29 June 2012 | 168 pages

Emerging Markets Macro and Strategy Outlook

Can EM keep the world growing?

- We think EM growth prospects have taken a turn for the worse in recent months. At the start of the year, we expected EM GDP growth to be 5.5% on average in 2012/13, led by an 8.5% average growth rate for China. Things look gloomier now: For these two years on average, we now expect GDP growth of only 5.2%. To put this into context: a 30 bp decline in EM GDP growth affects global demand in the same way as a 50 bp decline in US growth.

- China's slowdown has two broad sources. The first is the legacy of its own efforts to tighten policy in 2010 and 2011, which helped to precipitate a sharp fall in credit availability. The second is the impact of the declining external environment. Weaker global demand hits China in two ways. The first, naturally, is the impact on China's net exports. The second is the way in which smaller fx purchases by PBOC make it less easy to finance domestic liquidity creation. Although the PBOC has plenty of other options on which to rely if it wants seriously to underpin credit creation, it seems that China's policymakers have a bias towards caution these days. Overall, the slowdown creates some unpleasant feedback in EM.

- Brazil may be the most important example of this linkage**:** our 2012 GDP forecast is now 2.3%, down from 3.5% at the start of the year. This is partly thanks to the 'China effect'; but also due to the risks to Brazilian activity that seem to be coming from the household sector. Russia could soon become vulnerable too.

- Against these growth risks, there are two important sources of support. One is the increased room that exists for monetary easing in EM, particularly thanks to the strong fall in global commodity prices, especially food. Another is the expectation of more monetary easing in the developed world.

- With this in mind, we have some relatively constructive views on EM assets. In sovereign credit, our overweights focus on credits with either an idiosyncratic story behind them (Hungary) or that stand to benefit from liquidity-induced capital flows (Turkey and Poland). Indonesia and Russia are probably to be avoided. In local bond markets, we follow a similar approach, forcing greater diversification of portfolios and prioritizing over/under positions in relatively liquid markets. Our preferred overweights in local bonds are Turkey, Korea, Malaysia, Thailand and Brazil. We fund those positions with underweights in Russia, Czech, Peru, Singapore and Israel.

EM Economics and Strategy

Guillermo Mondino
+1-212-816-6499
guillermo.mondino@citi.com

Head of EM Economics

David Lubin
+44-20-7986-3302
david.p.lubin@citi.com

Head of Asia Economics

Johanna Chua
+852-2501-2357
johanna.chua@citi.com

Head of Latam Economics

Joaquin A Cottani
+1-212-816-2735
joaquin.cottani@citi.com

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

Contents

Can EM keep the world growing?

David Lubin
+44 20 7986 3302
david.p.lubin@citi.com

with thanks to Farouk Soussa

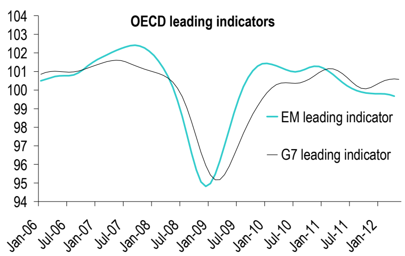
We think EM growth prospects have taken a dramatic turn for the worse in recent months. At the start of the year we expected EM GDP growth to be 5.5% on average in 2012/13, led by an 8.5% average growth rate for China. Things look gloomier now to us now, as Figure 1 illustrates. For these two years on average, we now expect GDP growth of only 5.2%. The picture looks a little less bad for 2012 on its own, where the decline in our EM GDP growth forecast has been 30 basis points since the start of the year, from 5.1% to 4.9%. But to put this into context: a 30 bp decline in EM GDP growth affects global demand in the same way as a 50 bp decline in US growth.

Figure 1. Our 2012/13 GDP forecasts for EM have been pushed down considerably since the start of the year

GDP growth: how things look to us now…	China	India	Brazil	Russia	BRIC	EM
2012	7.8%	6.4%	2.3%	3.5%	6.0%	**4.90%**
2013	7.9%	6.9%	4.5%	4.0%	6.6%	**5.50%**
Average	**7.85%**	**6.65%**	**3.40%**	**3.75%**	**6.30%**	**5.20%**
…and how they looked at the start of this year	China	India	Brazil	Russia	BRIC	**EM**
2012	8.4%	7.0%	3.5%	2.5%	6.4%	**5.10%**
2013	8.6%	7.7%	4.5%	4.2%	7.1%	**5.90%**
Average	**8.50%**	**7.35%**	**4.00%**	**3.35%**	**6.80%**	**5.50%**

Source: Citi Investment Research and Analysis

Figure 2. The OECD's leading indicators make EM look sicker than the G7…

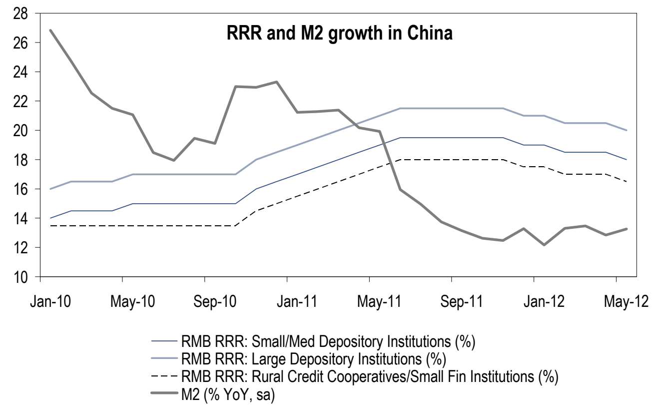


Source: OECD, Citi Investment Research and Analysis

So what's gone wrong? Most obviously China, where our 2012 GDP forecast has fallen from 8.4% at the start of 2012 to 7.8% now. China's slowdown has two broad sources. The first is the legacy of its own efforts to tighten policy in 2010 and 2011, which helped to precipitate a sharp fall in credit availability (Figure 3). The second source of China's slowdown is the impact of the declining external environment. This raises the prospect of an unpleasant feedback loop: slower external demand affects China, which in turn has some nasty consequences for other countries, as we'll show.

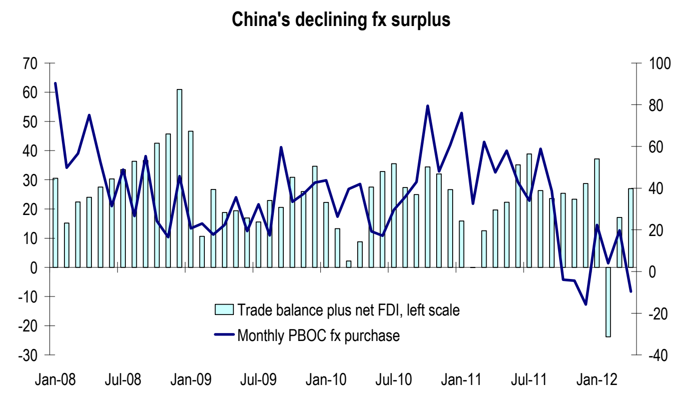
Weak global demand hits China in two ways. In the first place, of course, weaker external demand hurts China's net exports, and indeed, the news here has been unwelcome: net exports have subtracted from GDP in each of the last five quarters, and the drag from NX in Q1 this year was large: 0.8% of GDP. The drag from net exports is partly a new structural reality for the Chinese economy: China is simply not pursuing an export-driven growth model in the same way that it did between 1994 and 2008, when net exports contributed to GDP in every single year. At the same time of course, the drag from NX in China is being accentuated by renewed decline in global demand growth. The EU takes a fifth of China's exports, and during the first 5 months of 2012, those exports fell in YoY terms by 0.8%: not as bad the post-Lehman period when exports to the EU fell by 30%, but certainly worse than anything before or since then.

Figure 3. China's weakening outlook is partly thanks to a policy-driven tightening…



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 4. …as well as a negative shock to domestic credit conditions that comes from the diminishing balance of payments surplus

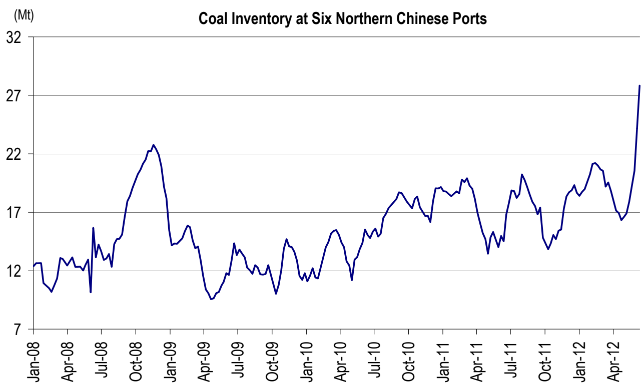


Source: Bloomberg, CEIC, Citi Investment Research and Analysis

The weakness of the external environment affects China not only through the direct impact on net exports, but also indirectly, because of its impact on domestic liquidity. An important debate in China these days is whether the credit market has suffered a demand problem or a supply problem this year. Of course demand has been affected — an obvious consequence of tighter monetary policy, and a possible loss of 'animal spirits' in the run up to the political transition that starts later this year. But it seems likely that credit *supply* has been constrained too, and it is reasonable to imagine that this supply constraint has its roots in the external environment. Since China's balance of payments surplus has been under pressure in recent quarters, it has become less easy for the PBOC to finance domestic liquidity creation via purchases of foreign exchange (Figure 4). Although the PBOC has plenty of other options on which to rely if it wants seriously to underpin credit creation, it seems that China's policymakers have a bias towards caution these days. One reason for this is that there is room for doubt about how desperate the economy is for further stimulus.

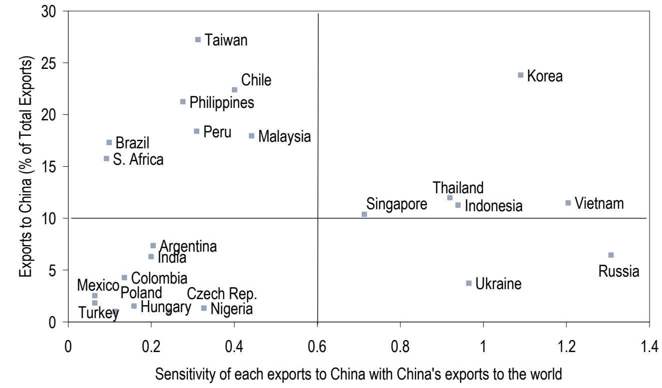
Chinese growth indicators appear to have stabilised in May, and we think a rebound is likely in the second half of the year (China Macro View - 2H Outlook: A Rebound in the Making). China's macro data in May, which showed that the growth rates of industrial production, fixed investment and monetary aggregates picked up a bit last month, didn't only contain good news for China itself; but for its trading partners too. And partly because the May data showed signs of stabilisation, we don't expect a significant new round of stimulus: Chinese officials are too wary of recreating some of the unpleasant side-effects of the post-Lehman stimulus: accelerating inflation, asset bubble risks and growing provincial debt levels. That said, we do see room for further rate cuts, further cuts in the RRR, further spending on infrastructure, and further measures to support the property market. All in all, we don't think there is a case for any catastrophic view about Chinese GDP growth this year or next. Risks remain, however — attention has focused recently for example on the level of Chinese coal inventories at major ports (Figure 5). And as long as these risks are visible, investors will need to worry about the international linkages across EM.

Figure 5. If anecdotal evidence such as this of a persistent Chinese slowdown has any truth…



Source: CEIC, Citi Investment Research and Analysis

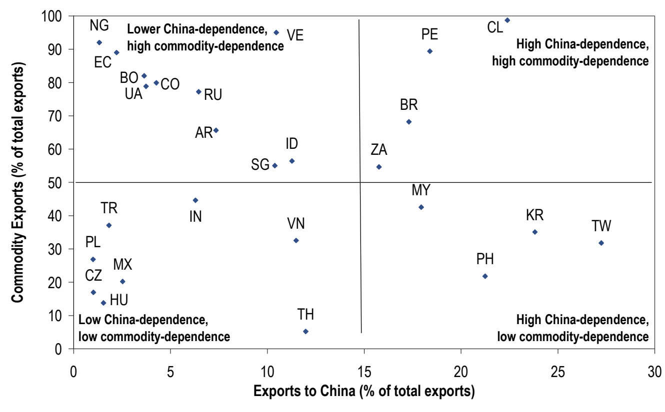
Figure 6. …it will be Asia that suffers the most as a result of weaker Chinese export growth…



Source: Citi Investment Research and Analysis from data provided by Haver Analytics

Brazil may be the most important example of this linkage. Market expectations for Brazilian GDP growth are now 2.3% in 2012, down from 3.5% at the start of the year. Citi's forecasts have moved in the same way. The collapse in Brazilian growth expectations can be at least partly attributed to the 'China effect' (Figure 7), given the large dependence that Brazil has on the export of commodities to China, and the extent to which that has helped to create Dutch Disease by helping to overvalue the exchange rate and divert resources away from the manufacturing sector. More recently, though, consumer confidence in Brazil has also started to weaken — maybe both a cause and effect of the signs of stress that exist in Brazilian credit markets (Figure 8) — and so the risks to Brazilian activity are coming from the household sector as well as the industrial sector.

Figure 7. …and commodity exporters that suffer the most as a result of declining Chinese demand growth…



Source: Citi Investment Research and Analysis from data provided by Haver Analytics

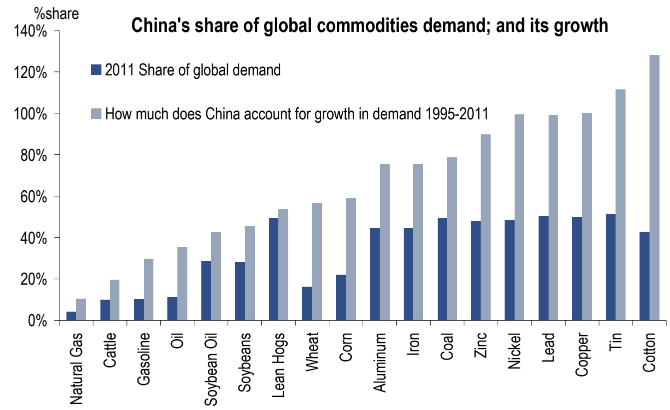
Figure 8. …and Brazil's problems are compounded by signs of stress of weakness in domestic credit markets

Source: Banco Central do Brasil, Citi Investment Research and Analysis

The decline in India's growth prospects is no less dramatic, albeit with fewer global consequences (India's share of global GDP is 2.7%, against Brazil's 3.7% and China's 10.4%). There is now near consensus that the India story had de-rated, with growth at best likely in the 6.0% to 6.5% range during FY13. The key reason for the lower growth path has been a near collapse in the investment cycle, which comprises 35% of GDP and where trends in investment growth have slipped from 17%YoY in the past to low single digits. Much of the problem appears to be from self-inflicted delays in project approvals, constraints on fuel supply issues, and controversies surrounding foreign investment. Added to this is the policy logjam since 2010, in which corruption scandals and a lack of traction in reforms have exacerbated pressures emerging in macro fundamentals. Moreover, India's deficits — both fiscal and in the current account — have deteriorated. The combined fiscal deficit (including the SEB losses) is at ~9% of GDP and the current-account deficit at ~4% of GDP. Last but not the least is the persistence of the liquidity deficit.

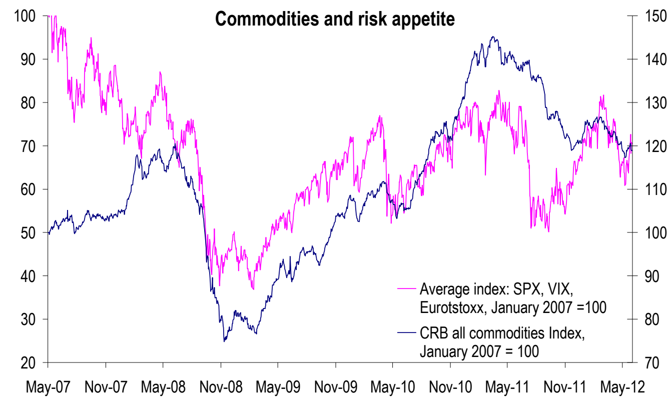
The global implications of all this could be severe. Although EM accounts for only 37% of global nominal GDP, the 0.3 ppt fall in our growth forecasts during the past 6 months is the equivalent of taking 0.5 ppt off of US growth. And that's not where the linkages finish, in our view. We think there are two additional considerations. The first is the way that downward pressure on EM growth — and China's growth, in particular — affect commodity prices. Figure 9 shows the evolution of China's share in global commodities markets, and makes the point that China's role in global metals markets is considerably more important than it is in global energy markets. And it is also true that the downward pressure on energy prices so far this year probably has less to do with China than with the increase in global supply: crude oil production in the US has risen nearly 0.5 mbd since the start of the year to around 6.2 mbd[1]. That said, the downward pressure on metals prices are probably more significantly a China-related phenomenon. And since global commodities prices seem correlated with measures of risk appetite, the combination of a weaker China and higher energy supply is related to a decline in measures of risk appetite (Figure 10).

Figure 9. China's dominance of world commodities markets – especially metals – is clear…



Source: Citi Investment Research and Analysis from data provided by Haver Analytics

Figure 10. …and the link between commodities and risk appetite puts China at the heart of EM financing prospects



Source: Bloomberg, Citi Investment Research and Analysis

Figure 11. Food and energy weights in CPI (%)

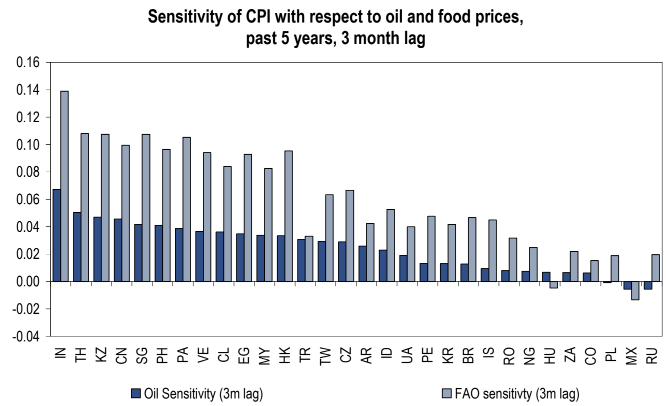
	PH	TU	IN	PD	PH	UA	MX	RO	BZ	CN	CO	ZA	PE	CH	KO	CZ	AR	TW	SG	MY	RU	KZ	HU
Food	39	25	14	22	47	51	19	37	15	32	28	17	26	17	13	17	28	26	22	30	39	35	18
Energy	22	16	15	13	11	11	10	9	9	8	6	6	6	5	5	4	4	4	4	3	2	2	2

Source: Haver Analytics, Citi Investment Research and Analysis

[1] Energy Watch Monthly, 1 June, p13 ff.

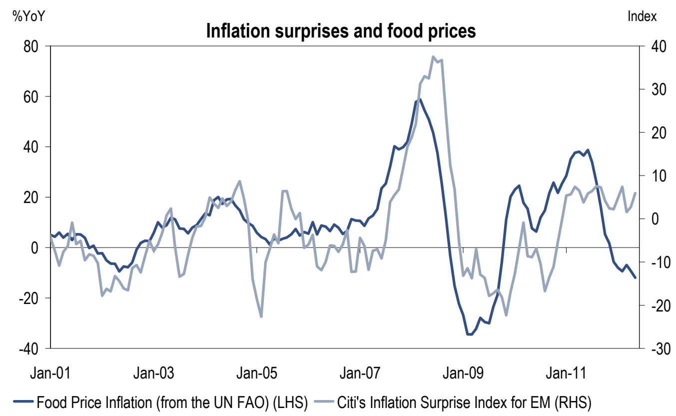
The feedback loops from this process are not pleasant. As we've highlighted before, weak growth in EM helps to highlight potential banking and sovereign insolvency risks in the Eurozone, since A's solvency partly depends on B's demand for A's exports. And since solvency in the Eurozone is routinely described as the principal threat that EM policymakers face, the loop is unlikely to be broken soon. We remain gloomy on euro area prospects[2]. We continue to believe that the current policy framework of liquidity assistance (via Troika bailouts and ECB liquidity measures) coupled with fiscal austerity and supply side reforms will fail to return the periphery economies to fiscal sustainability, economic recovery and tolerable yields on market financing. Economic weakness is likely to hit revenues and cause government debt/GDP ratios to overshoot official forecasts in most periphery countries this year, and also create continued widespread doubts about medium-term fiscal prospects. Moreover, all this worsens the vicious circle between weak economies, capital-weak banks (leading to worsening credit availability) and fiscally-weak governments (implementing fiscal austerity and reluctant to recapitalise banks on an adequate scale). For these reasons, we think that in spite of our expectation of some upside to China GDP in H2, it makes sense to stay cautious about EM growth in the near term.

Figure 12. CPI seems to be more sensitive to global food prices in EM than to oil prices…



Source: Citi Investment Research and Analysis from data provided by Haver Analytics

Figure 13. …and falling global food prices seems to create room for some downside risks for headline CPI across EM



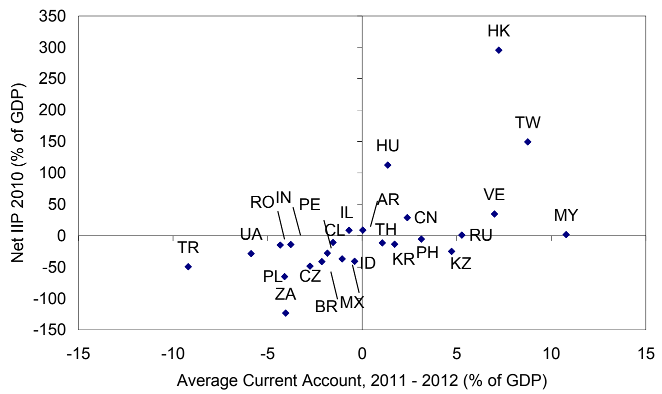
Source: Haver Analytics, Citi Investment Research and Analysis

But the policymakers in EM might have more room for manoeuvre now. This weak-growth-low commodity-price dynamic does at least raise the prospect of greater flexibility for EM monetary policy. Although much attention gets devoted to the disinflationary benefits of lower oil prices, we think it might be better to follow global food price dynamics (although the two are obviously linked, since energy is a production cost for food). Figure 12 shows the greater sensitivity of EM CPIs to food prices than to energy prices, largely thanks to the greater weight that food has in EM CPI baskets. And given the very sharp decline in food inflation that we've seen in the recent past — the FAO food price index fell last month by 4.2%, a decline not seen for over 2 years — there is a reasonable chance of some 'pleasant' inflation surprises in EM (Figure 13). Indeed, there is already some recent evidence of the impact this can have on inflation surprises. A number of countries — Israel, Ukraine, Turkey, Hungary, for example — saw YoY inflation rates last month that were at least 40 bp below the consensus estimates. Of course this is no universal rule: Indian inflation dynamics have been very negatively affected by domestic food prices, and the same has been true in Mexico recently. And supply-related concerns for some commodities — wheat prices have risen sharply since mid-May for example —– can complicate the picture.

[2] See "*Global Economics View: What's Next for Spain and Italy?*", Willem Buiter and Ebrahim Rahbari, 25 June 2012, and "*Race to Save the Euro Would Follow 'Grexit'*", Willem Buiter, 25 June 2012, Citi.

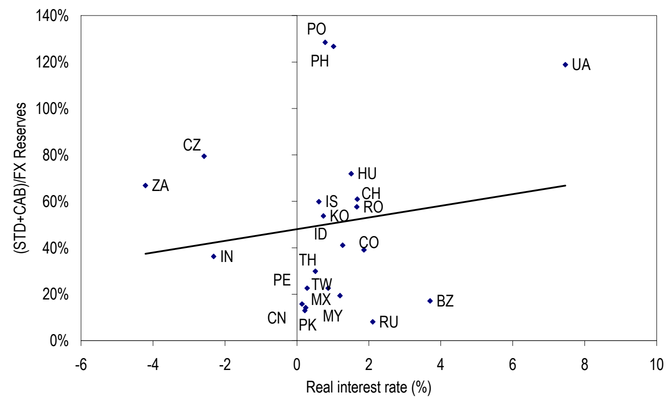
Still, there are going to be a number of limits to policy flexibility in EM. In the past we've highlighted a few constraints to delivering greater policy flexibility: i) depreciating exchange rates can deliver monetary stimulus on their own, and it might be dangerous for some countries to cut rates into a weak fx environment in case the currency runs out of control; ii) countries with low inflation-fighting credibility — ie if inflation is running well above target — will find it tougher to ignore CPI risks if they cut rates; iii) countries with large external financing gaps and weak balance sheets will equally find rate cuts tough for fear of losing access to much-needed capital inflows; and finally iv) countries where fiscal excess is evident will find monetary policymakers less inclined to deliver rate cuts.

Figure 14. Policy flexibility is likely to be highest in the upper right hand quadrant here, but that is scarcely populated…



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 15. …or put another way: the higher your financing needs, the more likely you'll need to keep real interest rates high



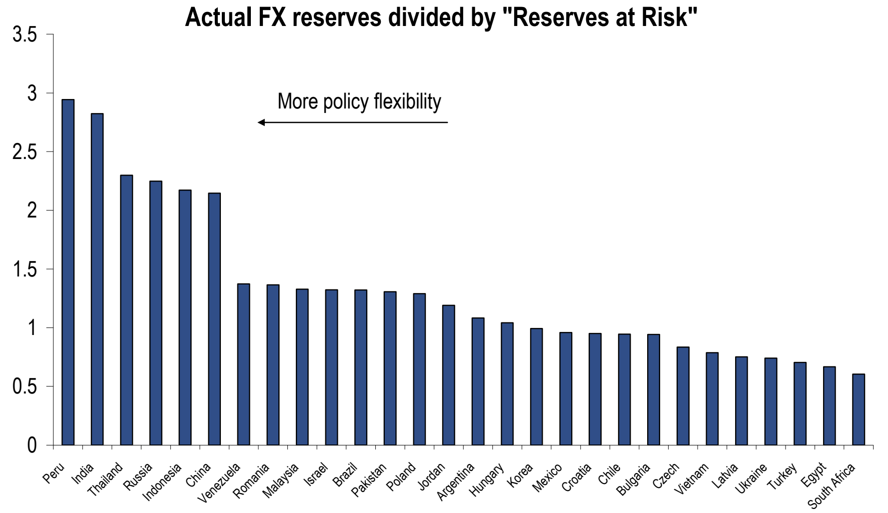
Source: Haver Analytics, Citi Investment Research and Analysis

In an environment where risk aversion and weak growth play off against each other, the countries with the greatest degree of flexibility could be those with the strongest levels of international liquidity. For that reason, it's worth presenting some new thinking on reserves adequacy. This new approach aims to assess reserves adequacy according to the likely call on foreign exchange reserves that may result from a list of economic shocks including:

- (i) a 20% fall in exports
- (ii) a 20% fall in M2 aimed at escaping the domestic monetary system
- (iii) a sudden stop in international financing, defined broadly as a failure to roll over short-term external debt
- (iv) a reversal of portfolio inflows, defined as a 50% fall in foreign investor holdings of debt and equity in each country, and
- (v) a sudden stop in foreign direct investment.

Of course not all these shocks would necessarily present a claim on fx reserves, to the extent that policymakers simply let the exchange rate adjust. That said, we attach probabilities to each of these shocks for each of the countries studied to arrive at a potential call on foreign exchange reserves, which we term Reserves at Risk (RAR). The methodology is analogous to the concept of expected losses commonly used to calculate loan loss reserves in banks. It is based on work done by the IMF (see Moghadam, Reza, Jonathan D. Ostry and Robert Sheehy, February 14 2011, 'Assessing Reserve Adequacy', IMF). For a more detailed explanation of our methodology, see Middle East Macro Monthly, Why Traditional Reserve Metrics Don't Make Sense, May 2012).

Figure 16. Policy flexibility is likely to be in countries whose actual reserves are a multiple of what the claims on reserves might be in the event of a trade shock or sudden stop in flows



Source: Haver Analytics, Citi Investment Research and Analysis

Guillermo Mondino
+1 212 816 6499
guillermo.mondino@citi.com

The strategy implications of the downgrade to EM growth start from the fact that positioning in EM markets has lightened up significantly. We perceive that the level of risk taking by market participants is rather limited, as if altogether discounting possible (short term) positive scenarios. Furthermore, we perceive that markets have behaved as if all risky assets would be under similar pressure, when it is possible that some assets in EM may behave better in the medium term.

While we have downgraded EM growth expectations, we are still of the opinion that most global growth will emerge from the space. This is in response to: (i) the larger share of global GDP accounted for by these countries; (ii) the fact that growth continues to be meaningful, despite the slowdown; and (iii) the likelihood that we are near a cyclical trough and that the room for macroeconomic policies discussed above will facilitate a (modest) recovery. Therefore, as markets have marked down expectations, it is likely that during Q3 economic surprises will turn positive once again. In fact, in many of our forecasts we anticipate a somewhat stronger Q3.

Globally, it appears that we are moving to a quasi-coordinated easing of monetary conditions by central banks around the globe. The Fed recently announced an extension of its operation twist until the end of 2012. Our US economics team thinks that if economic weakness (and particularly in labor markets) persists, it is likely that the Fed will do more. Two options seem most likely: (i) further quantitative easing; and (ii) extending the guidance over the period of extraordinarily low interest rates to 2015. In turn, the ECB is now expected to cut interest rates by 25bp. Importantly, market participants are likely to focus on whether the ECB signals future additional cuts, whether they bring deposit rates to negative territory, or whether they hint at a new round of LTROs. The effects of easier ECB policy may be somewhat discounted, though we still think that the actual process of injecting liquidity is likely to have further soothing effects on markets. Leaving aside other advanced economies potential monetary easing (i.e. the Bank of England or Japan) we also anticipate that in Q3 China and Brazil will continue their process of interest rate reductions and credit facilitation. Policies that may be mimicked by other EMs. All in all, we anticipate a quarter where easing of monetary conditions will take center stage.

Q3, seems to us, is likely to be a “sandwich” quarter in terms of meaningful EA economic developments. Greece is likely to negotiate actively new conditions for its program and, in our opinion, notwithstanding our view that there is a high likelihood of an exit from the eurozone in the next 12 months, we see it is less likely that it will unfold during the summer. Spain, in turn, will receive its EUR100bn for bank capitalization and the conditionality that governs its use, but we do not anticipate other major developments. For instance, a Troika program for Spain and/or Italy could materialize in 2012, yet it seems more likely to be a Q4 development.

It is difficult to be very excited about risk markets, given the challenges promised by Q4 and 2013, yet we anticipate some relief for risky assets during the summer. During periods of relative calm, one would expect markets to reconsider the relative merits of different regions and asset classes. In that vein, EM ought to stand out. We expect, therefore, that flows into EM will be somewhat rekindled driven by the relative fundamental strength of these countries. We imagine those flows will tend to be more focused on fixed income assets than equities, though we foresee capital inflows picking up across the board.
To take tactical advantage of our proposed modestly constructive Q3 scenario, we propose to move portfolios towards a somewhat more aggressive stance. We, however, postulate that investors should maintain well diversified portfolios and prioritize markets with greater liquidity. Therefore, we do not advocate adding exposure to High Betas (in any of the EM asset classes) but rather look for ways to profit tactically from our expected short break from risk aversion.

In the sovereign credit world, our overweights reflect credits with either an idiosyncratic story behind them (Hungary) or that stand to benefit from capital flows (Turkey and Poland). In Hungary, we recommend adding 2 pp to their weight in the index, while we add 4pp in Turkey and 2pp in Poland. Amongst the low betas, we place some emphasis on Mexico (+2.5pp), which could benefit from its low volatility and, potentially, positive post-election momentum. We would fund those long positions with underweights in Indonesia and Russia (4pp lower weight in our portfolio than in the index) as both credits emerge as relatively pricey given the risk outlook for oil. Figure 17 presents a proposed set of over/under-weights to address the scenario that we envisage for Q3.

In local bond markets we follow a similar approach, forcing greater diversification of (FX unhedged) portfolios and prioritizing over/under positions in relatively liquid markets. Our preferred overweights in local bonds in Asia are in Korea, Malaysia and Thailand. We fund this in part with small underweights in Indonesia (for idiosyncratic risks), Singapore and Philippines (on valuation grounds). In CEEMEA, we recommend overweights in Turkey (could benefit from inflows and central banks might also ease), South Africa and Hungary (once again, an IMF/EU deal seems increasingly likely). We hold underweights in Russia, Czech Republic and Israel. In Latam we recommend a small overweight in Brazil as we expect larger cuts than currently priced. Similarly, we are long Chile. We balance our portfolio with underweights in Mexico and Peru.

Figure 17. Proposed credit and local bond portfolios positioning

	Hard currency		Local Curency	
	Over/Underweight	Expected Return	Over/Underweight	Expected Return
Argentina	0.0%	2.07%	na	na
Belize	0.0%	-0.07%	na	na
Bulgaria	0.0%	-0.22%	na	na
Brazil	1.0%	1.77%	2.0%	4.62%
Chile	0.0%	0.87%	1.0%	3.42%
China	0.0%	0.21%	na	na
Colombia	1.0%	1.83%	0.0%	2.56%
Croatia	0.0%	2.89%	na	na
Czech Rep	na	na	-2.0%	0.77%
Dom_Rep	1.0%	1.43%	na	na
Egypt	-0.5%	0.46%	na	na
El_Salvador	0.0%	3.23%	na	na
Gabon	-0.5%	-0.18%	na	na
Ghana	-0.5%	0.38%	na	na
Hungary	2.0%	2.80%	1.0%	3.66%
Kazakhstan	1.0%	2.37%	na	na
Indonesia	-4.0%	1.66%	-2.0%	0.86%
Iraq	-1.0%	2.33%	na	na
Israel	na	na	-2.0%	0.43%
Jamaica	-0.5%	1.16%	na	na
Korea	na	na	2.0%	2.94%
Lithuania	0.0%	1.22%	na	na
Lebanon	0.0%	0.57%	na	na
Malaysia	0.0%	0.55%	1.0%	2.42%
Mexico	2.5%	1.45%	0.0%	2.30%
Nigeria	0.0%	0.96%	na	na
Pakistan	0.0%	1.63%	na	na
Panama	0.0%	1.34%	na	na
Peru	-2.0%	2.12%	-1.0%	-0.21%
Philippines	-1.0%	1.99%	0.0%	0.52%
Poland	2.0%	1.58%	0.0%	1.51%
Russia	-4.0%	0.95%	-3.0%	0.91%
Serbia	0.5%	1.92%	na	na
Singapore	na	na	-2.0%	0.61%
South Africa	0.0%	1.82%	1.0%	3.64%
Sri_Lanka	0.0%	1.54%	na	na
Thailand	na	na	2.0%	1.85%
Turkey	4.0%	3.68%	2.0%	4.31%
Ukraine	-1.5%	2.17%	na	na
Uruguay	0.0%	3.27%	na	na
Venezuela	1.0%	2.94%	na	na
Vietnam	-0.5%	1.95%	na	na

Source: Citi Investment Research and Analysis

Annual Indicators

Figure 18. Emerging Markets – Economic Forecasts, 2011F-2013F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F
Asia	**7.3**	**6.5**	**6.8**	**5.7**	**3.6**	**3.6**	**2.4**	**1.7**	**1.4**	**-2.1**	**-2.8**	**-2.1**
China	9.2	7.8	7.9	5.4	2.9	3.1	2.8	2.0	1.5	-1.3	-2.4	-1.5
Hong Kong	5.0	2.5	3.8	5.3	4.0	3.0	5.1	9.4	10.2	3.9	0.8	0.7
India*	6.5	6.4	6.9	9.0	7.0	6.5	-4.0	-3.5	-2.6	-8.4	-8.0	-7.7
Indonesia	6.5	6.1	6.3	5.4	4.4	4.7	0.2	-1.9	-1.2	-1.2	-1.8	-0.7
Korea	3.6	2.8	3.6	4.0	2.8	3.0	2.4	1.8	1.9	1.5	1.2	1.5
Malaysia	5.1	5.0	5.3	3.2	2.3	3.1	11.0	8.2	6.7	-5.0	-5.0	-4.7
Mongolia	17.3	16.0	17.5	9.6	13.5	14.5	-32.4	-25.4	-10.3	-3.6	-7.3	-0.9
Philippines	3.9	4.9	5.3	4.8	3.3	3.8	3.1	3.1	2.5	-2.0	-2.4	-2.1
Singapore	4.9	3.6	5.0	5.2	4.4	3.3	21.9	14.9	13.1	1.5	1.0	1.0
Sri Lanka	8.3	7.1	7.4	6.8	7.0	6.8	-7.4	-6.8	-6.1	-6.9	-6.5	-6.0
Taiwan	4.0	2.8	4.2	1.4	1.9	2.1	8.8	8.7	8.4	-1.9	-1.6	-1.6
Thailand	0.1	4.7	4.6	3.8	2.9	3.2	3.4	1.1	0.2	-1.5	-4.7	-3.9
Vietnam	5.9	5.0	5.6	18.6	9.1	7.3	-1.1	-1.2	-3.7	-3.5	-4.5	-4.3
Latin America	**3.9**	**3.1**	**4.1**	**6.8**	**5.8**	**6.1**	**-1.0**	**-1.4**	**-1.9**	**-2.3**	**-2.0**	**-2.2**
Argentina	8.9	3.0	3.0	9.8	9.6	11.4	0.0	0.1	-0.3	-1.6	-3.0	-2.0
Brazil	2.7	2.3	4.5	6.6	5.1	5.3	-2.1	-2.1	-2.5	-2.6	-1.9	-2.7
Chile	6.0	4.5	5.0	3.3	3.4	3.0	-1.3	-1.8	-1.9	1.6	0.7	0.6
Colombia	5.9	4.0	4.5	3.4	3.2	3.2	-3.0	-3.1	-2.9	-2.9	-1.8	-1.6
Mexico	3.9	3.9	3.8	3.4	4.0	3.9	-0.8	-1.4	-2.0	-2.5	-2.2	-2.0
Panama	10.6	9.2	7.0	5.9	5.6	3.2	-12.7	-11.6	-10.0	-2.3	-3.0	-3.0
Peru	6.9	5.7	6.5	3.4	3.6	2.9	-1.3	-2.4	-2.8	1.7	1.2	-0.3
Venezuela	4.2	5.0	3.5	27.1	23.6	27.5	9.1	4.9	3.7	-5.0	-5.0	-4.0
Europe	**5.0**	**2.8**	**3.6**	**6.7**	**5.4**	**5.7**	**-0.2**	**0.3**	**-1.1**	**-0.3**	**-1.2**	**-1.1**
Czech Republic	1.7	-1.0	1.0	1.9	3.2	2.4	-3.0	-2.2	-2.2	-3.1	-3.2	-2.9
Hungary	1.7	-0.9	0.8	3.9	5.2	3.5	1.7	1.2	1.9	4.3	-2.8	-2.5
Kazakhstan	7.5	5.8	5.7	8.3	5.2	5.8	7.6	1.9	2.4	5.9	1.7	3.0
Poland	4.3	2.7	2.4	4.3	3.9	2.6	-4.3	-3.8	-4.5	-5.1	-3.1	-2.5
Romania	2.5	1.3	3.0	5.8	2.8	2.7	-4.4	-4.5	-4.7	-4.1	-2.4	-2.2
Russia	4.3	3.5	4.0	8.4	5.1	6.9	5.3	5.8	2.4	2.0	0.3	0.1
Slovakia	3.3	2.2	1.8	3.9	3.6	2.8	0.1	0.5	-0.5	-4.8	-4.8	-3.2
Turkey	8.5	2.5	4.3	6.5	9.4	7.0	-10.0	-7.5	-6.9	-1.3	-2.2	-2.5
Ukraine	5.1	3.0	4.5	8.0	2.4	6.5	-5.2	-6.7	-4.5	-3.8	-3.5	-3.2
Africa/Mideast	**6.0**	**4.1**	**5.0**	**5.5**	**5.9**	**6.1**	**11.4**	**11.2**	**9.8**	**2.3**	**3.3**	**0.0**
Bahrain	3.2	3.0	3.9	-0.4	3.0	3.5	11.6	29.2	21.4	-1.2	4.8	5.1
Egypt	1.8	2.0	2.7	10.2	8.4	12.5	-2.3	-2.9	-3.4	-10.1	-9.3	-7.5
Ghana	14.4	7.5	6.5	8.7	10.2	11.6	-8.2	-7.3	-4.8	-5.4	-5.6	-6.0
Iraq	9.4	9.3	11.5	5.6	5.0	6.0	-5.1	28.1	50.7	15.8	11.8	14.3
Israel	4.9	2.7	3.0	3.4	2.0	2.2	0.1	-1.5	-1.0	-2.7	-3.7	-3.2
Jordan	2.6	2.5	3.0	4.4	5.0	5.0	-10.6	-12.4	-11.7	-3.9	-8.0	-9.5
Kenya	4.5	5.0	5.8	14.0	11.9	8.2	-11.8	-10.5	-9.5	-5.5	-5.0	-4.9
Kuwait	4.3	0.2	2.5	4.7	5.0	5.0	47.5	43.3	40.6	17.1	13.4	4.4
Lebanon	6.0	3.5	4.3	5.1	6.0	5.0	-21.3	-22.6	-23.5	-6.8	-8.0	-9.1
Nigeria	7.8	7.4	6.8	10.8	12.4	9.8	6.1	5.7	6.4	-3.1	-2.2	-2.1
Oman	4.9	3.0	4.5	4.0	3.0	3.0	3.4	2.7	15.3	5.4	3.0	0.2
Qatar	18.1	6.0	8.3	3.0	3.0	3.0	38.7	38.2	30.3	8.1	7.1	3.3
Saudi Arabia	6.8	6.8	6.0	5.0	7.0	8.0	26.8	26.8	17.4	13.7	16.9	4.3
South Africa	3.1	2.7	3.6	5.0	6.1	5.4	-3.4	-4.7	-5.6	-5.0	-4.8	-4.2
Tanzania	6.3	6.2	6.8	12.7	15.8	7.4	-10.5	-11.9	-11.2	-7.8	-6.2	-5.8
UAE	5.3	0.5	3.4	0.9	1.1	1.3	15.0	3.5	5.7	NA	NA	NA
Uganda	5.7	4.5	5.5	18.6	16.5	5.9	-11.1	-12.5	-10.7	-7.2	-5.5	-5.2
Zambia	6.6	6.5	6.9	8.7	7.5	8.0	2.5	1.2	-2.5	-3.2	-4.2	-5.2
Total	**6.0**	**4.9**	**5.5**	**6.0**	**4.6**	**4.7**	**2.3**	**1.9**	**1.3**	**-1.4**	**-1.8**	**-1.7**

Note: *We use the wholesale price index for inflation in India. Source: National sources, Citi Investment Research and Analysis

Economic Framework

Figure 19. Citi's Global Economic Forecasts

	GDP Growth (% YoY)			CPI Inflation (% YoY)			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Global	**2.6**	**2.7**	**3.6**	**2.8**	**2.7**	**2.8**	**0.3**	**0.3**	**0.1**	**-4.3**	**-3.4**	**-2.9**
Based on PPP weights	*3.0*	*3.2*	*3.9*	*3.2*	*3.1*	*3.1*	*0.5*	*0.3*	*0.1*	*-3.9*	*-3.2*	*-2.8*
Industrial Countries	**1.2**	**1.0**	**2.1**	**1.7**	**1.3**	**1.5**	**-0.6**	**-0.4**	**-0.3**	**-5.7**	**-4.5**	**-3.8**
United States	2.1	2.0	3.5	1.7	1.5	2.1	-3.2	-3.0	-3.1	-7.8	-5.9	-4.6
Japan	2.7	1.4	1.5	0.2	-0.1	0.3	1.5	1.7	2.0	-10.5	-8.1	-7.9
Euro Area	-0.7	-0.8	0.8	2.3	1.6	1.1	0.0	0.1	0.2	-3.3	-2.7	-2.5
Canada	2.0	2.2	2.7	1.6	1.6	2.0	-2.6	-2.4	-2.0	-1.2	-0.5	-0.1
Australia	3.7	3.4	3.8	1.8	3.2	2.9	-4.1	-5.3	-4.9	-3.0	0.1	0.1
New Zealand	2.3	2.8	3.0	1.6	2.4	2.6	-5.0	-7.0	-6.4	-4.1	-3.6	-0.9
Germany	1.2	0.9	1.0	1.9	2.1	2.2	5.2	3.8	3.5	-0.6	-0.4	-0.4
France	-0.1	-0.2	0.9	2.1	0.8	1.4	-1.9	-1.1	-0.3	-4.5	-4.0	-3.5
Italy	-2.6	-2.0	0.1	3.1	1.0	-0.4	-2.3	-1.8	-1.5	-2.9	-2.9	-3.0
Spain	-2.1	-3.1	0.4	1.5	0.3	0.2	-2.5	-1.7	-0.3	-6.2	-6.0	-5.1
Greece	-7.5	-10.1	-1.1	0.9	15.0	19.0	-7.6	-3.5	0.7	-10.8	-5.8	-4.9
Ireland	-1.0	0.4	2.0	0.1	0.2	0.5	3.8	4.0	6.4	-9.4	-9.8	-7.6
Portugal	-4.6	-5.5	-0.6	2.6	1.5	0.4	-4.5	-2.5	-1.5	-5.5	-4.2	-4.3
Netherlands	-1.5	-0.6	1.0	2.8	2.5	1.6	9.6	9.5	8.5	-4.5	-3.5	-2.3
Belgium	0.0	-0.3	0.8	2.9	1.7	1.9	-0.2	0.3	1.0	-2.8	-2.6	-2.3
Denmark	0.7	1.3	1.6	2.5	1.7	1.5	5.5	5.4	4.0	-3.5	-2.0	-1.9
Norway	3.0	2.9	2.7	1.3	1.8	2.0	14.3	14.9	15.2	13.6	14.0	15.0
Sweden	0.4	1.9	2.4	1.2	1.6	2.2	7.0	7.2	7.3	-0.1	-0.2	0.6
Switzerland	1.4	0.8	1.1	-0.9	-1.4	-0.9	12.4	11.1	10.4	0.5	0.1	0.2
United Kingdom	-0.4	0.6	1.1	2.6	1.8	1.8	-1.7	-0.7	0.2	-6.7	-7.9	-7.4

Source: National sources and Citi Investment Research and Analysis

Figure 20. G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 27 June 2012

	27-Jun	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	1.63	1.60	1.80	2.00	2.10	2.35	2.60
Euro Area: US$/€	1.25	1.24	1.21	1.18	1.15	1.19	1.23
Euro Repo Rate	1.00	0.50	0.50	0.50	0.50	0.50	0.50
10-Yr. Bunds (Period Average)	1.53	1.40	1.25	1.25	1.35	1.50	2.00
Japan: Yen/US$	80	80	81	81	82	83	83
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.82	0.95	1.10	1.20	1.10	1.30	1.30

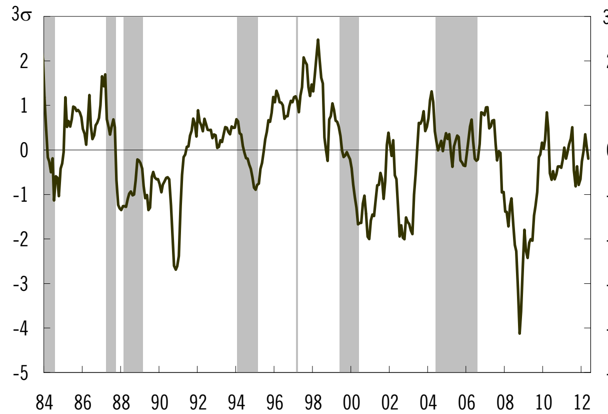
Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US$						Spread vs. Germany					
	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13
United States	NA	NA	NA	NA	NA	NA	11	21	56	76	76	86
Japan	-82	-66	-71	-81	-101	-106	-71	-45	-15	-5	-25	-20
Euro Area	-11	-21	-56	-76	-76	-86	NA	NA	NA	NA	NA	NA
Canada	12	5	5	30	40	41	23	26	61	106	117	127
Australia	136	157	147	142	162	168	146	177	203	218	238	254
New Zealand	179	203	203	203	234	244	190	223	259	279	310	331
France	100	94	64	44	39	24	110	115	120	120	115	110
Italy	448	504	594	624	574	564	458	525	650	700	650	650
Spain	517	504	594	624	574	564	527	525	650	700	650	650
Netherlands	44	49	24	-6	-16	-36	54	70	80	70	60	50
Belgium	158	149	134	124	104	74	168	170	190	200	180	160
Denmark	-25	-51	-116	-136	-106	-96	-15	-30	-60	-60	-30	-10
Norway	51	39	4	-16	-16	-31	61	60	60	60	60	55
Sweden	-39	-21	-56	-76	-71	-81	-29	0	0	0	5	5
Switzerland	-101	-101	-129	-149	-154	-171	-91	-80	-73	-73	-78	-85
United Kingdom	6	-1	-16	-31	-31	-36	16	20	40	45	45	50

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

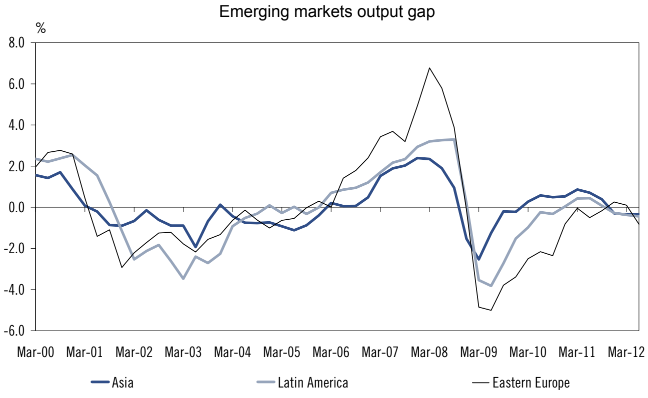
Regional Indicators

Figure 21. US Financial conditions has improved, but still teetering.



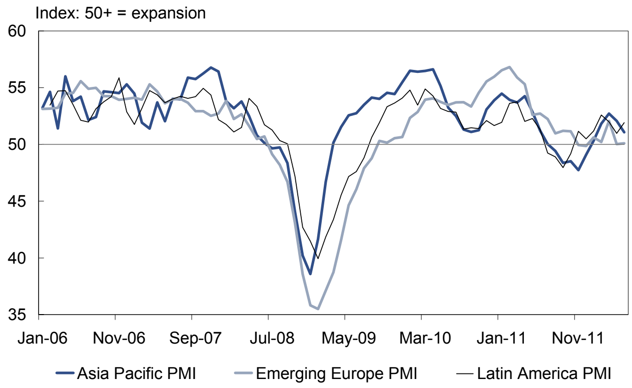
Source: Haver Analytics, Citi Investment Research and Analysis. Note: Shaded sections mark recession periods.

Figure 22. We believe the current output gap is (slightly) negative.



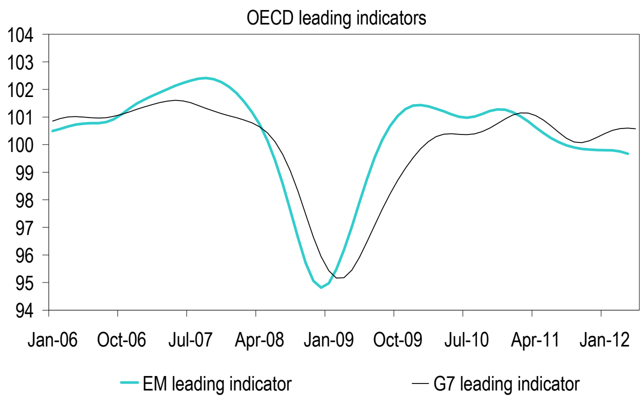
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 23. PMIs are still depressed



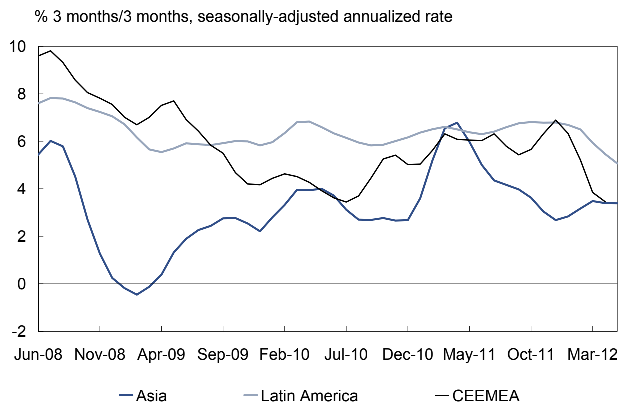
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 24. OECD leading indicators hint at lackluster momentum ahead



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 25. Underlying inflation stays benign



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 26. Allowing more rate cuts in EM in the second half of this year

Cumulative Rate Moves by (bps):

	Current Rate (%)	Sep-12	Dec-12
Brazil	8.50	-100	-25
China	3.25	-50	0
Hungary	7.00	-25	-75
India	8.00	-25	-50
Czech	0.75	-25	-25
Korea	3.25	-25	0
Colombia	5.25	0	-50
Chile	5.00	0	-50
South Africa	5.50	0	0
Turkey	5.75	0	0
Indonesia	3.75	0	0
Thailand	3.00	0	0
Philippines	4.00	0	0
Mexico	4.50	0	0
Israel	2.25	0	0
Poland	4.75	0	0
Russia	8.00	0	0

Source: Haver Analytics, Citi Investment Research and Analysis

Monetary Policy Watch

Figure 27. Asia Policy Rates and Movement

			Last Move		Likely Next Move		End-2012
		Spot	Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	3.25	Jun-12	-25	Aug-12	-25	2.75
India	Repo Rate	8.00	Apr-12	-50	Jul-12	-25	7.25
Indonesia	FasBI	3.75	Feb-12	-25	Mar-13	+25	3.75
Korea	BOK Policy Rate	3.25	Jun-11	+25	Aug-12	-25	3.00
Malaysia	Overnight Policy Rate	3.00	May-11	+25	2014	-	3.00
Philippines	Overnight Policy Rate	4.00	Mar-12	-25	Sep-13	+25	4.00
Taiwan	Discount Rate	1.875	Jun-11	+12.5	Sep-13	+12.5	1.875
Thailand	Overnight Repo Rate	3.00	Jan-12	-25	Sep-13	+25	3.00

Source: Bloomberg, Citi Investment Research and Analysis

Figure 28. CEEMEA Policy Rates and Movement

			Last Move		Likely Next Move		End-2012
		Spot	Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.75	Jun-11	-25	Jun-12	-25	0.25
Hungary	14-Day Repo Rate	7.00	Dec-11	+50	Sep-12	-25	6.00
Israel	Base Rate	2.25	Jun-12	-25	2014	-25	2.25
Poland	7-Day Repo Rate	4.75	May-12	+25	Feb-13	-25	4.75
Romania	Refinancing Rate	5.25	Mar-12	-25	1Q13	-25	5.25
Russia	Policy Rate	8.00	Dec-11	-25	1Q13	-25	8.00
S. Africa	Average Repo rate	5.50	Nov-10	-50	1Q13	+50	5.50
Turkey	1-week repo rate	5.75	Aug-11	-50	3Q13	+25	5.75
Ukraine	Discount Rate	7.50	Mar-12	-50	Nov-12	+25	7.75

Source: Bloomberg, Citi Investment Research and Analysis

Figure 29. Latin America Policy Rates and Movement

			Last Move		Likely Next Move		End-2012
		Spot	Date	Amount (bp)	Forecast	Amount (bp)	forecast
Brazil	SELIC	8.50	May-12	-50	Jul-12	-50	7.25
Chile	CAMARA (Overnight)	5.00	Jan-12	-25	Oct-12	-25	4.50
Colombia	Central Bank Repo Rate	5.25	Feb-12	+25	Nov-12	-25	4.75
Mexico	Official Overnight Rate	4.50	Jul-09	-25	Sep-14	+25	4.50
Peru	Reference Rate	4.25	May-11	+25	-	-	4.25

Source: Bloomberg, Citi Investment Research and Analysis

Figure 30. Asian Currencies Exchange Rates

		3Q12			4Q12			4Q13		
	27-June	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)
vs USD										
China yuan	6.36	6.33	6.36	0.5	6.34	6.38	0.7	6.25	6.45	3.2
Hong Kong dollar	7.76	7.75	7.76	0.1	7.75	7.75	0.0	7.75	7.75	0.0
India rupee	57.12	54.03	58.29	7.3	54.53	59.24	7.9	53.84	62.02	13.2
Indonesia rupiah	9490	9405	9680	2.8	9489	9830	3.5	9650	-	-
Korea won	1156	1140	1163	1.9	1149	1168	1.6	1121	1177	4.8
Malaysia ringgit	3.19	3.10	3.21	3.5	3.11	3.23	3.5	3.04	-	-
Philippines peso	42.4	42.1	42.6	1.1	42.2	42.7	1.1	41.6	43.3	4.0
Singapore dollar	1.28	1.25	1.3	2.2	1.26	1.3	1.5	1.24	1.3	2.9
Taiwan dollar	29.9	30.27	29.85	-1.4	29.77	29.75	-0.1	28.64	29.38	2.5
Thailand baht	31.9	30.7	32.04	4.1	31.1	32.18	3.3	30.9	-	-

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

Figure 31. CEEMEA Currencies Exchange Rates

		3Q12			4Q12			4Q13		
	27-June	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)
vs EUR										
Czech Republic koruna	25.9	25.9	25.94	0.1	26.0	25.94	-0.3	25.4	25.94	1.9
Hungary forint	287	275	290	4.9	280	290	3.2	290	290	-0.1
Poland zloty	4.25	4.22	4.25	0.8	4.33	4.25	-1.9	4.21	4.25	0.9
vs USD										
Israel shekel	3.95	3.95	3.95	0.0	3.97	3.95	-0.4	4.00	3.95	-1.2
Russia ruble	33.0	33.4	33.5	0.2	34.2	34.0	-0.5	34.3	36.1	5.0
Turkey new lira	1.81	1.78	1.84	3.3	1.82	1.87	3.1	1.86	1.99	6.5
S. Africa rand	8.40	8.41	8.52	1.3	8.56	8.62	0.7	8.85	9.03	2.0

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

Figure 32. Latin American Currencies Exchange Rates

		3Q12			4Q12			4Q13		
	27-June	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)	Forecast	Forward	Returns (%)
vs USD										
Brazil reais	2.08	2.01	2.11	4.8	1.99	2.14	6.9	1.90	2.24	15.1
Chile peso	509	493	515	4.2	498	520	4.2	498	535	6.9
Colombia peso	1803	1764	1855	4.9	1783	1874	4.9	1810	1947	7.1
Mexico new peso	13.8	13.4	13.8	2.4	13.5	13.8	1.8	12.9	13.8	6.1

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

Our Forecasts vs. Consensus

Figure 33. Citi vs. Consensus forecasts

	GDP Growth (% YoY)				CPI Growth (% YoY)				Current Account Balance (US$ bil)			
	2012F	Consensus	2013F	Consensus	2012F	Consensus	2013F	Consensus	2012F	Consensus	2013F	Consensus
Asia	**6.5%**	**6.7%**	**6.8%**	**6.7%**	**3.6%**	**4.0%**	**3.6%**	**4.1%**	**242.5**	**288.5**	**227.6**	**293.7**
China	7.8	8.1	7.9	8.1	2.9	3.3	3.1	3.6	166.0	203.5	139.3	199.9
Hong Kong	2.5	2.6	3.8	2.6	4.0	4.4	3.0	3.8	24.3	9.0	28.2	10.0
India	6.4	6.6	6.9	6.6	7.0	7.6	6.5	6.9	-65.3	-68.1	-57.4	-71.3
Indonesia	6.1	6.0	6.3	6.0	4.4	4.8	4.7	5.5	-17.2	-3.2	-11.4	-1.8
Korea	2.8	3.0	3.6	3.0	2.8	2.8	3.0	3.1	20.0	22.7	22.4	21.7
Malaysia	5.0	4.2	5.3	4.2	2.3	2.3	3.1	2.9	25.0	30.7	23.0	34.5
Philippines	4.9	4.9	5.3	4.9	3.3	3.4	3.8	4.1	7.7	7.3	6.8	8.1
Singapore	3.6	2.8	5.0	2.8	4.4	4.3	3.3	3.0	41.7	49.6	41.2	51.1
Sri Lanka	7.1	6.7	7.4	6.7	7.0	6.4	6.8	6.8	-4.0	-4.0	-4.2	-3.7
Taiwan	2.8	2.7	4.2	2.7	1.9	1.6	2.1	1.8	42.0	40.9	44.8	43.9
Thailand	4.7	5.2	4.6	5.2	2.9	3.3	3.2	3.4	4.0	4.3	0.6	7.6
Vietnam	5.0	5.5	5.6	5.5	9.1	10.6	7.3	8.9	-1.7	-4.2	-5.7	-6.2
Latin America	**3.3%**	**3.2%**	**4.3%**	**4.0%**	**6.1%**	**6.1%**	**6.6%**	**6.7%**	**-73.7**	**-73.2**	**-106.4**	**-85.3**
Argentina	3.0	2.4	3.0	2.9	9.6	10.0	11.4	10.2	0.3	1.8	-1.5	0.7
Brazil	2.3	2.4	4.5	4.2	5.1	5.0	5.3	5.4	-51.4	-61.2	-65.4	-69.5
Chile	4.5	4.6	5.0	4.7	3.4	2.9	3.0	3.1	-4.7	-7.1	-5.3	-7.1
Colombia	4.0	4.9	4.5	4.7	3.2	3.4	3.2	3.3	-11.2	-10.0	-11.4	-10.7
Mexico	3.9	3.8	3.8	3.5	4.0	3.7	3.9	3.7	-15.6	-10.8	-26.2	-15.5
Panama	9.2	6.9	7.0	6.7	5.6	5.2	3.2	4.5	-4.1	-4.3	-3.9	-4.5
Peru	5.7	5.8	6.5	6.1	3.6	3.1	2.9	2.8	-4.7	-4.6	-6.0	-5.4
Venezuela	5.0	4.6	3.5	2.3	23.6	25.2	27.5	30.5	17.7	23.0	13.4	26.7
Europe	**2.8%**	**2.9%**	**3.6%**	**3.6%**	**5.4%**	**6.0%**	**5.7%**	**5.3%**	**10.8**	**-6.4**	**-47.7**	**-49.3**
Czech R	-1.0	-0.5	1.0	1.3	3.2	3.3	2.4	2.2	-4.1	-4.2	-4.0	-4.4
Hungary	-0.9	-0.9	0.8	1.1	5.2	5.6	3.5	3.8	1.5	2.5	2.4	2.4
Kazakhstan	5.8	5.8	5.7	5.3	5.2	6.2	5.8	6.5	4.0	10.1	5.7	8.7
Poland	2.7	2.8	2.4	2.9	3.9	3.8	2.6	2.7	-18.3	-19.7	-20.8	-19.6
Romania	1.3	1.1	3.0	2.4	2.8	3.0	2.7	3.7	-7.7	-8.9	-8.2	-10.3
Russia	3.5	3.8	4.0	3.8	5.1	6.1	6.9	5.7	107.1	86.9	46.6	50.5
Slovak Rep	2.2	1.9	1.8	2.4	3.6	3.4	2.8	2.7	0.5	0.6	-0.4	0.4
Turkey	2.5	2.6	4.3	4.5	9.4	9.5	7.0	6.9	-60.3	-64.3	-60.1	-69.6
Ukraine	3.0	2.3	4.5	3.4	2.4	3.1	6.5	8.5	-11.8	-9.4	-8.8	-7.4
Above Total	**5.1%**	**5.2%**	**5.7%**	**5.5%**	**4.5%**	**4.8%**	**4.7%**	**4.9%**	**179.5**	**208.9**	**73.5**	**159.1**

Source: Consensus Economics, Citi Investment Research and Analysis

This page is intentionally left blank.

Asia-Pacific

China

Minggao Shen
+852 2501 2485
minggao .shen@citi.com

Shuang Ding
+852 2501 2769
shuang.ding@citi.com

Serena Wang
+852 2501 2794
serena.wang@citi.com

- **Summary view** – We trimmed our 2012 annual economic growth forecast to 7.8% from 8.1% to reflect anemic domestic activity in 2Q and further weakening of EU demand. Growth is expected to rebound in 2H with sustained policy easing and inflation is likely to stay below 3% in the next few months.
- **Things to watch** – More decisive policy easing, including two more rate cuts and two more RRR cuts, is anticipated while large-scale stimulus may not be introduced. We expect the incoming leaders to press ahead with structural reforms while tolerating slower growth for better quality.
- **Strategy** – The market is at a crossroad where cyclical policies have yet to deliver results and structural policies need to carry more conviction. We expect a volatile but positive direction to emerge. We prefer sectors benefiting from cyclical policy move and stocks with cheap valuation and solid earnings.

2H Outlook: a rebound in the making

Growth appears to have stabilized, but 2Q growth may fall below 7.5%. Industrial production (in real terms) accelerated slightly from 9.3% YoY in Apr to 9.6% in May. FAI and retail sales sped up in real terms, benefiting from falling inflation. Money and credit growth beat expectation in May, while the rebound of fiscal revenue and trade growth may reflect one-off factors. In general, economic activity in Apr and May was weak by historical standards. We estimate that GDP growth in 2Q would be about 7.3% YoY (lower than our previous forecast of 7.5%), down from 8.1% in Q1.

We expect a 2H growth rebound, but downgrade the annual forecast for 2012. Unless the sovereign debt problem in Europe escalates to a full-blown economic and financial crisis, we expect the government to make full use of the room under the current policy mix, instead of resorting to 2008-09 type of stimulus. Additional policy measures this year could include two more rate cuts to boost demand and two more RRR cuts to bring money growth to 14%. These measures, on top of the policy easing since the beginning of the year, are expected to support a rebound of YoY growth in 3Q. However, due to anemic domestic activity in 2Q and expected further weakening of EU demand, we trim 2012 growth forecast from 8.1% to 7.8%.

Inflation is likely to fall and stay below 3% in the next few months. Food prices tend to fall in June, and the fuel price cut early this month should help contain non-food prices. YoY inflation will most likely fall below 3% in June. More generally, agricultural production has been normal so far this year, and international commodity prices may remain weak due to sluggish global recovery. In addition, negative output gap in China may keep non-food inflation subdued, despite incoming electricity tariff hikes. These factors, together with favorable base effect, will likely keep CPI inflation below 3% for most of the remaining months this year. We therefore revise down average annual inflation from 3.5% to 2.9% for 2012E.

The market is at a crossroads. Cyclical policies have yet to deliver results and structural policies need to carry more conviction. We expect a volatile but positive direction to emerge. We prefer sectors benefiting from interest rate cut and cyclical policy move (e.g., property, capital goods, transportation, insurance), and stocks with cheap valuation and solid earnings.

What to expect from new leaders?

We expect the new leaders to press ahead with much-needed reforms from 2013. The Chinese government reshuffle takes place amidst prolonged global financial crisis. It's critical whether the new leaders view the crisis as a cyclical bump or a structural shift. Although the visibility will likely remain low until early December when the annual Central Economic Work Conference under the supervision of the new leadership lays out the policies for 2013, we expect the new leaders to strive for the objectives as below:

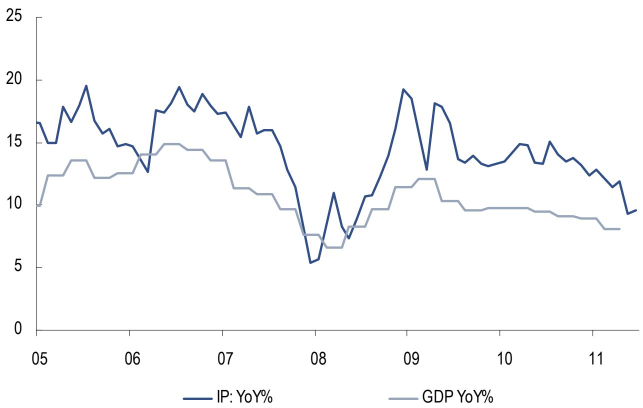
- **Tolerance of slower growth.** The growth target for 2013 could be further reduced from 7.5% this year to 7%. If true, this suggests that China will enter into a new era of slower but possibly better quality growth.
- **Cost normalization.** China may gradually eliminate cost distortions in capital, labor, resources and environment to rebalance the economy and make growth more sustainable. Interest rate liberalization, FX regime flexibility, QFII quota increase, and the Wenzhou financial reform are critical steps towards a new economy.
- **Investment Deregulation.** Alongside the cost normalization, China may open up investment opportunities for individuals and the private sector in infrastructure, manufacturing and services. The need for these moves is recognized by this government, in our view, and reforms may be implemented by its successor.

Near term risks and medium term prospects

An escalation of the European debt crisis may push China's growth below 7% in the absence of additional policy support. It is challenging to simulate the potential impact from a full-blown debt crisis in Europe, especially given its shock wave to the rest of the world and uncertainties about policy reactions. In a simplistic risk scenario where the euro area's recession reaches -2%, weaker external demand – including spillover to China's other trading partners – may further cut China's growth by nearly 1ppt, based on regression of net export contribution to China's growth over euro area's growth rate. This could cause a second-round effect on domestic demand due to higher unemployment in export-oriented industries, resulting in a hard landing of the economy (with growth below 7%).

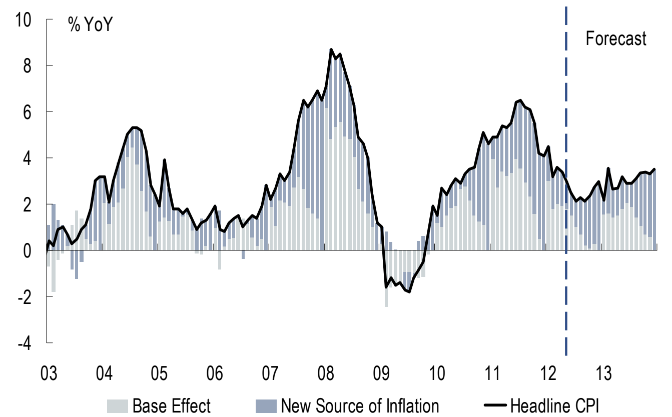
Growth may stay slightly below potential for a few years, but structure may improve. The lagged effect of policy easing in 2012 is expected to spill over into 1H13. However, the upside will likely be constrained by less accommodative macro policies in 2013 and introduction of reforms as well as external headwinds. As a result, growth may rebound slightly to 7.9% in 2013 (relative to our previous forecast of 8.5%). Going forward, we expect medium-term growth to approach 7% as China's economy may fail to grow at full capacity in the near future. The correction of over-investment in recent years and government policies to support consumption will likely decelerate investment more than consumption. Slower investment growth would help curb commodity price increases and investment deflator, causing the investment-to-GDP ratio to decline as early as in 2013-2014.

Figure 34. 2Q Growth May Have Slowed Further to Below 7.5%



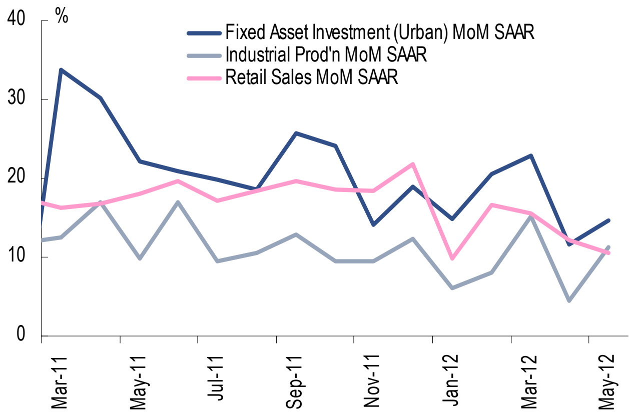
Source: NBS and CIRA

Figure 35. Inflation May Fall and Stay Below 3% in the Next Few Months



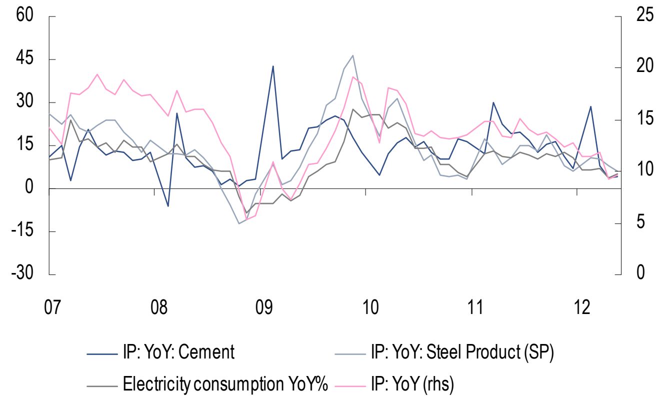
Source: NBS and CIRA

Figure 36. Seasonally Adjusted IP and FAI Growth Rebounded in May



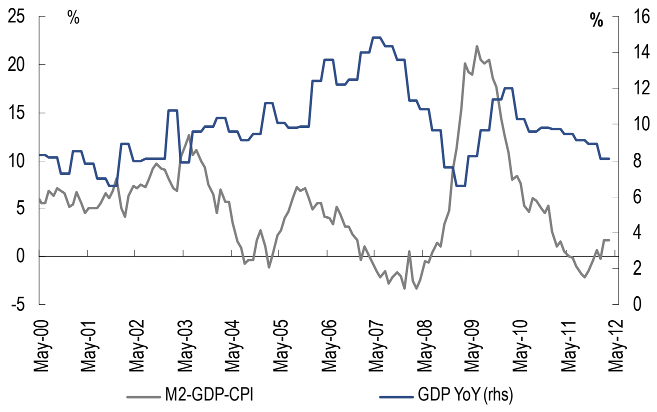
Source: NBS and CIRA

Figure 37. IP Growth Stopped Falling for Now



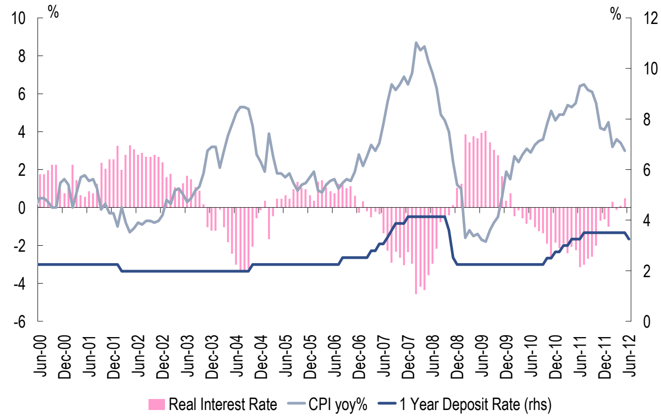
Source: NBS and CIRA

Figure 38. Monetary Condition Is Supportive of a Rebound



Source: PBOC, NBS and CIRA

Figure 39. Deposit Rate Has Turned Positive in Real Terms



Source: PBOC, NBS and CIRA

Figure 40. China Economic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	2,283.5	2,787.2	3,494.5	4,544.0	5,070.5	5,932.5	7,295.2	8,297.9	9,285.7
Nominal GDP, local currency bn	18,713	22,224	26,583	31,490	34,632	40,151	47,156	52,543	58,580
GDP per capita, US$	1,746	2,120	2,645	3,422	3,799	4,428	5,414	6,131	6,834
Population, mn	1,307.6	1,314.5	1,321.3	1,328.0	1,334.7	1,339.7	1,347.4	1,353.4	1,358.8
Unemployment, % of labour force	4.2	4.1	4.0	4.2	4.3	4.1	4.1	4.2	4.1
Economic Activity									
Real GDP, % yoy	11.3	12.7	14.2	9.6	9.2	10.4	9.2	7.8	7.9
Real investment growth % yoy	10.6	13.6	14.7	11.0	19.2	11.9	10.5	9.0	8.8
Real consumption growth % yoy	8.0	9.8	11.0	8.5	9.4	9.2	9.7	9.4	9.2
private consumption growth % yoy	9.4	11.3	11.1	9.2	10.3	8.4	10.0	9.6	9.4
Real export growth, % yoy	--	--	--	--	--	--	--	--	--
Real import growth, % yoy	--	--	--	--	--	--	--	--	--
Prices, Money & Credit									
CPI, % yoy	1.6	2.8	6.5	1.2	1.9	4.6	4.1	3.0	3.5
CPI, % avg	1.8	1.5	4.8	5.9	-0.7	3.3	5.4	2.9	3.1
Nominal wages, % yoy	14.3	14.6	18.5	16.9	11.6	13.3	17.4	11.4	11.5
Credit extension to private sector, % yoy	9.1	14.3	19.3	14.0	33.2	20.3	13.6	14.0	13.0
Policy interest rate, % eop	2.25	2.52	4.14	2.25	2.25	2.75	3.50	2.75	3.25
1 month inter-bank rate, % eop	1.90	2.58	3.61	1.23	1.79	6.17	5.99	3.47	3.66
Long term yield, % eop	2.49	2.62	4.19	1.80	3.06	3.61	3.27	2.37	2.87
lc/US$, eop	8.07	7.81	7.30	6.82	6.83	6.59	6.29	6.34	6.25
lc/US$, avg	8.19	7.97	7.61	6.95	6.83	6.77	6.46	6.33	6.31
Balance of Payments, US$ bn									
Current account	134.1	232.7	354.0	412.4	261.1	237.8	201.7	166.0	139.3
% of GDP	5.9	8.4	10.1	9.1	5.1	4.0	2.8	2.0	1.5
Trade balance	102.0	177.5	262.2	298.1	195.7	181.5	155.1	130.3	102.5
Exports	762.0	969.0	1,220.5	1,430.7	1,201.6	1,577.8	1,898.6	2,018.1	2,234.8
Imports	660.0	791.5	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,887.8	2,132.3
Service balance	-9.4	-8.8	-7.9	-11.8	-29.4	-22.1	-55.4	-60.9	-67.0
Income balance	-16.1	-5.4	7.9	17.7	7.3	30.4	-14.2	-5.0	-5.0
FDI, net	105.9	102.9	143.1	121.7	70.3	124.9	170.5	138.6	138.2
International reserves	818.9	1,066.3	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,423.3	3,543.9
Total Amortisations	21.9	22.1	25.0	30.0	35.0	34.4	38.3	35.5	39.0
Public Finances, % of GDP									
Consolidated government balance	-1.2	-1.0	0.6	-0.4	-2.2	-2.2	-1.3	-2.4	-1.5
Consolidated gov primary balance	-0.8	-0.5	1.0	0.1	-1.8	-1.7	-0.9	-2.0	-1.1
Public debt	17.4	15.8	19.6	17.0	17.7	16.8	15.3	16.1	15.9
of which Domestic	16.0	14.5	18.6	16.2	16.9	16.2	14.8	15.6	15.5
Foreign Assets & Liabilities, US$ bn									
External debt	296.5	338.6	389.2	390.2	428.6	548.9	695.0	764.5	840.9
Private	263.5	304.2	354.3	356.9	391.8	510.1	657.6	723.4	795.7
Public	33.0	34.4	34.9	33.3	36.9	38.8	37.4	41.1	45.3
External debt / GDP	13.0	12.1	11.1	8.6	8.5	9.3	9.5	9.2	9.1
External debt / XGS	35.5	31.9	29.0	24.7	32.2	31.4	33.4	34.5	34.2
Short-term debt	171.7	199.2	235.7	226.3	259.3	375.7	475.7	523.2	575.5
Short-term debt/International Reserves (%)	21.0	18.7	15.4	11.6	10.8	13.2	15.0	15.3	16.2

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	9.1	8.9	8.1	7.3	7.8	8.0	8.2	8.0	7.8
CPI, % yoy	6.1	4.1	3.6	2.5	2.1	3.0	2.7	2.9	3.3
Policy interest rate, % eop	3.50	3.50	3.50	3.25	2.75	2.75	2.75	2.75	3.00
1 month inter-bank rate, % eop	5.92	5.99	4.22	3.97	3.47	3.47	3.47	3.47	3.72
Long term yield, % eop	3.82	3.27	3.17	2.87	2.37	2.37	2.37	2.37	2.62
lc vs USD, eop	6.38	6.29	6.30	6.36	6.33	6.34	6.34	6.35	6.30

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and CIRA Estimates
*Note: Public debt is based on official data, not including the local government debt as audited by the National Auditing Office in summer 2011. External debt is based on the residency of the holder of the debt (not by currency denomination).

Hong Kong

Adrienne Lui
+852 2501 2753
adrienne.lui@citi.com

- **Summary view** – We lowered our 2012E and 2013E GDP forecasts to 2.5%yoy and 3.8%yoy, respectively, on China slowdown and European woes. Inflation moderating at a more visible pace, although 2012E likely average at 4%yoy, the year end CPI growth could be nearer to 3%.
- **Things to watch** – Moderation of decline in retail sales trend needs monitoring, as both local and visiting consumers cut spending. More policy announcements could come from President Hu's visit on 1st July. New Chief Executive will be sworn in on the 15th Anniversary of the HKSAR, look out of new policy focuses.
- **Strategy** – The HKD remained at the stronger end of the trading band, despite volatile equity market. We maintain our view of the HKD peg to stay status quo in the near/medium term. Given Fed's commitment to prolong low interest rates, our 3M HIBOR forecast only factor in very gradual rise over our forecast horizon.

The starting of a fragile recovery

A slower GDP growth path to reflect China slowdown and Eurozone crisis. We lowered our 2012E and 2013E GDP forecasts to 2.5%yoy (-0.1ppt) and 3.8%yoy (-0.4ppt), respectively. Our HK growth downgrade comes after our lowered China GDP, as weak demand is constraining China growth this year despite an expected 2H pickup on policy easing efforts, while reforms in the upcoming years would likely result in slower-than-trend growth. Moreover, our recent attempt to factor in a possible (50-75% probability) Grexit and subsequent European responses into our forecasts also weigh on our 2013 forecast.

Nonetheless, we continue to see a modest recovery starting in 2Q. Aside from the help of low YoY base effect, domestic resiliency is helping HK to muddle through external headwinds (plus we also saw some trade recovery in April-May data). The latest surprise fall in unemployment rate to 3.2%sa in Mar-May suggests that the near fully employed labor market would continue to be conducive for consumption. However, we expect some (but not drastic) softening in the labor market in the upcoming months, in particular in trade logistic and financial markets. Wages in sectors like construction could continue to see moderate uptrend, given ongoing private flats construction and government's large infrastructure projects.

A slowing trend in retail sales plus a policy pause to expand tourism plans may hurt shops/restaurants business. Retail sales likely post a soft reading in May, on more conservative tourist spending and local consumer sentiment likely dampened post large falls in the financial market. CE-elect CY Leung recently expressed concerns that the current Mainland tourist scheme is exacerbating price pressures on shop rentals while HK does not have sufficient tourist related facilities to cater for further increase in tourists volume. Therefore Leung has noted that he will not request the Chinese government to further relax visa/multiple entry rules under the Individual Travel Scheme to other cities. Without the policy support, we worry shops and restaurants could suffer from tighter pockets of locals/tourists.

The flipside benefit of slower consumption is that inflation will likely fall, which we have began to see more visible decline due to the moderation of pass-through rates from private housing rentals. Both headline and underlying CPI retreated in May to 4.3% (-0.4ppt) and 5.1%yoy (-0.5ppt), respectively. Although our CPI forecast is maintained at 4%yoy for the 2012E average, the year-end rate could come near 3%. Having said that, prices in several CPI components could remain sticky, such as in utilities charges and transportation fees.

