

EMERGING MARKETS WEEKLY PERSPECTIVE

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Global Economic Research

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	Moody's / S&P ¹ Rating	Expected Rating Trend	Foreign Currency Debt Rating
LATIN AMERICA			
¹ (POS) = Pos Outlook; (NEG) = Neg Outlook			
Argentina	B3 / B-	↔	Market Weight
Brazil	Baa3(POS) / BBB-	↑	Overweight
Chile	A1(POS) / A+	↑	Market Weight
Colombia	Ba1 / BBB-	↔	Market Weight
Costa Rica	Ba1(POS) / BB+	↔	Market Weight
Dominican Republic	B2 / B	↑	Overweight
Ecuador	Caa3 / CCC+	↔	Market Weight
El Salvador	Ba1(NEG) / BB	↓	Overweight
Jamaica	Caa1 / SD	↑	Overweight
Mexico	Baa1 / BBB	↓	Underweight
Panama	Ba1 / BB+(POS)	↔	Market Weight
Peru	Baa3 / BBB-	↔	Market Weight
Uruguay	Ba3 / BB	↑	Market Weight
Venezuela	B2 / BB-	↔	Overweight
ASIA			
China	A1(POS) / A+	↑	Market Weight
India	Baa2 / BBB-(NEG)	↔	Market Weight
Indonesia	Ba3 / BB-(POS)	↑	Overweight
Korea	A2 / A	↔	Market Weight
Malaysia	A3 / A-	↔	Market Weight
Pakistan	B3 / B-	↔	Underweight
Philippines	B1 / BB-	↔	Market Weight
Sri Lanka	NR / B(POS)	↑	Market Weight
Vietnam	Ba3(NEG) / BB(NEG)	↓	Market Weight
EMERGING EUROPE, MIDDLE EAST & AFRICA (EEMEA)			
Bulgaria	Baa3(POS) / BBB	↓	Market Weight
Egypt	Ba1 / BB+	↔	Market Weight
Gabon	NR / BB-	↔	Market Weight
Georgia	NR / B	↔	Market Weight
Ghana	NR / B+(NEG)	↔	Market Weight
Hungary	Baa1(NEG) / BBB-	↔	Market Weight
Kazakhstan	Baa1(NEG) / BBB-	↔	Overweight
Lebanon	B2(POS) / B(POS)	↑	Underweight
Lithuania	Baa1(NEG) / BBB	↔	Overweight
Poland	A2 / A-	↔	Market Weight
Russia	Baa1 / BBB	↔	Overweight
Serbia	NR / BB-(NEG)	↑	Market Weight
South Africa	A3 / BBB+(NEG)	↔	Market Weight
Tunisia	Baa2 / BBB	↔	Market Weight
Turkey	Ba2 / BB-	↔	Underweight
Ukraine	B2(NEG) / CCC+	↔	Overweight

Regional Reserve Accumulation Divergence. The dollar reserves of Mexico are rising rapidly, and as we have pointed out in the past, the dollar reserves of both Argentina and Brazil have flat-lined since around the beginning of December after rising strongly. We recap both tales for their implications. In the case of Mexico, reserves bottomed in late August at \$72.6B and currently stand at over \$93B. That rapid rise is simply the result of a policy shift rather than a surge of portfolio inflows and favorable fundamental dynamics, as is usually the case in emerging markets when that happens. Under the old head of the central bank, it was implicitly the policy that Mexico was a highly-rated credit on its way to ever higher credit ratings that did not need to pay the fiscal cost of excessive reserve accumulation. Over the past few years, the decline in oil production structurally and the country's ties to US economic volatility have changed that narrative. The new central bank president sees reserve accumulation as an important bulwark against market volatility. The policy shift simply tells the tale that Mexico has come back to the rest of the pack in terms of general creditworthiness. Additional reserves are indeed a good thing for creditworthiness but this is a rare case where this accumulation is not driven by a thumbs-up from investors for great fundamentals.

In Argentina and Brazil, we see the reserve sluggishness as indicative of tightening global liquidity. In Argentina, reserves have declined as of this Tuesday by about \$80 million from their highs, and Brazil's decline is about \$900 million. For liquidity-sensitive markets such as these, reserve stagnation is an indication to us that the environment for risk taking may be changing to more risk aversion—and recent market price action suggests the indicator retains some validity.

Brazil's Inflation Outlook Eroding. The weekly central bank survey this week showed inflation expectations for this year rising to 4.72% from 4.5% four weeks ago. Further erosion will likely tip the central bank towards hiking in March rather than in April, which is our current base case. Domestic demand has been quite robust—retail sales rose over 10% YOY in November. Capacity utilization has risen to 81.4% from 78.4% in January. However, industrial production in December declined 0.33% from the proceeding month, a second straight monthly decline. We continue to believe that the bank will not hike close to the 350bps or so priced into the market, but a gradual tightening beginning fairly shortly seems like a done deal.

