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Economics

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Emerging Markets
GEMS

Emerging Markets Macro and Strategy Outlook

Time for another tantrum?

- What we've been seeing in EM lately is a faint echo of May 2013, the start of the 'taper tantrum'. Last May, EM was faced with two shocks: i) expectations of a more unfriendly outlook for US monetary policy, and ii) nervousness about growth in China, raising questions about the global commodities cycle and hence EM exports. These two forces seem to be at work once again.

- Today's market won't be a simple repetition of May 2013 for precisely the reason that we've already lived through May 2013. The most important consequence of last year's shock is that parts of EM have gone through an adjustment process: current account deficits are smaller (or at least, not bigger); real interest rates higher (or at least, not lower); and real exchange rates are more depreciated, at least for those in EM running current account deficits.

- One of the reasons why today is different from May 2013 is that last year's easy distinction between 'deficit' (sell) and 'surplus' (buy) countries is morphing into a distinction between 'commodity exporters' and 'manufactured goods exporters'. In June we drew attention to the idea that there has been a widening divergence between the economic performance of commodities exporters vs the rest. In the former group we see deteriorating terms of trade, worse export performance, wider current account deficits, lower levels of investment efficiency, more depreciated currencies and bigger inflation problems.

- Among the Fragile 5, at least, the *manufacturing* exporters (India, Turkey) have staged the most decisive current account adjustments. Among the commodity exporters, meanwhile, current account deficits now are either *bigger* (Brazil, South Africa) or marginally smaller (Indonesia) than they were in Q2 last year. That state of affairs may have been acceptable during the spring and summer of 2014 when risk-appetite towards EM seemed stable. But if we are in the process of repeating last year's 'taper tantrum' these countries' failure to adjust will be punished.

- If investors build up a strong enough sense that commodity-exporting economies have higher levels of macro vulnerability, then capital flight from these markets will continue to pressure nominal exchange rates and, hence, continue to create challenges for central bankers. But it's not just commodity exporters with deficits that are at risk: those with surpluses (Russia, Nigeria) can also be affected. Certainly, equity returns have been weaker – in USD terms – for a group of commodity-exporting countries in each of the past three years than for their manufacturing counterparts. And since commodities tend to weaken when the dollar strengthens, commodity exporters are likely to underperform.

EM Economics and Strategy

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

Contents

Overview: Another ‘tantrum’?

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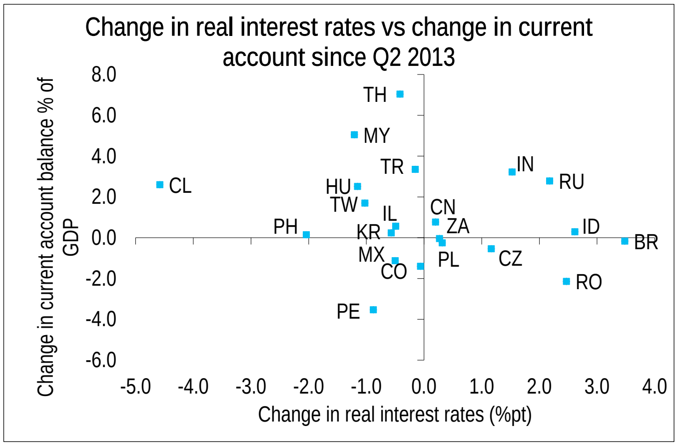
What we’ve been seeing in EM recently is a faint echo of May 2013 at the start of the ‘taper tantrum’. Last May, EM was faced with two shocks: i) expectations of a more unfriendly outlook for US monetary policy, and ii) nervousness about growth in China, raising questions about the global commodities cycle and hence EM exports. Thes0065 two forces seem to be at work once again. Last year, concerns about China saw its 5-year CDS spread rise from 70 bp to 140 bp between May and June last year. And concerns about US monetary tightening had nasty consequences for EM asset prices even though another major central bank – Japan’s – had recently announced a dramatic loosening of policy. And this provides another parallel with last year: for Japan in May 2013, read the ECB in September 2014.

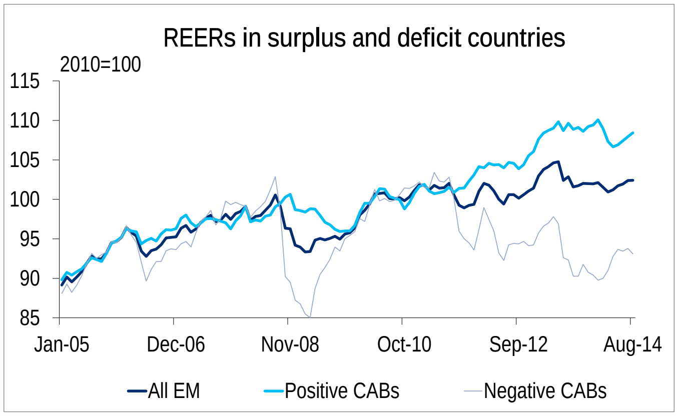
Are today’s parallels with May 2013 enough to justify a substantial EM sell-off? In one sense, today’s market won’t be a simple repetition of May 2013 for precisely the reason that we’ve already lived through May 2013. The most important consequence of last year’s shock is that EM has gone through an adjustment process: current account deficits are smaller (or at least, not bigger); real interest rates higher (or at least, not lower); and real exchange rates are more depreciated, at least for those in EM running current account deficits. These elements of the adjustment process are illustrated in Figures 1 and 2. The lower left quadrant in Figure 1 is relatively unpopulated, suggesting that there aren’t too many countries where current account deficits are bigger and real interest rates lower than in Q2 2013. And Figure 2 shows that, for deficit economies in EM, the average level of the real exchange rate has fallen since April last year by around 5%.

Figure 1. Since May 2013 we have seen a mild tendency towards higher real interest rates and stronger current account balances...



Source: Haver Analytics, Citi Research

Figure 2. ...while real exchange rates in ‘deficit’ countries are weaker than they were in Q2 last year



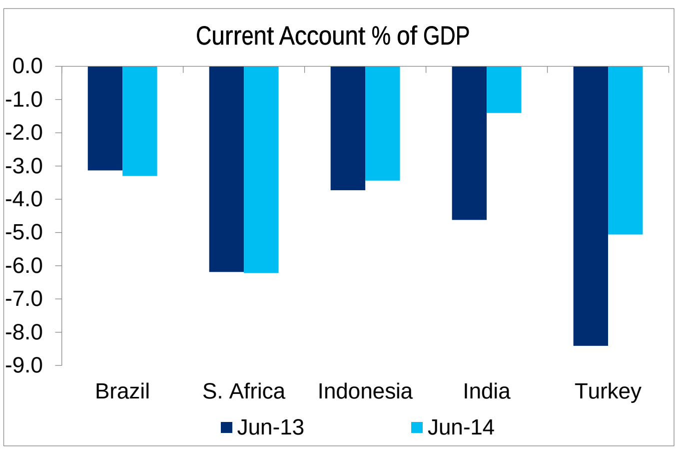
Source: Haver Analytics, Citi Research

One of the reasons why today is different from May 2013 is that last year’s easy distinction between ‘deficit’ and ‘surplus’ countries is morphing into a distinction between ‘commodity exporters’ and ‘manufactures exporters’. This is a theme that we began to explore in our June monthly (Emerging Markets Macro and Strategy Outlook - Bad news for commodities exporters?), but it is worth re-visiting: arguably it is the most important fault-line in EM these days. What we argued in June is that there has been a widening divergence between the economic performance of commodities exporters and that of manufactured goods exporters. In the former group we see deteriorating terms of trade, worse export performance, wider current account deficits, lower levels of investment efficiency, more depreciated currencies and bigger inflation problems. We suggested that ‘sell

commodities exporters, buy manufactured exporters' might be worth watching as a strategy. It is worth pursuing this line of thought.

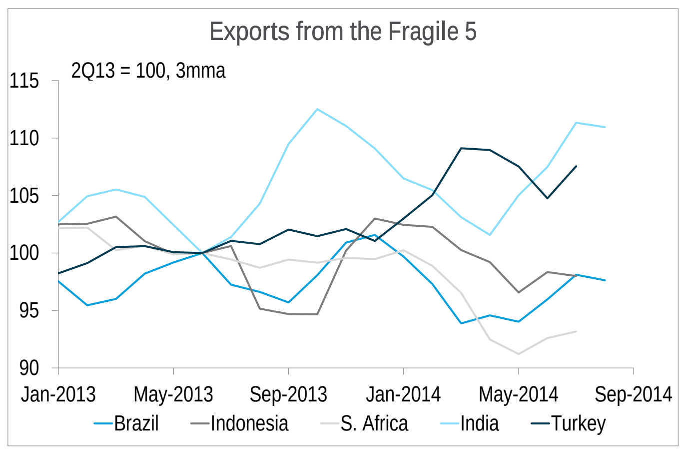
Among the Fragile 5, at least, the *manufacturing* exporters have staged the most decisive current account adjustments. India and Turkey are the two manufactured goods' exporters among the Fragile 5: around 70% of Turkey's exporters are manufacture goods (based on UN Comtrade data), and almost 60% of India's. What's striking in Figure 3 is that the current account adjustment for these two countries has been much more impressive than for the other three, all commodity exporters. Certainly there are some aspects of the current account adjustment in Turkey and India that can be considered 'one-off', particularly when it comes to *gold*. In India, for example, the raising of gold import-duties had an important impact on India's adjustment. Gross Indian gold imports in the first 7 months of 2014 were $14.2 bn, compared to $34.5 bn (!) in the same period of last year. That accounts for almost the entire reduction in India's import bill during this period. And gold also distorts Turkey's trade adjustment to some extent: gold exports rose (but only slightly) in 2014 year-to-date. None of this, though, alters the basic story here, which is that India and Turkey have enjoyed a better export performance than the commodity exporters (Figure 4) and this has supported their adjustment efforts.

Figure 3. It is no coincidence that the biggest external adjustments have been in India and Turkey, which are manufacturing economies…



Source: Haver Analytics, Citi Research

Figure 4. …because India and Turkey are the only fragile economies that have been able to grow their exports



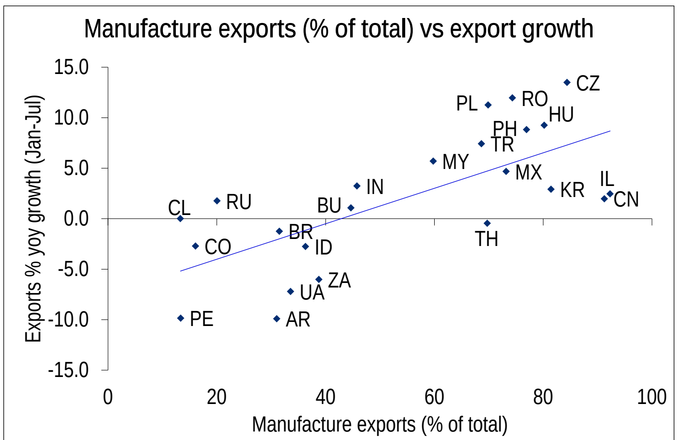
Source: Haver Analytics, Citi Research

The failure of the 'fragile' commodity exporters to adjust their deficits reflects a bigger problem. The terms of trade for commodity exporters is working against these economies, as Figure 4 highlights. In principle this creates a bigger need for import-compression as the only reliable route to shrinking a current account deficit. As we've seen, though, policymakers are reluctant to squeeze domestic spending when growth is already low. In Brazil's case, this has led to fiscal loosening which offsets the monetary tightening that's taken place. In South Africa, it has led to an unwillingness to tighten monetary policy more than is necessary to stabilize the fx market in the short run. So, current account deficits now are either *bigger* (Brazil, South Africa) or marginally smaller (Indonesia) than they were in Q2 last year. That state of affairs may have been acceptable during the spring and summer of 2014 when risk-appetite towards EM seemed stable. But if we are in the process of repeating last year's 'taper tantrum' these countries' failure to adjust will be punished.

Life for commodity exporters is grim across the board, and is being made worse by China. To get a picture of how export potential is constrained for

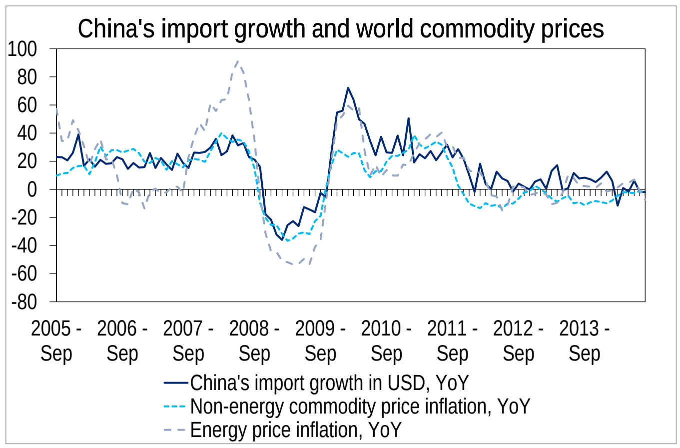
commodity exports, Figure 5 illustrates a simple relationship between a country's commodities-dependence and the growth rate of exports during the first 7 months of 2014. The more you depend on manufactured exports, the stronger your export growth is likely to have been so far this year. And this problem for commodities exporters is considerably influenced by China. In 2013, as we highlighted above, a relatively weak Chinese economy was an ingredient in the EM sell-off. But arguably things look a bit worse now. It is not just that China's production data is much weaker than it was then – China's industrial production growth rate was 9.4% in Q2 last year, but only 8% so far in Q3 2014 – but there has also been a marked change in China's import behavior: import growth is notably weaker so far in 2014 than it was last year – in value terms and in volume terms - and so global commodity price inflation remains very subdued thanks to weak-ish Chinese demand (Figure 6). The weakness of Chinese commodities demand has been broad-based, with those exposed to the industrial and real estate sectors worst affected.

Figure 5. The more you depend on manufactured exports, the stronger your export growth is likely to have been this year…



Source: Citi Research

Figure 6. …because China's very weak import growth doing some damage to commodity prices



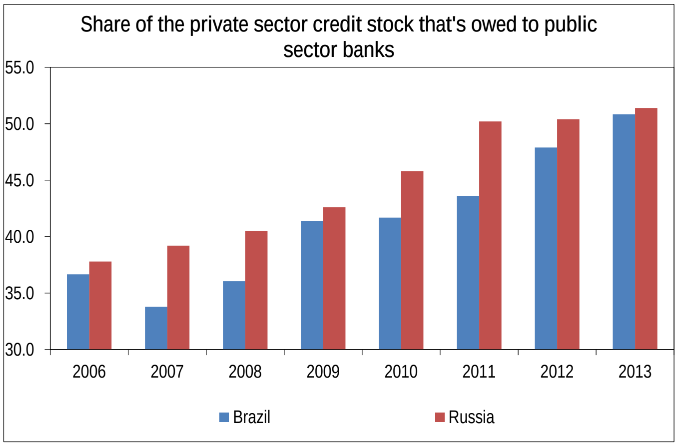
Source: Haver Analytics, Citi Research

And it's not just commodity producers with current account deficits who are at risk. While our analysis seems to point to '*commodity exporters with deficits*' as the most vulnerable group of countries in a risk-averse environment, it is also worth pointing out that some commodity exporters with current account surpluses are finding it difficult to distance themselves from balance-of-payments vulnerability. For example: we think the Nigeria naira is likely to come under pressure in the coming months, in spite of its recent stability (Nigeria Macro View - Africa's largest economy heads to the polls). In addition, it is possible to argue that Russia's vulnerability derives as much from the underlying pressures of its weak fundamentals as from the impact of sanctions. Many of the factors which explain Brazil's weakness, for example, also explain Russia's: deteriorating terms of trade, a real exchange rate that's still expensive in historical terms, a weak investment climate and diminishing risk appetite on the part of privately owned domestic banks. One consequence of this is the growing 'fiscalisation' of the credit stock, measured by the amount of the stock of credit that is on the books of publicly owned banks (Figure 7). In other words, Russia's public sector balance sheet – broadly-defined – is deteriorating, and this should be associated with a weaker exchange rate (as it has in Brazil).

Even if commodity producers have differing levels of external vulnerability – some have surpluses, some have deficits – they all seem to share a common growth problem. The weakness in the economic dynamism of commodity exporters compared to manufactures exporters is evident in Figure 8, which shows

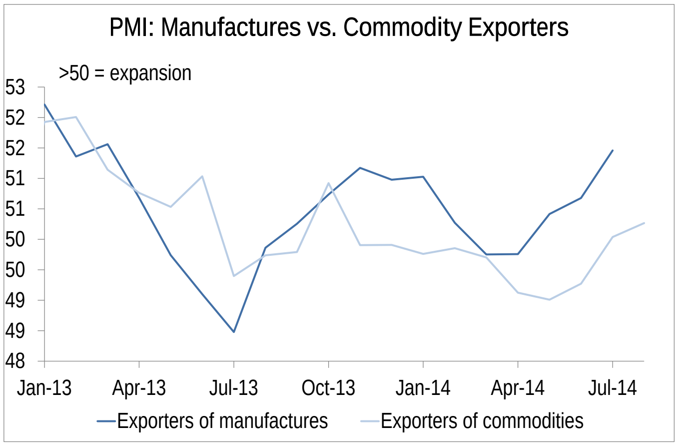
PMIs for these two groups of countries. This may not provide a complete picture of the economic potential of these two groups of countries, but it is at least backed up by evidence of declining investment efficiency. The Incremental Capital-Output Ratio (ICOR) for commodity exporters rose from just over 3 in the years 2000-2007 to just over 9 in the past three years, a much bigger deterioration in investment efficiency than is evident among manufacturing exporters.

Figure 7. Russia shares a number of problems with Brazil, including a growing 'fiscalisation' of the credit stock...



Source: IMF, Citi Research

Figure 8. There seems to be a growing divergence in the economic dynamism of commodity exporters vs manufacturing exporters

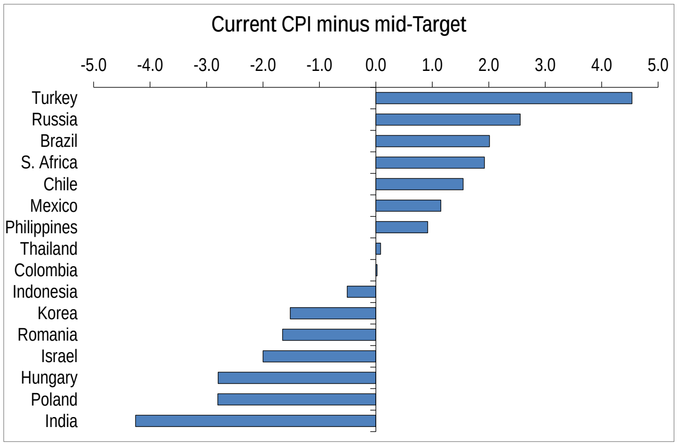


Source: Haver Analytics, Citi Research

And inflation problems seem more common among commodity exporters. With the notable exception of Turkey, weak inflation-fighting credibility is these days mostly associated with commodities-exporters, while the undershooting of inflation targets is more common among manufacturing exporters (Figure 9). Of course it is difficult to establish causation here: do countries have inflation problems because they are commodities exporters, or because they have been running current account deficits, which created a source of pressure on nominal exchange rates during most of 2013 and early 2014? The precise nature of the causation may not be relevant.

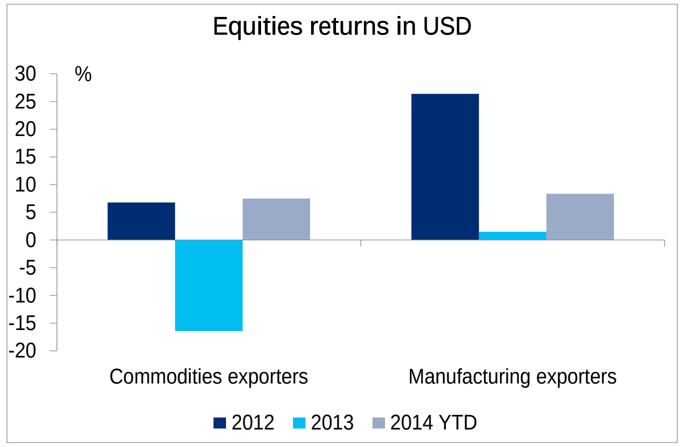
If investors build up a strong enough sense that commodity-exporting economies have higher levels of macro vulnerability, then capital flight from these markets will continue to pressure nominal exchange rates and, hence, continue to create challenges for central bankers. And for sure, the recent track record on returns for commodities-exporters is not particularly encouraging. Figure 10 shows that equity returns have been weaker – in USD terms – for a group of commodity-exporting countries in each of the past three years. And there might also be evidence that returns from fixed income markets have been more disappointing. An investor buying an fx-unhedged portfolio of commodities exporters' 10 year bonds – Brazil, Colombia, Peru, Chile, Indonesia, South Africa – would have suffered negative returns since the start of the year (and even more negative if Russia were included); while a portfolio of manufacturing exporters – Korea, China, Israel, Philippines, Tawian, Poland, Czech, Hungary, Mexico, Turkey, India – would have generated positive returns.

Figure 9. Inflation-fighting discipline, by and large, is weakest among commodities-exporters...



Source: , Haver Analytics, Citi Research

Figure 10. ...and equity returns – for most of the past 3 years – have been weaker from commodities-exporters.

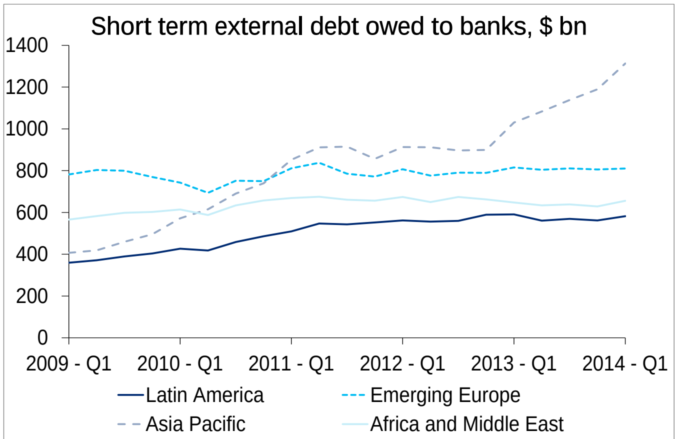


Source: Citi Research

While we think commodity exporters are now at the centre of vulnerability, the effects of a new tantrum might not be as devastating as in 2013. There are two points worth making, to do with EM's capital account. In the first place, there are many countries across EM that have already seen some cross-border de-leveraging. This is apparent from Figure 11 where the only substantial increase in short-term external debt is in Asia – and this is almost entirely explained by the continuing build-up of cross-border borrowing by China ([1], which rose in unabated fashion into Q1 of 2014 (and which we consider to be a possible source of risk for EM next year). But for some other large EMs – Brazil, Russia, Poland, Chile, Mexico, Nigeria, Korea, Thailand – stocks of short-term external debt to banks abroad have declined or at least remained stable since the 2013 tantrum. A second point is that while a 'tantrum' scenario might erode the flow of capital to EM, the amortization profile of the corporate sector in EM is relatively healthy, as Figure 12 shows. Although there was a lot of borrowing in the past few years by EM corporates, at least this was done with progressively longer average maturities: the average maturity of corporate bond issues in 2013 was 9.6 years.

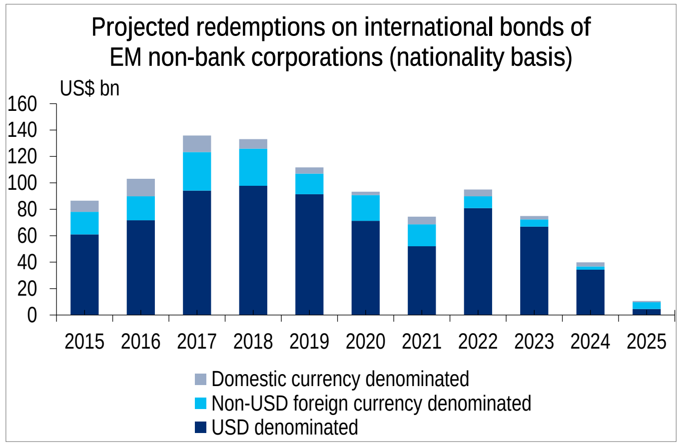
[1] "EM's Stagflation Puzzle", EMMSO, 1 May 2014

Figure 11. Cross-border deleveraging by banks has already started thanks to the 2013 tantrum episode…



Source: Citi Research

Figure 12. …and bond redemptions from EM corporates are not hugely onerous in the next couple of years



Source: BIS. Projected redemptions on international debt securities issued to date on non-bank coporations in Bulgaria, Brazil, Chile, China, Colombia, Czech, Estonia, HK, Hungary, Indonesia, India, Iceland, Korea, Lithuania, Mexico, Malaysia, Peru, Philippines, Poland, Romania, Russia, Singapore, Slovenia, Thailand, Turkey, Venezuela, and South Africa.

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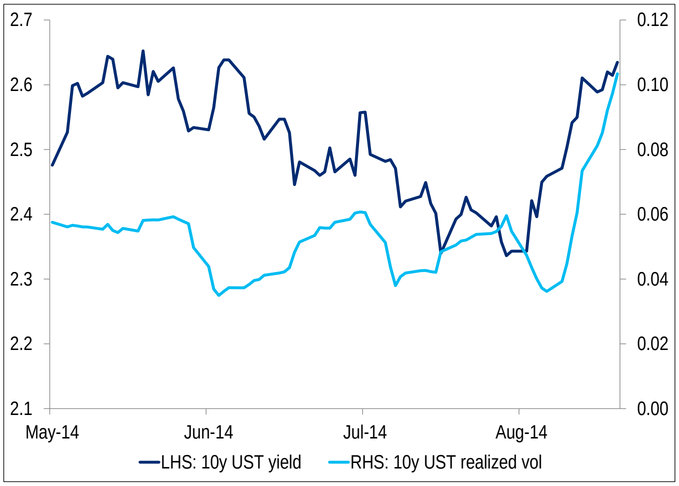
Strong US or Weak EM?

The sell-off in EM FX has not been a surprise in light of weaker global macro. For much of the 2014, the global macro background was conducive to risk-taking. With US Treasuries in a narrow range and VIX at a multi-year low, carry trade in EM had flourished, and EM FX had recouped much of the ground lost in 2013. Since September, 10y UST has risen 20 bps (Figure 13), and the Fed dots are now suggesting a consistent pace of tightening. The higher risk premium implied by these moves ought to have increased the required return on EM assets, producing systematic EM FX underperformance (Figure 14).

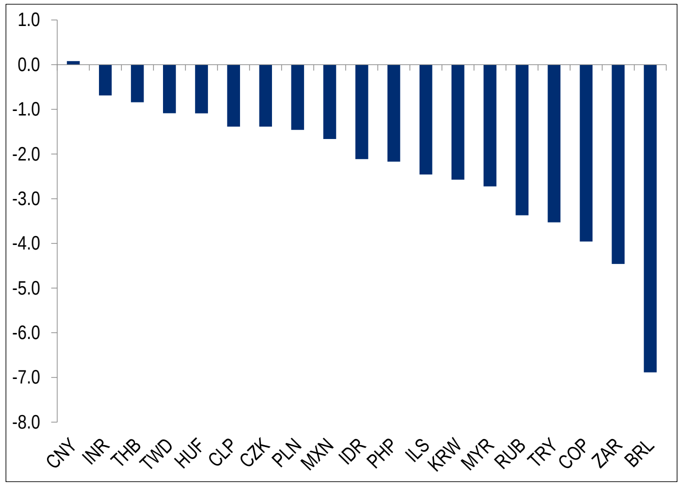
Markets did not differentiate much between EM macro stories going into carry trades. As long as global funding conditions remained stable, and EM carry was high, it did not matter whether there were fundamental risks. We wonder whether the current sell-off has been more discriminating. In other words, have local factors, in addition to the global conditions, been priced-in? We use three simple “cross-sectional tests” to gain insights.

Figure 13. 10y UST yield and realized volatility, (%)



Source: Citi Research, Bloomberg.

Figure 14. Mtd spot performance vs. USD, (%)

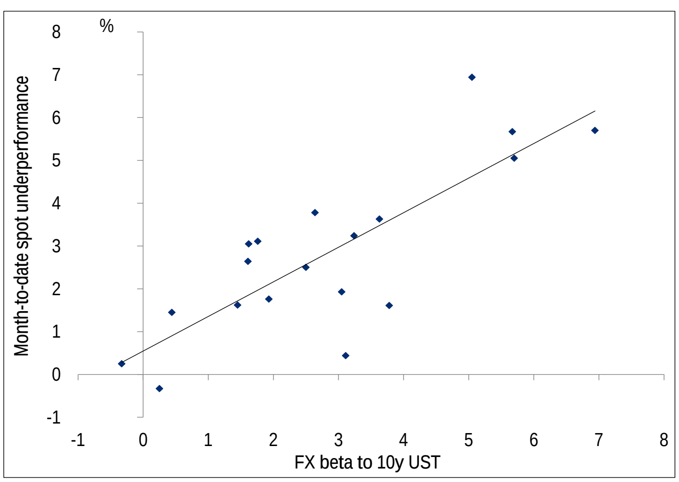


Source: Bloomberg.

EM FX betas to UST explain the pattern of EM FX underperformance in the current sell-off. Figure 3 reports the results of our first exercise where we plot EM currencies' underperformance in the sell-off against their betas to 10y UST. As the Figure shows, the trend is apparent: currencies with higher betas to UST were more likely to underperform. While beta estimates are not immune to the effects of noise (and in our case INR beta is imprecisely estimated), the steep slope and small "pricing errors" suggest that higher US rates have been central to the EM FX move.

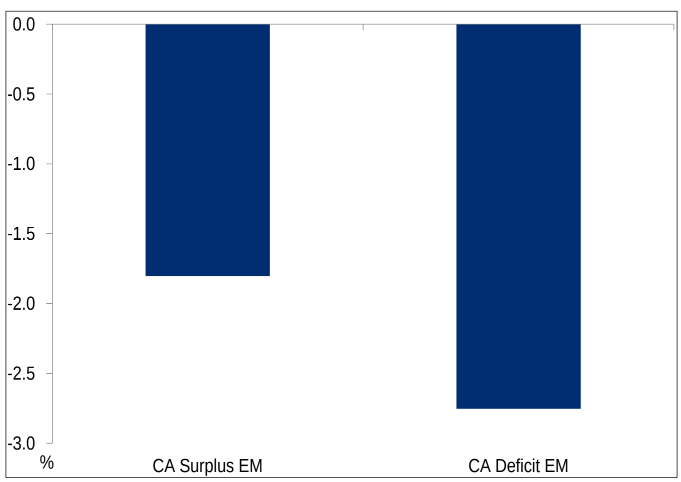
But markets don't seem to have fully discounted the differing levels of macro vulnerability in EM either. As a group, EMs with current account surpluses (CNY, TWD, THB, HUF, PHP, ILS, KRW, MYR, RUB) have seen their currencies weaken, on average, by about 1.8% month-to-date. In contrast, the current account deficit group (INR, CZK, CLP, PLN, MXN, IDR, TRY, COP, ZAR, BRL) has moved down by 2.75%. Within the current account deficit group, higher deficits are associated with greater underperformance. Within the current account surplus group, higher surpluses are positively related to smaller sell-off.

Figure 15. EM FX beta to 10y UST vs. mtd spot underperformance



Source: Citi Research

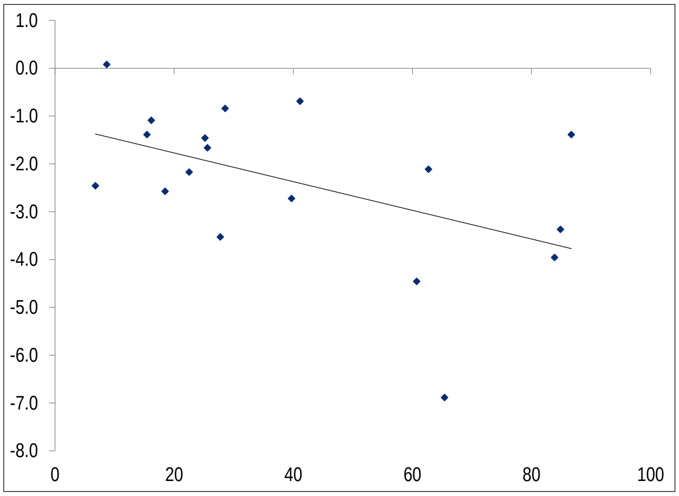
Figure 16. Month-to-date spot performance of CA deficit and CA surplus



Source: Citi Research. Note: CA surplus group: CNY, TWD, THB, HUF, PHP, ILS, KRW, MYR, RUB. CA deficit group: INR, CZK, CLP, PLN, MXN, IDR, TRY, COP, ZAR, BRL

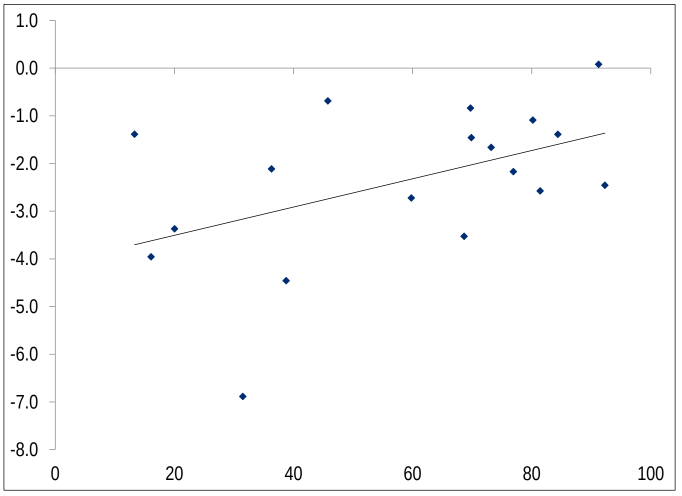
The wave of weakness in commodity prices also appears to have weighed in. As Figure 5 shows, countries with the highest exposure to commodities have been hit the most. Of the top 5 underperformers in Figure 14, 4 (ex. Turkey) are ranked in the top 6 of the list by the share of commodities in total exports (BRL = 65%, ZAR = 61%, COP = 84%, RUB = 85%). Importantly, the market pricing of FX in countries with high shares of manufactured goods has been relatively more benign. As Figure 6 suggests, manufactured goods exporters have tended to sell off less.

Figure 5. Share of commodities in total exports vs. spot FX performance month-to-date, %



Source: Citi Research, UNComtrade. Note: Country sample: CNY, IDR, INR, KRW, MYR, PHP, TWD, THB, CZK, HUF, ILS, PLN, RUB, ZAR, TRY, BRL, CLP, COP, MXN

Figure 6. Share of manufactured goods in total exports vs. spot FX performance month-to-date, %



Source: Citi Research, UNComtrade. Note: Country sample: CNY, IDR, INR, KRW, MYR, PHP, TWD, THB, CZK, HUF, ILS, PLN, RUB, ZAR, TRY, BRL, CLP, COP, MXN

Weaker EM FX, underperforming commodity exporters? Our analysis is consistent with the view that strong dollar is the underlying reason behind the EM sell-off. Yet, we also find evidence that pricing has responded to differentiated vulnerability conditions in EM. With long-term rates in the US poised to rise further, EM FX is likely to continue to be under pressure against USD. Since commodities tend to also weaken when the dollar strengthens, commodity exporters with current account deficits are likely to underperform.

Monetary Policy Watch

Figure 17. Asia Policy Rates and Movement

			Last Move		Likely Next Move		End-2015
		Spot	Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	3.00	Jul-12	-25	Dec-14	-25	2.25
India	Repo Rate	8.00	Jan-14	+25	Mar-16	-25	8.00
Indonesia	FasBI	5.75	Nov-13	+25	2016	+25	5.75
Korea	BOK Policy Rate	2.25	Aug-14	-25	Aug-15	-25	2.75
Malaysia	Overnight Policy Rate	3.25	Jul-14	+25	2018	0	3.50
Philippines	Overnight Policy Rate	4.00	Sep-14	+25	2018	+50	4.00
Taiwan	Discount Rate	1.875	Jun-11	+12.5	Sep-15	+12.5	2.125
Thailand	Overnight Repo Rate	2.00	Mar-14	-25	Sep-15	+50	2.00

Source: Bloomberg, Citi Research

Figure 18. CEEMEA Policy Rates and Movement

			Last Move		Likely Next Move		End-2015
		Spot	Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.05	Nov-12	-20	3Q16	+20	0.05
Hungary	14-Day Repo Rate	2.10	Jul-14	-20	Sep-15	+25	3.10
Israel	Base Rate	0.25	Jul-14	-25	Nov-15	-25	1.00
Poland	7-Day Repo Rate	2.50	Jul-13	-25	Nov-15	+25	2.75
Romania	Refinancing Rate	3.25	Aug-14	-25	Sep-14	-25	4.00
Russia	Refinancing Rate	8.00	Jul-14	+50	Jan-15	-50	7.50
S. Africa	Average Repo rate	5.75	Jul-14	+25	May-15	+25	6.75
Turkey*	Average Funding rate	8.25			by end-2014	+225	10.50
Ukraine	Discount Rate	12.50	Jul-14	+300	2015	+200	12.00

Source: Bloomberg, Citi Research.

Note: *For Turkey we use the average funding rate of the CBT instead of the 1-week repo rate.

Figure 19. Latin America Policy Rates and Movement

			Last Move		Likely Next Move		End-2015
		Spot	Date	Amount (bp)	Forecast	Amount (bp)	forecast
Brazil	SELIC	11.00	Apr-14	+25	Jan-15	+50	11.00
Chile	CAMARA (Overnight)	3.25	Sep-14	-25	Oct-14	-25	3.00
Colombia	Central Bank Repo Rate	4.50	Sep-14	+25	Mar-15	+25	5.00
Mexico	Official Overnight Rate	3.00	Jun-14	-25	Jun-15	+25	3.75
Peru	Reference Rate	3.50	Sep-14	-25	Jun-16	+25	3.50

Source: Bloomberg, Citi Research

FX Views

Figure 20. Asian Currencies Exchange Rates

		Dec-14			Jun-15			Dec-15		
	24-Sep	**Forecast**	**Forward**	**Returns**	**Forecast**	**Forward**	**Returns**	**Forecast**	**Forward**	**Returns**
vs USD				(%)			(%)			(%)
China yuan	6.13	6.10	6.15	0.7	6.04	6.19	2.5	6.02	6.24	3.5
Hong Kong dollar	7.75	7.75	7.75	0.0	7.75	7.75	0.0	7.75	7.75	0.0
India rupee	60.98	61.70	61.86	0.2	62.41	63.85	2.3	62.66	65.64	4.5
Indonesia rupiah	11954	12200	12155	-0.4	12190	12553	2.9	12030	n.a.	n.a.
Korea won	1040	1047	1044	-0.3	1039	1050	1.1	1010	1052	4.0
Malaysia ringgit	3.24	3.27	3.26	-0.1	3.30	3.30	-0.2	3.33	n.a.	n.a.
Philippines peso	44.5	45.0	44.5	-1.0	45.0	44.7	-0.6	44.1	#N/A	#N/A
Singapore dollar	1.27	1.27	1.27	-0.3	1.27	1.27	-0.3	1.27	1.27	0.0
Taiwan dollar	30.2	30.24	30.16	-0.3	30.09	30.03	-0.2	29.89	29.90	0.0
Thailand baht	32.2	32.75	32.37	-1.2	32.80	32.66	-0.5	32.89	n.a.	n.a.

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

Figure 21. CEEMEA Currencies Exchange Rates

		Dec-14			Jun-15			Dec-15		
	24-Sep	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs EUR				(%)			(%)			(%)
Czech Republic koruna	27.5	27.7	27	-0.6	28.0	27.5	-2.2	27.5	27.4	-0.5
Hungary forint	311	318	314	-1.3	325	314	-3.6	325	314	-3.6
Poland zloty	4.17	4.27	4.17	-2.3	4.33	4.17	-3.8	4.20	4.17	-0.5
vs USD										
Israel shekel	3.67	3.68	3.66	-0.4	3.75	3.65	-2.7	3.79	3.64	-4.3
Russia ruble	38.3	40.0	39.0	-2.4	41.4	40.5	-2.2	41.0	42.1	2.6
Turkey new lira	2.23	2.31	2.28	-1.3	2.45	2.38	-3.1	2.51	2.48	-1.4
S. Africa rand	11.13	11.30	11.31	0.1	11.49	11.68	1.6	11.33	11.93	5.1

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

Figure 22. Latin American Currencies Exchange Rates

		Dec-14			Jun-15			Dec-15		
	24-Sep	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
Brazil reais	2.41	2.37	2.47	4.1	2.53	2.60	2.6	2.58	2.73	5.5
Chile peso	600	611	605	-1.1	626	613	-2.0	615	621	1.0
Colombia peso	1997	1998	2019	1.0	1971	2058	4.2	2004	2098	4.5
Mexico new peso	13.3	13.3	13.3	-0.1	13.2	13.3	0.5	13.0	13.3	2.1

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

Global Assumptions

Macroeconomic Forecasts

	GDP Growth (% YoY)			CPI Inflation (% YoY)			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F
Global	2.8	3.3	3.6	2.8	3.0	3.2	0.8	0.7	0.5	-3.8	-3.3	-2.9
Industrial Countries	1.8	2.3	2.5	1.5	1.6	1.6	-0.1	-0.2	0.0	-4.7	-3.9	-3.4
United States	2.3	3.3	3.2	1.4	1.6	2.2	-2.4	-2.2	-1.8	-6.6	-5.7	-5.4
Japan	0.9	0.6	1.2	2.8	1.7	1.6	0.1	0.4	0.8	-8.0	-6.2	-5.8
Euro Area	0.8	1.4	1.8	0.6	1.1	1.3	2.8	3.0	3.0	-2.7	-2.3	-1.7
Germany	1.5	1.8	2.1	1.0	1.7	2.1	7.3	7.4	6.9	0.2	0.2	0.1
United Kingdom	3.3	3.5	2.9	1.6	1.8	2.0	-4.8	-5.7	-6.0	-5.9	-4.1	-1.9

G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 24 September 2014

	4Q 14F	1Q 15F	2Q 15F	3Q 14F	4Q 15F	1Q 16F
United States: Federal Funds	0.25	0.25	0.25	0.75	1.00	1.25
10-Yr. Treasuries (Period Ave.)	2.70	2.95	3.05	3.15	3.20	3.25
Euro Area: US$/€	1.21	1.18	1.15	1.16	1.17	1.18
Euro Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05
10-Yr. Bunds (Period Average)	0.75	1.00	1.25	1.50	1.50	1.75
Japan: Yen/US$	111	113	115	114	113	112
Call Money	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.50	0.70	0.80	0.85	0.75	0.85

Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US$						Spread vs. Germany					
	Current	4Q 14	1Q 15	2Q 15	3Q 15	4Q 15	Current	4Q 14	1Q 15	2Q 15	3Q 15	4Q 15
United States	NA	NA	NA	NA	NA	NA	154	197	197	182	167	173
Japan	-201	-222	-227	-227	-232	-248	-47	-25	-30	-45	-65	-75
Euro Area	-154	-197	-197	-182	-167	-173	NA	NA	NA	NA	NA	NA
United Kingdom	-7	-20	-15	-5	5	5	147	177	182	177	173	178

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

Commodities Price Outlook

	3M	6-12M	LT
Metals and Bulks			
Gold Price	1200	1240	1050
Silver Price	18.30	18.70	16.50
Platinum Price	1400	1500	1763
Energy			
WTI Oil Price	91	90	81
Brent Oil Price	100	98	85
Henry Hub Gas Price	3.90	3.80	5.50
Agriculture			
CBOT Corn - North America	310	390	
CBOT Wheat - North America	475	500	
CBOT Soybeans - North America	900	1000	
CBOT Rice - North America	13.00	14.00	

Source: Citi Research

EM: Key Forecasts

Figure 23. Emerging Markets – Economic Forecasts, 2013F-2015F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Asia	6.3	6.2	6.2	3.7	3.2	3.4	2.2	2.5	2.2	-2.3	-2.4	-2.2
China	7.7	7.3	6.9	2.6	2.3	2.6	2.0	2.3	2.3	-1.9	-2.1	-2.0
Hong Kong	2.9	2.6	3.3	4.3	4.0	3.6	1.9	2.8	3.2	1.0	1.3	0.7
India*	4.7	5.6	6.5	9.5	8.0	6.5	-1.7	-1.8	-1.9	-6.9	-6.7	-6.5
Indonesia	5.8	5.1	5.1	6.4	6.2	6.7	-3.3	-3.2	-2.8	-2.2	-2.4	-1.9
Korea	3.0	3.9	4.0	1.3	1.6	2.6	6.1	5.1	3.1	1.0	0.9	1.4
Malaysia	4.7	5.7	5.6	2.1	3.0	3.9	4.0	5.5	5.7	-3.9	-3.5	-3.0
Mongolia	11.7	10.0	9.0	10.5	13.8	12.0	-30.9	-10.3	-11.1	-7.8	-7.6	-4.4
Philippines	7.2	6.3	6.5	2.9	4.3	3.5	3.5	3.6	3.4	-1.4	-1.8	-1.6
Singapore	3.9	3.1	3.2	2.4	1.2	0.9	18.3	18.0	18.0	1.1	-0.3	0.2
Sri Lanka	7.3	7.7	7.5	6.9	3.3	5.6	-3.9	-3.3	-3.1	-5.9	-5.6	-5.3
Taiwan	2.1	3.6	4.0	0.8	1.5	2.0	11.7	11.0	10.2	-1.3	-1.4	-0.8
Thailand	2.9	1.2	3.9	2.2	2.2	2.1	-0.6	5.2	4.1	-1.8	-1.2	-1.8
Vietnam	5.4	5.4	5.7	6.6	4.5	5.8	5.6	5.1	4.2	-5.6	-6.4	-6.0
Latin America	2.6	1.2	2.2	7.3	9.2	10.2	-1.7	-1.7	-1.7	-2.8	-3.8	-3.3
Argentina	2.9	0.0	-1.0	10.6		29.0	-0.7	-1.2	-1.2	-1.9	-3.7	-4.7
Brazil	2.5	0.1	1.0	6.2	6.3	6.6	-3.7	-3.7	-3.8	-3.3	-4.4	-3.6
Chile	4.1	1.8	3.0	1.9	4.2	3.3	-3.4	-2.0	-2.8	-0.6	-2.0	-1.6
Colombia	4.7	4.8	5.2	2.0	2.8	3.2	-3.4	-3.7	-3.7	-0.9	-1.6	-1.5
Costa Rica	3.5	3.1	2.2	5.2	4.8	5.0	-5.1	-6.4	-6.5	-6.5	-7.2	-7.7
Dominican Republic	4.6	6.0	4.5	4.8	3.3	3.8	-4.0	-3.7	-3.8	-4.1	-4.0	-4.0
Ecuador	4.6	4.6	4.6	2.7	3.4	2.5	53.5	49.7	46.2	-5.8	-4.6	-3.6
El Salvador	1.7	2.2	2.5	0.8	1.4	2.1	-6.2	-6.4	-5.7	-4.2	-3.1	-3.0
Mexico	1.1	2.6	3.9	3.8	4.0	3.5	-2.1	-1.9	-1.9	-2.3	-3.6	-3.5
Panama	8.4	6.2	5.5	4.0	2.8	2.2	-11.3	-9.0	-8.6	-3.0	-4.0	-3.0
Peru	5.8	3.5	4.9	2.8	3.2	2.5	-4.4	-5.7	-5.2	12.5	9.0	9.0
Venezuela	1.3	-1.0	1.9	38.5	61.7	82.5	3.3	4.1	5.1	-11.9	-11.2	-10.3
Europe	2.0	1.6	2.3	5.3	5.9	5.3	-1.2	0.2	-0.1	-2.2	-3.5	-3.7
Bulgaria	0.9	1.5	2.5	0.9	-1.0	2.2	2.1	0.5	-1.0	-1.5	-2.5	-1.2
Croatia	-0.9	-0.7	1.2	2.2	-0.1	2.5	0.9	1.0	-0.5	-4.9	-5.0	-4.0
Czech Republic	-0.9	2.4	2.4	1.4	0.4	1.6	-1.4	0.1	-0.5	-1.5	-2.0	-2.5
Hungary	1.1	3.1	2.2	1.7	0.2	2.1	3.0	3.8	2.9	-2.2	-2.9	-3.0
Kazakhstan	5.9	5.0	6.0	5.8	6.6	6.2	-0.1	1.0	1.3	3.0	2.3	2.1
Poland	1.6	3.0	3.4	0.9	0.1	1.3	-1.3	-0.8	-2.0	-4.3	-3.3	-2.9
Romania	3.5	2.0	3.4	4.0	1.4	2.9	-1.1	-1.7	-3.0	-2.5	-2.3	-2.3
Russia	1.3	0.7	1.0	6.8	7.3	6.7	1.6	2.9	2.9	-2.1	-4.4	-4.9
Serbia	2.5	-0.5	2.3	7.9	2.7	5.8	-4.9	-5.3	-5.8	-5.7	-6.5	-6.5
Slovakia	0.9	2.3	2.6	1.4	-0.1	1.2	2.1	0.3	-0.3	-2.8	-3.0	-2.8
Turkey	4.1	3.5	3.5	7.5	9.0	6.7	-7.9	-5.3	-5.5	-1.2	-2.8	-3.2
Ukraine	0.0	-5.5	1.5	-0.3	11.0	12.6	-9.0	-3.7	-2.1	-6.5	-6.1	-4.1
Africa/Mideast	4.2	3.7	4.5	4.2	4.2	4.6	11.3	9.4	6.9	2.1	0.9	-1.2
Bahrain	5.5	4.8	4.4	3.3	4.2	4.6	6.8	6.6	2.2	-3.3	-3.7	-5.4
Egypt	1.5	2.4	3.2	9.5	10.4	11.1	-1.3	-2.4	-2.1	-13.7	-11.7	-9.5
Ghana	7.1	5.1	4.0	11.7	15.2	12.5	-11.5	-10.8	-11.6	-9.0	-8.7	-7.0
Iraq	6.8	0.1	8.9	1.9	2.5	5.0	14.1	10.7	9.5	-5.9	-5.9	-4.3
Israel	3.2	2.3	2.2	1.5	0.5	0.4	2.0	1.9	1.8	-2.7	-3.0	-3.3
Jordan	2.8	3.6	3.8	5.5	2.8	3.1	-10.0	-11.7	-12.9	-5.5	-4.9	-4.2
Kenya	4.7	5.3	5.8	5.7	7.5	7.2	-9.0	-7.6	-7.5	-7.8	-6.5	-6.7
Kuwait	5.7	3.8	3.9	2.6	3.0	3.5	40.7	38.4	35.0	31.6	26.7	15.1
Lebanon	0.7	0.4	2.5	2.1	1.9	2.6	-16.4	-15.0	-14.0	-9.6	-9.8	-9.8
Nigeria	5.5	6.4	6.4	8.5	8.2	9.5	4.0	2.3	1.8	-1.6	-2.0	-1.9
Oman	3.4	4.7	4.7	2.1	1.0	0.9	6.1	7.7	4.9	0.8	-1.4	-4.5
Qatar	6.5	5.5	6.9	3.1	3.0	3.5	30.9	28.8	23.7	15.6	13.0	9.5
Saudi Arabia	4.0	4.8	4.2	3.5	2.9	3.0	17.9	14.8	9.2	8.7	6.0	0.9
South Africa	1.9	1.4	2.6	5.8	6.2	5.7	-5.6	-5.3	-4.7	-4.1	-4.1	-4.1
Tanzania	7.0	7.1	7.2	7.9	6.4	6.3	-10.2	-13.9	-12.9	-6.0	-6.4	-6.5
UAE	5.2	4.0	4.0	1.1	2.0	2.4	28.4	23.7	19.1	NA	NA	NA
Uganda	5.8	6.1	6.5	5.5	4.6	4.9	-8.2	-9.5	-10.1	-4.5	-5.3	-5.6
Zambia	6.2	6.2	6.3	7.0	7.9	6.5	0.2	-1.0	-1.5	-6.5	-5.3	-4.6
Total	4.6	4.2	4.7	4.7	4.8	5.0	2.0	2.2	1.8	-1.9	-2.5	-2.5

Source: National sources, Citi Research forecasts

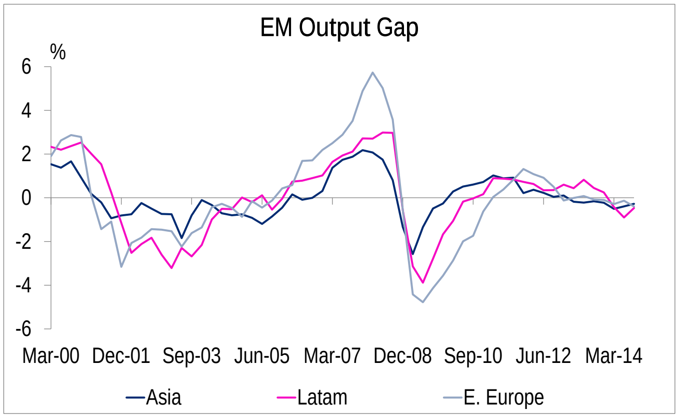
Our Forecasts vs. Consensus

Figure 24. Citi vs Consensus Forecasts

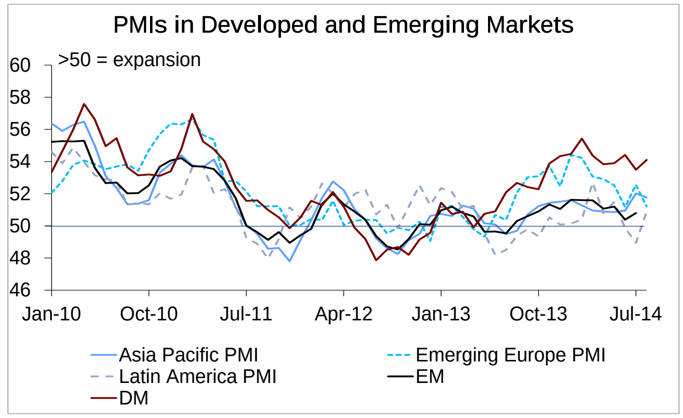
	GDP Growth (%)				CPI Inflation (%)				Current Account Balance (US$ bn)			
	2014F	Consensus	2015F	Consensus	2014F	Consensus	2015F	Consensus	2014F	Consensus	2015F	Consensus
Asia	6.2%	6.2%	6.2%	6.3%	3.2%	3.3%	3.3%	3.5%	421	378	419	362
China	7.3	7.4	6.9	7.2	2.3	2.4	2.6	2.9	233	213	259	214
Hong Kong	2.6	3.0	3.3	3.2	4.0	3.8	3.6	3.5	8	5	9	6
India	5.6	5.4	6.5	6.2	8.0	7.9	6.5	6.9	-37	-44	-44	-52
Indonesia	5.1	5.2	5.1	5.6	6.2	6.1	6.7	5.8	-28	-24	-27	-21
South Korea	3.9	3.6	4.0	3.7	1.6	1.7	2.6	2.4	76	78	49	65
Malaysia	5.7	5.3	5.6	5.0	3.0	3.2	3.9	3.6	18	16	20	17
Philippines	6.3	6.2	6.5	6.2	4.3	4.3	3.5	3.9	10	9	11	9
Singapore	3.1	3.4	3.2	3.9	1.2	1.8	0.9	2.3	59	56	65	58
Sri Lanka	7.7	7.2	7.5	7.0	3.3	5.6	5.6	6.3	-2	-3	-3	-3
Taiwan	3.6	3.5	4.0	3.6	1.5	1.4	2.0	1.8	56	58	56	58
Thailand	1.2	1.2	3.9	4.2	2.2	2.4	2.1	2.7	20	7	16	6
Vietnam	5.4	5.5	5.7	5.8	4.5	5.4	5.8	6.3	9	6	8	5
Latin America	1.2%	1.1%	2.3%	2.2%	12.0%	11.8%	12.5%	10.0%	-134	-135	-137	-138
Argentina	0.0	-1.7	-1.0	0.0	26.3	29.3	37.0	27.7	-6	-5	-5	-6
Brazil	0.1	0.4	1.0	1.1	6.4	6.3	6.8	6.2	-82	-81	-84	-78
Chile	1.8	2.1	3.0	3.2	4.4	4.2	3.0	2.9	-5	-4	-7	-6
Colombia	4.8	4.9	5.2	4.7	3.3	3.3	3.2	3.2	-14	-14	-15	-15
Mexico	2.6	2.5	3.9	3.8	3.9	3.9	3.3	3.5	-25	-25	-27	-28
Panama	6.2	6.6	5.5	6.4	2.4	3.5	2.6	3.5	-4	-5	-4	-5
Peru	3.5	3.9	4.9	5.3	3.1	3.0	2.5	2.7	-12	-10	-12	-10
Venezuela	-1.0	-2.9	1.9	-0.2	75.0	68.5	80.0	57.5	15	9	18	9
Europe	1.7%	1.3%	2.2%	2.1%	5.8%	5.9%	5.5%	5.2%	9.9	-0.8	-2.8	-21.0
Bulgaria	1.5	1.6	2.5	2.3	-1.0	-0.8	2.2	1.5	0.3	0.3	-0.5	-0.3
Croatia	-0.7	-0.6	1.2	0.5	-0.1	0.1	2.5	1.5	0.6	0.6	-0.3	0.3
Czech R	2.4	2.6	2.4	2.6	0.4	0.5	1.6	1.9	0.2	-1.0	-0.9	-2.0
Hungary	3.1	3.1	2.2	2.3	0.2	0.2	2.1	2.5	4.4	3.9	3.4	3.3
Kazakhstan	5.0	4.9	6.0	5.3	6.6	7.3	6.2	6.2	2.1	3.7	2.9	2.0
Poland	3.0	3.2	3.4	3.4	0.1	0.3	1.3	1.5	-4.1	-7.3	-9.6	-11.7
Romania	2.0	2.5	3.4	3.2	1.4	1.6	2.9	2.8	-3.2	-2.8	-5.4	-3.6
Russia	0.7	0.1	1.0	0.8	7.3	7.5	6.7	6.0	56.5	51.7	54.8	42.6
Slovak Rep	2.3	2.4	2.6	2.9	-0.1	0.2	1.2	1.5	0.3	1.9	-0.2	1.8
Turkey	3.5	3.0	3.5	3.5	9.0	8.8	6.7	7.0	-42.3	-47.2	-44.0	-49.2
Ukraine	-5.5	-6.5	1.5	0.6	11.0	10.7	12.6	9.7	-4.8	-4.6	-2.9	-4.2
MEA	3.7%	3.7%	3.8%	4.3%	5.0%	5.1%	5.2%	5.3%	107.0	110.2	64.0	86.8
Egypt	2.4	2.3	3.2	3.3	10.4	8.6	11.1	8.5	-6.8	-6.6	-6.4	-8.4
Israel	2.3	3.2	2.2	3.5	0.5	1.5	0.4	2.3	5.9	7.4	5.2	8.2
Nigeria	6.4	6.8	6.4	6.7	8.2	8.4	9.5	8.9	12.8	13.1	11.7	11.8
S. Africa	1.4	1.9	2.6	2.8	6.2	6.3	5.7	5.8	-17.7	-18.7	-16.5	-18.1
S. Arabia	4.8	4.1	4.2	4.6	2.9	3.3	3.0	3.7	112.8	115.0	70.0	93.3
Above Total	4.3%	4.2%	4.7%	4.7%	5.5%	5.5%	5.5%	5.1%	410.5	359.1	349.4	298.5

Source: Consensus Economics, National Sources, Citi Research forecasts

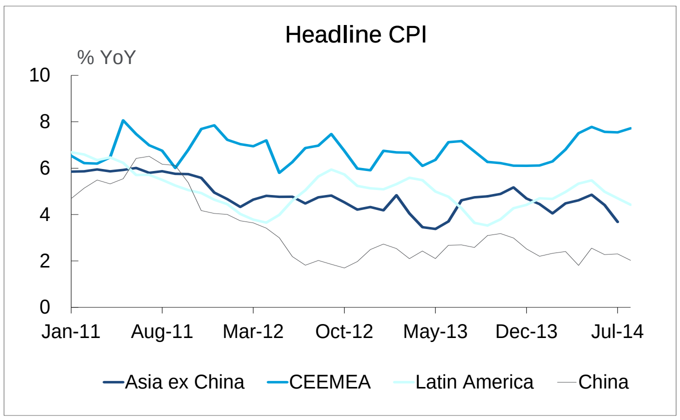
EM: Most requested regional charts



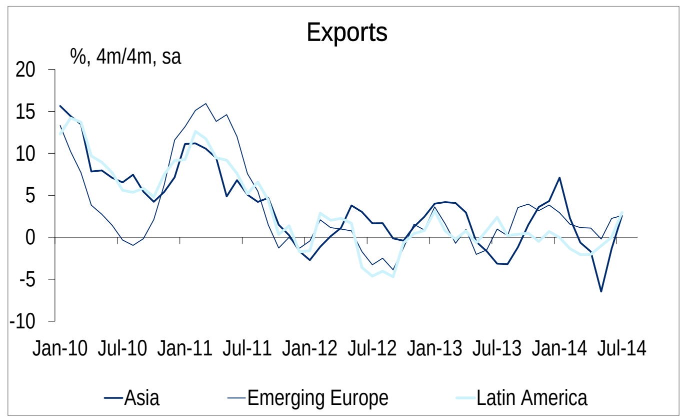
Source: Haver Analytics, Citi Research. Note: Shaded sections mark recession periods.



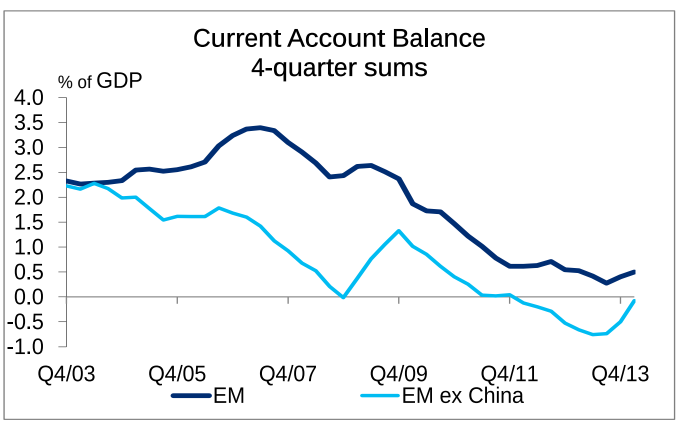
Source: Haver Analytics, Citi Research



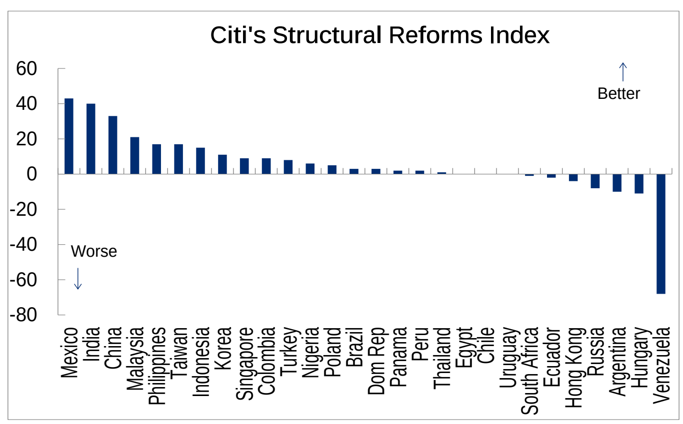
Source: Haver Analytics, Citi Research



Source: Haver Analytics, Citi Research



Source: Haver Analytics, Citi Research



Source: Citi Research

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- **Summary view** – The Aug data suggest the property drag is spreading to its production chain, and the impact cannot be fully offset by stronger exports and targeted policy easing. We cut GDP growth forecasts to 7.3% for 2014 and 6.9% for 2015 to reflect delay in policy response, and expect three policy rate cuts from now to 1H15.

- **Things to watch** – Recent policy changes have been slow relative to the deteriorating property sector growth. We expect policy-makers will stick to targeted easing, including removal of HPR, mortgage loan rate cuts, more fiscal spending, but broad-based rate cuts would be necessary to mitigate the downside risk of the property sector.

- **Strategy** – We expect the cost of funding continue to soften alongside targeted easing and possible rate cuts. A sizable trade surplus this year due to improved external demand paired with recessive domestic demand may continue to support the RMB. We expect 6.13 on a 0-3m month horizon due to stronger US dollar and 6.04 for the 6-12 month horizon.

Trimming growth forecasts amid property-led slowdown

Property sector slowdown is spilling over to a larger part of the economy. With housing sales registering negative growth since the beginning of the year, real estate investment growth moderated to 13.2%YoY in Jan-Aug from nearly 20% in 2013. Infrastructure investment growth also decelerated from 25%YoY in Jan-Jul to 23.5%YoY in Jan-Aug, likely reflecting funding constraints faced by local governments as land sales stagnated. Upstream industries of the property sector also suffered from the housing market correction: compared with Jan-Jul, the production growth of steel, cement and plain glass fell by 1.3ppts, 0.5ppts and 5.6ppts, respectively. Retail sales of home appliances, furniture and construction materials all saw slower growth. More strikingly, industrial production growth plummeted to 6.9%YoY, the third-slowest monthly growth since 1995.

We revised our 2014 growth forecast down to 7.3% from 7.5% to reflect delays in policy response. RMB credit and total social financing data for Jul-Aug suggest relatively weak demand for credit amid the property market correction, partly because the cost of borrowing has been elevated in real terms. The government accelerated fiscal spending earlier this year but, with the total budget unchanged, fiscal spending will have to grow less for the rest of year. This would be a drag on growth in 4Q and early next year. Stagnating land sales revenue would weigh on investment late this year and early next year. We therefore downgrade the 2014 growth forecast, and trim our 2015 growth forecast from 7.1% to 6.9%.

We expect targeted easing to be followed by broad-based easing. Home purchase restrictions will likely be abolished in most cities. Local governments may turn low-end residential property into social housing. Mortgage loan rates for first-home buyers may be cut to support demand. We think these measures may turn out to be insufficient, and broad-based rate cuts would be needed to mitigate the downside risk of the property sector. We now expect three policy rate cuts, 25bps each, from now on to mid-2015. This would bring the benchmark deposit rate to 2.25%, leading to a real interest rate of around zero.

How to make up the property loss in the near-term?

First, net exports may improve due to deteriorating import growth in 2H. Despite the pressure on export growth, net exports recorded strong growth since 2Q. In Jul-Aug, net exports surged by 109.6% yoy, indicating a positive contribution to 3Q GDP growth, which had already picked up from -1.4ppts in 1Q to 0.86ppts in 2Q. Though part of the net exports gain is captured by industrial production, it may have partially mitigated the impact of investment slowdown.

Second, the service sector may have benefited from the removal of some entry barriers and deregulation. The service sector has often served as an official growth buffer during economic downturns. It's more likely so this year due to administrative reform. According to the State Administration for Industry and Commerce, there were 2.33mn newly registered enterprises in Jan-Aug, and 78.5% of them fell into the services sector, which may imply resilient growth in this sector, supportive to economic growth in the near term.

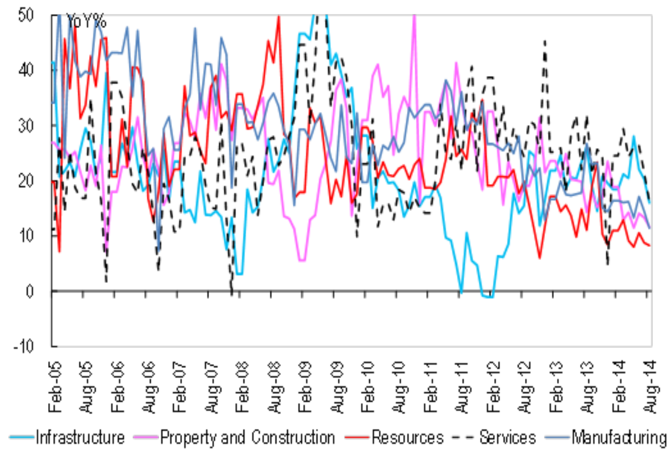
Third, more projects will likely be launched to partially offset the property downturn. Premier Li Keqiang argued that China's demand is suppressed mainly because of supply constraints, and thus the government will release the demand through supply-side reform. Three areas were highlighted with short supply: 1) more projects will be launched for environmental protection, particularly air and water pollution reduction; 2) medical and healthcare service is another area to meet rising demand, and the focus is on more investment in hospitals and aging care services, and developing commercial healthcare insurance; and 3) China will promote energy-saving technologies and the use of clean energy, with more projects in wind, hydro, solar and nuclear power to be rolled out.

Fourth, investment in social housing/slum rehabilitation can lift property investment growth at the margin this year. Fiscal spending on slum rehabilitation had increased steadily in recent years. In 2010-2013, fiscal spending recorded Rmb23.1bn, Rmb55.5bn, Rmb58bn, and Rmb72.3bn, respectively, and about 2.8mn, 4mn, 3mn and 3.04mn units of apartments were built over the same period of time. In 2014, about 4.7mn units will be reshuffled, with total investment of Rmb500bn, or about 5.1% of property investment in 2014 (assuming property investment growth remains unchanged at the Aug level of 13.2%), up from 2.4% last year. Based on these numbers, the direct impact of this investment on GDP growth will likely be around 0.35ppts, or about 0.6-1.1ppts if the investment is made during the year and the indirect spill-over impact is fully factored in.

However, these mark-ups could disappear next year due to high base this year and the property sector spill-over impact could be exacerbated in 1H 2015. A more likely scenario is that the growth target is set at around 7% in 2015. In this circumstance, further policy easing looks inevitable.

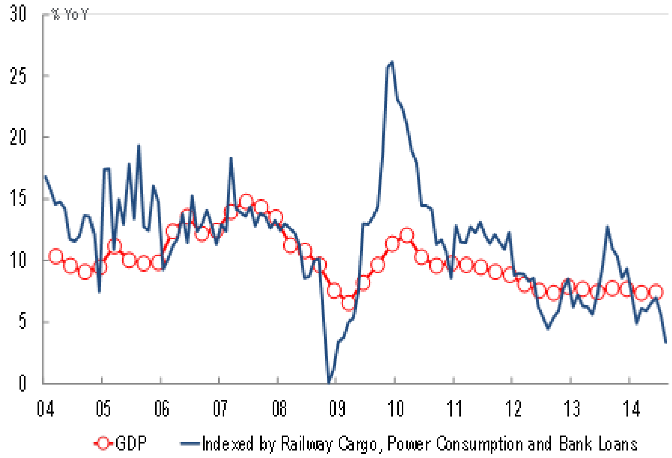
The ultimate purpose of cyclical policy easing is to bring up reforms in the near term. We view reform as a better solution and longer-term cure to the old growth model. What matters to market confidence is reform, not growth. Sensible reforms are wanted in coming quarters as the market expects policy breakthroughs in *hukou* reform, SOE reform and fiscal reform. *Hukou* reform should allow the market to assess how many migrant workers and their family members would be urbanized. SOE reform would target efficiency gains in investment and asset allocation. Fiscal policy can be more positive to bear a significant portion of the transition cost.

Figure 25. FAI growth sector breakdown



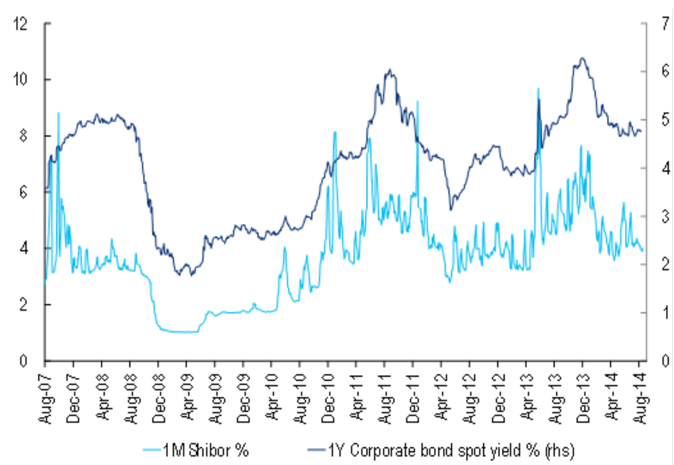
Source: NBS, CEIC and Citi Research

Figure 26. Li Keqiang Index fell to a new low after global financial crisis



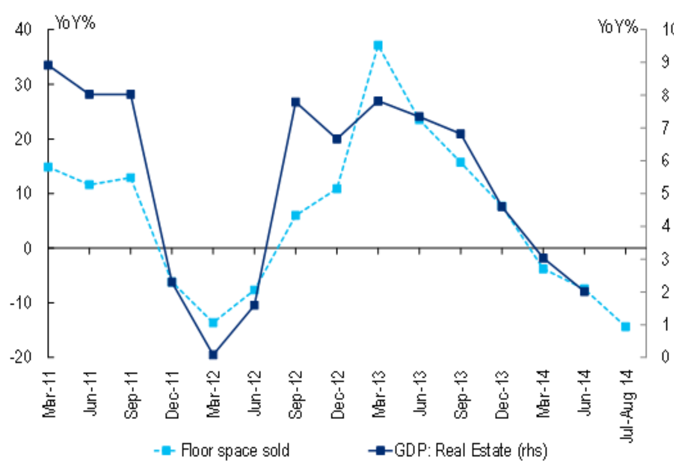
Source: NBS, CEIC and Citi Research

Figure 27. Interbank rate vs. corporate bond yield



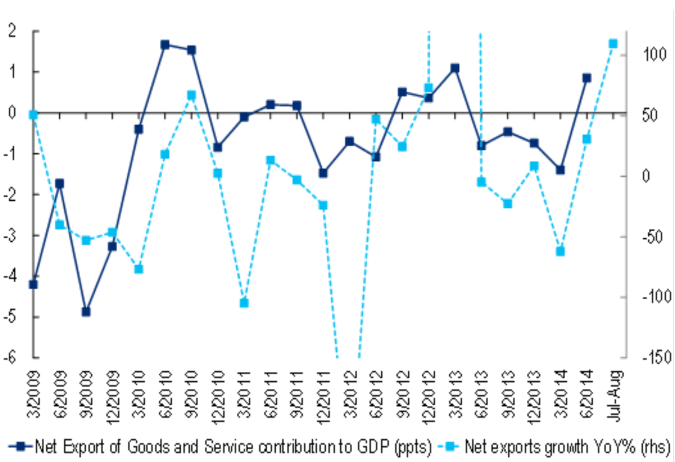
Source: NBS, CEIC and Citi Research

Figure 28. Real estate GDP vs. transaction volumes of the real estate



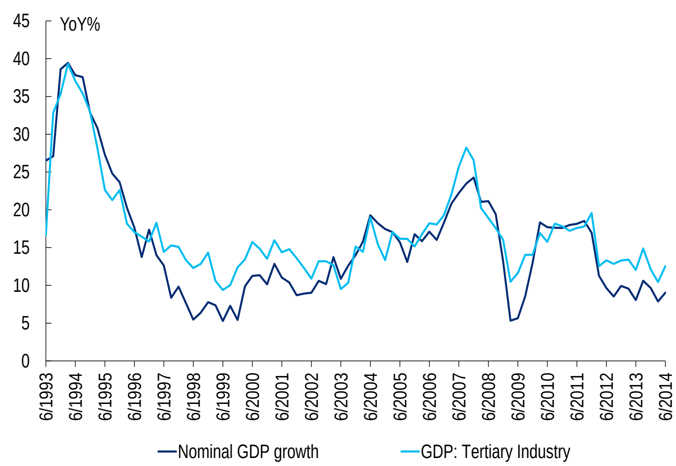
Source: NBS, CEIC and Citi Research

Figure 29. Net export growth and its contribution to GDP growth



Source: NBS, CEIC and Citi Research

Figure 30. Service sector GDP growth vs. GDP growth in nominal terms



Source: NBS, CEIC and Citi Research

Figure 31. China Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	3,494.5	4,544.0	5,070.5	5,932.5	7,319.0	8,246.9	9,245.4	10,132.2	11,262.2
Nominal GDP, local currency bn	26,583	31,490	34,632	40,151	47,310	51,947	56,885	62,361	67,982
GDP per capita, US$	2,645	3,422	3,800	4,424	5,432	6,091	6,794	7,417	8,222
Population, mn	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,360.7	1,366.2	1,369.7
Unemployment, % of labour force	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2	4.2
Economic Activity									
Real GDP, % yoy	14.2	9.6	9.2	10.4	9.3	7.7	7.7	7.3	6.9
Real investment growth % yoy	14.4	11.0	19.2	11.9	9.4	8.1	8.7	6.8	6.5
Real consumption growth % yoy	11.0	8.5	9.4	9.2	10.9	8.3	7.9	7.2	7.1
private consumption growth % yoy	11.1	9.2	10.3	8.5	18.2	7.8	7.2	7.4	7.3
Real export growth, % yoy	--	--	--	--	--	--	--	--	--
Real import growth, % yoy	--	--	--	--	--	--	--	--	--
Prices, Money & Credit									
CPI, % yoy	6.5	1.2	1.9	4.6	4.1	2.5	2.5	2.6	2.8
CPI, % avg	4.8	5.9	-0.7	3.3	5.4	2.6	2.6	2.3	2.6
Nominal wages, % yoy	18.5	16.9	11.6	13.3	14.4	11.9	9.5	9.6	9.0
Credit extension to private sector, % yoy	19.3	14.0	33.2	20.3	15.1	15.6	14.1	14.1	13.1
Policy interest rate, % eop	4.14	2.25	2.25	2.75	3.50	3.00	3.00	2.75	2.25
Short-term market rate, % eop	3.61	1.23	1.79	6.17	6.00	4.90	5.91	5.50	5.00
Long term yield, % eop	4.19	1.80	3.06	3.61	3.27	3.33	4.49	3.74	4.20
lc/US$, eop	7.30	6.82	6.83	6.59	6.29	6.23	6.05	6.10	6.02
lc/US$, avg	7.61	6.95	6.83	6.77	6.46	6.31	6.15	6.17	6.04
Balance of Payments, US$ bn									
Current account	353.2	420.6	243.3	237.8	136.1	215.4	182.8	233.0	259.0
% of GDP	10.1	9.3	4.8	4.0	1.9	2.6	2.0	2.3	2.3
Trade balance	264.3	298.1	195.7	181.5	154.9	230.3	259.2	331.7	388.6
Exports	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.7	2,209.5	2,322.3	2,478.7
Imports	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,818.4	1,950.3	1,990.6	2,090.2
Service balance	-7.9	-11.8	-29.4	-31.2	-61.6	-89.7	-124.5	-137.0	-150.7
Income balance	8.0	28.6	-8.5	-25.9	-70.3	-19.9	-43.8	-13.6	-19.2
FDI, net	139.1	114.8	87.2	185.7	231.7	176.3	185.0	170.3	118.1
International reserves	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,821.3	4,119.5	4,386.2
Total Amortisations	20.3	23.3	34.2	27.2	33.2	33.0	39.2	41.2	45.3
Public Finances, % of GDP									
Consolidated government balance	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-1.9	-2.1	-2.0
Consolidated gov primary balance	1.0	0.1	-1.8	-1.7	-0.9	-1.5	-1.4	-1.6	-1.5
Public debt	39.0	37.4	47.8	49.2	44.3	53.5	53.7	53.8	53.4
of which Domestic	38.0	36.6	47.0	48.6	43.7	53.0	53.3	53.4	53.1
Foreign Assets & Liabilities, US$ bn									
External debt	389.2	390.2	428.6	548.9	695.0	737.0	863.2	949.5	1,044.4
Private	354.3	356.9	391.8	510.1	657.6	700.4	828.8	911.7	1,002.9
Public	34.9	33.3	36.9	38.8	37.4	36.6	34.3	37.8	41.5
External debt / GDP	11.1	8.6	8.5	9.3	9.5	8.9	9.3	9.4	9.3
External debt / XGS	29.0	24.7	32.2	31.5	33.4	32.8	35.6	37.3	38.4
Short-term debt	235.7	226.3	259.3	375.7	500.9	540.9	676.6	744.3	818.7
Short-term debt/International Reserves (%)	15.4	11.6	10.8	13.2	15.7	16.3	17.7	18.1	18.7

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	7.4	7.5	7.2	7.1	6.9	6.7	7.0	7.1	6.6
CPI, % yoy	2.4	2.3	2.2	2.6	2.6	2.5	2.4	2.8	2.7
Policy interest rate, % eop	3.00	3.00	3.00	2.75	2.50	2.25	2.25	2.25	2.25
Short-term market rate, % eop	4.62	5.00	4.94	5.50	3.87	4.30	3.89	4.57	3.62
Long term yield, % eop	4.21	3.84	3.64	3.74	3.95	4.10	3.96	4.20	4.19
lc vs USD, eop	6.22	6.20	6.14	6.10	6.07	6.04	6.03	6.02	6.02

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

Hong Kong

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- **Summary view** – Our 2014-15 GDP forecasts are cut to 2.6% and 3.3%, on renewed China slowdown and a fall in tourist spending. The imminent launch of Shanghai-HK Stock Connect is a game changer for the CNH market. A potential Occupy Central over 1-2 Oct is likely to cause minimal business disruption.
- **Things to watch** – 1) Liquidity concerns on taper; 2) trade recovery and property market adjustment; 3) tourist shopping trends (volume vs. value/pax); 4) electoral reforms; 5) cooperating measures with Qianhai and Shanghai FTZ/stock exchanges; 7) changes to personal RMB conversion quota.
- **Strategy** – Pressure for interest rate increases will resurface as we come closer to the likley end of tapering in Oct. HKMA intervention is expected to continue with the HKD near its strong end. Citi's house view is for mass-market home prices to stay flat in 2014E and the HSI target for 2014 year-end is 25,000.

