See the Disclosure Appendix for the Analyst Certification and Other Disclosures

ECONOMIC &
MARKET ANALYSIS:
ASIA PACIFIC

Asia-Pacific Economics/Strategy

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Asia Economic Outlook and Strategy

China's Environmental Costs

- **Environmental damage is probably the biggest risk for the sustainability of China's rapid growth**
- **Lack of compensation for pollution improves the international competitiveness of Chinese products. But this cannot last for long**
- **Rising environmental costs could be a more important factor than wage increases contributing to global inflation**
- **We raised our forecast for global growth, but downside risks remain, particularly in the United States**
- **Recent interest-rate increases reflect strong demand, but also structural factors**
- **Appreciation of Asian currencies could slow in the near term while our equity strategy overweights consumer discretionary stocks**

Citi Key Economic Forecasts

Figure 1. GDP Forecasts (Growth Rate in Percent)

	2006 GDP			2007 GDP Forecasts			2008 GDP Forecasts		
	Current	Previous	Consensus	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	8.3	8.3	8.0	8.0	8.1	7.9	8.4	8.4	7.7
Asian NIEs	5.5	5.5	5.2	4.8	4.9	4.7	5.1	5.1	5.1
SEA-4	5.4	5.4	5.3	5.7	5.6	5.4	6.0	5.9	5.7
Bangladesh*	6.0	6.0	6.1	6.1	6.1	6.1	6.1	6.1	5.8
China	10.7	10.7	10.5	10.3	10.3	10.4	10.7	10.7	9.8
Hong Kong	6.9	6.9	6.5	6.0	5.9	5.4	5.8	5.8	5.1
India**	9.4	9.2	8.4	9.3	9.3	8.2	9.4	9.4	7.9
Indonesia	5.5	5.5	5.4	6.0	6.0	6.1	6.5	6.5	6.2
Malaysia	5.9	5.9	5.9	6.0	6.0	5.7	6.0	6.0	5.8
Philippines	5.4	5.4	5.4	6.3	5.7	5.7	6.4	5.8	5.7
Singapore	7.9	7.9	7.7	6.2	6.2	6.0	5.6	5.6	6.0
South Korea	5.0	5.0	5.0	4.4	4.7	4.5	5.0	5.0	5.0
Sri Lanka	7.4	#N/A	7.4	6.3	#N/A	6.0	6.6	#N/A	5.9
Taiwan	4.7	4.7	4.3	4.3	4.3	4.2	4.8	4.8	4.7
Thailand	5.0	5.0	4.6	4.7	4.7	4.1	5.0	5.0	4.9
Vietnam	8.2	8.2	8.0	8.0	8.0	8.1	8.0	8.0	8.1

Figure 2. CPI Forecasts (Growth Rate in Percent)

	2006 CPI			2007 CPI Forecasts			2008 CPI Forecasts		
	Current	Previous	Consensus	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	3.2	3.2	3.1	4.0	4.0	3.4	4.0	4.0	3.5
Asian NIEs	1.7	1.7	1.8	2.0	2.0	2.0	2.4	2.4	2.4
SEA-4	8.2	8.2	8.4	4.3	4.3	4.2	4.3	4.3	4.4
Bangladesh*	6.8	6.8	7.1	6.5	6.5	6.7	6.5	6.5	6.5
China	1.5	1.5	1.5	3.0	3.0	3.0	4.5	4.5	3.0
Hong Kong	2.0	2.0	2.1	1.8	1.8	2.1	3.6	3.6	2.9
India**	5.3	5.3	4.5	4.5	4.5	5.9	4.5	4.5	5.6
Indonesia	13.1	13.1	13.1	6.6	6.6	6.5	6.4	6.4	6.3
Malaysia	3.6	3.6	3.6	2.5	2.5	2.3	2.5	2.5	2.4
Philippines	6.3	6.3	6.3	3.0	3.0	3.6	3.8	3.8	4.4
Singapore	1.0	1.0	1.0	1.5	1.5	1.2	1.7	1.7	1.4
South Korea	2.2	2.2	2.3	2.4	2.4	2.4	2.6	2.6	2.6
Sri Lanka	9.6	#N/A	9.6	10.0	#N/A	13.2	8.0	#N/A	8.8
Taiwan	0.6	0.6	0.7	1.4	1.4	1.3	1.7	1.7	1.8
Thailand	4.7	4.7	4.6	2.7	2.7	2.4	2.6	2.5	2.6
Vietnam	7.5	7.5	7.4	6.8	6.4	6.6	6.4	6.2	5.9

Figure 3. Current Account Forecasts (Percent of GDP)

	2006 CAB Forecasts			2007 CAB Forecasts			2008 CAB Forecasts		
	Current	Previous	Consensus	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	5.8	5.8	5.6	5.7	5.7	6.2	5.2	5.2	5.6
Asian NIEs	5.6	5.6	6.7	4.3	4.3	6.3	3.9	3.9	6.0
SEA-4	4.7	4.7	4.7	6.2	6.2	5.4	3.2	3.2	4.9
Bangladesh*	1.4	1.4	0.6	1.3	1.3	0.6	1.3	1.3	0.2
China	9.0	9.0	8.2	9.5	9.5	9.8	8.9	8.9	8.8
Hong Kong	10.8	10.8	11.1	9.9	9.9	9.8	7.2	7.2	9.6
India**	-1.6	-1.6	-1.2	-1.4	-1.4	-1.8	-0.7	-0.7	-1.7
Indonesia	2.6	2.6	2.4	1.5	1.5	2.4	0.9	0.9	2.1
Malaysia	14.3	14.3	16.1	12.4	12.4	17.2	10.4	10.4	16.9
Philippines	4.3	4.3	3.7	4.2	4.2	3.8	2.8	2.8	2.6
Singapore	27.5	27.5	30.6	19.2	19.2	27.4	17.3	17.3	25.8
South Korea	0.7	0.7	0.6	0.0	0.0	0.3	0.3	0.3	0.1
Sri Lanka	-4.9	#N/A	-5.7	-4.0	#N/A	-3.9	-3.1	#N/A	-3.1
Taiwan	6.9	6.9	5.3	6.5	6.5	6.3	5.8	5.8	6.0
Thailand	1.6	1.6	1.0	1.7	1.7	3.6	0.3	0.3	2.7
Vietnam	0.3	0.3	-0.7	-1.4	-1.4	-1.2	-1.9	-1.9	-1.4

Note: Asian NIEs are Hong Kong, Korea, Singapore, and Taiwan. SEA-4 includes Indonesia, Malaysia, the Philippines and Thailand. Asia-Pacific is Asian NIEs + SEA-4 + China + India, GDP-weighted.

*Bangladesh Fiscal year runs for July-June. **India Fiscal year runs from April-March and inflation data are Wholesale Price Index forecasts

Source: CEIC Data Company Limited, Consensus Economics and Citi estimates.

Investment Summary

Global outlook and rate fundamentals

Recent data point to robust growth in many countries. We raised our forecast for global growth by 0.2 percentage points, but downside risks remain, particularly in the United States. We expect US growth to be modestly below trend in the second half of this year. Recent interest-rate increases reflect strong demand, but also structural factors. Rapid acceleration of investment and consumption in oil exporting countries is starting to unwind the global savings glut. Higher risk premia may also be pushing up long-term interest rates.

Environmental costs in China

While investors worry about a financial meltdown or a political crisis, the biggest risk in our view for China is environmental damage, which potentially could terminally end rapid growth. Although China's GDP growth averaged 10% during the reform period, an incomplete official estimate pointed to environment costs at 3.5% of GDP in 2004. China already faces serious environmental consequences – darkened sky, poisoned water, degrading soil, worsening climate and deteriorating health. Without compensating for it, the competitiveness of Chinese products improves temporarily. But this cannot last for long. When producers are forced to compensate for environmental damage later, production costs could rise rapidly in both agriculture and industry. This could be a much more important factor than rising wages contributing to global inflation.

More cautious near-term currency outlook

Asian currencies have generally moved up significantly for the last year. Even the Taiwan dollar and Malaysia ringgit strengthened significantly during the past month. With soft exports, benign inflation and interest rates, currency moves could moderate in the near term. However, faster appreciation of the renminbi seen in May and June could continue, given rising pressures to control the trade surplus. Asian long-term bond yields moved up by 25-50 basis points during the past month, but we think short rates are likely to remain stable in much of the region.

In search of pricing power, and finding it, selectively

A CFO survey across Asia-ex highlights growing wage pressures and higher wages vs. 12 months ago with a 200bp increase to 9.8% over the next 12 months. This bodes well for consumption. We are overweight consumers. Productivity growth looks set to decelerate to 4.3% vs. expectations of 6.5% in November-December 2006. Citi Asia Pacific Equity Strategist Markus Rosgen continues to overweight Singapore, Hong Kong, Korea and Malaysia while underweight China, Taiwan and India. Sector wise, we favor telecom and banks.

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Macro Overview

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- **China already faces serious environmental consequences – darkened sky, poisoned water, degrading soil, worsening climate and deteriorating health**
- **An official incomplete estimate of environment cost pointed to 3.5% of GDP in 2004. Without compensating for it, the competitiveness of Chinese products improves temporarily. But this cannot last for long**
- **Production costs could rise rapidly in both agriculture and industry. This could be a much more important factor than rising wages contributing to global inflation**

Rate Fundamentals

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Incoming economic data over the past few months have pointed to stronger growth in a number of key countries. The most significant change in our forecasts in recent months has been upward revisions to our growth outlook in Europe. The Chinese economy shows no signs of moderating in response to recent modest policy measures. Recent data point to a sharp rebound in US GDP growth in the second quarter. But US growth prospects are probably more circumscribed than GDP growth in the second quarter may suggest. We raised our forecast for global GDP growth by 0.2% over the last month.

Stronger growth has helped push up interest rates

Signs of stronger growth and some additional inflationary pressures around the world have helped to push up global interest rates (see Figure 4). But cyclical factors alone cannot account for the recent changes in interest rates. US Treasury 10-year yields are up almost half a percentage point since mid-May. Forward rates across the yield curve are up substantially. This suggests that some combination of long-run interest rate expectations and risk premia have changed.

Structural changes are also steepening the yield curve

We believe that some of the recent changes in interest rates reflect structural economic developments that are likely to persist. Rapid growth in investment and consumption in major oil exporters is undermining the long-term trend of ample global savings. Moreover, new uncertainty about the future path of interest rates may have increased term premia somewhat. In response to these factors, we raised our forecasts for long-term interest rates and the slope of the yield curve in coming years.

Further adjustments are likely to be gradual

We see a number of factors, however, that could limit near-term prospects for further interest rate increases. Material downside risks for growth remain, particularly in the United States. In addition, market expectations for further monetary tightening have gone beyond what is likely to happen in some cases. Finally, the economic factors that have tended in recent years to suppress risk premia and long-term interest rate expectations are not likely to unwind quickly. Consequently, we expect further changes in the structure of interest rates to be gradual.

Salient features of recent changes in interest rates

The pattern of interest rate changes points to causes

The pattern of interest rate changes in recent months hints at the causes for the moves. First, interest rates have increased substantially in a large number of countries, with euro-area bond yields up the most over the last three months. Moreover, the interest rate increases in the euro area were more front-loaded over this period.

Figure 4. United States, Euro Area, and Japan — Changes in Government Bond Yields, Implied Forward Interest Rates, and Breakeven Inflation Rates (Percent), 21 Mar 07-20 Jun 07

	United States			Euro Area			Japan		
	Mar 21 to May 10	May 10 to Jun 20	Mar 21 to Jun 20	Mar 21 to May 10	May 10 to Jun 20	Mar 21 to Jun 20	Mar 21 to May 10	May 10 to Jun 20	Mar 21 to Jun 20
Government Bond Yields									
2-year	0.19	0.27	0.46	0.32	0.28	0.60	0.07	0.19	0.26
10-year	0.12	0.49	0.61	0.29	0.44	0.73	0.09	0.22	0.31
Implied Forward Interest Rates									
3-5 years	0.12	0.54	0.66	0.32	0.45	0.77	0.14	0.30	0.44
6-10 years	0.07	0.50	0.57	0.29	0.38	0.67	0.09	0.18	0.27
Breakeven Inflation Rates	-0.01	0.03	0.02	0.04	0.01	0.06	0.10	0.06	0.16

Source: Citi.

Policy expectations affect the front end of the yield curve...

...but other factors may be driving the long end

Second, forward interest rates are up over most of the term structure. A repricing of the prospects for monetary policy in the near to medium term can explain part of the adjustment. But long-dated forward rates, which are less affected by near-term expectations about policy, have also gone up substantially. This pattern suggests that the market action was caused by some combination of structural factors that have raised the expected path of real short-term interest rates and increased the risk premium associated with holding duration.

Compensation for inflation risk has not increased

Third, breakeven inflation rates have gone up only modestly. This implies that investors have not demanded increased compensation for holding inflation risk.

Cyclical developments

Our growth forecasts have moved up

Recent changes in interest rates substantially reflect changes in the economic outlook. Over the last three months, our forecasts for global growth have generally increased (see Figure 5). The most significant adjustments have come in the euro area. Incoming data have indicated that the economy did not slow as much in the first quarter as had been expected. Strong export growth to some extent offset lagging domestic demand.

Euro area data have surprised largely on the upside, until recently

The left side of Figure 6 shows the average difference, expressed as standard deviations, between the first release of a range of euro-area economic indicators and the corresponding consensus market forecasts. Forecasters have generally underestimated the strength of euro area economic indicators for much of the past year. A period of sustained positive surprises starting at the end of the first quarter probably contributed to the initial upward momentum in euro area interest rates.

US indicators have been on a roller coaster...

In contrast, perceptions of prospects for the US economy have been on a roller coaster (see Figure 6, right). Toward the end of the first quarter, it became clear that estimates of GDP for that period would point to very slow growth. Recently, however, stronger data have pointed to a sharp statistical rebound in the second quarter. But the swing in reported GDP growth from an estimated 0.9% in the first quarter to our forecast of 3.7% growth in the second quarter is not reflective of the underlying trends in the economy. The fundamental drivers of economic growth were probably stronger in the first quarter, and are weaker in the second quarter, than headline GDP suggests. We expect the US economy to grow about 2½% in the second half of this year.

...but underlying momentum points to modestly below-trend growth

Indicators for the rest of the world have also been mostly positive

Indicators for most of the rest of the global economy have generally been positive. The estimate of Japan's first-quarter GDP was revised up sharply, but forward-looking indicators suggest that growth will be close to trend in coming quarters. China's economy continues to grow at a brisk pace with few signs that modest policy tightening has had much effect. Strong global demand for commodities continues to support the Australian economy.

Figure 5. Global — Citi Forecasts for GDP Growth in 2007 (Annualized Percent Change), 2007

	29-Mar				23-May				Current			
	Q1	Q2	H2	Full Year	Q1	Q2	H2	Full Year	Q1	Q2	H2	Full Year
United States	2.0	2.8	2.9	2.5	0.7	3.2	2.7	2.1	0.9	3.7	2.6	2.3
Japan	2.5	1.9	2.2	2.5	2.4	1.9	1.8	2.3	3.3	1.7	1.9	2.6
Euro Area	1.6	1.7	2.6	2.4	2.3	1.9	2.6	2.6	2.4	2.2	2.6	2.7
United Kingdom	3.0	3.6	3.0	3.1	2.6	3.4	3.2	3.0	3.0	3.4	3.2	3.0
Canada	3.1	2.4	3.1	2.4	5.2	2.7	2.8	2.6	3.7	3.3	3.1	2.6
Global				3.6				3.5				3.7

Sources: *Global Economic Outlook and Strategy*, March 29, 2007, May 23, 2007, and Citi.

Robust growth has raised concerns about inflationary pressures

Robust global growth has helped to push up a wide variety of commodity prices, raising concerns about global inflationary pressures. But with appropriate policy responses, inflation does not appear set to get out of hand in most places. Core inflation in the United States has edged lower in recent months. However, Federal Reserve officials remain concerned about price trends. In the euro area, higher food prices are likely to push headline inflation above 2% later this year. But underlying trends in core inflation appear consistent with the ECB's objectives. Headline inflation in China has continued to creep up due largely to higher food prices. With rapid growth in industrial capacity, China's export prices are unlikely to accelerate.

We expect further monetary tightening in many countries

In response to healthy demand and resilient inflationary pressures, we expect further monetary policy tightening this year in many places, including Japan, the euro area, the United Kingdom, Canada and Switzerland. To some extent, the recent increases in global bond yields reflect these cyclical trends. But in some cases markets may have gone too far. Officials from a number of central banks have struck a more cautious tone in recent statements. With inflation apparently contained in the very near term, central bankers from a number of regions — including the euro area, Japan and Australia — have indicated that they can afford to wait to assess trends, including the impact of recent increases in global interest rates on economic growth. In all three of those regions, markets appear to be pricing in a more rapid pace of interest rate hikes than now appears likely.

Investment, savings and the path of real interest rates

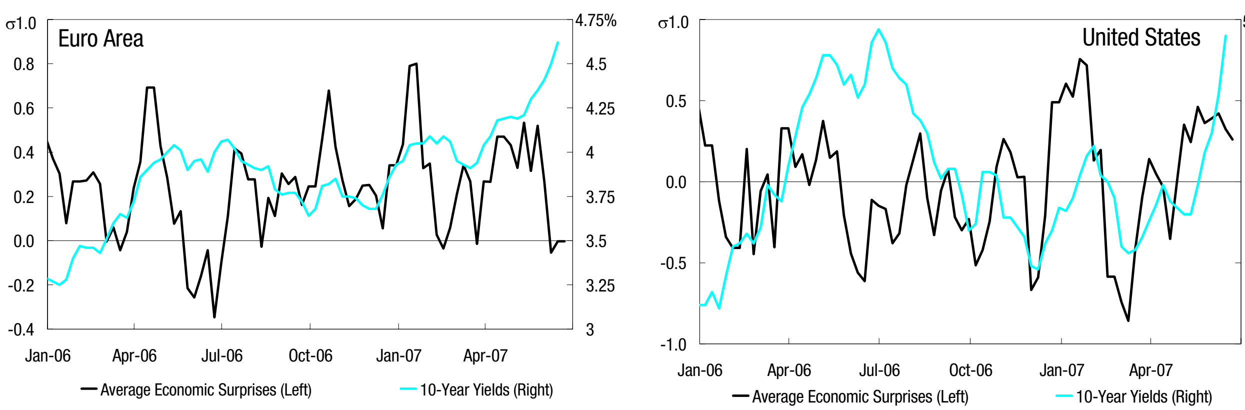
Rate increases at the long end of the yield curve point to non-cyclical factors

As noted above, cyclical developments can only account for some of the recent run up in global interest rates. The substantial increases in implied forward rates at the long end of the yield curve likely reflect a combination of factors that raise the expected path of real short-term rates and increase the risk premium for holding duration.

The global savings glut may be starting to unwind

A variety of factors have tended to suppress investment or boost savings. The resulting dearth of investment relative to the desired level of savings, the so-called global savings glut, has tended to hold down global real interest rates. There are some indications, however, that the global savings glut is starting to unwind, at least to some degree.[1]

Figure 6. Euro Area and United States — Average Deviation of Actual Economic Indicators from Consensus Forecast (Standard Deviations) and Ten-Year Government Bond Yields (Percent), 2006-20 Jun 07



Notes: Surprise series represent unweighted averages of differences between economic indicators, as first published, and the market consensus forecast, expressed in standard deviations. Each monthly observation stays in the average until new data are released. Indicators for the euro area are: IFO survey; German industrial production; German factory orders; decline in German unemployment, decline in French unemployment; French consumer spending; INSEE Business Confidence Survey; Italy Business Confidence Survey, and euro area surveys of business, industrial and consumer confidence. Indicators for the United States are: ISM Manufacturing and Non-Manufacturing surveys; non-farm payrolls; retail sales, autos; housing starts; new home sales; industrial production; Michigan Survey of Consumer Sentiment; and durable goods orders. See also "CitiFX Currency Adviser," September 2006 for a more structured way of relating economic "surprises" to asset markets.
Sources: National sources, Bloomberg, and Citi.

Investment and consumption are rising rapidly in oil exporting countries

When oil prices started to rise quickly a few years ago, the initial response of most oil exporters was to save most of the windfall. This was reflected in sharp increases in the current accounts of those countries (see Figure 7). Increasingly, however, these countries have been adjusting both investment and consumption to the new higher level of their income. Over the next two years, we expect the investment-to-GDP ratios in Russia and the Middle East to rise by 2.6 and 4.0 percentage points, respectively. In addition, their current account surpluses should fall substantially.

Europe is benefiting from stronger demand in Russia and the Middle East

These adjustments are already generating aggregate demand for the rest of the world, particularly in Europe. Figure 8 shows the sources of exports to Russia and the Middle East. Fifteen countries from the European Union account for 42% of exports to the oil exporters. Figure 9 shows the increase in exports to Russia and the Middle East from the United States, Germany and Japan. In recent quarters, those exports have generated a significant boost to German aggregate demand.

[1] For a discussion of these issues see Ben Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit," the Homer Jones Lecture, St. Louis, Missouri, April 14, 2005; Brigitte Desroches and Michael Francis, "World Real Interest Rates: A Global Savings and Investment Perspective," Bank of Canada Working Paper 2007-16, March 2007; and Joseph W. Gruber and Steven B. Kamin, "Explaining the Global Pattern of Current Account Imbalances," *Journal of International Money and Finance*, June 2007.

Figure 7. Global — Gross Fixed Capital Formation and Current Accounts (Percent of GDP), 2001-2008F

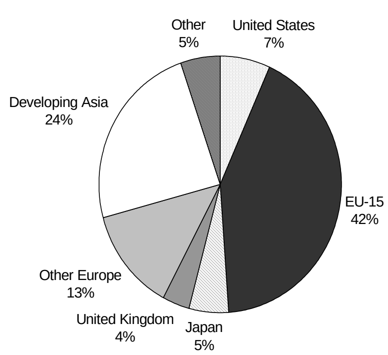
	2001-2004	2005	2006	2007F	2008F	Change 2006-2008F
Gross Fixed Capital Formation						
Industrial Countries	19.9	20.3	20.7	20.8	21.0	0.3
China	37.7	41.0	40.9	43.0	44.1	3.1
Russia	15.9	17.0	17.9	19.3	20.5	2.6
Middle East	22.5	22.2	22.5	25.3	26.5	4.0
Other Emerging	21.9	23.3	23.8	24.0	24.2	0.4
Total	21.0	21.8	22.3	22.8	23.2	0.9
Current Account						
Industrial Countries	-1.4	-2.1	-2.4	-2.4	-2.5	-0.1
China	2.5	7.0	9.0	9.5	8.9	-0.1
Russia	9.4	10.9	9.6	3.5	2.6	-6.9
Middle East	7.9	18.8	18.1	12.1	10.7	-7.4
Other Emerging	1.0	0.2	0.2	-0.2	-0.3	-0.5

Note: Forecasts for the Middle East are from the IMF. Sources: IMF and Citi.

Corporate releveraging is reducing businesses' contribution to the global savings glut

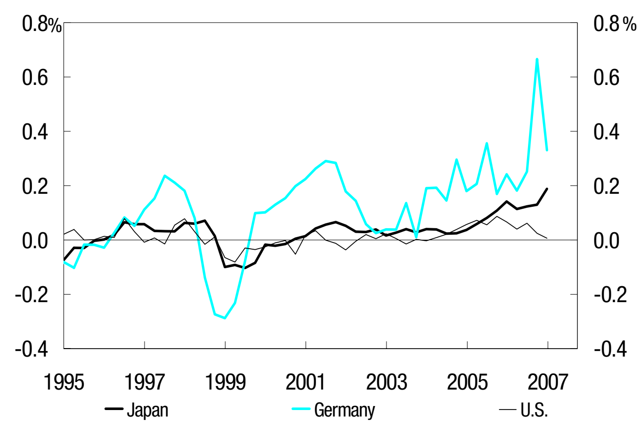
Investment in other regions has also increased in recent years. With robust global growth and low corporate borrowing costs, businesses in industrial countries have been increasing their investment moderately. Recent increases in equity prices may provide an additional lift to business investment in both industrial and other emerging economies. Moreover, other demands on corporate balance sheets, such as stock buybacks and leveraged buyouts, are also reducing the corporate sector's contribution to the global savings glut. But even with these trends, strong corporate profits mean that the corporate sector's demands on capital markets remain very low by past cyclical standards.

Figure 8. Global — Sources of Exports to Russia and Major Oil Exporters in the Middle East (Percent), 2006



Sources: IMF and Citi.

Figure 9. United States, Germany, and Japan — Change in Exports to Russia and Major Oil Exporters in the Middle East as a Share of Nominal GDP (Percent), 1995-Mar 2007



Sources: Haver and Citi.

Investment in emerging economies is rising, but so is savings

Investment is also increasing in other emerging economies, but savings are increasing as well. China continues to be the most noteworthy example. This year we expect Chinese investment as a share of GDP to be more than five percentage points higher than it was during 2001-04. But we also expect China's current account surplus to increase by seven percentage points.

Many emerging economies are setting up sovereign wealth funds to manage part of their reserves

Many emerging economies continue to run significant current account surpluses and contribute to the global savings glut, as governments are accumulating ever-larger portfolios of foreign assets. It seems unlikely that this pattern will continue indefinitely. Recently, a number of emerging countries have set up sovereign wealth funds with the objective of raising the rate of return on official foreign assets. The amounts involved — China's initial allocation to its fund is US$200bn — are large enough that shifts in asset allocation in these funds could generate short-term market volatility. But the bigger issue may be that emerging market governments have chosen to set up these funds, which is an early indication that their willingness to continue to accumulate foreign exchange reserves has limits.

We do not expect rapid changes in exchange rate policies

In the long run, it seems likely that the economic success of major emerging economies, such as China, India and others, ultimately will put upward pressure on global interest rates. We do not, however, expect dramatic changes in exchange rate and reserve accumulation policies in most emerging economies in the next few years. Consequently, we expect their contribution to the global savings glut to decline only slowly.

Declines in excess savings should contribute to gradual increases in global interest rates

All of these developments — particularly the adjustment in oil exporters — may mark a turning point in global savings and investment trends. As a result, they may have contributed to the recent increases in global interest rates. But change is likely to be slow and uneven.

Risk in the term structure

Higher risk premia may also be pushing up interest rates

Another important aspect of the constellation of interest rates in recent years has been flat yield curves — that is, low premia for holding duration risk. Some part of the recent rise in interest rates may reflect heightened concern about potential interest rate volatility. All of the factors cited above as potential reasons why real interest rates may have to be higher in the future are sources of uncertainty. Consequently, they may also contribute to higher term premia.

Stable compensation for inflation is surprising

In this context, it is surprising that investors have demanded additional compensation for holding duration without also demanding at least some additional compensation for holding inflation risk. The enhanced credibility of central banks has certainly reduced the sensitivity of inflation to a variety of shocks, but it has not completely eliminated it. Any economic process that generates shocks to short-term interest rates is also likely to generate at least some additional variance in inflation. The commitment and competence of most central banks is well established, but they are not clairvoyant.

Nonetheless, the foundations for low term premia appear solid

While greater compensation for holding duration risk is probably part of the current adjustment to interest rates, the foundations for low term premia appear solid. The gradual unwinding of the global savings glut likely will entail increased uncertainty about the path of short-term interest rates. But the main factors that have reduced macroeconomic volatility in recent years — credible monetary policy, improved information technology and financial innovation — remain in place. This should tend to limit upward pressure on term premia.

