| Global Research |

# Global Focus
# 2011 – The Year Ahead

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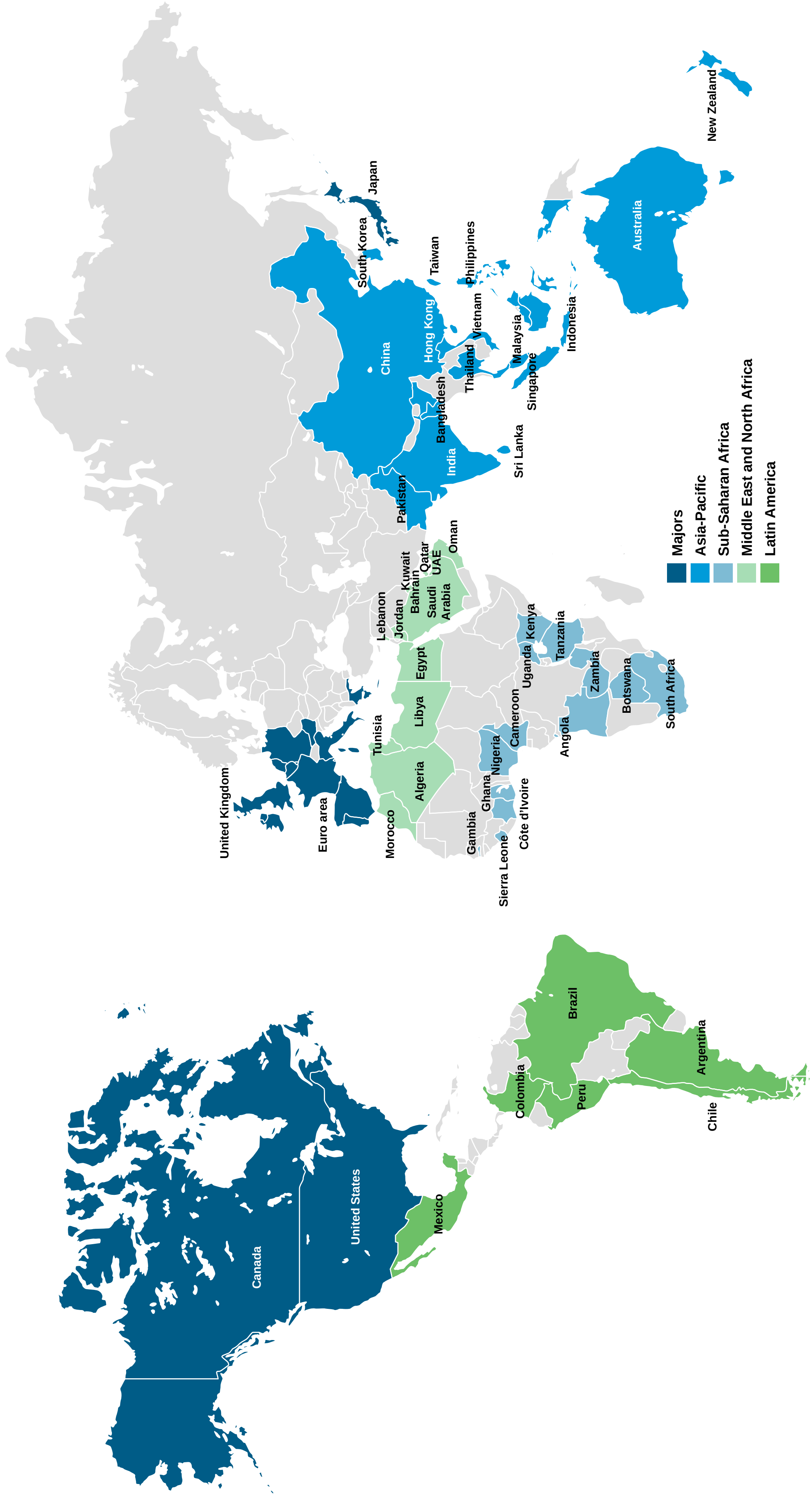
**Important disclosures can be found in the Disclosures Appendix.**

# Global overview




*Note: Economies covered in this report are shaded in blue and green.*

# Global overview

**Gerard Lyons**, Chief Economist and Group Head of Global Research
Standard Chartered Bank, United Kingdom
+44 20 7885 6988, Gerard.Lyons@sc.com

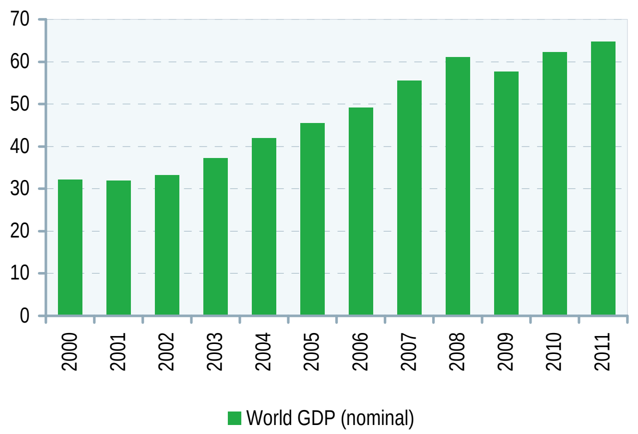
## Uneven recovery, diverging policies

### Introduction

The fundamentals, policy and confidence: focus on these in 2011 and one will not be far wrong on the course of the world economy and financial markets. Trouble is, whilst the economic fundamentals should be clear-cut, there appears to be widespread disagreement on what they are. One thing is clear, though: the fundamentals are stronger in the East. The policy debate, meanwhile, is very active, with many paths possible. In turn, confidence is almost impossible to predict, although we can conjecture on what will drive it and how it will turn out. Given this, predicting what will happen in 2011 is not so easy.

Indeed, it is possible to construct a host of widely different and credible scenarios for the year ahead. Within these, so-called 'tail risks', or extreme scenarios, cannot be ruled out. Certainly not in the West, where, after the boom, there is now a period of uncertainty and austerity. This is linked to a host of issues, including the fragile state of the banks, poor public finances, the impact of fiscal tightening on growth and, in some countries, the unknown consequences of policy-making driven by populist domestic agendas. Risks are not confined to the West. Excessive capital inflows, plus domestic inflation pressures, are already creating policy challenges across some emerging economies. Asia needs to act to prevent financial bubbles appearing. China is not immune to these. Overheating fears and over-investment will test its policy makers, although we expect they will overcome these challenges.

**Chart 1: World nominal GDP since 2000**
*USD trn*




Sources: IMF, Standard Chartered Research

We believe that we are in a super-cycle. Our recent report (**The Super-Cycle Report, 15 November 2011**) highlighted the factors driving this. Over time, the super-cycle will be driven by a combination of factors: the increased scale of emerging economies; the ability of many countries to have cash and financial resources at their disposal to invest; increased trade; urbanisation; and the combined impact of 'perspiration and inspiration' as more people work and spend and there is greater innovation and creativity. The net result will be a step-change upwards in global economic growth.

The countries that succeed will be those with the cash, the commodities and the creativity. The concept of a super-cycle does not rule out setbacks or volatility along the way, and indeed, it is an appropriate yardstick against which to put expected near-term challenges in context.

### Issues ahead

2010 was a year of recovery, albeit an uneven one. Indeed, much of what we had expected last year did materialise. **It was a tale of two worlds: a buoyant East contrasting with a sluggish West.** Although we were upbeat about growth at this time last year, we were not optimistic enough. We did say that the big risk may be the one that was least expected: stronger global growth. So it proved.

Given this, what are the key issues and questions that need to be answered in 2011? How resilient is the recovery in the West, and how sustainable is it in the East? Recessions end, and policy works. But as the previous policy stimulus wears off in the West, is the private sector resilient enough to lead the recovery? In turn, how sustainable is growth in the emerging world if the West stays weak?

This leads to what is likely to be one of the key issues this year: **how much of an inflation problem is there?** In the West it may prove to be mainly a commodity price concern, contrasting with strong deflation pressures across many economies. Meanwhile, inflation is a concern for a number of emerging economies. Hence, there are diverging policies between the East and the West, both orthodox and unorthodox. In such an environment, the focus on the financial sector will remain intense – particularly with so much bank and government debt being rolled over, not just in 2011, but in 2012 as well, which will also influence sentiment in the year ahead. In addition to these, there are also a host of issues linked to policy that need to be addressed, and we cover them all throughout this report.

# Global overview (cont)

### Economic outlook

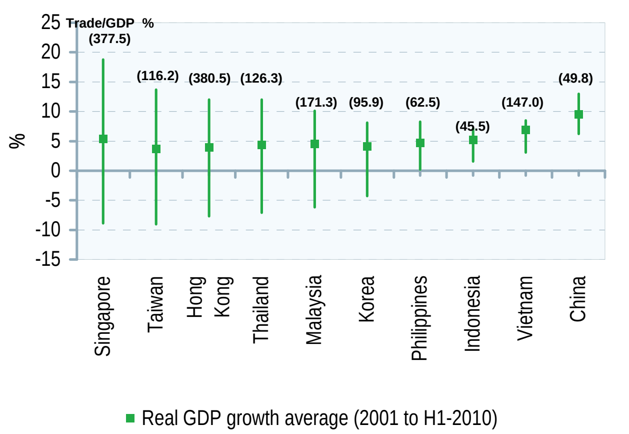
The fundamentals vary considerably across the globe, and this is expected to continue in 2011. **While the underlying trend is a global recovery, it varies considerably in scale.** We see the world economy growing further in size, from USD 62.3trn in 2010 to USD 64.7trn in 2011. This is shown in Chart 1, which shows that the size of global GDP is already back to pre-recession levels and is likely to grow further. Global trade has also recovered, and should continue to do so. After growth of 3.7% this year, we see the world economy growing 2.9% in 2011 and 3.4% in 2012. The IMF, by contrast, sees 3.3% in 2011 and 3.7% in 2012.

Sometimes people talk about the glass being half-full or half-empty. **In terms of the world economy, our view is that the glass is two-thirds full**. But in 2011, much attention will be on the one-third of the glass that is empty, namely the West. During 2010, the emerging economies, which represent one-third of global GDP, accounted for more than two-thirds of its growth. This should be repeated in 2011. We foresee a sluggish Western recovery alongside growth in the East that might be slower than in 2010, but which is solid and sustainable.

**Domestic demand is the key economic variable to focus on in 2011.** The fundamentals driving domestic demand vary considerably across the globe. Take Asia, for instance, where the employment outlook appears good, wages are rising and asset prices appear to be on an upward trend. All of this should be positive for consumption. Against this are measures to curb rising asset prices and the negative impact of rising food and commodity prices, which hits those on low incomes hardest. So while there are some offsetting factors,

**Chart 2: High trade openness = growth volatility**

*Length of the bar reflects max. and min. y/y growth between Q1-2001 and Q2-2010; numbers in brackets show the trade openness ratio*




Sources: CEIC, Bloomberg, ADB, Standard Chartered Research

the combination of jobs, wages and asset prices is generally positive for spending across Asia. The opposite is the case in the US and the West.

China is growing strongly. It still has huge imbalances, and as the economy grows, these will become harder to manage and will put greater pressure on existing policy tools and institutions. China is not a bubble economy, but it is an economy prone to bubbles – particularly in real estate, including prices in Tier 1 cities now. Food prices are also rising sharply. We expect further significant monetary policy tightening.

The challenge, of course, is to curb inflation through policy tightening without hitting growth too hard. The same challenges are already evident across much of South and East Asia, particularly India and Indonesia – the two economies, alongside China, that are not so open and are driven more by domestic demand (although in China, the economic balance still needs to shift from exports to domestic consumption). China's investment rate is so high that it is a concern, particularly since any hit to investment would impact growth significantly. Yet despite this, China should see strong growth in 2011, the first year of its 12th Five Year Plan, which is due to be approved in March.

India, too, is set to experience strong domestic demand in 2011, driven by private consumption and infrastructure spending. We see India growing at a strong pace in coming years. We expect to see further progress in two key areas: infrastructure and excess regulation.

**Trade remains vitally important, too.** New trade corridors continue to develop, with rising intra-Asian trade and increased trade ties across emerging regions, often with China at the centre. This means increased Asian trade with Africa, the Middle East and Latin America. This is expected to continue, reflecting increased flows of goods, commodities, people, remittances, and investment and portfolio flows.

Although the trend is up for Asia, many of its economies face potential volatility in their growth rates. This is characteristic of small, open economies. Chart 2 reflects this, showing that the more open an economy is, the more volatile its economic growth. This is particularly relevant across Asia, where, despite stronger domestic demand, export performance is crucial. The numbers show the openness of each economy, measured in terms of exports plus imports as a percentage of GDP. For Singapore this is 377.5%, while for China it is only 49.8%. The vertical line reflects fluctuations in annual

# Global overview (cont)

growth rates over the last decade. The square shows the average growth rate over that period. The longer the line, the more volatile growth is. Such volatility, a hallmark of the past, may be evident in the year ahead, particularly given the importance of confidence in driving overall growth.

**Infrastructure may also be one of the big themes in 2011.** Asia, as well as Africa and the Middle East, has huge infrastructure needs over the next decade. Funding these, and unlocking domestic savings, is an opportunity and a challenge.

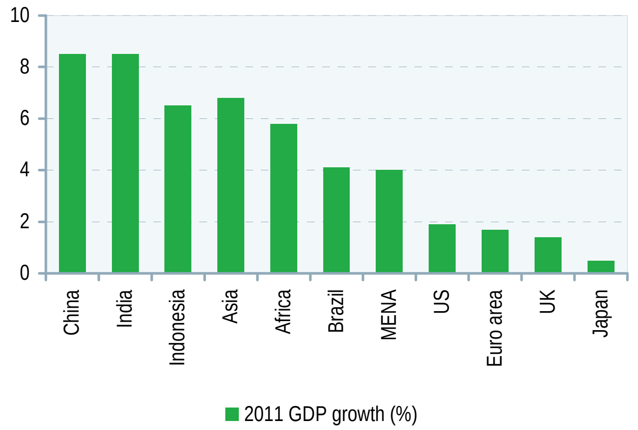
Although emerging markets are in better shape, the underlying picture varies across regions. For instance, in the Gulf and Middle East, the outlook is mixed. Dubai, like a number of economies in the West, faces a long transition as it deleverages. Much of the rest of the Gulf, meanwhile, enjoys the positives of continued high oil prices, the boost from being tied to low US rates, and the ability to fund large-scale infrastructure spending.

Likewise, across Africa, infrastructure spending is important. Although there is often a tendency to think the economies with the most to catch up will be outperformers in Africa, this is not the case. Those with better fundamentals and stronger domestic consumption are the ones that we expect will outperform. Expect more inward investment into Africa in coming years, given its resource potential and the high returns possible. Although China-Africa trade is rising, this is from a low level. Yet China's influence on the continent looks set to grow, particularly its demand for commodities.

**Debt, deflation and deleveraging are the macro themes in the West.** Thus, despite global recovery, the tale of two worlds is set to persist in 2011. In some Western economies,

**Chart 3: Leaders and laggards in 2011**

*Standard Chartered projections for real GDP growth (%)*




Source: Standard Chartered Research

the last couple of years have seen public-sector debt substitute for private-sector indebtedness. Deleveraging takes time. There will undoubtedly be pain, with a poor employment picture – the implications of which should not be underestimated in terms of the direct and indirect negative impact on spending, domestic politics and confidence. Yet even allowing for this, not all is bad, even in the West. There are many firms and people whose balance sheets are improving and who will be spending and positioning for growth. It is a complex picture. The net effect, though, is likely to be a sluggish recovery. Thus, the US economy is past the worst, but it faces a below-trend recovery bordering on stagnation, despite the likelihood of continued low interest rates and further liquidity injections.

The situation in the UK has many similarities to the US, but is better. Europe is the big problem area, even though the core, led by Germany and France, appears to be in good shape. In 2011, economies on the periphery – such as Ireland, Greece, Portugal, Spain and possibly Italy – face recession, high unemployment and probably social unrest. This will continue to raise questions about the euro's survival. For the euro area to survive in the long term, it needs to become a political union, with help from the centre to regions in difficulty.

**My view has always been that the euro would collapse at some stage, most likely in an external deflationary environment, where growth and jobs would be hard to come by.** It has always been difficult to say when this would occur, particularly given the political desire to make it succeed. No one should underestimate the contagion risks from further problems in the euro area. It is possible that 'crunch time' for the euro will be postponed for another year or two, as those countries which have the most to gain from devaluation may fear they have the most to lose from severing links with the EU institutions. But if and when the euro crisis unfolds, it could unravel far more quickly than expected.

**2011 may be a year of both inflation and deflation.** We expect inflation in the East as asset prices, food prices and commodity prices rise. This points to big challenges, with inflation emanating from many sources. These include external cost pressures driven by a rising trend in food and commodity prices, and the extent to which each country is impacted will depend on its currency's strength. Then there are domestic price pressures driven by the degree of spare capacity, competition and pricing power, and by people's ability and willingness to pay higher prices, influenced by wages and inflation expectations. And then there is liquidity and its impact on asset prices, influenced not only by

# Global overview (cont)

domestic monetary policy but also by inflows from the West. All of this suggests further monetary tightening and the use of other policy tools, including macro-prudential measures and capital controls.

In contrast, the West may face the worst of all worlds, with some rise in asset prices (which may help some), and cost-push inflation from China and rising commodity prices offset by domestic deflation, with stagnant wages and falling house prices. In that environment, corporate profits for domestically focused firms will be squeezed, adding to the pressure on big firms, whose balance sheets are in good shape, to look to the East to invest. Thus, whilst the focus may be on protectionist measures across countries, the greater challenge may be the divergent pressures on workers and companies in the West, which in turn could trigger further populist policies. It is a complex situation.

## Policy

**2011 should see a further divergence in global economic policy, reflecting differing fundamentals around the world.** In 2011, the G20 will focus on currencies, global governance and commodities, with attention on the latter being on reducing volatility and the role of speculators. About a year ago, there was much talk of ‘exit strategies’. This has largely been overlooked but is clearly an important issue, as already seen in macroeconomic terms with the global consequences of quantitative easing (QE) in the US, and also evidenced in financial policies. Although the G20 has come to centre stage, it is possible that regional blocs may become more important in policy-making terms.

There has been a shift from co-ordination of global policy in the wake of the financial crisis to policy stances that now reflect divergent domestic factors.

**Chart 4: World inflation**

*Annual average rate, % (GDP-weighted)*


Sources: IMF, Standard Chartered Research

In macroeconomic terms, this looks set to continue in 2011. Whilst we expect inflation to trigger rising rates across the emerging world, in the West, monetary policy looks set to remain accommodative. We see no Fed tightening in 2011 or possibly even in 2012. More QE could occur. Likewise in the UK, though one can never rule out a small one-off hike. The European Central Bank, meanwhile, may drain liquidity and come under pressure from Germany to tighten.

There are policy risks. The nature of these varies across the globe: premature policy tightening in the West, and being too slow to tighten monetary policy in the East. The flow of capital into emerging economies could be sizeable, especially early in the year, prompting further use of capital controls, including taxes on inflows.

Across the globe, one might expect greater acceptance and use of macro-prudential tools, which allow specific measures to be targeted at certain areas to curb imbalances or domestic asset-price inflation (such as cash reserve requirements or loan-to-value ratios). Such tools may well be needed in countries that are tied to US monetary policy but that are seeing stronger growth.

**Currency policy may continue to make the headlines in 2011.** Something will have to give. As part of global rebalancing, there is a need for the West to save more, Asia to spend more, and currencies to adjust. All three components are important. In the longer run, we expect more countries to manage their currencies against a basket of currencies with which they trade.

This would, at some stage, point to the dollar-pegged currencies shifting to a more credible and sustainable exchange rate regime. As with the euro break-up story, it is hard to say exactly when this shift in currency policy would occur, but it should be factored into thinking. Indeed, if the euro did look like collapsing, this might speed up the shift to global currency baskets. This outlook favours increased holdings of emerging-market currencies, with the biggest beneficiary being the Chinese yuan (CNY). **Thus, the growth seen in the offshore CNY market in 2010 is likely to be a major story in 2011, leading to a focus on future holdings of the CNY.**

For other currency issues, it may be more of the same in 2011: gradual, controlled currency appreciation across many emerging economies; perhaps greater volatility in freely floating emerging-market currencies linked to asset-price movements; and in the West, the euro in difficulty and the dollar experiencing periods of strength whilst facing a downside slide versus Asian currencies.

# Global overview (con'd)

**One big issue in 2011 will be the effectiveness and consequences of regulation.** Basel III has already imposed future liquidity and capital requirements on banks, and although the implementation period has been extended, there is a perception that countries may adopt independent timetables, either speeding up the implementation schedule or imposing greater constraints. The unintended consequences of this difference in implementation at the national level are hard to quantify. Such uncertainty suggests the need to proceed gradually with reforms.

**Gradualism should also apply to the pace of fiscal tightening in the West.** There is clearly a need for a credible medium-term plan to reduce sizeable budget deficits. Less clear-cut is the speed and the scale at which fiscal tightening needs to be done. This is a judgement call that will vary across countries, dependent upon domestic conditions. Some countries that tighten fiscal policy may be damned if they don't, being penalised by the markets, but damned if they do, as growth disappoints. And for those that do tighten, low interest rates are essential to ease the pain.

## Risks

What are the extreme events that one should be wary of? That is, events unlikely to occur but which are still possible and should not be ruled out, and early signs of which need to be taken seriously. The key ones are: another financial crisis triggered by a weak economic outlook that makes it hard to roll over maturing bank borrowing or government debt; inflation bubbles across Asia if policy makers fail to act on already evident pressures; a deflation environment that triggers a collapse of the euro, with some countries leaving; or political problems as divergent economic outlooks force Western policy makers to adopt protectionist measures. We do not expect these extremes, or others, to occur in 2011.

**Table 1: GDP size, key countries and regions**
*2010 GDP (USD trn)*

| | | | |
|---|---|---|---|
| **World** | **62.3** | **Russia** | 1.3 |
| **US** | 14.6 | **G7** | 31.9 |
| **China** | 5.7 | **EU** | 17.0 |
| **Japan** | 5.2 | **Euro area** | 12.9 |
| **Germany** | 3.5 | **Latam** | 4.4 |
| **France** | 2.8 | **MENA** | 2.2 |
| **UK** | 2.3 | **Central and Eastern Europe** | 1.7 |
| **Brazil** | 1.8 | **ASEAN-10** | 1.7 |
| **India** | 1.4 | **Sub-Saharan Africa** | 0.9 |

Sources: IMF, Standard Chartered Research

But the fact that they could may add both uncertainty and volatility to financial markets, and possibly even create uncertainty for policy decisions over the course of the year.

**The biggest immediate worry in the West is a double-dip. We do not think it will happen.** The potential triggers would be another external shock such as sharply higher oil prices; a policy mistake, through premature tightening or regulatory overkill; or a loss of confidence, particularly if the recovery disappoints. The fact that the possibility of such events needs to be taken seriously is an indication of the greater degree of uncertainty than usual in the global economy.

Yet at the same time, there are upsides that should not be overlooked. The challenge is that the downsides could all be triggered by circumstances that would have an immediate impact. In contrast, many of the upside pressures stem from processes that are ongoing, and whose major impact will only be seen over time.

In addition, there are countless geopolitical risks. The second half of 2010 has witnessed a number of skirmishes in the South China Sea, driven by territorial disputes. In addition, the friction on the Korean peninsula has led to some military engagement between the two sides. There are other regions where tensions could resurface. In addition to this, the relationship between China and the US will be key.

Whilst so much uncertainty naturally leads to a cautious perspective, it might be very wrong to allow this to drive thinking in 2011. After all, the last year has shown that, despite all the problems, the world economy and global trade have grown. Thus our underlying message is positive.

## Conclusion

The near-term challenges for the world economy should not be underestimated. The fear of demand deficiency in the West is genuine as the policy stimulus wears off and as the overhang of debt points to further restraint. As Table 1 shows, the West still accounts for a considerable portion of the world economy. Despite that, there are also huge upside pressures. And we believe the world economy is on an upward path – but not always a straight line. Emerging economies account for one-third of the world economy but are accounting for two-thirds of its growth. This shift in the balance of economic and financial power looks set to continue, driven by their better fundamentals, policy actions and increasing confidence.

# Strategy

# Commodities

**Michael Haigh**, Global Head of Commodities Research
Standard Chartered Bank, Singapore
+65 6596 8255, Michael.Haigh@sc.com

**Abah Ofon**, Softs Analyst
Standard Chartered Bank, UAE
+971 4 508 3738, Abah.Ofon@sc.com

**Dan Smith**, Metals Analyst
Standard Chartered Bank, United Kingdom
+44 20 7885 5563, Daniel.Smith@sc.com

## Bullish momentum should continue

### Top trades of 2011

1. **Platinum to outperform gold.** Platinum has been outshone throughout most of 2010 by other precious metals. However, we expect the cyclical upturn in industrial activity to boost platinum demand, and prices are still a long way down from their early 2008 highs, suggesting plenty of upside. Also, investor interest in platinum has made a comeback in recent weeks. In contrast, we expect gold to be weighed down by a stronger US dollar (USD), and returning confidence in the economic outlook should result in diminishing safe-haven inflows. As a result, we expect platinum to outperform gold in the year ahead.

2. **Copper to outperform aluminium.** Copper prices have already bounced back a long way from their recessionary lows, but we believe that prices can rally further in the year ahead on the back of an improving economic environment and continued strong demand growth in China. By contrast, we believe that aluminium has been artificially boosted by optimism about physical ETFs and potential supply cuts in China. Much stronger fundamentals for copper support the outlook for continued outperformance.

3. **Soybean/corn ratio to move back towards five-year average.** Corn futures far outperformed soybeans in October 2010 on concern over disappointing US yields. The soybean/corn price ratio has reflected market anxiety, dropping more than 25% below its five-year average in mid-October. While this ratio has since improved on a decline in corn prices and strengthening soybean futures, it is still noticeably below trend. While we expect the grain market to be choppy ahead of year-end, we expect corn prices to consolidate at around USc 535/bushel in H1. Against this backdrop, we favour soybeans over corn, as soybean prices need to gain further to attract acreage. Moreover, the risk remains that the Latin American soybean crop may disappoint due to potentially drier-than-usual weather, which will be supportive of soybeans in 2011.

#### Standard Chartered forecasts: Commodities

| Annual average price | 2010 | 2011 | 2012 |
|---|---|---|---|
| Crude oil (WTI), USD/bbl | 80 | 90 | 95 |
| Copper (LME 3M), USD/t | 7,482 | 8,375 | 8,750 |
| Aluminium (LME 3M), USD/t | 2,184 | 2,213 | 2,300 |
| Corn (CBOT), USc/bushel | 424 | 536 | 526 |
| Soybeans (CBOT), USc/bushel | 1,062 | 1,438 | 1,200 |
| Gold (spot), USD/oz | 1,221 | 1,400 | 1,200 |
| Platinum (spot), USD/oz | 1,625 | 1,850 | 2,050 |

Source: Standard Chartered Research

### Key issues

- A key issue for the commodity markets in 2011 will be the ongoing effect of the most recent quantitative easing (so-called QE2). In some respects, the potential impact of QE2 may be bullish for commodities for three reasons: It will (1) lift demand for commodities; (2) undermine the USD, creating even stronger demand for commodities (although we do forecast a USD recovery in 2011); and (3) generate liquidity by driving assets out of bonds and into commodities.

- By early November 2010, commodities had extended their rally to a 25-month high, driven by a surging global appetite for food and fibres, which outpaced dwindling supply. Indeed, from early October to early November 2010, sugar rose about 30%, cotton rose more than 50%, and corn and soybeans both rose more than 20%. These increases in food prices have yet to show up in broader inflation measures but remain a key issue. We expect commodity demand growth to continue into 2011, with some markets experiencing severe supply constraints and/or low inventory levels. We therefore remain generally bullish across the commodity complex.

- Despite our bullish overall outlook, there are several key risks to commodities going into 2011. Dangers to the recovery include a withdrawal of fiscal stimulus in the US, QE2 not working, the re-emergence of a euro-area debt crisis, spending cuts by US state and local governments, and interest rate hikes in China in response to possible inflationary concerns, which could dent commodity demand.

- 2011 will also bring some regulatory changes to speculative activity in commodities markets. The US Commodity Futures Trading Commission (CFTC) is charged with drafting 30 sets of rules affecting

# Commodities

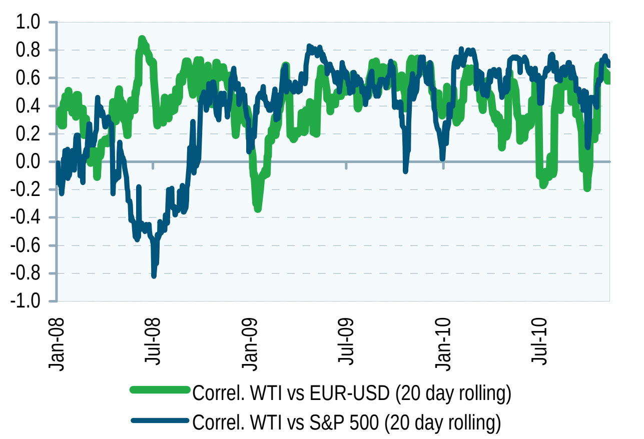
commodity markets and will impose limits on the number of contracts that a speculator may hold. Moreover, the CFTC will define what constitutes a bona fide hedging transaction, and higher margin levels may be introduced. These changes will affect speculators and hedgers. Details will be released by January 2011 for energy and metals markets, and by April 2011 for agricultural commodities. We should be prepared for a big move in commodities, especially if positions have to be cut and if traders move from US exchanges to new venues.

### Our key calls for 2011

- **Crude oil – more upside, but limited.** We forecast that the supply-demand balance will be relatively benign in 2011 and that the macroeconomic picture will continue to dominate. Oil prices were highly correlated with equity markets throughout 2010, and we expect this to continue. QE will continue to boost liquidity in oil, but the upside will be limited by the tolerance of the global economy for higher prices. From the demand side, we expect demand to moderate as the global economy loses some momentum, but we foresee a steady uptrend in 2011. While we expect non-OPEC supply growth and OPEC natural gas liquids (NGLs) to meet demand over the course of 2011, OPEC's price aspirations will also influence markets. We expect Brent to steadily move into the USD 85-95/barrel (bbl) range in 2011 and average USD 91/bbl over 2011, whereas WTI will average 90/bbl.

- **Base metals – bullish, nickel to underperform.** We have a bullish outlook for base metals for 2011. Copper and tin will trend higher on supply constraints. Copper demand growth is expected to moderate, but LME stocks should continue to fall, and overall market tightness will persist for the foreseeable future. Lead will rise due to both supply concerns and increased demand, and we expect a supportive environment for aluminium. For zinc, we expect a short-term pullback in prices into the New Year, but prices should move up again later in the year. Nickel will be the outlier in 2011 – we expect a balanced market over the course of the year, with prices rising moderately. The launch of ETFs is likely to provide support across all base metals. We believe this is a costly way to invest, and we expect an unenthusiastic response. While the introduction of the product may be bullish in the short run, we expect interest to drop subsequently.