Signs of economy slowing down

GDP downgrade: We cut our HK GDP forecast to 2.6%YoY for 2014 and 3.3% for 2015 after the release of 2Q GDP. We worry that a China slowdown would impact HK in several ways: lower exports to China for domestic use, delayed equipment and machinery purchases on a dismal China-related business outlook and also lower numbers of Chinese tourist arrivals and spending proceeds. We are more convinced of HK's GDP downgrade after Citi's recent downgrade to China's GDP forecast from 7.5%YoY to 7.3% for this year on imminent and lasting negative impact of property investment growth despite cyclical easing and stimulus. Citi further expects a RRR cut and three 25bps policy rate cuts in the upcoming three quarters will help alleviate the growth slump in China, and maintain 7.1%YoY GDP growth for 2015; which in turn will also help cap downside stress to HK.

Leading indicators also confirm economy is slowing: Markit PMI slipped into the contraction zone in Aug at 49.6, suggesting a cyclical slowdown with new orders contracting for a fourth consecutive month and new business from China falling again. Meanwhile the 3Q business tendency survey showed industries like trade, retail, accommodation and food services are in a deteriorating or contraction mode.

Retail sales in a 6-month decline as of July. Retail sales value and volume growth fell 3.1%YoY and 4.5%YoY, respectively, in July. Seasonally adjusted numbers also showed a declining trend. Especially, the typical goods that tourists favored continue to suffer, for example luxury goods like jewelry, watches, and valuable gifts (-22.2%YoY in July), electronics/photographic equipment (-10.4%YoY) and misc. consumer durable goods (this category includes smartphones and tablets, -16.6%YoY). We expect tourist spending per pax and tourist arrivals will continue to fall in the near term, an inevitable outcome of China's anticorruption moves, moderating economy and possibly changes in visa policy.

Fewer tourist arrivals and less spending per pax? Lower tourist spending will drag on GDP, affecting components of consumption and export of services. Latest smartphone model sales may not be as popular among Chinese tourists as many have previously hoped, which means the lift in Sep/Oct from misc. consumer durable goods is likely be decent but not stellar. We believe downward adjustments to shop sales expectations, hiring and store rentals are in progress. We expect the unemployment rate is likely to edge up to 3.5%sa by year end from 3.1% seen in Feb 14. Note that 17% of HK's employment is related to the retail sector, accommodation & food services.

Imminent launch of Shanghai-HK Stock Connect

Upcoming launch of Shanghai-HK Stock Connect. We expect the program to start either on 13 or 20 Oct (more likely the latter). Our understanding is all the pilot user-testing trials went well and it is ready to start operations when the program starts. However, the Chinese authorities have yet to clarify whether participants in Stock Connect may be subjected to capital gains tax (CGT) arising from the trading of A-shares, and where the CGT collection responsibility would lie is unclear.

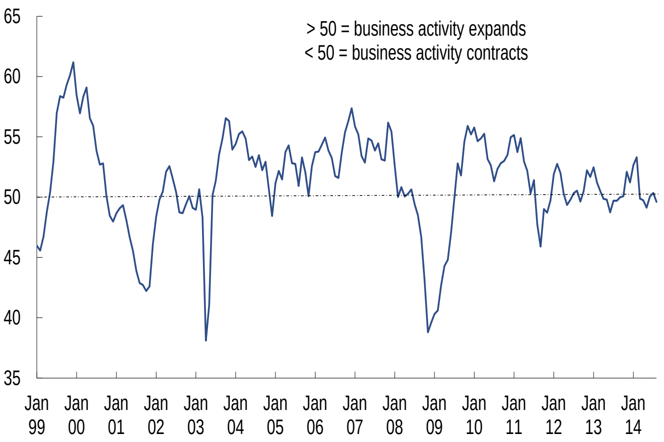
Stock Connect will increase liquidity in HK over time. We believe the Connect program will be a game changer for the dynamics of both markets and it will provide the accumulated CNH in HK a higher-yielding investment route back onshore and increase the multiplier of RMB in offshore centers. The Southbound scheme will provide a straightforward alternative for Mainland investors (including retail investors, who are currently not eligible for the QDII scheme) to access 82% of HK equity market capitalization (including 78 large-cap. stocks and 163 mid-cap. stocks in the Hang Seng Index, as well as the 68 dual-listed shares). The Northbound scheme, will also allow HK and overseas institutional and individual investors to access 90% of the Shanghai stock exchange's market cap (including all constituent stocks of the SSE 180 and 380, plus all dual-listed shares). The Northbound scheme will allow previously prohibited clients (like hedge funds, retail investors and investors located in jurisdictions which do not qualify for QFII or RQFII) access to A-shares for the first time through the HK platform.

HKMA and BOC will step up on providing RMB liquidity. One of the previous headaches for brokers and financial institutions to prepare for the implementation of the Connect program was to have enough RMB readied for all northbound stock purchases by 6pm of the transaction day. HKMA is planning to launch two new measures to help facilitate: (1) a new intraday repo facility where banks can borrow RMB from HKMA using eligible collaterals (likely to be EFB&Ns, HKSAR Gvt Bonds, the MOF dim sum bonds); and (2) assign 5-6 banks as Primary Liquidity Providers to provide intraday and overnight RMB liquidity to the rest of the market on behalf of HKMA. The two programs plan to provide up to RMB10bn of liquidity per day, and this should suffice the RMB needs as daily maximum northbound cap is set at RMB13bn. BOC – HK's yuan clearing bank -- currently also provides intraday repurchase facility for loans in RMB (around RMB50-60mn), and it also is in consideration to expand the list of collaterals that it accepts (currently include offshore sovereign and policy bank bonds). HKMA and PBOC are also in talks to lift the personal RMB conversion quota ahead of the Connect program launch.

Political update

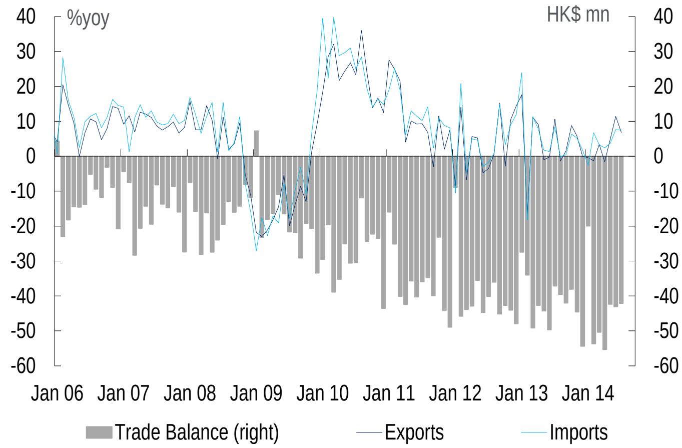
Political heat still escalating: The differing stance between Chinese Government and HK's democratic parties has always been wide and Beijing's final decision of the Chief Executive nominee has to be pre-selected by 50% of the nomination committee is not really surprising. However, democrats considered Beijing's decision on HK's electoral reform as a closing of dialogue and we expect waves of protests to follow. University and high school students have started a week-long class boycotts on 22 Sep. We think the large protest planned by pro-democracy groups on 1 Oct could turn into the official Occupy Central event. Given that 1-2 Oct are public holidays, the resulting business disruption will likely be kept to a minimum, but police clearance and arrests appear unavoidable. The second phase of public consultation on political reform will start soon after 8 Oct, putting forward more specific suggestions (e.g. the formation and representative mix of the nomination committee, the nominee voting protocol), hoping to forge consensus to enable legislation to be drafted and to be voted by legislators by summer 2015.

Figure 32. PMI retreated into contraction zone in Aug



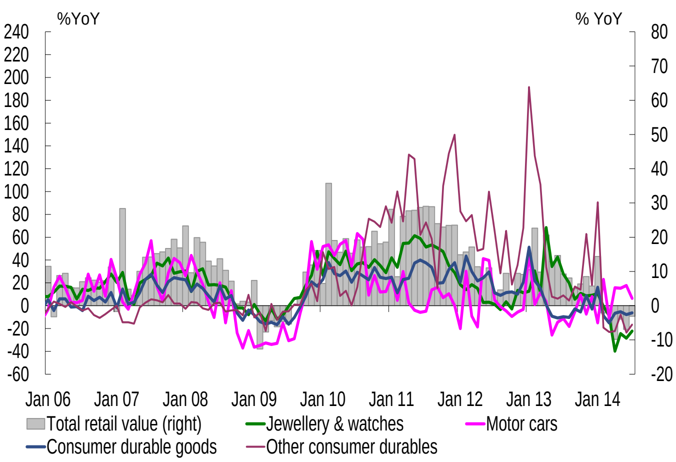
Source: Markit, Haver, Citi Research

Figure 33. Trade recovery likely to improve in 2H



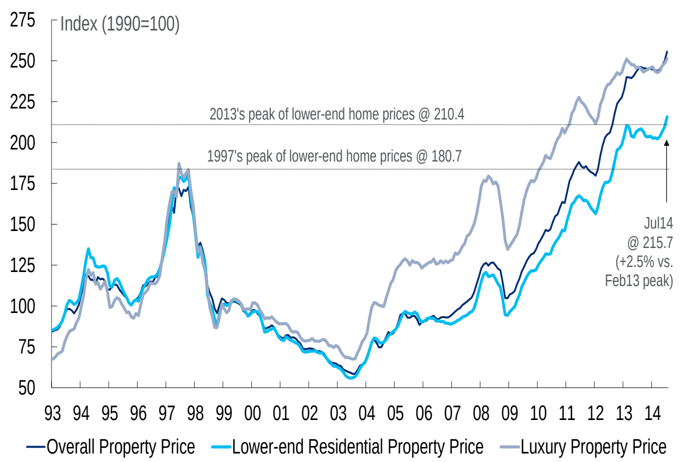
Source: CEIC, Citi Research

Figure 34. Retail sales slowing notably, as tourists spend less



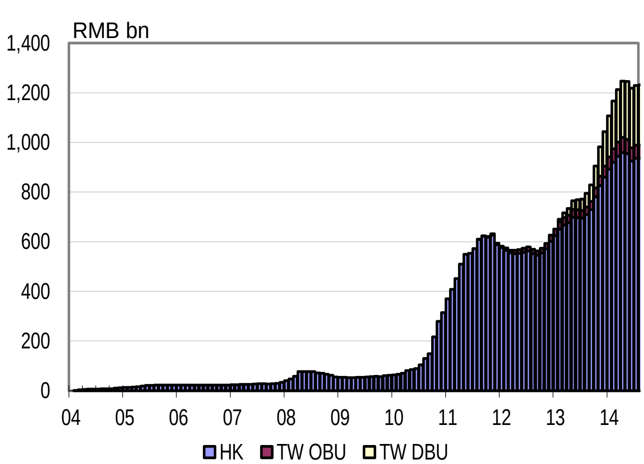
Source: CEIC, Citi Research

Figure 35. Price re-climbing for mass market residential property



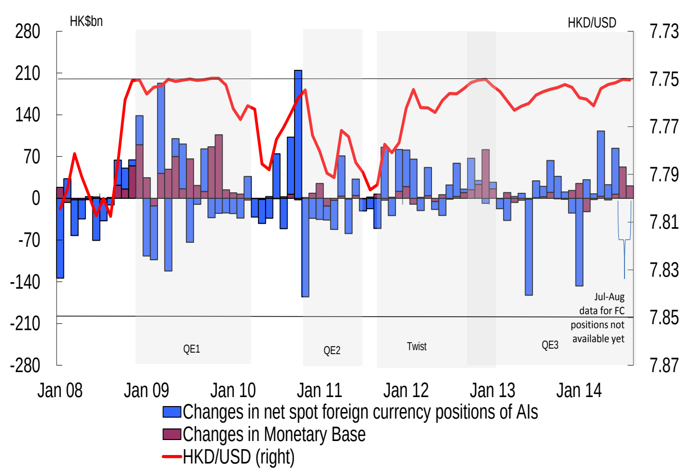
Source: CEIC, Citi Research

Figure 36. Offshore RMB deposits in HK+TW stays abundant



Source: CEIC, Citi Research

Figure 37. Net inflows continued in Jun14; HKD triggering strong end



Source: CEIC, Citi Research

Figure 38. Hong Kong Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	211.6	219.3	214.1	228.7	248.5	262.6	274.0	283.9	298.9
Nominal GDP, local currency bn	1,651	1,707	1,659	1,776	1,934	2,037	2,125	2,201	2,316
GDP per capita, US$	30,495	31,491	30,595	32,424	34,941	36,587	37,942	39,192	41,137
Population, mn	6.9	7.0	7.0	7.1	7.1	7.2	7.2	7.2	7.3
Unemployment, % of labour force	4.0	3.5	5.3	4.3	3.4	3.3	3.4	3.3	3.5
Economic Activity									
Real GDP, % yoy	6.5	2.1	-2.5	6.8	4.8	1.5	2.9	2.6	3.3
Real investment growth % yoy	7.9	-0.3	1.0	11.1	2.3	3.5	3.7	3.6	1.2
Real consumption growth % yoy	7.9	1.9	0.5	5.8	7.6	4.0	4.0	2.0	2.3
private consumption growth % yoy	8.6	1.9	0.2	6.1	8.4	4.1	4.2	1.9	2.4
Real export growth, % yoy	8.3	2.5	-10.0	16.8	3.9	1.9	6.5	2.8	6.3
Real import growth, % yoy	9.1	2.2	-9.0	17.4	4.6	2.9	6.9	2.7	5.7
Prices, Money & Credit									
CPI, % yoy	3.8	2.1	1.5	2.9	5.7	3.8	4.3	3.5	3.5
CPI, % avg	2.0	4.3	0.6	2.3	5.3	4.1	4.3	4.0	3.6
Nominal wages, % yoy	2.4	4.0	-1.9	2.4	9.9	4.7	4.9	4.5	4.5
Credit extension to private sector, % yoy	15.2	11.0	-2.1	20.9	12.5	7.0	10.6	11.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	3.45	0.95	0.14	0.28	0.38	0.40	0.38	0.50	1.20
Long term yield, % eop	3.10	1.19	1.93	1.76	0.96	0.32	1.40	1.75	2.40
lc/US$, eop	7.80	7.75	7.75	7.77	7.77	7.75	7.75	7.75	7.75
lc/US$, avg	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.75	7.75
Balance of Payments, US$ bn									
Current account	27.6	32.9	21.2	16.0	13.8	4.1	5.1	8.1	9.5
% of GDP	13.0	15.0	9.9	7.0	5.6	1.6	1.9	2.8	3.2
Trade balance	-23.1	-25.8	-28.8	-43.0	-54.9	-61.6	-64.6	-58.5	-63.1
Exports	344.5	362.7	318.5	390.2	428.7	442.8	458.9	495.6	530.8
Imports	367.6	388.6	347.3	433.1	483.6	504.3	523.5	554.1	593.8
Service balance	-4.3	-2.7	3.6	10.1	17.0	21.9	28.5	28.6	28.1
Income balance	6.8	12.9	6.4	4.8	6.8	3.8	5.4	5.4	5.4
FDI, net	-19.0	-8.9	-6.4	-10.5	-8.7	-11.2	-10.9	-11.0	-12.0
International reserves	152.6	182.5	255.7	268.6	285.3	317.2	311.1	340.0	360.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	7.3	0.0	1.5	4.1	3.8	3.1	1.0	1.3	0.7
Consolidated gov primary balance	7.4	0.0	1.6	4.2	3.8	3.2	1.0	1.3	0.7
Public debt	1.2	1.0	0.7	0.6	0.6	0.5	0.5	1.0	1.4
of which Domestic	0.4	0.2	0.1	0.0	0.0	0.0	0.0	0.1	0.1
Foreign Assets & Liabilities, US$ bn									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	2.6	1.8	2.7	3.1	2.9	2.4	3.9	3.8	4.0
CPI, % yoy	3.9	3.6	5.9	3.3	3.5	3.6	3.4	3.3	3.3
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.38	0.38	0.45	0.50	0.60	0.80	1.00	1.20	1.40
Long term yield, % eop	1.45	1.36	1.50	1.75	2.00	2.15	2.30	2.40	2.60
lc vs USD, eop	7.76	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates.
*Note: Public debt is general government debt.

India

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- **Summary view** – The acceleration in 1QFY15 GDP reinforces our view that Indian economy may indeed be turning a corner. The on-going macro stabilization process has led to resilience in INR and record-high equity markets.
- **Things to watch** – The markets will watch out for RBI's forward guidance on 30 Sept 30 for the rates trajectory. Other key domestic events include state assembly elections in Oct and decision by Supreme Court on the coal imbroglio.
- **Strategy** – Despite the 25%+ run up in Sensex this year and upcoming supply, equities remain the preferred asset class. On bonds, an improving inflation outlook could drive the 10yr yield to 8.25%-8.5%, while INR is likely to trade in a 59-62 band.

Macro stabilization pays off; INR stable in recent sell-off

India a turnaround story. A lot has changed since the taper tantrums last year which led to the INR depreciating to record lows of Rs68.3/US$. From an undesirable mix of sub-par growth, high inflation, elevated twin deficits in FY13, India is now looking at a pick-up in growth, moderating inflation and sharply lower current account deficits. To be sure, there is a cyclical component to the recovery, but the changing dynamics on political front and RBI has clearly helped

INR stable in recent sell-off. In the recent bout of EM risk aversion (UST yields up +20bps in Sep), the rupee has remained relatively stable within the 60-61 range, while several EM currencies have depreciated by 2% to 5%. Note that INR was the worst performer among the fragile five currencies last year. The recent outperformance indicates markets differentiating between EMs. While the macro is turning, we believe that India is not entirely immune and cannot afford to lower its guard.

Real economy: 1Q GDP accelerates; recovery on track

Turning a corner: The quarterly GDP data released earlier this month reinforce our view that the Indian economy may indeed be turning a corner. GDP growth accelerated to 5.7%YoY in 1QFY15 vs 4.6% in 4QFY14 with encouraging trends seen across supply and demand side components. Notably, a sharp upturn was seen in the capital expenditure which rose to a two-year high of 7%. Incorporating the 1Q data, we maintain our view of FY15 GDP growth at 5.6% with risks balanced on both sides. The upside could come from investments growth (thanks to PMG de-bottlenecking), while the downside could be from cutbacks in government spending.

On track for 7% GDP. While the process of macro stabilization has begun in earnest, there's still a long way to go. As observed in our latest macro trip, the pro-business Modi government has not only revived investor sentiment but is equally focused on policy reforms and execution e.g. (1) unlocking investments through PMG, (2) implementing fiscal reforms e.g. GST, expenditure commission, (3) financial inclusion scheme, (4) cutting red tape through online environment/forests clearance, (5) measures to contain food inflation and (6) delivering infrastructure and easier financing norms. These measures reinforce our view that, while one could debate on pace and timing, India is on its way back to 7% growth.

Inflation: to trend in line with RBI's "glide path"

Inflation eases, further decline likely: Headline CPI has come off but still remains elevated at 7.8%YoY in August. Despite favorable base effect, food inflation has remained high due to higher vegetable prices. Encouragingly, core CPI has softened to 6.9%, a three-year low. While headline inflation data in the coming months (both WPI and CPI) are likely to be influenced by the base effect, we maintain our view that (1) late recovery in the monsoons, (2) benign global commodity prices and (3) moderation in core inflation augur well for the RBI in achieving its glide path.

Possibility of easing exists in 2015: Looking through the base effect, the underlying trends support our view that the window to ease rates could open in 2015; however, key events that could determine the timing are: (1) budget, (2) Fed normalization and (3) geo-politics/commodity prices.

Fiscal: diesel at parity; positive for ratings

Fiscal trends improve, possibility of sovereign outlook revision. Thanks to a sharp compression in expenditure and a marginal pick-up in revenues, the July fiscal deficit was down 65.2% YoY. Nonetheless, though the cumulative deficit during Apr-July is currently at 61% of full-year targets, we expect the improved momentum seen in July to continue on the back of better revenues (pick-up in tax; divestment process) and containment in expenditure (particularly fuel subsidies). This bodes well for the government meeting its 4.1% fiscal deficit target and India's sovereign credit profile.

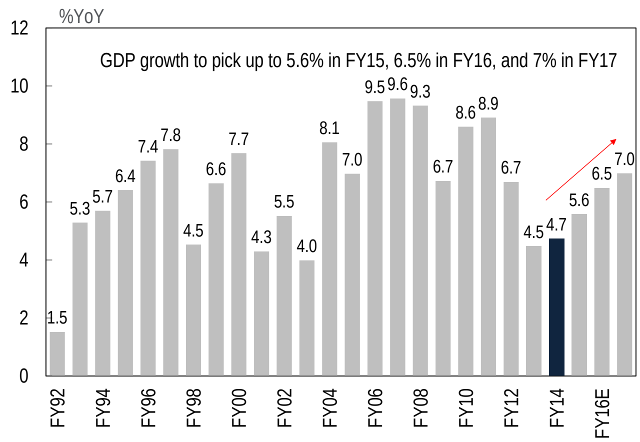
Diesel at parity. The key highlight on the fiscal front is the sharp drop in diesel under-recoveries to negligible (losses by oil marketing companies), due to lower crude, stable rupee and monthly hikes in retail prices. Going forward, the possible deregulation of diesel (similar to petrol) could structurally reduce the fiscal deficit by ~0.4-0.5% of GDP.

External: CAD in line; rupee in 59-62 range

1QFY15 CAD prints at US$7.9bn or 1.9% GDP. Following a low of US$1.3bn (0.3% of GDP) in 4QFY14, India's 1QFY15 current account deficit came in at US$7.9bn or 1.7% of GDP in 1QFY15. Despite a recent moderation in export trends and a pick-up in non-oil non-gold imports, the trade deficit has remained in check on softer oil prices and lower gold imports. As a result we continue to expect current account deficit to be contained within US$39bn or 1.9%of GDP with the balance of payment at a surplus of US$33bn.

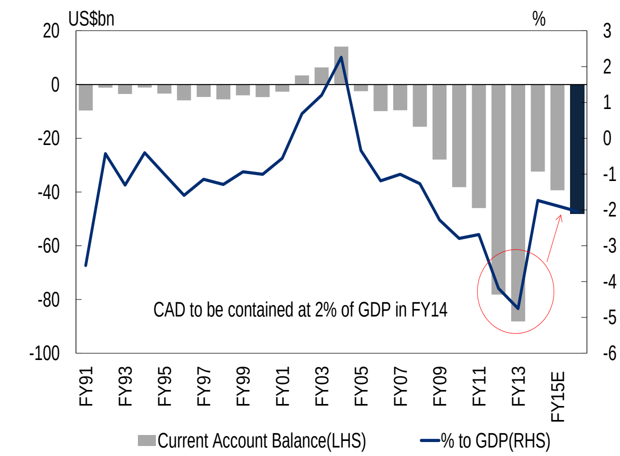
INR view. Strong capital flows this fiscal have not only allowed RBI to build up reserves to record high levels of US$317.3bn, but it has also converted RBI's net forward to positive (+US$5.4bn) for the first time in five years. We believe the build-up in reserves, a long forward position, flexibility to liberalize bond markets (e.g. higher limits, Euroclear), coupled with improving macro fundamentals, could limit the rupee depreciation in a generalized bout of EM risk aversion. We maintain our view of the rupee staying in a 59-62 range near term.

Figure 39. Trends in annual GDP growth (%YoY)



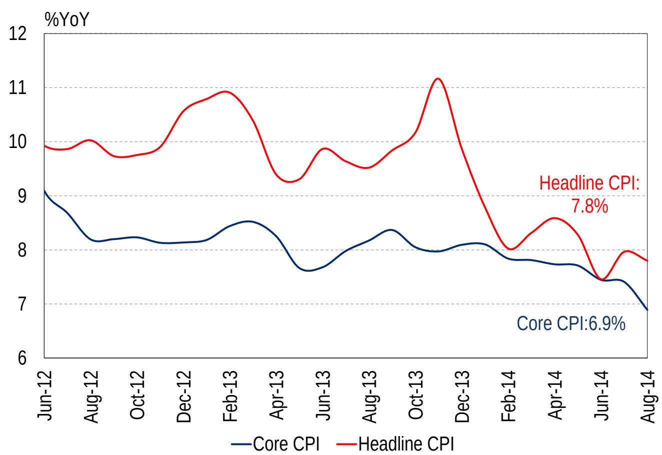
Source: CSO, Citi Research

Figure 40. Trends in current account deficit (US$bn, %GDP)



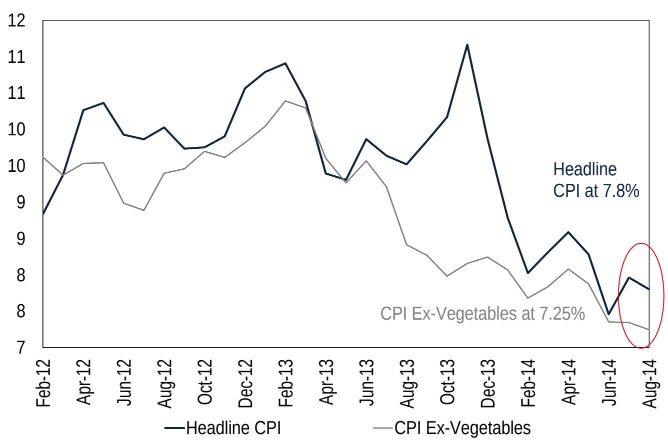
Source: CSO, Citi Research

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



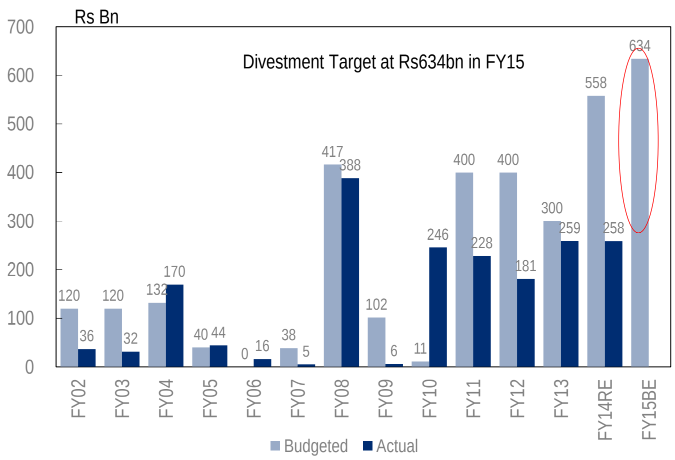
Source: CSO

Figure 42. Trends in headline CPI and CPI



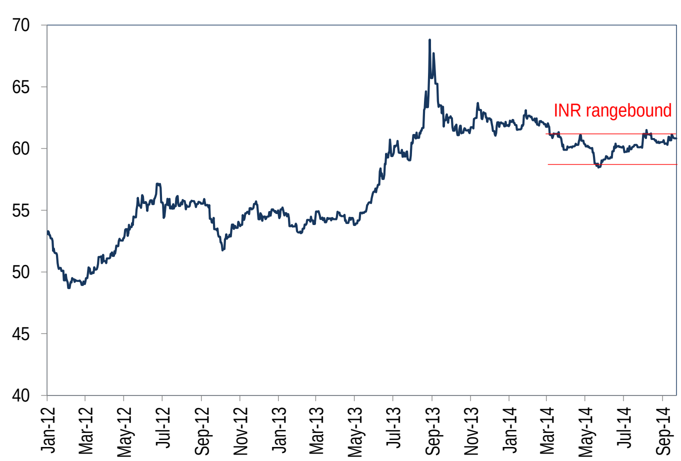
Source: Budget Documents, CGA

Figure 43. Trends in divestments – budgeted vs actual (Rs bn)



Source: Budget Documents

Figure 44. Trends in US$ / INR



Source: Bloomberg

Figure 45. India Economic Indicators

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15F	FY16F
Summary Data									
Nominal GDP, US$ bn	1,240.6	1,223.9	1,366.6	1,707.8	1,873.1	1,872.8	1,880.0	2,069.6	2,359.3
Nominal GDP, local currency bn	49,871	56,301	64,778	77,841	90,097	101,133	113,551	128,312	146,276
GDP per capita, US$	1,090	1,061	1,168	1,440	1,558	1,539	1,522	1,651	1,854
Population, mn	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,217.0	1,235.3	1,253.8	1,272.6
Unemployment, % of labour force	--	--	--	--	--	--	--	--	--
Economic Activity									
Real GDP, % yoy	9.3	6.7	8.6	8.9	6.7	4.5	4.7	5.6	6.5
Real investment growth % yoy	18.1	-5.2	17.3	14.1	3.9	4.9	-2.5	4.8	5.7
Real consumption growth % yoy	9.4	7.7	8.4	8.2	8.9	5.2	4.7	5.6	6.8
private consumption growth % yoy	9.4	7.2	7.4	8.7	9.3	5.0	4.8	5.5	7.0
Real export growth, % yoy	5.9	14.6	-4.7	19.6	15.6	5.0	8.4	11.0	9.3
Real import growth, % yoy	10.2	22.7	-2.1	15.6	21.1	6.6	-2.5	9.5	9.0
Prices, Money & Credit									
CPI, % yoy	7.9	8.0	14.9	8.8	9.0	10.4	8.3	8.0	6.5
CPI, % avg	6.2	9.1	12.4	10.4	8.4	10.2	9.5	8.0	6.5
Nominal wages, % yoy	--	--	--	--	--	--	--	--	--
Credit extension to private sector, % yoy	23.0	19.0	16.0	17.0	17.5	17.5	17.5	17.5	17.5
Policy interest rate, % eop	7.75	5.00	5.00	6.75	8.50	7.50	8.00	8.00	7.75
Short-term market rate, % eop	8.00	5.68	4.49	9.54	10.90	8.50	8.50	8.50	8.50
Long term yield, % eop	7.96	7.01	7.83	7.99	8.56	8.00	8.50	8.50	8.25
lc/US$, eop	39.41	48.62	46.41	44.71	53.02	55.00	61.81	61.70	62.66
lc/US$, avg	41.18	43.42	48.30	45.68	46.63	53.38	58.57	60.70	62.42
Balance of Payments, US$ bn									
Current account	-15.7	-27.9	-38.2	-45.9	-78.2	-88.2	-32.4	-39.3	-48.1
% of GDP	-1.3	-2.3	-2.8	-2.7	-4.2	-4.7	-1.7	-1.9	-2.0
Trade balance	-91.5	-119.5	-118.2	-130.6	-189.8	-195.7	-147.6	-155.5	-171.1
Exports	166.2	189.0	182.4	250.5	309.8	306.6	318.6	343.8	378.2
Imports	257.6	308.5	300.6	381.1	499.5	502.2	466.2	499.3	549.2
Service balance	38.9	53.9	36.0	48.8	64.1	64.9	73.0	73.3	79.1
Income balance	-5.1	-7.1	-8.0	-17.3	-16.0	-21.5	-23.0	-24.0	-24.0
FDI, net	15.9	22.4	18.0	9.4	22.1	19.8	21.6	24.6	27.6
International reserves	299.1	241.6	252.8	273.7	260.1	259.7	276.4	309.6	343.0
Total Amortisations	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9	21.0
Public Finances, % of GDP									
Consolidated government balance	-4.0	-8.3	-9.3	-6.9	-8.1	-7.2	-6.9	-6.7	-6.5
Consolidated gov primary balance	-1.2	3.3	4.5	2.4	3.6	--	--	--	--
Public debt	76.1	76.8	75.5	70.2	69.7	69.8	69.4	68.1	66.2
of which Domestic	71.4	72.2	70.6	65.6	65.9	65.4	65.4	64.6	63.1
Foreign Assets & Liabilities, US$ bn									
External debt	224.4	224.5	260.9	317.9	360.8	409.4	440.6	455.6	470.6
Private	166.3	168.6	193.9	239.8	278.9	327.8	359.0	372.0	385.0
Public	58.1	55.9	67.1	78.1	81.9	81.7	81.7	83.7	85.7
External debt / GDP	18.1	18.3	19.1	18.6	19.3	21.9	23.4	22.0	19.9
External debt / XGS	88.5	77.7	95.2	84.7	80.7	91.1	94.4	85.7	75.6
Short-term debt	45.7	43.3	52.3	65.0	78.2	96.7	89.2	94.2	99.2
Short-term debt/International Reserves (%)	15.3	17.9	20.7	23.7	30.1	37.2	32.3	30.4	28.9

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	4.6	5.7	5.7	5.3	5.6	5.8	6.6	6.0	6.1
CPI, % yoy	8.4	8.1	7.8	6.7	8.3	7.8	7.0	6.4	6.0
Policy interest rate, % eop	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	7.75
Short-term market rate, % eop	8.36	8.25	8.25	8.10	8.10	8.10	8.10	8.10	7.85
Long term yield, % eop	8.78	8.75	8.50	8.50	8.50	8.50	8.50	8.50	8.25
lc vs USD, eop	60.02	60.06	61.04	61.70	62.07	62.41	62.53	62.66	62.77

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

Indonesia

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- **Summary view** – We tune down our GDP growth forecast for 2015 to 5.1%, which is flat compared to our estimate for 2014. Commodity movements have mixed impacts but we think they are overall negative. Likely fuel price hikes may lead to a rebalancing between consumption (lower) and investment.
- **Things to watch** – Jokowi's coalition widening has not progressed as fast as expected, but statements from his camp remain consistent with our baseline scenario of a fuel price hike in November. A quick and blunt move on fuel prices by the new government should be taken positively.
- **Strategy** – As credit growth further slides, we now think that policymakers will be more inclined to maintain the policy rate at 7.50% despite any one-off inflation surge to 7 - 8% that may follow a fuel-price hike. We expect the IDR may see continued weakening bias.

Near-term global movements unfavorable

We tune down our GDP growth forecast for 2015 to 5.1%, from 5.2% previously. We are expecting flat growth vs. 2014. With household purchasing power eroded, we think the economy will go through a period of rebalancing between consumption and investment growth—with the former weakening relative to the latter. We expect investment growth to somewhat rebound in 2015 as industries start expanding capacity; stronger momentum on government capital spending may follow in 2016.

Commodity price movements have a mixed impact but likely net negative; CA deficit forecast further downgraded. Mineral (copper concentrate) exports, which in 2013 totaled about $3bn, resumed in August and September for US mining giants Freeport and Newmont. Furthermore, oil prices also fell by about 15% in Sep from the June highs. However the prices of key export commodities such as palm oil and coal have also dropped by a significant extent in the past couple of months. We expect the net impact of these developments will still be negative for the trade balance. In Jan-Jul, net oil imports averaged about $2.4mn per month and, coupled with the surplus of gas (for which prices are partly linked to oil), it is $1.1bn per month. In comparison, the surplus of coal and palm oil is between $3 – 3.5bn per month. We are further revising down our expectation for the FY14 and FY15 CA deficit to 3.2% and 2.9% GDP, from previously 3.1% and 2.6% GDP, respectively.

Politics: coalition-broadening prospects still fluid, but not as swift as planned. Golkar may remain in the opposition as calls for an early national convention have gone unheeded. However, there is now possibility that the Jokowi coalition could include two smaller parties (e.g. PPP and PAN or Demokrat), which may also result in majority support in parliament. Although certain reforms (e.g. fuel price hikes, infrastructure development and bureaucracy reform) can be implemented without legislative approval, we think that Jokowi will need a majority in parliament to govern effectively. A solid coalition support will also help to avert adverse maneuvers by the opposition.

Rhetoric on fuel prices from the Jokowi camp remains hawkish. Although coalition-broadening has not yet crystalized, Jokowi aides remain hawkish on fuel prices. They have put forward the possibility of fuel prices rising by around 50%. We think a November fuel price hike of 33% in our base-case forecast is still likely to go through.

Implications of fuel-price hikes revisited

Fuel demand and imports appear increasingly inelastic to domestic petrol prices. In 2013, the elasticity of fuel price hikes to fuel imports appears to have diminished. Several structural factors may have contributed to this: Oil production has been on a secular decline and income levels have increased overtime. The structural increase in dependence on private vehicle transport may have also played a role.

This has led to questions on how significant any forthcoming fuel price hike will impact the trade balance. To be meaningful, we think the next fuel price hike must be large enough to reduce subsidy spending and the budget deficit on a YoY basis. Given the annual subsidized fuel consumption of about 48bn – 50bn liters, every Rp1000/l hike can potentially lower subsidy spending by up to Rp50tn (0.4% of GDP).

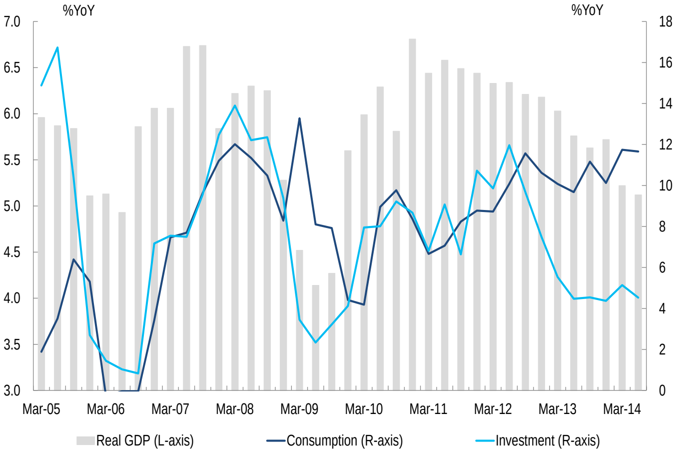
The way subsidy savings are spent will also determine the extent of trade balance improvement. A YoY reduction of subsidy spending would shift the burden of buying fuel to households. In turn, the government savings could be used to lower the budget deficit or reallocated towards capital / infrastructure spending, which may raise the imports of materials e.g. steel (although we believe the import elasticity of every rupiah spent on construction is lower than that spent on fuel subsidies).

We estimate that a 33% fuel price hike this year may improve the trade balance in 2015 by close to US$1bn (0.1% of GDP) against a no-hike scenario. This estimate assumes that the Rp2000/l price hike results in a YoY reduction of both subsidy spending and budget deficit. We expect some spending reallocation towards infrastructure but not one that is overwhelming. The bulk of any new infrastructure initiatives will likely be realized in 2016, as they need to go through multiple phases e.g. project design, feasibility studies, etc. before implementation.

Inflation impact could be in the range of 1.3 – 4.8pps, under 17 – 67% price hike. Our baseline scenario calls for an average 33% price hike in Nov, which we estimate may contribute about 2.6pps inflation impact. As with previous instances, we expect the direct impact to fuel prices will be about 40% of the incremental inflation, while the rest will be second round effects. Thus YoY inflation could head back towards 7% or higher in the ensuing months after any fuel price move. Meanwhile under a 50% fuel price hike, YoY inflation may slightly exceed 8%.

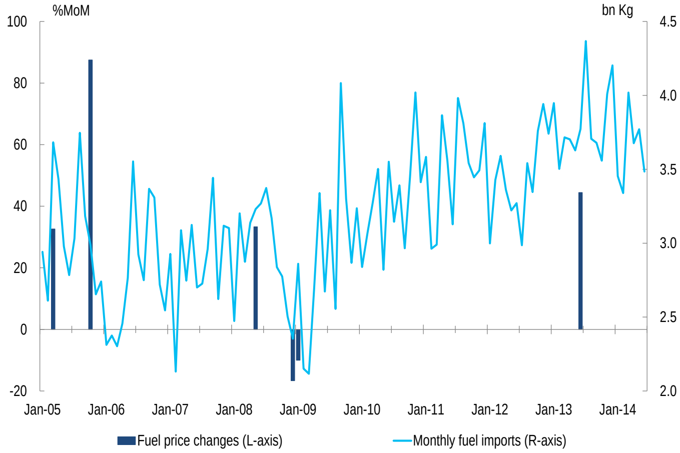
Monetary policy response: the need for rate hikes is fading. We had previously anticipated that BI will respond to a fuel price hike with a limited 25bps increase in the policy interest rate (in order to anchor inflation expectations). However credit growth continues to taper off, latest reaching 15% YoY in July which is in the lower end of BI's expectation range. We now think that policymakers will be more inclined to maintain the policy rate at 7.50% despite any one-off inflation surge to 7 - 8% that may follow a fuel price hike. Meanwhile we expect the IDR may see continued weakening bias amid possible near term deterioration of trade data and rising US treasury yield environment.

Figure 46. Indonesia quarterly GDP growth



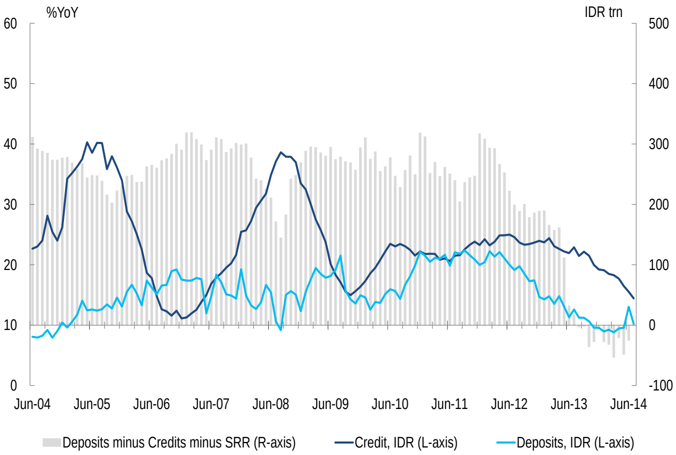
Source: CEIC, Citi Research

Figure 47. Fuel price changes (bar, LHS) vs. monthly fuel imports



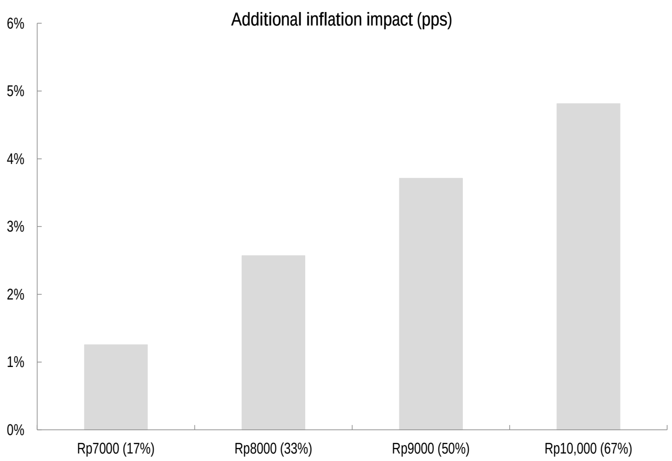
Source: CEIC, Citi Research

Figure 48. Credit growth, deposit growth, and excess liquidity



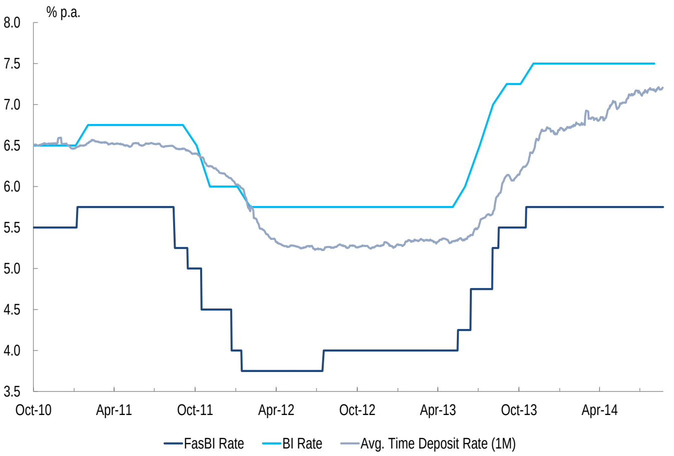
Source: CEIC, Citi Research

Figure 49. Estimated inflation impact of fuel price adjustments



Source: Citi Research

Figure 50. Policy interest rates vs. average time deposit rate



Source: CEIC, Citi Research

Figure 51. Indonesia palm oil and rubber prices

Source: CEIC, Citi Research

Figure 52. Indonesia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	432.2	510.7	538.6	709.5	845.4	876.9	868.5	869.4	941.7
Nominal GDP, local currency bn	3,950,893	4,948,688	5,606,203	6,446,852	7,419,187	8,229,439	9,083,972	10,099,370	11,282,681
GDP per capita, US$	1,896	2,207	2,292	2,975	3,493	3,573	3,491	3,486	3,731
Population, mn	228.0	231.4	235.0	238.5	242.0	245.4	248.8	249.4	252.4
Unemployment, % of labour force	9.1	8.4	7.9	7.1	6.6	5.8	5.8	6.5	6.3
Economic Activity									
Real GDP, % yoy	6.3	6.0	4.6	6.2	6.5	6.3	5.8	5.1	5.1
Real investment growth % yoy	1.9	12.4	2.4	8.8	10.1	16.3	4.9	4.8	5.7
Real consumption growth % yoy	4.9	5.9	6.2	4.1	4.5	4.8	5.2	4.5	4.2
private consumption growth % yoy	5.0	5.3	4.9	4.7	4.7	5.3	5.3	5.1	4.1
Real export growth, % yoy	8.5	9.5	-9.7	15.3	13.6	2.0	5.3	-1.4	4.8
Real import growth, % yoy	9.1	10.0	-15.0	17.3	13.3	6.7	1.2	-4.4	3.5
Prices, Money & Credit									
CPI, % yoy	5.8	11.1	2.8	7.0	3.8	3.7	8.1	7.0	6.3
CPI, % avg	6.3	9.9	4.8	5.1	5.3	4.0	6.4	6.2	6.7
Nominal wages, % yoy	9.7	5.0	6.3	18.2	-2.9	20.0	12.4	17.1	13.0
Credit extension to private sector, % yoy	22.4	30.7	18.0	20.6	25.9	22.3	18.0	15.0	16.0
Policy interest rate, % eop	3.00	8.75	6.00	5.50	4.50	4.00	5.75	5.75	5.75
Short-term market rate, % eop	3.35	9.44	6.39	5.66	4.57	4.24	6.01	5.85	6.90
Long term yield, % eop	10.02	11.92	10.07	7.83	6.05	5.39	8.60	8.25	8.75
lc/US$, eop	9,393	10,900	9,425	9,010	9,068	9,638	12,170	12,200	12,030
lc/US$, avg	9,140	9,673	10,376	9,078	8,763	9,361	10,449	11,873	12,133
Balance of Payments, US$ bn									
Current account	10.5	0.1	10.6	5.1	1.7	-24.4	-29.1	-28.1	-26.7
% of GDP	2.4	0.0	2.0	0.7	0.2	-2.8	-3.3	-3.2	-2.8
Trade balance	32.8	22.9	30.9	30.6	34.8	8.6	6.0	5.8	9.0
Exports	118.0	139.6	119.6	158.1	200.8	188.5	183.3	176.4	183.4
Imports	85.3	116.7	88.7	127.4	166.0	179.9	177.3	170.6	174.4
Service balance	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-12.1	-10.4	-11.1
Income balance	-15.5	-15.2	-15.1	-20.8	-26.7	-26.8	-27.0	-27.5	-28.5
FDI, net	2.3	3.4	2.6	11.1	11.5	13.7	13.7	15.0	17.0
International reserves	56.9	51.6	66.1	96.2	110.1	112.8	99.4	110.0	120.8
Total Amortisations	18.8	16.7	20.4	24.0	25.2	29.4	41.0	42.0	42.0
Public Finances, % of GDP									
Consolidated government balance	-1.3	-0.1	-1.6	-0.7	-1.1	-1.9	-2.2	-2.4	-1.9
Consolidated gov primary balance	0.8	1.7	0.1	0.6	0.1	-0.6	-0.9	-1.2	-0.9
Public debt	34.1	29.3	31.4	26.4	23.6	23.3	23.5	26.0	25.0
of which Domestic	19.7	16.2	19.3	16.7	15.5	16.1	16.2	15.6	16.0
Foreign Assets & Liabilities, US$ bn									
External debt	141.2	155.1	172.9	202.4	225.4	252.4	265.6	290.0	327.7
Private	60.6	68.5	73.6	83.8	106.7	126.2	142.0	160.5	192.2
Public	80.6	86.6	99.3	118.6	118.6	126.1	123.5	129.5	135.5
External debt / GDP	32.7	30.4	32.1	28.5	26.7	28.8	30.6	33.4	34.8
External debt / XGS	108.2	100.1	130.2	115.8	101.8	119.3	129.1	144.0	156.5
Short-term debt	18.7	20.5	24.0	31.6	36.6	43.4	44.6	50.0	55.0
Short-term debt/International Reserves (%)	32.8	39.7	36.4	32.8	33.2	38.4	44.9	45.5	45.5

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	5.2	5.1	5.0	5.0	5.0	4.7	5.2	5.3	5.3
CPI, % yoy	7.3	6.7	4.3	7.0	6.4	6.7	7.0	6.3	5.9
Policy interest rate, % eop	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75
Short-term market rate, % eop	5.86	5.85	5.85	5.85	5.85	5.85	5.85	5.85	5.85
Long term yield, % eop	8.21	8.35	8.10	8.25	8.40	8.50	8.60	8.75	8.75
lc vs USD, eop	11,360	11,855	12,054	12,200	12,200	12,190	12,110	12,030	11,950

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

Malaysia

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- **Summary view** – Growth momentum appears to have faltered in Jul, partly on moving holiday effects, which caused BNM to pause in Sep. The next window for a hike is in Nov, when the MPC can assess if recent weakness is temporary.
- **Things to watch** – [1] Aug growth data which can confirm if Jul weakness was merely due to moving holiday effects, [2] GST and targeted subsidy implementation on 10 Oct budget; [3] consumption credit and deposit indicators.
- **Strategy** – With rate hikes delayed, not derailed, we would be cautious in chasing the recent rally in 5Y MGS, bull flattening of the curve, and sharp spike in USD-MYR to 3.25 post the 18 Sep MPC decision to pause.

Jul data suggest weaker-than-expected start to 3Q

Demand and output momentum faltered in Jul, post the strong 2Q GDP performance. A mining-led sequential contraction in IP brought Jul IP levels 3.2% below the 2Q14 average, and weakness in agricultural and services activities was also observed in Jul. Exports to most major markets fell sequentially in Jul, with exports to US, China and Japan recording three straight months of seasonally adjusted MoM decline. The drag came from E&E and LNG, with the latter plunging by 22.9% MoM SA. Consequently, deteriorating exports may have dampened business confidence which in turn lowered investments – Jul imports of capital goods were 16.0% and 10.9% below 2Q14 and 1Q14 levels respectively. Similarly, other investment indicators such as MIDA investment approvals and new company registrations also fell. Jul consumption goods imports also weakened to 6.9% below 2Q14 while demand met through domestic production fell. In particular, passenger car production was 25.7% below 2Q14 levels as it fell sharply by 24.3% YoY, outpacing the 12.2% YoY drop in Jul car sales. Likewise, consumption credit continued to moderate.

Moving holiday effects may only partly explain Jul growth weakness. As Ramadan fell almost entirely in Jul 2014 (29 Jun to 27 Jul), but fell between 9 Jul to 7 Aug in 2013, this implies fewer working days in Jul, although this also implies an Aug bounce-back. Factoring in distortions from moving holiday effects, we still estimate 3Q GDP may slow to the lower end of BNM's 5-5.5% YoY forecast for 2H14. Downside risks are (1) a likely slowdown in 2H14 fiscal spending to meet the fiscal deficit target, (2) hit to rural incomes and consumption from lower CPO prices, and (3) deferral of car purchases as prices are expected to fall post the 6% GST. Mitigation could come from export duty exemption of CPO from Sep to Oct.

CA surplus likely to narrow QoQ in 3Q14. Jul trade surplus narrowed sequentially to RM3.64bn (Jun: RM3. 97bn) as both exports and imports declined on a MoM SA basis, exerting downward pressure on 3Q CA surplus. A second consecutive decline in Intermediate goods imports in Jul, historically a 4-6 month leading indicator of exports, suggests export figures are unlikely to pick up in 3Q. However, a mitigating factor is that intermediate goods imports have bottomed on a YoY, 3MMA basis, pointing to a bottoming in early 4Q. Factoring in seasonal trends in services trade deficit, and the income accounts, we think the CA surplus is likely to narrow QoQ in 3Q before widening in 4Q on renewed export growth momentum.

Limited demand-pull pressures on inflation

While Aug headline inflation ticked to 3.3% YoY, demand-pull pressures were limited. Excluding food, alcoholic beverages and tobacco, transport, and electricity (FATE), we estimate core inflation was stable at 2.0% YoY (Jul: 2.0%), with momentum ticking up slightly on a 3M/3M basis. More critically, our proxy for BNM's inflation pervasiveness index indicates that the (unweighted) proportion of the CPI basket now seeing above-2% YoY inflation was flat.

Disinflation from Sep on base effects, though could spike post GST in Apr 2015. With policymakers seemingly leaning towards a more targeted quota system to curb fuel subsidies rather than fuel price hikes, base effects point to quickening disinflation from Sep onwards, notwithstanding the slight uptick in Aug CPI. We expect headline CPI inflation to fall below 3% till Mar 2015 before rising to near 4-4.5% in Apr 2015 post GST. Even so, Gov Zeti earlier noted that inflation could quicken temporarily in 2015 but should stabilize in 2016.

Rate hike delayed but not derailed

BNM kept OPR unchanged%, as Citi expected, though market views were split. The statement emphasized a less upbeat assessment on private consumption and base effects weighing down on exports, while reiterating that inflation would remain above its long-run average on domestic cost factors.

MPC's decision to pause in Sep was justified on three recent data developments, (1) benign demand-pull inflation pressures, (2) disappointing Jul export and IP data, possibly placing 3Q growth at the lower end of BNM's 5-5.5% forecast for 2H14, and (3) tentative improvement in financial imbalances since the Jul hike, with slower growth in outstanding household loan and loan approvals, and a possible bottoming in individual deposit growth.

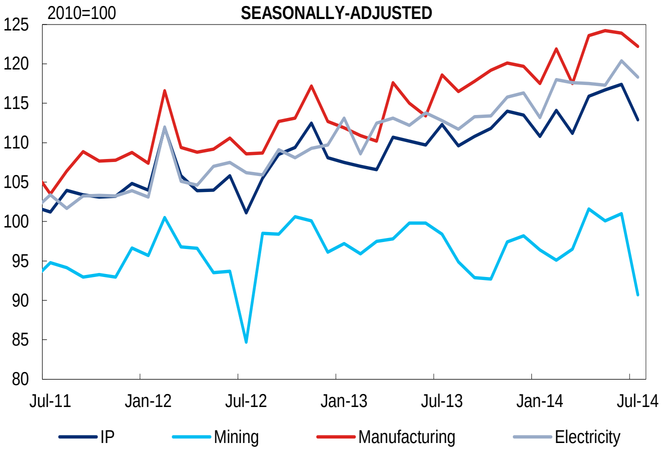
Call for Nov rate hike is data dependent. MPC's Sep assessment continued emphasis in data-dependence in possible "future adjustment to the degree of monetary accommodation", suggesting that rate normalization was delayed, not derailed. We see the next window for a hike in Nov, when Aug data allows the MPC to assess if recent growth weakness is temporary.

All eyes on GST and subsidy cuts in Budget 2015

3.5% of GDP deficit target for 2014 will likely be reiterated on 10 Oct, on a likely pick-up in revenues and subsidy rationalization measures in 2H14. PM Najib has already reiterated the smaller 2015 deficit target of 3% of GDP, which will come on the back of net revenue gains from GST, further efficiency gains in direct tax collections, possible investment income gains, cuts in fuel subsidies and development expenditure.

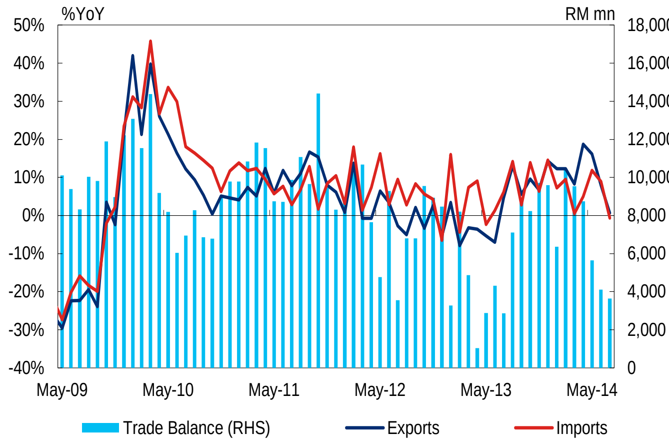
Budget 2015 will likely implement fiscal reforms pre-announced in Budget 2014. First, the 6% GST slated for implementation in Apr 2015 will likely be reiterated, with the list of exempted items to be finalized. Second, details of targeted subsidy system are anticipated with year-to-date subsidy spending data pointing to a sizeable overshoot of Budget 2014 targets. In addition, BR1M handouts will likely be enlarged to overcome opposition to GST and tackle rising cost of living. Rather than fuel price hikes, policymakers appear to be leaning towards a more targeted subsidy system varying according to income levels or engine capacity

Figure 53. Industrial Production Index, Seasonally-Adjusted



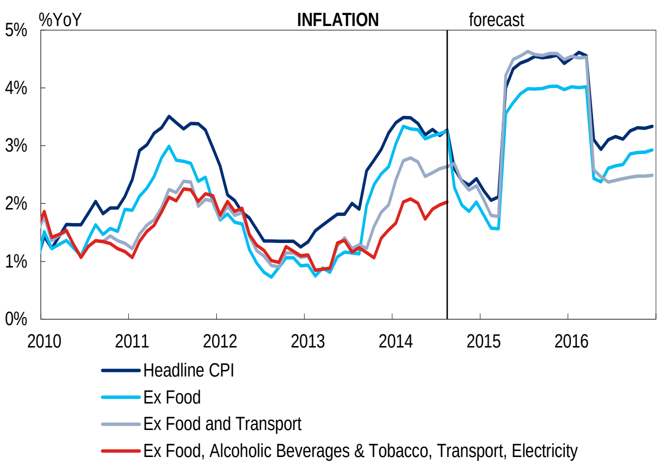
Source: CEIC, Citi Research

Figure 54. Export & Import Growth (%YoY), Trade Balance



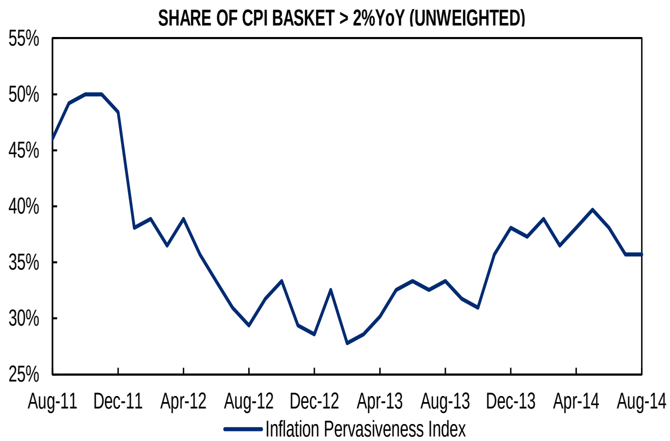
Source: CEIC, Citi Research

Figure 55. Headline and Core CPI moderated in recent months



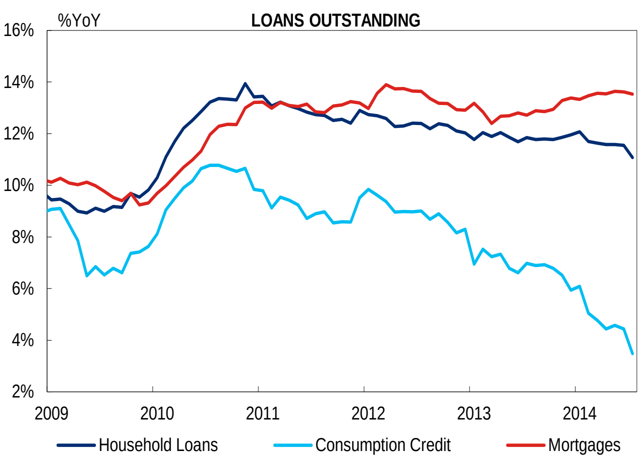
Source: CEIC, Citi Research

Figure 56. BNM's inflation pervasiveness index inched downwards



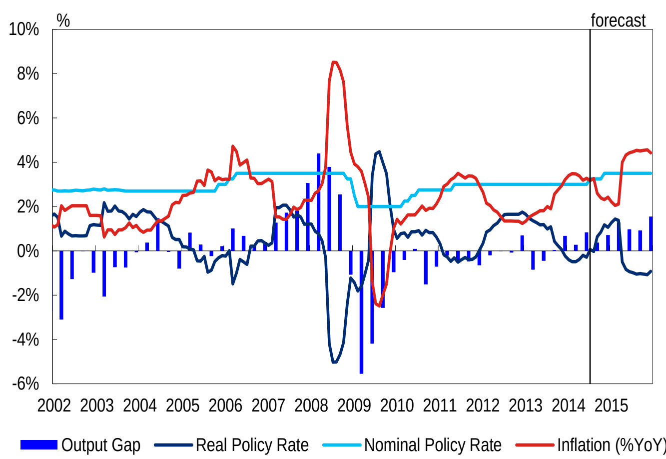
Source: Department of Statistics, Haver, Citi Research

Figure 57. Household loan growth edged down in Jul



Source: CEIC, Citi Research

Figure 58. Further OPR hikes should restore positive real policy rates



Source: CEIC, Citi Research

Figure 59. Malaysia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	193.7	231.1	202.4	247.7	289.5	305.3	313.3	330.2	345.1
Nominal GDP, local currency bn	665	770	713	797	885	942	987	1,066	1,135
GDP per capita, US$	7,123	8,393	7,255	8,664	9,997	10,405	10,544	10,827	11,131
Population, mn	27.2	27.5	27.9	28.6	29.0	29.3	29.7	30.5	31.0
Unemployment, % of labour force	3.2	3.3	3.7	3.4	3.1	3.0	3.1	2.9	2.9
Economic Activity									
Real GDP, % yoy	6.3	4.8	-1.5	7.4	5.2	5.6	4.7	5.7	5.6
Real investment growth % yoy	9.1	1.8	-9.4	25.3	3.0	20.3	4.9	0.5	4.9
Real consumption growth % yoy	9.7	8.4	1.4	6.2	8.8	7.5	7.0	5.9	5.2
private consumption growth % yoy	10.4	8.7	0.6	6.9	6.9	8.2	7.2	6.8	6.5
Real export growth, % yoy	3.8	1.6	-10.9	11.1	4.5	-1.8	0.6	7.9	6.8
Real import growth, % yoy	5.9	2.3	-12.7	15.6	6.2	2.5	2.0	6.5	6.3
Prices, Money & Credit									
CPI, % yoy	2.3	4.5	1.0	2.1	3.0	1.2	3.2	2.4	4.4
CPI, % avg	2.0	5.4	0.6	1.7	3.2	1.6	2.1	3.0	3.9
Nominal wages, % yoy	4.3	4.5	2.5	8.2	3.8	6.4	7.8	5.0	5.0
Credit extension to private sector, % yoy	9.2	10.2	6.8	10.6	12.5	12.1	11.0	10.0	10.0
Policy interest rate, % eop	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50	3.50
Short-term market rate, % eop	3.61	3.37	2.17	2.98	3.22	3.21	3.32	3.80	3.80
Long term yield, % eop	3.78	3.00	3.79	3.39	3.23	3.24	3.66	4.00	4.00
lc/US$, eop	3.31	3.45	3.42	3.08	3.17	3.06	3.28	3.27	3.33
lc/US$, avg	3.44	3.33	3.52	3.22	3.06	3.09	3.15	3.25	3.31
Balance of Payments, US$ bn									
Current account	29.7	39.4	31.4	27.1	33.5	17.6	12.7	18.3	19.6
% of GDP	15.4	17.1	15.5	10.9	11.6	5.8	4.0	5.5	5.7
Trade balance	38.1	51.1	39.8	42.5	49.6	40.6	34.4	41.0	50.7
Exports	176.5	198.9	157.0	199.2	228.8	222.3	215.6	230.6	258.1
Imports	138.5	147.7	117.1	156.7	179.2	181.8	181.3	189.6	207.3
Service balance	0.4	0.5	1.2	-0.4	-2.1	-5.3	-5.3	-5.5	-6.8
Income balance	-8.7	-12.2	-9.6	-15.0	-14.0	-17.7	-16.4	-17.2	-24.4
FDI, net	-2.7	-7.8	-6.3	-4.3	-3.1	-7.9	-1.7	-3.0	-1.0
International reserves	101.3	91.5	96.7	106.5	133.6	139.7	134.9	135.0	140.0
Total Amortisations	7.8	6.3	9.8	11.3	9.0	7.4	10.0	11.0	12.0
Public Finances, % of GDP									
Consolidated government balance	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-3.9	-3.5	-3.0
Consolidated gov primary balance	-1.2	-3.0	-4.7	-3.5	-2.8	-2.4	-1.8	-1.3	-0.9
Public debt	40.1	39.8	50.8	51.1	51.5	53.3	54.7	55.0	55.0
of which Domestic	37.1	37.2	48.9	49.0	49.5	51.5	53.0	53.5	53.5
Foreign Assets & Liabilities, US$ bn									
External debt	56.2	66.6	68.3	72.6	81.5	82.8	97.9	97.0	96.0
Private	37.8	41.5	41.9	44.7	53.7	55.6	69.2	67.0	67.0
Public	18.4	25.2	26.3	27.9	27.8	27.1	28.7	30.0	29.0
External debt / GDP	29.0	28.8	33.7	29.3	28.1	27.1	31.2	29.4	27.8
External debt / XGS	27.4	29.0	36.9	31.4	30.7	31.8	38.3	36.0	32.0
Short-term debt	16.3	22.5	22.7	25.4	32.8	30.4	39.4	42.0	42.0
Short-term debt/International Reserves (%)	16.1	24.6	23.5	23.8	24.6	21.8	29.2	31.1	30.0

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	6.2	6.4	5.4	5.0	6.0	5.1	5.6	5.9	5.4
CPI, % yoy	3.5	3.3	2.6	2.4	2.1	4.4	4.5	4.4	4.6
Policy interest rate, % eop	3.00	3.00	3.25	3.50	3.50	3.50	3.50	3.50	3.50
Short-term market rate, % eop	3.33	3.55	3.80	3.80	3.80	3.80	3.80	3.80	3.80
Long term yield, % eop	3.65	3.70	3.90	4.00	4.10	4.10	4.00	4.00	4.00
lc vs USD, eop	3.26	3.21	3.24	3.27	3.29	3.30	3.32	3.33	3.34

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

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- **Summary view** – Resumption of upbeat GDP momentum following 2Q growth of 6.4%YoY lead us to keep our GDP forecasts of 6.3% in 2014 and 6.5% in 2015. Onshore catalysts to domestic demand are expected to make a strong 2H14 comeback led by fiscal spending, private construction and re-stocking.

- **Things to watch** – BSP's shift to neutral rate stance following Sep CPI's signal of disinflation. Moody's rating action (or inaction) in 4Q14. Initiation of strong fiscal spending starting with reconstruction in typhoon devastated areas. Government strategy to avert risk of power shortage risk in 1H15.

- **Strategy** – Stronger local portfolio shift to long duration as disinflation ends rate tightening cycle. If disinflation anchors the policy rate, BSP's FX reserves would be key intervention tool in managing PHP as offshore portfolios exit in a strong USD episode. Expecting PHP to drift up to the range of 44.50 in 4Q14.

Resumption of upbeat GDP momentum

Better-than-expected 2Q GDP growth of 6.4%YoY (1.9%QoQ SA) had more diversified sources of growth despite lackluster public investments. A diversified growth setting is one of the consequences of having investment-driven growth. Mfg output due to expanded capacity grew by 10.7%YoY to meet export growth of 10%YoY. Real estate, renting and other business services (8.9%YoY) led services to complement mfg. Due to private construction growth of 15.7%YoY, total construction rose 5.1%YoY to regain its momentum. Previewed by lackluster infrastructure spending amid legal issues faced by Aquino's DAP, public construction fell 12.9%YoY. Capex disappointed with 2Q growth of 2.3%YoY after 5 straight quarters of double-digit gains.

Domestic demand growth narrowed to 4.4%YoY that was offset by a 6.2% contribution of net exports to GDP. Strong PHP and higher inflation in 2Q14 curbed growth of compensation income from abroad (OFW remittances) to 8.4%YoY that restrained consumption gains. Alongside sluggish investments and flattish government consumption, domestic demand gains eased. Upbeat exports amid destocking that cut imports uplifted net exports share of 2Q GDP.

Upbeat 2Q GDP sustained our GDP forecasts of 6.3% in 2014 and 6.5% in 2015. Inventory restocking coupled with fiscal spending de-compression and resumption of upbeat private construction would enable better 2H prospects. Favorable 2H export outlook could sustain mfg output.

We expect buoyant 2H domestic demand gains which implies greater reliance on onshore catalysts. Weak PHP late Sep (back to the 44 range) coupled with 4Q disinflation as food inflation eases would enable the real peso value of remittances to post strong growth and sustain its GDP contribution >20% in 4Q14 as the retail Christmas season peaks. Meanwhile, 1.1mn jobs were generated (July labor survey) ought to provide a lift to local consumption. The investment-driven backdrop is creating more opportunities for low-skilled workers that may not be qualified in the sectors requiring educated workers. Construction job creation of 178K was second only to jobs produced in the wholesale/retail trade & repair services of 183.7K.July exports grew 12.4%YoY largely on the back of the non-tech export segment (19.4%YoY). Exports of garments (44.9%YoY), textile yarns/fabrics (76.1%YoY), travel goods & handbags (85.5%YoY), furniture & fixtures (59%YoY), machinery & transport equipment (142%YoY) were the growth leaders. The export backdrop was consistent with a mfg index gain of 9.6%YoY during the month.

Onshore challenges to strong GDP momentum

Worries over higher prices of basic commodities and political noise e.g. DAP issue, that could stall fiscal spending, saw consumer sentiment sink in 3Q14 to -26.3% (vs -17.6% in 2Q14). Consumer sentiment in both National Capital Region (NCR) and areas outside NCR posted weakness during the current quarter. Over the next 12 months consumer sentiment recovered to +9.7%. With only 27% of HH having savings—a percentage that narrows among poorer HH (< Php10,000 earnings), most of the respondents surveyed are vulnerable to price and income shocks that weigh on sentiment and spending. Demand shock caused by familiar flooding in Metro Manila from strong rains dumped by typhoon Mario, reminiscent of 2009 typhoon Ondoy, hit low-income households in the low-lying areas prone to flooding. This may ease consumption's luster in late 3Q although the flooding event could prompt more remittance flows and fiscal spending relief. Lifting of the truck ban recently and initiatives to ease port congestion would mitigate logistical strains.

No overheating despite positive output gap for 7 quarters

We estimate a 2Q output gap of 1.6% up from 1.1% in 1Q. The 2Q positive gap is the seventh straight quarterly estimate of actual output exceeding potential. Clearly this condition ought to generate upside inflation risk as well. The positive gap is coincident with a declining jobless rate down to 6.7% (July labor survey) and seasonally adjusted utilization rate still elevated at 83.3%. Higher average labor productivity (ALP) that grew 4%YoY in 2Q following an 11%YoY gain in 1Q mitigated inflation risk from a positive gap and other resource utilization measures. ALP has posted a string of gains since 1Q12. Despite productivity gains, jobless rate remains elevated. Coupled with a double-digit underemployment rate, policymakers continue to downplay overheating risks from a positive output gap.

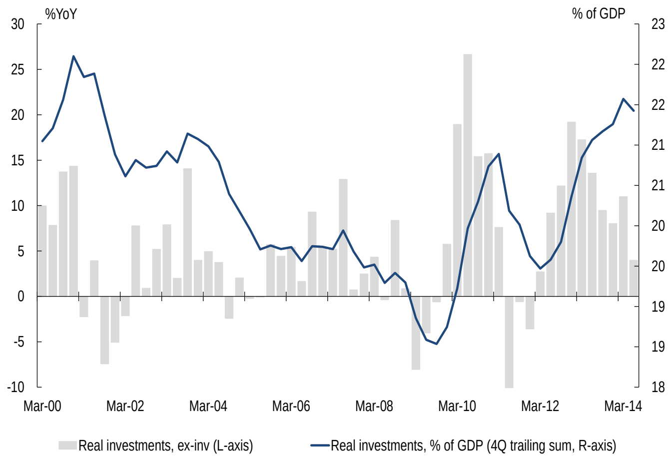
Events likely to contribute to 4Q disinflation

These events are: 1) 500,000 tons of rice imports over the next three months. 2) lifting of the truck ban ordinance in the city of Manila that should help ease logistical costs in the 4Q Christmas retail season according to a senior BSP official. 3) despite the national rice inventory being down 7.4%YoY to 1.7mn tons (Aug), households (HH) accounted for 700K tons (40.7% share) of inventory up 10%YoY to suggest HH may already be 'hedged' from current/prospective rice price shifts and any supply shortfall risk. 4) El Niño is late this year and may be subdued, according to the latest climate assessment, reducing the threat to 4Q local planting/harvest season. All these may contribute to dynamics of waning 4Q rice/food inflation from double-digit rates since Jan. Recent flooding in Metro Manila and surrounding areas constitute a demand shock that may deter higher food prices with government further regulating basic commodity prices in affected areas.

Rate tightening cycle ends as disinflation takes root

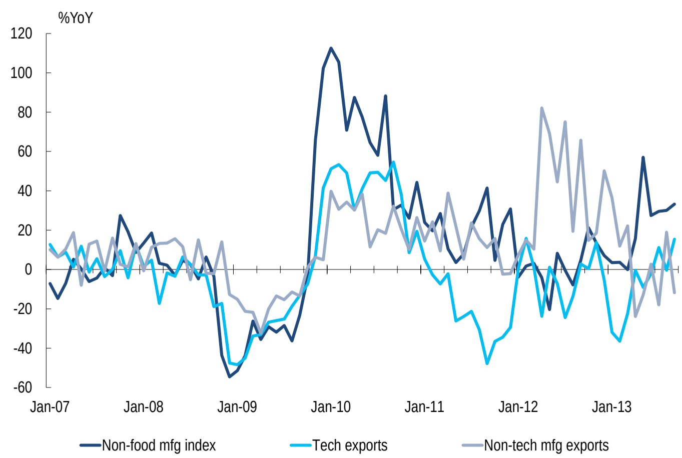
Start of disinflation in 4Q led by food CPI could spawn the following: 1) stronger local portfolio shifts to long duration as disinflation ends rate tightening cycle. 2) If disinflation anchors the policy rate, BSP's FX reserves would be a key intervention tool in managing PHP as offshore portfolios exit in a strong USD episode. 3) Food-led disinflation tempers upside imported inflation risk from a weak PHP. De-coupling PHP's downside from inflation risk with a current account surplus intact would enable BSP's policy bias and rates to stay focused on domestic monetary objectives despite tectonic shifts in global monetary conditions.