China's Environmental Costs

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What could permanently end China's extraordinary growth? Most investors are worried about a financial meltdown or a political crisis. But to us, such events could prove to be temporary, as long as an incentive structure and productive capability remain in place. What really makes us lose sleep at night is the perpetual damage of the environment.

China's GDP growth has averaged close to 10% for nearly 30 years. In the meantime, the sky has darkened, water has been poisoned, the climate has worsened and land has degraded. The environmental consequences of China's economic development are even felt in other places with consequences such as sand storms in Korea, poisoned water in Russia and air pollution in Hong Kong.

Optimists would point out that almost every rapidly growing economy in modern history experienced a kind of "Kuznetz" trajectory. The Kuznetz curve in its original form depicts the changing relation between income level and income distribution – income inequality would deteriorate in the early stage of development but would improve once income passes a certain level.

A similar dynamic relation can probably be found between economic development and environmental protection. Economic development would initially lead to deterioration of the environment, but could then improve after it reaches a certain level. This happened in the United States and Japan.

We can probably find a negative correlation between income levels and environmental indicators such as air quality across different regions in China. In remote and poor areas such as Guizhou and Sichuan provinces, occasionally we can still find clean water and clear skies. But pollution is visibly worse in the coastal areas, especially in areas where heavy industry dominates.

The hope is that as income levels rise further in the developed areas, consciousness about the environment would increase, which could lead to significant efforts for environmental protection. Indeed, we already see scattered evidence of that happening. Residents of Xiamen, for instance, protested against the construction of a factory that produces poisonous material, but such incidents are still rare. Worse, local governments still appear to be more interested in GDP than the environment.

Therefore, an important question to ask is: Will it be too late for China? We argue that the kind of environmental damage occurring in China today is probably much more serious than what happened in other countries previously. As a comparison, we look at the experience of the United States. During the 19th Century and early 20th Century, the United States had a population of about 200 million and its economy grew at a maximum pace of 5% per annum. Today's China is different from the United States about a century ago in at least three aspects.

First, on roughly similar land area, China has a population of 1.3 billion. Thus, pressure on the environment is much greater. Second, the economy has been growing at a pace double that of the United States during its peak years. And, finally, China's economy is definitely much more open than the United States at that time. The fact that China is a "global manufacturing center" also means China is generating even more environmental consequences at home.

Environmental damage is already serious in China. According to income measures based on market exchange rates, China currently accounts for less than 5% of the world economy, but it already contributes about 15% of the world's total carbon emission. Some scientists argue that such massive emission has already led to serious climate change in China, resulting in serious droughts in the north and floods in the south. The underground water table has dropped so sharply in Northern China that there were proposals to move the capital city away from Beijing. To solve this problem, China is investing massively in three projects to transfer water from the south to the north.

Meanwhile, since 2004, due to the emission of poisonous matter, China has reported at least eight serious incidents of water poisoning. One in Songhua River in Northeast China in November 2005 caused protests by Russia, and the latest one occurred in Lake Taihu in East China in May. In fact, water pollution is so serious that many scientists warn against a "death of lakes." None of the largest four lakes in China, including Lake Dongting in Hunan Province, has escaped the deadly fate.

An incomplete estimate of environmental cost by the National Development and Reform Commission and the National Environmental Protection Agency pointed to 3.5% of GDP in 2004. In that same year, official statistics suggested 10.1% real GDP growth. This means that net GDP growth was probably only 6.6%. We must stress that 3.5% was a substantial underestimate, as the officials considered only limited measurable impacts.

Following the same framework and assuming the environmental cost to be 1% of GDP during 1978-1987, 2.5% of GDP during 1988-1997 and 3.5% of GDP during 1998-2007, we conclude that the cumulative environmental cost during the reform period would be at least one-third of GDP in 2007. And, again, this probably still substantially underestimates the actual cost.

We may view such cost as a contingent liability that China will have to pay in the future. In this sense, China is currently making internationally competitive products by taxing future generations. When China is forced to repair the past damage or simply to compensate the current damage, production costs could rise significantly. Some agricultural economists estimate that the cost of crop production in Northern China has already doubled, controlling for inflation, due to worsening of the climate, deterioration of the soil and lack of water.

Such changes in China could generate a significant impact in the international markets by either reducing supply or raising prices. China has already caused prices in most commodity markets, including iron and ore, copper, gold and oil, to increase sharply. If this occurs in the agricultural market, the consequences could be more devastating, especially for low-income countries.

In 1994, Lester Brown published a book called "Who Will Feed China?" As agricultural economists, we rejected such a thesis as too pessimistic. A key reason, in our argument, is that pessimists such as Brown or the Rome Club earlier did not take into account possible supply responses. The Green Revolution in the 1960s was a good example that technology can respond to increases in demand for agricultural products. But if environmental degradation seriously destroys productive capacity, then room for supply responses may become more limited.

A rise in production costs could go well beyond the agricultural sector. Damage to water, land and air likely would push up production costs everywhere, especially in the manufacturing industry. In a way, as producers currently do not compensate for the environmental consequences, their production costs are being depressed artificially.

In our earlier analysis, we associated abnormal prosperity with cost distortion. In our view, the distortion of environmental cost, alongside distortions of labor, land and capital costs, is responsible for unusually strong activity. This helps to temporarily improve the competitiveness of Chinese products, but it cannot last for long.

Increases in production costs in China could lead to higher prices of Chinese products. If China ever contributes to global inflation, we believe this will be a much more significant factor than wage inflation that many investors worry about today.

Even more devastating is that a lot of damage being done is difficult to reverse. Chinese media reports that the life expectancy of traffic policemen in some major cities is only 49 years, due to pollution, compared with a national life expectancy of 73 years. Inevitably, the bad quality of air and water hurts people's health. In fact, the death toll due to cancer has increased significantly.

Projects transferring water from the south to the north may ease the problem temporarily. But an iceberg on the Tibet plateau is already shrinking at a very rapid pace. Once that ice melts completely, from where else can China transfer water?

Apparently, we are not pessimists. China's 11th Five-Year Plan demonstrates that policymakers recognize the environmental challenges ahead. Discussion about green GDP and sustainable growth are proof. The government now also makes commitment to control carbon emissions. The problem, however, is always with implementation. This is like a race. If the problem cannot be controlled before it gets too big, then we may all be in big trouble. But if we are successful, then the cost of production could increase and the pace of growth could moderate.

Strategy — Asian Currencies and Interest Rates

Figure 4. Currency Forecasts and Forwards

		Spot	3 Months		6 Months		12 Months					
	Range in May	21-Jun	Forecast	Forward	Forecast	Forward	Forecast	Forward	3Q07	4Q07	1Q08	2Q08
Versus USD												
Japan YEN*	119.93 - 121.77	123.65	125.00	*122.21*	124.00	*120.85*	122.00	*118.33*	125.00	124.00	123.00	122.00
Euro EUR*	1.34 - 1.36	1.3395	1.3500	*1.3435*	1.3700	*1.3468*	1.3600	*1.3514*	1.3500	1.3700	1.3800	1.3600
China RMB	7.65 - 7.71	7.6205	7.4200	*7.5343*	7.2800	*7.4495*	7.1000	*7.2835*	7.4200	7.2800	7.1900	7.1000
Hong Kong HK$	7.8 - 7.82	7.8118	7.8200	*7.7938*	7.8150	*7.7775*	7.8100	*7.7525*	7.8200	7.8150	7.8125	7.8100
India INR	40.2 - 41.18	40.79	40.70	*41.05*	40.20	*41.37*	40.00	*41.90*	40.70	40.20	40.10	40.00
Indonesia IDR	8679 - 9078	8980	9050	*9032*	9150	*9086*	9200	*9185*	9050	9150	9175	9200
Malaysia MYR	3.39 - 3.42	3.4455	3.3600	*3.4303*	3.3300	*3.4153*	3.2800	*3.3860*	3.3600	3.3300	3.3100	3.2800
Philippines P	45.85 - 47.58	46.105	46.000	*46.005*	44.500	*45.915*	43.500	*45.835*	46.000	44.500	44.000	43.500
Singapore SGD	1.52 - 1.53	1.5379	1.5150	*1.5273*	1.5000	*1.5173*	1.4700	*1.4989*	1.5150	1.5000	1.4850	1.4700
South Korea KRW	922.35 - 934.05	927.3	935.0	*924.7*	920.0	*922.7*	900.0	*920.0*	935.0	920.0	910.0	900.0
Taiwan TWD	32.99 - 33.42	32.961	32.800	*32.691*	32.500	*32.434*	32.200	*31.939*	32.800	32.500	32.350	32.200
Thailand THB	34.45 - 34.77	34.625	34.250	*34.505*	34.000	*34.373*	34.250	*34.095*	34.250	34.000	34.130	34.250
Vietnam VND	16035 - 16089	16121	16110	*16198*	16050	*16358*	16020	*16601*	16110	16050	16035	16020

* Forecast as of Global Economic Outlook and Strategy (21 June 2007)

Source: Reuters and Citi estimates.

Figure 5. Interest Rate Forecasts (% period end)

		Range in May	21-Jun	In 1M	In 3M	In 6M	In 12M	3Q07	4Q07	1Q08	2Q08
US*	Fed Fund Rate	5.25 - 5.25	5.25	5.25	5.25	5.25	5.00	5.25	5.25	5.25	5.00
	10-Year Treasuries	4.62 - 4.88	5.14	NA	NA	NA	NA	5.10	5.15	5.20	5.20
EU*	Repo Rate	3.75 - 3.75	4.00	4.00	4.25	4.25	4.25	4.00	4.25	4.25	4.25
	10-Year Bunds	4.14 - 4.42	4.64	NA	NA	NA	NA	4.60	4.65	4.70	4.70
JP*	Call Money	0.51 - 0.55	0.53	0.50	0.50	0.50	0.75	0.50	0.75	0.75	1.00
	10-Year JGBs	1.61 - 1.75	1.94	NA	NA	NA	NA	1.90	1.85	1.85	1.90
CN	1-year lending rate	6.39 - 6.57	6.57	6.57	6.84	6.84	7.11	6.84	6.84	6.98	7.11
	7-Day Shibor	1.79 - 3.3	2.25	2.50	2.70	2.90	3.00	2.70	2.90	2.95	3.00
	Government bond yield (5 -Year)	3.12 - 3.49	3.61	3.60	3.65	3.70	4.00	3.65	3.70	3.85	4.00
HK	3-Month Interbank Rate	4.22 - 4.70	4.47	4.60	4.60	4.66	4.45	4.56	4.63	4.65	4.54
	5-Year Exchange Fund Note	4.01 - 4.45	4.57	4.60	4.67	4.69	4.75	4.62	4.69	4.79	4.78
IN	Overnight Repo Rate	7.75 - 7.75	7.75	7.75	8.00	8.00	8.00	8.00	8.00	8.00	8.00
	Overnight Reverse Repo Rate	6 - 6	6.00	6.00	6.25	6.25	6.25	6.25	6.25	6.25	6.25
	91-Day T Bill	7.39 - 7.97	7.19	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50
	10-Year Gilt	8.06 - 8.15	8.15	8.10	8.00	8.00	8.00	8.00	8.00	8.00	8.00
ID	BI Rate**	3.51 - 3.85	8.50	8.25	8.25	7.00	6.50	8.25	7.00	6.75	6.50
	FR0026 11% 10/15/2014	8.49 - 9.23	8.56	8.85	8.75	8.35	8.00	8.75	8.35	8.18	8.00
MY	Overnight Policy Rate	3.5 - 3.5	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50
	3-Month Interbank Rate	3.6 - 3.61	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60
	5-year MGS	3.06 - 3.46	3.51	3.65	3.70	3.75	3.90	3.70	3.75	3.83	3.90
PH	O/N Rate	7.50 - 7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50
	91-Day T Bill	3.72 - 3.73	3.73	4.00	4.75	4.50	4.00	4.75	4.50	4.25	4.00
	5-Year T Bond	5.82 - 5.83	6.65	6.50	6.50	6.00	5.50	6.50	6.00	5.75	5.50
SG	3-Month Interbank Rate	2.31 - 2.63	2.56	2.40	2.40	2.50	2.50	2.40	2.50	2.50	2.50
	10-Year SGS	2.54 - 2.92	2.92	2.85	2.85	2.90	3.00	2.85	2.90	2.95	3.00
KR	Overnight Rate	4.5 - 4.5	4.50	4.50	4.75	4.75	4.75	4.75	4.75	4.75	4.75
	91-Day CD	4.94 - 5.07	5.04	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.10
	5-Year Treasury	5 - 5.22	5.37	5.30	5.40	5.30	5.20	5.40	5.30	5.25	5.20
TW	Overnight Rate	1.72 - 3.90	2.27	2.00	2.05	2.10	2.20	2.05	2.10	2.15	2.20
	Re-discount Rate	2.88 - 2.88	2.88	3.00	3.25	3.25	3.25	3.25	3.25	3.25	3.25
	91-Day CP Rate	1.76 - 2.20	2.42	2.05	2.10	2.15	2.25	2.10	2.15	2.22	2.25
	10-Year Government Bond	2.04 - 2.23	2.42	2.35	2.50	2.50	3.00	2.50	2.50	2.75	3.00
TH	Overnight Repo Rate	3.5 - 4.53	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50
	3-Month Interbank Rate	3.75 - 4.42	3.75	4.00	3.85	4.25	4.25	3.85	4.25	4.25	4.25
	10-Year Government Bond	3.51 - 3.86	4.32	4.50	4.50	4.75	4.50	4.50	4.75	4.63	4.50
VN	3-Month Interbank Rate	7.01 - 7.25	8.21	8.25	8.00	7.75	7.75	8.00	7.75	7.75	7.75
	5-Year Treasury	7.13 - 7.33	7.27	7.20	7.10	7.00	7.25	7.10	7.00	7.13	7.25

Source: Datastream, CEIC Data Company Limited, Bloomberg, Reuters, Citi estimates
Note: * Forecast as of Global Economic Outlook and Strategy (21 June 2007)
**Our forecasts on Indonesia policy rate from July 07 onwards are based on overnight BI rate rather than the current 1-month BI rate, following the expected change by Bank Indonesia

Strategy — Asian Equities

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In Search of Pricing Power, and Finding It, Selectively

Pricing power is not what the Asian region has historically been renowned for. If anything, it has been the opposite, with Asia ex known as the exporter of price deflation around the world. To some extent this has been and continues to be the case, but things are a changing. For the first time since 2004, US import prices from China have turned positive while US import prices for the rest of the region continue to decline.

Of interest was last week's survey done by Duke's Fuqua School of Business in conjunction with CFO Magazine. The survey's focus is on how the 172 Asian CFOs interviewed expect the various parts of their business to perform over the course of the next 12 months. It showed rising wage and higher price expectations. On the negative side, it showed declining productivity.

What remains positive for investors is that there is no big increase in capex expected over the next 12 months, which bodes well for free cash flow, and there is good news on the dividend front. Expectations for dividend growth over the next 12 months stand at 7.1% vs. 5.9% in November-December.

Investors can shield themselves from the effects of rising wages and falling productivity growth by going for companies that have either pricing power and hence rising margins or better asset turn.

CFOs see accelerating wage expectations for the next 12 months

The interesting data points are the change in wage expectations, up from +7.8% increases in the 12 months from November-December to now expectations of an increase by 9.8% over the next 12 months from June. This represents a net increase of 200bp. On average, wages represent 7% of sales. The sectors most affected by this are those with higher wage components: health care, banking and then real estate and consumer discretionary. At the other end of the scale, engineering, materials and utilities have the lowest salary expenses relative to sales/turnover. Rising wages thus push the comparative advantage away from the service sectors toward the manufacturing sectors and toward the more industrial markets of Korea and Taiwan. The simple rule: the more capital intensive the sector, the less the wage bill matters in relation to overall cost.

Productivity growth is set to slow

The other line item that we found of interest is the line item on productivity, which is expected to increase by 4.3% over the next 12 months vs. 6.5% just in December. Given the expected rise in wage costs over the next 12 months and the decline in productivity, the outlook for profit margins at some companies must look worse than a year ago. In the absence of strong top-line growth, expect earnings estimates to come under pressure among some companies. In terms of Citigroup earnings revisions, these are concentrated in the small-cap space.

The difficulty with the productivity numbers is that no definition is given. Looking at it across the region in terms of output per employee (GDP/total employment), the region seems to be averaging out at just 3.4% p.a for the 2005-06 period with

Singapore at 0.3% and Hong Kong at 4.7% being the outliers. If one looks at it from a sales per employee perspective, the growth numbers look vastly different for both India and Indonesia as well as Taiwan where sales per employee look to have fallen since 2000. What may also be happening is that there are sampling discrepancies between the CFOs' 172 companies and the listed universe. One thing's for sure, if wages and salaries are expected to rise by 9.8% and productivity by only 4.3%, margins somewhere will be squeezed. The best thing we can do is avoid these.

It seems to be a recurring theme from investors that top-line growth is certainly there, but pricing pressures remain exceedingly strong. As we have highlighted before, the Asia EBIT margin story is not a great one. Currently Asia ex, in aggregate, is at the bottom of the class, but there are some bright spots. On a sectoral basis, industrials, base materials and energy are seeing margin improvements vs. technology margins that are declining.

Figure 6. Model Portfolio (Asia/Pacific ex-Japan ex-Pakistan) Percentage Weighting Over/Under MSCI Benchmark

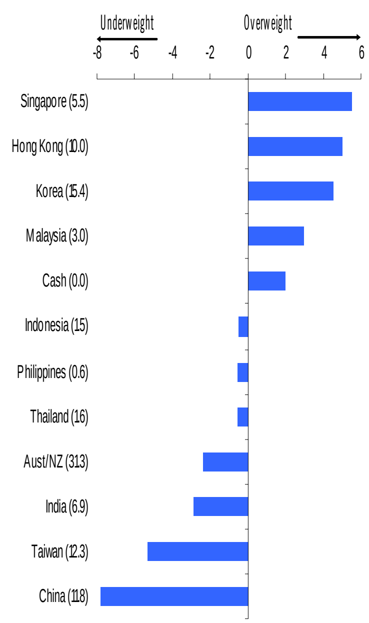


Figure 7. Model Portfolio (Asia/Pacific ex-Japan ex-Pakistan) Percentage Weighting Over/Under MSCI Benchmark

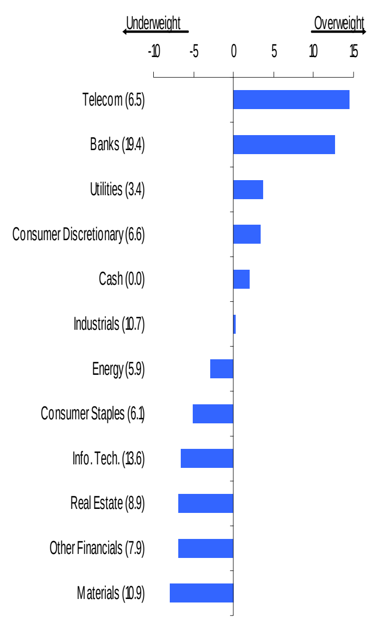
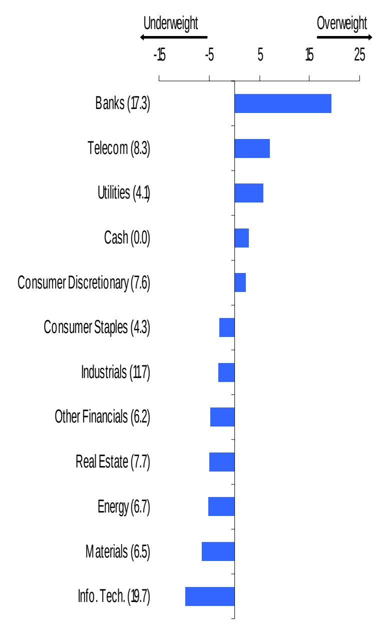


Figure 8. Model Portfolio (Asia ex-Japan ex-Pakistan) Percentage Weighting Over/Under MSCI Benchmark



Note: Numbers in brackets show neutral weights within MSCI Asia Free ex-Japan US$ Index as at Feb 9, 2007.
Consumer Staples includes food & staples retailing, food beverage & tobacco, household products, health care equipment & services, and pharmaceutical & biotechnology. Industrials include capital goods, commercial services & supplies and transportation. Information Technology includes technology hardware & equipment, semiconductors and semiconductor equipment, software & services. Other Financials include diversified financials and insurance. Source: MSCI, Citi Investment Research Estimates.

Investor Checklist & Asian Chart Summary

Asia Investor Checklist

Key Underlying Assumptions Behind Our Forecasts	Confidence	Citi Comments
Global		
Global inflationary pressure should be contained with moderate monetary policy tightening around the world	•	The rise in yields went beyond that implied by fundamentals. The Fed will probably be on hold this year, while BoJ and ECB may hike later in the year
A solid economic outlook in emerging markets means that market returns will be driven by convergence and by the quality of policymaking	•	The rise in G3 yields does not undermine the outlook for emerging markets, where growth is healthy and inflation subdued
The USD should continue to drift lower in trade-weighted terms, driven by declines against emerging Asian currencies	+	We have changed our USD forecasts and expect the USD to depreciate against most of the majors until sometime in the first half of 2008
Regional		
The evolution of the "Asian consensus" implies that Asian currencies as a group could show greater flexibility. Asian central banks may increasingly recycle surpluses within the region	•	With limited inflationary pressures, appreciation of Asian currencies could now moderate as stronger currencies already have started to weigh on exports
Return of investment to emerging Asia outside of China and India will support growth, but help regional surpluses	+	Southeast Asia showed initial signs of investment recovery, and investment continued to power on in China, India and Vietnam
Asian financial markets are becoming more politics-proof and increasingly correlated with each other	+	Political transitions could make drastic policy adjustments less likely in China but could result in significant turnarounds in Taiwan and, possibly, Thailand
Bangladesh		
Textile exports and workers' remittances should drive growth	•	Exports and remittances remain in positive territory
Natural disasters will remain a risk	•	Flood disasters have affected agricultural production in the past
Shifting political situation is likely to hinder growth	–	Elections have been postponed indefinitely due to violent protests. However, the interim government has been implementing measures aimed at removing corruption and revamping the electoral system
China		
Economic policies will likely focus on rebalancing between investment and consumption and between domestic and external demand	+	The government has adopted a set of policies to tame the trade surplus, such as widening the trading band, cutting export tax rebates and accelerating currency appreciation, but more is needed
The central bank will probably continue to tighten liquidity, liberalize the capital account and allow greater exchange rate flexibility	•	Premier Wen Jiabao warned recently about the economy turning from fast-paced growth to overheating. More tightening as well as administrative tightening is likely going forward
The financial market landscape will probably change rapidly, with increasing competition from foreign banks and foreign institutions, in the post-WTO era	•	Foreign banks have started to offer a full range of services to customers after being incorporated locally and will start bank card business shortly
Hong Kong		
Interest rates are in a downcycle	–	Interbank interest rates have rebounded, probably on outflows of funds that drained excess bank liquidity
The financial sector continues to gain strongly from fund-raising by Chinese firms and China's overseas investment	•	China has reformed the QDII to allow investment in Hong Kong's stock market and in overseas equities and equity-related products. Renminbi bonds are also likely to be issued in Hong Kong in the near term
RMB appreciation boosts Hong Kong's economy and the financial market, while the impact on inflation is likely to remain moderate	•	Inflation remains moderate despite faster RMB appreciation
India		
Strong trends in industry and services are likely to sustain growth. Other growth drivers (investment, consumption and outsourcing) remain on track	•	Strong savings, investment and key growth drivers support our GDP forecast for FY08. But the risk is on the downside with policy tightening
Solid consumption is supported by favorable demographics and the trickle-down impact; positive trends in outsourcing are likely to continue	•	There is strong potential for food processing, bio-fuels, microfinance and knowledge process outsourcing
India has the potential to further lift its trend growth level from 8% to more than 10%	•	Key hurdles include infrastructure development, a talent shortage, and bridging disparities between states and politics
Indonesia		
Macroeconomic stability continues, and the government should keep subsidies intact in 2007	•	Moderate core inflation, healthy real interest rates and rate differentials support capital inflows and the IDR. Supply constraint may induce inflation in the medium term. Food inflation continues to be a concern
Infrastructure investment slowly kicks in with the government sharing non-commercial risks. Domestic demand to return as interest rates decline	•	Implementation is key for recent policies to improve the investment climate. A proposal to restrict foreign ownership in key sectors undermined the new investment law. The new risk-sharing policy is proceeding very slowly
Efforts are being made to revitalize the agricultural sector and provide more jobs	–	Government efforts to boost agricultural productivity are still too little. Progress for making the labor market more flexible has been very slow. Don't expect labor law amendments
Korea		
A recovery in investment should underpin domestic demand	•	Investment activity rebounded in April. Strong corporate loan growth and sentiment improvement continue to support business investment
Expect consumption to slow slightly, but likely supported by steady income growth	•	Strength in consumer confidence (probably affected by stock prices) and a rebound in the job market are positive for the consumption outlook, but April activity data were generally weak
BOK will implement a 25bp rate hike in 3Q based on excess liquidity concern	•	Governor Lee's "upgraded" comments on excess liquidity issues and continued strength in SME loan growth led us to change our baseline forecast toward a 25bp rate hike

Note: Movement in Confidence Level reflects present assessment versus last month.
Source: Citi estimates.

