For example, while credit booms are not followed by a financial crisis, findings from Dell'Ariccia et al (2012) show that 60% of the cases of credit booms in their sample are *followed by an extended period of below-trend growth*, so only 31% of the cases of credit booms are found to have really benign outcomes (**Figure 8**). We think this potential for a subpar growth outcome is a risk factor we need to watch in Asia in lieu of early signs of multi-year periods of significant credit expansion but no major signs of systemic weaknesses in the banking sector.

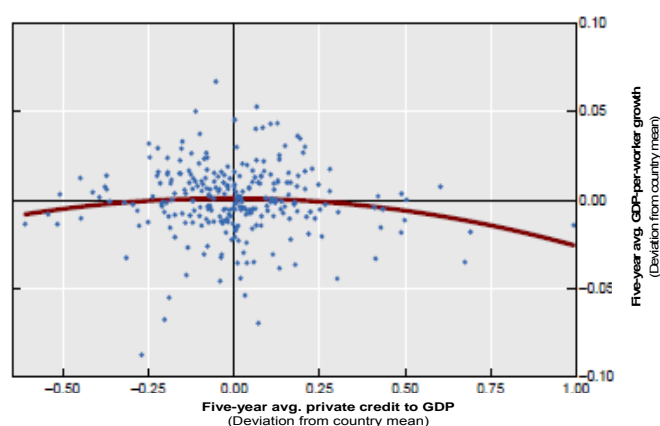
Figure 8. IMF (2012) Paper: Proportion of Credit Booms that are followed by either economic underperformance and/or financial crisis (the former more frequent than the latter).

Followed by financial crisis?	Credit Booms Gone Wrong					
	Followed by economic underperformance?					
	No		Yes		Total	
	Number	% of total cases	Number	% of total cases	Number	% of total cases
No	54	31%	61	37%	118	67%
Yes	16	9%	41	23%	57	33%
Total	70	40%	105	60%	175	

Note: Number and proportion of credit boom episodes are shown. A boom is followed by a financial crisis if a banking crisis happened within the three-year period after the end of the boom and is followed by economic underperformance if real GDP growth was below its trend, calculated by applying a moving-average filter, within the six-year period after the end of the boom.

Source: Dell'Ariccia et al (IMF Staff Discussion Note cited in Footnote 6)

Figure 9. BIS Paper: Private Credit only good up to a certain point? Private credit to GDP ratio and GDP per worker growth, adjusting for initial conditions via country-specific mean.



Source: Cecchetti & Kharroubi (2012)

Note: The study uses both a combination of 50 developed and emerging countries in 1980-2009

**Distinguishing bad credit booms and good ones is difficult – studies show the former tend to be larger and last longer, and at a higher level of financial depth.**

**Distinguishing “bad credit booms” from “good credit booms” is not easy.**

Bad credit booms are those associated with excessive credit-fueled exuberance and/or enabled by lax lending standards by creditors/agents that eventually lead to costly unwinds as asset prices correct, and whose economic impact is amplified by deterioration of balance sheets of financial institutions. Good credit booms are those associated with either/or both an uptrend of the business cycle (which could be more amplified in episodes of significant productivity improvements) and structural financial deepening. The macroeconomic symptoms accompanying both good and bad credit booms can look very similar – Dell'Ariccia et al (2012) and an earlier study by Barajas et al (2007) find no statistically significant differences in macro economic performance – e.g. the degree of asset price increase or trade balance deterioration – between good credit booms and bad credit booms, but those same studies do show that bad credit booms tend to be larger and longer, and tend to start at higher level of financial depth (measured as the level of credit to GDP ratio).<sup>8</sup> The latter point of this study is somewhat consistent with another recent study by Cecchetti & Kharroubi (2012) arguing that financial development is “good only up to a point, after which it becomes a drag to growth”, a point illustrated on **Figure 9**.<sup>9</sup>

<sup>8</sup> See footnote 5 for details on the 2007 study, and footnote 6 for the 2012 study.

<sup>9</sup> Cecchetti and E. Kharroubi. “Reassessing the impact of finance on growth”. *BIS Working Paper* 381 (July 2012).



We use the annualized change in credit-to-GDP ratio of at least 5-10ppts range as signs of a credit boom.

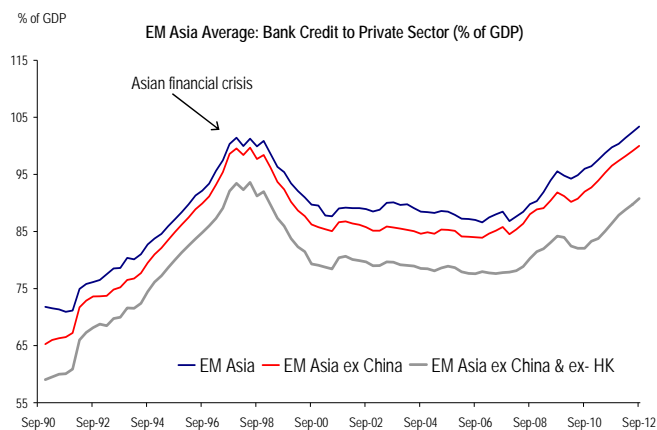
For our purposes here, we will focus mainly on both the level of leverage ratios and how much it has risen as a barometer to financial stability risks, as well as potential policy responses. Finding the appropriate “threshold” of increase in which good credit boom turns bad is difficult – studies often use some measure of trend deviation, or when the annual credit-to-GDP ratio exceeds a certain threshold (though this needs to be adjusted for distortions during sharp drops in nominal GDP, as we saw in some countries during the GFC). For this study, we use the annual 5 percentage point increase in credit-to-GDP ratio as benchmark for rising risks to financial stability – this was a benchmark used for a broader definition of credit in an IMF (2011) event study (which they found to be a good leading indicator for a financial crisis)<sup>10</sup> and is mid-way between the 3ppts used by that same IMF study for the narrower definition of bank credit-to-GDP and the 10ppts benchmark used by the Dell’Arricca (2012) paper.

## Asia’s Sharply Rising Bank Credit-to-GDP Ratio

We start our “measurement of leverage” exercise by looking at the domestic-bank credit to GDP ratio.

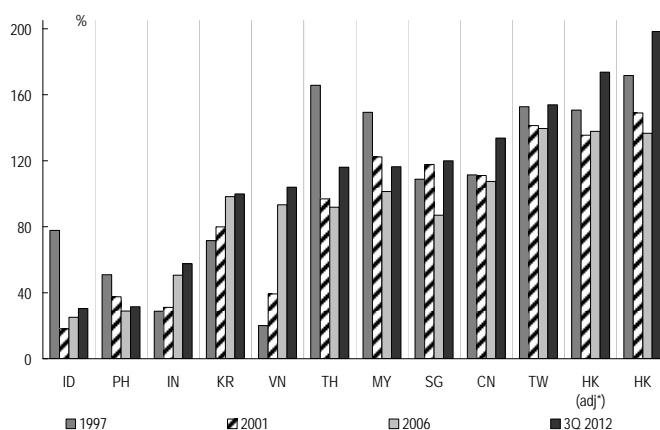
The most widely used metric of leverage in the economy, largely due to its accessibility, is domestic bank credit, via IMF’s data on banks’ domestic claims on the private sector, which we scale relative to GDP. Following the sharp run-up in bank credit-to-GDP ratios during the Asian crisis, we see a similar average run up since the GFC, with average bank credit-to-GDP ratios in Asia now surpassing pre-Asian crisis peaks in a few countries, namely in Hong Kong, China, Singapore, Taiwan, Korea, India and Vietnam (Figure 10 - Figure 11).

Figure 10. EM Asia Average\* – Domestic Bank Credit to GDP Ratio



Source: IMF International Financial Statistics, CEIC, Citi Research  
Note: \*We include CN, HK, IN, ID, KR, MY, PH, SG, TH & TW; To reduce distortions brought about by rising financial integration between China and HK, we only look at the ratio of HK’s credit identified for use in HK as a share of its GDP in constructing the EM Asia Averages.

Figure 11. Bank Credit to GDP Ratios, 1997, 2001, 2007 and Sep 2012



Source: IMF IFS, CEIC, Citi Research  
Note: \*We use CEIC data on HK loans identified for use in Hong Kong

We breakdown the annual changes in bank credit-to-GDP ratio in Figure 12 and make the following observations.

- **Vietnam** already saw two waves of bank-fuelled credit booms – in mid-2007 to early-2008, and another in mid-2009 to early-2011, which was then followed by very sharp deleveraging – bank credit-to-GDP ratio falling by at least 10ppts or more in the five last consecutive quarters, i.e. a “bad” credit boom already unraveling.

<sup>10</sup> International Monetary Fund. “Toward Operationalizing Macroprudential Policies: When to Act?”, Chapter 3, *Global Financial Stability Report* (September 2011).



- **China** saw a significant bank credit boom in 2009 to early-2010 following the post-crisis credit stimulus, but interestingly this credit boom moved to **Hong Kong** shortly after, which could be partly a symptom of “regulatory arbitrage” alongside HK’s own excessively accommodative monetary conditions.
- **Malaysia** is an interesting case – while bank credit to GDP decline was amplified during the GFC due to the decline in nominal GDP, we saw a sharp reversal in credit-to-GDP ratios in 3Q2009 to 1Q2010. Incidentally, even while inflation was still very benign, BNM surprised the market by hiking rates in early March 2010 – the *first* central bank in Asia to raise interest rates after the GFC, which we attribute to addressing financial stability risks.
- **Singapore** and **Thailand** are two countries whose recent domestic bank credit trends highlight a significant rise in leverage, and thus, may warrant some policy attention. This explains why BoT is now the most verbally “hawkish” central bank in the region, and why MAS didn’t change the SGD NEER slope in October 2012 despite very weak economic outcomes – and likely to remain on hold in April.

Figure 12. Annual Changes in Bank Credit-to-GDP Ratios, Dec-2007 to Dec-2012 (highlighting periods when ratio rose by at least 5ppt).

	CN	HK (for domestic use)	IN	ID	KR	MY	PH	SG	TW	TH	VN
Dec-07	-3.2	6.5	1.8	1.3	4.5	-2.1	0.2	0.8	-4.2	-3.4	22.1
Mar-08	-4.7	3.4	2.5	1.9	6.5	-4.2	-0.1	3.9	-4.6	-3.0	27.7
Jun-08	-6.6	1.3	3.5	2.3	7.0	-6.2	0.7	7.0	-2.7	-1.9	20.3
Sep-08	-6.9	0.3	2.8	2.2	8.1	-9.8	2.2	11.1	2.5	0.3	8.6
Dec-08	-3.8	10.1	1.9	1.1	9.0	-4.8	0.2	12.6	6.8	1.9	-2.7
Mar-09	8.6	2.9	0.5	-0.1	8.5	0.8	0.6	10.7	6.5	2.9	-9.0
Jun-09	18.7	2.8	0.7	-1.5	5.6	6.7	0.9	8.5	8.2	3.7	3.3
Sep-09	23.1	3.0	0.5	-1.9	3.2	13.1	0.2	5.4	5.7	4.1	17.1
Dec-09	23.5	1.1	0.5	-1.4	-1.2	14.8	0.1	0.2	2.7	2.8	22.1
Mar-10	14.1	5.9	0.8	-1.2	-4.7	10.2	0.6	-3.3	0.1	0.0	20.7
Jun-10	6.4	10.7	1.2	0.4	-5.7	5.4	-0.5	-4.9	-2.6	-1.7	14.9
Sep-10	3.2	18.5	0.2	0.7	-6.2	-0.7	0.3	-4.1	-4.7	-2.9	11.3
Dec-10	2.7	19.2	3.2	1.0	-5.9	-0.9	0.4	-1.4	-2.5	0.5	12.3
Mar-11	-0.7	23.2	1.7	1.7	-5.3	0.9	1.2	2.4	2.7	5.1	12.3
Jun-11	-2.2	17.2	1.2	1.8	-4.3	1.8	2.3	8.4	4.9	7.2	3.9
Sep-11	-3.5	5.9	2.7	2.2	-1.9	1.9	1.9	10.1	8.5	8.7	-5.1
Dec-11	-3.0	5.6	-0.2	2.4	-0.4	1.5	2.2	11.9	6.8	11.8	-13.4
Mar-12	-0.3	-1.7	1.0	2.8	-0.5	1.7	2.2	13.7	6.3	12.3	-19.5
Jun-12	2.1	-3.2	2.1	3.1	0.7	3.1	1.5	10.0	3.4	13.1	-15.5
Sep-12	5.4	-3.7	1.6	3.0	-1.2	5.2	1.0	9.9	1.4	14.1	-11.6
Dec-12e	4.2	2.6	2.8	2.8	-1.8	4.1	1.2	8.7	0.9	6.9	-9.6

Source: IMF, CEIC, Citi Research Estimates

**Domestic bank financing provides an incomplete picture of build up of excessive leverage in the economy – the role of non-bank financial institutions, for example, is increasingly important and may be indicative of rising vulnerabilities in China...**

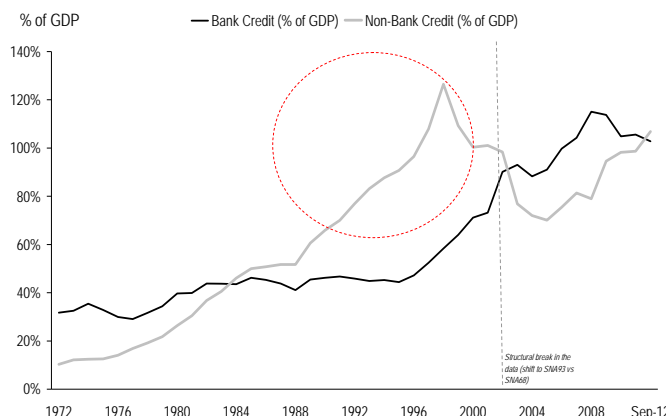
However, **domestic bank financing**, illustrated above, provides an incomplete picture of trends in the build of up leverage in the economy. A good example is the case of Korea in the run-up to the Asian Financial Crisis. Due to both financial liberalization and uneven regulatory treatment of banks vs. non-bank financial institutions (NBFIs), Korea saw a more rapid growth of financing originating from NBFIs – looking at bank financing alone would have understated Korea’s rising vulnerabilities (via corporate leverage) that were building (**Figure 13**). Similar vulnerabilities may also now be arising in China. In 2012, while China’s bank loans (including FCY loans) grew 15.6% YoY, the stock of total social financing expanded by roughly 19.5% with the sharp increase in both trust loans and bond financing, which rose around 80% and 45% YoY, respectively, becoming an increasingly important source of credit in the economy (**Figure 14**), we think a consequence of “regulatory arbitrage” (for example, circumventing regulated deposit rate ceiling in the banking sector).<sup>11</sup>

<sup>11</sup> See [China Economics Weekly - Shadow Banking: to Be Suppressed or Regulated?](#) (11-Jan-2013).

...but measuring non-bank financing sources of credit is difficult given lack of adequate data...

In sum, there are three other main sources of financing outside of domestic bank financing that give us a more complete measure of leverage trends: 1) cross border bank financing, be it in loans or debt-related securities; 2) domestic non-bank financial sources of credit; and, 3) cross-border non-bank financing sources. Unfortunately, measuring non-bank sources of financing is hindered by lack of comparable data, not to mention *timely* data given significant reporting lags. The only thing we can try to measure is the first item – cross-border bank financing.

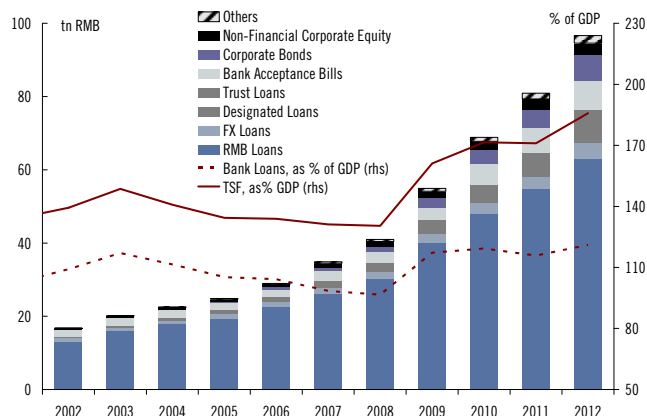
Figure 13. Korea – Stock of Credit from Banking & Non-Banking Financial Institutions (% of GDP), 1972-Sep 2012



Source: Korea National Flow of Funds Data, CEIC, Citi Research

Note: "In our definition of NFBFI, we include non-banks, insurance and pension funds and "other financial institutions". We define "credit" to include loans, securities other than shares, but excluding government bonds, public bonds (so we can reconcile with the older historical series under SNA68), financial debentures and external debt (issued by non-residents) to capture a measure of credit to the domestic private sector

Figure 14. China – Stock of Total Social Financing has Reached a Record High



Source: CEIC, Citi Research

...we supplement our analysis on domestic bank credit to include cross-border bank credit despite a few drawbacks.

BIS 'locational' bank statistics provides data on BIS reporting banks' cross-border financing activities on a country based on where the exposure resides (consistent with the BoP, external debt concept), and has a breakdown of claims towards the non-bank sector (BIS Table 6B). A recent BIS study using this data showed that international credit tended to amplify domestic credit cycles.<sup>12</sup> However, this data has at least two significant drawbacks: 1) this is not directly comparable with the IMF domestic credit data to the private sector in **Figure 10 - Figure 12** as some of this international credit may be going to the central government (e.g. via government securities)<sup>13</sup>; and 2) Mainland Chinese banks are not part of the BIS banking survey, and thus, we are not capturing the rising role of Chinese banks in international financing activities in the region.

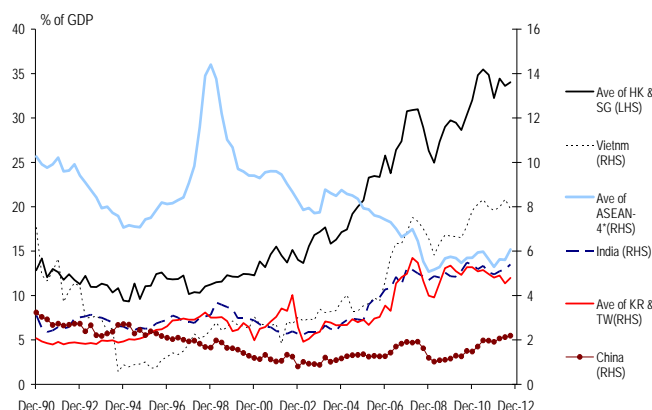
<sup>12</sup> For a previous analysis to this, see S. Avjiev et al. "Rapid credit growth and international credit: Challenges for Asia", BIS Working Paper No. 377.

<sup>13</sup> The BIS study cited in previous footnote was able to decompose bank credit to non-bank private sector and the government, but we can't replicate this analysis here as this data is non-public.

**Cross border bank credit only provides a small share to total bank financing, but seems to be amplifying the credit increases in some countries like SG, HK and TH.**

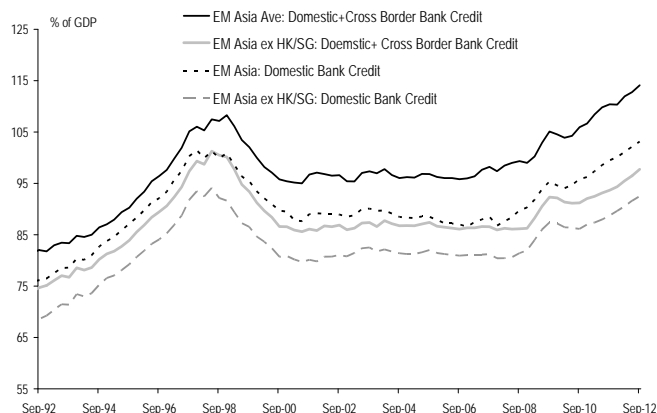
Overall, **the role of bank-funded international credit in EM Asia still remains relatively small** – approximately 3.9% of total bank financing, down from almost 6% share in the pre-Asian crisis peak – with significant variation across countries. Cross-border bank financing appears to have significantly decreased in importance for Indonesia vis-à-vis pre-Asian crisis, but has increased significantly in HK and SG in the same period. We think this is partly a byproduct of growing financial development and integration of the region, and the increasing use of HK and SG as a regional hub for financial operations of both local/regional and multinational companies. **Cross border bank financing appears to have amplified the increase in total bank credit financing in a few countries vis-à-vis pre-GFC (December 2007), especially in HK and Thailand.**

Figure 15. BIS Reporting Banks – Cross Border Bank Credit, (% of Country's GDP)



Source: BIS, Haver, Citi Research  
Note: \*Asean-4: Indonesia, Malaysia, Philippines & Thailand

Figure 16. EM Asia Average – Average combined domestic and cross border bank credit, as % of GDP ratio



Source: IMF, BIS, CEIC and Citi Research  
Note: \*We include CN, HK, IN, ID, KR, MY, PH, SG, TH & TW, but also show the average excluding HK and SG which are likely to have exaggerated cross-border bank financing given their role as regional financial centers

Figure 17. Recent Annual Changes in Domestic and International Bank Cross-Border Credit to GDP Ratios, Dec-2007 to Sep 2012

	CN	HK	IN	ID	KR	MY	PH	SG	TW	TH	VN
Dec-07	-2.6	10.9	2.7	0.5	6.9	-2.3	-0.4	6.3	-3.6	-4.3	24.3
Mar-08	-4.3	10.6	3.3	1.3	8.9	-3.2	-0.8	10.9	-2.2	-3.9	29.5
Jun-08	-6.4	5.7	3.7	2.2	8.8	-6.5	-0.9	11.7	-2.7	-2.3	21.3
Sep-08	-7.1	2.6	3.2	1.5	8.7	-11.2	0.2	11.9	1.6	-0.1	9.3
Dec-08	-4.5	3.2	1.4	0.0	8.3	-8.6	-1.7	10.6	5.5	1.8	-3.0
Mar-09	7.8	-3.1	0.2	-1.3	7.6	-3.5	-1.0	4.9	3.8	2.7	-10.7
Jun-09	17.8	-0.2	0.5	-2.3	5.5	3.5	0.2	4.1	6.5	3.8	2.3
Sep-09	22.5	2.4	0.7	-2.0	4.2	12.9	0.4	6.1	5.8	4.7	16.8
Dec-09	23.5	3.8	0.7	-1.3	-0.1	16.7	0.2	4.3	4.3	3.4	22.2
Mar-10	14.3	12.3	0.8	-1.2	-3.8	12.3	0.4	-0.6	1.6	0.3	21.5
Jun-10	6.6	14.7	1.5	-0.2	-5.6	6.4	-0.9	-6.2	-2.0	-1.0	15.1
Sep-10	3.6	23.5	0.7	0.5	-6.5	-0.5	0.1	-6.4	-4.3	-2.4	11.7
Dec-10	3.1	27.6	3.7	1.0	-6.3	-1.5	0.3	-5.3	-2.3	1.2	13.4
Mar-11	-0.3	33.8	2.0	1.9	-5.4	0.8	1.0	2.4	2.8	6.2	13.8
Jun-11	-1.5	27.4	1.4	2.4	-4.5	2.7	2.2	11.8	5.5	7.9	5.6
Sep-11	-3.0	13.7	2.3	2.2	-2.6	1.8	1.3	11.3	8.6	9.2	-4.3
Dec-11	-2.5	7.4	-0.7	2.2	-1.1	1.3	1.1	10.6	6.6	11.7	-13.4
Mar-12	0.0	-1.1	0.9	2.5	-0.8	1.1	1.6	12.5	6.2	12.7	-19.6
Jun-12	2.3	-5.4	2.0	2.8	0.3	2.1	1.0	8.5	2.7	13.5	-15.5
Sep-12	5.6	-6.9	1.9	3.0	-1.2	6.3	0.8	11.5	1.2	14.9	-11.7

Source: BIS, IMF, CEIC, Citi Research

## Other Potentially Useful Measures of Vulnerabilities

Studies have shown that credit-to-GDP ratio alone may not be a sufficient indicator to distinguish between bad credit booms and good ones, and tend to have a high propensity to yield “false alarms”. Thus, complimenting ones’ analysis with other information that could signal financial imbalances are useful. Here, we look at a few data on the financial sector, some leverage ratios from the debtors’ perspective, and other signals for credit overheating.

### Financial sector vulnerabilities – Nothing alarming here!

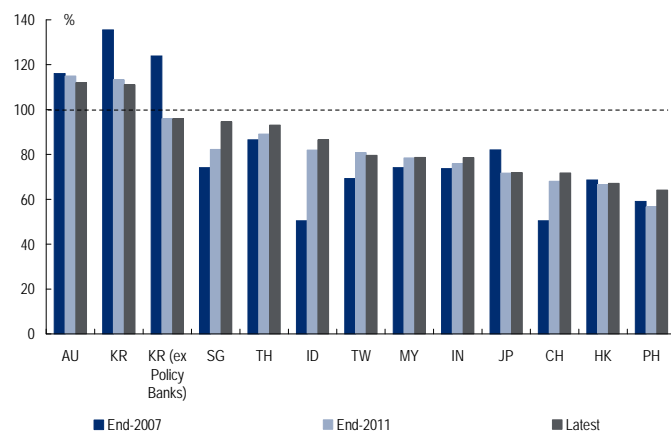
Liquidity has tightened across most countries, but most LTD ratios still well below 100%.

**Excessive credit growth can often also be detected in rising vulnerabilities in the balance sheet of banks.** So far, looking at a few metrics, we see no major alarming symptoms for systemic risks. One symptom of credit exuberance is the deterioration of the quality of banks’ funding as lending outstrips deposit growth resulting sharply rising loan-to-deposit (LTD) ratios. When LTD is well above 100%, it can make banks vulnerable to shifting funding conditions, as we saw with Korea in the run up to Lehman’s collapse, when we saw a sharp unwind of short-term borrowings by Korean banks and foreign bank branches. Since then, Korea has actively used regulation to drive LTD ratio (ex policy banks) below 100% while LTD ratio in the rest of the region has gone in the opposite direction. It rose the most in Indonesia (36.1ppts), followed by China (+21.3ppts), Singapore (+20.5ppts) & Taiwan (+10.1ppts), but LTD ratios in aggregate are still well below 100%.

We also see no signs of deteriorating capital adequacy.

**No signs of eroding capital ratios – NPL ratio is still low (but that is likely a lagging indicator).** An IMF (2011) event study showed that CAR deteriorates more during “bad” credit booms than “good” ones.<sup>14</sup> However, at least within our universe of listed banks covered by our equity research team, we see no signs of deteriorating capital ratios except in cases like Indonesia and Philippines where the ratio was coming from very elevated levels. NPL ratios are rising in both India and Vietnam but low and stable everywhere else – we see this more as a coincident and lagging indicator of a credit boom gone bad (rather than a leading indicator).

Figure 18. Comparing Bank Loan-to-Deposit Ratios



Source: CEIC, Citi Research

Figure 19. Asia – Capital Ratio of Select Listed Banks\* (Market-Cap Weighted Average)

	Tier 1 Capital Ratio				Capital Adequacy Ratio			
	2005	2007	2012E	2013F	2005	2007	2012E	2013F
CN	8.5	10.5	10.3	10.4	10.9	12.9	12.8	12.8
HK	12.3	10.0	12.2	12.3	14.6	12.5	15.6	15.2
IN	9.3	10.9	11.2	10.8	12.7	14.3	15.1	14.3
ID	15.3	15.8	15.1	15.5	20.2	18.8	16.6	16.9
KR	8.8	8.2	11.2	11.5	12.6	11.9	14.4	14.7
MY	11.1	10.2	12.1	12.0	15.4	13.6	15.8	15.6
PH	16.9	11.6	14.5	14.7	19.2	14.7	18.1	17.9
SG	12.3	10.8	15.5	15.3	16.8	13.4	18.4	17.9
TW	9.6	8.9	9.6	9.7	11.0	10.3	12.5	12.5
TH	9.9	11.4	10.8	11.0	13.8	14.7	16.4	16.0

Source: Citi Research

Note: \*Based on research coverage of the Citi Research Banks Team

<sup>14</sup> See footnote 10.

Household debt-to-GDP ratio has risen the fastest in China, Malaysia, Singapore and Thailand since 2007, although we think Malaysia and Korea may still be relatively more vulnerable.

## Rising household debt – More of a concern for Malaysia than Korea

**Countries with already high household (HH) debt could be another source of financial instability by amplifying the negative impact of economic downturns.**

Asia's HH debt-to-GDP ratio has risen sharply since 2007, with the most pronounced increase being in China, Malaysia, Singapore and Thailand (though outside of Asia, Australia also saw a sharp increase), while level remains elevated in Korea. We are not too concerned about the household debt increase in either China or Thailand – both seem to be coming from a low base, and look reasonable relative to per capita incomes. In China's case, macroprudential policy restrictions on property has likely reined in excessive mortgage-related lending in China, while Thailand's recent upturn in HH debt, driven largely by vehicle-related consumer loans, may be a temporary byproduct the government's first-car tax rebates. When adjusted for per capita income levels, it is Malaysia and Korea's level of household indebtedness that look particularly high, and the ratio of their households' financial assets to liabilities is not as comfortable as that we are seeing in other countries like Singapore or Taiwan, though a bit better than Australia (**Figure 21**). Nonetheless, looking at financial assets to liabilities ratio can be deceiving – even prior to the subprime crisis, US households had well over 3x the financial assets relative to liabilities – but was a poor predictor of the crisis. We think the distribution of the debt matters significantly – and Malaysia looks more vulnerable than Korea given a larger proportion of low income households have a greater share of the overall household debt.