Figure 60. Sorely missing strong investments in 2Q14



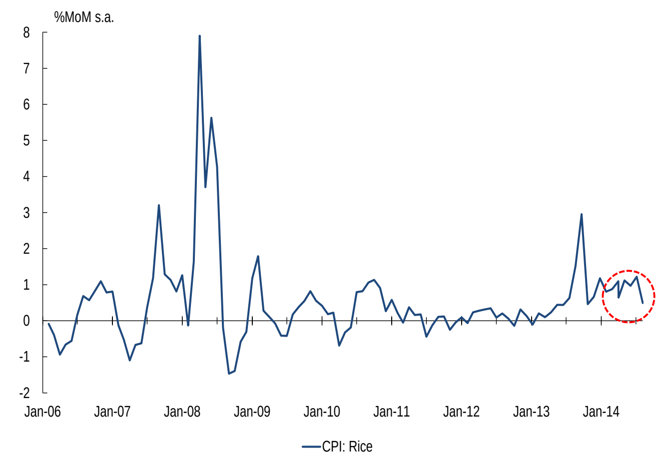
Source: CEIC, Citi Research

Figure 61. Upbeat non-food mfg. consistent with non-tech exports



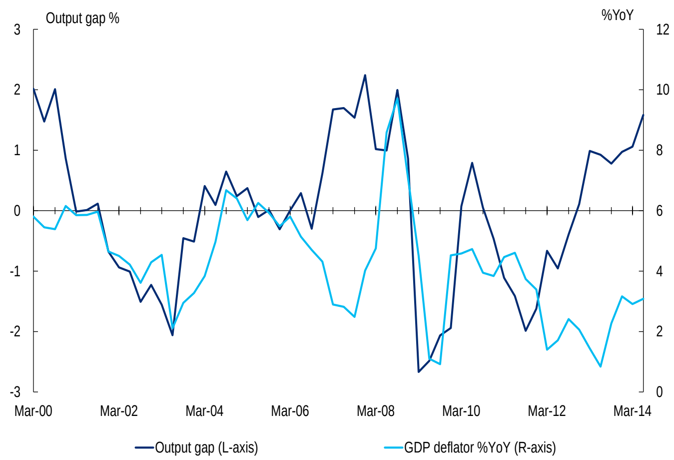
Source: CEIC, Citi Research

Figure 62. Monthly CPI rice gains narrowed in Aug



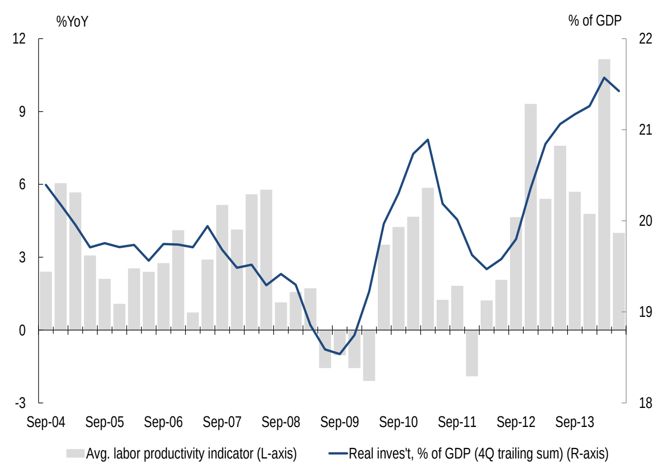
Source: CEIC, Citi Research

Figure 63. Output gap diverged from GDP deflator in 2Q14



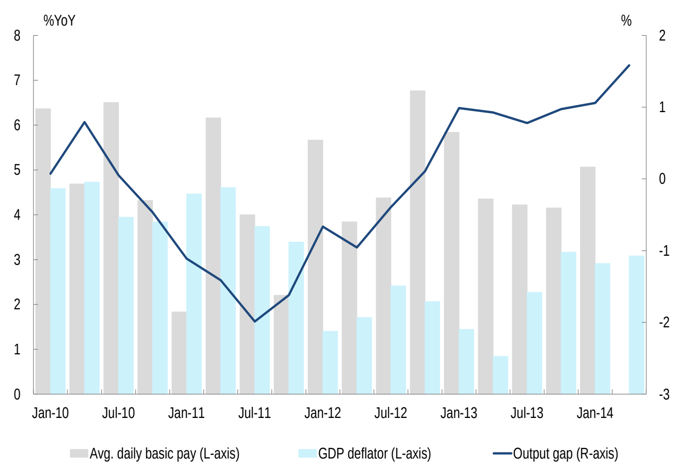
Source: CEIC, Citi Research

Figure 64. Rising labor productivity eased output gap pressures



Source: CEIC, Citi Research

Figure 65. No significant wage gains as average pay tracked inflation



Source: CEIC, Citi Research

Figure 66. Philippines Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	150.2	173.4	168.6	200.0	224.1	250.6	271.9	279.9	313.2
Nominal GDP, local currency bn	6,893	7,721	8,026	9,003	9,708	10,567	11,548	12,651	13,939
GDP per capita, US$	1,693	1,917	1,829	2,127	2,364	2,595	2,764	2,794	3,070
Population, mn	88.7	90.5	92.2	94.0	94.8	96.6	98.4	100.2	102.0
Unemployment, % of labour force	7.3	7.4	7.5	7.3	7.0	7.0	7.1	6.8	6.5
Economic Activity									
Real GDP, % yoy	6.6	4.2	1.1	7.6	3.7	6.8	7.2	6.3	6.5
Real investment growth % yoy	-0.5	23.4	-8.7	31.6	2.8	-5.3	29.9	2.8	11.7
Real consumption growth % yoy	4.9	3.3	3.3	3.4	5.1	7.7	5.9	5.9	6.2
private consumption growth % yoy	4.6	3.7	2.3	3.4	5.6	6.6	5.7	6.0	6.2
Real export growth, % yoy	6.7	-2.7	-7.8	21.0	-2.5	8.5	-1.1	7.5	4.8
Real import growth, % yoy	1.7	1.6	-8.1	22.5	-0.6	4.9	5.4	5.0	6.7
Prices, Money & Credit									
CPI, % yoy	3.9	8.0	4.3	3.6	4.2	3.0	4.1	4.1	3.3
CPI, % avg	2.8	9.3	3.2	4.1	4.7	3.2	2.9	4.3	3.5
Nominal wages, % yoy	3.4	5.5	0.0	5.8	5.4	7.0	2.2	0.0	2.5
Credit extension to private sector, % yoy	10.6	12.8	4.3	13.8	16.2	14.1	10.0	13.5	15.0
Policy interest rate, % eop	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.00	4.00
Short-term market rate, % eop	6.03	5.20	4.11	0.75	1.68	-1.38	-0.15	1.60	2.50
Long term yield, % eop	5.70	6.55	6.25	4.78	4.21	3.70	2.91	4.25	4.50
lc/US$, eop	41.23	47.47	46.50	43.65	43.84	41.06	44.39	44.96	44.15
lc/US$, avg	46.05	44.48	47.56	45.06	43.29	42.22	42.46	44.52	44.66
Balance of Payments, US$ bn									
Current account	8.1	0.1	8.4	7.2	5.6	7.0	9.4	10.0	10.7
% of GDP	5.4	0.1	5.0	3.6	2.5	2.8	3.5	3.6	3.4
Trade balance	-14.0	-18.6	-13.9	-16.9	-20.4	-18.9	-18.5	-19.7	-20.7
Exports	32.8	34.7	29.1	36.8	38.3	46.4	44.7	47.4	50.9
Imports	46.8	53.3	43.0	53.6	58.7	65.3	63.3	67.1	71.6
Service balance	6.0	2.0	4.9	5.8	6.6	6.2	6.8	7.2	7.5
Income balance	16.1	16.8	17.4	18.3	19.5	19.7	21.1	22.5	23.9
FDI, net	2.5	0.6	-0.2	1.6	0.3	1.0	-0.2	2.0	3.0
International reserves (ex-gold)	33.8	37.6	44.2	62.4	75.3	83.8	83.2	83.5	90.0
Total Amortisations	4.7	7.0	5.7	8.3	6.3	2.7	9.3	9.7	10.0
Public Finances, % of GDP									
Consolidated government balance	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-1.4	-1.8	-1.6
Consolidated gov primary balance	3.7	2.6	-0.2	-0.2	0.8	0.7	1.4	1.1	1.1
Public debt	53.9	54.7	54.8	52.4	51.0	51.5	49.2	46.0	45.0
of which Domestic	31.9	31.3	30.8	30.2	29.6	32.8	32.3	30.0	29.5
Foreign Assets & Liabilities, US$ bn									
External debt	55.5	54.3	54.9	60.0	60.4	60.3	58.5	61.0	63.5
Private	17.5	13.7	11.6	13.9	14.1	15.2	18.0	18.0	18.5
Public	38.0	40.6	43.2	46.2	46.4	45.2	40.5	43.0	45.0
External debt / GDP	36.9	31.3	32.5	30.0	27.0	24.1	21.5	21.8	20.3
External debt / XGS	119.8	113.8	126.9	110.1	105.7	90.3	87.9	86.8	84.7
Short-term debt	7.1	7.0	4.0	6.3	7.0	8.5	11.2	11.1	12.0
Short-term debt/International Reserves (%)	21.0	18.6	9.0	10.1	9.3	10.1	13.5	13.3	13.3

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	5.6	6.4	6.5	6.6	6.2	6.5	6.7	6.6	6.7
CPI, % yoy	3.9	4.4	4.8	4.1	3.7	3.6	3.4	3.3	3.5
Policy interest rate, % eop	3.50	3.50	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Short-term market rate, % eop	0.94	0.79	1.35	1.60	2.00	2.25	2.50	2.50	2.50
Long term yield, % eop	3.38	3.50	4.00	4.25	4.50	4.50	4.50	4.50	4.25
lc vs USD, eop	44.76	43.63	44.66	44.96	44.98	44.95	44.55	44.15	43.75

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

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- **Summary view** – Positive Jul-Aug data point to an improvement in the external environment, although weaker domestic demand limits the upside risks to core inflation, both of which render a MAS easing in October unlikely.
- **Things to watch** – [1] Near–term export and production momentum ,[2] house prices and sale volumes; [3] household debt, [4] labor market and core inflation trends, [5] signs of financial stress in the SME sector.
- **Strategy** – With expectations of MAS easing premature, we would be alert for MAS intervention to prevent the NEER from falling too far below the policy band mid-point though, unlike in Mar, sub-1% headline inflation rules out any swift rebound in the NEER above the mid-point. We remain alert for upward pressures on SOR on tighter banking liquidity and eventual Fed hikes.

Jul-Aug data point to an export-led recovery in 2H14

2Q GDP was revised up 0.1% QoQ SAAR (Advance Estimates: -0.8%), though this is still a marked slowdown from the 5% QoQ SAAR average in the past four quarters, as the export tailwind stalled. The relatively weak GDP number was led by sequential declines in manufacturing, which plunged 15.2% QoQ SAAR, on a pullback in electronics and transport engineering, which more than offset a rebound in biomed. In particular, a 6.5% MoM SA plunge in Electronics manufacturing, led by a 10.2% plunge in semiconductor manufacturing in Apr attributed by the Economic Development Board (EDB) to a "firm specific factor" exacerbated the weakness in headline GDP growth. While the EDB did not elaborate on the nature "firm specific factor", recent press reports have alluded to the relocation of the operations of a chip manufacturer upon the expiry of its tax incentives.

Jul-Aug data point to external demand improving, but tech still weak. Jul-Aug NODX surged sequentially, bringing seasonally-adjusted headline Jul-Aug NODX levels 3.5% above 2Q14 in real terms. Nonetheless, semiconductor output remains *below* 2Q levels, pointing to a permanent *step down* in output, possibly due to factor relocation. Non-oil retained imports of intermediate goods (NORI) jumped 10.8% MoM SA in Aug, manufacturers are gradually re-stocking parts and components in anticipation of demand recovery. Improving exports translated to a 2.7% MoM SA rise in Jul IP, bringing Jul seasonally adjusted headline IP 0.9% above 2Q levels, with "core" and electronics IP 1.6% and 1.3% above 2Q levels respectively. Overall, the Jul-Aug data are consistent with forecast of a modest pick-up in sequential growth to near trend at 3.6% QoQ SAAR on average in 2H14 (vs 1% in 1H14).

Domestic demand however, remains tepid at best. Retail sales fell 0.2% MoM SA in July (though 0.3% above 2Q), despite stronger real wage growth, on plummeting tourist arrivals from China, consumer deleveraging and negative wealth effects of falling home prices. Fixed investments have also been weak despite a pick-up in new company formation, with few signs of revival in early 3Q. A lack of new launches and tepid demand from buyers waiting for prices to fall contributed to a 50% YoY plunge in primary private home sales in Jul-Aug. Investments in machinery and equipment have been falling since early 2013, partly reflecting a structural shift towards less capital intensive services, but also hinting that government incentives for capex have not sufficient to offset competitiveness erosion from higher wage costs and REER appreciation.

Our headline inflation forecast of 1.2% for 2014 remains below MAS forecast. July headline inflation came in lower at 1.2% YoY, below consensus (1.8%), with the fall led by weakness in private transport (-1.6%) and rentals (0.0%). Headline inflation has been weaker than expected on soft housing rents and car prices, and may stay below 1% from Aug 2014- May 2015. MAS thus cut its headline inflation forecast to 1.5-2% with further cuts possible. The rise in core inflation to just 2.2% in 2Q and Jul appears weaker than expected, though MAS still expects core to stay "elevated" at 2-3% in 2013 on cost pressures from a tight labour market.

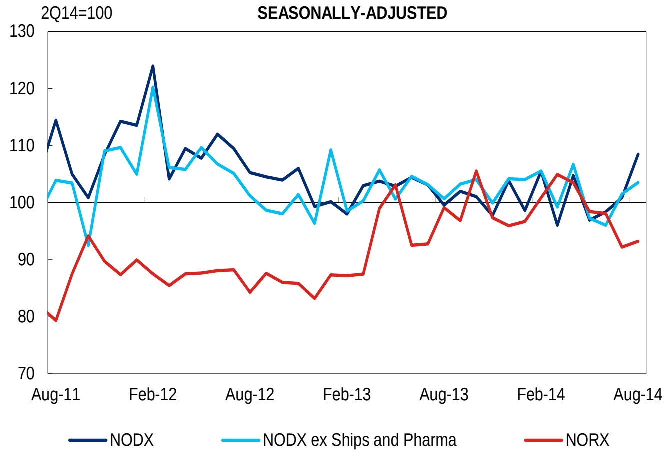
Pipeline disinflationary pressures could be gathering steam. [1] Private road transport inflation has been falling sequentially since May, though the 6.8% MoM increase in average COE premiums in Aug should raise private transport inflation by around 2% MoM in Sep. Assuming private road transport prices stay broadly flat through 2015, base effects would ensure that private road transport shaves off between 0.1-0.6%pts off headline inflation between Jul 2014 and May 2015. [2] Accommodation rentals are also likely to be a drag on inflation. Going forward, the rising pipeline in private housing completions from 2014 (28% of existing stock) onwards will likely push up vacancy rates, especially in the context of slower population growth. The turning demand-supply balance is likely to place downward pressure even on HDB rentals. [3] Weakness in private consumption in the context of negative wealth effects from lower house prices and deleveraging could hurt pricing power and limit the upside to core CPI despite higher costs. [4] Weak consumption and tourist arrivals have hurt retail sales, limiting landlords' ability to raise retail rents, which have essentially been flat since 2010 despite falling vacancy rates. The weak retail environment has already been reflected in the contraction in tenant traffic and sales of the major retail REITS, though this has yet to translate into rental pressures as yet.

Expectations of MAS easing in 2014 likely premature

MAS is unlikely to ease in Oct. First, given the MAS's outlook for the tight labour market to keep core inflation "elevated" at 2-3%, headline inflation forecast cuts are not a sufficient condition for MAS to ease policy - out of the 12 times official inflation forecasts were cut since 2000, policy has only been eased four times. Second, the pick-up in 3Q growth on external demand is in line with MAS's expectations and should allay concerns over the growth outlook, at least for now. Third, MAS aims to keep core inflation expectations anchored at about 2.5% - while the SMU-Mastercard survey showed a downward trend in expectations, inflation expectations for core remain above this threshold, at 4.5% on a five-year horizon. We would look for a material deterioration in the job market as a signpost for policy easing. Structurally, the MTI's recent findings that export oriented sectors have seen higher *trend* productivity growth vs domestically-oriented sectors is an argument for structurally faster-pace REER appreciation, accommodated by maintaining the "slightly steeper slope" of the SGD NEER.

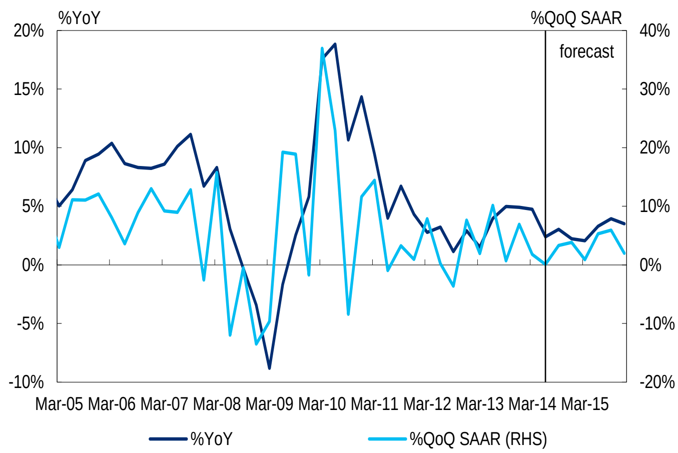
With expectations of MAS easing premature, we would be alert for MAS intervention to prevent the NEER from falling too far below the policy band mid-point though, unlike in Mar, sub 1% headline inflation rules out any swift rebound in the NEER above the mid-point.. Falling DBU deposits partly reflect a shift to foreign currency ACU deposits, and may exert further downward pressure on the SGD. With the DBU LDR ratio just a shade below the pre-Asian crisis peak of 116%, domestic SGD liquidity has tightened, exerting upward pressure on short term interest rates.

Figure 67. External demand has recovered in Jul-Aug



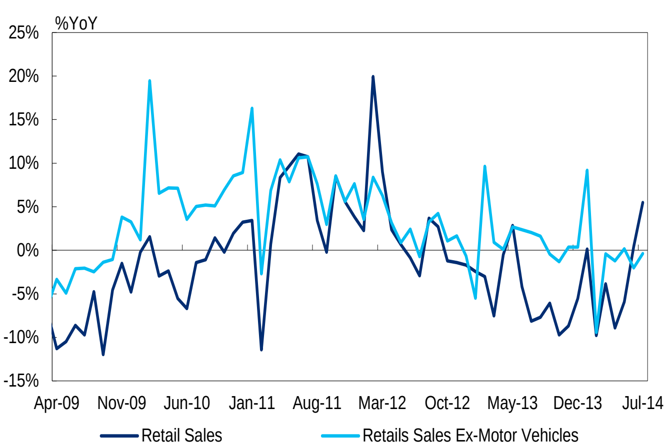
Source: CEIC, Citi Research

Figure 68. The export recovery is in line with our 2H GDP forecast



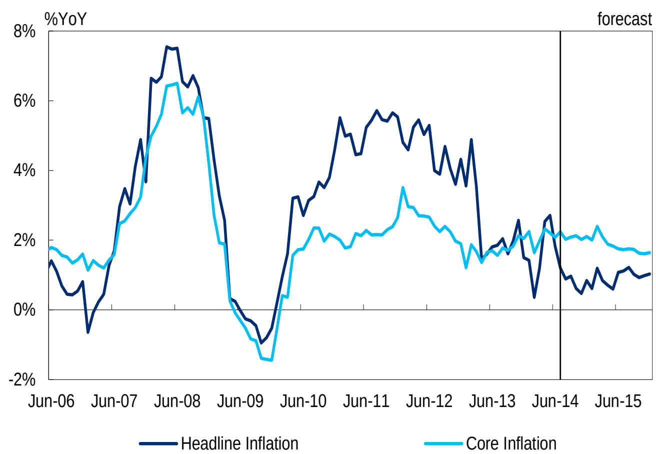
Source: CEIC, Citi Research

Figure 69. "Core" retail sales remains weak



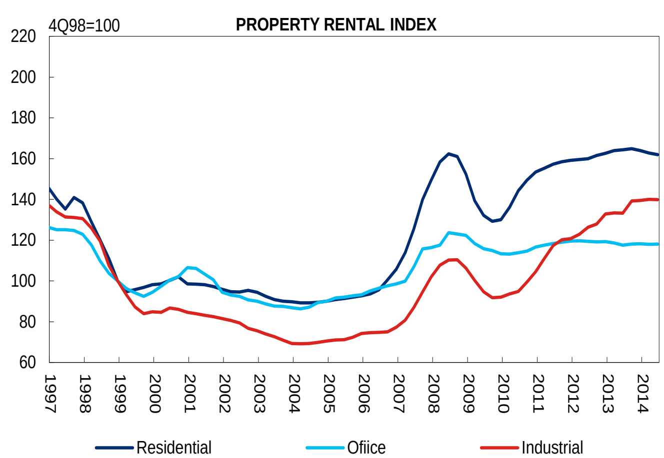
Source: CEIC, Citi Research

Figure 70. We expect headline inflation to fall below 1% YoY in August



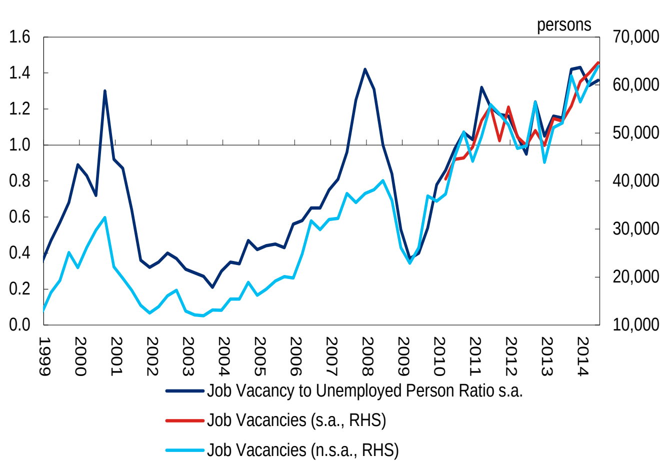
Source: CEIC, Citi Research

Figure 71. Rentals have peaked



Source: CEIC, Citi Research

Figure 72. We must look at the labour market for signs of distress



Source: CEIC, Citi Research

Figure 73. Singapore Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	180.3	192.5	193.0	236.9	274.3	287.2	298.0	325.1	359.7
Nominal GDP, local currency mn	271	272	280	322	345	359	373	410	456
GDP per capita, US$	39,287	39,772	38,694	46,671	52,908	54,058	55,199	59,111	64,224
Population, mn	4.6	4.8	5.0	5.1	5.2	5.3	5.4	5.5	5.6
Unemployment, % of labour force	2.1	2.3	3.0	2.2	2.0	1.9	1.9	2.0	2.1
Economic Activity									
Real GDP, % yoy	9.1	1.8	-0.6	15.2	6.1	2.5	3.9	3.1	3.2
Real investment growth % yoy	12.1	29.6	-11.3	24.4	4.3	14.9	-2.2	-0.8	-0.5
Real consumption growth % yoy	5.4	4.0	0.0	6.9	3.1	3.1	4.1	0.6	1.2
private consumption growth % yoy	6.1	3.5	-1.1	5.9	4.3	3.9	2.6	1.5	0.8
Real export growth, % yoy	8.6	4.6	-7.5	17.4	4.6	1.5	3.6	4.0	3.7
Real import growth, % yoy	7.4	10.0	-10.4	16.2	3.2	3.1	3.1	3.2	2.3
Prices, Money & Credit									
CPI, % yoy	3.7	5.5	-0.5	4.6	5.5	4.3	1.5	0.8	1.0
CPI, % avg	2.1	6.6	0.6	2.8	5.2	4.6	2.4	1.2	0.9
Nominal wages, % yoy	6.2	5.4	-2.7	5.6	6.0	2.3	4.3	3.5	3.5
Credit extension to private sector, % yoy	16.9	15.2	2.0	13.4	18.6	13.2	12.0	10.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	2.38	1.00	0.69	0.44	0.38	0.38	0.40	0.40	0.80
Long term yield, % eop	2.68	2.05	2.66	2.71	1.63	1.30	2.56	3.00	3.20
lc/US$, eop	1.44	1.43	1.41	1.28	1.30	1.22	1.26	1.27	1.27
lc/US$, avg	1.51	1.41	1.45	1.36	1.26	1.25	1.25	1.26	1.27
Balance of Payments, US$ bn									
Current account	46.8	27.7	32.4	56.0	62.6	50.2	54.6	58.5	64.7
% of GDP	25.9	14.4	16.8	23.6	22.8	17.5	18.3	18.0	18.0
Trade balance	57.8	41.6	47.6	62.9	69.6	63.5	67.8	65.0	70.0
Exports	312.4	352.9	287.4	370.5	432.0	434.5	437.7	440.0	450.0
Imports	254.6	311.3	239.8	307.6	362.5	371.0	369.9	375.0	380.0
Service balance	-2.3	-1.5	-2.3	-0.4	2.8	0.9	0.8	1.0	2.0
Income balance	-8.7	-12.4	-12.9	-6.5	-9.8	-14.2	-14.0	-7.5	-7.3
FDI, net	10.8	5.4	-2.4	21.7	26.9	47.7	36.8	32.0	32.0
International reserves	163.0	174.2	187.8	225.8	237.7	259.3	273.1	280.0	290.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	2.8	0.1	-0.3	0.3	1.2	1.7	1.1	-0.3	0.2
Consolidated gov primary balance	2.7	1.1	-0.8	0.2	1.3	2.0	1.3	0.7	0.5
Public debt	86.3	93.9	104.2	99.6	102.7	107.4	104.7	110.0	110.0
of which Domestic	86.3	93.9	104.2	99.6	102.7	107.4	104.7	110.0	110.0
Foreign Assets & Liabilities, US$ bn									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	4.8	2.4	3.0	2.2	2.1	3.3	3.9	3.5	3.8
CPI, % yoy	1.2	1.8	1.0	0.8	0.8	1.1	1.0	1.0	1.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
Short-term market rate, % eop	0.41	0.40	0.40	0.40	0.45	0.50	0.60	0.80	1.00
Long term yield, % eop	2.49	2.75	2.90	3.00	3.00	3.10	3.20	3.20	3.30
lc vs USD, eop	1.26	1.25	1.27	1.27	1.27	1.27	1.27	1.27	1.26

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates.
*Note: Public debt is general government debt.

South Korea

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- **Summary view** – The government is going to bolster economic recovery further in 2015 by increasing its spending by KRW7.6bn, following its implementation of extra spending in 2H14 and 2015 by KRW40.7trn in Aug. With this, real GDP growth in 2014-15 is expected to inch up by c0.2%p on average.
- **Things to watch** – We expect the BoK to hold policy rate at 2.25% in 2H14 after a cut by 25bps in Aug since economy growth is likely to maintain above potential growth in the coming quarters. Rate hike will likely begin in 2H15 along with the Fed's rate hikes, albeit slowly by 50bps to the end of 2015.
- **Strategy** – Over the 0-3m horizon USDKRW is likely to rise to 1050 as KRW is poised to come under additional pressure with expected BoJ QE in 4Q14 and higher UST yields towards year-end. But, 6-12 months out, better growth outlook and hefty current account surplus are likely to ease some of the short-term strains, converging USDKRW to 1040.

Growth is likely rebound in 3Q after a setback in 2Q

Preliminary 2Q growth turned out slightly weaker than the advance estimate. The BoK revised down 2Q14 real GDP growth by both 0.1%p to 0.5%QoQ sa and 3.5%YoY respectively from the advance estimate (0.6%QoQ sa and 3.6%YoY) released in Jul. We attribute the downward revision of growth to weaker construction and facilities investments, as well as exports, than previously estimated. However, the private consumption expenditure in 2Q14 was not worse than the advance estimate, and some signs of recovery in the housing market, such as increase in transactions and prices, along with the government's measures. Moreover, we believe the weaker-than-expected investments is mostly due to uncertainties of the domestic and external economies that expansionary measures implemented recently could dissolve to some extent. We maintain our 2014 and 2015 growth forecast at 3.9% and 4.0% since we expect the recovery to continue along with the government's boosting measures. In particular, we expect that growth in 3Q is likely rebound to 1.5%QoQ sa from 0.5%QoQ sa in 2Q.

Improving job growth and consumer sentiment hints at recovery. On a seasonally adjusted basis, the economically active population increased further by +185.2K from +117.0K in Jul as the employed and the unemployed both grew by +169.1K and +16.1K respectively. The MoM job growth in the service sector accelerated to +178K from +89K in Jul since the negative impact of the ferry sinking incident to service sector jobs seems to have faded further along with the summer holidays and the governments' measures. Composite Consumer Sentiment Index (CCSI) in Aug also rebounded to 107 from 105 a month ago. CSI for current and expectations domestic economic situation showed hefty improvements.

Exports declined on fewer working days, but stronger than expectations. Exports in Aug fell 0.1%YoY, following a 5.4%YoY gain in Jul. Exports dipped due to fewer working days this Aug than in the same month last year. But the decline was narrower than consensus since daily average exports grew by 4.6%YoY. Exports to the US (7.1%YoY) and EU (9.7%YoY) continued to recover on the back of export growth of LCD and autos for the former. However, exports to China (-3.8YoY vs. Jul: -7.0%) remained sluggish, continuing four consecutive months of YoY declines, partly due to continued contraction in petro products and steel exports.

…on the back of stimulus measures

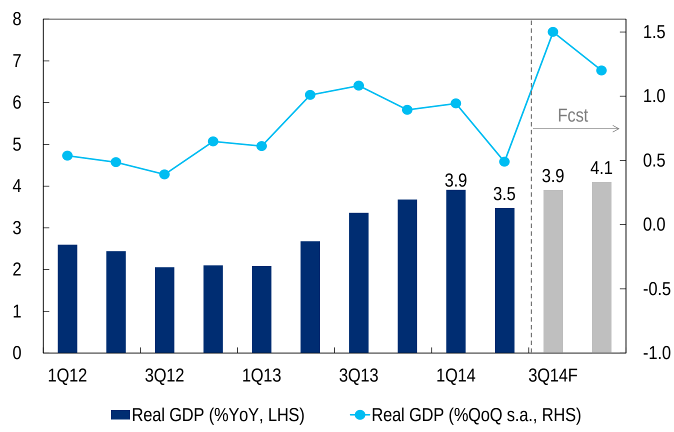
The new economic team unveiled a bold plan to revive growth. With Choi Kyung-hwan at his new post as the Deputy Prime Minister and finance minister, the government rolled out economic policies on Jul and Aug to boost growth. Main policies to shore up domestic demand include a KRW41trn stimulus package in 2H14-2015 and measures to increase household income. With this, real GDP growth in 2014-15 is expected to inch up by c0.2%p on average. The government plans to introduce tax incentives for higher wage income, higher dividend income, and larger corporate investment. To stimulate housing market, the package of housing market boosting measures was already announced. These measures include relaxation of real estate mortgage related financial regulation such as LTV and DTI, improvement of the housing subscription system, and relaxation of regulations on housing refurbishment.

Government spending in 2015 set to be larger than previously planned. The government rolled out details of the 2015 on Sep. Total government expenditure in 2015 is KRW376.0trn, a 5.7% (+KRW20.2trn) increase from a year ago, while total revenue is expected to increase by 3.6%YoY (+KRW13.4trn) to KRW382.7trn. The resulting fiscal balance excluding social security funds is expected to widen the deficit to KRW33.6trn (-2.1% of nominal GDP) from KRW25.5trn (-1.7%) in 2014. The spending increase is mostly likely to center on welfare (including subsides on equation) and employment, supporting SMEs, and social safety and SOC. To finance the deficit, the government plans to issue KRW33.1trn of deficit bonds, up by KRW5.4trn from 2014. We note that the government still expects nominal GDP growth at around 6% and real GDP growth at 4% in 2015.

BoK is likely to hold its policy rate unless 3Q14 growth falters unexpectedly. After the downward revision of 2Q14 growth amid concerns over sluggish economic sentiments, the BoK cut the policy rate by 25bps to 2.25% in Aug. The government seems to continue to put pressure on the BoK to take another step for a further accommodative stance. However, as the economy's growth is likely to maintain above potential growth in the coming quarters, the pressure seems to miss adequacy. BoK Governor said that recent low inflation is mainly due to temporary supply shocks to agricultural goods and oils as well as some policy impacts such as the government subsidies. He also added that a rate cut is not a desirable tool to support KRW against JPY. However, the likelihood of a rate cut could rise if the government's pressure on the BoK becomes harsher and the readings on IP in Aug and exports in Sep are very disappointing to lead a meaningful downgrade of 3Q14 growth forecast. The latter is not likely for now in our view since the government's measures and consumption recovery after the ferry incident in Apr seem to bolster economic growth.

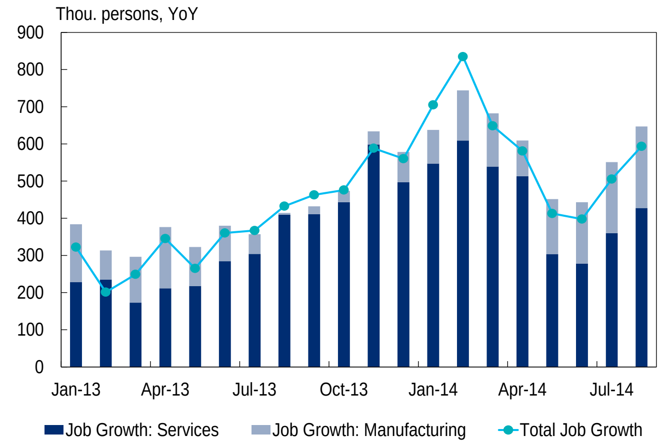
USDKRW is likely to rise but KRW depreciation expects to be limited. Over the 0-3m horizon, our forecast now shows USDKRW at 1050. KRW is poised to come under additional pressure with expected BoJ QE in 4Q14 and higher UST yields towards year-end. But we also expect offsetting pressures from Korea's FX authorities, explicitly said to engage in smoothing operation if KRW appreciates of depreciate excessively in short term. 6-12 months out, better growth outlook and hefty current account surplus are likely to ease some of the short-term strains, converging USDKRW to 1040. We maintain our view that KRW will eventually appreciate in the long term, reaching USDKRW to 1010 in 4Q15 and 970 in 3Q16.

Figure 74. We keep our 2014E growth at 3.9% given stimulus measures



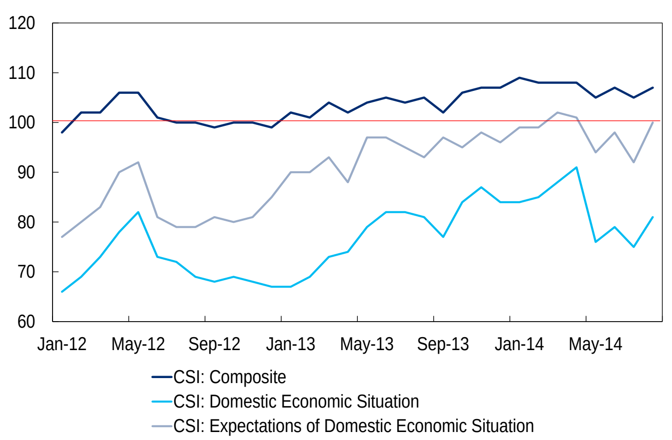
Source: Bank of Korea, Citi Research

Figure 75. Services sector has led the rebound in total job growth



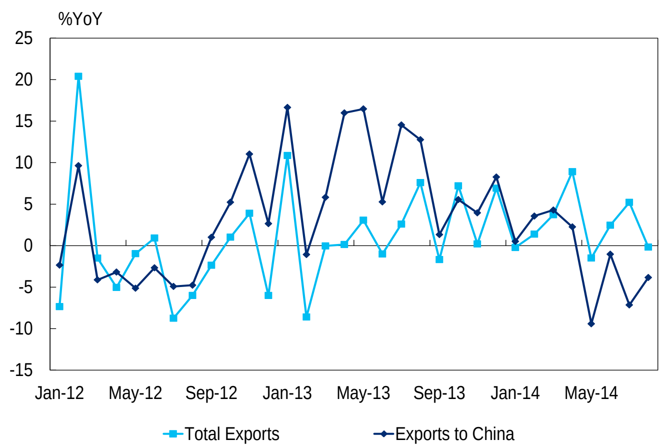
Source: Statistics Korea, Citi Research

Figure 76. Consumer sentiment on economic situation dropped in Jul



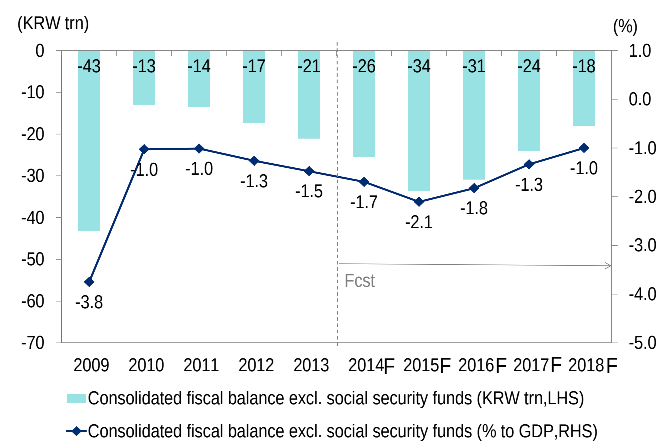
Source: Bank of Korea, Citi Research

Figure 77. Exports fell on fewer working days, China remained sluggish



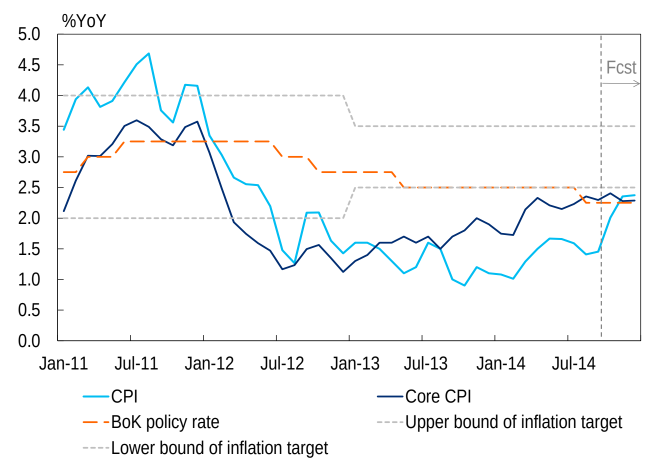
Source: Korea International Trade Association, Citi Research

Figure 78. Fiscal balance deteriorated to support stimulus measures



Source: Ministry of Strategy and Finance, Citi Research

Figure 79. We expect the BoK to hold after a cut by 25bps in Aug



Source: Bank of Korea, Statistics Korea, Citi Research

Figure 80. Korea Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	1,121.3	999.7	902.6	1,094.6	1,202.8	1,222.5	1,304.3	1,470.8	1,595.9
Nominal GDP, local currency bn	1,043,258	1,104,492	1,151,708	1,265,308	1,332,681	1,377,457	1,428,295	1,517,818	1,622,212
GDP per capita, US$	23,073	20,424	18,352	22,153	24,163	24,448	25,972	29,168	31,529
Population, mn	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4	50.6
Unemployment, % of labour force	3.2	3.2	3.6	3.7	3.4	3.2	3.1	3.5	3.1
Economic Activity									
Real GDP, % yoy	5.5	2.8	0.7	6.5	3.7	2.3	3.0	3.9	4.0
Real investment growth % yoy	4.5	-1.0	-10.1	17.8	3.5	-2.3	0.0	5.2	3.4
Real consumption growth % yoy	5.3	2.2	1.3	4.3	2.7	2.2	2.2	2.2	3.5
private consumption growth % yoy	5.1	1.4	0.2	4.4	2.9	1.9	2.0	2.0	3.4
Real export growth, % yoy	12.7	7.5	-0.3	12.7	15.1	5.1	4.3	5.2	7.1
Real import growth, % yoy	11.6	3.2	-6.8	17.3	14.3	2.4	1.6	4.2	6.6
Prices, Money & Credit									
CPI, % yoy	3.6	4.1	2.7	3.1	4.2	1.4	1.1	2.4	2.9
CPI, % avg	2.5	4.7	2.8	3.0	4.0	2.2	1.3	1.6	2.6
Nominal wages, % yoy	5.6	-4.1	2.6	6.8	1.0	5.3	3.9	4.8	5.1
Credit extension to private sector, % yoy	12.5	14.9	5.0	4.0	6.5	3.2	4.7	5.7	7.9
Policy interest rate, % eop	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.25	2.75
Short-term market rate, % eop	5.73	4.68	2.82	2.80	3.55	2.89	2.66	2.35	2.90
Long term yield, % eop	5.78	3.77	4.92	4.08	3.46	2.97	3.23	2.75	3.25
lc/US$, eop	936	1,263	1,166	1,121	1,159	1,064	1,051	1,047	1,010
lc/US$, avg	929	1,102	1,275	1,156	1,108	1,127	1,095	1,043	1,029
Balance of Payments, US$ bn									
Current account	11.8	3.2	33.6	28.9	18.7	50.8	79.9	75.6	48.9
% of GDP	1.1	0.3	3.7	2.6	1.6	4.2	6.1	5.1	3.1
Trade balance	14.6	-13.3	40.4	41.2	30.8	28.3	44.0	39.9	40.8
Exports	371.5	422.0	363.5	466.4	555.2	547.9	559.6	581.1	641.8
Imports	356.8	435.3	323.1	425.2	524.4	519.6	515.6	541.2	600.9
Service balance	-12.0	-5.7	-6.6	-8.6	-5.8	-5.2	-7.9	-3.7	-4.4
Income balance	-3.4	3.7	1.6	-2.1	0.3	6.6	7.2	2.8	-1.0
FDI, net	-17.9	-16.9	-14.9	-22.2	-16.4	-18.9	-13.1	-8.6	-4.3
International reserves	262.2	201.1	270.0	291.5	304.2	323.2	341.7	377.5	391.5
Total Amortisations	24.5	31.0	30.2	35.7	42.7	43.5	44.3	45.1	46.0
Public Finances, % of GDP									
Consolidated government balance	3.2	1.1	-1.5	1.3	1.4	1.3	1.0	0.9	1.4
Consolidated gov primary balance	4.5	2.4	-0.2	2.6	2.7	2.5	2.3	2.2	2.7
Public debt	27.7	27.0	30.1	29.5	30.2	30.9	32.5	30.7	28.9
of which Domestic	26.7	26.1	29.1	28.7	29.4	30.1	31.7	29.9	28.2
Foreign Assets & Liabilities, US$ bn									
External debt	333.4	317.4	345.7	359.8	398.7	409.4	416.6	420.5	428.5
Private	279.8	264.9	277.9	280.0	314.7	311.2	312.3	314.6	319.8
Public	53.6	52.5	67.8	79.7	84.0	98.2	104.3	105.9	108.7
External debt / GDP	29.7	31.7	38.3	32.9	33.1	33.5	31.9	28.6	26.9
External debt / XGS	75.0	61.9	79.1	65.0	61.3	62.1	61.8	59.7	55.2
Short-term debt	160.3	149.9	149.2	139.8	137.4	127.2	112.8	104.0	108.0
Short-term debt/International Reserves (%)	61.1	74.5	55.3	47.9	45.2	39.4	33.0	27.5	27.6

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.9	3.5	3.9	4.1	4.0	4.2	3.8	3.9	3.7
CPI, % yoy	1.3	1.7	1.5	2.4	2.4	2.5	3.1	2.9	2.9
Policy interest rate, % eop	2.50	2.50	2.25	2.25	2.25	2.25	2.50	2.75	3.00
Short-term market rate, % eop	2.65	2.65	2.35	2.35	2.40	2.40	2.65	2.90	3.15
Long term yield, % eop	3.16	2.88	2.65	2.75	2.95	3.05	3.20	3.25	3.50
lc vs USD, eop	1,065	1,012	1,047	1,047	1,044	1,039	1,024	1,010	996

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

Taiwan

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- **Summary view** – We continue to expect the economy to grow steadily in 3Q and 4Q at 3.6%YoY and 3.7%YoY, but the performance of tech and non tech exports is likely to diverge. Local elections in Nov will set the tone for future pace of cross-strait policies/cooperation.

- **Things to watch** – 1) Cross-strait momentum: Banks M&A, RMB swap line, ECFA for services and goods; 2) pension reform; 3) 2014's local elections; 4) Liberalization efforts in FEZ; 5) TPP and RECP talks; 6) fourth nuclear plant refrendum; 7) China impacts via exports, financials, RMB and geopolitics.

- **Strategy** – Policy rate likely stable till 2H15, CBC prefer to use NCD for liqudity managment; 10Y government bond yields likely on a gradual uptrend. TWD strength gave way to USD strength, we revised our 0-3M forecast to 30.3/USD . Our house view on TAIEX remains at 10,000.

Tech recovery vs non-tech uncertainty in 2H

Steady recovery in 3Q and 4Q expected: Aug Markit PMI (56.1) expanded at the quickest rate since Jan 11 and much stronger than regional peers; while the NCD published leading index for July continues to edge up, to 104.9. We continue to expect the economy to grow steadily in 3Q and 4Q at 3.6%YoY and 3.7%YoY.

Tech exports and production are driving recovery near term. An extended Apple product suite, wearable electronics, adoption of high-spec cameras, gradual PC revival, as well as Internet of Things are helping Taiwan's exports and driving the theme play in equities (despite a recent correction in the stock market). Tech goods have a strong seasonality characteristic; we expect to see two phenomena: (1) tech exports and production will improve all the way to Thanksgiving/Christmas sales, forming a peak in 4Q 2014; (2) new technology in chip manufacturing probably can help make the usual dip in tech component sales in 1H 2015 less pronounced. With these two trends in mind, we believe tech exports (which constitute >40% of total exports) will remain the driver for 4Q 2014E and early 2015.

Non tech exports depend on Chinese demand. Non tech exports make up about 30% of total exports, of which the four dominant categories are chemicals, plastics, basic metals and machinery. The exports of these four individual categories to China and HK are sizeable, i.e. 49% of chemicals exports go to CN+HK, 35% for plastics, 24% for machinery, and 17% for basic metals. Therefore recent renewed signs of weakness of China's economy will again take a toll on Taiwan's non-tech exports in 4Q. Note Citi's recent downgrade of China's GDP forecast from 7.5%YoY to 7.3% for this year on imminent and lasting negative impact of property investment growth. Citi believes if timely easing could come from the Chinese government (of potentially RRR cut and three 25bps policy rate cuts in upcoming three quarters) then a China growth slump could be alleviated, and it could maintain 7.1%YoY GDP growth for 2015. However, uncertainty in the China economy will put strain on Taiwanese non-tech exports, given the high concentration of Chinese buyers.

Retail sales gains are encouraging. Consumption has rebounded since Apr this year and earlier it was largely led by gains from the equity market and a spurt of small vehicles purchases. However, we have also noted a gradual improvement in regular wages lately, which will likely to support consumption recovery. Given somewhat better hiring sentiment, hiring in tech (in particular, chip) manufacturing is up, and there is hope that wages could continue to improve gradually for the upcoming quarters.

Market update

TWD weakness in the near term: We think China uncertainties and the strong USD and regional currency (especially CNY, KRW and JPY) weakness will likely weigh on the TWD to 30.3 in 0-3M, despite better tech exports before Christmas. A weaker TWD is also supportive for Taiwan's exports. In the medium term, we expect the TWD could appreciate gently amid a gradual G3 economic recovery, and a stabilized Chinese economy post policy easing. Net outflows occurred in Aug after an eleventh consecutive month of inflows, but our equity strategist still expects better equity performances towards year end which, if it materializes, will help support the TWD. Recent concerns of rising external short-term debt should not weaken the TWD fundamentals, in our view, as most of the increase is in trade-related loans and, after all, Taiwan continues to run a large and widening current account surplus coupled with its large external assets.

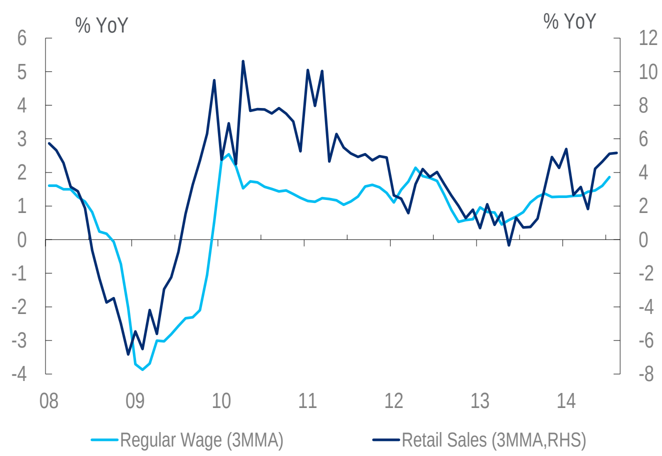
Prolonged low interest rate cycle for Taiwan: We do not agree with recent market concern about likely earlier 2015 US Fed Fund rate hikes and CBC policy rate hikes. Our house view remains that the Fed would rather attain more certainty and with rate hike rates only starting gradually in 3Q15E. We believe there is also no reason for the CBC to raise its policy rate (the rediscount rate) earlier than the Fed, given an uncertain external environment and worry about an exports recovery follow-through after the Apple-product suite is fully launched and, furthermore, inflation remains rather benign (official CPI forecasts at 1.64% for 2014E and 1.46% for 2015E). In fact, CBC Governor Perng recently expressed his preference to use NCD issuance to mop up excess liquidity from the market after the Fed starts hiking.

Early success of property curbs: The property cooling measures that were launched in June are dampening the property price rise in metropolitan areas, especially notable in Taipei City (as seen in data up to Aug), and CBC Governor has repeatedly said that raising rates is not a good tool to curb property price rise and instead endorses macro prudential measures as being more effective, according to international experience.

Taiwan is entering into its 14-month long election cycle

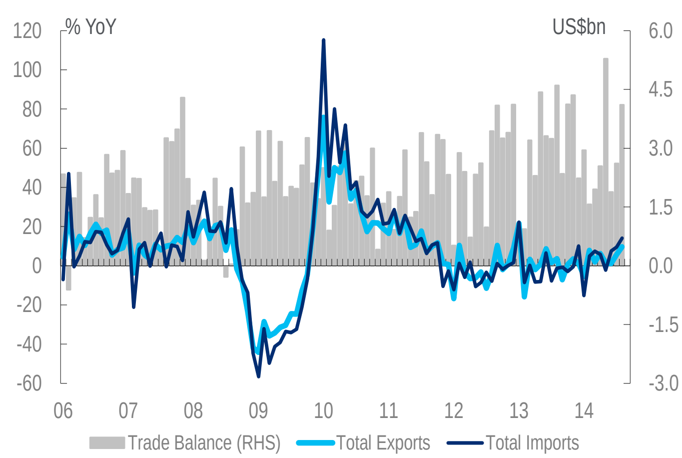
Local elections to be more closely watched than usual: The election cycle will be kick started by the super 7-in-1 local elections on 29 Nov 2014 to elect the municipal mayors, municipal councilors, and ward chiefs of the six special municipalities (Kaohsiung, New Taipei, Taichung, Tainan, Taoyuan and Taipei). These simultaneous elections will make the 7-in-1 the biggest local election ever in Taiwan history. In particular, we look for the races in the municipalities where DPP may make gains outside southern Taiwan, especially the crucial contest in Taichung. If this situation materializes, it will reflect recent policy initiatives, political scandals, as crisis management is making the ruling government KMT less popular. KMT's future direction and the pace of closer cross-strait cooperation may need to be re-examined. The local elections will therefore set the tone for the President, Vice-President and Legislative Elections in 2016 (which likely to be held in Jan). We noted that presidential election campaign starts six months ahead, therefore we see a very limited five-month window for passing the oversight bill and ECFA for services post local elections and before the next campaign round, and it is highly dependent on the results of the local elections.

Figure 81. Consumption improving more meaningfully



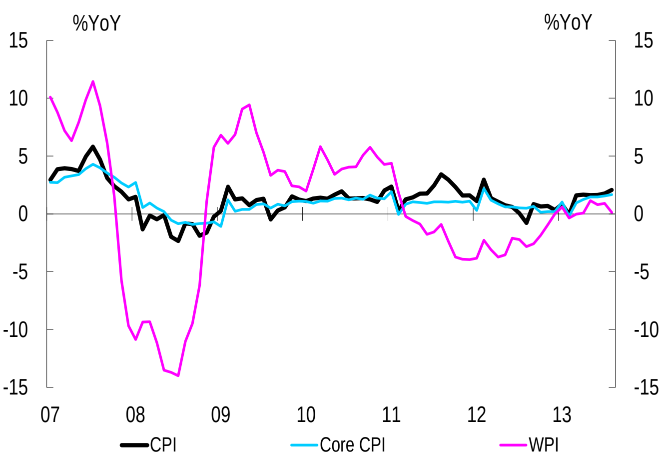
Source: CEIC, Citi Research

Figure 82. Trade recovery likely to pick up pace in 2H



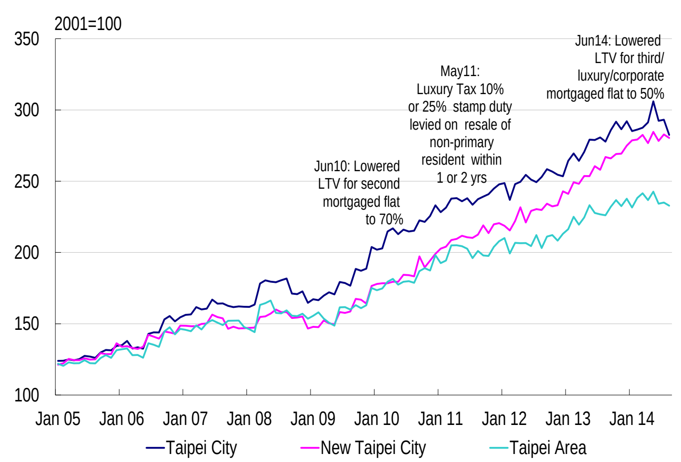
Source: CEIC, Citi Research

Figure 83. Benign inflation gives room for CBC's accommodation



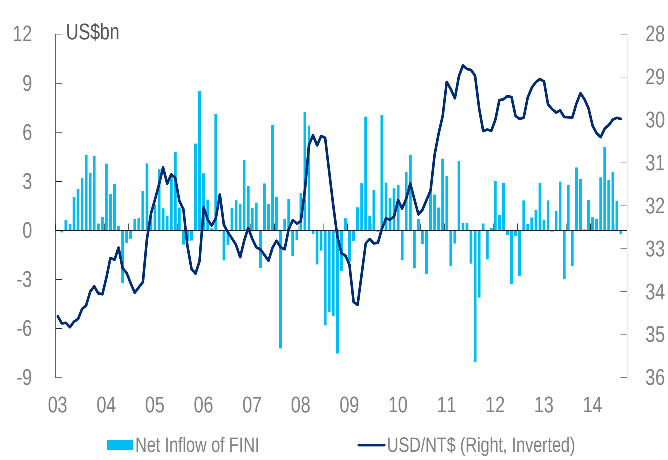
Source: CEIC, Citi Research

Figure 84. Sinyi price index retreated post new ppt measures



Source: CEIC, Citi Research

Figure 85. FINI outflow lowered support for TWD amid strong USD



Source: CEIC, Citi Research

Figure 86. 10Y govt bonds likely will rise, but more gradual than UST

Source: CEIC, Citi Research

Figure 87. Taiwan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	393.0	400.2	378.0	430.3	466.5	476.3	490.6	509.0	544.8
Nominal GDP, local currency bn	12,911	12,620	12,481	13,552	13,709	14,077	14,561	15,306	16,216
GDP per capita, US$	17,118	17,370	16,348	18,579	20,084	20,429	20,991	21,733	23,215
Population, mn	23.0	23.0	23.1	23.2	23.2	23.3	23.4	23.4	23.5
Unemployment, % of labour force	3.9	4.1	5.8	5.2	4.4	4.2	4.2	4.0	3.9
Economic Activity									
Real GDP, % yoy	6.0	0.7	-1.8	10.8	4.2	1.5	2.1	3.6	4.0
Real investment growth % yoy	-0.7	-7.9	-21.2	36.8	-6.8	-4.6	2.2	5.4	3.5
Real consumption growth % yoy	2.1	-0.6	1.3	3.3	2.9	1.5	1.6	2.0	2.3
private consumption growth % yoy	2.1	-0.9	0.8	4.0	3.1	1.6	2.0	2.2	3.0
Real export growth, % yoy	9.6	0.9	-8.7	25.6	4.5	0.1	3.8	4.7	6.3
Real import growth, % yoy	3.0	-3.7	-13.1	27.7	-0.5	-2.2	3.9	3.7	5.2
Prices, Money & Credit									
CPI, % yoy	3.3	1.3	-0.2	1.2	2.0	1.6	0.3	2.5	2.7
CPI, % avg	1.8	3.5	-0.9	1.0	1.4	1.9	0.8	1.5	2.0
Nominal wages, % yoy	2.1	-0.1	-5.0	5.3	2.6	0.1	0.2	1.5	3.0
Credit extension to private sector, % yoy	3.9	2.7	-0.8	6.7	5.6	4.1	5.3	7.0	8.5
Policy interest rate, % eop	3.38	2.00	1.25	1.63	1.88	1.88	1.88	1.88	2.13
Short-term market rate, % eop	2.04	1.02	0.57	0.74	0.87	0.87	0.87	0.93	1.17
Long term yield, % eop	2.53	1.44	1.47	1.47	1.27	1.15	1.69	1.80	2.00
lc/US$, eop	32.43	32.78	32.23	29.17	30.29	29.06	29.83	30.24	29.89
lc/US$, avg	32.85	31.58	33.04	31.50	29.40	29.57	29.68	30.22	30.03
Balance of Payments, US$ bn									
Current account	35.2	27.5	42.9	39.9	41.7	50.6	57.3	56.0	55.6
% of GDP	8.9	6.9	11.4	9.3	8.9	10.6	11.7	11.0	10.2
Trade balance	27.4	15.2	29.3	23.4	26.8	30.7	35.5	37.9	46.4
Exports	246.7	255.6	203.7	274.6	308.3	301.2	305.4	323.7	349.9
Imports	219.3	240.4	174.4	251.2	281.4	270.5	269.9	285.9	303.5
Service balance	-1.6	1.8	2.0	2.5	3.9	6.3	10.4	13.2	12.8
Income balance	10.1	10.0	12.5	13.6	13.2	15.3	14.3	17.0	19.0
FDI, net	-3.3	-4.9	-3.1	-9.1	-14.7	-9.9	-10.7	-10.0	-9.0
International reserves	270.3	291.7	348.2	382.0	385.5	403.2	416.8	440.0	460.0
Total Amortisations	8.8	2.5	3.2	6.8	3.4	2.9	3.1	3.2	3.2
Public Finances, % of GDP									
Consolidated government balance	0.9	0.9	-2.2	-1.2	-0.5	-1.4	-1.3	-1.4	-0.8
Consolidated gov primary balance	1.9	1.9	-1.2	-0.3	0.3	-0.5	-0.5	-0.6	-0.5
Public debt	33.3	34.7	38.0	38.3	40.0	41.0	39.9	39.4	39.1
of which Domestic	33.3	34.7	38.0	38.2	40.0	41.0	39.9	39.3	39.0
Foreign Assets & Liabilities, US$ bn									
External debt	94.5	90.4	82.0	101.6	122.5	130.8	170.1	175.4	180.4
Private	91.1	88.9	76.0	93.5	118.0	127.5	165.8	170.2	175.0
Public	3.5	1.5	5.9	8.0	4.5	3.3	4.3	5.3	5.4
External debt / GDP	24.1	22.6	21.7	23.6	26.3	27.5	34.7	34.5	33.1
External debt / XGS	33.4	30.9	34.7	32.0	34.6	37.4	47.6	46.9	44.3
Short-term debt	83.3	78.8	68.2	83.7	107.8	116.5	155.6	165.0	140.0
Short-term debt/International Reserves (%)	30.8	27.0	19.6	21.9	28.0	28.9	37.3	37.5	30.4

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.2	3.7	3.6	3.7	3.6	3.6	4.1	4.2	4.0
CPI, % yoy	1.6	1.6	1.1	2.5	1.3	1.3	2.1	2.7	2.3
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	2.00	2.13	2.25
Short-term market rate, % eop	0.87	0.87	0.87	0.93	0.99	1.05	1.11	1.17	1.22
Long term yield, % eop	1.56	1.58	1.72	1.80	1.85	1.90	1.95	2.00	2.08
lc vs USD, eop	30.45	29.87	30.26	30.24	30.16	30.09	29.99	29.89	29.79

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

Thailand

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- **Summary view** – We kept our growth forecast of 1.1% in 2014 and 4% in 2015 following 2Q growth of 0.4%YoY. Resilient slack amid inception of private and public spending initiated 3Q. Stronger fiscal spending with the FY15 budget would be regarded as among the key catalysts for recovery starting 4Q14.
- **Things to watch** – Implementation risk (or lack of it) of the approved FY15 budget of Bt2.6tn, particularly on infrastructure. Impact of energy price reforms on CPI particularly higher LPG price effect on CPI prepared food. Upcoming proposals for political/electoral amendments.
- **Strategy** – With the MPC on hold and recovery still in a fledgling state, THB would remain vulnerable to a strong USD episode that may prompt BoT intervention to mitigate market instability. BoT's accommodative bias would be consistent with a relatively weak THB likely settling to an average of 32.7 in Dec.

Resilient slack that requires stronger fiscal spending

We maintain our 2014-15 GDP forecasts of 1.1% and 4%, respectively, awaiting fiscal spending stimulus as the FY15 budget is rolled out together with gradual consumption and tourism recovery. The drag on recovery can be summarized by pervasive and resilient slack depicted by ebbing mfg capacity rate, recovering but still-low hotel occupancy rates and the jobless rate edging up in the domestic labor market. With exports alternating between shallow gains and losses despite strong shipments to G3 markets, the lack of strong onshore spending catalysts sustained de-stocking bias and dampened production particularly in the mfg sector. De-stocking has been mirrored by compressed non-oil import demand although recent non-oil import declines (-5.8%YoY in July) were less severe.

Start of 3Q14, the struggle with slack continues. Absent a firm export uptrend amid lackluster manufacturing (-0.1%MoM SA) in July, utilization rate fell to less than 60% SA for the first time since the great deluge. According to BoT, mfg index's downturn eclipsed declining finished goods inventory index to reflect sustained struggle with slack. Unadjusted utilization rates of textiles, apparel and food & beverages remain sub-50% since 2Q14 and these industries accounted for a shade below 30% of total mfg output. Hotel occupancy rate was subdued at 49.2% in July (vs 40.8% in June). Occupancy rate has yet to match 1Q level of 60.3%.Meanwhile, June-July jobless rate edged up past 1% SA when historical rate was less than 1%. Amid entrenched slack, private investments index fell 3.4%YoY (-0.4%MoM SA).

Private consumption index (PCI: 0.2%YoY/0.9%MoM SA), fiscal disbursements (9.7%YoY) together with tourist arrivals (9.1%MoM SA) supported a firmer demand backdrop in July but it wasn't enough to reverse slack. Upbeat July fiscal spending merely cushioned the downturn of -1.8%YoY in the first ten months of FY14. Current expenditures as of July accounted for 79.3% of FY14 program consistent with historical performance. Gov't capital expenditures managed a 55.5% accomplishment rate of the FY14 program. Any 3Q14 (4QFY14) fiscal resurrection bode well for consumption but unlikely to revive investment—a more effective means of limiting slack. **Compared to slack measures that are lagging indicators, forward-looking FDI approvals expanded to 4.3% of GDP in 2Q14 (vs 0.7% in 1Q14).** FDI approvals in June-July posted a hefty jump of 5.8x a year-ago but slumped back in Aug (-65%YoY) such that ytd Aug is a 27.6%YoY drop. Concentration risk dictated the hike in FDI approval as slack and lackluster export demand continues to restrain FDI approvals and impact private investments.

Energy price reforms underway

Aside from revive the public investment program (Bt450bn in FY15), the Prayuth government initiated energy price reforms. Other than strengthen the fiscal balance and 'free up' resources for increased public investments, the energy price reforms seek to restructure tax rates and allow for market-oriented pricing that bodes well for medium-term external trade outlook. The soft oil/commodity price backdrop also facilitates restructuring of price subsidies without causing much stress on low income HH. Last 29 Aug, government announced new retail prices of gasoline products and diesel in which excise taxes on gasoline/gasohol were cut that lowered their respective retail prices while excise taxes on diesel were hiked by 75 satang but the diesel retail price was kept at ~Bt30/liter. This excise tax rebalancing of retail gasoline/diesel prices implied a weighted decline of 1.2%. Government also cut down the contributions to the oil price stabilization fund (OPSF) from consumers of petroleum products. Conduit to inflation will be through CPI fuel which in our estimate is modest 0.2% decline. Rather than expecting a sharp downswing of inflation, HH's purchasing power would be accorded some relief with budget reallocation away from higher gasoline costs.

Direct benefits of energy price reforms

Following excise tax rebalancing of gasoline/diesel products, government expects to receive a net amount of Bt5bn-Bt6bn mainly coming from the diesel tax hike (>Bt10bn net take assuming 60mn liters/day of diesel consumption). Less contribution to the oil price fund would offer relief to vehicle owners as >Bt20bn in our estimate would be returned to them. Overall impact of the lower retail gasoline/diesel price adjustments is ~Bt17.2bn that can be deployed for consumption purposes and provide a lift to GDP prospects.

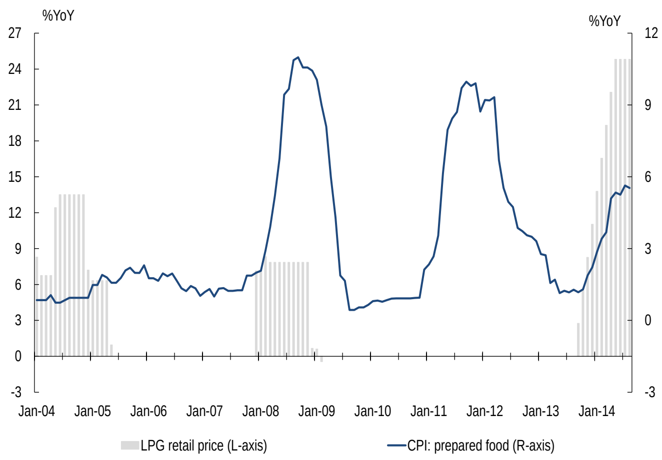
LPG price reforms

Government plans to increase LPG prices from a low of Bt0.62/kg (2.7% increase) to Bt1/kg (4.4% rise). LPG subsidy is sourced from OPSF. LPG is a basic cost catalyst in CPI prepared food. We estimate a direct impact of 0.11% to 0.18% on CPI prepared food that if annualized, implies a 1.4%-2.2% increase in CPI prepared food. In these computations, we employed a regression estimate that disclosed a 1% rise in average LPG retail prices would result in a 0.04% increase in CPI prepared food. Applying the weight of CPI prepared food, we obtain a 0.02%-0.03% rise in headline CPI for an annualized pace of 0.2%-0.3%. Spillover of LPG price adjustments to higher inflation expectations is a risk. LPG price adjustments lower the likelihood of core disinflation risk while sustaining the MPC's 'neutral' policy rate stance. LPG price hikes in our estimate would curb dependence on the oil fund by Bt4.1bn (62 satang hike) – Bt6.6bn (Bt1/kg hike) (assumes that most, if not all, of LPG production is consumed). These estimates are modest compared to the entire LPG price subsidy of Bt9/kg that probably would entail a gross bill of ~Bt60bn.

THB vulnerable to strong USD in the near-term

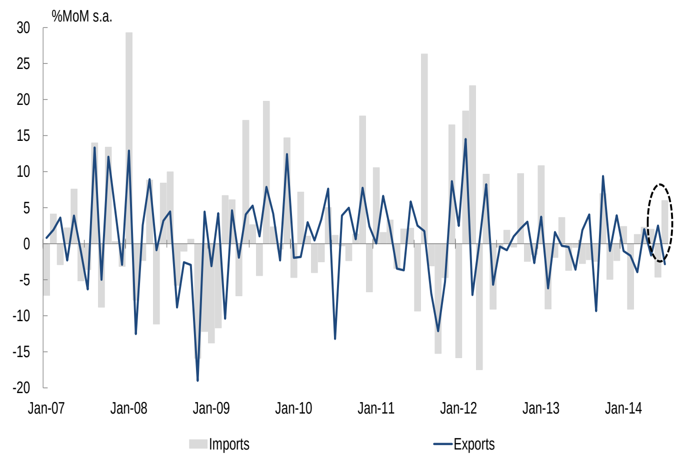
With the MPC on hold and recovery still in a fledgling state, THB would remain vulnerable to a strong USD episode. Any external financial shocks would require BoT intervention with its gross international reserves of US$166.3bn (5 Sep) and a forward book of US$23.6bn. Consistent with its accommodative monetary stance, we believe BoT would prefer a relatively weak THB but still in line with the regional currency movements. We expect THB to settle at an average of 32.7 in Dec.

Figure 88. LPG price hikes contributed to higher CPI prepared food



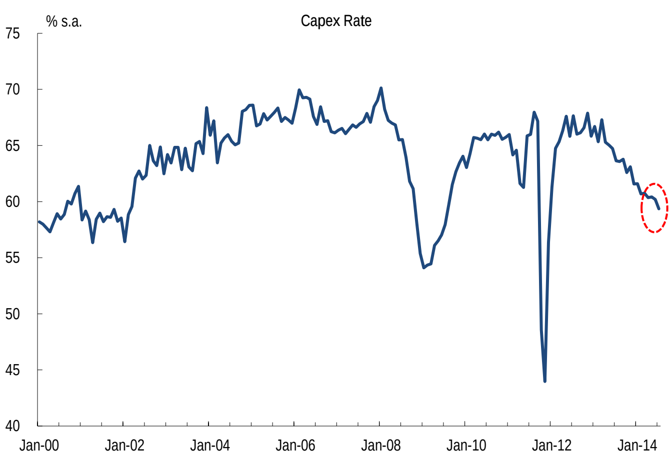
Source: CEIC, Citi Research

Figure 89. Disappointing Jul exports but improving non-oil imports



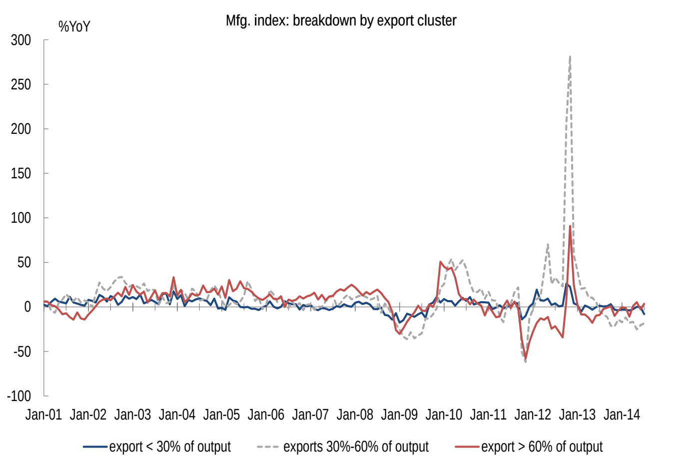
Source: CEIC, Citi Research

Figure 90. Capacity slack deepens in July



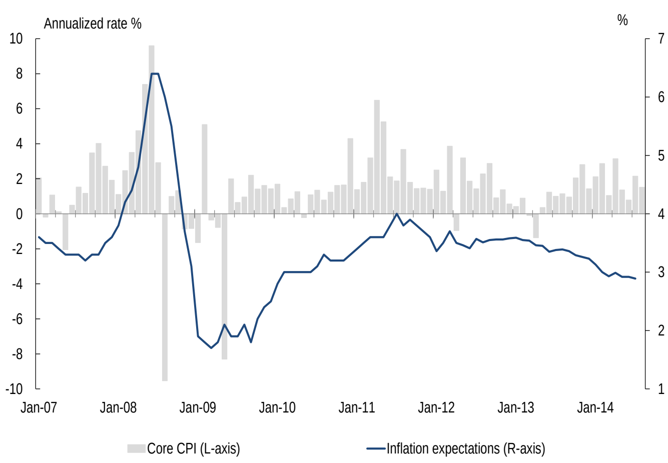
Source: CEIC, Citi Research

Figure 91. Underperformance of domestic market-oriented mfg. index



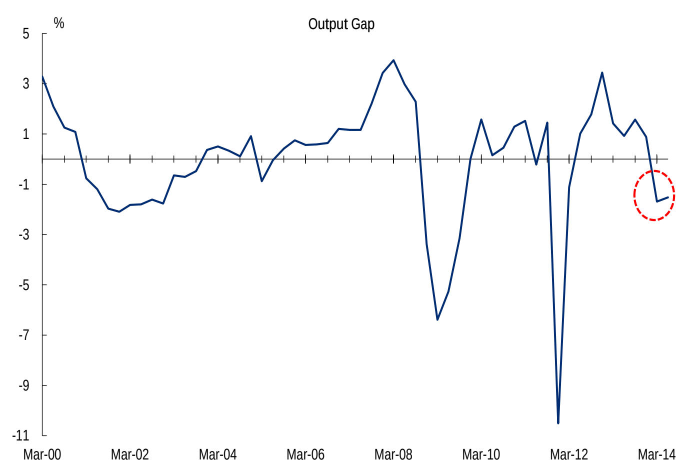
Source: CEIC, Citi Research

Figure 92. Slack, lower inflation expectations but no core disinflation



Source: CEIC, Citi Research

Figure 93. Persistent negative output gap in 2Q14 to mirror slack



Source: CEIC, Citi Research

Figure 94. Thailand Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data									
Nominal GDP, US$ bn	265.2	276.1	263.8	319.3	346.1	366.4	387.8	376.4	397.2
Nominal GDP, local currency bn	8,525	9,080	9,042	10,105	10,540	11,375	11,899	12,304	13,056
GDP per capita, US$	4,207	4,355	4,153	4,998	5,401	5,685	5,987	5,782	6,071
Population, mn	63.0	63.4	63.5	63.9	64.1	64.5	64.8	65.1	65.4
Unemployment, % of labour force	1.4	1.4	1.5	1.0	0.7	0.7	0.7	0.8	0.8
Economic Activity									
Real GDP, % yoy	5.0	2.5	-2.3	7.8	0.1	6.5	2.9	1.2	3.9
Real investment growth % yoy	1.0	8.1	-25.2	28.7	0.1	16.8	2.2	-10.7	3.4
Real consumption growth % yoy	2.9	2.9	0.1	5.1	1.3	6.8	1.1	0.9	3.6
private consumption growth % yoy	1.8	2.9	-1.1	4.8	1.3	6.7	0.3	0.5	3.3
Real export growth, % yoy	7.8	5.1	-12.5	14.7	9.5	3.1	4.2	0.8	3.8
Real import growth, % yoy	4.4	8.9	-21.5	21.5	13.7	6.2	2.3	-4.1	2.8
Prices, Money & Credit									
CPI, % yoy	3.1	0.4	3.5	3.1	3.5	3.6	1.7	1.8	2.2
CPI, % avg	2.2	5.5	-0.9	3.3	3.8	3.0	2.2	2.2	2.1
Nominal wages, % yoy	3.0	10.5	-1.9	5.8	7.2	11.9	7.9	4.0	3.5
Credit extension to private sector, % yoy	29.3	6.3	2.5	18.8	18.3	14.0	10.5	8.5	10.0
Policy interest rate, % eop	3.25	2.75	1.25	2.00	3.25	2.75	2.25	2.00	3.00
Short-term market rate, % eop	3.74	3.07	1.28	2.03	3.26	2.79	2.31	2.05	2.75
Long term yield, % eop	5.13	2.84	4.37	3.74	3.28	3.55	4.07	3.75	4.00
lc/US$, eop	30.05	34.79	33.36	30.07	31.57	30.60	32.70	32.75	32.89
lc/US$, avg	32.39	33.21	34.33	31.71	30.48	31.08	30.72	32.50	32.83
Balance of Payments, US$ bn									
Current account	15.7	2.2	21.9	10.0	8.9	-1.5	-2.5	19.7	16.1
% of GDP	5.9	0.8	8.3	3.1	2.6	-0.4	-0.6	5.2	4.1
Trade balance	26.6	17.3	32.6	29.8	17.0	6.0	6.7	28.7	25.3
Exports	151.3	175.2	150.8	191.6	219.1	225.9	225.4	233.3	247.3
Imports	124.6	157.9	118.2	161.9	202.1	219.9	218.7	204.6	222.0
Net service and Transfer accounts	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	3.7	-0.4	-0.8
Income balance	-3.0	-2.3	-4.4	-9.0	2.5	-4.0	-12.8	-8.6	-8.4
FDI, net	8.3	4.4	0.7	4.5	-2.8	-2.2	6.1	4.8	1.0
International reserves	87.5	111.0	138.4	172.1	175.1	181.6	167.3	170.0	180.0
Total Amortisations	20.3	15.4	11.3	9.4	8.8	9.5	18.0	19.0	20.0
Public Finances, % of GDP									
Consolidated government balance	-1.6	-1.0	-5.7	0.0	-1.0	-2.1	-1.8	-1.2	-1.8
Consolidated gov primary balance	-0.3	0.2	-4.5	1.1	-1.5	-1.6	-1.2	-0.3	-0.7
Public debt	38.3	37.3	45.2	42.6	41.7	45.4	45.9	47.2	48.1
of which Domestic	33.4	33.0	40.9	39.0	38.4	42.3	42.7	43.0	43.3
Foreign Assets & Liabilities, US$ bn									
External debt	74.4	76.1	75.3	100.6	104.3	130.7	139.8	135.0	140.0
Private	71.6	72.7	69.4	87.9	88.1	104.5	114.5	108.4	112.9
Public	2.8	3.4	5.9	12.7	16.2	26.2	25.2	26.6	27.1
External debt / GDP	28.1	27.6	28.5	31.5	30.1	35.7	36.0	35.9	35.2
External debt / XGS	41.0	36.5	41.6	44.5	40.0	47.5	49.1	45.7	44.7
Short-term debt	33.7	32.5	33.3	50.7	47.3	58.2	59.9	59.8	61.0
Short-term debt/International Reserves (%)	38.6	29.3	24.0	29.4	27.0	32.0	35.8	35.2	33.9

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	-0.6	0.4	1.8	3.1	3.4	3.9	4.1	4.3	4.4
CPI, % yoy	2.1	2.4	2.2	1.8	2.0	2.1	2.3	2.2	2.4
Policy interest rate, % eop	2.00	2.00	2.00	2.00	2.00	2.00	2.50	3.00	3.00
Short-term market rate, % eop	2.08	2.10	2.08	2.05	2.08	2.10	2.35	2.75	2.75
Long term yield, % eop	3.80	3.78	3.75	3.75	3.85	4.00	4.00	4.00	4.00
lc vs USD, eop	32.43	32.44	32.39	32.75	32.77	32.80	32.84	32.89	32.92

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

Frontier Asia

Mongolia

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OT2 Deal Goes Down to the Wire: We evaluate the implications of Go or no-go on OT2 in our latest *Mongolia Macro Flash*. We previously assigned a 60% probability to the Sep 30 deadline being met. A green-light from Rio would materially improve Mongolia's economy, in our view, and accentuate the potential from recent changes to regulations covering mining and foreign investment by attracting more foreign investment, a process that has been kick-started by visits from the Presidents of China and Russia. If the month-end OT2 deadline is missed, it would mean that Rio will have to seek another extension for the project financing, more negotiations and an OT2 restart will be delayed to 2H15. Even so, Mongolia's balance of payments is set to improve (via shrinking current account deficits so far and artificial replenishments later this year). Note our dip-buying recommendation on Mongolia's external debt in Jul (pg. 12 & 56 of *Asia Macro and Strategy Outlook*)

Two sides are busy trying to meet deadline: Rio Tinto's 51%-owned Turquoise Hill (TRQ) welcomed a tax cut by the Mongolian Tax Authority from US$127mn to US$30mn, but some aspects of the ruling require clarification. In another key development announced on Sep 22 by TRQ, the long-awaited 2014 Feasibility Study (FS) for Oyu Tolgoi (OT) has been presented to OT's board of directors. The updates in the 2014 FS are broadly in line with the estimates in the 2013 Technical Report (TR). The FS confirms the mineral reserves estimates, the underground ore plans to use existing and planned shafts that were previously defined in the 2013 TR, and the estimated capital expansion cost of US$4.9bn is in line with the previous US$5.1bn estimate (excluding the $0.5bn already spent). However, the FS also indicates a US$1.5bn reduction in the project's net present value as a result of delays and more cautious assumptions. A Mongolia delegation led by Minister of Cabinet Office Ch. Saikhanbileg is in London this week for further talks with Rio. Local news (*news.mn*) suggests a possible visit by Rio Chairman Jan du Plessis to UB later this month.