Asia Investor Checklist (continued)

Key Underlying Assumptions Behind Our Forecasts	Confidence	Citi Comments
Malaysia		
Investment recovery will help offset an export slump to deliver 6% GDP growth in 2007	–	Our GDP growth of 6% faces downside risk as the tech recovery looks weak while the investment pickup may not be as strong as expected because of delays in public spending
Policy interest rate will likely remain on hold at 3.5% for the rest of the year	●	Inflation remains benign, with the latest figure at 1.4% for May. Bank Negara Governor Zeti said the interest rate level looks appropriate
Investment revival and stabilization of consumption pullback	●	Higher approvals of manufacturing investment in 2006 and recent aggressive liberalization hint of an end to an "investment drought"
Philippines		
Likely shift of the monetary bias to "neutral"	●	Greater policy weight is being attached to bulging domestic liquidity growth and implications on future inflation
Increased fiscal spending in the post-election period	+	A bias for increased fiscal spending underscores improved growth prospects in the near term. Revenue slippage and absorptive capacity comprise the risk for a favorable fiscal spending scenario
Benign impeachment risk	+	Return of Arroyo's strong political coalition in the House of Congress and local governments erodes impeachment risk. The Senate in the hands of the opposition may pose a challenge over the next three years
Singapore		
The government recently upgraded GDP growth forecast to 5 -7% for 2007 from 4.5-6.5% previously	+	Stronger manufacturing figures in early 2Q suggest that GDP growth may exceed 7% in 2Q, up from 6.1% in 1Q. We maintain our 2007 GDP growth forecast of 6.2%, pending May IP figures
The government recently lowered its inflation forecast to 0.5-1.0% for 2007 from 0.5-1.5%. We maintain our inflation forecast at 1.5% for 2007	●	Despite recent weak inflation figures, we think inflation may surprise on the upside in 2H. A 2ppt hike in GST from 1 July, rising property rentals and higher wage costs may translate into stronger price pressures
The property market continues to recover strongly, with both prices and rents up some 20% from a year ago	●	There is some risk that the government may introduce some property measures to curb speculation
Sri Lanka		
Despite the ongoing civil conflict, volatile political conditions and a devastating tsunami in 2004, growth is likely to stay resilient at around 6%	●	We estimate growth to decelerate to 6.3% in 2007 due to tightening in 2006. We expect a marginal deceleration in investments and services led by tourism
Inflation has been a worry since the tsunami disaster, which set back agriculture and created supply shortages	●	With the fiscal deficit hovering at 8%, the bank will be forced to maintain a tight balance between raising rates and allowing for fiscal flexibility, given that debt servicing comprises a significant chunk of expenditure
Weak governance and a deteriorating political situation are the single largest threat to growth	●	An unstable government has stalled reforms and hindered growth to a significant extent
Taiwan		
Upcoming elections may boost the short-term economic outlook	+	Presidential candidates from both ruling and opposition parties likely will take less extreme positions and be more pragmatic toward cross-strait relations
Consumer and investment spending could recover moderately	●	Stable labor markets and resurging equity performance would support consumption. Corporate capital retrenchment could end on a sustained export and output expansion
We expect a moderate export uptrend on resilient global demand and a relatively weak NTD compared to other Asian currencies, while imports gear up on improving capex and higher material costs	●	We expect a moderate export uptrend on resilient global demand and relatively weak NTD compared to other Asian currencies, while imports gear up on improving capex and higher material costs
Thailand		
Re-drafting of the constitution and its approval will pave the way for general elections late in the year	+	Delays in constitutional amendments may occur. But amending the constitution is regarded as the first major step leading to general elections
Maintain neutral rate of 3.5%	+	Neutral' talk by senior monetary officials support the 'neutral' low for the policy rate at 3.5%. Downside risk to this policy rate could come from core inflation falling to zero or lower in 2H07
Fiscal deficit of 2% of GDP	–	Hefty deficits registered by the government's overall cash position in March and April may reflect a shift in the fiscal bias to increased fiscal spending. This will complement the neutral policy rate of 3.5%
Vietnam		
SBV will likely retain a tightening bias in monetary policy	●	Upside inflation risks from sustained high world oil/commodity prices and rapid monetary/credit expansion. The SBV hiked the reserve requirement ratio from June. Further measures to drain liquidity and curb bank lending are likely
Authorities would make efforts to accelerate bank and state-owned enterprise (SOE) reforms to cope with market liberalization	●	WTO commitments allow foreign investors to tap into previously restricted sectors such as telecommunications, banking and insurance. Speeding up of SOE equitization and bank restructuring is likely
The VND could depart from its past pattern of depreciation to end 2007 steady or appreciate mildly against the USD	–	The SBV appears keen to temper VND appreciation to boost exports and FX reserves as a cushion against potentially volatile capital inflows

Note: Movement in Confidence Level reflects present assessment versus last month.
Source: Citi estimates.

Asia Chart Summary

Figure 9. Asian economies expected to bottom out in 2007

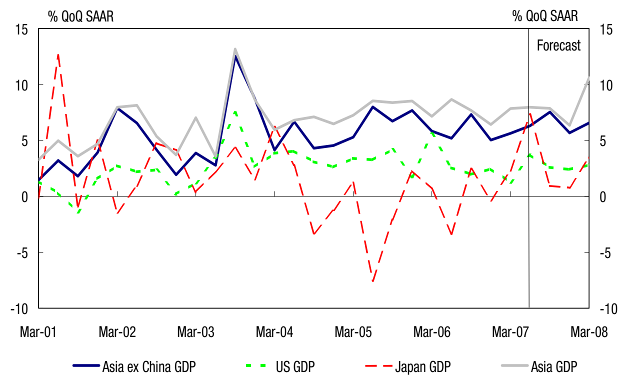
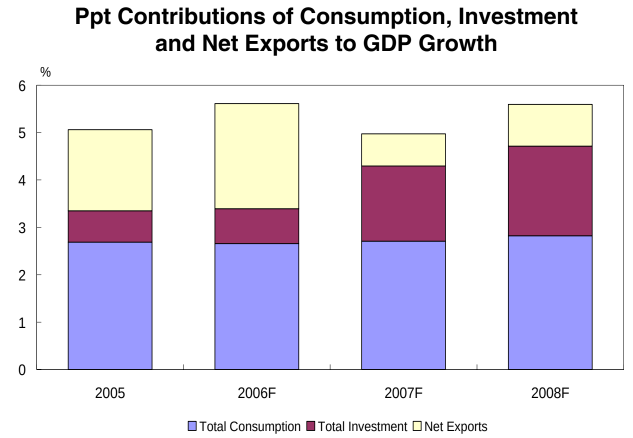


Figure 10. Asia's recent economic recovery largely due to external demand, but we expect investment to play a bigger role



Note: Asia Pacific ex-China, India and Vietnam

Figure 11. The worst of the manufacturing slowdown in Asia might be behind us

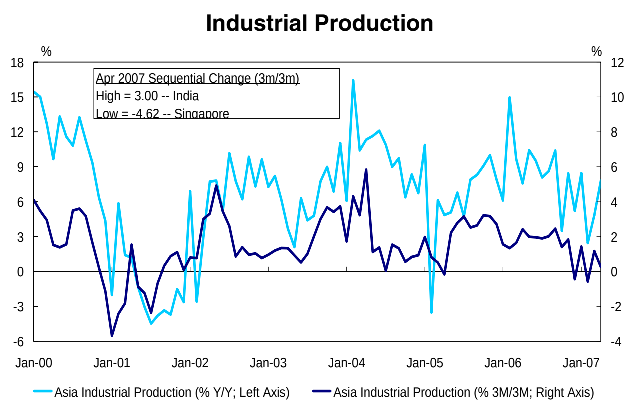
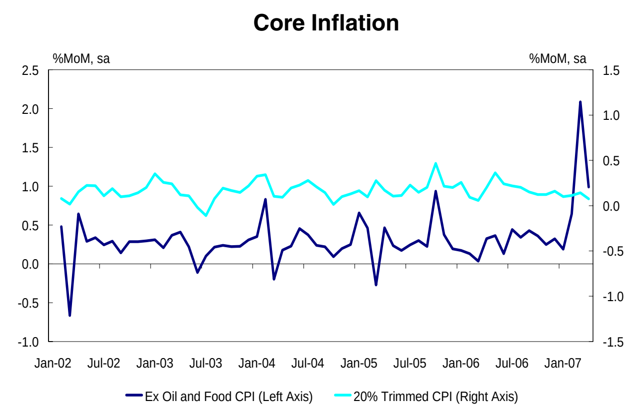
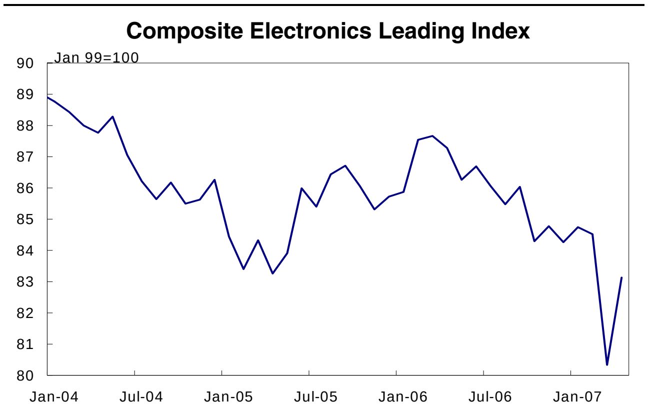


Figure 12. Overall inflation in Asia remains benign, despite being temporarily pushed up by food prices and a one-off distortion*



Note: Asia - Hong Kong, India, Indonesia, Malaysia, Korea, Philippines, Singapore, Taiwan, Thailand. *March ex-oil and food CPI surged mainly on the end of the waiver of public housing rents in Hong Kong.

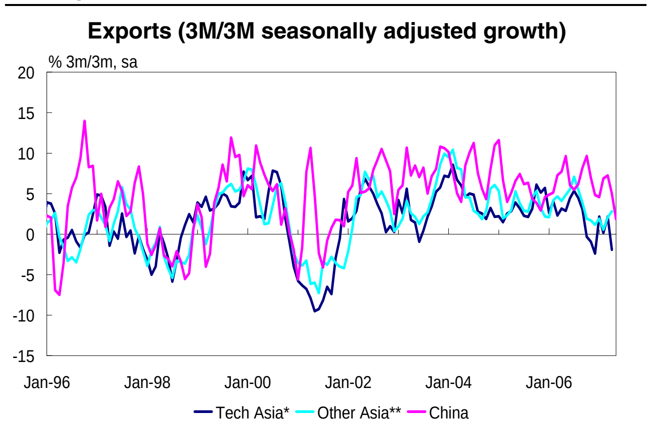
Figure 13. Rebound in our tech leading index points to a better outlook in Asia



Note: The index is a weighted average of six US leading electronic indicators (New Orders, US Book to Bill, PPI Chips, Shipment to Inventory Ratio, ISM Manufacturing PMI and NASDAQ).

Source: Citi calculations based on data collected by CEIC Data Company Limited.

Figure 14. Despite bumpiness, we see signs of recovery in Asia's tech exports



Note: Tech Asia – Malaysia, Philippines, Singapore, Taiwan; Other Asia – Hong Kong, India, Indonesia, Korea, Thailand

Citi Asia Monetary Conditions Index

Figure 15. China. PBOC may hike the reserve requirement by 50 bps this month, and a 27bps increase in policy rates in 3Q

China MCI (RHS) and GDP (LHS)

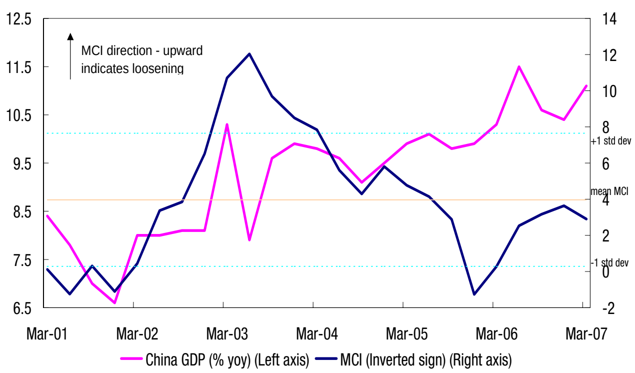


Figure 16. Hong Kong. Upward pressure of HIBOR resumed in current trend of higher interest rates in most major currencies

Hong Kong MCI (RHS) and GDP (LHS)

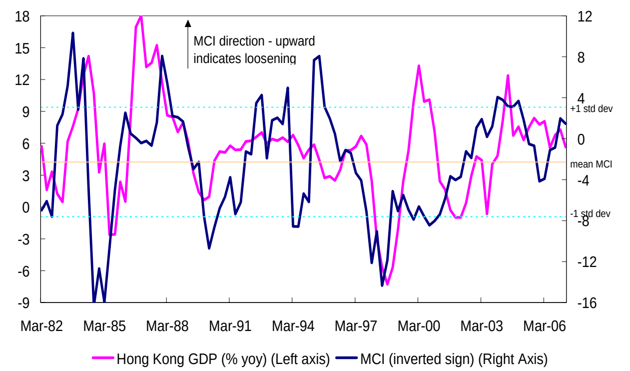


Figure 17. India. One more rate hike possible in FY08. RBI likely use the Cash Reserve Ratio to absorb capital flows driven liquidity

India MCI (RHS) and GDP (LHS)

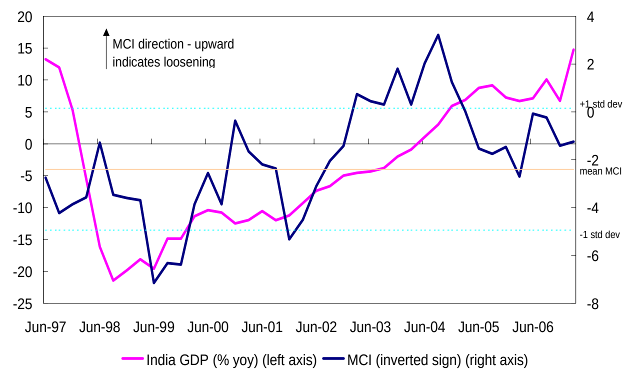


Figure 18. Indonesia. Signs of recovering consumption and investment seen in 1Q GDP data; we expect another 50bps rate cut

Indonesia MCI (RHS) and GDP (LHS)

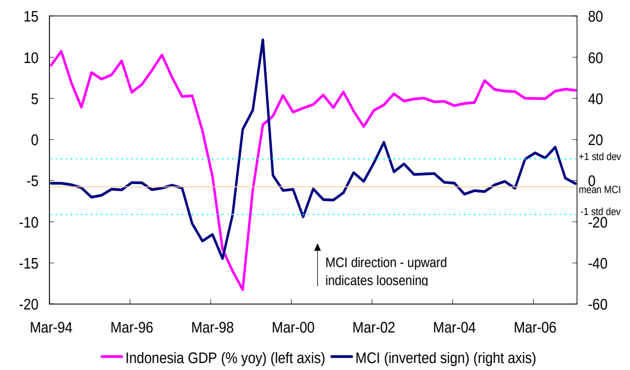


Figure 19. Korea. We expect 25bp BOK rate hike in 3Q as a policy action to address concerns on excess liquidity/SME loan

South Korea MCI (RHS) and GDP (LHS)

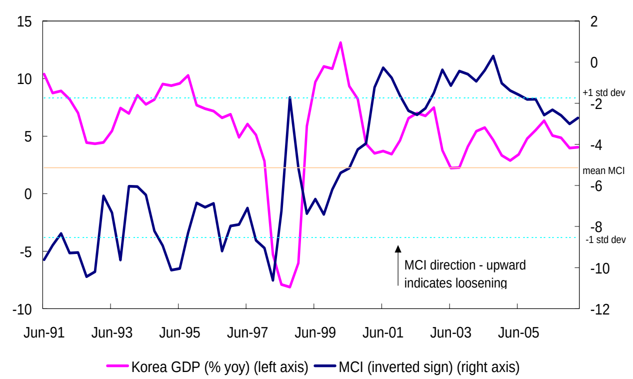
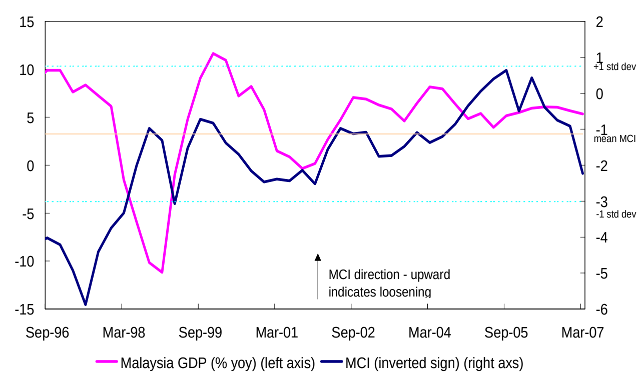


Figure 20. Malaysia. For the year, we think 1Q GDP growth may be the low point and OPR to stay at 3.5%

Malaysia MCI (RHS) and GDP (LHS)



Note: See "Asia Economic Outlook and Strategy: Measuring Monetary Conditions" February 2005
Source: Citi calculations based on data collected by CEIC Data Company Limited.

Figure 21. Philippines. With upbeat 1Q GDP growth and inflation bottoming out, we anticipate the removal of tiering before Sept

Philippines MCI (RHS) and GDP (LHS)

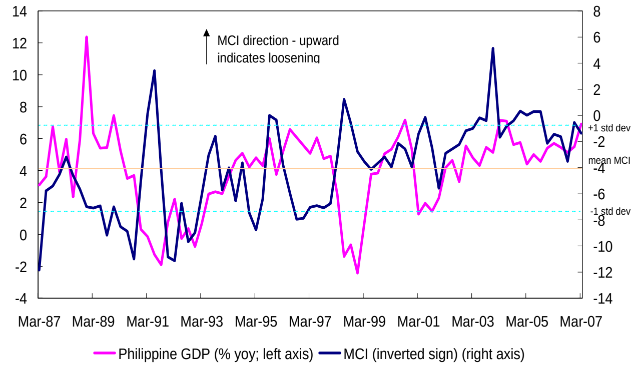


Figure 22. Singapore. MAS will likely maintain its policy stance of modest and gradual appreciation of the trade-weighted SGD

Singapore MCI (RHS) and GDP (LHS)

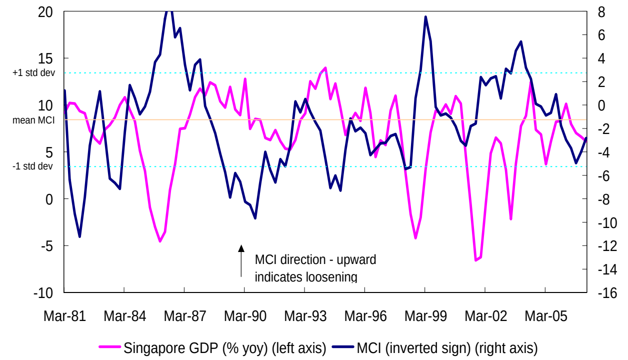


Figure 23. Taiwan. With financial conditions still accommodative, CBC likely will raise policy rates by 12.5bp in September, with contingent further rate hikes

Taiwan MCI (RHS) and GDP (LHS)

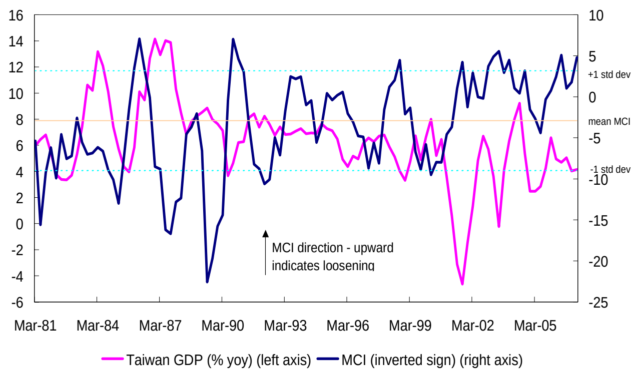
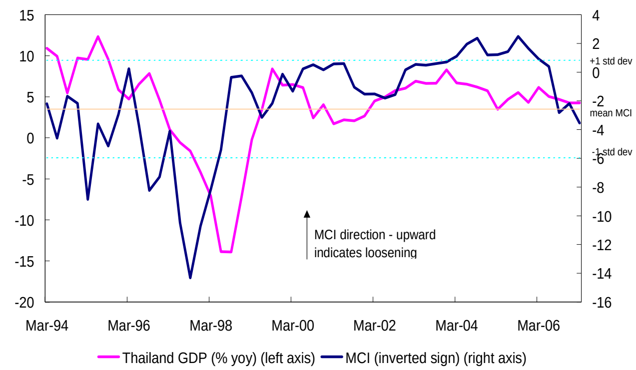


Figure 24. Thailand. Extent of weakness in the economic data and low core inflation sustains view of one more 25bps rate cut

Thailand MCI (RHS) and GDP (LHS)



Note: See "Asia Economic Outlook and Strategy: Measuring Monetary Conditions" February 2005
Source: Citi calculations based on data collected by CEIC Data Company Limited.

Long Term Forecasts

Figure 25. Citi GDP and CPI Forecasts (Period Average)

	GDP (Year-Year Growth Rate in Percent)					CPI (Year-Year Growth Rate in Percent)				
	2007E	2008E	2009E	2010E	2011E	2007E	2008E	2009E	2010E	2011E
United States	2.3	2.6	2.7	2.7	2.7	2.8	2.4	2.0	2.0	2.0
Japan	2.6	2.1	0.8	1.8	2.1	-0.3	0.3	2.3	0.7	0.8
Euro Area*	2.7	2.3	2.0	1.8	1.7	1.9	1.8	1.8	1.8	1.8
Asia-Pacific	8.0	8.4	8.0	7.9	7.8	3.2	4.0	3.6	3.4	3.3
China	10.3	10.7	10.0	9.8	9.5	3.0	4.5	3.5	3.0	3.0
India***	9.3	9.4	9.8	9.8	9.7	4.5	4.5	4.5	4.5	4.5
Asian NIEs	4.8	5.1	4.7	5.0	4.8	2.0	2.4	2.6	2.7	2.7
of which: Hong Kong	6.0	5.8	5.5	5.3	5.0	1.8	3.6	4.5	5.5	5.5
Korea	4.4	5.0	4.5	5.0	4.7	2.4	2.6	2.5	2.5	2.5
Singapore	6.2	5.6	5.2	5.6	5.8	1.5	1.7	1.7	1.7	1.7
Taiwan	4.3	4.8	4.5	4.5	4.5	1.4	1.7	2.0	2.0	2.0
SEA	5.7	6.0	6.0	5.7	5.6	4.3	4.3	4.5	4.4	4.0
of which: Indonesia	6.0	6.5	6.7	6.0	5.8	6.6	6.4	7.1	6.5	5.6
Malaysia	6.0	6.0	6.0	6.0	6.0	2.5	2.5	2.5	2.5	2.5
Philippines	6.3	6.4	6.0	6.0	5.8	3.0	3.8	4.0	4.3	4.2
Thailand	4.7	5.0	5.0	4.8	5.0	2.7	2.6	2.3	2.4	2.5
Bangladesh**	6.1	6.1	6.1	6.1	6.1	6.5	6.5	6.5	6.5	6.5
Sri Lanka	6.3	6.6	6.9	7.0	7.0	10.0	8.0	7.5	7.0	6.5
Vietnam	8.0	8.0	8.0	8.0	8.0	6.8	6.4	6.0	6.0	6.0

Note: * US$/Euro. **Bangladesh Fiscal year runs for July-June. ***India Fiscal year runs from April-March and inflation data are Wholesale Price Index forecasts
Source: Citi estimates.

Figure 26. Citi FX Forecasts (Calendar Average)

	Exchange Rate (Local Currency per U.S. Dollar)				
	2007E	2008E	2009E	2010E	2011E
Japan	121	121	114	104	94
Euro Area*	1.34	1.36	1.35	1.36	1.4
Bangladesh	73.8	79.2	83.2	86.3	90.3
China	7.566	7.000	6.650	6.320	6.000
Hong Kong	7.81	7.80	7.77	7.76	7.76
India	41.51	40.00	39.00	37.50	46.53
Indonesia	9071	9217	9306	9250	9150
Korea	932	900	880	860	840
Malaysia	3.41	3.31	3.21	3.08	2.96
Philippines	46.5	43.5	42.2	40.9	39.7
Singapore	1.52	1.44	1.38	1.33	1.27
Sri Lanka	110.00	115.00	120.00	125.00	130
Taiwan	32.9	32.3	31.0	30.0	29.0
Thailand	34.7	33.9	32.9	31.9	30.9
Vietnam	16065	16025	15988	15988	15865

Note: * US$/Euro.
Source: Citi estimates.

Figure 27. Citi Short Term Interest Rate Forecasts (Calendar Average)

	Instrument	2007E	2008E	2009E	2010E	2011E
United States	Fed Funds Rate	5.25	5.10	4.75	4.50	4.50
Japan	Call Money	0.50	1.06	1.38	1.75	2.38
Euro Area	Euro Repo Rate	3.90	4.25	4.00	4.00	4.00
Bangladesh	3-Month T-Bills	8.25	7.50	7.00	7.50	7.75
China	1-Year Lending Rate	6.84	7.36	6.42	7.36	6.42
Hong Kong	3-Month Interbank Rate	4.43	4.52	4.12	4.12	4.12
India	91-Day T Bill	7.50	5.60	5.60	5.60	5.60
Indonesia	1-Month SBI Rate	8.13	6.50	6.00	6.00	6.00
Korea	91-Day CD	4.30	4.30	4.30	4.30	4.30
Malaysia	3-Month Interbank Rate	3.63	3.85	4.10	4.10	4.10
Philippines	91-Day T Bill	4.49	4.63	4.38	4.63	5.25
Singapore	3-Month Interbank Rate	2.55	2.60	3.00	3.00	3.00
Sri Lanka	3-Month T-Bills	19.00	14.00	11.00	12.00	12.00
Taiwan	91-Day CP Rate	1.97	1.92	2.03	2.03	2.03
Thailand	3-Month Interbank Rate	4.23	4.00	4.50	4.50	4.50
Vietnam	3-Month Interbank Rate	7.85	7.63	7.25	7.00	7.00

Source: Citi estimates.

Figure 28. Citi Long-Term Bond Yield Forecasts (Calendar Average)

	Instrument	2007E	2008E	2009E	2010E	2011E
United States	10-Year Treasuries	4.95	5.15	5.25	5.35	5.35
Japan	10-Year JGB	1.78	1.90	1.80	2.60	2.90
Euro Area	10-Year Bunds	4.30	4.60	4.70	4.75	4.75
Bangladesh	10-Year Benchmark bond	12.50	11.25	10.25	10.50	10.75
China	5 Year Sovereign Bond	3.50	4.50	4.00	4.50	5.00
Hong Kong	5-Year Exchange Fund Note	4.41	4.73	4.52	4.58	4.65
India	10-Year GOI	8.00	7.50	7.50	7.50	7.50
Indonesia	FR0026 11% 10/15/2014	8.86	9.75	10.50	11.00	10.75
Korea	5-Year Treasury	5.19	5.20	5.20	5.20	5.20
Malaysia	5-Year MGS	3.64	3.80	4.00	4.15	4.20
Philippines	5-Year T Bond	5.92	6.50	6.00	6.25	6.50
Singapore	10-Year SGS	2.83	3.00	3.20	3.30	3.40
Sri Lanka	5-Year Treasury	16.00	13.00	12.00	13.00	13.00
Taiwan	10-Year Government Bond	2.30	2.37	2.50	2.50	2.50
Thailand	10-Year Government Bond	4.25	4.25	4.50	4.25	4.50
Vietnam	5-year Government Bond	7.25	7.10	7.00	7.10	7.10

Source: Citi estimates.

Selected Country Focus

China

Minggao Shen

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	•	•	•	•	•

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Re-Emerging Worry about Overheating

Premier Wen Jiabao warned on June 13 that the Chinese economy might turn from its fast-paced growth to overheating. Rising CPI and resurging investment growth could have been part of the concern. Other issues on the government's radar include a widening trade surplus, excess liquidity and low energy efficiency. Deep in the heart of these issues is the rigidity of the conventional growth model that favors capital over labor, or equivalently, puts investment on top of consumption. This model generates not only high growth, but also persistent overheating.

Overheating has been temporarily healed, but not cured, by tightening policies since last year. Monthly fixed asset investment softened to only below 20% yoy late last year after a mix of monetary and administrative tightening, but rebounded steadily to 25.9% in May. Industrial production followed a similar pattern, from below 15% to 18.1%, while retail sales edged up modestly from 14.6% in December to 15.9% in May partly on rising inflation. Volatile food CPI drove May CPI to a two-year high at 3.4%, while non-CPI remained firmly around 1%. Chinese savers were already under water given a one-year deposit rate of 3.06% and a 20% withholding interest tax.