Busy calendar on the policy front

Chinese and HK officials announced measures to promote the CNH market. China's Ministry of Finance will issue another batch of benchmark bonds for the dim sum bond market at the end of June; the four tranches ranging from 3-15 years will broaden participants from institutional/retail investors to foreign central banks. HKMA started to provide a new RMB liquidity facility for banks and simplified banks' requirements on their RMB liquidity position. The RMB liquidity facility, although not intended for day-to-day use, will be a useful tool to foster large scale RMB fund raising activities and backstop possible RMB liquidity squeeze.[3]

Market wishing for 'gifts' from President Hu Jintao upcoming visit to HK. President Hu will visit HK from June 29-July 1 to attend HKSAR's 15th anniversary celebrations and endorse the inauguration of HK's new Chief Executive CY Leung. Aside from reiterating announced policies such as MOF bond issuance, the enlarged quota of RQFII by RMB50bn to RMB70bn and perhaps speeding up of infrastructure project plans that links with the Pearl River Delta-Macau, we expect several key policies would be announced during Hu's visit:-- (1) CEPA 9 supplement presents further business opportunities for HK firms in the Mainland. According to Xinhua news, CEPA9 measures focus on six areas: economic trade, financial, education, tech, tourism and Guangdong-HK. Specific has yet to be announced, but mentioned policy directions that are of market interest are: promoting third-party RMB trade settlement via HK; providing ease/benefits to HK long term capital that invests in Mainland financial market; Shanghai-Shenzhen-HK Stock Exchanges to setup joint investment companies to facilitate cross listing financial products in the different SEs. We also expect mentioning of enhancing PRC-HK governmental departments' (G-to-G) cooperation to assist HK businesses to best leverage on the CEPA framework to tap the Mainland market. (2) We think an enlargement in the existing daily RMB conversion limits[4] by HK residents would help alleviate concerns of recent pausing in CNH deposit accumulation. (3) A potential market impacting move could be allowing 'professional/high net worth'-QDII to invest in HK's stock market. Similar plans have been raised in previous years, if indeed this gets announced, even with a quota attached (or a fraction of the US$50bn unused quota that was previously set by SAFE) would be positive for sentiment and liquidity; and would have an impact of narrowing the premium between A-H shares.

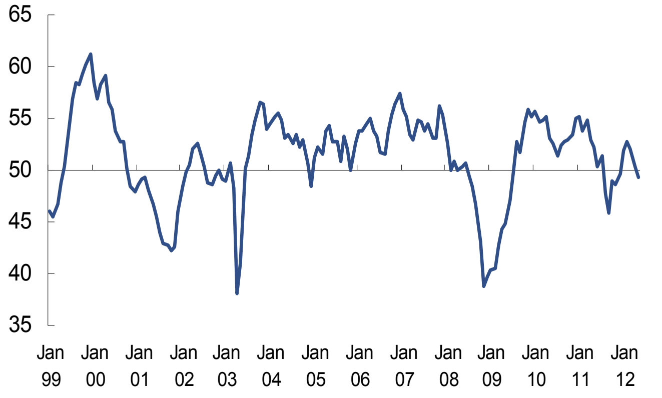
Likely new policy initiatives from the new Government administration. Incoming CE Leung has reiterated his ambition to implement the policy promises he made out in his election manifesto. We think, out of the long list, the following liked would be prioritized: (1) housing (providing land for private homes and quicken supply of public flats), (2) medical reform (increase supply of staff/facilities and reserve resources for local citizen use), (3) elderly care, (4) poverty (via reviving the Commission of Poverty) and (5) economic development (via establishing an inter-departmental agency to devise development strategies for HK).

HKD peg status quo. Despite a former HKMA Chief's paper suggesting a review of the peg, we believe the lack of threatening inflation nor political will, the worry of losing policy credibility and additional uncertainty created from tinkering with the peg will keep the HKD peg as it is. The peg is also likely to withstand challenges associated with HK further developing its IFC status and its evolution into an offshore RMB business center. We hold the view that the HKD will be re-pegged to the RMB once and for all after full capital-account liberalization in China.

[3] See HK Flash: *HKMA Moves to Enhance CNH Liquidity Management*, 14 June 2012.

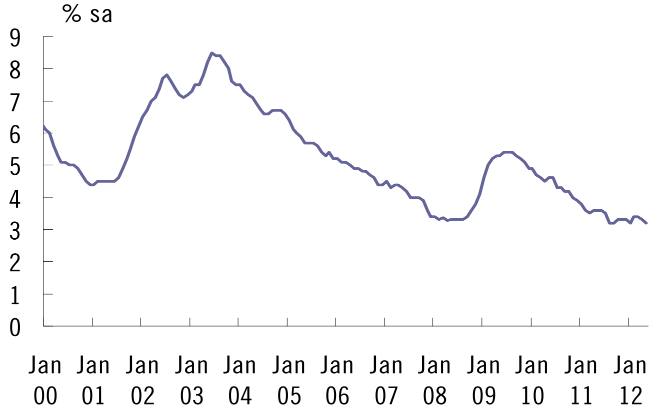
[4] HK currently has a daily quota of maximum RMB20,000 per person for converting to RMB and RMB80,000 for usage of RMB cheques.

Figure 41. PMI indicates economy has fallen back into contraction mode



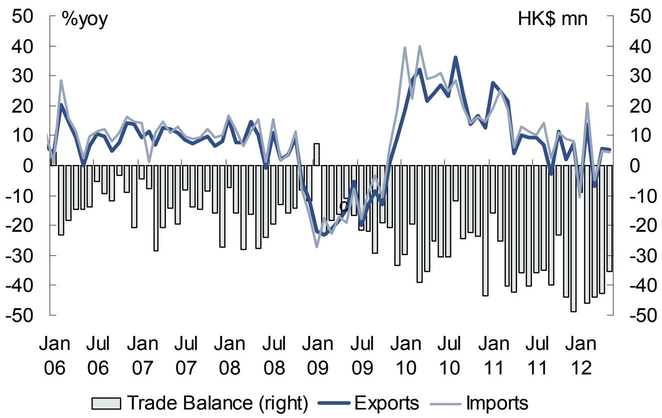
Source: Haver and CIRA

Figure 42. Jobless rate, the lagging indicator, still improved in May



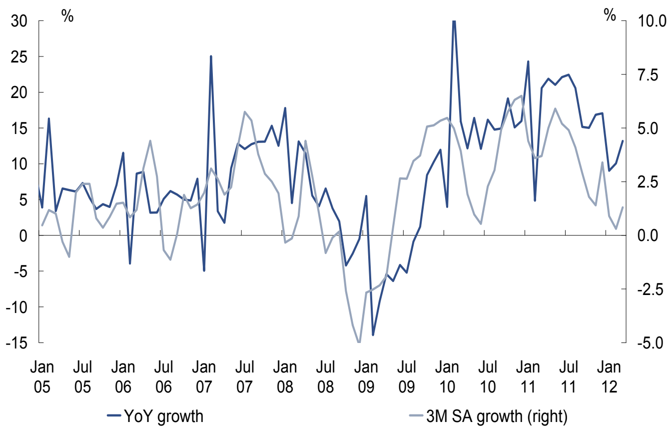
Source: CEIC and CIRA

Figure 43. Modest trade recovery (Apr-May) is mildly positive for 2Q GDP



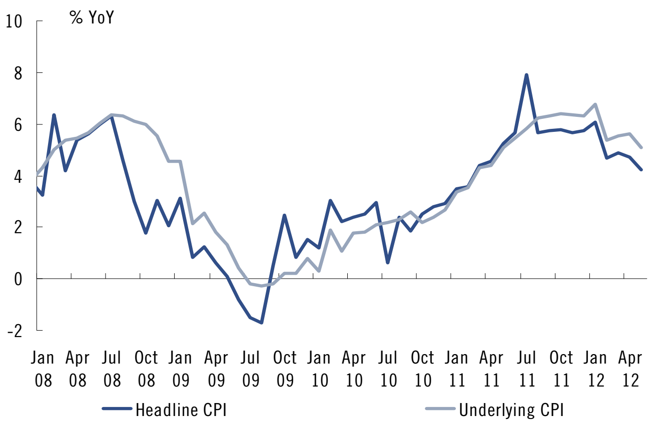
Source: CEIC and CIRA

Figure 44. Despite retail sales rebound in April, we see downside risk



Source: CEIC and CIRA

Figure 45. More visible declines seen in headline and underlying CPI



Source: CEIC and CIRA

Figure 46. HKD jitters in the mid-to-strong end of the band on newsflow

Source: Reuters and CIRA

Figure 47. Hong Kong Economic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	177.8	189.9	207.1	215.4	209.3	224.2	242.9	259.6	277.3
Nominal GDP, local currency bn	1,383	1,475	1,616	1,677	1,623	1,742	1,891	2,014	2,151
GDP per capita, US$	25,999	27,488	29,785	30,815	29,759	31,719	34,353	36,438	38,606
Population, mn	6.8	6.9	7.0	7.0	7.0	7.1	7.1	7.1	7.2
Unemployment, % of labour force	5.7	4.8	4.1	3.4	5.2	4.4	3.4	3.5	3.7
Economic Activity									
Real GDP, % yoy	7.1	7.0	6.4	2.3	-2.6	7.0	5.0	2.5	3.8
Real investment growth % yoy	-0.8	8.5	8.3	-0.7	0.4	11.5	1.2	-0.5	4.5
Real consumption growth % yoy	2.1	5.2	7.8	2.3	0.9	6.3	7.6	3.7	1.9
private consumption growth % yoy	3.0	5.9	8.5	2.4	0.7	6.7	8.4	3.8	2.0
Real export growth, % yoy	10.6	9.4	8.3	2.5	-10.3	16.7	4.2	0.5	6.0
Real import growth, % yoy	8.0	9.1	9.1	2.3	-9.0	17.3	4.6	1.0	5.1
Prices, Money & Credit									
CPI, % yoy	1.3	2.3	3.8	2.1	1.5	2.9	5.7	3.2	2.7
CPI, % avg	0.9	2.0	2.0	4.3	0.6	2.3	5.3	4.0	3.0
Nominal wages, % yoy	0.8	2.1	2.4	4.0	-1.9	2.4	9.9	5.0	4.0
Credit extension to private sector, % yoy	7.7	2.3	15.2	11.0	-2.1	20.9	12.8	8.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	4.16	3.84	3.31	0.89	0.13	0.33	0.38	0.55	1.00
Long term yield, % eop	4.11	3.69	3.10	1.19	1.93	1.76	0.96	0.90	1.40
lc/US$, eop	7.75	7.78	7.80	7.75	7.75	7.77	7.77	7.75	7.75
lc/US$, avg	7.78	7.77	7.80	7.79	7.75	7.77	7.78	7.76	7.76
Balance of Payments, US$ bn									
Current account	20.2	22.9	25.5	29.5	18.0	12.4	12.4	24.3	28.2
% of GDP	11.4	12.1	12.3	13.7	8.6	5.5	5.1	9.4	10.2
Trade balance	-10.5	-17.9	-23.5	-25.9	-28.9	-43.1	-54.8	-55.9	-61.0
Exports	289.5	316.8	344.7	363.0	318.7	390.4	429.2	463.2	513.2
Imports	299.9	334.7	368.2	388.9	347.6	433.5	484.0	519.1	574.2
Service balance	29.7	35.7	42.1	45.2	42.5	55.2	65.1	68.0	71.0
Income balance	0.2	3.5	5.7	10.7	5.5	3.6	7.3	8.5	10.0
FDI, net	6.4	0.1	-6.7	9.0	-11.6	-24.3	1.5	-1.0	3.0
International reserves	124.2	133.2	152.6	182.5	255.8	268.7	285.4	300.0	325.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	1.0	3.9	7.5	0.1	1.6	4.2	3.9	0.8	0.7
Consolidated gov primary balance	1.1	4.0	7.5	0.1	1.6	4.3	3.9	0.9	0.8
Public debt	1.7	1.4	1.2	1.0	0.7	0.6	1.1	1.8	2.4
of which Domestic	0.8	0.6	0.4	0.3	0.0	0.1	0.2	0.6	0.5
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

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	4.4	3.0	0.4	1.9	3.6	4.0	3.9	3.5	3.7
CPI, % yoy	6.3	6.2	4.9	4.0	3.8	3.3	2.3	2.0	5.1
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	0.21	0.24	0.30	0.37	0.42	0.47	0.57	0.67	0.82
Long term yield, % eop	0.76	0.96	0.55	0.60	0.80	0.90	1.00	1.10	1.30
lc vs USD, eop	7.78	7.77	7.77	7.76	7.75	7.75	7.76	7.76	7.76

Source: CEIC Data Company Ltd, IFS, Fitch and CIRA Estimates
*Note: Public debt is general government debt.

India

Rohini Malkani
+91 22 6631 9876
rohini.malkani@citi.com

- **Summary view** – GDP growth has slipped to a nine-year low. With limited fiscal and monetary maneuverability, we expect trends in growth to remain subdued at 6%-6.5% levels. The message from the RBI and rating agencies is clear – the onus is on government policy action to stem the deceleration in growth.
- **Things to watch** – Lower growth could take its toll on tax collections putting further pressure on meeting the deficit target. Key to watch is the possibility of fuel price hikes and policy measures post presidential elections due on July 19.
- **Strategy** – Our FX team believes the recent sell-off in the INR is overdone. They have revised Mar 13 and Mar 14 INR forecasts to Rs55/$ and Rs53.1/$ from Rs54.8/$ and Rs51.5/$ respectively.

Growth – a "U" shaped recovery; monsoons a risk

Trends likely to remain weak: India's recently released 4QFY12 GDP came in at 5.3%YoY, lower than expected. A key point is that this is the lowest quarterly GDP reading even during the 2008-09 global crisis, quarterly GDP growth had troughed to 5.6%. The slowdown in 4QFY12, coupled with revisions to previous data, resulted in the government's advance GDP estimate for FY12 being revised down to 6.5% from 6.9%. Following this, we now expect FY13/FY14 GDP estimates to come in at 6.4% and 6.9%, thereby expecting a 'U' shaped recovery. We reiterate our view that the interplay of the four deficits (current account, fiscal, liquidity and governance) has led to a de-rating of the India story. As mentioned earlier, aggressive thrust on policy and execution reform is key to reverse the slow down.

Monsoon Watch – Cloudy Outlook: While our base case for FY13 is that of a normal monsoon, trends so far have been weak, with cumulative rainfall 26% below normal. Despite the changing composition of GDP (share of agri at 15% v/s 30%) and mitigating factors such as NREGA, growing share of winter crop, use of gold as collateral, the economy is not yet water-proof. (1) Agriculture employs ~50% of the workforce. (2) Only ~36% of India's land area is irrigated. (3) Rainfall correlation with agri is (0.63) and private consumption (0.4). A sub-par monsoon is negative for growth, inflation and the deficit. A poor monsoon could shave off 40-80bps off growth to 5.6%-6% from 6.4% currently. Taking into account domestic factors (structural drivers, MSPs) our 7.5% average WPI estimate could be breached, but key to watch is the interplay of global prices (commodities and currencies).

Monetary policy – inflation remains priority; onus on govt

Inflation trends remain sticky – Food; Commodities and Currencies are key: Following the 10.3% print in April, the new combined CPI rose 10.4% in May, vs the 7.6% print in the WPI. The higher wt of food and inclusion of services in the CPI vs WPI are the key reasons for the ~280bps difference in the WPI/CPI inflation. Going forward, the inflation outlook is determined by (a) the interplay between commodities and currencies (b) Food prices, trending higher due to increase in minimum support prices, with the monsoons being an additional wide card.

RBI focuses on Inflation trends and supply side imbalances: Although domestic and global conditions have dampened growth, the RBI has put more weight on sticky inflation trends and supply side imbalances. This resulted in the RBI keeping all rates on hold - contrary to ours and market expectations. Going forward, with headline inflation to remain sticky, with recent MSP hikes further aggravating the outlook, we believe our rate cut call of 50-75bps for the year is contingent on gov't taking steps on fuel price adjustments/policy-related issues in the investment space.

Fiscal – pressure to keep deficit in check

Rating Action – Difference in Outlook: Following S&P's revision to India's sovereign outlook from stable to negative in April, Fitch also lowered India's outlook from Stable to Negative due to risks of a lower growth potential and limited progress on fiscal consolidation. However, Moody's has retained India's Baa3 sovereign outlook at Stable. The key difference between the rationales appears to be the view on India's growth potential remaining at ~7% levels. *(Moody's says that it was not convinced of the economy sustaining growth at 9-10% nor is it convinced that the medium-term outlook has slipped dramatically below 7%).*

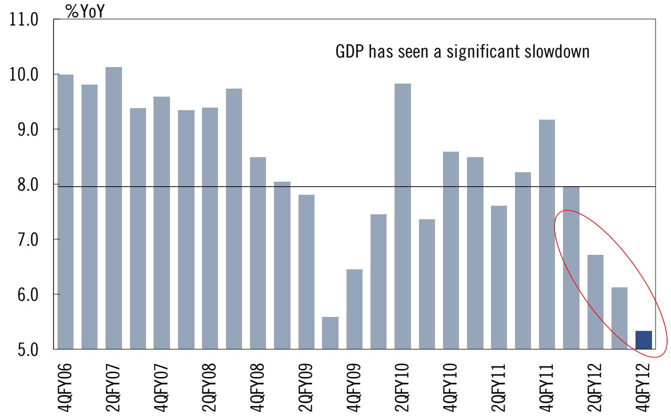
Deficit reduction remains key — While Moody's has retained the sovereign rating outlook as stable, it said that the stable outlook is predicated on some policy efforts to curtail the deficits, while the stable rating will bring some relief to policy makers, there is no room for complacency and efforts must be taken to stem the slowdown in growth. As Moody's says "the stable outlook is predicated that there will be some policy effort to curtail the primary deficit. Bottom Line, the message from both the RBI and rating agencies is loud and clear – i.e It puts the onus on the govt to create a positive investment environment and implement tax and subsidy reforms.

External – Lower Oil and Gold Imports to benefit CAD

Current Account to Improve: While most macro variables (growth, fiscal, inflation) still need to bottom out, the sharp fall in oil prices and lower gold demand are likely to stem weakness in the CAD. A quick re-cap, oil comprises ~30% of the import bill. Taking into account petro-product exports, everyUS$1/bbl change in oil prices impacts the CAD by US$900mn. With crude prices falling ~US$20/bbl since the start of this fiscal, we estimate savings to the tune of US$18bn. Like-wise gold comprises 10% of total imports. Over the last few years, India's gold imports have risen from 600-700 tonnes p.a. to 800-900tonnes. Recent measures to curb imports coupled with INR weakness could result in lower imports. We estimate that this would result in savings to the tune of US$7bn. Thus despite incorporating a slowdown in exports due to the near-synchronized global slowdown, the positives highlighted earlier are likely to offset weaker exports, thereby resulting in an improvement in the CAD to 3%-3.5% of GDP in FY13 v/s 4% in FY12E.

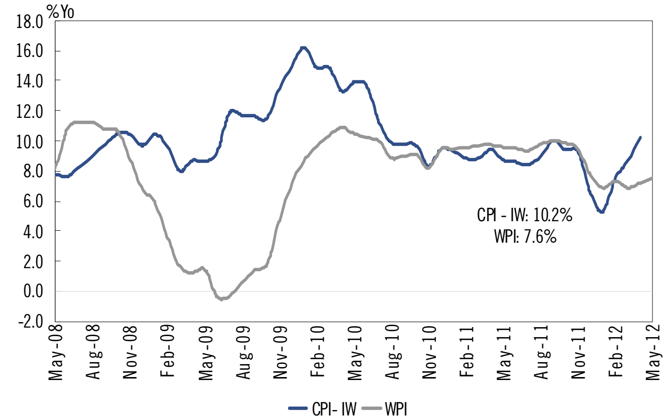
Overall BoP, still in the red: However, key to note despite various measures being taking to enhance flows, the overall BoP is still likely to be in the red due to lower (1) FDI and (2) Loans. As regards the INR, our global team expects the unit to retrace back to the 54-55.5 range over the 12 month forecast horizon. Admittedly, the projections have two powerful and conflicting forces. On one hand, INR is clearly oversold, and policy makers are expected to intervene strongly as the INR weakens further. To some extent, there is also room for INR to play "catch up" with equity gains and falls in oil prices. But on the other hand, the macro fundamentals in India are undoubtedly weak. With no historical support or resistance at current levels, our global FX team admits that the INR could be strained further in the near term.

Figure 48. Growth has slipped to a nine year low



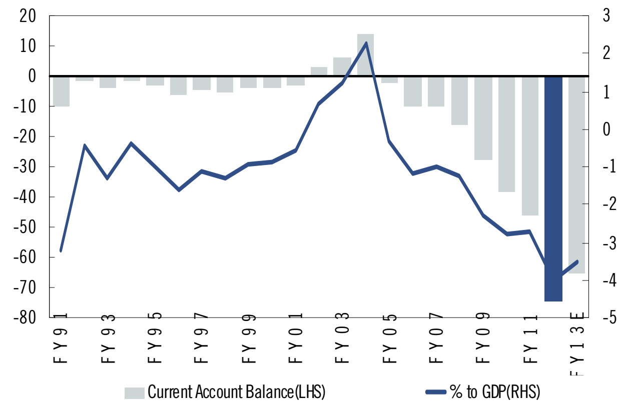
Source: CSO

Figure 49. Headline Inflation – both WPI and CPI remains sticky



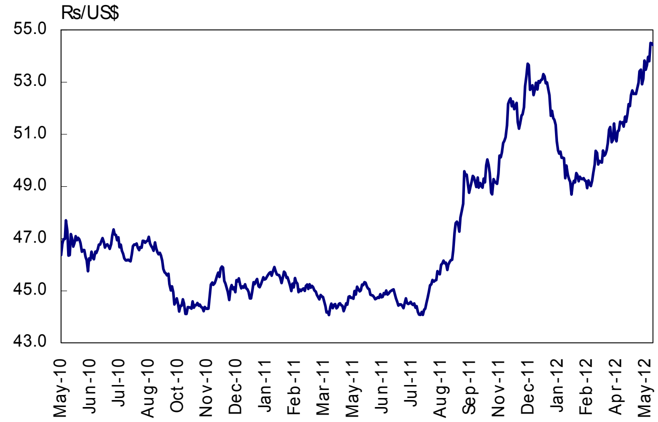
Source: RBI, Office of the Economic Advisor

Figure 50. The CAD improves due to oil and gold



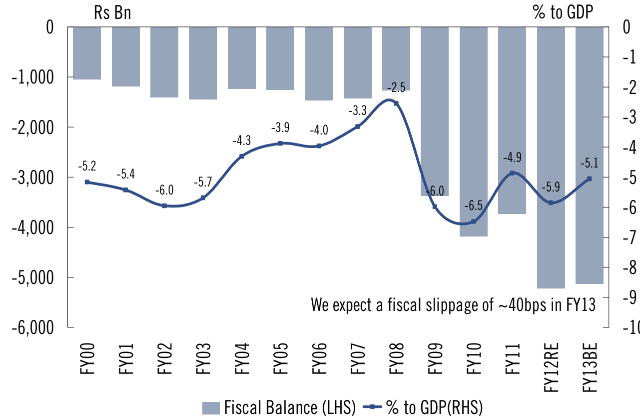
Source: RBI

Figure 51. Weak macro and low capital flows have weighed on the INR



Source: RBI

Figure 52. The government's deficit target of 5.1% is likely to be missed



Source: Ministry of Finance

Figure 53. This could have implications for ratings

	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 54. India Economic Indicators

	FY06	FY07	FY08	FY09	FY10	FY11	FY12F	FY13F	FY14F
Summary Data									
Nominal GDP, US$ bn	833.7	950.2	1,240.6	1,223.9	1,362.3	1,683.7	1,841.1	1,860.5	2,200.2
Nominal GDP, local currency bn	36,934	42,947	49,871	56,301	64,574	76,741	88,558	101,399	116,609
GDP per capita, US$	766	859	1,106	1,076	1,181	1,437	1,549	1,542	1,796
Population, mn	1,089.0	1,106.0	1,122.0	1,138.0	1,154.0	1,171.3	1,188.9	1,206.7	1,224.8
Unemployment, % of labour force	--	--	--	--	--	--	--	--	--
Economic Activity									
Real GDP, % yoy	9.5	9.6	9.3	6.7	8.4	8.4	6.5	6.4	6.9
Real investment growth % yoy	16.2	13.4	18.1	-5.2	15.6	11.1	5.5	5.4	6.8
Real consumption growth % yoy	8.6	7.9	9.3	7.6	8.1	8.1	5.4	5.8	6.7
private consumption growth % yoy	8.5	8.7	9.2	7.1	7.0	8.1	5.5	6.0	6.7
Real export growth, % yoy	25.9	19.9	5.9	14.4	-4.1	22.7	15.3	13.5	15.0
Real import growth, % yoy	32.5	21.3	10.2	22.7	-2.0	15.6	18.5	8.3	10.8
Prices, Money & Credit									
WPI, % yoy	3.9	6.8	7.7	1.5	10.2	9.0	6.9	7.4	6.5
WPI, % avg	3.7	6.5	4.8	8.0	3.6	8.6	8.8	7.4	6.5
Nominal wages, % yoy	--	--	--	--	--	--	--	--	--
Credit extension to private sector, % yoy	38.4	28.5	23.0	17.8	17.1	21.2	18.0	18.0	18.0
Policy interest rate, % eop	6.50	7.50	7.75	5.00	5.00	6.75	8.50	7.75	7.50
1 month inter-bank rate, % eop	6.11	7.98	7.23	4.95	4.38	7.31	8.10	7.69	7.50
Long term yield, % eop	7.55	7.98	7.96	7.01	7.83	7.99	8.25	8.25	8.25
lc/US$, eop	45.0	44.1	39.4	48.6	46.4	44.7	53.0	54.5	53.8
lc/US$, avg	44.0	45.2	41.2	43.4	48.3	45.7	46.6	54.0	54.7
Balance of Payments, US$ bn									
Current account	-9.9	-9.6	-15.7	-27.9	-38.2	-45.9	-74.3	-65.3	-57.4
% of GDP	-1.2	-1.0	-1.3	-2.3	-2.8	-2.7	-4.0	-3.5	-2.6
Trade balance	-51.9	-61.8	-91.5	-119.5	-118.2	-130.6	-183.4	-193.3	-199.2
Exports	105.2	128.9	166.2	189.0	182.4	250.5	300.6	336.6	383.8
Imports	157.1	190.7	257.6	308.5	300.6	381.1	483.9	529.9	582.9
Service balance	23.2	29.5	38.9	53.9	35.8	48.8	57.9	69.2	79.9
Income balance	5.9	7.3	5.1	7.1	8.0	17.3	14.0	10.0	11.0
FDI, net	3.0	7.7	15.9	19.8	18.0	9.4	19.0	13.0	14.0
International reserves	145.1	191.9	299.1	241.6	252.8	273.7	267.0	262.3	264.5
Total Amortisations	19.6	11.4	14.9	15.6	19.1	18.7	22.8	23.0	18.7
Public Finances, % of GDP									
Consolidated government balance	-6.5	-5.4	-4.1	-8.4	-9.7	-8.3	-8.4	-8.0	-7.7
Consolidated gov primary balance	-0.4	0.2	0.9	-2.6	-3.2	-1.8	-2.8	-1.9	-1.0
Public debt	83.0	79.3	76.1	76.1	75.0	71.3	68.9	68.8	68.2
of which Domestic	77.4	74.1	71.4	71.5	70.1	66.6	65.9	65.8	65.2
Foreign Assets & Liabilities, US$ bn									
External debt	139.1	172.4	224.4	224.5	261.0	306.1	334.9	349.9	364.9
Private	92.9	123.0	166.3	168.6	193.9	227.5	253.8	292.9	305.9
Public	46.3	49.4	58.1	55.9	67.1	78.6	81.2	57.0	59.0
External debt / GDP	16.7	18.1	18.1	18.3	19.2	18.2	18.2	18.8	16.6
External debt / XGS	86.5	85.3	88.5	77.7	95.2	79.8	73.8	71.7	59.4
Short-term debt	19.5	28.1	45.7	43.3	52.3	65.0	78.1	88.1	80.0
Short-term debt/International Reserves (%)	13.5	14.7	15.3	17.9	20.7	23.7	29.2	33.6	30.2

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1F	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.7	6.1	5.3	5.5	6.0	6.9	7.0	6.9	6.9
WPI, % yoy	10.0	7.7	7.7	7.5	7.6	7.5	7.5	7.0	7.0
Policy interest rate, % eop	8.25	8.50	8.50	8.00	7.75	7.25	7.25	7.25	7.25
1 month inter-bank rate, % eop	8.96	9.53	8.50	8.50	8.50	8.50	8.50	8.50	8.50
Long term yield, % eop	8.43	8.57	8.25	8.25	8.25	8.25	8.25	8.25	8.25
lc vs USD, eop	49.0	53.0	50.9	56.5	54.0	54.5	55.0	55.5	54.6

Source: CEIC Data Company Ltd and CIRA Estimates
*Note: Public debt is general government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Indonesia

Helmi Arman
+62 21 5290 8960
helmi.arman@citi.com

Brian Tan
+65 6657 1932
brian.tan@citi.com

- **Summary view** – We have downgraded our FY12 and FY13 GDP forecasts to 6.1% and 6.3%, respectively, amid increased external headwinds. The inflation outlook remains tame, however the risk of rising external imbalances make it more difficult for the central bank to turn dovish.
- **Things to watch** – The FX market has stabilized since May amid increased intervention. Yet non-oil commodity prices continue to fall, and the trade balance tilted to deficit in April. Import growth remains strong relative to exports and we think the current account deficit in 2Q12 may worsen relative to 1Q12.
- **Strategy** – Given the deteriorating current account forecast, we still see upside risk on the IDRUSD and have revised again our YE12 forecast to Rp9,490/US$. Despite the recent relief rally, we think IDR bonds still have upside risk in 3Q12, although we lower our peak forecast for the 10-yr yield to 7%, vs. prev. 7.25%.

FX market has stabilized since May

Bank Indonesia's intensity on FX intervention has improved. After experiencing a significant decline of liquidity in May, the FX market has started to normalized, as indicated by narrowing bid-offer spreads. Central bank intervention has been stepped up in recent weeks and foreign reserves dropped by almost $5bn to $111.5bn as of May. Also this month BI introduced the new USD time deposit facility for banks, which in the first auction drew in a total of $0.7bn, a modest addition to FX reserves. However although this facility entails some regulatory sweeteners (e.g. requires zero risk weighting and has net open position reduction properties) the average rate taken in the auction was below LIBOR. Therefore we may not see any further rapid increase in the amount placed in this facility by banks.

Steepening of money market curve since May appear to be yielding results. In contrast to the previous month, BI's recent policy statements in June have made fewer references to money market rates and the yield curve. Policymakers may view that their efforts to absorb daily excess liquidity have bore some results. Since the central bank began normalizing the money market yield curve by raising rates on the 1, 3, 6 and 9 month instruments (the 9M SBI rate has been increased to 4.3% from previously 3.9%), gradually the portion of bank liquidity placed in the O/N standing deposit facility (FasBI) has declined to about 25%, from over 45% as at end April. Meanwhile BI has also been seen again buying bonds this month by mild amounts, although no strong and sustained influx of foreign funds has been spotted yet.

Although the sea is calmer now, clouds remain visible as the prospect of current account deterioration still lingers. Export growth of manufactured goods has slid since 3Q11 and this has also been followed by slowing growth of raw material imports. However imports of capital goods have been relatively resilient (42% YoY as of April); this has helped prop up YoY import growth in positive territory. The ride doesn't seem to be over yet, as benchmark prices of Indonesia's non-oil commodity exports e.g. coal, CPO and rubber have continued to fall. Meanwhile domestic demand hasn't shown significant sign of slowing. Although rural purchasing power may have started to soften due to the declining plantation exports, consumer confidence seems to be picking up again following the cancellation of domestic fuel price hikes. We think this will cause import growth may remain relatively elevated relative to exports in the near term.

Tougher trade & investment policies shouldn't derail FDI

Recent policies in trade and investment have attracted attention. Indonesia recently introduced a number of aggressive foreign trade and investment policies. Examples in the past few quarters include export duties on mineral mining (along with on/off discussions on coal export duties), faster foreign ownership divestment requirements on mining stakes, and tighter regulations involving import of certain foods. Concern has emerged that this marks a new trend towards less investor friendly policies.

By our assessment, some of those policies appear symbolic and could have been better prioritized. The regulations on horticulture imports, for example, were likely a response to worsening trade balance trends. However it is not "the" issue. The horticulture trade deficit is relatively small compared with the burgeoning oil trade deficit, which is propped up by artificially low fuel prices. And arguably it would have been more effective to curb import growth through managing energy subsidies (though this has proven to be politically difficult).

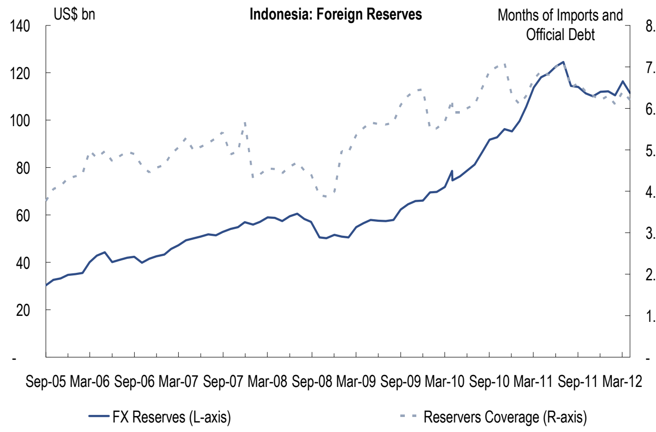
However the policies to manage mining export growth and affect the relative incentives between investment in the upstream and downstream sectors appears prudent, in our view. The growth of Indonesia mining exports in recent years has been dramatic. For example the projected time of depletion of coal reserves has halved since 2005, casting doubt on the sustainability of growth in mining exploitation and exports. The need for corresponding policies to manage resource exports is clearly visible and understandable, in our view.

We do not think recent policies have impacted medium-term FDI outlook. Let's not forget: Indonesia FDI is no longer all about mining. The share of manufacturing-sector FDI has been on the rise over the past few years, and this has, for a change, been followed by stronger formal sector job creation, which is a recipe for more sustainable economic growth. The application of disincentives against certain upstream activities therefore should not be misconstrued as a disincentive against all forms of foreign investment. The medium-term outlook on FDI we think will depend more on the government's structural policies, e.g. on developing infrastructure, as well as policies to stimulate supporting industries.

Currency forecast revised upward

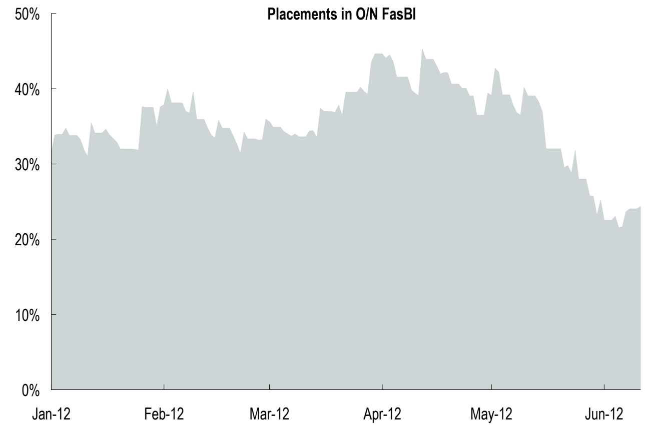
Amid changing BOP fundamentals, we see some risk of additional IDRUSD depreciation. We think the current account deficit may still widen in 2Q12 relative to 1Q and have revised our FY12 current account deficit forecast to 1.9% of GDP, from previously 1.0%. We expect the FY12 overall balance of payments to be in surplus of around $2 – 3bn. However since our current account deficit forecast is higher than the expected amount of net FDI, the size of any BOP surplus will be very much dependent on the amount of portfolio inflows (which will be volatile given lingering concerns over a potential Grexit and domestic FX market liquidity), as well as net other investments e.g. loan drawdowns. We have revised our YE12 IDR forecast to Rp9,490/US$ (prev: 9,350) and YE13 forecast to 9,650/US$ (prev: 9,370). We don't expect any benchmark policy rate hikes this year, but do not rule out a 50bps hike next year in order to keep consumption growth and import in check. Meanwhile for IDR bonds, we think the near term trend yields will still be upward. However we have revised down our peak forecast for the 10-yr yield to 7% this year, from previously 7.25%.

Figure 55. Foreign reserves dropped by around $5bn in May



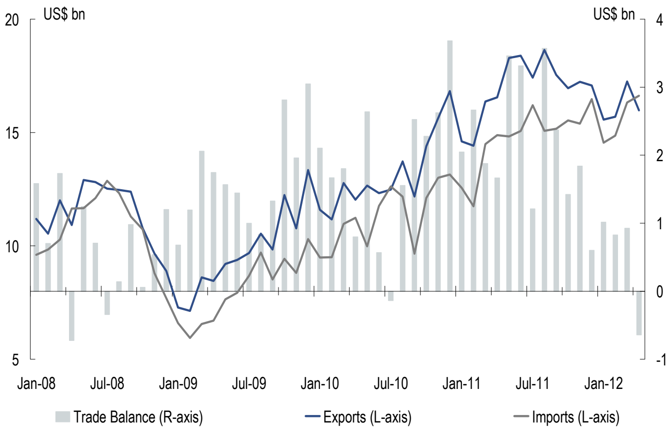
Source: Bank Indonesia, CIRA

Figure 56. . Portion of bank placements in O/N facility has declined



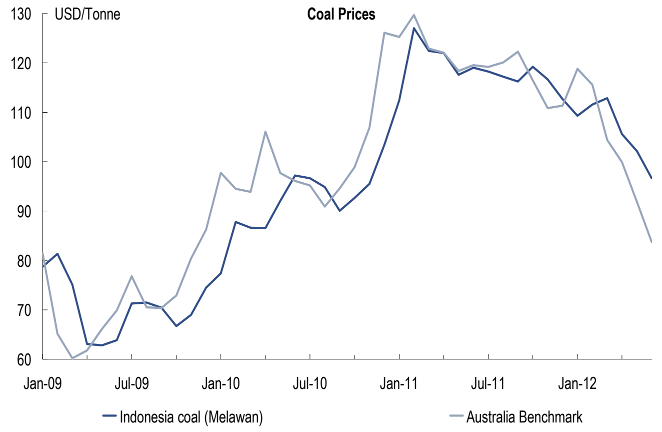
Source: CIRA

Figure 57. The trade surplus slipped to deficit in April



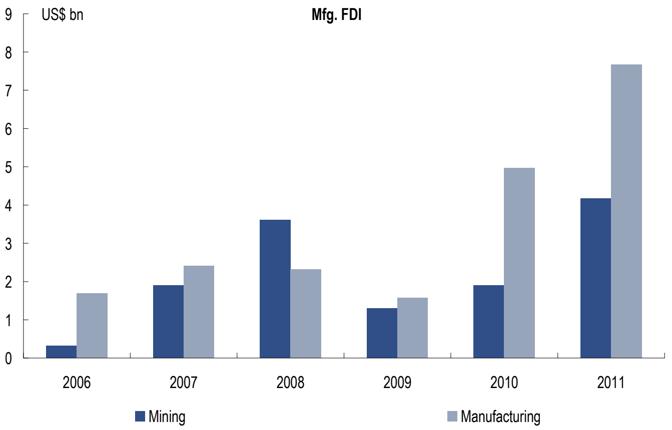
Source: BPS, CEIC, CIRA

Figure 58. Lower coal prices may further squeeze the trade surplus



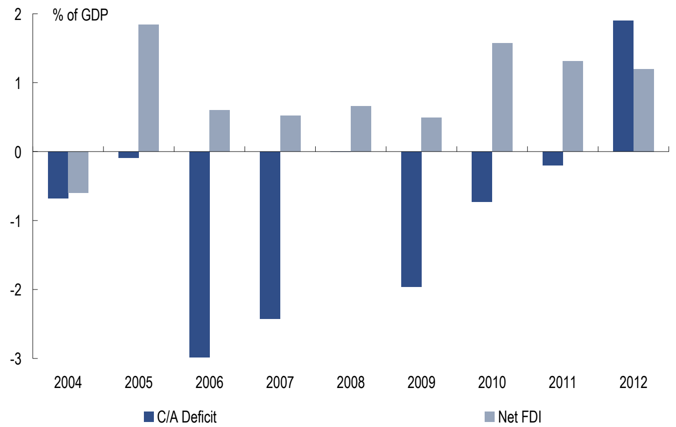
Source: Bloomberg, CIRA

Figure 59. Share of manufacturing FDI (US$mn) has grown vs. mining



Source: Bank Indonesia, CIRA

Figure 60. Current account deficit may exceed the net FDI in 2012



Source: Bank Indonesia, CEIC, CIRA

Figure 61. Indonesia Economic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	285.8	364.4	432.2	510.7	538.6	708.7	846.3	885.9	975.2
Nominal GDP, local currency bn	2,774,281	3,339,217	3,950,893	4,948,688	5,606,203	6,436,271	7,427,086	8,325,679	9,661,829
GDP per capita, US$	1,294	1,625	1,900	2,212	2,298	2,982	3,517	3,638	3,955
Population, mn	220.9	224.2	227.5	230.9	234.4	237.6	240.6	243.5	246.6
Unemployment, % of labour force	11.2	10.3	9.1	8.4	7.9	7.1	6.6	6.1	5.9
Economic Activity									
Real GDP, % yoy	5.7	5.5	6.3	6.0	4.6	6.2	6.5	6.1	6.3
Real investment growth % yoy	12.4	1.3	1.9	12.4	2.4	11.1	10.6	11.8	12.0
Real consumption growth % yoy	4.3	3.9	4.9	5.9	6.2	4.1	4.5	5.5	5.2
private consumption growth % yoy	4.0	3.2	5.0	5.3	4.9	4.7	4.7	4.4	4.5
Real export growth, % yoy	16.6	9.4	8.5	9.5	-9.7	15.3	13.6	4.3	11.7
Real import growth, % yoy	17.8	8.6	9.1	10.0	-15.0	17.3	13.3	6.4	15.1
Prices, Money & Credit									
CPI, % yoy	17.1	6.6	5.8	11.1	2.8	7.0	3.8	4.8	4.6
CPI, % avg	10.5	13.1	6.3	9.9	4.8	5.1	5.4	4.4	4.7
Nominal wages, % yoy	0.2	15.0	8.2	7.5	6.5	8.3	9.2	10.0	9.0
Credit extension to private sector, % yoy	24.6	14.1	26.4	30.7	10.6	22.8	25.0	23.0	25.0
Policy interest rate, % eop	7.75	4.75	3.00	8.75	6.00	5.50	4.50	3.75	4.25
1 month inter-bank rate, % eop	12.75	9.75	8.00	10.83	6.46	6.35	4.95	3.75	4.30
Long term yield, % eop	13.62	10.18	10.02	11.89	10.06	7.61	6.03	7.00	7.00
lc/US$, eop	9830	8994	9393	10900	9425	9010	9068	9489	9650
lc/US$, avg	9712	9171	9140	9673	10376	9078	8763	9387	9630
Balance of Payments, US$ bn									
Current account	0.3	10.9	10.5	0.1	10.6	5.1	1.7	-17.2	-11.4
% of GDP	0.1	3.0	2.4	0.0	2.0	0.7	0.2	-1.9	-1.2
Trade balance	17.5	29.7	32.8	22.9	30.9	30.6	33.9	15.2	23.6
Exports	87.0	103.5	118.0	139.6	119.6	158.1	200.6	201.8	249.7
Imports	69.5	73.9	85.3	116.7	88.7	127.4	166.6	186.6	226.1
Service balance	-9.1	-9.9	-11.8	-13.0	-9.7	-9.3	-10.6	-11.5	-12.5
Income balance	-12.9	-13.8	-15.5	-15.2	-15.1	-20.8	-25.8	-25.8	-27.0
FDI, net	5.3	2.2	2.3	3.4	2.6	11.1	11.1	11.5	13.0
International reserves	34.7	42.6	56.9	51.6	66.1	96.2	110.1	112.4	119.4
Total Amortisations	22.7	35.4	31.5	40.2	36.7	37.6	38.1	40.3	41.0
Public Finances, % of GDP									
Consolidated government balance	-0.5	-0.9	-1.3	-0.1	-1.6	-0.6	-1.2	-1.8	-0.7
Consolidated gov primary balance	1.8	1.5	0.8	1.7	0.1	1.1	0.1	0.1	0.1
Public debt	47.3	39.0	35.2	33.0	28.0	26.0	25.5	25.0	24.0
of which Domestic	23.1	18.9	17.4	16.4	15.3	14.0	13.5	13.0	12.0
Foreign Assets & Liabilities, US$ bn									
External debt	134.5	132.6	141.2	155.1	172.9	202.4	224.8	250.0	285.0
Private	54.3	56.8	60.6	68.5	73.6	83.8	106.1	116.5	146.5
Public	80.2	75.8	80.6	86.6	99.3	118.6	118.6	133.5	138.5
External debt / GDP	47.0	36.4	32.7	30.4	32.1	28.6	26.6	28.2	29.2
External debt / XGS	134.6	115.3	108.2	100.1	130.2	115.8	101.6	108.9	105.7
Short-term debt	11.0	12.2	12.8	14.6	18.1	25.1	28.7	27.5	27.5
Short-term debt/International Reserves (%)	31.7	28.7	22.4	28.2	27.5	26.1	26.1	24.5	23.0

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.5	6.5	6.3	6.1	6.0	5.9	6.2	6.3	6.4
CPI, % yoy	4.6	3.8	4.0	4.4	4.0	4.8	4.5	5.3	4.8
Policy interest rate, % eop	5.25	4.50	3.75	3.75	3.75	3.75	4.00	4.25	4.25
1 month inter-bank rate, % eop	5.71	4.95	3.75	4.00	4.00	4.00	4.25	4.50	4.50
Long term yield, % eop	6.92	6.03	5.93	6.50	6.75	7.00	6.75	6.75	6.75
lc vs USD, eop	8790	9068	9144	9508	9405	9489	9571	9650	9650

Source: CEIC Data Company Limited and CIRA 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

Kit Wei Zheng
+65 657 5079
wei.zheng.kit@citi.com

Brian Tan
+65 6657 1932
brian.tan@citi.com

- **Summary view** – Despite sluggish exports, domestic demand has improved into 2Q. Delaying elections beyond the Sep Budget may raise medium term concerns over fiscal health, but boost short term growth and raise the hurdle for rate cuts.
- **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** – Heavy foreign positioning keeps risk of a sell off high which could reverse the recent fall in MGS yields. Alongside a narrowing current account surplus and domestic portfolio outflows, we do not expect MYR to outperform.

GDP recovery tilted towards domestic drivers

Following the 4.7% growth in 1Q12, our forecast of 2012 growth of 5% will hinge increasingly on domestic demand, including the pre-election fiscal lift to consumer incomes. Growth will hinge more heavily first on pre-election fiscal boost to consumer incomes in 2Q and early 3Q, which could add up to 1.2-1.4%-pts to GDP growth this year, and subsequently on ETP related investment spending. We highlight in particular the massive infrastructure investments – especially the RM20bn Klang Valley MRT – and in the oil and gas sector where Petronas is committed to spending RM200bn in capex in 2011-2015. Fiscal data suggests that fiscal firepower is being deployed aggressively. After registering a RM3.7bn surplus in Jan, a 26.5% YoY increase in government spending has swung the fiscal position year-to-date to a deficit of RM11.3bn as at Apr, almost eight times wider than the unusually narrow RM1.4bn deficit in Jan-Apr 2011. A RM13.8bn supplementary budget, including additional cash transfers for households was tabled in mid-June.

Incoming data in Apr-May highlights the widening dichotomy between sluggish exports and improving domestic demand into early 2Q. The trade surplus narrowed in Apr as resumption of weakening in E&E exports largely offset the surge in commodity exports, even as capital goods continued their upward climb on the continued investment revival. Weak external demand was corroborated in soft IP figures, which saw continued de-stocking in the E&E production. Overall, as at Apr, seasonally adjusted manufacturing output and export levels for Apr are 2.1% and 2.9% below their 1Q averages, hinting at a manufacturing drag on sequential 2Q12 GDP growth. On a more positive note however, earlier weakness in car production and sales appears to be bottoming out, with a 27% YoY and 22% MoM surge in May on the back of supply chain normalization and introduction of new models. A 32% MoM surge in the sales of national cars hints that the industry is adjusting to the stricter loan approval process in place since Nov. While consumer loans continued to weigh on credit growth in Apr, business loans, and construction indicators have held up or accelerated, attesting to the investment revival.

We do not see significant spillovers from European bank deleveraging from Grexit contagion. While claims by European banks on Malaysia are relatively large as a % of GDP within a regional context, about three quarters of European bank claims are by local affiliates of less vulnerable UK bank whose lending is largely funded by local deposits. The impact of European bank deleveraging will be mostly felt via selling of MGS and BNM bills and its knock on impact on yields and the MYR, rather than a more severe contraction of credit to the real economy.

Fiscal slippage from the pre-election splurge in 2012 will be limited. Administrative efforts to close the tax gap have brought revenues from Jan-Apr to more than a third of full year Budget targets, whereas in the past, only about a quarter of revenues were collected in the same period. Overall, it is quite likely that the outperformance in full year revenues should be largely cover the additional RM13.8bn in spending from the supplementary budget. On balance, we maintain our FY12 deficit forecast of 5% of GDP, and policymakers remain reasonably confident of hitting their 4.7% of GDP target.

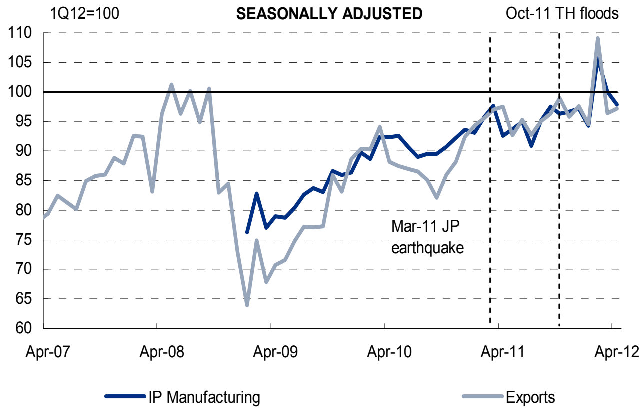
Delaying elections beyond the Sep 28th Budget may however raise concerns over fiscal health, even as it is growth friendly in the short term. Reports suggest that PM Najib's cautious approach in ensuring his party wins the next election will continue to push elections further back. With BN announcing a RM1.5mn allocation to each BN lawmaker as recently as June 11th to sweeten the ground, a July election looks less likely, especially as the money needs time to be spent and elections have be held before Ramadan which begins on July 21st. The next window could be in Sep/Oct, after the fasting month and festivities, with PM Najib not ruling out polls during the Haj month which starts in late Sep. Postponing the elections beyond the Budget would likely result in the third pre-election Budget in a row, and likely imply a slower pace of fiscal consolidation than would otherwise be the case. But notwithstanding a long Budget wishlist from the public, softening oil revenues may limit the generosity of any Budget measures. Delaying elections may however prolong the surge in fiscal spending – in the past 4 elections on average, domestic demand momentum – especially government consumption – tended to peak at or just before the quarter in which elections were held.

High hurdle to rate cuts; MYR unlikely to outperform

We see the OPR remaining at 3% for the rest of 2012, even though the July statement could strike a more dovish tone. Gov Zeti has reiterated recently that interest rates remain 'appropriate' as the domestic economy continues to hold up - in the past, the word "appropriate" has been used in MPC statements to signal a stable rate outlook. Inflation concerns have taken a backseat for now, as May headline CPI inflation fell further to 1.7%YoY on falling transport prices, though core inflation (ex food and transport) also ticked down. Nonetheless lingering pipeline pressures on core remain, especially if domestic demand picks up in 2H12 on the back of pre-election fiscal spending. Growth will have to slow much more sharply, with a material loss of jobs and/or contraction in credit, before concerns household debt are overcome and rate cuts are serious consideration

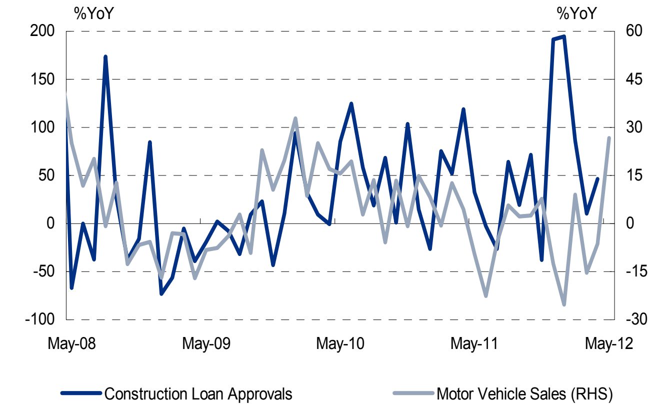
Fundamentals do not support MYR outperformance. A source of vulnerability is the heavy foreign positioning in the debt market at over 39% and 42% foreign ownership in MGS and BNM bills as at Apr. The overall balance of payments is also likely to turn less favourable – if the fall into deficit in 1Q for the first time in almost 2 years despite large portfolio inflows is a guide. A structural revival in domestic investments from a low base is likely to cause the current account surplus to continue narrowing further from 8% of GDP as at 1Q12 (4Q11: 9.8%, 3Q11: 12.3%) Large domestic institutional investors are also increasingly looking to diversify their portfolio overseas. With over RM442bn of assets, the Employees Provident Fund aims to increase the overseas portion of its portfolio to 30% by 2017 from just 10% now. Even assuming no new net inflows into EPF, this implies an additional RM95bn of outflows from EPF alone, as large as the annual current account surplus (2011: RM97bn), and twice as large as net foreign purchases of MGS in 2011 (RM44bn).

Figure 62. Weak external demand corroborated by soft IP



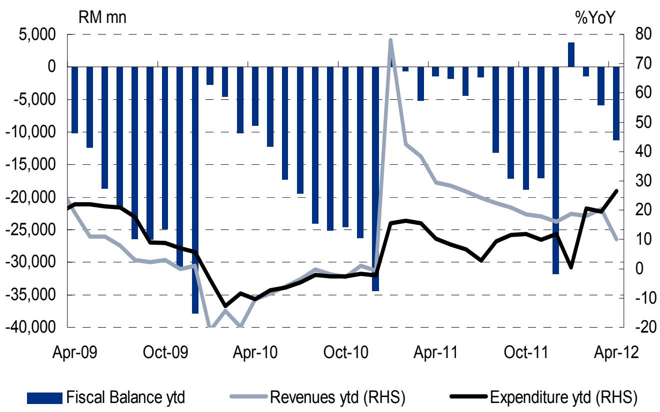
Source: CEIC, CIRA Estimates

Figure 63. Car sales rebounded in May



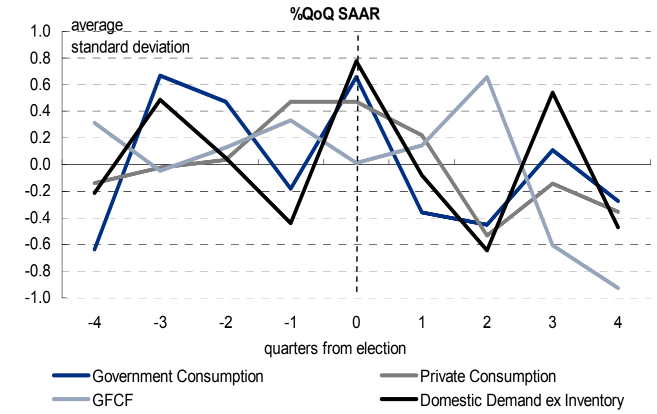
Source: CEIC, CIRA

Figure 64. Fiscal firepower is being deployed



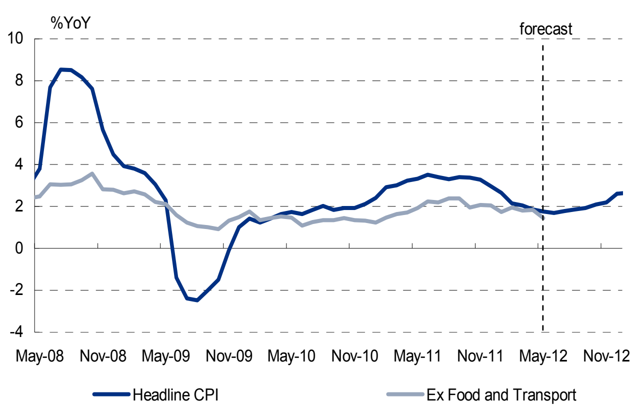
Source: CEIC, CIRA

Figure 65. Delayed elections positive for domestic demand near term



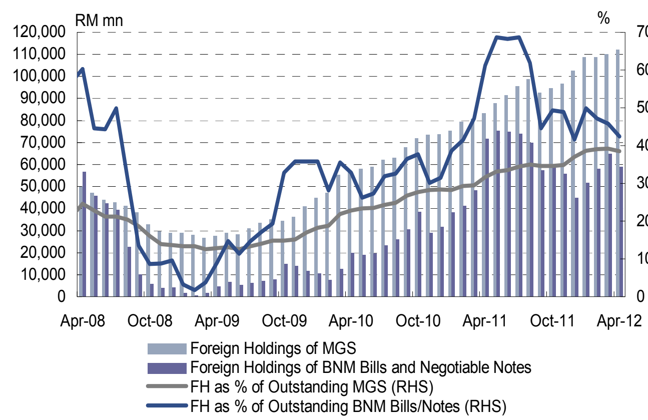
Note: Using the 9 quarters surrounding the election (4 quarters before, 4 quarters after, and the quarter of the election itself), we normalize the QoQ SAAR growth to the number of standard deviations from the mean for each election and then average the standard deviations for each quarter across the four elections.
Source: CEIC, CIRA Estimates

Figure 66. Inflation concerns have taken a backseat for now



Source: Haver, CIRA Estimates

Figure 67. Heavy foreign positioning in the debt market



Source: CEIC, CIRA

Figure 68. Malaysia Economic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	143.5	162.8	193.7	231.1	202.4	247.0	288.2	305.3	342.4
Nominal GDP, local currency bn	544	597	665	770	713	795	881	946	1,027
GDP per capita, US$	5,421	6,067	7,123	8,393	7,255	8,743	9,801	10,177	11,189
Population, mn	26.5	26.8	27.2	27.5	27.9	28.3	29.4	30.0	30.6
Unemployment, % of labour force	3.5	3.3	3.2	3.3	3.7	3.3	3.2	3.0	3.2
Economic Activity									
Real GDP, % yoy	5.3	5.6	6.3	4.8	-1.5	7.2	5.1	5.0	5.3
Real investment growth % yoy	-2.4	8.6	9.1	1.8	-9.4	23.8	3.2	10.6	9.0
Real consumption growth % yoy	8.6	6.4	9.7	8.4	1.4	5.8	8.9	6.8	5.3
private consumption growth % yoy	9.1	6.6	10.4	8.7	0.6	6.6	7.1	6.6	5.3
Real export growth, % yoy	8.3	6.7	3.8	1.6	-10.9	11.3	4.2	4.0	4.2
Real import growth, % yoy	8.9	8.2	5.9	2.3	-12.7	15.6	6.2	6.7	5.1
Prices, Money & Credit									
CPI, % yoy	3.3	3.1	2.3	4.5	1.0	2.1	3.0	2.6	3.0
CPI, % avg	3.0	3.6	2.0	5.4	0.6	1.7	3.2	2.3	3.1
Nominal wages, % yoy	3.3	0.9	5.8	7.1	0.6	4.0	5.0	3.0	5.0
Credit extension to private sector, % yoy	9.1	6.8	9.2	10.2	7.0	9.0	10.0	10.0	11.0
Policy interest rate, % eop	3.00	3.50	3.50	3.25	2.00	2.75	3.00	3.00	3.00
1 month inter-bank rate, % eop	3.22	3.71	3.61	3.37	2.17	2.98	3.22	3.28	3.28
Long term yield, % eop	3.73	3.70	3.78	3.00	3.79	3.39	3.23	3.10	3.60
lc/US$, eop	3.78	3.53	3.31	3.45	3.42	3.08	3.17	3.11	3.04
lc/US$, avg	3.79	3.67	3.44	3.33	3.52	3.22	3.06	3.12	3.10
Balance of Payments, US$ bn									
Current account	20.7	26.2	29.8	39.6	31.5	27.3	31.8	25.0	23.0
% of GDP	14.4	16.1	15.4	17.1	15.5	11.1	11.0	8.2	6.7
Trade balance	34.0	37.5	37.7	51.7	40.0	41.7	48.4	54.9	57.0
Exports	142.5	161.0	176.3	199.9	157.6	199.1	227.8	238.4	260.9
Imports	108.4	123.5	138.6	148.1	117.5	157.4	179.4	183.5	203.9
Service balance	-2.5	-2.0	0.8	0.0	1.1	0.5	-2.6	-2.0	-1.5
Income balance	-6.3	-4.7	-4.1	-7.0	-4.0	-8.1	-7.2	-8.0	-9.0
FDI, net	1.0	0.1	-2.7	-7.8	-6.5	-4.4	-3.2	5.0	7.0
International reserves	70.2	82.5	101.3	91.5	96.7	104.9	135.0	153.0	150.0
Total Amortisations	6.7	6.5	5.5	3.9	10.6	8.1	8.6	9.3	10.0
Public Finances, % of GDP									
Consolidated government balance	-3.6	-3.3	-3.2	-4.8	-7.0	-5.6	-5.0	-5.0	-4.7
Consolidated gov primary balance	-1.4	-1.2	-1.2	-3.1	-5.4	-3.5	-3.2	-3.0	-2.5
Public debt	42.1	40.6	40.1	39.8	50.8	51.2	51.8	51.0	50.0
of which Domestic	36.5	36.4	37.1	37.2	48.9	49.1	49.7	48.9	47.9
Foreign Assets & Liabilities, US$ bn									
External debt	52.3	52.2	56.7	68.2	68.0	73.7	81.0	73.9	79.8
Private	44.4	45.2	50.8	62.3	63.9	68.2	75.3	69.9	75.8
Public	7.9	7.1	5.9	5.9	4.0	5.4	5.7	4.0	4.0
External debt / GDP	36.4	32.1	29.3	29.5	33.6	29.8	28.1	24.2	23.3
External debt / XGS	32.3	28.6	27.5	29.6	36.6	31.7	30.8	25.4	24.9
Short-term debt	12.4	12.1	31.0	29.9	34.7	44.4	62.7	60.0	65.0
Short-term debt/International Reserves (%)	17.7	14.7	30.6	32.7	35.9	42.3	46.4	39.2	43.3

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	5.7	5.2	4.7	4.8	5.1	5.5	4.3	4.6	5.0
CPI, % yoy	3.4	3.0	2.1	1.7	1.9	2.6	2.6	3.0	3.0
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
1 month inter-bank rate, % eop	3.26	3.22	3.19	3.28	3.28	3.28	3.28	3.28	3.28
Long term yield, % eop	3.40	3.23	3.34	3.25	3.20	3.10	3.20	3.40	3.50
lc vs USD, eop	3.19	3.17	3.06	3.19	3.10	3.11	3.13	3.14	3.09

Source: CEIC Data Company Limited, IFS, Moody's and CIRA 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

Jun Trinidad
+63 2 894 7270
jun.trinidad@citi.com

- **Summary view** – The 6.4% GDP growth in 1Q will not be sustained in 2H12 but the fiscal spending catalyst from of revenue gains from improved collection efficiency can endure. Other than renewed drag from external headwinds, consumer sentiment may sputter on a bearish backdrop and affect consumption.
- **Things to watch** – Whether inflation upticks in 2Q12 will occur on benign oil/commodity prices. Our economists leave Grexit risk at 50-75% despite the Greek election outcome. Aquino's choice for new Chief Justice. Likelihood of electronic exports deeper into negative territory in the coming months.
- **Strategy** – We expect curve flattening with unchanged policy rate, negligible fiscal slippage risk, lower cash deposits of government as it funds PSALM's requirements and a 3Q12 borrowing program consistent with previous programs. Lacking BSP intervention, 42.1-42.50 could be the next 6-12 month peso outlook.

Collection efficiency gains to sustain fiscal catalyst

Strong 1Q12 GDP growth of 6.4%YoY led us to upgrade our FY12 forecast from 4.6% to 4.9%. Fiscal spending in the guise of 24%YoY rise in government consumption that includes social spending programs and a 62.2%YoY expansion in public construction keyed upbeat 1Q GDP. Disinflation and less peso appreciation supported a 7.7%YoY growth in the purchasing power of the OFW remittances to support local consumption. Key question is whether these catalysts will stay resilient in a slower global backdrop in 2H12. First quarter contribution of net trade to GDP at a surprising 2.7% will vanish and become a drag to growth as exports slacken. We think the fiscal spending catalyst would persist despite Grexit-shock since tax revenues on the back of collection efficiency gains, provide money to support fiscal spending and mitigate a fiscal deficit blowout. Other than subdued fiscal slippage risk (an actual fiscal gap undershooting the FY12 deficit target), sustained tax revenue gains on governance actions, would de-linked the fiscal position from the cyclical backdrop Fiscal spending catalysts which are resistant against significant undermining by global downside risks (and still lacks the PPP impact) would cushion domestic demand prospects from harsh external headwinds. **Fiscal spending with emphasis on public construction supported job creation in particular, the creation of 185K construction jobs according to the Jan labor survey.** There was also employment created in mining, manufacturing, and utilities to support industrial sector employment gains by 5.1%YoY that eclipsed job generation by agriculture and service. Onshore job creation from the FY12 infra budget and the PPP implementation alongside higher purchasing power of the remittances support local consumption.

Even with our upwardly revised FY12 GDP forecast of nearly 5%, it's still short of first quarter growth. While the fiscal spending agent won't be threatened by lackluster revenues from a slower macro backdrop, downside risks to growth can be as follows: 1) Consumer pessimism as a result of a raging euro crisis alongside respondents low perception of the country's economic condition despite strong 1Q12 GDP, followed by vulnerable family finances and family income to a bearish macro climate. Negative consumer sentiment can lead to prioritization of the basics like food and education while postponing discretionary spending. 2) Exposure to European labor markets where we hear of a deepening economic crisis can heighten risk of non-renewal of OFW job contracts and lackluster remittance flows. This will weigh down on consumer sentiment first before affecting actual spending. 3) Private investments might get delayed in a global crisis given tight finances particularly capex over time. Late 2H12, PPP can mitigate risk of delayed capex.

45% of 1Q tax gains due to higher collection efficiency

On sheer dint of the political will to catch tax cheats and evaders, tighten 'interpretation' of revenue guidelines and curb corruption within government despite the lack of new revenue measures, we estimate collection efficiency contributed 44.8% of 1Q12 tax revenue growth (13.8%YoY/~Php16.4bn). Efficiency gains accounted for the residual extracted from tax growth less real GDP growth and inflation. Our estimate of efficiency gains displaced inflation as a major revenue contributor in 1Q. The timing looks appropriate considering a subdued inflation outlook that implies less tax buoyancy. Over the past decade, inflation contributed 49% of tax growth while real GDP accounted for >50% contribution. Collection efficiency made positive contributions in FY05-06 when EVAT reforms were initiated. Assuming efficiency gains are maintained, fiscal slippage risk in FY12 would be negligible: we see a fiscal deficit would drop to Php255bn/2.4% of our FY12 GDP – lower than the FY12 fiscal deficit target of Php279bn. Improved collection efficiency could elevate the tax to GDP ratio to 13% – a higher ratio than our FY12 assumption of 12.5%. How can we be sure that tax collection efficiencies would persist? Other than Pres. Aquino's political will to institute strong governance measures on the revenues and expenditure side, we believe that much of what the government has done and accomplished is only a small sample of the tax or cash flow benefits that can be obtained from governance measures. After all, Pres. Aquino would only be into the 2^{nd} year of his term next month. Impeachment of the Chief Justice boosted credibility of government's resolve to improve tax compliance by jailing tax evaders and corrupt personnel.

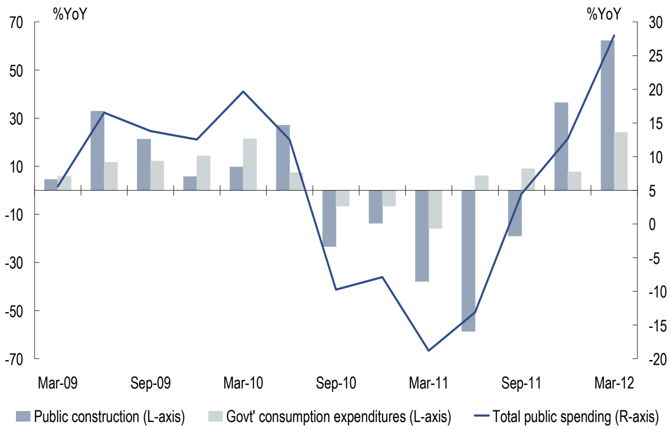
Dovish sounding MB in the face of global downside risk

Rate hike risk on buoyant 1Q GDP has been overtaken by dovish signals from the Monetary Board (MB) recently facing the buildup of headwinds from the eurozone crisis and fragile US and China prospects. Lackluster external demand as the global economy faces downside risk in the coming months could guarantee a benign inflation outlook with falling oil/commodity prices that may mute second round oil price effects. The prevailing soft inflation setting coupled with macro implications of offshore risk accord policymakers the flexibility to keep policy rates unchanged and enable the cumulative 50bp rate cut that led to the existing record low overnight rate (and the 'operational adjustments' in the reduced reserve requirements) to work its way into the economy. The MB noted upbeat 1Q12 GDP but it wasn't highlighted as a demand-side, inflation catalyst since disinflation in 1Q12 wasn't derailed at all by GDP growth. We believe rate cut prospects will be determined by an export collapse—the key downside risk to growth that harks back to FY09 crisis.

Will local bonds rally soon?

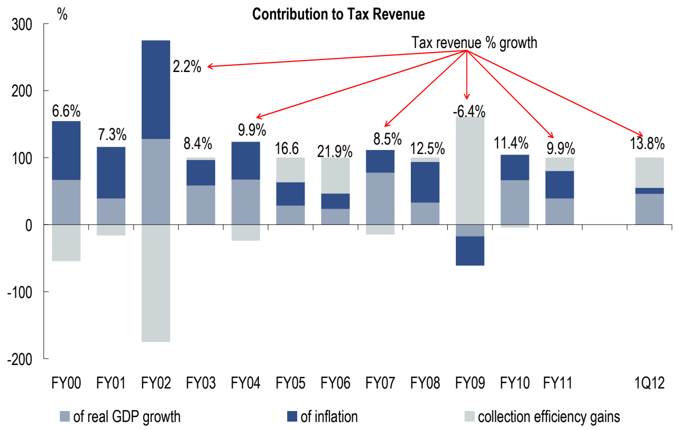
Curve flattening would happen only if negligible fiscal slippage risk would be in sync with debt supply risk. This can happen if the 3Q12 borrowing program stays in line with previous programs (3Q11: Php117bn) and government's cash deposits start to go down materially in 2Q12 which may suggest more government advances to PSALM/Napocor—the underlying basis for debt supply risk. As of April, the government's cash deposits stood at Php477.7bn (after funding a deficit of Php2.9bn) or more than 2 std deviations higher than its mean of Php300bn. Drawing these deposits to fund PSALM coupled with a 3Q borrowing program not materially different from a year ago should ease risk perception. Finalizing the global peso note funding would be the last factor likely to support a sustainable local bond rally. Because of fundamentals, peso has been the best in EM Asia vs. USD. Subdued inflation may justify BSP intervention against a strong peso but lacking this action, the range of 42.1-42.5 over the 6-12 month period may hold.

Figure 69. Fiscal spending accounted for 12.8% of 1Q GDP



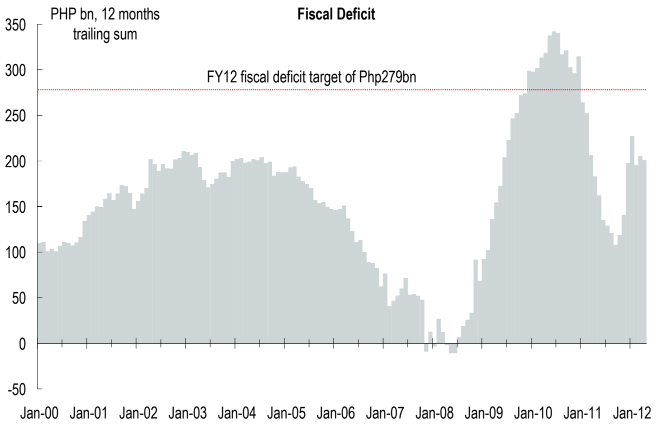
Source: CEIC Data Company Ltd., and CIRA

Figure 70. Collection efficiency gains support sustained fiscal spending



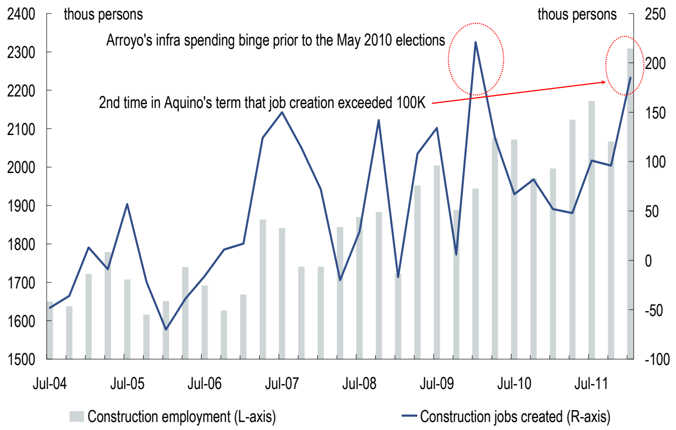
Source: CEIC Data Company Ltd., and CIRA

Figure 71. Fiscal deficit trending down and well below FY12 target



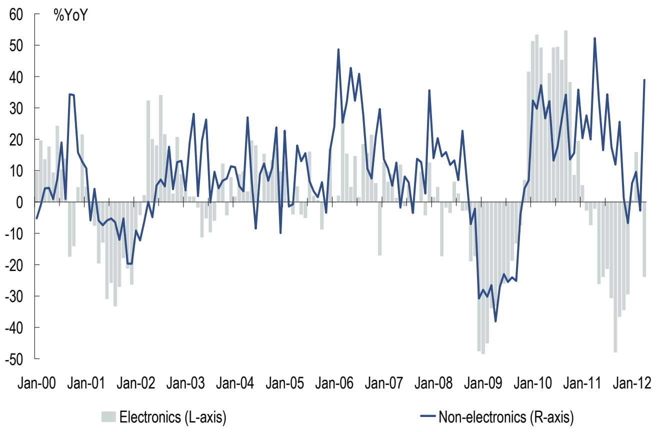
Source: CEIC Data Company Ltd., and CIRA

Figure 72. Public construction resulted in construction job creation



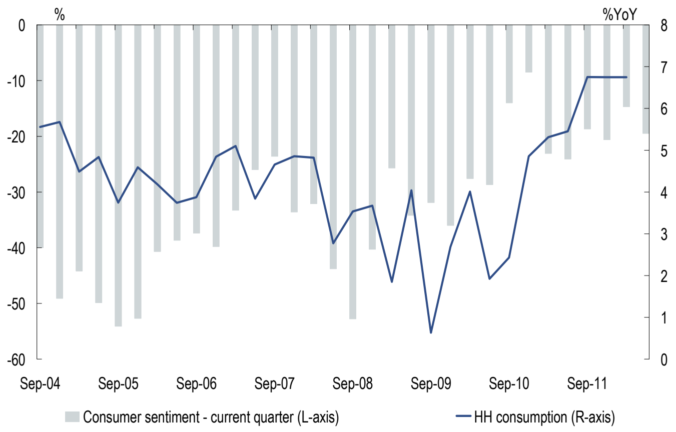
Source: CEIC Data Company Ltd., and CIRA

Figure 73. Electronic exports in Apr surprised on the downside



Source: CEIC Data Company Ltd., and CIRA

Figure 74. Consumer sentiment may turn more negative in 2H



Source: CEIC Data Company Ltd., and CIRA

Figure 75. Philippines Economic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	103.3	122.3	150.1	173.0	168.3	199.2	224.7	246.5	271.1
Nominal GDP, local currency bn	5,678	6,271	6,893	7,721	8,026	9,003	9,736	10,467	11,423
GDP per capita, US$	1,221	1,418	1,694	1,914	1,825	2,113	2,343	2,520	2,717
Population, mn	84.6	86.3	88.6	90.4	92.2	94.3	95.9	97.8	99.8
Unemployment, % of labour force	8.8	8.0	7.3	7.4	7.5	7.3	7.0	7.0	6.8
Economic Activity									
Real GDP, % yoy	4.8	5.2	6.6	4.2	1.1	7.6	3.9	4.9	5.3
Real investment growth % yoy	3.0	-15.1	-0.5	23.4	-8.7	31.6	8.1	5.6	7.3
Real consumption growth % yoy	4.2	4.9	4.9	3.3	3.3	3.4	5.6	5.5	5.2
private consumption growth % yoy	4.4	4.2	4.6	3.7	2.3	3.4	6.3	6.1	5.5
Real export growth, % yoy	5.0	12.6	6.7	-2.7	-7.8	21.0	-4.2	3.4	4.8
Real import growth, % yoy	3.3	3.5	1.7	1.6	-8.1	22.5	0.2	1.4	5.9
Prices, Money & Credit									
CPI, % yoy	6.7	4.4	3.8	7.7	4.5	3.6	4.2	3.5	4.0
CPI, % avg	7.7	6.3	3.0	8.2	4.2	3.8	4.8	3.3	3.8
Nominal wages, % yoy	9.5	8.7	3.8	6.2	0.0	5.0	6.0	5.0	6.5
Credit extension to private sector, % yoy	-2.2	7.4	4.8	17.5	10.0	10.0	12.1	9.0	11.3
Policy interest rate, % eop	7.50	7.50	5.25	5.50	4.00	4.00	4.50	4.00	4.50
1 month Philippine Reference rate, % eop	7.74	6.40	6.00	5.20	4.11	0.75	1.68	2.50	4.00
Long term yield, % eop	9.57	5.25	5.50	6.53	6.25	4.78	4.21	5.00	5.50
lc/US$, eop	53.0	49.1	41.2	47.5	46.5	43.6	43.8	42.2	41.6
lc/US$, avg	55.0	51.3	46.1	44.5	47.6	45.1	43.3	42.5	42.1
Balance of Payments, US$ bn									
Current account	2.0	5.3	7.1	3.6	9.4	8.9	7.1	7.7	6.8
% of GDP	1.9	4.4	4.7	2.1	5.6	4.5	3.1	3.1	2.5
Trade balance	-7.8	-6.7	-8.4	-12.9	-8.8	-11.0	-15.5	-15.7	-17.7
Exports	40.3	46.5	49.5	48.3	37.6	50.7	47.2	52.0	55.7
Imports	48.0	53.3	57.9	61.1	46.5	61.7	62.7	67.7	73.5
Service balance	-1.3	0.1	2.3	1.2	2.1	2.7	3.6	3.7	3.8
Income balance	-0.3	-1.3	-0.9	0.1	-0.2	0.5	1.3	1.2	1.2
FDI, net	1.7	2.8	-0.6	1.3	1.6	1.2	1.0	1.5	2.0
International reserves (ex-gold)	15.8	19.9	30.1	33.1	38.6	55.1	66.7	72.5	82.1
Total Amortisations	4.9	4.8	4.1	4.1	4.3	7.8	8.0	8.5	8.0
Public Finances, % of GDP									
Consolidated government balance	-2.6	-1.0	-0.2	-0.9	-3.7	-3.5	-2.0	-2.4	-2.1
Consolidated gov primary balance	2.7	3.9	2.6	-0.2	-0.3	-0.2	0.8	0.5	0.9
Public debt	71.4	63.9	55.9	54.7	54.8	52.4	50.0	49.1	48.5
of which Domestic	39.8	35.7	33.1	31.3	30.8	30.2	29.0	30.0	31.0
Foreign Assets & Liabilities, US$ bn									
External debt	54.4	53.9	55.5	54.3	54.9	60.0	61.7	63.5	65.0
Private	17.7	16.5	17.5	13.7	11.6	13.0	14.2	15.2	16.5
Public	36.7	37.4	38.0	40.6	43.2	47.0	47.5	48.3	48.5
External debt / GDP	52.7	44.1	37.0	31.4	32.6	30.1	27.5	25.8	24.0
External debt / XGS	121.5	101.8	93.6	93.7	112.8	93.9	103.7	97.0	92.6
Short-term debt	6.4	5.0	7.1	7.0	4.0	6.3	7.0	8.0	10.5
Short-term debt/International Reserves (%)	40.5	25.2	23.6	21.2	10.4	11.4	10.5	11.0	12.8

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.6	3.7	6.4	4.8	4.5	4.2	5.0	5.2	5.6
CPI, % yoy	4.8	4.2	2.6	3.0	3.2	3.5	3.5	3.6	3.8
Policy interest rate, % eop	4.50	4.50	4.00	4.00	4.00	4.00	4.00	4.00	4.25
1 month Philippine Reference rate, % eop	2.37	1.68	3.13	3.40	3.45	3.50	4.00	4.25	4.25
Long term yield, % eop	5.08	4.21	4.48	4.70	4.85	5.00	5.25	5.50	5.50
lc vs USD, eop	43.7	43.8	42.9	42.6	42.1	42.2	42.4	42.5	42.0

Source: CEIC Data Company Limited, IFS, Moody's and CIRA 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

Kit Wei Zheng
+65 657 5079
wei.zheng.kit@citi.com

Brian Tan
+65 6657 1932
brian.tan@citi.com

- **Summary view** – GDP is poised to slow sharply in the second quarter and 2H12. Despite some moderation, supply constraints could keep headline inflation elevated at 4% in 2H12. It would take a more severe growth slowdown in 2H12 for MAS to ease policy, and even so easing – if any – will likely be calibrated.
- **Things to watch** – [1] Leading indicators of manufacturing momentum; [2] Comments by MAS officials on the outlook and monetary policy; [3] Further property measures for private and HDB markets.
- **Strategy** – Conditional upon further weakening in EUR and no change to MAS policy in Oct, we revise up our 3M and 12M USD-SGD forecast to 1.25 and 1.28 respectively, which anticipates SGD NEER hugging the mid-point of the band.

External headwinds to weigh on growth in 2H12

GDP likely saw a broad based slowdown in 2Q12 on external headwinds. The recovery in NODX and manufacturing which propelled 1Q GDP has lost momentum, with Apr-May seasonally-adjusted NODX volumes at best flat vs 1Q, and also 0.8% lower after stripping out lumpy and volatile ships and pharmaceuticals exports, even if rising in the last two months from the lows in Mar. Mirroring the weakness in exports, Apr-May manufacturing output was also 1.3% below 1Q levels, with both biomedicals and electronics softening – pointing to at best flat manufacturing GDP momentum in 2Q. Similarly, other trade and transport related services have seen sluggish, but still positive growth – evident in slowing re-export volumes and tourist arrivals. Moderating domestic and regional business activities are also evident in slowing loan growth to residents and non-residents, while sentiment sensitive sectors such as car and primary home sales have also been hit in Apr-May.

Renewed external headwinds will likely weigh on trade-related and sentiment sensitive sectors in 2H12. The outlook for the US and to a lesser extent Europe probably matters relatively more for manufacturing exports, especially electronics, than China. Singapore's GDP exposure to China will likely be largely via tradables services including tourism and financial services. Our 3.6% 2012 growth forecast currently already incorporate a slowing of growth momentum in 2Q and 3Q to around 2.5-3%, from 10% QoQ SAAR in 1H12, which should result in a stabilization of the output gap in the near term. Manufacturers keeping inventories relatively lean in the face of uncertainty reduces the likelihood of a deeper, more prolonged de-stocking cycle, hinted at by PMI indices suggesting that the stocks of finished goods remain at lower levels compared to than in early 2011 or 2008/09.