Decision in the hands of Rio: We continue to believe that the decision to go-ahead or not with OT2 rests with Rio. The Mongolia side is politically incentivized to be flexible in resolving the remaining issues, among them: the feasibility study review (note, in the leaked Prime Minister's letter to Rio in March, a review of the study by the Mongolian side was said to be not necessary), the project financing agreement (with which the government previously signaled it had no issues), the granting of the necessary permits and a promise by the Government that it would not challenge the Investment Agreement, etc.

Sri Lanka

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Growth in 2Q14 surprises to the upside, we upgrade our forecast. While the pick-up has been partly distorted by a low base, we saw a sharper than expected rebound in both agri and industry, boosting 2Q14 growth to 7.8% YoY. We nudge both our 2014 and 2015 growth forecast up to 7.7% and 7.5%, respectively.

Inflation remains benign to be further helped by a 25% electricity tariff cut plus about 3% fuel price cuts and 19% cut in kerosene — CBSL injects liquidity. We think the recent price reduction could reduce CPI inflation by about 2-3ppts. We cut our inflation (average) forecast this year and next to 3.3% (from 4.5%) and 5.6% (from 6.2%), respectively. While CBSL has kept rates unchanged this year, they significantly limited the access of OMO participants to the Standing Deposit Facility (SD) in Sep (beyond 3x/month, interest received is cut from 6.5% to 5.0%). We think CBSL will eventually cut rates by another 50bps by early 2015F, to reflect market rates and support anemic credit growth.

No budget impact from price cuts; impact on SOE finances looks contained. We think the petrol & diesel price cuts should be neutral – a reflection fuel prices that had lagged of declining market price, while the 19% cut in kerosene will be a negative for Ceylon Petroleum Corp's (CPC) that could be buffered by its small profit ytd. The impact of the electricity cut is harder to decipher – will depend on savings Ceylon Electricity Board (CEB) will incur amid increased access to cheaper coal-based power, to offset the negative impact of a 25% electricity price cut alongside earlier drought-related losses. However, given the huge cost differential between coal- and thermal-based energy, cost savings could be substantial by next year from the operation of 900-MW coal plants. Overall, we think government wants to improve SOE standalone fundamentals, but it's not clear how policies will be influenced by expectation of an early presidential election in 2015.

While external picture has improved, July data warrant some caution. The July trade deficit rose sharply to its largest monthly deficit since November 2012 (54% larger than the average monthly deficit in 1H2014) on the back of very strong import growth led by fuel (partly distorted by base effect) and consumer goods imports. The prospect for strong import demand may persist amid the stimulative impact of the recent price cuts, plus portfolio flows could be vulnerable to a US hiking cycle. However, external liquidity is buffered by the signing of a RMB10bn swap line with China and a still wide (though narrowing) rate differential with US.

Vietnam

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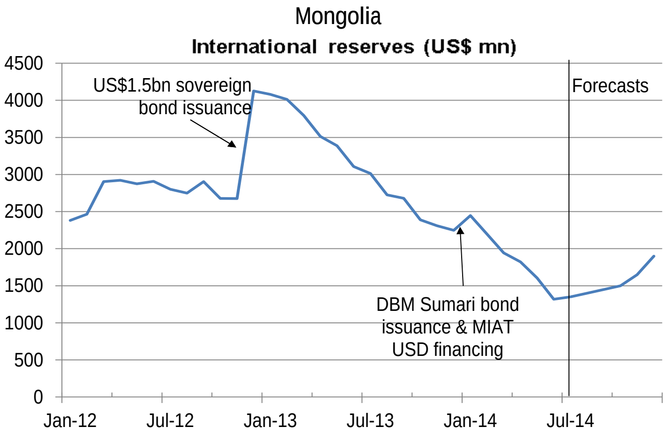
Recent economic data does not bode too well for growth. Manufacturing PMI decelerated for four consecutive months, though still slightly above 50, and export growth is waning on the back of high base effects and global demand challenges (18% and 10% of exports go to EU and China, respectively). Retail sales and credit growth do not look too encouraging, the latter only up about 4.5% ytd as of August (vs. 6.5% growth in the same period last year), highlighting lingering challenges in the banking sector (IMF/WB's Financial Sector Assistant Program (FSAP) reveal that NPLs hit about 12% of loans as of 2012, but with credit to GDP declining 8ppts since then, this is~10% of GDP). Resilient FDI trends and some fiscal support should cushion downside growth risk and we maintain our 5.4% growth forecast this year. The government has approved plans to issue $1bn in sovereign debt to refinance the $750mn bond in Jan 2016, though this may also be used as extra buffer a likely wider than targeted fiscal deficit of 5.3% of GDP

Inflation and external trends continue to remain benign but SBV reluctant to ease policy for now – expect easing in 2015F. Inflation receded to 3.6%, almost a five-year low, on the back of very benign non-food inflation which could get further reprieve after announced retail price cuts for gasoline, diesel and kerosene this month, plus relatively contained minimum wage hike of 15% proposed for 2015, below the 17.5% pay hike in 2013. We nudge our inflation forecast slightly lower. FX reserves have also risen sharply by 40% ytd, USD-VND rate remains very stable and goods trade surplus is much higher this year vs. last year, safeguarding external stability. Nonetheless, SBV is signaling reluctance to pursue further rate easing— we maintain our call of another rate cut, but more likely in 2015F.

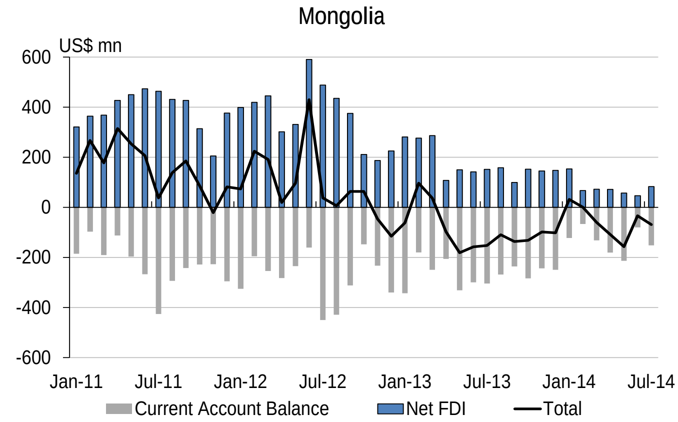
Structural reforms remain very slow; awaiting big-ticket IPOs. VAMC has bought about $2.6bn of bad debt since up to Aug 2014, a pace well below its $5bn target by year-end. Given inadequate legal framework for loan disposal, VAMC sold only ~$66mn of these loans, which alongside regulatory forbearance, is propagating 'zombie banks'. SOE privatization is also well behind plan of selling shares in 432 SOEs by 2014-15 (only 55 have equitized this year so far, 2 dissolved, 15 merged), but Vinatex finally completed its IPO and other big SOEs still in the pipeline.

Figure 95. Mongolia – FX reserves likely to be replenished in 4Q



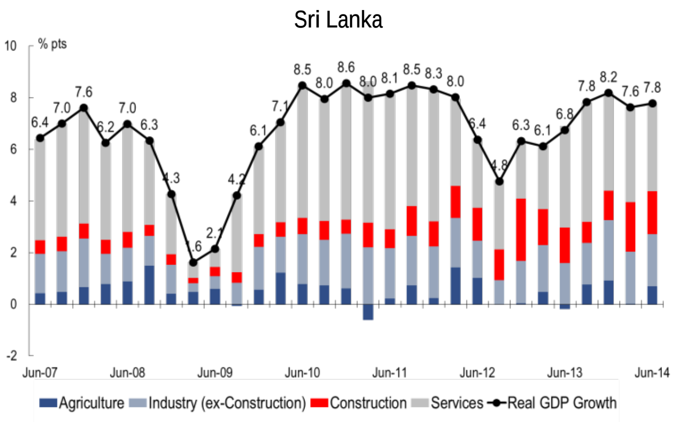
Source: BoM, CEIC and Citi Research

Figure 96. CA deficit shrinking; FDI has yet to improve materially



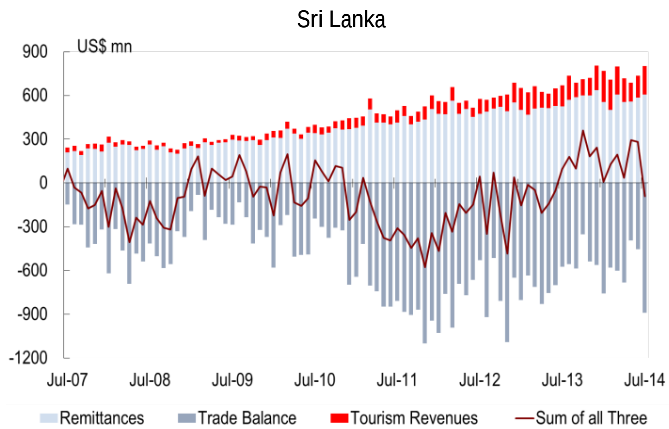
Source: BoM, CEIC and Citi Research

Figure 97. Sri Lanka – Growth surprises to the upside



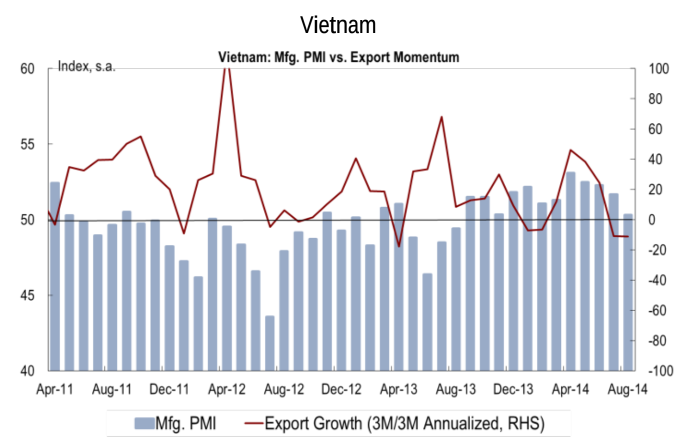
Source: CBSL, CEIC and Citi Research

Figure 98. Sharply higher Jul trade deficit on strong imports bear watching



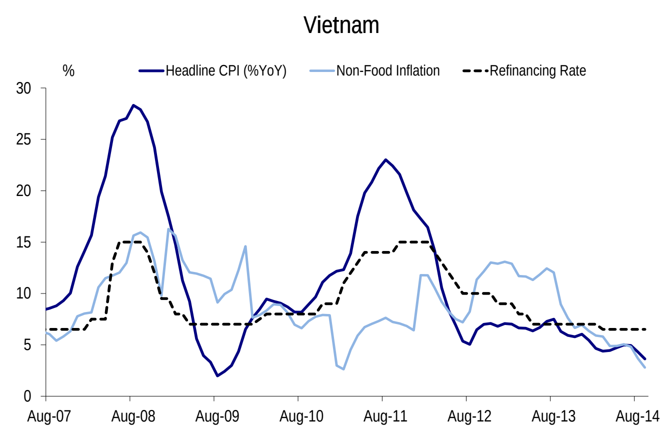
Source: CBSL, CEIC and Citi Research

Figure 99. Vietnam – PMI indices signaling growth challenges



Source: CEIC, Citi Research

Figure 100. Benign inflation still leaves room for rate cut



Source: CEIC, Citi Research

Figure 101. Asia Frontier Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Mongolia									
Nominal GDP, US$ bn	4.2	5.6	4.6	6.2	8.8	10.3	10.3	12.0	15.0
GDP per capita, US$	1,629	2,138	1,717	2,287	3,186	3,595	3,525	4,038	4,960
Population, mn	2.6	2.6	2.7	2.7	2.8	2.9	2.9	3.0	3.0
Real GDP, % yoy	10.2	8.9	-1.3	6.4	17.5	12.4	11.7	10.0	9.0
CPI, % yoy	15.1	22.1	4.2	13.0	10.2	14.0	12.5	14.0	11.5
CPI, % avg	--	28.0	8.0	10.1	9.2	14.3	10.5	13.8	12.0
Policy interest rate, % eop	8.40	9.75	10.00	11.00	12.25	13.25	10.50	13.00	13.50
Long term yield, % eop	21.83	20.58	21.67	20.07	16.61	18.11	18.48	19.68	21.08
lc/US$, eop	1,172	1,275	1,433	1,233	1,378	1,378	1,660	1,800	1,729
lc/US$, avg	1,171	1,167	1,434	1,349	1,256	1,353	1,505	1,809	1,755
Current account (US$ bn)	0.3	-0.7	-0.4	-0.9	-3.4	-3.2	-3.2	-1.2	-1.7
% of GDP	6.3	-12.8	-8.9	-15.0	-38.4	-31.1	-30.9	-10.3	-11.1
Trade balance (US$ bn)	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-2.1	0.4	0.2
Exports (US$ bn)	1.9	2.5	1.9	2.9	4.8	4.4	4.3	6.1	8.0
Imports (US$ bn)	2.2	3.2	2.1	3.2	6.6	6.7	6.4	5.7	7.8
FDI, net (US$ bn)	0.4	0.8	0.6	1.6	4.6	3.9	-2.1	1.1	3.0
International reserves (US$ bn)	0.8	0.6	1.3	2.2	2.3	3.9	2.2	1.9	3.0
Consolidated government balance (% of GDP)	2.6	-4.5	-5.2	0.5	-6.9	-9.9	-7.8	-7.6	-4.4
Public debt (% of GDP)	36.0	30.6	44.2	28.7	28.9	42.1	67.3	71.8	74.6
Sri Lanka									
Nominal GDP, US$ bn	32.4	40.7	42.1	49.6	59.2	59.4	67.2	73.8	84.0
GDP per capita, US$	1,617	2,014	2,057	2,400	2,836	2,923	3,281	3,576	4,038
Population, mn	20.0	20.2	20.5	20.7	20.9	20.3	20.5	20.6	20.8
Real GDP, % yoy	6.8	5.9	3.5	8.0	8.2	6.3	7.3	7.7	7.5
CPI, % yoy	18.8	13.9	5.0	6.8	4.9	9.2	4.7	3.4	6.0
CPI, % avg	15.8	22.5	3.6	6.2	6.8	7.5	6.9	3.3	5.6
Policy interest rate, % eop	12.00	12.00	9.75	9.00	8.50	9.50	8.50	8.00	7.50
Long term yield, % eop	19.96	19.20	11.50	9.24	10.00	11.81	9.91	7.75	8.00
lc/US$, eop	108.7	113.0	114.4	110.9	113.9	127.7	130.8	130.0	129.0
lc/US$, avg	110.6	108.3	114.9	113.0	110.5	127.2	129.1	130.3	129.4
Current account (US$ bn)	-1.4	-3.9	-0.2	-1.1	-4.6	-4.0	-2.6	-2.5	-2.6
% of GDP	-4.3	-9.5	-0.5	-2.2	-7.8	-6.7	-3.9	-3.3	-3.1
Trade balance (US$ bn)	-3.7	-6.0	-3.1	-4.8	-9.7	-9.4	-7.6	-7.8	-8.3
Exports (US$ bn)	7.6	8.1	7.1	8.6	10.6	9.8	10.4	11.6	12.5
Imports (US$ bn)	11.3	14.1	10.2	13.5	20.3	19.2	18.0	19.4	20.8
FDI, net (US$ bn)	0.5	0.7	0.4	0.4	0.9	0.9	0.9	0.9	1.0
International reserves (US$ bn)	3.1	1.8	5.1	6.6	6.0	6.9	7.2	7.3	7.9
Consolidated government balance (% of GDP)	-6.9	-7.0	-9.9	-8.0	-6.9	-6.4	-5.9	-5.6	-5.3
Public debt (% of GDP)	85.0	81.4	86.1	81.9	78.5	79.2	78.3	77.0	76.0
Vietnam									
Nominal GDP, US$ bn	77.5	98.3	101.6	112.8	134.5	155.5	170.4	170.7	187.8
GDP per capita, US$	920	1,154	1,181	1,297	1,532	1,751	1,901	1,886	2,057
Population, mn	84.2	85.1	86.0	86.9	87.8	88.8	89.6	90.5	91.3
Real GDP, % yoy	7.1	5.7	5.4	6.4	6.2	5.3	5.4	5.4	5.7
CPI, % yoy	12.6	19.9	6.5	11.8	18.1	6.8	6.0	4.6	6.3
CPI, % avg	8.3	23.1	7.0	9.2	18.6	9.3	6.6	4.5	5.8
Policy interest rate, % eop	6.50	9.50	8.00	9.00	15.00	9.00	7.00	6.50	6.00
Long term yield, % eop	8.73	10.00	11.68	11.49	12.55	9.75	9.29	6.25	7.00
lc/US$, eop	16,028	17,483	18,474	19,498	21,034	20,840	21,095	21,407	21,621
lc/US$, avg	16,081	16,445	17,806	19,123	20,648	20,875	21,028	21,276	21,567
Current account (US$ bn)	-7.1	-10.8	-6.6	-4.3	0.2	9.3	9.5	8.7	7.8
% of GDP	-9.1	-11.0	-6.5	-3.8	0.2	6.0	5.6	5.1	4.2
Trade balance (US$ bn)	-10.4	-12.8	-7.6	-5.1	-0.5	9.9	8.7	11.5	10.1
Exports (US$ bn)	48.6	62.7	57.1	72.2	96.9	114.6	132.1	152.0	170.2
Imports (US$ bn)	59.0	75.5	64.7	77.4	97.4	104.7	123.4	140.4	160.1
FDI, net (US$ bn)	6.5	9.3	6.9	7.1	6.5	7.2	6.9	7.0	7.0
International reserves (US$ bn)	23.5	23.9	16.4	12.5	13.5	25.6	25.9	35.4	40.2
Consolidated government balance (% of GDP)	-5.3	-2.2	-7.2	-3.0	-3.2	-4.8	-5.6	-6.4	-6.0
Public debt (% of GDP)	40.9	39.4	46.9	44.6	43.2	46.6	41.8	41.3	45.0

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

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- **Summary view** — We cut our 2015 GDP growth forecast by a tick to 2.4%, while increasing the CPI inflation forecast due to a weaker koruna. We see upside risks to our 2015 GDP forecast if peace process in Ukraine is successful.

- **Things to watch** — A series of knock-on effects from the ESA 2010 GDP revision could show worse internal and external balances. At the top line, nominal GDP will likely increase, which will have the effect of reducing the government debt ratio. Concurrently, it is likely to raise gross foreign debt but allow the international investment position to improve.

- **Strategy** — Our call for lower EURUSD suggests the koruna will weaken over 12-month horizon. Nevertheless, we expect the koruna to resume appreciation, albeit at a slower pace, but weaker growth and stronger ECB action are likely to postpone CNB tightening to mid-2016.

2015 GDP forecast reduced slightly but risks are balanced

We have edged down our 2015 GDP growth forecast to 2.4% from 2.5% the same as our expectation for 2014 growth. The upward revision to 1H 2014 GDP dynamics was offset by a weaker foreign demand outlook. At the same time, data showed that domestic demand was supportive in 2Q. This supportive trend is likely to continue in Q3 on the back of the July industrial data and the August PMI. On the flip side, industrial capacity utilization declined slightly in July and foreign demand outlook (euro area, Poland, Russia and China) appears to be weaker. As a result we trimmed our outlook on investment and export activity in the coming 4 quarters. Having said that, the investment outlook could improve due to government spending and exports could yet still outperform expectations due to the weaker currency. Overall, our forecast is in line with the sentiment survey that we find consistent with 2.4%YoY GDP growth and confidence indicators have remained supportive for industrial and construction output and retail sales in the near term.

Although elevated uncertainty stemming from the Ukraine/Russia conflict poses downside risks to our outlook, some factors at least partly offset this effect and could actually provide a boost if the peace process is successful. We think that the increase in real gross disposable income (4.4%YoY) in 2Q had a positive impact on foreign trade which has probably continued. While the effect is likely to persist for the rest of 2014, it is likely to be slightly negative in 2015. Also, we think the weaker currency and more positive export dynamics bodes well for manufacturing profits. This in turn would be supportive for wage growth (particularly in industry). This being said, the operating surplus did not accelerate as much in the service sector. At the same time, while the assessment of industrial production capacities declined in 3Q14, the utilization of production capacities decreased as well. On balance, they have remained supportive for fixed investment, though somewhat less than in 2Q14 and are not supported by external risks. On the other hand, we do not expect any stronger recovery in export activity in this optimistic scenario as the export activity to Russia is probably not only a cyclical issue, but also a structural challenge. In other words, the potential export activity to Russia probably decelerated in the long term.

Growth slightly disinflationary, but FX is more inflationary

The starting point is rather mixed for the CNB forecast. GDP came out 0.2%pt below the CNB forecast. However, the details seemed to be positive, with slightly better private consumption and lower Q2 export dynamics a result of an upward revision to Q1. With the new GDP methodology (ESA 2010), we think that the CNB will not yet focus on these small changes. Second, inflation overshot the CNB forecast by 0.2%pt, but the adjusted core measure was in line its expectations. Third, real wage growth decelerated to 2.1%YoY in 2Q14, but was less than the CNB had expected. Fourth, core (ex. cars, food and fuel) retail sales were relatively weak in past two months which makes the third factor less hawkish, in our view.

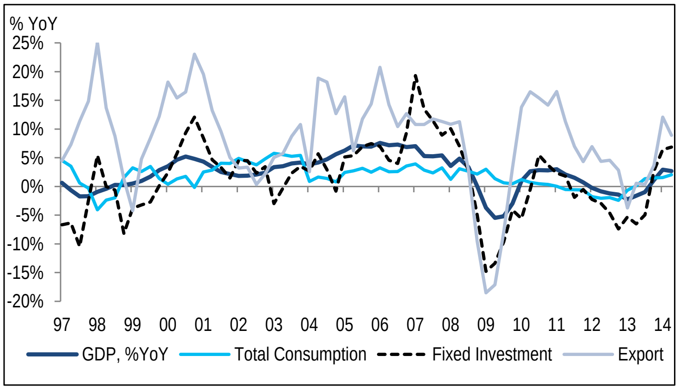
The outlook on CNB assumptions is rather disinflationary. Both global food and fuel prices are lower than the CNB assumed in late July. Also the ECB's monetary policy is likely to be more dovish than the CNB forecast assumes. But this probably plays a less important role as the CNB's Bank Board was more dovish than CNB's July staff forecast. Also the impact of more dovish ECB policy could influence the timing of CNB's first hike, but not current CNB's policy unless the ECB policy leads to stronger koruna, which so far has not been the case as the CNB forecasted the EURCZK close to 27.4 over (unspecified) several next quarters. While the Fed seems to be more hawkish, it is unlikely to have a meaningful impact on the CNB's decision until we see some larger and long-term koruna weakening.

Despite our lower GDP growth forecast, we raised the CPI forecast and in contrast to that we postponed the CNB exit from the FX intervention to mid-2016. While our lower GDP forecast is a disinflationary, our new FX forecast is opposite as expected fall in EURUSD is larger than a recent fall in energy and food prices (albeit less). On the other hand, electricity power prices declined further. This made us slightly increase our CPI forecast to by 0.2%pt to 1.6%YoY for 2015 after 0.4% in 2014. Our forecast still remains below the CNB's July forecast of 1.8%YoY for 2015, which will be, however, assessed as accompanied with the downside risk after the September meeting. Overall, the acceleration of the CPI growth is not at such a pace that would make the CNB scale back its decision on an exit from the FX intervention from 1Q16. This would be possible, if we see the EURCZK well above our forecast of 28 over 12 months. On the other hand, weaker growth and ECB's looser monetary policy may postpone the expectation for CNB's "exit" to mid-2016, with the first hike in 3Q16.

MinFin will continue with a light issuance of bonds

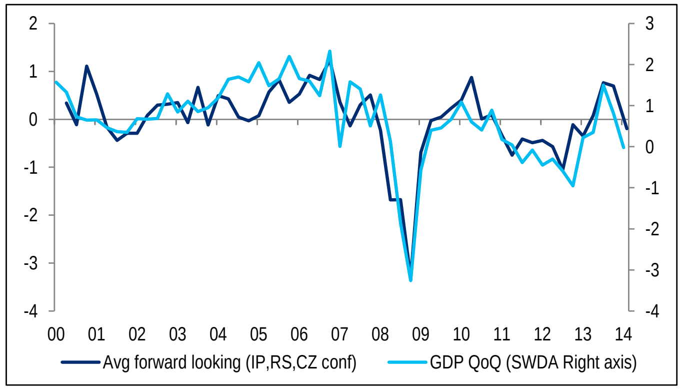
The net local bond issuance is likely to fall in 2015 compared to 2H14. MinFin issued only CZK11bn in the 3Q14, which is at a lower range of planned CZK10-20bn. In 4Q14, the MinFin plans to issue between CZK30-40bn, of which around CZK12bn will be done in October, and the size of 4Q14's issuance will depend on the size of MinFin's realized buybacks (probably up to CZK20bn) or eventual retail bond issuance, which was weak in June this year. As there is no redemption of local bond in 4Q14, there will be positive net bond issuance, which can be partly offset by eurobond redemptions (CZK37.6bn in October). T-bill issuance should reach around CZK30-40bn in 4Q14, which suggests to us net issuance of c. CZK15bn in 4Q14. This points to a CZK20bn fall in net T-bill issuance that could be partly offset by a lending facility. As the MinFin issuance also wants to keep the absolute level of debt unchanged in 2014-15 and potentially in 2016, it would mean higher utilization of cash from the Single Treasury Account and mild net bond issuance, which can be negative on local market, if there is a Eurobond next year.

Figure 102. There has been a broadbased recovery in 2Q14



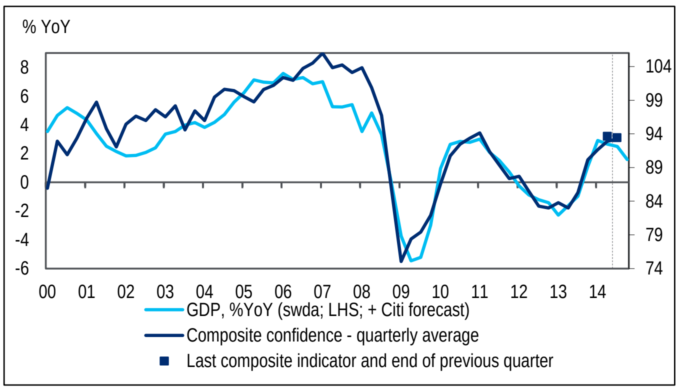
Source: Haver Analytics and Citi Research

Figure 103. Momentum worsened in July ...



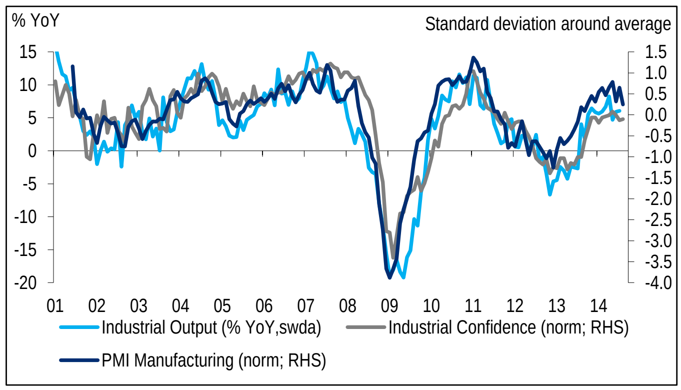
Source: CZSO, Haver Analytics, Citi Research calculation

Figure 104. ... but August confidence is supportive for GDP dynamics



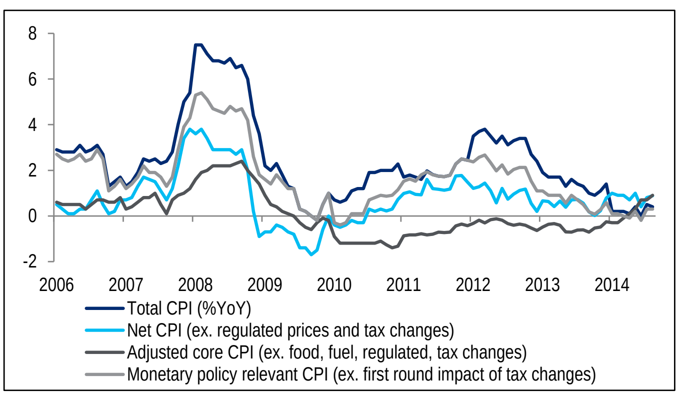
Source: CZSO, Citi Research forecast

Figure 105. Confidence still sugests around 5% industrial growth



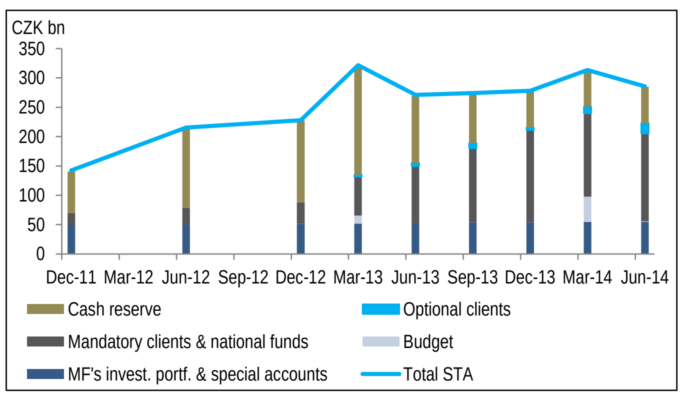
Source: CZSO, Haver Analytics, Citi Research calculation

Figure 106. Headline inflation is above the CNB forecast, core is in line



Source: CNB, CZSO, Citi Research calculation

Figure 107. MinFin plans to cut cash reserve and to utilize around CZK120bn from the other STA in 2014-15 that increased in 2013-2014



Source: Citi Research. Note: Clients deposits in 6/12,3/13 , 6/13 are interpolated.

Figure 108. Czech Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	180	225	197	198	216	196	198	208	204
Nominal GDP, local currency bn	3,663	3,848	3,759	3,791	3,823	3,846	3,884	4,073	4,223
GDP per capita, USD	17,484	21,614	18,795	18,873	20,584	18,693	18,881	19,781	19,401
Population, mn	10.3	10.4	10.5	10.5	10.5	10.5	10.5	10.5	10.5
Unemployment, % of labour force	5.3	4.4	6.7	7.3	6.7	7.0	6.9	6.2	5.9
Economic Activity									
Real GDP, yoy avg	5.7	3.1	-4.5	2.2	2.1	-1.0	-0.9	2.4	2.4
Real investment growth % yoy	15.5	1.9	-20.2	5.4	0.8	-5.0	-4.4	5.4	5.2
Real consumption growth % yoy	3.1	2.3	1.3	0.7	-0.4	-2.1	0.6	1.9	1.7
private consumption growth % yoy	4.2	2.8	0.2	0.9	0.5	-2.1	0.1	2.1	2.0
Real export growth, % yoy	11.2	4.0	-10.9	15.4	9.5	4.5	0.2	10.1	7.0
Real import growth, % yoy	12.8	2.7	-12.1	15.4	7.0	2.3	0.6	11.0	7.5
Prices, Money & Credit									
CPI, % yoy eop	5.5	3.6	1.0	2.3	2.4	2.4	1.4	0.7	1.8
CPI, % avg	2.9	6.3	1.0	1.5	1.9	3.3	1.4	0.4	1.6
Nominal wages, % yoy	7.2	7.9	3.4	2.2	2.5	2.5	0.0	2.9	3.4
Credit extension to private sector, % yoy	26.6	16.1	0.8	3.0	5.5	2.6	3.7	4.4	8.8
Policy Interest Rate, % eop	3.50	2.25	1.00	0.75	0.75	0.05	0.05	0.05	0.05
1 month inter-bank rate, %, eop	3.94	3.21	1.29	0.99	0.94	0.33	0.29	0.25	0.25
Long-term yield, %, eop	4.64	4.15	4.01	3.86	3.69	1.90	2.30	1.00	1.90
CZK/US$, eop	18.2	19.2	18.4	18.7	19.8	19.0	19.9	22.9	23.5
CZK/US$, avg	20.2	17.0	19.0	19.1	17.7	19.5	19.6	21.1	23.9
CZK/EUR, eop	26.5	26.8	26.4	25.0	25.6	25.1	27.3	27.7	27.5
CZK/EUR, avg	27.8	25.0	26.4	25.3	24.6	25.1	26.0	27.5	27.8
Balance of Payments, USD bn									
Current account	-7.9	-4.8	-4.8	-7.6	-6.3	-2.5	-2.9	0.2	-0.9
% of GDP	-4.4	-2.1	-2.5	-3.8	-2.9	-1.3	-1.4	0.1	-0.5
Trade balance	2.2	1.7	4.6	2.8	5.3	7.6	9.6	13.0	12.0
Exports	106.5	125.1	99.1	114.0	138.5	132.7	135.6	145.6	139.0
Imports	104.3	123.4	94.6	111.2	133.2	125.1	126.0	132.6	127.0
Service balance	2.9	4.4	3.9	3.9	3.8	3.2	2.7	2.4	1.6
Income balance	-12.7	-10.6	-13.2	-14.8	-15.6	-13.2	-16.0	-16.5	-15.1
FDI, net	9.0	2.3	2.0	4.9	4.2	6.2	1.7	7.1	5.3
International reserves	34.4	36.5	39.7	40.3	37.9	42.4	53.9	52.9	52.7
Total amortisations	4.0	4.2	6.2	5.4	8.6	5.4	7.4	6.7	6.7
Public Finances, % of GDP									
Consolidated government balance	-0.7	-2.2	-5.8	-4.7	-3.2	-4.2	-1.5	-2.0	-2.5
Consolidated gov primary balance	0.4	-1.2	-4.5	-3.3	-1.8	-2.7	-0.1	-0.2	-1.4
Public debt	27.9	28.7	34.6	38.4	41.4	46.2	46.0	44.1	42.6
of which Domestic	20.3	20.7	24.4	25.8	34.8	39.9	29.9	34.5	32.6
Foreign Assets & Liabilities, USD bn									
External debt	76.2	84.2	89.2	94.2	94.2	102.5	111.3	97.0	106.6
Public	15.0	15.3	19.8	24.0	22.6	28.3	30.2	18.0	22.6
External debt / GDP	42.2	37.4	45.3	47.5	43.6	52.2	56.1	46.6	52.2
External debt / XGS	61.5	57.3	75.3	69.8	58.3	65.9	70.5	57.3	66.0
Short-term debt	22.6	27.1	23.9	23.6	27.1	24.1	29.4	36.0	39.0
Short-term debt/International reserves (%)	65.5	74.2	60.2	58.5	71.5	56.8	54.6	68.1	74.1

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	2.9	2.7	2.6	1.7	1.5	2.3	2.8	3.2	3.3
CPI, % yoy eop	0.2	0.0	0.8	0.7	1.3	1.4	1.6	1.7	1.8
Policy interest rate, %, eop	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Short-term market rate, % eop	0.27	0.27	0.25	0.25	0.25	0.25	0.25	0.25	0.15
Long-term yield, %, eop	2.18	1.55	1.45	1.56	1.72	1.88	2.04	2.20	1.13
CZK/EUR, eop	27.46	27.45	27.54	27.67	27.89	28.05	27.79	27.53	27.28

Source: National Sources, Citi Research forecasts

Egypt

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

Improving security, consolidating political power

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

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

This also ties in with his second goal, to build a wider political power base capable of performing well in parliamentary elections, which will be held in late 2014. Given the weak and fragmented nature of the current political parties, none looks as if it can mount a successful campaign to secure a parliamentary majority. But with a couple of new parties being formed by supporters of the president and his ability to appoint 27 MPs, the goal will be to construct a supportive parliamentary alliance.

A technocratic approach to policy to start with

Since his election, there have been increasing indications on the overall direction of economic policy, with the third goal of the president being the need to kick-start the economy. The initial thrust in this respect has been relatively technocratic, with the president insisting on greater fiscal consolidation than proposed in the initial 2014/15 budget and also making an early start on addressing the thorny questions of subsidies, by increasing fuel prices for both petrol and industries on July 5.

This step is clearly a medium-term positive, and seems to have had faced little political backlash to date. But it clear has short term costs, as shown by the sharp jump in inflation in July. We expect upward pressure on prices to remain for several months and only start to ease in early 2015. But we still expect inflation to only peak at the 10-15% level. Whether this is enough to push the CBE into a further rate rise after the 100 basis point rise in the overnight deposit rate to 9.25% in July is not clear, but possible and would also help support the Egyptian pound, a factor which may be involved in the CBE's thinking on its policy options.

Boosting growth, with social justice

But while fiscal reform is a medium-term positive for the economy, despite the shorter-term economic consequences, the real challenge for the government is to boost growth. And while an improvement in the security environment and the end of political uncertainty will help this, it will not be sufficient. Instead, the government will have to push ahead with a more ambitious growth agenda.

This is likely to focus on growth with social justice. This will have both symbolic elements, such as raising taxes on the richer segments of society, although only a more significant implementation of VAT is likely to have a major impact on the revenue side. And it will also have a practical side led by a sharp rise in spending on infrastructure. This will be focussed on projects such as the building of low-cost housing or improving health and education facilities in the country.

The key questions in this respect are who will fund the programme and will it boost job creation? Initially, we expect ongoing support from Gulf states to be important. But it will not be open ended, and we expect Saudi Arabia and the Egyptian government to continue to push for a much wider investor and donor conference after the parliamentary elections. It is also not clear to what extent the investment push will boost job creation directly given that the army is one of the few institutions in the country which has the logistical capacity to support the ambitious investment agenda.

A formal reform programme may emerge

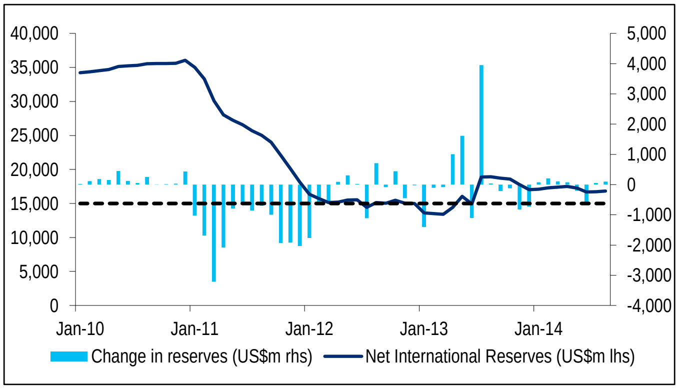
What we would also expect, is that over time these broad themes could potentially be brought together in a more formal home-grown economic reform programme. Essentially, this will be a programme of gradual fiscal consolidation, based around subsidy reform and raising more revenue. But with additional underpinning themes: the involvement of the military; growth yes, but with social justice; the need for many to make a sacrifice to support growth; and finally, probably a strong anti-corruption strand.

Only when this full home-grown reform programme has been running for some time do we think that the government will open negotiations with the IMF possibly to agree to a more formal programme. And given the political constraints, even a formal programme may be too controversial, with the IMF only providing a stamp of approval to the home grown programme through a Precautionary and Liquidity Line (PLL) as was the case with Morocco in 2012. In the meantime, the government will continue to use the IMF to help technical aspects of reform such as the introduction of VAT or subsidy reform.

The need for reality

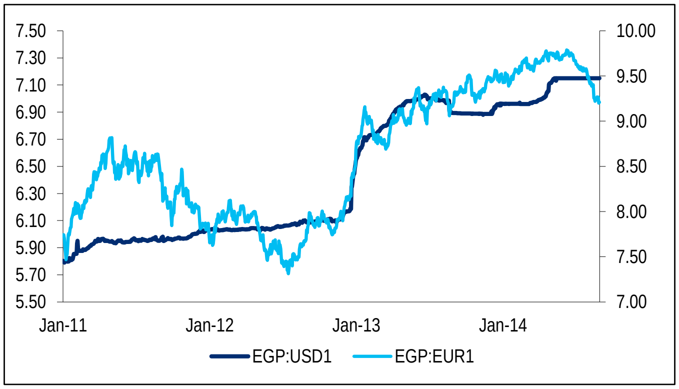
But the need for reality must also remain paramount. Even if an ambitious reform agenda along these lines is put in place, the reality remains that the state of the economy is still precarious, as shown by bouts of EGP weakness in 2014. Moreover, the current fragile stability is still heavily dependent on the current high levels of Gulf support. When set against the background of longer-term structural issues, such as a weak civil service, a poor education system and a politically divided country, the realities of running the country while boosting growth and job creation will quickly become apparent to the new president in 2015, even as political stability improves.

Figure 109. Reserves have stabilised since late 2013, but remain low



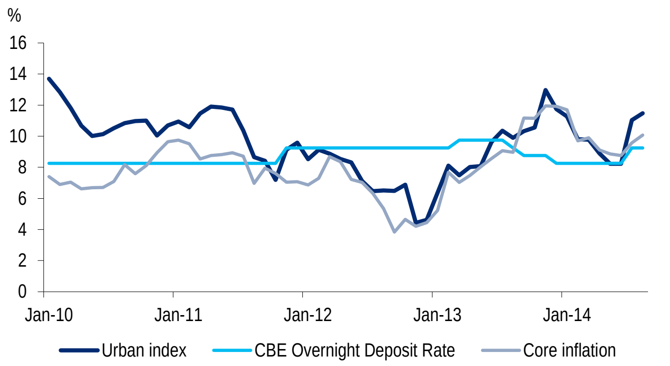
Source: Central Bank of Egypt, Haver Analytics

Figure 110. EGP – Downward steps against the US dollar



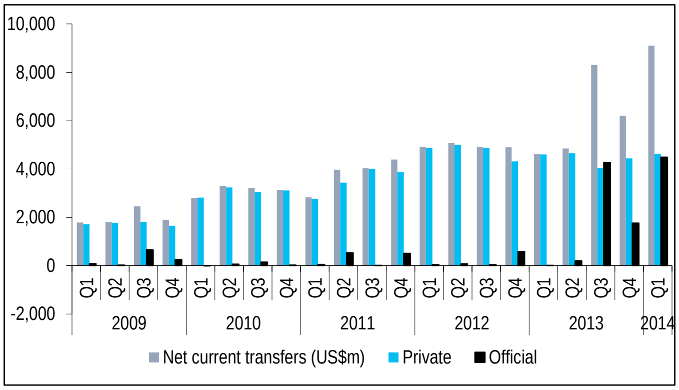
Source: Reuters

Figure 111. Inflation has picked up following subsidy cuts in July, forcing a response from the CBE



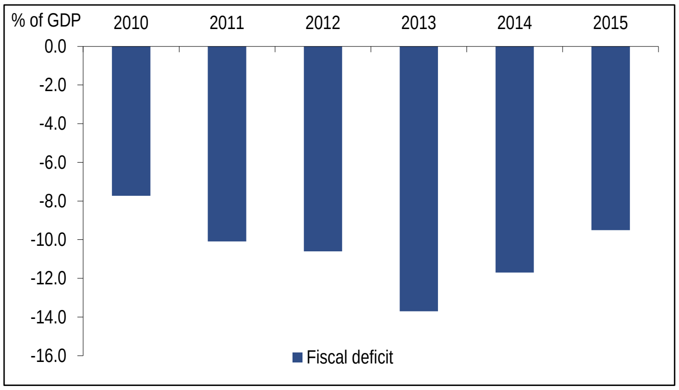
Source: Central Bank of Egypt, Haver Analytics and Citi forecasts for 2H 2013

Figure 112. Robust transfers have limited the deterioration in the current account and helped support consumption



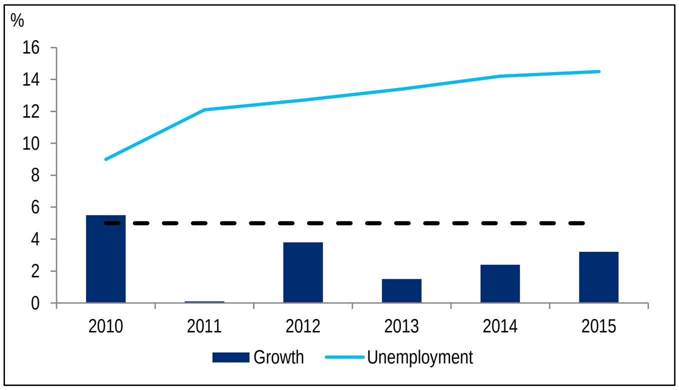
Source: Central Bank of Egypt, Haver Analytics

Figure 113. Modest fiscal consolidation is likely going forward



Source: Haver Analytics and Citi forecasts for 2013-2015

Figure 114. A slow recovery may now be possible in 2014-15



Source: Haver Analytics and Citi forecasts for 2013-15

Figure 115. Egypt Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	132	165	188	214	231	260	255	278	308
Nominal GDP, local currency bn	817	977	1,124	1,308	1,461	1,663	1,887	1,973	2,254
GDP per capita, USD	1,783	2,187	2,454	2,755	2,920	3,233	3,114	3,350	3,646
Population, mn	74.1	75.4	76.6	77.8	79.1	80.4	81.7	83.1	84.4
Unemployment, % of labour force	8.9	8.7	9.4	9.0	12.0	12.7	13.2	14.2	14.5
Economic Activity									
Real GDP, yoy avg	-	6.0	4.6	5.5	0.1	3.8	1.5	2.4	3.2
Real investment growth % yoy	-	9.2	-10.0	12.2	-3.6	7.2	-10.8	9.5	12.1
Real consumption growth % yoy	-	5.4	4.7	4.9	4.3	4.6	3.8	2.0	2.4
private consumption growth % yoy	-	5.7	4.6	5.0	4.6	4.9	3.7	2.0	2.6
Real export growth, % yoy	-	14.1	-18.8	8.1	-12.5	-2.0	-6.3	2.2	5.6
Real import growth, % yoy	-	13.7	-24.0	10.5	-0.9	4.9	-3.4	4.7	7.2
Prices, Money & Credit									
CPI, % yoy eop	6.9	18.4	13.2	10.6	9.5	4.7	11.7	12.8	9.5
CPI, % avg	9.5	18.3	11.8	11.1	10.1	7.1	9.5	10.4	11.1
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	10.0	12.0	3.0	6.7	6.1	7.6	6.4	6.3	7.6
Policy Interest Rate, % eop	8.75	11.50	8.25	8.25	9.25	9.25	8.25	9.50	8.50
1 month inter-bank rate, %, eop	8.75	11.95	8.30	8.30	10.05	10.10	9.25	13.22	9.93
Long-term yield, %, eop	9.50	9.00	9.00	9.00	9.50	10.00	13.50	11.00	10.00
EGP/US$, eop	5.53	5.50	5.48	5.81	6.03	6.36	6.95	7.20	7.45
EGP/US$, avg	5.64	5.44	5.55	5.63	5.94	6.07	6.87	7.09	7.32
Balance of Payments, USD bn									
Current account	0.2	-1.3	-3.2	-5.6	-7.9	-10.7	-3.3	-6.8	-6.4
% of GDP	0.2	-0.8	-1.7	-2.6	-3.4	-4.1	-1.3	-2.4	-2.1
Trade balance	-20.8	-26.8	-22.5	-27.7	-28.5	-36.8	-30.2	-33.2	-31.7
Exports	24.5	29.8	23.1	25.0	27.9	23.2	25.1	25.9	27.5
Imports	45.3	56.6	45.6	52.7	56.5	59.9	55.3	59.1	59.2
Service balance	12.7	15.7	11.3	9.6	5.4	6.3	2.9	2.5	3.5
Income balance	-	-	-	-	-	-	-	-	-
FDI, net	10.9	7.6	6.1	5.2	-1.1	6.7	5.3	-0.1	3.0
International reserves	31.7	34.2	34.2	36.0	18.1	15.0	17.1	17.9	20.4
Total amortisations	2.3	1.8	2.4	2.0	2.2	2.3	2.5	2.8	3.1
Public Finances, % of GDP									
Consolidated government balance	-5.2	-6.4	-6.6	-7.7	-10.1	-10.6	-13.7	-11.7	-9.5
Consolidated gov primary balance	0.0	-1.8	-2.4	-2.6	-4.5	-4.7	-6.0	-2.7	-0.2
Public debt	64.2	53.5	54.0	59.8	69.0	77.7	78.6	77.3	74.3
of which Domestic	64.2	53.5	54.0	59.8	69.0	77.7	78.6	77.3	74.3
Foreign Assets & Liabilities, USD bn									
External debt	32.8	32.1	33.3	35.0	33.7	38.8	45.8	39.3	35.6
Public	21.6	26.0	27.2	28.3	27.4	32.8	40.5	31.5	31.5
External debt / GDP	24.8	19.5	17.7	16.3	14.6	14.9	18.0	14.1	11.6
External debt / XGS	68.8	55.6	73.0	70.9	71.1	85.9	105.1	89.2	75.4
Short-term debt	2.2	2.8	2.6	3.1	3.0	6.7	2.8	2.8	2.8
Short-term debt/International reserves (%)	7.0	8.3	7.5	8.7	16.7	44.3	16.5	15.8	13.8

Quarterly Economic Indicators	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	1.5	1.8	3.0	3.2	3.0	3.2	3.0	3.5	4.0
CPI, % yoy eop	9.8	8.2	11.1	12.8	11.5	12.4	10.5	9.5	10.6
Policy interest rate, %, eop	8.25	8.25	9.25	9.50	9.50	9.50	9.00	8.50	8.00
Short-term market rate, % eop	9.25	9.25	11.55	13.22	11.99	12.82	10.91	9.93	11.02
Long-term yield, %, eop	13.50	13.50	13.00	12.50	12.00	11.50	11.50	11.00	11.00
EGP/US$, eop	6.97	7.15	7.15	7.20	7.20	7.30	7.45	7.45	7.60

Source: National Sources, Citi Research forecasts

GCC

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Saudi Arabia

The sharp fall in oil prices in recent weeks is potentially bad news for all oil producers, but for Saudi Arabia, the global swing supplier of crude oil, it raises particular challenges. Brent oil reached its lowest level (at $96 per barrel) in over two years, and bearish sentiment has been fed by stronger than expected global supply and continued weakness forecast in global demand. These expectations sit in direct contrast to the conditions of the past decade, where supply disruptions from Libya, Iran and elsewhere were combined with strong demand growth, mainly from China and the rest of EM, and point to a softening in oil prices going forward.

Saudi Arabia has in the past expressed a view that $100 per barrel is a 'fair price' for its oil, and is thus expected to act in its capacity as the world's largest crude exporter and OPEC's swing supplier to ensure that oil prices do not fall too far short of this mark. Just as the Kingdom acted to ease past supply concerns by raising exports, so we believe it will attempt to relieve over-supply concerns by reducing exports. Indeed, Saudi cuts appear to have begun, with our loading indicator suggesting a fall in Saudi crude exports by as much as 10% in recent weeks. While overall production remains high, however, at almost 10mbpd, this seems to be reflecting rising domestic consumption and expanding local refining capacity (as well as inconsistency in data sources). The bottom line is, however, a rise in downside risks to government revenues, as prices and export volumes decline in tandem.

Despite the recent cuts, we continue to expect average 2014 production for Saudi Arabia of 9.5mbpd (on par with 2013). This reflects a stronger than expected first half of the year. As a result, we expect public finances and external balances to remain robust in the near term, with a likely current account surplus of 14.8% this year, real GDP growth of 4.8%, and a fiscal surplus of 6.0% of GDP. That said, we think rising expenditures and an expected levelling off in oil revenues and production present a challenge in the medium- to long-term. We forecast the fiscal breakeven oil price will rise to close to US$95 per barrel in 2015 and will continue to rise, resulting in forecast deficits as early as 2016. Although Saudi has ample resources to finance expected deficits from current cash reserves, the outlook does underscore the need for structural reform to set public finances on a long-term sustainable footing.

We do see downside risks in Saudi production and outturns going forward. Our forecasts envision a relatively moderate 10% reduction in exports from current levels over the next two years, and a gentle decline in oil prices to $90 per barrel by 2017. But there are considerable risks that oil prices may fall more sharply, and that Saudi will have to cut production more deeply in an attempt to stabilize markets. The evolution of oil production developments in Iraq, developments with respect to the US crude export ban, and the ongoing negotiations between Iran and the P5+1 will all have a direct bearing on Saudi's economic prospects in the medium term.

United Arab Emirates

The UAE economy continues to perform strongly, driven by high oil prices and strong, wide-based growth in Dubai's non-oil economy. Asset values reflect this positive dynamic (as well as wider EM trends), but in the case of Dubai we believe they should also reflect three key risks that continue to mar the Emirate's credit profile (relative to many of its GCC peers). These are (i) high leverage, with ongoing rumbles of restructuring in Dubai's GRE sector, (ii) a highly cyclical real estate market with associated construction and financial sector risks, and (iii) high vulnerability to global financial and economic conditions. Balanced against these risks, however, is a relatively low direct dependence on oil markets, significant potential upside from any potential roll back of Iranian sanctions, and solid local liquidity that we believe will continue to support asset prices in the near to medium term (particularly short-term assets).

There are signs that housing prices in Dubai have begun to moderate. Cluttons data show that the price of mid-range villas (per square foot) rose 42% in 2013, around the same amount as mid-range apartments. By contrast, thus far in 2014, mid-range villa prices have fallen by an annualized rate of 7%, and while apartment rates continue to rise, the pace has moderated to 8% (annualized).

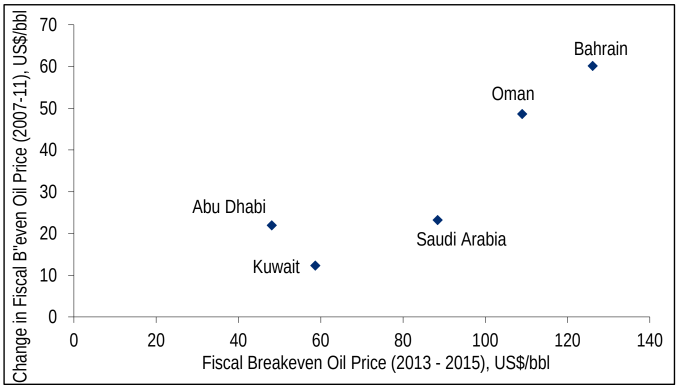
This does not mean, however, that the risks to the real estate market have subsided. Indeed, our concerns regarding signs of overheating in the real estate market have not been focused on prices, but on construction activity and leverage. Here, the lack of hard data makes analytical judgment much more difficult, but anecdotal evidence suggests that Dubai is beginning to experience something of a revival in construction activity. The future balance of supply and demand, the extent to which construction and real estate begin to dominate economic growth, and the level of leverage in the construction and real estate sectors are all things that we believe merit close monitoring.

Qatar

The findings of an ongoing investigation into alleged corruption in the bidding process that led to Qatar being awarded the 2022 World Cup have been submitted to FIFA's ethics committee. The committee is likely to take weeks to consider the report, including whether or not to make it public. It is also not clear whether the committee has the power to cancel the bid results, or whether this requires action by the body's Executive Committee. We do not have a view on the likelihood of Qatar losing the right to host the World Cup. However, were this to happen, we believe the impact on the Qatari economy would be limited. In the near term, construction activity and growth may experience some decline as ongoing projects are potentially curbed. Asset prices are also likely to experience some volatility as a result. In the longer term, however, we believe the impact may even be positive as we have always been skeptical about the long-term economic benefits to Qatar of hosting the event.

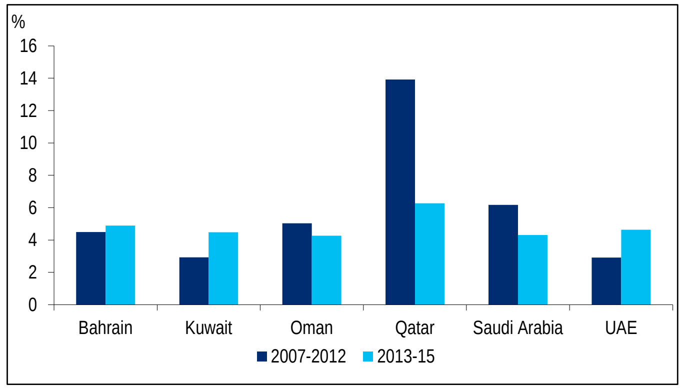
The Qatari economy continued to slow in 4Q with growth easing to 5.6%YoY from 6.9% reported in the 3Q. Despite this slowdown, growth for 2013 actually came in at 6.5%YoY – higher than our own expectations (5.9%). As was the case in 2012, the majority of growth in 2013 came from the non-mining and quarrying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

Figure 116. Fiscal breakeven oil prices on the rise



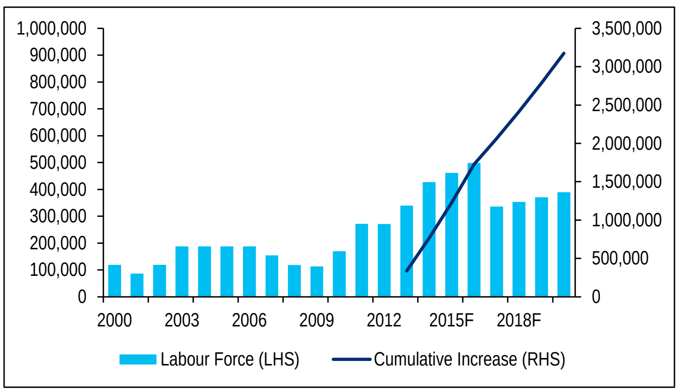
Source: Citi Research estimates

Figure 117. Economic growth will be uneven going forward



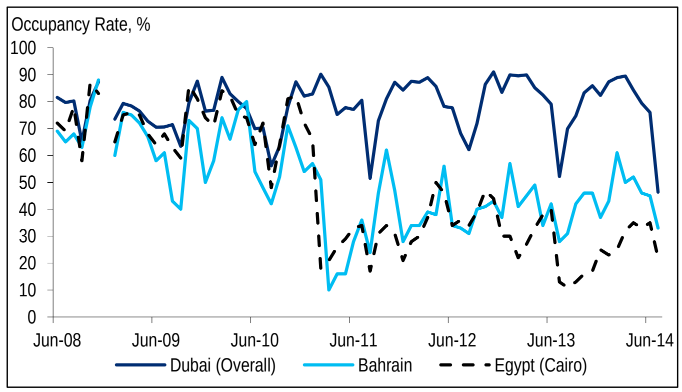
Source: Haver Analytics, Citi Research

Figure 118. 3.3 million entrants in Saudi job market by end of decade



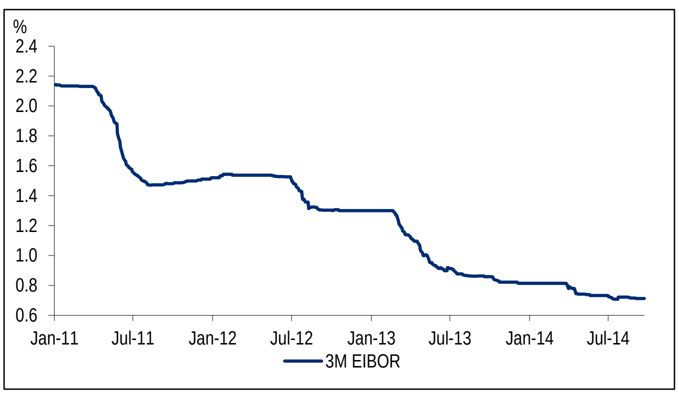
Source: Saudi Central Statistics Office, Citi Research

Figure 119. Dubai hotel occupancy continues to outperform its peers



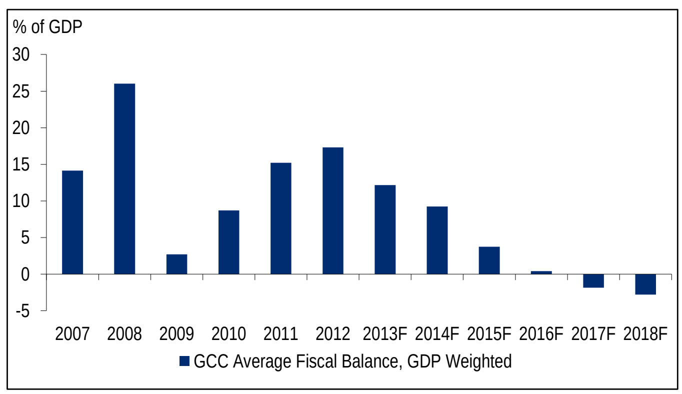
Source: Ernst & Young, Citi Research

Figure 120. EIBOR rates stablise at low levels



Source: Haver Analytics

Figure 121. High government expenditure will drive balances lower



Source: Haver Analytics, Citi Research estimates

Figure 122. GCC Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
BAHRAIN									
Nominal GDP, USD bn	21.7	25.6	22.9	25.6	29.0	30.7	32.8	35.0	37.2
GDP per capita, USD	21,072	22,983	19,192	20,482	22,401	23,272	23,931	24,582	25,088
Real GDP, yoy avg	8.3	6.2	2.5	4.3	2.1	3.4	5.5	4.8	4.4
CPI, % avg	3.3	3.5	2.8	1.9	-0.4	2.8	3.3	4.2	4.6
BHD/US$, avg	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
Current account, US$bn	2.8	2.1	0.4	0.6	3.0	2.0	2.2	2.3	0.8
% of GDP	12.7	8.1	1.7	2.3	10.3	6.4	6.8	6.6	2.2
Consolidated gov. balance, % of GDP	2.7	6.4	-4.3	-4.8	-0.3	-2.0	-3.3	-3.7	-5.4
KUWAIT									
Nominal GDP, USD bn	112.3	136.6	105.2	114.1	146.6	168.0	174.2	176.0	174.7
GDP per capita, USD	43,971	50,563	36,898	38,122	46,908	52,196	52,532	51,544	49,662
Real GDP, yoy avg	6.0	2.5	-7.1	-2.4	10.2	8.3	5.7	3.8	3.9
CPI, % avg	5.5	10.6	4.0	4.0	4.7	2.9	2.6	3.0	3.5
KWD/US$, avg	0.28	0.27	0.29	0.29	0.28	0.28	0.28	0.29	0.29
Current account, US$bn	41.9	57.8	29.1	37.8	66.2	78.7	70.9	67.5	61.1
% of GDP	37.3	42.3	27.6	33.2	45.2	46.9	40.7	38.4	35.0
Consolidated gov. balance, % of GDP	30.0	36.4	19.0	32.0	41.9	41.4	31.6	26.7	15.1
OMAN									
Nominal GDP, USD bn	42.0	59.9	53.4	53.4	53.4	53.4	84.3	88.9	92.9
GDP per capita, USD	15,326	20,887	18,015	17,438	16,881	16,180	24,363	24,608	24,604
Real GDP, yoy avg	4.5	8.2	6.1	4.8	0.9	5.8	3.4	4.7	4.7
CPI, % avg	5.9	12.5	3.6	3.2	4.0	2.9	2.1	1.0	0.9
OMR/US$, avg	0.38	0.38	0.38	0.38	0.39	0.39	0.38	0.39	0.39
Current account, US$bn	2.5	5.0	-0.5	5.0	8.9	7.8	5.1	6.8	4.6
% of GDP	5.8	8.4	-0.9	9.4	16.7	14.6	6.1	7.7	4.9
Consolidated gov. balance, % of GDP	2.7	0.3	-0.1	3.1	-0.4	-0.3	0.8	-1.4	-4.5
QATAR									
Nominal GDP, USD bn	79.7	115.3	97.8	125.1	171.5	192.4	202.5	213.4	227.5
GDP per capita, USD	85,712	104,982	80,294	92,546	114,241	118,688	115,635	112,836	111,419
Real GDP, yoy avg	18.0	17.7	12.0	16.7	13.0	6.1	6.5	5.5	6.9
CPI, % avg	13.6	15.2	-4.9	-2.4	1.9	1.9	3.1	3.0	3.5
QAR/US$, avg	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64
Current account, US$bn	11.5	26.6	6.4	24.0	52.0	62.0	62.6	61.5	54.0
% of GDP	14.4	23.1	6.5	19.1	30.3	32.2	30.9	28.8	23.7
Consolidated gov. balance, % of GDP	10.9	9.8	13.4	2.7	7.8	11.4	15.6	13.0	9.5
SAUDI ARABIA									
Nominal GDP, USD bn	415.6	519.4	429.0	526.8	669.5	733.8	748.4	763.6	763.4
GDP per capita, USD	17,111	20,861	16,811	20,178	25,645	27,559	27,553	27,561	27,016
Real GDP, yoy avg	6.0	8.4	1.8	6.4	8.6	5.8	4.0	4.8	4.2
CPI, % avg	4.1	9.9	5.1	5.3	3.9	2.9	3.5	2.9	3.0
SAR/US$, avg	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Current account, US$bn	94.3	133.0	21.5	67.4	159.3	165.7	133.6	112.8	70.0
% of GDP	22.7	25.6	5.0	12.8	23.8	22.6	17.9	14.8	9.2
Consolidated gov. balance, % of GDP	12.2	30.8	-3.0	6.3	13.2	15.4	8.7	6.0	0.9
UNITED ARAB EMIRATES									
Nominal GDP, USD bn	257.9	315.5	253.5	286.0	347.4	372.3	402.3	431.0	461.8
GDP per capita, USD	57,467	66,205	51,659	56,586	66,727	68,563	70,757	72,478	74,285
Real GDP, yoy avg	3.2	3.2	-5.2	1.6	4.9	4.7	5.2	4.0	4.0
CPI, % avg	11.1	12.3	1.6	0.9	0.9	0.7	1.1	2.0	2.4
AED/US$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account, US$bn	15.5	22.7	7.9	7.4	74.3	108.8	114.1	102.2	88.3
% of GDP	6.0	7.2	3.1	2.6	21.4	29.2	28.4	23.7	19.1

Source: National Sources, Citi Research forecasts

Hungary

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- **Summary view** — The delay of FX mortgage conversion and the NBH's willingness to provie FX to banks for the conversion eliminates the risk of abrupt short term FX weakening.
- **Things to watch** — Details of household FX mortgage conversion plans and the NBH's tools offered to banks to cover FX demand may be key domestic factors to watch.
- **Strategy** — We expect the NBH to stick to low interest rates in order to curb fiscal expenditures while the yield curve may steepen as the long end remains sensitive to rising external yield environment.

We have upgraded our growth forecasts

We have upgraded our GDP growth forecasts to 3.1%YoY in 2014 and 2.2%YoY in 2015 from 2.9% and 1.9%, respectively reflecting the following factors: i) EU fund absorption will likely exceed our expectations both this year and the next and may continue to lift public investments. The positive impact of EU fund utilization may slow in 2015 but only decline in 2016 when the 2007-2013 EU programs come to an end. ii) The NBH has doubled the available size of the second phase of its SME lending scheme introduced under the Funding for Growth Scheme (FGS) to HUF 1trn. Although the utilization has been sluggish until the summer months given that largest part of new lending is related to fixed investments, demand for the FGS has picked up from August and is likely to accelerate in the second half of the year supporting private sector investments. iii) Industrial output momentum has surprised to the upside in July, which suggests the auto industry may continue to expand output despite the slowing external environment. iv) The government's recent ruling that has deemed previously applied FX margins and increase in client interest rates as unfair, forces banks to deduct those charges from outstanding household FX loan principals. The settlement may take place in 1H15 and may reduce the average monthly FX debt installment by 25-30% without converting FX loans into HUF. The measures are likely to support a steady 2% recovery in household consumption next year while net real wage growth may slow as inflation picks up from close to zero in 2014.

FX loan conversion may be delayed to 2H15

Banks' burden related to the refunding obligation of applied FX margins and unilateral interest rate changes on household loan contracts may reach €3.2bn which may be partly compensated by unfreezing provisions. February 2015 is the deadline for banks to calculate refunding obligations and the actual settlements may take place in 2Q15. We do not expect that the ongoing court cases will deliver major change to the potential costs to banks.

There is no decision about the timing of details of FX mortgage loan conversion yet. The latest political comments suggest the conversion is unlikely to take place before 2H15. NBH has changed its stance and is willing to provide FX from its reserves for FX mortgage loan conversion even if it would take place in one step. The total portfolio to be converted is €11bn, of which €3bn needs to be covered as banks compensate households for the FX margins and loan condition changes in the first step. The utilization of FX reserves for loan conversion would be conditional: Banks would need to reduce short term external debt (currently around € 10bn) by similar sizes to improve the reserve coverage.

If the conversion is delayed, the NBH's participation may help to avoid major pressure on the FX market, in our view. The NBH has EUR5-6bn inflows from EU funds annually adding to FX reserves without utilizing FX for interventions or external debt redemptions. FX reserves stood at EUR34bn as of end-August and total short term external debt has been EUR 28bn as of 1Q14.

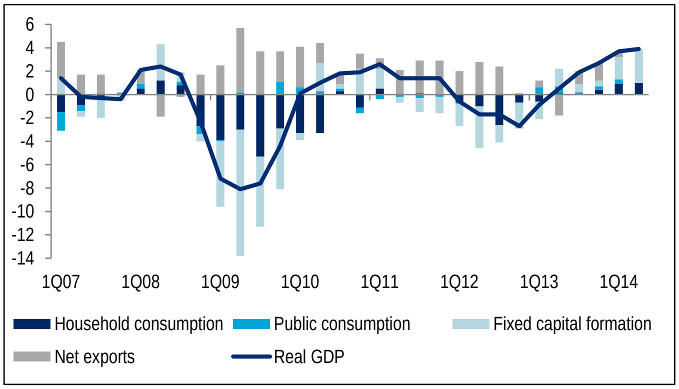
Rates to remain on hold, gradually weaker FX

The inflation outlook has not changed significantly, as trend inflation has remained broadly unchanged. Core price trends show that despite the recent FX weakening and ongoing recovery in domestic demand, inflationary pressures remain weak. We expect headline CPI to remain close to zero until October as new, smaller rounds of utility price cuts compress prices, but the elimination of larger utility price cuts is likely to lift CPI to around 1.4%YoY by year-end and to 2-2.3% by mid-2015. In our view, the NBH is unlikely to cut interest rates further unless incoming data shows a significant drop in the inflation outlook.

The MPC will focus on avoiding rate hikes as both public and household balance sheets become more sensitive to local yields with the ongoing shift towards local government funding, the increasing utilization of the FGS and the upcoming conversion of household FX debt. The soft inflation outlook leaves room to keep monetary conditions loose and tolerate some FX weakness, but the sensitivity of public debt ratio to FX weakening remains a hard constraint to keep depreciation pressures under control in order to avoid the reopening of the EDP. This, in our view, suggests that the NBH could intervene on the FX markets to mute pressure in the first place but may tolerate gradually weaker HUF, especially if depreciation pressures are driven by global flows also impacting other EM currencies.

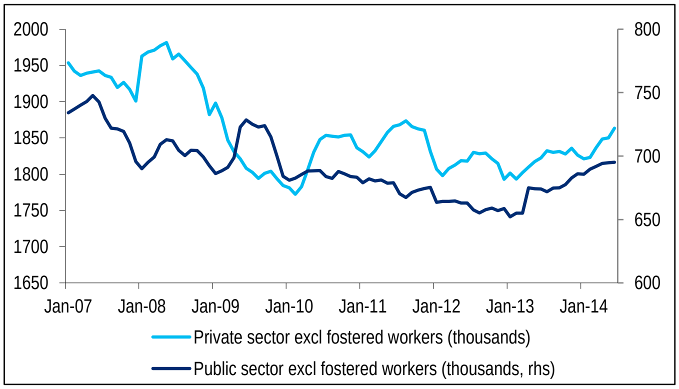
We expect rates to remain on hold until around mid-2015 but external factors may be the key determinant of local rates outlook. Based on our inflation forecast ex-post real interest rates would turn negative by 2Q15 as headline inflation rises above 2%YoY and towards 2.5% by end-2015. Rising headline inflation combined with the external outlook of first Fed hikes to begin sometime in 2015, we expect increasing pressure on local markets to force the initiation of gradual rate hikes around mid-2015, under our base line scenario. Given that inflation may remain close to the 3% target over the medium term amidst low imported inflation and large remaining slack in consumption related sectors and considering that Hungary's external balance is unlikely to turn negative even as domestic demand picks up, the magnitude of rate hikes is likely to be gradual, in our view. We forecast the base rate to reach 3.10% by end-2015 while we expect EURHUF to trade around 325 levels by late next year.

Figure 123. Increasing domestic demand contribution to GDP growth (contributions to YoY GDP growth, percentage points)



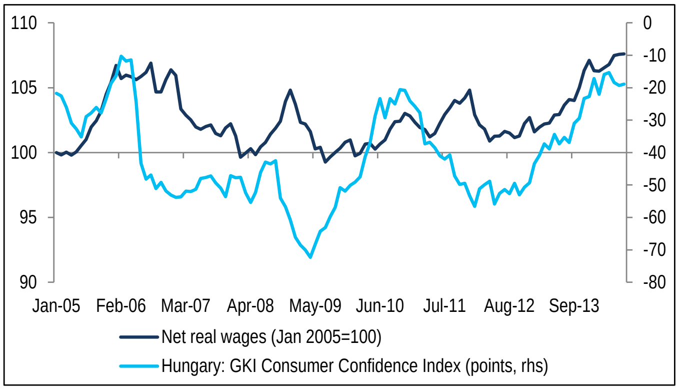
Source: Hungarian CSO, Citi Research

Figure 124....as private and public employment increases gradually...



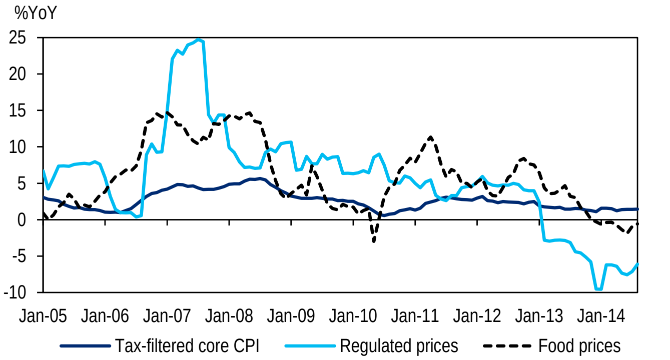
Source: Hungarian CSO, Citi Research

Figure 125. ...and net real wages are lifted by low inflation



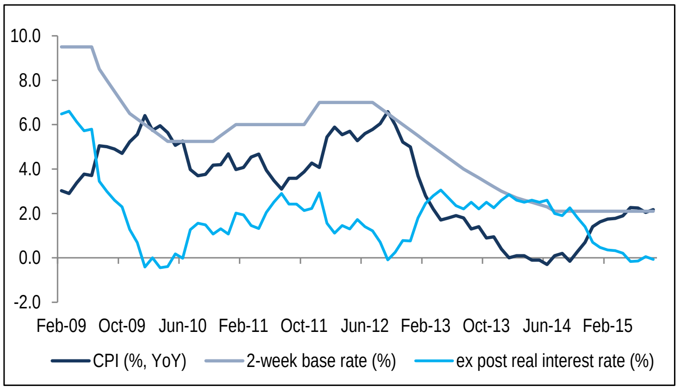
Source: Haver, Citi Research

Figure 126. Trend inflation remains soft compared to historical trend



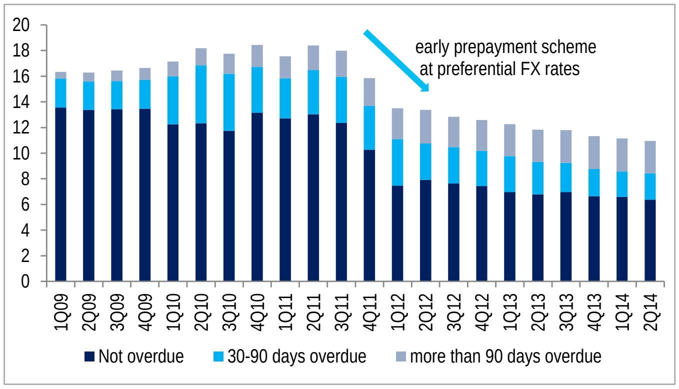
Source: National Bank of Hungary, Citi Research

Figure 127. Positive real interest rates to diminish by 3Q15 without corrective rate hikes



Source: National Bank of Hungary, Citi Research

Figure 128. Household FX mortgages by delay in payments (EUR bn)



Source: National Bank of Hungary, Citi Research

Figure 129. Hungary Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	145	141	136	127	115	127	135	116	116
Nominal GDP, local currency bn	25,167	26,554	25,743	26,612	27,727	28,109	29,262	30,585	32,080
GDP per capita, USD	14,390	14,061	13,584	12,688	11,487	12,726	13,573	11,685	11,661
Population, mn	10.1	10.0	10.0	10.0	10.0	10.0	9.9	9.9	9.9
Unemployment, % of labour force	7.7	8.0	10.5	10.8	10.7	10.7	9.1	8.6	8.1
Economic Activity									
Real GDP, yoy avg	0.1	0.9	-6.8	1.1	1.6	-1.7	1.1	3.1	2.2
Real investment growth % yoy	-1.5	3.7	-29.6	11.5	-3.6	-11.2	1.9	10.0	3.5
Real consumption growth % yoy	-1.4	-0.2	-4.5	-2.5	0.3	-1.5	0.5	1.4	1.6
private consumption growth % yoy	1.1	-0.7	-6.6	-3.0	0.4	-1.6	0.3	1.8	2.0
Real export growth, % yoy	15.0	5.7	-10.2	11.3	8.4	1.7	5.3	6.8	6.0
Real import growth, % yoy	12.8	5.5	-14.8	10.9	6.4	-0.1	5.3	7.2	6.2
Prices, Money & Credit									
CPI, % yoy eop	7.4	3.4	5.4	4.6	4.1	5.1	0.6	1.4	2.5
CPI, % avg	7.9	6.0	4.0	4.7	3.9	5.7	1.7	0.2	2.1
Nominal wages, % yoy	8.0	7.4	0.5	1.3	5.2	4.6	3.8	4.4	4.2
Credit extension to private sector, % yoy	18.8	21.7	-2.7	4.1	-0.5	-12.5	-5.7	1.7	-0.3
Policy Interest Rate, % eop	7.50	10.00	6.25	5.75	7.00	5.75	3.00	2.10	3.10
1 month inter-bank rate, %, eop	7.50	10.00	6.25	5.75	7.08	5.75	3.00	2.10	3.10
Long-term yield, %, eop	7.08	8.28	7.99	7.97	9.75	6.11	5.61	4.80	5.30
HUF/US$, eop	173	190	189	208	244	221	216	264	277
HUF/US$, avg	183	171	201	208	201	225	223	239	278
HUF/EUR, eop	253	266	271	278	315	291	297	318	325
HUF/EUR, avg	251	252	280	275	279	289	297	312	324
Balance of Payments, USD bn									
Current account	-9.9	-11.4	-0.3	0.3	0.6	1.1	4.0	4.4	3.4
% of GDP	-6.8	-8.1	-0.2	0.2	0.5	0.8	3.0	3.8	2.9
Trade balance	-0.9	-1.8	3.3	3.2	4.3	4.5	5.0	4.8	3.4
Exports	93.0	106.1	80.0	88.8	103.7	97.3	96.7	98.5	91.9
Imports	93.9	107.9	76.7	85.5	99.4	92.8	91.6	93.8	88.5
Service balance	1.8	2.2	2.8	3.8	4.4	4.3	5.3	5.7	5.2
Income balance	-10.1	-11.0	-6.9	-7.3	-8.9	-8.2	-5.9	-6.3	-5.5
FDI, net	7.5	8.4	3.9	3.4	10.1	25.3	10.9	9.4	8.9
International reserves	23.2	33.2	41.1	43.1	45.4	43.5	57.0	61.7	73.2
Total amortisations	9.3	15.2	21.9	20.5	25.8	21.6	21.5	19.9	19.2
Public Finances, % of GDP									
Consolidated government balance	-5.1	-3.7	-4.6	-4.3	4.3	-2.0	-2.2	-2.9	-3.0
Consolidated gov primary balance	-1.0	0.5	0.0	-0.1	8.5	2.4	2.2	0.9	0.8
Public debt	66.5	72.3	78.0	79.9	81.8	79.7	78.8	78.9	78.0
of which Domestic	35.8	37.5	36.8	40.7	40.8	43.5	44.6	48.9	48.9
Foreign Assets & Liabilities, USD bn									
External debt	151.7	172.6	196.3	185.1	172.5	164.9	164.4	152.3	146.6
Public	47.4	51.8	62.1	59.6	58.4	63.8	62.5	63.0	63.5
External debt / GDP	104.8	122.2	144.1	145.7	150.3	129.9	121.9	131.3	126.8
External debt / XGS	137.7	136.5	199.2	171.2	137.3	140.0	138.1	124.7	129.0
Short-term debt	32.9	27.5	28.0	32.9	31.7	22.8	22.9	18.8	17.1
Short-term debt/International reserves (%)	141.7	82.8	68.2	76.1	69.9	52.4	40.1	30.5	23.4

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.7	3.9	2.6	2.4	2.0	2.1	2.3	2.5	1.9
CPI, % yoy eop	0.1	-0.3	-0.2	1.4	1.8	2.2	2.2	2.5	3.0
Policy interest rate, %, eop	2.60	2.30	2.10	2.10	2.10	2.10	2.35	3.10	3.50
Short-term market rate, % eop	2.60	2.30	2.10	2.10	2.10	2.10	2.35	3.10	3.50
Long-term yield, %, eop	5.54	4.39	4.60	4.80	4.90	5.00	5.30	5.30	4.30
HUF/EUR, eop	307	310	312	318	322	325	325	325	325

Source: National Sources, Citi Research forecasts

Israel

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- **Summary view** — We think Israel will stay stuck in a relatively low-growth equilibrium for the next couple of years, caught between weak global demand growth and weak growth in domestic spending.
- **Things to watch** — Israeli price deflation is now a reality, and it is difficult to see why inflation will move back up to the 1-3% target range without further action by the Bank of Israel. This would require a) a further cut in the policy rate to zero, followed by b) aggressive action in the fx market, either by increasing the central bank's dollar-purchases or announcing a 'Minimum Exchange Rate'.
- **Strategy** — The shekel is likely to weaken. Not only is the market primed to expect the kind of central bank action outlined above, but there is also evidence that Israeli portfolio managers are less inclined to fx-hedge their purchases of foreign securities.