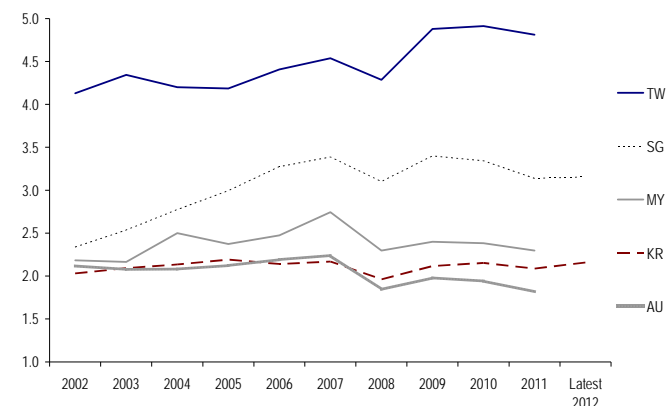
Figure 20. Asia – Comparing Household Debt (% of GDP)

	1996	2002	2007	Latest
CN	n.a.	n.a.	19.1	31.6
HK	44.4	60.5	51.1	60.0
IN	n.a.	3.6	9.8	8.4
ID	n.a.	n.a.	n.a.	10.0
KR	n.a.	64.5	68.2	74.0
KR (Flow of Funds)	55.0	74.1	81.5	89.6
MY	n.a.	67.2	65.9	76.6
SG	66.1	92.6	64.5	74.2
TW	38.2	42.7	52.1	49.4
TH	n.a.	n.a.	16.5	25.3
AU	58.5	84.7	100.5	110.4
US	66.1	79.3	97.7	83.0
EA	45.2	54.2	64.9	68.4
UK	77.3	83.4	100.5	105.6

Source: Citi Research

Note: We present two measures of household debt in Korea – the former is more consistent with how we compile data for other countries by looking at "credit to households" compiled from financial institutions versus financial liabilities for individuals in the Flow of Funds data compiled from the National Accounts.

Figure 21. Select Countries – Comparing Household Financial Assets relative to Financial Liabilities (Times)



Source: CEIC, Haver, Citi Research

## Corporate leverage ratios – China and India deserve some caution

**In the absence of more complete data on non-bank financing sources, we look at corporate debt vulnerabilities from the borrower side via data reported by listed companies.** From an aggregated regional perspective, the corporate debt-to-equity ratio had already been rising two years prior to the 1997-98 Asian crisis (by 16.3ppts), with leverage ratio peaking a full year after the onset of the crisis, likely exacerbated by the FX depreciation, which was then followed by about seven years of corporate deleveraging. More recently, corporate leverage ratio in Asia has risen sharply by 9.8ppts since pre-GFC period (end-2007), likely fuelled by historically low rates. Nonetheless, interest rate coverage ratios still looking relatively comfortable at about 7x in 3Q 2012.

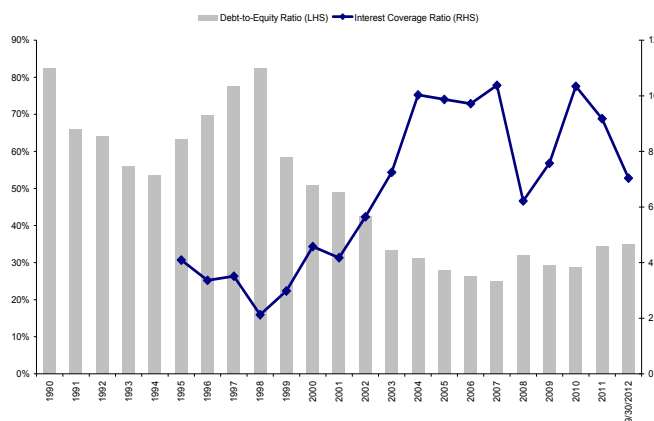
**The largest increase of corporate leverage since 2007 among listed companies seen in the Philippines, India, Thailand and China – we are more cautious about China and India than we are about Philippines and Thailand.**

**Philippines, India, Thailand and China saw the biggest increase in corporate leverage ratio since 2007 – we are more cautious about China and India.** We think the rise in corporate leverage in the Philippines and Thailand look manageable – it came from a low base, especially the former, and likely induced by structural investment upswings (plus in Thailand's case, capacity expansion due to post-flood replacement, some M&A activity and 3G telecom licensing-related financing). We think corporate debt in China and India deserves more caution – interest coverage ratios for both have deteriorated more markedly alongside rising leverage, and there are signs of concentrated leverage in certain vulnerable industries.

■ **China:** We see vulnerabilities in key industries that suffer overcapacity and inefficiencies, some being state-dominated sectors like utilities (debt-equity ratio up almost 78ppts since 2007 to over 210%!), transportation, materials, heavy machinery/capital equipment and property. If China were to pursue interest rate liberalization in the coming years, leading to upward pressure on rates, this would exacerbate vulnerabilities in these heavily levered sectors.

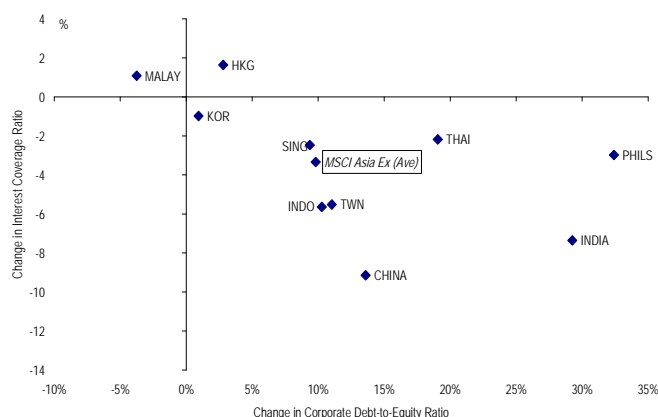
■ **India:** Debt-funded 3G investment has yet to pay off for the relatively more indebted telecom companies as well as regulatory hurdles (e.g. environmental clearances and land acquisition) and significant growth headwinds have also adversely impacted debt ratios of utility/power companies, conglomerates and construction/real estate. On the plus side, borrowing costs may ease over time as RBI cuts rates a few times and pursues further liberalization of debt-related capital inflows to ease funding costs.

Figure 22. Asia ex-Japan MSCI– Corporate Debt-to-Equity and Interest Coverage Ratios



Source: Factset, Worldscope, Citi Research

Figure 23. Change in Corporate Debt-to-Equity Ratios and Interest Coverage Ratios – Sep 2012 vs. 2007



Source: Factset, Worldscope, Citi Research

In EM Asia, we think only China seems to have significant run-up in quasi-fiscal debt (via local government borrowings) that is likely a significant source of financial stability risk.

## Other sources of leverage – Quasi-fiscal activities

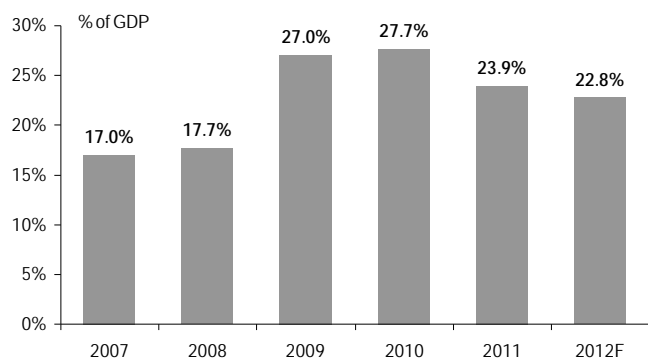
We exclude discussions about central government debt here for two reasons: 1) this should be perceived as the lowest-risk form of leverage in the domestic economy; and, 2) dynamics is not really in the control of monetary authorities/financial sector regulators. Moreover, Asian countries (outside of some South Asian ones and Malaysia if we include government guaranteed debt), have low and even declining levels of government debt ratios. With budgetary approval for annual deficit spending subject to legislative oversight in most cases, this provides natural constraints to credit over-exuberance. However, some of the vulnerabilities in Asia's leverage come from quasi-fiscal activities – particularly China's local government debt, which has risen sharply since 2007, a significant amount could have cash flow issues (much of this funded infrastructure spending during the 2009-10 credit stimulus; **Figure 24**). This is a further source of credit overhang that could adversely impact financial stability unless absorbed by the central government.<sup>15</sup>

## Credit overheating symptoms – Lessons from Stein

Applying some of the signals of credit overheating in the US to the Asian context, we also find early signs of exuberance in the high yield bond market.

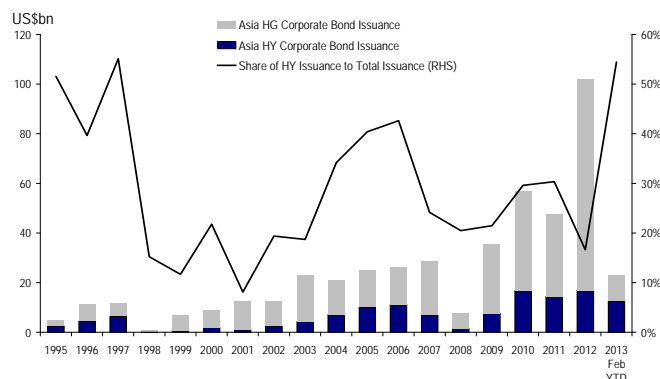
A recent speech by Fed Governor Stein highlighted some early signs of overheating in the credit markets that could undermine financial stability.<sup>16</sup> In that speech, Stein cites some empirical data which shows that aside from credit spreads, the share of US high yield to total bond issuance tends to strongly predict lower future returns to corporate credit vis-à-vis US Treasuries. If one applies this to the context of EM Asia, signs of credit exuberance in the region already look apparent. While Asia HY corporate spreads are not at their historic tights, the pace of both total Asia corporate bond supply, particularly HY issuance, has well surpassed historic peaks. In the first eight weeks of 2013 (*inclusive* of a full week of Lunar New Year holidays), Asia HY corporate bond issuance hit US\$12.5bn or 74% of the total EM Asia HY corporate bond issuance in *all of last year*. Asia HY bond issuance now accounts for a 54% share of total corporate bond issuance, back to pre-Asia financial crisis highs (**Figure 25**). While the HY share of corporate bonds was lower in 2012, this may be masking the true state of credit exuberance in Asia given that the *volume* of corporate bond issuance was up an astounding 112% YoY.

Figure 24. China – Local Government Debt (% of GDP)



Source: CEIC and Citi Research

Figure 25. EM Asia – International Corporate Bond Issuance – High Grade & High Yield Bond Supply and the Share of HY to Total



Source: Dealogic, Citi Research

<sup>15</sup> China's local government debt funded via domestic banks should be captured in the IMF data "domestic claims on the private sector" on Figs 10-12. The nomenclature is misleading as "private sector" includes households, non-profit institutions, nonfinancial corporations & local government.

<sup>16</sup>See "Overheating in Credit Markets: Origins, Measurement, and Policy Responses" presented 7<sup>th</sup> Feb 2013. Link to speech: <http://www.federalreserve.gov/newsevents/speech/stein20130207a.htm>



## Market Implications – Asia will likely lose the currency war

Less flexible exchange rates and prolonged low rates exacerbate credit booms; macroprudential policies help but are not a panacea.

Countries whose credit overheating risk looks low – i.e. the Philippines and more recently Korea – may gamble with looser monetary policies for longer; India's greater concern is growth rather than financial stability.

We think the case is strong for Thailand, China, and eventually Taiwan and Malaysia, to lean “against the wind” by tightening monetary conditions (partly thru accommodating some FX appreciation).

**History has shown that less flexible exchange rates, and also prolonged low rates, tend to exacerbate credit booms.** Inflationary, asset price consequences and potential financial instability risks of the latter is likely to be a bigger concern for most of EM Asia than it is for Advanced Economies. Macroprudential policies help mitigate financial stability risks associated with prolonged accommodative monetary stance – but there are clear limitations, especially when the incentive for yield-seeking/risk taking remain very high. Regulatory tools are often not applied equally throughout the broad financial system (e.g. banks versus non-bank FIs), as can be seen by the sharp rise in China's “shadow banking system”, or even across the type of assets (and thus, having to extend macroprudential tightening from residential to commercial/industrial properties, and more recently, even to car park mortgages in HK and vehicle financing in Singapore).

**Those less concerned about financial stability risks with recurring external surpluses will have greater propensity to “gamble” with looser monetary policies.** In our analysis above, signs of an unsustainable “bad” credit boom are not apparent in the Philippines yet nor in the CA deficit countries of India and Indonesia if one looks at the pace of credit-to-GDP increase and/or the level of financial depth in the economy, even if asset prices have risen sharply in the case of Philippines and Indonesia. Sharply slower growth and easing inflation gives India more room to ease than Indonesia. While Korea's household debt is high, we would argue that the recent trajectory does not look particularly alarming. In contrast to the rest, Korea's bank credit-to-GDP has already declined since mid-2009 and plateauing in recent years – household debt to GDP may be rising gradually, but the share of household loans related to housing/residential mortgages is falling, alongside the declining nationwide housing prices over the last year. Thus, we still expect BoK to cut rates one more time, but the expectation of further stimulus measures, including those aimed at stabilizing the housing market, and gradual rise in inflation would mean Korea's window for easing will narrow – and thus, we expect tolerance to let KRW appreciation do some of the tightening will rise in 2H.

**But many need and should already be “leaning against the wind”** via some combination of tolerating stronger FX appreciation and more proactive liquidity management tools (incl. reserve requirements, more proactive sterilization) before any gradual move towards policy rate normalization. **Excluding HK and SG where policy tools are limited given their FX regime** (thus, a heavy-handed approach to macroprudential policies), **we think the case is strong for Thailand, China, and eventually Malaysia and Taiwan**, to start “leaning” more against the wind.

- Recent data shows that **Thailand** is experiencing the sharpest upswing in credit-to-GDP, especially if we incorporate cross-border bank financing. While we see little systemic risks to the financial system brewing, BoT may have the greatest proclivity to lean against the upswing via tolerating more FX appreciation even while core inflation may still be benign, to mitigate longer-term financial stability risks, in the absence of “full autonomy” to adjust interest rates.
- **China** also has a stronger case for tightening including via RMB appreciation even if inflation remains benign – the basic balance surplus remains large, total social financing growth has expanded significantly and may need to be curbed to alleviate excesses, and nationwide housing prices has been rising for eight consecutive months. Moving towards a more market determined exchange rate will help reduce growing imbalances and vulnerabilities we are already seeing in segments of the corporate/SOE and local government. We expect China's debt-funded investment overhang will weigh in the years to come, and thus, we are more bearish than consensus on future growth trajectory.

- We think **Taiwan** and **Malaysia** need to remain vigilant – Taiwan's prolonged low real rates has already fuelled sharp property price run-up and few episodes of a significant upswing in credit-to-GDP ratios in 2011 that could be reignited again if global growth were to pick up. Thus, aggressive FX intervention to counteract potential JPY and KRW weakness by CBC is not costless – hopefully, eventual CNY flexibility will give TW some leeway. Malaysia is not being tested given the run-up in political turmoil, but very high levels of HH indebtedness will likely keep BNM on a hands-off approach to both FX intervention as well as maintain the highest real interest rate in the region.

## Asian Currencies & Interest Rate Forecasts

Figure 26. Currency Forecasts and Forwards

	Mkt Data			Forecasts								
vs USD	28-Feb	3M Fwd	12M Fwd	0-3 Mos	6-12 Mos	Long-term	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Euro	1.31	1.32	1.32	1.35	1.31	1.30	1.35	1.33	1.32	1.31	1.31	1.31
Japanese Yen	92	92	92	95	96	90	95	95	96	95	94	93
Chinese Renminbi	6.22	6.29	6.32	6.19	6.10	6.05	6.19	6.15	6.12	6.10	6.09	6.08
Hong Kong Dollar	7.76	7.75	7.75	7.75	7.76	7.75	7.75	7.75	7.76	7.76	7.76	7.76
Indonesian Rupiah	9667	9773	10109	9750	9800	9660	9752	9770	9789	9788	9760	9733
Indian Rupee	53.9	55.0	57.4	53.0	55.0	54.5	53.1	53.8	54.6	55.0	54.9	54.8
Korean Won	1081	1087	1100	1060	1030	995	1059	1048	1036	1027	1020	1013
Malaysian Ringgit	3.09	3.11	3.16	3.18	3.00	3.05	3.17	3.11	3.04	3.00	3.01	3.02
Philippine Peso	40.7	40.6	40.5	40.2	39.9	40.8	40.2	40.1	39.9	39.9	40.1	40.3
Singapore Dollar	1.24	1.24	1.24	1.23	1.22	1.19	1.23	1.23	1.22	1.22	1.21	1.21
Sri Lanka Rupee	127.5	130.2	NA	130.0	130.0	125.0	130.0	130.0	130.0	130.0	130.0	130.0
Thai Baht	29.8	30.0	30.3	29.6	30.5	29.9	29.6	30.0	30.3	30.4	30.3	30.2
Taiwan Dollar	29.6	29.6	29.5	29.7	28.5	28.2	29.7	29.2	28.8	28.5	28.4	28.4
Vietnam Dong	20940	21462	22910	20850	20850	21000	20850	20850	20850	20850	20850	20850

\*Forecast as of Citi Foreign Exchange: Forecasts (February 22, 2013)

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

Figure 27. Interest rate forecasts (% period end)

	28-Feb	In 3M	In 6M	In 12M	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14
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	1.90	NA	NA	NA	1.80	2.05	2.30	2.60	2.85	3.00
EU* Repo Rate	0.75	0.50	0.25	0.25	0.75	0.50	0.25	0.25	0.25	0.25
10-Year Bunds	1.45	NA	NA	NA	1.55	1.40	1.75	1.55	1.35	1.55
JP* Call Money	0.08	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Year JGBs	0.67	NA	NA	NA	0.80	0.85	0.80	1.00	1.00	0.90
CN 1-Year Deposit rate	3.00	3.00	3.00	3.25	3.00	3.00	3.00	3.25	3.50	3.50
1-Month Shibor	4.38	4.90	4.90	5.32	4.90	4.90	4.90	5.15	5.40	5.40
Government bond yield (5 -Year)	3.38	3.33	3.33	3.75	3.33	3.33	3.33	3.58	3.83	3.83
HK 3-Month Interbank Rate	0.38	0.46	0.60	0.82	0.40	0.50	0.65	0.75	0.85	0.95
5-Year Exchange Fund Note	0.53	0.71	0.81	1.13	0.65	0.75	0.85	1.00	1.20	1.40
IN Overnight Repo Rate	7.75	7.50	7.25	7.25	7.50	7.25	7.25	7.25	7.25	7.25
Overnight Reverse Repo Rate	6.75	6.50	6.25	6.25	6.50	6.25	6.25	6.25	6.25	6.25
91-Day T Bill	8.10	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50
10-Year Gilt	7.80	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25
ID BI Policy Rate	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75
FasBI Rate	4.00	4.00	4.00	4.25	4.00	4.25	4.25	4.25	4.50	4.50
O/N Interbank Rate	4.18	4.20	4.39	4.75	4.20	4.20	4.50	4.65	4.80	4.80
10-Year Government Bond	5.34	5.49	5.54	5.77	5.30	5.60	5.50	5.70	5.80	5.90
MY Overnight Policy Rate	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50
3-Month Interbank Rate	3.21	3.21	3.21	3.34	3.21	3.21	3.21	3.21	3.40	3.60
5-year MGS	3.22	3.23	3.25	3.37	3.20	3.25	3.25	3.30	3.40	3.50
PH O/N Rate	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.75	4.25
1-Month Reference Rate	0.50	1.32	1.82	3.17	1.00	1.50	2.00	2.50	3.50	4.00
5-Year T Bond	3.25	3.31	3.41	3.88	3.25	3.35	3.45	3.65	4.00	4.50
SG 3-Month Interbank Rate	0.38	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30
10-Year SGS	1.50	1.36	1.53	1.90	1.30	1.40	1.60	1.70	2.00	2.10
KR BOK Policy Rate	2.75	2.50	2.50	2.75	2.50	2.50	2.50	2.75	3.00	3.25
91-Day CD	2.82	2.70	2.70	3.17	2.70	2.70	2.70	3.00	3.25	3.45
5-Year Treasury	2.73	2.81	2.88	3.27	2.75	2.85	2.90	3.05	3.38	3.65
SL Repo Rate	7.50	7.50	7.25	7.25	7.50	7.25	7.25	7.25	7.25	7.50
1-Month T-Bills	12.33	12.18	11.68	10.50	12.50	12.00	11.50	10.50	10.50	10.50
364-Day T-bill	11.10	10.86	10.50	10.00	11.50	10.50	10.50	10.00	10.00	10.00
TW Overnight Rate	0.39	0.42	0.45	0.51	0.39	0.43	0.46	0.49	0.52	0.55
Re-discount Rate	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88
10-Year Government Bond	1.19	1.29	1.31	1.37	1.28	1.30	1.32	1.35	1.38	1.41
TH Overnight Repo Rate	2.75	2.75	3.00	3.75	2.75	3.00	3.50	3.75	3.75	3.75
1-Month interbank Rate	2.79	2.66	3.07	3.50	2.50	2.75	3.25	3.50	3.50	3.50
10-Year Government Bond	3.58	3.60	3.71	4.00	3.50	3.65	3.75	4.00	4.00	4.00
VN Refinance Rate	9.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00
1-Month interbank Rate	5.00	7.09	7.00	8.00	7.25	7.00	7.00	8.00	8.00	8.00
5-Year Treasury	9.20	9.50	9.66	10.00	9.50	9.50	9.75	10.00	10.00	10.00

Note: \*Forecast as of Global Economic Outlook and Strategy (February 27, 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** – A modest growth rebound appears on track despite holiday-related data distortions. With growth risks receding, inflation risk is on the rise. We continue to expect policies to shift gradually from an easing bias to a neutral position, in light of exceptionally strong money and credit growth in January.
- **Things to watch** – The government has started fiscal reforms to increase budgetary expenses on public health. Local governments face funding constraints for their investments in 2013. New policies on property markets have recently been introduced by the government to curb increase in property prices.
- **Strategy** – We continue to favor cyclical sectors in 1H this year, including consumer discretionary, airlines, materials, capital goods, insurance and securities. Our top stock picks are chosen based on two key criteria: 1) large earnings upside potential; 2) more room for re-rating.

### Mild rebound on track with rising inflation risks

**A mild economic rebound remains on track** – China's GDP grew at 7.8% in 2012. February HSBC manufacturing PMI dropped by 1.9ppts, to 50.4 (vs. market consensus of 52.2 and official PMI of 50.4 in January), from a 2-year high in January of 52.3, dragged by slowing production activities whose index dipped to 4-month low of 50.9 from 53.1 in January. The sentiment index, which stayed above 50 for the fourth month in a row, indicates the growth rebound is on track but the strength has been modest.

**Economic rebound in the old style** – It seems the economic recovery so far has gained support from investment in the infrastructure and property sectors. Production and investment in the manufacturing industries, especially over capacity industries, have experienced slower growth. The property sector recovery boosted loan growth. Total RMB bank loans in January went up by Rmb1.07tn from December, Rmb471.4bn to households and Rmb598.6bn to non-financial enterprises. This is again an old model recovery driven by credit expansion. The accelerating M1 growth and improved economic activity since 4Q last year will likely be positive for a further economic and equity market rebound in the near-term. But the old model recovery could come at a cost of rising inflation.

### Funding constraints and search for growth drivers

**The strong demand for investment funds** – The much stronger-than-expected monetary data in January has indicated a renewed momentum of investment after the leadership reshuffle. Substantial expansion of the non-bank loans in total social financial (TSF) signals a strong demand for funding. The share of RMB bank loans in TSF has dropped to 42.1% in January the fourth lowest since April 2011. Meanwhile, new foreign currency loans (equivalent to Rmb179.3bn in Jan), trust loans (Rmb205.4bn) and corporate bonds (Rmb220.1bn net) all surged roughly by Rmb200bn from a year ago. The funding pattern suggests that investments in infrastructure and real estate may continue to serve as growth drivers.

**Local governments face funding constraints for their investments in 2013 –**

Local governments in China have financed their investments mainly with bank loans (including trust loans) and funds from land sales. An economic slow-down, rising local debt levels and government control over property markets have reduced funds available for local investments. Local government unpaid debts to financial institutions are estimated at more than RMB9trn, with an annual interest rate payment at around RMB540bn (assume an average lending rate of 6% p.a.). Local government revenues from land sales have also been on a decline. According to the Ministry of Finance (MOF), income from land sales in 2012 amounted to Rmb2.85tn, a fall of 14% from a year ago. Unless land sales improve significantly this year, local governments may have to continue to rely on external financing to fund growth.

**The January trade figures improved, but forward-looking demand weakened –**

China's January exports surged 25% and imports rose 28.8% from a year ago, better than both our and market expectations. Seasonally-adjusted, exports went up by 12.4% and imports up by 3.4%, lower than the growth rates in December 2012. Exports of labor-intensive products have also been on an upward trend. Growth accelerated from -1.1% in November, to 20.5% in December 2012, and further to 24.5% in January, a steady pick-up relative to growth rates of total exports at 2.9%, 14.1%, and 25%, respectively. However, both the official and HSBC PMI indicate new export orders are contracting, clouding the trade outlook.

**Challenges, likely policies and strategy**

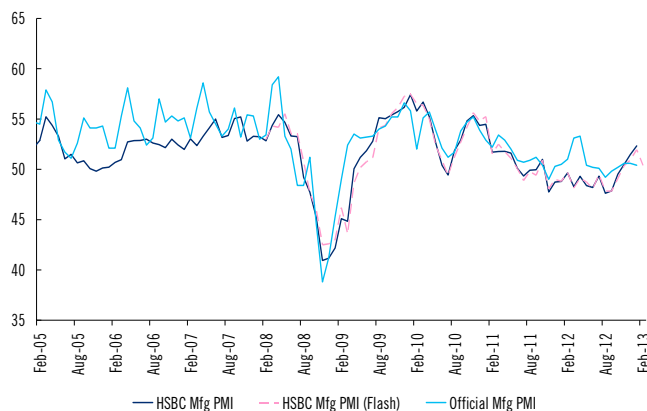
**Inflation pressure on the rise with moderate rebound –** Although YoY CPI inflation fell sizably in January to 2%, MoM inflation continued to pick up. Following a volatile 1Q, inflation may exhibit an uptrend for the rest of the year, as PMI input prices have already jumped in the past few months and food prices may continue to rally. In January, about 75% of the cities monitored by the National Bureau of Statistics (NBS) witnessed home price increases. Against surprisingly strong money and credit growth in January, the balance of risks between growth and inflation appears to be shifting.

**The policy stance may gradually return to a neutral position in 2013 –** The annual meetings of the National People's Congress in early March will provide more specifics about macro policies. The government may set the 2013 budget deficit at 2% of GDP. PBOC may target M2 growth at 13% and RMB credit growth at 13-14% (around RMB8.5tn), both lower than outcomes for 2012. During the year, the RMB exchange rate may appreciate gradually and interest rate level may rise as a result of further interest rate liberalization. The regulators may take measures to slow down the shadow banking business to contain credit risks. The government is also expected to enforce existing property market tightening measures more stringently while replicating property tax pilots to more cities.

**Market outlook –** We reiterate our view that the Chinese markets may hit a near-term high, probably in the middle of the year. Economic recovery supported by accommodative liquidity conditions, more policy visibility after NPC, and attractive valuations after recent corrections would all lead the market higher, alongside improved earnings in 2013 (albeit marginally). We expect 15-20% upside for MSCI China, HSCEI and the A-share index.

**Top picks –** We continue to favor cyclical sectors in 1H this year, including consumer discretionary, airlines, materials, capital goods, insurance and securities. Our top stock picks are chosen based on two key criteria: 1) large earnings upside potential; 2) more room for re-rating.

