BARCLAYS CAPITAL

EMERGING MARKETS RESEARCH
June 2010

# THE EMERGING MARKETS QUARTERLY
# IN THE SHADOW OF FEAR

PLEASE REFER TO THE LAST PAGE FOR ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES.

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The immediate economic and financial context remains market supportive. However, we expect market fears to cast a shadow on EM assets: investors are, justifiably in our view, increasingly focused on the riskier medium-term outlook, hence we are gradually fading our emphasis on the cyclical recovery as a market driver. Nevertheless, we continue to expect EM outperformance as emerging market countries are less vulnerable to the fiscal challenges facing industrial economies.

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# OVERVIEW

## In the shadow of fear

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**Our economic forecast for 2010 and 2011 is even more market supportive than previously, with a moderately stronger cyclical recovery and interest rates lower for longer in most of the world. However, the former is now largely anticipated by investors, who are increasingly focusing on longer-term risks and challenges that will confront world financial markets in the years to come. We think this is appropriate and consistent with our gradually fading emphasis on the cyclical recovery as a market driver in recent quarters.**

**The increasing salience of medium-term developments poses two challenges for emerging-market investors. The first is to manage the tension between the immediate future, when economic developments seem likely to remain market supportive, and the more uncertain and riskier medium-term outlook for global financial markets. The second is to manage the tension between a generally positive fundamental outlook for emerging markets and the more challenging outlook for most industrial economies, the fear of which is spreading to emerging markets – unjustifiably, in our view.**

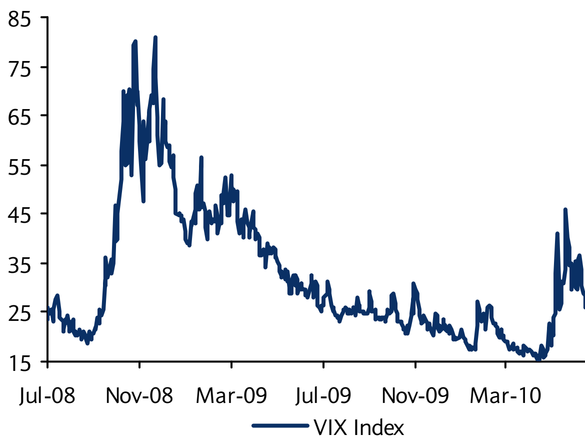
**Tactically, we remain bullish on emerging asset markets. But if the rally materializes as we expect, we would be inclined to pare back risk on the view that longer-term challenges will continue to justify caution in risk asset markets.**

### What we thought

*More peril than climb in Q2…*

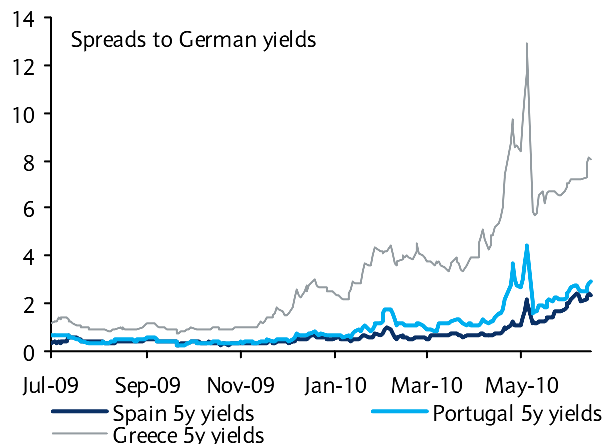
In our previous quarterly, we called for 'a perilous climb' in emerging markets, acknowledging the salience of the global risks that were then affecting investor sentiment, but arguing that these were either exaggerated (especially regarding China and the US economic recovery) or likely to unfold in a time-frame slow enough so that they would not be dominant drivers of Q2 market developments. In particular, we thought that concerns about Greece would at least temporarily fade on the EU backstop that, at that point, seemed to us almost guaranteed and that markets would continue to be supported (though not blindsided) by the ongoing economic recovery.

**Figure 1: A more volatile quarter**




Source: Bloomberg

**Figure 2: Southern Europe remained in the cross-hairs (pp)**




Source: Bloomberg, Barclays Capital

## What happened

*…despite generally upbeat news on the global economy*

Well, we got the peril, but we did not get much in the way of a climb. The spike in volatility and market sell-off occurred despite news about the world economy that was predominantly upbeat, leading to at least modest upgrades in consensus (and BarCap) forecasts of 2010 and 2011 growth in the US, Japan, China, emerging Asia, EMEA, and Latin America, with Europe the only exception. While we think that tail risks to the world recovery remain a concern for many investors, they have found little support in Q2 data or in consensus forecasts for the coming 12-18 months.

*Southern European debt problems were in the spotlight…*

The most important disturbance of the international financial peace came from the drama surrounding the public finances in Southern Europe. Contrary to our expectation that an EU bailout of the Greek government would put the issue on the back burner for a couple of months, markets have remained anxious. The issue remained alive due in part to a messy policy process that did little to reassure investors about the authorities' capacity to mount effective and well-coordinated policy initiatives. Scepticism and anxiety about highly indebted sovereigns has not only intensified, but also broadened well beyond Greece in recent months. Deterioration in sentiment toward Spain has been most significant and would seem to pose the greatest immediate market risk, but it is no secret that the fiscal imbalances facing many large industrial economies are comparable in magnitude to those facing much of Southern Europe.

*…along with new concerns about the state of the world's banks*

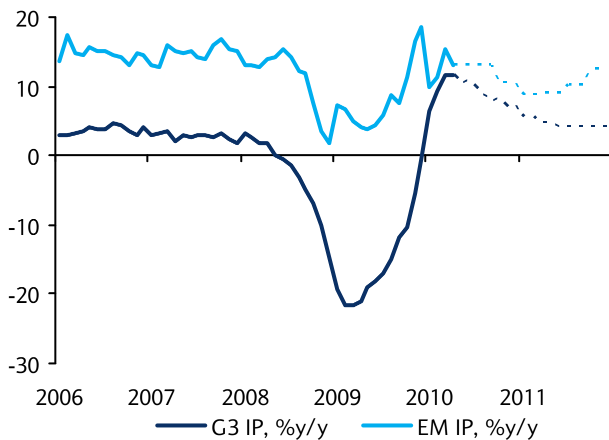
Finally, banks have emerged as a new risk for investors. Concerns about the global banking system were triggered by an abrupt rise in USD Libor, which created fears of a funding crunch analogous to the dollar squeeze that followed the Lehman failure. While those fears have so far proven overdone, investors remain anxious about legacy costs from the previous economic crisis, especially in Spain, where the real estate crash is still playing out; new and potentially devastating costs that could be created by a sovereign debt event, and the implications for banks of new regulatory frameworks that are being put in place in much of the world.

## What we learned

*Market developments highlight a heightened sensitivity to tail risks, arguably a legacy of the last financial crisis*

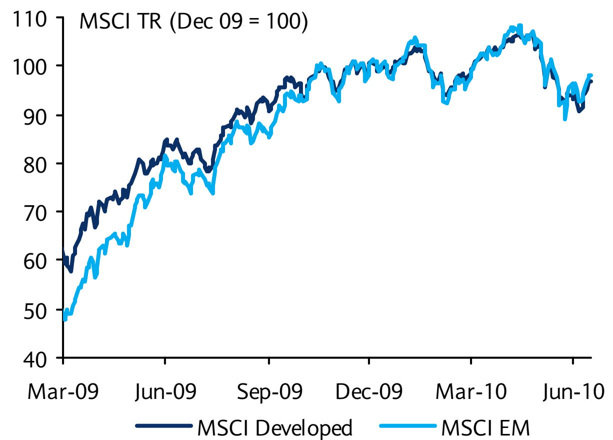
While news flow on key market drivers was generally in line with our expectations going into the quarter, the market traded much more anxiously than we had anticipated. Sometimes that just happens, but in this case we think there is a lesson to be learned. With the benefit of hindsight, it seems that we underestimated the market's sensitivity to perceived risks of low-

**Figure 3: A generally brighter outlook for growth**




Note: EM refers to Brazil, China, India, Indonesia and China. Source: Datastream, Barclays Capital

**Figure 4: Not reflected in Q2 asset prices**




Source: Bloomberg, Barclays Capital

probability, potentially very disruptive events – even if they are not likely to materialize for some time. This heightened sensitivity to tail risks is probably a legacy of the previous crisis, in which so many nearly unthinkable events actually materialized with such disruptive consequences, and it will in all likelihood be with us for some time. We have calibrated our assessment of market sensitivities to the various tail risks that face the world economy accordingly.

*While we are still optimistic about the ongoing cyclical recovery, it is largely priced in, and we share many market concerns about the longer term*

At the same time, the sheer passage of time is causing us to shift our focus from the cyclical economic recovery that was previously such a potent driver of markets toward the medium term, post-rebound outlook, which raises questions about the 'new normal' that are more structural than cyclical. While we have been consistently optimistic in our assessment of the cyclical rebound, we take seriously the challenges and risks that confront the world economy over the coming years. We think this shift of focus poses two key tensions for emerging market investors. The first is between a relatively positive outlook for the world economy in the near term, while cyclical considerations remain important, and a new normal that looks meaningfully less reassuring. The second is between a medium-term outlook that looks generally quite positive for most emerging market economies and the considerably less comfortable outlook for the industrial economies that are such potent drivers of world markets.

## The cyclical backdrop remains market supportive

*The cyclical recovery, while not the market driver it has been, still provides a positive backdrop*

Our shift in emphasis does not reflect a change in outlook for the immediate future, during which the global economic backdrop is likely to remain market supportive. We now forecast global economic growth of 4.7% in 2010 and 4.3% in 2011. Restrained inflationary pressure and concerns about the potential effect of an event in Europe have induced policymakers around the world to postpone monetary normalization. In the US, we have dropped our view that the Fed will hike this fall and are now expecting it to remain on hold until April of next year. This is, of course, reflected in our interest rate forecasts, which now see the US 10y bond at 3.85% by year-end, compared with a forecast of 4.3% three months ago. The bad news is that nervous markets may require a supportive economic and financial context to counter anxieties about the medium term; the good news is that they are likely to get it.

**Figure 5: 2010 growth forecasts generally stronger**

| | | Q1 10 forecasts | | Q2 10 forecasts | |
|---|---|---|---|---|---|
| | | 2010F | 2011F | 2010F | 2011F |
| US | Consensus | 3.1 | 3.0 | 3.3 | 3.1 |
| | BarCap | 3.6 | 3.2 | 3.6 | 3.5 |
| Other developed | Consensus | 1.4 | 1.8 | 1.6 | 1.7 |
| | BarCap | 1.4 | 2.0 | 1.7 | 1.8 |
| China | Consensus | 9.9 | 9.1 | 10.2 | 9.0 |
| | BarCap | 9.6 | 9.0 | 10.1 | 9.0 |
| EM Asia (ex-China) | Consensus | 6.4 | 6.1 | 7.0 | 6.4 |
| | BarCap | 6.8 | 6.3 | 7.5 | 6.2 |
| EMEA | Consensus | 3.4 | 4.1 | 4.3 | 4.1 |
| | BarCap | 4.1 | 3.8 | 4.2 | 4.3 |
| LatAm | Consensus | 4.0 | 3.8 | 4.9 | 3.9 |
| | BarCap | 4.8 | 3.9 | 5.3 | 4.1 |

Source: Consensus Forecast, Bluechip, Reuters, BCB

**Figure 6: But monetary tightening is being delayed**

| 2009-Q2 10 | 2010 | | 2011 |
|---|---|---|---|
| | Q3 | Q4 | Q1 |
| Brazil | Korea | China | Colombia |
| Chile | Taiwan | Indonesia | Czech |
| India | Thailand | Philippines | Mexico |
| Israel | | Sri Lanka | Poland |
| Malaysia | | Turkey | Q2 |
| Peru | | | ECB |
| Vietnam | | | Egypt |
| Australia | | | Hong Kong |
| New Zealand | | | US |
| | | | Q3 |
| | | | South Africa |

Source: Barclays Capital

*Faster-than-expected growth in emerging economies…*

Emerging markets are, of course, very much a part of this positive backdrop (Figure 5). Since our previous quarterly publication, we have increased our forecast of 2010 growth in China (by 0.5%), other EM Asia (by 0.7%), EMEA (by 0.1%) and Latin America (by 0.5%). For 2011, our forecast revisions have been small except in EMEA, where we have increased our growth forecast by 0.5%, to 4.3%, and our current forecasts are close to consensus in every time zone.

*…is not leading to tighter monetary policy*

The stronger-than-expected cyclical recovery is generally not leading to more rapid than previously expected monetary tightening (Figure 6). Echoing a theme from the industrial economies, and with some notable exceptions such as Brazil and, to a lesser extent, Chile, we have generally been postponing the initiation and scaling back the magnitude of the coming monetary normalization. This is motivated in part by precautionary considerations in the world's central banks, which see risks to world growth from fiscal imbalances in Southern Europe and in the industrial economies more generally. But it also reflects a generally benign outlook for inflation; some fading of cyclical drivers that is reducing the risk of overheating, even as output gaps close; and, in Asia, a substantial reduction in the contribution of fiscal policy toward demand growth, as temporary stimulus measures fade in significance.

## Beyond the cycle: Slouching toward the new normal

*Investors see risks in China, industrial-country fiscal imbalances, and the world's banks*

As we and the market turn our attention to medium-term considerations, three issues dominate investor concerns: China, anxiety about public finances in the industrial economies, and stresses that may re-emerge in the global banking system. These are discussed in more detail in the *Global Outlook*; here, we summarize those elements of the Barclays Capital view that we consider relevant for emerging-market investors.

### *China*

*We maintain a positive view on China*

With respect to China, our view has been clear for some time, and in broad outline it has not changed in recent months. We expect a soft landing from 10% growth to about 9% in 2011, with an acceleration of inflation that has required policy attention but does not constitute a monetary crisis. On balance, China has been an important source of stability for the global economy over the past 18 months, and we expect it to remain so for the next several quarters. Two recent developments have caught investors' attention and require closer scrutiny: the potential effects of the deflation of the real estate sector bubble and the recent wage pressures that suggest that the era of surplus labour may be ending.

- The Chinese wage increases are likely to be the more benign of the two. We believe that China is reaching a 'Lewis turning point', a period in which labour is becoming scarcer and wage pressures are rising. However, we do not see the wage increases as creating significant near-term inflationary pressures, as these have been circumscribed to a few coastal cities and profit margins are likely to absorb some of the wage rises. The change in labor market dynamics is a long-run, secular process that should play out over years, not months (see *China: The economic significance of wage inflation*, 14 June 2010).
- The policy-induced deflation of the real estate bubble carries with it more implementation risks. We expect housing prices to decline 20-30% over the next few quarters. In countries with different characteristics, a correction of that magnitude could clearly risk a hard landing, but China may be exceptional. First, wealth effects of the price declines on Chinese consumption may be less significant, since 50% of the population lives in rural areas where there is no active property trading. Moreover, low-income and migrant workers would benefit from housing price declines, as they are likely to be home buyers. Second, asset price bubbles have tended to be associated with

current account deficits, making economies vulnerable once international capital stopped flowing. This is certainly not the case in China, an exporter of capital. Arguably, the most important difference with other country episodes lies in the banks, which are unlikely to be forced on the defensive and limit lending since, being state owned, credit decisions will be determined by top-down political directives.

*We continue to think investors should fade anxieties on the Chinese economy*

This is not to say that there are no implementation risks, as errors can be made and we must be vigilant, but we should not automatically extrapolate the deflation of housing price bubbles in other countries to China, as the country's peculiarities suggest the outcome is likely to be very different. The housing adjustment merits continued scrutiny, but as things now stand, we think investors should fade anxieties associated with economic developments in China.

### *Fiscal risks: Fear and loathing in the fisc*

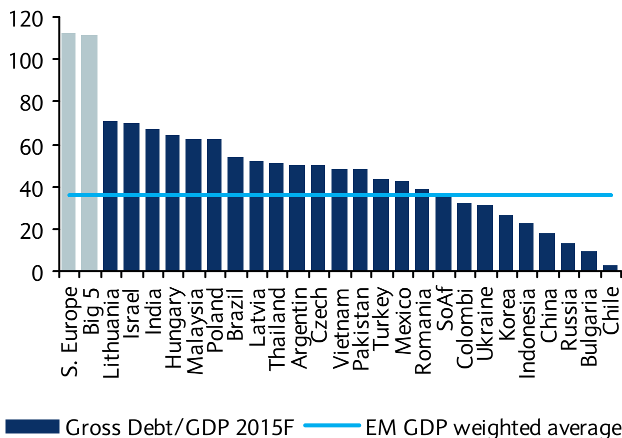
*Industrial-economy fiscal problems are a cloud on the horizon*

While the public financial challenges in Southern Europe are daunting, we think that markets have exaggerated the risks of a generalized fiscal crisis. In particular, we believe that the recent outbreak of concerns about Spain are overdone; while policy implementation will be crucial and needs to be monitored, we are increasingly confident that Spain can and will stave off a fiscal crisis. But even if a generalized fiscal crisis is unlikely, we think that emerging market investors are right to be worried about the situation in the industrial countries, which will affect asset prices as much through prospective fiscal adjustments in the major economies as through the risk of crisis in the periphery.

- As the American jurist Oliver Wendell Holmes reminded us, "The means by which the inevitable comes to pass is effort", and until the sustained effort to repair weak fiscal structures is finally put in place, the possibility of an event in a systemically important sovereign will remain. This means that investors will likely be living with this tail risk for a long time to come.

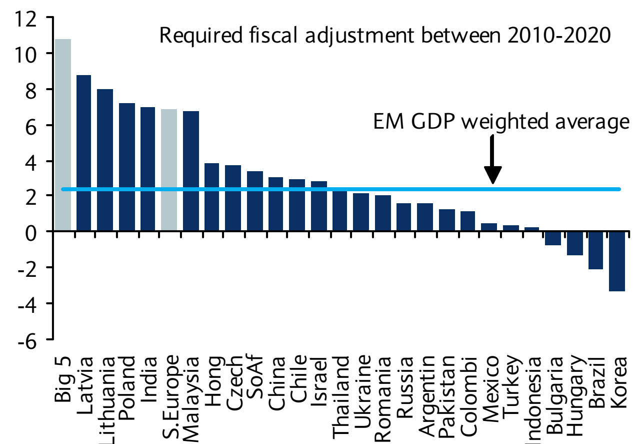
- The fiscal effort required to restore public sector solvency will have very large economic, not to mention political and social, implications. According to a recent IMF assessment, the five largest industrial economies are facing an increase in public debt from about 94% of GDP in 2010 to over 110% in 2015, and to restore long-term solvency, they will need to adjust their public finances by more than 11% of GDP. (See Box 1 for a more

**Figure 7: Public debt under control in most emerging economies (% of GDP)**




Source: IMF Fiscal Monitor, Barclays Capital

**Figure 8: IMF estimate of long-term fiscal adjustment required to secure sustainability (% of GDP)**




Source: IMF Fiscal Monitor, Barclays Capital

detailed discussion.) If they start soon enough, the adjustment can be made gradually and need not disrupt economic recovery. But to replace public-sector demand will require a meaningful adjustment of asset prices and will likely require sustained support from monetary policy. This is one powerful reason to expect low interest rates and supportive monetary policy for some considerable time to come.

- The massive run-up in industrial economy public debt is likely to constrain governments' capacity to implement counter-cyclical fiscal policy for a sustained period. This is not immediately relevant, in light of our view that the economic recovery is self-sustaining. But the much reduced scope for fiscal policy suggests a world economy that will be less resilient to economic shocks and therefore more volatile over the medium term.
- Finally, the massive run-up in public debt may complicate the management of monetary policy, since the private sector will have reason for concern that it may be unduly influenced by the difficult fiscal context. Even if the private sector views this unhealthy linkage only as a tail risk, it can adversely affect the asset market response to inflationary developments and make life meaningfully more difficult for central banks.

### *Fiscal crisis in emerging markets... not*

*But emerging market economies generally have much more solid fiscal positions...*

So while we would discount alarmist views about the fiscal crisis facing industrial economies, the situation is likely to be a dominant economic driver and policy problem confronting most industrial economies in the decade to come, and the risk of a policy mistake in some systemically important economy will remain alive for the foreseeable future. We would say the same is emphatically not true of emerging markets.

- On IMF projections, the average fiscal deficit for the emerging economies that we cover will be less than 4% of GDP, compared with 10% in the G5 and just under 8% in Southern Europe. (If we compute an average using the portfolio weights in the Barclays Capital EM sovereign index, which includes those countries for which sovereign debt metrics are most immediately relevant to EM investors, it is 3.3%.)
- The contrast is even more striking if we look at debt levels: on a GDP-weighted basis, public debt averages less than 40% of GDP in the countries that we cover, 37% in EM Asia and EMEA, and 50% in Latin America. And with few exceptions (discussed in detail in Box 1), the fiscal adjustments required to achieve long-run sustainability are small.

*…an important element of the EM outperformance thesis*

We are not advising complacency. There are, of course, emerging market economies where deficits and debt are a pressing policy problem. And fiscal policy mistakes that are large enough and sustained for a long period could create a large problem where one does not now exist. That said, the existing, far more comfortable fiscal context in most emerging market economies is an element of the EM outperformance thesis that becomes more compelling as the challenges facing industrial economies become more apparent.

### *Tail risks in global banking markets*

A final source of risk that has seized investors' imagination comes from the global banking system. Here, the concerns are several, and interacting. There are those about the legacy costs of the real estate collapse, most notably in Spain, where it remains unclear how large are the losses that have yet to be recognized. There are those about the effect on European banks – and banks that are exposed to them – of a potential accident among the Southern European sovereigns. Finally, there are those about the systemic implications of the changes in tax and regulatory regimes that are being put in place in response to the last crisis.

## Box 1. Fiscal Policy

When it comes to fiscal policy, it is generally recognized that the industrial countries are in a weaker position than the typical emerging market economy, while there are major differences between countries in the emerging markets universe. But it is not always recognized how stark both of these differences are. Here, we highlight some facts about the fiscal outlook, using projections from the recently published IMF Fiscal Monitor, supplemented with Barclays Capital projections where necessary.

With one exception, we present the IMF's outlook for the gross public debt, rather than net debt, mainly because comparable data are available for many more countries. The exception is Japan, where the gross debt (at 250% of GDP) grossly exaggerates the admittedly daunting fiscal challenge facing the country. In what follows, regional aggregates are GDP-weighted averages of the IMF country data.

The IMF's fiscal projections underscore the magnitude of the challenge facing most industrial economies. In the five largest industrial economies, the IMF projects that debt will reach 94% of GDP in 2010. The 2010 fiscal deficit is estimated at 10% of GDP, reflecting not only the recession, but also a large structural deficit. The cyclically adjusted primary deficit (which subtracts interest payments and the effect of the recession from the overall deficit) is 6.3% of GDP. The slow correction of fiscal imbalances means that public debt is forecast to continue to rise in the years to come, to over 110% of GDP in 2015. Only in Germany is the public debt forecast to be below 90% of GDP in 2015.

In the emerging market economies that we cover, the public debt is expected to average about 39% of GDP in 2010: 37% in both Asia and EMEA, and 50% in Latin America. But unlike in the major industrial economies, the IMF expects deficits to fall, on average, in emerging markets, reflecting public finances that are significantly less over-extended than in the industrial economies. One measure of this is the estimated fiscal adjustment that would be required between 2010 and 2020 to put the fiscal accounts on a sustainable footing. In the five largest industrial economies, the IMF estimates that adjustment at nearly 11% of GDP, ranging from 4% in Germany to 12% in the United States and 13% in Japan. In Southern Europe, it averages just under 7% of GDP. In EM, it is 2.5% of GDP.

Of course, not every emerging market economy is in pristine fiscal condition. Among the more precarious stories are:

- India's public debt, at nearly 80% of GDP, is closer to the industrial-country average than to the emerging market norm. The IMF suggests that a large fiscal adjustment will eventually be required to achieve a sustainable fiscal position. But in the mean time, debt dynamics are supported by very rates of economic growth, and strong domestic support for a tightly controlled government bond market.

- In Poland, Latvia, Lithuania and Malaysia, public debt is still at moderate levels by international standards. But structural imbalances are still meaningful, debt levels are forecast to rise, and the IMF estimates that fiscal adjustments of 7-8% of GDP will be required to achieve long-term sustainability. These countries should probably be on emerging market investors' fiscal watch list in the months and years to come.

- Hungary's public debt is also near 80% of GDP and the country is widely viewed as having one of the more precarious fiscal positions in EMEA. But an important fiscal adjustment has already been made, the IMF is projecting a meaningful decline in the public debt in the next five years, and it is not suggesting that a large additional fiscal effort will be required to achieve sustainability. Here, too, investors need to remain vigilant. But the question is not how Hungary will achieve sustainability, but rather whether governments will stay the course in the years to come.

## Fiscal balances (% GDP)

| | General gov't balance | | Gross debt | | Cyclically adjusted | Required adjustment | S&P |
|---|---|---|---|---|---|---|---|
| | 2010 | 2015 | 2010 | 2015 | primary balance 2010 | between 2010-20 | rating |
| Big 5 | -10.0 | -5.7 | 94 | 111 | -6.3 | 10.8 | AAA |
| France | -8.2 | -4.1 | 84 | 95 | -4.6 | 8.3 | AAA |
| Germany | -5.7 | -1.7 | 77 | 82 | -1.6 | 4.0 | AAA |
| Japan* | -9.8 | -7.3 | 122 | 155 | -6.5 | 13.1 | AA |
| UK | -11.4 | -4.3 | 78 | 91 | -5.4 | 9.0 | AAA |
| US | -11.0 | -6.5 | 93 | 110 | -7.6 | 12.0 | AAA |
| Southern Europe | -7.8 | -5.5 | 98 | 113 | -2.4 | 6.9 | A |
| Greece | -8.1 | -2.0 | 133 | 140 | -2.4 | 9.2 | BB+ |
| Ireland | -12.2 | -5.3 | 79 | 94 | -6.0 | 9.8 | AA |
| Italy | -5.2 | -4.6 | 119 | 125 | 0.9 | 4.1 | A+ |
| Portugal | -8.8 | -4.4 | 87 | 98 | -4.1 | 7.8 | A- |
| Spain | -10.4 | -7.7 | 67 | 94 | -5.8 | 9.4 | AA |
| EM (GDP weighted) | -3.9 | -2.5 | 39 | 36 | -1.4 | 2.5 | BBB |
| EM (benchmark weighted) | -3.3 | -2.1 | 46 | 43 | | | BB+ |
| EM Asia | -4.1 | -2.5 | 37 | 32 | -2.1 | 3.2 | BBB+ |
| China | -3.0 | -2.4 | 20 | 18 | -2.5 | 3.1 | A+ |
| Hong Kong | -1.4 | -0.1 | 1 | 1 | -3.5 | 3.8 | AA+ |
| India | -9.2 | -4.4 | 79 | 67 | -3.7 | 7.0 | BBB- |
| Indonesia | -2.0 | -1.6 | 28 | 23 | -0.1 | 0.3 | BB |
| Malaysia | -6.1 | -5.4 | 57 | 62 | -4.0 | 6.8 | A- |
| Korea | 1.1 | 2.9 | 33 | 26 | 2.8 | -3.3 | A |
| Pakistan | -4.6 | -2.0 | 56 | 48 | 0.0 | 1.3 | B- |
| Philippines | -3.4 | 0.3 | 48 | 37 | -0.4 | 0.8 | BB- |
| Sri Lanka** | -7.5 | N/A | 86 | N/A | N/A | N/A | B |
| Thailand | -2.3 | -0.5 | 48 | 51 | -0.8 | 2.3 | BBB+ |
| Vietnam | -7.0 | -7.0 | 48 | 48 | N/A | N/A | BB |
| EMEA | -4.6 | -3.5 | 37 | 39 | -1.5 | 2.4 | BBB |
| Bulgaria | -1.8 | 0.5 | 16 | 9 | 0.7 | -0.8 | BBB |
| Czech Republic | -5.1 | -5.3 | 38 | 50 | -2.4 | 3.7 | A |
| Egypt** | -7.7 | N/A | 78 | N/A | N/A | N/A | BB+ |
| Hungary | -3.8 | 0.1 | 79 | 64 | 3.5 | -1.3 | BBB- |
| Israel | -4.4 | -2.2 | 77 | 70 | -1.0 | 2.8 | A |
| Latvia | -12.9 | -1.8 | 49 | 52 | -7.1 | 8.8 | BB |
| Lebanon** | -11.0 | N/A | 154 | N/A | N/A | N/A | B |
| Lithuania | -8.6 | -7.3 | 39 | 71 | -4.9 | 8.0 | BBB |
| Poland | -7.5 | -3.8 | 55 | 62 | -4.5 | 7.2 | A- |
| Romania | -6.5 | -2.6 | 35 | 39 | -1.6 | 2.1 | BB+ |
| Russia | -2.9 | -4.2 | 8 | 13 | -1.1 | 1.6 | BBB |
| South Africa | -6.1 | -1.2 | 35 | 36 | -3.2 | 3.4 | BBB+ |
| Turkey | -3.4 | -1.9 | 45 | 44 | 0.0 | 0.4 | BB |
| Ukraine | -3.1 | -2.0 | 37 | 31 | -1.8 | 2.2 | B |
| Latin America | -2.4 | -1.4 | 50 | 43 | 1.1 | -0.2 | BBB- |
| Argentina | -3.5 | -2.2 | 51 | 50 | -0.6 | 1.6 | B- |
| Brazil | -1.5 | -0.7 | 67 | 54 | 3.4 | -2.1 | BBB- |
| Chile | -1.8 | 1.3 | 4 | 3 | -2.6 | 3.0 | A+ |
| Colombia | -3.5 | -2.0 | 35 | 32 | -0.6 | 1.1 | BBB- |
| El Salvador | -4.7 | -4.7 | 52 | 52 | N/A | N/A | BB |
| Mexico | -3.4 | -2.7 | 45 | 42 | 0.1 | 0.5 | BBB |
| Panama** | -2.6 | N/A | N/A | N/A | N/A | N/A | BBB- |
| Peru | -1.6 | 0.0 | 27 | 20 | -0.9 | 1.1 | BBB- |
| Uruguay** | -1.9 | N/A | 49 | N/A | N/A | N/A | BB |
| Venezuela** | -0.5 | N/A | 37 | N/A | N/A | N/A | BB- |

Note: * Net debt used for Japan, ** BarCap forecast for 2010 deficit and debt. For purposes of computing regional averages, 2015 debt/GDP ratios are assumed to equal 2010. *** El Salvador, Panama – IMF staff report. Source: IMF Fiscal Monitor, Barclays Capital.

In our view, the legacy costs of the previous crisis are manageable, notably in Spain where concern has recently been greatest. But their magnitude remains uncertain, and investors (and bank counterparties) are likely to remain nervous until there is more visibility. That nervousness could create intensified funding pressure for the private sector, which could in turn adversely affect the economy and intensify pressures on the budget. In short, it is a delicate situation with uncomfortably broad scope for negative feedback loops; official initiatives to increase transparency and calm fears about the status of the banks could therefore meaningfully improve the investment climate.

Regulatory and tax initiatives affecting banks are potentially more significant over the medium term. While some substantial uncertainty remains about the details of these initiatives, they are motivated by a desire to scale back dramatically the official backstop for banking systems, by raising capital and liquidity requirements, reducing reliance on short-term and wholesale funding, and raising taxes on banks. These point toward a higher cost of funding, lower bank profits, and smaller bank balance sheets. Other things equal, this should raise the cost and reduce the supply of credit in the economy. The contractionary effect of this potential retrenchment by banks would need to be offset by easier monetary policy. But if lower official interest rates are the silver lining, we think investors are right to keep one eye on the cloud.

## Market outlook – Two tensions

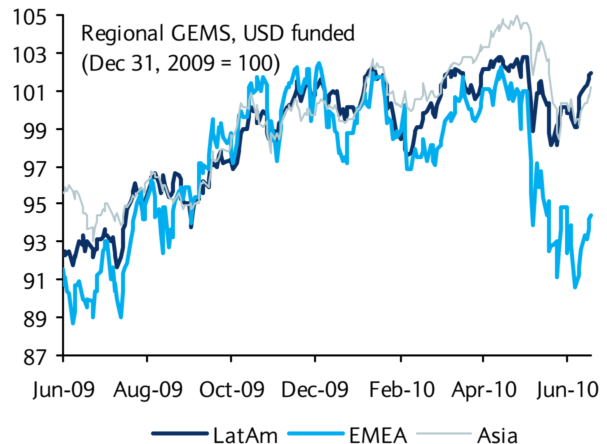
*Tension between a positive present context and a riskier future*

As we enter the second half of the year, it seems to us that emerging market investors face two key tensions. The first is the very sharp contrast between a very supportive present market context and a riskier medium-term outlook. For now, and in our base case for some time to come, emerging market investors are confronted with a robust economic recovery and rock-bottom policy rates that provide punishingly low returns for investors who remain out of risk assets. At the moment, valuations are generally more appealing than at year-end, and considerably more attractive than three months ago, while the recent outbreak of volatility seems to have improved positioning in most markets. Risks to this context are low probability (though potentially quite disruptive) events and/or in the relatively distant future. Yet investors have shown a strong disinclination to disregard them.

**Figure 9: Emerging market equities have not dramatically underperformed as in 2008-09**

Source: Bloomberg, Barclays Capital

**Figure 10: EM FX – Moderate declines in Asia and Latin America, underperformance in EMEA**




Source: Barclays Capital

We think that we will be living in this world for quite a while. The tail risks that concern investors are not going to vanish any time soon, but while anxieties are likely to remain, investors cannot hide in low-risk, even lower-return assets indefinitely. We think this sets up for a context similar to the one in which we have been living: volatile asset markets constrained (by present realities and the high cost of safety) in their ability to sustain sell-offs and (by fears about the future) in their ability to stage a lasting bull market.

*EM outperformance, not de-coupling*

The second tension is between a medium term that looks cloudy for industrial countries, but much more positive for most EM economies. The case for emerging market economic outperformance seems to become more compelling by the week, as the depth of the industrial economies' fiscal and financial challenges becomes more apparent. This would pose no conundrum if markets were not so tightly linked, but as we have seen, anxiety about core markets continues to be reflected in EM asset performance, and we do not expect this 'coupling' to change any time soon. So the question arises, how to retain exposure to EM asset classes without sustaining serious losses when anxieties surface about the industrial economies, as we suspect they periodically will in the quarters to come.

One answer is to find low-beta, including relative value investment themes that insulate positions from broad market developments; we present some of our ideas along these lines in the strategy sections that follow. But intra-EM relative value can provide only limited exposure to broad EM themes. Beyond that, we think the coming quarters will reward a range-trading approach, being willing to fade fears that exaggerate immediate market risks, as well as market rallies that seem difficult to sustain in light of the genuine tail risks that face the markets and the world economy.

*Tactically bullish*

We are now generally bullish EM asset markets, as we wait for the near-term market recovery that our global strategy team expects and for a further unwinding of the (generally mild) EM asset underperformance that was associated with the recent market downdraft. This is a tactical position, though; we stand ready to adopt a more cautious stance in the event that the rebound is associated with a substantial dissipation of market anxieties, because we doubt that concerns will be gone for long.

## EM sovereign credit

*EM sovereign debt followed global markets down in Q2*

With a few exceptions, EM sovereigns behaved more or less in line with global markets, underperforming industrial-country credit markets in the downdraft and staging a moderate recovery as global markets found their footing. Unsurprisingly, the high-beta credits Argentina and Venezuela were among the worst performers. Hungary's dramatic underperformance reflected anxiety associated with the incoming government's fiscal intentions and the fact that most of the Hungarian debt in the benchmark is euro-denominated.

*We expect roughly flat returns on the debt market portfolio in Q3*

For Q3, we expect a continued recovery in risk appetite to support emerging debt markets in the near term, with valuations somewhat undermined by an expected backup in the US yield curve that is more modest than we previously forecast, but still enough to create a mild market headwind; we expect the US 10y yield to rise to 3.70% by the end of the quarter. We expect spread compression to offset this in part, resulting in roughly flat returns for the benchmark portfolio, with higher-beta credits outperforming higher-quality names.

*Tactically comfortable with higher-beta credits*

On that basis, we remain moderately overweight high-beta credits where we also consider local fundamentals supportive, including Argentina, Ukraine, and Russia. Despite their strong underperformance in Q2, we share investor concerns about Hungary and Venezuela. In Hungary, we are underweight; short-dated CDS offer value, but in bonds we think it is too early to take a strong view that the incoming government will convince investors that it

intends to stay the course of fiscal adjustment. In Venezuela, we are recommending a marketweight allocation; while we remain of the opinion that the country retains its ability and willingness to pay, and acknowledge the potential for some market rebound from quite depressed levels in the coming weeks, the country's economic policies are deeply incoherent and in ways the pose headline and market-technical risks for investors in the medium term.

Away from these higher-beta credits, we recommend:

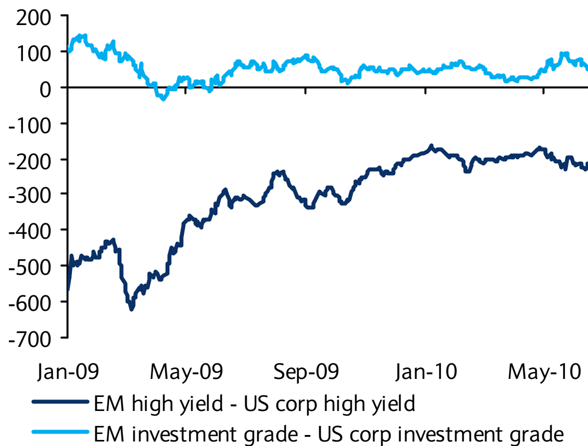
- A modest overweight position in Indonesia, at the expense of Philippines. Philippine outperformance in Q2 highlights the credit's relatively defensive positioning, but in the reasonably supportive market environment that we expect in Q3, we think investors should focus on Indonesia's strong growth prospects and credit profile.
- Overweight Turkey, at the expense of South Africa, on grounds of valuations and Turkey's more rapid economic and fiscal recovery.
- Underweight the higher-quality Latin credits: Brazil, Mexico, Panama and Peru. These have performed well in the defensive environment year-to-date, but look expensive now. With election risks behind Colombia and a stronger economic recovery ahead, we feel more comfortable with it and are recommending a neutral position.

## EM FX

*A difficult quarter for EM FX*

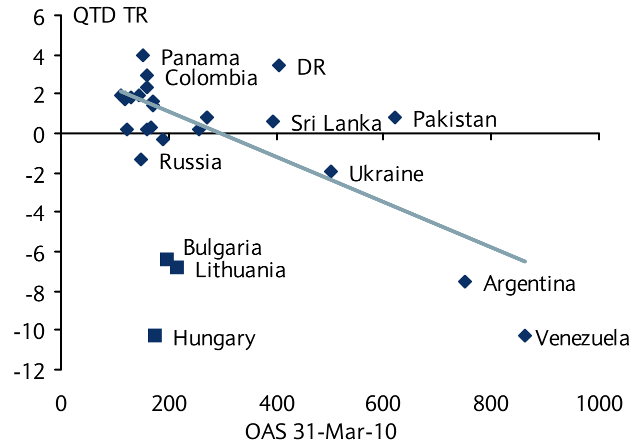
The second-quarter euro and market downdraft were, of course, unfriendly for EM FX. Currencies generally weakened against the dollar, despite some rebound late in the quarter as market anxieties waned. Against 'logical' financing baskets (we advocated financing against a basket that minimizes ex-ante volatility of the EM FX position, see *EM Weekly 'Return of Risk', 22 January 2010*), performance was less negative, reflecting the fact that those baskets generally include at least some EUR financing. By this metric, the BRL was the quarter's star performer; the minimum-variance financing basket is almost entirely EUR, but in Q2 the currency traded like part of the dollar bloc. Those close to the euro area generally underperformed, with the HUF also undermined by policy statements that sapped confidence in the new government. In Asia, the KRW underperformed, reflecting its

**Figure 11: Modest underperformance of EM sovereign credit (bp)**




Source: Barclays Capital

**Figure 12: Credit performance largely in line with historical market sensitivities**




Note: Bulgaria, Hungary and Lithuania are not included in computation of the trend line. Source: Barclays Capital

relatively high beta to global risk appetite and some idiosyncratic developments including renewed tension with North Korea and a revision of financial market regulations that put some pressure on the currency market.

*But Q3 looks more positive…*

We expect far less intense headwinds from global markets in Q3. In some key areas (notably with respect to Spain), market sentiment toward Southern Europe has overshot our assessment of the genuine risk. Partly because of this, we think that the EUR has found stability around current levels; risks remain, of course, but we do not expect a continuation of the EUR downdraft. And the recently announced revision of the FX regime in China has drawn investors' attention to the fact that risk-supportive surprises are possible, not just negative ones. After the recent outbreak of volatility, we believe that positioning is relatively supportive.

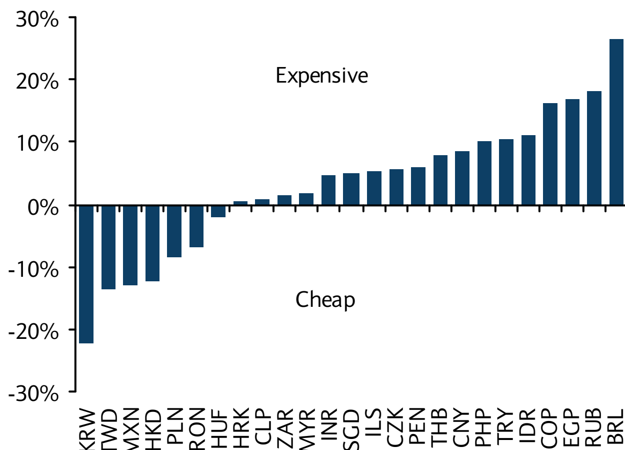
We think this sets the stage for a market in which global risks recede and positive emerging market fundamentals advance as drivers of EM FX. We think that the themes that we have been highlighting since the beginning of the year will return to relevance, with some modulation, as drivers in Q3 10. We highlight the following themes from our regional strategy teams, discussed in more detail in the regional market outlooks that follow.

*Stage is set for renewed currency appreciation in Asia*

In Asia, we think the stage is set for renewed currency appreciation, given the strong cyclical recovery and the associated prospect of monetary normalization well in advance of the industrial economies, strong external payments positions, reasonable currency valuations (with some qualifications), and support from the recent relaxation of the *de facto* CNY peg to the dollar.

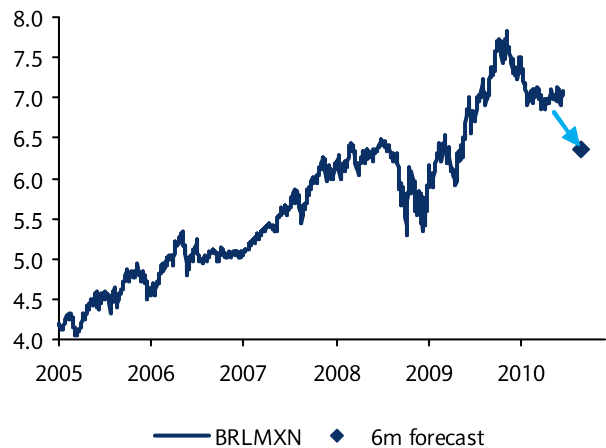
The MYR, TWD, KRW, and PHP sit near the top of our EM FX scorecard, supported by advanced economic recoveries, strong valuation metrics (according to our metric, the KRW is the most undervalued currency in our universe, though the PHP is on the expensive side), and strong external positions (with the KRW relatively weaker here). We recommend long positions in these, with some qualifications to the KRW due to the short-term effect of bank regulatory measures that may continue to put pressure on the currency market in the near term. We are less enthusiastic about the INR, as the EUR depreciation has led to a strong appreciation of the real exchange rate that creates the likelihood of a policy response to substantial additional appreciation.

**Figure 13: BarCap index of historical currency valuation**




Source: BIS, Barclays Capital

**Figure 14: BRL/MXN – Defying gravity?**




Source: Bloomberg, Barclays Capital

*In Latin America, we would still sell BRLMXN*

In LatAm, we remain of the view that the BRL is to some extent defying gravity and that the MXN will outperform, with the key question mark being timing and the catalyst. By our metrics, the BRL is the most expensive exchange rate in our universe, while the MXN is cheaper than any other than the KRW and TWD. In fact, on a trade-weighted basis, the Brazilian real is now meaningfully stronger than at its mid-2008 peak. BRL/MXN has been nearly unchanged for five months, during which Europe and the euro (to which Brazil is substantially more tied than is Mexico) have dramatically underperformed the US. While a stronger CNY is not particularly negative for Brazil, it benefits the MXN directly by offering some relief in trade competition in the US market. A key difference, of course, is monetary policy, carry, and the cyclical context, where Banxico's blasé response to the long period of above-target inflation contrasts sharply with Bacen's more decisive defence of the inflation target. Currency markets may need Mexican monetary normalization as a catalyst to unlock the value in the MXN. We see this as a risk to the trade, but still favour being long the MXN versus the BRL.

Elsewhere in Latin America, the CLP stands out for its reasonable valuation and a positive outlook, supported by the monetary tightening associated with the country's rapid recovery from the earthquake.

*More circumspect in EMEA*

In EMEA, we are more circumspect, in light of the region's proximity to the troubled economies of Europe. We see meaningful upside in the RUB and TRY, against EUR-USD baskets. In both cases, light positioning protected these currencies from the worst effects of the May-June downdraft and, in our view, reduces their vulnerability. For low beta longs, the EGP and UAH are particularly appealing. An improving political and policy context in the Ukraine and balance of payments trends in both countries reinforce the capacity of central banks to maintain stable exchange rates. We also find EMEA relatively fertile ground for 'tail risk' trades, including owning a low-delta HUF put/EUR call, on the view that Hungary is most at risk in the event of another outbreak of anxiety about the euro area.

## EM rates

The recent performance of local bond and rates markets underscores their generally defensive nature and (beyond that) their resistance to global generalizations. On the one hand, the longer-term challenges facing the world economy favour long positions in rates, since they are less exposed to tail risks and because they should benefit from the low (short tenor) interest rates that will likely be needed to support activity in years to come. On the other hand, rates are, almost by definition, one of the most idiosyncratic assets in EM, which, together with their defensive nature, explains why their valuation is not particularly compelling in many cases.

*Local rates are a lower beta-asset class. With positive carry, local markets are probably going to see further inflows to bonds*

The upward slope in the majority of EM curves still prices in monetary normalisation with the upshot that most receiving rates trades are afforded positive carry on an FX-hedged basis. Given the extremely low rates in core money markets, the carry on FX-unhedged receiving trades – for example, through owning local government bonds – is even more advantageous. However, we are not advocates of having generally received rates/long bond trades in EM at this juncture, as our view on the EM growth cycle is bullish. Nevertheless, one can understand how current investor anxieties regarding growth and tail risks could continue to benefit inflows into local bonds.

*EMEA rates: Supported by an improved inflation outlook and tail risks to growth*

EMEA offers more opportunities than the other regions, in our view, for being received rates. The economic and financial linkages with Europe are a tail risk for EMEA growth, and inflation in the region is generally more subdued than we had previously expected, leading us to push out our forecasts of rate hikes anyway. Our highest conviction recommendation

is to be long (FX-unhedged) Russian 3y and Turkey 2y local government bonds. The robust FX outlook in Russia dovetails with our forecast of further interest rate cuts by the Bank of Russia and the ample local money market conditions caused by capital inflows. Turkey is a slightly different proposition: there is no room for further cuts and the pace of rate hikes is likely to be slower than what is priced in by the market. Moreover, positioning technicals are helpful for Turkish bonds, with a strong local bid and a low, by historical standards, level of offshore holdings. The front end of the South Africa curve, given the stretched valuations, may be a good location for paying trades either on an outright basis or to hedge received trades elsewhere.

*Latin American yields are high but the inflation premia could still be higher*

LatAm, by contrast, seems a more fertile ground for bearish/paying rates trades. Inflation expectations are still at risk of being de-anchored in Brazil and Mexico. In the former, the valuations on shorter real bonds suggest investors should be long breakevens. In Mexico, stretched valuations at the back end of the nominal curve (in part due to the fact that the country has already benefited from index-related bond flows) highlight 10y TIIEs as a good location for paying trades. A series of 50bp rate hikes in Chile in the coming four meetings is not priced in and suggests that front-end rates are likely to remain under pressure; we therefore think investors should look to be paid 2y IRS. Due to potential global financial jitters, the BCCh may decide to slow the normalization cycle down, but there is little indication of this right now.

*Asia: Cash investors converging on local bonds*

Asia local rates and bonds stand at an interesting junction. The growth outlook is generally positive, but regional policymakers favour moving cautiously on monetary normalisation. Meanwhile, the region continues to see real money inflows to the local debt markets, with the 'stickiness of flows' contrasting to the slightly more volatile debt portfolio flows elsewhere (EMEA, for example). We think these flows are in part motivated by the low fiscal overhangs in the region and an anticipation of a steady climb in Asian currencies, likely reinforced by the recent CNY policy shift. In Korea, we recommend receiving 1y rates, as forward-implied rates are high and we believe the Korean central bank will be significantly more cautious in its rate hiking cycle. We also favour long 10y KTBs, which are supported by a strong duration bid by Korean institutional investors. We still like Indonesian government bonds but, given the recent outperformance at the belly of the curve, recommend investors look to the wings (5y and 20y) for value.

# EM CREDIT PORTFOLIO

| | OAS (bp) | | | OAD | Weights (%) | | | Returns (%) | | Bonds we recommend… | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 31-Dec | 18-Jun | 3m | | Benchmark | Model | | 1-week | YTD | Buying | Selling |
| EM Portfolio | 266 | 310 | 293 | 6.7 | 100 | 100 | | -0.7 | 2.3 | | |
| Arg, Ven, Ukr | 900 | 1018 | 1011 | 6.0 | 11 | 15 | over | -8.3 | -0.3 | | |
| Other | 190 | 227 | 208 | 6.8 | 89 | 85 | under | 0.2 | 2.6 | | |
| EM Asia | 207 | 231 | 205 | 7.2 | 14 | 14 | under | 1.9 | 5.2 | | |
| Philippines | 178 | 198 | 190 | 7.5 | 7.6 | 4.9 | under | 2.3 | 5.3 | | Phil 13s,14s,15s,16s |
| Indonesia | 196 | 224 | 190 | 7.2 | 5.8 | 8.0 | over | 1.4 | 5.0 | Indo 14s, 15s, 16s | |
| Vietnam | 324 | 339 | 300 | 5.8 | 0.5 | 0.7 | over | 0.8 | 5.6 | | |
| Pakistan | 681 | 712 | 500 | 4.9 | 0.3 | 0.6 | over | 0.8 | 6.7 | | |
| Sri Lanka | 434 | 460 | 400 | 2.9 | 0.3 | 0.3 | neutral | 0.6 | 3.8 | | |
| EMEA | 235 | 277 | 258 | 5.8 | 40 | 40 | over | -2.3 | 0.0 | | |
| Turkey | 185 | 246 | 215 | 6.8 | 13.5 | 15.0 | over | -0.3 | 0.2 | Turkey 19s,19Ns,20s,21s,25s,34s,36s | |
| Russia | 187 | 242 | 180 | 6.3 | 9.9 | 14.0 | over | -1.3 | 2.6 | Russia 15s,30s,28s | |
| Lebanon | 331 | 309 | 295 | 3.9 | 2.9 | 2.9 | neutral | 0.8 | 4.3 | Leb 4% 17s (amort.) | |
| South Africa | 160 | 180 | 200 | 5.6 | 3.0 | 1.5 | under | 0.2 | 0.1 | | SoAf 20s,22s |
| Ukraine | 1031 | 577 | 475 | 3.9 | 1.1 | 2.2 | over | -1.9 | 19.0 | Ukr 11s, 13s, Nafto 14s | |
| Hungary | 224 | 364 | 415 | 4.6 | 5.0 | 2.5 | under | -10.3 | -10.4 | | Hungary 15s |
| Lithuania | 347 | 345 | 390 | 4.5 | 2.6 | 0.4 | under | -6.8 | -3.1 | | |
| Bulgaria | 215 | 341 | 360 | 3.1 | 0.7 | 0.7 | neutral | -6.4 | -6.6 | | |
| Egypt | 205 | 241 | 265 | 9.0 | 0.4 | 0.1 | under | 0.3 | 1.8 | Egypt 40s | Egypt 20s |
| Serbia & Montenegro | 281 | 259 | 290 | 3.6 | 0.3 | 0.1 | under | 3.6 | 6.7 | | |
| Tunisia | 231 | 175 | 115 | 1.8 | 0.2 | 0.4 | over | 0.2 | 3.7 | BTUN 12s | |
| Qatar | 146 | 158 | 130 | 6.9 | 0.0 | 0.2 | over | 1.7 | 5.4 | Qatar 19s,30s, 40s | |
| Abu Dhabi | 166 | 136 | 130 | 4.5 | 0.0 | 0.0 | neutral | 1.9 | 5.9 | | |
| Latin America | 310 | 365 | 352 | 7.4 | 46 | 46 | under | -0.2 | 3.4 | | |
| Brazil | 137 | 167 | 156 | 7.2 | 13.7 | 12.5 | under | 1.9 | 3.7 | BR37, BR41 | BR19, BR A |
| Mexico | 149 | 160 | 148 | 7.7 | 10.3 | 9.0 | under | 1.8 | 5.4 | MX41, MX33 | |
| Venezuela | 1032 | 1177 | 1225 | 5.5 | 5.2 | 5.0 | neutral | -10.3 | 0.3 | VE23, VE28, VE34 | VE16, VE27 |
| Argentina | 708 | 938 | 890 | 7.2 | 4.3 | 7.6 | over | -7.5 | -5.9 | Bonar 13, EUR Warrants, Boden 15, EUR disc | Bonar 17 |
| Colombia | 177 | 191 | 153 | 7.0 | 3.8 | 3.8 | neutral | 3.0 | 6.0 | CO41 | CO19 |
| Peru | 155 | 193 | 156 | 10.1 | 2.6 | 1.5 | under | 1.9 | 4.2 | PE 33, PE 19 | |
| Panama | 154 | 189 | 163 | 9.2 | 2.5 | 2.0 | under | 4.0 | 6.0 | PA36 | |
| Uruguay | 215 | 230 | 210 | 9.5 | 1.8 | 2.5 | over | 1.6 | 7.4 | UY25 | |
| El Salvador | 353 | 317 | 321 | 6.7 | 1.2 | 0.4 | under | 0.2 | 7.6 | ELSALV 35 | |
| Dominican Republic | 438 | 418 | 347 | 5.6 | 0.4 | 1.3 | over | 3.5 | 7.5 | DR18, DR27 | DR 21 |

Source: Barclays Capital

# FX VIEWS ON A PAGE

| Currency | Tactical bias | Strategic directional view | Current strategy/trades we like | Vol adj 6m returns | Score (1-5) |
|---|---|---|---|---|---|
| **Emerging Asia** | | | | | |
| MYR | Bullish | We remain bullish as the government pursues its multi-year restructuring program, with the key catalysts being privatizations. | Buy 3m USD/MYR put spreads | 0.19 | 3.60 |
| TWD | Bullish | Cross-Strait agreement is still one of our favourite structural transformation stories. | Sell USD/TWD | 0.16 | 3.55 |
| KRW | Bullish | Although still bullish, we are slightly more cautious the KRW due to a smaller fiscal account surplus that reflects a more tepid interest rate outlook and tighter FX regulations. | | 0.31 | 3.50 |
| PHP | **Bullish** | Robust BoP and strong growth outlook indicate PHP strength despite recent underperformance. | Sell USD/PHP 3m NDF | 0.17 | 3.45 |
| IDR | Bullish | Structural reforms, putting the country on track to get investment grade, and robust BoP suggest IDR strength. | Buy 5y IDR bonds, FX unhedged | 0.18 | 3.25 |
| CNY | Neutral | We expect an increase in two-way variations in the CNY exchange rate, along with moderate appreciation. | | 0.12 | 3.10 |
| THB | Bullish | With fewer rate hikes and larger equity outflows, we expect slower THB appreciation. | | 0.10 | 3.00 |
| HKD | Neutral | Local equities markets and large IPOs will likely drive HKD. | | -0.46 | 3.00 |
| SGD | Neutral | We expect SGD NEER to trade above the midpoint in the coming months as we near the October policy statement. | | 0.10 | 2.65 |
| INR | Neutral | With INR being overvalued on the REER and a higher CA deficit, we expect the currency to remain range bound with a weakening bias. | | 0.06 | 2.45 |
| **Latin America** | | | | | |
| MXN | Bullish | Supportive technicals and valuations favor MXN appreciation. | Short BRL/long MXN, short EUR/MXN | 0.26 | 3.90 |
| CLP | Bullish | Strong domestic demand due to reconstruction efforts is supportive. | Short EUR/CLP | 0.35 | 3.35 |
| COP | Bullish | We are becoming more bullish based on a bright energy outlook and signs that the economy is taking off. | | 0.14 | 2.40 |
| BRL | Bearish | We remain bearish in the short term on political noise, but could be wild card due to supportive technicals. | 9m USD call/BRL put | -0.12 | 1.70 |
| **Emerging EMEA** | | | | | |
| EGP | **Bullish** | EGP basket is likely to remain range-bound in the short term, fine-tuning central bank intervention continues. | Long EGP via 3m T-bills, long EGP against USD and EUR (0.8, 0.2) | 0.85 | 3.85 |
| RON* | Neutral | Proximity to euro area, fiscal challenges and possible FX intervention likely to weigh on RON in the short term. | | 0.18 | 3.70 |
| RUB | Bullish | Supportive BoP dynamics, light positioning and a favourable oil outlook make the RUB appealing. | Jan 13's FX Unhedged (funding 45:55 inEUR, USD) | 0.33 | 3.30 |
| ILS | Neutral | Global growth risks may tilt the BoI towards a less hawkish stance. Expect intervention to continue. | | 0.15 | 3.15 |
| TRY | Bullish | A robust cyclical recovery, light positioning and large actively managed FX deposits suggest TRY will outperform during sell-offs. | sell EUR/TRY, long TRY/short ZAR | 0.16 | 2.85 |
| HUF* | Neutral | Fidesz's lack of commitment to fiscal discipline will put the HUF under pressure in bouts of risk aversion. | 6m 290-310 EUR call/HUF put (tail risk trade/hedge) | 0.06 | 2.80 |
| ZAR | Neutral | Remain constructive on positive EM, commodity and high yield attributes, but acknowledge susceptibility to global risk conditions. | | 0.05 | 2.60 |
| PLN* | Neutral | Investor perception of risks to the euro area as well as the continued threat of intervention will cap Zloty gains. | | -0.09 | 2.45 |
| CZK* | Neutral | Weak growth, euro area trade and banking linkages and potential FX intervention are not supportive CZK. | | -0.12 | 2.05 |
| UAH | Bullish | High carry, low vol and low beta provide technical support for the trade even though fundamentals have not changed. | Long UAH via 6m T-bills | | |
| KZT | **Neutral** | FX intervention to remain an obstacle to appreciation. | | | |

Note: *Versus EUR. Changes in tactical bias denoted in bold. The variable score is an index that ranks EM currencies according to the vol-adjusted returns, PPP valuation, carry, systemic risk, basic balance/GDP and reserves accumulated over the past 5y/GDP (5 is the best possible score). For more details on the trade recommendations, please see the EM Dashboard. Source: Barclays Capital

# MACRO OUTLOOK: ASIA

## Policy normalisation to continue

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**GDP growth is expected to slow to 7.6% in 2011 from 8.8% this year, as global PMIs peak, the inventory cycle draws to a close and fiscal stimulus dissipates. Excess capacity is largely absorbed, core CPI is close to trend and, outside China, credit growth is accelerating. Monetary conditions are likely to continue to normalise, driven by modest currency appreciation, cautious rate hikes and further quantitative measures.**

*We have revised up our 2010 GDP growth projections by 0.7pp, to 8.8%…*

We project regional GDP growth of 8.8% in 2010, slowing to 7.6% in 2011, implying an upward revision of 0.7pp in 2010 relative to our forecasts in the March Quarterly, but our 2011projection is unchanged. In 2010, we estimate China will contribute 5.1pp to regional GDP growth while India contributes 1.8pp and the rest of the region 1.9pp. In 2011, China's contribution declines to 4.5% as its economic expansion slows to 9% from 10.1% this year, while India's contribution declines only modestly, to 1.7pp as India slows to 8.4% from 8.8% this year. In nominal terms, regional GDP is expected to expand by USD1.3trn, to USD10.7trn in 2010, and climb a further USD1.6trn, to USD12.3trn in 2011.

*… robust near-term momentum is likely to dissipate in H2 10, leaving growth more or less at trend and modest excess capacity*

Indicators of economic activity, notably exports and industrial production, suggest that the strong momentum experienced in Q1 10 – when regional GDP expanded by 11.0% saar – continued into Q2, indicating upside risk to our projection of 6.5% saar. However, through H2 10, momentum is likely to ease, with output projected to expand by 7.6% in 2011, more or less in line with our estimate of trend GDP growth (currently 7.8%), and consistent with the continued presence of modest excess capacity.

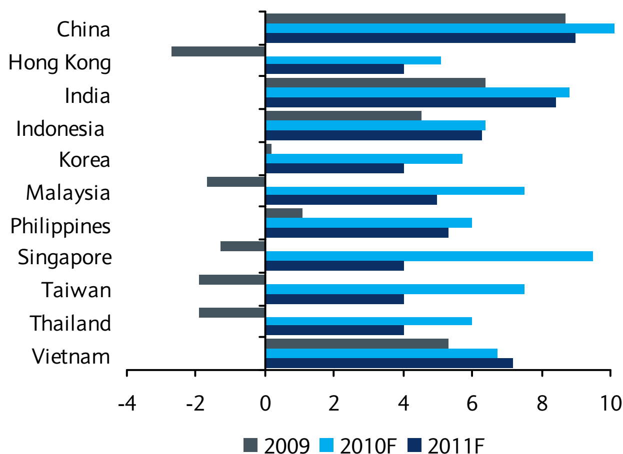
*Key factors driving the recovery are dissipating*

The rebound in activity over the past year can be attributed to four key factors: 1) a recovery in international demand; 2) an inventory cycle; 3) fiscal stimulus; and 4) monetary stimulus. These factors remain supportive of economic activity, but their momentum is dissipating.

*Our global PMI indicator softened in May…*

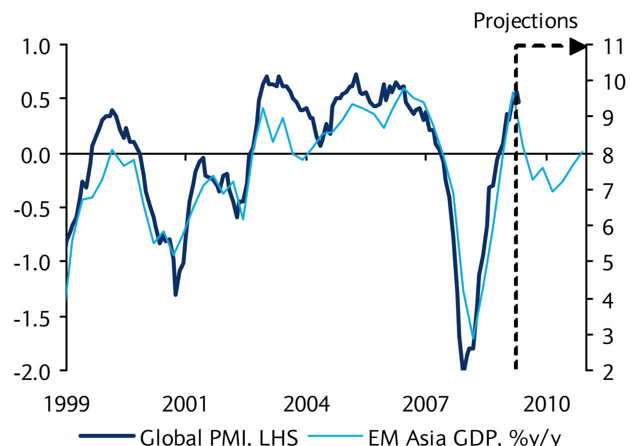
In April, our global Purchasing Managers Index (PMI) rose to 0.57, its highest level since June 2007. In May, the PMI eased back to 0.47 and has likely slipped further given persistent global economic uncertainty. Moderating global business confidence is consistent with a moderation in economic activity in Asia in H2 10 (see Figure 2).

**Figure 1: GDP growth is expected to slow in 2011**




Source: Barclays Capital

**Figure 2: Global PMI indicators appear to be peaking**




Source: Bloomberg, CEIC, Barclays Capital

*… manufacturers have largely adjusted their inventory levels and brought idle plant back online*

A key factor driving the sharp V-shaped recovery was the 2008-10 inventory cycle (see Figure 3). Over the past year, as orders and trade finance revived, collapsing inventory/shipment ratios encouraged manufacturers to quickly bring plant back online, leading to a surge in manufacturing activity. Inventory/shipment ratios are now slightly below their long-run average, indicating some residual adjustment, supporting our view that growth momentum continued through Q2 and probably into Q3, but the bulk of the stimulus has passed, and the rebound in manufacturing production is likely to slow.

*Fiscal stimulus remains strong, but its impulse is dissipating*

Fiscal stimulus remains a key driver of activity. Government consumption will contribute some 0.9pp to GDP growth in 2010, moderating to 0.8pp in 2011, while government investment is likely to contribute some 1.2pp in 2010, also slowing to 0.8pp in 2011. Taken together, government spending is likely to be around 0.4pp weaker in 2011 than this year.

*China accounts for the bulk of the stimulus….*

*…. elsewhere, spending is trailing plan and in some instances may be scaled back*

China accounts for the bulk of the region's fiscal spending, targeting infrastructure, public housing, slum area reconstruction, post-earthquake reconstruction, rural development and healthcare. India's fiscal stimulus has already been withdrawn, although the country's increasing revenues provide scope for greater spending on infrastructure and social services. In Korea, the Sejong City project and the KRW22.6trn Four Rivers project could be delayed or scaled back. Of the KRW14trn earmarked for spending on the Four Rivers project in 2010, actual disbursements could be as low as KRW5-8trn. In Indonesia, the Ministry of Finance may again undershoot its deficit target owing to challenges in disbursing funds. In several countries across the region, sunset clauses and fiscal conservatism imply spending is likely to prove weaker than budgeted.

*Our measure of the fiscal impulse will turn negative in 2011*

In order to further assess the stance of fiscal policy, we have calculated a fiscal impulse measure aggregated across China, India, Indonesia, Korea and Taiwan, which captures about 88% of regional GDP. The fiscal impulse, which peaked at 2.1% of GDP in 2008, is expected to be -0.2% of GDP this year and next (see Figure 4).

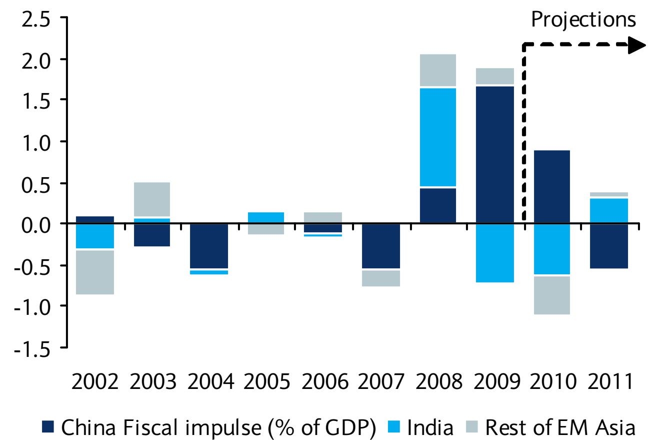
*Headline CPI inflation is likely to dissipate as we move into 2011…*

Over the past six months CPI inflation rebounded strongly, driven by four factors: 1) unfavourable base effects; 2) rising energy costs; 3) rising food prices; and 4) a rebound in core CPI inflation as domestic demand revived. In the near term, we expect sustained upward momentum in inflation, but as we enter 2011, inflationary pressures are likely to subside. Base effects are dissipating, food and energy price pressures are softening and core CPI inflation is likely to rise only modestly from current levels.

**Figure 3: The inventory cycle is drawing to a close**

Source: CEIC, Barclays Capital

**Figure 4: The fiscal impulse is fading (% of GDP)**




Source: CEIC, Barclays Capital

*… food price pressures are dissipating as weather patterns become more favourable…*

Falling wholesale prices across a broad range of agricultural commodities – cooking oil, rice, soy, sugar and wheat – are feeding through the supply chain, temporarily widening intermediaries' margins and pressuring prices lower. Weather patterns are turning more favourable as we migrate towards La Niña. In South Asia, the monsoon is tracking in line with historical patterns, so far, and could lead to significant price declines for rice, oil seeds and pulses. In East Asia, the typhoon season (June-November) is projected to result in fewer storms than normal, leading to downward pressure on prices of fresh fruit and vegetables.

*… energy price inflation is also likely to moderate…*

Over the past year, Brent crude oil rose to USD76.6/bbl (+11%y/y) while Newcastle steaming coal prices rose to USD98.5/ton (+40%y/y). In countries with flexible pricing arrangements (Korea, Singapore), pump prices have already adjusted and there are likely to be only residual adjustments to utility and transport costs. However, in countries with less flexible pricing arrangements (India, Indonesia), upward pressure from energy costs remains a key issue. Under-recoveries at oil companies are rising in India, and we believe fuel prices could be raised by perhaps 3-4% in late Q3 or early Q4. In Indonesia, the government has ruled out hikes in fuel prices but will raise electricity tariffs by 10% in July.

*… while core CPI inflation is likely to rise only modestly*

Core CPI inflation rose 1.6% y/y in March. With capacity pressures unlikely to tighten significantly further from current levels, we expect core inflation to remain in a 1-2% range.

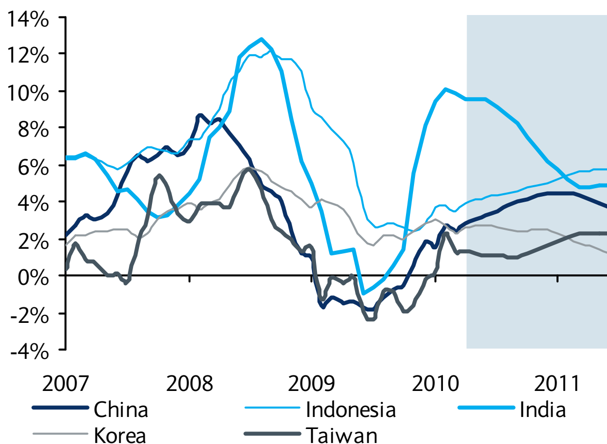
*China and India have led the tightening of monetary and credit policy…*

China has implemented window guidance on bank lending, hiked reserve requirements three times, implemented a range of macro-prudential measures on property and raised bill issuance rates. These policies are likely to be augmented by two 27bp hikes in deposit rates in H2 10, as well as CNY appreciation and further modest hikes in bill issuance rates. India has hiked reserve ratios by 100bp and policy rates by 50bp, while the INR is at multi-decade highs in real effective terms. Systemic liquidity is now in shortage, with credit growth outpacing deposit growth; the repo rate is likely to remain the effective policy constraint. We look for the RBI to hike rates by 75bp in H2 10 but expect no further hikes in the CRR.

*… elsewhere, policymakers are adjusting settings, but normalisation will proceed in baby steps*

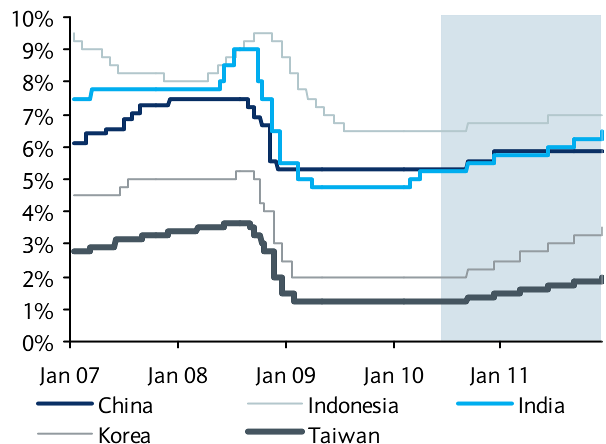
Elsewhere in Asia, only Malaysia and Singapore have formally commenced a tightening cycle. Malaysia hiked the overnight policy rate by 50bp, and is expected to hike another 25bp by year-end, and the MAS has moved to a tightening bias for the SGD NEER index. We expect Korea, Taiwan and Thailand to commence gradual rate hike cycles in Q3 with Taiwan possibly augmenting accelerated NCD bill issuance with reserve ratio hikes. We expect the pace of policy normalisation to slow, with policymakers moving in baby steps.

**Figure 5: Inflationary pressures to subside in 2011**




Source: Bloomberg, Barclays Capital

**Figure 6: Policy rate normalisation to continue**




Source: Bloomberg, Barclays Capital

## Asia policy trends

| | Current trends and policy priorities | Credit growth (Source) | Nature of inflation | Expected monetary policy adjustment | Expected FX policy adjustment | Important catalysts, signposts and general remarks |
|---|---|---|---|---|---|---|
| **Positive output gaps in 2009 (+/- 2%)** | | | | | | |
| China | Domestic demand-led growth with policy-led slowdown in investment in 2010; property price correction, but should not derail growth. Fiscal policy remains supportive, while monetary conditions tighten to pre-2009 levels. Policy aims to promote private consumption, improve income distribution and manage inflation. | YTD data suggest the PBoC is on track to achieve CNY7.5trn annual new loan target, a slowdown from CNY9.6trn in 2009. | Upward pressure from rising demand, resource price reforms and wage pressures, although pressure from commodity prices has subsided. | Expect a benchmark deposit rate hike in Q3, and then a rise in both deposit and lending rates in Q4 (27bp). Credit and liquidity may be tightened further. | With weaker EUR and market turmoil, a near-term move is unlikely. We expect a widening of the trading band in USD/CNY in 2010 if global markets stabilise. | Watch: 1) inflation pressures for the timing of the benchmark interest rate hike; 2) implementation details from the PBoC, including the emphasis, intensity and pace of monetary policy tightening; 3) implementation of plans to boost public housing supply. |
| India | Controlling inflation and supporting growth remain key policy priorities. | Has started to rise with strong economic activity. | Demand-pull inflation due to strong domestic demand. | Expect rate hikes to continue in the coming months. | Expect the RBI to cap the INR as it appreciates on a REER basis. | Watch credit trends, car sales, cement and textile demand as key measures of private consumption. |
| Indonesia | Domestic demand being led by private consumption, with investment rebounding as well. Policy focus is to remove structural bottlenecks to boost investment appeal | Credit growth has accelerated sharply. | Food, demand-pull, pressures rising gradually. | Q4 10 – gradual normalisation. | Policy bias for currency appreciation remains. | Watch credit growth and inflation; motorcycle sales, cement consumption are key measures of domestic demand. |
| **Moderate negative gaps (-2 to -6% of GDP)** | | | | | | |
| Korea | Continued policy support for growth and the job market. Activity indicators suggest Q2 GDP will be strong. This would close the output gap by Q2 and push it into positive territory in Q3. | Bottoming out, as business loans pick up in tandem with capex. | Modest cost-push pressure, while demand-pull is on the rise. | Q3 10. | KRW prospects limited by weaker EUR and planned restrictions on forward transactions. | Key signposts are Q2 GDP advance estimate (out late July 2010), inflation and employment reports. We expect the first rate hike in August. |
| Philippines | Policy aims to manage inflation and buffer growth risks. Remittances to support consumption. | Remains weak. | Demand-pull, relatively benign | Q4 10 – gradual and more widely spaced. | BSP to manage currency volatility. | Watch credit growth and buildup in demand-pull price pressures. |
| **Large negative gaps (>6% of GDP)** | | | | | | |
| Malaysia | Policy aims to divest non-core assets and lift trend growth through structural reforms. | Accelerating. | Inflationary pressures remain benign. | After two rate hikes, we expect another in Q4. | Bank Negara expects the MYR to normalise. | Export and investment indicators could dictate move on FX and rates. |
| Singapore | Policy focus is on longer-term competitiveness. Fiscal supports expire in 2010. Additions to capacity closed the output gap in Q1. | Accelerating since Oct 09 (helped by mortgage growth). | Core inflation to rise gradually. | MAS could maintain its stance of gradual appreciation in October. | In upper half of the band, but the NEER could drift towards mid. | Administered price adjustments to car quota costs and electricity tariffs could produce higher price expectations. |
| Thailand | Policy support, in terms of fiscal and monetary stimulus, to remain in place as the economy recovers from the political uncertainty in Q2. | Slow; excess liquidity is sitting in the system. | We expect core inflation to rise gradually. | Q3 10. | Trend appreciation to continue, with the BoT curbing volatility. | Key signposts are private consumption and investment, as well as bank credit, core inflation and tourist arrivals. |
| Taiwan | Confidence has improved, although concerns about weak job growth remain. With the strong revival in growth, the output gap will close by Q2. | Slow, but steadily accelerating. | Modest imported cost-push pressures, mainly from energy. | Turbulence in markets could push normalisation to Q3. | We believe inflows from the Mainland could push the TWD higher. | Credit growth, inflation expectations and the impact of landmark cross-Strait agreements on capital inflows. |

Source: Barclays Capital

# MACRO OUTLOOK: EMEA

## Sustaining recovery in times of euro angst

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**In light of a weaker euro, fiscal consolidation in the euro area, and delayed rate hikes in core markets, we see EM EMEA also focusing on fiscal consolidation while leaving monetary policy looser for longer. Inflation trends support this; the growth outlook is unchanged.**

*Growth recovery on track*

*Turkey revised upward*

*Poland revised downward*

Growth developments in the first half have on aggregate been more or less as expected, including the variations in the strength of the rebound (Figure 1). Our GDP growth forecast for the region as a whole is more or less unchanged from our forecasts in early March. Within the region the most notable change for 2010 GDP is probably the upward revision in Turkey on account of stronger-than-expected domestic demand, contrasted by a downward revision in Poland, which had escaped recession altogether in 2009 but showed weaker-than-expected growth in Q1. In some cases the data may have surprised on the upside in the first 4-5 months, but the more uncertain outlook for the second half of the year did not warrant upward revisions for the year as a whole.

*Exports remain driver*

*Hopes for bank lending in H2*

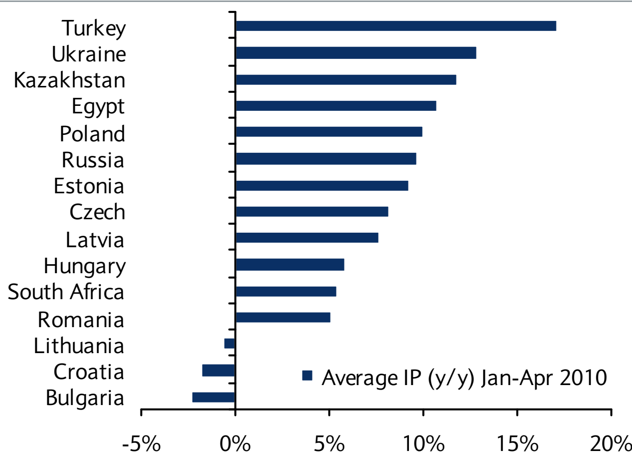
*But also more fiscal tightening in many countries*

*Export orientation of growth does not help revenue collection*

Exports remain the driver in the majority of the countries. For emerging Europe the recovery of export-related industries in core Europe (propelled by Asian demand and a weaker euro) play an important role, while for the commodity producers the recovery in oil prices is obviously key. Only in a few economies (Israel, Turkey, Lebanon) domestic lending is making a contribution, although household consumption in some of the worst-hit economies (Hungary, Latvia, Lithuania) has behaved somewhat less poorly than projected still a few months before. There is some hope that banks will cautiously start lending again in the second half of the year even in the more leveraged systems, but a continuation of the recovery is likely to remain chiefly dependent on external demand. This is particularly true for countries where the need to meet fiscal deficit reductions often requires additional fiscal retrenchment (more below). It is noteworthy that export orientation of the recovery (eg, exports are VAT exempt) is less helpful for revenue collection than the consumption-driven growth fiscal authorities in the region have been accustomed to.

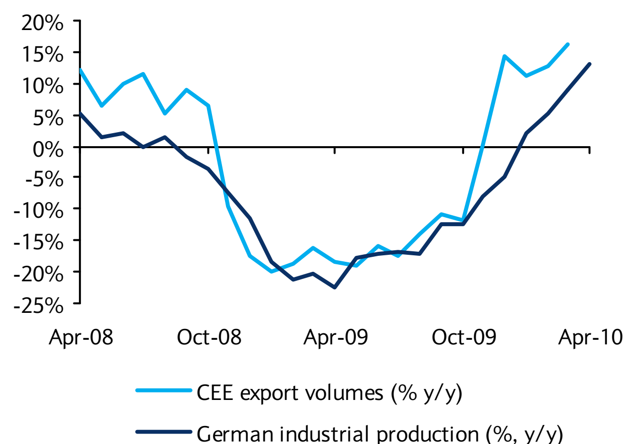
A collapse in export demand therefore remains the main risk for EM EMEA's recovery. However, the fears associated with the ongoing fiscal tightening in the euro area should not be exaggerated in this context – as long as a weaker euro and demand from the rest of the

**Figure 1: Output recovery at varying speeds (incl. low bases)**




Source: Haver Analytics, Barclays Capital

**Figure 2: Industrial production in core Europe is crucial**




Source: Haver Analytics, Barclays Capital

*EM Europe is supplier to euro area's export industries*

world continues to support the extra-euro area export activity of the industries in core Europe (Figure 2). The extent to which countries can benefit from this may vary depending on their main export links (core countries or euro periphery) and also the composition of exports (industrial supplies or final consumption). But safe a global 'double dip' – the risk of which seems further reduced by China's steps to allow for some currency appreciation – we believe the euro area's fiscal consolidation itself will not derail the region's recovery.

*Western European banks' exposure to euro periphery could also affect EM Europe…*

*… but EU facilities seem sufficient to contain this risk*

The larger immediate risks for EM Europe would seem to come from potential problems Western European banks could experience due to their exposure to the euro area periphery (e.g. a worsening of the Spanish banking-real estate issues). While the deleveraging of banking systems in the region is making progress (Figure 3), it will takes time to come down from the elevated levels and the dependence on Western European banks remains high. However, as we argue elsewhere, the amounts made available under the European support facility for euro area countries with financing problems seem sufficient to contain such scenarios.

*With monetary policy in core markets to remain loose…*

*… and benign inflation developments in EMEA so far…*

*… many local central banks are likely to also further delay hikes*

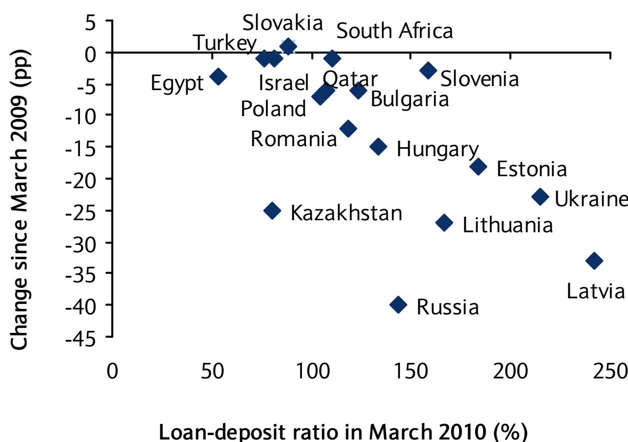
An important consequence of the euro area periphery turmoil and the associated fiscal consolidation efforts is that monetary policy in the euro area and other core markets will remain loose for longer. This dovetails with relative benign inflation developments in our region (Figure 4), where inflation prints tended to surprise on the downside (recently, in particular in Turkey and Russia). This has led to some unexpected additional policy rate cuts (South Africa in March and Czech Republic in May) and also led us to: 1) delay the timing for first rate hikes (Turkey, Poland, Czech Republic, South Africa, Egypt); and 2) moderate ongoing tightening cycles (Israel). Notably, we also stick to our forecasts of further rate cuts in Russia and also Hungary and Romania, in spite of the recent elevated market volatility, which in principle makes additional rate cuts more difficult.

*Current account changes reflect strength of the recovery and commodity prices…*

*… but are unlikely to become a focus point at this stage*

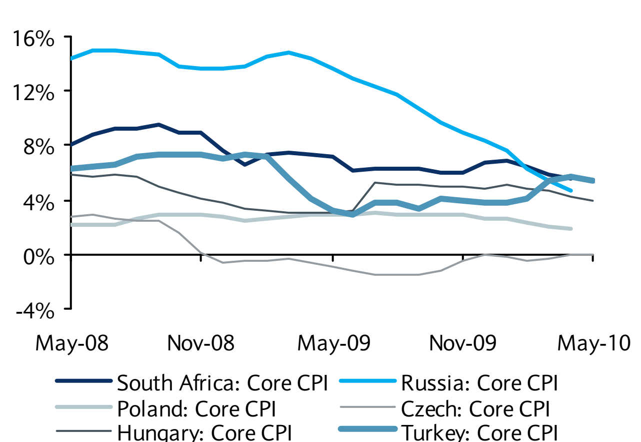
Current account developments remain a side issue for the time being, in our view. Recent developments in external accounts seem to reflect the strength of the growth recovery, particularly where aided by domestic demand contributions. Hence, where recoveries are the most robust, deficits started to widen again (or crisis-induced surpluses started to decline). However, with some exceptions – where this development coincides with particular high energy import dependency (Turkey) – current account developments are unlikely to become a cause of concern in the near future. Even where current accounts are in deficit, they remain below what can be considered their 'norm'. Their size will be a function of the available capital flows, with little risk of creating the overheating scenarios or being the reflection of significant exchange rate

**Figure 3: Financial system deleveraging takes time**




Source: National central banks, IMF, Barclays Capital

**Figure 4: Mostly quiet on the (core) inflation front**




Source: Haver analytics, Barclays capital

misalignments. On a final note in this context, the 'internal devaluation' strategies in the Baltics and the other fixed-currency regimes (Bulgaria and Croatia) are making good progress in terms of restoring competiveness, although not without creating extreme pain in terms of high unemployment and the need for continuing spending cuts.

*Spotlight on fiscal policies in Q3*

*Higher-growth countries and commodity exporters fair better*

*But many countries in EM Europe need to tighten 2011 budgets*

*IMF and EU are less lenient*

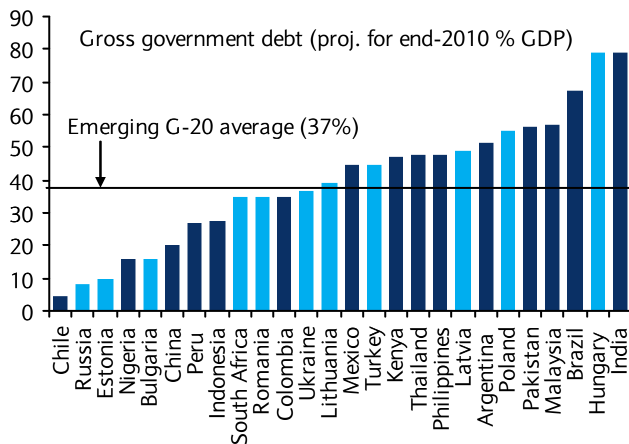
*Upcoming elections could create political noise*

The main policy challenge for the next quarter is in the area of fiscal policy. During the crisis stage in 2009 (which also affected the 2010 budgets) outright fiscal stimulus was advised globally and even the countries that had financing problems and had to ask for IMF support were allowed to adjust relatively mildly. For 2011, however, the IMF and EU are demanding more meaningful adjustments. At the same time, there are no more 'low hanging fruits' in the fiscal tightening process and growth is still too weak (and export heavy) to create easy revenue gains. Certainly, for some countries in the region strong growth (eg, Turkey) and/or higher commodity prices (Russia, Kazakhstan, GCC) imply robust fiscal performance. For most countries in EM Europe, however, the 2011 budget preparations that begin in Q3 are likely to be very difficult and could become politically charged, particularly where elections are underway. In Hungary, the Fidesz government has already received a lesson in expectation management when it thought its large majority gained in the April elections would permit it to deviate from IMF-EU programme targets and publicly speculate about default risks. However, it may raise the rhetoric again for the local elections in October. In anticipation of such problems, the IMF agreed in Latvia to postpone the 2011 budget discussions until after the general election in October. However, political noise will likely increase. In the recent Czech elections, however, voters seemed to have voluntarily opted for a government that runs on a fiscal consolidation platform. In Poland, we have moderated our hopes that after the Presidential elections in June, the government may feel encouraged to implement additional fiscal measures. Overall, we feel that fiscal issues will remain a focal point for markets and politics in the coming quarter.

*EMEA's public finances are not worse than in other EM regions*

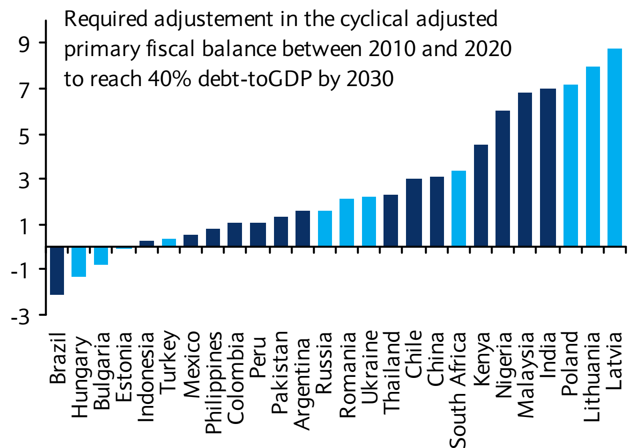
It would be wrong, however, to define EM EMEA as the region with particular public debt problems. EM Europe's true debt issue concerns the private sector's external liabilities not so much the public sector (as long as governments do not have to bail out the private sector). We had pointed out on earlier occasions that EM EMEA's debt dynamics look significantly better than those in the euro area periphery. Government debt ratios vary widely in the region and they also are not systematically worse than in other EM regions (Figure 5).

**Figure 5: Government debt stocks greatly vary in EMEA**




Source: IMF, Barclays Capital

**Figure 6: Debt stock and deficit adjustment need can differ**




Source: IMF, Barclays Capital

*High debt stock does not always imply a high adjustment need*

Notably, a high debt stock does not automatically also imply a high adjustment challenge and vice versa. Hungary is a prominent example: its level of debt stands out, but significant deficit adjustments have already been implemented during the recession (ie, pro-cyclically). Thus when the economy normalises, the additional adjustment effort is smaller than in countries where the debt levels are lower but adjustments have not yet begun (Figure 6).

*Painful 'internal devaluation' strategies are making progress*

*EU's clearance of Estonia's euro adoption removes tail risk…*

*… but in principle euro adoption is no longer an 'anchor'*

*New central bank governors in Poland and Czech Rep have different attitudes*

*Loss of euro-anchor gives larger weight to local policies*

*ECB accepts some responsibility for non-euro area EU countries*

The EU's recent approval of Estonia's euro adoption request removed a tail risk for the region. As we had argued in the last *Emerging Markets Quarterly*, Estonia was too far advanced in the process and also a poster child of the fiscal discipline the EU is now advocating so forcefully. In addition, Estonia's tiny economy is insignificant for the euro area, Estonia's statistics are proper and it actually did fulfil all Maastricht criteria. Thus, to have denied Estonia entry in the current situation could have had significant negative market and political repercussions. Beyond Estonia, however, we think euro adoption will not be easy for any other country soon. Euro adoption strategies have thus largely lost their role as an expectation anchor until the future the euro area has become clearer. Recent central bank governor nominations may make for some differentiation. In Poland, the new NBP's governor, Belka, should make the NBH less euro sceptical, whereby in the Czech Republic the new CNB governor, Singer, himself is a known euro sceptic. Overall, however, governments are relatively quiescent about concrete euro adoption plans. Even Bulgaria's outspoken ambition to enter ERM II has been dashed by the recent revelations about the need to revise upward fiscal deficit numbers. This at least temporary loss of the euro-adoption anchor is likely to give larger weight to local policies, as markets will need to differentiate more among countries, which also creates potential for volatility. On a positive note, recent developments have shown that the ECB – albeit reluctantly – recognises its need to also support the EU countries outside the euro area, as it has probably realised the potential repercussion from problems in these countries on the euro area itself. The ECB's willingness to finally extend a EUR-HUF swap line to Hungary's NBH – which it denied for a long time – is an indicator of this, in our view.

**Figure 7: Elections (P = Presidential; G = General/Parliamentary; L = Local government; R = other, including referendum)**

| Jul'10 | Aug'10 | Oct'10 | Nov'10 | Comments |
|---|---|---|---|---|
| Poland (P) | Kenya (R) | Latvia (G) | Egypt (G) | Latvia and Hungary: ongoing IMF-EU programs could create tension |
| Mauritius (G) | | Hungary (L) | Bahrain (G) | Egypt: presidential succession issues (Sep 2011) are coming closer |
| | | Tanzania (P, G) | Poland (L) | Turkey: Possible early election in Q4 10 (instead of mid-2011) |

Source: Barclays Capital.

*Event risks shift from default risks to geopolitical issues…*

*… particularly in MENA region*

*Ukraine benefits from improved Russia relations…*

*… and World Cup publicity should be good for Africa*

Potential event risks in the region have somewhat shifted from default-related issues to geopolitical issues, in our view. The ECB's buying government bonds in the euro periphery combined with the EU's EFSF has lowered the risk for sovereign restructurings in the near future and the associated regional contagion. Quasi-sovereign debt workouts in Dubai will continue for some time, but the market seems to have come to accept it. At the same time, political risk in the Middle East seem higher now, which affects the GCC (eg, via Iran trade links) as well as Lebanon, Egypt, Israel, and increasingly Turkey, via the tensions around the Gaza issue. In the CIS sphere, Ukraine seems to reap the benefits from its more united and more Russian-friendly government, which reduces political noise and raises financial support from Russia. Developments in Kyrgyzstan are troubling from many perspectives but are unlikely to develop into anything that would have market implications in the short term. Finally, the World Cup helps to put South Africa and, more generally Africa, in the spotlight. Safe any unexpected incident, this attention, coupled with robust commodity prices, should generally bode well for the Sub-Saharan region.

# MACRO OUTLOOK: LATIN AMERICA

## Cruising

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**Amid a volatile world economy, Latin America's economy has been remarkably uneventful. Growth has been fast and driven (almost everywhere) by domestic demand. While solvency conditions remain strong, fiscal policy is somewhat procyclical. The monetary outlook is diverse, with some countries tightening, others on hold and a couple with an ultra-easy stance. The positive domestic economic environment risks breeding complacency among policy makers. The political calendar for the second half of the year promises to bring, perhaps, a little more excitement.**

*Latin America's economies are recovering nicely despite the global turbulence*

The next semester appears relatively clear for the region. All countries seem to be cruising, though at different altitudes. Indeed, while there are significant differences across countries in their current economic and policy standing, the near future appears relatively uneventful. Granted, elections in Brazil are likely to dominate the political debate in LatAm. However, despite their unquestionable importance, short-term economic outcomes are unlikely to be much affected. Therefore, overall, we do not expect many policy changes for the remainder of 2010.

*Average growth is stronger than we expected. It is, in most cases, domestic expenditure led and, for the region, investment rates could reach a record*

The region is growing fast. Interestingly, consensus expectations are converging towards current growth rates from behind. The regional growth picture is not too dissimilar to the one we anticipated in March, in our previous *Emerging Markets Quarterly* (Figure 1). However, within the region there are a few noteworthy differences. Brazil and Argentina's growth in the first half of the year has been significantly faster than we anticipated. In both cases we have revised up growth expectations quite substantially. On the other end of the spectrum, we have revised down, quite substantially, our estimate of Chilean growth for the year. This is explained by the fact that the economic impact of the February earthquake was felt dramatically in March. Fortunately, the effects appear to be short lived and the economy is now recovering handsomely. Mexico, in turn, was also revised down a bit as domestic spending has not picked up as fast as we were predicting.

The strength in growth for the region is mostly dominated by robust domestic spending. Exports are normalizing but, for the overall region, net exports are a negative net contributor

**Figure 1: Growth has accelerated**

| | | Q1 10 forecasts | | Q2 10 forecasts | |
|---|---|---|---|---|---|
| | | 2010F | 2011F | 2010F | 2011F |
| US | Consensus | 3.1 | 3.0 | 3.3 | 3.1 |
| | Barcap | 3.6 | 3.2 | 3.6 | 3.5 |
| China | Consensus | 9.9 | 9.1 | 10.2 | 9.0 |
| | Barcap | 9.6 | 9.0 | 10.1 | 9.0 |
| LatAm | Consensus | 4.0 | 3.8 | 4.9 | 3.9 |
| | Barcap | 4.8 | 3.9 | 5.3 | 4.1 |
| Brazil | Consensus | 5.3 | 4.6 | 7.0 | 4.5 |
| y/y | Barcap | 5.7 | 4.5 | 7.3 | 4.4 |
| Mexico | Consensus | 3.7 | 3.5 | 4.3 | 3.7 |
| y/y | Barcap | 5.5 | 3.3 | 5.0 | 3.6 |
| Chile | Consensus | 4.5 | 5.4 | 4.5 | 5.5 |
| y/y | Barcap | 5.2 | 5.7 | 4.2 | 6.6 |
| Colombia | Consensus | 2.7 | 3.6 | 3.0 | 3.9 |
| y/y | Barcap | 3.6 | 4.8 | 4.5 | 4.3 |
| Peru | Consensus | 4.8 | 4.8 | 5.7 | 5.0 |
| y/y | Barcap | 6.3 | 6.2 | 7.1 | 6.4 |
| Venezuela | Consensus | -1.3 | 1.5 | -2.9 | 1.1 |
| y/y | Barcap | -1.7 | 1.0 | -5.4 | 2.0 |
| Argentina | Consensus | 3.7 | 2.6 | 5.0 | 3.2 |
| y/y | Barcap | 4.2 | 2.7 | 6.1 | 3.8 |

Source: Barclays Capital and consensus forecasts

**Figure 2: Investment rates are recovering**

| Investment rates (% GDP) | 2007 | 2008 | 2009 | 2010 F | 2011F |
|---|---|---|---|---|---|
| Argentina | 24.2 | 23.3 | 20.9 | 22.7 | 23.0 |
| Brazil | 17.4 | 18.7 | 16.7 | 19.1 | 19.8 |
| Chile | 19.8 | 24.4 | 21.4 | 23.6 | 23.1 |
| Colombia | 24.3 | 25.0 | 24.2 | 25.6 | 26.5 |
| Mexico | 21.4 | 21.9 | 21.8 | 21.5 | 21.6 |
| Peru | 17.4 | 20.2 | 19.1 | 25.2 | 27.5 |
| Uruguay | 18.6 | 20.2 | 19.1 | 20.7 | 21.1 |
| Venezuela | 24.5 | 20.4 | 22.1 | 18.0 | 17.7 |
| Average | 20.3 | 21.0 | 19.8 | 21.1 | 21.5 |

Source: Barclays Capital, based on Haver Analytics and own forecasts

to growth accounting. The fact that imports grow faster than exports in most countries helps illuminate the strength of domestic expenditure. Investment rates are recovering fast, though domestic consumption (and in many cases government spending) are leading the region's growth. Alternatively, recovering domestic investment rates, which have reached a record for the regional average (Figure 2), and weakening savings mirror a widening current account deficit. However, the numbers are far from worrisome. We are expecting the deficit to widen to -0.6% of GDP by the end of 2011, from -0.2% in 2009 and +2.2% in 2006, the peak current account surplus year. Ex-Venezuela, which we expect will sustain a current account surplus of nearly 10% of GDP on average, the regional gap would rise to -1.5% of GDP in 2011 from -0.5% last year.

*Fiscal solvency is not a concern. Only moderate adjustments are needed to ensure it*

Fiscal policy in the region is one of the differentiating factors with developed nations. Macroeconomically speaking, there are, at a minimum, two ways of analyzing a country's fiscal policy. To begin with the positive, most countries in Latin America are very close to sustainable levels of deficits and debts (Figure 3). The recent report by the IMF on fiscal sustainability finds that only remarkably small adjustments are needed to fiscal stances in order to reach a low gross debt to GDP ratio (40% or less).[1] For instance, besides El Salvador's concerning debt dynamics, the study shows that the largest adjustment is needed in fiscally prudent Chile (a required tightening in the full employment primary surplus of 3% of GDP). This is, in part, the result of a super-strict requirement that sustainable debt ought to stabilize, in Chile's case, at the end-of-2012 level of gross debt (gross debt was an extraordinarily low 5% of GDP at the end of 2009). On the other extreme, according to IMF estimates, Brazil could even reduce its full employment primary surplus somewhat and continue on a trend of debt reduction. The region as a whole has a strong fiscal position and is benefiting from a stable gross debt to GDP ratio, once we adjust for the state of the business cycle. For once in the past 40 years, debt sustainability is not an issue in Latin America.

*However, fiscal policy is taking an increasingly pro-cyclical bent*

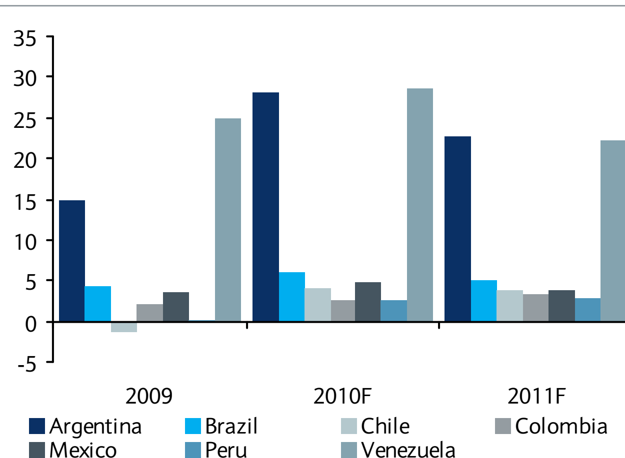
Fiscal policy, however, plays another important role in terms of the business cycle. Unfortunately, Latin American governments currently are running (modestly) pro-cyclical stances. As the region's recovery is well rooted and fast – in some countries, very fast – we would hope governments would take advantage of the opportunity to significantly improve

**Figure 3: Big fiscal adjustments are not needed to secure solvency, according to the IMF**

| | Gov't balance | Gross debt | CAPB | Required adjust. |
|---|---|---|---|---|
| LatAm | -2.4 | 50 | 1.1 | -0.2 |
| Argentina | -3.5 | 51 | -0.6 | 1.6 |
| Brazil | -1.5 | 67 | 3.4 | -2.1 |
| Chile | -1.8 | 4 | -2.6 | 3.0 |
| Colombia | -3.5 | 35 | -0.6 | 1.1 |
| El Salvador | -4.7 | 52 | | |
| Mexico | -3.4 | 45 | 0.1 | 0.5 |
| Panama | -2.6 | | | |
| Peru | -1.6 | 27 | -0.9 | 1.1 |
| Uruguay | -1.9 | 49 | | |
| Venezuela | -0.5 | 37 | | |

Note: Uruguay and Venezuela are BarCap forecast for 2010 deficit and debt. El Salvador and Panama taken from IMF staff report. Source: IMF *Fiscal Monitor*, Barclays Capital

**Figure 4: Ex Argentina and Venezuela, inflation is a smaller issue (%, y/y)**




Source: Barclays Capital, based on Haver Analytics and own forecasts

[1] IMF *Fiscal Monitor: Navigating the Fiscal Challenges Ahead*, May 14, 2010.

their primary budgets. This is not the case, however. Take, for instance, Brazil. Our forecasted primary surplus for the year is 2.5% (the IMF's own estimate is 3.4%), significantly below the fund's estimated full employment surplus (3.4%) at a time when we estimate that actual GDP is approximately 1.4% above potential. Chile presents, perhaps, a more difficult case as the country has a sizable primary deficit at a time when the economy is recovering fast. However, the country needs to engage in a reconstruction program after the earthquake. As justified as a deficit might be for a country with such a low level of indebtedness, the fact is that to balance out macroeconomic constraints, monetary policy will have to do some extra lifting. All in all, while the region is recovering at a solid pace, fiscal policy has not yet turned sufficiently neutral and risks shifting an excessive burden towards monetary policy.