Growth prospects turn sour

The data coming in over the summer shows deterioration in the pace of economic activity. While the PMI had been rising impressively in Q2, reaching 55.6 in May, it has fallen back below 50 in the subsequent three months. Manufacturing growth also returned to negative territory in June, and the Israeli construction sector is effectively in recession, partly thanks to uncertainty about the prospects for a zero VAT rate on couples' first purchase of newly built homes: builders are holding off to be sure of what specifications would attract the zero-rating, and buyers are holding off in case the VAT measure is passed. GDP growth fell to 1.5% annualized in Q2, the lowest rate since the aftermath of the 2008 financial crisis. Gross fixed capital formation and net exports are creating the biggest drag on economic activity.

The shekel is part of the problem…

Israeli gas production set to grow. Tamar, the smaller of two large gas fields being developed off Israel's northern coast, began production in April 2013. Gas from Tamar (around 300 bcm) substituted some US$2.1bn of energy imports in 2013. A larger field, Leviathan (around 600 bcm), will commence production in 2017 or just after. The government is in the process of creating a Sovereign Wealth Fund to capture the net income from gas production, and it reckons that the Fund will reach over US$80bn by 2040 (Israel's GDP this year is around US$300bn). We think it's worth assuming that more gas and oil will be discovered in the Eastern Mediterranean, and so Israel's emergence as an energy exporter is likely to become an even stronger story than it is at the moment: the US Geological Survey estimates that the Levantine Basin –40% of which is in Israeli waters –contains more than 3.4 trillion cubic meters of gas, suggesting that Israel might end up with twice the amount of gas that it has found to date.

Partly as a result of these developments, the shekel has been one of the strongest currencies in the world in the past 18 months: the real effective exchange rate appreciated by 10% during this period alone. The appreciation of the shekel might have something to do with the weakening performance of Israeli exports, but the Bank of Israel is unwilling to 'bail out' the corporate sector by artificially depreciating the shekel. However, the shekel's strength is a critical concern for the Bank because it is driving Israeli inflation way below the Bank's 1-3% inflation target. And since cutting the interest rate is no longer much use in creating inflation pressure, the Bank's only remaining tool is the currency.

…and disinflation looks like it's here to stay

The exchange rate's impact on CPI is evident from the collapse of tradeables inflation. Tradeables inflation has been negative every month this year, reaching -2% in August. That is dragging down overall CPI, and in turn that is pushing inflation expectations down. Moreover, it is not only the exchange rate that is creating disinflationary pressure in Israel. First, the government's efforts to increase workforce participation among the ultra-Orthodox and Arab Israelis seem likely to increase labour supply, possibly putting downward pressure on wages. Second, in the wake of a recent government commission to increase competition and reduce concentration of ownership in the economy, efforts are being made to increase competition in the retail food sector, in telecoms, TV services and in auto retail.

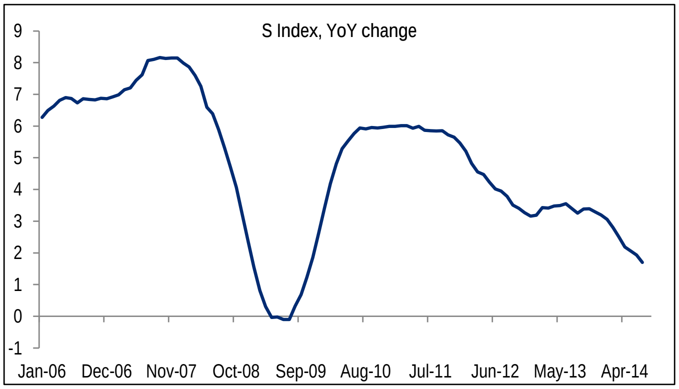
Time for radical thinking about the exchange rate?

The central bank is now close to running out of traditional policy tools. The BOI's policy rate has fallen from 1% at the start of this year, and now having nearly reached the zero lower bound the central bank will be forced to consider alternative ways of delivering monetary stimulus. In our view, that stimulus is most likely to come from the fx market: since Israel's low inflation problem is largely currency-induced, it follows that the solution should be currency-oriented. In that case, it might not be long before the Bank considers something like a 'Minimum Exchange Rate' along the lines pursued by the Czech and Swiss National Banks. An alternative to this would be simply for the Bank to pursue aggressive intervention in the fx market. Either way, the consequence is likely to be a weaker nominal exchange rate. The next couple of months' worth of inflation data will be particularly important in shaping the outlook for an unconventional exchange rate policy.

Fiscal and political noise rising

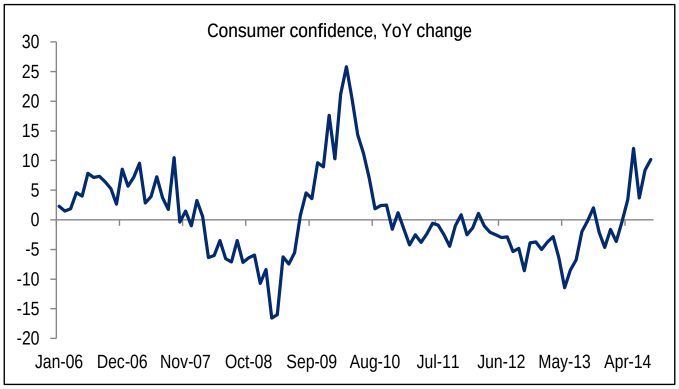
A dispute over fiscal policy might act as a constraint on the central bank's willingness to loosen monetary policy. The finance ministry has proposed a temporary departure from Israel's fiscal rules for 2015, which could lead to a deficit of up to 4% GDP next year, compared to the original target of 2.5%. While the Bank of Israel sympathises with the need for some leniency on next year's deficit – up to 3% of GDP, partly in acknowledgement of the costs of the 2014 conflict in Gaza – the Bank opposes the finance ministry's plan, and press reports suggest that the Prime Minister may support the Bank. This is relevant to the Bank's decision-making, since the looser fiscal policy is, the less easy it will be to justify extraordinary measures on the monetary side. At the same time, the Bank will also need to consider the impact of tighter monetary policy in the US: the 10 year Israeli shekel bond yield is now at a record-low spread to the US 10 year yield, and so there could be some tightening of financial conditions if Israeli yields rise on the back of a shock from the US. If higher US rates and a strong dollar help to suck capital out of Israel and generate a weaker shekel, that might suit the Bank of Israel's effort to find a way to push inflation up.

Figure 130. Economic activity is stabilizing at a weak level, partly due to what the BOI describes as a 'virtual standstill' in world trade…



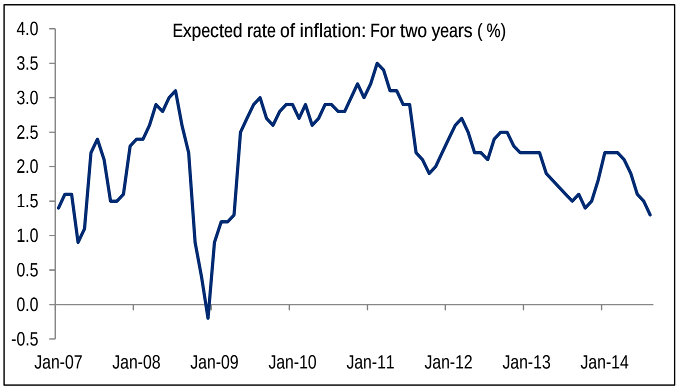
Source: Haver Analytics, Citi Research

Figure 131. ...and consumer confidence is fragile even though household borrowing has been relatively robust



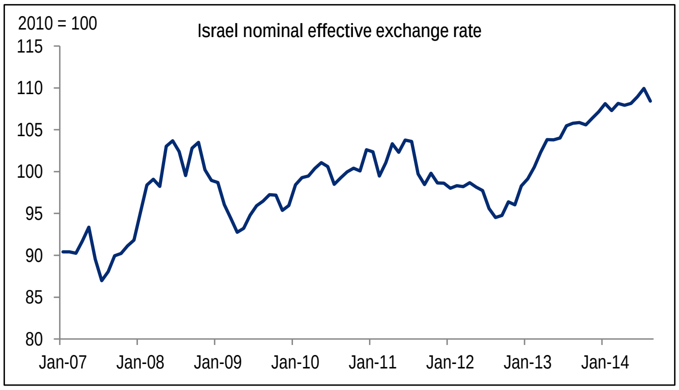
Source: Haver Analytics, Citi Research

Figure 132. Inflation expectations have fallen sharply…



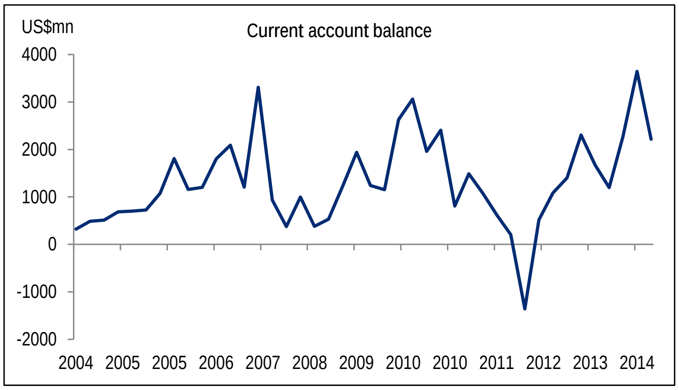
Source: Haver Analytics, Citi Research

Figure 133. …largely thanks to the appreciation of the shekel…



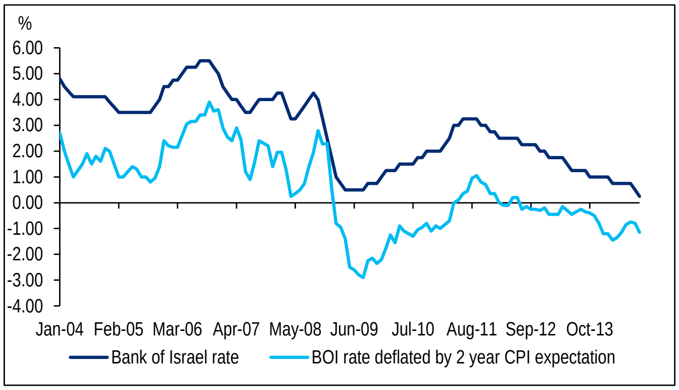
Source: Haver Analytics, Citi Research

Figure 134. …on the back of a sharply improving current account balance…



Source: Bloomberg, Citi Research

Figure 135. …giving room for the BOI to cut rates, and, probably, increase its effort to weaken the shekel.



Source: Bloomberg, Citi Research

Figure 136. Israel Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	175	213	206	232	258	258	291	304	295
Nominal GDP, local currency bn	719	765	809	866	924	993	1,052	1,081	1,109
GDP per capita, USD	25,248	29,990	28,289	31,273	34,236	33,702	37,677	38,813	37,265
Population, mn	6.9	7.1	7.3	7.4	7.5	7.6	7.7	7.8	7.9
Unemployment, % of labour force	9.2	7.7	9.4	8.3	7.1	6.9	6.3	6.0	5.8
Economic Activity									
Real GDP, yoy avg	6.8	5.0	1.0	5.3	4.7	3.5	3.2	2.3	2.2
Real investment growth % yoy	9.5	9.0	-4.5	9.2	15.8	3.6	0.9	4.5	6.5
Real consumption growth % yoy	6.6	1.6	2.5	4.4	3.6	3.2	3.4	2.0	2.1
private consumption growth % yoy	8.1	1.5	2.4	4.8	4.0	3.1	3.6	2.1	2.4
Real export growth, % yoy	11.2	6.6	-12.1	15.3	7.2	1.1	1.0	3.0	4.0
Real import growth, % yoy	10.6	2.3	-12.7	14.1	11.0	3.2	-1.7	1.6	3.5
Prices, Money & Credit									
CPI, % yoy eop	3.4	3.8	3.9	2.7	2.2	1.6	1.8	0.6	0.6
CPI, % avg	0.5	4.6	3.3	2.7	3.5	1.7	1.5	0.5	0.4
Nominal wages, % yoy	2.2	3.8	0.7	3.4	3.8	2.6	2.5	5.0	5.0
Credit extension to private sector, % yoy	10.8	-0.5	6.5	7.0	5.0	3.4	1.9	4.0	4.5
Policy Interest Rate, % eop	4.25	2.50	1.00	2.00	2.75	2.00	1.00	0.00	0.25
1 month inter-bank rate, %, eop	4.50	1.90	1.31	2.06	2.74	1.75	0.99	0.00	0.25
Long-term yield, %, eop	6.17	4.72	5.11	4.75	4.24	3.62	3.65	2.40	3.00
ILS/US$, eop	3.86	3.78	3.79	3.52	3.81	3.73	3.47	3.68	3.79
ILS/US$, avg	4.11	3.58	3.93	3.73	3.58	3.85	3.61	3.56	3.76
Balance of Payments, USD bn									
Current account	5.6	3.2	7.8	7.9	3.9	2.1	6.0	5.9	5.2
% of GDP	3.2	1.5	3.8	3.4	1.5	0.8	2.0	1.9	1.8
Trade balance	-5.2	-6.4	0.7	-1.9	-8.1	-9.7	-9.3	-5.0	-2.3
Exports	50.8	58.0	46.8	56.4	64.3	62.0	62.0	71.0	75.3
Imports	56.0	64.4	46.1	58.3	72.4	71.8	71.3	76.0	77.5
Service balance	3.7	5.2	5.0	6.7	6.8	10.2	12.6	9.0	12.0
Income balance	-0.2	-4.0	-5.1	-5.2	-3.6	-6.5	-6.3	-6.1	-4.5
FDI, net	17.4	18.1	6.1	14.6	18.3	11.3	16.5	4.0	6.0
International reserves	28.6	42.5	60.6	70.9	74.9	76.0	81.8	87.0	95.0
Total amortisations	10.6	4.1	4.7	5.2	16.2	7.8	7.3	4.2	3.0
Public Finances, % of GDP									
Consolidated government balance	0.5	-1.2	-4.2	-2.8	-2.5	-3.5	-2.7	-3.0	-3.3
Consolidated gov primary balance	6.1	4.1	1.0	2.3	2.5	1.4	2.1	1.6	3.0
Public debt	72.9	71.5	73.8	74.5	73.8	72.5	71.8	71.8	71.2
of which Domestic	56.5	57.3	60.1	57.7	57.4	56.4	55.1	54.6	54.1
Foreign Assets & Liabilities, USD bn									
External debt	92.3	89.6	94.6	107.8	105.6	97.5	95.4	104.0	105.0
Public	32.0	28.2	31.2	40.3	36.5	37.0	38.0	40.0	42.0
External debt / GDP	52.8	42.0	46.0	46.5	40.9	37.8	32.7	34.3	35.6
External debt / XGS	127.9	107.9	136.4	131.9	115.1	104.6	100.6	99.0	94.4
Short-term debt	39.9	40.3	42.2	55.7	51.0	43.9	42.2	45.0	45.0
Short-term debt/International reserves (%)	139.6	94.7	69.7	78.6	68.1	57.8	51.6	51.7	47.4

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.2	2.2	0.2	3.0	2.8	2.4	2.0	1.6	3.0
CPI, % yoy eop	1.3	0.5	-0.5	0.1	-0.1	0.2	1.3	0.6	1.3
Policy interest rate, %, eop	0.75	0.75	0.25	0.00	0.00	0.00	0.00	0.25	0.25
Short-term market rate, % eop	0.73	0.74	0.25	0.00	0.00	0.00	0.00	0.25	0.25
Long-term yield, %, eop	2.07	1.72	4.75	4.75	4.75	4.75	4.75	4.75	4.75
ILS/US$, eop	3.48	3.43	3.65	3.68	3.72	3.75	3.77	3.79	3.81

Source: National Sources, Citi Research forecasts

Kazakhstan

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- **Summary view** — Growth remains subdued with preliminary 2Q GDP expanding at 4.0% YoY (3.8% YoY in 1Q). We see GDP growth decelerating to 5% in 2014 on the back of heightened uncertainty in the CIS region and a China slowdown, but the risks to this forecast are slanted to the downside.
- **Things to watch** — One key macro concern recently has been the deterioration of the CA position, which was driven by a steady decline in exports related to sluggish global growth. The CA improved in 1Q and should be supported longer-term by the Kashagan oil field coming on stream.
- **Strategy** —The National Bank of Kazakhstan (NBK) devalued the tenge by 20% in Feb by announcing a new central level for the USDKZT of 185 within a 182-188 band. The NBK widened the corridor to 170-188 on 11 September. The NBK has the ability and resources to support the KZT at current levels.

Growth lost momentum in early 2014

GDP growth has been on a broad uptrend since 2010. Kazakhstan recovered strongly from the recession in 2009, posting above 7% GDP growth rates in 2010 and 2011. The pace of economic activity moderated in 2012 in line with more challenging global conditions, with GDP expanding at 5%, and picked up pace to 5.9%YoY in 2013.

2014 GDP will decelerate to 5% on heightened regional uncertainty and a China slowdown with downside risks. Events in Ukraine and Russia are already some headwinds for the economy. Industrial production has started the year on a downbeat note, contracting by 0.3%YoY in 1Q14 and by a further 0.4% in 2Q14. Consumption will remain a key driver in 2014, although the pace of expansion will moderate. A slowdown in China will also bite.

First half GDP data already showed some fragility. 1Q14 GDP grew only at 3.8%YoY while preliminary 2Q14 data points to a 4.0% YoY growth, confirming our view that Kazakhstan will not be able to emerge unscathed from the broader EM malaise and the regional geopolitical uncertainty. The short-term economic indicator, which captures around two thirds of the economy, expanded by a mere 2.7% during Jan-July on an YoY basis.

Growth is mainly driven by consumption as production struggles. This is best exemplified by the diverging behavior of retail sales and industrial production. Real retail sales grew at 12.8%YoY during 2013, broadly on par with its pace over 2011 and 2012. At the same time, industrial production has faced some headwinds, increasing by only 2.3%YoY during 2013. The same divergence has remained in place for the first half of 2014, with retail sales growing by 11.6%YoY, while industrial production contracting by 0.4%.

Consumption itself is increasingly led by robust retail loan growth. While consumption was initially supported by disposable incomes, which were growing at double digits in real terms, retail loans have taken over since about mid-2011. Real retail loan growth turned positive around that time, but has since accelerated to almost 27%YoY as of December 2013 (corporate loans grow at about 10%). This may be at least partly related to catching-up with post-crisis times as consumers deleveraged during 2009. Growth has moderated to 21.0%YoY in July this year, but remains robust enough to provide decent support for consumption spending.

Weaker current account leads to a currency devaluation

While the broader macro-economy has been healthy, the worsening current account position has been one key reason for concern. The current account was in deficit in 4 out of the last 6 quarters. After posting deficits of US$1.0bn in 3Q12 and US$2.5bn in 4Q12, the current account went into a surplus of US$2.2bn in 1Q13, before transitioning to a small deficit in 2Q13 (US$0.01bn) and plunging into a much bigger deficit in 3Q (US$2.2bn). 4Q13 current account was almost flat at -US$0.06bn. Correspondingly, the annual current account surplus dipped from 5.5% of GDP in 2011 to only 0.5% in 2012 and a deficit of 0.1% in 2013.

This led to the National Bank of Kazakhstan (NBK) to devalue the tenge by 20% in early February. The new central level for the USDKZT is 185, with the tenge being allowed to fluctuate between 182 and 188. The NBK has a history of adjusting the tenge to sizable moves in the RUB (early 2009 a prime example) and the NBK's statement explicitly cites concerns about the RUB and, more generally, about potential loss of competitiveness. Devaluation fears had also been growing in the country with the FX share of deposits rising rapidly from 29.8% in December 2012 to 39.6% in January 2014. The share rose sharply to 47.7% in March 2014, although it dropped to 44.8% in July.

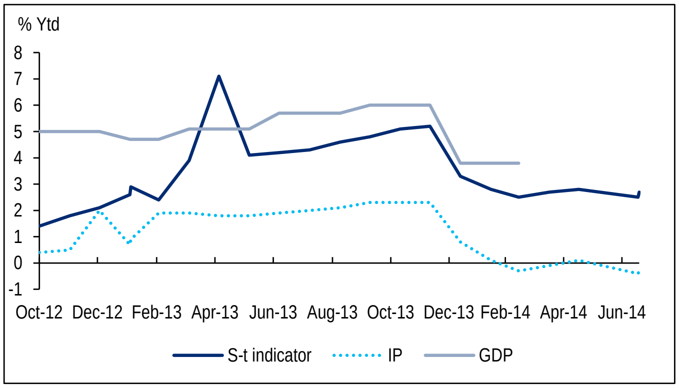
NBK widens USDKZT corridor in early September

It has always been our view that the original 20% devaluation was too large. According to the REER, the tenge actually looks now too weak rather than too strong. The tenge was only about 2% stronger in Jan relative to its 2008-2013 REER average. For comparison, in Jan 2009 the REER was about 15% overvalued, which is mostly consistent with the 20% devaluation implemented in Feb 2009. The same can be gleaned from looking directly at the RUBKZT, which also does not indicate levels of stress that existed around early 2009. While in Jan 2009, the RUBKZT was 17% stronger relative to its long-term average, justifying a 20% devaluation, in Jan 2014, the RUBKZT was only 8% stronger relative to its long-term average. Therefore, macroeconomic fundamentals, in our view, could have justified a maximum of about 10% devaluation

The current decision to widen the corridor on the downside should, thus, be taken, as a way to bring the exchange rate to levels more in line with macro fundamentals. NBK's actions may suggest that the NBK is explicitly acknowledging some mistakes in weakening the KZT too much. This may be related to concerns that the larger-than-warranted devaluation is contributing to accelerating CPI inflation, which accelerated from only 4.5%YoY in January to 7.1% in August. The proposed lower band of the corridor (170 vs 182 before) would in fact amount to exactly 10% devaluation relative to the original (pre-February) 155 USDKZT.

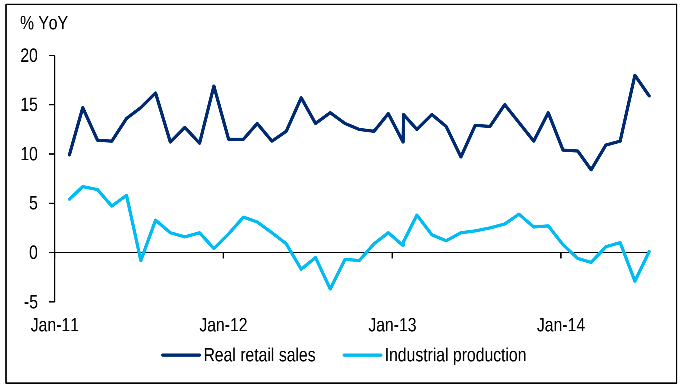
Softer growth and currency devaluation have boosted current account in 1Q. 1Q14 current account surplus came in very strong at US$5.5bn. This was driven by a significant 7.4%YoY drop in import growth on the back of slowing internal demand and a healthy 10.8% increase in export growth related to the weaker currency. Foreign reserves also benefited, rising to US$27.7bn in July from US$24.7bn in December.

Figure 137. Growth is still strong, but some weakness is evident



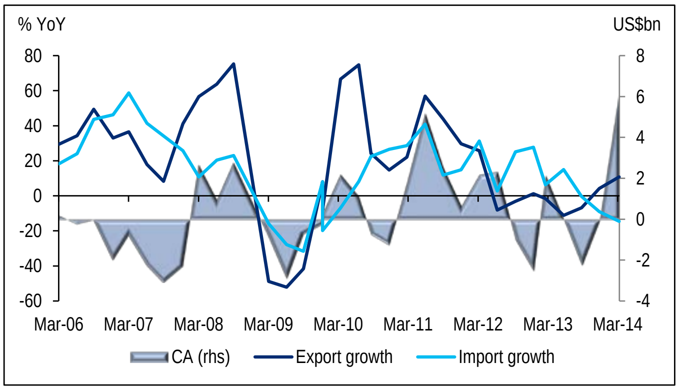
Source: Kazstat, Citi Research

Figure 138. It is mainly consumption driven as production struggles



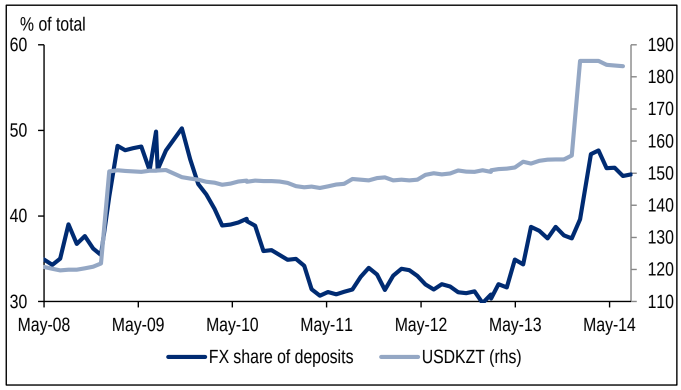
Source: Kazstat, Citi Research

Figure 139. Current account improved in 1Q



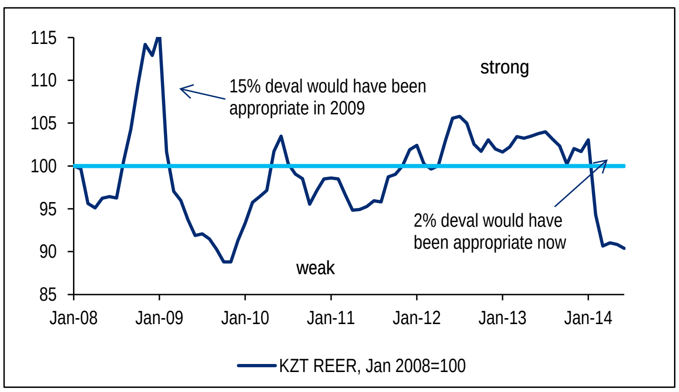
Source: NBK, Citi research

Figure 140. FX share of deposits have started to stabilize after the Feb devaluation



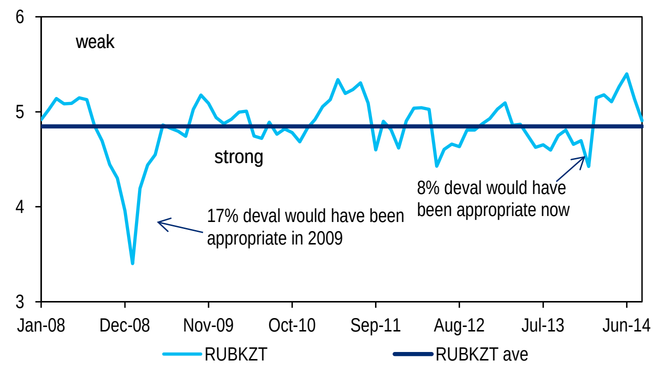
Source: NBK, Citi Research

Figure 141. The magnitude of the devaluation appears too big on REER…



Source: NBK, Citi Research

Figure 142. …and RUBKZT basis



Source: Bloomberg, Citi Research

Figure 143. Kazakhstan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	105	133	115	146	186	202	222	211	229
Nominal GDP, local currency bn	12,547	16,053	17,008	20,540	27,305	30,147	33,767	37,643	42,189
GDP per capita, USD	6,810	8,572	7,324	9,171	11,568	12,426	13,501	12,703	13,574
Population, mn	15.4	15.6	15.7	15.9	16.1	16.3	16.4	16.6	16.8
Unemployment, % of labour force	7.3	6.6	6.6	5.8	5.4	5.3	5.2	5.2	5.2
Economic Activity									
Real GDP, yoy avg	9.2	3.6	0.8	7.3	7.5	5.0	5.9	5.0	6.0
Real investment growth % yoy	23.4	-12.8	2.3	2.0	5.9	12.2	10.7	2.3	3.1
Real consumption growth % yoy	11.4	6.0	0.7	10.0	10.9	11.4	8.2	5.2	5.9
private consumption growth % yoy	11.1	6.4	0.7	10.9	10.9	11.2	9.0	5.5	6.0
Real export growth, % yoy	9.1	0.9	-11.9	3.1	1.5	4.2	-0.2	2.0	6.0
Real import growth, % yoy	26.1	-11.5	-15.7	2.9	3.5	22.5	5.2	2.0	8.0
Prices, Money & Credit									
CPI, % yoy eop	18.8	9.5	6.2	7.8	7.4	6.1	4.6	7.4	5.7
CPI, % avg	10.8	17.1	7.3	7.1	8.3	5.2	5.8	6.6	6.2
Nominal wages, % yoy	28.1	16.2	10.8	14.9	15.9	13.5	6.8	7.0	8.0
Credit extension to private sector, % yoy	55.2	5.2	7.3	0.3	15.8	12.1	12.8	12.0	12.0
Policy Interest Rate, % eop	11.00	10.50	7.00	7.00	7.50	5.50	5.50	5.50	6.00
1 month inter-bank rate, %, eop	11.50	9.00	4.00	1.50	1.50	1.50	5.50	3.48	3.98
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	121	121	149	147	148	150	154	185	185
KZT/US$, avg	123	120	147	147	147	149	152	178	185
Balance of Payments, USD bn									
Current account	-8.4	6.3	-4.1	1.4	10.2	1.1	-0.1	2.1	2.9
% of GDP	-8.0	4.7	-3.6	0.9	5.5	0.5	-0.1	1.0	1.3
Trade balance	15.2	33.6	15.0	28.5	44.8	38.1	33.7	35.7	39.1
Exports	48.3	72.0	43.9	61.4	85.2	86.9	83.4	88.4	95.5
Imports	33.1	38.4	28.9	32.9	40.3	48.8	49.7	52.7	56.4
Service balance	-8.4	-6.9	-6.0	-7.2	-6.6	-7.9	-6.9	-6.0	-7.0
Income balance	-12.9	-19.4	-12.4	-19.4	-27.7	-28.1	-25.3	-26.6	-28.2
FDI, net	-8.0	-13.1	-10.1	-3.7	-8.6	-11.8	-7.8	-6.0	-8.6
International reserves	17.6	19.9	22.7	27.7	28.8	27.7	24.1	27.2	30.5
Total amortisations	28.8	34.1	39.0	25.4	29.6	31.9	31.9	10.5	11.1
Public Finances, % of GDP									
Consolidated government balance	4.5	-9.3	-9.4	2.7	5.9	3.9	3.0	2.3	2.1
Consolidated gov primary balance	4.8	-8.9	-9.0	3.1	6.3	4.4	3.5	3.0	2.6

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	4.0	5.4	4.4	6.1	7.5	5.9	6.0	4.7	3.7
CPI, % yoy eop	6.0	6.9	7.4	7.4	6.3	6.1	5.9	5.7	5.8
Policy interest rate, %, eop	5.50	5.50	5.50	5.50	5.50	6.00	6.00	6.00	6.00
Short-term market rate, % eop	5.00	4.00	3.48	3.48	3.48	3.98	3.98	3.98	3.98
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
KZT/US$, eop	182	184	185	185	185	185	185	185	185

Source: National Sources, Citi Research forecasts

Levant

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After ISIS' sweeping gains in early summer, the counteroffensive is in full swing. A series of gruesome filmed beheadings of western hostages has acted to intensify western military action against the extremist group, with France joining the US in direct airstrikes on Iraqi soil. The US continues to gather support from a broad coalition of regional and international powers for greater action against ISIS, although the precise nature and scope of that action is as yet unclear.

Although Iraq's political elite have taken the first step in confronting the ISIS threat by forming a broad-based government under PM Haider al Abadi, we continue to have concerns over the durability and the likely effectiveness of the government in meeting the enormous challenges it is facing. To begin with, the government is on a sort of probationary period for the next three months, while outstanding issues with the Kurds are resolved. Kurdish MPs backed the new government only because of the looming constitutional deadline, and have given a 3-month deadline to Abadi to resolve issues including outstanding budget transfers, Kurdish oil exports and a national oil law, the status of disputed territories, and the financing of the Peshmerga forces, to name a few. It is therefore possible that we will be facing a renewed political crisis come December.

The sidelining of former Deputy Prime Minister for Energy, Ali Shahristani, does augur well, however, for a deal between the Kurds and Baghdad on oil exports and a national oil law. Indeed, according to Iraq Oil Report (Sept. 9), his replacement, Adel Abdulmahdi, has long been a supporter of devolved state powers to develop oil. This includes Basra, implying that a new national oil consensus may emerge which decentralizes decision-making, something which may be positive for oil and gas development given the effect of past capacity bottlenecks at the Ministry of Oil.

Sunni representation in the government is, in our opinion, relatively strong and likely to assure the buy-in of the Sunni leadership. Sunni Deputy PM Saleh al Mutlaq retains his job, while key portfolios such as Electricity and Defense have also gone to Sunnis (although the latter remains to be filled). The Defense Ministry, in particular, will be a key platform for Sunnis to extend patronage and to reverse some of the historic grievances they have had regarding staffing in the military.

Sticking points remain: in mid-September, al Abadi's nominees for Defense and Interior Minister were rejected by the Iraqi parliament. This highlights the intensity of the party-political jostling over these lucrative and powerful portfolios.

Finally, the government is likely to be viewed with some skepticism at the grass-roots level across all segments of Iraqi society. It is a decidedly political government, as opposed to technocratic, and its priority will be on its own survival and the balancing of its polarized constituents political demands. This does not augur particularly well for policy making, an improvement in governance, or the delivery of better services to the Iraqi people.

Aside from the headline-grabbing political developments over the past few months, the Iraqi economic outlook is facing significant headwinds with the fall in oil prices in recent weeks. Oil revenues account for around 95% of total government income, and we think oil prices are likely to remain under downward pressure for the foreseeable future as global supply strengthens and demand growth remains relatively soft. Moreover, Iraqi exports have been hampered from the north by the ongoing fighting, and the prospects for a rise in exports from the south in the near future appear weak. As we have argued previously, despite rising production capacity in Iraq's southern oil fields, and a major upgrade in the export capacity at the Al Basra Oil Terminal (ABOT), we believe the state of the

infrastructure between field and jetty (including pipes and pumping facilities) will remain a constraint on export growth for the next 2-3 years. Added to this, continued delays in the implementation of the water re-injection project (critical for raising output in some of Iraq's more mature fields) will hamper efforts to ramp up output.

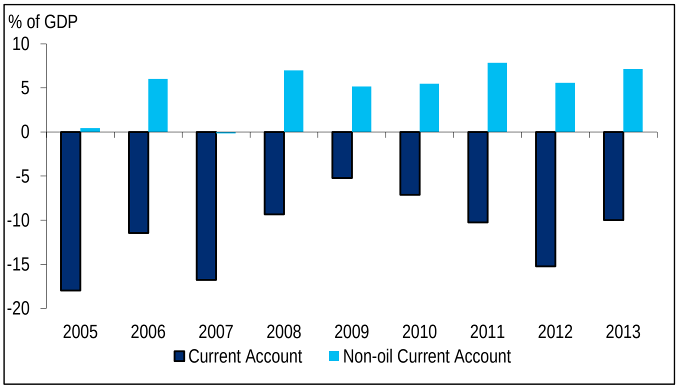
The bottom line is that we do not expect any increase in oil export volumes this year, and, as a result, in government revenues. Coupled with continued high expenditures (assuming payments to the KRG resume on short notice), we expect that the Iraqi federal government will run a deficit this year of around 6% of GDP, on par with that realized in 2013. Our forecasts assume a ramp up in exports of around 500kbpd per year from 2015 onwards, putting the fiscal balance on a trajectory to surplus by 2017. However, in the near term, the export rises we assume are dependent on a resumption of exports from the North, and in particular from the Kurdish fields. As discussed above, there is still considerable uncertainty surrounding Kurdish exports, and risks to our forecasts are accordingly great.

We are wary of the wider risks to the Levant and the region as a whole. The flow of refugees to Jordan and Lebanon presents challenges to these countries, as does the deterioration in border security. Moreover the risk that sectarian tensions are roused beyond current levels across the region is particularly problematic for Lebanon, given its more volatile ethnic mix and history. The holding hostage of dozens of Lebanese soldiers by ISIS and the Nusra front in Syria is adding to security tensions in the country.

Lebanon is also facing severe domestic political challenges. As we expected, no progress has been made in electing a new President (the post has been vacant since the spring), and we believe an extension of parliament by at least one year is highly likely. That said, political divides run deep, and the prospect for an extension of parliament is being linked to the ongoing salary scale issue. A significant raise in public sector salaries is likely to cost the Lebanese budget something in the order of 3% of GDP, we calculate, and there is an ongoing intense debate among political rivals regarding the funding of such an increase. Recent reports (Daily Star, Sept 19) suggest that this issue is to be decided upon as a pre-requisite to an extension of parliament, raising the prospect of a constitutional crisis with a vacuum in both the executive and legislative branches of government.

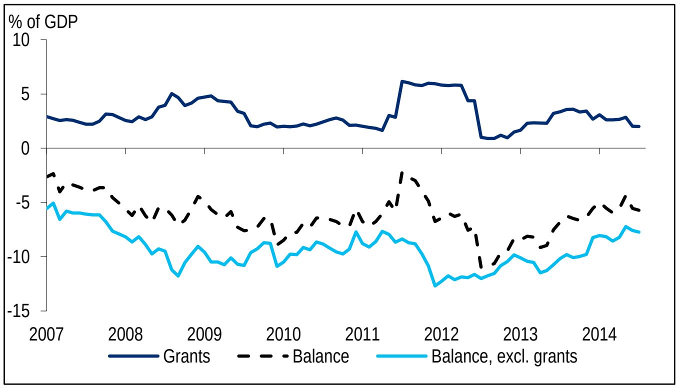
While the fiscal, economic and political picture look difficult, our view remains that the slide in country risk does not necessarily signal a slide in sovereign risk. This is because we believe the stability of the sovereign risk profile rests on the robustness of the Lebanese banking sector and its ability to continue funding the government. Banking sector indicators remain robust. Overall deposit growth was 7% yoy in February, with non-resident deposit growth remaining in the double digits (11%). The dollarisation ratio remained stable at under 60%, and the risk premium on Lebanese Lira deposits has likewise hardly moved in recent months. In our view, the banking sector remains sound and liquid and retains significant capacity to continue financing the Lebanese sovereign through the purchase of government securities. This keeps sovereign risk in check, despite an evidently deteriorating country risk profile (see Lebanon Macro View - The gap widens between country and sovereign risk)

Figure 144. Jordan current account dominated by oil imports ...



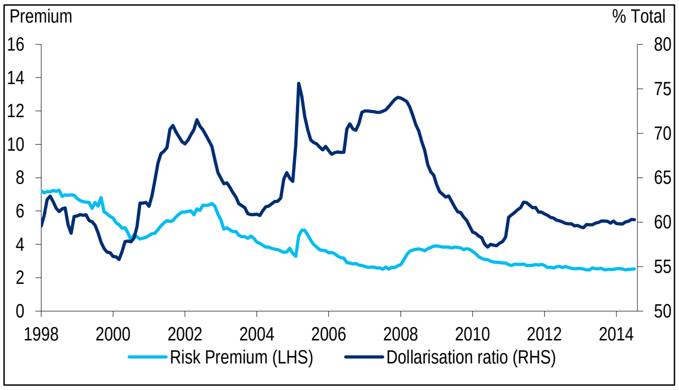
Source: Haver Analytics, Citi Research

Figure 145. Without grants Jordan's fiscal situation would be worse



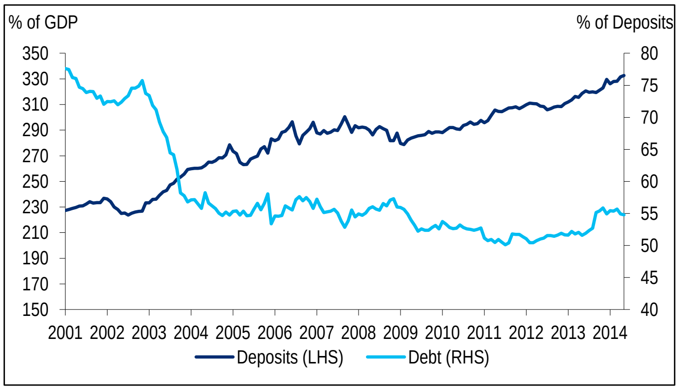
Source: Haver Analytics, Citi Research

Figure 146. Lebanon dollarization has gone up, but risk premium stable



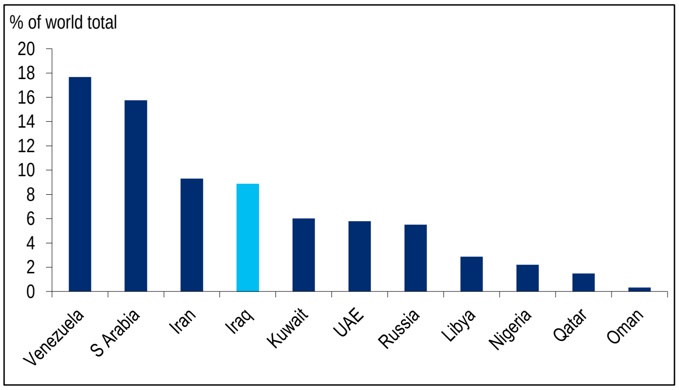
Source: Haver Analytics, Citi Research

Figure 147. Deposit growth slows, but still plenty of capacity



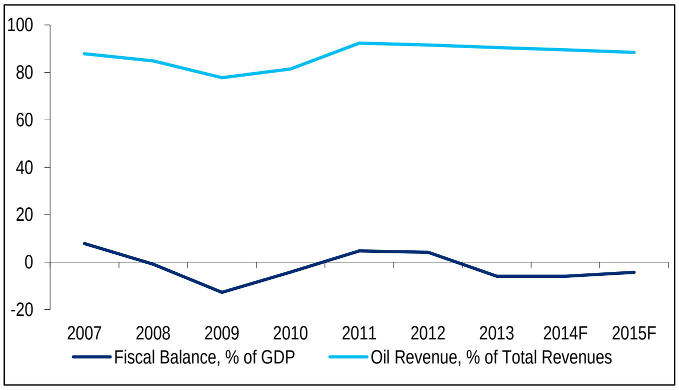
Source: Haver Analytics, Citi Research

Figure 148. Iraq has world's fourth largest proven oil reserves and ...



Source: BP, Citi Research

Figure 149. ... public finances should strengthen as a result



Source: Haver Analytics, Citi Research

Figure 150. Levant Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
IRAQ									
Nominal GDP, USD bn	91.7	135.6	113.6	138.9	186.3	216.6	230.1	229.5	248.6
GDP per capita, USD	3,190	4,607	3,766	4,487	5,871	6,655	6,892	6,705	7,080
Real GDP, yoy avg	1.4	6.6	5.8	5.5	10.2	10.3	6.8	0.1	8.9
CPI, % avg	20.8	2.7	-2.2	2.4	5.6	6.1	1.9	2.5	5.0
IQD/US$, avg	1,253	1,189	1,156	1,167	1,171	1,164	1,162	1,162	1,162
Current account, US$bn	20.0	28.4	-1.3	6.3	26.2	39.6	32.4	24.5	23.5
% of GDP	21.9	20.9	-1.1	4.6	14.1	18.3	14.1	10.7	9.5
Consolidated gov. balance, % of GDP	7.8	-0.9	-12.7	-4.2	4.7	4.1	-5.9	-5.9	-4.3
JORDAN									
Nominal GDP, USD bn	17.1	22.0	23.9	26.5	28.8	30.9	33.6	35.7	38.1
GDP per capita, USD	3,026	3,722	3,866	4,104	4,284	4,404	4,615	4,712	4,839
Real GDP, yoy avg	8.2	7.2	5.5	2.3	2.6	2.7	2.8	3.6	3.8
CPI, % avg	4.7	13.9	-0.7	5.0	4.4	4.8	5.5	2.8	3.1
JOD/US$, avg	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71
Current account, US$bn	-2.9	-2.1	-1.2	-1.9	-3.0	-4.7	-3.4	-4.2	-4.9
% of GDP	-16.8	-9.3	-5.2	-7.1	-10.3	-15.3	-10.0	-11.7	-12.9
Consolidated gov. balance, % of GDP	-5.1	-4.4	-8.9	-5.6	-6.8	-8.3	-5.5	-4.9	-4.2
LEBANON									
Nominal GDP, USD bn	24.6	28.8	35.1	38.0	40.1	43.0	43.8	45.1	47.4
GDP per capita, USD	6,538	7,572	9,111	9,726	10,126	10,647	10,626	10,744	11,059
Real GDP, yoy avg	9.3	9.1	10.3	8.0	2.0	2.5	0.7	0.4	2.5
CPI, % avg	4.1	10.8	1.2	4.0	5.0	6.6	2.1	1.9	2.6
LBP/US$, avg	1,512	1,507	1,504	1,502	1,506	1,504	1,507	1,508	1,508
Current account, US$bn	-1.8	-3.2	-4.4	-5.1	-6.3	-6.7	-7.2	-6.8	-6.6
% of GDP	-7.2	-11.1	-12.5	-13.3	-15.7	-15.6	-16.4	-15.0	-14.0
Consolidated gov. balance, % of GDP	-10.4	-10.1	-8.4	-7.6	-5.8	-9.1	-9.6	-9.8	-9.8

Source: National Sources, Citi Research forecasts

Nigeria

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- **Summary view** — Although political uncertainty is set to rise towards the February 2015 elections, we still expect growth to remain robust at around 6% in 2014-15. But the fiscal picture could deteriorate, notably in 2H 2014 if supplementary budgets are passed or oil production comes under pressure.

- **Things to watch** — We think the naira could come under a new bout of pressure in late 2014 or early 2015. This is especially the case if the oil price were to weaken towards US$90/barrel. But the CBN and policy makers have a number of policy options to limit naira weakness.

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

Africa's largest economy heads to the polls

Following the GDP rebasing exercise completed in early 2014, Nigeria is now Africa's largest economy with an estimated GDP of US$510bn in 2013. But the revisions have also led changes in the pattern of growth and a downward revision to the growth rate in the 2011-12 period to levels of around 4-5%, rather than the previous levels of 7%, although the economy has been picking up since 2H 2013.

And even though Nigeria is now the largest economy in Africa, it does not change the myriad challenges facing the government. These include the need to reduce high levels of poverty, boost electricity production or re-build savings in the excess crude account (ECA). Moreover, given the likely rise of political tensions as the country heads towards presidential and legislative elections set for February 2015, we only expect very limited progress with key, but long overdue, structural reforms, notably in the electricity sector.

Not only do we expect political tensions within the elite to rise sharply as the polls approach, but the elections will be set against the background of the on-going conflict with Boko Haram in the north. The likelihood of this spreading to other parts of the country still seems limited, but if it was to occur it would potentially have a much more significant impact on the economic outlook.

In terms of the elections, we expect that the ruling People's Democratic Party (PDP) will take the lead in selecting its presidential candidate. At present, this is likely to be the incumbent president, Jonathan Goodluck, who is expected to declare his intention to stand in the coming months. The battle to be the candidate for the opposition All Progressives Congress (APC) is likely to be more closely contested, but should be decided by early December. But with only three months to the election, the nominee may struggle to build enough momentum to defeat the PDP candidate.

But growth should remain robust

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

Macroeconomic and naira stability

Despite positive macroeconomic data, in recent years, the government has struggled to save into the ECA or SWF despite the oil price being over US$100/barrel. While a tight monetary policy and portfolio inflows has allowed the CBN to re-build reserves, these are not savings. Moreover, when foreign exchange demand has risen, reserves have quickly come under pressure. This in turn has created a number of self-fulfilling cycles of rising demand for foreign exchange and greater naira pressure. The last of these was in 1Q 2014, and demand has eased since the start of April, with reserves and the naira stabilizing, although this does not mean that the challenges of maintaining macroeconomic and naira stability in the rest of 2014 and into 2015 have ended.

The key variables to consider when thinking about the naira outlook and policy are the oil price and level of production. Since 2012 it has been production that has been under pressure, but this has been offset by a high oil prices. But, this equation could be reversed as 2014 progresses with rising oil production offsetting an easing price. However, if either, or both, were to come under more sustained pressure, the circle of naira pressure could easily re-emerge. Our rule of thumb is that a US$90/Barrel oil price with production of 2m b/d allows the CBN to maintain naira stability.

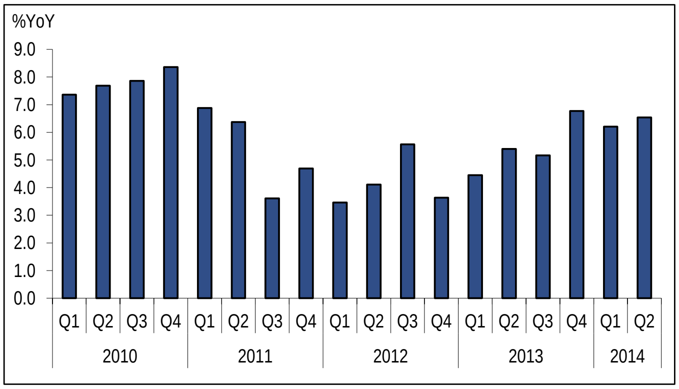
Beyond this point, the CBN will have to revisit its exchange rate policy. But it is likely to hold the line for some time before reacting, depending on the rate of reserve burn and the potential emergence of differential between the parallel and official exchange rates. Although the CBN has been ambiguous about what it considers a suitable level of foreign exchange reserves, it has increasingly mentioned that the internationally acceptable level of cover is three months of goods and services. This would indicate an ultimate cut off level of around US$20.5bn on our data forecasts, at which point the supply of foreign currency, and support for the naira, would need to be comprehensively re-evaluated.

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

Even if the naira does come under pressure in the run up to the elections, there are still a number of policy options that the CBN and policy makers can pursue to limit any depreciation. Moreover, with the elections approaching, the political pressure not to devalue the naira is likely to be substantial. The easiest solution would be to push oil production back up towards the 2.5m b/d level, boosting revenue and foreign exchange inflows, while keeping a tighter rein on disbursements from the ECA than in recent years. It should then be able to slowly, if only very modestly, rebuild its savings. And if this means that it can keep reserves in the US$35-US$40bn level, pressure on the naira will be less intense than in early 2014 even with the approach of the elections.

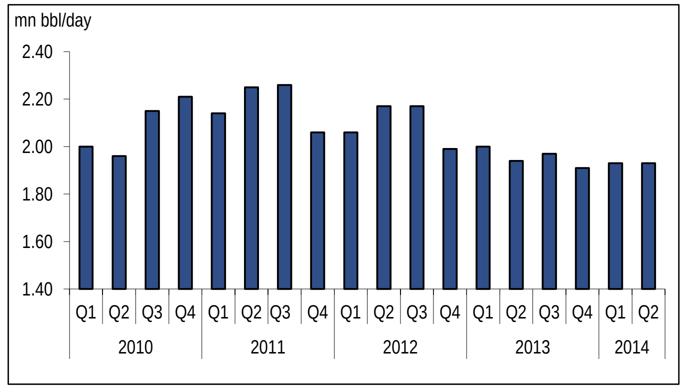
The CBN could also further tighten monetary policy to defend the naira. Not only can it more aggressively mop up liquidity, but we expect that inflation will start to trend back up again in early 2015, and if fiscal spending pressures were to rise, the CBN would be under no real pressure to lower interest rates until after the elections. In fact, it could probably justify a rate rise which would also provide support to the naira. But while such measures will limit any depreciation, they are arguably only temporary solutions. Therefore, once the elections are passed the more fundamental question will have to be asked about whether the current policy of naira stability is sustainable without a significant increase in the ECA and reserves.

Figure 151. New growth data shows economic weakness in 2011-12, with a recovery since 2H 2013



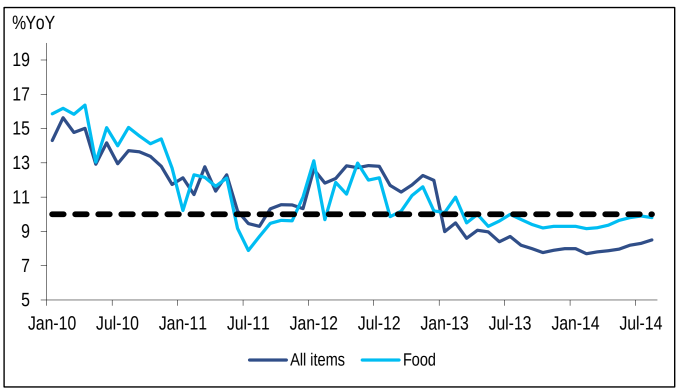
Source: National Bureau of Statistics

Figure 152. Oil production may have stabilized since late 2013



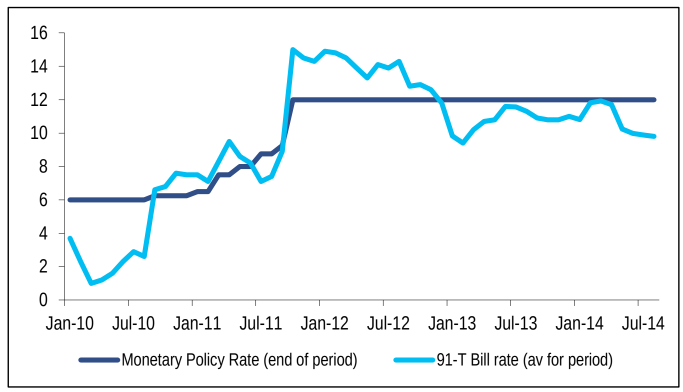
Source: International Energy Agency

Figure 153. Inflation has remained in single digits so far in 2014, but has started to edge up



Source: National Bureau of Statistics

Figure 154. The MPR has been left unchanged since October 2011

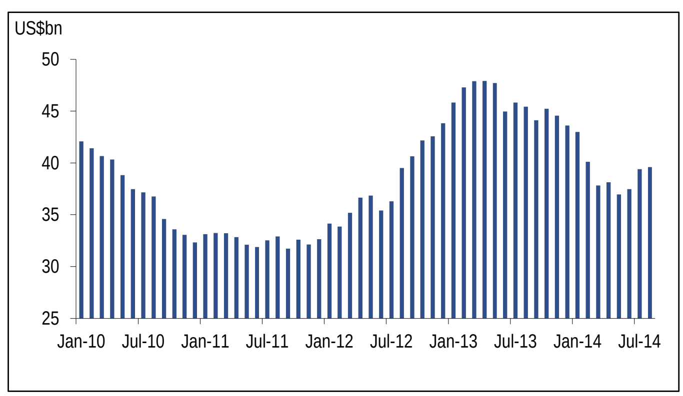


Source: Central Bank of Nigeria

Figure 155. Pressure on the naira has come and gone in 2014

Source: Reuters

Figure 156. Reserves have remained under pressure in 2014, but the downward trend has reversed since May



Source: Haver Analytics and Central Bank of Nigeria

Figure 157. Nigeria Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	-	-	-	361	404	452	509	566	638
Nominal GDP, local currency bn	-	-	-	54,612	62,980	71,714	80,093	92,209	107,425
GDP per capita, USD	-	-	-	2,283	2,488	2,712	2,983	3,230	3,553
Population, mn	146.8	150.6	154.4	158.4	162.4	166.6	170.8	175.2	179.7
Unemployment, % of labour force	-	-	-	-	-	-	-	-	-
Economic Activity									
Real GDP, yoy avg	-	-	-	-	5.3	4.2	5.5	6.4	6.4
Real investment growth % yoy	-	-	-	-	-	-	-	-	-
Real consumption growth % yoy	-	-	-	-	-	-	-	-	-
private consumption growth % yoy	-	-	-	-	-	-	-	-	-
Real export growth, % yoy	-	-	-	-	-	-	-	-	-
Real import growth, % yoy	-	-	-	-	-	-	-	-	-
Prices, Money & Credit									
CPI, % yoy eop	6.6	15.1	13.9	11.7	10.3	12.0	7.9	8.7	9.4
CPI, % avg	5.4	11.6	12.5	13.7	10.8	12.2	8.5	8.2	9.5
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	97.1	59.4	26.8	-3.8	44.3	6.8	9.0	11.0	19.0
Policy Interest Rate, % eop	9.50	9.75	6.00	6.25	12.00	12.00	12.00	12.00	11.75
1 month inter-bank rate, %, eop	12.50	18.00	15.79	13.07	17.17	14.39	12.61	13.00	13.00
Long-term yield, %, eop	11.00	12.45	8.32	7.15	16.50	11.90	11.77	12.00	13.50
NGN/US$, eop	118	138	150	152	162	156	160	165	169
NGN/US$, avg	126	119	150	151	156	159	159	163	167
Balance of Payments, USD bn									
Current account	27.6	29.1	14.0	14.5	12.6	18.9	20.6	12.8	11.7
% of GDP	-	-	-	4.0	3.1	4.2	4.0	2.3	1.8
Trade balance	37.8	45.9	25.7	31.7	35.0	40.9	43.7	37.0	35.4
Exports	66.1	85.7	56.8	78.5	97.2	94.3	95.1	90.2	91.5
Imports	28.3	39.8	31.1	46.8	62.2	53.4	51.4	53.2	56.1
Service balance	-16.9	-22.1	-16.7	-18.5	-21.4	-21.7	-20.1	-21.8	-21.6
Income balance	-11.8	-15.1	-14.6	-19.7	-23.0	-22.3	-25.2	-25.4	-25.3
FDI, net	-	-	-	-	-	-	-	-	-
International reserves	51.3	53.0	42.4	32.3	32.9	43.8	43.6	37.5	40.4
Total amortisations	0.9	0.6	0.5	0.5	0.4	0.3	0.3	0.3	0.3
Public Finances, % of GDP									
Consolidated government balance	-0.4	-0.1	-1.8	-2.0	-1.8	-1.4	-1.6	-2.0	-1.9
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	7.0	5.5	7.1	8.2	8.4	9.2	8.8	9.0	9.0
Foreign Assets & Liabilities, USD bn									
External debt	3.4	3.7	4.6	4.6	5.7	6.5	8.8	9.2	12.3
Public	3.0	3.2	3.9	4.4	5.0	6.0	7.3	7.7	10.0
External debt / GDP	-	-	-	1.3	1.4	1.4	1.7	1.6	1.9
External debt / XGS	5.0	4.2	7.7	5.6	5.6	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2013 Q4	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2016 Q1F
GDP, % yoy	6.8	6.2	6.5	6.1	6.7	5.2	6.2	6.9	6.3
CPI, % yoy eop	7.9	7.8	8.2	8.5	8.7	9.9	9.8	9.3	9.0
Policy interest rate, %, eop	12.0	12.0	12.0	12.0	12.0	12.0	12.0	11.8	11.8
Short-term market rate, % eop	11.1	11.4	12.1	12.8	13.0	13.5	13.5	13.0	12.5
Long-term yield, %, eop	13.3	14.0	12.2	11.7	12.0	12.4	12.8	13.1	13.0
NGN/US$, eop	160	165	163	163	165	165	168	169	170

Source: National Sources, Citi Research forecasts

Poland

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- **Summary view** — Despite a strong performance in 2Q, economic growth in 3Q is likely to slow more than the consensus expects. However, thanks to supportive fiscal policy, weaker PLN and low rates, we expect the slowdown to be short lived.
- **Things to watch** — MPC is likely to cut interest rates in October and we see a chance of significant reduction by 50bp at this meeting.
- **Strategy** — Policy easing by the MPC and ECB and small bond supply will likely support bonds until markets focus on expected tightening of policy by Fed. We also expect a weaker zloty on a stronger dollar and lower rates.

Weaker than expected 3Q followed by a rebound?

Despite significant drop in PMI the economic growth in 2Q slowed only marginally (to 3.3%YoY from 3.4% in 1Q). Both private consumption and fixed investment held up relatively well while domestic demand accelerated substantially to 5.1%YoY thanks to a large buildup of stocks. Higher inventories increase the risk of slowdown in the following quarter but it may be also a signal the data may be prone to revisions later this year.

After relatively strong 1H we expect 3Q growth to decelerate towards 2.6%YoY, the pace that would be below the market consensus of 2.9% (Reuters). In our view the slowdown is likely to be a result of weaker construction and industrial output data with the latter being partly affected by weaker growth in Germany and the Eurozone more generally. Growth may be additionally affected by sanctions imposed by Russia on EU (in particular the embargo on fruits and vegetable imports) as well as EU sanctions on Russia. All in all, however, the impact of the embargo is likely to be limited and we estimate it will deduct approximately 0.3-0.4% point from GDP growth. Our new forecast of 3.1% growth in 2014 already factors this in.

We expect that the slowdown in 3Q – although deeper than previously expected – will prove to be only temporary. There are several factors suggesting that the economy is in relatively good shape and may accelerate in 4Q. This scenario is supported by still positive trends in the labour market as the number of new job offers continues to grow at a dynamic pace while unemployment rate continues its downward path. Additionally, bank lending continues to rise at a relatively stable pace suggesting neither geopolitical uncertainty nor the level of interest rates have had significant impact on demand for lending. Additionally, the recent loan officers surveys suggest banks are not planning significant tightening of lending conditions. On the top of that, the relatively weak currency is supportive for growth as it helps offset the unfavourable impact of export shocks.

MPC to cut rates in October

The CPI dropped into deflation territory (-0.3%YoY in August) and is likely to stay below zero until year-end. The key drivers of deflation are low food prices and cheaper fuel, though the core inflation is also hovering at around +0.5%. However, it may be surprising that in August the drop in food prices was close to seasonal patterns and hasn't shown the impact of the new wave of Russian sanctions. Given that low prices on farmers' markets feed into CPI with some delay we expect the deflationary impact of sanctions to become more visible later this year and this is the key reason behind our forecasts of deflation in 4Q.

However, our forecasts suggest also the CPI is to rebound significantly next year and by the end of 2015 it is likely to reach approximately 2%. This will happen as the historically low levels of food price indices will start dropping out from the annual CPI index by 1H 2015, thus pushing inflation higher.

The Polish central bank has gone a long way from claiming rate cuts are ‘unlikely’ (in June) to stating they are ‘very likely’ (September). This change in rhetoric was mostly due to rising fears that weaker-than-expected growth in Germany as well as new economic sanctions in the wake of Russia-Ukraine military conflict could weigh on growth prospects and keep inflation low for longer. The policy statement published after the September meeting suggests the MPC is likely to cut rates in October but there seems to be no agreement on the size of the move. The minutes from September meeting show that two rate cut motions (by 25bp and 50bp) were discussed by the MPC. Given the MPC seems convinced that policy easing is warranted and has already postponed the rate cut by one month we believe a risk of 50bp is probably higher than widely believed. All in all we expect rates to be cut in this ‘cycle’ by 50-75bp which would imply the base rate at 1.75-2.00% (vs. 2.5% currently). Due to domestic and external factors we don’t expect deeper rate cuts. First, we expect improvement in growth and inflation numbers by the end of 2014 and early 2015 which would reduce pressure on the MPC. Second, the Polish MPC has proved generally unwilling to go down with rates in unchartered territories and we believe bringing rates towards 1.5% would most likely be considered diving into such a territory. Third, given that ‘dots’ presented by Fed show a relatively significant increase in rates in 2015 and 2016 we believe Polish policymakers will not want to face a risk of being forced to hike rates in 2015 in case of policy tightening by the Fed.

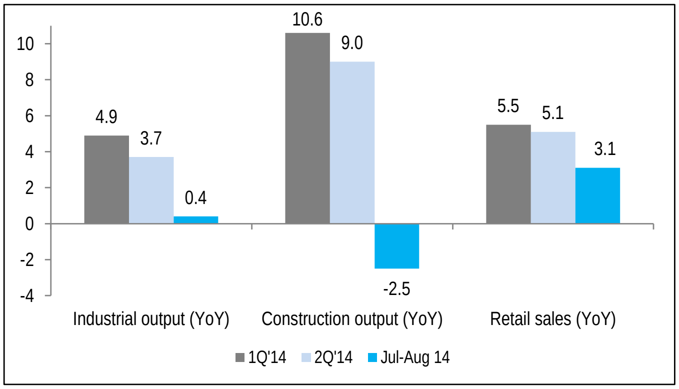
Political changes and fiscal policy easing

The new government is being formed in Poland after resignation of PM Tusk who was named new president of European Council. Despite personnel changes we don’t expect significant modification of economic policies. The previous government has already signaled more generous indexation of pension benefits and higher tax benefits for families with children. This could improve GDP growth marginally by around 0.2% points but we see chances of additional fiscal easing, especially given that parliamentary elections are scheduled for autumn 2015. All in all, however, a slight fiscal easing seems a welcome move given weaker growth prospects, all the more so that despite these measures the general government deficit in 2015 is likely to be close to 3% of GDP.

PLN and long term bonds under pressure from Fed

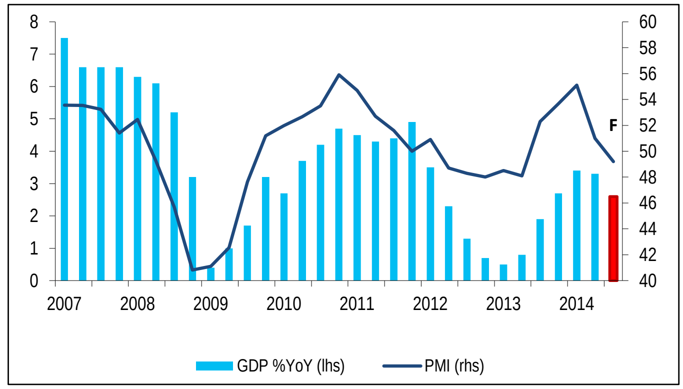
We expect the zloty will likely weaken vs. the euro and even more vs. the dollar on expected tighter monetary policy in the US, which will likely negatively affect EM FX. The zloty will also be impacted by the expected interest rate cuts and decline in interest rate disparity vs the euro zone as well as slower GDP growth at least in 3Q. Economic recovery in 2015 supported by fiscal easing will likely limit the scale of PLN weakening. Monetary policy easing by the MPC, low bond supply and policy easing by the ECB are likely to support bonds in the very near term. However, Fed’s tighter policy will likely eventually lead to some sell-off in the bond market, especially in the longer end.

Figure 158. Weak monthly indicators from the real economy ...



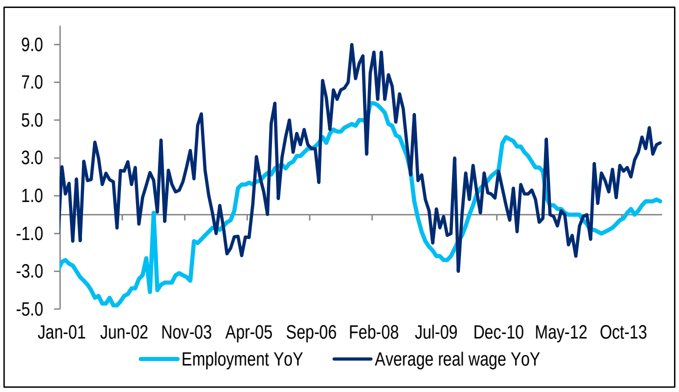
Source: CSO, Citi Research

Figure 159. ... and further fall in PMI signal weaker GDP growth in 3Q



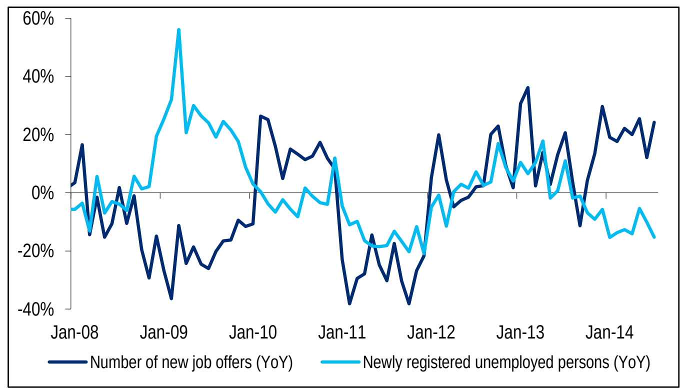
Source: Reuters, Citi Research Forecasts

Figure 160. Labour market likely to support private consumption in coming quarters ...



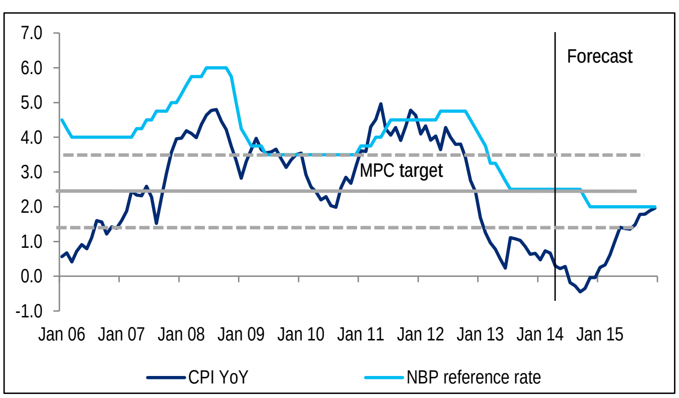
Source: GUS, Citi Research

Figure 161. ... as new job offers continue to grow and number of newly unemployed falls fast



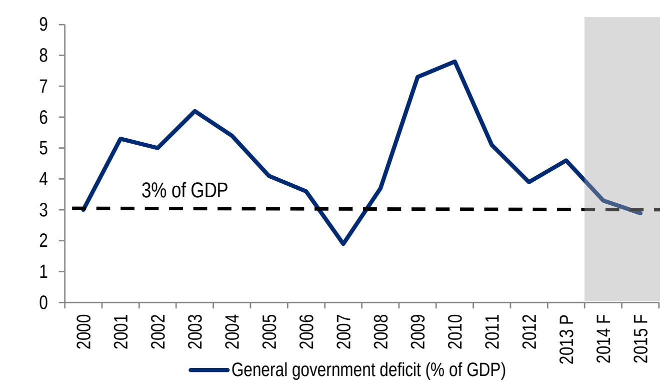
Source: CSO, Citi Research

Figure 162. We expect MPC to cut rates by 50bp till year-end with risk of additional 25bp cut



Source: CSO, Citi Research estimates

Figure 163. Despite fiscal easing general government deficit will likely stay under control



Source: Ministry of Finance, Citi Research

Figure 164. Poland Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	426	534	433	470	517	490	516	526	487
Nominal GDP, local currency bn	1,177	1,276	1,345	1,417	1,528	1,596	1,632	1,692	1,788
GDP per capita, USD	11,185	13,994	11,347	12,210	13,404	12,721	13,416	13,650	12,666
Population, mn	38.1	38.1	38.2	38.5	38.5	38.5	38.5	38.5	38.5
Unemployment, % of labour force	11.2	9.5	12.1	12.4	12.5	13.4	13.4	12.1	11.3
Economic Activity									
Real GDP, yoy avg	6.8	5.1	1.6	3.9	4.5	2.0	1.6	3.0	3.4
Real investment growth % yoy	24.3	4.0	-11.5	9.3	11.2	-4.0	-4.7	10.0	6.5
Real consumption growth % yoy	4.6	6.1	2.0	3.4	1.6	1.0	1.2	2.2	2.5
private consumption growth % yoy	4.9	5.7	2.1	3.2	2.6	1.3	0.8	2.5	2.8
Real export growth, % yoy	9.1	7.1	-6.8	12.1	7.7	3.9	4.6	3.5	4.9
Real import growth, % yoy	13.7	8.0	-12.4	13.9	5.5	-0.7	1.2	5.3	4.8
Prices, Money & Credit									
CPI, % yoy eop	3.9	3.4	3.7	3.2	4.6	2.6	0.8	0.0	2.0
CPI, % avg	2.5	4.2	3.5	2.6	4.3	3.7	0.9	0.1	1.3
Nominal wages, % yoy	9.1	10.5	4.2	3.6	4.9	3.5	2.6	4.1	4.8
Credit extension to private sector, % yoy	31.5	36.4	7.0	8.5	13.9	2.4	4.5	6.5	8.0
Policy Interest Rate, % eop	5.00	5.00	3.50	3.50	4.50	4.25	2.50	2.00	2.00
1 month inter-bank rate, %, eop	5.52	5.61	3.76	3.66	4.77	4.21	2.61	2.05	2.07
Long-term yield, %, eop	5.93	5.46	6.24	6.07	5.91	3.73	4.34	3.55	4.00
PLN/US$, eop	2.47	2.97	2.87	2.97	3.45	3.09	3.02	3.54	3.58
PLN/US$, avg	2.76	2.39	3.10	3.01	2.96	3.25	3.16	3.22	3.67
PLN/EUR, eop	3.60	4.15	4.10	3.97	4.47	4.08	4.15	4.27	4.20
PLN/EUR, avg	3.78	3.52	4.32	3.99	4.12	4.18	4.20	4.20	4.28
Balance of Payments, USD bn									
Current account	-26.5	-34.9	-17.3	-24.1	-25.8	-18.1	-6.6	-4.1	-9.6
% of GDP	-6.2	-6.5	-4.0	-5.1	-5.0	-3.7	-1.3	-0.8	-2.0
Trade balance	-19.1	-30.7	-7.6	-11.8	-14.1	-6.7	3.1	4.5	-0.4
Exports	145.3	178.7	142.1	165.9	195.2	191.0	207.2	222.6	218.7
Imports	164.4	209.4	149.7	177.7	209.3	197.7	204.2	218.1	219.1
Service balance	4.8	5.0	4.8	3.1	5.7	6.0	7.0	7.0	6.1
Income balance	-16.4	-12.8	-16.6	-19.1	-23.6	-22.6	-21.7	-21.5	-21.5
FDI, net	18.0	10.4	8.5	6.9	12.4	5.3	-1.3	4.0	6.0
International reserves	54.6	57.2	69.7	81.4	86.8	96.1	94.0	97.3	111.2
Total amortisations	43.0	44.0	46.9	44.1	38.3	47.5	48.7	49.2	51.0
Public Finances, % of GDP									
Consolidated government balance	-1.9	-3.7	-7.5	-7.8	-5.1	-3.9	-4.3	-3.3	-2.9
Consolidated gov primary balance	0.4	-1.5	-4.9	-5.1	-2.4	-1.1	-1.7	-1.2	-0.7
Public debt	44.8	46.9	49.8	52.8	53.4	52.7	53.9	47.6	46.9
of which Domestic	34.3	34.8	36.7	38.4	36.5	36.1	37.6	29.7	29.2
Foreign Assets & Liabilities, USD bn									
External debt	233.3	244.8	280.2	317.1	323.3	365.7	379.3	367.3	361.3
Public	86.8	69.4	92.2	116.5	121.0	155.9	161.1	156.0	153.4
External debt / GDP	54.7	45.9	64.7	67.4	62.6	74.6	73.4	69.9	74.2
External debt / XGS	133.9	114.2	163.8	159.6	138.9	159.8	153.3	139.3	139.5
Short-term debt	60.9	65.9	70.0	77.2	71.9	70.5	75.5	73.5	72.5
Short-term debt/International reserves (%)	111.4	115.1	100.4	94.9	82.8	73.3	80.3	75.5	65.2

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.8	3.3	2.6	2.9	2.8	3.0	3.6	4.0	3.8
CPI, % yoy eop	0.7	0.3	-0.4	0.0	0.6	1.4	1.8	2.0	2.8
Policy interest rate, %, eop	2.50	2.50	2.50	2.00	2.00	2.00	2.00	2.00	2.50
Short-term market rate, % eop	2.61	2.61	2.43	2.05	2.10	2.10	2.12	2.07	2.70
Long-term yield, %, eop	4.27	3.56	3.15	3.55	3.65	3.80	3.95	4.00	4.30
PLN/EUR, eop	4.17	4.16	4.21	4.27	4.31	4.33	4.27	4.20	4.13

Source: National Sources, Citi Research forecasts

Romania

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- **Summary view** — Recent developments led us to revise our 2014 growth forecast (to 2% from 3%) and inflation projection (to 2.5% from 3.0%). The emerging backdrop should pave the path for a 25bp rate cut at the September Board meeting.
- **Things to watch** — Political stability ahead of the November 2014 presidential election and the implementation of the IMF-EU supported economic program deserve close monitoring.
- **Strategy** — Despite the favorable relative performance of Romanian assets so far, we find it hard to get excited about the leu, as we question whether the bond market rally has more legs.