Growth could also be structurally lower in 3-4% range because of more binding supply side constraints especially in the labour market. Even after the marginal cyclical easing of labour market tightness in 1Q12, the unemployment rate remained near a 14 year low of 2.1%, with job vacancies still elevated at 50K. Meanwhile, with the resident labour force participation rate at record high, it is becoming increasingly difficult to substitute foreign for local workers. Thus even as labour demand moderated, supply was also tightened due to tighter immigration policies, which in turn limited the degree of economic slack in the economy. Anecdotal evidence is emerging of firms having to turn away export orders because of the labour shortage. With tighter foreign worker quotas kicking in w.e.f Jul 2013, and with the economy near full employment the impact of a slower labour force growth may be increasingly felt on growth, rather than just wages and inflation.

Supply constraints = higher hurdle for policy easing

Supply constraints could keep headline inflation at around 4% in 2H12. Base effects from cars and housing should help moderate headline inflation, as would lower oil prices, which could reduce headline CPI by as much as 0.5%-pts by year end. Even so, continuing supply constraints and a weaker SGD could pose challenges, including in core inflation, which may remain above 2.5%. With the Manpower survey pointing to a pick up in labour demand amidst tighter policy induced supply constraints, YoY unit labour costs could edge up in 2H12, which could be transmitted into higher services costs. Other pent up business costs - such as the doubling of goods vehicles COE premiums – may also be passed through to consumer prices.

The hurdle for supporting demand via fiscal and monetary easing is high given supply constraints reducing potential growth. Fiscal policy had been even more contractionary than earlier expected. The primary fiscal surplus has actually turned out to be S$4.5bn, 50% larger than MOF's revised forecasts in the Budget of S$3bn, thanks to the usual overshoot in revenues and underspending. Further assume that MOF's estimates of special transfers, endowments and income from reserves were consistent with Budget estimates, the Basic Balance (which excludes the effect of top ups to endowment funds that are not an immediate fiscal injection) would show a surplus of $1.4bn, instead of the original estimate of a small deficit. For FY12, if the fiscal outturn is in line with Budget estimates of a $1.3bn basic surplus, this could impute a broadly neutral fiscal impulse at best. Despite much room for fiscal easing, barring a 2008/09 style recession, we suspect the actual outturn could well be a slightly contractionary fiscal stance.

We continue to see a high hurdle for MAS easing in Oct with headline inflation well above MAS's (likely higher) inflation tolerance thresholds. To the extent that policy will respond primarily to demand pull pressures, the risk of an easing would increase materially if GDP growth slows much more sharply than anticipated in 2Q and 3Q. However, our estimates suggest that 2Q GDP growth momentum at 2-3% QoQ SAAR is broadly in line with MAS's implicit estimates in Apr. Even if MAS eases, the desire to keep inflation expectations anchored and accommodate medium term REER appreciation, will likely imply any fairly calibrated steps

Surveys suggest near term cost competitiveness has already been eroded by the inflation shock and exchange rate response which has caused the REER to appreciate 18% since 2010. Partly because of the strong exchange rate, Singapore is now the 6th most expensive city according to Mercer's cost of living survey, up from 8th last year The latest IMD World Competitiveness Survey, also saw Singapore slipped to 4th place from 1st in 2010.

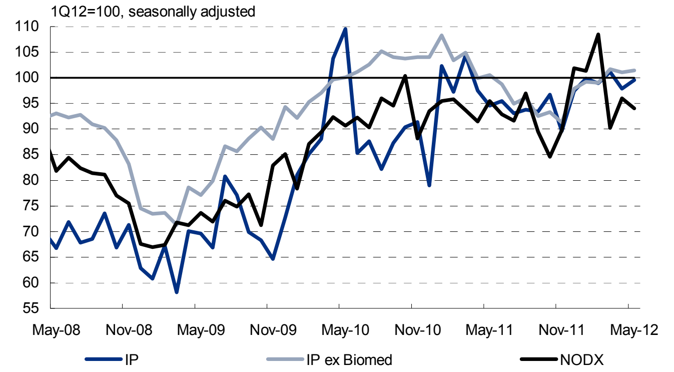
We are not convinced the risk of further property cooling measures has completely subsided, even if it has been reduced. Despite the 32%MoM fall in new private home sales to 1,702 in May (ex ECs) from the record 2,487 in Apr (ex ECs). But this remains above the monthly average of 1429 since 2009 – with resale volumes picking up since Mar and reports indicating a pick up in HDB and private home resale prices, we would not entirely rule out the risk of further targeted property cooling measures, even if economic weakness and incoming supply tempers the aggressiveness or timing of any measures.

Figure 76. US and EU outlook matters more for manufacturing exports

NODX, 2006 prices (%YoY)	GDP (%YoY)	Correlation
NODX to US	US GDP	0.63
NODX to EU	EU GDP	0.46
NODX to China	China GDP	0.02
NODX to China	US GDP	0.67
NODX to China	EU GDP	0.46

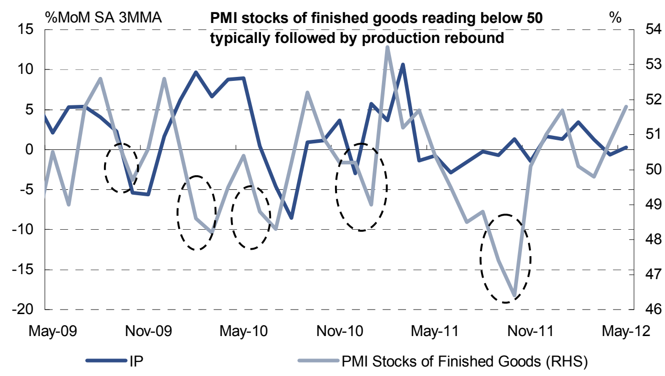
Source: CEIC, Haver, CIRA Estimates

Figure 77. Recovery in NODX and manufacturing has lost momentum



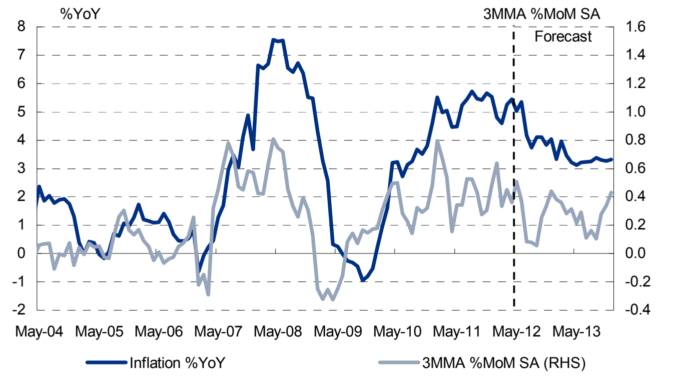
Source: CEIC, CIRA

Figure 78. PMI Stocks of finished goods low relative to past peaks



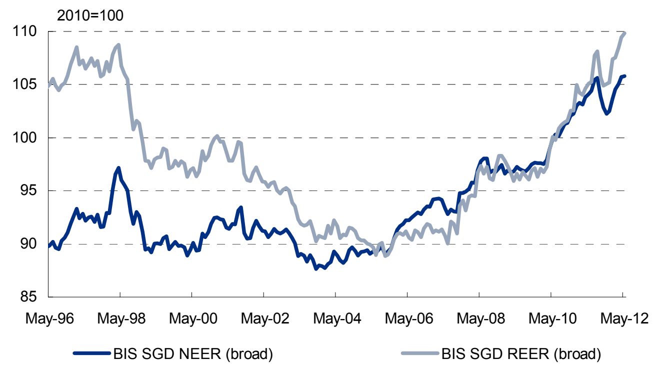
Source: CEIC, CIRA

Figure 79. Supply constraints could keep inflation at around 4% in 2H12



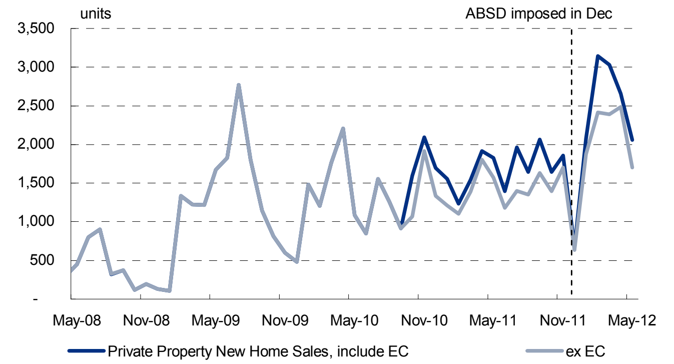
Source: CEIC, CIRA Estimates

Figure 80. The REER has appreciated 18% since 2010



Source: CEIC, CIRA

Figure 81. New home sales fell 32% MoM in May, but from a high base



Source: URA, CIRA

Figure 82. Singapore Economic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	125.4	145.9	177.9	190.2	186.2	227.9	260.0	280.6	314.2
Nominal GDP, local currency mn	209	232	268	251	249	310	327	354	383
GDP per capita, US$	29,396	33,155	38,764	39,305	37,329	44,889	50,157	53,379	58,762
Population, mn	4.3	4.4	4.6	4.8	5.0	5.1	5.2	5.3	5.3
Unemployment, % of labour force	3.1	2.7	2.1	2.3	3.0	2.2	2.0	2.2	2.1
Economic Activity									
Real GDP, % yoy	7.4	8.8	8.9	1.7	-1.0	14.8	4.9	3.6	5.0
Real investment growth % yoy	-0.4	17.4	16.5	27.4	-20.1	5.8	9.7	12.0	8.7
Real consumption growth % yoy	3.9	5.0	5.9	3.9	0.9	7.4	3.4	2.3	4.4
private consumption growth % yoy	3.6	5.0	6.8	3.3	0.1	6.5	4.1	3.8	4.8
Real export growth, % yoy	12.4	10.9	9.0	4.7	-7.8	19.1	2.6	3.8	5.9
Real import growth, % yoy	11.3	11.3	8.1	9.5	-11.1	16.2	2.4	5.2	6.6
Prices, Money & Credit									
CPI, % yoy	1.3	0.8	3.7	5.5	-0.5	4.6	5.5	4.2	3.3
CPI, % avg	0.5	1.0	2.1	6.6	0.6	2.8	5.2	4.4	3.3
Nominal wages, % yoy	3.5	3.2	6.2	5.4	-2.6	5.6	6.0	4.0	6.0
Credit extension to private sector, % yoy	2.0	4.9	16.9	15.2	2.0	6.0	16.5	8.0	10.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	3.25	3.44	2.38	1.00	0.69	0.44	0.38	0.30	0.30
Long term yield, % eop	3.21	3.05	2.68	2.05	2.66	2.71	1.63	1.80	2.12
lc/US$, eop	1.66	1.53	1.44	1.43	1.41	1.28	1.30	1.26	1.24
lc/US$, avg	1.66	1.59	1.51	1.41	1.45	1.36	1.26	1.26	1.26
Balance of Payments, US$ bn									
Current account	26.8	35.7	45.7	26.5	30.2	55.8	57.1	41.7	41.2
% of GDP	21.4	24.5	25.7	13.9	16.2	24.5	21.9	14.9	13.1
Trade balance	46.7	50.2	57.0	41.9	47.5	63.3	67.5	42.3	54.4
Exports	241.7	281.5	313.2	356.0	289.5	371.9	429.7	477.0	515.2
Imports	195.0	231.3	256.2	314.1	242.0	308.6	362.3	434.7	460.8
Service balance	-9.8	-7.3	-2.5	-2.7	-3.2	1.6	1.9	8.0	12.0
Income balance	-10.0	-7.2	-8.7	-12.7	-14.1	-9.1	-12.3	--	--
FDI, net	6.5	18.1	10.0	5.1	6.8	27.7	38.9	10.0	15.0
International reserves	115.7	135.8	162.5	173.6	186.0	230.0	280.0	330.0	200.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	6.4	9.1	11.1	9.0	-1.6	0.5	1.5	1.0	1.0
Consolidated gov primary balance	6.5	9.1	11.1	9.0	-1.6	0.5	1.5	2.0	1.0
Public debt	99.4	99.4	93.0	99.2	106.0	107.0	110.0	115.0	118.0
of which Domestic	99.4	99.4	93.0	99.2	106.0	107.0	110.0	115.0	118.0
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

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.0	3.6	1.6	3.2	4.0	5.7	5.4	4.3	5.9
CPI, % yoy	5.5	5.5	5.2	5.5	4.3	4.2	3.6	3.2	3.4
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	0.25	0.38	0.38	0.35	0.35	0.30	0.30	0.30	0.30
Long term yield, % eop	1.62	1.63	1.66	1.70	1.80	1.88	1.95	2.00	2.12
lc vs USD, eop	1.31	1.30	1.26	1.28	1.25	1.26	1.27	1.27	1.26

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

South Korea

Jaechul Chang
+82 2 3705 0727
jaechul.chang@citi.com

Hyejin Park
+82 2 3705 0768
hyejin.park@citi.com

- **Summary view** – We revise down 2012E and 2013E GDP growth again to 2.8% and 3.6% respectively, reflecting further slowdown of China and recession in Eurozone. Despite fall in oil price, we estimate CPI inflation is likely to stay at around 3% till 2013 due to weak KRW and public service tariff hikes offsetting the deflationary pressure.
- **Things to watch** – The BoK is expected to cut policy rate at least twice, each by 25bps, to the end of 1H13 to mitigate economic downturn. The MoSF will also implement extra fiscal spending to support economic growth by increasing fund limits but is unlikely to prepare a supplementary budget as it did during GFC.
- **Strategy** – We estimate risk aversion due to possible Grexit and US fiscal cliff will keep USDKRW above 1,150 levels in 12-month horizon. Likely policy rate cut and decreased risk appetite will lower yields on shorter end as well as flatten the curve for a while in our view.

Real economy continues downturn and inflation slows

Year-on-year downtrend in economic activities persists. Industrial production (IP) registered an unexpected monthly expansion of 0.9% in Apr following a sharp decline of 2.9% in Apr, on the back of large increase in productions of machinery & equipment and electrical equipment, However, IP posted the same level of a year ago, down from +0.7%YoY in Mar, with continued drag in exports. Moreover, slowdown in the manufacturing sector was affirmed by the third month rise in the inventory/shipment ratio, to 111.5 in Apr from 108.8 in Jan. Apr service activities and consumer sales also saw sequential growth, of 0.2% and 1.0% respectively, but their year-on-year growths were down at 1.0% and 0.4% vs. 2.5% and 2.0% in 1Q12.

Contraction in exports continued in 2Q12. Mirroring worsening external backdrop, exports have contracted for three consecutive months on YoY terms, recording -0.6%YoY in May. Despite benefits of FTAs, exports to the US reversed to decline by 8.3%YoY and those to EU fell by 0.5%YoY. Exports to China which takes up about 23% of total exports decreased for the third month by 4.9%YoY. While autos and auto parts are sustaining positive growths, most of the country's major export items such as cellular phones and shipbuilding have seen declines in recent months. Imports also slowed -1.1%YoY, continuing three months of fall from Feb along with decreases in demand for re-exports as well as domestic demand.

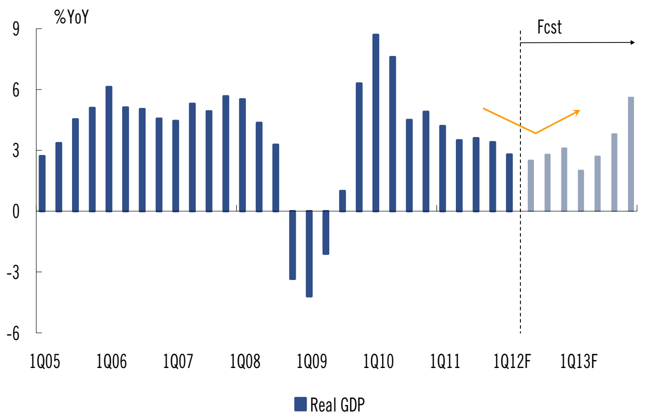
Headline inflation stabilizes and job growth remains solid. After four months of sharp moderation in this year, CPI inflation stayed at 2.5%YoY in May. High base effect and government measure, e.g. on childcare and free school meals, were the main contributors for the stabilization. However, inflationary pressures from agricultural goods and oils are still high. In May, agricultural goods price rose by 17.6%YoY due to spring drought, and oil price increased by 7.1%YoY, despite 0.3%MoM decline, on ripple effect of high crude oil price in Mar and Apr compared to year ago levels. The number of employed has grown by more than 400K YoY in recent months along with increase in self-employed workers, rather than in wage & salary workers. This could be ascribed to business startups which have grown by more than 6K during the last five months, mostly led by baby boomers striving to earn a living after retirement.

Revising down 2012-13E growth to 2.8% and 3.6%

We re-adjust real GDP growth for 2012 and 2013, each down by 0.6%p from May forecasts. Further slowdown of China and sluggish eurozone in the coming months will weigh on exports which already lost steam during the first five months of this year. In addition, financial market stress due to eurozone sovereign/banking crisis is likely to deteriorate economic sentiments, delaying the recovery of domestic demand. In particular, expected recession in the eurozone will strain exports both directly and indirectly. Exports to China have dropped sharply recently partly as China's export to the eurozone — which composes 17% of China's total exports — decreased by 0.8%YoY in the first five months of this year. We expect exports to remain weak in 2H12 and to fall by 3.5% in 1Q13 on expected possible Grexit, which is used as a baseline scenario in our economic forecasts. Exports in USD terms will likely slow down from 19.0% in 2011 to 2.2% in 2012, then rebound slightly to 4.7% in 2013. Our new export forecasts for 2012 and 2013 are 2.2%p and 3.6%p lower than previous forecasts. Import growth should wane further to 3.8% in 2012E and 4.2% in 2013E, revised down 3.9%p and 2.8%p respectively, due to weakening exports and lower raw material prices. For domestic demand, other than financial market stress, anemic nominal wage growth and sluggish exports would put a drag on private consumption and facilities investment. Given that exports will likely grow slower than previously forecasted, contribution of net-exports to growth would be reduced from 2.1%p in 2011 to 0.4%p in 2012 and 0.8%p in 2013 while that of domestic demands would increase from 1.2%p to 2.2%p and 2.9%p on the back of steady recovery of construction and larger government expenditures. Meanwhile, headline inflation is expected to remain below 3% till 3Q12 but rebound and stay above 3% in the following three quarters due to electricity tariff hikes and weakness of KRW. Despite resilient job growth of more than 300K YoY expected in the coming quarters, economic growth below potential would leave unemployment rate to remain at 3.3% both in 2012 and 2013. We think lingering eurozone risks and risk aversion would limit the strength of KRW, leading USDKRW to post 1,149 at end-2012 and 1,121 at end-2013. Weaker KRW and decline in raw material prices, especially crude oil prices, would leave current account surplus at around US$20bn in 2012 and 2013.

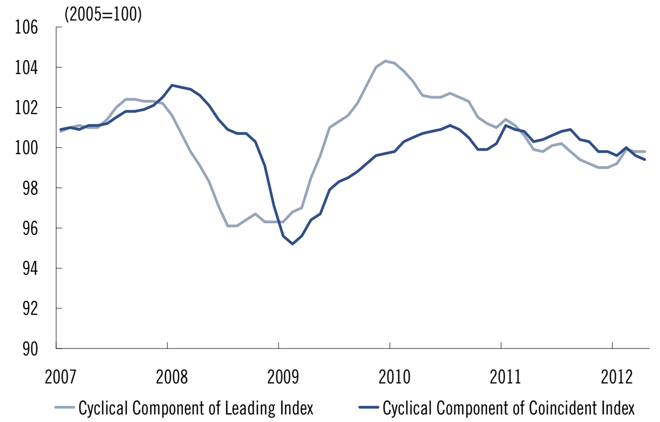
At least one rate cut and fiscal stimulus are highly likely in this year. We think policy authorities will implement accommodative measures to prevent further slowdown of the economy, especially before the presidential election in Dec and deterioration of global economic environment early in 2013 following a possible Grexit. In our view, the BoK is likely to cut the policy rate once by 25bps in 3Q12 to signal more accommodative stance given both headline inflation and real GDP growth expected to remain below 3% during the quarter. Another rate cut could happen in 1Q13 if the economy registers a negative sequential growth, hit hard by adverse shocks due to a possible Grexit, which we use as a baseline scenario in our economic forecasts. The MoSF will also consider additional fiscal outlays in 2H12 or early next year to mitigate side-effects of economic slowdown even if it still asserts the necessity of a balanced budget. Politicians, both from the ruling party and opposition parties, are likely to push the MoSF to implement extra budget spending ahead of the presidential election to gain votes from the public. However, additional fiscal spending will not be in the form of supplementary budget, which is tightly regulated by the National Finance Law, but measures to minimize the carry-over and increase spending of funds — e.g. 'funds for SME', 'credit guarantee funds', and 'trade insurance funds' — which the government can increase without the National Assembly's approval.

Figure 83. We revise down 2012-13 growths to 2.8% and 3.6%



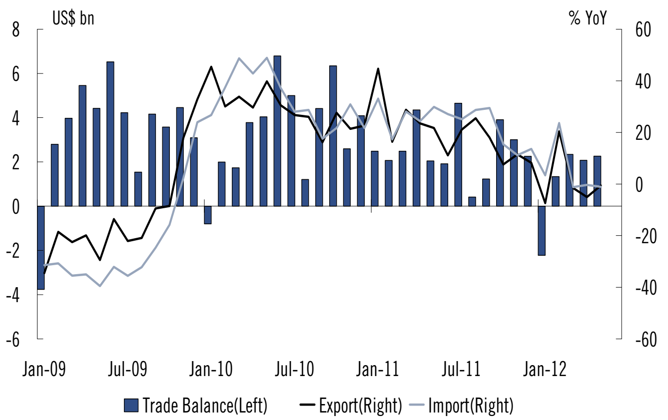
Source: Bank of Korea, CIRA estimates

Figure 84. Cyclical component of leading index stayed flat in Apr



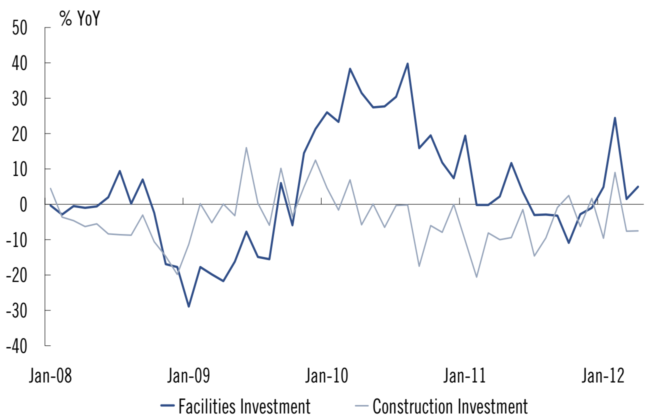
Source: Statistics Korea

Figure 85. Trade remained sluggish on worsening external backdrop



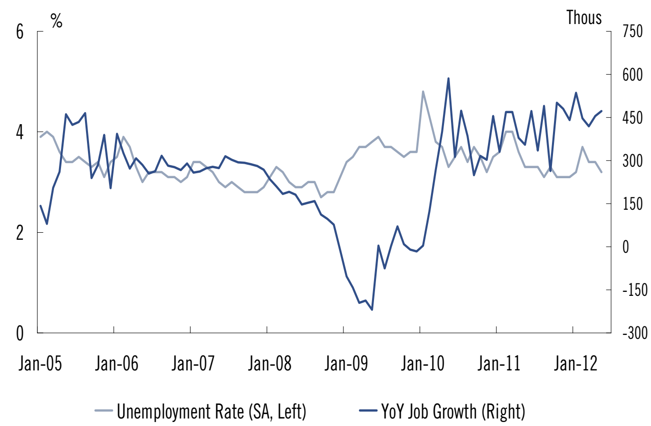
Source: Korea International Trade Association

Figure 86. Facilities investment headed up; construction dragged lower



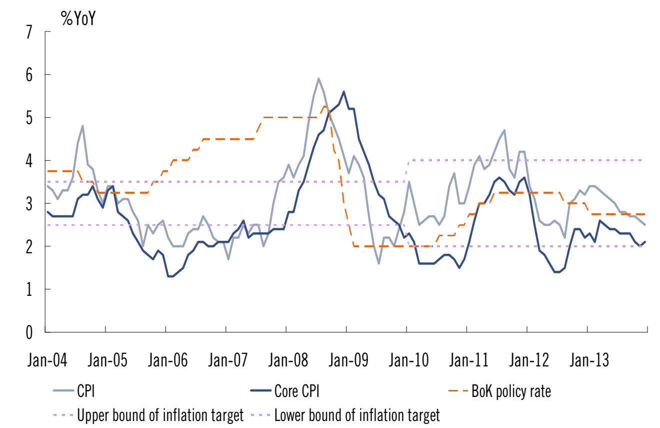
Source: Statistics Korea

Figure 87. Job growth of more than 400K YoY continues



Source: Statistics Korea

Figure 88. We expect policy rate cuts in 3Q12 and in 1Q13



Source: Statistics Korea

Figure 89. Korea Economic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013F
Summary Data									
Nominal GDP, US$ bn	845.7	954.0	1,048.0	929.1	834.7	1,014.9	1,116.6	1,131.4	1,204.7
Nominal GDP, local currency bn	865,241	908,744	975,013	1,026,452	1,065,037	1,173,275	1,237,128	1,296,605	1,380,629
GDP per capita, US$	17,568	19,722	21,565	18,981	16,972	20,540	22,431	22,626	23,988
Population, mn	48.1	48.4	48.6	48.9	49.2	49.4	49.8	50.0	50.2
Unemployment, % of labour force	3.7	3.5	3.2	3.2	3.6	3.7	3.4	3.3	3.3
Economic Activity									
Real GDP, % yoy	4.0	5.2	5.1	2.3	0.3	6.3	3.6	2.8	3.6
Real investment growth % yoy	2.3	4.4	3.5	0.0	-13.5	15.8	1.5	3.4	3.9
Real consumption growth % yoy	4.6	5.1	5.1	2.0	1.2	4.1	2.2	2.0	2.5
private consumption growth % yoy	4.6	4.7	5.1	1.3	0.0	4.4	2.3	1.5	2.0
Real export growth, % yoy	7.8	11.4	12.6	6.6	-1.2	14.7	9.5	2.0	3.3
Real import growth, % yoy	7.6	11.3	11.7	4.4	-8.0	17.3	6.5	1.6	2.0
Prices, Money & Credit									
CPI, % yoy	2.6	2.1	3.6	4.1	2.8	3.0	4.2	3.2	2.5
CPI, % avg	2.8	2.2	2.5	4.7	2.8	3.0	4.0	2.8	3.0
Nominal wages, % yoy	6.6	5.7	0.7	3.1	2.6	6.8	1.0	4.2	5.6
Credit extension to private sector, % yoy	7.4	14.7	12.4	15.0	2.3	3.6	5.1	7.6	12.6
Policy interest rate, % eop	3.75	4.50	5.00	3.00	2.00	2.50	3.25	3.00	3.00
91-Day CD Rate, % eop	4.00	4.80	5.70	4.70	2.80	2.80	3.55	3.25	3.25
Long term yield, % eop	5.36	5.00	5.78	3.77	4.92	4.08	3.46	3.40	3.65
lc/US$, eop	1008	930	936	1263	1166	1121	1159	1149	1121
lc/US$, avg	1024	955	929	1102	1275	1156	1108	1146	1146
Balance of Payments, US$ bn									
Current account	18.6	14.1	21.8	3.2	32.8	29.4	26.5	20.0	22.4
% of GDP	2.2	1.5	2.1	0.3	3.9	2.9	2.4	1.8	1.9
Trade balance	23.2	16.1	14.6	-13.3	40.4	41.2	30.8	23.6	27.2
Exports	284.4	325.5	371.5	422.0	363.5	466.4	555.2	567.7	594.2
Imports	261.2	309.4	356.8	435.3	323.1	425.2	524.4	544.1	567.1
Service balance	-10.0	-13.3	-12.0	-5.7	-6.6	-8.6	-4.4	-6.2	-6.9
Income balance	-4.3	-4.0	-3.4	3.8	1.6	-2.1	-0.1	0.0	-0.1
FDI, net	-0.1	-7.6	-17.9	-16.9	-14.9	-22.2	-15.7	-18.5	-12.5
International reserves	210.3	238.9	262.2	201.1	270.0	291.0	304.2	311.0	319.0
Total Amortisations	20.5	17.7	43.8	42.9	43.6	40.0	42.0	43.0	42.0
Public Finances, % of GDP									
Consolidated government balance	0.4	0.4	3.5	1.2	-1.7	1.4	1.5	1.2	1.5
Consolidated gov primary balance	1.6	1.7	4.9	2.6	-0.2	2.8	2.9	2.6	2.9
Public debt	27.6	30.1	29.7	29.0	32.5	31.9	32.6	33.4	32.4
of which Domestic	26.2	28.9	28.6	28.1	31.4	31.0	31.7	32.5	31.6
Foreign Assets & Liabilities, US$ bn									
External debt	161.4	225.2	333.4	317.4	345.7	359.4	398.4	413.2	426.0
Private	145.9	205.3	279.8	265.0	278.3	314.7	358.0	373.0	384.8
Public	15.5	19.9	53.6	52.4	67.4	44.7	40.4	40.2	41.2
External debt / GDP	19.1	23.6	31.8	34.2	41.4	35.4	35.7	36.5	35.4
External debt / XGS	48.3	58.9	75.0	61.9	79.1	64.9	61.3	61.1	60.1
Short-term debt	65.9	113.8	160.3	149.9	149.2	139.8	136.1	136.9	140.3
Short-term debt/International Reserves (%)	31.3	47.6	61.1	74.5	55.3	48.0	44.7	44.0	44.0

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.6	3.3	2.8	2.5	2.8	3.1	2.0	2.7	3.8
CPI, % yoy	3.8	4.2	2.6	2.6	3.0	3.2	3.3	3.0	2.7
Policy interest rate, % eop	3.25	3.25	3.25	3.25	3.00	3.00	2.75	2.75	3.00
91-Day CD Rate, % eop	3.58	3.55	3.55	3.54	3.25	3.25	3.05	3.05	3.25
Long term yield, % eop	3.66	3.46	3.70	3.40	3.30	3.40	3.35	3.40	3.60
lc vs USD, eop	1181.1	1159.3	1131.9	1160.5	1140.5	1148.9	1157.1	1163.8	1142.4

Source: CEIC Data Company Limited, Moody's and CIRA 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

Cheng-Mount Cheng
+886 2 8726 9096
chengmount.cheng@citi.com

- **Summary view** – We revise down 2012 GDP forecast again to 2.8% from 3.3% to reflect disappointing data in Apr-May. We still look for a recovery in 2H12, but at a slower speed than previously thought.
- **Things to watch** – (1) Development in Euro fiscal compact and bank union, (2) Whether China's loosening policies can make a noticeable rebound in 2H12 ; (3) Progress in cross-strait negotiation can bring some catalyst; (4) Retreating energy prices are positive for GDP growth.
- **Strategy** – Yield curve likely remains flat as long rates are well anchored. Risk-off sentiment and net outflow of foreign capital will likely weaken NT$ further. Equities are likely closer to a bottom as liquidity conditions gradually turns supportive.

We lower 2012 GDP forecast to 2.8% from 3.3%

Data in Apr-May indicate a lackluster GDP growth in 2Q12. We cut 2012 GDP forecast again on disappointing data from Apr-May, especially trade performance. Exports in Apr-May showed a deeper contraction of 6.4% YoY from a decline of 4.0% YoY in 1Q12. In particular, information and communication products (like handsets) and chemicals are two major items to explain export weakness in 2Q12. Nevertheless, exports in Apr-May are still 0.6% higher than 1Q12 average, the first positive sequential growth after contraction in the previous three quarters. By contrast, domestic demand appeared relatively resilient. Retail sales, a gauge of private consumption, showed a strong 2.3% gain in Apr-May from a decline of 1.1% in 1Q12. Industrial production also showed a 1.4% gain in Apr-May over 1Q12 average. Overall we estimate that GDP growth likely improved slightly to 1.0% YoY in 2Q12 from 0.4% YoY in 1Q12, with sequential growth picking up to 1.5% QoQ from 0.7% QoQ in 1Q12.

Survey data point to cautious outlook. Export orders stayed weak through May and diffusion index for June export orders (the proportion of optimistic firms minus those pessimistic) went down further to suggest flat exports in June. In addition, consumer confidence fell sharply in April and May as perception of overall economic outlook and investment opportunities waned. This could indicate cautious consumer spending in coming months. Most importantly, leading index has gradually softened to hint at slowing growth momentum ahead as both financial and real components of leading index kept weakening. On balance, we still believe a recovery in 2H12, albeit at a slower speed than previously thought.

Inflation pressure not likely eases on lower gasoline prices. Since the government raised gasoline prices in April to fully reflect international energy costs, international crude oil prices have been falling. Thus update retail gasoline prices have almost lowered back to pre-gasoline-hike level. However, heavy rains in May and June have caused fresh vegetable and fruit prices to soar. Consequently, CPI inflation increased to 1.74% YoY in May from 1.44% YoY in April and likely to go up further in June. We maintain our 2012 CPI forecast at 1.9% and believe CPI inflation will gradually rise going forward. This is one of reasons why we believe the CBC has not cut policy rates at June meeting and will likely maintain policy status quo for an extended period.

The CBC strengthened mortgage credit on luxury houses. At the June meeting the CBC announced a new measure to tighten mortgage credit on luxury houses. For houses worth higher than NT$80mn in greater Taipei area, and houses valued more than NT$50mn in other areas, mortgage loan-to-value ratio will be reduced to 60% or below, and with no grace period. According to Sinyi Real Estate, luxury house transaction accounted for 3% of total transaction in greater Taipei area such that CBC's new tightening measure is likely for token purpose only and will have limited impact on housing market. However, headwinds for housing markets are likely to persist as we think legislators will begin discussions on raising housing taxes in the next session, which is in September

Look for catalysts from cross-strait development

Cross-strait investment protection agreement will likely increase FDI from China. Despite the delay of eighth cross-strait meeting from original June 29 on some technical issues, we still expect representatives from Taipei and Beijing governments to conclude the agreement soon. Afterwards we expect the government to lift restrictions on incoming China FDI. Further open up in financial sector could also follow. Recent opening of two China banks' branches in Taipei and one Taiwan bank's branch opening in Suzhou China signal that further breakthrough in financial market access is getting closer.

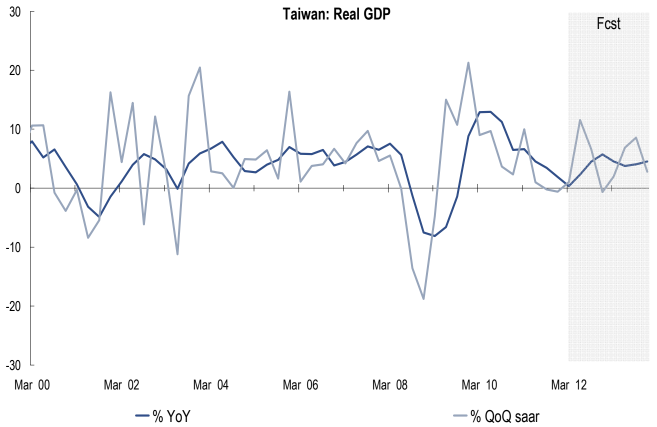
Cross-strait currency settlement will likely happen in the summer. The CBC has expressed that it is ready to sign a currency settlement agreement with China's PBoC in the summer. This agreement can save bank's transaction costs in the current CNY channel that goes through Hong Kong. The government has already granted CNY business in local bank's offshore units and we expect CNY business will continue to prosper as the business widens to domestic residents. It's still too early to prescribe Taiwan as one of CNY offshore center, but strong fundamental demand for the currency settlement will likely keep Taiwan as one of potential candidates for CNY offshore center.

Free trade agreement in service trade is next agenda. The government said that it hopes to sign a free trade agreement on service trade with Mainland China before the yearend, under which Taiwan will likely be able to increase services trade penetration to China. The government also hopes to sign a free trade agreement with China on goods trade next year on which Taiwan can expand the benefit from the so-called ECFA early harvest lists. FTA with other economies such as Singapore and New Zealand will also quicken the pace despite many hurdles ahead. The determination of the government to push forward US beef imports also demonstrates the urgency to establish FTA links with the US.

NT$ likely weakens in the summer

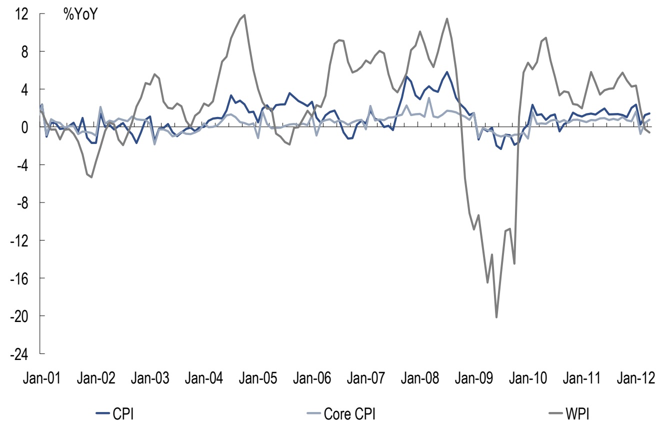
We expect NT$ to weaken to 30.3 against the USD in the next three month from current spot level to reflect persistent risk-off sentiment of investors on prolonged EU debt crisis. Long-term interest rates have been plunging along international rates and will likely stay low for a while, despite CBC's status quo in short rates. Equity markets remained downbeat but overall loose liquidity conditions could make a bottom more closer and downside protected.

Figure 90. GDP growth stay weak in 2Q12



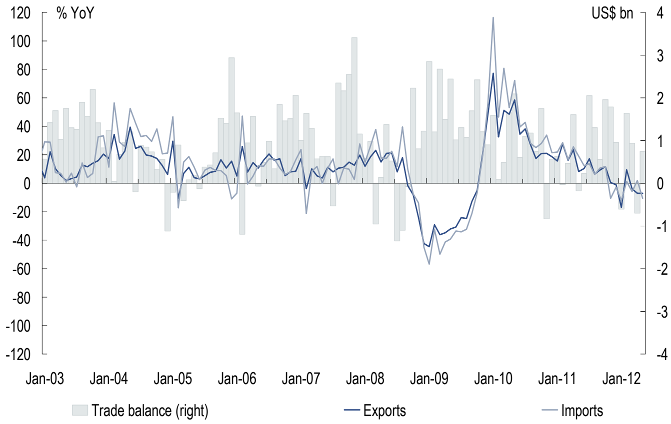
Source: CEIC Data Company Ltd., and CIRA

Figure 91. CPI inflation will not ease on lower energy costs



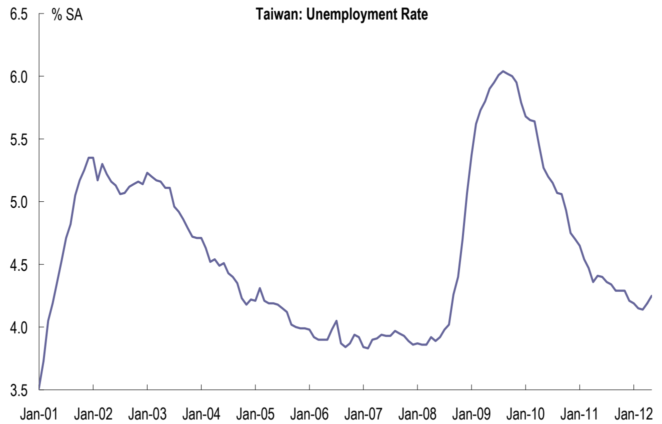
Source: CEIC Data Company Ltd., and CIRA

Figure 92. Exports weakened in 2Q12



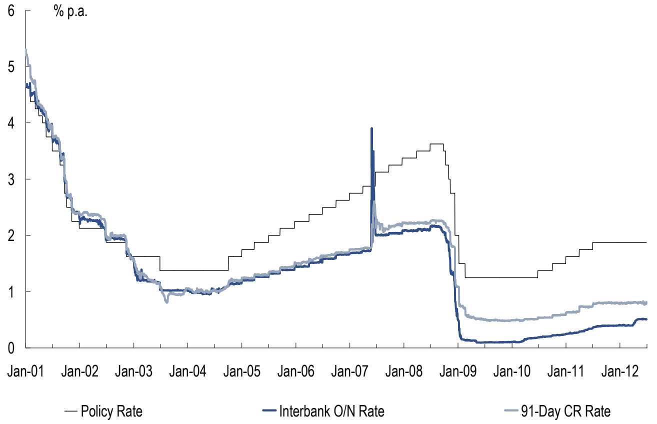
Source: CEIC Data Company Ltd., and CIRA

Figure 93. Unemployment rates have risen for recent two months



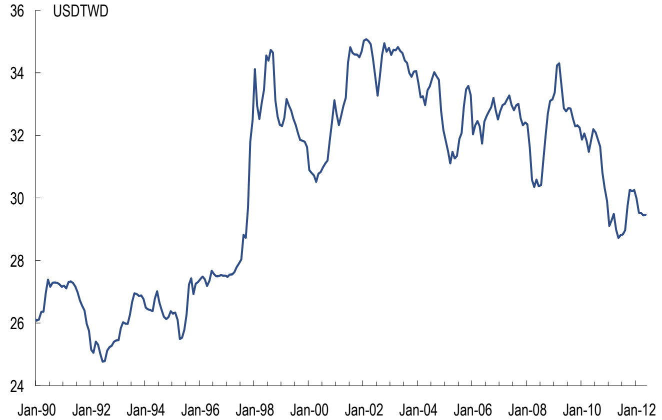
Source: CEIC Data Company Ltd., and CIRA

Figure 94. The CBC will likely keep policy rates unchanged for a while



Source: CEIC Data Company Ltd., and CIRA

Figure 95. NT$ depreciated on risk-off sentiment and net capital outflow



Source: CEIC Data Company Ltd., and CIRA

Figure 96. Taiwan Economic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	364.8	376.3	393.1	400.2	377.6	430.8	466.8	484.4	531.7
Nominal GDP, local currency bn	11,740	12,243	12,911	12,620	12,481	13,614	13,757	14,475	15,344
GDP per capita, US$	16,080	16,513	17,191	17,444	16,404	18,687	20,199	20,862	22,853
Population, mn	22.7	22.8	22.9	22.9	23.0	23.1	23.1	23.2	23.3
Unemployment, % of labour force	4.1	3.9	3.9	4.1	5.8	5.2	4.4	4.3	4.2
Economic Activity									
Real GDP, % yoy	4.7	5.4	6.0	0.7	-1.8	10.7	4.0	2.8	4.2
Real investment growth % yoy	0.0	0.5	-0.7	-7.9	-21.2	39.5	-7.6	-1.3	5.4
Real consumption growth % yoy	2.4	1.1	2.1	-0.6	1.3	3.1	2.8	1.6	2.4
private consumption growth % yoy	2.9	1.5	2.1	-0.9	0.8	3.7	3.0	1.9	3.0
Real export growth, % yoy	7.8	11.4	9.6	0.9	-8.7	25.6	4.5	2.2	6.2
Real import growth, % yoy	3.2	4.6	3.0	-3.7	-13.1	28.2	-0.6	-0.6	5.1
Prices, Money & Credit									
CPI, % yoy	2.2	0.7	3.3	1.3	-0.2	1.2	2.0	1.5	1.9
CPI, % avg	2.3	0.6	1.8	3.5	-0.9	1.0	1.4	1.9	2.1
Nominal wages, % yoy	1.0	0.8	2.1	0.0	-5.1	5.5	3.0	2.8	3.2
Credit extension to private sector, % yoy	9.7	6.8	4.8	3.9	-1.3	4.4	7.6	5.0	6.0
Policy interest rate, % eop	2.25	2.75	3.38	2.00	1.25	1.63	1.88	1.88	2.13
1 month inter-bank rate, % eop	1.45	1.69	2.04	1.02	0.57	0.74	0.87	0.87	1.00
Long term yield, % eop	1.84	1.99	2.53	1.44	1.47	1.47	1.27	1.40	1.50
lc/US$, eop	32.8	32.6	32.4	32.8	32.2	29.2	30.3	29.8	28.6
lc/US$, avg	32.1	32.5	32.9	31.6	33.0	31.5	29.4	29.9	28.9
Balance of Payments, US$ bn									
Current account	17.6	26.3	35.2	27.5	42.9	39.9	41.3	42.0	44.8
% of GDP	4.8	7.0	8.9	6.9	11.4	9.3	8.8	8.7	8.4
Trade balance	15.8	21.3	27.4	15.2	29.3	23.4	26.8	29.2	33.9
Exports	198.4	224.0	246.7	255.6	203.7	274.6	308.3	323.7	344.6
Imports	182.6	202.7	219.3	240.4	174.4	251.2	281.4	294.5	310.7
Service balance	-6.7	-3.5	-1.6	1.8	2.0	2.5	3.0	3.2	16.5
Income balance	9.0	9.6	10.1	10.0	12.5	13.6	13.0	13.5	14.0
FDI, net	-4.4	0.0	-3.3	-4.9	-3.1	-9.1	-14.5	-12.0	-7.5
International reserves	253.3	266.1	270.3	291.7	348.2	382.0	385.5	429.0	465.0
Total Amortisations	6.4	2.6	2.3	3.8	2.6	4.4	5.2	5.5	5.8
Public Finances, % of GDP									
Consolidated government balance	-0.1	0.1	0.3	-0.5	-3.5	-2.3	-1.9	-1.6	-1.6
Consolidated gov primary balance	1.2	1.4	1.6	0.8	-2.3	-1.1	-2.0	-1.5	-1.3
Public debt	30.2	29.6	28.8	30.0	38.0	38.6	38.9	39.2	39.5
of which Domestic	15.5	18.9	25.6	28.4	32.3	31.8	31.9	32.4	32.6
Foreign Assets & Liabilities, US$ bn									
External debt	86.7	85.8	94.5	90.4	82.0	101.6	124.6	117.3	112.0
Private	72.8	75.2	91.1	88.9	76.0	93.5	116.7	109.5	104.3
Public	13.9	10.6	3.5	1.5	5.9	8.0	7.9	7.8	7.7
External debt / GDP	23.8	22.8	24.0	22.6	21.7	23.6	26.7	24.2	21.1
External debt / XGS	43.7	38.4	38.3	35.5	40.3	37.1	40.6	32.2	27.5
Short-term debt	73.7	74.2	83.3	78.8	68.2	83.7	106.0	110.0	105.0
Short-term debt/International Reserves (%)	29.1	27.9	30.8	27.0	19.6	21.9	27.5	25.6	22.6

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.4	1.8	0.4	1.0	4.0	5.7	4.8	3.5	4.0
CPI, % yoy	1.4	2.0	1.2	2.0	2.4	2.5	3.2	1.6	1.7
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	2.00
1 month inter-bank rate, % eop	0.87	0.87	0.87	0.87	0.87	0.87	0.87	0.93	1.00
Long term yield, % eop	1.38	1.29	1.28	1.23	1.24	1.25	1.28	1.30	1.32
lc vs USD, eop	30.5	30.3	29.5	30.0	30.3	29.8	29.3	28.8	28.7

Source: CEIC Data Company Limited, IFS, Moody's and CIRA 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

Jun Trinidad
+63 2 894 7270
jun.trinidad@citi.com

- **Summary:** Our FY12 GDP forecast of 4.7% is unchanged although we trimmed our FY13 growth expectations to 4.6% from 5% previously lacking strong recoveries in the US and China. Replacement capex and fiscal spending catalyst should shield domestic demand in FY12 from global downside risk.
- **Things to Watch:** Sustained export gains following positive growth in May. Persistent rise in capital goods imports to signal investment-led growth. Extended delays in the passage of the reconciliation bill. More downside for core inflation with lower oil/commodity prices. Improving private spending uplifts taxes.
- **Strategy:** Value emerging in the long end with 'peak-ish' 7-month fiscal deficit, benign inflation outlook (unchanged policy rates still) and stabilizing 10yr-3yr spread. Expect the current account to revert back to a surplus (1.1% of GDP) on slumping oil prices that would ease poor sentiment on the Baht.

FY12 recovery intact despite rising global downside risk

We maintain our FY12 GDP growth forecast of 4.7%, but downgrade FY13 to 4.6% (from 5%) on the euro crisis and lack of upbeat recovery in the US and China. What can insulate the local economy from global downside risk in 2H12 would be the following: 1) sustained investment-driven growth in FY12 related to replacement capex of companies affected by the deluge; 2) fiscal spending on subsidies and cash transfers that intensified in Mar that has uplifted consumption and likely extended to the end of FY12 with a huge fiscal deficit tradeoff; 3) 1H core disinflation and a benign oil/commodity price outlook will sustain a subdued inflation setting that bodes well for purchasing power; 4) return to pre-deluge manufacturing capacity (or absence of supply disruption risk) that support 2H production and employment; 5) strong liquidity coupled government's subsidized loan program sustains bank loan growth at a healthy pace in a low interest rate setting conducive to manufacturing recovery; 6) rising investment project approvals as supply disruption risk faded; and 7) the pro-Thaksin government's willingness to delay passage of the controversial 'reconciliation bills' that won't threaten consumer/business sentiment. Spending triggers in our forecasts refer to replacement capex and the fiscal spending catalyst while the others cited support an upbeat backdrop for consumer/business sentiment while fortifying domestic demand (ex-inv) outlook which we peg at 5.1% in FY12 following 1.8% growth last year. Fiscal subsidies in particular the Bt100,000 grant to first time car buyers, have uplifted durable goods demand which in Apr grew 5.5%MoM SA (3MMA).

Global downside risk would downplay trade contribution to GDP. We think net exports would contribute 13% of FY12E GDP down from 15.7% in FY11. Next year lacking strong recovery in the US and China with the euro zone crisis persistent, we fear that the net export contribution would not change dramatically.

We lowered our growth expectations in FY13 to less than 5% on the back of a sustained bearish global trading climate. The FY12 spending triggers with emphasis on the replacement capex (underpinned upbeat private investments) do not have an indefinite life span. Next year with manufacturing production back to normal, private investments on the back of replacement capex would fade and compel investment growth to 'mean revert'. Ruling out strong recoveries in the US and China would sustain an unexciting external trade backdrop that would lead to cautious market sentiment and not just a lower net trade contribution. We continue to expect fiscal spending support but perhaps it won't be as strong as in FY12.

Fiscal deficit of Bt504bn in Oct-Apr may be peak-ish

Fiscal deficit of Bt504bn in first seven months of government's FY12 corresponds to 8.2% of GDP in our estimate. Primary expenditures soared in Jan-Apr traced to government's relief aid and rehabilitation efforts due to the floods. Primary expenditures rose by 9%yoy which masks a 32%yoy jump in 2QFY12. Subsidies, grants and social benefit spending growth of 40.2%yoy in 2QFY12 (vs -26.8%yoy in 1QFY12) provided the lift to primary expenditures. Gross revenues (before VAT transfers and rebates) grew 6.3%yoy in 2QFY12 (vs +0.1%yoy in 1QFY12). Excise taxes bucked the uptrend in collections posted by VAT (15.2%yoy), personal (5.8%yoy) and corporate (15.2%yoy) income taxes and specific taxes (21.6%yoy) in 2QFY12—a quarter of strong growth. Between soaring primary expenditures and in line revenues, the former was primarily responsible for the hefty fiscal deficit of Bt504bn (includes the non-budgetary component) roughly equal to 8.2% of GDP in the first seven months of FY12. The primary deficit was close to 6% of GDP for the same period to confirm the spending bias. Our existing FY12 fiscal deficit forecast of Bt520bn is 4.7% of FY12 GDP that's in sync with the 7-month fiscal gap. As GDP perks up in 2H12 alongside inflation stabilizing, nominal GDP gains would catch up with the deficit and cap the deficit ratio at the 4%-5%.

Expect the current account to revert back to a surplus

From a deficit of 1.3% of FY12GDP, we revise our current account forecast to a surplus of 1.1% of GDP. Behind the surplus upgrade are the following: 1) Potential for lower oil prices in the months ahead that could result in a lower oil import bill in FY12 (-3.5%). Non-oil imports still expected to post a 2-digit growth this year on the back of domestic demand could mitigate the oil price impact. The revised oil and non-oil import forecasts led to 1-digit import gain of 9.4% in FY12 (vs 19%yoy previously). 2) Slower export growth of 3.8% in FY12, down from the previous 8.5%. We align our export forecast with the Jan-Apr estimate (-3.9%yoy) which is still mired in negative territory as we enter a period of slower demand. Rewinding back to the FY09 crisis is not our base-case forecast. 3) Resulting trade surplus is estimated at US$13.1bn (vs. US$4.3bn previously) that allowed for return of the current account to a surplus of 1.1% of GDP. With a current account surplus of US$551mn in Jan-Apr, the bulk of the surplus will occur in 2H12 with significantly lower oil/commodity prices. The expected current account surplus need not jack up net exports to GDP since it is due to slumping oil prices with import volume intact.

Value emerging in the long end

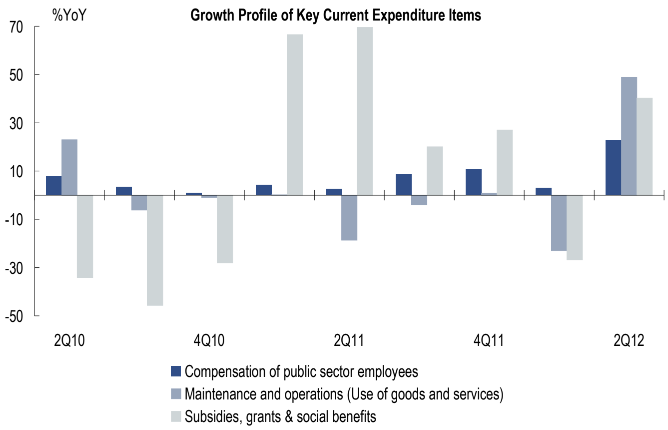
Value emerging in the long end with 'peak-ish' 7-month fiscal deficit, benign inflation outlook and stabilizing 10yr-3yr spread. Recent macro readings do not foreshadow sustained fiscal deterioration. The 1Q12 GDP upswing hailed the strong recovery that would enable tax revenues to catch-up with upbeat primary expenditures and lower the fiscal deficit risk. The ballooning fiscal deficit in Oct-Apr may be the 'fiscal worst' due to the deluge while deficit prospects may stabilize in the Bt500bn range or less depending on macro strength. Coupled with benign oil/commodity price outlook, the 10yr bond yield probing 4% has diminished. The 10yr spread versus the 3yr yield may be stabilizing at 34bp in line with its 22-day moving average, allowing value to emerge in the long end. The expected surplus could ease weakness in the capital/financial accounts in a global downturn scenario as portfolio investment flows may weaken (although a caveat would be QE3), FDI turns lackluster, and trade credits ease. Sterilization bias is likely to persist which sustains an elevated forward book in a current account surplus scenario because of the liquidity impact and threat from QE-driven portfolio investments.

Figure 97. Fiscal spending catalyst to insulate domestic demand from global downside risk

National Govt' Cash Budget Operations (Bt mn)	FY10	% NGDP	FY11	%YoY	%NGDP	FY12: Oct to Apr	%YoY	% NGDP
Revenues*	1,708,623	16.9	1,892,047	10.7	17.7	947,023	2.9	15.5
Revenue Dept	1,264,584	12.5	1,515,666	19.9	14.2	708,290	10.8	11.6
Excise Taxes	405,862	4	399,779	-1.5	3.7	211,461	-21	3.5
Customs	97,148	1	102,882	5.9	1	68,183	16.2	1.1
Others	235,453	2.3	206,051	-12.5	1.9	138,063	13.3	2.3
Expenditures	1,711,915	16.9	2,003,308	17	18.8	1,371,016	9.2	22.4
Primary expenditures	1,594,342	15.8	1,873,903	17.5	17.6	1,295,956	9	21.2
Current expenditures	1,447,373	14.3	1,672,402	15.1	15.7	1,212,445	10.6	19.8
Capital outlays	146,969	1.5	201,501	37.1	1.9	83,511	-10	1.4
Interest bill	117,573	1.2	129,405	10.1	1.2	75,060	11.9	1.2
Primary fiscal balance	114,281	1.1	18,144	-84.1	0.2	-348,933	30.2	-5.7
Budget deficit(-)/surplus(+)	-3,292	0	-111,261	3,279.70	-1	-423,993	26.6	-6.9
Non-budgetary component	-197,151	-2	-45,693	-76.8	-0.4	-80,324	30.2	-1.3
Overall fiscal deficit (-)/surplus(+)	-200,443	-2	-156,954	-21.7	-1.5	-504,317	27.1	-8.2

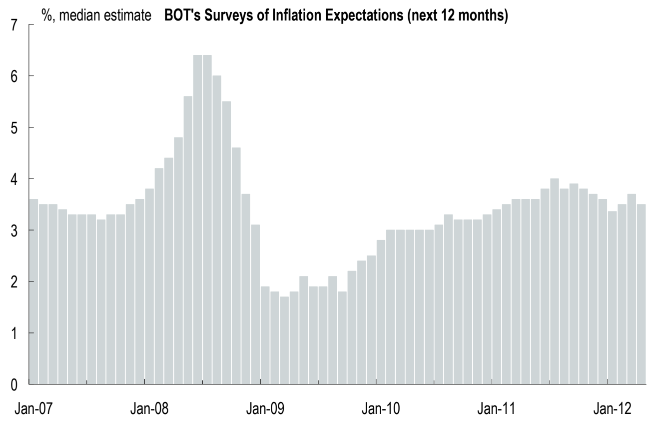
Source: CEIC Data Company Ltd., and CIRA
* - doesn't sum up to the components: Revenue department collections, excise, Customs, etc. since total revenues are net of VAT allocation to local governments, other tax rebates, etc.

Figure 98. Fiscal expenditures on maintenance, operations & subsidies



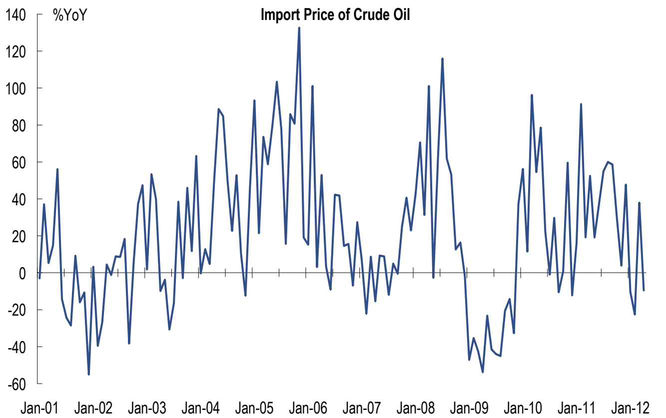
Source: CEIC Data Company Ltd., and CIRA

Figure 99. Inflation expectations eased to 3.5% in Apr



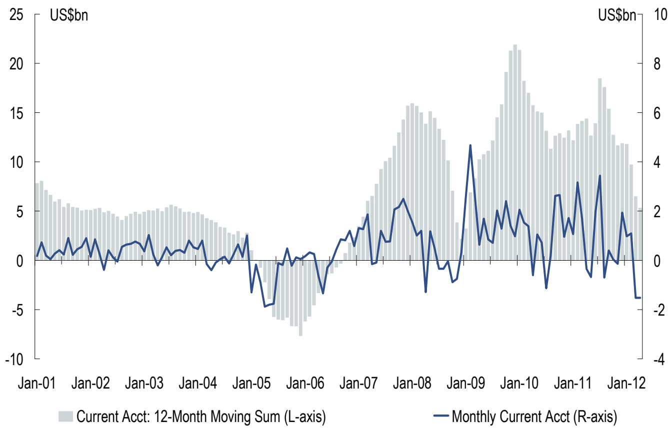
Source: CEIC Data Company Ltd., and CIRA

Figure 100. Softer average $ import price of crude in Apr



Source: CEIC Data Company Ltd., and CIRA

Figure 101. Expect the C/A revert to a surplus on slumping oil prices



Source: CEIC Data Company Ltd., and CIRA

Figure 102. Thailand Economic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	176.3	207.1	247.0	272.4	263.8	318.9	345.6	360.8	382.6
Nominal GDP, local currency bn	7,093	7,845	8,525	9,080	9,042	10,105	10,539	11,230	12,019
GDP per capita, US$	2,824	3,295	3,918	4,298	4,153	4,992	5,379	5,582	5,882
Population, mn	62.4	62.8	63.0	63.4	63.5	63.9	64.3	64.6	65.0
Unemployment, % of labour force	1.9	1.5	1.4	1.4	1.3	1.1	1.0	1.2	0.8
Economic Activity									
Real GDP, % yoy	4.6	5.1	5.0	2.5	-2.3	7.8	0.1	4.7	4.6
Real investment growth % yoy	12.8	-3.6	1.0	8.1	-25.2	28.7	0.0	21.5	9.7
Real consumption growth % yoy	5.5	3.0	2.9	2.9	0.1	5.1	1.3	3.4	3.7
private consumption growth % yoy	4.6	3.2	1.8	2.9	-1.1	4.8	1.3	3.3	3.6
Real export growth, % yoy	4.2	9.1	7.8	5.1	-12.5	14.7	9.5	4.7	4.3
Real import growth, % yoy	9.0	3.3	4.4	8.9	-21.5	21.5	13.6	9.3	5.6
Prices, Money & Credit									
CPI, % yoy	5.8	3.5	3.2	0.4	3.5	3.0	3.5	2.7	3.5
CPI, % avg	4.5	4.7	2.2	5.4	-0.9	3.3	3.8	2.9	3.2
Nominal wages, % yoy	6.9	6.2	3.0	10.2	-2.5	3.5	6.0	5.0	5.0
Credit extension to private sector, % yoy	8.0	4.5	4.8	8.8	2.5	9.1	15.0	8.8	10.0
Policy interest rate, % eop	4.00	5.00	3.25	2.75	1.25	2.00	3.25	3.00	3.50
1 month inter-bank rate, % eop	4.30	5.23	3.70	2.85	1.28	2.05	3.25	3.25	4.00
Long term yield, % eop	5.47	5.44	4.94	2.69	4.18	3.79	3.35	3.85	3.85
lc/US$, eop	41.0	35.5	30.1	34.8	33.4	30.1	31.6	31.1	30.9
lc/US$, avg	40.3	37.9	32.3	33.0	34.3	31.7	30.5	31.1	31.4
Balance of Payments, US$ bn									
Current account	-7.6	2.3	15.7	2.2	21.9	13.2	11.9	4.0	0.6
% of GDP	-4.3	1.1	6.3	0.8	8.3	4.1	3.4	1.1	0.2
Trade balance	3.4	13.7	26.6	17.3	32.6	31.8	23.5	13.1	9.1
Exports	109.4	127.9	151.3	175.2	150.8	193.7	225.4	233.9	253.8
Imports	106.0	114.3	124.6	157.9	118.2	161.9	201.9	220.8	244.7
Net service and Transfer accounts	-11.0	-11.4	-11.0	-15.2	-10.7	-18.6	-11.6	-9.1	-8.5
Income balance	-7.2	-6.7	-7.0	-7.1	-7.5	--	--	--	--
FDI, net	7.6	8.5	8.3	4.4	0.7	5.0	4.0	7.0	5.5
International reserves	50.7	65.3	85.2	108.7	135.5	167.5	167.4	175.0	185.0
Total Amortisations	8.0	15.4	19.5	12.7	16.1	15.0	16.7	17.3	18.0
Public Finances, % of GDP									
Consolidated government balance	-0.3	-1.1	-0.4	-4.3	-0.3	-2.0	-1.5	-4.7	-3.9
Consolidated gov primary balance	1.0	0.1	0.8	-3.1	0.9	-0.8	0.2	-3.1	-2.5
Public debt	26.2	24.9	24.1	23.5	29.2	29.7	29.7	31.1	30.7
of which Domestic	22.8	22.9	23.0	22.7	28.0	29.3	28.9	30.5	30.0
Foreign Assets & Liabilities, US$ bn									
External debt	59.3	70.0	74.4	76.1	75.3	100.6	97.8	100.1	102.5
Private	44.1	54.6	59.5	61.3	59.9	79.1	74.3	75.1	76.9
Public	15.2	15.4	14.9	14.8	15.4	21.5	23.5	25.0	25.6
External debt / GDP	33.6	33.8	30.1	27.9	28.5	31.5	28.3	27.7	26.8
External debt / XGS	54.2	54.7	49.2	43.4	49.9	51.9	43.4	42.8	40.4
Short-term debt	23.1	27.3	34.0	33.6	33.1	50.6	47.5	49.8	51.1
Short-term debt/International Reserves (%)	45.5	41.7	39.9	30.9	24.5	30.2	28.4	28.5	27.6

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.7	-8.9	0.3	3.8	7.2	8.0	5.0	4.7	4.3
CPI, % yoy	4.0	3.5	3.4	2.6	2.5	2.7	2.8	3.0	3.5
Policy interest rate, % eop	3.50	3.25	3.00	3.00	3.00	3.00	3.00	3.00	3.25
1 month inter-bank rate, % eop	3.55	3.25	3.04	3.25	3.25	3.25	3.25	3.25	3.50
Long term yield, % eop	3.75	3.35	3.82	3.60	3.75	3.85	3.65	3.70	3.75
lc vs USD, eop	31.2	31.6	30.9	31.8	30.7	31.1	31.5	31.9	31.4

Source: CEIC Data Company Limited, IFS, Moody's and CIRA 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

Adrienne Lui
+852 2501 2753
adrienne.lui@citi.com

Mongolia

We don't expect significant policy changes post Parliament elections (28 June). According to Polls in mid-June, the opposition Democratic Party (DP) leads the ruling Mongolian People's Partly (MPP). The economic policies in the election manifestos of these two major political parties are broadly similar and thus policy continuity with the new government (which likely would be a coalition) could be expected. The new government would have to address its citizen's dissatisfaction on unemployment, standard of living/poverty/income and inflation.

But future mining deals will likely see terms shift towards more resource nationalism. Despite the stellar 17.3%yoy and 16% real GDP growth in 2011 and forecasted in 2012E, the resource rich country is facing rising demands from its people to ensure wealth is fairly distributed and resource assets to be majority- (at least 51%) owned by Mongolian. Indeed these are advocated in both DP's and MPP's manifestos. However, as Mongolia continues to need FDI inflows (2011: USD3.8bn or 45% of GDP) to support its ongoing economic transformation, we expect full blown populist ideologies will be capped by practical needs. We take a more constructive view on the water-downed version of the Foreign Investment Law that was passed in late May, as it provides clarity to foreign participation in future projects, and signals that it will continue to welcome mutually beneficial investments.

Impacts of recent plunge in global commodity prices on Mongolian's trade, inflation and MNT -- Although Mongolian commodity exports value likely affected by recent global commodity price fall, production expansion in several mines (Oyu Tolgoi to begin copper production in 3Q12) would likely drive strong export growth this year. Meanwhile imports growth likely continue to post even faster growth given strong needs of mining machinery and fuel, sustaining the large trade deficit. CPI inflation rose 15.4%yoy or 9.2% YTD in May on food and utility price rise -- much higher than Bank of Mongolia's inflation target of 10%, calling of more monetary tightening. We have factored in another 25bps increase in our forecast this year after a 50bps hike in April. However, we do expect some reprieve in inflation on high comparison base effects in the 2H. MNT, after a 9.7% appreciation in Jan-early April (supported by exports growth and FDI inflows), has weakened by 3.5% since (reflecting the global risk-off sentiment). We expect risk appetite to dominate MNT movements in the near term with the central bank likely to intervene if pace of depreciation becomes too fast; but later in the year, the MNT could benefit from enlarge exports production.

Johanna Chua
+852 2501 2357
johanna.chua@citi.com

Sri Lanka

Significant macro policy tightening adjustments since February appear to be having a bite. Real GDP growth has slowed to 7.9% yoy in 1Q 2012 (versus 8.3% in previous quarter), the slowest pace since March 2010, led by the slowdown of manufacturing and services. With the lagged impact of macro policy tightening weighing on domestic demand alongside global growth risks (though Sri Lanka is not very exposed to external demand with a relatively low export to GDP ratio of 18%) , we nudge down our real GDP growth forecast this year to 7.1% (vs. previous 7.4%), still higher than IMF's forecast of 6.75%.

Prospects for stabilization of external finances from macro policy tightening are look more promising. Sri Lanka has one of the weakest FX reserve coverage ratios among EM (weakest in Asia). For awhile, it was unclear to what extent that several corrective action taken –floating the rupee; tax hikes on key import items such as motor vehicles, petroleum and gold; hiking petroleum and electricity prices by 30% and 20% - was having an impact. However, recent data releases in April are encouraging: 1) while yoy credit growth remain high at 34% as of April, the monthly change in loans in April has come down sharply at LKR18.1bn, only 34% of the monthly new loans in the previous six months, though this may be partly exaggerated by seasonal factors (Sinhalese/Tamil New Year); 2) imports have declined -3.3% 3% YoY (-15% MoM) in April – we estimate about 8.8% monthly decline on seasonal adjusted basis, led by consumer goods imports (especially the “others” category which include motor vehicles) and petroleum; 3) collapse in oil prices should also be favorable price effect on the trade deficit.

Post mission visit, IMF praises Sri Lanka and hints at a possible new program. With CBSL no longer intervening in the FX market (except to supply dollars for petroleum imports), and IMF disbursing a US$425mn tranche in April (a final trance is due in July) gross official FX reserves have stabilized, rising modestly from the trough of US$5.5bn in February to US$5.8bn in April. IMF praises recent policy steps, and said that it is in discussion with Sri Lanka on a “new” program (size and type unclear, though one official cited a precautionary lending facility). A new and sizeable (say ~$1.5bn) program would be positive in bolstering its BoP.

Vietnam

Johanna Chua
+852 2501 2357
johanna.chua@citi.com

Otto Chung
+852 2501 2775
otto.chung@citi.com

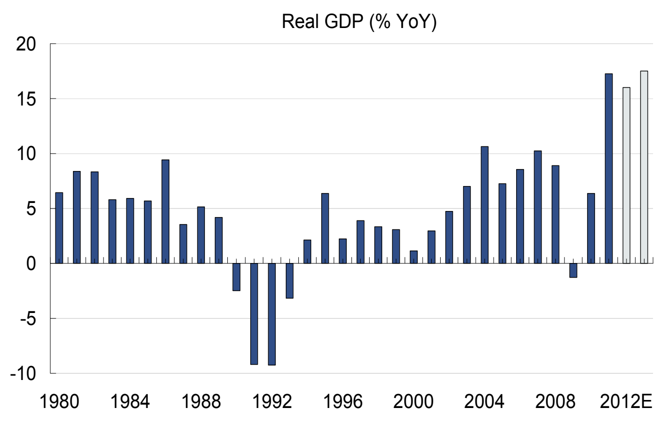
Inflation continued to come off in June led by monthly deflation on transportation and food prices. In response to the sharp decline in oil prices and Vietnam’s historical sensitivity to global oil prices, we lowered our 2012F and 2013F inflation forecasts to 9.1% and 7.3% respectively.

Growth concerns have led to more aggressive-than-expected policy easing stance, but deposit rate liberaization may contain dong weakness. After cutting 300bps ytd until May, SBV’s move this month to cut rates by “another” 100bps was a surprise following a round of fiscal easing. We think the move is driven by troubles in industrial sector and worries about asset quality deterioration in the banking sector. However, we take some comfort in the recent move to liberalize deposit rate for tenor >1 month could help contain risk of VND weakness. However, bad debts in the banking sector continue to mount. According to SBV’s report to the National Assembly, Vietnamese banks’ NPL rose further to 4.14% of total loans in April.

Policy credibility could be at risk if they loosen policy to quickly– we still expect at least 200bps of cuts. While growth/inflation still remains muted, aggressive policy easing could undermine credibility. While the trade numbers are subject to significant revisions, the preliminary trade numbers indicate a gradually widening trade deficit, albeit still much smaller than last year. We expect government will do more policy easing— at least another 200bps rate cuts this year.

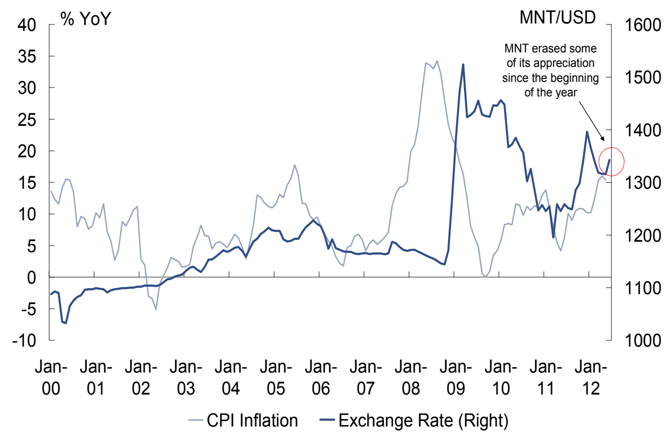
We are turning cautious on VND bonds, but dollar bonds to remain supported by scarcity. Earlier this month, we recommend taking profits on our recommendation to go long short tenor VND bonds. While VND depreciation pressure is still relatively limited, we could see renewed pressures resurfacing in 2H12 if they successfully stimulate growth. Despite lingering concerns over bank sector issues, Vietnam dollar bonds should be relatively well supported by lack of supply and some room for further positive rating developments after S&P revised the negative outlook to stable (we think Moody’s could eventually follow).

Figure 103. Mongolia: double digit real GDP growth expected in 2012-13



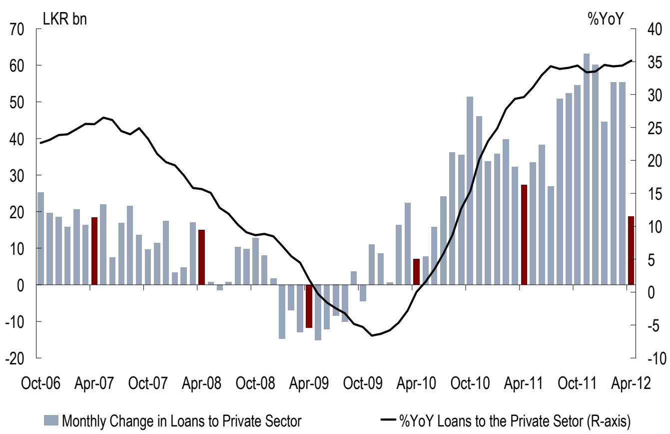
Source: IMF, Haver and CIRA estimates

Figure 104. Recent MNT depreciation could add to inflation pressures



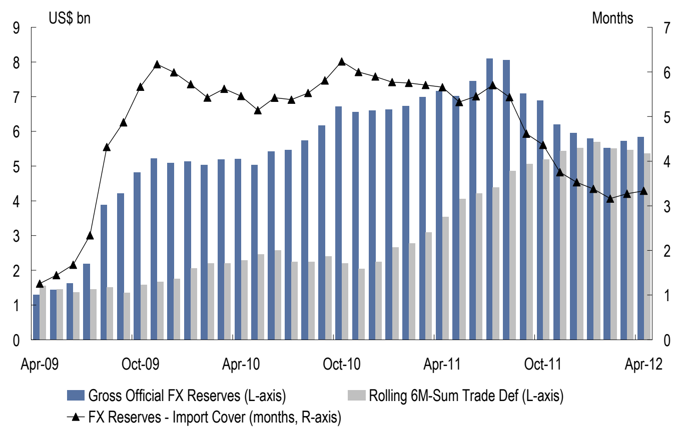
Source: BOM, NSO and CIRA

Figure 105. Sri Lanka's bank credit slowed in Apr, partly seasonal



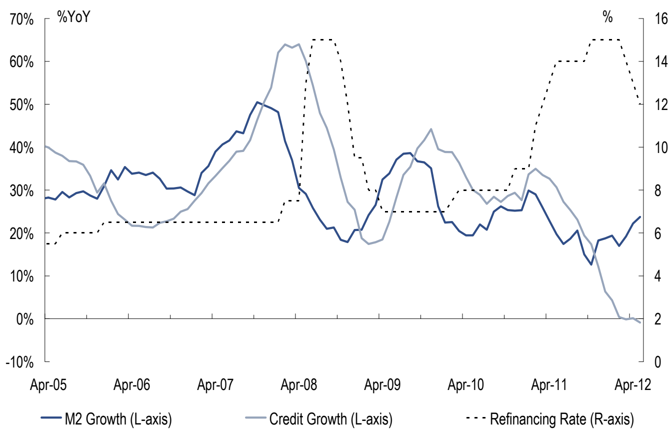
Source: CEIC Data Company Ltd., and CIRA

Figure 106. Slowing imports contained trade deficit despite weak exports



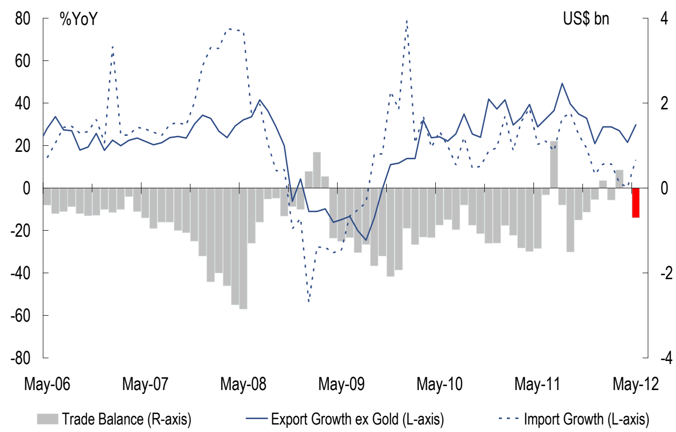
Source: CEIC Data Company Ltd., and CIRA

Figure 107. Vietnam: Monetary easing accelerated but credit still weak



Source: Various news sources, CEIC Data Company Ltd., IMF, and CIRA

Figure 108. Will the policy easing trigger trade balance deterioration?



Source: CEIC Data Company Ltd., and CIRA

Figure 109. Asia Frontier Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Mongolia									
Nominal GDP, US$ bn	2.5	3.4	4.2	5.6	4.6	6.2	8.5	11.0	14.5
GDP per capita, US$	990	1326	1623	2124	1713	2313	3105	3957	5121
Population, mn	2.6	2.6	2.6	2.6	2.7	2.7	2.7	2.8	2.8
Real GDP, % yoy	7.3	8.6	10.2	8.9	-1.3	6.4	17.3	16.0	17.5
CPI, % yoy	9.2	6.0	15.1	23.2	1.9	14.3	11.1	12.0	10.2
CPI, % avg	12.5	4.5	8.2	26.8	6.8	10.2	9.6	13.5	14.5
Policy interest rate, % eop	--	--	8.40	9.75	10.00	11.00	12.25	13.50	14.25
Long term yield, % eop	30.57	26.93	21.83	20.58	21.67	20.07	16.61	19.80	21.00
lc/US$, eop	1228	1164	1172	1275	1433	1233	1378	1312	1210
lc/US$, avg	1198	1181	1171	1167	1434	1349	1256	1326	1248
Current account	0.0	0.2	0.3	-0.7	-0.4	-0.9	-2.8	-2.8	-1.5
% of GDP	1.2	6.5	6.3	-12.9	-9.0	-14.9	-32.4	-25.4	-10.3
Trade balance	-0.1	0.1	-0.2	-1.1	-0.2	-0.4	-1.7	-1.9	-2.0
Exports	1.1	1.5	1.9	2.5	1.9	2.9	4.8	5.9	7.1
Imports	1.2	1.5	2.1	3.6	2.1	3.3	6.5	7.8	9.0
International reserves	0.3	0.6	0.8	0.6	1.3	2.2	2.7	3.2	3.7
Consolidated government balance	2.4	7.6	2.6	-4.5	-5.0	1.2	-3.6	-7.3	-0.9
Sri Lanka									
Nominal GDP, US$ bn	24.4	28.3	32.4	40.7	42.0	49.6	58.3	58.1	68.4
GDP per capita, US$	1242	1422	1609	2003	2044	2387	2775	2737	3184
Population, mn	19.7	19.9	20.1	20.3	20.5	20.8	21.0	21.2	21.5
Real GDP, % yoy	6.2	7.7	6.8	5.9	3.5	8.0	8.3	7.1	7.4
CPI, % yoy	7.5	13.5	18.8	13.9	5.0	6.9	4.9	9.1	6.7
CPI, % avg	11.0	10.0	15.8	22.5	3.4	6.0	6.8	7.0	6.8
Policy interest rate, % eop	8.75	10.00	10.50	10.50	7.50	7.25	7.75	7.50	7.50
Long term yield, % eop	10.37	12.96	19.96	19.08	9.33	7.55	7.50	7.25	7.25
lc/US$, eop	102.1	107.5	108.7	113.0	114.4	110.9	113.9	127.0	122.0
lc/US$, avg	100.5	103.9	110.6	108.3	114.9	113.0	110.5	127.5	123.6
Current account	-0.6	-1.5	-1.4	-3.9	-0.2	-1.4	-4.3	-4.0	-4.2
% of GDP	-2.7	-5.3	-4.3	-9.5	-0.5	-2.9	-7.4	-6.8	-6.1
Trade balance	-2.5	-3.4	-3.7	-6.0	-3.1	-4.8	-9.7	-10.7	-12.2
Exports	6.3	6.9	7.6	8.1	7.1	8.6	10.5	11.2	12.3
Imports	8.9	10.3	11.3	14.1	10.2	13.5	20.3	21.9	24.5
International reserves	2.5	2.5	3.1	1.8	5.1	6.6	6.0	7.0	8.0
Consolidated government balance	-8.4	-7.0	-6.9	-7.0	-9.9	-8.0	-6.9	-6.5	-6.0
Vietnam									
Nominal GDP, US$ bn	52.9	60.9	71.2	90.0	91.9	102.4	121.2	138.8	152.2
GDP per capita, US$	637	724	836	1044	1054	1163	1361	1542	1674
Population, mn	83.1	84.1	85.2	86.2	87.2	88.1	89.0	90.0	90.9
Real GDP, % yoy	8.4	8.2	8.5	6.3	5.3	6.8	5.9	5.0	5.6
CPI, % yoy	8.8	6.6	12.6	19.9	6.5	11.7	18.1	6.7	8.1
CPI, % avg	8.3	7.5	8.5	23.2	7.0	9.2	18.6	9.1	7.3
Policy interest rate, % eop	6.50	6.50	6.50	9.50	8.00	9.00	15.00	9.00	9.00
Long term yield, % eop	8.75	8.29	8.73	10.00	11.68	11.50	12.55	9.00	11.00
lc/US$, eop	15914	16056	16028	17483	18474	19498	21034	21269	21914
lc/US$, avg	15855	15990	16081	16445	17806	19123	20648	21007	21751
Current account	-0.6	-0.2	-7.0	-10.7	-7.2	-3.9	-1.3	-1.7	-5.7
% of GDP	-1.1	-0.3	-9.8	-11.9	-7.8	-3.8	-1.1	-1.2	-3.7
Trade balance	-2.4	-2.8	-10.4	-12.8	-8.3	-5.1	-3.8	-2.6	-7.7
Exports	32.4	39.8	48.6	62.7	57.1	72.2	95.2	114.2	132.5
Imports	34.9	42.6	58.9	75.5	65.4	77.3	99.0	116.8	140.2
International reserves	9.1	13.4	23.5	23.9	16.4	12.5	18.2	26.5	30.2
Consolidated government balance	-4.5	-1.1	-5.3	-4.7	-8.9	-7.9	-3.5	-4.5	-4.3

Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and CIRA

This page is intentionally left blank

CEEMEA

Czech Republic

Jaromir Sindel
+ 420 233 061 485
jaromir.sindel@citi.com

- **Summary view** — We deepened the recession of -1%YoY in 2012E, followed by a milder recovery of 1% in 2013E. We expect June CPI growth to ease to CNB tolerance band (due to be published on 11 July).
- **Things to watch** — Recent election polls suggests weakening support for the socialists, but right-wing parties are likely to lose in autumn owing to the austere 2013 budget, deal with churches and forthcoming pension reforms.
- **Strategy** — Despite weaker koruna we maintain our forecast of a cumulative 50bp cut this year to 0.25% during the 2H12. Koruna is likely to continue to underperform its trend – actually much weaker compared to pre-Lehman period.