*Monetary policy is very case-specific. Brazil, Chile and Peru are tightening. Mexico and Colombia are on hold for the year*

The region could not be more diverse in its monetary policy outlook. Brazil and Chile have initiated two aggressive processes of interest rate hikes. Brazil has produced two 75bp hikes and will conduct, in our opinion, at least two more (Figure 5). Chile has just begun its tightening cycle with a 50bp hike, and we expect the central bank to continue with this aggressive pace (another four 50bp hikes) to then slow down to 25bp until rates reach a level of neutrality. Peru introduced a more moderate 25bp hike path, and we expect it to continue hiking at this pace for another five meetings. On the other hand, both Colombia and Mexico are likely to stay on hold for the remainder of the year, as the two countries still sport a significant output gap and inflation expectations are contained (though above the inflation target). Finally, while neither Venezuela nor Argentina work under a fully spelled-out framework, their monetary policy is not only loose but is turning easier every day. In both cases, the monetary base expansion is growing fast, feeding inflation, while real interest rates are deeply negative.

*Portfolio flows are expected to remain strong. They are becoming more important for current account deficit financing*

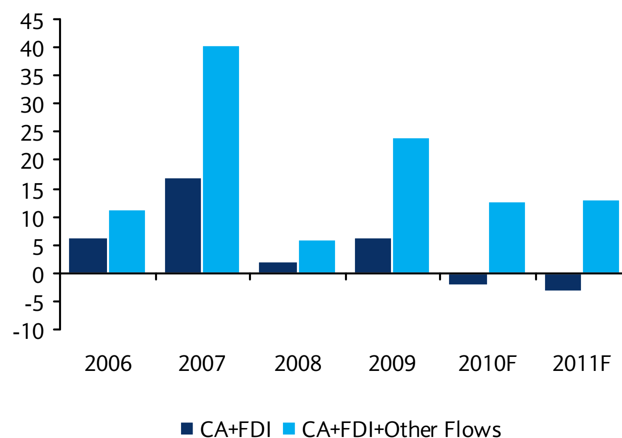
We continue to see direct and portfolio flows moving into our region. Figure 6 shows the importance of portfolio flows in financing the regional current account balance. The darker bars plot the sum of the CA and FDI, while the lighter bars add all other flows (including portfolio). All flows are weighted by the relative size of the country and positive readings imply excess availability of flows. While softer FDI in Brazil (see "Brazil: The Lula Factor") accounts for the slight negative reading, the growth in portfolio flows across the region more than compensates for the drag in FDI. While those flows are critical to finance the booming domestic expenditure, capital flows represent one of the greatest concerns

**Figure 5: Expected rate hikes**

| Country | Current | Next Meeting | End 2010 | End of Cycle |
|---|---|---|---|---|
| Brazil | 10.25 | Jul 10 (+75) | 11.75 | 11.75 |
| Chile | 1.00 | Jul 10 (+50) | 3.50 | 6.00 |
| Colombia | 3.00 | Jan 11 (+25) | 3.00 | 6.50 |
| Mexico | 4.50 | Jan 11 (+25) | 4.50 | 6.50 |
| Peru | 1.75 | Jul 10 (+25) | 3.00 | 4.50 |

Source: Barclays Capital

**Figure 6: Financing the regional CA deficit (USD bn*)**




* GDP Weighted. Source: Barclays Capital

expressed by regional policy makers. Most governments and central banks worry about the past appreciation and are considering alternative initiatives if capital flows drive further strengthening of the currencies. The lack of consensus and guidance over the proper approach to dealing with capital flows exacerbates the potential for interventions such as capital controls, taxes or FX intervention. Given that we anticipate capital flows will regain some of their recently lost strength, this could become one of the few areas in which we may see meaningful policy developments in the second half of 2010.

*We expect limited debt issuance and few liability management transactions*

Another area where we expect relatively few surprising developments is in liability management and debt issuance. In this space, the risk tends to be more concentrated in Venezuela and Argentina. In Venezuela, the new FX intervention scheme (which results in four FX markets) has changed expectations for issuance by the sovereign and PDVSA. While supply to the market will increase as local banks are forced to sell some of their position, we do not expect the sovereign to issue for most of the next semester – PDVSA is expected to issue towards the end of the year. In the case of Argentina, given the government's stated objective of only issuing in global markets at single-digit yields, it appears that it will also take a while before issuance materializes. Furthermore, while the market has speculated that other liability management exercises might be pursued, it does not look likely that the administration, disappointed as it seems to be with current yields, will implement them imminently. Rather, a necessary condition for them to materialize seems to be that market tone needs to improve significantly – something we think is likely but may not suffice to drive the authorities forward. Most other countries in the region are almost fully financed for the year, with the exception of Chile, which has indicated its willingness to issue in global markets. Therefore, other than from newcomer Chile, we expect very limited sovereign issuance for the second half of the year.

*Even on the political front, always a heated space, the region looks relatively calm*

The political calendar, so far containing a few presidential elections, promises to turn more interesting in the next few months. In the first place, the election of Juan Manuel Santos as Colombia's next president augurs an extremely smooth transition. However, Santos' economic agenda for the second semester could be front loaded with some tough fiscal issues. In October, Brazil's presidential election should attract much attention as it will mark the transition from Lula's extremely charismatic and popular administration to a new president with, probably, less charisma and with the need to establish a new agenda. Policy uncertainty is, therefore, likely to increase. We are, however, confident that much of the macroeconomic framework will remain unaltered. We do foresee, however, an increase in volatility in FX markets during Q3 and early Q4. Venezuela holds legislative elections in September. Recent polls (Datanalisis) show a fairly even race between President Chavez and the opposition. However, the same polls indicate that President Chavez would retain his majority in the Assembly, thanks to recent changes in the definition of electoral districts. Finally, Argentina's politics will heat up, again, as candidates compete for their party's nominations and as the opposition tries to undermine Nestor Kirchner's recent recovery in the polls.

*The risk is excessive complacency from policy makers and investors alike*

All in all, the region presents a favourable outlook, which should help attract portfolio flows and support asset valuations. Both factors should further contribute to growth, reducing the political appetite for policy corrections. At the risk of potentially growing excessively complacent, policy makers are likely to continue cruising for much of the second semester.

# MARKET OUTLOOK: ASIA

## Recovery on track; beware of tail risks

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**We enter the second half of the year still positive on EM assets and look to be cautiously positioned for a recovery. The slew of headline risks over the past quarter has brought heightened awareness of tail-risk events, such as Europe, and ongoing regulatory changes. The potential impact of these unknowns has increased and represents a much fatter tail risk than before the crisis. This has generally led to light positioning in EM Asia assets. Countering these trends is China's currency reform, announced just as we are finalising the quarterly. This may be the catalyst that sparks a rebound in risk-taking in Asia.**

Among tail risks, regulatory changes continue to weigh on investor confidence. The final form of US and UK banking regulations are still under development. In Asia, we are seeing increased attention towards FX and banking regulations.

*Korea and Indonesia have tightened FX rules; risks of more regulations to come*

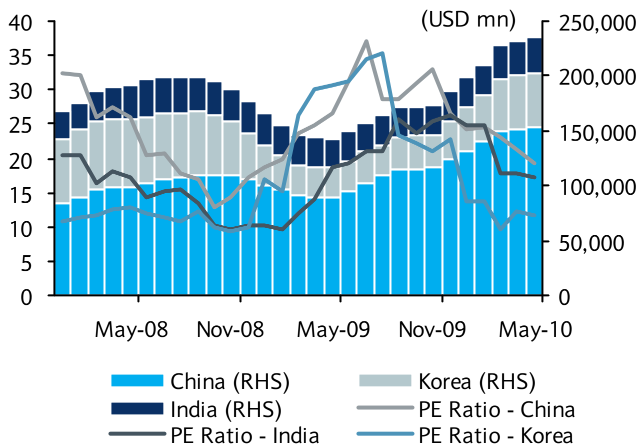
In particular, Indonesia and Korea recently imposed regulations aimed at reducing FX volatility and speculative inflows (see *Korea announces limits on FX positions*, 14 June 2010 and *Indonesia: Changes, not capital controls*, June 16, 2010). While final details are still being worked out in Korea, regulations will likely reduce the amount of USD provided by foreign banks. In Indonesia, imposing a one-month holding period on bills will greatly reduce the attractiveness of arbitrage trades. Neither regulation will have a meaningful impact on foreign investments in bonds. Our concern lies more with the signals the measures send and the state of future regulations.

### Position for the recovery

*Do not ignore improving fundamentals and base case scenario*

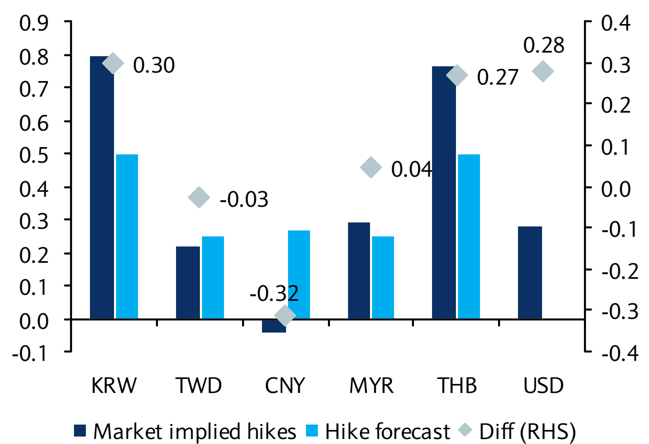
Despite these tail risks, we do not discount the positive news coming out of the region. Economic indicators continue on an upward trend, with improvements in growth and employment, and closing output gaps. Should there be another dip in the global markets, it is likely to be shallow and short lived.

**Figure 1: PEs cheaper as earnings climb and prices drop**




Source: Bloomberg, Barclays Capital

**Figure 2: Market-implied rate hikes in line with our forecasts**




Source: Barclays Capital

*Health of investors supportive of growth; dips, if any, likely to be shallow*

Corporations and financial institutions are better positioned for a downturn than previously. Earnings are on a positive trajectory despite limited appreciation in equity prices. This implies P/E valuations are looking more attractive (Figure 15). Also, corporate balance sheets have been built over the past one to two years, reflecting stronger capital bases, increased cash positions and reduced funding risks from lengthened funding profiles. In addition, financial institutions are generally underweight risky assets.

## Central banks remain cautious

*Central banks cautious about hiking; we have revised down our rate hike forecasts*

Growth in Asia is moving towards trend and output gaps are closing. As such, the central banks of India and Malaysia have started the normalisation process, and others are likely to follow in the coming quarter. Even so, global uncertainties may warrant a cautious approach. Also renewed FX appreciation following China's CNY reforms may temper inflationary pressures, affording policymakers room to be cautious. This was largely already factored in our central bank forecasts. Since our last quarterly, our rate hike forecasts have been cut by one to two hikes for the year.

*Risk/reward favours receive trades; we recommend receiving 1y in Korea*

In our view, forward pricing of rate hikes still favours receive trades. Even with our updated forecasts, the bias is for more cautious rather than aggressive hikes. Forward-implied rate hikes are highest for Korea and Thailand (Figure 16). Our confidence in receiving 1y rates in Korea is highest as there are fixing risks in Thailand. The position offers 10bp of carry a month and is trading near the upper end of a 2.80-3.05% range in place since April. The FRA curve indicates hikes are front-loaded, which leads us to see most value in receiving the 1y point.

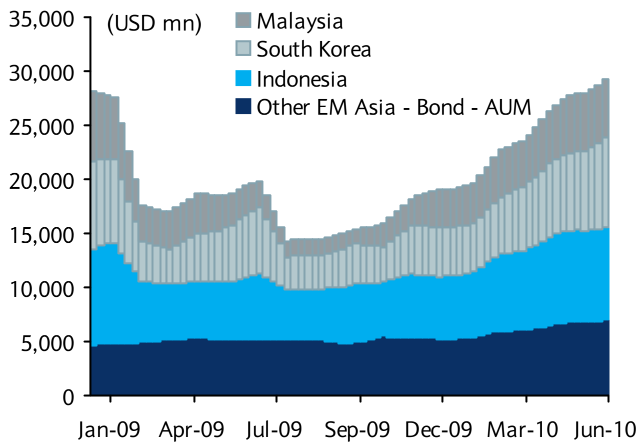
*Liquidity in India complicated by auction outflows, bond buybacks and possible intermeeting hike*

Front-end rates in India are being pressured due to liquidity shortages related to the recent 3G and BWA auction outflows. It may take up to two months for liquidity conditions to normalise. Meanwhile the RBI may continue injecting liquidity through OMO buybacks. Risks are further complicated by the possibility of an intermeeting hike. Therefore, we remain neutral on 1y OIS for the time being.

*Tactical trades in Asia: 2x5y flattener in India, pay 5y Taiwan, US-HK spread widener*

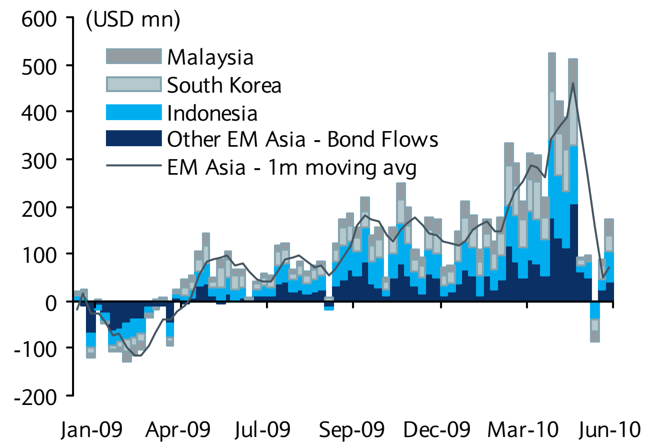
Elsewhere in derivatives space, the 2x5y curve in India will likely flatten due to sufficient demand for long -tenor bonds and reduced fiscal concerns. In Taiwan, 5y IRS is trading at the lower end of its trading range, which makes for attractive tactical paid positions. US-HK spreads have scope to widen when interest in CNY revaluation increases and pushes forward points lower.

**Figure 3: AUM at EM Asia funds continue to grow**




Source: EPFR Global, Barclays Capital

**Figure 4: Pace of inflows has slowed**




Source: EPFR Global, Barclays Capital

## Bond inflows remain strong into EM Asia

*Real money inflows to local markets in EM Asia to continue*

Real money flows into the region's local debt markets continue despite global concerns. Over the medium to long term, we remain confident a structural re-allocation of global portfolios into EM markets will continue. Indeed fundamentals for growth and low fiscal overhangs are positives for the region. As such, AUM at EM Asia funds continue to grow. (Figure 17) With these inflows, even establishing an underweight requires buying in local markets. Since July 2009, AUM for EM Asian bond funds has increased 2-4 times.

*Pace of buying has slowed due to risk aversion; we see a risk of selling if risk aversion escalates*

Risk aversion has slowed the pace of inflows. Average weekly inflows have slowed to USD74mn in May from about USD1.4bn a week in April. In the subset of funds we track, outflows have only been observed the last week of May (Figure 4). Although these flows appear resilient, we highlight the potential for outflows from local markets if risk aversion escalates. However, the wall of real money may temper any large selling pressures.

*In Indonesia, we recommend switching to 5y and 20y from 10y*

Through the recent bout of risk aversion, local bond markets traded less like risky assets due to stability of real money investors. Despite this stability, we remain concerned about tail risks. Thus, in Indonesia, we recommend switching to the 5y bond from the 10y bond. In addition to the 5y having lower duration risk, the 10y bond has outperformed both 5y and 20y sectors. For investors requiring more duration than the 5y, a mixed portfolio of 5y and 20y may be a good alternative to outright 10y.

*We recommend 10y KTBs in Korea due to local demand*

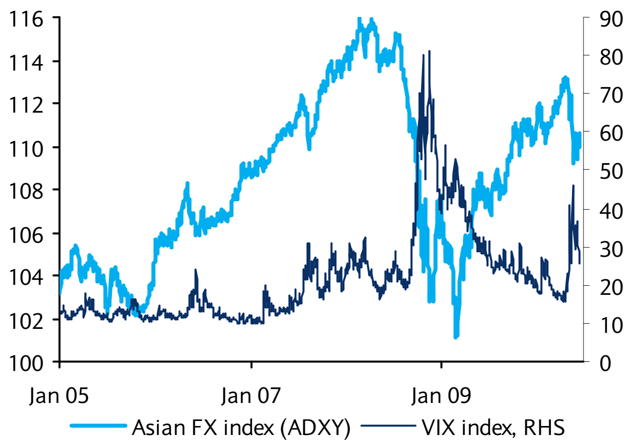
Korean bonds, being largely driven by domestic markets, continue to do well on weakened confidence in global assets. This is leading onshore institutional investors to overweight bonds. Additionally, life insurance and pension funds have an increased demand for long-tenor KTBs. The money they repatriated during the financial crisis has largely remained onshore as prospects for assets overseas remain questionable. Their need for duration will likely keep 10y bonds bid below 5.00%.

## Asian FX set to appreciate

*Asian currencies were badly positioned for the May bout of risk aversion…*

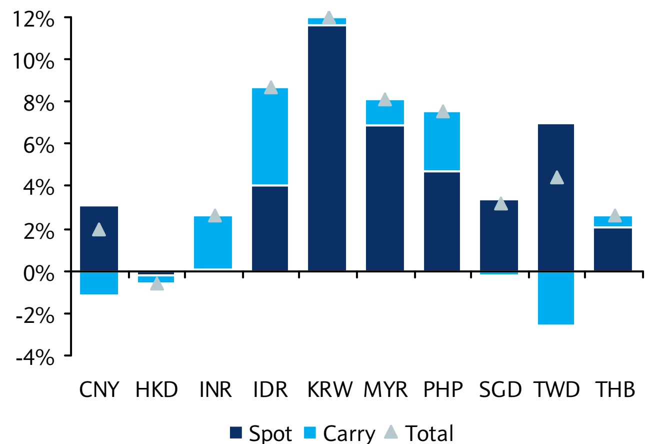
As we entered May, sentiment towards Asian currencies was uniformly bullish. We awaited the imminent resumption of CNY appreciation, and positioning across all currencies was heavy, funded by both short USD and short EUR positions (see *Emerging Asia: Positioning in Asian currencies*, 20 April 2010). Implied volatility had declined and looked likely to stay low.

**Figure 5: We expect Asian currencies to rally as risk aversion fades**




Source: Bloomberg, Barclays Capital

**Figure 6: Higher-yielding currencies are expected to outperform (one-year expected returns)**




Source: Bloomberg, Barclays Capital

While few investors had been brave enough to sell USD calls to fund their bullish Asian currency positions, they had been willing to cheapen funding through ratio call spreads and RKOs, in the belief that Asian currencies would grind stronger. However, as May progressed, EUR weakness evolved into a generalised flight to quality, rising implied volatility, weakness in equity markets and generalised USD strength.

*… but the technical position of the market has now lightened…*

Since late May, conditions have stabilised. Asian currencies are stronger across the board. Foreign Institutional Investors (FII) are again purchasing Asian equities (and currencies). Implied volatility is declining and risk reversals, which were heavily skewed in favour of USD calls, have begun to move towards balance. Sentiment towards Asian currencies remains weak, while Reuters' June survey points to light positioning. In our opinion, the technical backdrop for Asian currencies is as attractive as it has been at any time since early 2009.

*… CNY appreciation pressure has rebuilt…*

At its nadir on 7 June, the 1y CNY NDF was pricing an appreciation of only 39bp, but in the wake of China's announcement to resume CNY appreciation, this has widened to around 3%. We expect the CNY to appreciate by up to 5% on a NEER basis over the coming year, which, based on our cross-rate forecasts, implies a 5% appreciation against the USD.

*… we favour the MYR and PHP but remain concerned about policy risk in the KRW…*

We remain long the MYR via a 2m call spread with strikes at 3.20 and 3.10, while against the PHP we remain long via the 3m NDF outright, targeting a move to 45.50/USD. The KRW also appears attractive. Its high beta to equity market volatility and the USD index, and sensitivity to tensions with the North suggest it became oversold in May. While we expect the KRW to appreciate to 1,075/USD in one year, we remain cautious owing to heightened policy risk.

*… and we expect the SGD and INR to underperform*

The SGD is currently hovering around the top of the SGD NEER target zone. While we expect the SGD NEER index to strengthen 2% pa, the upward drift in the slope is relatively gradual, suggesting that at these elevated levels, the SGD becomes an attractive intra-regional funding vehicle. We note, too, the elevation of the INR REER at present. While the INR may appreciate in the short term as risk aversion fades, the EUR stabilises and FII inflows resume, balance of payments dynamics are becoming less supportive and INR strength will prove short lived, in our view.

## Asia credit: Shift towards liquid HY sovereigns

*Shift allocations incrementally towards the more liquid high yield sovereigns…*

Valuations for Asian credit have become more compelling in recent weeks, even as the fundamental backdrop continues to improve. Given current valuations and our altered view of the risk environment, we believe it makes sense to incrementally shift allocations towards the more liquid high-yield sovereign.

*… such as Indonesia, where structural reforms still have momentum*

Indonesian bonds have cheapened significantly in recent weeks. We are very constructive on the credit given low deficit and debt levels. The smooth transition in the finance ministry and the agreement on the power tariff hike reinforce our view that the country's structural reforms have sufficient momentum. Given our constructive view on the credit, quasi-sovereign bonds can be used as a way to pick up additional spread.

*Underweight Philippines – valuations are unattractive*

We recommend being underweight Philippines. While the Philippines benefits from a strong onshore bid for external debt and is a safe haven during times of volatility, current valuations are unattractive on a fundamental basis. We remain overweight on Sri Lanka and Vietnam, but would recommend trimming exposures given the strong performance these bonds have experienced and the lack of material positive catalysts.

# MARKET OUTLOOK: EMERGING EMEA

## Sailing close to the wind

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**Price correction and de-positioning have improved the EMEA market technical outlook. However, the proximity to the key market risk – Europe – continues to produce crosswinds for EMEA assets and tail risk trades warrant greater attention than usual.**

- We recommend receivers where there is a prospect of low-for-longer inflation and cautious monetary policy anchor yields. This provides opportunities for high carry/roll-down trades in EMEA. We see the greatest value in Turkey and Russia 2y bonds FX unhedged. We also recommend receiving Poland 2y IRS and Israel 5y IRS, with the latter likely to do especially well if global growth risks rise. We believe Pay 3X6 South Africa FRA has value given stretched valuations and the SA front end could be used to hedge receivers elsewhere.
- FX has become a more difficult place, but we do still see value in select bullish trades (RUB, TRY, UAH and EGP) and recommend blending them with tail risk trades (long TRY/ZAR and short HUF via options).
- In credit we look for selective longs where sound fundamentals argue for outperformance if more differentiation emerges. We recommend buying Turkey cash credit versus selling South Africa and maintain our long Russia credit recommendation. As a tail risk trade, we suggest buying 5y CDS protection on Lithuania (against selling 5y CDS protection on Croatia) and would add long Ukraine (Ukraine 11s, 13s, Naftogaz 14s) and long Cote d'Ivoire 32 positions for alpha.
- Low Sharpes. We use the past three months volatility to calculate the ex-ante Sharpe ratios in our favoured recommendations. Given the de-positioning swings that have taken place, volatility could easily be lower. Moreover, the recommendations benefit from the convergence of strong positioning characteristics (long Russia and Turkey local) and the risk profile on the key macro anchors (inflation and monetary policy).

**Figure 1: EMEA highest conviction trade recommendations**

| | Start | Target | Expected excess returns to Sept 10 | Expected Sharpe |
|---|---|---|---|---|
| **Thematic trades** | | | | |
| Credit: Buy Turkey cash versus sell SOAF cash | 248/180bp | 215/200bp | 3.0% | 2.2 |
| Credit: Long Russia | 242bp | 180bp | 4.5% | 0.9 |
| Rates: Rcv 2y PLN IRS | 4.57% | 4.00% | 1.4% | 2.5 |
| Rates: Rcv 5y ILS IRS | 3.80% | 3.50% | 2.2% | 1.8 |
| Rates/FX: Long Russia Jan'13 bonds funded 45:55 EUR,USD | 6.18% | 5.50% | 6.5% | 1.3 |
| Rates/FX: Long Turkey Mar'12 bonds funded 50:50 EUR,USD | 8.60% | 8.00% | 5.8% | 1.2 |
| **Alpha trades** | | | | |
| Credit: Long Ukraine | 572bp | 475bp | 5.3% | 0.7 |
| FX: Long UAH vs USD (rolling T-bill position) | 7.92 | 7.90 | 4.2% | 3.5 |
| **Tail risk trades** | | | | |
| Credit: Buy Lithuania 5y CDS, sell Croatia 5y CDS | 280/280bp | 240/340bp | 4.0% | 1.5 |
| FX: long EUR call/HUF 290-310 put spread | 280 | 310 | not applicable | -- |
| FX: Long TRY / short ZAR cash | 4.80 | 4.99 | 3.0% | 1.0 |

Note: Country credit spread levels are composite OAS levels. Source: Barclays Capital

*Deteriorating confidence in core-Europe may feed into anxieties about EMEA*

Linkages to Europe via trade or the banking sector may pose immediate risks for growth in parts of the EMEA region. While our baseline scenario is for the EMEA recovery to continue, deteriorating confidence in core Europe can feed into anxieties about the EMEA outlook and a negative feedback cycle, also via asset prices, cannot be neglected.

*The upshot is that policymakers in the region are likely to keep rates low for longer*

It is unlikely that policymakers will ignore these anxieties and with the improvement in the regional inflation outlook, we now look for the monetary authorities to keep rates low for longer. Governments' commitment to sound fiscal policies is a focal point for investors and while many part of EMEA are fiscally sound, the negative market reaction to the Hungarian government's initial comments on a wider budget deficit underscores the lack of manoeuvre on fiscal policy. If growth risks flare up, only monetary policy and FX can realistically take up the slack, making us more constructive on rates, more cautious on FX.

*Risk premia is still an issue in local markets, which cannot be ignored*

Receiving rates in EMEA still needs to be judged carefully. Risk premia shifts can still outweigh downward shifts in market expectations on monetary normalisation. The large budget deficits in the non-oil exporting countries have been funded by the market and increasingly by foreign investors. Poland has been at the forefront of this trend (around 70% of the YTD rise in stock of domestic bonds has been accounted for by foreign investors), but there have also been large inflows to South Africa, and to a lesser degree Hungary (40%).

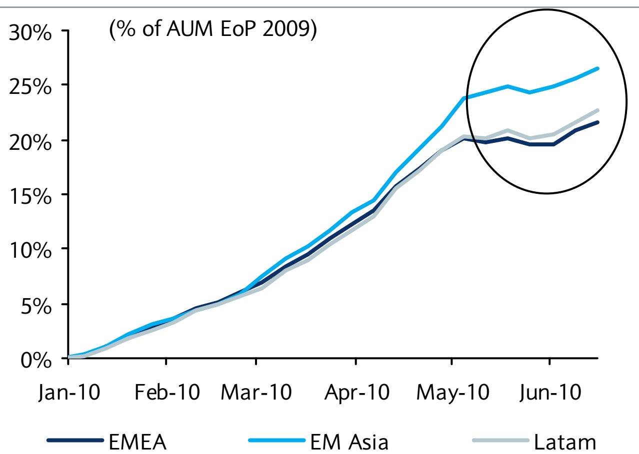
*Some re-allocations out of EMEA, but flows are picking up again*

Re-allocations out of EMEA bonds in May (and into EM Asia) reflect the growing scepticism towards the region. This reverses the catch-up trend of EMEA flows earlier in the year and as the risks from Europe are unlikely to vanish, continued scepticism could translate into more volatile EMEA flows. However, net flows in June have turned positive again and the recent unfavourable re-allocations means lighter positioning, which could provide some technical anchor for asset prices in the region. While delays in rate hikes should also support flows into local bonds, this is unlikely to benefit EMEA in particular as policy normalisation has been pushed back across EM (see Official Global Interest Rate forecast table).

*Tail risk trades deserve attention*

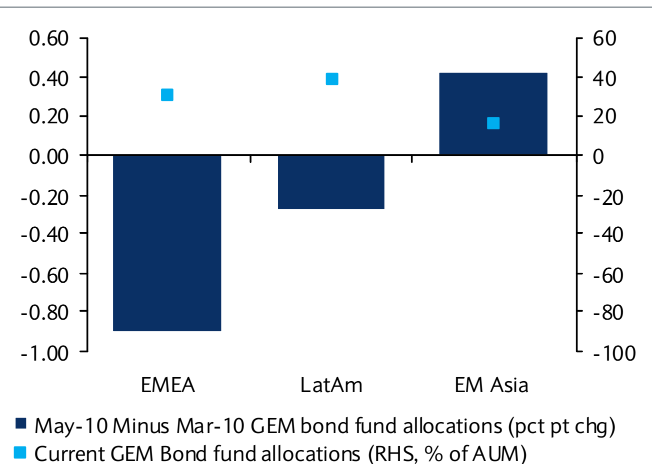
Alongside macro contagion avenues we will be monitoring the external funding climate for EMEA. Cross-currency basis swaps are a gauge of this and spreads on the most active tenors (1-2yrs) have re-widened to half of Mar'09 levels. A further widening would bring the issue of external debt rollover to the fore and would indicate a fall in foreigner appetite for local assets. We recommend tail-risk trades that lever on heightened investor concerns on these linkages, yet have limited downside on our core scenario of cautious risk-taking.

**Figure 2: Dip in May but flows have already picked up again (2010, YTD bond portfolio inflows)**




Source: EPFR global, Barclays Capital

**Figure 3: EM bond investor allocations to EMEA have fallen**




Source: EPFR Global, Barclays Capital

## EMEA rates: Lower for longer

The downside inflation surprises in EMEA have changed the landscape for monetary policy, both for market expectations and pushing out our own calls for hikes. Receiver positions have fared well under the lower-for-longer rates scenario and while local yields in some of our markets are near their lows (for 2010) there is not, in our view, an obvious trigger to push yields back up. Repeated bouts of risk aversion in recent months and the limited traction in local bonds, demonstrates some EMEA rates are mainly driven by local factors.

*Carry/rolldown is still high and bonds are cheap*

There are no major blackspots in the EMEA fiscal outlook and bond issuance is pretty much on track for most countries as well. Notwithstanding the fiscal developments, bonds continue to trade cheap on an asset swap basis. A part of this cheapness stems from the FX funding pressures/perceived counterparty risk in G3 markets, which has led some EMEA local banks to lock in FX funding via cross currency swaps by accepting a larger than usual discount on local libor cash flows in these swaps. This has percolated to lower interbank rates and IRS, if it sustains, short tenor bond yields should feel some natural gravity.

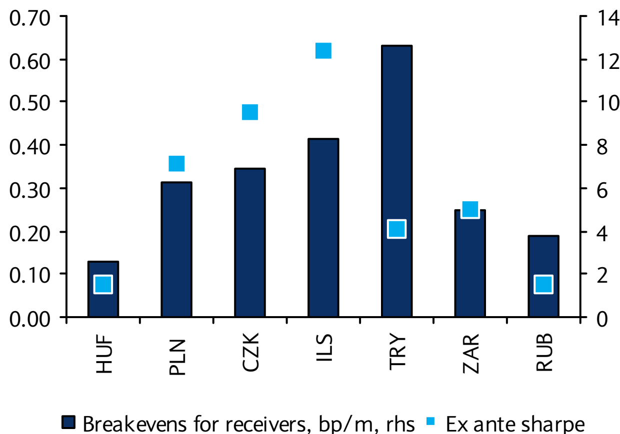
*Russia and Turkey, in our view, offer good opportunities to be long short tenor bonds, FX unhedged; technicals and monetary policy are supportive*

Our highest conviction views are to buy Russian (Jan'13) and Turkey (Mar'12) local government bonds FX unhedged. In Russia, there is still a window of opportunity for the Bank of Russia to cut interest rates and if the ruble remains under pressure to appreciate, the capital inflows should keep money market rates low. Turkish nominal bonds benefit from strong technicals, in particular light foreign positioning and aggressive hikes priced in by the market (starting soon and culminating in 200bp of increases by end-2011). We see a slower start to the hiking cycle, with a likely muted inflation outlook and perception of global risks offsetting – in the eyes of policymakers – the upward revisions on growth.

*Receive PLN and ILS rates*

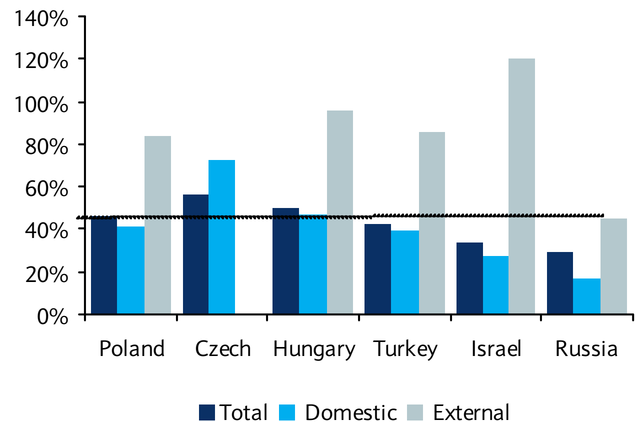
We also see value in being received PLN 2y and ILS 5y IRS, which benefit from significant carry/rolldown under a scenario of no change in the curves (see figure below). The Israeli rates position would actually benefit from a rise in global growth risks as the Bank of Israel is, in our view, one the most outwardly focused of the EMEA policymakers. Thus, the receive ILS 5y trade recommendation straddles both our core theme and the risk scenario.

**Figure 4: Carry/slide from receivers in swaps**




Source: Barclays Capital

**Figure 5: Government borrowing (gross) as % 2010 target***




Note:* Relative to the original target which might be revised such as in the case of Russia Source: Barclays Capital

## EMEA FX: The weight of uncertainty

External financing trends in the region are generally supportive but investor concerns that weighed on EMEA currencies in Q2 are likely to continue. It will be hard for investors to dismiss the tail risks to export growth and private external lending flows from Europe.

*Beyond exogenous risks looming over EMEA FX, FX intervention is an additional challenge for CE*

An additional risk is the high beta of EMEA FX to EUR/USD and on the latter, the risks are still skewed to the downside. The beta on CE currencies has increased, which underscores the weight that investors give to the aforementioned tail risks. FX intervention has become a widespread feature in the region. Although the interventions are aimed at pushing down FX volatility (stated goal of the Polish central bank), competitiveness and growth considerations are also factors. The Romanian central bank has regularly intervened in the market and the new Czech central bank governor is, in our view, more vocal against FX strength than his predecessor. Unlike Russia, where the central bank is leaning against a large current account surplus, FX intervention in CE is a factor skewing risk-reward on longs. Investors could use the background threat of intervention (CZK and PLN) to structure range trades.

*RUB, TRY and ZAR are likely to be less vulnerable particularly if EUR/USD swings can be neutralised*

Where we do see scope for modest spot gains is on the RUB, TRY and to a lesser degree, the ZAR. They have attractive bond markets and fewer fundamental contagion channels (from core Europe) than their CE peers. A key factor here – particularly on the RUB and TRY, is positioning. The modest setback in both RUB and TRY during the May sell-off is testament to the impact of the 'local bid' for both currencies. We favour being long both currencies, out of EUR and USD to neutralise the impact of future swings in EUR/USD.

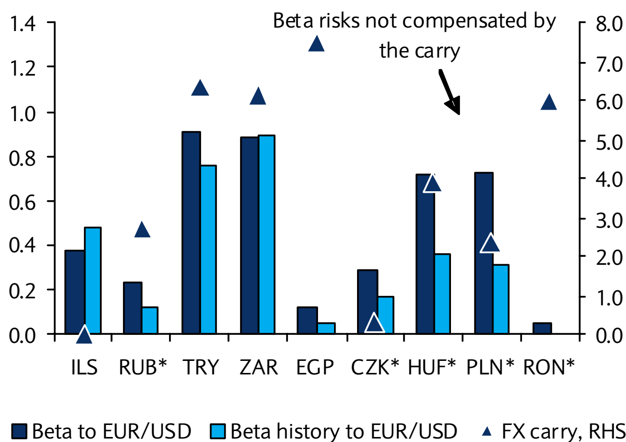
*Tail risk trades – Buy a EUR call/HUF put; go long TRY/ZAR*

In this quarterly we put more emphasis on tail-risk trades and recommend owning a low delta HUF put/EUR call given that we expect Hungarian markets would be the most vulnerable to a sustained period of risk aversion. We also favour long TRY against ZAR. Although we are constructive on both, the risk scenario of weak global growth and commodity prices would likely hit ZAR more than TRY. In addition, Turkey has only moderately benefited from portfolio flows that South Africa has already enjoyed.

*UAH and EGP remain our core FX alpha trades*

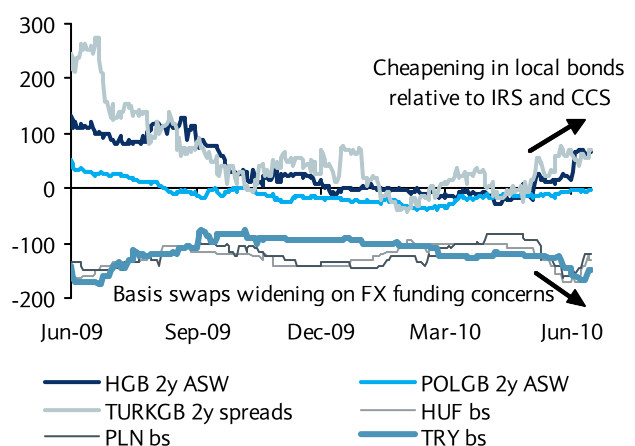
Our alpha trades in FX are to be long UAH and EGP (versus a basket of EUR and USD). Both are highly managed currencies with high carry and low beta. BOP fundamentals for both have improved, reinforcing the credibility of the central banks there to keep FX stable.

**Figure 6: Anxiety on euro area risks weigh on CE FX where the 'shield of carry' is slim**




Source: Barclays Capital

**Figure 7: Basis swaps widening in CCS indicates concerns over a future external funding squeeze (bp)***




Note: * Basis swaps vs EUR for PLN and HUF. USD for TRY. Source: Barclays Capital

## EMEA credit: Sharpening the pencils

Although exogenous risks for EMEA credit from core Europe have not vanished and volatility is likely to remain elevated for some time, new valuations, on a relative and absolute basis, have created opportunities, in our view.

*Selling SOAF cash versus buying Turkey, long Russia are our fundamentally-driven benchmark recommendations*

Among our fundamentally-driven, thematic recommendations, we highlight our switch recommendation from South Africa credit into Turkey credit. While in South Africa, fiscal concerns are on the rise, Turkey is outperforming fiscally, driven by a strong rebound in growth. It looks again like Turkey is on a firm path towards investment grade ratings in the medium term. We also reiterate our overweight stance on Russia credit. The debt metrics are rock-solid, in our view, although Russia remains a high-beta credit exposed to fluctuations in global risk drivers and commodity prices.

*We recommend going long Ukraine, Cote d'Ivoire for alpha…*

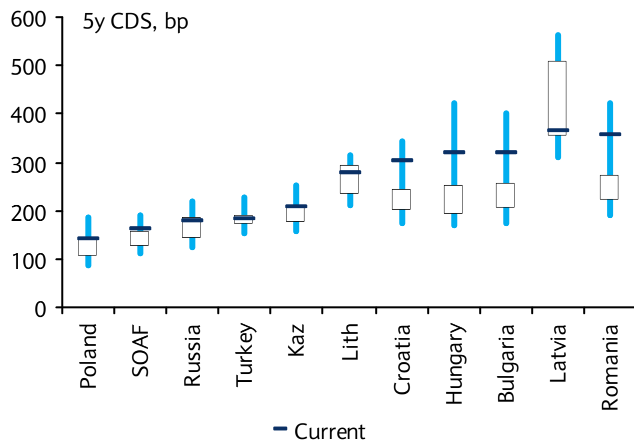
*…and long CDS protection on Lithuania versus short CDS protection on Croatia as a tail-risk trade*

We also continue to like Ukraine credit. The still comparatively high spread carry, coupled with a low correlation to global risk drivers, continue to argue for overweight positions, in our view. Looking towards more exotic credits for alpha, we see some further potential upside in the Cote d'Ivoire 32 bond, although political developments there need to be monitored closely. In the CE space, opportunities have crystallised on relative value considerations. We are taking a constructive stance on Croatia and recommend selling 5y CDS on Croatia versus buying 5y CDS on Lithuania. The latter's lack of an external anchor for fiscal discipline and the strong reliance on capital markets to finance the sizeable budget deficit may make it vulnerable if credit markets remain wobbly in a prolonged and intensified period of risk aversion. In CE cash credit, we would highlight the Poland USD 19 and Romania EUR 15 bonds as cheap on a relative value basis versus CDS and versus peers in the region.

*A light supply schedule in H2 should provide support for EMEA credit*

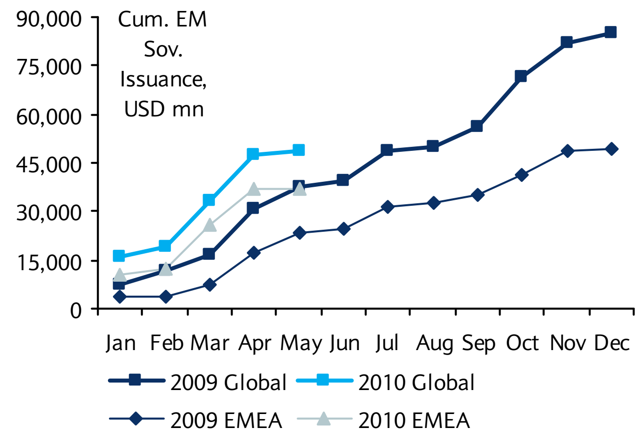
As a supportive factor for EMEA credit in general, we would finally point out the outlook for light supply. Most major issuers in the region have used the favourable conditions earlier this year to front-load their issuance plans to meet 2010 financing needs. While H2 10 may see some maiden eurobond issues from a number of countries, eg, in north and sub-Saharan Africa, and several others such as Kazakhstan and even Ukraine returning to the market, we would also expect the shift towards local funding to continue.

**Figure 8: Spread volatility in CEE has created opportunities**




Note: Box plots show 6m historical trading ranges with 25-75% inter-quartile range and current levels. Source: Markit, Barclays Capital

**Figure 9: EMEA YTD issuance at 67% of our 2010 forecast**




Source: Barclays Capital

# MARKET OUTLOOK: LATIN AMERICA

## Reassessing risks

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**We remain comfortable with risky assets in Latin America, particularly in credit and FX, but we are keeping an eye on hedging strategies and relative value. In low beta credit space, Colombia remains our favourite pick, and we prefer Argentina over Venezuela. In FX, we favour CLP and MXN longs against EUR. We see upside risks in the level of rates: we like paying 2y IRS in Chile, buy 1y breakeven in Brazil and pay 10y IRS in Mexico.**

- In the credit low beta space, we recommend relative value strategies. The large correlation validates mean-reverting behaviour of the spreads: we prefer Colombia (via CO'41s) versus the others.
- Keeping an eye on hedging strategies, we recommend taking exposure to Venezuela bonds, hedging the default risk by entering a "default neutral" basis trade. We would implement the strategy with the cheap VE'28s, VE'34s, VE'38s and VE'24s bonds.
- Argentina should continue outperform Venezuela. We would implement an outright long position on the short part of the curve, particularly via the Bonar '13s. EUR discount is extremely cheap to the curve and relative to CDS.
- In the Caribbean region, we recommend the Dominican Republic outright or relative to El Salvador for which we have an underweight position. We like DR'18s and DR'27s.
- FX positioning has improved significantly. With lower financial volatility, we favour CLP and MXN longs against EUR. BRL is the wild in this environment, so better to position for politics-induced depreciation pressures via financed USD call spreads.
- Key LatAm countries differ in their positions in the business cycle. However, we see upside risks in the level of rates in Chile, Brazil and Mexico. We thus like paying 2y IRS in Chile, buy 1y breakeven in Brazil and pay 10y IRS in Mexico.

### Credit: Still comfortable but keeping an eye on hedging strategies

LatAm spreads remained anchored during last quarter's volatility, a sign that the fundamentally strong but tight credits in the region were once again safe havens to weather the most recent euro periphery credit storm. Incidentally, the 2s5s CDS curve slopes that are usually an initial gauge of market anxiety have already normalised. Not surprisingly, the notable exceptions have been Venezuela, Argentina and some names in the Caribbean region that are trading at very attractive levels. While we continue to believe spread compression remains intact on a strong growth recovery, relatively solid fiscal accounts and limited supply, we recommend investors keep an eye on hedging strategies and relative value trades.

*Relative value strategies are suitable for our low beta universe: we favor Colombia*

Relative value strategies are particularly suitable for our low beta names, especially given their large correlation that validates mean-reversion behaviour of the spreads. As highlighted in *Colombia: Give me some credit!*, May 27, 2010, Colombia's spreads had been particularly penalized during the recent sell-off, particularly relative to Brazil and Mexico at the long-end of the bond curve. With election risk off the table and a somewhat benign fiscal outlook, we expect a re-pricing of growth expectations and a potential rating upgrade. We recommended investors take spread-DV01 exposure via CO41s – while the trade has worked, we do not see any strong catalyst to reduce exposure, especially given the higher carry.

A particular eye has to be kept on hedging strategies especially for high yielders where the mark-to-market volatility was large during the last two quarters and may continue during the next one. Venezuela is a credit where we find attractive potential though, because of global and idiosyncratic risks, we also remain cautious.

*We recommend "default neutral" basis trade in Venezuela*

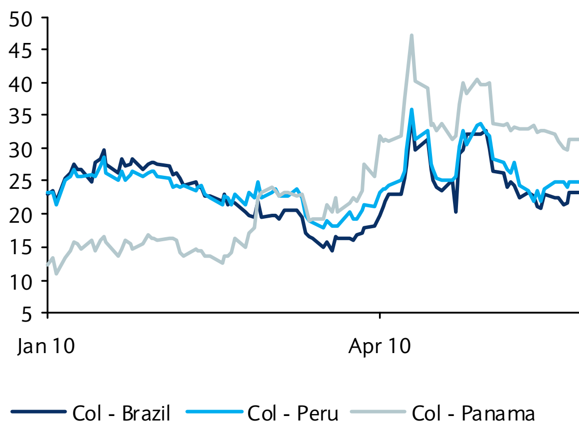
In *Venezuela: Expropriation and FX overvaluation: A perilous game*, June 11, 2010, we highlight our concerns and suggest that the best trading strategy is to go long low dollar price bonds hedging the default risk via 5y CDS – essentially a "default neutral" basis trade. To determine the hedging ratio, first we assume that any default will not occur before 2013 (ie, before the election) receiving coupon payments until this date. Then we assume that the recovery value will be 30 cents on the dollar (we refer to our publication for details). We recommend investors hedge with 5y CDS the notional difference between the dirty price and the sum of the coupon and the recovery value. The result of this exercise is in Figure 3. VE 28s, VE 34s, VE 38s and VE 24s remain the cheapest bonds with which to implement the "default neutral basis trade".

*Argentina remains one of our favorite picks, and we do not recommend a costly hedging strategy*

In Argentina, we maintain a more positive stance and do not recommend implementing a costly hedging strategy, at least for now. Despite the recent outperformance, we think the credit will continue to do better than Venezuela. Since Argentina's bonds suffered significantly during the recent sell-off, we think that with a relatively clear horizon in terms of idiosyncratic news the credit should perform very well. However, in line with our cautious approach, we favour trading strategies that take exposure to the short part of the curve in particular the Bonar '13. We also like to take some convexity exposure through the EUR warrant outright or relative to the USD warrant. For investors who want to increase duration we highlight that the EUR discount remains extremely attractive and has a very large negative basis; a potential strategy would be to implement a positive carry default neutral basis trade.

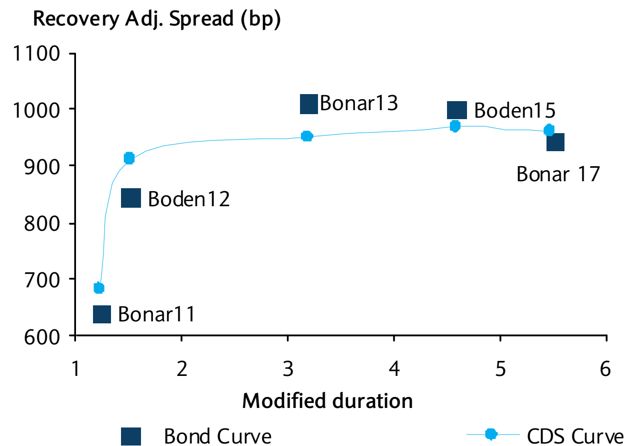
The recent global sell-off has created some dislocations in the front end of Argentina's curve. While in this kind of risk episode one would expect the credit curve to flatten or even to invert, two of the short-dated bonds, Bonar 11s and Boden 12s have been very well anchored relative to slightly longer bonds such as the Bonar 13s and Boden 15s. This implies the bond curve is steep on the short end and flattens or inverts thereafter. In particular, the Bonar 13s trades 400bp wider than the Bonar 11 on a recovery-adjusted spread for a duration extension of only 1.9 years. In contrast, Venezuela's short-end bond

**Figure 1: Colombia 5y CDS relative to other low beta names**




Source: Barclays Capital

**Figure 2: Argentina local law curve very steep on the front end**




Source: Barclays Capital

curve (VE 13 VE 10) is only 150bp steep. We stress that the recovery-adjusted spread takes into account the dollar price of the bonds and, for our purpose, we assume a recovery value of 25%. We prefer the Bonar '13 to Boden '15s. While Bonar '13s have a higher dollar price (in the 80s) than the Boden 15s, its shorter maturity may attract flow from holders of Bonar '11s and Boden '12s who do not want to take DV01 exposure. On the long end of the curve, the EUR discount remains extremely cheap and buying the basis (default neutral) is also an attractive trade for investors who do not want to take a large convexity exposure outright.

*Dominican Republic is our favorite credit in the Caribbean*

Finally, another compelling story in the Caribbean region that can be explored outright or relative to other credits is the Dominican Republic. As we highlight in the regional section, the country's fiscal situation is extremely solid and growth prospects have improved, especially following the Haiti reconstruction and investment to develop the Pueblo Viejo gold mines In addition to its high beta nature, this credit is limited by its historical volatility, which includes several episodes of political and monetary instability – as recently as 2005 the Dominican Republic was forced to restructure. Overall, we remain constructive given their solid balance sheet and lean towards an overweight position. As investment strategy, we believe the DR'18s and DR'27s look attractive relative to the new DR'21s since issuance has outperformed the rest of the curve. Within the region, we have an underweight position on El Salvador. Those accounts not comfortable taking an outright position in the Dominican Republic should consider a relative value trade against El Salvador.

**Figure 3: Venezuela bond valuation based on the restructuring value**

| Bond | Coupon (A) | Dirty price (B)* | Coupon leg (C) | New 30y bonds leg (D) | Estimated restructuring value (E) = (C)+(D) | Notional to hedge (F)=(B)-(E) | Current yield (A)/(B) | Cost of protection | Restructuring neutral yield (G) |
|---|---|---|---|---|---|---|---|---|---|
| VE 18N | 7.000% | 62.40 | **20** | 30 | **50** | 12 | 11.22% | 1.50% | 9.72% |
| VE 19 | 7.750% | 65.30 | **22** | 30 | **52** | 13 | 11.87% | 1.66% | 10.21% |
| VE 23 | 9.000% | 67.60 | **22** | 30 | **52** | 16 | 13.31% | 1.97% | 11.34% |
| VE 24 | 8.250% | 63.40 | **21** | 30 | **51** | 12 | 13.01% | 1.50% | 11.52% |
| VE 25 | 7.650% | 59.80 | **17** | 30 | **47** | 13 | 12.79% | 1.57% | 11.22% |
| VE 27 | 9.250% | 74.50 | **25** | 30 | **55** | 20 | 12.42% | 2.41% | 10.00% |
| VE 28 | 9.250% | 66.70 | **23** | 30 | **53** | 14 | 13.87% | 1.69% | 12.18% |
| VE 34 | 9.375% | 69.70 | **25** | 30 | **55** | 14 | 13.45% | 1.78% | 11.67% |
| VE 38 | 7.000% | 56.60 | **20** | 30 | **50** | 6 | 12.37% | 0.77% | 11.60% |

Note: *As of 18 June 2010 bid. Source: Barclays Capital

## FX: Supportive technicals

*Positioning is supportive of key LatAm currencies…*

Improved positioning is a key legacy of Q2 (Figure 4). The magnitude of the reversal of foreigners' net short USD/BRL exposures in BM&F between May and early June is comparable to what happened in mid-2008. Relative to late April shorts, current net long USD positions among foreign institutions are BRL-supportive. In Mexico, non-commercial net short USD positions versus MXN have declined more than in mid-2008. Current USD/MXN shorts are small vis-à-vis late-Q1 levels. In the case of Chile, local pension funds' short USD/CLP forwards against local banks remain below late-April levels. In the options space, although recovered from recent highs, risk-reversals remain skewed towards depreciation, particularly so for the USD/BRL. The 3m 25-delta risk-reversal for USD/BRL trades more than two vols above May 3 levels when risk aversion jumped higher, while they trade 1.5 vols below May 3 levels in MXN, COP and CLP. Finally, price action against EUR around mid-May suggested less crowded positioning for CLP and COP: while strong

liquidation took place in EUR/BRL and EUR/MXN (with sell-offs close to 6% in a few days), EUR/CLP and EUR/COP rose less than 3% and 4%, respectively.

*…and the volatility outlook looks supportive for longs in Q2*

Meanwhile, the volatility outlook is FX supportive. To the extent global financial conditions continue to normalize, we expect FX implied vols to keep their downward trend. For example, if VIX recovers to 20%, MXN's 3m implied vol may rally the most, followed by BRL's and CLP's. The spread between BRL and MXN vols could rise more than three vols (2.5 now) as the market pays more attention to Brazil's political context.

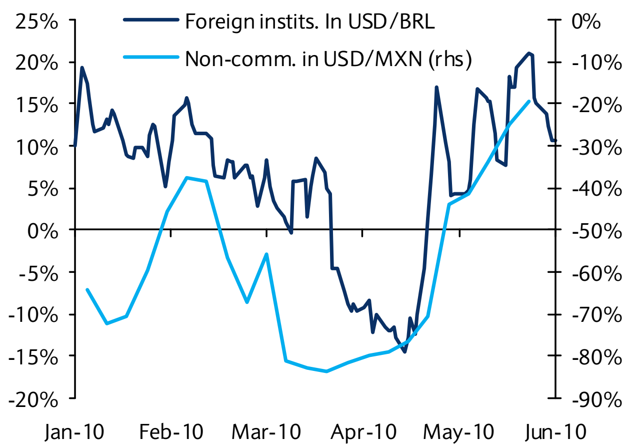
*We favor MXN and CLP, particularly against EUR*

Given cleaner positioning and a supportive vol outlook, conditions are adequate for tactical longs. We favour MXN and CLP, although we see potential for USD/COP to remain supported on growth prospects and less intervention. Recently improved growth expectations provide less room for positive surprises regarding Mexico's GDP expansion this year, though we remain more bullish than the consensus. With lighter risk positions globally, EUR/USD's fundamentals-driven path lower (Barclays Capital base forecast: 1.20 in 3m) may occur without as much disruption as in May. Considering Europe is not a key trading partner of Chile or Mexico, the aforementioned conditions call for longs against EUR. We re-establish a EUR/MXN short (target: 14.40) and remain short EUR/CLP (target: 615). Although the latter has suffered from being a funding currency, its improving carry profile as the BCCh continues to normalize monetary policy (while the ECB remains on hold for longer) bodes well for EUR/CLP shorts into Q3.

*USD/BRL: wild card for Q3 on supportive technicals…*

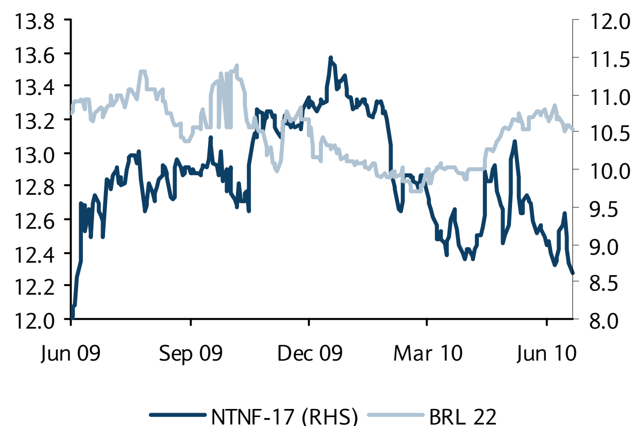
With better positioning and over-heating risks (reinforcing the carry argument), BRL is the wild card in an environment of low risk aversion. Yet, to the extent political noise would be rising as the presidential campaign intensifies (media campaigning starts on August 17), amid uncertainty about candidates' economic views and considering BCB's interventionist bias, we believe risks of a sustained rally below 1.75 are limited. We are positioned bearish BRL via a USD call spread (strikes: 1.90/2.10) expiring in mid-October ("Brazil: Hedging tail risks", *The Emerging Markets Weekly*, January 15, 2010).

**Figure 4: Short USD positions versus BRL and MXN**




Source: Bloomberg, Barclays Capital

**Figure 5: Global BRL bonds have lagged the rally**




Source: Bloomberg, Barclays Capital

*… but we retain a bearish stance: financed 5m USD call spreads attractive*

Investors not yet positioned for politics-induced upward pressures on USD/BRL could buy a USD call spread (expiry: Nov 12 to account for risks that political noise remains through the second round of voting on October 31): buy a USD call/BRL put (strike: 1.90; prem: 3.0%); sell a USD call/BRL put (strike: 2.05; prem: 0.83%), with spot/fwd refs at 1.77/1.835. To finance the structure, sell a USD put/BRL call (strike: 1.75; prem: 2.18%). If USD/BRL rallies below 1.75 on a sustained basis (key risk for the structure), the 1.75 USD put could be bought back at cheaper prices because it could be accompanied by lower volatility levels. On the other hand, in case USD/BRL actually rises to our target range, the position would remain short vol (the 1.75 USD put would be worthless) in a context where volatility would likely be increasing. In our opinion, chances are low that any candidate will jeopardize Brazil's strong policy and economic fundamentals and thus drive the BRL above 2.20.

## Rates: Different speeds

As has been the case recently, the dynamics of LatAm rates should remain driven by factors (global and domestic) affecting how the business cycles evolve in coming months. While overheating concerns in Brazil were tamed by recent questions over the potential impact of Europe on the country's growth prospects, domestic demand remains very strong and inflation risks are non-negligible. While not in overheating terrain, Chile's economy already shows that the earthquake only had temporary effects on the recovery. Although Mexico's economy is not yet in such an advance state of the cycle, the market seems complacent regarding monetary policy and rates are too low. Technicals have compounded these effects in the long end. Positioning for upside risks in these markets makes sense, in our view.

*Cheap 1y BE inflation in Brazil: pay Jul11s; receive May11 NTNBs*

In Brazil, we do not rule out higher inflation expectations once the ongoing food disinflation trend ends (beyond declining food prices, inflation dynamics remain strong) and in light of prevailing growth momentum. We reckon 1y BE inflation (Jul11 DI versus May11 NTNB) is cheap at about 5%. Food-related downside risks to inflation pushing m/m readings lower in the near term indicate risks of better entry points. That said, we recommend building a long 1y breakeven position: pay Jul11 DI (ref: 11.92%), buy May11 NTNB (ref: 6.54%). Given our view for IPCA y/y inflation to rise to 5.80% in 12m (versus 4.76% in surveys) and even assuming some decline of inflation premia, 1y breakeven should rise to 6.0%. Regarding the DI curve, our risk-adjusted base path for Selic (two more 75bp hikes) implies Jan11s and Jan13s trade fair (ref: 11.95% and 12.28%) and that the Jul11-Jul12 segment of the DI curve is about 20bp. However, if the external context remains calm, growth momentum and inflation risks may lead the market to price in larger-than-75bp hikes and/or larger cycle.

*Global BRL bonds offer attractive entry points to get structural exposure to Brazil's rates market*

From a medium-term perspective, we still like long positions in Brazil's long-end rates. Better policy management should translate into structurally lower risk premium, especially considering that the BCB would resume efforts to bring Selic significantly lower. Moreover, with looming fiscal risks in some developed countries, global investors may increasingly look at Brazil's elevated yields as an attractive place to invest. In this context, long positions in global BRL bonds offer an interesting opportunity ("Brazil: Tactically bullish on global BRL-denominated bonds", *The Emerging Market Weekly*, May 27, 2010). While they provide lower carry than NTNFs (NTNF17's IOF-adjusted yield is c.150bp above BRL22's yield), they have lagged the recent rally, suggesting a sizable risk premium remains priced in. Moreover, with risk appetite returning, there is room for global investors to replenish their holdings of global BRLs after May's liquidation. We stress that investors in Asia (particularly Japan, which have tax advantages in buying these bonds) take exposure to Brazil's rates and FX markets through these bonds. We prefer the BRL22, which remains very attractive vis-à-vis NDF yields.

*Keep 2y Camara payers in Chile; we see risks for 2y breakeven inflation to rise*

In light of BCCh's surprise 50bp hike, we now believe there could be similar moves (not fully priced in) in the next four meetings before slowing the pace to 25bp (policy rate at 6% in Q4 11). However, we acknowledge risks that BCCh could finish the tightening cycle closer to the low end (5%) of its definition of neutrality or, due to potential financial jitters, decide to slow the normalization cycle. In a smaller, slower cycle, the 2y Camara would already be trading fair. For now, we do not think the central bank is putting too much weight on the latter scenario, so remain paid in 2y Camara (target: 4.05%). On the inflation front, median inflation expectations are at 3.0-3.2% in 1y-2y (below our 3.45-4.05% view). Even assuming that inflation risk premia declines somewhat as data are released (diminishing uncertainty), we believe 1y breakeven inflation is just a bit too high now (3.58%). In contrast, we see some potential for 2y breakeven to rise from 3.40% to better reflect Chile's inflation outlook.

*Mexico: Pay 10y TIIE*

We reiterate our recommendation to pay 10y TIIE outright *(Mexico: Pay 10y TIIE;* June 11, 2010). Besides removing priced-in tightening on generally positive inflation surprises since Q4 and Banxico's dovish stance, long-end rates have been supported by momentum from Mexico's inclusion to the WGBI. We believe the rally is overdone and, relative to our risk-adjusted base view on monetary policy, the TIIE curve is, on average, 60bp expensive. Unless one assumes Banxico raises the O/N target rate only to 5.5% next year, it is difficult to justify 10y TIIE at 7% as some investors believe. With un-anchored inflation expectations (relative to the 3% official target) and the output gap closing (albeit more gradually than in other LatAm countries), we expect Banxico to start the normalization cycle in January and attach a low probability of a delay well beyond March. Relative to other segments of the TIIE curve, we prefer to pay the long end of the curve.

# EM CORPORATE CREDIT OUTLOOK

## New issuance takes a vacation, but solid fundamentals remain

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**We view the recent pullback as an opportunity to add corporate exposure, given the strong fundamental backdrop, but expect credit differentiation to gain importance when technicals ease. Corporate liquidity, earnings and commodity prices are likely drivers.**

### Risk repricing provides opportunities in EM corporates

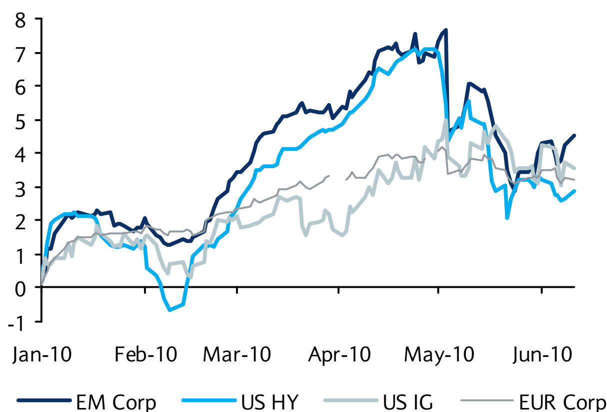
The environment for risk assets turned challenging in 2Q10, but on a total return basis the Barclays EM Corporate index outperformed the US HY, US IG, and Euro corporate indices (Figure 1). Away from macro risk factors, liquidity, earnings and commodity prices are the three themes that are likely to drive idiosyncratic performance, in our view.

With risk aversion increasing in recent weeks, issuance volumes have declined significantly. Thus far in 2Q10, $27.3bn in EM corporate bonds (including financials) has been issued, down from $41.8bn during 1Q10. While onshore liquidity (from banks) remains high across EM, local bond markets do not have the depth to provide large issuers with the liquidity and tenors typically available in external capital markets. Also, with local rates increasing, the onshore option could become less attractive for issuers, and we expect some to bring bonds during periods of stability. That said, many corporates pre-funded their needs last year and in 1Q10, making refinancing risk less of a concern. It is important to note that despite the drop off in issuance volumes, flows into emerging market bond funds remain positive.

Strong growth across emerging markets has translated into an upward trajectory for corporate earnings. At the same time, many EM companies have been conservative, choosing to use cash flow to decrease leverage rather than undertake shareholder-friendly transactions. M&A activity in EM corporates has been significantly lower than in the US and Europe, and we expect most transactions to have limited credit implications.

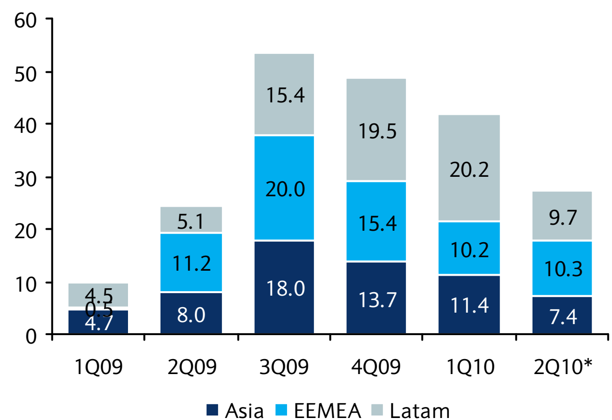
Commodity prices, which have been a driver of strong corporate earnings, dipped in recent weeks; nevertheless, they remain high relative to historical averages. Many of the companies in our coverage universe are exposed to commodity prices from the revenue or cost side, and we explore nuances in the regional sections.

**Figure 1: YTD Bond index total returns (%)**




Source: Barclays Capital

**Figure 2: Corporate and financial issuance by region, $ bn**




Note: *Up to June 11, 2010. Source: Bond Radar

## Asia

*Issuance dried up with increased risk aversion and an overhang of issuance in April…*

After a strong beginning to Q2, issuance in Asian corporates dried up in mid-May. Increased risk aversion, coupled with an overhang of paper from issuance in April, led to a swift deterioration in market sentiment. QTD issuance stands at $7.4bn versus $11.4bn for Q1. The decreased appetite for new issues is unlikely to translate into stress for Asian issuers. High grade issuers have significant cash balances and access to bank lines on favorable terms. Most high yield corporates have sufficient liquidity. Moreover, access to local debt markets remains open. Companies with flexible capex requirements/plans may delay upcoming refinancing needs, and some companies have the flexibility to redeem upcoming bonds maturing in 2011 with internal resources, rather than refinance them, if market sentiment continues to remain weak.

*… decreased appetite for new issues is unlikely to translate into stress for corporates*

*Commodity price fluctuations will remain predominantly a source of equity volatility*

Unlike LatAm and EMEA, commodity producers are a smaller portion of Asian credit. We view the region as a potential safe haven in the event of increased volatility in commodity prices. On the whole, we believe the credit profiles of most Asian corporates (non-utility sector) are buffered from price moves through local government regulations, hedges and/or arrangements to pass through costs. Across our coverage universe, we would be most concerned with the impact of increases in the prices of oil, gas and coal for the utility sector. Higher rubber prices could have an effect on high yield tire producers (Figure 3). Indonesian coal miners could benefit from a long-term increase in the price of coal. Overall, we believe commodity price fluctuations will remain predominantly a source of equity volatility.

*Indonesian coal mining companies remain strong*

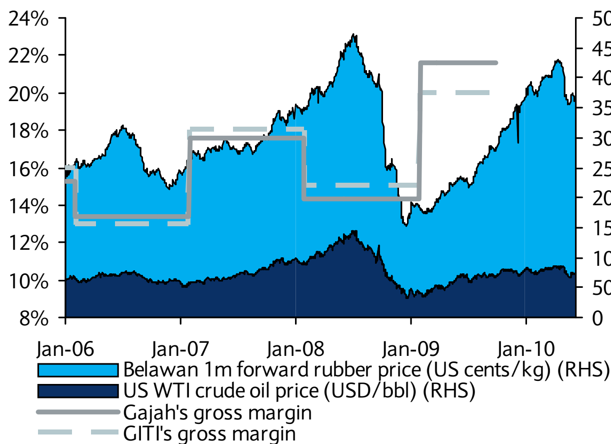
*We prefer larger and more diversified Chinese real estate issuers*

At a sector level, in high yield, we expect earnings for Indonesian coal mining companies to remain strong, given that coal prices have remained high this year. From a credit perspective, the focus for Chinese real estate companies will be on the extent to which sales momentum has declined and how liquidity could be affected. We believe the coming months will see increased differentiation in this sector, and we favor the larger, more diversified Chinese real estate issuers, with stronger liquidity and more conservative growth strategies.

*Bank capital securities are supported by strong fundamentals and benign technical backdrop*

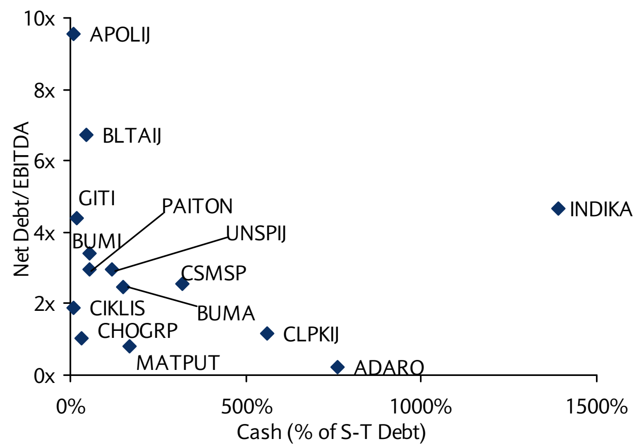
In high grade, we expect strong fundamentals and the benign technical backdrop to provide ongoing support for bank capital securities across the region. The recent market pullback has presented attractive entry levels into these securities. Korean regulators' new limits on foreign-currency borrowing for domestic purposes could alleviate the longstanding technical imbalance in the Korean quasi-sovereign sector and ultimately tighten spreads.

**Figure 3: Tire producers vulnerable to high rubber prices**




Source: Bloomberg, Barclays Capital

**Figure 4: Liquidity versus leverage for Asian HY companies**




Source: Barclays Capital

## CIS corporates

*The CIS region underperformed in a volatile market*

This sub-segment of our coverage universe exhibited a high level of volatility during the past two months. Gazprom, in particular, was one of the weakest performers within the investment grade EM corporate universe during the spread widening.

Looking at fundamentals, we are comfortable with most of the CIS corporate universe. Our economists have a positive view on Russia, and our commodities analysts maintain a constructive view on oil and metals prices.

At a micro level, most CIS corporates reported relatively strong 1Q10 results. Companies in the oil and gas sector showed solid improvement after oil prices doubled from Q1 09. Mobile operators delivered solid results, supported by RUB strength, illustrating again the resilient nature of their business. Mining and metals issuers showed improved performance against easy 2009 comparables, although the recovery of this sector has been slow.

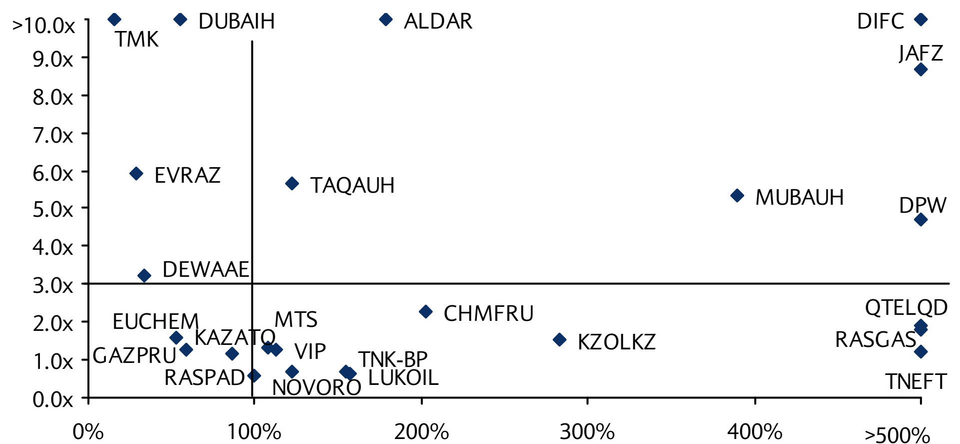
*The risks are external so access to financing is the first line of contagion*

With this in mind, it is not local fundamentals but external market risk that is most concerning at this stage. If this persists, the first symptom is likely to be restricted access to financing, in our view. Russian corporates and the sovereign issued $6.2bn of bonds during the first six weeks of the quarter, but there has been no issuance since, highlighting the strains in the market (the exception was MTS which issued a $750mn 10y deal as we were going to print but had to offer a significant concession).

In Figure 5 we look at the liquidity positions of corporates under our coverage and their leverage to gauge their exposure to the risk of continued market volatility or further deterioration in financial markets. The names in the top left quadrant carry the highest risk, and in Russia, unsurprisingly, the metals and mining sector stands out as the most exposed. Having said this, we have little doubt that the government would once again provide liquidity support to its flagship corporates if this becomes necessary.

With the above in mind we recommend defensive positioning with names with strong fundamental characteristics and solid liquidity profiles. Our preferred names in the Russian corporate universe are Gazprom and Vimpelcom.

**Figure 5: EEMEA corporates – Leverage (ND/EBITDA) vs liquidity (cash/short-term debt)**




Note: Based on most recent available financials; data not adjusted for post-balance sheet events.
Source: Barclays Capital

## GCC corporates

*A safe haven in a volatile market?*

Abu Dhabi and Qatar corporates maintained their safe-haven status during the widening, given their high ratings and quasi-sovereign nature. News flow from the region was limited, but many benefit from high oil prices, limited exposure of most of the Abu Dhabi and Qatar corporates to refinancing risks and technical support from domestic investors.

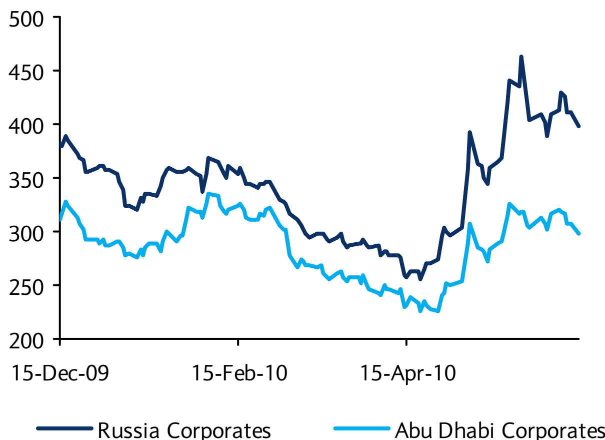
Dubai corporates' results came in unsurprisingly weak – DIFCI and DHCOG both received help from the government. However, investors were comforted by DHCOG management's assurances that bond restructuring will not be necessary. While the repayment of Nakheel's 2010 sukuk in May was one step, Dubai World's loans traded in the mid-50s. With final terms still to be confirmed, and given that Dubai Holdings entities are just starting their restructuring, the process is far from over.

Given this situation, issuance from the region has been subdued. The success of Dubai's DEWA issue demonstrated that investors value strong fundamentals. On the other hand, SABIC – a fundamentally solid Saudi story and the only other issuer from the region to approach the market – had to postpone its deal. We expect SABIC to try to complete its deal if markets stabilize in the near term, but on the whole, we expect limited issuance from corporates in this region.

We believe the region's outperformance is partly a result of its strong idiosyncratic drivers, as well as its underperformance in the Q1 10 rally. Of course, the Gulf is far from immune to wider market developments, and Dubai is especially exposed if market volatility remains elevated or increases, given that the sovereign is looking to tap the markets in order to support the country's weaker corporates through the restructuring process.

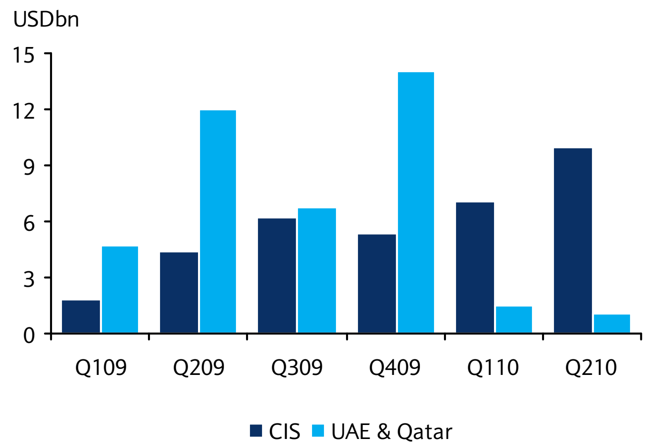
In this environment we recommend fundamentally strong names, and our top pick in the region remains Dolphin Energy. We also like Aldar from a risk/return perspective, given our belief that Abu Dhabi's government is highly likely to provide support to its flagship property developer if this becomes necessary.

**Figure 6: Russian vs Abu Dhabi corporates**




Source: Barclays Capital

**Figure 7: EEMEA corporate and sovereign bond issuance**




Source: Dealogic, Barclays Capital

## Latin America

*Pullback creating opportunities in Latin America, as intrinsic analysis becomes more relevant*

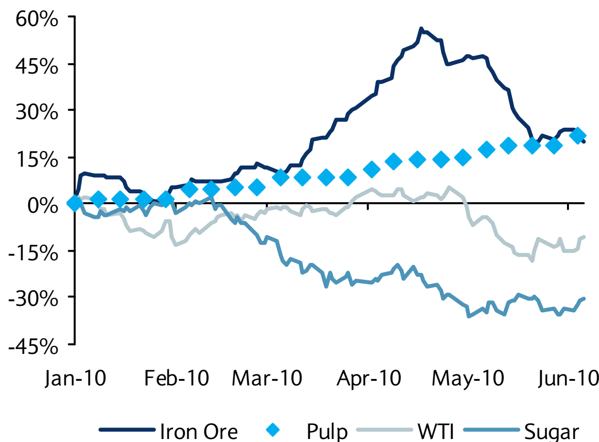
Earnings performance in Latin America has varied but generally has been solid thus far in 2010, bolstered by strong commodity prices and robust regional and global growth. However, macro concerns in Europe and China, as well as financial regulation and higher funding costs have weighed on markets, commodities and the general earnings outlook recently. We believe the sell-off has created opportunities in the LatAm corporate space given our constructive view on growth. We encourage investors who took our advice from the March EM Quarterly – to do homework in advance and buy with conviction on pullbacks – to act now. We believe credit differentiation will continue to increase in importance as technical factors ease, in which case fundamentals will support selective credits.

Corporate liquidity risk is regaining importance, as access to capital markets has diminished and local rates are on the rise. During 2Q10 several Latin American deals were pulled from the market, including Elementia, Odebrecht, IRSA, and Banco Cruzeiro do Sul. While it is difficult to say how long the new issue market will remain on hold, we expect these deals to resurface in 2010, along with a modest pipeline. We also expect the cost of local-currency funding to rise further this year. Brazil hiked rates 75bp in April, and Peru and Chile followed with 25bp and 50bp hikes, respectively. Our economists forecast rates will rise further this year in Brazil, Peru, and Chile, followed by Mexico and Colombia in early 2011.

Many LatAm credits took advantage of favorable market conditions earlier in 2010 and 2009 to take care of refinancing needs – Cemex, America Movil, Axtel, Columbus International, Digicel and Magnesita are good examples. Conversely, some credits may face liquidity challenges. We estimate Su Casita faces a $109mn cash shortfall in 2010 and another $119mn in 2011. Additionally, at the end 1Q10, Marfrig had $1.2bn in ST debt versus cash of $867 (and it just announced a major acquisition), and JBS has ST debt of $3.0bn versus cash of $1.7bn.

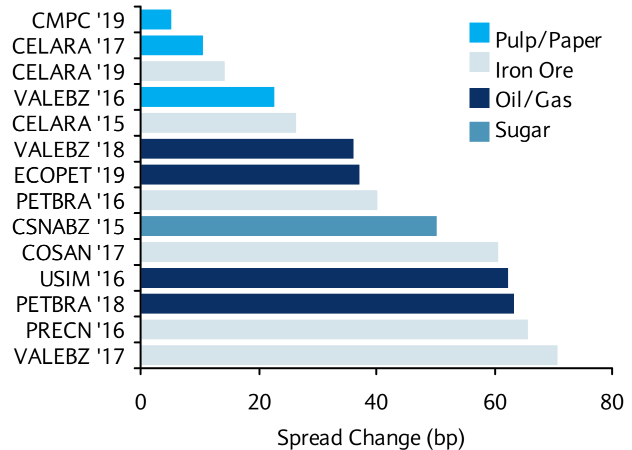
Although BarCap recently increased its GDP forecasts for the US and Brazil and the outlook remains positive, we note that, overall, the industrial sector remains near the low point of the cycle with relatively low output, particularly in exports and/or foreign markets. This is magnified at companies with exposure to Europe, but is also true of US markets. One segment that could face pressure is Brazil's beef industry, which traditionally has exported to the euro area.

**Figure 8: Commodity price trends (% change)**




Source: Bloomberg

**Figure 9: 2Q10 Top LatAm commodity performers***




Note: *Maturity 5y or longer. Source: Barclays Capital

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# COUNTRY OUTLOOKS

## EMERGING ASIA: CHINA

# Policy-driven soft landing

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**Significant monetary tightening has already taken place owing to credit controls, as broad money growth in real terms slowed from 30% in Q3 09 to 18% in May. We have reduced our forecast of the number of hikes in the benchmark interest rates, and expect a 27bp hike in the 1y deposit rate by end-Q3, followed by a rise in both the deposit and lending rates in Q4, each by 27bp. While a tightening bias is likely to remain, the probability of a strengthening of credit controls or large rises in the benchmark rates has declined materially, in our view. We expect growth to slow to 9% y/y in Q4 from 11.9% in Q1 – a policy-driven soft landing for the economy.**

## Credit controls have led to a significant tightening of monetary conditions

*M2 growth slowed markedly in H1 10*

In the March EM quarterly, we argued that the main part of monetary tightening would fall in H2 10, as bank lending tends to concentrate in the first half of the year and bank credit is the main form of monetary policy transmission in China. Developments so far suggest greater tightening has taken place than we expected. Total new lending in the first five months, at about CNY4trn, is 53% of the CNY7.5trn target set for the year, compared with 61% in the year-earlier period. We think the PBoC is on track to achieve the lending target for 2010. As new lending slowed, broad money growth decelerated markedly (Figure 1).

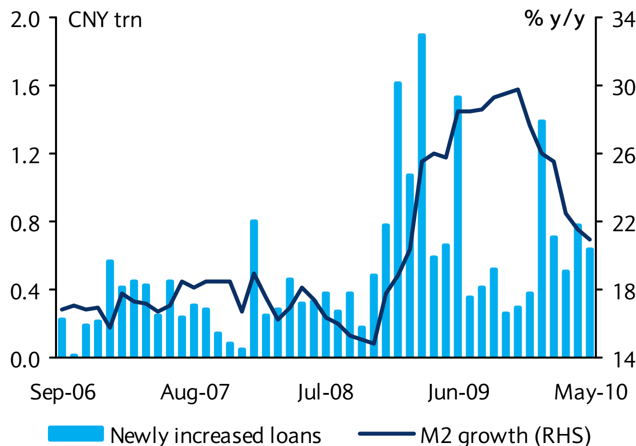
*Interbank rates moved higher*

In the first five months of the year, the central bank has guided the pace of bank lending using window guidance (administrative controls on banks), as well as liquidity management, including three hikes of the reserve requirement ratio (RRR). Interbank interest rates rose and, the central bank raised the interest rate at which it issues its own debt (Figure 2). An increase in interbank interest rates raises banks' opportunity costs of investing in asset markets and lending to the nonbank sector (see "China: The significance of the latest RRR hike", *Global Economics Weekly*, 19 February 2010).

*Monetary conditions have tightened significantly relative to 2009*

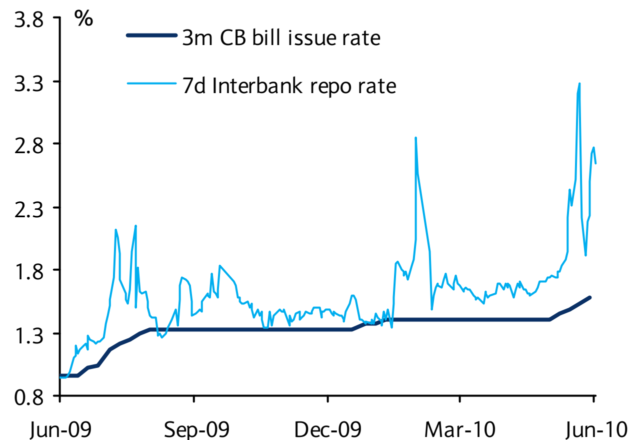
Our estimated monetary conditions index (MCI), which is a weighted average of real credit growth, real lending interest rates and the real effective exchange rate, suggests significant tightening of monetary conditions in 2010 relative to 2009, but not tighter than pre-2009 levels (Figure 3). The tightening of the MCI reflects mainly a sharp slowdown in real credit growth, while real interest rates have eased.

**Figure 1: Growth in credit and broad money has slowed**




Source: CEIC, Barclays Capital

**Figure 2: 3m CB bill issuing rate moved up**




Source: CEIC, Barclays Capital

*We reduce our projection of the number of benchmark interest rate hikes*

Owing to the monetary tightening, there are signs of slowing growth, led by government-related investment, and we see moderate downside risks to our projection of real GDP growth of 10.1% and inflation of 3.5% in 2010 (see below). We now expect a 27bp hike in the benchmark 1y deposit rate by end-Q3, followed by an increase in both the deposit and lending rates in Q4, each by 27bp. This compares with our earlier forecast of three hikes of 27bp in both benchmark rates, one each in Q2, Q3, and Q4. We also now expect stable benchmark rates in 2011, instead of the two hikes we previously projected. In addition to the credit tightening that has already taken place and the signs of slowing growth, the increased uncertainty about the external environment is likely to make the authorities more cautious in raising rates (see *China: Risks to our policy outlook call from the debt crisis in southern Europe*, 7 May 2010).

*Increase in two-way variations in the CNY exchange rate, along with moderate appreciation*

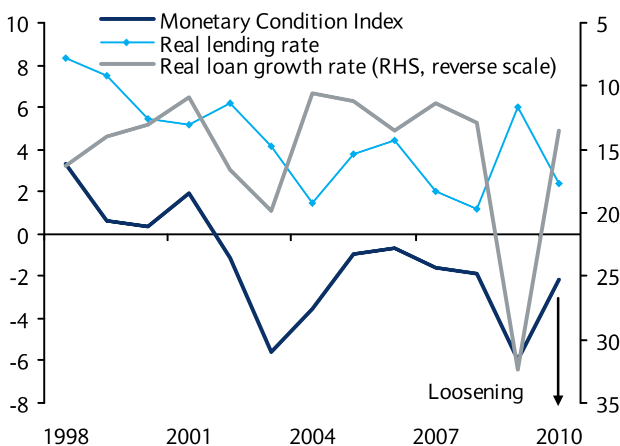
The PBoC issued a policy statement on resuming exchange rate reform on 19 June 2010, signaling an end of a de facto peg to the USD that started in mid-July 2008. By our reading, the statement points to a rise in two-way variations in USD/CNY with reference to basket of currencies, along with a moderate pace of appreciation in the effective exchange rate (see *China: Resuming exchange rate reform*, 20 June 2010). Assuming broad stability in USD cross rates, we expect up to 5% appreciation of the CNY versus the USD in the next 12 months. We do not see a need to change our view on the growth and inflation outlook in China for 2010 and 2011, which already factors in modest currency appreciation. While capital inflows may rise on increased expectations of appreciation, we believe monetary policy – particularly administrative controls on bank credit – will continue to be effective and facilitate a soft landing of the economy.

## Soft landing in growth

*Growth slowdown led by government investment*

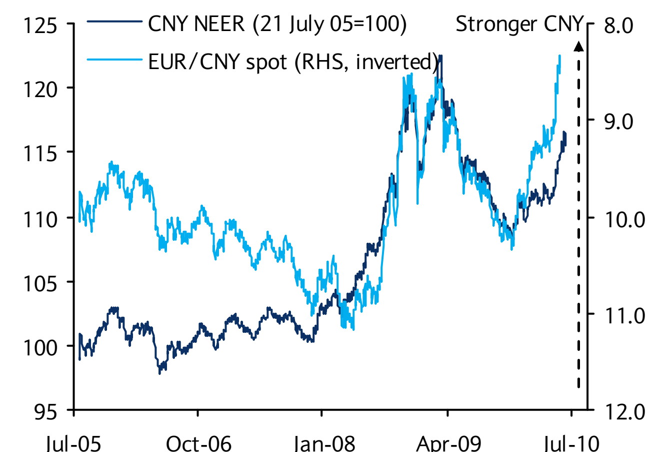
In line with our growth forecast of 10.1% in 2010 and 9% in 2011, we see a quarterly path with the y/y growth rate slowing from 11.9% in Q1 10 to around 9% in Q4. The slowdown is mainly led by government-related investment (Figure 5). We believe this is a policy-driven soft landing and believe risks of a hard landing or a double dip are small. The latest data for May suggest that retail growth remained strong, particularly in consumer spending on durable goods. While auto sales slowed from a record high of 1.7mn units in March, they remained at a high level of over 1.4mn in May. Consumer spending is likely to be supported by rising incomes and employment levels, particularly in relation to recent increases in the minimum wage in many provinces, as the low-income earners have a relatively high

**Figure 3: Monetary conditions tighten relative to 2009**




Source: CEIC, Barclays Capital

**Figure 4: CNY NEER appreciated along with a weaker EUR**




Source: CEIC, Barclays Capital

propensity to consume. Exports in May surprised on the upside by a large margin, and while growth at the 50% level may not be sustained, the May figure helps to reduce concerns on the momentum of external demand.

*Property price decline unlikely to cause a hard landing in the economy*

One particular concern for the growth outlook is related to government tightening measures on the housing market introduced in mid-April, which focus on limiting investment demand and increasing the supply of public and low-cost housing. This represents a regime shift in housing policy, in our view, and more measures – related to taxes, regulation and the public housing framework – will likely be introduced. We expect significant price declines in the next few quarters as the effects of the measures work through. The impact on the economy should be small, however, with the main result likely to be a significant slowdown in private housing construction. By our estimate, even assuming an extreme scenario where private housing construction slows to zero growth in 2011, the downside risk to our forecast of 9% economic growth in 2011 would be 0.7pp (see *China: Managing a property bubble*, 7 June 2010). Moreover, policy can be relaxed in other areas, particularly investment in infrastructure and public utilities, to support growth, if needed.

## Near-term concerns about inflation have declined

*Non-food prices continued to rise, but at a moderate pace*

CPI inflation rose to 3.1% y/y in May from 2.8% in April%. The pick-up was mainly attributable to a base effect. According to the NBS, on a m/m basis, the CPI fell 0.1% in May after rising 0.2% in April, mainly because food prices declined (-0.5%) as weather conditions improved, while non-food pries rose by 0.1%. PPI inflation increased to 7.1% y/y from 6.8% in April, also mainly owing to the base effect. The m/m rise in non-food prices points to continued inflationary pressures, in our view. This, combined with the base effect, suggests that CPI inflation is likely to rise further before easing (Figure 6).

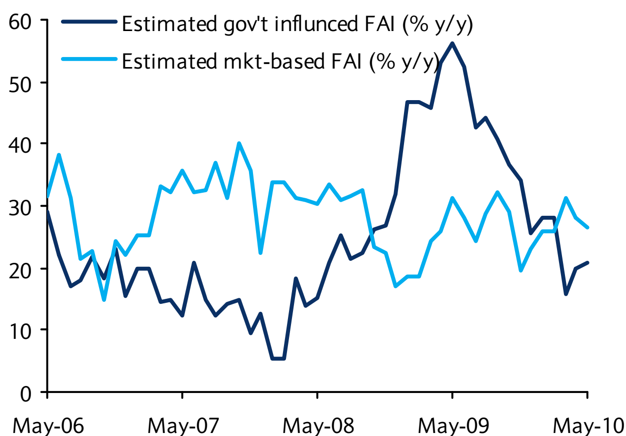
*Near-term inflation risks have declined*

Nevertheless, we see moderate downside risk to our forecast of 3.5% average inflation in 2010. The recent effective exchange rate appreciation and weakened commodity prices will likely help to dampen inflation pressures, along with a slowdown in domestic growth and excess capacity in the global economy, which should help to restrain prices of tradable goods.

*A long-trend of wage inflation may have started…*

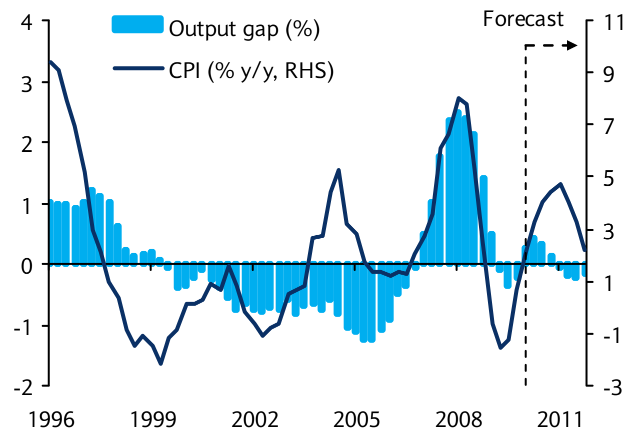
One particular concern is related to the recent labour unrest and wage increases in coastal areas (see *China: The economic significance of wage inflation*, 14 June 2010). China is likely experiencing a Lewis Turning Point, after which the disappearance of surplus labour will raise real wage inflation and trigger a rise in wages' share of income. China's vast size and

**Figure 5: Growth of government-related investment fell**




Source: CEIC, Barclays Capital

**Figure 6: Inflation is likely rise further before easing**




Source: CEIC, Barclays Capital

the differing stages of development of its regional economies suggest that the turning point is likely to be a gradual process lasting many years, rather than an abrupt shock. Nevertheless, a rise in the reserve wage owing to government policies designed to support rural development and the peaking of working-age population in the next few years are likely to add momentum to the process.

*… but near-term impact is likely limited*

The near-term impact on inflation is likely to be small, however. The recent labour unrest and wage increases are limited to some coastal areas and are not a broad-based phenomenon yet. Also, wage inflation initially is likely to be at least partly absorbed by reduced profit margins. In particular, the rate of wage increases, at about 20%, is not far above nominal output growth of 14-15% at this point. However, sustained wage inflation would eventually increase the rate of consumer price inflation. We believe monetary policy is likely to become more accommodative to inflation over time as wage inflation accelerates in order to avoid unnecessarily depressing real growth. In the longer term, China is likely to see slower growth but a higher rate of inflation than in the past decade. Nominal exchange rate appreciation is likely to be required to prevent high inflation in China, part of a gradual process of equilibrium appreciation in the real exchange rate.

**Figure 7: China macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 12.7 | 14.2 | 9.6 | 8.7 | 10.1 | 9.0 |
| Domestic demand contribution (pp) | 10.3 | 11.1 | 8.8 | 12.6 | 10.4 | 9.3 |
| Private consumption (% y/y) | 10.5 | 10.7 | 10.6 | 9.7 | 12.1 | 11.2 |
| Gross capital investment (% y/y) | 12.7 | 13.9 | 9.8 | 19.0 | 11.9 | 10.5 |
| External demand contribution (pp) | 2.4 | 3.1 | 0.8 | -3.9 | -0.3 | -0.3 |
| Exports (% y/y) | 27.2 | 25.8 | 17.4 | -16.0 | 20.2 | 13.5 |
| Imports (% y/y) | 19.9 | 20.8 | 18.5 | -11.2 | 26.0 | 14.6 |
| GDP (USD bn) | 2,722 | 3,517 | 4,533 | 4,909 | 5,707 | 6,766 |
| **External sector** | | | | | | |
| Current account (USD bn) | 253 | 372 | 426 | 297 | 300 | 335 |
| CA (% GDP) | 9.3 | 10.6 | 9.4 | 6.1 | 5.3 | 5.0 |
| Trade balance (USD bn) | 178 | 262 | 297 | 198 | 176 | 187 |
| Utilised FDI (USD bn) | 73 | 84 | 108 | 94 | 104 | 114 |
| Gross external debt (USD bn) | 323 | 374 | 375 | 429 | 489 | 557 |
| International reserves (USD bn) | 1066 | 1528 | 1946 | 2399 | 2800 | 3200 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | | | | | | |
| Fiscal balance (% GDP) | -0.8 | 0.6 | -0.4 | -2.2 | -2.7 | -2.0 |
| Gross public debt (% GDP) | 16.5 | 15.0 | 15.5 | 17.7 | 20.4 | 22.4 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 2.8 | 6.5 | 1.2 | 1.9 | 4.7 | 1.8 |
| FX, eop | 7.80 | 7.35 | 6.83 | 6.83 | 6.67 | 6.35 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | 7.9 | 11.9 | 10.4 | 9.3 | 8.8 | 8.6 |
| CPI (% y/y, avg) | -1.5 | 2.2 | 3.1 | 3.9 | 4.7 | 4.7 |
| FX (domestic currency/ USD, eop) | 6.83 | 6.83 | 6.81 | 6.75 | 6.67 | 6.59 |
| Monetary policy benchmark rate (%, eop) | 5.31 | 5.31 | 5.31 | 5.31 | 5.58 | 5.58 |

Source: Barclays Capital

## EMERGING ASIA: HONG KONG

# External demand the swing factor

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**We have raised our 2010 growth forecast to 5.1% from 4.3% to reflect the stronger-than-expected Q1 outturn. The improving labour market, a likely extended period of easy monetary conditions and a stimulative fiscal policy will continue to underpin domestic demand. Strong growth has also added to price pressures. We raise 2010 CPI inflation forecast to 2.5%. External developments remain the key risk to our outlook.**

*Economic activity returned to pre-crisis level in Q1…*

Economic activity has returned to pre-crisis levels (Figure 1), with real GDP growing at its fastest pace in four years in Q1 (8.2% y/y). While the y/y figure was partly boosted by base effects, sequential momentum was also strong at 2.4% q/q, the same as in Q4.

*… driven by strong domestic demand…*

The solid expansion was driven by domestic demand, which contributed 14.5pp to growth (Figure 2). Benefiting from the steadily improving labour market, with the unemployment rate falling to 15-month low of 4.4% in March-April, private consumption contributed 4pp. Investment surged, with capital formation adding 2.1pp and inventories 8.4pp to growth. Sequential growth in domestic expenditure also accelerated to 4% q/q from 1.5% in Q4.

*… which will continue to be supported by easy monetary conditions and fiscal stimulus*

We expect stable consumption and investment growth in the remainder of 2010. We believe inventory adjustment is nearing an end, and will likely subtract from growth in H2. A likely extended period of easy monetary conditions, with our US economists' now forecasting the Fed will raise interest rates only in April 2011, and stimulative fiscal policy (see "Hong Kong: Fiscal stimulus to support growth", *Emerging Market Quarterly*, March 2010) will continue to support private consumption and public construction in the coming quarters.