Growth data continue to disappoint…

At 1.2%YoY, Romania's second quarter GDP growth came in line with the flash estimate published on 14 August. The contribution of private consumption and investment to GDP growth in the second quarter stood at 3.6pp and -3.3pp, respectively. In parallel, net exports shaved 1.8pp off GDP growth in 2Q, whereas changes in stocks contributed positively (2.5pp). We believe that the ongoing weakness in investment spending is discouraging if one considers the improvement in the absorption of EU funds and the low interest rate environment, among other things. Against the noted backdrop—in particular, the absence of a pick-up in investment spending, the anemic recovery in private consumption, the deterioration in the growth outlook in the Eurozone—we decided to revise our 2014 GDP forecast to 2.0% from 3.0% with the risks tilted to a weaker reading.

…and inflation prints remain below consensus estimates

At 0.8%YoY, the inflation outturn in August came in considerably lower than the consensus and our projections (both 1.2%MoM). Our forecast error stems largely from lower-than-expected food prices, which, at -0.9%MoM, came in well below its seasonal average of -0.18%MoM. Using seasonally adjusted data, the August print translates into a flattish inflation reading, which has been the case since May.

In light of the recent softening in non-food and service inflation, including the recent historically low readings (below 1%YoY) since April—we have decided to revise our year-end inflation forecast from 3.0% to 2.5%. We believe that the pace of disinflation in non-food and food components is unsustainable. In particular, we reiterate the importance of historically low year-to-date food inflation, which could, through a possible reversal and strong base effects, complicate price dynamics in 2015. Moreover, a weaker-than-expected leu and uncertainties related to the timetable for the deregulation of natural gas/electricity markets emerge as additional risk factors that require close monitoring. Nonetheless, we remain cognizant of another favorable tax-related shock to inflation. Specifically, there are signs suggesting that the government may consider VAT cuts for vegetables, fruit and meat in 2015 (Bloomberg, 17 September, 2014). We will monitor this matter closely and stand ready to make the necessary adjustments to our 2015 inflation projection.

Will weaker growth and low inflation prompt further cuts?

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

In our view, the disappointing GDP growth in 2Q, along with the Governor's relatively dovish remarks and the August inflation print, should pave the way for a 25bp cut at the September Board Meeting. Nonetheless, with the policy rate standing at 3.25%, the NBR's 2015 inflation forecast of 3% corroborates our view that those who wait for aggressive rate cuts during the remainder of the year may be disappointed. Our more cautious inflation forecast trajectory, unimpressive capital inflows, the uncertainty surrounding the EU-IMF supported program and the possibility of a higher level of political noise ahead of the upcoming presidential elections also lend support to this conjecture.

Fiscal performance remains strong thanks to revenues

Standing at around RON 1.0 billion, the budget gap in the first seven months of the year was considerably narrower than the deficit seen in the same period of 2013 (RON 6.0bn). While revenues during the period under consideration increased by about 4.0%YoY, expenditures were down by about 0.2%YoY. Based on the available data, it looks like the 2014 budget deficit target of 2.2% of GDP looks attainable. Nonetheless, the slower-than-desired progress on reforming SOEs--one of the key challenges in the fiscal sphere—and improving the quality of public spending warrant concern.

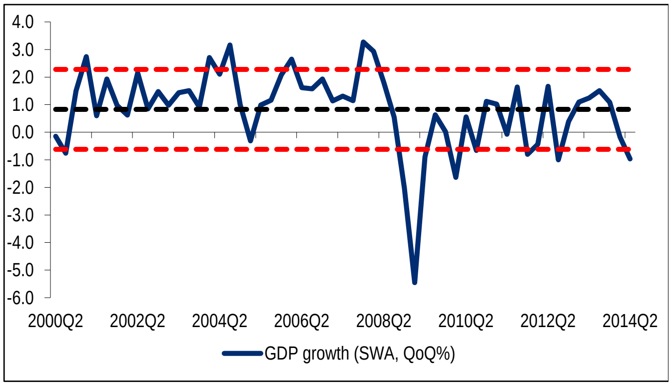
Current account gap is on track to widen moderately

Romania's current account balance printed a deficit of about €990 million in the first seven months of 2014, which is wider than the deficit seen in the same period of 2013 (€59 million). This outcome was mainly driven by a wider deficit in in the income balance. In line with our expectations of a moderate pick up in domestic demand and private credit growth, we expect the current account deficit to widen to around 1.7% of GDP this year from 1.1%. On the capital account front, we are yet to see a meaningful recovery in inflows, which warrants concern.

EURRON continues to muddle-through

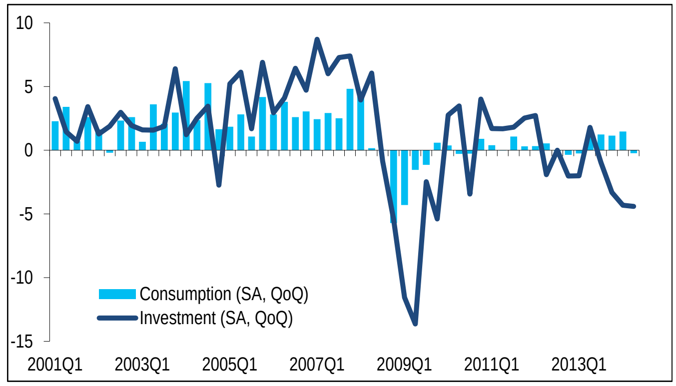
We observe a moderate deterioration in the leu's relative performance with respect to its regional peers (HUF, PLN, CZK) since end August. In our view, low yields and weak capital inflows—coupled with the NBR's inclination to keep money market rates below the policy rate and its increased pain threshold for FX volatility—cloud the outlook for the leu. Against this backdrop, we expect the EUR/RON to be around 4.45 by the end of 2014.

Figure 165. Slowing growth momentum...



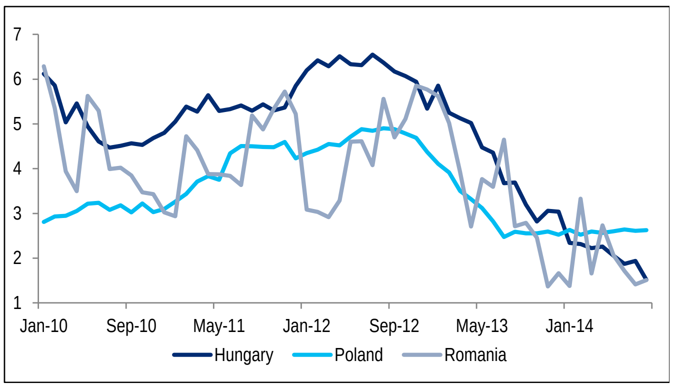
Source: Haver Analytics and Citi Research

Figure 166. ...and weak domestic demand warrant concern



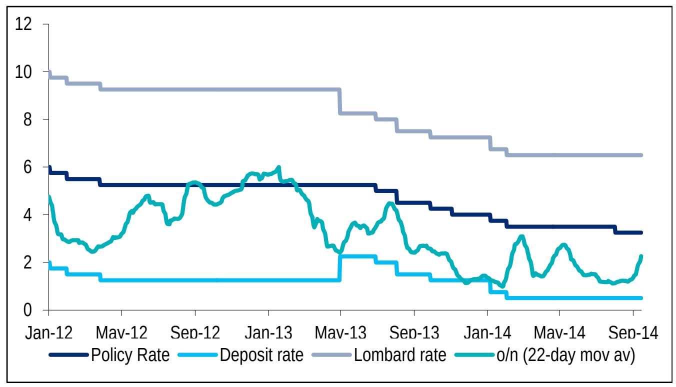
Source: Haver Analytics and Citi Research

Figure 167. Low growth and inflation allow NBR to keep rates low...



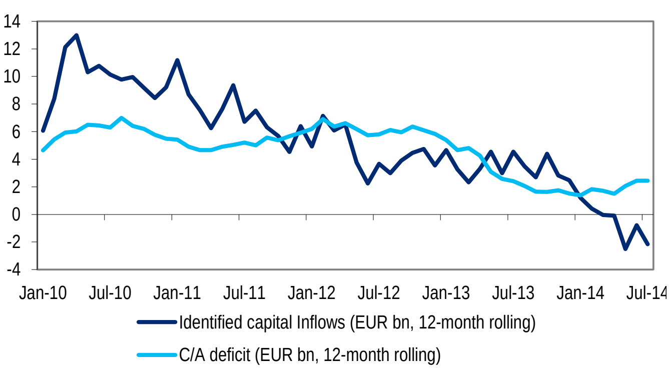
Source: Haver Analytics and Citi Research

Figure 168. ...and maintain an accommodative stance...



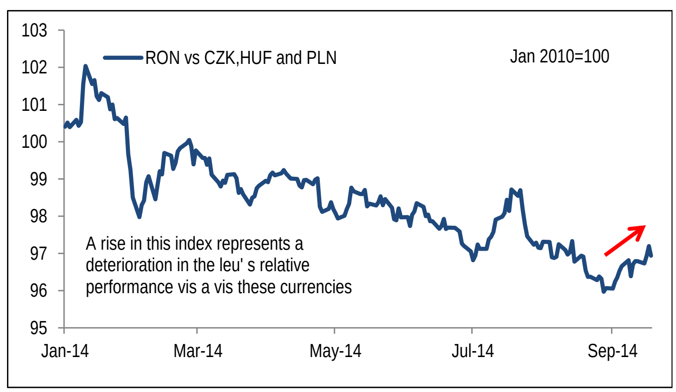
Source: Haver Analytics and Citi Research

Figure 169. ... which, given subdued capital inflows,...



Source: Haver and Citi Research

Figure 170. ...overshadows the leu outlook



Source: Haver and Citi Research

Figure 171. Romania Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	171	204	165	165	183	169	189	191	181
Nominal GDP, local currency bn	416	515	501	524	557	587	629	650	691
GDP per capita, USD	7,653	9,176	7,397	7,413	8,246	7,642	8,550	8,653	8,241
Population, mn	22.3	22.3	22.2	22.2	22.2	22.1	22.1	22.1	22.0
Unemployment, % of labour force	4.3	4.0	6.3	7.6	5.4	5.1	5.3	5.5	5.5
Economic Activity									
Real GDP, yoy avg	6.3	7.5	-6.6	-1.2	2.4	0.5	3.5	2.0	3.4
Real investment growth % yoy	42.6	3.0	-34.3	8.9	12.1	-0.3	-8.7	-2.7	1.8
Real consumption growth % yoy	10.6	9.3	-9.0	-0.8	1.4	1.4	1.0	3.7	3.3
private consumption growth % yoy	12.0	9.5	-10.4	-0.3	1.5	1.4	1.3	4.0	3.5
Real export growth, % yoy	7.7	7.6	-6.3	14.2	12.0	-1.8	13.1	9.5	4.5
Real import growth, % yoy	27.8	7.6	-21.4	12.5	10.6	-0.3	2.3	7.5	4.0
Prices, Money & Credit									
CPI, % yoy eop	6.6	6.3	4.7	8.0	3.1	5.0	1.6	2.5	3.2
CPI, % avg	4.8	7.9	5.6	6.1	5.8	3.3	4.0	1.4	2.9
Nominal wages, % yoy	22.6	23.6	8.4	2.5	4.9	5.0	5.0	5.0	4.5
Credit extension to private sector, % yoy	60.4	33.7	0.9	4.7	6.6	1.3	-3.3	3.0	6.0
Policy Interest Rate, % eop	7.50	10.25	8.00	6.25	6.00	5.25	4.00	3.00	4.00
1 month inter-bank rate, %, eop	8.24	15.35	10.60	4.05	5.72	6.04	1.88	2.50	3.80
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/US$, eop	2.47	2.89	2.96	3.17	3.33	3.37	3.25	3.69	3.76
RON/US$, avg	2.43	2.50	3.04	3.17	3.04	3.46	3.33	3.41	3.81
RON/EUR, eop	3.61	4.03	4.24	4.24	4.32	4.45	4.46	4.45	4.40
RON/EUR, avg	3.33	3.68	4.24	4.21	4.24	4.46	4.42	4.44	4.44
Balance of Payments, USD bn									
Current account	-22.9	-23.8	-6.8	-7.3	-8.2	-7.5	-2.0	-3.2	-5.4
% of GDP	-13.4	-11.6	-4.2	-4.4	-4.5	-4.4	-1.1	-1.7	-3.0
Trade balance	-24.4	-28.1	-9.6	-10.1	-10.3	-9.5	-4.6	-4.8	-7.8
Exports	40.5	49.6	40.5	49.6	63.0	57.9	65.8	67.7	62.6
Imports	64.9	77.7	50.1	59.6	73.3	67.4	70.4	72.5	70.4
Service balance	0.6	1.0	-0.4	0.5	0.5	1.5	3.6	4.4	3.6
Income balance	-5.7	-5.4	-2.6	-2.5	-3.1	-3.9	-6.1	-7.6	-5.4
FDI, net	9.7	13.7	5.0	3.0	2.6	2.9	3.5	3.1	3.6
International reserves	37.3	36.5	39.4	42.3	42.4	41.8	45.7	37.3	36.7
Total amortisations	12.2	18.1	17.7	19.7	19.6	25.0	34.1	30.8	31.0
Public Finances, % of GDP									
Consolidated government balance	-2.3	-4.8	-7.3	-6.4	-4.3	-2.2	-2.5	-2.3	-2.3
Consolidated gov primary balance	-1.5	-3.9	-5.7	-4.9	-2.6	-0.4	-0.3	-0.1	-0.1
Public debt	19.8	21.3	29.4	37.1	40.1	41.0	42.5	41.9	40.9
of which Domestic	10.2	12.6	15.4	19.8	21.9	18.5	18.8	21.5	19.1
Foreign Assets & Liabilities, USD bn									
External debt	80.3	105.8	113.0	122.4	137.3	128.1	127.6	137.5	127.0
Public	13.9	14.2	19.6	24.8	28.9	34.2	40.3	34.4	35.1
External debt / GDP	47.0	51.8	68.7	74.3	75.1	75.7	67.5	72.0	70.0
External debt / XGS	160.8	169.4	224.4	209.7	187.7	186.4	159.2	166.1	165.2
Short-term debt	28.7	28.5	22.5	26.2	29.5	28.0	26.3	23.5	23.8
Short-term debt/International reserves (%)	77.1	78.1	57.0	61.9	69.7	66.9	57.7	63.1	64.7

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	3.9	1.2	1.2	2.1	2.8	4.6	3.4	2.8	3.2
CPI, % yoy eop	1.1	0.7	1.7	2.5	2.5	3.0	3.3	3.2	2.7
Policy interest rate, %, eop	3.50	3.50	3.00	3.00	3.00	3.50	3.75	4.00	4.00
Short-term market rate, % eop	2.23	2.08	2.90	2.50	2.80	3.30	3.55	3.80	3.80
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/EUR, eop	4.46	4.39	4.40	4.45	4.47	4.45	4.43	4.40	4.42

Source: National Sources, Citi Research forecasts

Russia

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- **Summary view** — The newly imposed sanctions by the US and EU will make for a more challenging backdrop for the Russian economy, creating additional risks to growth. The combination of more subdued investment and consumption spending related to heightened uncertainty, and tighter monetary policy, lead us to downgrade our 2015 GDP forecast from 2.3% to 1.0%.
- **Things to watch** — Uncertainty will remain elevated at least until the end of the year. The possibility that yet further sanctions are imposed may impose additional costs to the economy and endanger our new 2015 GDP forecast. The monetary hiking cycle could continue, creating more headwinds for the economy.
- **Strategy** — The expected transition from a current account surplus to current account deficit over the next couple of years will put structural pressure on the currency. Cyclical pressures will also weigh on the currency as tapering fears may weaken the RUB basket to 44.0 by the end of the year.

Russia avoids recession, for now

Second-quarter GDP grew at 0.8%YoY. Preliminary estimates from Rosstat pointed to economic growth slowing marginally to 0.8%YoY, down from the 0.9% expansion posted in 1Q14. While on a downtrend, GDP grew better than the consensus estimate of 0.7%YoY.

More importantly, Russia avoided recession. We estimate that after the 1.1% seasonally-adjusted QoQ contraction in 1Q14, the economy expanded by 0.3% on a seasonally-adjusted QoQ basis in 2Q14. The quarterly expansion is very modest, yet it is just enough to avoid a technical recession.

Investment spending, a key way geopolitical uncertainty has weighed on growth, improved in 2Q. After the very large first-quarter contraction in fixed investment (-4.9%YoY), which has been the key GDP component suffering from the geopolitical tension, incoming data has been pointing to a significant moderation in the pace of decline, with fixed investment declining by 1.6%YoY in 2Q and actually emerging into positive territory in June (0.5%) for the first time in the year. At the same time, we now anticipate that the new more severe sanctions imposed on Russia in July and September may reverse this momentum in fixed investment, forcing it to re-enter negative territory in 2H14. However, given that preliminary data suggests that 1H GDP already grew at a stronger-than-expected 0.9%, we anticipate that full-year GDP performance (forecast at 0.7% at Citi) will still be higher than the consensus view of 0.3%

Consumer spending has been robust, but lost some vigor in 2Q. While consumption is the only bright spot in Russian macro, it has been on a downtrend recently as fears of a consumer boom turning into a bubble have led to more restrictive regulatory behavior. Real retail spending moderated from 3.6%YoY in 1Q to 1.8% in 2Q as rising currency-driven inflation has eaten away at real incomes.

We downgrade 2015 GDP growth on heightened uncertainty. The newly imposed sanctions by the US and EU will make for a more challenging backdrop to the Russian economy, creating additional risks to growth. The combination of more subdued investment and consumption spending related to heightened uncertainty, and tighter monetary policy, lead us to downgrade our 2015 GDP forecast from 2.3% to 1.0% (1.3% in 2013).

CBR's rate hikes will further constrain growth. The Central Bank of Russia raised the one-week REPO rate by 150bp to 7.00% on 3 March and a further 50bp to 8.00% on 25 April and 25 July. The CBR argued that the recent decisions were driven by a desire to ensure financial stability and ward off the build-up of inflationary expectations against the backdrop of heightened market volatility

In our view, the CBR has been responding to the currently fraught political and economic backdrop in an orthodox manner. Heightened uncertainty argues for temporarily raising interest rates to protect financial stability, while allowing a gradual currency weakening to help facilitate economic adjustment to adverse macroeconomic shocks. While it is clear that higher interest rates will eat away at economic growth, this orthodox approach should be well suited to warding off contagion and demonstrate the central bank's willingness to further tighten policy should market backdrop deteriorate further.

The CBR's task to bring inflation down will be complicated by the recent food import ban. On 7 August Russia banned the imports of some agricultural, raw products and food for a year as a response to Western sanctions. Agricultural and food imports are the third largest import category, accounting for about 14.5% of all Russian imports and amounting to about US$40.6bn per year. According to Rosstat, in 2013 the highest import content belonged to milk and milk products at 26.4% of domestic consumption. Fruit followed second at 24.6%, meat and meat products third at 22.7% and vegetables fourth at 17.9%. This is already fuelling food inflation and contributing to CPI inflation running at 7.6%YoY in August, which is well above the sustainable medium-term 4.0% target.

In addition, the confluence of slowing growth and elevated inflation are fuelling tensions between the central bank and the Ministry of Economy. These tensions apparently manifested themselves in a renewed fashion on 28 August when the Minister of Economy announced that President Putin had approved the creation of a mechanism for the CBR, MinFin and MinEcon to jointly determine inflation objectives. In theory, at least, this may impinge on the CBR's ability to conduct monetary policies in an independent way and endanger the definitive progress that the central bank has achieved during the last 5 years on the road to inflation targeting.

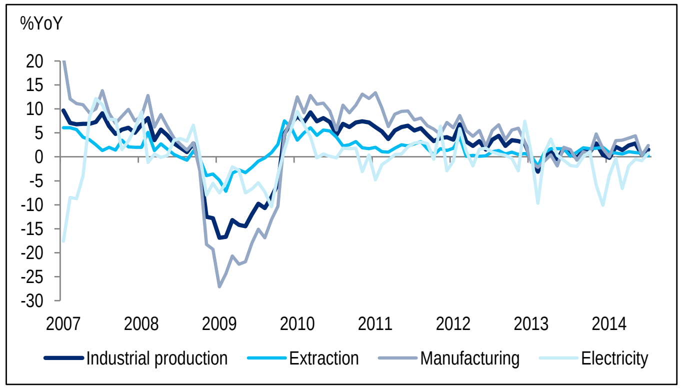
Still, Russia faces a tight fiscal-monetary policy mix. In addition to the CBR being unwilling to jeopardize its credibility on inflation, Russia is pursuing a tight fiscal policy, which limits the borrowing requirement to no more than 1% of GDP. The MinFin argues that the small output gap and sensitivity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

Structural challenges pose medium-term risks for the rouble. Russia is likely to gradually transition from a twin surplus to a twin deficit economy over the next couple of years – a phenomenon that historically has been associated with downward pressure on EM currencies. While Russia already runs (admittedly small) budget deficits, the positive current account balance still provides some currency cover during periods of market turbulence. However, we project its disappearance in the not too distant future will constitute a drag on the rouble. In addition, the expected medium-term deterioration in the public sector balance sheet may also weigh on medium-term rouble prospects. Against that background, Ukraine contagion risks have served to expose Russia as a proxy for expressing bearish views on the region, with equity and fixed income markets coming under pressure. As a result, we see the rouble basket weakening towards 44 by the end of the year.

Figure 172. Growth struggles, but modest recovery is on the cards

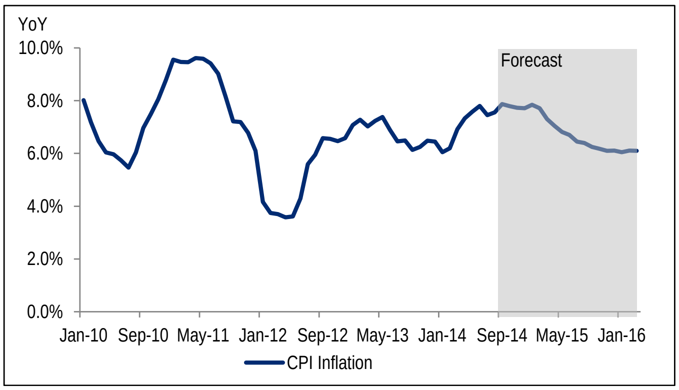
Source: Rosstat, Citi Research

Figure 173. Industrial activity is also weak



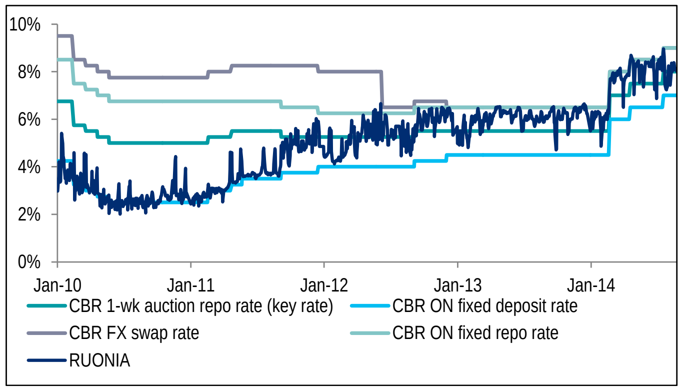
Source: Rosstat, Citi Research

Figure 174. CBR will miss its 2013 inflation target of 5-6%...



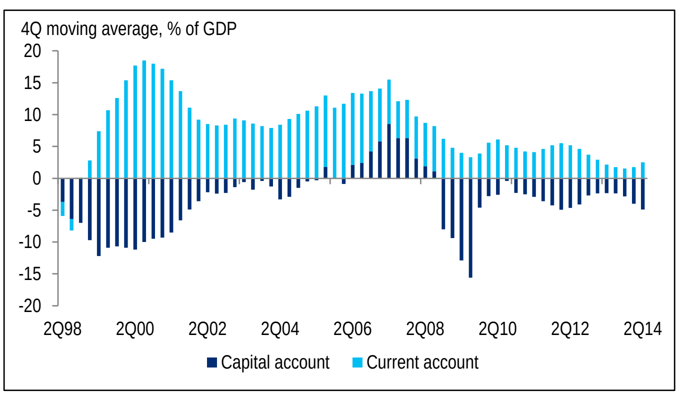
Source: Rosstat, Citi Research

Figure 175. ...and keep policy rates unchanged until 1Q14



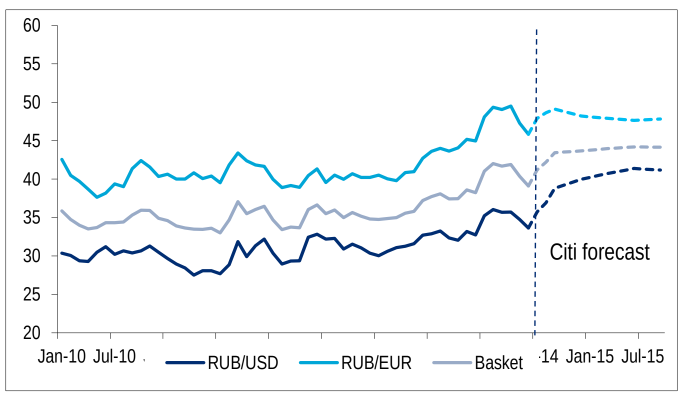
Source: Bloomberg, Citi Research

Figure 176. The gradual disappearance of the current account...



Source: CBR, Citi Research

Figure 177. ...poses risks for the ruble



Source: Bloomberg, Citi Research

Figure 178. Russia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,304	1,665	1,229	1,524	1,903	2,000	2,093	1,951	1,913
Nominal GDP, local currency bn	33,248	41,277	38,807	46,309	55,967	62,218	66,755	72,154	78,537
GDP per capita, USD	9,081	11,585	8,554	10,611	13,267	13,969	14,656	13,694	13,460
Population, mn	143.7	143.7	143.7	143.6	143.4	143.2	142.8	142.5	142.1
Unemployment, % of labour force	6.0	6.2	8.2	7.4	6.5	5.5	5.5	5.7	5.8
Economic Activity									
Real GDP, yoy avg	8.5	5.2	-7.8	4.5	4.3	3.4	1.3	0.7	1.0
Real investment growth % yoy	22.0	10.5	-41.0	28.5	21.0	1.5	-6.1	-2.8	1.6
Real consumption growth % yoy	10.7	8.4	-3.9	3.5	5.3	7.0	3.6	1.4	0.8
private consumption growth % yoy	14.2	10.4	-5.1	5.5	6.7	7.9	4.7	1.9	1.0
Real export growth, % yoy	6.3	0.6	-4.7	7.0	0.3	1.4	4.2	2.0	2.0
Real import growth, % yoy	26.2	14.8	-30.4	25.8	20.3	8.8	3.7	2.5	2.0
Prices, Money & Credit									
CPI, % yoy eop	11.9	13.3	8.8	8.8	6.1	6.6	6.5	7.7	6.1
CPI, % avg	9.0	14.1	11.6	6.8	8.4	5.1	6.8	7.3	6.7
Nominal wages, % yoy	26.0	27.4	9.1	12.8	11.7	13.3	12.3	13.5	12.7
Credit extension to private sector, % yoy	49.3	37.2	2.6	12.9	28.1	19.4	17.2	15.0	10.0
Policy Interest Rate, % eop	6.50	9.50	6.00	5.00	5.25	5.50	5.50	8.00	7.50
1 month inter-bank rate, %, eop	6.09	20.20	6.32	3.78	6.37	6.90	6.81	7.94	6.59
Long-term yield, %, eop	6.58	10.90	9.45	8.23	8.77	7.04	7.88	9.44	8.09
RUB/US$, eop	24.6	30.5	30.3	30.6	32.2	30.6	32.9	40.0	41.0
RUB/US$, avg	25.6	24.9	31.7	30.4	29.4	31.1	31.9	37.0	41.1
RUB/EUR, eop	35.9	42.7	43.4	40.9	41.7	40.3	45.2	48.2	48.0
RUB/EUR, avg	35.1	36.6	44.2	40.3	41.0	40.0	42.3	48.2	47.8
Balance of Payments, USD bn									
Current account	72.2	103.9	50.4	67.5	97.3	71.3	34.1	56.5	54.8
% of GDP	5.5	6.2	4.1	4.4	5.1	3.6	1.6	2.9	2.9
Trade balance	123.4	177.6	113.2	147.0	196.9	191.7	181.9	188.5	194.2
Exports	346.5	466.3	297.2	392.7	515.4	527.4	523.3	536.4	552.4
Imports	223.1	288.7	183.9	245.7	318.6	335.8	341.3	347.8	358.3
Service balance	-16.7	-20.4	-17.6	-26.1	-33.5	-46.6	-58.3	-54.0	-59.9
Income balance	-28.8	-46.5	-39.7	-47.1	-60.4	-67.7	-80.2	-69.0	-70.5
FDI, net	11.1	19.1	-6.7	-9.4	-11.8	-18.1	12.4	-5.0	10.0
International reserves	466.4	410.7	405.8	432.9	441.2	473.1	496.1	462.7	492.5
Total amortisations	28.5	47.2	49.9	40.8	52.0	90.5	139.1	163.1	81.4
Public Finances, % of GDP									
Consolidated government balance	6.7	5.1	-5.6	-3.2	2.1	-0.7	-2.1	-4.4	-4.9
Consolidated gov primary balance	5.8	4.4	-5.4	-3.4	1.2	0.6	1.6	1.8	0.8
Public debt	6.6	5.2	7.3	7.6	8.2	7.7	6.7	9.6	13.3
of which Domestic	3.8	3.4	4.7	5.3	6.3	5.9	4.6	7.2	10.8
Foreign Assets & Liabilities, USD bn									
External debt	471.2	480.6	467.3	488.9	538.9	636.4	728.9	655.9	694.4
Public	37.4	29.5	31.3	34.5	34.7	38.1	43.1	42.7	47.7
External debt / GDP	36.1	28.9	38.0	32.1	28.3	31.8	34.8	33.6	36.3
External debt / XGS	120.7	91.8	136.3	110.7	94.0	107.9	122.8	111.2	115.5
Short-term debt	99.7	73.6	52.7	60.2	68.2	81.5	85.3	74.5	84.2
Short-term debt/International reserves (%)	21.4	17.9	13.0	13.9	15.5	17.2	17.2	16.1	17.1

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	0.9	0.8	0.5	0.7	1.0	1.0	1.1	1.0	1.4
CPI, % yoy eop	6.9	7.8	7.9	7.7	7.3	6.7	6.2	6.1	6.1
Policy interest rate, %, eop	7.00	7.50	8.00	8.00	8.00	7.75	7.50	7.50	7.00
Short-term market rate, % eop	8.74	9.20	7.94	7.94	6.68	6.59	6.59	6.59	5.42
Long-term yield, %, eop	8.80	8.53	9.44	9.44	8.71	8.09	8.09	8.09	7.67
RUB/US$, avg	35.0	35.0	38.8	40.0	40.7	41.4	41.2	41.0	40.8

Source: National Sources, Citi Research forecasts

Slovakia

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- **Summary view** — Three factors – weaker foreign demand outlook, weaker currency and robust domestic demand – influenced our September forecast. While we kept our 2014's GDP forecast unchanged at 2.3%YoY, followed by marginally lower 2015's 2.6% (vs. 2.7% initially), the structure of growth has changed more in favour of domestic demand.

- **Things to watch** — New GDP and gov't data in ESA2010 will be on 21 Oct (annual) and 14 Nov (quarterly). We made simulations for the MinFin's Debt to GDP outlook under several scenarios of the nominal GDP revision. If additional fiscal measures are not realized, it should not trigger the 57% level of the debt-brake rule unless we see more negative GDP revision than -2.5% of GDP due to larger errors in the balance of payments.

- **Strategy** — Activated trigger in debt-brake rule probably forced the MinFin to utilize more cash from the treasury account to help to lower the debt-to-GDP ratio, which together with likely further easing by ECB should be supportive for bonds.

Three factors supported domestic demand in 2Q14

July performance of real economy is likely to keep domestic demand a main driver of GDP growth. GDP growth of 0.6%QoQ in 2Q14 was driven by domestic demand that benefited from favourable labour market, higher public consumption, and recovery in fixed investment. Productivity increased slightly due to a 0.5%QoQ increase in employment. Favourable labour market and disinflation resulted into a strong 4.8%YoY nominal and real wage growth, which is likely to remain supportive for private consumption also onwards. However, other two factors – public consumption and fixed investment is likely to be weaker ahead. First, the activated 55% level of the debt-brake rule is likely to lower the public consumption as the source of growth after it increased cumulatively by 5.8% during 3Q12-2Q14, which is above 4.9% in Poland or 3.1% in Czech Republic. Second, the external risk represents downside risks to fixed investments, though the 3Q's report on utilization of manufacturing production capacities remains supportive. Industrial confidence – supported by export orders – improved in July-August and suggests the annual pace of industrial output growth rather closer to 10% than to zero, which remains supportive to our forecast of 5.7%YoY swda growth in 2014, virtually unchanged compared to 2013. Our momentum indicator improved in July compared to 2Q, which points to an upside risk to our GDP forecast of 0.4%QoQ and 2.3%YoY in 3Q14 after 0.6%QoQ and 2.4%YoY swda in 2Q14.

All in all, while we kept our 2014's GDP forecast unchanged at 2.3%YoY, followed by marginally lower 2015's 2.6% (vs. 2.7% initially), the structure of growth has changed more in favour of domestic demand. We cut our 2015 forecast as we find some improvement in domestic demand rather temporary and the outlook on foreign demand worsened, which is likely to be only partly offset by forecast of weaker currency development due to both larger portion of euro-intra trade and also weaker forecast of other CEE currencies. We think that risks to our forecast are balanced and our forecast is close to MinFin's forecast after the MinFin slashed its forecast for 2015 from 3%YoY to 2.6%. A key risk for both our economic and fiscal forecast remains the ESA2010 revision of GDP (2Q's GDP report was still in ESA95, while ESA2010 will be available on 21-Oct for annual and on 14-Nov fore quarterly data) and the government debt/GDP ratio — which could potentially trigger another debt-brake rule, although MinFin plans to utilize more cash to avoid this.

CPI still in deflation, but FX is likely to change that

We continue to expect acceleration in core prices, while food prices pose a risk to our CPI outlook that is likely to be offset by weaker EUR. Consumer prices fell by 0.2%MoM in August due to another drop in food prices. As result, the annual contraction slightly strengthen to -0.2% (below our forecast at 0%, and consensus at -0.1%). While the main disinflation forces were the utilities and transport segments in 2013, they have been mainly food prices (they have increased year-to-date by 0.6%m which is well below 2.4% increase in the same period of 2013) accompanied by lower transport prices this year.

Looking forward, we continue to see domestic demand supporting the annual growth of our measure of core CPI basket (ex. regulated, food and fuel) to slightly accelerate to 0.6%YoY by end of 2014 vs. 0.3% in August this year. However, food prices and to some extent also oil prices point to downside risk. However, our forecast of further weakening of the EUR vs. USD is likely to accelerate the CPI to 1.2%YoY in 2015 (we previously expected 0.9%) -0.1%YoY in 2014, followed by 1% in 2015. Anyway, low CPI growth suggests a low GDP deflator that will not ease the life of the government to cope with the debt-brake rule.

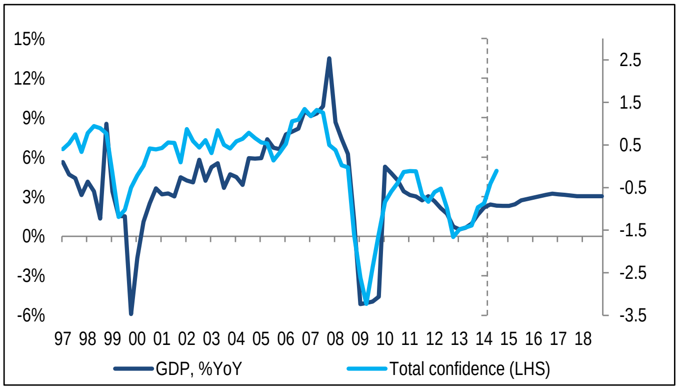
Temporary utilization of cash from STA to reduce GBR

Lower debt-to-GDP ratio does not look ambitious under scrutiny and even narrower deficit is not so rosy if you look into details. MinFin's proposal of state budget for 2015 showed a lower outlook on government debt-to-GDP ratio in forthcoming years with 51.4% in 2017. However, more detailed analysis shows that the change is not so robust and beneficial from a longer point of view. MinFin expects a higher utilization of Single Treasury Account (STA) sources to cover its financing needs. MinFin's lower debt-to-GDP outlook at 51.4% in 2017 requires additional fiscal measures of 0.7% GDP in 2015-17. Our outlook on debt-to-GDP ratio does not differ too much from the MinFin. However, we see an upside risk to our forecast as we assume somewhat stronger role of the cash financing of deficits than the MinFin assumes, while we expect a wider deficits, partly due to somewhat lower GDP. MinFin's target for a small general government deficit of 0.4% of GDP in 2017 after 2.6% in 2014 requires additional measures. Our forecast assumes the general government deficit wider due to three reasons at -3% in 2014 (vs. MinFin's -2.6%), followed by gradual narrowing to -1.8% of GDP in 2017 (vs. -0.4%).

The more assets will lower the debt, the lower GBR will be. Gross financing needs (GFN) are expected to return to levels seen one or two years ago, but less than previously expected. Taking into account MinFin outlook on GFN and utilization of STA, we estimate that MinFin expects the GBR to increase to €6bn in 2015-16 and to €6.7bn in 2017 (which we, however, see quite high as we assume a lower redemptions by €600mn in 2017) after €3.6bn in 2014. The year-to-date issuance in 2014 would signal a continuing small issuance of bonds in the rest of 2014 and buybacks to lower the redemptions profile in 2015. The utilization of the STA suggests the gross borrowing requirements (GBR) are likely to reach 67% of GFN in 2014, 90% in 2015, 82% in 2016 and 91% in 2017.

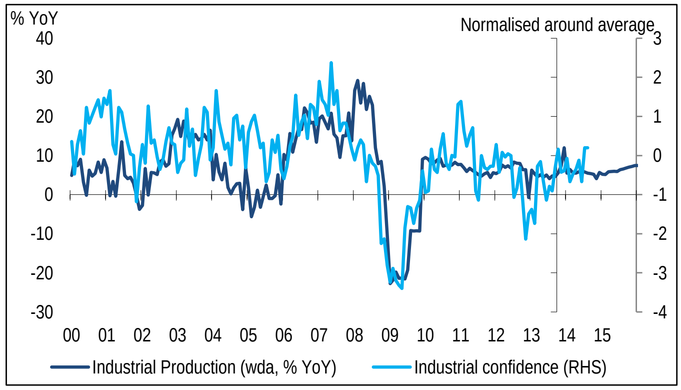
ESA 2010 could still play its role as we think that the main risk in our view is an eventual downward revision of the nominal GDP to reflect large errors in the balance of payments. We made simulations for the MinFin's Debt to GDP outlook under several scenarios of the nominal GDP revision. If additional fiscal measures are not realized, it should not trigger the 57% level of the debt-brake rule unless we see more negative GDP revision than -2.5% of GDP due to larger errors in the balance of payments. MinFin does not assume such increase as well.

Figure 179. August confidence represents an upside risk



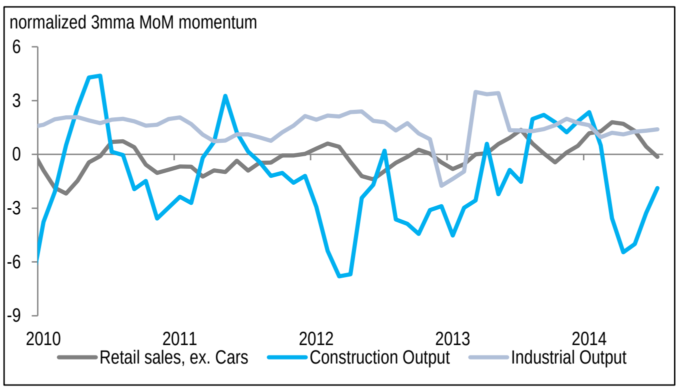
Source: Statistical Office of the Slovak Republic, Citi Research estimates

Figure 180. Industrial confidence became supportive in August



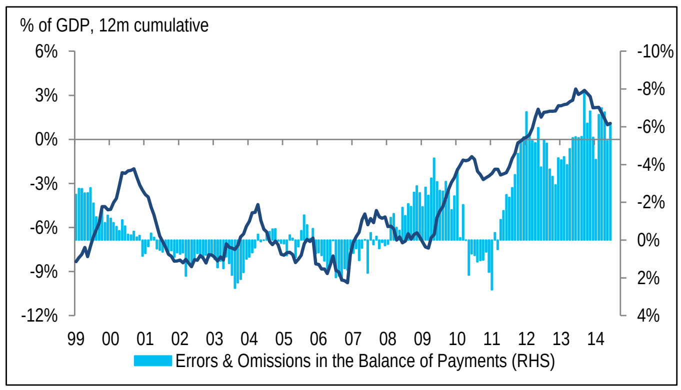
Source: Statistical Office of the Slovak Republic, Citi Research estimates

Figure 181. But momentum in monthly data has continued to worsen in construction and eased in retail in July



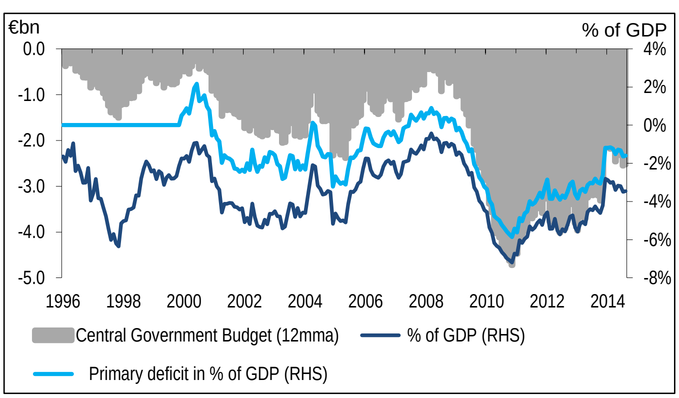
Source: Statistical Office of the Slovak Republic, Haver Analytics, Citi Research

Figure 182. BoP´s errors remains elevated and we doubt if it will be reflected in forthcoming GDP revision



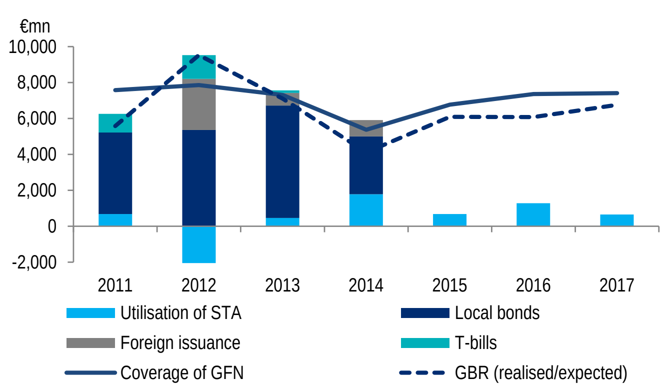
Source: Haver Analytics, Citi Research calculations

Figure 183. Deficit worsened in further August due to milder improvement in revenues (3%YoY for ytd), while expenditures remained elevated (8%)



Source: Haver Analytics and Citi Research calculations

Figure 184. MinFin plans to lower GBR by cash from the Single Treasury Account



Source: ARDAL, Eurostat, Haver Analytics and Citi Research

Figure 185. Slovakia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	75	95	88	87	96	91	96	98	90
Nominal GDP, local currency bn	61	67	62	66	69	71	72	74	76
GDP per capita, USD	13,936	17,493	16,156	16,087	17,654	16,781	17,577	17,940	16,441
Population, mn	5.4	5.4	5.4	5.4	5.4	5.4	5.5	5.5	5.5
Unemployment, % of labour force	8.4	7.7	11.4	12.5	13.2	13.6	14.1	12.9	12.3
Economic Activity									
Real GDP, yoy avg	10.5	5.8	-4.9	4.4	3.0	1.8	0.9	2.3	2.6
Real investment growth % yoy	9.7	4.7	-31.5	20.0	9.5	-16.0	-5.1	10.6	5.7
Real consumption growth % yoy	5.1	6.1	1.6	-0.3	-1.4	-0.4	0.3	3.1	2.0
private consumption growth % yoy	6.8	6.1	0.2	-0.7	-0.5	-0.2	-0.1	2.9	2.0
Real export growth, % yoy	14.3	3.1	-16.3	16.0	12.2	9.9	4.5	5.7	6.5
Real import growth, % yoy	9.2	3.1	-18.9	14.9	9.7	3.3	2.9	7.8	7.3
Prices, Money & Credit									
CPI, % yoy eop	3.4	4.4	0.5	1.3	4.4	3.2	0.4	0.3	1.8
CPI, % avg	2.8	4.6	1.6	1.0	3.9	3.6	1.4	-0.1	1.2
Nominal wages, % yoy	7.5	8.2	3.0	3.3	2.2	2.5	2.4	5.0	2.2
Credit extension to private sector, % yoy	23.4	16.3	0.9	4.8	8.6	2.8	1.5	1.9	4.0
Balance of Payments, USD bn									
Current account	-4.1	-5.9	-2.3	-3.3	-3.6	2.0	2.0	0.3	-0.2
% of GDP	-5.4	-6.2	-2.6	-3.7	-3.8	2.2	2.1	0.3	-0.3
Trade balance	-1.0	-1.1	1.3	1.0	1.4	4.6	5.7	4.1	3.5
Exports	64.9	72.9	55.4	64.0	79.0	79.9	85.5	87.9	84.1
Imports	65.9	74.0	54.1	63.0	77.6	75.4	79.9	83.8	80.6
Service balance	0.5	-0.7	-1.4	-1.0	-0.5	0.4	0.2	-0.2	-0.2
Income balance	-3.2	-2.8	-1.2	-2.7	-4.0	-2.1	-2.4	-3.1	-3.0
FDI, net	3.0	4.3	-0.9	0.8	2.8	2.9	1.2	1.0	1.5
Total amortisations	1.7	1.7	1.8	2.1	2.1	2.2	2.6	2.6	2.6
Public Finances, % of GDP									
Consolidated government balance	-1.6	-2.0	-8.0	-7.5	-4.8	-4.5	-2.8	-3.0	-2.8
Consolidated gov primary balance	-0.4	-0.8	-6.6	-6.3	-3.5	-3.2	-1.5	-1.7	-1.5
Public debt	26.6	27.9	35.7	40.6	43.6	52.7	55.4	55.5	55.6
of which Domestic	18.1	19.0	20.4	25.2	30.8	49.6	93.1	59.6	66.4
Foreign Assets & Liabilities, USD bn									
External debt	44.3	52.5	65.3	65.8	68.5	70.9	82.3	83.5	85.7
Public	9.5	10.3	11.4	13.3	15.5	25.9	34.2	37.3	36.2
External debt / GDP	58.8	55.5	74.5	75.3	71.3	77.6	85.9	85.3	95.3
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	23.6	27.1	37.4	36.3	36.7	28.1	25.0	23.0	24.4

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	2.2	2.4	2.3	2.1	2.2	2.4	2.8	3.2	3.2
CPI, % yoy eop	-0.2	-0.1	-0.2	0.3	0.8	1.0	1.2	1.3	1.8
Short-term market rate, % eop	0.23	0.15	0.07	0.09	0.06	0.30	0.30	0.30	0.33
Long-term yield, %, eop	2.47	2.05	1.52	1.11	1.36	1.61	1.86	1.84	1.23

Source: National Sources, Citi Research forecasts

South Africa

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(On Maternity Leave)

- **Summary view** — The GDP outlook is poorer at 1.4% for 2014 and 2.6% for 2015.
- **Things to watch** — Policy rate normalization remains data-dependent but a weaker economy allows for rates to remain unchanged until Q2 15.
- **Strategy** — ZAR volatility ahead of Fed hiking is an upside risk to inflation over coming months.

Another GDP 'strike-out'

South Africa's macro outlook has changed significantly since the start of the year and GDP downgrades have been significant. We now look for 2014 GDP growth of 1.4% from a forecast of just above 2.0% at the start of the year. This is below the Reuters consensus (1.6%) and the SARB's July MPC statement revision (1.7%). Key to our downgrade is the deteriorating effect that the H1 14 platinum strike and Q3 14 metals manufacturing strike have had on the various supply chains of the economy. What's more, rebalancing from consumption to production took a step back in H1 14 as a result and even looking to H2 14, the recovery in production appears shallow. The July manufacturing strike amplified the negative effect of the 22-week platinum strike given low levels of inventories which put exports at risk and July trade data has already shown a wider deficit. The consumption side of the economy has also proved weaker than our initial expectations and looking out, headwinds remain. For H2 14, the combination of still relatively high inflation, tight lending standards, still-high consumer indebtedness and lackluster consumer confidence makes for a sub-par purchasing power environment. We don't expect any significant rebound for the consumer in 2015 given rising electricity tariffs and continued policy rate normalization by the SARB. For the rest of the economy, potential labour unrest again rears its head mid-year when the coal and gold sector starts negotiations while at the same time, electricity constraints will keep a lid on investment intentions as, although the first unit of the Medupi power station will be fully operational by Q2 15, the additional electricity supply will be offset by increased maintenance.

A wider current account deficit reflects the lack of rebalancing in the economy. The welcomed narrowing of the Q1 14 current account deficit to4.5% of GDP was never sustainable given that it was driven by a large once-off dividend inflow while the trade deficit continued to widen. With dividend inflows unable to persist into Q2, the negative impact of strikes on exports led the Q2 14 current account deficit widening considerably to 6.2% of GDP. Though platinum stockpiles remained relatively intact through Q2, a greater negative impact to its manufacturing supply chain started to take effect. Furthermore, we see the Q3 current account deficit remaining wide given the follow-on impact of the 4-week metals manufacturing strike in July. Together, the 2014 current account deficit thus remains 'stuck' around 5.3% from 5.6% in 2013 – frustratingly wide given the extent of currency weakness thus far. This leaves roughly R200bn in annual financing necessary to fund such a deficit and with the composition of the financial account viewed as unpredictable (as it is made up of portfolio flows and unrecorded transactions mostly) we continue to expect the ZAR to remain on the backfoot, weakening to R11.25/USD on a 6-12 month basis.

Monetary policy remains highly data-dependent

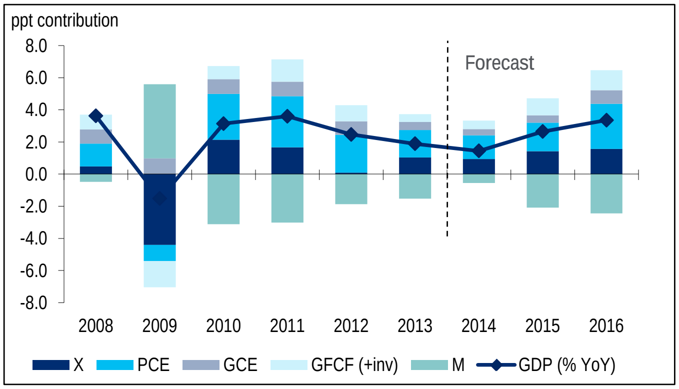
Inflation peaked in June at 6.6% in our view. And while CPI is generally expected to trend downwards from here (though slowly) the trajectory will prove slow and sticky. Downward pressures should emerge from CPI food which, given that the 9-month lag from the Q1 maize price spike is coming to an end however, upward pressure continues to come from ZAR pass-through in the form of higher core inflation, even if incredibly muted versus previous cycles. The lack of ZAR pass-through to-date is not surprising given the efforts of the listed retail sector to push volumes while absorbing cost push pressures. This is affirmed by both the BER retail survey and financial statements of the listed retail sector. Put together, this allows CPI to move back within the 3-6% target band by the end of Q1 15 however, is only likely to get as low as 5.7% before upside inflation risks associated with Fed hiking in Q2 15 starts to become a greater concern for the SARB MPC.

Inert and high inflation together with weak GDP leaves monetary policy decisions highly data-dependent. The SARB has hiked twice this year so far: first by 50bp in January and then by 25bp in July. This leaves the policy rate at 5.75% currently. The reason for a slow moderate hiking cycle thus far has been the trade-off between downside GDP growth risk and upside inflation risk – this was reason why the SARB kept the policy rate unchanged in March, May and September and reason why we expect no further change until Q2 15. What's more, the SARB has moved to smaller incremental hikes of 25bp as a way of signaling that it remains tough on inflation risks but remains concerned about GDP prospects. Given a far weaker outlook for both 2014 and 2015 GDP, we believe that SARB prefers to push the remainder of this hiking to Q2 15 when US monetary policy tightens. We further believe that the SARB will be able to justify this by the fact that inflation is now only expected to remain outside the target band for two more quarters before trending back below 6.0% in Q2 15. The risks to this outlook, however, lie in the data-dependent nature of monetary policy decisions and specifically, how the ZAR reacts to changing market expectations of Fed monetary policy. As such, we would only expect the SARB to move earlier than Q2 15 if ZAR weakness was substantial enough to push its inflation outlook back above 6.0% for 3 or more quarters. This data-dependency of monetary policy decisions is unfortunate for rates markets, as it keeps the timing of rate hikes difficult to forecast.

Tough structural policy decisions

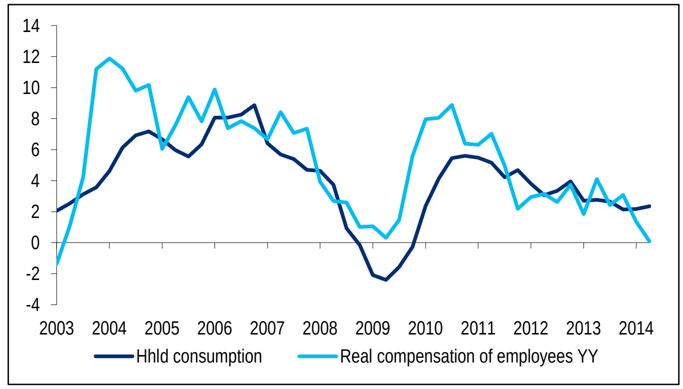
The market is watching keenly for any indication of changes in the upcoming October MTBPS. The S&P sovereign ratings downgrade (to BBB-) one notch above junk encapsulates the fine line of policy dynamics in the economy. As a result, the upcoming October Medium-term Budget will be key for signaling policy direction. The new Finance Minister Nhlanhla Nene will also be examined by the markets for any signs of political sway. We continue to expect an announcement on tax revenue given the need to credibly narrow the budget deficit but near-impossibility to do so significantly from the expenditure side. Our research points to a higher VAT rate as the most obvious tax policy shift but we also acknowledge how difficult it will be for National Treasury and the Davis Tax Committee to pass this through the various constituencies (South Africa Macro View - Time to tax? The macro-economic implications of VAT). The risk is that tax changes are only mentioned in the Budget speech and actual implementation is pushed to 2015.

Figure 186. GDP to remain lackluster in 2013 and 2014



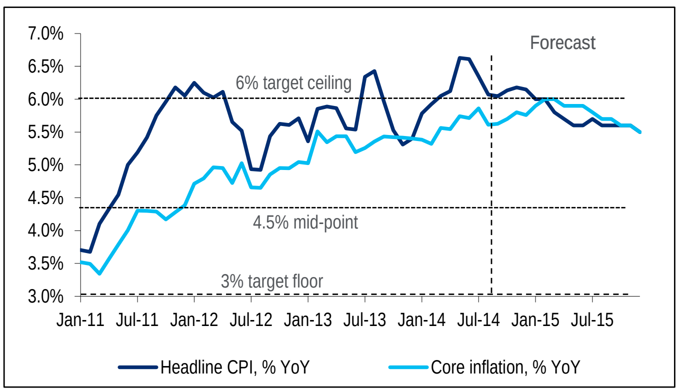
Source: SARB, Citi Research Projections

Figure 187. Consumption is slowing as real incomes decelerate



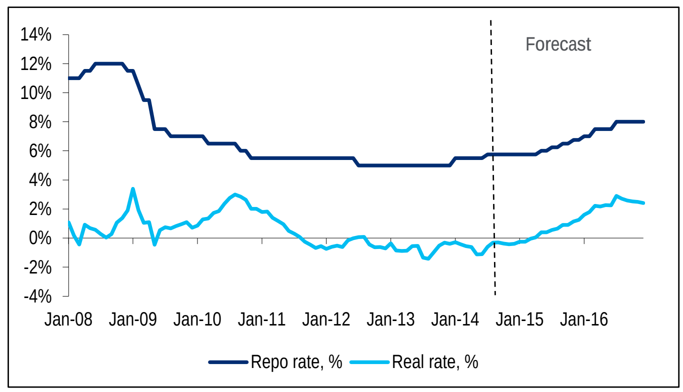
Source: SARB, Citi Research calculations

Figure 188. The CPI will remain at the top of the SARB ceiling in 2H 2013



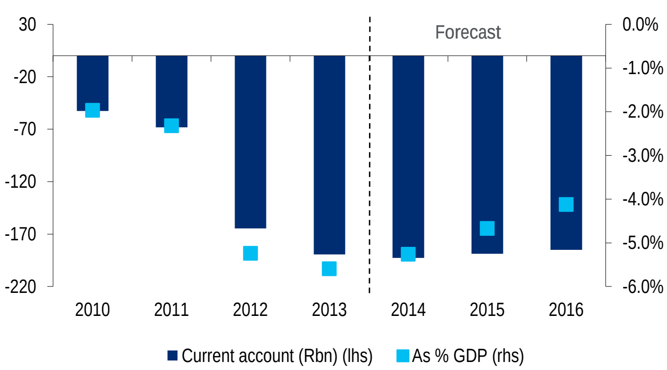
Source: Stats SA, Citi Research projections

Figure 189. Rand volatility suggests further Repo rates cuts are unlikely



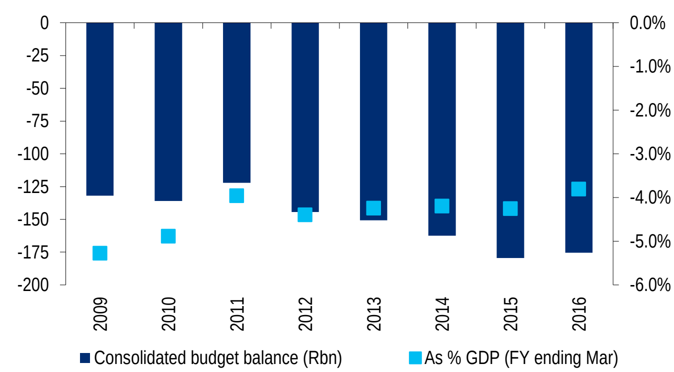
Source: SARB. Stats SA

Figure 190. No meaningful narrowing in the current account deficit



Source: SARB, Citi Research projections

Figure 191. Fiscal consolidation will likely be slow



Source: National Treasury, Haver Analytics, Citi Research projections

Figure 192. South Africa Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	286	273	287	366	404	382	351	337	354
Nominal GDP, local currency bn	2,016	2,256	2,408	2,674	2,933	3,139	3,385	3,661	4,038
GDP per capita, USD	5,763	5,613	5,825	7,312	8,081	7,646	6,986	6,691	7,023
Population, mn	49.6	48.7	49.3	50.0	50.0	50.0	50.2	50.3	50.4
Unemployment, % of labour force	-	22.5	23.7	24.9	24.8	24.9	24.7	25.0	24.6
Economic Activity									
Real GDP, yoy avg	5.5	3.6	-1.5	3.1	3.6	2.5	1.9	1.4	2.6
Real investment growth % yoy	12.0	4.4	-8.6	4.3	7.0	4.9	2.4	2.6	5.0
Real consumption growth % yoy	5.2	2.8	-0.1	4.4	4.7	3.7	2.5	2.1	2.5
private consumption growth % yoy	5.5	2.2	-1.6	4.4	4.9	3.5	2.6	2.2	2.7
Real export growth, % yoy	6.6	1.8	-19.5	9.0	6.8	0.4	4.2	3.7	5.5
Real import growth, % yoy	9.0	1.5	-17.4	11.0	10.0	6.0	4.7	1.7	6.3
Prices, Money & Credit									
CPI, % yoy eop	7.6	9.3	6.0	3.4	6.4	5.7	5.3	6.1	5.5
CPI, % avg	6.2	10.0	7.2	4.1	5.0	5.7	5.8	6.2	5.7
Nominal wages, % yoy	7.9	12.8	11.8	13.5	7.2	7.5	8.1	8.5	8.7
Credit extension to private sector, % yoy	21.5	13.6	-0.1	5.5	6.2	10.1	6.1	8.2	9.0
Policy Interest Rate, % eop	11.00	11.50	7.00	5.50	5.50	5.00	5.00	5.75	6.75
1 month inter-bank rate, %, eop	11.18	11.35	6.94	5.44	5.47	5.02	5.10	5.94	6.94
Long-term yield, %, eop	8.58	7.33	9.05	8.14	7.93	6.39	7.91	7.90	8.00
ZAR/US$, eop	6.87	9.49	7.41	6.62	8.09	8.46	10.50	11.30	11.33
ZAR/US$, avg	7.05	8.27	8.41	7.32	7.26	8.21	9.65	10.88	11.41
Balance of Payments, USD bn									
Current account	-19.9	-19.6	-11.6	-7.2	-9.4	-20.0	-19.6	-17.7	-16.5
% of GDP	-7.0	-7.2	-4.0	-2.0	-2.3	-5.2	-5.6	-5.3	-4.7
Trade balance	-5.2	-4.3	0.3	6.8	6.5	-4.8	-7.6	-7.8	-6.3
Exports	76.2	85.3	66.4	89.8	108.8	99.2	95.1	91.7	93.6
Imports	81.4	89.6	66.1	83.0	102.3	104.0	102.7	99.5	100.0
Service balance	-2.7	-4.1	-2.8	-4.4	-4.7	-2.5	-2.2	-1.6	-2.2
Income balance	-9.8	-8.9	-6.4	-7.2	-9.2	-8.9	-6.6	-5.5	-5.4
FDI, net	3.6	12.3	6.4	3.7	4.5	1.6	2.6	2.2	2.1
International reserves	29.6	30.6	35.3	38.2	42.6	44.0	44.8	46.4	47.2
Total amortisations	2.5	2.7	2.1	1.7	2.4	7.4	4.0	5.5	2.8
Public Finances, % of GDP									
Consolidated government balance	0.9	-1.0	-5.1	-4.9	-3.9	-4.5	-4.1	-4.1	-4.1
Consolidated gov primary balance	3.4	2.4	-3.0	-2.7	-1.6	-2.0	-1.5	-1.4	-1.4
Public debt	28.3	27.8	31.3	35.6	39.4	42.5	46.1	49.6	50.8
of which Domestic	24.5	23.4	27.7	32.3	35.6	38.8	41.9	45.6	46.7
Foreign Assets & Liabilities, USD bn									
External debt	63.0	60.4	63.8	80.6	89.7	113.7	108.6	101.3	106.8
Public	19.5	18.1	22.6	35.8	41.5	55.9	52.8	55.7	55.7
External debt / GDP	22.0	22.1	22.2	22.1	22.2	29.7	31.0	30.1	30.2
External debt / XGS	70.0	61.6	81.4	77.7	72.6	99.4	99.4	95.6	98.8
Short-term debt	24.0	25.5	21.3	21.7	20.5	27.9	27.2	28.7	29.2
Short-term debt/International reserves (%)	81.2	83.2	60.4	56.9	48.2	63.3	60.9	61.9	62.0

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	1.6	1.0	1.5	1.6	2.3	2.8	2.7	2.8	-3.9
CPI, % yoy eop	6.0	6.6	6.0	6.1	5.8	5.6	5.6	5.5	5.3
Policy interest rate, %, eop	5.50	5.50	6.00	5.75	5.75	6.00	6.50	6.75	7.50
Short-term market rate, % eop	5.63	5.73	5.94	5.94	5.94	6.19	6.69	6.94	7.69
Long-term yield, %, eop	8.30	8.17	7.80	7.90	8.00	8.05	8.00	8.00	8.10
ZAR/US$, eop	10.53	10.64	11.07	11.30	11.40	11.49	11.41	11.33	11.25

Source: National Sources, Citi Research forecasts

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- **Summary view** — Policy trade-offs are becoming more acute, with the growth outlook becoming more challenging against the backdrop of a deterioration in underlying inflation dynamics.
- **Things to watch** — The new Medium-term Plan (to be released in early October) and the CBT's new Inflation Report (to be released on October 31) require close monitoring.
- **Strategy** — Our empirical findings suggest that, standing at around 9.2%, the 2-year bond yield doesn't look particularly attractive from a valuation point of view.

2Q GDP data confirms downside risks to growth…

The release of the 2Q GDP corroborate our view that growth will get harder to achieve going forward. A closer look at the data points to broad-based domestic demand weakness with foreign demand saving the day through contributing 2.9pp to overall growth. After a somewhat surprisingly resilient first quarter, economy has slowed quite sharply in Q2 and contracted by 0.5%QoQ. In our view, developments to date demonstrate that rebalancing the economy through largely relying on domestic demand is not only painful, but also unsustainable. In this respect, the markets will focus on whether the new Medium-term Program (to be released in early October) will contain credible targets and structural reforms focusing on the supply side.

...as capital inflows remain subdued

At US$2.6 billion, the current account deficit in July came in somewhat narrower than the consensus (US$2.8bn). With the July outturn, the current account gap in the first seven months of the year stands at US$26.8bn, which is considerably narrower than the deficit seen in the same period of 2013 (US$43.4bn). At around US$9.1bn, the magnitude of the correction in Turkey's underlying deficit excluding energy and gold during the same period points to a less aggressive but still meaningful adjustment.

On the capital account front, standing at US$5.5bn in the first seven months of the year, FDI inflows are slightly weaker than they were in the same period of 2013 (US$5.6bn). During the same period, we saw a sharp reversal in errors and omissions (to US$8.2bn from -US$2.3bn), as portfolio inflows (equity net) remain in line with 2013. Reversals in currency and deposits as well as short-term debt are noteworthy when compared with the same period of 2013. All in all, while the overall financing picture warrants concerns, there are some encouraging signs suggesting that residents are reducing their reliance on short-term external borrowing when compared with the same period of 2013.

Inflation continues to dispute the CBT's stance

At 9.5%YoY, the August inflation reading came in somewhat higher than the consensus (9.4%YoY). While seasonally adjusted underlying inflation measures suggest that inflationary momentum is softening, standing at around 8.5% and 7.7% (SA, 3-month moving average annualized H and I, respectively), core measures remain too high for comfort, leading us to believe that lowering inflation to 5% by the end of 2015 as is currently envisaged by the CBT looks difficult. Against this backdrop, we believe that year-end inflation is likely to be around 9.0% with the risks tilted toward a higher print.

The CBT does not surprise for a change

At the September MPC meeting, the CBT kept both the interest rate corridor (7.5%-11.25%) and the one-week repo rate (8.25%) unchanged—an outcome which is in line with the consensus and our expectations. Despite the challenging external and domestic backdrop, we believe the CBT will look for opportunities to ease if the lira and global conditions permit. However, we remain sceptical about this approach and CBT's narrative. First, while we agree that inflation will likely fall in the coming months on the back of cyclical factors, there is some strong evidence of a secular deterioration in the inflation outlook. Second, in our view, the CBT's stance is difficult to justify on the back of unimpressive capital inflows and the marked deterioration in forward-looking inflation expectations. Moreover, the fact that the short-end of the US yield curve is under pressure—coupled with Turkey's low real yields—further weakens the case for the CBT's recent cuts, in our view. Looking ahead, we believe the CBT will find it harder to strike a balance between steering inflation closer to the 5% target and addressing growth concerns, as we get more evidence on subdued economic activity ahead of the 2015 general elections with subsiding capital inflows.

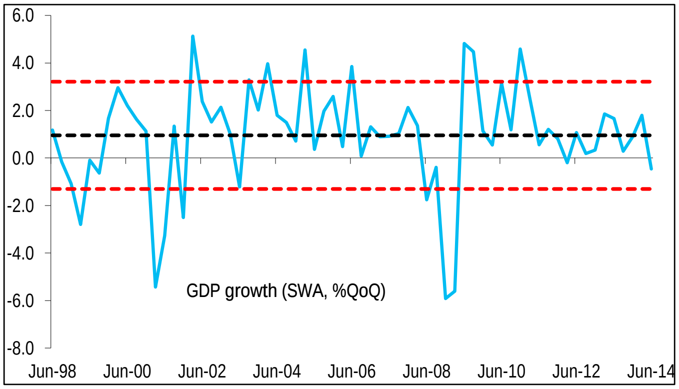
Lira has been underperforming since end-July…

In terms of year-to-date total return, the lira holds fourth place among EM currencies. It is worth nothing that the lira's favorable standing is solely driven by interest return, as year-to-date spot return is in negative territory. Consequently, we argue that CBT's inclination to carry out additional easing is likely to undermine the lira's performance. Moreover, our analysis suggests that yields don't provide adequate buffer to offset downside risks (Economics Presentation - Turkey: Monetary policy is testing its outer limits, again). Concerning the valuation of the lira, it is true that the lira has weakened considerably and that a quick look at the deviation of the real effective exchange rate from its long-term average suggests that the currency isn't overvalued. However, the fundamental equilibrium approach indicates that bringing the current account gap closer to its norm may require additional depreciation—particularly if external financing conditions deteriorate.

.. as valuation concerns curb investors' appetite for bonds

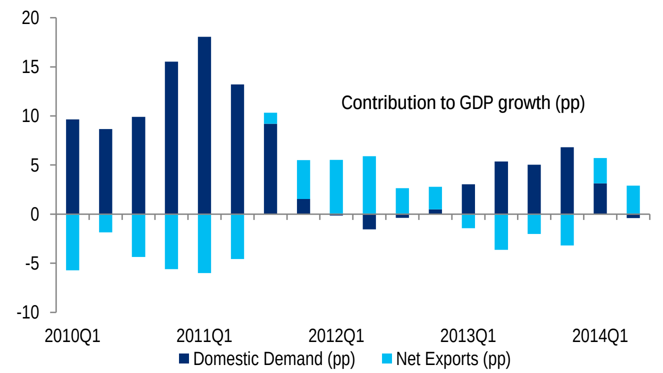
Our empirical findings lead us to believe that, standing at around 9.2%, the 2-year bond yield doesn't look particularly attractive from a valuation point of view (Turkey Macro View - After a turbulent journey, what lies ahead for bonds?)**.** More importantly, our fitted estimates for 2015 typically see the 2-year bond yield above 10.8%, which, we think, is in line with challenging prospects for the bond market. The Treasury's light domestic debt redemption schedule and our inflation forecast trajectory suggest to us that there may be cyclical opportunities in the bond market. However, given our 2-year bond yield estimate for 2015 of about 11%—along with the low likelihood of a durable deceleration in inflation, poor liquidity conditions in the bond market and higher geopolitical risks—we believe that investors should tread carefully when considering cyclical opportunities in the Turkish fixed income market.

Figure 193. Economic activity is losing momentum...



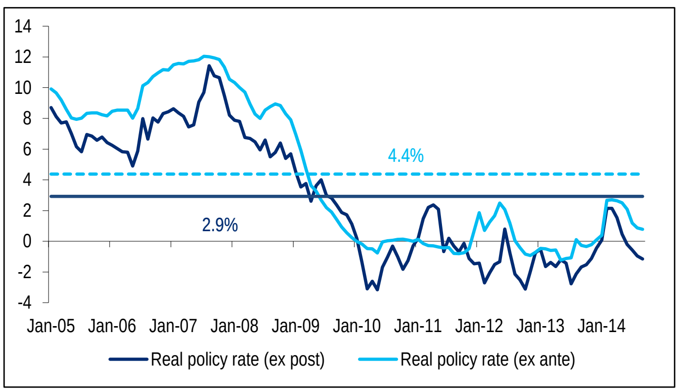
Source: Haver Analytics and Citi Research

Figure 194. ...as the cost of rebalancing becomes more evident...



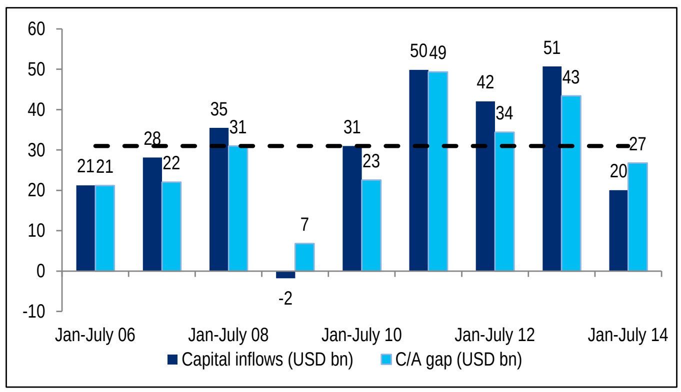
Source: CBT and Citi Research

Figure 195 ...which is likely to raise pressures for additional easing...



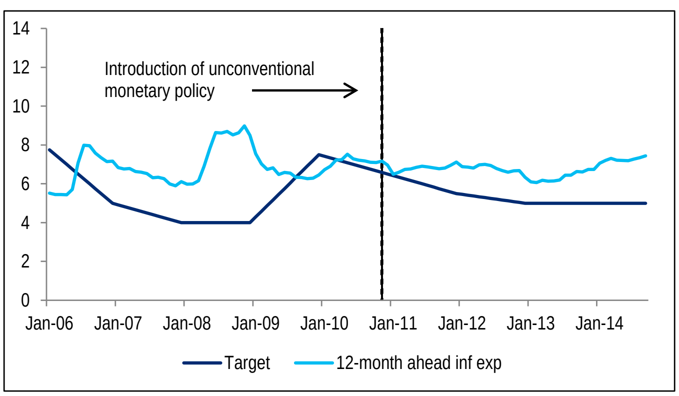
Source: Ministry of Development.

Figure 196. ...despite unimpressive capital inflows...



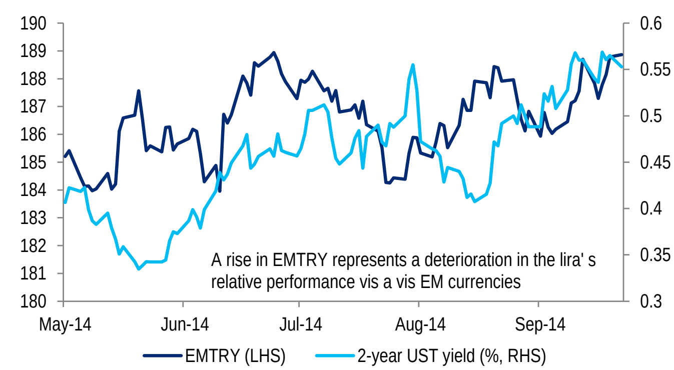
Source: Haver and Citi Research

Figure 197. ...and the challenging inflation prospects...



Source: CBT and Citi Research

Figure 198. ...leaving the lira at the mercy of global factors.