Excess liquidity probably caused economic overheating, but a widening trade surplus is to blame. Investment tightening late last year weakened domestic demand and made the economy more dependent on external demand. The monthly trade surplus has been maintained at roughly above US$20bn since October. Net exports in May reached US$22.5bn, up 72.2% yoy. Strong capital inflows held the interbank offer rate at around 2% even after a 45bp rate hike and a 200bp reserve requirement increase by the People's Bank of China (PBOC) this year. Cheap credit led to concern about asset pricing bubbles. Adding to the heat of the equity market, average housing prices in cities rose 6.4% yoy in May from 5.4% a month ago.

A huge trade imbalance resulted in not only abundant liquidity domestically but also mounting international pressure on the renminbi. Despite a friendly atmosphere created in the second strategic economic dialogue between China and the US, recent developments suggest that trade and exchange rate tensions focused on China are rising, not easing. With little demonstrable change in the real effective exchange rate of the Chinese currency and the still uprising trade surplus, the US Congress is calling for substantial, time-bound deliverables. Two new proposed bills, one by Senators Dodd and Shelby and another by Senators Baucus, Grassley, Schumer and Graham, seek to link judgments about exchange rates to trade sanctions more directly. Recent trade disputes about food safety and toxic toothpaste and debates on greenhouse gas emission point to cloudy days ahead.

The government's worry about overheating may be followed by a series of new policy initiatives. The government could cool down the economy in two different approaches. One, further tightening polices might refocus on structural adjustments through external and domestic price adjustments. The renminbi rose 0.71% in May against the dollar, or above 8% annualized appreciation, the largest monthly gain since the depeg in July 2005. The momentum was carrying on in June, with a record weekly appreciation of 0.55% over June 11-15. The newly widened trading band from a previous 0.3% to 0.5% was tested by 0.4% daily appreciation on June 11. We continue to expect another 5% gain of the renminbi for the rest of the year to achieve 7.5% annual appreciation, alongside a 1ppt increase in the reserve requirement and at least one more 27bp interest rate hike.

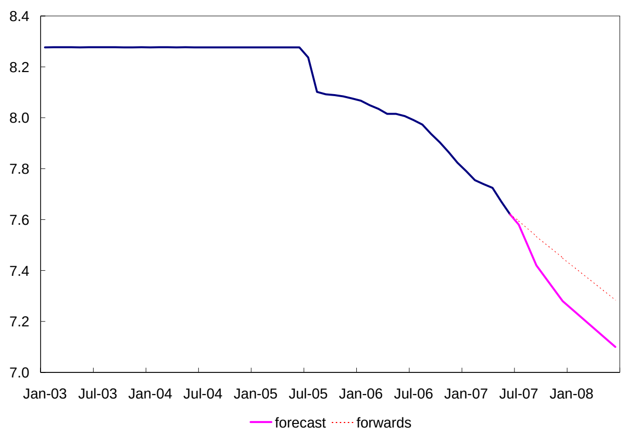
Two, the government could introduce more administrative measures to directly ease the excess liquidity problem and lower the temperature of the economy. It could abolish or lower the 20% flat interest rate tax in the near term in order to slow down the loss of bank deposits to investments in the equity market or real estate market. The Ministry of Finance announced on June 19 to eliminate VAT rebates on exports of energy-intensive, highly pollutant and resource-intensive products, and it reduced tax rebates on products likely to be involved in trade disputes. This is the second time this year that the government adjusted such a policy. The Chinese Securities Regulatory Commission released preliminary regulations on QDII products by mutual funds and brokerages to promote overseas portfolio investment. As China for the first time committed to cut 950mn metric tons of greenhouse gas by 2010, energy and environmental policies will likely be tightened further, probably by imposing a fuel tax and resource tax.

Figure 29. Key Economic Forecasts

	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
Real Sector									
Real GDP (% yoy)	8.4	8.3	9.1	10.0	10.1	10.2	10.7	10.3	10.7
Domestic demand ex Inventory (% yoy)	10.2	9.0	11.1	12.2	11.8	13.1	12.9	14.1	14.0
Real Consumption: Private (% yoy)	9.0	6.6	7.7	6.8	8.1	9.6	10.9	10.3	11.9
Real Gross Fixed Capital Formation (% yoy)	9.8	11.2	15.4	20.4	16.1	17.1	15.3	18.0	16.0
Consumer Prices (period average, % yoy)	0.4	0.7	-0.8	1.2	3.9	1.8	1.5	3.0	4.5
Nominal GDP (US$ bn)	1,193	1,317	1,454	1,648	1,937	2,303	2,765	3,408	4,394
GDP per capita (USD)	856	1,032	1,132	1,275	1,490	1,761	2,104	2,557	3,251
Unemployment Rate (Urban, %)	3.1	3.6	4.0	4.3	4.2	4.2	4.1	4.2	4.0
External Sector									
Exports (% yoy, US$)	27.8	6.8	22.4	34.6	35.4	28.4	27.2	25.0	22.0
Imports (% yoy, US$)	35.8	8.2	21.2	39.8	36.0	17.6	20.0	21.0	23.0
Trade balance (US$ bn)	24	23	30	25	32	102	177	253.5	299.7
Current account (% of GDP)	1.7	1.3	2.4	2.8	3.5	7.0	9.0	9.5	8.9
International Reserves ex. Gold (US$ bn)	168	216	291	408	615	822	1068	1380	1550
Local Currency/USD (period average)	8.28	8.28	8.28	8.28	8.28	8.19	7.97	7.57	7.00
Other									
1 Year Lending rate (period average, %)	5.9	5.9	5.4	5.3	5.4	5.6	5.9	6.8	7.1
5 Year Benchmark bond (period average, %)	#N/A	#N/A	#N/A	2.7	4.1	3.2	2.6	3.5	4.5
Fiscal balance (% of GDP)	-2.5	-2.3	-2.6	-2.2	-1.3	-1.2	-0.7	-1.8	-2.0
Population (persons million)	1267	1276	1285	1292	1300	1308	1314	1333	1352

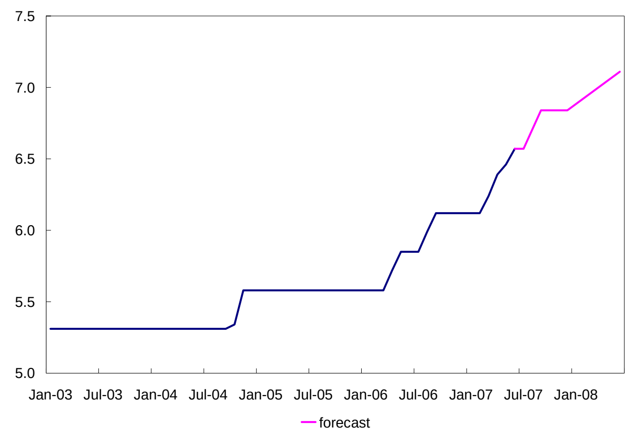
Source: CEIC Data Company Limited, IFS and Citi estimates.

Figure 30. Exchange Rate: USD-CNY



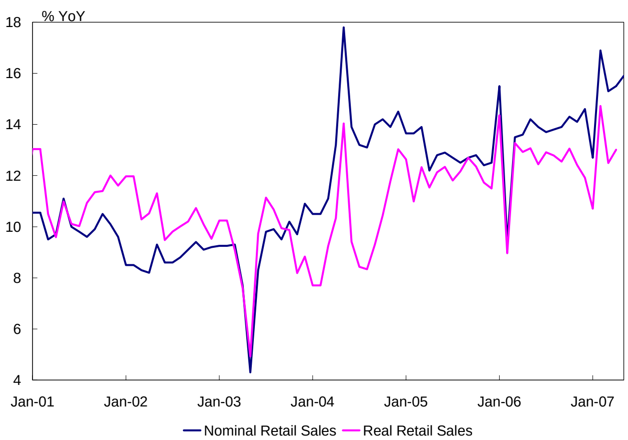
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 31. Short Rate (%): One-Year Lending Rate



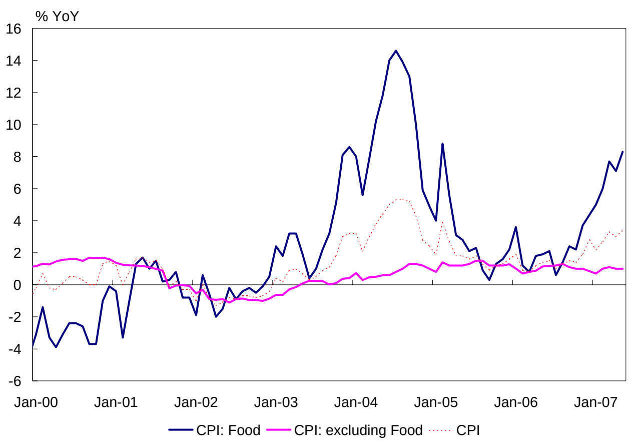
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 32. Retail sales reflect strengthening consumption, but change in real consumption remains modest



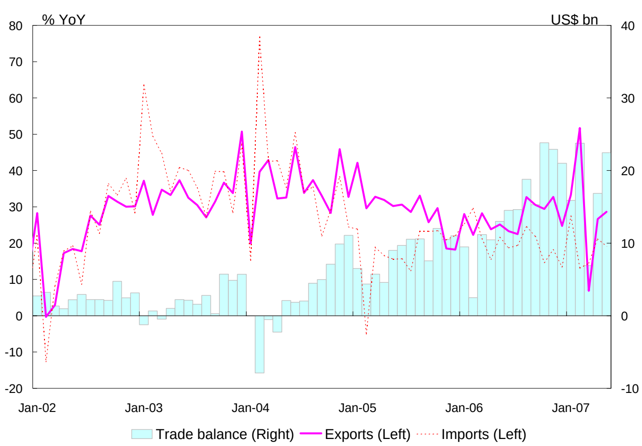
Source: CEIC Data Company Limited

Figure 33. CPI reached new high in May on food inflation; this will likely induce further tightening



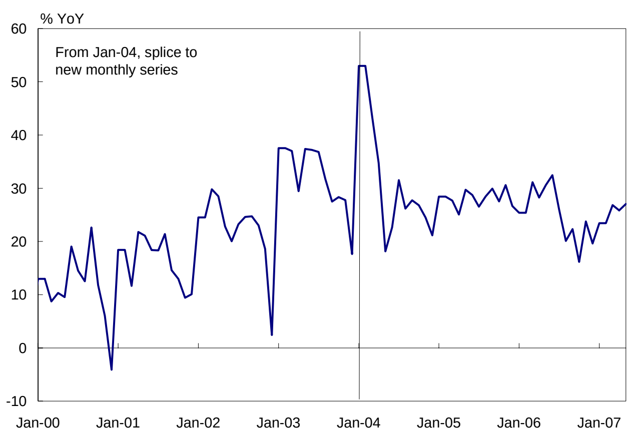
Source: CEIC Data Company Limited

Figure 34. To contain monthly surplus, the government adjusted its export tax rebate policy again and we expect another 5% RMB gain for the rest of 2007



Source: CEIC Data Company Limited

Figure 35. Monthly fixed asset investment remains on a uptrend on loose liquidity conditions, despite tightening measures so far



Source: CEIC Data Company Limited

India

Rohini Malkani and Anushka Shah

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	•	•	•	•	•

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Growth Momentum Remains Strong

FY07 GDP growth came in at 9.4%, higher than the government's first estimate of 9.2%[2]. Growth was led by the continuation of double-digit non-farm growth with industry rising 10.9%, services 11% and agriculture 2.7% yoy. The near-term outlook for interest rate-sensitive sectors (such as autos and retail lending) appears to be impacted by the Reserve Bank of India (RBI) stepping up its tightening stance since October. Overall, we expect GDP growth to sustain at 9% levels in FY08, given continuation of the key growth drivers, an uptrend in savings and investment, and our expectations that interest rates are close to peaking. Recently released industrial production, which grew 13.6% in April, higher than expectations and the 9.9% growth in April 2006, supports the growth numbers.

Inflation, as measured by the WPI, which crossed the 5.5% level in December and touched a high of 6.69% on January 27, prompted the RBI to step up its tightening stance coupled with a series of fiscal measures (import duty reductions, and export and price controls). On the back of monetary and fiscal measures coupled with a strong base effect, headline inflation has fallen below 5% levels, coming in at 4.85% for the week ended May 25, in line with expectations[3]. While growth in primary articles rose 8.6% yoy, the index for manufactured products increased by 5.1% while the fuel index inched up 0.5%. Going forward, we expect inflation to remain at sub-5% levels over the coming months.

Having lowered its medium-term target range for inflation from 5.0%-5.5% to 4.0%-4.5%, we believe the RBI has kept a window open for one more rate hike in FY08. While we expect policy rates to peak soon, we believe the RBI will continue to use the cash reserve ratio to absorb liquidity arising due to capital flows. However, not wanting to upset the growth momentum, we could see a reduction in the statutory liquidity ratio in 2H FY08.

On the external front, we maintain our view that the government's target for exports rising US$160bn in FY08 (+28%) is very optimistic. We think growth is likely to decelerate to the sub-15% yoy level due to moderation in the US, a high base effect and a lack of new export initiatives. In addition, the rupee's recent strength could impact sectors such as textiles, gems and jewelry. However, imports are also likely to slow to the 13.5% level. This assumes stable oil prices (oil at US$65/bbl) but also the continuation of 20%+ non-oil imports. While we expect customs trade deficit to widen to US$66.1bn in FY08 versus US$56.7bn in FY07, we expect higher invisible inflows (software exports and remittances) coupled with strong capital flows to limit

[2] The CSO releases four sets of GDP data each year- Advance, Updated Advance, Quick and Revised estimates. The **Advance** estimates are released in February - two months before the close of the year for the current FY. These estimates are revised in May

[3] For more details please see our note dated 2nd March 07 at https://www.citigroupgeo.com/pdf/SAP03261.pdf

the rise in the current account deficit to 1.5% of GDP in FY07 and FY08 and keep the currency on an appreciating trend.

Following the 8% sharp appreciation seen during end-March and early April, the rupee moved in a range of Rs40.3/US$ to Rs41.3/US$ last month. A slew of overseas public issuances are likely to be rupee-positive in the near term. While the medium-term outlook is clouded due to a strong exporter lobby coupled with the recent tightening of measures for companies accessing funds overseas, given the overall surplus on the balance of payments coupled with our house view on the CNY, we expect the rupee to stay on a long-term appreciation path and maintain our 12-month estimate of Rs40/US$.

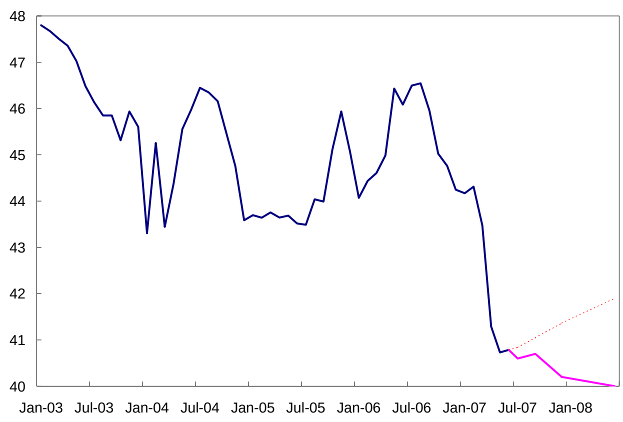
Figure 36. Key Economic Forecasts

	FY01	FY02	FY03	FY04	FY05	FY06	FY07E	FY08E	FY09E
Real Sector									
Real GDP (% yoy)	4.4	5.8	3.8	8.5	7.5	9.0	9.4	9.3	9.4
Agriculture (% yoy)	-0.2	6.3	-7.2	10.0	0.0	6.0	2.7	3.0	2.8
Industry (% yoy)	6.3	2.7	7.1	7.4	9.8	9.6	10.9	10.0	10.4
Services (% yoy)	5.7	7.2	7.4	8.5	9.6	9.8	11.0	11.0	11.0
Wholesale Prices (period average, % yoy)	7.1	3.6	3.4	5.5	6.5	4.4	5.3	4.5	4.5
Nominal GDP (US$ bn)	460	475	509	603	695	805	919	1117	1322
GDP Per Capita (US$)	457	467	495	584	673	769	864	1035	1207
External Sector									
Exports (US$, % yoy)	21.1	-1.6	20.3	23.3	28.5	23.4	19.5	15.0	20.0
Imports (US$, % yoy)	4.6	-2.8	14.5	24.1	48.6	32.0	23.0	13.5	12.0
Trade Balance (US$ Bils.)	-12.5	-11.6	-10.7	-13.7	-33.7	-51.8	-67.4	-74.7	-72.1
Current Account (% of GDP)	-0.6	0.7	1.2	2.3	-0.4	-1.1	-1.6	-1.4	-0.7
International Reserves ex. Gold (US$ Bils.)	40	51	72	106	135	145	192	213	238
Local Currency/USD (period average)	45.70	48.00	48.30	45.90	45.00	44.30	44.90	41.50	40.00
Other									
Prime Lending Rate (period average, %)	11.5	11.3	10.8	10.3	10.0	10.8	10.8	10.8	10.5
10 Year Benchmark bond (period average, %)	9.8	7.3	5.9	4.7	5.2	7.0	7.8	8.0	7.5
Fiscal balance (% of GDP)	-9.5	-9.9	-9.6	-8.5	-7.5	-7.4	-6.3	-6.0	-6.1
Population (persons million)	997	1007	1017	1027	1031	1032	1047	1063	1079

Note: India's fiscal year runs from April – March.

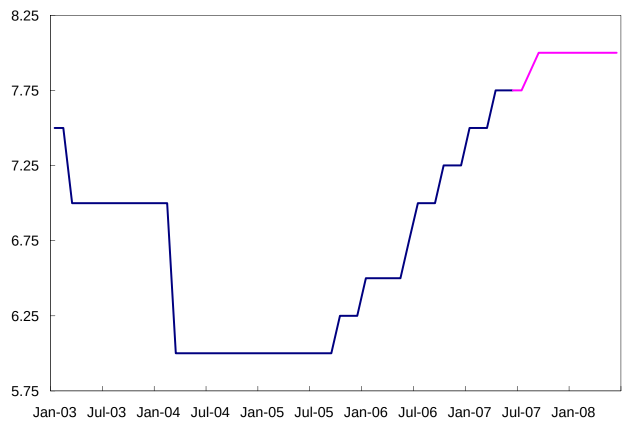
Source: CSO, RBI, Ministry of Finance, CEIC Data Company Limited, IFS and Citi estimates.

Figure 37. Exchange Rate: USD-INR



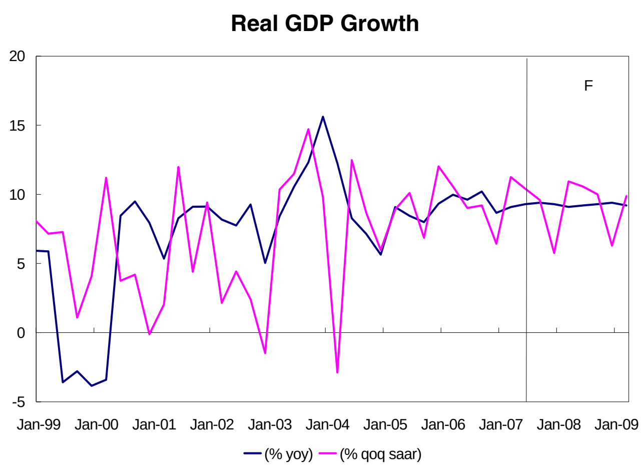
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 38. Short Rate: Overnight Reverse Repo Rate



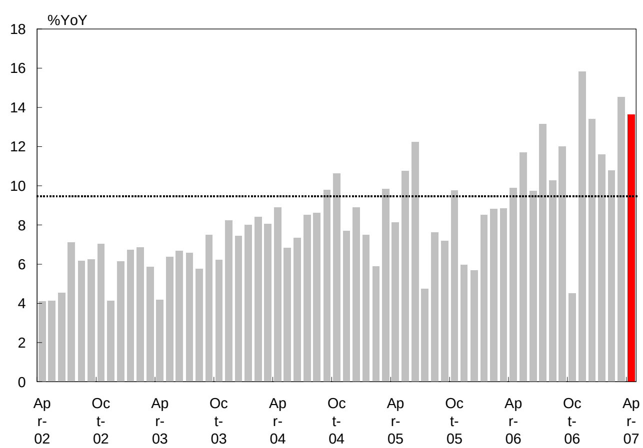
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 39. 4QFY07 GDP growth of 9.1%yoy was led by agriculture, industry and services



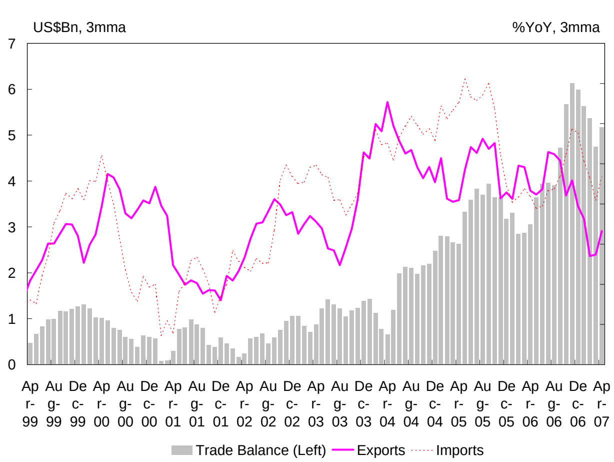
Source: CEIC Data Company Limited and Citi estimates

Figure 40. Robust IP led by manufacturing; we expect growth to slow from 11% in FY07 to 10% in FY08 due to higher rates



Source: CSP

Figure 41. Trade deficit is likely to widen further in FY08 due to a deceleration in exports but flows remain strong to finance the deficit



Source: DGCI&S

Figure 42. Higher rates weighed on retail lending, resulting in a credit growth slowing to 26% levels while deposits remain strong

Source: RBI

Thailand

Jun Trinidad

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	•	•	•	•	•

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Unchanged Favorable Policy Setting

We recommend a neutral position on local currency bonds and a long position on the baht. A loosening of monetary policy (150bp cumulative cuts since January), a larger fiscal deficit outlook and key political decisions undertaken by the government comprise factors that can enhance the private spending outlook on consumer durables and investment goods. We expect private spending to improve, although an investment recovery may lag, in support of GDP growth of 4.7% for 2007E following 1Q07 growth of 4.3% yoy. Coupled with the monetary policy bias turning neutral, the bond market might have limited impetus to rally although it probably will be prone to downside corrections. We think that overweighting short duration will be appropriate in the face of political challenges ahead en route to general elections in November. A recent collapse in local bond yields provides an opportunity to 'bottom fish' rather than shift to overweight, in our view. Low core inflation risk and the likelihood of the government easing long bond supply in 2H07 could firm up bond values.

Unless the global trading environment slows down unexpectedly, a strong baht outlook remains intact, in our view. Thai exports may defy expectations of a late year correction, as firming US growth, positive view on Europe and Japan, and buoyant Asian regional prospects ought to sustain export growth in the 15%-20% range. An import recovery would ease the current account surplus, but prospects for a gradual economic upturn in 2H07 should sustain the surplus. The YTD trade surplus of US$4bn remains elevated against our full-year surplus forecast of US$3.1bn. A volume-driven trade surplus underpins a large share of net exports to real GDP in the 16% range. We expect Bank of Thailand (BoT) to continue to be the main USD buyer in the spot market only because of the strong potential for currency appreciation. Policy rate easing that cut the overnight rate to a neutral 'low' of 3.5% lowered BoT's cost of sterilization.

Another 25bp rate cut can help fast-track recovery of private expenditure paced by demand for consumer durables. The key drag will likely be private investment. This component of domestic demand need not react strongly to policy accommodation. We think the unwinding of political risk premia has to materialize before this long-term component of private spending improves. Declining FDI project approvals (–35%yoy) in 2006 also contributed to this year's lackluster private investment trend. An expanded contribution of net exports to GDP (17.2%) underwrote much of first quarter GDP growth. Net exports grew 32.9% yoy in 1Q07, which dwarfed domestic demand growth of 1.6% yoy during the same quarter.

We expect private spending to improve in 2H07 and support GDP growth of 4.7% in 2007. Although driven largely by net exports, 1Q07 GDP growth of 4.3% yoy (+1.2% qoq sa) provides a good backdrop for a 2H07 recovery. 1Q resilience came by way of upbeat spending on non-durable goods and services despite political noise.

With a larger FY08 fiscal deficit forecast of about 2% of GDP, we think the fiscal content of 2H07 growth will be larger than in the preceding period. Political imperatives should also compel the government to loosen up its purse strings. The government plans to incur a fiscal deficit of US$4.76bn in FY08, which should be positive for shoring up GDP prospects in the 4Q07. The central government plans to raise spending by 15%, while revenue collections, which include profit remittances of state-owned companies, may fall by 13% in next year's budget program.

Expected low core inflation for rest of 2007 should ensure policy accommodation and supportive growth. The export outlook continues to support near-term growth, as we expect Thailand's major export markets will be lifted by favorable developments. January-April FDI approvals grew 63.6% yoy. Given an implementation lag time of 12-18 months, we think real investment next year will get a boost.

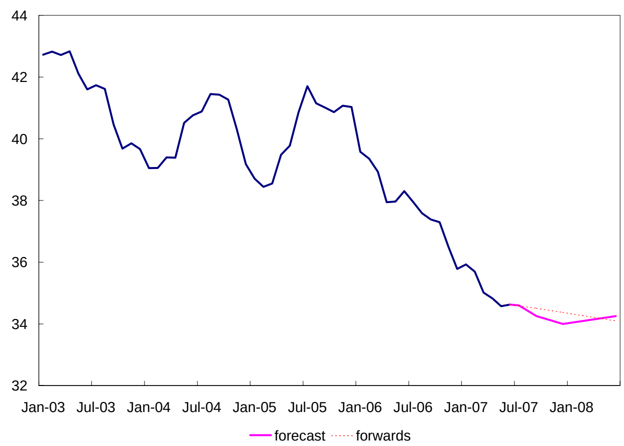
Despite political drift and external financial market shocks, the favorable policy setting, which remains focused on fiscal and monetary accommodation to elevate growth prospects, remains unchanged. A prudential policy stance in the face of oil price shocks in 2005-06 underpinned the 'mean-reversion' of core inflation to less than BoT's inflation target range. The inflation downtrend accorded flexibility to the monetary authority to lower policy rates by 150bp and hopefully reverse domestic demand weakness. Market volatility posed by external financial market shocks as global investor risk appetite changes should not derail policy accommodation. Lower overnight rates enable BoT to sterilize offshore flows and prevent a rapid nominal exchange appreciation at cheaper interest costs. Despite providing a lift to growth, policy accommodation can neither substitute for nor overcome the negative political setting and its effects on private investment and durable goods spending. Rising political risk premia that aggravated the poor regulatory setting (revised foreign business act) may have discouraged private investment.