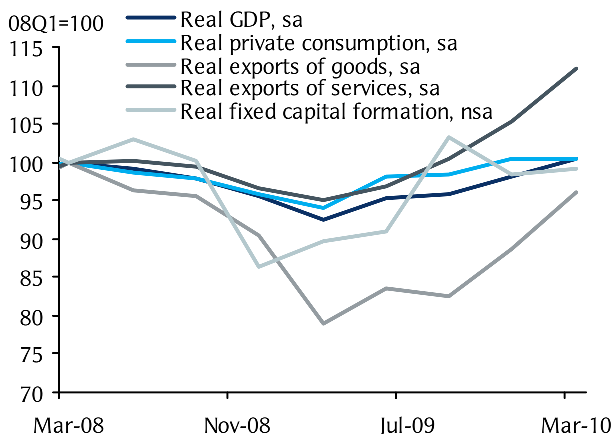
*Goods exports were driven by demand from emerging Asia…*

On the external front, real goods exports remained below pre-crisis levels in Q1, despite a considerable rebound (Figure 1). Exports to the EU and the US were still about 20% below the Q1 08 level. That weakness was partly offset by strong shipments to Mainland China and other Asian economies, which led the 22% y/y expansion in Q1 (versus -3% in Q4).

*… and the acceleration in services exports highlights Hong Kong as a regional services hub*

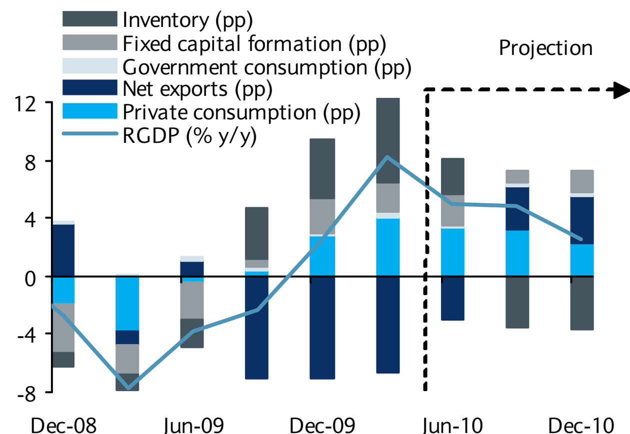
Real services export growth accelerated further (18% versus 9% in Q4), bringing volume well above pre-crisis levels. The strong performance highlights Hong Kong's status as a regional services hub: double-digit growth was seen on all fronts, ranging from financial services and tourism, to trade-related and transportation services. On the other hand, as

**Figure 1: Economic activity returned to pre-crisis levels**




Source: CEIC, Barclays Capital

**Figure 2: … with domestic demand the main driver**




Source: CEIC, Barclays Capital

import growth (26% y/y in Q1) outpaced export growth due to strong investment, net exports made another significant subtraction from overall growth (Figure 2).

*Developments in Europe pose downside risks to external demand*

Looking ahead, the European debt crisis and increased global uncertainties pose downside risks to Hong Kong's external demand. This would work through Hong Kong's direct trade with the EU (which accounts for 14% of Hong Kong's exports and 19% of its GDP), and indirectly through the impact on the growth in Hong Kong's other major trading partners. That said, we remain optimistic given recent strong momentum in exports, particularly services exports. Barring any significant deterioration in euro area growth, and given the strong growth we expect in China and the US, we forecast a continued recovery in exports and a positive contribution from net exports to overall growth in H2 10.

*We expect GDP to rise 5.1% in 2010 and slow to 4% in 2011*

Overall, we expect real GDP to rise 5.1% in 2010 after falling 2.8% in 2009, and expect y/y growth to moderate over the course of the year as base effects taper off. Stronger-than-expected domestic demand has increased inflation pressures in recent months. We raise our 2010 CPI inflation forecast to 2.5% from 2.0%, also considering the lagged effect of increased rental and fiscal concessions in the budget. For 2011, we forecast growth will slow given the inevitable tightening in monetary conditions (our US economists now forecast three rate hikes in 2011 for a total 150bp), and the slowdown we expect in China and the US. We maintain our projection of 4% growth in real GDP in 2011.

## More measures to cool the property market

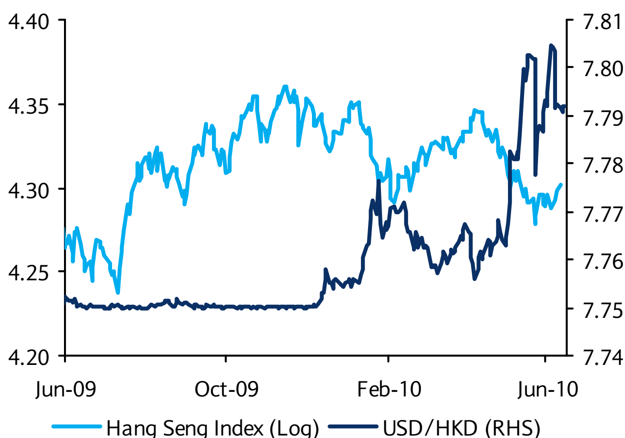
*The local property market remained buoyant …*

The Hong Kong property market remained buoyant despite repeated government warnings about the risk of a real estate bubble and market-cooling measures announced in February (including a 50bp increase in the stamp duty on luxury property effective on 1 April to curb speculation, and a commitment to increase the supply of land and residential units; see *The Emerging Markets Quarterly*, March 2010). Property prices rose 5% or more across all classes from February to April, and transactions rose steadily to nearly 14,000 units in April.

*… but transactions moderated following the latest measures announced in late-April*

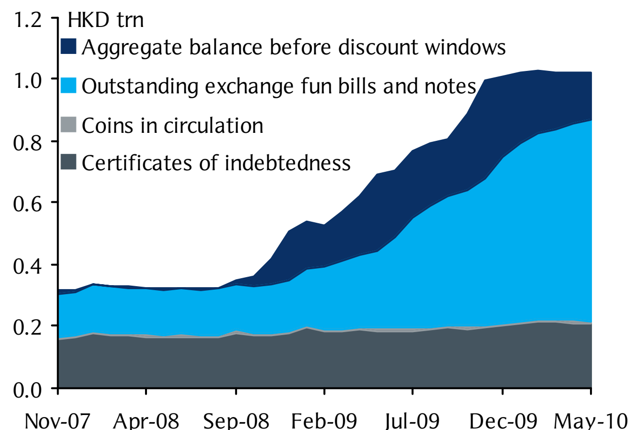
This likely contributed to the government's announcing four new land auctions over the next three months and nine measures to strengthen regulations in primary property sales in late-April. Transaction volume has thereafter moderated and price increases seem to have slowed somewhat. Below-forecasts results at land auctions for two mass market sites in May pointed to some developer caution and weak market sentiment. However, the success of the third auction in June for an upscale site, at which the selling price was 60% higher than the opening price, suggests developers are selective and remained bullish about the luxury home market.

**Figure 3: The HKD weakened as equity market retreated**




Source: CEIC, Barclays Capital

**Figure 4: Local liquidity conditions remain stable**




Source: CEIC, Barclays Capital

*We think the probability of a meaningful correction is small*

We continue to believe that any drastic measures to cool property prices are less likely, as the government will balance the interests of prospective buyers against those of existing homeowners. Very low interest rates and abundant liquidity will continue to support property demand, and this has helped to slow the deterioration in the affordability. According to the HKMA, mortgage repayment-to-income ratio for the mass market has increased to 47% currently from around 40% in 2008 despite a 40% rise in prices. However, a 300bp increase in mortgage rates from current levels is projected to increase the ratio significantly to 61%.

*The HKD weakened as the equity market consolidated*

The HKD has weakened since April on continued consolidation in the local equity market. The lack of large fund-raising activities and the absence of new net inflows of funds are in contrast to 2008-09 when the HKMA's strong-side convertibility undertaking (CU) was repeatedly triggered. Since May, the European sovereign debt crisis has led to a further equity market sell-off, with the HKD rising to above 7.80. The local equity market, and large IPO activities, will likely be the main driver of the HKD movement in H2 2010.

*The aggregate balance declined as a result of HKMA issuance of Exchange Fund bills and notes*

While the weak HKD suggests pressures of capital outflows, local liquidity conditions have remained stable. The weak side CU (7.85) was not triggered; therefore, the HKMA did not need to intervene and withdraw HKD liquidity. We think the significant decline in the aggregate balance (HKD170bn since Q4 09; Figure 4) mostly reflects the continued issuance of Exchange Fund papers, with the amount outstanding also up by around HKD180bn.

**Figure 5: Hong Kong macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 7.0 | 6.4 | 2.2 | -2.8 | 5.1 | 4.0 |
| Domestic demand contribution (pp) | 5.4 | 7.0 | 1.4 | 0.8 | 5.7 | 4.1 |
| Private consumption (% y/y) | 5.9 | 8.5 | 2.6 | -0.4 | 5.1 | 4.6 |
| Gross fixed capital formation (% y/y) | 7.1 | 3.4 | 1.3 | -1.2 | 8.1 | 5.9 |
| Net exports contribution (pp) | 1.6 | -0.7 | 0.7 | -3.6 | -0.6 | -0.1 |
| Exports (% y/y) | 9.6 | 8.4 | 2.9 | -10.3 | 15.7 | 7.8 |
| Imports (% y/y) | 9.2 | 9.1 | 2.6 | -9.0 | 16.9 | 8.1 |
| GDP (USD bn) | 189.9 | 207.1 | 215.2 | 210.7 | 226.6 | 243.2 |
| **External sector** | | | | | | |
| Current account (USD bn) | 22.9 | 25.5 | 29.3 | 18.3 | 17.7 | 17.5 |
| CA (% GDP) | 12.1 | 12.3 | 13.6 | 8.7 | 7.8 | 7.2 |
| Goods balance (USD bn) | -17.9 | -23.5 | -25.9 | -28.9 | -33.5 | -35.7 |
| Net FDI (USD bn) | 0.1 | -6.7 | 9.1 | -3.8 | -3.0 | 0.0 |
| Other net inflows (USD bn) | -14.1 | 0.7 | -8.6 | 58.9 | 0.3 | -2.5 |
| Gross external debt (USD bn) | 514.7 | 711.9 | 663.2 | 672.6 | 693.6 | 708.6 |
| International reserves (USD bn) | 133.2 | 152.7 | 182.5 | 255.8 | 270.8 | 285.8 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | 3.9 | 7.5 | 0.1 | 0.8 | -1.5 | -0.7 |
| Gross public debt (% GDP) | 1.5 | 1.3 | 1.0 | 0.7 | 1.1 | 1.3 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 2.3 | 3.8 | 2.0 | 1.3 | 2.5 | 2.6 |
| FX (USD/HKD, eop) | 7.78 | 7.80 | 7.75 | 7.75 | 7.80 | 7.80 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | -3.8 | 8.2 | 4.8 | 4.8 | 2.7 | 1.7 |
| CPI (% y/y, avg) | -0.1 | 1.9 | 2.6 | 3.1 | 2.3 | 2.3 |
| FX (USD/HKD, eop) | 7.75 | 7.76 | 7.78 | 7.80 | 7.80 | 7.80 |
| Monetary policy benchmark rate (%, eop) | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |

Source: Barclays Capital

# EMERGING ASIA: INDIA

## Positioning for the pause

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**Even as inflation remains a policy concern in the near term, lower food prices on the back of normal monsoon rainfall are likely to prompt the RBI to pause and take stock of its tightening cycle beyond the October policy review. With INR being overvalued on the REER and a higher current account deficit, we expect USD/INR to rise to 46.50 in 12 months.**

As the economic recovery gains momentum in India, inflation is set to remain a policy concern in the near term. Even though we expect WPI inflation to remain above 8% until August, inflation is likely to come down gradually in H2 FY11. We expect food prices to normalise on the back of standard monsoon rainfall as predicted by India's meteorological department. Furthermore, even though manufacturing inflation is likely to rise in the coming months, we expect manufacturing inflation to start declining sequentially from Q3 10 as supply bottlenecks ease in the manufactured food and textiles sector. Finally, a fuel price hike is unlikely to materialise soon, as policymakers remain cautious about its effect on inflation in the near term.

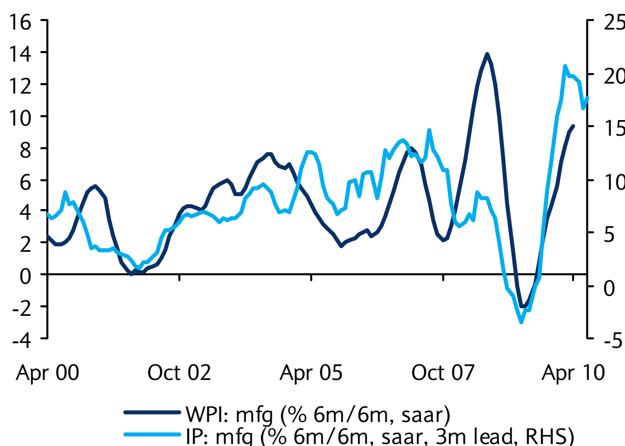
*We expect RBI to conclude its current rate hike cycle in October credit policy review*

We expect WPI to decline below 6% by December, thus giving the RBI enough policy room to finish its current rate hike cycle, likely at the October credit policy review, in our view. We now expect the RBI to hike the repo and the reverse repo rate by a further 75bp by October. We do not expect any additional increases in the CRR in the next six months, given that credit growth has risen significantly over the past three months and liquidity conditions remain tight. Indeed, the next leg of monetary tightening will depend upon the pace of credit growth. If credit growth remains strong, we believe the RBI is likely to begin hiking rates again in FY 11-12, possibly from the April 2011 credit policy review.

*Growth outlook remains robust; FY10-11 growth seen at 8%*

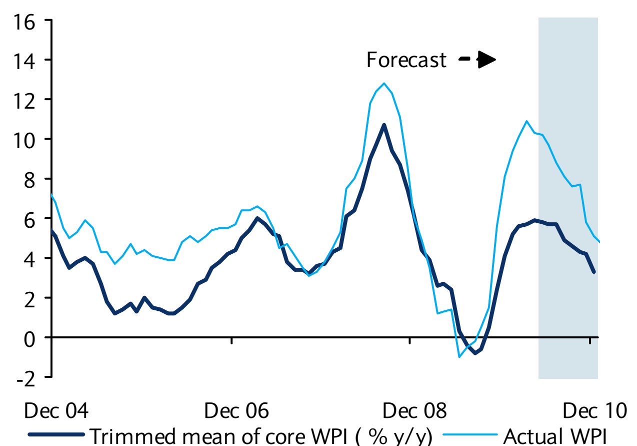
Meanwhile, the outlook for economic growth remains favourable. Strong momentum in industrial production and normalisation of agricultural output is likely to support GDP growth hitting 8% for FY 10-11, with a bias to the upside. Even with production momentum in autos, textiles and consumer goods coming down to more sustainable levels, capital formation and consumption are likely to remain supported. However, with the government pulling back on the fiscal stimulus, the fiscal impulse for the economy should turn negative.

**Figure 1: Inflation to remain a policy concern in near term…**




Source: CEIC, Barclays Capital

**Figure 2: … but likely to subside in H2 FY 10-11**




Source: CEIC, Barclays Capital

*Windfall gains through telecom auctions increase chances of a reduced borrowing programme…*

The fiscal picture has improved considerably. The recent successes of telecom-related auctions and changes in rules favouring divestment of public companies (every listed company has to have 25% public ownership within the next five years) are likely to boost the government's revenue coffers. However, given recent market volatility, the large public offering pipeline is likely to be deferred to ensure that the market response is adequate. We remain comfortable with our forecast for central government fiscal deficit of 4.5% of GDP in FY 10-11 for now. We maintain that the recent fiscal gains are unlikely to lead to any major change in the borrowing calendar in H1 FY 10-11. However, the chances of second-half borrowing (INR1.7trn) being reduced have risen significantly.

*…and helps the government push back fuel pricing reforms*

At the same time, the increased sources of revenue are giving the government enough fiscal leeway to defer fuel price hikes. The government is likely to look for opportunities to implement fuel price reforms, but is likely to be wary of its effects on inflation. A 10% hike in administered fuel prices contributes around 2.3pp to headline inflation in 3-4 months. While under-recoveries of oil companies took a breather in FY 09-10, they should rise significantly in FY10-11. In our view, if Brent crude oil averages USD85/bbl during FY 10-11, fuel subsidies will rise to INR815bn (1.1% of GDP) from INR461bn (0.7% of GDP) in FY 09-10. A reduction in under-recoveries will be a positive for India's foreign currency ratings and could lead to an upgrade at some point, from its current BBB- rating by S&P.

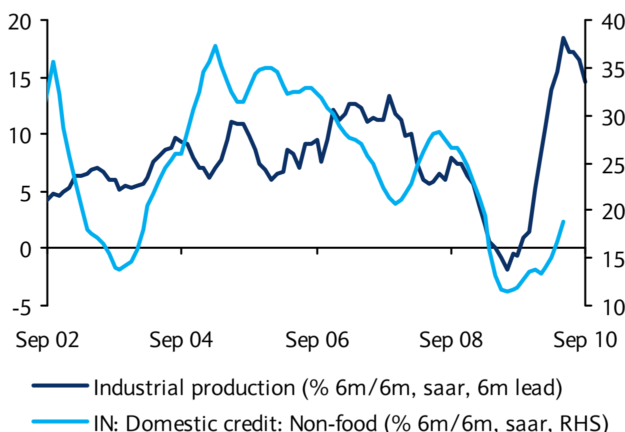
*INR remains overvalued on the REER*

Since April 2009, the INR has appreciated about 19% on a real effective exchange rate (REER) basis. Ordinarily, high inflation differentials, coupled with weakness in EUR/USD, imply a further increase in the REER. Tactically, we expect the REER to peak in Q3 10, and then gradually trend down marginally in the following months. Given the high growth differentials, the current account deficit is likely to widen further. We expect a deterioration in the current account from the USD32.5bn (2.5% of GDP) deficit in FY09-10 to USD44bn (2.8% of GDP) in FY10-11 on account of higher oil prices and strong domestic demand.

*Current account deficit likely to rise in tandem with strong demand, especially for commodities*

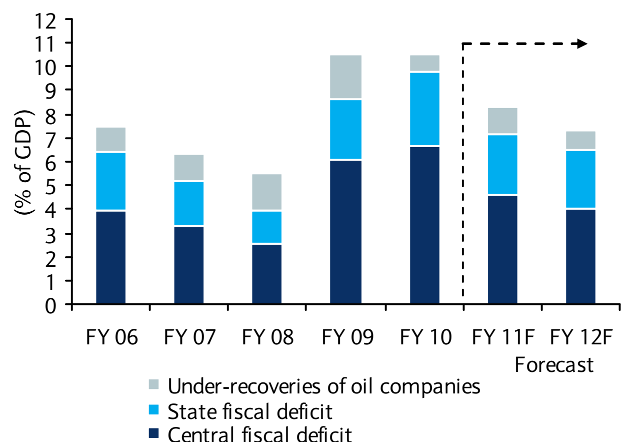
This increases the INR's sensitivity to volatile capital flows. We expect equity-related inflows to moderate in FY 11. This decline is likely to be offset by rising foreign direct investment. There is also likely to be more debt-related inflows such as bank capital and external commercial borrowings as domestic credit conditions tighten. Together, we expect smaller balance of payment surpluses, which are likely to result in a weaker INR. We expect INR to underperform other Asian currencies and reach 46.50/USD in one year. While in the near term there could be some INR appreciation, it is likely to be modest.

**Figure 3: Credit growth likely to rise further**



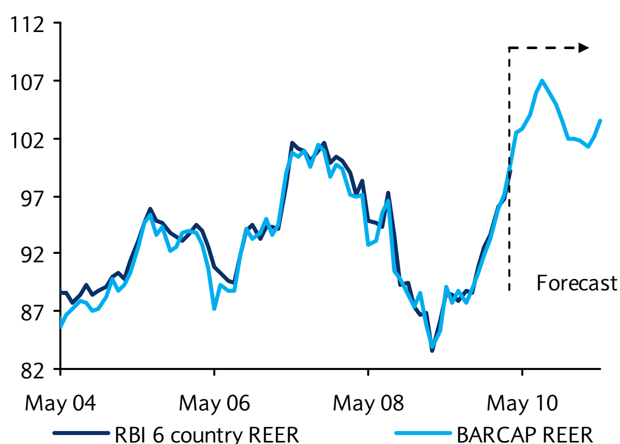

Source: CEIC, Barclays Capital

**Figure 4: Fiscal consolidation likely to continue**



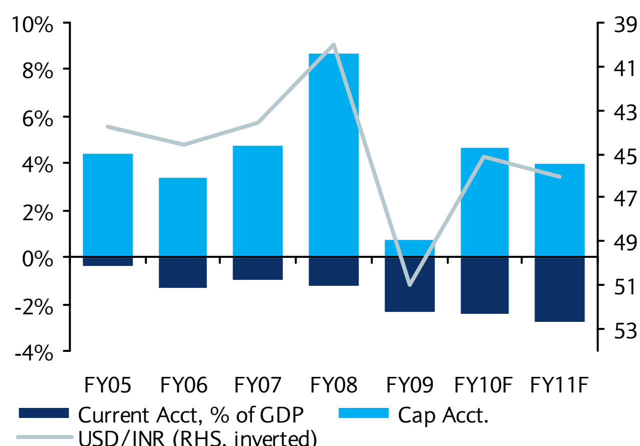

Source: CEIC, Barclays Capital

**Figure 5: INR appears overvalued on REER basis**




Source: CEIC, Barclays Capital

**Figure 6: Current account deficit likely to increase further**




Source: CEIC, Barclays Capital

**Figure 7: India macroeconomic forecast**

| | FY 06-07 | FY 07-08 | FY 08-09 | FY 09-10F | FY 10-11F | FY 11-12F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 9.7 | 9.2 | 6.7 | 7.4 | 8.0 | 8.5 |
| Domestic demand contribution (pp) | 10.8 | 12.1 | 5.1 | 6.3 | 9.1 | 9.0 |
| Private consumption (% y/y) | 8.2 | 9.8 | 6.8 | 4.3 | 6.6 | 7.5 |
| Fixed capital investment (% y/y) | 14.3 | 15.2 | 4.0 | 7.2 | 13.3 | 11.9 |
| Net exports contribution (pp) | -0.8 | -1.4 | -1.9 | 0.6 | -1.3 | -0.4 |
| Exports (% y/y) | 21.8 | 10.2 | 10.2 | -6.7 | 15.2 | 14.3 |
| Imports (% y/y) | 22.0 | 10.0 | 10.0 | -7.3 | 17.3 | 12.6 |
| GDP (USD bn) | 947 | 1233 | 1201 | 1316 | 1582 | 1785 |
| **External sector** | | | | | | |
| Current account (USD bn) | -9.6 | -15.7 | -28.7 | -32.5 | -44.0 | -50.0 |
| CA (% GDP) | -1.0 | -1.3 | -2.4 | -2.5 | -2.8 | -2.8 |
| Trade balance (USD bn) | -61.8 | -91.5 | -118.7 | -112.5 | -130.0 | -140.0 |
| Net FDI (USD bn) | 7.7 | 15.9 | 17.5 | 20.5 | 25.0 | 30.0 |
| Other net inflows (USD bn) | 37.5 | 90.7 | -10.3 | 42.1 | 38.5 | 50.0 |
| Gross external debt (USD bn) | 172.4 | 224.8 | 224.0 | 255.0 | 265.0 | 280.0 |
| International reserves (USD bn) | 199.2 | 309.7 | 252.0 | 279.6 | 298.0 | 325.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -6.3 | -5.5 | -10.5 | -10.5 | -8.3 | -7.3 |
| Gross public debt (% GDP) | 88.5 | 85.6 | 81.0 | 80.0 | 80.0 | 78.0 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 5.7 | 3.8 | 6.2 | 7.3 | 5.1 | 5.9 |
| FX, eop | 43.6 | 40.0 | 51.0 | 45.1 | 46.25 | 46.5 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | 5.8 | 8.6 | 8.10 | 8.10 | 7.80 | 8.10 |
| WPI (% y/y, eop) | -1.0 | 10.9 | 9.7 | 7.6 | 5.1 | 4.7 |
| FX (domestic currency/USD, eop) | 47.9 | 45.1 | 45.50 | 45.50 | 46.00 | 46.25 |
| Repo rate (%, eop) | 4.75 | 5.25 | 5.50 | 5.75 | 6.00 | 6.00 |
| Reverse repo rate (%, eop) | 3.25 | 3.75 | 4.00 | 4.25 | 4.50 | 4.50 |

Source: Barclays Capital

# EMERGING ASIA: INDONESIA

## On track for Investment Grade

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**Structural reforms are expected to continue in Indonesia, putting the country on a firm path towards investment grade status, in our view. Although policy normalisation is important, BI's dovish comments suggest rates will remain on hold until Q4. Robust BoP should see USD/IDR drift towards 8800 in 12 months.**

*Structural reforms to continue at a sustainable pace*

Indonesia remains on track to achieve investment grade over the coming 12-18 months with the government continuing structural reforms. For example, Indonesia has increased foreign investment limit in construction and healthcare services and made foreign investment in small scale power projects easier. At the same time, the President has appointed reform-minded individuals at the helm of the finance ministry and Bank Indonesia, which we believe will ensure policy continuity. The government also remains committed to reducing subsidy cost, announcing a 10% hike in electricity tariffs effective July. Overall, we expect reforms to continue at a sustainable pace.

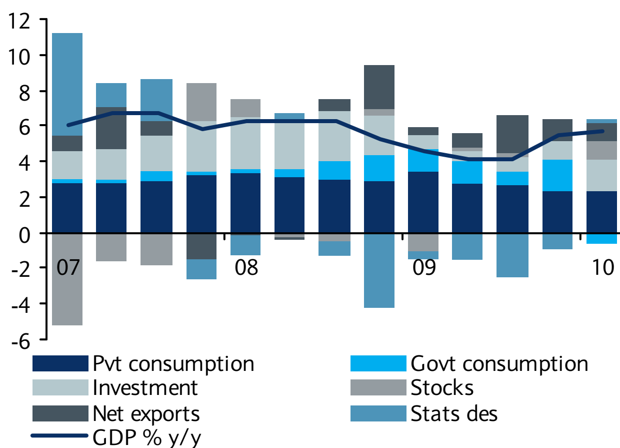
*GDP to expand by 6.3%; supported by consumption and increasing investment*

The recovery in Indonesia continues to broaden, with GDP expanding 5.7% in Q1, versus a low of 4.1% in Q2 09. Excluding government spending, GDP was up nearly 7%. We expect consumption to remain solid given upbeat consumers, positive wealth effects from the equity/property market and the strength in indicators such as motor cycle sales. The much-anticipated bounce in investment started in Q1, and we expect it to gather pace through the year, given business's more positive outlook and momentum in high frequency indicators such as capital goods imports, cement consumption and commercial motor vehicle sales. Overall, we expect the economy to expand 6.3% in 2010, versus 4.5% last year.

*Inflation to grind higher – year-end forecast: 5.4%*

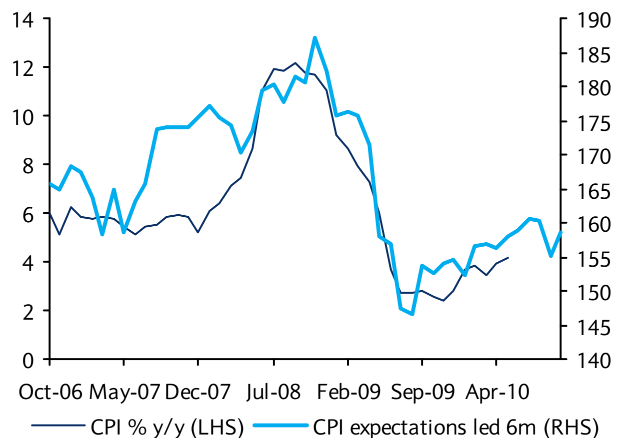
Inflation remains benign given the dampening effect of a strong rupiah. However, price pressures have been gradually grinding higher, running at 4.2% in May from a low of 2.4% in November. We expect inflation to continue to rise gradually, in line with our preferred lead indicator – Bank Indonesia's 6-mth hence price expectations. We expect the 10% electricity price hike in July to directly add 40bp to CPI, with the indirect pass-through being twice as much over the next 6-9 months. There will also be the Ramadan festival-related uptick in prices in August-September. With the economy already close to potential capacity, upside risks to core inflation remain, though the structural transformation in Indonesia may mean

**Figure 1: Investment becoming a key driver of growth**




Source: CEIC, Barclays Capital

**Figure 2: Inflation to gradually grind higher**




Source: CEIC, Barclays Capital

that standard models will have an underestimation bias for potential GDP. Overall, we expect inflation to end the year at 5.4%, compared with the central bank's target of 4-6%.

*Policy normalisation is important to keep inflation expectations anchored…*

The contained inflation prints have continued to give BI the flexibility to keep policy rates unchanged since August 2009 with the main objective of supporting credit growth. We believe this is materialising with credit growth running at 25% on a 3m/3m saar basis, compared with a low of 5% in November. Although the relatively benign inflation outlook means there is no urgent need to raise rates, real interest rates in the economy are falling. We believe rate normalisation is important to ensure that low inflation expectations become entrenched. However, comments from the BI remain dovish, with Deputy Governor Hartadi expecting policy rate to be flat through 2010. With Acting Governor Nasution predicting "second-round effects" from the EU crisis "in a couple of months" on account of "market tensions", it seems the willingness to hike is not present. We are pushing back our first 25bp rate hike to Q4 (previously Q3).

*… but BI's unwillingness to hike has seen us push our forecast of the first rate hike to Q4*

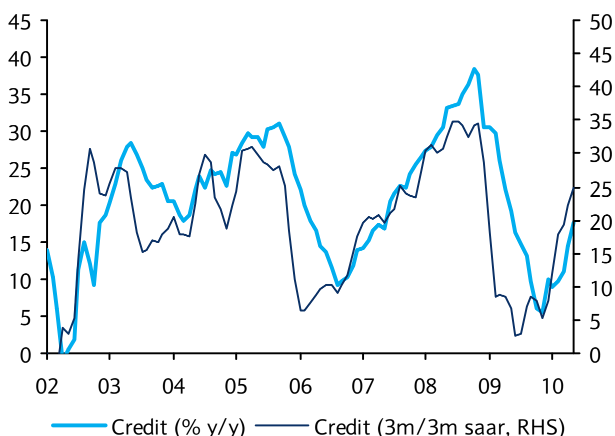
*Robust BoP position and BI's comfort with FX strength should see IDR drift towards 8,800 in 12-mths*

Indonesia's external position remains comfortable with FX reserves of USD74.5bn at the end of May, versus short-term external debt of USD25bn as of Q1 10 according to BI data. We expect FX reserves to exceed USD100bn by end 2011. The fundamental backdrop for the rupiah remains robust with the rise in financial flows more than offsetting the reduction in current account surplus over the coming year. We expect the BoP surplus to be 2.6% of GDP, with FDI being a key driver. In Q1, Indonesia received USD2bn of net FDI. We expect bond related inflows to continue, given still attractive carry and structural increase in flows to EM, though the pace will be more moderate. We also expect equity inflows to pick up. Given this backdrop, together with Bank Indonesia's comfort with FX strength, we expect USD/IDR to drift to 9,000 in three months and 8,800 in 12 months.

*BI introduces changes not capital controls*

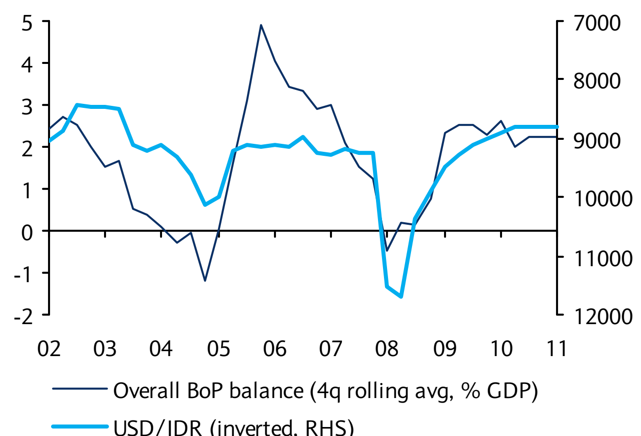
Bank Indonesia announced a range of strategic measures in early June, which we believe will improve the effectiveness of monetary policy and develop the financial market (see *Indonesia: Changes, not capital controls*, 16 June 2010). We believe the one-month holding period requirement for SBIs will deter offshore-onshore spread related trades there by reducing additional liquidity withdrawal via SBI issuance to foreigners, which represents both a balance sheet cost to BI and a dead-weight cost to Indonesia. The widening of the interest rate corridor to +/-100bp from +/- 50bp should help boost inter-bank transactions. The issuance of 6m and 9m SBI bills will likely help develop a well-defined money market, which over time would enable market participants to gauge expectations of future policy rates.

**Figure 3: Credit growth has accelerated**



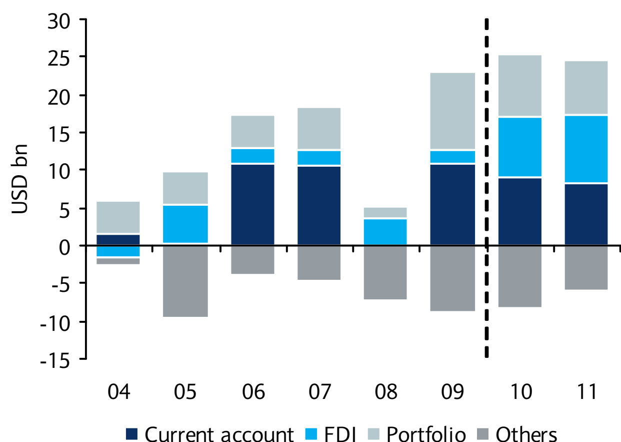

Source: CEIC, Bank Indonesia, Barclays Capital

**Figure 4: Robust balance of payments to support IDR**



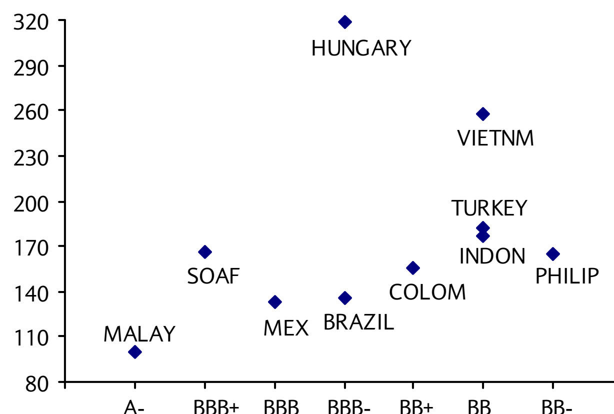

Source: CEIC, Barclays Capital

**Figure 5: Foreign direct investment to become a key driver**




Source: CEIC, Barclays Capital

**Figure 6: 5y CDS vs S&P rating CDX.EM (bp)**




Source: CEIC, Bloomberg, Barclays Capital

**Figure 7: Indonesia macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009E | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 5.5 | 6.3 | 6.0 | 4.5 | 6.3 | 6.2 |
| Domestic demand contribution (pp) | 3.0 | 3.7 | 6.7 | 4.7 | 6.2 | 6.2 |
| Private consumption (% y/y) | 3.2 | 5.0 | 5.3 | 4.9 | 4.9 | 5.5 |
| Fixed capital investment (% y/y) | 2.6 | 9.3 | 11.9 | 3.3 | 10.7 | 11.6 |
| Net exports contribution (pp) | 1.1 | 0.6 | 0.7 | 1.2 | 0.5 | 0.1 |
| Exports (% y/y) | 9.4 | 8.5 | 9.5 | -9.7 | 15.0 | 9.4 |
| Imports (% y/y) | 8.6 | 9.1 | 10.0 | -15.0 | 18.2 | 11.8 |
| GDP (USD bn) | 365 | 431 | 507 | 542 | 683 | 789 |
| **External sector** | | | | | | |
| Current account (USD bn) | 10.9 | 10.5 | 0.1 | 10.7 | 9.1 | 8.3 |
| CA (% GDP) | 3.0 | 2.4 | 0.0 | 2.0 | 1.3 | 1.0 |
| Trade balance (USD bn) | 29.7 | 32.8 | 22.9 | 35.2 | 36.8 | 36.7 |
| Net FDI (USD bn) | 2.2 | 2.3 | 3.4 | 1.9 | 7.8 | 9.2 |
| Other net inflows (USD bn) | 0.5 | 0.8 | -5.5 | 1.5 | 0.0 | 1.0 |
| Gross external debt (USD bn) | 129 | 137 | 149 | 173 | 170 | 178 |
| International reserves (USD bn) | 42.6 | 56.9 | 51.6 | 66.1 | 82.8 | 101.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -0.9 | -1.3 | -0.1 | -1.6 | -1.5 | -1.5 |
| Primary balance (% GDP) | 1.5 | 0.8 | 1.7 | 0.6 | 0.7 | 0.5 |
| Gross public debt (% GDP) | 39.0 | 35.2 | 33.1 | 28.3 | 26.8 | 26.1 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 6.6 | 6.0 | 11.1 | 2.8 | 5.4 | 5.6 |
| FX, eop | 9,020 | 9,419 | 10,950 | 9,400 | 8,900 | 8,800 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | 4.5 | 5.7 | 6.3 | 6.5 | 6.6 | 6.3 |
| CPI (% y/y, eop) | 7.9 | 3.4 | 4.6 | 4.6 | 5.4 | 5.7 |
| FX (domestic currency/USD, eop) | 11,575 | 9,115 | 9,100 | 9,000 | 8,900 | 8,800 |
| Overnight policy rate (%, eop) | 7.75 | 6.50 | 6.50 | 6.50 | 6.75 | 6.75 |

Source: Barclays Capital

# EMERGING ASIA: KOREA

## Time to apply the brakes… gently

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**We now expect a smaller financial account surplus, reflecting a more tepid interest rate outlook and tighter regulations on FX forwards. While fundamentals still favour KRW appreciation, we have revised our 1y USD/KRW forecast higher to 1,075 from 1,025.**

*We remain in the early-normalisation camp*

Policymakers are starting to pay attention to the strong revival in growth and jobs. On 16 June, the Prime Minister told lawmakers to prepare for an increase in inflation expectations in H2 – a sign that the government accepts the BoK's assessment that inflation is becoming demand-led. This is consistent with our view that the BoK will signal its intent at the July policy meeting, before hiking rates by 25bp in August. A crucial factor will be the Q2 GDP advance estimate (released on the week of 22 July), which we expect to expand by a solid 1% in Q2 on a seasonally adjusted q/q basis, even after the 2.1% pick-up in Q1. This is likely to warrant a 50bp upgrade of the official growth forecast to around 5.5% – closer to our estimate of 5.7% (see *Korea: Above cruising altitude*, 27 April 2010).

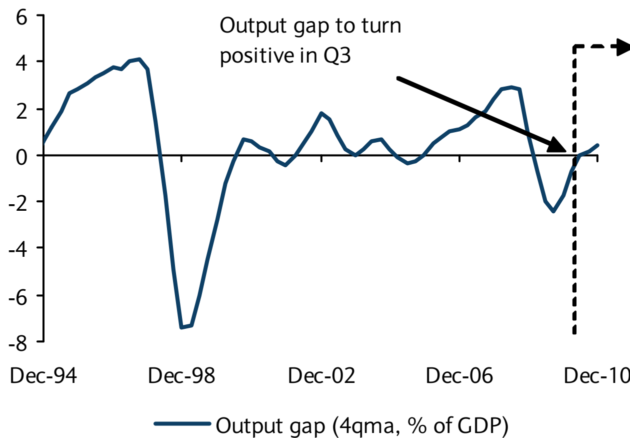
*The nature of inflation is changing – becoming more demand-led*

Inflation expectations are rising, although this is not evident from the headline readings. Headline CPI is expected to peak in June at 2.9% (after rising 2.7% in May), before rolling gradually down. The roll down in headline from June reflects largely the dropping out of base effects from the transport and fuel components. On a full-year basis, we project prices to rise 2.6% this year, down from 2.8% last year – remaining well within the policy limits (2-4%). However, what is likely to draw more policy concern is the changing mix of inflation. Stripping out energy and food, core CPI climbed (0.24% m/m in May), accelerating for the third successive month – a sign that inflation is becoming more demand pull in nature. At the same time, imported inflation risks remain. While food is now less of a concern with the ebbing of El Niño weather conditions in Q2, the persistent rise in liquefied natural gas prices this year has been fuelling imported inflation.

*But the rate hike trajectory will be milder than usual – with 50bp of cumulative rate hikes by year-end*

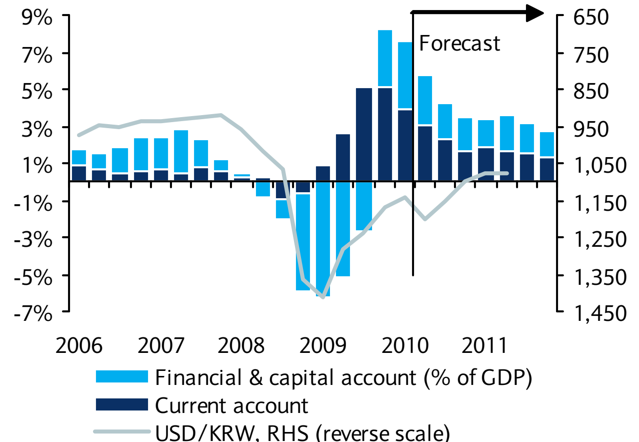
On the other hand, offsetting these inflation concerns are the intermittent jitters in the market over Europe's problems, as well as the weak property market – which is likely to limit the gains in consumer confidence. As a result, even as we expect normalisation to begin early, the expected rate trajectory is likely to be milder than usual. We now believe the BoK

**Figure 1: Economy close to full employment**




Source: CEIC, Barclays Capital

**Figure 2: Expect a more modest financial account surplus**




Source: CEIC, Barclays Capital

will pause after the first hike in August and remain on hold until after the G20 meetings in November. This reduces our cumulative tightening from 75bp in 2010 to 50bp for the year.

*The economy is close to full employment – with the pass-through from growth to jobs remaining healthy*

What indications are there that demand will remain strong? So far, the key May releases – exports, unemployment and inflation – have suggested that the economy's vital signs remain good. With the jobless rate close to a 10-year low (3%) and the output gap turning positive in Q3, the economy is near full employment. The May employment report is a case in point – with the unemployment rate improving dramatically to 3.2% in May, from 3.7% a month earlier and 4.8% since our last quarterly publication in March. Excluding government jobs, job growth in the private sector has accelerated in May to 0.8% m/m on a seasonally adjusted basis – for six consecutive months.

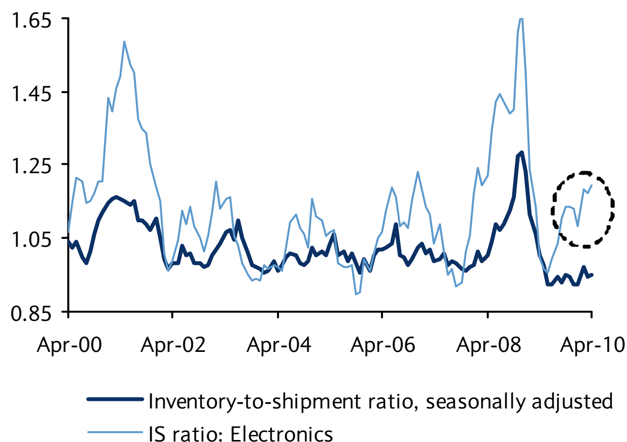
*Even lagging indicators such as facilities investment are starting to re-awaken*

The electronics industry has been a key source of vigour. On 10 June, the Semiconductor Industry Association raised its forecast for growth in global chip sales to 28.4% in 2010, after the 9.6% tumble in 2009. This has been led by stronger demand for LCD and LED products and the slew of launches of Internet-enabled mobile phones. This is, in turn, inducing growth in private investment. On 17 May, Samsung announced record capex plans of KRW11trn for its semiconductor business – to build its first chip plant since 2005 – and an additional KRW5trn for its LCD business in 2010. Other chipmakers like Hynix are following suit. Meanwhile, inventory levels are low – a signal for industrial activity to remain brisk. We note that while the producer inventory index has risen to 125.4 in April, this continues to be outpaced by growth in shipments. As a result, the inventory/shipment ratio remained low at 0.95 in April, still below the five-year average of 1.01.

*More headwinds for the KRW – we have revised our 12m forecast to 1,075/USD from 1,025*

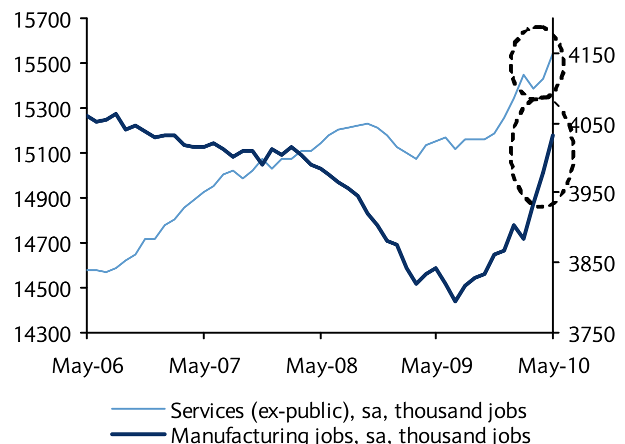
Meanwhile, the headwinds facing the KRW have increased, even as we continue to believe that the currency is fundamentally undervalued. First, we expect the financial account to post a more modest surplus of USD18.6bn in 2010 (previous forecast: USD23bn), or over 1.8% of GDP – a reduction from the USD25.3bn last year. Second, in the wake of regulations on FX forward exposures, we have reduced the size of expected inflows associated with the WGBI inclusion and MSCI upgrade into portfolio assets. Although the regulations are not deemed as capital controls per se, it could limit risk appetite in the market. In a similar vein, our credit strategy team has cut their forecasts for USD bond issuance from Korean companies to around USD15bn (USD5bn less than we had earlier pencilled). As a result, we have moved higher our 12m USD/KRW forecast from 1025 to 1075.

**Figure 3: Low inventories point to upside for production**



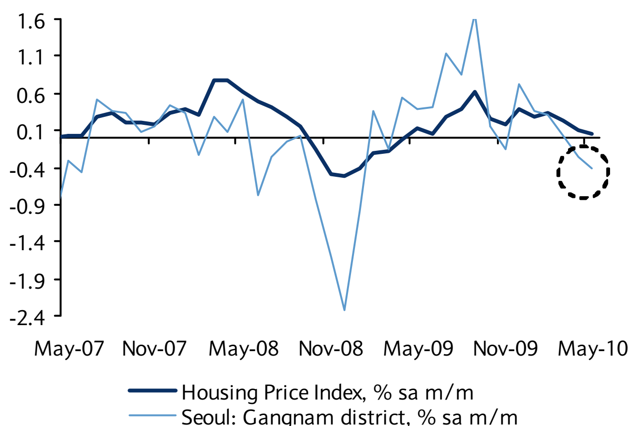

Source: CEIC, Barclays Capital

**Figure 4: This is powering the revival in private job creation**



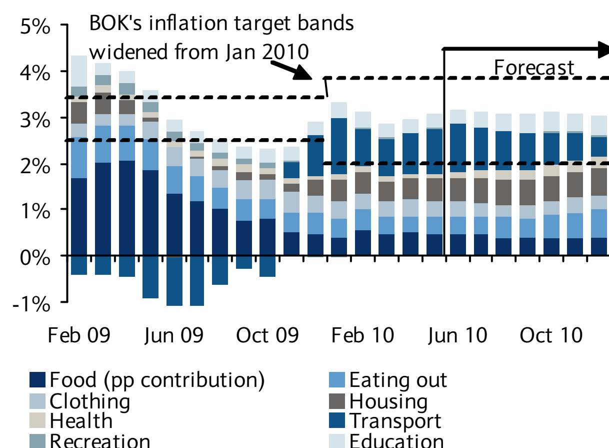

Source: CEIC, Barclays Capital

**Figure 5: Even though the property market is in the doldrums**




Source: CEIC, Barclays Capital

**Figure 6: Inflation expectations are still rising**




Source: CEIC, Barclays Capital

**Figure 7: Korea macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009F | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 5.2 | 5.1 | 2.3 | 0.2 | 5.7 | 4.0 |
| Domestic demand (pp) | 4.8 | 4.4 | 1.4 | -3.0 | 6.1 | 3.8 |
| Private consumption (% y/y) | 4.7 | 5.1 | 1.3 | 0.2 | 3.8 | 4.6 |
| Fixed capital investment (% y/y) | 3.4 | 4.2 | -1.9 | -0.2 | 5.2 | 1.9 |
| Net exports contribution | 0.3 | 0.7 | 1.1 | 3.1 | 0.0 | 0.3 |
| Exports (% y/y) | 11.4 | 12.6 | 6.6 | -0.8 | 9.6 | 7.8 |
| Imports (% y/y) | 11.3 | 11.7 | 4.4 | -8.2 | 11.4 | 7.6 |
| GDP (USD bn) | 952 | 1050 | 948 | 842 | 1056 | 1189 |
| **External sector** | | | | | | |
| Current account (USD bn) | 5.4 | 5.9 | -5.8 | 42.7 | 19.1 | 15.8 |
| CA (% GDP) | 0.6 | 0.6 | -0.6 | 5.1 | 1.8 | 1.4 |
| Trade balance (USD bn) | 27.9 | 28.2 | 5.7 | 56.1 | 33.4 | 25.0 |
| Net FDI (USD bn) | -4.5 | -13.8 | -15.6 | -9.1 | -7.1 | -4.0 |
| Other net inflows (USD bn) | 25.6 | 23.4 | -34.6 | 34.3 | 25.8 | 19.8 |
| Gross external debt (USD bn) | 260 | 383 | 378 | 402 | 410 | 410 |
| International reserves (USD bn) | 239 | 262 | 201 | 270 | 305 | 335 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | 0.4 | 3.5 | 1.2 | -1.7 | -0.2 | 0.2 |
| Primary balance (% GDP) | -1.2 | 0.4 | -1.5 | -4.1 | -2.7 | -2.0 |
| Gross public debt (% GDP)* | 30.0 | 29.7 | 29.0 | 32.6 | 33.0 | 32.0 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 2.1 | 3.6 | 4.1 | 2.8 | 2.3 | 1.6 |
| FX, eop | 930 | 936 | 1260 | 1158 | 1100 | 1025 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | -2.2 | 8.1 | 6.6 | 3.9 | 4.5 | 3.7 |
| CPI (% y/y, eop) | 2.0 | 2.3 | 2.8 | 2.2 | 2.3 | 1.7 |
| FX (domestic currency/USD, eop) | 1282 | 1143 | 1175 | 1150 | 1100 | 1075 |
| Monetary policy benchmark rate (%, eop) | 2.00 | 2.00 | 2.00 | 2.25 | 2.50 | 2.75 |
| Market implied benchmark rate (%, eop) | 2.41 | 2.78 | 2.45 | 2.50 | 2.70 | 2.90 |

Note: *Excludes monetary stabilisation bonds. Source: Barclays Capital

# EMERGING ASIA: MALAYSIA

## Excited about privatisation

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**We expect USD/MYR to fall to 3.05 in 12 months as the government pursues its multi-year re-structuring program. A key catalyst will be the privatisation of government-linked companies. We expect GDP to grow 7.5% in 2010 and expect Bank Negara to hike its policy rate again by 25bp in Q4 10, thus attracting more bond-related inflows.**

We continue to expect the MYR to move towards its trend value in 12 months, which we believe is close to 3.05/USD. First, capital inflows are set to rise as the government bolsters the country's investment appeal through its plan to divest sizeable holdings of non-core assets. Spearheading the privatisation initiative is the state-owned oil company, Petronas, which is going to sell stakes in its petrochemicals subsidiary and Malaysia Marine & Heavy Engineering, a unit of MISC Bhd (63% owned by Petronas). According to Reuters, the petrochemicals unit could be listed later this year and could be Malaysia's second-largest IPO after the recent Maxis (USD3.25bn) listing.

*Privatisation programme remains on track, 12m MYR forecast remains at 3.05/USD*

More details about the 10th Malaysia Plan were released on 10 June 2010, which promises to increase the private sector's share in the economy. PM Najib announced a review of barriers to investment and, specifically, his intention to attract foreign investors to take stakes in non-core, state-owned companies. Indeed, this is a clear signal that the government is committed to promoting competition and that the privatisation drive is a means to this end. The proceeds from stake sales will also benefit the government's fiscal position.

*Fiscal deficit can be reduced significantly*

Indeed, we estimate that if fiscal deficit is reduced below 2%, it will lead to a favourable re-rating of Malaysia's local currency debt. We estimate that an additional MYR15bn of revenue from disinvestment proceeds can cut the fiscal deficit to as low as 2.2% of GDP (from 7.1% of GDP last year). If the government is able to generate MYR20bn, the fiscal deficit could be reduced to below 2% of GDP.

**Figure 1: What is being lined up for stake sales**

| Possible | S/holding (%) | Mkt value of s/holding (USD bn) | Comments |
|---|---|---|---|
| **Candidates already announced for a stake sale / already seen reduction in stakes** | | | |
| Petronas Petrochemicals | 100 | 4.0* | The petrochemicals unit posted revenues of more than USD4bn in the latest financial year. Soon to be the biggest producer in Asia-Pacific region. |
| Petronas – Malaysia Marine & Heavy Engineering Sdn | 100 | 2.5* | A subsidiary of MISC Bhd, MMHE's listing is likely to attract strong investor attention. Together with the petrochemicals unit, initial market estimates put their value at more than USD5bn. |
| Malaysia Airports Holdings | 67.5 | 1.0 | Khazanah sold another 7.7% stake recently. This could be reduced further. |
| Tenaga | 35.7 | 3.8 | Khazanah could reduce its stake further. |
| **Stake sales which may be announced over the course of next year** | | | |
| Petronas Gas | 60.66 | 3.7 | Natural gas subsidiary of Petronas, which continues to "explore the possibility of listing its subsidiaries"; stakes could be reduced in future. |
| Petronas Dagangan | 69.86 | 1.9 | Retail arm of Petronas; stake could be reduced further to unlock value. |
| PLUS Expressways | 55.24 | 2.8 | Small stake of 9.4mn shares was sold recently by Khazanah |
| Sime Darby | 50.6 | 7.4 | 10% stake sale to Chinese investors was reportedly discussed during Premier Wen's visit to Malaysia, according to Malaysian newspapers. |
| Bumiputra-Commerce | 28.4 | 4.4 | Owns CIMB Bank Bhd, a large regional commercial bank. |

Note: * Denotes internal estimates. Source: Bloomberg, Barclays Capital

*More portfolio inflows seen coming via bond and equity markets in 2010*

Taken together, this could mean upside for local-currency bonds and equities. Coupled with the recent issuance of dollar-denominated Islamic bonds worth USD1bn, it could put Malaysia back on the map for foreign portfolio investors. In fact, according to media reports, the government may approach the market again before the budget in Q4 10, given the strong response to the recent issue. Foreign holdings of MGS have risen significantly (18% in April 2010), but remain below the peak seen in 2008 (22% in April 2008). Also, Malaysia could be upgraded within the FTSE EM equity indices. Currently, Malaysia is classified as a secondary emerging market, and if upgraded, would join such economies as Brazil, Taiwan and South Africa in the FTSE's EM index. Historically, a FTSE upgrade is seen as the precursor to a weight increase in the MSCI global EM equity indices, which could trigger more inflows.

*MYR appreciation in line with growth fundamentals; MYR remains undervalued relative to regional peers*

Governor Zeti has re-emphasised that the MYR's strength is a reflection of strong economic fundamentals and, hence, not a big concern for policymakers. Furthermore, she indicated that Malaysia's export sector does not rely on currency weakness to gain competitive advantage. Indeed, the central bank continues to signal that currency remains undervalued on a REER basis. The MYR remains the best-performing currency in Asia year to date. While there are concerns about the strong rise of the MYR against the EUR, the appreciation is comparable with regional peers and mostly driven by EUR weakness.

**Figure 2: Expect more positive news flow for Malaysian assets**

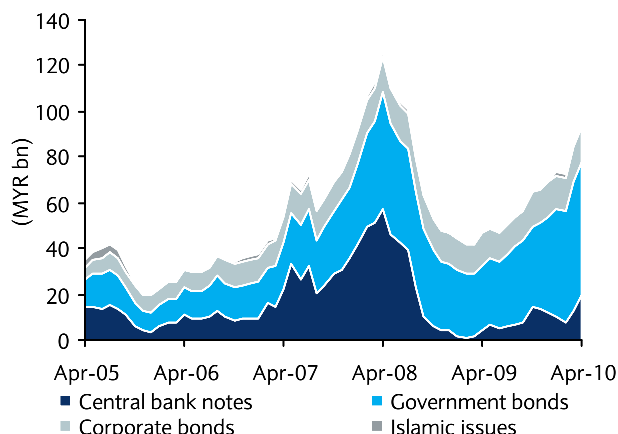
| Date | Event | Comments | Positive for |
|---|---|---|---|
| **Positive news for Malaysia in last few months** | | | |
| 17 Sep 2009 | Added to the FTSE watch list | On watch for upgrade to the advanced emerging economy tier | Equities, FX |
| 23 Oct 2009 | Annual budget | Fiscal consolidation began in the budget | MYR bonds |
| 4 March 2010 | Bank Negara policy meeting | Ahead-of-the-curve decision to normalise the policy rate | FX |
| 30 March 2010 | Bursa Malaysia investor conference | Announcement of the NEM and privatisation programme | Equities, FX |
| May 2010 | Article IV consultations with IMF | The Fund is likely to have strongly supported reform programmes. | FX |
| June 2010 | 10th Malaysia plan unveiled in the parliament | More clarity on the privatisation programme, ie, definite timelines | Equities, FX |
| **Events that could bring more positive news for Malaysia** | | | |
| August 2010 | Detailed release of the NEM | Provides more clarity on timelines for privatisation and stake sales | Local currency bonds, FX |
| August 2010 | FTSE annual review of equity indices | Potential upgrade of Malaysia by FTSE, a precursor for an upgrade in the MSCI | Equities, FX |
| Q4 2010 | Listing of Petronas's petrochemicals business | According to a Reuters report, Petronas is likely to list its petrochemicals business in the last quarter of 2010. | Equities, FX, local currency bonds |

Source: Factiva, Bloomberg, Barclays Capital

*Bank Negara likely to hike policy rates again Q4 10 by 25bp*

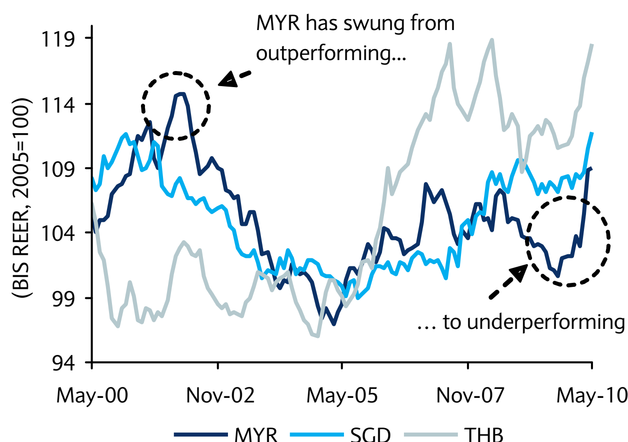
In the backdrop of strong growth and benign inflation, BNM has remained ahead of the curve in conducting its monetary policy by hiking the overnight rate 50bp. This has enhanced the yield differential offered by Malaysian assets and has attracted capital inflows into local bond markets. We expect BNM to hike rates another 25bp in Q4 10, although risks of an earlier move remain. We believe the Malaysian economy will expand 7.5% in 2010, boosted by stronger consumption and exports. As growth conditions remain robust in Asia, we see that the growing trade links between Malaysia and China, especially in commodities, bode well for Malaysian exports. Indeed, China's share in Malaysian exports has grown to over 12% – a fourfold rise in the past decade. The inflation picture remains manageable. The CPI index has remained flat since the start of the year, indicating lack of demand-side pressures for now. While the central bank has noted the risk of possible adjustments in electricity tariffs later in the year, we believe inflation will not be a key driver of policy in the near term.

**Figure 3: Foreign bond holdings continue to rise**




Source: CEIC, Barclays Capital

**Figure 4: The MYR remains significantly undervalued**




Source: BIS, Barclays Capital

**Figure 5: Malaysia macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009E | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 5.8 | 6.5 | 4.7 | -1.7 | 7.5 | 5.0 |
| Domestic demand contribution (pp) | 6.3 | 7.9 | 5.1 | -2.3 | 6.5 | 4.9 |
| Private consumption (% y/y) | 6.8 | 10.5 | 8.5 | 0.7 | 5.8 | 5.7 |
| Fixed capital investment (% y/y) | 7.5 | 9.4 | 0.7 | -5.6 | 6.1 | 6.5 |
| Net exports contribution (pp) | -0.5 | -1.4 | -0.4 | 0.6 | 1.0 | 0.2 |
| Exports (% y/y) | 6.6 | 4.1 | 1.6 | -10.4 | 14.8 | 10.4 |
| Imports (% y/y) | 8.1 | 5.9 | 2.2 | -12.3 | 15.9 | 11.7 |
| GDP (USD bn) | 156.0 | 187.2 | 222.8 | 193.7 | 234.6 | 252.1 |
| **External sector** | | | | | | |
| Current account (USD bn) | 26.3 | 29.9 | 38.9 | 31.7 | 35.0 | 33.0 |
| CA (% GDP) | 16.8 | 16.0 | 17.4 | 16.4 | 14.9 | 13.2 |
| Trade balance (USD bn) | 37.6 | 37.8 | 51.2 | 40.3 | 43.5 | 38.0 |
| Net FDI (USD bn) | 0.0 | -2.8 | -7.8 | -6.6 | 2.4 | -5.0 |
| Other net inflows (USD bn) | -12.0 | -8.7 | -25.9 | -16.0 | -14.2 | -15.0 |
| Gross external debt (USD bn) | 50.9 | 55.8 | 66.4 | 71.0 | 80.2 | 85.0 |
| International reserves (USD bn) | 83.2 | 119.5 | 92.1 | 97.6 | 123.0 | 138.6 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -3.3 | -3.2 | -4.8 | -7.1 | -4.2 | -3.0 |
| Gross public debt (% GDP) | 42.2 | 41.7 | 41.5 | 48.8 | 49.3 | 48.3 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 3.1 | 2.4 | 4.4 | 1.1 | 1.5 | 2.0 |
| FX, eop | 3.60 | 3.30 | 3.60 | 3.40 | 3.12 | 3.05 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | -3.9 | 10.1 | 7.3 | 6.2 | 6.7 | 4.9 |
| CPI (% y/y, eop) | -1.4 | 1.3 | 1.5 | 1.6 | 1.5 | 1.7 |
| FX (domestic currency/USD, eop) | 3.52 | 3.33 | 3.20 | 3.17 | 3.12 | 3.05 |
| Overnight policy rate (%, eop) | 2.00 | 2.25 | 2.50 | 2.50 | 2.75 | 2.75 |

Source: Barclays Capital

# EMERGING ASIA: PHILIPPINES

## Peso to play catch-up

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**We expect USD/PHP to drift towards 44 in 12 months given robust balance of payments and the strong growth outlook. We now expect rate normalisation to begin in Q4 given BSP concerns about global growth and a relatively benign inflation outlook.**

*Peso underperformance not justified by fundamentals; expect PHP to hit 44 in 12-mths*

The PHP has underperformed its regional peers such as IDR, SGD, MYR and THB, over the past month. In our opinion, this underperformance cannot be easily explained by Filipino fundamental conditions – a smooth political transition, robust balance of payments, rising FX reserves and strong growth outlook. Rather, we believe that the PHP was most likely stabilised by policymaker action in the period of transition to a new executive administration. With this transition drawing to a close, global risk aversion fading and macroeconomic conditions being favourable, we expect PHP underperformance to reverse. Our 3-month forecast for USD/PHP is 45.25, with our 12-month forecast being 44.

*Aquino's clear Presidential mandate positive for economy*

On the political front, the election outcome was better than most expected, with Benigno Aquino III winning with a clear majority. At the same time, the level of violence in the country was much lower compared with past elections. This is a positive development and shows that that democracy continues to gradually move on the right track in the country.

*Balance of payments position to remain robust; supported by remittances*

Philippines' external position is expected to remain strong through 2010. We project a current account surplus of 5% of GDP, supported by USD17.2bn worth of remittances (up 10% from 2009). Although the trade deficit is expected to widen to USD10bn, lower commodity prices, especially oil and food, should limit the extent of deterioration. We expect FDI inflows to rise, consistent with the global growth turnaround. At the same time, from a valuation perspective, the Philippines stock exchange is looking attractive on a historical and regional basis, which together with solid GDP growth, should support equity inflows.

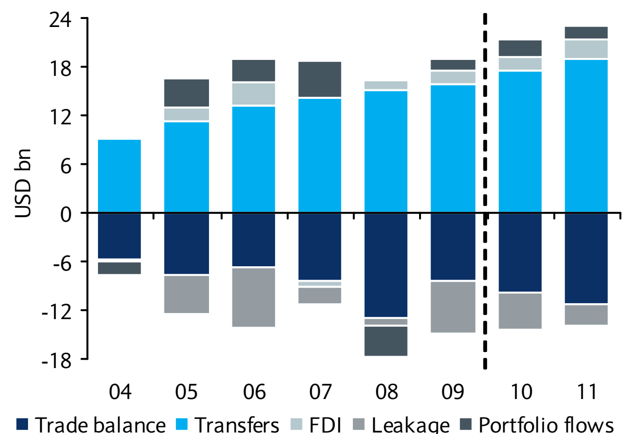
*FX reserves continue to rise; BSP aims to reduce PHP volatility*

With a robust balance of payments, the Philippines has continued to build foreign exchange reserves, running at USD47.7bn at the end of May 2010. This compares with short-term external debt by residual maturity of USD8.9bn, according to Bangko Sentral ng Pilipinas data. BSP is typically present on both sides of the market, with the primary objective being to cap excessive volatility in the pair.

**Figure 1: Peso to play catch-up…**

Source: Bloomberg, Barclays Capital

**Figure 2: …given robust fundamentals (BoP)**




Note: Leakages=other investments + errors &omissions.
Source: CEIC, Barclays Capital

*GDP to expand by 6% in 2010; supported by consumption and investment*

The Philippine economy is currently enjoying the best of both worlds – a solid growth outlook and relatively benign inflation. GDP expanded by 13.2% on an annualised basis in Q1, driven by election-related spending. For 2010, we expect the economy to expand by 6%, with the bulk of the impetus coming from consumption. However, with businesses becoming more positive, we also expect strong investment spending of 8.6%. At the same time, exports are expected to remain underpinned given the strong global electronics cycle.

*Inflation outlook is relatively benign, giving BSP policy flexibility*

Inflation has consistently surprised on the downside since the start of the year, largely on the back of lower-than-expected gains in food prices. CPI fell by 0.2% m/m in May, with the 3m/3m saar easing to 3% from a recent peak of 9.3% in December. With global commodity prices taking a breather, especially oil and food, the outlook for inflation is relatively benign, despite some up–tick in core prices. Overall, we expect inflation to average 4.5% in 2010, in the middle of the central bank's 2010 target of 3.5-5.5%.

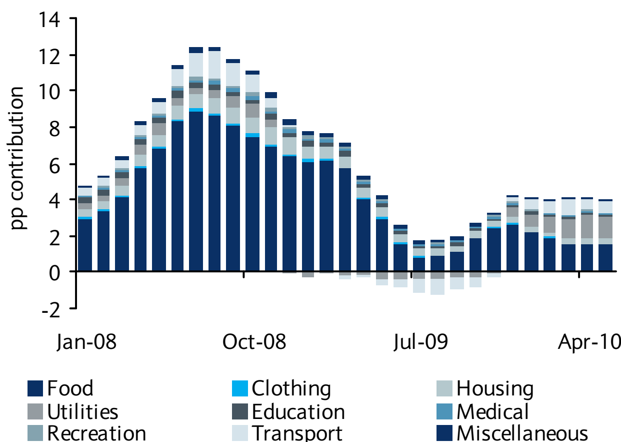
*BSP has a bias to err on the side of caution; we now expect rate normalisation to begin in Q4*

Bangko Sentral ng Pilipinas kept the policy rate unchanged for the eighth consecutive meeting at 4.0% in June. The central bank said that in the face of uncertain global economic prospects and the flexibility provided by the inflation outlook, it was "prudent" to keep policy rates unchanged. With the BSP remaining watchful of developments in Europe, we believe it has a bias to err on the side of caution. Governor Tetangco recently noted that BSP has "room" for a "more prudent" stance. We now expect rate normalisation to begin later and be more spread out. We expect the first 25bp hike in Q4 (previously Q3); followed by a pause in Q1. We expect a second rate hike to come through in Q2 11 – at the time our US colleagues expect the Fed to begin its tightening cycle – and possibly one more hike in Q4 11.

*Budget deficit to hold at 4% of GDP in 2010*

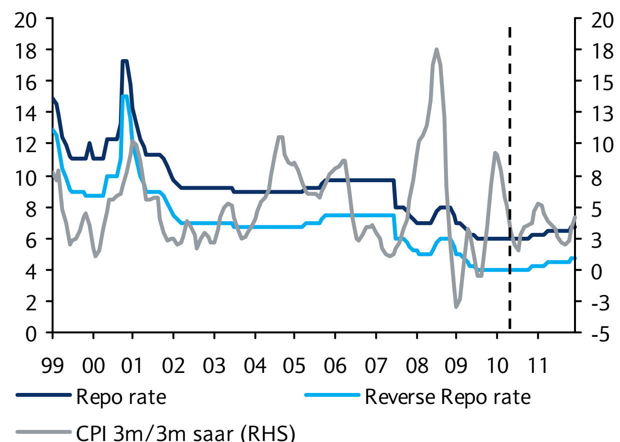
The key concern for investors remains the country's fiscal situation. Despite a cyclical bounce in revenues, the budget shortfall was PHP131.5bn in the January-April period – 44% of the annual target of roughly PHP300bn (3.6% of GDP). Given the permanent revenue-eroding measures announced in 2009 such as VAT exemptions, etc, we expect the budget deficit to be PHP335bn (4% of GDP) compared with a shortfall of PHP298.5bn last year. The government's asset sales programme has now been pushed to H2 10, and we believe its success remains uncertain. However, deficit funding should not be a problem, given flush domestic liquidity.

**Figure 3: Food and utilities are the main drivers of inflation**



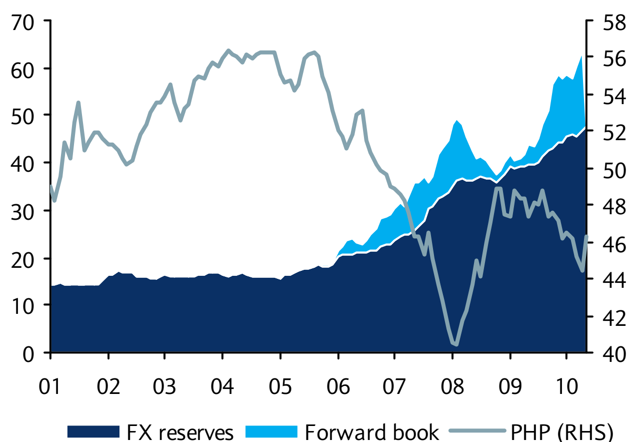

Source: CEIC, Barclays Capital

**Figure 4: Gradual rate normalisation**



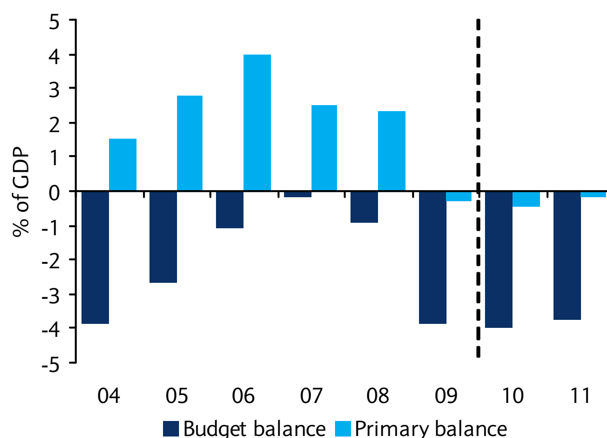

Source: CEIC, Barclays Capital

Figure 5: FX reserves have been rising




Source: CEIC, Barclays Capital

Figure 6: Fiscal deficit to remain large




Source: CEIC, Barclays Capital

Figure 7: Philippines macroeconomic forecasts

| | 2006 | 2007 | 2008 | 2009F | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 5.3 | 7.1 | 3.7 | 1.1 | 6.0 | 5.0 |
| Domestic demand contribution (pp) | 5.9 | 7.2 | 4.1 | 2.8 | 7.0 | 4.9 |
| Private consumption (% y/y) | 5.5 | 5.8 | 4.7 | 4.1 | 5.5 | 5.2 |
| Fixed capital investment (% y/y) | 3.9 | 10.9 | 2.7 | -0.4 | 8.6 | 6.0 |
| Net exports contribution (pp) | 5.3 | 4.9 | -1.3 | -5.4 | 0.5 | -0.1 |
| Exports (% y/y) | 13.4 | 5.5 | -2.0 | -13.4 | 13.5 | 4.7 |
| Imports (% y/y) | 1.8 | -4.1 | 0.8 | -1.9 | 11.3 | 4.5 |
| GDP (USD bn) | 118 | 144 | 167 | 161 | 186 | 208 |
| **External sector** | | | | | | |
| Current account (USD bn) | 5.3 | 7.1 | 3.6 | 8.6 | 9.3 | 9.6 |
| CA (% GDP) | 4.5 | 4.9 | 2.2 | 5.3 | 5.0 | 4.6 |
| Trade balance (USD bn) | -6.7 | -8.4 | -12.9 | -8.4 | -9.9 | -11.2 |
| Net FDI (USD bn) | 2.8 | -0.6 | 1.3 | 1.6 | 1.9 | 2.3 |
| Other net inflows (USD bn) | -2.9 | 4.1 | -3.1 | -3.7 | -0.4 | 0.2 |
| Gross external debt (USD bn) | 53.4 | 54.9 | 53.9 | 53.3 | 54.4 | 53.7 |
| International reserves (USD bn) | 23.0 | 33.7 | 36.0 | 44.2 | 52.9 | 63.8 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -1.1 | -0.2 | -0.9 | -3.9 | -4.0 | -3.7 |
| Primary balance (% GDP) | 4.0 | 2.5 | 2.3 | -0.3 | -0.5 | -0.2 |
| Gross public debt (% GDP) | 82.0 | 71.8 | 63.8 | 72.9 | 67.2 | 64.0 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 4.3 | 3.9 | 8.0 | 4.3 | 3.7 | 3.5 |
| FX, eop | 49.1 | 41.4 | 47.5 | 46.4 | 45.0 | 44.0 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | 0.5 | 7.3 | 5.7 | 6.1 | 5.0 | 3.8 |
| CPI (% y/y, eop) | 6.4 | 4.4 | 4.7 | 4.7 | 3.7 | 3.6 |
| FX (domestic currency/USD, eop) | 48.4 | 45.2 | 45.5 | 45.25 | 45.0 | 44.5 |
| Overnight policy rate (%, eop) | 4.78 | 4.00 | 4.00 | 4.00 | 4.25 | 4.25 |

Source: Barclays Capital

# EMERGING ASIA: SINGAPORE

## Quietly confident

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**With growth and inflation dynamics in the sweet spot, there is a window of opportunity to address longer-term priorities – namely competitiveness. We expect the SGD NEER to trade above the midpoint in the coming months as we near the October monetary policy statement. We expect USD/SGD to drift to 1.35 in one year.**

*Q2 GDP likely held up at levels close to the Q1 record*

A sense of quiet confidence within policy circles continues to prevail, even amid the recent bout of market turbulence. A key factor has been the robust Q1 GDP report on 19 May. In year-on-year terms, Q1 GDP was up 15.5% – the fastest pace of growth since the 1960s – led by a synchronised resurgence in activity in the manufacturing, construction and tourism-related industries, coupled with higher asset prices and job gains, which stoked consumer spending. A second factor is the strength of the cyclical upturn in the global electronics sector, which should sustain Q2 GDP at levels close to the Q1 record.

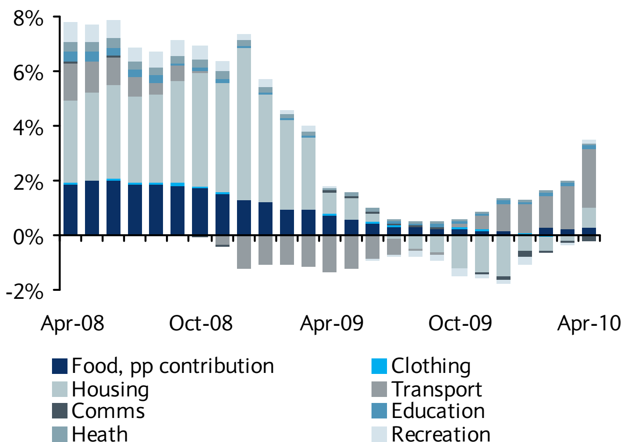
*Capacity additions will buffer growth this year; we look for the economy to expand 9.5%*

A third factor is the sizeable addition to capacity this year – the phased opening of two SGD6bn casino-resorts and the doubling of both retail and exhibition space in the central business district. At the same time, there will also be additions to manufacturing capacity in the form of three biologics (vaccine) plants, new aerospace maintenance facilities and Shell's USD3bn petrochemical complex. Adding to that are the Youth Olympics in August and the F1 race in September, which should boost tourism receipts. Even though we have assumed a large correction in pharmaceuticals output that could drop Q3 GDP by 10% on quarter, the economy is still likely to grow 9.5% this year, above the official 7-9% forecast.

*Europe is seen as a risk, but the impact on the real economy is expected to be mild for now*

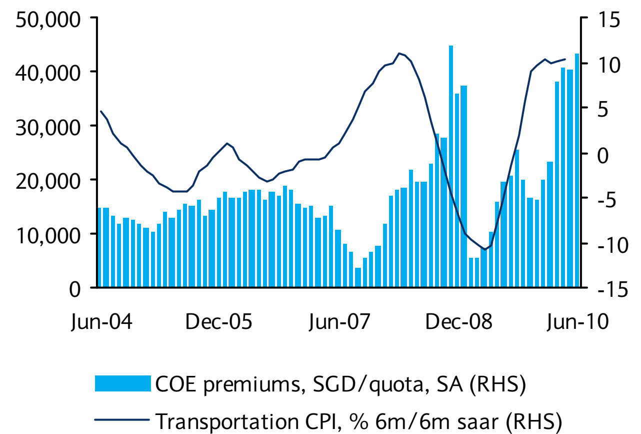
The government's policy challenge will increasingly be to manage supply bottlenecks, contain pockets of overheating and keep a close watch on concerns about the global economy. While it has expressed increased wariness that Europe's debt problems and the synchronised withdrawal of fiscal measures could trigger a sharp asset price correction, this risk is seen to be modest at this stage. On balance, the base case is still that interest rates around the world remain low and that Asian growth robust. There is also some optimism regarding the stronger-than-expected job market recovery and business conditions in the US, which could suggest that private demand could perform well.

**Figure 1: Inflation is generally well behaved**




Source: CEIC, Barclays Capital

**Figure 2: Higher transport prices driven by car quota costs**




Source: CEIC, Barclays Capital

*Inflation likely to remain elevated, due to the pass-through of administered price hikes*

We believe the shift to a more aggressive tightening stance in April should be taken as a sign of greater determination by the central bank to pre-empt inflationary pressures, partly due to the possibility that general elections could be called as early as September. Indeed, the upside surprises to inflation in recent months have been largely due to administered price changes, namely the cost of car quotas, which jumped to SGD41,000 in June, up 271% y/y. Another driver of inflation is the 3.02% upward adjustment to electricity tariffs on 1 April, the fourth consecutive quarterly increase, which will start to feature more strongly in services costs. Indeed, the cost of restaurant meals has continued to trend steadily higher since the start of the year. Offsetting these factors is the dissipation of base effects in the fuel category, which should reduce the large contributions from transport (+208bp in April). Taking these effects into consideration, our CPI forecast remains at 2.8%.

*We expect business costs to rise this year, led by wages, utilities and industrial rents*

An emerging area of concern is the rise in business costs. Beyond the cost of utilities, the immediate concern is the cost of labour, the largest component of business costs in Singapore. With labour markets generally tight, the increase in foreign worker levies from July could hurt relatively labour-intensive industries. Compounding this is the 1% increase in the Central Provident Fund contributions that employers will also have to pay this year, a move that will cost businesses an additional SGD0.9bn in statutory pension contributions. While commercial and retail rents were stable in Q1 due to the deluge of additional supply, industrial and residential rents have also trended higher.

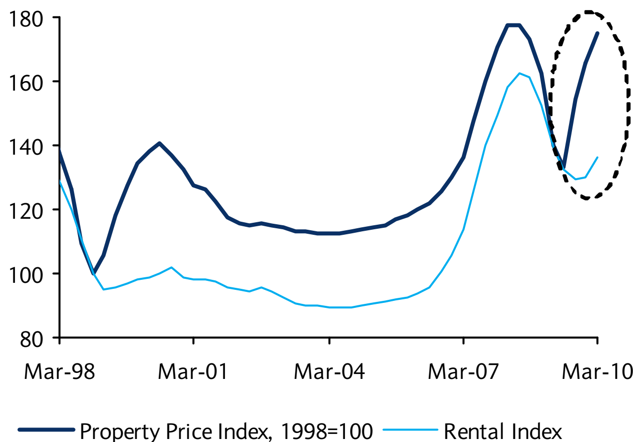
*We believe there are reasons to expect the SGD NEER to underperform in the target band in the coming months.*

All in, with growth likely to remain above trend for the rest of the year, the MAS may be inclined to maintain the policy of gradual appreciation at its October policy meeting. However, we believe there are reasons to expect the SGD NEER to underperform in the target band in the coming months. First, the pace of reserve accumulation will start to slow in the coming quarters as the current account surplus narrows. The second is the prospect of reduced global growth, with the risk of a slower expansion in Europe. Under these conditions, while we would still expect the SGD NEER to trade above the midpoint in the coming months, we do not expect it to be close to the top.

*A source of prudential risk is runaway property prices, which have defied two rounds of cooling measures*

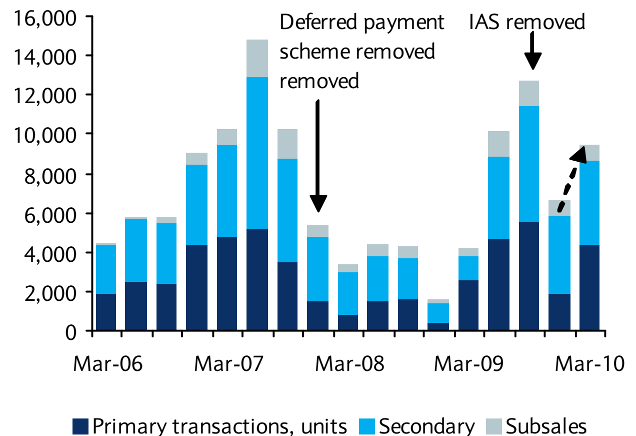
Signs of overheating add another dimension of risk. As of March 2010, average private home prices had risen 31.3% from the bottom of the cycle in June 2009. In contrast, the rental index showed only a pickup of 5.3% from its low in September, a clear sign that rental yields have fallen sharply. There are indications that more buyers are now remaining on the sidelines. For instance, data from the Singapore Institute of Surveyors and Valuers show that

**Figure 3: Runaway house prices, shrinking rental yields**




Source: CEIC, Barclays Capital

**Figure 4: Further tightening of prudential measures needed**




Source: CEIC, Barclays Capital

there were only 899 caveats lodged for condominiums in the first three weeks of May compared with 3,060 in April. Even so, with the job market set to remain strong amid an environment of low interest rates, the current standoff between buyers and sellers could prevail. This implies a growing need for a further tightening of prudential measures (debt-to-income limits, stamp duty increases) in Q3 to pre-empt overheating pressures and to orchestrate a soft landing.

*Focus is turning to how to boost longer term competitiveness – by looking at ways to increase productivity*

This is perhaps why attention is shifting to longer-term priorities – namely ways to generate productivity gains over time to cushion the impact of higher business costs. The government also recognizes that Singapore cannot compete on costs, but can instead improve its value proposition through productivity. Indeed, a high-level council (National Productivity and Continuing Education) headed by the Deputy Prime Minister will aim to boost productivity by 2% to 3% every year for the next 10 years. Aside from targeting a set of 12 priority sectors that make up 50% of the economy, it will also ensure that skills development is keeping up with the needs of the firms.

**Figure 5: Singapore macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009F | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 8.6 | 8.5 | 1.8 | -1.3 | 9.5 | 4.0 |
| Domestic demand (pp) | 5.0 | 5.4 | 10.2 | -3.8 | 6.4 | 2.2 |
| Private consumption (% y/y) | 3.1 | 6.5 | 2.7 | 0.4 | 3.9 | 1.9 |
| Gross fixed capital investment (% y/y) | 14.6 | 19.9 | 13.6 | -3.3 | 8.9 | 3.7 |
| Net exports contribution | 3.4 | 4.7 | -9.0 | 2.3 | 2.7 | 1.4 |
| Exports (% y/y) | 11.2 | 8.9 | 4.1 | -9.0 | 10.9 | 4.6 |
| Imports (% y/y) | 11.2 | 7.8 | 9.2 | -11.0 | 11.0 | 4.5 |
| GDP (USD bn) | 141.2 | 172.1 | 188.4 | 177.9 | 209.3 | 224.9 |
| **External sector** | | | | | | |
| Current account (USD bn) | 29.8 | 47.1 | 36.0 | 32.5 | 32.2 | 28.9 |
| CA (% GDP) | 21.8 | 26.6 | 18.6 | 17.8 | 15.4 | 12.7 |
| Trade balance (USD bn) | 43.6 | 46.0 | 26.6 | 30.2 | 33.5 | 24.8 |
| Net FDI (USD bn) | 10.6 | 8.7 | 18.5 | 10.9 | 15.0 | 15.0 |
| Other net inflows (USD bn) | -29.0 | -37.5 | -40.3 | -34.0 | -25.0 | -30.0 |
| Gross external debt (USD bn) | 99.9 | 97.4 | 92.2 | 99.3 | 89.5 | 88.3 |
| International reserves (USD bn) | 136.3 | 163.0 | 174.2 | 187.8 | 210.0 | 224.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | 0.0 | 3.1 | 0.1 | -1.2 | -0.3 | 0.5 |
| Primary balance (% GDP) | 0.0 | 2.5 | -0.2 | -1.5 | -0.7 | 0.2 |
| Gross public debt (% GDP) | 95.1 | 96.3 | 92.0 | 117.0 | 98.1 | 95.0 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 0.8 | 3.7 | 5.5 | -0.5 | 4.0 | 1.0 |
| FX, eop | 1.54 | 1.45 | 1.48 | 1.40 | 1.36 | 1.34 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | -1.7 | 15.5 | 11.3 | 5.6 | 6.4 | 0.1 |
| CPI (% y/y, eop) | 0.0 | 1.6 | 3.9 | 3.6 | 4.0 | 3.2 |
| FX (domestic currency/USD, eop) | 1.47 | 1.40 | 1.3800 | 1.3750 | 1.3600 | 1.3600 |

Source: Barclays Capital

# EMERGING ASIA: SRI LANKA

## Drifting in the right direction

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**We expect the LKR to drift towards 112.5 in 12 months given the strong balance of payments position, with a continued buildup in FX reserves. We expect the budget deficit to improve to 7.5% of GDP, and the IMF stand-by facility to continue. Benign inflation and the bias to support credit growth will likely anchor the policy rate until Q4. Dividends of peace, stronger external balances and a gradual improvement in the budget deficit should see Sri Lanka spreads tighten.**

*LKR to hit 113 in 6 months given the robust balance of payments*

We expect Sri Lanka's external position to remain strong in 2010. We project a balance of payments surplus of USD2bn (4.6% of GDP), supported by remittances inflows of USD3.5bn, up 16% from 2009. We look for FDI inflows of USD1bn and overseas development assistance disbursements worth USD1.8bn. These structural flows would more than cover the trade deficit shortfall of USD4.5bn. Given this backdrop, we expect the LKR to appreciate to 113 in 6 months and 112.5 in 12 months. We forecast FX reserves to rise to USD6.5bn by end-2010 providing import cover of 6.4 months. FX reserves were USD5.2bn at the end of March, with import cover of 5.6 months. This compares with short-term external debt of USD2bn as at Q4 09, according to World Bank data.

*2010 budget deficit to improve to 7.5% of GDP from 10.3% last year.*

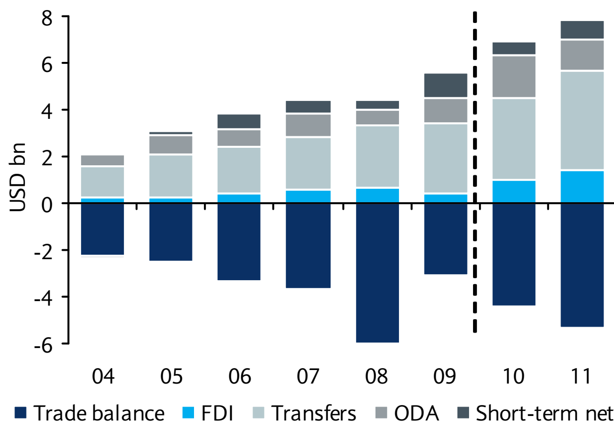
*Government to announce a sustainable deficit reduction strategy*

The budget deficit in Q1 10 was LKR123bn (2.2% of GDP) down 22% from the same period last year and equivalent to 28% of the pre-election annual deficit target of LKR438bn (8% of GDP). The improvement was driven by a 26% y/y bounce in revenues, while at the same time the government kept a tab on current expenses, which rose by a paltry 1.6%. The final budget should be tabled shortly and according to the IMF, the government is planning a substantial deficit reduction for the year, driven primarily by savings in recurrent expenditure. We expect the budget shortfall to be 7.5% of GDP compared with 10.3% in 2009. The government is also planning to under take comprehensive tax reform and to correct slippages in order to move towards a sustainable deficit reduction path.

*IMF stand-by facility to continue*

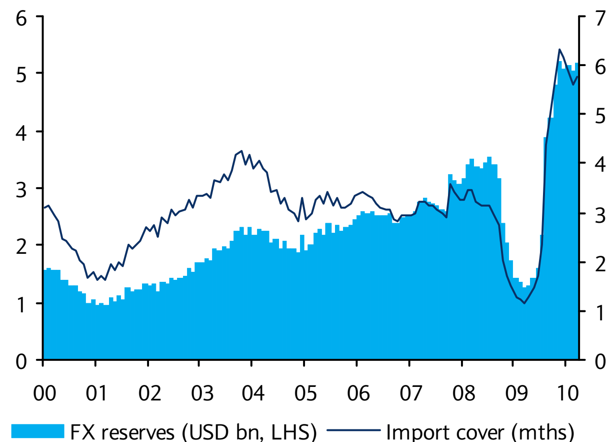
The IMF concluded the Stand-by Arrangement (SBA) Staff Mission to Sri Lanka on 21 May, with the fund's target for international reserves, reserve money and net domestic financing being met by the authorities. We expect the IMF to continue with the USD2.6bn SBA and the delayed third tranche to be released over the coming quarter.

**Figure 1: Robust balance of payments position**




Source: CEIC, Barclays Capital

**Figure 2: FX reserves are very comfortable**




Source: CEIC, Barclays Capital

*Economy to expand by 7% in 2010; up from 3.5% in 2009*

We still expect the Sri Lankan economy to grow by 7% in 2010, twice the pace of last year. The strength in the economy is driven by robust tourist inflows and expanding services, especially retail trade and financial. The outlook for consumer spending remains robust given an improving labour market, positive wealth effects from the equity/property market and healthy remittances inflows. At the same time, construction should remain underpinned given re-building work and increased infrastructure investment. The country is also benefitting from positive terms of trade based on the higher price for key exports such as tea and rubber, while declines in the international price of key imports such as oil, sugar, wheat and rice have also helped. There are, however, some risks as Sri Lanka has the highest export exposure to Europe among the Asian economies, with 38% of exports headed to the EU (7% of exports go to Greece, Portugal, Spain, Italy and Ireland combined). Nevertheless, private sector credit growth continues to turn around and businesses remain upbeat, which should help to solidify recovery.

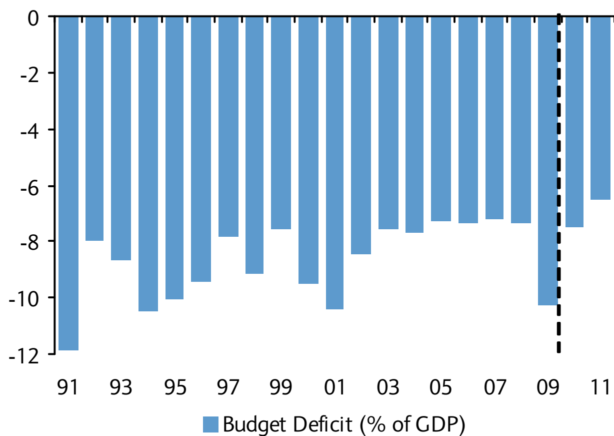
*Inflation to remain relatively benign given lower food and oil commodity prices; keeping policy rates anchored until Q4 20*

Price pressures have eased over the past few months given improved domestic food supplies on account of the harvesting season, with the 3m/3m saar collapsing to -1% from a recent peak of nearly 12% in February. Looking ahead, we expect inflation to remain benign based on lower international commodity prices, especially food and oil. Core inflation is also expected to remain contained despite solid growth momentum, as trend GDP based on historical data will have an underestimation bias. Overall we forecast inflation to average 5.7% in 2010 compared with 3.5% last year. Given the relatively benign inflation outlook and the bias to support credit growth, we expect the policy rates to remain anchored until Q4 10. This should provide a favourable backdrop for the local bond market.

*Potential for one notch upgrade to B+*

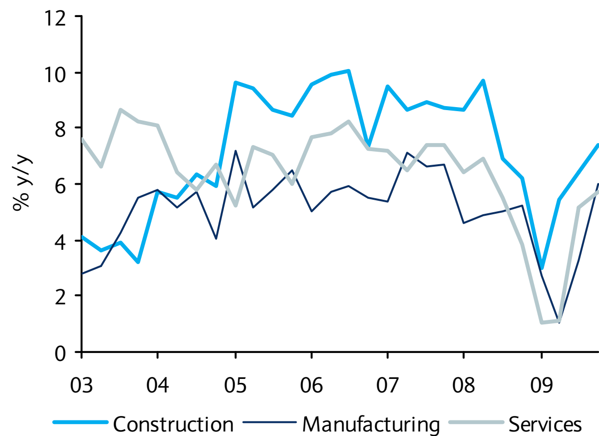
Given the improving external balance, a budget deficit moving gradually in the right direction and positive benefits from the end of the war, our credit strategist believes there is scope for Sri Lanka's sovereign spread to tighten. As a part of the Central Bank Road Map 2010, the Central Bank of Sri Lanka has set up a high level Sovereign Rating Committee to develop a strategy to help upgrade the country's sovereign rating from the current B (Positive outlook) to an investment grade of BBB- or higher over the next four years. The committee will make regular reviews of developments in the economy and convey these improvements to the rating agencies. We believe there is potential for the sovereign to be upgraded by one notch to B+ by S&P in 2010, catching up with Fitch's rating.

**Figure 3: Budget deficit to improve**



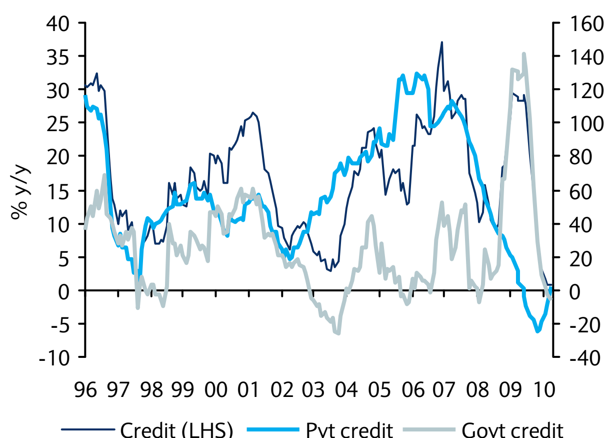

Source: CEIC, Barclays Capital

**Figure 4: Growth to remain robust**



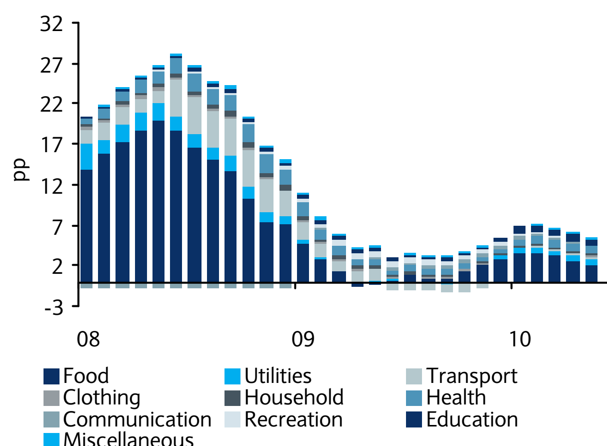

Source: CEIC, Barclays Capital

Figure 5: Private sector credit growth has turned




Source: CEIC, Barclays Capital

Figure 6: Inflation remains benign




Source: CEIC, Barclays Capital

Figure 7: Sri Lanka macroeconomic forecasts

| | 2006 | 2007 | 2008 | 2009F | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 7.7 | 6.8 | 6.0 | 3.5 | 7.0 | 6.6 |
| Domestic demand contribution (pp) | 9.3 | 5.9 | 7.5 | 3.8 | 8.5 | 8.1 |
| Private consumption (% y/y) | 7.1 | 4.5 | 7.9 | 3.6 | 7.5 | 7.0 |
| Fixed capital investment (% y/y) | 12.9 | 9.1 | 5.3 | 1.0 | 8.0 | 11.0 |
| Net exports contribution (pp) | -1.7 | 0.9 | -1.6 | -0.2 | -1.4 | -1.5 |
| Exports (% y/y) | 3.8 | 7.3 | 0.4 | -12.3 | 4.3 | 6.8 |
| Imports (% y/y) | 6.9 | 3.7 | 4.0 | -9.1 | 7.0 | 9.0 |
| GDP (USD bn) | 27 | 31 | 39 | 40 | 45 | 51 |
| **External sector** | | | | | | |
| Current account (USD bn) | -1.5 | -1.4 | -3.9 | -0.2 | -1.4 | -1.3 |
| CA (% GDP) | -5.6 | -4.5 | -10.1 | -0.5 | -3.0 | -2.5 |
| Trade balance (USD bn) | -3.4 | -3.7 | -5.9 | -3.1 | -4.5 | -5.3 |
| Net FDI (USD bn) | 0.5 | 0.5 | 0.7 | 0.4 | 1.0 | 1.4 |
| Other net inflows (USD bn) | 1.4 | 1.6 | 1.1 | 2.2 | 2.4 | 2.2 |
| Gross external debt (USD bn) | 14.0 | 16.5 | 17.8 | 20.9 | 23.3 | 24.5 |
| International reserves (USD bn) | 2.5 | 3.1 | 1.8 | 5.1 | 6.5 | 8.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -7.3 | -7.2 | -7.4 | -10.3 | -7.5 | -6.5 |
| Primary balance (% GDP) | -2.0 | -1.9 | -2.3 | -3.6 | -0.9 | 0.2 |
| Gross public debt (% GDP) | 92.2 | 89.1 | 85.3 | 90.5 | 90.5 | 88.6 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 19.3 | 18.8 | 14.4 | 4.8 | 5.8 | 6.0 |
| FX, eop | 107.5 | 108.7 | 113.0 | 114.4 | 113 | 112 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | 1.6 | 8.0 | 7.3 | 6.3 | 6.4 | 6.9 |
| CPI (% y/y, eop) | 5.3 | 6.3 | 5.3 | 5.2 | 5.8 | 6.0 |
| FX (domestic currency/USD, eop) | 115.8 | 114.1 | 113.5 | 113.2 | 113.0 | 112.8 |
| Overnight policy rate (%, eop) | 11.75 | 9.75 | 9.75 | 9.75 | 10.00 | 10.00 |

Source: CEIC, Barclays Capital

# EMERGING ASIA: TAIWAN

## Strategic re-rating of investment prospects

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**The cross-Strait economic engagement is still one of our favourite structural transformation stories. As fundamentals improve, reserve accumulation will eventually give way to TWD strength. We maintain our USD/TWD forecast at 30 in 12 months.**

*Beginning of a multi-year structural revival*

The government is pursuing a comprehensive economic revitalisation agenda. A large part of this is regional integration. To date, Taiwan 1) has opened key sectors of the economy to Chinese investment; 2) reduced the cost of freight across the Strait of Taiwan; and 3) is now close to reducing import tariffs on trade with China. Another area is the streamlining of tax and industrial policies to boost its ability to compete for FDI – addressing a key deficiency. These structural policies could add to the strong cyclical boost the economy is experiencing. Taiwan is the only economy in Asia to have recorded four successive quarters of double-digit growth, pushing the output gap into positive territory by Q2. We believe the economy could expand 7.5% in 2010 – the strongest pace since 1989.