Source: Bloomberg and Citi Research

Figure 199. Turkey Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	646	731	615	731	775	789	822	803	793
Nominal GDP, local currency bn	843	951	953	1,099	1,298	1,417	1,565	1,766	1,949
GDP per capita, USD	9,207	10,282	8,530	10,016	10,473	10,531	10,746	10,384	10,141
Population, mn	70.2	71.1	72.1	73.0	74.0	74.9	76.5	77.3	78.2
Unemployment, % of labour force	10.3	10.0	13.0	11.2	9.1	8.5	9.1	9.5	9.5
Economic Activity									
Real GDP, yoy avg	4.7	0.7	-4.8	9.2	8.8	2.1	4.1	3.5	3.5
Real investment growth % yoy	5.8	-4.8	-28.6	48.4	16.8	-8.5	11.3	-0.2	3.9
Real consumption growth % yoy	5.6	-0.1	-1.0	6.0	7.3	0.4	5.3	1.6	3.2
private consumption growth % yoy	5.5	-0.3	-2.3	6.7	7.7	-0.5	5.1	0.5	3.2
Real export growth, % yoy	7.3	2.7	-5.0	3.4	7.9	16.3	-0.3	8.1	4.4
Real import growth, % yoy	10.7	-4.1	-14.3	20.7	10.7	-0.4	9.0	-0.6	4.0
Prices, Money & Credit									
CPI, % yoy eop	8.4	10.1	6.5	6.4	10.4	6.2	7.4	9.0	7.0
CPI, % avg	8.8	10.4	6.3	8.6	6.5	8.9	7.5	9.0	6.7
Nominal wages, % yoy	9.5	11.6	9.9	11.8	9.7	11.5	12.4	16.0	14.0
Credit extension to private sector, % yoy	27.8	22.4	13.4	40.4	32.8	19.8	33.5	15.0	15.0
Policy Interest Rate, % eop	15.75	15.00	6.50	6.50	5.75	5.55	7.10	10.50	10.50
1 month inter-bank rate, %, eop	17.21	17.16	7.20	6.89	11.54	5.80	8.66	10.75	10.75
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	1.17	1.54	1.50	1.54	1.89	1.78	2.15	2.31	2.51
TRY/US$, avg	1.31	1.31	1.55	1.51	1.68	1.80	1.91	2.20	2.46
TRY/EUR, eop	1.70	2.15	2.15	2.06	2.44	2.35	2.95	2.79	2.94
TRY/EUR, avg	1.79	1.92	2.17	2.00	2.34	2.32	2.53	2.87	2.86
Balance of Payments, USD bn									
Current account	-37.8	-40.4	-12.1	-45.4	-75.1	-48.5	-65.1	-42.3	-44.0
% of GDP	-5.8	-5.5	-2.0	-6.2	-9.7	-6.1	-7.9	-5.3	-5.5
Trade balance	-46.9	-53.0	-24.9	-56.4	-89.1	-65.3	-80.0	-61.3	-65.7
Exports	115.4	140.8	109.6	120.9	143.4	163.2	163.4	181.2	193.8
Imports	162.2	193.8	134.5	177.3	232.5	228.6	243.4	242.5	259.5
Service balance	14.0	18.9	18.6	16.7	20.2	22.6	23.1	26.6	28.6
Income balance	-7.1	-8.4	-8.3	-7.2	-7.9	-7.2	-9.4	-8.8	-8.2
FDI, net	19.9	17.2	7.1	7.6	13.8	9.2	9.8	10.2	11.0
International reserves	73.3	71.0	70.7	80.7	78.5	99.9	109.8	114.8	119.8
Total amortisations	37.6	41.1	47.4	45.0	37.9	33.5	36.7	39.0	41.0
Public Finances, % of GDP									
Consolidated government balance	-1.6	-1.8	-5.5	-3.6	-1.3	-2.0	-1.2	-2.8	-3.2
Consolidated gov primary balance	4.1	3.5	0.1	0.8	1.8	1.4	0.9	0.3	0.3
Public debt	40.4	41.2	47.7	44.4	41.2	38.8	38.7	37.7	36.7
of which Domestic	30.3	28.9	34.6	32.1	28.4	27.3	25.7	25.3	25.0
Foreign Assets & Liabilities, USD bn									
External debt	250.4	281.1	269.1	292.0	304.4	337.5	391.4	417.0	447.3
Public	89.3	92.4	96.6	100.6	90.0	101.8	118.1	117.1	122.1
External debt / GDP	38.7	38.5	43.8	39.9	39.3	42.8	47.6	51.9	56.4
External debt / XGS	172.4	158.1	185.1	185.8	165.4	163.6	186.4	180.1	180.3
Short-term debt	43.2	52.5	49.0	77.3	81.9	100.8	129.4	127.4	134.7
Short-term debt/International reserves (%)	58.9	74.0	69.3	95.8	104.4	100.9	117.8	110.9	112.4

Quarterly Economic Indicators

	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	4.7	2.1	3.4	3.9	2.9	3.6	3.8	4.4	3.8
CPI, % yoy eop	8.4	9.2	9.4	9.0	7.1	6.3	6.0	7.0	7.1
Policy interest rate, %, eop	10.27	8.82	8.25	10.50	10.25	9.00	9.25	10.50	10.00
Short-term market rate, % eop	12.28	9.19	8.80	10.75	10.75	9.80	10.00	10.75	10.80
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	2.14	2.12	2.23	2.31	2.38	2.45	2.48	2.51	2.54

Source: National Sources, Citi Research forecasts

Other Africa

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Ghana

- Following on from its September Eurobond issuance, investors will now focus on whether the government can agree upon a deal with the IMF and the 2015 budget presentation in November. Both need to outline a credible plan for fiscal consolidation before the country moves into a period of intensive cedi bond repayments in 2H 2015 and into 2016. But, fiscal consolidation will be tough, with the government needing to significantly boost revenue collection which is well below the levels of other middle income governments in Africa.

- With inflation creeping up, the Bank of Ghana (BoG) has slowly tightened monetary policy in 2014. But the cedi has continued to remain under huge pressure and the reality is that the ability of the BoG to limit cedi depreciation depends on fiscal developments. So the real question will be whether progress in fiscal consolidation means that we enter a new period of lower cedi depreciation at some point in 2015-16.

- So while the government will probably be able to muddle through, especially if a deal can be struck with the IMF, there is a very real chance that without this the government could face a wider loss of investor confidence in late 2015 or early 2016. This could potentially lead to a wider economic crisis and a complete loss in confidence in the cedi.

Kenya

- A slow pick-up in growth towards 6% by 2015 seems underway, but it is constrained by ongoing political uncertainty, sporadic terrorist incidents, periodic drought and infrastructure bottlenecks.

- Proposed revisions to the GDP and balance of payments statistics before year end should reduce the twin fiscal and current account deficits and provide a more logical explanation of only gradual Kenyan shilling depreciation in recent years and the ability of the CBK to build foreign exchange reserves. But the government will have to avoid the temptation of using the lower fiscal deficits debt stock as an excuse for not continuing with its programme of gradual mid-election fiscal consolidation.

- Although the Central Bank of Kenya (CBK) will be sorely tempted to cut rates to support the slow recovery, with inflation remaining either above, or at the top end of its inflation target (5%, +/- 2.5pp), for the rest of 2014 and into early 2015 we think it will act cautiously. Especially as rate cuts could spill over into more substantial KES depreciation than the gradual depreciation the CBK seems comfortable with.

Tanzania

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

- Given political developments, the prospects for rapid progress towards gas production are now very limited. But growth should continue to be robust at around 7%. The current account deficit is set to remain substantial, but with donor support and FDI inflows remaining high, the balance of payments will remain in surplus, especially if the government does issue a Eurobond.

- While, strong capital inflows coupled with capital controls and the Bank of Tanzania's (BoT) tight monetary policy have helped maintain shilling stability in 2013, we think the reality is that, after two years of relative stability, the substantial fiscal and current account deficits should drive more significant shilling weakness in 2014-15.

Uganda

- The Uganda economy is slowly recovering after the sharp slowdown in 2012. The recovery should be helped by the expansionary fiscal budget announced in June 2014 which is based on a sharp rise in infrastructure spending. But external financing could be problematic, and coupled with capacity issues the deficit may well prove lower than the 7.6% projected by the government. If external borrowing is problematic, increased domestic borrowing can partially offset, although domestic debt has already risen significantly in recent years.

- In this environment, the Bank of Uganda (BoU) will face a difficult balancing act. While it probably wants to cut the Central Bank Rate (CBR) in 2H 2014 in line with its inflation outlook this may well spill over into potential Ugandan shilling (UGX) weakness given the fiscal stance especially if the government bows to raising recurrent spending in 2015 as the February 2016 elections loom closer. So we expect it will opt for a more cautious approach limiting depreciation.

- At some point in the next five years, Uganda will become an oil producer. But this is still a long term promise, and its impact on growth and government revenue will, initially, be minimal. While the development of the fields will push up the current account deficit, it should be largely funded through FDI.

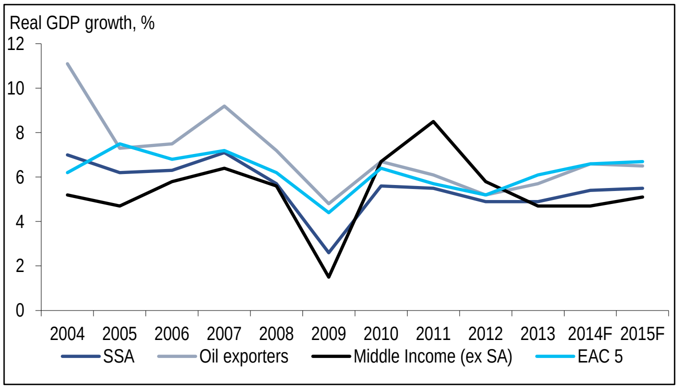
Zambia

- The widening fiscal deficit in 2013 meant higher government wages spilled over into strong demand for imports in early 2014. Combined with disruptions to flows from the copper sector on the market, this drove significant kwacha depreciation.

- While the current account is likely to move to a small deficit in 2014, we expect it to be largely funded by FDI inflows. In addition, we do expect an improvement in the fiscal deficit in 2014-15 as the government freezes government wages. The rise in the cost of financing the deficit could also prove an important factor in clarifying government thinking on the need to bring the fiscal deficit back under control and push it into signing a new agreement with the IMF in late 2014. Although inflationary pressures will remain in 2H 2014, we think inflation will moderate towards the end of year. We also expect a modest recovery in growth on the back of rising agricultural and copper production in 2014.

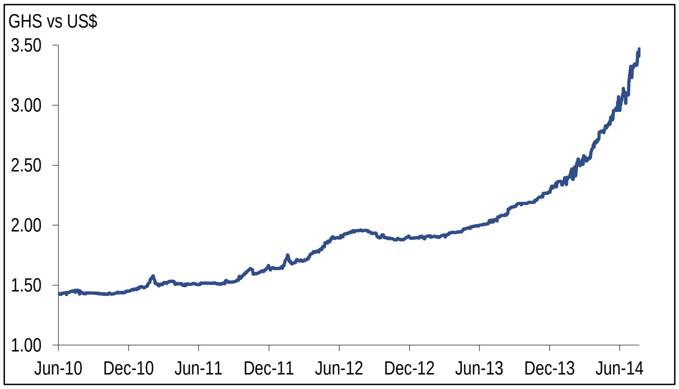
- These developments, coupled with the sharp tightening of monetary policy in early 2014, will continue to provide support for the kwacha, with only modest depreciation going forward once the current bout of weakness has run its course. And it should allow the Bank of Zambia (BoZ) to rebuild foreign exchange reserves which are low by regional standards.

Figure 200. Growth should be robust in 2014-15



Source: IMF

Figure 201. The cedi charges through the GHS3:US$1 level



Source: Haver Analytics

Figure 202. A gradual depreciation of the Kenyan shilling in 2014

Source: Haver Analytics

Figure 203. Is the Tanzanian shilling now too strong?

Source: Haver Analytics

Figure 204. The Ugandan shilling is now coming under more pressure

Source: Haver Analytics

Figure 205. Has kwacha weakening in 1H 2014 now run its course?

Source: Haver Analytics

Figure 206. Other Africa Economic Forecasts

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
GHANA									
Nominal GDP, USD bn	24.8	28.5	26.0	32.2	39.6	41.7	45.2	36.9	32.6
GDP per capita, USD	1,099	1,234	1,096	1,326	1,594	1,646	1,744	1,396	1,210
Real GDP, yoy avg	6.5	8.4	4.0	8.0	15.0	8.8	7.1	5.1	4.0
CPI, % avg	10.7	16.5	19.3	10.7	8.7	9.2	11.7	15.2	12.5
Policy Interest Rate, % eop	13.5	17.0	18.0	13.5	12.5	15.0	16.0	19.0	16.0
GHS/US$, avg	0.95	1.07	1.43	1.43	1.55	1.85	2.06	3.10	4.15
Current account, US$bn	-2.1	-3.5	-1.6	-2.6	-2.5	-4.9	-5.2	-4.0	-3.8
% of GDP	-8.6	-12.4	-6.2	-8.2	-6.3	-11.8	-11.5	-10.8	-11.6
Consolidated gov. balance, % of GDP	-5.6	-8.4	-7.0	-9.4	-5.5	-9.3	-9.0	-8.7	-7.0
KENYA									
Nominal GDP, USD bn	27.2	30.5	30.6	32.2	34.3	40.7	44.1	51.8	59.2
GDP per capita, USD	721	786	768	788	817	943	995	1,138	1,266
Real GDP, yoy avg	7.0	1.5	2.7	5.8	4.4	4.6	4.7	5.3	5.8
CPI, % avg	4.3	15.1	10.6	4.3	14.0	9.4	5.7	7.5	7.2
Policy Interest Rate, % eop	8.8	8.5	7.0	6.0	18.0	11.0	8.5	8.5	8.0
KES/US$, avg	67.3	68.8	77.3	79.2	88.4	84.5	86.1	87.7	92.5
Current account, US$bn	-1.1	-2.0	-1.7	-2.4	-3.8	-4.2	-4.0	-3.9	-4.4
% of GDP	-4.0	-6.5	-5.5	-7.3	-11.2	-10.4	-9.0	-7.6	-7.5
Consolidated gov. balance, % of GDP	-4.2	-3.5	-6.2	-4.7	-5.5	-9.0	-7.8	-6.5	-6.7
TANZANIA									
Nominal GDP, USD bn	16.8	20.7	21.4	22.9	23.9	28.2	32.5	36.6	40.8
GDP per capita, USD	409	489	490	509	515	590	661	721	781
Real GDP, yoy avg	7.1	7.4	6.0	7.0	6.4	6.9	7.0	7.1	7.2
CPI, % avg	7.0	10.3	12.1	7.2	12.7	16.0	7.9	6.4	6.3
TZS/US$, avg	1,237	1,198	1,324	1,439	1,582	1,586	1,617	1,653	1,730
Current account, US$bn	-2.3	-3.2	-2.5	-2.7	-4.6	-3.4	-3.3	-5.1	-5.3
% of GDP	-13.9	-15.2	-11.5	-11.9	-19.1	-11.9	-10.2	-13.9	-12.9
Consolidated gov. balance, % of GDP	-1.9	-2.6	-6.0	-6.5	-5.0	-5.4	-6.0	-6.4	-6.5
UGANDA									
Nominal GDP, USD bn	13.5	16.4	16.5	17.2	18.2	21.2	23.1	25.6	27.2
GDP per capita, USD	441	515	503	506	518	584	613	659	678
Real GDP, yoy avg	8.1	10.4	4.1	6.2	6.4	3.6	5.8	6.1	6.5
CPI, % avg	6.1	12.0	13.0	4.0	18.7	14.0	5.5	4.6	4.9
UGX/US$, avg	1,723	1,714	2,025	2,173	2,511	2,501	2,584	2,576	2,735
Current account, US$bn	-0.6	-1.2	-1.1	-1.6	-2.1	-1.7	-1.9	-2.4	-2.7
% of GDP	-4.2	-7.5	-6.4	-9.6	-11.4	-8.0	-8.2	-9.5	-10.1
Consolidated gov. balance, % of GDP	-2.7	-2.7	-1.6	-6.6	-3.9	-3.8	-4.5	-5.3	-5.6
ZAMBIA									
Nominal GDP, USD bn	14.1	17.9	15.3	20.3	23.7	25.0	26.9	27.1	29.8
GDP per capita, USD	1,161	1,438	1,195	1,533	1,740	1,774	1,853	1,804	1,917
Real GDP, yoy avg	6.2	5.7	6.4	7.6	6.8	7.3	6.2	6.2	6.3
CPI, % avg	10.6	12.4	13.4	8.5	6.4	6.6	7.0	7.9	6.5
ZMK/US$, avg	3,992	3,702	5,020	4,791	4,861	5,139	5,195	6	6
Current account, US$bn	-0.9	-1.3	0.6	1.4	0.9	0.0	0.1	-0.3	-0.4
% of GDP	-6.5	-7.2	4.2	7.1	3.7	0.1	0.2	-1.0	-1.5
Consolidated gov. balance, % of GDP	-1.3	-0.8	-2.5	-3.0	-2.2	-3.9	-6.5	-5.3	-4.6

Quarterly Economic Indicators

	2014 Q1	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GHS/US$, eop	2.69	3.33	3.60	3.80	4.00	4.10	4.30	4.60	4.80
KES/US$, eop	86.40	87.65	88.50	89.50	90.00	92.00	92.00	93.50	95.00
TZS/US$, eop	1,638	1,658	1,660	1,680	1,700	1,725	1,750	1,785	1,810
UGX/US$, eop	2,547	2,600	2,615	2,650	2,700	2,700	2,800	2,825	2,900
ZMK/US$, eop	5,195.00	5,195.00	6.15	6.20	6.25	6.30	6.30	6.40	6.50

Source: National Sources, Citi Research forecasts

Other Europe

Bulgaria

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Bulgaria's annual GDP growth rose to 1.6%YoY (WD) in 2Q from 1.2% in the first quarter. As was the case in the first quarter, private consumption and investment expenditures, which rose by 1.6%YoY and 3.9%, respectively, were the main driver of the 2Q outturn. Standing at 0.5%QoQ, the 2Q GDP reading represents a moderate pick-up in economic activity when compared with 1Q (0.3%QoQ). On the supply side, growth is mainly driven by industrial production (3.8%YoY), while agriculture output contracted by 1.6%YoY. Looking ahead, while we expect to see a continued recovery in domestic demand, we also acknowledge the existence of major headwinds to growth such as relatively high unemployment rate (11.5%, SA), anemic loan growth (0.2%YoY) and the low level of consumer confidence (-37%, balance). We note that consumer confidence may partially recover after the October 5 elections. However, based on poll results and recent statements by senior politicians, there seems to be a high likelihood that no single party will secure an overall majority, which, in our view, doesn't bode well for political stability. In light of developments to date, we expect the GDP growth to accelerate to 1.5% in 2014 from 0.9% in 2013.

Turning to price developments, at -0.6%YoY, deflationary pressures continued to soften in August, compared with -1% (July) and -1.9% (in June). Looking ahead, we project inflation to rise to markedly by end of the year on the back of base effects. However, there is some evidence suggesting that deflationary pressures to date have been stronger than our expectations. Against this backdrop, we now see the inflation at about 1% by the end of the year—lower than our earlier forecast of 1.5%. Regarding external developments, the current account balance recorded a surplus of €594mn in July, compared with a surplus of about €194mn in the same month of 2013. With the July data, the current account deficit in the first seven months of the year stood at €528mn, compared with a surplus of €400mn in the same period of 2013. Going forward, our expectation of stronger domestic demand this year leads us to look for a current account surplus of about 0.5% of GDP in 2014, compared with a surplus of 2% of GDP in 2013.

Croatia

2Q GDP contracted by 0.8%YoY, which represents the 11th consecutive negative reading in annual GDP growth. We are particularly concerned with the drop in the seasonally adjusted GDP in 2Q (0.4%QoQ) following a 0.2%QoQ rise in 1Q. The weakness in the second quarter growth was mainly driven by domestic demand—particularly by gross fixed formation, which contracted by 5.2%YoY in 2Q. We see broad-based weakness in domestic demand, with household consumption and government consumption registering negative growth rates of -0.5%YoY and -3.4%YoY, respectively. Net exports, however, contributed about 2pp to the annual growth in 2Q, which was mainly driven by significant rise in exports (7.9%YoY). Looking ahead, we expect to see a rebound in investment activity driven by EU-funded projects. Nonetheless, the likely decline in export growth owing to slower EU growth and constraints on government spending to meet the EDP targets lead us believe that GDP will contract by 0.7% this year, compared with a contraction of 0.9% in 2013.

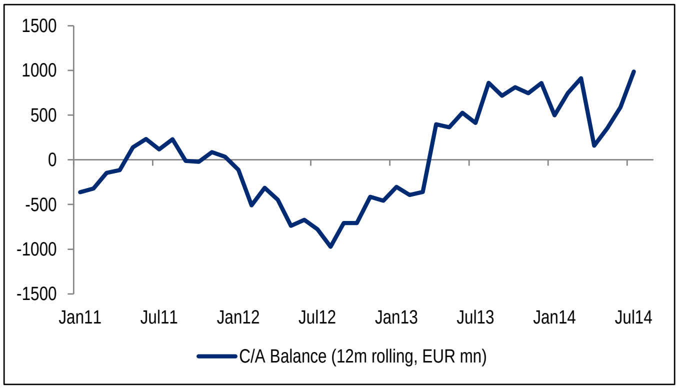
Regarding inflation, consumer prices fell by 0.1%MoM in August, bringing the annual inflation rate to -0.3%YoY from -0.1%YoY in July. The monthly inflation print in August was about 0.2pp lower than its seasonal average (+0.1%MoM)—an outcome mainly driven by below-average readings in transport inflation. Looking ahead, while weak domestic demand is likely to keep inflationary pressures in check, we think that inflation is likely to rise gradually to about 1.0% by end-2014 owing to base effects and the unwinding of cyclical factors. In parallel, we expect the current account balance to remain in positive territory this year on the back of the continued sub-par growth in domestic demand, a relatively strong export performance in 1H and a solid tourism season. Against this backdrop, we look for a current account surplus of 1.0% of GDP this year, compared with a surplus 0.9% in 2013.

Serbia

According to the preliminary 2Q GDP data, the Serbian economy contracted by 1.1%YoY in 2Q, following a 0.1%YoY rise in 1Q. The adverse of the recent became more evident in the second quarter data with the GDP contracting 1.3%QoQ after shrinking 0.9%QoQ in 1Q. The detailed final report, which will be released September 30th, will provide further insight into state of the economy, as we expect to see significant loss of output in agriculture, energy and transportation sectors due to the unprecedented floods in mid-May. Looking ahead, while annual growth is likely to remain in negative territory during the remainder of this year, we expect to see a QoQ rebound in growth in 2H and thereafter. Against this backdrop, we maintain our 2014 GDP growth forecast at -0.5%, with risks tilted to a weaker reading, and look for a pick-up in economic activity next year to about 2.3%.

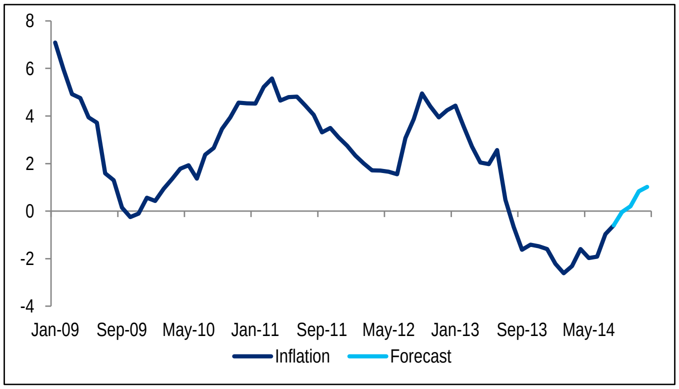
Turning to price developments, annual inflation fell to 1.5%YoY in August from 2.1% in July thanks mainly to base effects of associated with utility prices. Particularly, utilities prices whose growth decelerated sharply to 2.3%YoY in August from 6.3% in July contributed almost the entire 0.6pp drop in August inflation. Looking ahead, however, we expect to see a reversal of this effect, as the gas and electricity prices are set to be raised in the last quarter of the year. In addition, we expect to see a reversal—albeit only partial—in food inflation in the rest of the year, as we now see year-end inflation at around 4.5%, compared with our earlier forecast of 5%. We note that while inflation continued to hover below the below the lower bound of the target tolerance band of NBS (4±1.5%), the Bank opted to keep rates on hold at September MPC meeting on the back of continued uncertainties in the domestic and international environment. Particularly, the Bank drew attention to the ongoing geopolitical tensions and the Fed's reduced monetary accommodation. We acknowledge that softer domestic demand, relatively low inflation outturn, and the likely IMF arrangement in the coming months should strengthen the NBS's hand to cut the rates by another 50bp to 8.0%. However, developments to date lead us to believe that the NBS will be reluctant to ease unless the currency recovers and remains stable.

Figure 207. Bulgaria: Current account performance has been stronger than our expectations ...



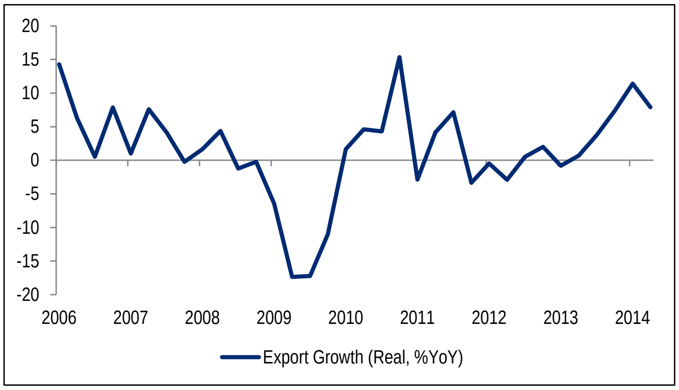
Source: Haver Analytics and Citi Research

Figure 208. ...as deflationary pressures are likely to soften going forward



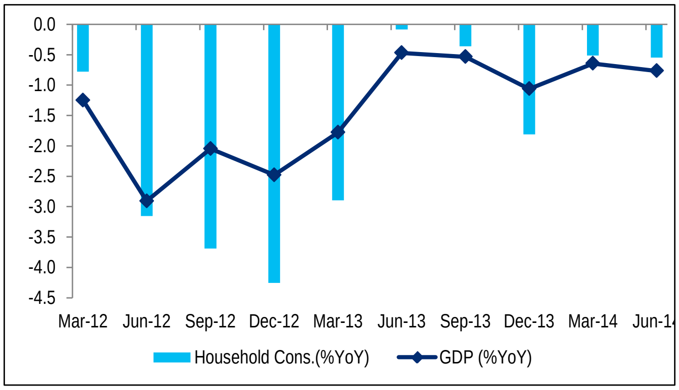
Source: Haver Analytics and Citi Research

Figure 209. Croatia: Strong export performance is likely to lose steam going forward...



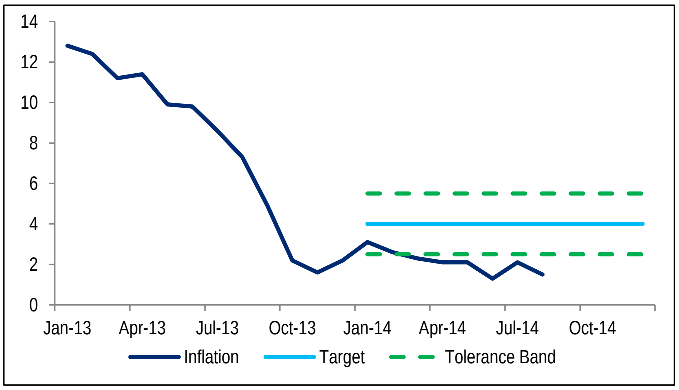
Source: Haver Analytics and Citi Research

Figure 210. ... further complicating recovery prospects



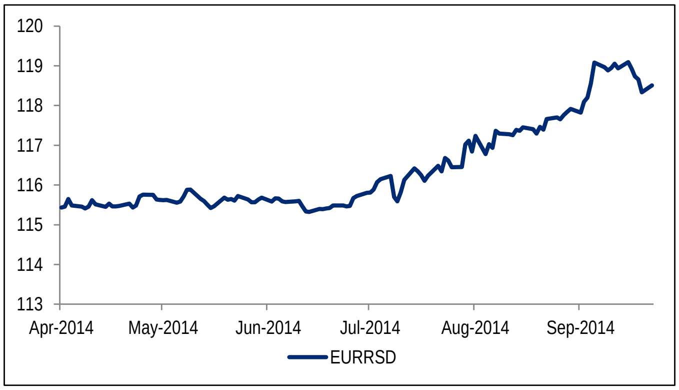
Source: Haver Analytics and Citi Research

Figure 211. Serbia: Despite favorable price developments...



Source: Haver Analytics, NBS and Citi Research

Figure 212. ... the NBS is likely to refrain from easing due to the RSD weakness.



Source: Bloomberg and Citi Research

Figure 213. Other Europe Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
BULGARIA									
Nominal GDP, USD bn	42.2	52.1	48.7	47.8	53.6	51.3	53.9	53.2	49.8
GDP per capita, USD	5,521	6,849	6,435	6,374	7,314	7,040	7,446	7,384	6,943
Real GDP, yoy avg	6.4	6.2	-5.5	0.4	1.8	0.6	0.9	1.5	2.5
CPI, % avg	8.4	12.3	2.8	2.4	4.2	3.0	0.9	-1.0	2.2
BGN/US$, avg	1.43	1.33	1.40	1.47	1.40	1.52	1.47	1.50	1.68
BGN/EUR, avg	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
Current account, US$bn	-10.6	-12.0	-4.3	-0.7	0.0	-0.6	1.2	0.3	-0.5
% of GDP	-25.2	-23.1	-8.9	-1.5	0.1	-1.1	2.1	0.5	-1.0
Consolidated gov. balance, % of GDP	1.2	1.7	-4.3	-3.1	-2.0	-0.8	-1.5	-2.5	-1.2
CROATIA									
Nominal GDP, USD bn	59.3	69.6	62.2	58.9	61.5	55.9	57.9	56.0	51.0
GDP per capita, USD	13,581	15,960	14,299	13,577	14,227	12,978	13,495	13,106	11,997
Real GDP, yoy avg	5.1	2.1	-6.9	-2.3	-0.2	-2.2	-0.9	-0.7	1.2
CPI, % avg	2.9	6.1	2.4	1.0	2.3	3.4	2.2	-0.1	2.5
Policy Interest Rate, % eop	9.00	9.00	9.00	9.00	7.00	7.00	7.00	7.00	7.00
HRK/US$, avg	5.35	4.91	5.26	5.49	5.34	5.84	5.70	5.85	6.66
HRK/EUR, avg	7.34	7.23	7.34	7.29	7.43	7.51	7.58	7.63	7.75
Current account, US$bn	-4.3	-6.2	-3.2	-0.7	-0.5	-0.1	0.5	0.6	-0.3
% of GDP	-7.2	-8.8	-5.1	-1.1	-0.9	-0.1	0.9	1.0	-0.5
Consolidated gov. balance, % of GDP	-	-	-5.3	-6.4	-7.8	-5.0	-4.9	-5.0	-4.0
SERBIA									
Nominal GDP, USD bn	39.0	47.8	40.2	37.1	43.7	38.1	42.5	41.3	38.1
GDP per capita, USD	5,277	6,497	5,496	5,086	6,047	5,288	5,903	5,736	5,291
Real GDP, yoy avg	5.4	3.8	-3.5	1.0	1.6	-1.5	2.5	-0.5	2.3
CPI, % avg	6.0	12.5	8.2	6.2	11.2	7.3	7.9	2.7	5.8
Policy Interest Rate, % eop	10.00	17.75	9.50	11.50	9.75	11.25	9.50	8.00	8.00
RSD/US$, avg	58.3	55.2	67.4	77.5	73.2	87.8	85.1	89.5	105.0
RSD/EUR, avg	80.0	81.4	94.0	102.9	102.0	112.9	113.1	116.7	122.3
Current account, US$bn	-6.9	-10.5	-2.9	-2.8	-4.0	-4.1	-2.1	-2.2	-2.2
% of GDP	-17.7	-21.9	-7.2	-7.6	-9.2	-10.9	-4.9	-5.3	-5.8
Consolidated gov. balance, % of GDP	-1.4	-2.0	-3.9	-3.9	-4.3	-7.2	-5.7	-6.5	-6.5

Source: National Sources, Citi Research forecasts

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Latin America

Argentina

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- **Summary view** — The scarcity of foreign currency continues to worsen and the next few months will probably be even more challenging. Meanwhile, the likelihood of a prolonged default has increased, despite the need for external financing, exacerbating the pressures on FX markets. We have downgraded our growth forecast for next year, while raising our FX and inflation forecasts.

- **Things to watch** — Keep a close eye on the external front, as the next months will be, in all likelihood, challenging. To prevent the situation from deteriorating further, the authorities should get some external financing, and curing the current default should be of big help for this.

- **Strategy** — We believe that the sticky inflation has pushed the government to maintain a slow pace of depreciation of the official FX rate. However, the government will eventually have to allow the peso to depreciate faster. We continue to have a bearish view on the country's credit.

As we were anticipating, the external front is getting complicated, as we enter into the dry months in terms of FX-flow seasonality. For instance, international reserves have already dropped USD1.5bn since July 24, when they reached a 6-month high, to USD28.2bn. And the drop in international reserves would have been larger if the payment on the foreign-law Discounts had not been blocked (the Bank of New York has USD0.5bn deposited at the Central Bank of Argentina (BCRA), which are part of gross reserves). Given the recent trend, we now see international reserves at USD25bn at the end of the year, compared to a previous forecast of USD26bn. The increased pressure on the FX front has also translated into a widening in the spread between the official and the blue chip exchange rates, with the latter now trading at around 14. The widening in the spread between the official and parallel exchange rates works against BCRA's international reserves as it: i) fuels devaluation expectations; and ii) reduces the incentives to sell foreign currency through the official FX market, while it encourages export under-invoicing and import over-invoicing and other illegal practices.

The drop in reserves has taken place despite the authorities' tightening of import controls. According to the Argentine Importers' Chamber, the BCRA already "owes" USD5bn on imports that have already been made, as per an article from El Cronista on September 15. Furthermore, other press reports suggest that some importers have been told to secure the needed FX in the Blue Chip market. In line with that, according to the same El Cronista article, the authorities would be analyzing delivering bonds to the importers so they can pay for their imports. This course of action, if taken, would result in importers covering their foreign currency needs at an FX rate equivalent to the blue chip swap market. We believe that this course of action would result in inflationary and recessionary pressures.

The gist of the matter

The authorities continue to show reluctance to addressing the underlying causes of the drain in reserves. For starters, the printing of ARS continued to assist the Treasury, and at an increasing pace. Year-to-date (as of September 5), the BCRA has transferred ARS68bn to the Treasury, an amount which represents 18.0% of the M0 at the beginning of the year. During the same period in 2013 the BCRA transferred 10% of the M0. This trend signals that money printing due to fiscal reasons will be super-strong in the seasonally challenging 4Q14 (in 2011-2013, 53% of the monetization of the deficit took place in the fourth quarter). As a result, we expect pressures to build on the FX front.

The authorities are also reluctant to allow interest rates to increase. This policy decision has two implications. On one hand, it reduces the sterilization of pesos by the BCRA via the issuance of short-terms notes (Lebacs) at a time of the year when it is particularly difficult to sterilize monetary injections. On the other hand, low interest rates, relative to the expected devaluation in the official FX market, reduce the demand for local currency assets, increasing the demand for assets denominated in foreign currency, and adding pressure on the FX markets.

Expectations of devaluation continue to mount. Not only has the default increased the demand for FX denominated assets but also the trade surplus is likely to be much narrower in 2015. After a large crop in 2014, the El Niño phenomenon could affect (negatively) the crop in 2015. Furthermore, soybean prices have declined sharply and today they stand nearly 20% below the average price observed during the 2014 harvest season. The negative terms of trade shock will have a significant impact on dollar availability in H1-2015 and, furthermore, will put additional negative pressure on economic activity.

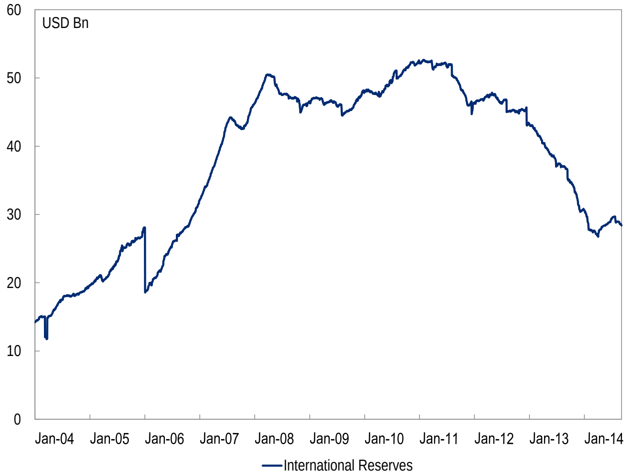
The authorities face difficult tradeoffs. In the current situation, with low levels of reserves, growing fiscal needs and very limited access to external financing, the authorities need to choose between raising the rate of depreciation in the official FX market, increasing FX controls and/or hiking interest rates. We believe the authorities will likely opt for a combination of all of them. If not, they will risk a liquidity crisis next year, when public debt payments in foreign currency increase significantly due to the maturity of the Boden 2015 in October. Yet, accelerating the rate of depreciation of the ARS in the official FX market will fuel inflationary pressures, while tightening monetary policy and increasing FX controls will add an extra layer of downward pressure on activity.

Argentina needs to restore some financial viability to its program or else the accumulating imbalances promise a very challenging 2015. Our forecasts, premised on the stated government intentions of no settlement with holdouts, reflect a negative spiral: further inflation acceleration and decline in activity. Based on the scenario described above, we have updated our main forecasts. On the FX front, we are increasing our forecast for the official USDARS for 2015. We now see the USDARS at 14 by the end of next year. For this year, however, we continue to expect the official USDARS to stand at 9.2 by yearend. We believe that the authorities will try to use the official FX rate as the main inflationary anchor, particularly as we get closer to December, when social tension tends to build up.

We are also revising our inflation forecasts, for both 2014 and 2015. We now see non-official annual inflation at 38% this year, up from 36% before. Monthly inflation has come above expectations despite the slow rate of depreciation of the peso in the official FX market in the last few months, as it continued to print in the 2.5-3% range. Regarding 2015, we now expect inflation to accelerate to 45%, mostly on the back of higher expected devaluation in the official FX market and the pressure of the parallel FX market. Were a new devaluation to take place in a disorderly manner, then inflation could spiral above our current forecast.

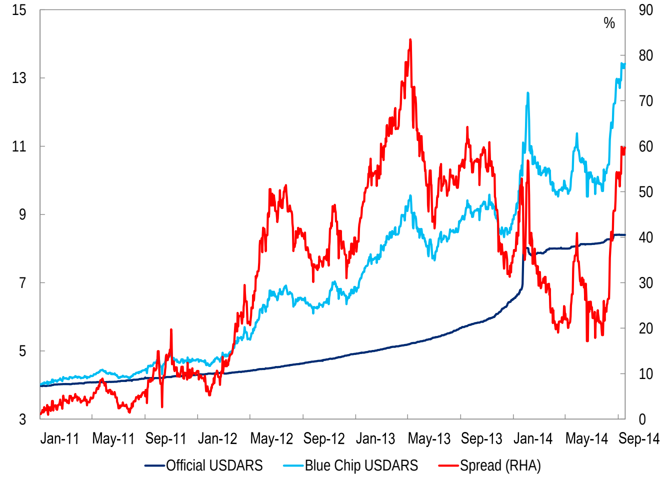
We have also downgraded our growth forecasts for next year. While we continue to expect negative 1.5% growth this year, absent a resolution to the default, we foresee an additional contraction in output next year. We expect real GDP to shrink 2% in 2015, compared to our previous call for 0% growth. The accumulating relative price tensions, rationing of FX and negative (devaluation) expectations, plus the expected worse terms of trade (and crop) are responsible for the downward revision.

Figure 214. International reserves have started to drop again



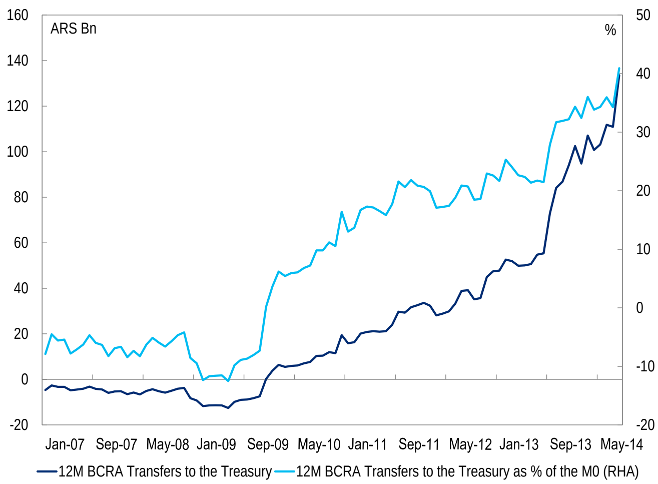
Source: BCRA and Citi Research

Figure 215. The parallel market's premia has been trending up



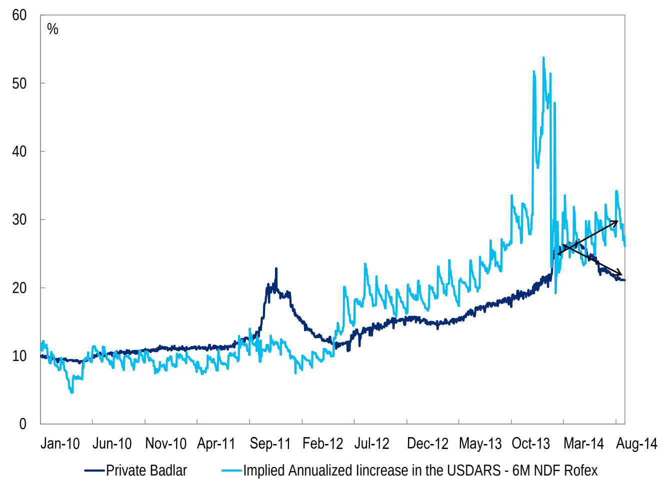
Source: Bloomberg and Citi Research

Figure 216. Fiscal money printing keeps soaring



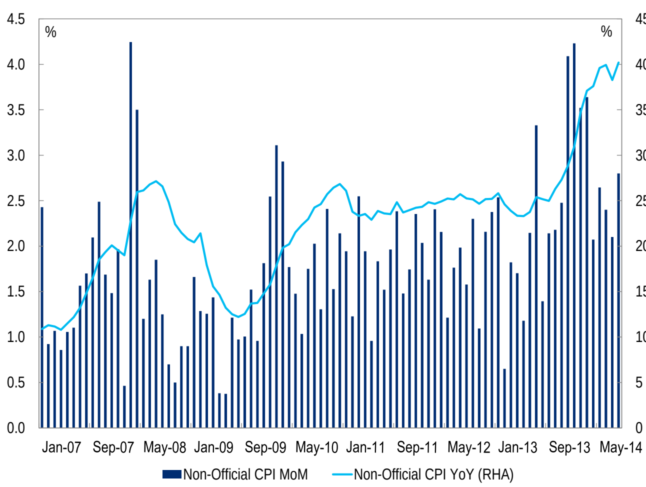
Source: BCRA and Citi Research

Figure 217. Interest rates look to low



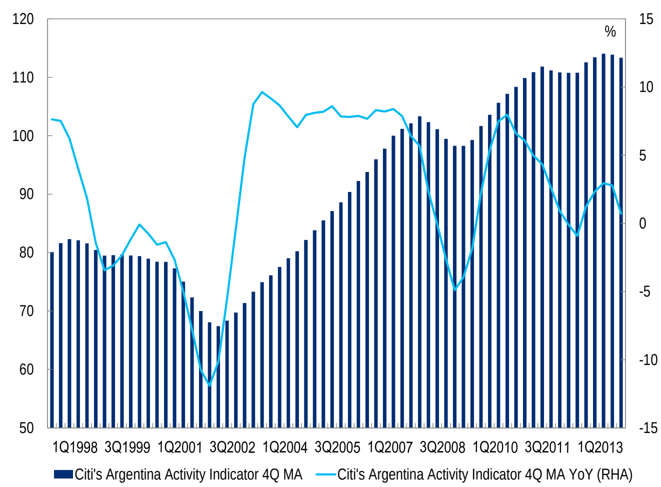
Source: Bloomberg and Citi Research

Figure 218. Inflation has not receded, despite…



Source: MyS and Citi Research

Figure 219. … activity has been shrinking



Source: Citi Research

Figure 220. Argentina Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	332	409	380	464	560	604	605	506	457
Nominal GDP, local currency bn	1,027	1,284	1,412	1,810	2,303	2,745	3,346	4,242	5,287
GDP per capita, USD	8,428	10,281	9,470	11,456	13,684	14,628	14,517	12,012	10,752
Population, mn	39.4	39.7	40.1	40.5	40.9	41.3	41.7	42.1	42.5
Unemployment, % of labour force	8.5	7.9	8.7	7.8	7.2	7.2	7.1	7.6	8.9
Economic Activity									
Real GDP, yoy avg (Citi estimates)	8.4	2.3	-3.9	7.5	5.0	-0.1	2.9	-1.5	-2.0
Real investment growth % yoy	16.3	6.2	-24.0	38.4	15.6	-11.5	1.5	-2.4	-5.9
Real consumption growth % yoy	8.9	5.5	4.1	7.2	10.5	4.5	4.5	0.2	-0.3
private consumption growth % yoy	9.0	5.6	3.5	7.1	10.8	4.2	4.3	-0.3	-0.8
Real export growth, % yoy	8.0	0.8	-8.7	14.4	4.9	-5.9	-3.8	-4.8	-2.5
Real import growth, % yoy	21.9	13.5	-19.3	35.0	19.8	-4.7	1.9	-5.1	-3.5
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	20.1	20.7	14.8	26.8	24.2	25.2	28.8	38.0	45.0
CPI, % yoy eop (reported)	8.5	7.2	7.7	10.9	9.5	10.8	10.9	26.3	37.0
Nominal wages, % yoy	20.3	22.4	20.0	21.7	27.5	27.1	24.7	29.8	32.0
Credit extension to private sector, % yoy	25.4	10.5	11.5	31.6	34.6	39.0	23.8	26.0	36.0
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	13.63	19.75	10.00	11.25	17.19	15.44	21.63	25.00	39.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	3.15	3.45	3.80	3.97	4.30	4.92	6.52	9.20	14.00
ARS/USD, avg	3.12	3.16	3.73	3.91	4.13	4.54	5.45	8.38	11.63
Balance of Payments, USD bn									
Current account	7.4	6.8	11.0	-0.8	-2.3	0.1	-4.3	-6.2	-5.3
% of GDP	2.2	1.7	2.9	-0.2	-0.4	0.0	-0.7	-1.2	-1.2
Trade balance	13.5	15.4	18.5	14.3	12.9	15.4	12.2	10.9	12.5
Exports	56.0	70.0	55.7	68.1	84.1	80.9	83.0	76.3	72.3
Imports	42.5	54.6	37.1	53.9	71.1	65.6	70.9	65.4	59.8
Service balance	-0.5	-1.3	-1.3	-1.2	-2.2	-3.4	-5.1	-4.1	-4.1
Income balance	-5.9	-7.6	-9.0	-13.5	-12.4	-11.5	-10.7	-12.3	-13.1
FDI, net	6.5	9.7	4.0	11.3	10.7	12.1	9.1	10.0	10.0
International reserves	46.2	46.4	48.0	52.2	46.4	43.3	30.6	25.0	17.5
Total amortisations	5.2	4.7	11.2	10.7	12.0	9.7	9.3	9.3	9.3
Public Finances, % of GDP									
Consolidated government balance	0.9	1.1	-0.5	0.2	-1.3	-2.0	-1.9	-3.7	-4.7
Consolidated gov primary balance	2.5	2.5	1.2	1.4	0.2	-0.2	-0.7	-2.0	-3.0
Public debt	43.6	35.7	38.7	35.4	32.0	31.7	31.3	37.4	46.1
of which Domestic	22.3	20.0	22.4	20.4	18.9	19.7	19.8	24.5	30.0
Foreign Assets & Liabilities, USD bn									
External debt	124.5	124.9	115.6	129.3	141.1	142.2	137.6	122.2	125.0
Public	70.8	64.4	61.8	69.5	73.2	72.0	70.1	65.0	73.3
External debt / GDP	37.5	30.6	30.4	27.9	25.2	23.5	22.7	24.2	27.4
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators									
	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	-0.5	-1.7	-1.6	-2.1	-1.8	-2.8	-2.3	-1.3	-0.1
CPI, % yoy	37.0	39.9	40.7	38.0	35.5	38.6	41.3	45.0	42.4
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	26.40	22.75	21.38	25.00	27.00	30.00	35.00	39.00	43.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	8.00	8.13	8.60	9.20	10.22	11.35	12.61	14.00	14.95

Source: National Sources, Citi Research

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- **Summary view** —We now expect Marina Silva to beat Dilma Rousseff in the second-round runoff, becoming the new president in 2015. Under this political assumption, the already published Silva's platform suggests the new government would implement more market friendly economic policies to restore the macroeconomic tripod: floating exchange rate, credible inflation targets and primary surplus. Provided this backdrop, and given the deeper contraction seen in 2Q14, we now expect GDP growth to reach 0.1% this year, accelerating next year to 1.0%. On the inflation front, we see CPI increasing 6.4% at 2014 year-end, rising next year to 6.8%. In light of this challenging inflation outlook, we see Copom hiking interest rate by 100bp in the first two meetings of 2015, giving leeway to reduce it back to 11% along 2H15.

- **Things to watch** — US economic data has been showing to be a relevant driver of domestic forward interest rates and exchange rate. On the domestic front, presidential election polls have been increasingly affecting domestic asset prices. Apart from that, domestic activity and inflation indicators keep playing an important role in fine tuning next steps for monetary policy.

- **Strategy** — Given our skepticism regarding domestic fundamentals, we continue seeing an opportunity in staying long USDBRL in the medium/long term. Basically, the absence of a significant fiscal adjustment points to weaker BRL ahead. On rates, the stagnant economy may cause the yield curve to price-in smaller increases for the Selic rate in 2015. Therefore, receiving the short end of the yield curve seems attractive in the near term.

We Now Expect Marina Silva to Become Next President

We now expect Marina Silva to win the second-round runoff presidential election. Since the death of Eduardo Campos and the replacement of his candidacy with Marina Silva, polls have been showing her as a significantly more competitive candidate ahead the presidential election. In particular, according to the last Datafolha poll (released on September 18), incumbent Dilma Rousseff would win the first round (on October 5) with 37% of votes, while Marina Silva would get 30% and Aécio Neves 17%. In the second-round runoff simulation, Silva would reverse the scenario beating Rousseff with 46% of votes against 44%. These results suggest that Silva has the highest likelihood of winning the presidential election in October when compared with the other candidates.

Rousseff's popularity and low rejection of Silva reinforce our view of opposition victory on October 26. Even after considering the recent increase in President Dilma popularity (evaluations excellent and good) to 37%, up from 32% at the beginning of free electoral campaign on TV, this current level seems insufficient to ensure her reelection. In particular, FHC was reelected with 43% of popularity in 1998, while Lula had 47% of approval in 2006. Apart from that, polls show Silva has a 22% rejection rate, compared with Rousseff's 33% negative image (according to Datafolha), supporting our call that her victory is the most likely outcome. All in all, we attribute 55% of probability for Silva being elected, while the incumbent president Rousseff has a 40% probability (for more details about our political outlook see Brazil Macro View, September 4, 2014) –and Aecio Neves has a 5% probability.

Sharper contraction in the 2Q14 leads us to estimate that GDP growth will reach 0.1% in 2014. 2Q14 GDP declined 0.6% QoQ, performing worse than expected. The frustrating result was broad based and was severely hurt by the performance of the industrial sector (-1.5% tQoQ) on the supply side and investment (-5.3% QoQ) on the demand side. Looking ahead, we see fundamentals pointing to no meaningful recovery in the 2H14. In particular, all confidence indicators have continued declining in the 3Q14 and reaching the lowest levels since 2009. Credit growth continues decelerating steadily, while labor market is showing increasing signs of weakening. Based on this evidence, we now forecast 2014 GDP growth to reach 0.1%, keeping us at the bearish side of Street (consensus at 0.3%).

For 2015, we expect GDP growth of 1.0%. Among the fundamentals mentioned previously, we believe that a hypothetical Silva's administration may improve confidence indicators faster than under Rousseff's reelection. Under this assumption and taking into account the potential monetary easing in 2H15, we see a stronger economic recovery next year, especially in the second half. Overall, we forecast GDP growth to stay in the range 0.2%–0.3% QoQ in 1H15, accelerating to 0.6%–0.8% QoQ in 2H15. This quarterly path implies a 2015 GDP growth of 1.0%.

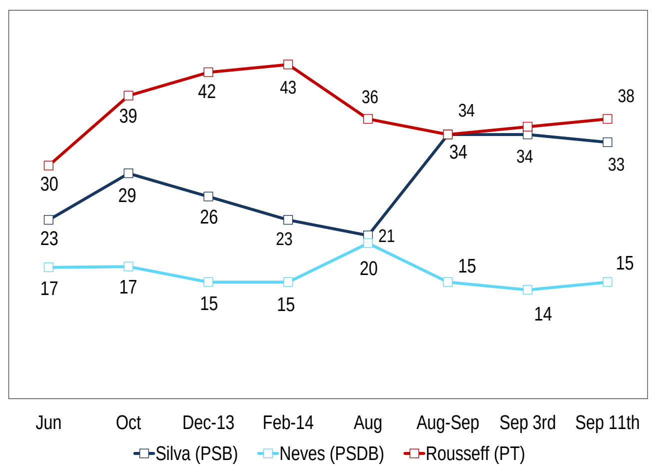
We now expect Copom to raise Selic rate in the 1Q15, bringing it back to 11% along the 2H15. In terms of monetary policy, we think that the Central Bank under Marina's administration, to show independence and signals higher aversion against inflation, will hike Selic by 100bps in the first two meetings of next year (50s bp in each). This hawkish action will likely happen even under low growth as described previously and a falling unregulated-prices' inflation. If we are right about our assumption on these prices, the CB will likely start an easing cycle in 2H15, cutting the policy rate by 25bps in each of next year's four last Copom meetings.

Benign food prices and the World Cup's end in the short term precede expected seasonal headwinds. Over the next months, we expect seasonality to prevail and the headline CPI inflation prints to notch up gradually to levels similar to the ones observed in 1H2014. Our 2014 year-end CPI inflation forecast is 6.4%. For 2015, we see an increase in headline inflation to 6.8% due to sharper offloads of pent-up monitored prices. The new economic team will likely have more room to allow monitored prices to adjust, as they always can blame the previous administration.

We see Silva's administration pursuing a tighter fiscal policy next year. Although the government still publicly claims to pursue a year-end consolidated public sector primary surplus of 1.9% of GDP for 2014, monthly fiscal results continue to disappoint. One-off revenues have not been enough to make up for poor recurrent revenues. Moreover, expenditures have accelerated, and we forecast a primary surplus of 1.0% of GDP at the end of 2014. In our view, upon winning the presidential election, we believe Silva will tighten the fiscal accounts next year, driving the primary surplus to 2.0% of the GDP in 2015.

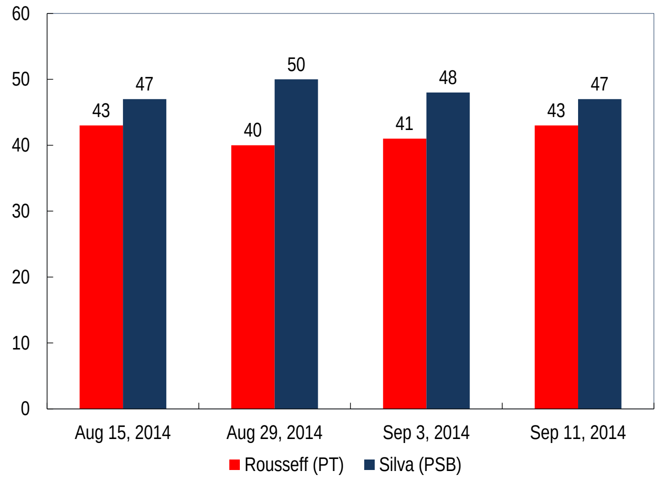
Our new domestic political scenario does not change our view of depreciating trend for BRL in the medium/long term. On the FX front, the level of current account deficit (3.7% of GDP) and the steady unwinding of US monetary policy stimuli will likely have a dominant role in depreciating BRL in the medium/long term. Therefore, we think Silva's potential election does not change the FX direction in the medium and long run. Thus, in our view, the 2014 year-end USD/BRL will hover around 2.37, and weaken to 2.58 by December 2015. Regarding FX interventions, we continue to believe CB will not alter the BRL trend, but rather smooth the transition towards a new equilibrium.

Figure 221. First round voting intention poll results



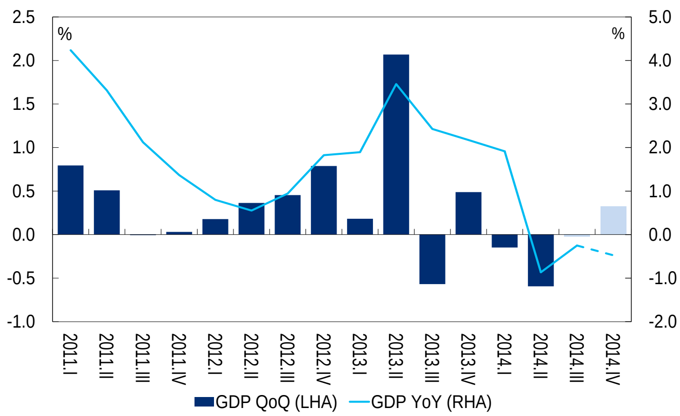
Source: Citi Research and Datafolha

Figure 222. Second round voting intention poll results



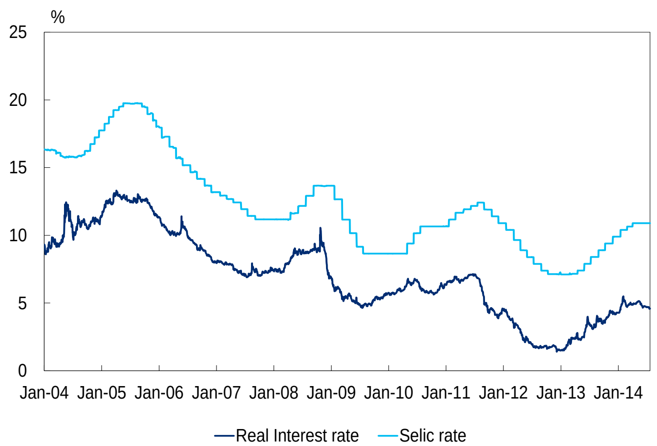
Source: Citi Research and Datafolha

Figure 223. We see no meaningful GDP recovery ahead



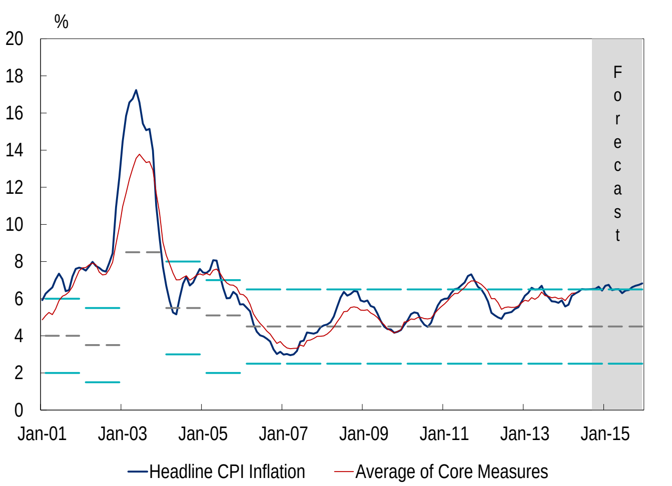
Source: Citi Research and IBGE

Figure 224. We expect Copom to keep Selic rate stable until 2014 year end



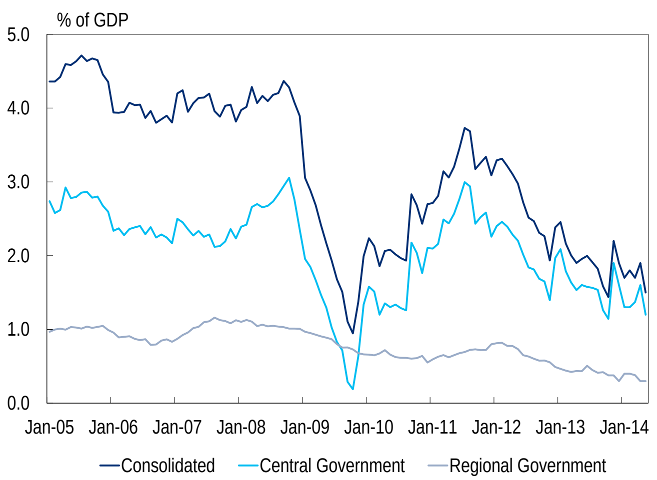
Source: Citi Research and BCB

Figure 225. CPI inflation will stay close to the upper limit of the target



Source: Citi Research, IBGE and BCB

Figure 226. The primary fiscal surplus continues below 2% of GDP



Source: Citi Research and BCB

Figure 227. Brazil Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,317	1,746	1,622	2,142	2,475	2,247	2,215	2,227	2,195
Nominal GDP, local currency bn	2,661	3,032	3,239	3,770	4,143	4,392	4,815	5,116	5,496
GDP per capita, USD	6,950	9,114	8,379	10,955	12,536	11,278	11,019	10,984	10,727
Population, mn	189.5	191.5	193.5	195.5	197.4	199.2	201.0	202.8	204.6
Unemployment, % of labour force	9.3	7.9	8.1	6.7	6.0	5.5	5.5	5.8	5.9
Economic Activity									
Real GDP, yoy avg (Citi estimates)	6.1	5.2	-0.3	7.5	2.7	1.0	2.5	0.1	1.0
Real investment growth % yoy	16.9	16.4	-16.0	33.4	4.0	-7.9	7.9	-6.7	2.4
Real consumption growth % yoy	5.8	5.1	4.1	6.3	3.6	3.2	2.4	1.5	0.8
private consumption growth % yoy	6.1	5.7	4.4	6.9	4.1	3.2	2.6	1.2	1.3
Real export growth, % yoy	6.2	0.5	-9.1	11.5	4.5	0.5	2.5	2.3	2.4
Real import growth, % yoy	19.9	15.4	-7.6	35.8	9.7	0.2	8.3	0.2	2.8
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	4.5	5.9	4.3	5.9	6.5	5.8	5.9	6.4	6.8
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	7.0	10.4	4.8	12.7	8.9	10.7	10.8	11.3	11.7
Credit extension to private sector, % yoy	-	30.9	15.1	20.6	18.8	16.4	14.7	11.7	14.1
Policy Rate (eop)	11.25	13.75	8.75	10.75	11.00	7.25	10.00	11.00	11.00
1 month inter-bank rate, %, eop	11.11	13.49	8.61	10.64	10.87	6.59	9.78	11.00	11.00
Long-term yield, %, eop	12.95	12.27	12.25	12.24	10.66	7.96	12.00	11.50	12.00
BRL/USD, eop	1.78	2.31	1.74	1.66	1.86	2.05	2.36	2.37	2.58
BRL/USD, avg	1.95	1.84	2.00	1.76	1.67	1.95	2.16	2.30	2.53
Balance of Payments, USD bn									
Current account	1.6	-28.2	-24.3	-47.3	-52.5	-54.2	-81.1	-81.9	-84.4
% of GDP	0.1	-1.6	-1.5	-2.2	-2.1	-2.4	-3.7	-3.7	-3.8
Trade balance	40.0	24.8	25.3	20.1	29.8	19.4	2.6	4.2	7.8
Exports	160.6	197.9	153.0	201.9	256.0	242.6	242.2	244.3	259.9
Imports	120.6	173.1	127.7	181.8	226.2	223.2	239.6	240.1	252.1
Service balance	-13.2	-16.7	-19.2	-30.8	-37.9	-41.0	-47.2	-50.9	-56.7
Income balance	-29.3	-40.6	-33.7	-39.5	-47.3	-35.4	-39.8	-37.9	-39.1
FDI, net	34.6	45.1	25.9	48.5	66.7	65.3	64.0	60.3	60.0
International reserves	180.3	193.8	238.5	288.6	352.0	373.1	375.8	380.5	380.5
Total amortisations	38.2	22.4	30.1	33.8	37.7	39.7	60.1	67.0	73.0
Public Finances, % of GDP									
Consolidated government balance	-2.8	-2.0	-3.3	-2.6	-2.6	-2.5	-3.3	-4.4	-3.6
Consolidated gov primary balance	3.8	3.9	2.0	2.7	3.1	2.4	1.9	1.0	2.0
Public debt	55.0	55.9	60.9	53.4	54.2	58.8	56.7	57.1	57.6
of which Domestic	50.9	51.2	57.5	50.5	51.5	55.9	53.8	54.2	54.6
Foreign Assets & Liabilities, USD bn									
External debt	193.6	198.3	198.2	256.8	298.2	312.9	322.8	318.6	312.0
Public	86.0	84.2	93.3	103.6	102.1	113.7	119.5	116.4	112.9
External debt / GDP	14.7	11.4	12.2	12.0	12.1	13.9	14.6	14.3	14.2
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	38.9	36.4	31.0	57.3	40.1	37.2	40.0	42.0	44.0
Short-term debt/International reserves (%)	21.6	18.8	13.0	19.9	11.4	10.0	10.6	11.0	11.6

Quarterly Economic Indicators	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	1.9	-0.9	-0.3	-0.5	-0.1	0.9	1.4	1.9	2.5
CPI, % yoy	5.6	6.3	6.5	6.4	6.5	6.3	6.6	6.8	6.6
Policy interest rate, %, eop	10.75	11.00	11.00	11.00	12.00	12.00	11.50	11.00	10.75
Short-term market rate, % eop	10.56	10.80	11.00	11.00	12.00	12.00	11.51	11.00	10.51
Long-term yield, %, eop	12.88	12.24	11.50	11.50	12.00	12.00	12.00	12.00	12.50
BRL/USD, eop	2.27	2.21	2.34	2.37	2.45	2.53	2.55	2.58	2.60

Source: National Sources, Citi Research

CCA

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- **Summary view** — The Dominican Republic is disputing Panama the position of the fastest growing country in the region. In the Dominican Republic, we see exports, tourism and remittances supporting growth. Panama has experienced a few headaches in its way towards more "normal" growth rates.
- **Things to watch** — Costa Rica is expected to send congress a proposal to transform the current sales tax into a value-added tax. El Salvador's electoral cycle is already at full steam, thereby potentially delaying some policy actions.
- **Strategy** — In the Dominican Republic, we expect the O/N rate to remain at 6.25% during 2014-15. By keeping the overnight rate at high levels, real deposit rates could remain in positive territory. It seems that when real deposit rates fall too much or move to negative territory, the local currency experiences more pressure.

Challenging the Pole Position

The Dominican Republic is disputing Panama the position as the fastest growing country in the region. For quite some time we got used to saying (and hearing) that Panama is the fastest growing country in the Caribbean and Central America (and sometimes even in Latin America). However, during 1H14 real GDP in the Dominican Republic increased 7.2% YoY, while in Panama grew 6.2% YoY. In the case of the Dominican Republic, this growth rate is also a result of the favorable base comparison, while in Panama the halt in works in the Panama Canal expansion pulled down growth. Our recently upgraded 2014 real GDP growth forecast in the Dominican Republic (6%) is not so different from that for Panama (6.2%).

In the Dominican Republic, we see exports, tourism and remittances supporting growth. The outlook of the country's two main trading partners (United States and Haiti[2]) remains benign and therefore it seems unlikely that exports could suffer a downturn in the next 1-1½ years. Gold exports have continued to grow, while tourism and inflows from remittances remain solid. The main source of tourism revenue and remittances is the United States and consequently it would be natural to expect that these sources of income will continue to grow.

Domestic demand has recovered in the Dominican Republic, but we think there is some uncertainty about its strength. After last year's tax reform and fiscal adjustment, domestic demand fell, but it began to recover after the Central Bank of the Dominican Republic (BCRD) loosened reserve requirements for the banking sector. This policy action translated into a jump in credit growth that has lent a hand to domestic demand. However, growth in loans could begin to slow. In our view, if credit growth were to slow, the BCRD would prefer to use reserve requirements (rather than the O/N rate) as its main policy tool. Besides the proved effectiveness of lowering reserve requirements, there are other factors that would prevent the BCRD from cutting the overnight (O/N) rate. These factors are the potential increase in interest rates in the United States in 2015 and the need to keep a tight grip on the FX market. That is why we expect the O/N rate to remain at 6.25% during 2014-15. By keeping the overnight rate at high levels, real deposit rates could remain in positive territory. It seems that when real deposit rates fall too much or move to negative territory, the local currency experiences more pressure.

[2] The International Monetary Fund (IMF) expects real GDP growth of 4% in 2014-15 in Haiti (world Economic Outlook Database, April 2014).

Panama has experienced a few headaches in its way towards more "normal" growth rates. For quite some time, we have been saying that growth in Panama is expected to moderate as the Panama Canal expansion gets closer to its conclusion. However, the temporary halt in works in the Panama Canal expansion, together with the fall in exports from the Colón Free Zone (ZLC), slowed down the economy in the first half of this year. The halt in works in the Panama Canal was solved a few months ago, but the ZLC continues to suffer from the FX restrictions in Venezuela. It is worth remembering that Venezuela is one of the major importers of ZLC's goods. The fall in ZLC's exports has affected trade accounts, but we cannot blame it for the high current account deficit. In our view, the main reason why the current account deficit is high is because of the capital accumulation the country is experiencing. As the rate of capital accumulation begins to slow, we would also expect the current account deficit to narrow.

In the case of Costa Rica and El Salvador, the main stories are not about growth, but rather about the fiscal accounts. In Costa Rica, the recently announced loss of the investment grade status has put the need for a fiscal adjustment back on the spotlight. Moody's downgraded Costa Rica's government bond rating to Ba1 from Baa3. At the same time it changed the outlook to stable from negative. Moody's said that the country's institutional weakness and inaction to address fiscal problems were behind the decision. According to Moody's communiqué, "material fiscal improvements are unlikely in the next one to two years", and also said that it expects "continued political obstacles to comprehensive fiscal reform" during the current administration.

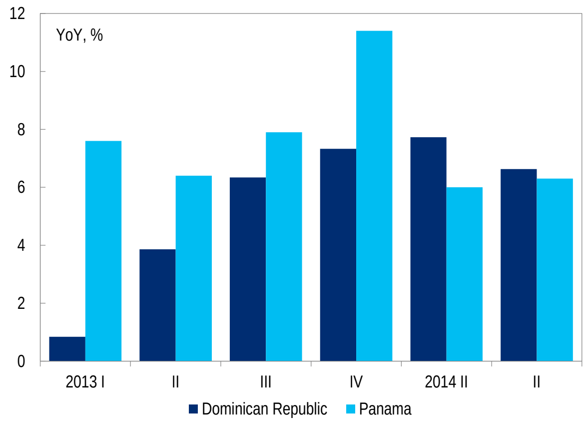
Costa Rica is expected to send congress a proposal to transform the current sales tax into a value-added tax.[3] This proposal would seek to raise around 1.2% of GDP in new taxes. In our view, this would be a first step in the right direction, but would certainly not be enough to put back the fiscal concerns behind us. From what we have seen in Congress, it may take a significant amount of time to the get the approval of such a kind of bill. The bill could arrive to Congress sometime before the end of the year.

In El Salvador, the fiscal deficit continues to narrow. According to our nominal GDP estimations, the 4-quarter rolling nonfinancial public sector (NFPS) deficit narrowed to 3.2% of GDP in 2Q14 from 4% of GDP in 4Q13. The improvement in the fiscal deficit during this period mainly stems from a decrease in primary expenditures. Tax revenues have decreased slightly during that period of time, but we would expect an increase in tax collection after the recent approval of the fiscal reform. The fiscal reform could collect new taxes of around 0.8% of GDP per year.

Attention in El Salvador is gradually moving away from fiscal topics to the country's electoral cycle. Next year (March 1), El Salvador will hold congressional and municipal elections, and although it may seem to still be far away, the cycle is already at full steam. In our view, the composition of Congress will most likely mimic the qualitative results of the previous presidential election, thereby showing that the country continues to be highly polarized. We think that any potential reform or any major policy actions will be postponed until the congressional election is behind us.

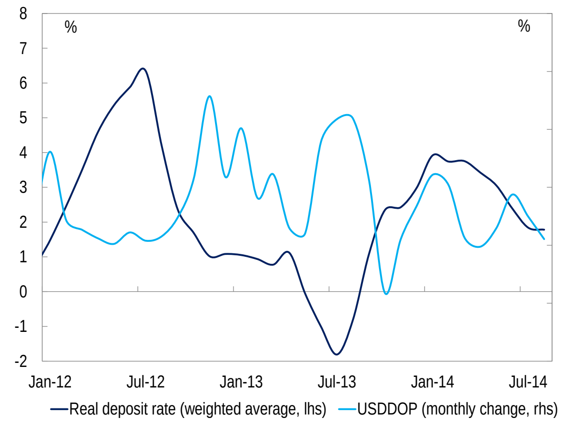
[3] Source: Bloomberg and WSJ (both on September 22, 2014)

Figure 228. DomRep & Panama : Real GDP growth



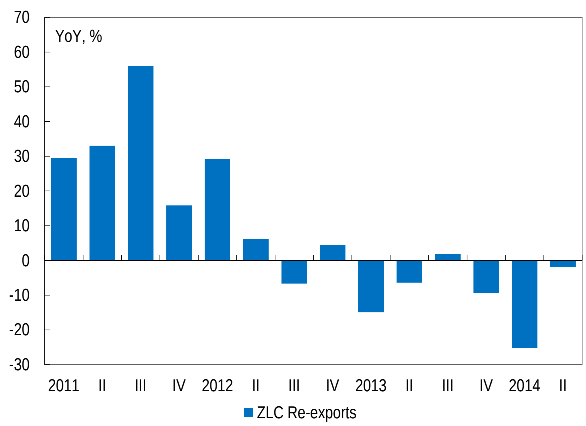
Source: BCRD, INEC (Contraloria), Haver and Citi Research

Figure 229. DomRep: Real deposit rates and FX volatility



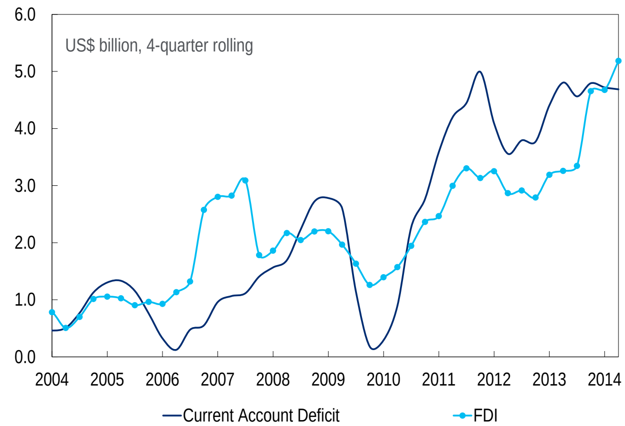
Source: BCRD, Haver and Citi Research

Figure 230. Panama: Colon Free Zone (ZLC) Re-exports



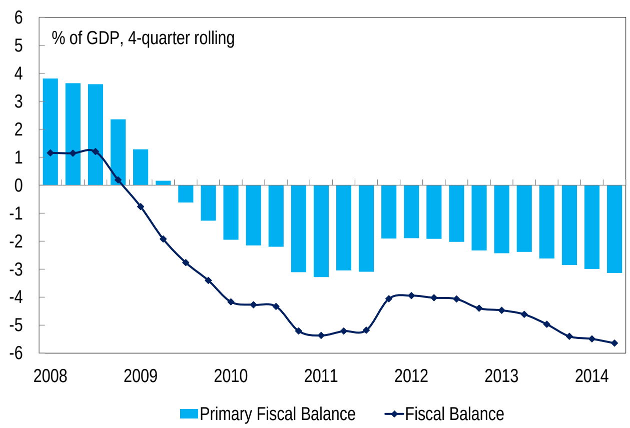
Source: INEC (Contraloria), Haver and Citi Research

Figure 231. Panama: FDI is higher than the current account deficit



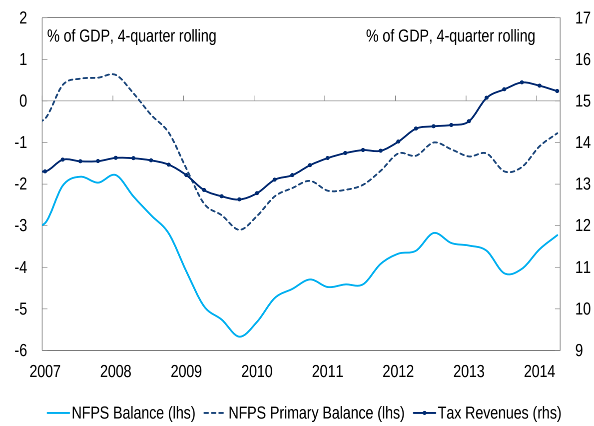
Source: INEC (Contraloria), Haver Citi Research

Figure 232. Costa Rica: Central government balance



Source: Hacienda, BCCR, Haver and Citi Research

Figure 233. El Salvador: Nonfinancial public sector (NFPS) deficit



Source: BCRES, Hacienda, Haver and Citi Research

Figure 234. CCA Economic Research Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Costa Rica									
Nominal GDP, USD bn	26.3	29.8	29.4	36.3	41.2	45.4	49.6	49.5	51.1
GDP per capita, USD	5,925	6,583	6,359	7,955	8,964	9,654	10,557	10,307	10,636
Real GDP, yoy avg	7.9	2.7	-1.0	5.0	4.5	5.1	3.5	3.1	2.2
CPI, % avg	9.4	13.4	7.8	5.7	4.9	4.5	5.2	4.8	5.0
CRC/US$, avg	517	525	570	521	502	503	501	541	562
Real GDP, yoy avg (Citi estimates)	496	560	555	504	506	513	501	550	570
Current account	-1.6	-2.8	-0.6	-1.3	-2.2	-2.4	-2.5	-3.2	-3.3
% of GDP	-6.3	-9.3	-2.0	-3.5	-5.3	-5.3	-5.1	-6.4	-6.5
Consolidated government balance	0.8	0.5	-3.9	-6.0	-5.6	-5.7	-6.5	-7.2	-7.7

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Dominican Republic									
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
GDP per capita, USD	4,708	5,053	4,967	5,454	5,816	5,909	5,955	6,261	6,590
Real GDP, yoy avg	8.5	3.1	0.9	8.3	2.9	2.7	4.6	6.0	4.5
CPI, % avg	6.1	10.6	1.4	6.3	8.5	3.7	4.8	3.3	3.8
Policy Interest Rate, % eop	7.00	9.50	4.00	5.00	6.75	5.00	6.25	6.25	6.25
DOP/US$, avg	32.8	34.4	35.9	36.8	38.0	39.2	41.7	43.4	44.7
DOP/US$, eop	33.0	35.4	36.2	37.4	38.7	40.4	42.7	44.0	45.5
Current account	-2.2	-4.5	-2.3	-4.0	-4.4	-4.0	-2.5	-2.4	-2.6
% of GDP	-4.9	-9.4	-4.8	-7.4	-7.5	-6.6	-4.0	-3.7	-3.8
Consolidated government balance	-1.7	-4.3	-4.8	-3.7	-3.8	-7.9	-4.1	-4.0	-4.0

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
El Salvador									
Nominal GDP, USD bn	20.1	21.4	20.7	21.4	23.1	23.8	24.3	25.2	26.3
GDP per capita, USD	3,500	3,705	3,548	3,653	3,919	4,006	4,043	4,192	4,385
Real GDP, yoy avg	3.8	1.3	-3.1	1.4	2.2	1.9	1.7	2.2	2.5
CPI, % avg	4.6	7.3	0.5	1.2	5.1	1.8	0.8	1.4	2.1
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
SVC/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.2	-1.5	-0.3	-0.6	-1.1	-1.3	-1.5	-1.6	-1.5
% of GDP	-6.1	-7.1	-1.5	-2.7	-4.6	-5.3	-6.2	-6.4	-5.7
Consolidated government balance	-1.9	-2.8	-5.5	-4.4	-4.0	-3.5	-4.2	-3.1	-3.0

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Panama									
Nominal GDP, USD bn	21.1	24.9	25.9	28.8	33.3	38.0	42.6	46.6	50.2
GDP per capita, USD	6,318	7,312	7,482	8,170	9,242	10,543	11,668	12,589	13,222
Real GDP, yoy avg	12.1	9.1	4.0	5.9	10.8	10.2	8.4	6.2	5.5
CPI, % avg	4.2	8.8	2.4	3.5	5.9	5.7	4.0	2.8	2.2
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
PAB/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-1.4	-2.7	-0.2	-2.8	-5.0	-3.8	-4.8	-4.2	-4.3
% of GDP	-6.7	-10.9	-0.7	-9.6	-15.0	-10.1	-11.3	-9.0	-8.6
Consolidated government balance	3.5	0.4	-1.0	-1.9	-2.2	-1.5	-3.0	-4.0	-3.0

Source: National Sources, Citi Research forecasts

Chile

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- **Summary view** — Confidence is heading downwards and the government's approval rates are falling sharply. We now expect real GDP growth to be 1.8% in 2014 and 3% in 2015, and we see the BCCh keeping rates at low levels for a long period of time.
- **Things to watch** — The current administration is gearing up for education reform, which is its most important political project. Also watch for macro assumptions in the 2015 budget.
- **Strategy** — The Central Bank of Chile's (BCCh) policy rate is at 3.25% and we expect another rate cut of 25bps in October. A further cut could be possible in November, but it is not part of our baseline scenario.

