Asia Macro and Strategy Outlook

Prospects for 2013

- **Theme #1: China's steady growth leads to US as major driver of Asia cyclical trends.** New Chinese leaders are likely to pursue a pro-stability growth stance (we expect China's real GDP growth at 7.8% in 2013F vs. 7.7% in 2012F). With the Euro Area in a prolonged shallow recession, we think the US growth path — slow in 1H but accelerating to 3% by late 2013—will be the *dominant* driver of the cyclical trends in Asia in 2013F. We expect the more open economies in Asia (TW, KR & SG) will eventually have a bigger growth upturn in 2013F than the rest.
- **Theme #2: Part of Asia as a safe haven comes of age.** Growing confidence over Asia's growth resilience, strong external and fiscal balance sheets and expectations of some Asia FX de-coupling from DXY on the back of a "regime change" in China's FX policy towards a more market-based RMB will reinforce perception of (parts of) Asian fixed-income markets receiving "safer-haven" flows.
- **Theme #3: MP transition: accommodation to (some) normalization.** Gradually rising inflation will lead to a transition in monetary policy (MP) – from some residual easing in early 2013 (Korea, India, Vietnam) to progressively more hawkish bias with Indonesia being earlier to hike, and some like China and Korea may begin policy normalization by late 2013F. Many countries will be very slow to hike, and will lean on macro-prudential policies to contain financial stability concerns.
- **Risk #1: Inflation surprises from commodity- or administered price hikes.** Countries whose inflation is already above or close to their central banks' comfort threshold and have buoyant domestic demand that could exacerbate second round effects could see earlier and more abrupt monetary tightening than expected.
- **Risk #2: Re-pricing of Asian rates in a US Treasury sell-off.** Lower yielding and more correlated Asian bonds (HK, KR, MY, TW) are likely to be more sensitive to a re-pricing of US rates (KR rates are particularly more sensitive) but US Treasury sell-offs associated with stronger growth/inflation cycles will likely have a more positive impact on some of the more cyclical Asian FX (e.g. KRW, TWD).
- **Risk #3: Capital controls re-visited?** Subdued global growth/inflation limits tolerance to significant FX outperformance, and countries that continue to see outsized gains given yield and fundamental factors on the backdrop of even more monetary easing by AEs could be susceptible to unfriendly policies on capital flows.
- **Macro Strategy – Favoring high yield plays & cyclicals.** We expect Asian FX (exclude IDR) to outperform amid a gradual CNY "regime change"; We favor higher yielding and less US-correlated government bonds—INR government bonds and frontier markets (LKR & VND Treasury bonds); Higher beta sovereign dollar bonds are expected to outperform; Our Asia equity strategist expects a moderate 15-18% return on equities, driven by North Asia, financials and cyclicals.

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

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Citi Key Economic Forecasts

Figure 1. GDP forecasts (growth rate in percent)

	2012 GDP Fcsts			2013 GDP Fcsts			2014 GDP Fcsts
	Current	Previous	Consensus	Current	Previous	Consensus	Current
Asia-Pacific	6.1	6.2	6.2	6.6	6.5	6.8	6.6
Asian NIEs	1.8	2.1	2.0	3.1	3.5	3.4	3.9
SEAN	5.5	5.6	5.7	5.5	5.5	5.4	5.9
China	7.7	7.7	7.7	7.8	7.6	8.1	7.3
Hong Kong	1.4	2.2	1.6	2.8	3.8	3.5	3.5
India**	5.4	5.4	5.6	6.2	6.2	6.6	6.9
Indonesia	6.2	6.2	6.2	6.1	6.1	6.0	6.3
Malaysia	5.2	5.0	4.8	5.2	5.3	4.8	6.0
Mongolia	12.0	12.0	—	13.8	13.8	—	11.0
Philippines	5.0	5.0	5.4	5.3	5.3	5.1	5.8
Singapore	1.4	2.3	2.0	2.0	3.2	3.4	4.0
South Korea	2.3	2.3	2.3	3.4	3.4	3.3	4.0
Sri Lanka	6.7	6.7	6.6	7.3	7.3	6.8	7.5
Taiwan	1.0	1.7	1.2	3.0	3.6	3.5	3.8
Thailand	4.0	4.8	5.2	4.5	4.6	4.4	4.8
Vietnam	5.0	5.0	5.1	5.4	5.4	5.8	6.0

Figure 2. CPI forecasts (growth rate in percent)

	2012 CPI Fcsts			2013 CPI Fcsts			2014 CPI Fcsts
	Current	Previous	Consensus	Current	Previous	Consensus	Current
Asia-Pacific	3.5	3.5	3.8	3.5	3.7	3.9	3.9
Asian NIEs	2.7	2.7	2.7	2.8	2.8	2.7	2.8
SEAN	3.5	3.5	3.6	3.8	3.8	4.2	4.1
China	2.7	2.7	2.7	2.8	3.2	3.3	3.6
Hong Kong	4.0	3.8	4.0	3.5	3.2	3.8	3.7
India**	7.5	8.0	9.3	7.0	7.0	7.6	6.0
Indonesia	4.4	4.4	4.5	4.7	4.7	5.2	4.7
Malaysia	1.8	1.8	1.7	2.1	2.1	2.3	2.6
Mongolia	14.2	13.8	—	12.0	12.0	—	10.0
Philippines	3.1	3.1	3.3	3.5	3.5	3.9	3.8
Singapore	4.6	4.6	4.6	3.8	3.5	3.6	3.4
South Korea	2.3	2.4	2.3	2.7	2.8	2.7	3.1
Sri Lanka	7.4	7.4	7.5	6.7	7.6	7.2	6.5
Taiwan	2.0	2.0	2.0	2.0	2.0	1.8	1.1
Thailand	3.0	3.0	3.0	3.3	3.3	3.3	4.3
Vietnam	9.4	9.4	9.0	8.2	8.1	8.4	7.5

Figure 3. Current account forecasts (percent of GDP)

	2012 CAB Fcsts			2013 CAB Fcsts			2014 CAB Fcsts
	Current	Previous	Consensus	Current	Previous	Consensus	Current
Asia-Pacific	1.9	1.5	0.8	1.5	1.2	0.7	1.2
Asian NIEs*	6.2	5.6	1.5	5.0	5.1	1.3	4.6
SEAN**	0.1	-0.5	-0.3	0.2	-0.3	-0.1	0.1
China	2.5	2.0	2.7	2.0	1.5	2.3	1.5
Hong Kong	5.0	5.0	2.9	5.6	5.5	2.6	6.2
India	-3.7	-3.0	-3.1	-2.8	-2.1	-2.8	-2.5
Indonesia	-2.3	-2.3	-2.0	-1.7	-1.7	-1.2	-1.5
Malaysia	5.0	5.0	6.2	4.0	4.0	6.2	3.3
Mongolia	-25.5	-25.7	—	-10.8	-10.5	—	3.0
Philippines	2.8	2.6	3.2	2.3	2.4	2.9	1.1
Singapore	16.2	15.1	16.4	13.9	14.1	15.6	13.3
South Korea	2.9	2.1	2.8	1.4	1.5	2.3	1.0
Sri Lanka	-5.4	-4.5	-5.6	-4.3	-3.8	-4.0	-3.6
Taiwan	8.7	8.7	8.6	8.4	8.4	8.0	8.0
Thailand	0.1	-2.9	-0.4	0.4	-2.2	0.5	0.9
Vietnam	0.3	0.3	0.0	-0.5	-0.6	0.0	-0.9

Note: Asian NIEs are Hong Kong, Korea, Singapore, and Taiwan. SEA-4 includes Indonesia, Malaysia, the Philippines and Thailand. Asia-Pacific is Asian NIEs + SEA-4 + China + India + Mongolia + Sri Lanka + Vietnam, GDP-weighted. *India Fiscal year runs from April-March and inflation forecasts are Wholesale Price Index.
Source: CEIC Data Company Limited, Consensus Economics (November 12, 2012) and Citi Research estimates.

Macro Overview

Prospects for 2013

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We summarize our three key themes for Asia in 2013F, three key risks and our main outlook on various asset classes in the region.

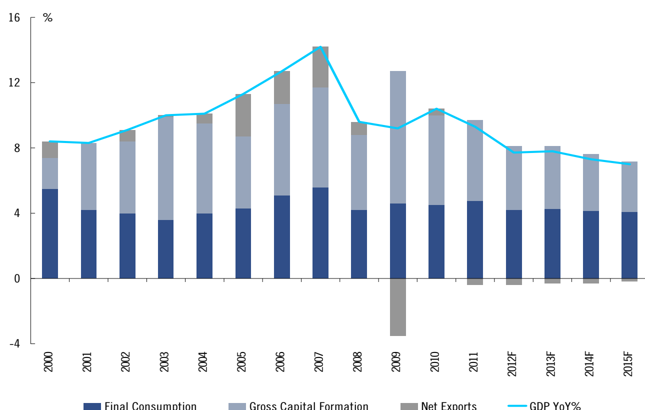
Macro Themes

Theme #1: Pro-stability stance of China's new leaders means US growth will be the dominant driver of Asia's economic cycle next year

New Chinese leaders are likely to pursue a "pro-stability" agenda with incremental reforms in the coming year. The once in a decade transfer of a new generation of leaders is expected to usher in a period of reforms over the coming five years given inevitable constraints of the previous export & investment- heavy growth model. However, these pending reforms – likely to revolve around improving investment efficiency, via financial sector reforms, and generating new growth engines via service sector liberalization, agricultural modernization, industrial upgrading and urbanization – are unlikely to happen quickly, and details may not be unveiled until the Third Plenary Session of the 18th Party Congress (likely around October 2013).[1] Thus, given China's acceptable employment condition, we expect the new leadership will *continue the current policy stance* to support stable growth of 7.8% in 2013F (vs. 7.7% in 2012F).

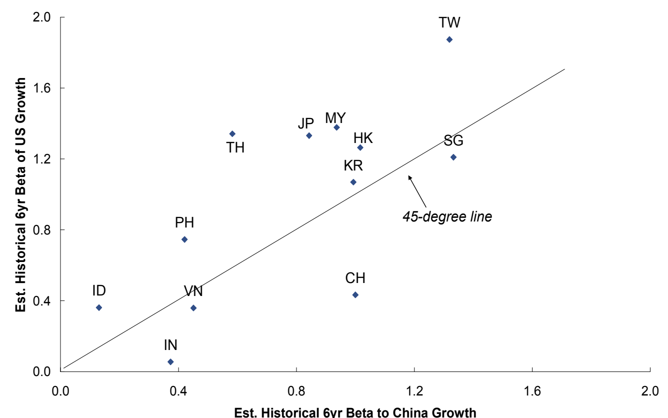
China setting a lower growth target of 7% could be seen as positive for longer term sustainability—but a dampener for commodity prices. With increasing acknowledgement of China's potential growth challenges as it undergoes reforms, we think Chinese leaders may set a conservative growth target of 7% in the National People's Congress in March (lower than the 7.5% growth target in 2012), a growth rate consistent with the prescribed goal of doubling per capita income by 2020 from 2010 levels. This could help contain commodity price pressures, benefiting most of the net-commodity importing Asian countries. In reality, China's policies will likely be supportive of achieving higher growth than this target, with stronger momentum in the first half on the back of carryover investment impulse from policy easing in 2012.

Figure 4. China's Real GDP Growth Path and Composition of Growth



Source: CEIC, and Citi Research

Figure 5. Asia's historical growth sensitivity to US growth versus sensitivity to China's growth



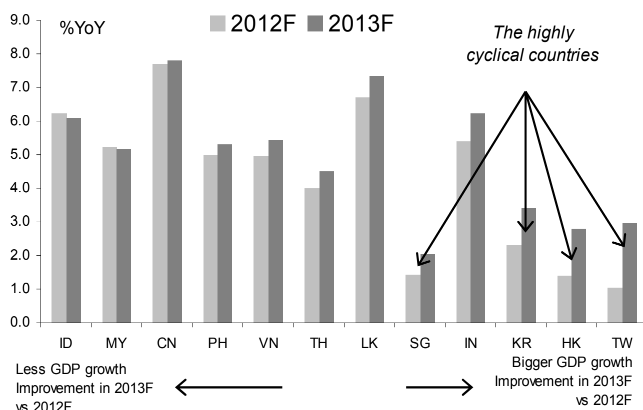
Source: CEIC, and Citi Research

[1] See *Citi GPS: CHINA IN TRANSITION - What We Know, What We Don't Know*

A steady growth path in China next year would imply the dominant driver of cyclical trend in the region will likely be the US. A mild China rebound extending into 1H of 2013 will help offset growth drag from a weak US momentum in early 2013 and contraction in Europe – but we expect the overall growth backdrop during this period will remain challenging for the more external growth-dependent economies of Singapore, Taiwan and Korea – with Singapore expected to be in mild technical recession through 1H 2013. Korea will likely try to temper the drag in 1H by boosting stimulus efforts through a rate cut and front-loaded fiscal easing, but both Singapore and Taiwan won't have that option (Singapore will likely maintain a tightening policy bias). Thus, we won't really see a more meaningful rebound in these countries until the second half as we envision the US economy transitions to a 3% growth path in late 2013, on the back of private sector balance sheet improvement, loose financial conditions and some clarity over the "fiscal cliff" (leading to only a mild fiscal tightening path). *We expect these cyclical economies will see a bigger upturn in 2013F than the rest.*

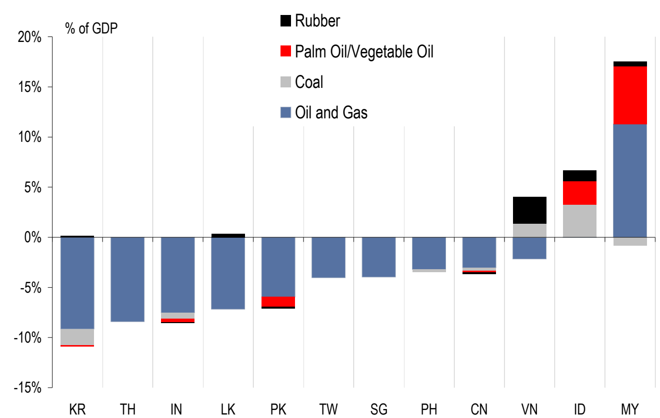
For the first half of 2013, the outperformance of ASEAN's (ex Singapore) domestic-driven growth will be the lingering theme – but we think Philippines and Thailand may gain ascendance, while Indonesia and Malaysia may lose some luster for three reasons: First, both Philippines and Thailand can benefit from the lagged impact of prolonged low real rates (and prospect for further monetary/liquidity easing) given still manageable inflation within their inflation-targeting frameworks[2]. Meanwhile, Indonesia's basic balance deficit and Malaysia's household debt concerns will constrain monetary policy flexibility for both (with Indonesia expected to hike earlier). Second, in the absence of "fresh" stimulus, China's transition to a slower and less commodity-intensive growth will continue and weigh on the commodity exporting countries of Malaysia and Indonesia. Third, fiscal policy has room to be more proactive in Philippines and Thailand in 2013F with a significant pipeline of infrastructure projects that can complement private investment, while Indonesia and Malaysia, at the margin, are in fiscal consolidation mode (even though the former doesn't really need to be).

Figure 6. Assuming a US rebound, cyclical countries' growth upturn to outperform the more domestic driven countries in 2013F



Source: Citi Research

Figure 7. Select Commodities Trade Balance in 2011 (% of GDP)



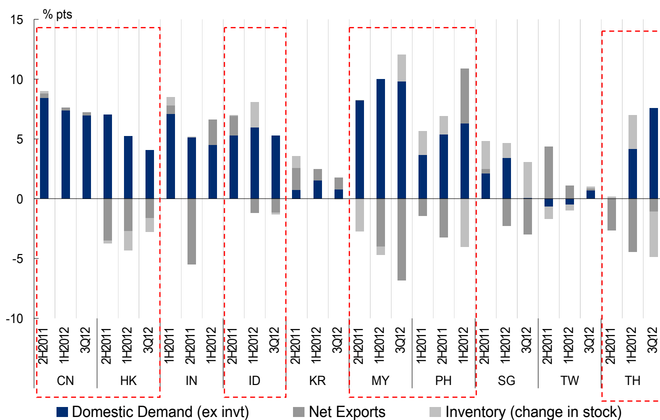
Source: CEIC, and Citi Research

[2] While not a primary reason, we think the implicit desire to deter capital inflows and reduce sterilization costs owing to the significant deterioration in their central banks' balance sheet may be another reason. See *Asia Macro View - FX Policy: To Intervene or Not to Intervene?* (19 Nov 2012).

Theme #2: Parts of (East) Asia increasingly attract safe-haven flows

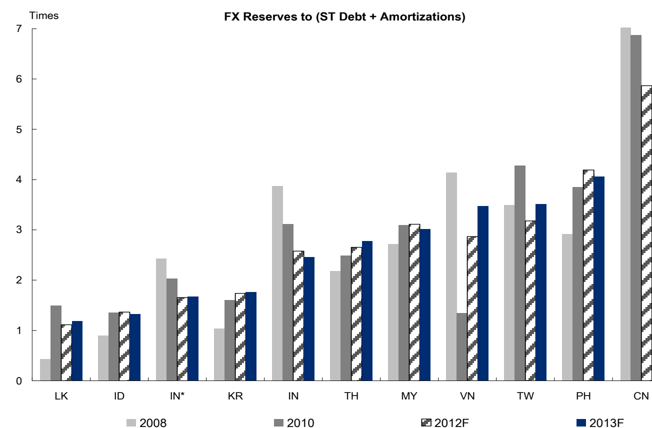
Since the global financial crisis, the theme of Asia as a "safe-haven" occasionally arises. Of course, Asian economies/markets cannot completely decouple from external shocks. However, over the last few years, confidence over the resilience of Asia's fundamentals has gathered momentum – we think this will persist in 2013F: **First, the region, to varying degrees, has demonstrated inherent growth resilience** owing to its strong balance sheet and other structural advantages (such as demographics). Prolonged low rates and fiscal easing in some countries have supported domestic-demand growth, with investment-led rebound in parts of Southeast Asia. Unemployment rates have remained persistently low even amid periodic bouts of manufacturing weakness, helping cushion consumption. Despite export headwinds and REER appreciation (especially in CNY and SGD) over the years, EM Asia's global export market share has been barely dented, highlighting the region's ability (so far) to boost productivity by moving up the value chain and taking advantage of regional integration to relocate supply chains. As Asia's growth mildly rebounds and China's "hard-landing" fears dissipate amid a gradual move to towards more sustainable growth drivers, we think confidence in Asia's enduring growth prospects will improve next year.

Figure 8. Asia's domestic demand has acted as a strong buffer to external growth slowdown, especially in CN and Southeast Asia



Source: CEIC, and Citi Research

Figure 9. FX reserve coverage (% of STED by remaining maturities)



Source: Haver, and Citi Research
Note: *We include all non-resident deposits as a short term external liability

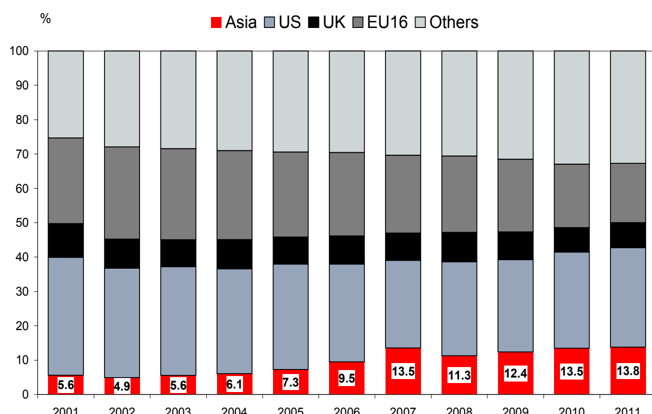
Second, most countries (except in South Asia and, more recently, Indonesia) have been able to reduce their external vulnerability via rising reserve coverage ratios (see Figure 9), complimenting this reserve buffer via an enhanced regional safety net.[3] The region's financial system has also, at the margin, become more insulated to potential funding shocks from advanced economies through both a reduction in wholesale funding reliance (in the case of Korea) and through enhanced regional financial integration. In fact, we think concerns about Asia's exposure to European bank deleveraging have almost become a non-issue (except in how risk appetite is impacted) given the availability of domestic/regional funding sources, including rising share Asia Pacific banks (especially Chinese banks) to meet the region's cross-border financing needs.[4]

[3] See *Asia Macro Flash - Who Benefits the Most from the CMIM Regional Safety Net? (16 May 2012).*

[4] See *Asia Macro View - European Bank Deleveraging in Asia - An Update* (30 August 2012)

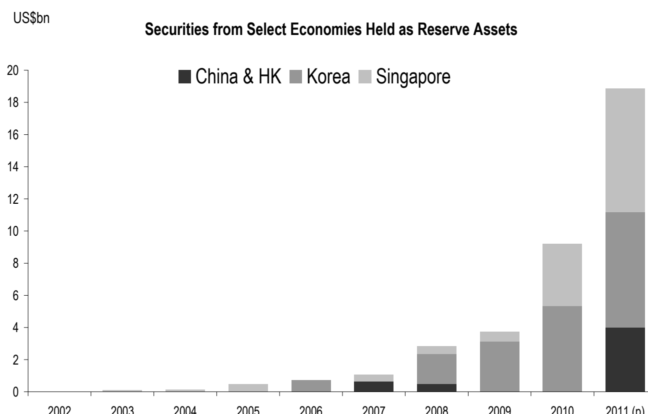
Perhaps one tell-tale sign of the region's rising role as a "safer" or even "safe haven" asset class can be seen in flows into select fixed income markets. With the exception of Indonesia, foreign inflows into Asia's local currency bond markets have resumed quickly after the Sep-Nov 2011 sell-off, and we think the investor base is broadening with growing support from intra-Asia portfolio investments, hopefully less volatile, which we expect will continue in the coming years (see Figure 10). One unique" feature of Asian debt markets within EM is the role of reserve diversification flows, especially to higher rated Asia LCY debt instruments – notably Singapore, HK/China and Korean debt securities. While Asia LCY debt instruments only account for a tiny fraction (0.4%) of total value of portfolio investments in the Reserve Assets surveyed by the IMF (see Figure 11), this came from virtually zero a few years ago— no other EM country has featured in the survey (outside of a minuscule allocation into Mexico), and we think this has further room to expand, especially if China gradually continues to develop its bond markets and further liberalize its capital account, plus if low risk-adjusted returns in advanced economies persist (which we expect they will).

Figure 10. Increasing Intra-Asia Portfolio Investments – Geographic Share of Non-resident Portfolio investments from Asia*



Source: IMF Coordinated Portfolio Investment Survey (CPIS)
Note: *Destination of portfolio investments originating from the following: Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Pakistan, Philippines, Singapore & Thailand

Figure 11. A Rising Trend –Structural Rise in Reserve Diversification flows into Select Asian-issuer securities, 2006-2011



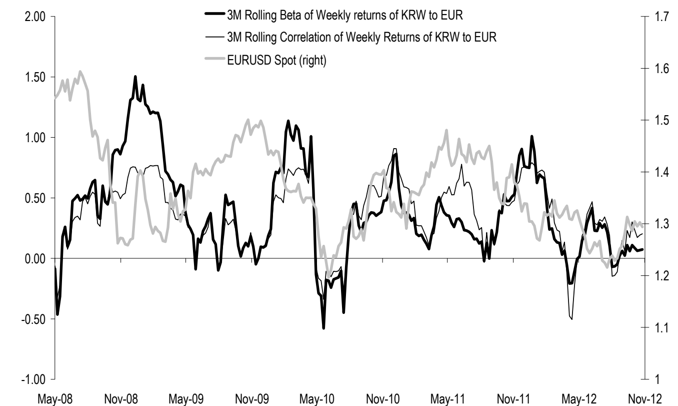
Source: IMF Survey of Securities Held as Foreign Exchange Reserves (SEFER)
Note: The survey includes of 73 participating countries, but unfortunately, excludes two large holders of official reserves – China and Taiwan.

Reinforcing the perception of (East) Asia's safe haven properties is our projected (partial) de-coupling of Asia FX to DXY. We believe we are in the midst of a "regime change" in China's FX policy towards a more market-determined RMB fixing as pressures for economic rebalancing and costs of further excessive reserve accumulation grows. In fact, we are already seeing early signs of market-based FX reforms with recent outsized gains in CNY vs. USD even amidst DXY strength, coinciding with the period in which CNY spot was hitting the strong side of the FX band. Given our outlook for China's external flows next year (shrinking but still sizeable basic balance surplus), we expect a modest appreciation of CNY versus USD even as USD is expected to rebound across other majors (i.e. rising DXY). A "de-coupling" of CNY will likely influence the movements of other "managed"/potentially "managed" currencies in East Asia with a bias to appreciation (e.g. KRW, TWD, SGD, MYR, PHP, THB). This, could raise outperformance expectations of Asia FX, reinforcing capital flows into the region, leading to a trend of diminishing sensitivity to global shocks as is already apparent in KRW (see Figure 13).

Figure 12. De-coupling of USD-CNY and DXY

Source: Bloomberg, and Citi Research

Figure 13 – Diminishing Sensitivity and Correlation of KRW with EUR



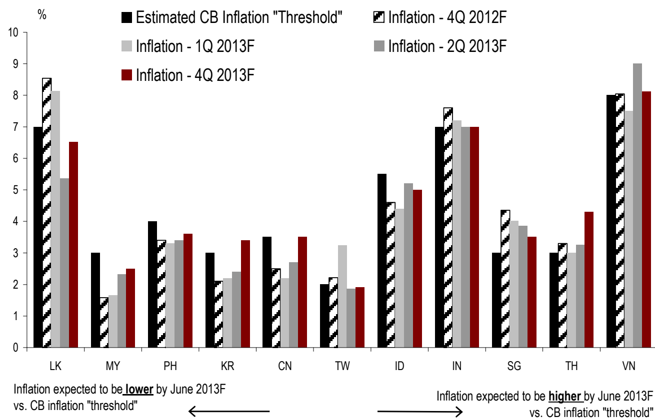
Source: Bloomberg, and Citi Research

Theme #3: Monetary policy transition – from accommodation to (some) hints towards normalization

Inflation momentum in the region will likely be on a gradually rising trend in 2013F. Even without assuming major food/agri supply or oil price shock, we expect a prolonged period of ample liquidity and low real rates fueling credit growth and resilient EM demand, alongside a less favorable base effect, will drive the headline inflation higher for most countries. Output gaps are projected to gradually narrow and be increasingly positive in some parts of Asia, especially the more buoyant Southeast Asian economies. Beyond cyclical drivers to inflation, there are also structural policies influencing inflation that need to be monitored. China may expand its resource price reform from electricity to other utilities like coal, gas and water (these are more likely to be raised when CPI inflation remains relatively low). Jakarta has launched an aggressive 44% minimum wage hike next year which could spillover to Indonesia's price expectations and wage setting in other regions, plus the potential for a subsidized fuel price hike is a key event to watch (though we still expect it is less than likely in a pre-election year). Post elections in Malaysia could prompt long delayed subsidy rationalisation that could also lead to administered price adjustments in the latter part of 2013. A few Asian countries are expected to see inflation ease, but mostly where inflation has been very elevated in 2012 – India, Singapore and Sri Lanka – due to various administered price adjustments – gradual disinflation will kick in with the help of the base effect, though in Singapore's case, will likely stay above its comfort threshold.

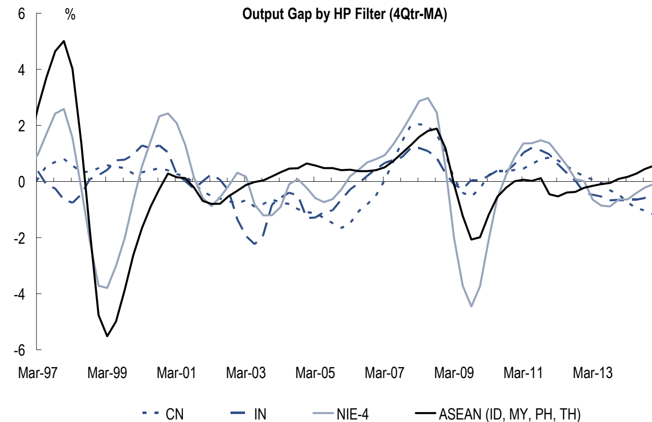
Most central banks will stay neutral to dovish in early 2013 with some having residual rate cuts. We think the uptrend of headline inflation will be gradual for most of these countries, and amid lingering growth risks, and we expect a few central banks will still cut – particularly in Korea, India, possibly Vietnam – and China is expected to cut the reserve requirement ratio (RRR) throughout the year to ease liquidity.

Figure 14. Headline Inflation Projections versus Our Estimated Central Bank Comfort Threshold



Source: CEIC, and Citi Research

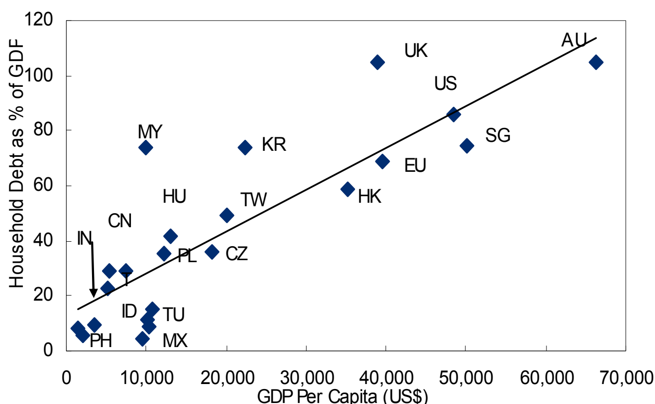
Figure 15. Asia – Output Gap estimates and projections going into 2014F using HP Filter*



Source: CEIC, and Citi Research
Note: *The output gap estimates in China are likely too low and HP filter is not capturing structural change since the economy that arguably is lowering potential growth, and thus, output gap may not be increasingly negative as depicted in the chart above.

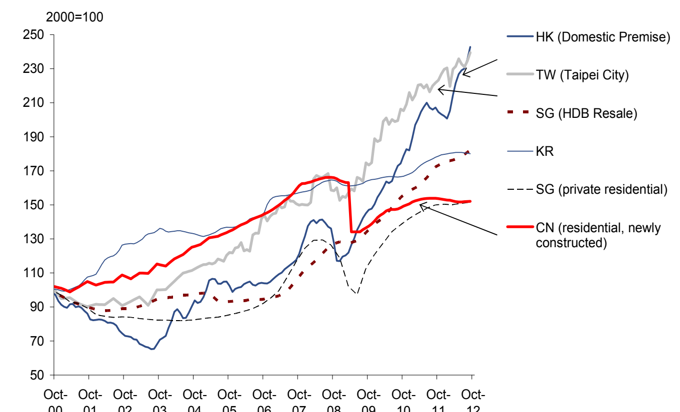
However, central bank rhetoric will likely shift to a more neutral-to-hawkish tone by 2Q 2013. First path to tightening monetary conditions will likely be to lean a bit of currency appreciation rather than rate hike assuming trade flows are supportive. However, with some current account deficit countries not having that option, we think Indonesia will be one of the first central banks in the region to hike rates – we are assuming 3Q 13 but timing of this will depend on how external flows evolve (could be earlier if currency weakening pressure escalates). Assuming a US-led global recovery in 2H 2013, and inflation progressively rises, we could see an early move towards policy normalization via rate hikes in a few countries by 4Q 2013 – China, Korea, possibly Thailand (given our inflation forecast by 4Q). Nonetheless, we think most countries will be slow to hike in an environment of prolonged negative real rates in advanced economies plus further monetary accommodation in the pipeline (e.g by ECB and BoJ).