Economy weakens more and expect weaker recovery

With disappointing confidence survey and a significant fall of GDP in 1Q12, we now expect Czech GDP to fall 1%YoY in 2012E, followed by a milder recovery of 1% in 2013E. In our new forecast we try to balance the following risks – possible upward correction of GDP in 2Q12, which is, however, offset by weaker confidence indicators – both domestic and foreign – and by somewhat weaker foreign demand. Domestic demand remains weak, hit by both fiscal consolidation and the higher CPI outturn at the beginning of 2012. While the latter is likely to ease from mid-2012, fiscal consolidation is likely to remain in place and remains one of the key disinflationary factors in the Czech economy.

Despite our negative revision of GDP forecast we incline to see further downside risks that can outturn into another downgrade in next months. The May fall in confidence highlights a risk of a stronger GDP fall by 1.3%YoY this year, below our baseline of 1%YoY contraction. The alternative scenario of deeper recession reflects a 0.2%QoQ fall in GDP in 2Q12 (there were a few one-off falls in 1Q12s GDP), while our baseline suggests a stronger benign base effect for 2Q12 (0.2%QoQ GDP growth), both followed by a cumulative 0.6% fall in 2H12. Overall, we think that these risks are conditional on: i) an upward correction of value added in the financial sector later this year; ii) benefits from still solid German growth assumed in our forecast. If neither of these conditions is fulfilled, we would expect GDP to fall 1.3%YoY in 2012 with a milder recovery in 2013 (0.6%YoY), particularly, if we take into account the fact the German PMI suggests 4-5%YoY fall in Czech industrial production, while we expect it to fall by more than 2% by end of 2012.

Domestic demand remains poor

Although GDP declined more strongly than expected in 1Q12, the fall of domestic demand was even larger and there is no improvement on the horizon. Household consumption fell 2.9%YoY in 1Q12, much stronger than real wage growth would indicate and the outlook is not rosy. The monthly April data suggests weaker wage growth. Moreover, retail sales prospects look poor as a recent fall in retail and consumer confidence suggests a 3-5%YoY contraction in retail sales (ex auto) after a 2.5% fall in April. Additionally, while the unemployment rate decreased to 8.2% in May from 8.4% in April, the reduction was less than what the seasonal factor implied. Therefore, we estimate a mild increase in the seasonally-adjusted unemployment rate of 0.1%pt MoM. Together with milder wage growth in industry, this supports our forecast of a further worsening of the labour market with the seasonally-adjusted unemployment rate at 9% at the end of 2012E from the current 8.5%.

Again, current account better, financial not so

March current account surplus improved compared to the previous year, while financial account remains weak. The March large trade surplus offset a lower inflow of EU funds and thus it continued to keep the monthly current account in surplus, although the dividend outflow has remained quite large. As a result the annual current account narrowed to 2.1% of GDP in March 2012 from 3.9% a year ago. Excluding reinvested earnings it reached -0.4% of GDP, while it was 5x larger a year ago. FDI disappointed after strong inflows into equity a month ago and returned to a performance last seen in 2011. There was an outflow from the equity and loans provided to parent companies in March. The portfolio account was negatively influenced by investment abroad. Overall, we expect the current account to be around 2.2% of GDP in 2012, narrowing from 3% in 2011, and is likely to remain a supportive fundamental for the currency, which, we however, expect to depreciate to 26 against the euro on 1year horizon.

CPI is likely to touch CNB's tolerance band earlier

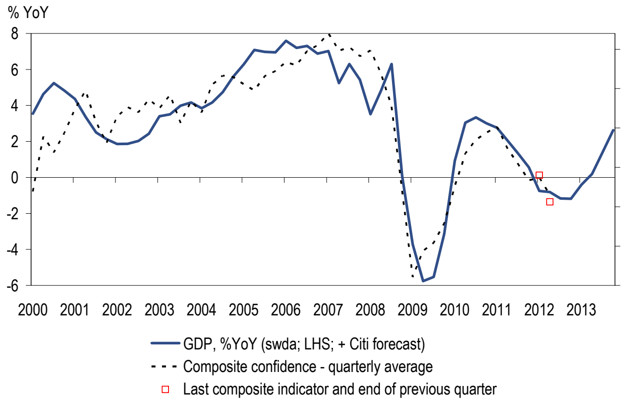
Falling food and fuel prices are likely to push down the CPI by 0.4%MoM in June that would lead to undershooting of CNB's YoY forecast by 0.6% pts. The weekly survey of food prices from the statistical office suggests to us a fall of food prices by 2%MoM that together with falling fuel prices (by 1.7%MoM) are likely to cut 0.4% pts from June's CPI outturn. As result, we lowered our forecast of CPI growth to 3%YoY in June from 3.4% initially that would be below the CNB's forecast at 3.6%. In 2013, we expect disinflation to continue, also reflecting a milder hike in the VAT rate compared to the hike in January this year - VAT rates will be hiked by another 1 percentage point to 15% and 21% (impact of 0.7%pt). This is actually a disinflationary risk for the CNB until we see a stronger wage growth.

Weaker koruna, lower policy rate and fiscal tightening

Recent data and short-term outlook support our call for 25bps cut in CNB's policy rate to 0.5% in June and another 25bps in 2H12, which is accompanied with two risks. All data published last month looked disinflationary and we expect another overshoot of CPI outturn in June that would ease concerns of some CNB Bank Board members of the potential second round effects of January's VAT hike. Therefore, despite the disinflation being driven by the non-core segment, we think it has impact on the central bank. However, the second cut in the CNB's policy rate to 0.25% later this year could be accompanied with two risks: i) easing contraction of adjusted core CPI to -0.1%, slightly above CNB's forecast (-0.2%), however, there is no apparent demand side pressure that would point to strong upside risks; ii) the EURCZK around 26 on 1year horizon is 6% weaker compared to CNB's forecast (24.4 in 2H12 and 1H13) that would point to 50bps upside risks in the policy rate. However, we think that we should relate this risks to CNB's May alternative scenario that point to zero policy rate in early 2013 owing to stronger fiscal consolidation, which we see as the baseline. Moreover, the both domestic and foreign demands are weaker that suggests the weaker koruna to be actually less inflationary.

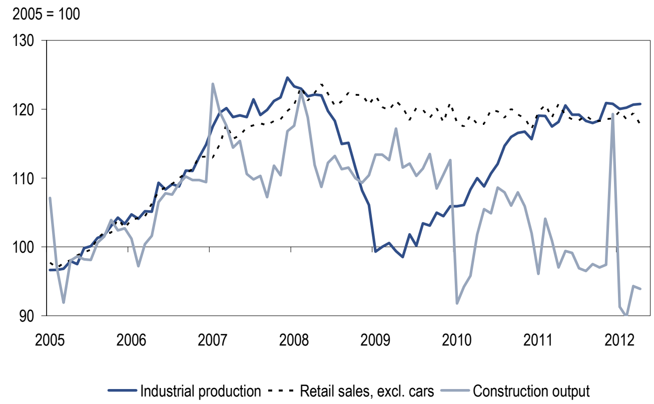
Despite the covered necessary issuance of government bonds for this year, we see some negative risks: : i) possible risk of frozen bond market during a potential "Grexit"; ii) weaker economic growth that could widen the fiscal deficit this year as, though the government remains committed to consolidation, we do not expect any new austerity measures (beyond the current large austerity package) to be introduced before autumn local and Senate election; iii) pending EU funds that point to a risk of wider fiscal deficit of around CZK23bn in 2012.

Figure 110. Confidence data points o stronger recession



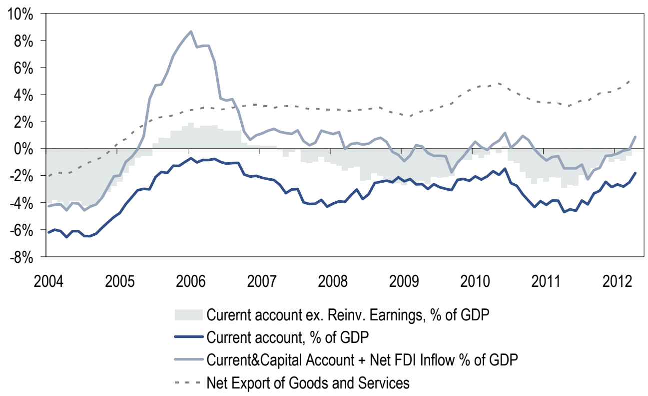
Source: Czech Statistical Office, CIRA

Figure 111. Domestic demand still far from any recovery



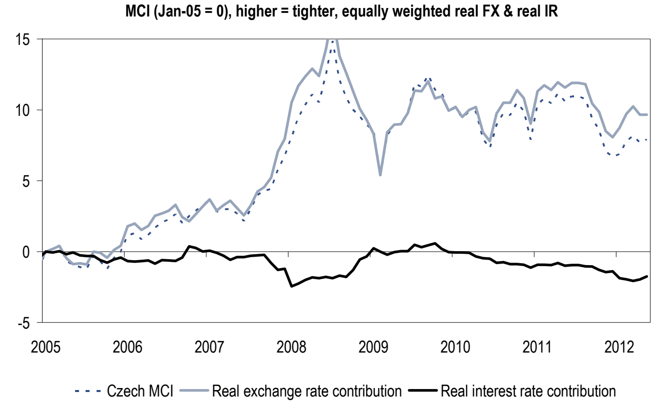
Source: Eurostat, CIRA

Figure 112. Historical trade surplus narrows the current account gap



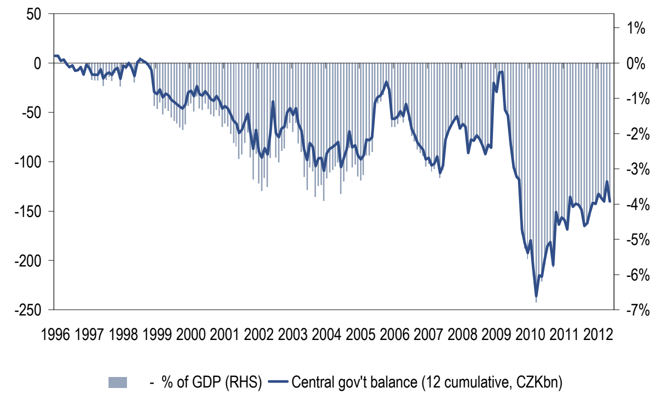
Source: Czech National Bank, CIRA

Figure 113. Monetary conditions eased somewhat , but not too much



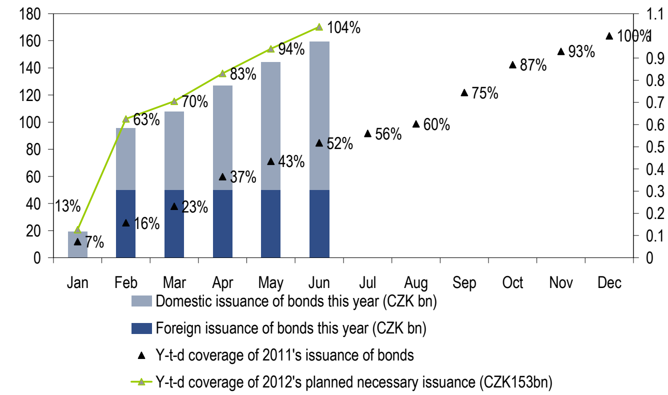
Source: Czech National Bank, Czech Statistical Office, CIRA

Figure 114. But fiscal policy continue its consolidation effort



Source: Ministry of Finance, CIRA.

Figure 115. And borrowing requirements covered this year



Source: Ministry of Finance, CIRA

Figure 116. Czech Republic Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	114.0	130.1	148.4	180.5	225.4	196.2	197.7	215.2	186.1	180.5
Nominal GDP, local currency bn	2,929	3,116	3,353	3,663	3,848	3,739	3,775	3,808	3,791	3,940
GDP per capita, US$	11,167	12,709	14,452	17,484	21,614	18,696	18,795	20,502	17,701	17,146
Population, mn	10.2	10.2	10.3	10.3	10.4	10.5	10.5	10.5	10.5	10.5
Unemployment, % of labour force	9.8	8.9	8.1	6.6	5.4	8.1	9.0	8.5	8.7	8.8
Economic Activity										
Real GDP, % yoy	4.7	6.8	7.0	5.7	3.1	-4.7	2.7	1.7	-1.0	1.0
Real investment growth % yoy	3.0	6.0	5.8	13.2	4.1	-11.5	0.1	-0.9	0.1	3.8
Real consumption growth % yoy	1.3	2.7	2.9	3.1	2.3	0.8	0.6	-1.0	-0.7	0.9
private consumption growth % yoy	3.2	3.1	4.4	4.2	2.8	-0.4	0.6	-0.6	-1.5	1.2
Real export growth, % yoy	13.6	11.6	13.8	11.2	4.0	-10.0	16.4	11.0	5.0	4.1
Real import growth, % yoy	10.0	5.9	10.8	12.8	2.7	-11.6	16.0	7.5	0.5	4.1
Prices, Money & Credit										
CPI, % yoy	2.7	2.2	1.7	5.5	3.6	1.0	2.3	2.4	3.1	2.7
CPI, % avg	2.8	1.8	2.5	2.9	6.3	1.0	1.5	1.9	3.2	2.4
Nominal wages, % yoy	6.3	5.0	6.5	7.2	7.9	3.4	2.2	2.4	2.9	3.2
Credit extension to private sector, % yoy	12.4	20.0	20.5	26.6	16.1	0.8	3.0	5.5	2.9	0.0
Policy interest rate, %, eop	2.50	2.00	2.50	3.50	2.25	1.00	0.75	0.75	0.25	0.50
1 month inter-bank rate, %, eop	2.53	2.05	2.52	3.94	3.21	1.29	0.99	0.94	0.45	0.65
Long-term yield, %, eop	-	3.57	3.72	4.72	4.29	4.04	3.95	3.59	3.50	3.30
CZK/US$, eop	22.4	24.6	20.9	18.1	19.3	18.4	18.8	19.9	21.5	20.7
CZK/US$, avg	25.7	24.0	22.6	20.3	17.1	19.1	19.1	17.7	20.4	21.8
CZK/EUR, eop	30.5	29.0	27.5	26.6	26.9	26.5	25.1	25.8	26.0	25.4
CZK/EUR, avg	31.9	29.8	28.3	27.8	25.0	26.5	25.3	24.6	25.6	25.9
Balance of Payments, US$ bn										
Current account	-5.8	-1.2	-3.1	-7.9	-4.8	-4.8	-7.6	-6.3	-4.1	-4.0
% of GDP	-5.0	-0.9	-2.1	-4.4	-2.1	-2.5	-3.8	-3.0	-2.2	-2.2
Trade balance	-0.5	2.1	2.6	2.2	1.7	4.6	2.8	5.3	6.6	7.8
Exports	67.2	71.8	85.6	106.5	125.1	99.1	114.0	138.5	130.7	122.9
Imports	67.8	69.7	83.0	104.3	123.4	94.6	111.2	133.2	124.0	115.1
Service balance	0.6	1.6	2.2	2.9	4.4	3.9	3.9	3.8	3.2	3.2
Income balance	-6.1	-5.3	-7.4	-12.7	-10.6	-13.2	-14.8	-15.6	-14.1	-15.3
FDI, net	3.9	11.6	4.0	9.0	2.3	2.0	4.9	4.2	6.0	6.0
International reserves	27.8	29.1	31.1	34.4	36.5	39.7	40.3	37.9	42.0	44.0
Total amortisations	4.52	5.26	6.00	6.04	7.67	10.06	9.85	12.9	13.7	11.5
Public Finances, % of GDP										
Consolidated government balance	-2.8	-3.2	-2.4	-0.7	-2.2	-5.8	-4.8	-3.1	-3.2	-2.9
Consolidated gov primary balance	-1.8	-2.2	-1.3	0.4	-1.2	-4.5	-3.4	-1.4	-1.6	-1.4
Public debt	28.9	28.4	28.3	27.9	28.7	34.4	38.1	41.2	44.5	45.7
of which Domestic	23.8	21.2	21.0	20.3	20.7	24.1	25.2	28.5	30.5	31.1
Foreign Assets & Liabilities, US$ bn										
External debt	45.2	46.5	57.3	76.2	84.2	89.2	94.2	93.9	90.3	98.3
Public	6.6	9.1	12.0	15.0	15.3	19.8	24.0	22.6	27.8	32.3
External debt / GDP	34.5	36.7	35.7	37.6	42.3	43.8	46.8	49.2	51.3	51.7
External debt / XGS	58.8	55.7	57.4	61.5	57.3	75.3	69.8	58.1	59.2	68.4
Short-term debt	15.4	14.6	15.4	22.6	27.1	23.9	23.6	27.7	24.5	26.0
Short-term debt/International reserves, %	55.3	50.1	49.6	65.5	74.2	60.2	58.5	73.1	58.3	59.1

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	2.1	1.3	0.6	-0.7	-0.8	-1.2	-1.2	-3.2	3.4	8.3
CPI, % yoy	1.8	1.8	2.4	3.8	3.0	2.9	2.2	2.0	2.5	2.7
Policy interest rate, %, eop	0.75	0.75	0.75	0.75	0.50	0.50	0.25	0.25	0.25	0.25
1 month inter-bank rate, %, eop	0.98	0.95	0.94	0.95	0.70	0.70	0.45	0.40	0.40	0.40
Long-term yield, %, eop	3.75	2.90	3.69	3.42	3.20	3.50	3.50	3.45	3.40	3.35
CZK/US$	16.8	18.4	19.8	18.6	20.6	20.9	21.5	22.2	22.8	21.7
CZK/EUR	24.3	24.7	25.6	24.8	25.8	25.9	26.0	26.1	26.2	25.8

Source: National Sources, Citi Investment Research and Analysis

Egypt

David Cowan
+44 20 7986 3285
david.cowan@citi.com

- **Summary view** — With the political outlook now more uncertain for 2H 2012 than at any time since early 2011, the prospects for economic reform are limited. Instead, we believe the government will continue with its economic policy of muddling through, although this should come under increasing strain.

- **Things to watch** — The new president will face a political minefield as he tries to oversee the drafting of a new constitution and balance the competing political demands of the SCAF with those of political parties and activists for more fundamental political reform.

- **Strategy** — We believe Government economic policy will continue to preserve the status quo in 2012, notably a stable exchange rate. But falling foreign exchange reserves continue to highlight that this policy option may well have run its course and harder choices have to be made in late 2012 in our view.

All eyes on the politics

For much of 2012 it was believed that the recent presidential election would mark the end of the political transition underway since early 2011. However, recent events now mean that the election is in some ways a new start. Although the election of the new president, Mohammed Mursi, probably means that protests against the Supreme Council of the Armed Forces (SCAF) are muted in the coming months, the reality is that the low voter turn-out and myriad allegations of electoral violations could undermine the strength of his mandate. The effectiveness of the government he forms will also be curtailed by the need to draw its members draws upon individuals from across Egypt's political spectrum, a potential recipe for bickering and in-fighting in the current political context.

He also faces the political reality that events prior to the presidential election mean that the SCAF has effectively wrestled back control of the political transition. Not only has parliament now been dissolved, but crucially the SCAF is now set to appoint the members of the Constituent Assembly and it will have a strong influence over the drafting process. To this end it has also indicated that a new constitution will be ready by end of October, with new parliamentary elections to be held in December. Faced with this new reality, the most likely scenario is that the transition proposed by the SCAF is accepted by the Muslim Brotherhood and other political activists. But even assuming political compromises can be cobbled together, more worrying is that there will not be decisive policy action until 2013 as the government continues to muddle through.

Funding the current account deficit

The need for more decisive policy action may come to a head in 2H 2012 if the current account continues to deteriorate. The deficit rose to US$2.34bn in 1Q 2012 as the services surplus fell sharply. But even if this is a temporary rise due to income outflows, we forecast a deficit of 2.9% of GDP with tourism earnings and Suez canal receipts both under pressure in 2H 2012. Moreover, the deficit will remain difficult to fund without a return of portfolio investors, a substantial increase in external donor support (either from the Gulf, or more widely) or a major pick up in investment inflows all of which seem unlikely with the current uncertainty. This means a return to the situation for much of 2011 in 2H 2012 when the deficit has largely been funded by the draw down of foreign exchange reserves. But with foreign exchange reserves now only US$15.5bn at the end of May 2012, the ability of the government to continue to follow this policy is severely constrained.

An exchange rate adjustment

The most obvious way to close the current account deficit in the medium term would be via a devaluation of the exchange rate. But there is a concern this would both be inflationary and increase political uncertainty and capital flight. However, with reserves now reaching critical levels, the options are limited, unless the government is prepared to open up negotiations with donors to attract sufficient funding for the current account deficit which may also “crowd in” private sector portfolio flows. Although there has been dialogue with the IMF, we think a deal is very unlikely to be a deal until 2013 at the earliest. But we also think even without donor inflows a devaluation will still be necessary in 2H 2012 or early 2013, unless the government seeks to impose some form of capital controls (or both). However, we still think the government will be reluctant to allow a major one off fall in the Egyptian pound and may seek a stepped devaluation.

Inflation may only pick up in 2013

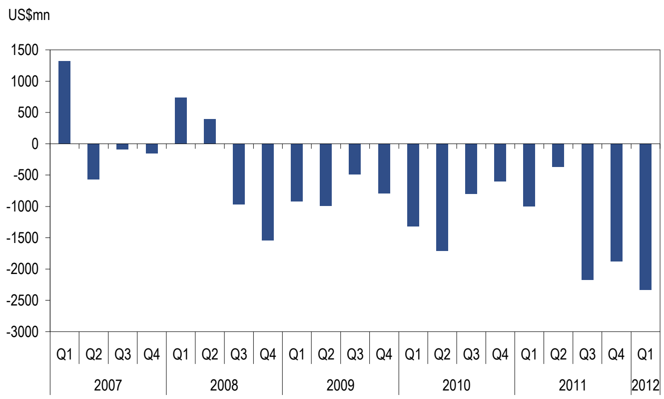
With weak growth and a stable exchange rate, inflation has remained subdued in 1H 2012. Moreover, we expect that this will continue in 2H, although we still think that the likely devaluation of the currency will mean that the inflation rate picks up in late 2012 and into 2013, although the increase will be partially limited by the country’s food and fuel subsidies. There is also likely to be an increase in the core inflation rate, which means that the Central Bank of Egypt (CBE) will have to increase interest rates. However, we think the CBE will be reluctant to raise interest rates quickly because of the weak growth environment and given the size of the fiscal deficit.

While the expected fall in the exchange rate is likely to drive a short term increase in inflation the real issue is more a medium term one: **will it help improve the current account balance?** While we think it will help, it will also be needed to be supported by other reform efforts, notably structural reforms to make the economy more competitive. Supporting this reform process and helping to fund the current account deficit, notably through the funding of infrastructural spending, is a key area that donors could support to help offset the economic dislocation caused by the devaluation. But this will require the new government and donors to reach some form of compromise agreement in early 2013, and without this, the adjustment could be much more traumatic.

Where to in 2013?

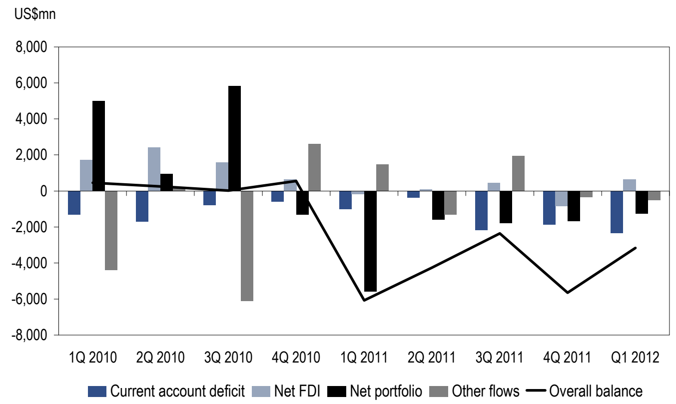
If 2012 proves to be a year of ongoing political uncertainty and economic malaise, then 2013 is potentially the year the government will have to confront the need for economic reform. But in order to more fundamentally restore growth and confidence in the economy, any government will have to quickly formulate a more coherent medium to long term policy in early 2013, either with IMF support, or on its own terms. If this is a more populist economic policy, with no long term goal to reduce the fiscal deficit, then the medium-term economic outlook in Egypt could prove to be relatively unpromising. However, we expect a more reformist minded government to push ahead with long overdue reforms. But meeting the main aim of political protestors to date - the need to create jobs and reduce inflation – against the background of the need to reduce the fiscal deficit and devalue the exchange rate, will continue to remain a tricky policy goal for any new government, especially one with only limited political experience and a weak fiscal inheritance, without significant external support.

Figure 117. The current account deficit is substantial



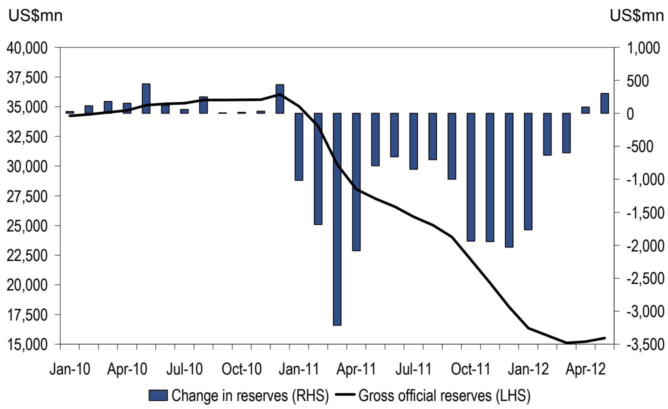
Source: Haver Analytics

Figure 118. Funding the balance of payments deficit



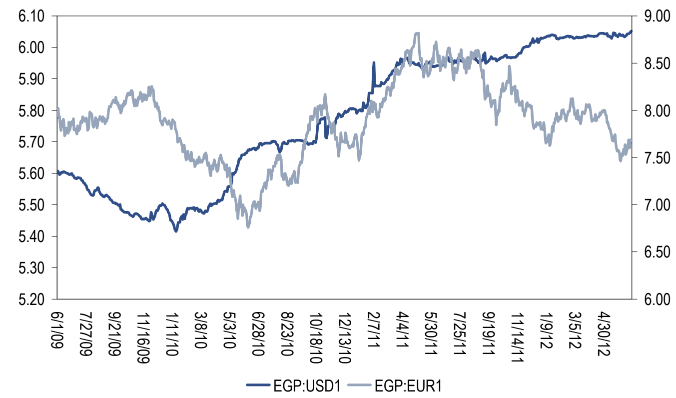
Source: Haver Analytics

Figure 119. The fall in reserves slows in early 2012



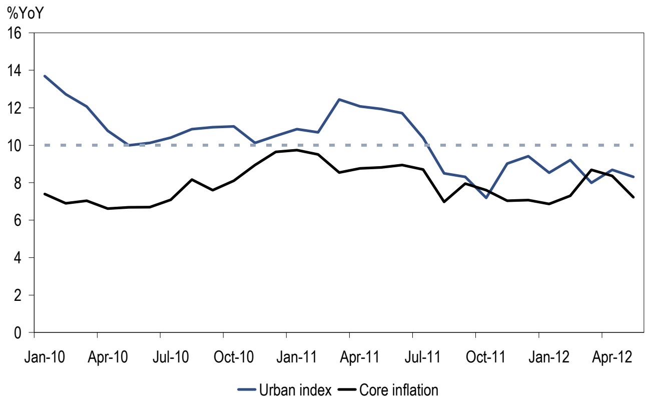
Source: Central Bank of Egypt

Figure 120. A broadly stable EGP:USD despite the pressure



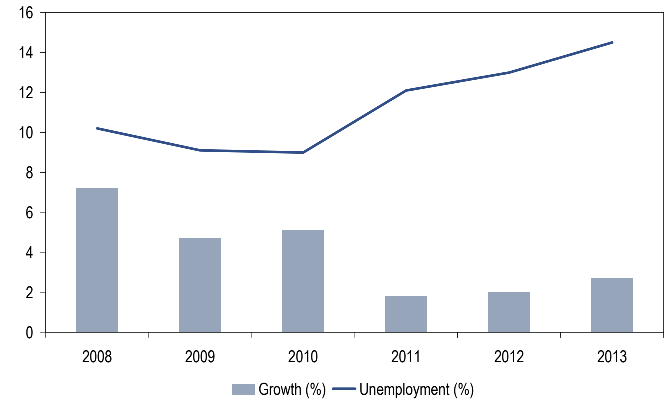
Source: Reuters

Figure 121. Inflation remains subdued



Source: Haver Analytics

Figure 122. Politics continues to weigh on the prospects of recovery



Source: Haver Analytics

Figure 123. Egypt Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	78.3	93.2	107.9	132.2	164.8	188.0	214.4	231.1	249.4	263.2
Nominal GDP, local currency bn	485	539	618	745	896	1042	1207	1372	1515	1745
GDP per capita, US$	1,075	1,256	1,427	1,717	2,101	2,352	2,634	2,787	2,952	3,059
Population, mn	73	74	76	77	78	80	81	83	84	86
Unemployment, % of labour force	10.3	11.2	10.6	8.9	8.7	9.4	9.0	12.1	13.0	14.5
Economic Activity										
Real GDP, % yoy	4.1	4.5	6.8	7.1	7.2	4.7	5.1	1.8	2.0	2.7
Real investment growth % yoy	6.3	14.2	13.8	23.7	14.8	-10.2	7.7	-5.6	3.7	6.5
Real consumption growth % yoy	2.1	4.5	5.9	7.6	5.2	5.7	4.2	4.9	2.4	1.8
private consumption growth % yoy	2.1	4.8	6.4	8.8	5.7	5.7	4.1	5.0	0.9	0.8
Real export growth, % yoy	25.3	20.2	21.2	20.2	28.8	-14.5	-3.0	3.7	-3.8	6.3
Real import growth, % yoy	17.2	23.8	21.7	30.5	26.3	-17.9	-3.2	8.1	-2.3	5.5
Prices, Money & Credit										
CPI, % yoy	11.4	3.2	12.3	6.9	18.4	13.2	10.6	9.5	8.4	13.9
CPI, % avg	11.3	4.9	7.6	9.5	18.3	11.8	11.1	10.2	8.4	12.5
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	3.6	6.3	10.3	10.0	12.0	3.0	6.7	6.1	4.0	7.5
Policy interest rate, %, eop	10.00	9.50	8.75	8.75	11.50	8.25	8.25	9.25	10.00	15.00
1 month inter-bank rate, %, eop	11.78	9.41	9.00	8.75	11.95	8.30	8.30	10.05	8.89	14.36
Long-term yield, %, eop	-	9.10	10.75	9.50	9.00	9.00	9.00	9.50	9.00	9.00
EGP/US$, eop	6.22	5.73	5.71	5.53	5.50	5.48	5.80	6.05	6.30	7.00
EGP/US$, avg	6.20	5.78	5.73	5.63	5.43	5.55	5.63	5.94	6.07	6.63
EGP/EUR, eop	8.29	6.75	7.53	8.05	7.53	7.77	7.66	7.91	7.61	8.59
EGP/EUR, avg	7.70	7.19	7.19	7.71	7.99	7.69	7.47	8.26	7.70	7.85
Balance of Payments, US$ bn										
Current account	3.2	2.0	2.5	0.2	-1.3	-3.2	-5.6	-5.4	-7.2	-9.0
% of GDP	4.1	2.2	2.3	0.2	-0.8	-1.7	-2.6	-2.3	-2.9	-3.4
Trade balance	-9.3	-11.3	-12.7	-20.8	-26.8	-22.5	-27.7	-26.1	-30.4	-26.8
Exports	12.3	16.1	20.5	24.5	29.8	23.1	25.0	27.9	26.6	28.5
Imports	21.6	27.4	33.3	45.3	56.6	45.6	52.7	54.0	57.0	55.3
Service balance	8.0	7.6	9.5	12.7	15.7	11.3	9.6	5.4	4.5	0.7
Income balance	-	-	-	-	-	-	-	-	-	-
FDI, net	2.0	5.3	9.9	10.9	7.6	6.1	5.2	-1.1	2.3	2.6
International reserves	15.5	21.9	26.1	31.7	34.2	34.2	36.0	18.1	14.0	13.4
Total amortisations	1.9	2.1	2.5	2.3	2.1	2.1	1.0	1.0	2.3	2.3
Public Finances, % of GDP										
Consolidated government balance	-6.1	-7.0	-7.7	-5.2	-6.4	-6.6	-7.7	-10.1	-9.3	-7.5
Consolidated gov primary balance	-0.4	-1.5	-2.1	0.0	-1.8	-2.4	-2.6	-4.5	-5.1	-3.7
Public debt	60.3	64.8	62.8	64.2	53.5	54.0	59.8	68.9	78.9	77.1
of which Domestic	60.3	64.8	62.8	64.2	53.5	54.0	59.8	68.9	78.9	77.1
Foreign Assets & Liabilities, US$ bn										
External debt	31.1	29.7	29.0	32.8	32.1	33.3	35.0	31.5	42.3	57.6
Public	20.7	19.7	19.0	21.6	26.0	27.2	28.3	27.2	28.2	29.7
External debt / GDP	39.7	31.9	26.8	24.8	19.5	17.7	16.3	13.6	17.0	21.9
External debt / XGS	117.6	92.4	73.9	68.8	55.6	73.0	70.9	66.5	90.8	116.8
Short-term debt	1.7	1.7	1.7	2.2	2.8	2.6	3.1	3.1	3.1	3.1
Short-term debt/International reserves, %	11.1	7.5	6.6	7.0	8.3	7.5	8.7	17.4	22.5	23.5

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	0.4	0.3	1.0	1.5	2.5	3.4	3.7	3.5	3.7	4.2
CPI, % yoy	11.7	8.3	9.4	7.9	7.7	8.3	8.4	9.9	13.1	14.5
Policy interest rate, %, eop	8.25	8.25	9.25	9.25	9.25	9.25	10.00	12.00	13.00	15.00
1 month inter-bank rate, %, eop	9.55	9.70	10.05	11.00	8.12	8.72	8.89	10.31	13.58	14.93
Long-term yield, %, eop	9.25	9.50	9.50	9.50	10.00	10.75	12.00	15.00	13.00	13.00
EGP/US$	5.97	5.97	6.03	6.04	6.05	6.05	6.30	6.50	6.50	6.80

Source: National Sources, Citi Investment Research and Analysis

Gulf Cooperation Countries

Farouk Soussa
+971 (4) 509 9750
farouk.soussa@citi.com

Saudi Arabia

We have lowered our price forecasts for Brent for 2012 and 2013, to US$115 and US$99 per barrel respectively. Although May figures show sustained oil production at just below the 10mbpd mark, meaning an average oil production of 9.75mbpd so far this year, we are lowering our production assumption to 9.5mbpd, from 9.7mbpd previously, given our view that over-supply risks in the remainder of the year will likely lead to production cuts. The result is that our economic forecasts have been revised, somewhat. We reduce our GDP growth forecast from 7.1% in 2012 to 6.8%. With no change to our expenditure forecast, we expect the government's budget surplus will come in at around 16.9% of GDP in 2012, compared to our previous forecast of 20.5% of GDP. We have not revised our forecast for growth in the non-oil economy, which should remain strong, around 8.5%, on the back of continued high government expenditure and increased domestic demand. We continue to expect progress on passing of the mortgage law in 2012, which we believe will create a significant boost to the local housing sector and domestic demand. Meantime, inflation remains sticky, flat at 5.2% in May, but we continue to expect demand side pressure to pose a significant threat to price stability in the coming months.

United Arab Emirates

Dubai International Financial Centre Investments (DIFCI) has repaid the US$1.25bn sukuk due June 13. The repayment is the second major repayment by a Dubai-based government-related entity this year, and is likely to reinforce investor confidence in Dubai's ability to manage its public sector debt overhang, in our view. We believe the macro story also remains positive. Lead indicators point to a continued recovery in Dubai's economy, with DP World announcing a 9% increase in volumes at Jebel Ali Port and DHCOG, which owns the Jumeirah Hotel group, announcing strong revenue growth. In a recent Knight Frank report, Dubai premium property prices are showing a strong recovery as well, up 4% in the first quarter of 2012, higher than any of the 22 other global cities surveyed in the report. That said, supply continues to come on line, meaning prices are likely to remain soft outside the mature premium areas of Dubai. We still see down-side risks to economic growth in the coming 18 months, including uncertainty over global economic growth and regional geo-political risks.

Kuwait

On 20 June, the constitutional court issued a ruling declaring the country's parliament null and void on the basis the Royal Decrees scrapping the previous parliament and calling for fresh elections were unconstitutional. As a result, the previous parliament, in which the opposition held a minority, has been re-instated. In addition, on 25 June the cabinet resigned over concerns it would no longer be operating within the constitutional framework. The court's decision dramatically turns on its head the balance of power within government – in February's contest, the opposition won 34 of 50 seats in parliament, giving them the majority to dominate parliamentary proceedings. In effect, this meant they had the legal muscle to 'grill' and withdraw confidence from ministers, giving them a great deal of leverage over the government. Our expectation was they would use this to pressure the government on broader reform, a possibility highlighted by two cabinet ministers' resignations in the past few weeks, including finance minister Al Shamali, who faced a grilling over allegations of financial and administrative irregularities.

The scrapping of parliament by no means heralds a more stable or co-operative policy-making environment, however. The opposition are refusing to acknowledge the decision, and have issued a statement declaring the court's ruling invalid on the basis that it does not have the authority to review Royal decrees. Opposition MPs are also likely to boycott the re-instated parliament, and there is a risk that demonstrations such as those witnessed in the lead up to parliament's dissolution last November will recur. We do not, in these circumstances, expect any progress on economic policy, particularly the implementation of the country's US$104bn economic development plan.

Bahrain

A civilian appeals court has reduced the sentences of nine medics convicted for their role in anti-regime protests last year, and acquitted a further nine. The original sentencing of medics for up to 15 years by a semi military court last year caused significant controversy and added to the unrest that the country has been experiencing since last February.

We continue to expect that plans to enter into a Union with Saudi Arabia will ramp up political and social tensions. Saudi intervention and proximity the Bahraini government is already a source of resentment to the Bahraini opposition, and the idea of a formal union with Saudi Arabia has been perceived by them as a signal that the government is digging its heals in further with respect to ongoing confrontations over political reform. Saudi Arabia is the regional Sunni power that, in the eyes of the Bahraini opposition, supported the suppression of protests in March through military intervention. Saudi is seen as hostile by the opposition, and supportive of the hard-line anti-opposition members of the Bahraini ruling family. As such, the proposed union has been strongly opposed by the opposition, and has lead to a marked escalation in anti-government protests in recent weeks.

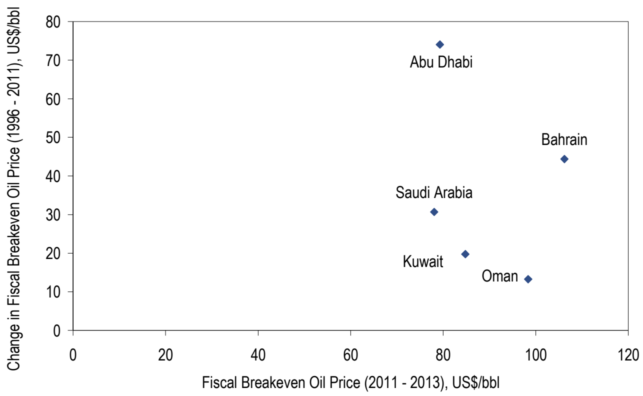
Qatar

Qatar's credit boom continues unabated. Credit growth has accelerated to over 40% yoy in May, the highest rate of growth since January 2009. The growth is fuelled by a rise in public sector deposits of 42%, and is being channelled almost exclusively to public sector entities. Their share of total credit has risen from 32% a year ago, to 45% in May.

Oman

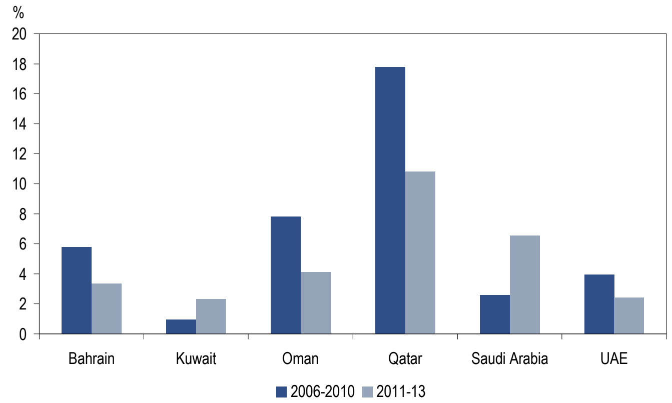
On a one-year rolling basis, latest fiscal data show a marked improvement in Oman's public finances. The budget has gone from a deficit position equivalent to 8.1% of GDP in the 12 months to Q1 2011, to a surplus position of over 10% of GDP for equivalent period in 2012, according to our calculations. However, the turnaround masks growing imbalances in Oman's public finances. The improvement reflects soaring oil production and prices, which have swelled revenues by almost 30% of GDP during this period. At the same time, government expenditure has risen by a massive 20% of GDP, leaving the budget highly exposed to a future fall in the oil price. Indeed, we estimate a fiscal break-even oil price of almost US$110 per barrel in 2012, compared with just over US$90 per barrel last year.

Figure 124. Fiscal breakeven oil prices on the rise



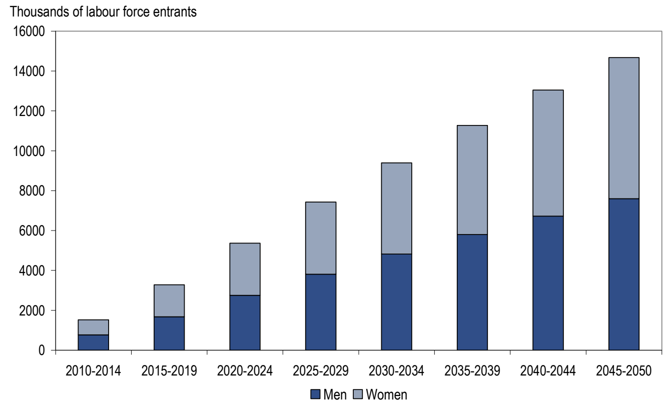
Source: Citi Investment Research and Analysis estimates

Figure 125. Economic growth will be uneven going forward



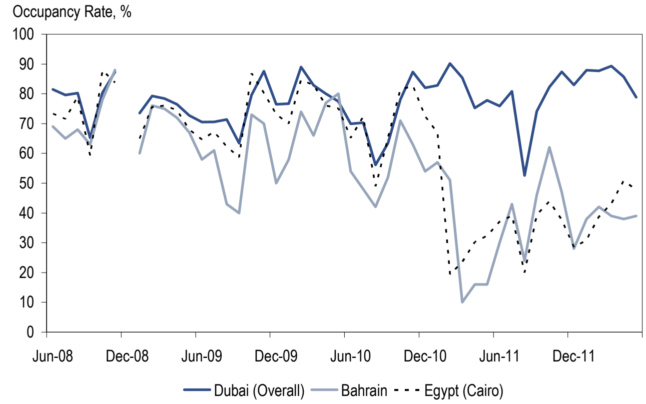
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 126. 3 million entrants in Saudi job market by end of decade



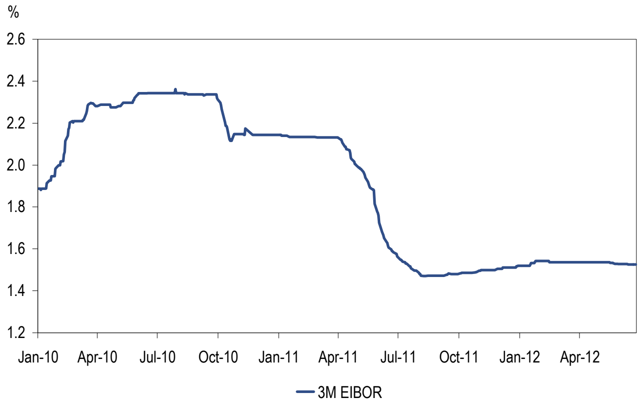
Source: Saudi Central Statistics Office, Citi Investment Research and Analysis

Figure 127. Dubai hotel occupancy continues to outperform its peers



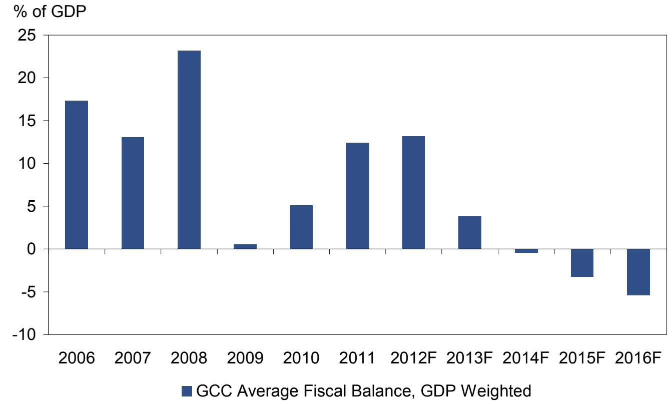
Source: Ernst & Young, Citi Investment Research and Analysis

Figure 128. EIBOR rates appear to have bottomed



Source: Haver Analytics

Figure 129. High government expenditure will drive lower surpluses



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 130. GCC Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
BAHRAIN										
Nominal GDP, US$ bn	11.2	13.4	15.8	18.5	22.4	19.6	21.9	25.8	24.7	26.3
GDP per capita, US$	16,677	18,511	19,493	19,963	21,329	16,725	17,330	19,813	18,282	24,454
Real GDP, % yoy	5.6	7.9	6.7	8.4	6.3	3.1	4.5	3.2	3.0	6.9
CPI, % avg	2.2	2.6	2.0	3.3	3.5	2.8	1.9	-0.4	3.0	3.5
BHD/US$, avg	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
Current account, US$bn	0.4	1.4	2.0	2.8	2.1	0.4	0.6	3.0	6.1	-0.4
% of GDP	3.3	10.2	12.9	14.9	9.3	1.9	2.7	11.6	24.8	-1.5
Consolidated government balance, % of GDP	4.6	7.6	4.7	3.1	7.3	-5.1	-5.6	-1.2	2.6	-4.0
KUWAIT										
Nominal GDP, US$ bn	59.4	80.8	101.9	119.2	143.2	106.2	122.8	159.1	170.6	148.5
GDP per capita, US$	27,144	35,663	43,471	49,119	57,023	40,832	45,634	57,143	59,181	49,789
Real GDP, % yoy	10.2	10.6	5.2	4.4	-1.1	-9.3	5.5	4.3	0.2	2.5
CPI, % avg	1.3	4.1	3.1	5.5	10.6	4.0	4.0	4.7	5.0	5.0
KWD/US$, avg	0.29	0.29	0.29	0.28	0.27	0.29	0.29	0.28	0.29	0.29
Current account, US$bn	15.6	30.1	45.5	43.0	58.5	25.8	37.5	75.7	73.8	60.2
% of GDP	26.2	37.2	44.6	36.0	40.9	24.3	30.6	47.5	43.3	40.6
Consolidated government balance, % of GDP	11.9	23.2	18.1	22.2	14.4	13.9	11.0	17.1	13.4	4.4
OMAN										
Nominal GDP, US$ bn	24.6	30.9	36.8	41.9	59.9	53.4	57.7	62.6	80.2	79.4
GDP per capita, US$	10,362	12,702	14,756	15,259	20,887	18,015	18,833	19,781	24,094	22,599
Real GDP, % yoy	0.5	12.2	3.7	10.4	14.0	4.3	6.7	4.9	3.0	4.5
CPI, % avg	0.4	1.2	3.0	5.9	12.5	3.6	3.2	4.0	3.0	3.0
OMR/US$, avg	0.39	0.39	0.39	0.38	0.38	0.39	0.39	0.39	0.39	0.39
Current account, US$bn	0.9	5.2	5.7	2.5	5.0	-0.6	1.5	2.1	2.2	12.2
% of GDP	3.6	16.8	15.4	5.9	8.4	-1.1	2.6	3.4	2.7	15.3
Consolidated government balance, % of GDP	5.4	2.5	-0.1	2.7	0.3	-3.8	-0.2	5.4	3.0	0.2
QATAR										
Nominal GDP, US$ bn	31.7	44.5	60.5	80.8	110.7	98.3	110.1	167.3	195.3	199.2
GDP per capita, US$	44,383	55,930	72,192	86,829	100,831	80,717	81,443	111,486	120,451	113,762
Real GDP, % yoy	19.2	7.5	26.2	18.0	17.7	12.0	15.2	18.1	6.0	7.8
CPI, % avg	6.8	8.8	11.8	13.6	15.2	-4.9	-2.4	3.0	3.0	3.0
QAR/US$, avg	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.6
Current account, US$bn	7.6	7.5	9.5	9.0	15.9	6.7	32.2	64.8	74.6	21.5
% of GDP	23.8	16.8	15.6	11.2	14.3	6.8	29.2	38.7	38.2	10.8
Consolidated government balance, % of GDP	16.4	9.2	8.5	10.9	10.0	15.2	2.9	8.1	7.1	14.0
SAUDI ARABIA										
Nominal GDP, US$ bn	250.3	315.3	356.1	384.6	475.9	376.6	450.8	576.8	588.6	670.8
GDP per capita, US$	11,110	13,638	15,028	15,835	19,116	14,758	17,266	21,620	21,629	24,166
Real GDP, % yoy	5.3	5.6	3.2	2.0	4.2	0.1	3.4	6.8	6.8	6.1
CPI, % avg	0.4	0.6	2.3	4.1	9.9	5.1	5.4	5.0	7.0	8.0
SAR/US$, avg	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.8
Current account, US$bn	49.3	90.6	99.6	94.3	133.0	21.5	67.4	154.3	157.7	47.6
% of GDP	19.7	28.7	28.0	24.5	27.9	5.7	14.9	26.8	26.8	7.1
Consolidated government balance, % of GDP	11.4	18.4	21.0	12.2	32.5	-6.1	5.2	13.7	16.9	-6.1
UNITED ARAB EMIRATES										
Nominal GDP, US$ bn	147.8	180.6	222.1	258.2	314.8	270.3	297.6	325.4	340.2	329.9
GDP per capita, US$	40,408	44,388	52,521	57,526	66,069	55,079	58,882	62,488	62,642	58,022
Real GDP, % yoy	9.6	4.9	9.9	3.2	3.3	-1.6	1.4	5.3	0.5	2.3
CPI, % avg	5.0	6.2	9.3	11.1	12.3	1.6	0.9	0.9	1.1	2.9
AED/US$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account, US$bn	5.6	11.6	15.2	6.0	7.4	3.0	8.2	15.0	3.5	6.4
% of GDP	27.6	42.8	57.5	46.5	63.8	42.5	63.6	89.0	55.1	2.0
Consolidated government balance, % of GDP	-	-	-	-	-	-	-	-	-	-

Source: National Sources, Citi Investment Research and Analysis

Hungary

Eszter Gargyan
+36 (1) 374 5573
eszter.gargyan@citi.com

- **Summary view** — Progress in IMF talks may deliver a short term rally but the process may slow during official talks. In our view, renewed market pressure may be needed to force the government to compromise on conditions.
- **Things to watch** — ECB/IMF assessment of the Central Bank Bill modifications, comments from the IMF about the start date of loan talks and about potential loan conditions may be key market moving factors.
- **Strategy** — We expect Hungarian assets to outperform in the short term which may open the door for gradual rate cuts if inflation continues to surprise to the downside and the external risk environment remains supportive.

CB Bill modifications milestone to start IMF loan talks

Modifications to the Central Bank Bill close a seven-month long debate about monetary policy independence which has been the key obstacle to start loan aid talks since December 2011. The new Central Bank Bill addresses the IMF's key concern about monetary policy independence – which has been related to the transfer of executive rights to the MPC by the December 2011 Central Bank Bill – and may open the door to start official loan aid negotiations after the bill has been passed. The expansion of the MPC and the option to appoint one more Vice Governor has not been removed from the Bill, but PM Orban's letters to the EC, ECB and IMF aim to provide guarantee that the MPC will not be expanded before Governor Simor's mandate expires in March 2013. This in our view may be sufficient for the IMF and ECB given the next governor will be appointed by the government anyway. Parliamentary support for the Bill is likely to be a done deal, in our view, given the governing party's voting pattern and may facilitate the start official loan aid negotiations with the IMF and EU in the second half of July, according to our expectations.

We believe the government's decision to take a step forward in the negotiating process and deliver loan conditions has been motivated by the deepening EMU crises. The positive market reaction however eliminates pressure on the Government to move forward and compromise on loan conditions. Moreover the two months long summer recess starting in mid-July will also slow the process from a technical standpoint as the government may ask for parliamentary support for the loan conditions, and legal issues related to the harmonization of the judiciary bill are also part of the loan conditions. We believe the government is probably underestimating the required compromise on fiscal issues in the framework of a precautionary stand-by arrangement, which we expect to be offered to Hungary. We believe the IMF may require a shift towards more growth supportive fiscal policy and a change in the personal income tax or social contribution system in order to lower labor cost for low wage earners. Given a fully flat personal income tax system has been in the centre of the government's communication, this does not suggest a smooth agreement. We stick to our earlier view that market pressure will be needed to force the government to compromise finally, and a deal looks more likely to be concluded by late 2012. While markets could rally further in the short term on the start of the official loan talks, if external liquidity conditions will be supportive, we believe a large part of the short-term gains may be eroded as official negotiations take place and the distance between the government and the IMF's requirements become clearer.

Financial transaction tax drives fiscal adjustment in 2013

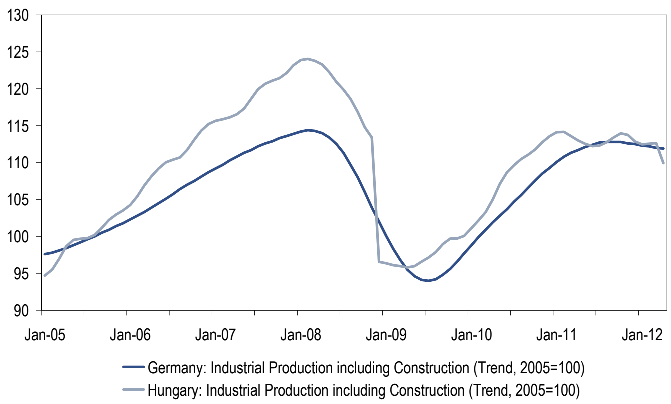
In our view the EC may be more flexible on fiscal loan conditions as the positive ECOFIN decision to lift the suspension of Cohesion Funds based on the newly announced fiscal measures suggests that the EC is unlikely to oppose the introduction of the financial transaction tax (FTT), which provides the largest part of fiscal adjustment in 2013. The EC has lowered its deficit forecasts to 2.5% and 2.7% of GDP for 2012 and 2013, respectively, following the announcement of the Szell Kalman Plan 2.0 and the submission of the 2013 budget draft bill to parliament. The most controversial part of the fiscal adjustment may be the FTT, which may be levied on all cash transactions. The government plans to collect about 1% of GDP revenues from the tax, although details have not yet been finalized. The FTT in our view may weaken local banks liquidity position further through the risk of transferring large multinational companies accounts off-shore, may contribute to bank deleveraging and adds to concerns over an unstable economic environment that has been partly explaining Hungary's weak investment ratio.

Tax revenue based fiscal measures and deteriorating external outlook suggests no improvement for Hungary's growth problems. The only positive turn in 1Q12 GDP is the stabilization in household consumption but the collapse in investments increases the negative contribution of domestic demand to growth. In the meanwhile manufacturing exports, the only driver of growth, have lost momentum, suggesting the economy is likely to decelerate further during 2012. Based on the weakening industrial outlook and the sharp fall in investments we have further downgraded our growth forecast to -0.9%YoY for 2012 and to 0.8%YoY for 2013 from -0.5% and 0.9% last month.

Lower CPI supports doves but risk premium remain key

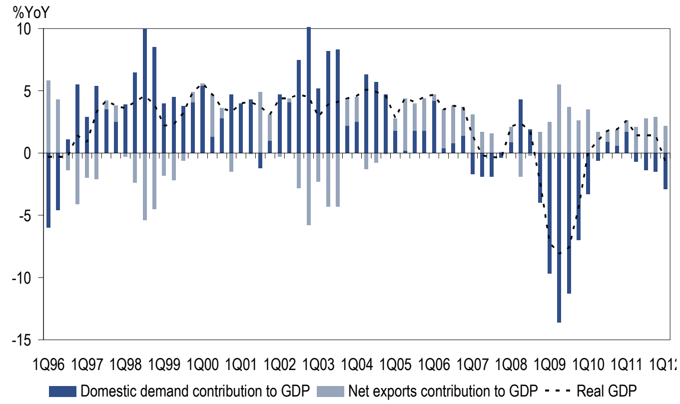
The MPC's dovish tone may strengthen as inflation surprises to the downside and the progress in the loan aid negotiating process delivers sharp decline in risk premiums. CPI has fallen from 5.7%YoY in April to 5.3% in May. The decline has been largely related to lower oil and food prices but core prices have also decelerated in the past two months breaking the accelerating core price trend from the first months of the year that has been likely driven by FX pass-through. The collapse in commodity prices and the recent currency appreciation may deliver further downside surprise in the CPI, in our view, which we now expect to decline to 4.9%YoY by year-end. Since the tax filtered core inflation measures are already close to the official 3% target and the deteriorating growth outlook may curb inflation on the medium term policy horizon, monetary policy may turn increasingly dovish in the coming months. The MPC's assessment on update of the NBH's quarterly inflation report in June will be an important anchor for rate outlook, in our view. External environment driving risk premiums and the ECB decision early July may also be key factors in the short term, determining the potential start of the rate cutting cycle in Hungary. Our base line scenario is that the MPC will start cutting rates in September delivering 100bp cumulative cuts in 25bp steps by year-end, but rate cuts starting late July or August can also be on cards if the ECB delivers significant liquidity supportive steps early July, CPI continues to surprise to the downside and the start of official IMF/EU loan negotiations delivers further appreciation in Hungarian assets.

Figure 131. Industrial exports remain exposed to downside risks…



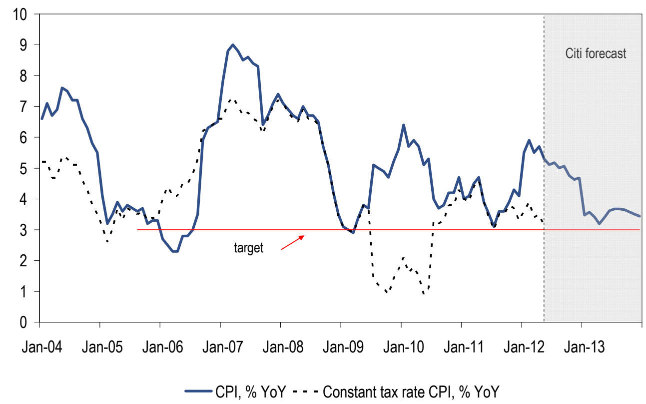
Source: Haver, CIRA

Figure 132. …while domestic demand is still contracting



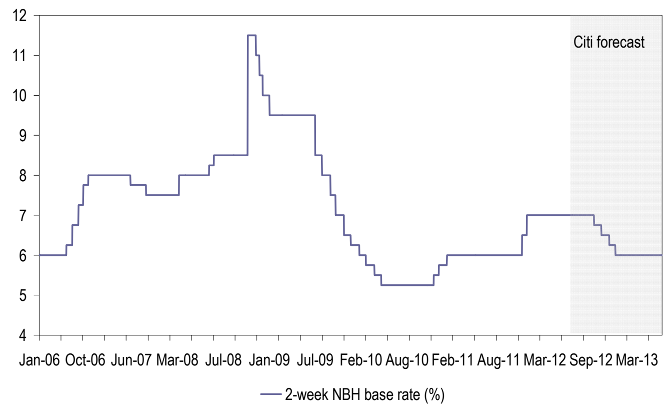
Source: Hungarian Central Statistical Office, CIRA

Figure 133. CPI shifts lower on oil and food price moderation…



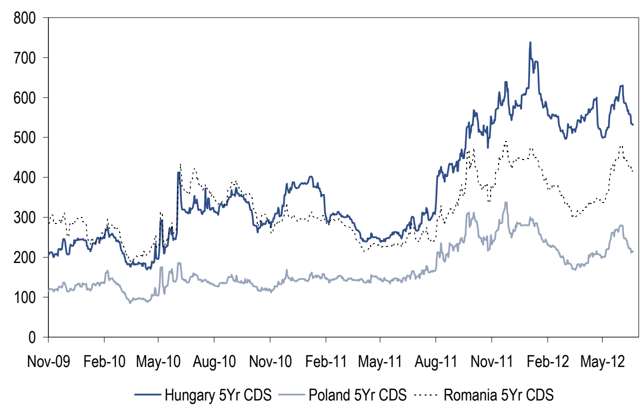
Source: National Bank of Hungary, CIRA

Figure 134. …providing arguments for significant rate cuts…



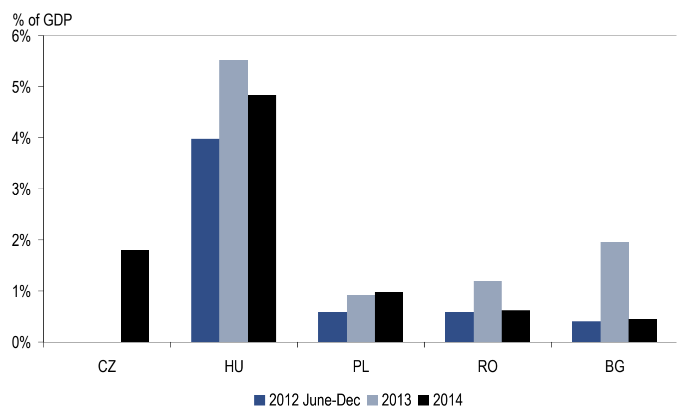
Source: National Bank of Hungary, CIRA

Figure 135. …as progress in IMF talks help to lower risk premium…



Source: Bloomberg, CIRA

Figure 136. …and cover Hungary's large FX debt redemptions



Source: Bloomberg, CIRA

Figure 137. Hungary Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	114.6	103.0	123.6	144.8	141.3	136.2	128.2	116.9	124.2	127.7
Nominal GDP, local currency bn	20,665	22,008	23,676	24,992	26,546	25,623	26,748	28,080	28,816	30,158
GDP per capita, US$	11,337	10,215	12,277	14,417	14,096	13,621	12,817	11,741	12,501	12,852
Population, mn	10.1	10.1	10.1	10.0	10.0	10.0	10.0	10.0	9.9	9.9
Unemployment, % of labour force	6.1	7.2	7.5	7.4	7.8	10.0	11.2	11.6	11.8	11.0
Economic Activity										
Real GDP, % yoy	4.8	4.0	3.9	0.1	0.9	-6.8	1.3	1.7	-0.9	0.8
Real investment growth % yoy	7.2	4.5	-2.7	3.8	2.9	-11.0	-9.7	-5.4	-5.6	-2.0
Real consumption growth % yoy	1.7	2.3	2.2	-1.4	-0.2	-4.6	-2.1	-0.1	-0.9	-0.9
private consumption growth % yoy	1.7	2.3	1.7	1.1	-0.7	-6.2	-2.2	0.0	-1.1	-0.8
Real export growth, % yoy	15.0	11.3	19.1	15.0	5.7	-10.2	14.3	8.4	2.1	5.3
Real import growth, % yoy	14.3	6.9	15.1	12.8	5.5	-14.8	12.8	6.3	1.0	4.0
Prices, Money & Credit										
CPI, % yoy	5.5	3.3	6.6	7.4	3.4	5.4	4.6	4.1	4.7	3.4
CPI, % avg	0.1	0.0	0.0	0.1	0.1	0.0	0.0	3.9	5.2	3.5
Nominal wages, % yoy	-	0.1	0.1	0.1	0.1	0.0	0.0	0.1	6.5	4.5
Credit extension to private sector, % yoy	18.6	18.9	16.7	18.8	21.7	-2.7	4.1	-0.5	-12.5	-4.1
Policy interest rate, %, eop	9.50	6.00	8.00	7.50	10.00	6.25	5.75	7.00	6.00	6.00
1 month inter-bank rate, %, eop	9.60	6.04	8.08	7.50	10.00	6.25	5.75	7.08	6.10	6.10
Long-term yield, %, eop	7.05	6.97	6.71	7.08	8.28	7.99	7.97	9.75	8.00	8.00
HUF/US$, eop	180	214	192	173	188	188	209	240	232	236.2
HUF/US$, avg	203	200	210	184	172	202	208	201	226	243.3
HUF/EUR, eop	246	253	252	253	265	271	279	311	280	290.0
HUF/EUR, avg	252	248	264	251	251	281	275	279	284	288.8
Balance of Payments, US$ bn										
Current account	-8.8	-8.2	-8.3	-9.9	-11.4	-0.2	1.6	2.0	1.5	2.4
% of GDP	-8.5	-7.6	-7.1	-7.3	-7.7	-0.1	1.2	1.6	1.2	1.9
Trade balance	-3.9	-3.2	-3.1	-0.9	-1.8	3.3	4.3	5.6	5.8	6.4
Exports	55.4	61.8	73.3	93.0	106.1	80.0	91.5	107.2	99.3	99.2
Imports	59.3	65.0	76.4	93.9	107.9	76.7	87.2	101.5	93.6	92.8
Service balance	0.6	1.5	1.8	1.8	2.2	2.8	3.9	4.5	4.3	4.5
Income balance	-5.4	-6.2	-6.7	-10.1	-11.0	-6.8	-7.1	-8.8	-9.2	-9.2
FDI, net	3.2	5.5	2.9	0.3	3.9	0.1	1.0	-0.2	1.1	1.2
International reserves	15.3	18.3	20.9	23.2	33.2	41.1	43.1	42.7	36.6	37.3
Total amortisations	7.5	8.8	7.7	9.3	15.2	16.1	15.2	14.5	15.4	14.5
Public Finances, % of GDP										
Consolidated government balance	-6.4	-7.9	-9.4	-5.1	-3.7	-4.6	-4.2	4.3	-2.8	-2.5
Consolidated gov primary balance	-2.0	-3.8	-5.5	-1.0	0.5	0.0	0.0	8.5	1.7	1.9
Public debt	59.5	61.6	65.7	66.9	72.3	78.4	80.2	81.0	79.0	78.0
of which Domestic	34.8	33.8	35.9	36.1	37.6	36.9	40.9	39.6	41.4	42.2
Foreign Assets & Liabilities, US$ bn										
External debt	81.1	85.0	114.4	151.7	172.7	194.9	183.7	174.9	162.0	168.3
Public	32.4	31.9	40.7	50.5	55.3	67.4	69.5	311.1	67.5	71.6
External debt / GDP	70.7	82.5	92.6	104.8	122.2	143.0	143.3	149.7	130.4	131.8
External debt / XGS	122.5	113.7	131.5	137.7	136.6	197.7	165.6	135.7	135.7	141.3
Short-term debt	17.0	18.6	21.9	32.0	26.8	27.3	31.3	28.5	27.8	30.7
Short-term debt/International reserves, %	111.3	101.9	105.0	138.1	80.7	66.4	72.5	66.7	76.0	82.3

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	1.4	1.4	1.4	-1.0	-0.9	-1.2	0.6	0.4	0.9	1.1
CPI, % yoy	3.5	3.8	4.0	5.4	5.1	5.1	4.7	3.4	3.6	3.6
Policy interest rate, %, eop	6.00	6.00	7.00	7.00	7.00	6.75	6.00	6.00	6.00	6.00
1 month inter-bank rate, %, eop	6.05	6.05	7.08	7.14	7.10	6.73	6.10	6.10	6.10	6.10
Long-term yield, %, eop	7.31	8.14	9.75	9.06	8.30	8.20	8.00	8.00	8.00	8.00
HUF/US$	183	219	244	221	230	222	232	242	252	244
HUF/EUR	266	293	315	295	287	275	280	285	290	290

Source: National Sources, Citi Investment Research and Analysis

Israel

David Lubin
+44 20 7986 3302
david.p.lubin@citi.com

- **Summary view** — Strong investment spending kept growth relatively robust in Q1, but Israel still faces a fall in growth this year to levels below 3%, largely driven by external shock.
- **Things to watch** — Inflation expectations have declined a bit, and are likely to stay under some downward pressure in particular because of the fall in oil prices – it was the rise in oil prices earlier this year that was instrumental in pushing expectations up in the first place.
- **Strategy** — Weaker growth and lower oil prices have led the BOI to cut its policy rate by 25 bp, and another 25 bp now seems likely against our relatively gloomy view of global developments in the next few months.

External shock is clear but domestic signals are mixed

External demand is clearly a drag on Israeli growth. Export performance has been disappointing recently, and YoY export growth has been negative in the past four months. This is mostly due to the weakness of external demand, but Israel's export performance is also being hindered by the fact that the shekel is no longer as competitive as it was during the 2000s when it benefited from the substantial real exchange rate depreciation that occurred between 2001 and 2005. One consequence of this performance is the decline in the current account surplus, which was close to zero in 2011 having enjoyed a string of surpluses between 2004-2010 averaging 2.8% GDP. Although import growth has remained rather high – again, partly thanks to an appreciated real exchange rate, although also due to low unemployment and rapid investment growth – there are other indicators of domestic spending that point to weakness. House price inflation is low; credit markets are relatively weak because banks are under pressure to rebuild their capital bases to meet new regulatory minima; and there is an absence of much wage pressure. Overall, we expect a slowdown in GDP growth to below 3% in 2012, from 4.7% in 2011.

Small current account deficits, and not permanent

The current account is likely to move into deficit for the whole year. In addition to the exchange rate, another factor supporting import growth has been the rise in energy prices in Q1: Israel is a heavy importer of energy, and the rise in raw materials imports last year accounts for half the deterioration in the trade balance. Weak global demand and high-ish energy prices have pushed the current account into deficit during the past 2 quarters: the Q1 deficit was $1.7 bn, or 2.8% GDP. Although the softening of energy prices recently will help keep the deficit manageable in 2012, there should be some upward pressure from the import requirement associated with the development of Israel's gas resources. In addition, Egypt's suspension of gas exports to Israel is likely to raise the foreign exchange cost of meeting Israel's electricity demand. Once Israel becomes a serious gas producer – around 2017 – the current account deficit will shrink rapidly, and the sovereign balance sheet should improve: the government estimates that the present value of fiscal revenues generated by Israeli gas production is in the order of US$35bn, or 15% of current GDP. A sovereign wealth fund will be created which, according to the Prime Minister's office, could reach over US$80bn in current dollars by 2040. So, the pressure on Israel's balance of payments is not structural.

Inflation expectations are on a decline

After a sharp rise in inflation expectations, things have improved and are set to get even better. 2 year inflation expectations had risen from 2% in September last year to 2.7% now, but have come under a lot of downward pressure since the start of May. We think this is largely due to the decline in oil prices: there is a strong relationship between Israeli inflation expectations and energy prices. Indeed, the global environment already been deemed sufficient to justify a June rate cut by the Bank of Israel, and it seems likely now that another cut will be delivered this year – in line with market expectations.

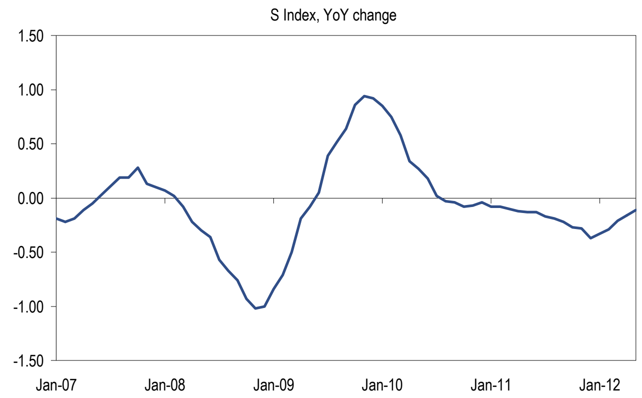
The BOI responds to global risks

The Bank of Israel cut rates in June, and another cut this year seems likely now. There are aspects of the Bank's statement this month which make its decision to cut the policy rate a bit puzzling. It notes that inflation expectations are 'relatively high'; that recent indicators of the real economy show no particular signs of slowdown; and that companies' expectations for future activity are 'slightly more positive than in previous surveys'. Moreover, the Bank's Research Department issued new forecasts that show unchanged growth in 2012 (3.1%) with inflation running during the next four quarters at 2.4%, above the 2% target midpoint. Taking all this together, our view is that the MPC has cut in order to create some preemptive stimulus on the grounds that 'concerns of a renewed worsening' of Europe's debt crisis have increased in the past few weeks. The cut, therefore, seems to us as an attempt to look beyond the data at the overall risks to the world economy. In that interpretation is correct, it seems likely that the MPC will react to further global deterioration with more monetary loosening. One possible constraint on further monetary easing is the fiscal stance. The Prime Minister has committed the government to a 3% deficit next year, which is no disaster, but probably looser than the Bank would like.

Shekel is set for further depreciation

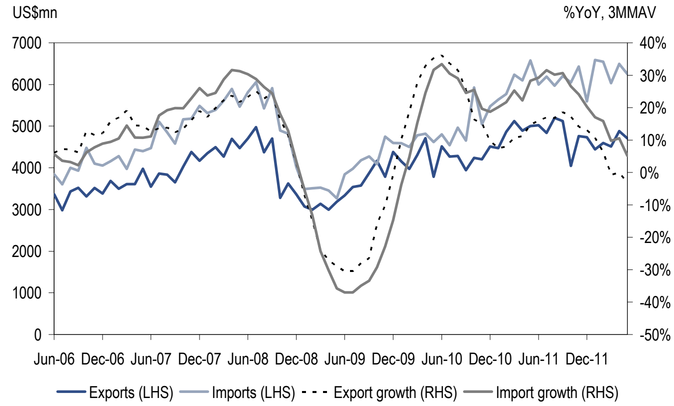
Citi's expectation that the Euro will continue to weaken is likely to put pressure on USDILS, and we expect the exchange rate to hit 4.0 in due course. It is also likely that the trade-weighted shekel will weaken if risk aversion remains alive, as was the case during late 2011. Although the shekel is relatively protected by the fact that foreigners do not own large chunks of the domestic bond market – foreign ownership is around 5-6% - the openness of the Israeli economy by itself is enough, we think, to create downward pressure on the exchange rate that prevents the Bank of Israel from needing to cut rates. Exchange rate pressure would be reinforced, of course, if the market worries again about the risk of an Israeli attack n Iran. A recent absence of that risk has helped Israeli CDS spreads to remain rather stable versus similarly-rated sovereigns. The spread between Israel and South Africa for example has narrowed from around 40bp in March – when geopolitical fears were at their height – to less than 10bp now.

Figure 138. Signs of decelerating activity…



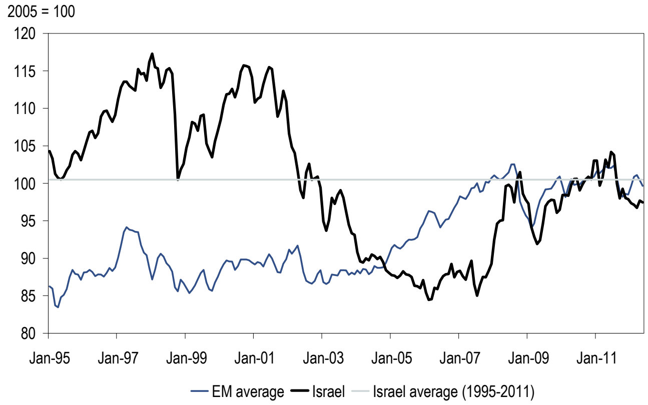
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 139. ...coincides with a deterioration in the current account



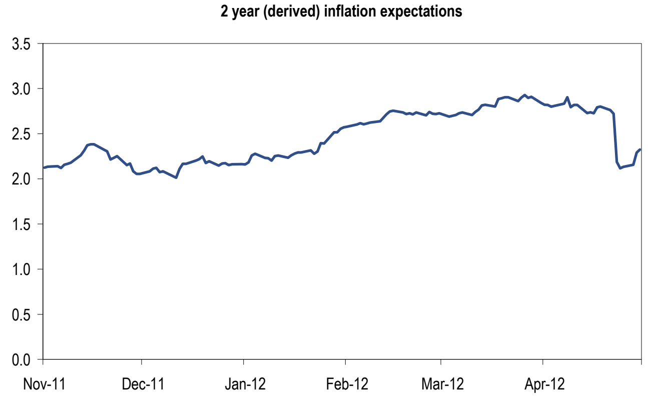
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 140. The shekel is no longer as cheap as it used to be



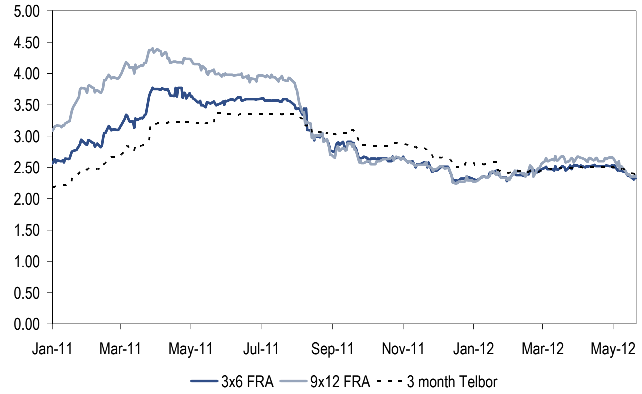
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 141. Inflation expectations have fallen…



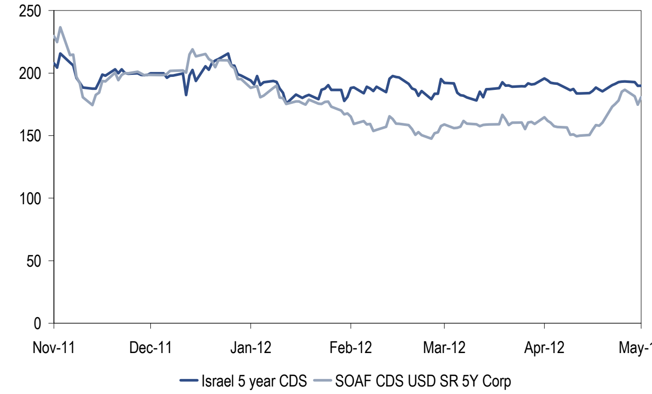
Source: Bloomberg

Figure 142. …and the market continues to price further rate cut



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 143. Falling regional risks have supported Israel CDS



Source: Markit, Citi Investment Research and Analysis

Figure 144. Israel Economic Indicators

	2004	2005	2006	2007	2008	2009F	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	126.6	134.0	145.5	167.1	201.7	194.8	217.8	242.9	236.6	244.1
Nominal GDP, local currency bn	567	601	648	687	724	766	813	869	919	976
GDP per capita, US$	19,560	20,282	21,533	24,149	28,436	26,692	28,285	27,922	29,943	30,141
Population, mn	6.5	6.6	6.8	6.9	7.1	7.3	7.7	8.7	7.9	8.1
Unemployment, % of labour force	10.4	9.0	8.4	7.3	6.2	7.6	6.5	106.5	6.2	5.7
Economic Activity										
Real GDP, % yoy	4.6	5.1	5.6	5.5	4.2	0.4	5.1	4.9	2.7	3.0
Real investment growth % yoy	-0.2	3.7	13.1	14.4	3.9	-4.3	12.7	17.7	-5.9	-0.6
Real consumption growth % yoy	2.9	2.7	3.8	5.5	2.3	1.6	4.4	3.7	5.0	3.3
private consumption growth % yoy	5.1	3.1	4.2	6.4	2.7	1.5	5.1	3.8	5.4	4.3
Real export growth, % yoy	18.0	4.5	5.2	9.8	6.5	-12.6	14.7	3.9	4.0	2.0
Real import growth, % yoy	11.8	3.9	2.7	11.7	2.5	-13.9	12.5	9.1	8.4	2.9
Prices, Money & Credit										
CPI, % yoy	1.2	2.4	-0.1	3.4	3.8	4.0	2.6	2.2	2.1	2.4
CPI, % avg	-0.4	1.3	2.1	0.5	4.6	3.3	2.7	3.4	2.0	2.2
Nominal wages, % yoy	3.8	7.0	8.2	7.2	7.9	0.9	7.5	7.7	7.0	7.2
Credit extension to private sector, % yoy	3.2	4.2	6.3	7.6	12.2	5.0	6.0	5.9	3.2	2.4
Policy interest rate, %, eop	3.70	4.50	4.50	4.25	2.50	1.00	2.00	2.75	2.00	2.00
1 month inter-bank rate, %, eop	4.06	4.75	5.03	4.50	1.90	1.31	2.06	2.74	2.00	2.00
Long-term yield, %, eop	NA	5.54	5.61	6.17	4.72	5.11	4.75	4.55	4.20	4.50
ILS/US$, eop	4.31	4.60	4.23	3.85	3.80	3.78	3.55	3.82	3.97	4.00
ILS/US$, avg	4.48	4.49	4.46	4.11	3.59	3.93	3.73	3.58	3.89	4.00
Balance of Payments, US$ bn										
Current account	2.2	4.1	7.0	4.6	1.8	7.0	6.3	0.2	-3.5	-2.5
% of GDP	1.7	3.1	4.8	2.7	0.9	3.6	2.9	0.1	-1.5	-1.0
Trade balance	-2.6	-3.5	-3.2	-5.2	-6.7	0.3	-1.9	-9.1	-9.0	-10.0
Exports	36.9	40.4	43.9	50.8	57.7	46.3	56.1	62.8	69.0	75.0
Imports	39.5	43.9	47.2	56.0	64.4	46.0	58.0	71.9	78.0	85.0
Service balance	2.5	3.0	3.6	2.7	4.1	4.3	6.2	7.0	6.0	7.0
Income balance	-4.0	-1.4	-0.8	-0.3	-4.1	-5.1	-6.3	-6.4	-7.5	-7.0
FDI, net	-1.6	1.9	-0.2	0.2	3.7	2.7	-2.8	8.1	0.0	2.0
International reserves	26.6	27.8	29.0	28.4	42.3	60.6	67.6	74.9	72.0	74.0
Total amortisations	4.73	4.72	5.31	5.60	4.66	4.47	5.00	5.00	4.00	3.80
Public Finances, % of GDP										
Consolidated government balance	-3.1	-1.4	-0.4	0.5	-1.2	-4.4	-3.0	-2.7	-3.7	-3.2
Consolidated gov primary balance	3.6	5.1	5.9	6.7	4.9	1.6	3.1	3.3	1.7	2.7
Public debt	96.1	92.0	83.0	76.2	75.5	77.9	79.3	78.5	78.3	77.4
of which Domestic	72.6	68.2	62.3	59.1	60.6	63.5	61.5	61.0	60.9	59.5
Foreign Assets & Liabilities, US$ bn										
External debt	78.5	78.2	87.5	90.8	88.4	93.3	106.0	91.0	93.0	95.0
Public	31.3	31.2	34.9	36.2	28.9	35.0	35.0	36.5	37.0	38.0
External debt / GDP	62.0	58.4	60.1	54.4	43.8	47.9	48.7	37.5	39.3	38.9
External debt / XGS	149.9	136.6	140.5	127.9	108.2	137.7	131.9	101.6	95.9	90.5
Short-term debt	6.1	6.5	7.3	8.0	8.5	9.0	9.0	10.0	12.0	13.0
Short-term debt/International reserves, %	22.8	23.3	25.1	28.2	20.1	14.9	13.3	13.4	16.7	17.6

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	5.2	4.9	3.8	3.3	2.5	2.7	3.0	2.9	3.1	2.8
CPI, % yoy	4.2	3.0	2.2	1.9	1.6	2.3	2.1	1.8	2.2	2.3
Policy interest rate, %, eop	3.25	3.25	2.75	2.50	2.25	2.00	2.00	2.00	2.00	2.00
1 month inter-bank rate, %, eop	3.27	3.00	2.74	2.50	2.25	2.00	2.00	2.00	2.00	2.00
Long-term yield, %, eop	4.70	3.80	3.50	3.59	2.90	2.80	3.90	4.00	4.25	4.75
ILS/US$	3.40	3.72	3.81	3.71	3.92	3.95	3.97	3.98	4.00	4.00

Source: National Sources, Citi Investment Research and Analysis

Kazakhstan

David Lubin
+44 20 7986 3302
david.p.lubin@citi.com

Elina Ribakova
(On maternity leave)

Natalia Novikova
(On maternity leave)

Olga Ponomarenko
+7 495 643 1549
olga.ponomarenko@citi.com

- **Summary view** — Slowdown of 1Q 12 GDP to 5.6%YoY pose risks to our annual growth forecast of around 6% and government support remains important. However the critical oil price for the economy is about US$50-60/bbl.
- **Things to watch** — The government is pursuing a risk-off strategy by rebalancing its reserves, limiting expansion of foreign capital in banks at 30% and preparing oil price at US$50/bbl.
- **Strategy** — We expect KZT/USD to weaken to 150 by the end-2012. NBK likely to resist any major appreciation. Further cuts of the refinancing rate are unlikely given the expected acceleration of inflation.