**Chart 1: Macro sentiment will continue to dominate energy**



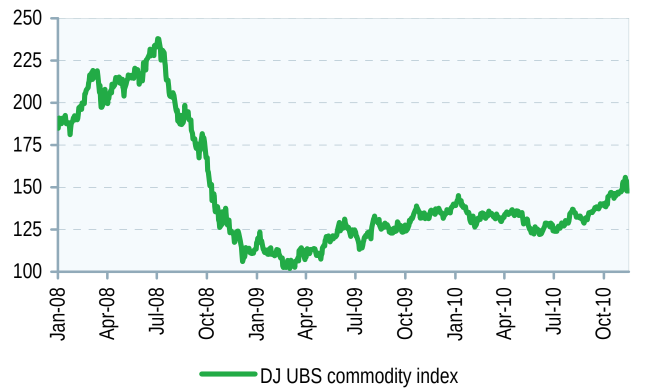

Sources: Bloomberg, Standard Chartered Research

- **Precious metals – expect strength.** Gold rallied strongly throughout most of 2010, but the momentum has slowed because of mixed fundamentals. We expect gold to trend higher in 2011 on the back of low US interest rates and uncertainty over the path of QE2. Silver has outperformed gold in 2010, but we believe a correction is due. The average gold/silver ratio for the last 30 years was 64; it now stands at 53, meaning silver is relatively expensive. For the PGMs, we believe that palladium will outperform platinum, as palladium's fundamentals still look relatively strong. In particular, China's auto sector is showing strength and tends to favour palladium due to the significant number of gasoline cars in the country.

- **Agriculture – mixed outlook.** 2010 was a tale of two halves for the agricultural sector. Record prices were achieved on collective weather-induced events resulting in sub-par supply, exacerbated by declining stocks. Sugar touched 30-year highs, and cotton had a blistering rally, achieving its highest price ever. For 2011, the outlook is mixed. We expect both cotton and sugar prices to moderate as inventories (sugar) and acreage (cotton) increase. The grain market will be choppy, but corn prices should remain elevated in H1-2011 on thin global stocks. Soybeans should outperform relative to corn, and wheat is likely to stay high at least through Q1-2011. While higher wheat prices in Q2-2010 stoked fears of a return to 2007/08 levels, we do not expect the wheat market to rally to those levels. We forecast that wheat prices will average 634 USc/bushel in 2011, but until global wheat acreage recovers, we expect prices to remain volatile.

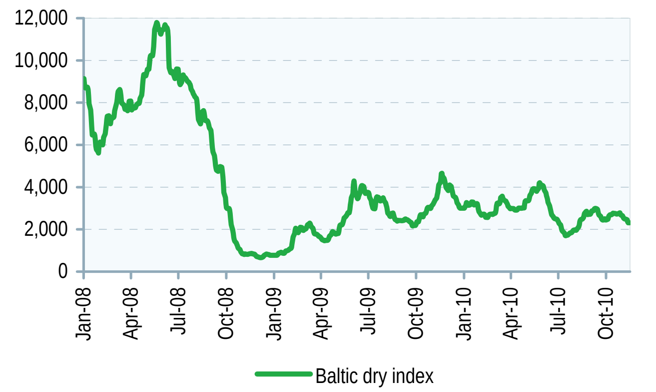
# Commodities – Charts of the year

**Chart 1: Commodity prices have picked up and should trend higher in 2011**



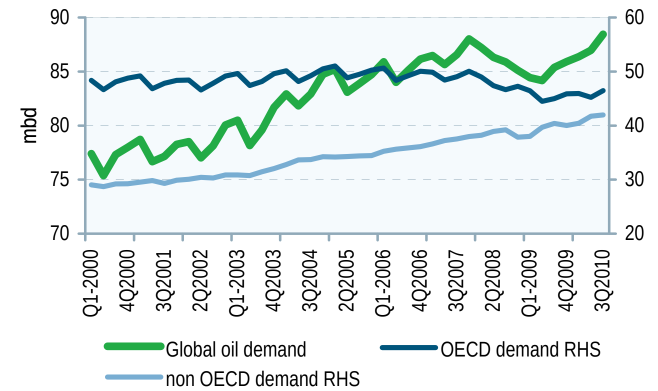

Source: Bloomberg

**Chart 2: Freight rates continue to move sideways, despite a supply overhang**



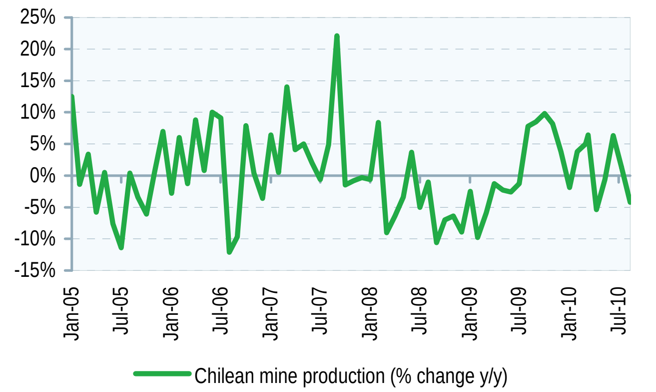

Source: Bloomberg

**Chart 3: Oil demand has now returned to pre-financial crisis levels, driven by non-OECD**



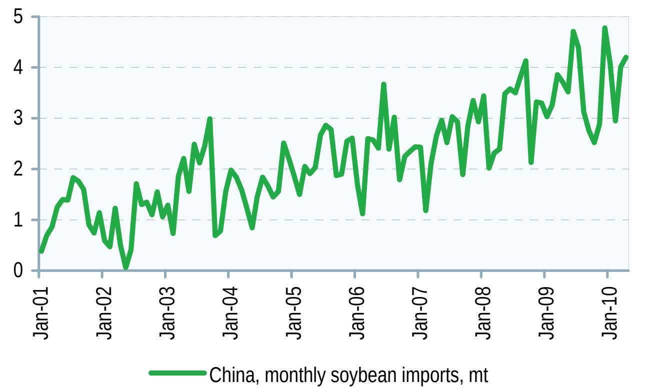

Sources: IEA, Standard Chartered Research

**Chart 4: Chile's copper production growth is still erratic and will struggle to keep up with demand**




Source: Bloomberg

**Chart 5: China's monthly soybean imports are expected to soar as crushers enjoy higher soyoil demand**




Sources: Bloomberg, Standard Chartered Research

**Chart 6: Gold/silver ratio suggests silver may correct**


Sources: Bloomberg, Standard Chartered Research

# Credit

**Kaushik Rudra**, Global Head of Credit Research
Standard Chartered Bank, Singapore
+65 6596 8260, Kaushik.Rudra@sc.com

## Middle East credit offers compelling value

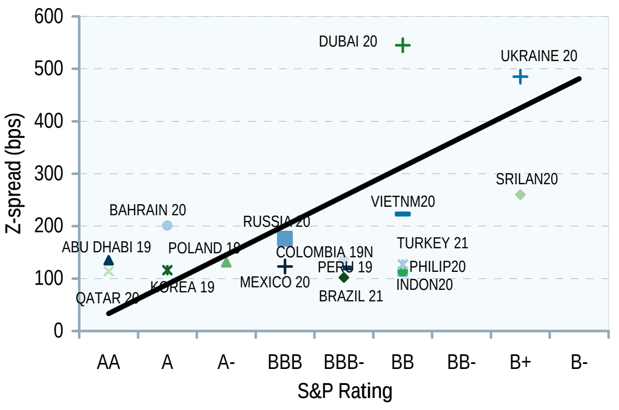
### Top trades of 2011

1. **Middle East credit offers attractive value:** Investors' continued wariness towards Middle Eastern quasi-sovereigns in the wake of the Dubai World restructuring has caused a number of these issues to trade wider to their respective sovereigns than comparable quasi-sovereigns in Asia. For this reason, Middle Eastern paper offers relative value. The Qatar Inc. space remains our favourite. We recommend the Qatar sovereign, the explicitly guaranteed Qatari Diar bonds and the Abu Dhabi quasi-sovereign Mubadala bonds.

2. **Asian higher-yielding paper will continue to perform:** We expect select high-yield (HY) corporates out of China and Indonesia to continue to perform well. In the Chinese HY property space, our top picks include the Country Garden 2017s, the Evergrande 2015s and the short-dated Hopson 2012s. In the Indonesian resources space, we like the Bumi Resources 2016s. We also recommend a switch out of the Indosat 2020s into the Adaro 2019s. Even among the financials, we expect the Tier 1 bonds – and specifically Indian Tier 1 issues such as the ICICI '49s and SBI '49s – to perform well.

3. **Asian quasi-sovereign paper trades cheap:** In our view, quasi-sovereign paper out of Indonesia, Korea and Malaysia trades cheap on a relative basis. In the HY sovereign space, we continue to like the PLN bonds. In the high-grade (HG) space, we like Korea Electric and Korea Hydro and Nuclear Power 5Y bonds out of Korea and the Petronas bonds (2014 sukuks and 2019s) out of Malaysia.

**Chart 1: Middle East appears cheap for its rating**




Sources: Bloomberg, Standard Chartered Research

### Key issues

- We are constructive on the Asian and Middle East credit markets. Although valuations appear stretched across the board, the fundamental and technical picture for emerging markets (EM) is very supportive.

- Emerging markets continue to drive global growth for the time being. Little growth can be expected from the developed world – especially economies like the US, the euro area and Japan. Although economic growth is going to be very weak and is unlikely to result in significant job creation, we do not expect a double-dip in the US.

- Weak employment generation, however, means that the output gap will remain large for the time being. This will likely ensure that the major central banks (Federal Reserve, European Central Bank, Bank of England and Bank of Japan) keep rates and monetary policy accommodative for the time being.

- In our view, these policies are likely to continue to fuel the search for yield that has been seen throughout 2010. EM debt funds have received record inflows in 2010, and we expect this dynamic to continue in 2011. With EM – in particular Asia and the Middle East – continuing to be the growth engine of the world, fund flows into these regions are likely to remain strong next year.

- EM bond funds have attracted close to USD 50bn on a year-to-date basis. This dwarfs the previous highest year of inflows (USD 9.7bn in 2005) by a factor of 5. HY bond funds have also had a strong year, drawing in more than USD 28bn in 2010. This is despite the May market wobble, which saw the sector lose funds to redemptions. Similarly EM equity funds have had a strong year of inflows, attracting close to USD 73bn, according to EPFR data. Strong inflows help to explain the very strong relative performance of these markets.

- Asia and the Middle East also continue to be generators of the marginal savings dollar globally. With a strong local bias in place, the debt markets of both regions are finding very strong support from the local bid. Private banks in Asia in particular continue to be a very important driver of the region's HY markets.

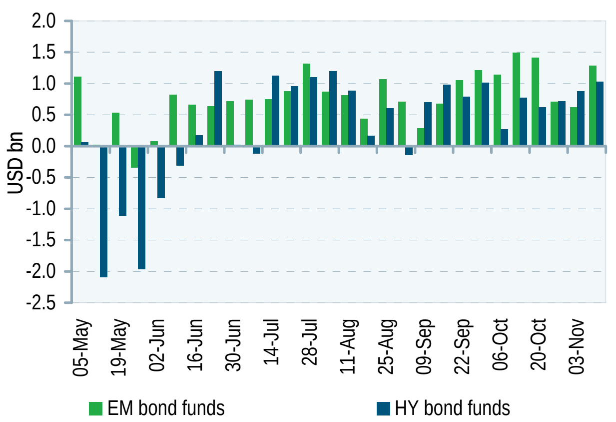
# Credit

- The size of these flows needs to be viewed in the context of the size of the markets. As of mid-2010, the size of the Asian credit markets was equivalent to around USD 330bn. The size of the Asian HY markets was a relatively small USD 26bn. The inflows witnessed in 2010 (year-to-date inflows into EM bond funds stood at around USD 42bn as of end-September, according to EPFR data) are very large in the context of the size of the market, and are sufficient to impact the market from a valuation standpoint.

- With relatively tight spread levels and historically tight US Treasury (UST) yield levels, current levels remain very attractive for potential issuers from an all-in cost standpoint. This has resulted in about USD 70bn in issuance in the Asian credit markets in 2010. Total EM issuance of foreign currency-denominated debt stands at around USD 278bn on a year-to-date basis. Asian net new issuance has totaled around USD 34bn (redemptions in 2010 were equivalent to USD 36.5bn). A number of first-time issuers came to the market in 2010, with issuance back-loaded due to the market wobble in May. We expect the current pace of issuance to continue, at least in the first half of 2011. Similar to 2010, we expect more first-time issuers to come to the market in 2011. Redemptions from the Asian credit markets for 2011 total around USD 34.5bn.

- Although issuance in 2011 is expected to be large, we expect the market to be able to absorb the supply given the continuing strength of inflows. The contest between supply and inflows is likely to result in a range-bound market – with a slight bias towards tighter spreads.

**Chart 2: EM and HY bond fund inflows accelerate**




Sources: EPFR Global, Standard Chartered Research

- The clear challenge for investors will be to find sectors and names that offer compelling value. Most markets appear fully valued to us. For the most part, only names that have fundamental negative issues remain cheap from a spread and yield perspective. In our view, Asian credit markets are fairly valued at this point. Although spreads are arguably tight on a relative basis, the region continues to find support on the back of strong fundamentals and very supportive fund flows.

- In the Asian credit space, we continue to favour bank Tier 1 paper among financials, and select HY names and quasi-sovereigns from Korea and Indonesia among corporates. We do not see a lot of value in Asian sovereign paper at current levels.

- The Middle East stands out in terms of valuations. The regional sovereigns trade wide to their peers, both in their rating classes and when compared to lower-rated EM sovereigns. Similarly strong standalone quasi-sovereign credits from the region offer value on both an absolute and a relative basis.

### Risks

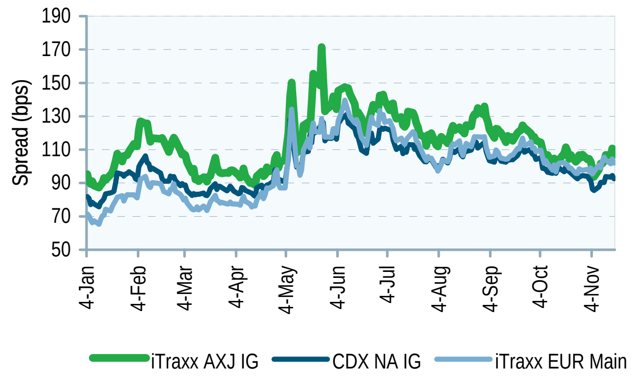
- With relatively tight spread levels, the movement in UST yields remains one of the biggest risks to credit markets – and to HG credit markets in particular. With investors expecting a steady dose of quantitative easing (QE), positioning in the UST market space remains fairly crowded. Moreover, investors are long long-dated credit markets with a view to playing UST rates compression. We remain concerned about the risk of a significant yield back-up, which could cause investors to sell credit markets. Although we do not expect a strong recovery in the US, stronger economic data remains a risk to the UST markets.

- The financial health of the European sovereigns – in particular those of Greece, Ireland, Portugal and Spain – remains a potential risk for credit markets. While developments in Greece are to some extent in the price, we anticipate that headlines on the subject will be a source of persistent risk to the market. We also expect market players to use the negative headlines as an excuse to take profits from time to time – especially given the relatively stretched valuations in the credit space.

# Credit – Charts of the year

### Chart 1: Credit spreads are flat for 2010

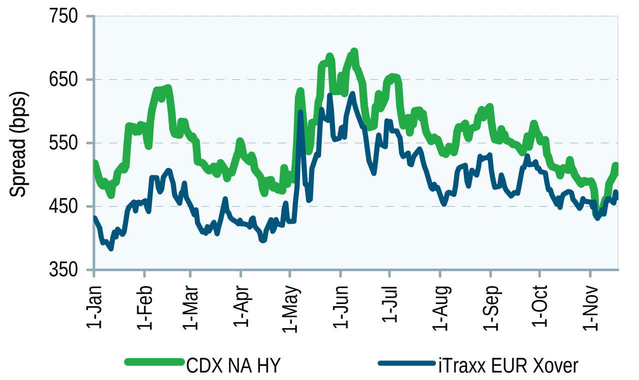
*iTraxx AXJ IG vs. CDX NA IG vs. iTraxx EUR Main*




Sources: Bloomberg, Standard Chartered Research

### Chart 2: Credit spreads are flat for 2010

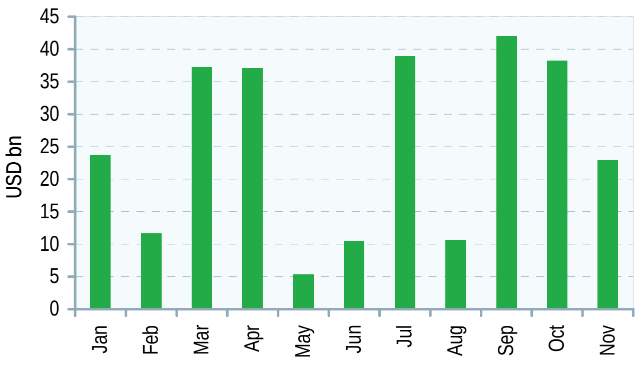
*CDX NA HY vs. iTraxx EUR Xover*




Sources: Bloomberg, Standard Chartered Research

### Chart 3: EM issuance picked up in H2-2010

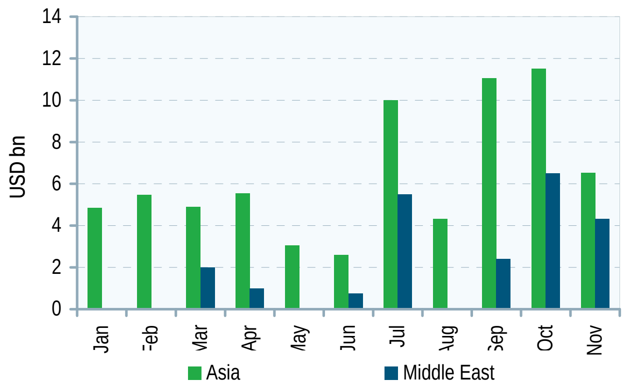
*EM hard-currency bond issuance YTD 2010*




Sources: Bloomberg, Standard Chartered Research

### Chart 4: Asia and Middle East issuance is healthy

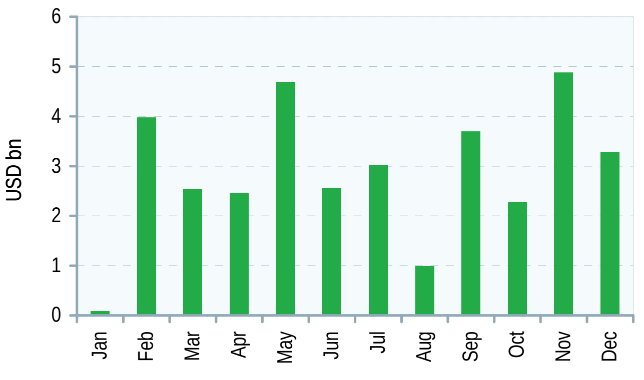
*Asia and Middle East hard-currency bond issuance YTD 2010*




Sources: Bloomberg, Standard Chartered Research

### Chart 5: Asian hard-currency bond redemptions

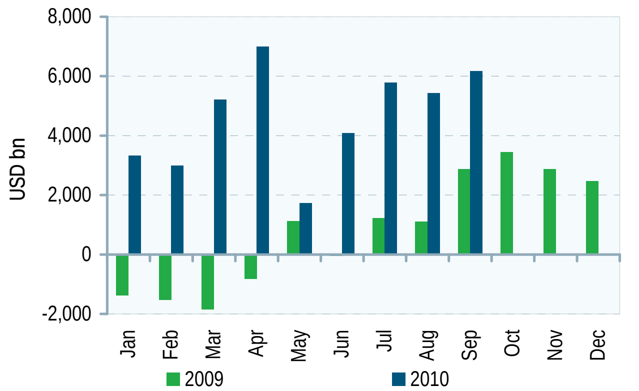
*Expected bond redemptions in 2011*




Sources: Bloomberg, Standard Chartered Research

### Chart 6: EM bond funds see record inflows in 2010

*EM bond monthly flows, 2009 and 2010*




Sources: EPFR Global, Standard Chartered Research

# FX

**Callum Henderson**, Global Head of FX Research
Standard Chartered Bank, Singapore
+65 6596 8246, Callum.Henderson@sc.com

## A tale of two cities – once again

### Top trades of 2011

1. **Short EUR-KRW.** We expect the Korean won (KRW) to be the best-performing AXJ currency in 2011 against the US dollar (USD) on strong growth, strong external balances, monetary tightening and still very attractive valuation. While the down-move in USD-KRW in H1-2011 is likely to be bumpy given global market volatility, the trend remains for further KRW appreciation. Meanwhile, we forecast renewed weakness in EUR-USD in H1-2011 on weaker euro-area growth prospects and renewed sovereign debt concerns in the region. We forecast EUR-KRW at around 1,333 at end-2011.

2. **Long CNY-JPY.** We expect the pace of Chinese yuan (CNY) appreciation to pick up in 2011, particularly in H1, on growth reacceleration, strong external balances and rising CPI inflation. Meanwhile, throughout 2011, we expect USD-JPY to break higher as the impact of the Fed's 'QE2' gradually fades, while the Bank of Japan (BoJ) continues to provide excess liquidity to the market. Meanwhile, the upturn in global PMIs is a fundamental negative for the Japanese yen (JPY). We forecast CNY-JPY at 15.16 at end-2011.

3. **Short EUR-INR.** We remain bullish medium-term on the Indian rupee (INR) given strong growth, higher policy interest rates and the prospect of a narrowing of the current account deficit in FY11. USD-INR may see some volatility in H1-2011 due to fickle risk appetite. However, we see short EUR-INR as a better trade given prospects for trade-weighted appreciation in Asia ex-Japan (AXJ) currencies.

#### Key G10 and EM FX forecasts

*USD strength in H1, weakness in H2*

| 2011 | End-Q1 | Q2 | Q3 | Q4 |
|---|---|---|---|---|
| EUR-USD | 1.28 | 1.20 | 1.26 | 1.30 |
| USD-JPY | 87 | 90 | 92 | 94 |
| USD-CNY | 6.49 | 6.37 | 6.28 | 6.20 |
| USD-IDR | 8,900 | 9,100 | 8,800 | 8,500 |
| USD-INR | 44.00 | 45.80 | 44.20 | 43.00 |
| USD-KRW | 1,075 | 1,100 | 1,050 | 1,025 |

Source: Standard Chartered Research

### Key issues

- Our economic backdrop of a modest deceleration in global growth, coupled with relatively benign inflation in the G3 countries and rising inflation in the emerging markets (EM), suggests that 2011 will be another year of high volatility and large swings in FX markets.

- More specifically, we expect 2011 to again be 'a tale of two cities' to some extent, as we saw in 2010 – US dollar (USD) strength in H1, particularly against G10 currencies, and a reversion to trend weakness in H2.

- In H1-2011, we expect the USD to receive support from reduced global growth expectations due to basing effects, US consumer deleveraging, some US fiscal tightening, faltering European growth and valuations. Weak US M2 growth – and reports that no-longer-published M3 is contracting – confirms that the Federal Reserve has its work cut out for it to produce a sustained economic rebound in the face of consumer saving.

- In H2-2011, we expect a reversion to trend weakness in the USD. We remain of the view that the USD is seeing another multi-year downtrend similar to the early 1990s and 1970s. The usual response to US recessions has been major monetary and fiscal easing, and this time is different only in its magnitude. Fed QE2 will continue through end-Q2-2011 and there is a risk of 'QE3' if the former is insufficient to raise economic expectations.

- European growth outperformed the US in Q3- and early Q4-2010, leading to an unfavorable move against the US in rate spreads and driving down the USD. More recently, negative economic surprises have started to increase in the euro area. European debt concerns have also started to pick up again. We expect these factors to see more sustained EUR weakness in H1-2011.

- Year-end profit-taking may keep EM currencies slightly more on the defensive in general heading into year-end. However, the structural story for EM – multi-year growth outperformance, stronger domestic and external balances, and higher potential underlying asset returns – remains very much in place. As such, we remain bullish on EM currencies generally, depending on considerations such as valuation, external balances and FX policy.

# FX (cont)

- The underlying drivers of further appreciation of AXJ currencies in 2011 remain firmly intact, including: (1) growth outperformance, (2) widening US-AXJ interest rate spreads, and (3) strong external balances. The biggest risk to our bullish AXJ view is that AXJ central banks will fall behind the curve of an eventual inflation shock. With AXJ currencies now more sensitive to inflation given foreign inflows to AXJ local bonds, this is a key threat – though we expect inflation to remain broadly contained in 2011.

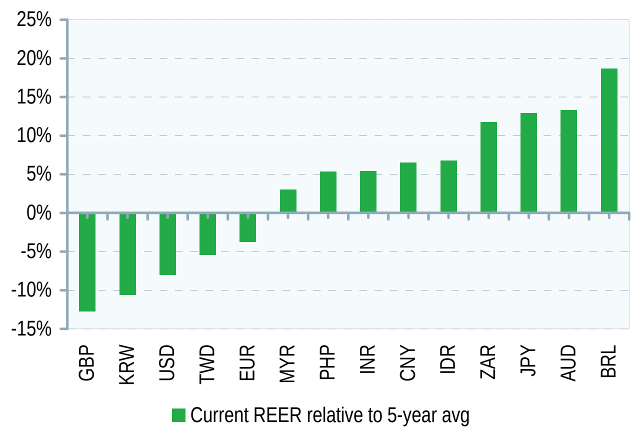
- Another key focus will be the risk of more capital controls in EM countries. In AXJ, this risk appears greatest in Korea, Taiwan, Thailand and the Philippines. However, this is unlikely to stop the trends of capital inflows into the region, build-up of reserves, and currency appreciation.

- Within AXJ, we expect North East Asian (NEA) currencies to out-perform South East Asian (SEA) currencies due to large external surpluses, monetary tightening and better valuation. South Asian currencies are likely to fall between the two in terms of performance.

- From a macro perspective, two key AXJ focuses for 2011 will be (1) the China slowdown and (2) strength elsewhere, notably in India and Indonesia. We expect China's growth to continue to moderate in Q1-2011 on slower trade growth and real-estate construction. Moreover, we look for the People's Bank of China to tighten policy further in response to inflation. More positively, we expect growth to improve from Q2-2011 after fixed asset investment projects initiated in the 12th Five Year Plan get started.

**Chart 1: BIS REEER versus 5-year moving average**

*BRL is overvalued, KRW undervalued*




Sources: BIS, Standard Chartered Research

- Given the inflation threat in China, we expect a sharp pick-up in the pace of CNY appreciation in 2011, notably in H1 – not just against the USD, but also on a trade-weighted basis. The CNY nominal effective exchange rate (NEER) actually fell in H2-2010 against the euro (EUR), as well as most Asian currencies.

- CNY appreciation should be a particular boost for NEA currencies, notably the KRW. We expect the KRW to be the best-performing AXJ currency against the USD in spot terms – though not in risk-adjusted terms – given strong external balances, monetary tightening and valuation. While the Korean authorities are likely to temper currency appreciation through persistent FX intervention and further capital-flow measures, these moves are unlikely to stop trend KRW appreciation.

- In SEA, we expect the best performers to be the Philippine peso (PHP), Singapore dollar (SGD) and Indonesian rupiah (IDR). Strong growth and solid external balances should continue to provide fundamental support for the PHP and IDR. We expect the Monetary Authority of Singapore (MAS) to maintain a tight FX stance in 2011, with the risk skewed towards more tightening. We expect the Malaysian ringgit (MYR) and the Thai baht (THB) to underperform given slowing growth, deteriorating external balances and FX policy.

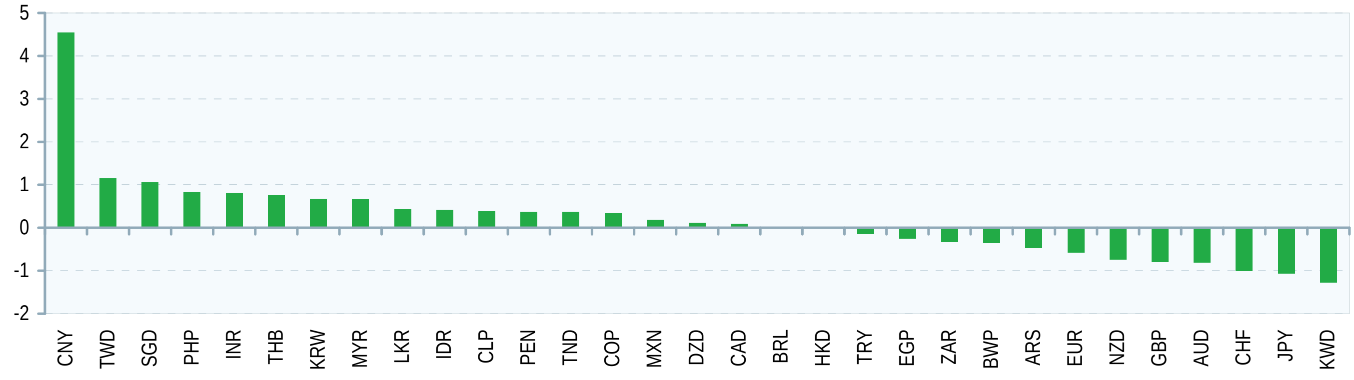
- South Asia is likely to show mixed performance – between those of NEA and SEA. We remain constructive overall on the INR given high policy rates and stronger growth in 2011. The INR typically does well in calendar Q1 given strong seasonal inflows. However, the 2011 trend in USD-INR is likely to be choppy, as global uncertainty may weigh on capital flows, on which the INR continues to depend for current account financing. We also expect the Sri Lankan rupee (LKR) to appreciate on continued foreign interest in Sri Lankan markets.

- The Brazilian real (BRL) has traded in a tight range in 2010 and faces increasing challenges, including possible further capital measures in 2011. First, growth is expected to ease back to more inflation-neutral levels as stimulus fades. Second, the current account deficit will pose a major challenge. Third, fiscal policy will remain an important focus. In sum, we do not think that long BRL is a good risk/reward trade for 2011, not least because there is much better value in the Mexican peso (MXN).