Figure 43. Key Economic Forecasts

	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
Real Sector									
Real GDP (% yoy)	4.8	2.2	5.3	7.1	6.3	4.5	5.0	4.7	5.0
Domestic demand ex Inventory (% yoy)	5.0	3.2	5.2	7.4	7.9	7.0	3.4	2.5	3.0
Real Consumption: Private (% yoy)	5.2	4.1	5.4	6.5	6.2	4.3	3.1	2.5	3.0
Real Gross Capital Formation (% yoy)	5.5	1.1	6.5	12.1	13.2	11.1	4.0	0.0	2.5
Consumer Prices (% yoy)	1.6	1.7	0.6	1.8	2.8	4.5	4.7	2.7	2.6
Nominal GDP (US$ bn)	123	116	127	143	161	176	206	243	267
GDP per capita (USD)	1,965	1,835	1,999	2,230	2,478	2,705	3,061	3,559	3,858
Manufacturing Production (% yoy)	6.7	2.7	9.1	14.0	11.7	9.1	7.4	6.0	7.0
External Sector									
Exports (% yoy, US$)	19.5	-7.1	4.8	18.2	21.6	15.0	17.4	10.3	9.5
Imports (% yoy, US$)	31.3	-3.0	4.6	17.4	25.7	25.9	7.0	8.5	9.8
Trade balance (US$ bn)	5.5	2.5	2.7	3.8	1.5	-8.5	2.2	4.7	4.8
Current account (% of GDP)	7.6	4.4	3.7	3.4	1.7	-4.5	1.6	1.7	0.3
International Reserves ex. Gold (US$ bn)	32	32	38	41	49	51	65	63	64
Local Currency/USD (period average)	40.1	44.4	43.0	41.5	40.2	40.2	37.9	34.7	33.9
Other									
3M Interbank Rate (period average, %)	3.90	3.04	2.17	1.56	1.59	3.23	5.16	4.23	4.00
10 Year Government Bond (period average, %)	6.51	5.82	5.06	3.76	5.06	5.00	5.39	4.25	4.25
Fiscal balance (% of GDP; FY)	-2.4	-2.1	-2.4	0.4	0.3	-1.8	-0.3	-1.0	-2.0
Population (persons million)	62	63	63	64	65	65	67	68	69

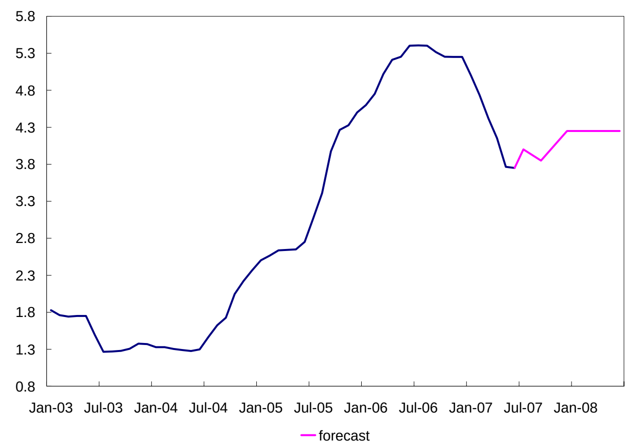
Source: CEIC Data Company Limited, IFS and Citi estimates.

Figure 44. Exchange Rate: USD-THB



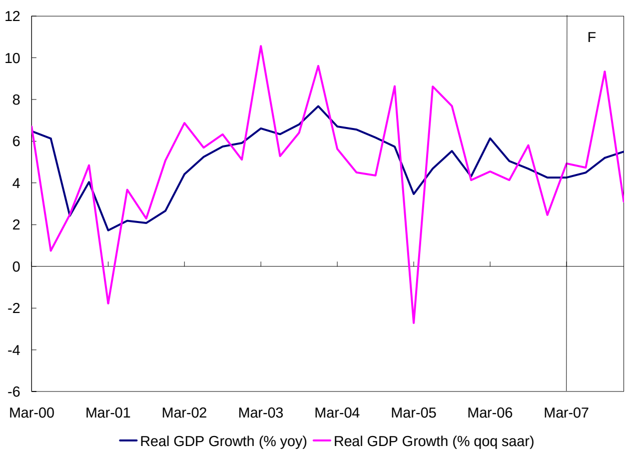
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 45. Short rate (%): 3 Months Interbank Rate



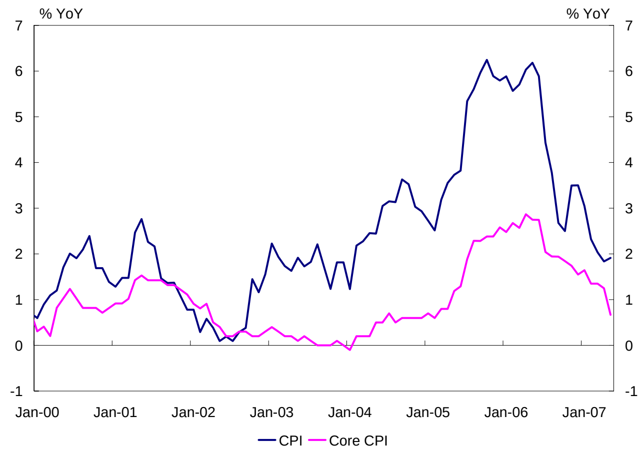
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 46. 1Q07 Real GDP growth rules out the likelihood of a sharp slowdown in economic momentum in the succeeding quarters



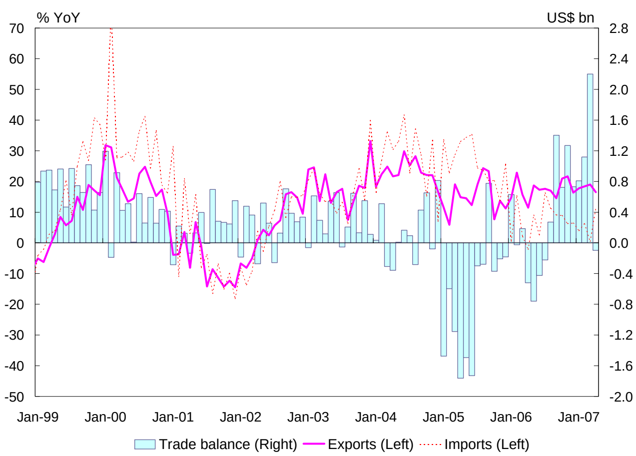
Source: CEIC Data Company Limited and Citi estimates

Figure 47. Lower core inflation in May increases the likelihood of a final quarter point rate cut as a fitting end to the rate cutting cycle



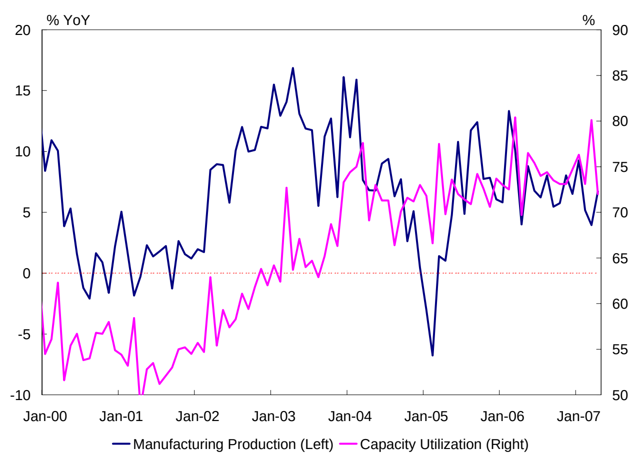
Source: CEIC Data Company Limited

Figure 48. Volume-driven imports caused the trade balance to shift to a modest deficit in April



Source: CEIC Data Company Limited

Figure 49. Favorable manufacturing stats injects hope for the view of a changing cyclical environment for the better



Source: CEIC Data Company Limited

Vietnam

Renee Chen

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	+	+	•	+	-

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

SBV Tightened Monetary Expansion to Tame Inflation

The economy has maintained strong momentum into 2007 on broad strength from investment, consumption and exports. Real GDP expanded by 7.9% yoy in the first five months of this year, the highest growth rate for the same period since 2000. The Ministry of Planning and Investment reported that newly registered FDI rose by more than 30% yoy to US$5.2bn in the first five months of this year, and a target of US$12bn for 2007 appears to be within reach. Rising FDI has fueled exports and industrial output, and retail sales maintained robust double-digit growth.

Disappointing crude oil and rice exports have dragged on this year's export expansion, but other exports have held up well. However, surging imports due to a sharp pickup in industrial raw material and capital good imports more than offset the export gain, resulting in a wider trade deficit. A larger trade deficit and net income payment will likely turn the current account balance into a deficit of 1.4% of 2007E GDP from a surplus of 0.3% of 2006E GDP. However, large foreign direct and portfolio capital inflows and official development aid should help improve the balance of payments. FX reserves built up sizably to US$12bn at end-2006 from US$8.6bn at end-2005. The World Bank estimated that reserves rose further by US$3bn in 1Q07.

The State Bank of Vietnam (SBV) is keen to temper appreciation of the Vietnamese dong (VND) to preserve export competitiveness and accumulate FX reserves as a cushion against potentially volatile capital inflows. While the VND/USD could weaken further in the near term on strong USD demand from importers, we are concerned about the sustainability of depreciating the VND amid large capital inflows with partial sterilization while facing rapid monetary and credit expansion.

Inflation accelerated to a five-month high of 7.3% yoy in May, on persistent supply-side pressures from food, energy and construction material costs. Gasoline prices rose by 7.3% in May following the removal of price controls, despite lower import tariffs. The potential spillover effect from higher energy costs on other prices and risks from a reacceleration in credit growth on the back of excess bank liquidity and epidemics such as a bird flu outbreak deserve close watch. We see the chance for meeting the 2007 official inflation target at or below 7%, given the SBV's tightening bias, possible further cuts in import duties, and official efforts to control price manipulation, but the price risk is significantly biased to the upside.

Credit growth picked up to 27.4% yoy in 4Q06 from 23.5% yoy in July 2006 and is estimated to have reached 30% yoy in March. The faster credit expansion was mainly due to increased lending for securities trading, especially by joint-stock banks (JSBs). To control money supply and credit expansion and tame inflation, the SBV raised the reserve requirement ratio from June 1. While the higher reserve requirement has had a modest impact on liquidity at state-owned commercial banks, which has been in large excess due to much faster deposit growth than loan growth, it has tightened liquidity at JSBs. Banks have raised deposit rates, mainly for USD deposits following recent USD appreciation and higher US interest rates overseas.

Overnight interbank rates jumped to 7% on 14 June from below 3.7% at end-May. The five-year government bond yield edged higher to 7.208% on June 14 from a recent low of 7.093% on June 5. The rise in local bond yields coincided with the latest global bond sell-off. Despite stubborn inflation, a potential rise in term premium around the globe, market caution over possible further SBV tightening measures likely exerting upward pressure on bond yields in the near term and resilient (foreign) demand vs. limited supply should keep bond yields well anchored.

Tax revenue has faced an adverse impact from declining oil production and revenue from crude oil exports, but we expect non-oil revenue growth from the private sector to remain buoyant. Fiscal policy will likely remain expansionary, with a rising wage bill due to an increase in the public sector minimum wage, social insurance payments and strong infrastructure spending, but a (planned) reduction in subsidies could help contain the budget deficit. Import tariff cuts eroding import duty receipts could offset the removal of trade barriers spurring import growth.

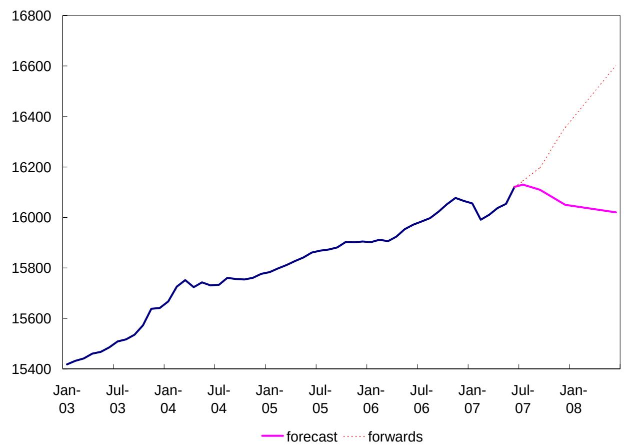
The SBV tightened stock-related lending by limiting the outstanding bank loans for stock trading to 3% of total outstanding loans. It also required banks to limit non-resident investors' holdings of bank certificates in VND at 50% to help better monitor foreign portfolio capital inflows. Authorities are soliciting public feedback on a proposal to levy taxes on stock earnings of personal income, which could include a 5% tax on dividend income and a 25% capital gains tax for retail investors on securities trading. Non-resident foreigners' securities investment will also be taxed, but institutional investors will not come under the proposal. We think these tightening measures may increase investor caution in the near term, but are positive for sustained stock market development.

Figure 50. Key Economic Forecasts

	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
National Account									
Real GDP (% yoy)	6.8	6.9	7.1	7.3	7.8	8.4	8.2	8.0	8.0
Domestic demand ex Inventory (% yoy)	5.2	6.5	9.0	9.2	8.3	8.6	8.2	8.4	8.8
Real Consumption: Private (% yoy)	3.1	4.5	7.6	8.0	7.1	7.3	7.5	7.7	8.0
Real Gross Capital Formation (% yoy)	10.2	10.7	12.9	11.9	10.4	9.7	8.6	9.8	10.2
Consumer Prices (% yoy)	-1.6	-0.3	3.9	3.1	7.8	8.3	7.5	6.8	6.4
Nominal GDP (US$ bn)	31.2	32.5	35.1	39.5	45.5	52.9	60.9	69.6	79.8
GDP per capita (USD)	401	413	440	489	554	637	724	816	923
Unemployment Rate (%)	6.4	6.3	6.0	5.8	5.6	5.3	4.4	4.3	4.2
External Sector									
Exports (% yoy, US$)	25.5	3.8	11.2	20.6	31.4	22.5	22.1	19.5	20.6
Imports (% yoy, US$)	33.2	3.7	21.8	27.9	26.6	15.7	20.1	21.2	19.5
Trade balance (US$ bn)	-1.2	-1.2	-3.0	-5.1	-5.5	-4.5	-4.8	-6.5	-7.2
Current account (% of GDP)	2.1	2.1	-1.9	-4.9	-3.4	0.4	0.3	-1.4	-1.9
International Reserves ex. Gold (US$ bn)	3.4	3.7	4.1	6.2	7.0	9.1	12.0	19.5	23.0
Local Currency/USD (period average)	14174	14808	15270	15513	15732	15855	15985	16065	16025
Other									
3 Month VNIBOR Rate (period average, %)	#N/A	#N/A	#N/A	7.2	7.0	7.6	8.0	7.9	7.6
5 Year Government Bond (period average, %)	#N/A	#N/A	#N/A	#N/A	8.4	8.7	8.6	7.3	7.1
Fiscal balance (% of GDP; FY)	-2.8	-2.8	-1.4	-1.2	0.9	-1.2	-1.8	-2.2	-2.5
Population (persons million)	78	79	80	81	82	83	84	85	87

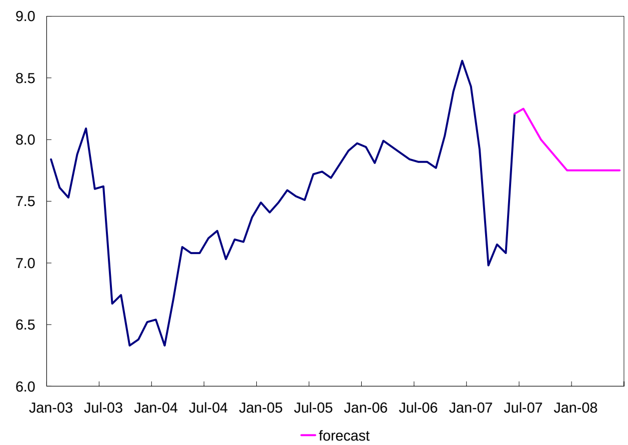
Source: CEIC Data Company Limited and Citi estimates.

Figure 51. Exchange rate: USD-VND



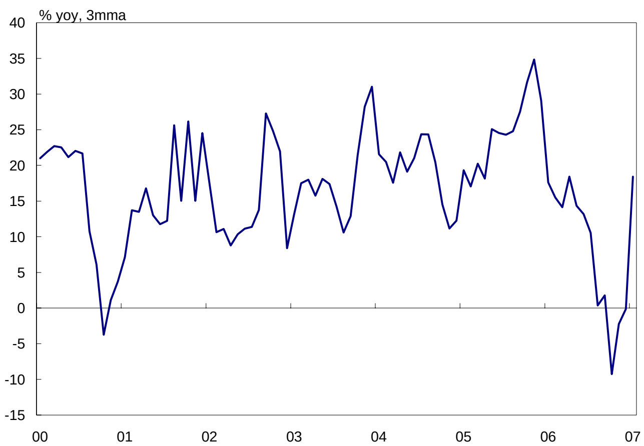
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 52. Short rate: 3 Month Interbank Rate



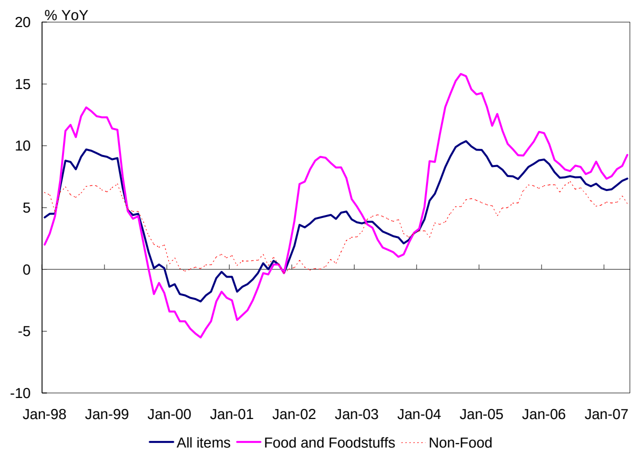
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 53. Rising FDI has fueled exports and industrial output



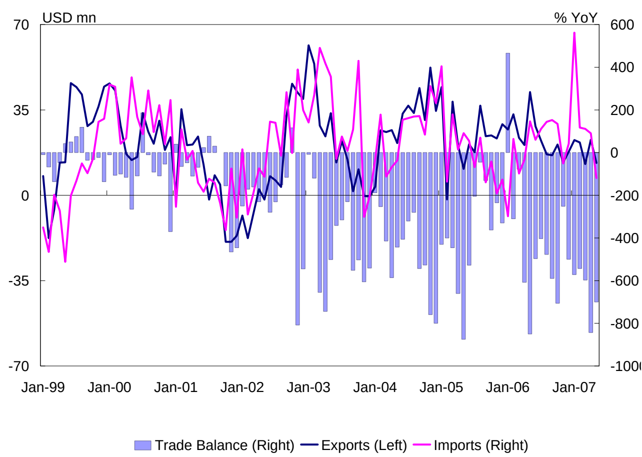
Source: CEIC Data Company Limited

Figure 54. Inflation accelerated on persistent supply-side pressures from food, energy and construction material costs



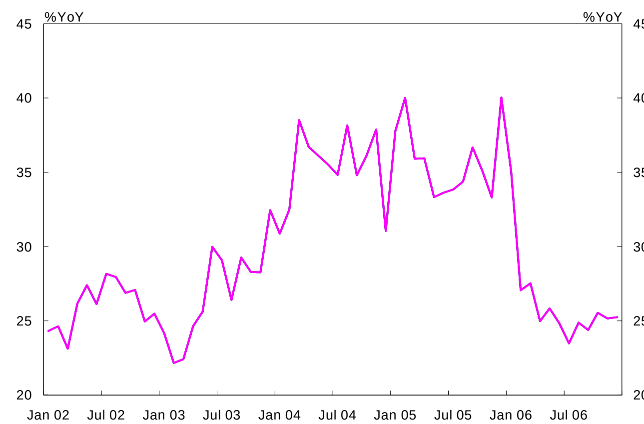
Source: CEIC Data Company Limited

Figure 55. Surging imports more than offset the export gain, resulting in a wider trade deficit



Source: CEIC Data Company Limited

Figure 56. SBV raised the reserve requirement ratio from June 1 to slow fast credit expasion and tame inflation



Source: CEIC Data Company Limited

Other Country Section

Bangladesh

Rohini Malkani and Anushka Shah

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	•	•	•	•	•

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Recent Economic Developments and Prospects

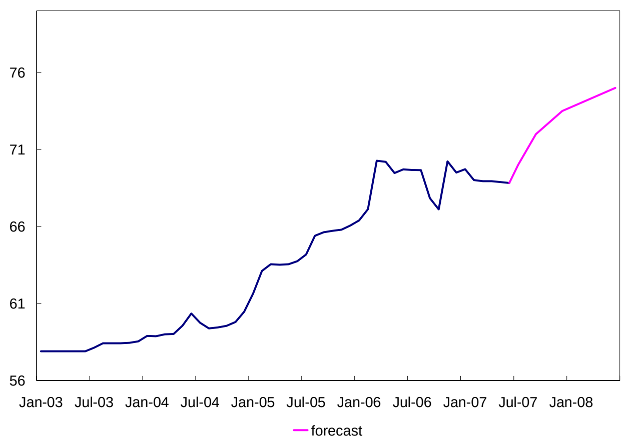
Real Sector	Growth trends remain on track despite political uncertainty. A reduction in economic disruptions due to strikes has resulted in industrial production continuing to report an uptrend, with growth in February up 12.6% yoy. Growth over July-February rose 11.4% yoy. The FY08 budget is based on a GDP estimate of 7%, but factoring in the political volatility in the run-up to elections we expect growth to moderate to the 6-6.5% levels.
Inflation	Inflation as measured by the CPI hit a nine-year high in April, rising 8.3% yoy. The rise in prices is a result of an administered hike in domestic fuel prices and rising import costs. In a bid to curb inflation, the government approved an allocation of Tk900mn for Bangladesh Rifles, which would aid the import of essential items. We expect inflation to come down to the 6.5-7% range in FY08, in line with budget estimates.
Monetary/Fiscal Policies	The budget projects revenue to rise by 16% yoy in FY08 vs. the 10.3% growth seen in FY07 while expenditure is projected to rise (+19% yoy in FY08E vs. 9.5% in FY07E). This will result in the budget deficit rising to 4.2% of GDP, higher than the previous year (3.7% of GDP). Key revenue measures include rationalization in the income tax brackets, a restructuring of customs duty rates, and widening the VAT net.
External Sector	Although investment slowed in FY07 (FDI over July-March totaled US$385mn, down from US$500mn during the same period last year), this could see a reversal, following the Board of Investment's recent road show when it signed 36 memoranda of understandings across sectors totaling US$2.3bn from non-resident Bangladeshis. India-based Mittal Group's recent proposal to invest US$2.9bn in coal and gas exploration is encouraging.
Other (e.g. Political) Developments	Although the launch of Nobel laureate Muhammad Yunus's political party was welcomed with the hope that it would infuse a greater degree of competition into Bangladesh's political system, Dr Yunus has withdrawn from the political arena. Meanwhile, elections to be held in January remain postponed indefinitely.
Issues to Watch/Key Risks	Political volatility, labor unrest, natural disasters and a deterioration in exports are key risks to our outlook.

Figure 57. Key Economic Forecasts

	FY01	FY02	FY03	FY04	FY05	FY06	FY07E	FY08E	FY09E
Real Sector									
Real GDP (% yoy)	5.3	4.4	5.3	6.3	6.0	6.7	6.0	6.1	6.1
Domestic demand (% yoy)	5.0	6.3	5.0	5.0	5.8	6.1	6.1	6.3	6.3
Real Consumption: Private (% yoy)	4.7	4.9	3.5	3.2	3.9	5.2	5.2	5.2	5.2
Real Total Investment (% yoy)	5.8	8.2	7.9	9.2	10.7	8.0	7.9	8.3	8.3
Consumer Prices (period average, % yoy)	1.9	2.8	4.4	5.8	6.5	7.2	6.8	6.5	6.5
Nominal GDP (US$ bn)	47	48	52	56	61	62	66	71	74
GDP per capita (USD)	362	362	389	418	442	448	473	500	516
Industrial Production (% yoy)	7.4	6.5	7.3	7.6	8.3	9.6	8.1	8.2	8.2
External Sector									
Exports (% yoy, US$)	12.6	-7.6	9.5	15.9	14.0	21.6	17.0	17.0	17.0
Imports (% yoy, US$)	11.4	-8.7	13.1	13.0	20.6	12.1	13.0	15.5	15.5
Trade balance (US$ bn)	-2	-2	-2	-2	-3	-3	-3	-3	-3
Current account (% of GDP)	-2.3	0.3	0.3	0.3	-0.9	0.9	1.4	1.3	1.3
International Reserves ex. Gold (US$ bn)	1	2	2	3	3	3	5	6	7
Local Currency/USD (period average)	54.0	57.4	57.9	58.9	61.3	67.0	70.3	73.8	79.2
Other									
Bank rate (period end, %)	7.0	6.0	6.0	5.0	5.0	5.0	5.0	6.0	6.0
10 Year Benchmark bond (period end, %)	#N/A	#N/A	#N/A	#N/A	10.0	11.0	11.8	12.5	11.3
Fiscal balance (% of GDP)	-5.2	-4.3	-4.2	-4.2	-4.4	-3.9	-3.7	-4.2	-3.7
Population (persons million)	130	132	133	135	137	139	140	141	143

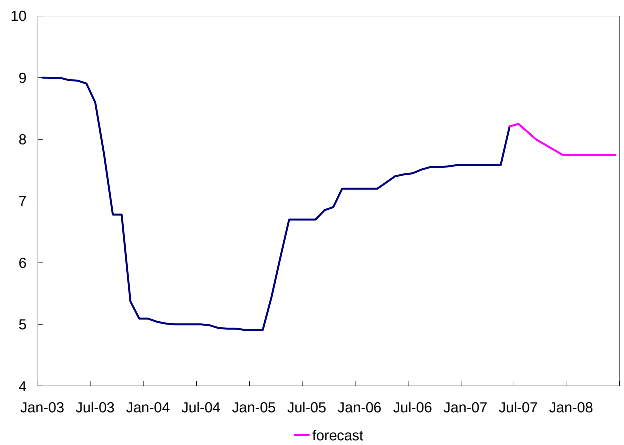
*Bangladesh Fiscal year runs from July-June. Source: Historical data from CEIC Data Company Limited and Bangladesh Bank, forecasts are by Citi

Figure 58. Exchange Rate: USD-BDT



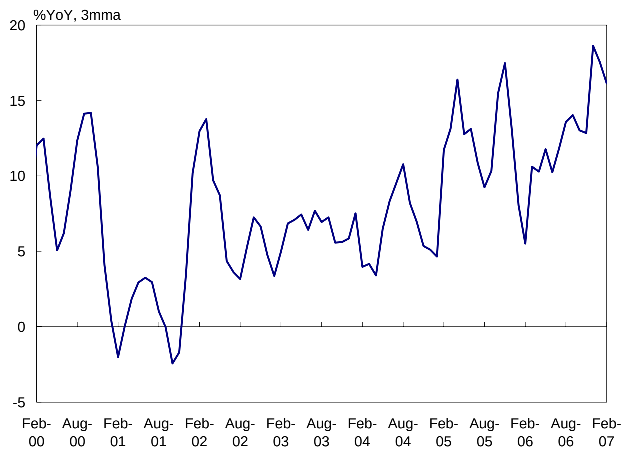
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 59. Short rate (%): 91 Day T-bills