Figure 28. PMI flash indicates the strength of growth has been modest



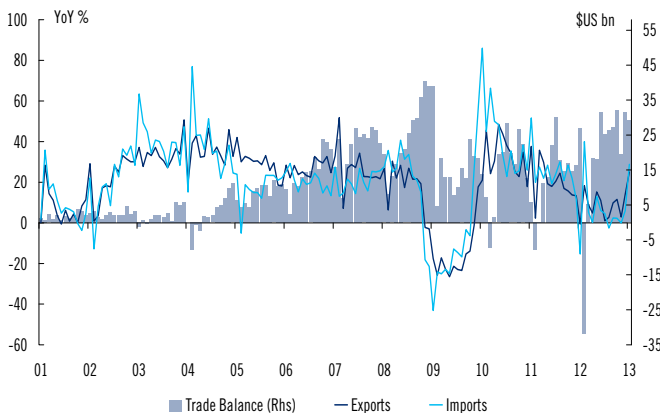
Source: CEIC, and Citi Research

Figure 30. CPI faces upward pressure



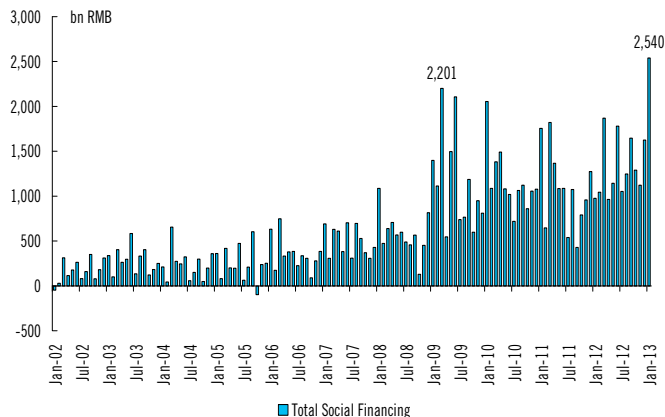
Source: PBOC, CEIC, NBS, and Citi Research

Figure 32. Jan trade improved, but forward-looking demand weakened



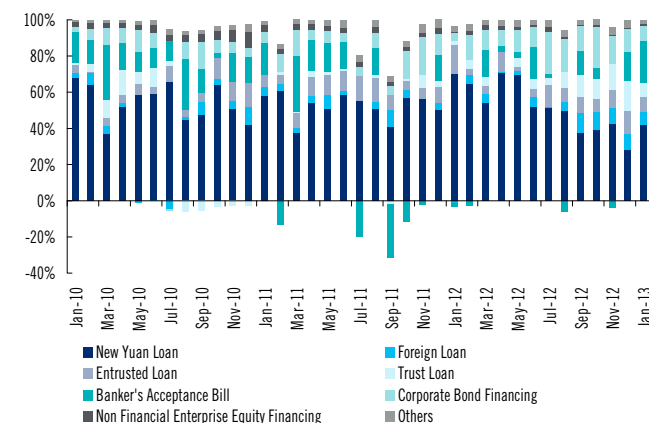
Source: NBS, CEIC, and Citi Research

Figure 29. TSF increased by Rmb2.54tn in Jan, a record high in history



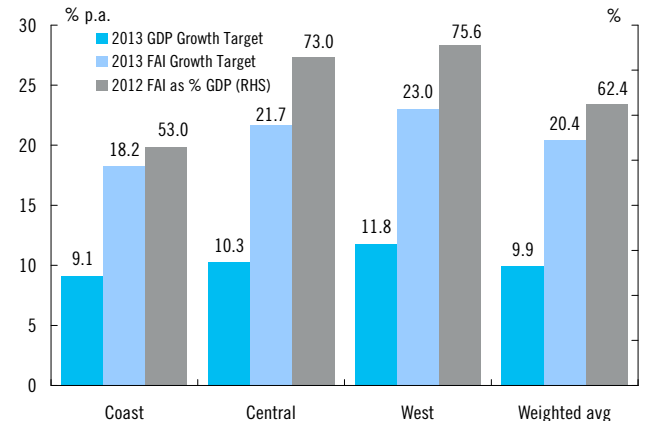
Source: PBOC, CEIC, NBS, and Citi Research

Figure 31. The share of bank loans in TSF stayed low



Source: PBOC, CEIC, NBS, and Citi Research

Figure 33. Local government growth target in 2013 and FAI as % of GDP



Source: NBS, CEIC, and Citi Research



Figure 34. China Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	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	8,244.5	9,255.3	10,348.4
Nominal GDP, local currency bn	22,224	26,583	31,490	34,632	40,151	47,310	51,932	57,048	62,931
GDP per capita, US\$	2,120	2,645	3,422	3,800	4,424	5,432	6,089	6,808	7,582
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	7.8	7.8	7.3
Real investment growth % yoy	13.6	14.7	11.0	19.2	11.9	9.7	8.4	8.2	7.3
Real consumption growth % yoy	9.8	11.0	8.5	9.4	9.2	10.7	8.2	8.5	8.1
private consumption growth % yoy	11.3	11.1	9.2	10.3	8.5	17.1	8.4	8.7	8.3
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	2.8	6.5	1.2	1.9	4.6	4.1	2.5	3.5	4.0
CPI, % avg	1.5	4.8	5.9	-0.7	3.3	5.4	2.6	2.8	3.6
Nominal wages, % yoy	14.6	18.5	16.9	11.6	13.3	17.8	9.8	9.9	10.3
Credit extension to private sector, % yoy	14.3	19.3	14.0	33.2	20.3	15.1	14.8	13.6	13.4
Policy interest rate, % eop	2.52	4.14	2.25	2.25	2.75	3.50	3.00	3.25	3.75
1 month inter-bank rate, % eop	2.58	3.61	1.23	1.79	6.17	6.00	4.90	5.15	5.65
Long term yield, % eop	2.62	4.19	1.80	3.06	3.61	3.27	3.33	3.58	4.08
lc/US\$, eop	7.81	7.30	6.82	6.83	6.59	6.29	6.23	6.10	6.06
lc/US\$, avg	7.97	7.61	6.95	6.83	6.77	6.46	6.31	6.14	6.07
<b>Balance of Payments, US\$ bn</b>									
Current account	231.8	353.2	420.6	243.3	237.8	201.7	213.8	185.1	155.2
% of GDP	8.3	10.1	9.3	4.8	4.0	2.8	2.6	2.0	1.5
Trade balance	177.5	264.3	298.1	195.7	181.5	154.9	231.1	205.0	190.2
Exports	969.0	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.9	2,205.5	2,452.8
Imports	791.5	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,817.8	2,000.5	2,262.6
Service balance	-8.8	-7.9	-11.8	-29.4	-31.2	-55.2	-89.5	-98.5	-108.3
Income balance	-5.1	8.0	28.6	-8.5	-25.9	-11.9	-23.5	-0.6	-1.9
FDI, net	102.9	143.1	121.7	87.2	185.7	170.4	180.1	125.6	94.3
International reserves	1,066.3	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,522.2	3,646.7
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	-2.4	-2.0	-2.0
Consolidated gov primary balance	-0.5	1.0	0.1	-1.8	-1.7	-0.9	-2.0	-1.6	-1.6
Public debt	18.6	39.0	37.4	47.8	49.2	44.3	43.7	42.6	40.9
of which Domestic	17.4	38.0	36.6	47.0	48.6	43.7	43.2	42.1	40.5
<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	8.9
External debt / XGS	31.9	29.0	24.7	32.2	31.5	33.4	34.0	34.8	34.4
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	16.3	17.4
<b>Quarterly Economic Indicators</b>									
	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F
GDP, % yoy	7.6	7.4	7.9	8.0	8.2	7.7	7.5	7.1	7.2
CPI, % yoy	2.2	1.9	2.5	2.2	2.7	3.1	3.5	3.5	3.3
Policy interest rate, % eop	3.25	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.50
1 month inter-bank rate, % eop	4.48	3.99	4.90	4.90	4.90	4.90	5.15	5.40	5.40
Long term yield, % eop	2.92	3.24	3.33	3.33	3.33	3.33	3.58	3.83	3.83
lc vs USD, eop	6.35	6.28	6.23	6.19	6.15	6.12	6.10	6.09	6.08

\*Note: Public debt is based on official data, not including the local government debt as audited by the National Auditing Office in summer 2011. External debt is based on the residency of the holder of the debt (not by currency denomination).

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

## Hong Kong

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- **Summary view** – Economic recovery likely continued in 4Q12 (2.5%YoY) and we upgrade our 2013 GDP forecast to 3%YoY. Policymakers launched the 6th round of property curbs. The Government proposed a more expansionary budget to address social problems in the city.
- **Things to watch** – 1) Inflation likely to start rising in February, kick-started by CNY distortions; 2) Pace of trade recovery; 3) How the property market reacts to the latest set of property curbs; 4) Look out for regulation details on how the HK financial sector can benefit from Qianhai developments.
- **Strategy** – Upward pressure on the HKD has eased slightly, reflecting lesser near-term revaluation bets as HKMA continue to show its determination in keeping the HKD peg. 5Y EFN bills are likely to continue to rise in tandem with its US counterparts in the near-term. Our equity strategists target for the HSI Index in FY13 is 22,700.

### An expansionary budget

**The Budget Speech for FY13/14 on 26 Feb indicates fiscal expansion** – Acting on a larger than earlier expected fiscal surplus of HK\$64.9bn (or around 3.2% of our estimated GDP), the Government once again shared the additional wealth with the public using familiar one-off relief measures (including public rent waiver, utility subsidies, and additional allowance for the different welfare programs). The 11 relief measures, which will cost the Government HK\$33bn, are aimed at easing pressure on HK's middle class, grass roots and SMEs. On top of this, a major part of the surplus (HK\$15bn) will be injected into the Community Care Fund to alleviate poverty. Although there were no cash handouts like last year, tax benefits were introduced (such as tax reduction for salaries and businesses, increased tax allowances for individuals, parents and businesses). Moreover, the inflation-linked bonds were again offered. The Financial Secretary stepped up reoccurring expenses to target the city's rising problems of creating jobs, servicing an aging society, enhancing social welfare, and environmental issues. To help SMEs cope with economic uncertainties, the SME loan guarantee was extended and the quota was raised. For details, see [Hong Kong Macro Flash - A Conservative Expansionary Budget](#), 28 Feb 2013.

### Upgrading our 2013E GDP and CPI forecasts

**2012 ended with a good note** – 4Q12 GDP grew at 2.5%YoY or 4.9%QoQ saar. The GDP strength was driven by private consumption, fixed asset investment, and a smaller drag of net exports.

**Enforcing recovery in 2013E** – We believe economic recovery likely continued at 2.5%YoY in 1Q12E. Moreover, monthly YoY comparisons are likely to be volatile in Jan and Feb, and investors should look at the 2-month average instead to decipher through distortions caused by the Chinese New Year timings. The government turning more expansionary, together with the lack of independent monetary policy, is keeping liquidity loose in the economy. We think credit growth will improve as the economy warms up further. We upgrade our 2013E GDP slightly to 3%YoY (prev. 2.8%YoY) and some recent data points have been particularly encouraging.

**Pleasant surprise in export resiliency in January 2013** – Even after discounting for the statistical boost from CNY timing, exports were resilient. Intraregional trade was particularly strong, but exports to Germany and the UK continue to register positive growth. Withstanding some YoY setbacks likely in February due to the reverse of the statistical distortion, we think HK will benefit from modest global demand recovery in 2013.

**Leading indicators also supportive of growth expectations** – Jan PMI rose to 52.7 from previous month's 51.7, the strongest improvement since February 2012, which signals that business conditions are improving, and solid increases were noted in both output and orders.

**Back on rising inflation path** – Despite a lower CPI print in January (at 3%YoY), we expect headline CPI could initiate its climb again, kick-started by the low-base affected February. We also raise our CPI inflation forecast for 2013E to 4.3%YoY (prev. 4%YoY), on economic momentum gathering, faster pass-through from housing rental, hikes in various public transportation charges and utilities fees, and the increase in minimum hourly wage in May.

## **Entrenching HK's role as an offshore RMB business hub**

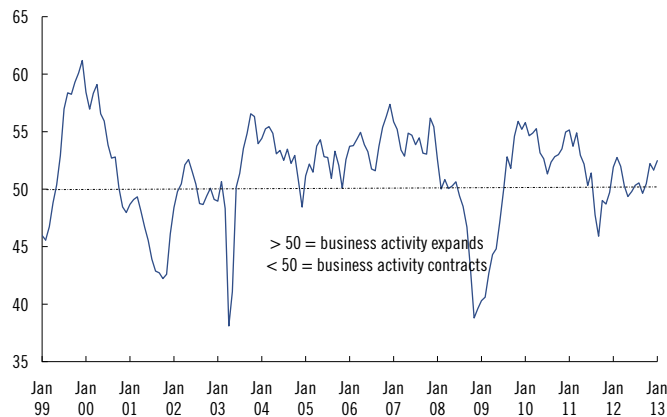
**Growing use of RMB in cross-border trade and investments in 2012** – HKMA announced that daily turnover in RMB spot/forward transactions in HK reached US\$5bn equivalent by end-2012, with RMB trade settlement handled by banks in HK increasing by 37.4%YoY to RMB2.6trn. Although RMB deposits now account for 9.1% of HK's total deposits, slightly less than the 9.6% at the end-2011, RMB certificates of deposits outstanding have increased to RMB117.3bn (+60.4%YoY). In terms of investible instruments, dim sum bond issuances increased by RMB112.2bn, taking the outstanding dim sum bond market to RMB237.2bn (+61.7%YoY). More encouragingly, we finally witnessed growing momentum in RMB loans, with outstanding loans more than doubling to RMB79bn in 2012. Other RMB denominated financial products emerged in 2012 too, for example, RMB A-Share ETFs, RMB Futures, and RMB equities.

**More competition or symbiosis going forward?** – As China steps up on its RMB internationalization progress, HK's offshore RMB banking businesses are seeing competition from other joining financial centers (Singapore and Taiwan). Given HK's headstart into the game and plenty of room for the growing pie of offshore RMB business, we believe HK banks will continue to reap benefits from new business opportunities such as those in Qianhai (note, HK banks initiated around RMB2bn cross-border loans to Qianhai companies at the end of Jan).

## **Policy vigilance against overheated property market**

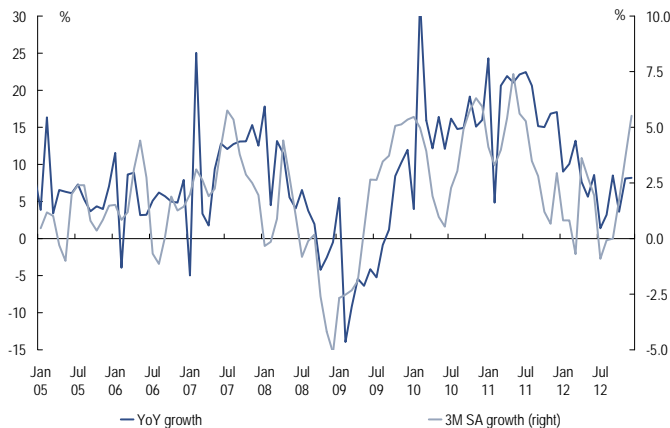
**The Government finally launched another round of demand curbs on 22 Feb** – Property market activities have been picking up since the start of 2013, and the market widely expected another round of property cooling measures would be administered after Singapore imposed its 7<sup>th</sup> round of tightening measures back in Jan. The cooling measures administered by HK, which entailed a doubling of stamp duty on all property transactions and lowering LTV ratios for non-residential properties, was more broad-based and steeper-than-expected. In fact, this is the first time that commentators criticized the Government, saying it may have overdone the tightening this round. We disagree and think the latest measures will likely quiet down transaction volumes and introduce a pause in price rises, but fire-sales remain unlikely. This 6<sup>th</sup> policy round merely reflects the administration's determination to apply near-term dampening measures when property market activities ramp up and to buy time for the announced supply-side measures to become effective. Follow-up statements from senior officials indicate they stand ready to act if needed (i.e. will lean against the wind for both upwind or downwind). Resulting higher total cost and down-payments required for property purchases post this set of policies are intended to deter investments or speculations in the overheated market, but by exempting single property owners from the extra stamp duty will preserve the genuine home buyers in the market. For details, see [Hong Kong Macro Flash - Broad-based and Steep Property Cooling Measures Announced](#), 25 Feb 2013.

Figure 35. PMI indicates further expansion



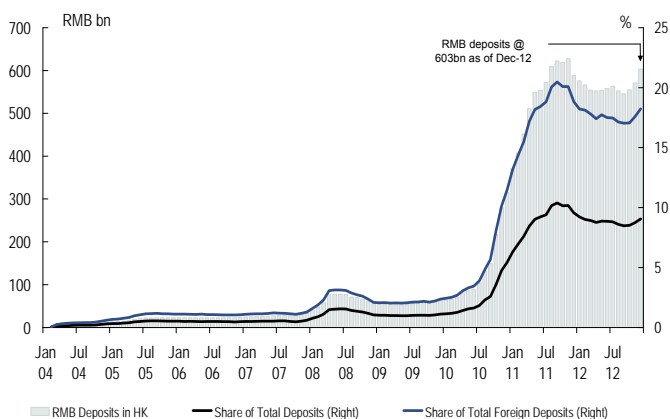
Source: Markit, Haver, and Citi Research

Figure 37. Consumption warming up earlier than we expected



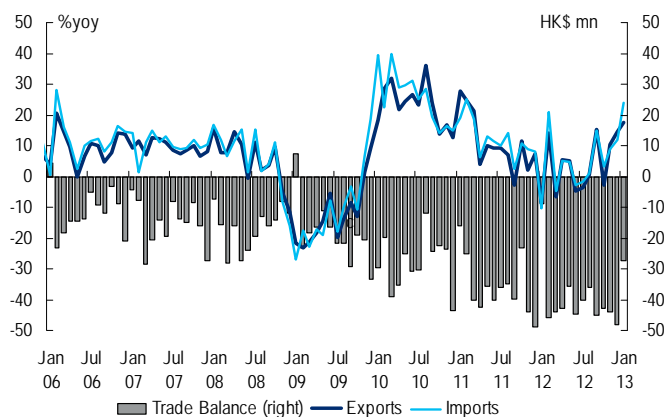
Source: CEIC, and Citi Research

Figure 39. RMB deposits accounts for 9.1% of total deposits



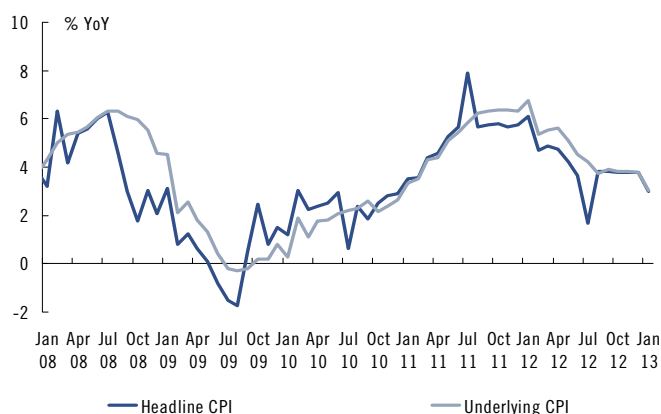
Source: HKMA, CEIC, and Citi Research

Figure 36. Expect uneven, but nonetheless, trade recovery in 2013E



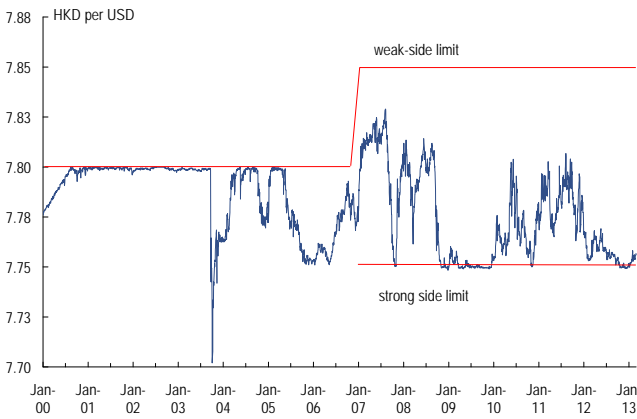
Source: CEIC, and Citi Research

Figure 38. Inflation likely on a rise again starting in Feb-2013



Source: CEIC, and Citi Research

Figure 40. Slight retracement but HKD largely still at the strong end



Source: Reuters, and Citi Research

Figure 41. Hong Kong Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	193.5	211.6	219.3	214.0	228.7	248.7	263.0	282.2	302.8
Nominal GDP, local currency bn	1,503	1,651	1,707	1,659	1,777	1,936	2,040	2,189	2,347
GDP per capita, US\$	28,031	30,497	31,488	30,594	32,429	34,970	36,705	39,072	41,582
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	3.3	3.2
<b>Economic Activity</b>									
Real GDP, % yoy	7.0	6.5	2.1	-2.5	6.8	4.9	1.4	3.0	3.5
Real investment growth % yoy	8.4	7.8	-0.3	1.0	10.4	3.1	4.4	5.7	2.1
Real consumption growth % yoy	5.4	7.9	1.9	1.0	5.9	8.1	3.9	2.1	2.0
private consumption growth % yoy	6.1	8.6	1.9	0.8	6.3	9.0	4.0	2.1	2.1
Real export growth, % yoy	9.4	8.3	2.5	-10.2	16.8	3.7	1.3	1.9	4.3
Real import growth, % yoy	9.1	9.1	2.2	-9.0	17.4	4.6	2.5	1.9	3.7
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	2.3	3.8	2.1	1.5	2.9	5.7	3.8	4.2	3.5
CPI, % avg	2.1	2.0	4.3	0.6	2.3	5.3	4.1	4.3	3.7
Nominal wages, % yoy	2.1	2.4	4.0	-1.9	2.4	9.9	5.0	3.5	4.5
Credit extension to private sector, % yoy	2.3	15.2	11.0	-2.1	20.9	12.5	7.0	7.0	8.0
1 month inter-bank rate, % eop	3.84	3.31	0.89	0.13	0.33	0.33	0.50	0.75	1.15
Long term yield, % eop	3.69	3.10	1.19	1.93	1.76	0.96	0.32	1.00	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	7.75
<b>Balance of Payments, US\$ bn</b>									
Current account	24.6	27.6	32.9	20.3	15.0	16.2	13.2	15.9	18.7
% of GDP	12.7	13.0	15.0	9.5	6.6	6.5	5.0	5.6	6.2
Trade balance	-17.9	-23.5	-25.9	-28.9	-43.1	-54.8	-61.6	-52.4	-53.3
Exports	316.8	344.7	363.0	318.7	390.4	429.2	443.1	479.8	524.7
Imports	334.7	368.2	388.9	347.6	433.5	484.0	504.7	532.2	577.9
Service balance	-9.3	-4.3	-2.7	3.4	10.1	19.0	18.0	18.2	18.4
Income balance	4.6	6.8	12.9	6.4	4.8	8.8	7.1	7.1	7.2
FDI, net	-15.5	-19.0	-8.9	-6.4	-10.5	-6.9	-9.8	-11.0	-12.0
International reserves	133.2	152.6	182.5	255.7	268.6	285.3	317.2	340.0	365.0
<b>Public Finances, % of GDP</b>									
Consolidated government balance	3.8	7.3	0.1	1.5	4.1	3.8	3.2	1.8	1.0
Consolidated gov primary balance	3.9	7.4	0.1	1.6	4.2	3.8	3.2	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>									
	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F
GDP, % yoy	1.0	1.4	2.5	2.3	2.9	3.4	3.5	3.6	4.7
CPI, % yoy	3.7	3.8	3.8	3.7	4.4	4.3	4.2	4.1	3.6
1 month inter-bank rate, % eop	0.33	0.33	0.35	0.25	0.37	0.55	0.67	0.77	0.87
Long term yield, % eop	0.38	0.32	0.33	0.65	0.75	0.85	1.00	1.20	1.40
lc vs USD, eop	7.76	7.75	7.75	7.75	7.75	7.76	7.76	7.76	7.76

\*Note: Public debt is general government debt.

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

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## India

- **Summary view** – GDP growth has hit a decadal low at 5%, the fiscal deficit (centre) is above 5%, the current account could cross 5% – and both WPI and CPI are well in excess of 5%. See [The 5% Trap](#) for more.
- **Things to watch** – While things do look grim, incremental policy has surpassed expectations, but the momentum needs to be sustained. That's what should get India out of the 5% trap.
- **Strategy** – While growth has fallen off the cliff, elevated levels of CPI and CAD are likely to result in modest easing of a further 50bps in 2013. High deficits are likely to result in the INR trading in the Rs54-56 range over the next few months.

### GDP – Pegged at 5% in FY13; expect 5.7% in FY14

**GDP skids to 10-year low** – The government's first GDP estimate for FY13 pegs growth at 5%, lower than market expectations of it coming in the 5.5% range. The slowdown in growth was evident in all three sectors – services fell to 6.6%, with industry at 3.1% and agri at 1.8%. On the expenditure side, while there are data issues in this series, key to note is the near halving of consumption growth which, after being steady at ~8% levels for the last 6 years, slowed to a mere 4.1%. This could be attributed to the relatively higher rate environment and containment in government spending seen since Sept-2012. As regards investments, while gross capital formation saw a pickup to 3.9%, net investments decelerated further to 2.5%.

**Expect a shallow recovery** – Taking into account the FY13 numbers, we expect a shallow recovery to 5.7% in FY14 from 5.0% in FY 13. This factors in: (1) The RBI easing rates by a further 50bps by 1H13; (2) A pick-up in consumption as FY14 is a pre-election year and lower rates could help; (3) A marginal uptick in investments, which rests on continued government efforts – both policy change and execution.

### External – CAD emerges as a bigger concern now

**Current account deficit (CAD) to remain elevated** – Following a record high CAD of US\$78bn or 4.2% of GDP in FY12, India's FY13 CAD is likely to edge higher to US\$89bn or 4.7% of GDP. This is on the back of: (1) A widening trade deficit as given the changing composition of exports, Indian exports are now more sensitive to global demand rather than a weaker INR. As regards imports, despite the deceleration in GDP, higher oil and gold imports have kept the bill high. (2) A moderation in invisibles. As we have previously highlighted, while software exports and remittances remain buoyant, the factor resulting in a moderation in invisibles is the near doubling of investment income outflows. This is a result of recourse to external debt which has risen from US\$224bn in FY08 to US\$365bn in FY13.

**Revision in oil data key to keeping the deficit <5% of GDP** – A peculiarity in the FY13 import data is the substantial difference between the reporting of the oil import bill by the Commerce Ministry and that of the Petroleum Ministry. At that outset, key to note is that there is generally a difference of ~US\$1.5bn, with higher numbers being reported by the Petroleum Ministry. However, in the current year, oil imports during Apr-Dec as reported by the Commerce Ministry stand at US\$125bn while those by the Petroleum Ministry were at US\$113bn. Given that the Finance Ministry is scrutinizing all the data closely, we expect this difference of ~US\$10bn to be adjusted. **However, if there is no adjustment to the data, the FY13 CAD could touch US\$99bn or 5.3% of GDP.**

**Capital raising a priority, INR to remain under pressure** – Policy makers are aware of the gravity of the problem as reflected in Governor Subbarao's recent comments on the level, the quality, and the financing of the CAD. Over the last few months, officials have taken several steps to boost dollar inflows including: (1) de-regulating NRI deposit rates, (2) relaxing ECB norms, (3) increasing FII debt limits, (4) liberalization of FDI, (5) postponement of GAAR, and (6) higher duties on gold. Given India's rising external financing requirements, we expect capital raising to remain a priority. As regards the INR, on a 6-month perspective, taking into account the relative growth story and capital inflows being close to financing the CAD, we maintain our view of the unit trading in the Rs54-56 range. However, risks to watch include a reversal in global liquidity, oil prices, and pre-election political spending.

## **RBI – Expect moderate easing due to high CPI and CAD**

**Inflation: Diverging trends in WPI and CPI to continue** – India's WPI surprised positively for the fourth consecutive month in Jan with the headline print coming in at 6.6%, lower than expectations and the 7.2% in the last month. While core inflation is now at the RBI's comfort zone of 4%, the CPI continued to inch higher, coming in at 10.8% vs. the 10.6% reading last month. Given sticky trends in food inflation, and it having a higher weightage in the CPI, we expect headline WPI to average 6.5%-7% and CPI forecasts in the 8%-9% range in FY14

**Tough balancing act for the RBI** – While growth has fallen off the cliff, the RBI is equally concerned about: (1) Sharp fall in financial savings; (2) Double-digit CPI; and (3) Level, Composition & Financing of the CAD. Thus in view of the above, despite positive surprises in WPI, we maintain our view of a further modest 50bps easing in 2013 with a 25bps cut in the 19<sup>th</sup> March policy.

## **Fiscal – Cautious Budget...Could Have Been Courageous**

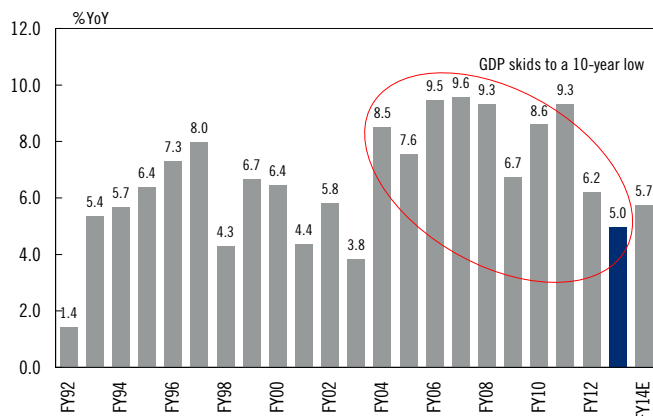
**FY14 Budget: Partially Delivers** — The three things we were looking out for in the budget were steps towards fiscal consolidation, measures to incentivize growth and focus on capital raising. In this context, the budget has partially delivered. (1) Fiscal Consolidation – More than delivers on FY13 and promises a lot for FY14 (with some risks), but overall is a key plus. (2) Growth – It disappoints. While measures such as the 15% investment allowance, additional tax breaks on housing loans are positive, they are not enough to revive growth. (3) Capital Raising – A little bit. The budget has liberalized savings for the small investor, proposes inflation-indexed instruments and takes steps towards deepening capital/bond markets.

**Budget Arithmetic: A Tad on the Optimistic Side** — The FM did keep his word on fiscal targets, with the deficit in FY13 coming in at 5.2%, marginally below his 5.3% target. This was in line with expectations - largely due to expenditure compression (plan exp at 4.1% v/s budget rate of 22.7%) and the usual deferment in fuel subsidies. Going forward for FY14, the budget arithmetic is based on nominal GDP growth of 13.4%, total receipts of 23.4% and expenditures up 16.4% - all of which we believe are a tad on the optimistic side.

**Bottom Line** — The FY14 deficit of Rs5,425bn or 4.8% of GDP is in line with expectations of the FM likely to stick to his fiscal consolidation plan. Consequently, the gross and net market borrowing program of the government stands at Rs6.2trn and Rs4.8trn. However, key to watch in the coming months is the possibility of supplementary spending ahead of elections. To conclude, the FY13 fiscal is a job well done, the growth incentives fall short and the budget lacks any big structural change/direction.

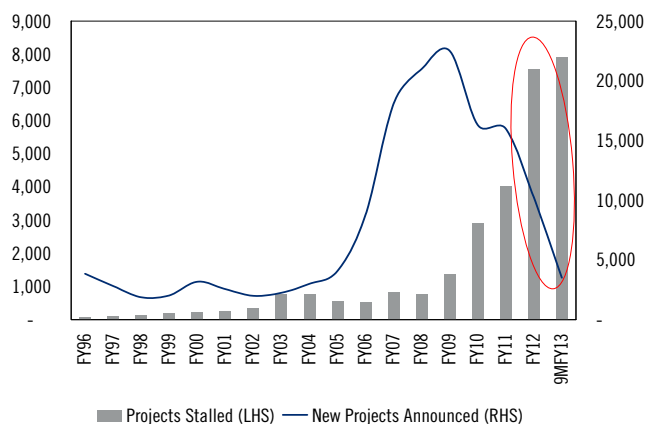


Figure 42. GDP (%) – Expect a shallow recovery...