# FX – Charts of the year

### Chart 1: AXJ to outperform, G10 to underperform

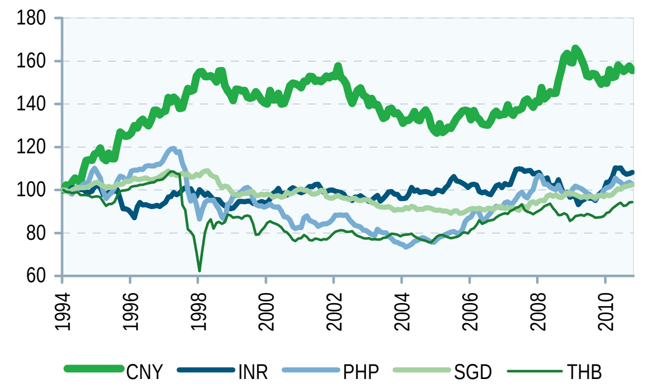
*Forecast risk-adjusted spot return versus USD in 2011, % (adjusted for average daily historical volatility over last 5 years)*




Sources: Bloomberg, Standard Chartered Research

### Chart 2: CNY REER to rally in 2011

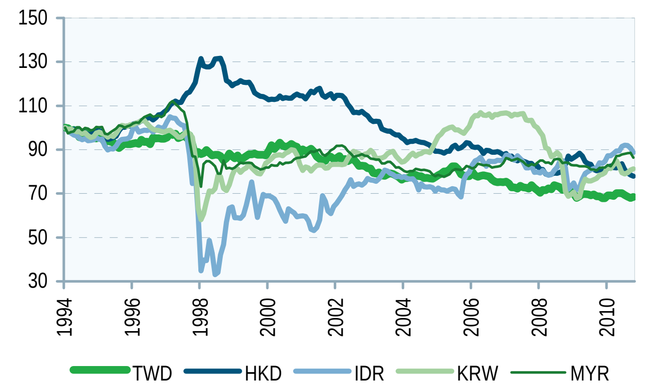
*AXJ REERs: Top 5 performers*




Sources: BIS, Standard Chartered Research

### Chart 3: KRW and TWD to catch up in 2011

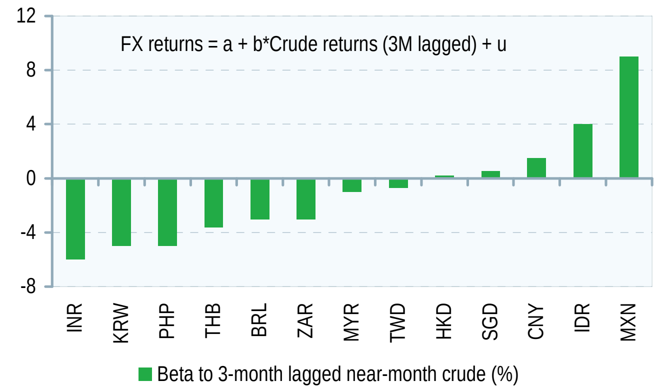
*AXJ REERs: Bottom 5 performers*




Sources: BIS, Standard Chartered Research

### Chart 4: FX sensitivities to crude prices

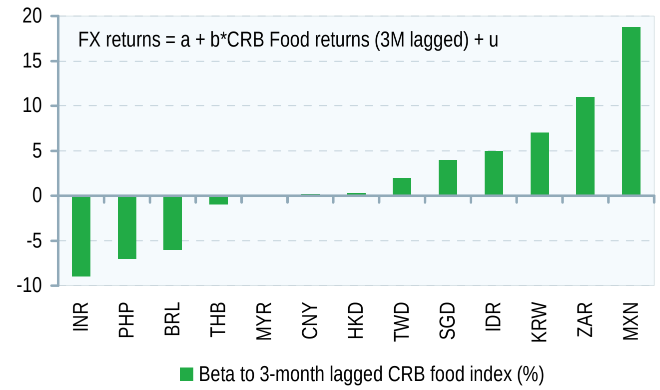
*MXN to benefit most from higher crude; INR at greatest risk*




Sources: Bloomberg, Standard Chartered Research

### Chart 5: FX sensitivities to food prices

*Higher food prices most negative for INR; KRW to benefit*




Sources: Bloomberg, Standard Chartered Research

# Rates

**Will Oswald**, Head of FICC Research
Standard Chartered Bank, Singapore
+65 6596 8258, Will.Oswald@sc.com

## Positioning in a highly correlated world

### Top trades of 2011

1. **Stay long carry across EM local-currency debt, but close to benchmark.** Local-currency government bond markets remain highly correlated, suggesting little value in significant diversification. With the outlook for US Treasuries (USTs) flat through 2011 and emerging-market (EM) debt trading at a stable spread for the past 16 months, most returns will come from carry.

2. **Hold long 10Y UST.** We see the recent back-up in US 10Y yields as predominantly a position-adjustment move. While some of the recent macro data have been more positive, underlying growth dynamics remain weak, while the easing in credit conditions seen in Q2-2010 appears to have flattened out in Q3. With the Fed absorbing much of the new supply, we expect the downward trend to continue.

3. **Maintain long positions in countries with stronger fiscal balance sheets.** Resilience is likely to persist where balance-sheet adjustments are not required, predominantly in Asia and parts of Latin America. By contrast, Central European markets have higher food-price inflation risks because of FX performance and are more at risk from European sovereign debt resolution.

4. **Hold linkers**. While real yields in many markets are not at especially cheap levels versus historical pricing, tail risks arise from continued commodity price inflation and the small output gaps now seen in many EM economies.

### Key issues

- Global government bond yields remain highly correlated, with the spread between EM local-currency bond yields and both USTs and Bunds range-bound since July 2009. The primary risk, then, is a broad-based unwinding of rates exposure.

- We see the strong performance of fixed income as being partly driven by structural adjustments. For example, pre-credit crunch, US defined benefit private-sector pension schemes held 60% of their assets in equities and 20% in fixed income; the position has now shifted, with fixed income at 40% and equities at just 34% – a relative positioning not seen since data on this sub-sector started in 1985. This shift has been partly a function of regulatory changes (the Pension Protection Act of 2006), but also the impact of baby boomers retiring and equity holdings generating low cash flow.

- The tight trading range for EM bond yields versus Bunds and USTs partly reflects the better balance-sheet positions of EM countries, with lower fiscal deficits and debt/GDP ratios than in developed markets. The close tracking behaviour suggests that price volatility in EM is trading as a flight-to-quality instrument, but at a 400bps pick-up.

- Allocations to EM fixed income instruments are also coming from a very low base. US defined benefit pension plans had just 0.25% of their portfolios allocated to EM debt as of September 2009, according to the P&I/Watson Wyatt annual survey. The picture is similar in Europe: only 0.1% of UK pension funds had any exposure to EM debt in the 2010 Mercer survey; of these funds, the average allocation was just 2.0%, giving an overall allocation of just 2bps. In other European plans, the picture is only marginally better: 4% have EM debt allocations, with the average allocation of those funds at 4.2%, giving an industry-wide average of 0.17%.

- We anticipate that USTs will be broadly range-bound throughout 2011. Our US growth forecast remains below consensus, and we have pushed back our forecast for the first Fed rate hike to Q1-2013. The output gap remains significant, while the relationship between non-farm payrolls and jobs advertised suggests that a significant skills gap is emerging. With QE2 likely to keep yields broadly range-bound, the US backdrop should also be supportive of EM.

- We do not foresee a resolution of European sovereign debt issues in 2011. The shift towards debt sustainability requires a multi-year adjustment in primary fiscal balances against a backdrop of limited competitiveness gains via the exchange rate (given the extent of intra-euro-area trade). A positive and definitive resolution appears unlikely, suggesting that European sovereign credit concerns will remain a persistent feature throughout 2011.

# Rates (cont)

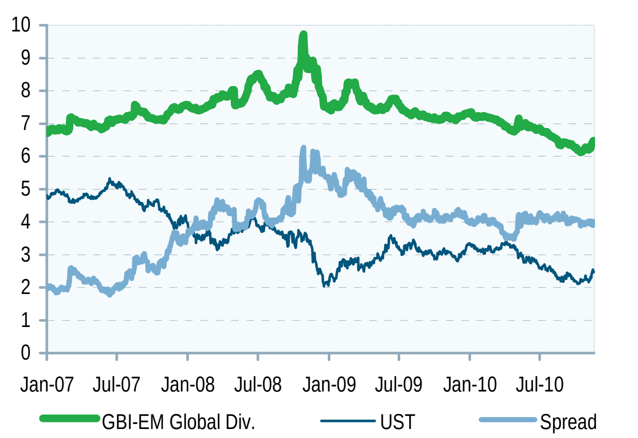
- The combination of weak growth and balance sheets in developed markets with a stronger economic rebound and better balance sheets in EM has contributed to strong inflows to EM in 2010. With asset allocations switching from equities into fixed income, the net impact has been unprecedented inflows to EM debt instruments, especially in local currency.

- While EPFR data reflect only a portion of all flows into EM debt, inflows have nevertheless been extremely impressive. Local-currency funds had received USD 25.6bn of inflows year-to-date in 2010 as of 12 November, more than their assets at the beginning of the year; total EM debt inflows had reached just under USD 50bn.

- The shift of money into EM local-currency debt has not just generated stability in spread terms for USTs and Bunds, it has also contributed to high correlations between local-currency markets. We have estimated diversification within local-currency debt by taking a sample of 10 local bond markets, expressed in USD-unhedged terms (Malaysia, Thailand, Korea, Indonesia, South Africa, Brazil, Hungary, Poland, Russia, Mexico and Turkey). We have then calculated the ratio of the 30-day rolling volatility of an equally weighted portfolio of these 10 countries to the sum of the volatility of each of the country sub-indices. This ratio shows the extent to which holding a portfolio provides diversification benefits. This ratio has been persistently at around 70% and rose to 90% in May 2010, emphasising the high degree of correlation.

- Increased foreign ownership shares have been a common feature across almost every EM local market, with a continuing rise since mid-2009. Two of the strongest increases have been in Asia: Indonesia (from 14.6% to 30.3%) and Malaysia (12.4% to 26.8%). In both countries, foreigners have accounted for more than 100% of the increase in debt stock year-to-date (the same occurred in Poland, where foreign ownership rose from 13.6% in mid-2009 to 24.9% as at end-September 2010).

**Chart 1: EM yields have followed UST yields closely since mid-2009**




Sources Bloomberg, Standard Chartered Research

- The high correlation between markets, the importance of pricing relative to Bunds and USTs, and increasing foreign ownership all suggest that correlations will remain high and that global factors will remain significant in price determination.

- The greatest risk we see to fixed income in broad terms is supply-driven inflation. The UN FAO Food Price Index rose again in October, bringing the increase in food prices since end-June to 21%. Although in USD terms this is below the mid-2008 peak, the broad USD index is marginally stronger; in EUR terms, the Food Price Index is at a record high.

- In our November 'Global Focus', we highlighted the risks from food-price inflation to EM fixed income, and these risks remain. As we discussed then, EM currencies are positively correlated with global commodity prices, given that emerging markets in aggregate are net commodity exporters. This relationship dampens the impact of imported food-price inflation.

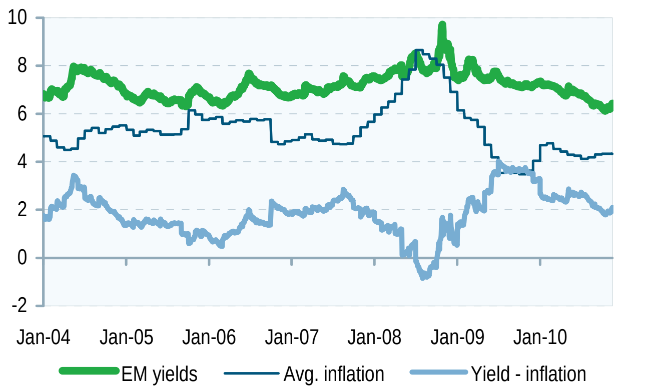
- The significant negative, however, is the high share of food and energy in EM CPI baskets. According to our estimates, the average weighting of food across the GBI-EM Global Diversified (the main benchmark local-currency bond benchmark) is 25.6%; for energy, it is 11.8%.

- Food-price inflation had a strong relationship with EM bond yields until mid-2008, when significant divergence emerged. This divergence is explained partly by the low level of global demand-driven inflation and the limited pick-up in headline inflation to date. However, with output gaps in many emerging markets already closed, the risks from sustained supply-driven inflation remain significant, as the potential for second-round inflation is higher than in developed markets.

- Real yields (we use GBI-EM Global Diversified yields versus weighted average headline inflation) remain at 2% and have been lower in the past. However, the cushion is not significant.

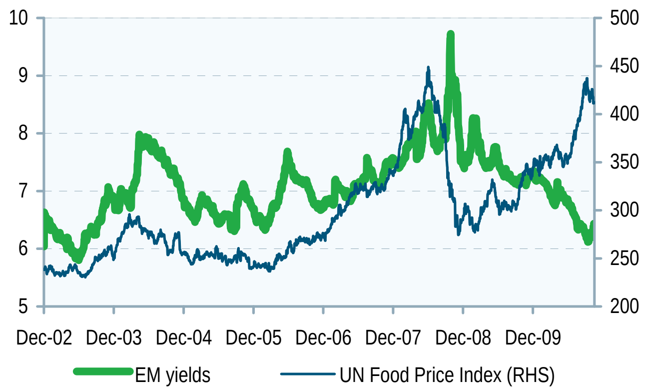
# Rates – Charts of the year

### Chart 1: EM real yields have declined sharply



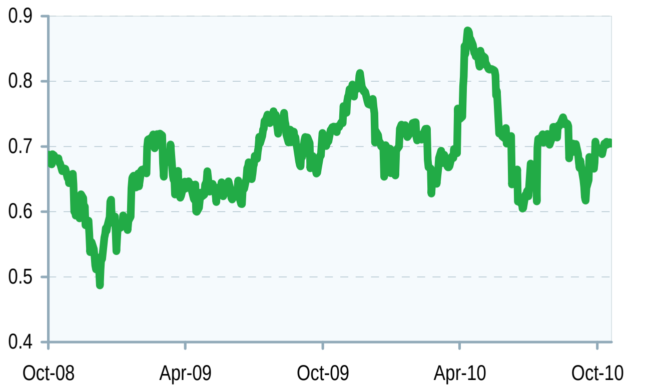

Bloomberg, Standard Chartered Research

### Chart 2: EM yield/food price relationship diverges widely



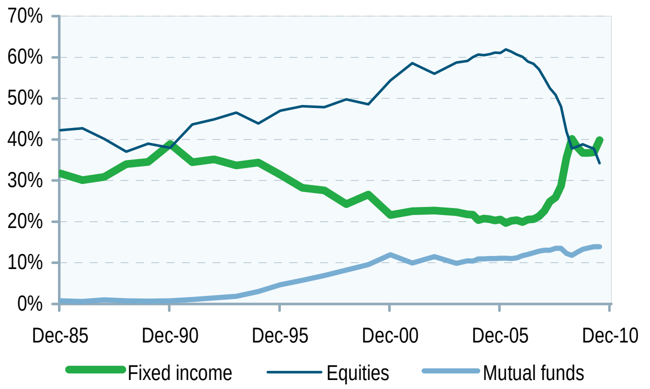

Source: Bloomberg

### Chart 3: Local-currency debt exhibits little diversification



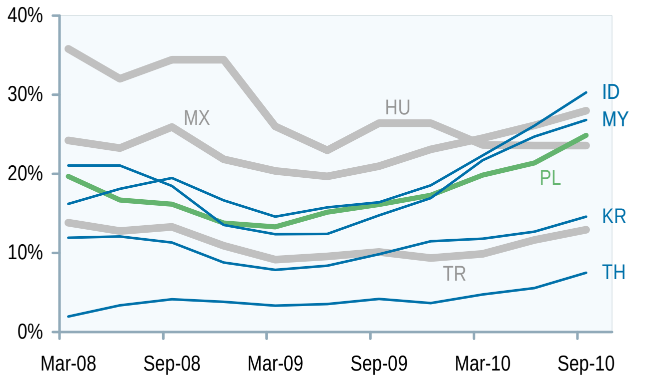

Sources: Bloomberg, Reuters, Standard Chartered Research

### Chart 4: US private defined benefit funds have switched aggressively from equities to fixed income



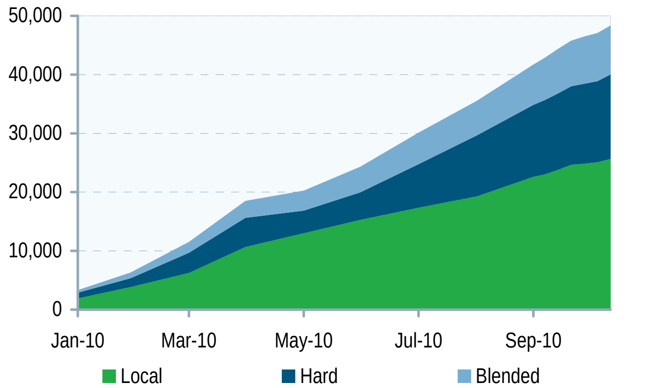

Source: Federal Reserve

### Chart 5: Indonesia and Malaysia have seen particularly strong increases in foreign ownership of local debt




Sources: National sources, Standard Chartered Research

### Chart 6: EM bond fund inflows have been strong, particularly to local markets *(USD mn)*




Source: Emerging Portfolio Research

# Sovereign risk

**Christine Shields**, Head of Country Risk Research
Standard Chartered Bank, United Kingdom
+44 20 7885 7068, Christine.Shields@sc.com

## Sovereign risk to the fore

### Ratings outlook

- The sovereign ratings environment has resumed the pre-crisis trend, whereby ratings upgrades comfortably exceed downgrades, though the number of upgrades is still slightly lower than pre-2007. However, the uncertainty has not yet passed, and there are still more negative than positive outlooks in some regions.

- Most notable are the industrial countries, where some of the highly indebted peripheral euro-area sovereigns may face further ratings downgrades. Despite broad adherence to their fiscal consolidation programmes, Greece and Ireland, in particular, still face serious challenges.

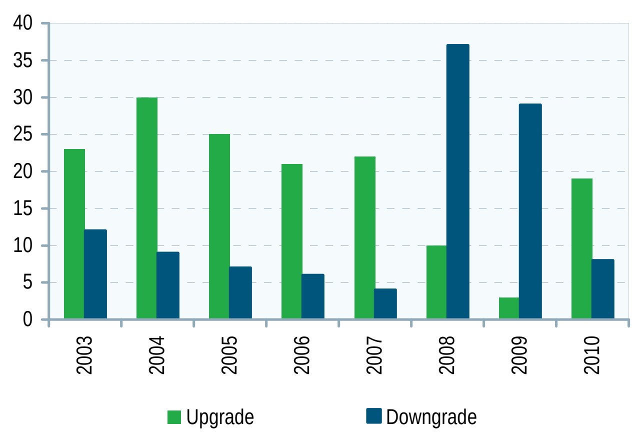
### Euro area will remain centre-stage

- In the case of Greece, the deficit target of 8% of GDP for 2010 looks likely to be missed, and the 2009 shortfall appears to have been even larger than previously reported. EU and IMF officials are currently assessing whether the next tranche of the support package can be released, given the scale of the slippage – the full-year 2010 budget deficit is likely to be 9.4% of GDP, a significant breach.

- This is despite the fact that the government has pushed ahead with politically difficult decisions, even though local and regional elections were recently held. Strong support for the ruling PASOK in these polls suggests that the government has a mandate to undertake further fiscal cuts and structural reform.

- In Ireland, despite no new finance being required until mid-2011, markets have driven spreads sharply higher. This, together with political pressure from within the euro area – principally Germany – finally forced the Irish government to formally request support from the European Financial Stability Mechanism and the European Financial Stability Fund. The package is still being finalised, but will likely provide around EUR 90bn under a three-year, highly conditional programme. Until the details emerge, the scale of the impact on the real economy cannot be determined, but there are serious downside risks to the outlook for growth. Longer-term – as in Greece – a question mark remains over whether debt will need to be restructured.

**Chart 1: Ratings upgrades/downgrades, 2003-10**




Sources: Standard & Poor's, Standard Chartered Research

### Will the tensions spread?

- The key question is whether other euro-area economies are at risk. Portugal and Spain are the obvious worries, and their CDS spreads have widened considerably. But Portugal has a much lower ratio of gross public debt to GDP than Ireland or Greece – and than Italy, the US or France. Spain has net public debt of 54% of GDP, compared with Germany's 59%.

- A crisis in Spain would constitute a far greater challenge for EU policy makers because it is a much larger economy – 12% of euro-area GDP, close to double that of Greece, Ireland and Portugal combined. Portugal faces a front-loading of debt obligations in early 2011, suggesting that the markets' focus will shift there soon. With the country suffering prolonged recession even before this crisis, it may have no alternative but to approach the EU bailout fund for support. Confidence is key.

### Better news from Asia

- On the upside, Asia, Africa, the Middle East and Latin America all look very positive.

- In Asia, Indonesia is arguably looking the most positive, having performed resiliently throughout the crisis. Past worries over fiscal management and political uncertainty have proven to be unfounded. Similarly, the Philippines

# Sovereign risk (con'd)

may be entering a new, stronger phase of growth. There are still uncertainties surrounding Thailand, where the political situation has stabilised but the underlying issue of the legitimacy of the Abhisit government remains unresolved. Until new elections are held, this will remain a drag on the outlook, despite a better-than-expected economic performance.

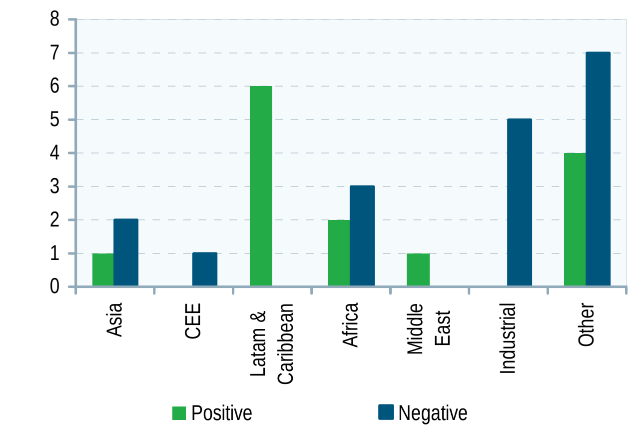
- Vietnam is vulnerable to another downgrade because of policy inconsistency. Renewed talk of imminent devaluation in early November was quieted by a sharp interest rate hike. Whether and for how long this can protect the currency is a moot point, though the authorities may prefer to focus on longer-term strategy as their important Party Congress looms in January. Malaysia also deserves a mention due to its large fiscal deficit.

- Of the larger Asian economies, China and India could see further improvement in their sovereign ratings. Though there are worries in both countries about rising inflationary pressures, fundamentals are strong and recent policy initiatives have been sure-footed. External balances are set to improve and reserves have been climbing. In India, fiscal news has been better than feared, limiting the chances of a downgrade. Sell-offs of state assets offer additional fiscal flexibility.

### Potential worries in Nigeria and South Africa

- In Africa, there are still concerns about South Africa, where the political climate is threatening to become more interventionist – a worrying development. External debt is also picking up.

**Chart 2: Changes in outlook by region, Q3-2010**




Sources: Standard and Poor's, Standard Chartered Research

- Elsewhere in the region, ratings trends have been positive, though Nigeria is looking more vulnerable to a downgrade as the elections near and the amnesty in the Niger Delta strains in the run-up to the polls. There have been more reports of kidnappings and incidents involving offshore oil rigs and pipelines. The risk is that this steps up. Perhaps of greater concern is the fall in official reserves, despite higher oil production and a solid oil price. The excess crude account has also dropped, from USD 20bn in January 2009 to close to zero now. The question is where these funds are going.

### Middle East helped by solid oil price outlook

- In the Middle East, ratings have been stable, though there are some worries about Bahrain and Kuwait. These partly reflect new data showing higher imports and lower exports than previously reported.

- However, policy management in both countries is sound, the oil price has been rising in recent months, and reports that the Saudi oil minister was comfortable with prices in a USD 70-90 band suggest that prices will hold near that level for some time.

### Elsewhere

- Latin America is powering ahead, with a number of countries in the region seeing their sovereign ratings lifted. The IMF has highlighted that the region is exiting the crisis faster than expected, though those most exposed to the US – Mexico and Central America – are more vulnerable than commodity exporters such as Brazil and Chile.

- Many outlooks are positive, suggesting that more upgrades are possible. With commodity prices rising, prospects are good. In addition, policy has been sound – apart from in the 'usual suspects' of Argentina, where the economy is overheating after government profligacy, and Venezuela, where there have been more expropriations and supply bottlenecks are an ongoing problem.

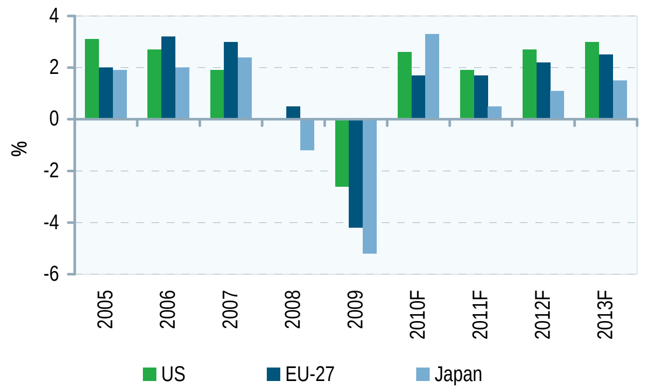
- Though better than last year, ratings trends in Central and Eastern Europe are still weak. Imbalances have generally narrowed, economies are recovering, and trade and remittance flows have picked up again. Russia remains a worry, though, because the recovery is only likely to be modest and the economy is too narrowly based.

# Economies – Majors

# Majors – Charts of the year

**Chart 1: Below-trend growth in the coming years**

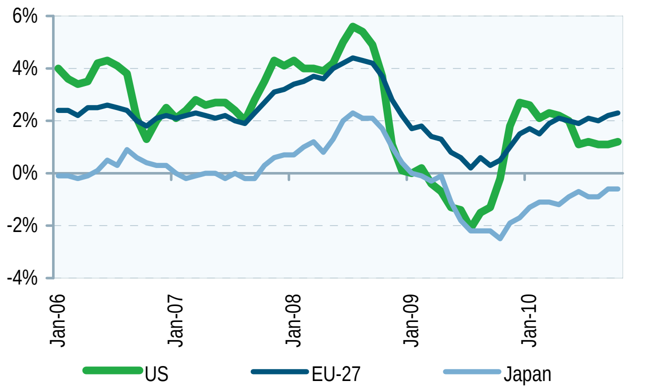
*Our forecasts for real GDP growth*




Sources: CEIC, Standard Chartered Research

**Chart 2: Benign inflation as overcapacity persists**

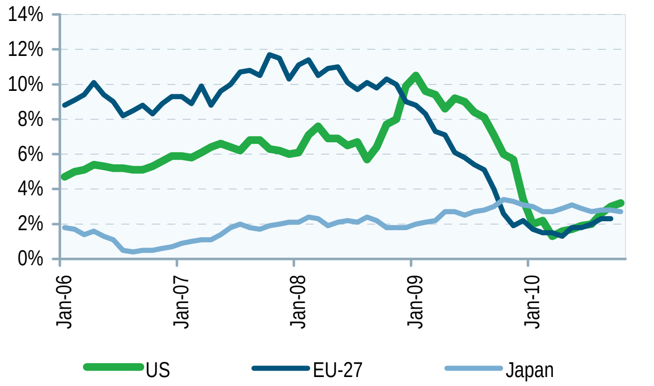
*% y/y*




Sources: CEIC, Standard Chartered Research

**Chart 3: Subdued money supply growth, despite easing**

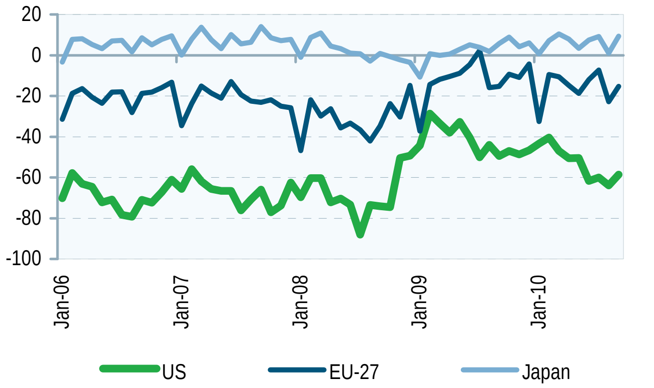
*M2 money supply growth, % y/y*




Sources: CEIC, Standard Chartered Research

**Chart 4: Trade imbalance is widening again**

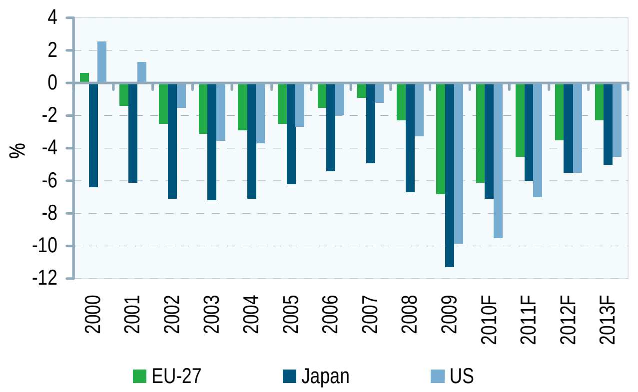
*USD bn*




Sources: CEIC, Standard Chartered Research

**Chart 5: Budget tightening ahead**

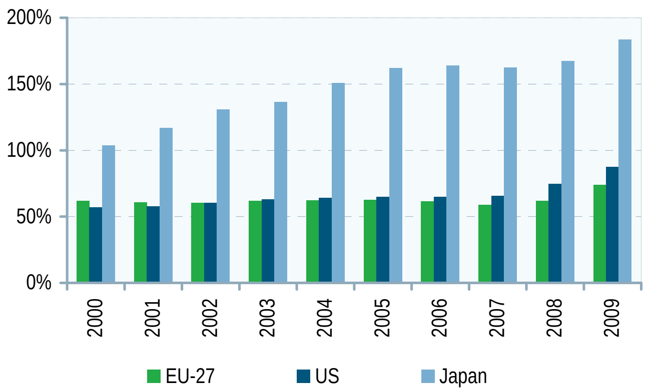
*Fiscal balance, % of GDP*




Sources: CEIC, Standard Chartered Research

**Chart 6: Fiscal positions remain a concern**

*Gross government debt, % of GDP*




Sources: CEIC, Standard Chartered Research

# Canada

**David Semmens**, Economist
Standard Chartered Bank, United States
+1 212 667 0452, David.semmens@sc.com

**David Mann**, Head of Research, Americas
Standard Chartered Bank, United States
+1 646 845 1279, David.Mann@sc.com

## Trying to shift focus from the US

### Economic outlook

- Canada's growth is likely to be modest throughout 2011, gently gathering pace in subsequent years. Consumption continues to benefit from a firmer labour market turnaround than that seen south of the border. Although growth lost steam in H2-2010, we expect progress to resume in 2011. Business investment will continue to recover. The swift resurgence in housing construction appears to have passed, and as such, we do not fear a bubble. The biggest risk remains the path of the US economy; commodity prices are a secondary consideration, in our view.

- Canada's economic fundamentals remain sturdy. The country's banking system has required no government support to date. Much of the turnaround since the crisis has been driven by business investment, consumer spending and housing. The improvement in the labour market has seen employment return to pre-crisis levels, although hours worked have not. The government and finance minister have committed to the lowest corporate taxes in the G7 by 2012; this, coupled with high immigration and abundant natural resources, should keep Canada's long-run growth run above that of the US.

### Financial issues

- Canada's financial industry went into the crisis with more conservative loan books and higher capital ratios than its G7 counterparts. As such, the financial-services index on the Toronto stock exchange is only 20% off its pre-crisis levels, compared with -60% in the US.

**Standard Chartered forecasts: Canada**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 3.0 | 2.2 | 2.5 | 3.0 |
| **CPI (% y/y)** | 1.6 | 2.1 | 2.5 | 2.5 |
| **Policy rate (%)*** | 1.00 | 2.00 | 3.00 | 3.50 |
| **USD-CAD*** | 1.01 | 1.00 | 1.03 | 1.05 |
| **Current account balance (% GDP)** | -2.4 | -2.2 | -2.0 | -1.8 |
| **Fiscal balance (% GDP)**** | -2.8 | -1.9 | -1.4 | -1.0 |

*end-period; **for fiscal year starting 1 April

Sources: Bloomberg, Standard Chartered Research

- Canadian house prices have declined only 3.5% nationally from pre-crisis levels, much less than the 33% drop in the US. With tighter mortgage regulations, the Canadian housing market has been much less volatile than that of the US. Concerns about a housing bubble appear to have passed, although consumer credit is returning to former highs.