Figure 16. Select DM and EM countries – Household debt to GDP ratio versus per capita GDP



Source: CEIC, IMF, PBOC, and Citi Research

Figure 17. Select Asia – Residential property Prices



Source: CEIC, and Citi Research

With difficulty in adjusting rates, macro-prudential policies will likely remain in active use to address financial stability concerns. The regressive nature of property price surges amid rising inequality will remain a politically sensitive issue – and we expect property curbs to persist and selectively expand next year (e.g. China may expand its pilot property tax program to more cities). We also think a number of central banks in the region could become more creative in monetary policy tools to tighten liquidity without exacerbating sterilization costs and attracting more inflows – for example, lowering rates on sterilization instruments (like SDAs in the Philippines), further use of reserve requirements and targeted adjustments to LTV regulations to curb riskier types of lending.

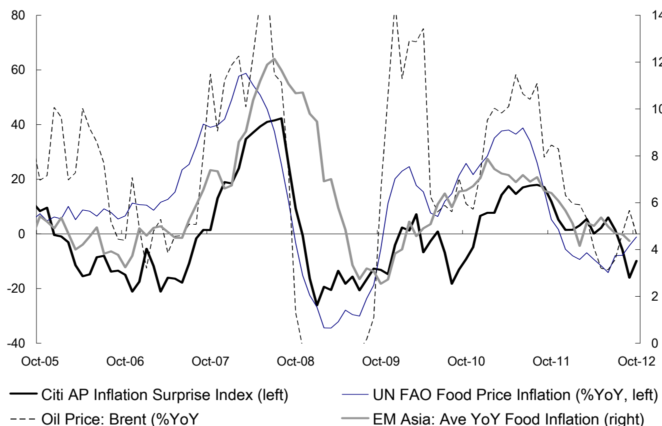
Risk #1: Inflation could surprise to the upside –fueled by agri shocks, belated administered price adjustment – spilling over to core

With the exception of US drought induced agri price spikes, commodity price trends that heavily influence Asia's inflation – oil, rice, pork (in the case of China) have been benign for the most part of 2012, giving central banks room to maintain or loosen monetary conditions to buffer growth. However, this benign outlook could change amid the rising frequency of extreme weather (which has made global grain prices particularly more volatile), while rising incomes of EM countries have already resulted in higher income elasticity of demand for certain types of food (e.g. meat, dairy). Thus, supply-demand dynamics can make food inflation trends particularly sensitive to unforeseen supply shocks. Escalation of Mideast risk could also lead to an upside surprise to our rather benign base case outlook for oil prices.

Beyond commodity prices, risk for **belated administered adjustment to subsidized (fuel) prices** – be it for fiscal (India, Malaysia, Sri Lanka) or external (India, Indonesia and Sri Lanka) reasons – **and various adjustments to factor costs** in order to rebalance the economy (Singapore and China) could also generate positive inflation surprises at a time when domestic demand dynamics and the risk to second round inflationary risks are also high. The lagged impact of property price surge feeding into housing components of CPI could also intensify.

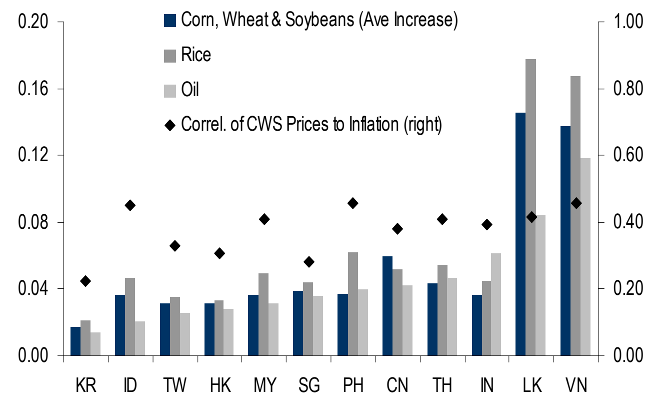
Countries whose 2013F inflation is already above or very close to the central banks' inflation threshold (Korea, China, Thailand, Vietnam), with relatively high sensitivity to commodity prices (assuming it's a commodity shock) or risk to administered price adjustments (Indonesia and Malaysia are key to watch given their buoyant domestic demand dynamics leading to risks to demand-side inflation spillovers) could lead to an earlier/ more than expected monetary tightening than envisioned. The pressure on rates could also be higher if countries cannot lean on currency strength owing to external vulnerability – applicable to Indonesia and India, though we see less risk to rate hike in India owing to an already sharp investment-led slowdown.

Figure 18. Asia Inflation Surprise Index vs. Food and Oil Price Inflation



Source: Bloomberg, CEIC, and Citi Research

Figure 19. Asia's inflation sensitivity to a rebound in commodity prices varies (historical beta to select commodity prices in last 6 years)



Source: CEIC, and Citi Research

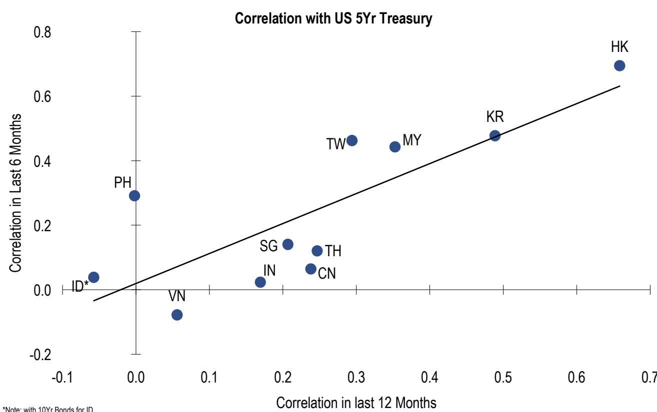
Risk #2: Re-pricing of Asian rates in a US Treasury sell-off

An important driver of capital inflows and a significant curve flattening of yield curves in Asia has been the rally in US Treasuries. Year-to-date, 10yr Treasury yields are almost 100bps lower than they were a year ago, and lower than what growth-inflation dynamics in the US would suggest. This historically low rate environment has been bolstered via the strong commitment by the Fed to keep rates low for longer, market intervention via QE/Operation Twist, and lingering growth/safe haven concerns on the back of the European crisis and US fiscal cliff concerns. This has been a powerful catalyst for yield demand towards EM assets including Asia. However, if US recovery were to surprise positively, US rates would be vulnerable to a back-up in yields. With historically high foreign ownership in Asia LCY government bonds, historically low (or close to historically low) yields and historically flat curves, we think local rates in Asia will be vulnerable, particularly the more correlated markets of Hong Kong, Korea, Malaysia and Taiwan (Korea and HK are the most historically "sensitive" to US yield movements), but even Philippine bonds have been more correlated to US Treasury movements than they had been in previous history, and could also be vulnerable.

The impact of a US Treasury sell-off on Asia currencies is more ambiguous. A sell-off in US treasuries associated with stronger growth/inflation cycles will likely have a less negative impact on more cyclical Asian currencies like KRW and TWD, either due to export and/or (more equity-related) capital flows, and central banks becoming more willing to lean on currency appreciation as a monetary policy tightening tool. Our strategists have analyzed episodes of US Treasury sell-offs associated with "growth periods" in the last 14 years (i.e. when US Treasury has sold off more than 20bps during a period with rising ISM manufacturing indices or rising Fed Funds rate) and find that Asia FX has fared relatively well during this period relative to other EM FX (see Figure 21).[5]

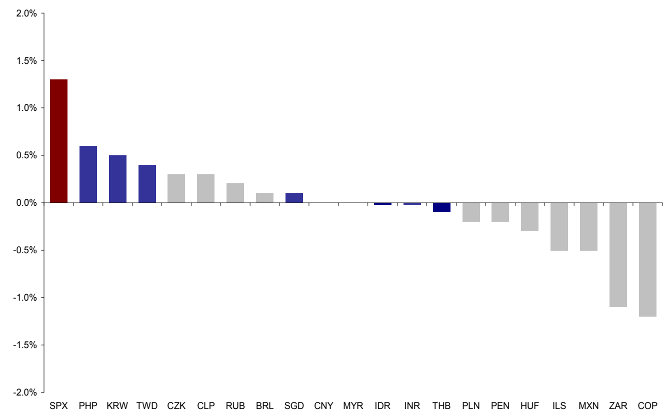
[5] See Kenneth Lam & Dirk Willer. "*EM Focus: US Treasury Sell-Off Not a Risk to EM FX*" (9 Aug 2012).

Figure 20. Correlation of Asia LCY Government Bond Yields with US 5yt Yields (weekly yield change)



Source: Bloomberg, and Citi Research

Figure 21. Median returns of EM FX and S&P in UST sell-offs coinciding with "growth periods"



Source: Bloomberg, Citi Research

Risk #3: REER appreciation pressure beyond policymakers' tolerance level leads to less market-friendly policies on capital flows

Lingering growth concerns and worries about adverse impact of exchange rate outperformance could raise the risk of less market-friendly policies on capital flows. While we argue that recent external flows driving Asia's FX outperformance are more trade- than financial flow-driven,[6] we think these dynamics could shift next year on Asia's rising interest rate differential and advanced economies still poised to inject liquidity, particularly by BoJ, ECB and BoE, while we think Fed will likely maintain its very accommodative monetary policy tone (even if market may price-in some changes). Thus, liquidity conditions will remain ample, and alongside attractive fundamentals in the region (as argued in our "Theme #2" earlier), will make management of capital flows an increasing challenge. While the move towards a more market-based CNY fixing certainly helps ease some constraints on Asian currencies to absorb some of the adjustment to more inflows, it is unlikely we will see big CNY adjustment. Moreover, Asian countries have varying levels of financial/capital market openness alongside attractiveness from a risk-adjusted return basis – and this could also lead to unwanted FX outperformance in some more than others.

Countries which value FX stability and monetary independence are more likely to be at risk of imposing less friendly measures on capital flows. We think countries' which value FX stability more due to an external demand-sensitive economy, as well as those which have sufficient inflation and financial stability concerns that would warrant a greater premium on having monetary autonomy, may be more likely to forego capital mobility somewhat in order to address the policy 'trilemma' of international finance (i.e. a country cannot have exchange rate stability, monetary autonomy and capital mobility all at the same time). Moreover, if erosion of central banks' financial strength becomes an issue, this could also lead to sub-optimal policy tools to address capital flows. Moreover, countries that do not need foreign capital to meet their financing needs are likely to be less sensitive to the potential adverse negative market responses to capital flow-related measures.

[6] See *Asia Macro View - FX Policy: To Intervene or Not to Intervene?* (19 Nov 2012).

Based on experiences we saw in 2010 after QE2 (wherein restrictions to capital inflows weren't effective but ended up impeding financial market deepening)**, we think punitive restrictions on capital inflows are still unlikely, but cannot be precluded**. Korea, Taiwan and Thailand have historically been countries that have introduced measures to curb short-term capital flows, but in Korea's case, we expect it may only expand on existing measures already in place rather than introduce new ones (such as the Tobin tax), while for Taiwan and Thailand (and Philippines), measures will likely be more focused more on boosting capital outflows (or keeping rates at sub-optimal levels for longer). Meanwhile, current account deficit countries are likely to continue to *encourage* capital inflows, especially those with room to liberalize capital account inflow restrictions (India and Sri Lanka).

Figure 22. Recent Regulations on Capital Flows and Potential Future Measures in the Pipeline

	Last measures targeted at capital flows	Potential New Measures
China	(April 2012) The authorities expanded the renminbi Qualified Foreign Institutional Investors (RQFII) pilot program by increasing the investment quota by 50 billion yuan from the previous 20 billion yuan and also raised the investment quota of Qualified Foreign Institutional Investors (QFII) by $50 billion to $80 billion; (Nov 2012) The authorities further expanded RQFII quota from 70bn yuan to 270bn yuan.	Speed up QFII approvals and facilitate the operation of the QFII program to attract more long-term overseas investment; loosen restrictions to allow more institutions to apply for exchange-traded-fund (ETF) products under a pilot scheme; encourage more two way flows
Hong Kong	(Oct 2012) Announced a new Buyer's Stamp Duty (BSD) on property purchases by any non-HK permanent resident or corporate	We think that the government could lower the mortgage Loan-to-Value ratio for foreign buyers and corporate/multiple property investors
India	(Sep-Oct 2012) FDI reforms on some multibrand retail and pension/insurance (subject to parliamentary approval) and WHT reduction to encourage capital inflows including lower WHT on interest payments on overseas borrowings	Further widening of the scope of the External commercial borrowing window, Further increasing the FII limits on govt and corporate debt, issuance of dollar bonds targeted to NRIs
Indonesia	(Aug 2012) reduction of minimum onshore hedging period from 3 months to 1 week (aimed more at deepening the onshore derivatives market rather than influencing IDR)	None (Indonesia would welcome capital inflows)
Korea	(Aug 2011) Bank levy in the name of 'Macro-prudential Stability Levy' will be imposed on non-deposit foreign currency liabilities held by domestic and foreign banks. Differential rates will be applied by duration. Short-term (~1 yr): 0.2%, mid-term (1~3 yrs): 0.1%, long-term (3~5 yrs): 0.05%, (over 5 yrs): 0.02%). Additional tax of less than 1% will be imposed in case of a sudden surge in foreign capital inflows.	Expand on existing measures: e.g. tighten limits on forward position of banks (currently 200% for foreign bank branches & 40% for domestic banks) and/or increase macroprudential levy on ST borrowing of banks (currently 0.2% for less than 1yr, 0.1% for 1-3yrs, 0.05% for 3-5yrs, 0.02% for longer than 5 yrs); Housing measures may be more geared towards loosening than tightening via tax cuts on capital gains or transfer taxes, but will unlikely relax DTI or LTV measures further
Malaysia	None	None
Philippines	(Jul 2012) Restriction of non-resident access to accounts linked to the Special Deposit Accounts (SDAs), (Jul-Aug 2012) Tighter monitoring of bank NDF positions, (Nov 2012) Announce a reduction in government's foreign borrowing plans next year	Relaxing regulations pertaining to capital outflows, for example easing the restrictions on selling dollars to offshore entities. BSP may also extend the BSRD (Bangko Sentral Registration Document) requirement not only for 90-day Time Deposit but also for portfolio investments for all types of fixed income instruments.
Taiwan	(Nov 2012) Tighten regulation on reporting FX transactions greater than $1mn -- banks now have to report the transactions to CBC (central bank) before dealing	Liberalize regulations for overseas investment of Taiwan institutions, especially insurance companies, to encourage capital outflow;
Thailand	(Oct 2012) Announced the "Capital Account Liberalization Master Plan" to encourage overseas investment; remove limits to ODI by Thai individuals, widen institutional investor base and raise limits for outward portfolio investment; remove limit on FCY deposit account, etc.	Lower taxes or grant tax exemption to dividends/profits repatriated from abroad to encourage more capital outflows, could tighten foreign exemptions from paying the 15% WHT
Singapore	(Dec 2011) Discriminatory property stamp duties based on residency status of the buyer	Could raise the Additional Buyer Stamp Duty for foreign buyers. We could also see tighter regulations on mortgage lending related to non-residential property segments.
Sri Lanka	(Jul 2012) Liberalized fund transfer rules between Non-resident foreign currency and resident foreign currency accounts; (Sep 2012) increased flexibility of the 12.5% foreign quota rule on T-bills/bonds by allowing this quota to be applied to the combined amount (rather than separately)	Raise the quota for foreign holdings of Treasury bonds/bills further; take further steps to enhance the attractiveness of foreign investment in corporate bonds

Source: Citi Research

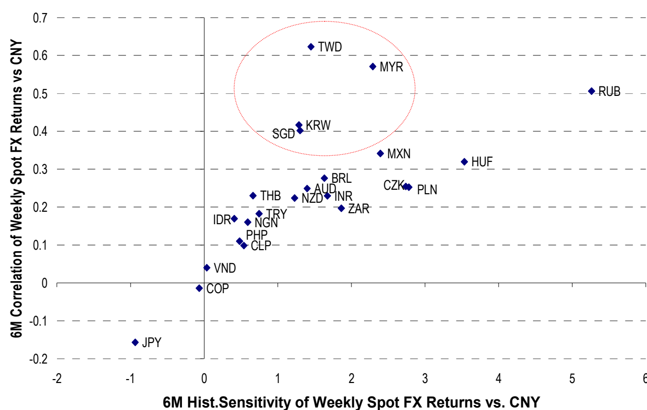
Macro Strategy

Asian FX: Global outperformance as we anticipate a gradual "regime" change in CNY towards more market-based fixing driving the correlated surplus currencies of KRW, TWD, SGD and MYR – meanwhile IDR is likely to underperform.

We expect a "de-coupling" of CNY versus DXY with a projected gradual CNY appreciation to 6.15 in 6-12M even as DXY is projected to rebound in that period. We think we are in the midst of a "regime change" in China towards a more market-based RMB fixing that will continue in 2013 as the costs of further reserve accumulation, in terms of delaying much needed economic rebalancing, rising sterilization costs and financial risks involved with excessive reserves, and inflation/asset bubble concerns well outweigh the benefits of trying to keep the currency undervalued. Notwithstanding some financial outflows, China's structurally large basic balance surplus argues for a bias towards gradual appreciation.

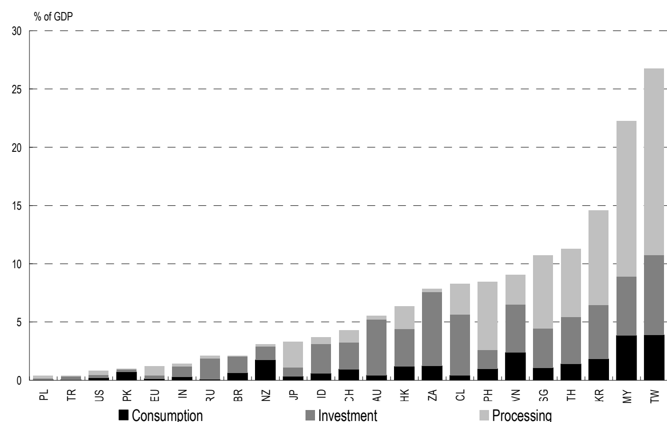
We think a more flexible market-determined CNY appreciation will influence the movements of the more "managed" (CA surplus) currencies in East Asia whose performance is constrained (partly via intervention) by desire to stay competitive with China given sizeable trade linkages. The correlation of spot FX returns with CNY is relatively higher among the currencies of very trade linked economies – TWD, MYR, KRW and SGD. While SGD is bound by MAS' use of a SGD NEER band as its monetary policy tool, steady RMB appreciation throughout next year, alongside Singapore's own inflation and financial stability concerns, likely makes it less likely we see further MAS policy easing. Meanwhile, the current account deficit countries of IDR and INR are more vulnerable to underperforming in an environment where financial flows may not fully cover their financing needs but we are more optimistic further reforms in India alongside liberalization of its capital inflow restrictions can still provide room for INR outperformance in the coming year.

Figure 23. Historical Correlation and EM FX with CNY



Source: Bloomberg, and CIRA

Figure 24. Exports to China by Inferred End-use in 2011 (as a % of GDP)



Source: Citi Research. Note that usage is based on our own analysis and assumptions. See *Asia Macro View – Who Benefits from China's Domestic Demand* (5 June 2009) for details on methodology.

Asian rates: Lower yielding and US-Treasury-correlated Asia bond markets are susceptible to a re-pricing of the US rate curve and we would pare down duration; we think less correlated markets like INR bonds do better subject to reform progress, but we expect higher yielding frontier local markets like LKR and VND bonds will outperform

We think 2013F will favor outperformance of high yielding local bonds that are less sensitive to a correction in US rates and will benefit from continuing bias towards yield. With easing cycle among Asian countries coming to a close next year-- some already expected to hike rates by 2H 2013— and most Asian bonds already rallying to historically low yield ranges and very flat curves (especially in Korea), we think they are susceptible to both a re-pricing of rate expectations both domestically and in the US (see Figure 20) even if partly offset by structural inflows persist. We recommend paring down duration exposure on lower yielding and more US-Treasury correlated Asian bonds. We think the best way to express expectation

of a steepening bias in the US curve is via KRW IRS steepeners – swap curves are historically too flat, trade rich to KTBs and are highly sensitive to US swaps.

Less US Treasury correlated markets like India and Indonesia government bonds may do better, but **we prefer India to Indonesia** --- INR bond valuations already reflect significant negative developments on the fiscal front and there is prospect for pricing in favorable fiscal/capital flow-related reforms. However, **we think frontier local markets like Vietnam and Sri Lanka have more room to shine.** Vietnam short-tenor bonds provide compelling carry trade opportunities amid a *very stable outlook* for the dong and we think inflation pressures will remain contained amid a dysfunctional and insolvent banking system. Meanwhile, we remain bullish on the prospects that LKR-denominated Treasury bonds can outperform both on substantial carry and capital appreciation with yield compression on the back of inflation deceleration and further liberalization of the currently "binding" 12.5% of outstanding quota for foreign access.

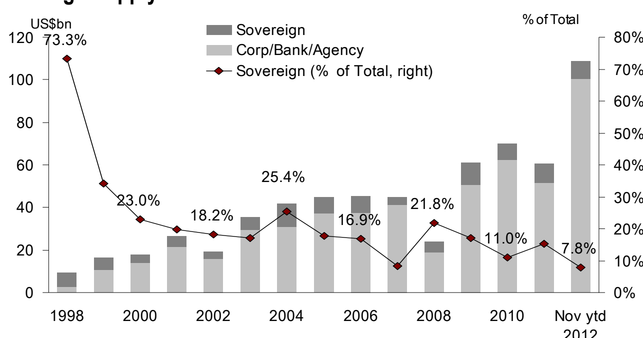
Asian credit: Expect credit spreads can grind tighter. Indonesia should do better vis-a-vis the lower-beta sovereigns but higher beta Vietnam and Sri Lanka sovereigns are expected to outperform.

Asia's dollar bond issuance "exploded" in 2012, up 80% YoY, dominated by high grade corporate issuance (45% of outstanding). Share of sovereign issuance continues to dwindle as many Asian issuers of the past don't need external funding or can tap local currency markets instead–Philippines' dollar issuance is disappearing, leaving Indonesia as the dominant issuer in the region (more so if we include the quasi-sovereigns) alongside frontier economies—Sri Lanka and Mongolia (Vietnam hasn't issued since 2010 and unlikely to next year) — where issue sizes tend to be smaller. With a lingering search for yield and safety among sovereign/quasi-sovereign space, we expect the following:

- Spreads among "lower beta" Asia sovereigns can still grind a bit tighter on diminishing supply and safe-haven bid, *with outperformance of Indonesia*, as it is still trading at a substantial premium to other investment-grade and "borderline" investment grade EM sovereigns. Despite concerns about macro policy management, its strong balance sheet and bullish growth prospects underpinning its credit profile remain well intact (See Figure 26).

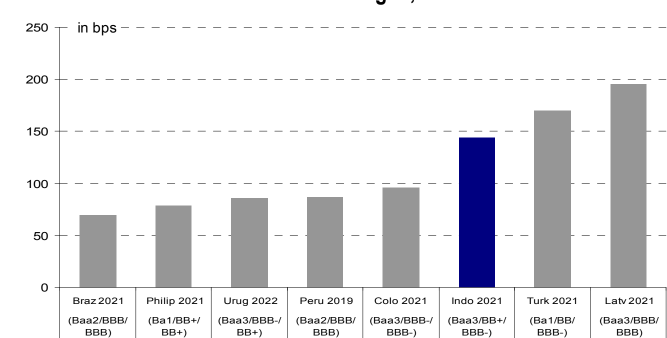
- *We expect outperformance among the higher beta sovereigns* – there are three main candidates – Sri Lanka ($B1^{pos}$/B+/BB-), Vietnam (B2/BB-/B+) and Mongolia (B1/BB-/B+) – but we are more wary of Mongolia as its credit profile is vulnerable to weaker policy discipline amid excessively expansionary fiscal policy (including off-budget spending) funded via significant borrowings. At least in Sri Lanka and Vietnam, we sense more policy discipline, in the latter more than the former, and notwithstanding Vietnam's bank sector problems, its external liquidity position looks very strong, delaying the pressure for front-loaded offshore funded bank recapitalization.

Figure 25. History of Asia Dollar Bond Issuance – Sovereign vs. Non-Sovereign Supply



Source: Citi Research

Figure 26. Comparing Z-spreads (mid) of 10yr Investment Grade and "Borderline" Investment Grade Sovereigns, as of 23 Nov



Source: Citi Research, Bloomberg

Asia equities: We expect a 15-18% moderate return on Asian equities, driven by a better performance out of North Asia, financials and cyclicals.

Our Asia equity strategist, Markus Rosgen, expects Asian markets to have another up year in 2013 just as they did in 2012. The key reasons behind this optimism are five fold. First, valuations are still very much at the cheap end of the range between 0.5 to 0.8 standard deviations below their historic means for P/E and P/BV. Compared to short term interest rates equities look cheap and the same can also be said vs. fixed income. Over half of the countries in Asia have dividend yields which exceed local bond yields. What you pay for a financial asset ultimately determines how much you make. Right now, investors are not paying a lot to own Asian shares. Second, liquidity story remains supportive. The asset side of Asian central banks is expanding again, +6.7% yoy. Whenever this has been the case, valuation multiples have expanded. Linked to liquidity are bank deposits which have grown by 14% this year even though investors have received negative real rates of interest on these deposits. Retail is more concerned about the return of money than a return on money which is indicative of quite how negative retail investors are. Third, earnings revisions, though we are still seeing more downward revisions vs. upward revisions, the pace of negative revisions has declined. With earnings growth by IBES at 13% for 2013 a little on the high side-top down we are at 6-8% next year will be the 2nd year of +ve earnings growth. Earnings growth won't be stellar but growth there will be nonetheless. Fourth, economic data is generally coming in better than expected which is a positive change from where we were 6 months ago. Yes, lowered expectations have helped but at the same time, the economic data with the exception of Europe has not been as bad as expected. Finally, positioning remains light, in favor of further short-squeeze rally. Investors remain very cautiously positioned expecting truly debilitating news around every corner and this just hasn't been the case. Retail investors are long cash, institutional investors are long defensives and overall investors have sold equities to buy bonds. In conclusion, another moderate return year for Asia ex, 15-18% total return driven by a better performance out of North Asia, financials and cylicals.

Asian Currencies & Interest Rate Forecasts

Figure 27. Currency Forecasts and Forwards

	Mkt Data			Forecasts								
vs USD	26-Nov	3M Fwd	12M Fwd	0-3 Mos	6-12 Mos	Long-term	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Euro	1.30	1.30	1.30	1.25	1.21	1.19	1.23	1.22	1.21	1.20	1.20	1.20
Japanese Yen	83	83	82	84	85	82	84	85	85	84	84	83
Chinese Renminbi	6.23	6.28	6.32	6.21	6.15	6.05	6.18	6.16	6.14	6.12	6.10	6.08
Hong Kong Dollar	7.75	7.75	7.75	7.75	7.76	7.75	7.75	7.76	7.76	7.76	7.76	7.75
Indonesian Rupiah	9613	9715	10043	9700	9850	9660	9763	9819	9833	9794	9757	9719
Indian Rupee	55.5	56.3	58.5	52.5	54.0	53.5	53.1	53.7	54.0	53.9	53.8	53.7
Korean Won	1085	1089	1100	1080	1070	995	1076	1072	1063	1048	1033	1018
Malaysian Ringgit	3.05	3.07	3.12	3.08	3.04	3.05	3.06	3.05	3.04	3.04	3.04	3.05
Philippine Peso	41.1	40.9	40.9	41.0	41.5	40.8	41.2	41.4	41.4	41.3	41.2	41.0
Singapore Dollar	1.22	1.22	1.22	1.22	1.20	1.19	1.21	1.20	1.20	1.20	1.20	1.19
Sri Lanka Rupee	130.2	133.8	NA	130.0	130.0	130.0	130.0	130.0	130.0	130.0	130.0	130.0
Thai Baht	30.7	30.8	31.2	30.3	30.8	29.9	30.5	30.7	30.7	30.5	30.4	30.2
Taiwan Dollar	29.1	29.1	28.9	28.5	28.5	28.2	28.5	28.5	28.5	28.4	28.4	28.3
Vietnam Dong	20860	21266	22772	20877	21000	20973	20892	21000	21000	21000	21000	21000

*Forecast as of Citi Foreign Exchange: Forecasts (November 19, 2012)
Source: Bloomberg, CEIC Data Company Limited, Reuters, and Citi Research estimates

Figure 28. Interest rate forecasts (% period end)

		26-Nov	In 3M	In 6M	In 12M	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14
US*	Fed Fund Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
	10-Year Treasuries	1.68	NA	NA	NA	1.75	1.95	2.20	2.50	2.65	2.90
EU*	Repo Rate	0.75	0.50	0.25	0.25	0.50	0.25	0.25	0.25	0.25	0.25
	10-Year Bunds	1.44	NA	NA	NA	1.50	1.75	1.75	1.50	1.25	1.50
JP*	Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
	10-Year JGBs	0.74	NA	NA	NA	0.85	1.00	0.90	1.10	1.10	1.00
CN	1-Year Deposit rate	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.50
	1-Month Shibor	3.73	3.99	3.99	4.15	3.99	3.99	3.99	4.24	4.49	4.49
	Government bond yield (5 -Year)	3.24	3.24	3.24	3.40	3.24	3.24	3.24	3.49	3.74	3.74
HK	3-Month Interbank Rate	0.40	0.43	0.51	0.71	0.45	0.55	0.65	0.75	0.85	0.95
	5-Year Exchange Fund Note	0.30	0.35	0.52	0.91	0.40	0.60	0.75	1.00	1.30	1.50
IN	Overnight Repo Rate	8.00	7.75	7.50	7.25	7.50	7.25	7.25	7.25	7.25	7.25
	Overnight Reverse Repo Rate	7.00	6.75	6.50	6.25	6.50	6.25	6.25	6.25	6.25	6.25
	91-Day T Bill	8.19	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50
	10-Year Gilt	8.23	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25
ID	BI Policy Rate	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75
	FasBI Rate	4.00	4.00	4.00	4.25	4.00	4.00	4.25	4.50	4.50	4.50
	O/N Interbank Rate	4.17	4.15	4.15	4.59	4.15	4.15	4.40	4.70	4.70	4.70
	10-Year Government Bond	5.41	5.56	5.58	5.89	5.70	5.50	5.70	6.00	6.25	6.23
MY	Overnight Policy Rate	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50
	3-Month Interbank Rate	3.21	3.21	3.21	3.21	3.21	3.21	3.21	3.21	3.40	3.60
	5-year MGS	3.19	3.20	3.23	3.28	3.20	3.25	3.25	3.30	3.40	3.50
PH	O/N Rate	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.75
	1-Month Reference Rate	0.81	0.91	1.31	2.31	1.00	1.50	2.00	2.50	3.00	3.50
	5-Year T Bond	3.73	3.82	3.81	3.85	3.75	3.85	3.85	3.85	3.85	4.00
SG	3-Month Interbank Rate	0.38	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30
	10-Year SGS	1.36	1.30	1.36	1.66	1.30	1.40	1.60	1.70	2.00	2.10
KR	BOK Policy Rate	2.75	2.50	2.50	2.75	2.50	2.50	2.50	2.75	3.00	3.25
	91-Day CD	2.85	2.77	2.70	2.89	2.70	2.70	2.70	3.00	3.25	3.45
	5-Year Treasury	2.91	2.80	2.81	2.99	2.75	2.85	2.90	3.05	3.38	3.65
SL	Repo Rate	7.75	7.75	7.75	7.25	7.75	7.50	7.25	7.25	7.25	7.25
	1-Month T-Bills	12.84	12.50	12.19	10.87	12.50	12.00	11.50	10.50	10.00	10.00
	364-Day T-bill	12.81	12.18	12.00	10.37	12.00	12.00	11.00	10.00	10.00	9.08
TW	Overnight Rate	0.39	0.42	0.45	0.51	0.43	0.46	0.49	0.52	0.55	0.58
	Re-discount Rate	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88
	10-Year Government Bond	1.14	1.14	1.17	1.23	1.15	1.18	1.21	1.24	1.27	1.30
TH	Overnight Repo Rate	2.75	2.50	2.50	3.00	2.50	2.50	2.50	2.50	2.50	3.00
	1-Month interbank Rate	2.79	2.47	2.48	2.69	2.45	2.50	2.60	2.75	2.70	3.00
	10-Year Government Bond	3.39	3.09	3.22	3.46	3.00	3.35	3.40	3.50	3.50	3.75
VN	Refinance Rate	10.00	10.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00
	1-Month interbank Rate	4.57	7.25	7.40	8.00	7.25	7.50	8.00	8.00	8.00	8.33
	5-Year Treasury	9.83	9.32	10.12	11.00	9.50	10.50	11.00	11.00	11.00	9.83

Note: *Forecast as of Global Economic Outlook and Strategy (November 26, 2012)
Source: Bloomberg, CEIC Data Company Limited, Reuters, and Citi Research estimates

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- **Summary view** – We expect the new leaders to take a pro-stability policy stance while pursuing incremental structural reforms. The current growth rebound may last into 1H next year, followed by a slowdown due to weak external demand and more neutral policy stance. GDP will likely grow by 7.8% in 2013.
- **Things to watch** – In the near term, financial and fiscal reforms can be the bright spots, including introduction of deposit insurance, interest rate and exchange rate reforms, tax cuts for small business, and expansion of the pilot programs on service VAT and residential property tax to more regions.
- **Strategy** – There are sector opportunities while concerns over pro-stability policy weighs on the market index. Sectors that suffer less from over-capacity and anticipate earning stabilization will likely outperform, and sectors exposed to infrastructure, urbanization and environment protection should beat the market.

