BEAR STEARNS

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# Emerging Markets
## Sovereign Journal Weekly

To our clients and readers:

This is likely to be our last Sovereign Journal Weekly, as our group is being wound down due to the impending merger. We have been publishing this weekly piece every non-holiday Friday since 2000. We have attempted to provide a weekly, succinct snapshot of our views on the countries we follow, in the context of unfolding events. All of us in the Fixed Income Emerging Markets Research Group have valued your comments, feedback, and attention. The phone calls, the meetings, the conferences, and the research trips have been fun and rewarding for us. We look forward to working with you in the future, either as part of the JP Morgan team or in other capacities.

*Carl Ross, on behalf of the Emerging Markets Sovereign and Corporate team*

**Special Topic: Perspectives on Mexico's Energy Reform**

*John Welch discusses the issues surrounding the recent introduction of an energy-reform package in the Mexican Congress. He expects the reform to be approved after a protracted struggle.*

**Country Commentaries (click on country name)**

| Latin America/Carib. | EMEA | Asia |
|---|---|---|
| Argentina | Egypt | Asia Currency Outlook |
| Brazil | Kazakhstan | China |
| Colombia | Russia | India |
| Costa Rica | Serbia | Indonesia |
| Dominican Republic | South Africa | Malaysia |
| El Salvador | Turkey | Pakistan |
| Guatemala | Ukraine | Philippines |
| | | South Korea |

**Economic Calendar**

Click here for our most recent *Central America & Caribbean Monthly* report.

Click here for our most recent *Emerging Markets Sovereign Quarterly* report.

**Recent Recommendation Changes**

| **Week of April 11, 2008** | **New Recommendation** | **Prior Recommendation** |
|---|---|---|
| *No Recommendation Changes* | | |
| **Week of April 4, 2008** | **New Recommendation** | **Prior Recommendation** |
| *No Recommendation Changes* | | |
| **Week of March 28, 2008** | **New Recommendation** | **Prior Recommendation** |
| *No Recommendation Changes* | | |
| **Week of March 21, 2008** | **New Recommendation** | **Prior Recommendation** |
| *No Recommendation Changes* | | |
| **Week of March 14, 2008** | **New Recommendation** | **Prior Recommendation** |
| *Panama* | *Marketperform* | *Outperform* |
| **Week of March 7, 2008** | **New Recommendation** | **Prior Recommendation** |
| *El Salvador* | *Marketperform* | *Underperform* |
| *Thailand (CDS)* | *Marketperform* | *Underperform* |

*Please see the addendum to this report for important disclosures and analyst certification.*

*Special Topic*

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## Perspectives on Mexico's Energy Reform

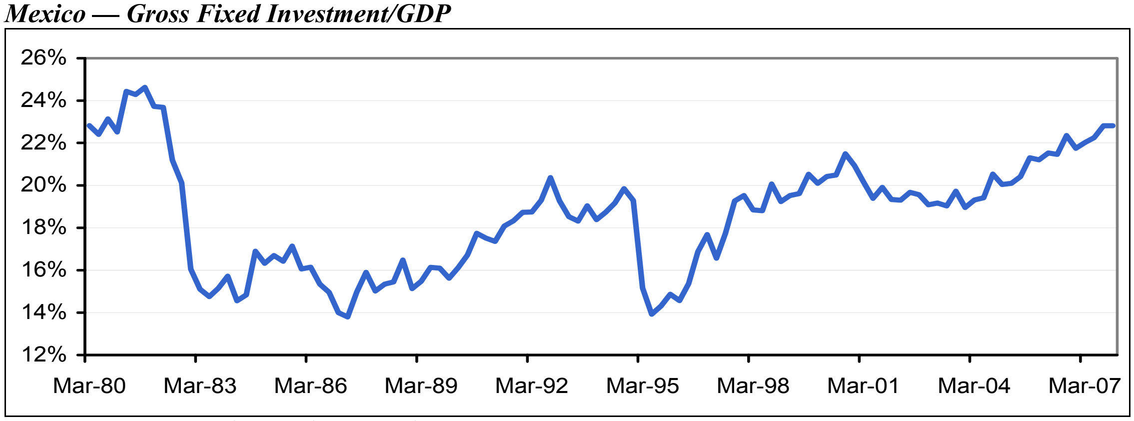
This week, President Felipe Calderón sent a Petroleum Industry Reform package to Congress. We had expected the Calderón administration to pursue this reform only after the midterm elections in 2009. But the weakening of the opposition PRD party because of internal fighting (most recently around the election of a new president) as well as positive feedback from within the opposition PRI convinced President Calderón (a member of the PAN) to move ahead. Moreover, when it was clear that some type of reform would occur, we had expected a purely administrative reform for PEMEX. But the PRD tried to radicalize the reform before it was even revealed. Consequently, the administration has offered a more ambitious project perhaps because they expect a radical opposition in any event.

The main points of the reform are: 1) The reform keeps the constitutional prohibition on private investment in the hydrocarbons upstream activities (constitutional articles 25, 27 and 28); 2) The reform includes a new charter law for PEMEX which will gradually free PEMEX financing and budgeting from the current tight federal government control; 3) It introduces change to oil industry secondary laws (constitutional article 27) in order to open to private investment upstream activities such as transportation, storage and distribution of refined and based petrochemical products. Crude oil refining, transportation and storage will remain in public-sector hands; 4) The reform creates a crude oil commission to look after government interests in the oil industry and to work as a technical advisory board to the secretary of energy. It also modifies the National Energy Commission charter law expanding its regulatory authority to the transportation, storage and distribution of refined products.

The new PEMEX law will: 1) Create a new board of directors which includes the current one that has six representatives of the government and five of the unions and will add four new professional directors named by the president. Two of these new directors will work full time for PEMEX. All strategic PEMEX decisions will need at least two favorable votes from these directors; 2) PEMEX will issue a new bond called the "bono ciudadano" which will pay interest according to how PEMEX performs. Only Mexican citizens and Mexican institutional investors are allowed to purchase and trade these securities; 3) PEMEX will have a government ad-hoc acquisition/agreements policy which, in principle, will allow it to design performance contracts with other oil companies.

What all this means is that PEMEX will gradually, through the achievement of certain targets, become increasingly more autonomous (from the government) in its capital budgeting and debt policy. We view the reform as positive because it will likely increase potential growth on the back of higher levels of domestic investment. The reform also lays the path for the presentation of a more ambitious reform after the midterm 2009 elections, a reform that could feasibly open the door for PEMEX to enter into joint-venture schemes to search for oil in deep waters. We think that the reform just presented will likely pass in the fall sessions of Congress, despite the negative headlines that will most probably erupt regarding this issue. In fact, the PRD already blocked the entrance to Congress last week in order to delay the discussions on the reform. The PRI and the PAN have already argued that if the PRD maintains the blockade, they will just vote in some other venue. We expect this reform to follow the same path as the tax reform of 2007—meaning that the decibels of political noise will be high.