Deteriorating global environment weighs on growth

We revise growth forecast to 5.5-6% due to the weaker external environment, while domestic demand remains strong. Meanwhile, industrial production growth faded to 0.9%YoY in May. The main drag on output came from declining metal and oil production partially caused by weaker exports, with volumes of exported crude falling by about 10%YoY in January-April. Retail sales maintained 11-12%YoY growth aided by commensurate increases in real wages. Investment activity remains unstable, but still posts 5%YoY gains on average. In the base case of Brent averaging US$100 per barrel in 2H12 we see GDP moderating and annual growth falling short of our initial forecast. Weaker external demand will bring export growth down to 2%YoY (5% in 2011), while budgeted 7-7.5% hikes in wages and transfers (wages were raised by 30% in 2011) will lead to slower growth in consumption.

This year's budget based the average oil price of US$90/bbl looks manageable, but cuts may be required if it falls to US$50/bbl next year. The 2012-2013 base case assumption of Brent oil price is set at US$90/bbl, but officials do not rule out a cut in 2013 spending should oil average US$50/bbl next year. We expect no spending cuts this year since the government increased the guaranteed transfer from the Oil Fund to budget by 15%, and upbeat oil prices of 1Q12 make it more likely that 2012-average Brent will not come in lower than the US$90/bbl baseline. The government is likely to concentrate on investments, while wages will be a secondary spending item for the budget. We believe the key projects scheduled for 2013 will be implemented. Among them, the housing program implies building around 0.5mn square meters (around 10% of housing built in 2011) of residential housing annually starting in 2013 and providing subsidies to households.

Real credit growth remains strong but NPLs still weigh on the banking system. Credit growth accelerated to 18%YoY and 12-14% for corporates and households in Jan-Apr 2012. Mortgages were up 30%YoY in April. However a high proportion of NPLs and lack of reliable borrowers remain major brakes on the credit recovery, according to polls. In the meantime, the government wants to see a more robust credit growth to corporates and continues subsidizing credits. We believe NPLs will weigh on the banking system in 2013 as well, though some improvement from the residential projects and the Distressed Assets Fund is possible. The Distressed Assets Fund is expected to buy bad loans from commercial banks, issuing bonds to finance its activities. Moreover, the desire of officials to limit foreign entry into the sector may grant additional stability through isolation.

Further rate cuts are unlikely…

We do not expect further rate cuts, as inflation continued to accelerate in May and is likely to be pushed higher in 2H. The NBK slashed the refinancing rate by another 50bp to 6% on 2 June as inflation remained below the target range of 6-8% in May. The NBK expects inflation to be around 4.8-5%YoY at the end of 3Q. Meanwhile consumer inflation actually accelerated to 5%YoY in May from 4.8% in April due to the of electricity tariffs (1.6% of the CPI). We see inflation going up to the lower boundary of the target range by year-end as domestic demand remains strong and the favorable base effect fades away.

Due to the ample liquidity, the 6% refinancing rate will remain ineffective. The banking system holdings of the NBK notes remain high at US$13.5bn. Furthermore, in January-May NBK injected about US$2bn (US$0.6 in May) through the FX market, and provided about US$0.3bn net through notes in May, while the MoF sold only US$60mn of debt. This means liquidity is abundant in the system, and with net claims of the NBK to banks (excluding NBK notes) remaining negative, the 6% refinancing rate is likely to be ineffective.

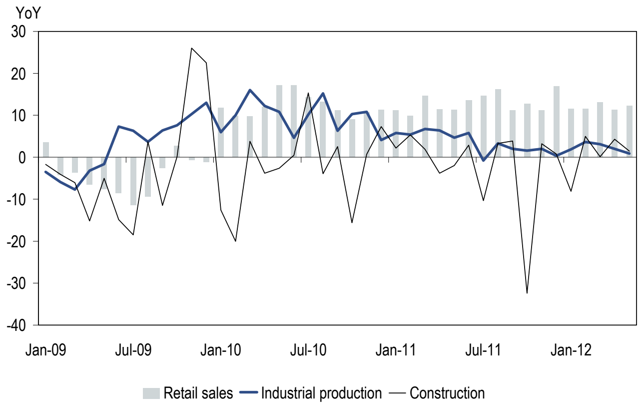
… while stable tenge remains priority

The tenge remained stable, losing just 0.5% in early June. The sharp decline in oil prices did not impose significant depreciation pressures on the tenge, and the National Bank in fact was buying FX in interventions in May. In June, however, the tenge moved to 149KZT/USD as export revenues continued declining.

The capital account should remain stable this year, while oil prices could adjust lead to the current account surplus declining. With exports falling by US$5bn annually for each US$10/bbl decrease in oil prices, we expect the current account to decline US$2bn should Brent remain at 90/bbl levels in 2H12. If Brent recovers to US$100/bbl, FDI should remain positive at US$4bn in 2012, but we envisage the balance of payments weakening, with the current account surplus falling to US$4bn. We also believe most foreign investors closed their positions in 2Q-3Q11, and therefore the volume of portfolio outflows is limited by available tenge liquidity. External debt repayments (about US$13bn including US$3.6bn of intercompany debt and about US$3bn of bank external debt) represent about half of the National Bank's reserves in foreign currencies. The NBK is concerned with the stability of its reserves, and this year it will almost double the amount of gold in them. Moreover, the concerns about Europe made NBK slash the share of EUR reserves to 25% from 30%.

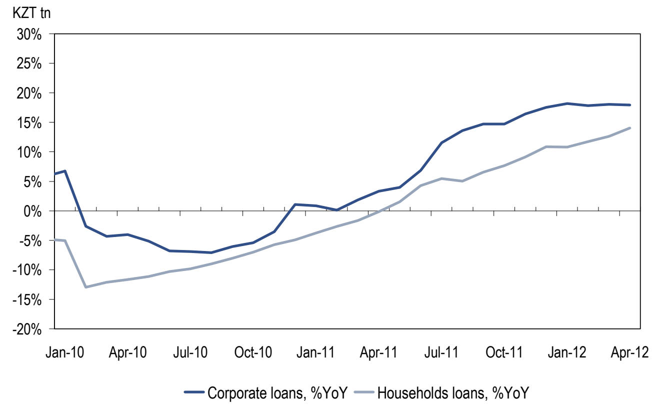
We expect KZT/USD to weaken to 150 by year-end. In its monetary policy guidelines the NBK said it would start to gradually reduce its FX market operations. However it will continue to smooth exchange rate volatility to limit its negative effect on competitiveness. National Bank Chairman, Grigory Marchenko, assured the NBK would keep tenge in the 145-151 KZT/USD range (Reuters, June 4). However, tenge depreciation would be triggered should the Russian ruble fall to 40-45 RUB/USD. In our base case scenario we see ruble at 34-35 RUB/USD by the year-end and, at these levels, the NBK will keep tenge at around 150KZT/USD. KZT devaluation looks more likely if oil falls to US$80/bbl and global risk aversion imposes pressures on ruble.

Figure 145. Robust retail sales amid other sectors' underperformance



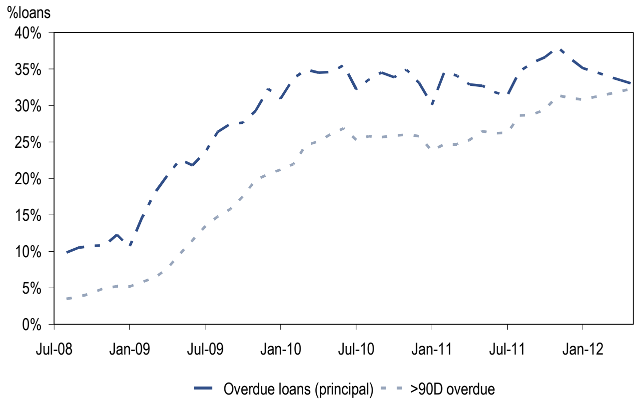
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 146. Credit growth remains strong…



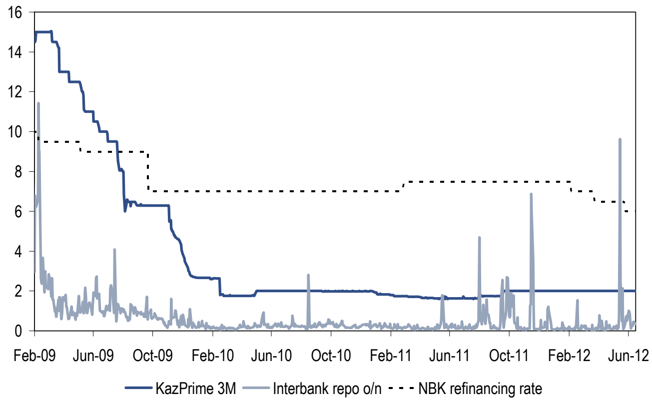
Source: AFN, CIRA estimates

Figure 147. …but still around 1/3 of loans are non-performing



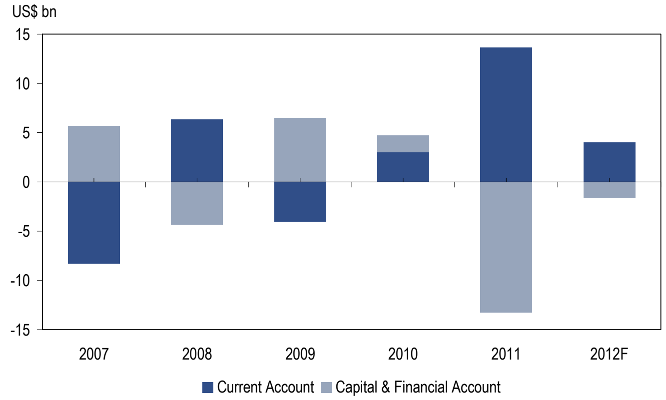
Source: Haver Analytics, Ministry of Finance, CIRA estimates

Figure 148. Market is unlikely to be affected by the cut in refinancing rate



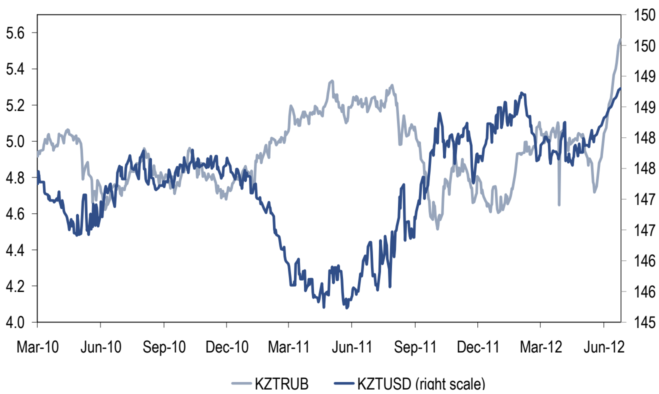
Source: Haver Analytics, NBK, CIRA

Figure 149. Current account is likely to narrow from extremely high 2011



Source: Haver Analytics, CIRA estimates

Figure 150. Tenge to stay below 150 KZT/USD in 2H12



Source: Haver Analytics, CIRA

Figure 151. Kazakhstan Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	43.2	57.1	81.0	104.8	133.4	115.3	146.0	186.2	211.0	241.7
Nominal GDP, local currency bn	5,870	7,591	10,214	12,850	16,053	17,008	21,516	27,303	31,259	35,623
GDP per capita, US$	2,867	3,765	5,290	6,775	8,524	7,279	9,218	11,755	13,323	15,261
Population, mn	15.1	15.2	15.3	15.5	15.7	15.8	15.8	15.8	15.8	15.8
Unemployment, % of labour force	8.4	8.1	7.8	7.3	6.6	6.6	5.8	5.5	5.5	5.5
Economic Activity										
Real GDP, % yoy	9.6	9.7	10.7	8.9	3.3	1.2	7.3	7.5	5.8	5.7
Real investment growth % yoy	22.5	28.1	29.7	17.3	1.0	-0.8	3.8	3.6	6.0	7.0
Real consumption growth % yoy	13.3	10.7	11.6	11.4	4.8	0.7	10.0	11.0	7.7	7.2
private consumption growth % yoy	13.8	10.7	11.7	11.8	3.9	0.5	11.0	11.9	8.0	7.5
Real export growth, % yoy	11.2	1.1	6.5	9.0	0.9	-11.6	1.9	3.5	2.0	2.0
Real import growth, % yoy	14.9	12.5	12.2	25.8	-11.3	-16.0	0.9	6.9	7.0	7.0
Prices, Money & Credit										
CPI, % yoy	6.5	7.5	8.4	18.8	9.5	6.2	7.8	7.4	5.7	4.8
CPI, % avg	6.8	7.5	8.6	10.8	17.1	7.3	7.1	8.3	5.2	5.8
Nominal wages, % yoy	21.9	19.7	20.6	28.1	16.2	10.8	14.9	15.9	8.1	7.6
Credit extension to private sector, % yoy	53.7	74.2	80.2	55.2	5.2	7.3	0.3	15.5	10.0	8.0
Policy interest rate, %, eop	-	8.00	9.00	11.00	10.50	7.00	7.00	7.50	7.00	5.50
1 month inter-bank rate, %, eop	-	5.83	6.25	11.50	-	6.50	1.50	1.50	2.50	2.50
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
KZT/US$, eop	130.0	134.0	127.4	120.3	120.8	148.4	147.4	148.0	149.0	146.5
KZT/US$, avg	136.0	132.9	126.1	122.6	120.3	147.5	147.4	146.6	148.1	147.4
KZT/EUR, eop	177.1	159.0	167.3	177.2	170.9	212.8	195.2	191.4	180.0	179.9
KZT/EUR, avg	169.0	165.4	158.3	167.8	177.0	205.7	195.7	204.1	187.9	174.5
Balance of Payments, US$ bn										
Current account	0.3	-1.1	-2.0	-8.3	6.3	-4.1	2.4	14.1	4.0	5.7
% of GDP	0.8	-1.8	-2.5	-7.9	4.7	-3.6	1.6	7.6	1.9	2.4
Trade balance	6.8	10.3	14.6	15.1	33.5	15.0	28.7	47.3	32.1	34.5
Exports	20.6	28.3	38.8	48.4	72.0	43.9	61.6	88.5	77.4	79.8
Imports	13.8	18.0	24.1	33.3	38.5	29.0	32.9	41.2	45.3	45.3
Service balance	-3.1	-5.3	-5.9	-8.2	-6.7	-5.8	-7.1	-6.4	-9.3	-9.3
Income balance	-2.9	-5.7	-9.5	-13.1	-19.5	-12.6	-18.7	-26.5	-18.5	-18.5
FDI, net	5.4	2.1	6.7	8.0	13.1	10.1	2.9	8.4	8.9	3.0
International reserves	9.3	7.1	19.1	17.6	19.9	22.7	27.4	27.7	30.1	34.8
Total amortisations	7.2	9.2	8.5	19.7	25.2	16.0	14.0	16.8	11.5	11.7
Public Finances, % of GDP										
Consolidated government balance	-	5.5	7.8	4.5	-9.3	-9.6	2.6	5.9	1.7	3.0
Consolidated gov primary balance	-	5.1	7.5	4.2	-9.7	-10.0	2.1	5.4	1.2	2.4
Public debt	10.0	7.1	5.9	5.3	6.3	9.5	10.3	10.0	11.2	11.1
of which Domestic	3.9	3.9	3.7	4.0	5.1	7.6	7.8	7.6	9.1	9.3
Foreign Assets & Liabilities, US$ bn										
External debt	32.7	43.4	74.0	96.9	107.9	112.9	118.2	134.2	145.7	157.4
Public	2.5	1.6	2.6	1.6	1.7	3.2	4.8	5.1	5.7	6.2
External debt / GDP	75.8	76.0	91.4	92.4	80.9	97.9	81.0	72.1	69.0	65.1
External debt / XGS	144.7	142.3	178.0	186.6	141.3	234.3	179.6	144.3	171.5	182.7
Short-term debt	3.9	8.2	12.7	12.0	10.0	10.3	9.1	9.1	11.1	11.1
Short-term debt/International reserves, %	42.5	115.3	66.2	67.8	50.2	45.2	33.3	33.0	36.9	31.9

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	7.2	7.5	8.2	5.6	5.8	6.3	5.5	9.0	6.1	5.1
CPI, % yoy	8.2	8.9	7.4	4.5	5.2	5.2	5.7	6.6	6.0	5.4
Policy interest rate, %, eop	7.50	7.50	7.50	7.00	7.00	7.00	7.00	6.75	6.75	6.75
1 month inter-bank rate, %, eop	1.50	1.50	1.50	1.50	2.50	2.50	2.50	2.50	2.50	2.50
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
KZT/US$	145.9	148.2	148.5	148.0	148.5	148.7	149.0	146.0	146.0	146.0

Source: National Sources, Citi Investment Research and Analysis

Levant

Iraq

Farouk Soussa
+971 (4) 509 9750
farouk.soussa@citi.com

Iraq concluded its fourth round of oil contract bidding at the end of May. Only three of the twelve exploration contracts on offer were awarded, following limited interest by international oil companies (IOCs). Despite the relatively poor result, we do not consider this a setback to Iraq's oil story. The exploration contracts do not factor into current plans to ramp up production, and were being offered as part of a plan to add to the country's proven reserves. Indeed, one of the main reasons why there was limited interest from IOCs, in our view, was the fact that the government insisted on maintaining the right to declare a moratorium on any discovered oil fields for a period of up to seven years, making it difficult for IOCs to monetise their discoveries in a timely manner. The contracts may come back to tender in further bidding rounds (which we expect later this year or early next), and there has also been discussion of awarding them to local start-ups to develop the domestic oil and gas industry.

The fall in oil prices is presenting Iraq with considerable fiscal challenges in the near term. The ramp up in expenditure penciled in for 2012 (a 34% increase on 2011) has meant that the fiscal breakeven price of oil has shot up to $98 per barrel this year, from $86 per barrel last year. We are currently forecasting $115 per barel, meaning Iraq should be in the black, but uncertainties are high and Iraq is vulnerable to further falls. To put Iraq's sensitivity to oil price swings into context, were oil to average $80 per barrel, the current projected surplus of 13% of GDP would swing to a deficit of the same magnitude. That said, we believe Iraq has greater flexibility in dealing with a fall in prices than the above suggests. Firstly, Iraq's production is ramping up quicker than we have assumed in our forecasts, meaning a lower breakeven oil price is likely. Secondly, much of the rise in expenditures is discretionary and related to projects, and so the scope for Iraq to cut back exists. Finally, Iraq has good funding options, including drawing down its substantial holdings at the Development Fund for Iraq (we estimate these to be in excess of $20bn at present).

June has been a particularly violent month in Iraq, with the Shia pilgrimage season providing a target for Sunni insurgents. We maintain our view, however, that the violence is likely to remain contained and will not lead to fundamental instability or widespread conflict. The political scene does, however, remain fraught, with Prime Minister al Maliki narrowly surviving an attempt by parliament to remove him, and the ongoing trial of VP Al Hashemi stoking the frictions that remain between Mr Al Maliki and his political rivals.

Jordan

June has seen an escalation in protests against the government, and a rise in political tensions. Jordanians have demonstrated against last month's price hikes on certain goods, including fuel, which the government said were necessary in order to avoid a fiscal crisis. As expected, the adoption of the electoral reform law by parliament has also raised political tensions, with mass demonstrations witnessed throughout the past week and the opposition calling for a boycott of upcoming elections. As we have long-argued, the significance of the electoral reform law should not be under-estimated: it is a significant litmus test with respect to the government's sincerity in its pursuit of political reform. The recently endorsed law is seen by opposition as falling far short of their democratic demands, and should therefore further erode their confidence in the government's intentions regarding political reform.

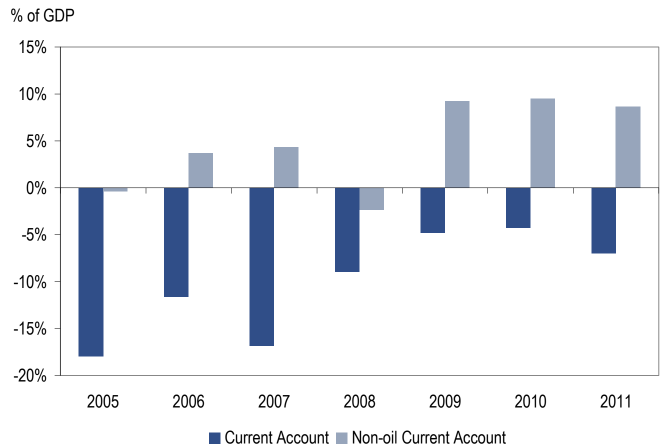
Politics in Jordan therefore remain precariously poised, in our view. We believe protests against the poorly-received government of Fayez Tarawneh are likely to continue, potentially leading to further changes. Ultimately, however, our concern is that a bleak economic outlook will exacerbate political tensions and lead to an escalation that may results in widespread instability. The current account showed a 59% widening in the deficit in the first 4 months of 2012 compared with the same period last year, according to government figures. While the outlook has been somewhat improved by the recent fall in oil prices, we continue to expect an average (Brent) oil price of $115 per barrel this year, which will continue to weigh on the country's external balances, eroding reserves and draining public finances. The situation has led the Jordanian government to request assistance from the IMF, with talks ongoing regarding a US$1.4bn facility, according to local reports.

Lebanon

Sporadic fighting has continued throughout June in the northern city of Tripoli between gunmen loyal to the regime of Bashar al Assad and those opposed to it. Tripoli is home to a variety of Muslim sects, including Alawis and Sunni, and has seen occasional outbursts of violence over the past year. However, the past few weeks have seen a worrying escalation that has required repeated intervention by Lebanon's army to quell. The fighting highlights the ongoing risk of serious spillover of sectarian violence from Syria into Lebanon. However, we believe that the risk is greatest among minor competing neighbourhood militia and is unlikely to descend into a nation-wide sectarian crisis so long as the will to avoid such a scenario remains at the leadership level of Lebanon's main political and sectarian groupings.

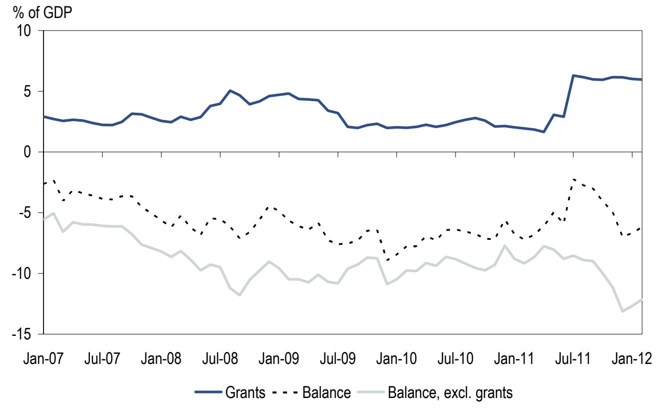
Lebanon's spending crisis is nearing a resolution. Over the past few months, a row had erupted between rival political factions over the need to obtain legal authorization for expenditure over and above the 2005 budget, the last one passed by a Lebanese government. The cabinet has agreed a deal that would see the financing of over LL10 trillion (US$6.7 billion) in spending through t-bills and loans. The money will be used to cover budgets of state institutions until the end of the year, as well as development projects in violence-hit Tripoli. The deal still requires parliamentary approval, although President Sleiman has said that he will use his presidential prerogative to sign it into law if parliament fails to ratify it. The lack of agreement on how to resolve the spending crisis, and President Sleiman's prior refusal to sign extra-budgetary expenditure into law, had threatened a freezing in government spending and a collapse of government.

Figure 152. Jordan current account dominated by oil imports …



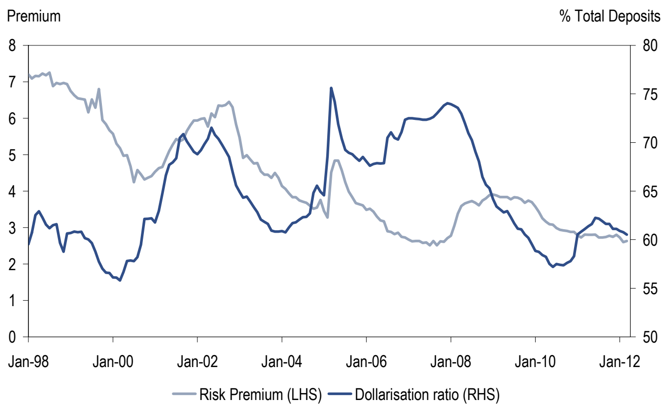
Source: Haver Analytics, USEIA, Citi Investment Research and Analysis

Figure 153. Without grants Jordan's fiscal situation would be worse



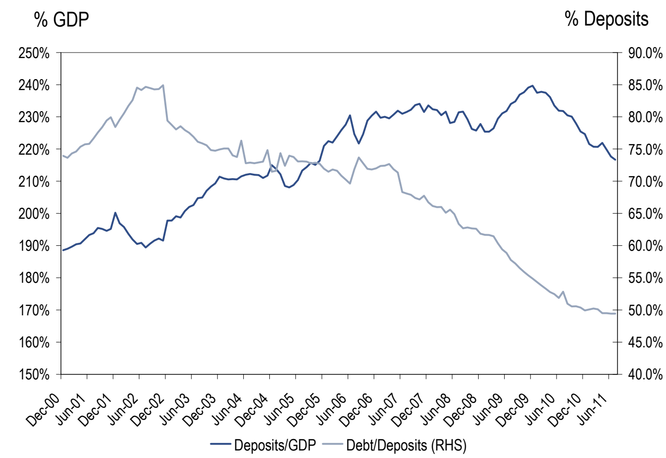
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 154. Lebanon dollarization has gone up, but risk premium stable



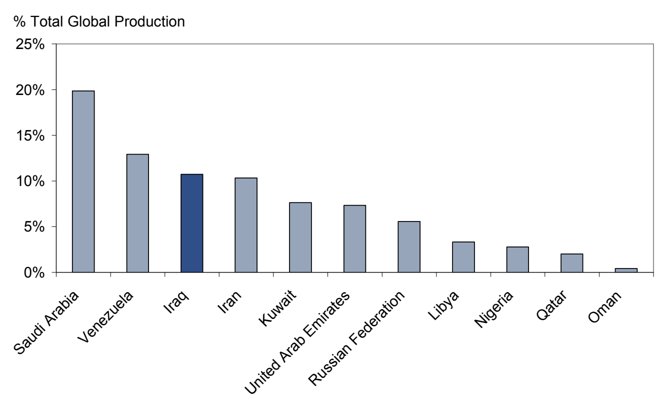
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 155. Deposit growth slows, but still plenty of capacity



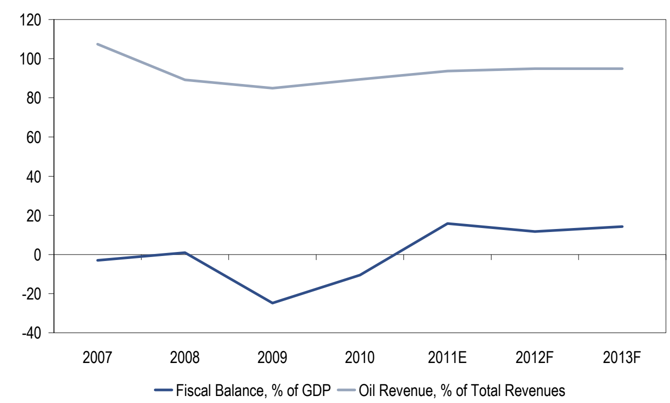
Source: Banque Du Liban, Citi Investment Research and Analysis

Figure 156. Iraq has world's third largest oil reserves and …



Source: BP, Citi Investment Research and Analysis

Figure 157. … public finances to strengthen on greater oil revenues



Source: IMF, Citi Investment Research and Analysis

Figure 158. Levant Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
IRAQ										
Nominal GDP, US$ bn	25.8	31.4	45.1	58.8	87.2	66.6	79.4	121.5	138.9	135.6
GDP per capita, US$	968	1,147	1,602	2,031	2,926	2,168	2,507	3,729	4,145	3,932
Real GDP, % yoy	54.0	4.4	10.1	1.4	9.5	4.2	5.9	9.4	9.3	11.5
CPI, % avg	NA	NA	NA	32.6	2.8	-2.8	2.4	5.6	5.0	6.0
IQD/US$, eop	NA	NA	NA	1216	1158	1150	1167	1166	1166	1166
IQD/US$, avg	NA	NA	NA	1223	1188	1152	1164	1168	1168	1168
Current account	-2.4	-3.3	2.7	15.5	27.1	-12.8	-14.4	-6.2	39.0	68.8
% of GDP	-9.3	-10.6	5.9	26.4	31.1	-19.2	-18.2	-5.1	28.1	50.7
Consolidated government balance, % of GDP	NA	NA	NA	-2.9	0.9	-24.8	-10.4	15.8	11.8	14.3
JORDAN										
Nominal GDP, US$ bn	11.4	12.6	15.0	17.1	22.0	23.9	26.5	28.0	30.0	31.8
GDP per capita, US$	2,133	2,288	2,653	2,929	3,656	3,851	4,151	4,255	4,435	4,567
Real GDP, % yoy	9	8.1	8.1	8.2	7.2	5.5	2.3	2.6	2.5	3.0
CPI, % avg	2.6	3.5	6.3	4.7	13.9	-0.7	5.0	4.4	5.0	5.0
JOD/US$, eop	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
JOD/US$, avg	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Current account	0.0	-2.3	-1.7	-2.9	-2.1	-1.2	-1.9	-3.0	-3.7	-3.7
% of GDP	0.3	-18.0	-11.5	-16.8	-9.3	-5.2	-7.1	-10.6	-12.4	-11.7
Consolidated government balance, % of GDP	-1.9	-5.4	-4.2	-5.1	-4.4	-8.9	-5.6	-3.9	-8.0	-9.5
LEBANON										
Nominal GDP, US$ bn	21.8	21.9	22.4	25.1	30.1	34.7	37.1	40.8	43.9	47.5
GDP per capita, US$	5,804	5,823	5,969	6,666	7,899	8,984	9,499	10,318	10,874	11,545
Real GDP, % yoy	7	1.0	0.6	7.5	9.3	8.5	6.0	6.0	3.5	4.3
CPI, % avg	1.7	-0.7	5.6	4.1	10.8	1.2	4.0	5.1	6.0	5.0
LBP/US$, eop	1508	1508	1508	1508	1508	1508	1508	1508	1508	1508
LBP/US$, avg	1508	1508	1508	1508	1508	1508	1508	1508	1508	1508
Current account	-4.1	-2.2	-1.1	-1.4	-4.1	-6.7	-7.5	-8.7	-9.9	-11.2
% of GDP	-18.9	-10.3	-5.1	-5.5	-13.8	-19.5	-20.1	-21.3	-22.6	-23.5
Consolidated government balance, % of GDP	-9.2	-8.5	-13.5	-10.2	-9.7	-8.5	-7.8	-6.8	-8.0	-9.1

Source: National Sources, Citi Investment Research and Analysis

Nigeria

David Cowan
+44 20 7986 3285
david.cowan@citi.com

- **Summary view** — Despite the ongoing political uncertainties in the north due to the activities of Boko Haram, we still expect growth to remain robust in 2012-13 driven by strong activity in the south. Although inflation may rise in mid-2012, it should be modest and trend down to low single digits again in 2013.
- **Things to watch** — With the naira under pressure, the key economic indicator to watch in the coming months are foreign exchange reserves. Falling reserves should increase the pressure on the central bank.
- **Strategy** — With Ngozi Okonjo-Iweala as finance minister, alongside incumbent central bank governor, Lamido Sanusi, Nigeria has a respected economic team committed to improving fiscal discipline and driving a return to more orthodox monetary policies and improved fiscal discipline.

Savings and global uncertainty

One way to think about Nigeria's recent economic history is that having built up savings, most visibly in the accumulation of foreign reserves, in 2003-08, successive governments have now drawn these down in the 2009-11 period. While there has been some rebuilding of foreign exchange reserves in 1H 2012, this strategy is now under pressure as the price of Brent crude fell below US$100 in May and global economic uncertainty has increased increasing demand for foreign exchange. But, with only limited savings the government's room for policy manoeuvre is limited.

This pressure is most clearly seen in the performance of the naira in May, although the pressure on the naira is not new. With the running down of reserves and increased government spending, against the background of political uncertainty, the naira had been under periodic pressure throughout 2010-11. But this had eased substantially in early 2012 following the aggressive hiking of the Monetary Policy Rate (MPR) to 12% by the Central Bank of Nigeria (CBN) in 2H 2011. The CBN has also opened up the T-bill market, by removing the one-year lock in for foreign investors attracting significant portfolio inflows.

In addition, the CBN has placed stricter limits on the amount of foreign exchange that various groups can buy at its twice weekly Wholesale Dutch Auction (WDAS). The initial target was the Bureau de Change (BDC) but this now includes other groups, notably oil importers whose demand has risen very sharply in recent years. Finally, the CBN is also hoping that reduced government spending, notably by state governments in 2012, will also reduce the demand for imports and pressure on the naira. These measures led to a significant reduction in demand for foreign exchange at the WDAS in Q1 2012.

Is the pressure on the naira temporary?

At present, we think the CBN is assuming that naira weakness is due to a temporary surge in demand for foreign exchange. In particular, it is a result of negative sentiment in the local market due to the weakening global oil price and a modest outflow from some portfolio investors. Moreover, we think the CBN is happy to meet a temporary increase in demand, especially if reserves remain broadly unchanged (and even rise modestly) in the coming months from their current level of US$37.7bn at the end of May. Then, a rebound in the oil price to levels back over US$100/barrel - Citi currently forecasts Brent crude will trade at around US$100 in a 6-12 month time frame - helps to restore confidence in the naira.

But the bottom line remains that in the current uncertain global economic outlook, the oil price remains vulnerable. A weakening oil price going forward, could easily mean that demand for foreign exchange remains elevated. Moreover, a falling oil price, and crucially for the CBN, falling foreign exchange reserves, would mean that although unlikely, the current naira soft-peg could quickly come under real and sustained pressure. We think that once reserves fall towards the US$30bn level, the CBN will have to start to quickly rethink its current exchange rate policy.

But even this raises problems. While we do think that the CBN is thinking about how to adjust the naira in response to a potential, but substantial, drop in the oil price, it will still have to work out how to implement a devaluation, and crucially, the scale of the adjustment required without guidance from the market if it does, as seems likely, opt to move first. While a soft peg can create exchange rate stability, the cost is that when it comes under pressure the uncertainty hangs over the market, or the smaller probability of a large adjustment haunts the market.

Rising inflation and easing growth

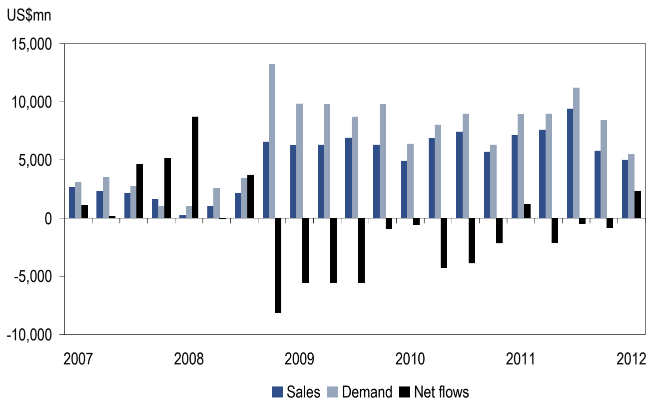
One reason that the CBN is keen to maintain naira stability is that it should help to reduce inflationary pressures and maintain overall confidence. The fact that inflation fell back marginally in May to 12.7% YoY does not alter our view that it will rise in the coming months on the back of rising food prices and increases in electricity tariffs. Moreover, with the naira under pressure the key question for the MPC at its July and September meetings will be how to respond. Although the obvious response is to raise the Monetary Policy Rate (MPR), and one further rise cannot be ruled out, we still think this is unlikely

This is because as well as inflation, the CBN is also worried about the growth outlook for Nigeria with Q1 2012 growth having come in at 6.2%. On the one hand there is an argument that this is still a relatively robust growth rate, and while a drop off from 2011, growth is traditional lower in Q1. Moreover, the drop off has been compounded by stagnant oil production in early 2012. But where the CBN is likely to be concerned, are the increasing reports that agricultural production, and trade activities, in the north of the country are being negatively impacted by the ongoing violence caused by the activities of Boko Haram. However, it is worth noting that the growth story could be slightly complicated by a proposed revision to GDP data following a rebasing exercise. If a similar change in Ghana in 2010 is a guide, this could increase total GDP in the order of 40%.

Getting back on track

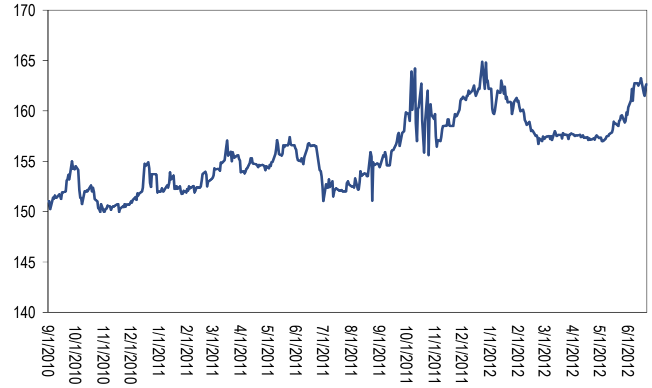
Despite the uncertainty created by the recent fallback in oil prices, we think that the reform process is gaining momentum in Nigeria and that 2H 2012 should provide a clear indication of whether progress is possible. Even with the fallback in oil prices, the tough benchmark oil price of US$72 per barrel for the 2012 budget means that the efforts to reduce government spending should remain on course, although the key fiscal reform is still the need to implement the new Sovereign Wealth Fund (SWF). The government also seems to be making some progress with power sector reform, having outlined a timetable for tariff rises, and is in the process of trying to unify the various editions of the Petroleum Industry Bill which have been debated over the last few years. However, we still await concrete progress with all these key reforms if Nigeria is not to lurch from mini crisis to mini crisis in the coming years against the background of a lower oil price and limited savings to fall back on.

Figure 159. Demand had eased on the WDAS



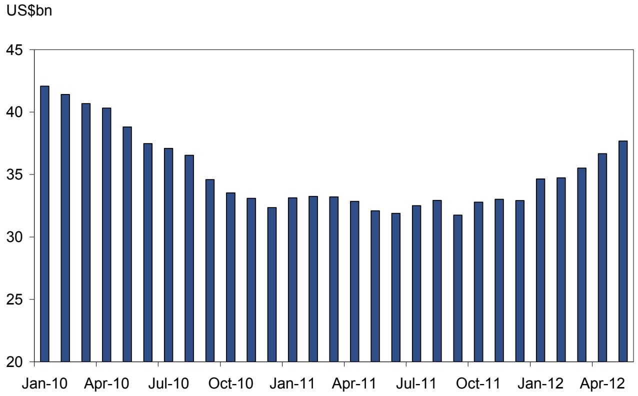
Source: Central Bank of Nigeria

Figure 160. Pressure on the naira has returned since May



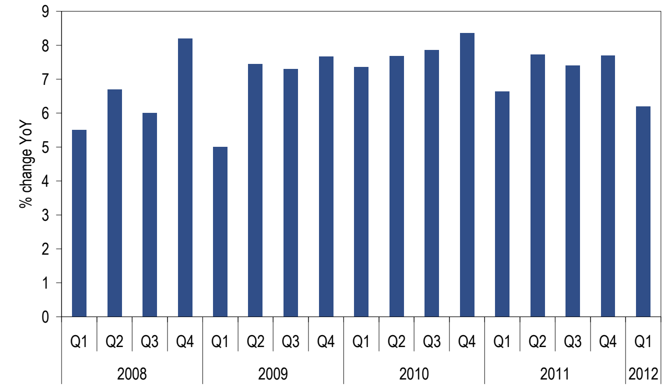
Source: Reuters

Figure 161. Reserves modestly rebound in early 2012



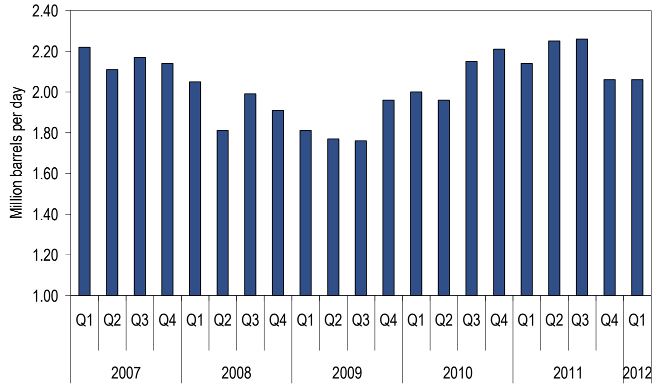
Source: Haver Analytics, Central Bank of Nigeria

Figure 162. Growth slowed marginally in early 2012



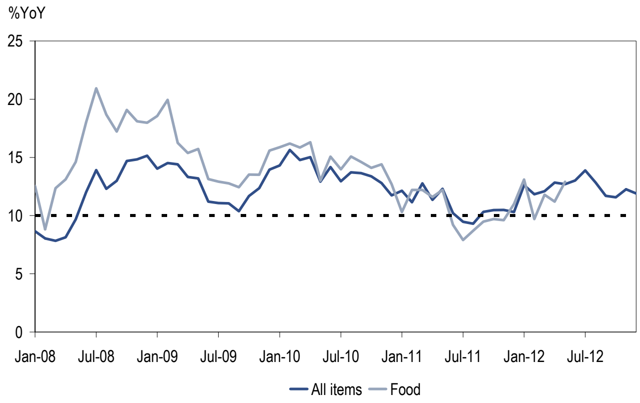
Source: National Bureau of Statistics

Figure 163. Oil production moves sideways in Q1 2012



Source: International Energy Agency

Figure 164. We only expect a modest pick up in inflation in 2012



Source: National Bureau of Statistics

Figure 165. Nigeria Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	85.9	111.0	144.3	164.2	201.1	189.2	225.3	259.2	300.5	341.7
Nominal GDP, local currency bn	11,411	14,572	18,565	20,657	23,842	28,263	34,035	40,385	48,379	56,436
GDP per capita, US$	622	785	997	1,109	1,329	1,225	1,430	1,613	1,833	2,043
Population, mn	138	141	145	148	151	154	158	161	164	167
Unemployment, % of labour force	-	-	-	-	-	-	-	-	-	-
Economic Activity										
Real GDP, % yoy	9.3	1.0	8.2	4.4	2.3	-8.3	7.8	7.4	6.8	7.2
Real investment growth % yoy	-	-	-	-	-	-	-	-	-	-
Real consumption growth % yoy	-	-	-	-	-	-	-	-	-	-
private consumption growth % yoy	-	-	-	-	-	-	-	-	-	-
Real export growth, % yoy	-	-	-	-	-	-	-	-	-	-
Real import growth, % yoy	-	-	-	-	-	-	-	-	-	-
Prices, Money & Credit										
CPI, % yoy	10.0	11.6	8.5	6.6	15.1	13.9	11.7	10.3	11.9	9.9
CPI, % avg	15.0	17.8	8.2	5.4	11.6	12.5	13.7	10.8	12.4	9.8
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	26.6	30.8	27.8	97.1	59.4	26.6	-4.9	15.0	19.0	23.0
Policy interest rate, %, eop	-	13.00	10.00	9.50	9.75	6.00	6.25	12.00	12.00	11.00
1 month inter-bank rate, %, eop	14.41	13.00	12.00	12.50	18.00	15.79	9.00	7.50	-	-
Long-term yield, %, eop	-	-	-	9.3	9.3	11.8	8.5	10.0	9.0	9.3
NGN/US$, eop	133.2	130.4	128.8	117.9	139.7	149.5	152.6	162.3	164.0	168.0
NGN/US$, avg	134.4	132.9	128.5	125.8	119.0	149.8	151.1	155.8	161.0	165.2
NGN/EUR, eop	180.5	154.4	170.0	172.0	195.3	214.0	204.2	210.1	198.1	206.2
NGN/EUR, avg	167.3	165.4	161.5	172.4	175.1	208.9	200.4	216.9	202.5	196.1
Balance of Payments, US$ bn										
Current account	16.8	36.5	36.5	27.6	28.1	22.0	14.2	15.9	17.0	21.9
% of GDP	19.4	32.9	25.1	16.6	13.5	11.6	6.3	6.1	5.7	6.4
Trade balance	19.8	29.2	34.9	37.7	45.9	29.4	33.4	40.8	40.0	45.5
Exports	34.8	55.2	56.9	66.0	85.7	60.0	74.6	92.0	86.0	93.0
Imports	15.0	26.0	22.0	28.3	39.8	30.6	41.2	51.2	46.0	47.5
Service balance	-2.6	-4.8	-11.6	-16.9	-22.1	-15.5	-19.5	-20.5	-21.0	-21.9
Income balance	-2.5	-3.0	-4.6	-11.7	-15.1	-10.1	-16.9	-22.5	-21.1	-21.4
FDI, net	-	-	-	-	-	-	-	-	-	-
International reserves	17.0	28.3	42.3	51.3	53.0	42.4	32.3	32.9	39.9	45.5
Total amortisations	1.2	3.9	6.5	0.9	0.6	0.5	0.5	0.4	0.3	0.3
Public Finances, % of GDP										
Consolidated government balance	-1.5	-1.1	-0.5	-0.6	-0.2	-2.9	-2.4	-3.1	-2.2	-2.1
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-	-
of which Domestic	12.0	10.7	9.6	10.9	8.7	11.4	13.2	13.4	13.3	13.3
Foreign Assets & Liabilities, US$ bn										
External debt	35.9	20.5	3.5	3.4	3.7	4.6	4.6	5.7	7.1	7.5
Public	33.7	18.4	2.9	3.0	3.2	3.9	4.4	4.6	5.2	5.5
External debt / GDP	41.9	18.4	2.5	2.1	1.8	2.4	2.0	2.2	2.4	2.2
External debt / XGS	97.4	40.8	6.2	5.1	4.4	7.6	6.1	6.2	8.2	8.0
Short-term debt	-	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves, %	-	-	-	-	-	-	-	-	-	-

Source: National Sources, Citi Investment Research and Analysis

Other Africa

David Cowan
+44 20 7986 3285
david.cowan@citi.com

Ghana

- Although peak production level is now unlikely to be reached until 2013, rising production from the Jubilee oil field and strong government spending should continue to help drive strong GDP growth in 2012-13, even if the rate slows from the double digit rate recorded in 2011.

- While there were many forecasts that the start of oil production should have had a positive impact on cedi stability, it has weakened substantially in 2012. In fact, the speed and scale of the depreciation has been surprising and seems to be at least in part driven by rising government spending as Ghana moves towards presidential and parliamentary elections in December 2012. Having failed to significantly reduce the fiscal deficit in 2010-11, we expect it to widen marginally in 2012 driven by both higher capital spending and the ongoing implementation of the single spine salary structure. In addition, the ongoing build-up of debt, domestic and external, will remain a concern and could potentially sow the seeds to a new fiscal crisis in 2013, as occurred in 2000 and 2008.

- The weakening of the cedi in early 2012 has already forced the Bank of Ghana to tighten monetary policy with a 250 basis point rise in MPR in 2012 to 15%. But the modest pick up in inflation to date may means further rises are political difficult in 2H. Meanwhile, we do think that the cedi has overshot and should stabilize in 2H 2012 at around GSH1.90:USD1 as it already looks relatively cheap and as the current pressures on the currency run their natural course.

Kenya

- The decision to delay holding elections until March 2013 has created some uncertainty. But we think that they delay should mean the polls are less rushed and in the end the delay is a positive. However, it does mean that political campaigning will rise steadily in 2H 2012 and act as a drag on investment.

- Although the sharp rise in inflation and shilling weakness in 2011, against the background of the approaching elections has undermined confidence in the economy, we still think that growth in 2012-13 will pick up modestly driven by the private sector boosting trade with the East Africa region, the ongoing recovery in the tourism and the agricultural sectors and strong government spending. The government is also moving ahead with ambitious plans to end the current power constraint on growth.

- The shilling has probably over reacted to the Central Bank of Kenya's (CBK) tightening of monetary policy in late 2011. Although inflation has eased steadily in 2012, the overall pressure will be for shilling depreciation given the large current account deficit, slowness in bringing the fiscal deficit under control against the background of rising political tensions and a slow easing of monetary policy.

Tanzania

- The review of Tanzania's constitution is set to gather pace in 2012 with the creation of a Constitutional Review Commission. However, the main focus of the government will be on economic reform, and crucially implementation of policy. The most immediate pressing priorities are resolving the ongoing power sector crisis, which has led to prolonged electricity shutdowns in major urban centres, and sharply rising inflation.

- Growth should continue to be robust in 2012-13, although for it to really pick up strongly the government will have to make real progress in implementing its *Kilimo Kwanza* (Agriculture First) policy. The current account deficit is set to remain substantial despite ongoing increases in gold exports, but with aid and FDI inflows, increasingly into the gas sector, remaining high, the deficit should prove relatively easy to finance compared to Kenya and Uganda.

- As with the other two East African shillings, the Tanzanian shilling came under pressure in 2H 2011 as inflation rose and due to a delayed monetary policy response. Although the shilling will continue to weaken in 2012-13, we expect this to be relatively modest as inflation falls back, monetary policy remains relatively tight while the fiscal deficit is slowly brought back under control.

Uganda

- 2012 is set to be a difficult year for the Uganda economy as growth looks set to slow to its lowest level for over a decade and the fiscal and current accounts remain substantial. Meanwhile, the Bank of Uganda (BoU) has had to tighten monetary policy sharply to stabilize the shilling and in response to the sharp rise in inflation in 2H 2011.

- While the BoU would like to loosen monetary policy more aggressively to support growth, the reality is that although inflation will fall, its fall may be more moderate than in Kenya and the authorities need to continue to attract portfolio inflows to fund the twin deficits. The trick for the central bank will be to ease monetary policy only slowly, balancing the need to maintain inflows and so there is only modest weakening of the Shilling against the US dollar.

- On a positive note, in late 2013 and into 2014, the country should become an oil producer, although the impact on growth and government revenue will, initially, be minimal given that production will initially only be very limited. While the development of the field will push up the current account deficit, it should be largely fully funded through FDI inflows.

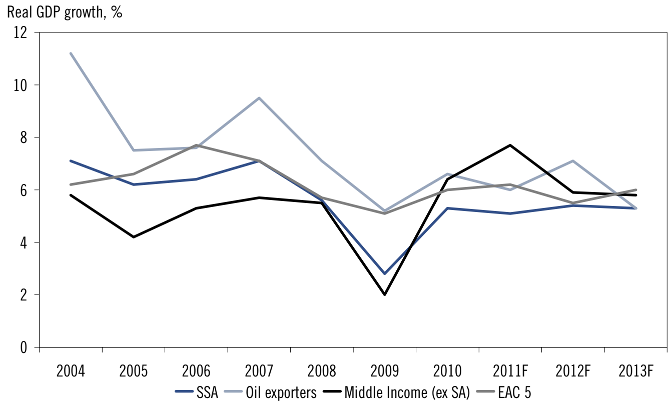
Zambia

- Following his victory in the September 2011 elections, the new president, Michael Sata, of the Patriotic Front, is now set to oversee a gradual rise in government spending over the next few years. This will be funded both domestically and with a debut Eurobond issue, probably in Q3 2012. But while government spending is set to increase, the rise may be slower than budget for as the new government only slowly gets to grips with being in power given the general inexperience of many of the new ministers.

- The wave of FDI into the copper mining sector in 2004-07 will continue to drive a steady increase in copper production in 2012-13, helping underpin growth. But the copper price crash of late 2008 is still fresh in the minds of the government, reinforced by the fall in the price in 2H 2011, and the focus of policy will continue to be economic diversification and the need to create jobs and push ahead with infrastructure development.

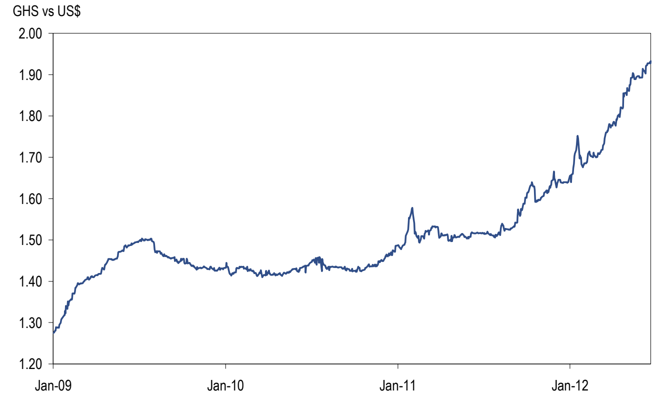
- Strong growth and rising government spending is likely to suck in imports, reducing the current account surpluses of recent years, while the government is also likely to try and keep interest rates low. We think this will eventually feed into a gradual pick up in inflation and a weakening kwacha in 2012-13.

Figure 166. Growth should be robust in 2012-13



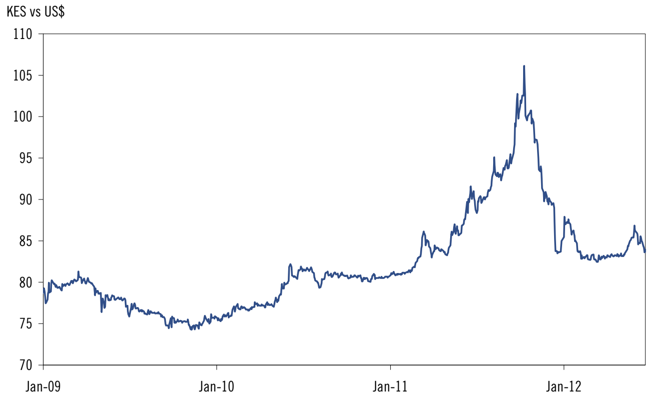
Source: IMF

Figure 167. The cedi slide continues apace



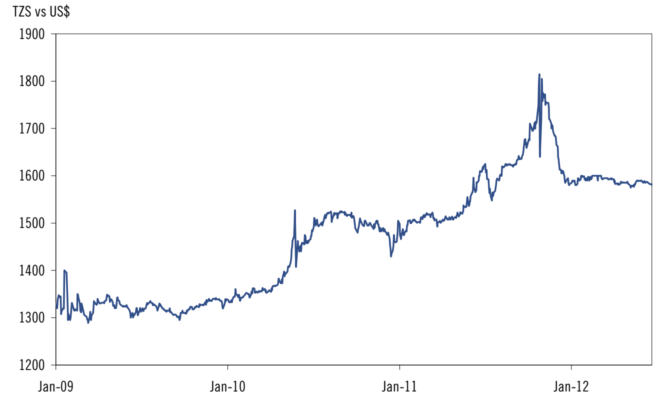
Source: Haver Analytics

Figure 168. The Kenyan shilling is starting to show the strain



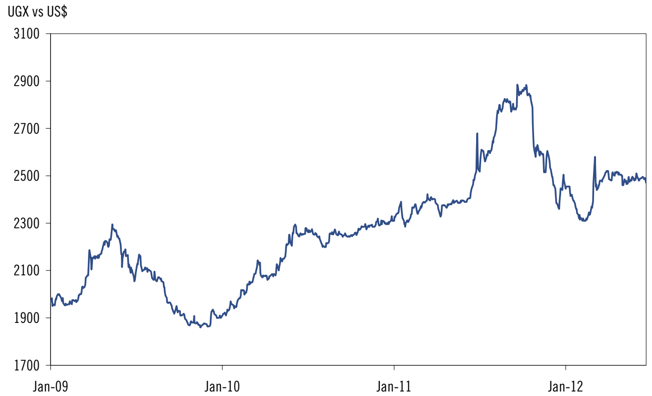
Source: Haver Analytics

Figure 169. Tanzanian shilling stability in 2012



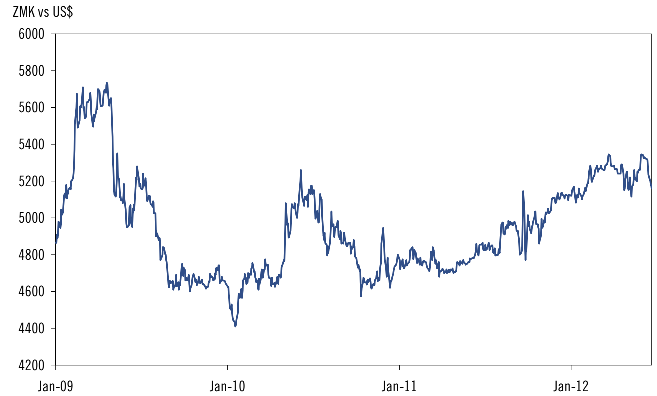
Source: Haver Analytics

Figure 170. Portfolio inflows drive a major Ugandan shilling rebound



Source: Haver Analytics

Figure 171. The roller coaster ride for the kwacha continues



Source: Haver Analytics

Figure 172. Other Africa Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
GHANA										
Nominal GDP, US$ bn	14.6	17.4	20.4	24.8	28.5	26.0	32.2	39.2	38.2	43.8
GDP per capita, US$	689	804	921	1,090	1,226	1,090	1,319	1,570	1,493	1,677
Real GDP, % yoy	5.3	6.0	6.1	6.5	8.4	4.0	8.0	14.4	7.5	6.5
CPI, % avg	18.0	15.4	11.7	10.8	16.5	19.2	10.7	8.7	10.2	11.6
Policy interest rate, %, eop	18.50	15.50	12.50	13.50	17.00	18.00	13.50	12.50	16.00	15.00
GHS/US$, eop	0.89	0.91	0.92	0.97	1.27	1.43	1.49	1.64	1.90	1.95
GHS/US$, avg	0.88	0.90	0.91	0.96	1.08	1.43	1.43	1.55	1.83	1.91
Current account, US$ bn	-0.3	-0.8	-1.0	-2.1	-3.5	-1.6	-2.6	-3.2	-2.8	-2.1
% of GDP	-2.2	-4.4	-5.1	-8.6	-12.4	-6.2	-8.1	-8.2	-7.3	-4.8
International reserves, US$ bn	1.6	1.8	2.1	2.8	2.0	3.0	4.7	4.9	5.3	6.0
Consolidated government balance, % of GDP	-	-3.2	-5.0	-6.1	-8.5	-5.8	-7.4	-5.4	-5.6	-6.0
KENYA										
Nominal GDP, US$ bn	16.1	19.4	23.3	28.5	30.5	30.6	32.2	33.7	41.2	43.6
GDP per capita, US$	464	544	638	760	793	776	794	811	963	994
Real GDP, % yoy	4.6	6.0	6.3	7.0	1.5	2.6	5.6	4.5	5.0	5.8
CPI, % avg	11.8	9.9	6.0	4.3	15.1	10.6	4.1	14.0	11.9	8.2
Policy interest rate, %, eop	11.04	11.07	10.00	8.75	8.50	7.00	6.00	18.00	13.50	11.00
KES/US$, eop	78.6	72.4	69.6	63.8	78.2	75.9	80.7	85.1	88.0	93.0
KES/US$, avg	79.1	75.3	72.0	64.4	69.2	77.3	79.3	88.9	85.2	91.6
Current account, US$ bn	0.0	-0.3	-0.5	-1.1	-2.3	-1.7	-2.1	-4.0	-4.3	-4.1
% of GDP	0.1	-1.4	-2.2	-3.7	-7.4	-5.7	-6.5	-11.8	-10.5	-9.5
International reserves, US$ bn	1.5	1.8	2.4	3.4	2.9	3.8	4.3	4.3	4.5	4.8
Consolidated government balance, % of GDP	-0.1	-1.8	-2.5	-3.0	-3.9	-5.5	-6.5	-5.5	-5.0	-4.9
TANZANIA										
Nominal GDP, US$ bn	12.0	13.7	14.3	15.2	19.0	21.0	22.6	22.7	27.3	27.3
GDP per capita, US$	318	353	359	370	450	481	504	491	574	556
Real GDP, % yoy	7.8	7.4	7.0	6.9	7.3	6.7	6.9	6.3	6.2	6.8
CPI, % avg	4.1	4.4	5.6	6.3	8.4	11.8	6.2	12.7	15.8	7.4
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-	-
TZS/US$, eop	1036	1145	1260	1154	1318	1340	1505	1582	1675	1800
TZS/US$, avg	1084	1121	1247	1148	1199	1323	1443	1586	1606	1719
Current account, US$ bn	-0.3	-0.7	-1.2	-1.6	-2.3	-2.2	-2.1	-2.4	-3.3	-3.1
% of GDP	-2.5	-5.1	-8.2	-10.4	-11.9	-10.7	-9.3	-10.5	-11.9	-11.2
International reserves, US$ bn	2.3	2.0	2.3	2.9	2.9	3.5	3.9	3.7	3.9	4.3
Consolidated government balance, % of GDP	-2.7	-2.8	-4.7	-3.7	0.0	-4.8	-7.0	-7.8	-6.2	-5.8
UGANDA										
Nominal GDP, US$ bn	7.9	9.2	10.0	11.9	14.4	15.8	17.2	17.2	21.1	21.2
GDP per capita, US$	288	324	339	393	461	488	514	498	591	576
Real GDP, % yoy	6.8	6.3	10.8	8.4	8.8	7.2	5.9	5.7	4.5	5.5
CPI, % avg	5.0	8.0	6.6	6.8	7.3	14.2	9.4	18.6	16.5	5.9
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-	-
UGX/US$, eop	1,730	1,812	1,734	1,698	1,943	1,900	2,310	2,480	2,600	2,800
UGX/US$, avg	1,799	1,771	1,825	1,711	1,719	2,032	2,182	2,525	2,493	2,692
Current account, US$ bn	0.0	-0.1	-0.3	-0.4	-0.4	-1.4	-1.7	-1.9	-2.6	-2.3
% of GDP	0.1	-1.4	-3.4	-3.1	-3.1	-8.7	-9.6	-11.1	-12.5	-10.7
International reserves, US$ bn	1.3	1.3	1.8	2.6	2.3	3.0	2.7	2.6	3.1	3.0
Consolidated government balance, % of GDP	-1.4	-0.5	-0.9	-1.3	-3.0	-2.4	-5.0	-7.2	-5.5	-5.2
ZAMBIA										
Nominal GDP, US$ bn	5.4	7.2	10.7	11.5	14.6	12.8	16.2	18.4	19.9	22.1
GDP per capita, US$	486	626	911	957	1,183	1,006	1,237	1,366	1,433	1,541
Real GDP, % yoy	5.4	5.3	6.2	6.2	5.7	6.4	7.6	6.6	6.5	6.9
CPI, % avg	18.0	18.3	9.0	10.7	12.4	13.4	8.5	8.7	7.5	8.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-	-
ZMK/US$, eop	4,700	3,415	4,428	3,863	4,795	4,641	4,800	5,125	5,150	5,450
ZMK/US$, avg	4,765	4,442	3,588	3,996	3,748	5,046	4,801	4,863	5,131	5,313
Current account, US$ bn	-0.6	-0.6	0.0	-0.8	-1.1	0.5	1.1	0.5	0.2	0.3
% of GDP	-10.4	-8.5	-0.4	-6.5	-7.2	4.2	7.1	2.5	1.2	1.3
International reserves, US$ bn	0.3	0.6	0.7	1.1	1.1	1.9	2.1	2.3	2.6	3.2
Consolidated government balance, % of GDP	-2.9	-2.7	19.8	-1.3	-1.5	-2.6	-3.1	-3.2	-3.5	-3.7

Source: National Sources, Citi Investment Research and Analysis

Poland

Piotr Kalisz
+48 (22) 692 9633
piotr.kalisz@citi.com

Cezary Chrapek
+48 (22) 692 9421
cezary.chrapek@citi.com

- **Summary view** — We estimate that economic growth will decelerate in the second half of this year. However, we expect no changes to monetary policy parameters this year as inflation could stay elevated. As CPI growth decelerates starting from 4Q12 and real interest rates increase in 2013 we expect the MPC will have room to ease monetary policy only next year.
- **Things to watch** — The MPC will focus on the results of new Inflation Report focusing on the persistence of increased inflation in the inflation projection and expected scale of the economic slowdown.
- **Strategy** — As Poland still has high current account deficit, the zloty remains vulnerable to changes in risk appetite. Scale of expected weakening may be reduced by potential interventions by the NBP of MoF and relatively good economic and fiscal outlook versus other EU countries, which limits biggest risks.

Growth is losing momentum

Relatively small export exposure to euro area peripheries makes Poland somewhat less vulnerable to euro area downturn than other CEE countries. However, despite this, the economy is already showing signs of slowdown, reflecting domestic demand weakness. In 1Q economic growth slowed to 3.5%YoY from 4.3% in 4Q 2011 and both private consumption and fixed investment surprised on the downside. It seems the investment slowdown was partly driven by weaker spending of smaller firms, a trend that is likely to be maintained in coming months. However, we also expect a decline in public investment spending as infrastructure projects will be finalized at relatively slower pace after the football championships. We also feel household consumption growth of 2.1%YoY in 1Q has been disappointing. Given recent trends in the labour market we think there is little rationale for optimism regarding private consumption trends in the near term. Real wage bill growth continues to fluctuate close to 0%, while unemployment remains high. Given tight lending standards and the already very low savings rate, drivers of consumer spending are rather weak. Having said this we expect growth to slow substantially in 2H 2012 and expect full year growth to reach 2.7% vs. 4.3% in 2011. We expect the depreciated PLN is likely to work as a stabilizing factor, contributing to an improvement in the foreign trade balance despite a recession in the euro area.

Inflation to reach the target early next year

Overall economic growth will most likely be below Poland's potential both in 2012 as well 2013, contributing to gradual fall in demand side pressures. In recent months the CPI has fluctuated around 4% but in May it surprised on the downside by falling to 3.6%. The downward surprise reflected core inflation components – in particular lower prices of clothing and cable TV services. Although inflation is likely to jump again slightly above 4% in June on the back of price changes related to Euro 2012 football championships this should be only a temporary move that will be reversed in July and August. The downward inflation trend should be – at least in the near future – supported by a substantial drop in commodity prices. Having said this we expect consumer price inflation to fall towards or even below 3% in December 2012 and we expect the 2.5% inflation target will be reached in early 2013.

In June the Monetary Policy Council (MPC) left rates on hold but kept its relatively hawkish rhetoric. Apparently the monetary authorities believe the CPI remains stubbornly high and they are waiting for results of July macroeconomic projection to assess how serious the inflation risks are. Given the relatively balanced comments of governor Belka, and recent improvement in inflation outlook, we believe central bank rates will remain on hold in the coming months. The data released in May and June suggest there is no need for monetary tightening in the economy though we believe the MPC will be reluctant to admit this, especially given that it invested a lot of reputational capital to convince markets the rate hike in May was justified. Therefore we expect the tone of MCP comments will turn less hawkish only very gradually and we see some room for rate cuts only next year.

Slowing indirect tax revenues

The fiscal data appear to confirm the economy is losing momentum. The most recent data has shown that after five months indirect taxes reached only 38.9% of the annual plan, while the central budget gap rose to PLN 27bn (77.2% of the annual ceiling). Despite this fiscal underperformance we expect the budget deficit will remain under control throughout the year mostly thanks to a one-off inflow of PLN 8bn from central bank's profit, the unexpected gain that was not included in initial budget plans. The wider version of the fiscal gap (general government deficit) is likely to be slightly higher than previously expected but should be below 3.5% of GDP allowing for withdrawal of excessive deficit procedure in 2013. In our scenario the public debt calculated according to Polish methodology is likely to be well below the key threshold of 55% of GDP.

Portfolio capital outflow the biggest contagion risk

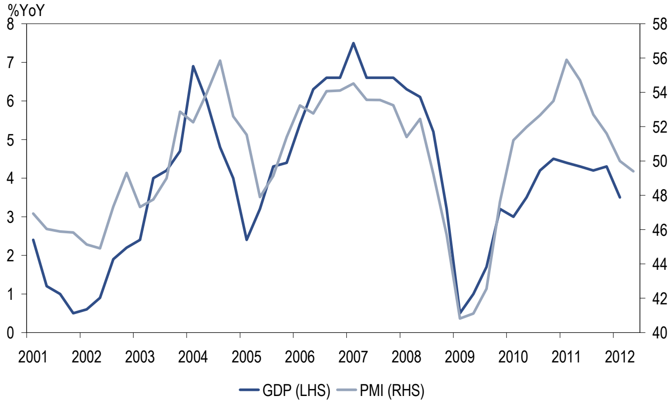
In our view the biggest potential contagion risks stemming from euro zone crisis are related to a possibility of portfolio capital outflows (see also: What Could "Grexit" Mean For Central Europe?). Poland enjoyed substantial inflow of portfolio investments to debt and equity markets reaching around 12% of GDP in 2009-2011 period. This is significantly more than in other Central European economies and given the diminishing importance of FDI inflows this makes the zloty and Poland vulnerable to changes in investors' sentiment.

However, relatively sound fundamentals and positive fiscal outlook limits risk of substantial bond sell-off. In our view in case of moderate changes in risk appetite the probability of substantial portfolio capital outflows would be reduced by still relatively high economic growth as compared to other EU countries and favorable fiscal prospects. At the same time since the Polish government has already managed to fund 80% of its borrowing needs we think that low bond supply in the second half of this year would limit the scale of capital outflows in a period of increased risk aversion and would not cause serious funding issues for MinFin. We also presume the relatively sound economic fundamentals will allow for rating outlook upgrade within the coming quarters if situation in the euro zone calms.

Zloty may weaken

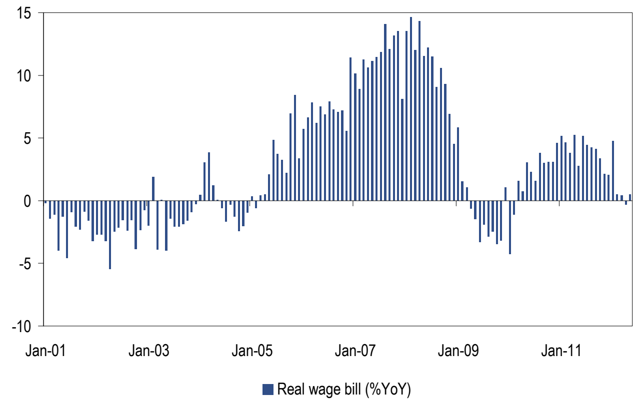
We expect some weakening of the zloty along with deterioration in risk appetite. Zloty vulnerability will result, among other things, from still relatively high current account deficit and low coverage of the deficit by inflows of long term capital. However, the scale of zloty weakening may be limited by potential MinFin's and central bank interventions aimed at reducing short-term speculative flows and the relatively positive economic outlook as compared to other EU countries.

Figure 173. Low PMI signals economic slowdown



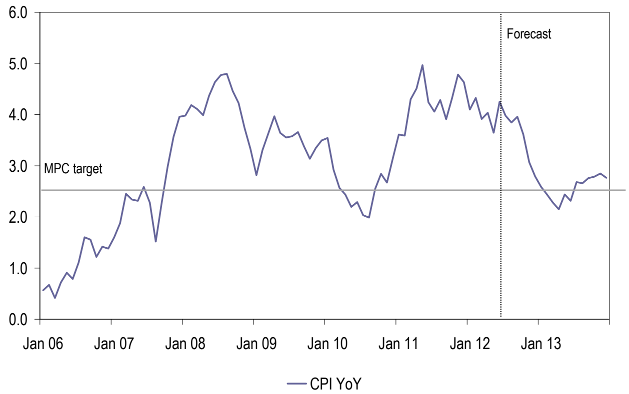
Source: Reuters, GUS.

Figure 174. Labour market slowdown keeps consumption growth low



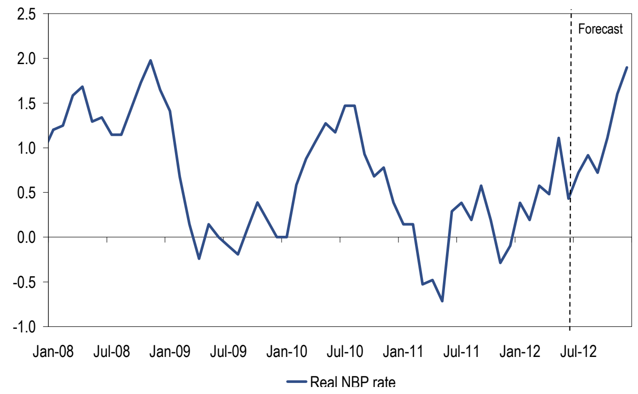
Source: GUS, CIRA.

Figure 175. Inflation will likely return to the target within next 12 months



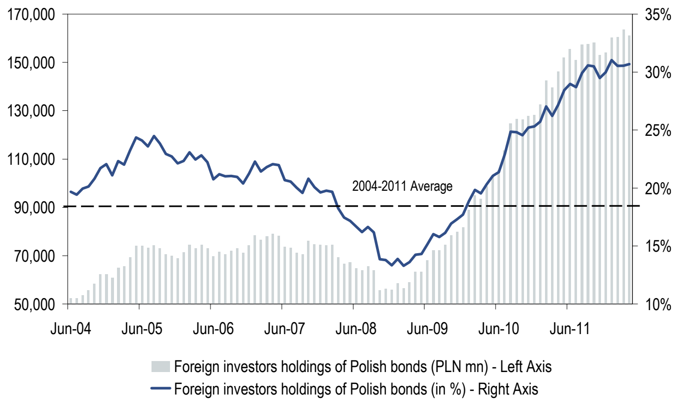
Source: Central Statistical Office, Citi Investment Research and Analysis

Figure 176. Current nominal interest rate can be too high if inflation falls



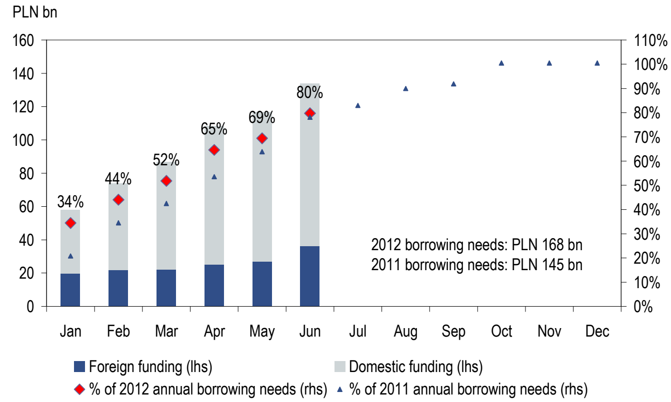
Source: NBP, GUS, CIRA.

Figure 177. Foreign demand for Polish domestic bonds is still high



Source: NBP, Citi Investment Research and Analysis

Figure 178. Realization of borrowing needs is supportive of bonds



Source: Finance Ministry, CIRA estimates

Figure 179. Poland Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	254	304	342	426	534	434	470	515	482	462
Nominal GDP, local currency bn	925	983	1,060	1,177	1,275	1,344	1,416	1,525	1,625	1,708
GDP per capita, US$	6,644	7,966	8,969	11,185	13,995	11,360	12,306	13,492	12,622	12,127
Population, mn	38.2	38.2	38.1	38.1	38.1	38.2	38.2	38.2	38.2	38.1
Unemployment, % of labour force	19.5	18.2	14.9	11.2	9.5	11.9	12.2	12.5	12.9	11.7
Economic Activity										
Real GDP, % yoy	5.3	3.6	6.2	6.8	5.1	1.6	3.9	4.3	2.7	2.4
Real investment growth % yoy	6.4	1.4	16.1	24.3	4.0	-11.5	9.3	9.9	2.3	-1.1
Real consumption growth % yoy	4.3	2.7	5.2	4.6	6.1	2.0	3.5	2.0	2.0	2.3
private consumption growth % yoy	4.7	2.1	5.0	4.9	5.7	2.1	3.2	3.1	2.3	2.5
Real export growth, % yoy	14.0	8.0	14.6	9.1	7.1	-6.8	12.1	7.5	4.5	4.5
Real import growth, % yoy	15.2	4.7	17.4	13.7	8.0	-12.4	13.9	5.8	2.9	2.3
Prices, Money & Credit										
CPI, % yoy	4.3	0.5	1.4	3.9	3.4	3.7	3.2	4.6	3.0	2.8
CPI, % avg	3.5	2.1	1.0	2.5	4.2	3.5	2.6	4.3	3.9	2.6
Nominal wages, % yoy	4.2	3.2	5.0	9.1	10.5	4.2	3.6	4.9	4.1	4.8
Credit extension to private sector, % yoy	10.0	9.3	24.0	31.5	36.4	7.0	8.5	13.0	15.0	15.0
Policy interest rate, %, eop	6.50	4.50	4.00	5.00	5.00	3.50	3.50	4.50	4.75	4.25
1 month inter-bank rate, %, eop	6.46	4.40	3.96	5.37	5.41	3.56	3.46	4.77	4.89	4.37
Long-term yield, %, eop	5.81	5.11	5.20	5.93	5.46	6.24	6.07	5.91	5.55	5.40
PLN/US$, eop	3.00	3.27	2.91	2.45	3.00	2.86	2.95	3.40	3.59	3.43
PLN/US$, avg	3.65	3.24	3.10	2.76	2.39	3.10	3.01	2.96	3.37	3.70
PLN/EUR, eop	4.08	3.86	3.83	3.58	4.17	4.11	3.96	4.42	4.33	4.21
PLN/EUR, avg	4.54	4.03	3.89	3.78	3.52	4.33	3.99	4.12	4.24	4.39
Balance of Payments, US$ bn										
Current account	-13.3	-7.3	-13.1	-30.5	-35.0	-17.2	-21.9	-22.2	-18.3	-20.8
% of GDP	-5.2	-2.4	-3.8	-7.2	-6.5	-4.0	-4.7	-4.3	-3.8	-4.5
Trade balance	-5.9	-3.1	-7.3	-19.1	-30.7	-7.6	-11.8	-14.2	-11.6	-11.6
Exports	81.9	96.4	117.5	145.3	178.4	142.1	165.9	193.9	184.8	201.2
Imports	87.8	99.5	124.8	164.4	209.1	149.7	177.7	208.1	196.3	212.9
Service balance	0.1	0.7	0.7	0.7	5.0	4.8	3.1	6.1	6.6	6.6
Income balance	-8.4	-6.8	-9.7	-16.4	-12.9	-16.6	-17.0	-20.2	-18.2	-20.7
FDI, net	11.8	6.9	10.7	18.0	10.4	8.5	3.6	9.1	4.2	8.0
International reserves	34.5	38.8	45.1	54.6	57.2	69.7	81.4	86.8	94.0	102.0
Total amortisations	21.3	30.1	23.5	30.2	32.4	32.8	32.1	37.3	37.4	38.9
Public Finances, % of GDP										
Consolidated government balance	-5.4	-4.1	-3.6	-1.9	-3.7	-7.4	-7.9	-5.1	-3.1	-2.5
Consolidated gov primary balance	-2.6	-1.3	-1.0	0.4	-1.5	-4.8	-5.2	-2.3	-0.1	0.5
Public debt	46.7	47.5	47.8	44.8	46.9	49.8	52.8	53.5	51.6	50.2
of which Domestic	34.5	34.5	35.6	34.3	34.8	36.7	38.4	36.5	34.7	33.7
Foreign Assets & Liabilities, US$ bn										
External debt	129.9	132.9	169.8	233.3	244.8	280.2	315.3	321.9	335.9	354.9
Public	57.9	60.8	69.1	86.8	69.4	92.2	116.5	120.2	125.4	132.5
External debt / GDP	51.2	44.1	46.6	48.3	56.8	59.4	66.0	72.2	69.7	76.9
External debt / XGS	136.3	117.9	123.0	140.6	114.4	163.8	158.7	139.4	152.9	148.3
Short-term debt	24.8	27.1	34.6	60.9	65.9	70.0	76.5	72.1	76.1	80.1
Short-term debt/International reserves, %	71.9	69.7	76.7	111.4	115.1	100.4	93.9	83.1	81.0	78.6

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	4.2	4.2	4.4	3.5	3.8	2.1	1.6	1.2	1.3	3.1
CPI, % yoy	4.2	3.9	4.6	3.9	4.4	4.2	3.0	2.5	2.3	2.8
Policy interest rate, %, eop	4.50	4.50	4.50	4.50	4.75	4.75	4.75	4.50	4.25	4.25
1 month inter-bank rate, %, eop	4.34	4.43	4.56	4.52	4.91	4.90	4.89	4.44	4.37	4.39
Long-term yield, %, eop	5.92	5.82	5.90	5.48	5.65	5.70	5.55	5.40	5.30	5.40
PLN/US$	2.75	3.29	3.43	3.12	3.56	3.66	3.55	3.44	3.34	3.24
PLN/EUR	4.01	4.36	4.23	4.18	4.47	4.47	4.37	4.27	4.18	4.09

Source: National Sources, Citi Investment Research and Analysis

Romania

Ilker Domac
+90 212 319 4623
ilker.domac@citi.com

Gultekin Isiklar
+90 212 319 4915
gultekin.isiklar@citi.com

- **Summary view** – Recovery prospects have deteriorated, as main growth indicators fail to offer much hope for a meaningful pick up.
- **Things to watch** – The upcoming general elections in November—along with the implementation of the IMF-EU supported economic program—deserve close monitoring.
- **Strategy** – We think the NBR will remain reluctant to ease RON liquidity, preferring currency over growth unless there is a pick up in capital inflows. Against this backdrop, the EURRON is likely to remain range bound in the near-term.