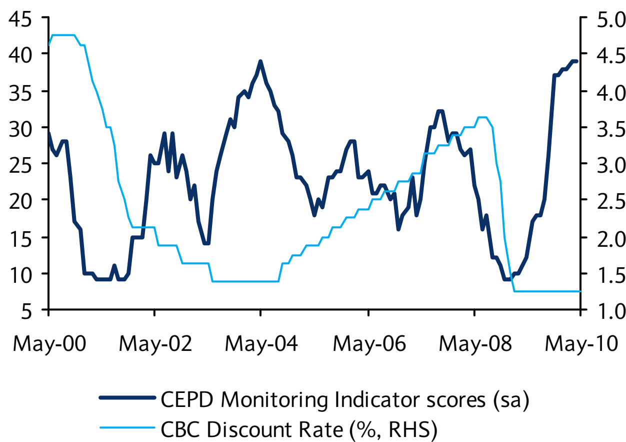
*We have pushed back our rate normalisation call to the end of Q3*

The Central Bank of China could still begin to normalise rates at its June 24 board meeting by delivering a 12.5bp hike to pre-empt demand-pull inflation and rein in property prices, but this is now looking less likely. While policymakers cannot easily ignore the strong domestic growth, the continued turbulence in global markets will blunt the impetus to hike rates immediately. We believe there is now a higher likelihood that the central bank will defer a hike until its next board meeting in September. One factor is that the revival in credit growth is still nascent and narrowly based. Moreover, inflation could remain benign for longer than expected. A further consideration is the impact of the EUR's depreciation on Taiwan's exports to Europe, which we believe the central bank is currently assessing.

*CBC could continue to manage liquidity; outside chance of an RRR hike in June*

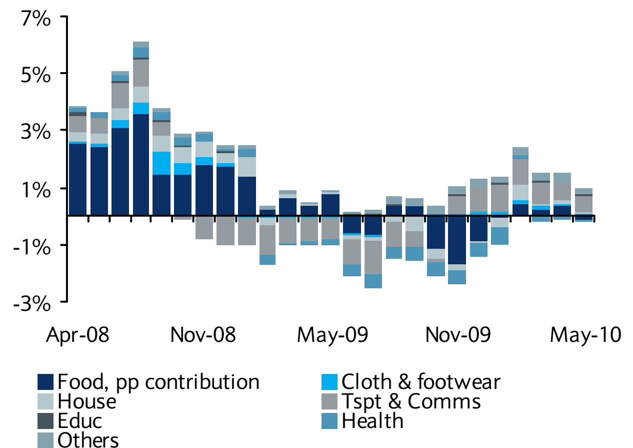
Meanwhile, we expect the CBC to continue draining excess liquidity by stepping up NCD issuance, as it indicated at its March Board meeting. NCDs outstanding hit TWD6.3trn in May 2010, a new record high (although with rates at a historical low, the fiscal cost is generally lower than it was in 2008). At the same time, excess reserves in the financial system receded to TWD32bn in May, down significantly from the peak of TWD154bn a year earlier. At the June policy meeting, the central bank could drain liquidity by raising reserve ratios.

**Figure 1: CBC could continue pro-growth stance until Q3**




Source: CEIC, Barclays Capital

**Figure 2: … since the inflation picture remains benign**




Source: CEIC, Barclays Capital

Beyond trade, consumer confidence readings, which collapsed in H2 08, have now recovered close to historical highs. This is also due to the catalytic effect of closer economic relations with China. A key driver is the resurgence in the number of Chinese tourist arrivals, which have regularly exceeded the quota limit of 3,000 per day, compared with an average of fewer than 500 per day in 2009 and since the program started in February 2008. Chinese visitors surpassed those from Japan for the first time as the largest group of visitors. For instance, Taiwan received 1.76mn visitors in the first four months of 2010, up 23.3% from a year ago. Of the total, 525,000 (29.8%) were tourists from the Mainland, with 181,000 arriving in April alone. By contrast, Japanese tourists totalled 352,000 in the first four months of the year.

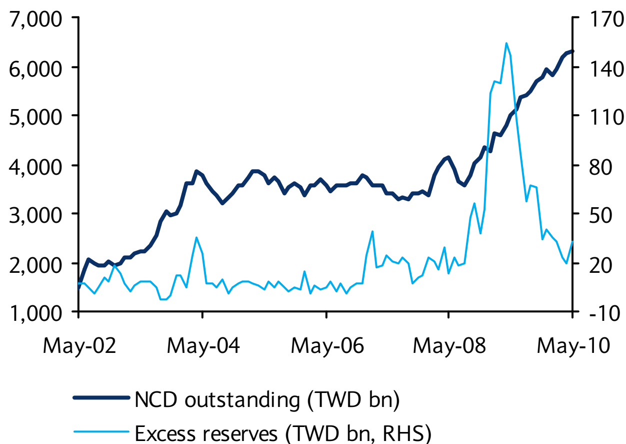
*Food prices could soften further in Q3, keeping inflation in check*

Even so, inflation is still benign, which affords the CBC some room to keep rates on hold. May inflation is a case in point. Consumer prices rose just 0.74% y/y, tilting the seasonally adjusted trend into negative territory. One downward bias has been fuel – its contribution to headline inflation has declined since January 2010 as base effects roll off. The food component is becoming another drag, as vegetable and fruit prices are likely to remain low. Taiwan's Central Weather Bureau has forecast fewer typhoons than usual in Q3, along with above average rainfall. Indeed, rainfall in the food-producing regions has been above average since May, which points to a bumper summer harvest (peaking in July). For instance, the authorities have already started to purchase bananas from local farmers. As a result, food subtracted 11bp from headline inflation in May, reversing the positive contributions of April (+34bp) and the prior three months.

*Reserve accumulation must eventually give way to currency appreciation*

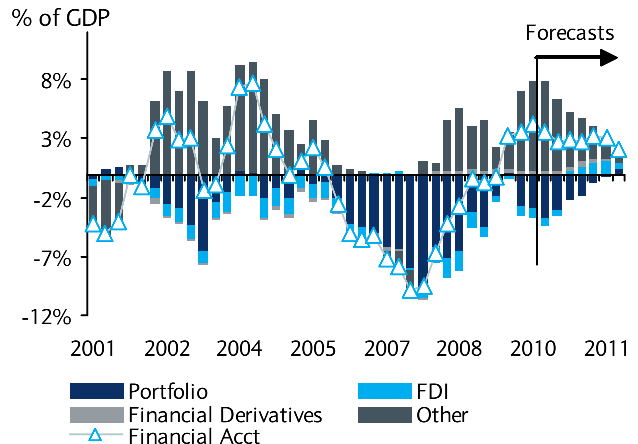
A key priority area for the Ma administration is regional integration, starting with China when both countries conclude ECFA in June 2010. This will set the stage for more capital inflows, both portfolio and direct investments. A second catalyst for the TWD is the Industry Innovation Bill, which would cut the corporate tax rate to 17% from 20%, which could slow the outward relocation of heavy industry and capital outflows. While near-term capital withdrawals from equity investors in Taiwan are possible, we believe the inflow of capital from the Mainland could offset this. As a result, we expect the financial account surplus to reach 2.9% of GDP in 2010, adding to the expected current account surplus (7.5% of GDP). As growth fundamentals start to improve at a faster pace from Q3 onwards, reserve accumulation must eventually give way to currency appreciation. We maintain our USD/TWD forecast at 30 in 12 months.

**Figure 3: CBC has started to normalise liquidity**



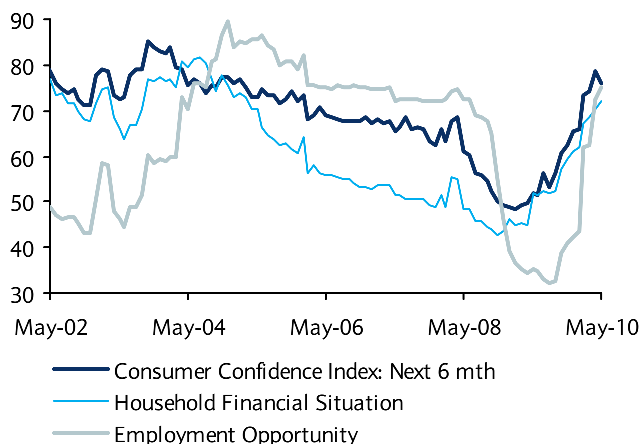

Source: CEIC, Barclays Capital

**Figure 4: More capital inflows as cross-Strait ties warm**



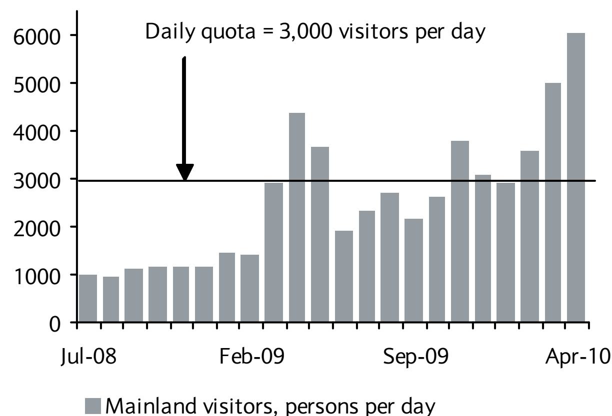

Source: CEIC, Barclays Capital

**Figure 5: Consumer confidence close to all-time high**




Source: CEIC, Barclays Capital

**Figure 6: Rising tourist flows from the Mainland**




Source: CEIC, Barclays Capital

**Figure 7: Taiwan macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009F | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 5.4 | 6.0 | 0.7 | -1.9 | 7.5 | 4.0 |
| Domestic demand (pp) | 0.9 | 1.3 | -1.5 | -3.3 | 5.8 | 2.2 |
| Private consumption (% y/y) | 1.5 | 2.1 | -0.6 | 1.4 | 2.4 | 2.2 |
| Fixed capital investment (% y/y) | 0.1 | 0.6 | -11.2 | -11.1 | 15.5 | 4.9 |
| Net exports contribution | 4.5 | 4.6 | 2.3 | 1.4 | 1.6 | 1.8 |
| Exports (% y/y) | 11.4 | 9.6 | 0.6 | -9.1 | 15.7 | 6.5 |
| Imports (% y/y) | 4.6 | 3.0 | -3.1 | -13.4 | 16.8 | 5.0 |
| GDP (USD bn) | 376.2 | 393.3 | 403.0 | 379.0 | 426.2 | 472.2 |
| **External sector** | | | | | | |
| Current account (USD bn) | 26.3 | 33.0 | 25.1 | 42.1 | 31.8 | 18.5 |
| CA (% GDP) | 7.0 | 8.4 | 6.2 | 11.1 | 7.5 | 3.9 |
| Trade balance (USD bn) | 24.2 | 30.4 | 18.5 | 30.6 | 22.1 | 13.0 |
| Net FDI (USD bn) | 0.0 | -3.3 | -4.9 | -3.1 | 1.2 | 2.0 |
| Other net inflows (USD bn) | -19.6 | -35.6 | 3.0 | 16.7 | 11.3 | 7.3 |
| Gross external debt (USD bn) | 85.8 | 94.5 | 90.4 | 82.0 | 90.0 | 93.0 |
| International reserves (USD bn) | 266.2 | 270.3 | 291.7 | 348.2 | 392.5 | 415.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | 0.1 | 0.3 | -0.7 | -4.1 | -2.5 | -1.9 |
| Gross public debt (% GDP) | 29.6 | 28.8 | 29.8 | 33.1 | 34.1 | 32.9 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 0.7 | 3.3 | 1.3 | -0.2 | 2.1 | 1.5 |
| FX, eop | 32.52 | 32.42 | 33.15 | 31.75 | 30.75 | 30.00 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | -6.9 | 13.3 | 8.7 | 6.0 | 3.3 | 2.1 |
| CPI (% y/y, eop) | -2.0 | 1.3 | 1.1 | 1.2 | 2.1 | 2.5 |
| FX (domestic currency/USD, eop) | 32.80 | 31.80 | 31.75 | 31.00 | 30.75 | 30.25 |
| Monetary policy benchmark rate (%, eop) | 1.250 | 1.250 | 1.250 | 1.375 | 1.500 | 1.625 |
| Market implied benchmark rate (%, eop) | 0.10 | 0.16 | 0.20 | 0.40 | 0.60 | 1.00 |

Source: Barclays Capital

# EMERGING ASIA: THAILAND

## A speed bump for growth

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**Despite political tensions, economic growth is expected to remain strong. With inflation grinding higher, we expect the Bank of Thailand to begin raising its policy rate in Q3 10 with a 25bp increase. With fewer rate hikes and larger equity outflows, we have revised our USD/THB forecast modestly higher, to 31.75 in 12 months.**

*Political tension unlikely to have major effect on growth as domestic demand remains stable*

Despite the recent political demonstrations, domestic demand has remained stable. Indeed, private investment and consumption have been increasing, supported by a strong pick-up in farm incomes due to high commodity prices in Q1 10. This positive income effect was clearly evident in higher motorcycle sales in the first three months. And while the positive shock is dissipating, its effect is likely to linger for a while. Indeed, while we expect domestic demand indicators to decline moderately in Q2 due to the political tensions, domestic demand should recover as policy uncertainty reduces gradually.

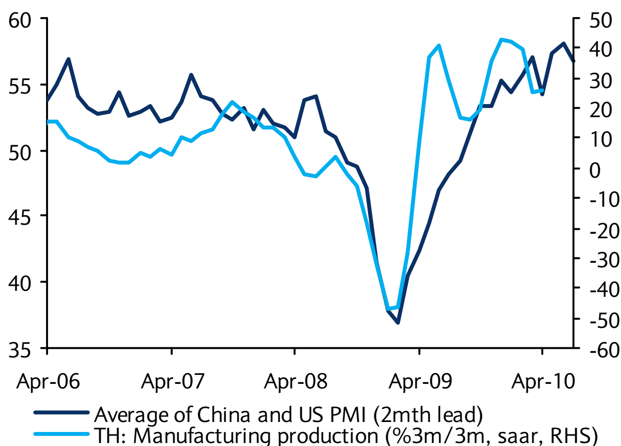
*We upgrade our 2010 growth forecast to 6% from 5%; 2011 lowered marginally to 4%*

We now expect GDP to rise 6% in 2010 (5% previously) after two consecutive quarters of double-digit sequential growth. The risks to our forecasts are biased to the upside. Economic growth is likely to remain supported by strong regional demand, which bodes well for Thai shipments, especially with Chinese and US PMI remaining in expansive territory. Manufacturing activity, especially in export-oriented industries such as electronics and autos, is likely to remain elevated. This is corroborated by total forward order books of the export sector, which have started rising again after taking a breather. Further, we expect fiscal stimulus related spending to pick up some pace in the coming months, which is likely to support growth. While the tourism and hospitality sector has been the hardest hit, we believe the strong export momentum will override its net effect on growth. As such, we expect tourism industry to recover quickly from the recent shock.

*We now expect Bank of Thailand to hike policy rates 50bp in 2010*

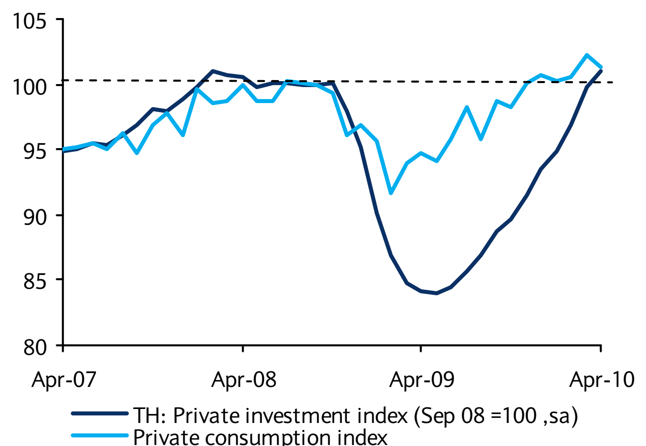
We believe the Bank of Thailand's recent monetary decisions were largely a function of the recent violence in Bangkok. We expect the BoT to remain vigilant and assess the effect of the political demonstrations before beginning its rate normalisation. While the BoT has indicated that it is monitoring closely the European sovereign debt problems and their dampening effect on regional economic growth, we believe a monetary stimulus exit is

**Figure 1: Growth outlook propped up by external demand**




Source: CEIC, Bloomberg, Barclays Capital

**Figure 2: Private investment likely to expand further**




Source: CEIC, Barclays Capital

likely to be a function of domestic realities. As indicated after the 2 June MPC meeting, rate hikes are likely to commence soon, as the growth recovers quickly from the negative shock of political demonstrations, supported by government measures. Indeed, assistant governor Paiboon Kittisrikangwan has indicated that the BoT may raise its official growth forecasts to 5.8% from 4.3% currently. As such, we now expect the BoT to hike the policy 25bp in the August policy review after the release of Q2 GDP. However, the risks of BoT hiking rates in the July meeting remain ever present. We expect the BoT to again hike the policy rate 25bp in Q4 10.

*Core inflation to rise gradually in H2 10*

Meanwhile, while headline inflation has risen due to the partial withdrawal of emergency government support measures, core inflation remains benign, thus giving the central bank enough room to keep rates steady. Headline CPI inflation is likely to rise modestly through the year on imported price pressures. Indeed, although we expect core inflation rise further, the momentum is likely to remain manageable enough for the central bank to keep rates accommodative. Further, we revise our headline and core inflation forecasts for 2010 downwards to 3.5% and 1.2%, respectively, due to lower crude prices and slower re-emergence of demand pull price pressures. Further, food price pressures have started to decline gradually, which should continue to take food inflation lower.

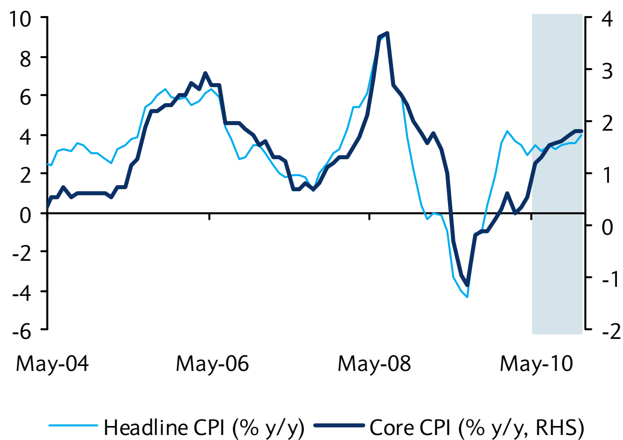
*Current account surplus to remain high as external demand keeps exports supported*

We expect the 2010 current account surplus (USD16bn) to be lower compared with 2009 (USD20bn), but remain on strong footing due to the positive momentum in the exports sector. This would ensure that the overall balance of payments remains in a comfortable surplus despite negative portfolio outflows. Due to the recent political demonstrations, inflows into the Thai equity markets turned negative. We expect the trend of negative outflows to continue, as investors remain cautious and take a “wait and see” approach. We expect FDI related inflows to pick up marginally to USD3bn in 2010, up from USD2.3bn in 2009.

*We expect THB to appreciate to 31.75/USD in 12 months*

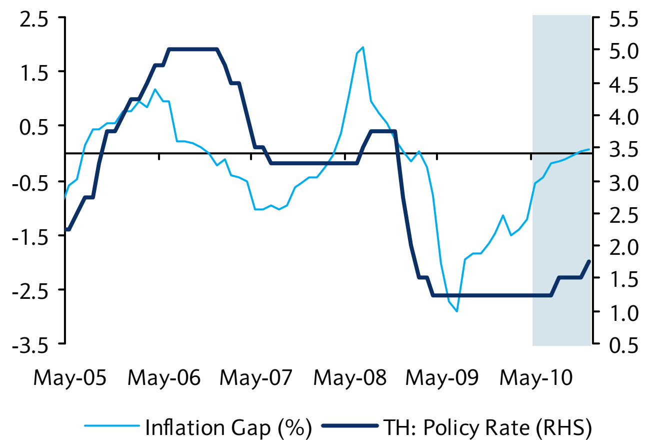
We believe the BoT to continue to curb volatility in the spot and forward FX markets. In our view, while Thailand is likely to benefit from debt inflows into local bond market, fewer rate hikes by the BoT, more investment into the Korean asset markets by Thai asset managers and equity outflows are likely to translate into a slower pace of appreciation in the THB than previously expected. Even then, foreign reserves are likely to expand to USD155bn by end 2010. We now expect THB to appreciate to 31.75/USD in 12 months.

**Figure 3: We expect inflation to rise gradually…**



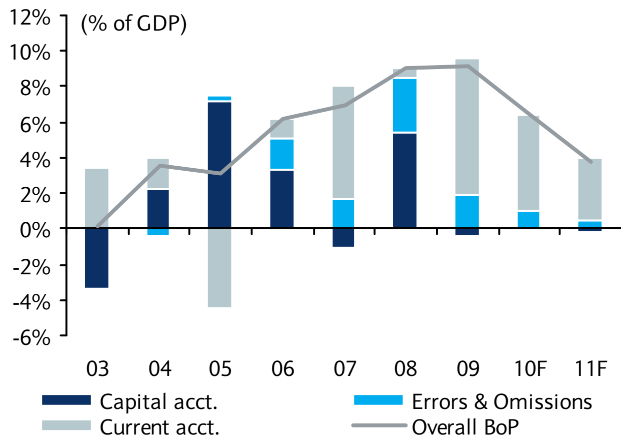

Source: CEIC, Barclays Capital

**Figure 4: … allowing rate hikes to begin in Q3 10**



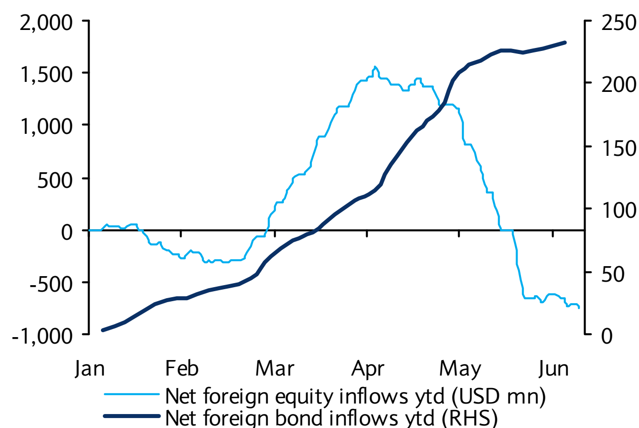

Source: CEIC, Barclays Capital

Figure 5: Balance of payments to remain in surplus…




Source: CEIC, Barclays Capital

Figure 6: … even as net portfolio inflows remain negative




Source: EPFR, Bloomberg, Barclays Capital

Figure 7: Thailand macroeconomic forecast

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 5.1 | 4.9 | 2.5 | -2.2 | 6.0 | 4.0 |
| Domestic demand contribution (pp) | 1.0 | 2.0 | 3.4 | -5.6 | 6.6 | 2.9 |
| Private consumption (% y/y) | 3.2 | 1.7 | 2.7 | -1.1 | 3.6 | 4.0 |
| Fixed capital investment (% y/y) | 3.9 | 1.5 | 1.2 | -9.0 | 8.4 | 4.1 |
| Net exports contribution (pp) | 4.2 | 2.9 | -1.0 | 3.4 | -0.8 | 1.0 |
| Exports (% y/y) | 9.1 | 7.8 | 5.1 | -12.7 | 12.2 | 9.0 |
| Imports (% y/y) | 3.3 | 4.4 | 8.5 | -21.8 | 18.7 | 10.0 |
| GDP (USD bn) | 207 | 247 | 272 | 264 | 300 | 327 |
| **External sector** | | | | | | |
| Current account (USD bn) | 2.3 | 15.7 | 1.6 | 20.3 | 16.0 | 11.4 |
| CA (% GDP) | 1.1 | 6.4 | 0.6 | 7.7 | 5.3 | 3.5 |
| Trade balance (USD bn) | 1.0 | 11.6 | 0.2 | 19.4 | 19.4 | 12.5 |
| Net FDI (USD bn) | 8.5 | 8.5 | 6.0 | 2.3 | 3.0 | 3.0 |
| Other net inflows (USD bn) | -1.7 | -11.1 | 8.6 | -3.6 | -3.0 | -4.0 |
| Gross external debt (USD bn) | 60.0 | 62.0 | 64.8 | 70.2 | 75.0 | 78.0 |
| International reserves (USD bn) | 67.0 | 87.0 | 111.1 | 138.4 | 155.0 | 165.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | 0.5 | -1.9 | -0.9 | -4.3 | -6.0 | -4.5 |
| Gross public debt (% GDP) | 40.5 | 38.9 | 37.6 | 43.9 | 50.5 | 55.0 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 3.5 | 3.2 | 0.4 | 3.5 | 3.9 | 1.8 |
| FX, eop | 35.8 | 33.7 | 35.0 | 33.2 | 32.0 | 31.25 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | -4.9 | 12.0 | 5.7 | 4.6 | 2.2 | 1.2 |
| WPI (% y/y, eop) | -4.0 | 3.4 | 3.1 | 3.5 | 3.9 | 3.0 |
| FX (domestic currency/USD, eop) | 34.1 | 32.5 | 32.25 | 32.10 | 32.0 | 31.80 |
| Policy rate (%, eop) | 1.25 | 1.25 | 1.25 | 1.50 | 1.75 | 1.75 |

Source: Barclays Capital

# EMERGING ASIA: VIETNAM

## Building up FX reserves

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**We expect FX reserves to rise through 2010 given a balance of payments surplus. However the VND may feel some pressure in H2 10 given rollover risks on USD lending. With inflationary pressures dissipating, policy bias has shifted towards growth. We maintain our overweight on the Vietnam sovereign.**

*The VND to remain stable in the near term, but rollover risks on USD loans may apply some pressure*

The VND official rate has been trading just below the top end of the +/-3% trading band since the pre-emptive 3.3% weakening on 11 February. Importantly, the grey market rate has been trading close to the official rate, suggesting reduced currency pressures given the improved trade deficit and inflation trajectory. In the near term, we expect the currency to remain broadly stable; however, if dollar loans extended over the past few months, which fall due in H2 10, are not rolled over, then there may be some pressure on the VND as USD demand increases. We maintain our six-month forecast of 19,500 for USD/VND.

*Trade deficit to be more than covered by remittances and FDI inflows; BoP to be in surplus, allowing buildup of FX reserves*

Vietnam's customs trade deficit was USD5.4bn in the first five months of the year, compared with a shortfall of USD932mn in the year-earlier period (supported by gold re-exports) and a deficit of USD12.1bn in 2008. On a three-month rolling basis, the deficit has stabilised at around USD1bn. The trade deficit, although seemingly sizeable, is more than covered by FDI disbursements of USD4.5bn combined with remittances inflows of USD1.7bn over the same period. For the year as a whole, we expect the customs trade deficit to be roughly USD14bn, compared with FDI disbursements of USD9bn and remittances of USD7.5bn. Overall, we believe the balance of payments will be in surplus, allowing the country to build FX reserves. We maintain our overweight on the credit.

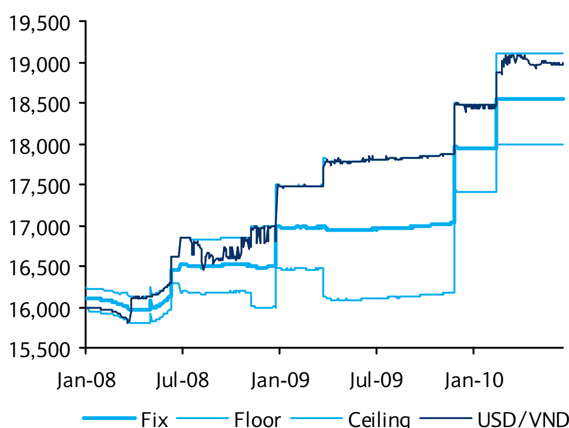
*External debt levels remain low*

Vietnam's external position remains fairly healthy, with external debt equal to roughly 30% of GDP, and most in the form of multilateral and bilateral loans with long maturity profiles. Short-term external liabilities were USD5.8bn as of Q4 09, according to World Bank data, versus FX reserves of USD15.2bn at the end of 2009, implying a cover ratio of 2.6 times.

*Easing inflation, driven by food and energy*

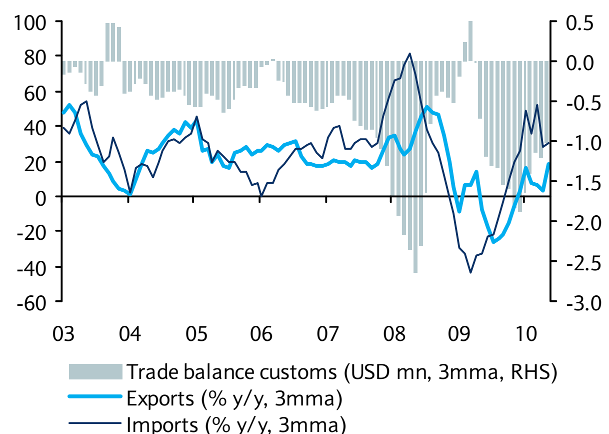
Inflationary pressures have dissipated over the last few months, with the 3m/3m saar down to 6.8% in May from a recent high of 15.1% in January. This turnaround is driven by lower food and fuel-related prices and the lagged impact of slowing in credit growth. In H2 10

**Figure 1: USD/VND spot versus band**




Source: Reuters, Bloomberg, Barclays Capital

**Figure 2: Trade deficit has stabilised**




Source: CEIC, Barclays Capital

inflation is expected to ease further given the dampening impact of lower commodity prices. However, upside risks emanate from relatively strong domestic demand. At the same time there is risk of second-round effects as the minimum wage for public staff and employees of state-owned enterprises increased 12.3% to VND730k (USD38.25) a month effective 1 May 2010. Monthly pension payments also rose by the same amount. Overall, we expect inflation to average 8.7% in 2010 compared with 7% last year.

*Rapid rise in USD lending poses some risks to VND stability*

The government is targeting credit growth of 25% in 2010, down from 38% last year. Year-to-date credit is up 10.5% from levels at the end of 2009 compared with deposit growth of 9.6%. However the momentum in credit has been skewed towards USD-denominated loans, which have risen 25% YTD – 10 times the pace of domestic lending – given the stability of the VND. With the bulk of the USD loans falling due in H2 10, there may be some pressure on the VND if these are not rolled over. The SBV is aware of the risks and is putting pressure on local banks to restrict USD lending to enterprises importing non-essential commodities.

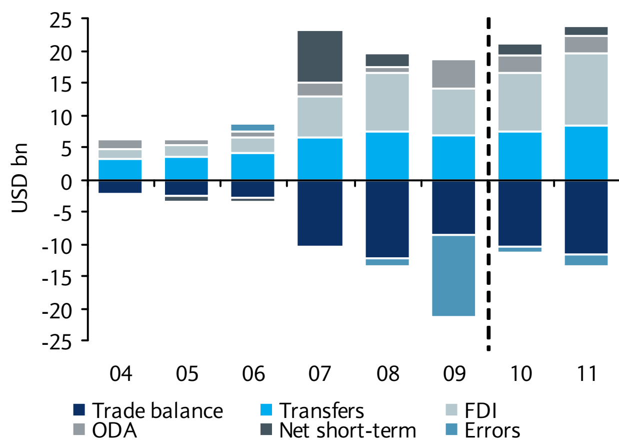
*Growth to remain underpinned by consumer spending; 2010 GDP growth at 6.8%*

GDP expanded by 5.8% in Q1 driven by manufacturing, retail trade and construction. Service sector growth was also robust, especially for hotels and restaurants, and financials. With retail sales up 27% YTD in May, and given the improving labour market, the outlook for consumer spending remains robust. The external environment is also more favourable, with Vietnam's key exports – textiles, footwear and fisheries – seeing solid expansion. However crude oil exports have been falling given maturing fields and greater volumes being diverted to onshore refining. We expect the economy to grow by 6.8% in 2010 (government target: 6.5%) versus 5.3% last year.

*Policy bias has shifted towards growth*

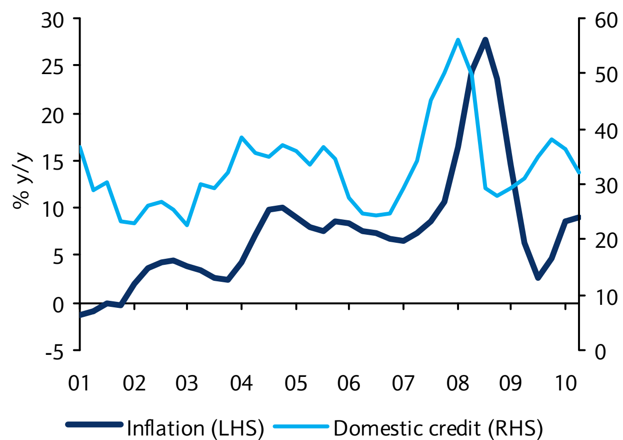
On the policy front, the State Bank of Vietnam has kept the base rate unchanged at 8% since the 100bp hike in November 2009. Although the removal of the lending interest rate cap in February was in line with the central bank's objective of tightening monetary conditions to contain inflation, policy direction has recently shifted towards supporting credit growth. This is reflected in the State Bank's directive to commercial banks in early April to lower negotiable interest rates on loans, as well as its increased liquidity injection to bring down money market rates. The government has also set a target that lending interest rates in the economy should not be higher than 12% and deposit interest rates no more than 10%. It is also worth highlighting that with the removal in interest rate caps, the base rate is no longer an effective policy instrument.

**Figure 3: Robust balance of payments**



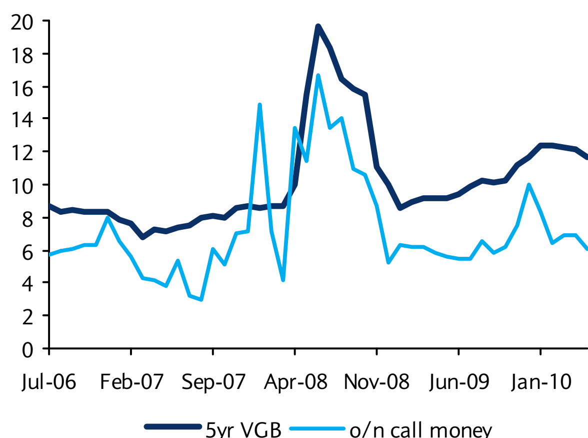

Source: CEIC, Barclays Capital

**Figure 4: Credit growth is key determinant of inflation**



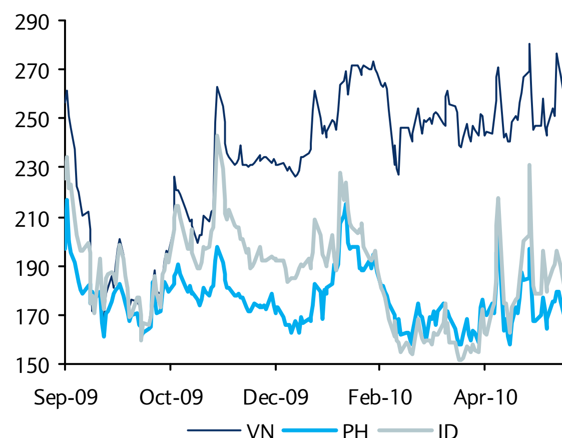

Source: CEIC, Barclays Capital

### Figure 5: The SBV has been injecting liquidity




Source: CEIC, Barclays Capital

### Figure 6: Vietnam 5y CDS vs Indonesia and Philippines




Source: CEIC, Barclays Capital

### Figure 7: Vietnam macroeconomic forecasts

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 8.2 | 8.5 | 6.2 | 5.3 | 6.8 | 7.2 |
| Domestic demand contribution (pp) | 10.3 | 17.7 | 9.4 | 5.0 | 9.4 | 11.1 |
| Private consumption (% y/y) | 8.3 | 10.8 | 9.3 | 3.7 | 7.5 | 9.0 |
| Fixed capital investment (% y/y) | 9.9 | 24.2 | 3.8 | 8.7 | 9.2 | 10.3 |
| Net exports contribution (pp) | -1.6 | -13.2 | -3.2 | 1.7 | -2.0 | -2.9 |
| Exports (% y/y)* | 22.7 | 21.9 | 29.5 | -11.6 | 20.0 | 18.0 |
| Imports (% y/y)* | 22.1 | 38.3 | 27.6 | -14.5 | 19.9 | 17.1 |
| GDP (USD bn) | 61 | 71 | 80 | 93 | 100 | 116 |
| **External sector** | | | | | | |
| Current account (USD bn) | -0.2 | -7.0 | -9.2 | -7.8 | -9.3 | -9.0 |
| CA (% GDP) | -0.3 | -9.8 | -11.6 | -8.4 | -9.3 | -7.7 |
| Trade balance (USD bn)# | -2.8 | -10.4 | -12.3 | -8.7 | -10.4 | -11.5 |
| Net FDI (USD bn) | 2.4 | 6.6 | 9.2 | 7.2 | 9.0 | 10.0 |
| Other net inflows (USD bn) | 0.4 | 10.3 | 3.0 | 4.7 | 4.7 | 4.3 |
| Gross external debt (USD bn) | 15.6 | 19.3 | 21.8 | 23.3 | 26.2 | 29.0 |
| International reserves (USD bn) | 13.4 | 23.5 | 23.9 | 15.2 | 17.0 | 19.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -5.0 | -5.6 | -5.0 | -8.5 | -6.5 | -5.5 |
| Primary balance (% GDP) | -3.5 | -3.4 | -2.5 | -5.0 | -3.8 | -3.0 |
| Gross public debt (% GDP) | 41.5 | 42.3 | 44.4 | 46.3 | 49.1 | 47.5 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 6.6 | 12.6 | 19.9 | 6.5 | 8.2 | 9.0 |
| FX, eop | 16,050 | 16,017 | 17,483 | 18,500 | 19,500 | 19,000 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | 3.1 | 5.8 | 6.7 | 7.1 | 7.4 | 6.5 |
| CPI (% y/y, eop) | 11.2 | 9.5 | 8.8 | 8.5 | 8.2 | 8.0 |
| FX (domestic currency/USD, eop) | 17,797 | 19,069 | 19,000 | 19,500 | 19,500 | 19,250 |
| Overnight policy rate (%, eop) | 7.00 | 8.00 | 8.00 | 8.00 | 8.00 | 8.00 |

Note: *Nominal as real data not available. # Balance of payments basis, not customs basis. Source: Barclays Capital

## EMEA: BALTIC STATES – ESTONIA, LATVIA, LITHUANIA

# Euro for some, more fiscal pain for others

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**Strong export growth is driving the Baltic economies' slow exit from recession. However, this does very little to improve the fiscal situation. Indeed, Latvia and Lithuania continue to face significant challenges to reduce their fiscal deficits in coming years—with or without IMF programs. Meanwhile, the EU has given Estonia the go-ahead to adopt the euro in January 2011, removing a tail risk for Estonia and the region.**

*Strategy:*
*- Taking profit on the 'sell Latvia 5y CDS' trade*

*- Buying CDS protection on Lithuania versus selling CDS protection on Croatia*

**Strategy**: Given Latvia's ample liquidity and reduced financial vulnerabilities, we had recommended selling Latvia 5y CDS, which has largely escaped the aggressive spread widening seen in other parts of CEE in recent weeks. The carry still looks reasonably attractive and some further spread-tightening seems justified. However, further outperformance naturally looks more limited now, in particular as the October elections could add Latvia-specific noise. We thus recommend taking profits on this trade.

We take a more cautious stance on Lithuania. In particular, CDS valuations seem stretched (with the CDS also trading well inside cash spreads). We recommend buying CDS protection on Lithuania versus selling CDS protection in Croatia, which now trades flat to Lithuania. This trade should work particularly well in a tail-risk environment in which wobbly market conditions and prolonged risk aversion could expose Lithuania's vulnerabilities – particularly its reliance on capital markets to finance its still sizeable budget deficits, and the lack of an external anchor (i.e. IMF program) to fiscal discipline. Estonia's CDS remains orphaned (although the government has said it may consider eurobond issuance to finance energy investments). Given Estonia's strong debt metrics, we do not think that the continued spread premium over some of its Eurozone peers (Slovenia, Slovakia) is justified. Nevertheless, spread levels do largely reflect Estonia's successful path towards euro adoption and further upside for spreads is thus naturally limited at current levels.

### Macro developments in the region

*Countries look to be exiting recession, albeit with some growth differentiation*

Q1 GDP fell y/y in all three countries, but all look set to exit recession in Q2 (Estonia and Lithuania) or Q3 (Latvia). Some differentiation is visible. Latvia's growth path resembles a drawn out 'U' while Lithuania's looks more like a 'V'. Estonia's recession was shallower, and with the euro adoption process now secured, it may be best placed to receive additional foreign investment. Both Estonia and Lithuania should show positive growth this year. We forecast another negative annual growth number for Latvia, but think the risk is on the upside.

*Growth is being driven by exports and inventories*

*The weaker EUR helps*

The recovery remains chiefly driven by exports and related inventory changes, on the back of higher demand from trading partners. The EUR weakness also helps the euro-pegged economies in the Baltics as a significant share of their trade is with non-euro countries (eg, Russia, Sweden and Poland). The outlook for domestic demand is likely to remain subdued for a few more quarters, despite slightly better-than-expected retail sales numbers this year. Wage growth is still negative (albeit at a decelerating pace in recent months), unemployment levels are very high and bank lending so far continues to contract on y/y basis. At the same time, pro-cyclical fiscal tightening is set to continue and EU-funded projects remain one of the few sources of investment. External current account developments seem to reflect the degree to which the economies are recovering. In Latvia, where Baltic growth is still weakest, the current account remained solidly in surplus in Q1 10, although it seems to have turned around again in Estonia and Lithuania (that said, in Lithuania, idiosyncratic factors, including the shut down of the nuclear power plant, played a large role).

*The process of regaining competitiveness is well under way*

It may still be too early to pass final judgements, but we note that the 'internal devaluation' process is making significant progress. The CPI-based real effective exchange rates (REER) have declined notably from their peaks (in particular in Latvia, see charts) and the depreciations are even larger when using the unit labour cost (ULC) given the large wage adjustments. The 'internal devaluation' process though domestic price and wage moderation will likely have to continue, and comes not without pain: unemployment levels are very high and likely to decline only slowly as labour needs to be directed from the non-tradable to the tradable sector. However, progress so far further raises the likelihood that the 'internal devaluation strategy' will ultimately prove successful.

## Estonia: Euro adoption in January 2011

*EU approved Estonia's euro adoption for January 2011…*

*…conversion rate to be the fixed rate sustained since 1992*

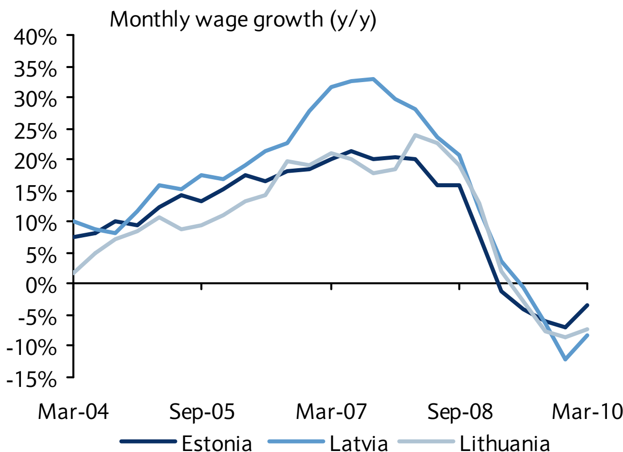
Estonia has jumped almost all crucial hurdles in the euro adoption process. In May, the European Commission (EC) and the ECB gave the green light for Estonia's adoption of the euro at the beginning of 2011. True, the ECB' assessment was more critical on issues such as the sustainability of low inflation – as we expected – but its language was in our view ultimately more favourable than had been anticipated by those close to the process (eg, the EC left out such words as "considerable" when describing potential concerns). The ECOFIN meeting (8 June) and the European Council meeting (18 June) agreed with the EC's assessment, providing the political go-ahead for the process to continue and for Estonia to adopt the EUR on 1 January 2011. In an ECOFIN meeting on 13 July, finance ministers will take the final decision on the conversion rate. It seems to us that the rate will be the one Estonia has maintained against the EUR (and versus DEM, previously) since 1992. We believe the risk of this process being derailed is minimal.

*Estonia will have the soundest public debt dynamics in the euro area*

*The 'yes' to Estonia removes a tail risk for the region…*

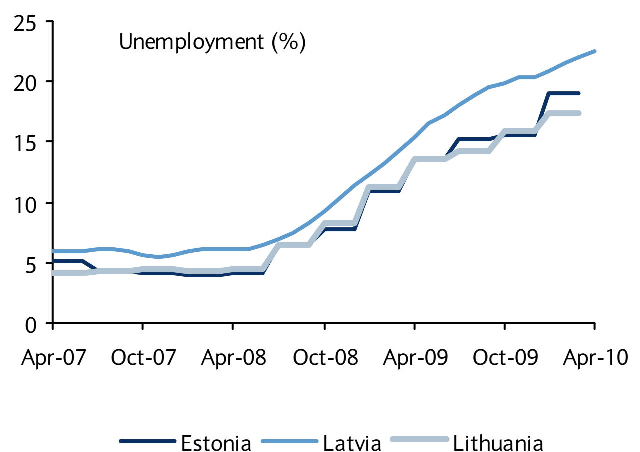
In parallel to these developments, Estonia already received a rating upgrade from S&P and Moody's and Fitch seem likely to follow. Once it enters the euro area, Estonia will be by a large margin the country with the most solid debt dynamics, given its low debt (7.2% of GDP) and low deficit (1.7% of GDP). We expect Estonia to receive additional FDI and other capital inflows, in particular from businesses in Finland, now that the potential exchange rate risk is to be removed. The challenge will be the associated pressures for local prices and wages to rise too rapidly, although Estonia has proven its ability to adjust to such pressures in the past. Overall, we feel quite confident about future developments in Estonia.

**Figure 1: Wage declines have started to moderate …**



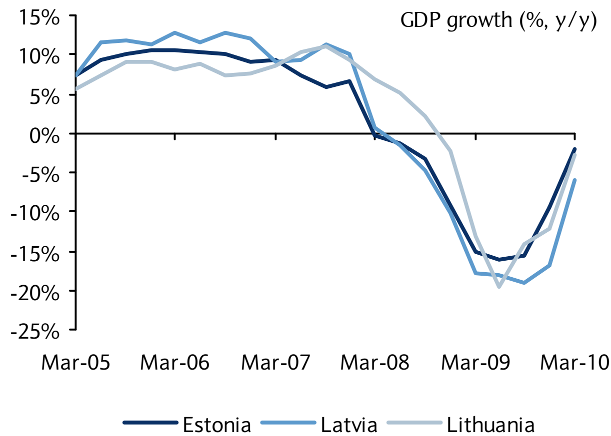

Source: Central banks, Haver Analytics, Barclays Capital

**Figure 2: … but unemployment has continued to rise**



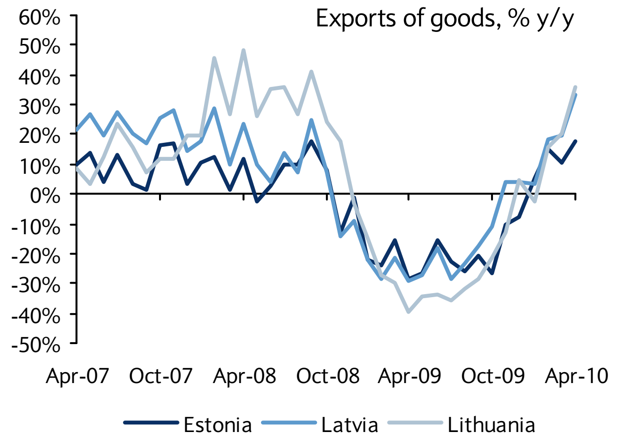

Source: Central banks, Haver Analytics, Barclays Capital

**Figure 3: GDP made a 'U' rather than a 'V' recovery**



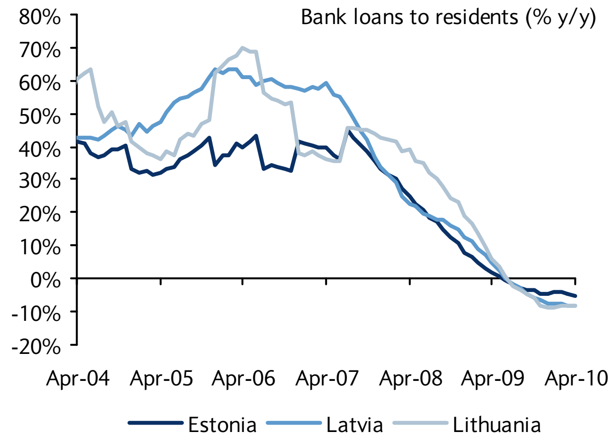

Source: National statistic offices, Haver Analytics, Barclays Capital

**Figure 4: Export growth is still leading the way ...**



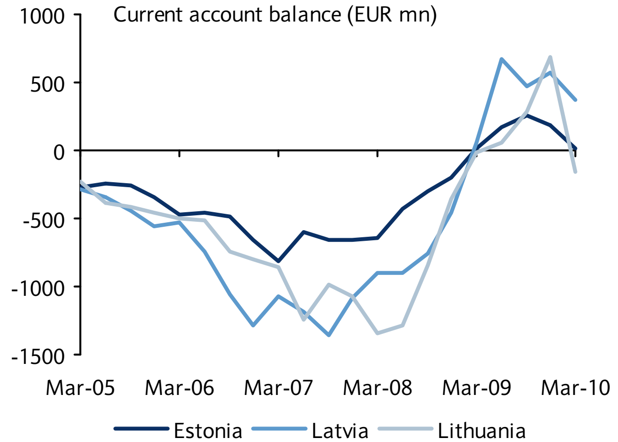

Source: National statistic offices, Haver Analytics, Barclays Capital

**Figure 5: … while a lending recovery is not in sight**



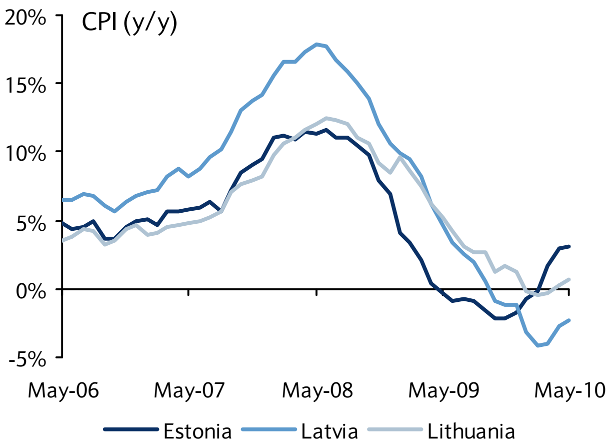

Source: Source: National statistic offices, Haver Analytics, Barclays Capital

**Figure 6: Current accounts seem to turning around again…**



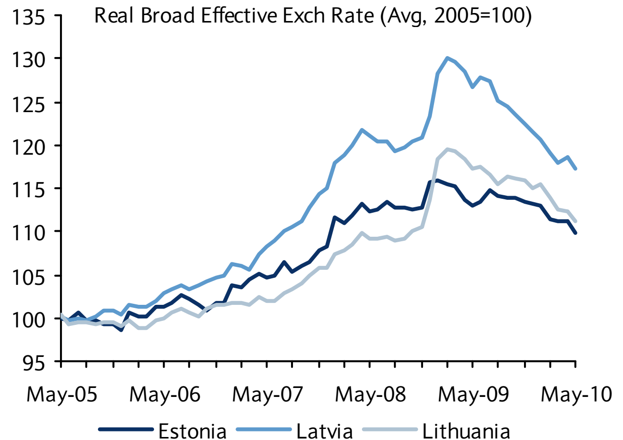

Source: Source: National statistic offices, Haver Analytics, Barclays Capital

**Figure 7: … and so does inflation (particularly in Estonia)**




Source: Source: National statistic offices, Haver Analytics, Barclays Capital

**Figure 8: Latvia's REER adjustment has been impressive**




Source: Eurostat, Haver Analytics, Barclays Capital

*…but euro adoption by other fixed-ER regimes are likely to remain difficult*

For Latvia and Lithuania, Estonia's success may signal that the door to the euro is not closed for them in principle, which may help to maintain morale during the painful adjustment process. However, their ambitions for euro adoption in 2013/14 strike us as too optimistic given their economic challenges and the problematic backdrop in the euro area generally. At a minimum, however, the EU's decision removes a potential tail risk that a rejection of Estonia's euro request could have created for the region and probably for all pegged FX regimes with euro-adoption aspirations.

## Latvia: Mindful of October elections

*Economy slowly turns around*

Latvia's economy seems to be slowly pulling out of recession. Besides impressive export growth numbers and slightly better-than-expected retail sales, the official statistics also signal that the real estate market has stabilized: in Q1 'construction price' statistics did not decline from the previous quarter for the first time in six quarters, and deflation and wage reductions have reversed much of past REER and ULC increases. That said, the economy remains in a very difficult situation, exemplified by the fact that the unemployment rate continues to climb – up to 22.5% in April 2010, the highest rate in the EU.

*IMF staff agreement on third review reached in early June*

*IMF Board meeting in July could trigger release of additional EUR 1bn of funds*

*Liquidity is no longer an issue*

While the economy seems to be very gradually coming back to life, the fiscal adjustment continues its painful course. In early June, the government was able to reach agreement with IMF staff on the completion of the third review (based on the Q1 program targets). The approval by the IMF Board meeting in the second half of July would make available a total of around EUR1bn from the IMF, European Commission, the Nordic countries, Czech Republic and Poland combined. Financing and FX liquidity are no longer an immediate issue: the current account is in surplus and the Bank of Latvia's foreign reserves rose 16% in the first five months of 2010 to EUR5.5bn (30% of GDP). Of this, the State Treasury owns more than EUR1.8bn (one third of which is earmarked for the stabilization of the financial sector). In early June, the treasury sold 6- and 12-month T-bills at rates of 2.1% and 3.7% – this compares with the threat of auction failures a year ago, when the Treasury at times could not sell its 3-month bills at yields exceeding 15%

*General elections in October will create noise…*

*…but 2011 budget is due* after *the elections*

*Additional fiscal measures totalling 3.4% of GDP are needed*

The main risk in the coming quarter is the general election in October, where some of the competing parties could run on an anti-IMF program platform. This year, Latvia must reduce its deficit to 8.5% of GDP (from 9.0% in 2009), but in 2011 the deficit target is 6% under the program. The IMF estimates this to require additional budget savings and revenue increases of about 3.4% of GDP. Given this challenge, the IMF agreed that the 2011 budget would be finalised only after the October elections. This should ensure the commitment of the new government and avoid the threat of the current government possibly collapsing under the burden of finding a majority for the required adjustments in the 2011 budget. As a reminder, since the People's Party withdrew from the governing coalition, PM Valdis Dombrovskis has been left with a minority in parliament. However, this only postpones the burden of taking additional painful measures. Although we continue to believe that any government will ultimately have to implement what is required to remain on the IMF-EU program, the coming months could see increased headline risks as politicians aim at votes from disgruntled citizens.

## Lithuania: Waiting for more fiscal adjustment

*Growth in 2010 could exceed 2%, driven by export growth*

Lithuania's larger and more diversified economy, combined with the fact that its overheating phenomena were less extreme, helped it to weather the global crisis better than neighbouring Latvia. The economy contracted by close to 15% in 2009, but overall the path looks more like a 'V' – mainly due to a shocking GDP contraction of 19.5% in Q2 09 – than the 'U' shape seen in Latvia. Driven by robust export growth and inventory changes, we think the economy could grow by 2% or more in 2010.

*Government started with very low debt …*

*… but the dynamics have deteriorated significantly*

*Growth recovery alone will not be sufficient Additional fiscal measures will be needed*

However, exiting recession does not make the fiscal challenge disappear – in particular as export-led growth is less fiscal revenue intensive and as growth will remain much lower than in the past decade. Following the 8.9% deficit in 2009, this year the deficit is estimated to decline to around 7.7% in 2010. However, this leaves the debt ratio on a rising trend. Lithuania started with very low debt levels, but the debt-to-GDP has almost doubled to roughly 30% and without further adjustment measures would breach the 60% Maastricht criteria within the next three years. Officially, the government aims to reduce the deficit to the 3% Maastricht criterion by 2012, which would stabilize the debt ratio, but this will require significant effort: First, some of the fiscal measures taken in 2009 and 2010 to contain the deficit are set to expire in 2011 – they will have to be extended. Even then, however, the government still needs to make an additional 5.5 percentage points of GDP adjustment. This is unlikely to come from better growth alone, but will require significant additional measures on the spending side (eg, social benefits such as generous parental payments etc and pension reform) and revenue side (eg, phasing out tax relief on mortgage interest payments and corporate tax incentives).

*Minster of Finance appears committed…*

*… but multi-party government may hesitate*

*Local elections in early 2011 could concern some parties*

The Minister of Finance appears committed to pursuing the fiscal consolidation effort, but the question is whether the multi-party coalition government will be able to muster the strength to decide on the unpopular measures needed. The window of opportunity may not be open for long: local elections are coming up in early 2011, and some of the coalition partners may fear losses if they agree to unpopular measures. Still, the ease with which international financing has been secured – USD1.5bn issues last fall and USD2.0bn in February – may also create a sense of comfort for politicians. The government now plans to begin sales of euro-denominated bonds in domestic auctions from next month to diversify borrowing opportunities. Again, in principle this is a positive development as it may reduce financing vulnerabilities. But for investors it will ultimately be important to see whether the debt dynamics can be turned around. Therefore, indications for serious fiscal reform efforts will be crucial to watch for in Q3, in our view. An IMF program always remains an option for Lithuania in a worst-case scenario where market financing should freeze up. But while this limits the ultimate financing risk, such a step would unlikely come without some market volatility

*Developments in the banking system remain an issue*

Another challenge remains the banking system. NPls have risen almost four-fold since 2008 to more than 19% in Q1 10. Loan-loss provisions now cover close to 40% of NPLs in aggregate (almost double the 2008 level), but the provisioning may vary significantly between banks. The capital adequacy ratio stands at 15%, but under anticipated changes in Basel and EU prudential regulations covering asset valuation and capital, Lithuanian banks would have to raise capital. The weaker link in this respect is likely to be the locally-owned banks, as Swedish banks (which constitute about 60% of the system's assets) could withstand shocks to their capital relatively well, according to tests carried out by Riksbank.

**Figure 9: Baltic states (Estonia, Latvia, Lithuania) macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009F | 2010F | 2011F | 2006 | 2007 | 2008 | 2009F | 2010F | 2011F |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Real GDP (% y/y) | | | | | | CPI (% average) | | | | | |
| Estonia | 10.0 | 7.2 | -3.6 | -14.1 | 2.3 | 4.0 | 4.4 | 6.6 | 10.4 | -0.1 | 1.4 | 2.3 |
| Latvia | 12.2 | 10.0 | -4.6 | -18.1 | -1.1 | 2.9 | 6.5 | 10.1 | 15.4 | 3.5 | -2.2 | 0.3 |
| Lithuania | 7.8 | 9.8 | 2.8 | -14.8 | 2.0 | 2.5 | 3.8 | 5.8 | 11.1 | 4.2 | 0.9 | 1.5 |
| | Current account balance (% GDP) | | | | | | External debt (% GDP) | | | | | |
| Estonia | -16.9 | -18.0 | -9.4 | 4.6 | 3.1 | 0.5 | 88.7 | 101.9 | 118.7 | 131.8 | 128.6 | 125.3 |
| Latvia | -22.0 | -22.5 | -13.0 | 9.4 | 6.0 | 3.0 | 118.9 | 135.0 | 124.0 | 159.5 | 169.5 | 181.0 |
| Lithuania | -10.5 | -14.6 | -12.2 | 3.8 | 2.1 | 1.3 | 41.7 | 48.3 | 63.6 | 84.8 | 90.1 | 95.2 |
| | General government balance (% GDP) | | | | | | General government debt (% GDP) | | | | | |
| Estonia | 2.5 | 2.6 | -2.7 | -1.7 | -3.0 | -3.0 | 4.5 | 3.8 | 4.6 | 7.2 | 10.9 | 12.9 |
| Latvia | -0.5 | -0.3 | -4.1 | -9.0 | -8.5 | -7.5 | 10.7 | 9.0 | 19.5 | 36.1 | 44.6 | 53.2 |
| Lithuania | -0.4 | -1 | -3.2 | -8.9 | -7.7 | -5.8 | 18 | 16.9 | 15.6 | 29.3 | 41.1 | 47.0 |

Source: Barclays Capital

# EMEA: BULGARIA

## Currency board survives fiscal deterioration

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**Bulgaria is experiencing major deterioration in its fiscal position primarily because of recession-induced falls in revenue. Previously the economy had expanded rapidly, fuelled by foreign financed domestic spending. The government accumulated fiscal surpluses, building solid financial support for the currency board. However, this expansion was unsustainable, dependent on large current account deficits and financed by a build up in external debt. An extended period of fiscal adjustment, external adjustment and low growth is required to rebalance the economy. Nevertheless, the currency board remains secure financially, provided fiscal balance is re-established, and there is no reason to expect changes in Bulgaria's exchange rate system.**

*The deterioration in Bulgaria's fiscal position may continue to cause negative headlines – we prefer other credits in the region*

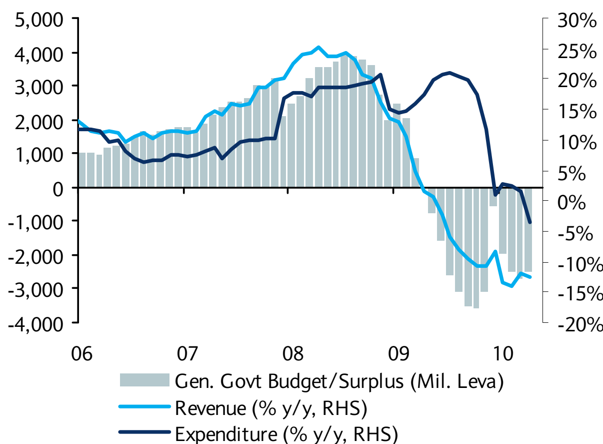
**Strategy:** Bulgarian credit spreads have faced strong headwinds over the past weeks, suffering from a cautious stance towards the Balkan region as a whole and exacerbated by the country's budget deficit revisions, which caused "irritation" among the European commission. The Commission will now send a mission to Sofia to examine Bulgaria's finances. The Bulgaria USD 15 bonds in particular have cheapened, underperforming CDS and ending an extended period of positive basis. While spread levels now look more favourable again and the country's low debt levels should provide some comfort for investors, we maintain an overall cautious stance. The deterioration in the country's fiscal position and the EC's doubts about Bulgaria's methodologies may continue to cause some negative headlines. On relative value considerations, we therefore prefer other credits in the CEE region, such as the Romania EUR 15s or the Poland USD 19s at current levels.

### Bulgaria's fiscal problems

*A large fiscal swing in 2008-10 from surplus to deficit*

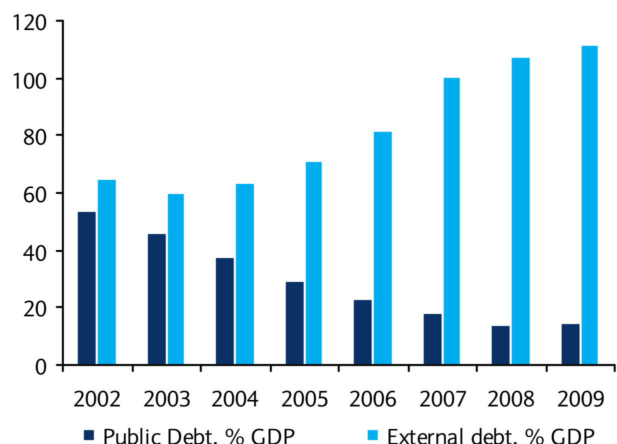
Bulgaria is experiencing a significant deterioration in their fiscal accounts (Figure 1). The ongoing recession has led to significant drops in revenues. In addition, the previous government raised spending in the run-up to the mid-2009 parliamentary elections. On a cash basis, 2009 revenue declined 8.4% y/y and has fallen 17.7% y/y in 2010 YTD. Government expenditures rose 0.9% in 2009 and are up 4.9% YTD in 2010. Accordingly, the government has been unable to stick to its budget targets. After many years of surpluses, a deficit of -0.8%

**Figure 1: Fiscal deterioration as revenues dropped**




Source: Bulgaria Ministry of Finance, Haver Analytics

**Figure 2: While government debt is very low, external private sector debt is high**




Source: Bulgaria National Bank, Ministry of Finance, Haver Analytics

of GDP was registered in 2009, and the revised budget deficit for 2010 is -4.8% of GDP. Overall, the shift in the fiscal position is expected to be -7.8pp during 2008-10.

The pattern of deficits using ESA95 accrual accounting is very different because the government ran up large arrears at end-2009 in an effort to minimize the recorded deficit. In addition, timing differences are common between EU disbursements for co-financed capital projects and the government's use of the funds. In cash accounts, unused EU funds are counted as revenues in the year they are received and then as expenditures in the year they are used. This can cause a false sense of fiscal strength in the first year and then a fiscal shock the next, as happened with Bulgaria. Using ESA95 accrual accounting, the fiscal deterioration was much less severe: -5.7pp of GDP in 2009 versus 2008 as Bulgaria went from a surplus of 1.8% of GDP to a deficit of -3.9% of GDP. Approximately the same deficit level is targeted in 2010.

*Bulgaria's fiscal deterioration was worse than the EU average…*

*… but its fiscal position remains strong*

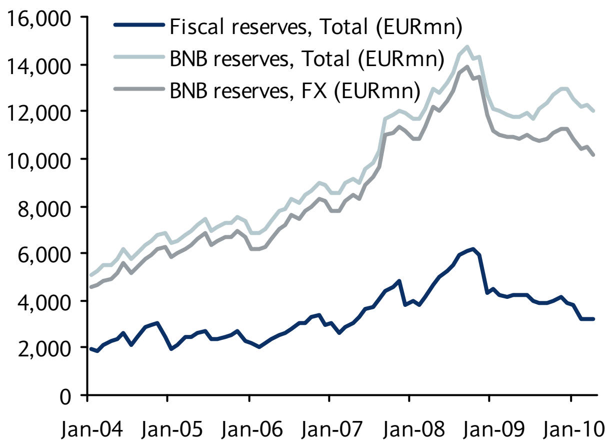
Bulgaria's fiscal deterioration has occurred at a time when many other countries have experienced the same. However, Bulgaria was late to publically recognize the seriousness of the fiscal setback, and its -5.7pp decline was worse than the EU average of -4.5pp of GDP. At the same time, Bulgaria's starting point was much better than the EU average. The 2009 deficit of -3.9% of GDP remains considerably below the EU average of -6.8% of GDP. Government debt of 14.8% of GDP is one of the lowest in the EU and compares very favourably with the EU average of 73.6% of GDP (Figure 2).

*Fiscal reserves and international reserves have been depleted*

To finance the deficit, the government has been using its fiscal reserves. The fiscal reserves of the government are deposited in the Bulgarian National Bank (BNB); thus, by design of the currency board, fiscal reserves are part of international reserves. Fiscal reserves peaked at €6.2bn in mid-2008 and have since declined to €3.3bn (Figure 3). The revised budget envisages further depletion of fiscal reserves to €2.3bn at end-2010. This is leading to a similar decline in foreign currency reserves from a peak of €13.4bn to €10.2bn. Total reserves including gold are €12.2bn and have not declined quite as much because of higher gold prices and the IMF SDR allocation last year.

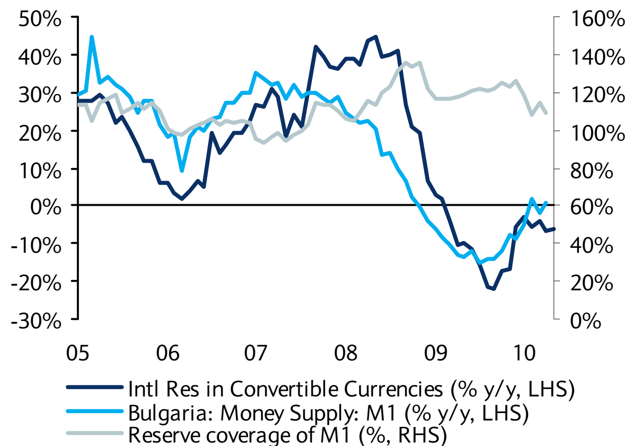
In 2011, the government has indicated that it wants to limit the budget deficit to -2% of GDP (about US$1bn). It plans to rely on external financing because it will have largely depleted its fiscal reserves by end-2010 and would not want to risk further drawdown. Given the expected fiscal adjustment, multilateral financial support would likely be available to Bulgaria.

**Figure 3: International reserves falling as fiscal reserves are depleted**




Source: Bulgaria National Bank, Ministry of Finance, Haver Analytics

**Figure 4: Central bank reserves still fully cover M1 money**




Source: Bulgaria National Bank, Haver Analytics

## Currency board preserves

*The currency board remains well financed as reserves fully cover M1 money supply*

While the fiscal position has deteriorated, the currency board position has remained strong. Money supply has dropped in line with foreign currency reserves of the BNB so that foreign exchange reserve coverage of M1 money is still well above 100% (Figure 4). This is one of the strengths of a well-designed currency board arrangement – money supply closely mirrors reserves. However, it is also the weakness because the drop in money supply contributes to real sector declines just when the real sector is most vulnerable. Thus, this structure contributes to the real sector volatility.

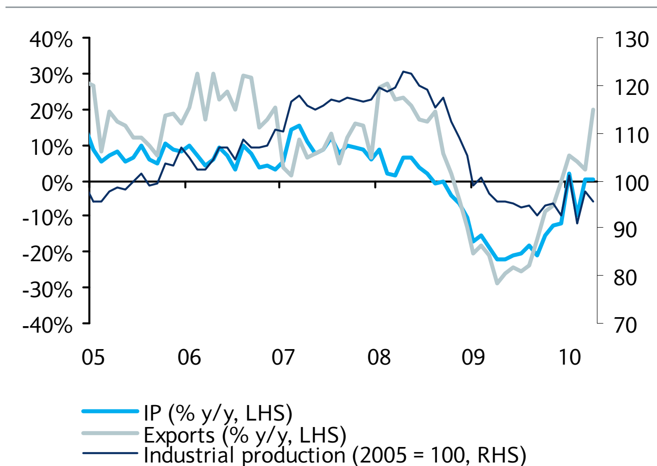
## Real sector shrinkage

*Real GDP is -9% below mid-2008 peak*

Real GDP declined a total of 9% during 2008-10, falling 5% in 2009 and declining a further 2.8% q/q in Q1 10. This apparent double dip reflects external pressures from the euro area and Bulgaria's heightened fiscal problems. Unemployment is still rising and approaching 10%, and trading levels have deteriorated further in 2010 YTD. However, there are signs of recovery as industrial production and exports are increasing from their lows (Figure 5). As with many of the hard-hit countries, declines in exports and a sudden stop of external financing led to a precipitous drop in domestic demand, particularly investments. As a consequence, imports declined even more than exports, leading to a net export contribution to growth that partially offset the steep decline in domestic demand. This also led to a strong improvement in the current account balance (Figure 6). As the current account deficit is still relatively high and Bulgaria external debt burden is very heavy, further external adjustment may be necessary in the next few years. Low wage growth and high productivity increases are needed to improve competitiveness to achieve this result since the currency board rules keeps the exchange rate fixed to the euro.

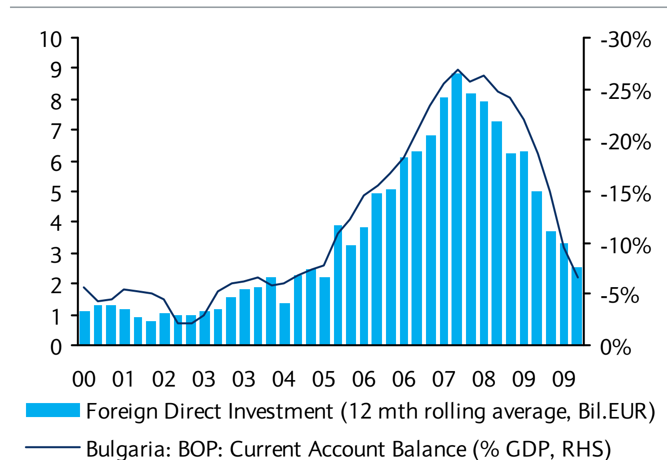
The IMF has predicted that growth will be about zero this year and increase next year. Given the weak first quarter and expected fiscal adjustment, however it will be a challenge for the economy to achieve zero growth this year even with some upward signs in activity. Domestic demand remains very weak, and there is a risk that growth will remain depressed, notwithstanding the improving base effects.

**Figure 5: Real sector signs of recovery…**




Source: Bulgaria National Statistics Institute, Haver Analytics

**Figure 6: … as the current account deficits becomes more reasonable**




Source: Bulgaria National Statistics Institute, Haver Analytics

**Figure 7: Bulgaria macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 6.3 | 6.2 | 6.0 | -5.0 | 0.2 | 2.0 |
| Domestic demand contribution (pp) | 10.7 | 11.1 | 8.4 | -17.7 | -2.2 | 1.4 |
| Private consumption (% y/y) | 8.5 | 8.9 | 7.8 | -15.9 | -2.4 | 1.3 |
| Fixed capital investment (% y/y) | 14.7 | 21.7 | 20.4 | -26.9 | -2.1 | 2.4 |
| Net exports contribution (pp) | -4.4 | -4.9 | -2.3 | 12.6 | 2.4 | 0.6 |
| Exports (% y/y) | 8.7 | 5.2 | 2.9 | -9.8 | 6.2 | 4.4 |
| Imports (% y/y) | 14.0 | 9.9 | 4.9 | -22.3 | 1.2 | 3.1 |
| GDP (USD bn) | 31.8 | 39.6 | 49.9 | 47.1 | 50.6 | 52.1 |
| **External sector** | | | | | | |
| Current account (USD bn) | -5.9 | -10.6 | -12.1 | -4.5 | -3.2 | -3.0 |
| CA (% GDP) | -18.4 | -26.8 | -24.0 | -9.4 | -6.3 | -5.8 |
| Trade balance (USD bn) | -7.0 | -9.9 | -12.6 | -5.7 | -5.0 | -5.1 |
| Net FDI (USD bn) | 7.8 | 12.1 | 9.1 | 4.6 | 4.1 | 4.1 |
| Other net inflows (USD bn) | -0.6 | 1.1 | 4.8 | 0.0 | 0.5 | 0.5 |
| Gross external debt (Eur bn) | 25.9 | 39.7 | 54.1 | 52.3 | 55.3 | 55.4 |
| International reserves (USD bn) | 11.8 | 17.4 | 17.2 | 18.8 | 15.3 | 16.4 |
| **Public sector** | | | | | | |
| Public sector balance cash basis (% GDP) | 3.5 | 3.5 | 3.0 | -0.8 | -4.8 | -2.0 |
| Primary balance (% GDP) | 4.6 | 4.6 | 3.9 | 0.0 | 0.1 | -1.0 |
| Gross public debt (% GDP) | 24.6 | 19.8 | 16.1 | 16.1 | 16.2 | 16.2 |
| General government balance ESA95 accrual basis (% GDP) | 3.0 | 0.1 | 1.8 | -3.9 | -3.8 | … |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 6.1 | 11.6 | 7.2 | 1.6 | 2.7 | 3.0 |
| EUR/BGN, eop | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| | **1yr Ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | -3.7 | -2.8 | 0.7 | -1.4 | 0.1 | 4.2 |
| CPI (% y/y, eop) | 6.0 | 2.0 | 2.3 | 2.5 | 2.7 | 2.9 |
| Exchange rate (eop) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |

Source: IMF, Bulgarian National Statistics Institute, Ministry of Finance, Bulgarian National Bank, Haver Analytics, Barclays Capital

# EMEA: CROATIA

## Slow to recover but financially stable

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**Croatia's economy has been slow to exit the recession, but financial stability and debt dynamics look comparatively robust. Additional fiscal consolidation efforts and progress in the negotiations towards EU accession are likely to be the focus in coming months.**

***Strategy:***

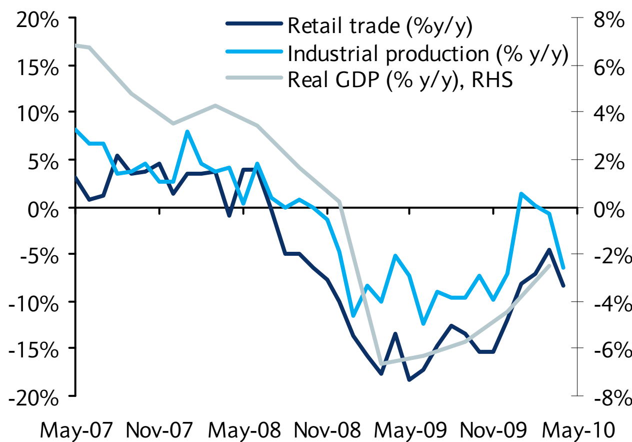
*- Sell 5y CDS on Croatia versus buying 5y CDS on Lithuania*

**Strategy**: Croatia spreads have been dragged into the downward trend experienced across the Balkan region. This has reshaped relative spread relations across the CEE credit space and opened up relative value opportunities. While the challenging growth outlook may put pressure on spreads, Croatia does not share some of the key vulnerabilities of other countries in the region. The banking sector seems comparatively healthy, and public debt and budget deficit metrics do not argue for immediate debt sustainability issues. Hence, we see room for Croatian spreads to regain lost territory and outperform on a relative basis (eg, versus Lithuania, which now trades flat to Croatia in 5y CDS). On the cash curve, we highlight the continued richness of the Croatia EUR 14s versus the Croatia EUR 15s and recommend that holders of the EUR 14s switch into the 15s for a Z-spread pick-up of about 50bp (accounting for bid-offer).

*Croatia still struggles to exit recession*

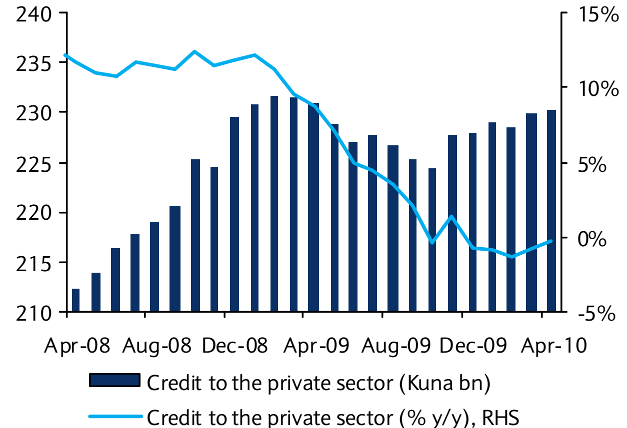
Despite some relative improvement in Q1 10, the economy has not yet exited the recession and is likely to remain one of the laggards in the region. The real GDP decline in 2009 (by 5.8%) was driven by large drops in investment and private consumption. This trend has not yet changed in Q1 10, when GDP again fell 2.5% y/y, cushioned only by improved exports and related inventory restocking. However, Croatia is a relatively closed economy (goods exports are only 17% of GDP, compared with 64% in Hungary for example), which limits the benefits from the global trade recovery. In addition, export performance in the coming months will largely depend on demand from its main trading partners Italy (20% of Croatian exports), Bosnia (14%) and Germany (11%). The partially offsetting effects of a weaker euro and fiscal consolidation measures create additional uncertainty. Higher frequency indicators such as retail sales and construction permits suggest that domestic demand remains weak; with unemployment at about 18%, this is unlikely to change soon. On a positive note, however, credit to the private sector shows some gradual improvement in recent months. Overall, we forecast a fragile recovery in H2 10 – helped by the

**Figure 1: Recovery remains subdued thus far**




Source: Haver Analytics , Barclays Capital

**Figure 2: Private sector credit shows some improvement**




Source: Haver Analytics , Barclays Capital

contribution from tourism (which accounts for about 15% of the economy) in Q3. This should allow slightly positive growth for 2010 as a whole. Growth should further normalize to 2.5-3.0% in 2011.

*Current account to remain unchanged*

*FDI coverage lower than in past*

*Short-term external debt is matched by CNB reserves*

The combination of weak private consumption and subdued capital inflows led to a substantial improvement in the current account balance in 2009. The deficit shrank to 5.6% of GDP, from 9.3% in 2008, with exports declines being more than offset by imports contraction. We expect the current account deficit in 2010 to remain broadly unchanged. On the capital account side, net FDI flows also dropped sharply in 2009. They continue to cover 40-50% of the current account deficit but no longer close to or above 100% as in the boom years. In principle, this could make external financing more of an issue because, in addition to the current account deficit, it is estimated that about 20% of the external debt stock (at 95% of GDP in end-2009) matures in 2010. However, about two-thirds of this debt are loans from foreign parent banks and corporations, which thus far have provided sufficient rollover. Also, the CNB's official foreign exchange reserves amounted to about EUR10bn – over 20% of GDP, thus covering the short-term external debt falling due within the next year. A gradual recovery of capital inflows in 2010 should help to further alleviate potential external financing concerns.

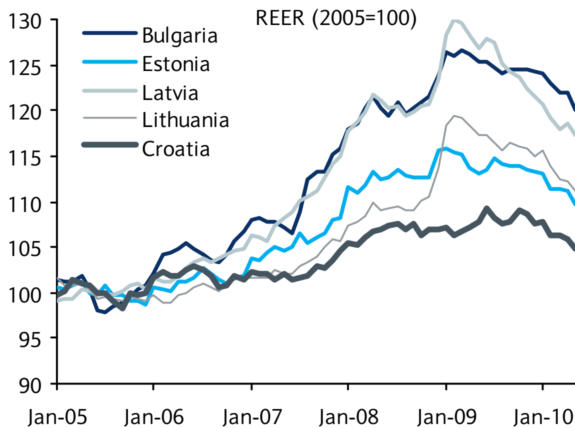
*Competitiveness is not a key concern*

The CNB's stable exchange rate policy towards the euro in principle raises the same competitiveness issues discussed for the fixed exchange rate regimes in the Baltics and Bulgaria. However, although Croatia also experienced robust growth in previous years, boosted by foreign capital inflows, the domestic price developments remained much more moderate. This implies much less REER appreciation and contains competitiveness concerns in spite of the current account deficit. The IMF's recent assessment that the Kuna "could be slightly overvalued" also seems quite benign, given that its ER valuation models typically show overvaluation for countries with such current account deficits.

*Inflation expected to pick up by the end of the year*

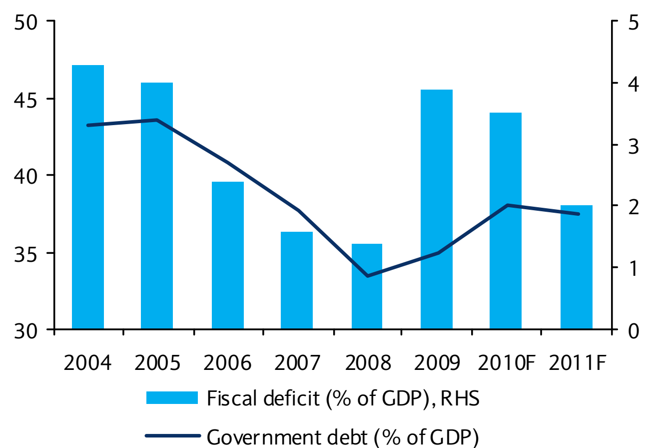
After ending 2009 at 1.9%, inflation has moderated further. The CPI printed 0.8% y/y in May with a 3% y/y drop in food prices offset by 6-7% increases in transport and housing inflation. These three categories account for about two-thirds of the Croatian CPI basket. Core inflation (excluding energy and food) hovered only around 0.35% y/y in recent months. Given the sizable output gap, we expect inflation to pick up only slowly in the coming months, ending the year somewhat above 2%.

**Figure 3: Croatia's REER appreciated less than other pegs**




Source: Haver Analytics, BIS, Barclays Capital

**Figure 4: Public debt dynamics looks manageable**




Source: Haver Analytics , Barclays Capital

*Banks have weathered the crisis relatively well*

Given the high share of FX deposits and the continuing reliance on foreign funding, banking system health will remain an issue to follow in principle. That said, we are not particularly concerned at this point. Supported by their foreign parent banks and benefiting from tight regulations, local banks have weathered the crisis relatively well and have been able to maintain adequate capitalization. The ratio of NPLs to total loans increased from 4.9% in 2008 to 6.4% in September 2009, but this still looks good compared with the CEE average of 9.9%. Lower household income and corporate profitability through delayed effects of the recession could still worsen the situation in 2010, but the system seems able to cope with this.

*Ongoing efforts to reduce the budget deficit*

Government efforts to achieve fiscal consolidation are likely to remain in focus for the rest of the year. The budget deficit has been declining steadily since 2003, but the crisis widened it to 3.9% of GDP in 2009 (from a 1.4% deficit in 2008). In April this year, the government adopted a programme aimed at increasing public sector efficiency (job cuts), boosting privatization (selling stakes in all companies in which it owns up to 25%) and reforming the tax system. According to Prime Minister Jadranka Kosor, the majority of measures will be carried out by the end of this year, thus showing results in 2011. The government also intends to revise the budget in July in view to reduce spending in H2 and it plans to adopt legislation on fiscal responsibility by November. The government originally aimed for an ambitious 2.5% deficit in 2010, but first-quarter results were quite poor with about 60% of the planned deficit already in place. Despite the expected improvement in revenue with the beginning of the tourist season, we believe a budget deficit in 2010 of around 3.5% of GDP to be more realistic.

*Public debt dynamics look manageable in general …*

*… but extended debt guarantees are a vulnerability*

Despite this likely miss of the original budget target, debt dynamics are not yet alarming. Public debt has remained relatively low and was on a declining path in the past few years, before rising to 35% of GDP in 2009. Funds were raised in domestic markets (loans and T-bills) and through two bond issues in the foreign market. The government also tentatively plans to tap foreign markets in the coming months. Given strong local demand for government securities, financing the deficit and debt rollover should not be a significant problem. One of the debt vulnerabilities, however, comes from contingent government liabilities associated with extended debt guarantees. Taking into account these guarantees, the current government debt amounts to 50% of GDP.

*Negotiations towards EU accession continue as Slovenia lifted its block*

The negotiations towards EU accession will remain in focus for the country in the coming months. Croatia became an official candidate for EU membership in 2004. Among the latest positive developments is Slovenia's decision to unblock the Croatian bid due to some progress in resolving an 18-year-old border dispute between the two countries. However, it is still uncertain whether Croatia will be able to conclude the talks with the EU on the remaining chapters (main issues now include judiciary and shipping industry restructuring) by the end of the year. A further delay of EU membership (ie, beyond 2012) could have negative financial implications for Croatia, as it could reduce the amount of EU funds made available made under the EU's new seven-year financial framework for 2014-2020.

### Figure 5: Croatia macroeconomic forecasts

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 4.7 | 5.5 | 2.4 | -5.8 | 0.3 | 2.7 |
| Domestic demand contribution (pp) | 5.4 | 6.3 | 2.9 | -6.0 | -2.1 | 3.8 |
| Private consumption (% y/y) | 3.5 | 6.1 | 0.8 | -8.4 | -2.7 | 4.7 |
| Fixed capital investment (% y/y) | 11.7 | 9.0 | 9.0 | -14.6 | 0.5 | 2.1 |
| Net exports contribution (pp) | -0.9 | -1.0 | -0.3 | -0.2 | 2.4 | -1.3 |
| Exports (% y/y) | 6.5 | 4.3 | 1.7 | -16.2 | 3.7 | 5.9 |
| Imports (% y/y) | 7.4 | 6.5 | 3.6 | -20.7 | 2.2 | 7.5 |
| GDP (USD bn) | 49 | 59 | 69 | 63 | 62 | 66 |
| **External sector** | | | | | | |
| Current account (USD bn) | -3.3 | -4.4 | -6.3 | -3.2 | -3.6 | -4.4 |
| CA (% GDP) | -7.0 | -7.6 | -9.3 | -5.6 | -5.8 | -6.7 |
| Trade balance (USD bn) | -10.5 | -12.9 | -15.9 | -10.3 | -10.2 | -11.5 |
| Net FDI (USD bn) | 3.2 | 4.8 | 4.6 | 1.3 | 1.5 | 2.5 |
| Gross external debt (USD bn) | 37 | 45 | 57 | 60 | 63 | 68 |
| International reserves (USD bn) | 11.5 | 13.7 | 13.0 | 14.4 | 13.3 | 14.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -2.4 | -1.6 | -1.4 | -3.9 | -3.5 | -2.0 |
| Primary balance (% GDP) | -0.2 | 0.4 | 0.1 | -2.5 | -1.9 | -0.1 |
| Gross public debt (% GDP) | 40.8 | 37.7 | 33.5 | 35.0 | 38.0 | 37.5 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 2.0 | 5.8 | 2.9 | 1.9 | 2.4 | 2.7 |
| EUR/Kuna, eop | 7.32 | 7.34 | 7.22 | 7.34 | 7.33 | 7.33 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | -6.3 | -2.5 | -0.8 | 2.0 | 2.3 | 2.6 |
| CPI (% y/y, eop) | 2.1 | 0.8 | 1.0 | 1.7 | 2.4 | 2.5 |
| Exchange rate | 7.30 | 7.26 | 7.33 | 7.33 | 7.33 | 7.33 |
| CNB policy rate (%, eop) | 6.00 | 6.00 | 6.00 | 6.00 | 6.00 | 6.00 |

Source: Barclays Capital

# EMEA: CZECH REPUBLIC

## Growth but no recovery

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**The Czech economy is caught in a low growth equilibrium. Even though the subdued inflation level is countered by a reduced policy rate of 0.75%, money supply is still declining. The new government is pledged to reduce the fiscal deficit through expenditure cuts. While this improves Czech economic fundamentals and could raise long-term growth prospects, it adds to the near-term downdraft on growth.**

*Waiting for an opportunity to buy the cheap-to-swaps 2019 CZGBs*

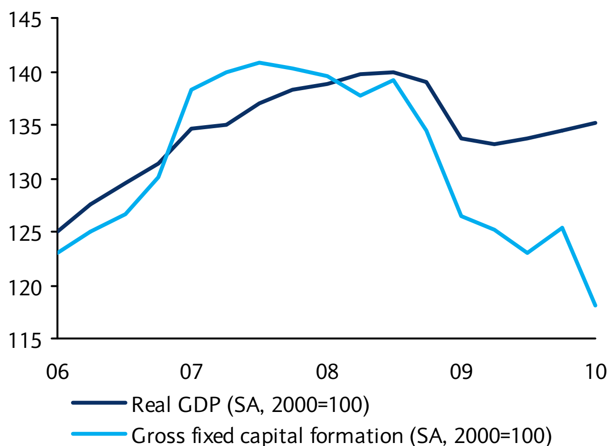
**Strategy:** The next few months should provide an opportunity to be long bonds on an FX-hedged basis. The cheapness of local bonds to swaps (at the most extreme at 127bp ASW on the '19 bonds) and the high carry/roll-down makes these bonds appealing to buy, in our opinion. However, the heavy local supply calendar means better opportunities (higher yields) before going long (funded out of CZK money markets). On EUR/CZK FX, we urge caution as exogenous risks related to euro area growth and banking continue to represent negative tail risks for regional currency markets. Moreover, FX intervention risks by the CNB are unlikely, anyway, to dissipate as inflation is low and the economy is only recovering slowly. This means an asymmetric risk profile on the crown with a baseline scenario of range trading but skewed tail risks. Czech fundamentals, notably the low levels of external leverage and low sovereign risk should keep EUR/CZK a low beta currency pair, which probably makes dip-buying of EUR (cash) against CZK a likely enduring trading stance.

### Gradual growth

*Although the economy is expanding off cyclical lows, it remains depressed*

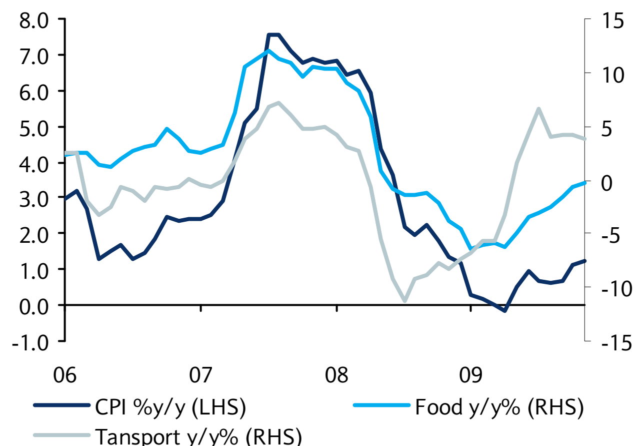
Czech has struggled to recover from its relatively severe 2008-09 recession. Even though GDP has been growing at a rate of 0.5% q/q for the past three quarters, this has not compensated for the 5% decline in GDP during the recession (Figures 1). Economic sentiment has come off its lows, but remains below average and thus relatively depressed. Investment is still declining owing to excess capacity in the system. Private consumption is still low as labour markets strains are leading to small wage increases. Fiscal adjustments have resulted in government wage freezes and higher taxes; expectations are for more of the same under the new government. The construction sector remains under pressure. Finally, it should be noted that Czech growth did not get any boost from net exports as the decline in exports and imports of goods and services was nearly identical in 2009 and Q1 10. Czech net exports are highly dependent on consumer

Figure 1: Even though GDP is growing, it hasn't recovered




Source: Czech Statistical Office and Haver.

Figure 2: Inflation is rising from very low levels




Source: Czech Statistical Office and Haver.

durables, machinery and transport exports that have been particularly hard hit in this recession. The Czech economy is gradually growing on base effects, without yet reaching pre-recession levels of real GDP. We expect growth this year will be positive at 1% y/y and then accelerate in the next two years to an average of 3% per annum as investment expenditure recovers.

## Inflation off the lows

*Inflation has crept up into the CNB target zone and deflation no longer appears to be a threat*

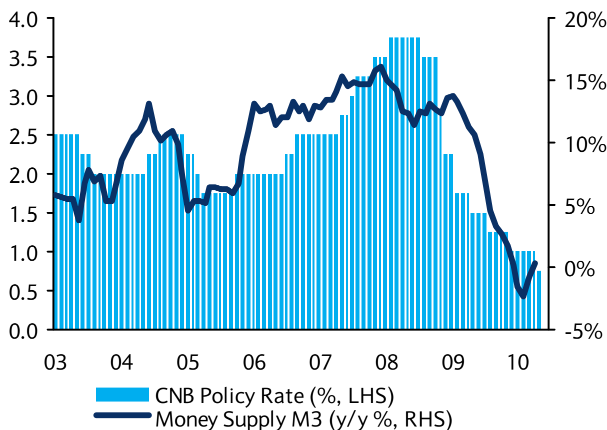
Inflation remains at low levels, 1.2% y/y (Figure 2). However, this is an improvement from before when inflation was below even the new inflation target of 1-3% for three consecutive months. The factors contributing to rising inflation are excise taxes, utility prices, transportation, education, restaurants and hotels. Food inflation is still negative as is telecommunications, clothing and footwear, and recreation and culture. We believe the recent increases are helpful even if raised taxes are partly responsible. The fear of deflation is generally a nominal concern rather than a core inflation issue.

*While the CNB rate is low, the bank never instituted quantitative measures that might have helped the economy to grow*

The Czech National Bank (CNB) recently cut rates to an all-time low of 0.75%. We have recently revised our forecast and now expect the bank to keep rates at this level until 2011. The delay in rate increases by the US and ECB will probably keep the CNB from raising rates in 2010. However, it may increase rates slightly before the ECB since its rate is lower (Figure 3). Even though policy rates have been very low, M3 money supply growth has collapsed. This implies that interest rates lost their effectiveness because the transmission through the banking system was non-operative. As with many other countries last year, quantitative measures would have been needed to boost the money supply and economic activity. The CNB choice not to engage in quantitative measures has probably been an important contributing factor to the lack of economic dynamism.

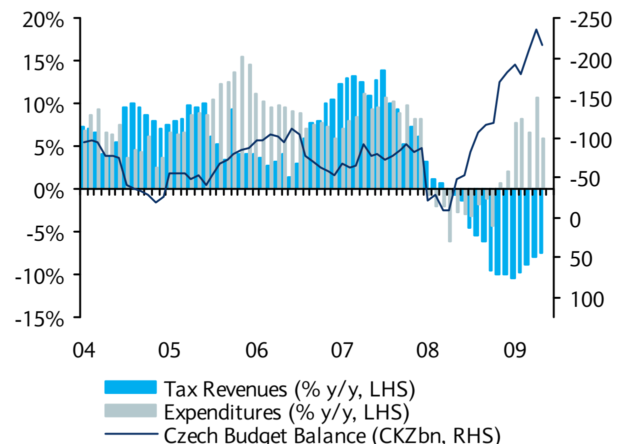
The Czech currency has depreciated in sympathy with the euro and other CEE currencies. We think the CZK, in line with neighbouring currencies, will be susceptible to further sell-off in the next quarter as euro area fiscal concerns continue to fuel market risk aversion. We subsequently expect a sporadic depreciation pressure on the CZK to resurface and for the CZK to resume its long-term appreciation trend only once these risks are laid to rest (unlikely this year, in our view). Intervention risk is highly asymmetrical. Given that inflation is below the middle of the range, we expect that the CNB will not mind depreciation. However, it could well intervene if the currency strengthens too much. Although the CNB has threatened to intervene, it has not done so yet in part because its verbal interventions seem to have helped. Further, the maintenance of low policy rate in part reflects its preference for CZK weakness.

**Figure 3: Inflation is starting to creep higher**




Source: Czech National Bank and Haver

**Figure 4: Further fiscal improvements in prospect**




Source: Czech Ministry of Finance and Haver

## Fiscal policy politics

*Czech parliamentary elections resulted in a strong mandate to lower fiscal deficits*

Fiscal policy loosening to offset the recession is essentially finished. In the recently concluded parliamentary elections, budget deficits were the most important political issue of the campaign. The election result gave a mandate to the new government to cut deficits through reductions of government expenditures to achieve faster deficit reduction than previously envisaged. The anticipated fiscal adjustment is probably having a negative impact on domestic demand because large civil service wage cuts and lay-offs are widely expected. However, the alternative plan of raising taxes substantially to both cut the deficit and raise social welfare spending would have had a much more severely negative impact on domestic demand. Furthermore, the improvement in economic fundamentals could increase medium-term growth rates.

*Public debt dynamics remain favourable*

The emphasis on fiscal austerity is perhaps surprising since Czech fiscal finances were already in much better shape than most. Public debt is still only around 35% of GDP, notwithstanding the fiscal loosening in 2009. Czech started in a stronger position than other countries with fiscal deficits in 2006-08 inside the Maastricht criteria. Furthermore, the interim government managed to get a large fiscal adjustment for the 2010 budget that raised taxes (including a 1% increase in the VAT rate and much higher beer taxes) and extended the freeze on wages and pensions. For this reason, the deficit has already moderated on containment of expenditures (Figure 4). While the government estimates that the fiscal deficit will exceed the 2010 target of 5.3%, expenditure cuts of CZK10-15bn will probably be enacted to bring the deficit back on target. We expect that tax revenues will begin to recover during the second half of 2010 and that should help the government reach the target. Tax revenue has already stabilised in recent months.

Figure 5: Czech Republic macroeconomic forecasts

| Czech | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 6.8 | 6.1 | 2.5 | -4.1 | 1.1 | 2.8 |
| Domestic Demand Contribution (pp) | 5.4 | 5.4 | 1.1 | -3.5 | 1.2 | 2.7 |
| Private Consumption (% y/y) | 5.0 | 4.8 | 3.6 | -0.3 | 1.3 | 3.5 |
| Fixed Capital Investment (% y/y) | 6.0 | 10.8 | -1.5 | -8.3 | -5.5 | 4.0 |
| Net Exports Contribution (pp) | 1.3 | 0.9 | 1.4 | -0.7 | -0.1 | 0.2 |
| Exports (% y/y) | 15.8 | 15.0 | 6.0 | -10.2 | 19.0 | 6.4 |
| Imports (% y/y) | 14.3 | 14.3 | 4.7 | -10.2 | 19.7 | 6.3 |
| GDP (USD bn) | 143 | 175 | 217 | 192 | 215 | 230 |
| **External Sector** | | | | | | |
| Current Account (USD bn) | -3.8 | -5.6 | -6.6 | -2.0 | 1.4 | 2.8 |
| CA (% GDP) | -2.7 | -3.2 | -3.1 | -1.1 | 0.7 | 1.2 |
| Trade Balance (USD bn) | 2.8 | 5.9 | 6.4 | 10.4 | 11.3 | 12.9 |
| Net FDI (USD bn) | 4.2 | 9.4 | 8.5 | 1.4 | 7.5 | 8.0 |
| Other Net Inflows (USD bn) | 0.2 | -2.6 | 0.0 | 1.0 | 1.3 | 1.5 |
| Gross External Debt (USD bn) | 57 | 76 | 80 | 81 | 82 | 83 |
| International Reserves (USD bn) | 32 | 35 | 37 | 42 | 54 | 68 |
| **Public Sector** | | | | | | |
| Public Sector Balance (% GDP) | -2.6 | -0.7 | -2.7 | -5.9 | -5.3 | -4.4 |
| Primary Balance (% GDP) | -1.5 | 0.5 | -0.3 | -4.2 | -3.8 | -3.1 |
| Gross Public Debt (% GDP) | 26.7 | 28.3 | 25.8 | 30.7 | 35.1 | 37.9 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 1.7 | 5.5 | 3.6 | 1.0 | 2.0 | 1.8 |
| EUR/CZK, eop | 27.5 | 26.6 | 26.9 | 26.5 | 26.1 | 25.4 |
| | **1yr Ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | -3.6 | 1.1 | -1.6 | 0.3 | 4.0 | 2.2 |
| CPI (% y/y, eop) | 1.2 | 1.2 | 1.4 | 1.9 | 2.0 | 1.5 |
| Exchange Rate (eop) | 25.89 | 25.51 | 25.80 | 26.25 | 26.10 | 25.50 |
| CNB policy rate (%, eop) | 1.50 | 0.75 | 0.75 | 0.75 | 0.75 | 1.25 |
| Market implied rate (%,eop) | NA | NA | 0.75 | 0.75 | 0.75 | 1.00 |

Source: National sources, Haver, Barclays Capital

# EMEA: EAST AFRICA

## No alarm bells, but public finances under pressure

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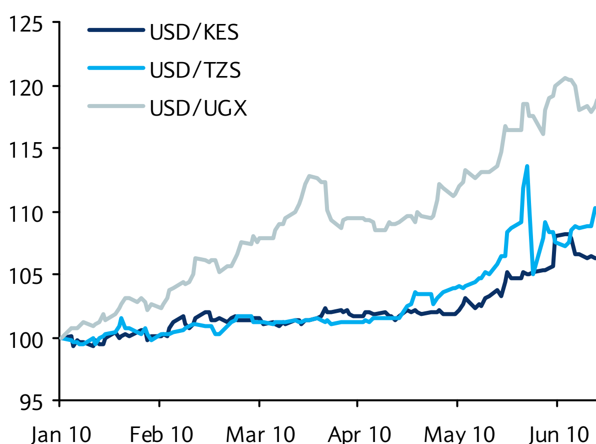
**Although east African fiscal deficits remain manageable, the more expansionary budgets are a concern given the current global uncertainties. Moreover, the upcoming elections in the region's three largest economies could put further pressure on fiscal balances. Kenya and Tanzania have indicated that they are looking to tap international capital markets to bridge the financing gap.**

East African currencies (UGX, KES and TZS) have been hit hard by the strong USD during the past few weeks, falling up to 5%. However, year-to-date, the UGX has depreciated around 15% against the USD, with the initial depreciation triggered by the Bank of Uganda's statement that it prefers a more competitive currency closer to 2,000/USD (USD/UGX1,900 at the time). The TZS weakened by around 8% and the KES by around 6% year-to-date against the USD, reflecting the negative impact of the European crisis on risk appetite. Looking ahead, we expect some correction in east African currencies toward year-end, strengthening by between 4% and 5%. Our view is based on several support pillars that might come into play: our expectation of a marginally weaker USD by year-end, improved capital flows when risk appetite returns, and continued firm commodity export revenues.