***Mexico — Gross Fixed Investment/GDP***




*Sources: Bear Stearns EM Debt Research; Haver Analytics.*

## *Sovereign Views*

| Country | Recommendation | Rationale |
|---|---|---|
| **Argentina**<br>B3/B+<br><br>Alberto Bernal | **Outperform** | The INDEC (official index) once again proved to be immune to coming closer to reality. According to the INDEC, the rate of inflation stood at 1.1% month over month in March, about one-third of the reading that was expected by a series of local private-sector estimates. The rate of inflation did increase in year-over-year terms to 8.8% from 8.4% in February, since during March 2007 the INDEC maintained that the pace of price increases had stood at 0.7% month over month. Keep in mind that in March, Argentina underwent the strike from the farming sector—implying substantial shortages of agricultural products. Also of note, the reading on inflation was delayed by six days—its expected date of publication had been April 4.<br><br>The reading published by the INDEC includes some "impressive" statistics. For example, the consensus of the local community is that the price of beef increased by 20% in the month on the back of the strike. According to the INDEC, beef prices only increased by 3.4%. The same story holds for vegetables (which increased by 33% according to the consumer survey but by only 2.2% according to the INDEC). The other rather remarkable statistic involved the price of clothing, which according to the INDEC actually fell in March, despite the change in seasons, and despite the economy growing at rates close to 10% year over year. We find it relevant to mention that the World Bank has decided to no longer include Argentina's CPI statistics in any of its documents. We expect the rest of the investment community to do something similar in the months ahead. We also think that analysts will soon stop forecasting inflation rates.<br><br>*Please click **here** for the latest Sovereign Update.*<br><br>*Please click **here** for the latest Sovereign Update on the Province of Buenos Aires.* |
| **Asia Currency Outlook**<br><br>John Stuermer | | The two most interesting currency developments in Asia this week have been the Chinese yuan's approach to a benchmark level of 7 yuan/US$ and the Singapore dollar's sudden climb to a record high after the Monetary Authority of Singapore (MAS) unexpectedly decided on an "upward shift" in the range in which it manages its currency to curb inflation. The continued climb of the Chinese yuan has been in progress since late last year, and the market believes that it is only a matter of time before the yuan breaks through 7 yuan/US$. The graph at the end of this report shows that, if anything, the pace of appreciation for the yuan slowed slightly over the last several weeks, but is still headed inexorably toward the 7 yuan/US$ level. The movement in the SGD, however, was more of a surprise. In fact the Singapore dollar's pace of appreciation had slowed considerably in recent weeks, leading some market observers to wonder if the Singapore authorities were deliberately slowing the SGD due to concern about another quarter of somewhat weakish growth after GDP grew by only 5.4% in 4Q07. However, the actual outcome for 1Q08 was an impressive 7.2%, due, in large part, to a sudden uptick in pharmaceutical production, which the government has been encouraging to offset the slowdown in electronics exports over the last several years. With growth for 2008 now assured, the MAS apparently shifted its focus to inflation, which had risen to a plateau of 6.6% and 6.5% in January and February, respectively, and moved the trading band for the SGD.<br><br>The rapid appreciation of both currencies has seemingly pulled most other currencies in the region along with them in recent days, including the Malaysian ringgit and Philippine peso, which had been drifting somewhat in recent weeks. We view these developments, however, as more of an adjustment than the beginning of any new trend. The graph below, displaying the trend of all major Asian currencies since the yuan and ringgit were de-pegged in 2005, shows that the index for the yuan and SGD has been bending slightly downward since late last year, while the peso and the baht are more or less going sideways at present, after having been the most rapidly appreciating currencies in 2007. We continue to believe that the most exciting currency to watch in 2008 is the Malaysian ringgit. The ringgit generally moves with the SGD, although it has lagged slightly over the last month, due in part to investor uncertainty over the surprising election results of March 8. We think the March 8 results are positive, and will create a more transparent political system and investment environment in Malaysia. And, in tandem with other positive trends (still-large current account surplus, industrial restructuring, close interrelationship with the Singapore economy and financial markets), they will likely make the ringgit a strong performer in the rest of 2008. |

## *Sovereign Views (Continued)*

| Country | Recommendation | Rationale |
|---|---|---|
| **Brazil**<br>Ba1/BB+<br><br>John H. Welch | **Marketperform** | The IBGE reported that March IPCA inflation came in at 0.48% or 4.72%, well above consensus of 0.36% and our forecast of 0.32%. The recent pickup in food prices was more than we had expected in the collection period. The measures of core inflation also showed significant acceleration. Core inflation measured by trimmed means with smoothing increased to 0.39% from 0.28% in February. The trimmed means without smoothing increased to 0.41% from 0.28%, while the exclusionary measure increased to 0.36% from 0.28%. Both tradables and non-tradables price inflation increased, with tradables inflation increasing to 0.53% from 0.16% in February despite the strong BRL. More importantly, non-tradable inflation accelerated to 0.45%, reflecting in part increases in food prices at restaurants. The high inflation print all but seals the beginning of a tightening cycle at the COPOM meeting of April 16. We now expect a 50-bp increase in the SELIC target, to 11.75%, followed by another 150-bp hike (50 bps in June, 50 bps in July, 25 bps in September, and 25 in October) in 2008. Hence, we expect the SELIC rate to end 2008 at 13.25%.<br><br>*Please click* ***here*** *for the latest Sovereign Update.* |
| **China**<br>A1/A<br><br>John Stuermer | **Underperform** | China reported a large number of economic data points today. To begin with, the trade surplus for March rose to US$13.4 billion, compared with US$8.56 billion in February. This is an increase from a below-trend figure in February, but indicates the magnitude of China's trade surplus is finally cresting. The 12-month rolling surplus reached US$257 billion in March, compared to US$250 billion in February, but was less than the 2007 calendar-year surplus of US$262 billion. Furthermore, China's foreign-exchange reserves rose to US$1.6822 trillion at the end of the first quarter, up by US$153.0 billion from the previous quarter. China's M2 money-supply growth rate fell to 16.3% in March, down from 17.5% in February and 18.9% in January, suggesting that government efforts at slowing down the economy are beginning to have an effect. Other indicators, however, tell a different story. FDI for the January–March quarter of US$27.4 billion was up by 61.6% year over year, with FDI in March alone rising 39.6% year over year. Also, China revised its GDP growth rate for 2007 up to 11.9% from the initially-stated figure of 11.4%.<br><br>*Please click* ***here*** *for the latest Sovereign Update.* |
| **Colombia**<br>Ba2/BB+<br><br>Alberto Bernal | **Outperform** | The saga of the hoped-for approval of the Colombia-U.S. Free Trade Agreement continued to evolve this week; in fact, it is probable that the climax was reached with President Bush sending the treaty to Congress despite opposition from Democrats, and with Congress deciding to downgrade the treaty to the committee level to avoid having to make a decision on the Colombia deal. The tactic used by House Speaker Nancy Pelosi to delay the vote is unprecedented, and it goes completely against the norm established for the "fast-track" rules—which prevent Congress from having a say in the shape and form of the treaty during the negotiation process. The decision taken by the House of Representatives also means that the "fast-track", 90-day limit to vote the deal up or down will no longer hold, implying that the treaty will most probably languish at the committee level before Congress decides to do its job and vote on the legislation.<br><br>We, paradoxically perhaps, find this development not that bad. Here is why: first, the pathetic argument that was being used by the leadership of the Democratic Party to not vote on the deal with Colombia (i.e., that Colombia has not "done enough" to control violence) has been, in our view, all but dropped after the latest developments. Speaker Pelosi implied that the trade treaty would not be voted on unless President Bush backs the Democrats' child health care initiative and unless the president also approves a trade displacement program and additional subsidies for families in danger of losing their homes. This realization is important because Colombia was becoming increasingly annoyed by the continued implication by the U.S. Congress that reducing violent deaths from 32,000 per year to 17,000 or kidnappings from 3,000 per year to 200 per year was "not enough". The Democratic Party's negative stance has never been about lingering violence or impunity, but rather about U.S. labor unions' fear of having to compete with lower salaries in Colombia. That part of the discussion has been made clear, in our view, and that is a positive step. The second issue we would point to is that delaying the vote until Congress has "lame-duck" status will take Ms. Pelosi out of the equation, and frees key Democratic leaders to vote their conscience on the bill. We think that a November vote on the Colombia trade deal is likely, because Colombia is a "good story" and because the country is perceived as an ally.<br><br>Here is the bad part of the whole saga: the ability of the U.S. to portray itself as a loyal ally in Latin America is now over, in our view. As some pundits argued last week in Miami (during the Inter-American Development Bank's annual meeting), perhaps, in the end, Latin America is really not that |