Recovery seems to be losing steam

Recent data fails to alleviate our concerns about the growth outlook. Although sentiment indicators suggest that consumers may be turning somewhat more optimistic, the absence of strong signals from supply side indicators and concerns about the sustainability of Romania's strong export performance paint a challenging outlook for the much-needed recovery. Specifically, after growing by 2.5% last year on the back of an exceptional agricultural harvest, supply side indicators—service sector in particular—don't point to a meaningful pick up. In parallel, Romania's non-food export growth paints a less favorable picture, raising doubts about the future export performance given the weak situation in the euro area. Moreover, a quick glance at the evolution of the seasonally adjusted stock building data, which has been above its average since 1Q 2010, suggests that this trend is likely to be reversed going forward. Against this backdrop, we continue to expect GDP growth to decelerate to 1.3% this year from 2.5% in 2012. Turning to politics, the National Liberal Party and the Conservative Party—the so called Social Liberal Union—got 723 seats of the county councilors, or 54.03% of the vote in the June 10 local elections. The former ruling Democratic Liberal Party (PD-L) won 212 seats, or 15.84% of the vote. Based on the outcome of the local elections, which are widely regarded as a litmus test of parliamentary elections, Romania's Social Liberal Union seems to be in a more advantageous position ahead of the November elections.

Inflation expectations display a marked improvement

At 1.8% YoY, the inflation outturn in May came in line with the consensus. Using seasonally adjusted data, the May print translates into a 0.3%MoM rise in CPI inflation following a flattish monthly inflation in April. In parallel, the evolution of the seasonally adjusted core inflation suggests that underlying inflation dynamics in May remain benign. The marked improvement in forward-looking inflation expectations in May provides further comfort about the near-term inflation outlook. Going forward, we look for a moderate upward trend in year-on-year inflation after May, with year-end inflation reaching about 3.5% (vs. the NBR's most recent forecast of 3.2%). We believe that the possibility of additional administrative price adjustments and a reversal in food prices are the key risk factors requiring close monitoring.

NBR trapped between a rock and hard place

The combination of growing concerns about economic recovery and depreciation pressures complicate the conduct of monetary policy. While the deterioration in growth prospects and the benign inflation outlook call for a more accommodative stance, the depreciation of the leu makes it difficult for the NBR to cut rates. The NBR has in fact tightened RON liquidity to stem currency weakness, driving money markets higher, closer to the policy rate. Where do we go from here? We believe that the NBR is likely to keep RON liquidity tight enough to maintain money market rates in line with the policy rate. All in all, we maintain our view that the NBR is likely to keep the policy rate constant at 5.25% during the remainder of this year.

Tax revenues soften in April

Romania's consolidated budget balance printed a deficit of RON 5.0bn in the first four months of the year, which represents a wider gap when compared with the same period of 2011 (RON 4.4 bn). In the first four months of the year, revenues and expenditures rose by 7.4%YoY and 7.9%YoY, respectively. In seasonally adjusted terms, there is a marked decline in revenues (almost 6%MoM), which, if sustained, would reduce the likelihood of attaining the 2012 budget deficit target to 2.2% of GDP from 1.9%. Looking ahead, we believe that the bleak recovery prospects ahead of the November elections will continue to overshadow fiscal performance.

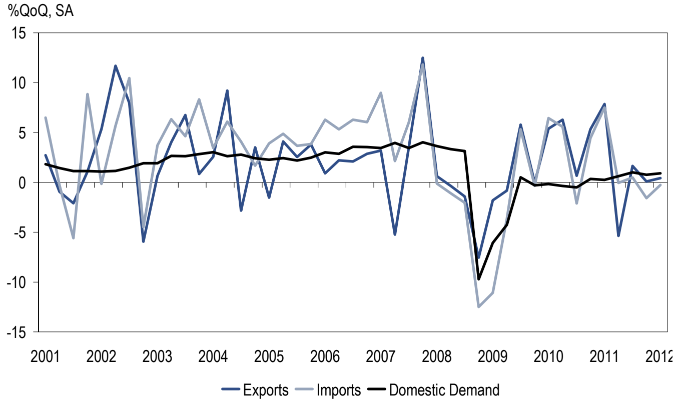
C/A gap is on track to settle around 4.5% of GDP

At EUR 1.2bn, the current account gap in the first four months of the year compares favorably with the deficit seen in the same period of 2011 (EUR 1.6bn). Seasonally adjusted export and import series suggest that the former may be losing momentum, as the 12-month rolling deficit has been stuck at around EUR 10bn in recent months. Against this backdrop, we look for a moderate widening in the current account gap to 4.5% of GDP this year from 4.2% in 2011. On the capital account front, the weakness in identified inflows compared to the current account deficit levels in recent months warrants concern, particularly in the absence of an improvement in the FDI coverage of the current account gap.

Prepare for a range bound EURRON in the near-term.

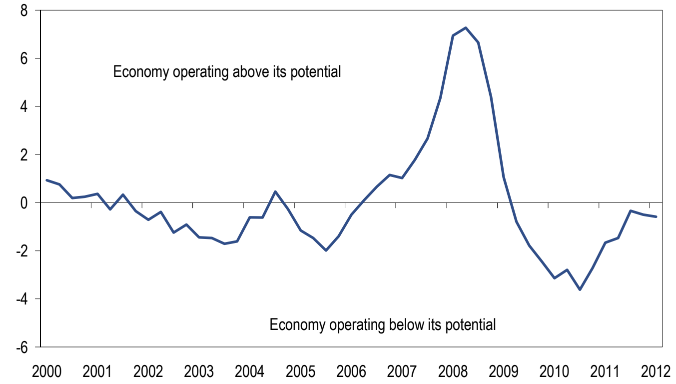
Our analysis suggests that the leu's disappointing performance with respect to its peers in the region is more to do with the low interest rate differential and less to do with the EU sovereign debt crisis. In line with our expectations, the NBR has tightened RON liquidity to contain depreciation pressures. In the near-term, we think the NBR will remain reluctant to ease RON liquidity, preferring currency over growth unless there is a pick up in capital inflows. The noted backdrop, coupled with euro zone woes, suggests to us that the EUR/RON is likely to remain range bound in the near-term, ending the year around 4.40 with risks tilted towards a weaker currency.

Figure 180. Recovery prospects have deteriorated…



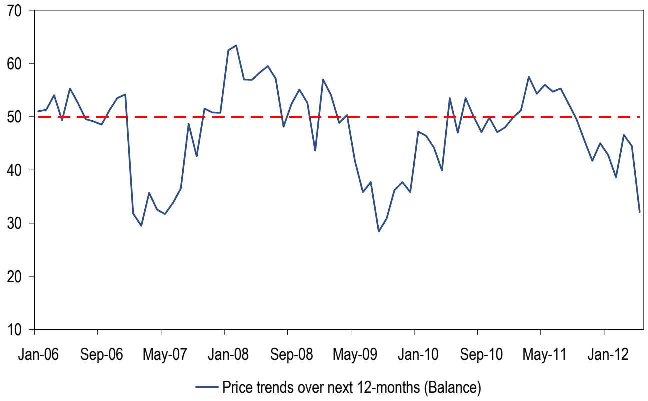
Source: Haver

Figure 181. …as the output continues to remain below its potential.



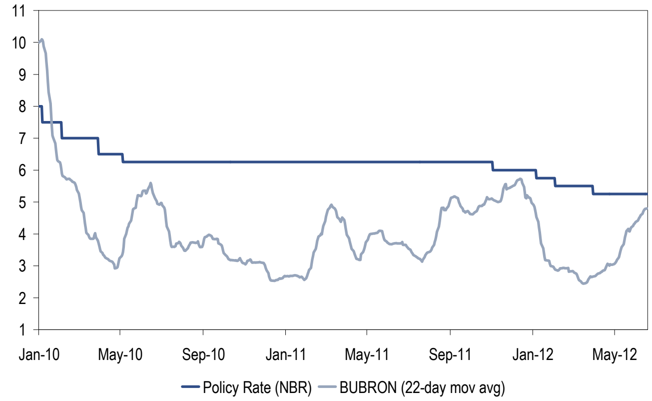
Source: Haver and CIRA

Figure 182. Despite the marked improvement in inflation expectations…



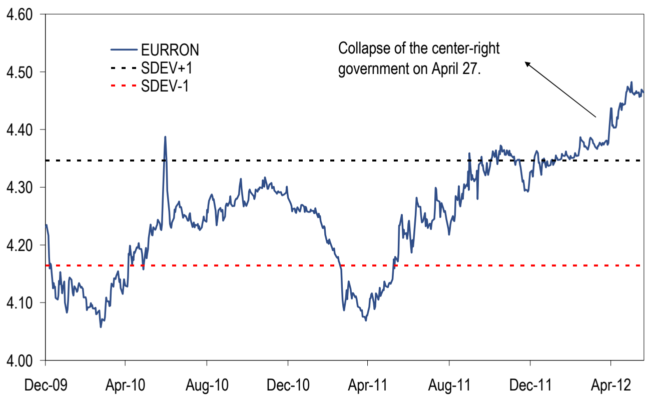
Source: Haver

Figure 183. …NBR was forced to tighten RON liquidity…



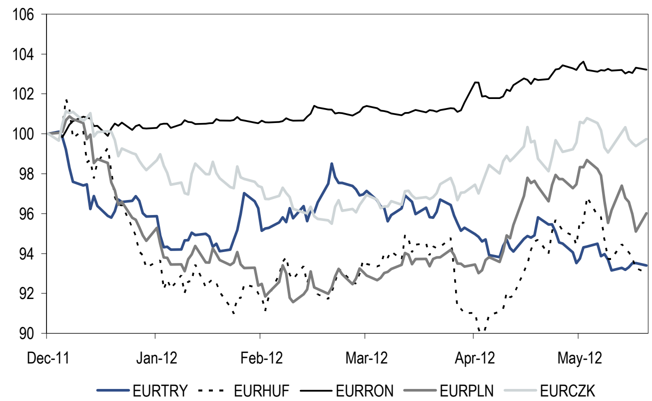
Source: Bloomberg.

Figure 184. …to prop up the leu…



Source: Bloomberg and CIRA

Figure 185. …which has been lagging behind its peers in the region



Source: Bloomberg. Note: Dec 30, 2011=100

Figure 186. Romania Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	75.8	99.2	122.7	170.7	204.4	164.6	164.3	189.9	171.2	175.4
Nominal GDP, local currency bn	247.4	289.0	344.7	416.0	514.7	501.1	522.6	578.6	602.4	637.5
GDP per capita, US$	3,388	4,436	5,496	7,653	9,176	7,397	7,397	8,559	7,732	7,934
Population, mn	22.4	22.4	22.3	22.3	22.3	22.2	22.2	22.2	22.1	22.1
Unemployment, % of labour force	6.8	5.8	5.4	4.3	4.0	6.3	7.6	5.4	5.2	5.2
Economic Activity										
Real GDP, % yoy	8.5	4.1	7.9	6.3	7.4	-6.6	-1.7	2.5	1.3	3.0
Real investment growth % yoy	17.6	4.7	21.7	29.9	12.1	-28.8	0.3	12.5	2.9	3.3
Real consumption growth % yoy	11.7	9.2	10.6	10.5	8.9	-8.9	-0.8	0.8	0.9	2.5
private consumption growth % yoy	15.9	10.0	12.8	11.8	9.0	-10.3	-0.4	1.3	0.9	2.7
Real export growth, % yoy	14.3	7.2	9.8	7.8	7.3	-6.2	15.1	10.5	5.5	4.2
Real import growth, % yoy	22.1	16.0	22.7	27.9	7.1	-21.4	12.7	11.5	3.9	3.2
Prices, Money & Credit										
CPI, % yoy	9.3	8.6	4.9	6.6	6.3	4.7	8.0	3.1	3.5	3.3
CPI, % avg	11.9	9.0	6.6	4.8	7.9	5.6	6.1	5.8	2.8	2.7
Nominal wages, % yoy	22.6	17.0	18.9	22.6	23.6	8.4	2.5	4.9	4.7	5.3
Credit extension to private sector, % yoy	-	45.8	54.5	60.4	33.7	0.9	4.7	6.6	6.7	7.7
Policy interest rate, %, eop	-	7.50	8.75	7.50	10.25	8.00	6.25	6.00	5.25	5.00
1 month inter-bank rate, %, eop	17.38	7.51	8.67	8.24	15.35	10.60	4.05	5.72	5.85	5.60
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
RON/US$, eop	3.27	2.77	2.34	2.53	2.81	2.95	3.21	3.34	3.64	3.50
RON/US$, avg	3.26	2.91	2.81	2.43	2.50	3.04	3.17	3.04	3.52	3.64
RON/EUR, eop	3.87	3.66	3.41	3.54	3.92	4.23	4.29	4.33	4.40	4.30
RON/EUR, avg	4.05	3.62	3.52	3.34	3.68	4.24	4.21	4.24	4.42	4.31
Balance of Payments, US$ bn										
Current account	-6.3	-8.6	-12.8	-22.9	-23.8	-6.8	-7.3	-8.3	-7.7	-8.2
% of GDP	0.0	-8.6	-10.4	-13.4	-11.6	-4.2	-4.5	-4.4	-4.5	-4.7
Trade balance	-6.6	-9.7	-14.8	-24.4	-28.1	-9.6	-10.1	-10.5	-11.6	-10.2
Exports	23.5	27.7	32.5	40.5	49.6	40.5	49.6	62.7	49.7	54.4
Imports	30.2	37.4	47.2	64.9	77.7	50.1	59.7	73.2	61.3	64.5
Service balance	-0.3	-0.4	0.0	0.6	1.0	-0.4	0.5	0.5	0.5	0.5
Income balance	-3.2	-2.9	-4.1	-5.7	-5.4	-2.6	-2.5	-3.3	-3.4	-6.3
FDI, net	6.4	6.5	11.0	9.7	13.7	5.0	3.0	2.6	3.4	4.4
International reserves	14.8	19.8	28.1	37.3	36.5	39.4	42.3	45.8	43.8	50.7
Total amortisations	5.4	6.2	8.6	12.2	18.1	17.7	19.7	18.4	17.9	21.8
Public Finances, % of GDP										
Consolidated government balance	-1.0	-0.8	-1.7	-2.3	-4.8	-7.3	-6.4	-4.1	-2.4	-2.2
Consolidated gov primary balance	0.3	0.3	-0.6	-1.5	-3.9	-5.7	-4.9	-2.4	-0.6	-0.4
Public debt	22.6	20.4	18.4	19.8	21.3	29.6	37.9	38.9	39.2	38.9
of which Domestic	16.1	8.4	7.7	11.7	14.4	17.6	22.5	25.3	24.1	21.7
Foreign Assets & Liabilities, US$ bn										
External debt	28.6	36.4	54.8	84.5	100.1	116.9	123.9	145.2	127.6	122.8
Public	11.9	11.9	13.1	13.9	14.2	19.6	24.8	28.9	25.4	30.7
External debt / GDP	37.8	36.7	44.6	49.5	49.0	71.1	75.4	76.5	74.5	70.0
External debt / XGS	105.4	110.9	138.7	169.3	160.3	232.2	212.2	199.2	214.4	191.0
Short-term debt	4.3	7.4	16.7	28.7	28.5	22.5	26.2	29.8	29.6	32.5
Short-term debt/International reserves, %	28.9	37.3	59.6	77.1	78.1	57.0	61.9	65.1	67.5	64.2

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	1.4	4.4	1.9	0.3	0.8	1.1	2.6	3.3	3.3	3.0
CPI, % yoy	7.9	3.5	3.1	2.4	2.5	3.6	3.5	2.4	2.6	3.2
Policy interest rate, %, eop	6.25	6.25	6.00	5.25	5.25	5.25	5.25	5.00	5.00	5.00
1 month inter-bank rate, %, eop	4.68	6.18	5.72	5.75	5.75	5.75	5.75	5.50	5.50	5.50
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
RON/US$	2.92	3.23	3.34	3.29	3.58	3.59	3.64	3.69	3.75	3.61
RON/EUR	4.24	4.32	4.33	4.39	4.47	4.45	4.40	4.35	4.32	4.30

Source: National Sources, Citi Investment Research and Analysis

Russia

David Lubin
+44 20 7986 3302
david.p.lubin@citi.com

Elina Ribakova
(On maternity leave)

Natalia Novikova
(On maternity leave)

Olga Ponomarenko
+7 495 643 1549
olga.ponomarenko@citi.com

- **Summary view** — After robust 1Q 12 GDP growth of 4.9%YoY the economy moderated in April and May. We estimate GDP will be supported by consumption and in the base case scenario (oil at US$110 in 2H12) will grow by 3-3.5%. However risks are skewed to the downside.
- **Things to watch** — The government will be discussing 2013-2015 budget plan and will probably be focusing on stress-test scenarios of oil at US$60/bbl.
- **Strategy** — Ruble stability will hinge on investors' risk attitude. Should global growth concerns build up and oil prices fall to US$80/bbl, the ruble may trade at 39 against the basket. Meanwhile, in a tight liquidity environment the central bank might be more tolerant to marginal ruble depreciation.

Strong growth for now

Russian economic growth remained broadly stable in May and was aided by the working-day effect. Retail sales added 6.8%YoY in May – slightly above our expectations. Food spending grew by 4.8%YoY, while non-food items added 8.5% decelerating from 9.7% in 1Q12 mostly due to a weaker passenger cars demand. Meanwhile, car production is still showing a robust growth of 38%YoY, driven by exports to CIS countries. Both real wages and investments maintained their April YoY growth rates adding 11.1% and 7.7% respectively. Meanwhile, we believe industrial production managed to come in above expectations due to the working day effect, as was the case in February.

We stick to our deceleration scenario pointing to downside risks. In our base case scenario of oil trading in the range US$100-110/bbl, we expect GDP growth to slow to an average 3-3.5% this year, but see downside risks due to the global factors. These risks are accounted for by the authorities, with the CBR easing access to refinancing for banks and the MoF working on anti-crisis measures. In particular, the MoF is suggesting cancelling about 18% of spending budgeted for 2013 or 1.5-3% of GDP if revenues miss Ministry targets, while continuing to provide support to consumers and enterprises.

The central bank prepares for liquidity tightening

The CBR kept the key rates unchanged as expected in June, but lowered the rate on currency swap operations. Currency swaps were actively traded in 2008 when volumes were as high as US$25bn monthly. However, there was no demand for them after 2009. Cutting the rate on the currency swaps from 8.0% to 6.5% allows the provision of cheaper liquidity and exchange rate adjustments through limits. Meanwhile, the overnight swap rate is 125bp higher than the minimal repo auction rate and 25bp higher than the fixed repo rate. However, there remains uncertainty about the volume of refinancing provided by the regulator through currency swaps. We believe the CBR may decrease or increase limits on currency swaps as a complement to interventions when the ruble deviates from mid-corridor.

The CBR remains concerned about inflation, but sees growth close to potential levels. The regulator sees inflation expectations risks stemming from tariffs increases, a lower base effect, and global uncertainty. We expect July inflation to come in 1-1.5pp higher than in June (3.8%YoY in May) due to tariff increases. Meanwhile, the regulator sees risks to growth stemming from lower commodities prices, but the switch of focus to growth is unlikely in the medium-run.

Key rate cuts are unlikely until 2013, but we expect the regulator to refine its set of instruments and their parameters. We believe the CBR will try to keep interest rates in the 5-6% range, which would be consistent with our 6-9 month inflation forecast. Even though the CBR will be watching commodities prices, we do not expect key rate cuts until 2013. Meanwhile, the CBR has been systematically expanding the list of securities eligible as collateral, and as of June 15 three bonds were added to the list, allowing banks to borrow RUB200bn more (Bloomberg, 15 June). Moreover, we expect further fine-tuning of non-key operations.

Ruble driven by risk attitude

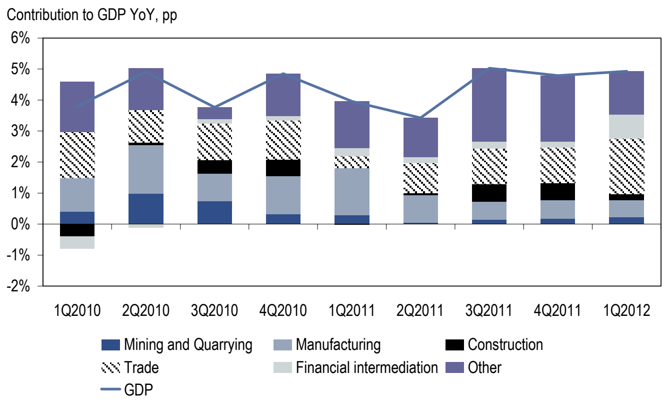
Internal factors are supportive for ruble. We believe that decelerating domestic demand should be favorable for ruble. Furthermore, tight domestic liquidity would not allow for large volumes of short ruble positions in the market. Even though liquidity is likely to improve in the year-end due to less withdrawals by the budget, the Central bank has a set of instruments to efficiently regulate ruble supply to the banking system.

Balance of payments is neutral. In the base case of oil trading at US$100-110/bbl in 2H12 we expect the current account surplus to marginally exceed US$100bn. However, most of it will be drained by capital outflows that are likely to go beyond US$70bn. According to the CBR chairman Sergei Ignatiev (RBC, 6 June), in January-May US$47bn left the country. Should oil decline further and average US$80/bbl in 2H12, the current account is likely to fall to US$80bn, while capital flight should decelerate as well. Overall, we expect the balance of payments to be close to balanced.

Risk-off is detrimental. We see ruble's high sensitivity to risk aversion, and even when oil is trading at reasonably high levels ruble may depreciate due to the risk-off attitude. We believe that should oil prices recover to US$100-110/bbl, risk aversion will become the key factor for ruble. In the base case (oil at US$100-110 and GRAMI slightly above normal in 2H) we expect the basket to stay within 36-37 rubles during the remainder of 2012. Appreciation below 35 is very unlikely even if oil prices recover in 3Q. Ruble basket might trade through 39 if oil prices fall to about US$80/bbl and risk aversion goes up to at least half of Lehman levels.

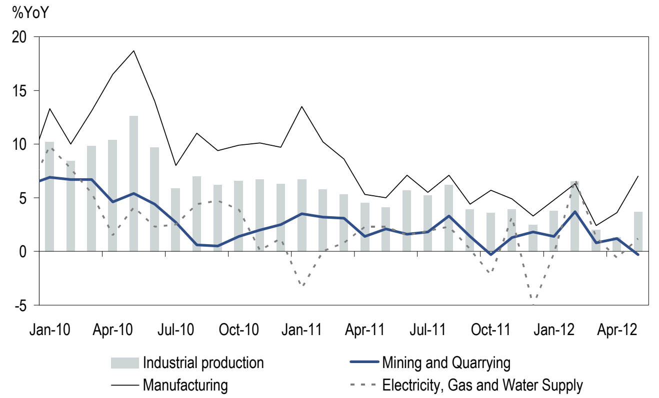
Central bank interventions are asymmetric. The Central bank seems to intervene less when the ruble depreciates and liquidity is tight. Ruble has lost 9% against the basket since the beginning of May on eurozone concerns and increase in global risk-off. We looked at the daily history of the CBR interventions in 2011-2012, and found that since late 2011, the CBR was more active on the FX market when the ruble was appreciating 1-1.5 rubles vs the middle of the operating band. And the regulator was reluctant to intervene when the basket was weakening by the same amount. The difference in FX sales/purchases was less pronounced when the basket was 1.5-2 rubles away from the middle. When describing its FX policy in late 2011, CBR mentioned FX policy parameters are set taking into account the drivers of the balance of payments, budget balance, as well as the stance of the money market. We believe the recent asymmetric response to FX movements by the CBR could reflect its concerns with tightening bank liquidity. We expect to see more aggressive interventions from the CBR if bank liquidity improves or basket deviates by more than 1.5 rubles from the middle of the target band.

Figure 187. GDP accelerated on trading activity



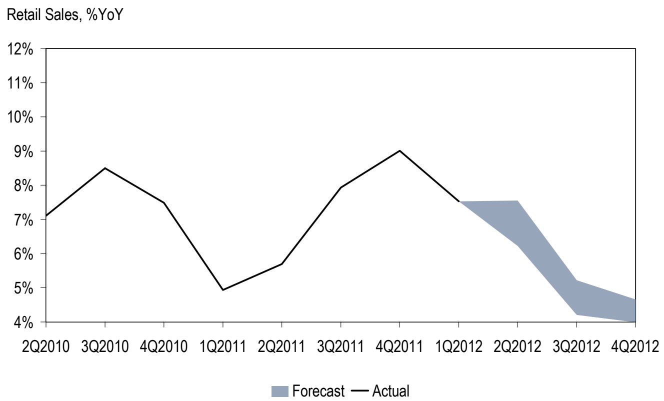
Source: Citi Investment Research and Analysis, Rosstat

Figure 188. Industrial production gained on the working day effect



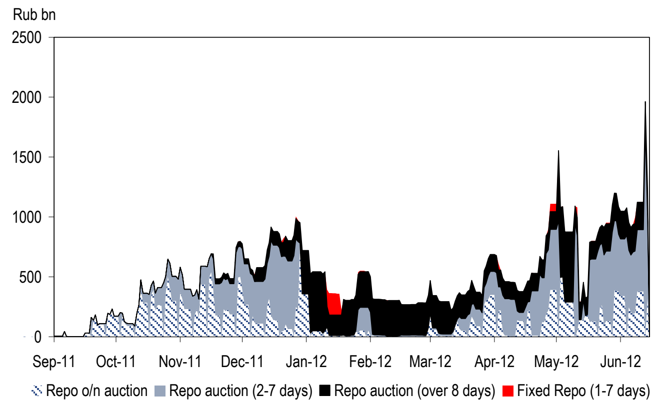
Source: Citi Investment Research and Analysis, Rosstat

Figure 189. A slowdown in GDP will be due weaker consumer demand



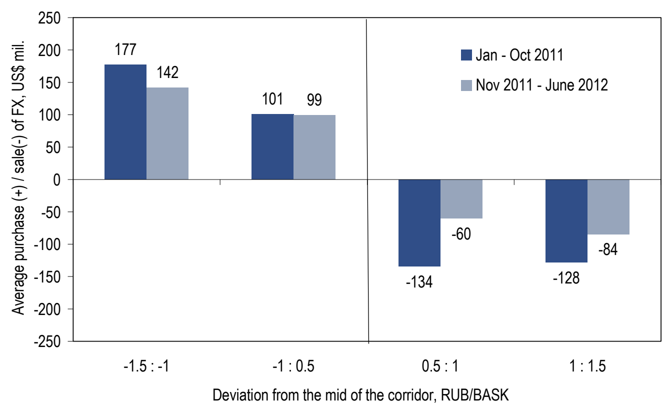
Source: Citi Investment Research and Analysis, MinFin

Figure 190. In the tight liquidity environment…



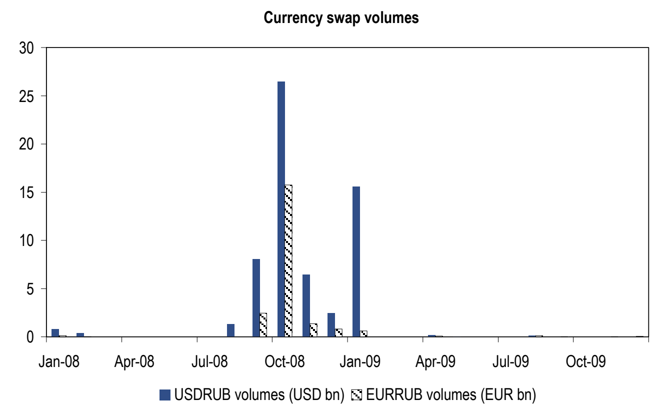
Source: Citi Investment Research and Analysis, MinFin

Figure 191. …CBR sells less FX when ruble depreciates…



Source: Citi Investment Research and Analysis, Bloomberg

Figure 192. …and reintroduces currency swaps used during 2008-09



Source: Citi Investment Research and Analysis, Bloomberg

Figure 193. Russia Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	591	764	990	1,300	1,661	1,223	1,487	1,850	1,841	1,943
Nominal GDP, local currency bn	17,027	21,610	26,917	33,247	41,277	38,807	45,173	54,586	59,921	67,835
GDP per capita, US$	4,097	5,309	6,898	9,070	11,601	8,546	10,404	12,955	12,904	13,629
Population, mn	144.3	143.8	143.5	143.3	143.2	143.1	143.0	142.8	142.7	142.6
Unemployment, % of labour force	8.2	7.6	7.2	6.1	6.4	8.4	7.5	6.6	7.5	7.5
Economic Activity										
Real GDP, % yoy	7.2	6.4	8.2	8.5	5.2	-7.8	4.3	4.3	3.5	4.0
Real investment growth % yoy	12.6	10.6	18.0	21.0	10.6	-14.4	5.8	8.0	6.7	9.0
Real consumption growth % yoy	8.3	8.1	8.8	10.7	8.4	-3.9	3.3	4.8	5.2	4.4
private consumption growth % yoy	11.8	11.6	11.9	14.2	10.4	-5.1	5.1	6.3	5.9	5.3
Real export growth, % yoy	11.8	6.5	7.3	6.3	0.6	-4.7	7.0	0.4	1.0	2.7
Real import growth, % yoy	23.3	16.6	21.3	26.2	14.8	-30.4	25.8	20.3	4.3	5.8
Prices, Money & Credit										
CPI, % yoy	11.7	10.9	9.0	11.9	13.3	8.8	8.8	6.1	6.9	5.6
CPI, % avg	10.9	12.7	9.7	9.0	14.1	11.6	6.8	8.4	5.1	6.9
Nominal wages, % yoy	24.0	25.2	25.5	26.0	27.4	9.1	13.9	10.6	6.0	6.0
Credit extension to private sector, % yoy		34.6	48.7	49.3	37.2	2.6	12.9	28.0	18.0	20.0
Policy interest rate, %, eop	13.00	12.00	11.00	10.00	13.00	8.75	7.75	8.00	8.00	6.00
1 month inter-bank rate, %, eop	-	6.39	5.71	6.09	20.20	6.32	3.78	6.37	5.50	4.50
Long-term yield, %, eop	-	6.9	6.6	6.6	10.9	9.5	8.2	8.8	8.0	7.5
RUB/US$, eop	27.8	28.8	26.4	24.6	29.4	30.2	30.5	32.2	34.2	34.3
RUB/US$, avg	28.8	28.3	27.2	25.6	24.9	31.8	30.4	29.4	32.5	34.9
RUB/EUR, eop	37.8	34.2	34.6	35.7	41.4	43.4	40.3	41.7	41.3	42.1
RUB/EUR, avg	35.8	35.3	34.1	35.0	36.4	44.2	40.3	40.9	40.9	41.4
Balance of Payments, US$ bn										
Current account	59.5	84.6	94.7	77.8	103.5	48.6	95.3	98.8	107.1	46.6
% of GDP	10.1	11.2	9.9	6.1	6.2	4.0	6.4	5.3	5.8	2.4
Trade balance	85.8	118.4	139.3	130.9	179.7	111.6	151.7	198.2	207.1	142.4
Exports	183.2	243.8	303.6	354.4	471.6	303.4	400.4	522.0	556.1	521.6
Imports	97.4	125.4	164.3	223.5	291.9	191.8	248.7	323.8	349.0	379.2
Service balance	-12.7	-13.8	-13.6	-18.9	-24.3	-19.8	-7.8	-35.9	-32.2	-49.3
Income balance	-12.8	-19.0	-29.4	-30.8	-49.2	-40.3	-48.6	-60.2	-64.9	-44.0
FDI, net	1.7	0.1	6.6	9.2	19.4	-7.2	-9.2	-14.4	-11.9	3.9
International reserves	120.8	175.7	295.3	466.4	410.7	405.8	432.9	441.2	479.9	528.9
Total amortisations	0.4	0.3	0.4	0.4	30.4	117.0	90.0	60.0	50.0	50.0
Public Finances, % of GDP										
Consolidated government balance	4.6	8.1	9.4	6.7	5.3	-5.7	-3.3	2.0	0.3	0.1
Consolidated gov primary balance	5.8	9.0	10.0	7.2	5.6	-5.2	-2.8	2.5	0.9	0.7
Public debt	21.5	13.2	8.3	6.6	5.2	7.3	7.8	8.3	8.5	8.5
of which Domestic	4.4	3.9	3.8	3.8	3.4	4.7	5.4	6.5	6.7	6.6
Foreign Assets & Liabilities, US$ bn										
External debt	196.8	239.9	250.7	361.3	480.0	469.7	489.7	509.7	519.7	529.7
Public	100.8	71.1	44.7	37.4	29.5	31.3	34.5	33.2	32.6	36.7
External debt / GDP	33.3	31.4	25.3	27.8	28.9	38.4	32.9	27.5	28.2	27.3
External debt / XGS	96.6	89.3	74.9	91.8	91.8	136.2	109.9	88.5	84.5	92.0
Short-term debt	26.4	27.1	40.6	72.0	73.0	48.0	53.0	58.0	65.5	73.0
Short-term debt/International reserves, %	21.9	15.4	13.8	15.4	17.8	11.8	12.2	13.1	13.6	13.8

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.4	5.0	4.8	4.9	4.8	2.4	2.4	3.9	5.4	5.9
CPI, % yoy	9.4	7.2	6.1	3.7	4.0	6.4	6.9	8.0	7.9	5.8
Policy interest rate, %, eop	8.25	8.25	8.00	8.00	8.00	8.00	8.00	7.50	7.00	6.50
1 month inter-bank rate, %, eop	4.06	5.19	6.64	5.80	4.00	4.10	4.10	4.10	4.10	4.10
Long-term yield, %, eop	8.34	8.84	8.77	8.11	7.50	7.60	7.60	7.60	7.60	7.60
RUB/US$	27.9	32.2	32.2	29.3	33.2	33.4	34.2	34.9	35.6	34.9
RUB/EUR	40.5	43.1	41.7	39.1	41.5	41.4	41.3	41.1	41.0	41.5

Source: National Sources, Citi Investment Research and Analysis

Slovakia

Jaromir Sindel
+ 420 233 061 485
jaromir.sindel@citi.com

- **Summary view** — We retain our forecast of 2.2%YoY in 2012 and 1.8% in 2013. The trend of foreign trade driven recovery and domestic demand weakness is likely to continue. Our forecast is below official forecasts.
- **Things to watch** — National Council approves the ESM without any amendments. Slovakia has to pay the initial contribution of €264mn to the ESM capital this year. The Fiscal Compact Treaty is planned to be approved in 2H12.
- **Strategy** — Total issuance for the year-to-date likely covers the total gross borrowing requirements for this year, with some upside risk at €0.5bn. With the current issuance, this would suggest that the borrowing requirement would now be covered 94%.

GDP driven by foreign trade, while domestic demand lost

We keep our forecast of 2.2%YoY in 2012 and 1.8% in 2013. However, these are accompanied by downside risks, particularly for 2013. Next quarter, GDP will probably grow by 0.3%, and then more or less flat growth in 2H12. This is contrasts with the central bank's forecast that was revised upward to 2.5%YoY in 2012 (2.1% previously) and retained its outlook for an ongoing recovery in 2013 (3.1%) and 4.3% in 2014. This is well above our forecast of 2.2%, 1.8% and 2.8% in 2012, 2013 and 2014 respectively. The economy has been driven by strong industrial production, particularly in autos. April's industrial production experienced a mild monthly gain of 0.3%MoM after seasonal adjustment which means industrial output has increased by a cumulative 8.6% since Dec11, though the recent dynamics have eased markedly compared to an average 2.7% monthly gain in 1Q12. However, a trend is likely to continue with April new orders rising 1%MoM (or 14.9%YoY) and May industrial confidence also rising though, in the latter, the new orders component deteriorated.

GDP growth in 1Q12 was mainly driven by foreign trade, while domestic demand was poor, falling 0.7%YoY and April data suggest this will continue. Slovak GDP growth was slightly revised downward to 0.7%QoQ from its flash estimate of 0.8%, slightly lower than the average quarterly growth of 0.8% in 2011. GDP growth rode on net exports, which is actually on a downward path in volume terms (export decelerated to 2.6%YoY and imports fell by 1.3%). April data suggest this trend has continued. Domestic demand weakness mainly reflects a drop in investment activity (both fixed and inventories) after new production capacities in automotive industry have been gradually put in place (fixed investment increased 5.7%YoY in 2011). Private consumption also fell by 0.1%YoY (milder compared to -0.4%YoY in 2011) as the impact from the 0.6%YoY fall in average real wages bit in 1Q12 and April retail sales do not suggest any domestic demand improvement given its 0.8%MoM fall after 0.7% fall in March. Moreover, construction output fell 14.6%YoY in April after an average fall by 9.7% in 1Q12. Although construction confidence slightly improved in May, it remains well below the long-term average.

Cars still boost industrial production and trade surplus. Industrial output is still driven by the car industry which accelerated production 56%YoY in April from 29% in 1Q12 (and after 19% in 2011). The combination of strong car-driven export activity and domestic demand weakness resulted in another historically high trade surplus that we estimate at 4.7% of GDP, up from 1.1% in April last year. We estimate the current account surplus at 1.4% of GDP in April, representing an upside risk to our whole year forecast of 1.3% of GDP.

CPI eased in May, but is likely to remain above target

Consumer price inflation decelerated to 3.4%YoY in May from 3.6% a month earlier, reaching a 15-month low and we now expect the national measure of CPI growth to ease to 3.3%YoY in 3Q12 (from 3.8% in 1Q). The easing of consumer price growth was in line with price expectations, though they do remain at somewhat elevated levels. The deceleration in May reflects the base effect as there was a 0.1%MoM increase in May driven by an increase in clothes and food prices. Clothing prices have changed their seasonality since last year and, in contrast to the Czech Republic, outturned an annual growth rate of 2.1% in 2011, the strongest since 2002. This could reflect somewhat stronger domestic economic growth and a less competitive environment. We expect Slovak CPI growth to ease to 3.6% in 2012 from 3.9% in 2011 and our mid-term outlook for CPI is close to 3% in 2012-16. This suggests a real appreciation, in contrast to larger fall in the real interest rate.

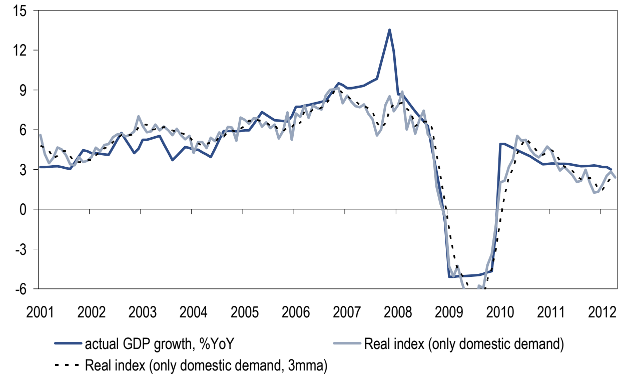
Borrowing requirements almost covered for the year

Total issuance for year-to-date likely covers the total gross borrowing requirements for this year, with some upside risk of €0.5bn. We estimate this year borrowing requirements at around €7.8bn, of which €4bn is from the fiscal deficit and then €2.2bn from bonds (which have already matured) and €1.6bn from maturing t-bills of which €0.74bn remains in the pipeline for July this year. Slovakia's debt and liquidity agency (ARDAL) has tapped the market for €7.8bn year-to-date of which €6.3bn has come in the form of long-term bonds and €1.47bn in t-bills. ARDAL has issued €3.5bn of local and EUR syndicated long-term bonds year-to-date (this includes buy-backs of €252mn), with an average maturity of 5.8 years, up slightly from 5.7 years in 2011. On top of that, ARDAL issued three foreign-currency denominated bonds totaling €2.8bn and t-bills at €1.47bn.

The risks of larger issuance are slightly on the upside due to wider deficit and payment of ESM capital. If these upside risks were to materialize, we think it would increase the borrowing requirements by €0.5bn to €8.3bn. With the current issuance, this would suggest that the borrowing requirement would now be covered 94%. Key risks are: i) delivery of part of the ESM capital at €264mn until end of this year that is 40% of total "cash" commitment to ESM capital of €659mn (or 0.97% of Slovak 2011's GNI); ii) wider fiscal deficit despite solid GDP growth. The central gov´t deficit reached €2.29bn, €0.6bn wider compared to year ago due to increased expenditure (9%YoY) and lower revenues (-1%). However, this upside risk is mitigated by our expectation that the fiscal deficit this year will be wider than the government forecast (we expect the full-year deficit at €4bn, while government plan is €3.7bn). Moreover, the proposed tax-based consolidation measures point to "extra tax collection" of about €625-1,000mn in 2012-13, of which around €125mn could already be delivered this year.

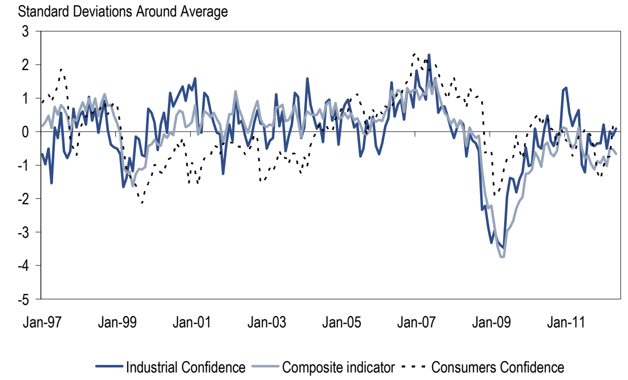
Moreover, PM Robert Fico has introduced additional lists of consolidation measures totaling €2.3bn for 2013. This implies an additional buffer of €0.6bn that should be sufficient in the event of economic growth decelerating by 1-2% points. In other words, the consolidation of the fiscal deficit to 3% of GDP in 2013 should also be achievable under a scenario of GDP growth at around 1% in 2013, as the MinFin expects GDP growth of 2.6% in 2013 following 2.5% in 2012; we expect a deceleration to 1.8% in 2013 and fiscal deficit at 3.2% of GDP. Moreover, the Slovak Institute for Financial Policy at Ministry of Finance said that Greek default would cost Slovakia €701mn. This would boost the general government deficit by 1% of GDP beyond our forecast of 4.8% of GDP in 2012 and 3.2% in 2013.

Figure 194. March data improved further to support GDP growth



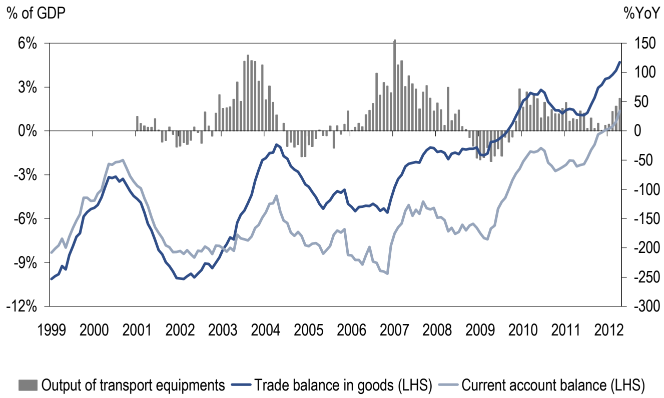
Source: Statistical Office of the Slovak Republic, Haver, CIRA

Figure 195. Confidence worsened, but still better than early 2012



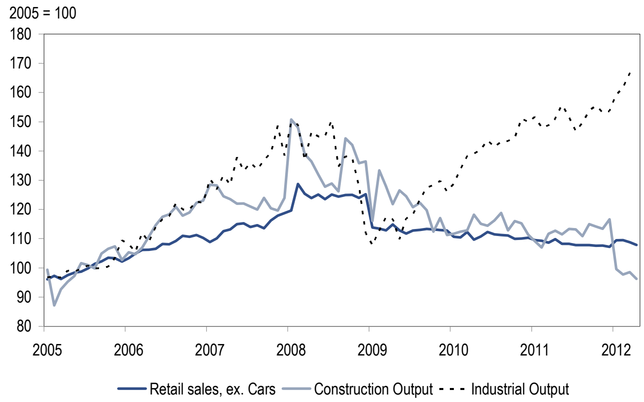
Source: Statistical Office of the Slovak Republic, CIRA

Figure 196. Improvement in trade/current surplus depends on car s



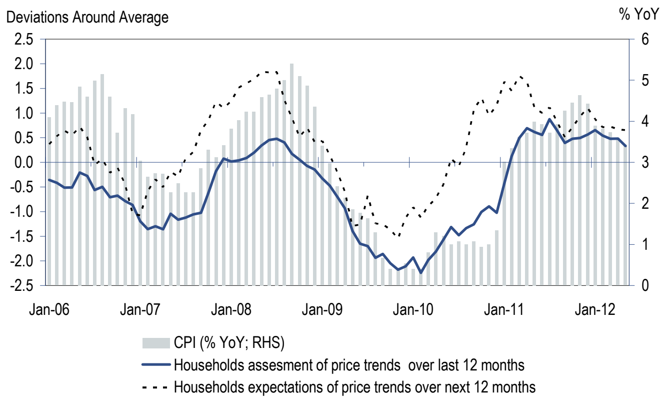
Source: Haver Analytics and Citi Investment Research and Analysis calculation

Figure 197. Industry has continued in outperformance rest of economy



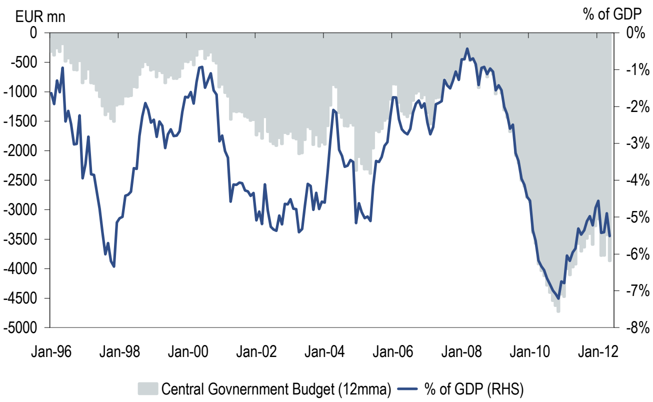
Source: Haver, Eurostat, Statistical Office of the Slovak Republic, CIRA

Figure 198. Households price expectations still far from disinflation



Source: European Commission, Haver Analytics, CIRA calculation

Figure 199. Central gov't deficit €0.6bn wider compared to last year



Source: Haver Analytics and Citi Investment Research and Analysis calculation.

Figure 200. Slovakia Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	42.3	47.9	56.2	75.3	94.7	87.6	87.2	96.2	89.7	86.9
Nominal GDP, local currency bn	34	38	45	55	64	63	66	69	71	73
GDP per capita, US$	7,812	8,837	10,371	13,872	17,410	16,076	15,964	17,573	16,355	15,816
Population, mn	5.4	5.4	5.4	5.4	5.4	5.5	5.5	5.5	5.5	5.5
Unemployment, % of labour force	14.3	11.7	10.4	8.4	7.7	11.4	12.5	13.2	13.6	13.5
Economic Activity										
Real GDP, % yoy	5.1	6.7	8.3	10.5	5.8	-4.9	4.2	3.3	2.2	1.8
Real investment growth % yoy	4.8	17.5	9.3	9.1	1.0	-19.7	12.4	5.7	1.5	3.2
Real consumption growth % yoy	2.7	5.8	6.6	5.0	6.1	1.6	-0.3	-1.2	0.1	0.2
private consumption growth % yoy	4.6	6.5	5.9	6.8	6.1	0.2	-0.7	-0.4	-0.4	0.6
Real export growth, % yoy	7.4	10.0	21.0	14.3	3.1	-15.9	16.5	10.8	3.7	3.5
Real import growth, % yoy	8.3	12.3	17.8	9.2	3.1	-18.1	16.3	4.5	2.9	3.7
Prices, Money & Credit										
CPI, % yoy	6.0	3.7	4.2	3.4	4.4	0.5	1.3	4.4	3.4	3.2
CPI, % avg	7.5	2.7	4.5	2.8	4.6	1.6	1.0	3.9	3.6	2.8
Nominal wages, % yoy	10.1	9.2	8.6	7.5	8.2	3.0	3.3	3.0	3.5	4.0
Credit extension to private sector, % yoy	5.7	27.6	23.7	22.7	17.4	0.8	4.8	8.6	0.5	-0.5
Policy interest rate, %, eop	4.00	3.00	4.75	4.25	2.50	1.00	1.00	1.00	0.50	0.50
1 month inter-bank rate, %, eop	2.08	2.14	2.94	4.08	4.27	0.90	0.57	1.18	0.20	0.40
Long-term yield, %, eop	4.58	3.62	4.15	4.61	4.72	4.12	4.06	5.21	5.70	4.1
€/US$, eop	1.4	1.2	1.3	1.5	1.4	1.4	1.3	1.3	1.2	1.2
€/US$, avg	1.2	1.2	1.3	1.4	1.5	1.4	1.3	1.4	1.3	1.2
Balance of Payments, US$ bn										
Current account	-3.8	-4.7	-5.0	-4.1	-5.9	-2.3	-2.2	0.0	0.5	-0.4
% of GDP	-9.0	-9.9	-8.9	-5.4	-6.2	-2.6	-2.5	0.1	0.5	-0.5
Trade balance	-2.0	-3.1	-3.2	-1.0	-1.1	1.3	1.0	3.4	2.9	1.6
Exports	36.8	40.9	51.4	64.9	72.9	55.4	64.0	78.5	76.5	75.4
Imports	38.8	44.0	54.6	65.9	74.0	54.1	63.0	75.1	73.6	73.8
Service balance	0.3	0.3	0.8	0.5	-0.7	-1.4	-1.0	-0.5	-0.1	0.2
Income balance	-2.2	-2.0	-2.5	-3.2	-2.8	-1.2	-1.7	-2.3	-2.4	-2.5
FDI, net	3.1	2.3	4.2	3.0	4.3	-0.9	0.1	1.7	-0.5	0.5
International reserves	18.9	NA	NA	NA	NA	NA	NA	NA	NA	NA
Total amortisations	1.6	1.6	1.6	1.7	1.7	1.8	2.1	2.1	2.4	2.6
Public Finances, % of GDP										
Consolidated government balance	-2.4	-2.8	-3.2	-1.8	-2.1	-8.0	-7.7	-4.8	-4.8	-3.2
Consolidated gov primary balance	-0.2	-1.1	-1.7	-0.4	-0.8	-6.6	-6.3	-3.5	-3.4	-1.8
Public debt	42	34	31	30	28	36	41	43	47	48
of which Domestic	15	9	22	20	19	20	26	31	17	18
Foreign Assets & Liabilities, US$ bn										
External debt	23.4	26.9	32.0	44.1	52.3	43.6	46.0	47.5	57.6	62.1
Public	6.7	5.6	7.7	9.5	10.3	11.4	13.3	15.5	20.2	22.2
External debt / GDP	55.4	56.3	56.9	58.5	55.2	49.8	52.7	49.4	64.2	71.5
External debt / XGS	57.8	59.4	56.3	61.3	64.0	71.0	65.8	55.8	69.6	76.1
Short-term debt	8.5	12.9	11.1	17.4	20.1	8.8	10.3	9.0	13.6	13.9

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.4	3.2	3.3	3.2	2.6	1.9	1.0	4.9	2.9	2.9
CPI, % yoy	3.9	4.3	4.4	3.7	3.5	3.5	3.4	2.6	2.7	2.8
Policy interest rate, %, eop	1.25	1.50	1.00	1.00	0.75	0.50	0.50	0.50	0.50	0.50
1 month inter-bank rate, %, eop	1.28	1.35	1.14	0.47	0.05	0.00	0.20	0.20	0.30	0.35
Long-term yield, %, eop	4.39	-	-	5.24	5.30	5.70	5.70	5.30	5.40	4.00

Source: National Sources, Citi Investment Research and Analysis

South Africa

David Cowan
+44 20 7986 3285
david.cowan@citi.com

- **Summary view** — Growth is set to remain weak in 2012 at under 3% and only modestly rebound in 2013 on our estimates. Inflation seems stuck at upper end of its target, although monetary policy will remain accommodative. We expect no interest rate hikes until early 2013.
- **Things to watch** — The economy remains sensitive to the global economic cycle, especially the crisis in the Euro Zone. A sudden weakening in the rand is potentially a risk, complicating monetary policy. Higher taxes on the mining sector will be dominate the ANC's December National Elective Conference.
- **Strategy** — The weakening of the rand since March highlights its sensitivity to global risk aversion and swings in commodity prices. Bond yields remain at risk of further rises in global risk aversion and eventually, policy normalization. Curve flattening probably will need to wait for genuine economic improvement.

Growth looks set to remain subpar

As expected, the GDP growth data for 1Q 2012 showed that growth continued to weaken compared to an already weak 2011. More worryingly for the authorities, however, was the while the volatile agricultural and mining weighed on growth, the more solid consumer demand seen in 2011 seems to be loosing steam. Until recently, consumer spending has shown surprising resilience, helped by supportive policy. In addition, the prices of South African commodity exports have declined of late but the weaker rand is cushioning local producer margins, while giving some boost to competitiveness. Nonetheless, real export performance remains poor and is further undermined by the Euro Zone debt crisis. In fact, the only positive outlook seems to be in the manufacturing sector at present.

But the impact of the Euro Zone debt crisis does seem to be running deeper given South Africa's strong trading links with the EU. Despite the modest upturn in business confidence in early 2012, this has now declined in Q2 and the combination of weak data and lack of clarity on the economic situation in the EU will continue to weigh on both business and consumer confidence in 2012.

With weak growth, the current account deficit was moderate in 2011 but as 1Q data shows, we expect it to widen in 2012 to 4.7% of GDP. Although weak growth continues to constrain import demand, the less favorable terms-of-trade environment and weak EU growth continues to weigh on exports. Businesses also have kept dividend payments low, helping narrow the investment income deficit. By 2013, however, the deficit could move closer to 6% of GDP as import demand accelerates and export performance remains hindered by poor competitiveness. Current account deficit financing typically takes place through portfolio inflows, which came under pressure of late as foreigners sold both SA equities and bonds. Net FDI inflows remain volatile, but relatively low by global EM standards

Monetary policy dilemmas in 2H 2012

With weak growth, monetary policy has remained accommodative for a sustained period. But the SARB will have a difficult policy choice in 2H 2012 about whether to ease rates further, or to leave them unchanged. This is especially the case as real rates are already slightly negative when compared to both actual and expected inflation. The SARB nonetheless feels that low real rates are justified due to the existence of a rather large output gap, the threat of economic disruption from the EU debt crisis and the absence of demand-driven price pressures.

We do not think this situation will change substantively as we still think inflationary pressures will remain relatively strong running into 2013. Although, we still do not expect a significant and sustained breach of the 3%-6% inflation target, we still think that inflation is likely to hover around the top end of the target range for most of 2012 and the weakening of the rand in 2012 should, over time, lead to a rise in core inflation, especially in the consumer goods sector, where prices are still mostly down on a YoY basis. Nonetheless, the renewed widening in the output gap should continue to limit the pricing power of local producers and retailers, while food price inflation is probably close to its peak. Longer term, though, it is going to be difficult for inflation to fall below the 5%-6% range, amid prospective further rand depreciation and sticky wage demands. This would imply a rate cut is unlikely, unless there was a significant deterioration in the growth outlook.

Fiscal policy will remain supportive, but will other policy?

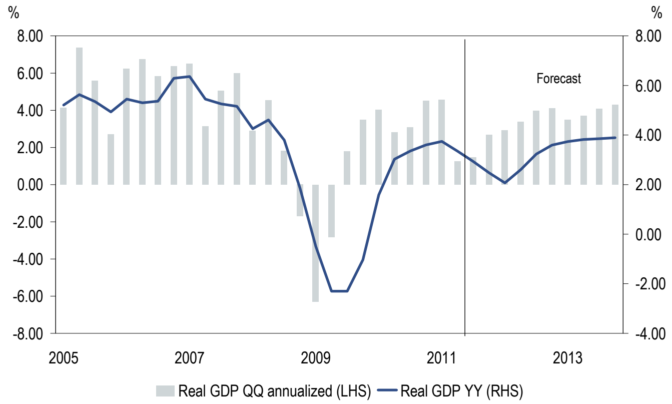
The February 22 budget presentation maintained the recent emphasis of fiscal policy, which we think is unlikely to changed unless the economy falls back into recession. It reaffirmed the government's commitment to support growth with ongoing investment in infrastructure projects, while retaining its commitment to long-term deficit reduction and debt stabilization, with consolidation only expected to begin in earnest when the economy picks up in 2014/15 pushing the deficit back down to levels of around 3.5% of GDP. In addition, the government will continue to focus on other reform efforts to boost growth. But the reality remains that despite efforts at more micro-focused policy interventions, structural obstacles to stronger growth will not dissipate soon and continue to limit the economy's ability to generate sufficient employment.

But with a weak economy pressures for a more populist policy are bound to rise in the run up the ANC elective conference in December. Although there appears to be a strong will among the ANC leadership to rein in the most vocal populists, and their calls for nationalization of the mining sector, it seems policy could move towards higher taxes in the sector, more regulatory commissions and the establishment of a new super-state mining company. Whether this will undermine general business confidence is less clear, but coupled with the need to eventually withdraw the policy stimulus, these policy moves and the economy's structural constraints are likely to limit the extent of the pick up in growth in 2013.

Risk aversion, rand key determinants of bond yields

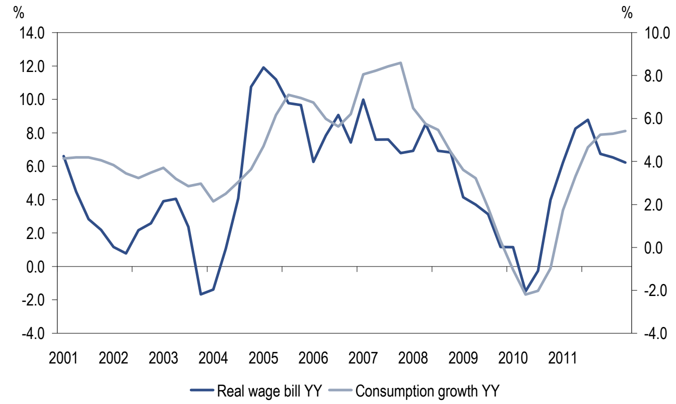
Bond yields have settled in a range that appears justified by current conditions. At around 8.00%, ten-year government yields are relatively low when compared with inflation (and inflation expectations) of around 6%, but this can be explained by the still-large output gap and the loose monetary policy stance. Equally, the yield curve is steep by historical standards but not so when compared to the level of real short-term rates, and an eventual "bear flattening" of the curve probably will await for clearer signs that interest rate hikes are in the pipeline. Swap yields should continue to trade through bond yields of similar maturities amid weak private borrowing demand and elevated public deficits, but recent better fiscal news limit the risk of major bond underperformance. Sovereign and CDS spreads should continue to take their cue from global benchmarks. The rand still looks vulnerable near- to medium-term to global uncertainties and a less favorable commodity price environment, and currency weakness could in turn result in a bond sell-off.

Figure 201. Not another recession, but still a marked slowdown



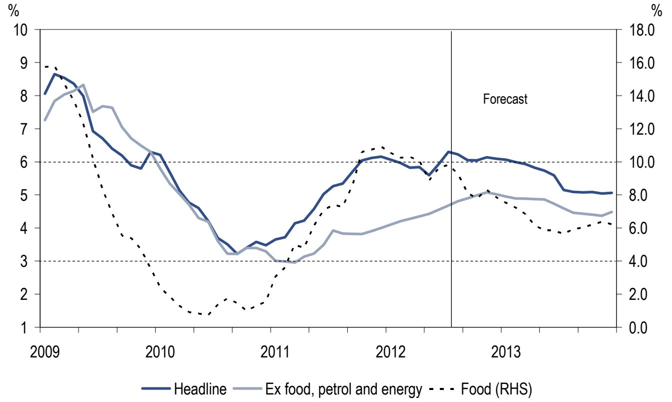
Source: Stats SA

Figure 202. Real wage support to consumption is fading



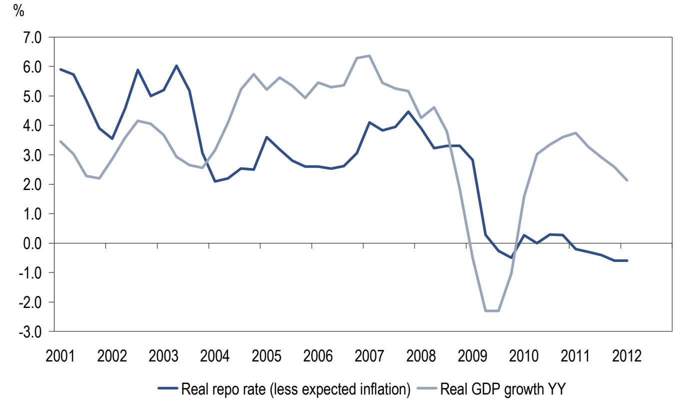
Source: SARB, Stats SA , Citi Investment Research and Analysis calculations

Figure 203. No sustained breach of inflation target in sight



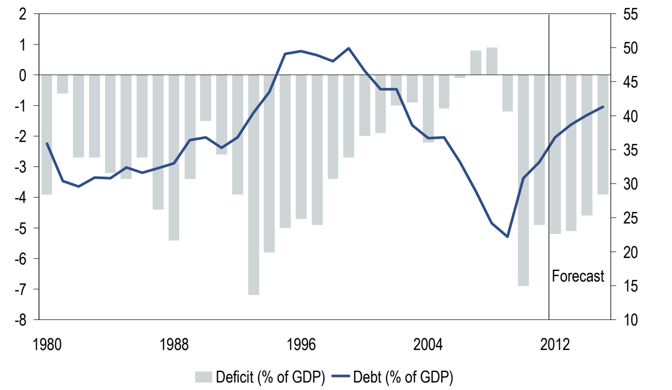
Source: Stats SA and CIRA projections.

Figure 204. Unlike in 2008, loose monetary policy supports activity



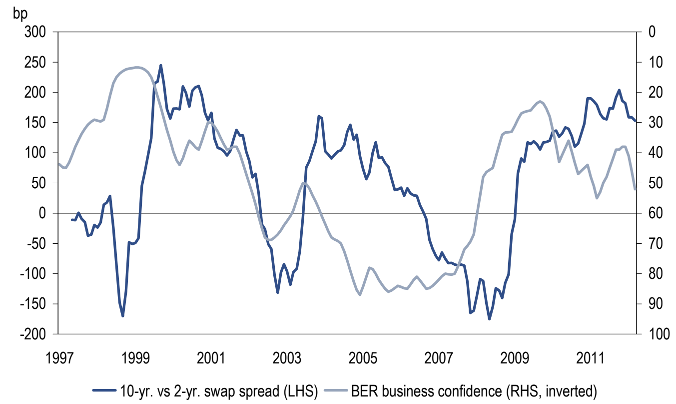
Source: Stats SA, SARB, BER.

Figure 205. Public debt still rising despite deficit reduction plans



Source: National Treasury and CIRA projections.

Figure 206. Flatter yield curve may have to wait for GDP recovery



Source: RMB/BER and Ecowin.

Figure 207. South Africa Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	219.7	246.7	260.9	285.9	274.0	286.1	363.8	401.2	379.1	388.9
Nominal GDP, local currency bn	1,415	1,571	1,767	2,016	2,263	2,398	2,661	2,912	3,135	3,428
GDP per capita, US$	4,736	5,259	5,511	5,993	5,628	5,801	7,278	7,930	7,419	7,523
Population, mn	46.4	46.9	47.3	47.7	48.7	49.3	50.0	50.6	51.1	51.7
Unemployment, % of labour force	25.5	25.0	23.9	23.3	22.9	24.0	25.5	26.0	25.7	25.2
Economic Activity										
Real GDP, % yoy	4.6	5.3	5.6	5.5	3.6	-1.5	2.9	3.1	2.7	3.6
Real investment growth % yoy	12.9	5.7	12.9	12.0	4.5	-8.4	6.0	6.0	3.7	6.2
Real consumption growth % yoy	6.2	5.8	7.5	5.2	2.7	-0.1	4.0	4.7	2.8	3.3
private consumption growth % yoy	6.2	6.1	8.3	5.5	2.2	-1.6	3.7	4.9	2.5	2.9
Real export growth, % yoy	2.8	8.6	7.5	6.6	1.8	-19.5	4.5	5.9	5.3	6.2
Real import growth, % yoy	15.5	10.9	18.3	9.0	1.5	-17.4	9.6	9.1	6.7	7.0
Prices, Money & Credit										
CPI, % yoy	2.2	2.0	4.8	7.6	9.4	6.0	3.4	6.4	6.1	4.9
CPI, % avg	-0.7	2.1	3.2	6.2	10.1	7.2	4.1	5.0	6.1	5.4
Nominal wages, % yoy	0.1	0.1	0.1	0.1	0.1	8.9	7.8	7.2	7.5	8.0
Credit extension to private sector, % yoy	14.6	17.0	25.4	22.0	10.0	4.6	2.0	6.0	8.5	9.5
Policy interest rate, %, eop	7.50	7.00	9.00	11.00	11.50	7.00	5.50	5.50	5.50	6.50
1 month inter-bank rate, %, eop	7.30	6.86	8.98	11.18	11.35	6.94	5.44	5.47	5.60	6.60
Long-term yield, %, eop	8.18	7.48	7.86	8.58	7.33	9.05	8.14	7.93	8.75	8.85
ZAR/US$, eop	5.63	6.34	7.05	6.83	9.25	7.36	6.62	8.07	8.56	8.85
ZAR/US$, avg	6.44	6.37	6.78	7.05	8.26	8.38	7.31	7.26	8.27	8.81
ZAR/EUR, eop	7.66	7.48	9.30	9.99	12.85	10.57	8.88	10.48	10.34	10.86
ZAR/EUR, avg	8.00	7.91	8.52	9.66	12.06	11.64	9.69	10.09	10.40	10.46
Balance of Payments, US$ bn										
Current account	-6.7	-8.6	-13.8	-19.9	-19.6	-11.6	-10.2	-13.6	-17.8	-21.9
% of GDP	-3.0	-3.5	-5.3	-7.0	-7.2	-4.0	-2.8	-3.4	-4.7	-5.6
Trade balance	-0.2	-0.3	-4.3	-5.2	-4.3	0.3	3.7	2.3	-1.3	-3.8
Exports	48.2	56.3	66.1	76.2	85.3	66.4	85.5	102.8	102.9	107.8
Imports	48.4	56.6	70.4	81.4	89.6	66.1	81.8	100.6	104.2	111.5
Service balance	-0.5	-0.8	-2.1	-2.7	-4.1	-2.8	-4.4	-4.7	-3.2	-2.4
Income balance	-4.3	-4.9	-5.1	-9.8	-8.9	-6.4	-7.2	-9.2	-10.9	-13.3
FDI, net	-0.6	5.7	-6.6	1.8	12.5	4.2	4.8	3.4	3.4	3.3
International reserves	13.2	18.6	23.1	29.6	30.6	35.3	38.2	42.6	50.0	52.8
Total amortisations	3.9	2.6	2.0	1.8	2.0	2.5	1.4	2.1	7.3	4.2
Public Finances, % of GDP										
Consolidated government balance	-1.1	-0.1	0.8	1.0	-1.0	-6.9	-5.0	-5.0	-4.8	-4.2
Consolidated gov primary balance	1.4	3.6	4.3	4.4	1.3	-4.7	-2.6	-2.2	-1.8	-1.1
Public debt	35.9	34.7	32.6	28.3	27.2	31.0	35.3	37.7	40.9	42.2
of which Domestic	31.4	30.3	28.1	24.5	22.8	27.4	31.9	33.6	36.7	37.9
Foreign Assets & Liabilities, US$ bn										
External debt	37.1	40.3	51.2	63.0	60.4	63.8	80.6	88.3	85.2	91.8
Public	18.1	18.5	20.7	19.5	18.1	22.6	35.8	51.0	48.0	52.0
External debt / GDP	16.9	16.3	19.6	22.0	22.0	22.3	22.2	22.0	22.5	23.6
External debt / XGS	9.9	9.4	9.7	9.9	7.5	9.7	11.1	75.0	71.1	72.4
Short-term debt	11.2	14.3	20.6	24.0	25.5	21.3	21.7	19.5	19.2	19.8
Short-term debt/International reserves, %	85.1	76.8	89.1	81.2	83.2	60.4	56.9	45.8	38.4	37.5

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.3	3.0	2.9	2.7	2.5	2.7	3.0	3.2	3.6	3.7
CPI, % yoy	5.1	5.7	6.4	6.1	5.9	6.0	6.1	5.9	5.5	5.0
Policy interest rate, %, eop	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	6.00	6.50
1 month inter-bank rate, %, eop	5.50	5.46	5.47	5.49	5.60	5.60	5.60	5.60	6.10	6.60
Long-term yield, %, eop	8.40	8.27	7.93	7.88	8.20	8.48	8.75	8.88	9.00	8.93
ZAR/US$	6.77	8.10	8.09	7.67	8.44	8.41	8.56	8.71	8.85	8.85
ZAR/EUR	9.82	10.84	10.47	10.24	10.55	10.41	10.34	10.26	10.20	10.53

Source: National Sources, Citi Investment Research and Analysis

Turkey

Ilker Domac
+90 212 319 4623
ilker.domac@citi.com

Gultekin Isiklar
+90 212 319 4915
gultekin.isiklar@citi.com

- **Summary view** — The decline in oil prices and the drop in non-energy imports led us to revise our current account gap forecast to 7.5% of GDP from 8.4%.
- **Things to watch** — Developments in the Middle East, the constitutional reform process and the pace of external adjustment deserve close monitoring.
- **Strategy** — We believe that the currency is likely to benefit from the CBT's lira put, high yields, Moody's recent upgrade and lower oil prices.

A limited rebound in 2Q economic activity…

After a soft patch in 1Q, high frequency indicators point to a pick-up in economic activity in 2Q, albeit somewhat weaker than our expectations. For example, the PMI manufacturing index averaged 51.2 in April and May, compared with its first quarter average of 50.3. While April's industrial production came in notably stronger than consensus (1.8%YoY vs. 0%), our analysis suggests that the uptick is mainly driven by one-off factors and unlikely to continue in May. In parallel, capacity utilization rate fell to 74.4% (SA) in May, the lowest since July 2011, compared with the first quarter average of 76.6%. Nonetheless, demand side indicators paint a somewhat more favorable picture: the CNBC-e consumption index averaged 0.8%MoM (sa) growth in April and May, compared with average growth of 0.3% in the first quarter. Against this backdrop, we maintain our 2012 GDP growth projection at 2.5% and see the risks associated with our projection broadly balanced, as the high uncertainty surrounding the euro zone debt crisis is likely to continue.

…and lower oil prices lead us to revise CA gap forecast

At US$5.0 billion, the current account deficit in April broadly came in line with expectations. With this outcome, the current account gap in the first four months of the year becomes US$21.2bn, which compares favorably with the deficit seen in the same period of 2011 (US$29.3bn). Standing at US$4.3bn in the first four months of the year, the improvement in the non-energy current account deficit is even more pronounced (vs. US$15.2bn in over the same period in 2011). While we expect the non-energy current account deficit to widen in the second half of the year, favorable developments to date, along with lower oil prices, led us to revise our 2012 current account deficit forecast to 7.5% of GDP from 8.5% of GDP. On the capital account front, the low FDI coverage of the current account gap (around 12%) and the importance of unidentified inflows continue to warrant concern.

Mind the possible reversal in food inflation

At 8.3% YoY, the May inflation reading came in considerably lower than the consensus (9.0%YoY) on the back of favourable food prices. While the May inflation reading improved sentiment regarding the inflation outlook, our analysis suggests that, following the 2.4%MoM drop in May, food inflation is likely to display a gradual upward trend until November. In addition, despite the recent drop in oil prices, we remain uncomfortable about the outlook given the high core inflation and sticky forward-looking inflation expectations, not to mention the possibility of further administrative price adjustments. Against this backdrop, we expect inflation to fluctuate between 9.0% and slightly below 10% until October before declining to around 7.5% by the year-end — well above the CBT's forecast of 6.5%.

CBT drops reference to "tight stance"

In line with expectations, the CBT kept the interest rate corridor intact at the June MPC meeting. While the gist of the brief statement accompanying rate decision looks fairly similar to the previous one, the Bank dropped a direct reference to "tight policy stance" from the statement, which portrays a less hawkish CBT, in our view. In addition, the CBT seems to be more comfortable with the inflation outlook, citing more favorable developments in energy and unprocessed food prices than envisaged in the April Inflation Report. In our view, the key question is whether the CBT will continue to keep TRY liquidity tight going forward, particularly if the lira strengthens further. This is not a trivial risk, as high interest rates would hurt growth dynamics. In our view, the CBT has limited flexibility in terms of relaxing its policy stance until external financing pressures subside. However, a marked deviation of growth from the official 4% forecast may force the CBT to relax its stance, which would, in turn, hurt the lira performance.

Budget details show signs of weakness

The budget posted a deficit of TRY 0.4bn billion in the first five months of the year, which, is a comparable performance with the same period of 2011 when the budget printed a deficit of TRY 0.2bn. However, a closer looks at the data suggests that one-off factors have played a key role in shaping the budget performance to date. For example, revenues from SEE's and public banks amounted to TRY7.4bn in the first five months of the year (compared with TRY3.5bn in the same period of 2011), thanks largely to a hefty profit transfer from the CBT in April (TRY 5.7bn). In addition, while tax revenues rose by 0.6%YoY in real terms in the first five months of the year, non-interest expenditures rose by 4.3%YoY over the same period, highlighting the moderation in economic growth and the pick up in non-interest spending. Against this backdrop, we project budget deficit to widen to about 2.2% of GDP in 2012 from 1.3% of GDP in 2011, as we continue to question the adequacy of fiscal stance in the context of the wide current account gap.

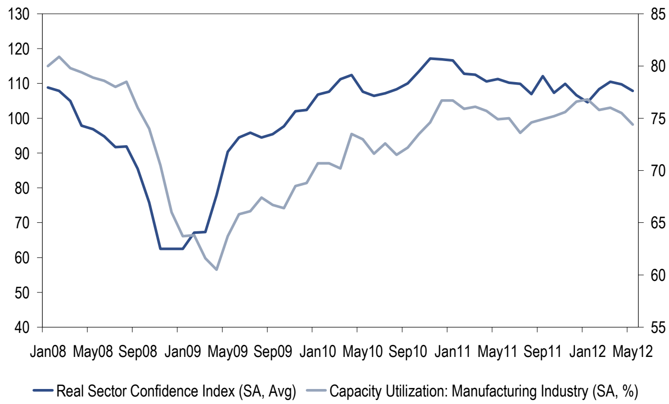
Cyclical factors remain lira-supportive

In the near-term, we believe that the currency is likely to benefit from the CBT's lira put, high yields, Moody's recent upgrade and lower oil prices. However, since risk appetite is likely to remain impaired, as the EMU crisis continues to play on investors' mind (with Grexit 75% probability), the outlook for the lira is likely to become more challenging once the favorable impact of these factors fade away. It is true that the CBT has so far been keeping TRY liquidity relatively tight. However, defending the currency is not a free lunch since high rates would hurt growth prospects, thereby raising questions about the CBT's ability to sustain its current stance.

Linkers deserve a closer look

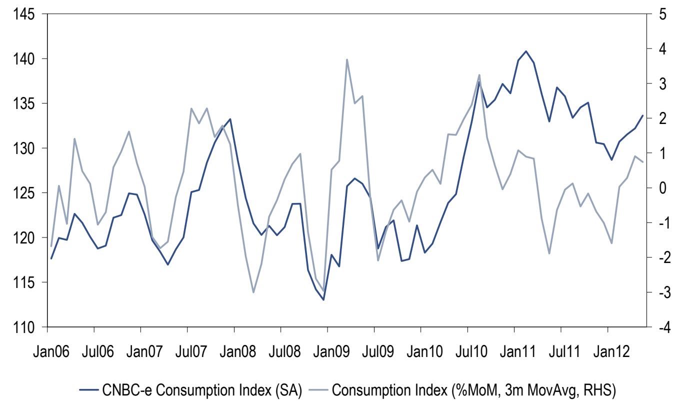
In our view, the magnitude of the recent decline in the breakeven inflation rate is difficult to reconcile with the nature of Turkey's inflation dynamics. Specifically, our findings suggest that Turkey's trend inflation remains relatively high and rigid, as cyclical factors such as food/oil prices and the exchange rate continue to shape the headline inflation number. From this angle, we believe that the 3-year and the 10-year breakeven inflation rates, which at the time of writing stand at about 5.8% and 5.3%, respectively, are below our inflation forecasts of 7.0% and 5.7%.

Figure 208. While manufacturing activity has softened recently…



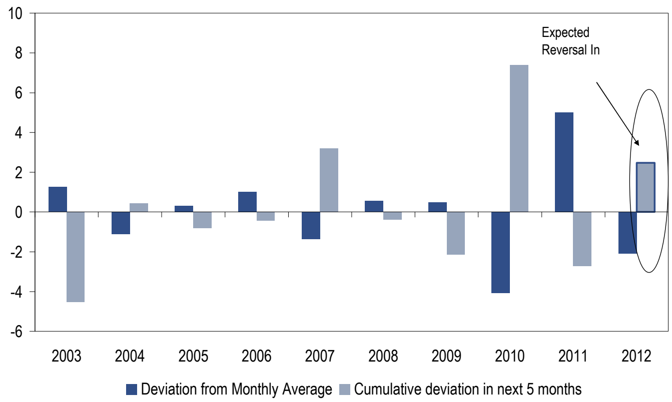
Source: Haver Analytics and CIRA.

Figure 209. …demand side data paint a somewhat more favorable picture



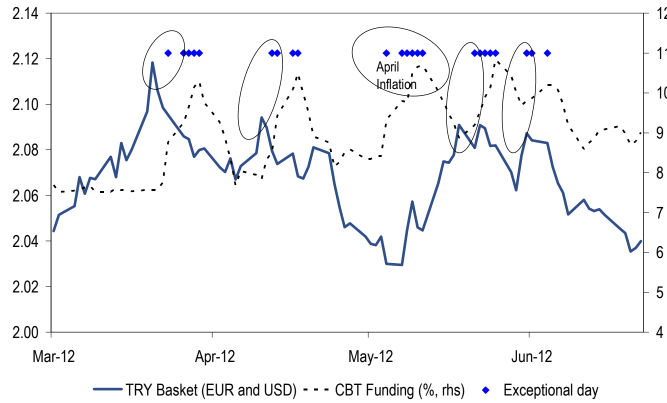
Source: CNBC-e and CIRA.

Figure 210. Food inflation is likely to accelerate in the coming months



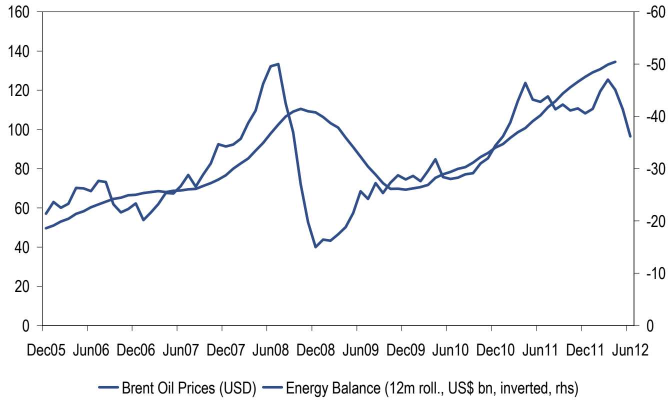
Source: Haver and CIRA

Figure 211. The CBT's put on the lira…



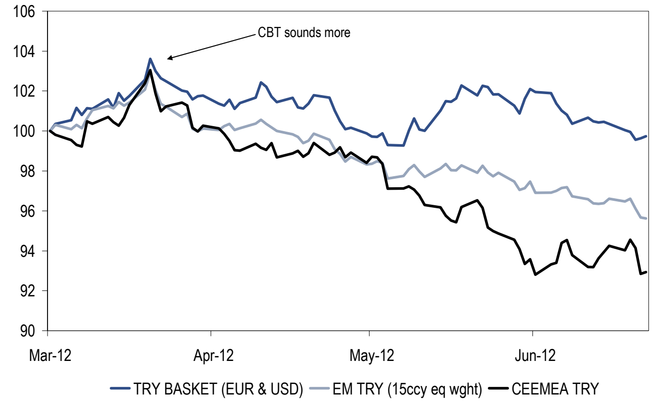
Source: Bloomberg, CBT and CIRA

Figure 212. …and the recent drop in oil prices,…



Source: Haver, Bloomberg and CIRA Note: Brent oil price for June 2012 is monthly average through June 22.

Figure 213. …will likely be supporting the lira-in the short-term



Source: Bloomberg and CIRA. Note: March 1, 2012=100. Lower values represent stronger Turkish lira. CEEMEA currency basket includes equal weighted HUF, PLN, ZAR, CZK and RUB.