Longer term challenges

Recent leadership reshuffle will likely reshape China's economy in the next 10 years. The report approved by the recent national party congress aims at doubling 2010 GDP and per capital income of urban/rural households by 2020. The new leaders may accept lower potential growth, but may not see it as an option to implement big bang reforms that promise to unleash long-term potential but can sacrifice growth significantly in the short run. In particular, the government may see 7% annual growth as a minimum acceptable growth rate, which is required to double 2010 GDP by 2020.

In our base case scenario, the government can just achieve the growth target. By following sufficient reforms without introducing aggressive stimulus measures, we estimate that average GDP growth can reach roughly 7.1% during 2013-20, and 2020 GDP in real terms would be twice as much as that of 2010. To achieve the household income target, it requires significant income redistribution measures. We estimate that in 2020, China's nominal GDP may reach about US$20tn, or roughly US$15,000 per capita.

A substantial structural reform will be needed to strengthen the growth potential. The new leaders are likely more pro-stability with only incremental reforms to sustain growth. In order to fulfill the growth targets, in our view, a reform agenda will have to be launched in the fall of 2013 to address the following issues: (1) making investment more efficient by normalizing the cost of capital; (2) promoting new growth drivers to balance between investment and consumption and service industries through urbanization and fiscal reforms; (3) encouraging innovations by introducing a more effective incentive system, including protection of intellectual property rights; (4) facilitating job creation by deregulating the service sector to absorb possible layoffs from the manufacturing sector that suffers from over capacity.

A near-term mild rebound

Policy continuity is likely to be maintained in the near term. The Central Economic Work Conference in mid-Dec will be hosted by the new leaders and shall voice their policy for 2013. It may keep the current macro policy mix, i.e., proactive fiscal policy and prudent monetary policy, to consolidate the growth rebound. Meanwhile, we do not expect fresh stimulus from the new leadership, especially when the growth target is within reach and the job market remains stable.

The government may set the 2013 growth target at 7%. The majority of the policy makers appear to agree that China's potential GDP growth rate will fall into the 7-9% range in next five years, and faster growth supported by another stimulus or further loosening monetary policy would only be costly for future reforms. The official growth target for 2013 may be set at 7% during the National People's Congress in Mar, with macro policies supportive of somewhat higher growth rate.

The policy stance may gradually return to neutral amid strong investment impulse. The policy may be normalized by shifting from an easing bias to a neutral position amid possible inflation rebound. We expect the government to reduce the budget deficit (according to our definition) to 2.0% of GDP in 2013. PBOC may set broad money growth target at 13%, and keep RMB new lending at 8.5-9.0tn. We think 3-5 RRR cuts (50bps each) would be necessary in 2013 to ensure an adequate liquidity condition. RMB may continue to appreciate gradually against the USD and reach 6.15 at end-2013. Benchmark interest rates will likely be raised by 25bps in late 2013 due to rising inflation, but PBOC may instead increase the floating range.

Reform measures that have started are expected to be implemented. In the next 12 months, resource price reform may be expanded from electricity to coal, gas and water. Deposit insurance is likely to be introduced. Interest rate and exchange rate flexibility may be further increased. Barriers for long-term capital flows will likely be further reduced. We may see tax cuts for small business, and an expansion of the pilot programs to introduce VAT in service industries and residential property tax.

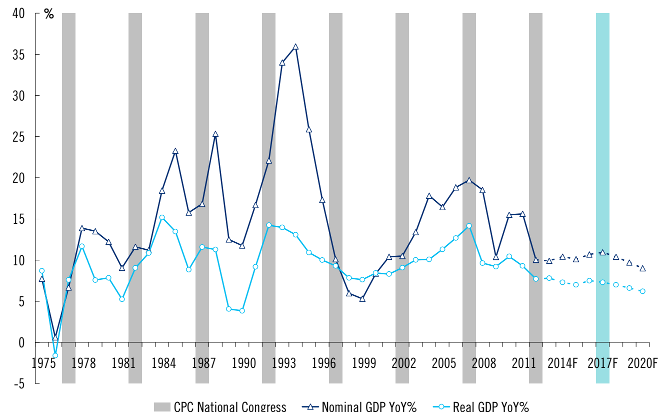
Growth may reach 7.8% in 2013. The current growth rebound would last into 1H next year, due to lagged effects of policy easing of 2012 and supported by the investment impulse of local governments. As the policy stance returns to neutral and external demand is expected to remain sluggish, growth may decelerate again in 2H. More aggressive reforms are likely to be introduced in late 2013, and the quarterly growth may briefly fall below 7% in early 2014.

Picking market winners

In the near term, there are sector opportunities while the concern over pro-stability policy weighs on the market index. Sectors that suffer less from overcapacity (e.g., mostly service sectors including healthcare, non-bank financials, internet and transportation) and anticipate earnings stabilization (e.g., some materials with deep price corrections) will likely outperform. Sectors that are exposed to infrastructure investment, urbanization and environmental conservation (e.g., agriculture, capital goods, consumers, property and energy-saving products) should beat the market.

In the longer term, equity market winners will be those that are able to explore the potentials in an US$20 trillion economy. China's household consumption at a percent of GDP was 35% in 2011, and China's service sector constituted 43% of GDP, the lowest share among peers. Consumer/service sectors will see explosive growth over the next decade if China is able to double its 2010 GDP in 2020.

Figure 29. Political Cycle and China's GDP Growth: A Base Case



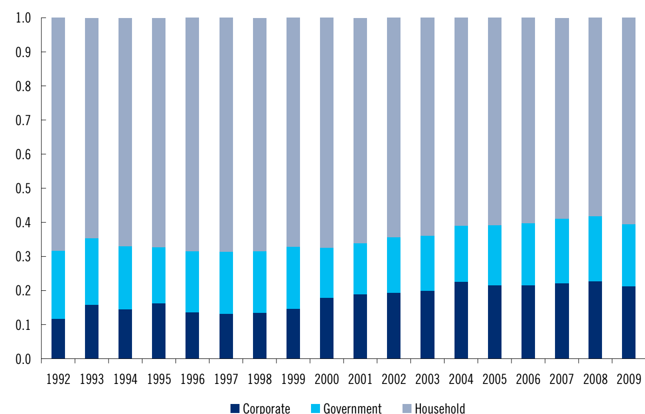
Source: CEIC and Citi Research

Figure 30. Forecasts of China Potential GDP Growth Rates

	2015	2020
Citi: Assuming no significant rebalancing	7.7%	5.5%
Citi: Assuming fast and smart urbanization	8.4%	6.8%
	2011-2015	2016-2020
World Bank and Development Research Center of the State Council	8.6%	7.0%
	2012-2016	2017-2021
OEF	8.3%	7.2%
	2008-2016	2017-2025
Conference Board	6.5%	4.3%
	2011-2015	2016-2020
DRC Aggregated Provincial Data	8.2%	7.3%
	2012-2016	
The State Information Center	7-9%	

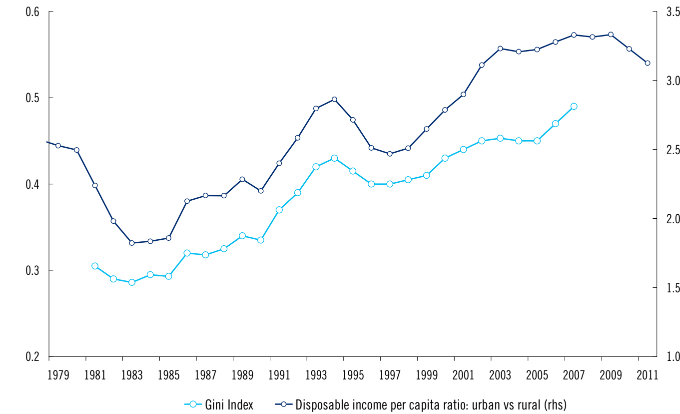
Source: OEF, World Bank, Development Research Center of the State Council, The Sate Information Center and Citi Research

Figure 31. Household share of income generally declined



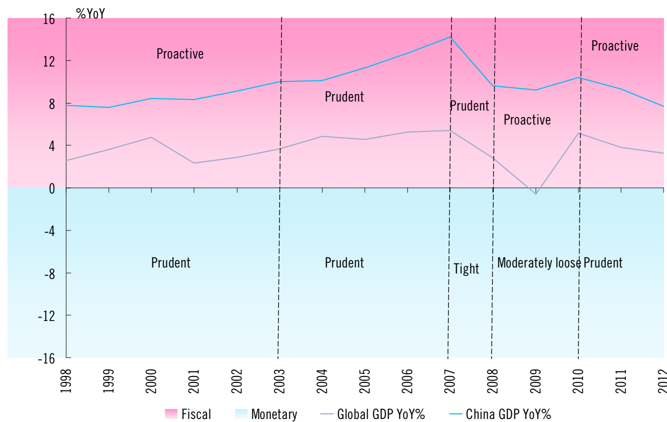
Source: CEIC and Citi Research

Figure 32. Income disparity intensified



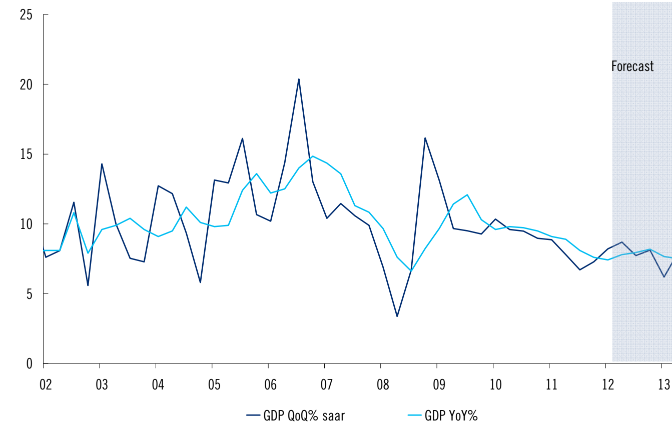
Source: CEIC , World Bank and Citi Research

Figure 33. GDP growth vs Policy mix



Source: CEIC and Citi Research

Figure 34. GDP quarterly growth pattern



Source: CEIC and Citi Research

Figure 35. China Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	2,787.2	3,494.5	4,544.0	5,070.5	5,932.5	7,315.6	8,257.5	9,280.4	10,382.4
Nominal GDP, local currency bn	22,224	26,583	31,490	34,632	40,151	47,288	52,026	57,179	63,138
GDP per capita, US$	2,120	2,645	3,422	3,800	4,424	5,430	6,101	6,830	7,610
Population, mn	1,314.5	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,353.4	1,358.8	1,364.3
Unemployment, % of labour force	4.1	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2
Economic Activity									
Real GDP, % yoy	12.7	14.2	9.6	9.2	10.4	9.3	7.7	7.8	7.3
Real investment growth % yoy	13.6	14.7	11.0	19.2	11.9	10.6	8.3	8.1	7.3
Real consumption growth % yoy	9.8	11.0	8.5	9.4	9.2	9.8	8.6	8.7	8.4
private consumption growth % yoy	11.3	11.1	9.2	10.3	8.5	10.1	8.8	8.9	8.6
Real export growth, % yoy	--	--	--	--	--	--	--	--	--
Real import growth, % yoy	--	--	--	--	--	--	--	--	--
Prices, Money & Credit									
CPI, % yoy	2.8	6.5	1.2	1.9	4.6	4.1	2.5	3.5	4.0
CPI, % avg	1.5	4.8	5.9	-0.7	3.3	5.4	2.7	2.8	3.6
Nominal wages, % yoy	14.6	18.5	16.9	11.6	13.3	17.8	10.0	9.9	10.4
Credit extension to private sector, % yoy	14.3	19.3	14.0	33.2	20.3	14.6	15.0	13.6	13.4
Policy interest rate, % eop	2.52	4.14	2.25	2.25	2.75	3.50	3.00	3.25	3.75
1 month inter-bank rate, % eop	2.58	3.61	1.23	1.79	6.17	6.00	3.99	4.24	4.74
Long term yield, % eop	2.62	4.19	1.80	3.06	3.61	3.27	3.24	3.49	3.99
lc/US$, eop	7.81	7.30	6.82	6.83	6.59	6.29	6.21	6.12	6.05
lc/US$, avg	7.97	7.61	6.95	6.83	6.77	6.46	6.29	6.15	6.07
Balance of Payments, US$ bn									
Current account	231.8	353.2	420.6	243.3	237.8	201.7	206.4	185.6	155.7
% of GDP	8.3	10.1	9.3	4.8	4.0	2.8	2.5	2.0	1.5
Trade balance	177.5	264.3	298.1	195.7	181.5	154.9	202.2	171.0	151.5
Exports	969.0	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,041.2	2,179.4	2,422.7
Imports	791.5	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,839.1	2,008.4	2,271.2
Service balance	-8.8	-7.9	-11.8	-29.4	-31.2	-55.2	-60.8	-66.8	-73.5
Income balance	-5.1	8.0	28.6	-8.5	-25.9	-11.9	-2.0	-0.6	-1.9
FDI, net	102.9	143.1	121.7	87.2	185.7	170.5	157.0	125.6	94.3
International reserves	1,066.3	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,340.9	3,517.5	3,603.3
Total Amortisations	22.1	25.0	30.0	35.0	34.4	38.3	42.1	46.3	50.9
Public Finances, % of GDP									
Consolidated government balance	-1.0	0.6	-0.4	-2.2	-2.2	-1.3	-2.4	-2.0	-2.0
Consolidated gov primary balance	-0.5	1.0	0.1	-1.8	-1.7	-0.9	-2.0	-1.6	-1.6
Public debt	18.6	39.0	37.4	47.8	49.2	44.3	43.6	42.5	40.8
of which Domestic	17.4	38.0	36.6	47.0	48.6	43.8	43.1	42.0	40.3
Foreign Assets & Liabilities, US$ bn									
External debt	338.6	389.2	390.2	428.6	548.9	695.0	764.5	840.9	925.0
Private	304.2	354.3	356.9	391.8	510.1	657.6	723.4	795.7	875.3
Public	34.4	34.9	33.3	36.9	38.8	37.4	41.1	45.2	49.7
External debt / GDP	12.1	11.1	8.6	8.5	9.3	9.5	9.3	9.1	8.9
External debt / XGS	31.9	29.0	24.7	32.2	31.5	33.4	34.1	35.1	34.7
Short-term debt	199.2	235.7	226.3	259.3	375.7	475.7	523.2	575.5	633.1
Short-term debt/International Reserves (%)	18.7	15.4	11.6	10.8	13.2	15.0	15.7	16.4	17.6

Quarterly Economic Indicators

	2012 Q1	2012 Q2	2012 Q3	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	8.1	7.6	7.4	7.8	8.0	8.2	7.7	7.5	6.9
CPI, % yoy	3.6	2.2	1.9	2.5	2.2	2.7	3.1	3.5	3.5
Policy interest rate, % eop	3.50	3.25	3.00	3.00	3.00	3.00	3.00	3.25	3.50
1 month inter-bank rate, % eop	4.22	4.48	3.99	3.99	3.99	3.99	3.99	4.24	4.49
Long term yield, % eop	3.17	2.92	3.24	3.24	3.24	3.24	3.24	3.49	3.74
lc vs USD, eop	6.30	6.35	6.28	6.21	6.18	6.16	6.14	6.12	6.10

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: 1. Public debt includes the debt of central, local govt and Ministry of Railway. 2. External debt is based on the residency of the holder of the debt (not by currency denomination).

Hong Kong

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- **Summary view** – The economy is likely to embark on an uneven recovery in 2013E, with 1Q13E being another quarter of adjustment. Inflation is likely to trend lower in early 2013E, but overall average should be sticky around 3%. Policy actions and politics are in high gears. We think the HKD peg will stay status quo.
- **Things to watch** – 1) The pace of consumer (confidence) retrenchment; 2) property price reaction vs. property policy tool kit; 3) liquidity in/out-flows associated with global monetary easing and risk appetite; 4) pace of trade recovery; 5) possible welfare policies to alleviate poverty.
- **Strategy** – With regional stronger FX trends, HKMA may be forced to further FX intervention at the strong end of the trading band. Given interest rates are at ultra low levels, there is little room for HIBORs to lower despite liquidity injection. Our equity strategist target for the HSI Index in FY13 is at 22,700.

An uneven recovery likely in 2013E

HK's economy likely to embark on an uneven recovery in 2013E. We expect GDP to slowly recover from 2012E's 1.4%yoy to 2.8%yoy in 2013E. The economy bottomed out in 2Q12, but the recovery thus far has been mild as the small open economy continues to be masked by global unsorted affairs. Given our views of a bungee jump reaction to US fiscal cliff discussions, Chinese GDP growth likely to peak in 2Q13E, potential resurgent European risks in 2H13E, the recovery path of HK in 2013E will most likely not be a straight line.

1Q13E could be another quarter of adjustment. Local consumer confidence has been on a downtrend and is unlikely to recover in early 2013, given lingering economic downturn and asset market volatilities. Business sentiment also likely plagued by the unfolding global issues; plus jobs retrenchment customarily takes place around the Chinese New Year. Exports to western countries could also slow again after the festive season and recent tech product launches. An expected appreciating RMB would again raise import prices and allow export prices to be set more competitively, thus aggravating the merchandize trade deficit. Per tourist spending have been shrinking, making large ticket items much less popular; the increase of tourist volume due to multiple entry visa is visible but these type of tourists shop for basic goods are unlikely able to offset the negative impact on retail sales. We expect 1Q13E GDP to grow at 1.7%yoy, slower than 4Q12E's 2.4%yoy.

Economic momentum in HK could firm up modestly in 2Q and 3Q of 2013, partly helped by base effect, and consumer and business confidence could normalize with pent up demand and benefit from improvements in the Chinese economy. Vibrant property construction and on-going large scale infrastructural works are also good cushioning to growth. Fiscal stimulus is also likely to support the needy and employment, possible measures to help mitigate the inflationary impacts on lower income group are also likely.

Some more liquidity inflows expected. Since mid-Oct12, there were episodes of capital inflows which triggered HKMA undertaking at the strong end of the HKD trading band. The scale of inflows observed has been small relative to the 2009 round. We expect modest inflows in early 2013E, if US fiscal discussions work out and easy global money would continue to find interest in the Chinese recovery theme. In light of this, we expect further HKMA interventions to defend the HKD peg. We expect the HKD peg to stay status quo until China liberalizes its capital accounts.

Consumer inflation likely sticky around 3.5%yoy, on average. In 2013E. The economy has been undergoing disinflation (especially seen in underlying inflation trend) in 2012, and disinflation likely would be exaggerated by base effects in early 2013. However, with the likely gradual warming of the economy, passthrough from private rentals, the RMB appreciation impacts on imported goods and the increase of minimum wage from HK$28/hour to HK$30/hour could put a floor to disinflation starting in 2Q13E. Although liquidity inflows have helped ease funding tightness in banks lately, our view is that potential credit growth remains capped by the lack of loan demand and banks' preparation for Basel III. We, therefore, are less concerned about the potential inflationary impacts from liquidity/credit.

Policy actions in high gear

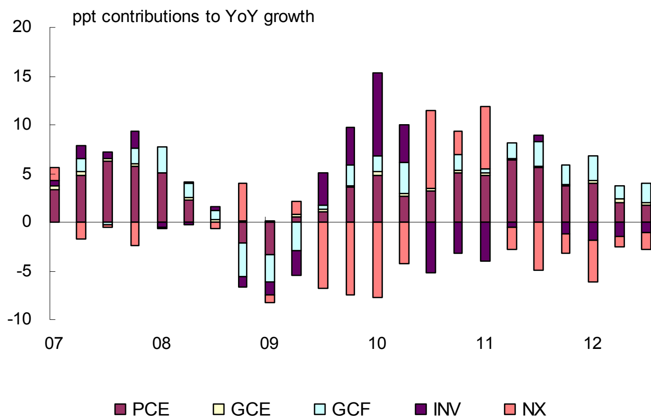
The upcoming Policy Address (PA) likely focus on housing policies, alleviating poverty and ironing out kinks for better integration with the Mainland. The Chief Executive (CE) Leung will deliver his comprehensive policy blueprint in his first PA in Feb. Population, land and housing reviews are currently underway and initial results could be discussed then. Piecemeal policies regarding alleviating poverty and elderly subsidies have been announced and are being reviewed at the legislature, but a more comprehensive summary of welfare policies would be needed during the PA. We also expect more updates on medical reforms. Longer term plans set by the previous government administration regarding infrastructural plans to link up with the Pearl River Delta and better cooperation with the Mainland will unlikely be altered; we expect the PA would address soft/hard-ware bottlenecks that are causing HK-ers/Mainland Chinese conflicts.

Housing policy likely still takes center stage in the PA. Policymakers have set providing affordable housing to the HK people as a top policy agenda, and active interventions in the property market appears to be the new modus operandi. So far regulations have been revised to inhibit unfair marketing practices, mitigate the systemic risks of over leverage in this sector, and taxing property investments by foreign buyers and speculators, while the Government provides more land for private flats building and increasing public housing supply. Our property analyst believes that the late Oct12 demand side measures would likely stabilize home prices and lower turnover at least for 6 months (i.e. till Apr13), and indeed initial success is seen at calming market activities and home price rise. Policymakers are still gauging the effects of announced measures, but we believe more policy tools are ready should home prices surge again or spread to other types of properties.

We do not regard the new property tax changes as a sign that policymakers are deviating from the free-market doctrine (as described by some critics). We concur with the Government that the latest changes in Buyers/Special Stamp Duties are implemented at an abnormal market period, when housing in-affordability are unprecedented under the prolong ultra-low interest rate environment. Although this new Government administration appears more re-active than its predecessor, we would like to point out that the HK Government has never been afraid to intervene in the market at times of abnormal market behavior, where the classic example dates back to 1997 with the Government stock market intervention.

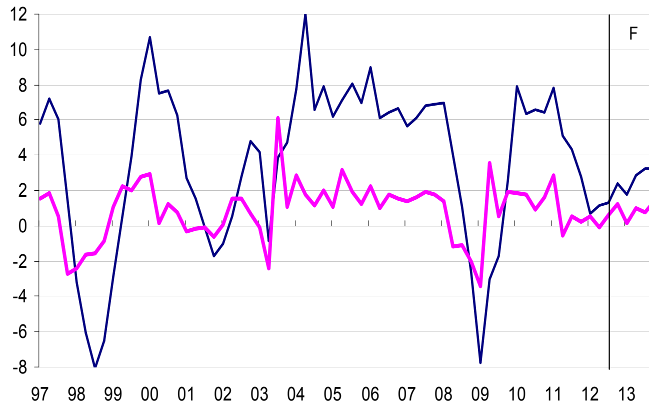
More politicking as political parties prepares for the likely universal suffrage in 2017 CE elections. Regular high profile but peaceful protests are to be expected going forward. The challenging relationship between the government and the legislature will likely inhibit efficient policy implementation. The cabinet would need to work on better communication with the Legislative Council and to improve its current low popularity ratings, in our view.

Figure 36. Trade & inventories are still drags to GDP growth in 1Q-3Q



Source: CEIC and Citi Research

Figure 37. We expect economic recovery will be uneven in 2013E ...

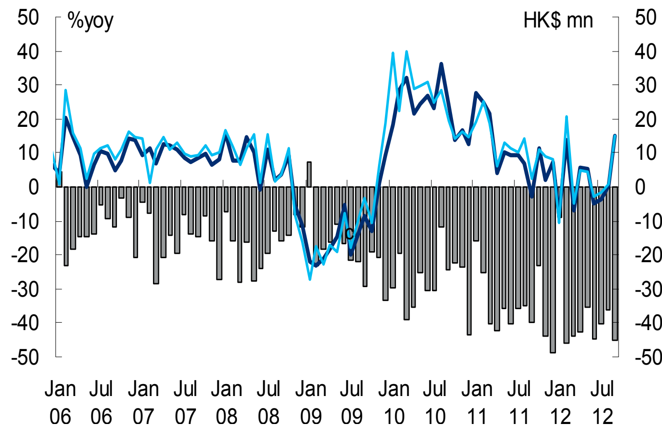


Source: CEIC and Citi Research estimates

Figure 38. ... As consumer confidence remains on a downtrend, ...

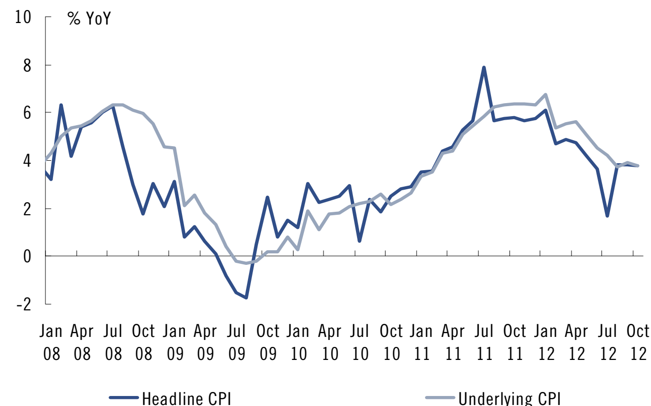
Source: CEIC and Citi Research

Figure 39. ... And trade recovery are plagued with external uncertainties



Source: CEIC and Citi Research

Figure 40. Further disinflation likely in early 2013E on base effects



Source: CEIC and Citi Research

Figure 41. HKD peg strength likely maintained near term

Source: Reuters and Citi Research

Figure 42. Hong Kong Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	193.5	211.6	219.3	214.0	228.8	248.6	263.0	279.5	300.0
Nominal GDP, local currency bn	1,503	1,651	1,707	1,659	1,778	1,935	2,040	2,168	2,325
GDP per capita, US$	28,010	30,434	31,375	30,432	32,375	35,157	36,918	38,913	41,437
Population, mn	6.9	7.0	7.0	7.0	7.1	7.1	7.1	7.2	7.2
Unemployment, % of labour force	4.8	4.1	3.4	5.2	4.4	3.4	3.4	3.7	3.5
Economic Activity									
Real GDP, % yoy	7.0	6.5	2.1	-2.5	6.8	4.9	1.4	2.8	3.5
Real investment growth % yoy	8.4	7.8	-0.3	0.9	10.1	1.9	2.6	5.0	2.3
Real consumption growth % yoy	5.4	7.9	1.9	1.0	6.0	7.5	3.7	2.0	2.0
private consumption growth % yoy	6.1	8.6	1.9	0.8	6.3	8.2	3.8	1.9	2.1
Real export growth, % yoy	9.4	8.3	2.5	-10.2	16.8	4.1	1.0	1.8	4.3
Real import growth, % yoy	9.1	9.1	2.2	-9.0	17.4	4.6	1.9	1.7	3.7
Prices, Money & Credit									
CPI, % yoy	2.3	3.8	2.1	1.5	2.9	5.7	3.5	3.7	3.5
CPI, % avg	2.0	2.0	4.3	0.6	2.3	5.3	4.0	3.5	3.7
Nominal wages, % yoy	2.1	2.4	4.0	-1.9	2.4	9.9	5.0	3.5	4.5
Credit extension to private sector, % yoy	2.3	15.2	11.0	-2.1	20.9	12.8	6.0	7.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	3.84	3.31	0.89	0.13	0.33	0.38	0.40	0.75	1.15
Long term yield, % eop	3.69	3.10	1.19	1.93	1.76	0.96	0.25	1.00	2.10
lc/US$, eop	7.78	7.80	7.75	7.75	7.77	7.77	7.75	7.76	7.75
lc/US$, avg	7.77	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.75
Balance of Payments, US$ bn									
Current account	24.6	27.6	32.9	20.3	15.0	16.2	13.2	15.7	18.5
% of GDP	12.7	13.0	15.0	9.5	6.6	6.5	5.0	5.6	6.2
Trade balance	-17.9	-23.5	-25.9	-28.9	-43.1	-54.8	-62.3	-62.3	-64.6
Exports	316.8	344.7	363.0	318.7	390.4	429.2	444.2	466.2	509.8
Imports	334.7	368.2	388.9	347.6	433.5	484.0	506.5	528.5	574.4
Service balance	-9.3	-4.3	-2.7	3.4	10.1	19.0	18.0	18.2	18.4
Income balance	4.6	6.8	12.9	6.4	4.8	8.8	7.1	7.1	7.2
FDI, net	-15.5	-19.0	-8.9	-6.4	-10.5	-6.9	-9.8	-11.0	-12.0
International reserves	133.2	152.6	182.5	255.8	268.7	285.4	300.0	325.0	350.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	3.8	7.3	0.1	1.5	4.1	3.8	0.8	1.1	1.1
Consolidated gov primary balance	3.9	7.4	0.1	1.6	4.2	3.8	0.9	1.1	1.1
Public debt	1.4	1.2	1.0	0.7	0.6	0.6	0.5	1.0	1.3
of which Domestic	0.6	0.4	0.2	0.1	0.0	0.0	0.1	0.2	0.3
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

	2012 Q1	2012 Q2	2012 Q3	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	0.7	1.2	1.3	2.4	1.7	2.2	3.4	3.7	3.6
CPI, % yoy	4.9	3.7	3.8	3.5	2.8	3.5	3.4	3.7	4.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	0.30	0.30	0.30	0.32	0.37	0.47	0.57	0.67	0.77
Long term yield, % eop	0.55	0.38	0.32	0.25	0.40	0.60	0.75	1.00	1.30
lc vs USD, eop	7.77	7.76	7.75	7.75	7.75	7.76	7.76	7.76	7.76

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

India

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- **Summary view** – 2013 is a crucial year for the economy (1) Economically - will the economy respond to recent reform measures and (2) Politically – will the government be able to pass legislation given its minority status; will a pre-election year take its toll on the fiscal?
- **Things to watch** – While positive on the reform front, S&P has said that the political calendar gives the government limited room to implement reforms. We maintain our view that the recent reforms have "bought" India time to avoid a downgrade, but implementation and fiscal consolidation measures are key.
- **Strategy** – Despite growth plummeting to a 10 year low, sticky inflation is likely to result in modest monetary easing. As regards FX, India's relatively high CAD, declining fx import cover and rating agencies on the vigil, is likely to result in the INR trading in the Rs54 range over the next 12 months.