The Honeymoon (if any) is Over

It seems that confidence is heading downwards in Chile. In our view the combination of low commodity prices, the tax reform and weaker economic activity have undermined confidence in Chile. It is difficult to say how much each of these factors weighs, but certainly each one is laying an important role in the way expectations have been and would continue shaping up in the short-term.

The government's approval rate is falling sharply. During the last couple of months both President Michelle Bachelet's and the government's approval rates have begun to collapse. Currently they are at the lowest levels since this administration began its term (March). After only six months in office, it seems that the honeymoon (if any) is over. During the past two months, not only has economic activity slowed even further, but confidence among the population has also reached new lows. The monthly indicator of business confidence (IMCE) has gone to levels that are not too far away from those of the global crisis.

The current administration is gearing up for its most important political project, education reform, at a time when confidence and approval rates are plummeting. In our view, the tax reform was the first step towards education reform. President Bachelet has been an advocate of free college education, and this was one of her main campaign promises. Of course, now that resources for this reform have been secured, the government is reallocating its energy towards the modification of laws associated with education. Unfortunately for the government, it is heading to education reform at a time in which its popularity is weakening. It seems reasonable to expect that the government would have to use even more political capital to make progress in education reform.

In the meantime, there seems to be no other choice than downgrading our growth outlook. We now expect real GDP growth to be 1.8% in 2014 and 3% in 2015. Our previous forecasts (3% in 2014 and 4% in 2015) look too optimistic at this stage of the game. Besides the actual outcomes in economic activity, one of the main reasons we downgrade our growth outlook is precisely the aforementioned loss of confidence. We think this loss in confidence would take time to recover, thereby extending the fall in investment and slowdown in private consumption. The tax reform that was recently approved would also work against private consumption and investment.

Under a more bearish growth outlook, we would expect interest rates to remain low for a longer period of time. Currently, the Central Bank of Chile's (BCCh) policy rate is at 3.25% and we expect another rate cut of 25bps in October. A further cut could be possible in November, but it is not part of our baseline scenario. After this, we would expect the central bank to remain on hold for a long period of time. At some point we were expecting a moderate tightening cycle at the end of 2015. However, with our new growth outlook, we would expect the BCCh to keep its policy rate unchanged throughout 2015. This would allow the BCCh to have a zero or even negative real interest rate policy for a prolonged period of time, which is consistent with our call for below-trend growth for next year. We believe that, in this context, the BCCh is unlikely to be very sensitive to whatever happens with monetary policy in the United States. We think that the central bank is more concerned (regarding monetary policy matters) about China's business cycle than that of the U.S.

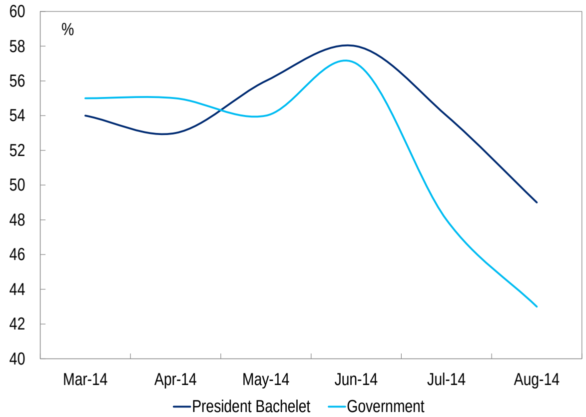
Labor markets are expected to weaken—otherwise rates could not stay at low levels. During this year, the unemployment rate has been slowly moving up—nonetheless, it remains at relatively low levels. At the same time, the rise in wages has been accelerating. We expect labor markets to begin showing more signs of weakness—namely, a further rise in the unemployment rate and a deceleration in wage growth. Usually, labor markets react with a little bit of lag. Our views on labor markets are key for our inflation outlook, which assumes inflation will slowdown and return within the BCCh's range in 1H15.

Dynamics in the trade balance would also allow the BCCh to keep interest rates at low levels. Imports are falling more than exports, thereby increasing the trade surplus, and preventing the current account deficit from widening. In our view, the current account deficit will remain at manageable levels. We must note however, that foreign direct investment is expected to fall.

Finally, the topic that will likely draw attention in the next few months is the 2015 budget proposal. The government is expected to send the 2015 budget no later than September 30. Fiscal accounts have been weakening as a result of lower mining revenues and higher primary expenditures. We have yet to see what the government's 2015 growth assumption will be. In our view, the government could increase expenditures to lend a hand to growth. What we already know is that the assumptions regarding trend GDP and the copper reference price will be 4.3% and USD3.07/lb, respectively.[4]

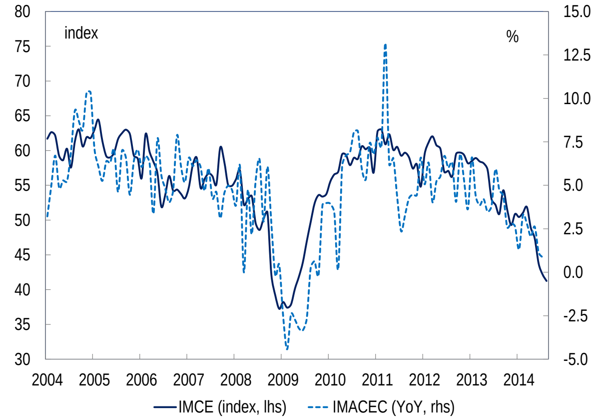
[4] Source: Bloomberg (September 8, 2014).

Figure 235. Approval rates began to plummet in July



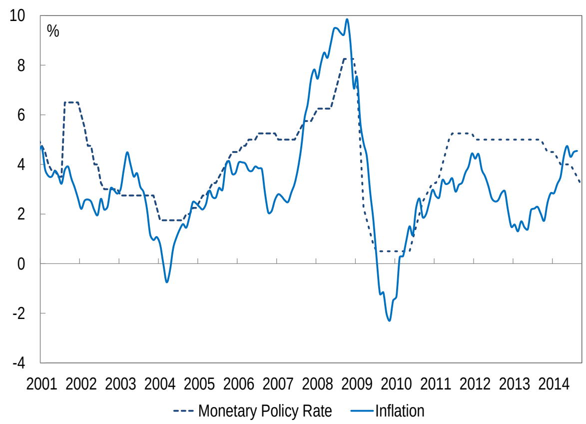
Source: GFK Adimar and Citi Research

Figure 236. Confidence is getting closer to crisis levels



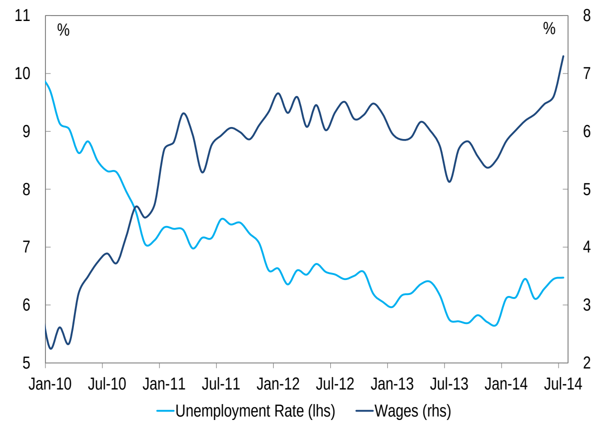
Source: ICARE, Haver and Citi Research

Figure 237. Real interest rates are flirting to come into negative territory



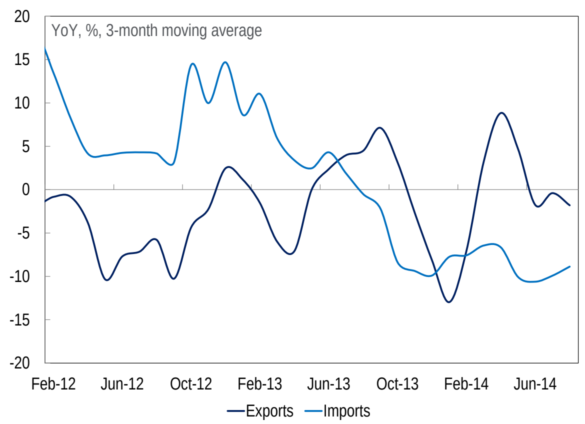
Source: BCCh, INE, Haver and Citi Research

Figure 238. Labor markets could begin showing more signs of weakness



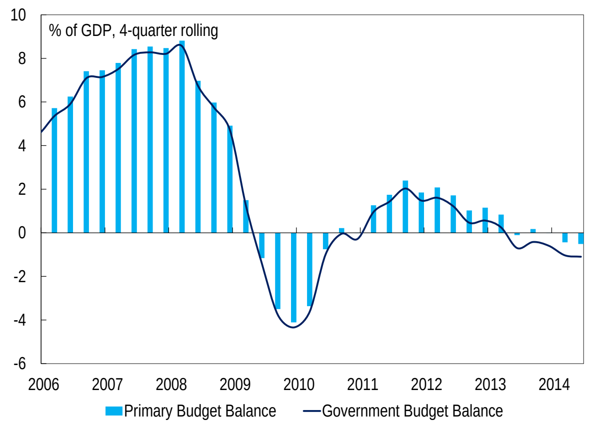
Source: INE, Haver and Citi Research

Figure 239. Imports are falling more than exports



Source: BCCh, Haver and Citi Research

Figure 240. The fiscal deficit is widening



Source: Hacienda, Haver, BCCh and Citi Research

Figure 241. Chile Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	173	183	173	218	251	267	277	253	247
Nominal GDP, local currency bn	90	94	96	111	121	130	137	144	153
GDP per capita, USD	10,414	10,876	10,199	12,861	14,639	15,398	15,863	14,306	13,840
Population, mn	16.6	16.8	17.0	17.0	17.1	17.3	17.5	17.7	17.8
Unemployment, % of labour force	7.1	7.8	10.8	8.2	7.1	6.4	5.9	6.4	7.2
Economic Activity									
Real GDP, yoy avg (Citi estimates)	5.2	3.3	-1.0	5.8	5.8	5.4	4.1	1.8	3.0
Real investment growth % yoy	6.4	20.8	-23.5	33.4	10.7	10.6	-3.7	-8.6	2.0
Real consumption growth % yoy	7.5	4.4	0.8	9.8	7.8	5.6	5.4	2.4	3.7
private consumption growth % yoy	7.6	5.2	-0.8	10.8	8.9	6.0	5.6	2.0	3.5
Real export growth, % yoy	7.2	-0.7	-4.5	2.3	5.5	1.1	4.3	1.1	2.6
Real import growth, % yoy	14.3	11.2	-16.2	25.9	15.6	5.0	2.2	-5.8	3.8
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	7.8	7.1	-1.5	3.0	4.4	1.5	2.9	4.4	3.0
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	7.1	8.5	5.8	3.5	5.8	6.3	5.8	6.0	4.9
Credit extension to private sector, % yoy	21.0	18.7	-1.4	7.1	16.9	12.1	9.7	5.2	6.5
Policy Rate (eop)	6.00	8.25	0.50	3.25	5.25	5.00	4.50	3.00	3.00
1 month inter-bank rate, %, eop	5.93	8.24	0.45	3.13	5.23	4.99	4.50	3.00	3.00
Long-term yield, %, eop	6.30	5.93	5.38	5.81	4.92	5.45	5.10	5.00	5.00
CLP/USD, eop	498	638	507	468	520	479	525	611	615
CLP/USD, avg	522	524	559	510	484	486	496	578	620
Balance of Payments, USD bn									
Current account	7.1	-5.8	3.5	3.6	-3.1	-9.1	-9.5	-5.1	-6.9
% of GDP	4.1	-3.2	2.0	1.6	-1.2	-3.4	-3.4	-2.0	-2.8
Trade balance	24.1	6.1	15.4	15.7	11.0	2.5	2.1	6.3	3.3
Exports	68.6	64.5	55.5	71.1	81.4	78.0	76.7	73.5	69.4
Imports	44.4	58.4	40.1	55.4	70.4	75.5	74.6	67.2	66.1
Service balance	-1.3	-1.2	-2.0	-1.9	-3.1	-2.3	-2.9	-1.7	-0.1
Income balance	-18.9	-13.6	-11.4	-14.7	-13.9	-11.5	-11.1	-11.7	-12.1
FDI, net	12.6	15.5	12.9	15.7	23.4	28.5	20.3	15.1	14.0
International reserves	16.9	23.2	25.4	27.9	42.0	41.6	41.1	37.5	40.0
Total amortisations	14.3	14.3	16.4	12.3	12.8	22.4	22.7	22.7	23.6
Public Finances, % of GDP									
Consolidated government balance	8.4	4.3	-4.3	-0.3	1.4	0.6	-0.6	-2.0	-1.6
Consolidated gov primary balance	9.0	4.8	-3.8	0.2	2.0	1.2	0.0	-1.4	-1.0
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	2.0	2.4	4.9	7.4	7.7	9.9	10.2	5.8	6.7
Foreign Assets & Liabilities, USD bn									
External debt	53.4	63.7	71.9	84.5	98.7	117.8	130.7	129.3	127.1
Public	4.0	3.3	4.0	5.6	7.1	7.9	7.5	7.3	7.4
External debt / GDP	30.8	34.9	41.5	38.7	39.3	44.2	47.1	51.2	51.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	9.0	14.0	15.8	16.2	19.6	22.8	21.9	19.6	19.1
Short-term debt/International reserves (%)	53.4	60.6	62.4	58.3	46.6	54.9	53.3	52.3	47.8

Quarterly Economic Indicators									
	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	2.4	1.9	0.9	2.0	2.2	2.9	3.4	3.3	3.3
CPI, % yoy	3.5	4.4	4.6	4.4	3.6	3.1	3.0	3.0	3.0
Policy interest rate, %, eop	4.00	4.00	3.25	3.00	3.00	3.00	3.00	3.00	3.25
Short-term market rate, % eop	4.00	4.00	3.25	3.00	3.00	3.00	3.00	3.00	3.25
Long-term yield, %, eop	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
CLP/USD, eop	549	552	600	611	619	626	620	615	610

Source: National Sources, Citi Research

Colombia

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- **Summary view** — Economic activity in the first half of the year depicts an economy that is being driven by domestic sectors such as construction, the financial sector, and retail. That being said, the country is also suffering from weak external demand with the expectations of external factors such as oil prices only raising questions about for how long can local activity continue to outperform. These questions are behind the pause we expect Banrep will decide in its monetary policy normalization process.

- **Things to watch** — Watch for the tax reform bill and the discussion that this proposal should have in Congress.

- **Strategy** — With the pause by Banrep already priced-in by the market, we believe the steepening or flattening of the local curve will depend on the reaction of US Treasuries. On the FX, although the observed speed of the recent COP depreciation was not expected, fundamentals always pointed toward a depreciated currency by year-end.

Economic Activity: Still warm but with chances of scattered showers

Although the 4.3% YoY GDP growth observed in the second quarter was in line with our expectation and somewhat below what the market forecasted, the composition of growth by sectors came with some surprises. In particular, the -2.2% YoY print of the oil and mining sector as well as the -1.4% YoY growth of manufacturing left a somewhat sweet and sour taste for the overall growth figure for the quarter. Oil and mining have not shown negative growth since 2007, and after a mild recovery in manufacturing in 1Q14 the sector went back to red in 2Q14. The retreat of oil and mining is of special interest as it represents the weak external demand the country is currently facing. On this regard, it is worth noting that although it looks like the current weakness has more to do with factors of a transitory nature (e.g. lower oil production due to attacks on pipelines), the results raise questions about the outlook for the Colombian oil sector going forward and the likelihood of increases in production which can compensate for the expected reduction in oil prices in the years ahead.

Although the second quarter was not as good as the first one, activity should continue to exhibit growth consistent with a 4.8% expansion for the year as a whole. We continue to expect construction, financial services, and retail to remain among the top performers of the year. On the other hand, we expect the industrial sector to continue underperforming (i.e., to grow below GDP). Regarding the expected behavior for the industrial sector, we see some moderate recovery this year, but mostly as a result of a low base of comparison. Also, we expect the construction sector to be the best performer; nonetheless we also acknowledge its performance is the major source of uncertainty, as during the past two years the construction sector and particularly civil works projects have shown significant volatility. While we think that most of the fundamental problems (corruption scandals, microeconomic bottlenecks, and coordination among ministries) have taken their toll on growth, we expect to see a significant improvement in the aggregate construction sector in 2014, mostly driven by private construction, spending at the regional level and ongoing civil works projects. Having said that, most of the impact of the civil works projects (currently known as fourth generation) is expected to materialize in the second half of 2015.

On the inflation front, so far this year we have observed upward surprises in most of the months. Most of the inflation surprise has to do with increases in foodstuffs, which last year were falling due to excellent weather conditions which translated in an abundant supply. Hence, as the situation has reversed this year, we have seen a normalization of foodstuff inflation. For 2014, we expect CPI to end at 3.3%. For 2015, the main risk for the inflation outlook in Colombia could be adverse weather shocks (e.g., an eventual El Niño phenomenon), but it is worth recalling that even if such an event materializes it will have effects of a transitory nature..

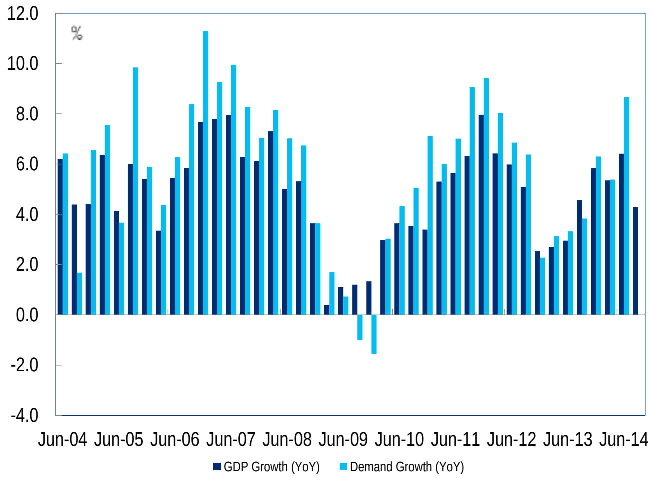
Monetary policy. Back in April the central bank decided to begin its policy normalization stating that it preferred to do a gradual adjustment rather than an abrupt one. Now, after the August meeting, Banrep has raised valid questions regarding the effect that weak external demand could have over domestic economic activity. As the governor of the central bank put it in a lunch with analysts recently, the problem when an economy is growing based solely on domestic factors is that it critically depends in the maintenance of confidence. In our view, the fact these questions can only be answered over time is part of the reasons why Banrep will pause at the current repo rate of 4.5% and it will keep this rate for the rest of the year. For us, this is a pause and not the end of the hiking cycle as we expect for the repo rate to reach 5% after 25bp increases in March and April of 2015. Going forward, it is worth mentioning that monetary policy will continue to be determined by the interaction of both activity and inflation and that the biggest threat to our call comes from inflation surprises that end up affecting inflation expectations.

Tax reform: pick your poison. The need to finance COP12.5 trillion of next year's budget, led the government to propose the extension for four years of both the financial transaction tax and the wealth tax but with a catch in the case of the latter. In this case the government decided to increase the tax rate on the wealth tax in a situation which has generated a movement against such proposal especially by corporates which have asked the government to consider alternatives such as VAT increases or even increases in the income tax. We believe in this case time is running against the government and this is the reason why it will stick to the proposal of extending both taxes but at the same time we expect a strong opposition in Congress from where the government could come out with the approval of this extension but only for one year instead of the four years originally proposed. If our expectations materialize, the government will have to present a detailed tax reform next year.

The TES market: Is it ALL about Treasuries? Throughout the quarter we saw the local TES curve continued to react favorably to offshore inflows originated by the rebalancing of the GBI index and the fact the government ended in August the auctions for the year, although recent movements stemming from the behavior of US treasuries triggered a sell-off. With the end of Banrep increases already priced-in by the market, the steepening or flattening of the curve will depend on the reaction of the long-end which seems to be following closely the behavior of US Treasuries these days.

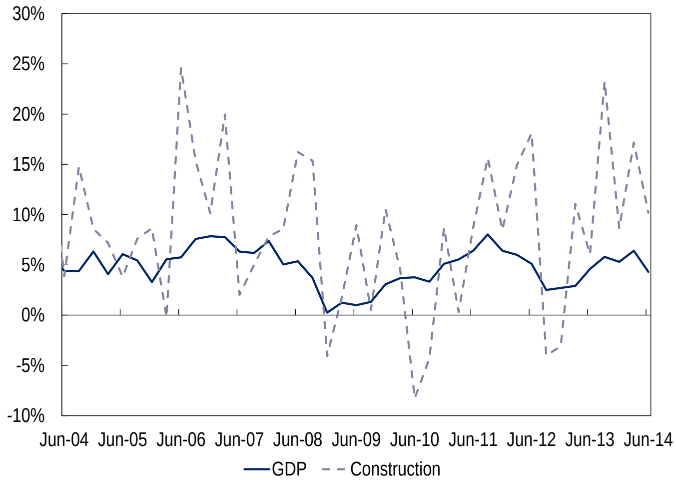
USDCOP: Too fast, too soon? In the FX front we finally saw some depreciation of the COP against the USD but the speed of the reaction took us by surprise. In particular we were always of the view that most of the flows associated to the GBI rebalancing were going to be over by the third quarter and that afterwards, fundamentals should begin to cause the COP to depreciate. Our in-house calculations continue to point towards an equilibrium exchange rate with corresponding nominal exchange rate between 1950 and 2050 so we expect for the USDCOP to end the year at 2,000.

Figure 242. Down to earth 2Q14 GDP growth



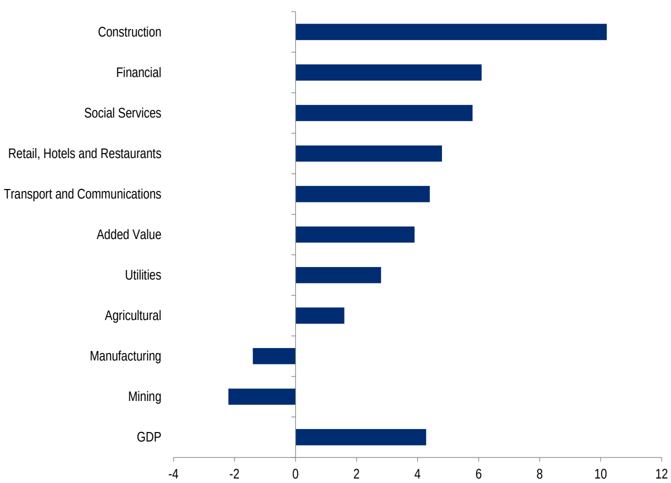
Source: Dane and Citi Research

Figure 243. The construction sector is the main source of uncertainty



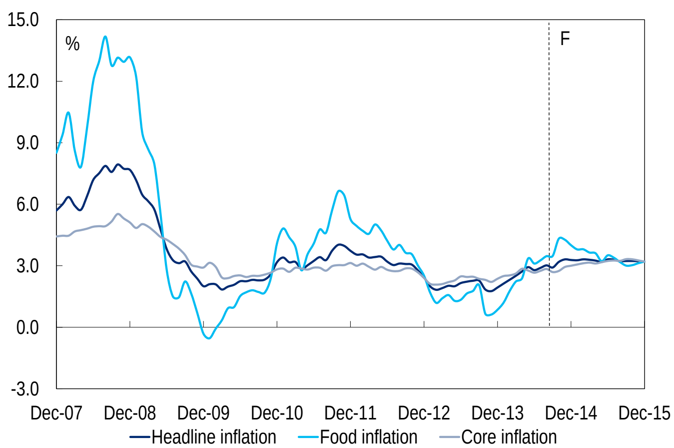
Source: Dane and Citi Research

Figure 244. Oil & Mining and Manufacturing posted negative growth



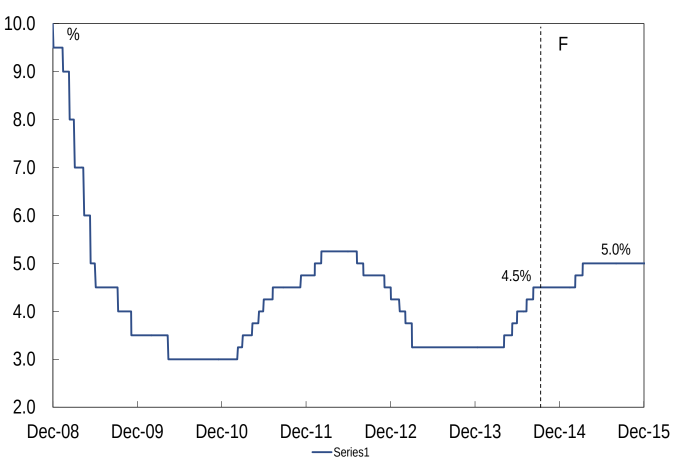
Source: Dane and Citi Research

Figure 245. Foodstuffs to remain as the main cause of inflation



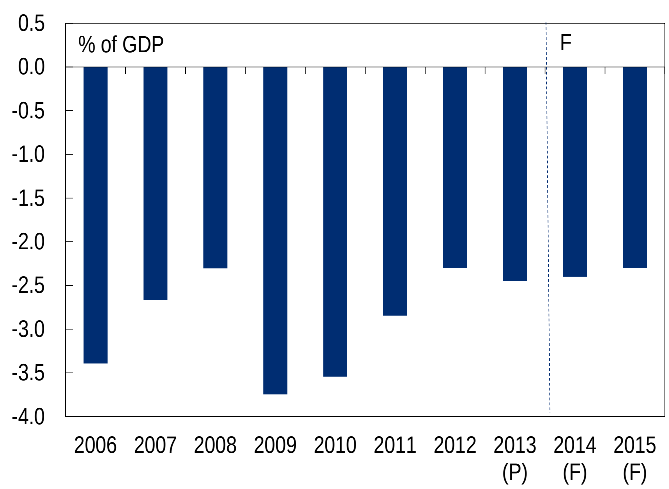
Source: Dane and Citi Research

Figure 246. We expect for Banrep to pause for the rest of the year



Source: Banrep and Citi Research

Figure 247. Central government deficit requires a tax reform



Source: Ministry of Finance and Citi Research

Figure 248. Colombia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	208	242	231	285	334	370	376	388	402
Nominal GDP, local currency bn	431	480	505	544	616	673	732	762	824
GDP per capita, USD	4,726	5,447	5,136	6,262	7,269	7,954	7,979	8,152	8,351
Population, mn	43.9	44.5	45.0	45.5	46.0	46.5	47.1	47.6	48.1
Unemployment, % of labour force	11.4	11.5	13.0	12.4	11.5	11.2	10.6	10.1	9.9
Economic Activity									
Real GDP, yoy avg (Citi estimates)	6.9	3.5	1.7	4.0	6.6	4.0	4.7	4.8	5.2
Real investment growth % yoy	12.8	9.0	-3.9	7.7	18.5	4.6	5.1	9.8	5.6
Real consumption growth % yoy	7.0	3.5	1.6	5.1	5.5	4.7	4.5	5.6	5.5
private consumption growth % yoy	7.3	3.5	0.6	5.0	6.0	4.4	4.2	5.4	5.5
Real export growth, % yoy	6.9	4.5	-2.8	1.3	11.8	6.1	5.4	2.0	4.5
Real import growth, % yoy	14.0	10.5	-9.1	10.8	21.5	8.9	4.5	9.3	4.6
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	5.7	7.7	2.0	3.2	3.7	2.4	1.9	3.3	3.2
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	5.4	19.1	3.0	4.1	4.2	4.3	4.4	4.5	4.6
Credit extension to private sector, % yoy	19.9	14.3	6.8	9.8	18.3	10.0	13.7	14.0	15.9
Policy Rate (eop)	9.50	9.50	3.50	3.00	4.75	4.25	3.25	4.50	5.00
1 month inter-bank rate, %, eop	9.35	8.87	3.10	3.00	4.81	4.27	3.30	4.52	5.02
Long-term yield, %, eop	10.27	12.76	8.47	7.70	7.60	5.86	6.75	7.32	7.82
COP/USD, eop	2,018	2,249	2,043	1,920	1,939	1,767	1,930	1,998	2,004
COP/USD, avg	2,076	1,968	2,154	1,898	1,848	1,798	1,869	1,958	1,986
Balance of Payments, USD bn									
Current account	-6.0	-6.9	-5.1	-8.9	-9.9	-11.8	-12.7	-14.4	-15.0
% of GDP	-2.9	-2.8	-2.2	-3.1	-2.9	-3.2	-3.4	-3.7	-3.7
Trade balance	-0.6	1.0	2.5	2.3	6.1	4.7	2.8	1.2	4.1
Exports	30.6	38.5	34.0	40.8	58.3	61.4	60.0	61.2	64.7
Imports	31.2	37.6	31.5	38.5	52.2	56.7	57.2	60.0	60.6
Service balance	-2.6	-3.1	-2.9	-3.7	-4.7	-5.5	-5.5	-8.7	-11.2
Income balance	-8.0	-10.2	-9.3	-12.0	-16.0	-15.7	-14.7	-11.9	-13.1
FDI, net	9.0	10.6	7.1	6.7	13.4	15.5	16.8	17.2	17.6
International reserves	20.9	24.0	25.4	28.5	32.3	37.5	43.6	47.2	50.8
Total amortisations	5.7	5.1	5.8	6.5	6.3	12.1	6.3	7.2	7.9
Public Finances, % of GDP									
Consolidated government balance	-0.6	-0.1	-2.7	-3.3	-2.9	0.3	-0.9	-1.6	-1.5
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	32.9	34.0	36.7	37.2	34.6	33.7	34.8	35.1	33.9
of which Domestic	21.9	22.6	24.9	26.3	24.3	23.6	25.6	25.0	23.9
Foreign Assets & Liabilities, USD bn									
External debt	44.6	46.4	53.7	64.1	75.9	78.8	91.9	95.8	99.7
Public	28.8	29.4	37.1	38.9	42.8	46.1	52.1	55.9	59.9
External debt / GDP	21.5	19.1	23.2	22.5	22.7	21.3	24.4	24.7	24.8
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	5.1	5.7	3.9	8.1	10.8	9.8	10.0	10.3	10.6
Short-term debt/International reserves (%)	24.6	23.5	15.6	28.3	33.4	26.2	22.8	21.8	20.8

Quarterly Economic Indicators									
	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	6.4	4.3	4.6	4.1	4.9	4.5	5.6	5.9	5.1
CPI, % yoy	2.5	2.9	2.9	3.3	3.3	3.2	3.2	3.2	3.2
Policy interest rate, %, eop	3.25	4.00	4.50	4.50	5.00	5.00	5.00	5.00	5.00
Short-term market rate, % eop	3.27	3.53	4.52	4.52	4.77	5.02	5.02	5.02	5.02
Long-term yield, %, eop	6.93	6.60	7.32	7.32	7.57	7.82	7.82	7.82	7.82
COP/USD, eop	1,972	1,880	1,985	1,998	1,983	1,971	1,988	2,004	2,020

Source: National Sources, Citi Research

Mexico

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- **Summary view —** As expected, economic activity rebounded strongly in 2Q14. Our GDP growth forecast for 2014 remains at 2.6% and at 3.9% for 2015. Annual inflation has exceeded 4%, but we think the rise is temporary and we continue to estimate that the monetary policy rate will be held constant at 3.0% until mid-2015.
- **Things to watch —** Congress will debate the budget for 2015; the proposal submitted by President Peña implies modest increases in public revenue and expenditure, and a marginal reduction in the deficit in comparison with the estimates for year-end 2014.
- **Strategy—** A stronger cyclical recovery story, coupled with low carry, has made the MXN one of the most resilient in EM August to date. We see USD/MXN at 13.3 over the 0-3m, and expect appreciation to 13.2 6-12 months out.

GDP recovery gained momentum in 2Q14

Activity rebounded in 2Q14, as we expected. GDP growth came in at 1.6%YoY in 2Q14, a slightly faster rate than our forecast of 1.5%YoY, and below 1Q14's 1.9%YoY. However, it should be noted that this annual result for 2Q14 was negatively affected by the Easter Week, as this implied fewer working days in April this year than in April 2013 (while favoring the annual result for 1Q14). Therefore, using the seasonally-adjusted series is more appropriate to assess the short-term dynamics. On this basis, the strong upswing in economic activity in 2Q14 was evident, with GDP up 4.2% SAAR versus 1.8% SAAR in 1Q14.

The main driver of this performance is external demand, although internal market is finally gaining momentum. The improved economic performance in the United States is boosting a sharp upswing in manufacturing exports, which grew at an average monthly rate of 0.7% in 2Q14, and accelerated to a monthly rate of 3.8% in July. Better prospects for external demand should maintain an uptrend in manufacturing exports and have a positive indirect effect on local demand, which in time should lead to some strengthening. Also, performance in the labor market reinforces this perception, as formal sector employment data show that its annual growth rate further improved in July-August, up 3.6%YoY. In fact, a faster recovery in local demand took place in 2Q14, as household consumption grew by 4.5% SAAR and investment increased by 9.1% SAAR. The evolution of these sources of demand will be the factors we will be tracking more closely in the coming quarter. However, we are confident that the U.S. economy will continue to work as the engine for economic recovery in Mexico in coming months. All in all, we reiterated our GDP growth forecast for 2014 and 2015 in 2.6% and 3.9% respectively. The economic rebound responds to several factors, mainly: 1) stronger US economic growth, in particular for manufacturing; 2) several determinants of consumption improved, above all job creation, which grew by 3.5%YOY in the formal sector in June versus 2.9% at the end of last year; 3) home construction, which faced severe deterioration from the second half of 2012, hitting a low at the end of 2013, began to improve gradually from then on; 4) investment, although it fell annually in the first half of 2014, grew strongly in quarterly terms in 2Q14. The influence of the strong rise in government spending, which first was registered in the fiscal figures but took time to be reflected in actual activity, now is becoming more evident according to national account figures.

Monetary policy will remain unchanged

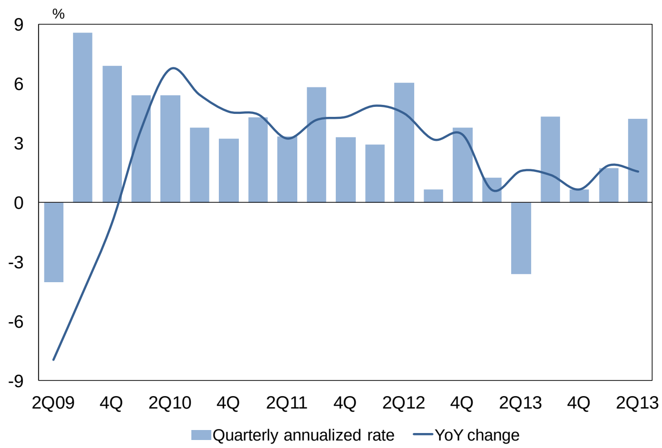
Despite greater economic dynamism, we estimate that the output gap will remain in negative territory for practically the whole of 2015. According to our estimates, the output gap should move into slightly negative territory throughout the year, which should help to keep inflationary pressures at bay. We think that the recent rebound in annual headline inflation (in August it reached 4.15%) is temporary, and related to a rebound in farm prices. We consider that from September to November this year annual inflation will hover close to the level it reached in August, until year end, when pressure from farm prices will fall, with headline inflation ending at around 3.9%, rather than the 3.8% we had anticipated. The upward effect that the new tax rate imposed at the beginning of 2014 had on the inflation will work in favor of a steep fall in the annual inflation at the beginning of 2015. We are therefore sticking to our forecast of 3.3% at year-end 2015. Meanwhile, an ongoing debate on revising minimum wage policy could lead to changes whose inflationary implications are not clear at this moment, but that already deserved a comment in the minute of Banxico´s September policy decision. Thus, while underlying inflationary trends are well anchored, attention to some structural aspects relevant for price formation will be required.

In this context, we reiterate our call of Banxico remaining on hold during the rest of the year. Banxico's Board decided to leave its reference rate at 3% at its meeting on September 5. In its communiqué it drew attention to the improvement in economic activity, while anticipating an increase in inflationary pressures. However, the Board considers that economic slack prevails, while inflationary pressures are temporary. In fact, we continue to believe that the main factor behind Banxico's stance now has more to do with how monetary conditions move in the industrial countries, especially in the United States. In this context, we reiterate our expectation that Banxico will stay on hold until mid-2015, with its funding rate remaining at its present 3.0%.

Mexico's Congress will focus on discussing the 2015 budget in the short term

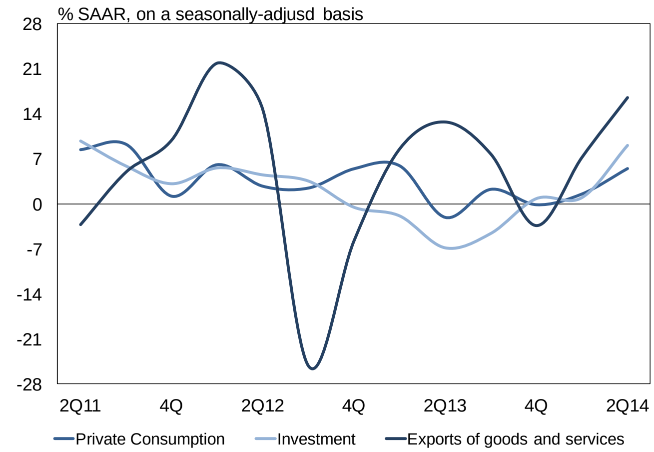
The first ordinary period of sessions of the 62nd Legislature opened on September 1st. As well as the summary of President Peña Nieto's Address, hearings with members of the Presidential cabinet and work on the economic package for 2015, the legislative agendas of the two largest opposition parties, the PAN and the PRD, will focus on bills about fighting corruption, state and municipal public debt, and rural reform. Moreover, during this legislative period, and as we already commented upon, the issue of raising the minimum wage will be debated alongside the decision to stop using minimum wages as a unit of account (to establish the payment of fines, for example). Independently of decisions on minimum-wage setting, de-indexation of items to the minimum wage makes sense, in our view.

Figure 249. GDP recovery accelerated in 2Q14, boosted mainly by ...



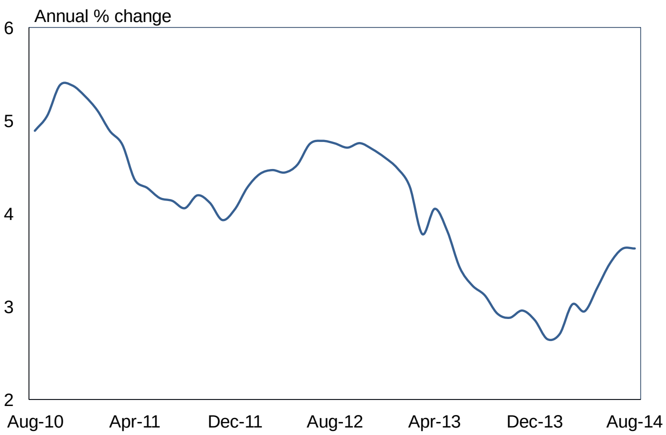
Sources: INEGI and Banamex

Figure 250. ... external demand, but local demand gains momentum



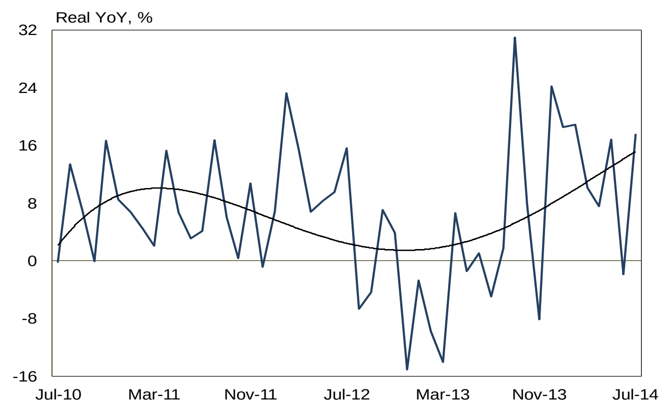
Sources: INEGI and Banamex

Figure 251. Formal sector job growth is on an positive path



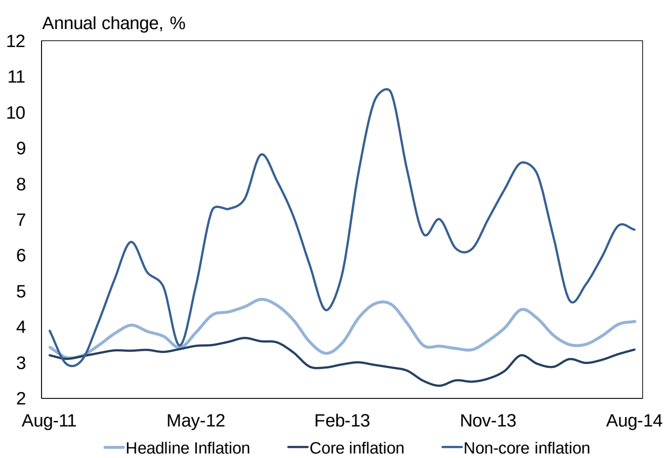
Sources: IMSS and Banamex

Figure 252. Government spending is increasing



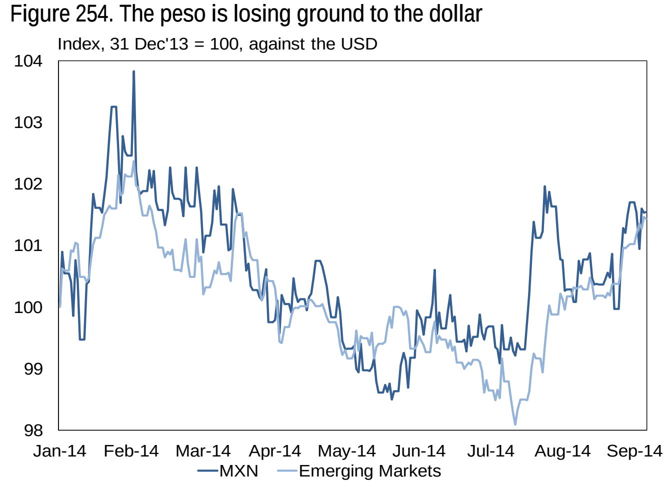
Sources: Ministry of Finance and Banamex

Figure 253. Non-core component has pushed Inflation up



Source: INEGI and Banamex

Figure 254. The peso is losing ground to the dollar



Sources: Bloomberg and Banamex.

Figure 255. Mexico Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	1,044	1,109	897	1,052	1,171	1,186	1,261	1,310	1,424
Nominal GDP, local currency bn	11,403	12,257	12,094	13,282	14,550	15,615	16,104	17,154	18,538
GDP per capita, USD	9,507	9,967	7,952	9,209	10,124	10,135	10,653	10,942	11,771
Population, mn	109.8	111.3	112.9	114.3	115.7	117.1	118.4	119.7	121.0
Unemployment, % of labour force	3.7	4.0	5.5	5.4	5.2	5.0	5.0	4.8	4.5
Economic Activity									
Real GDP, yoy avg (Citi estimates)	3.1	1.4	-4.7	5.1	4.0	4.0	1.1	2.6	3.9
Real investment growth % yoy	3.7	6.2	-13.3	4.5	5.4	5.5	-2.4	2.3	4.8
Real consumption growth % yoy	3.0	2.1	-5.2	5.1	4.5	4.6	2.3	2.3	3.3
private consumption growth % yoy	3.0	1.9	-6.5	5.7	4.8	4.9	2.5	2.3	3.6
Real export growth, % yoy	3.6	-1.3	-11.8	20.5	8.2	5.9	1.2	6.9	6.7
Real import growth, % yoy	5.9	4.4	-17.6	20.5	8.0	5.5	1.5	5.5	8.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.8	6.5	3.6	4.4	3.8	3.6	4.0	3.9	3.3
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	5.4	5.3	4.2	3.0	5.4	4.4	4.6	4.2	4.3
Credit extension to private sector, % yoy	12.0	9.6	0.6	5.6	7.4	6.8	6.7	8.5	9.8
Policy Rate (eop)	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.00	3.75
1 month inter-bank rate, %, eop	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.00	3.75
Long-term yield, %, eop	8.03	8.35	7.99	6.95	6.51	5.38	6.45	6.02	6.95
MXN/USD, eop	10.91	13.67	13.06	12.36	13.95	12.87	13.04	13.30	13.00
MXN/USD, avg	10.93	11.16	13.50	12.63	12.44	13.16	12.76	13.14	13.15
Balance of Payments, USD bn									
Current account	-14.7	-20.2	-8.3	-3.5	-12.3	-15.0	-26.5	-25.2	-27.4
% of GDP	-1.4	-1.8	-0.9	-0.3	-1.1	-1.3	-2.1	-1.9	-1.9
Trade balance	-10.1	-17.3	-4.7	-3.0	-1.4	0.0	-1.2	-0.6	-2.2
Exports	271.9	291.3	229.7	298.5	349.4	370.8	380.0	403.5	446.0
Imports	281.9	308.6	234.4	301.5	350.8	370.8	381.2	404.1	448.2
Service balance	-7.6	-8.2	-10.0	-9.9	-14.1	-14.0	-11.7	-12.6	-12.8
Income balance	-23.4	-20.2	-15.2	-12.1	-19.7	-23.6	-35.7	-35.0	-36.1
FDI, net	32.3	28.3	17.3	23.4	23.4	17.6	38.3	22.7	27.1
International reserves	78.0	85.4	90.8	113.6	142.5	163.5	176.5	198.0	211.6
Total amortisations	37.3	46.0	79.0	57.0	47.7	52.9	50.5	43.3	39.9
Public Finances, % of GDP									
Consolidated government balance	0.0	-0.1	-2.3	-2.8	-24.0	-2.6	-2.3	-3.6	-3.5
Consolidated gov primary balance	2.2	1.8	-0.1	-0.9	-0.6	-0.6	-0.4	-1.5	-1.3
Public debt	33.7	36.5	40.3	38.8	39.6	39.5	38.2	38.1	37.9
of which Domestic	22.1	24.8	26.8	24.0	23.9	18.9	17.8	18.3	18.8
Foreign Assets & Liabilities, USD bn									
External debt	196.2	204.7	194.4	260.0	298.0	367.7	413.3	433.5	449.0
Public	121.0	129.3	120.9	167.1	198.9	263.6	292.8	306.8	335.6
External debt / GDP	18.8	18.5	21.7	24.7	25.4	31.0	32.8	33.1	31.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	26.1	25.1	21.3	21.3	22.8	22.4	21.9	22.9	23.7
Short-term debt/International reserves (%)	33.4	29.4	23.5	18.8	16.0	13.7	12.4	11.5	11.2

Quarterly Economic Indicators									
	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	1.9	1.6	3.0	3.9	4.4	4.2	4.0	3.3	3.8
CPI, % yoy	3.8	3.8	4.3	3.9	3.4	3.8	3.5	3.3	3.4
Policy interest rate, %, eop	3.50	3.00	3.00	3.00	3.00	3.25	3.50	3.75	4.00
Short-term market rate, % eop	3.50	3.00	3.00	3.00	3.00	3.25	3.50	3.75	4.00
Long-term yield, %, eop	6.20	5.68	5.95	6.02	6.25	6.49	6.72	6.95	7.11
MXN/USD, eop	13.06	12.97	13.24	13.30	13.26	13.22	13.11	13.00	12.90

Source: National Sources, Citi Research

Peru

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- **Summary view** — Economic activity continued to perform poorly during July, although it showed some mild improvement after the observed weakness in June. With the government announcing a series of measures to boost investment and the central bank reducing 50bps its policy rate in the last quarter, the country is following the standard recipe to counteract an adverse economic environment. As we have mentioned before, the analysis of the balance of payments and the trade balance will continue to be the main variables to assess eventual vulnerabilities during 2014 and 2015.

- **Things to watch** — Inflation and the monthly economic activity will be important to assess the future evolution of monetary policy.

- **Strategy** — The relatively weak economic activity displayed during 2014 could take the BCRP to further reduce its policy rate going forward.

Economic activity

The economic activity index displayed a 1.2% YoY growth in July, a print below our own-in-house expectations (2.1%), taking economic annual growth during the first 7 months of the year to 3% and 12-month accumulated growth to 4.4%. According to the National Statistics Institute (INEI), core activities displayed a weak performance. According to the report mining fell 1.6% YoY, construction contracted 6% YoY, retail advanced a weak 4.2% YoY and manufacturing fell 5.7% YoY. Although we continue to expect Peru to be one of the best performing economies in the region, the recent results along with the change in the base of GDP (which imply an upward revision of 2013 growth to 5.8%) lead us to reduce once again our GDP growth forecast for the year as a whole to 3.5%, from 4%.

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

Nonetheless, a rebound in economic activity could be seen in 2015. Given our view that external factors will likely fail to boost growth in Peru, we believe it is important to look at the health of domestic drivers. Household consumption has been increasing recently and we expect these dynamics to continue throughout 2014 as credit conditions remain favorable, even despite the recent increases in non-performing loans. This is why we expect for GDP growth to be 4.9% next year.

Inflation and monetary policy

Inflation continued above the target-range in August. During 2014 inflation has systematically stood above the 1-3% target-range for most of the year, although the August inflation print surprised on the downside. Inflation has been mostly driven by supply shocks associated with foodstuffs and, thus, we expect inflation to gradually converge to the inflation target. Nonetheless, for the time being we keep our inflation forecast for 2014 at 3.1%, given the recent dynamics of consumer prices. This forecast still incorporates an important deceleration of core inflation during 4Q14, which should have a crucial importance on the evolution of monetary policy.

Monetary policy. In its last monthly meeting, the Central Bank of Peru (BCRP) decided to cut its reference rate by 25bps to 3.5%, as expected by the consensus and us. According to the communiqué, the Board considered that (i) inflation expectations continued to be anchored; (ii) The recent below-potential GDP growth is expected to be temporary; (iii) the external outlook continues displaying mixed signals; and (iv) supply-side inflation pressures seem to be receding. The Board mentioned that even after the August print, inflation is expected to continue above the upper bound of the inflation target range, given the effect of supply-side pressures mostly associated with foodstuffs. However, inflation is still expected to be within the target range by yearend and to converge to 2% in 2015. The BCRP highlighted that economic activity has shown weak results, mostly driven by lower dynamics in investment and exports. As in previous statements, the Board mentioned that it will be vigilant of the inflation outlook and its drivers to take further easing measures if necessary.

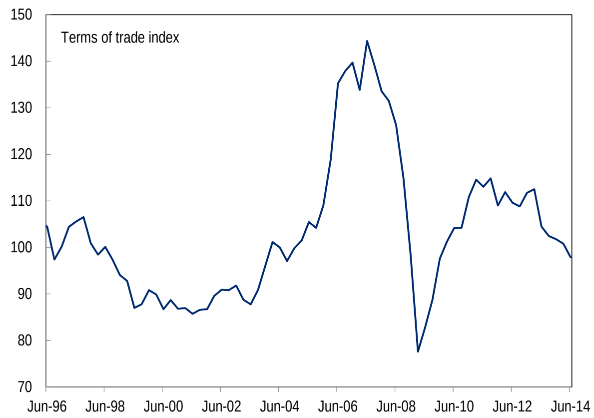
Waiting for the effects of fiscal and monetary policy. In our view, the reaction of both monetary and fiscal policy amid an environment of weakness in economic activity was the correct one, with the government announcing increases in government spending as well as reforms to improve investment and the central bank reducing its policy rate. Although the effects of fiscal policy should be felt first, due to the lag of monetary policy, we are optimistic about the reaction of the Peruvian economy to these measures and, hence, we expect for GDP growth to recover in 2015 to 4.9%. Having said that, we do not rule out one more reduction to the policy rate going forward if the economy continues underperforming and the inflation falls within the 1-3% inflation target range.

The Minister of Finance change: new name, same policies. By mid-September the market was surprised by the announcement that Luis Miguel Castilla, the longest running Minister of President Ollanta Humala's cabinet, was stepping down for personal reasons. In his replacement, President Humala appointed Alonso Segura, former Chief of Staff of the Ministry of Finance and right hand of Mr. Castilla. We believe this change does not imply a change in the policies Peru has been following but, on the contrary, the appointment of Mr. Segura guarantees the continuation of sound fiscal policies.

External sector

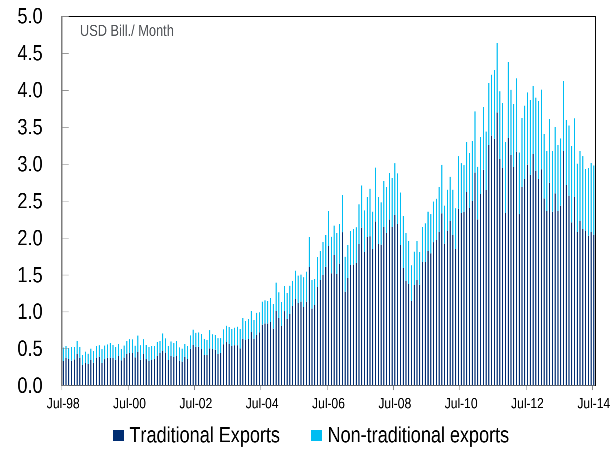
Balance of payments. During 2013, the current account deficit stood at 4.8% of GDP, increasing 1.6 percentage points versus the previous year. This increase in the current account deficit was mostly driven by the deterioration of the trade balance, a situation we anticipate to continue this year. This month we have marginally revised our forecasts and we now expect the current account to further deteriorate and post a 5.7% of GDP deficit this year, on the back of stagnant exports and lower commodity prices. For the time being, the current account deficit continues to be financed by foreign direct investment inflows, something that has led to significant increases in international reserves. Nonetheless, we expect a slower reserves accumulation moving forward.

Figure 256. Terms of trade dynamics…



Source: Bloomberg and Citi Research

Figure 257. Could translate into weaker traditional exports…

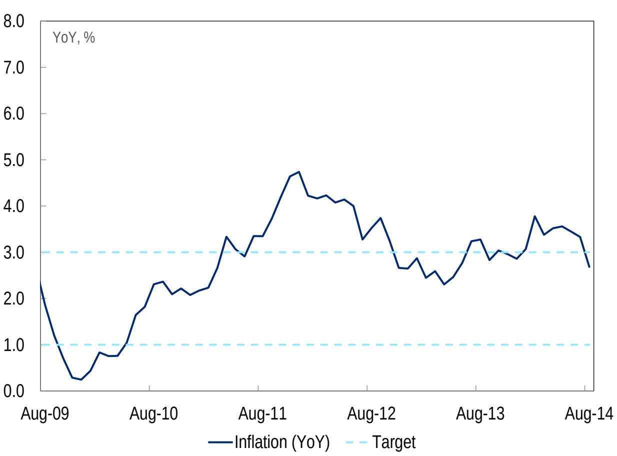


Source: BCRP and Citi Research

Figure 258. And a weaker exchange rate

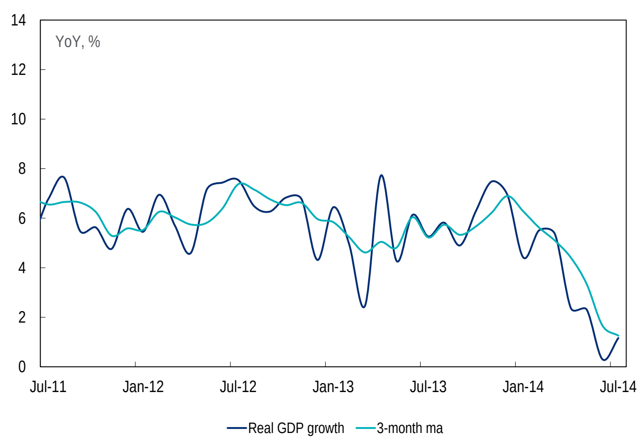
Source: Bloomberg and Citi Research

Figure 259. Inflation dynamics



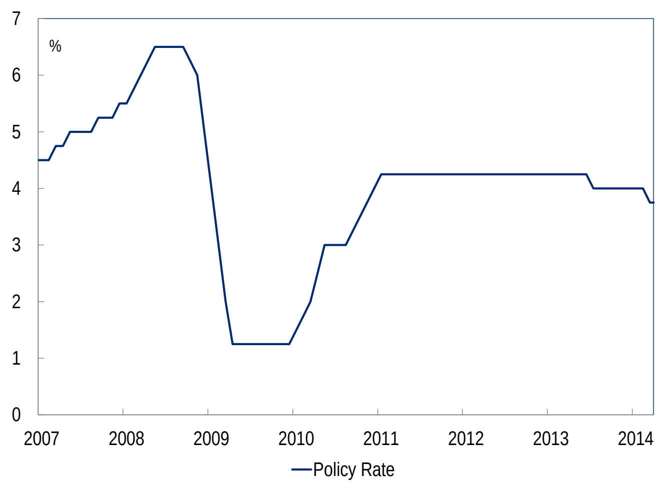
Source: BCRP, Haver and Citi Research

Figure 260. GDP Dynamics



Source: INEI, Haver and Citi Research

Figure 261. The latest BCRP's communiqué came with a dovish tone



Source: BCRP, Haver and Citi Research

Figure 262. Peru Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	107	127	127	153	176	199	208	207	224
Nominal GDP, local currency bn	336	371	382	435	486	526	563	584	628
GDP per capita, USD	3,906	4,562	4,482	5,344	6,033	6,712	6,909	6,768	7,230
Population, mn	27.4	27.8	28.3	28.7	29.2	29.7	30.1	30.6	31.0
Unemployment, % of labour force	8.4	8.4	8.4	7.9	7.7	6.8	5.9	6.0	5.9
Economic Activity									
Real GDP, yoy avg (Citi estimates)	8.5	9.1	1.0	8.5	6.5	6.0	5.8	3.5	4.9
Real investment growth % yoy	31.3	29.4	-22.9	38.8	12.9	12.3	10.5	0.1	3.5
Real consumption growth % yoy	8.0	8.6	4.1	8.2	5.8	6.4	5.5	4.7	5.1
private consumption growth % yoy	8.6	8.9	2.8	8.7	6.0	6.1	5.3	4.4	5.0
Real export growth, % yoy	4.3	7.1	-0.7	1.3	6.9	3.7	-0.9	0.5	4.0
Real import growth, % yoy	20.2	24.1	-16.7	26.1	11.6	11.3	3.6	0.1	3.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.9	6.7	0.2	2.1	4.7	2.6	2.9	3.1	2.5
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	5.0	12.8	23.1	-8.8	15.1	5.4	5.0	5.0	0.0
Credit extension to private sector, % yoy	29.9	14.3	10.4	20.1	14.2	13.8	12.4	11.0	12.0
Policy Rate (eop)	5.00	6.50	1.25	3.00	4.25	4.25	4.00	3.50	3.50
1 month inter-bank rate, %, eop	5.51	6.68	1.28	3.20	4.17	4.22	4.58	4.00	4.00
Long-term yield, %, eop	6.44	7.69	6.31	6.34	6.16	4.24	6.16	5.30	5.00
PEN/USD, eop	3.00	3.13	2.89	2.81	2.70	2.55	2.80	2.90	2.80
PEN/USD, avg	3.13	2.92	3.01	2.82	2.75	2.64	2.70	2.82	2.80
Balance of Payments, USD bn									
Current account	1.5	-5.3	-0.6	-3.5	-3.2	-6.3	-9.1	-11.8	-11.7
% of GDP	1.4	-4.2	-0.5	-2.3	-1.8	-3.2	-4.4	-5.7	-5.2
Trade balance	8.5	2.6	6.1	7.0	9.2	5.2	0.0	-2.7	-2.4
Exports	28.1	31.0	27.1	35.8	46.4	46.4	42.2	37.0	38.8
Imports	19.6	28.4	21.0	28.8	37.2	41.1	42.2	39.7	41.2
Service balance	-1.2	-2.1	-1.2	-2.4	-2.2	-2.4	-1.8	-1.8	-1.9
Income balance	-8.3	-8.7	-8.4	-11.2	-13.4	-12.4	-10.6	-10.8	-11.0
FDI, net	5.5	6.9	6.4	8.5	7.7	11.9	9.3	10.0	9.6
International reserves	27.7	31.2	33.1	44.1	48.8	64.0	65.7	66.6	69.1
Total amortisations	6.8	3.3	2.2	4.1	1.4	4.0	4.2	4.1	4.1
Public Finances, % of GDP									
Consolidated government balance	2.6	2.3	-1.6	-0.3	1.8	1.9	12.5	9.0	9.0
Consolidated gov primary balance	4.4	3.8	-0.3	0.8	2.9	3.0	13.5	10.1	10.0
Public debt	29.8	24.1	27.2	23.5	21.8	19.9	17.4	17.4	17.0
of which Domestic	11.1	9.0	10.9	10.5	10.3	10.3	8.9	8.9	8.7
Foreign Assets & Liabilities, USD bn									
External debt	31.8	34.0	35.5	40.6	44.0	51.9	54.3	52.7	53.6
Public	20.1	19.2	20.6	19.9	20.2	19.0	17.5	17.5	17.9
External debt / GDP	29.8	26.8	28.0	26.4	25.0	26.1	26.1	25.4	23.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	20.6	19.5	20.1	22.9	24.2	26.5	24.0	24.1	25.2
Short-term debt/International reserves (%)	74.2	62.5	60.7	52.0	49.6	41.3	36.6	36.2	36.5

Quarterly Economic Indicators									
	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	5.1	1.7	3.7	3.8	4.8	5.1	4.9	4.9	5.5
CPI, % yoy	3.4	3.4	2.9	3.1	2.3	2.2	2.3	2.6	2.3
Policy interest rate, %, eop	4.00	4.00	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Short-term market rate, % eop	5.08	4.99	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Long-term yield, %, eop	6.30	5.70	5.30	5.30	5.70	5.70	5.70	5.70	5.70
PEN/USD, eop	2.81	2.80	2.83	2.90	2.90	2.90	2.90	2.90	2.90

Source: National Sources, Citi Research

Venezuela

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- **Summary view** — The Venezuelan economy continues exhibiting negative growth and high inflation. The latest inflation data released by the central bank shows inflation at 63.4% in August and although GDP growth data has not been provided throughout the year at this point it is clear the economy is in a recession. The low availability of US dollars continues and this is the factor affecting the most normal operations in the country. Against this backdrop the government has not made announcements aimed at boosting economic activity or reducing inflation but instead decided to rebalance its cabinet with the most important adjustment consisting on changing Rafael Ramirez from Minister of Oil and Energy to Minister of Foreign Relations. Indicators of external liquidity continue to weaken as international reserves and balances at the special funds are both trending down in an environment where an important debt amortization (USD4.8 billion) from both the sovereign and PDVSA is about to take place early in October. The growing macroeconomic imbalances amid an environment of low external liquidity, and the fact the government is not acting in order to improve economic conditions, signal a situation where the country will continue trending down in terms of activity and up in terms of inflation.

- **Things to watch** — Watch for ratings agencies Fitch and Moodys which could follow Standard & Poors decision of downgrading the country's rating and putting it in negative watch.

- **Strategy** — Amid an environment where activity is weak, inflation is high, external liquidity is low, and the government has postponed any announcements aimed at improving the situation, the outlook for this credit is negative.

Economic outlook: Stagflation

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

Unfortunately, delays in the publication of both activity and inflation data are fueling the uncertainty about the behavior of the economy. Recently the central bank released some inflation data for the months of June, July and August, showing inflation at 63.4%. Having said that, the data by groups was only released for the month of August and the scarcity index, which measures the percentage of the CPI basket currently unavailable has not been updated since March. Adding to the uncertainty is the fact that economic activity data has not been provided throughout the year and even the last print known, which corresponds to 4Q13 was only released at the aggregate level, with growth by sectors and balance of payments data only available until 3Q13. The fact the data is not being released on a regular basis is raising questions about the behavior of inflation and activity.

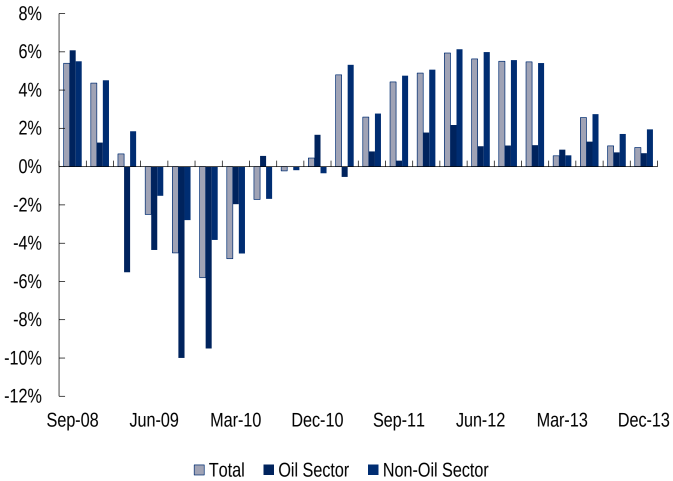
We continue to expect annual inflation to reach 75% by yearend, as we do not foresee a reduction on scarcity and we now see evidence of a wage spiral. Using data from the Ministry of Finance we can now say that most of the growth on fiscal spending has to do with increases in expenditures associated with government payrolls. This fact can be interpreted as evidence of increasing wage's indexation, a factor that leads to higher inflation persistency.

Imports' restrictions continue as the main tool used to manage the overall reduction on USD availability. According to the National Statistics Institute, between January and June, imports by the private sector represented USD10.2 billion which represents a reduction of 32% when compared to the same period a year ago when imports were USD15 billion. A simple extrapolation shows that if this trend continues, by year-end the reduction in imports could be close to USD10 billion, which explains most of the weakness in economic activity. Along with these results for the private sector, imports by the public sector have not increased, as the data show that in the first half of the year the government imported USD7.1 billion which is practically unchanged compared with the USD7.2 billion imported by the government in 1H13. Normally, the reduction in imports could be considered as an adjustment tool but in our view this only works if the country uses the "savings" stemming from this restriction to fix the balance of payments misalignments, in other words, to improve the level of international reserves or funds available at special funds, a situation that is not happening as both international reserves and balances at special funds have been falling throughout the year.

A lot has been said about changes to the FX system, and although clearly needed, the government has abstained from announcing any changes. Nevertheless, we believe the adjustment is inevitable and the 6.3 exchange rate will be eliminated with only the SICAD I and SICAD II rates being left. With this fix, which could be announced before yearend of early in 2015, the government will be able to buy some time specially when thinking about 2015, when elections for the National Assembly are expected to take place. We think that the initial rates that will be in pace should be the 11-12 exchange rate for SICAD I and the 50 exchange rate for the SICAD II.

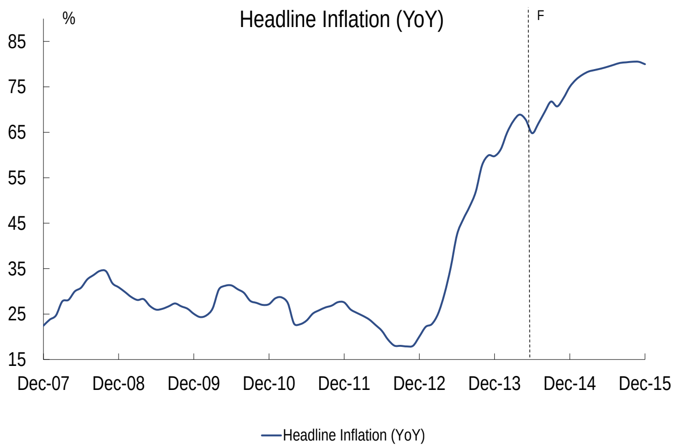
In an environment where the government needs to reconnect with the private sector in order to increase output and reduce inflation, we do not expect a reduction of fiscal spending and the necessary announcements seem less likely to take place in the immediate future. Given the trade-offs available for the government, we expect the latter to maintain its levels of social spending at the same time that it embarks in discussions with the private sector in order to convince it of increasing production. However, given the inflationary effects of keeping fiscal spending at full speed, the government needs to consider measures aimed at increasing revenues. This is the reason why there were strong expectations of the government announcing increases in gasoline prices and public services. However the only announcement made by the government consisted of a cabinet reshuffle, with the biggest change being the movement of Rafael Ramirez from Minister of Energy and President of PDVSA to Minister of International Relations. Although we initially thought authorities wanted to act sooner rather than later, given the fact National Assembly elections will take place in the fourth quarter of 2015, we now see the government decided to postpone any of these actions with the consequence that when they are finally decided, the adjustments will have to be stronger.

Figure 263. GDP growth performance in 4Q13



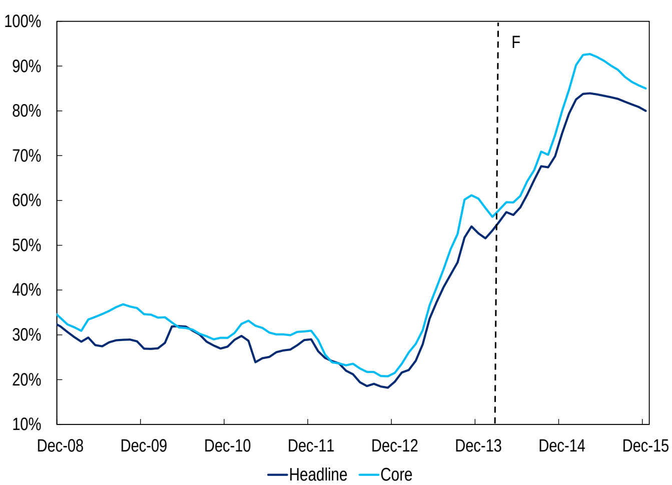
Source: BCV and Citi Research

Figure 264. Inflation should accelerate despite the weak GDP growth



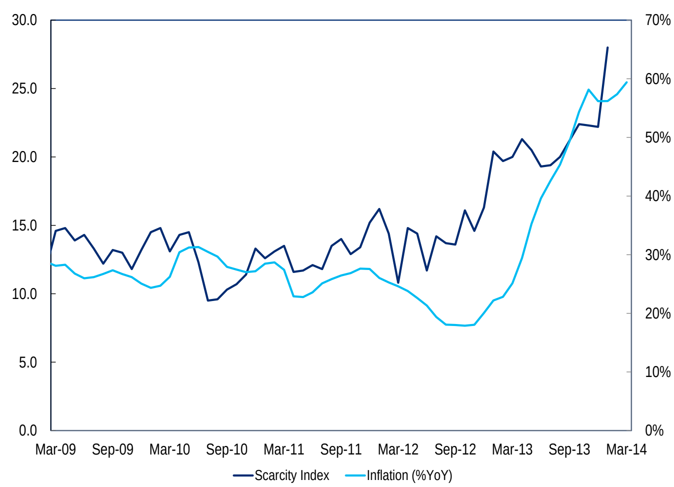
Source: BCV and Citi Research

Figure 265. Caracas inflation



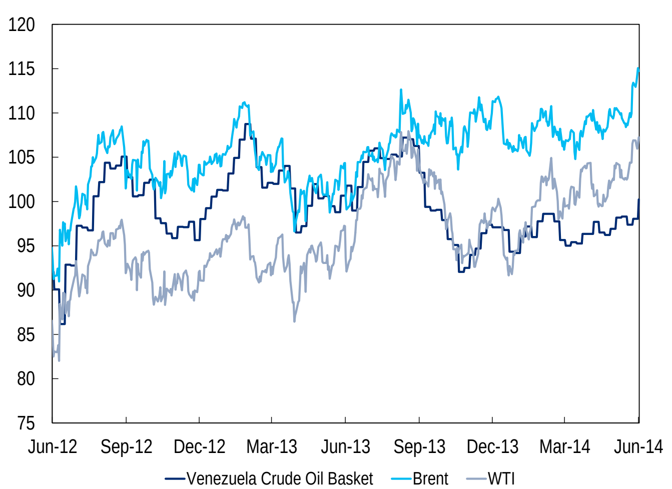
Source: BCV and Citi Research

Figure 266 Scarcity continues to be one of the drivers of inflation



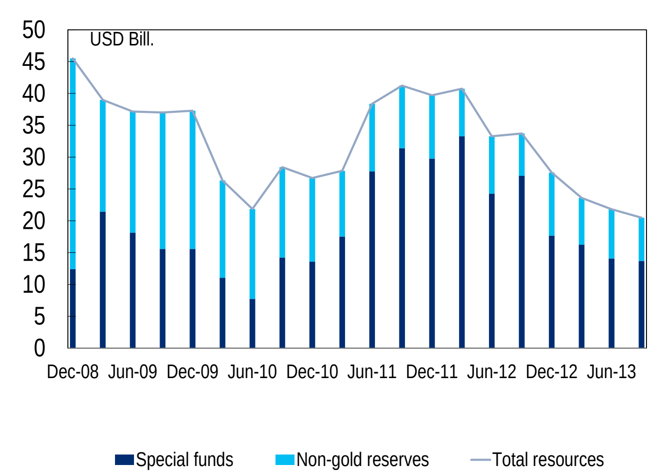
Source: BCV and Citi Research

Figure 267. Venezuelan oil basket prices and WTI prices



Source: BCV and Citi Research

Figure 268. Could total liquid resources continue its downtrend?



Source: BCV and Citi Research

Figure 269. Venezuela Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, USD bn	213	298	284	257	298	361	372	368	359
Nominal GDP, local currency bn	495	678	707	1,017	1,357	1,642	2,595	4,152	6,778
GDP per capita, USD	7,738	10,683	9,996	8,925	10,188	12,141	12,341	12,025	11,578
Population, mn	27.5	27.9	28.4	28.8	29.3	29.7	30.2	30.6	31.0
Unemployment, % of labour force	6.2	6.1	6.6	6.5	6.5	5.9	5.6	4.8	4.0
Economic Activity									
Real GDP, yoy avg (Citi estimates)	8.8	5.3	-3.2	-1.5	4.2	5.6	1.3	-1.0	1.9
Real investment growth % yoy	28.2	2.2	-19.1	1.0	15.2	24.1	-7.5	-3.6	1.5
Real consumption growth % yoy	16.3	6.0	-2.1	-1.1	4.4	6.9	3.5	0.1	0.3
private consumption growth % yoy	16.9	6.3	-2.9	-1.9	4.0	7.0	3.7	0.1	0.3
Real export growth, % yoy	-7.6	-1.0	-13.7	-12.9	4.7	1.6	-3.8	1.3	4.2
Real import growth, % yoy	33.0	1.4	-19.6	-2.9	15.4	24.4	-4.6	-0.7	-1.0
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	22.5	31.9	26.9	27.4	29.0	19.5	52.7	75.0	80.0
CPI, % yoy eop (reported)	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	20.7	25.0	23.7	24.5	27.0	30.0	45.0	60.0	60.0
Credit extension to private sector, % yoy	43.3	30.6	18.0	27.6	36.8	55.3	65.8	80.0	80.0
Policy Rate (eop)	18.00	28.10	14.00	12.50	-	-	-	-	-
1 month inter-bank rate, %, eop	18.00	28.10	11.30	12.30	14.50	14.50	14.50	14.50	14.50
Long-term yield, %, eop	12.00	12.00	14.38	13.02	13.93	9.18	12.88	15.20	16.88
VEF/USD, eop	2.15	2.15	2.15	4.29	4.29	4.29	6.29	12.00	19.80
VEF/USD, avg	2.15	2.15	2.15	4.20	4.29	4.29	5.99	9.15	19.80
Balance of Payments, USD bn									
Current account	18.1	37.4	8.6	12.1	27.3	11.0	12.2	14.9	18.2
% of GDP	8.5	12.5	3.0	4.7	9.1	3.1	3.3	4.1	5.1
Trade balance	23.0	45.7	19.2	27.1	46.4	38.0	36.7	33.5	36.8
Exports	69.0	95.1	57.6	65.7	92.7	97.3	89.2	83.5	88.9
Imports	46.0	49.5	38.4	38.6	46.2	59.3	52.4	50.0	52.0
Service balance	-7.0	-8.4	-7.6	-9.2	-10.7	-16.0	-13.8	-7.7	-7.8
Income balance	2.5	0.7	-2.7	-5.3	-7.9	-10.0	-9.8	-9.8	-9.8
FDI, net	1.0	-0.9	-4.9	-1.5	5.1	0.8	2.4	0.8	0.8
International reserves	34.3	43.1	35.8	30.3	29.9	29.9	25.0	23.5	22.0
Total amortisations	4.0	7.5	4.3	6.9	11.0	4.1	6.8	4.5	0.1
Public Finances, % of GDP									
Consolidated government balance	-2.8	-3.5	-8.7	-10.4	-11.6	-15.0	-11.9	-11.2	-10.3
Consolidated gov primary balance	-1.2	-2.0	-7.2	-8.6	-9.4	-12.3	-9.4	-8.9	-8.2
Public debt	25.5	21.6	31.3	42.0	44.2	43.4	41.5	40.2	39.7
of which Domestic	7.3	4.5	7.5	8.9	11.4	14.1	12.3	9.6	7.2
Foreign Assets & Liabilities, USD bn									
External debt	56.3	66.4	81.9	97.1	110.7	118.9	123.3	127.5	131.7
Public	38.7	50.9	67.4	85.3	98.0	105.8	108.8	112.8	116.8
External debt / GDP	26.5	22.2	28.9	37.7	37.1	33.0	33.1	34.7	36.7
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	18.1	19.9	17.4	16.8	16.7	21.1	21.8	21.5	21.0
Short-term debt/International reserves (%)	52.8	46.1	48.4	55.3	55.8	70.6	87.0	91.5	95.4

Quarterly Economic Indicators									
	2014 Q1	2014 Q2	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2015 Q3F	2015 Q4F	2016 Q1F
GDP, % yoy	-1.5	-0.9	-1.1	-0.4	2.6	1.4	2.0	1.8	1.5
CPI, % yoy	54.8	56.8	66.9	75.0	83.8	84.4	82.4	80.0	82.7
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	13.53	11.80	14.71	15.88	14.53	12.80	15.71	16.88	16.88
VEF/USD, eop	6.29	6.29	12.00	12.00	19.80	19.80	19.80	19.80	19.80

Source: National Sources, Citi Research

Appendix A-1

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