Figure 214. Turkey Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	392.1	482.8	529.1	646.4	731.0	614.6	731.2	772.8	806.2	867.4
Nominal GDP, local currency bn	559	649	758	843	951	953	1099	1295	1451	1619
GDP per capita, US$	5,789	7,039	7,621	9,201	10,285	8,549	10,058	10,515	10,854	11,556
Population, mn	67.7	68.6	69.4	70.3	71.1	71.9	72.7	73.5	74.3	75.1
Unemployment, % of labour force	10.8	10.6	10.2	10.3	11.0	14.0	12.0	9.8	9.8	10.0
Economic Activity										
Real GDP, % yoy	9.4	8.4	6.9	4.7	0.7	-4.8	9.2	8.5	2.5	4.3
Real investment growth % yoy	17.4	18.4	13.3	5.8	-4.8	-28.6	48.4	17.0	2.3	4.9
Real consumption growth % yoy	10.3	7.2	5.1	5.6	-0.1	-1.0	6.0	7.3	1.3	4.4
private consumption growth % yoy	11.0	7.9	4.6	5.5	-0.3	-2.3	6.7	7.7	1.0	4.5
Real export growth, % yoy	11.2	7.9	6.6	7.3	2.7	-5.0	3.4	6.5	1.8	5.5
Real import growth, % yoy	20.8	12.2	6.9	10.7	-4.1	-14.3	20.7	10.6	-1.4	6.2
Prices, Money & Credit										
CPI, % yoy	9.4	7.7	9.7	8.4	10.1	6.5	6.4	10.4	7.2	6.5
CPI, % avg	8.6	8.2	9.6	8.8	10.4	6.3	8.6	6.5	9.4	7.0
Nominal wages, % yoy	10.2	12.8	11.0	9.5	11.6	9.9	11.8	8.0	10.4	9.0
Credit extension to private sector, % yoy	52.8	67.1	36.1	27.8	22.4	13.4	40.4	32.8	17.0	20.0
Policy interest rate, %, eop	18.00	13.50	17.50	15.75	15.00	6.50	6.50	5.75	5.75	7.25
1 month inter-bank rate, %, eop	20.90	14.82	19.58	17.21	17.16	7.20	6.89	11.54	10.45	9.97
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
TRY/US$, eop	1.35	1.35	1.41	1.17	1.54	1.50	1.54	1.89	1.82	1.86
TRY/US$, avg	1.43	1.35	1.44	1.31	1.31	1.55	1.51	1.68	1.80	1.87
TRY/EUR, eop	1.83	1.60	1.87	1.70	2.15	2.15	2.06	2.44	2.19	2.29
TRY/EUR, avg	1.78	1.68	1.81	1.79	1.92	2.17	2.00	2.34	2.26	2.22
Balance of Payments, US$ bn										
Current account	-14.4	-22.3	-32.2	-38.4	-41.5	-13.4	-46.6	-77.2	-60.3	-60.1
% of GDP	-3.7	-4.6	-6.1	-5.9	-5.7	-2.2	-6.4	-10.0	-7.5	-6.9
Trade balance	-22.7	-33.1	-41.1	-46.9	-53.0	-24.9	-56.4	-89.5	-75.6	-76.9
Exports	68.5	78.4	93.6	115.4	140.8	109.6	120.9	143.4	151.6	148.0
Imports	91.3	111.4	134.7	162.2	193.8	134.5	177.3	232.9	227.2	224.9
Service balance	12.8	15.2	13.6	13.3	17.7	17.3	15.5	18.3	20.9	22.0
Income balance	-5.6	-5.8	-6.7	-7.1	-8.4	-8.2	-7.1	-7.8	-7.4	-7.1
FDI, net	2.0	9.0	19.3	19.9	17.0	6.9	7.6	13.4	14.5	15.3
International reserves	36.0	50.5	60.9	73.3	71.0	70.7	80.7	78.5	81.5	83.5
Total amortisations	22.9	28.2	30.3	37.6	41.2	47.5	45.0	37.5	43.8	46.2
Public Finances, % of GDP										
Consolidated government balance	-5.4	-1.5	-0.6	-1.6	-1.8	-5.5	-3.6	-1.3	-2.2	-2.5
Consolidated gov primary balance	4.7	5.5	5.4	4.1	3.5	0.1	0.8	2.0	1.0	1.7
Public debt	56.7	51.1	45.6	39.6	40.0	46.4	43.1	40.1	39.8	38.2
of which Domestic	40.2	37.7	33.2	30.3	28.9	34.6	32.1	30.5	29.8	29.5
Foreign Assets & Liabilities, US$ bn										
External debt	161.0	170.6	208.4	250.4	281.4	269.6	292.3	331.8	363.9	403.8
Public	97.1	85.8	87.3	89.3	92.4	96.8	100.8	117.3	132.1	147.9
External debt / GDP	41.1	35.3	39.4	38.7	38.5	43.9	40.0	42.9	45.1	46.5
External debt / XGS	176.0	162.0	174.9	173.6	159.6	187.8	187.8	182.0	188.2	210.7
Short-term debt	32.2	38.9	42.9	43.2	52.5	49.0	77.5	88.1	100.1	115.1
Short-term debt/International reserves, %	89.4	77.0	70.4	58.9	74.0	69.4	96.0	112.3	122.9	138.0

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	9.1	8.4	5.2	2.8	2.5	2.2	2.5	1.6	3.4	5.3
CPI, % yoy	6.2	6.2	10.4	10.4	9.6	9.5	7.2	7.1	7.0	6.7
Policy interest rate, %, eop	6.25	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75	6.50
1 month inter-bank rate, %, eop	8.71	7.66	11.54	10.72	9.90	9.24	10.45	10.29	10.19	10.07
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
TRY/US$	1.62	1.86	1.89	1.78	1.82	1.78	1.82	1.85	1.88	1.87
TRY/EUR	2.35	2.49	2.44	2.38	2.27	2.21	2.19	2.18	2.17	2.23

Source: National Sources, Citi Investment Research and Analysis

Ukraine

David Lubin
+44 20 7986 3302
david.p.lubin@citi.com

Elina Ribakova
(On maternity leave)

Natalia Novikova
(On maternity leave)

Olga Ponomarenko
+7 495 643 1549
olga.ponomarenko@citi.com

- **Summary view** — Despite double-digit consumer spending growth, weak external demand is contributing to an overall slowdown. Record low inflation does not look sustainable in our view. Major policy moves are unlikely before the October election, making IMF disbursements unlikely.
- **Things to watch** — The 2012 budget plan has become more risky after Rada adopted a US$4.2bn increase in expenditures. In addition to the primary budget gap, in 2H 12 the government will need pay UAH25bn (US$3bn) of principal and interest to outstanding liabilities (excluding the IMF loan).
- **Strategy** — NBU is likely to keep liquidity tight as pressure on FX increases. We do not see any significant hryvnia weakening in the short run, however we maintain our view there is potential for a UAH correction later this year.

Growth loses steam despite strong consumption

While consumer spending has grown at a double-digit pace, weak external demand is contributing to an overall slowdown. GDP growth fell to 2%YoY in 1Q (down 0.3%QoQ in seasonally adjusted terms) as key export oriented sectors were negatively affected by the deteriorating global environment and industrial production grew by just 0.7%YoY in Jan-May. At the same time, a major deceleration in inflation helped to maintain high real income growth and household consumption (14%YoY in Jan-May). We expect GDP growth to slow to 2.8-3% in 2012 assuming growth of domestic demand of about 4-5% (additional budget spending is supportive for household consumption but is likely to come at the expense of investment spending) and only marginally increasing in exports.

Fiscal position looks risky

The 2012 budget plan became more risky after Rada adopted an increase in both revenue and expenditure by UAH33.4bn (US$4.2bn). While the cabinet's forecast of GDP growth (3.9%) and inflation remained unchanged; revenue forecasts were raised to UAH366.2bn in April, assuming increased tax collection and additional revenues from administrative fees. This allowed for increased planned expenditures to incorporate an additional pension hike in May, a cut in mortgage loan interest and other social expenditures before parliamentary elections in October. So far consolidated budget revenue growth looks less optimistic than the budgeted 20%YoY increase (up 14%YoY in Jan-May). Expenditures were up 17%YoY already Jan- May and will likely accelerate going forward. While financing of the pension fund deficit fell by half at the beginning of the year, by end-June the government approved an increase in pensions funding from the budget by 57% (by about US$0.7bn) this year. Taking into account the lower than expected inflation and most likely slower than budged growth we think the 2012 deficit will exceed the budgeted UAH25bn. In addition, we believe the Naftogaz deficit will likely exceed projected UAH12bn (0.8% of GDP).

However the government has managed to get financing so far. Privatization revenues amounted to over UAH5bn (about 50% of the annual plan) in the first five months of the year. In addition, MoF net borrowings from NBU (increase in direct ownership of government debt on NBU's balance sheet) and local banks (as NBU was financing purchases of state banks) was abaout about UAH23bn (36% of the annual plan). The VTB loan was partially rolled over, but in addition to the primary budget gap, in 2H 12 the government will need pay UAH25bn (US$3bn) of principal and interest to outstanding liabilities (excluding the IMF loan).

NBU turns to tightening mode…

Meanwhile, despite historically low inflation, NBU tightened monetary policy in June as pressure on the currency increased. Headline CPI index was down 0.5%YoY, and core inflation continued to slow, falling to 4.2%YoY in May. Since the beginning of the year, the NBU cut the overnight refinancing rates by 50bp in total and also reduced the share of reserves required to be kept on a special account at the NBU. However, as pressure on the FX market increased, the NBU cut the volume of refinancing. Also effective from 1 July the NBU increased the required reserve requirements on FX liabilities of banks by 1pp to 9% for short-term deposits and to 3% on long-term deposits. The measure aims to reduce dollarization and shore up forex reserves. The actual pace of inflation during 2012 will obviously depend heavily on the quality of the harvest and indexation of gas tariffs, but the government's pre-election fiscal expansion is likely to create inflationary pressure in 2H. Signs that inflation is accelerating above 7-8% could induce the NBU to tighten policy further, not least because higher inflation might threaten hryvnia stability.

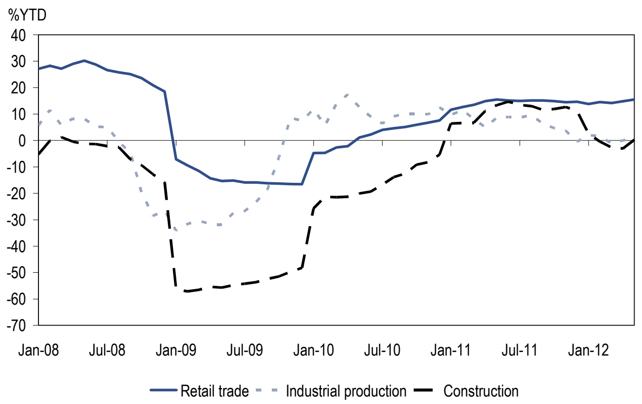
… as FX comes under pressure

While we cut our forecast for the annual current account deficit to slightly below US$12bn, we stress most of the deficit likely to come in 2H. The current account deficit Jan-May stood at US$2.6bn roughly at the level of last year but falling to about 4% of GDP, according to the NBU estimates. Exports increased about 5%YoY over the period as strong agriculture exports were offset by falling metals sales. Imports growth moderated to 10%YoY in May due to falling gas import volumes, while growth in machinery remained strong. The 2Q current account is likely to be similar to 1Q due to the seasonal fall in energy and construction imports, and a rise in tourism inflows related to Euro 2012. However, increasing energy costs and an acceleration of consumer imports (supported by higher pre-election social spending) could push the current account deficit to about US$4bn per quarter in 2H.

The capital account could also be a source of stress. The financial account remained positive in May – net capital inflows reached about US$3bn over the first five months. The real sector continued to attract external funding – net inflows of about US$2.3bn in Jan-May. Meanwhile net FDI stood at US$1.7bn (down 40%YoY due to a major contraction in credit from direct investors in Apr-May). Our external financing gap estimate in 2012 is US$10-12bn (excluding IMF credit) or a third of the current level of FX reserves. We estimate there is about US$27bn of debt repayments over 2H including repayments to the IMF of some US$3bn. Major policy moves are unlikely before the October election, making IMF disbursements unlikely

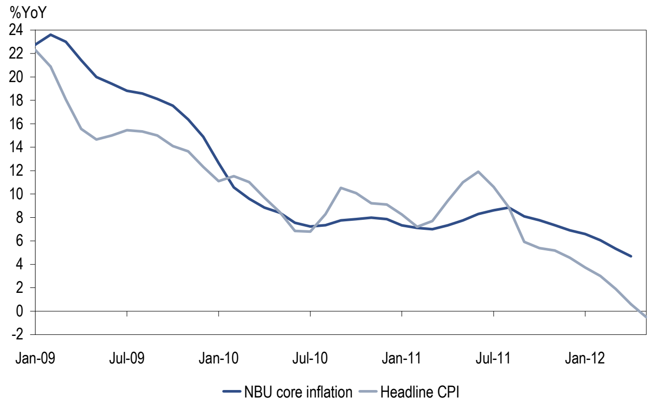
We do not see any significant hryvnia weakening in the short run, however we maintain our view there is potential for a UAH correction later this year. Exchange rate stability remains an important objective for the authorities in the pre-election period. Therefore, we believe they will likely resist any significant devaluation in the short run. The pressure on the UAH may be partly eased due to improvements in the private sector's FX balance sheet: the total unhedged FX debt of the private sector has fallen from US$38bn in Oct 2008 to less than US$14bn in the beginning of 2012. Rising inflation later this year, however, could be the trigger for more speculative demand for FX. There appears to be a consensus the exchange rate's current stability is not be sustainable in the latter part of the year and this means demand for foreign exchange might be triggered sooner (i.e. in the summer) rather than later (i.e. closer to the elections).

Figure 215. As growth loses steam despite strong consumption …



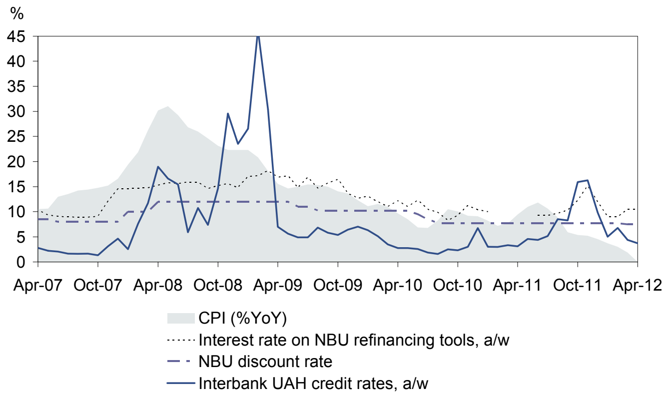
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 216. ….and inflation remains at historic lows



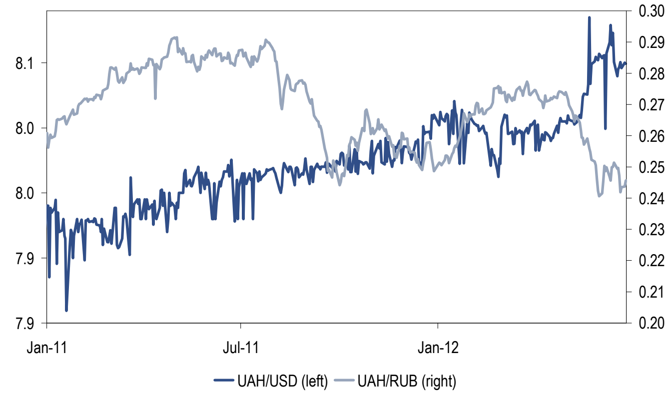
Source: Haver Analytics

Figure 217. Meanwhile the NBU allowed rates to go up….



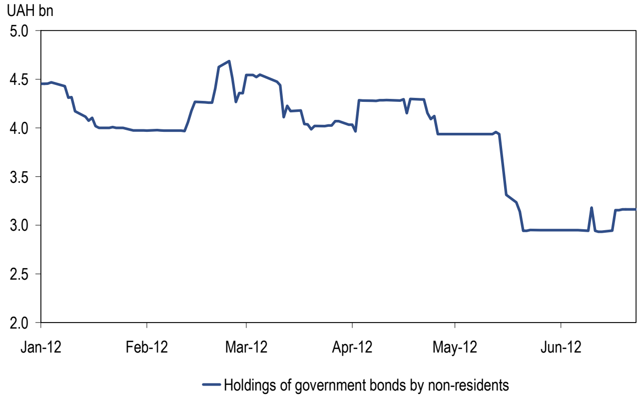
Source: Haver Analytics, CIRA estimates

Figure 218. as hryvnia comes under pressure…



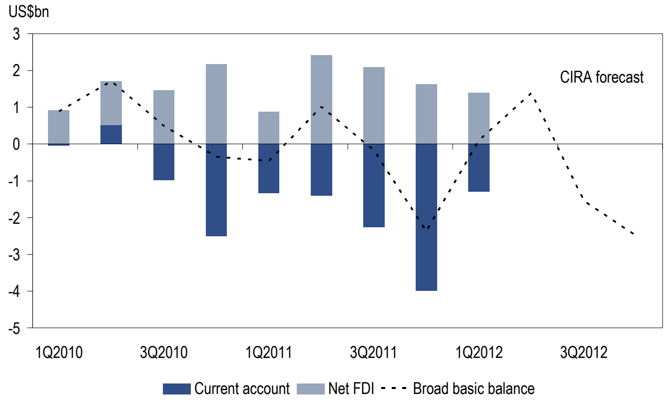
Source: Bloomberg

Figure 219. … and non-residents cut their government bond holdings



Source: Haver Analytics, CIRA.

Figure 220. FX risks likely to increase further in 2H



Source: Haver Analytics, NBU, CIRA estimates.

Figure 221. Ukraine Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	64.9	86.1	107.8	142.7	180.0	117.2	136.4	164.9	177.4	197.3
Nominal GDP, local currency bn	345	441	544	721	948	913	1083	1314	1438	1670
GDP per capita, US$	1,372	1,836	2,313	3,084	3,914	2,566	3,006	3,657	3,959	4,433
Population, mn	47.3	46.9	46.6	46.3	46.0	45.7	45.4	45.1	44.8	44.5
Unemployment, % of labour force	8.6	7.2	6.9	6.4	6.4	8.8	8.1	6.5	5.3	4.4
Economic Activity										
Real GDP, % yoy	12.1	3.0	7.4	7.6	2.3	-14.7	4.2	5.1	3.0	4.5
Real investment growth % yoy	20.4	3.9	20.9	24.4	-1.2	-50.5	4.9	10.4	5.0	5.0
Real consumption growth % yoy	8.7	14.0	12.2	13.1	10.1	-12.3	6.0	11.0	4.0	4.0
private consumption growth % yoy	12.1	19.3	15.4	17.0	12.8	-14.9	7.0	15.0	5.0	5.0
Real export growth, % yoy	21.5	-12.7	-5.8	2.8	5.7	-22.0	4.5	1.8	2.5	3.5
Real import growth, % yoy	15.5	6.7	8.3	23.9	17.0	-38.9	11.1	17.0	5.0	3.0
Prices, Money & Credit										
CPI, % yoy	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	5.8	5.7
CPI, % avg	9.0	13.5	9.1	12.8	25.2	15.9	9.4	8.0	2.4	6.5
Nominal wages, % yoy	27.7	36.5	29.4	29.7	33.7	5.5	17.7	17.5	16.4	15.5
Credit extension to private sector, % yoy	32.2	63.6	69.8	73.7	67.1	-4.2	0.7	12.0	19.0	25.0
Policy interest rate, %, eop	9.00	9.50	8.50	8.00	12.00	10.25	7.75	7.75	7.75	7.25
1 month inter-bank rate, %, eop	-	-	-	8.41	23.78	19.00	10.75	20.25	9.69	9.06
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
UAH/US$, eop	5.31	5.05	5.05	5.05	7.70	7.99	7.96	7.99	8.50	8.60
UAH/US$, avg	5.32	5.12	5.05	5.05	5.27	7.79	7.94	7.97	8.11	8.47
UAH/EUR, eop	7.22	5.97	6.65	7.33	10.86	11.45	10.57	10.30	10.27	10.56
UAH/EUR, avg	6.61	6.38	6.34	6.92	7.70	10.86	10.53	11.09	10.25	10.04
Balance of Payments, US$ bn										
Current account	6.9	2.5	-1.6	-5.3	-12.8	-1.7	-3.0	-8.6	-11.8	-8.8
% of GDP	10.6	2.9	-1.5	-3.7	-7.1	-1.5	-2.2	-5.2	-6.7	-4.5
Trade balance	3.7	-1.1	-5.2	-10.6	-16.1	-4.3	-8.4	-13.8	-16.1	-14.6
Exports	33.4	35.0	38.9	49.8	67.7	40.4	52.2	69.4	69.6	72.4
Imports	29.7	36.2	44.1	60.4	83.8	44.7	60.6	83.2	85.7	87.0
Service balance	1.2	1.8	2.1	2.4	1.7	2.4	4.4	4.9	3.5	4.5
Income balance	-0.6	-1.0	-1.7	-0.7	-1.5	-2.4	-2.0	-3.2	-2.2	-2.0
FDI, net	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	6.5	7.0
International reserves	9.7	19.4	22.4	32.5	31.5	26.4	36.7	30.1	19.8	14.0
Total amortisations	1.5	1.2	14.3	20.4	29.9	39.6	37.7	53.7	56.7	57.0
Public Finances, % of GDP										
Consolidated government balance	-3.1	-1.7	-0.6	-0.8	-1.2	-7.3	-8.8	-3.8	-3.5	-3.2
Consolidated gov primary balance	-2.2	-0.9	0.2	-0.3	-0.7	-6.2	-7.6	-2.9	-2.6	-2.4
Public debt	25.5	16.4	13.2	10.8	14.4	26.7	31.5	29.7	30.4	28.5
of which Domestic	10.0	4.3	3.1	2.5	4.7	10.0	13.1	13.9	14.6	8.2
Foreign Assets & Liabilities, US$ bn										
External debt	30.6	39.6	54.5	80.0	101.7	103.4	117.3	119.3	121.5	123.7
Public	11.7	11.8	11.8	12.3	16.7	24.0	32.5	34.7	36.9	39.1
External debt / GDP	47.2	46.0	50.6	56.0	56.5	88.2	86.0	72.4	68.5	62.7
External debt / XGS	74.2	89.3	108.5	124.9	118.7	256.0	224.8	171.9	174.5	170.9
Short-term debt	10.4	10.9	15.2	20.7	20.3	19.0	23.5	24.9	26.4	23.9
Short-term debt/International reserves, %	107.4	56.4	68.0	63.7	64.4	72.0	64.1	82.8	133.3	171.1

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.9	6.5	4.6	2.0	2.7	2.9	3.5	4.2	4.2	4.2
CPI, % yoy	11.9	5.9	4.6	1.9	-0.5	2.7	5.8	6.9	7.2	6.3
Policy interest rate, %, eop	7.75	7.75	7.75	7.50	7.50	7.50	7.75	7.75	7.50	7.25
1 month inter-bank rate, %, eop	6.50	12.60	20.25	9.50	9.38	9.38	9.69	9.69	9.38	9.06
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
UAH/US$	7.97	7.97	7.99	7.99	8.00	8.10	8.50	8.50	8.45	8.50
UAH/EUR	11.50	10.85	10.30	10.60	9.99	10.03	10.27	10.02	9.73	10.11

Source: National Sources, Citi Investment Research and Analysis

This page is intentionally left blank

Latin America

Argentina

Joaquin A Cottani
+1 212 816 2735
joaquin.cottani@citi.com

- **Summary view** — Argentina has likely entered into a period of "stagflation", i.e. a combination of low to negative growth and high inflation. Both official and non-official indicators confirm this. We expect stagflation to be long-lasting. The run against USD deposits continued in the first half of June, adding pressure to foreign reserves.
- **Things to watch** — Congress will soon begin debating the unification of the Civil and Commercial codes, with the proposed reforms of some articles by a commission of experts overseen by the government. Yet, the reform involving pesification will likely not affect pre-existing contracts, including dollar bonds issued under local law.
- **Strategy** — We believe the spread between local and international law bonds will start decreasing as concern about pesification recedes.

Stagflation rears its ugly head

Argentina has likely entered into a period of "stagflation", i.e. a combination of low growth and high inflation. We expect this scenario to be long lasting, as real GDP growth has plummeted, primarily for domestic reasons since the external scenario continues to be relatively supportive.

Private activity indicators suggest annual GDP growth is already in negative terrain. Orlando J Ferreres & Asociados (OJF), a local consultancy firm, informed that its General Activity Index (IGA) decreased by 1.2% YoY in May, after shrinking 0.1% MoM, SA. The decline is generalized across sectors, with industrial production falling by 1.5% YoY in May; construction activity, by 3.1%; and agricultural production, by 18.8%.

Surprisingly, the government agrees. After an upbeat 1Q12 GDP growth figure (+5.2% YoY), INDEC surprised market participants by releasing two definitely more bearish activity indicators for April: a +0.6% YoY (-1.3% MoM SA) EMAE (economic activity) and a negative 7.6% YoY ISAC (construction). In May, the surprise turned into shock, as INDEC reported that the EMI (industrial production) had plunged 4.6% YoY (i.e., more than the print reported by OJF), posting its biggest annual drop since January 2009.

We do not expect growth to rebound anytime soon. A combination of both supply and demand factors should keep growth at bay for a relatively long period of time, in our view. On the supply side, the combination of low idle capacity levels and insufficient investment are on the back of our prognosis. For instance, OJF reported that in April gross investment decreased 16.3% YoY while investment in machinery and equipment plunged 27.9% YoY, both in real terms. On the demand side, private and public consumption are highly unlikely to continue being growth engines. For instance, Universidad Torcuato Di Tella (UTDT) reported that consumer confidence shrank 20.3% YoY during June, posting its biggest annual drop since February 2009. As regards government consumption, a markedly pro-cyclical fiscal policy during Ms. Fernandez's first period in office has led to a weak fiscal stance, and therefore we are expecting public expenditure growth to decelerate, especially since tax revenues are, currently, not increasing in real terms.

All in all, we keep our non-official and official real GDP growth forecasts unchanged, but we acknowledge that there are significant downward risks for both. We expect non-official (or true) real GDP growth to be 1% in 2012, down from 5.7% in 2011. As regards official prints, we expect the government to stop overestimating real GDP growth to avoid triggering a GDP warrant payment in 2013. Currently, we expect official real GDP growth to stand at 3% in 2012, down from 8.9% in 2011. Needless to say, both forecasts imply a very marked deceleration.

Despite the deceleration, we expect true annual inflation to continue around 25% throughout the rest of 2012. The UTDT reported that inflation expectations 12 months ahead came at 30% in June for the fourth consecutive month. Additionally, the government could not achieve its 18% nominal wage increases objective as most of the unions obtained improvements of around 25%. Based on this information, our inflation forecasts are 25% this year and 35% in 2013.

FX controls notwithstanding, international reserves fall

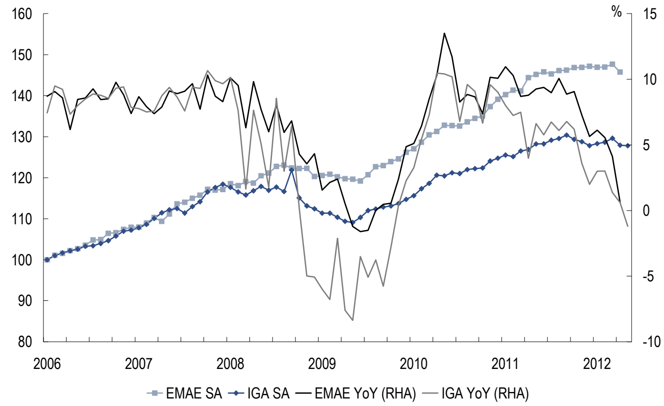
Due to USD deposit withdrawal, international reserves are below the level they had at the beginning of the year. Private USD deposits withdrawal accelerated in May after the government tightened capital controls. Since May 11, the stock of deposits dropped by USD2.5bn to 9.4bn. The daily reduction was USD88m in the week of June 11-15. International reserves were affected since liquidity requirements on USD deposits held at the BCRA are computed as reserves. They currently stand at USD46.3bn, slightly below the level prevailing at the beginning of the year (USD46.4bn). Although we do not expect pesification of dollar deposits, the incipient decline in reserves adds pressure on the government to introduce measures to stop the drain. Besides further tightening controls on capital outflows, which causes the parallel FX premium to increase, we expect the government to accelerate depreciation of the official FX rate and relax quantitative restrictions on some exports, such as wheat and beef. Further tightening of import controls is less likely due to the negative effect these have on industrial production.

To pesify or not to pesify

Authorities say that no pesification is under way, but proposed legal changes say the opposite. The government sent to Congress a comprehensive overhaul of the Civil and Commercial Codes of Argentina, that seeks to reform and unify both. The original version, prepared by a commission headed by Supreme Court of Justice President Ricardo Lorenzetti and presented to the government on March 27, makes no reference to dollar contracts. However, the version sent by the government to the Congress does. Specifically, the later version modifies two articles (617 and 619) of the Civil Code legalizing pesification of dollar-denominated contracts at the official exchange rate. Understandably, this created a lot of confusion among market participants that led to a widening of the spreads of local law bonds relative to foreign law ones. To calm the waters, Ms. Kirchner stated that the government will make the last payment on Boden 12 (about USD2bn) in dollars, as expected.

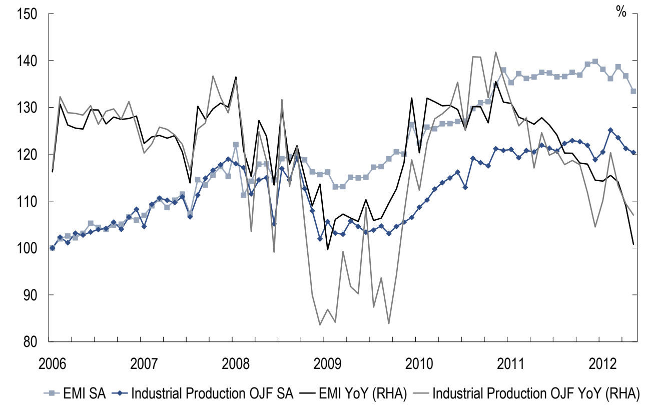
Also unsurprisingly, the spread between the official USDARS and the blue chip swap (BCS) increased further following these events. Currently, the BCS stands around 6.7 (ARS/USD), i.e. the spread has surpassed 45%. Additionally, bonds under foreign law have been outperforming the ones under local legislation.

Figure 222. Annual growth of official and private activity indicators…



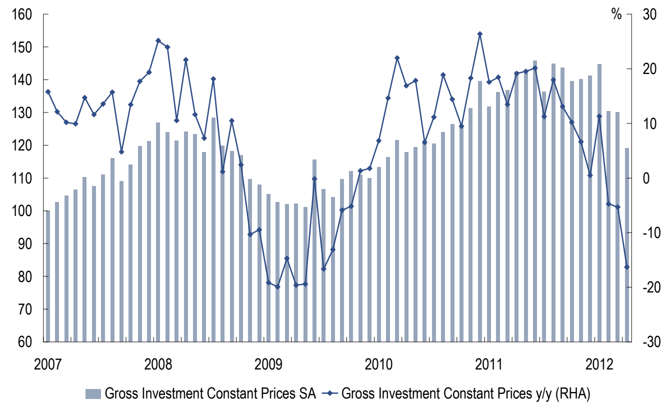
Source: INDEC and OFJ

Figure 223. … are converging



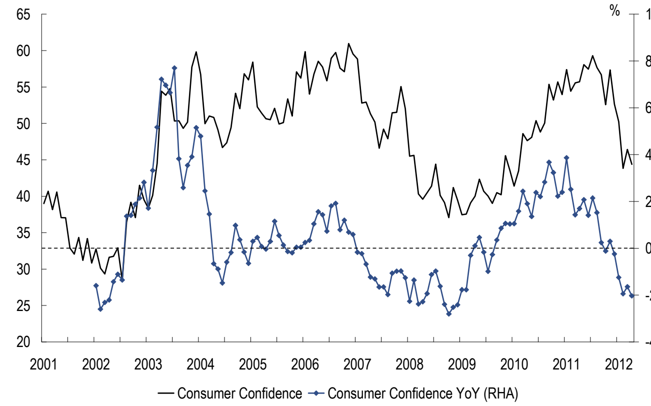
Source: INDEC and OFJ

Figure 224. Investment has plummeted



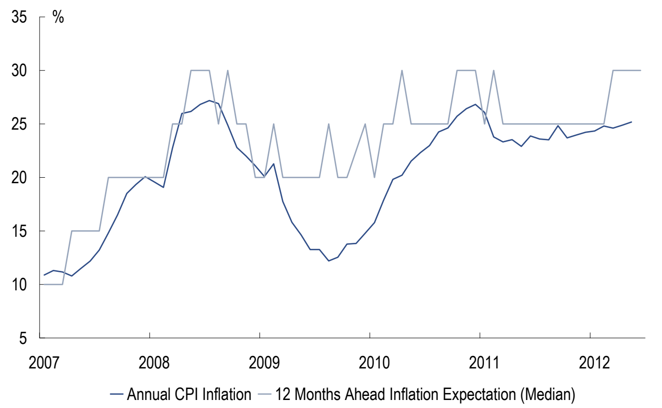
Source: OFJ

Figure 225. Consumer confidence is taking a nosedive



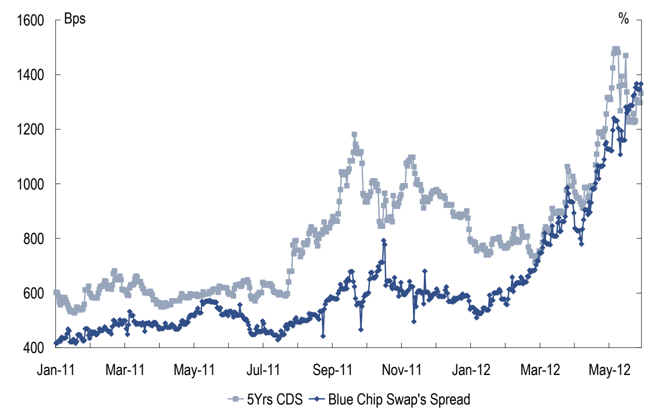
Source: UTDT

Figure 226. Inflation expectations remain high



Source: MyS Consultores and UTDT

Figure 227. Risk perception has increased markedly



Source: Bloomberg

Figure 228. Argentina Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	151.8	181.5	212.6	260.5	325.1	305.5	367.9	441.9	474.0	466.0
Nominal GDP, local currency bn	447.6	531.9	654.4	808.6	1032.8	1145.5	1442.7	1838.3	2158.6	2539.9
GDP per capita, USD	3971.6	4702.3	5454.3	6618.1	8179.8	7612.0	9078.5	10797.9	11466.9	11167.1
Population, mn	38.2	38.6	39.0	39.4	39.7	40.1	40.5	40.9	41.3	41.7
Unemployment, % of labour force	13.6	11.6	10.2	8.5	7.9	10.1	9.3	8.1	8.1	8.0
Economic Activity										
Citi's Argentina Activity Indicator, % yoy	9.0	9.2	8.5	8.7	6.8	0.9	9.2	8.9	3.0	3.0
Real investment growth % yoy	34.4	22.7	18.2	13.6	9.1	-10.2	21.2	16.6	2.3	4.4
Real consumption growth % yoy	8.3	8.5	7.4	8.8	6.6	1.5	9.1	12.0	3.3	3.8
private consumption growth % yoy	9.5	8.9	7.8	9.0	6.5	0.5	9.0	10.7	2.8	2.8
Real export growth, % yoy	8.1	13.5	7.3	9.1	1.2	-6.4	14.6	4.3	1.9	2.1
Real import growth, % yoy	40.1	20.1	15.4	20.5	14.1	-19.0	34.0	17.8	5.2	6.5
Prices, Money & Credit										
CPI, % yoy (Citi estimates)	8.5	15.4	14.4	20.2	19.2	15.2	25.0	24.2	25.0	35.0
CPI, % avg	10.3	11.9	14.4	16.9	21.9	15.8	21.3	23.4	25.2	30.3
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	7.1	4.9	20.5	29.3	19.0	20.1	38.6	32.6	23.5	27.2
BADLAR Private Banks Rate (eop)	-	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	-	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
ARS/USD, eop	2.98	3.03	3.07	3.15	3.45	3.80	3.97	4.30	4.80	6.00
ARS/USD, avg	2.95	2.93	3.08	3.12	3.18	3.74	3.92	4.16	4.55	5.45
Balance of Payments, USD bn										
Current account	12.2	11.7	7.8	7.4	6.7	11.1	2.8	0.0	0.3	-1.5
% of GDP	8.0	6.4	3.7	2.8	2.1	3.6	1.0	0.0	0.1	-0.3
Trade balance	12.2	11.7	12.4	11.3	12.6	16.9	11.6	10.3	10.0	8.1
Exports	34.6	40.4	46.5	56.0	70.0	55.7	68.1	83.1	85.6	90.4
Imports	22.4	28.7	34.2	44.7	57.5	38.8	56.5	72.8	75.6	82.3
Service balance	-1.5	-1.4	-0.5	-0.5	-1.3	-1.2	-1.1	-2.2	-1.8	-2.0
Income balance	8.9	6.6	-6.1	-5.9	-7.6	-9.0	-9.9	-10.8	-10.7	-11.7
FDI, net	4.1	5.3	5.0	6.5	9.7	3.9	7.0	7.2	4.4	4.4
International reserves	19.6	28.1	32.0	46.2	31.7	47.7	51.9	46.4	42.3	40.0
Total amortisations	-	-	-	-	-	-	-	-	-	-
Public Finances, % of GDP										
Consolidated government balance	3.7	2.1	1.8	1.2	1.4	-0.6	0.2	-1.6	-3.0	-2.0
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-	-
Public debt	126.0	84.2	64.2	55.5	44.7	48.0	44.6	40.8	43.0	47.2
of which Domestic	49.7	48.3	37.8	31.7	27.6	30.0	28.0	26.1	27.5	30.1
Foreign Assets & Liabilities, USD bn										
External debt	-	-	-	-	-	-	-	-	-	-
Private	-	112.3	102.9	114.9	114.9	108.1	119.3	98.0	118.6	138.8
Public	115.8	65.2	56.2	62.1	55.5	54.8	61.0	65.3	73.8	79.6
External debt / GDP	112.7	62.5	48.9	44.6	35.7	35.8	32.8	22.4	25.3	30.1
External debt / XGS	430.7	243.5	182.2	156.7	169.1	166.2	142.6	130.0	128.9	115.6
Short-term debt	-	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	9.1	9.3	7.3	4.3	2.5	2.5	2.9	3.5	3.5	3.0
CPI, % yoy	9.7	9.9	9.5	9.7	9.6	9.4	9.7	10.0	11.0	12.2
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-	-
BADLAR Private Banks Rate, %, eop	11.43	14.00	17.20	13.00	13.00	13.00	15.00	16.25	17.50	18.75
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
ARS/USD	4.10	4.20	4.30	4.38	4.53	4.67	4.80	5.10	5.40	5.70

Source: National Sources Citi Investment Research and Analysis

Brazil

Marcelo Kfoury Muinhos
+55 11 4009 3470
marcelo.kfoury@citi.com

Leonardo Porto de Almeida
+55 11 4009 2947
leonardo.porto@citi.com

Marcela Prada
+55 11 4009 3412
marcela.prada@citi.com

- **Summary view** — The disappointing 1Q12 GDP figure triggered a significant downward revision in our 2012 GDP growth estimate to 2.3%, consequently supporting a lower CPI inflation estimate this year (4.9%). Under a softer expansion and lower inflation scenario, we now expect the Selic rate to reach 7.25% by 2012 year-end. Current global turmoil should keep USD/BRL temporarily higher in the near term, while we keep our bullish view for BRL in the medium/long term.

- **Things to watch** — The yield curve should remain sensitive to developments in the international scenario, given the deterioration in the global outlook, as well as to activity and inflation data. Overall, we continue to expect activity to show increasing signs of acceleration throughout the year, although in the near term we do not rule out additional downward surprises, especially in the industrial sector. Meanwhile, risks for inflation are tilted to the downside.

- **Strategy** — The unfavorable global scenario, the weaker GDP growth outlook and well-behaved inflation indicate that the monetary easing cycle should continue for a while. This inference points to further gains in receiving rates in the short end of the yield curve. Regarding the FX, gradual improvement in the European sovereign debt crisis tends to open room for some BRL appreciation in the medium/long term.

Lower growth but accelerating in coming quarters

Weak 1Q12 GDP figure motivated a downward revision in our 2012 GDP growth forecast to 2.3%, even after assuming a steady acceleration ahead. Even though most of the disappointment in 1Q12 GDP growth of 0.2% q/q was associated with the contraction in the agriculture/livestock sector (-7.3% q/q), it triggered a significant decline in our 2012 annual GDP growth estimate to 2.3% from 3.3% before. We still see economic growth accelerating steadily in coming quarters, reflecting the monetary, credit and fiscal stimuli already undertaken. Behind this activity outlook, the industrial sector should continue to underperform the overall economy, reflecting the greater dependence of the manufacturing sector to global conditions. This evidence reinforces the view that potential GDP growth in Brazil has been declining lately (likely below 4%), in part due to the softer expansion in total factor productivity.

The inflation scenario has improved recently, leading to a drop in our year-end 2012 CPI inflation forecast to 4.9% (from 5.3%). The weaker-than-expected GDP growth in 2012 signals a smoother path for the output gap and consequently lower inflation pressures this year. Moreover, the worsening of the global outlook points to a reversal of the potential effects from the exchange rate pass-through. Moreover, government measures to boost growth are disinflationary in the near term and mean more downside risks. We highlight the IPI tax cut for the automobile sector, which we estimate will have a -30bp impact on CPI inflation. In particular, this effect will contribute to a relatively low monthly rate in June, which we estimate at 0.1%, driving the annual rate to 4.9%, the lowest level since the peak in September 2011 (7.3%). For year-end 2013, we keep our CPI inflation forecast at 5.6%, based on the scenario of higher inflation pressures related to the activity recovery, as well as the reversal of the temporary tax cuts.

We reduced our Selic rate forecast to 7.25% by year-end 2012. The soft economic recovery, the improvement in the inflation outlook and the risks in the international scenario indicate room for further cuts in the Selic rate. The persistence of dovish communications from the central bank, in the minutes and in recent speeches, along with the government's commitment to fiscal "austerity" reinforces the likelihood of more aggressive monetary policy easing. Therefore, we expect two more 50bp cuts in July and August and a final 25bp cut in October. We also lowered our 2013 Selic rate forecast to 9.25% (from 9.75%), although we still expect a tightening in monetary policy because of the higher inflation pressure scenario next year. We expect a 200bp increase, starting July 2013.

Worse global conditions keep USD/BRL at higher level

Global turmoil continues to hurt commodity prices and increase risk aversion, keeping USD/BRL at higher level in the near term. The strains associated with the European sovereign debt crisis tend to maintain risk appetite below its historical average, constraining capital inflows to the Brazilian economy, consequently sustaining USD/BRL at higher level. For the coming months, the expectation of gradual improvement in global conditions along with the Brazilian economy's sound fundamentals (especially trade balance/current account) point toward a bullish view for BRL in the medium/long term.

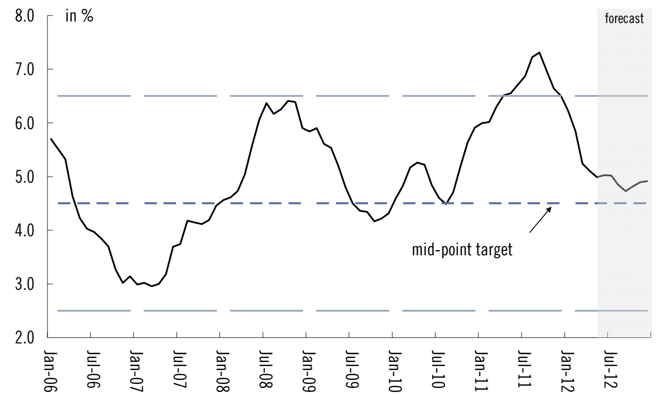
Government signals more stimuli amid fiscal austerity

We expect more stimuli to be announced by the government, but without giving up the commitment with the fiscal target. In recent speeches, President Dilma has stated that she will continue to boost consumption and investment. In this regard, the government has announced a credit line through BNDES with low costs for states in order to boost their investments. In our view, other likely measures in the near term may include the extension of the temporary tax cuts for cars and home appliance as well as new tax cuts in other sectors, such as energy and telecom. However, we do not expect the government to give up the fiscal target in the near term, in order to allow room for more interest rate cuts, which we expect to take place until October. In addition, fiscal results remain positive, in line with targets, despite the acceleration of public spending growth and the deceleration of public revenues, which have been moderate. In a more negative activity scenario, though, the government may give up the target, by opting for a more expansionary fiscal policy.

Global woes imply longer monetary easing cycle

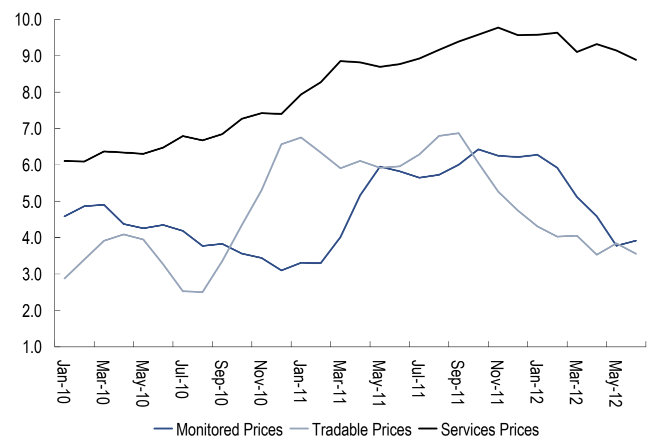
Global woes suggest gains in receiving rates in the short end of the yield curve, while expectation of a gradual improvement in the European sovereign debt crisis points to BRL appreciation in the medium term. The yield curve is currently pricing in further declines in Selic rate. However, current global woes should lead the central bank to become increasingly more comfortable with monetary policy easing, contributing to further declines at the short end of the yield curve. Overall, our Selic rate call of 7.25% by 2012 year end embeds a premium of 14bp in PreDI Jan13. On the FX front, although a more favorable scenario is unlikely in the near term, the outlook for a solution in coming months suggests BRL should appreciate in relation to spot levels in the medium/long term.

Figure 229. Better inflation outlook in 2012



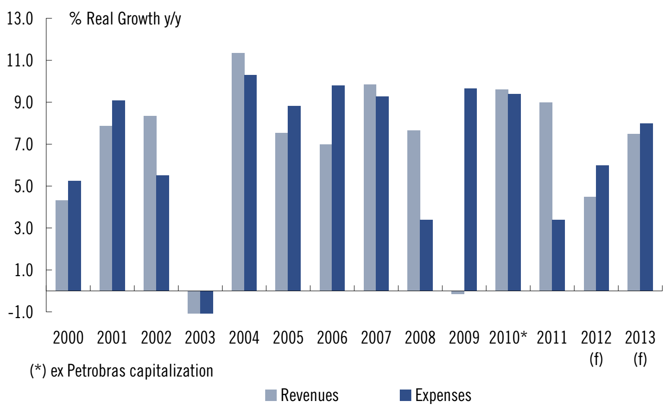
Sources: IBGE and Central Bank of Brazil

Figure 230. Favorable trend in tradable and services prices inflation



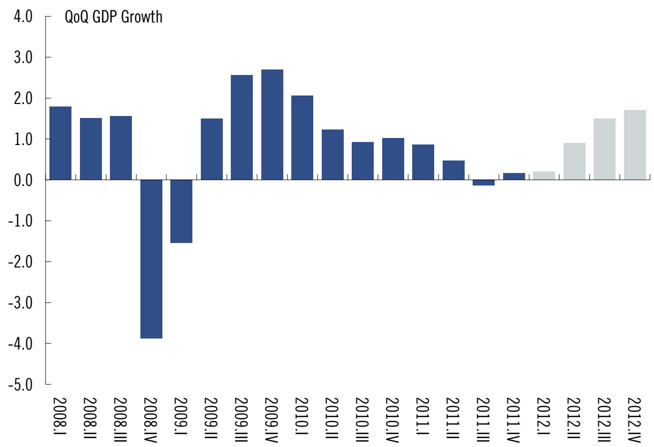
Sources: Citi Investment Research and Analysis and IBGE

Figure 231. Weaker public revenues, amid moderate spending growth



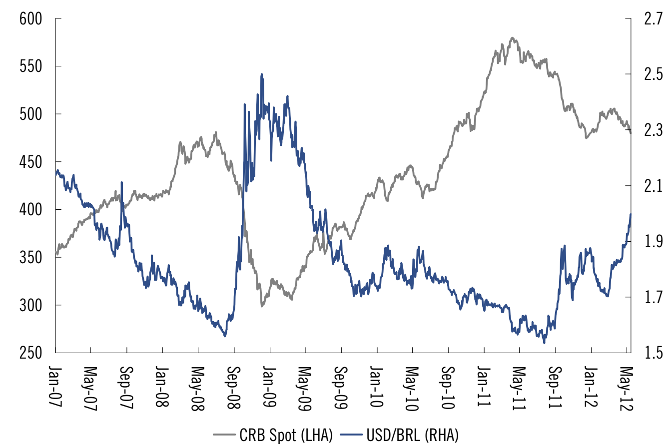
Sources: Citi Investment Research and Analysis and Central Bank of Brazil

Figure 232. GDP growth should accelerate in coming quarters



Sources: Citi Investment Research and Analysis and IBGE

Figure 233. Global turmoil hurt commodity pressuring USD/BRL



Sources: Citi Investment Research and Analysis and Bloomberg

Figure 234. Real interest rate has reached even lower levels recently

Sources: Citi Investment Research and Analysis, Central Bank of Brazil, Bloomberg

Figure 235. Brazil Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	663.6	881.7	1096.2	1411.0	1640.6	1540.5	1992.8	2305.2	2392.6	2648.2
Nominal GDP, local currency bn	1941.5	2147.2	2369.5	2661.3	2959.8	3077.3	3504.6	3834.5	4117.3	4547.0
GDP per capita, USD	3716.3	4890.6	6020.9	7668.9	8815.0	8177.0	10446.9	11929.2	12144.4	13269.2
Population, mn	178.6	180.3	182.1	184.0	186.1	188.4	190.8	193.2	197.0	199.6
Unemployment, % of labour force	10.3	9.2	10.0	9.3	7.9	8.1	6.7	6.1	6.3	6.5
Economic Activity										
Real GDP, % yoy	5.7	3.2	4.0	6.1	5.2	-0.3	7.5	2.7	2.3	4.5
Real investment growth % yoy	11.5	-2.4	9.9	16.9	16.4	-16.0	33.4	4.0	-0.2	6.5
Real consumption growth % yoy	3.9	3.9	4.5	5.8	5.1	4.1	6.3	3.6	3.7	4.8
private consumption growth % yoy	3.8	4.5	5.2	6.1	5.7	4.4	6.9	4.1	4.0	5.0
Real export growth, % yoy	15.3	9.3	5.0	6.2	0.5	-9.1	11.5	4.5	4.4	4.5
Real import growth, % yoy	13.3	8.5	18.4	19.9	15.4	-7.6	35.8	9.7	7.4	7.7
Prices, Money & Credit										
CPI, % yoy	7.6	5.7	3.1	4.5	5.9	4.3	5.9	6.5	4.9	5.6
CPI, % avg	6.6	6.9	4.2	3.6	5.7	4.9	5.0	6.6	5.1	5.3
Nominal wages, % yoy	5.4	11.3	7.4	7.0	10.4	4.8	12.7	10.4	8.8	9.5
Credit extension to private sector, % yoy	24.4	27.0	23.4	32.6	31.9	12.0	17.0	17.0	17.0	17.0
Policy interest rate, %, eop	17.75	18.00	13.25	11.25	13.75	8.75	10.75	11.00	7.25	9.25
1 month inter-bank rate, %, eop	…	…	…	…	…	…	…	…	…	…
Long-term yield, %, eop	16.83	15.58	12.33	12.95	12.27	12.25	12.24	10.66	9.48	9.48
BRL/USD, eop	2.65	2.34	2.14	1.77	2.34	1.74	1.67	1.88	1.99	1.90
BRL/USD, avg	2.93	2.44	2.18	1.95	1.83	2.00	1.76	1.67	1.94	1.94
Balance of Payments, USD bn										
Current account	11.7	14.0	13.6	1.6	-28.2	-24.3	-47.7	-48.6	-51.4	-65.4
% of GDP	1.8	1.6	1.2	0.1	-1.7	-1.6	-2.4	-2.1	-2.1	-2.4
Trade balance	33.6	44.7	46.5	40.0	24.8	25.3	19.9	29.8	27.0	15.8
Exports	96.5	118.3	137.8	160.6	197.9	153.0	201.6	256.0	251.7	259.7
Imports	62.8	73.6	91.4	120.6	173.1	127.7	181.7	226.3	224.7	243.9
Service balance	-4.7	-8.3	-9.6	-13.2	-16.7	-19.2	-30.8	-37.5	-37.3	-40.2
Income balance	-20.5	-26.0	-27.5	-29.3	-40.6	-33.7	-39.6	-43.8	-44.8	-44.6
FDI, net	18.1	15.1	18.8	34.6	45.1	25.9	48.4	65.1	55.0	55.0
International reserves	52.9	53.8	85.8	180.3	206.8	239.1	288.6	354.1	378.1	378.1
Total amortisations	33.2	32.8	43.0	39.7	22.4	30.1	33.8	29.7	35.7	151.2
Public Finances, % of GDP										
Consolidated government balance	-2.9	-3.6	-3.6	-2.8	-2.0	-3.3	-2.6	-2.6	-1.9	-2.7
Consolidated gov primary balance	4.2	4.4	3.9	4.0	4.2	2.0	2.7	3.1	3.0	2.5
Public debt	65.4	67.4	64.2	61.2	61.3	67.6	62.6	62.6	62.6	63.1
of which Domestic	45.5	56.0	58.0	57.0	56.6	64.1	59.8	57.9	58.2	58.7
Foreign Assets & Liabilities, USD bn										
External debt	201.4	169.5	172.5	193.6	198.3	198.2	255.2	257.6	222.7	228.7
Private	69.1	69.2	83.2	107.6	114.2	100.3	151.9	153.5	118.2	122.7
Public	132.3	100.3	89.2	86.0	84.2	93.3	105.6	108.4	104.8	108.8
External debt / GDP	30.3	19.2	15.7	13.7	12.1	12.9	12.9	11.2	9.1	8.6
External debt / XGS	184.6	126.1	109.6	104.9	86.8	109.7	109.3	87.5	75.9	74.5
Short-term debt	…	18.8	20.3	38.9	36.4	31.0	56.4	60.0	65.0	65.0
Short-term debt/International reserves (%)	…	34.9	23.7	21.6	17.6	13.0	19.6	16.9	17.2	17.2

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.3	2.1	1.4	0.8	1.2	2.9	4.4	5.4	5.3	4.4
CPI, % yoy	6.7	7.3	6.5	5.2	5.0	4.7	4.9	5.1	5.3	5.4
Policy interest rate, %, eop	12.25	12.00	11.00	9.75	8.50	7.50	7.25	7.25	7.25	8.25
1 month inter-bank rate, %, eop	-	-	-	-	-	-	-	-	-	-
BRL/USD	1.57	1.67	1.79	1.76	1.99	2.02	1.99	1.97	1.95	1.93

Source: National Sources Citi Investment Research and Analysis

Chile

Camilo Gonzalez
+1 212 816 9901
camilo.gonzalezgarcia@citi.com

Fernando Diaz
+54 11 4329 1931
fernando.jorge.diaz@citi.com

- **Summary view** — Activity indicators are not doing bad, but are not doing great either. There are already signs that external demand is suffering, and in a small open economy such as Chile's, this has certainly raised policymakers' eyebrows. For the time being we keep our 2012 GDP estimate at 4.5%. In addition, we have revised our year-end inflation forecast to 2.5%, from 3% before.
- **Things to watch** — Watch for how the international situation continues evolving, as this will have major implications for next year's outlook, especially on the growth and monetary policy fronts.
- **Strategy** — Our call remains for 50bp worth of cuts toward the end of the year. To us, the 2Q12 Monetary Policy Report is a transition phase toward a dovish stance.

Activity not bad, but not great either

For the moment, the economy is neither booming, nor faltering. According to the central bank's GDP proxy, the IMACEC, the economy expanded 5.1% YoY in April. Although the figure is far from stellar, it does not say the economy is in the doldrums either. Nonetheless, authorities are starting to get uncomfortable, as this hapless pace of economic growth seems to be the transition phase toward a less rosy outlook. There are several areas that have ignited concern. Manufacturing and mining activity remain sluggish. Exports are starting to fall in YoY terms, not only as a result of lower commodity prices, but also due to weakening external demand. External financing is getting harder to come by, even if it is not drying out.

Consumption remains as an important source of growth, but the question is how long we can expect this to last. Our analysis (for more information please see Emerging Markets Daily - Latin America Edition May 31, 2012) suggests that there have been three main drivers behind this trend: 1) labor market tightness and rising wages; 2) strong growth in consumer loans; and 3) the boost stemming from the earthquake rebuilding effort. On all three fronts, we expect further moderation in private consumption. Although the labor market remains tight and wage growth remains favorable, they usually react to the economic activity with a lag. Consumer loans are still growing at a healthy clip, but nowadays banks are less willing to extend credit. Finally, the earthquake rebuilding effort is not going to last indefinitely (and might even be over by now). Therefore, we believe it is highly unlikely that consumption alone will be able to keep growth from slowing down in the next couple of quarters.

We expect a moderate slowdown in the next couple of quarters, but external events can drastically alter the outlook for next year. For the time being our forecast for 2012 GDP growth stands at 4.5%. This implies slowdown in the pace of growth during 2Q12 and 3Q12, followed by a rebound in the final quarter of the year. However, recent international events suggest that uncertainty is going to linger on for quite sometime. Therefore, any deviation in the quarterly path will have important implications for next year's outlook. We are currently expecting the economy to grow 5% next year, but acknowledge that the risks are on the downside.

Inflation is no longer a concern

Inflation is now comfortably within the central bank's range. In May, monthly inflation was flat once again, surprising the market on the downside once again. As a result, annual headline inflation is now running at 3.1%, in line with the central bank's 3% midpoint target. Although we were expecting inflation to slow down after the temporary spike in 4Q11, the speed at which it has come back to the target has been surprising nonetheless. The strong downward correction in food and fuel prices has certainly helped. Still, core inflation measures are slightly below the 3% midpoint.

We revise our 2012 year end inflation forecast to 2.5% from 3% before. Our new forecast incorporates the recent downward surprises in prices, but the price dynamics should remain unchanged from those in our previous scenario. With the global outlook still uncertain, commodity prices are unlikely to represent a major risk for the moment. Our call for sluggish growth in 2Q12 and 3Q12 means that pressures on core prices are unlikely to surface this year. Finally, the high comparison base in the last quarter of 2011 should give inflation more room to trend down.

Central bank starts transition toward dovish stance

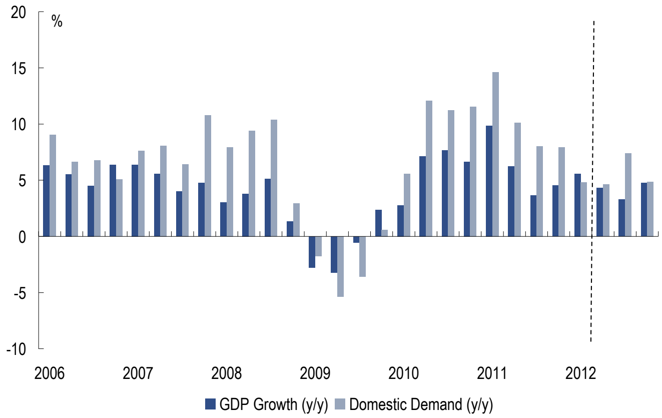
The BCCh has now kept the policy rate unchanged for five straight months. At its June meeting, the central bank decided to keep the policy rate at 5%. However, it is worth remembering that the 1Q12 Monetary Policy Report, the BCCh's working assumption was that moderate interest rate hikes would come toward the end of the year. In that vein, the central bank considered the option of interest rate hikes in its April and May meetings.

Interest rate hikes no longer seems to be the base case. With the international situation worsening and inflation no longer a source of concern, the June policy statement was less hawkish than in previous months. The central bank remains concerned about labor market tightness, which it cites as a prominent risk for the medium-term inflation outlook.

Our take on the 2Q12 Monetary Policy Report is that it is a transition phase toward a dovish stance. In the 2Q12 IPOM, the central bank revised its forecasts to reflect the more challenging outlook, not only for the remainder of this year, but also for next, meaning lower global (and trade partner) growth and terms of trade across the board. Regarding domestic variables, the BCCh maintained its estimate for 2012 growth unchanged at 4.0-5.0%, but lowered its inflation estimate to 2.7% from 3.5%. The working assumption is that the policy rate will remain stable in the "short-term". To us this is a similar situation to the one observed in the second half of last year, as the IPOM went from hawkish in the first half of the year, to stable rates in the "short-term" in 3Q11 to a rate cut scenario in 4Q11.

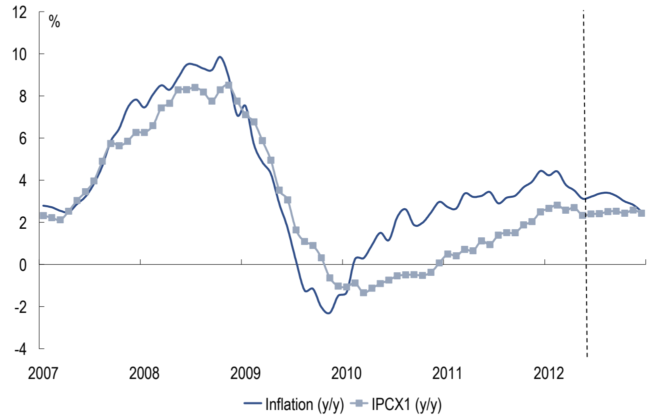
Our call is for 50bp in cuts toward the end of the year. In the absence of a severe and sudden negative shock, we do not see the central bank cutting rates in preventive fashion. Given that the BCCh has highlighted, on several occasions, the importance of expectations and the shortcomings of surprising the market, we expect the discourse to turn dovish before interest rate cuts materialize, so as not to induce the market into believing that the situation is more complex than it actually is.

Figure 236. We expect 2012 growth at 4.5%



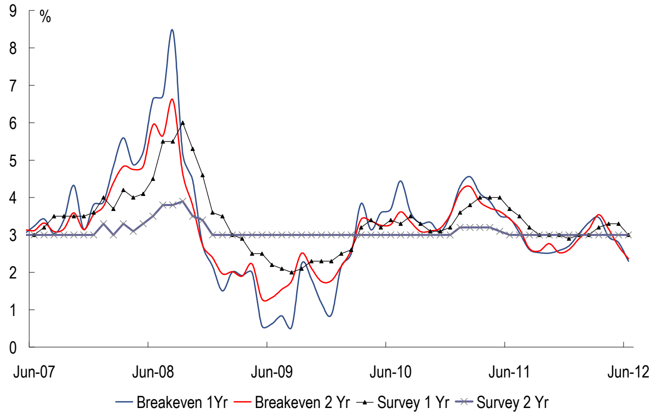
Source: BCCh and Citi Investment Research and Analysis

Figure 237. We have lowered our 2012 inflation estimate to 2.5%



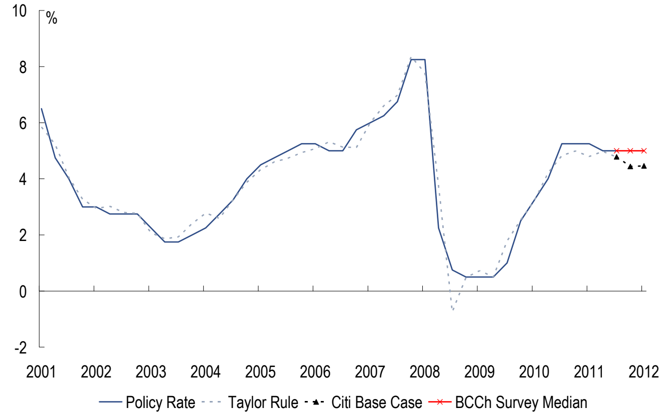
Source: BCCh and Citi Investment Research and Analysis

Figure 238. Market inflation expectations below 3% target



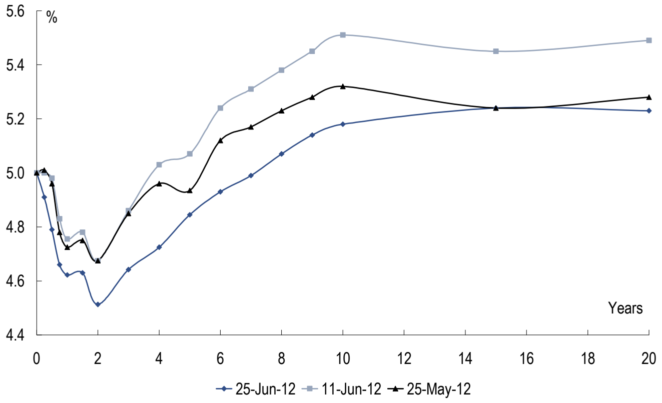
Source: INE and Citi Investment Research and Analysis

Figure 239. We still expect cuts in the policy rate in 2012



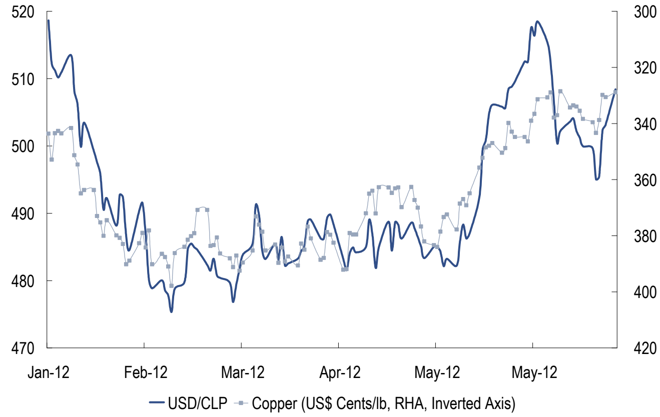
Source:BCCh and Citi Investment Research and Analysis

Figure 240. CAMARA Swap pricing cuts in coming months



Source: Bloomberg

Figure 241. CLP to remain sensitive to copper prices



Source: Bloomberg

Figure 242. Chile Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	99.4	123.4	154.7	173.3	182.8	173.8	217.1	248.6	259.4	276.6
Nominal GDP, local currency bn	60.5	68.9	82.0	90.4	93.8	96.8	110.4	120.2	128.6	139.0
GDP per capita, USD	6179.3	7588.5	9413.0	10440.7	10903.9	10239.3	12786.3	14500.4	14986.0	15104.7
Population, mn	16.1	16.3	16.4	16.6	16.8	17.0	17.0	17.1	17.3	18.3
Unemployment, % of labour force	9.2	9.1	7.9	7.1	7.8	10.8	8.2	7.1	7.0	7.7
Economic Activity										
Real GDP, % yoy	7.0	6.2	5.7	5.2	3.3	-1.0	6.1	6.0	4.5	5.0
Real investment growth % yoy	8.5	22.8	9.1	6.4	20.8	-23.5	35.6	13.0	6.2	8.9
Real consumption growth % yoy	8.0	8.0	7.5	7.5	4.4	0.8	9.0	7.9	5.1	5.3
private consumption growth % yoy	8.4	8.5	7.8	7.6	5.2	-0.8	10.0	8.6	5.5	5.5
Real export growth, % yoy	14.0	2.8	5.1	7.2	-0.7	-4.5	1.4	4.6	4.6	4.1
Real import growth, % yoy	18.3	17.3	11.4	14.3	11.2	-16.2	27.4	14.4	6.3	7.2
Prices, Money & Credit										
CPI, % yoy	2.4	3.7	2.6	7.8	7.1	-1.5	3.0	4.4	2.5	3.0
CPI, % avg	1.1	3.1	3.4	4.4	8.7	1.5	1.4	3.3	3.4	3.0
Nominal wages, % yoy	3.0	4.7	5.5	7.1	8.5	5.8	3.5	5.8	6.1	4.5
Credit extension to private sector, % yoy	10.6	11.9	11.4	14.7	19.1	-1.4	11.2	18.7	10.8	8.2
Policy interest rate, %, eop	2.25	4.50	5.25	6.00	8.25	0.50	3.25	5.25	4.50	5.00
1 month inter-bank rate, %, eop	2.37	4.53	5.36	5.93	8.24	0.45	3.13	5.23	4.50	4.75
Long-term yield, %, eop	…	…	…	6.25	5.92	5.78	5.11	4.98	4.90	5.90
CLP/USD, eop	589	512	532	505	662	497	468	520	498	498
CLP/USD, avg	611	555	527	523	529	553	509	483	495	503
Balance of Payments, USD bn										
Current account	2.6	1.9	7.1	7.1	-5.8	3.5	3.3	-3.2	-4.7	-5.3
% of GDP	2.6	1.5	4.6	4.1	-3.2	2.0	1.5	-1.3	-1.8	-1.9
Trade balance	10.2	11.3	22.9	24.1	6.1	15.4	15.3	10.8	7.8	6.7
Exports	33.0	42.0	59.4	68.6	64.5	55.5	70.9	81.4	80.6	82.3
Imports	22.9	30.7	36.4	44.4	58.4	40.1	55.6	70.6	72.8	75.6
Service balance	-0.8	-0.8	-0.9	-1.3	-1.2	-2.0	-1.8	-2.4	-1.6	-2.1
Income balance	-7.8	-10.4	-18.4	-18.9	-13.6	-11.4	-14.8	-14.0	-13.8	-13.0
FDI, net	7.2	7.1	7.4	12.6	15.5	12.9	15.4	17.3	18.4	19.1
International reserves	16.0	17.0	19.4	16.9	23.2	25.4	27.9	42.0	42.0	41.1
Total amortisations	8.1	6.1	12.6	9.7	14.3	15.6	11.0	18.7	21.4	21.7
Public Finances, % of GDP										
Consolidated government balance	2.1	4.7	7.9	8.4	4.3	-4.3	-0.3	1.6	0.7	0.6
Consolidated gov primary balance	3.1	5.6	8.5	9.0	4.8	-3.8	0.0	2.0	1.0	0.9
Public debt	11.6	7.9	5.3	4.4	4.3	7.6	10.6	11.1	6.6	5.4
of which Domestic	6.4	4.3	2.4	2.1	2.5	5.3	8.0	8.2	5.2	4.2
Foreign Assets & Liabilities, USD bn										
External debt	43.2	45.6	48.3	53.4	63.7	71.9	84.1	98.6	112.6	119.4
Private	38.1	41.2	43.8	49.4	60.4	67.9	78.5	91.4	109.0	116.2
Public	3	2	2	2	2	2	3	3	2	2
External debt / GDP	43.5	37.0	31.2	30.8	34.9	41.4	38.8	39.7	43.4	43.2
External debt / XGS	130.8	108.7	81.3	77.9	98.8	129.7	118.7	121.1	139.8	145.0
Short-term debt	…	6.8	8.1	9.0	14.0	15.8	16.5	19.4	20.6	22.0
Short-term debt/International reserves (%)	…	39.9	41.7	53.4	60.6	62.4	59.0	46.3	49.1	53.5

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.3	3.7	4.5	5.6	4.3	3.3	4.8	5.6	4.7	4.7
CPI, % yoy	3.4	3.3	4.4	3.8	3.2	3.3	2.5	3.0	3.2	3.1
Policy interest rate, %, eop	5.25	5.25	5.25	4.75	4.50	5.00	4.50	4.50	4.50	4.50
Long-term yield, %, eop	6.03	4.84	4.98	5.20	5.10	5.00	4.90	5.15	5.40	5.65
CLP/USD	467	520	520	488	503	493	498	503	507	503

Source: National Sources Citi Investment Research and Analysis

Colombia

Munir Jalil
+57 1 639 4195
munir.jalil@citi.com

José Vicente Romero
+57 1 638 4025
jose.v.romero@citi.com

- **Summary view** — The Colombian economy has finally entered a deceleration phase, as evidenced by the recent 1Q12 GDP print, two consecutive declines in industrial production and the first negative annual growth print in retail sales since 2009. This situation led us to downgrade our GDP forecast for the year as a whole to 4.0% from 5.0% before. In line with this lower GDP growth estimate, we revised down both our inflation and repo rate forecasts which now stand at 2.9% and 4.75% by year end, respectively.
- **Things to watch** — Watch for the CB's meeting communiqué and minutes, which could provide hints regarding the timing of future interest rate moves.
- **Strategy** — With a weak external outlook and domestic activity decelerating, it should be easier for the CB to relax its neutral monetary stance, which consequently should support the local curve. Nonetheless, the local market will experience external risk aversion shocks arising from Europe in the meantime, creating some volatility as well as FX depreciation episodes.

Macroeconomic outlook: The winter is here

As we have mentioned before, the economy has entered a deceleration phase. As we explained in our previous research piece Colombia Macro View - The Winter is Here, weak industrial production, retail sales and construction sector results in 1Q12 make it difficult for the economy to gain the required momentum for GDP to expand at a rate close to 5%, as the market and the government were expecting at the beginning of the year. In our view, the economic deceleration is a result of four elements: 1) normal business cycle dynamics which translate into growth moderation in industrial production and retail sales; 2) the effect of interest rate increases made by Banrep which are aimed at reducing domestic demand and loan growth; 3) below-target levels of infrastructure spending by the government, something we expect to be solved at least partially by year end but mostly in 2013; and 4) the weak external outlook and its effect on commodity prices and hence terms of trade.

We now expect 4% GDP growth for the year as a whole. This forecast includes a 1.5% growth in the agricultural sector, 9% growth in the oil and mining sector, 1.2% expansion in manufacturing, 3.6% expansion in retail and 3% growth in construction. These results incorporate some civil works' acceleration in 3Q12 and 4Q12, but still not enough to take GDP to the 5% mark.

With lower GDP expectations come lower demand-side inflation pressures, which translate into a reduction of our year-end headline inflation estimates, now at 2.9%. Given the downward revision to our GDP outlook, our inflation expectations needed an update as well. Hence, we now expect core inflation to stand at 2.85% by year end while food inflation should increase 3%, taking headline inflation to 2.9% in December 2012. This updated view on inflation is also supported by the observed results year to date, as inflation has accumulated 1.92% up to May. It is important to note that the only foreseeable risks on the inflation front should be related to El Niño phenomenon which some meteorological agencies have begun to talk about, and changes to the VAT as presented in the forthcoming tax reform. Nonetheless, we know none of these effects should be felt in 2012, as the El Niño effect on food prices should be felt 1H13 and the tax reform, if approved by Congress, should become effective in 2014. In addition, it is worth mentioning that both effects should be of transitory nature.

Monetary policy

We now expect the CB to reduce the Repo rate by year-end down to 4.75%, with downward interest rate moves occurring in 4Q12. A lower domestic economic activity outlook, coupled with lower inflation pressures, should allow Banrep to reduce interest rates at some point in time. In particular, we consider that the ongoing deceleration, along with the challenging external outlook, should take the CB's Board to reduce the Repo rate in 4Q12. In particular, our base case scenario contemplates two 25bp reductions in the repo rate this year. In our view, the current growth of consumer loans (which have been fluctuating between 22%-23%) would maintain some members of the CB's board uncomfortable, in a situation that would prevent interest rate cuts to happen sooner. Having said this, we think elements to follow in order to assess future CB's behavior rely on faster-than-expected domestic deceleration, consumer loan growth slowing down to 18% with a resulting deterioration in loan quality, and finally a higher-than-expected external shock stemming from the fragile external economic conditions.

Fiscal policy

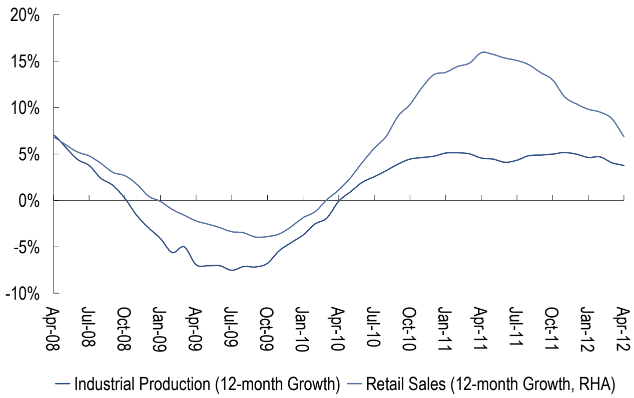
Low spending this year will improve fiscal figures while giving leeway for a fiscal expansion in 2013. The new Medium Term Fiscal Plan presented by the Ministry of Finance in mid-June reflected the good momentum that the government is displaying in terms of fiscal figures. While we believe fiscal consolidation in the country is necessary and there is no doubt the staff at the Ministry of Finance is working hard towards achieving that goal, it is also important to recognize that the country needs significant levels of investment in infrastructure and unfortunately, almost two years into president Santos administration, the speed at which infrastructure spending is taking place is hardly noticeable. We also understand that this has nothing to do with the will and determination this government has to execute, but rather with an old history of legal, environmental and contractor issues associated with these projects.

However, independently of what is causing these delays, we needed to incorporate them in our models and we now think that an important part of this fiscal spending should happen in 2013 rather than this year. This negatively affected growth perspectives this year, but should prove useful in mitigating the effects of a worse-than-expected external outlook. Thus, in an environment in which tax revenues are posting better-than-expected results, and infrastructure money is not being spent, we expect good figures on the fiscal front this year, a situation we believe has been already discounted by the markets. At the same time, the most important event for this year's second half would be the tax reform discussion in Congress. We think the main result stemming from this reform would be a higher tax base, which consequently will increase tax collections in 2014 as the government has explained.

Investment Implications

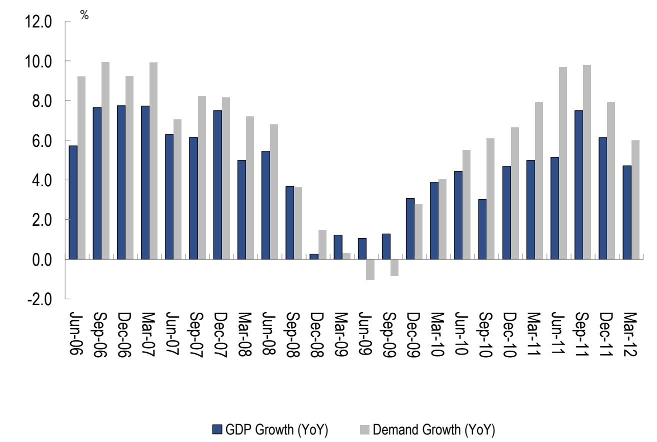
At the moment, local rates will benefit from the expectation of repo rate cuts in 2H12. Nevertheless, this should give way to questions on the effects that lower growth and weaker terms of trade should have on fiscal numbers next year. That is why we believe a debt swap operation makes a lot of sense at this stage and could be announced at some point in 3Q12. On the FX front, we expect the COP to show some convergence towards the behavior observed in other LatAm currencies. In particular, we expect the exchange rate to oscillate at the 1800 mark during most of 2H12 along with increases in volatility.

Figure 243. Retail Sales and IP continue decelerating…



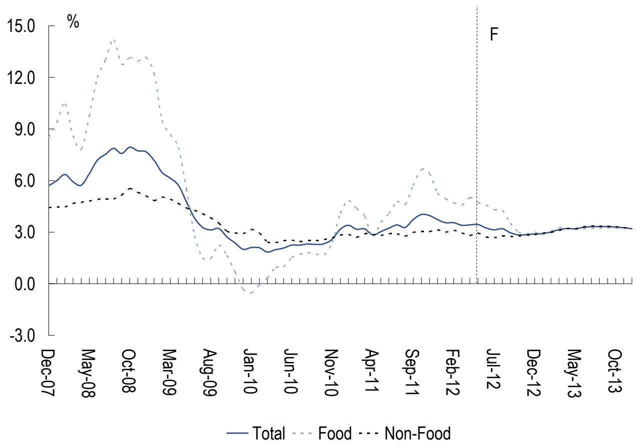
Source: DANE and Citi Investment Research and Analysis

Figure 244. 1Q12's GDP ratify our 4% growth for 2012 as whole



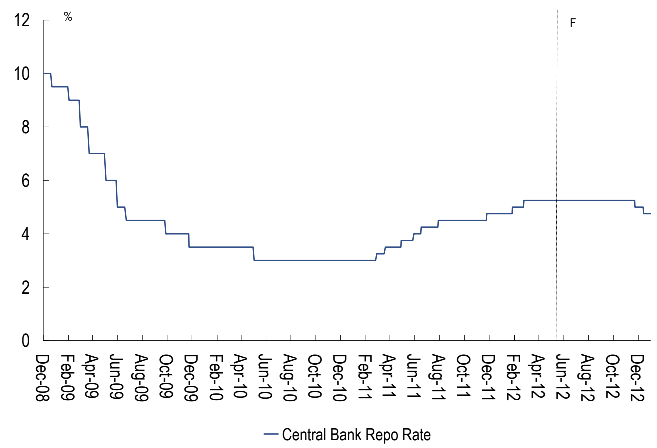
Source: Banrep and Citi Investment Research and Analysis

Figure 245. Which led us to reduce our inflation forecast to 2.9%



Source: Banrep and Citi Investment Research and Analysis

Figure 246. We think is likely for the CB to reduce its Repo rate

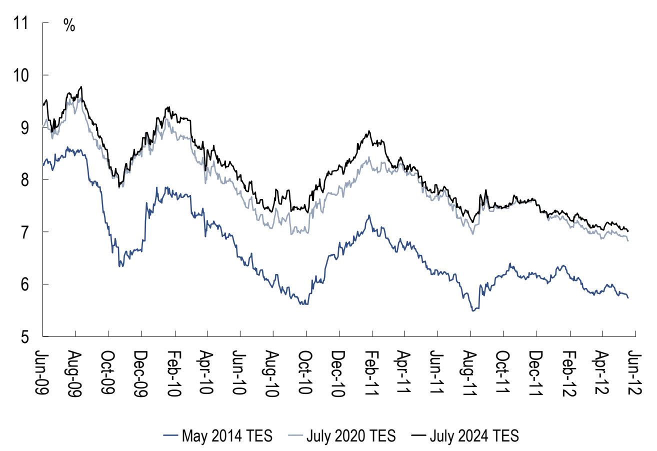


Source: Banrep and Citi Investment Research and Analysis

Figure 247. USDCOP should partially converge to its LatAm's peers

Source: Bloomberg and Citi Investment Research and Analysis

Figure 248. The TES market could benefit from CB's interest rate moves



Source: Bloomberg and Citi Investment Research and Analysis

Figure 249. Colombia Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	118	147	163	208	243	233	287	328	360	389
Nominal GDP, local currency bn	308	340	384	431	481	509	548	608	649	707
GDP per capita, USD	2778	3420	3744	4726	5458	5176	6300	7133	7739	8259
Population, mn	42.4	42.9	43.4	43.9	44.5	45.0	45.5	46.0	46.5	47.1
Unemployment, % of labour force	15.4	13.9	13.0	11.4	11.6	13.0	12.4	11.5	10.9	10.2
Economic Activity										
Real GDP, % yoy	5.3	4.7	6.7	6.9	3.5	1.7	4.0	5.9	4.0	4.5
Real investment growth % yoy	12.2	12.6	19.2	12.8	9.0	-3.9	7.4	17.2	11.1	4.4
Real consumption growth % yoy	4.3	4.3	6.3	7.0	3.5	1.6	5.1	5.7	4.0	4.6
private consumption growth % yoy	3.9	4.0	6.4	7.3	3.5	0.6	5.0	6.5	4.3	4.7
Real export growth, % yoy	9.8	5.7	8.6	6.9	4.5	-2.8	1.3	11.4	8.5	8.0
Real import growth, % yoy	10.3	11.9	20.0	14.0	10.5	-9.1	10.5	21.5	13.6	7.0
Prices, Money & Credit										
CPI, % yoy	5.5	4.9	4.5	5.7	7.7	2.0	3.2	3.7	2.9	3.2
CPI, % avg	5.9	5.0	4.3	5.5	7.0	4.2	2.3	3.4	3.2	3.2
Nominal wages, % yoy	…	5.3	9.2	5.4	19.1	3.0	4.1	5.2	6.3	7.4
Credit extension to private sector, % yoy	10.6	15.5	43.0	28.8	17.7	2.3	16.8	22.4	17.4	17.0
Policy interest rate, %, eop	6.50	6.00	7.50	9.50	9.50	3.50	3.00	4.75	4.75	5.25
1 month inter-bank rate, %, eop	6.59	5.92	7.50	9.35	8.87	3.10	3.00	4.81	4.82	5.32
Long-term yield, %, eop	…	9.07	9.00	10.27	12.76	8.47	7.70	7.60	6.72	7.22
COP/USD, eop	2390	2284	2239	2015	2234	2046	1990	1943	1813	1835
COP/USD, avg	2615	2319	2362	2076	1981	2183	1911	1854	1803	1816
Balance of Payments, USD bn										
Current account	-0.9	-1.9	-3.0	-6.0	-6.8	-5.0	-8.8	-10.0	-11.2	-11.4
% of GDP	-0.8	-1.3	-1.8	-2.9	-2.8	-2.1	-3.1	-3.0	-3.1	-2.9
Trade balance	1.3	1.6	0.3	-0.6	1.0	2.5	2.2	5.5	4.5	7.0
Exports	17.2	21.7	25.2	30.6	38.5	34.0	40.9	57.7	66.1	75.3
Imports	15.9	20.1	24.9	31.2	37.6	31.5	38.6	52.2	61.6	68.3
Service balance	-1.7	-2.1	-2.1	-2.6	-3.1	-2.8	-3.6	-4.6	-3.5	-3.8
Income balance	-4.3	-5.5	-5.9	-8.0	-10.2	-9.3	-11.9	-15.8	-17.0	-19.6
FDI, net	3.0	10.3	6.7	9.0	10.6	7.1	6.9	13.2	14.2	12.5
International reserves	13.5	14.9	15.4	20.9	24.0	25.4	28.5	32.3	36.7	41.5
Total amortisations	5.6	8.4	8.0	5.7	5.1	5.8	6.5	6.3	7.6	6.8
Public Finances, % of GDP										
Consolidated government balance	-1.0	0.0	0.7	-0.6	-0.1	-2.7	-3.2	-2.9	-1.8	-1.6
Consolidated gov primary balance	…	…	…	…	…	…	…	…	…	…
Public debt	38.9	39.1	37.5	32.9	33.9	36.4	37.0	34.8	36.3	35.2
of which Domestic	21.6	25.1	23.8	21.9	22.6	24.7	26.2	24.3	23.8	23.1
Foreign Assets & Liabilities, USD bn										
External debt	39.5	38.5	40.1	44.6	46.4	53.7	64.1	75.9	73.8	78.3
Private	13.7	14.3	13.8	15.6	16.5	16.3	25.0	32.8	31.0	32.4
Public	25.9	24.2	26.3	28.5	28.8	36.4	38.6	42.4	45.3	46.9
External debt / GDP	33.6	26.3	24.6	21.2	18.7	22.6	22.2	22.9	21.2	20.4
External debt / XGS	202.7	157.8	140.4	130.2	108.7	140.5	141.4	121.1	104.7	97.9
Short-term debt	…	…	…	…	…	…	…	…	…	…
Short-term debt/International reserves (%)	…	…	…	…	…	…	…	…	…	…

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	5.1	7.5	6.1	4.6	4.0	3.5	4.1	4.2	4.3	4.6
CPI, % yoy	3.2	3.7	3.7	3.4	3.2	3.0	2.9	3.1	3.3	3.3
Policy interest rate, %, eop	4.25	4.50	4.75	5.25	5.25	5.25	4.75	4.75	4.75	5.00
1 month inter-bank rate, %, eop	4.19	4.56	4.81	5.25	5.32	5.32	4.82	4.82	4.82	5.07
Long-term yield, %, eop	7.75	7.59	7.60	7.27	7.08	7.22	6.72	6.72	6.72	6.97
COP/USD	1780	1915	1943	1792	1800	1814	1813	1811	1815	1825

Source: National Sources Citi Investment Research and Analysis

Mexico

Sergio Luna
+52 55 2226 6799
sergio1.luna@banamex.com

- **Summary view** — First activity data for 2Q12 suggest a modest deceleration and thus we keep our GDP growth forecast for this year unchanged at 3.9%. On inflation, we expect an upward trend in coming months albeit of a transitory nature: accordingly, we think Banxico is most likely to keep the overnight rate unchanged at 4.5%% in the foreseeable future.
- **Things to watch** — Polls show PRI's Enrique Peña Nieto as the most likely winner of the presidential election on July 1. Also watch for the results of the congressional elections on the same day, as they will be relevant to determine the extent of cooperation/opposition the new president can expect from the legislative branch, particularly on issues such as structural reform proposals. The agenda on this front is apparently concentrating around the three aspects we had already defined as central: fiscal reform, labor market reform and energy reform.
- **Strategy** — The local yield curve – M Bonos in particular – has proved extremely resilient to the latest episode of global risk aversion. This positive sentiment about local assets could continue after the election, provided global risk aversion does not rebound. If this is the case, the record-high TIIE-Swap M Bono spreads is likely to show some compression.