### *Sovereign Views (Continued)*

| Country | Recommendation | Rationale |
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| | | important for most members of the U.S. Congress, even if these same officials argue that it is a keyregion. Colombia would be wise to continue to quickly close trade deals with other world powers, so that the country can diversify away from its dependence on Venezuela and the United States.<br><br>*Please click **here** for the latest Sovereign Update.* |
| **Costa Rica**<br>Ba1/BB+<br><br>Carl Ross<br>Franco Uccelli<br>Kathryn Rooney | **Outperform** | Tourism continues to make its mark in Costar's economy. The country's National Tourism Chamber (Canatur) announced this week that tourist arrivals had soared by 13.9% during the first three months of the year to total 532,000, compared with 467,000 during the same period of 2007. Foreign visitors totaled 1.9 million and generated US$1.9 billion in revenues last year, making the tourism industry one of Costar's key contributors of foreign exchange, employment and ultimately economic dynamism. Meanwhile, Costar's sound macroeconomic conditions are creating a supportive environment for market rates to decline. Indeed, prompted by a 50-bp drop this week, the tasa básica (basic rate), which is the market's six-month benchmark interest rate, has dropped by 250 bps so far this year and currently stands at 4.75%, its lowest level in history. |
| **Dominican Republic**<br>B2/B+<br><br>Carl Ross<br>Franco Uccelli<br>Kathryn Rooney | **Marketperform** | Dominican President Leonel Fernandez continues to strengthen his lead ahead of the upcoming May 16 election and, according to the most recent voter surveys, has become a virtual shoo-in to serve for a third (second consecutive) presidential term. Indeed, the latest pre-election poll, released this week by CLAVE-NOXA-CIES, gives Fernandez (PLD) a sizeable 54%–30% lead over Miguel Vargas Maldonado (PRD), his closest adversary, enough to win the election in the first round and avoid a June 30 runoff between the top two vote-getters. Fernandez's voter support rose from 45% in February, while Vargas Maldonado's declined slightly, from 31%, during the same period. According to the CLAVE-NOXA-CIES poll, and irrespective of electoral preferences, some 65% of Dominicans believe that Fernandez will win the election, with only 28% of respondents (less than the percentage that said would vote for him) believing that Vargas Maldonado has the highest probability of wining the race. As we have noted before, we believe that a Fernandez victory, which is both our base- and best-case scenario, would be positive for DomRep as it would guarantee policy continuity. |
| **Egypt**<br>Ba1/BB+<br><br>Timothy Ash<br>Raza Agha | **Outperform** | Egypt's Central Agency for Public Mobilization and Statistics (CAPMAS) reported inflation numbers for March, wherein headline urban inflation accelerated to 14.4% from 12.1% in February, the highest levels since December 2004. The primary driving force behind the increase was rising food prices, which rose by 20.5% driven by rising prices for bread, grains, fruits, vegetables, and edible oils. We note that higher food costs are a sensitive issue in Egypt, which has recently seen strikes, queues and violence as declining real wages take their toll on the Egyptian population. It is then not surprising that the government has planned a number of quick-fix unorthodox policy responses, which includes a ban on the export of some food commodities, a waiver on import duties on selected items, an increase in subsidies, along with directions to the army to start producing the local staple bread to alleviate shortages. On the monetary-policy front, the government has reportedly asked the Central Bank of Egypt (CBE) to utilize monetary policy to ensure inflation stays in the 6%–8% range. As a result, the CBE hiked its benchmark overnight interest rate corridor to 9.5% and 11.5% at the end of March. Looking ahead, press reports suggest that the government expects inflation to ease somewhat in the coming months as the impact of its various measures begin to kick in. We note that the next meeting of the CBE's Monetary Policy Committee (MPC) is scheduled for May 8, when rates will likely be held for now. However, whether domestic interest rates have peaked or not is dependent on inflationary outcomes over the next few months. In this regard, a point to watch will be the extent to which the CBE permits the pound to appreciate by scaling down its purchases of excess forex liquidity in Egyptian markets to allow the pound to appreciate. |
| **El Salvador**<br>Baa3/BB+<br><br>Carl Ross<br>Franco Uccelli<br>Kathryn Rooney | **Marketperform** | Driven by an impressive 15.5% increase in income taxes, El Salvador's tax revenues soared by 10.3% during the first quarter, compared with 8.3% during the same period of last year, to total US$745.8 million (versus US$676.1 million in January–March 2007). The government expects improved tax collection levels to boost the tax take as a percentage of GDP to 14.5% by year-end 2008 from 14.2% in 2007. Such an improvement, and despite public-sector investment levels planned to reach historical highs, should enable El Salvador's non-financial public sector (NFPS) to reduce its deficit from 2.0% of GDP in 2007 to 1.9% this year and to lower its NFPS debt burden from 38.7% of GDP last year to 37.6% in 2008. |