2013 – A crucial year for the economy

Reforms Positive, but Implementation is Key. 2012 was clearly a year of two halves, with the despair seen in 1H reversed to optimism following the slew of government measures post September. However, while the current reforms have led to a revival in investor sentiment and "bought" India time to avoid a rating downgrade, implementation of measures is important. Key steps that could help accelerate growth would be setting up the National Investment Board and addressing execution related obstacles in power, coal, gas, land and environment.

2013 is crucial both economically and politically. Economically - will the economy respond to recent measures? On the political front, key issues include (1) Will the government be able to pass legislation given its minority status (2) Will a pre-election year take its toll on the fisc (3) Could we have early elections? Or (4) Could this be the stepping stone for accelerated economic reform? We maintain our view that as the UPA government is currently in a "minority", there will be parliamentary uncertainty and challenges. We expect these reforms will take time to have an impact and maintain our growth estimates of 5.4% in FY13 and 6.2% in FY14

Growth – Investments, the key delta driver

Setting up the National Investment Board could help speed up projects: The key factor that has led to the deceleration in GDP growth from >8% levels to the last quarterly print of 5.5% is a near collapse in investments. As is well known, this is a result of an amalgamation of factors including (a) lack of sufficient coal/gas and (b) land acquisition/environmental clearance concerns. To this end, the proposed National Investment Board (NIB) where-in the responsibility to make final decisions on investment projects will likely be vested in one single authority will help. The Board will help expedite clearances for projects and promote their implementation by (1) Identifying key projects in each sector (2) Setting and enforcing timelines for clearances/approvals from various ministries (3) Monitoring project progress (4) Taking up the case if ministry/dept fails to act within the stipulated timeline and (5) Resolving inter-ministry/department disputes

Election spending could prop up consumption. A key factor that could support headline GDP at ~5.5%-6% levels is consumption led by election spending. With 8 states going to polls and all eyes on the next general elections in 2014, one could expect continued focus on government welfare schemes as well as a continued increase in minimum support prices of agricultural products.

Fiscal – Consolidation measures key for sovereign rating

FY13 Slippage Priced In, but Reforms Offer Some Hope for FY14: On the fisc, accounting for expenditure and revenue slippages, we maintain our view of the FY13 deficit coming in at 5.9% of GDP vs. the government's target of 5.1%. Going forward, for FY14, the government has taken initiatives toward fiscal consolidation which include (1) Setting up a platform for cash transfers and (2) Focusing on implementing GST. If implemented, this could possibly offset market fears of "yet another easy budget" in FY14, ahead of the next general elections. This would be one of the key factors that could help India avert a sovereign rating downgrade and help the government peg a lower deficit of 5.5% in FY14.

Cash Transfers Led By Aadhaar, a Reality: While implementing the GST is dependent on parliamentary approval, the one area where we could see some reform in the coming months is in the subsidy component. Encouragingly, the Government is turning to direct cash transfer to effectively funnel welfare and subsidy payments to the intended beneficiaries through the use of direct electronic payments. This is by leveraging Aadhaar - a unique biometric-based individual identification number being issued by the Unique Identification Authority of India (UIDAI) to all residents.

RBI – Still stuck between a rock and a hard place

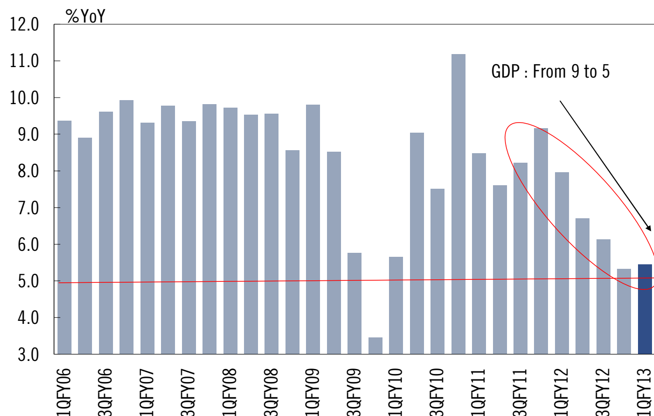
Inflation likely to moderate but remain well over comfort zone: A combination of cyclical and structural factors has resulted in inflation remaining well above the RBI's comfort zone of 4%-5% over the last three years. The latest readings of the WPI and CPI stand at 7.5% and 9.7% respectively. Going forward, given the downtrend in commodity prices and a stable rupee, we expect inflation to moderate to ~7% levels.

RBI to ease, but not much: During 2012, the RBI has (1) cut the repo rate by 50bps from 8.5% to 8% (2) Lowered the SLR by 100bps from 24% to 23% and (3) Reduced the CRR by 175bps from 5.5% to 4.25%. Going forward, despite growth coming off sharply from ~8% levels to 5.4% in FY13E, sticky inflation leaves little room for much monetary easing. We thus maintain our view of the RBI likely to ease policy rates by 50bps taking repo rate to 7.50%.

External – Deficits to remain high; INR likely range-bound

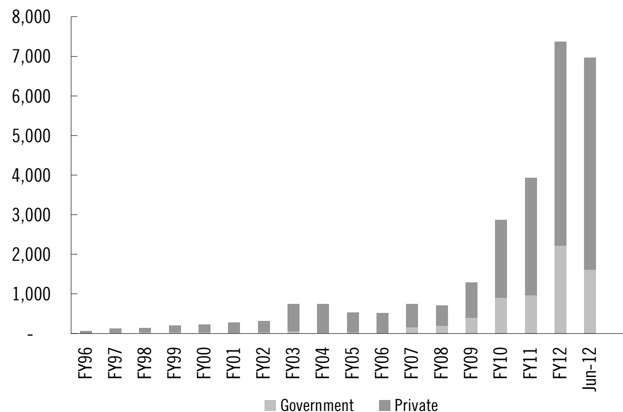
Deficits to Remain High: On the external account, the global slowdown is taking its toll on exports (both merchandise and software). As regards imports, despite lower crude prices, India's inelastic oil demand and gold is likely to keep the current account deficit elevated at 3.7% of GDP in FY13 and 2.8% in FY14. While the reforms are likely to aid capital flows, the relatively high CAD is likely to limit any reserve build-up. This coupled with the declining fx import cover and rating agencies on the vigil, is likely to result in the INR trading in the Rs52.50-Rs54 range over the next 12 months.

Figure 43. Trends in Quarterly GDP (%)



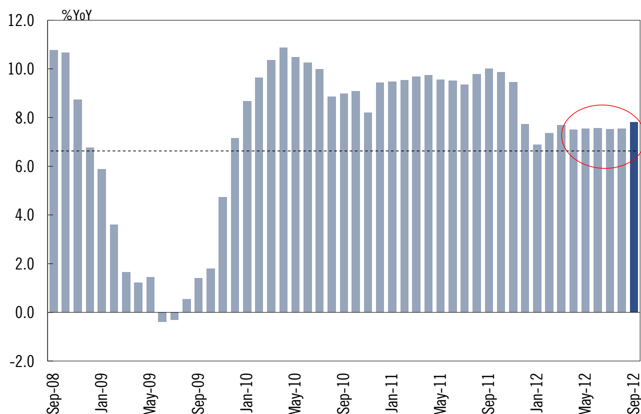
Source: CSO;

Figure 44. Projects Cancelled (Rs bn)– NIB could Reverse Trend



Source: CMIE

Figure 45. Inflation to remain sticky

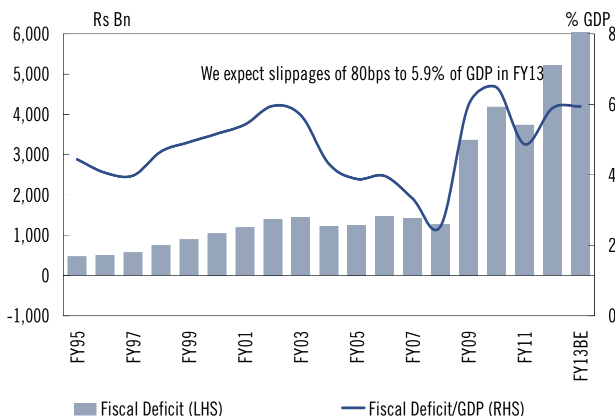


Source: Office of the Economic Advisor

Figure 46. Stable USD/INR could Help Inflation (USD/NR)

Source: Bloomberg

Figure 47. Trends in Centre's Fiscal Deficit (Rs bn, %)



Source: Budget Documents; Citi Research

Figure 48. Sovereign Ratings - Reforms "Buy Time"

	S&P	Moody's	Fitch
LT Foreign Currency	BBB-	Baa3	BBB-
LT Local Currency	BBB-	Baa3	BBB-
Outlook (FC)	Negative	Stable	Neagative

Source: Rating Agencies

Figure 49. India Economic Indicators

Fiscal Year (Calendar Year)	FY07 2006	FY08 2007	FY09 2008	FY10 2009	FY11 2010	FY12F 2011	FY13F 2012F	FY14F 2013F	FY15F 2014F
Summary Data									
Nominal GDP, US$ bn	950.2	1,240.6	1,223.9	1,362.3	1,683.7	1,841.1	1,877.8	2,179.6	2,508.2
Nominal GDP, local currency bn	42,947	49,871	56,301	64,574	76,741	88,558	101,399	116,609	132,934
GDP per capita, US$	847	1,090	1,061	1,164	1,420	1,532	1,539	1,760	1,996
Population, mn	1,122.0	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,220.0	1,238.3	1,256.9
Unemployment, % of labour force	--	--	--	--	--	--	--	--	--
Economic Activity									
Real GDP, % yoy	9.6	9.3	6.7	8.4	8.4	6.5	5.4	6.2	6.9
Real investment growth % yoy	13.4	18.1	-5.2	15.6	11.1	5.3	4.6	5.1	7.4
Real consumption growth % yoy	7.9	9.3	7.6	8.1	8.1	5.4	5.0	5.7	6.6
private consumption growth % yoy	8.7	9.2	7.1	7.0	8.1	5.5	5.0	5.5	6.7
Real export growth, % yoy	19.9	5.9	14.4	-4.1	22.7	15.3	8.0	15.0	11.0
Real import growth, % yoy	21.3	10.2	22.7	-2.0	15.6	18.5	6.0	10.8	9.5
Prices, Money & Credit									
WPI, % yoy	6.8	7.7	1.5	10.6	9.7	7.7	7.5	7.0	6.0
WPI, % avg	6.5	4.8	8.1	3.8	9.6	8.9	7.5	7.0	6.0
Nominal wages, % yoy	--	--	--	--	--	--	--	--	--
Credit extension to private sector, % yoy	28.5	23.0	19.0	16.0	17.0	17.5	17.5	17.5	17.5
Policy interest rate, % eop	7.50	7.75	5.00	5.00	6.75	8.50	7.75	7.50	7.50
1 month inter-bank rate, % eop	9.43	8.00	5.68	4.49	7.25	6.50	6.50	6.50	6.50
Long term yield, % eop	7.98	7.96	7.01	7.83	7.99	8.25	8.25	8.25	8.25
lc/US$, eop	44.12	39.41	48.62	46.41	44.71	53.02	52.57	53.85	53.37
lc/US$, avg	45.19	41.18	43.42	48.30	45.68	46.63	52.99	53.66	53.58
Balance of Payments, US$ bn									
Current account	-9.6	-15.7	-27.9	-38.2	-45.9	-78.2	-69.9	-62.1	-62.3
% of GDP	-1.0	-1.3	-2.3	-2.8	-2.7	-4.2	-3.7	-2.8	-2.5
Trade balance	-61.8	-91.5	-119.5	-118.2	-130.6	-189.8	-188.4	-193.8	-208.1
Exports	128.9	166.2	189.0	182.4	250.5	309.8	291.2	314.5	345.9
Imports	190.7	257.6	308.5	300.6	381.1	499.5	479.6	508.3	554.1
Service balance	29.5	38.9	53.9	35.8	48.8	64.1	65.1	70.4	82.4
Income balance	-7.3	-5.1	-7.1	-8.0	-17.3	-16.0	-15.0	-11.0	-11.0
FDI, net	7.7	15.9	19.8	18.0	9.4	22.1	16.0	21.0	23.0
International reserves	191.9	299.1	241.6	252.8	273.7	260.9	262.5	266.0	272.3
Total Amortisations	11.4	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9
Public Finances, % of GDP									
Consolidated government balance	-5.4	-4.1	-8.4	-9.7	-8.3	-8.4	-8.5	-8.0	-7.5
Consolidated gov primary balance	0.0	-1.1	3.4	4.7	2.7	2.3	--	--	--
Public debt	79.3	76.1	76.1	75.0	71.3	68.9	69.2	68.3	67.5
of which Domestic	74.1	71.4	71.5	70.1	66.6	65.9	66.2	65.6	65.0
Foreign Assets & Liabilities, US$ bn									
External debt	172.4	224.4	224.5	260.9	305.9	345.7	360.7	375.7	390.7
Private	123.0	166.3	168.6	193.9	227.9	263.8	303.7	316.7	329.7
Public	49.4	58.1	55.9	67.1	78.1	81.9	57.0	59.0	61.0
External debt / GDP	18.1	18.1	18.3	19.2	18.2	18.8	19.2	17.2	15.6
External debt / XGS	86.1	88.5	77.7	95.1	79.8	76.2	--	--	--
Short-term debt	28.1	45.7	43.3	52.3	65.0	78.2	83.2	88.2	93.2
Short-term debt/International Reserves (%)	14.7	15.3	17.9	20.7	23.7	30.0	31.7	33.1	34.2

Quarterly Economic Indicators	2012 Q1	2012 Q2	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	5.3	5.5	5.0	5.3	6.1	6.1	6.0	6.3	6.4
WPI, % yoy	7.7	7.6	7.8	7.6	7.2	7.0	7.0	7.0	7.0
Policy interest rate, % eop	8.50	8.00	8.00	7.75	7.50	7.25	7.25	7.25	7.25
1 month inter-bank rate, % eop	8.50	8.50	8.50	8.50	8.00	8.00	8.00	8.00	8.00
Long term yield, % eop	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25
lc vs USD, eop	50.88	55.51	52.86	52.57	53.13	53.69	53.95	53.85	53.75

Source: CEIC Data Company Ltd and Citi Research estimates
*Note: 1. India fiscal year runs from April-March. 2. Public debt is general government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Indonesia

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- **Summary view** – The pace of the economic slowdown, which has mainly been driven by export-related sectors, has been in-line with our expectation and we continue to see GDP growth slowing to a still respectable rate of 6.1% in 2013, from an expected 6.2% in 2012.
- **Things to watch** – Fuel price hike remains a low-probability high impact event worth monitoring. Meanwhile although the CA deficit has shown signs of moderating, the basic balance (CA deficit + FDI) will remain in negative territory, making the balance of payments susceptible to swings in portfolio inflows.
- **Strategy** – The IDR still risks further depreciation despite the improved near term outlook on portfolio inflows. Our YE12 forecast is Rp9,707/US$ and 6-12M forecast remains at 9,850. On rates, we still think the next move will be upward, but have shifted our rate hike call to 2H12.

2013: Modest slow-down ahead

Economic growth slow-down underway, initiated by weakness in net exports. Export growth has declined YoY for the past two quarters. And in 3Q12 we have seen domestic demand also start to weaken. We think this is indicative of upcoming trends for 2013, whereby the weakness in the export sector may eventually impact domestic demand. We expect slower investment growth in 2013 due to declining mining / commodity related machinery investment. And also slower growth in consumption as the impact of weakening plantation commodity sectors impact purchasing power in the rural areas. The slow-down in consumption growth, however, should not be overemphasized. An environment of relatively benign inflation will help maintain domestic purchasing power in urban areas.

Headline inflation may accelerate at a manageable pace. In 2013, we have factored in a 15% increase in electricity tariffs which may push up headline inflation by 0.3-0.4pps from a no-hike scenario. Higher minimum wage hikes may not automatically raise the inflation rate; however we may need to watch for any ensuing impact to price expectations. Another issue to monitor for 2013 is the changing of the CPI base year, which may (favorably) affect the headline inflation rate. The quinquennial cost of living survey is to be completed in 2012 and will be incorporated into the new CPI in mid-2013. Given the secular rise in income per capita, we think it may lead to a further reduction in weightings of foodstuffs, and increase in weights of more stable price discretionary items e.g. cellular phones, cell-phone tariffs, motorcycles, etc.

Fuel price increases remain a low-probability but high impact event to watch. The 2013 budget law states that subsidy spending can be adjusted to anticipate realized deviations from the budget's macro assumptions. Hence in theory, conditional of an overrun in subsidy spending, the government can adjust fuel prices. But in reality, we think a significant political process will likely still precede any fuel price hike Looking at past experiences, all episodes of fuel price hikes in 2005 and 2008 (as well as 2012, though it was cancelled) were accompanied by some form of compensatory / social safety net program. And the legal basis of such programs is usually embedded in the government budget law revision, which does require parliamentary approval. Hence in our view, any fuel price increase will not appear suddenly and without warning (it will likely be preceded by consultations with parliament and possibly a revision of the 2013 government budget).

Labor dynamics will remain at the fore

Unemployment rate decline may continue, though at a reduced pace. Employment absorption of export and commodity-related industries will remain relatively weak. However other sectors e.g. construction, retail trade and manufacturing (domestic-oriented) may continue to absorb labor. We think the investment / GDP ratio will remain over 30% in 2013 and expect the unemployment rate to decline to slightly below 6 percent, from around 6.1% in 2012. This, along with the heightened political temperature in the run up to the 2014 general elections, may continue to result in significant momentum on wage pressures next year. Wages in Jakarta, for example, reportedly may rise by around 40% YoY in 2013.

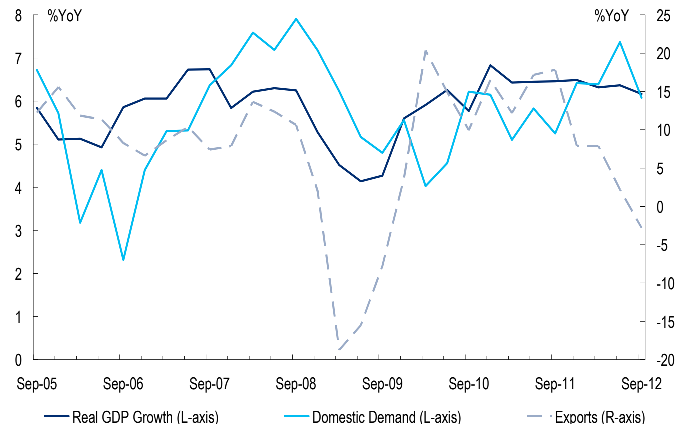
Labor protests have been disruptive, but dramatic impact to FDI outlook not seen yet. Despite forthcoming increases next year, minimum wages will on average still be lower vs. in many peer countries. Domestically there is also still a wide discrepancy between regions, so that room to maneuver or relocate within the country still exists. (Minimum wages is Central Java, for example, is over 40% lower than in the Greater Jakarta area). For now, we do not see a severe negative impact of the labor unrest to the FDI outlook yet. However this may change in the medium term if issues related to law and order (e.g. thuggery), are not quickly resolved and continues to cause disruptions to business operations.

The direct impact of higher wages to CPI inflation is not straightforward; but the impact to price expectations should be closely monitored. Manufacturing wages are not a component of the CPI. Wages that are included in the CPI are housemaid and non-foreman construction workers. Most of these workers are employed in the informal sector thus may not be automatically affected by the minimum wage hikes. Meanwhile the impact of minimum wage hikes to production costs is not negligible, but will not be drastic either. Based on 2-digit industrial classifications, on average, labor costs comprise around 7.4% of the value of goods produced. However for certain industries, the portion of labor costs are higher e.g. 16% for furniture, and between 11-15% for industries such as apparels, textiles and non-metallic mineral production. However given that millions of people will be affected by the minimum wage increase, inflation potential from demand pressures and price expectations should not be overlooked.

CAD may ease, but BOP to continue affecting rates and FX

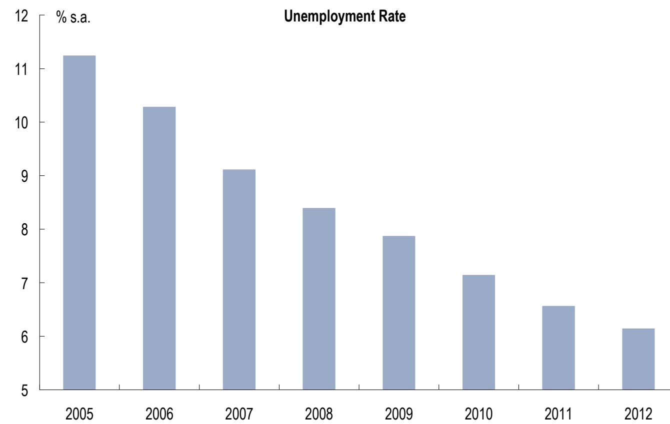
We still expect to see improving domestic capacity and slowing domestic demand growth (as well as possibly increased exchange rate pass-through to import prices) in 2013. We see the current account deficit narrowing to around 1.7% of GDP, from an expected 2.3% of GDP in 2012. However the basic balance may remain negative; i.e. the CA deficit will still be higher relative to FDI inflows. Indeed the outlook for portfolio inflows has turned more positive lately which would help reduce tail risks on the BOP. Yet even though the BOP may show zero or a small positive balance, we think the IDR could still see depreciation pressure, especially as money supply growth remains in double digit territory (credit growth forecast at 18%). Downside on the IDR is also capped by BI's apparent desire to rebuild their reserve position. Our IDR forecast for YE12 is at Rp9,707/US$ while our 6-12M projection is at 9,850. Separately as for interest rates, we see the bias is still to the upside. However given a potentially favorable outlook for portfolio inflows in the near term (which we think will keep the 10-yr yield below 6%), we have pushed back our 2 x 25bps rate hike call to 2H12.

Figure 50. GDP growth slow-down underway



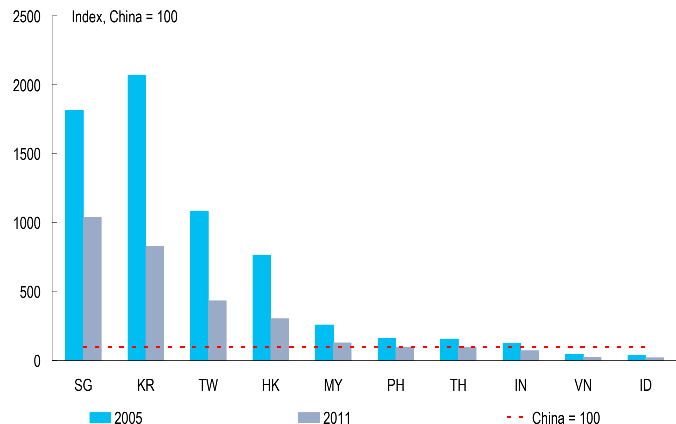
Source: CEIC, Citi Research

Figure 51. Indonesia's unemployment rate may dip further in 2013



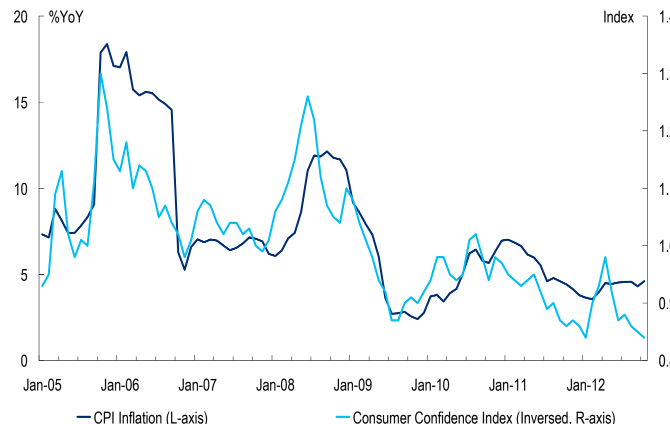
Source: CEIC, Citi Research

Figure 52. Indonesia has a wage cost advantage, but could narrow



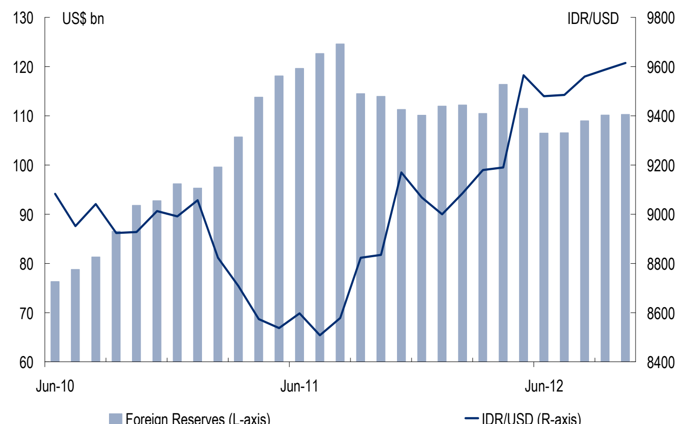
Source: Economist Intelligence Unit, Citi Research

Figure 53. Benign inflation environment helps to prop up confidence



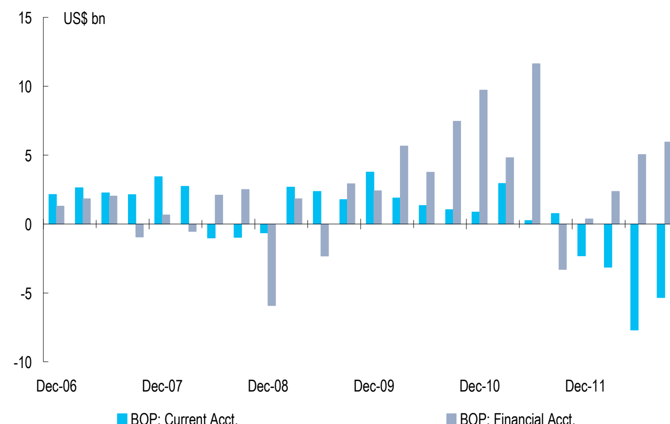
Source: CEIC, Citi Research

Figure 54. BI is aiming to rebuild precautionary reserves



Source: CEIC, and Citi Research

Figure 55. The current account deficit has improved in 3Q12



Source: CEIC, and Citi Research

Figure 56. Indonesia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	364.4	432.2	510.7	538.6	708.7	846.3	878.5	973.8	1,107.3
Nominal GDP, local currency bn	3,339,217	3,950,893	4,948,688	5,606,203	6,436,271	7,427,086	8,318,564	9,545,103	10,744,505
GDP per capita, US$	1,636	1,915	2,235	2,328	2,982	3,488	3,606	3,950	4,440
Population, mn	222.8	225.6	228.5	231.4	237.6	242.6	243.6	246.5	249.4
Unemployment, % of labour force	10.3	9.1	8.4	7.9	7.1	6.6	6.1	5.9	5.8
Economic Activity									
Real GDP, % yoy	5.5	6.3	6.0	4.6	6.2	6.5	6.2	6.1	6.3
Real investment growth % yoy	1.3	1.9	12.4	2.4	11.1	10.6	12.7	12.1	10.6
Real consumption growth % yoy	3.9	4.9	5.9	6.2	4.1	4.5	4.3	4.9	6.0
private consumption growth % yoy	3.2	5.0	5.3	4.9	4.7	4.7	5.1	4.4	5.0
Real export growth, % yoy	9.4	8.5	9.5	-9.7	15.3	13.6	1.3	5.5	10.2
Real import growth, % yoy	8.6	9.1	10.0	-15.0	17.3	13.3	4.3	7.7	11.9
Prices, Money & Credit									
CPI, % yoy	6.6	5.8	11.1	2.8	7.0	3.8	4.6	5.0	4.3
CPI, % avg	13.1	6.3	9.9	4.8	5.1	5.4	4.4	4.7	4.7
Nominal wages, % yoy	15.0	8.2	7.5	6.5	8.3	9.2	10.0	15.0	12.0
Credit extension to private sector, % yoy	14.1	26.4	30.7	10.6	22.8	25.0	22.0	18.0	20.0
Policy interest rate, % eop	4.75	3.00	8.75	6.00	5.50	4.50	4.00	4.50	4.50
1 month inter-bank rate, % eop	5.75	3.35	9.44	6.39	5.66	4.57	4.15	4.70	4.70
Long term yield, % eop	10.18	10.02	11.92	10.07	7.83	6.05	5.30	6.00	6.20
lc/US$, eop	8994	9393	10900	9425	9010	9068	9707	9794	9654
lc/US$, avg	9171	9140	9673	10376	9078	8763	9469	9802	9703
Balance of Payments, US$ bn									
Current account	10.9	10.5	0.1	10.6	5.1	1.7	-20.4	-17.0	-16.4
% of GDP	3.0	2.4	0.0	2.0	0.7	0.2	-2.3	-1.7	-1.5
Trade balance	29.7	32.8	22.9	30.9	30.6	34.8	12.1	17.3	17.8
Exports	103.5	118.0	139.6	119.6	158.1	200.8	187.8	209.7	252.9
Imports	73.9	85.3	116.7	88.7	127.4	166.0	175.7	192.4	235.1
Service balance	-9.9	-11.8	-13.0	-9.7	-9.3	-10.6	-10.2	-11.0	-11.2
Income balance	-13.8	-15.5	-15.2	-15.1	-20.8	-26.7	-26.4	-26.5	-28.0
FDI, net	2.2	2.3	3.4	2.6	11.1	11.5	11.5	13.0	14.5
International reserves	42.6	56.9	51.6	66.1	96.2	110.1	109.2	111.8	114.9
Total Amortisations	35.4	31.5	40.2	36.7	37.6	38.1	40.3	41.0	42.0
Public Finances, % of GDP									
Consolidated government balance	-0.9	-1.3	-0.1	-1.6	-0.6	-1.2	-2.1	-1.5	-1.4
Consolidated gov primary balance	1.5	0.8	1.7	0.1	1.1	0.1	-0.8	-0.4	-0.2
Public debt	39.6	34.1	29.3	31.4	26.3	29.5	23.6	21.9	20.9
of which Domestic	22.6	19.7	16.2	19.3	16.7	15.5	16.1	15.6	15.6
Foreign Assets & Liabilities, US$ bn									
External debt	132.6	141.2	155.1	172.9	202.4	225.4	250.0	285.0	310.0
Private	56.8	60.6	68.5	73.6	83.8	106.7	116.5	146.5	168.0
Public	75.8	80.6	86.6	99.3	118.6	118.6	133.5	138.5	142.0
External debt / GDP	36.4	32.7	30.4	32.1	28.6	26.6	28.5	29.3	28.0
External debt / XGS	115.3	108.2	100.1	130.2	115.8	101.8	118.7	122.0	111.6
Short-term debt	12.2	18.7	20.5	24.0	33.0	36.6	39.0	42.0	45.0
Short-term debt/International Reserves (%)	28.7	32.8	39.7	36.4	34.3	33.2	35.7	37.6	39.2

Quarterly Economic Indicators

	2012 Q1	2012 Q2	2012 Q3	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	6.3	6.4	6.2	6.1	6.0	6.0	6.1	6.2	6.0
CPI, % yoy	4.0	4.5	4.3	4.6	4.4	5.2	4.6	5.0	4.8
Policy interest rate, % eop	3.75	3.75	4.00	4.00	4.00	4.00	4.25	4.50	4.50
1 month inter-bank rate, % eop	3.78	3.98	4.11	4.15	4.15	4.15	4.40	4.70	4.70
Long term yield, % eop	6.02	6.28	5.98	5.30	5.70	5.50	5.70	6.00	6.25
lc vs USD, eop	9144	9393	9570	9707	9763	9819	9833	9794	9757

Source: CEIC Data Company Limited 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).

Malaysia

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- **Summary view** – With exports under pressure and limits to credit-driven consumption, our 2013 growth forecast will hinge on fiscal transfers to households and the continued revival in private investments.
- **Things to watch** – [1] News flow on election timing; [2] Export performance, especially E&E, and spillovers on employment; [3] Implementation of fiscal spending and ETP projects.
- **Strategy** – A narrowing current account, heavy foreign positioning in bonds and overseas purchases by domestic institutional investors will weigh on the MYR's relative performance in the medium term.