*Short-dated yields are likely to remain low in east Africa in the near term, but should pick up marginally towards year-end*

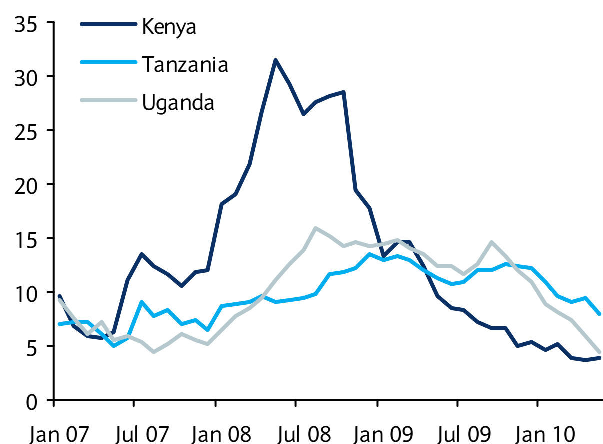
Lower food inflation has driven inflation lower across the region, resulting in a benign inflation environment. Kenya's headline rate was 3.9% y/y in May, Uganda's 4.4% and Tanzania's 7.9%. Despite the impact of weaker currencies, the outlook for inflation remains subdued, in our view, as food inflation remains moderate. We expect Kenya's inflation to be just over 3% y/y by year-end and Uganda around 6%. While Uganda and Tanzania use open market operations to target monetary aggregates, Kenya uses the central bank rate (CBR) in policy implementation. The Central Bank of Kenya (CBK), which has cut 225bp to help support growth, left policy rates on hold at its 20 May MPC meeting amid indications that the accommodative stance was having a positive impact on credit extension and overall economic growth. As such, although Kenya's inflation rate is well inside its 5% target, we do not expect a further decline in the policy rate. Given subdued inflationary conditions, we expect yields on short-dated assets to remain unattractive in the near to medium term, picking up only slightly late in H2 10. Kenya and Tanzania are all planning sovereign bond issuances during the 2010-11 fiscal year, while Uganda considered such a bond shortly before the crisis in 2008.

**Figure 1: Currencies under pressure from strong USD**




Note: Exchange rates indexed to 1 January 2010 = 100.
Source: Reuters, Absa Capital

**Figure 2: East African inflation remains benign (% y/y)**




Source: Statistical offices, Absa Capital

## Economic growth has solid momentum

*East Africa economic growth rebounding*

Growth in East Africa's major economies (we focus on Kenya, Tanzania and Uganda only) remained solid in 2009 despite the global crisis. Adverse weather conditions weighed on the region's economic growth in 2009 although indications are that conditions in the agriculture sector are better this year. Coupled with ongoing infrastructure outlays and higher exports, we see the outlook for the region as upbeat. Indeed, we expect Kenya's recovery to strengthen this year, with growth of around 4% likely, while Tanzania's economy is also poised to record growth of above 6%. Similarly, Uganda is set for growth of just over 6% in 2010 (around 5% in 2009), rising further in 2011 with the commencement of commercial oil production expected to boost the economy.

*External balances to deteriorate marginally in 2010*

The region's current account balances are likely to deteriorate marginally in 2010, as imports of investment goods and a higher oil import bill have an impact on trade balances. However, a pick-up in average commodity prices from next year, in tandem with the recovery of global demand, may result in current account balances narrowing again.

## Fiscal situation showing strain ahead of elections

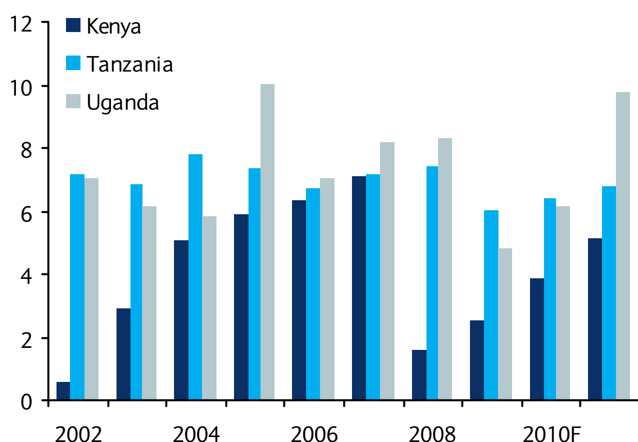
*Fiscal pressures remain ahead of general elections*

East Africa's three largest economies reported their fiscal positions at the beginning of June. Kenya is projecting a fiscal deficit equivalent to 6.8% of GDP in fiscal year 2010-11 (estimated at 7% in 2009/10), and Uganda a deficit of 3.5% of GDP (3% in 2009-10). Tanzania plans to increase its borrowing to around to 4% of GDP from a budgeted 3.5% in 2009-10. The 2009-10 budget deficits in these countries reflect a combination of factors: adverse weather conditions that had a negative impact on agricultural output; and the spill-over effects of the global crisis which had an impact on the region's economies through a decline in trade tariffs, elevated spending to stimulate economic growth and lower donor flows.

*Election and infrastructure commitments possibly behind higher spending*

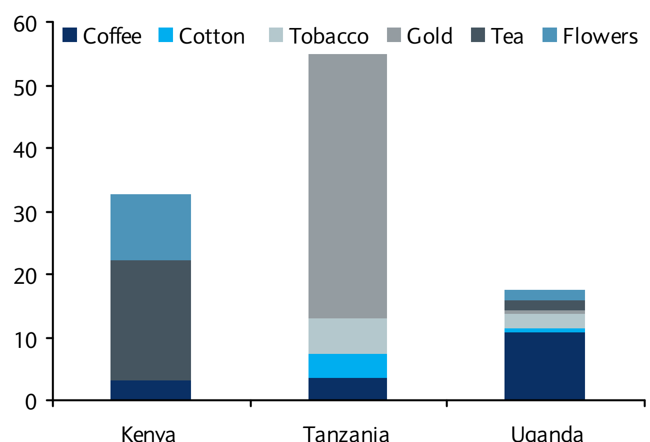
With the exception of Kenya, Uganda and Tanzania project their budget deficits to widen further in 2010-11 despite improved economic growth, which means that there may be some other factors at play. One explanation for the increased spending could be the upcoming elections – Tanzania and Uganda expect to hold elections in October 2010 and February/March 2011, respectively. Kenya is planning an election in 2012 and spending may also be negatively affected from next year. Another explanation is the severe backlog of infrastructure, with their economies severely constrained by power shortages, poor transport network, etc. As a result, the governments have increased their focus on development spending, which was ramped up markedly in all three markets. Kenya plans to

**Figure 3: Real GDP growth like to increase further (% y/y)**




Source: Official offices, Absa Capital

**Figure 4: Contributions of key exports (% total exports)**




Source: Central banks, Absa Capital

increase its development expenditure outlay to 11.7% of GDP in 2010-11 from 10.3% in 2009-10, while in Uganda, the development budget is projected to rise to 8.5% of GDP from 7.2% in 2009-10.

The East Africa Community's (ECA) focus in terms of spending remains energy and transport infrastructure projects, while also prioritising expenditure towards human capital with the aim of improving the economies' productivity. To maintain sustainable budgets, all three governments expect revenue collections to be higher, with Kenya expecting revenues to rise to 24.5% of GDP (estimated at 23.7% in 2009-10), while domestic revenue in Uganda and Tanzania is projected to rise from 12.7% to 13.4% and 16.1% to 17.3%, respectively. In Tanzania, 28% of expenditure will be financed from loans and grants (33% in the previous fiscal year). Although Tanzania's ratio of donor support in the budget is lower, in absolute terms, government expects total grants and loans to be 3% higher at TZS3.3trn (USD2.3bn) compared with last year's budgeted figures.

*Several sovereign issuances planned in 2010-11 fiscal year*

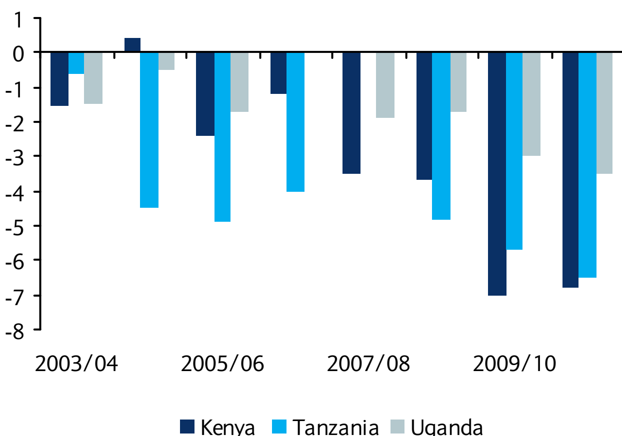
Fiscal deficits will mostly be financed through domestic sources with Kenya, which houses the region's largest bond market, planning to reduce its domestic borrowing to 3.8% of GDP, from 5.1% of GDP in 2009-10. Tanzania plans to borrow a total of TZS1.3trn (USD0.9bn or around 4% of GDP) from domestic and foreign sources to finance priority infrastructure projects. Early in the year, Tanzania's government confirmed plans to issue a USD500mn eurobond in the 2010-11 fiscal year to help finance infrastructure projects. Kenya and Uganda are also looking to sovereign bond issuances over the next few months although, disappointingly, no details have been provided during the budget presentations. We remain concerned about potential near-term upside risks, such as pre-election expenditure pressures and lower-than-expected revenues, and the impact on debt ratios. Indeed, external debt ratios are creeping higher, post debt relief lows (Figure 6).

## East African political situation needs close monitoring

*Political risk in Tanzania low despite tension in Zanzibar*

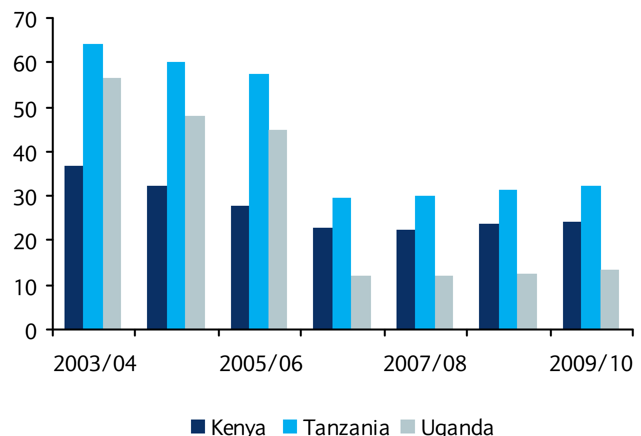
Tanzania remains a politically stable democracy and despite long-standing political tensions on the island of Zanzibar, we see the risk of political instability over the medium term as relatively low, as the Chama Cha Mapinduzi (CCM) party dominates the political scene on the mainland. Although there is a risk that political tensions in Zanzibar may spill over to the mainland ahead of the elections, we believe that recent reconciliatory gestures between the ruling and opposition parties in Zanzibar suggest that the risk may not be significant. Against this backdrop, we do not expect any major problems in the upcoming election in October 2010.

**Figure 5: Fiscal deficits deteriorate further (% GDP)**




Source: Official Offices, Absa Capital

**Figure 6: External debt creeping higher (% GDP)**




Source: Official offices, Absa Capital

*Uncertainties in Uganda increasing*

The political situation in Uganda, however, is more worrying due to several factors: the instability in neighbouring countries, land disputes following the discovery of oil in the Lake Albert region, and opposition parties' discontent about the electoral commission. Uganda is planning an election in February/March 2011, but opposition parties have voiced their concern over the past few months about the impartiality of the electoral commission. Opposition parties organised nationwide protests in early June against electoral commissioners re-appointed last year despite alleged irregularities in the 2006 election which they oversaw (AllAfrica.com, 10 June). The current commissioners were re-appointed despite a court ruling in 2006 that declared the electoral commission incompetent. Uganda's main opposition party has meanwhile threatened violent protests unless the commission is replaced as it is worried about free and fair elections (Africa Review, 10 June). The opposition is also worried that the electoral commission is biased towards President Museveni and his NRM party, which has been in power since 1986 – Museveni will be standing for a fourth term. With the commencement of commercial oil production next year, we do not expect Museveni to loosen his grip on power.

*Kenya's unity government remains fragile*

In Kenya, the unity government remains fragile with Prime Minister Odinga and President Kibaki regularly clashing although, for strategic reasons, we do not expect either party to pull out of the unity government. Parliament has, meanwhile, approved a draft constitution on 1 April, which will be subject to a referendum on 4 August 2010. While the adoption of a new constitution, which limits the power of the executive, will go a long way to solving the country's political issues, we continue to believe that political tension may increase closer to the election in 2012.

**Figure 7: Macroeconomic forecasts of selected countries in east Africa**

| | Kenya | | | Tanzania | | | Uganda | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010F | 2011F | 2009 | 2010F | 2011F | 2009 | 2010F | 2011F |
| Real GDP (% y/y) | 2.6 | 3.9 | 5.1 | 6.0 | 6.4 | 6.8 | 4.8 | 6.2 | 9.8 |
| CA (% GDP) | -6.2 | -6.6 | -6.1 | -7.8 | -9.3 | -9.7 | -1.5 | -4.9 | -3.9 |
| FX reserves (eop) | 3.9 | 3.0 | … | 3.6 | 3.0 | … | 2.8 | 2.6 | … |
| External debt (% GDP)[1] | 23.9 | 24.3 | 23.2 | 31.5 | 32.3 | … | 12.7 | 13.3 | … |
| Overall fiscal balance (% GDP)[1] | -3.7 | -7.0 | -6.8 | -4.8 | -5.7 | -6.5 | -1.7 | -3.0 | -3.5 |
| CPI (% y/y, eop) | 5.3 | 3.3 | 8.7 | 12.2 | 5.7 | 10.9 | 11.0 | 5.7 | 9.5 |
| Currency per USD (eop) | 75.85 | 78.09 | 76.50 | 1339 | 1360 | 1299 | 1900 | 1880 | 1850 |
| Benchmark policy rate (%, eop) | 7.00 | 6.75 | 8.00 | NA | NA | NA | NA | NA | NA |

Note: [1]Fiscal year ending. Source: BoG, IMF, Reuters, Absa Capital

# EMEA: EGYPT

## Elections first, reforms after

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**Parliament approved an expansionary FY 10-11 budget, while anchoring it to a medium-term fiscal plan aimed at reducing debt to less than 44% of GDP by 2014-15. Q1 10 GDP growth surprised to the upside at 5.8% y/y and FX reserves increased, indicating that much of the EGP weakening has been driven by EUR/USD.**

*We continue to recommend the EGP by owning 3m T-bills FX unhedged (via a EUR-USD funding basket)*

**Strategy:** We continue to recommend our FX unhedged 3M T-Bill carry trade based on Egypt's healthy balance of payments dynamics, solid growth prospects and improved positioning outlook. The poor performance of local yields and equities in recent months, coupled with a weaker EGP, suggests some unwinding of dollar FX unhedged positions. We look for a gradual EGP appreciation trend against the dollar with the currency reaching 5.55 in 12 months. That said, in the current risk-averse environment, we think it prudent to continue hedging any potential EUR/USD swings via an 80%-dollar/20%-euro funded basket. In addition, potential local issuance in the coming months to help finance the large budget deficit for FY 10-11, possibly in the longer end of the curve, argues for shorter duration curve exposure. On the external debt side, Egypt credit valuations seem somewhat stretched to us at current levels on a relative basis, given Egypt's outperformance in the latest period of risk aversion. The postponement of fiscal reforms, risks from higher spending during election time, uncertainty about President Mubarak's succession and potential further Eurobond supply may put some pressure on spreads, in our view. We therefore recommend underweighting Egypt in our Global EM credit portfolio. We note, however, that the Egyptian spread curve looks steep versus global peers, and we highlight the Egypt 40s as the best pick on the curve for spread-oriented investors (Figure 2).

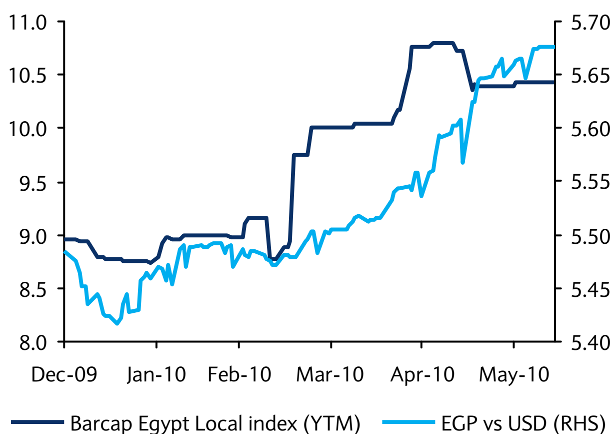
### Fiscal policy: A postponed commitment to fiscal adjustment

*President Mubarak's return reduced uncertainty…*

*… and the government postponed its plans for fiscal consolidation*

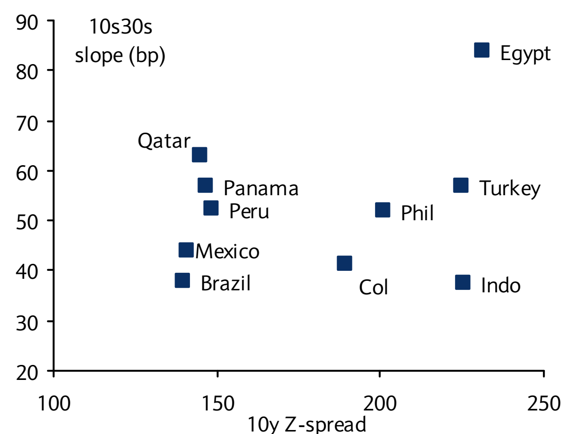
The return of President Mubarak to public office after a critical surgery in March helped dissipate, at least momentarily, market tensions and speculation about imminent succession arrangements. However, in our view, the imperative of managing the power transition, including the forthcoming parliamentary elections this November and the presidential elections in 2011, explains much of the government recently further postponing its plans for fiscal consolidation. In 2005-06, it aimed to reduce the deficit to 3% of GDP by 2010-11.

**Figure 1: Local yields have risen and EGP has depreciated**




Source: Bloomberg, Barclays Capital

**Figure 2: Egypt's 10s30s spread curve looks steep**




Source: Bloomberg, Barclays Capital

*MoF foresees a reduction in the deficit to 3.5% of GDP and in debt to 44% of GDP by 2014-15*

Amidst mounting concerns about sovereign debt in Europe, the need to bring Egypt's high deficits and debt levels onto a sustainable path took centre stage in the government's 2010-11 budget recently approved by the People's Assembly. There, and for the first time, the Ministry of Finance (MoF) lays down a medium-term fiscal framework, the objective of which is to bring the overall budget deficit from the highs of 8.2% of GDP this fiscal year, to 3.5% of GDP in FY 14-15 (Figure 4), while reducing gross public debt from an estimated 80% of GDP to less than 44% of GDP over the same period. The bulk of the proposed adjustment is expected to take place in 2012-13 following the planned introduction of VAT by end 2011-12, which the MoF estimates to yield 1.5-2.0% of GDP in additional revenues. The government's baseline scenario relies on a bullish growth outlook in the medium term, where it projects real GDP to register no less than 6.8% y/y growth in FY 2011-12, and then 7.1%, 8.1% and 8.5% in the following three fiscal years, respectively.

*For that, stronger external demand and a firm resolve to implement reforms are essential*

In our opinion, the above scenario seems plausible, though ambitious, given previous episodes of fiscal reforms implementation. For it to happen, a strengthened global recovery engendering a stronger external demand would be necessary. The realization of this scenario also depends on a smooth political transition by end 2011 and a resolve to implement much-needed structural and fiscal reforms (notably the introduction of the VAT, the modernization of the property tax and the rationalization of subsidies). Downside risks include a weaker global recovery and political unrest that could delay and derail reform implementation.

*Fiscal policy in FY 10-11 will remain expansionary*

*We project deficit to remain at 7.7% of GDP*

*Capital spending is reduced while wages and subsidies are increased*

In the immediate future, however, namely FY 2010-11, fiscal policy remains expansionary, only gradually withdrawing the fiscal stimulus as growth momentum picks up. As we stated in our previous EM Quarterly and in *Egypt trip notes: Succession politics, more risk but ample rewards*, 9 April 2010, the new budget law will maintain the deficit almost unchanged from our forecast for this ending fiscal year: 7.7% of GDP. While the budget law does not anticipate any new notable revenue measure, the proposed reconfiguration of the spending composition is noteworthy. The budget foresees an 30% y/y reduction in capital spending compared with last year's budget and deploys significantly more resources to current expenditures, with a particular emphasis on raising wages (by 10%) and subsidies (by 21.8%), as one would expect in an election year. Given the large size of Egypt's public debt, which is mostly concentrated in short-term domestic Treasury bills, the budget law projects interest payments will increase almost 27.5% (Figure 3).

**Figure 3: Egypt's fiscal performance (central government) and Budget 2010-11 (% of GDP unless otherwise specified)**

| | | | 2009-10 | | 2010-11F | | % change Budget 2010-11 vs 2009-10 (in %) |
|---|---|---|---|---|---|---|---|
| | 2007-08 | 2008-09 | Actual8 | Barcap | Budget | Barcap | |
| Total revenues | 24.7 | 27.2 | 21.6 | 20.7 | 20.4 | 20.7 | 8.6 |
| Tax revenues | 15.3 | 15.7 | 14.3 | 14.1 | 14.3 | 15.0 | 15.1 |
| Non tax revenues | 9.2 | 10.7 | 6.9 | 6.2 | 5.8 | 5.6 | -2.9 |
| Total expenditures | 31.5 | 33.8 | 29.7 | 28.4 | 28.6 | 28.8 | 10.7 |
| Wages and compensation | 7.0 | 7.3 | 7.2 | 7.1 | 6.9 | 7.4 | 10 |
| Goods and Services | 2.1 | 2.4 | 2.3 | 2.1 | 2.1 | 2.1 | 2.6 |
| Interest | 5.6 | 5.1 | 5.9 | 6.2 | 6.6 | 6.4 | 27.5 |
| Subsidies, grants and social allowances | 10.3 | 12.2 | 7.9 | 7.1 | 8.4 | 8.6 | 21.8 |
| Overall deficit | -6.8 | -6.9 | -8.2 | -7.7 | -7.7 | -7.6 | |
| Primary deficit | -1.2 | -1.8 | -2.3 | -1.5 | -1.1 | -1.1 | |

Note: MoF's estimated of actual 2009-10 budget outturns. Source: Ministry of Finance, Barclays Capital

*A rise in political tension could put pressure for higher spending*

*We expect financing to be secured by the market*

We see downside risks to these projections as political considerations could put further pressure on the fiscal accounts. Most recently, in Cairo and across the country there were several protests and demands for raising the minimum wage and improving socio-economic conditions of the poor, which represent almost 19.6% of the total population[2]. At the same time, there have been several riots by the opposition demanding political reforms, including clashes between the Muslim Brotherhood and the ruling National Democratic Party during the elections at the Shura Council (upper House) in May. We thus expect wages and subsidies to overshoot the budgeted figures by about 0.5% of GDP and 0.2% of GDP. Buoyant tax revenues should keep the deficit in line with the bottom line figure foreseen in the budget law (Figure 3). The large deficit notwithstanding, we believe the government should be able to secure its financing needs through domestic borrowing, given its liquidity-flush banking sector, and possibly tapping the international markets for another Eurobond issue following the last April's issuance.

## External balances continue to strengthen

*Q1 current account widened despite improved receipts*

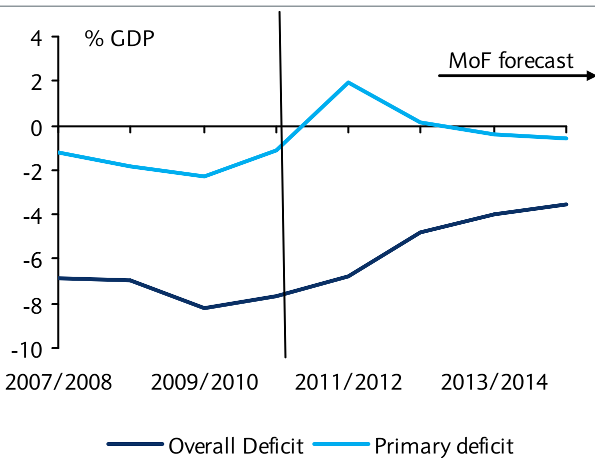
*But portfolio inflows led to higher BoP surpluses*

The transitional weakening of the fiscal accounts is expected to be counterbalanced by improvements in Egypt's external position. The widening of Q1 10 trade balance by 35% notwithstanding, much of it resulted from an increase of 18% in the non-oil import bill compared with the same period last year. Meanwhile, current account drivers, including receipts from tourism, the Suez Canal and remittances, seem to be sustaining their upward growth momentum. However, these receipts did not prevent a widening of the current account balance in Q1 10 by 44%. This was more than offset by large capital inflows into Egyptian debt and equity markets which rose to USD5.5bn in one quarter, as well as by a surge in FDI (41% y/y) that left the balance of payments (BoP) in surplus for the third consecutive quarter (USD0.4bn in Q1 10), allowing a continued accumulation of FX reserves, which reached USD32.1bn at the end of May (Figure 5). We expect the base effects from higher oil prices to fade, against strengthening tourism, Suez Canal and remittances, and the current account deficit to shrink in H2 10.

*Growth surprised to the upside*

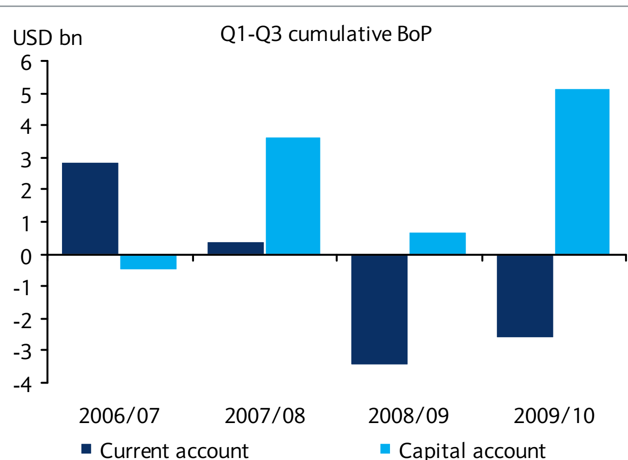
The above developments shed light on the changing pattern of Egypt's growth drivers. The impetus of the government's fiscal stimulus is being complemented by rising foreign investment, which is shoring up private investment and, subsequently, consumption, with

**Figure 4: Fiscal balances are projected to improve**




Source: MoF, Barclays Capital

**Figure 5: External balances continue to improve**




Source: Central Bank of Egypt, Barclays Capital

[2] World Bank Poverty Assessment, September 2007

more jobs being created as reflected in the slightly reduced unemployment rate (9.1% in Q1 10 compared with 9.4% in Q4 09). In addition, a gradual intensification of external demand translated to rising non-oil exports and tourism receipts (11% and 24.2% y/y, respectively, in Q1 10) and expanding trade and transport activities are supporting growth (Figure 6). We believe these trends should persist and consolidate over time. In our view, they explain, along with rising momentum in the construction sector, much of the Q1 10 real GDP growth that surprised on the upside at 5.8% y/y, much higher than anticipated by the authorities and markets (Barcap forecast was 5.4%).

*Weaker growth in the EU and southern Europe will have a limited effect*

While the unfolding debt crisis in the European Union and the implementation of austerity measures across several EU countries could dampen external demand, we believe its effect on Egypt's recovery will be limited. After all, about 38% of Egypt's exports are destined for the euro area, of which 18% is to Southern Europe, most notably to Italy, where the effect of the crisis remains contained. Similarly, while almost 50% of tourists into Egypt come from the EU, we do not expect tourism activity to be affected significantly. Having said that, another episode of market volatility, similar to that in May, could weaken the EGP further on renewed deterioration in the EUR/USD and negatively affect export competitiveness in EU markets. However, we believe this could then be partially offset by a significant reduction in Egypt's import bill, 32.4% of which is sourced into the euro area.

*But renewed market volatility could weaken the EGP*

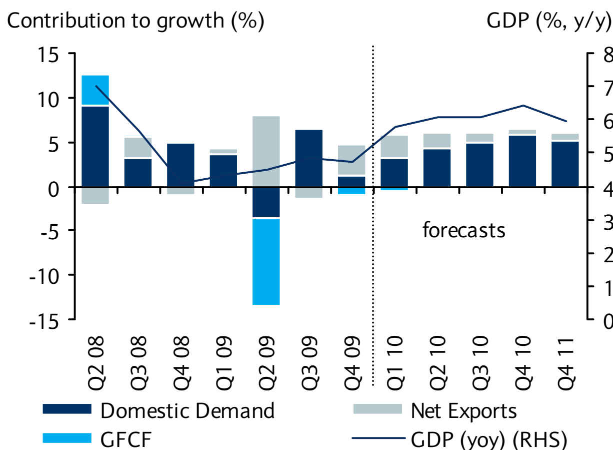
## Inflation rolling down… possibly delaying rate hikes further

*Inflation continues to fall, while core inflation is stable*

In the meantime, inflation declined for the fourth consecutive month to 10.6% in May down from 13.7 in January (Figure 7). Core inflation remained at 6.8%, comfortably within the CBE range. We expect prices to keep declining in June, although the period preceding the holy month of Ramadan (July-August) could witness an up-tick in food prices. While depreciation in EGP could affect the pricing of products labelled in USD, we believe much of Egypt's imports will see their prices drift downward on the EUR/EGP deterioration. Recently, we heard contradictory statements about the phasing out of the energy subsidy and maintain the view that the government is unlikely to raise local energy and food administered prices given the upcoming elections, thus muting a potential key source of inflationary pressures.

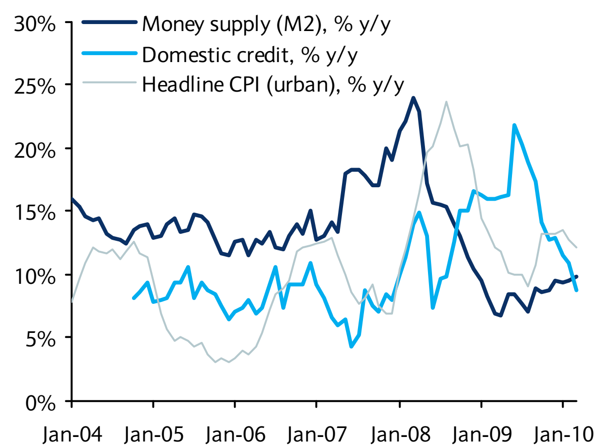
*We see little chance for reducing energy subsidies in FY 10-11*

**Figure 6: Growth momentum is likely to strengthen**




Source: Haver Analytics, Barclays Capital

**Figure 7: Inflation pressures continue to abate against subdued money supply and credit growth**




Source: Central Bank of Egypt, Barclays Capital

*CBE unlikely to react to a possible increase in prices during Ramadan*

Against this backdrop, we do not expect the CBE to react to seasonal increases in prices should they occur, but rather to keep watching inflation for any spill-over from the increase in food prices to other items. We think the CBE is likely to keep rates on hold for a while, encouraged by a strengthening USD. The relatively high unemployment levels and rather slow credit extension encouraged us to adjust our rate trajectory. We now do not expect the first hike to occur before early 2011 (February) unless inflation surprises upward in a sustained manner ahead of that date. Moreover, and given the government's decision to sustain large deficits next fiscal year, we believe the CBE will delay its plans to move towards inflation targeting in 2011.

*Rates to remain on hold until early 2011*

**Figure 8: Egypt macroeconomic forecasts**

| | 2005-06 | 2006-07 | 2007-08 | 2008-09E | 2009-10F | 2010-11F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 6.8 | 7.1 | 7.2 | 4.7 | 5.5 | 6.2 |
| Domestic demand contribution (pp) | 7.3 | 10.7 | 7.6 | 2.1 | 5.0 | 5.8 |
| Private consumption (% y/y) | 6.4 | 8.8 | 5.7 | 4.5 | 5.5 | 5.7 |
| Fixed capital investment (% y/y) | 13.8 | 23.7 | 14.8 | -10.2 | 4.0 | 5.0 |
| Net exports contribution (pp) | -0.4 | -3.3 | -0.5 | 2.6 | 0.5 | 0.4 |
| Exports (% y/y) | 21.2 | 20.2 | 28.8 | -12.8 | 8.0 | 18.0 |
| Imports (% y/y) | 21.7 | 30.5 | 26.3 | -17.7 | 6.0 | 16.0 |
| GDP (USD bn) | 107.6 | 130.5 | 162.9 | 188.4 | 219.3 | 254.6 |
| **External sector** | | | | | | |
| Current account (USD bn) | 1.8 | 2.3 | 0.9 | -4.4 | -3.7 | -7.5 |
| CA (% GDP) | 1.6 | 1.7 | 0.5 | -2.3 | -1.7 | -3.0 |
| Trade balance (USD bn) | -12.0 | -16.3 | -23.4 | -25.2 | -25.8 | -30.0 |
| Net FDI (USD bn) | 6.0 | 10.5 | 12.1 | 6.8 | 7.0 | 8.8 |
| Other net inflows (USD bn) | -4.5 | -8.1 | -2.2 | 4.2 | -3.8 | -2.7 |
| Gross external debt (USD bn) | 29.6 | 29.9 | 33.9 | 31.5 | 36.6 | 40.5 |
| International reserves (USD bn) | 21.6 | 27.2 | 32.8 | 29.4 | 33.8 | 39.4 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -9.2 | -7.5 | -7.5 | -7.0 | -7.7 | -7.6 |
| Primary balance (% GDP) | -3.5 | -2.4 | -3.0 | -1.9 | -1.5 | -1.1 |
| Gross public debt (% GDP) | 93.7 | 81.2 | 72.9 | 75.9 | 76.0 | 75.5 |
| **Prices** | | | | | | |
| CPI (% June/June) | 7.2 | 8.7 | 20.2 | 9.9 | 10.0 | 9.8 |
| FX, eop (June) | 5.73 | 5.69 | 5.34 | 5.59 | 5.65 | 5.55 |
| | **1yr Ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | 4.5 | 5.8 | 6.1 | 6.1 | 6.4 | 5.9 |
| CPI (% y/y, eop) | 9.9 | 10.6 | 10.0 | 10.3 | 9.5 | 9.7 |
| Exchange rate (eop) | 5.59 | 5.58 | 5.65 | 5.66 | 5.60 | 5.55 |
| Monetary policy benchmark rate (%, eop) | 9.00 | 8.25 | 8.25 | 8.25 | 8.25 | 8.25 |

Source: IMF, Haver Analytics, Egyptian Ministry of Finance, Central Bank of Egypt, Barclays Capital

# EMEA: GULF STATES

## Muted risks so far; Saudi Arabia drives growth

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**Strong sovereign balance sheets in Saudi Arabia, Qatar and Abu Dhabi are likely to contain any spillover from the euro debt crisis. Oil prices remain at comfortable levels, and international bank lending to the region is focused on stronger sovereigns. Weaker credits in Dubai are at risk should market volatility reignite. Meanwhile, we expect Saudi Arabia to lead the way in regional growth and surplus accumulation.**

*We favor Qatar over Abu Dhabi in cash credit*

**Strategy:** While the Gulf Cooperation Countries (GCC) credits could not completely decouple from the risk aversion spreading across global markets, they generally managed to outperform other regions. We continue to see Qatar as the fundamentally strongest credit in the region and see value in the longer-dated bonds in particular. Qatar trades through Abu Dhabi in CDS, but the relation is reversed in the cash space. At a comparable cash price, the Qatar 19s trade flat to slightly wider in Z-spread than the Abu Dhabi 19s (Figure 1). We see more upside potential for Qatar here and would recommend overweighting Qatar versus Abu Dhabi. On Dubai, we remain cautious, as we think that investors will need greater clarity about potential liabilities for the Dubai sovereign stemming from the Dubai World restructuring before a more positive stance towards the sovereign credit can be justified.

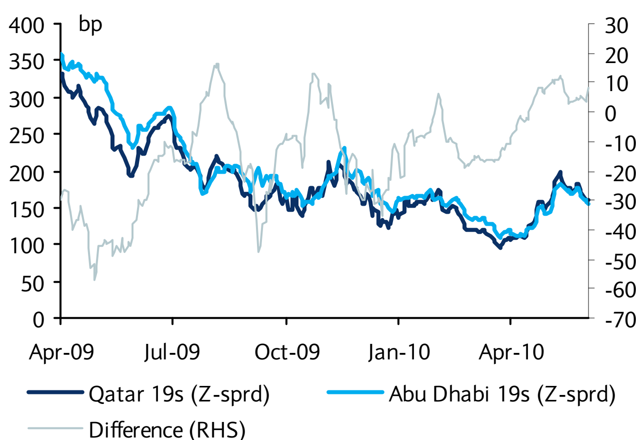
### EU debt woes unlikely to weaken GCC recovery…

*Recent market volatility raised concern about spillovers to the GCC …*

*… as oil prices and stock market indices fell sharply*

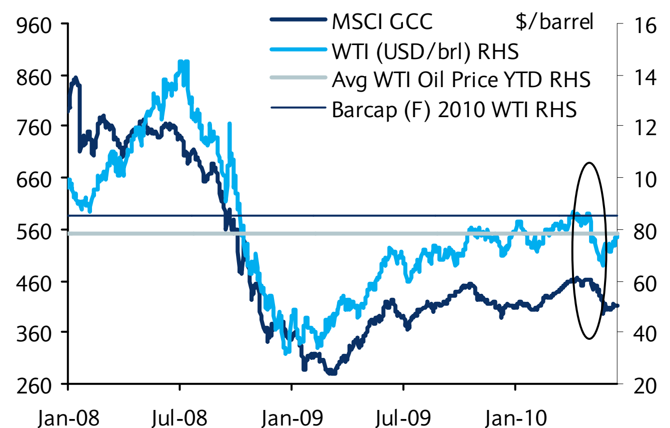
The recent spurt of risk aversion and market volatility on the back of mounting sovereign debt concerns in southern Europe reignited fears that a double dip in global growth could reverse the gradual recovery in the GCC economies. On the back of weakened investor sentiment, oil prices fell by more than 14% in May, hitting a bottom of USD65.9/barrel and taking the average oil price for the year to USD78/barrel, compared with Barclays Capital's forecast of USD85/barrel. It also sent shock waves across GCC stock markets, with indices falling sharply and the MSCI-GCC Index tumbling by almost 11.5% in May 2010 (Figure 2).

**Figure 1: Qatar cash looks cheap to Abu Dhabi (bp)**




Source: Bloomberg, Barclays Capital

**Figure 2: Euro debt crisis hits oil and GCC stock markets**




Source: Bloomberg, Barclays Capital

*Our growth outlook remains unchanged: we think global recovery and oil demand will be sustained*

These developments notwithstanding, our outlook for the region's growth prospects remains largely unchanged. This stems from our view that the path for global recovery is unlikely to be derailed by an earlier-than-expected withdrawal of fiscal stimulus in the euro area (*Global Economics Weekly: Fiscal consolidation unlikely to derail recovery*). It is also based on our belief that the strength of global oil demand hinges primarily on a recovery in the US, China and the Middle East, where growth momentum remains positive and should translate into oil prices' trending higher while exhibiting higher volatility over the coming 6-12 months (*Oil Sketches - Oil for the lamps of China*).

*Oil price volatility is unlikely to affect real GDP growth prospects…*

A quick stress testing of the sensitivity of our macroeconomic forecasts to oil price moves indicates a limited effect on the real GDP growth of GCC countries. The exception is an extreme scenario in which a sustained low price level below USD55/barrel pushes OPEC countries to cut production further in an attempt to prop up prices, therefore slashing hydrocarbon growth output across the GCC (excluding Oman). This seems to us highly unlikely given consensus forecasts on oil demand and recent announcements by OPEC countries' officials (*Weekly Oil Data Review: Vuvuzela*). Accordingly, we are not worried about negative spillovers to GCC growth being transmitted through oil price volatility.

*… but could affect the pace and size of surplus accumulation*

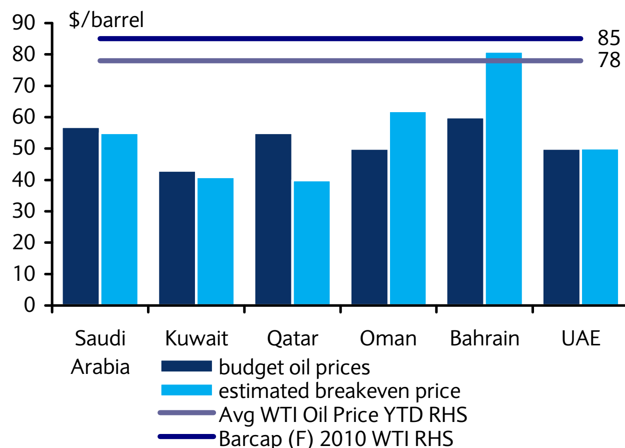
Renewed and sustained downward pressures on oil prices will, however, hurt the pace of surplus accumulation. Our estimates of fiscal break-even oil price levels indicate that on average, fiscal balances are likely to remain positive as long as prices are higher than USD56/barrel, except maybe for Bahrain (Figure 3). Within that range, governments should be able maintain their fiscal stimulus plans by expanding the investment programmes necessary to hold up non-oil growth (notably in Saudi Arabia). Even more extreme scenarios may not derail government plans in Saudi Arabia, Abu Dhabi and Qatar as these are likely to resort to drawing down their own reserves and net foreign assets. Saudi Arabia acted as such last year, bringing SAMA's net foreign assets down to USD409.7bn at end-2009 from USD442.6bn at end-2008. Alternatively, they could leverage the strength of their sovereign balance sheets and their superior credit ratings to raise cheap funding from the international and local markets, as Qatar did in 2009.

*Strong balance sheets and ample foreign assets provide enough of a cushion*

*The effect of renewed market volatility on bank lending will be limited, in our view*

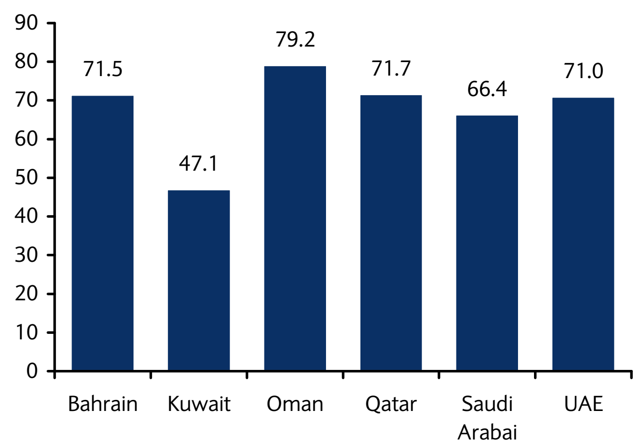
The banking or credit channel, which was a critical transmission mechanism during the 2009 fallout, is also unlikely to add to any potential market crisis, in our view. The level of international bank lending to the GCC has stabilised since end-2008, with limited new loan extensions since the start of the crisis. Although euro area banks have been providing

**Figure 3: Oil prices for 2010 are still at comfortable levels**




Source: SAMA, IMF, Haver Analytics, Barclays Capital

**Figure 4: Euro area banks share in total BIS lending to GCC**




Source: BIS, Barclays Capital

almost 70% of total international bank lending to the region (Figure 4), the total amount of new lending by BIS reporting banks extended in 2009 did not exceed USD15bn, compared with USD18bn in 2008, and most of it was allocated to Saudi Arabia and Qatar, the two strongest sovereigns in terms of the size of balance sheets and net foreign assets. Should international bank liquidity tighten even more, we think that any shortfall in financing could be secured easily by local sources either directly by the sovereign or with participation from local banks in both countries, whereas others in which bank liquidity is tighter (UAE, Bahrain) may proceed to scale back planned projects.

### … but could exacerbate refinancing risks for weaker credits

*Renewed risk aversion could exacerbate refinancing risks in Dubai*

A renewed episode of risk aversion could reignite refinancing risks for the weaker credits in the region, notably Dubai. As we had expected, and since our previous EM Quarterly (*The Emerging Markets Quarterly: A perilous climb*), the Dubai World restructuring process has progressed slowly, except for a formal announcement by Dubai World (DW) that a deal with the creditors has been agreed (see details in EM corporate section). Owing to the support of policymakers in Dubai, restructuring has gathered momentum; however, the DW announcement was never confirmed by the creditors, leaving much uncertainty about the debt rescheduling profile, the timing of the agreed deal, and the extent to which the Dubai government would shoulder the agreement and on what terms. On the other hand, recent downgrades of Dubai banks on account of their exposure to the restructured entities reflects the market's re-assessment of the extent of asset quality deterioration on banks' balance sheets, as well as the ability of the Dubai government to bear these without support from the central bank. We remain of the view that the Central Bank of UAE (CBUAE) will be ready to provide support and liquidity to any UAE-based bank should this be necessary.

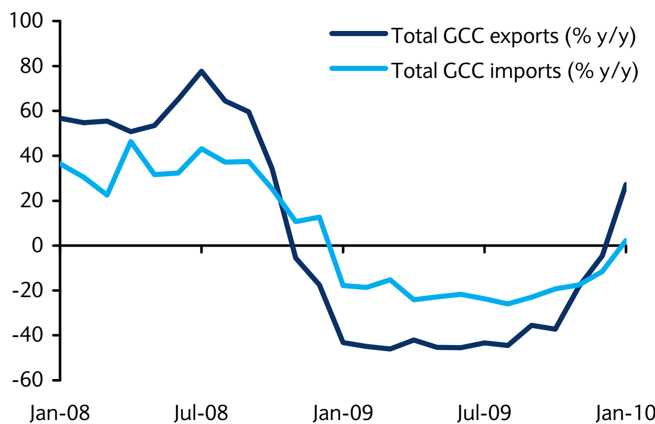
*Details of the Dubai World agreement with creditors are not clear yet*

### Saudi Arabia sets the tone

*Policy stimulus, notably in Saudi Arabia, is the main growth driver…*

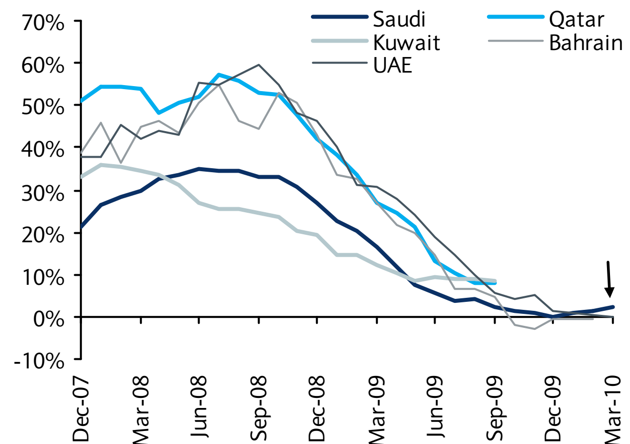
The recent market turmoil served as a reminder to the region that its economic fortunes continue to hinge largely on its key export products – oil – the price of which has risen on average by 64.6% so far this year compared with the corresponding period last year. GCC export growth has moved into positive territory since January 2010 (Figure 5), jumping to 27% y/y – close to the October 2008 levels. This, coupled with substantial policy stimulus, should have underpinned growth in H1 10, in the absence of any noticeable sign of recovery in private sector credit growth (Figure 6). The latter remains muted across the region,

**Figure 5: Export growth moves to positive territory…**




Source: IMF, Haver Analytics, Barclays Capital

**Figure 6: … but credit growth is still lagging (y/y, %)**




Source: Haver Analytics, Barclays Capital

reflecting, in our view, a combination of: 1) continued asset deterioration (notably in UAE and Kuwait); 2) liquidity shortages (UAE, Bahrain); 3) weak demand (Dubai, Qatar); and 4) heightened risk aversion following defaults of big family-based companies (Saudi Arabia, Kuwait). We expect credit growth to remain a drag on the rapid increase in non-oil growth across the region, justifying continued policy stimulus, notably through public sector funding of investment projects.

*Public investment and private consumption should drive the recovery*

In that respect, Saudi Arabia, the region's largest economy, sets the pace for regional growth. After shrinking by 6.4% y/y in 2009, we expect hydrocarbon growth to rebound by 4% y/y this year, largely due to base effects in the face of unchanged oil production and strict compliance with OPEC quotas. Non-oil growth, on the other hand, which held at 2.8% y/y in 2009, is likely to continue to rise, mainly due to the ongoing implementation of a large policy stimulus package aimed at propping up public investment in the face of the sharp fall in private investment following the tightening of liquidity conditions in the banking sector and the spread of risk aversion. In fact, after raising public spending from in the 2010 budget (Figure 7) and with the deployment of additional resources through the Saudi public Investment Fund and other government entities (all together, we estimate to increase by 10% y/y), we expect non-oil growth to rise to 4% this year (Figure 7).

*Private investment remains constrained by financing*

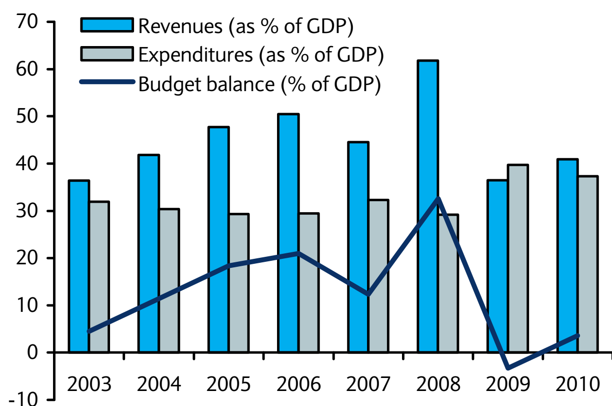
*As banks remain cautious in their lending activities … given muted credit growth*

This is also supported by domestic consumption, which continues to firm up – as reflected in the upward trending point-of-sales transactions (a proxy for retail activity), which increased 15% y/y over the first five months, compared with 6% y/y during the same period last year (Figure 8). The rise in private sector imports (23% y/y over Q1 10) financed through commercial banks (as indicated by letters of credits opened) portrays a return of private sector demand after a sharp fall in 2009, while the increase in imports of construction-related materials and reported sales of cement for domestic use also confirms the strengthening of domestic investment activity. In our opinion, the main drag on higher domestic demand growth will remain the slow pace of credit extension by domestic banks, which registered only 2.4% y/y in May, though this was higher than levels in other GCC countries (Figure 6).

*Inflation is trending higher*

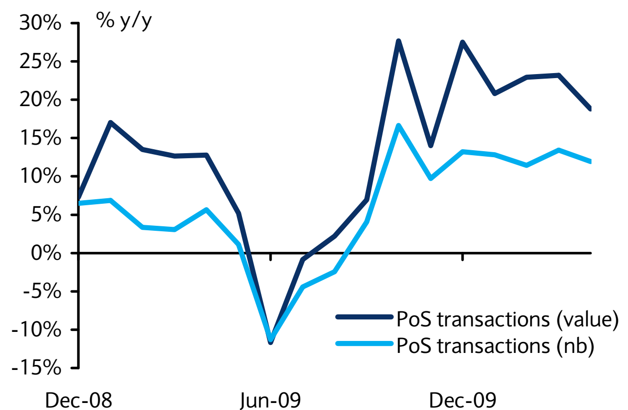
Accordingly, Saudi Arabia stood out as the only country in the region in which monthly inflation has embraced an upward trend. It increased from 4.25% y/y in December 2009 to 5.44% y/y in May 2010. As we expected earlier, this rise in inflationary pressures is mainly

**Figure 7: Fiscal stimulus in Saudi Arabia continues to support growth**




Source: SAMA

**Figure 8: Private consumption is picking up**




Source: SAMA

driven by increases in rental prices, given the strong demand for housing, which is in limited supply, and a gradual pick-up in food price increases. Against that background, we expect the SAMA to keep its policy rates on hold in line with the Fed's calendar, where we expect it tighten in Q2 11.

**Figure 9: GCC macroeconomic forecasts**

| | Real GDP (% y/y) | | | | | | Hydrocarbon growth (% y/y) | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2010f | 2011f | 2006 | 2007 | 2008 | 2009 | 2010f | 2011f |
| Saudi Arabia | 3.2 | 3.3 | 4.4 | 0.15 | 4.0 | 4.6 | -0.8 | 0.5 | 4.8 | -6.4 | 3.5 | 3.5 |
| Bahrain | 6.7 | 8.1 | 6.1 | 2.9 | 3.8 | 4.1 | -1.0 | 1.1 | 1.2 | 0.1 | 0.2 | 0.2 |
| Kuwait | 5.2 | 4.4 | 6.6 | -2.7 | 3.2 | 5.0 | 2.8 | -2.6 | 4.0 | -7.5 | 4.5 | 6.0 |
| Oman | 6.0 | 7.7 | 12.8 | 3.4 | 5.1 | 5.4 | -3.1 | -1.7 | 4.0 | 5.9 | 6.0 | 6.0 |
| Qatar | 15.0 | 15.3 | 16.4 | 9.0 | 19.5 | 15.3 | 10.7 | 16.2 | 15.5 | 10.0 | 30.4 | 17.6 |
| UAE | 8.7 | 6.1 | 5.1 | -0.7 | 2.1 | 3.7 | 6.5 | 0.4 | 4.5 | -6.3 | 3.5 | 5.3 |
| | Non-Hydrocarbon growth (% y/y) | | | | | | Inflation (Avg, % y/y) | | | | | |
| | 2006 | 2007 | 2008 | 2009 | 2010f | 2011f | 2006 | 2007 | 2008 | 2009 | 2010f | 2011f |
| Saudi Arabia | 5.1 | 4.7 | 4.3 | 3.0 | 4.0 | 5.0 | 2.3 | 4.1 | 9.9 | 5.1 | 5.7 | 5.5 |
| Bahrain | 8.1 | 9.2 | 6.9 | 3.3 | 3.5 | 4.5 | 2.0 | 3.3 | 3.5 | 2.8 | 3.7 | 3.8 |
| Kuwait | 7.0 | 9.2 | 6.8 | 4.0 | 2.5 | 4.5 | 3.1 | 5.5 | 10.6 | 4.7 | 4.8 | 4.6 |
| Oman | 9.4 | 12.6 | 13.0 | 2.1 | 6.3 | 6.5 | 3.4 | 5.9 | 12.6 | 3.5 | 3.5 | 3.7 |
| Qatar | 19.9 | 14.5 | 13.3 | 8.0 | 8.5 | 10.0 | 11.8 | 13.8 | 15.0 | -4.9 | 3.3 | 4.0 |
| UAE | 10.4 | 9.1 | 8.6 | 1.0 | 1.7 | 3.2 | 9.3 | 11.1 | 12.6 | 1.0 | 1.8 | 2.5 |
| | Current account balance (% GDP) | | | | | | Fiscal balance (% GDP) | | | | | |
| | 2006 | 2007 | 2008 | 2009 | 2010f | 2011f | 2006 | 2007 | 2008 | 2009 | 2010f | 2011f |
| Saudi Arabia | 27.7 | 24.3 | 28.6 | 5.5 | 11.9 | 12.5 | 21.0 | 12.3 | 34.1 | -4.6 | 5.3 | 10.2 |
| Bahrain | 13.8 | 15.8 | 10.6 | 4.1 | 8.5 | 8.2 | 4.7 | 3.2 | 8.5 | -8.4 | 2.6 | 4.3 |
| Kuwait | 43.9 | 39.8 | 41.7 | 25.8 | 34.0 | 36.4 | 32.7 | 40.0 | 11.8 | 27.0 | 33.8 | 35.4 |
| Oman | 12.1 | 5.9 | 6.1 | 0.3 | 3.5 | 4.1 | 14.2 | 10.3 | 12.8 | 3.0 | 8.2 | 9.1 |
| Qatar | 28.3 | 30.9 | 25.3 | 16.4 | 21.4 | 25 | 9.1 | 12.8 | 13.1 | 12.9 | 12.5 | 15.3 |
| UAE | 22.6 | 16.1 | 12.8 | -3.1 | 10.5 | 12.4 | 28.4 | 25.2 | 21.9 | 0.4 | 11.6 | 12.3 |

Source: National ministries of finance and central banks, IMF, Haver Analytics, Barclays Capital

# EMEA: HUNGARY

## Taking lessons in expectation management

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**It took a severe market reaction to make the new Fidesz government drop its demand for wider fiscal targets. Although this may not have been Fidesz' last lesson in expectation management, we continue to believe that the government simply has no choice but to comply with the IMF-EU programme. Indeed, Hungary is already further advanced in its fiscal adjustment than other countries in the region with debt issues.**

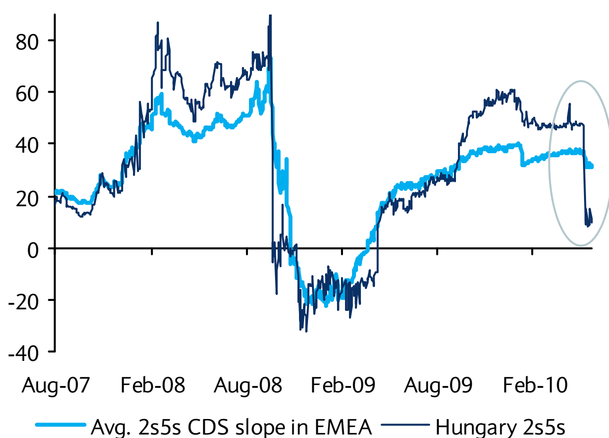
*Strategy:*
*- Sell short-dated CDS*
*- IRS curve flattener*
*- Tail risk bear HUF position*

**Strategy:** Regaining market trust will take time, in our view. For a sustainable recovery in Hungarian asset prices, investors will likely need to become more confident that the Fidesz government is truly committed to fiscal discipline and to stabilising the country's comparatively high debt level. We therefore remain cautious towards Hungary credit. However, we think that the substantial flattening of the front-end CDS curve is overdone and recommend selling short-dated CDS as near-term default risks are very low, in our view. In local markets, we see more value in RV than outright directional trades. We recommend a dv01 neutral 2s5s flattener trade on HUF IRS (targeting a potential 10bp from the current 53bp, risking 70bp). This has a zero cost of carry and we see the curve flattening under two scenarios. First, is a moderately bullish scenario in which investor confidence in the new government triggers capital inflows to the medium- to long-tenor bonds/swaps, pushing down yields faster here than at the front end where the NBH proceeds cautiously with rate cuts. Second is a very bearish scenario (not our baseline scenario), in which a sharp forint sell-off leads to a bear-flattening as has historically been the case. We also see value in owning an FX tail-risk trade and recommend buying a 6m 290-310 EUR call/HUF put (1.52% premia). The maximum net-payout-to-cost ratio on this is attractive (3.5:1) and it can be used to hedge a bullish local bond trade. Alternatively investors might look to hold this FX trade on its own if they see non-negligible risks of further missteps by local policymakers and/or regional market risks.

*Recession ended in Q1, earlier than expected*

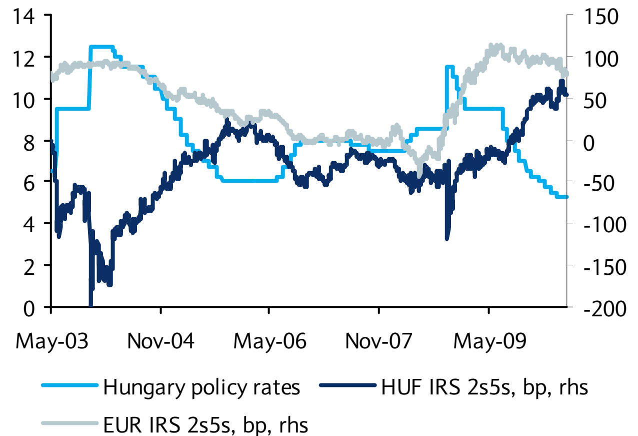
GDP continues to surprise to the upside. Following a somewhat stronger-than-expected Q4 GDP number, GDP grew 0.1% y/y in Q1 10. This was the first positive number after five quarters of decline; it translated into 0.9% q/q growth on a seasonally adjusted basis and implied that the economy exited the recession a quarter earlier than expected. This was

**Figure 1: Front-end CDS curve now flattest in the region…**




Note: Average of Russia, Turkey, SOAF, Poland, Hungary, Czech, Slovak, Slovenia, Romania, Bulgaria, Croatia. Source: Markit, Barclays Capital

**Figure 2: … and 2s5s IRS looks excessively steep**




Source: NBH, Barclays Capital

mainly the consequence of stronger external demand. Asia plays a non-negligible role in this as Asian growth propels Germany's export sector, which in turn is a key destination for Hungarian exports. Direct exports to Asia have also risen in recent years, faster than in other countries in the region. Given Hungary's role as a supplier for euro area exporters, the weaker EUR should compensate for the potential growth slowdown in the euro area from the ongoing fiscal retrenchments. According to NBH estimates, a 10% depreciation in the EUR nominal effective exchange rate (assuming a stable EUR/HUF) raises Hungarian GDP by 0.2-0.3ppt. Domestic demand remains weak, although household consumption has been somewhat less of a drag on demand than expected. Retail figures thus far signal that the consumption path may be more favourable in 2010 than previously thought. Put together, we think the continued upswing in external demand – promoting export growth as well as inventory rebuilding – and a somewhat stronger-than-expected household consumption should allow growth to exceed 1% this year (up from our 0.4% forecast in early March).

*Export demand, including from Asia, is key to recovery*

*Household consumption not as poor as expected*

*Trade surplus still rising*

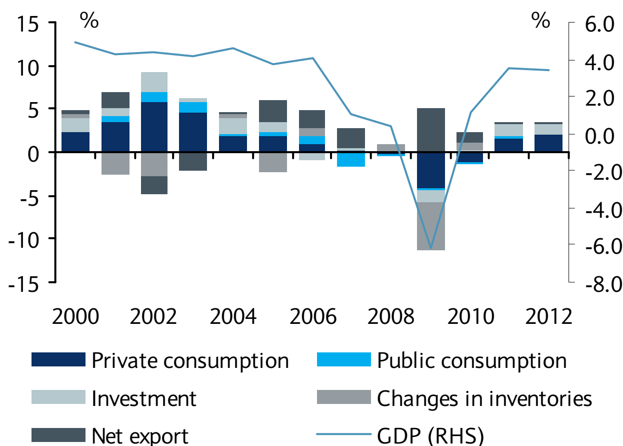
The export reliance of the recovery has continued to drive up the trade surplus in the first four months of the year. Besides the much better trade balance, lower deficits in the income balance (a consequence of lower profit in foreign-owned companies) helped generate the small current account balance in 2009. While profits should remain weak and export performance strong in 2010, we expect the improving domestic demand to turn the current account back into deficit in 2010 (less than 1% of GDP). This is still very low, both from a historical perspective and on a regional comparison, and it should be more-than-financed by EU transfers and FDI. Certainly, total external debt remains high (EUR130bn or 137% of GDP) and will take time to be reduced. But with reserves standing at EUR35bn and a EUR5bn half-repo, half swap line with the ECB, EUR1bn more from the EU, and another potential EUR3.3bn from the IMF (assuming the remaining two IMF reviews are completed, see below), external financing risks have significantly receded, in our view.

*Current account to turn into small deficit in 2010*

*External financing risk reduced: High reserves, ECB swap line and more potential IMF money*

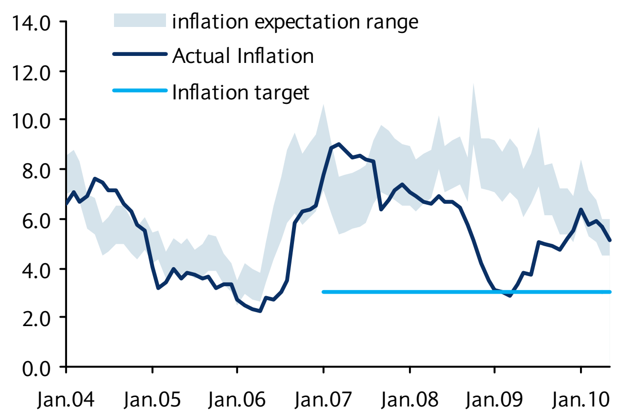
At the same time, inflation may not come down as fast and as far as earlier expected. This is not caused by the better-than-expected growth – as the output gap should still remain sizable – but results mainly from higher imported energy prices. While the February inflation report forecasted headline inflation to undershoot the 3% target in 2011, it now sees inflation settle around that target. The divergence between wage developments in the industrial (ie, tradable) sector and the service sector continued. However, in parallel, the unemployment rate continued to increase to over 11%. In our view, the wage acceleration in the manufacturing sector does not therefore reflect any true labour market tightening and is likely to prove temporary. There are indications that jobseekers are returning from 'inactivity' to the labour

**Figure 3: Recovery after a protracted dip**




Source: NBH, Barclays Capital

**Figure 4: Inflation and expectations on downward trend**




Source: NBH, Barclays Capital

*Inflation path shifted upward, but remains set to moderate*

market, as the government's reduction of certain social benefits raised incentives to remain in the workforce. Overall, we therefore believe that there is sufficient slack in the economy to prevent any demand-driven inflation pressures for some time. Inflation expectations are also declining. Although the NBH stresses that they are still above the 3% target, we believe this could correct once the headline rate starts to decline more pronouncedly starting in July, when the VAT base effects fade out. We forecast CPI inflation to moderate to just below 3% by end-2010 and, due to base effects further to around 2.5% in Q1.

*Given the right environment, NBH could cut rates further*

*4.5% final policy rate still possible in our view*

Has the easing cycle come to an end? The last MC meeting minutes from end-May were decisively hawkish, highlighting the deterioration in the inflation outlook. But we caution that this must have been influenced by the deterioration in risk appetite around that time. We actually believe that if the government completes the IMF review in July and further underlines its determination to stick to the 3.8% deficit target in 2010 – reducing risk premium on HUF assets – the NBH could implement further rate reductions. We continue to believe that the final rate could reach 4.5% in the second half of 2010. While the domestic risk factors to this view may have increased, the global environment seems to signal that rates in the region may stay low for longer. As we opined before, we think that the interest rate differential does little for HUF stability in the current environment where bouts of global risk aversion can drive HUF weaker irrespective of incremental interest rate differentials. In such events, the NBH may have to use its reserves to smooth volatility and possibly make FX available through swap lines. In a more stable environment, however, lower rates – reflecting good fiscal performance and the desire to foster local HUF lending – may actually incentivise foreign inflows in support of HUF.

*Fidesz learned lesson the hard way*

*Now agreed to 3.8% fiscal target and additional fiscal measures…*

*… which still need to be discussed with IMF in July*

Can the new government win the market's trust? Fidesz had been aggressively demanding upward revisions of the 2010 deficit target (of up to 7% of GDP), in part based on the argument that hidden liabilities ('skeletons') in state companies should be accounted for. We had analysed the issue, fearing a potential escalation (see *Hungary: Could 'skeletons' come back to haunt?* 28 May 2010). The violent market reaction in early June to the talk by top Fidesz officials of a 'Greek-like' situation and possible defaults – most likely intended for a domestic audience only – turns out to have been a useful lesson in expectation management. The government, including PM Orban, has now publicly committed to deliver the EU-IMF-agreed 3.8% deficit in 2010. The government announced spending measures, including freezes in ministerial spending (0.4% of GDP), a 15% cut of the pubic sector wage bill (0.2% of GDP), salary caps for public sector salaries and reduced severance payments at state enterprises. On the revenue side, the government proposes a levy on the financial sector (0.6% of GDP). At the same time, the government wants to introduce a flat rate income tax and lower corporate tax for SMEs. While the tax reductions would likely imply revenue losses, we think the government would be willing to postpone them into 2011, while implementing the expenditure saving measures with immediate effect.

*Two more IMF reviews until programmes end in October*

*New IMF programme after October local election?*

Where to from here? It seems that rather than negotiating a new programme, the government is now planning to complete the two outstanding IMF reviews before the programme officially ends on 5 October. The IMF will return to Budapest in July for the sixth review, for which the fiscal targets in end-June will be tested. The official fiscal results in Q1 seemed to be on target, but indications are that the performance may have deteriorated more recently. However, reviews can still be completed even if targets are missed as long as governments agree to remedial measures. Negotiating the various tax and revenue measures is likely to be tough, however, and, while the reviews will ultimately be completed, the process is likely to be a lot less smooth than what investors were used to under the interim government. Following the local elections in October, we believe the government would likely consider negotiating a precautionary standby arrangement.

*Further noise possible…*

*… but in principle Hungary's fiscal adjustment is much further advanced than elsewhere*

While potential commotions in the fiscal discussions with the IMF/EU can cause bouts of market volatility over the summer – in particular as developments in the euro area periphery will keep investors focused on countries with debt issues – it must be stressed that Hungary is already much further ahead in its fiscal adjustment process. The country has already been generating primary fiscal surpluses during the worst of the recession. Hence, as the economy normalises and some of the structural reforms start to show supply-side effects (eg, as already partly observable in the labour market), the debt-to-GDP ratio should steadily decline. This forward-looking element implies that Hungary's sustainability is better than a glance at the present debt ratio of close to 80% of GDP may suggest.

*Risks:*
*Political noise in run-up to local elections in October*

*Disputes over banking levy*

Risks remain. On the macro side, it is chiefly a potential slump in demand for Hungarian exports and on the political side it could be a return of aggressive government rhetoric in the run-up to the October local elections – which Fidesz seems to take very serious despite its comfortable two-thirds majority in Parliament. The financial sector levy could also create disputes with banks, although we are not overly concerned in this area. From a market perspective, foreigners' low positions in local bonds helps to contain potential sell-offs.

**Figure 5: Hungary forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 3.6 | 1.0 | 0.6 | -6.3 | 1.1 | 3.6 |
| Domestic demand contribution (pp) | 1.3 | -1.2 | 0.7 | -11.4 | -0.1 | 3.2 |
| Private consumption (% y/y) | 1.9 | -1.6 | -0.6 | -6.7 | -1.7 | 3.5 |
| Fixed capital investment (% y/y) | -3.6 | 1.6 | 0.4 | -6.5 | 1.5 | 5.4 |
| Net exports contribution (pp) | 2.3 | 2.2 | 0.0 | 5.1 | 1.2 | 0.4 |
| Exports (% y/y) | 18.6 | 16.2 | 5.6 | -9.1 | 8.9 | 8.2 |
| Imports (% y/y) | 14.8 | 13.3 | 5.7 | -15.4 | 8.2 | 8.5 |
| GDP (USD bn) | 113 | 138 | 155 | 131 | 123 | 152 |
| **External sector** | | | | | | |
| Current account (USD bn) | -8.1 | -9.0 | -10.9 | 0.4 | -0.9 | -1.7 |
| CA (% GDP) | -7.2 | -6.5 | -7.0 | 0.3 | -0.7 | -1.1 |
| Trade balance (USD bn) | -2.9 | -0.1 | -0.6 | 5.6 | 4.5 | 4.0 |
| Net FDI (USD bn) | 3.6 | 2.2 | 3.7 | -0.3 | 0.5 | 1.0 |
| Gross external debt (USD bn) | 108 | 148 | 169 | 176 | 160 | 182 |
| International reserves (USD bn) | 21.6 | 24.0 | 33.9 | 44.2 | 43.2 | 40.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -9.3 | -5.0 | -3.8 | -4.0 | -3.9 | -3.5 |
| Primary balance (% GDP) | -5.4 | -0.9 | 0.4 | 0.7 | 1.0 | 1.5 |
| Gross public debt (% GDP) | 65.6 | 65.9 | 72.9 | 78.3 | 77.6 | 76.1 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 6.5 | 7.4 | 3.5 | 5.6 | 2.9 | 3.1 |
| EUR/HUF, eop | 252 | 253 | 265 | 270 | 280 | 270 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | -7.5 (Q2) | 0.1 | 1.6 | 1.5 | 1.3 | 3.1 |
| CPI (% y/y, eop) | 3.7 (Jun) | 5.1 | 4.5 | 3.1 | 2.9 | 2.4 |
| Exchange rate (EUR/HUF, eop) | 280 (Jun) | 280 | 280 | 285 | 280 | 280 |
| NBH policy rate (%, eop) | 9.50 (Jun) | 5.25 | 5.25 | 5.25 | 4.50 | 4.50 |
| Market implied rate (%, eop) | NA | NA | 5.25 | 5.25 | 5.25 | 5.50 |

Source: Barclays Capital

# EMEA: ISRAEL

## Upward trend continues

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**Israel's technology exports, sound financial sector, and supportive economic policy have helped growth performance. Inflation is set to decline towards the middle of the target range on base effects. The BoI continues to gradually tighten monetary policy to normalise, although we now predict some postponement of rate increases. We expect Israel's financial markets to continue to outperform.**

*5y offers attractive carry/roll for being received and should do well under a 'tail risk' risk scenario for global growth*

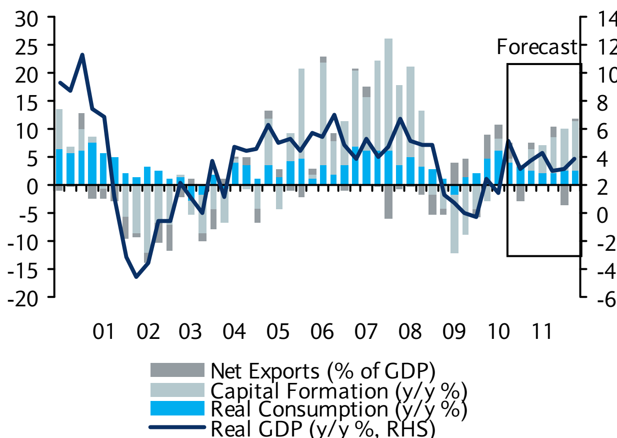
**Strategy:** While the macro economic backdrop in Israel is healthy with policy normalisation taking place at an appropriate pace, local rates are an attractive destination for 'tail risk' trades, in our view. We recommend receiving 5y rates at the current 3.80%, looking to realize the majority of the 6bp/month of carry/rolldown under our baseline scenario of gradual monetary tightening in Israel (we would risk 4.00% on this trade). In our 'tail risk scenario', worsening euro area fiscal and banking problems would likely make the BoI worried about global growth. In turn, the BoI could further delay monetary tightening, contributing to a bull steepening on the nominal curve. We opt for 5y swaps rather than shorter (higher carry/rolldown) instruments as the paucity of local government bond supply should anchor medium-to-long tenor nominal yields in both baseline and risk scenarios. For investors looking for a cash trade, we think being long the Shahar 2014 (at 3.39%) is a good alternative to swaps. Although the yields are lower than 5y swaps, the bonds are trading flat on an ASW basis. However, we would urge funding the long bond position out of local short-end rates as the 'tail risk' scenario would likely engender more aggressive FX intervention, with a goal to cheapen the shekel.

### Growth: Not too hot, not too cold

*Growth in 2009 was supported by net exports*

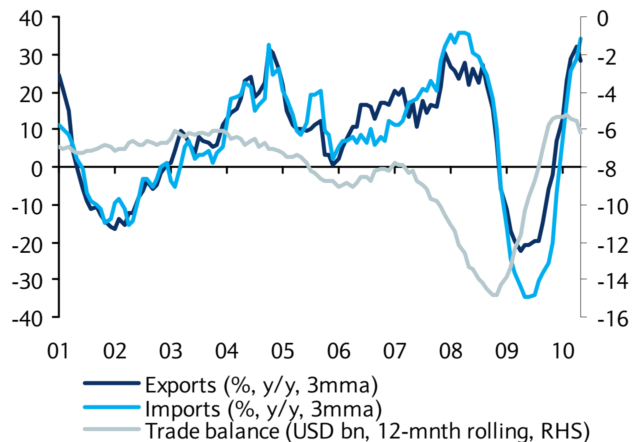
Israel's growth is maturing and changing focus (Figure 1). During the global recession of 2008-09 it experienced a drop in domestic demand - led by declining investment - which negatively effected GDP growth. Although growth only slowed to 0.7% in 2009 from 4% in 2008 and over 5% in previous years, formally speaking, Israel had a recession as q/q growth was negative during Q4 08-Q1 09. The slowdown was not as sharp as it could have been

**Figure 1: Domestic demand is taking over as the driver of growth**




Source: Israel Central Statistic Office, Haver Analytics, Barclays Capital

**Figure 2: Net Exports supported growth last year, but are more likely to soften as imports pick up**




Source: Israel Central Statistic Office, Haver Analytics

because of several offsetting factors. First, net exports expanded. Export volume declines of -9% in 2009 were compensated by import volume declines of -15% (Figure 2). There was a disproportionate drop in imports of fuels, capital goods, and raw materials. In contrast, Israel high technology exports continued to expand. Another factor in preserving Israel growth was that private consumption held up well. The favourable trends in net exports were well known and this bolstered domestic confidence. The currency weakening caused some demand to shift from imports to domestic goods. A fiscal stimulus package was introduced and monetary policy was loosened in parallel with G4 countries. Finally, the Israel banking sector proved to be financially sound.

*Growth in 2010-11 will rely more on domestic demand, particularly investment*

This sends Israel's economy into 2010 in very strong shape. We expect growth of 3.3% in 2010 and a slight acceleration in 2011. Reliance on net exports is no longer possible; instead, we expect imports to recover more than exports. Private consumption looks set to accelerate back to normal levels in the range of 3% per annum growth. The main growth driver, in our opinion, will be an acceleration in investments, which we expect to recover gradually to 7% growth in 2011 from -7% in 2009. The main vulnerability stems from geopolitical risks. The ongoing conflicts with Lebanon and Palestinians, so far, have not had a lasting detrimental impact on Israel's financial markets in recent years. A tail risk exists that a more threatening conflict might break out, potentially negatively affecting growth and financial markets.

## Gradual refocusing of monetary policy

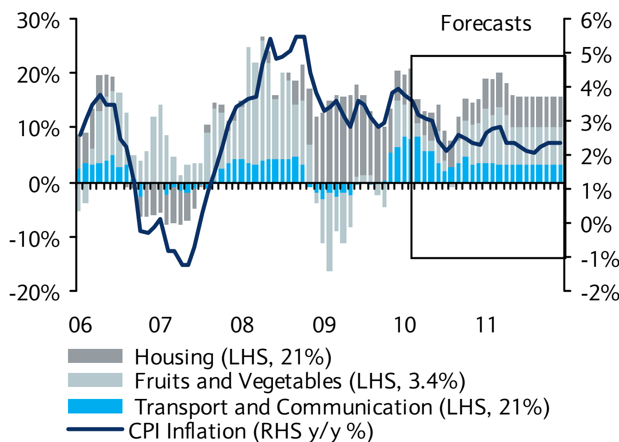
*Inflation has been declining for the past six months*

Inflation has been declining for the past six months as housing price inflation, in particular, has eased. We expect inflation to decline in Q3 10 on favourable base effects and approach the middle of the 1% to 3% target range (Figure 3).

*The BoI is slowly tightening monetary policy conditions as the recession has ended*

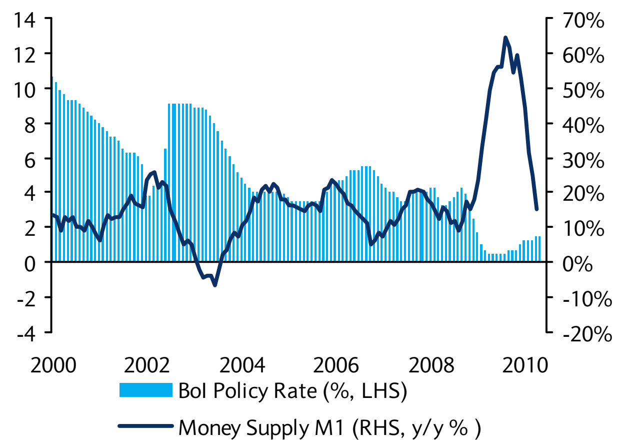
Following the extraordinary accommodative monetary policy in 2008-09, the BoI is ahead of most of the rest of the world in reining in its monetary stimulus. The BoI started raising rates early, but has kept to a very gradual pace. In the past 10 months it has increased the rate only 100bp to 1.5%. This is still quite low compared with the level of inflation at 3%. However, the BoI has also reined in a great deal of liquidity (Figure 4). The transition is reasonably far advanced. We have changed our view on BoI rates, expecting an even more gradual path than previously predicated. We predict the BoI will hold rates unchanged in Q3 given concerns over global growth and our house view that the US Fed will not raise rates

**Figure 3: Inflation is declining and we expect further decreases**




Source: Bank of Israel, Haver Analytics

**Figure 4: Monetary policy has taken away much of the extraordinary liquidity provided at the height of the recession**




Source: Bank of Israel, Haver Analytics

until 2011. We predict the BoI will resume raising rates in Q4 10 by 25bp, approximately every other meeting. This would bring the rate to 2% at end-2010, and we expect it to reach a maximum of 2.5% in 2011 as inflation eases. This, in conjunction with the decline in inflation, should progressively eliminate the negative real rates and bring monetary policy towards "normal".

## Exchange rate policy

*The BoI is resisting exchange rate appreciation to protect Israel's dynamic export sector*

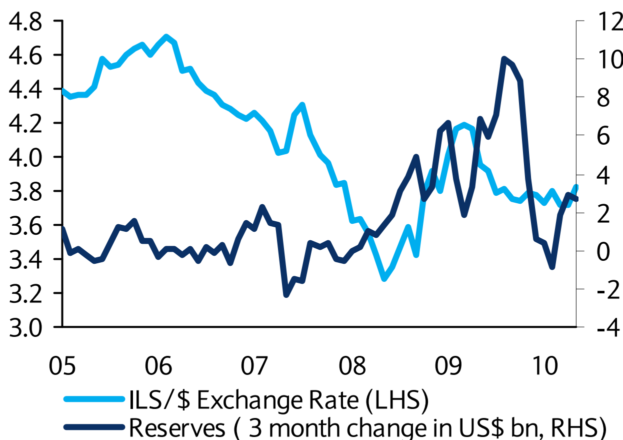
An over-riding concern of the BoI has been exchange rate competitiveness. During 2006-08 the shekel appreciated vis-à-vis the dollar and to a lesser extent versus the euro (Figure 5). Among the factors that have caused shekel strength were the reduction in government deficits and strong growth of technology exports. The BoI was very concerned about the competitiveness of Israel's exports at these exchange rates and, in particular, thought the speed of appreciation was too severe. It started buying dollars on a regular basis in 2008 to build up its relatively low reserves and weaken the shekel. In mid-2009 the BoI switched to ad hoc interventions and began tightened liquidity conditions anticipating the end of the recession. While actively intervening in FX markets during this period, net purchases had declined to nil by end-2009 and the BoI seemed to be moving towards containing volatility instead of targeting a particular rate. However, as the shekel appreciated in 2010, the BoI ramped up its interventions again, and in our baseline scenario of monetary tightening, plus a still-strong BoP backdrop, the medium-term appreciation pressure is unlikely to dissipate. The government passed a new BoI law that will lead to the formation of a monetary policy committee to make rate decisions. While institutionally this is a big change, we do not expect much impact on actual policy path. No schedule has yet been announced.

## Bright fiscal prospects

*Fiscal policy is likely to be a fundamental strength of Israel as the government gradually lowers debt-to-GDP*

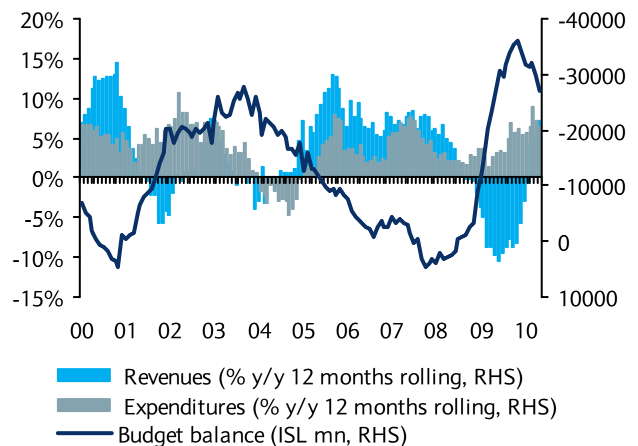
Although Israel has a somewhat high fiscal deficit in 2009 and high government debt at 78% of GDP, the enhanced control over its fiscal deficits is a potential strength. After several years of very low budget deficits, the government allowed the deficit to expand in 2009 to -5.2% of GDP, as revenues declined and expenditures were increased to provide a fiscal stimulus. However, taxes were increased in 2009 to limit the fiscal slippage as monetary policy was used for limiting growth declines. YTD in 2010, with growth rising, a strong rebound in revenues is developing and the deficit is declining. The government has resumed

**Figure 5: BoI resumed active net reserve purchases after a hiatus of several months**




Source: Bank of Israel, Haver Analytics

**Figure 6: The fiscal deficit is declining rapidly as revenue growth has resumed due to the pickup in the economy**




Source: Israel Ministry of Finance, Haver Analytics

its progress towards lowering government debt to 60% of GDP from over 100% previously. The government passed a fiscal responsibility law that will help shepherd deficits towards its -1% of GDP target. One of the factors that helped to manage high debt levels in the past was access to foreign financing. Ten years ago, when debt levels were higher, 25% of government debt was FX denominated, helped by US government debt guarantees. The proportion of FX denominated debt declined to 18% in 2009, as Israel reduced overall government debt relative to GDP. With the recent build-up in BoI reserves, they now are twice the level of government FX debt. The proportion of local currency government debt that is foreign owned is very small.

**Figure 7: Israel macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y)* | 5.3 | 5.2 | 4.0 | 0.7 | 3.3 | 3.5 |
| Domestic demand contribution (pp) | 4.5 | 7.1 | 4.3 | -3.5 | 5.0 | 4.7 |
| Private consumption (% y/y) | 3.9 | 5.5 | 3.0 | 1.5 | 3.9 | 2.4 |
| Fixed capital investment (% y/y) | 11.3 | 15.0 | 4.5 | -6.7 | 1.8 | 7.0 |
| Net exports contribution (pp) | 0.8 | -1.9 | -0.3 | 4.2 | -1.7 | -1.1 |
| Exports (% y/y) | 8.4 | 5.2 | -0.9 | -8.5 | 11.3 | 6.2 |
| Imports (% y/y) | 6.4 | 9.7 | -0.2 | -17.8 | 16.8 | 9.1 |
| GDP (USD bn) | 146 | 167 | 202 | 192 | 217 | 234 |
| **External sector** | | | | | | |
| Current account (USD bn) | 7.4 | 4.9 | 1.3 | 7.2 | 5.0 | 1.2 |
| CA (% GDP) | -2.7 | 2.9 | 0.7 | 3.7 | 2.3 | 0.5 |
| Trade balance (USD bn) | 0.7 | -2.2 | -3.1 | 4.3 | 1.7 | -0.5 |
| Net FDI (USD bn) | -0.2 | 0.2 | 3.7 | 2.6 | 3.1 | 2.9 |
| Other net inflows (USD bn) | 6.6 | 7.4 | -8.2 | **3.2** | 5.6 | 4.4 |
| Gross external debt (USD bn) | 87 | 89 | 86 | 84 | 84 | 84 |
| International reserves (USD bn) | 29 | 28 | 42 | 60 | 69 | 77 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -0.4 | 0.5 | -1.2 | -5.2 | -4.5 | -4.0 |
| Gross public debt (% GDP) | 82.8 | 76.4 | 75.4 | 78.4 | 78.1 | 76.6 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 1.7 | 3.4 | 3.8 | 4.0 | 2.3 | 2.3 |
| USD/ILS, eop | 4.23 | 3.85 | 3.80 | 3.78 | 3.75 | 3.60 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | -0.3 | 1.4 | 5.1 | 3.1 | 3.7 | 4.3 |
| CPI (% y/y, eop) | 3.6 | 3.0 | 2.4 | 2.6 | 2.3 | 2.8 |
| Exchange Rate (eop) | 4.19 | 3.71 | 3.81 | 3.80 | 3.75 | 3.70 |
| BOI policy rate (%, eop) | 0.50 | 1.50 | 1.50 | 1.50 | 2.00 | 2.25 |
| Market implied rate (%, eop) | NA | NA | 1.50 | 2.00 | 2.00 | 2.50 |

Note: *The component parts of GDP are now based on seasonally adjusted data and therefore differ from previous tables.
Source: Israel Central Statistics Office, Bank of Israel, Ministry of Finance, Haver Analytics, Barclays Capital

# EMEA: LEBANON

## Going against the current

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**Despite market concerns about sovereign risks, the government approved the 2010 budget targeting a deficit of c.11% of GDP. With upward GDP growth revisions (9% in 2008/09 and 7-8% in 2010), and delays in budget execution, the deficit is not likely to exceed 8.5% of GDP, in our view. Meanwhile, political risk remains a constant with the Iran sanctions adding further complications.**

*Spread performance anchored by local demand but tail risk on the rise: Maintain Market Weight*

**Strategy:** Lebanon has offered some shelter for credit investors over the past few weeks of heightened risk aversion despite its high debt-to-GDP ratio, which continues to stand out as the highest in the EMEA credit space. Spread performance remains anchored by strong liquidity and demand in the local banking sector, which continues to see deposit growth rates of c.20%. However, geopolitical tail risks in the region seem to be on the rise. Against this background, we keep a Market Weight stance on Lebanese credit. Hedging of geopolitical risks has also likely been a driver of the recent CDS underperformance versus bonds (Figure 1). In this context, we also highlight CDS protection as a potential tail risk hedge versus long 1y T-bill positions, whose yields have continued their downward trend towards current levels of c.5.4% and have proven to be more resilient than external spreads in previous periods of regional conflict.

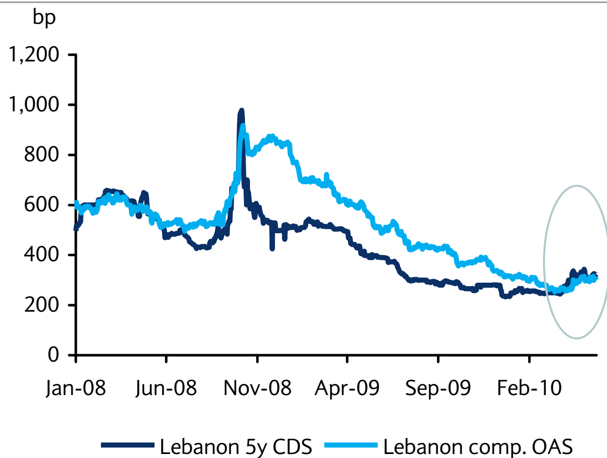
### The 2010 budget: The trip of a thousand miles

*The government just approved the 2010 draft budget*

*Parliamentary discussions will further delay implementation, notably of capital spending*

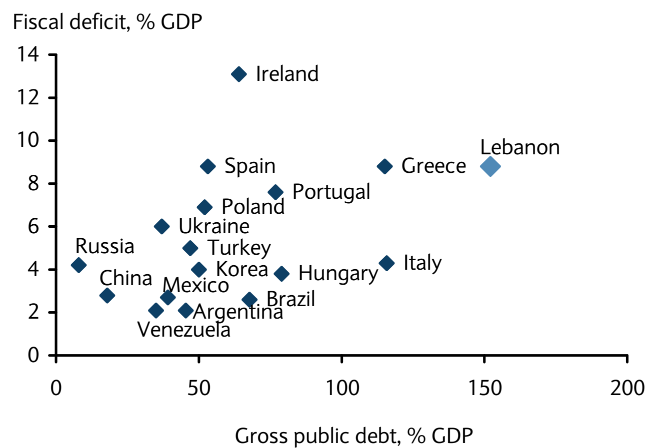
In *The Emerging Markets Quarterly*, 18 March 2010, we were too optimistic in our assessment of the political consensus forming around the 2010 budget and an imminent approval in early April. Six months into the fiscal year, the draft budget, which targets a deficit of c.11% of GDP, was only approved last week by the government and awaits discussions in Parliament in July. We expect the latter to take at least another month if not more as the budget provides enough material for further political infighting and an opportunity to rally popular support, thus limiting significantly the ability of the government to deploy resources into capital investment projects, the main focus of this year's budget.

**Figure 1: Tail risk hedges – CDS underperforming bonds**




Source: MarkIt, Barclays Capital.

**Figure 2: Standing out from the crowd, Lebanon debt and deficit**




Source: Haver Analytics, IMF, Barclays Capital

We will have the chance to look at the draft budget in more detail soon, but the contentious points that have delayed and could further delay discussions among political factions (all of which are represented in the national unity government) are manifold. Some are technical in nature and purely policy related (e.g., presentation of consolidated fiscal accounts, limits on indebtedness, tax policy and direct versus indirect taxation), and others purely political, confirming our view that moving forward with fiscal and economic reforms under this national unity government will be fraught with difficulties, sub-optimal at best and slow given the urgent nature of these much-needed reforms necessary to address Lebanon's debt problems, *Lebanon Trip Notes: Promising results but challenging prospects*, 10 February 2010.

*But the 2010 deficit target is likely to be undershot*

Taking into consideration the headline figures in the proposed 2010 draft budget and fiscal performance indicators for January-April 2010, we have revised our deficit and debt forecasts lower. On the one hand, revenues grew 1.8% y/y in the first four months compared to the same period last year, while total spending retracted 12% y/y, as interest payments slightly diminished in line with lower interest on local papers, and Treasury expenditures shrank by more than 42% y/y,. Much of this decline can be explained by a fall in transfers from the Treasury to Electricite du Liban (EDL), whose total bill reached over 4% of GDP in 2009. Accordingly, the primary balance registered during January-April 2010 reached LBP1trn, a five-fold increase compared to the same period last year (Figure 3).

*The primary surplus during January-April increased five fold compared to the same period last year*

On the other hand, the 2010 budget earmarks almost 4% of GDP or 10% of total planned expenditures for capital investment projects (24% of which is allocated for the purpose of expanding electricity generation), representing an increase of 148% y/y compared to 2009 (Figure 3). Given absorptive capacity limitations, we believe only a small fraction of this allocation is likely to be spent this year after the budget ratification. We thus expect the overall deficit not to exceed 8.5% of GDP this year, allowing for a realisation of about 2% of GDP in primary surplus, and subsequently a reduction in the overall debt to GDP to 147% by year end. The estimated overall fiscal financing requirements, hovering near USD13bn should be secured through the market, and notably through the liquidity-flush banking sector.

*The planned capital spending is unlikely to be disbursed before Q4 2010*

**Figure 3: Selected indicators of fiscal performance, 2009-2010**

| | January-April (trn LBP) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | % y/y | % of 2010 budget | Actual 2009 (trn LBP) | Budget 2010 (trn LBP) | y/y, % | % of total, 2009 | % of total, 2010 |
| **Total revenues** | **4.2** | **4.3** | **1.8** | ***30.9*** | **12.7** | **13.8** | **8.5** | **100.0** | **100.0** |
| Primary expenditures | 2.1 | 2.2 | 4.5 | *18.9* | 6.9 | 11.4 | 64.1 | 40.4 | 57.0 |
| *of which capital* | | | | | 0.8 | 2.0 | 148.2 | 4.8 | 10.2 |
| *of which wages* | | | | | 4.9 | 5.6 | 14.1 | 28.8 | 28.2 |
| Interest | 2.0 | 2.0 | -1.7 | *32.8* | 5.8 | 6.1 | 5.2 | 33.7 | 30.5 |
| Treasury payments | 1.9 | 1.1 | -42.3 | *43.2* | 4.1 | 2.5 | -39.6 | 24.1 | 12.5 |
| **Total expenditures** | **6.0** | **5.3** | **-12.0** | ***26.4*** | **17.2** | **20.0** | **16.3** | **100.0** | **100.0** |
| **Primary balance** | **0.2** | **1.0** | **372.1** | | **1.3** | **-0.1** | **-108.5** | | |
| **Total balance** | **-1.8** | **-1.0** | **-43.7** | ***16.6*** | **-4.5** | **-6.2** | **38.8** | | |
| *Total deficit/GDP* | | | | | *-8.8* | *-11.0* | | | |
| *Total primary deficit/GDP* | | | | | *2.6* | *-0.2* | | | |

Source: Ministry of Finance, IMF, Haver Analytics, Barclays Capital

## Mounting fiscal vulnerabilities but not yet southern-European like

*The fiscal stance increases fiscal vulnerabilities*

Amid mounting concerns about sovereign debt risks worldwide, the proposed expansionary fiscal stance and delay in structural reforms, puts Lebanon at odds with the rest of the world, and further exacerbates its fiscal vulnerabilities. Yet, unlike other countries in Southern Europe, we are less concerned about solvency risks.

*But real GDP growth has been a stellar 9% in 2008 and 2009*

*And Q1 indicators point to growth of 7-8% in 2010*

First, Lebanon's growth has been robust and is expected to continue at high levels. Recent growth revisions by the government and the IMF indicate a real GDP growth of 9% in 2008 and 2009, largely driven by increased consumption, and higher private investments, which rebounded in the context of a prolonged period of political stability following the May 2007 Doha accord, as reflected in a rapid expansion of tourism and construction activity, which continues until now. Growth momentum, which is also benefiting from the sustained recovery in regional and global economies, remains upbeat and almost unaffected by the current woes in the euro area. In addition to thriving tourism, real estate and construction sector indicators construction permits and cement deliveries registered increases of 57.3% and 15.1%, respectively, during the first four months of 2010. Exports rebounded by 18.5% y/y, reflecting base effects to a large extent, while imports also expanded by 14.2%, with the largest increase coming from machineries and capital goods products hinting at future waves of investments. This was reflected in the surge of the BdL coincident indicator by 18.1% during Q1 10, compared to 9.2% in Q1 09 (Figure 4). Finally, credit growth continues to trend upward, rising by 21.2% y/y in April, further contributing to the boost in consumption and investment. Accordingly, we have revised our forecasts for GDP growth to 7% in 2010 up from 6%, with potential upside for further revisions to 8% by year end. This growth is contributing to further enhancing the overall dynamics of the colossal debt.

*Average cost of debt has been falling*

Second, average interest rate on total public debt has been steadily declining over the past five years. Interest rates on Treasury bills have fallen almost 300 basis points since end-2008, while spreads on Lebanese external debt have declined since end-2008 and are today close to all-time lows (Figure 1). The total interest rate bill has recently seen its share of total spending decline from 39.2% of total in 2005 to 33.7% of total in 2009

*The capacity to generate primarily surplus is there*

Third, Lebanon has achieved successive primary surpluses over the past five years, and has the potential to continue doing so in 2010 as mentioned earlier. This has allowed it to steadily reduce the ratio of its debt/GDP from more than 180% in 2005 to 152% at end-2009. We believe that possibilities to generate additional primarily surpluses through further expanding the revenue base abound, whether by the way of introducing new taxes (without necessarily constraining growth) or by widening the tax base. Such long overdue debate about tax policy reform options, in our view, should inform the preparation of the 2011 budget. Delay in structural reforms on the expenditure side is, however, a significant downside risk.

*Most of the debt is held locally…*

Fourth, more than 75% of total debt is held locally either by local banks (more than 60%), or by local public entities (eg, BdL, Social Security Fund). Local banks in particular, have demonstrated significant resilience during past crises, with robust indicators of financial soundness (*Lebanon trip Notes*, January 2010). In addition to an asset base exceeding three times Lebanon's GDP, ample liquidity and sustained levels of relatively high profitability and capital adequacy, the banks have low leverage and have been trying aggressively to diversify away from their sovereign exposure, expanding into regional and international markets. Their reliance on a dedicated deposit base, the growth of which has steadily held near 20% over the past year, secures a solid source of funding for both private and public sector needs.