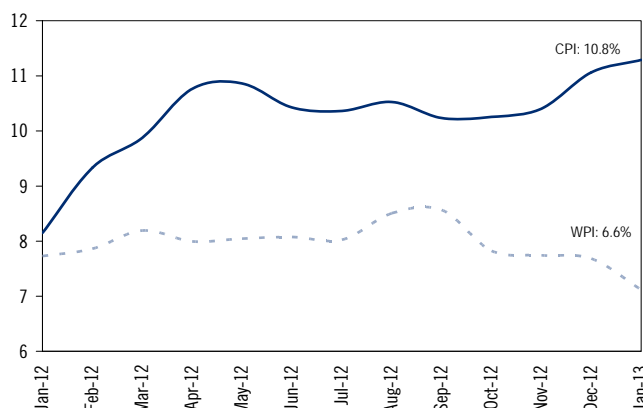
Source: CSO; and Citi Research Estimates

Figure 43. ...as projects cancelled and announced stay high (Rs bn)



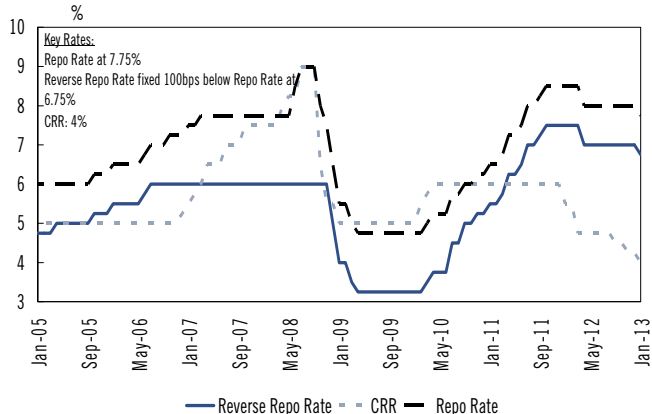
Source: CMIE

Figure 44. Diverging trends in WPI and CPI to continue (%)



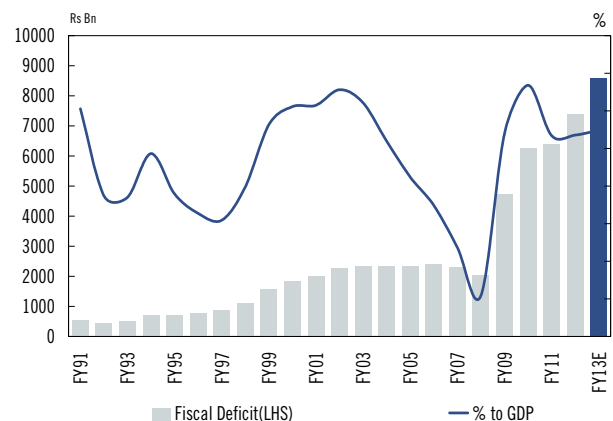
Source: Office of the Economic Advisor

Figure 45. Limited room for monetary easing (%)



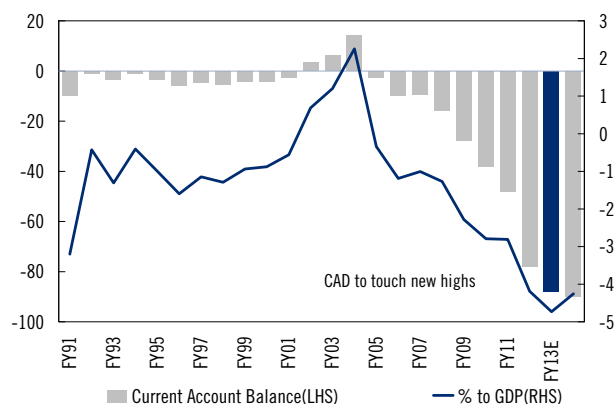
Source: Bloomberg

Figure 46. Fiscal Consolidation – Key for ratings (Rs bn, %)



Source: Budget Documents; and Citi Research Estimates

Figure 47. Elevated CAD – Headwind for the INR



Source: RBI; and Citi Research Estimates

Figure 48. India Economic Indicators

	FY07	FY08	FY09	FY10	FY11	FY12	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	1,857.1	2,073.7	2,355.4
Nominal GDP, local currency bn	42,947	49,871	56,301	64,778	77,953	89,749	100,281	113,017	128,839
GDP per capita, US\$	847	1,090	1,061	1,168	1,442	1,552	1,522	1,675	1,874
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	5.7	6.4
Real investment growth % yoy	13.4	18.1	-5.2	16.7	16.2	1.5	3.9	4.2	4.5
Real consumption growth % yoy	7.9	9.3	7.6	8.2	8.1	8.1	4.1	5.7	6.6
private consumption growth % yoy	8.7	9.2	7.1	7.1	8.6	8.0	4.1	5.5	6.7
Real export growth, % yoy	19.9	5.9	15.2	-4.7	19.7	15.3	5.1	10.0	11.0
Real import growth, % yoy	21.3	10.2	23.0	-2.1	15.8	21.5	5.7	12.0	9.5
<b>Prices, Money &amp; Credit</b>									
WPI, % yoy	6.8	7.7	1.5	10.6	9.7	7.7	7.5	7.0	6.0
WPI, % avg	6.5	4.8	8.1	3.8	9.6	8.9	7.5	7.0	6.0
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	7.75	7.50	7.50
1 month inter-bank rate, % eop	9.43	8.00	5.68	4.49	7.25	6.50	6.50	6.50	6.50
Long term yield, % eop	7.98	7.96	7.01	7.83	7.99	8.25	8.25	8.25	8.25
lc/US\$, eop	44.12	39.41	48.62	46.41	44.71	53.02	55.00	54.96	54.56
lc/US\$, avg	45.19	41.18	43.42	48.30	45.68	46.63	53.38	54.10	54.71
<b>Balance of Payments, US\$ bn</b>									
Current account	-9.6	-15.7	-27.9	-38.2	-48.1	-78.2	-87.9	-89.9	-88.3
% of GDP	-1.0	-1.3	-2.3	-2.8	-2.8	-4.2	-4.7	-4.3	-3.7
Trade balance	-61.8	-91.5	-119.5	-118.2	-127.3	-189.8	-200.3	-206.4	-221.8
Exports	128.9	166.2	189.0	182.4	256.2	309.8	294.3	317.8	349.6
Imports	190.7	257.6	308.5	300.6	383.5	499.5	494.5	524.2	571.4
Service balance	29.5	38.9	53.9	35.8	44.1	64.1	62.0	64.1	73.1
Income balance	-7.3	-5.1	-7.1	-8.0	-18.0	-16.0	-17.0	-17.0	-11.0
FDI, net	7.7	15.9	19.8	18.0	11.8	22.1	23.0	28.0	30.0
International reserves	191.9	299.1	241.6	252.8	273.7	260.9	259.6	257.3	255.6
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	-4.1	-8.4	-9.6	-8.2	-8.2	-8.6	-8.3	-7.8
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	345.4	360.4	375.4	390.4
Private	123.0	166.3	168.6	193.9	227.9	263.5	278.4	291.4	304.4
Public	49.4	58.1	55.9	67.1	78.1	81.9	82.0	84.0	86.0
External debt / GDP	18.1	18.1	18.3	19.1	17.9	18.5	19.4	18.1	16.6
External debt / XGS	86.1	88.5	77.7	95.2	81.5	77.5	79.9	--	--
Short-term debt	28.1	45.7	43.3	52.3	65.0	78.2	83.2	88.2	93.2
Short-term debt/International Reserves (%)	14.7	15.3	17.9	20.7	23.7	30.0	32.0	34.3	36.5
<b>Quarterly Economic Indicators</b>									
	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F
GDP, % yoy	5.5	5.3	4.5	5.0	5.3	5.7	5.9	6.0	6.0
WPI, % yoy	7.6	8.1	7.2	7.0	7.0	6.8	6.5	7.0	7.0
Policy interest rate, % eop	8.00	8.00	8.00	7.50	7.25	7.25	7.25	7.25	7.25
1 month inter-bank rate, % eop	8.50	8.50	8.50	8.00	8.00	8.00	8.00	8.00	8.00
Long term yield, % eop	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25
lc vs USD, eop	55.51	52.86	55.00	53.07	53.82	54.57	54.96	54.86	54.76

\*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).  
Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research Estimates

## Indonesia

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- **Summary view** – We expect GDP to grow 6.2% this year, up from a forecast 6.1% previously. Net exports should gradually recover while domestic demand will improve towards year end, in the run up to the 2014 elections. We expect YoY inflation may exceed 5% in coming months (YE forecast: 5.5%).
- **Things to watch** – Cost push pressures coming from electricity tariff hikes and food, amid wet weather, will kick-in in coming months. The external imbalance is still an issue as the current account deficit in 4Q12 left a basic balance deficit of over US\$3.2bn. However, we still believe the deficit will moderate this year.
- **Strategy** – Bank Indonesia (BI) has been more willing to deploy reserves, reducing near-term tail risks on the IDR. We have revised our 3M IDR forecast slightly lower to Rp9,750/US\$ (while 6-12M forecast remains at 9,800/US\$). We also push back our 25bps rate hike call to end-2Q, from previously end-Feb.

### Growth momentum slightly better than expected

**GDP growth forecast slightly revised upward** – Up to 4Q12, GDP growth slowed, dragged primarily by net exports and a slow-down in investment growth. However, the latter was mostly due to slower growth of investment in machinery (especially imported machinery). This came amid declining demand for trucks and heavy equipment for primary commodities sectors. Growth in building investment, by contrast, was still robust and even managed to accelerate to 7.8% YoY. Going into 1H13, we still expect growth to stay relatively weak. Monthly indicators point to no strong pick up yet in exports and domestic demand. However, we expect that in 2H13 growth will see stronger momentum, as exports recover and campaigning starts (informally) heading towards the 2014 elections. We expect GDP to grow 6.2% this year (prev. 6.1%).

**Inflation pressures to start kicking-in in coming months** – This will be mainly from cost push pressures, e.g. administered price hikes (electricity and possibly gas), minimum wage hikes, and possibly the impact from various import regulations such as horticulture import restrictions. January already saw household worker wages rising higher than usual, following the minimum wage hikes implemented in Jan-2013. We expect inflation to head towards or above 5% by end 1Q and we expect YE13 headline inflation at 5.5% [2013 year-end fcsts]. We think the possibility of an inflation surprise due to fuel subsidy reform remains minimal, as the administration has been pre-occupied by cabinet personnel changes and President SBY's party plagued by negative publicity from a high profile corruption case.

**Current account deficit reached record highs in 2012, but is that history?** – The current account deficit reached US\$7.8bn or an annualized 3.6% of GDP in 4Q12 (2.8% FY12), with a basic balance deficit (excess of CA over FDI) of about US\$3.2bn during the quarter. The oil and gas trade deficit is not totally anchored, as gas is diverted for domestic use and domestic fuel consumption for transportation continues to grow unabated, i.e. in the absence of any policy to reduce fuel subsidies. However, the risk of a further spiral, especially in the non-oil and gas trade balance, is receding. Prices of key commodity exports such as coal and palm oil are no longer falling. Meanwhile import growth may be tempered in light of the various new regulations which tighten imports (e.g. on mobile phones, electronics, textiles, etc.). Overall, we expect the 2013 CA deficit to narrow to US\$20.5bn (2.1% of GDP).

## BI due for leadership change, the implications?

### **Finance Minister has been nominated for BI Governor post – Agus**

Martowardojo has been nominated by President Yudhoyono as the only candidate for Bank Indonesia Governor (a 5-year term), replacing Darmin Nasution who will be retiring in May. If the nomination is approved by parliament, BI would continue to be run by professionals who are free from partisan politics. Given Agus' experience in the bureaucracy, the ongoing transfer of bank supervisory responsibilities from BI to the financial services authority (OJK) should also resume without major obstacles.

**We don't think BI's policy mix will see any drastic change –** Considering Mr. Agus' background as a career banker, we think BI may continue to have an apparent pro-growth bias. We also think BI will continue to be mindful of the need to maintain adequate liquidity in the FX market. That said, there is the new uncertainty over who will run the Finance Ministry if Mr. Agus does head over to BI. In the run up to the 2014 elections, any Finance Minister will face the tough task of guarding against fiscal profligacy and a tendency amongst politicians to push through with inefficient projects. Negotiation and lobbying skills will also be needed to garner consensus for long-overdue unpopular reforms e.g. cutting fuel subsidies.

## Revisiting our expectation on the FasBI rate

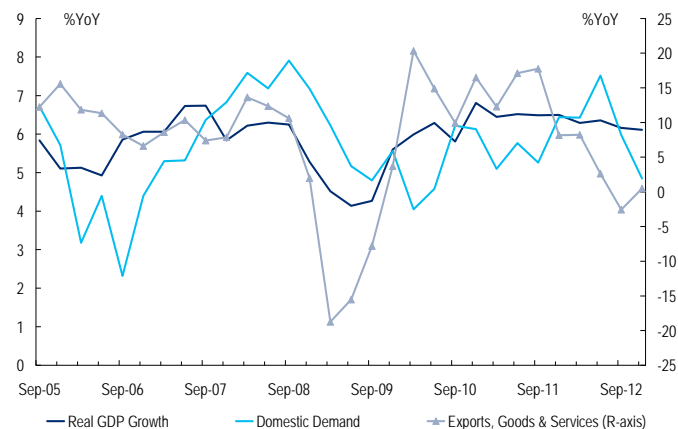
### **BI's increased willingness to deploy FX reserves reduces near-term tail risks**

– Relative to last year, we sense that BI's willingness to deploy reserves has improved recently. The change in stance has been apparent since January, marked by a decline of about US\$4bn in reserves. From a recent meeting with top officials, BI appears to have finally realized that imbalances in the FX market can be exacerbated by perception of tight liquidity (because exporters tend to hang on more to their foreign currency). Therefore a consistent improvement of liquidity may help prevent sharp exchange rate swings, such as the one witnessed in May-2012, and also improves price transparency. We have revised our 0-3M IDR forecast to Rp9,750/US\$ (prev. Rp9,950/US\$). Our 6-12M forecast is unchanged at Rp9,800/US\$.

**Yet there is risk of reserves falling if portfolio inflows stall –** Indonesia's basic balance deficit (the excess of current account deficit over FDI) has fluctuated in the region of US\$3-4bn per quarter. Therefore if portfolio and debt inflows stall, there is risk that exchange market pressure could re-intensify and reserves could drop by several billion dollars per month if BI does not tolerate a weaker currency (as the cash realization of exports is usually less than 100%). Yet global liquidity conditions appear to have been quite resilient so we think the risk of this happening is receding.

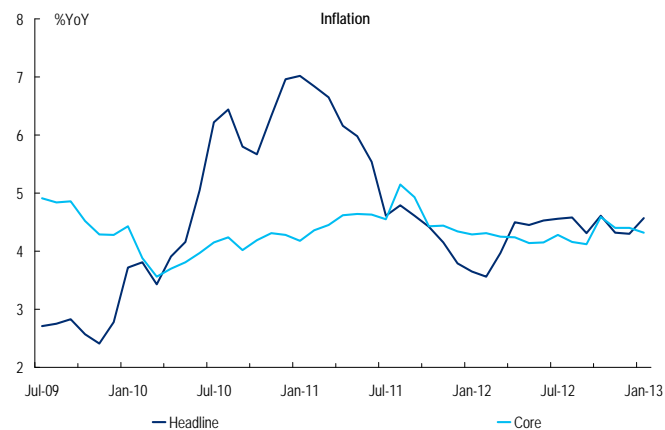
**Will there be any rate hike at all this year? –** The trade deterioration has been increasingly driven by the oil and gas trade deficit which is a byproduct of government subsidy policy (this is apart from the structurally high need for raw material imports due to limited capacity of basic industries). Thus, in our view BI doesn't see tightening monetary policy as an appropriate response, except merely for signaling purposes in the event of capital outflow. As our baseline forecast is for the commodity trade balance to gradually improve, we think the possibility of BI hiking rates on the basis of external imbalances may decline as we go further into the year, especially in 2H. However, amid apparent pressure on inflation also lingering, a move cannot be totally ruled out. As such, we still expect one 25bps FasBI rate hike by end-2Q.

Figure 49. GDP growth slowed to 6.1% in 4Q12



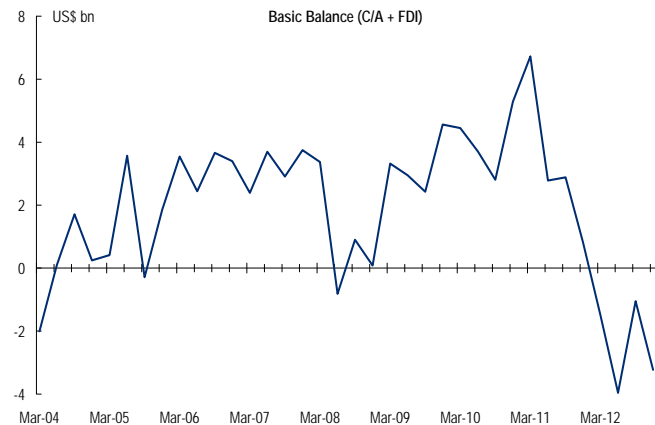
Source: CEIC, and Citi Research

Figure 51. CPI inflation well anchored but pressures emerging



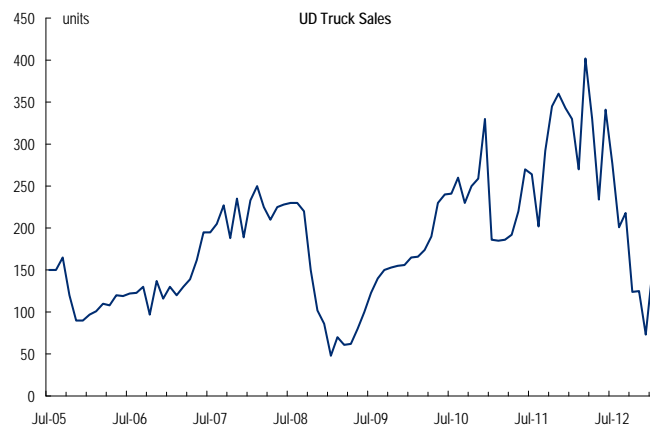
Source: CEIC, and Citi Research

Figure 53. The CA deficit has not been wholly covered by FDI



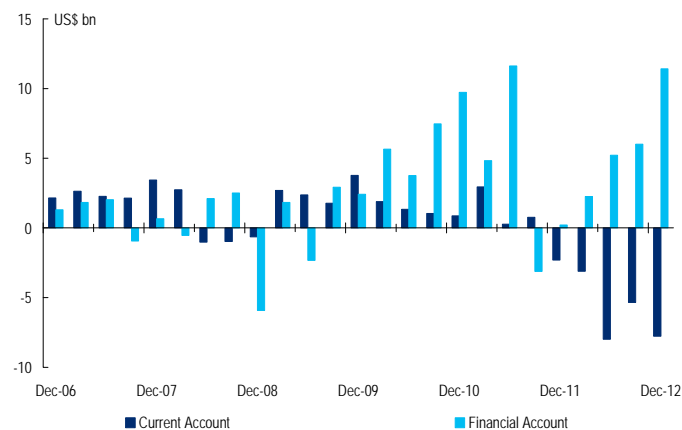
Source: CEIC, and Citi Research

Figure 50. Slower fixed investment amid declining truck/equip. sales



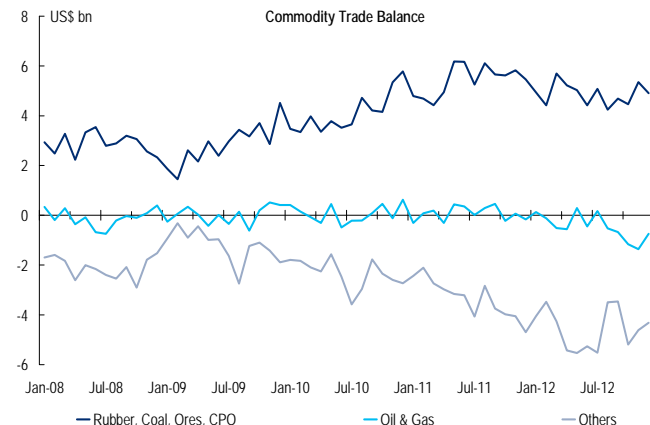
Source: CEIC, and Citi Research

Figure 52. Current account deficit has been offset by capital surplus



Source: CEIC, and Citi Research

Figure 54. Deterioration of oil and gas trade balance must be watched



\*Note: December 2012 figures are Citi Estimates  
Source: CEIC, and Citi Research Estimates

Figure 55. 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	709.9	845.8	878.6	962.5	1,093.0
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	9,407,966	10,621,769
GDP per capita, US\$	1,636	1,915	2,235	2,328	2,987	3,486	3,597	3,904	4,383
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	5.8
<b>Economic Activity</b>									
Real GDP, % yoy	5.5	6.3	6.0	4.6	6.2	6.5	6.2	6.2	6.3
Real investment growth % yoy	1.3	1.9	12.4	2.4	11.1	8.2	16.9	7.1	8.7
Real consumption growth % yoy	3.9	4.9	5.9	6.2	4.1	4.5	4.8	5.7	5.9
private consumption growth % yoy	3.2	5.0	5.3	4.9	4.7	4.7	5.3	5.2	5.1
Real export growth, % yoy	9.4	8.5	9.5	-9.7	15.3	13.6	2.0	5.0	9.1
Real import growth, % yoy	8.6	9.1	10.0	-15.0	17.3	13.3	6.6	5.1	10.6
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	6.6	5.8	11.1	2.8	7.0	3.8	4.3	5.5	4.3
CPI, % avg	13.1	6.3	9.9	4.8	5.1	5.4	4.3	4.7	4.7
Nominal wages, % yoy	6.3	4.2	7.6	5.3	12.2	4.6	12.0	28.0	15.0
Credit extension to private sector, % yoy	12.1	22.4	30.7	18.0	20.8	25.7	22.0	18.0	20.0
Policy interest rate, % eop	4.75	3.00	8.75	6.00	5.50	4.50	4.00	4.25	4.50
1 month inter-bank rate, % eop	5.75	3.35	9.44	6.39	5.66	4.57	4.24	4.65	4.80
Long term yield, % eop	10.18	10.02	11.92	10.07	7.83	6.05	5.39	5.70	6.00
lc/US\$, eop	8994	9393	10900	9425	9010	9068	9638	9788	9676
lc/US\$, avg	9171	9140	9673	10376	9078	8763	9361	9775	9718
<b>Balance of Payments, US\$ bn</b>									
Current account	10.9	10.5	0.1	10.6	5.1	1.7	-24.2	-20.5	-19.1
% of GDP	3.0	2.4	0.0	2.0	0.7	0.2	-2.8	-2.1	-1.7
Trade balance	29.7	32.8	22.9	30.9	30.6	34.8	8.4	12.4	15.9
Exports	103.5	118.0	139.6	119.6	158.1	200.8	188.1	209.1	256.4
Imports	73.9	85.3	116.7	88.7	127.4	166.0	179.7	196.7	240.5
Service balance	-9.9	-11.8	-13.0	-9.7	-9.3	-10.6	-10.8	-11.0	-11.2
Income balance	-13.8	-15.5	-15.2	-15.1	-20.8	-26.7	-25.8	-25.8	-28.0
FDI, net	2.2	2.3	3.4	2.6	11.1	11.5	14.4	14.4	15.5
International reserves	42.6	56.9	51.6	66.1	96.2	110.1	112.8	112.2	114.1
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	-1.8	-1.5	-1.4
Consolidated gov primary balance	1.5	0.8	1.7	0.1	0.6	0.1	-0.8	-0.4	-0.2
Public debt	39.6	34.1	29.3	31.4	26.3	23.5	23.6	21.9	20.9
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	250.0	285.0	310.0
Private	56.8	60.6	68.5	73.6	83.8	106.7	116.5	146.5	168.0
Public	75.8	80.6	86.6	99.3	118.6	118.6	133.5	138.5	142.0
External debt / GDP	36.4	32.7	30.4	32.1	28.5	26.6	28.5	29.6	28.4
External debt / XGS	115.3	108.2	100.1	130.2	115.8	101.8	118.3	122.3	110.2
Short-term debt	12.2	18.7	20.5	24.0	31.6	36.6	39.0	42.0	45.0
Short-term debt/International Reserves (%)	28.7	32.8	39.7	36.4	32.8	33.2	34.6	37.4	39.4
<b>Quarterly Economic Indicators</b>									
	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F
GDP, % yoy	6.4	6.2	6.1	6.0	5.9	6.3	6.5	6.7	6.7
CPI, % yoy	4.5	4.3	4.3	4.9	5.5	4.8	5.5	4.6	4.0
Policy interest rate, % eop	3.75	4.00	4.00	4.00	4.25	4.25	4.25	4.50	4.50
1 month inter-bank rate, % eop	3.98	4.11	4.24	4.20	4.20	4.45	4.65	4.80	4.80
Long term yield, % eop	6.28	5.98	5.39	5.30	5.60	5.50	5.70	5.80	5.90
lc vs USD, eop	9393	9570	9638	9752	9770	9789	9788	9760	9733

\*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).

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

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## Malaysia

- **Summary view** – We maintain our 2013 GDP forecast at 5.5%. Stronger growth virtually eliminates the possibility of rate cuts, although still-low inflation suggests there is no urgency to hike rates immediately in our view. Media reports suggest that PM Najib may dissolve Parliament in March.
- **Things to watch** – (1) Newsflow on election timing; (2) Export performance, especially E&E, and spillovers on employment; (3) Implementation of fiscal spending and ETP projects.
- **Strategy** – Notwithstanding near-term cyclical outperformance, heavy foreign positioning in bonds and bills may leave MYR and MGS/bills vulnerable to pre-election jitters, although onshore investors may pick up some of the slack.

### 4Q GDP accelerated on wider current account surplus...

**4Q GDP accelerated past market expectations to 6.4%YoY (4Q: 5.3%), bringing full-year 2012 GDP growth to 5.6%** – The drag from net exports narrowed, offsetting still resilient but moderating domestic demand (4Q: 7.5%YoY, 3Q: 11.4%). Private consumption moderated to 6.1% (3Q: 8.5%) while public consumption slowed to 1.1% (3Q: 2.3%). Fixed investment growth also eased to 15.0% (3Q: 22.7%), bringing the full-year 2012 fixed investment share of real GDP to 26.7% vs. 23.5% in 2011. Inventories contributed a smaller 0.2%-pts to growth in 4Q (3Q: 2.2%-pt). By sector, the main drivers were manufacturing (4Q: 5.8%, 3Q: 3.3%), agriculture, and mining & quarrying, offsetting slightly slower growth in construction (4Q: 18.1%, 3Q: 18.3%) and services (4Q: 6.3%, 3Q: 7.0%).

**The smaller net exports drag was reflected in the current account surplus more than doubling** – The CA surplus increased to RM22.8bn (9.4% of GDP) in 4Q from RM9.5bn (4% of GDP) as the goods surplus widened while the services, income and current transfer deficits narrowed. This brought the full-year 2012 current account surplus to 6.4% of GDP from 11.0% in 2011. The financial account deficit widened slightly (4Q: -RM9.0bn, 3Q: -RM8.7bn) as net direct investments fell into deficit on surging outward direct investments and slowing FDI inflows.

**Nonetheless, we would remain cautious on the export outlook** – We continue to see ample reasons to remain cautious in 1H13. December exports and IP for example had disappointed with sequential contractions, with the critical electrical & electronics sector in the doldrums. The continued fall in intermediate good imports suggests exporters are not sufficiently confident over the demand outlook to restock inventories of components. Moreover, Malaysia is less exposed to “star” product segments like tablets and smartphones that have lifted North Asian tech exports – although the smaller exposure could limit the impact from weak iPhone 5 shipments on exports and production.

**Despite some slowdown, consumption and investment should remain resilient** – Consumption will likely remain supported by low unemployment as well as more handouts announced in the Budget including the second round of BR1M handouts, half-month civil service bonus, higher minimum pensions, and incentives to military personnel. Overall, assuming a somewhat faster pace of QoQ growth momentum given continued implementation of investment projects and a 2H13 export recovery, we maintain our 2013 GDP growth forecast at 5.5%.



**The investment revival has been further boosted by announcements of joint projects with Singapore** – In focus is the long-anticipated high-speed rail link between Singapore and KL that will cut travel time to just 90 minutes, with operations targeted to begin in 2020. Meanwhile, Khazanah Malaysia and Singapore's Temasek also announced details on two wellness projects in Iskandar worth a combined RM3bn – Avira, marketed for older Singaporeans, and Afiniti, for families, tourists, and professionals. This comes on top of an RM8bn deal by Singapore's CapitaLand and Temasek, and Malaysia's Iskandar Waterfront Holdings to develop a waterfront township in Danga Bay, Johor Bahru. That these projects are announced before elections could suggest confidence that the convergence of bilateral economic interests will continue regardless of the election outcome.

### **...but rate outlook stable as inflation remains contained**

**Jan inflation ticked up to 1.3%YoY (Dec: 1.2%) on food and clothing & footwear** – We expect inflation to average 1.7% in 2013, picking up to 1.5-2.5% in 2H13. Excluding food and transport, inflation was again unchanged at 1.1%YoY in Jan and flat MoM SA (Dec: 0.1%), easing on a 3MMA basis.

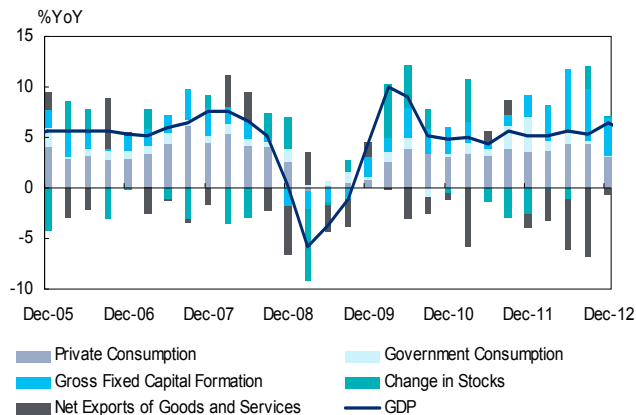
**Our base case remains for a stable rate outlook through 2013, although risks are to the upside** – The January MPC statement continued to flag a stable rate outlook and was explicit that there is no hurry to hike "while inflation remains contained". Gov Zeti has previously mentioned that "inflation is not a concern unless it exceeds 3% and is seen to be primarily demand driven". The Jan inflation uptick reflected mainly seasonality as well as supply side factors – core inflation momentum eased and services inflation fell despite the imposition of the minimum wage. In any case, inflation remains well below BNM's implicit 3% tolerance threshold and is expected to average just 2-2.5% in 2H13 even under the assumption of two 10sen/litre hikes in RON95 each in Jun and Dec. With new capacity additions from the investment upswing pushing down capacity utilization rates, demand pressures remain contained at this stage. Macroprudential measures on household lending seem to have successfully slowed household loan growth, giving few reasons to hike on household debt concerns either.