Outlook dominated by private investment revival

We nudged up our 2012 GDP forecast to 5.2% (prev: 5%) and expect broadly stable 2013 growth of 5.2% (prev: 5.3%). 3Q GDP demonstrates that the Malaysian economy continues to hold up despite softening on the external front. Going forward, drags from spillovers from the European recession, US fiscal uncertainties and a rebalancing (and slowing) Chinese economy will continue to weigh on trade related activities. This will likely translate into further de-stocking pressures in Malaysia’s critical Electrical and Electronics (E&E) sector, and consequently a negative contribution from inventories in GDP growth over the next 1-2 quarters. Overall, we do not expect the recent rebound in exports to be sustained, with a firmer bottom to be seen only in early 2013.

Consumption will probably moderate slightly in 2013, but remain fairly resilient, as a fairly tight labour market and fiscal transfers cushion against near term drags from CPO prices (which could reverse in 2013), and tighter consumer credit. The relatively mild export downturn thus far – which we expect to continue – has helped resist job losses so far. We estimate fiscal transfers totaling around RM7bn could also lift consumption by between 1-1.5%-pts (or GDP by 0.5-0.7%-pts). With regards to the minimum wage, we had earlier noted that assuming that the 3.2mn workers earning under RM700/m each see a RM200/m increase in wages, the annual increase in incomes will be around RM7.7bn or 0.9% of GDP (1.9% of PCE). Finally, Budget measures may also provide temporary fiscal relief for the most indebted group of consumers who may otherwise see their consumption crimped by credit constraints.

We continue to see scope for a continued rise in the fixed investment share of GDP, given the long implementation pipeline of projects in the next 3-4 years. Work on the Klang Valley MRT project should contribute to fixed investments until its scheduled completion in 2017 even as contracts for the Circle and third lines begin to be awarded in mid-2013. In the oil and gas sector, there is similarly a strong pipeline of projects both from the Petronas capex programme, as well as private and foreign players. Meanwhile Iskandar, and more broadly South Johor, may be beginning to gain critical mass in terms of interest from Singapore investors across a range of sectors. While FDI has slowed because of the challenging external environment, we remain cautiously optimistic on the prospects for FDI. Both from a cost and logistical perspective, Malaysia remains better placed to attract manufacturing FDI as costs in China rise vs many other emerging economies.

The pace of the investment recovery has raised concerns about over-leverage and misallocation of resources to unproductive sectors. Coming after a decade of massive under-investment, concerns are probably over-blown. The impact on corporate balance sheets should not be exaggerated as businesses had relatively limited leverage to begin with. Nonetheless, policymakers are cognizant of several pockets of vulnerability that could be tackled using macro-prudential measures.

Base case of rate pause with risks of 2H13 hike

While inflation has been trending down for the past year or so, we think it may be near the trough. We expect a modest pick up in inflation after Nov as base effects should recede after Oct (inflation peaked in Oct-2011). Our inflation forecasts also incorporate two RON95 fuel price cuts of 10 sen in Jun and Dec, which should result in inflation picking up to around 2.5% in 2H13. The fiscal lift to domestic demand also has the potential to add to core inflation pressures.

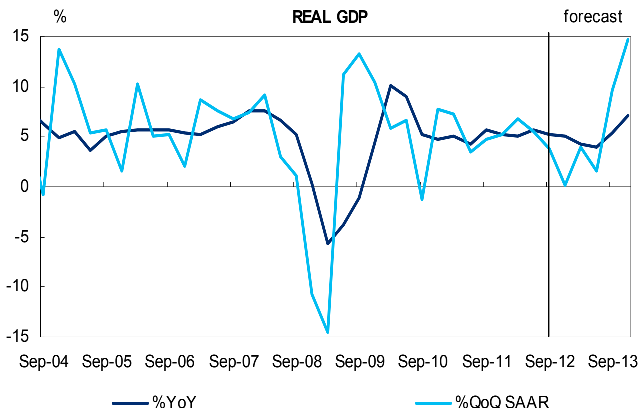
We see few reasons for BNM to cut rates with inflation picking up and domestic demand likely to keep growth within the 4.5-5.5% target next year unless there are signs of a spike in retrenchment or sharp contraction in credit. A second reason for arguing against a rate cut is concern over re-igniting household debt, which is now at around 75% of GDP. Overall, we continue to expect a stable rate outlook into 2013, though with rates assessed to be slightly below neutral and sufficiently accommodative, the risk to this view is probably more a hike in 2H13 if inflation or household debt becomes a concern. Should there be concern about over-investments in non-productive sectors, policymakers will likely opt for macroprudential and non-monetary tightening as a first policy choice, rather than the more blunt interest rate instrument.

Post-election fiscal reforms to keep consolidation on track

The 2012 and 2013 deficit targets of 4.5% and 4.0% of GDP appear realistic, with gross issuance expected to fall to RM94bn in 2013, from RM96.6bn in 2012. The subsidy bill could shrink further if subsidy rationalization indeed resumes after elections as we expect. Policymakers view fuel as the key subsidy to cut, with the rest really quite peripheral. The reduction in personal income taxes for middle-income groups in the Budget was also likely a pre-cursor to GST implementation, which will also likely come after elections. These will help keep Malaysia on track to hit its 10th Malaysia Plan fiscal deficit target of 3% of GDP by 2015. Nonetheless, the disquieting surge in the consolidated public sector deficit and debt guaranteed by the federal government remains a concern.

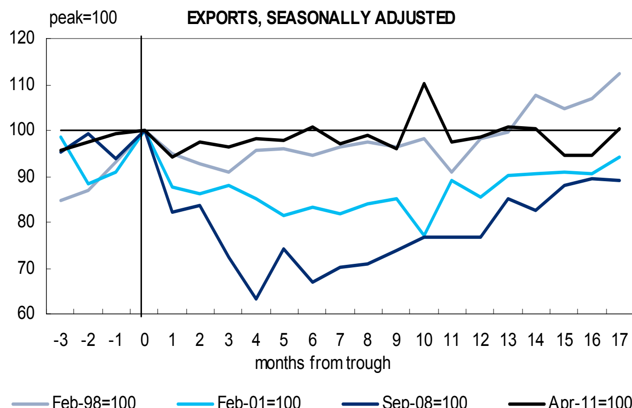
After numerous delays in the last two years, PM Najib will have to call elections by Apr 2013. Earlier delays had resulted in the BN losing the initiative and held it ransom to events orchestrated by the Opposition. The timing of the monsoons therefore suggests elections will likely be held only after February to avoid the worst of the Northeast Monsoon – Malaysia's major rainy season. The most likely scenario is that BN will either maintain the status quo or win with a narrower margin than 2008. The electoral outcome is not expected to affect the growth significantly, given lower incidence of politically-connected projects and generally pragmatic, pro-business policies – even those of the Opposition. However, a much lower margin of victory for the BN (<60%) may risk delays of subsidy rationalization, with a negative knee jerk market reaction.

Figure 57. We expect broadly stable 2013 growth of 5.2%



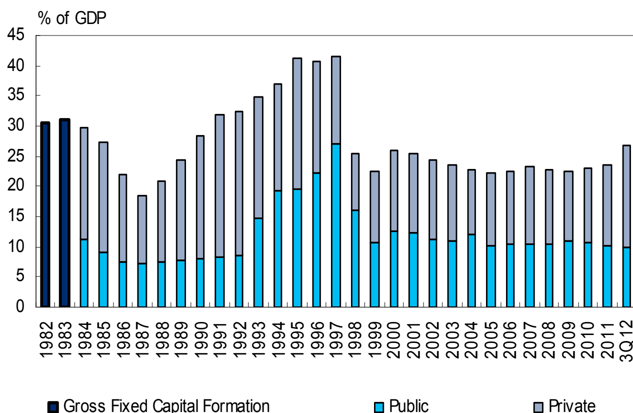
Source: Haver, Citi Research

Figure 58. Current export downturn has been relatively mild



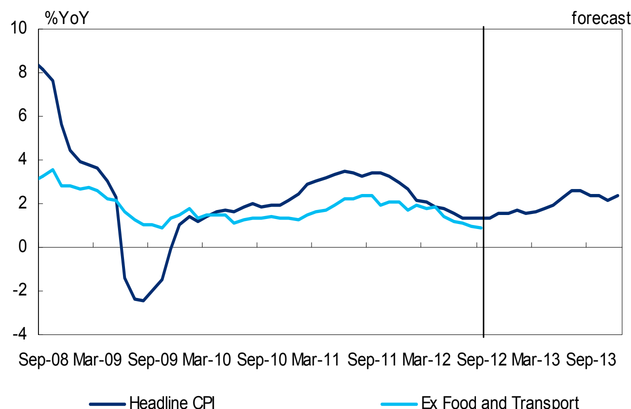
Source: CEIC, Citi Research

Figure 59. Gross fixed capital formation share of GDP has risen



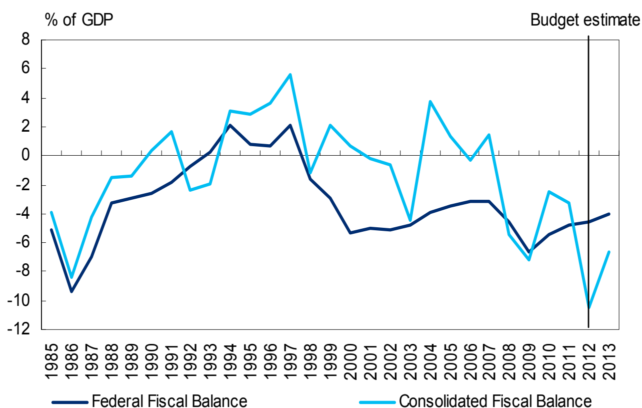
Source: CEIC, Citi Research

Figure 60. Inflation may be near its trough



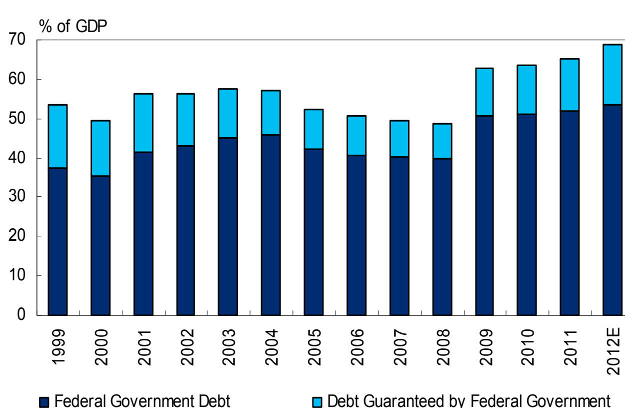
Source: Haver, Citi Research

Figure 61. Consolidated public sector deficit has surged…



Source: MoF, CEIC, Citi Research

Figure 62. … along with debt guaranteed by the federal government



Note: 2012E is Citi estimate using debt guaranteed by Federal Government as of 3Q12 and Budget estimates of Federal Government debt

Source: CEIC, Citi Research

Figure 63. Malaysia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	162.8	193.7	231.1	202.4	247.0	288.2	305.5	332.4	361.5
Nominal GDP, local currency bn	597	665	770	713	795	881	944	1,014	1,103
GDP per capita, US$	6,067	7,123	8,393	7,255	8,639	9,949	10,390	11,117	11,852
Population, mn	26.8	27.2	27.5	27.9	28.6	29.0	29.4	29.9	30.5
Unemployment, % of labour force	3.3	3.2	3.3	3.7	3.2	3.1	3.0	2.9	2.9
Economic Activity									
Real GDP, % yoy	5.6	6.3	4.8	-1.5	7.2	5.1	5.2	5.2	6.0
Real investment growth % yoy	8.6	9.1	1.8	-9.4	23.8	3.2	22.8	12.4	10.3
Real consumption growth % yoy	6.4	9.7	8.4	1.4	5.8	8.9	7.5	5.7	5.9
private consumption growth % yoy	6.6	10.4	8.7	0.6	6.6	7.1	8.1	6.2	6.4
Real export growth, % yoy	6.7	3.8	1.6	-10.9	11.3	4.2	0.1	3.2	4.4
Real import growth, % yoy	8.2	5.9	2.3	-12.7	15.6	6.2	5.8	5.7	5.7
Prices, Money & Credit									
CPI, % yoy	3.1	2.3	4.5	1.0	2.1	3.0	1.6	2.5	2.8
CPI, % avg	3.6	2.0	5.4	0.6	1.7	3.2	1.8	2.1	2.6
Nominal wages, % yoy	2.1	4.3	4.5	2.5	8.2	3.8	6.0	5.0	5.0
Credit extension to private sector, % yoy	6.7	9.0	10.3	8.0	9.5	11.8	12.0	11.0	11.0
Policy interest rate, % eop	3.50	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50
1 month inter-bank rate, % eop	3.71	3.61	3.37	2.17	2.98	3.22	3.21	3.21	3.70
Long term yield, % eop	3.70	3.78	3.00	3.79	3.39	3.23	3.20	3.30	3.70
lc/US$, eop	3.53	3.31	3.45	3.42	3.08	3.17	3.08	3.04	3.05
lc/US$, avg	3.67	3.44	3.33	3.52	3.22	3.06	3.09	3.05	3.05
Balance of Payments, US$ bn									
Current account	26.2	29.7	39.4	31.4	27.3	31.7	15.3	13.2	12.0
% of GDP	16.1	15.4	17.1	15.5	11.1	11.0	5.0	4.0	3.3
Trade balance	37.4	37.7	51.5	39.9	41.8	48.4	32.9	26.2	27.0
Exports	160.8	176.1	199.2	157.0	198.7	227.7	227.9	236.2	242.0
Imports	123.4	138.4	147.6	117.1	156.9	179.3	195.0	210.0	215.0
Service balance	-2.0	0.8	0.0	1.1	0.5	-2.6	-6.6	-1.0	-3.0
Income balance	-4.7	-4.1	-6.9	-4.0	-8.2	-7.2	-11.0	-12.0	-12.0
FDI, net	0.0	-2.7	-7.8	-6.3	-4.2	-3.3	-2.0	-2.0	-1.0
International reserves	82.5	101.3	91.5	96.7	106.5	133.6	140.0	151.0	157.0
Total Amortisations	6.5	5.5	3.9	10.6	8.1	8.6	9.3	10.0	10.0
Public Finances, % of GDP									
Consolidated government balance	-3.2	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-4.0	-3.5
Consolidated gov primary balance	-1.1	-1.2	-3.0	-4.7	-3.5	-2.8	-2.3	-1.8	-1.3
Public debt	40.6	40.1	39.8	50.8	51.2	51.8	53.7	53.7	53.0
of which Domestic	36.4	37.1	37.2	48.9	49.1	49.7	51.8	52.0	51.4
Foreign Assets & Liabilities, US$ bn									
External debt	52.2	56.7	68.2	68.0	73.6	81.0	87.6	94.7	98.5
Private	45.2	50.8	62.4	63.9	68.2	75.3	82.0	89.0	93.0
Public	7.1	5.9	5.9	4.0	5.4	5.7	5.6	5.7	5.5
External debt / GDP	32.1	29.3	29.5	33.6	29.8	28.1	28.7	28.5	27.2
External debt / XGS	28.6	27.6	29.7	36.8	31.8	30.7	33.1	33.9	34.3
Short-term debt	12.1	16.5	23.0	22.6	25.8	32.7	35.0	40.0	42.0
Short-term debt/International Reserves (%)	14.7	16.3	25.2	23.4	24.2	24.5	25.0	26.5	26.8

Quarterly Economic Indicators

	2012 Q1	2012 Q2	2012 Q3	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	5.1	5.6	5.2	5.0	4.2	3.9	5.4	7.1	6.1
CPI, % yoy	2.1	1.6	1.3	1.6	1.7	2.3	2.4	2.5	2.5
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25
1 month inter-bank rate, % eop	3.19	3.19	3.20	3.21	3.21	3.21	3.21	3.21	3.40
Long term yield, % eop	3.34	3.21	3.31	3.20	3.20	3.25	3.25	3.30	3.40
lc vs USD, eop	3.06	3.17	3.06	3.08	3.06	3.05	3.04	3.04	3.04

Source: CEIC Data Company Limited, 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).

Philippines

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- **Summary view** – Sustained fiscal stimulus with a strong infrastructure bias coupled with a low interest rate setting underpin our FY13 GDP forecast of 5.3%. Roads and bridges account for 50% of the FY13 infra budget. Downside fiscal risk consists of the expenditure shortfall and slowdown in collection efficiency.

- **Things to watch** – Passage of the FY13 budget and excise tax reforms within 4Q12. Early pre-bidding/auction activities of FY13 infra budget to skirt the election ban on new projects. Macro prudential tools deployed by BSP to ease peso appreciation. Election spending impact in 1Q13.

- **Strategy** – Due to weak global demand, BSP likely to hold the line at 41. Into the peak remittance months of Nov-Dec, strengthening appreciation risk likely. Amid strong liquidity, interest rate lows and benign inflation, subdued debt supply risk on collection efficiency gains and new sin taxes bode well for flatter bond yields.

Fiscal stimulus to firm up domestic demand in FY13

Spending catalysts in FY13 likely to defy the ‘base effect’. After a slower momentum in 2H12 that probably led to GDP growth of 4 -4.5%YoY, we expect next year’s spending catalysts to sustain domestic demand and contribute to growth in the range of 5%YoY or more. Key upside trigger to growth will be sustained primary expenditures with the strong bias for infrastructure spending. Capital outlays are expected to rise 15.1%YoY with a larger share of 18.7% of the proposed FY13 budget. Infra bias for roads & bridges (50% share of total infra budget) remained intact followed by floodworks/seawalls (9.2%), irrigation (9%), basic educational facilities (9.4%), and housing (7.7%). All these are anticipated to benefit construction activity and employment in the sector. Increased public construction in 1H12 led to creation of more than 100,000 jobs in 1Q12 and 2Q12. Available public construction data for 1H12 indicated strong growth of 51.3%YoY to lift total fiscal spending by 17.2%YoY. Downside risk to expecting sustained fiscal spending will be the hefty budget underspending on the primary side. From a primary expenditure shortfall of Php84bn (1.7% of GDP) in 1H12, the year-to-date September shortfall expanded to Php114bn. While money is not the issue since tax collections have kept pace with expenditures and locally funded infra projects account for 85%-90% of the infra program, PPP program slippage led to budget underutilization. Funds earmarked for government’s participation in some of the PPP projects scheduled to be rolled out this year but has been delayed, contributed to bulk of the fiscal underspending. Government may have to prioritize execution of the fiscal budget to get the spending lift while fast-tracking the PPP projects. We’re also assuming approval of the FY13 budget will not get delayed as government has also laid the groundwork for early pre-bidding/auction phase of these projects to circumvent the election ban on new projects. Resilient remittances coupled with low inflation expectations in 4Q12 and likely extending for the rest of FY13 on subdued oil/commodity price outlook bode well for consumption. Election spending in 1Q13 would uplift consumption to help defy the base effect in 1Q13. Rising investment approvals this year (Php203bn up 27.2%YoY in June) concentrated in manufacturing, power and real estate sectors will contribute to a stronger investment setting in FY13 amid higher public construction. As such, we expect domestic demand gains of 5.7%YoY in FY13 compared to 6.2%YoY in FY12 against negative net exports to GDP of 1% from -0.5% this year. De-stocking in FY13 will be less as downside risk to exports ease. Expect FY13 growth of 5.3% up from FY12 growth of 5%.

Higher 'sin' taxes can sustain collection efficiency gains

Collection efficiency gains remain elevated to mute risk of fiscal slippage. We estimate collection efficiency gains accounted for 67.7% of quarterly tax growth since the start of Aquino's term in 3Q10. However tax growth narrowed to 9%YoY in 3Q12 following 3 straight quarters of 2-digit gains. While tax collection gains exceed inflation, the primary spending load including the PPP contribution in the last three years of Aquino's term will benefit from new revenue legislation of higher 'sin' taxes while mitigating risk of a larger fiscal deficit. Collection efficiency gains have also led to a higher tax to GDP ratio of 13.2% in 1H12 (vs 12.7% in 1H11). Passage of the 2nd best policy option for sin taxes that can potentially generate Php30bn-Php40bn annually (assumed Php15bn in FY13 forecast) and sustained gains in the tax to GDP ratio (13.3%) due to collection efficiency cut our FY13 fiscal deficit forecast to 2.2% of GDP from 2.9% without these assumptions.

Structural peso appreciation that compels low rates

Without BSP intervention, the peso could have appreciated by 6% since FY11. The average monthly values (Jan 2011 to Apr 2012) of the key determinants of the exchange rate: BOP, rate differential, US$TWI, NEER, oil prices, mfg output, and primary fiscal balance when fed into the model resulted in an annualized estimate of 6% appreciation (since FY11, the average peso appreciation was 2.9%) versus 4% depreciation for 2001-2010. The peso determinants alongside QE3 will support a strong peso outlook that's likely to compel low interest rates and ease the rate differential as well as curb arb options offered by better yielding peso assets. BSP will NOT abandon inflation targeting in favor of keeping policy rates in sync with rapid peso appreciation. BSP signaled the use of macro prudential tools as well eg tighten monitoring and limit exposure of bank lending to the real estate sector and mortgage lending. BSP's unsterilized USD purchases can keep the forward book of US$3.5bn (Sep) modest and thus lower intervention costs. With SDA at Php1.87tr, excess liquidity can be drained by the high yielding BSP account.

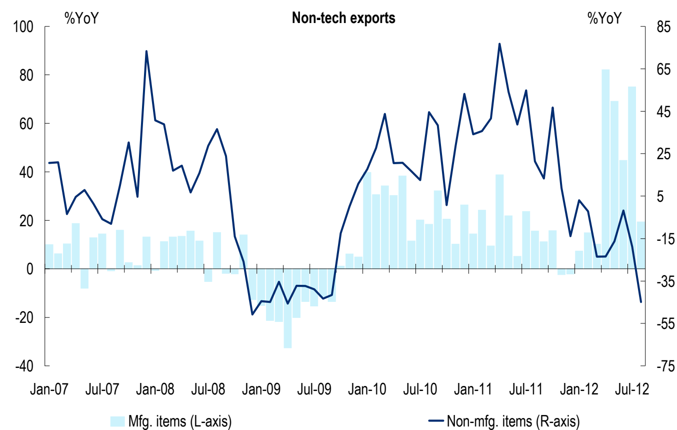
Medium-term: Need to shift to investment-driven growth

Since productivity or the 'cost of doing business' will not compensate for loss in exchange competitiveness, authorities are reluctant to see a strong peso. Behind the high costs of doing business is the poor infrastructure services that includes the high power costs and power supply constraints. Having stronger infrastructure would spark a shift to investment-driven growth or investment to GDP ratio of 22%-25% from the current 20%, that can lower the costs of doing business, create more jobs and sustain growth of 7%-8% despite strong peso risk.

Hold the line at 41 in 4Q12 but strong peso risk likely

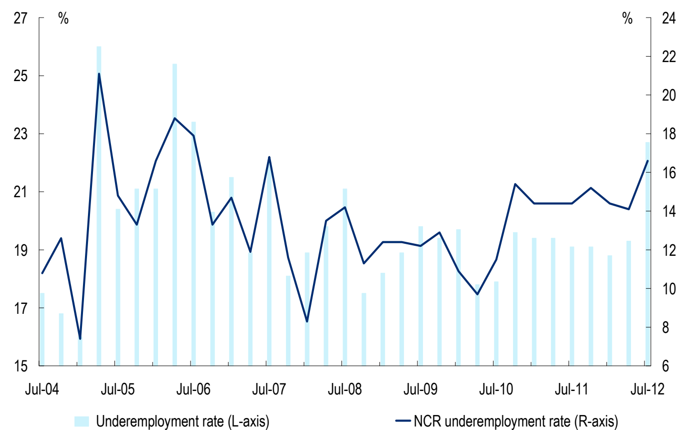
As we go through the peak of the remittance season in Nov-Dec, strong peso pressures will strengthen likely to be resisted by the BSP. BSP will rely more on its existing macro prudential tool kit to ease peso appreciation and hold the line at 41. Risk-on environment in 2H13 when China and intra-Asian market prospects improve support the peso probing 41 and lower. Short-duration bonds respond to strong liquidity alongside a low interest rate and benign inflation setting. Subdued fiscal debt supply risk on collection efficiency gains and new sin taxes bode well for flatter bond yields. Expect a policy rate steady at 3.5% for the rest of year.

Figure 64. Previously robust non-tech mfg exports eased in Aug



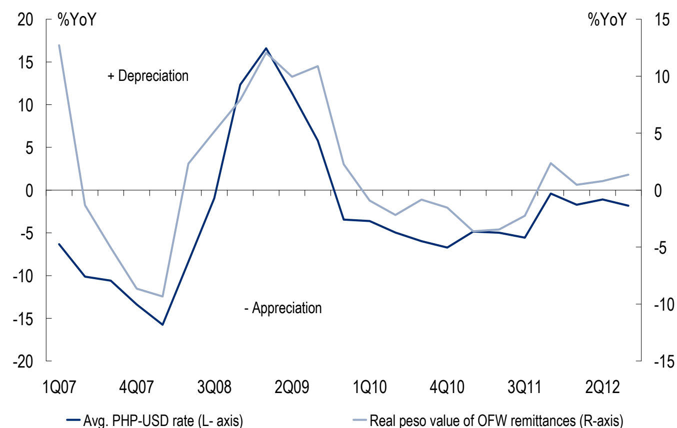
Source: CEIC, and Citi Research

Figure 65. Rising two-digit underemployment rate undermine sentiment



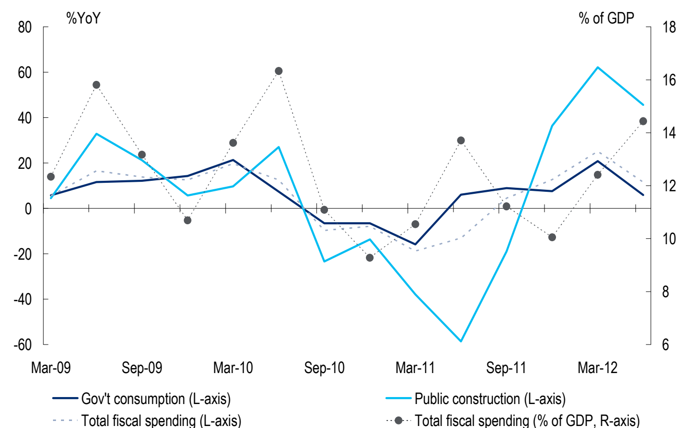
Source: CEIC, and Citi Research

Figure 66. Purchasing power of remittances track peso movement



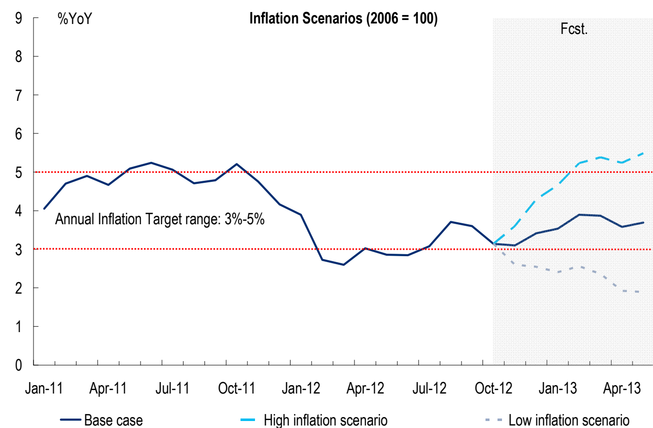
Source: CEIC, and Citi Research

Figure 67. Fiscal contribution to growth rose sharply since 4Q11



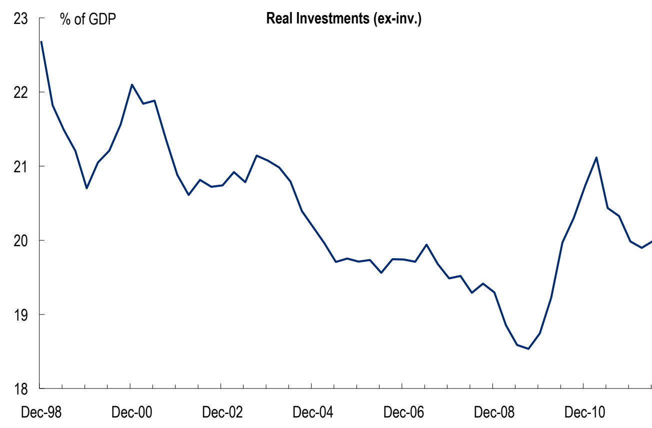
Source: CEIC, and Citi Research

Figure 68. Benign inflation trajectory (base case) over next 12 months



Source: CEIC, and Citi Research

Figure 69. Need to shift to investment-driven growth over the MT



Source: CEIC, and Citi Research

Figure 70. Philippines Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	122.3	150.1	173.0	168.3	199.2	224.7	248.8	273.4	306.7
Nominal GDP, local currency bn	6,271	6,893	7,721	8,026	9,003	9,736	10,455	11,409	12,575
GDP per capita, US$	1,418	1,694	1,914	1,825	2,113	2,343	2,544	2,740	3,042
Population, mn	86.3	88.6	90.4	92.2	94.3	95.9	97.8	99.8	100.8
Unemployment, % of labour force	8.0	7.3	7.4	7.5	7.3	7.0	7.0	6.8	6.5
Economic Activity									
Real GDP, % yoy	5.2	6.6	4.2	1.1	7.6	3.9	5.0	5.3	5.8
Real investment growth % yoy	-15.1	-0.5	23.4	-8.7	31.6	8.1	-7.4	-11.7	16.6
Real consumption growth % yoy	4.9	4.9	3.3	3.3	3.4	5.6	6.4	5.2	5.1
private consumption growth % yoy	4.2	4.6	3.7	2.3	3.4	6.3	5.7	5.5	5.2
Real export growth, % yoy	12.6	6.7	-2.7	-7.8	21.0	-4.2	5.7	4.8	8.4
Real import growth, % yoy	3.5	1.7	1.6	-8.1	22.5	0.2	2.2	5.9	11.8
Prices, Money & Credit									
CPI, % yoy	4.4	3.8	7.7	4.5	3.6	4.2	3.4	3.6	4.0
CPI, % avg	6.3	3.0	8.2	4.2	3.8	4.8	3.1	3.5	3.8
Nominal wages, % yoy	8.7	3.8	6.2	0.0	5.0	6.0	5.0	6.5	7.5
Credit extension to private sector, % yoy	7.4	4.8	17.5	10.0	10.0	12.1	9.0	11.3	15.0
Policy interest rate, % eop	7.50	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.00
1 month Philippine Reference rate, % eop	6.40	6.00	5.20	4.11	0.75	1.68	0.75	2.50	3.50
Long term yield, % eop	5.25	5.50	6.53	6.25	4.78	4.21	3.95	3.85	5.00
lc/US$, eop	49.05	41.23	47.47	46.50	43.65	43.84	41.02	41.29	40.77
lc/US$, avg	51.28	46.05	44.48	47.56	45.06	43.29	41.96	41.33	40.96
Balance of Payments, US$ bn									
Current account	5.3	7.1	3.6	9.4	8.9	7.1	7.0	6.3	3.4
% of GDP	4.4	4.7	2.1	5.6	4.5	3.1	2.8	2.3	1.1
Trade balance	-6.7	-8.4	-12.9	-8.8	-11.0	-15.5	-14.9	-16.9	-19.3
Exports	46.5	49.5	48.3	37.6	50.7	47.5	49.9	53.4	59.7
Imports	53.3	57.9	61.1	46.5	61.7	63.0	64.8	70.3	79.0
Service balance	0.1	2.2	1.2	2.1	2.7	3.6	3.4	3.0	2.7
Income balance	-1.3	-0.9	0.1	-0.2	0.5	1.3	0.1	1.0	0.8
FDI, net	2.8	-0.6	1.3	1.6	1.2	1.0	1.5	2.0	3.0
International reserves (ex-gold)	19.9	30.1	33.1	38.6	55.1	66.7	72.5	82.1	86.8
Total Amortisations	4.8	4.1	4.1	4.3	7.8	8.0	8.5	9.3	9.7
Public Finances, % of GDP									
Consolidated government balance	-1.0	-0.2	-0.9	-3.7	-3.5	-2.0	-2.4	-2.2	-1.8
Consolidated gov primary balance	3.9	2.6	-0.2	-0.3	-0.2	0.8	0.6	0.8	1.2
Public debt	63.9	55.9	54.7	54.8	52.4	50.0	49.1	48.5	48.0
of which Domestic	35.7	33.1	31.3	30.8	30.2	29.0	30.0	31.0	32.0
Foreign Assets & Liabilities, US$ bn									
External debt	53.9	55.5	54.3	54.9	60.0	61.7	63.5	65.0	68.7
Private	16.5	17.5	13.7	11.6	13.0	14.2	15.2	17.0	21.2
Public	37.4	38.0	40.6	43.2	47.0	47.5	48.3	48.0	47.5
External debt / GDP	44.1	37.0	31.4	32.6	30.1	27.5	25.5	23.8	22.4
External debt / XGS	101.8	93.6	93.7	112.8	93.9	103.1	101.1	96.7	91.4
Short-term debt	5.0	7.1	7.0	4.0	6.3	7.0	8.0	10.5	11.8
Short-term debt/International Reserves (%)	25.2	23.6	21.2	10.4	11.4	10.5	11.0	12.8	13.6

Quarterly Economic Indicators

	2012 Q1	2012 Q2	2012 Q3	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	6.3	5.9	4.7	3.3	5.0	5.5	5.3	5.4	5.9
CPI, % yoy	2.7	2.8	3.5	3.4	3.3	3.4	3.5	3.6	3.7
Policy interest rate, % eop	4.00	4.00	3.75	3.50	3.50	3.50	3.50	3.50	3.50
1 month Philippine Reference rate, % eop	3.13	3.28	0.85	0.75	1.00	1.50	2.00	2.50	3.00
Long term yield, % eop	4.48	4.70	4.35	3.95	3.75	3.85	3.85	3.85	3.85
lc vs USD, eop	42.93	41.93	41.68	41.02	41.21	41.40	41.44	41.29	41.16

Source: CEIC Data Company Limited, 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).