### Policy

- We expect the Bank of Canada (BoC) to keep rates on hold at 1.00% until Q3-2011. This pause will be in response to concerns about both domestic and external growth, especially the uncertain outlook for the US. The lack of inflationary pressure, supported by persistent Canadian dollar (CAD) strength, will keep the BoC on hold through Q3-2011, in our view.

- The budget deficit is expected to narrow from 5.1% of GDP in FY09 to 0.5% by FY16 – an enviable position within the G7. The outstanding federal debt looks likely to peak at 35%, which is also low among the G7.

### Other issues

- While manufacturing has been impacted by the strength of the CAD against the US dollar (USD), the sector has rebounded firmly. Further CAD strength would be undesirable, but we expect any future gains to be muted.

- Oil prices are a key factor for growth in Western Canada. If prices remain firm, as we expect, this will support the CAD even if the BoC pauses on rates.

### Politics

- Since he took office in 2006, Prime Minister Harper has signed free-trade agreements to reduce Canada's dependence on the US economy. An agreement with the EU is due by end-2011, and Canada is expected to start negotiations on an agreement with India. According to a joint India-Canada study, the agreement could boost Canada's GDP by at least USD 6bn.

- The next regular general election is not due until October 2012. The minority government is at risk of triggering a general election in the event that it cannot pass any important legislation.

# Euro area

**Sarah Hewin**, Senior Economist
Standard Chartered Bank, United Kingdom
+44 20 7885 6251, Sarah.Hewin@sc.com

## Stable core, volatile periphery

### Economic outlook

- Euro-area GDP growth lost momentum in Q3-2010, and we expect activity to be subdued in H1-2011 before gathering pace again later in 2011. Household spending is likely to stay moderate, although rising employment should underpin incomes. Investment should continue to recover as capacity use rises and credit constraints ease, and net exports are likely to be mildly supportive as export growth outstrips imports.

- Many countries in the region continued to benefit from lingering fiscal stimulus in 2010, but this is now over, and fiscal consolidation will be a headwind to growth in 2011. Government deficit ratios in many of the 'core' euro-area economies are falling as a result of higher nominal GDP, so the impact on economic growth is likely to be muted.

- By contrast, the peripheral economies (Spain, Portugal, Greece and Ireland) have embarked on austerity programmes in an effort to reduce excessively high fiscal deficits to EU-mandated levels within the next few years. They are likely to see cuts in their structural deficits of more than 2ppt of GDP.

- As a result of legacy problems and differing fiscal constraints, rates of growth are likely to differ among the euro-area economies. We expect Germany to continue to drive growth in the region, along with the Benelux countries, Austria and Finland. France and Italy should hold up reasonably well. But the peripheral economies are likely to experience weak growth at best, possibly falling back into recession.

#### Standard Chartered forecasts: Euro area

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 1.7 | 1.7 | 2.2 | 2.5 |
| **CPI (% y/y)** | 1.5 | 1.6 | 1.9 | 1.9 |
| **Policy rate (%)*** | 1.0 | 1.75 | 2.75 | 4.00 |
| **EUR-USD*** | 1.36 | 1.30 | 1.38 | 1.42 |
| **Current account balance (% GDP)** | -0.5 | -0.2 | -0.2 | -0.4 |
| **Fiscal balance (% GDP)** | -6.1 | -4.5 | -3.5 | -2.3 |

*end-period Source: Standard Chartered Research

### Financial issues

- There are concerns that banks' balance-sheet problems, alongside the need to rebuild capital ahead of the Basel III regulatory changes, will keep loan availability weak and limit growth prospects. The IMF estimates that a bank credit crunch could shave about 1ppt from the region's GDP growth in 2011. Nevertheless, money supply growth and lending appear to be turning positive, which would echo the experience of earlier recovery periods – loans to the non-financial corporate sector usually pick up with a lag of some three to four quarters following the start of an economic upswing.

### Policy

- The European Central Bank (ECB) will continue to withdraw its emergency liquidity measures gradually, but sufficient liquidity support will remain for those banks that need it in 2011. The ECB is keen to normalise policy, but we think that policy makers will wait until late 2011 before withdrawing some of the current policy accommodation. The pace of economic activity is likely to stay subdued in early 2011, pulling inflation lower. A stronger pace of growth in H2-2011 should allow the ECB to start to tighten rates in Q4-2011 – but policy makers will remain attentive to economic developments.

### Other issues

- Following Ireland's request for financial support from the EU and IMF, the risk remains that Portugal may also need to tap the European Financial Stability Facility. Spain's debt ratios are lower, but there are concerns over the potential burden from the real-estate sector. The EU will outline a permanent crisis mechanism to take the place of the current mechanism in mid-2013, but the process of amending the EU treaty may not be straightforward. The peripheral economies remain vulnerable to further ratings downgrades in 2011.

### Politics

- Minority governments in Portugal and Spain are likely to face periodic demands from opposition parties for new elections. Ireland will have elections early in 2011. Political stalemate in Belgium has still not been resolved; a break-up of the country is being threatened, but appears to be a low risk at this point.

# Japan

**Simon Wong**, Regional Economist
Standard Chartered Bank, Hong Kong
+852 3983 8559, Simon.Wong@sc.com

## Deleveraging, deflation and demographics

### Economic outlook

- 2011 is likely to be the true test of whether Japan's economic rebound since 2009 is sustainable. A trade rebound and strong fiscal stimulus buoyed headline GDP growth for most of 2010, but industrial and export growth have decelerated towards year-end. The lack of a real improvement in high unemployment and the decline in consumer prices also testify to continued pressure on the domestic economy. Another risk factor is recent Japanese yen (JPY) appreciation, which, if sustained, could further arrest the recovery momentum.

- We expect 2011 to be a year of subdued growth. We forecast a markedly lower contribution from net exports, reflecting both a normalised base of comparison and, more importantly, the adverse impact of a stronger JPY. While we expect slight gains in domestic demand, these will be driven by relatively supportive asset prices as a result of extremely loose monetary policy rather than a fundamental improvement in incomes.

- We expect the decline in headline CPI to narrow but deflation risks to linger. Higher international food and energy prices in H2-2010 have slowed the fall in headline CPI, but most domestic components are still biased downwards. The slowing recovery momentum could also delay the closing of the current 4.3% output gap. As a result, we expect the economy to remain under a deflationary spell in 2011.

### Financial issues

- Bank of Japan (BoJ) flow-of-funds data show that loan liabilities assumed by the corporate and household sectors hit new lows in mid-2010. This contrasts with the government's continued heavy reliance on debt issuance to finance fiscal spending. Outstanding national government debt rose 5.1% y/y to JPY 904trn, or close to 190% of GDP, as of mid-2010. Q3-2010 data showed that bank credit to households is rebounding but credit to businesses is still sluggish, underpinning still-cautious commercial sentiment amid lingering external uncertainty.

#### Standard Chartered forecasts: Japan

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| GDP (real % y/y) | 3.3 | 0.5 | 1.1 | 1.5 |
| CPI (% y/y) | -0.8 | -0.2 | 0.2 | 0.7 |
| Policy rate (%)* | 0.1 | 0.1 | 0.1 | 0.25 |
| USD-JPY* | 84 | 94 | 100 | 105 |
| Current account balance (% GDP) | 3.2 | 2.9 | 2.5 | 2.3 |
| Fiscal balance (% GDP)** | -7.1 | -6.0 | -5.5 | -5.0 |

*end-period; **for fiscal year starting 1 April

Sources: Standard Chartered Research

### Policy

- The government approved a JPY 5trn supplementary budget in October 2010 that should push total spending in FY10 (began 1 April 2010) to just below JPY 100trn, compared with JPY 102.5trn in FY09. Welfare spending and medical services account for the bulk of the administration's new spending initiatives, echoing its earlier pledge to trim wasteful public-works projects. We expect fiscal consolidation pressure to limit the initial budget for FY11 to a relatively modest JPY 90trn, down from a record JPY 92trn in FY10.

- With fiscal policy unlikely to expand further, the burden will fall on monetary policy to support the economy. We see persistent pressure on the BoJ to expand its QE programme, and expect its asset purchase programme to grow to JPY 25trn by end-2011 from JPY 5trn currently.

### Other issues

- Adjustment pressure from the ageing population is at its peak. The working-age (20-64) population is set to shrink at an annual pace of 1.5% between now and 2015. This threatens to add to the government's fiscal burden via higher welfare spending, and to weigh on medium-term prospects for economic growth and the property market.

### Politics

- The smooth passage of the supplementary budget in late October suggests that the DPJ government has not suffered a debilitating defeat after losing its upper house majority in the July 2010 election.

- The next critical test will be the FY11 budget bill due to be submitted to the Diet in early 2011. The administration has hinted that it would seek co-operation with long-time LDP partner New Komeito to secure the bill's passage.

# United Kingdom

**Sarah Hewin**, Senior Economist
Standard Chartered Bank, United Kingdom
+44 20 7885 6251, Sarah.Hewin@sc.com

## Battling against spending cuts

### Economic outlook

- The rebound in GDP growth has been in line with the experience of other post-recession periods, but the UK faces a much harsher fiscal consolidation this time, which is likely to dampen activity next year. A turn in the inventory cycle has supported growth in recent quarters – but this boost is likely to fade in 2011.

- High debt and the need for households to rebuild savings are likely to dampen demand. Financial and housing assets are greater than the stock of household debt, but the debt burden has risen sharply for some households, and there are ongoing concerns about jobs and housing.

- Real business investment fell more than in previous recessions, and its recovery has been restrained by tight credit conditions. But a gradual improvement in credit availability (in particular for large corporations), as well as larger-than-normal cash holdings, should allow investment to rise over the coming year. Survey data point to tight capacity in some areas, which should trigger higher investment unless demand falls sharply. But construction looks likely to remain weak.

- Sluggish domestic spending in 2011 means that there will be a greater reliance on external demand. But so far, trade has been less supportive of the recovery than had been anticipated given the rapid pick-up in world trade and the competitiveness boost resulting from sterling's 2008 depreciation. However, weak import growth should boost the contribution from net exports.

**Standard Chartered forecasts: United Kingdom**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 1.8 | 1.4 | 1.9 | 2.3 |
| **CPI (% y/y)** | 3.1 | 3.1 | 1.9 | 1.9 |
| **Policy rate (%)*** | 0.5 | 0.5 | 1.5 | 3.5 |
| **GBP-USD*** | 1.60 | 1.52 | 1.62 | 1.67 |
| **Current account balance (% GDP)** | -1.7 | -1.6 | -1.4 | -1.6 |
| **Fiscal balance (% GDP)**** | 10.5 | 8.0 | 6.2 | 4.1 |

*end-period; **for fiscal year starting 1 April

Source: Standard Chartered Research

### Financial issues

- Banks will need to build their balance sheets ahead of the Basel III regulatory changes. In addition, a commercial debt refinancing hump in 2011-12 and the expiry of the government's special liquidity scheme in 2012 are likely to lead banks to maintain a cautious approach to lending.

### Policy

- The VAT rate hike in January 2011 is expected to take inflation up towards 3.5% y/y in Q1-2011, and is likely to hold CPI inflation above 3% for much of the year. Nevertheless, the factors which are keeping inflation high (including base effects from food and energy price increases) are viewed as temporary. Once the VAT impact drops out, inflation is likely to fall sharply, to well below the 2% target by end-2012.

- A key uncertainty relates to how large the margin of spare capacity is in the economy. The view of the Bank of England (BoE) is that the depth of the recession has left substantial excess spare capacity, which should keep underlying inflation low, even given the bank's relatively upbeat GDP growth forecasts. Our more pessimistic growth forecasts raise the risk that inflation will undershoot the target by a wider margin.

- We expect interest rates to stay at 0.5% in 2011, with policy tightening unlikely to be considered ahead of 2012. The BoE is ready to embark on further asset purchases if required, and is likely to keep this option open in 2011.

### Politics

- The UK's Conservative-Liberal Democrat (Lib-Dems) coalition will be tested in 2011 as the impact of severe budget cuts begins to be felt. The Liberal Democrat junior partners already face criticism for backtracking on election pledges on education and on the pace of cuts.

- A referendum on an Alternative Voting system will be held on 5 May 2011, but is likely to be opposed by the Conservatives and the opposition Labour Party. If voted in, the new system would increase the leverage of the Lib-Dems over the Conservatives, though it would fall short of delivering substantial gains to the Lib-Dems.

# United States

**David Semmens**, Economist
Standard Chartered Bank, United States
+1 212 667 0452, David.semmens@sc.com

**David Mann**, Head of Research, Americas
Standard Chartered Bank, United States
+1 646 845 1279, David.Mann@sc.com

## Recession is over, weak growth is not

### Economic outlook

- Growth will likely gather pace in 2011 and 2012. While the inventory cycle has been the biggest contributor to growth since the end of the recession, the US consumer has proven resilient in the face of multi-decade-high unemployment and immense wealth destruction.

- Unusually cautious American consumers have been held back by a stagnant labour market, restricted access to credit and the need to rebuild their balance sheets. This continued adjustment has resulted in a sub-par recovery given the depth of the recession experienced.

- Market players are currently divided about the outlook for inflation. Large capacity overhang, weak wage growth and high unemployment will keep core inflation weak in the short to medium term, although rising energy-price volatility has the potential to raise the headline inflation rate. Similarly, a weaker recovery could spark a deflationary scare, but this appears much less likely.

- The impact of quantitative easing (QE) is arguably being limited by protests against it in Washington. Given still-tough credit conditions for most businesses, especially SMEs, we cannot rule out the possibility that more easing will become necessary in 2011. This would help to boost growth expectations for 2012.

### Financial issues

- Foreclosures remain elevated. Government measures to protect home-buyers are prolonging the adjustment, not avoiding it, in our view. There is potential for a further 3-5% decline in home prices to bring them closer in line with rents and earnings.

- Unprecedented and aggressive action from the Federal Reserve has restored the functioning of the interbank market; ample liquidity and interest rates on hold for the foreseeable future will keep the LIBOR curve relatively flat.

- The weak labour market and cautious financial institutions have forced consumers to deleverage. This has seen mortgage applications fall to 1997 levels and consumer credit decline to 2007 levels. We look for further deleveraging, but at a less aggressive rate.

- The US dollar (USD) undeniably remains the world's reserve currency. While the fiscal deficit has added significantly to the US national debt, fiscal concerns in Europe have ensured that Treasuries remain the benchmark for bond markets around the world.

### Policy

- Steady but uninspiring growth, coupled with high unemployment, should allow the Fed to keep rates on hold until Q1-2013. The reversal of QE2 will be driven in part by the rolling off of shorter-term Treasuries and MBS due to refinancing. The Fed's clearly outlined exit policy is likely to remain on ice.

- A further fiscal stimulus package is unlikely to gather political momentum. The coming change in political dynamics in Washington following the midterm elections will result in a more right-wing agenda. We do not expect to see unemployment benefits extended beyond the 99-week mark.

- The ongoing debt crises in Europe act as a reminder that market confidence needs to be well supported. We will watch for further assurances from the US government that the priority is to restore fiscal soundness once the recovery is on a firmer footing. We are less aggressive than the Congressional Budget Office (CBO) in our forecasts for the fiscal deficit.

**Standard Chartered forecasts: United States**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 2.6 | 1.9 | 2.7 | 3.0 |
| **Core CPI (% y/y)** | 0.9 | 0.5 | 1.0 | 1.5 |
| **Policy rate (%)*** | 0.25 | 0.25 | 0.25 | 1.25 |
| **USD** | NA | NA | NA | NA |
| **Current account balance (% GDP)** | -3.5 | -3.6 | -3.8 | -4.0 |
| **Fiscal balance (% GDP)**** | -9.5 | -7.0 | -5.5 | -4.5 |

*end-period; **for fiscal year ending 30 September

Sources: Bloomberg, Standard Chartered Research

# United States (con'd)

- With the majority of the government stimulus having passed, most of the burden of stimulating the US economy will continue to fall on the Federal Reserve. We cannot rule out more easing in 2011, though the FOMC will have more hawkish members than it did in 2010.

## Other issues

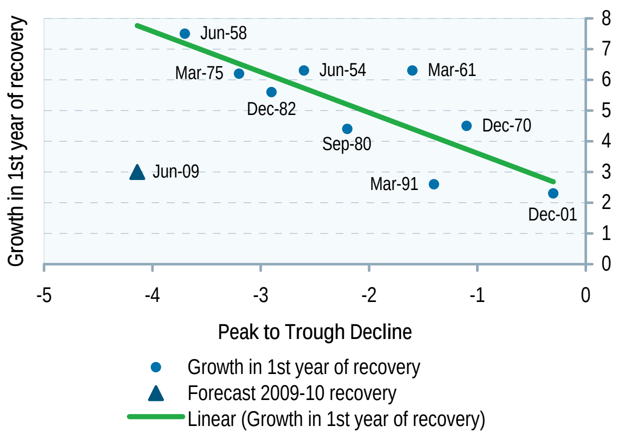
- The labour market is suffering from massive over-investment in real estate and financial training. This skills gap has resulted in a supply and demand mismatch that will keep unemployment above 9% until 2012. Even when hiring resumes, the resulting increase we expect in the participation rate will keep the unemployment rate elevated.

- While inflation expectations have been relatively firm, any renewed economic weakness would likely trigger further unconventional policy from the Federal Reserve. We see an extension of QE, rather than a curtailment, as the more likely path. In this case, Treasuries would continue to benefit from planned purchases by the Federal Reserve.

- Small businesses continue to report tight credit conditions, limited appetite for hiring and declining price pressure. The lack of a turnaround in the small business sector is another key reason why unemployment will remain high. We stress the importance of watching the National Federation of Independent Business (NFIB) survey closely. Once this recovers sharply, we will be more convinced of the strength of the broader recovery.

**Chart 1: Historical comparison of US recoveries since 1954**

*This recovery remains the weakest*




Sources: Bloomberg, Standard Chartered Research

- Once the housing-market adjustment has run its course, we cannot rule out even stronger growth than our forecasts suggest, driven by a resumption of investment, although this is not our central scenario for 2011. Indeed, we do not believe the conditions will be in place for the US to see above-trend growth until at least 2012-13.

- The recovery has been particularly weak given the depth of the recession. Consumers are still burdened with debt, businesses remain cautious, and a spilt Congress could see government spending aggressively curtailed.

## Politics

- The midterm elections saw the Republicans take control of the House of Representatives, with the Democrats narrowly retaining control of the Senate. This was well received by the markets. It appears likely that a compromise will delay the forthcoming expiry of tax cuts for all but the very wealthy.

- The overwhelming quandary of American politics remains how to support growth while narrowing the fiscal deficit. Possible measures include limiting federal spending on health care, increasing the retirement age and tightening social security spending. None of these are easy options for either party.

- The federal debt outstanding (USD 13.7trn) is dangerously close to the limit (USD 14.3trn) set in February. The Republican House is unlikely to approve a further extension of the ceiling without definite plans to reduce government spending.

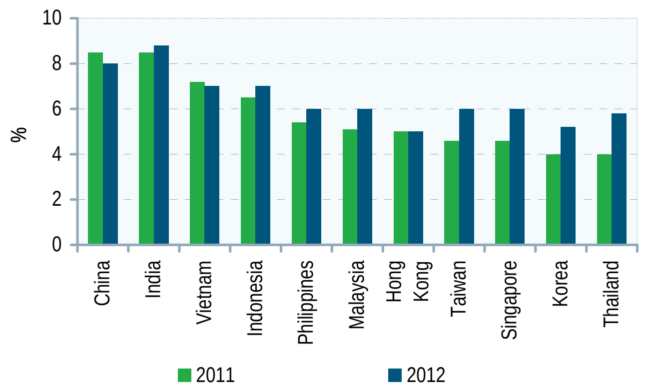
- Recoveries can be V-shaped, and given how hard the world has been hit, there is a logical reason for believing this could be the case now. But unlike previous US recoveries, this one lacks conviction (see Chart 1). Underlying confidence in the US has been dented so badly, the fear is that a private-sector recovery will be sluggish. Policy is driving this pick-up, but there are deep worries about the sustainability of the increase in debt, which may keep the political will for more stimulus weak.

# Economies – Asia-Pacific

# Asia – Charts of the year

### Chart 1: Giants continue to lead the recovery

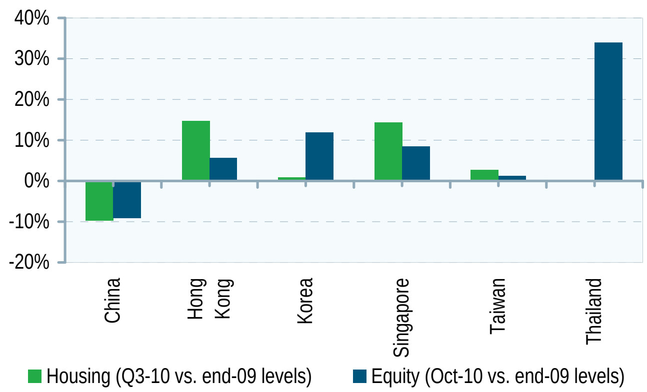
*Our real GDP growth projections, y/y%*




Source: Standard Chartered Research

### Chart 2: Asian asset prices – a one-way bet?

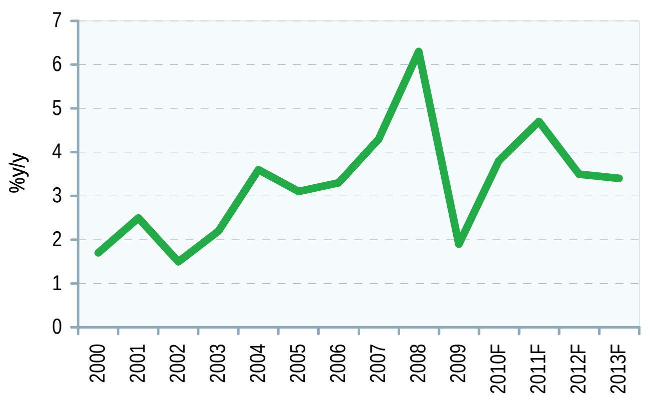
*Year-to-date price index changes*




Sources: CEIC, Standard Chartered Research

### Chart 3: Inflation is rising but manageable

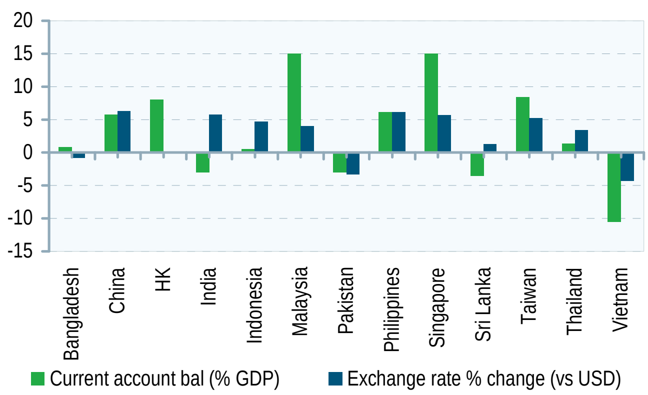
*GDP-weighted CPI, % y/y*




Sources: IMF, CEIC, Standard Chartered Research

### Chart 4: Currency war to escalate?

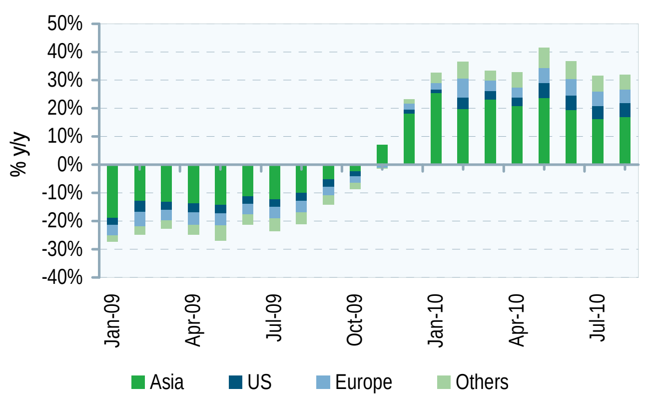
*2011 current account balance and currency change forecasts*




Source: Standard Chartered Research

### Chart 5: Intra-regional trade is a key export driver

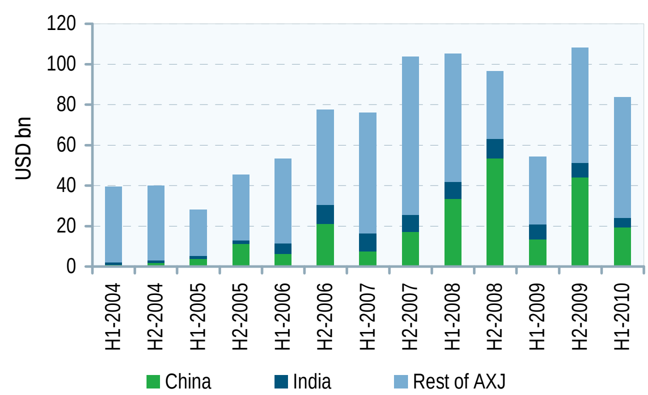
*Growth in Asia's exports*, *% y/y*




Sources: CEIC, Standard Chartered Research

### Chart 6: Asia as a world investor

*BoP gross outward direct investment, USD bn*




Sources: CEIC, Standard Chartered Research

# Asia

**Nicholas Kwan**, Head of Research, East
Standard Chartered Bank, Hong Kong
+852 2821 1013, Nicholas.Kwan@sc.com

## Tackling the problems of success

### Economic outlook

- Asia will continue to lead the world recovery in 2011, with output growth topping all other regions and contributing 40% of the world's growth. Real GDP growth is likely to stay strong at 6.8%, albeit lower than the 8.1% expected in 2010 due to base effects and fading fiscal and monetary stimulus.

- Growth will generally be better balanced and more sustainable, with more diversified sources of demand. Domestically, improving confidence will lead to stronger private-sector demand, reducing the reliance on public spending. Externally, growing intra-regional and South-South trade will support exports and reduce the region's dependence on mature markets.

- China, India and Indonesia will continue to lead Asian growth with their large domestic markets and strong growth momentum. Growth in Korea, Taiwan and Hong Kong will leverage on these economies' privileged access to China's domestic market, tourist spending and capital outflows. Growth in South East Asia will be supported by solid commodity prices and by accelerating regional trade and investment flows.

- Inflation will rise and become the primary concern in 2011, both in terms of consumer prices and asset prices. While higher food and commodity prices may be driven by seasonal and transient factors, surplus liquidity will push up asset prices and threaten financial stability. Wages and service charges will also rise as unemployment recedes and the recovery takes hold. Central banks seen as slow or late to respond, like those of Korea, Indonesia and the Philippines, may risk having to play catch-up with inflation expectations.

**Standard Chartered forecasts: Asia***

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **Real GDP growth** | 8.1 | 6.8 | 7.4 | 6.8 |
| ***IMF*** | 8.5 | 7.3 | 7.2 | 7.2 |
| **Inflation** | 3.8 | 4.7 | 3.6 | 3.5 |
| ***IMF*** | 4.7 | 3.5 | 2.8 | 2.7 |
| **Current account balance (% GDP)** | 3.3 | 3.2 | 3.2 | 3.3 |
| ***IMF*** | 3.1 | 3.1 | 3.0 | 3.1 |

*2009 USD GDP-weighted total of 15 regional economies

Sources: IMF, Standard Chartered Research

### Financial issues

- Managing the threat of asset bubbles will be Asia's key financial challenge in 2011. Ironically, this threat is fueled by the risk of a double-dip in the G3 economies. This will keep major central banks priming their liquidity pumps, driving more capital to Asia in search of higher yields.

- Capital controls and more targeted macro-prudential measures will be selectively introduced to restrain asset prices, on top of more aggressive monetary tightening and stronger currencies. Economies with open capital accounts or fixed/targeted exchange rates – or worse, both – will be in a dilemma. Their efforts to drain domestic liquidity through higher interest rates or to curb import prices through currency appreciation will attract stronger capital inflows, disrupting or undermining their original objectives. The challenge will be striking the right balance, but draconian capital controls like those imposed by Thailand in 2006 or Malaysia in 1998 are unlikely.

- Averting a currency war among the major economies will also top Asia's financial agenda in 2011. While China is likely to maintain a steady pace of Chinese yuan (CNY) appreciation against the US dollar (USD), most other Asian currencies could face stronger and more erratic upward pressure, given their generally more open capital accounts and smaller economies. The Hong Kong dollar (HKD) peg will not be compromised, but adjustment pressure will fall on asset prices. While no major changes are expected to exchange rate regimes, the war of words in currency markets will undermine financial-market stability and fuel protectionism.

- In the longer run, the challenge is how to develop the region's capital markets to absorb excess short-term liquidity and channel it into long-term productive uses, such as physical and social infrastructure and funding for SMEs and innovation. This may lead to closer co-operation among the region's market participants and some realignment of the regulatory and financial infrastructure.

# Asia (con'd)

- Strong capital inflows and sizeable current account surpluses will see a further build-up of Asia's official FX reserves in 2011. The threats of a currency war and protectionism will prompt Asian governments to build up their own war chests and/or expand regional liquidity support arrangements like the Chiang Mai Initiative Multilateralisation (CMIM). This will also facilitate the internationalisation of the CNY to become a regional trade and reserve currency.

- Outward investment by Asian companies and public entities, especially from China and India, will gain further momentum in 2011. Supported by their newfound wealth and driven by their thirst for natural resources, technology and markets, these new international investors could face protectionist resistance in host countries; this is especially true for state-owned companies. Longer-term, such investment should promote economic integration and growth in both host and home economies.

- Strong balance sheets and good economic growth should enable Asian financial institutions to adapt better to reforms mandated by Basel III and other initiatives than their counterparts in other regions. This should lead to a further expansion of Asian banks overseas.

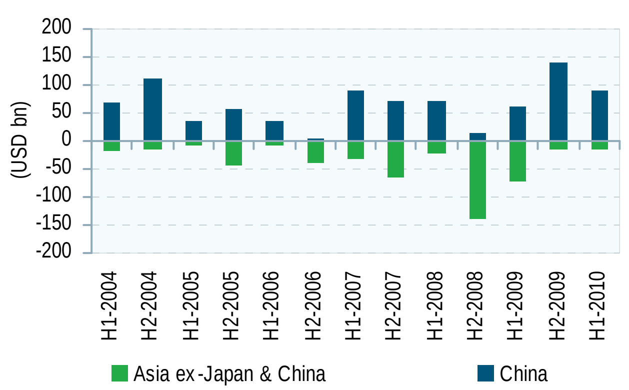
## Policy

- The solid recovery in 2010 will allow Asian governments to gradually scale back fiscal stimulus, cutting budget deficits and improving their fiscal health. While most Asian governments are in much healthier fiscal positions than the major economies, some – including Malaysia, India, Vietnam and the Philippines – will need to keep the fiscal reins tight in order to keep the rating agencies off their backs. Others, like Indonesia, could enjoy rating upgrades upon further improvement in their fiscal positions.

- More efforts are needed to improve the private-sector operating environment, especially for SMEs, which provide most of the employment in the region. Fiscal policy should focus on sustaining long-term growth drivers like infrastructure development, and on promoting more equitable and inclusive growth to correct imbalances that emerged during the recovery.

**Chart 1: Asia continues to see large inflows**

*Financial account aggregates, USD bn*




Sources: CEIC, Standard Chartered Research

## Other issues

- Rising trade protectionism and weak demand in the major economies will push Asian exporters to seek further opportunities in higher-growth emerging markets, fueling growth in intra-regional and South-South trade. China will remain a key focus, supported by a widening network of bilateral and multilateral trade agreements, as well as its deep pockets and cheap products. Changing demand sources and falling trade and investment barriers will also facilitate gradual adjustments to the global and regional supply chain. Longer-term, this could lead to another round of industry relocation across the region, promote intra-regional economic integration and reduce Asian exporters' dependence on traditional Western markets.