### *Sovereign Views (Continued)*

| Country | Recommendation | Rationale |
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| **Guatemala**<br>Ba2/BB<br><br>Carl Ross<br>Franco Uccelli<br>Kathryn Rooney | **Marketperform** | Guatemala's tax revenues continue to grow robustly, albeit at a slower pace than in 2007. According to figures for the first two months of 2008 released this week by the Superintendence of Tax Administration (SAT), collections rose by 13.5%, compared with 15.8% during the same period of last year, to total some US$750 million (versus US$660 million in January–February 2007). Thanks to changes in the country's tax administration and to efforts to crack down on tax evasion, growth in Guatemala's tax revenues has recently outpaced the surge in consumer prices and in nominal GDP, suggesting that the country's fiscal situation, as measured by an improvement in its tax take, has strengthened in real terms. |
| **India**<br>Baa2/BBB-<br><br>John Stuermer | **Marketperform** | The good news in India this week was industrial production for February—up by 8.6% over February 2007—and the bad news was the rise of WPI inflation to 7.41% (year over year) for the week ended March 29. Industrial production grew at the fastest pace in four months in February as record investment in power plants and factories boosted demand for electricity and cement. The steady rise of inflation in recent months may soon force the Reserve Bank of India (RBI) to raise both its borrowing and lending rates (6.00% reverse repo rate; 7.75% repo rate) at its April 29 meeting. Before then, the RBI might raise its cash-reserve ratio by as much as 50 bps. The key policy conclusion of all of this is that the government may settle for a less rapid growth rate in 2008, perhaps as low as 7%. Growth has averaged 8.7% since 2003, but inflation is quickly becoming a political liability for the government, which is likely to face parliamentary elections in the not too distant future. The outlook for lower growth has already led to a 22% decline of the SENSEX stock market index this year, and is generating an overall retrenchment in the domestic financial markets. |
| **Indonesia**<br>Ba3/BB-<br><br>John Stuermer | **Marketperform** | Standard & Poor's reported this week that its rating for Indonesia might be raised if it reduces the subsidies it pays to protect the population from rising fuel prices. Finance Minister Sri Mulyani Indrawati has said that allowing retailers to charge higher prices for fuel is "one of the options" the government is considering to reduce the amount of subsidies it would pay should oil prices average more than US$100 a barrel this year. President Susilo Bambang Yudhoyono's government has budgeted 14% of its estimated 896-trillion rupiah (US$97-billion) revenue in 2008 for subsidies to cap fuel prices. Investors are concerned that rising oil prices will raise the subsidy costs and widen the budget deficit, forecast at 2.1% of gross domestic product. (We discussed the Indonesian budget in more detail in the research note we published this week: *Last Week's Market Plunge and the Budget; Will Bank Indonesia Governor Boediono Raise Interest Rates?*, April 8, 2008.) We would like to see S&P focus its analysis of Indonesia on monetary policy as well, given an inflation rate of 8% and rising that will confront current Economics Minister Boediono when he assumes the post of Bank Indonesia Governor in May.<br><br>*Please click* ***here*** *for the latest Sovereign Update.* |
| **Kazakhstan**<br>A2/BBB-<br><br>Timothy Ash | **Outperform** | We broadly concur with the IMF's assessment of the economic outlook for Kazakhstan in 2008. The Fund assumes that real GDP growth will slow to 5%, which is in complete agreement with our own forecast held for the past few months. The IMF assumes that the slowing in domestic demand will also narrow import demand which, with a pick-up in exports (induced by high oil/energy prices and increased volumes of production and exports) will cut the current account deficit to just 1.7% of GDP from 7% of GDP in 2007. The slowing in the domestic economy should help ease concerns over the outlook for the tenge, and should allow the NBK to replenish FX reserves. The downside is that the slowing in domestic demand and credit growth will presumably produce a rise in NPLs in the banking sector, which will need to recapitalize as a result. We think there are the resources both domestically and externally (via foreign M&A interest) to facilitate this process, which should ease the threat of a major bank failure. |
| **Malaysia**<br>A3/A-<br><br>John Stuermer | **Marketperform** | Most Malaysians still want Abdullah Badawi to continue as prime minister, according to recent public-opinion polls. However, this is more in the spirit of a desire for continuity and an orderly transition to some new type of political party system, be it led by opposition leader Anwar Ibrahim or by a reformed and newly multi-ethnic UMNO. Moreover, the public has a laundry list of demands including resolving the burden brought about by rising prices and inflation. Furthermore, most Malaysians are not happy with the way Badawi and his government have handled certain issues like rising prices, crime and public safety, ethnic inequality and corruption, the recent hold-up of a money-changing stand in broad daylight in the Kuala Lumpur International Airport being a case in point.<br><br>As we go to press, Prime Minister Badawi is facing division heads from the bastion of UMNO in the state of Johor (across from Singapore), including six federal ministers. If, as expected, they politely tell him that he should set a timetable for political succession and suggest that the handover be done before the party polls in December, it will be untenable for him to stay on or even consider defending his position as party president. Still, Badawi's supporters say that they expect him to |