Singapore

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- **Summary view** – Macro backdrop will remain challenging, including continuation of a starker growth-inflation trade-off, tighter policy bias, faster REER appreciation and adjustments across industries, including relocating abroad.
- **Things to watch** – [1] Leading indicators of manufacturing momentum; [2] Signs of wage inflation pressures; [3] Property market developments; and [4] Household balance sheet data.
- **Strategy** – Barring a further large risk-off environment, SGD NEER could hug the strong side in the near-term. SOR fixings have fallen relative to USD-SIBOR, but a further 5-10bps downside remains possible.

Persistent pains of restructuring

We downgraded our GDP forecasts to 1.4% and 2% for 2012 and 2013 (prev: 2.3%, 3.2%). This reflects continued weakness in external demand, drags from increasingly binding supply constraints and competitiveness erosion from real exchange rate appreciation, although fairly resilient domestic demand should provide a cushion. Quarterly growth profiles should be hesitant and patchy in the current fluid and uncertain environment, with shorter and shallower cycles and less clearly defined peaks and troughs, but within a context of generally slower growth. Our forecasts currently incorporate a mild technical recession in 4Q12, but we do not rule out a mild recession risks persisting into 1H13, though this will not be severe enough to close the positive output gap.

Leading indicators point to a mild sequential contraction in 4Q12, and drags could persist through 1H13 on [1] spillovers from a European recession, US fiscal uncertainties and a rebalancing China on trade related sectors; [2] increasingly binding supply constraints; and [3] competitiveness erosion from structural REER appreciation on tradables sectors.

Domestic demand has stayed relatively firm in the recent downturn, which is a stark contrast to past downturns where domestic demand saw a strong correlation with exports. One important reason for the recent "decoupling" is because of the muted magnitude of the downturn in exports, which we expect to continue barring an outsized financial shock. As a result, firms decision to invest and hire have remained relatively impervious to the mild export downturn so far. Domestic demand may have also seen a structural lift from the immigration boom since 2004.

Labour supply constraints have also likely hurt GDP growth. Parliament's vote on population policy in January will likely re-affirm the tightening of immigration policy, with a medium term target of labour force growth of just 2% vs almost 4% in 2012, with tightening expanded to higher income Employment Pass Holders over time. With productivity challenged by cyclical and structural factors, rising unit labour costs could cause services inflation could contribute at least a fifth of headline inflation of 3.8% in 2013, besides supply constraints in housing and cars. Until productivity growth is able to accelerate sufficiently to offset the slower labour force growth, the negative supply shock is likely to keep the growth inflation trade-off far starker than it was in the past. If Singapore's recent experience and the experience of other developed counties, serves as a guide, we suspect that raising productivity could be a long slog.

Monetary and fiscal policies to maintain tightening bias

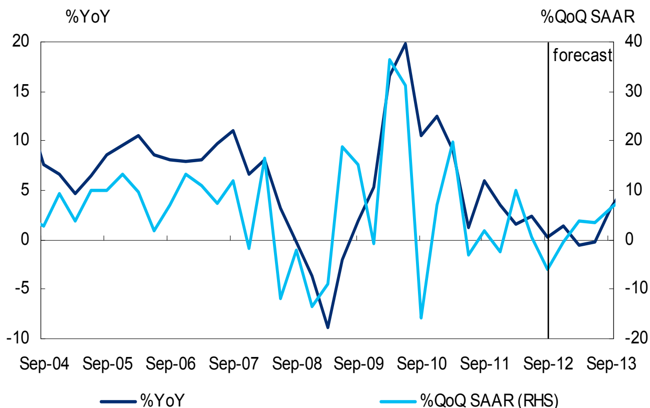
MAS's decision to refrain from reducing the slope in Oct suggests the hurdle for policy easing remains high. Barring large downside cyclical growth surprises beyond the current 1-3% official growth forecast for 2013, that would cause the output gap to turn negative, the bar for MAS to ease policy would remain high: [1] MAS recognizes that it needs to accommodate faster medium term real appreciation pressures and [2] the need to look past shorter and shallower cyclical fluctuations to avoid volatility in monetary policy decisions that could exacerbate volatility in economic outcomes.

The Budget will likely maintain a mild contractionary stance and stay focused on restructuring given the still positive output gap. A positive output gap was the rationale behind the negative fiscal impulse and contractionary stance of Budget 2012. Indeed, the FY12 fiscal stance could be even more contractionary than anticipated in the Budget, as an overshoot in revenues could imply a larger surplus than budgeted for. Given the Budget balanced rule, the government will probably aim to run another primary surplus of close to 1-1.5% of GDP, and possibly another basic and overall surplus.

In the property market, policy risk will likely to persist in the residential segment, though the slowdown in property price increases would suggest a more incremental and calibrated approach to tightening going forward. Any new measures will continue to be aimed at curbing investment demand amidst continued tightness in supply for genuine home-owners. Recent cooling measures to limit mortgage tenors to 35 years have only had limited impact so far. There may moreover be a risk that the Hong Kong government's imposition of 15% buyer stamp duty on foreigners (vs 10% for Singapore) could divert some foreign demand to Singapore. That said, property analyst Adrian Chua notes that with the sale of commercial and industrial strata units hitting highs, future rounds of policy measures could potentially target the non-residential segment.

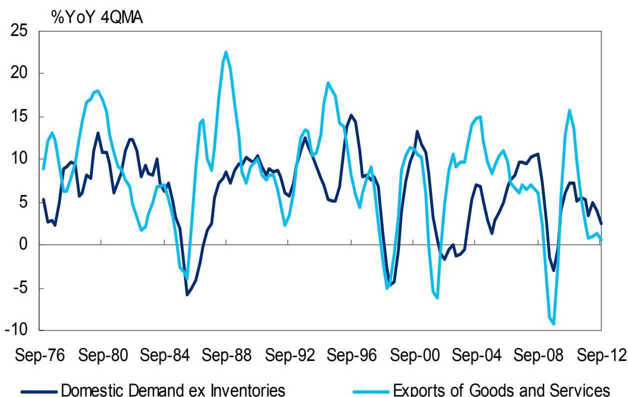
Faster real exchange rate appreciation may entail adjustment costs and catalyze regionalization. With productivity growth – including in the non-tradables sector – likely to be weak amidst the cyclical slowdown, coupled with faster wage increases, the resulting upward pressures on unit labour costs could spill over into inflation and faster real exchange rate appreciation pressures going forward. REER appreciation is likely to reshape the industrial landscape, as industries which had thrived on a lower cost structure may have to restructure and raise productivity, consolidate or relocate altogether. In our recent *Singapore Macro View - Who Gets Hit Harder by Real Exchange Rate Appreciation?*, we analyzed the relative impact of REER appreciation on various industry groups. REER appreciation can be a powerful catalyst for restructuring to move up the value-added chain over time, and the relocation of more labour-intensive/exchange rate-sensitive services. Thus manufacturing, especially transport engineering, segments of electrical and industrial machinery, and even food manufacturing may face greater pressures to relocate overseas. Where Singapore Inc chooses to relocate to – be it China and ASEAN – will very much depend on how the more relative cost structures stack up compared to perceived market potential in each of these markets. While we have classified healthcare and education services within the non-tradables sector, we would not be surprised if higher labour driven costs increases divert demand towards neighboring countries, including Iskandar, especially when improved connectivity makes it easier for locals to access such services.

Figure 71. Quarterly growth profiles will be hesitant and patchy



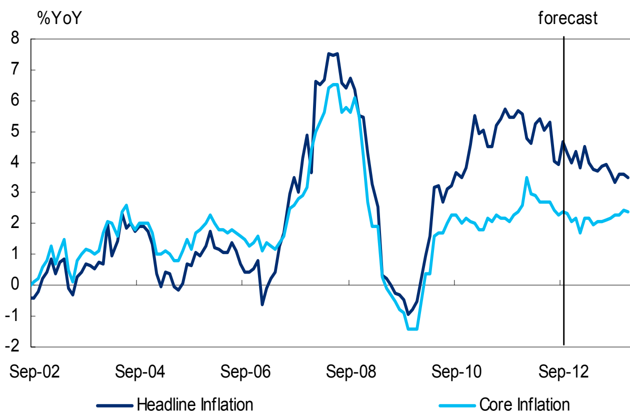
Source: CEIC, Citi Research

Figure 72. Domestic demand has been able to stay relatively firm



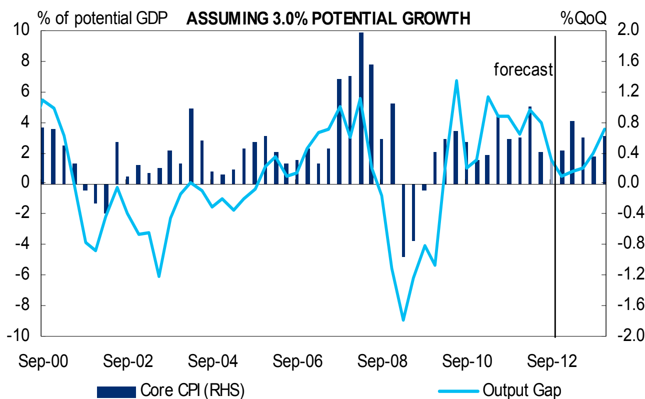
Source: CEIC, Citi Research

Figure 73. Core inflation could pick up in 2H13 after falling in 1H13…



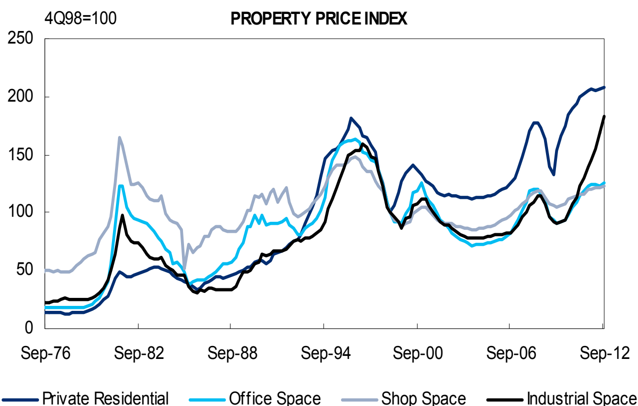
Source: CEIC, Citi Research

Figure 74. …as the output gap stabilizes



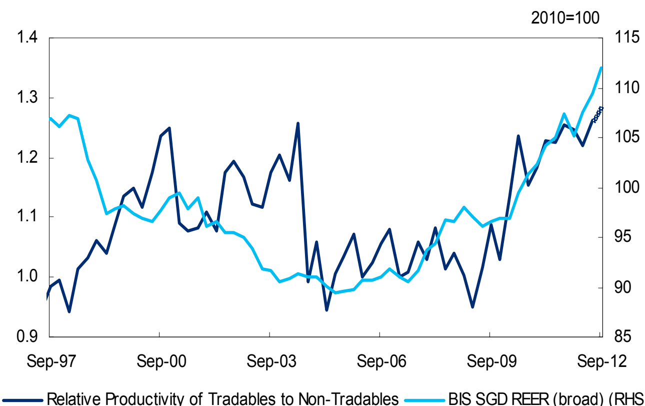
Source: CEIC, Citi Research

Figure 75. Property measures pushed investors to the industrial space



Source: CEIC, Citi Research

Figure 76. Tradables/non-tradables productivity differential widening



Note: 3Q12 is Citi estimate

Source: CEIC, Citi Research

Figure 77. Singapore Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	145.9	177.9	190.2	186.2	227.9	260.0	279.7	306.1	331.9
Nominal GDP, local currency mn	232	268	269	270	310	327	347	367	395
GDP per capita, US$	33,155	38,764	39,305	37,329	44,889	50,157	52,651	56,652	60,353
Population, mn	4.4	4.6	4.8	5.0	5.1	5.2	5.3	5.4	5.5
Unemployment, % of labour force	2.7	2.1	2.3	3.0	2.2	2.0	2.2	1.9	1.8
Economic Activity									
Real GDP, % yoy	8.8	8.9	1.7	-1.0	14.8	4.9	1.4	2.0	4.0
Real investment growth % yoy	17.4	16.5	27.4	-20.1	5.8	9.7	12.3	2.1	6.7
Real consumption growth % yoy	5.0	5.9	3.9	0.9	7.4	3.4	1.1	2.8	3.3
private consumption growth % yoy	5.0	6.8	3.3	0.1	6.5	4.1	2.0	2.9	3.2
Real export growth, % yoy	10.9	9.0	4.7	-7.8	19.1	2.6	0.2	2.1	2.8
Real import growth, % yoy	11.3	8.1	9.5	-11.1	16.2	2.4	1.4	3.0	2.7
Prices, Money & Credit									
CPI, % yoy	0.8	3.7	5.5	-0.5	4.6	5.5	4.4	3.5	3.5
CPI, % avg	1.0	2.1	6.6	0.6	2.8	5.2	4.6	3.8	3.4
Nominal wages, % yoy	3.2	6.2	5.4	-2.6	5.6	6.0	4.0	5.0	5.5
Credit extension to private sector, % yoy	4.9	16.9	23.2	3.5	4.5	18.6	14.0	12.0	11.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
3 month inter-bank rate, % eop	3.44	2.38	1.00	0.69	0.44	0.38	0.30	0.30	0.40
Long term yield, % eop	3.05	2.68	2.05	2.66	2.71	1.63	1.30	1.60	2.40
lc/US$, eop	1.53	1.44	1.43	1.41	1.28	1.30	1.22	1.20	1.19
lc/US$, avg	1.59	1.51	1.41	1.45	1.36	1.26	1.24	1.20	1.19
Balance of Payments, US$ bn									
Current account	35.7	45.9	26.3	30.1	55.5	57.0	45.2	42.5	44.0
% of GDP	24.4	25.8	13.8	16.2	24.4	21.9	16.2	13.9	13.3
Trade balance	50.2	57.1	41.7	47.3	63.1	67.5	58.1	59.8	66.0
Exports	281.3	312.8	354.8	288.5	371.3	429.6	431.0	443.9	456.0
Imports	231.2	255.8	313.2	241.2	308.1	362.1	372.9	384.1	390.0
Service balance	-7.3	-2.5	-2.7	-3.2	1.5	1.8	2.5	1.4	2.0
Income balance	-7.2	-8.7	-12.6	-13.9	-9.1	-12.3	-15.4	-18.7	-24.0
FDI, net	18.1	10.0	5.0	6.7	27.4	38.8	36.0	33.0	32.0
International reserves	136.3	163.0	174.2	187.8	225.8	237.7	254.0	260.0	270.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	9.1	11.1	9.0	-1.6	0.5	1.5	1.3	1.0	1.0
Consolidated gov primary balance	9.1	11.1	9.0	-1.6	0.5	1.5	2.0	1.0	1.0
Public debt	89.1	87.5	95.0	108.0	103.6	108.3	115.0	118.0	120.0
of which Domestic	89.1	87.5	95.0	108.0	103.6	108.3	115.0	118.0	120.0
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

	2012 Q1	2012 Q2	2012 Q3	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	1.6	2.5	0.3	1.4	-0.6	-0.2	3.3	5.6	4.8
CPI, % yoy	5.2	5.3	4.7	4.4	4.0	3.9	3.4	3.5	3.4
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	0.38	0.38	0.38	0.30	0.30	0.30	0.30	0.30	0.30
Long term yield, % eop	1.66	1.61	1.47	1.30	1.30	1.40	1.60	1.70	2.00
lc vs USD, eop	1.26	1.27	1.23	1.22	1.21	1.20	1.20	1.20	1.20

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

South Korea

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- **Summary view** – Economic growth will edge up to 3.4% in 2013 from 2.3% in 2012 but will stay below our estimated potential growth of 3.8%. While the economy will remain weak in 1H by lackluster domestic demand, improvement in global economic environment may open the way to a more visible pick up in 2H.
- **Things to watch** – Regardless of who wins the presidential election in Dec 2012, we do not expect any drastic change in fiscal and monetary policies next year. Concerns on economic growth will override economic democratization hopes, and budget front-loading is mostly possible.
- **Strategy** – The BoK will likely cut the policy rate by 25bps in early 2013 and be poised for rate normalization as the economy recovers and CPI inflation heads up in 2H. We expect KRW appreciation to be restrained by FX authorities' market intervention and toughened oversight.

Lukewarm growth in 1H but visible rebound in 2H

We expect the economy to grow 3.4% in 2013. Given recent macro readings, the economy appears to have bottomed out and the upward trend is likely to continue throughout next year. However, external and domestic demand constrained by subdued sentiments due to lingering external uncertainties and households' high leverage, will continue to weigh on economic growth in 1H of 2013 at 2.6%YoY. Exports growth will likely be limited at about 1%YoY as the recovery would not be strong enough to overcome the base effect. With consumption and exports still sluggish, we expect businesses to remain reluctant to investment in facilities. A more distinct recovery will be seen in 2H with GDP growth reaching 4.1%YoY as exports and facilities investment pickup along with improvement in global economic environment and better prospects for the following year. We estimate that annual economic growth will rise to 3.4% but stay below our estimated potential growth of 3.8% for the third year. Trade surplus will likely narrow to US$24.1bn, from an estimated US$26.3bn in 2012, and current account surplus would shrink further to US$19.3bn as services account deficit widens on strong KRW.

CPI inflation will continue to rise to the end of next year. We expect CPI inflation at 2.7% in 2013 with limited demand-side pressures. However, narrowing negative output gap, rising inflationary pressures from the supply-side and low base effect will push up the headline inflation to above 3% in 2H. Services inflation will likely rise as the government resumes public tariff hikes, and upside risk to oil price inflation exists in the event of tensions in the Middle East. CPI inflation is projected to rise from 2.2%YoY in 1H to 3.2% in 2H.

Policies to stay course after the presidential election

Stimulus efforts will likely be continued by the new government. Regardless of who becomes elected as the new president, we do not expect any drastic changes in macroeconomic policies or reforms but stimulation measures could be implemented in the first half of next year to prevent delay in economic recovery. The measures will be focused on boosting domestic demand, especially construction and facilities investment, by relaxing regulations on the housing market and improving corporate investment environment. Stabilization of housing price in Seoul metropolitan area will be essential for supporting construction investment and private consumption.

There is a better chance of budget front-loading than a supplementary budget. Given continued sub-par economic growth and wobbly global economic conditions, we cannot cross out the possibility of a supplementary budget in 2013. However, we think that the government would have little motive to come up with a large scaled supplementary budget as economic rebound is expected in 2H. Instead, there is a high probability that the government will front-load its 2013 annual budget in 1H as it did in 2012 to support economic recovery and prevent negative contribution of government spending to growth.

Implementation of economic democratization will likely be delayed. Though presidential candidates are all promising economic democratization to appeal to the public, their pledges are unlikely to be fulfilled to prevent investments of large corporations being discouraged. Changes in the tax system could be discussed to set aside government revenue for social welfare spending which candidates have proposed competitively. However, in case of a tax reform, income tax is more likely to be changed rather than corporate tax.

BoK's narrowed CPI inflation band for 2013-2015

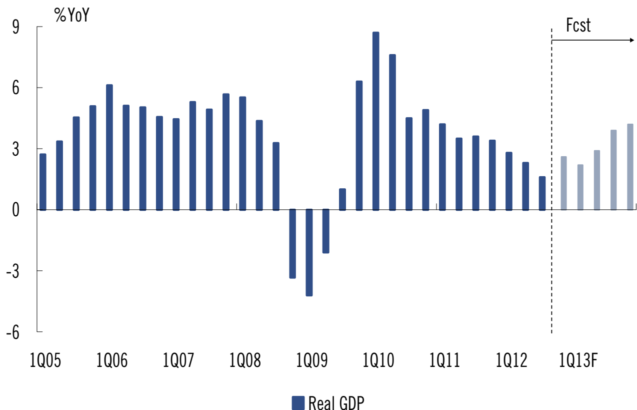
We expect another rate cut before BoK gets ready for normalization. Based on economic growth and inflation path, we expect the BoK to cut the policy rate by 25bps in early next year, probably at the Feb MPC meeting after assuring CPI inflation below the lower threshold of its new inflation target band and languid production activities. At last Oct MPC meeting, the BoK had reset its inflation target band for 2013-15 at 2.5-3.5% from current 3.0±1% with a mid-point of 3%. As the economy begins to perk up entering the 2H of 2013 and headline inflation continues an upward trend, the narrowed target band will bring a chance of the BoK turning hawkish. We expect the BoK to be poised to shift to a normalization stance in late 2H by raising the rate at the end of 2013, at the earliest.

Increased FX oversight

FX intervention will likely slow KRW appreciation. USDKRW has fallen sharply from this year's peak of 1,185.5 (May 25th) and lingers around its year-low below 1,100 on the back of relatively strong economic fundamentals and fiscal soundness, and current account surplus. With USDKRW down near the break-even level of large corporations and SMEs, further decline to 1,080 would trigger the FX authorities to intervene the market next year to support export sectors.

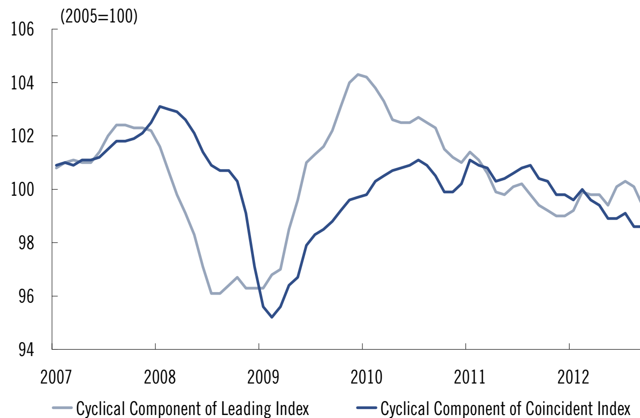
Existing capital flow measures could be tightened. If KRW strengthens faster than other EM currencies, macro-prudential measures that are already in place will likely be toughened to slow the appreciation but introduction of new measures seems unlikely, despite recent proposal of Tobin tax from opposition parties. The MoSF and the BoK are against introducing Tobin tax without international coordination for tax. The expected options would be: 1) Lowering the ceilings on FX forward positions of domestic banks (current: 40%) and foreign bank branches (current: 200%); 2) raising bank levy, i.e. macro-prudential stability levy, on short-term borrowing of banks (current: 0.2% for less than 1yr, 0.1% for 1-3yr, 0.05% for 3-5yrs, and 0.02% for longer than 5yrs); and 3) re-introducing a withholding tax on foreigners for KTBs and MSBs. If strong KRW causes short-term borrowings to increase, we expect the first two options to come into play. We forecast USD/KRW at 1,080 in near term and 1,070 over 6-12 months. We expect that continued current account surplus, foreign inflows to capital markets and increased dollar selling forward to support KRW appreciation against USD.

Figure 78. We expect 2013 GDP growth at 3.4%, with rebound in 2H



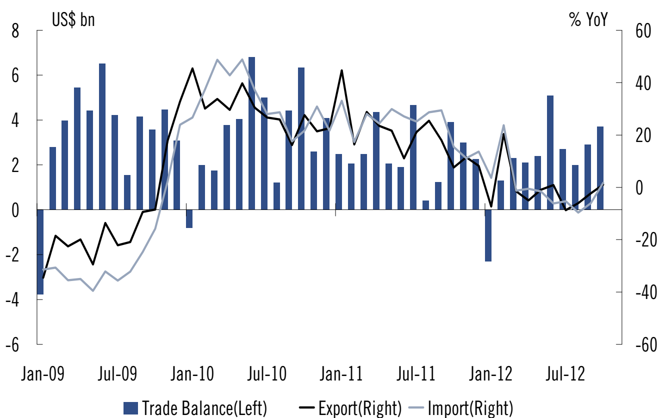
Source: Bank of Korea, Citi Research Estimates

Figure 79. Cyclical component of leading index hasn't tilted up yet



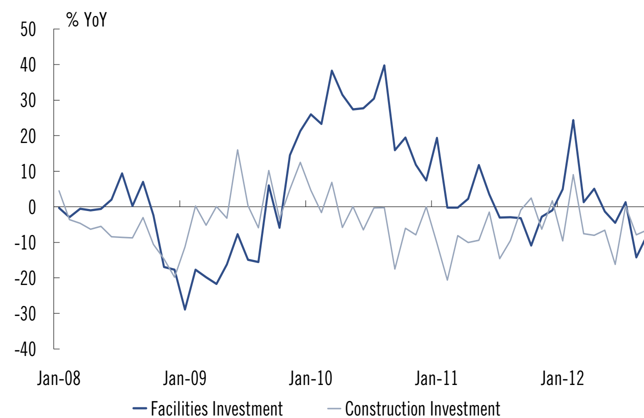
Source: Statistics Korea

Figure 80. Export rebound is likely to be limited at a single digit growth



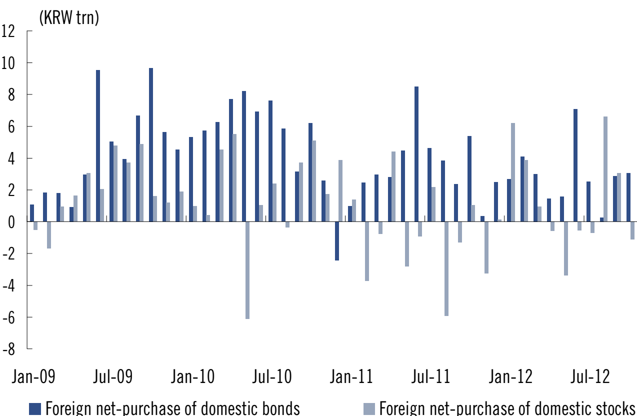
Source: Korea International Trade Association

Figure 81. Investment remains repressed by subdued sentiment



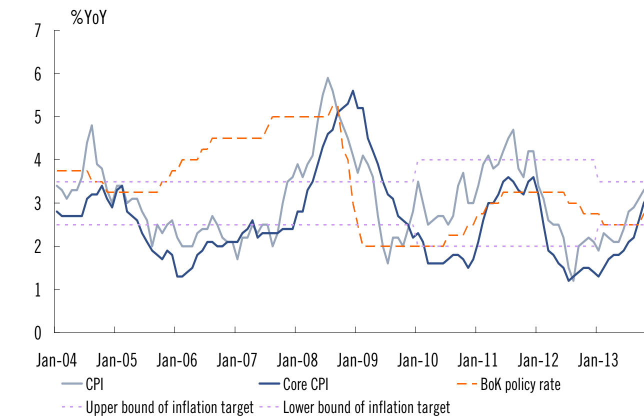
Source: Statistics Korea

Figure 82. Foreign fund inflows have shrunk recently



Source: Financial Supervisory Service

Figure 83. BoK will likely prepare for rate normalization in 4Q13, if early



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

Figure 84. Korea Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	954.0	1,048.0	929.1	834.7	1,014.9	1,116.6	1,155.5	1,288.0	1,451.4
Nominal GDP, local currency bn	908,744	975,013	1,026,452	1,065,037	1,173,275	1,237,128	1,290,665	1,371,407	1,469,144
GDP per capita, US$	19,722	21,565	18,981	16,972	20,540	22,431	23,108	25,647	28,784
Population, mn	48.4	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4
Unemployment, % of labour force	3.5	3.2	3.2	3.6	3.7	3.4	3.2	3.3	3.3
Economic Activity									
Real GDP, % yoy	5.2	5.1	2.3	0.3	6.3	3.6	2.3	3.4	4.0
Real investment growth % yoy	4.4	3.5	0.0	-13.5	15.8	1.5	-0.7	1.9	3.0
Real consumption growth % yoy	5.1	5.1	2.0	1.2	4.1	2.2	2.2	2.4	3.3
private consumption growth % yoy	4.7	5.1	1.3	0.0	4.4	2.3	1.7	2.1	3.5
Real export growth, % yoy	11.4	12.6	6.6	-1.2	14.7	9.5	4.0	5.1	9.2
Real import growth, % yoy	11.3	11.7	4.4	-8.0	17.3	6.5	2.5	4.0	8.4
Prices, Money & Credit									
CPI, % yoy	2.1	3.6	4.1	2.8	3.0	4.2	2.1	3.4	2.9
CPI, % avg	2.2	2.5	4.7	2.8	3.0	4.0	2.3	2.7	3.1
Nominal wages, % yoy	5.7	0.7	3.1	2.6	6.8	1.0	4.2	5.6	6.2
Credit extension to private sector, % yoy	14.7	12.4	15.0	2.3	3.6	5.1	7.6	12.6	10.1
Policy interest rate, % eop	4.50	5.00	3.00	2.00	2.50	3.25	2.75	2.75	3.50
91-Day CD Rate, % eop	4.80	5.70	4.70	2.80	2.80	3.55	2.90	3.00	3.70
Long term yield, % eop	5.00	5.78	3.77	4.92	4.08	3.46	2.90	3.05	4.05
lc/US$, eop	930	936	1263	1166	1121	1159	1080	1048	995
lc/US$, avg	955	929	1102	1275	1156	1108	1117	1065	1012
Balance of Payments, US$ bn									
Current account	14.1	21.8	3.2	32.8	29.4	26.5	33.8	19.3	15.2
% of GDP	1.5	2.1	0.3	3.9	2.9	2.4	2.9	1.5	1.0
Trade balance	16.1	14.6	-13.3	40.4	41.2	30.8	26.3	24.1	21.8
Exports	325.5	371.5	422.0	363.5	466.4	555.2	551.9	574.2	633.2
Imports	309.4	356.8	435.3	323.1	425.2	524.4	525.6	550.1	611.4
Service balance	-13.3	-12.0	-5.7	-6.6	-8.6	-4.4	-6.2	-6.9	-10.1
Income balance	-4.0	-3.4	3.8	1.6	-2.1	-0.1	1.5	0.0	-0.7
FDI, net	-7.6	-17.9	-16.9	-14.9	-22.2	-15.7	-18.5	-12.5	-8.6
International reserves	239.0	262.0	201.0	270.0	291.0	304.0	311.0	319.0	336.0
Total Amortisations	17.7	43.8	42.9	43.6	40.0	42.0	43.0	42.0	40.0
Public Finances, % of GDP									
Consolidated government balance	0.4	3.5	1.2	-1.7	1.4	1.5	0.8	1.3	1.6
Consolidated gov primary balance	1.7	4.9	2.6	-0.2	2.8	2.9	2.2	2.7	2.9
Public debt	30.1	29.7	29.0	32.5	31.9	32.6	34.0	33.0	31.0
of which Domestic	28.9	28.6	28.1	31.4	31.0	31.7	32.9	32.0	29.9
Foreign Assets & Liabilities, US$ bn									
External debt	225.2	333.4	317.4	345.7	359.4	398.4	413.2	426.0	441.8
Private	205.3	279.8	265.0	278.3	314.7	358.0	373.0	384.8	399.6
Public	19.9	53.6	52.4	67.4	44.7	40.4	40.2	41.2	42.2
External debt / GDP	23.6	31.8	34.2	41.4	35.4	35.7	35.8	33.1	30.4
External debt / XGS	58.9	75.0	61.9	79.1	64.9	61.3	62.5	61.9	57.9
Short-term debt	113.8	160.3	149.9	149.2	139.8	136.1	136.9	140.3	150.5
Short-term debt/International Reserves (%)	47.6	61.2	74.6	55.3	48.0	44.8	44.0	44.0	44.8

Quarterly Economic Indicators

	2012 Q1	2012 Q2	2012 Q3	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	2.8	2.3	1.6	2.6	2.2	2.9	3.9	4.2	3.3
CPI, % yoy	2.6	2.2	2.0	2.1	2.2	2.4	3.1	3.4	3.2
Policy interest rate, % eop	3.25	3.25	3.00	2.75	2.50	2.50	2.50	2.75	3.00
91-Day CD Rate, % eop	3.55	3.54	3.09	2.90	2.70	2.70	2.70	3.00	3.25
Long term yield, % eop	3.70	3.42	2.87	2.90	2.75	2.85	2.90	3.05	3.38
lc vs USD, eop	1132	1141	1114	1080	1076	1072	1063	1048	1033

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

Taiwan

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- **Summary view** – We expect very gradual GDP recovery throughout 2013E. Inflation likely to stable around 2%yoy, allowing CBC to keep the policy rate on hold next year. Recent policy reforms are hurting the ruling party's popularity ratings, which needs to be worked on before 2014's local elections.
- **Things to watch** – (1) The severity of consumption retrenchment; (2) CBC's FX intervention to alleviate currency strength impacts on the country's export sector; (3) ECFA for services and for goods could be signed next year; (4) FTA negotiations with Singapore and New Zealand.
- **Strategy** – The TWD likely to follow regional (especially the RMB's) strength in the near/medium term. We believe interest rates will stay low for an extended period and CBC likely 1to maintain neutral stance till end-2013. Our strategist has set 8,200 as TAIEX YE2013 target.