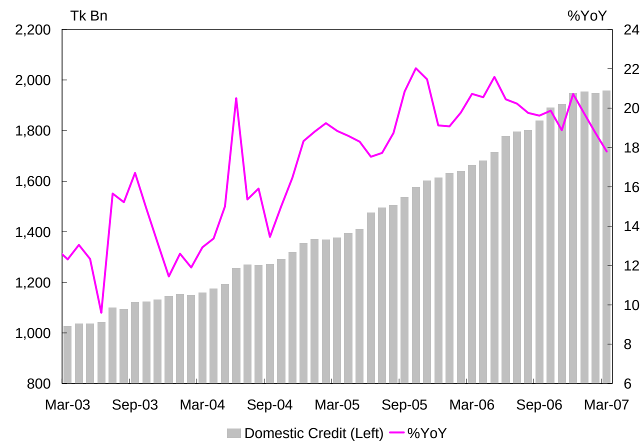
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 60. A reduction in economic disruptions due to strikes has resulted in industrial production continuing to report an uptrend



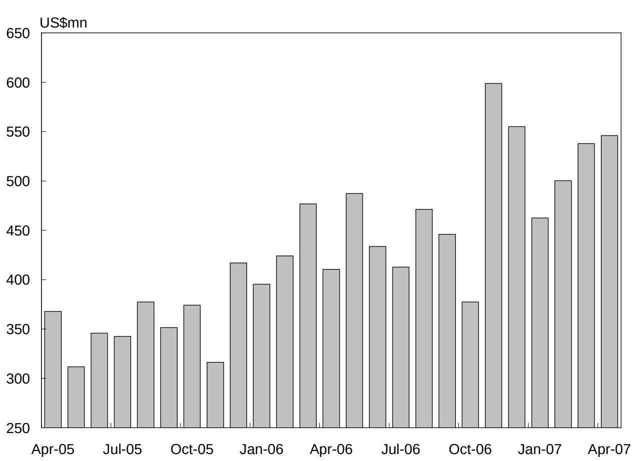
Source: Bangladesh Bank

Figure 61. Domestic credit remained strong, albeit slowing slightly



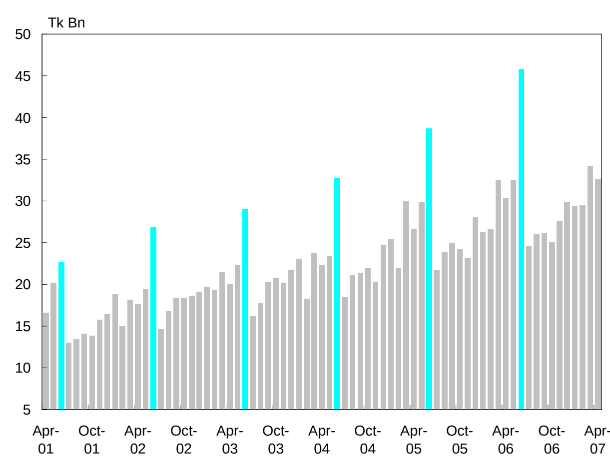
Source: Bangladesh Bank

Figure 62. Steady growth in remittances continue to underpin the current account



Source: Bangladesh Bank

Figure 63. Key measures to boost tax revenue include: rationalization of the income tax brackets, a restructuring of customs duty rates, and widening the VAT net



Source: Bangladesh Bank

Hong Kong

Joe Lo and Patricia Pong

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	•	•	+	+	+

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Recent Economic Developments and Prospects

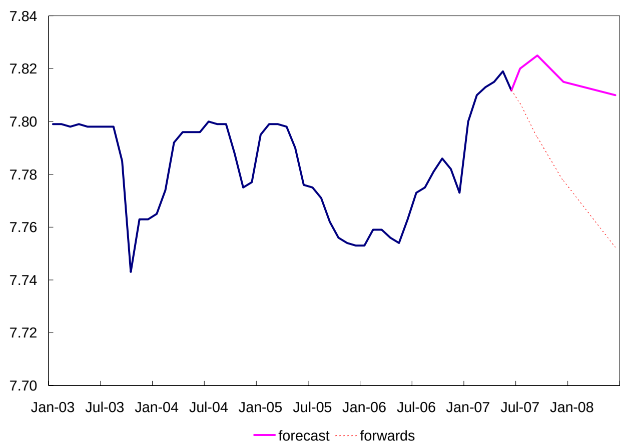
Real Sector	Economic growth seems to pick up in 2Q07E after falling to 5.6% yoy in 1Q07. A rebound in May's Purchasing Manager Index to 54.9 from 52.9 in April suggests a broad-based improvement in the economy. Reports of strong output and more new orders indicate that the rebound in exports in April may continue in the near term. Robust employment would be favorable for consumer spending and help retail sales rebound after temporary weak growth in April. Rising consumer demand should prompt businesses to increase investment.
Inflation	The headline inflation rate is expected to fall this year, as the government cut rates (a levy on property) and public housing rent. But underlying inflation is edging up. Tighter labor supply is pushing up wages while import prices are rising due to the RMB appreciation.
Monetary/Fiscal Policies	The HKD/USD likely remains steady with a moderate weakening bias. We expect lower selling pressure on HKD, as a larger inflow of funds to local stock market would offset the outflow of funds to the USD to earn higher interest. Thanks to more balanced flows of funds, HIBOR should be stable in near term. In the 2007-08 budget, the government announced tax cuts, rebates and other measures to increase household disposable income by HK$19.7bn (2.3% of annual private consumption). We expect a further fiscal surplus this year, enabling the government to cut taxes again next year.
External Sector	Exports are stronger than expected (up 12.6% yoy in April from 9% in 1Q07) and should benefit from robust overseas demand. A rebound in the US economy, Hong Kong's second largest export market, would help local exporters receive more orders. Local exporters have been successful in opening up new markets with strong economic growth or currency appreciation.
Other (e.g. Political) Developments	We expect a stable political environment. Chief Executive Donald Tsang starts his second term in July. The next major event will be a Legislative Council election in 2008.
Issues to Watch/Key Risks	(1) Global equity markets; (2) RMB appreciation; (3) interest rates; (4) US consumer spending; (5) protectionism against China; and (6) bird flu.

Figure 64. Key Economic Forecasts

	2000	2001	2002	2003	2004	2005	2006	2007E	2008E
Real Sector									
Real GDP (% yoy)	10.0	0.6	1.8	3.2	8.6	7.5	6.9	6.0	5.8
Domestic demand ex Inventory (% yoy)	7.0	2.6	-1.6	-0.1	5.4	3.0	5.5	5.0	4.6
Real Consumption: Private (% yoy)	6.0	2.1	-1.0	-0.9	7.2	3.3	5.2	4.8	4.3
Real Gross Fixed Capital Formation (% yoy)	11.0	2.6	-4.5	0.9	3.1	4.6	7.9	5.9	6.0
Consumer Prices (period average, % yoy)	-3.7	-1.6	-3.0	-2.6	-0.4	0.9	2.0	1.8	3.6
Nominal GDP (US$ bn)	169	167	164	158	166	178	190	203	218
GDP per capita (USD)	25,319	24,804	24,274	23,544	24,439	26,093	27,677	29,276	31,172
Unemployment Rate (%)	4.975	5.125	7.3	7.9	6.8	5.5	4.8	3.9	3.4
External Sector									
Exports (% yoy)	16.1	-5.9	5.4	11.8	15.8	11.6	9.5	9.3	8.8
Imports (% yoy)	18.5	-5.5	3.3	11.7	16.9	10.5	11.7	10.2	10.0
Trade balance (US$ bn)	-10.9	-11.2	-7.6	-8.1	-11.8	-10.2	-17.9	-22.3	-28.8
Current account (% of GDP)	4.1	5.9	7.6	10.4	9.5	11.4	10.8	9.9	7.2
International Reserves ex. Gold (US$ bn)	108	111	112	118	124	124	133	140	145
Local Currency/USD (period average)	7.791	7.799	7.799	7.787	7.790	7.777	7.768	7.815	7.804
Other									
3M Interbank Rate (period average, %)	6.1	3.4	1.8	1.1	0.5	3.1	4.3	4.4	4.5
5 Year Exchange Fund Note (period average, %)	6.8	5.1	4.2	3.1	3.1	3.7	4.2	4.4	4.7
Fiscal balance (% of GDP; FY)	-0.6	-4.9	-4.8	-3.3	-0.3	1.0	4.0	2.0	1.5
Population (persons million)	6.7	6.7	6.8	6.8	6.9	6.8	6.9	6.9	7.0

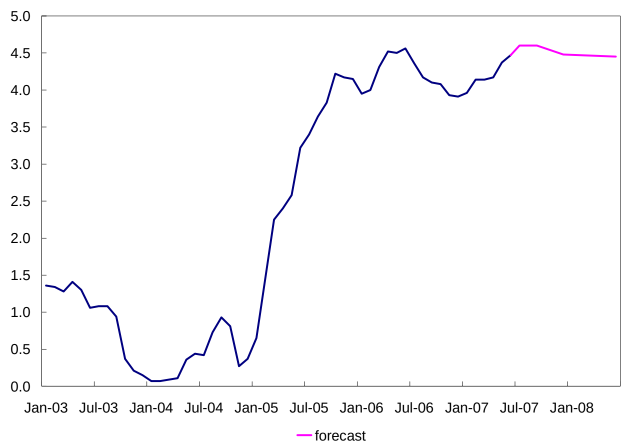
Source: CEIC Data Company Limited, IFS, Citi estimates.

Figure 65. Exchange Rate: USD-HKD



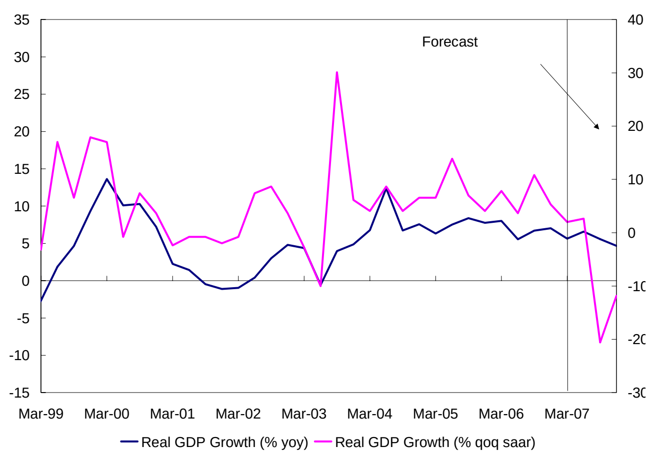
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 66. Short Rate: 3 Month HIBOR



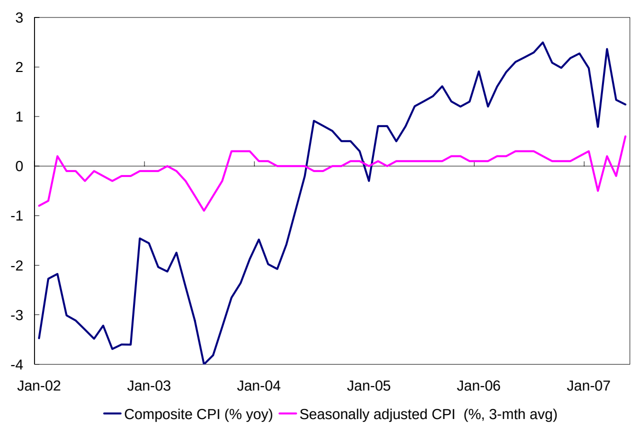
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 67. Economic slowdown in 1Q07 likely to be temporary and reverse in coming quarters



Source:

Figure 68. Inflation remains steady and at a healthy level, which should promote and support economic growth

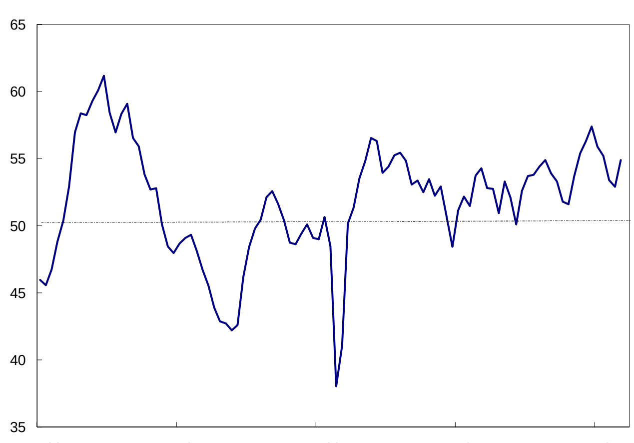


Source: CEIC Data Company Limited, HK SAR Government

Figure 69. Trade data shows recovery in exports and robust domestic demand

Source: CEIC Data Company Limited, HK SAR Government

Figure 70. A rebound in PMI suggests a broad-based improvement in the economy in May



Source: CEIC Data Company Limited, HK SAR Government

Indonesia

Anton H. Guanwan

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	•	–	–	–	•

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Recent Economic Developments and Prospects

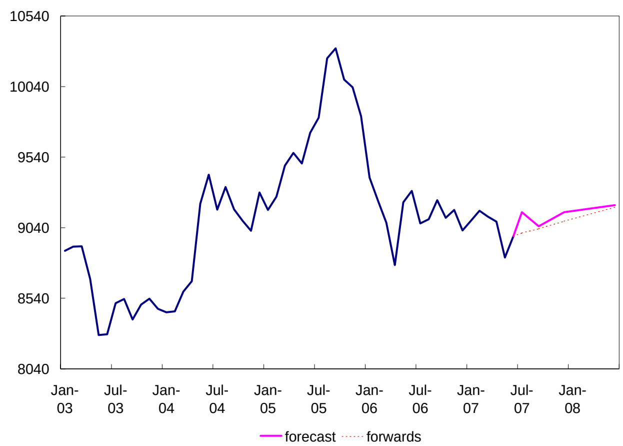
Real Sector	Labor reform and key infrastructure projects have been left out of the latest policy reform package aimed at boosting investment and increasing real sector activity. Thus, the pace of the investment uptrend is unlikely to significantly improve. Resolving logistical problems at the country's main port (Tanjung Priok) is necessary, but this may take longer than the time suggested in the policy. We maintain our GDP forecasts at 6.0% this year and 6.5% next year versus the government's forecast of 6.3% and 6.9%, respectively.
Inflation	Despite YTD inflation rate up to May at 1.84%, we expect the FY07 inflation rate to reach 6.6% yoy. Core inflation will likely be milder, as money supply growth is relatively under control and the currency is roughly stable. The problem of high prices of cooking oil continues to linger, as crude palm oil exports are preferable than domestic consumption in the high commodity price environment.
Monetary/Fiscal Policies	We see further room for Bank Indonesia (BI) to cut the policy rate, as BI still expects relatively benign inflation of 6% toward year-end. With that level of inflation, the policy rate will likely be guided toward 8.0% by year-end before a switch to the overnight policy rate. On the fiscal front, slow spending continued in 1H07, as only 18% of the central government's spending has been done. Only a few companies are benefiting from tax incentives given to boost investment and the capital market.
External Sector	Exports (especially manufacturing products) have been slowing in past months. The continuing strength of commodity prices and demand were the drivers behind the high export value, while imports are slowly picking up. Capital inflows continue. BI's sterilized intervention raised FX reserves beyond US$50bn.
Other (e.g. Political) Developments	The inflation rate still looks relatively benign, but because most of the increase in inflation is due to food prices, consumed more by the poorest of the population, we anticipate a rise in the poverty level. More captures of high-ranked terrorists by the Indonesian police bring hope of a more secure environment.
Issues to Watch/Key Risks	(1) Sudden reversal of an influx of short-term foreign portfolio investment - due to a profit-taking cycle, over confidence of BI, or sentiment turnaround - may depress the IDR; (2) the state bank's excessive lending to infrastructure projects; and (3) newly proposed regulation to relax the inflexibility of the labor market.

Figure 71. Key Economic Forecasts

	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
Real Sector									
Real GDP (% yoy)	4.9	3.6	4.5	4.8	5.0	5.7	5.5	6.0	6.5
Domestic demand ex Inventory (% yoy)	4.6	4.5	4.7	3.6	7.0	5.8	3.7	6.5	8.4
Real Consumption: Private (% yoy)	1.6	3.5	3.8	3.9	5.0	4.0	3.2	4.7	5.4
Fixed Investment (% yoy)	16.7	6.5	4.7	0.6	14.7	10.8	2.9	10.7	15.0
Consumer Price (% yoy)	3.8	11.5	11.8	6.8	6.1	10.5	13.1	6.6	6.4
Nominal GDP (US$ bn)	166	161	196	235	257	287	364	414	460
GDP per capita (US$)	742	697	928	1,100	1,187	1,308	1641	1844	2023
Unemployment Rate (%)	6.1	8.1	9.1	9.5	9.9	10.3	10.3	10.0	9.6
External Sector									
Exports (US$% yoy)	27.7	-9.3	1.5	6.8	17.2	19.7	17.5	7.0	10.0
Imports (US$% yoy)	39.6	-7.6	1.1	4.0	42.9	24.0	5.9	15.3	20.0
Trade Balance (US$ bn)	29	25	26	29	25	28	40	37	34
Current Account (% of GDP)	4.8	4.3	4.0	3.5	0.6	0.1	2.6	1.5	0.9
International Reserves ex. Gold (US$ bn)	29	28	32	36	36	35	43	50	54
Local Currency/USD (period average)	8389	10247	9315	8573	8936	9711	9167	9071	9217
Other									
1M SBI Rate (period average, %)	12.4	16.5	15.1	10.1	7.5	9.6	11.6	8.1	6.5
FR0026 11% 10/15/2014 (period average, %)	#N/A	#N/A	#N/A	#N/A	11.0	11.0	12.1	8.9	9.8
Fiscal balance (% of GDP)	-1.2	-2.5	-0.9	-1.9	-1.2	-0.5	-1.1	-1.6	-1.5
Population (persons million)	205	208	211	214	216	219	222	225	228

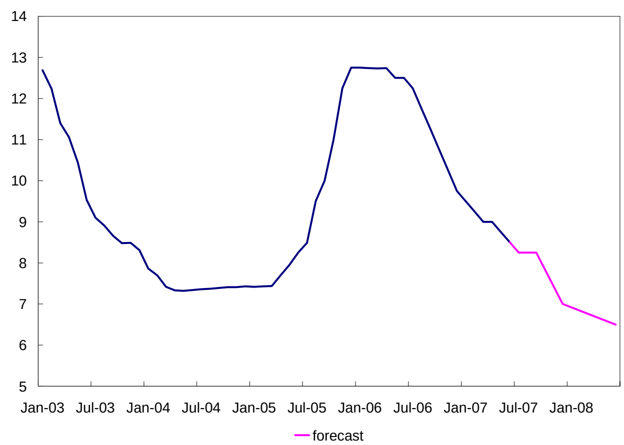
Source: CEIC Data Company Limited and Citi estimates.

Figure 72. Exchange rate: USD-IDR



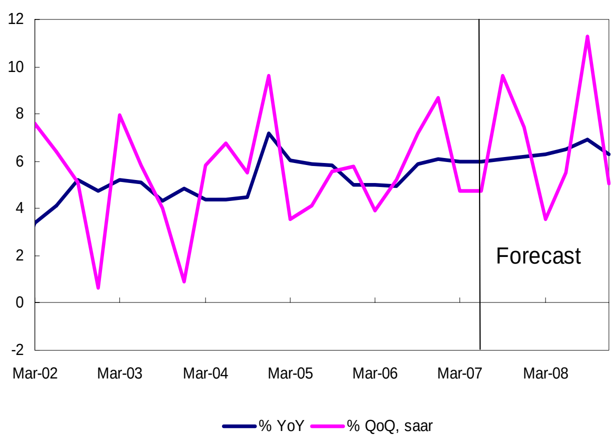
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 73. Short rate (%): BI Rate



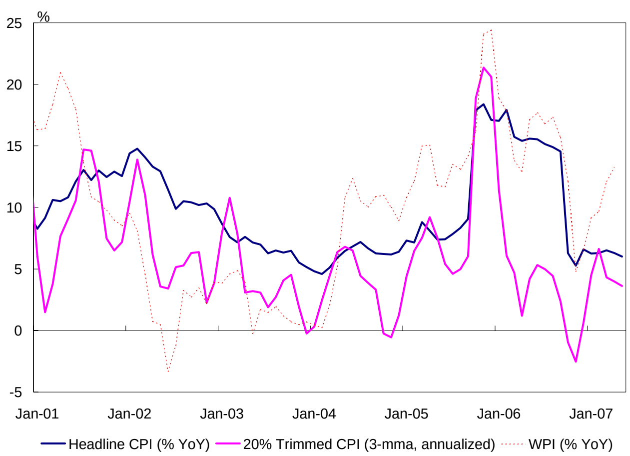
Our forecasts on Indonesia policy rate from Nov 07 onwards are based on overnight BI rate rather than the current 1-month BI rate, following the expected change by Bank Indonesia
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 74. Despite slower growth in 1Q, we see signs of recovering consumption and investment, while net exports support growth



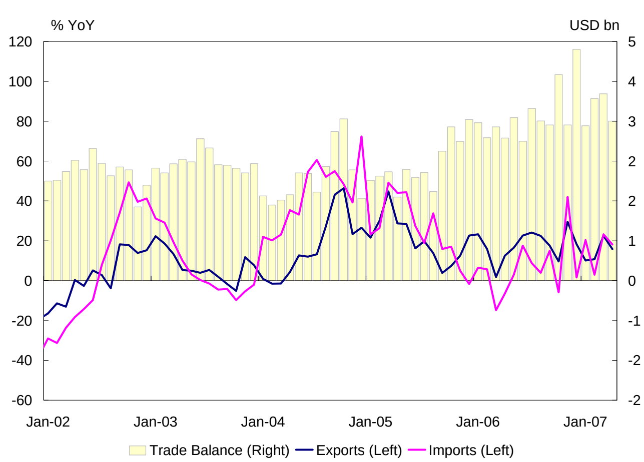
Source: CEIC Data Company Limited and Citiestimates

Figure 75. Although rice price decline pushed down inflation in April, it may return if the rice supply does not increase quickly



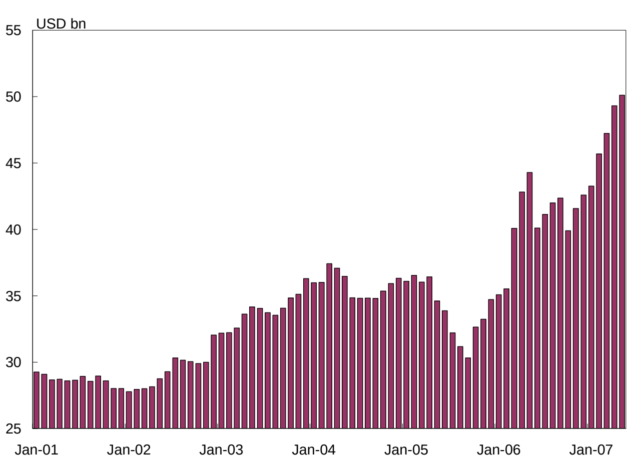
Source: CEIC Data Company Limited and Citigroup estimates

Figure 76. Trade growth moderated in April, but the healthy trade surplus points to robust outlook for both growth and the IDR



Source: CEIC Data Company Limited

Figure 77. Significant influx of foreign capital help support the currency and raise the official FX reserves to break above USD50bn



Source: CEIC Data Company Limited

Korea

Suktae Oh

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	•	+	+	•	•

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Recent Economic Developments and Prospects

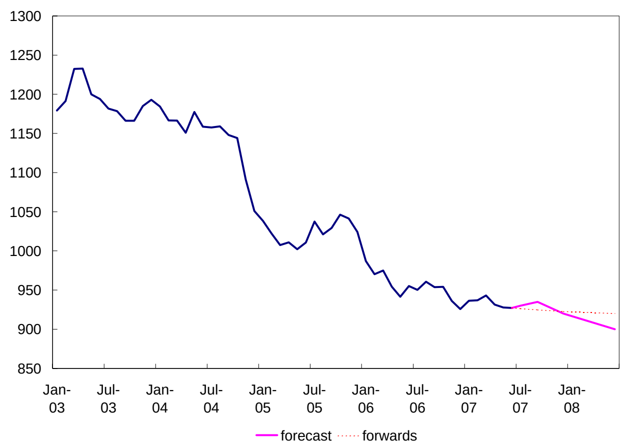
Real Sector	April activity data generally support our forecast of convergence between tech exports and domestic demand, as they showed recovery in tech production (not dollar-term exports), sluggish consumption and resilient investment. In 2H, we continue to expect a decent recovery in tech exports and steady growth in non-tech exports as well as domestic demand, which would lead to a jump in GDP growth toward the potential level. An impressive equity market rally is positive for the near-term growth outlook, while a weak housing market and likely policies addressing "excess liquidity" concerns would be key downside risks.
Inflation	Stability in inflation has been largely maintained. Both headline and core inflation (YoY) fell in May. We do not think inflation will become a major issue at least within this year, but an adverse base effect from oil prices would raise headline inflation near year-end.
Monetary/Fiscal Policies	We expect a 25bp Bank of Korea (BOK) rate hike in 3Q as a policy action to address concern about excess liquidity and SME loans. Governor Lee seems to be leaning toward a rate hike at the June MPC meeting, as his comments about excess liquidity were "upgraded" with an explanation about its potential negative impact. But the stable growth and inflation outlook lowers the chances of an aggressive rate hike beyond 25bp.
External Sector	We continue to think that the balance of payment condition is slightly won negative. The basic balance showed a significant swing from a large deficit in March to a slight surplus in April, but it would show a decent deficit for the time being, considering the balanced current account, continued popularity of overseas equity investment among retail investors and the slowdown of capital inflows from foreign equity investors.
Other (e.g. Political) Developments	The issue of a fund transfer from a Macau bank, which had been a major obstacle for the progress of North Korea's nuclear disarmament, was finally resolved with Russia's help.
Issues to Watch/Key Risks	(1) Sustainability of the strength in domestic demand, with relation to the weak housing market and the likely monetary tightening to control excess liquidity; (2) a recovery in the high-tech sector; (3) movements in the currency market; and (4) presidential election.

Figure 78. Key Economic Forecasts

	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
Real Sector									
Real GDP (% yoy)	8.5	3.8	7.0	3.1	4.7	4.2	5.0	4.4	5.0
Domestic demand ex Inventory (% yoy)	8.7	3.3	7.3	1.0	1.0	3.4	4.1	4.9	4.2
Real Consumption: Private (% yoy)	8.4	4.9	7.9	-1.2	-0.3	3.6	4.2	4.0	3.7
Real Gross Fixed Capital Formation (% yoy)	12.2	-0.2	6.6	4.0	2.1	2.4	3.2	7.0	5.4
Consumer prices (% yoy)	2.3	4.1	2.8	3.5	3.6	2.8	2.2	2.4	2.6
Nominal GDP (US$ bn)	512	482	547	608	681	791	887	965	1,064
GDP per capita (USD)	10,888	10,177	11,483	12,704	14,173	16,438	18,373	19,911	21,880
Unemployment Rate (%)	4.4	4.0	3.3	3.6	3.7	3.7	3.5	3.3	3.3
External Sector									
Exports (% yoy, US$)	21.2	-14.0	7.9	20.7	30.6	12.1	14.8	13.0	16.0
Imports (% yoy, US$)	36.2	-13.4	7.7	18.0	25.6	16.0	18.5	14.5	15.5
Trade balance (US$ bn)	17.0	13.5	14.8	22.0	37.6	33.7	29.2	28.5	34.8
Current account (% of GDP)	2.4	1.7	1.0	2.0	4.1	1.9	0.7	0.0	0.3
International Reserves ex. Gold (US$ bn)	96	103	121	155	199	210	239	260	285
Local Currency/USD (period average)	1131	1291	1251	1192	1145	1024	956	932	900
Other									
Overnight Rate (period average, %)	5.1	4.7	4.2	4.0	3.6	3.3	4.2	4.6	4.8
5 Year Treasury Yield (period average, %)	8.70	6.20	6.30	4.82	4.30	4.52	4.95	5.19	5.20
Fiscal balance (% of GDP)	1.1	1.2	3.3	1.1	0.7	0.4	0.4	2.0	2.0
Population (persons million)	47	47	48	48	48	48	48	48	49

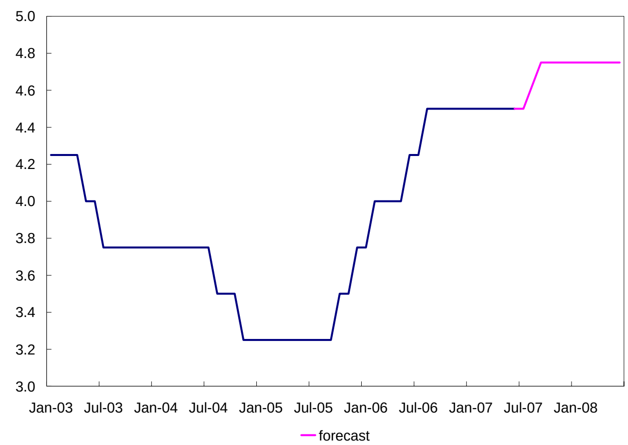
Source: CEIC Data Company Limited and Citi estimates.