### *Sovereign Views (Continued)*

| Country | Recommendation | Rationale |
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| | | convince Johor UMNO that he remains the best man to shepherd the party through this rebuilding period and then hand over the leadership to Datuk Seri Najib Tun Razak sooner rather than later. He is likely to acknowledge his faults and even take the lion's share of responsibility for the poor performance of the Barisan Nasional in the recent elections.<br><br>Officials who have followed him to Sarawak and Sabah and those familiar with his meetings with party officials in Sri Perdana say that Badawi has been willing to take a lot of abuse. Some of it was directed at his alleged over-reliance on Khairy Jamaluddin and his group of young aides, known as the Fourth Floor. He has also been willing to eat humble pie and reach out to some of his most vocal critics. In Sabah, he made the first move of reconciliation with Zaharin Yasin, the former party member who has attacked him relentlessly on his blog since 2006. The prime minister will need all his diplomatic skills to turn to the power brokers in Johor now.<br><br>*Please click **here** for the latest Sovereign Update.* |
| **Pakistan**<br>B1/B+<br><br>John Stuermer<br>Raza Agha | **Marketperform** | Pakistan's new finance minister, Ishaq Dar (a senior leader in Nawaz Sharif's PMLN), held a press conference highlighting the state of the economy as of the end of March 2008. The key takeaway was an expansion in the fiscal deficit to "around 6.0% of GDP" from -4.7% of GDP as of the end of February 2008 (the first eight months of FY08). More alarmingly, the minister also noted that if the new government paid off all deferred and accrued expenditures, the deficit would reach -9.6% of GDP in FY08. This compares with a revised deficit of -4.5% of GDP in FY07, and is more than double the target set for the current fiscal year. And while details regarding the precise measures being undertaken were not made available, the finance minister suggested that "fire-fighting" measures were under way to ensure a fiscal deficit outcome of around -6.0% of GDP for FY08. We believe that there are two principal factors which explain the finance minister's somewhat sensationalist depiction of Pakistan's economic conditions:<br><br>(a) Retribution for charges of fiscal misreporting during 1997 and 1999, when a PMLN-led government under-reported the fiscal deficit by 2% in FY98 and by 1.4% in FY99 according to the IMF; deficit numbers for these two years were subsequently revised upwards to -7.5% and -5.9% of GDP, respectively. The IMF explained this misreporting as follows: "…discrepancies had arisen principally in the domestic non-bank financing data, where the amount of sales of National Savings Schemes (NSS) instruments had been erroneously recorded in the fiscal reports. External and domestic bank financing data also required revision. The corresponding adjustments to expenditure data, which have so far only been completed for 1998–99, had been mainly to interest payments—corresponding to the higher-than-previously-reported domestic non-bank debt—and defense spending. In addition, some unbudgeted spending was identified." (IMF News Brief No. 00/23; April 28, 2000).<br><br>Looking at published Ministry of Finance data for the first half of this year, the primary driving force behind the higher fiscal deficit was a 59.1% increase in domestic debt servicing. As we have noted since the beginning of this fiscal year, these higher domestic debt payments reflect maturing Defense Savings Certificates (bullet bonds that are part of the government-owned NSS schemes) issued between 1997 and 1999 at coupon rates of 16%–18% during the PMLN's last government; not surprisingly, since Mr. Dar was finance minister at that point, this was not highlighted in the press briefing.<br><br>(b) Political maneuvering which requires exaggeration of "inherited" policy problems, since that gives the new government more leeway in achieving outcomes. In the present context, at its current pace, the fiscal deficit for the full fiscal 2008 would amount to around -7.0% of GDP. That the new government is targeting around -6.0% implies that actual "fire fighting" will not be as gargantuan as it is being made out to be. For example, the full-year budget target for development spending was Rs546.5 billion, while the first half has seen some Rs225 billion being spent (41.2% of the budgeted amount). Even if half of the remaining amount is cut to contain the fiscal deficit, that amounts to a saving of around 1.6% of GDP. If realized, reducing this item alone can bring down the fiscal deficit to around -5.6% of GDP.<br><br>However, the above should not be taken to suggest that the fiscal deficit is not a problem. Indeed, we had been talking of a worsening fiscal situation since the start of this calendar year; our end-of-January 2008 fiscal deficit projection for the full FY08 was -5.2% of GDP, which was subsequently revised to over -5.6% of GDP. We continue to believe that the fiscal deficit this year will be at least this number, but recognize that the range could be as high as -6.2% of GDP. Furthermore, our estimates show that maturing DSCs will continue to pressure fiscal accounts till the end of FY10, while maintaining a large and delicate coalition government may detract policy focus on macroeconomic slippages; hence, we remain sanguine about the prospects of yields on Pakistan's |

## *Sovereign Views (Continued)*

| Country | Recommendation | Rationale |
|---|---|---|
| | | traded external debt tightening in the near term.<br><br>Indeed, what could dampen such prospects further are claims by the new government that the current account deficit (CAD) would rise to -9.2% of GDP in FY08 compared to a revised -5.9% of GDP in FY07. And while no breakdown of the deficit projection is available, the fact that the reported current account deficit stands at -5.4% of GDP as of the end of March 2008 (the first nine months of FY08) also suggests to us that the year-end government projection may be an exaggeration; note that at its current pace the deficit would touch around -7.3% of GDP by the end of the current fiscal year. Nonetheless, since we are not privy to the calculations that the Finance Ministry used to come to these numbers, a full-year CAD of US$14.4 billion, of which US$8.5 billion has been realized, implies that Pakistan will need to secure US$5.9 billion of additional financing until the end of this fiscal year at a time when the world economy is slowing and global markets are fragile. Finally, we further note that in his press conference, the new finance minister assumed that FY08 would end with a downgrade of Pakistan's sovereign ratings to B2/B.<br><br>In addition to the above-noted macroeconomic slippages, we are also concerned with a delicate social picture, with the dismissed chief justice's "lawyers' movement" becoming violent, as are newly elected members of Bhutto's PPP to the Sind assembly. If the ruling coalition and its supporters do not show more grace in their recent electoral victory, this could eventually solicit a response from the former ruling party and its allies. This was already evident in 1990s-type violence witnessed in Pakistan's financial and industrial capital, Karachi, over the last couple of days which has claimed some eight lives. More broadly, we anticipate Bhutto's PPP to have a difficult time in keeping its grand coalition together given the unrelentingly confrontational stance Sharif's PMLN maintains with regard to the Musharraf presidency, in contrast to a seemingly more accommodative PPP. This also appears to be the case in terms of the judicial issue, with the PMLN calling for an unconditional reinstatement of the 60-odd dismissed judges, whereas the PPP seems half-hearted; the latter could be a reflection of the legal challenges Asif Zardari, the PPP's co-chairman and Bhutto's widower, has faced in recent years, all of which have been pardoned under a Musharraf-promulgated national reconciliation ordinance (NRO). It is widely expected that a reinstated judiciary will shoot down the NRO, possibly overturning Zardari's acquittals.<br><br>All in all, after eight years of solid performance, we are concerned over a weakening macroeconomic framework in Pakistan. From a medium-term perspective, the key question is whether this is likely to become a trend, or will it be a mere blip? In all likelihood, macroeconomic outcomes for FY08 will turn out to be a blip, in large part because of how the new government will exaggerate the deterioration in FY08. This implies that from next year (FY09) on, we are likely to see improvements in most indicators. However, what should be noted is that the PPP will need to engage in delicate political balancing if it is to successfully maintain the current ruling coalition. Hence, the prospect of deteriorated FY08 macroeconomic outcomes becoming trends could be a real possibility.<br><br>*Please click **here** for the latest Sovereign Update.* |
| **Philippines**<br>B1/BB-<br><br>John Stuermer | **Marketperform** | Philippine exports rose by 10.7% from a year earlier to US$4.12 billion in February. Electronics, which make up two-thirds of the Philippines' total exports, rose by 4.7 % year over year to US$2.45 billion, following a rise of only 1.6% in January. Exports to the U.S., the Philippines' largest market, advanced 10% from a year earlier to US$717 million after falling by 1% in January. Shipments to Japan, the Philippines' second-largest market, rose by 16.5% to US$656 million, up from 3.9% in January. Overseas remittances for February have yet to be reported, but they rose by 15% in January, and will likely perform even more strongly in February. Overall the cash flow is still very strong, and we still forecast a substantial current account surplus of at least US$4 billion for 2008. The peso/US$ exchange rate has tightened modestly in recent days to 41.59 pesos/US$ due to these positive cash-flow indicators, as well as an overall positive environment for Asian exchange rates in general.<br><br>*Please click **here** for the latest Sovereign Update.* |
| **Russia**<br>Baa2/BBB+<br><br>Timothy Ash | **Outperform** | It is still difficult to be negative on Russia in the current market environment and with oil up at close to US$110 per barrel. The impact of high oil prices was clearly evident in merchandise trade data for February released by the Central Bank of Russia this week. This put the monthly surplus at US$14.63 billion, an increase of just short of 54% year over year. Exports were higher by 50% year over year, outpacing the 48.1% year-over-year increase in imports. High oil prices clearly explain the continued accumulation in FX reserves, which rose by another US$1.4 billion in the week to April 4 to US$508 billion. Reserves have now increased by US$34 billion thus far this year. Given the government's strong financing position, its debt financing needs are minimal. The Ministry of Finance announced this week that the stock of public-sector debt now stands at just 7.1% of GDP, and is expected to rise to just 8.7% of GDP by 2010. Note that the debt/GDP ratio was over 100% in |