*…and capital flows are far from abating*

*Deposit growth was still running at 20% in January-April 2010*

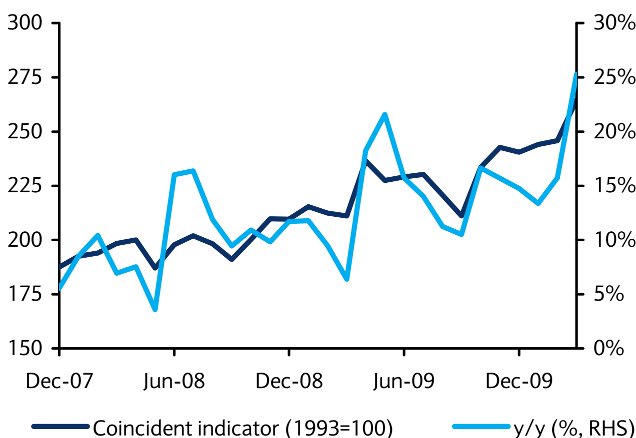
In fact, Lebanon's external position continued to strengthen into 2010. Despite the widening of the trade balance during the first four months of 2010, the balance of payments registered a cumulative surplus of USD1.4 bn, increasing by 23.4% y/y compared to the same period last year. This reflects a sustained increase in net non-goods related trade and capital flows, including remittances, net services exports (notably tourism), and non-debt creating flows (Figure 5). In fact, deposit growth sustained its momentum despite a slight retreat in April and market volatility in May. Deposits grew on average by 20% during the first four months, and 18.9% on a 12-month rolling basis, bringing total assets of the banking system to USD121 bn at end April 2009. The small decline in deposit growth in April to 18.8% from 20.34% in March, in our view, reflects banks' eagerness to improve management of inflows into the system in view of balancing liquidity and profitability objectives, as recent volatility in external markets seems to be slowing down the expected decline in the interest rate differential.

## Political risk is a constant

Political risk came to the fore again since the latest statements by Israeli authorities and the US administration regarding the acquisition by Hizbollah of long-range Scud missiles (see *Lebanon: Gathering (geopolitical) clouds*, April 15, 2010). The recent Gaza flotilla incident in early June, raising tensions between long-time strategic allies Israel and Turkey and other countries in the region, as well as the vote by the UN Security Council on a new wave of more stringent sanctions on Iran to rein in its nuclear program, are adding to this risk. Israel's letter to the UN Security Council this weekend warns Lebanon about allowing flotillas to sail from Lebanese ports towards Gaza.

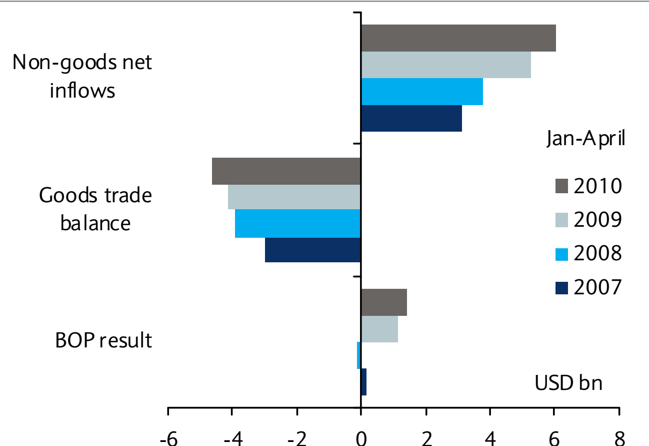
There are various scenarios under which a war could be triggered, whether willingly or by accident, and we will not dwell on explaining these scenarios. We believe, however, that should a war erupt similar to the July 2006 war, the Lebanese economy is most likely to be under extreme strain, but that with support from Arab governments and the international donor community, and endowed with a robust and sound financial sector with ample liquidity, it will be able to avoid any major refinancing problem, despite a potentially severe weakening of its growth drivers for a period to come.

**Figure 4: BdL coincident indicator surged**




Source: Banque du Liban, Barclays Capital

**Figure 5: Balance of payments continue to record surpluses**




Source: Banque du Liban, Barclays Capital

**Figure 6: Key macroeconomic indicators, 2006-2011**

| | 2006 | 2007 | 2008F | 2009E | 2010F | 2011F |
|---|---|---|---|---|---|---|
| Activity | | | | | | |
| Real GDP (% y/y) | 0.6 | 7.5 | 9.0 | 9.0 | 7.0 | 6.0 |
| CPI (% average) | 5.6 | 4.1 | 10.8 | 3.1 | 4.0 | 4.5 |
| GDP (USD bn) | 22.4 | 25.0 | 29.5 | 33.6 | 37.4 | 41.0 |
| FX, eop | 1507.5 | 1507.5 | 1507.5 | 1507.5 | 1507.5 | 1507.5 |
| External sector | | | | | | |
| Current account (USD bn) | -1.2 | -1.7 | -3.4 | -3.7 | -3.3 | -3.3 |
| CA (% GDP) | -5.3 | -6.8 | -11.5 | -11.1 | -8.9 | -7.9 |
| Gross external debt (% of GDP)[1] | 199 | 194 | 175.3 | 193.5 | 181.9 | 175.8 |
| Foreign currency external debt (% of GDP) | 90.6 | 81.2 | 71.9 | 63.3 | 56.4 | 50.8 |
| International reserves (USD bn)[2] | 19.2 | 20.5 | 28.3 | 39.2 | 45.1 | 48.4 |
| Public sector | | | | | | |
| Public sector balance (% GDP) | -11.2 | -10.2 | -9.9 | -8.8 | -8.5 | -10.0 |
| Primary balance (including grants) (% GDP) | 1.7 | 1.6 | 2.0 | 3.2 | 1.1 | 1.5 |
| Gross public debt (USD bn) | 40.4 | 42.0 | 47.0 | 51.1 | 54.9 | 58.6 |
| Gross public debt (% GDP) | 179.9 | 167.8 | 159.5 | 152.1 | 146.9 | 143.0 |

Note: [1]Includes all banking deposits held by non-residents, including estimated deposits of Lebanese nationals living abroad but classified as residents.
[2]Total gross reserves including gold. The national valuation of the latter amounts to around USD10bn as at March 2010.
Source: MoF, BDL, Haver Analytics, Byblos Bank, Barclays Capital

# EMEA: NORTH AFRICA

## Coping with Euro dependence

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**Having emerged from the crisis relatively unscathed, Morocco's and Tunisia's recoveries are gathering pace, albeit slowly, supported by continued fiscal stimulus measures. Their growth and external outlook, however, remain dependent on trade and investment flows from the EU and are vulnerable to downside risks to its recovery.**

*North African credit held up well despite close links to the euro area*

**Strategy**: Despite the countries' dependence on the EU and strong ties to southern Europe, Tunisia and Morocco credit held up well in the recent period of risk aversion. As a consequence, both countries now screen as relatively expensive in a global credit context (also compared with their respective ratings) and, against a background of rising macroeconomic risks, we find it hard to see enticing opportunities at current levels. Nevertheless, we recommend overweighting the BTUN USD 12s benchmark bond in our Global EM Credit portfolio. With a maturity of less than two years, we think the bond should benefit from roll-down and, given Tunisia's solid credit profile, would expect any pressure on the front end of the Tunisian curve to be limited (Figure 1).

### Growth is resilient but at risk of weaker euro area growth

*Growth remained resilient throughout the crisis…*

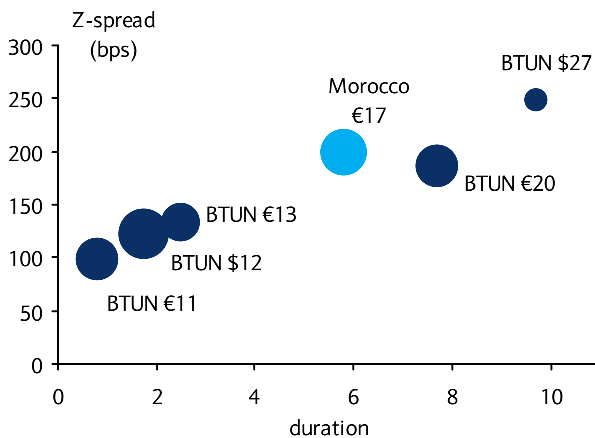
*…but is vulnerable to weak EU recovery*

Despite high levels of dependence on trade and investment flows from the EU, Tunisia and Morocco weathered the global financial crisis well. While slowing, growth in 2009 registered 3.1% y/y and 5.3% y/y, down from 4.6% and 5.6% in 2008, in Tunisia and Morocco respectively. Fiscal stimulus measures in the face of falling external demand, as well as strong agricultural output growth due to favourable climatic conditions, were supportive factors. With dependence on the EU averaging 70% for exports, 82% for tourism, and 90% for remittances, North African economies remain vulnerable to downside risks to euro area growth (Figure 2).

*Solid record of past reforms facilitated the adoption of stimulus measures*

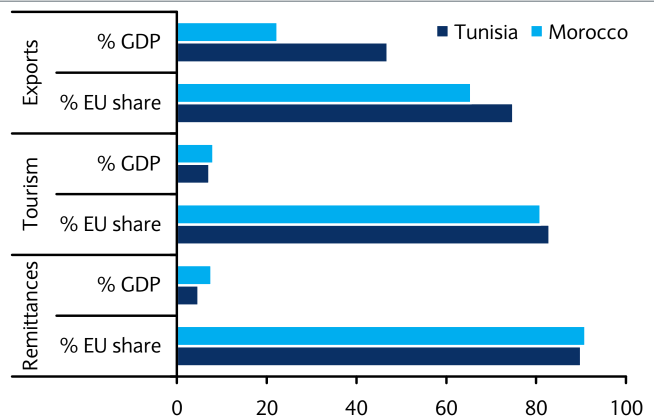
Against this background, the steadfastness of the policy response helped dampen the negative effects of the crisis, and authorities remain vigilant to a renewed setback to euro area growth. Sustained implementation of fiscal reforms over the past several years, leading to a significant lowering in public debt levels (Figure 10) conferred on the governments a

**Figure 1: Opportunities in NA credit seem limited at present**




Note: Bubble size illustrates outstanding volume.
Source: Bloomberg, Barclays Capital

**Figure 2: Significant dependence on EU economies**




Source: IMF, Barclays Capital

significant margin of manoeuvre to confront the sharp fall in external demand. In both countries, fiscal stimulus packages focused on accelerating public investment projects, as well as supporting the export sectors. These measures helped limit labor shedding and sustain domestic demand through strong investment and consumption.

*Domestic demand will remain the engine of growth in 2010-11*

*Export growth is lower than pre-crisis levels*

We expect domestic demand to remain the main engine of growth in 2010 and 2011 given the slow economic recovery in euro area countries. Average export growth for the first quarter was much lower than in the pre-crisis 2008 period (10.5% in Morocco and 13.2% y/y in Tunisia, compared with 24.2% and 21.9%, respectively), pointing to a subdued recovery in external demand and highlighting the importance of the fiscal stimulus measures to keep growth at 3.5-4.0%. We see risks tilted to the downside should prospects in the EU deteriorate or lead to a protracted slowdown in activity in key trading partners (France and Spain for Morocco, France and Italy for Tunisia). Output volatility in the agriculture sector, namely in Morocco, also adds to downside risks.

## Current accounts to improve gradually

*Current account deficits narrowed in 2009*

*But FDI fell sharply*

*Debt-creating flows help restore BoP surpluses and reserve accumulation*

Surprisingly, external positions improved in 2009 despite the shock to current account receipts. The decline in imports, namely due to much lower commodity prices, outweighed the contraction in exports and remittances, leading to a narrowing of the current account deficit to 2.8 % of GDP in Tunisia and 4.5% in Morocco, compared with 4.4% and 5.2%, respectively, in 2008. In parallel, the financial account deteriorated sharply, reflecting a 38.4% and 31.1% decrease in FDI into Tunisia and Morocco, respectively, as a result of the slowdown in the euro area (which accounts for about 70% of total FDI inflows). Portfolio flows remain very thin, however, partly due to capital account restrictions. Nevertheless, large debt-creating flows from bilateral and multilateral donors helped support the financial account and boosted FX reserves by USD1bn, to USD10.6bn, in Tunisia, while keeping them almost constant at USD21.9bn in Morocco in 2009.

*In Q1, current account receipts rebounded*

*But so did imports, notably oil*

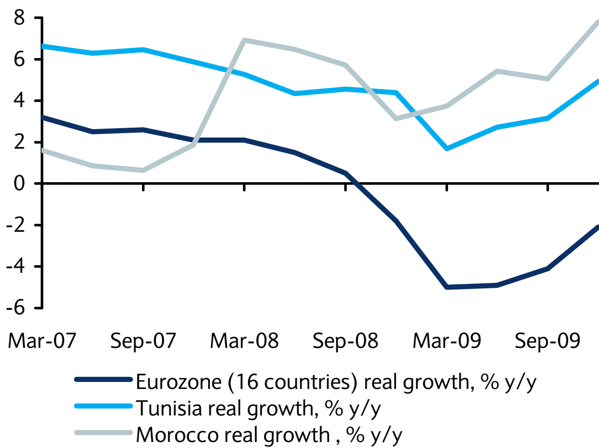
Q1 10 indicators point to a rebound in current receipts which were more than offset by a growing import bill. Exports increased 13% y/y and 9.3% y/y in Tunisia and Morocco, respectively, as did remittances (4.1% y/y and 13.6% y/y, respectively). In the meantime, tourism revenues picked up in Morocco (12.7% y/y) but declined in Tunisia (-5.9% y/y). In parallel, the import bill expanded significantly on account of a jump in oil imports by 31.3% y/y and 13.1% y/y in Tunisia and Morocco, respectively, Higher non-oil imports in Tunisia reflect a restocking of intermediary goods that should translate in higher exports in the coming months.

*We expect a modest recovery in FDI*

*And increased net borrowing*

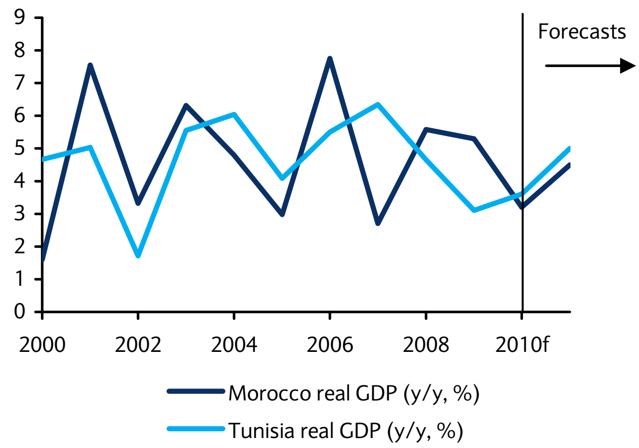
As the base effect from higher oil prices fades in H2 10, we expect current account balances to strengthen, despite the peak of the tourism season coinciding with the holy month of Ramadan (August). Thus, we expect the current account balance to narrow only slightly in 2010, with risks to the upside. Further improvements in external balances in 2010 hinge primarily on the external environment and notably, on the pace of recovery in the euro area. A gradual but modest recovery of FDI, along with an expected increase in net borrowing from bilateral and multilateral debt should maintain the balance of payments in surplus and contribute to reserve accumulation beyond the current levels.

**Figure 3: Quarterly GDP tracks EU growth trends…**



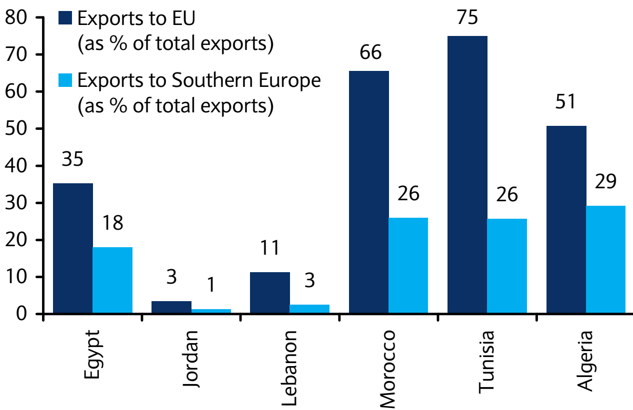

Source: Haver Analytics, Barclays Capital

**Figure 4: …but is highly volatile, notably in Morocco**



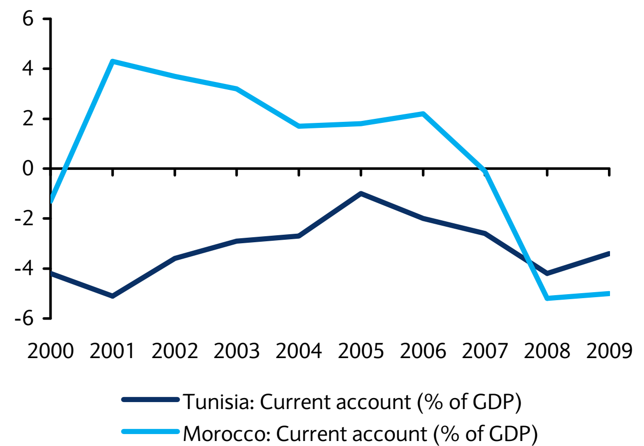

Source:: Haver Analytics, IMF, Barclays Capital

**Figure 5: Exports linkages to the EU and southern Europe …**



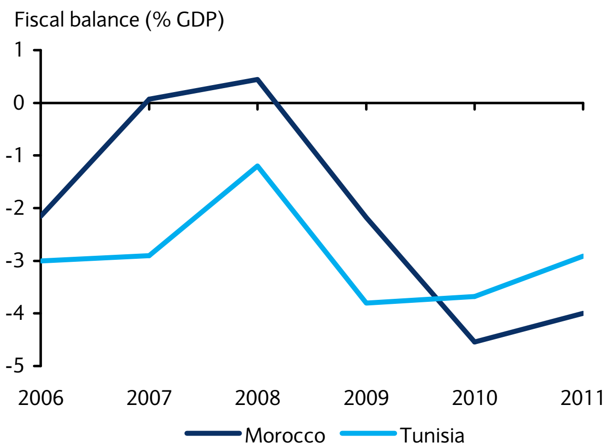

Source: Haver Analytics, IMF, Barclays Capital

**Figure 6: …risk adding pressure to the current accounts**



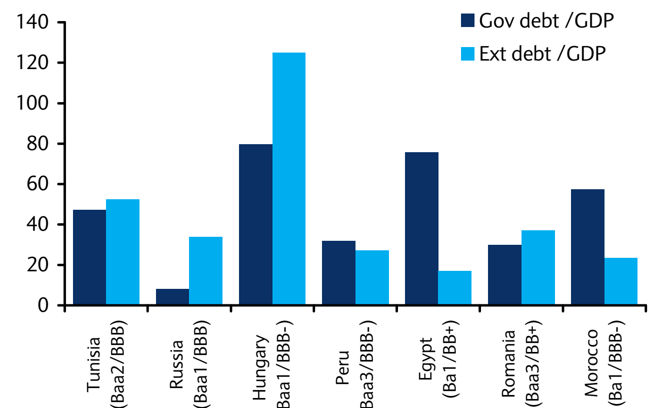

Source: Haver Analytics, Barclays Capital

**Figure 7: The need for fiscal stimulus is still there.**




Source: Haver Analytics, Barclays Capital

**Figure 8: Debt levels are manageable compared with peers**




Source: Haver Analytics, IMF, Barclays Capital

## But continued stimulus measures will likely bring deficits wider

*Fiscal stimulus is maintained in 2010*

Against a fragile recovery in the external environment, both Tunisian and Moroccan authorities confirmed their commitment to maintaining fiscal stimulus measures in 2010 until downside risks to growth abate and to gradually phasing out the stimulus accordingly. In Morocco, the 2010 budget foresees a bigger deficit, which we estimate to reach 4.5% of GDP, reflecting an increase in spending over a range of sectors, including social services, infrastructure, and export promotion activities. It also introduced reforms to the income tax brackets and reductions in rates, as well as a reduction in corporate tax rates to stimulate private investment. In Tunisia, we foresee a deficit of 3.7% of GDP, with measures focused on accelerating investment projects, support for employment and for exports, as well as support for enterprise restructuring.

*Fiscal reforms leading to manageable debt levels provide flexibility*

Relatively strong fiscal positions and manageable public debt levels provide this flexibility. After several years of implementing fiscal reforms and sustaining high levels of growth, both countries strengthened their fiscal positions. This turned the deficit into a modest surplus of 0.1% and 0.4% of GDP in 2007 and 2008, respectively, in Morocco, while narrowing the deficit from 2.6% on average in 2000-05 to 1.2% in 2008 in Tunisia. Concurrently, general government debt fell more than 20 and 15pp in Tunisia and Morocco, respectively. over the past five years, reaching 46.9% and 47.1% of GDP at end-2009.

*Deficits will be reined in as of 2011*

*Unless weakness in EU growth imposes a continuation of the stimulus*

We believe the authorities are committed to reining in the budget deficit as of 2011 and forecast a downward trend in the latter then. The output gap remains negative in both countries and its evolution will determine the pace at which the fiscal stimulus will be wound down. However, both countries agree with the IMF, that they should anchor their fiscal policy into a medium-term fiscal framework aimed at reducing the deficits to below 3%of GDP. While we expect a pickup in 2011 growth and dividends from tax reforms to result in a widening of the tax base and further revenue increases, the downside risk is prolonged weakness in the EU outlook and external demand. In such a scenario, the continuation of the stimulus measures might be necessary. The use of privatisation proceeds in both countries is expected to help accelerate debt reduction further.

## Banking system: more challenges in Tunisia

*Banks remain unscathed by the global financial turmoil*

With the capital account only partially open, and several restrictions on capital outflows, the integration of local banks into the international financial markets is limited, which helped shield them from the global financial turmoil. In Tunisia, in particular, the banking sector remains largely under public sector control/management (about 38.5% of total assets). In Morocco, foreign currency-denominated assets and liabilities constitute a small fraction of banks' balance sheets (less than 5%). With the exchange rate tightly managed by the central banks, FX reserves at comfortable levels, and small exposure to foreign-denominated assets, banks' foreign exchange risk seems to be limited.

**Figure 9: Key indicators for the banking sector**

| | Morocco | | | Tunisia | | |
|---|---|---|---|---|---|---|
| | 2005 | 2008 | 2009 | 2005 | 2008 | 2009 |
| Capital adequacy ratio (%) | 11.5 | 11.2 | 11.8 | 12.4 | 11.7 | 12 |
| NPLs (% of total loans) | 15.7 | 6.0 | 5.5 | 20.9 | 15.5 | 13.2 |
| Return on assets (%) | 0.5 | 1.2 | 1.3 | 0.6 | 1.0 | N/A |
| Return on equity (%) | 6.3 | 16.7 | 15.2 | 5.9 | 11.2 | N/A |
| Total assets to GDP (%) | 88.0 | 112.4 | 114.1 | 78.0 | 85.0 | 87.0 |
| Credit to the private sector, % y/y | 13.0 | 23.0 | 9.4 | 10.0 | 15.0 | 10.0 |

Source: Banque Al-Maghrib, Central Bank of Tunisia, IMF, Barclays Capital

*Credit growth receded as growth slowed*

However, general risk aversion and a slow recovery reduced the pace of private sector credit growth, notably in Morocco. The latter grew rapidly at an average rate of 17.7% over 2004-08 but decelerated to 9.4% in 2009, while it stabilized at10% in Tunisia. The slowdown in credit highlighted the need to address asset quality issues, particularly in Tunisia. There, NPLs remain at a relatively high level of 13.2%, albeit declining from 20.9% of total loans in 2005 (Figure 9).

*NPLs in Tunisia remain at high levels*

In Morocco, however, the share of NPLs-to-total loans declined from 15.7% in 2005 to 5.5% in 2009, and provisioning increased. Conscious that the receding path of credit growth could see NPLs bounce back modestly, the authorities have been stepping up their efforts to strengthen monitoring and supervision, including the establishment of a credit bureau (in Morocco) and the continued implementation of Basle II, which will require further increases in bank capital (notably in Tunisia).

**Figure 10: Morocco and Tunisia: Main economic indicators**

| | 2006 | 2007 | 2008 | 2009 | 2010f | 2011f | | 2006 | 2007 | 2008 | 2009 | 2010f | 2011f |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Real GDP (% y/y) | | | | | | | GDP (USD bn) | | | | | |
| Morocco | 7.8 | 2.7 | 5.6 | 5.3 | 3.5 | 4.5 | Morocco | 65.7 | 75.2 | 89.1 | 89.4 | 92.9 | 101.4 |
| Tunisia | 5.5 | 6.3 | 4.6 | 3.1 | 4.0 | 5.0 | Tunisia | 31.9 | 37.4 | 38.5 | 40.6 | 43.4 | 46.7 |
| | Current account balance (% of GDP) | | | | | | | Net FDI (USD bn) | | | | | |
| Morocco | 2.7 | -0.1 | -5.2 | -4.5 | -4.5 | -4.1 | Morocco | 3.4 | 5.0 | 4.5 | 3.1 | 3.2 | 3.5 |
| Tunisia | -1.9 | -2.5 | -4.4 | -2.8 | -2.6 | -2.8 | Tunisia | 3.2 | 1.5 | 2.6 | 1.6 | 1.7 | 1.9 |
| | Fiscal balance (% of GDP) | | | | | | | Public debt (% of GDP) | | | | | |
| Morocco | -2.2 | 0.1 | 0.4 | -2.2 | -4.5 | -4.0 | Morocco | 57.3 | 53.5 | 47.3 | 47.1 | 48.3 | 49.1 |
| Tunisia | -3.0 | -2.9 | -1.2 | -3.8 | -3.7 | -2.9 | Tunisia | 53.7 | 50.0 | 47.4 | 46.9 | 47.3 | 46.8 |
| | Primary balance (% of GDP) | | | | | | | External debt (USD bn) | | | | | |
| Morocco | 1.5 | 3.7 | 3.1 | 0.2 | -1.7 | -1.1 | Morocco | 23.9 | 23.7 | 20.6 | 23.3 | 24.4 | 25.1 |
| Tunisia | -0.3 | -0.3 | 1.1 | -1.4 | -1.4 | -0.7 | Tunisia | 18.5 | 20.1 | 20.6 | 20.5 | 21.1 | 21.6 |
| | International reserves (USD bn) | | | | | | | CPI (% Dec/Dec) | | | | | |
| Morocco | 20.2 | 24.0 | 22.0 | 21.9 | 22.9 | 23.5 | Morocco | 3.3 | 2.0 | 3.9 | -1.0 | 2.0 | 2.6 |
| Tunisia | 6.6 | 7.6 | 9.5 | 10.6 | 11.1 | 12.0 | Tunisia | 4.5 | 3.1 | 5.1 | 3.7 | 3.4 | 3.3 |

Source: Bank Al-Maghrib, Central Bank of Tunisia, IMF, Haver Analytics, Barclays Capital

# EMEA: POLAND

## Fiscal policy politics

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**With the economy in sound shape, Poland economic policy has been taking a backseat to politics. In particular, the fiscal position has deteriorated without immediate plans for correction. We expect the government will eventually seek to improve the fiscal deficit and government debt levels, possibly in reaction to pressure from the EC and the desire to move towards euro adoption. However, we do not see this point being reached in the near future, capping upside potential for Poland assets.**

*We recommend avoiding PLN exposure but would look to receive 2y IRS*

**Strategy:** We turn more cautious on Polish local markets, recommending investors target receive trades at the front end of the bonds and swaps curve and that they adopt a neutral zloty stance. Although local rates are near the year lows, we see monetary tightening being pushed further out, which makes the carry on the front end attractive. We favour receiving 2y PLN IRS 4.40%, looking to collect the 6bp/m carry/rolldown. We also see helpful factors for front-end rates: local banks have ample liquidity (in PLN) and local pension funds have already re-weighted into equities, which may reverse in a more bearish global risk environment. Non-resident positions are heaviest in 5y and 10y bonds. Zloty valuations are not stretched and BoP fundamentals are strong. However, the positive surprises from FDI and privatisations are likely behind us. The threat of FX intervention is also a cap on the zloty. On Polish credit, we see any significant upside capped by concerns about the country's loose fiscal stance. We point out, however, that the Poland USD 19s benchmark bond trades cheap on a rating basis and with a substantial negative basis to CDS.

### Steady growth

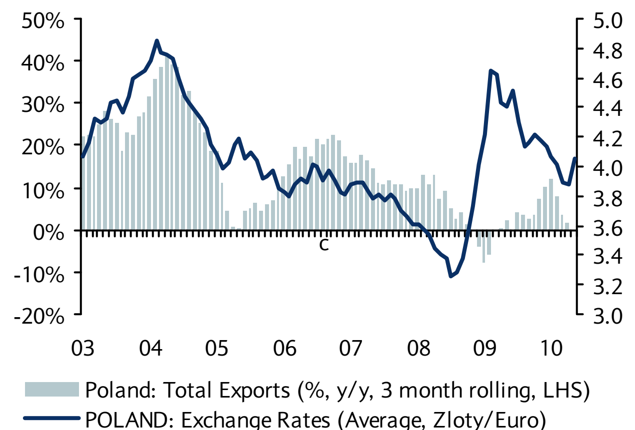
*Growth should accelerate due to a pickup in exports from the more competitive exchange rate*

Poland's growth remained steady during 2009, accelerating to 1.1% q/q during Q4 09. There has been some deceleration in Q1 10 when q/q growth slipped to 0.5% as domestic demand softened (Figure 1). This is probably weather-related and therefore a temporary deceleration rather than a new trend. The other factor was deceleration in exports due in part to zloty strength (Figure 2). With recent depreciation of the euro and associated zloty weakness relative to the euro, we expect Polish exports to perform well during the remainder of the year. Polish exports are well balanced with trade surpluses expanding in machinery and transport equipment, foods, and manufacturing. Deficits in fuels, chemicals

Figure 1: Growth decelerated in Q1 10 on softer domestic demand

Source: Poland Central Statistical Office, ABN Amro, Haver Analytics

Figure 2: Exports stagnated due in part to currency strength




Source: National Bank of Poland, Poland Central Statistical Office, Haver Analytics

and other crude materials have declined. While Poland growth would be vulnerable to a slowdown in the German economy, we see Germany performing well on the back of euro weakness. We forecast Poland's growth at 2.9% in 2010 and see a slight acceleration in subsequent years.

## Fiscal policy

*Fiscal deficits are high and government debt levels rising*

The government has allowed the fiscal deficit to expand in recent years. Tax revenues have fallen as a % of GDP, in part due to tax cuts instituted in 2007, which took effect in 2008-09 designed to increase efficiency (Figure 3). The timing of the tax cuts was fortuitous; they helped Poland to avoid a recession in 2008-09. In addition, the government boosted expenditures to help stimulate the economy. In 2009 the deficit reached -7.5% of GDP compared with -3.9% of GDP in 2008. For 2010 the government is targeting a deficit of -6.9% of GDP.

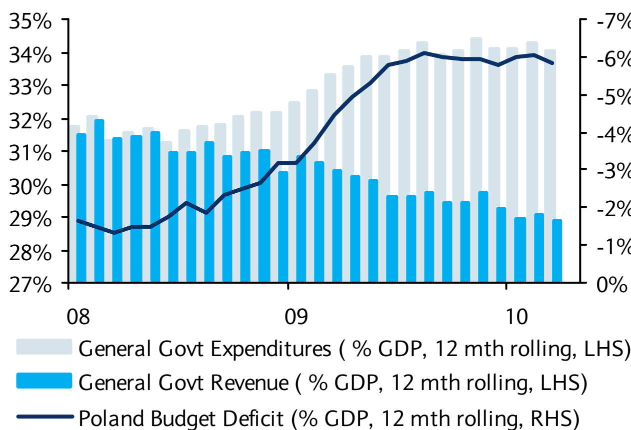
*Fiscal adjustments are being delayed until 2012 after a series of elections…*

The government does not appear to place a high priority on limiting fiscal deficits and instead has adopted an aggressive pro-growth agenda. It is gradually limiting current expenditures, preferring to avoid unpopular cuts in wages and pensions with presidential elections and local elections this year and parliamentary elections next year. The first round presidential results resulted in a surprisingly close finish between the top two candidates, but the market implications of this result are modest. Even the market favoured candidate is unlikely to accelerate fiscal adjustment. In their EC convergence plan, the government indicated that it is targeting a budget balance of -5.5% of GDP in 2011 and -3% of GDP in 2012. During 2009-11 the government plans to contain current expenditures so it can raise capital spending. By end-2011 they hope to have complete many of the EU co-financed capital projects and therefore will be able to decrease capital spending in 2012 to lower the fiscal deficit. We suspect construction delays will limit the ability of the government to cut expenditures in 2012 and that fiscal adjustment will be pushed out further in particular since Poland is hosting the European soccer championship in 2012.

*…government debt levels rising*

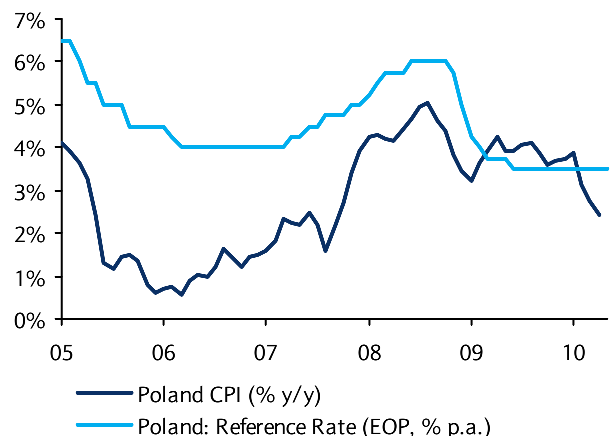
Government debt has risen into ranges controlled by their fiscal responsibility law. At end-2009 government debt rose to 51% of GDP triggering automatic limits on expenditures starting in 2011, real expenditures cannot increase more than 1% per annum. The 2010 deficit will likely push government debt over the 55% of GDP threshold triggering automatic limits on the 2012 deficit. If the 2012 deficit is higher than the current target, this could nudge government debt towards the 60% of GDP when further sanctions are triggered.

**Figure 3: Government deficits have accelerated**




Source: Poland Ministry of Finance, Haver Analytics

**Figure 4: Inflation has dropped to within the NBP target range**




Source: National Bank of Poland, Poland Central Statistical Office, Haver Analytics

## Inflation well within target

*Inflation has declined significantly in the past year and rate increases look to be far off*

Inflation has eased considerably in Poland during the past year and at 2.2% y/y is below the middle of the 1.5-3.5% target range (Figure 4). Among the factors that contributed are a large decline in food inflation, which partly reflects a drop in global food prices during the global recession, and exchange rate appreciation. Housing inflation has plunged due to soft domestic housing markets. Services inflation decelerated reflecting declines in wage inflation and soft domestic demand. In our view, there is no particular reason to be concerned about an imminent uptick in inflation; we expect inflation to remain in the middle of the target range for the next three years. With the policy rate at 3.5%, Poland is one of the few countries in the region with positive real rates and thus there is no reason to raise rates until inflation starts rising. This is in contrast to many other countries where rates are far below inflation rates and a normalisation of policy is needed. We have changed our view and do not expect the NBP to raise rates at all in 2010, in line with our view that major global central banks will further delay rate increases. We think the NBP will increase rates by a total of 50bp in the first half of 2011 as a precautionary measure when the major global central banks start raising their rates.

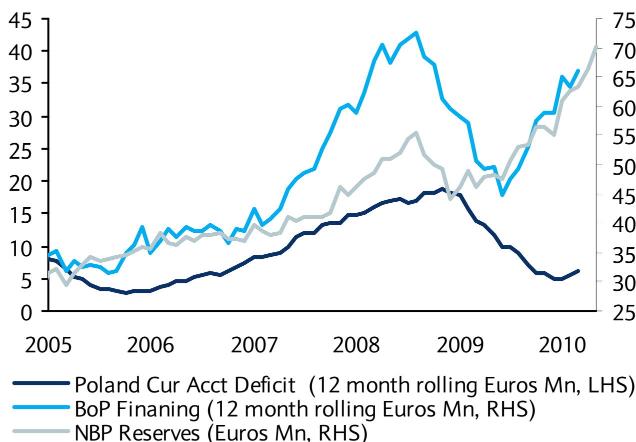
*The new NBP governor and recently restaffed MPC will likely bring a new approach to monetary policy*

The recent appointment of Marek Belka as Governor means that all the members of the MPC have changed this year. We expect him to try to foster a more academic-technical approach in an effort to depoliticize monetary policy. He has indicated that the weak fiscal stance would force the NBP to keep monetary policy tighter and thus rule out rate cuts (notwithstanding recommendations of the recent IMF mission). Belka and the MPC seem to favour FX intervention only to lower volatility, but not to target an exchange rate. Belka indicated that he wants more cooperation with the government within the context of central bank independence. The NBP is renewing its FCL with the IMF, which strengthens the already strong financial position of the NBP.

## External accounts and the exchange rate

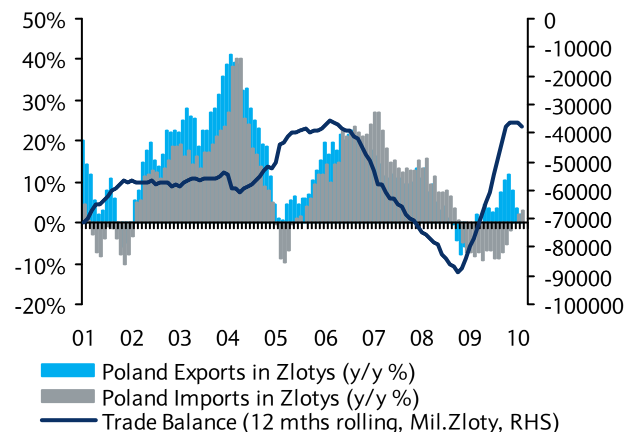
The exchange rate has weakened recently due to rising global risk aversion. Poland was hit harder than others, apparently because of positioning. In the medium term we foresee considerable appreciation pressure on the currency. The current account deficit has declined due to improvements in the trade balance (Figure 5 and 6). The pendulum is starting to swing back and the current account deficit will likely increase, but at mild rates

**Figure 5: Reserves are rising on lower current account deficits and rising BoP financing…**




Source: National Bank of Poland, Poland Central Statistical Office, Haver Analytics

**Figure 6: … as the trade deficit has declined**




Source: Poland Central Statistical Office, Haver Analytics

and we expect it to remain at around 2% of GDP. At the same time, Poland is receiving ample BoP inflows, mainly from EU post accession funds, as it takes advantage of opportunities to increase co-financed public investment projects. The NBP as taken the opportunity to increase its reserves and we expect further increases as inflows continue.

**Figure 7: Poland macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 6.2 | 6.8 | 4.9 | 1.7 | 2.9 | 3.3 |
| Domestic demand contribution (pp) | 7.5 | 9.4 | 5.8 | -0.6 | 3.0 | 3.7 |
| Private consumption (% y/y) | 5.2 | 5.3 | 5.4 | 2.1 | 3.3 | 3.8 |
| Fixed capital investment (% y/y) | 16.1 | 24.3 | 3.8 | -14.1 | -1.2 | 7.8 |
| Net exports contribution (pp) | -1.2 | -2.6 | -0.9 | 2.3 | -0.1 | -0.2 |
| Exports (% y/y) | 14.6 | 9.1 | 7.2 | -9.7 | 8.2 | 6.6 |
| Imports (% y/y) | 17.3 | 13.7 | 8.5 | -13.6 | 7.9 | 6.6 |
| GDP (USD bn) | 342 | 425 | 533 | 419 | 435 | 492 |
| **External sector** | | | | | | |
| Current account (USD bn) | -9.1 | -19.9 | -26.7 | -7.3 | -8.4 | -9.5 |
| CA (% GDP) | -2.7 | -4.7 | -5.0 | -1.7 | -1.9 | -1.9 |
| Trade balance (Goods and services) USD bn) | -6.9 | -16.9 | -25.9 | -4.3 | -5.7 | -6.0 |
| Net FDI (USD bn) | 10.7 | 18.0 | 11.6 | 10.6 | 12.8 | 15.6 |
| Other net inflows (USD bn) | 4.7 | 25.8 | 35.4 | 32.3 | 20.9 | 8.4 |
| Gross external debt (USD bn) | 170 | 234 | 243 | 280 | 308 | 339 |
| International reserves (USD bn) | 48 | 66 | 62 | 84 | 97 | 104 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -3.8 | -2.0 | -3.9 | -7.5 | -6.9 | -6.0 |
| Primary balance (% GDP) | -1.1 | 0.1 | -1.8 | -5.0 | -4.4 | -3.5 |
| Gross public debt (% GDP) | 47.7 | 45.0 | 47.2 | 51.0 | 55.0 | 57.9 |
| Prices | | | | | | |
| CPI (% Dec/Dec) | 1.4 | 4.2 | 3.3 | 3.5 | 2.2 | 2.3 |
| EUR/PLN, eop | 3.83 | 3.60 | 4.15 | 4.10 | 4.15 | 3.88 |
| | **1yr Ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | 2.7 | 2.9 | 3.6 | 3.3 | 1.8 | 4.2 |
| CPI (% y/y, eop) | 3.3 | 3.5 | 2.1 | 2.4 | 2.2 | 2.1 |
| Exchange Rate (eop) | 4.45 | 4.08 | 4.20 | 4.20 | 4.15 | 3.90 |
| NBP policy rate (%, eop) | 3.50 | 3.50 | 3.50 | 3.50 | 3.50 | 3.75 |
| Market implied rate (%,eop) | NA | NA | 3.50 | 3.50 | 3.75 | 4.00 |

Source: Haver Analytics, National Bank of Poland, Poland Central Statistical Office, Poland Ministry of Finance, Barclays Capital

# EMEA: ROMANIA

## Midcourse fiscal correction

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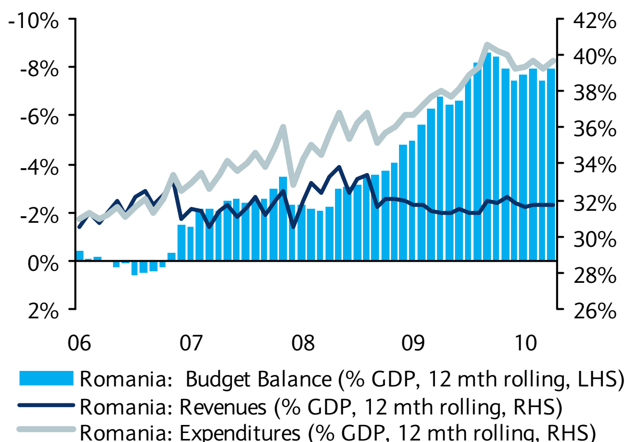
**Romania is cutting wages and pensions across-the-board to restore fiscal sustainability. The government will attempt to institutionalize these cuts during 2010, with new pension and social benefits systems, new civil service wage schedules, and a substantial reduction of government workers. The Romanian population seems prepared to accept lower government spending if improvements in efficiency and fairness can be made that enhance social cohesion. Implementation of the structural reforms will be a challenge and subject to conflicts and delays. During this transition period, the recession will likely continue unabated. Stable financial markets, lower current account deficits, exchange rate stability, and high NBR reserves provide a stable background as the fiscal conflicts are worked out. With declining inflation we expect further NBR rate reductions, provided the government remains on track with the IMF programme.**

*Romania EUR 15 bonds look attractive; we recommend waiting for stabilisation of the RON before going long local currency bonds*

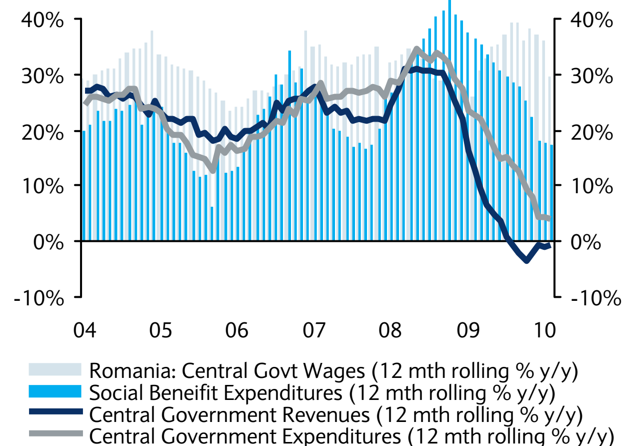
**Strategy:** The challenges to a smooth implementation of the necessary reforms – and the tail risks of a failure – are likely to continue to weigh on Romanian assets for some time. However, in our baseline scenario, we see risks tilted towards the upside and highlight that Romania's comparatively low debt levels and high FX reserves should also provide some comfort for credit investors in particular. Likely new Eurobond supply in the coming months, potentially in USD, should provide a litmus test for global investors' appetite. At current spread levels, we recommend taking long risk exposure on a 3m horizon and highlight the Romania EUR 15s as our preferred instrument. Local bond yields are high compared with inflation (1.5-2y: c.7.50%) and we see more rate cuts. However, we are circumspect on the RON and local funding costs can be volatile. RON valuations are not stretched but with still-weak growth, policymakers are probably exercising greater than usual asymmetry in their FX intervention (leaning more heavily against appreciation than depreciation pressures), skewing the risk/reward on unhedged local asset positions.

**Figure 1: Expenditure increases as share of GDP were not matched by revenue increases**




Source: Romania Ministry of Finance, Haver Analytics

**Figure 2: Large wages and pensions awards limited flexibility of expenditures**




Source: Romania Ministry of Finance, Haver Analytics

## Emergency fiscal measures

*Economic recession led to self reinforcing fiscal deterioration*

The Romanian government is implementing extreme fiscal measures to avert a financial emergency. Marginal fiscal measures have become insufficient, drastic action is needed to reverse fiscal trends and restore confidence. The emergency resulted from accumulation of large structural current account deficits, a build-up in government spending during 2006-08, and delays in structural reforms (Figure 1 and 2). When the global recession caused declines in exports and a sudden stop of external financing, this led to steep declines in Romanian GDP and currency depreciation, which set in motion a self-reinforcing cycle of accelerated fiscal deterioration during 2008-10. Original IMF programme forecasts for growth and the deficit proved far too optimistic. The fiscal deficit swelled to -7.4% of GDP in 2009 and the government struggled to stay within IMF fiscal targets, containing expenditures by running up arrears and cutting capital investment. In addition, political instability during 2009 led to delays in the passage of wage, pension, and tax administration reforms.

*Structural reforms are needed to institutionalise these temporary cuts*

*Delays in structural reforms look likely*

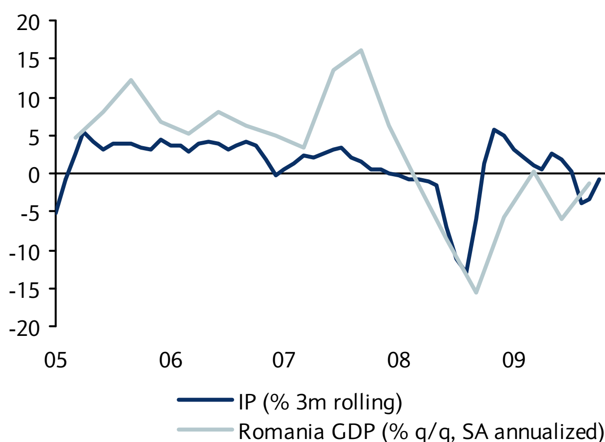
The reductions of government wages by 25% and social benefits (including pensions) by 15% are 'temporary'. They only apply to June-December 2010. In the interim, the government plans to pass legislation reforming pensions, social benefits and civil service wages, and to cut government workers. These will institutionalise the spending cuts within a more equitable system that equalizes pay scales across the public sector, lays offs redundant workers, cuts luxury pensions, and delays early retirement. These reforms are necessary and can only be implemented in extraordinary circumstances such as these. However, such changes are notoriously hard to implement and we expect that delays will likely result in at least partial extension of the across-the-board cuts as the new legislation is formulated and applied.

## Real sector growth downturn continues

*Romania economy is still in recession with no end in sight*

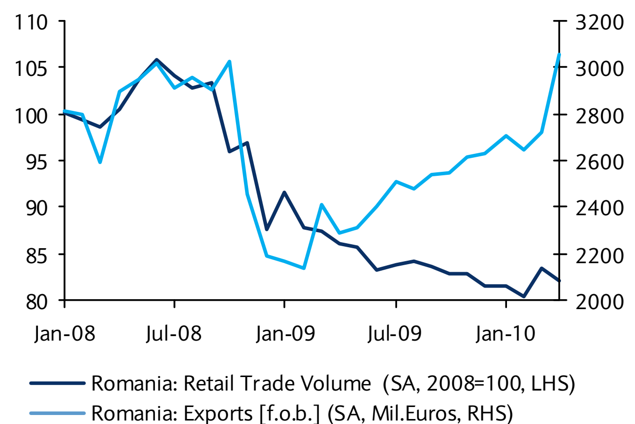
The economy is unable to gain traction even though exports are providing a boost (Figures 3 and 4). We predict continued recession in 2010 with growth of -1.2%. Economic sentiment indicators show that confidence has remained depressed. The ongoing fiscal woes are weighing heavily on domestic confidence. Consumption and investment look set to decline further and more than offset continued improvements in net exports. Owing to weak domestic demand, imports have been flat. Exports of capital goods, transport vehicles, and light manufacturing have led to a recovery of exports to pre-recession levels.

**Figure 3: Economy is still struggling to gain traction**




Source: Romania Institute of Statistics and Economic Studies, Haver Analytics

**Figure 4: Different pattern of external and domestic demand**




Source: Romania Institute of Statistics and Economic Studies, Haver Analytics

## Declining inflation and policy rates

*Inflation at 4.4%, is just inside the NBR target range of 2.5-4.5%*

Inflation has considerable downward momentum and the factors that contributed to declines remain in place (Figure 5). In 2008-09 currency depreciation led to a one-time increase in inflation, particularly for tradable goods that reflect international prices. As the currency has remained broadly stable, goods inflation is decelerating. Weak domestic demand and low wages have caused services inflation to ease. Food inflation has declined due to lower world food prices.

*Still room for further rate cuts*

With the policy rate at 6.25% and inflation at 4.4%, there is still room for the NBR to lower rates, particularly as we expect inflation to decline to about 4% at end-2010 and further in 2011, nearer the middle of its 2.5-4.5% inflation target range. Rate cuts can only proceed as long as the government remains on track with the IMF programme. We expect 75bp of cuts to 5.5% in 2010. A negative risk exists that political turmoil could lead to a currency sell-off and higher inflation.

## Current account imbalances

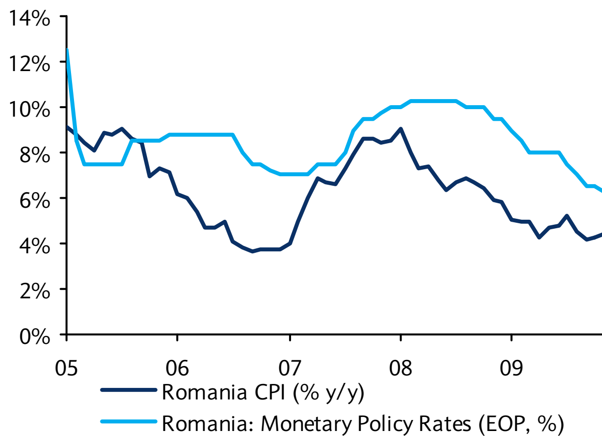
*High reserves partially offset private sector external debt*

Previously Romania's main economic weakness was its external imbalances (Figure 6). During 2006-08 current account deficits averaged -12% of GDP annually, while external debt tripled in nominal terms to €86bn and doubled to 57% of GDP. The government's share of this debt is very small, only one-fifth as government debt remains reasonable at about 32% of GDP. With €22bn of external debt falls due in 2010 and a €8bn current account deficit, total external financing needs are €30bn, which central bank reserves of €35bn are sufficient to cover.

## Exchange rate policy and forecast

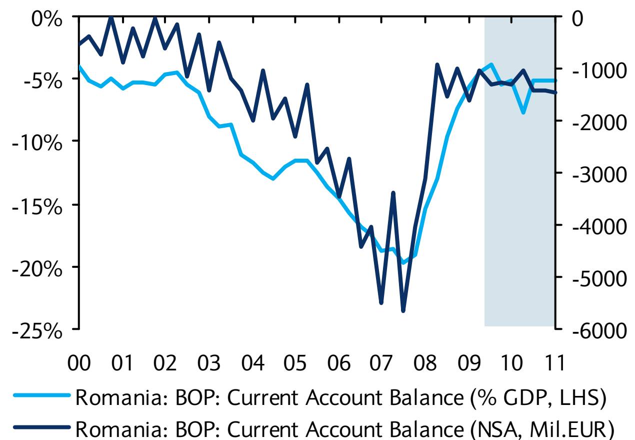
The NBR maintains a strictly managed exchange rate that has fluctuated in the range of RON4.05-4.25 per euro. Provided the IMF programme remains on track – our baseline view – the NBR's credibility on FX intervention is likely to remain high as FX reserves are regularly bolstered by inflows from the Fund and the EU. Yet it is noteworthy that the 'defence' of the RON against the early-June depreciation pressure has been modest and it did not recover most of its losses against the euro even though the forint (the source of contagion) already rebounded. This suggests that the NBR prefers RON to hold at low levels, probably with a view to keeping the exchange rate competitive to shore up growth. Indeed, ytd in 2010 reserves have increased by over €5bn, well above IFI disbursements of €3.5bn, suggesting active intervention on the part of the NBR to keep the currency competitive.

**Figure 5: Inflation declines leave room to lower rates**




Source: National Bank of Romania, Romania Institute of Statistics and Economic Studies, Haver Analytics

**Figure 6: Current Account imbalances have disappeared**




Source: National Bank of Romania, Haver Analytics

Figure 7: Romania macroeconomic forecasts

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 7.9 | 6.3 | 7.3 | -7.1 | -1.2 | 2.5 |
| Domestic demand contribution (pp) | 18.1 | 23.0 | 9.9 | -23.2 | -2.3 | 1.6 |
| Private consumption (% y/y) | 12.0 | 10.9 | 9.4 | -10.0 | -2.3 | 0.7 |
| Fixed capital investment (% y/y) | 19.9 | 30.3 | 16.1 | -25.3 | -4.9 | 1.4 |
| Net exports contribution (pp) | -10.2 | -16.7 | -2.6 | 16.1 | 1.1 | 0.9 |
| Exports (% y/y) | 9.8 | 7.8 | 7.7 | -5.2 | 21.0 | 12.6 |
| Imports (% y/y) | 22.7 | 27.9 | 7.0 | -21.3 | 11.7 | 7.5 |
| GDP (USD bn) | 121.8 | 169.0 | 203.6 | 175.0 | 179.4 | 190.1 |
| **External sector** | | | | | | |
| Current account (USD bn) | -12.7 | -22.9 | -24.1 | -7.1 | -9.2 | -8.4 |
| CA (% GDP) | -10.4 | -13.6 | -11.8 | -4.0 | -5.1 | -4.4 |
| Trade balance (USD bn) | -15.0 | -24.7 | -28.1 | -10.7 | -10.4 | -11.0 |
| Net FDI (USD bn) | 11.0 | 9.7 | 13.8 | 6.1 | 5.4 | 6.4 |
| Other net inflows (USD bn) | 0.8 | 10.4 | 8.5 | 1.7 | 1.8 | 2.0 |
| Gross external debt (EUR bn) | 36.6 | 48.7 | 63.8 | 80.2 | 92 | 98 |
| International reserves (USD bn) | 28.1 | 37.2 | 36.7 | 40.8 | 38.7 | 38.8 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -1.6 | -2.3 | -4.8 | -7.4 | -6.8 | -6.0 |
| Primary balance (% GDP) | -0.8 | -1.5 | -4.1 | -6.5 | -5.8 | -4.8 |
| Gross public debt (% GDP) | 12.4 | 12.7 | 13.3 | 28.5 | 34.6 | 39.7 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 8.6 | 4.9 | 6.6 | 4.7 | 3.8 | 3.4 |
| EUR/RON, eop | 3.38 | 3.61 | 3.99 | 4.23 | 4.25 | 4.10 |
| | **1yr Ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | -8.7 | -2.6 | -1.1 | -0.8 | -0.9 | 0.6 |
| CPI (% y/y, eop) | 5.9 | 4.4 | 4.3 | 4.4 | 3.8 | 3.3 |
| Exchange rate (eop) | 4.18 | 4.18 | 4.20 | 4.30 | 4.25 | 4.10 |
| Policy rate (%, eop) | 9.50 | 6.25 | 6.25 | 5.75 | 5.50 | 5.50 |

Source: Romania Institute of Statistics and Economic Studies, Romania National Bank, Ministry of Finance, Haver Analytics, Barclays Capital

# EMEA: RUSSIA

## The recovery has firmed up

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**The lower inflation outlook should support the consumer sector recovery and keep policy rates low until well into 2011, in our view. The strong balance of payments remains supportive of the RUB, providing a backdrop for investors to be long FX-unhedged bonds.**

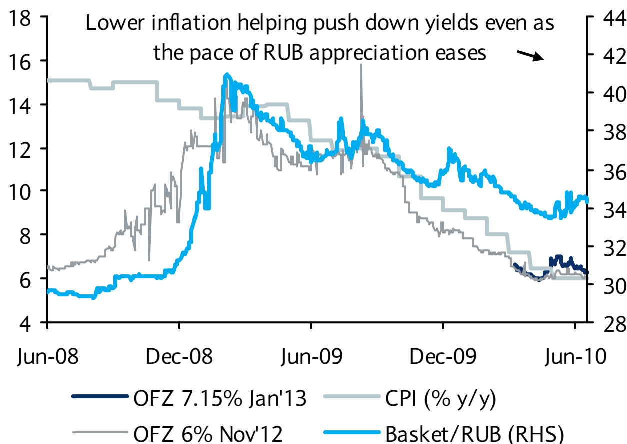
*We recommend being overweight Russia credit and see value in buying the Jan'13 OFZ FX-unhedged*

**Strategy**: The latest period of risk aversion has once again exposed Russia as a high-beta credit, closely correlated with global drivers and commodity prices. Hence, Russia has underperformed, and the spread differential to its peers in LatAm, in particular Brazil and Mexico, has re-widened to 75-80bp (composite OAS). This can be partly explained by Russia's reliance on commodities for revenues and growth, but the lack of a strong local market as an anchor for demand for Russian sovereign paper has likely contributed as well. We see the recent underperformance as an opportunity rather than a weakness. Positioning has naturally lightened up and Russia's debt metrics remain solid, in our view, based on the low debt levels, the prudent fiscal policy and the firming up of the recovery. We see Russia as one of our high-conviction overweights within the Global EM credit portfolio at current levels. We also favour buying local government bonds. The beta to global risk drivers has been moderate, suggesting that positioning was already light before the bouts of risk reduction in Q2. The inflation and RUB-supportive BoP outlook argue for being long these bonds, and we recommend buying the Jan '13s yielding 6.20% FX unhedged (funding 45:55 in EUR and USD as per the weights of the managed FX basket). The carry/rolldown is highest on the shorter tenor instruments as local money conditions are still flush. In addition, the Jan '13s are trading cheap to CCS implied yields (Figure 1), making them a good instrument, in our view, for cash investors to own and for leveraged accounts to fund out of local rates (70bp pick up over 2y CCS yields).

*Industry continues to outperform consumer sectors*

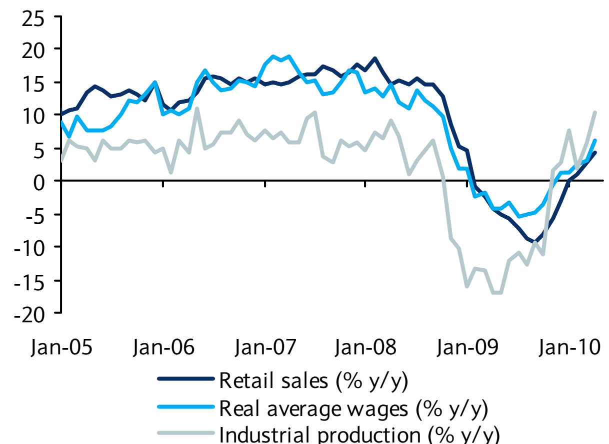
The Russian economy continues to recover, with growth now extending to virtually all sectors (Figure 2). The January-April GDP growth estimate by the Economy Ministry was 3.5% y/y, with the April figure at 5.5%. However, the performance remains uneven: the industry leads the way, up by 6.9% year-to-date. PMI indicators (52 in May) continue to point towards further industrial recovery. At the same time, consumer sectors still lag

**Figure 1: Easing inflation continues to push yields lower and the cyclical recovery should not derail this**




Source: Bloomberg, Rosstat

**Figure 2: Consumer sectors began to recover but still lag the trend. IP is leading the upswing**




Source: Haver Analytics

behind: retail trade volumes crossed into the growth territory only in January, increasing only 2% y/y through April.

Inflation subsided to 6.0% y/y in April-May and the outlook remains positive (Figure 3). However, we expect the Bank of Russia (CBR) to pause rate cuts in June, keeping the key refinancing at 7.75%. If inflation declines further (we expect the bottom at 5.4% in July), the final 25bp rate cut will likely follow. This will bring the rate to 7.5%, yet keep the real rate in positive territory.

*Lower inflation will extend the period of low policy rates*

Although the inflation trend will reverse soon, due, in large part, to already-high money supply growth, we believe the pace of the reversal will be moderate; our inflation forecasts are below the consensus levels. Among key factors, the core inflation continues to subside, and personal incomes are well below the pre-crisis levels. In addition, the euro weakening makes the import component of the consumer basket cheaper. The key risks to our view are: an extreme utility tariff hike in January; a much stronger euro; and additional social spending. However, we view these risks as moderate.

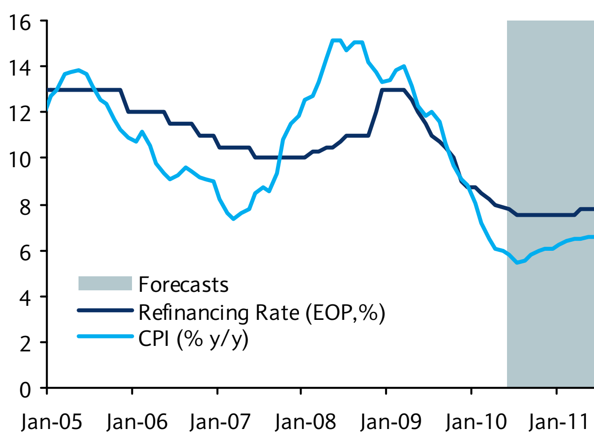
The recent troubles in Europe have raised the rouble volatility. The weakening euro helped the CBR to let the rouble depreciate against the dollar despite high export currency inflows (Figure 4). Another effect is coming via improving terms of trade, as Russian exports are mainly USD-based versus 30% of imports coming from the EU. Overall, the weaker euro should have a positive broad-based effect on domestic assets.

Relatively high oil prices have, so far, maintained strong terms of trade position, resulting in monthly trade surpluses in excess of USD15bn. However, the trade – and the current account – surplus will likely start declining in the near future. Oil prices have stabilized, while imports expand with consumer demand.

*The rouble will likely appreciate in the near term*

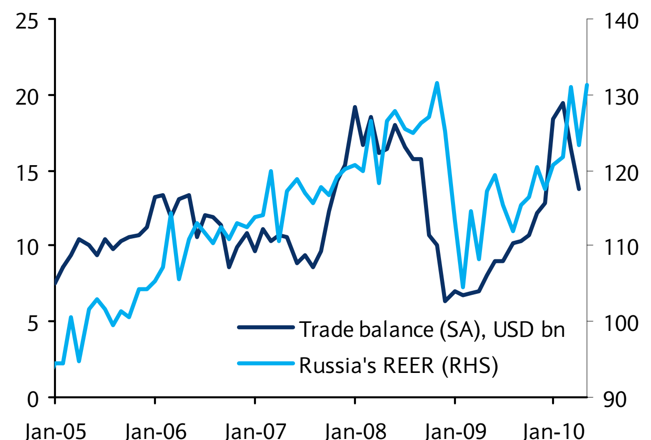
Although this will ease the pressure on the rouble somewhat, high currency inflows will keep enough pressure and remain the key factor determining the local FX market evolution. Therefore, the rouble will likely continue erasing its depreciation since April on the back of the weakening euro. We estimate the year-end USD rate at 29.5. However, the rouble trajectory will likely stay volatile in the current shaky global environment.

**Figure 3: Low inflation will keep interest rates positive without a need for a hike until well into 2011**




Source: Bank of Russia, Rosstat, Barclays Capital

**Figure 4: Foreign trade balances remain high but have begun to moderate**




Source: Haver Analytics

*Fiscal performance improved y/y and will remain solid but will weaken somewhat in the second half*

The fiscal situation has improved significantly, helped by oil prices averaging above $70 per barrel and by the growing economy. The budget deficit in the first five months of the year has been smaller than a year ago, albeit modestly (2.9% of GDP versus 3.2%). The government is phasing out its support to the economy, yet several new items have been added to this year's bill (the pension increase and the Ukraine gas export subsidy among the largest). With the official 2010 oil price estimate revised from USD58 to USD75/bbl, expenditures will increase in the second half of the year in a usual "spend the windfall gain" style and due to the end-of-year effect. Nevertheless, on the back of higher revenues, we expect the budget deficit to decline to 4.6% of GDP this year versus 5.9% in 2009.

*Recovery and low debt levels allow banks to boost lending while reducing NPLs*

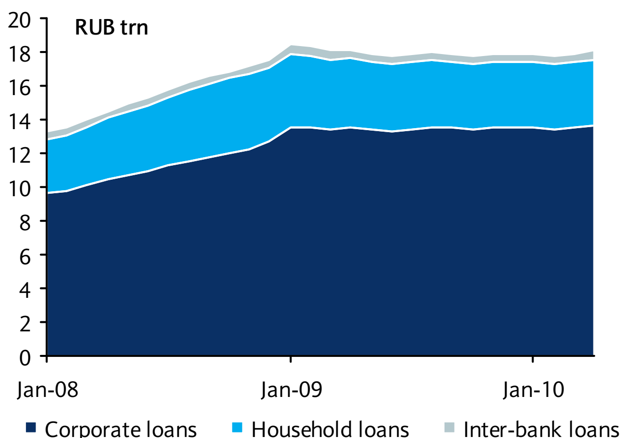
Credit growth is picking up, with the bank loan book expanding since last November. Although credit volumes are still below their pre-crisis highs, they began to exceed the levels recorded a year earlier (Figure 5). At the same time, NPL ratios continue to increase, and banks will keep cleaning up their balance sheets (Figure 6). In comparison, expensive deposits accumulated during the early period of the crisis, when the competition for deposits raised the cost of funding, encourage new lending despite the backdrop of rising NPL. Moreover, a low penetration of loans in the private sector means there remain deep unexplored pockets of borrowers with good credit, particularly on the retail side. This is an important characteristic that sets Russia apart from many other countries, particularly developed ones, which currently experience strong deleveraging in corporate and household sectors.

*Investment is lagging*

An essential side of the economy that still lags behind is investment. Although the credit growth points towards improvement in this area in the coming months, corporate investment programs remain rather cautious. The government is exploring several ways to encourage investment (the creation of an innovative incubator near Moscow, nanotech programs, lighter oil taxation). However, these are yet to produce significant results.

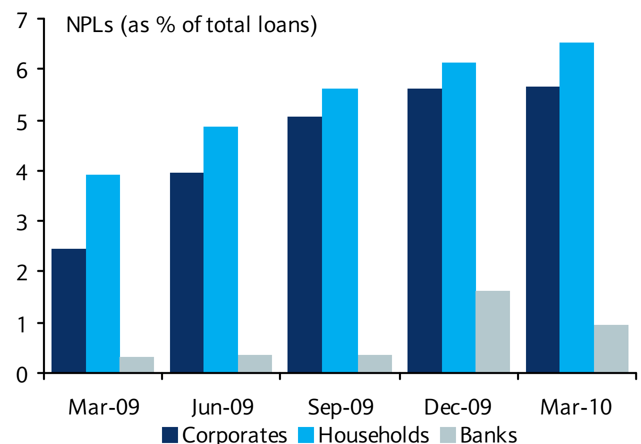
Overall, the Russian economy looks firmly set on the recovery path. A lower inflation trend will support the consumer sector recovery and extend the period of low policy interest rates. The risks remain primarily external, with oil prices and the global rebound being the most important.

**Figure 5: Banks began to rebuild their loan books…**




Source: Haver Analytics, Barclays Capital

**Figure 6: … although NPLs are still increasing**




Source: Bank of Russia, Barclays Capital

**Figure 7: Russian macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| Activity | | | | | | |
| Real GDP (% y/y) | 7.4 | 8.1 | 5.6 | -7.9 | 4.5 | 5.0 |
| Domestic demand contribution (pp) | 8.5 | 9.8 | 7.1 | -9.3 | 3.4 | 4.0 |
| Private consumption (% y/y) | 11.4 | 13.9 | 10.7 | -8.1 | 2.9 | 3.9 |
| Fixed capital investment (% y/y) | 18.0 | 21.1 | 10.6 | -18.2 | 3.2 | 4.0 |
| Net exports contribution (pp) | -1.1 | -1.7 | -1.5 | 1.4 | 1.1 | 1.0 |
| Exports (% y/y) | 7.3 | 6.3 | 0.6 | -4.8 | 8.3 | 6.4 |
| Imports (% y/y) | 21.3 | 26.6 | 14.9 | -30.9 | 16.9 | 10.5 |
| GDP (USD bn) | 990.0 | 1295.0 | 1679.5 | 1233.1 | 1410.3 | 1562.8 |
| External sector | | | | | | |
| Current account (USD bn) | 96.1 | 76.2 | 101.3 | 47.5 | 85.7 | 72.1 |
| CA (% GDP) | 9.7 | 5.9 | 6.0 | 3.9 | 6.1 | 4.6 |
| Trade balance (USD bn) | 125.5 | 111.1 | 154.6 | 92.1 | 115.0 | 97.3 |
| Net FDI (USD bn) | 6.6 | 9.2 | 19.4 | -7.3 | 5.0 | 7.0 |
| Net other capital inflows (USD bn) | -3.3 | 75.3 | -150.7 | -37.0 | -1.1 | 6.2 |
| Gross external debt (USD bn) | 313.2 | 463.9 | 479.4 | 471.6 | 470 | 500 |
| International reserves (USD bn) | 303.7 | 478.8 | 426.3 | 439.5 | 475.0 | 520.0 |
| Public sector | | | | | | |
| Public sector balance (% GDP) | 7.4 | 5.4 | 3.8 | -5.9 | -4.6 | -2.5 |
| Primary balance (% GDP) | 8.1 | 5.9 | 4.4 | -0.8 | 0.1 | 1.2 |
| Gross public debt (% GDP) | 9.4 | 7.6 | 5.6 | 6.0 | 7.9 | 7.4 |
| Prices | | | | | | |
| CPI (% Dec/Dec) | 9.0 | 11.9 | 13.3 | 8.8 | 6.1 | 6.8 |
| RUB / USD, eop | 26.3 | 24.5 | 29.4 | 30.2 | 29.5 | 30.5 |
| Urals oil price, avg | 61.2 | 69.5 | 95.1 | 61.3 | 80.0 | 91.0 |
| | **1yr Ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | -10.8 | 2.9 | 5.8 | 5.6 | 3.6 | 5.1 |
| CPI (% y/y, eop) | 11.9 | 6.0 | 5.8 | 5.8 | 6.1 | 6.5 |
| Exchange rate (eop) | 31.3 | 30.5 | 30.8 | 30.3 | 29.5 | 29.5 |
| Refinancing rate (%, eop) | 11.5 | 7.75 | 7.75 | 7.5 | 7.5 | 7.5 |

Source: Rosstat, Bank of Russia, Finance Ministry, Haver Analytics, Bloomberg, Barclays Capital

# EMEA: SOUTH AFRICA

## Recovery extends beyond the World Cup

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**South Africa's economy grew 4.6% in Q1, we have pushed up our full-year forecast to 3.3%. Happily, inflation has also fallen to a four-year low in April (4.8% y/y) and shows few near-term signs of rising back above 5%. With a cautious eye on external events, we expect the current record low policy rate (6.5%) to be maintained well into 2011.**

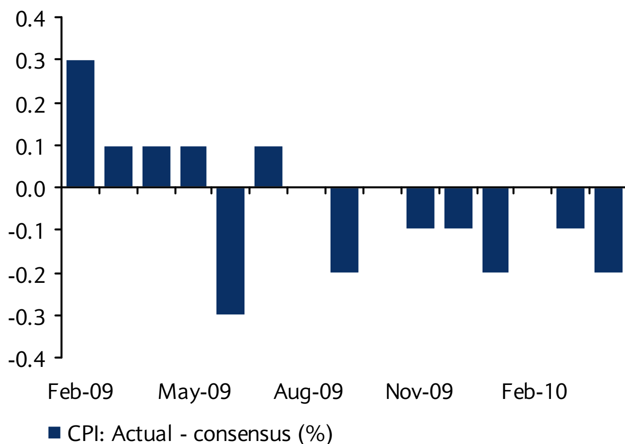
**Strategy:** We see limited upside potential for South Africa's credit rating at this juncture. This is due to the official fiscal projections showing only a slow pace of fiscal consolidation over the medium term. Since SOAF bonds have outperformed CDS recently and are now trading expensive, we recommend moving to underweight in our Global EM credit portfolio and recommend switching into Turkey. The SAGB market has benefitted from lower inflation and, more importantly, lower-than-expected prints. This has driven a downward adjustment in near-term inflation expectations, which along with strong foreign demand, provides current market support. Unfortunately, the medium-term inflation outlook is not as promising and together with nagging fiscal concerns ensures that we see more value in ILBs over nominal bonds on a strategic basis. Currently the rates market places a 50% probability of an additional repo rate cut, but we see this as too aggressive and instead we recommend carry efficient payer positions in the near-dated FRAs. The ZAR IRS curve trades well through bonds across the entire term structure, making payer positions in bond-swap spreads attractive, although triggers for timing are crucial. Notwithstanding, the Greece-inspired ZAR weakness in May, the currency has recovered most of the losses. In general, foreign investors chose not to reduce EM exposure, and the resuscitation of portfolio inflows into EM should see more flows to SA. We remain constructive on the ZAR outright, but on a relative value basis recommend going long TRY against ZAR.

### So far the economic recovery has surprised to the strong side

*Economic growth gained pace in Q1, with GDP rising by 4.6% at quarterly annualised rates*

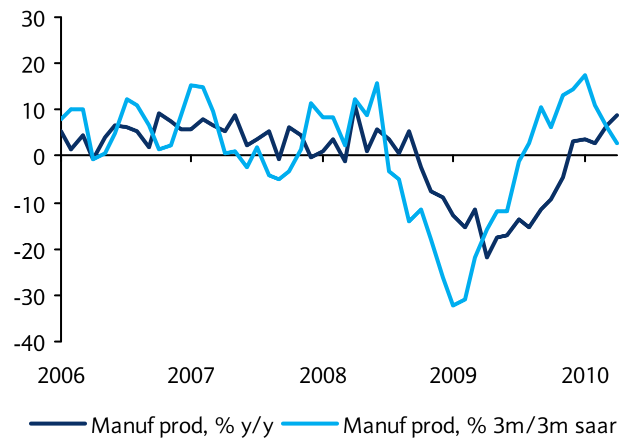
South Africa's recovery from last year's recession continues to impress, as Q1 GDP came in at 4.6% q/q saar (1.6% y/y). The release of production side data show that the further removed the sector is from the consumer, generally the stronger the cyclical recovery has been thus far. Output in the mining sector jumped by 15% q/q (6.5% y/y), the

**Figure 1: The last upside inflation surprise was in July 2009**




Source: Bloomberg, Absa Capital

**Figure 2: Manufacturing's cyclical recovery has impressed**




Source: StatsSA, Absa Capital

manufacturing sector grew by 8.4% (3.1%), and growth in the tertiary sector reached 2.7% (1.1%) in Q1. Importantly, all sectors of the economy are now growing again, attesting to the broad-based – if still somewhat tepid – economic recovery.

*Business confidence remains fragile, following on from last year's downturn*

Psychologically, the pain of last year's recession remains fresh, however: for example, note the vulnerability of business confidence, which slipped back 9 points to +36 in Q2 as headline concerns over potential spillovers from Europe's debt problems rattled markets and the country's own transport workers strike hit business logistics. These same factors also have impacted the PMI, which has slipped back to 51.9 points below the February high.

*Households are starting to respond to the favourable push from record-low policy rates*

For the markets, we believe that the outlook for the South African consumer is the key. Expenditure-side GDP data will only be available on 24 June, but from the higher frequency data we see evidence to suggest that households are beginning to feel more comfortable as the record-low interest rates from the SARB filter into lower debt servicing costs. Consumer confidence may have slipped one point in Q2, but at 14 remains well above its 10-year average of 5. Wealth effects continue to assist, with the equity market showing downside resilience and house prices up 15% y/y and to levels 11% above their 2008 peak. Retail sales bested expectations in the April reading (at 3.2% y/y) and the March figure was revised up significantly to 2.7%, while auto sales have jumped 28% y/y in the latest figure.

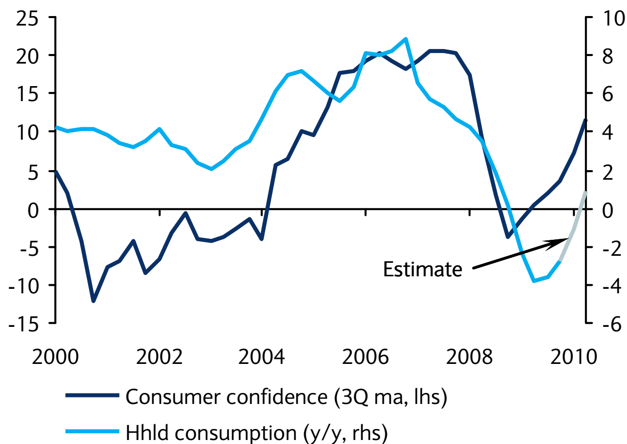
*It is important not to mix growth rates with levels; however, in level terms much improvement is needed before the activity peak of 2008 can be attained*

Admittedly, optimism is tempered when variables are considered in level rather than growth rate terms. Auto sales have been growing at a double-digit pace for five consecutive months, but in level terms they are still more than 35% down from their 2006 peaks. Private sector credit extension remains flat-lined, and outside some growth in mortgage extension, other components of consumer credit are actually still shrinking (marginally) on a y/y basis. Part of the explanation may be the labour market: with about one million jobs lost since the beginning of 2009, we believe that interest rate policy can do only so much to improve the credit quality of those freshly unemployed. This may continue to weigh on aggregate credit quality and credit growth for some time.

*We see GDP growth of 3.3% this year*

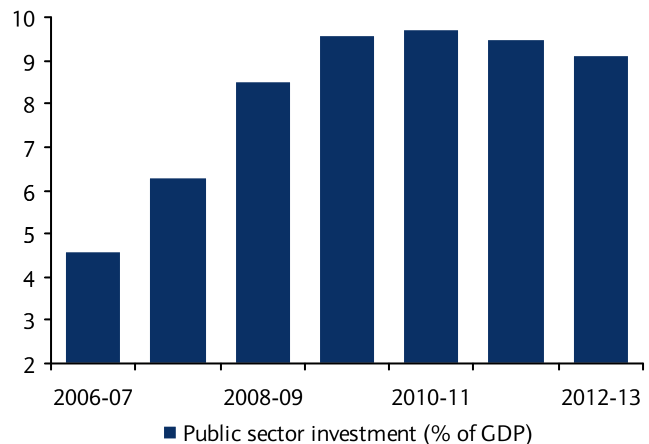
That said, we remain generally upbeat on the recovery, and have recently upgraded our full-year forecast to 3.3% (from 3.1%). We expect q/q growth rates to remain above 4% for the remainder of the year. In level terms, this would see the economy rise above its previous peak during Q2 10. In the near term, the impact of the World Cup remains one key

**Figure 3: Improving consumer confidence trend bodes well for consumption spending growth**




Source: SARB, Absa, Absa Capital

**Figure 4: Public sector investment spending to continue well beyond the Soccer World Cup**




Source: National Treasury, Absa Capital

uncertainty, as our macro models continue to show little overall impact on GDP (and that impact spread over two quarters) while a look outside our Johannesburg office window suggests a greater influence. Concern that there will be a post-World Cup slump in infrastructure spend sits at odds with the plans of the broader public sector (particularly in the areas on power and transport). May's transport workers' strike will also introduce some volatility into the near-term macro figures.

*In terms of monetary policy, March's rate cut was made possible by a favourable move down in inflation and we see CPI remaining below 5% y/y for most of 2010*

For the MPC, we believe there are three focus issues. The first, clearly, is inflation, where the recent CPI prints have continued to impress on the downside. At 4.8% y/y in April, consumer inflation has fallen to its lowest level since May 2006, led by goods' price inflation (at 3.5% y/y). Food price inflation also remains extremely benign (0.3% y/y) and even the inflationary impact of the rand's depreciation against the USD disappears when considering that on a trade-weighted basis, by mid-June the rand was trading 5% strong to its Q1 10 average, and 15% stronger than its 2009 average. We have pushed our 2010 inflation forecast marginally lower again, and now expect a trough of 4.4% in Q3 and remaining below 5% for most of the year. We believe that the Reserve Bank's central forecast is also likely to be tweaked lower in the coming MPCs. Administered prices, which are currently rising 11.6% y/y, are one key upside risk, although we expect the SARB to look through this pressure when considering rates. Even signs of high real wage growth may not cause undue alarm at the MPC as firms seem to be matching their higher wage settlements with employment losses.

*The MPC will also look at the labour market and global risks when considering the right monetary stance*

The MPC is also looking closely at the real economy and whether monetary policy is sufficiently loose to help ensure a smooth recovery path. On the evidence that the SARB has already begun pushing its GDP growth outlook higher, and that the weakness in credit extension may be more about a labour market problem than a policy rate problem, there appears little to be gained from further monetary stimulus. The third focus for monetary policy will be an external one, and reflects the MPC's desire to watch carefully for any sign that the impact of the debt challenges in Europe might generate a spill-over into SA.

*We believe rates will be left on hold until well into 2011. There is a minority of analysts that expect 50-100bp in further rate cuts before the end of this year*

Where does this leave the outlook for policy rates? Although the comfortable CPI outlook over the coming months could provide some room for a further rate cut, the generally stronger-than-expected outturn in the real economy suggests that enough monetary stimulus had already been delivered, and some uncertainty around the impact from global events argues for a cautious approach to policy. As a baseline, then, we now expect policy rates to be held at the current 6.5% into mid-2011, which is later than our previous expectation.

*Portfolio flows are running slightly ahead of last year's record-setting pace, helping to support the rand even as fears over Europe hit some risky assets*

We see local interest rates as largely neutral for the currency. Q1 balance of payments data will be released on 24 June, but from tracking the monthly trade data (the trade deficit is just over half that of a year earlier), we see only a small deterioration of the current account deficit to 3-4% during 2010. Global risk appetite, and in particular portfolio flows, have been critical currency drivers. In line with the global trend in EM flows, South Africa has continued to see significant portfolio inflows this year. Through 15 June, portfolio inflows have totalled R52bn this year, somewhat ahead of the run rate that generated last year's record R102bn inflow. These inflows have been sufficient to see the rand retain a broad range against the USD, and to appreciate against other major trading partners. On a view that the major moves in G7 currency pairs have already been delivered, fundamentally we see the rand retaining its 7.40-7.90 range for the coming quarters.

*Fiscal consolidation is a global theme currently, but we expect little market pressure – or policymaker action – in South Africa as debt levels remain low when compared its global peers*

Despite the increasing focus on fiscal issues globally, we believe that this will remain a peripheral issue in South Africa. Finance Minister Gordhan announced recently that the preliminary 2009-10 budget deficit outcome was 6.7% of GDP (against an official estimate of 7.3%). Our expectation for the economy to perform somewhat better than the Treasury's estimates is likely to lead to the budget deficit narrowing to around 5.7% in 2010-11. Although there is a global push towards a greater commitment to deficit normalisation, South Africa's favourable starting point in terms of debt levels means that an explicit tightening of fiscal policy through hiking existing taxes or cutting expenditure remains unlikely. Rather, the introduction of perhaps new consumption-based "green" taxes similar to the vehicle emissions tax introduced in the past budget, and not fully compensating tax payers for the effects of bracket creep, could see an implicit tightening of fiscal policy as the tax burden creeps modestly higher in coming years.

**Figure 5: South Africa macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 5.6 | 5.5 | 3.7 | -1.8 | 3.3 | 4.5 |
| Domestic demand contribution (pp) | 5.8 | 5.7 | 3.8 | -1.9 | 3.4 | 4.7 |
| Private consumption (% y/y) | 8.2 | 5.5 | 2.4 | -3.1 | 1.2 | 4.0 |
| Fixed capital investment (% y/y) | 13.8 | 14.2 | 11.7 | 2.3 | 4.5 | 5.9 |
| Net exports contribution (pp) | -0.2 | -0.2 | -0.1 | 0.1 | -0.2 | -0.3 |
| Exports (% y/y) | 5.6 | 5.9 | 2.4 | -19.5 | 1.5 | 7.3 |
| Imports (% y/y) | 18.8 | 9.0 | 1.4 | -17.4 | 7.4 | 9.1 |
| GDP (USD bn) | 261 | 286 | 280 | 290 | 348 | 379 |
| **External sector** | | | | | | |
| Current account (USD bn) | -13.8 | -20.6 | -19.9 | -11.5 | -12.7 | -18.7 |
| CA (% of GDP) | -5.3 | -7.2 | -7.1 | -4.0 | -3.6 | -4.9 |
| Trade balance (USD bn) | -4.2 | -5.9 | -3.6 | 0.3 | 1.1 | -1.0 |
| Net FDI (USD bn) | -6.3 | 2.8 | 10.1 | 4.1 | 0.4 | 0.8 |
| Other net inflows (USD bn) | 23.9 | 25.3 | 8.8 | 10.5 | 13.1 | 17.5 |
| Gross external debt (USD bn) | 59.4 | 75.3 | 71.8 | ... | ... | ... |
| Net international reserves (USD bn) | 23.0 | 31.3 | 33.5 | 39.0 | 41.3 | 42.6 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 5.8 | 9.0 | 9.6 | 6.3 | 5.2 | 5.9 |
| CPI (% average)-new weights/base | 4.7 | 7.1 | 11.5 | 7.1 | 4.9 | 5.7 |
| Exchange rate (USD/ZAR, eop) | 6.97 | 6.79 | 9.30 | 7.37 | 7.59 | 8.03 |
| Exchange rate (USD/ZAR, period average) | 6.77 | 7.06 | 8.26 | 8.44 | 7.61 | 7.70 |
| **Public sector** | **2006-07** | **2007-08** | **2008-09** | **2009-10** | **2010-11** | **2011-12** |
| Budget balance (% of GDP) | 0.6 | 0.9 | -1.2 | -6.7 | -5.7 | -4.8 |
| Primary balance (% of GDP) | 3.5 | 3.4 | 1.2 | -4.1 | -3.2 | -2.5 |
| Total government debt (% of GDP) | 26.1 | 23.2 | 22.7 | 28.2 | 33.2 | 37.3 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | -2.7 | 1.6 | 3.2 | 4.1 | 4.4 | 4.4 |
| CPI (% eop)-new weights/base | 8.4 | 4.8 | 4.5 | 4.6 | 5.2 | 5.6 |
| Exchange rate (USD/ZAR, eop) | 8.05 | 7.43 | 7.70 | 7.73 | 7.59 | 7.57 |
| Monetary policy benchmark rate (%, eop) | 7.50 | 6.50 | 6.50 | 6.50 | 6.50 | 6.50 |

Source: Barclays Capital

# EMEA: SOUTHERN AFRICA

## Global jitters unlikely to derail economic recovery

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**Economic activity in the region has been brisk thus far in 2010 and we look forward to continued buoyant growth despite global downside risks. Global uncertainties mean that most central banks are likely to postpone monetary policy tightening until next year, while the outlook for currencies is more uncertain.**

**Strategy:** Across our focus area in southern Africa, short-term yields remain at unattractive levels. Lower inflation and improved liquidity conditions in H2 09 and in early 2010 drove yields lower albeit the downtrend in yields appear to have turned. Although the picture varies, inflation is picking up in many countries and we expect this trend to continue into 2011. As such, we expect Treasury bill yields to continue their uptrend during the remainder of the year. On the other hand, there are some opportunities in longer-dated assets, in Zambia specifically. Despite liquidity issues, we favour Zambian long-term yields which are still in double-digit territory.

### Inflation a concern

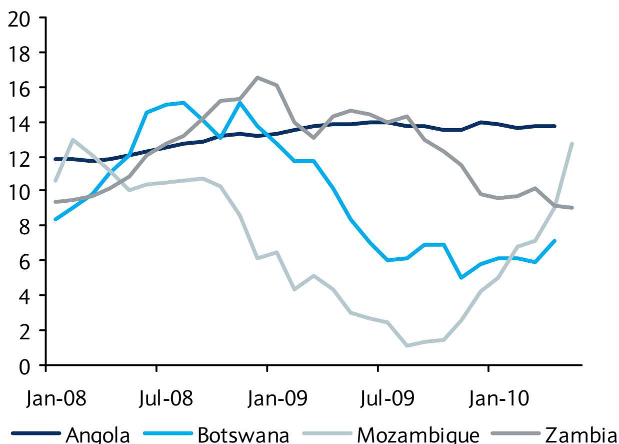
*Inflation picking up in southern Africa*

With the exception of Mauritius and Namibia, inflation is a concern in the region. Angola's inflation remains sticky at around 14%, Botswana's rate is outside its target band, while Zambia's inflation is just above 9%. Mozambique's inflation accelerated from 4.2% y/y at the end of 2009, to 12.7% in May, forcing its central bank to raise the interest rate on the standing lending facility by a cumulative 300bp this year. We anticipate further tightening in H2 in Mozambique as inflation is likely to rise further. Despite inflation being outside the target zone in Botswana, we do not anticipate any policy rate tightening until H1 2011, as the economy is still recovering from recession. In Zambia, the central bank is confident that inflation will fall to its targeted 8% by year-end, although we believe that will be difficult to achieve.

*Currencies may show some appreciation against USD towards year-end*

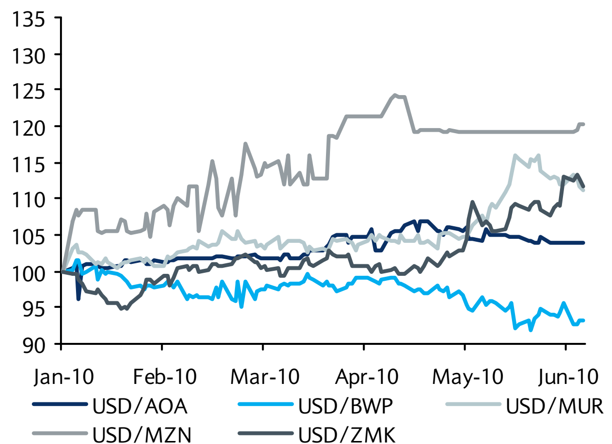
The weakening currencies may have some impact on inflation in the near term, although over the medium term, we expect the impact to be limited. Currencies have come under severe pressure from the strong USD in recent months, although it has appreciated against some other major currencies. The MZN and the ZMK depreciated by 16% and 12%, respectively, against the USD, year-to-date, followed by the MUR (-11%), SCR (-9.9%), BWP (-7%), NAD (-5%) and Angola (-4%). Once the global uncertainties taper off, we expect improved inflows, firm export revenues and a slightly weaker USD to be supportive of currencies towards year-end.

**Figure 1: Inflation a concern in several countries**




Source: Statistical offices, Absa Capital

**Figure 2: Currencies under pressure so far this year [1]**




Note: 1 Exchange rates indexed to 1 January 2010=100. Source: Reuters, Absa Capital

*We remain upbeat on growth prospects despite global uncertainties*

Substantial policy stimulus, multi-lateral support, higher export revenues and improved capital inflows underpinned economic growth going into 2010. However, the euro area crisis and the increase in risk aversion have spilled over to Sub-Sahara Africa, with currencies weakening and capital inflows also being affected. Nonetheless, despite the dampening impact that current global uncertainties may have on growth prospects, we believe the economic recovery will continue to gain traction.

*External accounts improving*

External accounts across the region are improving as higher average commodity prices continue to benefit trade balances. In Zambia, higher average copper prices and production levels continue to underpin the current account, which we expect to narrow to -3.2% of GDP in 2010. In Angola, higher oil export revenues are likely to push last year's small deficit to a healthy surplus this year. The outlook for current accounts in the rest of the region also appears upbeat and we expect a narrowing in deficits across the southern African region.

*Divergent fiscal trends across the region*

The region's has, however, very divergent fiscal trends. Botswana, Namibia and Mauritius' fiscal positions show deterioration this year as revenues are expected to remain under pressure, while infrastructure commitments put pressure on spending. Botswana, which saw a collapse in revenues, is expecting another substantial deficit in 2010-11 (12.2% of GDP versus -15.1% in 2009-10). It aims to balance its budget within three years although this could be difficult to achieve given lower anticipated SACU receipts resulting from lower imports, relaxation of tariffs and a possible change in the SACU revenue-sharing formula. We expect this to hit Botswana and Namibia hard as SACU receipts contribute substantially to total revenues. Zambia, in turn, is looking to narrow its deficit to 2.9% of GDP in 2010 (3% in 2009), while Angola is likely to record a sizeable surplus as a result of higher oil export revenues – we expect a surplus of 6.5% of GDP, from -7.3% in 2009.

*Angola and Zambia planning sovereign bond issuances later this year*

Despite more favourable fiscal positions, Angola and Zambia have recently announced plans to issue sovereign bonds in H2, which will be used to expand infrastructure. We expect Angola's bond issuance to be much smaller (possibly USD2bn) than the originally envisaged USD4bn, while Zambia is planning a USD1bn bond. Angola recently received its credit rating from three agencies (B+/B1/B+ from S&P/Moody's/Fitch, respectively). We believe that Angola's bond yield may be higher than that of similarly rated Ghana, which now has an established record of debt servicing through a major economic crisis. Depending on the final issuance size, a premium of around 100bp for the new Angola bond over the Ghana 17s seems justified, in our view. We expect Zambia to receive a rating much later this year and given its generally sound macroeconomic fundamentals, stable political situation and low debt levels, we also expect a rating of B+.

**Figure 3: Macroeconomic forecasts of selected countries in southern Africa**

| | Angola | | | Botswana | | | Mauritius | | | Zambia | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010F | 2011F | 2009 | 2010F | 2011F | 2009 | 2010F | 2011F | 2009 | 2010F | 2011F |
| Real GDP (% y/y) | -0.4 | 10.9 | 13.5 | -6.0 | 6.4 | 3.6 | 2.2 | 4.1 | 3.7 | 6.3 | 6.6 | 7.1 |
| CA (% GDP) | -3.2 | 5.2 | 12.4 | -7.4 | -3.4 | -1.9 | -7.8 | -8.5 | -9.1 | -4.6 | -3.2 | -3.6 |
| External debt (% GDP)* | 21.1 | 22.2 | 22.6 | 2.4 | 15.9 | 18.6 | 6.2 | 6.5 | … | 9.9 | 10.2 | 10.4 |
| Overall fiscal balance (% GDP)* | -7.3 | 6.5 | 8.6 | -5.4 | -15.1 | -12.2 | -3.9 | -5.0 | -4.0 | -3.0 | -2.9 | -2.5 |
| CPI (% y/y, eop) | 14.0 | 12.8 | 11.3 | 5.8 | 8.0 | 9.3 | 1.5 | 5.1 | 7.2 | 9.9 | 8.4 | 13.3 |
| Currency per USD (eop) | 89.15 | 90.00 | 89.50 | 6.66 | 6.97 | 7.12 | 29.50 | 31.99 | 30.20 | 4641 | 4900 | 4300 |
| Benchmark policy rate (%, eop) | 30.00 | 30.00 | 25.00 | 10.00 | 10.00 | 10.50 | 5.75 | 5.75 | 7.00 | n/a | n/a | n/a |

Note: *Fiscal balance and external debt figures reflect fiscal years ending in the years indicated. Source: IMF, Official offices, Reuters, Absa Capital

# EMEA: TURKEY

## Safe enough to carry bonds

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**The economy's rebound is strong and the evolving macro pattern looks similar to that of previous post-crises recoveries. Turkey's financial resilience is much improved, however, and the public debt dynamics look solid. Financing a widening current account deficit and stubborn inflation remain the key challenges. However, capital flows have picked up and inflation prints surprised on the downside, pushing potential rate hikes further out. We recommend holding TRY bonds FX-unhedged.**

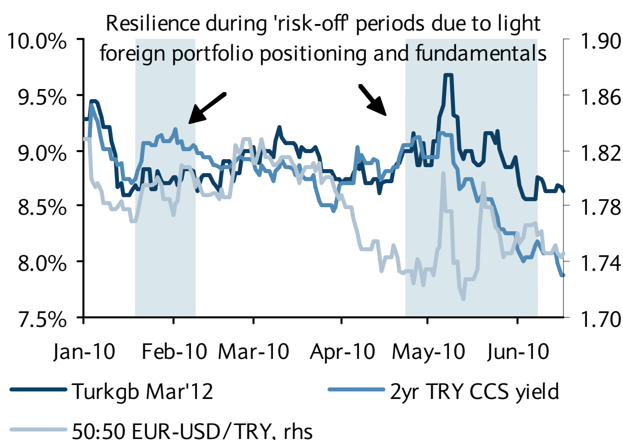
*Strategy:*
*- Long 2y nominal TRY bond*
*- Long TRY/ short ZAR*
*- Buy Turkish credit versus South Africa*

**Strategy:** The favourable fiscal and inflation developments in Turkey provide a 'sweet spot' for nominal bonds. The likely gradual pace of monetary tightening is already priced in and the low CCS yields should help to pull down bond yields. We recommend buying 2yr nominal bonds (TURKB'12 at the current 8.66% yields) FX unhedged. These offers investors one of the highest potential carry/roll in EMEA, to about 55bp/m FX unhedged (13bp/m hedged). Offshore positioning is relatively light, suggesting limited sell-off potential during bouts of risk aversion. We recommend funding out of both EUR and USD (50:50) to neutralise the impact of EUR/USD swings. As a tail risk trade in EMEA, for a scenario of prolonged risk aversion, we recommend long TRY/short ZAR FX. This offers positive potential carry with relatively more favourable FX technicals (eg, large local FX deposits) in Turkey. We also recommend overweighting Turkey versus South Africa in our Global EM credit portfolio. Turkish cash credit trades at a significant negative basis to CDS and the strong economic rebound with solid growth and fiscal outperformance argues for a positive outlook for Turkish credit. Passing of the proposed fiscal rule could trigger further rating upgrades, consolidating the country's path towards investment grade space in the medium term.

*Favourable developments since last EM Quarterly*

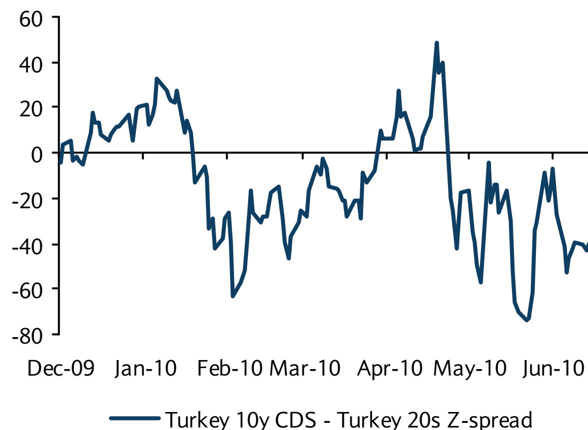
Since our last EM Quarterly in early March, developments in Turkey have been quite favourable on most fronts: growth, inflation, fiscal outlook and politics. The rebound in GDP growth this year is likely to reach above 6%. Growth in Q4 09 was stronger than expected: 6% y/y and 2% q/q on a seasonally adjusted basis. This implies that the economy shrank less than anticipated in 2009 and also creates a robust 'carry-over' into 2010. Data have been very robust thus far: IP grew at an average of over 17% from Jan-Apr, the CBT's real confidence index is at levels last seen in early 2007 and PMI components have remained robustly in

**Figure 1: Local bonds to remain resilient against risk aversion**




Source: CBT Bloomberg, Barclays Capital

**Figure 2: CDS-cash basis firmly in negative territory again**




Source: Bloomberg, Barclays Capital

*Domestic demand supported by robust credit growth*

expansionary territory. In contrast to the rest of non-commodity exporting emerging Europe, the rebound is driven not just by an export recovery and re-building of inventories. Domestic demand is supported by accelerated lending by local banks to consumers and corporates (to the latter mainly in FX). The unemployment rate started to decline in Q1 on seasonally adjusted terms, albeit remaining at relatively elevated levels (12.7% in SA terms). Certainly, base effects play an important role in the high y/y increases and also the pace of domestic lending – in part a function of competition among banks and their need to compensate for lower interest margins with higher volumes – is unlikely to be sustained throughout the year. However, with our estimate for Q1 y/y GDP growth possibly to exceed 13%, our growth forecast of 6.3% for the year as a whole could even be conservative. We expect growth to moderate towards 4% in 2011.

*Current account widening rapidly…*

*…and TRY is near its all-time high in real effective terms*

The flipside of our further upward revision in growth for 2010 is also a larger-than-expected current account (CA) deficit. Since end-2009, when the 12-month rolling deficit reached USD 14bn (just above 2% of GDP), it has climbed back to c.USD25bn (in April this year) – faster than we had expected. While energy prices behaved more or less in line with our assumptions, import volumes drove the growing non-energy trade deficit. With our forecast of robust growth and gradually rising oil prices to above $/b 90 by end-2010, we now expect the CA deficit to widen to up to USD35bn in 2010, reaching roughly 5% of GDP. Notably, due to Turkey's relatively high inflation, TRY is close to its all-time highs in real effective terms.