**That said, the risk of a more hawkish MPC would rise as we head towards 2H13** – This could be when the growth recovery becomes more entrenched and inflation likely breaches 2% levels. Should there be concern about over-investments in non-productive sectors, policymakers will likely opt for macroprudential and non-monetary tightening as a first policy choice. Interest rates will likely be used if there are clearer signs of domestic demand overheating, which can be seen in inflation or broader credit/leverage indicators. Key to watch will be inflation risks from the minimum wage and demand pull pressures.

### **Last leg of the race to elections**

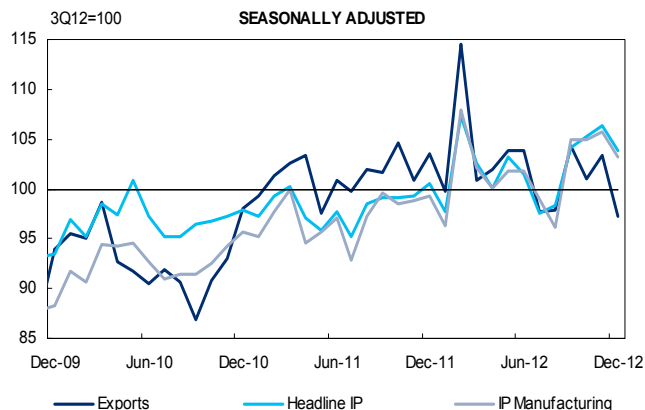
**PM Najib will have to call elections by April 2013** – Latest reports suggest PM Najib will dissolve parliament on 16 March and hold elections in mid-April – not long after the last of the next handouts in March, we note. The BN has apparently yet to complete its manifesto, candidates' list, and general preparations, while the Election Commission will require at least four weeks to prepare for the polls. Meanwhile, the Opposition has released its manifesto, promising to disburse RM1,000 to every citizen above 60 years old, raise minimum wages to RM1,100/month, and raise the top income tax bracket. The recent armed incursion by more than 100 Filipino gunmen in Sabah could also have shaken confidence in the BN.

Figure 56. 4Q GDP accelerated to 6.4%YoY as net exports drag eased...



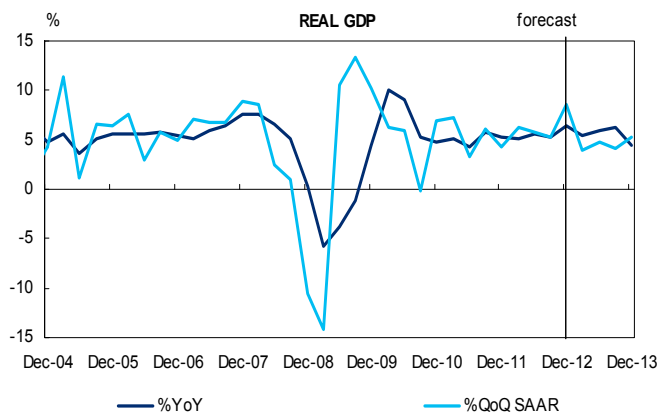
Source: Haver, and Citi Research

Figure 58. Exports and IP contracted sequentially in Dec



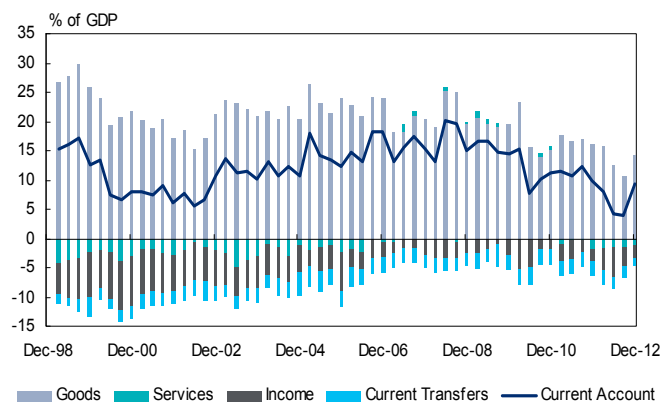
Source: CEIC, and Citi Research

Figure 60. We maintain our 2013 GDP growth forecast at 5.5%



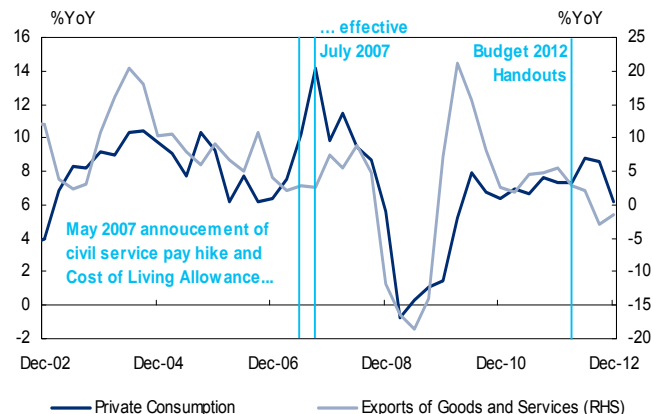
Source: Haver, and Citi Research Estimates

Figure 57. ... and current account surplus more than doubled



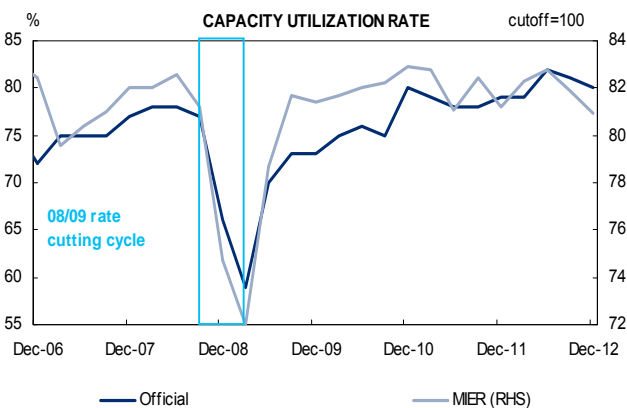
Source: CEIC, and Citi Research

Figure 59. Consumption will likely remain supported by more handouts



Source: CEIC, and Citi Research

Figure 61. New capacity additions pushing down capacity utilization



Source: CEIC, and Citi Research

Figure 62. 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	247.0	288.2	303.8	338.7	380.8
Nominal GDP, local currency bn	597	665	770	713	795	881	938	1,043	1,154
GDP per capita, US\$	6,067	7,123	8,393	7,255	8,639	9,949	10,357	11,328	12,485
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	7.2	5.1	5.6	5.5	6.0
Real investment growth % yoy	8.6	9.1	1.8	-9.4	23.8	3.2	20.7	14.1	8.8
Real consumption growth % yoy	6.4	9.7	8.4	1.4	5.8	8.9	7.1	5.3	5.6
private consumption growth % yoy	6.6	10.4	8.7	0.6	6.6	7.1	7.7	6.1	6.6
Real export growth, % yoy	6.7	3.8	1.6	-10.9	11.3	4.2	0.1	3.0	4.9
Real import growth, % yoy	8.2	5.9	2.3	-12.7	15.6	6.2	4.5	5.4	5.5
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.1	2.3	4.5	1.0	2.1	3.0	1.2	2.3	2.7
CPI, % avg	3.6	2.0	5.4	0.6	1.7	3.2	1.6	1.7	2.4
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	10.6	12.3	12.0	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
1 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	3.30	3.70
lc/US\$, eop	3.53	3.31	3.45	3.42	3.08	3.17	3.06	3.00	3.04
lc/US\$, avg	3.67	3.44	3.33	3.52	3.22	3.06	3.09	3.08	3.03
<b>Balance of Payments, US\$ bn</b>									
Current account	26.2	29.7	39.5	31.4	27.4	31.8	19.4	16.9	15.2
% of GDP	16.1	15.4	17.1	15.5	11.1	11.0	6.4	5.0	4.0
Trade balance	37.4	37.7	51.6	40.0	41.9	48.4	40.6	26.2	27.0
Exports	160.9	176.1	199.3	157.1	198.8	227.8	227.8	236.2	242.0
Imports	123.5	138.5	147.7	117.1	157.0	179.4	187.2	210.0	215.0
Service balance	-2.0	0.8	0.0	1.1	0.5	-2.6	-4.3	-1.0	-3.0
Income balance	-4.7	-4.1	-6.9	-4.0	-8.2	-7.2	-10.9	-12.0	-12.0
FDI, net	0.0	-2.7	-7.8	-6.3	-4.2	-3.3	-7.1	-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	-4.0	-3.5
Consolidated gov primary balance	-1.1	-1.2	-3.0	-4.7	-3.5	-2.8	-2.3	-1.8	-1.3
Public debt	40.6	40.1	39.8	50.8	51.2	51.8	53.7	53.7	53.0
of which Domestic	36.4	37.1	37.2	48.9	49.1	49.7	51.8	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	87.6	94.7	98.5
Private	30.8	37.8	41.5	41.9	44.7	53.7	82.0	89.0	93.0
Public	21.2	18.4	25.2	26.3	27.9	27.8	5.6	5.7	5.5
External debt / GDP	32.0	29.0	28.8	33.7	29.4	28.3	28.8	27.9	25.9
External debt / XGS	28.5	27.4	29.0	36.9	31.3	30.9	33.0	33.9	34.3
Short-term debt	12.1	16.3	22.5	22.7	25.4	32.9	35.0	40.0	42.0
Short-term debt/International Reserves (%)	14.6	16.1	24.6	23.5	23.8	24.6	25.0	26.5	26.8
<b>Quarterly Economic Indicators</b>									
	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F
GDP, % yoy	5.6	5.3	6.4	5.1	5.4	5.8	5.5	6.5	6.4
CPI, % yoy	1.6	1.3	1.2	1.3	2.0	2.0	2.3	2.4	2.6
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	3.19	3.20	3.21	3.21	3.21	3.21	3.21	3.40	3.60
Long term yield, % eop	3.21	3.31	3.24	3.20	3.25	3.25	3.30	3.40	3.50
lc vs USD, eop	3.17	3.06	3.06	3.17	3.11	3.04	3.00	3.01	3.02

\*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).

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

## Philippines

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- **Summary view** – We upgrade our 2013 and 2014 GDP forecasts to 6.2% and 6.6% respectively, after the 4Q 2012 GDP updates. Discretionary spending likely to drive consumption this year, arising from the wealth effects alongside rising per capita incomes. Private construction which expanded 23.3%YoY in 4Q12 may again spark faster investments.
- **Things to watch** – Senate election results that serve as a referendum of Aquino's policies and agenda. Whether headline inflation has bottomed out. Lift to fiscal revenues from new sin tax measure. 'Refinement' of the SDA. Whether the election period will lend pause to searing equity and bond market rallies.
- **Strategy** – Overweight 20yr-25yr bond segment. Expect compression of the 20y10y spread to 80bp-90bp on the back of strong liquidity, unchanged overnight rate, and sustained fiscal consolidation. Having lagged local risk market gains, prevailing peso ranges reflect shallow undervaluation.

### Faster discretionary consumer spending in 2013

**Similar to last few quarters, we may see discretionary spending continue to outpace food and other basic expenditures in 2013** – In our review of 4Q12 GDP, we saw that health expenditures grew 19.8%YoY – the third quarter of double-digits gains, perhaps aided by government's social spending programs. Communications (10.4%YoY), recreation & culture (12.6%YoY), and restaurants & hotels (15.7%YoY) also reported hefty gains. Miscellaneous consumption also grew by 11.2%YoY. These account for 27.4% of total PCE. Car sales grew 47.7%YoY in Jan but were down 1.2%MoM SA after recording three straight intra-month gains.

**Wealth effect accruing to middle class households** due to investments in outperforming local equity market (20 new highs established by the index since start of the year) and flattening bond curve, upbeat consumer sentiment, tightening onshore labor markets, and an accommodative financial setting, probably supported the robust discretionary consumption – We think this trend will persist in 2013 to underscore the improving quality of consumption.

**Coincident with faster discretionary spending, we noted the strong contribution of private construction which expanded 23.3%YoY as providing the spark for investment-driven growth in 4Q12** – While private capex was not as strong (investments in durable goods grew 4.5%YoY), we noted that 12 out of 20 categories of durable equipment purchases recorded gains in 4Q12. Road vehicles (5.2%YoY), mining & construction machineries (60.1%YoY), telecoms & sound recording equipment (4.2%YoY), and aircon & refrigeration equipment (17.5%YoY) posted upbeat gains during the quarter. Other than construction-related equipment, we expect sustained investments in equipment for residential/commercial buildings and industrial parks. The key result was easing of the adult jobless rate to 24.6% in December according to the SWS survey, down from 34.4% in March 2012.

**Seasonally adjusted exports closed 2012 on an upbeat note (+7.7%MoM s.a.) due to expansion of non-tech manufactured exports (+15.6%MoM s.a.)** – A recovering global semiconductor industry (signaled by the US semiconductor industry's book-to-bill ratio edging up to 0.92x in Dec from less than 0.8x since Sep) and firmer global prospects in 2H13, suggest there is upside risk to tech exports. OFW remittances from recession-plagued Europe managed to post growth in 2012, enhancing the 'resiliency' of remittances and its outlook for this year.

## Buoyant business sentiment staying upbeat

**Sectors catering to the domestic markets (construction, financial intermediation, real estate, etc.) supported favorable business sentiment in 1Q13 and 2Q13** – In BSP's survey, the construction (50.5%) and services (52%) sectors keyed the business sentiment index of 41.5% in 1Q13, although down from the preceding quarter's index (49.5%). Election spending and lingering impact of private construction activity in 4Q12 probably supported the strong business outlook of respondents in the construction sector. Post-Christmas retail overhang weighed on 1Q13 sentiment. Industry (53.8%), wholesale & retail trade (57.1%), and other services sector (60.1%) led next quarter's upbeat business sentiment of 56.4%. Interest rates and inflation expectations remain benign and are unlikely to threaten the business outlook. Insufficient demand and strong business competition are the key constraints that may explain why only 29.6% of survey participants in the industrial sector – a slight improvement last year – cited expansion plans in 2Q13. At 40% or more, respondents in the mining & quarrying and utilities sectors reported capex plans. About 28.4% of manufacturing sector respondents will undertake expansion. Investment-driven growth sparked by infra spending hopefully can trigger more onshore jobs and income creation and generate fiscal 'crowding-in' effects – a positive response from private companies to undertake capex.

## Curve inversion in the long end

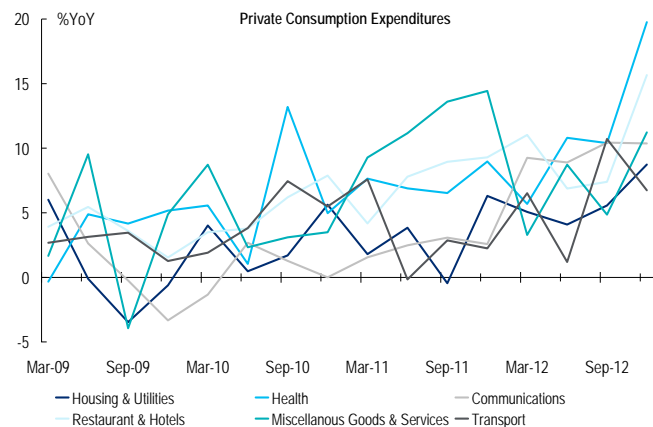
**Strong liquidity may have been obvious in the 10-yr yield compression as it dipped below the overnight rate of 3.5% in the recent auction** – We think there is strong market conviction of benign inflation and appreciation of new fiscal risk metrics consisting of stronger fiscal revenue flows (from proceeds of new sin taxes coupled with sustained collection efficiency gains) and extended expenditure shortfalls. Fiscal consolidation remains the norm although the government faces the challenge to ease budget shortfall risk. As a result, 20-25yr yield has room for compression in light of 10yr yield inversion. Last week's 20y10y spread at 116bp remains well above the average spread of 87.9bps over the past 12 months. Assuming a spread range of 80bp-90bp, the 20yr-25yr segment of the curve has to compress in line with the fresh low of the 10yr yield. Liquidity migration away from low yielding SDA while facing SDA rate cut risk support rallies in the long end.

**'Correction' in the long bond segment may come from market responses to inflation upticks, tightening signals from BSP aside from a strong peso, and less uncertain G3 recovery prospects that will signal firming up of oil/commodity price futures** – With fiscal consolidation, a 'correction' of curve inversion in the long end due to possible policy rate tightening would offer a good opportunity to re-establish bond positions. Staying 'nimble' to exploit market corrections may require keeping to within the historical 20y10y spread of 80bp-90bp while also taking a cue from long bond yields staying positive after inflation.

## Peso lagging an outperforming equity and bond markets

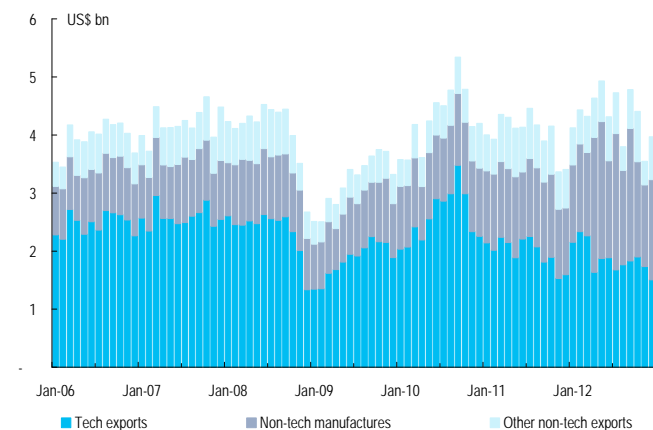
**JPY weakness prompted BSP to resist further PHP appreciation** – However, local risk asset market rallies on strong macro translated into good 4Q12 earnings momentum and fiscal consolidation that supported curve inversion. Subdued macro risk, accommodative financial setting, and SDA yield cut, spurred liquidity migration into risk asset markets. Having lagged local risk markets amid upside surprises to macro readings to kick-start 2013, BSP may allow further peso appreciation to sustain the initial 'tightening' gesture in response to a positive output gap in place.

Figure 63. Discretionary consumption spending on the rise



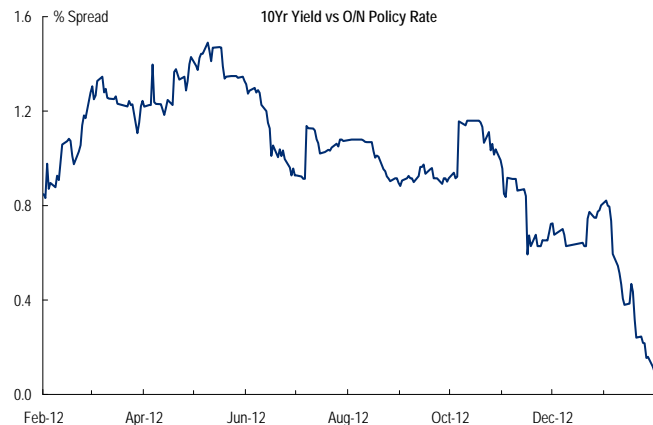
Source: CEIC, and Citi Research

Figure 65. Non-tech commodities accounted for 57% of exports in 2012



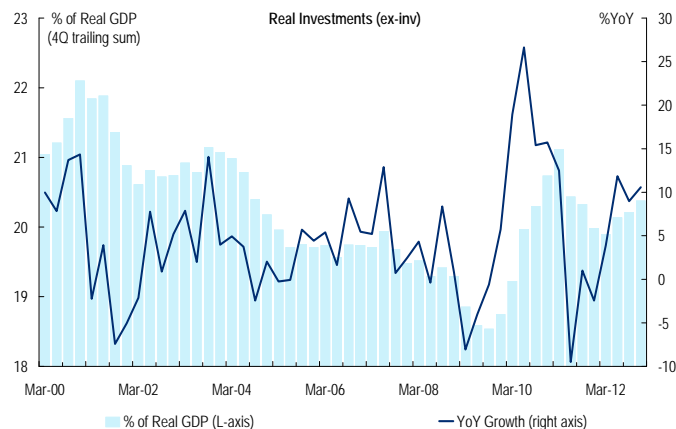
Source: CEIC, and Citi Research

Figure 67. Yield inversion in the 10yr segment of the bond curve



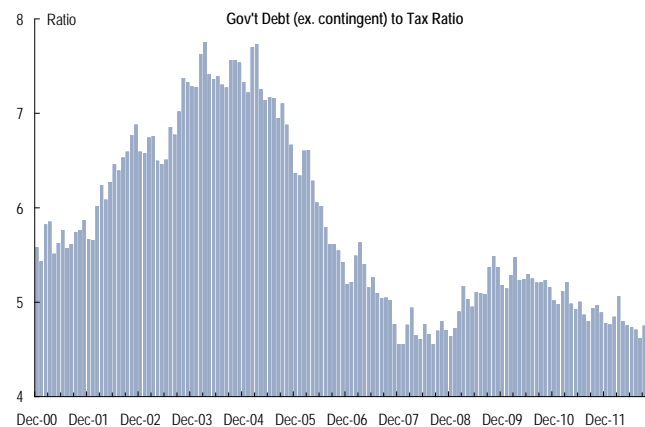
Source: Bloomberg, and Citi Research

Figure 64. Construction firming up real investments to GDP at 20%



Source: CEIC, and Citi Research

Figure 66. Government debt to tax ratio likely to trend down



Source: CEIC, and Citi Research

Figure 68. Potential for 20y10y spread to compress further



Source: Bloomberg, and Citi Research

Figure 69. 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	224.7	250.6	289.8	318.7
Nominal GDP, local currency bn	6,271	6,893	7,721	8,026	9,003	9,736	10,568	11,592	12,877
GDP per capita, US\$	1,408	1,693	1,916	1,853	2,160	2,386	2,616	2,904	3,162
Population, mn	87.0	88.7	90.5	91.0	92.6	94.2	95.8	99.8	100.8
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	3.9	6.6	6.2	6.6
Real investment growth % yoy	-15.1	-0.5	23.4	-8.7	31.6	8.1	-4.4	10.8	16.4
Real consumption growth % yoy	4.9	4.9	3.3	3.3	3.4	5.6	6.8	6.1	6.1
private consumption growth % yoy	4.2	4.6	3.7	2.3	3.4	6.3	6.1	5.8	6.0
Real export growth, % yoy	12.6	6.7	-2.7	-7.8	21.0	-4.2	8.7	6.3	7.7
Real import growth, % yoy	3.5	1.7	1.6	-8.1	22.5	0.2	4.2	7.6	10.9
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	4.3	3.9	8.0	4.3	3.6	4.2	2.9	3.6	4.0
CPI, % avg	6.3	2.8	9.3	3.2	4.1	4.7	3.1	3.5	3.8
Nominal wages, % yoy	9.0	5.1	5.9	2.5	3.7	6.7	5.4	6.5	6.0
Credit extension to private sector, % yoy	9.0	10.6	12.8	4.3	13.8	16.2	13.5	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	2.50	4.50
Long term yield, % eop	5.99	5.70	6.55	6.25	4.78	4.21	3.70	3.65	5.00
lc/US\$, eop	49.05	41.23	47.47	46.50	43.65	43.84	41.06	39.93	40.69
lc/US\$, avg	51.28	46.05	44.48	47.56	45.06	43.29	42.22	40.03	40.40
<b>Balance of Payments, US\$ bn</b>									
Current account	5.3	7.1	3.6	9.4	8.9	7.0	9.8	9.3	7.1
% of GDP	4.4	4.7	2.1	5.5	4.5	3.1	3.9	3.2	2.2
Trade balance	-6.7	-8.4	-12.9	-8.8	-11.0	-15.5	-13.2	-13.9	-16.4
Exports	46.5	49.5	48.3	37.6	50.7	47.5	51.1	55.8	61.9
Imports	53.3	57.9	61.1	46.5	61.7	63.0	64.3	69.7	78.4
Service balance	0.1	2.2	1.2	2.1	2.7	3.6	3.8	3.4	3.1
Income balance	-1.3	-0.9	0.1	-0.2	0.5	1.3	0.8	0.5	0.2
FDI, net	2.8	-0.6	1.3	1.6	0.7	1.3	1.5	2.0	3.0
International reserves (ex-gold)	23.0	33.8	37.6	44.2	62.4	75.3	83.8	92.5	100.0
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	-2.1	-1.6
Consolidated gov primary balance	3.9	3.7	2.6	-0.2	-0.2	0.8	0.6	0.9	1.4
Public debt	70.5	60.9	61.7	62.4	58.5	56.7	49.1	48.5	48.0
of which Domestic	39.0	35.5	32.9	32.2	31.8	31.3	30.0	31.0	32.0
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	53.9	55.5	54.3	54.9	60.0	61.7	63.5	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	47.6	48.3	48.0	47.5
External debt / GDP	44.0	36.9	31.3	32.5	30.0	27.5	25.3	22.4	21.6
External debt / XGS	101.8	93.6	93.7	112.8	92.6	98.0	93.0	88.0	84.8
Short-term debt	5.0	7.1	7.0	4.0	6.3	7.0	8.0	10.5	11.8
Short-term debt/International Reserves (%)	21.8	21.0	18.6	9.0	10.1	9.3	9.5	11.4	11.8
<b>Quarterly Economic Indicators</b>									
	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F
GDP, % yoy	6.0	7.2	6.8	6.0	5.8	6.4	6.7	6.6	6.8
CPI, % yoy	2.8	3.6	2.9	3.3	3.4	3.5	3.6	3.7	3.9
Policy interest rate, % eop	4.00	3.75	3.50	3.50	3.50	3.50	3.50	3.75	4.25
1 month Philippine Reference rate, % eop	2.61	0.85	-1.38	1.00	1.50	2.00	2.50	3.50	4.00
Long term yield, % eop	4.70	4.35	3.70	3.25	3.35	3.45	3.65	4.00	4.50
lc vs USD, eop	41.93	41.68	41.06	40.19	40.06	39.93	39.93	40.12	40.31

\*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).

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



## Singapore

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- **Summary view** – GDP should see small positive growth in early 2013. With core inflation to rise as the output stabilizes, we expect MAS stand pat in April. The Budget saw foreign worker inflows further tightened, but with mitigating support packages for businesses, whilst redistribution to the needy was given priority.
- **Things to watch** – [1] Near-term export momentum, especially electronics; [2] inflation related developments, particularly Feb core CPI; [3] Labour market developments; [4] Hints of further property measures; [5] Newsflow on Iskandar.
- **Strategy** – SGD NEER has returned to the upper quartile of the band, but the low core CPI and IP print for Jan could renew speculation of MAS easing in Apr, which is not our base case. Any dip to below the upper quartile of the band may provide good opportunities to long the SGD NEER.

### Modest growth in early 2013; labour market stays tight

**Despite weak Jan data, small positive growth in 1Q13 is possible...** – 4Q12 GDP saw a larger than expected upward revision to 1.5%YoY, 3.3%QoQ SAAR (Adv Est. 1.1%YoY, 1.8%QoQ SAAR), which alongside numerous upward revisions in back data brought full year 2012 GDP growth to 1.3%. Incoming Jan data has surprised on the downside, although small positive sequential growth in 1Q13 is possible given: [1] Sequential increases in Jan “core” NODX and IP (ex lumpy biomed and ships), as well as overall NODX volumes (despite falls in nominal NODX); [2] 1.6%QoQ rise in the 4Q Composite Leading Indicator; [3] Small rise in EDB’s Survey of Business Expectations for Biomedicals Output for 1Q13.

**...although headwinds suggest growth rates could be capped** – Headwinds from lingering fiscal uncertainties in US growth could cap the pace of demand recovery, while weak iPhone 5 shipments may hit supply chains, although the impact on Singapore’s electronics sector may be more muted due to less exposure to the smartphone/tablet product segments. Non-oil retained imports of intermediate goods (NORI) also fell 7.5%MoM SA (Dec: +6.6%), pointing to insufficient confidence on the export outlook by manufacturers. Volatility in biomedical and lumpy marine and offshore engineering output may also weigh on headline GDP. REER appreciation and labour shortages may have contributed to Singapore’s export underperformance. With 1Q13 growth not likely to exceed potential growth of 3-5%, we see a stabilization (rather than widening) of the positive output gap.

**Mixed surveys on hiring intentions, although labour market remains tight** – The Manpower Inc survey showed a fall in the net employment outlook to just 10% in 1Q13, the lowest since Sep-2009, with weakness more pronounced in services. On the other hand, a survey by Hudson showed 44.6% of employers intend to raise headcount in 1Q13, a 8.7%pt increase over 4Q, while a survey by the Achiever Group showed stronger hiring intentions in 1H13 with particular strength in more cyclical sectors such as IT and financial services. Rather than a softening of labour demand, we suspect that softening in the Manpower survey could either be a lagged response to weakness in 3Q12 GDP and/or a front-loading of hiring in 4Q12 in anticipation of a further tightening of foreign worker inflows in 2013. For example, the unemployment rate unexpectedly fell to 1.8% in 4Q12 with quarterly job creation surging to a four year high of 44.5K. Thus wage pressures are likely to remain similar to 2012 – the Hays survey indicates 52% of firms plan a raise of 3%-6% in 2013, similar to 2012.

## Limited room to ease despite temporary fall in core

**As anticipated, base effects pushed down Jan core inflation to just 1.2% (Dec: 1.9%)** – There was a similar fall in headline inflation to 3.6% (Dec: 4.3%).

Admittedly, core inflation in recent months has been slightly lower than MAS's expectations in Oct, which had anticipated core CPI staying above 2%YoY and rising 0.8%QoQ in 4Q12 and 1Q13 on average (or 0.2%MoM), compared to 1.8%YoY or 0.13%MoM in Oct-Jan. This may be partly a lagged response to the sharper contraction in 3Q12 GDP than MAS had expected in Oct (given downward revisions in the data).