## *Sovereign Views (Continued)*

| Country | Recommendation | Rationale |
|---|---|---|
| | | 1998, and the improvement reflects the combination of the debt default in 1998–2000, plus the tenfold increase in oil prices over this period. Clearly, Russia's biggest problem at the moment appears to be how to manage its wealth, rather than debt financing. Even the IMF, a long-time critic of Russia's economic model, struggled to give a downbeat assessment of Russia's prospects in its Spring World Economic Outlook. The IMF predicts real GDP growth of 6.8% in 2008 and 6.3% in 2009, a modest slowdown compared to 2007. |
| **Serbia**<br>NR/BB-<br><br>Timothy Ash | **Underperform** | Uncertainty on the political front in the run-up to the May 11 elections has encouraged us to retain our ***underperform*** recommendation on this credit. Tensions over the Kosovo issue remain high, and this could still sway the electorate into backing a nationalist-led administration. This is not inevitable, though, as opinion polls still show 63.8% backing for EU accession; victory by the nationalists could well see EU accession talks put into the deep freeze. However, the elections are now simply too close to call. On the economic front, news this week has been mixed. News that the government has pulled the plug on the RTB Bor privatization is disappointing, but the government appears optimistic that Russian investors will increase their bid from the US$370 million already on the table. Budget performance to March was also reasonably good. The state budget thus posted an RSD13.9-billion surplus. While this was half the year-earlier level, note that non-tax revenues (largely privatization-related) were two-thirds lower year over year, and indeed account for the bulk of the shortfall. Tax receipts were higher by 20.3% year over year, while spending was higher by just 11.7% year over year; with the CPI rising by 13.4% year over year in 1Q08, this implies a real cut in spending. The IMF, meanwhile, released its latest musings on the Serbian economy in its Spring World Economic Outlook forecasts. For Serbia, they assume a significant growth slowdown, with real GDP growth easing back to 4% from the 7.5% outturn in 2007. The current account deficit is, meanwhile, expected to slow to 16.1% of GDP from 16.5% of GDP in 2007; given the near halving in real GDP growth, we would assume a more marked improvement on the current account. |
| **South Africa**<br>Baa1/BBB+<br><br>Timothy Ash<br>Raza Agha | **Underperform** | The South African Reserve Bank (SARB) hiked its benchmark repo rate by 50 basis points to 11.5%, its highest level since August 2003, on the back of mounting inflationary pressures; note that headline inflation touched 9.8% in February 2008, compared to 9.3% in January 2008 and 5.7% in February 2007. In the statement that accompanied the repo-rate decision, the SARB's Monetary Policy Committee (MPC) noted that the inflationary outlook had deteriorated since its last meeting at the end of January 2008, wherein the benchmark repo rate was left unchanged. The SARB now expects inflation to remain outside its 3%–6% target range till the fourth quarter of 2009; this compares with earlier estimates of inflation returning to range by the end of the current calendar year. In addition, while oil prices may be stabilizing somewhat, and domestic credit growth slowing down, a possible hike in electricity price tariffs will add to inflationary pressures. A further key to watch will be the rand, which has risen after the SARB's interest-rate hike given rising interest-rate differentials with developed countries; these differentials currently stand at 650 basis points with the U.K., 1100 bps with Japan and 925 bps with the U.S. Federal Funds rate. And while that may well provide something of a cushion against a rapid fall in the rand, the currency does remain vulnerable, in our view, given a wide current account deficit (-7.5% of GDP in 2007) and a large negative net international investment position (-18.55 of GDP in 2007).<br><br>*Please click **here** for the latest Sovereign Update.* |
| **South Korea**<br>A2/A<br><br>John Stuermer | **Underperform** | The ruling Grand National Party (GNP) won a simple majority as expected in this week's parliamentary election, but only by a slim margin. The GNP secured 153 out of the 299 seats—short of initial poll predictions that the party would win 155–180 seats. The discrepancy comes from the more than 30% of undecided voters, a record low turnout of 46% (even lower than the anticipated 50%–55% turnout), and the 80 closely fought electoral districts. Elections in some districts were determined by only a few hundred votes. Thus, President Lee Myung-bak's GNP party underperformed compared to expectations. President Lee won the presidential race on a promise to deregulate and revitalize the South Korean economy. Some observers, however, are concerned that what he may actually do is revitalize the chaebol and their propensity to create protected markets, engage in anti-competitive behavior, and overextend themselves financially, all factors that led to South Korea's inclusion in the 1997–1998 financial crisis. President Lee's proposals to "defang" the financial regulator and allow the chaebol to buy up banks are of special concern.<br><br>The biggest winner in the election was in fact President Lee Myung-bak's intraparty rival, former GNP chairwoman Park Geun-hye (daughter of the late president Park Chung-hee), and her supporters. The pro-Park alliance, a coalition of independent candidates who defected from the ruling party, won 14 seats. Combined with pro-Park legislators within the GNP, the former chairwoman now has 50 assemblymen who are loyal to her. Given the slim margin, Lee and other |