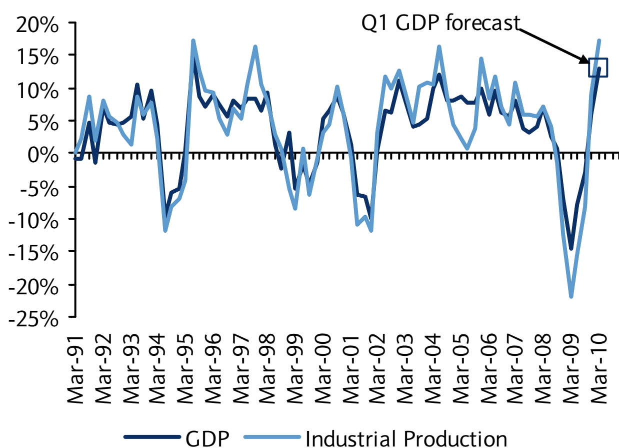
*External financing is key challenge*

*Quality of flows has deteriorated…*

*…but net capital inflows increased in recent months*

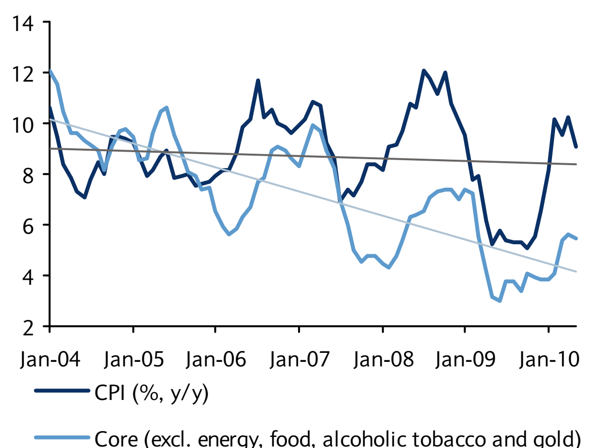
This leaves external financing one of the main risks to the performance of TRY assets. Turkey's gross external financing needs in 2010 (current account deficit plus external debt repayment) add up to USD75-80bn. In the post-Lehman environment, the composition of capital flows has shifted from external corporate borrowing and FDI to banks' external assets draw-downs, unidentified inflows (errors and omissions) and proportionally more portfolio inflows. There are some particular reasons for this: eg, changed regulation now allows local banks to lend to local corporations directly in FX, eliminating the need for Turkish banks to use their foreign subsidiaries to carry out such lending: this previous 'round-tripping' had resulted in loans from Turkish banks to Turkish corporations being registered in statistics as 'foreign lending'. Consequently, lending is now taking place onshore and Turkish banks repatriate their FX deposits held abroad to provide these FX loans onshore. However, the fact that FDI inflows have not recovered yet is not a mere statistical issue. They are being replaced by portfolio and 'unidentified' inflows (in part explained by foreign asset repatriation by residents in response to tax amnesty schemes), which could prove to be more fickle in nature. The quality of the

**Figure 3: A deep dip followed by a sharp rebound**




Source: Turkstat, Barclays Capital

**Figure 4: Core inflation still trending down**




Source: Turkstat, Barclays Capital

inflows aside, however, it must be noted that in aggregate, capital flows have improved in recent months. In April, the capital account for the first time exceeded the current account deficit, the first surplus since September 2008. Moreover, the government seems determined in its privatization programme, in particular in the energy sector, which should also brighten up the outlook for FDI and/or longer-term external borrowing.

*Government committed to privatisation (including FDI)*

*Inflation started to surprise on the downside, lowering the forecasted inflation path*

Inflation had accelerated faster than expected early in the year, but after peaking at 10.2% y/y in April, the May print came in much lower than expected at 9.1% y/y. This was largely the result of a large drop in food prices, apparently associated with the government's permission of meat imports, which could make the effect more structural. We forecast inflation to moderate to 7.7% by end-2010. While this would be markedly above the 6.5% target for end-2010, y/y inflation could drop towards the target in Q1 11, albeit temporarily, helped by base effects. Also, thus far the increase of the CBT's favoured core inflation indices H and I has been contained to 5.0-5.5, leaving the longer-term downward trend intact. Indeed, the CBT's communication has increasingly focused on core inflation measures.

*CBT likely to delay hikes further, possibly implementing only a token 50bp hike in Q4*

*Reduced risk premium allows for lower real rates*

We believe the more benign inflation backdrop combined with the further delays in monetary policy tightening in core markets will also shift the CBT's rate hikes further back. We think the CBT is likely to start in Q4 but may contained to a token 50bp hike just to signal its seriousness, in particular as headline inflation is likely to moderate in Q1 helped by base effects and the US Fed is unlikely to hike until Q2 11. The question is how much would high policy rates have to rise again once the output gap has closed? After the CBT started to target inflation under a floating exchange rate following Turkey's banking crisis in 2001, real policy rates remained in a corridor between 11% and 7%. We think these high rates were largely explained by the risk premium on TRY assets, which remained high in the years after the 2001 banking crisis and decades of very high inflation. Currently, the policy rate is slightly negative and it would seem that a final nominal policy rate would have to reach at least 9.5-10% to lift the real policy rate to – 4-5%, assuming inflation expectations align with the 5.5% target.

*Fiscal performance has been impressive thus far*

*Deficit target should be easily met…*

*..and debt sustainability looks very solid*

This reduction in risk premium is largely the result of the much improved resilience of the domestic banking system and the solid fiscal sustainability outlook, which was re-confirmed during the global crisis. The fiscal performance has continued to be very robust in recent months. Supported by the strong growth, some tax increases, and apparently increased collection efforts, tax revenues rose significantly. In the first five months of the year, the primary surplus was already more than double the annual target. Thus, seasonality aside, the government looks on track to meet its 2010 fiscal target of 4.7% (using the EU definition), which should provide for a slight reduction in the debt to GDP ratio. Further fiscal deficit reductions set out in the government's medium-term fiscal plan should help to reduce the debt towards 40% of GDP within a few years. In short, although further improvements are possible (including the lengthening of local debt maturities), Turkey's debt dynamics appear comparatively safe. The proposed fiscal rule – lauded in the IMF's recent Art IV statement – seems to signal commitment to sound fiscal policy and could also lead to further rating upgrades once it is approved by parliament.

*The power of 'local bid'*

Another reason for greater stability is that FX and rates in Turkey are supported by 'local bid': about 90% of the domestic government debt is held by residents, mainly local banks, reducing the dependence on foreign buyers. Similarly, resident households hold close to USD60bn FX deposits in local banks, which they tend to sell in episodes of TRY weakness (and vice versa). This stabilises rates and FX compared with other markets in the region where local households are structurally short FX and/or foreigners hold significant shares in local bond markets.

*Remaining risks:*

*Potential lack of external financing*

*Acceleration of inflation*

*Domestic political considerations (referendum; early elections) could lead government to loosen fiscal again*

Notwithstanding our relatively constructive view on Turkey, there are risks. 1) The outlook for the economy and in particular TRY continues to be very dependent on the availability of sufficient external financing. 2) Headline inflation could be higher than forecasted and the CBT's generally dovish attitude could make it fall behind the curve. 3) Future fiscal performance highly depends on political will and we do not think the fiscal rule materially changes this, in particular as its enforcement mechanisms remain limited. Overall, political risks have calmed compared with earlier in the year, when conflict between the AKP government and the military related to the Ergenekon affair seemed to escalate (see *Turkey: Political risk is back*, 24 February 2010). This threat has abated and with a new opposition leader, the secular establishment may also see better chances in regaining power in the next election. The risk for another closure cases against the AKP is low, in our view. The question at this point seems whether the general election scheduled for mid-2011 could be brought forward by the government, if the constitutional court does not approve AKP's proposals for constitutional reform (for which a referendum is planned on 12 September). However, by now such a 'snap election' would bring forward the regular election schedule by not much more than six months. Certainly, AKP may be tempted to increase spending in the run-up to any election, but we would expect it to refrain from any policies/activities that would disrupt the markets.

**Figure 5: Turkey forecasts**

| | 2006 | 2007 | 2008 | 2009F | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 6.9 | 4.7 | 0.7 | -4.7 | 6.3 | 4.0 |
| Domestic demand contribution (pp) 1/ | 7.2 | 5.9 | -1.2 | -7.4 | 8.3 | 4.4 |
| Private consumption (% y/y) | 4.6 | 5.5 | -0.3 | -2.3 | 5.5 | 4.2 |
| Fixed capital investment (% y/y) | 13.3 | 3.1 | -6.2 | -19.2 | 7.8 | 6.0 |
| Net exports contribution (pp) | -0.3 | -1.2 | 1.9 | 2.7 | -2.0 | -0.4 |
| Exports (% y/y) | 6.6 | 7.7 | 2.8 | -4.3 | 7.9 | 7.0 |
| Imports (% y/y) | 6.9 | 10.6 | -2.8 | -13.8 | 16.0 | 8.0 |
| GDP (USD bn) | 529 | 653 | 740 | 620 | 707 | 812 |
| **External sector** | | | | | | |
| Current account (USD bn) | -32.1 | -38.3 | -41.9 | -14.0 | -34.0 | -40.0 |
| CA (% GDP) | -6.1 | -5.9 | -5.7 | -2.3 | -5.0 | -4.9 |
| Trade balance (USDbn) | -40.9 | -46.7 | -52.8 | -24.9 | -46.0 | -50.0 |
| Net FDI (USDbn) | 19.0 | 19.9 | 15.7 | 6.1 | 9.0 | 10.0 |
| Gross external debt (USDbn) | 207 | 249 | 278 | 271 | 277 | 287 |
| International reserves (USDbn) | 60.9 | 73.3 | 71.0 | 70.7 | 72.0 | 74.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | 1.2 | -1.0 | -2.2 | -5.7 | -4.7 | -4.5 |
| Primary balance (% GDP) | 7.3 | 4.8 | 3.1 | -0.1 | 0.6 | 1.0 |
| Gross public debt (% GDP) | 46.1 | 39.4 | 39.5 | 45.5 | 45.0 | 44.4 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 9.7 | 8.4 | 10.1 | 6.5 | 7.7 | 6.9 |
| USD/TRY, eop | 1.42 | 1.17 | 1.54 | 1.50 | 1.55 | 1.50 |
| | **1y ago** | **Last** | **Q2 10** | **Q3 10** | **Q4 10** | **Q1 11** |
| Real GDP (y/y) | -7.7 (Q2 09) | -6.0 (Q4 09) | 7.1 | 4.1 | 1.5 | 1.0 |
| CPI (% y/y, eop) | 5.7 (Jun 09) | 9.1 (May 10) | 8.6 | 8.6 | 7.7 | 5.7 |
| Exchange rate (USD/TRY, eop) | 1.54 | 1.54 | 1.55 | 1.55 | 1.55 | 1.50 |
| CBT policy rate (%, eop) | 8.75 (Jun 09) | 7.00 | 7.00 | 7.00 | 7.50 | 8.00 |
| Market implied rate (%, eop) | NA | NA | 7.00 | 7.50 | 8.00 | 8.50 |

Source: Barclays Capital; 1/ Includes contribution from change in inventory.

## EMEA: UKRAINE

# New old friends

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**The stabilised political situation has made a more coherent economic policy possible. The improved stance with Russia and advanced negotiations with the IMF should support the nascent growth. However, there remains a lot to be done by the new cabinet, particularly on the fiscal side.**

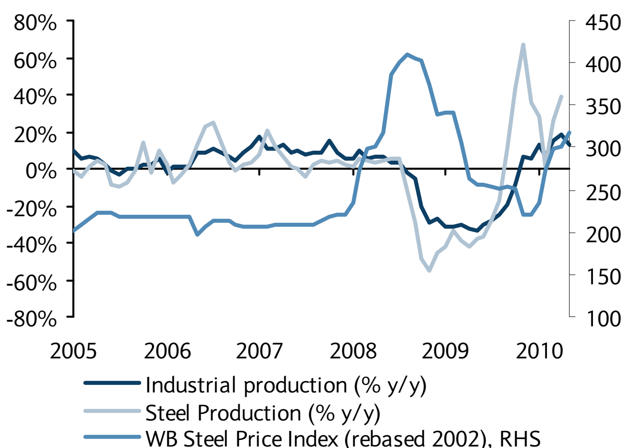
*Stay long the front end of the Ukrainian credit curve; long UAH/short USD via 6m T-bills on upside bounces of yield*

**Strategy**: Receding concerns about a near-term debt accident have been reflected in Ukrainian asset prices. Ukrainian credit spreads continued to outperform over the past quarter, and the curve steepened considerably (yet remained slightly inverted on the cash side). A successful completion of the talks with the IMF could provide a further boost to Ukrainian credit, yet the failure to reach an agreement by now has exposed the underlying challenges, particularly concerning the budget. While further spread compression may be limited until a breakthrough in IMF negotiations is reached (which remains our base case), the attractive carry continues to argue for an overweight/long Ukraine credit stance, in our view. We continue to prefer the short end of the curve because a planned new Eurobond issue would likely put some re-pricing pressure on the long end. In the local markets, we maintain our long UAH/short USD recommendation (we published this recommendation in the previous quarterly, arguing that investors should buy 6-month T-bills at the yields of 17% at the time). The central bank has continued to keep the USD/UAH exchange rate stable at about 7.90, allowing very little in the way of spot volatility, further bolstering the Sharpe ratio on the carry trade. The credibility of this policy stance has, in our view, improved in line with the BoP and the overall economy. However, new investors to the trade should wait for sporadic upside bounces of yield before buying. Recent auctions have seen 6-9 month yields drop to 13%, but only as the majority of bids were rejected. It is unclear if this stance can be sustained without the resumption of IMF loans.

*Better relations with Russia already brought strong economic gains*

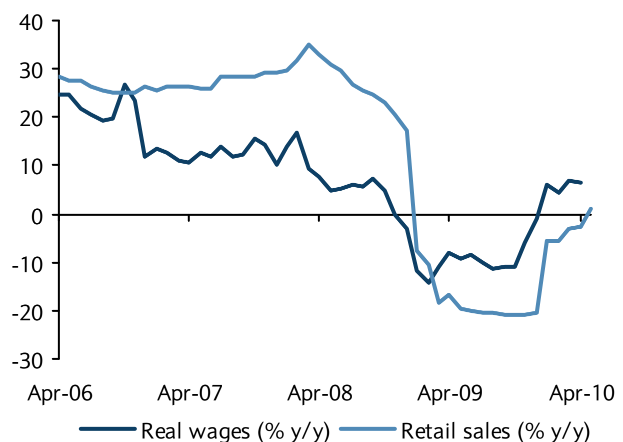
With the new president and the government firmly in place, internal political squabbles in Ukraine have drifted into the background, allowing top politicians to tend to pressing economic issues. This "refocusing" has already produced impressive results. A long-term gas supply agreement with Gazprom should cut the import bill significantly. A USD2bn loan from VTB boosted the currency reserves (above USD29bn as of 17 June). At the same time, the "costs" of reaching these agreements appear moderate (long-term lease on the

**Figure 1: Higher steel prices support industrial recovery**




Source: Haver Analytics

**Figure 2: Retail sales closely follow wage growth**




Source: Haver Analytics

Sevastopol base for the Russian navy, potential acquisitions and joint projects for Russian companies). The normalization of relations with Russia is clearly beneficial to both parties, and there remain many low lying fruits to be picked, even if smaller in size.

Although the main achievements are the result of improved relations with Russia, the government exercised a much broader agenda. It managed to restart the negotiations with the IMF, most recently inviting its two top European officials to Kiev. It is also important to note that a resumption of IMF financing should allow other lenders (EBRD, World Bank) to proceed with their programs. Judging by the IMF mission arrival in Kiev, the government has managed to make progress on the issues that derailed the current agreement in November.

*Reaching agreement with the IMF is still crucial*

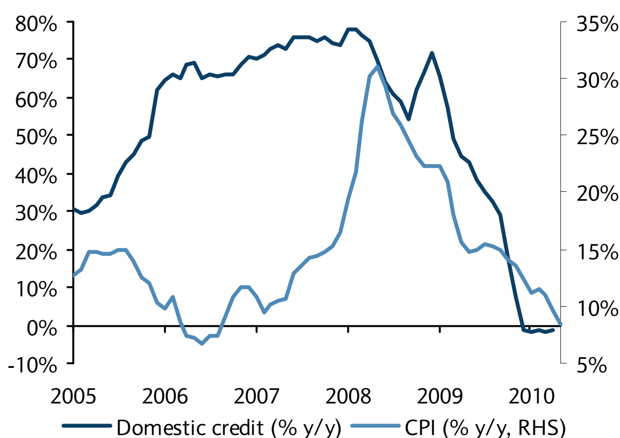
However, getting the remaining SDR4bn (USD5.9bn) of the IMF money – let alone signing a new agreement with a higher allocation – will not be easy, particularly because of different views on the budget. The key items are financing Naftogaz deficits, lifting internal gas prices for households and utilities, accounting for VAT refunds and expenditures required to recapitalize the banking system, and a continued revenue overestimation by the government compared with the IMF staff. The difference between the two parties currently sums up to about 3% of GDP, showing an improvement on the previous review. The gas price discount from Gazprom is already discounted, undoubtedly, and some upside growth risks provide a good base for revenues – but the gap is there and will now have to be negotiated. We maintain a successful compromise with the IMF as our base-case scenario but understand that this is far from a done deal.

*Finally, the growth is here*

Uncertainty due to the election delayed Ukraine's recovery from one of the region's worst downturns compared with its peers. A sharp recovery in Q1/Q2 was predetermined by the base effect, and improving external demand has played an important supportive role (IP has risen 12.6% y/y in January-May 2010, led by steel production and machine building, Figure 1).

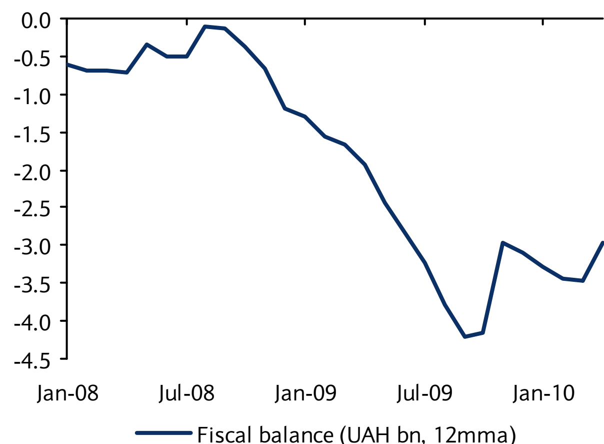
In previous commentaries, we alluded to the extreme lack of confidence felt by households in 2008-09 amidst the collapse of the Hryvnia, political developments and failings of the banking system. While the consumer sector is still lagging, pent-up demand and the improving political and economic conditions finally push consumption up. Retail trade volumes just crossed into the positive territory (1.1% y/y in January-May). Growing salaries (6.0% y/y in January-April), falling unemployment and inflation (8.5% y/y in April) pave a way for further improvements (Figure 2). Although post-crisis wage and household credit growth will be restrained, savings in FX and outside the financial system can be a catalyst.

**Figure 3: Low inflation is a particularly welcome trend**




Source: Ukrstat, Haver Analytics

**Figure 4: The budget gap is narrowing**




Source: Haver Analytics, Barclays Capital

Declining inflation is of particular importance for the consumer sector recovery (Figure 3). Ukraine still has a large share of its population living off social benefits, and a major portion of the household bill is spent on basic necessities. We believe this consideration will limit domestic gas price hikes, although the latter will still lead to a reversal of the inflation trend.

*Declining inflation will help consumer sector recovery*

The fiscal performance began to improve as well, with the 12-month average budget deficit shrinking below UAH3bn (4% of GDP) in April (Figure 4). However, we expect the end-of-year effect and delayed VAT rebates to worsen the performance, and the full-year budget to close with deficit of 6.5% of GDP (versus 5.0-5.3% being negotiated with the IMF).

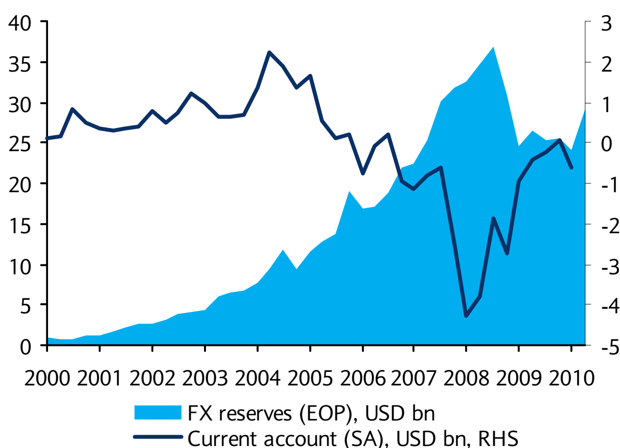
*Fiscal improvement will be short lived but external balances will show positive dynamics*

The external sector remains a bright spot, benefiting from higher metal prices (Figure 5). The 12-month trade deficit declined to USD1.7bn at the end of March versus USD10.7bn a year earlier, almost closing the current account gap (Q1 deficit was a mere USD69mn). The performance is set to improve in the short term.

The de-dollarization process continues on the back of the appreciating Hryvnia, as reflected in the outstanding currency balances held by residents. On the other hand, households are still cautious regarding switching deposits into the local currency (Figure 6). However, a stable Hryvnia should stimulate the resumption of the de-dollarization trend and further boost the NBU FX reserves. The recent reserve growth has eased concerns about debt repayments, and the government should easily cover its short-term obligations (about $3bn domestic, $4bn external in 2010-11). Banks have also reduced their FX exposure, with their total net foreign liabilities down to $16.8bn in April.

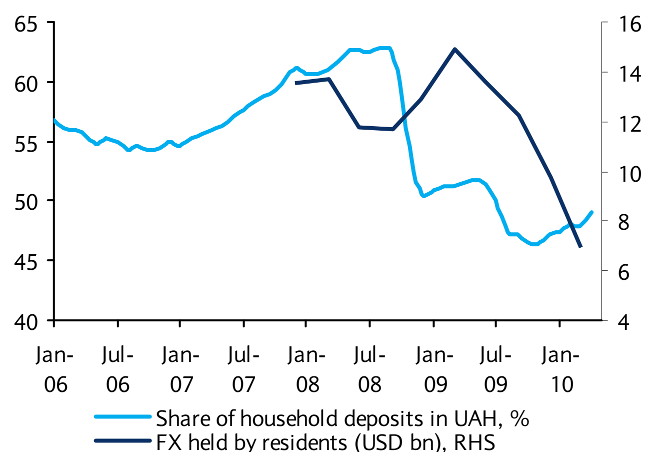
Despite these positive developments, the government faces a challenging task of putting the fiscal books in order and convincing the IMF that it will meet the key targets. No longer being under huge pressure to get the IMF funds and having Russian money as a back-up plan weakens the incentive. However, we see strong commitment among top Ukrainian politicians to resume the IMF program. It will be interesting to see what compromises are made to come to an agreement.

**Figure 5: The current account approached a balanced point**




Source: NBU, Haver Analytics

**Figure 6: FX holdings by residents are on the decline, although households remain somewhat hesitant**




Source: NBU, Haver Analytics

**Figure 7: Ukraine macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 7.3 | 7.6 | 2.1 | -15.1 | 5.4 | 4.5 |
| Domestic demand contribution (pp) | 14.0 | 16.8 | 8.2 | -26.8 | -3.2 | 6.0 |
| Private consumption (% y/y) | 15.9 | 17.2 | 10.2 | -12.4 | 2.8 | 5.0 |
| Fixed capital investment (% y/y) | 20.9 | 24.4 | 1.9 | -46.6 | 3.8 | 7.5 |
| Net exports contribution (pp) | -6.7 | -9.2 | -6.1 | 11.7 | 8.6 | -1.5 |
| Exports (% y/y) | -5.8 | 2.8 | 5.5 | -26.1 | 30.8 | 3.4 |
| Imports (% y/y) | 8.3 | 23.9 | 16.8 | -41.2 | 9.5 | 7.5 |
| GDP (USD bn) | 107.8 | 142.7 | 180.4 | 115.6 | 136.6 | 162.0 |
| **External sector** | | | | | | |
| Current account (USD bn) | -1.6 | -5.3 | -12.8 | -1.8 | 1.2 | -2.1 |
| CA (% GDP) | -1.5 | -3.7 | -7.1 | -1.6 | 0.9 | -1.3 |
| Trade balance (USD bn) | -4.6 | -9.0 | -16.9 | -2.8 | -0.8 | -4.6 |
| Net FDI (USD bn) | 5.7 | 9.2 | 9.9 | 4.7 | 7.7 | 9.5 |
| Net other capital inflows (USD bn) | -2.1 | 5.5 | 3.4 | -9.2 | -3.8 | -6.5 |
| Gross external debt (USD bn) | 54.5 | 80.0 | 101.7 | 104.0 | 110.0 | 130.0 |
| International reserves (USD bn) | 22.4 | 32.5 | 31.5 | 26.5 | 31.2 | 32.0 |
| **Public sector** | | | | | | |
| Public sector balance (% GDP) | -0.7 | -1.1 | -1.5 | -4.1 | -6.5 | -4.7 |
| Gross public debt (% GDP) | 14.8 | 12.3 | 19.9 | 35.2 | 36.8 | 37.4 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 11.6 | 16.6 | 22.3 | 12.3 | 8.5 | 7.9 |
| UAH / USD, eop | 5.1 | 5.1 | 7.7 | 8.0 | 7.8 | 7.9 |
| | **1yr Ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (% y/y) | -17.8 | 4.8 | 6.4 | 5.5 | 5.0 | 5.2 |
| CPI (% y/y, eop) | 15.0 | 9.7 | 7.7 | 8.0 | 8.5 | 7.4 |
| Exchange rate (eop) | 7.6 | 7.9 | 7.9 | 7.9 | 7.8 | 7.8 |
| NBU policy rate (%, eop) | 11.0 | 10.3 | 10.3 | 10.0 | 10.0 | 10.0 |

Source: Ukrstat, NBU, Finance Ministry, Haver Analytics, Barclays Capital

# EMEA: WEST AFRICA

## Growing economic momentum but looming risks

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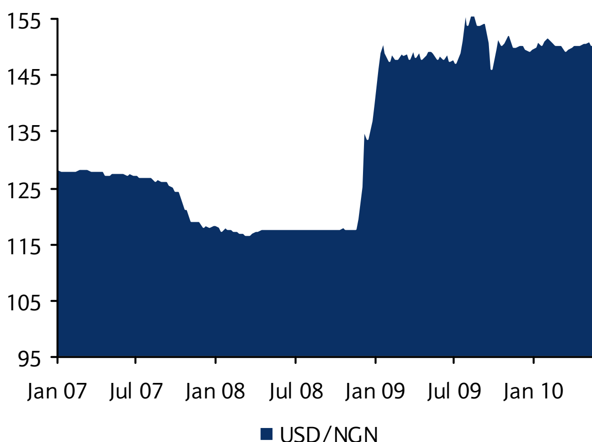
**Economic growth continues to improve, underpinned by higher oil export revenues and infrastructure development. In addition, the positive long-term outlook for oil bodes well for overall growth. However, Nigeria's political and fiscal problems and Cote d'Ivoire's political uncertainties continue to weigh on their respective economies.**

**Strategy:** West African currencies remained resilient despite the strong USD – Nigeria's central bank continues to intervene to keep the naira at about 150 per USD, while Ghana's cedi is buoyed by attractive yields, gaining 0.8% against the USD year-to-date. We expect higher oil inflows to push the naira to just below 150/USD by year-end, while the GHS may find support from oil-related inflows and a slightly weaker USD exchange rate, resulting in a year-end level of about 1.40/USD. Though still offering the most attractive yields in SSA, Ghanaian short-term yields are declining steadily. Inflation continues to fall, although we believe it may have bottomed in May when it fell to 10.7% y/y. Steep utility price increases, effective 1 June, put upside risk to the inflation picture, and we expect the Bank of Ghana (BoG) to miss its 7.2-11.2% year-end inflation target. Nonetheless, continued weak demand conditions may convince the Bank of Ghana to ease monetary policy further at its July MPC meeting, and we have pencilled in another 50bp cut. Hereafter, we expect monetary policy to remain on hold until H1 11. Nigeria's inflation has remained in double digit territory (11% y/y in May), and its outlook is clouded by a surge in fiscal spending and the planned withdrawal of fuel subsidies this year. Hence, we expect monetary policy to remain on hold for the foreseeable future.

*We recommend overweighting Ghana 17s versus Gabon 17s and recommend buying Cote d'Ivoire's 32s*

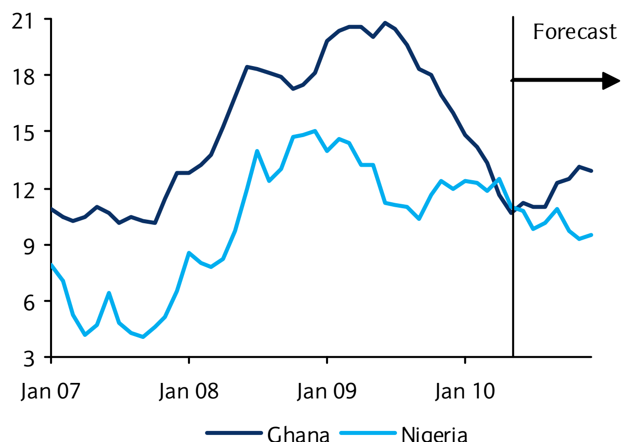
As outlined in *Sub-Saharan African Credit – A growing Story* (3 June 2010), we recommend overweighting Ghana 17s versus Gabon 17s among SSA benchmark credits. The bonds have been trading range-bound to each other for some time, and while we acknowledge Gabon's stronger fiscal position, we think the positive oil outlook and cheaper valuations argue for some outperformance of the Ghana 17s. We also recommended buying Cote d'Ivoire 32s, mainly based on technical arguments. We think that after the successful exchange, short-term investors have likely used the recent market weakness to clear their positions. We would expect interest from longer-term, index-oriented investors to continue to pick up over the next few weeks, however, as the bond enters benchmark indices. We target a cash price in the 60 area with a target yield of c.10%.

**Figure 1: CBN keeping naira at preferred USD/NGN150**




Source: Reuters, Absa Capital

**Figure 2: Inflation risks have increased (% y/y)**




Note: Nigeria CPI forecast excludes the effect of the removal of fuel subsidies.
Source: Statistical offices, Absa Capital

## Nigeria sets the pace

*Nigeria expected to grow over 7% in 2010*

West Africa's economic fortunes continue to hinge largely on its key export products – oil and cocoa – both of which are 20% higher on average so far this year compared with the corresponding period last year. This, coupled with substantial monetary policy stimulus and multilateral support, underpinned growth in H1 10. Nigeria, the region's largest economy, continues to set the pace in terms of growth despite struggling with the after-effects of last year's global fallout. Nigeria's National Bureau of Statistics (NBS) estimated that growth was as high as 6.7% y/y in Q1 10, down from 7.4% in Q4 09. The NBS projects a gradual rise in quarterly growth rates over the next few quarters, with overall real GDP growth expected at 7.5% from 6.7% in 2009, in line with our expectations. It expects the non-oil sector to again be the main driver of growth, with agriculture, trade and services the main growth contributors.

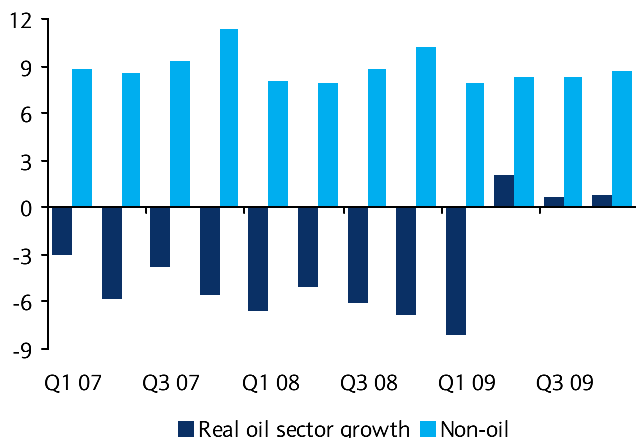
*Reforms in Nigeria's banking sector continuing*

Despite buoyant economic activity and the positive outlook in Nigeria, the CBN remains concerned about relatively weaker credit growth. Credit extension to the private sector (41% of GDP in 2009) was -6.8% y/y in March 2010; the reluctance to extend credit comes despite a significant improvement in the health of the banking sector following a series of actions and reforms by the CBN. In April, the CBN reiterated that it is working to improve the supply side of credit through various reforms to strengthen bank's balance sheets, remove toxic assets and fix the financial system to promote the flow of credit. The Amcon (Asset Management Corporation of Nigeria) Bill, which is aimed to prop up banks' balance sheets and unlock credit flow, was signed by the House of Representatives on 3 June and now awaits the Senate's approval. The CBN has, meanwhile, announced that it is determining the value of bad bank loans that will be purchased by Amcon (Reuters, 4 June).

*Ghana's economic growth solid, but demand side remains weak*

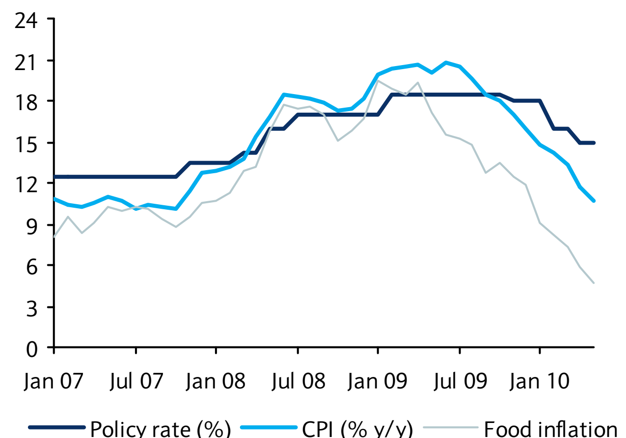
Ghana's real sector's performance in the first quarter disappointed as consumer demand remained weak. However, we believe that continued infrastructure spending, high average prices for its main exports (cocoa and gold) and substantial monetary policy easing should buoy activity throughout the year – we project overall growth of just above 6% for the full year (up from 4.7% in 2009). The favourable inflation environment has allowed the Bank of Ghana (BoG) to reduce the policy rate by 350bp over the past eight months, which is supportive to consumer demand. Of course, the outlook for 2011 is considerably more optimistic as a result of oil production, which we expect to commence by December 2010. We project growth of about 17% in 2011, assuming no significant delays in oil production.

**Figure 3: Non-oil sector underpinning Nigeria's growth (% y/y)**




Source: NBS, Absa Capital

**Figure 4: Ghana policy easing nears the end**




Source: BoG, GSS, Absa Capital

## Fiscal pressures closely watched

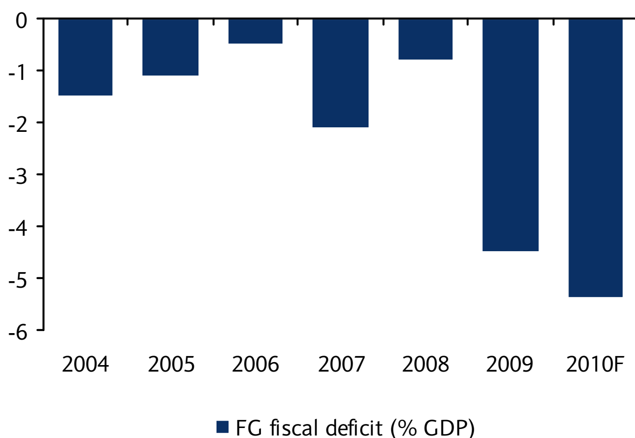
*Ghana's fiscal deficit continuing to narrow*

With the exception of Gabon, where we expect a fiscal surplus, the rest of the countries in West Africa (in our focus area) are struggling with deficits. Cote d'Ivoire is facing a manageable deficit of below 3% of GDP in 2010, while Ghana's deficit is likely to narrow to about 8% from -9.9% in 2009. Despite having to repay sizable outstanding arrears in 2011-12, the commencement of oil production expected by December 2010 means that Ghana's fiscal outlook for 2011 and beyond is very positive indeed.

*Nigeria's fiscal deficit likely to be much higher than projected*

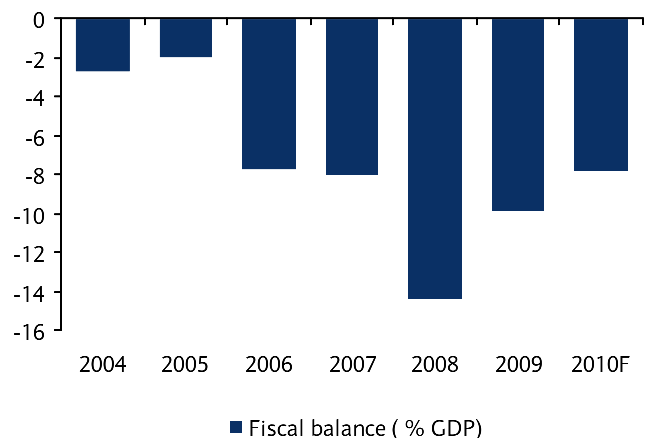
In contrast, in Nigeria, the federal government's fiscal deficit is likely to exceed the projected 5.4% of GDP (revised from 4.9% originally) for 2010, while the consolidated deficit could be even larger (IMF estimates it could be about 7.5%). Nigeria's fiscal risks have been accentuated following the near depletion of the excess crude account (ECA), which has only USD3bn remaining from USD20bn at the beginning of 2009. The deterioration in the ECA prompted President Jonathan to review the 2010 budget, and he submitted a new budget proposal on 1 June to cut spending and rebuild the ECA, which accrues from oil revenue earned above the benchmark oil price. The new proposal seeks to trim the 2010 budget to USD28bn from USD30.7bn and includes the lowering of production projections from 2.32mbpd to 2.25mbpd and the oil price from USD67/bl to USD60/bl. However, peculiarly, Jonathan proposed a USD4.3bn supplementary budget at the same time. In a letter to the Senate on 1 June, Jonathan defended the supplementary budget by saying it was necessitated by certain critical items such as statutory transfer, debt service, the service-wide vote and other critical expenditures that were either inadvertently omitted or under-provisioned. He also admitted that "recent revenue developments indicate significant shortfalls in both oil and non-oil revenue" (Nigerian Tribune, 2 June). Despite efforts to fix the country's fiscal issues, we remain concerned about a number of issues. First, the 2.25mbpd oil production assumption seems optimistic given current production of about 2mbpd and OPEC's 1.7mbpd limit. Second, the continuing delay in the proposed deregulation of the downstream petroleum sector means the government has to continue subsidising fuel. The finance minister recently revealed the government spent close to USD7bn on fuel subsidies last year, while about USD3.8bn will be spent on subsidies in 2010. Third, the spending habits of states are a concern and need to be contained. Removing the fuel subsidies will also help states and local governments, which bear the brunt of the petroleum subsidies. Fourth, the upcoming elections could cause the budget deficit to deteriorate further. Finally, though we are not yet concerned about fiscal sustainability given that the total-debt-to-GDP ratio is about 15% of GDP, there are some upside pressures that need to be closely monitored.

**Figure 5: Nigerian fiscal deficit has upside risk**




Source: FMF, Absa Capital

**Figure 6: Ghana fiscal deficit continuing to narrow**




Source: MoFEP, Absa Capital

## Political risks continue to dominate

*Cote d'Ivoire's political impasse continues*

Though the political situation in Ghana remains stable, the West African region remains a political hot spot. The political situation in Cote d'Ivoire has shown no meaningful progress since President Gbagbo replaced his government and the electoral commission in February. President Gbagbo, increasingly under pressure to hold the elections, promised (again) that elections will be held before the end of 2010. Indeed, the lack of political progress has led to UN Secretary General Ban Ki-moon warning earlier this month of violence if elections are not held (allAfrica.com, 2 June). Mr Ban Ki-moon has recommended the UN maintains its peacekeeping force until the end of 2010 and adjusts the mission's mandate to focus on implementing priority tasks such as the elections and disarmament. While a return to serious armed conflict does not seem imminent, in our view, there is a risk that patience among the population and the international community runs out eventually. The latter could be a risk to further debt relief measures under the HIPC and MDRI initiatives.

*Risk to further violence in Nigeria closer to elections*

In Nigeria, we are concerned about the prospects of political and socioeconomic violence ahead of the 2011 elections. The jostle for power within the ruling PDP, which we believe may intensify, may also hamper the implementation of urgent policy reforms. Although we do not expect major instability, there is a real threat of political and sectarian violence given the socioeconomic destitution and ethnic and religious tensions. Furthermore, despite relative calm in recent months, the situation in the Niger Delta area remains volatile after militants threatened to resume attacks if their grievances are not addressed.

**Figure 7: Macroeconomic forecasts of selected countries in West Africa**

| | Nigeria | | | Ghana | | | Cote d'Ivoire | | | Gabon | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010F | 2011F | 2009 | 2010F | 2011F | 2009 | 2010F | 2011F | 2009 | 2010F | 2011F |
| Real GDP (% y/y) | 6.7 | 7.3 | 7.5 | 4.7 | 6.3 | 17.7 | 3.8 | 3.0 | 4.0 | -1.4 | 5.4 | 4.9 |
| CA (% GDP) | 11.6 | 13.1 | 14.2 | -7.8 | -8.4 | -1.7 | 7.3 | 4.4 | 3.2 | 11.6 | 2.1 | 2.3 |
| FX reserves (eop) | 42.4 | 45.8 | … | 3.2 | 3.0 | … | 2.8 | … | … | 1.8 | … | … |
| External debt (% GDP) | 2.4 | 2.3 | 3.0 | 38.0 | 41.7 | 43.9 | 60.6 | 59.2 | 58.0 | 18.0 | 15.5 | 13.9 |
| Overall fiscal balance (% GDP)* | -4.5 | -5.4 | -5.0 | -9.9 | -7.9 | -2.8 | -2.1 | -2.5 | -3.9 | 7.5 | 2.0 | 2.1 |
| CPI (% y/y, eop) | 12.0 | 10.7 | 11.2 | 16.0 | 12.9 | 12.4 | -1.7 | 2.1 | 2.5 | 0.8 | 7.5 | 9.0 |
| Currency per USD (eop) | 149.5 | 149.0 | 145.0 | 1.43 | 1.40 | 1.30 | 455.3 | n/a | n/a | 455.3 | n/a | n/a |
| Benchmark policy rate (%, eop) | 6.00 | 6.50 | 8.50 | 18.00 | 14.50 | 15.00 | n/a | n/a | n/a | n/a | n/a | n/a |

Note: *Fiscal year; federal government for Nigeria. Source: IMF, Official offices, Reuters, Absa Capital

## LATAM: ARGENTINA

# More Kirchner, less market

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**Argentina's economy has recovered rapidly, aided by very expansive monetary, fiscal and income policies. As a result, inflation has accelerated. The policy response is becoming increasingly heterodox. Similarly, despite being nearly done with the holdout exchange, the authorities seem to be shifting their focus towards greater reliance on the use of domestic sources of financing. We believe the strategy is likely to last through 2011.**

*We believe that Cristina Kirchner's administration will not default; we expect an increasing reliance on domestic financing*

We believe that Cristina Kirchner's administration will not default, at least not if it can avoid it. This willingness to pay is reassuring, since the country, in principle, has enough reserves and local resources available to avoid a credit event before the end of its term. However, while the government reassuringly plans to stay current on its obligations, the general conduct of economic policy seems to have changed in the past few weeks. After the June 2009 mid-term electoral defeat and the appointment of Minister Boudou, Argentina seemed to initiate a process of returning to global markets with a roadmap that included the exchange of bonds still in default, a planned negotiation with the Paris Club and a renewed relationship with the IMF. The fundamental purpose was to cure Argentina's default and regain the ability to issue debt in the global markets that would fund an expansionary fiscal policy. As the months went by, the strategy lost, one by one, its building blocks. While the transaction with holdouts is in its final stage, the administration seems to have lost its will to issue global debt. Rather, the government seems to be preparing to run a policy by which the central bank will provide the critical financing needed for the next 18 months.

*The government will likely revert to its instinctive heterodox approach to economic policy, possibly implying tighter capital controls and restrictions on imports*

Political considerations, rather than financial or economic ones, seem to underpin the change in tactics. The Kirchner administration has shown consistent distrust in the markets and appears to have, somewhat reluctantly, adopted Boudou's proposed path. In the end, even after the exchange closes, faced with steep costs of raising fresh cash, the authorities appear prone to reassert their conviction that a heterodox path is their best option. For this reason, the government is likely to construct its policies around a key principle: maximize the dollars the central bank holds. To do so, it will likely deepen its use of two policy instruments: maximize the trade surplus through discretionary restrictions on imports and, minimize capital outflows through tighter capital controls. However, rather than a change of strategy, it would be more fitting to argue that the government will revert to its instinctive heterodox approach to economic policy. Such an approach has the government running an expansionary monetary and fiscal policy at a time when the economy is recovering rapidly and using microeconomic distortions in the markets to contain the side effects that result from their pump-priming. The results are rapid growth, high inflation and deepening relative price distortions: a combination unsustainable in the long run but that will probably suffice to prevent Argentina from having a serious macroeconomic accident before the end of Kirchner's term.

*The heterodox policies may be unsustainable but will help the government finish its term without a macro crisis*

Economic activity has recovered more than expected, and we are upgrading our growth forecasts to 6.1% from 4.2% in 2010. We are now expecting Q1 10 growth at 4.7% y/y (7.5% saar), and based on very supportive Q2 data, we forecast 7.0% y/y (7.5% saar) in Q2 10. The economic headwinds that could develop in H2 10 are only likely to result in a mild deceleration in growth as the economy closes the output gap. Given the carry-over effect, of about 1.8pp, and that expansionary policies will likely remain in place, we now forecast 2011 real growth at 3.8%, up from 2.7% before.

*We are upgrading our growth forecast to 6.1% in 2010 and 3.8% in 2011; Indec could report well over 7%*

Besides the expansionary monetary and fiscal policy, GDP growth was boosted by wage increases of 25-35%, above inflation, and the vigorous recovery in manufacturing exports to Brazil. Services and manufacturing (+10.5% y/y) led the recovery. Construction activity, which had lagged the cycle somewhat, has contributed decisively since the beginning of the year with a +15.4% y/y jump. Despite a strong 2010 grain harvest, crushing output dropped about -3.6% y/y in Q1 10 and -4.0% y/y in May. A recent trade conflict with China, linked to Argentina's trade restrictions, ultimately reduced crushing output. Finally, while the harvest had a significant 2.0pp effect on 2010 dollar GDP, its spill-over to the rest of the economy has been more limited because of the hoarding of grains by farmers as an alternative to financial savings. This has, in fact, become an alternative investment, particularly as capital controls increase the hurdle to acquiring dollars. Nevertheless, the wealth effect of a record crop supports private consumption. Investment spending is growing at close to 15%.[3] Despite the political uncertainty, businesses need to rebuild their capital stock on the back of a rapidly shrinking idle capacity.

*We expect inflation to remain elevated in 2010-11*

The main macroeconomic challenge is inflation. In 2009, it had gone down to 16.3% (from 26.7% the previous year) as activity tanked -4%. The rapid recovery of the past couple of quarters and the resurgence of inflation expectations have contributed to an acceleration of inflation to close to 25%. In May, privately reported inflation printed 1.2% m/m.[4] The outlook for inflation in 2010 and 2011 suggests that it will remain quite elevated as the administration steps on the gas with expansionary fiscal and monetary policies and wage increases settle at 25-35%. The only elements likely to be used to fight inflation will be an active set of price controls (increasingly ineffective and dysfunctional), restrictions on international trade, and other microeconomic distortions.

Interestingly, a rapid real recovery and the increasing differences between the growth in nominal variables and the inflation rate reported by INDEC result in a higher measured GDP growth rate. In fact, we estimate that INDEC GDP will reach 8% in 2010, as the measurement bias grows the faster inflation becomes.

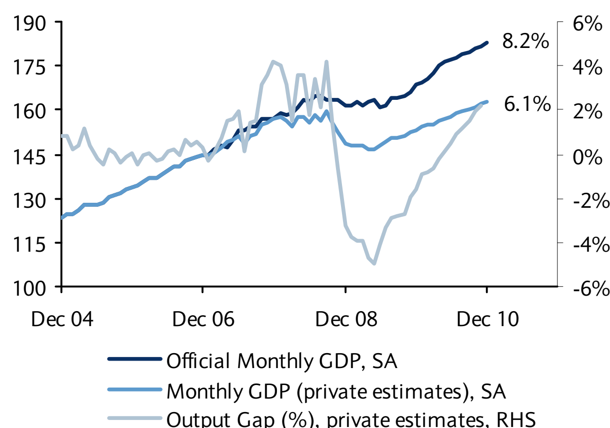
The recovery is mostly domestic demand driven. We expect net exports to contribute -1.0pp to 2010 growth. So far, real exports have recovered modestly, at 4.5% y/y in Q1 10, though

**Figure 1: USD demand/supply**

| USD bn | 2009 | 2010F |
|---|---|---|
| **USD Sources** | **18.0** | **20.3** |
| Net Exports (cash basis) | 16.2 | 18.5 |
| FDI & Portfolio | 1.8 | 1.8 |
| **USD Needs** | **-16.6** | **-16.7** |
| Asset Formation, net | -14.1 | -9.8 |
| Loans, net | -1.2 | -0.8 |
| Interests/Transfers | -6.7 | -6.5 |
| Banking system | 0.1 | 0.0 |
| IFI's, net | 3.6 | 1.5 |
| Public Sector, net | -2.6 | -2.1 |
| Other, net | 4.3 | 1.0 |
| **Reserves Change** | **1.4** | **3.6** |
| Stock of Reserves | 48.0 | 51.1 |

Source: Central bank

**Figure 2: Growth is strong. Watch out for 8% INDEC figures**




Source: Mecon, Barclays Capital

[3] According to Orlando Ferreres y Asociados.
[4] Buenos Aires City Consultants

they printed 16% y/y in April. Export growth, particularly to Brazil, was led mostly by manufacturing exports, which expanded at a solid 44.5% y/y in Q1. In contrast, primary and crushing exports collapsed (-6% y/y and -17% y/y, respectively), even though the harvest reached a record in 2010. We expect that if trade conflicts with China recede, the increase in primary and crushing exports will pick up. Domestic expenditure resulted in an increase of real imports of 35.4% in Q1 and 44% during April. This recovery is large relative to the GDP rebound, even after controlling for the real appreciation of the currency. To fight this trend, the authorities are likely to maintain, and even expand, some of the administrative controls on imports that have already given rise to complaints from G-20 governments (particularly Brazil and China).

*The central bank will allow the ARS to depreciate gradually, it is their main anti-inflation policy.*

The central bank is likely to maintain its policy of allowing for a gradual depreciation of the peso, only partially compensating for the increase in domestic prices. In part, the slow pace of depreciation operates as an anti-inflation policy, given the growing pass-through to domestic prices. It also the helps anchor domestic money demand. Domestic interest rates remain extraordinarily low in real terms – private sector Badlar is close to 10%, while expected inflation is 25% (Universidad Di Tella index). However, when measured in dollar terms, interest rates are not as negative – 1y NDFs price at most a 15% expected depreciation. Slowing down capital outflows (they continue to average about USD1bn per month) is important for reaching the government's fundamental objective of closing 2010 with sufficient reserves on the central bank balance sheet to be able to fund the treasury in 2011 – dollar financing needs will grow at least USD3.0 in 2011, over USD6.8bn in 2010.

**Figure 3: The government will shift its financing strategy to domestic sources**

| | 2010 | 2011 |
|---|---|---|
| **Gross financing needs** | **14.7** | **15.6** |
| Government holdings | 2.9 | 2.5 |
| Market holdings | 7.0 | 9.7 |
| Interest | 2.8 | 2.8 |
| Principal | 4.2 | 5.6 |
| GDP warrants | 0.0 | 1.3 |
| IFI's & others | 2.6 | 2.5 |
| Debt repurchases | 2.2 | 0.9 |
| **Provinces gap** | **3.5** | **3.5** |
| **Primary deficit** | **3.7** | **5.4** |
| **Other resources** | **-6.7** | **-5.2** |
| Central Bank capital gains | -5.5 | -4.0 |
| Social Security rents | -1.2 | -1.2 |
| **Net financing needs** | **15.3** | **19.2** |
| **Financing sources** | **-14.9** | **-5.8** |
| Rollover public sector holdings | -1.3 | -1.0 |
| Debt repurchases | -2.2 | -0.9 |
| IFI's rollover (IADB/WB/CAF) | -2.0 | -1.9 |
| Central Bank borrowing | -1.6 | -1.9 |
| Banco Nacion borrowing | -1.4 | |
| Debt Repayment Fund (reserves) | -6.5 | |
| **Financing gap** | **0.4** | **13.5** |

Source: Mecon, Central Bank and ANSES

*The primary budget deficit could reach 1.1% of GDP in 2010 and 1.3% in 2011*

The administration seems to be rotating its financing strategy to rely increasingly on domestic sources. What it is unlikely to do is tighten fiscal policy. Primary spending grew 31% y/y up to April, led mostly by the increase in non-discretionary spending, which contributed 20pp. In turn, tax revenues, while growing strongly helped by growth and inflation, accumulated only a 25% y/y increase through April. The cumulative primary balance, until April, printed a meagre USD0.3bn surplus, about USD1.0bn less than last year. Taking into account profit transfers of the central bank, its reserve transfers to pay interest services under the debt repayment fund, and income from social security, the reported primary balance printed a USD1.4bn primary surplus. Interestingly, while we expect the ongoing fiscal expansion to keep its current pace, we expect a significant reduction in y/y spending growth rates during May-June because of base effects (mid-term elections took place in June 2009). Going later into the year, we expect the fiscal position to deteriorate further. We are forecasting a primary deficit (net of gap filers) of USD3.7bn or 1.1% of GDP and an overall balance of USD7.9bn, or 2.3% of GDP. 2011 will present the authorities with a trade-off: the government will be tempted to deteriorate fiscal accounts further, as it is an electoral year, but financing will be scarce. We expect primary spending growth to reach 25% y/y (above the growth on nominal GDP) and the primary balance to reach USD5.3bn. or 2.7% of GDP (net of accounting gimmicks).

*Financing for 2010 is covered; there are several options open to finance 2011*

Financing in 2010 seems to be within reach, but next year promises to present the authorities with new challenges. The financial gap in 2010 is covered, according to our calculations, using IFIs rollovers, international reserves (the debt reduction funds) and other domestic sources. In 2011, it amounts to USD13.5bn. The government has yet to provide any guidance on how they plan to finance it. However, there are several potential ways that Kirchner's administration could cover the needs. It is clear that additional support from the central bank and the social security agency (ANSES) will be needed. We would not be surprised if the president appropriates another USD6bn of international reserves. In addition, provincial administrations will likely be pushed to seek external funding, rather than rely on central government support. The administration is also likely to use a program of short-term notes to be placed within the local financial system for USD 2.0-3.0bn. Finally, the government could sell assets held by the social security agency in markets and use those proceeds to finance the gap. All in all, while the year looks challenging, we find that the options open to the administration are sufficiently plentiful to keep the government compliant with its obligations.

*Political noise is likely to pick up in H2 10*

The second semester promises additional political noise. The presidential elections of 2011 should bring forward significant domestic noise as the parties narrow down the candidate lists and the opposition sharpens its teeth. Similarly, in August, the administration has to face some legislative challenges that could affect export taxes. In September, the 2011 budget promises lots of political fireworks. The government's heterodoxy, political climate and tightness of financing are expected to make a dent on growth and domestic sentiment. However, despite this, we expect Argentina to avoid a serious economic crisis.

### Figure 4: Argentina macroeconomic forecasts

| | 2006 | 2007 | 2008E | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 8.5 | 7.8 | 3.3 | -4.0 | 6.1 | 3.8 |
| Domestic demand contribution (pp) | 9.2 | 9.8 | 4.2 | -5.8 | 7.3 | 4.1 |
| Private consumption (% y/y) | 7.8 | 9.0 | 0.0 | -6.0 | 6.5 | 4.2 |
| Fixed capital investment (% y/y) | 18.2 | 13.6 | 9.0 | -12.1 | 10.7 | 3.8 |
| Net exports contribution (pp) | -0.7 | -1.2 | -1.7 | 1.9 | -0.9 | -0.4 |
| Exports (% y/y) | 7.3 | 9.1 | 1.2 | -6.9 | 12.1 | 7.4 |
| Imports (% y/y) | 15.4 | 20.5 | 14.1 | -19.0 | 20.6 | 10.6 |
| GDP (USD bn) | 213 | 261 | 317 | 306 | 370 | 419 |
| **External Sector** | | | | | | |
| Current account (USD bn) | 7.7 | 7.1 | 7.1 | 11.3 | 8.9 | 7.4 |
| CA (% GDP) | 3.6 | 2.7 | 2.2 | 3.7 | 2.4 | 1.8 |
| Trade balance (USD bn), FOB | 14.0 | 13.3 | 15.5 | 18.6 | 16.7 | 16.6 |
| Net FDI (USD bn) | 3.1 | 5.0 | 8.3 | 4.2 | 5.0 | 5.0 |
| Other net inflows (USD bn) | 6.9 | -2.1 | 15.2 | 13.9 | 10.3 | 16.0 |
| Gross external debt (USD bn) | 108.9 | 124.6 | 128.1 | 133.2 | 138.6 | 144.1 |
| International reserves (USD bn) | 32.0 | 46.2 | 46.4 | 48.0 | 51.6 | 48.0 |
| **Public Sector** | | | | | | |
| Public sector balance (% GDP) ** | 1.6 | 0.0 | 0.9 | -2.6 | -2.3 | -2.7 |
| Primary balance (% GDP) ** | 3.4 | 2.1 | 2.7 | -0.4 | -1.1 | -1.3 |
| Gross public debt (% GDP) | 64.2 | 55.5 | 46.0 | 48.1 | 46.8 | 43.6 |
| Net public debt (% GDP) | 49.2 | 37.8 | 31.4 | 32.4 | 32.8 | 32.2 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) * | 10.7 | 25.7 | 23.0 | 14.8 | 28.2 | 22.8 |
| CPI (% average) * | 10.9 | 18.4 | 26.7 | 16.3 | 22.8 | 27.2 |
| Exchange rate (ARS/USD, eop) | 3.06 | 3.15 | 3.45 | 3.80 | 4.30 | 4.73 |
| Exchange rate (period average) | 3.07 | 3.12 | 3.16 | 3.73 | 4.05 | 4.52 |
| | **Last** | **Q2 10** | **Q3 10** | **Q4 10** | **Q1 11** | **Q2 11** |
| Real GDP ( % y/y) | 4.7 | 7.0 | 6.7 | 6.1 | 5.0 | 4.0 |
| CPI (% y/y, eop) * | 13.3 | 21.4 | 24.2 | 27.2 | 26.9 | 25.4 |
| Exchange rate (ARS/USD, eop) | 3.93 | 3.94 | 4.05 | 4.30 | 4.45 | 4.60 |
| Benchmark rate (%, eop), BADLAR | 10.3 | 10.3 | 10.1 | 9.8 | 9.6 | 9.3 |

Note: * Private estimate, differs with official inflation. ** Excludes central bank profit transfers, rent transfers of the nationalized pension fund system (FGS) and reserves to pay debt transfers of the central bank. Source: Mecon, Indec, Banco Central de la Republica Argentina, Buenos Aires City Consultores

## LATAM: BRAZIL

# The Lula factor

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**Strong growth, deafening vuvuzelas and presidential elections are the key Q3 events in Brazil. While stronger-than-expected growth would validate an even more hawkish BCB, global growth anxiety helps support the 75bp tightening pace.**

After the World Cup, the presidential election will finally take centre stage in Brazil. The back drop is set by a blistering hot pace of real GDP growth, a declining rate of unemployment and some pick-up in inflation, although still constrained within the BCB's targets. When we shift to electoral mode, the situation campaign, with President Lula pounding the table that Ms. Rousseff represents continuity of his government, will face the opposition with Mr. Serra (PSDB party) criticizing the government on the basis of ethics and efficiency. And while we do not expect either of the leading candidates to drastically change gears in terms of economic policymaking, the devil is always in the details. And we should only learn about them as we head up to the October 3 polls.

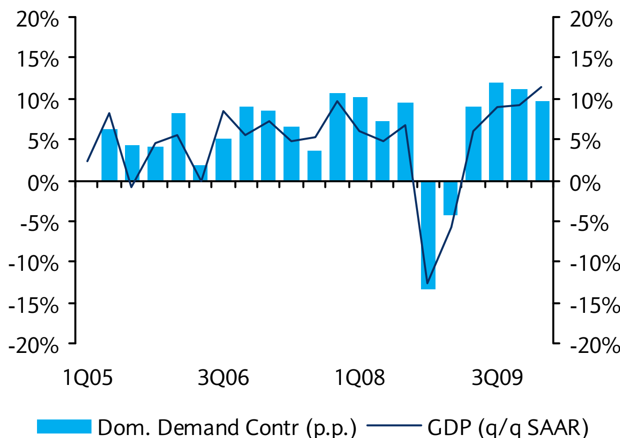
*We are revising growth and the IPCA up this year to 7.3% and 6.1%, respectively.*

The Brazilian economy is firing on all cylinders. Real GDP growth rose by a stronger-than-expected 2.7% q/q sa rate in Q1 10, with domestic demand leading the way, expanding at a strong 2.4% q/q sa (9.8% SAAR) pace. The GDP gap bounced back again to positive territory, although shy of the mid-2008 highs, but, clearly, this pace of recovery is unsustainable. We are revising up real GDP growth this year to 7.3%, from 6.5% while trimming growth down next year to 4.4% from 4.5%.

*Signs of growth moderation are materializing, but risk of overheating is still present.*

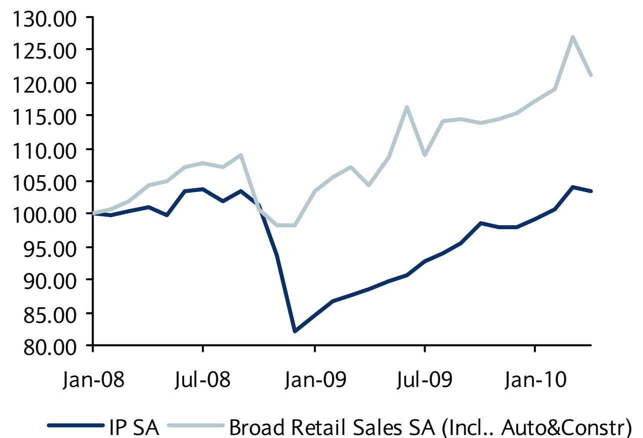
There are preliminary signs that Q2 growth is consolidating at a softer pace. April IP and retail sales have already started moving south, contracting by 0.7% m/m and 3% m/m, respectively. Most of the tax incentives implemented during the crisis to support consumption have already been phased out, helping to explain the slowdown in durable goods demand. To be sure, new auto registration (Fenabrave) continued dropping in May (-4.6% m/m sa) after falling by nearly 9% m/m in April (incentives phased out in March). But the slowdown will likely be smooth. While monetary policy tightening should gradually constrain credit supply, tight labor markets and a rising real wage bill should keep consumers afloat.

**Figure 1: Blistering hot growth lead by domestic demand…**




Source: IBGE, Barclays Capital

**Figure 2: ...with first signs of moderation in early Q2 10**




Source: IBGE, Barclays Capital

*We do not expect the BCB to miss its targets, but reckon that the balance of risks is tilted towards higher inflation, not lower*

A higher level of inflation is a side effect of the stronger pace of economic activity. We have revised up our IPCA forecasts to 6.1% and 5.0% in 2010 and 2011, respectively (from 5.4% and 4.8%). We are concerned that the overheating economy could translate into higher goods and wage inflation, even though such trends are still insipient. Food prices, however, have been driving most of the dynamics of headline IPCA, rising earlier in the year and falling over the past few weeks. Meanwhile, the non-food component of the IPCA remains resilient. In addition, once the deflation in food prices eases, headline IPCA should go back to 0.40-0.45% in H2 10, from the upcoming harvest of 0.20%, or lower, releases. We do not expect the BCB to miss its targets, but reckon that the balance of risks is tilted towards higher inflation, not lower.

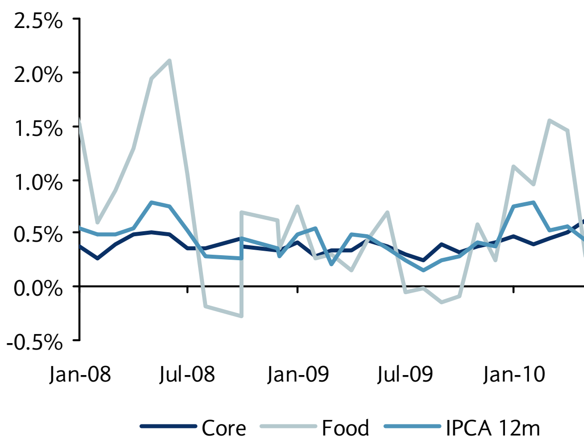
The overall outlook of Brazil's balance of payments is also shifting, with some improvements in the outlook of trade and the current account balance. But financing is more reliant on portfolio than on FDI flows. We are lifting our 2011 trade balance surplus to $9.2bn, from $3.1bn in the previous quarter, as global growth appears to be more constructive. Meanwhile, we are trimming down the current account next year to 2.7% from 3.0%. While better trade numbers are playing a role, profit and dividend remittals continue to pressure the outflows this and next year. Finally, financing the current account deterioration should be more based on portfolio flows than on FDI. This was the new trend observed in Q1 10, and there are no reasons, in our view, to expect it to change. Especially as southern Europe, an important source of FDI inflows to Brazil, remains under the gun. This latter point implies a larger potential for BRL volatility, especially if negative news from Europe revives concerns about global-growth anxiety, dampening portfolio flows.

*BCB will be deliberating between a blistering hot pace of domestic demand …*

*…and concerns about the southern European sovereign crisis when deciding how much more to tighten*

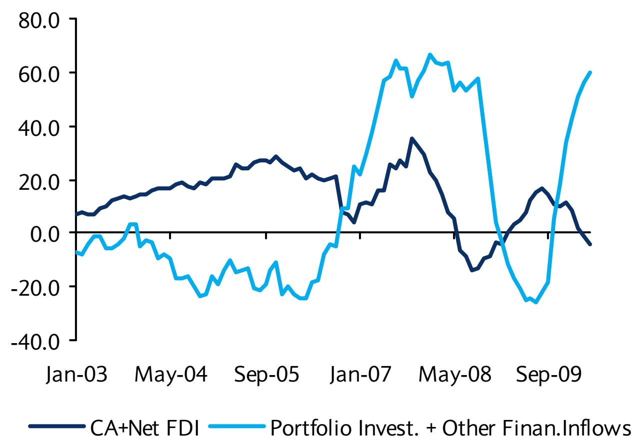
And it is exactly the uncertainty regarding southern Europe that is keeping us from revising up our monetary policy tightening cycle. Even though signs of overheating and rising demand-side inflationary pressures call for more tightening than our base case scenario (two more 75bp hikes, lifting the Selic rate to 11.75% by the beginning of September), worsening global growth anxiety works in the other direction. Hence, we believe the BCB will continue with their 75bp pace, and if this anxiety wanes, they could extend the cycle through the end of the year. But DI markets should continue to track the global recovery path very closely. On days of less global growth anxiety, the EUR/USD rallies, lifting the BRL and forcing a sell-off of the short end of the DI curve.

**Figure 3: Food prices first up and now down (%,m/m)**




Source: IBGE, Barclays Capital

**Figure 4: Portfolio flows (USD bn) increasing in importance**




Source: BCB, Barclays Capital

*We continue to see little countercyclical fiscal effort. The next president will have the challenge of reigning in expenses*

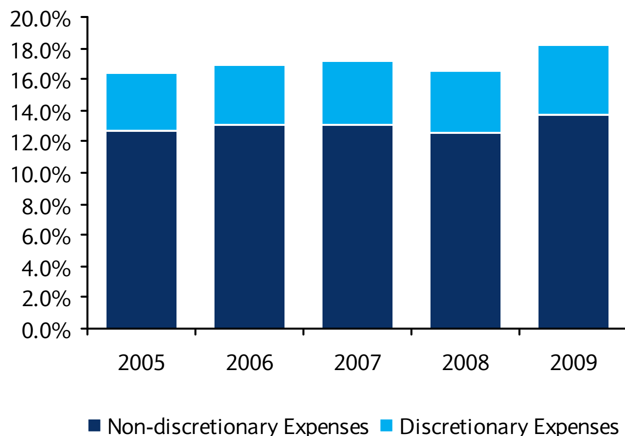
Considering the fiscal/monetary policy mix, we continue to see little help coming from discretionary fiscal policy cuts. Finance Minister Mantega has announced a new round of fiscal restrains, which we believe should do little to contain the excess growth of domestic activity. But strong growth does have a positive fiscal impact on flows and stocks. Strong growth lifts tax collection, leading larger primary surpluses (2.5% and 2.8% of GDP in 2010 and 2011, respectively, from 2.4% and 2.3%). But more importantly, net and gross indebtedness levels as a percentage of GDP should grind lower than we had previously expected. Net debt/GDP ratio should fall to 40% this year and 39% next year, while gross debt, which reflects the BNDES capitalization and FX sterilized interventions, will now likely grind down to 68% this year to only bump up to 69.5% next year. We still believe that some retrain on fiscal spending will need to happen to return government savings back to an upward trend and, consequently, free more private investment for infrastructure projects. But this should not happen in an electoral year; it will be a mission inherited by the next president elect who takes office in January 2011.

*Elections are four months away; the first hurdle will be dissipating the uncertainties about the main economic programs*

Elections are just four months away, and the first major hurdle will be dissipating the uncertainties around the main economic programs. It is this uncertainty that we believe will start to drive BRL weakness as polls start to show a clearer picture of who may win. Currently, the two leading candidates are tied (Figure 6), and a more defining trend should start to emerge after August 17, when the TV and radio campaigns roll out. This is when we should be able figure out the weight of the Lula Factor, or how much vote-transfer capacity he will be able to deliver.

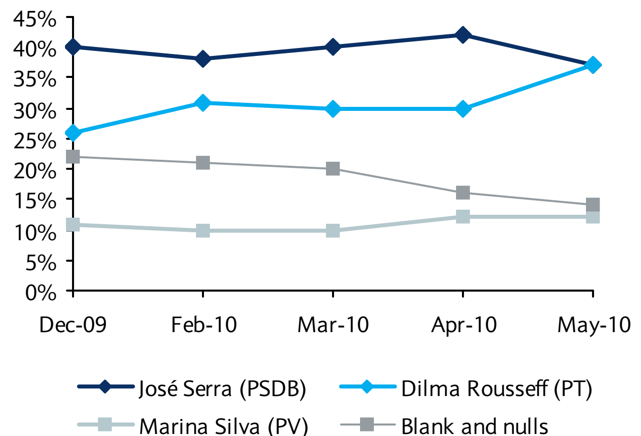
The next hurdle will be understating the macroeconomic blueprint of each candidate. On the fiscal front, signs of a possible fiscal adjustment in the start of the next administration will be very welcome. It was the strong fiscal adjustment implemented in President Lula's first year of government that helped set the conditions for crowding in private investment and gave the administration the tools to act in a countercyclical manner during the 2008 crisis. Apparently, there will be very little crisis-led urgency to adjust this time around. On the contrary, strong economic growth breeds complacency from policymakers and markets participants. Hence, any signs that the upcoming president could move in a more restrictive direction will be very welcome. Mr. Serra has been associated with more austere fiscal policy making, while Ms. Rousseff has, of late, been considering these ideas. The role private capital will play in financing the large infrastructure projects slated for the coming years

**Figure 5: Controlling permanent spending* is a challenge…**




Note: *Non-discretionary is wage bill, social security and non-investment and mandatory expenses (% GDP). Source: STN, Barclays Capital

**Figure 6: … for the next president**




Source: Datafolha, Barclays Capital

(2014 World Cup; 2016 Olympic games and the pre-salt oil extraction industry) will also be key in understanding the size of the government and the future need to increase taxation.

However, more monetary policy details are really needed. While Ms. Rousseff has committed to maintaining the current monetary policy stance, keeping the BCB's operational independence in place, Mr. Serra's ideas are still not clear, which should help boost the USDBRL rate towards the 2.0 range in the pre-electoral period.

**Figure 7: Brazil Macroeconomic Forecasts**

| | 2005 | 2006 | 2007 | 2008 | 2009F | 2010F | 2011F |
|---|---|---|---|---|---|---|---|
| **Activity** | | | | | | | |
| Real GDP (% y/y) | 3.2 | 4.0 | 6.1 | 5.1 | -0.2 | 7.3 | 4.4 |
| Domestic demand contribution (pp) | 10.2 | 13.4 | 7.3 | 8.1 | -0.6 | 11.0 | 5.3 |
| Private consumption (% y/y) | 4.5 | 5.2 | 6.1 | 7.0 | 4.1 | 6.2 | 4.3 |
| Fixed capital investment (% y/y) | 3.6 | 9.8 | 13.9 | 13.4 | -9.9 | 23.8 | 8.3 |
| Net exports contribution (pp) | 1.3 | -1.8 | -1.7 | -2.8 | 0.4 | -3.7 | -0.9 |
| Exports (% y/y) | 9.3 | 5.0 | 6.2 | -0.6 | -10.3 | 10.0 | 10.1 |
| Imports (% y/y) | 8.5 | 18.4 | 19.9 | 18.0 | -11.4 | 33.8 | 12.2 |
| GDP (USD bn) | 882 | 1,094 | 1,378 | 1,641 | 1,577 | 1,966 | 2,053 |
| **External sector** | | | | | | | |
| Current account (USD bn) | 14.0 | 13.6 | 1.6 | -28.2 | -24.3 | -47.5 | -54.5 |
| CA (% GDP) | 1.6 | 1.2 | 0.1 | -1.7 | -1.5 | -2.4 | -2.7 |
| Trade balance (USD bn) | 44.7 | 46.5 | 40.0 | 24.8 | 25.3 | 11.3 | 9.2 |
| Net FDI (USD bn) | 12.5 | -9.4 | 27.5 | 24.6 | 36.0 | 30.0 | 35.0 |
| Other net inflows (USD bn) | -22.7 | 24.8 | 60.8 | 3.7 | 34.1 | 33.0 | 36.0 |
| Gross external debt (USD bn) | 169.5 | 172.6 | 193.2 | 198.3 | 198.2 | 216.5 | 222.3 |
| International reserves (USD bn) | 53.8 | 85.8 | 180.3 | 193.8 | 238.5 | 260.1 | 277.6 |
| **Public sector** | | | | | | | |
| Public sector balance (% GDP) | -3.4 | -3.5 | -2.7 | -1.9 | -3.3 | -2.5 | -2.3 |
| Primary balance (% GDP) | 3.9 | 3.2 | 3.4 | 3.5 | 2.1 | 2.5 | 2.8 |
| Gross public debt (% GDP) | 67.7 | 65.7 | 64.4 | 63.6 | 68.6 | 68.0 | 69.5 |
| Net public debt (% GDP) | 48.2 | 47.0 | 45.1 | 38.4 | 42.8 | 40.0 | 39.0 |
| **Prices** | | | | | | | |
| CPI (% Dec/Dec) | 5.7 | 3.1 | 4.5 | 5.9 | 4.3 | 6.1 | 5.0 |
| CPI (% average) | 6.9 | 4.2 | 3.6 | 5.7 | 5.1 | 5.2 | 5.6 |
| Exchange rate (BRL/USD, eop) | 2.34 | 2.14 | 1.77 | 2.34 | 1.74 | 1.90 | 1.85 |
| Exchange rate (period average) | 2.43 | 2.18 | 1.95 | 1.84 | 2.04 | 1.87 | 1.86 |
| | **1y ago** | **Last** | **4Q09F** | **1Q10F** | **2Q10F** | **3Q10F** | **4Q10F** |
| Real GDP ( % y/y) | -1.6 | 9.0 | 4.3 | 5.7 | 8.4 | 6.8 | 5.4 |
| CPI (% y/y, eop) | 4.8 | 5.2 | 4.3 | 5.2 | 5.0 | 5.6 | 6.1 |
| Exchange rate (BRL/USD, eop) | 1.95 | 1.82 | 1.75 | 1.79 | 1.85 | 2.00 | 1.90 |
| Monetary policy benchmark rate (%, eop) | 9.25 | 10.25 | 8.75 | 8.75 | 10.25 | 11.75 | 11.75 |
| Market implied benchmark rate (%,eop) | – | – | - | - | - | 11.37 | 12.30 |

Source: IBGE, BCB, STN, Bloomberg, Barclays Capital

# LATAM: CENTRAL AMERICA AND THE CARIBBEAN

## One region, different countries, good opportunities

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**Central American and the Caribbean (CAC) economies are mostly recovering well and in a sustainable way after the international stress in 2009. External accounts remain strong, with FDI and multilateral organizations providing a secure source of financing. Using debt path dynamics, we recommend an Overweight in the Dominican Republic and Costa Rica, a Market Weight in Guatemala, and an Underweight in El Salvador and Jamaica. Panama is a success story but, in our opinion, is already priced in.**

### A good recovery after an important contraction

CAC countries will pass from an average contraction of -0.2% in 2009, to an estimated growth of 4.0% in 2010, lower than the average growth of the Latin American region. The timid recovery is explained by the greater CAC dependence on the US economy through remittances and tourism revenues, clearly lagging sectors. The most relevant change with respect to our last quarterly is our bullish position taken about the Dominican Republic. As we said in *Dominican Republic: Our top credit pick in the CAC*, April 21, 2010, we believe that Haiti reconstruction, coupled with more than USD3.0bn (6.4% of DR GDP) in investment to develop the Pueblo Viejo gold mine through 2011, will boost growth, and with fiscal and electric structural reforms on track, the Dominican assets should continue to outperform the market. We also improved our growth forecast for Costa Rica (see *Costa Rica: A proven track record*, May 14, 2010). Jamaica and El Salvador worry us, given their low economic dynamism.

**Figure 1: High economic growth moderated inflation**

| | GDP growth (%) | | | Inflation (%) | | |
|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2009 | 2010 | 2011 |
| Dominican Republic | 3.5 | 7.9 | 9.7 | 5.8 | 7.0 | 6.5 |
| Costa Rica | -1.1 | 5.7 | 4.8 | 4.5 | 7.4 | 6.7 |
| Panama | 2.4 | 6.6 | 6.2 | 1.9 | 3.5 | 2.9 |
| Guatemala | 0.6 | 2.9 | 3.2 | 2.0 | 3.9 | 5.6 |
| El Salvador | -3.5 | 2.7 | 3.2 | -0.2 | 2.3 | 1.5 |
| Jamaica | -3.3 | -0.5 | 1.5 | 9.0 | 8.5 | 8.2 |
| **Average** | **-0.2** | **4.2** | **4.8** | **3.8** | **5.4** | **5.2** |

Source: DR, SLV, JAM, CRI, GTM central banks, Panama's statistics office of comptroller, Barclays Capital

*FDI guarantees a stable source of financing for the current account deficit*

On the other hand, there is an increase in the expected inflation, partly due to higher commodity prices, which are also negatively affecting the current account. Nonetheless, the average current account deficit remained below the level reached in 2008 at -4.8% of GDP for 2010 and -5.4% of GDP for 2011. In the Dominican Republic, Costa Rica, and Panama, the current accounts deficits are being backed by foreign direct investment (FDI), which guarantees a stable source of financing. As a reminder, for El Salvador, FDI does not cover the current account deficit, leaving the country in a vulnerable external position. In the case of Jamaica, the expected current account deficit is almost backed by FDI.

**Figure 2: Current account deficit backed by FDI**

| | Current account (% GDP) | | | FDI (% GDP) | | |
|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2009 | 2010 | 2011 |
| Dominican Republic | -1.7 | -4.3 | -3.3 | 4.7 | 4.3 | 3.9 |
| Costa Rica | -2.7 | -4.4 | -4.5 | 4.6 | 5.5 | 5.3 |
| Panama | 0.0 | -7.0 | -10.8 | 11.9 | 12.9 | 13.6 |
| Guatemala | -0.6 | -1.4 | -2.5 | 1.1 | 1.4 | 1.5 |
| El Salvador | -1.8 | -6.8 | -5.7 | 0.8 | 1.6 | 2.0 |
| Jamaica | -11.7 | -9.1 | -7.5 | 4.87 | 5.5 | 5.2 |
| **Average** | **-3.1** | **-5.5** | **-5.7** | **4.7** | **5.2** | **5.2** |

Source: DR, SLV, JAM, CRI, GTM central banks, Panama's statistics office of comptroller, Barclays Capital

## Public sector balances improving slowly

In line with the expected higher growth, the position of the public sector is expected to improve with the average fiscal deficit passing from 4.0% in 2009 to 3.3% in 2010. The weakest countries are El Salvador, with a forecasted fiscal deficit of 4.1%, and Jamaica, with 7.0% in 2010. There is just one country with a primary surplus: Panama, which should contribute to keeping the country's debt outstanding at a stable level, while falling with respect to GDP, due to the high economic growth. Costa Rica, Dominican Republic, and Guatemala maintain a primary deficit of 1.0% or lower. We want to highlight that the average tax collection for these countries were 15.6% and 13.9% of the GDP for 2008 and 2009, respectively, which shows the necessity for fiscal reform. In all of them, the respective central governments are trying to pass it, with a low probability of success in Costa Rica, in our view, as the central government does not have a majority in the national assembly.

**Figure 3: Improving fiscal accounts**

| | Fiscal balance (% GDP) | | | Primary fiscal balance (% of GDP) | | |
|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2009 | 2010 | 2011 |
| Dominican Republic | -3.5 | -3.2 | -2.6 | -1.2 | -0.9 | -0.3 |
| Costa Rica | -3.5 | -3.3 | -2.6 | -1.3 | -1.0 | -0.3 |
| Panama | -1.9 | -1.3 | -0.7 | 1.3 | 1.8 | 2.6 |
| Guatemala | -3.2 | -2.4 | -1.4 | -1.8 | -0.9 | 0.1 |
| El Salvador | -4.7 | -2.4 | -1.4 | -2.3 | -1.7 | -1.3 |
| Jamaica | -7.1 | -7.0 | -6.8 | 4.7 | 0.9 | 1.0 |
| **Average** | **-4.0** | **-3.3** | **-2.6** | **-0.1** | **-0.3** | **0.3** |

Source: DR, SLV, JAM, CRI, GTM central banks, Panama's statistics office of comptroller, Barclays Capital

*Multilaterals' help have ensured financing for the region as well as support structural reforms*

It is important to highlight the relevance that multilaterals' help has had in ensuring financing for the region. In our meetings with the IMF and the IDB, we were impressed by the high degree of commitment these multilaterals have in the region. The IMF has approved loans for US$5.6bn in stand-by agreements, the World Bank USD2.5bn, the IADB USD2.7bn, and others USD0.4bn, which, in aggregate, represent 6.0% of the total region GDP. In addition to financing, these agreements have contributed to preserving investors' confidence in the region, as well as supporting structural reforms, particularly in fiscal policy that could help to reduce current account deficit, minimizing the dependence on capital inflow.

Figure 4: Multilaterals' support (USD bn)

| | IMF | IADB | WB | Others | Total | Total (% GDP) |
|---|---|---|---|---|---|---|
| Dominican Republic | 1.7 | 0.9 | 0.4 | 0.1 | 3.1 | 5.9% |
| Costa Rica | 0.7 | 0.1 | 0.5 | 0.1 | 1.4 | 4.2% |
| Salvador | 1.0 | 0.2 | 0.8 | 0.2 | 2.1 | 9.5% |
| Guatemala | 0.9 | 0.7 | 0.5 | 0.0 | 2.1 | 5.4% |
| Panama | 0.0 | 0.7 | 0.1 | 0.0 | 0.8 | 3.4% |
| Jamaica | 1.3 | 0.0 | 0.2 | 0.0 | 1.5 | 11.8% |
| **Total** | **5.6** | **2.7** | **2.5** | **0.3** | **11.0** | **6.0%** |

Source: IMF, IADB, World Bank, CAF, Barclays Capital

## Debt dynamics

In almost all the countries in the region, there has been a substantial improvement in their debt dynamics, going from an average ratio of total public debt over GDP of 61.3% in 2003 to 53.2% in 2009. The strongest declines in the debt/GDP ratio were achieved by Costa Rica and Panama. In the case of Panama, a primary surplus has actually been registered, which should help keep the country's debt outstanding at a stable level, while falling with respect to GDP, due to the country's high growth. Similarly, high economic growth in the Dominican Republic and Costa Rica is expected to preserve the declining trend of the weight of debt with respect to GDP for these countries, despite registering a small primary deficit. Guatemala is also an interesting country to highlight. First, Guatemala's exports are expected to grow more than 10% this year and 11% in 2011, improving the availability of foreign currency for the country also with a stronger current account position. Additionally, although Guatemala has not improved its debt ratios, it remains in a clearly sustainable path, and liquidity issues prevent us from recommending increasing exposure to this country. We highlight that although these four countries maintain positive debt/GDP ratios, when we measure debt over total government income (to measure their capacity to pay), given that they have a relatively small government, these ratios are not favourable.

Figure 5: Sustainable debt path

| | Total Public Debt/GDP (%) | | | Tot Pub Debt/ Income (%) | | |
|---|---|---|---|---|---|---|
| | 2003 | 2009 | 2011 | 2003 | 2009 | 2011 |
| Dominican Republic | 30.9 | 28.4 | 28.5 | 238.1 | 209.4 | 179.4 |
| Costa Rica | 60.5 | 43.6 | 39.3 | 456.2 | 317.6 | 271.4 |
| Panama | 65.8 | 45.1 | 45.8 | 278.7 | 246.0 | 247.7 |
| Guatemala | 22.2 | 23.2 | 25.6 | 176.9 | 208.0 | 171.0 |
| El Salvador | 47.4 | 52.8 | 51.8 | 359.3 | 391.1 | 345.1 |
| Jamaica | 140.9 | 126.1 | 127.2 | 482.4 | 488.0 | 453.2 |
| **Average** | **61.3** | **53.2** | **53.1** | **331.9** | **310.0** | **278.0** |

Source: DR, SLV, JAM, CRI, GTM central banks, Panama's statistics office of comptroller, Barclays Capital

On the contrary, El Salvador has been increasing its debt/GDP ratio due to low economic growth and a high fiscal deficit. Clearly, in the medium term, its payment capacity remains vulnerable, as the government revenues are growing at a lower pace than the expenditures and the debt outstanding. In our opinion, this country is in more urgent need of fiscal reform to return to a sustainable fiscal path. Given that the FSLN (the government party) and GANA (which has emerged from a division of the opposition party ARENA) have been

allies in the past, it is possible that the government could pass this fiscal reform. We want to highlight that the risk of a default in El Salvador is low, given that it is fully supported by the multilaterals.

In the case of Jamaica, at the beginning of 2010, it was able to implement a debt swap to prevent default; however, its indicators remain weak, with a still-high fiscal deficit, although they have a primary surplus. We are of the opinion that Jamaica is still on a non-sustainable fiscal path and will need to restructure its debt some time in the future. Clearly, the swap of the domestic debt was not enough.

# LATAM: CHILE

## BCCh: 1, Overheating: 0; Match: Far from over

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**In the coming quarters, we continue to expect above-trend, demand-driven growth, above-trend inflation, and a swift withdrawal of monetary stimulus. We think the peso offers a lot of value in this context.**

Strategy: We have strong conviction in our bullish CLP call. We think recent underperformance has created substantial value in the currency. The upside potential of our 2y Camara payer has moderated, but we still think the balance of risks favours the position.

### Risen from ruin

*The earthquake effect was larger than anticipated but also more short-lived*

Since the publication of "*Chile: Rising from ruin,*" in the 16 March 2010, edition of our *Emerging Markets Quarterly*, our conviction in the assessment we presented then has increased. Although the immediate effect of the February 27 earthquake on real GDP proved much stronger than we had expected (roughly one percentage point of GDP), it was also very short-lived. More important, domestic demand indicators have not only emerged unscathed from the catastrophe, but have displayed extraordinary strength in recent months, even before the first penny in reconstruction-related spending had kicked in.

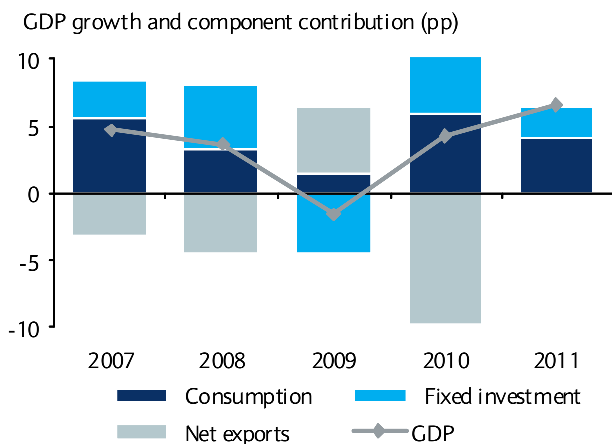
*Although 2010 GDP figures will suffer, we have an above-consensus forecast for 2011*

This leaves us with a moderate GDP growth projection for 2010 of 4.2%, but an above-consensus growth forecast of 6.6% for 2011. This outcome is likely to result from an outlier drag from trade in 2010, as real exports remain muted and real imports soar 24% to meet consumption, investment, and inventory replenishment needs (Figures 1 and 5).

*Soaring domestic demand is a distinct aspect of the recovery*

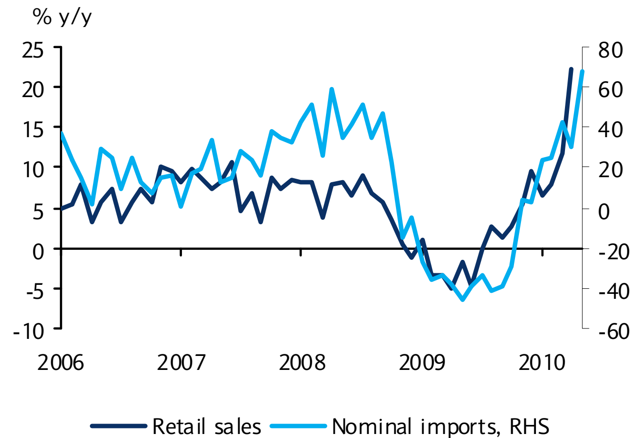
As the central bank (BCCh) highlighted in its June 16 monetary policy report, it is possible that the intense growth in some demand indicators in Q2 (Figure 2) stemmed from temporary substitution effects. That said, with a significant reconstruction effort ahead and strong commitment from the authorities to support it, the strength of domestic demand seems hard to overstate.

**Figure 1: An outlier GDP composition**




Source: Haver Analytics, Barclays Capital

**Figure 2: Strong demand indicators**




Source: Haver Analytics, Barclays Capital

The new government's plan is to spend USD8.4bn on reconstruction efforts in addition to USD9.3bn on special projects over the next four years. It plans to almost cover these costs via a combination of new, temporary taxes (USD2.5bn); economic growth (USD7.5bn); better tax collection (USD2.9bn); and external debt issuance (USD1.5bn). The large reliance on growth and tax collection, in the context of a deviation from the structural balanced-budget rule, suggests some worsening in the counter-cyclical framework that, in the medium term, could be problematic. That said, Chile's fiscal indicators look strong enough to be able to worsen substantially before raising serious concerns (as the recent sovereign rating upgrade by Moody's attests). More immediately, the small share of taxation in the equation suggests a strong fiscal impulse and supports our bullish growth views.

## Inflation and monetary policy

*Our activity outlook suggests that inflation will probably surge temporarily above BCCh's target*

Against this backdrop, we continue to expect inflation to surge temporarily above the central bank's 3% target. We maintain our 4.0% and 3.7% forecasts for end-2010 and end-2011, respectively. With the central bank having demonstrated that it is distinctly ahead of the curve, however, activity data seem likely to take precedence over actual inflation prints in informing the near-term monetary policy outlook.

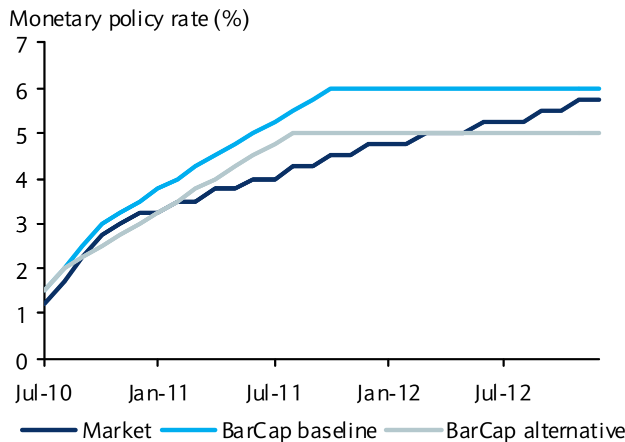
*BCCh looks set to be more focused on activity, however, with an eye on two-sided risks*

The likely pace of the normalization cycle is the big question at this point. Although we continue to think that the bright outlook for activity merits a swift normalization, two-sided risks have made the outlook for monetary policy more data-contingent. On one hand, the evolution of domestic demand would seem to call for a fast withdrawal of the monetary stimulus. On the other hand, global risks argue for a cautious pace.

*Our revised monetary policy baseline view assumes an optimistic global backdrop, but we recognize the downside risks*

Supported by Barclays Capital's constructive global call, we pencil in a baseline scenario in which BCCh continues to hike at a 50bp pace for four more meetings, slows the pace to 25bp per meeting after that, and takes the policy rate to 6% by Q4 11 (Figure 3). We acknowledge, however, that financial markets jitters or anxiety about the global recovery, could lead BCCh to intermittently pause, slow the pace, or call the cycle over before reaching a neutral stance, leaving more moderate potential upside in our 2y payer recommendation than our baseline scenario would suggest.

**Figure 3: Monetary policy prospects and risks**




Source: Bloomberg, Barclays Capital

**Figure 4: A relatively poor quarter for the peso**

Source: Bloomberg, Barclays Capital

## We see much value in CLP

*Our bullish peso view remains intact*

Although developments in Q2 were broadly supportive of our bearish views on Chile's rates, our bullish peso call has not yet been proved right (Figure 4). Yet our conviction that the growth and monetary policy outlook warrants strong peso appreciation remains intact, and we think the CLP's soft performance in Q2 has created substantial value in the currency.

As we explained in detail in *Chile: A case for further CLP strength*, 31 March 2010, the rationale for this call is that the reconstruction will trigger greater demand for Chilean goods, which in the context of a small, open economy and an inflation-targeting regime, should lead to higher rates and nominal appreciation. We think a focus on export performance or the net foreign asset position would be misleading. First, growth-driven current-account deterioration such as the one we expect in Chile is typically associated with currency *appreciation* rather than depreciation. Second, it is only *after* this deterioration (and peso appreciation) has taken place that net foreign assets are likely to look weaker.

**Figure 5: Chile macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| Activity | | | | | | |
| Real GDP (% y/y) | 4.6 | 4.6 | 3.7 | -1.5 | 4.2 | 6.6 |
| Domestic demand contribution (pp) | 6.9 | 7.8 | 8.1 | -6.5 | 14.0 | 6.9 |
| Private consumption (% y/y) | 7.1 | 7.0 | 4.6 | 0.9 | 7.9 | 5.1 |
| Fixed capital investment (% y/y) | 2.3 | 11.2 | 18.6 | -15.3 | 17.4 | 8.3 |
| Net exports contribution (pp) | -2.3 | -3.2 | -4.4 | 5.0 | -9.7 | -0.3 |
| Exports (% y/y) | 5.1 | 7.6 | 3.1 | -5.6 | 1.8 | 12.9 |
| Imports (% y/y) | 10.6 | 14.5 | 12.2 | -14.3 | 23.8 | 9.9 |
| GDP (USD bn) | 146.7 | 164.5 | 170.4 | 164.0 | 191.1 | 222.2 |
| External Sector | | | | | | |
| Current account (USD bn) | 7.2 | 7.5 | -2.5 | 4.2 | 0.0 | -2.1 |
| CA (% GDP) | 4.9 | 4.5 | -1.5 | 2.6 | 0.0 | -1.0 |
| Trade balance (USD bn) | 22.8 | 23.9 | 8.8 | 14.0 | 12.5 | 14.1 |
| Net FDI (USD bn) | 4.6 | 9.6 | 9.9 | 4.7 | 7.0 | 8.5 |
| Other net inflows (USD bn) | -8.8 | -18.6 | 2.1 | -8.9 | -7.0 | -4.4 |
| Gross external debt (USD bn) | 49.5 | 55.7 | 64.8 | 74.1 | 81.5 | 89.6 |
| International reserves (USD bn) | 19.4 | 16.9 | 23.2 | 25.4 | 25.4 | 27.4 |
| Public Sector | | | | | | |
| Public sector balance (% GDP) | 7.7 | 8.8 | 5.3 | -4.4 | -2.1 | -3.0 |
| Primary balance (% GDP) | 8.4 | 9.4 | 5.8 | -4.2 | -1.8 | -2.5 |
| Gross central govt. debt (% GDP) | 5.3 | 4.1 | 5.2 | 6.1 | 8.7 | 10.0 |
| Net central govt. debt (% GDP) | -7.0 | -13.7 | -20.4 | -11.1 | -8.0 | -5.7 |
| Prices | | | | | | |
| CPI (% Dec/Dec) | 2.6 | 7.8 | 7.1 | -1.4 | 4.0 | 3.7 |
| CPI (% average) | 3.4 | 4.4 | 8.7 | 1.5 | 1.9 | 3.5 |
| Exchange rate (dom currency/USD, eop) | 533 | 498 | 611 | 507 | 500 | 480 |
| Exchange rate (period average) | 531 | 522 | 524 | 559 | 515 | 490 |
| | **1yr Ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | -4.5 | 1.0 | 5.1 | 5.3 | 5.5 | 8.9 |
| CPI (% y/y, eop) | 1.9 | 1.5 | 1.6 | 2.9 | 4.0 | 3.6 |
| Exchange rate (dom currency/USD, eop) | 534 | 530 | 520 | 510 | 500 | 495 |
| Monetary policy benchmark rate (%, eop) | 0.75 | 1.00 | 1.00 | 2.50 | 3.50 | 4.25 |

Source: Haver Analytics, Bloomberg, Barclays Capital

# LATAM: COLOMBIA

## Prepare the cabin for take-off

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**We revised our growth forecast for Colombia to 4.5% this year, making it the country in which we see greater potential for upside surprises in the region. This should bode well for the currency and for creditworthiness without spoiling, for now, a benign inflation outlook.**

Strategy: We are constructive on the COP and credit. We think the name stands out within the low-beta space, given the upside potential associated with a re-pricing of growth expectations and a credit rating upgrade. We maintain our recommendation to take spread DV01 exposure via C041s, even though the upside has moderated.

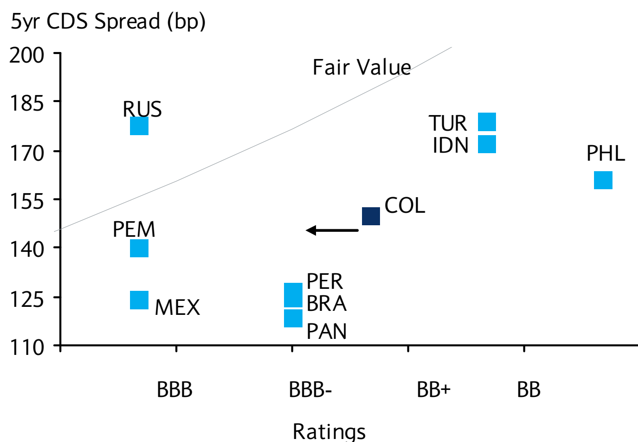
### The region's next growth shocker

Since publishing *Colombia: The region's new maverick* in the previous *Emerging Markets Quarterly* on 16 March 2010, the dominant consensus narrative in Colombia has remained, by and large, that the country is recovering slowly from the trade disruptions with Venezuela. We believe, however, that incoming data have compellingly supported our view that the Venezuela shock has run its course, paving the way for global external tailwinds and expansionary monetary policy to produce a swift economic bounce. Indeed, we have revised our 2010 real GDP growth forecast upwards to 4.5%, from 3.6%, well above still-guarded consensus expectations at 3%. The revision makes Colombia the economy in which we see greater potential for upside activity surprises in the near future, which should lead to a meaningful re-pricing of growth expectations such as those for Chile in mid-2009 and Mexico at the turn of the year.

*The economy is accelerating at the margin*

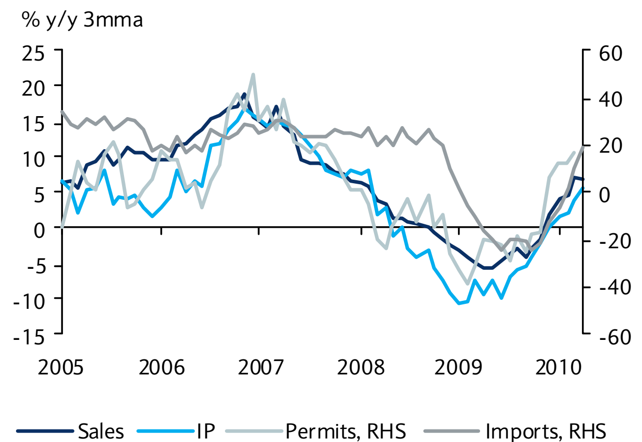
In particular, we expect a 4.0% y/y expansion in Q1 real GDP (due for publication on 24 June), consistent with acceleration in the sequential pace of expansion to 6.50% q/q saar. As well, we see risks tilted to the high side. High-frequency indicators – from retail sales to IP to trade flows – all suggest this acceleration has been taking place (Figure 2). Moreover, we expect a fairly elevated pace of growth to be sustained in coming quarters, facilitated by spare capacity, the continuation of the global recovery, and easy money.

**Figure 1: We see value in the credit**




Source: Bloomberg, Barclays Capital

**Figure 2: Everything bouncing**




Source: Haver Analytics, Barclays Capital

*The composition of growth poses a challenge for its employment and exchange rate effects*

From a longer-term perspective, as we highlighted in *Colombia: Going to the polls*, 14 May 2010, the economy is likely to continue facing the challenge associated with the composition of growth, which has relied in recent years on extractive and non-tradable activities to the detriment of the competitiveness of other tradable sectors. Figure 3 illustrates this problem, showing traditional exports almost at pre-crisis levels (even though prices have not recovered as much), whereas non-traditional exports, absent Venezuelan demand, remain comparatively stagnant even if they stopped being a drag. This bias is unlikely to revert as the country braces for a mining-energy boom (Figure 4.) The situation, however, represents a challenge for employment and exchange rate policy rather than a threat to growth, which, on the contrary, is likely to ride merrily on the oil boom.