Gradual recovery throughout 2013E

We expect 2013E GDP to recover to 3%yoy from 2012E's 1%yoy. With exports shares of GDP at above 60%, any expected GDP recovery would have to entail some degree of trade recovery (but not necessarily in a straight line). Our base case is that European deleveraging trend would linger in 2013E but Taiwanese exports could benefit from the expected moderate recovery in China and US (post reaching budget agreements). New tech product launches have started to contribute to exports recovery starting Sep-12, and we expect this to continue in 4Q12E and early 2013E.

Subdued consumption trends likely to keep inflation at bay. Consumer confidence has been on a sharp decline since Mar12, we believe it would take material economic improvements and nominal wages to pick up before consumption could be revived. We would unlikely see this until the later part of 2013. Also, additional spending from Mainland tourists will only make small contribution. Sluggish consumption would likely help cap inflation pressures in 1H13E, however, the second phase of the utility price rationalisation expected in Oct13 will likely add to inflation. Although CPI average around 2% in 2012E and 2013E are not high compared to regional standards, falling real wages and lack of financial wealth gains from the stock market and low interest returns in traditional savings are making any inflation unbearable, and the rise in food prices due to weather shocks is inflicting sharper pain on the lower income group.

Room for fiscal stimulus likely limited, although the Government has been credited for successfully reducing the fiscal deficit during the past few years, and we expect fiscal deficit to be around 1.6% of GDP in 2012E/13E. The recent income tax deductions likely have limited impact on GDP growth. The tax changes were part of an automatic mechanism whenever the inflation threshold was breached, and does not represent a change in the conservative fiscal stance. Fiscal ammunition is also constrained by Taiwan's general government debt (ex. self-redeeming and short-term debt), which is at 40.5% of past 3 years' GDP in 2011, and this is close to the 50% debt ceiling stipulated by the revised Public Debt Act. In addition, historical fiscal hangover from non-profit special funds (for instance, education, hospitals, infrastructure, privatization of SOEs, etc.), will add to public debt beyond what is stated in the general government budget. Taiwan is mulling over the Sovereign Wealth Fund concept, using its large FX reserves (4th largest in the world), to sponsor longer-term local investments. However, discussions are still in early stage.

CBC likely to maintain neutral stance on concerns of home prices and inflows. Despite our expectation of a gradual economic recovery and inflation remains manageable, we expect the policy rate will be kept at 1.875%pa till the end of 2013E. Albeit property transaction volumes have declined, the rise in the Sinyi residential property price index for the Greater Taipei remains unabated as of Sep12, despite the 60% loan-to-value ratio cap for luxury houses, the 15%-10% luxury tax on properties that are resold within one or two years, requirement of actual realty transactions and public disclosure of prices.

Stepping up on cross-strait cooperation and FTAs

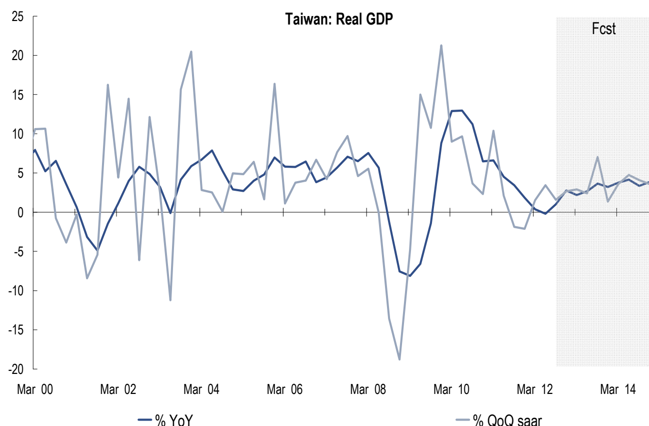
CNT banking business likely the new limelight for banks in 2013E. After the signing of the currency settlement MOU, both CBC and PBOC have chosen their respective clearing banks, we expect the expansion of RMB banking business will be fast tracked in 2013E. We expect the initial accumulation of the RMB deposit pool in Taiwan (CNT) could be exponential, especially with Taiwan's running trade surplus with China and at times when RMB appreciation hopes are high (and our house expect RMB to reach 6.15/USD in 6-12M). The development of CNT market would likely be smoother, as policy kinks have been ironed out and CNT roadmap development can benefit from the lessons learnt from other offshore RMB centers. However, ultimately the growth of CNT banking business would depend on the availability of CNT financial products (which regulatory approval on financial innovation is part of the function) and demand of CNT loans (which most likely will be driven by CNY and CNT interest rates differentials).

ECFA for services and goods are next on the cross-strait economic cooperation agenda. After the complete implementation of tariff concessions of the products under the Early Harvest List (EHL), cross-strait negotiations are now working towards the signing of the ECFA for Services, expected to take place early 2013. The more significant ECFA agreement for Goods (a wider list beyond those in the EHL) will likely be signed toward the end of 2013. The elimination of tariffs would therefore make Taiwanese exports to China more competitive.

More FTA talks underway to expand Taiwan's export market in the long run. Taiwan is currently in discussion with Singapore and New Zealand for potential FTAs -- the Singapore one is expected to be signed in early 2013, while the complementary agricultural sectors in Taiwan and New Zealand would make the FTA discussion much more feasible. The lifting of the ban on US beef imports in Jul12 could also help restart negotiations of the Trade and Investment Framework Agreements (TIFA) with Washington in 2013. Through signing FTAs with smaller countries, Taiwan could gradually reform and liberalize its economy (e.g. bringing Taiwanese safety/health/certificate standards more in line with international practices) and thus would prepare Taiwan for talks for joining the Trans-Pacific Partnership (TPP). President Ma has just set a goal to join the TPP in 8 years.

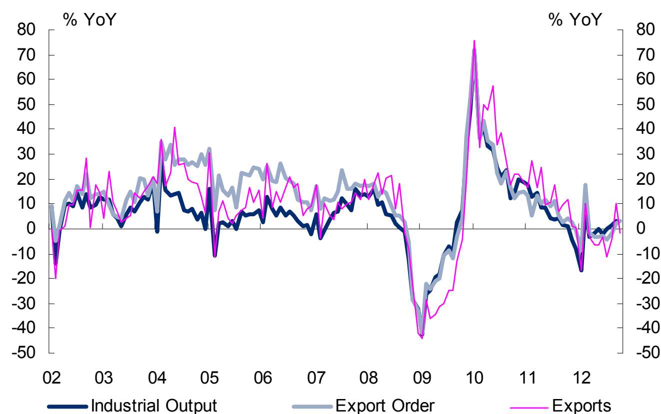
Politics gearing up for 2014 local elections. Although the "seven-in-one" local elections are still two years away and the next presidential race is four years away, both the ruling KMT and the opposition DPP are already in intense preparation mode. All upcoming policy/political decisions are expected to be heavily debated in relation with the speed and depth of rapprochement with China. Economic downturn and recent regulatory changes have taken toll on approval ratings of President Ma and his administration (Ma's rating is at its lowest at 15.2% in Oct12). A noteworthy event to watch out in mid-2013 would be the KMT's chairperson election, which Ma has already announced his intention for re-election.

Figure 85. Gradual recovery expected in 2013E



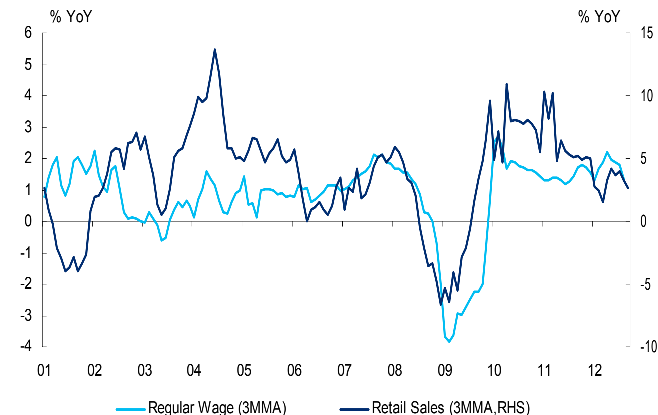
Source: CEIC and Citi Research estimate

Figure 86. IP and exports likely on recovery but in a zig-zag path



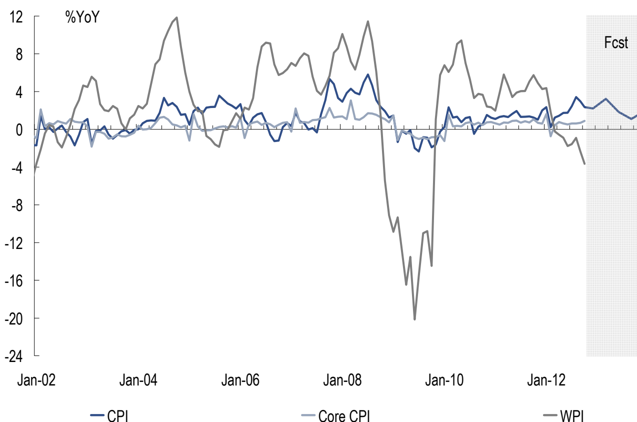
Source: CEIC and Citi Research

Figure 87. Consumption recovery likely to lag



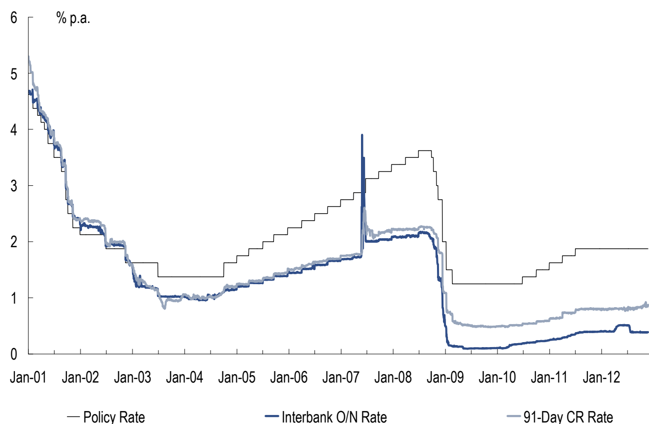
Source: MOEA and Citi Research

Figure 88. Benign inflation expected in 2013E



Source: MOEA and Citi Research

Figure 89. CBC likely to sustain its neutral stance in 2013E



Source: Bloomberg

Figure 90. NT$ appreciation likely with regional FX trends/risk-on mode

Source: CEIC and Citi Research

Figure 91. Taiwan Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	376.3	393.1	400.2	377.6	430.8	466.8	494.1	538.9	569.6
Nominal GDP, local currency bn	12,243	12,911	12,620	12,481	13,614	13,757	14,475	15,344	16,102
GDP per capita, US$	16,513	17,191	17,444	16,404	18,687	20,199	21,278	23,163	24,432
Population, mn	22.8	22.9	22.9	23.0	23.1	23.1	23.2	23.3	23.3
Unemployment, % of labour force	3.9	3.9	4.1	5.8	5.2	4.4	4.3	4.2	4.0
Economic Activity									
Real GDP, % yoy	5.4	6.0	0.7	-1.8	10.7	4.0	1.0	3.0	3.8
Real investment growth % yoy	0.5	-0.7	-7.9	-21.2	39.5	-7.6	-3.1	3.0	5.5
Real consumption growth % yoy	1.1	2.1	-0.6	1.3	3.1	2.8	1.1	1.6	2.3
private consumption growth % yoy	1.5	2.1	-0.9	0.8	3.7	3.0	1.2	1.9	2.7
Real export growth, % yoy	11.4	9.6	0.9	-8.7	25.6	4.5	-0.5	3.9	4.3
Real import growth, % yoy	4.6	3.0	-3.7	-13.1	28.2	-0.6	-2.1	2.6	3.0
Prices, Money & Credit									
CPI, % yoy	0.7	3.3	1.3	-0.2	1.2	2.0	2.2	1.9	1.2
CPI, % avg	0.6	1.8	3.5	-0.9	1.0	1.4	2.0	2.0	1.1
Nominal wages, % yoy	0.8	2.1	0.0	-5.1	5.5	2.7	0.0	1.5	3.0
Credit extension to private sector, % yoy	4.7	3.9	2.7	-0.8	6.7	5.7	3.0	5.0	7.0
Policy interest rate, % eop	2.75	3.38	2.00	1.25	1.63	1.88	1.88	1.88	2.13
1 month inter-bank rate, % eop	1.69	2.04	1.02	0.57	0.74	0.87	0.87	0.93	1.05
Long term yield, % eop	1.99	2.53	1.44	1.47	1.47	1.27	1.12	1.24	1.36
lc/US$, eop	32.59	32.43	32.78	32.23	29.17	30.29	28.50	28.41	28.20
lc/US$, avg	32.52	32.85	31.58	33.04	31.50	29.40	29.30	28.47	28.27
Balance of Payments, US$ bn									
Current account	26.3	35.2	27.5	42.9	39.9	41.3	42.9	45.4	45.6
% of GDP	7.0	8.9	6.9	11.4	9.3	8.8	8.7	8.4	8.0
Trade balance	21.3	27.4	15.2	29.3	23.4	26.8	27.3	36.0	47.7
Exports	224.0	246.7	255.6	203.7	274.6	308.3	302.0	322.2	353.1
Imports	202.7	219.3	240.4	174.4	251.2	281.4	274.8	286.2	305.4
Service balance	-3.5	-1.6	1.9	2.0	2.5	4.3	4.4	9.2	5.8
Income balance	9.6	10.1	10.0	12.5	13.6	13.2	16.8	17.5	19.0
FDI, net	0.0	-3.3	-4.9	-3.1	-9.1	-14.7	-13.0	-11.0	-9.0
International reserves	266.1	270.3	291.7	348.2	382.0	385.5	403.0	425.0	450.0
Total Amortisations	7.6	6.9	5.6	4.6	4.9	5.7	7.0	6.8	6.0
Public Finances, % of GDP									
Consolidated government balance	0.1	0.3	-0.5	-3.5	-2.3	-1.9	-1.6	-1.6	-1.3
Consolidated gov primary balance	1.2	1.4	0.6	-2.4	-1.3	-2.0	-1.5	-1.3	-1.0
Public debt	29.6	28.8	30.0	38.0	38.6	38.9	39.2	39.5	42.0
of which Domestic	18.9	25.6	28.4	32.3	31.8	31.9	32.4	32.6	36.6
Foreign Assets & Liabilities, US$ bn									
External debt	85.8	94.5	90.4	82.0	101.6	122.5	124.0	125.5	127.0
Private	75.2	91.1	88.9	76.0	93.5	118.0	119.0	120.5	121.9
Public	10.6	3.5	1.5	5.9	8.0	4.5	5.0	5.0	5.1
External debt / GDP	22.8	24.0	22.6	21.7	23.6	26.2	25.1	23.3	22.3
External debt / XGS	38.4	38.3	35.4	40.3	37.1	39.9	33.9	32.0	29.8
Short-term debt	74.2	83.3	78.8	68.2	83.7	107.8	120.0	115.0	110.0
Short-term debt/International Reserves (%)	27.9	30.8	27.0	19.6	21.9	28.0	29.8	27.1	24.4

Quarterly Economic Indicators

	2012 Q1	2012 Q2	2012 Q3	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	0.6	-0.1	1.0	2.6	2.1	2.6	3.1	4.0	3.7
CPI, % yoy	1.3	1.8	3.0	2.2	3.2	1.9	1.1	1.9	1.2
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88
1 month inter-bank rate, % eop	0.87	0.87	0.87	0.87	0.87	0.87	0.87	0.93	0.99
Long term yield, % eop	1.28	1.24	1.19	1.12	1.15	1.18	1.21	1.24	1.27
lc vs USD, eop	29.52	29.79	29.32	28.50	28.50	28.50	28.47	28.41	28.35

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 expect FY13 growth at 4.5% following a revised FY12 GDP growth of 4%. Investment-driven growth support the economy's return to potential growth in the 4%-5% range as flood-induced spending tapers off. Net exports contribution to GDP in FY13 remains subdued at 11.9%.
- **Things to watch** – MPC's tightening signals in 2H13 with external demand recovery. Core inflation likely to hit bottom in June-July. Possibility of new revenue measures to ease risk of a rising government debt to GDP ratio. Application of macro prudential tools to ensure financial market stability.
- **Strategy** – Upbeat growth prospects, improving terms of trade in 2H13 coupled with investment flows will lead to a Baht probing 30 by end-FY13. Low policy rate setting, core inflation expected at less than 2% and higher fiscal debt supply risk bode well for the 3yr-5yr segment of the bond curve.

Return to potential growth of 4.5% in FY13

Domestic demand expected to post solid growth in FY13 while net exports struggle to match the FY12 net export contribution to GDP of 12.8%. After upbeat 2H12 growth estimated at 7.8%YoY largely due to the base effect, we expect the domestic economy in FY13 to head back to potential growth in the range of 4%-5%. Flood-induced private spending peaked in 3Q12 although we expect fiscal stimulus spending with an infrastructure bias to provide a lift to real investments (ex-inv) by 8.4% in FY13 or roughly the same pace of FY12 investment spending. The next phase of the floodworks control and drainage systems are likely to be pursued on the assumption that political risk premia will not derail implementation of the public investment agenda. Government's cash budget data flagged infrastructure spending's upbeat growth exceeding 30%YoY in FY3Q12 and FY4Q12 that can carryover into government's FY13. Despite this we continue to expect private investments to account for nearly 80% of real investments (ex-inv) as FDI approvals that hit a high of Bt221bn (37.5%YoY) last July will probably contribute to a better investment setting in FY13. On an annualized basis, a 1% increase in FDI approvals potentially results in a 0.09% gain in real private investments. The FDI gain of 37.5% can contribute an additional 3.2% investment gain aside from ongoing investment activities. Investment activities can generate upside pressure on labor demand and wages that in turn support consumer sentiment and eventually consumption. Government's one-off car subsidy may extend to 1H13 that will get reflected in higher car sales although the base effect will normalize growth in the sector. Other towns and provinces that have yet to adjust to the wage rate of Bt300/day will help augment rural incomes and provide a bit more upside to consumption. Coupled with government's cash transfers & subsidies in the FY13 budget of Bt2tr, domestic demand could grow by 5% in FY13 after rising by 6.9% in FY12. We expect modest export recovery in 2H13--a period long enough for US policymakers to put safeguards in place to address the fiscal cliff and mitigate likelihood of a US recession while China's economy regains its bearings that bode well for intra-Asian trading. However limited export gains expected will result in a net export contribution to GDP of 11.9% in FY13 that will barely matched the preceding year's net exports of 12.8% of GDP. Our net export estimates in FY12-FY13 remain well below preceding years' contribution of at least 14%. Subdued net exports contribution to GDP could explain why we expect growth will settle to within potential after the flood-induced private spending expires.

Fiscal deficit of 2.2% of GDP likely to persist in FY13

We expect tax revenue growth to catch up but not exceed primary spending gains in FY13. As a result, the budget deficit may edge up to 2.2% of FY13 GDP following a fiscal deficit ratio of 2.1% in FY12 (including the non-budgetary position leads to an overall budget deficit of 2.4% of FY13 GDP). Tax collections: revenue department (includes corporate & personal income taxes and VAT), excise and Customs revenues are projected to rise by 8.9%YoY in FY13 against a 4.8%YoY growth in FY12 as the macro backdrop normalizes and growth heads back to potential. Primary expenditures are likely to be driven by investments in non-financial assets or infra spending following upbeat gains in 2H FY12. The primary fiscal deficit outcome may expand slightly to 0.9% of GDP down slightly from the preceding year's primary deficit of 0.8% of GDP to suggest sustained bias for fiscal expansion. Risk to our forecast is that government may 'overpromise & underdeliver' once again particularly if absorptive capacity issues and political risk premia derail a more effective implementation of the infra agenda. Excise taxes are expected to recover by 10% next year following a 5% contraction in FY12 due to the deluge and supply disruption. Corporate income taxes fell 5.2% in FY12 that's likely to rebound in a better growth setting alongside sustained gains for VAT and personal income tax collections. A chronic fiscal deficit to GDP ratio in the 1%-2% range will probably elevate the government debt to within 33%-34% of GDP following an estimated fiscal debt ratio of 34.8% in FY12. In the last decade, the government debt ratio was consistently less than 30% of GDP.

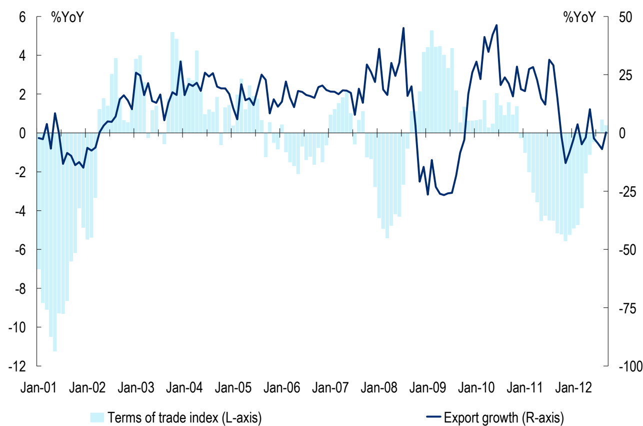
Expecting a marginal current account surplus in FY13

Exports likely to recover next year but unlikely to show robust growth while domestic demand will firm up non-oil imports. Export growth of 7.5% following this year's marginal gain of 0.5% will lag import growth of 8% to support a trade surplus of US$7.1bn compared to FY12 estimated surplus of US$7.6bn. We expect exports particularly the industrial segment to report stronger gains in 2H12 when terms of trade are likely to improve as the US fiscal cliff risk eases and China's sustained rebound become more apparent. We remain positive that the motor vehicle industry will support a sanguine outlook for exports and manufacturing output. Electronics and other heavy export industries would have healed completely with available capacity to address improving external demand. Despite export recovery and ensuing trade surplus, we estimate a muted current account surplus at 0.45% of GDP up from 0.1% of GDP in FY12. Capital account flows will fare better than the current account in sustaining the GIR buildup. On this note, capital flows predicated on QE-driven portfolio investments, FDI resumption and trade credits alongside a favorable GDP backdrop support a strong Baht outlook.

Short-duration to belly of the curve still preferred

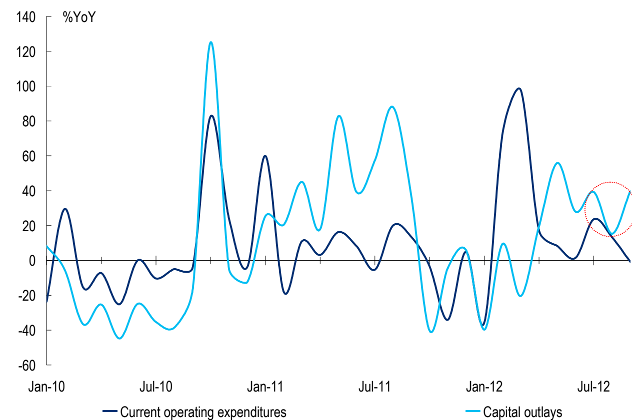
Rising government debt to GDP ratio next year will probably reduce appeal of the long end of the curve. Chronic fiscal deficit ratios in the range of 1%-2% likely to extend to FY14 could curb risk appetite for the long bonds. Long bond risk perception however may be softened by the MPC's accommodative rate bias of an overnight rate steady at 2.5% in FY13. Low policy rate setting, core inflation expected at less than 2% and higher fiscal debt supply risk will favor the 3yr-5yr segment. Upbeat growth prospects, improving terms of trade in 2H13 coupled with steady to improving investment flows will lead to a Baht probing 30 by end-FY13. This is likely to compel BoT to step in and soothe strong Baht pressures.

Figure 92. Improving terms of trade bodes well for exports



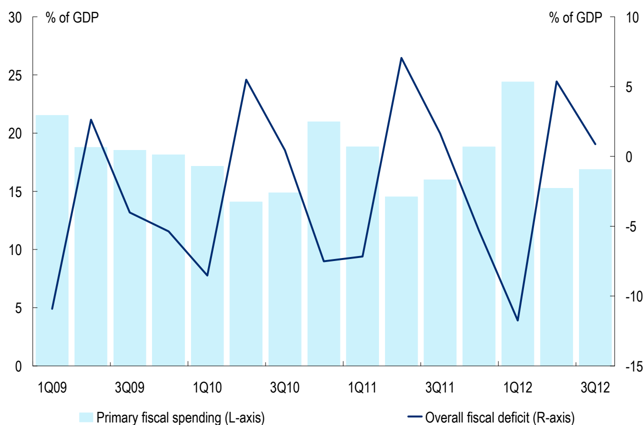
Source: CEIC, and Citi Research

Figure 93. Gov capital outlays rose sharply in 2HFY12



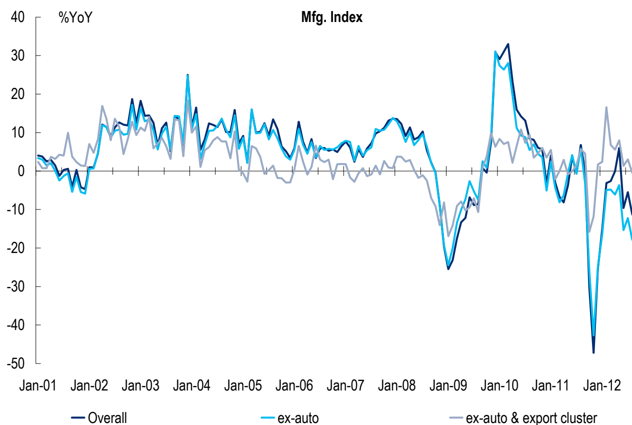
Source: CEIC, and Citi Research

Figure 94. After accelerating in 1Q12, primary expenditures faded



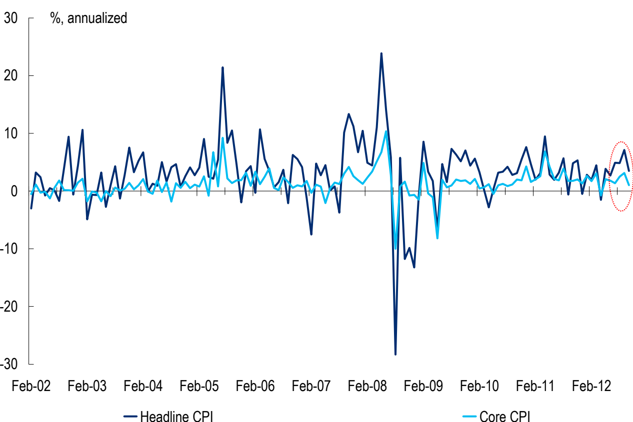
Source: CEIC, and Citi Research

Figure 95. Sustained weakness of mfg ex-autos, ex-export industries



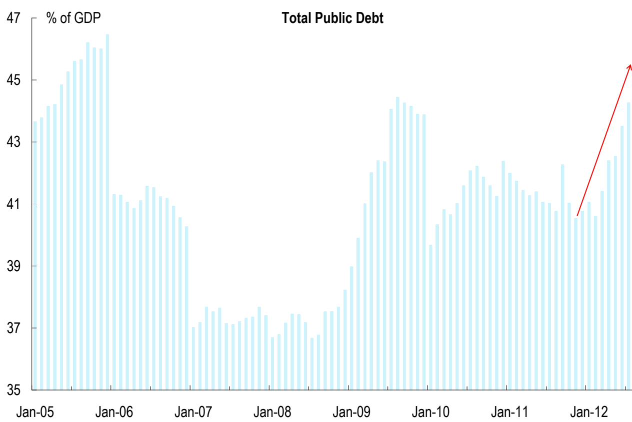
Source: CEIC, and Citi Research

Figure 96. Annualized rates of core and headline CPI waned in Oct



Source: CEIC, and Citi Research

Figure 97. Rising fiscal debt to GDP ratio because of chronic deficits



Source: CEIC, and Citi Research

Figure 98. Thailand Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	207.1	247.0	272.4	263.8	318.9	345.7	360.3	388.9	426.2
Nominal GDP, local currency bn	7,845	8,525	9,080	9,042	10,105	10,540	11,128	11,905	12,827
GDP per capita, US$	3,295	3,918	4,298	4,153	4,992	5,379	5,573	5,979	6,453
Population, mn	62.8	63.0	63.4	63.5	63.9	64.3	64.6	65.0	66.0
Unemployment, % of labour force	1.5	1.4	1.4	1.3	1.1	1.0	1.1	0.8	1.8
Economic Activity									
Real GDP, % yoy	5.1	5.0	2.5	-2.3	7.8	0.1	4.0	4.5	4.8
Real investment growth % yoy	-3.6	1.0	8.1	-25.2	28.7	0.1	14.2	10.1	8.3
Real consumption growth % yoy	3.0	2.9	2.9	0.1	5.1	1.3	5.2	3.7	4.0
private consumption growth % yoy	3.2	1.8	2.9	-1.1	4.8	1.3	5.4	3.7	4.0
Real export growth, % yoy	9.1	7.8	5.1	-12.5	14.7	9.5	-0.3	3.3	7.0
Real import growth, % yoy	3.3	4.4	8.9	-21.5	21.5	13.7	3.7	4.8	5.1
Prices, Money & Credit									
CPI, % yoy	3.5	3.2	0.4	3.5	3.0	3.5	3.3	3.5	4.3
CPI, % avg	4.7	2.2	5.4	-0.9	3.3	3.8	3.0	3.3	4.3
Nominal wages, % yoy	6.2	3.0	10.2	-2.5	3.5	6.0	40.0	0.0	0.0
Credit extension to private sector, % yoy	4.5	4.8	8.8	2.5	9.1	15.0	12.7	13.5	11.5
Policy interest rate, % eop	5.00	3.25	2.75	1.25	2.00	3.25	2.50	2.50	3.50
1 month inter-bank rate, % eop	5.23	3.70	2.85	1.28	2.05	3.25	2.50	2.75	3.75
Long term yield, % eop	5.44	4.94	2.69	4.18	3.79	3.35	3.25	3.50	4.50
lc/US$, eop	35.45	30.05	34.79	33.36	30.07	31.57	30.32	30.54	29.87
lc/US$, avg	37.93	32.33	33.03	34.33	31.71	30.48	30.89	30.62	30.10
Balance of Payments, US$ bn									
Current account	2.3	15.7	2.2	21.9	10.0	5.9	0.4	1.7	4.0
% of GDP	1.1	6.3	0.8	8.3	3.1	1.7	0.1	0.4	0.9
Trade balance	13.7	26.6	17.3	32.6	29.8	17.0	7.6	7.1	9.9
Exports	127.9	151.3	175.2	150.8	191.6	219.1	220.2	236.7	260.4
Imports	114.3	124.6	157.9	118.2	161.9	202.1	212.6	229.7	250.5
Net service and Transfer accounts	-11.4	-11.0	-15.2	-10.7	-19.7	-11.6	-7.2	-5.3	-5.9
Income balance	-6.7	-7.0	-7.1	-7.5	--	--	--	--	--
FDI, net	8.5	8.3	4.4	0.7	5.0	4.0	7.0	5.5	6.5
International reserves	65.3	85.2	108.7	135.5	167.5	167.4	180.0	195.0	200.8
Total Amortisations	15.4	19.5	12.7	16.1	15.0	16.7	17.3	18.0	19.0
Public Finances, % of GDP									
Consolidated government balance	-1.1	-0.4	-4.3	-0.3	-2.0	-1.0	-2.1	-2.2	-2.1
Consolidated gov primary balance	2.5	-1.1	-1.7	-1.1	-1.0	0.2	-0.8	-0.9	-0.7
Public debt	24.9	24.1	23.5	29.2	29.7	29.7	34.5	33.8	32.9
of which Domestic	22.9	23.0	22.7	28.0	29.7	28.9	33.8	32.9	31.9
Foreign Assets & Liabilities, US$ bn									
External debt	70.0	74.4	76.1	75.3	100.6	97.8	100.1	102.5	103.5
Private	54.6	59.5	61.3	59.9	79.1	74.3	75.1	76.9	76.9
Public	15.4	14.9	14.8	15.4	21.5	23.5	25.0	25.6	26.6
External debt / GDP	33.8	30.1	27.9	28.5	31.5	28.3	27.8	26.4	24.3
External debt / XGS	54.7	49.2	43.4	49.9	52.5	44.6	45.4	43.3	39.7
Short-term debt	27.3	34.0	33.6	33.1	50.6	47.5	49.8	51.1	52.1
Short-term debt/International Reserves (%)	41.7	39.9	30.9	24.5	30.2	28.4	27.7	26.2	25.9