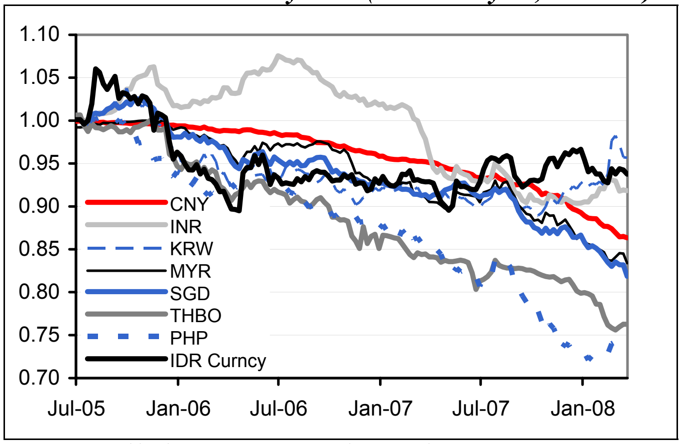
## *Sovereign Views (Continued)*

| Country | Recommendation | Rationale |
|---|---|---|
| | | GNP leaders will need to make overtures to the pro-Park independent assemblymen in order to reach a solid 168-seat majority needed to secure committee chairs as well as majority votes in all the committees.<br><br>*Please click **here** for the latest Sovereign Update.* |
| **Turkey**<br>Ba3/BB-<br><br>Timothy Ash | **Underperform** | We remain bearish on Turkey due to a combination of concerns over the credit's large external financing needs, plus mounting tensions on the domestic political front over the AKP party closure case. On the former of these, the CBRT released balance-of-payments data for February this week. These showed the current account deficit continuing to widen to US$3.8 billion (+19% year over year). Encouragingly, merchandise exports were up by 43.4%, although with 41.2% year-over-year growth in imports and due to the higher import base, the overall merchandise trade deficit rose to US$3.4 billion, higher by one-third. On the financing side, net FDI was sluggish, posting a monthly total of US$574 million, one-third the year-earlier level. And, for the first two months of 2008, net FDI has totaled just US$1.4 billion, one-fifth the year-earlier level, and providing just 18% coverage of the current account deficit (down from 113% coverage over the corresponding period of 2007). Interestingly, despite the difficult global environment there does not appear to have been a mass flight of portfolio investors, as portfolio flows actually posted a net inflow of US$637 million over the first two months of the year (albeit down from +US$6.4 billion over the first two months of 2007), with high real interest rates still attracting a net inflow of US$1.2 billion for the period January–February 2008. Still, the key underpinning for the balance of payments remains "other investment assets" which recorded an overall inflow of US$6 billion, which appears to be a combination of increased external borrowing by domestic corporations plus a likely drawdown of overseas assets by corporates/banks. The increase in external debt obligations is not particularly encouraging, from a longer-term perspective. In terms of the political outlook, the situation appears difficult. We think the market is perhaps too sanguine over the risks that the AKP party will actually lose the ongoing party-closure case. On this issue, our growing sense is that those who lodged the case are now determined to decapitate the party, as from their perspective it is a case of now or never in terms of derailing the party. All this suggests a tense year on the political front, with the threat of ruptures on the EU accession front, domestic political protests, and early elections with an uncertain outcome. In the interim, policy reform could well be put on the back burner. |
| **Ukraine**<br>B1/BB-<br><br>Timothy Ash | **Outperform** | Ukraine's parliament this week ratified World Trade Organization-related agreements, suggesting that Ukraine will formally become an associated member of the WTO over the next 30 days. Of note, 441 MPs back WTO-related legislation, out of the 449 MPs in parliament. This clearly shows the strong cross-party backing for WTO accession. It also demonstrates that when push comes to shove, on issues of national importance, Ukrainian politicians can put aside their intense personal rivalries. The news on the inflation front is less encouraging, with the year-over-year CPI coming in at a whopping 26.2% in March, up from 21.9% in February and 10.1% in March 2007. Ukraine now has the highest inflation rate in Europe. The problems are numerous but include supply-side shocks (food and energy), credit-induced growth in domestic demand, plus also hefty unsterilized capital inflows which are boosting monetary aggregates. The government has announced various strategies to rein in inflation, but clearly fiscal and monetary policy needs to be tightened still further. The budget is running a modest surplus, but this needs to be increased substantially, to something similar to the 4%–5% surpluses posted by Russia. On the monetary policy front, the National Bank of Ukraine is limited to an extent by the exchange-rate anchor but is still resisting the obvious move to revalue the UAH. Despite the above, we still believe that Ukraine's favorable debt ratios, hefty stock of FX reserves, alongside the fact that its widening current account deficit is mostly funded from net FDI makes it a relative safe haven in current global market travails, and would still advise selling Ukraine 5-year CDS against Turkey. |

# Selected EMEA Data Releases (Week of April 14–18, 2008)

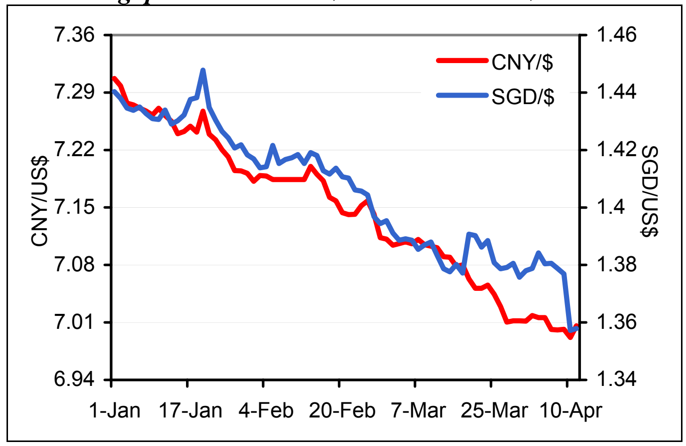
| Country/ Variable | Release Date | Historical Data | | Commentary |
|---|---|---|---|---|
| **Turkey**<br>Unemployment Rate (Jan-08) | 04/15 | 01/07:<br>11/07:<br>12/07:<br>01/08E: | 11.0%<br>10.1%<br>10.6%<br>10.9% | With real GDP growth slowing and with continued high population growth/flows into the labor market, unemployment is expected to rise. |
| **Serbia**<br>Repo Rate (April 15, 2008) | 04/15 | 04/13/07:<br>02/28/08:<br>03/13/08:<br>04/15/08E: | 10.5%<br>11.5%<br>14.5%<br>14.75% | Given continued growth in inflation, weak domestic politics and regional trends, we expect another 25-bp hike by the MPC. |
| **Poland**<br>Unemployment Rate (YOY; Mar-08) | 04/15 | 03/07:<br>01/08:<br>02/08:<br>03/08E: | 4.5%<br>5.9%<br>5.9%<br>5.9% | The Polish economy continues to go from strength to strength, boosting job growth. |
| **Poland**<br>Consumer Prices (YOY; Mar-08) | 04/15 | 03/07:<br>01/08:<br>02/08:<br>03/08E: | 2.5%<br>4.0%<br>4.2%<br>4.3% | The strength of domestic demand plus supply-side shocks are expected to outweigh the impact of the strong zloty and recent rate hikes. |
| **Russia**<br>Industrial Production (Mar-08) | 04/15–16 | 03/07:<br>01/08:<br>02/08:<br>03/08E: | 7.5%<br>4.5%<br>7.5%<br>6.0% | The economy shows little sign of slowing thus far, as high commodity prices/exports and strong investment growth continue to fuel expansion. |
| **South Africa**<br>Retail Sales, Constant (Feb-08; YOY) | 04/16 | 03/07:<br>01/08:<br>02/08:<br>03/08E: | 10.5%<br>-0.5%<br>0.2%<br>0.0% | Real growth in retail sales peaked in late December 2006, after which it has continued to weaken on the back of the South African Reserve Bank (SARB)'s monetary tightening, which has seen benchmark rates rise from 7.0% in mid-2006 to 11.0% at present. With credit growth slowing, we anticipate retail sales to come in flat over last year. |
| **Russia**<br>Gold & Forex Reserves (April 11) | 04/17 | 04/13/07:<br>03/28/08:<br>04/04/08:<br>04/11/08E: | $356.6bn<br>$506.8bn<br>$508.0bn<br>$510.0bn | Oil prices at US$110 a barrel will continue to bolster FX reserves. |
| **Poland**<br>Producer Prices (YOY; Mar-08) | 04/18 | 03/07:<br>01/08:<br>02/08:<br>03/08E: | 3.3%<br>2.9%<br>3.2%<br>3.3% | Energy and food price hikes will continue to push the PPI higher. |