Figure 79. Exchange Rate: USD-KRW



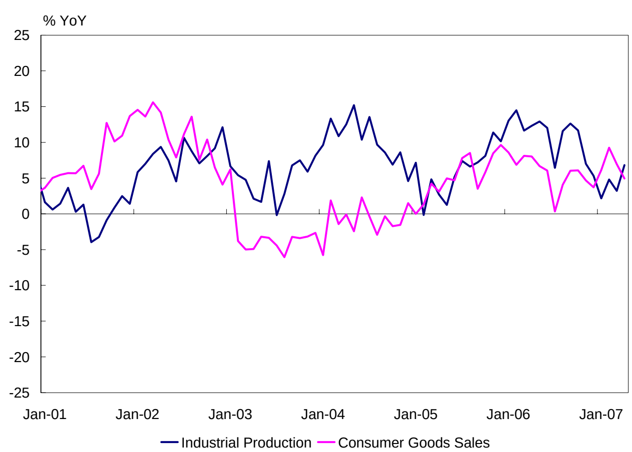
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 80. Short rate (%): Overnight Rate



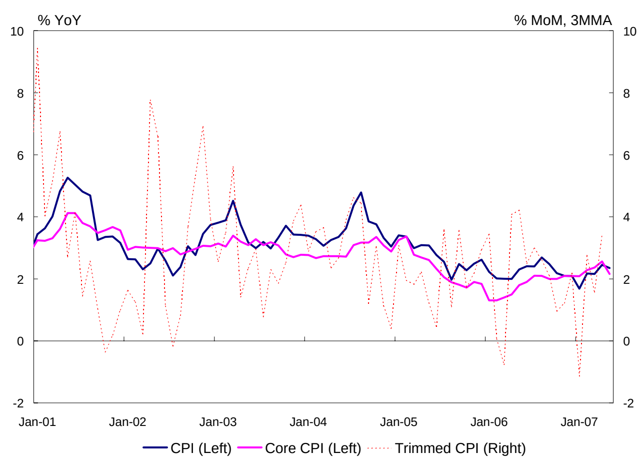
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 81. Strength in industrial production (in both high-tech and non-tech sectors) suggests overall growth momentum



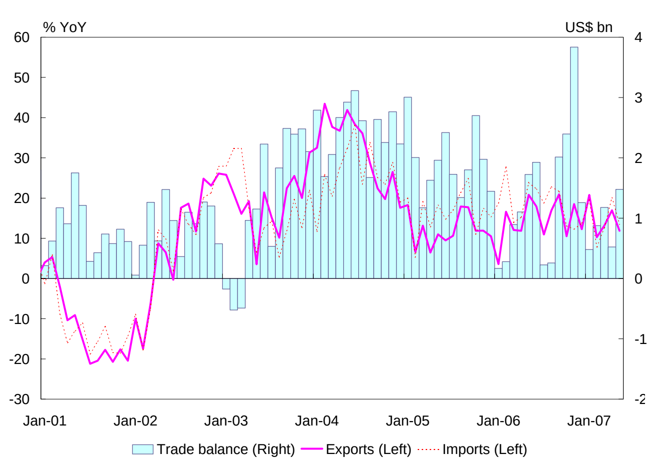
Source: CEIC Data Company Limited

Figure 82. Inflation remained stable, thanks to the decline in food prices



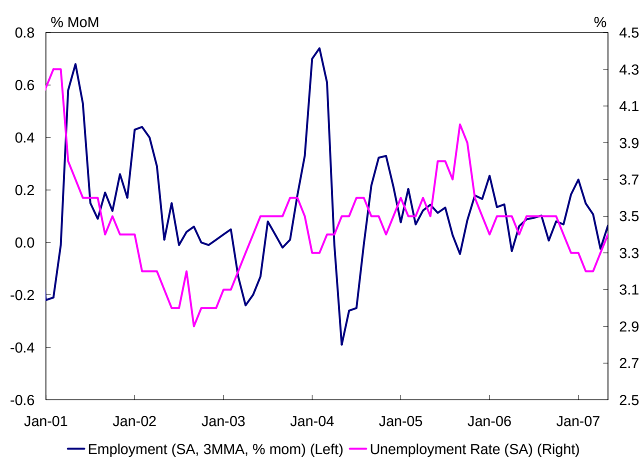
Source: CEIC Data Company Limited

Figure 83. Steady trade growth also points to resilient overal growth momentum; we await clear evidence of tech recovery in export data



Source: CEIC Data Company Limited

Figure 84. Rebound in job market in May eases the concern on the weakness in job growth we saw in February to April



Source: CEIC Data Company Limited

Malaysia

Hak Bin Chua

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	•	•	•	+	•

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Recent Economic Developments and Prospects

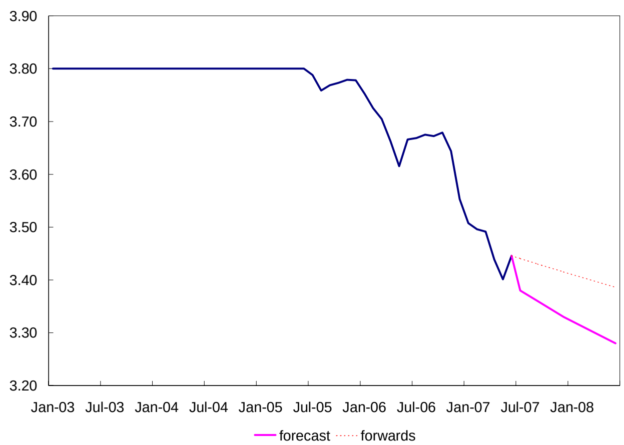
Real Sector	First quarter GDP growth came in at 5.3%, with strong services growth helping to offset manufacturing weakness. Disappointing April figures for IP and exports suggests that manufacturing may remain lackluster in the second quarter.
Inflation	Inflation pressures remain benign, coming in at only 1.4% for May. A stronger RM has helped contain imported inflation. But inflation will likely edge higher for the rest of the year on higher food & transport prices, and fading base effects from a fuel price increase in February last year.
Monetary/Fiscal Policies	Bank Negara Governor Zeti has reiterated that the current policy rate at 3.5% is appropriate given current growth and inflation conditions. Wage hikes for civil servants, of between 7.5% and 42% from 1 July, will cost the government some RM8bn annually or 1.4% of GDP. We have raised our fiscal deficit forecast for 2007 and 2008 to 3.6% and 3.8% of GDP, respectively, as a result.
External Sector	Exports continue to disappoint, weighed down by the poor performance of tech exports. The export slump, if protracted, raises the risk of a GDP growth downgrade.
Other (e.g. Political) Developments	PM Badawi may call for early elections, possibly closer to end-07 or early 2008. The timing of the generous civil servant wage hike, stronger government spending, and liberalization measures suggest that the government may capitalize on the improvement in sentiments and market conditions.
Issues to Watch/Key Risks	Our GDP growth forecast of 6% for 2007 is at risk if electronics output does not recover more strongly, or if an investment recovery is slower than expected.

Figure 85. Key Economic Forecasts

	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
Real Sector									
Real GDP (% yoy)	8.9	0.3	4.4	5.5	7.2	5.2	5.9	6.0	6.0
Domestic demand ex Inventory (% yoy)	15.5	2.5	3.9	6.1	7.5	7.3	7.4	6.9	7.1
Real Consumption: Private (% yoy)	13.0	2.4	4.4	6.6	10.5	9.2	7.0	6.2	6.2
Real Gross Fixed Capital Formation (% yoy)	25.7	-2.8	0.3	2.7	3.1	4.7	7.9	8.5	9.0
Consumer prices (% yoy)	1.6	1.4	1.7	1.2	1.4	3.1	3.6	2.5	2.5
Nominal GDP (US$ bn)	90	88	95	104	118	131	149	174	194
GDP per capita (USD)	3,844	3,665	3,884	4,152	4,631	5,005	5,591	6,396	7,000
Unemployment Rate (%)	3.1	3.7	3.5	3.6	3.6	3.6	3.5	3.4	3.4
External Sector									
Exports (% yoy, US$)	16.2	-10.4	6.9	11.6	20.5	11.4	14.0	13.0	14.0
Imports (% yoy, US$)	25.5	-10.2	8.0	4.8	25.9	8.9	14.4	15.0	17.0
Trade balance (US$ bn)	16.1	14.2	14.3	21.4	21.2	26.4	29.6	30.8	30.6
Current account (% of GDP)	9.4	8.3	8.4	12.8	12.6	15.2	14.3	12.4	10.4
International Reserves ex. Gold (US$ bn)	30	30	34	45	66	70	82	90	100
Local Currency/USD (period average)	3.800	3.800	3.800	3.800	3.800	3.787	3.668	3.408	3.310
Other									
3 Month KLIBOR Fixing (period average, %)	3.19	3.13	2.92	2.88	2.84	2.88	3.55	3.63	3.85
5 Year MGS Yield (period average, %)	5.11	3.54	3.47	3.60	4.09	3.57	4.01	3.64	3.80
Fiscal balance (% of GDP)	-5.7	-5.5	-5.6	-5.3	-4.3	-3.8	-3.5	-3.6	-3.8
Population (persons million)	23	24	25	25	26	26	27	27	28

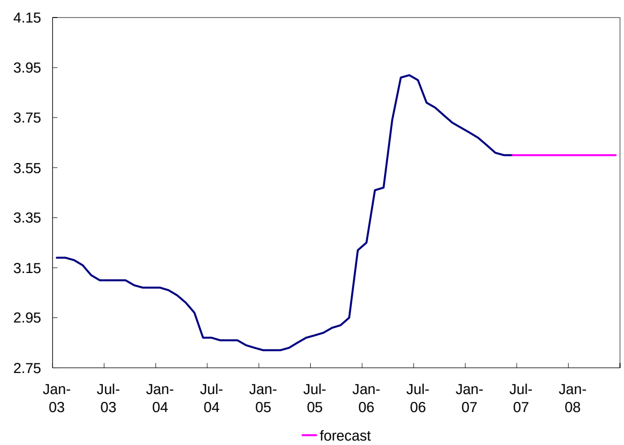
Source: CEIC Data Company Limited and Citi estimates.

Figure 86. Exchange Rate: USD-MYR



Source: Bloomberg, Haver Analytics, Citi estimates

Figure 87. Short rate (%): 3 Month KLIBOR



Source: Bloomberg, Haver Analytics, Citi estimates

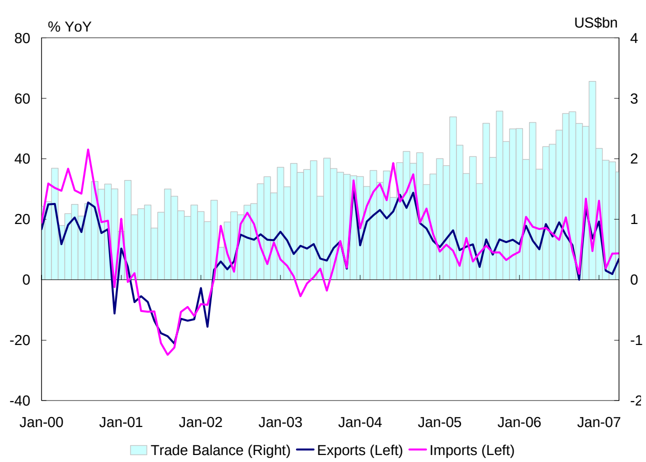
Figure 88. 1Q07 YoY growth suggests a more moderate than expected slowdown and the worse may be behind us

Source: CEIC Data Company Limited and Citi estimates

Figure 89. A stronger ringgit is helping to contain imported inflation. Overall inflation remains benign

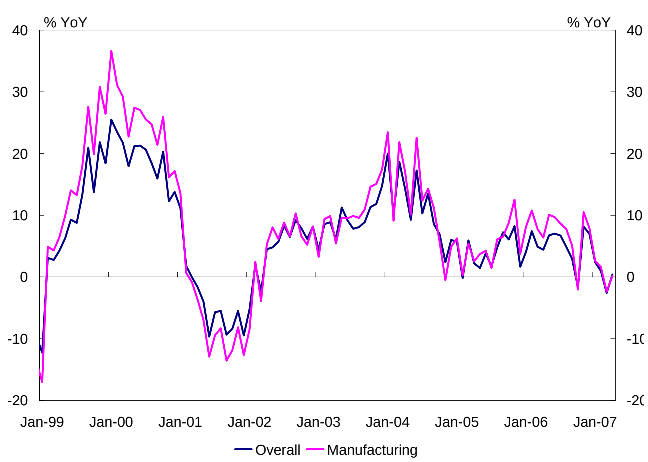
Source: CEIC Data Company Limited

Figure 90. We expect a gradual manufacturing recovery in 2H, as some leading tech indices suggest that the worst of the tech slump may already be past



Source: CEIC Data Company Limited

Figure 91. Poor industrial production reading for April suggests that the manufacturing slump may persists through the second quarter



Source: CEIC Data Company Limited

Philippines

Jun Trinidad

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
+	•	•	•	•	•

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Recent Economic Developments and Prospects

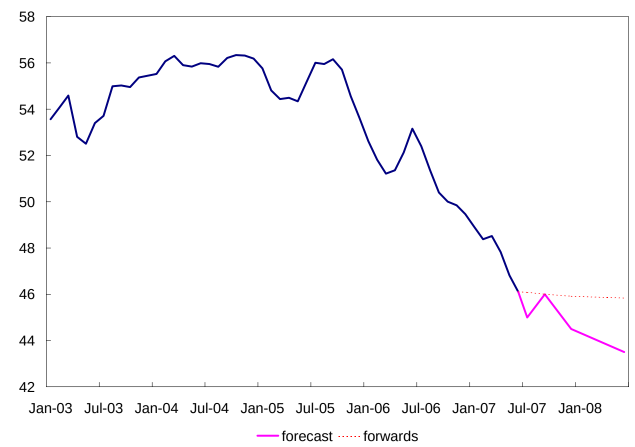
Real Sector	We upgraded our GDP forecast to 6.3% in 2007 on better-than-expected 1Q07 growth of 6.9% yoy. Pre-election spending, increased non-interest fiscal spending and net exports were behind the upsurge in growth. A strong contribution from real investments is still lacking. In April, overseas remittance growth of 32.6% yoy, loan growth of 12.1% yoy and the jobless rate down to 7.4% depict sustained economic impetus in 2Q07.
Inflation	Having bottomed out in March, the inflation upturn remains benign and policy neutral. An incremental pass-through of rising fuel prices and strong PHP can help keep near-term inflation risk in check. Strong domestic demand, declining jobless rate and abundant liquidity are factors that can speed up the CPI uptrend in 2H07.
Monetary/Fiscal Policies	With economic and financial updates turning buoyant amid inflation bottoming out, we anticipate the removal of tiering before September. Yield inversion will further narrow with tiering's withdrawal, particularly in the two- to three-year segment of the curve. We estimate BSP froze about 25% of broad money supply. Sterilizing liquidity arising from BSP's spot market purchases is an offshoot of BSP's penchant to deter rapid peso appreciation. BSP's swapping of about US$7.8bn for pesos helped restrain liquidity. Risk of undershooting the 2Q07 fiscal target of a Php14bn surplus looms large with persistent revenue shortfalls.
External Sector	The peso slid back to nearly 47 to mirror external financial shocks from receding global investor risk appetite. However, strong external accounts, firm growth footing and lackluster risk premia enabled the peso to retest 46. Strong remittance flows, offshore portfolio inflows and FDI triggered by M&A and privatization supported GIR's new high in excess of US$25bn (precludes BSP's onshore dollar swaps).
Other (e.g. Political) Developments	A revamp of Arroyo's cabinet and heads of government corporations is planned following her party's defeat in the Senate elections. This may be an indication of more professional appointments in key agencies to kindle a reform environment for the remainder of her term.
Issues to Watch/Key Risks	Post-elections, we continue to be upbeat on investment. The anti-graft court will soon decide on Estrada's plunder trial, which may lead to market caution.

Figure 92. Key Economic Forecasts

	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
Real Sector									
Real GDP (% yoy)	6.0	1.8	4.4	4.9	6.2	5.0	5.4	6.3	6.4
Domestic demand ex Inventory (% yoy)	7.0	-0.8	3.1	4.8	4.7	3.2	4.6	5.5	6.4
Real Consumption: Private (% yoy)	3.5	3.6	4.1	5.3	5.8	4.9	5.5	5.4	5.5
Real Gross Capital Formation (% yoy)	19.9	-13.0	2.1	3.8	1.3	-3.9	0.6	4.9	12.2
Consumer prices (% yoy)	4.3	6.1	2.5	3.5	6.0	7.7	6.3	3.0	3.8
Nominal GDP (US$ bn)	76	71	77	80	87	98	116	147	173
GDP per capita (USD)	985	906	956	972	1,037	1,153	1,352	1,673	1,933
Unemployment Rate (%)	11.7	10.9	11.5	11.5	11.9	11.2	11.0	10.0	9.0
External Sector									
Exports (% yoy, US$)	9.1	-16.2	9.9	2.7	9.8	3.8	14.6	10.0	8.0
Imports (% yoy, US$)	7.7	-13.3	6.3	3.1	8.0	8.0	10.6	8.5	9.5
Trade balance (US$ bn)	-6.0	-6.3	-5.5	-5.9	-5.7	-7.8	-7.0	-6.9	-8.3
Current account (% of GDP)	-2.9	-2.4	-0.4	0.4	1.9	2.0	4.3	4.2	2.8
International Reserves ex. Gold (US$ bn)	13.1	13.5	13.3	13.7	13.1	15.9	20.0	22.0	24.1
Local Currency/USD (period average)	44.2	51.0	51.6	54.2	56.0	55.1	51.6	46.5	43.5
Other									
91 Day T-Bill (period average, %)	9.9	9.7	5.5	5.4	7.3	6.1	5.1	4.5	4.6
5-Year T-Bond (period average, %)	16.5	14.7	11.7	10.8	11.7	10.9	7.9	5.9	6.5
Fiscal balance (% of GDP)	-4.0	-4.0	-5.3	-4.6	-3.8	-2.7	-1.0	-0.7	-0.3
Population (persons million)	76	78	80	81	83	84	86	88	90

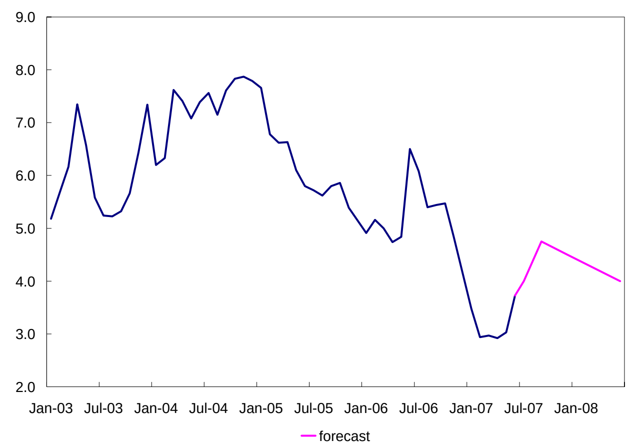
Source: CEIC Data Company Limited and Citi estimates.

Figure 93. Exchange rate: PHP-USD



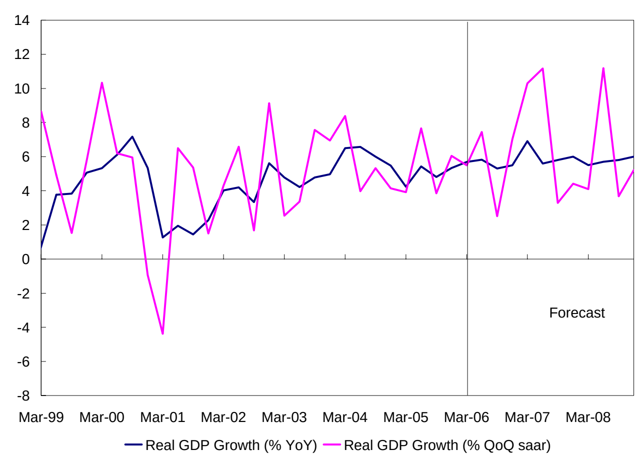
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 94. Short rate (%): 91 Day T-Bill



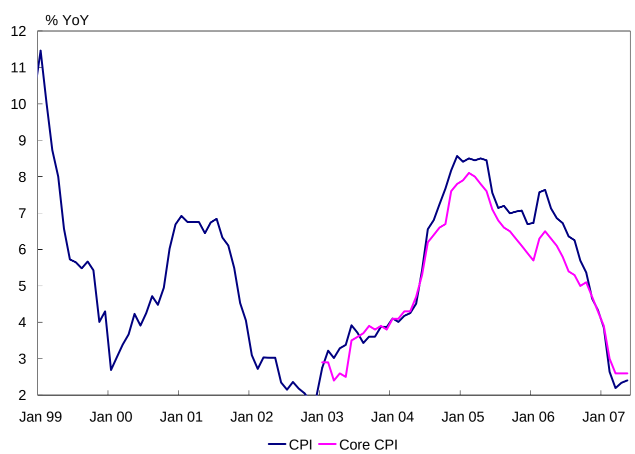
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 95. The upbeat GDP update compels us to revise up our 2007 GDP growth to 6.3% on the back of investment gains



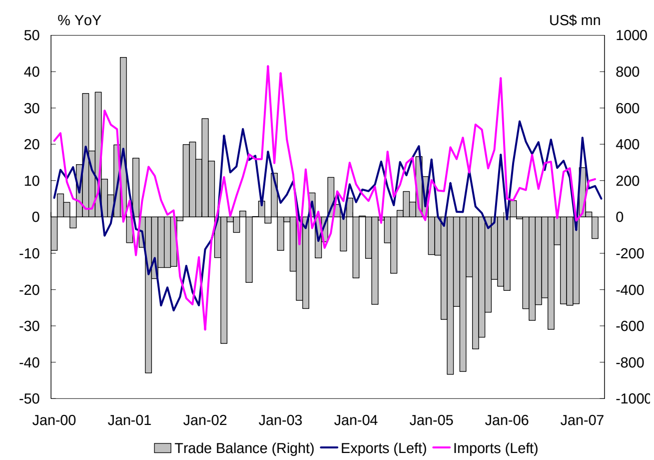
Source: CEIC Data Company Limited and Citi estimates

Figure 96. Headline inflation edged up in May to reconfirm that inflation has bottomed out although the uptrend remains benign



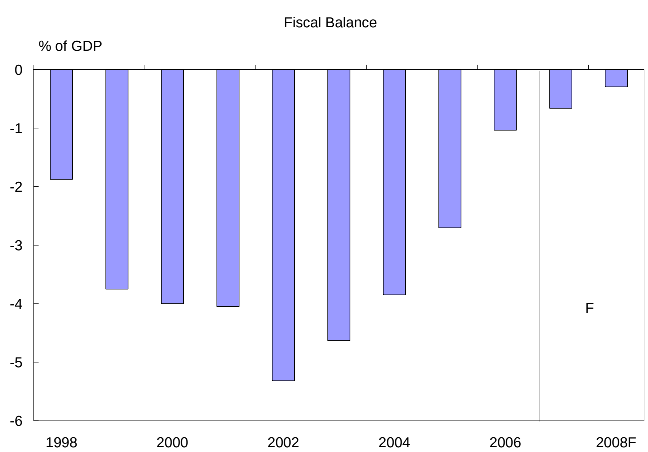
Source: CEIC Data Company Limited

Figure 97. We remain positive that exports will post better growth led by electronics over the next few months



Source: CEIC Data Company Limited

Figure 98. Modest fiscal deficit in May hikes likelihood of 2Q07 fiscal slippage



Source: CEIC Data Company Limited and Citi estimates

Singapore

Hak Bin Chua

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	•	–	+	•	•

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Recent Economic Developments and Prospects

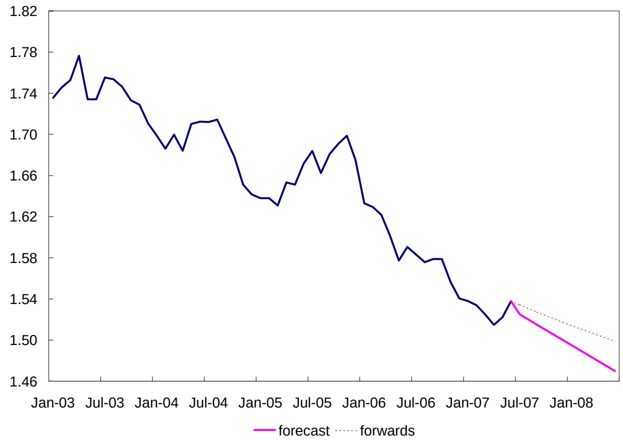
Real Sector	First quarter GDP growth came in at a stronger-than-expected 6.1%. Strong construction and robust services growth are offsetting a manufacturing slump. The government has upgraded GDP growth forecast to 5-7% from 4.5-6.5% for 2007.
Inflation	Inflation remains benign, with a fall in electricity prices in the second quarter helping to cap inflation below 1%. The MAS has lowered its inflation forecast to 0.5-1.0% from 0.5-1.5% for 2007. We are, however, maintaining our inflation forecast at 1.5%, given an impending 2% points GST hike from 1 July, rising property rents, and higher fuel and food prices.
Monetary/Fiscal Policies	The SGD exchange rate has depreciated on the back of lower short-term interest rates and has drifted to the middle of the band. The MAS has unwound a large portion of the forward positions. Long bond yields rose sharply and re-established their positive relationship with US yields after decoupling for about a month.
External Sector	Exports remain sluggish, with pharmaceuticals helping to offset slower tech exports. We expect tech exports to show a more visible recovery in the second half.
Other (e.g. Political) Developments	The government has expressed some concern about the buoyant property market, releasing more land for residential, hotel and commercial units for the second half of the year.
Issues to Watch/Key Risks	The government may introduce measures to curb speculation in the property market. The MAS has expressed some concern about the deferred payment scheme and risks to property developers & construction companies. Loans for building and construction are rising at about 27% from a year ago.

