

EMERGING MARKETS WEEKLY PERSPECTIVE

January 20, 2010

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Global Economic Research

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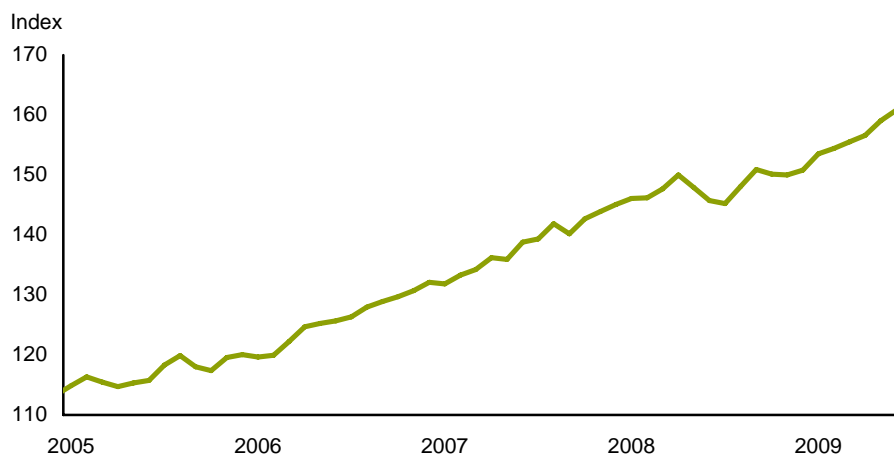
	Moody's / S&P ¹ Rating	Expected Rating Trend	Foreign Currency Debt Rating
LATIN AMERICA ¹ (POS) = Pos Outlook; (NEG) = Neg Outlook			
Argentina	B3 / B-	↔	Market Weight
Brazil	Baa3(POS) / BBB-	↑	Market Weight
Chile	A1(POS) / A+	↑	Market Weight
Colombia	Ba1 / BBB-	↔	Market Weight
Costa Rica	Ba1(POS) / BB+	↔	Market Weight
Dominican Republic	B2 / B	↑	Overweight
Ecuador	Caa3 / CCC+	↔	Market Weight
El Salvador	Ba1(NEG) / BB	↓	Overweight
Jamaica	Caa1(NEG) / SD	↓	Market Weight
Mexico	Baa1 / BBB	↓	Underweight
Panama	Ba1 / BB+(POS)	↔	Market Weight
Peru	Baa3 / BBB-	↔	Market Weight
Uruguay	Ba3 / BB	↑	Market Weight
Venezuela	B2 / BB-(STA)	↔	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 / 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(NEG)	↔	Market Weight
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

Mexico: The murkiest interest rate call in Latam. Last Friday the central bank kept rates unchanged. The market was set up for a relatively dovish outcome, so some language warning about second round inflation effects of administrative price hikes sparked a modest sell-off in domestic rates. The rates call is tougher here not just because those administrative measures will push inflation above 5%, but because they are temporary, and they expire just when the output gap should be closing towards the end of the year. That will leave the market, and the central bank, having to choose between arguing that rates should go up because economic activity is improving and inflation would be above target, or that rates should stay put because the effects of the earlier price hikes is diminishing. We don't see the bank hiking rates until the second half, at the earliest. The new central bank head will likely come down on the side of tolerance for an extended period. But if inflation looks like it will stay above 5% on an extended basis, he will be forced to become aggressive later.

Venezuela—Balancing Good and Bad. Over the weekend the planning minister said that state oil company PDVSA had closed its arrears with suppliers. That should be good news in that future debt supply should be expected to be lower than otherwise feared, if this is true. Along with this, we like the new system whereby the government is auctioning short-term dollar bills to keep the parallel rate down, rather than issuing dollar debt that finds its way to international markets. Arrayed against these positive measures, the government announced a seizure of a French food store chain for raising prices, an action that should only exacerbate product shortages down the road. For now, we are favorably disposed towards Venezuela, because we think the market has not yet priced in the more favorable supply-demand potential that falls out from the devaluation and modest policy changes.