## Politics

- Regional political tensions may rise and risk undermining Asia's long-term growth potential. Active US diplomacy in South Asia, ASEAN, Japan and Korea is fueling Beijing's suspicions that the US is adopting a renewed strategy to contain or encircle China. Within the region, Sino-Japanese confrontation is the biggest threat. Economic disputes between the two giants would be costly in terms of regional trade and investment co-operation, even though the threat of military conflict remains distant. Instability on the Korean peninsula caused by a power succession in the North could easily take years to resolve. All of these risks have the potential to undermine Asia's recovery and long-term peace.

- Domestic politics may remain relatively calm in 2011, but they also have the potential to affect long-term regional stability – especially in terms of power transitions in China, Thailand and Japan.

# Australia

**Vincent Tsui**, Economist
Standard Chartered Bank, Hong Kong
+852 3983 8563, Vincent.Tsui@sc.com

## Closer links with emerging Asia

### Economic outlook

- The current mining boom will sustain Australia's strong economic performance in 2011. Buoyant demand for raw materials from emerging Asia and improving terms of trade have fueled mining investment and growth in construction activity and peripheral services. Asia now accounts for more than 70% of Australia's exports. Asia's still-wide infrastructure gap and its ongoing urbanisation and industrialisation, along with China's investment needs under its 12th Five-Year Plan, will ensure a solid trade performance for Australia going forward.

- An increasing reliance on the mining sector could amplify economic cycles, making Australia more vulnerable to policy risks in emerging Asia and changes in commodity demand and prices. The proceeds of a rent tax on mineral resources may provide a fiscal cushion against the economic impact of volatility in commodity markets.

- The fiscal impulse will be less supportive of growth given the government's commitment to balance the budget by FY13. In addition to AUD 3.5bn of spending cuts outlined in the mid-year economic and fiscal outlook in November 2010, the government will keep annual real spending growth at 2% or less until the budget returns to surplus.

- Robust mining activity will put capacity pressure on the Australian economy, resulting in a tighter labour market and an increase in household incomes. We expect inflation to accelerate to 3.4% in 2011, driven by demand-pull pressure and a liquidity-driven upswing in commodity prices.

### Standard Chartered forecasts: Australia

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 3.2 | 3.4 | 3.8 | 3.8 |
| **CPI (% y/y)** | 3.0 | 3.4 | 3.9 | 4.1 |
| **Policy rate (%)*** | 5.0 | 5.5 | 6.0 | 6.5 |
| **AUD-USD*** | 1.00 | 0.88 | 0.98 | 1.05 |
| **Current account balance (% GDP)** | -3.7 | -3.6 | -3.2 | -2.8 |
| **Fiscal balance (% GDP)**** | -4.2 | -3.0 | -0.8 | 0.2 |

*end-period; **for fiscal year ending 30 June

Source: Standard Chartered Research

### Financial issues

- The policy of allowing the Australian dollar (AUD) to float freely cushions the economy against hot money inflows. Gross external debt amounts to about 100% of GDP, half of which has maturities of less than one year. As a result, volatility in global financial markets may increase funding costs for Australian financial institutions and risk slowing the pace of recovery.

- Household leverage continued to increase during the recession, but still-low interest rates and rising wages have kept interest payments as a share of disposable income below their peak level in 2008. Households' net worth has also been strengthened by higher house prices. However, with the Reserve Bank of Australia (RBA) continuing to normalise monetary policy, the household sector will face higher debt-servicing costs, and banks may become more cautious in expanding their consumer finance portfolios.

### Policy

- The RBA has been ahead of the curve in raising rates, and early tightening may result in a lower terminal rate. Credit spreads of financial institutions remain wide, and rate hikes are likely to be magnified in the retail market. High household debt and external uncertainties such as policy tightening in China could also delay the pace of rate hikes. We expect two more 25bps hikes in Australia's benchmark rate in Q2- and Q3-2011.

### Other issues

- Housing activity has eased, with transactions declining and prices plateauing in Q3-2010. However, we see a low risk of a meaningful correction given that demand is supported by 2% annual population growth, an influx of immigrants and rising wages. Supply is also constrained by the tightening of local zoning and construction rules.

### Politics

- The Labor party currently leads a minority government with the Greens and independent MPs. The latest opinion poll in November 2010 showed that Prime Minister Julia Gillard maintained a comfortable lead over opposition leader Tony Abbott. The next federal election will be held by 30 November 2013.

# Bangladesh

**Christine Shields**, Head of Country Risk Research
Standard Chartered Bank, United Kingdom
+44 20 7885 7068, Christine.Shields@sc.com

**Philip Ryan**, International Graduate
Standard Chartered Bank, United Kingdom
+44 20 7885 5786, Philip.Ryan@sc.com

## Bangla-yes!

### Economic outlook

- Bangladesh has continued to perform strongly throughout the global crisis and is one of the most impressive performers in the region. The economy likely slowed a little in 2010 but should rebound in 2011 and 2012.

- Long-term macroeconomic prospects remain good. Government policies are helping to drive further growth, and structural reform, coupled with investment in infrastructure, is painting a positive long-term economic picture.

- GDP grew 5.5% in FY10 (ended 30 June 2010), slightly down from FY09's 5.7% but solid nevertheless. We expect growth to pick up to 6% in FY11, somewhat lower than the official forecast of 6.7%, as we anticipate downside risk from the manufacturing sector due to power shortages and labour unrest.

- The agriculture sector, as always, is susceptible to the unpredictability of the weather but is still expected to grow at 4-5% in 2011. The economy is highly dependent on the textiles sector, which should continue to be resilient, despite subdued Western demand, as it supplies cheaper alternatives. Exports and imports have both picked up from 2009 levels.

- GDP per capita is much lower than that of regional peers (except Nepal), and is forecast at USD 640 this year. As a low-income country, Bangladesh has many structural shortcomings, such as low literacy and education attainment levels, poor infrastructure, unequal distribution of income and endemic corruption. However, Bangladesh is a major recipient of donor support. Foreign aid is estimated to be as much as 2% of GDP.

- Inflation has been climbing higher since mid-2009 on the back of rising food prices. Given sufficient supply of foodgrains domestically, this reflects demand-side factors. Going forward, we expect average inflation to decline to 6.8% y/y in FY11 from 7.3% in FY10, though expected fuel-price hikes, public spending and wage increases will limit the downside.

- Despite its status as 'free-floating', the Bangladeshi taka (BDT) is de facto pegged to the USD. This stability is favourable for exporters who would struggle were the taka allowed to appreciate too far.

- Recently the BDT has weakened by more than 2% on the back of higher imports and lower remittances. The central bank has intervened, and we expect it to continue to do so in order to limit further weakness in USD-BDT. Any pressure on the BDT to appreciate will likely be limited by the narrowing of the current account surplus.

- The country's external position is relatively strong. FX reserves surpassed the USD 10bn mark in 2010. The current account surplus was 3.7% of GDP in FY10, of which 80% was due to textiles exports and inward remittances from abroad. We expect the surplus to narrow to 0.8% of GDP in FY11.

- The trade deficit widened in FY10 to USD 5.2bn from USD 4.7bn in FY09, as imports have risen over 50%. High overseas remittances (12% of GDP) have typically financed the trade deficit, although their growth rate has fallen recently. FDI inflows were disappointingly low at USD 0.6bn in FY10, down from the FY09 figure of 0.9bn. We expect to see a rebound over the coming year.

**Standard Chartered forecasts: Bangladesh**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 5.5 | 6.0 | 6.6 | 6.9 |
| **CPI (% y/y)** | 7.3 | 6.8 | 6.3 | 5.0 |
| **Policy rate (RR, %)*** | 5.5 | 5.5 | 5.5 | 5.5 |
| **USD-BDT*** | 70.2 | 70.8 | 70.0 | 69.0 |
| **Current account balance (% GDP)** | 3.7 | 0.8 | 0.3 | 0.0 |
| **Fiscal balance (% GDP)** | -5.0 | -5.0 | -4.5 | -4.5 |

Note: All forecasts except USD-BDT refer to the July-June fiscal year ending in the year in column heading; *end-period

Source: Standard Chartered Research

# Bangladesh (con'd)

## Financial issues

- Bangladesh relies on external funds for its budgeting needs, as well as for humanitarian and development purposes. The authorities continue to pursue financial stability, and the financial sector was resilient throughout the crisis. Risk and capital management standards are improving, and the country formally entered the Basel II accord at the start of 2010.

- Though far from the most sophisticated in the region, regulation and supervision are impressive. However, poor infrastructure and power shortages pose a serious threat to Bangladesh's continued growth and affect everyday life in the country. An unfriendly business image also remains an issue that could be helped by revamping.

- The economy remains relatively undiversified but is improving. Half of the workforce is employed in agriculture (80% of the population still lives in rural areas), and this sector contributes 20% of GDP. Services and industry contribute 50% and 30% to GDP, respectively. Within industry, textiles and clothes manufacturing are hugely important and comprise over 80% of the country's exports.

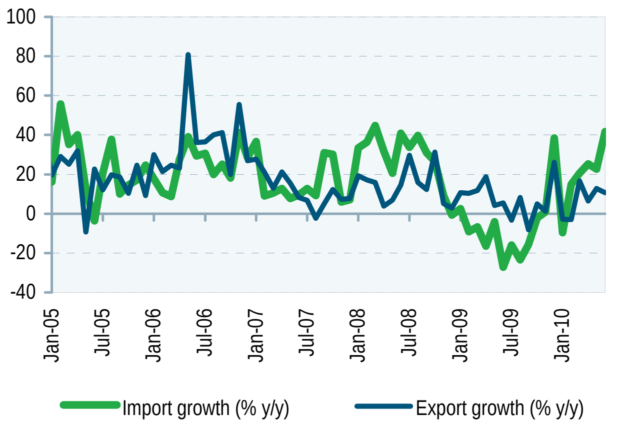
## Policy

- The authorities take a prudent approach to fiscal management, with the budget deficit stable at 4-5% of GDP. However, the fiscal deficit has been climbing somewhat in recent months due to higher power purchases from private companies to provide subsidies. The government plans to seek financing of USD 300mn from the World Bank to help address this problem.

- Government debt is quite high, at 40% of GDP, albeit down from the 2002 peak of over 50%. The tax-to-GDP ratio is 8.5%, a very low figure. This is a result of an extremely narrow tax base, poor administration and collection, and the fact that the agriculture sector is not taxed. However, there has been some improvement recently in the efficiency of tax administration, and this has led to higher revenue collection.

- Monetary policy is tight. Bangladesh Bank has conflicting policies – focusing on inflation targeting as well as managing the exchange rate at a stable level. If capital inflows were to increase and create excess liquidity within the system, maintaining the BDT peg to the USD could lead to inflationary pressure. We forecast very little change in interest rates.

**Chart 1: Imports surge, while export growth is erratic**




Sources: CEIC, Standard Chartered Research

## Politics

- Prime Minister Hasina and her reformist Awami League (AL) face mounting public discontent, as they have yet to address power outages and widespread poverty. Tensions are growing between AL supporters and those of the main opposition party, the Bangladesh Nationalist Party (BNP). Recently, the BNP has organised non-violent protests and strikes that can bring Dhaka to a standstill. These may continue into 2011.

- There were concerns that the August 2010 outbreak of anthrax in the north of the country could affect both agriculture and much-improved bilateral relations with India were it to spread across the border. However, the spread appears to have been contained.

- India and Bangladesh have recently seen their historically difficult relations thaw somewhat. Bangladesh has opened up the 'Bangla corridor', allowing India much shorter passage to its troubled secessionist north eastern states. Additionally, in August 2010, India granted Bangladesh a 20-year, USD 1bn loan to be used to finance 14 infrastructure projects.

# China

**Stephen Green**, Regional Head of Research, Greater China
Standard Chartered Bank (China) Limited
+86 21 3851 5018, Stephen.Green@sc.com

**Li Wei**, Economist
Standard Chartered Bank (China) Limited
+86 21 6168 5017, Li.Wei-CN@sc.com

## A year of fighting bubbles

### Economic outlook

- Slower growth and higher inflation look set to be the defining trends of 2011 for China. We expect policy to be tightened across the board – interest rates and bank reserve requirements will likely go up, the Chinese yuan (CNY) will appreciate faster, and food and utilities prices will be controlled. We forecast GDP growth of 8.5% in 2011 (compared to 10% in 2010) and CPI inflation of 5.5%, up from around 3.2% in 2010. We look for fixed investment growth of 9% (12% in 2010) and private consumption growth of 8.5% (9.5%). H1-2011 will be a time of higher inflation and slower growth; we think inflationary pressures will subside in H2 and growth will reassert itself. The biggest risk is that inflation – in food, commodities and assets – will be resistant to policy in H1, which will mean that policy cannot be meaningfully loosened in H2. Growth could then suffer more.

- We expect slower investment growth to drag on overall GDP growth, especially in H1-2011. Many stimulus projects begun in 2009 will be winding down, and the real-estate construction boom will also end. Higher food-price inflation may already be undermining household consumption growth. Export growth is likely to decelerate to 10-15% in 2011. The 12th Five Year Plan will result in new infrastructure projects, which we guess will boost investment growth momentum in H2, and indicators of private investment sentiment still look strong.

### Financial issues

- The People's Bank of China (PBoC) and the China Banking Regulatory Commission (CBRC) will control loan growth, particularly credit extension to local government infrastructure vehicles (LGIVs). We estimate that about two-thirds of the current outstanding credit to LGIVs (CNY 8trn, or some 20% of GDP) will either require local governments to repay the loans out of fiscal or land-sale revenues (unlikely, in our view) or will turn into bad loans. These loans would be borne by the banks or would ultimately be resolved by a central government recapitalisation of the banking sector (especially smaller institutions) if the problem presented a systemic risk. While these loans are unlikely to appear as non-performing on the banks' books in 2011 (since the interest will continue to be paid), stress will increase. These vehicles are already facing financing difficulties, and banks are not allowed to extend any more credit to them on a non-commercial basis. This could well dampen investment growth in 2011.

- China already has plenty of capital controls – but there are more coming in 2011, we believe. In November 2010, the authorities basically closed down the onshore forward market by stopping banks from expanding their net cash FX positions. This put a stop to both hedging and speculative activity in the onshore FX market. We expect the authorities to continue to squeeze onshore US dollar (USD) liquidity by reducing the foreign debt quota (driving up onshore USD rates), introducing new controls on FDI projects, and pursuing high-profile prosecutions of those bringing in hot money. Foreign investment in real-estate projects will also be squeezed.

**Standard Chartered forecasts: China**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 10.0 | 8.5 | 9.0 | 8.0 |
| **CPI (% y/y)** | 3.2 | 5.5 | 3.0 | 3.0 |
| **Policy rate (%)*** | 5.81 | 6.56 | 6.56 | 6.56 |
| **USD-CNY*** | 6.59 | 6.20 | 5.95 | 5.80 |
| **Current account balance (% GDP)** | 5.5 | 5.8 | 5.8 | 5.9 |
| **Fiscal balance (% GDP)** | -2.0 | -1.0 | -0.5 | -0.5 |

*end-period Source: Standard Chartered Research

### Policy

- 2011 is the first year of the 12th Five Year Plan. The big aim is to rebalance growth towards the consumer by accelerating urbanisation and tackling income inequality. Both are easier said than done. Quicker urbanisation requires cities to open their social safety nets to migrants, something most are reluctant to do because of the costs involved (although migrants would also make contributions to help finance the scheme, a point often forgotten in the debates). Tackling income inequality will require introducing a capital gains tax (currently none is imposed on equity or housing investments) and an inheritance tax. On the corporate side, it will necessitate forcing state firms to pay more dividends to the state budget. And on the spending side, it will require a huge commitment to funding health care (spending has already

# China (con'd)

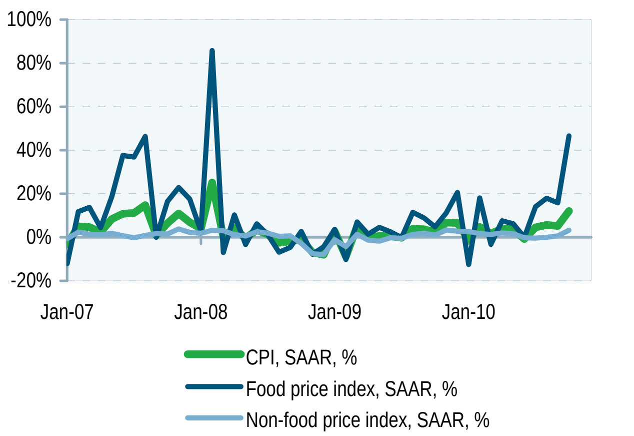
accelerated in 2010) and solving the problems that cripple the delivery side of the public health-care system.

- Of more immediate concern in 2011 will be the fight to prevent asset-price inflation. We look for four more 25bps rate hikes (one each in Q4-2010, Q1-2011, Q2-2011 and Q3-2011) and several more hikes in the reserve requirement. However, we believe the key will be quantitative controls on loans and thus M2 growth. Some fear that raising rates enough to take real rates into positive territory would encourage hot money inflows. An annual bank loan quota of CNY 6-7trn in 2011 (which would imply loan growth of some 12-14%, down from 18% in 2010) would be the first step. But if inflation continues to threaten, month-by-month management of credit extension (especially in January) is entirely possible. There is already talk of more price controls (see below).

- The pace of CNY appreciation is set to accelerate, we believe. We have previously called for annual appreciation of 4-5%, but things have changed. While the CNY rose some 3% against the USD from June to mid-November 2010, it had depreciated 1.5% on a real effective basis as of end-October. Now, with inflation threatening, Beijing will likely decide it is time for the CNY to appreciate on an effective basis. We expect appreciation of some 6% against the USD in 2011, with the pace faster in H1, taking the CNY to 6.20 by year-end. The PBoC will likely increase CNY volatility to try to confuse the market. In the medium term, inflation will help to spur real exchange rate appreciation.

**Chart 1: Inflationary pressures build**

*CPI, food and non-food inflation, SAAR, %*




Sources: CEIC, Standard Chartered Research

- Beijing will continue to squeeze the housing sector, especially in H1-2011. Some 15 cities recently introduced limits on how many apartments residents can buy (and tightened bans on purchases by non-residents). Our research suggests that a large amount of new apartment supply should now be hitting the market – and that if sales continue at their current limited levels, inventories will inevitably rise nationwide. This will mean price weakness in many cities in H1-2011 and a construction slowdown (with implications for steel and, to a lesser extent, copper). However, our research also suggests that new supply will be very limited in Tier 1 and many Tier 2 cities, including Shanghai and Beijing, so prices will be under less pressure there. As long as inflationary worries trump concerns about growth, policy makers will continue to squeeze the sector. However, if prices do fall in H1, this will give Beijing room to begin a gradual loosening process in H2. This would set us up for more price inflation at some point, assuming that real rates are still low and the CNY is perceived as undervalued. Demand for housing still seems robust.

## Politics

- Food-price inflation is a big problem for the government. It hits low-income groups the hardest since food accounts for 40-50% of low-income households' spending, and there are no easy ways for the authorities to ease the pressure. Food stamps are a great way of targeting support to the needy, but China does not have such a system in place. Instead, the authorities will likely hike urban and rural 'minimum support' (*dibao*) payments and increase food subsidies at schools and universities. Bureaucrats will demand that food manufacturers, wholesalers and supermarkets keep prices stable. However, such tools do not work beyond the short term.

- We expect bilateral relations with the US to deteriorate. The US trade deficit with China is unlikely to narrow – and although CNY appreciation will accelerate, this will not be enough to make Washington happy. Beijing's frustration with QE2 and its belief that Washington's ultimate ambition is to quietly devalue the USD (and China's USD 2trn or so of US securities holdings) will also sour the relationship. We expect US legislation to define CNY undervaluation as an export subsidy, as well as other trade complaints.

# Hong Kong

**Kelvin Lau**, Regional Economist
Standard Chartered Bank, Hong Kong
+852 3983 8565, Kelvin.KH.Lau@sc.com

## Living with rising inflation

### Economic outlook

- For better or for worse, 2011 is likely to be an extension of what we have seen in 2010. In our view, inflation worries will continue to dominate. Growth, however, should stay resilient. We believe the Hong Kong dollar (HKD) peg will stay unchanged, and cooling the property market will remain the primary policy focus. The development of the CNH (offshore CNY) market should continue to amaze, and the flood of liquidity from foreign money pouring in should keep interest rates low.

- Monetary conditions in Hong Kong are determined by US interest rates and by capital flows. We now expect the US Federal Reserve to start hiking rates only in Q1-2013. Meanwhile, more US quantitative easing could mean more money heading towards Asia. At the same time, the fundamental Greater China story should remain compelling to global investors. With Hong Kong's Aggregate Balance – a gauge of interbank liquidity – still close to HKD 150bn (versus a historical norm of less than HKD 5bn), there also appears to be a large liquidity buffer in place, capping rates on the upside.

- Barring transitory spikes running up to period-ends, 3M HIBOR should trade around 0.25% throughout 2011, in our view. This means that real interest rates will likely stay negative in 2011.

- Ample liquidity, well-supported asset prices, a further drop in the jobless rate and sustained tourist arrivals should underpin strong retail consumption in 2011. Net exports will also likely play a key role in spurring growth, despite the still-fragile recovery in the West, mainly because of the favourable base effect (a massive drag on headline growth in H1-2010). We expect GDP growth of 5.0% in 2011, which is still above the 4.5% trend growth rate.

- CPI inflation is set to head higher in 2011, probably to 4.0% from about 2.5% in 2010. In particular, the lagged effect of higher residential rents since early 2009 should finally start to bite (CPI tracks the average rent of all private residential flats, not just new rentals). This matters because housing accounts for around 30% of the CPI basket.

- Higher rents – along with rising public transport fares, the impending introduction of a minimum wage and the wildcard of food inflation – mean that CPI inflation could rise above the pre-crisis, post-deflation norm of 2-3%. While manageable, this should prompt the government to extend some of its economic relief measures in the budget in February to help households cope with higher living costs.

- Asset-price inflation could be a bigger worry than CPI inflation. We are unlikely to see the significant improvement in real-estate affordability that the government (and the public) hopes for anytime soon – at least not without further measures to restrain prices and pre-empt the further build-up of a bubble. The good news is that the extent of household leverage and speculative activity appears far from alarming for now.

**Standard Chartered forecasts: Hong Kong**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 6.5 | 5.0 | 5.0 | 4.5 |
| **CPI (% y/y)** | 2.5 | 4.0 | 4.0 | 3.5 |
| **3M HIBOR (%)*** | 0.25 | 0.25 | 0.35 | 1.30 |
| **USD-HKD*** | 7.76 | 7.76 | 7.76 | 7.76 |
| **Current account balance (% GDP)** | 7.5 | 8.0 | 8.5 | 9.0 |
| **Fiscal balance (% GDP)**** | 1.5 | 2.0 | 2.5 | 2.5 |

*end-period; **for fiscal year starting 1 April

Sources: Standard Chartered Research

### Financial issues

- Cross-border financial integration has been elevated to a new level thanks to the growth of the CNH market in 2010, which was made possible by a series of ground-breaking policy liberalisations. The market's infancy and its strong political backing from Beijing mean that it has plenty of room to grow. While more deregulation could be in store (the listing and trading of CNH-denominated stock, perhaps?), we believe the continued improvement in CNH liquidity – primarily stemming from further increases in CNY trade settlement volumes between China and the rest of the world – will take over as the main driver in 2011. In addition to the many quotas and administrative limitations still imposed on cross-border money flows, the fact that demand for CNH liquidity has

# Hong Kong (con'd)

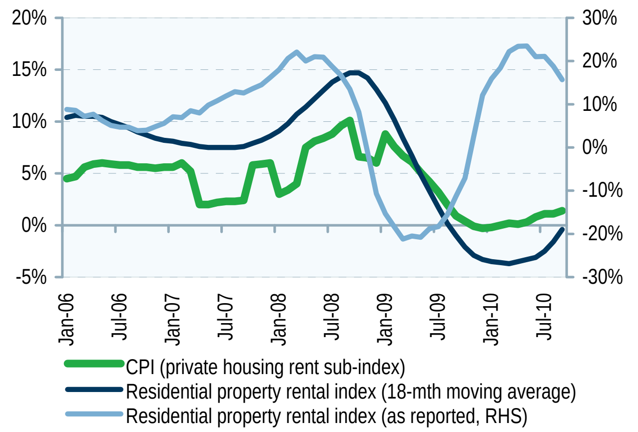
been exceeding supply has also kept CNH markets (such as the 'Dim Sum', or CNH-denominated, bond market in Hong Kong) from growing even faster. This will most likely improve in 2011.

## Policy

- We do not expect the existing USD-HKD peg to change in the foreseeable future. For one, the rapid emergence of the CNH market in Hong Kong will not break the peg, in our view. There is a long list of preconditions that will take years to meet before full currency substitution can occur. For now, the increased availability of CNH investment products has done little to distinguish the CNY from the many other foreign currencies that currently account for almost half of Hong Kong's deposits. Regulatory limitations also impede a behavioural change in consumer borrowing (personal CNH loans are still prohibited), and retailers that accept CNY payment still mostly cater for mainland tourists.

- We believe 'renminbisation' will indeed be the end-game for the HKD. However, it will happen only when the right conditions are in place – a fully convertible and highly internationalised CNY; improved monetary transparency, credibility and stability on mainland China's part; and low transaction costs relative to the HKD. It will also need to occur for the right reasons, as a natural result of closer economic and financial ties between Hong Kong and the mainland. In the meantime, and certainly in 2011, the HKD's credibility will continue to be derived from the time-tested, rule-based Linked Exchange Rate System.

**Chart 1: Rent increases finally start to spill over to CPI**
*y/y change*




Sources: CEIC, Standard Chartered Research

- The lack of a viable alternative to the peg (and the risk that any 'fine-tuning' measures would fuel even more market speculation) suggests that economic factors do not pose a threat to the peg, either. That said, we acknowledge that keeping the peg comes at a cost, and the price tag is likely to remain hefty in the coming years. In particular, asset prices will need to adjust on behalf of the HKD in the face of sustained low interest rates and more capital inflows. To keep property prices in check, the government needs to impose more macro-prudential measures.

- Despite the absence of monetary policy tools to manage interest rate expectations, the policy cupboard appears far from bare when it comes to defusing a potential real-estate bubble. Transaction costs for luxury residential flats could be raised (e.g., by hiking the stamp duty) to further discourage speculation. Rules on mortgage lending could be tightened further to prevent excessive household leverage. But thanks to recent cooling measures from the Hong Kong Monetary Authority (HKMA) and the low likelihood that interest rates will rise anytime soon, the industry-wide mortgage debt-servicing ratio should stay manageable in 2011 (it was at 41.5% as of end-Q2-2010, compared to the 20-year historical average of 53.0%).

- Addressing the housing affordability issue, and dealing with continued inflows of capital chasing local (mainly luxury) property prices higher, could be much trickier. The new 'rent-to-buy' programme announced in the latest Policy Address may be too long-term and too small initially to have an immediate impact. The temporary exclusion of real-estate investment from the Capital Investment Entrant Scheme also appears to be more about form than substance. The HKMA is now studying the idea of 'reverse mortgages' in view of Hong Kong's ageing population.

## Politics

- With the 2012 Chief Executive and Legislative Council elections still more than a year away, the political scene in 2011 will likely be dominated by (1) the upcoming District Council elections, which should provide a gauge of the relative popularity of the political parties; and (2) heated speculation on who will jockey to replace outgoing Chief Executive Donald Tsang.

# India

**Samiran Chakraborty**, Regional Head of Research, India
Standard Chartered Bank, India
+91 22 6735 0049, Samiran.Chakraborty@sc.com

## Support growth momentum with policy

### Economic outlook

- India's recovery from the global financial crisis has been spectacular in 2010, and a strong repeat performance is possible in 2011. We expect GDP growth to accelerate to 8.5% in FY12 (begins 1 April 2011) from an estimated 8.1% in FY11. Infrastructure-related investment spending is likely to be the primary driver, but the consumer is not far behind. Although the effects of fiscal stimulus are likely to wear off, the government is unlikely to shy away from building critical infrastructure and spending on its inclusive growth strategy.

- Average growth of 28% in consumer durables production over the 12 months to September 2010 was fueled by wage growth and the wealth effect of higher asset prices. This frenzied pace of growth will most likely moderate in urban centres, but huge opportunities remain in semi-urban and rural areas. However, consumer non-durables growth of 3.5% over the same period is cause for concern. If this weakness is caused by persistent inflation, demand for consumer non-durables may pick up in 2011 as inflation starts to moderate.

- The investment pipeline remains strong, with 87 projects worth INR 1trn approved by banks in Q1-FY11 alone (a jump of 230% y/y). Much of this planned investment is in infrastructure. Capex also needs to pick up in other areas in order to sustain high growth. Industrial growth had decelerated from very high levels by mid-2010. This trend may be further accentuated in early 2011 by the strong base effect and tightening of the policy stance. However, later in the year, industrial growth should recover as the investment pipeline is realised.

- Persistent inflation has dominated policy discussions in 2010, but a significant base effect is likely to pull it down in early 2011. The Reserve Bank of India (RBI) has recently emphasised structural factors like steep price rises for protein-rich food items (pulses, eggs, meat and fish) as the key driver of inflation. While demand-side inflation has been contained recently, these structural factors may cause prices to be downwardly rigid. H2-2011 could see inflation inch up, especially if global commodity prices trend higher.

**Standard Chartered forecasts: India**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 8.1 | 8.5 | 8.8 | 9.0 |
| **WPI (% y/y)** | 8.2 | 5.0 | 4.5 | 4.5 |
| **Policy rate (%)*** | 6.25 | 6.75 | 6.75 | 6.75 |
| **USD-INR*** | 45.5 | 43.0 | 40.0 | 39.0 |
| **Current account balance (% GDP)** | -3.5 | -3.0 | -2.0 | -1.8 |
| **Fiscal balance (% GDP)** | -5.5 | -4.8 | -4.0 | -3.8 |

Note: All forecasts except policy rate and USD-INR refer to the April-March fiscal year starting in the year in column heading; *end-period

Sources: CEIC, Standard Chartered Research

### Financial issues

- The RBI is considering deregulating the interest rate for savings deposits. The mechanism through which the RBI manages banking-system liquidity is also being re-examined. Both of these reforms are aimed at improving the monetary policy transmission mechanism.

- Three developments in the banking sector are worth following in 2011. The RBI is likely to issue new banking licenses for the first time in 11 years. To promote financial inclusion, the RBI will also require banks to provide services to 73,113 unbanked villages by March 2012. Finally, implementation of Basel III could prove to be a challenge for India's banking sector.

- After subdued growth for almost two years, bank credit has become the dominant source of funding for the commercial sector – although 80% of bank credit to industry went to the infrastructure sector in H1-FY11. With external commercial borrowings and FDI below trend levels, the onus will be on bank credit and fresh equity issuance to fund corporates' expansion plans.

### Policy

- The government expects to reduce the fiscal deficit to 4.8% of GDP in FY12 from a budgeted 5.5% in FY11. Robust tax collection and the overwhelming success of the divestment exercise may embolden the government to target a further reduction of the deficit ratio. However, the government's large subsidy burden and emphasis on redistributing income will limit deficit reduction, in turn preventing a reduction in bond-market supply.