*The current and elected authorities have emphasized the role of fiscal policy to counteract these influences*

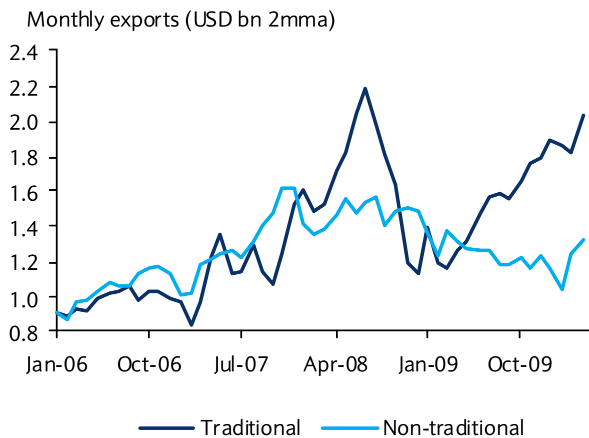
Both the current administration and the elected authorities seem well aware of this challenge, having emphasized the role of fiscal policy in restraining domestic demand and moderating the appreciation pressures emanating from the current and prospective oil bonanza. The outgoing government has worked until the last day on a fiscal rule, which it leaves at the disposal of the next administration. Moreover, in its Medium Term Fiscal Plan (MFMP) it has set targets for 2011 that are consistent with a moderate fiscal contraction. In particular, the plan considers a reduction in the central government deficit from 4.4% this year to 3.9% the next, consistent with public debt ratios peaking in 2011. These numbers seem realistic and rely on conservative assumptions, in our view (Figure 5). Overall, while they may represent too timid an effort to tame oil-fuelled domestic demand and currency strength, we see them as positive insofar as fiscal policy has been one of the sovereign's Achilles' heels in the road to investment grade. An upgrade, thus, seems likely.

## Sweet spot gets sweeter

*We do not expect the positive growth outlook to spoil a benign inflation outlook for a while…*

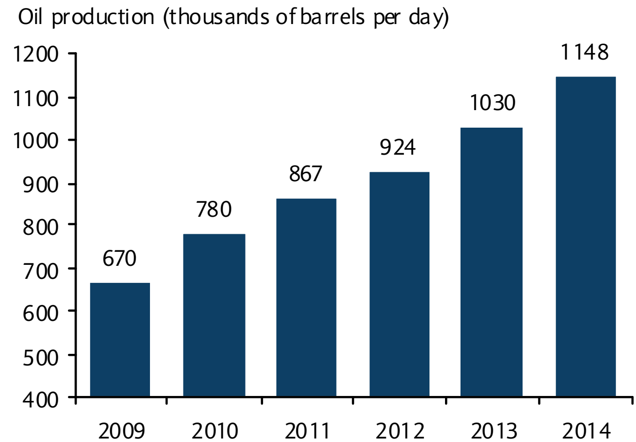
In line with the message we conveyed in our previous quarterly report, our improved growth outlook is unlikely to pose, for now, inflation threats. This is because the underlying inflation trend is still very low and, even though we think the output gap probably started narrowing in Q4 09, this process began later than in other Latin American economies. Accordingly, we expect inflation to end this year at a modest 2.6%, a touch below our previous 2.9% expectation, inching higher next year toward 3.3%. Upside risks to growth this year are consistent with upside risks to future inflation, of course, but we believe the near-term risks are quite limited.

**Figure 3: Symptoms of Dutch disease**




Source: Haver Analytics, Barclays Capital

**Figure 4: Crude prospects**




Source: Latin Source based on DNP, Barclays Capital

*… allowing Banrep to remain on hold in the remainder of the year*

Consistent with this, we believe Banrep can afford to maintain its current, very expansionary monetary policy stance until the end of the year, and only start normalizing rates next January. We pencil in a gradual but steady normalization process of 25bp increases, with the policy rate reaching 6.0% by end-2011, close to the 6.5% level we deem as neutral.

**Figure 5: Conservative fiscal assumptions**

| | | 2010 | 2011 |
|---|---|---|---|
| Real GDP | Treasury | 3.0 | 3.0 |
| | BarCap | 4.5 | 4.3 |
| WTI | Treasury | 80.0 | 80.0 |
| | BarCap | 85.0 | 97.0 |

Source: Ministry of Finance, Barclays Capital

## Let it be, let it be

*The COP has behaved by its own beat in recent months*

Much as the overall economy during 2009, the peso has been a bit of a maverick among LatAm currencies during Q2. Since mid-March and until global financial conditions took a turn for the worse in early May, the depreciation of the COP, concurrent with appreciation in other LatAm currencies, matched the bearish view we had outlined for the currency in *Colombia: The region's new maverick*, discouraged by a rich valuation, intervention, comparatively slow growth, and possible political and fiscal risks (which we changed to neutral on 22 April). Since the beginning of the May sell-off, however, the currency outperformed significantly vis-à-vis other LatAm FX, in our view reflecting cleaner positions combined with the government seizing the opportunity to repatriate dollars. The recovery since then has been more than proportionate to the May weakness, but, taking a three-month spam into account, leaves the currency more or less where it was.

*We are more constructive regarding its outlook*

What next? Despite the virtual "return to square one" in the currency behaviour during the quarter, we are much more constructive on its medium-term prospects than we were three months ago. Granted, valuations are roughly unchanged. Yet, the growth and fiscal outlook have improved. Moreover, elections, however small their effect might have been on asset prices, are also out of the way.

*Intervention is a recurrent risk, but we think limited in the near term*

Based on the statement accompanying the 18 June monetary policy decision, we believe the central bank is unlikely to extend its current program of dollar purchases beyond the end this month. We believe Banrep recognizes that structural changes in the economy associated with the mining boom can warrant a more appreciated peso. Thus, after its relative success in stopping the appreciation trend, we can envision the central bank tolerating another round of real exchange rate gains in coming months, with the USD/COP reaching 1870 by year-end. This is not to say the debate concerning intervention will be gone forever, of course, as a fast and deep appreciation would surely trigger political pressure to action. For now, however, we think Banrep will likely let the peso be, particularly as this may elude political discomfort, unnoticed in the new government's transition.

*Fiscal consolidation is a more structural risk, but seems distant still*

Perhaps the main idiosyncratic downside risk for the peso comes from the possibility of decisive fiscal tightening and the implementation of a fiscal rule, a la Chile. We believe this is likely to be attempted by the next administration; however, even if this project were to make progress, we think it remains a relatively distant risk.

## New pilot, same course

*The government transition will barely represent a policy transition, but if anything, we see upside potential*

The winner of the 20 June run-off election, Juan Manuel Santos is scheduled to take office as Colombia's new president on 7 August. Having been part of the outgoing government, his transition into power is bound to be orderly and smooth, in our view. As we highlighted in *Colombia: Going to the polls*, we expect few changes in terms of economic, security, or foreign policy relative to the Uribe administration, but we do expect some improvement in fiscal policy – an area of neglect in the current government, especially during the boom years. The timing will be ripe to switch the focus from the management of a crisis to the management of prosperity: the economy, according to our forecasts, will be already up in the air by the time it welcomes its new pilot.

**Figure 6: Colombia macroeconomic forecasts**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| Activity | | | | | | |
| Real GDP (% y/y) | 6.9 | 7.5 | 2.4 | 0.4 | 4.5 | 4.3 |
| Domestic demand contribution (pp) | 9.5 | 9.2 | 3.9 | -0.8 | 6.8 | 5.5 |
| Private consumption (% y/y) | 6.8 | 7.6 | 2.5 | 0.1 | 4.5 | 4.3 |
| Gross fixed capital formation (% y/y) | 19.1 | 13.7 | 7.5 | -5.2 | 12.5 | 8.5 |
| Net exports contribution (pp) | -2.6 | -1.7 | -1.4 | 1.2 | -2.3 | -1.2 |
| Exports (% y/y) | 8.0 | 11.4 | 7.2 | -8.2 | -3.5 | 5.0 |
| Imports (% y/y) | 16.2 | 13.9 | 9.8 | -9.1 | 6.5 | 7.3 |
| GDP (USD bn) | 162 | 208 | 243 | 250 | 280 | 315 |
| External sector | | | | | | |
| Current account (USD bn) | -3.0 | -6.0 | -6.9 | -5.1 | -6.6 | -10.1 |
| CA (% GDP) | -1.8 | -2.9 | -2.8 | -2.1 | -2.4 | -3.2 |
| Trade balance (USD bn) | 0.3 | -0.6 | 1.0 | 2.6 | 1.9 | 0.9 |
| Net FDI (USD bn) | 5.6 | 8.1 | 8.3 | 4.2 | 9.0 | 9.5 |
| Other net inflows (USD bn) | -2.7 | 2.2 | 1.2 | 2.6 | -0.8 | 1.6 |
| Gross external debt (USD bn) | 40.1 | 44.6 | 46.4 | 53.6 | 59.0 | 64.9 |
| International reserves (USD bn) | 15.4 | 21.0 | 24.0 | 25.4 | 27.0 | 28.0 |
| Public sector | | | | | | |
| Public sector balance (% GDP) | -0.7 | -0.6 | -0.1 | -2.8 | -3.6 | -2.9 |
| Central government balance (% GDP) | -3.4 | -2.7 | -2.3 | -4.2 | -4.3 | -3.8 |
| Central primary balance (% GDP) | 0.2 | 1.0 | 0.9 | -1.1 | -1.2 | -1.1 |
| Gross public sector debt (% GDP) | 36.0 | 32.3 | 31.9 | 35.2 | 37.0 | 37.8 |
| Net public sector debt (% GDP) | 26.0 | 22.4 | 24.9 | 27.2 | 28.6 | 29.2 |
| Gross central government debt (%GDP) | 40.4 | 36.5 | 36.4 | 38.5 | 39.5 | 40.5 |
| Prices | | | | | | |
| CPI (% Dec/Dec) | 4.5 | 5.7 | 7.7 | 2.0 | 2.6 | 3.3 |
| CPI (% average) | 4.3 | 5.5 | 7.0 | 4.2 | 2.2 | 3.1 |
| Exchange rate (dom currency/USD, eop) | 2240 | 2018 | 2249 | 2029 | 1870 | 1830 |
| Exchange rate (period average) | 2359 | 2075 | 1970 | 1988 | 1925 | 1850 |
| | **1yr Ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | -0.3 | 2.5 | 4.5 | 4.8 | 4.7 | 4.2 |
| CPI (% y/y, eop) | 3.8 | 2.1 | 2.3 | 2.3 | 2.6 | 3.0 |
| Exchange rate (dom currency/USD, eop) | 2143 | 1902 | 1900 | 1890 | 1870 | 1855 |
| Monetary policy benchmark rate (%, eop) | 4.50 | 3.00 | 3.00 | 3.00 | 3.00 | 3.75 |

Source: Barclays Capital

# LATAM: MEXICO

## Little room for surprises

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**We continue to expect a robust 5% recovery this year, but room for positive growth surprises has narrowed. Combined with a more dovish monetary policy outlook, this makes our bullish peso call increasingly tactical. Fiscal and external risks remain muted.**

Strategy: We remain near-term bullish on the MXN but highlight this view as tactical. In rates, we have switched to recommending paying 10y TIIE on valuation grounds. Regarding credit, we think spreads are unlikely to move away from those of Brazil or Peru in the foreseeable future and have an underweight recommendation in our model portfolio, reflecting somewhat rich valuations in the whole low-beta lot.

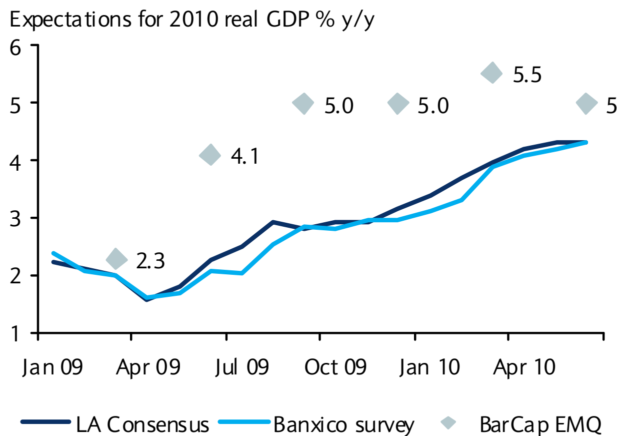
### The recovery, its composition, and its risks

Since the publication of "*Mexico: Enjoy yourself*" in the previous edition of our *Emerging Markets Quarterly*, the recovery of the Mexican economy has become, by now, well established. In the past few months, indeed, the analyst consensus has become more optimistic, in line with our call for 5% real GDP growth this year. At this point, we continue to see some room for positive activity surprises in the near term but recognize this has narrowed and the potential to trade the strong cyclical bounce has moderated and become increasingly tactical (Figure 1).

*Still bullish on growth, but with a narrower difference relative to the consensus*

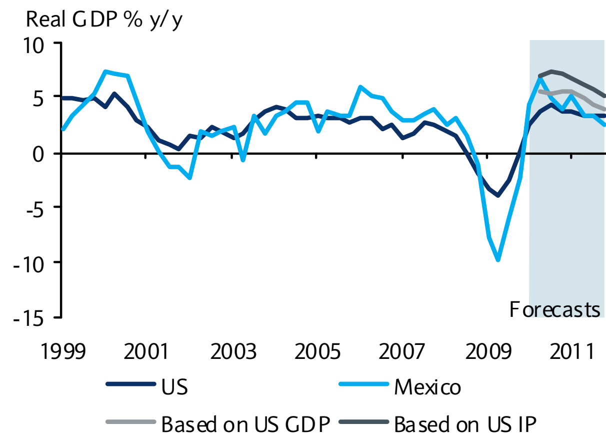
For 2011, we stick to our moderate 3.6% growth forecast, which is broadly in line with the consensus. On one hand, the recovery outlook in the US outlined in *US: Faster growth, slower Fed*, 4 June 2010, would suggest stronger growth than that (Figure 2). On the other hand, we view the likely pace of expansion this year as a distinctively cyclical bounce from very depressed activity levels and, therefore, deem it unlikely to repeat. Indeed, in recent weeks, we learnt that real GDP growth took a breather in Q1 10 and, more recently, saw some softness in April industrial figures (see *Soft activity and soccer numbers*, 11 June, 2010). Overall, these data do not change our view that we will still see solid sequential expansion in H1 10 as a whole, but they buttress the notion that the blistering pace of growth of H2 09 was exceptional.

**Figure 1: The consensus has moved toward our bullish view**




Source: Haver Analytics, Barclays Capital

**Figure 2: The US outlook could entail higher growth in 2011**




Source: Haver Analytics, Barclays Capital

As a result, our current point growth estimates do not differ too much from those of the consensus. With the cyclical bounce now largely discounted by the market, we believe the more interesting questions have shifted toward two qualitative aspects of the recovery: its composition and risks.

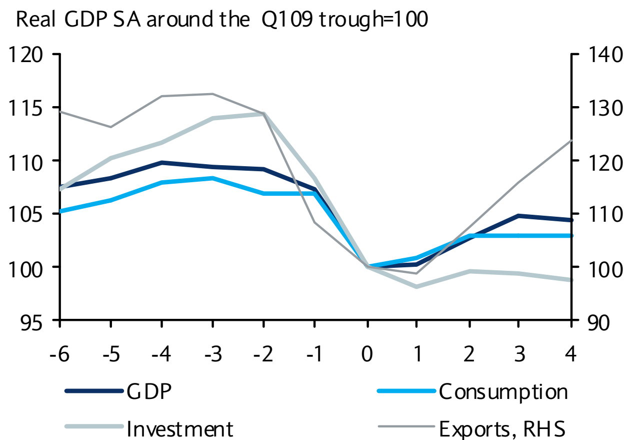
*Recent national account data show a more downbeat picture regarding domestic demand conditions*

The make-up of the recovery has caught quite a bit of attention in recent months, becoming a focal point for the monetary policy outlook. Since we made the call that Mexico would recover strongly from the crisis (*Mexico: Growing its way out of troubles*, 22 September 2009) we have emphasized the leading role of the US cyclical bounce and Mexico's export sector but also conveyed a constructive reading of the behaviour of domestic demand, particularly consumption. Figure 3 shows that, adjusting for the higher volatility of exports, a relatively balanced composition of the recovery indeed prevailed through Q3 09. Most recent national account data, however, showed weak consumption figures in Q1 10, along with downside revisions in previous quarters, resulting in stagnant private consumption since Q4 09 and only a modest 2.5% increase from year-earlier levels. Similarly, the national account investment figures remain flat, casting doubt over the incipient sequential improvement evident in the monthly series. As we highlighted in *Mexico: Searching for industrial spillovers*, 13 May 2010, we continue to think positive spillovers from the exporting sector will support a broader economic recovery in coming quarters but, admittedly, recent data have not yet backed this view.

*Risks to our recovery call remain linked to the US outlook; the direct effect of a European slowdown seems limited*

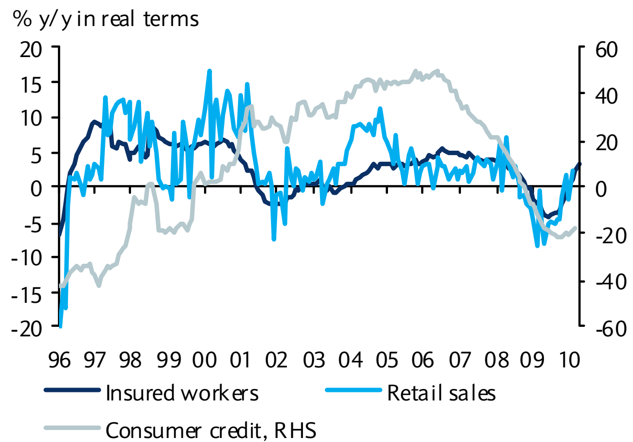
The other recurrent concern surrounding the recovery has to do with the problems in Europe, particularly in the banking sector. Indeed, although less than 5% of export demand from and FDI to Mexico comes from Europe, the strong presence of Spanish banks in the domestic financial system (37% of assets) raises understandable anxiety. There are two reasons why we think that, barring a global contagion derailing the US's own recovery, problems in European banks will have a limited direct effect on Mexico's growth. First, Mexico boasts one of the lowest loan/deposit ratios in the world at 0.79, indicating that credit is fully funded domestically. Second, it is important to recall that the economy is notorious for its financial shallowness and, at 13% of GDP, bank credit is a much smaller channel of contagion than in developed economies and other emerging markets. Consumption, in fact, appears much more strongly correlated with employment than credit, suggesting that a credit pullback would not derail a recovery if production and labor market conditions continue to improve (Figure 4).

**Figure 3: Domestic demand recovery has stalled since Q4 09**




Source: Haver Analytics, Barclays Capital

**Figure 4: Consumption seems driven by jobs more than loans**




Source: Haver Analytics, Barclays Capital

## Inflation risks still distant

*The underlying inflation trend is bottoming out*

Our activity outlook is consistent with ongoing narrowing of the output gap. A filter-based measure suggests the gap may have closed fully between Q4 10 and Q2 11, depending on the parameter imposed (Figure 5.) Meanwhile, though we expect further recovery in the peso, we forecast the currency to peak at 12.00 soon. The combination of these two inputs suggests to us that the underlying trend of core inflation (defined as the 3mma of m/m sa increases, annualized, and correcting for the tax increases in early 2010) has bottomed at roughly 3%. We expect it to inch higher in coming quarters, hovering around 3.75% and 4.0% in 2011 (Figure 6).

*Y/y inflation, however, is likely to show a benign picture for longer*

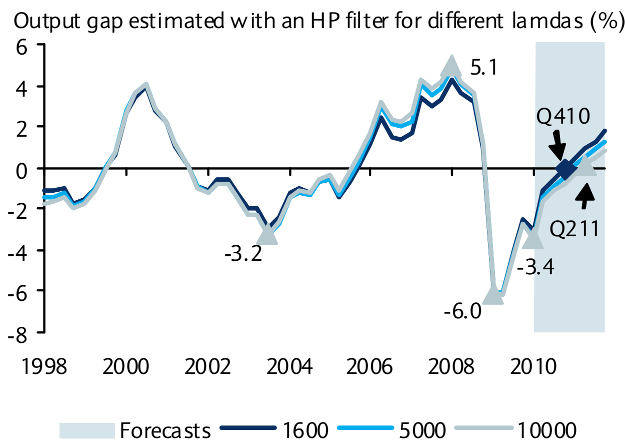
What this entails for y/y inflation, however, is not bad near-term news. This is because there are various factors boding well for y/y inflation in the coming months. First, because the current underlying trend of core inflation, even if bottoming, is still below year-earlier levels, y/y inflation has been declining. In H2 10, this decline should stop or slow (mostly because the favourable base effects from the H1 09 FX pass-through shock will have faded away) but the risk of a significant increase seems limited. Second, non-core inflation will probably continue to move higher in y/y terms, as the gradual adjustment in gasoline prices proceeds, but an increase beyond what was announced by the government is unlikely. Third, at the turn of the year, y/y inflation will get some further help from the fading away of this year's tax and regulated price increases, leading to a gap lower. Overall, thus, we continue to project inflation to behave as forecast by Banxico in the near term, ending the year at 4.75% and with slight downside risks. Upside risks, meanwhile, are concentrated in 2011, when all the helping factors outlined above will have run their course and leave the increasing trend of core inflation exposed.

## Monetary policy outlook

*In line with the consensus, we do not expect Banxico to move this year...*

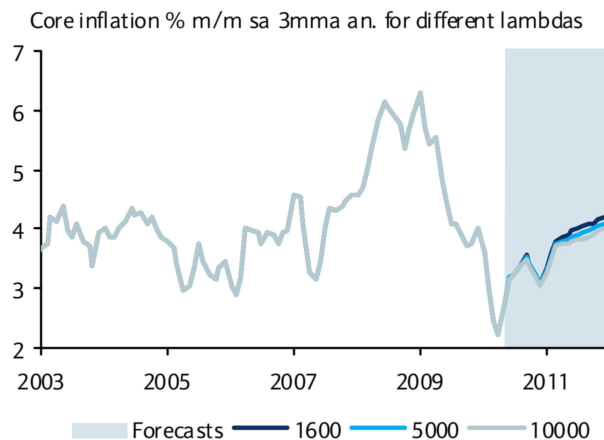
Against this backdrop, we have changed our monetary policy call, pushing back the beginning of the rates normalization cycle to January 2011, from August 2010 (see *Mexico: Banxico in no rush to normalize rates*, 21 May 2010). Central bank communication, as well as recent domestic demand data, suggest that even these more dovish expectations have risks of further postponement. While long-term breakeven inflation remains well above the bank's 3% target, it has been falling since the new central bank governor took over, lifting pressure from the bank to normalize. Moreover, Banxico's rhetoric shows it in no rush to tackle the longstanding problem of above-target expectations.

**Figure 5: The output gap has narrowed substantially…**




Source: Haver Analytics, Barclays Capital

**Figure 6: …suggesting m/m core inflation should increase**




Source: Haver Analytics, Barclays Capital

*…and even when it does, we think it will be cautious*

As it eventually moves to normalizes rates, the central bank might also bring into debate the level of neutral rates in the Mexican economy, possibly arguing that the new normal merits a lower level. Taking that into account, we pencil in a cycle of four 25bp hikes between January and April 2011, with a further 100bp in tightening spaced out in subsequent months in response to upward-trending inflation.

## MXN, an increasingly tactical call

*We remain near-term bullish on the peso, but just near term*

Since "*Mexico: Enjoy yourself*", our growth-driven bullish peso call worked for a while, but reversed drastically with the worsening of global financial conditions. We believe that as global volatility abates, some of that upside potential will probably continue to materialize, bringing the USD/MXN up to 12.00 by end-Q3. Yet disappointing Q1 sequential growth, combined with an upgrade in consensus growth forecasts, renders the space for growth-driven gains more limited. The return to trend growth in 2011 and the more dovish outlook for monetary policy should also bound the peso prospects down the road. Overall, we retain a bullish three-month view but highlight it as tactical (see *Mexico: Last call*, 13 April, 2010) and expect the MXN to, if anything, underperform other regional currencies after that horizon.

## Back-seat concerns still in the back seat

*Aside the activity outlook, other idiosyncratic risks are likely to remain in oblivion*

Although less excited about the peso on account of the narrower room for growth surprises and the more dovish outlook for monetary policy, we do not expect other idiosyncratic risks, such as concern about fiscal or external sustainability, to resurface any time soon. Granted, the excessive risk premium weighing on Mexico's credit, long-end rates, and currency since the recovery started has been largely removed, so that further gains from the mere "absence of troubles" can hardly been expected. However, for the coming months, we do not expect investor attention to turn back toward these issues either nor, therefore, risky assets to underperform on this account. The sole exception is long-end rates, for different reasons, as we simply think valuations there have become too stretched relative to fundamentals, leading us to recommend a 10y payer.

*External and fiscal metrics remain sound…*

For what it is worth, Figure 7 shows some actual and forecast metrics for standard country-risk determinants. On the fiscal front, we believe the stabilization of public debt ratios below 40% remains secure, thanks to the fiscal reform passed in Q4 09, as well as the cyclical recovery in tax collection. On the external front, meanwhile, several trends suggest that the build-up of vulnerabilities seems ages away. First, the economy is heading to post a near nil current account deficit this year (-0.3% of GDP) and only a very modest one next year (0.9%). Second, FDI, which was quite weak in H2 09, recovered in Q1 10 and augurs a decent full-year inflow. Finally, the central bank continues to increase its reserves war chest and is likely to breach the USD100bn mark by year-end.

*…and there is likely no political event with the potential to become a market mover*

Regarding the political outlook, Q3 kicks off with a round of gubernatorial elections on July 4, but the event is likely to be a non-issue for markets. If anything, the elections might just serve as an indication, ahead of the more meaningful 2012 presidential race, of whether the governing PAN can recover a little from its daunting mid-term elections defeat – which election polls do not seem to augur. For political junkies and believers in the Mayan prophecies alike, however, 2012 is far away.

*Crime, lately more visible, is still very unlikely to pose a macro threat*

Finally, crime may be more of a disturbing factor in investors' minds, given that the news flow on this front has deteriorated recently. We do not expect headlines necessarily to get better; however, we stick to our assessment that the situation does not represent a threat to economic or political stability that would warrant higher compensation for risk (see "Mexico: No regime threat", *Global Economics Weekly*, 20 March 2009).

Figure 7: Mexico macroeconomic forecasts

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 4.9 | 3.3 | 1.5 | -6.5 | 5.0 | 3.6 |
| Domestic demand contribution (pp) | 5.6 | 3.9 | 2.3 | -8.2 | 3.9 | 4.3 |
| Private consumption (% y/y) | 5.6 | 4.0 | 1.9 | -6.1 | 3.0 | 3.7 |
| Fixed capital investment (% y/y) | 9.9 | 6.9 | 4.4 | -10.1 | 1.8 | 4.0 |
| Net exports contribution (pp) | -0.7 | -0.6 | -0.8 | 1.7 | 1.0 | -0.6 |
| Exports (% y/y) | 10.9 | 5.7 | 0.5 | -14.8 | 21.5 | 6.8 |
| Imports (% y/y) | 12.6 | 7.1 | 2.8 | -18.2 | 16.5 | 8.5 |
| GDP (USD bn) | 952 | 1026 | 1087 | 876 | 1037 | 1142 |
| GDP (MXN bn) | 10382 | 11208 | 12131 | 11823 | 12968 | 14043 |
| **External sector** | | | | | | |
| Current account (USD bn) | -4.8 | -8.7 | -16.2 | -5.6 | -2.9 | -10.1 |
| CA (% GDP) | -0.5 | -0.8 | -1.5 | -0.6 | -0.3 | -0.9 |
| Trade balance (USD bn) | -6.1 | -10.1 | -17.3 | -4.7 | -2.6 | -9.6 |
| Net FDI (USD bn) | 14.2 | 19.2 | 22.5 | 4.9 | 14.0 | 21.0 |
| Other net inflows (USD bn) | -16.7 | 0.6 | 2.5 | 10.7 | 3.5 | 1.5 |
| Gross external debt (USD bn) | 169 | 193 | 201 | 192 | 204 | 215 |
| International reserves (USD bn) | 68 | 78 | 85 | 91 | 105 | 118 |
| **Public sector** | | | | | | |
| PS traditional balance (headline % GDP) | 0.1 | 0.0 | -0.1 | -2.3 | -2.7 | -1.9 |
| PS primary balance (% GDP) | 2.5 | 2.2 | 1.8 | -0.1 | -0.6 | 0.0 |
| PSBR (% GDP) | -0.8 | -1.1 | -2.1 | -3.2 | -3.7 | -2.7 |
| Gross public debt (% GDP) | 22.5 | 22.8 | 27.0 | 35.1 | 34.0 | 33.6 |
| Net public debt (% GDP) | 18.5 | 17.5 | 21.4 | 31.4 | 30.4 | 30.1 |
| Historical balance of PSBR (% GDP) | 31.3 | 29.9 | 35.7 | 39.1 | 37.9 | 37.5 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 4.1 | 3.8 | 6.5 | 3.6 | 4.8 | 3.8 |
| CPI (% average) | 3.6 | 4.0 | 5.1 | 5.3 | 4.4 | 3.8 |
| Exchange rate (dom currency/USD, eop) | 10.80 | 10.90 | 13.67 | 13.09 | 12.10 | 12.50 |
| Exchange rate (period average) | 10.91 | 10.93 | 11.16 | 13.50 | 12.50 | 12.30 |
| | **1y ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | -10.0 | 4.3 | 6.8 | 4.8 | 4.0 | 5.3 |
| CPI (% y/y, eop) | 5.7 | 3.9 | 4.0 | 4.1 | 4.8 | 3.3 |
| Exchange rate (dom currency/USD, eop) | 13.51 | 12.57 | 12.50 | 12.00 | 12.10 | 12.20 |
| Monetary policy benchmark rate (%, eop) | 4.75 | 4.50 | 4.50 | 4.50 | 4.50 | 5.25 |

Source: Haver Analytics, Barclays Capital

## LATAM: PERU

# A strong economic story, with some uncertainty still on the political front

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**The Peruvian economy is doing well. High economic growth has been accompanied by a slight deterioration in the current account that could easily be financed with FDI. Monetary policy started a tightening cycle that could bring the overnight rate to 4.5% in 2011. Fiscal accounts have remained solid and inflation under control. The only source of concern preventing an overweight recommendation is the uncertainty from the 2011 presidential election.**

### Peru's economic growth: On its way to pre-crisis levels

*Peru will likely lead economic growth in the region*

The Peruvian economy is doing well and, along with Brazil, had the best performance in the region during Q1 10 when it grew +6.0% y/y. Recently, the Peruvian National Statistics Institute (INEI) released GDP figures for April, showing an impressive 9.3% y/y increase, the highest rate since September 2008 (when the crisis started). These results put YTD growth at 6.9% y/y, versus 1.08% y/y in the same period of 2009, leading us to change our growth estimate to 7.1% for 2010 and 6.4% for 2011. Despite the good results in the past two months (+8.8% and +9.3% y/y), by Q4 10 the growth rate will probably be a little bit lower since the 2009 base will be higher.

*There was a decline in the mining sector, but the strength in external and internal demand is evident*

When we analyze the data, the strength of external and internal demand is evident. As for the tradable sectors, there is very positive growth in manufacturing, up 16.4% y/y in April and 9.5% YTD (this explains 28.2% of total growth in April). In addition, important non-tradable sectors reflect the recovery in domestic demand: retail sales grew 11.1% y/y in April and 8.9% y/y YTD (this explains 20.4% of total growth in the month); and construction was up 21.1% y/y in April and 17.9% y/y YTD. We want to highlight the fact that the mining sector, the main export sector, contracted 7.4%y/y (-2.9% y/y YTD).

### External sector: All is going up!

*High growth will hurt external accounts a bit*

On the external front, high economic growth implies some deterioration in the trade balance. As for exports, we estimate an increase of 15.3% y/y, reaching USD31.0bn in 2010, which could be seen as highly conservative if we consider the 44.0% y/y increase in January-April, when export volumes increased only 0.2% y/y, since mining production has been decreasing. Imports should end 2010 at USD26.2bn (+24.5% y/y), as domestic demand recovery and the reposition of inventories should continue in the near future. The dynamic of exports and imports will likely lead to a trade surplus of USD5.1bn (-13.6% y/y) and a current account deficit of USD2.3bn, falling from a surplus of USD0.3bn in 2009.

*FDI will finance the CA deficit and allow BCRP to continue accumulating reserves*

As for the capital account, we expect a substantial inflow of foreign currency due to the sound economic policies recently implemented by the government, which also explain the good sovereign risk performance. This could put more appreciation pressure on the PEN and generate further accumulation of foreign reserves by the Peruvian central bank (BCRP).

## Fiscal accounts also look solid

*Previous surpluses allow authorities to implement an efficient counter-cyclical fiscal policy*

On the fiscal front, Peru also looks solid. For 2010, we estimate a deficit of 0.3% of GDP, the second consecutive year with a deficit after three years with an average surplus of 1.7% of GDP. Last year, President Alan Garcia's economic team applied a countercyclical fiscal policy to energize the economy (spending expanded 14.1% y/y, while income contracted 9.4% y/y). The main variable in the policy was the anti-crisis plan of 2.6% of GDP (about USD3.3bn), with the intention of keeping the domestic economy dynamic (an important proportion of the plan has been going to the construction sector). Two-thirds of the plan (USD2.2bn) was to be spent in 2009 and the remaining third (USD1.1bn) in 2010. For 2011, we expect fiscal accounts to return to a surplus, due to higher tax collections on a more invigorated economy and no extension of anti-crisis plan beyond 2010. Financing needs will be covered by past years' surpluses (according to the Ministry of Finance, fiscal surpluses totalled USD8.0bn in 2006-08) and small debt issues (internal and external).

## BCRP start a hike cycle in its reference rate

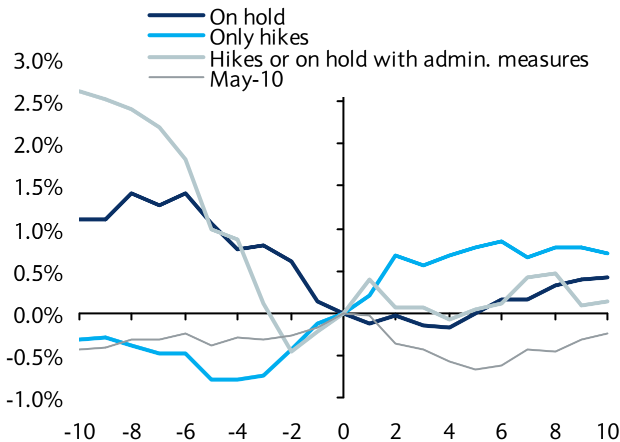
*High growth with low inflation pressure, but the need for interest rate normalization remains*

The board of the BCRP raised the overnight policy rate 25bp in the previous two monetary policy meetings, bringing it from 1.25% to 1.75% and starting the tightening cycle. The first hike was not expected by the market. Given the lack of inflation pressures, the increase was a pre-emptive move due to the great dynamism in domestic demand and a way to normalize the Peruvian curve. In the previous 12 months to May, headline inflation was 1.04% y/y (inside the 1-3% band) and core inflation was 1.8% y/y. Although the BCRP said that the increases in the reference rate will not mean a tightening cycle and that further changes will depend on inflation figures, we expect it to have an upfront monetary policy, increasing the benchmark rate to 3% by year-end and 4.5% for 2011.

*High growth with low inflation pressures*

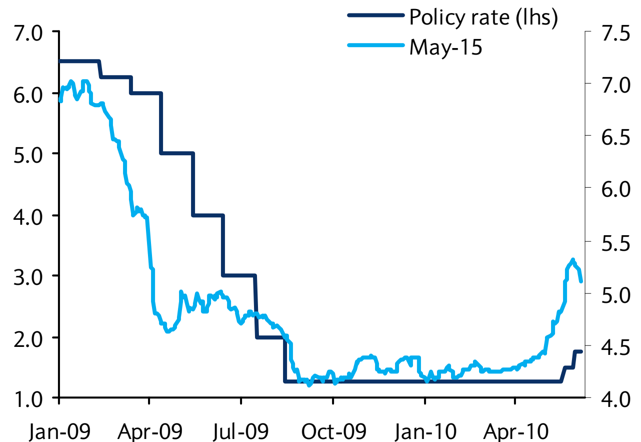
As we said in *Peru: A 25bp hike on June 10*, 8 June 2010, in light of Peru's strong economic outlook, the low level of the reference rate provides the BCRP with tactical room to continue the necessary normalization process of monetary policy and, at the same time, maintain the reference rate below neutral levels while uncertainty about the effects of Europe's fiscal problems on global growth dissipates. With regards to price evolution, we expect inflation to rise from 0.25% y/y last year to 2.8% y/y in 2010, maintaining our inflation call despite higher expected growth.

**Figure 1: Average PEN behavior in days around monetary policy decisions in hiking cycle**




Source: Bloomberg, Barclays Capital

**Figure 2: Monetary policy and dynamics of May15s**




Source: Bloomberg, Barclays Capital

## The only source of concern is the electoral uncertainty

Peru's presidential election, scheduled to take place next year, could bring greater economic uncertainty. According to a recent survey by the pollster Ipsos-Apoyo, Lima mayor and centre-right candidate Luis Castañeda is leading the polls with 22%. He is followed by Keiko Fujimori with 18% and Ollanta Humala and Alejandro Toledo with 13% each of intended votes. There is no presidential candidate for the ruling and biggest political party, APRA, yet. Additionally, after Colombia's elections, we believe that it is important to highlight that these polls cover large urban areas only. Rural areas and small cities are not taken into consideration, yet represent a little bit more than 40% of the electoral universe. Using the 2006 presidential elections and other Ipsos-Apoyo studies, one can infer that these less densely populated areas would favour Humala, Toledo and Fujimori, tightening the intended vote levels close to 20% each. In this scenario, there is a high degree of uncertainty over the two candidates who will compete in the second round. Although that round limits the possibility for a radical anti-system candidate, we are of the opinion that the market will pressure Peruvian assets if Humala reaches it.

**Figure 3: Peru macroeconomic forecast**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| Activity | | | | | | |
| Real GDP (% y/y) | 7.6 | 9.0 | 9.8 | 0.9 | 7.1 | 6.4 |
| Private consumption (% y/y) | 6.4 | 8.3 | 8.7 | 2.4 | 9.1 | 7.5 |
| Private fixed capital investment (% y/y) | 20.1 | 23.4 | 25.8 | -15.2 | 16.3 | 17.0 |
| Exports (% y/y) | 0.8 | 6.2 | 8.8 | -2.5 | 12.2 | 10.5 |
| Imports (% y/y) | 13.1 | 21.3 | 19.8 | -18.4 | 16.2 | 8.8 |
| GDP (USD bn) | 92.3 | 107.3 | 127.4 | 129.2 | 149.0 | 162.4 |
| External sector | | | | | | |
| Current account (USD bn) | 2.9 | 1.2 | -4.7 | 0.3 | -2.0 | -2.3 |
| CA (% GDP) | 3.1 | 1.1 | -3.7 | 0.2 | -1.3 | -1.4 |
| Trade balance (USD bn) | 9.0 | 8.3 | 3.1 | 5.9 | 5.1 | 5.2 |
| Net FDI (USD bn) | 3.5 | 5.4 | 6.1 | 4.5 | 5.9 | 6.6 |
| Gross external debt (USD bn) | 28.4 | 32.6 | 35.1 | 34.9 | 35.7 | 36.3 |
| International reserves (USD bn) | 17.3 | 27.7 | 31.2 | 33.2 | 38.2 | 43.1 |
| Public sector | | | | | | |
| Public sector balance (% GDP) | 2.1 | 3.1 | 2.1 | -1.8 | -0.3 | 0.5 |
| Primary balance (% GDP) | 4.0 | 4.9 | 3.7 | -0.6 | 1.1 | 1.8 |
| Gross public debt (% GDP) | 30.5 | 31.9 | 27.7 | 31.7 | 33.5 | 33.8 |
| Prices | | | | | | |
| CPI (% Dec/Dec) | 1.1 | 3.9 | 6.7 | 0.3 | 2.7 | 2.7 |
| FX (PEN per USD, eop) | 3.2 | 3.0 | 3.1 | 2.9 | 2.8 | 2.9 |
| | 1yr Ago | Last | Q2 10F | Q3 10F | Q4 10F | Q1 11F |
| Real GDP (y/y) | -1.2 | 6.0 | 7.8 | 7.4 | 6.9 | 6.3 |
| CPI (% y/y, eop) | 3.1 | 1.0 | 1.6 | 2.3 | 2.8 | 3.0 |
| Exchange rate (PEN per USD, eop) | 3.01 | 2.84 | 2.84 | 2.84 | 2.83 | 2.84 |
| Monetary policy rate (%, eop) | 2.5 | 1.25 | 1.75 | 2.50 | 3.00 | 3.25 |

Source: National Statistics Institute, BCRP, Barclays Capital

## LATAM: URUGUAY

# A hectic quarter

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**The administration is concerned about the appreciation of the currency, and it is taking heterodox measures to depreciate the UYU despite the economy's being in good shape. Inflation pressures are underway. Fiscal consolidation is on track.**

*In his first 100 days, Mujica's economics seem more dovish and heterodox than those of ex-president Tabare Vazquez*

There has been a remarkable change in economic policy since Mujica took office last March. The administration has expressed its desire to use central bank reserves and, more recently, the Treasury announced it would intervene more frequently in the currency market to actively manage the currency. On March 22, President Mujica said that he was considering using central bank reserves to build railroads and schools. Minister Lorenzo's comments a few weeks later were a bit calmer, as he said that he would consider using reserves to reduce debt. To our knowledge, the government has not taken any material step towards instrumentation for the time being. On June 7, Minister Lorenzo said that the Treasury would intervene in the foreign exchange market to pursue a depreciation of the real exchange rate, on the back of evident pressures from the business sector. High ranking Ministry of Finance officials have even made explicit comments on exchange rate levels (USD/UYU 21-22) with which the administration would likely be comfortable. The UYU depreciated 7% in the following two sessions. However, President Mujica has shown significant conviction on other pending economic issues, such as reducing the fiscal deficit. In our view, the administration has clearly hinted that investors should expect a looser monetary policy, higher inflation, and should remain confident that fiscal consolidation continues in 2010 and 2011.

*However, the administration has shown significant conviction in fiscal consolidation*

*We have upgraded our 2010 growth forecast to 7% from 4.5%*

Economic activity surprised on the upside in Q1 10, leading us to upgrade our growth forecasts to 7% in 2010, up from 4.5% before. Output expanded at a fast clip of 6.9% saar, or 8.9% y/y in Q1 10, which, together with our forecast for the following quarters, implies a carry over of 1.0% to 2011. However, if global growth remains on track as we expect, we forecast growth at 4.1% in 2011. The main driver of the strong recovery is domestic demand, while net exports are expected to contribute negatively to growth in 2010. Real exports grew a moderate 3.8% in Q1 10, outstripped by the 10.1% y/y jump in imports. Brazil remains the main contributor to export growth as it accounts for 25% of Uruguay exports, followed by exports to Europe, which account for 23.5%. The relatively large trade connection with Europe, of course, is a source of risk in the current global juncture. Finally, private investments are expected to recover from last year's 10.6% y/y drop, as we expect a 15.8% y/y increase for 2010.

*The fiscal deficit is expected to fall to 1.2% of GDP; supply of USD1bn in a 20-year Globals is expected in 2011*

Higher-than-expected growth and high rainfall levels led us to reduce our fiscal deficit forecast for the current year to 1.2% from 1.9%. The deficit reduction is mostly a result of the increase in the surpluses of public enterprises, due to lower cost of energy because of higher rainfall. Tax collection increased 10.9% y/y though April, driven mostly by taxes related to domestic activity, although trade taxes also recovered, at 8.8% y/y. On the spending side, primary spending has grown 10.8% y/y since the beginning of the year. Spending is running in line with nominal GDP growth, though at a lower pace than last year's 15.3% y/y. The fiscal adjustment is falling mainly on capital spending budget lines that were reduced 19%y/y through April. While the government has planned to issue USD500mn in 2010, we believe that hostile market conditions will likely force the administration to rely on past savings to face 2010 financing needs. However, we do not discard that the government might rush to the market opportunistically if market conditions

improve. In fact, Debt Director Steneri said that they plan to issue a 20-year global bond as part of 2011 financial program. For 2011, according to our calculations, the government would need to issue about USD1.0bn, although 2011 financing plans include issuances for USD1.3bn. However, given the administration's open strategy to aid the central bank against appreciation pressures, we expect the government to issue local-denominated paper (UI or nominal), and buy dollars in the market with the proceeds of the issuance. The government is also looking to reduce the foreign currency composition of its debt, which currently stands at about 65%. In our view, debt services in 2010 and 2011 remain very manageable for the government.

*Conflicting monetary objectives are the main challenge for the central bank; we have increased our inflation forecasts slightly*

The main challenge of the administration is to reconcile their explicit weak currency objective with increasing inflation pressures. So far, the strong growth momentum has been paralleled by receding inflation pressures, possibly due, paradoxically, to the relatively stronger UYU. These favourable conditions could change drastically in the following quarters if the economy continues to expand as we expect. The central bank, we envisage, will more likely leave rates unchanged at the June 24 monetary policy meeting. In the past few weeks, the central bank has only partially rolled over short-term maturing peso debt in the local financial system to increase liquidity, lower rates, and weaken the UYU. The direct influence of the executive on the central bank is visible, but the BCU might be reluctant to reduce interest rates, increasing the likelihood, in our view, that the rates remain unchanged, although risks are tilted to the downside.

**Figure 1: At least USD1.0bn in global issuance is expected in 2011**

| USD bn | 2010 E | 2011 F |
|---|---|---|
| Gross financing needs | 2.2 | 2.2 |
| Interests | 1.1 | 1.0 |
| Principal | 1.2 | 1.2 |
| Primary deficit | -0.6 | -0.9 |
| Net financing needs | 1.6 | 1.3 |
| Total sources | -2.1 | -1.6 |
| IFIs | -1.1 | -0.4 |
| Issuances | 0.0 | -1.2 |
| of which are Globals | 0.0 | **-1.0** |
| Deposits, net | -1.0 | 0.0 |
| Financing Gap | -0.6 | -0.3 |

Source: Banco Central de Uruguay

*What define the president's first days in office are his efforts to bridge the divides. Will he be able to reap the benefits of this strategy?*

President Mujica recently passed his first 100 days in office. He has a lofty 63% approval rate, similar to that of ex-president Tabare Vazquez. The economic recovery is playing to his advantage, as is the historically low unemployment rate. What defines his days in office, in our view, is his continued effort to bridge the divide on several issues within Uruguay's politics, including the opposition factions within the Frente Amplio coalition, the Kirchner administration, and, in a more historical dimension, the military. Take the more recent case of Argentina: Mujica's vote crucially helped ex-president Nestor Kirchner to become Secretary General of the UNASUR, in exchange for a tacit agreement from the Kirchners to resolve several longstanding bilateral conflicts.[5] Now, it is payback time. The risk is that the

[5]T he pulp mill (Botnia), the toll Argentina would charge for the use of their gas pipelines to import cheap gas from Bolivia, and the dredge of the Martin Garcia Canal.

Uruguayan constituency's expectations are not met, which would imply a sizable political cost for the Mujica administration.

**Figure 2: Uruguay macroeconomic forecasts**

| | 2006 | 2007 | 2008F | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| Activity | | | | | | |
| Real GDP (% y/y), RHS | 4.7 | 7.2 | 8.7 | 2.5 | 7.0 | 4.1 |
| Domestic Demand Contribution (pp) | 8.1 | 6.8 | 12.2 | -1.2 | 9.3 | 5.4 |
| Private Consumption (% y/y) | 6.1 | 7.0 | 8.5 | 1.2 | 7.9 | 5.0 |
| Fixed Capital Investment (% y/y) | 18.5 | 7.9 | 19.0 | -4.4 | 12.3 | 6.7 |
| Net Exports Contribution (pp) | -3.4 | 0.4 | -3.5 | 3.7 | -2.2 | -1.3 |
| Exports (% y/y) | 3.2 | 7.4 | 10.1 | 2.5 | 5.2 | 2.5 |
| Imports (% y/y) | 15.3 | 5.7 | 21.0 | -8.6 | 12.3 | 6.4 |
| GDP (USD bn) | 19.9 | 24.1 | 31.0 | 31.7 | 36.9 | 40.3 |
| External Sector | | | | | | |
| Current Account (USD bn) | -0.4 | -0.2 | -1.5 | 0.3 | 0.1 | 0.3 |
| CA (% GDP) | -2.0 | -0.9 | -4.8 | 0.8 | 0.3 | 0.8 |
| Trade Balance (USD bn) ( FOB) | -0.5 | -0.5 | -1.7 | -0.3 | -0.6 | -0.5 |
| Net FDI (USD bn) | 1.5 | 1.2 | 1.8 | 1.1 | 1.8 | 2.1 |
| Other Net Inflows (USD bn) | 0.4 | 1.3 | 3.7 | 1.3 | 1.8 | 2.0 |
| Gross External Debt (USD bn) | 10.6 | 12.2 | 12.0 | 12.9 | 13.8 | 14.7 |
| International Reserves (USD bn) | 3.1 | 4.1 | 6.3 | 7.9 | 9.8 | 12.1 |
| Public Sector | | | | | | |
| Public Sector Balance (% GDP) | -0.5 | 0.0 | -1.5 | -1.7 | -1.2 | -0.7 |
| Primary Balance (% GDP) | 3.5 | 3.4 | 1.4 | 1.1 | 1.8 | 2.1 |
| Gross Public Debt (% GDP) | 69.1 | 67.7 | 53.4 | 62.9 | 54.3 | 49.4 |
| Net Public Debt (% GDP) | 53.5 | 50.6 | 32.9 | 37.9 | 27.8 | 19.3 |
| Prices | | | | | | |
| CPI (% average) | 6.4 | 8.1 | 7.9 | 7.1 | 7.0 | 6.5 |
| FX (UYU per USD, eop) | 24.4 | 21.5 | 24.4 | 19.5 | 20.7 | 22.0 |
| Exchange Rate (period average) | 24.1 | 23.3 | 21.0 | 22.4 | 21.5 | 21.8 |
| | **Last** | **10Q2** | **10Q3** | **10Q4** | **11Q1** | **11Q2** |
| Real GDP (y/y) | 8.9 | 8.3 | 6.4 | 5.0 | 4.3 | 4.1 |
| CPI (% y/y, average) | 6.8 | 6.8 | 6.8 | 7.0 | 7.1 | 6.9 |
| Exchange Rate (UYU/USD, eop) | 20.6 | 20.6 | 23.1 | 22.0 | 22.0 | 22.0 |
| Reference rate | 6.25 | 6.25 | 6.75 | 7.25 | 7.25 | 7.25 |

Source: Banco Central de Uruguay, INE

# LATAM: VENEZUELA

## Deeper recession despite increasing oil prices

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**The Venezuelan economy is contracting sharply and inflation is rising as a result of the increase in political stress and the new exchange-rate regime. Surprisingly, the government is addressing this situation with a more conservative fiscal policy, despite a higher oil price and devaluation. Its nationalization program has led to a decline in private investment, leaving the oil sector as the only engine of economic growth. Nonetheless, the public sector's position seems strong enough to guarantee external debt payments. We continue to expect new issuance by PDVSA.**

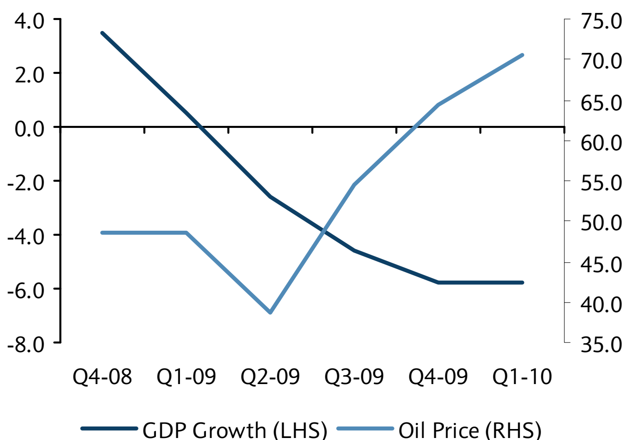
### Political stress, investment collapse and output contraction

Economic activity data for the first quarter of the year show that real GDP fell 5.8% y/y, driven by a 27.9% y/y drop in investment, the largest decline since 2003, just after the oil strike. These results reflect the effect of the increase in political stress since the beginning of the year stemming from the acceleration of the government's reform agenda, which includes a broad-based program of nationalizations. In our view, the electric utility sector provides a good example of this. The government nationalized four power companies, paying almost USD2.0bn, thereby forgoing the same amount in new investment. Just three years later, it has had to ration power, causing production disruptions that have undermined economic activity.

*Lack of investment limits the capacity of the economy to respond to a fiscal stimulus.*

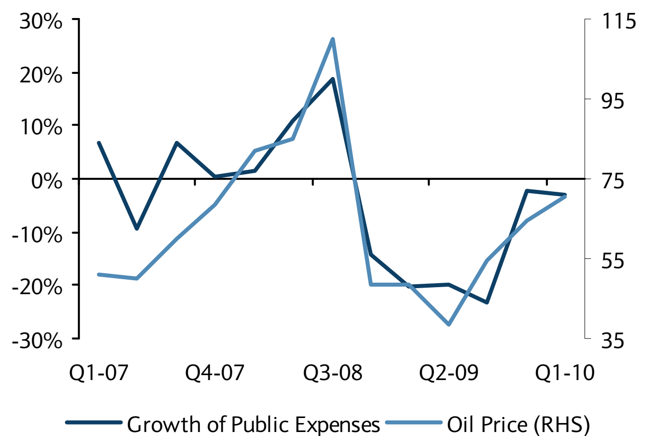
We do not expect an improvement in economic activity in the second half of the year, given the likely production disruption caused by delays in imports that are a consequence of the new exchange rate regime. In addition, the public expenditure increase expected before the National Assembly election in September of this year has not started yet, which suggests to us that it will be tiny. For these reasons, we expect a deeper recession for 2010, with GDP contracting 5.4%. Nonetheless, for 2011, given a "rebound effect" and increased investment in the oil sector, we expect an increase in economic activity of 2.0%. However, the low level of private investment will likely limit the ability of the non-oil sectors of the economy to respond to fiscal stimulus. For the next 30 months, any increase in aggregate demand is likely to generate an increase in import demand and higher inflationary pressures. Therefore, we expect an inflation rate of 34.3% in 2010 and 29.3% in 2011.

Figure 1: Deep recession despite higher oil prices




Source: Venezuelan Central Bank, Ministry of Energy and Petroleum, Barclays Capital

Figure 2: Fiscal policy simply follows oil prices




Source: Ministry of Finance, Ministry of Energy and Petroleum, Barclays Capital

It is important to highlight that the increase in inflation expectations, particularly this year, is also associated with the tighter restrictions the government has imposed on access to foreign currency, which is likely to lead to the emergence of a black market that will likely become a reference for price-setting and generate higher inflationary pressures.

### *Government expenditures adjust to changes in oil prices*

*The next big fiscal push will likely be for the presidential election in 2012*

Given that the country is experiencing a deep recession, it seems ironic that public expenditures have not registered a significant increase, despite higher oil prices, the positive effect of currency devaluation, and the fact that elections will be held next September. In fact, cumulative central government expenditures for the first five months of 2010 declined 8.1% in real terms from the same period in 2009. These figures appear to signal that a more conservative fiscal policy is being implemented by Finance Minister Jorge Giordani, which could be consistent with a strategy of conserving resources in order to be in a better position for a bigger battle: the presidential election in 2012.

**Figure 3: A more conservative fiscal policy – Non-financial public sector (% of GDP)**

| | 2008 | 2009 | 2010 F | 2011 F |
|---|---|---|---|---|
| **Income** | **31.4** | **28.5** | **31.9** | **32.3** |
| PDVSA's Operational Surplus | 13.8 | 8.2 | 13.2 | 14.3 |
| Non-oil Income | 17.6 | 20.2 | 18.7 | 18.0 |
| **Expenditures** | **34.0** | **33.0** | **33.8** | **34.2** |
| Current Expenditures | 22.7 | 22.6 | 23.5 | 24.9 |
| Interest Payment | 1.3 | 1.3 | 1.4 | 1.0 |
| Capital Expenditures | 10.4 | 10.0 | 9.9 | 9.0 |
| Others | 0.9 | 0.3 | 0.3 | 0.2 |
| **Balance (Surplus +, Deficit -)** | **-2.6** | **-4.5** | **-1.9** | **-1.9** |
| **Primary Balance (Surplus +, Deficit -)** | **-1.3** | **-3.1** | **-0.5** | **-0.8** |

Source: Ministry of Finance, Barclays Capital

*We expect an improvement in the public sector balance*

Under these circumstances, we expect an improvement in the public sector balance despite the deep contraction in the economy. We expect total income for the restricted public sector to reach 31.9% of GDP. Considering that total expenditures amount to 33.8% of GDP, this should result in a deficit of 1.9% of GDP. Similarly, for 2011, we expect public sector income to increase to 32.3% of GDP, which could give the government room to increase expenditures to 34.2% of GDP, resulting, again, in a deficit of 1.9% of GDP.

### *Capital outflows should persist despite restrictions*

*Significant current account surpluses, mostly offset by capital outflows from the public sector*

We expect current account surpluses of USD25.1bn in 2010 and USD30.7bn in 2011 as a result of the increase in oil prices and a sharp contraction in imports, driven by the recession and the restrictions imposed on the parallel FX market. The surpluses in the current account will likely be offset by similar deficits in the capital accounts of USD23.9bn in 2010 and USD29.6bn in 2011. We expect capital outflows to be led by the government, with a reduction in private capital outflows, given the FX restrictions the authorities have imposed.

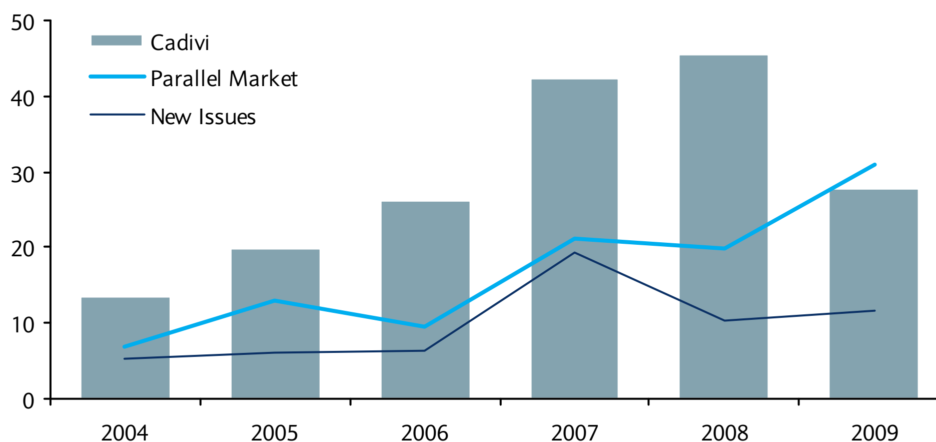
**Figure 4: Public sector set to lead capital flight, offsetting CA surpluses (USD bn)**

| | 2008 | 2009 | 2010 F | 2011 F |
|---|---|---|---|---|
| Oil price (Venezuelan basket, USD/bl) | 86.6 | 57.0 | 69.3 | 79.0 |
| **Current Account** | **37.4** | **8.6** | **25.1** | **30.7** |
| Trade Balance | 45.6 | 19.2 | 34.8 | 41.4 |
| Exports | 95.1 | 57.6 | 66.3 | 77.5 |
| Imports | -49.5 | -38.4 | -31.5 | -36.1 |
| Services and Income Balances | -8.3 | -10.6 | -9.7 | -10.8 |
| **Capital Account (USD bn)** | **-24.4** | **-19.6** | **-23.9** | **-29.6** |
| **Change in International Reserves** | **13.0** | **-11.0** | **1.2** | **1.1** |
| **International Reserves** | **43.0** | **35.0** | **36.2** | **37.3** |

Source: Venezuelan central bank, Barclays Capital

Another important change expected for 2010 will be the way in which imports are financed. Until 2008, Cadivi, the commission that administers currency exchange in Venezuela, provided 94% of the foreign currency demanded for the private sector's imports. Therefore, most of the debt issuance of the VEB/USD operations was actually financing private sector capital flight while helping the government to sterilize liquidity in an effort to control the parallel exchange rate and inflation. This situation changed last year with the decline in oil prices. Cadivi became more restrictive and transferred a higher proportion of import financing to the parallel market, and its new issuance went to finance both capital flight and non-priority imports. For 2010, the government's priorities have changed, and it is focusing on providing cheap foreign currency for imports. But for now, the authorities have stated that they are not planning to sell hard currency for private capital flight.

**Figure 5: In 2009, the final demand in the parallel market was higher than Cadivi disbursement (USD bn)**




Source: Ecoanalitica, Barclays Capital

As we commented in *Venezuela: We have become more cautious, given VEB weakness*, May 6, 2010, the weaker the VEB, the higher the probability of new issuance. Under the new FX regime, the authorities are trying to restrict demand through quantitative measures. In this scenario, Venezuelans will likely look for alternative ways to buy hard currency. In a country where oil accounts for 95.7% of total exports (completely controlled by the public sector), and given the nationalization program, a thriving black market would be a strong distortion, with incentives for the depreciation of the currency. Therefore, as the black market gains

importance, we expect it to become a reference for price-setting and to tend to generate higher inflationary pressures. Under these conditions, we expect new issuance in H2 10, likely via PDVSA, with maturities in 2012 and 2013, under local law and a coupon of about 4.75%.

### *Orinoco oil belt projects*

Another important point to highlight is how the government has been more flexible with regard to new development projects in the oil sector. In our opinion, it has changed its approach because it is now aware that it needs partners to develop the Orinoco belt. Clearly, it realizes that Venezuela does not have the capacity to extract and refine all of the heavy oil it has, and for the government, it is very important to ensure the inflow of foreign currency. Based on this, we see more FDI in the oil sector (USD40bn in the next three years). The government expects to increase production by 400,000 bpd by 2012 in what has been called early production at the new Orinoco projects, and by 2016, the authorities expect production in Junin and Carabobo to reach 2mn bpd. We do not expect the government to meet those goals in the stated time frame, but if it reaches half of the targeted levels, the improvement in Venezuelan debt could be significant.

**Figure 6: Venezuela macroeconomic forecast**

| | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|---|---|
| **Activity** | | | | | | |
| Real GDP (% y/y) | 10.3 | 8.4 | 4.8 | -3.3 | -5.4 | 2.0 |
| Oil GDP (% y/y) | -2.0 | -4.2 | 2.5 | -7.2 | 1.6 | 3.4 |
| Non-Oil GDP (% y/y) | 11.7 | 9.5 | 5.1 | -2.0 | -6.2 | 2.0 |
| Consumption (% y/y) | 15.6 | 16.1 | 7.0 | -2.2 | -3.0 | 3.1 |
| Fixed Capital Investment (% y/y) | 26.6 | 25.4 | -3.3 | -8.2 | -16.5 | 1.7 |
| Exports (% y/y) | -4.5 | -5.6 | -2.7 | -19.6 | -3.9 | 2.5 |
| Imports (% y/y) | 31.1 | 33.6 | 3.8 | -19.7 | -16.8 | 4.6 |
| GDP (USD bn) | 166.2 | 227.8 | 313.4 | 348.4 | 250.6 | 312.4 |
| **External Sector** | | | | | | |
| Oil Price (Brent, USD/bl.) | 66.1 | 72.6 | 98.5 | 62.6 | 80.0 | 90.0 |
| Current Account (USD bn) | 27.1 | 20.0 | 38.9 | 8.6 | 25.1 | 30.7 |
| CA (% GDP) | 16.3 | 8.8 | 12.4 | 2.5 | 10.0 | 9.8 |
| Trade Balance (USD bn) | 32.9 | 23.7 | 47.0 | 19.2 | 34.8 | 41.4 |
| Gross External Debt (USD bn) | 30.2 | 39.7 | 41.8 | 53.8 | 54.4 | 59.2 |
| International Reserves (USD bn) | 37.4 | 33.5 | 43.0 | 35.0 | 36.2 | 37.3 |
| **Public Sector** | | | | | | |
| Public Sector Balance (% GDP) | 0.4 | -2.6 | -2.6 | -4.5 | -1.9 | -1.9 |
| Primary Balance (% GDP) | 2.5 | -1.1 | -1.3 | -3.1 | -0.5 | -0.8 |
| Gross Public Debt (% GDP) | 28.3 | 24.8 | 17.9 | 22.5 | 28.3 | 25.6 |
| Net Public Debt (% GDP) | -26.2 | -48.1 | -55.0 | -32.5 | -40.1 | -31.0 |
| **Prices** | | | | | | |
| CPI (% Dec/Dec) | 17.0 | 22.5 | 30.9 | 25.1 | 34.3 | 29.3 |
| Exchange Rate (VEB/USD, eop) | 2.15 | 2.15 | 2.15 | 2.15 | 4.30 | 4.30 |
| | **1yr Ago** | **Last** | **Q2 10F** | **Q3 10F** | **Q4 10F** | **Q1 11F** |
| Real GDP (y/y) | 0.5 | -5.8 | -6.5 | -4.4 | -4.9 | -0.7 |
| Exchange Rate (VEB/USD, eop) | 2.15 | 3.15 | 3.62 | 3.62 | 3.62 | 3.79 |

Source: Venezuelan Central Bank, Ministry of Finance, Ministry of Energy and Petroleum, National Statistics Institute, Barclays Capital

# OVERVIEW OF KEY ECONOMIC AND FINANCIAL INDICATORS

| | 2009 GDP | 2009 population | 2009 GDP | 2009 GDP | 2009 Share of world | Real GDP growth | Inflation | 2009 Inflation Target | 2010 Inflation Target | Sovereign credit rating | | | 2009 Reserves | 2009 Gross External Debt | 2009 Gross Public Debt | 2009 Saving Rate | 2009 Opennes |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | (USD bn) | (mn) | (USD pc) | (PPP pc) | GDP at PPP | (2000-2009) | (2000-2009) | (%) | (%) | Moody's | S&P | Fitch | (USD bn) | (% GDP) | (% GDP) | (% GDP) | ((X+M)/GDP) |
| PR China | 4,909 | 1338.6 | 3,667 | 6,546 | 12.05 | 9.7 | 1.9 | 4.0 | 3.0 | A1 | A+ | A+ | 2399 | 8 | 18 | 52 | 59 |
| Hong Kong, SAR | 211 | 7.1 | 29,865 | 42,574 | 0.45 | 4.2 | -0.2 | N/A | N/A | Aa2 | AA+ | AA | 256 | 318 | 1 | 32 | 380 |
| China, Taipei | 379 | 23.0 | 16,497 | 29,829 | 1.06 | 3.5 | 1.0 | 0% | 0-2% | Aa3 | AA- | A+ | 292 | 21 | 42 | 32 | 116 |
| India | 1,320 | 1166.1 | 1,132 | 2,932 | 4.95 | 7.2 | 5.2 | - | - | Baa3 | BBB- | BBB- | 283 | 19 | 93 | 29 | 41 |
| Indonesia | 542 | 240.3 | 2,256 | 4,149 | 1.34 | 4.9 | 8.5 | 4-6% | 3.0-5.0% | Ba2 | BB | BB+ | 66 | 29 | 47 | 31 | 46 |
| Malaysia | 194 | 28.3 | 6,843 | 13,551 | 0.57 | 4.8 | 2.2 | - | - | A3 | A- | A- | 98 | 37 | 49 | 36 | 172 |
| Philippines | 161 | 92.3 | 1,744 | 3,536 | 0.47 | 4.6 | 5.3 | 2.5-4.5% | 3.5-5.5% | Ba3 | BB- | BB | 44 | 36 | 70 | 20 | 62 |
| Singapore | 178 | 5.0 | 35,693 | 49,433 | 0.34 | 4.9 | 1.4 | -1.0% | 2-3% | Aaa | AAA | AAA | 189 | 62 | 91 | 54 | 385 |
| South Korea | 842 | 48.6 | 17,306 | 27,791 | 1.84 | 4.4 | 3.1 | 2.5-3.5% | 2.0-4.0% | A2 | A | A+ | 270 | 48 | 50 | 39 | 95 |
| Thailand | 264 | 63.5 | 4,156 | 7,998 | 0.81 | 4.1 | 2.5 | 0.0-3.5% | 0.5-3.0% | Baa1 | BBB+ | BBB | 138 | 27 | 44 | 33 | 126 |
| Vietnam | 93 | 86.0 | 1,081 | 2,933 | 0.36 | 7.3 | 7.1 | - | - | Ba3 | BB | BB- | 16 | 23 | 45 | 29 | 138 |
| **Emerging Asia** | **9,092** | **3,099** | **2,934** | **9,685** | **24.2** | **7.6** | **3.1** | | | | | | **4,052** | | | | |
| Czech Republic | 195 | 10.4 | 18,557 | 24,093 | 0.37 | 3.3 | 2.6 | 2%-4% | 1%-3% | A1 | A | A+ | 42 | 42 | 31 | 22 | 111 |
| Hungary | 129 | 10.0 | 12,927 | 18,567 | 0.27 | 2.5 | 5.9 | 3% | 3% | Baa1 | BBB- | BBB | 44 | 134 | 78 | 23 | 122 |
| Kazakhstan | 109 | 15.8 | 7,019 | 11,693 | 0.25 | 8.5 | 8.7 | - | - | Baa2 | BBB- | BBB- | 23 | 106 | 14 | 33 | 67 |
| Poland | 430 | 38.1 | 11,288 | 18,072 | 0.98 | 3.9 | 3.2 | 1.5%-3.5% | 1.5%-3.5% | A2 | A- | A- | 84 | 67 | 51 | 21 | 66 |
| Ukraine | 116 | 45.6 | 2,542 | 6,339 | 0.42 | 4.4 | 12.3 | -- | -- | B2 | B | B- | 27 | 90 | 35 | 15 | 74 |
| Russia | 1,229 | 141.4 | 8,694 | 14,920 | 3.05 | 5.3 | 13.1 | -- | -- | Baa1 | BBB | BBB | 437 | 38 | 6 | 23 | 40 |
| Turkey | 615 | 70.4 | 8,723 | 12,476 | 1.25 | 3.6 | 19.4 | 8% | 6.5% | Ba2 | BB | BB+ | 71 | 44 | 46 | 13 | 40 |
| South Africa | 287 | 49.3 | 5,824 | 10,244 | 0.70 | 3.6 | 6.1 | 3-6% | 3-6% | A3 | BBB+ | BBB+ | 39 | 28 | - | 15 | 46 |
| **EMEA** | **3,112** | **381** | **8,167** | **14,460** | **7.3** | **4.5** | **11.2** | | | | | | **766** | | | | |
| Argentina | 324 | 40.1 | 8,065 | 14,126 | 0.83 | 3.4 | 13.5 | -- | -- | B2 | B- | B- | 48 | 37 | 46 | 22 | 30 |
| Brazil | 1,577 | 191.4 | 8,239 | 10,456 | 2.87 | 3.3 | 6.7 | 4.5% | 4.5% | Baa3 | BBB- | BBB- | 239 | 13 | 69 | 15 | 18 |
| Chile | 164 | 16.9 | 9,693 | 14,299 | 0.36 | 3.7 | 3.3 | 3% | 3% | Aa3 | A+ | A | 25 | 45 | 6 | 18 | 57 |
| Colombia | 250 | 45.0 | 5,567 | 8,206 | 0.58 | 4.0 | 6.0 | 5% | 3% | Ba1 | BB+ | BB+ | 25 | 21 | 35 | 21 | 37 |
| Mexico | 876 | 107.5 | 8,143 | 13,542 | 2.20 | 1.9 | 4.9 | 3% | 3% | Baa1 | BBB | BBB | 91 | 22 | 35 | 21 | 53 |
| Peru | 130 | 29.6 | 4,378 | 8,723 | 0.37 | 5.2 | 2.5 | 2% | 2% | Ba3 | BBB- | BBB- | 33 | 16 | 25 | 21 | 37 |
| Uruguay | 33 | 3.5 | 9,360 | 13,019 | 0.06 | 2.6 | 8.9 | 7%-3% | 6%-4% | Ba3 | BB | BB- | 9 | 41 | 61 | 18 | 50 |
| Venezuela | 350 | 28.2 | 12,401 | 12,496 | 0.52 | 3.9 | 21.3 | -- | -- | B2 | BB- | BB- | 35 | 19 | 27 | 12 | 29 |
| **Latin America** | **3,703** | **462** | **8,010** | **11,702** | **7.8** | **3.1** | **7.4** | | | | | | **506** | | | | |
| **Emerging Markets** | **15,907** | **3,942** | **4,035** | **10,970** | **39.3** | **6.2** | **5.5** | | | | | | **5,324** | | | | |

Source: Barclays Capital

# GLOBAL FORECASTS

| | Real GDP % over previous period, saar | | | | | | | Real GDP % annual chg | | | Consumer prices % over a year ago | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 3Q09 | 4Q09 | 1Q10 | 2Q10 | 3Q10 | 4Q10 | 1Q11 | 2009 | 2010 | 2011 | 4Q09 | 2Q10 | 4Q10 | 2Q11 |
| **Global** | 5.2 | 4.8 | 5.1 | 4.5 | 3.9 | 3.8 | 4.1 | -0.8 | 4.7 | 4.3 | 1.6 | 2.6 | 2.7 | 2.6 |
| Developed | 1.5 | 3.5 | 2.6 | 3.3 | 2.7 | 2.7 | 2.2 | -3.4 | 2.6 | 2.6 | 0.7 | 1.4 | 1.4 | 1.5 |
| Emerging | 9.7 | 6.5 | 8.2 | 5.9 | 5.4 | 5.2 | 6.5 | 2.4 | 7.3 | 6.4 | 3.7 | 5.3 | 5.9 | 5.3 |
| BRIC | 11.9 | 6.0 | 9.8 | 7.1 | 6.8 | 6.1 | 7.5 | 5.0 | 8.7 | 7.8 | 2.2 | 4.5 | 5.0 | 4.4 |
| **America** | 3.0 | 5.8 | 3.6 | 4.8 | 3.8 | 3.7 | 3.3 | -2.5 | 4.0 | 3.6 | 2.4 | 3.0 | 3.0 | 3.1 |
| United States | 2.2 | 5.6 | 3.0 | 4.5 | 4.0 | 3.5 | 3.0 | -2.4 | 3.6 | 3.5 | 1.4 | 1.8 | 1.3 | 1.7 |
| Canada | 0.9 | 4.9 | 6.1 | 4.0 | 3.5 | 3.5 | 3.0 | -2.5 | 3.8 | 3.1 | 0.8 | 1.5 | 2.5 | 2.2 |
| Latin America | 5.7 | 6.4 | 4.5 | 5.7 | 3.4 | 4.3 | 4.2 | -2.5 | 5.3 | 4.1 | 6.5 | 8.4 | 9.8 | 9.1 |
| Argentina | -4.9 | 0.1 | 4.7 | 7.0 | 6.7 | 6.1 | 5.0 | -4.0 | 6.1 | 3.8 | 14.8 | 22.9 | 28.8 | 25.6 |
| Brazil | 9.0 | 9.3 | 11.4 | 4.0 | 2.8 | 3.5 | 4.0 | -0.2 | 7.3 | 4.4 | 4.3 | 5.0 | 6.1 | 5.8 |
| Chile | 5.2 | 6.2 | -5.9 | 15.0 | 7.0 | 7.0 | 6.0 | -1.5 | 4.2 | 6.6 | -1.9 | 1.3 | 3.6 | 3.4 |
| Colombia | 1.7 | 4.7 | 6.5 | 5.0 | 3.0 | 4.5 | 4.5 | 0.4 | 4.5 | 4.3 | 2.4 | 2.1 | 2.4 | 2.8 |
| Mexico | 10.1 | 7.9 | -1.4 | 9.5 | 3.5 | 3.5 | 3.5 | -6.5 | 5.0 | 3.6 | 4.0 | 4.1 | 4.6 | 3.9 |
| Peru | 5.0 | 6.1 | 10.1 | 5.3 | 6.3 | 7.1 | 7.0 | 0.9 | 7.1 | 6.4 | 0.2 | 1.6 | 2.7 | 2.9 |
| Venezuela | -7.9 | -3.7 | -10.6 | -8.4 | -2.9 | 4.6 | 3.5 | -3.3 | -5.4 | 2.0 | 25.1 | 32.2 | 34.3 | 31.8 |
| **Asia/Pacific** | 9.7 | 6.2 | 9.7 | 5.7 | 5.5 | 5.6 | 6.8 | 3.6 | 7.6 | 6.4 | 0.5 | 2.2 | 2.6 | 2.4 |
| Japan | 0.4 | 4.6 | 5.0 | 3.0 | 1.4 | 2.1 | 1.6 | -5.2 | 3.4 | 1.7 | -1.7 | -1.3 | -0.7 | -0.2 |
| Australia | 0.8 | 1.9 | 4.7 | 2.5 | 3.2 | 4.0 | 4.2 | 1.3 | 3.3 | 3.7 | 2.0 | 3.1 | 3.3 | 3.5 |
| Emerging Asia | 12.4 | 6.8 | 11.0 | 6.5 | 6.6 | 6.5 | 8.1 | 5.9 | 8.8 | 7.6 | 1.6 | 4.1 | 4.4 | 3.8 |
| China | 12.5 | 10.1 | 10.4 | 8.7 | 8.1 | 8.1 | 9.5 | 8.7 | 10.1 | 9.0 | 0.7 | 3.1 | 4.7 | 4.1 |
| Hong Kong | 1.2 | 10.0 | 10.0 | -1.4 | 1.2 | 1.2 | 5.9 | -2.8 | 5.1 | 4.0 | 1.3 | 2.6 | 2.3 | 2.1 |
| India | 17.7 | -2.9 | 13.4 | 8.0 | 8.0 | 7.0 | 8.0 | 6.7 | 8.8 | 8.3 | 5.0 | 9.9 | 6.2 | 4.9 |
| Indonesia | 6.1 | 6.6 | 5.3 | 6.6 | 7.8 | 6.1 | 4.9 | 4.5 | 6.3 | 6.2 | 2.8 | 4.6 | 5.4 | 5.9 |
| Korea | 13.4 | 0.7 | 8.8 | 3.9 | 2.3 | 3.1 | 5.5 | 0.2 | 5.7 | 4.0 | 2.4 | 2.7 | 2.5 | 1.2 |
| Malaysia | 9.7 | 13.3 | 6.9 | 4.7 | 2.8 | 4.1 | 5.5 | -1.7 | 7.5 | 5.0 | -0.2 | 1.5 | 1.6 | 1.9 |
| Philippines | 0.7 | 7.2 | 13.2 | 2.6 | 1.8 | 3.1 | 7.4 | 1.1 | 6.0 | 5.0 | 4.3 | 4.7 | 3.7 | 3.9 |
| Singapore | 11.1 | -1.0 | 38.6 | 0.5 | -9.8 | 2.1 | 8.6 | -1.3 | 9.5 | 4.0 | -0.8 | 3.4 | 3.8 | 1.8 |
| Sri Lanka | 4.2 | 6.2 | 8.0 | 7.3 | 6.3 | 6.4 | 6.9 | 3.5 | 7.0 | 6.6 | 4.8 | 5.3 | 5.8 | 6.2 |
| Taiwan | 11.2 | 16.7 | 11.3 | 0.5 | 0.5 | 1.4 | 6.1 | -1.9 | 7.5 | 4.0 | -1.3 | 1.1 | 1.6 | 1.9 |
| Thailand | 5.7 | 17.0 | 16.0 | -13.3 | 4.1 | 2.0 | 5.5 | -2.2 | 6.0 | 4.0 | 1.9 | 3.2 | 3.7 | 2.6 |
| Vietnam | 5.4 | 7.7 | 5.8 | 6.7 | 7.1 | 7.4 | 6.5 | 5.2 | 6.8 | 7.2 | 6.5 | 8.8 | 8.2 | 8.3 |
| **Europe and Africa** | 1.1 | 1.2 | 0.9 | 2.4 | 1.7 | 1.9 | 1.7 | -4.4 | 2.0 | 2.5 | 1.6 | 2.3 | 2.6 | 2.2 |
| Euro area | 1.6 | 0.5 | 0.8 | 1.9 | 1.5 | 1.6 | 1.2 | -4.1 | 1.1 | 1.8 | 0.4 | 1.5 | 1.9 | 1.5 |
| United Kingdom | -1.1 | 1.8 | 1.2 | 2.8 | 2.0 | 2.1 | 2.2 | -4.9 | 1.2 | 2.2 | 2.1 | 3.4 | 2.9 | 2.0 |
| Sweden | 1.4 | 1.7 | 5.9 | 3.4 | 3.1 | 3.1 | 2.8 | -5.1 | 3.3 | 2.9 | -0.4 | 1.0 | 1.4 | 1.8 |
| EM Europe & Africa | 4.2 | 5.1 | 2.0 | 3.6 | 3.4 | 1.2 | 3.0 | -5.0 | 4.1 | 4.3 | 6.6 | 5.4 | 5.3 | 5.4 |
| Czech Repub. | 2.0 | 2.2 | 2.0 | 0.6 | 3.2 | 3.1 | 2.9 | -4.1 | 1.1 | 2.8 | 1.0 | 1.4 | 2.0 | 1.3 |
| Hungary | -2.3 | 1.0 | 1.4 | 1.2 | 0.8 | 1.0 | 3.2 | -6.3 | 1.1 | 3.6 | 5.6 | 4.5 | 2.9 | 2.7 |
| Poland | 2.8 | 8.4 | -4.1 | 7.7 | 1.6 | 2.4 | 5.3 | 1.7 | 2.9 | 3.3 | 3.5 | 2.1 | 2.2 | 2.1 |
| Russia | 2.7 | 0.9 | 0.1 | 1.7 | 3.2 | -1.3 | 1.4 | -7.9 | 4.5 | 5.0 | 8.8 | 5.8 | 6.1 | 6.6 |
| Turkey | 12.7 | 15.8 | 10.0 | 6.0 | 5.5 | 4.0 | 4.0 | -4.7 | 6.3 | 4.0 | 6.5 | 8.6 | 7.7 | 7.3 |
| South Africa | 0.9 | 3.2 | 4.6 | 4.1 | 4.4 | 4.5 | 4.5 | -1.8 | 3.3 | 4.5 | 6.0 | 4.5 | 5.1 | 5.6 |

Note: Weights used for real GDP are based on IMF shares of world GDP, PPP-based (2009). Weights used for consumer prices are based on nominal GDP in USD (2009). Source: Barclays Capital

# WORLD AT A GLANCE

| | CPI inflation (% change) | | | | | Current account (% GDP) | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010F | 2011F | 2007 | 2008 | 2009F | 2010F | 2011F |
| **Global** | 3.1 | 4.3 | 0.9 | 2.5 | 2.4 | -0.3 | -1.0 | -0.2 | -0.2 | -0.4 |
| Developed | 2.1 | 3.1 | 0.0 | 1.4 | 1.5 | -1.6 | -2.2 | -1.1 | -1.0 | -1.1 |
| Emerging | 5.5 | 7.3 | 3.0 | 5.0 | 4.6 | 2.8 | 1.8 | 2.1 | 1.7 | 1.4 |
| BRIC | 4.9 | 6.7 | 1.5 | 4.7 | 4.3 | 6.5 | 5.3 | 3.2 | 2.6 | 2.3 |
| **America** | 3.5 | 4.9 | 1.1 | 3.2 | 3.0 | -3.6 | -3.6 | -2.2 | -2.6 | -3.3 |
| United States | 2.9 | 3.8 | -0.4 | 1.7 | 1.7 | -5.2 | -4.9 | -2.7 | -3.3 | -4.2 |
| Canada | 2.1 | 2.4 | 0.3 | 1.9 | 2.2 | 1.0 | 0.5 | -2.5 | -1.5 | -0.5 |
| Latin America | 6.5 | 10.1 | 7.2 | 9.2 | 8.5 | 1.0 | -0.1 | -0.2 | -0.2 | -0.6 |
| Argentina | 18.4 | 26.7 | 16.3 | 22.8 | 27.2 | 2.7 | 2.2 | 3.7 | 2.4 | 1.8 |
| Brazil | 4.5 | 5.9 | 4.3 | 6.1 | 5.0 | 0.1 | -1.7 | -1.5 | -2.4 | -2.7 |
| Chile | 4.4 | 8.7 | 1.5 | 1.9 | 3.5 | 4.5 | -1.5 | 2.6 | 0.0 | -1.0 |
| Colombia | 5.5 | 7.0 | 4.2 | 2.2 | 3.1 | -2.9 | -2.8 | -2.1 | -2.4 | -3.2 |
| Mexico | 4.0 | 5.1 | 5.3 | 4.4 | 3.8 | -0.8 | -1.5 | -0.6 | -0.3 | -0.9 |
| Peru | 1.8 | 6.7 | 0.2 | 2.7 | 2.7 | 1.2 | -3.7 | 0.2 | -1.3 | -1.4 |
| Venezuela | 18.7 | 30.9 | 25.1 | 34.3 | 29.3 | 8.8 | 12.4 | 3.6 | 10.1 | 9.4 |
| **Asia/Pacific** | 2.7 | 4.2 | 0.2 | 2.2 | 2.3 | 5.7 | 4.2 | 3.8 | 3.3 | 2.9 |
| Japan | 0.0 | 0.0 | -1.3 | -1.0 | -0.3 | 4.8 | 3.2 | 2.8 | 3.5 | 3.6 |
| Australia | 2.4 | 4.4 | 2.1 | 3.3 | 3.4 | -5.9 | -5.8 | -3.4 | -4.6 | -5.6 |
| Emerging Asia | 4.2 | 6.6 | 0.8 | 3.9 | 3.6 | 7.4 | 5.9 | 5.1 | 4.0 | 3.5 |
| China | 4.8 | 5.9 | -0.7 | 3.5 | 3.5 | 10.6 | 9.4 | 6.1 | 5.3 | 5.0 |
| Hong Kong | 2.0 | 4.3 | 0.5 | 2.5 | 2.5 | 12.3 | 13.6 | 8.7 | 7.8 | 7.2 |
| India | 4.7 | 8.4 | 3.8 | 7.0 | 5.5 | -1.3 | -2.4 | -2.5 | -2.8 | -2.8 |
| Indonesia | 6.4 | 10.3 | 4.3 | 4.5 | 5.8 | 2.4 | 0.1 | 2.0 | 1.3 | 1.0 |
| Korea | 2.5 | 4.7 | 2.8 | 2.6 | 1.5 | 0.6 | -0.6 | 5.1 | 1.8 | 1.3 |
| Malaysia | 2.0 | 5.4 | 0.6 | 1.5 | 1.8 | 16.0 | 17.5 | 16.4 | 14.9 | 13.2 |
| Philippines | 2.8 | 9.4 | 3.2 | 4.4 | 3.7 | 4.9 | 2.1 | 5.3 | 5.0 | 4.6 |
| Singapore | 2.1 | 6.6 | 0.6 | 2.8 | 1.7 | 26.6 | 18.6 | 17.8 | 15.4 | 12.7 |
| Sri Lanka | … | 22.7 | 2.9 | 5.7 | 6.0 | -4.5 | -10.1 | -0.5 | -3.0 | -2.5 |
| Taiwan | 1.8 | 3.5 | -0.9 | 1.2 | 1.8 | 8.4 | 6.2 | 11.1 | 7.5 | 3.9 |
| Thailand | 2.2 | 5.5 | -0.8 | 3.5 | 2.5 | 6.4 | 0.6 | 7.7 | 5.3 | 3.5 |
| Vietnam | … | 23.0 | 6.0 | 8.8 | 8.5 | -9.8 | -11.6 | -8.4 | -9.3 | -7.8 |
| **Europe and Africa** | 2.3 | 3.4 | 0.7 | 1.8 | 1.7 | -0.3 | -1.6 | -0.8 | -0.1 | 0.5 |
| Euro area | 2.1 | 3.3 | 0.3 | 1.6 | 1.5 | 0.2 | -1.5 | -0.7 | 0.2 | 0.9 |
| United Kingdom | 2.3 | 3.6 | 2.2 | 3.1 | 2.0 | -2.7 | -1.6 | -1.3 | -1.9 | -1.2 |
| EM Europe & Africa | 6.9 | 6.7 | 3.7 | 4.0 | 3.8 | -3.7 | -3.6 | -1.3 | -0.8 | -0.7 |
| Czech Republic | 5.5 | 3.6 | 1.0 | 2.0 | 1.8 | -3.2 | -3.1 | -1.1 | 0.7 | 1.2 |
| Hungary | 7.4 | 3.5 | 5.6 | 2.9 | 3.1 | -6.5 | -7.0 | 0.3 | -0.7 | -1.1 |
| Poland | 4.2 | 3.3 | 3.5 | 2.3 | 2.3 | -4.7 | -5.0 | -1.7 | -1.9 | -1.9 |
| Russia | 11.9 | 13.3 | 8.8 | 6.1 | 6.8 | 5.9 | 6.0 | 3.9 | 6.1 | 4.6 |
| Turkey | 8.4 | 10.1 | 6.5 | 7.7 | 6.9 | -5.9 | -5.7 | -2.3 | -5.0 | -4.9 |
| South Africa | 7.1 | 11.5 | 7.1 | 5.0 | 5.7 | -7.2 | -7.1 | -4.0 | -3.6 | -4.9 |

Note: weights used for aggregate consumer prices and current account balances based on nominal GDP in USD (IMF 2009). Source: Barclays Capital

# OFFICIAL INTEREST RATES

| Official rate | Current | Start of cycle |  | Last move | Next move expected | Forecasts as at end of |  |  |  |
|---|---|---|---|---|---|---|---|---|---|
|  |  | Date | Level |  |  | Q2 10 | Q3 10 | Q4 10 | Q1 11 |
| % per annum (unless stated) |  |  |  |  |  |  |  |  |  |
| **Advanced** |  |  |  |  |  |  |  |  |  |
| Fed funds rate | 0-0.25 | Easing: 17 Sep 07 | 5.25 | Dec 08 (-75-100) | Apr 2011 (+25) | 0-0.25 | 0-0.25 | 0-0.25 | 0-0.25 |
| BoJ overnight rate | 0.10 | Easing: 30 Oct 08 | 0.50 | Dec 08 (-20) | Q2 12 (+20) | 0.10 | 0.10 | 0.10 | 0.10 |
| ECB repo rate | 1.00 | Easing: 8 Oct 08 | 4.25 | May 09 (-25) | Q2 11 (+25) | 1.00 | 1.00 | 1.00 | 1.00 |
| **Emerging Asia** |  |  |  |  |  |  |  |  |  |
| China: Working capital rate | 5.31 | Easing: 12 Sep 08 | 7.47 | Dec 08 (-27) | Q4 10 (+27) | 5.31 | 5.31 | 5.58 | 5.58 |
| Hong Kong: Base rate | 0.50 | Easing: 19 Sep 07 | 6.75 | Dec 08 (-100) | Apr 2011 (+25) | 0.50 | 0.50 | 0.50 | 0.50 |
| India: Repo rate | 5.25 | Tightening: 19Mar 10 | 4.75 | Apr 10 (+25) | Jun 2010 (+25) | 5.50 | 5.75 | 6.00 | 6.00 |
| Indonesia: O/N policy rate | 6.50 | Easing: 4 Dec 08 | 9.50 | Aug 09 (-25) | Q4 10 (+25) | 6.50 | 6.50 | 6.75 | 6.75 |
| Korea: O/N call rate | 2.00 | Easing: 8 Oct 08 | 5.25 | Feb 09 (-50) | Aug 10 (+25) | 2.00 | 2.25 | 2.50 | 2.75 |
| Sri Lanka: Reverse Repo | 9.75 | Easing: 20 Feb 09 | 12.00 | Nov 09 (-75) | Q4 10 (+25) | 9.75 | 9.75 | 10.00 | 10.00 |
| Malaysia: O/N policy rate | 2.50 | Tightening: 04 Mar 10 | 2.00 | May 10 (+25) | Q4 10 (+25) | 2.50 | 2.50 | 2.75 | 2.75 |
| Philippines: O/N lending | 4.00 | Easing: 18 Dec 08 | 6.00 | May 09 (-25) | Q4 10 (+25) | 4.00 | 4.00 | 4.25 | 4.25 |
| Taiwan: Rediscount rate | 1.25 | Easing: 25 Sep 08 | 3.625 | Feb 09 (-25) | Q3 10 (+12.5) | 1.25 | 1.375 | 1.50 | 1.625 |
| Thailand: O/N repo rate | 1.25 | Easing: 3 Dec 08 | 3.75 | Apr 09 (-25) | Q3 10 (+25) | 1.25 | 1.50 | 1.75 | 1.75 |
| Vietnam: Base rate | 8.00 | Tightening: 1 Dec 09 | 7.00 | Dec 09 (+100) | - | 8.00 | 8.00 | 8.00 | 8.00 |
| **Emerging Europe and Africa** |  |  |  |  |  |  |  |  |  |
| Czech R: 2w repo rate | 0.75 | Easing: 8 Aug 08 | 3.75 | Apr 10 (-25) | Feb 11 (+25) | 0.75 | 0.75 | 0.75 | 1.25 |
| Hungary: 2w deposit rate | 5.25 | Easing: 24 Nov 08 | 11.50 | Apr 10 (-25) | Oct 10 (-25) | 5.25 | 5.25 | 4.50 | 4.50 |
| Poland: 2w repo rate | 3.50 | Easing: 26 Nov 08 | 6.00 | Jun 09 (-25) | Mar 11 (+25) | 3.50 | 3.50 | 3.50 | 3.75 |
| Romania: Key policy rate | 6.25 | Easing: 4 Feb 08 | 10.25 | Apr 10 (-25) | Jul 10 (-25) | 6.25 | 5.75 | 5.50 | 5.50 |
| Russia: refi rate | 7.75 | Easing: 24 Apr 09 | 13.00 | Apr 10 (-25) | Jul 10 (-25) | 7.75 | 7.50 | 7.50 | 7.50 |
| South Africa: repo rate | 6.50 | Easing: 11 Dec 08 | 12.00 | Mar 10 (-50) | Jul 11 (+50) | 6.50 | 6.50 | 6.50 | 6.50 |
| Turkey: 1wk repo rate | 7.00 | Easing: 20 Nov 08 | 16.75 | Nov 09 (-25) | Dec 10 (+50) | 7.00 | 7.00 | 7.50 | 8.00 |
| Egypt: Deposit rate | 8.25 | Easing: 13 Feb 09 | 11.50 | Sep 09 (-25) | Apr 11 (+25) | 8.25 | 8.25 | 8.25 | 8.25 |
| Israel: Discount Rate | 1.50 | Tightening: Aug 09 | 0.50 | Mar 10 (+25) | Oct 10 (+25) | 1.50 | 1.50 | 2.00 | 2.25 |
| **Latin America** |  |  |  |  |  |  |  |  |  |
| Brazil: SELIC rate | 10.25 | Tightening: 28 Apr 10 | 8.75 | Jun 10 (+75) | Jul 2010 (+75) | 10.25 | 11.75 | 11.75 | 11.75 |
| Chile: Monetary Policy Rate | 1.00 | Tightening: 15 Jun 10 | 0.50 | Jun 10 (+50) | Jul 2010 (+50) | 1.00 | 2.50 | 3.50 | 4.25 |
| Colombia Repo Rate | 3.00 | Easing: 19 Dec 08 | 10.0 | Apr 10 (-50) | Jan 2011 (+25) | 3.00 | 3.00 | 3.00 | 3.75 |
| Mexico: Overnight Rate | 4.50 | Easing: 16 Jan 09 | 8.25 | Jul 09 (-25) | Jan 2011 (+25) | 4.50 | 4.50 | 4.50 | 5.25 |
| Peru: Reference rate | 1.75 | Tightening: 6 May 10 | 1.25 | Jun 10 (+25) | Jul 2010 (+25) | 1.75 | 2.25 | 3.00 | 3.50 |

Note: Changes denoted in bold. *Israel: June 2010 forecasted hike of 25bp be effective as of July 1st 2010. Source: Barclays Capital

# FX FORECASTS AND FORWARDS

Koon Chow, George Christou, Roberto Melzi, Kumar Rachapudi

| | FX forecasts | | | | | Forecast vs outright forward | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Spot | 1m | 3m | 6m | 1y | 1m | 3m | 6m | 1y |
| G7 countries | | | | | | | | | |
| EUR | 1.23 | 1.20 | 1.20 | 1.25 | 1.25 | -2.7% | -2.8% | 1.2% | 1.1% |
| JPY | 91 | 92 | 94 | 96 | 98 | 1.1% | 3.4% | 5.8% | 8.5% |
| GBP | 1.48 | 1.45 | 1.48 | 1.57 | 1.57 | -1.9% | 0.1% | 6.2% | 6.2% |
| CHF | 1.11 | 1.21 | 1.23 | 1.20 | 1.24 | 8.9% | 10.5% | 8.5% | 12.6% |
| CAD | 1.02 | 1.00 | 1.00 | 1.03 | 1.07 | -2.1% | -2.2% | 0.6% | 4.1% |
| AUD | 0.88 | 0.88 | 0.88 | 0.84 | 0.82 | 0.5% | 1.3% | -2.3% | -2.5% |
| NZD | 0.71 | 0.70 | 0.70 | 0.69 | 0.67 | -1.1% | -0.6% | -1.3% | -2.4% |
| Emerging Asia | | | | | | | | | |
| CNY | 6.797 | 6.800 | 6.746 | 6.666 | 6.505 | 0.3% | 0.1% | -0.7% | -2.0% |
| HKD | 7.77 | 7.80 | 7.80 | 7.80 | 7.80 | 0.4% | 0.4% | 0.5% | 0.7% |
| INR | 45.73 | 45.50 | 45.50 | 46.00 | 46.50 | -0.6% | -1.3% | -1.0% | -1.0% |
| IDR | 9008 | 9100 | 9000 | 8900 | 8800 | 0.9% | -1.0% | -3.3% | -6.7% |
| KRW | 1177.0 | 1175 | 1150 | 1100 | 1075 | 0.1% | -2.6% | -6.9% | -9.1% |
| LKR | 113.5 | 113.5 | 113.2 | 113.0 | 112.5 | -0.4% | -1.4% | -2.8% | -3.2% |
| MYR | 3.1885 | 3.20 | 3.17 | 3.12 | 3.05 | 0.4% | -0.8% | -2.8% | -5.6% |
| PHP | 45.53 | 45.50 | 45.25 | 45.00 | 44.00 | -0.1% | -1.3% | -2.6% | -6.1% |
| SGD | 1.3754 | 1.3800 | 1.3750 | 1.3600 | 1.3500 | 0.3% | 0.0% | -1.1% | -1.7% |
| THB | 32.29 | 32.25 | 32.10 | 32.00 | 31.75 | -0.1% | -0.7% | -1.1% | -2.1% |
| TWD | 31.75 | 31.75 | 31.00 | 30.75 | 30.00 | 0.3% | -1.5% | -1.5% | -2.7% |
| VND | 18965 | 19000 | 19500 | 19500 | 19000 | -0.4% | 0.6% | -2.2% | -9.5% |
| Latin America | | | | | | | | | |
| ARS | 3.92 | 3.94 | 4.05 | 4.30 | 4.60 | -0.3% | 0.5% | 3.2% | 2.8% |
| BRL | 1.77 | 1.80 | 2.00 | 1.90 | 1.90 | 0.9% | 10.5% | 2.6% | -2.1% |
| CLP | 535 | 520 | 510 | 500 | 480 | -2.8% | -4.8% | -6.9% | -11.6% |
| MXN | 12.46 | 12.50 | 12.00 | 12.10 | 12.30 | 0.0% | -4.6% | -4.8% | -5.3% |
| COP | 1,910 | 1,900 | 1,890 | 1,870 | 1,840 | -0.6% | -1.4% | -2.9% | -6.0% |
| PEN | 2.83 | 2.85 | 2.85 | 2.87 | 2.87 | 0.7% | 0.4% | 0.8% | -0.1% |
| EMEA | | | | | | | | | |
| EUR/CZK | 25.73 | 25.80 | 26.25 | 26.10 | 25.50 | 0.2% | 1.9% | 1.3% | -1.0% |
| EUR/HUF | 279 | 280 | 285 | 280 | 280 | 0.2% | 1.3% | -1.2% | -2.7% |
| EUR/PLN | 4.04 | 4.20 | 4.20 | 4.15 | 3.90 | 3.7% | 3.3% | 1.6% | -5.2% |
| EUR/RON | 4.23 | 4.20 | 4.30 | 4.25 | 4.10 | -1.1% | 0.3% | -2.1% | -7.9% |
| RUB | 30.77 | 30.80 | 30.30 | 29.50 | 29.50 | -0.2% | -2.2% | -5.5% | -7.3% |
| BSK/RUB | 34.04 | 33.57 | 33.03 | 32.82 | 32.82 | -1.52% | -3.49% | -5.06% | -6.80% |
| TRY | 1.55 | 1.55 | 1.55 | 1.55 | 1.50 | -0.7% | -1.7% | -3.2% | -9.3% |
| ZAR | 7.50 | 7.75 | 7.73 | 7.59 | 7.63 | 2.9% | 1.6% | -1.7% | -3.8% |
| ILS | 3.82 | 3.81 | 3.80 | 3.75 | 3.70 | -0.2% | -0.5% | -1.8% | -3.2% |
| EGP | 5.67 | 5.65 | 5.66 | 5.60 | 5.55 | -0.9% | -1.7% | -4.9% | -8.3% |

Source: Barclays Capital

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