**Core inflation will likely pick up, limiting room for MAS to ease** – [1]

Stabilization of the positive output gap, as demand recovers and as a further slowdown in labour supply from Budget measures caps potential growth. [2] Continued pass through of earlier pent up cost pressures – for example, the Transport Minister has already hinted at hikes in public transport fares in response to higher wages for bus-drivers in the wake of strikes in Dec. [3] Lagged pass-through of commodity price increases and SGD weakness – for example in SGD terms, Brent crude prices have risen more than 13% from their recent lows in early Nov 2012. As such, headline and core inflation will probably return to near 4% and 2% by year-end in line with MAS's Oct expectations. Notwithstanding policy easing risk, barring a cyclical drag large enough to place the official 1-3% GDP growth forecast at risk, priority on accommodating structural REER appreciation may favour standing pat in our view. Focus on reducing living costs and comments from DPM Tharman on an economy at "full capacity" also point to a high hurdle for easing.

## Population White Paper a political hard sell

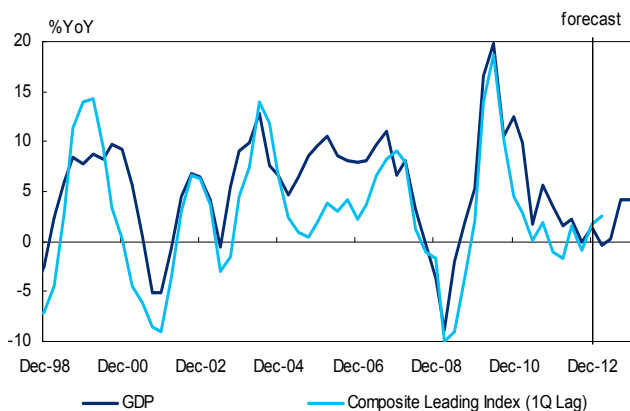
**The White Paper has thus far been a political hard-sell for businesses and voters alike** – The 6.5-6.9mn headline population target generated significant unhappiness amongst an electorate already facing overcrowding, inflation, and other social strains. Singapore citizens will be just 55% of the population in 2030, down from 62% today. On the other hand, SMEs facing significant labour shortages were clearly disappointed by the further tightening of foreign worker inflows. Given political obstacles, we would not be surprised if the targets in the White Paper are quietly shelved or significantly amended. Recent announcements of joint projects in Iskandar can be viewed as logical extensions of the supply side measures in the White Paper to expand Singapore's economic space.

## Budget for restructuring and redistribution

**The FY13 Budget projects a small expansionary fiscal impulse and an overall surplus of around S\$2.4bn in FY13 (0.7% of GDP)** – This follows a FY12E

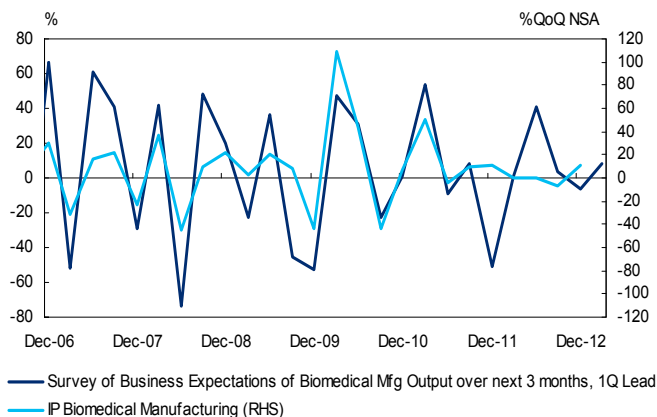
surplus of S\$3.9bn (Budget: S\$1.3bn). The restructuring thrust since 2010 has placed a greater emphasis on minimizing the transitional costs for both businesses and households. While businesses will be disappointed by tighter foreign worker rules, these are calibrated at sectors with low productivity growth and high foreign worker dependence. Direct wage subsidies should also moderate the erosion of labor cost competitiveness. Increased social protection for vulnerable groups may be needed to secure the political consensus in favor of growth friendly policies, particularly given that income inequality widened in 2012 and real wages of the lowest income groups declined. With greater contribution from the fiscal coffers, restructuring need not be a zero sum game between workers and businesses.

Figure 70. 1.6%QoQ rise in the 4Q Composite Leading Indicator



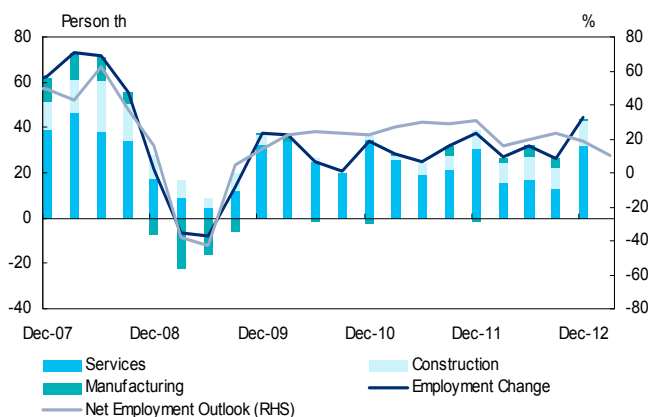
Source: CEIC, and Citi Research

Figure 71. EDB survey suggests higher biomedical output in 1Q13



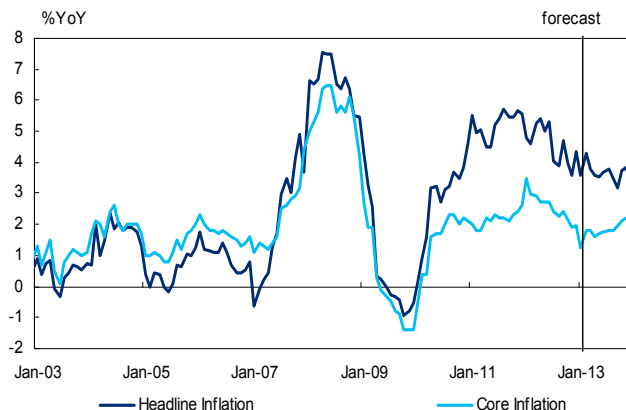
Source: CEIC, and Citi Research

Figure 72. Manpower Inc survey showed fall in net employment outlook



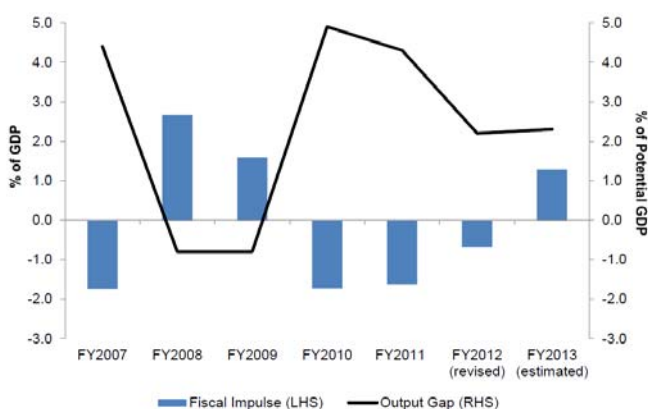
Source: Manpower Inc, Haver, and Citi Research

Figure 73. Core inflation will likely pick up



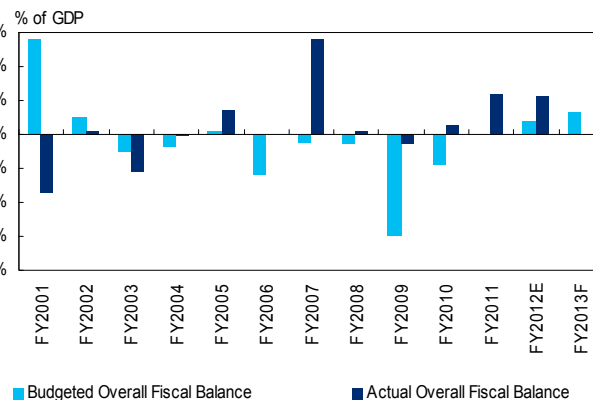
Source: CEIC, and Citi Research Estimates

Figure 74. FY13 Budget projects a small expansionary fiscal impulse...



Source: Ministry of Finance, CEIC, and Citi Research

Figure 75. ...and an overall surplus



Source: Ministry of Finance

Figure 76. Singapore Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	145.8	178.2	190.8	189.4	232.2	265.8	276.8	299.4	327.4
Nominal GDP, local currency mn	231	268	270	275	316	334	346	365	393
GDP per capita, US\$	33,131	38,827	39,434	37,970	45,741	51,275	52,098	55,424	59,532
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	2.0	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	2.0	4.0
Real investment growth % yoy	17.2	16.8	28.5	-21.0	5.4	12.7	26.8	-2.9	3.5
Real consumption growth % yoy	4.5	5.9	3.6	0.5	7.2	3.7	0.9	2.5	3.3
private consumption growth % yoy	4.5	6.7	2.9	-0.5	6.2	4.6	2.2	2.8	3.3
Real export growth, % yoy	10.8	9.0	5.0	-7.6	18.6	3.5	0.3	2.2	3.2
Real import growth, % yoy	11.1	8.1	9.6	-11.2	15.9	3.6	3.2	2.4	2.9
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	0.8	3.7	5.5	-0.5	4.6	5.5	4.3	3.3	3.5
CPI, % avg	1.0	2.1	6.6	0.6	2.8	5.2	4.6	4.0	3.4
Nominal wages, % yoy	3.2	6.2	5.4	-2.6	5.6	6.0	4.0	5.0	5.5
Credit extension to private sector, % yoy	4.8	17.2	23.4	4.9	4.7	19.0	14.0	12.0	11.0
3 month inter-bank rate, % eop	3.44	2.38	1.00	0.69	0.44	0.38	0.38	0.30	0.40
Long term yield, % eop	3.05	2.68	2.05	2.66	2.71	1.63	1.30	1.70	2.40
lc/US\$, eop	1.53	1.44	1.43	1.41	1.28	1.30	1.22	1.22	1.19
lc/US\$, avg	1.59	1.51	1.41	1.45	1.36	1.26	1.25	1.22	1.20
<b>Balance of Payments, US\$ bn</b>									
Current account	35.7	45.9	26.3	33.5	62.1	65.4	51.5	41.9	44.2
% of GDP	24.5	25.7	13.8	17.7	26.7	24.6	18.6	14.0	13.5
Trade balance	50.2	57.1	41.7	49.3	66.0	72.7	61.0	59.8	66.0
Exports	281.3	312.8	354.8	288.6	371.2	434.4	436.0	443.9	456.0
Imports	231.2	255.8	313.2	239.3	305.2	361.7	375.1	384.1	390.0
Service balance	-7.3	-2.5	-2.7	-1.7	2.3	0.7	0.4	1.4	2.0
Income balance	-7.2	-8.7	-12.6	-14.1	-6.3	-8.0	-9.9	-18.7	-24.0
FDI, net	18.1	10.0	5.0	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>									
	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F
GDP, % yoy	2.3	0.0	1.5	-0.4	0.2	4.2	4.2	4.6	4.8
CPI, % yoy	5.3	4.7	4.3	3.8	3.7	3.2	3.3	3.4	3.4
1 month inter-bank rate, % eop	0.38	0.38	0.38	0.30	0.30	0.30	0.30	0.30	0.30
Long term yield, % eop	1.61	1.47	1.30	1.30	1.40	1.60	1.70	2.00	2.10
lc vs USD, eop	1.27	1.23	1.22	1.23	1.23	1.22	1.22	1.21	1.21

\*Note: Public debt is general government debt.

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

## South Korea

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- **Summary view** – Although monthly gains in industrial production continued, momentum of economic recovery seems tepid, weighed on by weak domestic/external demand. We expect accommodative measures to be implemented in the first half of this year.
- **Things to watch** – With the opposing parties yet to reach an agreement on the Government Organization Act, BoK's policy rate will likely be cut in March or April and the new government's comprehensive countermeasures for the housing market are likely to be announced in late March.
- **Strategy** – We hold an outlook of less strong KRW with increased volatility on the back of lingering North Korea risk and concerns about JPY weakness. We have raised our 0-3 month forecast for USD/KRW to W1,060 (prev. W1,050).

### Weak recovery in economic activities

**Industrial activities continued to improve but require stronger momentum** – Industrial production (IP) continued a sequential increase for the fourth month in December but the YoY growth was low at 0.8%. Increased overseas demand and termination of analogue TV broadcasting expanded productions in ICT sectors. Service activity and retail sales shifted to lower gears in December, discouraged by exceptionally cold weather and heavy snow. Equipment investment and construction completed increased over the month, but both fell short of a year ago levels. Although the cyclical component of leading composite index showed two months of improvement, we expect the economy to remain weak on the back of sluggish domestic demand and deterioration in competitiveness of exporters. Thus, we maintain our view of further accommodative policy measures in 1H13.

**January export surged on temporary factors** – Export growth in January surprised on the upside at 10.9%YoY, following -6.0% in December. The surge mainly resulted from more working days due to difference in timings of Lunar New Year and release of new smartphones and autos. Major products (except shipbuilding and steel & iron) took a favorable turn, and exports to the US and China expanded sharply by 21.3%YoY and 16.6% respectively. Imports also came in above expectations at 3.9%YoY, lifted by energy imports, particularly petroleum products and natural gas. Despite sharp YoY export growth, trade surplus narrowed to US\$476mn from US\$1.8bn in December.

**CPI inflation reversed up with mounting monthly upward pressure** – CPI further rose on a MoM basis, by 0.6% in January, pushing up YoY inflation to 1.5% from 1.4% in December. Agricultural products price hit by cold wave and heavy snow and also resumed public tariff hikes – e.g. electricity and water utility bills – were the main culprits. We expect the difference in timing of the Lunar New Year to push up February CPI inflation but to stay below 2%. We expect BoK's one last 25bp rate cut in March or April, depending on the timing of when the revision of the Government Organization Act will be finished and the Minister of Strategy and Finance will be appointed.

**Jobless rate rose alongside active job seeking** – The seasonally adjusted jobless rate rose to 3.2% in January, from 3.0% in December, as unemployed persons grew sharply along with surge in job seeking activities on the back of improved sentiment for future employment situation. Job growth improved to 322K YoY, from 277K in December, with the manufacturing sector posting a heftier gain of 156K.

## Heightened geopolitical risk but limited market impact

**International society will likely impose sanctions on North Korea** – Geopolitical risk in the Korean peninsula once again has been heightened by North Korea's third nuclear test on 12<sup>th</sup> February. With the international community against nuclear testing, further sanctions are likely to be imposed on North Korea. While the US and Japan have affirmed they will work together to seek a strong resolution including financial sanctions, at the UN Security Council, China and Russia are standing against military intervention, asserting peace and stability on the Korean peninsula. Sanctions on the North were tightened following a rocket launch last December, and reactions of financial markets to the North's previous provocations were muted. Market impact of likely UN sanctions will be limited but the uncertainties lie on sanction intensity.

## Less strong KRW outlook with a risk of volatility

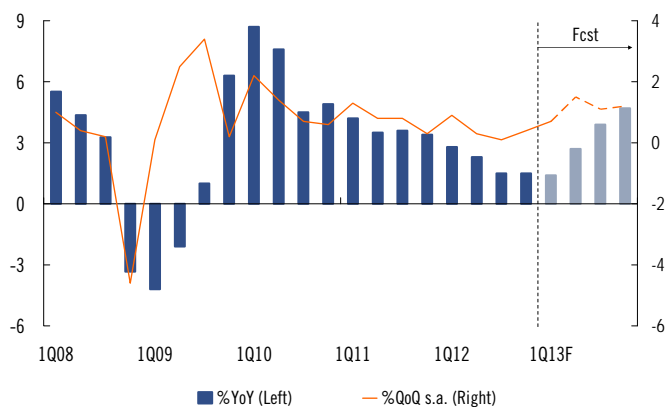
**KRW volatility increased with risk on/off and geopolitical risk** – The KRW depreciated rapidly against USD in early-Feb, reaching over W1,090 on concerns about North Korea's nuclear threat and tighter capital controls along with FX market volatility and weaker JPY. Then it appreciated as uncertainties eased after the North's nuclear test and as foreigners turned to net-purchase at stock markets. With market volatility increased, expectation of tightening of existing macro-prudential measures continues. President Park stressed currency stabilization and the government is considering taxes on FX and bond trading. Moreover, before Park's inauguration as President, the transition committee mentioned about reviewing such taxes. Although we still expect KRW strength to be supported by current account surplus and sound sovereign ratings, we have lifted our 0-3 month forecast for USD/KRW to W1,060 from previous W1,050 to reflect North Korea risk.

## The new government set to stabilize the housing market

**Trend of apartment price in Seoul shifted up on government policy expectation** – Nationwide housing purchase price has fallen since June 2012 on a month-on-month basis, whereas jeonse price has continued to rise. Housing purchase prices up to now show that apartment purchase price in Seoul – which mainly has dragged the overall purchase price – reversed up in February. The shift was mainly due to anticipation of the incoming government's countermeasures to stabilize the housing market. The new president referring to the current housing market as abnormal and the transition committee's statement that prolonged contraction in transaction is imposing a strain on the economy, both imply the new government's strong will on stabilizing the housing market.

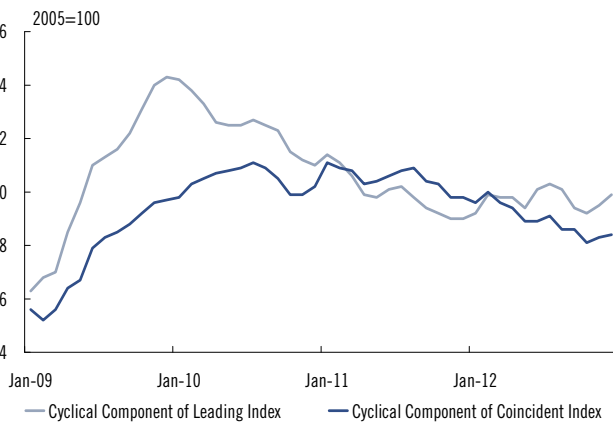
**Comprehensive countermeasures are likely to be announced in late March** – In addition to extension of reduction on property acquisition tax passed by the National Assembly, the highest possible actions are abolishment of: 1) apartment presale price ceiling to support constructors and 2) transfer tax on owners of multiple homes to increase transactions. As the ceiling on presale price was essentially implemented to restrain price from surging in 2007, it rather has been accused of constricting housing supply afterwards. Transfer tax on multiple home owners has been criticized for putting tax burden on the owners who are likely to be rental business owners. However, we think the government will change DTI and LTV in the last resort as it can aggravate the household debt issue by increasing mortgage loan demand.

Figure 77. Real GDP growth will likely show a visible rebound in 2H13



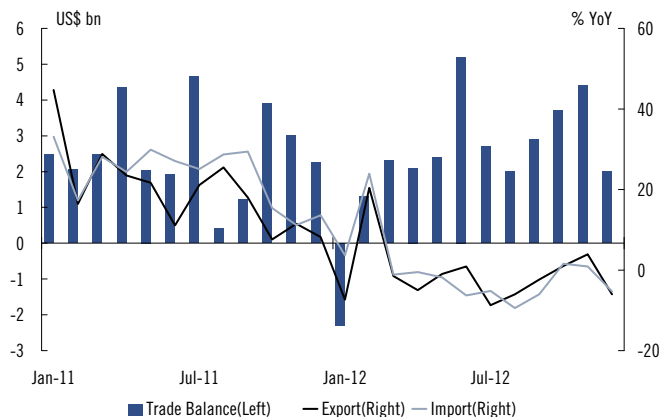
Source: Bank of Korea, and Citi Research Estimate

Figure 78. Cyclical component of leading index rose for two months



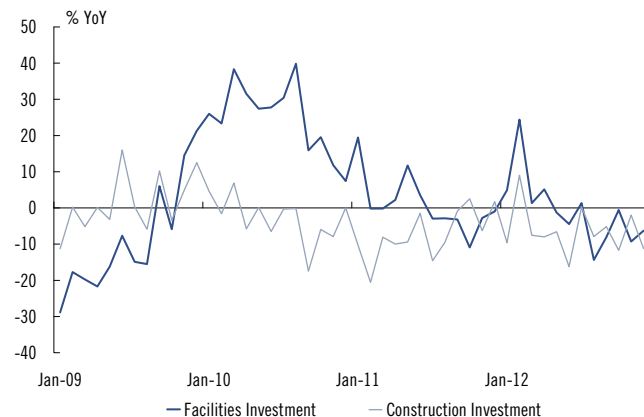
Source: Statistics Korea

Figure 79. Export rebounded sharply but trade surplus narrowed



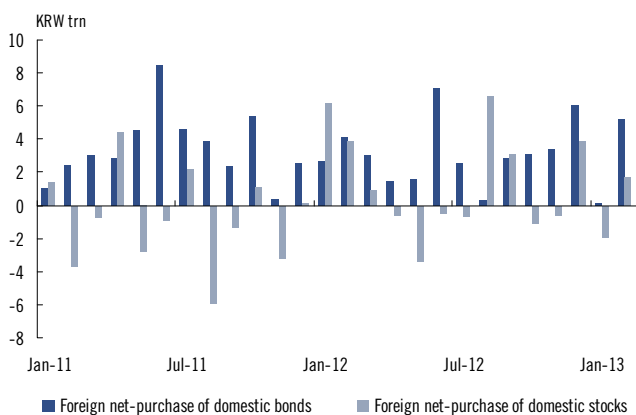
Source: Korea International Trade Association

Figure 80. Investment continued to contract



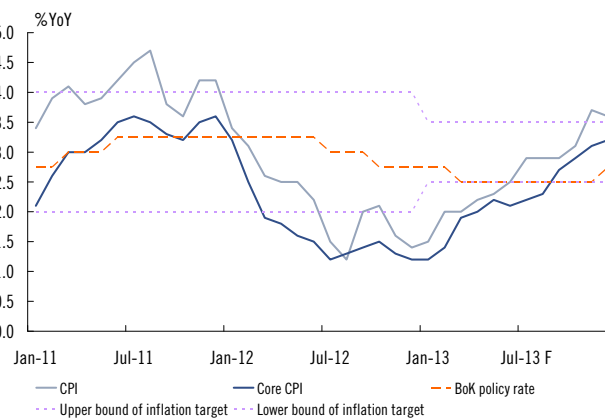
Source: Statistics Korea

Figure 81. Foreign fund flows reversed to an inflow in Feb



Source: Financial Supervisory Service, Infomax

Figure 82. BoK is likely to cut the rate soon along with fiscal stimulus



Source: Bank of Korea, Statistics Korea, and Citi Research Estimates



Figure 83. 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	1,116.6	1,142.1	1,304.8	1,444.4
Nominal GDP, local currency bn	908,744	975,013	1,026,452	1,065,037	1,173,275	1,237,128	1,286,889	1,360,284	1,458,073
GDP per capita, US\$	19,722	21,565	18,981	16,972	20,540	22,431	22,840	25,982	28,645
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	3.6	2.0	3.2	4.1
Real investment growth % yoy	4.4	3.5	0.0	-13.5	15.8	1.5	-1.5	1.3	3.5
Real consumption growth % yoy	5.1	5.1	2.0	1.2	4.1	2.2	2.2	2.9	3.3
private consumption growth % yoy	4.7	5.1	1.3	0.0	4.4	2.3	1.8	2.4	3.4
Real export growth, % yoy	11.4	12.6	6.6	-1.2	14.7	9.5	3.7	4.8	9.5
Real import growth, % yoy	11.3	11.7	4.4	-8.0	17.3	6.5	2.3	4.3	9.3
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	2.1	3.6	4.1	2.8	3.0	4.2	1.4	3.6	3.1
CPI, % avg	2.2	2.5	4.7	2.8	3.0	4.0	2.2	2.6	3.0
Nominal wages, % yoy	5.7	0.7	3.1	2.6	6.8	1.0	5.4	4.3	5.2
Credit extension to private sector, % yoy	14.7	12.4	15.0	2.3	3.6	5.1	4.7	5.3	7.0
Policy interest rate, % eop	4.50	5.00	3.00	2.00	2.50	3.25	2.75	2.75	3.50
91-Day CD Rate, % eop	4.76	5.73	4.68	2.82	2.80	3.55	2.89	3.00	3.70
Long term yield, % eop	5.00	5.78	3.77	4.92	4.08	3.46	2.97	3.05	4.05
lc/US\$, eop	930	936	1263	1166	1121	1159	1064	1027	999
lc/US\$, avg	955	929	1102	1275	1156	1108	1127	1043	1010
<b>Balance of Payments, US\$ bn</b>									
Current account	14.1	21.8	3.2	32.8	29.4	26.1	43.3	26.7	23.3
% of GDP	1.5	2.1	0.3	3.9	2.9	2.3	3.8	2.0	1.6
Trade balance	16.1	14.6	-13.3	40.4	41.2	30.8	28.3	23.8	21.8
Exports	325.5	371.5	422.0	363.5	466.4	555.2	547.9	577.4	633.2
Imports	309.4	356.8	435.3	323.1	425.2	524.4	519.6	553.6	611.4
Service balance	-13.3	-12.0	-5.7	-6.6	-8.6	-4.4	2.7	0.9	-1.1
Income balance	-4.0	-3.4	3.8	1.6	-2.1	0.3	2.1	-0.1	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	336.6	350.2
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	1.4	1.1	1.4
Consolidated gov primary balance	1.7	4.9	2.6	-0.2	2.8	2.9	2.7	2.4	2.7
Public debt	30.1	29.7	29.0	32.5	31.9	32.6	34.0	33.0	31.0
of which Domestic	28.9	28.6	28.1	31.4	31.0	31.7	33.3	32.4	30.1
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	225.2	333.4	317.4	345.7	359.8	398.7	413.4	426.0	441.8
Private	225.0	333.1	317.1	345.4	359.4	358.3	373.2	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	35.7	36.2	32.6	30.6
External debt / XGS	58.9	75.0	61.9	79.1	65.0	61.3	62.9	61.6	57.9
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	38.7	40.1
<b>Quarterly Economic Indicators</b>									
	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F
GDP, % yoy	2.3	1.5	1.5	1.4	2.7	3.9	4.7	3.9	3.6
CPI, % yoy	2.2	2.0	1.4	2.0	2.5	2.9	3.6	3.1	2.8
Policy interest rate, % eop	3.25	3.00	2.75	2.50	2.50	2.50	2.75	3.00	3.25
91-Day CD Rate, % eop	3.54	3.09	2.89	2.70	2.70	2.70	3.00	3.25	3.45
Long term yield, % eop	3.42	2.87	2.97	2.75	2.85	2.90	3.05	3.38	3.65
lc vs USD, eop	1141	1114	1064	1059	1048	1036	1027	1020	1013

\*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).

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

## Taiwan

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- **Summary view** – We upgrade our 2013E GDP forecast to 3.5%YoY (prev. 3.0%) but lower our CPI inflation forecast to 1.7%YoY (prev. 2.0%). The impressive start of DBM accumulating RMB deposits since 6<sup>th</sup> February lays out the potential for launching other RMB financial products.
- **Things to watch** – 1) The momentum of RMB deposits accumulation. 2) Other cross-straits developments (ECFA for services and the broader goods list). 3) Ongoing FTA negotiations with Singapore and New Zealand. 4) Political undercurrent starting to mount ahead of 2014's "seven-in-one" local elections.
- **Strategy** – NTD has followed the JPY to depreciate thus far this year, but we still see mild NTD appreciation in 2013 mainly on expected RMB and KRW appreciation. CBC is likely to keep policy rates on hold throughout 2013, but longer tenor yields could rise with US treasuries' yields. Our strategist, Peter Kurz, has set 8,200 as TAIEX year-end target.

### Trade and investment to lead recovery in 2013E

**Economic recovery picked up pace in 4Q12** – 4Q12 GDP grew 3.72%YoY, improving from 3Q's 1%YoY growth. Full-year 2012 GDP came in at 1.3%YoY, still short of 2011's 4.07% growth as it was dragged by both global demand slowdown and domestically weak consumption/investment in 2012.

**Positive trends in both exports and imports** – Recovery in net exports sponsored better 4Q12 GDP growth, which is crucial given that exports account for roughly 60% of GDP and net exports take up ~6% of GDP. Cognizant of CNY timing distortions, Jan exports grew an impressive 21.8%YoY (from 9% in Dec), while imports also surged to 22.3%YoY (from 1.6% in Dec). This is the sixth consecutive month of exports increase, with mineral products, optical instruments and electronics as drivers. Demands from Mainland China+HK, SE Asia and Japan all registered double digit gains, even European demand continue to grow for the second month and US demand came back from the red zone.

**Worries of regional currency war may be overblown** – As an extension to our previous net exports similarities study, which showed about 25% of Taiwanese net exports are similar to Japan's (see pg 56 of the January 2013 [Asia Macro and Strategy Outlook](#)), we have found that about 50% of Taiwanese net exports are similar to Korea's (note index similarity could be exaggerating the competition risk). Overlapping products are mostly telecom products, machineries and parts. In light of this finding, should there be sharp KRW depreciation following suit of JPY's trend, caution on Taiwanese export competitiveness would be warranted. However, a sharp KRW depreciation in 2013E (aside from temporary North Korea driven FX volatility) is not in our base-case, our latest JPY short-medium term forecasts are maintained at around 95-96 range, and warnings against sharp depreciation of the yen have also risen from both Japanese and foreign officials.

**NTD to follow regional trends** – We have noted that the correlation between TWD vs. RMB has shot up in the past six months, where it was much smaller say a year ago. Even though Taiwan is a net importer from Japan, recent spot movements indicate that CBC remains sensitive to headline news which will affect exporters and overall sentiment. We now expect USD/TWD to hold on to recent depreciation and trade around NT\$29.7/US\$ in 0-3 months, but TWD likely will resume appreciation in 6-12 months time to NT\$28.5. Sharper appreciation in the 6-12 months timeframe is mainly affected by our regional FX appreciation trend (led by expected appreciation of 2.2% in the RMB and 5.3% in KRW).