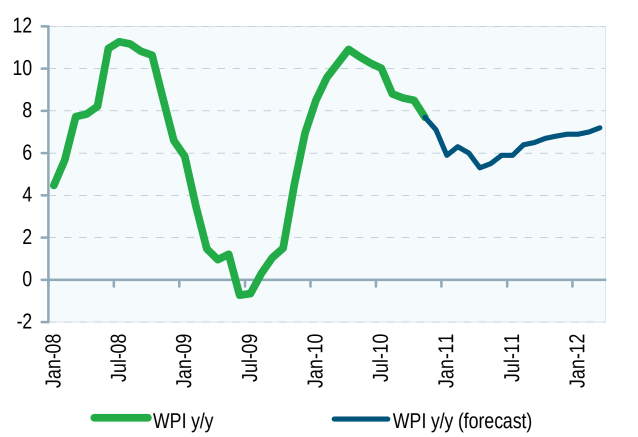
# India (con'd)

- After normalising policy rates for most of 2010, the RBI has indicated its intent to pause until January 2011. If inflation moderates to the RBI's forecast of 5.5% by end-March 2011, this pause may be extended further. The RBI will be especially wary of tightening monetary policy too much when inflation is coming largely from the supply side. Further tightening of 50bps is likely in H2-2011, when demand-side inflationary pressures could re-emerge.

- Liquidity tightness is improving the monetary policy transmission mechanism, and the RBI might prefer to continue with such a stance. However, it needs to ensure that tight liquidity does not starve genuine demand for funds, especially with early signs emerging of softness in industrial production. The RBI might favour sector-specific macro- and micro-prudential regulations if asset-price inflation becomes a concern.

- The current account deficit is likely to exceed 3% of GDP in FY11, and is likely to remain significant in FY12. However, a large current account deficit could be beneficial in some ways, helping to absorb capital inflows without too much impact on the currency or Indian rupee (INR) liquidity. Indian policy makers have not joined the chorus for imposing capital controls, and we expect 2011 to be the same. Concerns about loss of competitiveness arising from INR strength have been muted, and we do not expect the RBI to try to influence the currency's trajectory. We forecast a trend appreciation in USD-INR towards 43.00 by end-2011, interspersed with short bouts of reversal triggered by global uncertainties.

**Chart 1: Elevated inflation**




Sources: CEIC, Standard Chartered Research

### Other issues

- The government's goal of fostering 'inclusive' growth is likely to result in more policies to bridge India's rural-urban divide. The roll-out of the Unique Identification (UID) system in 2011 will be the first step towards improved targeting of subsidies. However, the Food Security Act could increase food subsidies by 25-30% from the already-elevated levels of FY10. Accommodating a food subsidy of more than 1% of GDP would require a substantial reduction in the fuel subsidy. The deregulation of retail fuel prices in 2010 will help, but further reduction of the fuel subsidy might be needed in case of an oil-price shock.

- Critical reforms are pending across various key areas: land acquisition; FDI in retail, insurance and pension companies; streamlining of bureaucracy; and overhauling the direct and indirect tax systems. Any progress on these fronts would attract more foreign funds.

- India will enter the final year of its $11^{th}$ Five Year Plan in FY12. A 15% y/y jump in infrastructure spending is planned for FY12 to meet the five-year target. Infrastructure companies' order books have been growing, and project execution could begin in 2011. In particular, government-sponsored road and housing projects will have to pick up in order for momentum in the infrastructure space to continue. Ensuring adequate coal and gas supply will be critical for the energy sector.

### Politics

- After a quiet year for elections in 2010, five states will go to the polls in 2011. The performance of the ruling United Progressive Alliance (UPA) and its allies will reflect midterm voter perceptions. The pace of reforms may be delayed if consensus politics prevail and lack of a majority in both houses hampers legislative business.

- Tackling internal security issues in Kashmir and states affected by the Maoist movement will continue to be challenging. Cross-border terrorism has been limited in 2010; however, peace needs to be sustained over a longer period in order to reap growth dividends.

- The recent visit of US President Obama and his support for India's quest for a permanent seat on the UN Security Council reflect India's growing role as a powerful geopolitical force globally.

# Indonesia

**Fauzi Ichsan**, Senior Economist
Standard Chartered Bank, Indonesia
+62 21 2555 0117, Fauzi.Ichsan@sc.com

**Eric Alexander Sugandi**, Economist
Standard Chartered Bank, Indonesia
+62 21 2555 0596, Eric.Alexander-Sugandi@sc.com

## Easy money, tight budget

### Economic outlook

- We expect GDP growth to pick up to 6.5% in 2011 from 6.0% in 2010, fueled by domestic consumption, investment and strong demand for commodities, which make up over 50% of exports. Domestic consumption will remain the key engine of growth. Growth in household spending is expected to rise to 5.3% in 2011 from 4.7% in 2010, helped by credit growth and falling unemployment. The biggest boost to GDP growth will likely come from a pick-up in investment growth to 12.1% from 6.7% as private investment surges. However, slow infrastructure development may limit overall GDP growth.

- Higher GDP growth (and thus higher imports) is expected to reduce Indonesia's current account surplus to USD 4bn in 2011 from USD 6bn in 2010. Meanwhile, the surplus in the capital and financial account is expected to fall to USD 16bn from USD 27.9bn as net foreign portfolio investment in debt securities falls to USD 8bn from USD 16bn, given the expected rise in domestic interest rates. FDI is likely to remain resilient at USD 13bn in 2011, up from USD 12.5bn in 2010 and USD 5.3bn in 2009.

- The balance-of-payments surplus is therefore expected to fall to USD 20bn in 2011 from USD 33.9bn in 2010. We expect Indonesia's FX reserves to rise further to USD 120bn by the end of 2011, from USD 100bn in 2010 and USD 66.1bn in 2009. We believe the availability of more than USD 100bn in FX reserves, a continuing current account surplus and rising FDI will have two notable implications. First, Bank Indonesia (BI) will be more confident in managing foreign 'hot money' inflows and will likely allow more rapid Indonesian rupiah (IDR) appreciation by limiting its FX intervention. Second, international rating agencies are likely to upgrade Indonesia's sovereign rating further, particularly in light of Indonesia's healthy fiscal position. We expect Indonesia to attain investment grade in 2012.

**Standard Chartered forecasts: Indonesia**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 6.0 | 6.5 | 7.0 | 7.0 |
| **CPI (% y/y)** | 5.0 | 6.0 | 6.2 | 5.0 |
| **Policy rate (%)*** | 6.50 | 7.50 | 7.50 | 6.50 |
| **USD-IDR*** | 8,900 | 8,500 | 8,100 | 7,800 |
| **Current account balance (% GDP)** | 0.9 | 0.5 | 0.5 | 0.0 |
| **Fiscal balance (% GDP)** | -1.5 | -1.3 | -1.5 | -1.5 |

*end-period

Sources: Bank Indonesia, Standard Chartered Research

### Financial issues

- Despite these positive macro factors, there are two emerging risks. First, inflation may accelerate, and BI's reluctance to raise interest rates (while central banks in India, Thailand and Malaysia, among others, did so in H2-2010) may create the market perception that BI is 'behind the curve' on its rate policy. We expect headline inflation to accelerate to 6.5% y/y by December 2011 from 6.0% in December 2010. There is a risk of even higher inflation, as potential supply shocks to crops and speculative buying could lead to global food-price inflation in 2011.

- An unexpectedly sharp rise in inflation, coupled with BI's reluctance to hike its policy rate, could eventually trigger a rapid reversal of foreign portfolio flows, weakening the IDR. By Q4-2010, foreign investors held approximately USD 29bn of IDR government bonds and BI certificates (SBI), or 30% of the total stock – a record high that has raised concerns among policy makers. That said, barring another global financial crisis on the scale witnessed in H2-2008, any capital flight from Indonesia is likely to be sharp but temporary, in our view.

### Policy

- Despite IMF pressure on BI to hike its policy rate to cap expected inflation, BI has argued that doing so may be counter-productive in the current environment. Higher domestic interest rates would attract further foreign capital inflows, intensifying upward pressure on the IDR and necessitating more BI intervention in the FX market. Without sterilising such intervention, domestic money supply growth would accelerate, which would be inflationary. Meanwhile, BI cannot continually sterilise its FX intervention, as the cost of absorbing excess IDR liquidity exceeds the return on its FX reserves (predominantly in USD), and the negative carry is eroding BI's capital. Continual depletion of its capital could eventually compel BI to turn to the government and parliament for recapitalisation, which it would likely avoid

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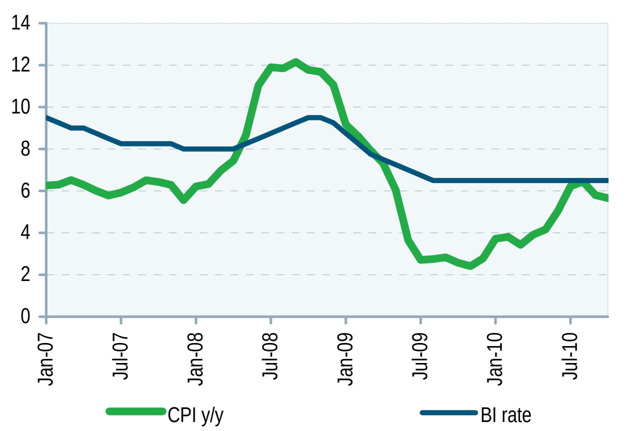
for political reasons. Consequently, we expect BI to raise the BI rate to 7.5% (from 6.5%) in 2011 – although there is a risk of further rate-hike delays unless US interest rates rise or the IDR weakens sharply. In the event of capital flight and a strong market perception that BI is behind the curve, BI rate hikes would need to exceed 100bps.

- A key reason for BI's reluctance to raise interest rates is its inability to impose restrictions on foreign capital inflows, as Brazil and Thailand have done. Law 24/1999 specifically prohibits capital controls and discrimination against foreign portfolio flows in favour of local investors. A change in the law would necessitate the support of two-thirds of parliament, which is unlikely. Furthermore, the Ministry of Finance (MoF), which has the power to impose a withholding tax on capital flows, is openly reluctant to do so and is happy with the decline in IDR bond yields (and in government borrowing costs) due to capital inflows. Both BI and the MoF may impose and extend minimum holding periods for BI and government securities, while stopping short of imposing draconian measures.

- While BI monetary policy is loose, the government's fiscal policy is expected to remain conservative, even if by default. There is a risk that the 2010 fiscal deficit will be lower than the already reduced target of 1.5% of GDP (from 2.1% initially), and that the MoF will again have a balance carried forward into 2011 (as it did in 2009). We expect the 2011 fiscal deficit to be 1.3% of GDP, versus the 1.8% government target. Slow fiscal disbursal due to delayed land clearance for infrastructure projects and regional governments' weak project execution capability (as well as accelerating tax revenues on higher GDP growth) should keep the fiscal deficit below the 3% constitutional cap. As a result, public debt is likely to continue to fall to 25.5% of GDP in 2011 from 27% in 2010 and 28% in 2009.

**Chart 1: Headline y/y inflation vs. BI rate** *(%)*




Sources: Bank Indonesia, Standard Chartered Research

### Politics

- Tensions between the government and parliament over the Bank Century rescue (during the global financial crisis in H2-2008) have eased following the resignation of former Finance Minister Sri Mulyani Indrawati, who joined the World Bank in May 2010. Investors' initial concerns that her successor, former bank CEO Agus Martowardojo, may discontinue her bureaucratic reforms have also eased, as he continues to reform the tax office while managing fiscal policy like a conservative banker.

- Tensions may, however, intensify between BI, the MoF and parliament over the planned establishment of a UK-style Financial Services Authority (OJK), which will take over banking regulatory powers from BI. The BI law (passed in response to the Asian financial crisis) requires the OJK to be established in 2010, although the actual transfer of regulatory responsibilities may take up to three years.

- The political environment is expected to be largely stable in 2011. A cabinet reshuffle is possible but would likely be minor and, like past ministerial changes, would be unlikely to create political uncertainty. Analysts are nevertheless concerned that, having wasted a year in political deadlock over the Bank Century case, President Yudhoyono's second government may fail to implement politically sensitive reforms such as the revision of the manpower law and the diversion of Indonesia's natural gas exports to domestic power plants.

- The next general election will be in 2014, and Yudhoyono is constitutionally barred from running for a third term, opening the way for new presidential contenders. Until 2013, when political manoeuvrings are expected to intensify, the focus on Indonesia is likely to be economic as the country takes a more dominant role in ASEAN and in the G20 forum.

# Malaysia

**Alvin Liew**, Economist
Standard Chartered Bank, Singapore
+65 6596 8245, Alvin.Liew@sc.com

## Investment to lead the way

### Economic outlook

- We expect GDP growth to ease to 5.1% in 2011 after a strong recovery to 6.8% in 2010. Investment will lead growth in 2011 and 2012, with a slew of projects announced in the 2011 budget and the government implementing its Economic Transformation Programme (ETP). Spending will be led by government-linked companies, but private investment may fall short of the official 12% annual growth target for the next decade.

- Private consumption is likely to make a positive but small contribution to growth in 2011. In comparison, growth in manufacturing exports is expected to moderate as inventory restocking ends. Commodity exports could provide a positive offset if commodity prices rise on a sustained basis.

- We expect inflation to accelerate to 3.4% in 2011 from 1.7% in 2010 on the back of a narrowing output gap and the risk of commodity price rises. Administrative measures such as food and fuel subsidies will help to offset inflationary pressure. Proactive monetary tightening by the central bank in 2010 will also help to contain demand-side inflation risk, but not eliminate it.

### Financial issues

- Malaysia has so far refrained from being drawn into the debate on capital controls, and the authorities continue to pursue capital account liberalisation. While China is internationalising its currency, Malaysia may see no need to allow the Malaysian ringgit (MYR) to be traded offshore more freely, especially during this period of currency-market volatility. Given that potential capital inflows into Malaysia in 2011 may cause the MYR to strengthen considerably, the central bank would need to be convinced that further liberalisation of the exchange rate regime would not undermine its ability to manage exchange rate volatility.

#### Standard Chartered forecasts: Malaysia

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 6.8 | 5.1 | 6.0 | 5.0 |
| **CPI (% y/y)** | 1.7 | 3.4 | 2.5 | 2.5 |
| **Policy rate (%)*** | 2.75 | 3.50 | 3.50 | 3.50 |
| **USD-MYR*** | 3.10 | 2.98 | 2.87 | 2.77 |
| **Current account balance (% GDP)** | 17.0 | 15.0 | 15.5 | 16.5 |
| **Fiscal balance (% GDP)** | -5.6 | -5.4 | -4.5 | -4.0 |

*end-period Source: Standard Chartered Research

### Policy

- After having front-loaded rate hikes in early 2010, Bank Negara Malaysia (BNM) kept the overnight policy rate (OPR) unchanged at 2.75% in H2-2010. With economic activity maintaining steady momentum, commodity prices rising and subsidy reforms gradually being implemented, inflation expectations are likely to rise in 2011. Given its proven independence and proactive approach, we expect BNM to be at the forefront of rate hikes again, raising the policy rate by another 75bps in 2011.

- Malaysia has posted fiscal deficits since 1998. While the government plans to narrow the deficit further in 2011, it is still forecast at a significant 5.4% of GDP. This implies that subsidy reforms are likely to be moderate, while the government will incur higher development expenditure as it revs up infrastructure investment.

### Other issues

- Malaysian household debt has risen in recent years. Household debt climbed from 47% of GDP in 2000 to 63.9% in 2008, and we expect it to have increased further to 75% in 2010. BNM has already introduced measures to curb leverage. This also implies that the Malaysian economy cannot rely on rising consumer borrowing to support growth in a sustainable manner.

### Politics

- General elections are looming – as indicated recently by the prime minister when he asked his political party to prepare for elections, and by heavy spending in the 2011 budget. The ruling Barisan Nasional (BN) coalition is likely to maintain its simple majority in the parliament, but whether it can regain a two-thirds majority is a much closer call. If BN is able to regain its two-thirds majority, PM Najib will have a stronger mandate to push ahead with his economic reform programme.

# New Zealand

**Vincent Tsui**, Economist
Standard Chartered Bank, Hong Kong
+852 3983 8563, Vincent.Tsui@sc.com

## Rebalancing the indebted economy

### Economic outlook

- Deleveraging pressure on both the household and corporate sectors will continue to restrain private-sector consumption and investment in 2011. The gradual normalisation of Reserve Bank of New Zealand (RBNZ) monetary policy settings will lift households' debt servicing costs, and stubbornly high unemployment will delay wage growth and the debt reduction process. The pace of the current recovery should be more gradual than in previous cycles.

- Reconstruction projects after the Canterbury earthquake in September 2010 will provide a one-off boost to GDP growth in the coming quarters. Meanwhile, supply constraints due to capacity damage from the earthquake, as well as a 2.5% GST hike, will result in an upward distortion to headline CPI inflation in 2011.

- New Zealand's exports are dominated by agricultural commodities. While terms of trade should improve with the expected upswing in food prices in H1-2011, agricultural incomes remain vulnerable to fluctuations in animal feed prices, rising leverage in the dairy sector, and the still-spreading kiwifruit vine disease.

- Buoyant demand from Australia should gradually benefit New Zealand's private sector due to close trade links and heavy financial flows between two economies.

### Financial issues

- New Zealand's financial sector is dominated by four Australian-owned banks. Thanks to the resilience of Australia's banking sector to the global recession, New Zealand has enjoyed less volatile financing conditions than other advanced economies. However, the fact that New Zealand's rate-hiking cycle has lagged Australia's could lift funding costs for New Zealand's financial institutions, which could eventually be transmitted to the retail segment.

**Standard Chartered forecasts: New Zealand**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 1.7 | 2.0 | 3.0 | 3.0 |
| **CPI (% y/y)** | 2.3 | 3.9 | 2.4 | 2.9 |
| **Policy rate (%)*** | 3.00 | 4.00 | 4.50 | 5.25 |
| **NZD-USD*** | 0.79 | 0.70 | 0.75 | 0.80 |
| **Current account balance (% GDP)** | -3.5 | -4.0 | -5.0 | -5.0 |
| **Fiscal balance (% GDP)**** | -3.7 | -4.2 | -2.5 | -1.9 |

*end-period; **for fiscal year ending 30 June

Source: Standard Chartered Research

### Policy

- The RBNZ is likely to normalise monetary policy at a gradual pace in 2011. The debt overhang in the private sector and continued weakness in the housing market will keep inflation manageable, and premature tightening would put the still-fragile recovery momentum at risk.

- Tax reforms outlined in the FY11 budget – including a reduction in corporate and personal tax rates and a GST hike – may widen the fiscal deficit due to still-sluggish domestic consumption. However, the new tax regime would encourage savings and investment, which would facilitate the rebalancing of the indebted economy over the medium term.

### Other issues

- New Zealand's twin deficits will remain a medium-term concern for credit rating agencies. The current account deficit has been persistently wide due to an ongoing shortfall in domestic savings and an over-reliance on foreign funding. Although the corporate sector has gradually reduced its external debt since Q2-2009, outstanding debt levels remain high by historical standards. A gradual increase in interest rates will widen New Zealand's current account deficit going forward.

- The housing market remains soft, with housing prices and transaction volumes having resumed their downtrend in Q2-2010. There may be room for a downward correction, which would further weaken household balance sheets.

### Politics

- The next general election must be held on or before 7 January 2012, and Prime Minister John Key will likely dissolve the parliament in H2-2011. The incumbent National Party has maintained a comfortable lead since the 2008 election.

# Pakistan

**Sayem Ali**, Economist
Standard Chartered Bank (Pakistan) Limited
+92 3245 7839, Sayem.Ali@sc.com

## End of the IMF programme

### Economic outlook

- Pakistan's USD 11.3bn IMF Stand-By Arrangement (SBA) ends in December 2010. Fundamentals have improved, with FX reserves strengthening to a record high of USD 17bn (5.6 months of import cover). However, large external debt payments and a slowdown in FDI inflows indicate that the economy remains vulnerable to balance-of-payments shocks. There is a strong possibility that the government will seek further support from the IMF, but this would be a difficult and unpopular move.

- Growth has suffered in FY11 (began July 2010) due to the heavy floods in August, leaving 20mn people homeless and causing widespread damage to crops and infrastructure. Damages are estimated at USD 9.7bn (5% of GDP), based on preliminary assessments by the World Bank and Asian Development Bank. However, growth is likely to pick up in FY12 on higher reconstruction spending and record-high remittances, which should sustain consumption spending.

- Inflation remains the biggest risk to economic and political stability. The government revised up its headline inflation target for FY11 to 15% from 9.5% due to the crop damage caused by floods. Inflation is also being fueled as the government prints money to finance its large deficits. We expect CPI inflation to average 16% y/y in FY11, exceeding the government target.

### Financial issues

- Financial-sector health has improved. Risk-adjusted capital had increased to 13.9% as at June 2010 as banks retained a larger portion of their earnings to meet the higher minimum capital requirement of PKR 10bn set by the central bank. This will encourage mergers and acquisitions in the banking industry in 2011. Bad debts increased to 12.9% of total loans as of June 2010 from 11.5% a year earlier. NPLs will pose a significant risk in 2011 as the rising cost of doing business erodes corporate earnings.

#### Standard Chartered forecasts: Pakistan

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 4.1 | 2.5 | 4.5 | 5.0 |
| **CPI (% y/y)** | 11.7 | 16.0 | 13.0 | 10.0 |
| **Policy rate (%)*** | 12.5 | 15.0 | 15.0 | 12.5 |
| **USD-PKR*** | 86.8 | 89.8 | 93.0 | 97.0 |
| **Current account balance (% GDP)** | -2.0 | -3.0 | -3.4 | -3.5 |
| **Fiscal balance (% GDP)** | -6.3 | -6.0 | -4.8 | -4.2 |

Note: All forecasts except USD-PKR refer to the July-June fiscal year ending in the year in column heading; *end-period
Source: Standard Chartered Research

### Policy

- Fiscal consolidation is critical to curbing the build-up of public debt and bringing down inflation. A revised sales tax, power subsidy cuts and a flood tax are measures outlined by the government to reduce the FY11 deficit to 4.7% of GDP from 6.3% in FY10. We expect the FY11 deficit to remain high, at 6% of GDP, given the likely shortfall in tax revenues and higher debt-servicing costs as borrowing costs rise.

- Monetary policy will remain hawkish given inflation risks. The central bank raised the policy rate by 100bps in 2010 to 13.5%, and we forecast that rates will rise further to 15% in 2011.

- The free-float exchange rate regime has worked well for the Pakistani rupee (PKR), resulting in an increase in the FX reserves to a record-high USD 17bn. The PKR depreciated 2.4% in 2010, 8% in 2009 and 28% in 2008.

### Politics

- President Zardari's Pakistan Peoples Party (PPP)-led government is struggling to deal with the aftermath of the floods. It has pushed through unpopular yet necessary reforms including subsidy cuts and new tax measures, drawing sharp criticism from coalition partners and opposition parties. The PPP leadership also faces charges of corruption in the courts after a controversial amnesty law was struck down. Despite these challenges, the government has done remarkably well in keeping its coalition in power in the central government and all four provinces. The next elections are scheduled for 2013.

- Relations with the US have improved, and the Obama administration has increased military and economic aid to Pakistan. Peace talks with India are likely to resume as tensions ease.

# Philippines

**Simon Wong**, Regional Economist
Standard Chartered Bank, Hong Kong
+852 3983 8559, Simon.Wong@sc.com

## Boom-time challenges

### Economic outlook

- We expect the economy's strong comeback in 2010 to carry over into 2011, eventually confronting authorities with overheating concerns. Investment growth began to recover in 2010; this, together with continued remittance-driven consumption, propelled GDP growth to almost 8% y/y in H1. The latest data have shown renewed momentum in export growth in late 2010 as shipments to other Asian markets surge, paving the way for the trade sector to contribute to headline growth in the coming quarters.

- Inflation has remained benign throughout 2010 and has been little affected by the rise in global food prices since mid-year. However, we think the biggest threat to medium-term price stability arises not from external shocks but from the narrowing output gap in the domestic economy – especially if the central bank is forced to delay meaningful tightening for fear of encouraging further capital inflows into the country.

### Financial issues

- The authorities are confronted with surging capital inflows that have pushed the Philippine peso (PHP) to decade-highs on a real effective exchange rate (REER) basis. The central bank has refrained from imposing capital controls, but it eased restrictions on capital outflows in late October in an attempt to lessen appreciation pressure on the currency. The government is also considering ways to steer further inflows to more productive and lasting uses, including a change in its debt profile.

### Standard Chartered forecasts: Philippines

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 7.2 | 5.4 | 6.0 | 6.0 |
| **CPI (% y/y)** | 3.8 | 4.3 | 5.4 | 5.8 |
| **Policy rate (%)*** | 4.00 | 5.25 | 6.00 | 7.00 |
| **USD-PHP*** | 43.50 | 41.00 | 39.00 | 37.50 |
| **Current account balance (% GDP)** | 6.5 | 6.1 | 5.5 | 4.2 |
| **Fiscal balance (% GDP)** | -3.5 | -2.7 | -1.0 | -0.5 |

*end-period

Source: Standard Chartered Research

### Policy

- The Aquino government's maiden budget for 2011, approved by Congress in October 2010, envisions a mild tightening of fiscal policy, with total expenditure of PHP 1.645trn – a 6.4% gain from 2010. This lags the projected 8.8% gain in nominal GDP and reduces spending as a percentage of GDP to 18.2% from 18.5% in 2010. There is a clear shift in spending away from capital items like infrastructure and towards social services like welfare and transfer payments. The government expects the fiscal deficit to narrow to PHP 290bn in 2011 from PHP 325bn in 2010. We forecast an even smaller shortfall of PHP 256bn in 2011, as we expect a booming economy and improved tax collection efforts to boost revenues.

- Even as inflation remains well behaved for now, we believe current real interest rates are too low for such a strong economy. As such, we expect overheating concerns to prompt Bangko Sentral ng Pilipinas (BSP) to start tightening in 2011. We see the policy rate rising to 5.25% by end-2011.

### Other issues

- There is considerable uncertainty as to whether the government can secure sufficient and stable funding to finance the so-called 'public-private partnership' for infrastructure projects, which it has said could amount to PHP 718.8bn (USD 16.7bn, or 8% of forecast 2011 GDP) over the next two years. Failure would not only undermine the government's goal of fiscal consolidation, but would also prevent the economy from closing the infrastructure gap with the rest of the region.

### Politics

- The six-month-old Aquino (Liberal Party) administration has suffered little political setback from the August hostage incident. A poll conducted in October continued to show a relatively high approval rating of 71%.

- The government hopes to renew dialogue with the Muslim separatist rebel movement in Mindanao. Meaningful progress on this front would improve the country's security outlook and increase the administration's credibility ahead of the midterm elections due in 2013.

# Singapore

**Alvin Liew**, Economist
Standard Chartered Bank, Singapore
+65 6596 8245, Alvin.Liew@sc.com

## No stagflation

### Economic outlook

- Following a strong recovery in H1-2010, Singapore's growth is likely to return to trend in 2011 on a moderation in the manufacturing sector (especially in pharmaceuticals) and a high base effect. We expect the economy to expand by 4.6% in 2011.

- The services sector, especially tourism-related and financial services, is expected to become a more prominent driver of headline growth in 2011. These industries feed off of rising regional domestic demand from China and ASEAN and are expected to continue to benefit from the strength of the Asian consumer. Notwithstanding the upgrading of Singapore's manufacturing sector to higher-value activities, the composition of GDP is set to shift away from manufacturing and towards services. We expect services to account for 75% of GDP in 2013, up from 64% in 2008. The construction sector should contribute positively to growth in 2011, but the strong growth rates recorded in 2010 are likely to ease. Public transport and infrastructure projects will be supportive of industry in the next decade, with the government set to inject SGD 50bn to upgrade the transport system.

- As in the rest of the region, inflation is expected to be Singapore's key challenge in 2011. CPI inflation, which was largely driven by higher car prices and housing costs in 2010, will switch to domestic drivers such as higher residential property rents and services costs in 2011. And while imported inflation sources have been largely benign in 2010, we expect them to become more prominent in 2011, mainly via higher food prices. Inflation reached a 20-month high of 3.7% y/y in September. It looks likely to reach the central bank's projection of 4% y/y by end-2010 and stay high in H1-2011, before moderating in H2. We expect inflation to average 3.4% in 2011, following an estimated 2.9% in 2010 – far above the 10-year average of 1.4%. In addition, car prices could remain high in 2011 due to the expected fall in the supply of car ownership certificates in February 2011, although the already-high base in 2010 should temper inflation pressures.

### Financial issues

- Concerns about the weak US growth outlook and a highly accommodative US Federal Reserve have led us to revise our Fed rates view – we now expect the Fed to start hiking only in Q1-2013. In line with our latest US interest rate forecasts, we also see Singapore's short-term interest rates remaining depressed until end-2012. As the Monetary Authority of Singapore (MAS) does not have an explicit interest rate policy, domestic short rates track US rates quite closely.

- We believe the delay in US interest rate normalisation will have three key implications for Singapore: (1) Despite the MAS' Singapore dollar nominal effective exchange rate (SGD NEER) appreciation policy stance, we expect the SGD SIBOR curve to stay above the USD LIBOR curve until at least end-2012. (2) While we still expect 3M SGD SIBOR to head above 3%, this will only happen after 2013, in our view. (3) Prolonged low global interest rates imply sustained capital flows into Asia, including Singapore.

- Extraordinarily low global interest rates will continue to channel foreign funds to Singapore seeking investment opportunities – especially in property, where locals are also expected to add exposure. The MAS' strong SGD policy adds to the attractiveness of domestic property. Units of new private homes sold picked up in October, after a short breather in September following a third round of anti-speculative measures introduced in August. This has prompted expectations of a fourth wave of measures, which may include temporary restrictions on foreigners taking mortgages, a limit of one mortgage for permanent residents, and a capital gains tax on property transactions.

### Standard Chartered forecasts: Singapore

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 14.0 | 4.6 | 6.0 | 5.0 |
| **CPI (% y/y)** | 2.9 | 3.4 | 2.5 | 2.5 |
| **3M SGD SIBOR (%)*** | 0.50 | 0.50 | 0.50 | 1.65 |
| **USD-SGD*** | 1.30 | 1.23 | 1.17 | 1.13 |
| **Current account balance (% GDP)** | 17.0 | 15.0 | 16.7 | 15.5 |
| **Fiscal balance (% GDP)**** | -1.1 | 0.5 | 2.5 | 1.5 |

*end-period; **for fiscal year starting 1 April

Sources: Standard Chartered Research

# Singapore (con'd)

## Policy

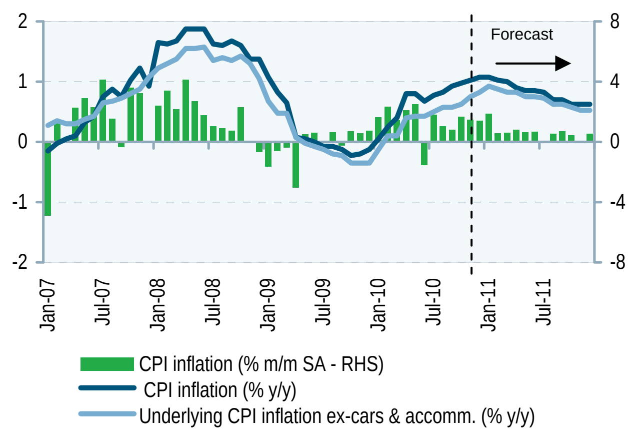
- We see a 40% chance that the MAS will opt for further tightening in 2011, most likely via a one-off appreciation of the SGD by repositioning the policy mid-point. Inflationary concerns may deepen across Asia, and inflation risks for Singapore appear to be tilted towards the upside.