Brazil: We Remain More Sanguine Than Consensus on Rates. Rates are currently 8.75%, and the weekly central bank survey this week pegs expectations for the end of the year at 11.25%, or a hefty 250 bps of hiking. But the market is even more aggressive, implying end of year rates at 12.44%. While we are bullish on growth (forecasting 5.5% this year) we do not believe rates will rise that aggressively. Unlike other regional central banks, the Brazilians meet 8 times a year, like the Fed, rather than monthly. Such aggressive hiking implies a certitude and aggressiveness that is, at least for now, nowhere in evidence despite the fact that the bank recognizes the strong growth numbers. Second, more aggressive growth forecasts of over 6% do not consider, in our view, that net exports will subtract from growth markedly this year. Third, we think the central bank will take this cyclical opportunity to keep real rates lower than historical averages, given the still declining Brazilian risk premium.

Display: Brazil's Retail Sales Strength



Source: Fundação Instituto Brasileiro de Geografia e Estatística and Haver Analytics

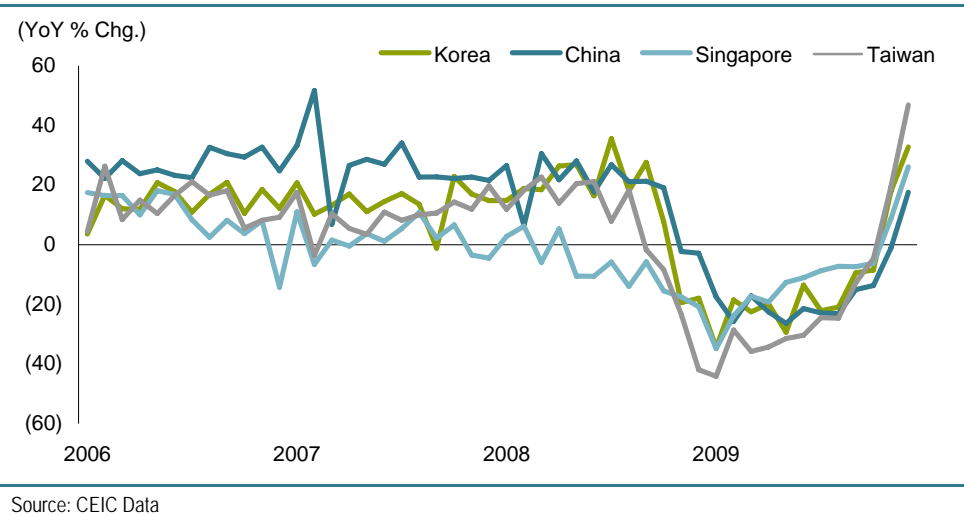
Jamaica: Launch on the Domestic Debt Exchange. Last Thursday, the Government of Jamaica announced its Debt Exchange initiative. An immense undertaking – the program will recall at par 350 Government of Jamaica bonds (*effectively the entire domestic debt stock*) to replace them with issuance of 24 new GoJ bonds at lower interest rates. The Government expects this exchange to result in J\$40bn in interest savings (3.5% of GDP) over the coming fiscal year. The debt exchange is a decisive component within the comprehensive IMF program.

Whilst the ultimate form to this exchange has not avoided the 'SD' sovereign rating, this negative must be taken in context to the overall picture. First – by taking the more aggressive approach, this plan should realize immediate and significant benefits, reducing near-term risks and improving the medium-term outlook in the process. Next, the government did not ask for a haircut on the domestic debt – as such, locals perceive the government through this plan to have made good on its obligations. For the external bondholders, the announcement is mostly good news. As expected, the liability management program exempts the external bonds. As such, ratings on external bonds will remain at previous 'CCC' levels. Untouched and left with substantive improvements in credit metrics, external bondholders should realize important positives through this decision. Lastly, the announcement of the debt liability program solves months of uncertainty and should provide relief to many investors who feared a more severe restructuring. Should the exchange proceed as expected and we move into the IMF program, perceptions on Jamaica should benefit substantively over the medium-term.