Activity in the second quarter likely to slowdown a bit

After a strong start this year, early activity indicators for 2Q suggest a more modest pace of expansion ahead. In particular, external demand appears to be slowing down: industrial output in April rose 3.6% y/y, below our estimate at 5.2%. This is mostly explained by the performance of manufacturing output during the month and its auto-industry component in particular. The extent of the rebound we were expecting turned out to be slightly more modest, but still impressive, as it involved annual growth rates of 4.6% and 20.5%, respectively. Meanwhile, domestic demand is still showing good momentum, with private consumption and investment in 1Q12 posting solid growth rates of 4.3% and 8.6% y/y, respectively, and formal job creation for May up 4.5% y/y. All in all, we are confident that the internal market is better positioned to offset a slowdown in export demand, which in turn has improved thanks to market share gains in the US, on the basis of renewed competitiveness against countries such as China. Thus, we keep our annual GDP growth estimates for 2Q12 and the whole year unchanged at 4.5% and 3.9%, respectively.

Inflation is likely to keep rising in coming months, but we believe inflation risks remain limited. Inflation results for the whole month of May confirmed that the trough of annual inflation is now behind us, as headline for the month was reported at 3.9%, up from a 3.4% level in the previous month. Moreover, headline inflation has surprised on the upside in the first half of June, as the 4.3% y/y print is already above Banxico's variability range of 3% +/- 1%. We nevertheless see limited inflation risk, as the rise is essentially driven by volatile farm prices, while core inflation remains well behaved at 3.5% y/y during the said period. Moreover, expectations about the persistance and the impact of recent peso depreciation against the USD suggest limited effects. Our latest Banamex survey shows that the consensus sees the year-end USD/MXN at 12.95 – actually slightly down from the USD/MXN 13.00 median expectation at the beginning of this year. Meanwhile, revisions by the consensus in terms of year-end inflation expectation are also quite modest, as the median stands at 3.75% y/y in the last survey vs.3.70% in the first survey we collected this year.

Accordingly, Banxico's neutral policy stance should remain essentially unchanged: we see the policy rate closing this year at its current 4.5% level. Although Banxico's communication has recently become more diffuse, we still keep our view of a "policy bias" in the direction of easing, but quite conditional on global financial conditions and potential actions by central banks in the industrial world.

Focus on the July 1 elections and reform prospects

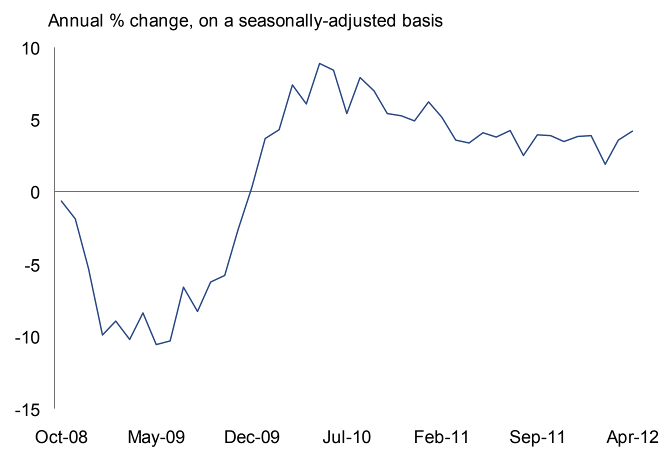
The presidential race comes to an end. After several polls suggested that the presidential race was heating up on the back of a youth movement relying heavily on social networks, the last batch of polls at the moment of this writing suggest that this episode — which in our view was a welcome sign of active Mexican democracy — did not fundamentally alter electoral trends. The average of six polls collected after the second compulsory presidential debate of June 10 gives Enrique Peña Nieto (EPN) from the PRI 43% of the effective preferences (i.e. netting out undecided/did not answer) vs. 28% for Andres Manuel Lopez Obrador (AMLO) from the PRD and 26% for Josefina Vazquez Mota (JVM) from the incumbent PAN.

With PRI´s Peña Nieto leading in all polls, it seems that the main source of uncertainty about the presidential election is who finishes in second place. We think this is important for several reasons: 1) although the potential for post-electoral conflict is substantially lower than six years ago, a quick concession by the runner up would further diffuse this possibility; 2) performance by presidential candidates could influence how well their parties do in Congress. It is important to keep in mind that, in addition to a new president, on July 1 Mexicans will also elect 500 members of the lower chamber of Congress, as well as 128 senators and local officials in 15 out of 32 states. From this point of view, PRI, PAN and PRD performance in the congressional elections would be quite important to assess the strength of the president's mandate and also the extent of support/opposition that can be expected from Congress when it comes to presidential initiatives, such as structural reform bills.

Our central scenario is that the new administration could achieve progress on several items of the reform agenda. In particular, we think that when it comes to the reform agenda attention has centered on the three topics we had already identified as the most relevant ones: the fiscal structure, the labor market, and the energy sector. Both EPN and JVM have argued that promoting structural reforms is necessary to boost economic growth and from this point of view, a victory by a pro-reform candidate along with a good showing of the PRI and the PAN in the legislative elections could create the right political framework for progress on these fronts.

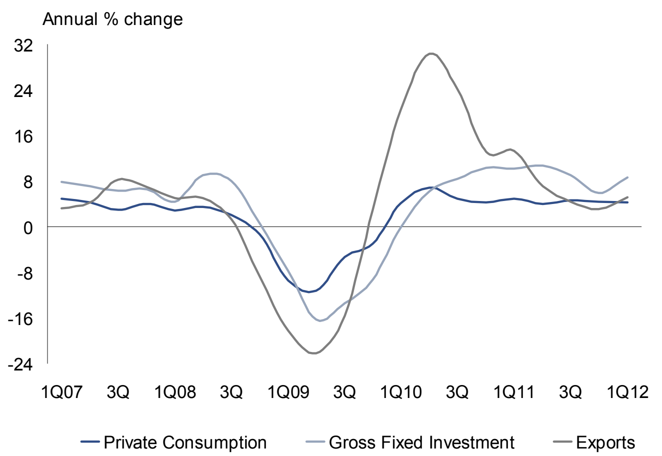
We nonetheless believe progress will be gradual, although probably operating simultaneously on several fronts. Independently of the electoral outcome, our central scenario remains one of gradual progress of the reform agenda. This is so because reforms will alter the status quo and thus affect interest groups; political negotiations will have to go beyond the legislative realm. That said, the momentum for reforms is favorable and negotiations could involve reforms on several fronts so as to increase their political feasibility. In particular, a scheme aimed at replacing social security contributions by workers and employers by a universal system aimed at reducing informality and financed via taxes has the advantage of simultaneously touching tax and labor reform issues. At this stage, we think a scheme along these lines could prove the first item in the policy agenda of the coming administration.

Figure 250. Industrial production rebounds



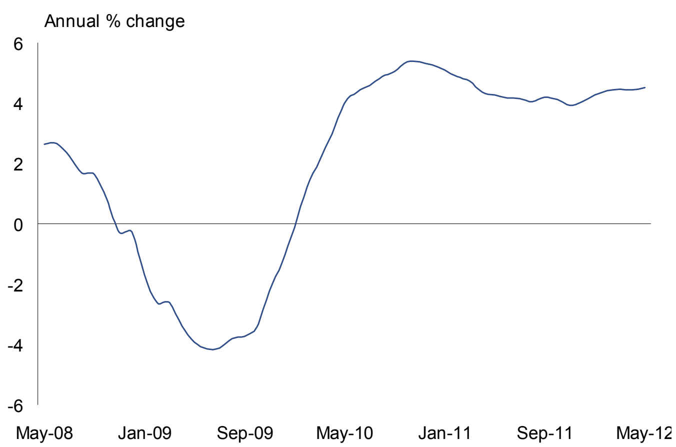
Source: INEGI and Banamex

Figure 251. Local demand compensates for slowing exports



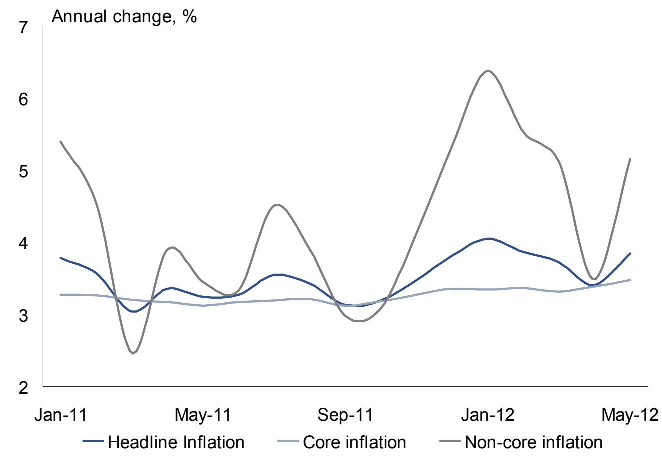
Source: INEGI and Banamex

Figure 252. Formal job creation keeps trending upwards



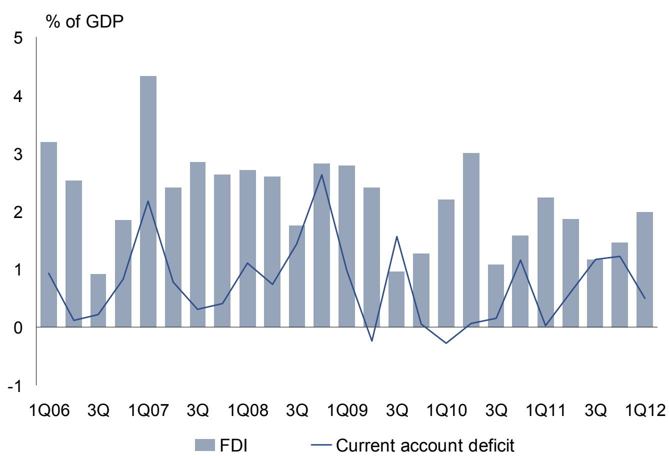
Source: IMSS and Banamex

Figure 253. The trough in annual inflation is now behind us



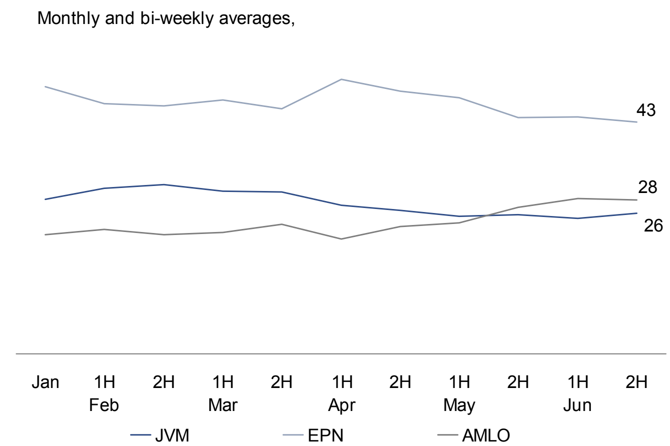
Source: Banxico and Banamex

Figure 254. External deficit remains manageable



Source: Banxico and Banamex

Figure 255. The PRI leading in all polls



Source: Banamex on polls released by Consulta, Covarrubias, Buendía&Laredo, Reforma, Milenio/GEA-ISA, El Universal, Excelsior/BGC, Ipsos, Parametría, ConEstadística and Votia

Figure 256. Mexico Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	759.6	850.1	951.8	1036.3	1102.7	885.1	1036.9	1155.5	1144.4	1284.3
Nominal GDP, local currency bn	8574.8	9251.7	10379.1	11320.8	12181.3	11923.7	13089.3	14352.9	15608.6	16850.6
GDP per capita, USD	7322.1	8078.9	8922.2	9585.2	10067.1	7978.8	9231.2	10163.2	9946.8	11034.0
Population, mn	103.7	105.2	106.7	108.1	109.5	110.9	112.3	113.7	115.1	116.4
Unemployment, % of labour force	3.9	3.6	3.6	3.7	4.0	5.5	5.4	5.3	5.2	5.3
Economic Activity										
Real GDP, % yoy	4.1	3.2	5.2	3.3	1.2	-6.0	5.5	3.9	3.9	3.8
Real investment growth % yoy	2.6	1.2	7.9	3.3	2.6	-14.7	8.6	4.0	5.0	2.3
Real consumption growth % yoy	4.4	4.5	5.1	3.9	1.6	-5.8	4.6	3.9	3.8	3.6
private consumption growth % yoy	5.6	4.8	5.7	4.0	1.7	-7.2	5.0	4.5	4.2	4.0
Real export growth, % yoy	11.5	6.8	10.9	5.7	0.5	-13.5	21.7	6.7	8.6	7.5
Real import growth, % yoy	10.7	8.5	12.6	7.1	2.6	-18.4	20.5	6.7	8.9	6.1
Prices, Money & Credit										
CPI, % yoy	5.2	3.3	4.1	3.8	6.5	3.6	4.4	3.8	3.7	3.9
CPI, % avg	4.7	4.0	3.6	4.0	5.1	5.3	4.2	3.4	4.0	3.9
Nominal wages, % yoy	6.1	5.8	5.1	5.4	5.3	4.2	3.3	4.5	5.0	4.5
Credit extension to private sector, % yoy	2.6	8.3	11.4	12.0	9.6	0.5	5.6	7.5	7.4	7.1
Policy interest rate, %, eop	8.50	8.22	7.05	7.50	8.25	4.50	4.50	4.50	4.50	4.50
1 month inter-bank rate, %, eop	8.50	8.22	7.05	7.50	8.25	4.50	4.50	4.50	4.50	4.50
Long-term yield, %, eop	9.82	8.30	7.46	8.03	8.35	7.99	6.95	6.51	6.05	6.55
MXN/USD, eop	11.15	10.63	10.80	10.90	13.67	13.09	12.34	13.94	13.50	12.90
MXN/USD, avg	11.31	10.85	10.91	10.93	11.21	13.60	12.67	12.48	13.41	13.43
Balance of Payments, USD bn										
Current account	-5.2	-5.9	-4.5	-9.3	-15.7	-5.1	-3.1	-8.7	-15.6	-26.2
% of GDP	-0.7	-0.7	-0.5	-0.9	-1.4	-0.6	-0.3	-0.8	-1.4	-2.0
Trade balance	-8.8	-7.6	-6.1	-10.1	-17.3	-4.7	-3.0	-1.2	-3.6	-10.4
Exports	188.0	214.2	249.9	271.9	291.3	229.7	298.5	349.7	381.3	415.3
Imports	196.8	221.8	256.1	281.9	308.6	234.4	301.5	350.8	384.9	425.7
Service balance	-4.7	-4.7	-5.7	-6.3	-7.4	-8.4	-9.7	-14.3	-18.2	-23.2
Income balance	-10.5	-15.7	-18.6	-19.3	-16.5	-13.6	-11.9	-16.1	-17.6	-18.0
FDI, net	24.8	24.4	20.0	31.3	26.9	16.0	20.2	19.4	20.3	20.4
International reserves	61.5	68.7	67.7	78.0	85.4	90.8	113.6	142.5	163.4	180.3
Total amortisations	36.8	35.5	22.8	26.2	30.1	27.7	32.4	51.5	50.2	52.7
Public Finances, % of GDP										
Consolidated government balance	-0.2	-0.1	0.2	0.0	-0.1	-2.3	-2.7	-2.5	-2.2	-2.0
Consolidated gov primary balance	1.8	2.4	2.6	2.2	1.8	-0.1	-0.9	-0.5	-0.1	0.0
Public debt	38.8	38.3	33.7	33.7	36.5	40.3	38.8	39.6	39.5	38.2
of which Domestic	24.4	25.0	22.8	22.0	24.7	26.6	23.9	23.8	22.8	22.6
Foreign Assets & Liabilities, USD bn										
External debt	166.2	173.1	171.4	196.4	204.8	194.2	246.6	281.1	290.1	299.4
Private	56.5	60.2	67.2	75.4	75.4	73.3	91.5	98.1	98.5	86.3
Public	109.7	112.9	104.2	121.0	129.3	120.9	155.1	183.0	191.6	201.0
External debt / GDP	21.9	20.4	18.0	18.9	18.6	21.9	23.8	24.3	24.5	22.4
External debt / XGS	82.3	75.1	64.4	67.8	66.3	79.3	78.5	77.0	73.1	69.5
Short-term debt	…	…	…	…	…	…	…	…	…	…
Short-term debt/International reserves (%)	…	…	…	…	…	…	…	…	…	…

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.1	4.3	3.9	4.6	4.5	3.3	3.3	2.7	4.1	4.0
CPI, % yoy	3.3	3.1	3.8	3.7	4.3	4.3	3.7	4.0	3.8	4.3
Policy interest rate, %, eop	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
1 month inter-bank rate, %, eop	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Long-term yield, %, eop	6.94	6.61	6.51	6.24	5.37	5.71	6.05	6.18	6.30	6.43
MXN/USD	11.72	13.91	13.94	12.80	13.80	13.40	13.50	13.60	13.70	13.30

Source: National Sources Citi Investment Research and Analysis

Panama

Jorge Pastrana
+1-212-816-5728
jorge.armando.pastranavillegas@citi.com

Camilo Gonzalez
+1-212-816-9901
camilo.gonzalezgarcia@citi.com

- **Summary view** — Higher deficits would become the core of the government's political strategy. We expect the nonfinancial public sector (NFPS) to run a deficit of at least 3% of GDP until further notice
- **Things to watch** — Politics is the main thing to watch in Panama. The ruling CD party is already gearing up for the 2014 presidential election.
- **Strategy** — Growth would be higher, but the market's tolerance toward the country will likely diminish. In our view the institutional erosion we are witnessing in the country will eventually take its toll in the investor community.

Putting the pedal to the metal

Higher deficits would become the core of the government's political strategy. We argue that despite the impressive results in growth, the government would try to boost growth even further through fiscal spending. The reason behind this view is that we believe that the political situation in Panama would lead President Ricardo Martinelli to try to deliver the highest possible growth rate at any cost. In a previous comment we said that there were strong political motivations behind the modification to the fiscal responsibility law (Emerging Markets Daily - Latin America Edition). Such modifications were mostly associated with the need to boost the government's popularity. We think that this boost is even more necessary as, we have previously discussed, Mr. Martinelli is showing signs that he will do whatever it takes to circumvent the ban that prevents him from running again for office (see Emerging Markets Daily - Latin America Edition).

Growth remains high, but that has not overshadowed the country's political conflicts. During the past year, we have been witnessing several political events that have undermined President Martinelli's popularity, which seems to have started when Mr. Martinelli broke the gentlemen's agreement with Vice President Juan Carlos Varela that put an end to the ruling coalition (see Emerging Markets Daily - Latin America Edition). After that, we witnessed conflicts with journalists and businessmen, protests by indigenous people, corruption scandals, and further disagreements with Vice President Varela. Most would expect that in a country with double-digit growth rates (10.6% YoY in 1Q12), the government would be in a honeymoon with its citizens. This is no longer the case of Panama.

The "continuity" motto

The government is banking on the "continuity" motto to remain in power. As long term as it may seem, the ruling CD party is already gearing up for the 2014 presidential election. In our view, the continuity motto is related to nothing other than delivering high growth rates. Fiscal policy is the only available policy tool in this dollarized economy and, in this case, it is probably the only one to turnaround the incumbent government's declining popularity. At some point we thought that political conflicts had eroded the chances of modifying the Constitution to allow immediate reelection. Earlier this year, Mr. Martinelli even signed a statement saying that he would not seek reelection. However, recent events suggest otherwise.

President Martinelli held back from two proposals which, in our view, unveiled his strategy to remain in power. Earlier this month, President Martinelli “reactivated” the Sala V of the Supreme Court of Justice by appointing its three members. In our view, these appointments would allow Mr. Martinelli to hold a stronger grip on the judicial branch. Having a stronger control of this branch could prove useful in case someone were to make an attempt to modify the reelection ban. In addition, the government sent Congress a proposal that allows the government to sell the stakes it has in the electricity sector. We think that the sale of the aforementioned stakes was not necessarily based on a strategic decision to stay away from the electricity sector. It is worth remembering that the government is now entitled to spend all the money associated with the proceeds from these kinds of divestments. Last week, President Martinelli announced that he was holding back from his nominations to the Sala V and from his proposal to sell the government’s stake in an electricity companies. This announcement came after the local Congress was shut down for a second day, as people protested against these proposals. According to La Estrella de Panama (June 19), Mr. Martinelli will send these proposals to the Mesa de Concertacion Nacional.

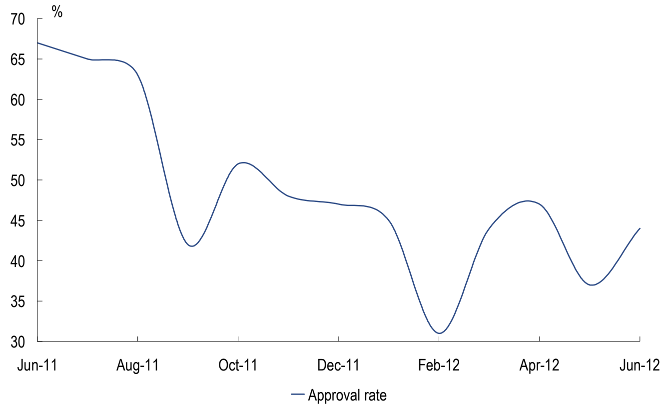
Higher NFPS deficit

We expect the nonfinancial public sector (NFPS) to run a deficit of at least 3% of GDP until further notice. The table below shows the modifications to the fiscal responsibility law. The most recent (second proposal in 2012) puts ceilings to the NFPS that are lower than 3% of GDP. However, in light of what we have been witnessing in this administration, we think it would be naïve to expect that these ceilings would be either binding or permanent. For us, it is clear that the original spirit of the fiscal responsibility was abandoned a long time ago. The most likely scenario is that the ceilings would be modified again to allow for even higher deficits. That is why we think that a 3% of GDP deficit seems to be a reasonable forecast for the time being.

Investment Implications

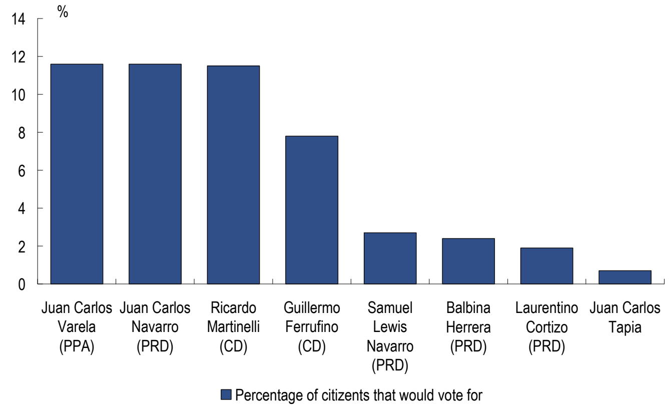
Growth would be higher, but the market’s tolerance toward the country will likely diminish. During the past few years, Panama has been one of the darlings among the emerging markets community. High growth, lower debt ratios and the investment grade status put the country on a privileged place. Real GDP would probably increase more than 9% this year, but that would not necessarily mean that markets will continue to turn a blind eye to what is going on in Panama. In our view the institutional erosion we are witnessing in the country will eventually take its toll in the investor community.

Figure 257. President Martinelli's popularity remains low



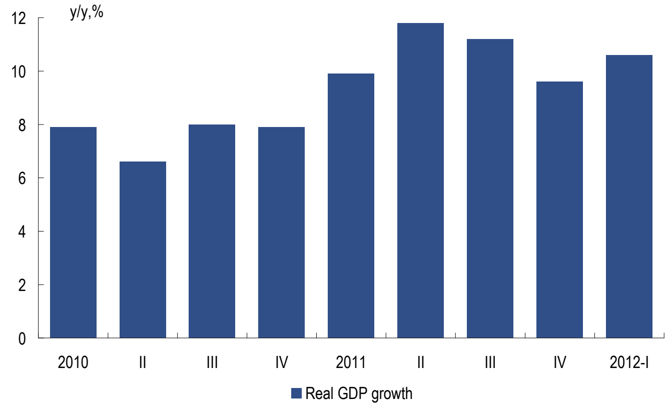
Source: Dichter & Neira and Citi Investment Research and Analysis

Figure 258. Three politicians are ahead in the polls



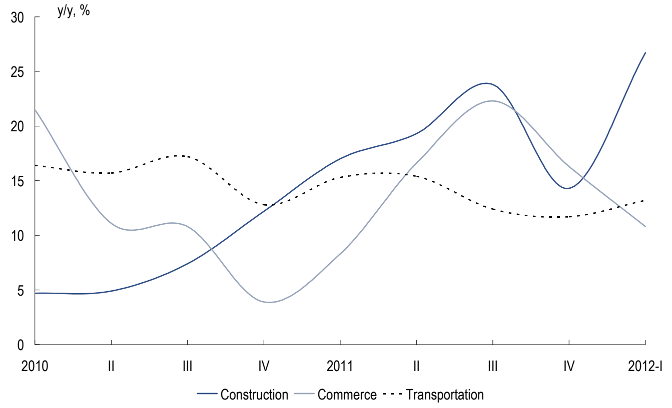
Source: Dichter & Neira and Citi Investment Research and Analysis

Figure 259. Real GDP increased 10.6% YoY in 1Q12



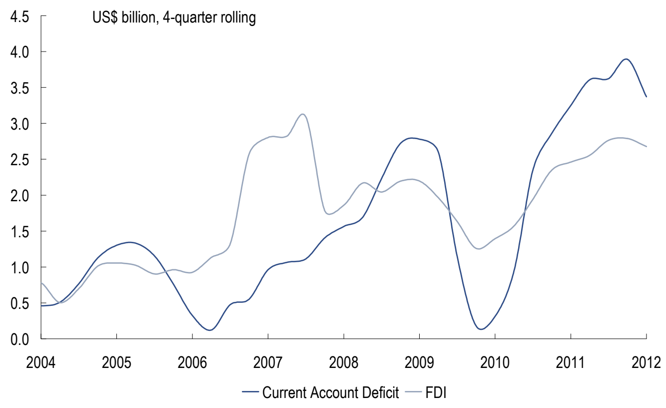
Source: Contraloria and Citi Investment Research and Analysis

Figure 260. Construction rebounded in 1Q12



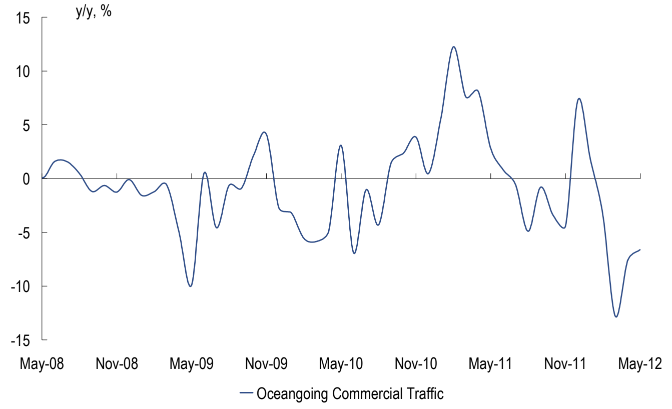
Source: Contraloria, and Citi Investment Research and Analysis

Figure 261. FDI finances a high portion of the current account deficit



Source: Contraloria and Citi Investment Research and Analysis

Figure 262. Traffic in the Panama Canal fell again in May



Source: ACP, Contraloria, and Citi Investment Research and Analysis

Figure 263. Panama Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	14.2	15.5	17.1	19.8	23.0	24.2	26.6	30.7	35.4	39.1
Nominal GDP, local currency bn	14.2	15.5	17.1	19.8	23.1	24.2	26.6	30.7	35.4	39.1
GDP per capita, USD	4470.1	4796.5	5218.3	5920.9	6759.2	6973.4	7538.9	8545.1	9678.0	10686.9
Population, mn	3.2	3.2	3.3	3.3	3.4	3.5	3.5	3.6	3.7	3.7
Unemployment, % of labour force	12.4	10.3	9.1	6.8	5.8	6.9	5.5	4.3	3.7	3.7
Economic Activity										
Real GDP, % yoy	7.5	7.2	8.7	12.1	10.1	3.9	7.6	10.6	9.2	7.0
Real investment growth % yoy	9.9	2.8	13.5	33.2	22.0	3.0	8.0	11.0	10.0	8.0
Real consumption growth % yoy	3.9	7.9	4.1	9.7	5.9	-1.5	6.0	8.6	8.0	6.0
private consumption growth % yoy	4.3	8.8	4.4	10.4	5.9	-2.0	6.0	8.8	7.0	6.0
Real export growth, % yoy	18.6	11.3	11.1	15.0	4.4	-3.0	5.1	5.0	5.1	5.1
Real import growth, % yoy	14.4	11.2	7.4	19.3	6.6	-4.0	5.5	8.0	7.0	5.5
Prices, Money & Credit										
CPI, % yoy	1.2	3.4	2.2	6.4	6.8	1.9	4.9	6.3	5.4	5.5
CPI, % avg	0.2	2.8	2.5	4.2	8.8	2.4	3.5	5.9	5.6	3.2
Nominal wages, % yoy	...	...	...	...	...	…	…	…	…	…
Credit extension to private sector, % yoy	…	…	…	…	…	…	…	…	…	…
Policy interest rate, %, eop	…	…	…	…	…	…	…	…	…	…
1 month inter-bank rate, %, eop	...	...	...	...	...	…	…	…	…	…
Long-term yield, %, eop	7.99	7.22	6.39	6.30	7.43	6.23	5.10	4.73	4.80	4.40
lc/USD, eop	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
lc/USD, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Balance of Payments, USD bn										
Current account	-1.1	-0.8	-0.4	-1.4	-2.7	-0.2	-2.9	-3.9	-4.1	-3.9
% of GDP	-7.5	-5.2	-2.2	-7.2	-11.8	-0.7	-10.8	-12.7	-11.6	-10.0
Trade balance	-1.5	-1.3	-1.8	-3.2	-4.5	-2.2	-4.6	-6.0	-6.0	-6.0
Exports	6.1	7.6	8.5	9.3	10.3	12.0	12.7	16.9	18.0	19.0
Imports	7.6	8.9	10.3	12.5	14.9	14.2	17.2	22.9	24.0	25.0
Service balance	1.3	1.4	2.2	2.8	3.2	3.3	3.4	3.8	3.7	3.9
Income balance	-1.0	-1.1	-1.3	-1.3	-1.6	-1.4	-1.9	-1.8	-1.9	-2.0
FDI, net	1.0	0.9	2.5	1.8	2.2	1.3	2.4	2.8	2.8	2.8
International reserves	0.6	1.2	1.3	1.9	1.7	1.4	1.1	1.2	1.3	1.3
Total amortisations	…	…	…	…	…	…	…	…	…	…
Public Finances, % of GDP										
Consolidated government balance	-4.9	-3.2	0.5	3.5	0.4	-1.0	-1.9	-2.3	-3.0	-3.0
Consolidated gov primary balance	-0.6	1.3	4.9	6.9	3.5	1.9	0.8	0.1	-0.6	-0.6
Public debt	70.4	66.2	61.0	52.9	45.4	45.6	43.4	43.5	42.5	41.0
of which Domestic	19.4	17.1	15.5	11.1	8.5	3.4	4.4	5.0	5.0	5.0
Foreign Assets & Liabilities, USD bn										
External debt	…	…	…	…	…	…	…	…	…	…
Private	…	…	…	…	…	…	…	…	…	…
Public	7.2	7.6	7.8	8.3	8.5	10.2	10.4	11.8	13.3	14.1
External debt / GDP	…	…	…	…	…	…	…	…	…	…
External debt / XGS	81.4	70.1	62.6	58.0	52.6	58.0	55.3	49.0	52.0	52.5
Short-term debt	…	…	…	…	…	…	…	…	…	…
Short-term debt/International reserves (%)	…	…	…	…	…	…	…	…	…	…

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	11.8	11.2	9.6	10.6	9.2	9.0	8.0	7.5	7.0	7.0
CPI, % yoy	6.5	6.0	6.3	5.6	5.5	5.6	5.4	5.0	5.0	5.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	-	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	5.38	4.85	4.73	4.34	4.80	4.80	4.80	5.00	5.00	5.00
PAB/USD	-	-	-	-	-	-	-	-	-	-

Source: National Sources Citi Investment Research and Analysis

Peru

Camilo Gonzalez
+1 212 816 9901
camilo.gonzalezgarcia@citi.com

- **Summary view** — We keep our GDP growth forecast for the year at 5.7%, as it implies a moderate slowdown in activity during 2Q12 and 3Q12. Softer activity will also help inflation, which, coupled with the favorable comparison base, should lead annual inflation lower in 2H12.
- **Things to watch** — The political scene is heating up once again, with President Humala's approval rating declining substantially in the last couple of months, thanks to a rising sense that the government lacks a grip on security.
- **Strategy** — Although the central bank has shifted the inflation balance of risks to the downside once again, we do not expect changes in monetary policy for the time being. Nevertheless, that option cannot be ruled out in case of a severe negative (external) shock.

Sluggish GDP in April: Start of a trend?

There have been several indicators pointing toward a slowdown in economic activity during the past couple of weeks. First and foremost, monthly GDP growth came in at 4.4% YoY in April, the lowest figure since January 2010. More importantly, the release showed that the manufacturing sector continues to struggle, as it has failed to rebound after a 2.2% monthly decline in March and poor performance since late 2011. Meanwhile, mining production remains sub-par and the remaining drivers of growth for the past couple of years, namely the retail and services sectors, are gradually slowing down. This leaves the construction sector as the main beacon of growth, delivering double-digit growth for the last four months. In addition, exports took a 11.8% YoY nosedive in April. Although most of this was related to lower commodity prices, exporting volumes nonetheless declined 4.5% YoY. This event led Finance Minister Castilla to announce that the government is considering measures to help exporters cope with the decline in external demand.

The combination of an adverse external outlook and domestic demand growth converging to long-term trends will keep activity relatively subdued in the next couple of quarters. Although we expect growth to remain relatively resilient in 2012, we do not see the economy operating above capacity under the current outlook. The government stimulus plan has certainly helped, but it has not entirely offset the slowdown in private investment. In the meantime, we do not see major reasons for private consumption to outperform. Households already show a relatively high degree of indebtedness and credit growth has started to come down from its peak in late 2011. Furthermore, in the current environment, it is clear that external accounts will not make a positive contribution to economic activity growth. As such, we keep our GDP growth forecast of 5.7% for 2012, which implies relatively softer growth in 2Q12 and 3Q12, with a mild rebound in 4Q12. In fact, if the economy was to stagnate at April’s levels for the rest of the year, the carry over for 2012 growth would stand at 4.4%.

Inflation: It's all downhill from here

We expect food inflation to slowdown in the coming months. In May, annual headline inflation remained relatively unchanged at 4.1%, well above the central bank's 2% ± 1% target. However, there are encouraging signs that inflation will continue trending down in the months to come. It is worth recalling that during the second half of last year, food prices spiked and led annual food inflation to double from 3.8% y/y in June 2011 to 8% by the end of the year. The favorable comparison base should therefore help lead food inflation, weighing 37.8% of the index, lower from its actual 6%. The main risk on the food inflation front is related to the upcoming El Niño episode. Although the authorities have stated that they expect a mild El Niño, weather conditions always represent a sizable risk for the inflation outlook.

Fuel prices are a variable worth watching out for. The existence of the Fuel Price Stabilization Fund means that changes in international prices are reflected in local prices with a two-month lag (regulator Osinergim sets the maximum and minimum fuel price bands every two months). By definition, this also implies that declines in international oil prices take some time to work their way into local fuel prices. Reference gasoline prices are now below the maximum and minimum bands, suggesting that Osinergmin should lower fuel prices in the months to come. Furthermore, it is expected that by August, some types of gasolines will be dropped from the fuel price stabilization scheme, which means that we could see a faster downward adjustment in fuel prices.

Finally, since we do not see the economy operating beyond capacity, we see little risk on the core inflation front for the next couple of months. With the economy slowing down, or continue growing in line with potential output at most, we see little room for substantial upside surprises in core inflation. As such, we currently stick to our forecast that annual inflation will close the year at 2.8%.

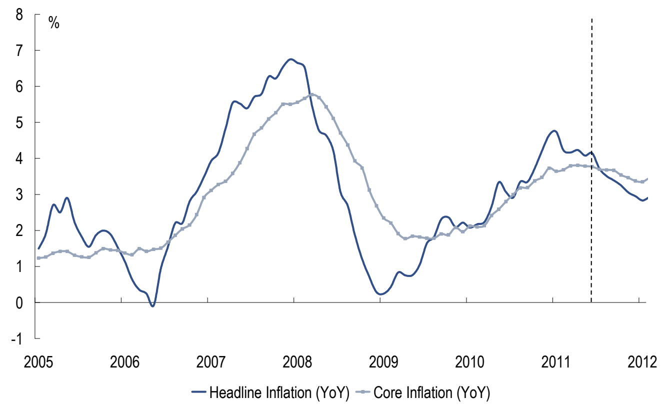
Central bank: Back to the dovish camp

The 2Q12 Inflation Report shifted the inflation balance of risks to the downside once again (from neutral in the 1Q12 edition). According to the central bank there are both external and local reasons to tilt the risks for the inflation outlook on the downside. On the external front, the reasons are unsurprisingly related to the deteriorating outlook for the world economy, which could ultimately have an effect on Peru. On the domestic front, the main risk is related to delays and cancellations in potential investment projects that would cool the pace of economic growth. In these were to materialize, the BCRP says it would provide stimulus and use its stock of international reserves. The upside risks for inflation stem from the outlook for commodity prices and potential weather disruptions, to which the BCRP would only react if they translate into higher inflation expectations. As such, the bias is set for lower interest rates. For the time being, we still think that the central bank will keep monetary policy unchanged for the rest of the year but acknowledge that a severe external shock should prompt an expansionary response.

Politics: The honeymoon is over

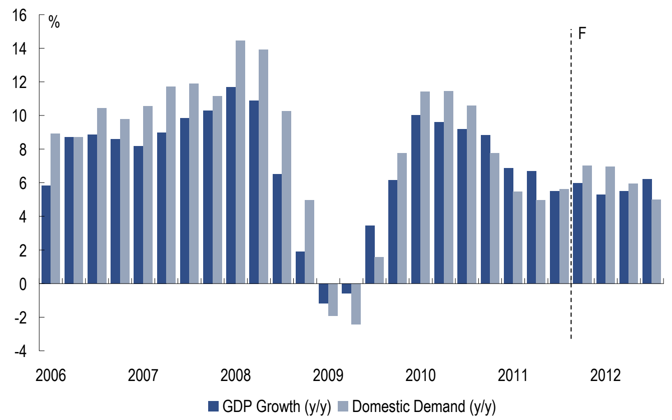
President Humala's popularity ratings have declined substantially. Over the last two months, his approval rating has declined by 11 percentage points to 45%. To a large extent, the decline has been driven by the perception that the government does not have full control, result of reemerging rebel attacks, failed military operations and spreading social protests. As usual, politics should remain one of the issues to watch out for in the months to come.

Figure 264. We expect inflation slowdown to accelerate in 2H12



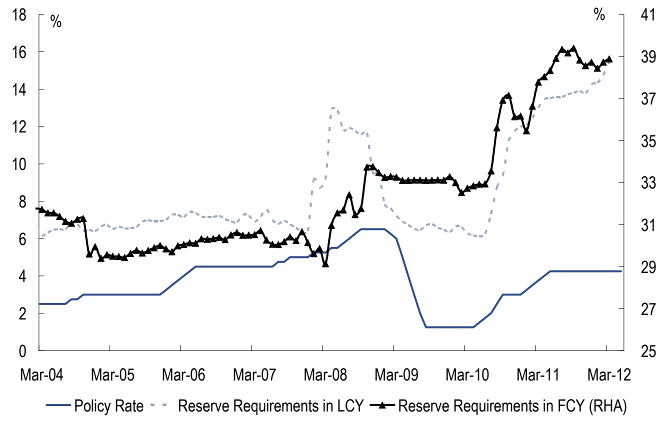
Source: INEI and Citi Investment Research and Analysis

Figure 265. …and GDP growth to remain in neutral terrain at 5.7%



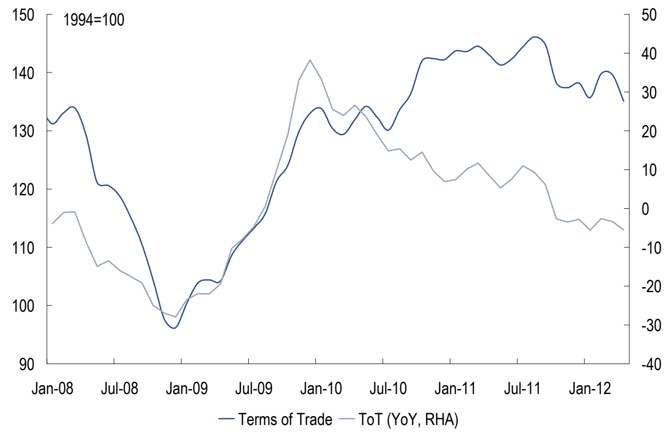
Source: BCRP and Citi Investment Research and Analysis

Figure 266. We see rates on hold for the time being



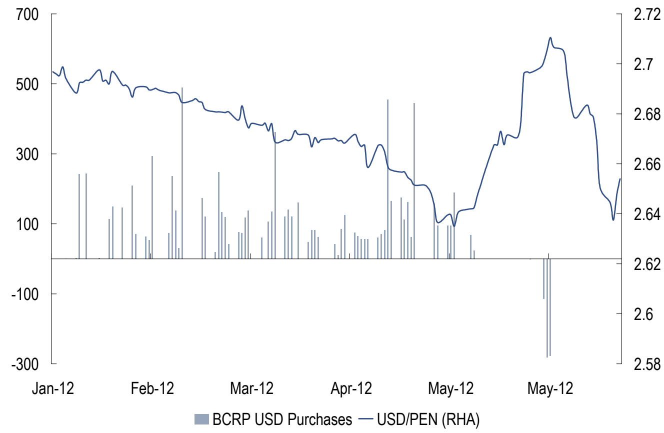
Source: BCRP

Figure 267. Peru's terms of trade are deteriorating



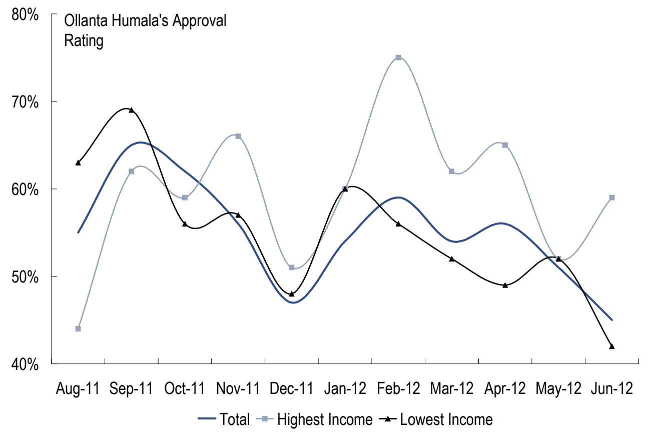
Source: BCRP and Citi Investment Research and Analysis

Figure 268. USD/PEN has come back down after a spike



Source: Bloomberg

Figure 269. President approval ratings took a nosedive



Source: MEF and Citi Investment Research and Analysis

Figure 270. Peru Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	69.5	79.5	92.1	107.0	127.0	126.7	153.5	176.1	196.7	216.5
Nominal GDP, local currency bn	237.9	261.7	302.3	335.5	371.1	382.3	434.7	486.5	527.2	575.5
GDP per capita, USD	2663.1	2997.1	3415.0	3906.2	4562.5	4482.2	5345.1	6035.4	6634.0	7187.7
Population, mn	26.1	26.5	27.0	27.4	27.8	28.3	28.7	29.2	29.7	30.1
Unemployment, % of labour force	9.4	9.6	8.5	8.4	8.4	8.4	7.9	7.7	7.8	7.8
Economic Activity										
Real GDP, % yoy	5.0	6.8	7.7	8.9	9.8	0.9	8.8	6.9	5.7	6.5
Real investment growth % yoy	4.3	9.2	26.5	25.8	25.8	-20.6	36.9	10.0	6.1	6.8
Real consumption growth % yoy	3.7	5.1	6.6	7.9	8.0	3.9	6.3	6.2	5.3	6.3
private consumption growth % yoy	3.6	4.6	6.4	8.3	8.7	2.4	6.0	6.4	5.3	6.4
Real export growth, % yoy	15.2	15.2	0.8	6.9	8.2	-3.2	1.3	8.8	6.3	7.1
Real import growth, % yoy	9.6	10.9	13.1	21.4	20.1	-18.6	24.0	9.8	5.2	6.6
Prices, Money & Credit										
CPI, % yoy	3.5	1.5	1.1	3.9	6.7	0.2	2.1	4.7	2.8	3.0
CPI, % avg	3.7	1.6	2.0	1.8	5.8	2.9	1.5	3.4	3.6	2.9
Nominal wages, % yoy	…	…	9.2	2.7	14.2	11.5	1.1	15.0	9.0	9.0
Credit extension to private sector, % yoy	8.4	18.7	9.2	23.7	25.5	5.2	22.6	11.8	13.3	13.2
Policy interest rate, %, eop	3.00	3.25	4.50	5.00	6.50	1.25	3.00	4.25	4.25	4.25
1 month inter-bank rate, %, eop	4.69	5.33	5.38	6.29	1.34	3.81	4.15	4.30	4.25	4.25
Long-term yield, %, eop	…	…	…	6.44	7.69	6.31	6.34	6.17	6.20	6.40
PEN/USD, eop	3.30	3.42	3.20	3.00	3.10	2.88	2.81	2.70	2.70	2.65
PEN/USD, avg	3.42	3.30	3.27	3.13	2.96	3.02	2.83	2.75	2.68	2.66
Balance of Payments, USD bn										
Current account	0.0	1.1	2.9	1.5	-5.3	0.2	-2.6	-2.3	-4.7	-6.0
% of GDP	0.0	1.4	3.1	1.4	-4.2	0.2	-1.7	-1.3	-2.4	-2.8
Trade balance	3.0	5.3	9.0	8.5	2.6	6.0	6.8	9.3	6.8	6.8
Exports	12.8	17.4	23.8	28.1	31.0	27.0	35.6	46.3	47.1	50.8
Imports	9.8	12.1	14.8	19.6	28.4	21.0	28.8	37.0	40.3	44.1
Service balance	-0.7	-0.8	-0.7	-1.2	-2.1	-1.1	-2.3	-2.1	-2.5	-2.3
Income balance	-3.7	-5.1	-7.6	-8.4	-8.8	-7.5	-10.1	-12.6	-12.9	-14.6
FDI, net	1.6	2.6	3.5	5.5	6.9	5.6	7.3	7.7	7.3	8.1
International reserves	12.6	14.1	17.3	27.7	31.2	33.1	44.1	48.8	57.3	66.0
Total amortisations	1.3	4.2	1.6	6.8	3.3	2.2	4.1	3.3	3.7	4.4
Public Finances, % of GDP										
Consolidated government balance	-1.2	-0.6	1.7	3.0	2.3	-2.0	-0.6	1.7	1.2	-0.3
Consolidated gov primary balance	0.8	1.3	3.6	4.7	3.8	-0.7	0.6	2.9	2.1	0.6
Public debt	44.4	37.7	33.1	29.8	24.1	27.2	23.5	21.7	17.1	16.0
of which Domestic	9.3	9.7	9.3	11.1	9.0	10.9	9.5	8.8	6.9	6.5
Foreign Assets & Liabilities, USD bn										
External debt	31.2	28.6	28.8	32.0	34.1	35.6	40.5	43.1	48.1	57.4
Private	…	…	…	…	…	…	…	…	…	…
Public	…	…	…	…	…	…	…	…	…	…
External debt / GDP	44.9	36.0	31.3	29.9	26.9	28.1	26.4	24.5	24.4	26.5
External debt / XGS	243.8	164.9	121.0	113.8	109.9	132.1	113.9	93.2	101.9	113.0
Short-term debt	…	22.3	22.0	20.1	19.2	20.6	19.9	20.2	23.1	25.5
Short-term debt/International reserves (%)	…	158.0	127.2	72.5	61.7	62.2	45.1	41.4	40.4	38.7

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.9	6.7	5.5	6.0	5.3	5.5	6.2	6.5	6.5	6.3
CPI, % yoy	2.9	3.7	4.7	4.2	3.7	3.3	2.8	2.6	3.1	2.9
Policy interest rate, %, eop	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25
1 month inter-bank rate, %, eop	-	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	6.90	6.45	6.17	5.91	5.90	5.90	6.20	6.40	6.40	6.40
PEN/USD	2.75	2.77	2.70	2.67	2.66	2.70	2.70	2.67	2.65	2.65

Source: National Sources Citi Investment Research and Analysis

Venezuela

Munir Jalil
+57 1 639 4195
munir.jalil@citi.com

José Vicente Romero
+57 1 638 4025
jose.v.romero@citi.com

- **Summary view** — The presidential campaign has heated up with the official registration by president Chávez and opposition candidate Henrique Capriles. There are now clear attacks between candidates, although President Chávez still avoids a debate with Mr. Capriles. The latest polls show Mr. Chávez maintaining an advantage over Mr. Capriles, while the percentage of undecided voters lingers around 29%. Strategies from both sides are not proving effective to convince these voters, in a framework that benefits the incumbent candidate. Although everything seems to be about politics these days in Venezuela, some dark clouds are forming on the economic outlook, as oil prices have been relentlessly below USD100, reducing oil revenues. We expect this situation to have an impact next year, as a Venezuelan version of the fiscal cliff unfolds due to what we forecast to be a sharp fall in fiscal spending.

- **Things to watch** — Watch for additional poll results, particularly on the evolution of undecided voters which should play an important role for the numbers of both candidates. Also, it is important to keep monitoring any information regarding the health evolution of President Chávez.

- **Strategy** — Political news should continue to be the main driver behind this credit's performance. Nonetheless, with the possibility of a worse-than-expected crisis in Europe along with lower oil prices, higher duration bonds should be the most affected.

The gloves are off

With both candidates officially registered, their campaigns have stepped up the attacks on each other, something especially new from Mr. Capriles. After a period in which confrontation with President Chávez was avoided, we note that the hostile tone and attacks from Mr. Capriles against Mr. Chavez have finally appeared. We believe this has to do with polls showing that the candidate perceived the strongest by potential voters was Mr. Chávez, whereas Mr. Capriles' image was positive but seemed to communicate weakness. As a consequence, both candidates are attacking each other, an attitude we expect to continue going forward.

With most polls showing no changes in vote intention trends in and still a big fraction of undecided voters, questions about how to better convince the latter arise. In particular, the latest Datanálisis poll shows President Chávez with 43% of vote intention and Henrique Capriles with 28.8%. At the same time, the percentage of undecided voters remains at 28.6%. There is not doubt that the polls show how difficult it has been for both candidates to win over undecided voters, which are by far the most important force of this political campaign as whoever is able to convince this fraction of the voters, will ensure his election. The opposition has claimed that among these, there are voters who want to vote for Mr. Capriles but who are afraid of explicitly saying so in an anonymous survey. Although that could be the case, the fraction of undecided voters is so significant that it is difficult to expect that all of them to belong to the group the opposition claims. The problem with undecided voters, in our view, is that they have not seen their lives changing significantly under President Chávez's mandate and if anything they feel less secure. But they do not want to return to the days before Chávez either, in which there was no social agenda. This is the reason why Mr. Capriles is selling the idea that security will be a priority in his presidency and more importantly, that the social programs will continue. Mr. Chávez has been selling the idea that the only way of keeping the social programs going forward is to vote for him.

Going forward, we believe both candidates need to concentrate on gaining support from this fraction of the electorate, as those already decided are very unlikely to change their vote intention. What should the candidates' focus be in order to capture these votes? It seems the answer from the Capriles campaign has been to talk about insecurity and offering to tackle this problem that affects main street Venezuelans at the same time its candidate assumes a stronger position against the current government, as have been observed in the last weeks. President Chávez instead has focused on his housing construction programs and the creation of new social programs or *misiones,* creating an economic boom by substantially increasing fiscal spending, while downplaying the opposition candidacy, linking it to the old republic.

Oil prices down… should we worry?

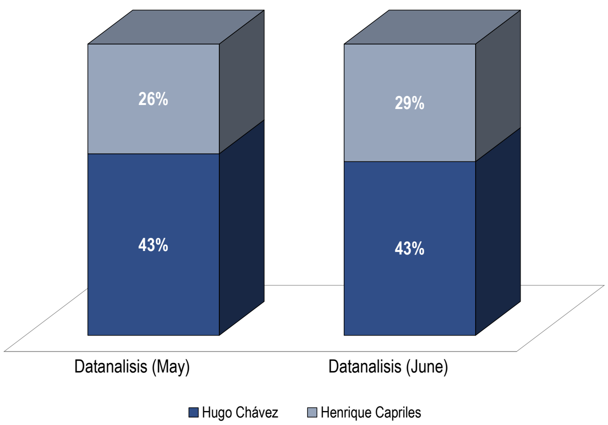
Using historical results from the capital account, we have calculated that in order to have a current account surplus between 7.0% to 9% of GDP next year, the average oil price has to be in the USD109-US$117 range. Based on historical data, we found that the current account surplus has never been lower than 7.0% of GDP. Using this number, we found that the minimum average price for the Venezuelan oil basket needed to meet this 7.0% goal is USD107 per barrel in 2012 and USD109 per barrel in 2013. If this is not the case, and the size of financial account outflows requires a higher current account surplus, the average price of oil should be higher. Keeping our assumptions constant, if the required surplus turned out to be, for instance, 9.0% of GDP, then the minimum oil price should be at least USD116 per barrel in 2012 and USD117 per barrel in 2013. Hence, with the year-to-date average price of the Venezuelan oil basket around US$108, the government should begin to worry about 2013. As is usual in Venezuela, the country has always depended on oil revenues.

Venezuela has proven to be the country most affected by external shocks given its heavy dependency in oil revenues. In a scenario in which oil prices remain below USD100 for the rest of the year, the country will find itself with problems to sustain growth. We believe this situation should not affect 2012 growth prospects, but it will definitely show in 2013, when growth should be affected (we currently expect 3.4% GDP growth) and a devaluation should take place.

Investment implications

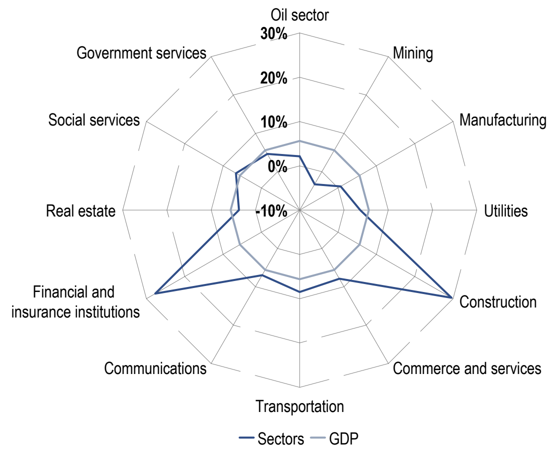
There are two elements that could affect Venezuela credit over the short run: the political race and the evolution of oil prices. In terms of this credit, most of this year's price action associated with Venezuelan debt has had to do with news associated with President Chávez's health condition, and we believe this should continue to be one of the main factors behind price dynamics going forward. While we think that any development that shows the opposition having a chance of winning this upcoming election should continue creating demand for Venezuelan debt, the evolution of the international outlook, and particularly how it affects oil prices should be an additional factor behind short-term price movements of this credit. In that sense, we could see additional falls in Venezuelan bonds prices if the European crisis deteriorates further and oil prices continue falling or stabilize at current levels.

Figure 271. President Chávez still leads the presidential race



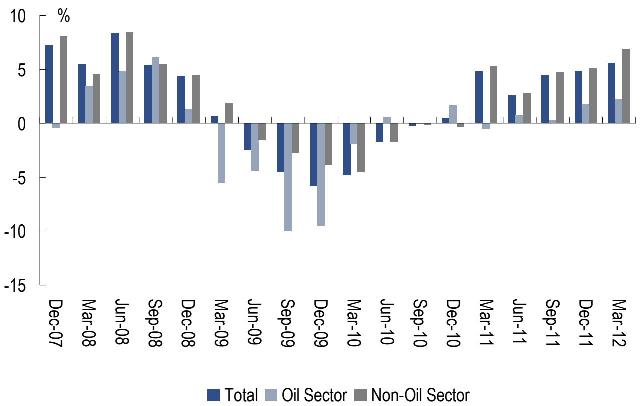
Source: Datanálisis, Consultores 21, Citi Investment Research and Analysis

Figure 272. 1Q12 GDP main driver was the construction sector



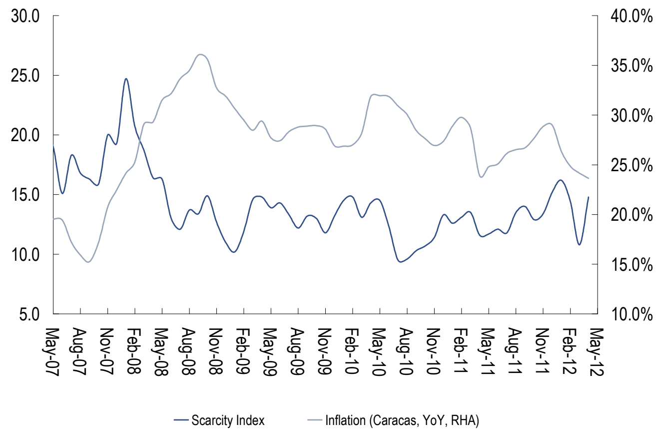
Source: BCV and Citi Investment Research and Analysis.

Figure 273. GDP surprised on the upside



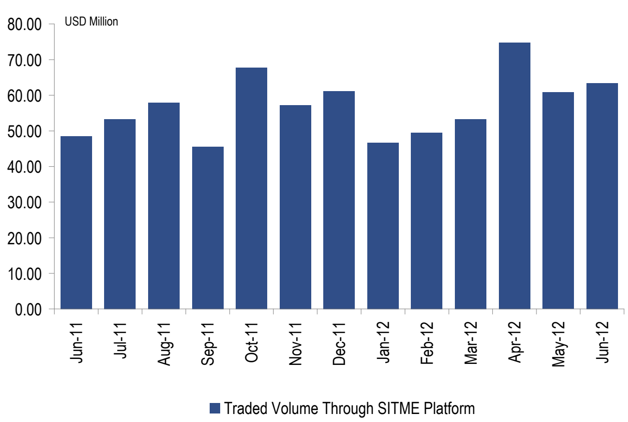
Source: BCV and Citi Investment Research and Analysis

Figure 274. Inflation at bay, despite the law of costs and fair prices



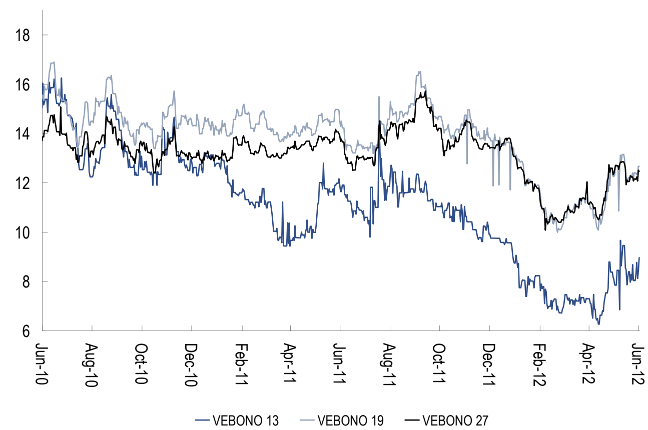
Source: BCV and Citi Investment Research and Analysis

Figure 275. Low USD supply continues



Source: BCV and Citi Investment Research and Analysis

Figure 276. Political events and oil prices are the main driver of credit



Source: Bloomberg and Citi Investment Research and Analysis

Figure 277. Venezuela Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	111.2	146.1	187.6	212.7	298.4	283.7	257.3	298.3	363.6	358.9
Nominal GDP, local currency bn	212.7	304.1	393.9	494.8	677.6	707.3	1016.8	1357.5	1775.1	2333.0
GDP per capita, USD	4256.0	5496.5	6939.9	7737.6	10682.9	9995.8	8925.0	10188.3	12235.7	11902.6
Population, mn	26.1	26.6	27.0	27.5	27.9	28.4	28.8	29.3	29.7	30.2
Unemployment, % of labour force	10.9	8.9	8.4	6.2	6.1	6.6	6.5	6.5	6.4	6.7
Economic Activity										
Real GDP, % yoy	18.3	10.3	9.9	8.8	5.3	-3.2	-1.5	4.2	5.0	3.5
Real investment growth % yoy	91.3	30.5	36.3	28.2	2.2	-19.1	1.0	15.2	1.6	3.3
Real consumption growth % yoy	15.2	14.6	14.3	16.3	6.0	-2.1	-1.1	4.4	8.0	1.1
private consumption growth % yoy	15.4	15.7	15.5	16.9	6.3	-2.9	-1.9	4.0	6.4	0.7
Real export growth, % yoy	13.7	3.8	-3.0	-7.6	-1.0	-13.7	-12.9	4.7	6.8	5.2
Real import growth, % yoy	57.7	35.2	34.8	33.0	1.4	-19.6	-2.9	15.4	8.5	-0.9
Prices, Money & Credit										
CPI, % yoy	19.2	14.4	17.0	22.5	31.9	26.9	27.4	29.0	24.5	27.0
CPI, % avg	21.7	16.0	13.7	18.7	31.4	28.6	29.1	27.1	23.6	27.5
Nominal wages, % yoy	22.0	19.1	19.3	20.7	25.0	23.7	24.5	27.0	28.0	29.0
Credit extension to private sector, % yoy	93.7	72.8	81.8	72.5	24.5	12.8	19.7	42.4	26.5	28.6
Policy interest rate, %, eop	7.20	1.88	5.90	18.00	28.10	14.00	12.50	…	…	…
1 month inter-bank rate, %, eop	7.20	1.88	5.90	18.00	28.10	11.30	12.30	14.50	14.50	14.67
Long-term yield, %, eop	…	…	5.41	12.00	12.00	14.38	13.02	13.93	15.50	15.67
VEB/USD, eop	1.92	2.15	2.15	2.15	2.15	2.15	3.80	4.30	4.30	6.50
VEB/USD, avg	1.89	2.11	2.15	2.15	2.15	2.15	3.80	4.30	4.30	6.50
Balance of Payments, USD bn										
Current account	15.5	25.4	26.5	18.1	37.4	8.6	12.1	27.2	17.7	13.4
% of GDP	14.0	17.4	14.1	8.5	12.5	3.0	4.7	9.1	4.9	3.7
Trade balance	22.6	31.7	32.0	23.0	45.7	19.2	27.1	46.2	35.1	29.4
Exports	39.7	55.7	65.6	69.0	95.1	57.6	65.7	92.6	87.9	82.0
Imports	17.0	24.0	33.6	46.0	49.5	38.4	38.6	46.4	52.8	52.7
Service balance	-3.4	-4.0	-4.4	-7.0	-8.4	-7.6	-9.2	-10.5	-9.2	-7.7
Income balance	-3.7	-2.2	-1.0	2.5	0.7	-2.7	-5.3	-8.0	-7.8	-7.9
FDI, net	0.9	1.4	-2.0	1.0	-0.9	-4.9	-1.5	5.1	-3.1	-3.5
International reserves	24.2	30.4	37.4	34.3	43.1	35.8	30.3	29.9	29.1	27.6
Total amortisations	7.6	4.0	7.4	4.0	7.5	3.9	6.1	16.7	27.6	39.0
Public Finances, % of GDP										
Consolidated government balance	2.5	4.1	-1.5	-2.6	-2.6	-5.8	-6.0	-5.0	-5.0	-4.0
Consolidated gov primary balance	6.2	7.1	0.6	-1.0	-1.2	-4.4	-5.5	-3.5	-3.5	-2.5
Public debt	39.3	32.0	23.4	25.6	20.1	29.2	41.2	42.6	34.5	34.6
of which Domestic	14.0	11.1	9.2	7.3	4.5	7.5	8.9	10.3	9.0	7.7
Foreign Assets & Liabilities, USD bn										
External debt	42.3	44.8	41.8	55.9	60.7	73.8	92.8	107.4	104.8	109.0
Private	14.2	14.3	15.2	16.9	14.0	12.2	9.6	11.0	12.1	12.3
Public	28.1	30.5	26.6	38.9	46.7	61.6	83.2	96.4	92.7	96.7
External debt / GDP	38.0	30.7	22.3	26.3	20.3	26.0	36.1	36.0	28.8	30.4
External debt / XGS	106.6	80.4	63.8	80.9	63.8	128.2	141.2	116.0	119.2	132.9
Short-term debt	…	…	…	…	…	…	…	…	…	…
Short-term debt/International reserves (%)	…	…	…	…	…	…	…	…	…	…

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	2.6	4.4	4.9	5.6	5.2	5.4	4.0	3.4	3.5	3.4
CPI, % yoy	25.1	26.7	29.0	24.2	21.9	23.8	24.5	26.7	28.8	27.9
Policy interest rate, %, eop	…	…	…	…	…	…	…	…	…	…
Short-term Rate (90-day Deposit Rate, eop)	14.68	14.82	14.50	14.50	14.50	14.00	14.50	15.00	14.50	13.90
Long-term yield, %, eop	13.02	15.47	13.93	10.57	11.20	12.16	15.50	16.00	15.50	14.90
VEB/USD	4.30	4.30	4.30	4.30	4.30	4.30	4.30	6.50	6.50	6.50

Source: National Sources Citi Investment Research and Analysis

Notes

Appendix A-1

Analyst Certification

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

IMPORTANT DISCLOSURES

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability which includes investment banking revenues.

For important disclosures (including copies of historical disclosures) regarding the companies that are the subject of this Citi Investment Research & Analysis product ("the Product"), please contact Citi Investment Research & Analysis, 388 Greenwich Street, 28th Floor, New York, NY, 10013, Attention: Legal/Compliance [E6WYB6412478]. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments and historical disclosures, are contained on the Firm's disclosure website at https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company. Historical disclosures (for up to the past three years) will be provided upon request.

NON-US RESEARCH ANALYST DISCLOSURES

Non-US research analysts who have prepared this report (i.e., all research analysts listed below other than those identified as employed by Citigroup Global Markets Inc.) are not registered/qualified as research analysts with FINRA. Such research analysts may not be associated persons of the member organization and therefore may not be subject to the NYSE Rule 472 and NASD Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account. The legal entities employing the authors of this report are listed below:

Citigroup Global Markets Inc	Guillermo Mondino; Joaquin A Cottani; Jorge A Pastrana; Camilo Gonzalez
Citigroup Global Markets Ltd	David Lubin; Farouk Soussa; David Cowan
Citigroup Global Markets Asia	Johanna Chua; Adrienne Lui; Minggao Shen; Otto Chung; Shuang Ding; Serena Wang
Banco Citibank S.A.	Marcela Prada; Leonardo Porto; Marcelo Kfoury
Citigroup Global Markets India Private Limited	Rohini Malkani
Acciones y Valores Banamex, S.A. de C.V	Sergio Luna
Citibank N.A. Argentina	Fernando Jorge Diaz
Citibank - Colombia S.A.	Jose Vicente Romero; Munir Jalil
Citibank Anonim Sirketi	Gultekin Isiklar; Ilker Domac
Citibank Europe Plc Hungary	Eszter Gargyan
Citigroup Global Markets Korea Securities Ltd	Hyejin Park; Jaechul Chang
Bank Handlowy w Warszawie	Cezary Chrapek; Piotr Kalisz
ZAO Citibank	Olga Ponomarenko
PT Citigroup Securities Indonesia	Helmi Arman
Citigroup Global Markets Singapore PTE LIMITED	Wei Zheng Kit; Brian Tan
Citibank N.A. Philippines	Jun Trinidad
Citibank Europe plc Czech Republic	Jaromir Sindel
Citibank Taiwan Ltd.	Cheng-Mount Cheng

OTHER DISCLOSURES

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the issuer(s) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. The Firm's research department has received assistance from the subject company(ies) referred to in this Product including, but not limited to, discussions with management of the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and these, plus any other information contained in the Product, are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Notwithstanding other departments within the Firm advising the companies discussed in this Product, information obtained in such role is not used in the preparation of the Product. Although Citi Investment Research & Analysis (CIRA) does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of CIRA to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

Important Disclosures for Morgan Stanley Smith Barney LLC Customers: Morgan Stanley & Co. LLC (Morgan Stanley) research reports may be available about the companies that are the subject of this Citi Investment Research & Analysis (CIRA) research report. Ask your Financial Advisor or use smithbarney.com to view any available Morgan Stanley research reports in addition to CIRA research reports.
Important disclosure regarding the relationship between the companies that are the subject of this CIRA research report and Morgan Stanley Smith Barney LLC and its affiliates are available at the Morgan Stanley Smith Barney disclosure website at www.morganstanleysmithbarney.com/researchdisclosures.
For Morgan Stanley and Citigroup Global Markets, Inc. specific disclosures, you may refer to www.morganstanley.com/researchdisclosures and https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures.
This CIRA research report has been reviewed and approved on behalf of Morgan Stanley Smith Barney LLC. This review and approval was conducted by the same person who reviewed this research report on behalf of CIRA. This could create a conflict of interest.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by. The Product is made available in **Australia** through Citigroup Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992), participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in Australia to Private Banking wholesale clients through Citigroup Pty Limited (ABN 88 004 325 080 and AFSL 238098). Citigroup Pty Limited provides all financial product advice to Australian Private Banking wholesale clients through bankers and relationship managers. If there is any doubt about the suitability of investments held in Citigroup Private Bank accounts, investors should contact the Citigroup Private Bank in Australia. Citigroup companies may compensate affiliates and their representatives for providing products and services to clients. The Product is made available in **Brazil** by Citigroup Global Markets Brasil - CCTVM SA, which is regulated by CVM - Comissão de Valores Mobiliários, BACEN - Brazilian Central Bank, APIMEC - Associação dos Analistas e Profissionais de Investimento do Mercado de Capitais and ANBID - Associação Nacional dos Bancos de Investimento. Av. Paulista, 1111 - 11º andar - CEP. 01311920 - São Paulo - SP. If the Product is being made available in certain provinces of **Canada** by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. This product is available in **Chile** through Banchile Corredores de Bolsa S.A., an indirect subsidiary of Citigroup Inc., which is regulated by the Superintendencia de Valores y Seguros. Agustinas 975, piso 2, Santiago, Chile. The Product is made available in **France** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. 1-5 Rue Paul Cézanne, 8ème, Paris, France. The Product is distributed in **Germany** by Citigroup Global Markets Deutschland AG ("CGMD"), which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). CGMD, Reuterweg 16, 60323 Frankfurt am Main. Research which relates to "securities" (as defined in the Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong)) is issued in **Hong Kong** by, or on behalf of, Citigroup Global Markets Asia Limited which takes full responsibility for its content. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Research is made available through Citibank, N.A., Hong Kong Branch, for its clients in Citi Private Bank, it is made available by Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citibank N.A. is regulated by the Hong Kong Monetary Authority. Please contact your Private Banker in Citibank N.A., Hong Kong, Branch if you have any queries on or any matters arising from or in connection with this document. The Product is made available in **India** by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. The Product is made available in **Indonesia** through PT Citigroup Securities Indonesia. 5/F, Citibank Tower, Bapindo Plaza, Jl. Jend. Sudirman Kav. 54-55, Jakarta 12190. Neither this Product nor any copy hereof may be distributed in Indonesia or to any Indonesian citizens wherever they are domiciled or to Indonesian residents except in compliance with applicable capital market laws and regulations. This Product is not an offer of securities in Indonesia. The securities referred to in this Product have not been registered with the Capital Market and Financial Institutions Supervisory Agency (BAPEPAM-LK) pursuant to relevant capital market laws and regulations, and may not be offered or sold within the territory of the Republic of Indonesia or to Indonesian citizens through a public offering or in circumstances which constitute an offer within the meaning of the Indonesian capital market laws and regulations. The Product is made available in **Israel** through Citibank NA, regulated by the Bank of Israel and the Israeli Securities Authority. Citibank, N.A, Platinum Building, 21 Ha'arba'ah St, Tel Aviv, Israel. The Product is made available in **Italy** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. Via dei Mercanti, 12, Milan, 20121, Italy. The Product is made available in **Japan** by Citigroup Global Markets Japan Inc. ("CGMJ"), which is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Shin-Marunouchi Building, 1-5-1 Marunouchi, Chiyoda-ku, Tokyo 100-6520 Japan. If the Product was distributed by SMBC Nikko Securities Inc. it is being so distributed under license. In the event that an error is found in an CGMJ research report, a revised version will be posted on the Firm's Citi Velocity website. If you have questions regarding Citi Velocity, please call (81 3) 6270-3019 for help. The Product is made available in **Korea** by Citigroup Global Markets Korea Securities Ltd., which is regulated by the Financial Services Commission, the Financial Supervisory Service and the Korea Financial Investment Association (KOFIA). Citibank Building, 39 Da-dong, Jung-gu, Seoul 110-180, Korea. KOFIA makes available registration information of research analysts on its website. Please visit the following website if you wish to find KOFIA registration information on research analysts of Citigroup Global Markets Korea Securities Ltd. http://dis.kofia.or.kr/fs/dis2/fundMgr/DISFundMgrAnalystPop.jsp?companyCd2=A03030&pageDiv=02. The Product is made available in **Malaysia** by Citigroup Global Markets Malaysia Sdn Bhd (Company No. 460819-D) ("CGMM") to its clients and CGMM takes responsibility for its contents. CGMM is regulated by the Securities Commission of Malaysia. Please contact CGMM at Level 43 Menara Citibank, 165 Jalan Ampang, 50450 Kuala Lumpur, Malaysia in respect of any matters arising from, or in connection with, the Product. The Product is made available in **Mexico** by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, Integrante del Grupo Financiero Banamex ("Accival") which is a wholly owned subsidiary of Citigroup Inc. and is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In **New Zealand** the Product is made available to 'wholesale clients' only as defined by s5C(1) of the Financial Advisers Act 2008 ('FAA') through Citigroup Global Markets Australia Pty Ltd (ABN 64 003 114 832 and AFSL No. 240992), an overseas financial adviser as defined by the FAA, participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in **Pakistan** by Citibank N.A. Pakistan branch, which is regulated by the State Bank of Pakistan and Securities Exchange Commission, Pakistan. AWT Plaza, 1.1. Chundrigar Road, P.O. Box 4889, Karachi-74200. The Product is made available in the **Philippines** through Citicorp Financial Services and Insurance Brokerage Philippines, Inc., which is regulated by the Philippines Securities and Exchange Commission. 20th Floor Citibank Square Bldg. The Product is made available in the Philippines through Citibank NA Philippines branch, Citibank Tower, 8741 Paseo De Roxas, Makati City, Manila. Citibank NA Philippines NA is regulated by The Bangko Sentral ng Pilipinas. The Product is made available in **Poland** by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Nadzoru Finansowego. Dom Maklerski Banku Handlowego S.A. ul.Senatorska 16, 00-923 Warszawa. The Product is made available in the **Russian Federation** through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in **Singapore** through Citigroup Global Markets Singapore Pte. Ltd. ("CGMSPL"), a capital markets services license holder, and regulated by Monetary Authority of Singapore. Please contact CGMSPL at 8 Marina View, 21st Floor Asia Square Tower 1, Singapore 018960, in respect of any matters arising from, or in connection with, the analysis of this document. This report is intended for recipients who are accredited, expert and institutional investors as defined under the Securities and Futures Act (Cap. 289). The Product is made available by The Citigroup Private Bank in Singapore through Citibank, N.A., Singapore Branch, a licensed bank in Singapore that is regulated by Monetary Authority of Singapore. Please contact your Private Banker in Citibank N.A., Singapore Branch if you have any queries on or any matters arising from or in connection with this document. This report is intended for recipients who are accredited, expert and institutional investors as defined under the Securities and Futures Act (Cap. 289). This report is distributed in Singapore by Citibank Singapore Ltd ("CSL") to selected Citigold/Citigold Private Clients. CSL provides no independent research or analysis of the substance or in preparation of this report. Please contact your Citigold//Citigold Private Client Relationship Manager in CSL if you have any queries on or any matters arising from or in connection with this report. This report is intended for recipients who are accredited investors as defined under the Securities and Futures Act (Cap. 289). Citigroup Global Markets (Pty) Ltd. is incorporated in the **Republic of South Africa** (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in **Spain** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. 29 Jose Ortega Y Gasset, 4th Floor, Madrid, 28006, Spain. The Product is made available in the **Republic of China** through Citigroup Global Markets Taiwan Securities Company Ltd. ("CGMTS"), 14 and 15F, No. 1, Songzhi Road, Taipei 110, Taiwan and/or through Citibank Securities (Taiwan) Company Limited ("CSTL"), 14 and 15F, No. 1, Songzhi Road, Taipei 110, Taiwan, subject to the respective license scope of each entity and the applicable laws and regulations in the Republic of China. CGMTS and CSTL are both regulated by the Securities and Futures Bureau of the Financial Supervisory Commission of Taiwan, the Republic of China. No portion of the Product may be reproduced or quoted in the Republic of China by the press or any third parties [without the written authorization of CGMTS and CSTL]. If the Product covers securities which are not allowed to be offered or traded in the Republic of China, neither the Product nor any information contained in the Product shall be considered as advertising the securities or making recommendation of the securities in the Republic of China. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security or financial products. Any decision to purchase securities or financial products mentioned in the Product must take into account existing public information on such security or the financial products or any registered prospectus. The Product is made available in **Thailand** through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in **Turkey** through Citibank AS which is regulated by Capital Markets Board. Tekfen Tower, Eski Buyukdere Caddesi # 209 Kat 2B, 23294 Levent, Istanbul, Turkey. In the **U.A.E**, these materials (the "Materials") are communicated by Citigroup Global Markets Limited, DIFC branch ("CGML"), an entity registered in the Dubai International Financial Center ("DIFC") and licensed and regulated by the Dubai Financial Services Authority ("DFSA") to Professional Clients and Market Counterparties only and should not be relied upon or distributed to Retail Clients. A distribution of the different CIRA ratings distribution, in percentage terms for Investments in each sector covered is made available on request. Financial products and/or services to which the Materials relate will only be made available to Professional Clients and Market Counterparties. The Product is made available in **United Kingdom** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. This material may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in **United States** by Citigroup Global Markets Inc, which is a member of FINRA and registered with the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is regulated by Financial Services Authority.

Pursuant to Comissão de Valores Mobiliários Rule 483, Citi is required to disclose whether a Citi related company or business has a commercial relationship with the subject company. Considering that Citi operates multiple businesses in more than 100 countries around the world, it is likely that Citi has a commercial relationship with the subject company.

Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to CIRA's Products can be found at https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures.

Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations.

The Product may have been distributed simultaneously, in multiple formats, to the Firm's worldwide institutional and retail customers. The Product is not to be construed as providing investment services in any jurisdiction where the provision of such services would not be permitted.

Subject to the nature and contents of the Product, the investments described therein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Certain investments contained in the Product may have tax implications for private customers whereby levels and basis of taxation may be subject to change. If in doubt, investors should seek advice from a tax adviser. The Product does not purport to identify the nature of the specific market or other risks associated with a particular transaction. Advice in the Product is general and should not be construed as personal advice given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs. Prior to acquiring any financial product, it is the client's responsibility to obtain the relevant offer document for the product and consider it before making a decision as to whether to purchase the product.

With the exception of our product that is made available only to Qualified Institutional Buyers (QIBs), CIRA concurrently disseminates its research via proprietary and non-proprietary electronic distribution platforms. Periodically, individual CIRA analysts may also opt to circulate research posted on such platforms to one or more clients by email. Such email distribution is discretionary and is done only after the research has been disseminated via the aforementioned distribution channels. CIRA simultaneously distributes product that is limited to QIBs only through email distribution.

The level and types of services provided by CIRA analysts to clients may vary depending on various factors such as the client's individual preferences as to the frequency and manner of receiving communications from analysts, the client's risk profile and investment focus and perspective (e.g. market-wide, sector specific, long term, short-term etc.), the size and scope of the overall client relationship with Citi and legal and regulatory constraints.

CIRA product may source data from dataCentral. dataCentral is a CIRA proprietary database, which includes Citi estimates, data from company reports and feeds from Reuters and Datastream.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST EU20628E