**Upgrading growth forecasts** – The official GDP forecast for 2013 from DGBAS (Directorate General of Budget, Accounting and Statistics) is raised to 3.59%YoY and we raise our forecast to 3.5%YoY. Aside from faster economic momentum seen at the end of 2012, we see more positive signs, such as better liquidity conditions globally, green shoots in leading index/PMI, recovery in the local stock market, breakthroughs in cross-strait RMB/financials, growing capex and Citi's recent upgraded US outlook. Recent marketing feedback indicates that both local and foreign investors overall remain sceptical on Taiwan's economic recovery, despite better the 4Q12 GDP print and the DGBAS growth forecast upgrade.

**Stronger capex growth to sponsor GDP recovery** – Aside from a low comparison base, we expect the government policies to attract foreign-nationals and Mainland FDI to invest in Taiwan (which is a key part of the Economic Power Up Plan by the Executive Yuan) will gradually see results in 2013. Already this year, MOEA announced several notices of FDI approvals of foreign nationals relocating their investments back to Taiwan. We reiterate it will take time before investment plans materialize into economic benefits (such as job increases), but nonetheless it is an encouraging start. Warming up of cross-strait ties will further attract Mainland FDI.

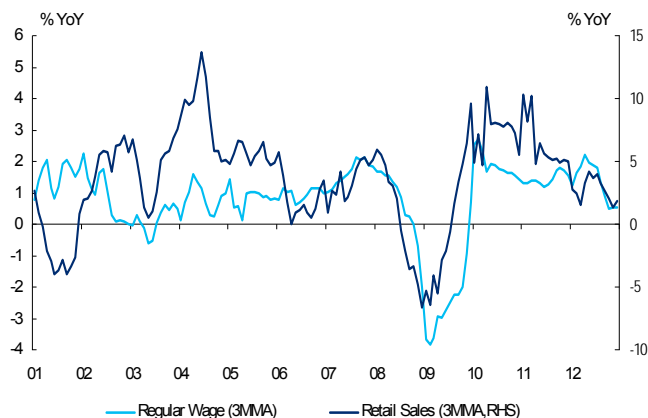
**Consumption recovery likely to be a laggard** – Retail sales growth rose to 1.8%YoY in Dec 2012 (from 1.3%YoY in Nov). Consumer confidence finally suspended the downtrend that was seen almost throughout 2012, and recovered slightly in Jan 2013 (+1.8%MoM), mainly on better investment prospects of the stock market. However, anecdotal evidence like credit card spending indicates that consumption remains restrained as of Jan (even ahead of the festive season). We continue to attribute the lackluster consumption to falling regular wages. We expect that eventually consumption will recover with industrial production trends, and traction could be gained in 2H.

**Benign inflation prompts us to cut our CPI forecast for 2013 to 1.7%YoY (prev. 2.0%)** – Jan saw much lower than expected headline and core CPI readings of 1.15%YoY and 0.33%YoY, respectively. However, we expect consumer inflation to rise sharply in Feb to near 3%YoY. As these data prints are distorted by the different Chinese New Year timings, we think it is more appropriate to read Jan-Feb readings as an average (Citi Forecast: 2%YoY).

## **New RMB banking business is another long term positive**

**The kick-start of offshore RMB banking on 6<sup>th</sup> Feb marks another landmark milestone in cross strait cooperation** – Domestic banking units (DBU) are now allowed to commence RMB banking business (spot, forward, deposits & loans), opening up these services to the retail market. All RMB conversion that has relevant trade documents and individual (retail) conversions are eligible to trade with the BOC (Taipei branch) on the same day. Other types of RMB conversion are still tapping the CNH market in HK, and when the scale is built up these could tap the RMB interbank market in Taiwan. The amount of initial RMB intake has been impressive, and according to CBC data DBUs took in RMB7bn of RMB deposits (~0.1% of total deposits) over eight working days (6-22 Feb), in-line with our view of a near-term surge in retail RMB deposit growth. However, the worry of sharp TWD liquidity decline due to switching into RMB is overblown, as banks ultimately will need to secure higher returns for their collected RMB deposit to continue offering high deposit rates to customers (after the initial phase of RMB deposit competition). Taiwan could potentially be a cheap source of RMB loans given its large trade surplus with China (2012: US\$39.8bn), but we are still at early stages. Talks of RMB bond issuances are in the pipeline and selective RMB insurance/wealth management products are being approved (this could flourish if withholding tax on interest income (10% residents, 15% non-residents) can be eliminated as proposed).

Figure 84. Consumption recovery likely to lag on negative real wages



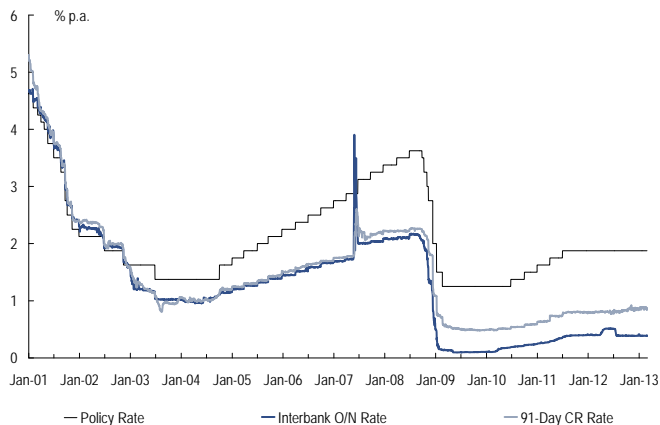
Source: MOEA, and Citi Research estimate

Figure 86. IP and exports recovering but in a zig-zag path



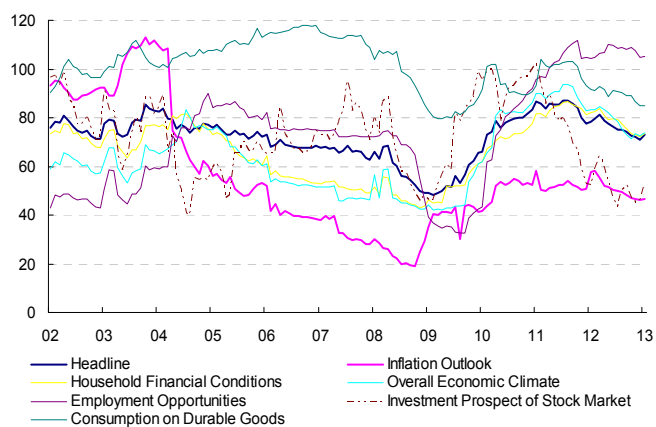
Source: CEIC, and Citi Research

Figure 88. CBC likely to sustain its neutral stance in 2013E



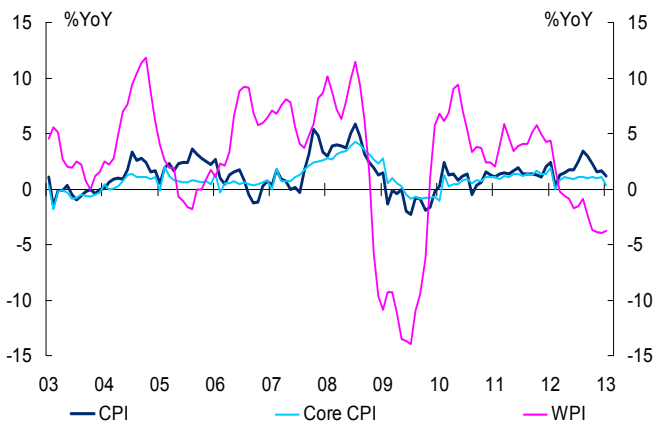
Source: Bloomberg

Figure 85. Consumer confidence only marginally uptick in Jan 2013



Source: CEIC, and Citi Research

Figure 87. Benign inflation expected in 2013E



Source: CEIC, and Citi Research

Figure 89. NTD depreciated along regional trend



Source: CEIC, and Citi Research

Figure 90. Taiwan Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
<b>Summary Data</b>									
Nominal GDP, US\$ bn	376.3	393.1	400.2	377.6	428.2	464.0	474.0	518.1	552.9
Nominal GDP, local currency bn	12,243	12,911	12,620	12,481	13,552	13,674	14,037	14,750	15,631
GDP per capita, US\$	16,513	17,191	17,444	16,404	18,574	20,078	20,437	22,295	23,747
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	3.5	4.0
Real investment growth % yoy	0.5	-0.7	-7.9	-21.2	36.8	-7.5	-4.2	4.7	5.9
Real consumption growth % yoy	1.1	2.1	-0.6	1.3	3.3	3.0	1.3	1.6	2.4
private consumption growth % yoy	1.5	2.1	-0.9	0.8	4.0	3.1	1.5	1.9	2.7
Real export growth, % yoy	11.4	9.6	0.9	-8.7	25.6	4.4	0.1	4.3	4.3
Real import growth, % yoy	4.6	3.0	-3.7	-13.1	27.7	-0.5	-1.9	2.7	3.0
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	0.7	3.3	1.3	-0.2	1.2	2.0	1.6	2.7	2.0
CPI, % avg	0.6	1.8	3.5	-0.9	1.0	1.4	1.9	1.7	2.0
Nominal wages, % yoy	0.8	2.1	0.0	-5.1	5.5	2.7	1.0	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	1.27	1.39
Long term yield, % eop	1.99	2.53	1.44	1.47	1.47	1.27	1.15	1.35	1.47
lc/US\$, eop	32.59	32.43	32.78	32.23	29.17	30.29	29.06	28.47	28.23
lc/US\$, avg	32.52	32.85	31.58	33.04	31.50	29.40	29.57	29.03	28.33
<b>Balance of Payments, US\$ bn</b>									
Current account	26.3	35.2	27.5	42.9	39.9	41.2	49.6	43.6	44.2
% of GDP	7.0	8.9	6.9	11.4	9.3	8.9	10.5	8.4	8.0
Trade balance	11.6	16.8	4.4	20.3	11.0	11.3	14.4	19.1	32.9
Exports	213.2	235.1	243.8	193.8	261.6	291.9	284.2	303.5	331.9
Imports	201.6	218.2	239.5	173.5	250.5	280.6	269.8	284.4	298.9
Service balance	-3.5	-1.6	1.9	2.0	2.5	3.9	6.1	25.0	18.4
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	425.0	450.0
Total Amortisations	5.8	3.8	8.8	2.5	3.2	6.8	3.0	3.3	4.5
<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	1.4	0.5	-2.5	-1.4	-0.9	-0.6	-0.3	-0.6
Public debt	29.6	28.8	29.9	33.1	33.5	34.9	39.2	39.5	42.0
of which Domestic	19.0	25.3	28.4	27.2	25.5	30.4	32.4	32.6	36.6
<b>Foreign Assets &amp; Liabilities, US\$ bn</b>									
External debt	85.8	94.5	90.4	82.0	101.6	122.5	124.0	125.5	127.0
Private	75.2	91.1	88.9	76.0	93.5	118.0	119.0	120.5	121.9
Public	10.6	3.5	1.5	5.9	8.0	4.5	5.0	5.0	5.1
External debt / GDP	22.8	24.0	22.6	21.7	23.7	26.4	26.2	24.2	23.0
External debt / XGS	33.9	33.8	31.0	34.9	32.3	34.7	35.6	32.6	30.9
Short-term debt	74.2	83.3	78.8	68.2	83.7	107.8	120.0	115.0	110.0
Short-term debt/International Reserves (%)	27.9	30.8	27.0	19.6	21.9	28.0	29.8	27.1	24.4
<b>Quarterly Economic Indicators</b>									
	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F
GDP, % yoy	-0.1	0.7	3.7	3.0	3.1	3.7	4.1	4.0	4.4
CPI, % yoy	1.7	2.9	1.8	2.2	1.1	1.1	2.7	2.3	1.6
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88
1 month inter-bank rate, % eop	0.87	0.87	0.87	0.87	0.87	0.87	0.93	0.99	0.99
Long term yield, % eop	1.24	1.19	1.17	1.28	1.30	1.32	1.35	1.38	1.41
lc vs USD, eop	29.79	29.32	29.06	29.66	29.21	28.76	28.47	28.42	28.36

\*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).

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

## Thailand

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- **Summary view** – We upgrade our GDP forecast to 4.7% in FY13 (prev. 4.5%) while retaining our 4.8% growth forecast for next year. Post-recovery from the floods, GDP may mean revert to normal or potential growth of 4.5%. Public investments may figure prominently in 2013 growth with the fading of populist fiscal policies.
- **Things to watch** – BoT's sustained hawkish signals. Parliamentary approval of the MT public investment program in 1Q13. Inflation upticks driven by a positive output gap and faster cost-push pass-through. Hefty FDI approvals in 2012 converted to investments. Strong exports that facilitate a strong Baht outlook.
- **Strategy** – We maintain our base case scenario of an overnight policy rate hike late 2Q13, which implicitly supports the strong Baht outlook although 'tightening' has already begun with BoT accommodating THB/USD down to 29.88. Investors with a strong Baht view should extend duration in a rate tightening cycle.

### Expecting growth ahead of potential

**We raise our FY13 growth forecast for the 2nd time this year to 4.7% (from 4.5%) on the back of unexpectedly strong 4Q12 GDP (18.9%YoY)** – The key driver is domestic demand although upside surprise will likely be from 2H13 exports. We think fiscal spending drivers, particularly public investments, and lingering effects of upbeat durable goods consumption in 1H13 can be relied on. However, we still think without an extraordinary lift like last year's flood-induced private investment spending, GDP growth may recede to potential ~4.5%. The challenge is to sustain investment-driven growth in 2013-14 entailing more public investment, likely to result in 'fiscal crowding-in' that can sustain private capex and elevate potential output.

**The US semi-conductor industry's book to bill ratio in Jan at 1.14x more than signals an improving global demand for 'chips', and we see tech exports could surprise on the upside** – The broad electronic export segment was down 3.9%MoM SA in Dec but up 3.8%QoQ SA due to the monthly gains in Oct-Nov. There is more than enough room for production expansion in the IC & semi-conductor segment with a capacity utilization rate of 50.5% in Dec, staying in line with the utilization rate of the export mfg cluster of 52.6% during the month.

**First quarter of government's new fiscal year (or 4Q12) saw infrastructure spending in the FY13 budget up by 20.5%QoQ SA (or 101%YoY)** – This supported real public construction growth of 11.8%QoQ SA in 4Q12. While the government has yet to secure parliamentary approval (in 1Q13) of its Bt2.2tr medium-term public investment program that includes new transport lines for its urban mass transit system, it has not delayed the central government's infrastructure program under the FY13 budget of Bt2tr. During a recent country visit, we found that only 30% of the projects comprising the MT investment program are new. Nonetheless, execution risk rather than budget size is more essential to generate a favorable impact of public investments on GDP prospects.

**We expect the demand side, led by consumption during post-recovery period in 2013, to 'mean-revert' to its normal or potential rate** – This mean reversion follows what transpired in 2010 after 2H09 recovery from the crisis. Consumption's (durable goods) post-recovery in 2010 saw growth ease back to an average quarterly growth of 1%QoQ SA (4.7%QoQ SA) from growth of 1.9%QoQ SA (10.8%QoQ SA) in 2H09 when the economy recovered from the great recession.

## Estimate a positive output gap in place

**We believe a positive gap in place, coupled with wage cost pressures felt by SMEs, will lead to a higher inflation trajectory likely in 2H13** – From HP filtered non-farm GDP (s.a.), we see an output gap of +5% in 4Q12, and a cumulative gap of +2.6% at the close of 2012. With our upbeat GDP forecasts, we believe the positive gap will be here to stay, thus heightening upside inflation risk, and this suggests that most firms and producers have ‘re-acquired’ the advantage to pass on costs to their markets (particularly those sourced from higher wage rates) without fear of losing market share, although some may be subject to regulator’s approval. Capacity utilization rates in 4Q12 provided support for positive gaps but not overwhelming evidence. Utilization rate (s.a.) of the mfg cluster producing for the domestic markets settled at an average 66.8% in 4Q12, up from 65% in the preceding quarter. Utilization rates have tightened since the 4Q11 deluge. Tightening utilization rates came despite higher private investments last year to suggest new or upgraded capacities in place or additional efficiencies that may imply a slower cost pass-through.

## Implications of new CPI weights

**Rising per capita incomes led to more discretionary spending in the guise of more HH allocating their budget for transport vehicles & operations that includes gasoline/diesel fuel purchases** – This is our key takeaway from the comparison of the CPI weights under 2007 and the latest 2011 consumption survey periods. The shifting weights may reflect average HH budget allocation on key consumption preferences. Discretionary spending items in the guise of vehicles & operations (new weight of 15.6% up 15% vs. its CPI 2006 weight), recreation & education (6% up 15.7%), rent (15.42% up 1.5%), and apparel & footwear (3.06% up 3.4%) posted higher CPI weights or more HH budget allocation. CPI vulnerability to food shocks were enhanced by higher weight of CPI rice of 3.44% up 19.4% vs. its 2006 weight. Weight of CPI meat, poultry & fish in the basket expanded 10.8% to 6.35%. Higher protein demand related to rising incomes but with the higher weight of CPI rice led to higher weight for CPI prepared food at home of 9% up by 13.1%.

## Primary fiscal deficit of 8.2% of GDP in 1QFY13

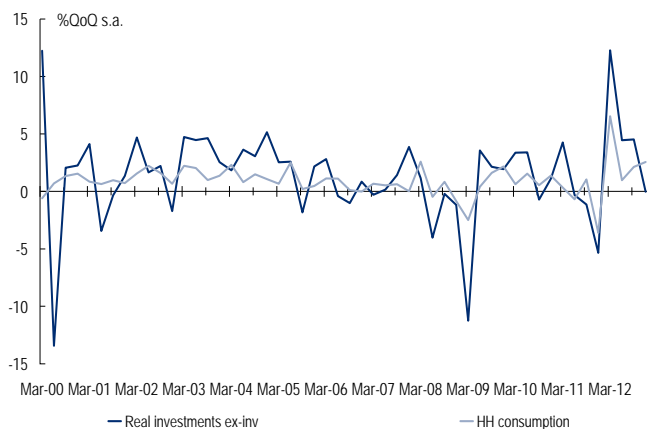
**Fiscal expansionary bias in 1QFY13 (OR 4Q12) was reflected by a primary fiscal deficit of Bt243bn or 8.2% of GDP** – Both current and capital expenditures were responsible for the strong fiscal contribution. Gross revenues were up 28.5%YoY in 4Q12, driven by corporate income (32%YoY), VAT (22.1%YoY) and personal income taxes (15%YoY) with muted base effects. Excise auto taxes rose 180%YoY. We continue to expect a fiscal deficit exceeding 2% of GDP this year.

## Hawkish MPC guarding against courting asset bubble risk

**Hawkish MPC sentiment persisted in the Feb policy rate meeting** – We think MPC continues to signal the economy likely to move away from the sweet spot, shifting to an inflation hot spot if accommodative policy rates are maintained for an extended period. Risk of asset bubbles may be spawned by further rate cuts. MPC also signaled that the non-interest rate policy tool kit will be used, if needed, to address excess liquidity and other risks associated with extraordinary capital flows. Even before the cost push pass through uplifts the CPI print, we maintain our view that the MPC will gradually hike its policy rate within the year, perhaps as early as late 2Q13, that can spill over into a stronger Baht outlook. Political pressures would be the only constraint that may serve to delay the policy rate action in our view.

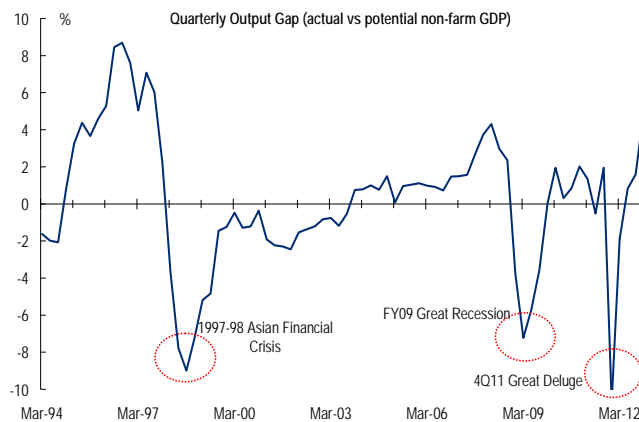


Figure 91. Consumption 'outgrew' real investments (ex-inv) in 4Q12



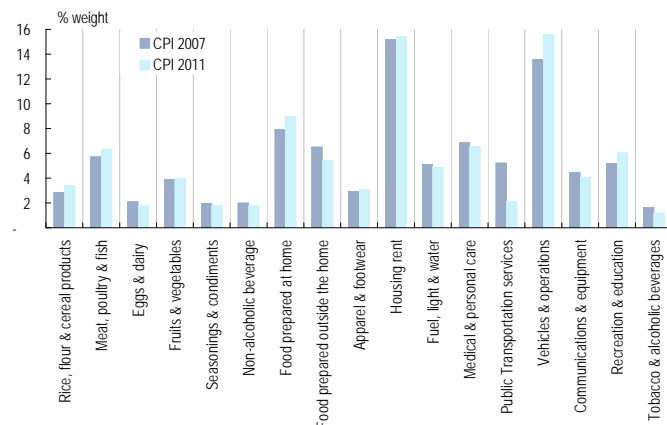
Source: CEIC, and Citi Research

Figure 92. Output gap estimated to be more positive in 4Q12



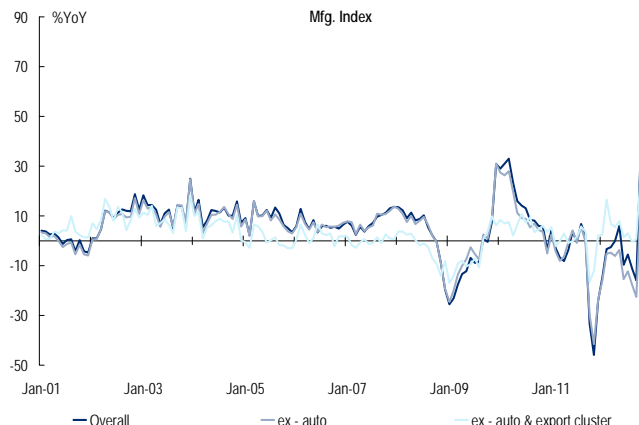
Source: CEIC, and Citi Research

Figure 93. New CPI assigned a larger weight to vehicles & operations



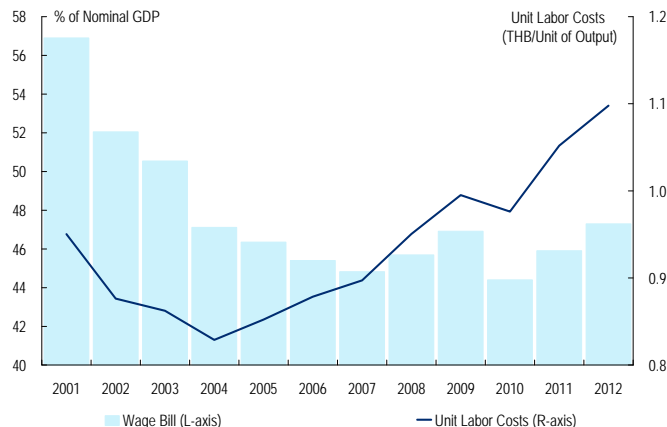
Source: CEIC, and Citi Research

Figure 94. Mfg production indices closed 2012 on a slower note



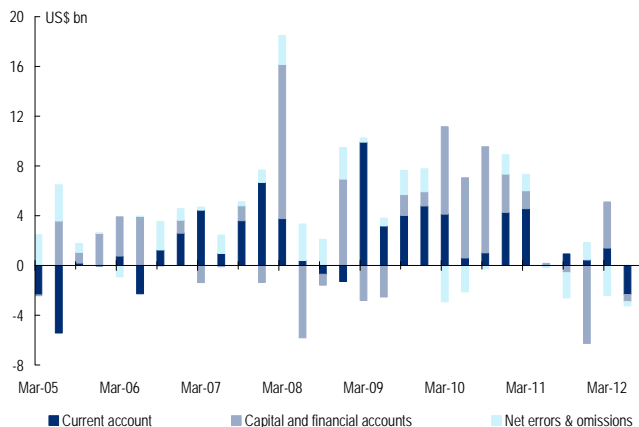
Source: CEIC, and Citi Research

Figure 95. Rising unit labor costs with wage bill expansion in 2011/12



Source: CEIC, and Citi Research

Figure 96. Capital & financial accounts can support the BOP in 2013



Source: CEIC, and Citi Research

Figure 97. 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	366.0	402.7	432.7
Nominal GDP, local currency bn	7,845	8,525	9,080	9,042	10,105	10,540	11,363	12,122	13,067
GDP per capita, US\$	3,301	4,207	4,355	4,153	4,998	5,401	5,678	6,217	6,552
Population, mn	62.8	63.0	63.4	63.5	63.9	64.1	64.5	64.8	66.0
Unemployment, % of labour force	1.5	1.4	1.4	1.5	1.0	0.7	1.1	0.8	1.0
<b>Economic Activity</b>									
Real GDP, % yoy	5.1	5.0	2.5	-2.3	7.8	0.1	6.4	4.7	4.8
Real investment growth % yoy	-3.6	1.0	8.1	-25.2	28.7	0.1	17.0	9.9	7.4
Real consumption growth % yoy	3.0	2.9	2.9	0.1	5.1	1.3	6.7	4.1	3.2
private consumption growth % yoy	3.2	1.8	2.9	-1.1	4.8	1.3	6.6	3.9	3.1
Real export growth, % yoy	9.1	7.8	5.1	-12.5	14.7	9.5	2.9	9.1	10.6
Real import growth, % yoy	3.3	4.4	8.9	-21.5	21.5	13.7	6.2	11.8	11.2
<b>Prices, Money &amp; Credit</b>									
CPI, % yoy	3.6	3.1	0.4	3.5	3.1	3.5	3.6	3.3	4.3
CPI, % avg	4.6	2.2	5.5	-0.9	3.3	3.8	3.0	3.3	3.5
Nominal wages, % yoy	5.8	3.0	10.5	-1.9	5.8	7.2	11.7	5.5	4.0
Credit extension to private sector, % yoy	4.5	29.3	6.3	2.5	18.9	18.0	16.0	13.5	11.5
Policy interest rate, % eop	5.00	3.25	2.75	1.25	2.00	3.25	2.75	3.75	3.75
1 month inter-bank rate, % eop	5.22	3.74	3.07	1.28	2.03	3.26	2.79	3.50	3.50
Long term yield, % eop	5.04	5.13	2.84	4.37	3.74	3.28	3.55	4.00	4.00
lc/US\$, eop	35.45	30.05	34.79	33.36	30.07	31.57	30.60	30.45	29.97
lc/US\$, avg	37.93	32.33	33.03	34.33	31.71	30.48	31.08	30.09	30.15
<b>Balance of Payments, US\$ bn</b>									
Current account	2.3	15.7	2.2	21.9	10.0	5.9	2.7	-1.0	-2.0
% of GDP	1.1	5.9	0.8	8.3	3.1	1.7	0.7	-0.3	-0.5
Trade balance	13.7	26.6	17.3	32.6	29.8	17.0	8.3	4.3	3.9
Exports	127.9	151.3	175.2	150.8	191.6	219.1	226.2	252.6	285.7
Imports	114.3	124.6	157.9	118.2	161.9	202.1	217.8	248.3	281.8
Net service and Transfer accounts	-8.0	-8.0	-12.9	-6.4	-10.7	-10.6	-5.1	-6.1	-7.0
Income balance	-3.4	-3.0	-2.3	-4.4	-9.0	-0.5	-0.5	0.2	0.0
FDI, net	8.5	8.3	4.4	0.7	4.5	-0.4	-2.6	4.2	3.1
International reserves	67.0	87.5	111.0	138.4	172.1	175.1	181.6	190.0	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	-2.2	-2.1
Consolidated gov primary balance	0.9	-0.3	0.2	-4.5	1.2	0.2	-0.8	-0.9	-0.7
Public debt	40.3	37.4	38.2	43.9	42.4	40.8	43.7	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	128.0	132.3	135.0
Private	64.7	71.6	72.7	69.4	87.9	88.4	101.1	106.7	108.4
Public	5.2	2.8	3.4	5.9	12.7	16.2	26.9	25.6	26.6
External debt / GDP	33.7	28.1	27.6	28.5	31.5	30.2	35.0	32.9	31.2
External debt / XGS	45.9	41.0	36.5	41.6	44.5	40.1	46.9	43.6	39.7
Short-term debt	27.2	34.0	33.6	33.1	50.7	47.3	58.0	60.0	59.8
Short-term debt/International Reserves (%)	40.7	38.9	30.3	23.9	29.4	27.0	31.9	31.6	30.2
<b>Quarterly Economic Indicators</b>									
	2012 Q2F	2012 Q3F	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F
GDP, % yoy	4.4	3.1	18.9	5.5	4.8	4.3	4.0	4.5	4.8
CPI, % yoy	2.6	3.4	3.6	3.5	3.7	3.6	3.3	3.5	3.7
Policy interest rate, % eop	3.00	3.00	2.75	2.75	3.00	3.50	3.75	3.75	3.75
1 month inter-bank rate, % eop	3.05	3.05	2.79	2.50	2.75	3.25	3.50	3.50	3.50
Long term yield, % eop	3.62	3.62	3.55	3.50	3.65	3.75	4.00	4.00	4.00
lc vs USD, eop	31.57	30.83	30.60	29.63	29.97	30.31	30.45	30.33	30.21

\*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).  
Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research Estimates

# Frontier Asia

## Mongolia

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**Mining law to be revised ahead of Presidential election** – The Government wants to revise the mining law by April and coincidentally the presidential election is in June. The draft of the law has prompted foreign miners and Business Council of Mongolia to raise objections openly. Two draft terms are particularly not-business friendly to miners: 1) Requiring exploration decisions to be approved by hyper-local level (incl. villages); 2) The Government will be entitled to a free stake in all companies developing strategic deposits, where the % ownership is decided on a case by case basis. We believe the draft terms will be watered down after ongoing consultation. Aside from the mining law discussion, we note increasing tension between foreign miners and the authorities – there were repeated attempts to renegotiate investment agreements of Oyu Tolgoi (OT) for the Government to gain a bigger share of profit, and recently President Elbegdorj's call for increasing local control and auditing expenses in the OT project. In light of these, FDI decisions are likely to be on hold awaiting clarity and we think clarity won't come till election dust settles.