Display: Brazil: Capacity Utilization Tightening



Source: Confederação Nacional da Indústria and Haver Analytics

Costa Rica: Elects First Female President. Laura Chinchilla becomes Costa Rica's first female president following Sunday's electoral victory. Chinchilla (PLN) held onto sizable early poll advantages to win 47% of the popular vote. Opposition PAC candidate, Otton Solis, received 25% and ML's Otto Guevara finished third with 20%. The PLN campaign platform focused on improvements in the country's infrastructure, creation of a progressive income tax and new jobs with its "green jobs" initiative. The win for Chinchilla ensures continuity of progressive policies instituted by her predecessor, current president Oscar Arias. Under Costa Rican law, presidents cannot be elected to consecutive four-year terms. However, they may run for office again, but only after sitting out a term.

El Salvador: Fiscal Deficit Will Remain Wide in 2010. FY 2009 fiscal deficit estimates are in at 5.5% of GDP (from 2008's 2.9% deficit) driven by falling tax revenues. The government will hold preference on reigniting growth in 2010 instituting its anti-crisis deficit spending plan and boosting public investments on post-Hurricane Ida recovery. As such, though revenues will benefit from a more favorable economic environment and recent tax reforms, we think spending pressures will keep the deficit at an elevated 5.7%. Over this next year, the strength in commitment to long-term fiscal stability will prove critical to maintaining market confidence. We forecast the public sector debt-to-GDP to peak in 2011 at ~52% (from 42% pre-crisis).

Jamaica: IMF Board Approves US\$1.3bn Program. Last Thursday, the IMF Executive Board signed off on Jamaica's request for a 27-month US\$1.3bn (300% of quota) Stand-By Arrangement; the approval of the SBA comes after seven-months of negotiations. Key to the Executive Board's decision was the successful execution on the J\$722bn Debt Exchange Operation. The Jamaica Debt Exchange (JDX) has registered 97% participation to-date and is expected to settle on February 16th. The IMF approval paves the way for an additional \$1.1bn in multilateral funds from the World Bank, IDB, CDB and EU. Disbursements from the IMF and multilateral agencies will be front-loaded with roughly one-half to be introduced in the near-term. \$950mn of this will be set aside for establishment of the 'Financial Sector Support Fund'.

China's Trade Recovery. January export growth increased to 21% y/y (weaker than consensus forecast of 28%) from 18% in December. Import growth accelerated by a stronger-than-expected 85.5% y/y (from 56% in December), which continues to reflect China's domestic demand recovery (**Display**). By destination, exports to US eased to 8.3% y/y (vs. 16% in December), to EU increased to 18% (vs. 10%), to Brazil up 79% (vs. 90%), to Australia up 27% (vs. 27%), and to ASEAN up 53% (vs. 50%).

Philippines Inflation Remains Benign. As argued in last week's report, inflation across the region has been reasonably well-behaved, and the latest print in the Philippines is another case in point. January CPI surprised on the downside at 4.3% y/y (0.2% m/m) versus 4.4% in the previous month. Lower food and housing inflation were the reasons behind the lower headline number, but even core CPI slowed to 3% y/y from 3.2%. This reinforces our view that the economy's lagging growth recovery and still relatively subdued inflation should give room for the central bank to hike policy rate later than some of its regional peers. We stick to our forecast that the first policy-rate hike will occur in the second quarter.

Indonesia's Bond Issue. This week, the government issued Rp8.033 trillion (US\$854 million) of 3-year retail sukuk bonds at a yield of 8.7%, with the issued size more than doubling the indicative amount. Officials said that a global sukuk bond is planned for the second half of 2010. According to the government's 2010 borrowing plan, total bond issue will amount to Rp175 trillion (about US\$19 billion) with a domestic-to-external mix of 75:25. Indonesia issued US\$2 billion of sovereign USD bond in January and this made up about 40% of the US\$4.75 billion external funding requirement. As such, there should be US\$2.75 billion left for the rest of this year.

Display: Huge Import Surge China's Foreign Trade



Sri Lanka: President's Main Opponent Arrested. In dramatic fashion post-election, military police late Monday arrested ex-general and defeated presidential candidate, Sarath Fonseka. The former general has been charged with conspiring to undermine the existing government of re-elected President Mahinda Rajapaksa. This will increase near-term political noise; the peaceful conduct of the country's first post-war national election has been high in the minds of international observers. Former allies in the war against the LTTE, the relationship between Fonseka and Rajapaksa turned personal and bitter during the presidential campaign with both sides slinging accusations of corruption and nepotism. It really has been a case of who comes out on top and since the decisive January 26th election victory – Rajapaksa has been provided the full faith of the Sri Lankan electorate and handed the keys to his agenda. The final nail in the coffin probably came when Fonseka promised following the election to “reveal war crimes committed under the Rajapaksa regime”. From here, regardless of the government's reasons, it will be critically important that respect be given to the due process of law and guarantee the safety of Fonseka in coming tribulations. The sudden arrest of political opponents certainly does not empower democracy in Sri Lanka and will impede progress in the country's post-war image. That said – we think the political confrontation will likely fade over time and this event does not change our positive fundamental opinion. Should present sociopolitical tensions look unlikely to boil over, we could buy Sri Lanka bonds into any near-term selling pressure.