Singapore's Accelerating Export Momentum – December non-oil domestic exports beat expectation, up a massive 26.1% y/y compared to consensus 22%. Shipments managed a 1.7% m/m (SA) growth following a staggering 19.8% m/m in November, which suggests considerable strength in sequential momentum in addition to the low-base bounce. Singapore joined other Asia's major exporters in showing above-consensus export performance in December (Taiwan's exports expanded 47% y/y, Korea up 33%, Thailand up 26%, and China up 18%, **Display**).

By product, Singapore's electronics exports showed strong rebound of 25% y/y in December (vs.-6.1% in November), while the breakdown by destination confirmed the trend of improving developed markets' demand. Exports to US increased 6% y/y (vs. -13% in November), EU up 27% (vs. 18%), China up 20% (vs. 22%), and all emerging markets up 12% (vs.6%).

Display: Considerably Recovery Momentum Export Performance



India's Inflation Spike – As anticipated, wholesale price inflation (WPI) accelerated noticeably in December thanks to the low-base effect as well as weather-induced food price spike. Inflation jumped to 7.3% y/y from 4.8% in November, boosted mainly by a 19% surge in the food component of the index (followed by the utility and manufacturing components). We expect WPI will rise further to 9-10% y/y by end-1Q/10, and maintain our forecast for 25bp hike in the repo rate by the Reserve Bank of India at the policy meeting on January 29. We will not be surprised that the central bank's first strike will include a 50bp rise in cash reserve requirement.

Philippines Raises Funding Requirement - The government has revised up its 2010 fiscal deficit forecast to PHP293 billion (3.5% of GDP) from initial PHP233 billion (2.8%). This compares to an estimated budget shortfall of PHP290 billion (3.8% of GDP) in 2009. Next year's borrowing limit will be raised to PHP718.5 billion – an 8.8% increase from the initial plan – and all of the additional borrowings will come from the offshore market.

Officials said that the government's planned borrowing from the local bond market would be unchanged at PHP475.8 billion, while offshore borrowing will increase to US\$4.9 billion (from US\$3.7 billion in original plan). In the latter, the extra US\$1.2 billion borrowing is said to be coming from official development lenders and, probably, increased issuance in Samurai bonds. This implies that the government is trying to stick to its original borrowing program of tapping US\$2 billion from the US\$ sovereign bond market. However, we think that, given the risk of further fiscal slippage in the run-up to the presidential election in May, Philippines' US\$ bond supply is likely to subject to upside risk in 2010.

Ukraine: Favorable Outcome to First Round of Presidential Elections Warrants Increasing Sovereign Exposure. The advancement to the second round by the two frontrunner candidates, Victor Yanukovich with 35% of the vote and Yulia Timoshenko with 25%, is a positive outcome because it helps to further consolidate decision making authority since both individuals have the largest blocs in parliament. In addition, the elections were considered free and fair, which reduces the probability of a protracted dispute following the second round to be held on February 7. As a result of the reduction in many downside scenarios, namely the election of an alternative candidate with minimal parliamentary support, we recommend opportunistically adding exposure and increasing our overweight position given still very cheap valuations.

The arguments against a sovereign default remain very strong:

- Economic adjustment following the overheating period before 2008 has been massive. The current account deficit has moved into balance from a deficit of -7% of GDP. Capital outflows, reserves and deposit withdrawals are all stable. Growth has started to recover sequentially, driven by an industrial production rebound in chemical and steel exports.
- Policy is tight, which is necessary to ensure a rise in the national savings rate and stability in interest rates and asset prices. Monetary policy is tight following a 75% nominal depreciation of the exchange rate; fiscal policy has also tightened toward the end of 2009 and in 2010 due to financing constraints.
- Maturing external and domestic debt is very low. Gross public sector debt to GDP is low at 30% of GDP, while FX reserves of \$26 billion, or 23% of GDP, leaves net public sector debt at 7% of GDP.
- It is not in Yanukovich's or Timoshenko's political interest to default. A default would delay a recovery in growth by hurting investor confidence, would generate further losses in the banking system at a time when the government is trying to restructure the sector, and would spark deposit withdrawals that would impede macro-economic stability. Both leaders have publicly stated, and privately indicated, that they will seek to reengage with the IMF if elected.