Quarterly Economic Indicators

	2012 Q1	2012 Q2F	2012 Q3	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	0.4	4.4	3.0	8.6	5.0	4.7	4.3	4.0	4.5
CPI, % yoy	3.4	2.6	3.4	3.3	3.0	3.3	3.3	4.3	4.3
Policy interest rate, % eop	3.00	3.00	3.00	2.50	2.50	2.50	2.50	2.50	2.50
1 month inter-bank rate, % eop	3.04	3.05	3.05	2.50	2.45	2.50	2.60	2.75	2.70
Long term yield, % eop	3.82	3.47	3.50	3.25	3.00	3.35	3.40	3.50	3.50
lc vs USD, eop	30.85	31.57	30.83	30.32	30.51	30.70	30.72	30.54	30.36

Source: CEIC Data Company Limited, 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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GDP likely to pick up from 12%YoY in 2012E to 13.8%YoY in 2013E with new mining capacity. With the Oyu Tolgoi copper-gold mine going into commercial production in 2013E, exports growth and fiscal revenues are likely to see sizeable improvements. Despite global commodity price decline remains unfavorable for MN, a gradual warming up of the Chinese economy will be a positive. We expect policy rates would be hiked by 75bps in 2013E, as M2 and credit growth still rapid as of Oct12 at 17.3%YoY and 31.3%YoY, respectively; while inflation remains sticky at 15%YoY as of Oct12, above the central bank's inflation target of 10%.

On fiscal watch -- The approved 2013 State Budget dedicated equal 1/3 weightings to investment, gov't consumption and transfer payments. The Budget expects fiscal deficit would improve to 2% of GDP in 2013 and therefore would satisfy the requirements of the Fiscal Stability Law. However, we remain concerned on their fiscal stability, as: 1) budget tax revenue assumptions are subjective to commodity prices/outlook; 2) investment projects sponsored by gov't funds are often being criticized as lacking of rigorous feasibility studies; and 3) infrastructure works are partially funded by the off budget vehicle – the Development Bank of Mongolia. We also worry about active fiscal financing and the resulting debt servicing cost. The gov't has been selling 10% of Erdnes TT shares to domestic companies to raise cash for the preferred share buybacks from those citizens who opted for cash, and a successful sale is needed in order to prevent additional budget liabilities. Also the parliament has just approved US$5bn worth of gov't bond issuances to finance railway and other infrastructure works. Given current market conditions, and foreign investors' concern about the extent to which resource protectionism could hurt FDI prospects, upcoming external financing likely remain expansive (although likely still cheaper than domestic rates).

Sri Lanka

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Growth should recover in 2013F with the help of more "normal" weather conditions, some export rebound and continued public investment spending. We also see sustained growth in tourism-related sectors in 2013F after 22.4%YoY gains in tourism revenues in Jan-Sep 2012 (though lower than 55% average annual growth rate in 2010-11) as we see more tourism-related infrastructure pick up.

Inflation deceleration in 2013 should facilitate some monetary policy easing. Recently benign MoM inflation has been aided by benign food prices, but base effect should keep headline inflation elevated until 2Q 2013 where headline could recede to around 6.0% range. We expect CBSL to keep rates on hold until 1Q 2013 but may eventually reduce policy rates when headline inflation recedes in a bid to lower government's domestic borrowing costs. With a persistent current account (CA) deficit, room to ease policy rate corridor is limited to about 7.25%-8.75% range (from current 7.75%-9.75% corridor), assuming the O/N corridor reverts to 150bps.

We see some modest fiscal consolidation in 2013F with room for revenue disappointments. Given rising funding constraints amid a hefty debt ratio, we see the gov't will be more sensitive to spending slippages so to cap the budget deficit below 6% of GDP. But with ambitious revenue targets, and no IMF program in place to impose strong discipline, we see a slippage towards 6.2% of GDP deficit.

LK's key risk is how external accounts evolve. The 2012 CA deficit improvement is less than what we had hoped for given challenges to Iran oil sanctions hurting refined petroleum output, poor agri output, weak global demand for exports and still robust public investment driving capital goods imports. The 2013F CA deficit is likely narrow to 4.3% of GDP as the negative trade hit from the first three factors wane. Nonetheless, net FDI has remained disappointing over the years, raising LK's reliance on debt-creating capital inflows. With elevated external financing requirements, gov't likely will lean banks/corps/sov to raise FCY funding overseas and open up the foreign quota for Treasury bills/bonds further. Despite attractive yields, we still see lingering mild LKR depreciation pressure next year.

Vietnam

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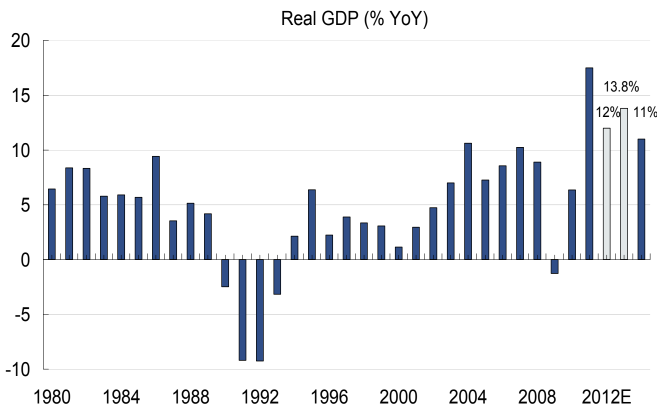
We expect 203F growth recover modestly to ~5.4% (vs 5.0% in 2012), aided by some modest global rebound, continued structural support for FDI inflows into manufacturing given VN's cost competitiveness, lagged impact of moderate fiscal and monetary easing started this year. We see a bit more monetary easing and extension of this year's tax waivers in 2013, but we are encouraged by government's willingness to tolerate slower growth to safeguard macro stability.

Inflation moderation and prolonged FX stability could push SBV to cut at least 100bps in 2013F. While rate cuts have proven ineffective in boosting credit, political pressure to ease remains high, especially when headline disinflation materializes, possibly in 1Q 2013F. We also think we could see continued fiscal policy support for enterprises with the extension of tax cuts/waivers next year – while this may have manageable impact on gov't debt, it may raise concerns that the gov't not building enough buffer to absorb future contingent liabilities from the banking sector.

Expect a slow pace of bank restructuring in 2013F – We could see attempts to raise capital by increasing bank foreign ownership limits (possibly to 49% from 30%), and more forceful efforts to address/restructure/close the weak banks (i.e. "Group 4") which are unnecessarily driving up cost of funding across the banking system. However, we may not will see significant resolution of the bank sector problems just yet: First, information quality on the extent of the NPL problem is still very weak – NPL ratio may be higher than 8.6%-10% as mentioned by SBV given that collateral is not valued at market prices. Second, legal/regulatory framework for disposing of bad assets, and the governance structure and capital to support the gov't run DATC (Debt Asset Trading Company) is lacking. Third, decisive leadership driving tough decisions on reforms (e.g. size of gov't funds for recapitalization) look unclear. Lastly, the lack of market pressure (e.g. no external funding issue, still stable domestic deposit funding base amid financial repression, resilient growth in other parts of the economy) has allowed the gov't to take their time with reforms.

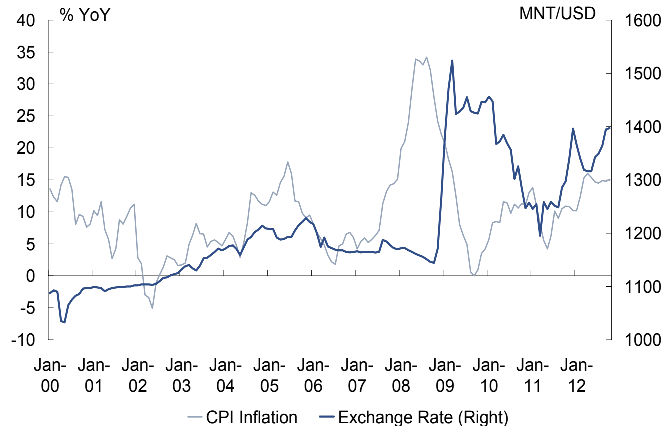
The massive trade/CA deficit seems to be over (we see a small CA deficit in 2013) and SBV will maintain a stable USD-VND rate through most of 2013F. Sub-bar domestic growth amid unresolved overhang in the banking sector will mean import growth is contained, while a continuing engine of growth is the FDI-funded export-driven manufacturing base which likely will persist. Exports have been the best performing in Asia led by significant production expansion in tech companies. With gradual rise in FX reserves, we think SBV will be able to maintain the dong at a peg-like range next year – a deliberate policy to devaluate the currency looks unlikely given unnecessary risks it brings to destabilizing dong-sentiment and destabilizing deposits in an environment where banks are already relative fragile.

Figure 99. Mongolia – GDP growth could climb again in 2013E



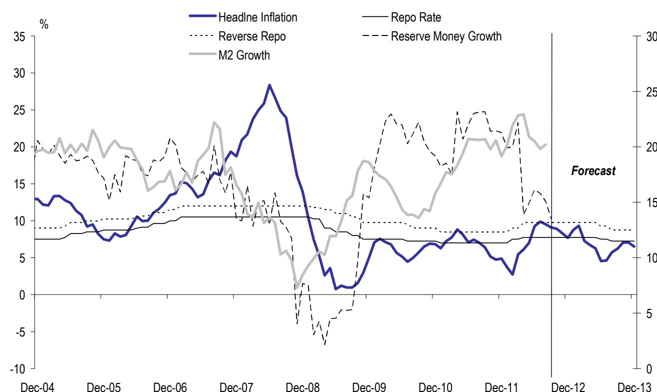
Source: IMF, Haver and Citi Research estimates

Figure 100. MNT depreciation keeping inflation elevated



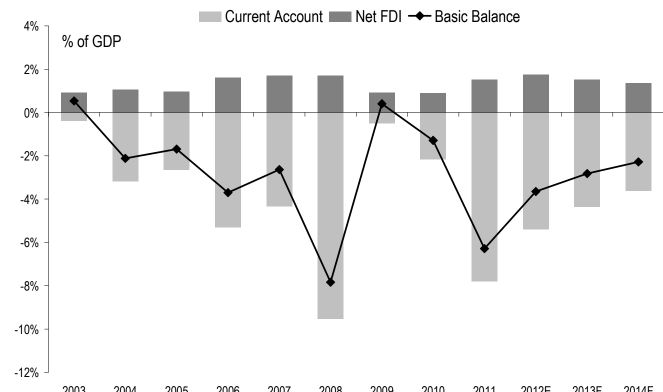
Source: BoM, NSO and Citi Research

Figure 101. Sri Lanka – Disinflation could prompt monetary easing...



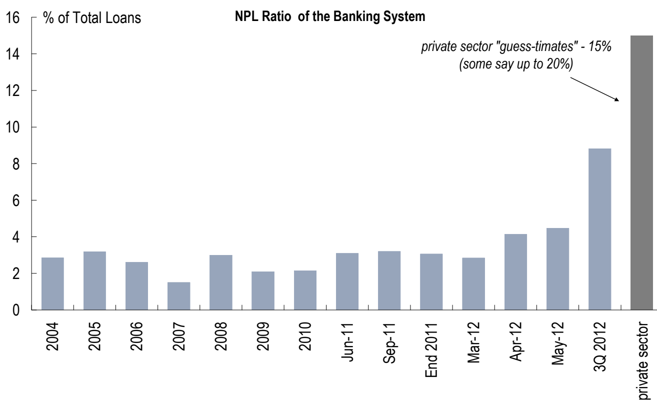
Source: CBSL, CEIC, and Citi Research

Figure 102. …but will be constrained by lingering external funding gap



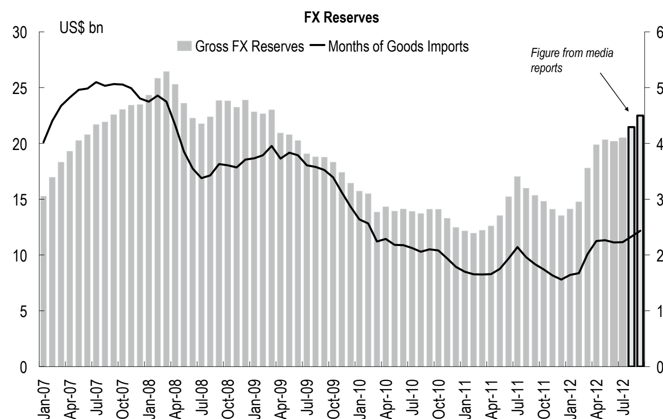
Source: CEIC, and Citi Research

Figure 103. Vietnam – Rising NPL Ratio will remain a key issue next year



Source: Factiva, VCBS, and Citi Research

Figure 104. Improving reserves should help anchor dong



Source: IMF, and Citi Research

Figure 105. Asia Frontier Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Mongolia									
Nominal GDP, US$ bn	3.4	4.2	5.6	4.6	6.2	8.7	11.0	13.8	16.7
GDP per capita, US$	1326	1616	2100	1688	2262	3110	3864	4766	5654
Population, mn	2.6	2.6	2.7	2.7	2.8	2.8	2.8	2.9	3.0
Real GDP, % yoy	8.6	10.2	8.9	-1.3	6.4	17.3	12.0	13.8	11.0
CPI, % yoy	6.0	15.1	22.1	4.2	13.0	10.2	14.0	10.2	10.0
CPI, % avg	4.5	9.0	28.0	8.0	10.1	9.2	14.2	12.0	10.0
Policy interest rate, % eop	6.42	9.85	14.78	10.82	10.99	14.25	13.25	14.25	14.75
Long term yield, % eop	26.93	21.83	20.58	21.67	20.07	16.61	19.20	20.40	21.60
lc/US$, eop	1164	1172	1275	1433	1233	1378	1400	1331	1266
lc/US$, avg	1181	1171	1167	1434	1349	1256	1362	1369	1285
Current account (US$ bn)	0.2	0.3	-0.7	-0.4	-0.9	-2.8	-2.8	-1.5	0.5
% of GDP	6.5	6.3	-12.9	-9.0	-14.9	-31.7	-25.5	-10.8	3.0
Trade balance (US$ bn)	0.1	-0.2	-1.1	-0.2	-0.4	-1.7	-1.8	-1.4	-1.3
Exports (US$ bn)	1.5	1.9	2.5	1.9	2.9	4.8	5.8	7.2	8.4
Imports (US$ bn)	1.5	2.1	3.6	2.1	3.3	6.5	7.6	8.6	9.7
International reserves (US$ bn)	0.6	0.8	0.6	1.3	2.2	2.3	2.4	2.9	3.4
Consolidated government balance (% of GDP)	7.6	2.6	-4.5	-5.0	1.2	-3.5	-4.0	-2.0	-2.0
Public debt (% of GDP)	40.3	37.7	32.0	43.2	38.3	46.1	49.2	41.4	40.0
Sri Lanka									
Nominal GDP, US$ bn	28.3	32.4	40.7	42.1	49.6	59.2	56.9	65.9	75.1
GDP per capita, US$	1422	1615	2014	2058	2400	2836	2696	3089	3483
Population, mn	19.9	20.0	20.2	20.5	20.7	20.9	21.1	21.3	21.6
Real GDP, % yoy	7.7	6.8	5.9	3.5	8.0	8.3	6.7	7.3	7.5
CPI, % yoy	13.5	18.8	13.9	5.0	6.9	4.9	7.7	6.5	6.5
CPI, % avg	10.0	15.8	22.5	3.4	6.2	6.8	7.4	6.7	6.5
Policy interest rate, % eop	10.00	10.50	10.50	7.50	7.25	7.00	7.75	7.25	7.50
Long term yield, % eop	12.96	19.96	19.08	9.33	7.55	7.50	7.25	7.25	7.25
lc/US$, eop	107.5	108.7	113.0	114.4	110.9	113.9	130.0	130.0	130.0
lc/US$, avg	103.9	110.6	108.3	114.9	113.0	110.5	130.4	130.0	130.0
Current account (US$ bn)	-1.5	-1.4	-3.9	-0.2	-1.1	-4.6	-3.1	-2.8	-2.7
% of GDP	-5.3	-4.3	-9.5	-0.5	-2.2	-7.8	-5.4	-4.3	-3.6
Trade balance (US$ bn)	-3.4	-3.7	-6.0	-3.1	-4.8	-9.7	-9.2	-10.4	-11.1
Exports (US$ bn)	6.9	7.6	8.1	7.1	8.6	10.6	9.9	10.8	12.2
Imports (US$ bn)	10.3	11.3	14.1	10.2	13.5	20.3	19.1	21.1	23.3
International reserves (US$ bn)	2.5	3.1	1.8	5.1	6.6	6.0	7.5	9.2	11.5
Consolidated government balance (% of GDP)	-7.0	-6.9	-7.0	-9.9	-8.0	-6.9	-6.7	-6.2	-5.5
Public debt (% of GDP)	87.9	85.0	81.4	86.1	81.9	78.5	83.1	77.8	76.0
Vietnam									
Nominal GDP, US$ bn	60.9	71.2	90.0	91.9	102.4	121.6	139.1	157.2	178.2
GDP per capita, US$	724	836	1044	1054	1163	1366	1545	1729	1940
Population, mn	84.1	85.2	86.2	87.2	88.1	89.0	90.0	90.9	91.8
Real GDP, % yoy	8.2	8.5	6.3	5.3	6.8	5.9	5.0	5.4	6.0
CPI, % yoy	6.6	12.6	19.9	6.5	11.7	18.1	8.0	8.1	6.5
CPI, % avg	7.5	8.5	23.2	7.0	9.2	18.6	9.4	8.2	7.5
Policy interest rate, % eop	6.50	6.50	9.50	8.00	9.00	15.00	10.00	9.00	8.00
Long term yield, % eop	8.29	8.73	10.00	11.68	11.50	12.55	9.00	11.00	7.50
lc/US$, eop	16056	16028	17483	18474	19498	21034	20850	21000	21000
lc/US$, avg	15990	16081	16445	17806	19123	20648	20850	20973	21000
Current account (US$ bn)	-0.2	-7.0	-10.7	-7.2	-4.3	-0.7	0.4	-0.9	-1.6
% of GDP	-0.3	-9.8	-11.9	-7.8	-4.2	-0.6	0.3	-0.5	-0.9
Trade balance (US$ bn)	-2.8	-10.4	-12.8	-8.3	-5.1	-0.5	0.4	-1.9	-2.5
Exports (US$ bn)	39.8	48.6	62.7	57.1	72.2	96.9	115.3	136.1	152.7
Imports (US$ bn)	42.6	58.9	75.5	65.4	77.3	97.4	114.9	137.9	155.2
International reserves (US$ bn)	13.4	23.5	23.9	16.4	12.5	13.8	22.3	29.6	32.1
Consolidated government balance (% of GDP)	-1.1	-5.3	-1.2	-9.0	-6.4	-3.9	-4.4	-4.2	-4.0
Public debt (% of GDP)	37.5	39.0	34.9	40.0	45.5	45.9	47.6	48.6	49.1

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

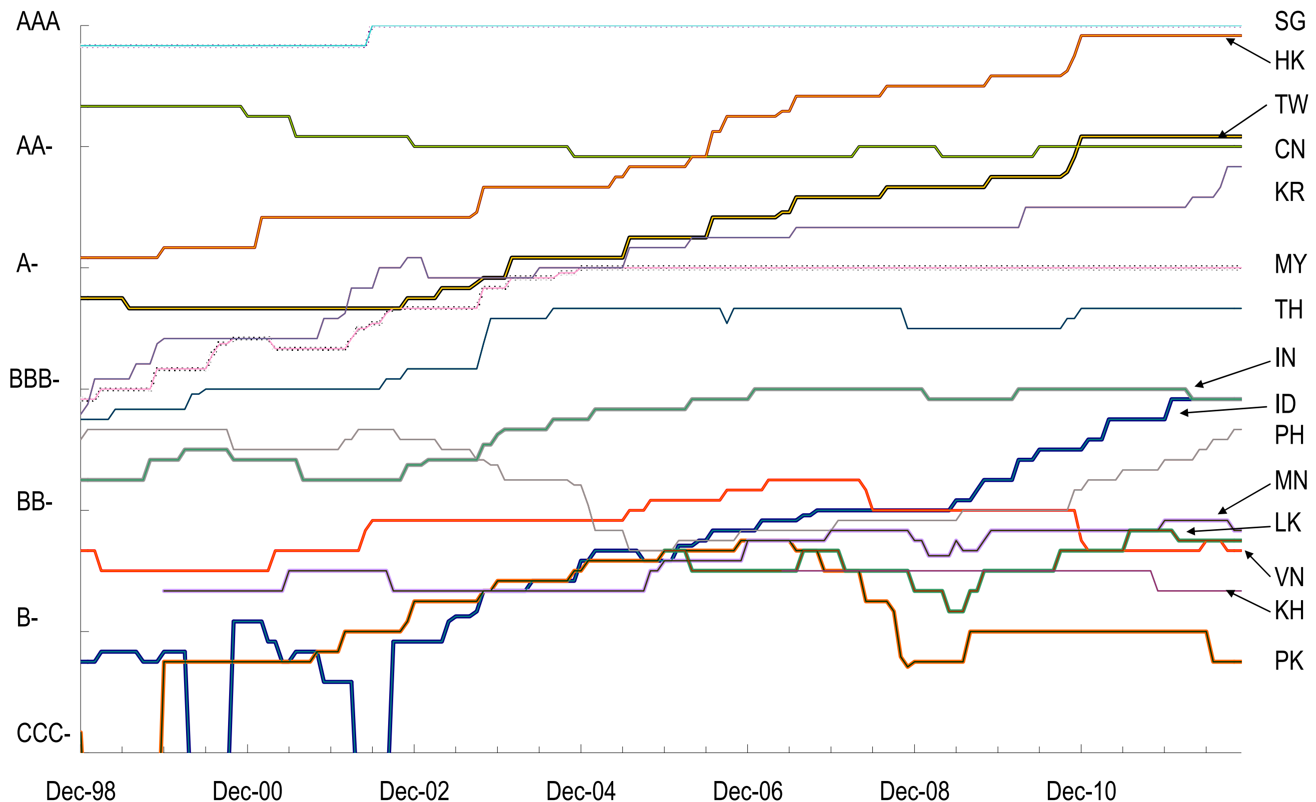
Appendix: Sovereign Risk Ratings Summary

Figure 106. Long-Term Foreign Currency Ratings

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

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

Figure 107. Ratings History (Average of S&P and Moody's Ratings), December 1998-November 2012



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

Global Assumptions

	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2012F	2013F	2014F	2015F	2016F	2017F
Global Indicators														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	2.5	2.6	3.1	3.6	3.8	3.7
CPI Inflation (average, y/y %)	—	—	—	—	—	—	—	—	2.9	2.8	3.0	2.9	2.8	2.9
Current Account (% of GDP)	—	—	—	—	—	—	—	—	0.2	0.1	-0.1	-0.2	-0.3	-0.3
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-4.5	-3.8	-3.2	-2.8	-2.5	-2.3
Industrial Countries*														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	1.2	0.9	1.5	2.2	2.5	2.2
CPI Inflation (average, y/y %)	—	—	—	—	—	—	—	—	1.9	1.7	1.8	1.7	1.6	1.6
Current Account (% of GDP)	—	—	—	—	—	—	—	—	-0.8	-0.7	-0.7	-0.5	-0.4	-0.4
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-5.9	-4.9	-3.8	-3.0	-2.7	-2.5
United States														
GDP Growth (SAAR %)	3.0	0.6	1.1	1.3	2.4	3.0	3.0	3.4	—	—	—	—	—	—
GDP Growth (y/y %)	2.6	1.7	1.5	1.5	1.3	2.0	2.4	2.9	2.2	1.6	3.0	3.5	4.0	3.0
CPI Inflation (average, y/y %)	1.5	1.9	1.7	2.0	2.1	1.9	1.9	2.0	1.8	1.9	2.0	2.0	2.0	2.0
Current Account (% of GDP)	-2.6	-2.9	-2.9	-3.0	-2.9	-3.0	-3.0	-3.2	-3.0	-3.0	-3.1	-3.2	-3.2	-3.0
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-8.3	-7.0	-5.0	-4.0	-4.0	-4.0
S&P 500 EPS (y/y %)	1.0	4.5	2.7	4.7	4.6	7.4	5.7	4.6	5.3	4.9	4.6	—	—	—
Business Investment (y/y %)	5.0	2.2	0.8	0.7	1.9	3.7	4.9	5.6	7.2	1.8	5.7	—	—	—
Imports (y/y %)	2.7	2.0	1.8	1.8	2.4	2.7	3.4	4.1	3.0	2.2	4.1	—	—	—
Japan														
GDP Growth (SAAR %)	-3.5	-1.4	1.8	2.4	3.1	2.0	3.5	-6.8	—	—	—	—	—	—
GDP Growth (y/y %)	0.2	0.1	-0.7	-0.2	1.4	2.3	2.8	0.4	1.6	0.7	0.7	1.5	1.2	1.2
CPI Inflation (y/y %)	-0.3	-0.2	-0.7	-0.4	-0.1	0.0	0.0	2.1	0.0	-0.3	1.6	0.5	0.2	0.5
Current Account (% of GDP)	0.8	0.7	0.9	1.1	1.1	1.1	1.4	1.7	1.0	1.1	1.6	1.5	1.5	1.3
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-10.7	-8.1	-6.6	-6.2	-5.8	-5.4
Euro Area														
GDP Growth (SAAR %)	-0.3	-1.7	-0.7	0.0	0.1	-0.2	-1.2	-0.4	—	—	—	—	—	—
GDP Growth (y/y %)	-0.6	-0.7	-0.9	-0.7	-0.6	-0.2	-0.3	-0.4	-0.4	-0.7	-0.4	0.7	1.1	1.3
CPI Inflation (y/y %)	2.5	2.5	2.0	2.1	2.0	1.7	1.6	1.5	2.6	2.0	1.5	1.5	1.3	1.2
Current Account (% of GDP)	—	—	—	—	—	—	—	—	0.9	1.2	1.3	1.3	1.3	1.4
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-3.3	-2.9	-2.4	-1.5	-0.9	-0.4
Exchange Rates														
US$ vs. Euro (eop)	1.29	1.24	1.23	1.22	1.21	1.20	1.20	1.20	1.28	1.21	1.20	1.24	1.31	1.38
US$ vs. JPY (eop)	78	84	84	85	85	84	84	83	81	85	83	82	82	82
JPY vs. Euro (eop)	100	104	104	103	102	101	100	99	104	103	99	102	108	113
Short Interest Rates (eop)**														
United States	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	1.10	2.10	2.90
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.07	0.07	0.13	0.10	0.27	0.50
Euro Area	0.75	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.88	0.31	0.25	0.25	0.31	0.75
10-Yr Yield Forecasts (Period Avg.)														
United States	1.60	1.65	1.75	1.95	2.20	2.50	2.65	2.90	1.80	2.10	2.80	3.25	3.50	3.75
Japan	0.78	0.95	0.85	1.00	0.90	1.10	1.10	1.00	0.85	0.96	1.13	1.50	1.75	1.75
Euro Area***	1.44	1.50	1.50	1.75	1.75	1.50	1.25	1.50	1.59	1.63	1.44	1.50	2.00	2.50
Emerging Markets														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	4.7	5.3	5.5	5.5	5.6	5.7
CPI Inflation (eop, y/y %)	—	—	—	—	—	—	—	—	4.4	4.6	4.7	4.6	4.5	4.5
Current Account (% of GDP)	—	—	—	—	—	—	—	—	1.8	1.2	0.6	0.1	-0.1	-0.3
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-2.0	-2.1	-2.3	-2.4	-2.2	-2.1
Commodities														
WTI Oil price (US$/bbl)	92.2	80.0	85.0	85.0	85.0	85.0	—	—	92.0	85.0	83.0	—	—	—
Copper (Average, USD/MT)	7711	8020	8160	8000	7800	7900	—	—	7970	7965	7775	—	—	—
Gold (Average, US$/oz)	1654	1760	1790	1750	1735	1720	—	—	1679	1749	1655	—	—	—

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

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Asia-Pacific Economics and Market Analysis

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Appendix A-1

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