- In its second and final Monetary Policy Statement of 2010, the MAS surprised the markets in October by opting to "slightly" tighten monetary policy for the SGD NEER. Assuming that both headline and underlying inflation are within the MAS' target of 2-3% in 2011, and that growth decelerates towards its potential rate (4-5%, in our view), we expect the MAS to keep policy steady in April 2011 after tightening in April and October 2010.

## Other issues

- The government's labour policy of restricting inflows of foreign workers will lead to wage pressures and higher services costs in 2011 and beyond. Economic growth in the past decade has been strongly correlated with the abundant use of labour, but this strategy came at the cost of low productivity and strains on Singapore's physical infrastructure and social fabric. The government has therefore decided to shift from the previous model towards one of higher efficiency and productivity, as it outlined in the budget speech in February.

**Chart 1: Headline and underlying inflation to stay high in H1-2011 before easing in H2**




Sources: CEIC, Standard Chartered Research

- The focus is now on enhancing the quality of growth, but this will mean a structural shift to lower trend growth in the medium term – a bitter pill the government seems willing to swallow for now.

- Growth volatility is likely to be a problem for Singapore, stemming from its over-reliance on external demand. GDP data from recent quarters showed swings from a 10% y/y contraction to a 20% expansion, driven by changes in the external environment. This volatility puts Singapore at risk of stagflation (albeit temporary) in 2011 if the world economy were to head towards a double-dip recession.

- Notwithstanding the volatility of export performance, Singapore's small domestic market implies that external demand will remain a critical engine of growth. The country has enjoyed some success in diversifying its exports and manufacturing away from electronics-based production in recent years, into biomedical production, offshore marine engineering, and innovation- and technology-intensive industries such as clean water technology. It is also allowing the services sector – including tourism, business and financial services, and logistics – to expand further and make an even more prominent contribution to headline growth.

- While FY10 (began 1 April 2010) will see Singapore's third consecutive annual deficit, the shortfall is moderate compared with those of many other economies, and we expect the government to return to small fiscal surplus in FY11. We see a low risk that Singapore will face chronic fiscal imbalances.

## Politics

- The next general elections are likely to take place in H1-2011, even though they are not due until February 2012. The ruling party, the PAP, is likely to maintain its absolute dominance in the next parliament. The government operates as a parliamentary republic, with a unicameral parliament to which members are elected by popular vote to serve five-year terms.

- The PAP currently has 82 seats, while two opposition parties have one seat each. Given the expectation of another strong result in favour of the PAP, these elections are unlikely to have a significant impact on the financial markets or on near-term economic developments.

# South Korea

**Suktae Oh**, Regional Head of Research, Korea
Standard Chartered First Bank Korea
+822 3702 5011, Suktae.Oh@sc.com

## Currency, exports and real estate

### Economic outlook

- Currency, exports and real estate are key to the 2011 economic outlook. We expect continued strength in the Korean won (KRW), a modest slowdown in exports and a mild recovery in the real-estate market. GDP growth is likely to slow to 4.0% in 2011 from 6.1% in 2010, largely due to the export slowdown. CPI inflation will remain stable, at around 2.8%, thanks to slower growth, a stronger KRW and the base effect of a recent surge in fresh food prices. The current account surplus is expected to decline gradually to a more sustainable level, mainly driven by KRW appreciation.

- The slowdown in exports will be driven by the end of global inventory restocking and the relative weakness of developed economies. The negative impact from the inventory cycle has already been seen in Korea's exports to China and other Asia ex-Japan economies. Exports to developed economies will soon show a slowdown due to both inventory factors and weak final demand. But the structural strength of emerging economies will continue to underpin exports. The stronger KRW will not be a serious threat to exports as long as it is a part of an overall appreciation trend in emerging-market currencies.

- The recovery of the real-estate market will boost construction and GDP growth. Construction activity was weak in 2010 due to fiscal tightening and the deterioration in the housing market. The upside potential for residential construction is large considering its prolonged weakness since 2006. A property-market recovery is crucial to the construction outlook, given the government's plan to cut infrastructure spending.

#### Standard Chartered forecasts: South Korea

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 6.1 | 4.0 | 5.2 | 4.6 |
| **CPI (% y/y)** | 2.9 | 2.8 | 3.0 | 3.0 |
| **Policy rate (%)*** | 2.50 | 3.50 | 4.00 | 4.00 |
| **USD-KRW*** | 1,120 | 1,025 | 975 | 925 |
| **Current account balance (% GDP)** | 3.0 | 2.0 | 1.0 | 1.0 |
| **Fiscal balance (% GDP)** | 0.5 | 1.0 | 1.5 | 2.0 |

*end-period Source: Standard Chartered Research

- Private and government consumption will show steady growth. The recovery in payrolls and wages will continue to support consumption. The real-estate recovery will also be positive for consumer confidence. But the structural burden of a low household savings rate and high household debt will weigh on consumption, and the labour-market recovery has started to show signs of fatigue. Government consumption will get a boost from the normalisation of fiscal policy after a contraction in spending in 2010.

### Financial issues

- Appreciation pressure on the KRW will persist, as the Korean economy will continue to record a considerable current account surplus. While some think that capital inflows are leading to the stronger KRW, the capital account was actually balanced in 2010. Steady portfolio inflows are offset by deficits in the 'other investment' account (including the repayment of external debt) and the direct investment account. The G20 focus on current account imbalances will also affect the KRW. Our forecast of a smaller current account surplus in 2011 is based on our assumption of a stronger KRW.

- The real-estate market recovery will help to normalise credit growth. Bank loan growth was only 3% y/y in H2-2010 due to a slowdown in mortgages and loans for construction and real-estate development. Loans to the construction and property sector, which are directly related to the housing market, have been the biggest driver of the credit cycle in the last 10 years. The recovery in the housing market will lead to a turnaround in credit growth, which will be bearish for the bond market. When credit growth bottomed previously, in late 2001 and early 2005, this coincided with the bottoming of benchmark bond yields. The real-estate recovery will also ease market concerns about project financing and the debt of state-owned property development companies.

### Policy

- The government is likely to introduce capital control measures soon, though their impact on capital flows should be limited. We believe that three specific tools will be considered: reintroducing the withholding tax on foreign investors' government bond investments; lowering forward FX position limits for foreign banks'

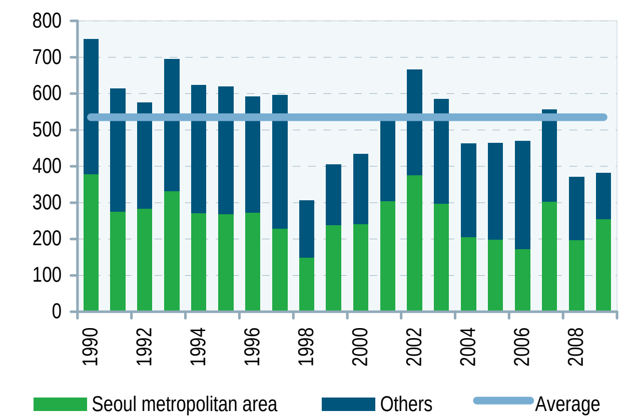
# South Korea (con'd)

Korea branches; and imposing fees (a bank levy) on banks' short-term external debt. Portfolio inflows are unlikely to be significantly affected by the withholding tax on bonds. Korea's equity and bond markets will basically remain open to foreign investors, even after a minor change in the tax regime. While FX position limits and a bank levy would lead to continued outflows from the 'other investment' account, we do not expect any dramatic short-term impact.

- We expect the Bank of Korea (BoK) to cautiously normalise the base rate to 3.5% by the end of 2011. While we expect slower GDP growth, the underlying growth momentum will be strong enough to support gradual rate hikes of 100bps over 12 months. Headline inflation is forecast to stay around 2.8%, lowering the chances of more aggressive hikes. The currency and real-estate markets will also be key to the monetary policy outlook. Signs of a housing-market recovery will favour the rate-hiking cycle, while concerns about 'excessive' KRW appreciation will slow the pace of hikes.

- The 2011 budget proposal favours growth, following fiscal tightening in 2010. The 2011 budget plans to normalise spending growth to 5.7%, following a 3.0% contraction in the 2010 budget; infrastructure spending is the exception, as it is expected to decline again in 2011. The government is likely to repeat the usual front-loading of fiscal spending in 2011 to offset the slowdown in growth. But it is unlikely to introduce a supplementary budget to increase fiscal stimulus, given the recent rise in fiscal conservatism within the ruling party.

**Chart 1: Housing permits** *(annual, thousands)*




Source: Ministry of Land, Transport and Maritime Affairs

## Other issues

- We expect a mild recovery in the housing market in 2011. The housing supply burden does not look heavy – the annual average number of housing permits issued from 2005-09 was much lower than the 20-year average (see Chart 1). This does not match the typical pattern of a burst bubble, where excess supply leads to an extended period of housing-market weakness. A temporary jump in housing permits in 2007 to avoid regulations on new home prices may partly explain the housing-market weakness seen in 2010, given the three-year timeframe to complete a housing project. The number of permits declined in 2008 due to the global financial crisis; the number of unsold new homes also declined significantly in 2009 and 2010.

- The outlook for housing demand is also reasonably strong. Housing affordability should improve significantly thanks to the labour-market recovery and the continuing decline in mortgage rates. Admittedly, the household debt burden is a long-term negative for the housing market, and explains why we do not expect a strong housing boom. But the healthy balance sheets of Korean banks can easily accommodate a mild increase in housing demand and mortgage loans. Policy will also support housing demand. The temporary lifting of macro-prudential measures (debt-to-income ratio on mortgage loans) until March 2011 may be extended if it fails to boost the market. A gradual BoK rate-hiking cycle will not seriously hurt housing demand.

## Politics

- Domestic politics will focus on two key elections in 2012: general elections in April and presidential elections in December. To win the elections, the ruling party is likely to revise some of its right-wing policies, such as tax cuts for the rich, while continuing its push to boost the real-estate market. Presidential hopefuls from both the ruling and opposition parties are likely to keep a low profile in 2011.

- Six-party talks on North Korea's nuclear programme are likely to resume in 2011. The South Korean government is likely to drop its demand for a North Korean apology for the 2010 sinking of the Cheonan naval ship as a precondition for the talks. North Korea will also become more active in talks with South Korea to help smooth the transition of power to Kim Jong-Un. However, we do not expect a real breakthrough in relations with North Korea under South Korea's current right-wing government.

# Sri Lanka

**Samantha Amerasinghe**, Economist
Standard Chartered Bank, Sri Lanka
+94 11 2480015, Samantha.Amerasinghe@sc.com

## Rebound gains momentum

### Economic outlook

- GDP growth has outperformed market expectations in 2010. The government expects growth of close to 8.0%; we forecast a slower pace of 6.8%, picking up slightly in 2011. Much will depend on curtailing inflationary pressures and exercising fiscal restraint. Growth will be underpinned primarily by infrastructure-related construction, tourism and port services, and to a lesser extent by a fast-growing agriculture sector. Sri Lanka is poised to achieve a growth rate of 7.1% in 2011, despite the challenges of a large fiscal deficit and high debt-servicing costs.

- Sri Lanka is back on investors' radar, but FDI inflows have been too slow for comfort. FDI is likely to total a dismal USD 400mn in 2010, 200mn short of 2009 inflows, hindered by excessive bureaucracy and policies that deter investment. We expect this trend to change in 2011. The expected narrowing of the current account deficit to 3.5% of GDP on improved exports may revive investor optimism. Proposed changes to FDI policy aimed at attracting investment in key sectors, and FX liberalisation measures introduced in the 2011 budget, should also provide some upside. However, tax incentives offered to attract foreign investors during the war were watered down substantially in the latest budget, and this is a concern.

### Financial issues

- The central bank's relaxation of capital controls in November 2010 did not include a change to the existing 10% cap on foreign investment in government securities. However, restrictions in areas where foreign investors could do business – including unlisted companies and corporate debt – were relaxed. It appears likely that foreign investors will be allowed to invest in local-currency-denominated debt issued by local companies. This would be a significant step towards developing the country's debt markets, and would help to increase currently thin liquidity in secondary markets.

### Policy

- Gradual monetary policy tightening is possible in H2-2011 in response to stronger credit demand and economic activity. This may fuel inflationary expectations. The central bank's focus is expected to shift from controlling inflation via money supply to managing inflation via interest rates; hence, we expect CPI inflation to remain below 7% y/y in 2011. Fiscal policy will remain expansionary, in line with the 'pro-growth' agenda outlined in the 2011 budget. However, sustained growth at current levels should help to narrow the 2011 deficit to around 7.5% of GDP. The government's need to support growth in 2011 may outweigh pressure for deficit containment. However, we believe some fiscal restraint is critical to improving the country's public debt dynamics.

### Other issues

- Fast-tracking infrastructure development will likely continue to dominate policy in 2011, as infrastructure bottlenecks could stifle medium-term growth prospects. A strategic focus on roads, ports and airports is required to keep pace with higher expected levels of economic activity, particularly in the ports and tourism sectors.

### Politics

- Political stability is expected to prevail, providing a solid foundation for the country's 2011 development strategy. The January 2010 re-election of President Mahinda Rajapaksa and the victory of his United People's Freedom Alliance (UPFA) in the April parliamentary elections with an almost two-thirds majority suggest a stable government. Critics argue that the dominance of the government by Rajapaksa and his family could undermine Sri Lanka's democratic institutions. That said, the president's overwhelming popularity with the public and his visionary outlook may be needed as the country strives to achieve sustainable growth.

#### Standard Chartered forecasts: Sri Lanka

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 6.8 | 7.1 | 7.5 | 8.0 |
| **CPI (% y/y)** | 5.7 | 6.5 | 7.0 | 7.2 |
| **Policy rate (%)*** | 7.25 | 7.75 | 8.0 | 8.0 |
| **USD-LKR*** | 111.5 | 110.2 | 109.0 | 108.0 |
| **Current account balance (% GDP)** | -6.0 | -3.5 | -2.5 | -2.0 |
| **Fiscal balance (% GDP)** | 8.5 | 7.5 | 6.5 | 6.0 |

*end-period
Source: Standard Chartered Research

# Taiwan

**Tony Phoo**, Economist
Standard Chartered Bank, Taiwan
+886 2 6603 2640, Tony.Phoo@sc.com

## Staying on the recovery path

### Economic outlook

- Taiwan's economy is likely to remain on the recovery path, despite an expected slowdown in exports. We expect GDP growth to be in the low single digits in Q4-2010 and Q1-2011, before picking up to 5-6% in H2-2011. The slowdown in exports will be mitigated by a continuing revival in domestic spending, boosted by rebounding equity prices and improving employment.

- The economy will also be supported by the further liberalisation of cross-straits ties, particularly in tourism. Mainland Chinese were already the largest group of visitors to Taiwan in 2010, creating jobs in tourism, retail, hotels and restaurants. In 2011, the government is expected to increase the daily target for mainland visitor arrivals to 7,000 from 5,000. Talks are underway to create a simplified visa programme to accommodate 300-500 mainland visitors a day.

- The Economic Cooperation Framework Agreement (ECFA) signed in June 2010 between Taiwan and the mainland should boost cross-straits trade and SMEs, which employ over 76% of Taiwan's 2.9mn manufacturing workers. Under the ECFA, Taiwan's exporters could save USD 1bn in tax and tariffs on more than 800 items exported to the mainland in 2011.

### Financial issues

- The risk of a property bubble will grow, though it is likely to be limited to pockets of the greater Taipei region. Government efforts to contain housing prices will be countered by improving consumer confidence, relatively low mortgage rates and ample market liquidity. Capital inflows from overseas Taiwanese, wooed in part by a reduced 10% inheritance tax (cut from 50% in 2008) and improved cross-straits ties, have also boosted property prices.

**Standard Chartered forecasts: Taiwan**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 9.7 | 4.6 | 6.0 | 4.6 |
| **CPI (% y/y)** | 1.0 | 2.2 | 2.2 | 1.8 |
| **Policy rate (%)*** | 1.63 | 2.13 | 2.63 | 3.13 |
| **USD-TWD*** | 30.3 | 28.8 | 28.0 | 27.3 |
| **Current account balance (% GDP)** | 9.6 | 8.4 | 7.5 | 7.0 |
| **Fiscal balance (% GDP)** | -4.0 | -3.0 | -2.5 | -2.0 |

*end-period　　Source: Standard Chartered Research

### Policy

- Policy makers will continue to roll back the monetary stimulus of 2008-09, given rising risks of both consumer and asset price inflation in 2011. Given rising wage growth and rental expenses, local businesses will consider passing on higher costs to consumers. However, the central bank is likely to stay cautious, taking small and measured steps, in light of the uncertainty surrounding the recovery in key overseas markets such as the US and Europe.

- Rising interest rates will result in higher sterilisation costs, making it costly for the central bank to intervene in the foreign exchange market. As a result, there are rising concerns that local regulators may opt for capital control measures, such as a tax on inflows, to curb short-term capital inflows. However, we see a low risk that policy makers will adopt draconian measures. This is especially true given that such measures could trigger massive equity outflows, which would find little support from local lawmakers ahead of general elections in early 2012.

### Politics

- There are no major elections expected in Taiwan in 2011. The island will hold legislative and presidential elections in January and March 2012, respectively. There is currently no clear candidate from the opposition Democratic Progressive Party (DPP) to challenge incumbent President Ma Ying-jeou, who is expected to seek re-election for the ruling Nationalist (KMT) Party. Currently, the odds favour the ruling KMT party if the economic recovery is sustained and the local job market continues to improve. More importantly, a win by the KMT in the 2012 elections would be taken as a strong sign of public approval of President Ma's economic and cross-straits policies.

# Thailand

**Usara Wilaipich**, Senior Economist
Standard Chartered Bank (Thai) PCL
+662 724 8878, Usara.Wilaipich@sc.com

**Tai Hui**, Regional Head of Research, South East Asia
Standard Chartered Bank, Singapore
+65 6596 8244, Tai.Hui@sc.com

## Political wildcard is still in play

### Economic outlook

- With Thailand's total trade at 126% of GDP, moderating global growth is expected to bring economic growth a notch closer to trend in 2011, to 4.4%. Domestic demand should play a more prominent role in driving headline growth. While private consumption is supported by a resilient labour market, investment – especially on the public side – remains uncertain due to ongoing political tensions.

- Exports have been a key driver of growth for Thailand, particularly in H1-2010. We expect export growth to decelerate from an estimated 24.7% in 2010 to 10% in 2011. Although the US and Europe directly account for only 25% of Thai exports, their contribution to final export demand is likely higher, as some Thai exports to China, Hong Kong and ASEAN (which account for 50% of total exports) are processed and re-exported to the US and Europe. Thai baht (THB) strength could also dampen the competitiveness of labour-intensive and price-sensitive export products. Moderating demand for electronic products is also likely to slow the pace of export growth.

- 2010 proved that the domestic economy was more resilient to political instability than expected. Industrial activity and local consumption were hardly affected by the protracted and violent protests in Bangkok in Q2-2010. The impact of the protests on tourism was more profound, but that sector also recovered swiftly. Since long-standing political tensions remain unresolved and a sustainable resolution is unlikely in the near term, government spending – especially on infrastructure and economic development – is likely to remain sluggish. A return of political uncertainty could also slow private-sector investment.

**Standard Chartered forecasts: Thailand**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| GDP (real % y/y) | 6.3 | 4.4 | 5.8 | 6.0 |
| CPI (% y/y) | 3.2 | 3.7 | 3.8 | 4.2 |
| Policy rate (%)* | 1.75 | 2.25 | 3.00 | 3.75 |
| USD-THB* | 30.00 | 29.00 | 28.25 | 27.50 |
| Current account balance (% GDP) | 3.0 | 1.3 | 0.4 | -0.8 |
| Fiscal balance (% GDP)** | -3.5 | -3.6 | -3.3 | -3.1 |

*end-period; **for fiscal year ending 30 September

Source: Standard Chartered Research

### Financial issues

- On 28 October 2010, Moody's raised Thailand's Baa1 local- and foreign-currency government bond rating outlook to stable from negative. The decision was prompted by the robust economic recovery and the stabilisation of government finances, despite continuing domestic political turmoil. Thailand's solid external payments position, including large foreign exchange reserves, provides an ample cushion against volatile capital inflows. We believe that Thailand's resilient economic performance amid political turbulence also led to the improved outlook. That said, a further upgrade of the ratings outlook will probably require greater political stability.

- Despite volatile capital inflows into the country, concerns about asset-price inflation remain muted. On the property-market front, housing and land price indices from the Bank of Thailand (BoT) show only marginal increases in 2010, with growth in mortgage loans in line with the historical average. The equity market has performed strongly in 2010 – the SETI was up 34% in the first 10 months of the year (in local-currency terms) – but does not look significantly overvalued on a forward P/E ratio basis. Much of the concern over capital inflows lies in the bond market, with foreign holdings of government bonds rising from 3.7% of the total at the end of 2009 to 7.5% as of September 2010.

### Policy

- On the policy front, the focus will be on the measures to curb short-term capital inflows, as the government is expected to stem currency appreciation to protect exporters that are sensitive to exchange rate movements. Finance Minister Korn Chatikavanij has already commented on his concerns about excessive short-term volatile capital inflows, which pushed the THB to a 13-year high against the US dollar (USD). While the authorities have not excluded further measures to stem capital inflows, the finance minister acknowledged the fact that "controls will not work since the liquidity injected by the US is overwhelming." Meanwhile, measures to

# Thailand (con'd)

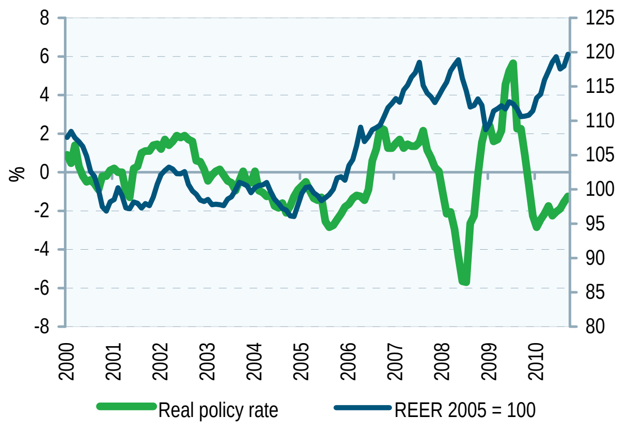
relax capital outflows are unlikely to be effective against THB appreciation, as local investors' expectations of currency appreciation will likely prompt them to keep their capital onshore.

- On the policy rate front, THB appreciation, the moderation in cyclical growth and a slow return to full manufacturing capacity utilisation may persuade the BoT to keep policy rates on hold until the end of Q3-2011. Political uncertainty in H1-2011 may also cause the central bank to take a cautious approach to monetary tightening. We expect the BoT to resume policy rate increases in Q4-2011, as core inflation is expected to rise towards the upper limit of its 0.5-3% target. There should also be greater certainty by then on the global recovery, giving the BoT more confidence to normalise rates in line with their long-term average.

- Severe flooding in several provinces across the northern, central, north eastern and southern parts of Thailand damaged crops, livestock and dairy farms in October-November 2010. This will put upward pressure on raw food prices in the months ahead. Meanwhile, the government has imposed temporary price controls on several consumer products to mitigate the adverse impact of the floods, ensuring that the increase in core inflation is gradual.

- The fiscal deficit is expected to widen modestly from 3.5% of GDP in FY10 (ended 30 September 2010) to 3.6% in FY11. There are two opposing forces at work on Thailand's fiscal position. The government is expected to maintain fiscal spending to build up support ahead of the 2011 elections, which should keep the recurring fiscal deficit high. However, political uncertainty may further delay implementation of fiscal spending, limiting the rise in capital expenditure. We expect the former factor to prevail, keeping the fiscal deficit high, despite the improving outlook for revenues brought by better economic growth.

**Chart 1: Real policy rate still very low, despite currency appreciation on real effective exchange rate basis**




Sources: BIS, Bloomberg, Standard Chartered Research

### Politics

- Ongoing tensions between supporters of former Prime Minister Thaksin Shinawatra and the ruling Democrat Party have yet to find a sustainable resolution, and this is likely to plague the domestic political landscape for the foreseeable future. This largely reflects deep-rooted social divisions within the country. Notably, a state of emergency is still in place in Bangkok due to sporadic bomb threats from unknown sources.

- Looking ahead, two key events will determine the next phase of Thai politics. The first is the Constitutional Court's ruling on allegations against the ruling Democrat Party of illegal political donations and misappropriation of political subsidies. If the party is found guilty, PM Abhisit and senior party executives would be banned from politics for five years, and the party would be dissolved (under the current constitution). A guilty verdict would therefore raise the risk of political power shifting back to Thaksin's supporters.

- Another key upcoming event is the long-awaited national political reform and reconciliation process to resolve the political conflict. There is a fundamental need for a new constitution that will be accepted by all parties and ensure fair elections. A successful rewriting of the constitution could result in general elections before the government's full term ends at the end of 2011. However, progress on this front remains slow.

- With the Constitutional Court ruling and the 2011 elections looming, the current administration is expected to focus on short-term policies and gather as much political support as possible, especially in rural areas. Medium-term infrastructure projects and economic strategy and planning may take a backseat until there is more clarity on the future of the current administration.

# Vietnam

**Tai Hui**, Regional Head of Research, South East Asia
Standard Chartered Bank, Singapore
+65 6596 8244, Tai.Hui@sc.com

## Avoiding economic overheating

### Economic outlook

- Vietnam's economic growth in 2011 is expected to outperform relative to more open economies, thanks to robust domestic demand. Retail sales have been expanding at a rate of 10-15% in real terms for the past two years. This consumption growth is expected to remain well supported by rising incomes. On the external front, more moderate global growth should cause export growth to decelerate to 10% in 2011. However, an expansion of Vietnam's manufacturing capacity due to rising foreign investment will give exports a structural boost.

- Strong economic growth will also raise the risk of economic overheating, leading to rising inflation and a widening of the trade deficit – both of which created considerable financial instability in Vietnam in 2008. Inflationary threats have already emerged in Q4-2010, with y/y inflation rising towards 10%. External factors such as surges in global food and energy prices will exacerbate inflationary pressures.

- After a year of stability in the trade deficit, strong domestic demand and higher raw-material costs are fuelling risks of a wider deficit. We expect Vietnam's trade deficit to widen from our 2010 estimate of USD 12bn to USD 15bn in 2011. However, other sources of inflows, including FDI and remittances from overseas Vietnamese, are expected to continue. We expect disbursed FDI to rise to USD 10bn in 2011, and overseas workers' remittances to reach USD 7bn.

#### Standard Chartered forecasts: Vietnam

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 6.7 | 7.2 | 7.0 | 6.5 |
| **CPI (% y/y)** | 8.9 | 10.5 | 9.5 | 8.0 |
| **Policy rate (%)*** | 9.0 | 11.0 | 11.0 | 9.0 |
| **USD-VND*** | 19,900 | 20,800 | 21,000 | 20,500 |
| **Current account balance (% GDP)** | -8.5 | -10.5 | -8.5 | -7.5 |
| **Fiscal balance (% GDP)** | -5.5 | -4.0 | -3.0 | -3.0 |

*end-period Source: Standard Chartered Research

### Financial issues

- We expect international investors to remain cautious towards portfolio investment in Vietnam, contrary to the rest of Asia. Currency risk and sporadic liquidity in the FX and bond markets are two areas of concern for investors.

### Policy

- Although the government and the State Bank of Vietnam (SBV) tried to reduce commercial lending rates for much of 2010 to promote lending and economic growth, rising inflation and market anxiety over Vietnamese dong (VND) depreciation are likely to force the authorities to push interest rates higher. This was illustrated by the SBV's 100bps increase in the base rate in November 2010. We expect further rate hikes in 2011 in response to rising inflationary pressure.

- In addition to raising interest rates, the government could impose price controls on selected daily necessities to limit inflation. However, considering the market distortions that such price controls would create, they would likely be only a temporary measure. Curbs on exports of some commodities, such as rice, could also be implemented to stabilise domestic prices.

- We expect the VND to weaken further in an orderly manner to support export performance. Even in the event of significant net inflows into Vietnam, the authorities are likely to sell VND and buy USD in order to maintain the VND's competitiveness and replenish the country's FX reserves.

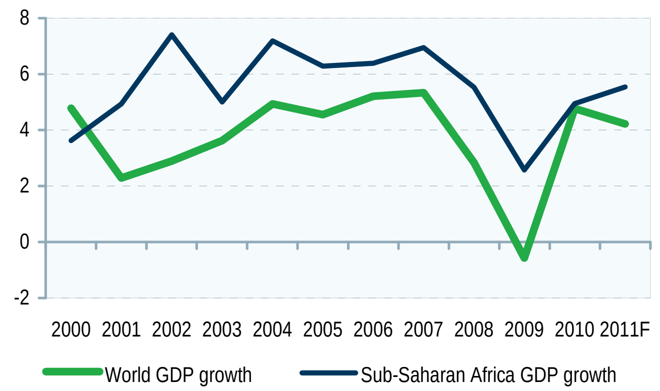
### Politics

- The 11th National Party Congress will be the political focal point of 2011, with a new group taking over the party leadership. Overall, we expect a smooth political transition. The emphasis will remain on raising national incomes. This will require further reform of economic policy tools and additional measures to attract FDI, including improving the logistics infrastructure and the business operating environment.