There are two key risks that may raise short-term volatility, but ultimately do not sufficiently counter the above arguments. First, if Yanukovich were to become president, he may call early parliamentary elections to increase his party's seats in parliament. This could delay the timing of the next IMF funding tranche due to the government's transition. Given very tight fiscal financing constraints, this may force the government to run arrears. Second, Yanukovich's chief economic advisor has said privately that they may seek to terminate some public debt and guarantees which they believe Timoshenko extended illegally. While this could generate negative press, they have stressed that they would avoid defaulting on any debt that triggers cross-default provisions with other domestic or external debt.

Turkey's Central Bank Kept Rates on Hold As Expected. In its statement, the central bank continues to state that it expects to keep interest rates stable for an extended period of time because (i) the recovery globally remains uncertain, (ii) Turkey still has a large negative output gap, and (iii) inflation indicators remain low. On inflation, the central bank has now shifted the goal posts for the second time in two years. The first switch occurred when in 2008 it raised the inflation target to 7.5% from 4.0%. Now, the central bank is arguing that core inflation indicators are likely to remain low despite a rise in headline inflation from base effects, energy and food prices, and tax hikes. The central bank is being dovishly one-sided since throughout 2009 it argued that the decline in overall inflation—including these headline figures—was grounds to cut interest rates aggressively.

The proof will be in the pudding. If Turkey's economy, with its rapid recovery, history of high inflation, and currently ultra-loose monetary conditions, can really withstand a rise in headline inflation without pass-through to higher inflation expectations, core inflation and wages, then the central bank is correct. But the history of other countries that sustained permanent declines in inflation suggests that nil real interest rates (soon to be negative) is incompatible with the central bank's dovish view. 12 month inflation expectations track headline CPI—not core inflation—very closely in Turkey, and have now risen 40 bps to 6.7% from a low of 6.3% in October in 2009.

Russia: Central Bank Initiates Discussion About Possible Monetary Policy Tightening in the Second Half. A senior central bank official stated that more interest rate cuts are likely in the first half, but that Russia may start to tighten policy again in the second half. Tightening could include interest rate hikes and prudential measures, including hiking reserve requirements, unwinding uncollateralized loans from the central bank (almost complete) and raising minimum capital adequacy ratios for banks. In addition, the central bank has announced that it will hold regular, pre-announced monthly meetings on monetary policy and issue a more detailed statement. Further rate cuts are incorporated in our forecast, while we had not been forecasting rate hikes in the second half.

This first central bank reference to higher interest rates is significant because it raises the question about how the central bank may respond to a renewed tradeoff between targeting inflation versus the exchange rate. The strong expected economic recovery in Russia and our expected rise in inflation in the second half is likely to create a similar monetary policy dilemma for the central bank as in 2002 to 2007. This dilemma is the trade-off between allowing more exchange rate appreciation given large current account surpluses and expected capital inflows, or higher inflation. Economists are divided over whether the central bank's preferences have shifted more toward curtailing inflation versus fixing the exchange rate. Our view is that the central bank and government are only slightly more inclined than previously to combat inflation, in part because they remain concerned that tightening policy will exacerbate exchange rate strength. They will likely employ a combination of some interest rate hikes, tighter prudential measures and some exchange rate appreciation, but are likely to act reactively to real data releases rather than pro-actively.

Ghana: Inflation Continues to Decline. December inflation fell to 16.0% year-over-year from 16.9%. This is the sixth month inflation has declined since reaching a peak of 24.7% in June. However, this confirms market expectations that the government would miss its end of year target of 14.5%. The bank of Ghana's last move was a 50 bp cut in interest rates to 18.00%. The bank's president commented that if inflation continued to decline as forecasted he would cut rates further in 2010. We believe the disinflationary trend will continue through the first half of this year because of an appreciation of the currency and lower food price; this leaves room for looser policy. However, higher oil prices and IMF recommendations for a focus on lowering inflation should temper a sustained cutting cycle.

Israel: Inflation Remains Stable. December inflation was 3.9% year-over-year from 3.8% in November, and is still above the central bank's target of 1-3%. However, the bank estimates that 1.2 percentage points is attributed to VAT increases, which puts adjusted inflation back in the target range at 2.7%. We forecast the BoI to continue raising rates throughout the year to normalize monetary conditions.