***Asia FX Trends Since July 2005 (Index: July 22, 2005 = 1)***



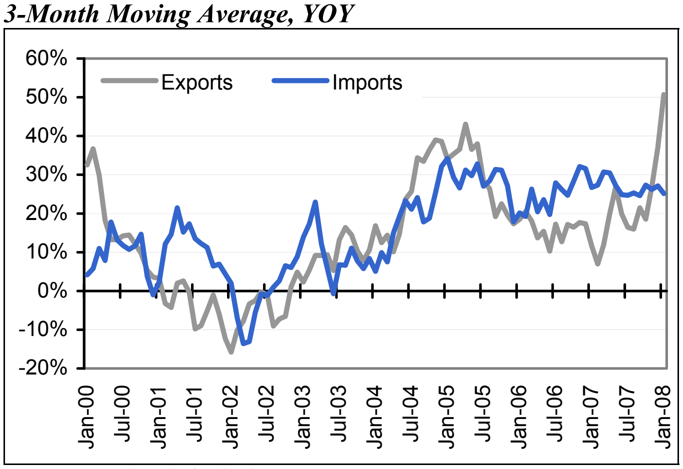

*Sources: Central banks; Bear Stearns EM Debt Research.*

***China/Singapore — CNY/US$ Versus SGD/US$***



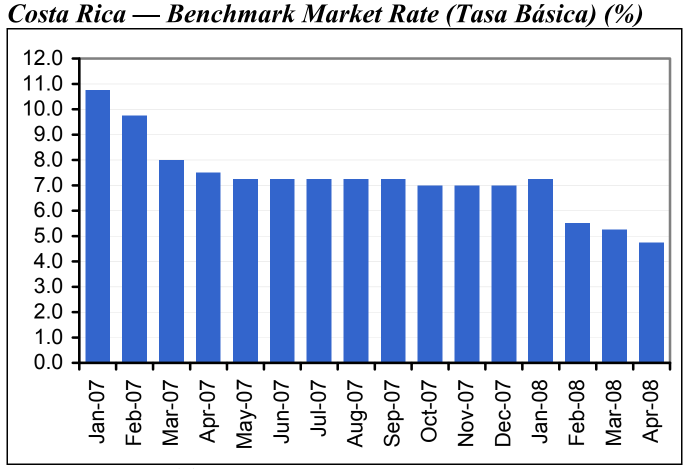

*Sources: MAS; PBOC.*

***Colombia — Total Imports and Exports***
***3-Month Moving Average, YOY***



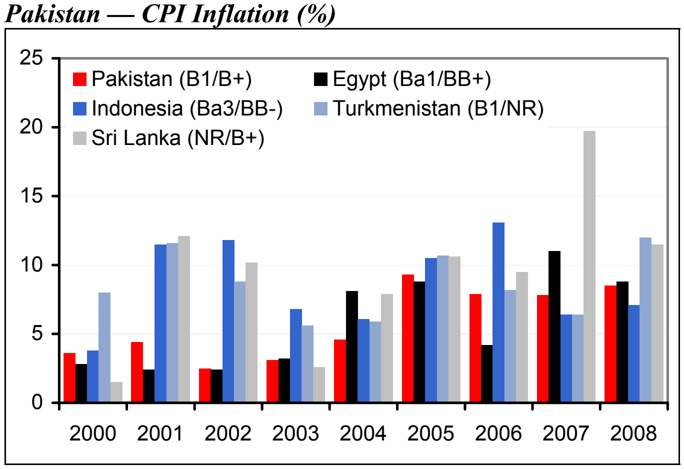

*Sources: Central Bank of Colombia; DANE.*

***Costa Rica — Benchmark Market Rate (Tasa Básica) (%)***



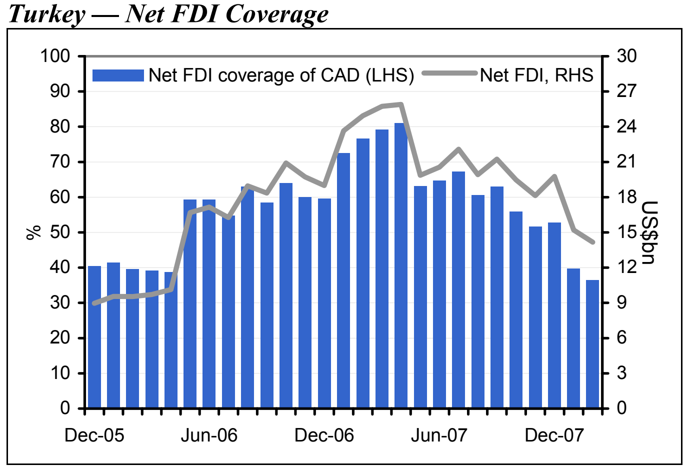

*Source: Banco Central de Costa Rica.*

***Pakistan — CPI Inflation (%)***




*Source: IMF.*

***Turkey — Net FDI Coverage***




*Sources: BSIL; CBRT.*

## Addendum

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Underweight: Over the next six-months, the sector's total return is expected to be below the average total return of the relevant market index, on a risk-adjusted basis.

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Marketperform: Over the next six-months, the total return of the issuer's class of securities is expected to be in-line with the average total return of the analyst's relevant coverage sector, as indicated on the coverpage hereof, on a risk-adjusted basis.
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