Figure 99. Key Economic Forecasts

	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
Real Sector									
Real GDP (% yoy)	10.1	-2.4	4.2	3.1	8.8	6.4	7.9	6.2	5.6
Domestic demand ex Inventory (% yoy)	13.4	0.9	-0.5	-0.1	6.2	2.7	6.4	6.0	5.2
Real Consumption: Private (% yoy)	14.9	4.0	5.1	1.2	5.6	3.1	2.5	3.8	4.1
Real Gross Fixed Capital Formation (% yoy)	9.8	-3.8	-11.4	-3.3	10.2	0.1	11.5	8.9	7.0
Consumer prices (% yoy)	1.3	1.0	-0.4	0.5	1.7	0.5	1.0	1.5	1.7
Nominal GDP (US$ bn)	93	85	88	92	107	117	132	149	169
GDP per capita (USD)	23,077	20,693	21,113	22,066	25,329	26,876	29,475	33,230	36,635
Unemployment Rate (%)	2.7	2.7	3.6	4.0	3.4	3.1	2.6	2.5	2.5
External Sector									
Exports (% yoy, US$)	20.2	-11.7	2.8	16.9	25.0	25.5	18.4	10.2	10.4
Imports (% yoy, US$)	21.1	-13.8	0.4	12.0	26.9	20.8	19.3	11.2	11.1
Trade balance (US$ bn)	3.3	5.8	8.7	15.9	17.4	29.6	33.1	34.1	35.8
Current account (% of GDP)	11.6	14.0	13.7	24.2	20.1	24.5	27.5	19.2	17.3
International Reserves ex. Gold (US$ bn)	80	75	82	96	112	116	137	145	160
Local Currency/USD (period average)	1.72	1.79	1.79	1.74	1.69	1.66	1.59	1.52	1.44
Other									
3M Interbank Rate (period average, %)	2.6	2.0	0.9	0.7	1.0	2.2	3.5	2.5	2.6
10 Year SGS Yield (period average, %)	4.4	3.6	3.5	2.9	3.2	2.9	3.4	2.8	3.0
Fiscal balance (% of GDP)	11.3	-0.3	-1.6	6.5	5.6	6.9	10.0	7.0	6.0
Population (persons million)	4.0	4.1	4.2	4.2	4.2	4.3	4.5	4.5	4.6

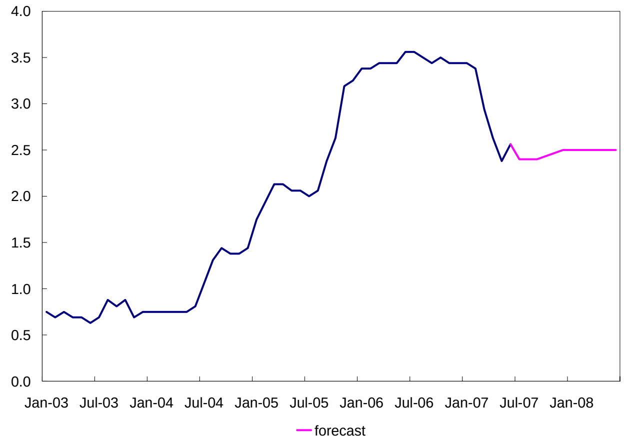
Source: CEIC Data Company Limited and Citi estimates.

Figure 100. Exchange Rate: USD-SGD



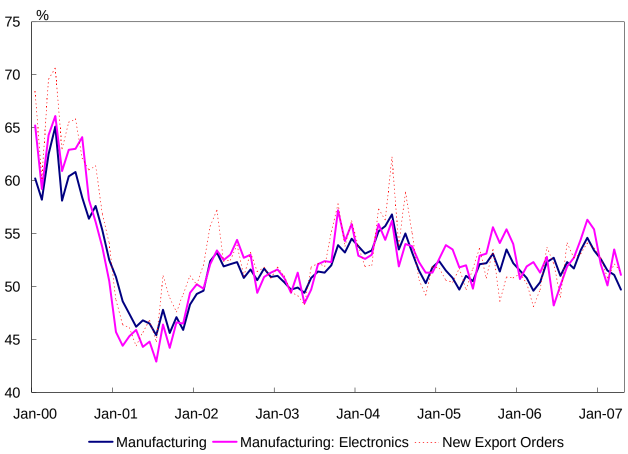
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 101. Short rate(%): 3-Month SIBOR



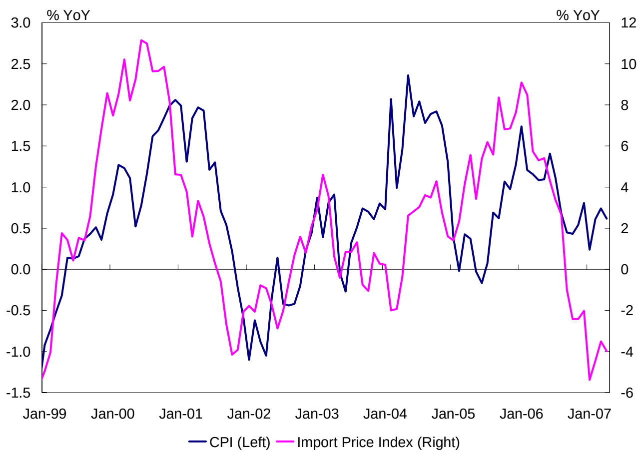
Source: Bloomberg, Haver Analytics, Citi estimates

Figure 102. PMI inches back to 50 in May, suggests manufacturing may remain soft in 2Q



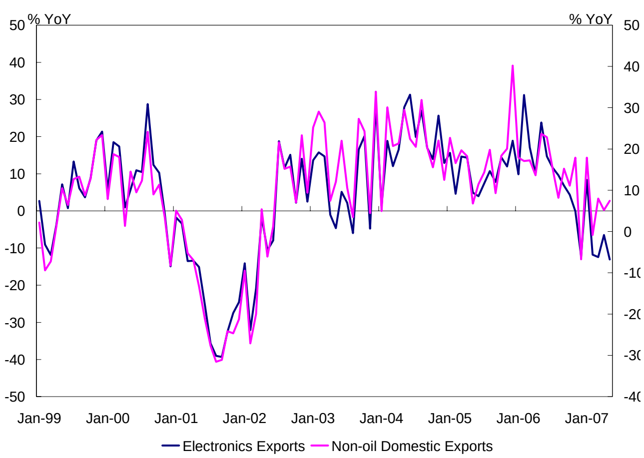
Source: CEIC Data Company Limited

Figure 103. CPI inflation slowed to 0.6% yoy at the back of lower electricity tariffs and a fall in transport and communication costs



Source: CEIC Data Company Limited

Figure 104. May NODX expanded higher due to strength in the non-electronics sector which offset the decline in the electronics sector



Source: CEIC Data Company Limited

Figure 105. We expect higher spending in May and June post the Great Singapore Sales and the run up to the 2% GST hike in July

Source: CEIC Data Company Limited

Sri Lanka

Rohini Malkani and Anushka Shah

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
N/A	N/A	N/A	N/A	N/A	N/A

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Recent Economic Developments and Prospects

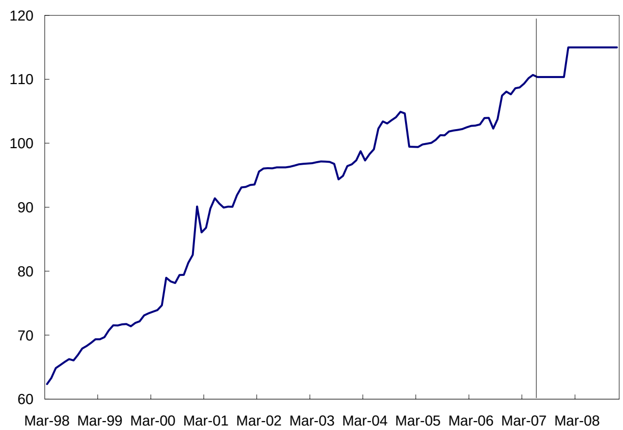
Real Sector	Despite decades of civil conflict, volatile political conditions, a devastating tsunami in 2004 and tense domestic security situations, the economy has exhibited resilience with growth averaging 5% in the 1990s and touching 7% in 2006. Going forward, we expect growth to decelerate to 6.3% in 2007 due to tightening in 2006, coupled with a marginal deceleration in investments and services led by tourism.
Inflation	Inflation has been a worry since the tsunami disaster, which set back agriculture and created supply shortages. This, along with higher oil prices, a depreciating rupee and increased government spending on wages resulted in inflation touching a 10-year high of 20% in January. However, the Colombo CPI fell to 13.7% in May on tight monetary policy measures. Looking ahead, we expect inflation to trend closer to 13% although the central bank expects to see inflation moderating to single-digit levels in 2007.
Monetary/Fiscal Policies	The central bank continues to retain its tight monetary policy stance to curb runaway growth in money supply (up over 19% in April) on account of rapid credit growth (+29.3%). Total revenue in March rose 15% yoy due to continued buoyancy in tax revenues. However, expenditures are also on an uptrend (+18% yoy). The government has budgeted a decline in the fiscal deficit to 7.5% in 2007, but given intractable military expenditure coupled with a small tax base, we expect the deficit to remain in the 8% range.
External Sector	Exports rose 11.5% over January-April, led by agricultural exports (particularly tea), textiles and garments. Imports (+7.4% over January-April) led by consumer goods and investment goods have also been on an uptrend. The trade deficit has remained at US$1bn. Going forward, the trade deficit may widen further if exports weaken on growing security concern. However, trends in remittances remain strong (+17.4% over January-April). This has resulted in the overall BOP posting a surplus of US$292mn during the period.
Other (e.g. Political) Developments	Civil conflicts between the ruling government and the Liberation Tigers of Tamil Eelam (LTTE) continue. Despite a ceasefire in place, both sides still resort to violent attacks, hence disrupting economic activities.
Issues to Watch/Key Risks	Key risks to our outlook are politics, weak governance, higher inflation and a deterioration in the BOP.

Figure 106. Key Economic Forecasts

	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
Real Sector									
Real GDP (% YoY)	5.9	-1.5	4.1	6.0	5.4	6.0	7.4	6.3	6.6
Agriculture (% YoY)	1.8	-3.4	2.5	1.6	-0.3	1.9	4.7	3.0	3.0
Industry (% YoY)	7.5	-2.1	1.0	5.5	5.2	8.3	7.2	7.0	7.0
Services (% YoY)		-0.5	6.3	7.9	7.6	6.2	8.3	7.0	7.5
Consumer Price (Period Average, % YoY)	1.5	12.0	10.2	2.6	7.9	10.6	9.6	10.0	8.0
GDP (US$ Bils.)	16.6	15.7	16.5	18.3	20.1	23.5	27.0	30.1	33.1
GDP Per Capita (US$)	857	840	870	948	1030	1197	1355	1495	1627
External Sector									
Exports (US$, % YoY)	19.8	-12.8	-2.4	9.2	12.2	10.2	8.4	11.0	12.0
Imports (US$, % YoY)	22.4	-18.4	2.2	9.3	19.9	10.8	15.7	12.0	11.0
Trade Balance (US$ Bils.)	-1.8	-1.2	-1.4	-1.5	-2.2	-2.5	-3.4	-3.8	-4.2
Current Account (% of GDP)	-6.4	-1.4	-1.4	-0.4	-3.3	-2.8	-4.9	-4.0	-3.1
International Reserves ex. Gold (US$ Bils.)	1.0	1.3	1.7	2.3	2.2	2.5	2.5	2.7	3.2
Currency/USD (Period Average)	75.8	89.4	95.7	96.5	101.2	100.5	104.0	110.0	115.0
Other									
3 Months Treasury Bills (Average, %)	12.3	17.1	12.0	8.2	7.5	8.7	10.7	19.0	14.0
T-bill; 364-Day (Average, %)	13.1	17.5	12.7	8.1	7.7	8.9	10.9	18.0	15.0
Consolidated Fiscal Balance (% of GDP)	-9.9	-10.8	-8.9	-8.0	-8.2	-8.7	-8.8	-8.5	-8.4
Population (persons million)	19.0	19.3	19.5	19.7	19.9	20.1	20.3	20.5	20.8

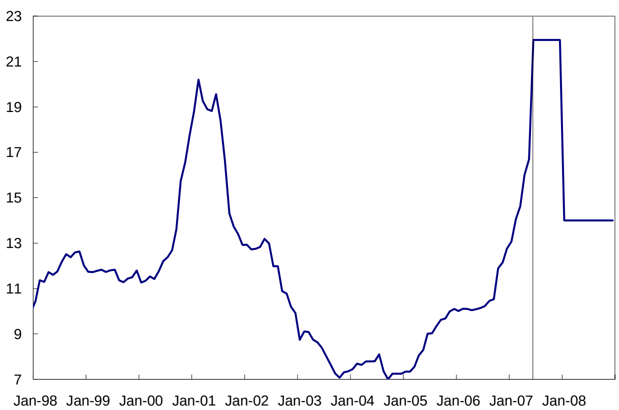
Source: CEIC Data Company Limited and Citi estimates.

Figure 107. Exchange Rate: USD-LKR



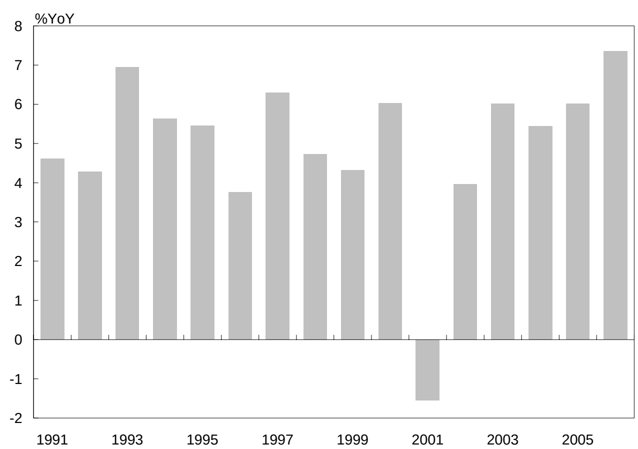
Note: Historicals up to May07 are monthly data; Jun07 onwards data are annual forecasts
Source: Bloomberg, Haver Analytics

Figure 108. Short rate (%): 3-Months Treasury Bills



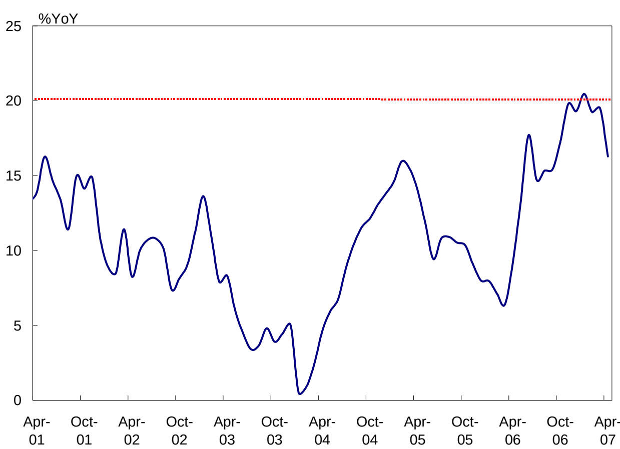
Note: Historicals up to Mar07 are monthly data; Apr07 onwards data are annual forecasts
Source: Bloomberg, Haver Analytics

Figure 109. Sri Lanka continues to demonstrate resilience with growth crossing 7% in 2006; despite political volatility and a tense domestic security



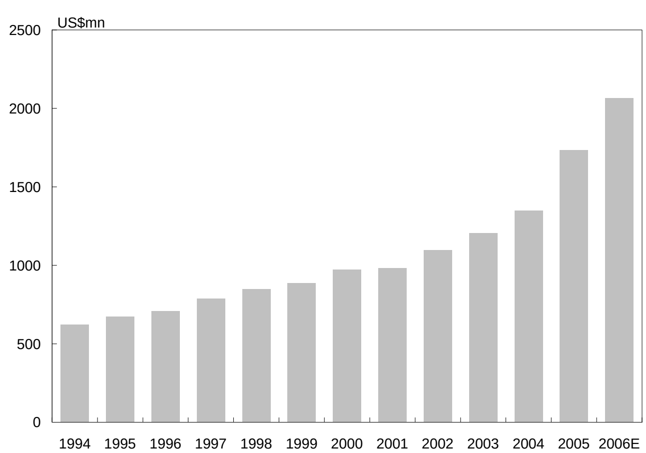
Source: CEIC Data Company Limited and Central Bank of Sri Lanka

Figure 110. Inflation remains a worry with the CCPI touching a 10 yr high in Jan07. Pricing pressures are a concern due to food supply shortages



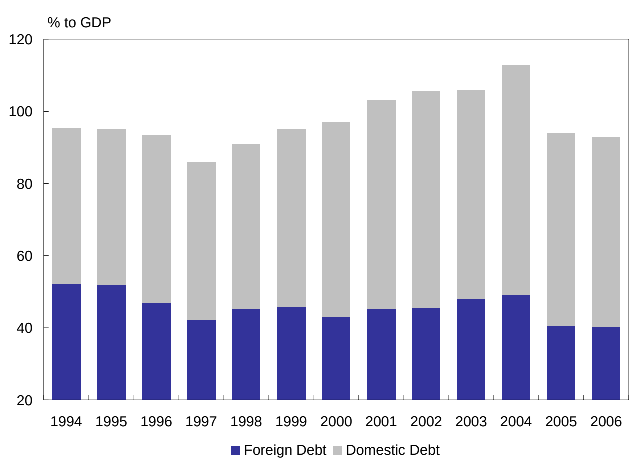
Source: CEIC Data Company Limited and Central Bank of Sri Lanka

Figure 111. Growth in remittances continues to partially offset the trade deficit



Source: CEIC Data Company Limited and Central Bank of Sri Lanka

Figure 112. With public debt is amongst the highest in the region, debt servicing is becoming a fiscal strain



Source: CEIC Data Company Limited and Central Bank of Sri Lanka

Taiwan

Cheng-Mount Cheng and Renee Chen

Summary of Direction in Change in Views

Growth	Inflation	Short Rates	Long Rates	Exchange Rate	Current Account
•	•	+	+	–	•

Note: (+) implies a more positive view since last write-up, (–) a fall, and (•) no change. Source: Citi estimates.

Recent Economic Developments and Prospects

Real Sector	1Q07's GDP growth of 4.15% yoy was attributed to resilient external demand but weak domestic demand. The government raised its 2007 GDP forecast to 4.38% from 4.30%. With buoyant global asset prices, a US recovery and an uptrend in the tech outlook, Taiwan's economic activity likely will pick up in 2H07.
Inflation	Inflation pressure remained low, with headline CPI and core CPI up 0.72% yoy and 0.68% yoy, respectively, over January-May. Recent rain has caused fresh food prices to go up, and higher gasoline prices may raise headline inflation slightly. With WPI surging 7.39% yoy in the first five months, we continue to expect slight upside risk ahead, but weak domestic demand will likely cap inflation pressure.
Monetary/Fiscal Policies	The CBC surprised the market by short squeezing bank liquidity in late May, which caused a jump in overnight interest rates and other short-term interest rates. The on-the-run 10-year government bond yield surged by more than 30bps in June. In our view, the CBC may shift away from its low interest rate policy to raising interest rates to support the TWD and boost local asset valuation. Meanwhile, the passage of this year's government budget dispelled the hanging uncertainty.
External Sector	Both export and import momentum slowed over April-May, and the trade surplus narrowed a bit. Nonetheless, we expect exports to pick up speed in 2H07 on continuous strong China demand and resurgent tech demand. On the other hand, weak domestic demand likely will drag imports.
Other (e.g. Political) Developments	Cross-strait relations remain stable. The ruling DPP and opposition KMT have not reached an agreement on a revised bill for a central election commission, which both parties thought was important for the presidential election in March. Both parties agreed to hold a referendum together with the presidential election, but they have not agreed on the timing of the legislative election. With rising equity prices, downside political risks appear to have diminished, but we expect the government to launch more simulative policies before elections.
Issues to Watch/Key Risks	(1) Development of cross-strait relations and domestic politics; (2) potential US and China economic slowdown; (3) oil prices; (4) continuous tightening of monetary policy to cool the housing market; sharp capital movements and associated FX fluctuations such as an unwinding of USD/TWD carry trade.

Figure 113. Key Economic Forecasts

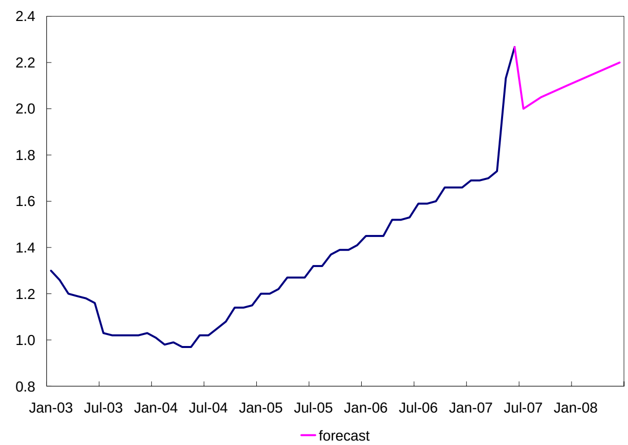
	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
Real Sector									
Real GDP (% yoy)	5.8	-2.2	4.6	3.5	6.2	4.1	4.7	4.3	4.8
Domestic demand ex Inventory (% yoy)	5.0	-4.3	2.2	1.4	6.7	1.9	1.1	2.4	3.4
Real Consumption: Private (% yoy)	4.6	0.7	2.6	1.5	4.5	2.8	1.4	2.8	3.2
Real Gross Capital Formation (% yoy)	9.0	-19.9	1.1	1.7	19.5	0.2	1.0	2.0	5.1
Consumer prices (% yoy)	1.3	0.0	-0.2	-0.3	1.6	2.3	0.6	1.4	1.7
Nominal GDP (US$ bn)	321	292	298	306	331	355	364	377	404
GDP per capita (USD)	14,519	13,093	13,163	13,327	14,271	15,271	15,991	16,433	17,575
Unemployment Rate (%)	3.0	4.6	5.2	5.0	4.4	4.1	3.9	3.8	3.7
External Sector									
Exports (% yoy, US$)	22.8	-16.9	7.1	11.3	21.1	8.8	12.9	7.0	9.5
Imports (% yoy, US$)	26.6	-23.3	4.9	13.0	31.8	8.2	11.0	7.8	9.7
Trade balance (US$ bn)	11.2	18.3	22.1	22.6	13.6	15.8	21.3	21.1	22.7
Current account (% of GDP)	2.8	6.3	8.6	9.6	5.6	4.5	6.9	6.5	5.8
International Reserves ex. Gold (US$ bn)	107	122	162	207	242	253	266	275	287
Local Currency/USD (period average)	31.2	33.8	34.6	34.4	33.4	32.2	32.5	32.9	32.3
Other									
Money Market 90-day (period average, %)	4.7	3.6	2.0	1.1	1.0	1.3	1.6	2.0	1.9
10 Year Government Bond (period average, %)	5.6	4.0	3.5	2.2	2.7	2.1	2.0	2.3	2.4
Fiscal balance (% of GDP)	-4.5	-6.4	-4.2	-2.7	-2.8	-0.6	-1.1	-1.0	-1.0
Population (persons million)	22	22	22	23	23	23	23	23	23

Source: CEIC Data Company Limited and Citi estimates.

Figure 114. Exchange Rate: USD-TWD

Source: Bloomberg, Haver Analytics, Citi estimates

Figure 115. Short rate (%): Interbank Call Loan Rate

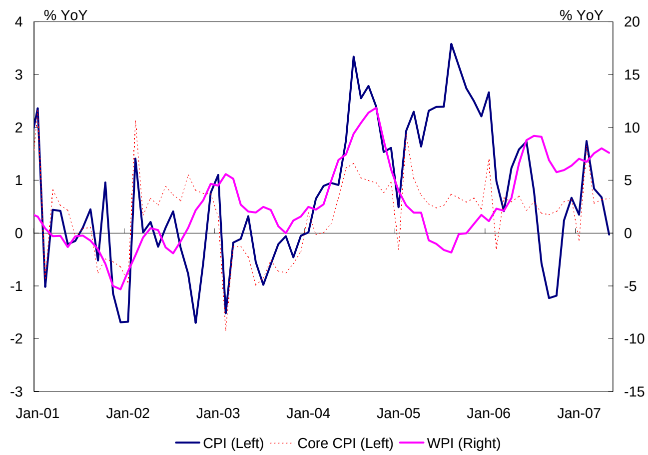


Source: Bloomberg, Haver Analytics, Citi estimates

Figure 116. 1Q07 GDP shows that the economy is weak in domestic demand, while net exports outperform

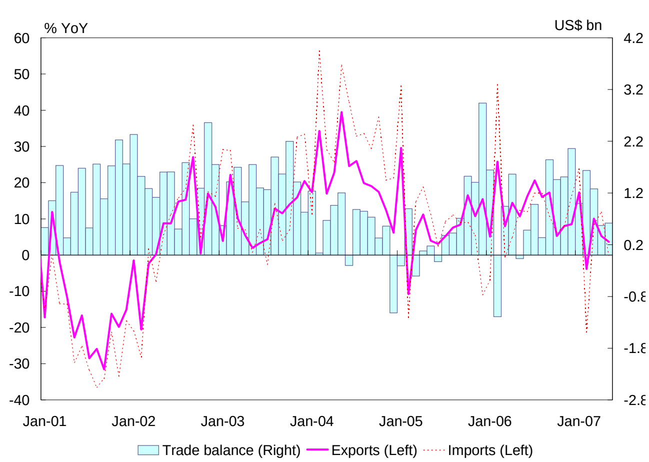
Source: CEIC Data Company Limited and Citi estimates

Figure 117. Tame inflation, but risk in inflation outlook is likely biased to the upside amid persistent supply-side pressures



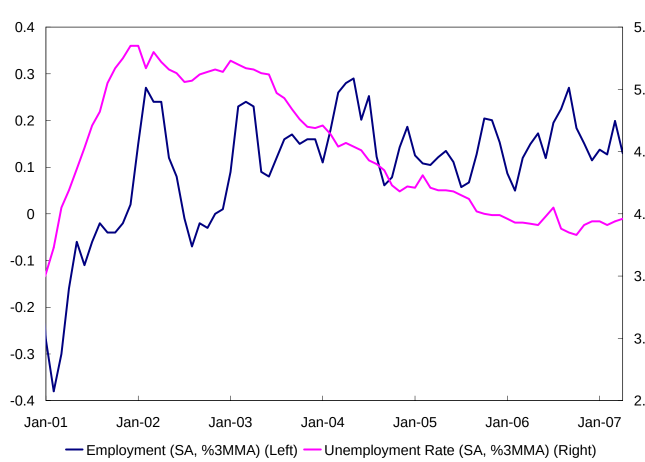
Source: CEIC Data Company Limited

Figure 118. If trade surplus remains at the lower end of government forecasts (US$25.6bn), CBC may need to reconsider its recent policy to keep the TWD from weakening



Source: CEIC Data Company Limited

Figure 119. Weak domestic demand suggests that the central bank's liquidity tightening campaign will likely be moderate and gradual



Source: CEIC Data Company Limited

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Notes

Notes

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