**Tapping the USD sovereign markets again in 2013E** – While the Policy Council are picking which infrastructure projects (roads, highways, power plants) will be financed by the US\$1.5bn raised from last year's sovereign bond issuance. The Government mentioned that it may expand its international issuances in 6-12M.

**News headline worries have yet to trickle into lower economic forecasts** – Despite a growing sense of cautiousness, we maintain our GDP forecast of 2013 at 13.8%YoY, banking on the increase in coal and copper exports, as the latest update from OT remains on schedule to achieve commercial production in 1H13.

**BoM surprisingly cut interest rates by 75bps late Jan** – Contrary to our expectation and supra-national's warning of potential hyper-inflation, BoM believes that Mongolia can achieve its 8% inflation target (previous year's target was 10%) in 2013E. In January 2013 the BoM cut policy rates for the first time since 2009, to bolster growth considering uncertainties in trade and FDI. Although CPI eased in Jan to 13%YoY, we remain skeptical on BoM's ability to meet its new single digit inflation target. In Jan, BoM implemented programs to stabilize key commodities prices and extended loans to selected businesses to finance their imports. However, we believe inflation can be sticky given Mongolia's high credit and M2 growth (26.5%YoY & 19.5%YoY in Jan, respectively), higher import price of goods with expected MNT depreciation, potential electricity tariff hike, and services charges being lifted by rising labor cost.

## Sri Lanka

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**The Sri Lankan government officially announced it was dropping plans for a new US\$1bn program with the IMF** – We suspect this was driven by growing resistance from Sri Lankan authorities to abide by IMF conditionalities (likely focused on tax-enhancing and subsidy-reducing structural reforms) weighed against precautionary IMF funds which authorities deem as unnecessary due to growing confidence in its ability to tap the international markets. Certainly, the IMF news was a negative for bond investors for two reasons: 1) Sri Lanka's FX reserve coverage is relatively low and could use additional IMF reserve backstop to mitigate external funding risks (i.e. sudden stop to capital flows); 2) IMF would help boost investor confidence that Sri Lankan authorities would stick with more prudent policies – something of value to the market given investor concerns that Sri Lanka has tendencies towards pro-growth policy bias, especially on fiscal policy. Not surprisingly, since the IMF news, Sri Lanka's external funding costs have been adversely impacted, underperforming other higher yielding sovereign peers.

**Growth is likely to be weaker-than-expected, but CBSL has limited room to ease monetary policy, more likely to wait until 2Q 2013** – We cut our 2012E growth to 6.2% (prev. 6.4%) as we expect fiscal spending was curbed in 4Q, although partly with the “artificial” help of building up arrears, and recently released Nov IP was weaker-than-expected — we think 4Q12 GDP growth will only bounce back to ~6% after bottoming in 3Q due to the drought. We cut 2013E & 2014E growth to 6.8% (prev. 7.1%) and 7.1% (prev. 7.5%), due to expectation that public spending will be restrained with tighter funding and likely significant revenue slippage vs. targets, and we will see more hikes in subsidized prices on power & fuel this year, likely also during the time when the base effect on inflation is most favorable (starting 2Q).

**There is no reason to panic on the IMF news for three reasons** – First, Sri Lanka's external vulnerability is somewhat exaggerated as the government includes foreign holdings (FH) of *all* Treasury bonds as part of its definition of ST external debt even if the maturity is >1yr (other countries only include FH of instruments with < 1yr maturity, i.e. mostly T-bills) – we estimate that FX reserves only covers about 0.9x ST debt by remaining maturity if we include FH of T-bonds, but rises to 1.3-1.4x if we exclude this (ratio akin to Indonesia). Moreover, FH of LKR Treasury instruments have increasingly migrated from bills to bonds and even during late 2011/1H 2012 when LKR depreciated sharply, FH were very stable. Second, recent Dec trade data confirm that normalization of hydropower post drought is helping curb petrol imports, although we'll need to monitor the recent ascent of global crude price. Third, despite liquidity easing, there are no signs this is translating to a pick up in private sector credit growth as of Dec yet – but policy lags bear watching.

## Vietnam

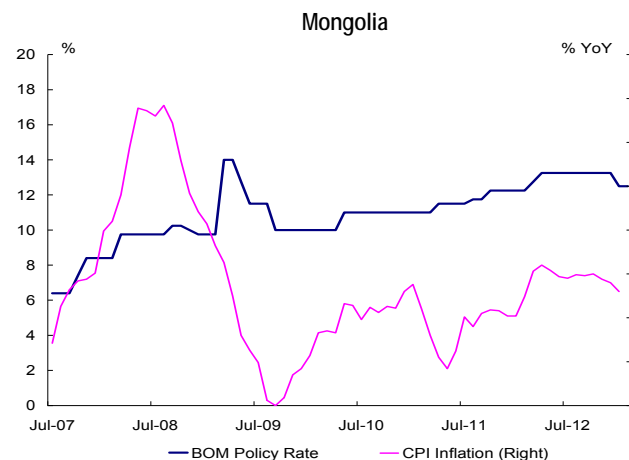
**We expect growth to recover modestly to 5.4% in 2013 vs. 5.0% in 2012, upgrade inflation forecast slightly** – Recovery will be aided by some external demand rebound, continued structural support for FDI inflows into manufacturing, and lagged impact of further monetary & fiscal easing that started in 2012. Inflation was a bit higher-than-expected in Jan (+1.25% MoM, 7.1% YoY) largely driven by food, which we think is seasonal, but we still see inflation this year staying in the 7-8% range. We revise up our average inflation forecast in 2013E and 2014E to 7.6% (prev. 7.2%) and 7.2% (prev. 7.0%), respectively, with risks coming from commodity prices and further administered price adjustments. The saving grace to inflation is the weakness in domestic demand and excess capacity in certain sectors that is keeping second round inflationary impact of price adjustments relatively muted.

**We'll need to monitor the impact of domestic liquidity easing** – Broad money growth has eased substantially on both SBV's monetary easing and FX intervention (to prevent VND appreciation and build precautionary reserves). So far, the very weak balance sheet of the banks has impeded the intermediation of this liquidity to bank credit, which has curbed import growth and inflation, but will need to be monitored. The government has come out with relatively prudent “targets” for broad money growth at 14%-16% range and credit growth at 12%, although political pressure for lower rates lingers – we expect another 100bps rate cut this year.

**External position still looks very strong and we continue to like the dong (VND), gaining exposure via local bonds** – Vietnam ended 2012 with a goods trade surplus of US\$2bn (trade surplus likely much higher when reported in the BoP given differing accounting treatment to imports) and a current account surplus that we estimate will hit around 3% of GDP with the help of record remittances. We estimate SBV saw its FX reserves rise at least US\$10bn in 2012F (SBV said it purchased US\$15bn) –and SBV said it bought as much as US\$2bn in Jan alone.

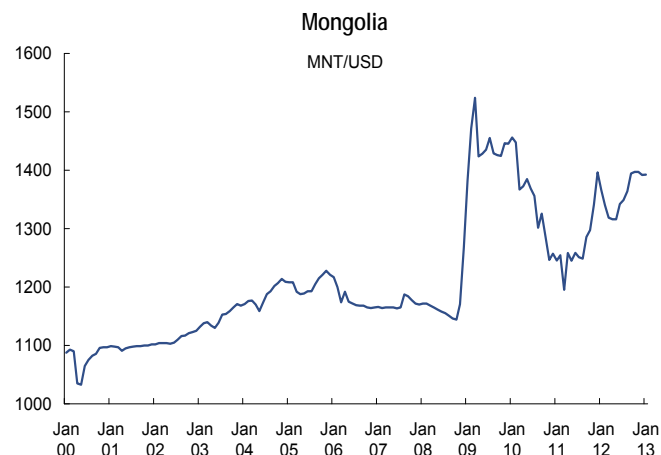
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Figure 98. Mongolia – Policy rate cut on lower inflation prospects



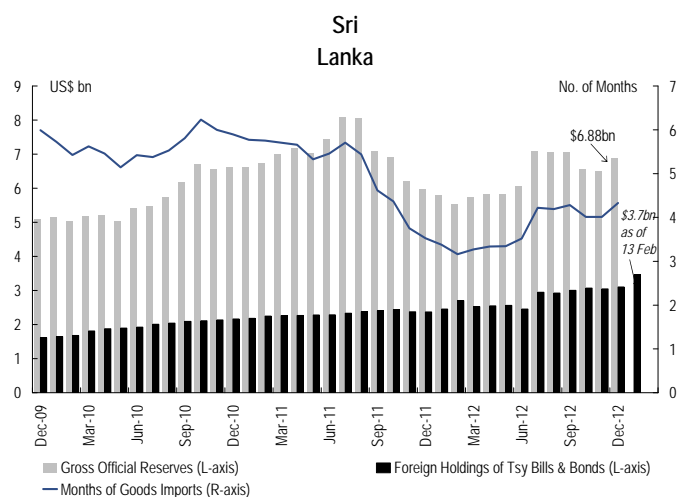
Source: BoM, CEIC, and Citi Research

Figure 99. MNT still in a general depreciating mode



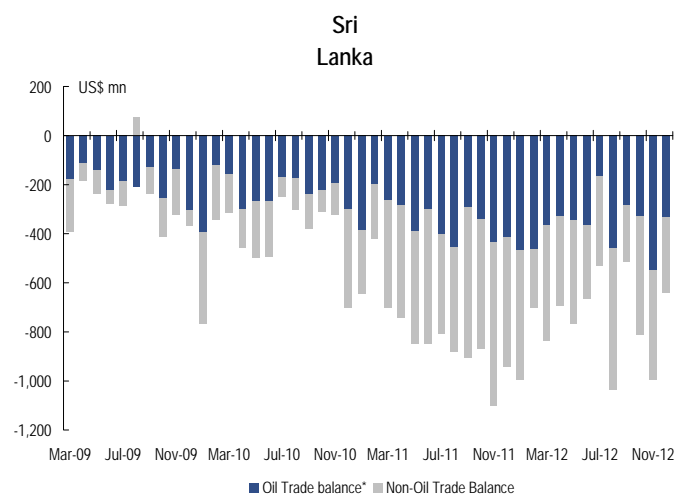
Source: BoM, CEIC, and Citi Research

Figure 100. Sri Lanka – FX reserve ratio may not be so weak given the stability of foreign holdings of Tsy bonds & bills



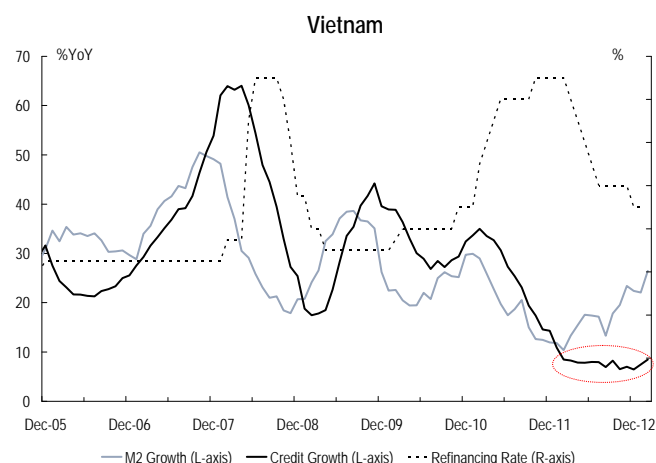
Source: CBSL, CEIC, and Citi Research

Figure 101. Trade deficit has narrowed on declined petroleum imports



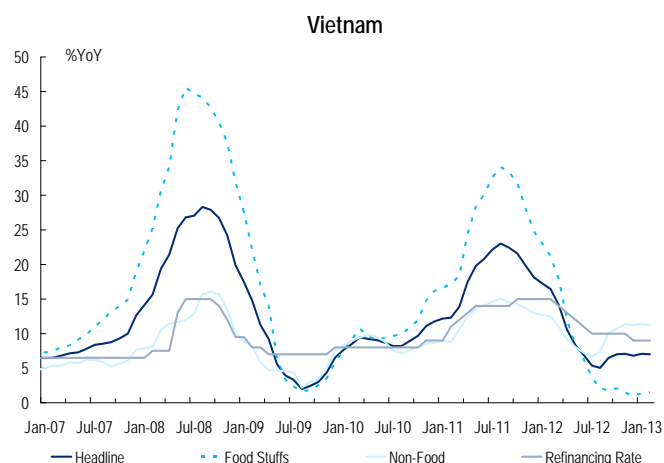
Source: CEIC, and Citi Research; Note: \*Data on petroleum exports for Dec are not yet available—we assume they are unchanged vs. Nov

Figure 102. Vietnam – Subdued credit growth despite easing liquidity



Source: Factiva, IMF, and Citi Research

Figure 103. Inflation risk linger though demand-driven pressure subdued



Source: CEIC, and Citi Research

Figure 104. Asia Frontier Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
<b>Mongolia</b>									
Nominal GDP, US\$ bn	3.4	4.2	5.6	4.6	6.2	8.7	10.3	12.5	15.9
GDP per capita, US\$	1326	1616	2100	1688	2262	3110	3607	4295	5365
Population, mn	2.6	2.6	2.7	2.7	2.8	2.8	2.8	2.9	3.0
Real GDP, % yoy	8.6	10.2	8.9	-1.3	6.4	17.3	12.3	13.8	11.0
CPI, % yoy	6.0	15.1	22.1	4.2	13.0	10.2	14.0	10.2	10.0
CPI, % avg	4.5	9.0	28.0	8.0	10.1	9.2	14.3	12.0	10.0
Policy interest rate, % eop	--	8.40	9.75	10.00	11.00	12.25	13.25	12.50	13.00
Long term yield, % eop	26.93	21.83	20.58	21.67	20.07	16.61	19.20	20.40	21.60
lc/US\$, eop	1164	1172	1275	1433	1233	1378	1378	1385	1317
lc/US\$, avg	1181	1171	1167	1434	1349	1256	1353	1408	1337
Current account (US\$ bn)	0.2	0.3	-0.7	-0.4	-0.9	-2.8	-3.2	-2.8	0.5
% of GDP	6.5	6.3	-12.9	-9.0	-14.9	-31.7	-31.3	-22.5	3.1
Trade balance (US\$ bn)	0.1	-0.2	-1.1	-0.2	-0.4	-1.7	-2.4	-2.0	-1.9
Exports (US\$ bn)	1.5	1.9	2.5	1.9	2.9	4.8	4.3	5.6	6.8
Imports (US\$ bn)	1.5	2.1	3.6	2.1	3.3	6.5	6.7	7.7	8.7
International reserves (US\$ bn)	0.6	0.8	0.6	1.3	2.2	2.3	4.1	4.6	5.1
Consolidated government balance (% of GDP)	7.6	2.6	-4.5	-5.2	0.5	-4.8	-8.3	-2.4	-2.0
Public debt (% of GDP)	40.3	37.7	32.0	43.2	38.3	46.1	62.8	55.9	60.0
<b>Sri Lanka</b>									
Nominal GDP, US\$ bn	28.3	32.4	40.7	42.1	49.6	59.2	57.3	65.2	74.1
GDP per capita, US\$	1422	1615	2014	2058	2400	2836	2718	3057	3434
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	8.3	6.2	6.8	7.1
CPI, % yoy	13.5	18.8	13.9	5.0	6.8	4.9	9.2	6.2	6.5
CPI, % avg	10.0	15.8	22.5	3.6	6.2	6.8	7.5	7.1	6.5
Policy interest rate, % eop	10.00	10.50	10.50	7.50	7.25	7.00	7.50	7.25	7.50
Long term yield, % eop	12.98	19.96	19.12	9.33	7.55	8.99	11.69	10.00	10.50
lc/US\$, eop	107.5	108.7	113.0	114.4	110.9	113.9	127.7	130.0	130.0
lc/US\$, avg	103.9	110.6	108.3	114.9	113.0	110.5	127.2	130.0	130.0
Current account (US\$ bn)	-1.5	-1.4	-3.9	-0.2	-1.1	-4.6	-3.2	-3.1	-3.0
% of GDP	-5.3	-4.3	-9.5	-0.5	-2.2	-7.8	-5.5	-4.7	-4.0
Trade balance (US\$ bn)	-3.4	-3.7	-6.0	-3.1	-4.8	-9.7	-9.3	-10.6	-11.4
Exports (US\$ bn)	6.9	7.6	8.1	7.1	8.6	10.6	9.7	10.5	11.9
Imports (US\$ bn)	10.3	11.3	14.1	10.2	13.5	20.3	19.0	21.1	23.2
International reserves (US\$ bn)	2.5	3.1	1.8	5.1	6.6	6.0	6.8	8.3	9.1
Consolidated government balance (% of GDP)	-7.0	-6.9	-7.0	-9.9	-8.0	-6.9	-6.7	-6.2	-5.5
Public debt (% of GDP)	87.9	85.0	81.4	86.1	81.9	78.5	83.0	80.0	78.0
<b>Vietnam</b>									
Nominal GDP, US\$ bn	60.9	71.2	90.0	91.9	102.4	121.6	139.0	157.1	176.3
GDP per capita, US\$	724	836	1044	1054	1163	1366	1544	1728	1920
Population, mn	84.1	85.2	86.2	87.2	88.1	89.0	90.0	90.9	91.8
Real GDP, % yoy	8.2	8.5	6.3	5.3	6.8	5.9	5.0	5.4	5.8
CPI, % yoy	6.6	12.6	19.9	6.5	11.7	18.1	6.8	7.8	7.0
CPI, % avg	7.5	8.5	23.2	7.0	9.2	18.6	9.3	7.6	7.2
Policy interest rate, % eop	6.50	6.50	9.50	8.00	9.00	15.00	9.00	8.00	8.00
Long term yield, % eop	8.29	8.73	10.00	11.68	11.50	12.55	9.75	10.00	10.00
lc/US\$, eop	16056	16028	17483	18474	19498	21034	20840	20850	21000
lc/US\$, avg	15990	16081	16445	17806	19123	20648	20875	20850	21000
Current account (US\$ bn)	-0.2	-7.0	-10.7	-7.2	-4.3	-0.7	4.4	3.7	1.2
% of GDP	-0.3	-9.8	-11.9	-7.8	-4.2	-0.6	3.2	2.4	0.7
Trade balance (US\$ bn)	-2.8	-10.4	-12.8	-8.3	-5.1	-0.5	5.4	5.2	2.2
Exports (US\$ bn)	39.8	48.6	62.7	57.1	72.2	96.9	114.5	133.9	150.3
Imports (US\$ bn)	42.6	58.9	75.5	65.4	77.3	97.4	109.1	128.7	148.0
International reserves (US\$ bn)	13.4	23.5	23.9	16.4	12.5	13.8	23.6	33.7	36.2
Consolidated government balance (% of GDP)	-1.1	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-3.8	-4.0
Public debt (% of GDP)	37.5	39.0	34.9	40.0	45.5	45.9	44.2	43.8	44.3

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

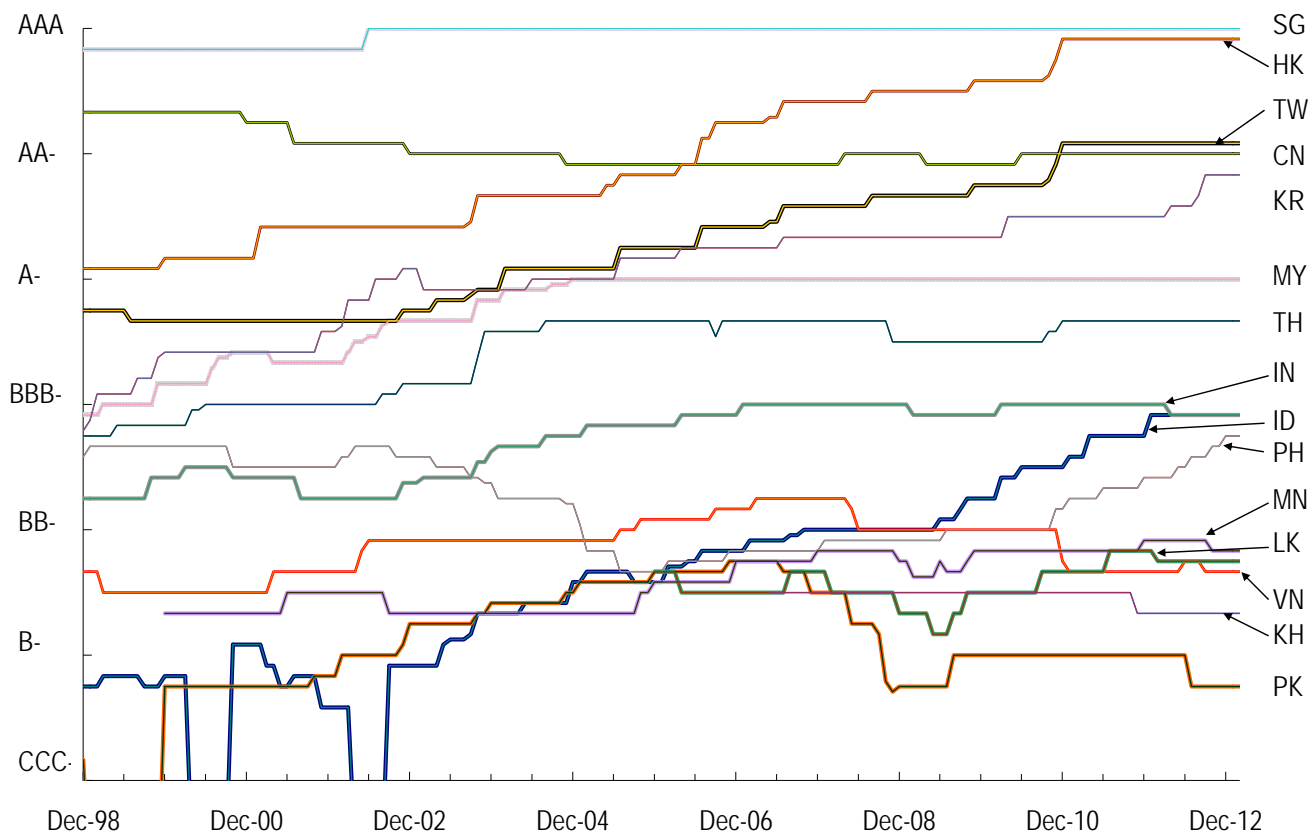
## Summary

Figure 105. 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 (positive)			Hong Kong (stable)	
AA/Aa2	—	—	—			—	
AA-/Aa3	China (stable)	Taiwan (stable)	China (positive)	Korea (stable)	Taiwan (stable)	Korea (stable)	
A+/A1	Korea (stable)		—			China (stable)	Taiwan (stable)
A/A2	—		—			—	
A-/A3	Malaysia (stable)		Malaysia (stable)			Malaysia (stable)	
BBB+/Baa1	Thailand (stable)		Thailand (stable)			—	
BBB/Baa2	—		—			Thailand (stable)	
BBB-/Baa3	India (negative)		India (stable)	Indonesia (stable)	—	India (negative)	Indonesia (stable)
BB+/Ba1	Indonesia (positive)	Philippines (positive)	Philippines (stable)			Philippines (stable)	
BB/Ba2	—		—			—	
BB-/Ba3	Mongolia (stable)	Vietnam (stable)	—			Sri Lanka (stable)	
B+/B1	Sri Lanka (stable)		Fiji (stable)	Mongolia (stable)	Sri Lanka (positive)	Mongolia (stable)	Vietnam (stable)
B/B2	Cambodia (stable)	Fiji (stable)	Cambodia (stable)			—	
B-/B3	Pakistan (stable)		—			—	
CCC+/Caa1	—		Pakistan (negative)			—	
CCC/Caa2	—		—			—	
CC+/Ca1 & Below	—		—			—	

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

Figure 106. Ratings History (Average of S&P and Moody's Ratings), December 1998-February 2013



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



## Global Assumptions

	2012 Q3	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2012F	2013F	2014F	2015F	2016F	2017F
<b>Global Indicators</b>														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	2.5	2.7	3.2	3.6	3.9	3.7
CPI Inflation (average, y/y %)	—	—	—	—	—	—	—	—	2.8	2.8	3.1	2.4	2.4	2.4
Current Account (% of GDP)	—	—	—	—	—	—	—	—	0.4	0.4	0.3	0.1	0.0	-0.1
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-4.4	-4.1	-3.3	-2.8	-2.4	-2.3
<b>Industrial Countries*</b>														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	1.2	1.1	1.6	2.3	2.5	2.1
CPI Inflation (average, y/y %)	—	—	—	—	—	—	—	—	1.8	1.5	1.9	0.9	0.9	0.9
Current Account (% of GDP)	—	—	—	—	—	—	—	—	-0.7	-0.2	-0.1	0.1	0.1	0.0
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-5.9	-5.3	-3.9	-3.0	-2.7	-2.5
<b>United States</b>														
GDP Growth (SAAR %)	3.1	0.2	2.8	1.2	2.8	2.9	3.1	3.2	—	—	—	—	—	—
GDP Growth (y/y %)	2.6	1.6	1.8	1.8	1.7	2.4	2.5	3.0	2.2	2.0	2.9	3.5	4.0	3.0
CPI Inflation (average, y/y %)	1.5	1.5	1.2	1.6	1.7	1.9	2.1	2.1	1.7	1.6	2.1	2.1	2.1	2.1
Current Account (% of GDP)	-2.7	-3.0	-2.9	-2.8	-2.8	-2.8	-2.9	-3.0	-3.0	-2.8	-3.0	-3.0	-3.0	-3.0
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-8.3	-7.2	-5.0	-4.0	-4.0	-4.0
S&P 500 EPS (y/y %)	1.4	5.7	5.0	6.3	6.0	8.2	5.7	5.2	5.7	6.4	5.0	—	—	—
Business Investment (y/y %)	4.6	4.8	3.2	3.0	5.0	4.1	5.3	6.1	7.8	3.8	5.9	—	—	—
Imports (y/y %)	2.5	0.0	0.1	-0.2	0.7	3.0	3.3	4.2	2.4	0.9	4.3	—	—	—
<b>Japan</b>														
GDP Growth (SAAR %)	-3.8	-0.4	2.3	3.9	3.8	3.2	2.8	-4.7	—	—	—	—	—	—
GDP Growth (y/y %)	0.4	0.1	-0.8	0.4	2.4	3.3	3.4	1.2	1.9	1.4	1.3	1.5	1.2	1.2
CPI Inflation (y/y %)	-0.3	-0.2	-0.6	-0.4	0.0	0.1	0.2	2.6	0.0	-0.2	1.9	0.5	0.2	0.5
Current Account (% of GDP)	0.8	0.6	0.1	0.1	0.2	0.6	1.0	1.5	1.0	0.3	1.4	1.5	1.5	1.3
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-10.7	-9.8	-7.0	-6.2	-5.8	-5.4
<b>Euro Area</b>														
GDP Growth (SAAR %)	-0.3	-2.3	0.0	0.1	-0.1	-0.5	-1.0	-0.1	—	—	—	—	—	—
GDP Growth (y/y %)	-0.6	-0.9	-0.8	-0.6	-0.6	-0.1	-0.4	-0.4	-0.5	-0.5	-0.3	1.0	1.2	1.3
CPI Inflation (y/y %)	2.5	2.3	1.8	1.7	1.8	1.5	1.6	1.5	2.5	1.7	1.5	1.4	1.4	1.3
Current Account (% of GDP)	—	—	—	—	—	—	—	—	1.2	3.0	3.4	3.4	3.3	3.3
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-3.3	-2.7	-2.4	-1.4	-0.8	-0.3
<b>Exchange Rates</b>														
US\$ vs. Euro (eop)	1.32	1.35	1.33	1.32	1.31	1.31	1.31	1.30	1.28	1.33	1.30	1.32	1.35	1.38
US\$ vs. JPY (eop)	87	95	95	96	95	94	93	92	81	95	93	89	86	83
JPY vs. Euro (eop)	114	128	127	126	125	123	122	120	104	127	121	117	116	115
<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	1.10	2.10	2.90
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.07	0.07	0.13	0.10	0.10	0.10
Euro Area	0.75	0.75	0.75	0.50	0.25	0.25	0.25	0.25	0.88	0.44	0.25	0.25	0.31	0.75
<b>10-Yr Yield Forecasts (Period Avg.)</b>														
United States	1.60	1.76	1.80	2.05	2.30	2.60	2.85	3.00	1.80	2.20	2.90	3.25	3.50	3.75
Japan	0.78	0.79	0.80	0.85	0.80	1.00	1.00	0.90	0.85	0.85	1.00	1.38	1.50	1.63
Euro Area***	1.44	1.32	1.55	1.40	1.75	1.55	1.35	1.55	1.57	1.56	1.60	1.80	2.00	2.50
<b>Emerging Markets</b>														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	4.7	5.2	5.5	5.5	5.6	5.7
CPI Inflation (eop, y/y %)	—	—	—	—	—	—	—	—	4.5	4.7	4.8	4.7	4.5	4.5
Current Account (% of GDP)	—	—	—	—	—	—	—	—	2.1	1.3	0.7	0.1	-0.2	-0.3
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-1.9	-2.1	-2.4	-2.4	-2.0	-2.1
<b>Commodities</b>														
WTI Oil price (US\$/bbl)	92.2	88.2	85.0	85.0	85.0	85.0	—	—	94.1	85.0	83.0	—	—	—
Copper (Average, USD/MT)	7711	7921	8160	8000	7800	7900	—	—	7945	7965	7775	—	—	—
Gold (Average, US\$/oz)	1654	1718	1705	1685	1665	1650	—	—	1669	1675	1655	—	—	—

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.

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## Asia-Pacific Economics and Market Analysis

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