Ukraine: Presidential Elections Should Ultimately Improve Policy Framework: The completion of the second round presidential elections is likely to improve the economic policy framework as the winner consolidates decision making authority in parliament. Currently, Yanukovich is the winner with 49% of the vote compared with 45.5% for Timoshenko 45.5%. Turnout was very high at 69%, as compared with 52% in 2004 and 56% in 1999. International observers have called the election free, fair and calm, similar to the first round. Timoshenko has decided to contest the results in some polling stations, but it is unlikely that she will prevail or delay her concession for more than several weeks. We expect Yanukovich to seek to form a new parliamentary coalition that forms a new government, or, in a less likely scenario, to call early parliamentary elections. When compared with the potential negative scenarios in these elections, namely the victory of a third party candidate other than Timoshenko or Yanukovich or widespread fraud, the outcome of these elections are very favorable.

As a result, we expect the next President and prime minister to reengage with the IMF and to start to implement domestic reforms, such as raising the domestic price of natural gas. A recent quote of Yanukovich's about debt renegotiation was a communications error, and is probably a sign of being rusty. The thrust of his written statement published on his website was the importance of improving the investment climate in Ukraine to drive growth. Encouraging foreign investment from Russia, the US and EU is a central strategy, as is reengaging the IMF. Through private conversations with Yanukovich's senior economic advisors, our understanding is that the new leadership will seek to renegotiate state loans and guarantees that they believe Timoshenko extended illegally. However, they are very aware of the need to not trigger any cross-default provisions on remaining domestic and foreign debt. Our view remains that a default is highly unlikely because (i) there is little debt and maturing amortizations to default on, (ii) it would jeopardize depositor confidence, which places bank reform at risk, and (iii) it would diminish foreign investor confidence, which as Yanukovich just stated, is a core economic strategy for recovery.

South Africa: Activity Rebound Is Ahead of Expectations. Industrial production (IP) rose by a strong 3.0% month-over-month seasonally adjusted in December, bringing year-over-year growth to 3.2%, which is the first positive reading since August 2008. Trend growth in sequential terms remains strong at 14.2% 3m/3m saar. The improvement in South Africa's production has been much faster than consensus has expected, and is being met with upwardly revised consensus GDP forecasts. The improvement is being driven by a rebound in the trade cycle, ongoing public investment, and restocking, following the unprecedented large inventory liquidation in 2009.

Turkey: Inflation Expectations Continue to Rise. CPI survey inflation expectations jumped again in the first half of February to 7.52% for end-2010 CPI from 7.18% versus a target of 6.5%. 12-month rolling CPI expectations rose to 6.93% from 6.84% and a low of 6.26% in mid-October. Expectations and economic agents follow headline CPI, not core, so the central bank's attempt to refocus attention on core CPI lacks credibility.

Israel: Inflation is set to Decline. Israel's central bank is likely to slow the pace of interest rate hikes since headline inflation is expected to decline to within the target range. Two supply-side factors are likely to drive inflation lower in the near-term. First, the government announced a 50 bps cut in the maximum VAT rate to 16.0% from 16.5%. This is a partial reversal from last July's increase of 100 bps made in order to raise revenue. The government originally had planned to remove the entire increase by the end of the year but has begun earlier than expected. Last month the central bank kept interest rates stable at 1.25% despite December inflation of 4.0% year-over-year, which is above the target band of 1-3%. The bank had estimated that 1.2 percentage points of inflation is attributed to VAT increases. Second, the Public Utilities Authority announced that electricity prices would be cut by 8% to 16% in February due to lower production costs.

Egypt: Rising Core Inflation Will Prompt Rate Hikes Later This Year. January inflation was 13.6% year-over-year, up marginally from 13.3% in December. The increase was attributable to a rise in food and electricity prices. January core inflation rose 7.4% year-over-year, up from 6.9% in December. This increase is within the central bank's targeted core inflation range of 6-8%. In February, the central bank kept interest rates on hold. We expect the central bank to begin hiking later this year as core inflation exceeds the upper boundary of the target range.

Czech Republic: Inflation Remains Low. January inflation was 0.7% year-over-year compared to 1.0% in December. The number was lower than most analysts expected, and is attributable to base effects and lower services prices. This month the central bank held the policy rate at 1.00%, the lowest rate in the country's history, and in line with ECB rates. We believe the central bank will begin to normalize rates in the second or third quarter of this year, though current inflation levels, which are below the target range, suggest the bank will have some room to wait. In addition, the European periphery, including Greece, presents uncertainty which also may postpone rate hikes this year.