# Economies – Sub-Saharan Africa

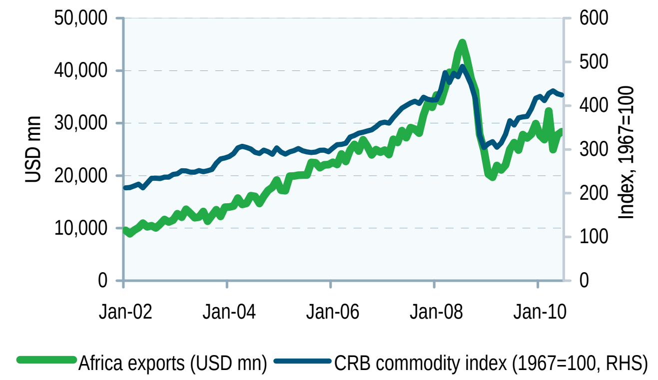
# Sub-Saharan Africa – Charts of the year

**Chart 1: African growth – headed back to trend in 2011**




Sources: Stock Exchanges, IMF, Standard Chartered Research

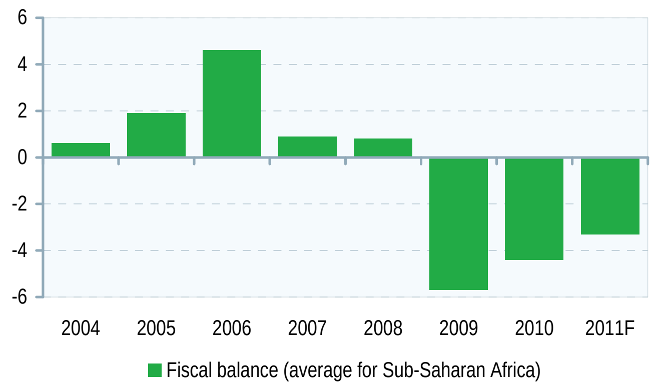
**Chart 2: Trade rebounds in line with commodity prices**




Sources: IMF DOTS, Reuters, Standard Chartered Research

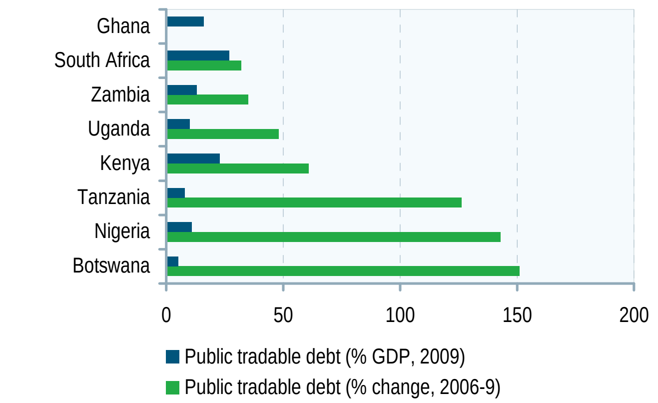
**Chart 3: Fiscal adjustment is in sight**

*Fiscal balance,% of GDP, average for Sub-Saharan Africa*



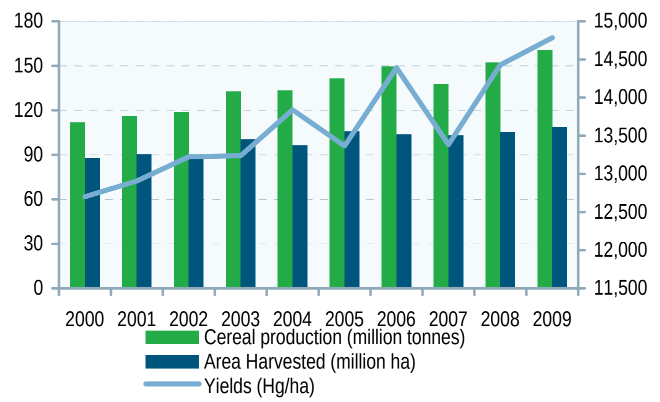

Sources: IMF, Standard Chartered Research

**Chart 4: Although local-currency debt markets have grown rapidly, public debt ratios remain negligible**



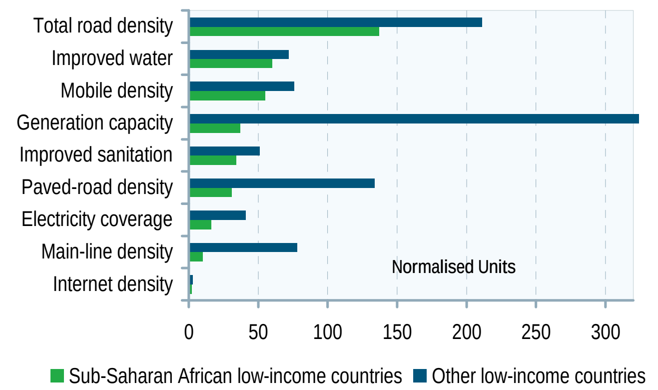

Sources: Stock Exchanges, IMF, Standard Chartered Research

**Chart 5: Agriculture, a key focus since the 2007-08 food crisis, has been recovering** *(Sub-Saharan Africa)*




Sources: FAO, Standard Chartered Research

**Chart 6: Addressing Africa's infrastructure deficit is high on the agenda**




Sources: World Bank, *Africa's Infrastructure: A Time for Transformation*, Standard Chartered Research

# Africa

**Razia Khan**, Regional Head of Research, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6914, Razia.Khan@sc.com

## Return to trend as recovery matures

### Economic outlook

- The outlook for African economies remains favourable, with a return to trend growth anticipated following the global crisis. The sustainability of the economic recovery beyond 2011 will depend in part on the external environment. Despite strong trade grains by Asian economies, especially China, Europe (largely the core) remains Africa's largest trading partner. Moreover, African export shares of GDP are probably too small for increased trade with Asia to compensate for a renewed downturn in the West. For now, Africa's economic recovery appears to be intact, helped by strong Asian growth and the support provided to commodity prices by quantitative easing in the West. However, the external environment is still characterised by some uncertainty, and overall risks remain.

- Domestic factors were a strong driver of Africa's pre-crisis trend growth, and 2011 should see the re-emergence of consumption as the key driver of GDP gains. In some ways, this will represent a maturing of the 'Africa recovery story' beyond the immediate lift provided by higher commodity prices. While the efficacy of monetary easing in response to the crisis has been questioned by many – there are well-documented problems with the transmission of monetary policy, and loan rates did not always match policy easing – private-sector credit should at least recover across a broad swathe of African economies. Much of the focus will be on Nigeria, which experienced the worst fallout, with a domestic banking crisis in which loan-loss provisions eroded two-thirds of the banking sector's capital. Efforts to recapitalise the sector, in part through an asset management company, should see credit growth recover. Economies such as Ghana and Angola, which ran up considerable crisis-related fiscal arrears, have also experienced some banking-sector fallout, with rising NPLs. Improved fiscal receipts and official efforts to clear these arrears should benefit the banking-sector outlook.

- Near-term, the strongest growth gains should continue to be seen in oil-producing economies that were hit hard during the crisis. Countries transitioning to oil producer status, such as Ghana and Uganda, are also likely to see a multi-year period of healthy growth based on this structural shift. In Ghana's case, the benefit of a well-diversified economy is expected to pay dividends, with non-oil growth of 7% expected in 2011 (when oil is factored in, projected growth rises to 12.3%). Zambia, which saw a doubling of output on its copper belt before the crisis, looks set to do it again, although questions will persist about effective taxation of the mining sector and making this growth more meaningful.

- East Africa was the clear winner during the latest crisis as Africa's other, more commodity-dependent regions were hit harder. Growth momentum here is expected to continue, led by gains in the region's largest economy, Kenya, which should continue to benefit from a stabilisation of its political outlook. The Southern Sudan referendum in early 2011 will be a key influence, with the potential redrawing of East Africa's geographic landscape. Access to ports will be an important consideration, and Kenya looks set to benefit strongly from regional infrastructure development.

- During the crisis, southern Africa was hardest hit. In part, this was due to the South Africa's greater level of development and closer links with the global economy. However, the diamond mining economies of Botswana and Namibia were also hard-hit, experiencing outright contractions. While 2010 represented little more than a recovery from a weak base, countries such as Botswana, which saw substantial fiscal deterioration in response to the crisis, must now undergo a steep fiscal adjustment, even as diamond prices recover. Weak growth for a multi-year period looks likely. In South Africa, the initial recovery boost provided by the supply side may lose momentum, especially as the country's external sectors – mining and manufacturing – struggle with a strong currency. Nonetheless, household consumption continues to recover and a more normal consumer cycle

**Standard Chartered forecasts: Sub-Saharan Africa***

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **Real GDP growth** | 4.4 | 5.9 | 5.8 | 5.8 |
| ***IMF*** | 5.0 | 5.5 | 5.7 | 5.7 |
| **Inflation** | 8.3 | 7.7 | 6.8 | 6.9 |
| ***IMF*** | 7.5 | 7.0 | 6.3 | 5.9 |
| **Current account balance (% GDP)** | 0.4 | 0.9 | 1.5 | 0.8 |
| ***IMF*** | -1.1 | -1.9 | -1.5 | -1.6 |

*Data is for the 13 Sub-Saharan African economies included in this report; Sources: IMF, Standard Chartered Research

# Africa (con'd)

is set to reassert itself, helped by interest rate easing. Zambia, also a mining economy, has proven to be the exception to the southern African picture of sluggish growth, helped by the strong China-driven rebound in copper prices. Record agri-yields during the crisis also helped. In Zimbabwe, positive growth is expected in 2011 given the low base following years of crisis.

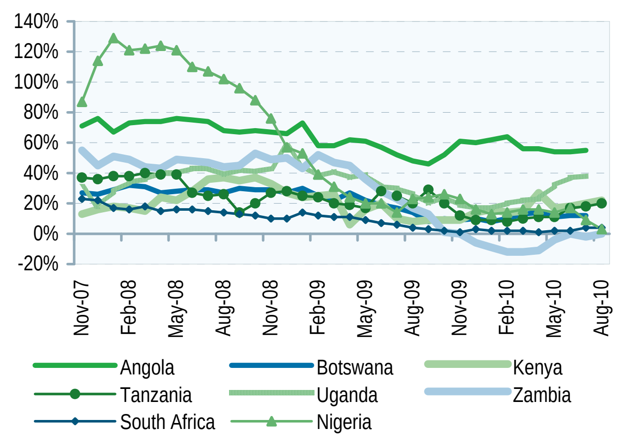
### Financial issues

- Given the persistence of low interest rates in the West, and an anticipated correction in domestic interest rates in Africa, many countries will look to tap international capital markets for funding in 2011. The cost of capital is only one factor. Increasingly, sovereigns will seek to establish a benchmark for corporate issuance. While Africa will benefit from increased market access, the underlying driver of increased fiscal space – progress in revenue generation – appears to be lagging. Moreover, other measures of external creditworthiness, such as liquidity ratios, have fallen behind. While emerging markets have seen strong capital inflows, many frontier economies have not yet benefited from this trend. With most African sovereigns B-rated, a conducive external environment will be needed to realise the region's eurobond plans.

### Policy

- African economies benefited from an unprecedented level of counter-cyclical policy during the crisis. The challenge in 2011 will be to achieve an orderly removal of some of that stimulus. With fiscal spending focused on long-term infrastructure, dramatic deficit reductions – even given more favourable commodity prices – may not be easy to achieve across all economies. Efforts to widen the domestic tax base have been variable. In the coming year, resource nationalism (essentially an increase in royalties) and the rewriting of tax concessions and other fiscal incentives offered to mining and oil and gas companies are expected to feature heavily, although there may be important exceptions.

**Chart 1: Credit to private sector in selected countries**
*% change y/y*




Sources: IMF, Standard Chartered Research

- With Africa's inflation cycle lagging that of the rest of the world, pressure to tighten monetary policy will only be seen in 2011. With a less favourable base, inflation should rise in most markets, driven also by global and regional food price pressures. Given the exposure of banking sectors to government bond markets, central banks are likely to proceed cautiously with tightening, with gradualism the preferred approach. Tanzania and Zambia have already led the way with increased open-market operations, and Nigeria has tightened policy. Botswana raised reserve requirements at the tail end of 2010. In 2011, many more economies will follow.

### Politics

- Nigerian elections, currently due by April 2011 (unless the constitution is changed) will be one of Africa's most-watched political events in 2011. The issue of rotation – whether there should be a power-sharing agreement between the north and south – has proven to be contentious, increasing the risks. Given highly flawed polls in 2003 and 2007, since the country's transition to civilian rule, 2011 polls are likely to be a key test of Nigeria's reform credentials. Depending on outcomes, the restive Niger Delta will be closely watched. Politics could all too easily influence real economic performance.

- Attention will also be focused on the Southern Sudan referendum in January 2011, which is likely to alter the East African landscape if it leads to the emergence of a new oil-rich, albeit landlocked, African country. This will be followed by Uganda's elections, due between February and March, in which the issue of multi-partyism versus stability (as it is presented to voters) will be closely contested. Elections not due until 2012 will also influence events in the coming year – whether Kenya's investigation into corruption or Ghana's plans for increased spending. In South Africa, political manoeuvring ahead of the ruling ANC's internal congress in 2012 may also shape policy outcomes.

# Angola

**Victor Lopes**, Economist
Standard Chartered Bank, UAE
+971 4 508 4884, Victor.Lopes@sc.com

## Oiling the growth engine

### Economic outlook

- Economic growth will continue to pick up in 2011, driven by higher oil output and prices, as well as more sustained non-oil growth as public investment increases amid easing pressure on public finances. Domestic payment arrears accumulated throughout 2009 (of an amount estimated at 10% of GDP), mainly towards Portuguese and Brazilian construction companies, have started to be repaid and are likely to be cleared in 2011 as oil revenues continue to increase. This will help to improve the financial condition of the private sector.

- The fiscal and external accounts are likely to remain in surplus in 2011 given higher oil prices. Improvement in the current account balance will be limited by rising imports (Angola is hugely import-dependent) on the back of better domestic economic momentum. FX reserves are likely to increase from their current level of USD 16bn.

### Financial issues

- Eurobond issuance plans have been delayed, and it remains uncertain whether the government will try to tap the international markets in 2011. Angola will continue to rely on credit lines from its strategic partners – China, Brazil and Portugal – to meet its financing needs. The country will also benefit from further disbursements from the IMF under the Stand-By Arrangement signed in November 2009. Debt levels remain moderate, with total public debt at 38% of GDP in 2009.

**Standard Chartered forecasts: Angola**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 2.5 | 7.0 | 6.5 | 6.5 |
| **CPI (% y/y)** | 13.3 | 11.0 | 10.5 | 9.0 |
| **Policy rate (%)*** | 25 | 20 | 16 | 13 |
| **USD-AOA*** | 93.0 | 93.0 | 92.0 | 90.0 |
| **Current account balance (% GDP)** | 2.0 | 1.5 | 3.0 | 4.0 |
| **Fiscal balance (% GDP)** | 2.7 | 3.3 | 3.5 | 5.0 |

*end-period Sources: IMF, Standard Chartered Research

### Policy

- We expect the exchange rate to remain broadly stable in 2011. The progressive normalisation of the FX market in 2010 following the 2009 devaluation of the Angolan kwanza (AOA) is likely to continue, with improved US dollar liquidity helping to ease FX shortages.

- A key monetary policy objective is to bring inflation down to the single digits. The removal of fuel subsidies in September 2010 will put additional pressure on inflation. We expect inflation to remain in the double digits despite tight monetary policy, as structural bottlenecks such as port congestion will remain a key obstacle to the disinflation process.

- Progressive rebalancing of the economy is underway, but an improvement in budget management is crucial. Arrears accumulation was an unwelcome reminder of weak budget management. In this respect, IMF involvement is important not only from a funding perspective, but also because the IMF programme is helping to improve overall fiscal management. The agreement implies that there will be improvements in debt management and measures to restrain or control expenditures, such as the removal of fuel subsidies.

### Politics

- A new constitution was adopted in February 2010. It reinforces the president's control of the government, and replaces the prime minister role with a vice president. The president will also be elected by the parliament rather than by direct popular vote. A limit of two five-year terms will apply to the president for the next parliamentary election, due to be held in 2012. The changes to the constitution do not really change the political outlook, as they do not address uncertainty regarding the succession issue. No clear successor has emerged to President Dos Santos, the leader of the ruling MPLA (Movement Popular para Libertação de Angola), who has ruled for almost three decades. The ruling president is likely to seek re-election in 2012.

# Botswana

**Razia Khan**, Regional Head of Research, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6914, Razia.Khan@sc.com

**Amina Adewusi**, Economist, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6593, Amina.Adewusi@sc.com

## Difficult fiscal adjustment ahead

### Economic outlook

- Botswana experienced one of the sharpest growth contractions of any African economy as a result of the global crisis. GDP declined 4% in 2009 following the forced closure of the country's diamond mines over a four-month period. While official estimates suggest that growth will bounce back to 7.9% in 2010, the medium-term outlook, especially for the non-mining economy, remains subdued. Ambitious fiscal consolidation plans (perhaps in reaction to an earlier downgrade of Botswana's prized single-A rating by S&P) aim to restore a balanced budget by FY13. Given the dependence of the non-mining economy on government spending (which averaged 40% of GDP or more pre-crisis), Botswana may not see a sustained return to pre-crisis growth rates for some time. This is despite improved prices for gem diamonds, which reflect output curbs as well as a recovery in global demand.

- Austerity measures will remain a key focus in 2011 and in the years ahead, following 2010's rise in VAT and other administered prices and levies. Development projects related to power, road infrastructure and mining will continue, preventing a more severe economic slowdown. However, consumption is likely to remain subdued, with an overall recessionary feel dominating, especially as curbs on recurrent spending start to bite.

### Financial issues

- FX policy poses a challenge for Botswana. The Botswana pula (BWP) is pegged to a basket of currencies dominated by the South African rand (ZAR). Record capital inflows into emerging markets have fed ZAR appreciation, with the BWP strengthening in sympathy. But Botswana needs a weaker, not a stronger, currency, especially if it hopes to boost fiscal receipts from mining, which are largely USD-denominated. While the BWP-ZAR rate has declined significantly, it is unlikely to shoot through parity in 2011 because of the inflation problems this would trigger – most of Botswana's imports are sourced from South Africa. Ultimately, in the absence of FX policy flexibility, actual government spending and the real economy will bear the burden of adjustment.

**Standard Chartered forecasts: Botswana**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| GDP (real % y/y) | 7.9 | 4.9 | 5.4 | 3.2 |
| CPI (% y/y) | 6.9 | 5.1 | 5.6 | 5.9 |
| Policy rate (%)* | 10 | 10.50 | 11.0 | 10.50 |
| USD-BWP* | 6.44 | 6.73 | 7.29 | 7.52 |
| Current account balance (% GDP) | -0.5 | 1.5 | 3.5 | 6.0 |
| Fiscal balance (% GDP)** | -13 | -9.0 | -5.6 | -2.0 |

*end-period; **for fiscal year ending 31 March

Sources: CSO, Bank of Botswana, Standard Chartered Research

### Policy

- Post-crisis policy choices pose a key challenge in the years ahead. While the World Bank has recommended a steep reduction in the size of Botswana's public sector, signs of recovery in the global diamond market (despite the fact that exports remain below previous peaks) raise questions over how aggressive fiscal consolidation needs to be, especially if it comes at the expense of growth. While the IMF has urged an improvement in public finances and greater promotion of private industry, long-standing constraints on Botswana's diversification (small market size, a landlocked economy with expensive transport and utility costs) also need to be taken into account. Despite its successful growth record and reputation for sound economic management, Botswana has always struggled to attract FDI outside of mining. Models assuming that private investment will readily replace public spending are therefore likely to be flawed.

- Inflation is likely to remain above the 3-6% preferred band in early 2011 as a result of administered price increases and imported inflation, and to fall within the target by H2. Nonetheless, the late 2010 increase in the reserve requirement on BWP deposits, to 6.5% from 5%, is seen as a one-off aimed at absorbing excess liquidity more cheaply than through issuance of Bank of Botswana certificates (BoBCs). With the output gap likely to persist, further tightening is not imminent, in our view.

### Politics

- Growing factionalism and defections from the ruling Botswana Democratic Party (BDP) will continue to be a key focus. However, given the divided opposition, little change to the status quo is expected.

# Cameroon

**Victor Lopes**, Economist
Standard Chartered Bank, UAE
+971 4 508 4884, Victor.Lopes@sc.com

## Rebounding but not taking off

### Economic outlook

- We expect economic growth to remain relatively weak in 2011, below 3%, as oil production declines. However, higher oil prices, an improving external environment and higher public spending will drive a slight pick-up in the economy. The economy continues to be negatively impacted by infrastructure bottlenecks (power-sector projects to address the lack of electricity supply have been delayed) and a difficult business environment. Implementation of investment projects is slow, reflecting weak capacity within the government and slow disbursement of donor funds. Unless these issues are addressed, growth will likely remain modest and continue to lag the rest of Africa.

- Cameroon is a modest oil producer, with output of 73,100 barrels per day in 2009. Oil receipts are important to public finances, accounting for around 32% of fiscal receipts on average between 2006 and 2009. Total fiscal revenues remain low, at only 16.5% of GDP, due to the size of the informal sector. The government faces the challenge of increasing non-oil fiscal revenues.

- Cameroon's external current account balance is likely to remain in surplus, in line with higher exports. The outlook for capital inflows is favourable, especially for FDI; projects are currently underway in cobalt, nickel, iron and bauxite.

### Financial issues

- The government plans its first local bond issuance, of XAF 200bn (EUR 305mn), on the Douala Stock Exchange by end-2010.

**Standard Chartered forecasts: Cameroon**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| GDP (real % y/y) | 2.6 | 2.9 | 3.2 | 3.5 |
| CPI (% y/y) | 3.0 | 2.7 | 2.5 | 2.5 |
| Policy rate (%)* | 4.00 | 4.25 | 4.25 | 4.25 |
| USD-XAF* | 469 | 497 | 475 | 462 |
| Current account balance (% GDP) | 1.6 | 1.3 | 1.4 | 1.2 |
| Fiscal balance (% GDP) | -2.1 | -1.8 | -2.0 | -2.5 |

*end-period Sources: IMF, Standard Chartered Research

### Policy

- Inflation will remain low given Cameroon's membership in the CFA franc zone. Monetary policy is conducted by the regional central bank, which relies more on reserve requirements than interest rates to manage liquidity. The CFA franc is expected to remain pegged to the euro at the current parity, despite the fact that CFA franc strength has fuelled concerns about competitiveness.

- The government has accumulated payment arrears towards the national oil refinery and domestic suppliers (estimated at around 1.5% of GDP in 2009). Despite higher oil revenues, it remains unclear whether all of these arrears will be cleared in 2011. The overall fiscal stance is likely to remain expansionary in 2011. Public investment will increase, and public servants' wages are likely to continue to rise, as it will be an election year and the government will be keen to avoid any deterioration in the social climate.

### Other issues

- The key to improving the economic outlook is a badly needed improvement in the business climate. Cameroon's international competitiveness and governance indicators are weaker than those of many other African countries. For example, it ranked 168th out of 183 countries in the World Bank's Doing Business 2011 survey. The government has been addressing obstacles to business, including adopting measures to accelerate the registration of small and medium-sized businesses.

### Politics

- The constitution has been changed to allow the ruling president, Paul Biya, to stand for a third term in presidential elections due to be held in October 2011. He is likely to be re-elected given his political dominance and a very weak opposition. In the medium term, the succession issue is a source of uncertainty, as Biya has been in power for 28 years.

# Côte d'Ivoire

**Victor Lopes**, Economist
Standard Chartered Bank, UAE
+971 4 508 4884, Victor.Lopes@sc.com

## Post-electoral rebound

### Economic outlook

- At the time of writing, results of the second round of presidential elections between ruling president Laurent Gbagbo and opposition candidate Alassane Ouattara have not yet been released. Whoever wins, whether the election results are accepted by the losing candidate will be key to the immediate outlook.

- Successful elections are critical to improving the economic outlook. They should boost confidence and investment and allow the disbursement of funds pledged by donors (the World Bank and others pledged USD 750mn in July). GDP growth is likely to rebound to 4.5% in 2011, assuming a smooth post-electoral period. Growth has picked up since 2007, in line with increased political stability. In 2009, despite the global crisis, GDP growth managed to accelerate to the highest rate since 1998 (3.7%); however, it likely slowed in 2010 due to the impact of power outages and financial difficulties in the refinery sector.

- While successful elections are necessary, they are not sufficient to ensure a sustained economic rebound. To achieve this, the government will have to address issues in the cocoa sector and reach the completion point of the Highly Indebted Poor Countries (HIPC) initiative.

- Cocoa is a pillar of the economy that has helped to keep public finances afloat through heavy government taxation (cocoa contributes roughly 14% of fiscal revenues). However, the sector needs to be reformed to increase production capacity and reverse the deterioration in the quality of cocoa produced. Cocoa-sector reform – especially improving the governance of the sector and reviewing the tax regime – is one of several macroeconomic objectives that must be met in order to comply with the IMF programme (three-year Extended Credit Facility). This would in turn meet the requirements of the HIPC initiative, lowering the country's debt burden and giving it increased access to external financing.

### Standard Chartered forecasts: Côte d'Ivoire

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 3.0 | 4.5 | 5.5 | 6.0 |
| **CPI (% y/y)** | 1.4 | 2.5 | 2.5 | 2.5 |
| **Policy rate (%)*** | 4.25 | 4.25 | 4.00 | 4.00 |
| **USD-XOF*** | 469 | 497 | 475 | 462 |
| **Current account balance (% GDP)** | 6.8 | 2.5 | 1.0 | -0.5 |
| **Fiscal balance (% GDP)** | -0.2 | -2.6 | -3.0 | -2.5 |

*end-period Sources: IMF, Standard Chartered Research

### Financial issues

- In April 2010, Côte d'Ivoire successfully restructured its USD 2.8bn London Club debt. 20% of the Brady bond stock was cancelled, and the remainder was swapped to a new USD-denominated bond maturing in 2032. But external debt currently represents 50% of GDP, and to see a meaningful improvement in its debt ratios, the country still has to obtain debt relief under the HIPC initiative.

### Policy

- Public finances are likely to remain relatively tight, despite increasing donor support, given pressure on expenditures from electricity subsidies, public servants' wages and high debt-service costs. Increased donor disbursements following the elections should help to cover an increasing share of financing needs. The government will also continue to rely on bond issuance in the regional market, the West African Economic and Monetary Union (WAEMU).

- Inflation is to set remain low given the country's CFA franc zone membership. The CFA franc is expected to remain pegged to the euro at the current parity.

### Politics

- The post-election government will have many political issues to address in the short term – including the effective disarmament and reintegration of rebel forces and the affirmation of the state's authority in the north. This, coupled with local and legislative elections due to be held in early 2011, increases the risk of delays in the implementation of economic reforms.

# Gambia

**Amina Adewusi**, Economist, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6593, Amina.Adewusi@sc.com

## Agri-driven growth

### Economic outlook

- We have an optimistic outlook for Gambia in 2011, expecting GDP growth to accelerate to 5.5% from 5.0% in 2010. The agriculture-led economy performed well in 2010, despite worries of flooding. Agricultural output has helped to offset the weak performance of tourism and remittances due to the global economic slowdown. The president's policy of 'Back to the Land: grow what you eat, eat what you grow' is likely to sustain increased rice cultivation for domestic consumption. This will help to lower inflation, as food accounts for 55% of the CPI, and boost the economy (agriculture accounts for over 25% of GDP).

- The tourism industry is yet to recover from the decline in tourism receipts due to the economic slowdown in the EU. Tourism is highly dependent on the British market, where 40% of tourists to Gambia originate. The outlook for tourism in 2011 depends on the success of a redirection of marketing to potential tourists in countries where the economic recovery has gained more momentum, as well as the economic recovery in traditional markets such as the UK.

### Financial issues

- Debt-servicing requirements are high, at 13.2% of total government expenditure in 2009. Domestic debt totals 54% of GDP, and external debt 34% of GDP. The domestic debt is of particular concern, consisting almost entirely of short-term T-bills, which pose high roll-over risks. High interest rates on domestic debt will continue to be a drain on public resources.

**Standard Chartered forecasts: Gambia**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 5.0 | 5.5 | 6.0 | 6.0 |
| **CPI (% y/y)** | 4.0 | 5.0 | 5.0 | 5.0 |
| **Policy rate (%)*** | 9.70 | 10.00 | 10.31 | 10.50 |
| **USD-GMD*** | 30.5 | 31.5 | 33.0 | 34.0 |
| **Current account balance (% GDP)** | -11.1 | -10.8 | -10.3 | -10.0 |
| **Fiscal balance (% GDP)**** | -2.3 | -4.0 | -1.5 | -1.5 |

*end-period; **for fiscal year ending 31 March

Sources: IMF, Standard Chartered Research

- Pressure on inflation is forecast to continue as the Gambian dalasi (GMD) continues to depreciate gradually, and as a second round of wage increases for civil servants boosts domestic demand. Given the heavy weighting of food in the CPI basket, inflation will remain vulnerable to any deterioration in weather conditions.

- The GMD is forecast to continue its depreciation in 2011, after depreciating sharply in early 2010 due to poor tourism receipts and reduced remittances.

### Policy

- The fiscal balance is a major challenge and will remain under pressure in 2011 due to poor fiscal planning on the part of the government. We forecast that the fiscal deficit will widen to 4.0% of GDP in FY11 (ends 31 March 2011), due to increases in global oil prices and a depreciating currency. The public-sector wage bill looks set to rise by 19% in FY11.

### Other issues

- The re-export industry has declined, and the government will look to improve transit traffic in 2011 through improved customs regulation. This is in part due to increased regional competition from Senegal, which has seen higher levels of FDI into the port of Dakar.

- Banking-sector regulation is improving and will continue to do so. The minimum capital ratio is set to increase to GMD 150mn in December 2010 from GMD 60mn. There are plans to raise this further to GMD 200mn by 2013.

### Politics

- President Yahya Jammeh and his Alliance for Patriotic Reorientation and Construction (APRC) have won the last three elections, in 1996, 2001 and 2006, after staging a bloodless coup in 1994. Given the powers of incumbency, media controls and a tight hold on the opposition, Jammeh looks set to win the next presidential elections, to be held in September 2011.

- In July 2010, eight men, including a former army chief, were sentenced to death for their role in an alleged coup plot in 2009. Little change in the political environment is expected in the near to medium term.

# Ghana

**Razia Khan**, Regional Head of Research, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6914, Razia.Khan@sc.com

## Oil to boost growth

### Economic outlook

- Ghana's economy should benefit strongly from the first year of oil production in 2011. According to government projections, the non-oil economy should grow by 7%, boosted also by a surge in activity in other parts of the economy. When oil-sector growth is factored in, the economy should grow by 12.3%.

- However, this data does not take into account the recent rebasing of Ghana's GDP statistics. This was done not only to update the methodology of GDP calculation and change the base to a more recent year (2006), but also to take into account sectors that had become much more important to the economy and were not being measured properly. While GDP rebasing is typically conducted every five years, Ghana's methodology for calculating GDP had not been changed since 1993. Sectors such as telecoms, which had contributed significantly to growth in the interim, were not properly taken into account under the previous measures of GDP.

- Ahead of the rebasing exercise, consensus expectations were that Ghana's economy would turn out to be 30-40% larger than previously measured. The results, a 63% upward revision to Ghana's GDP, surprised many. 2009 GDP, originally measured at GHS 22.598bn (USD 15.7bn), was re-estimated at GHS 36.867bn (USD 25.6bn). As a result of the rebasing, Ghana suddenly found itself to be a middle-income country, with 2010 GDP per capita provisionally estimated at USD 1,318, against a prior estimate of only USD 753.

**Standard Chartered forecasts: Ghana**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)**** | 6.5 | 12.3 | 8.0 | 7.7 |
| **CPI (% y/y)** | 10.9 | 9.6 | 10.3 | 8.9 |
| **Policy rate (%)*** | 13.50 | 13.50 | 13.0 | 12.5 |
| **USD-GHS*** | 1.45 | 1.37 | 1.40 | 1.48 |
| **Current account balance (% GDP)** | -19 | -13 | -7 | -6 |
| **Fiscal balance (% GDP)** | -9.8 | -7.5 | -4.7 | -3 |

*end-period; **old GDP series is used

Sources: Bank of Ghana, Budget, Standard Chartered Research

- While this may have implications for the amount of concessional financing Ghana is eligible to receive, the rebasing also reduced other key metrics that are typically measured as a percentage of GDP. The worryingly high fiscal deficit as a percentage of GDP, which soared to the double digits during the crisis, appears less worrying following the rebasing. However, revenue collection ratios (domestic tax to GDP), as well as measures of financial depth (M2 to GDP) and the openness of the economy (total trade or exports to GDP) slumped to levels below most Sub-Saharan African peers, putting pressure on future policy to correct this.

- What will all of this mean for 2011? On the face of it, very little. The revisions to Ghana's GDP measure suggest that the economy was growing faster than previously thought all along. Also, with a larger base off of which to measure GDP in the first year of oil production, the growth impact of the oil sector may not be as large as the 5.3ppt the authorities had previously assumed. Interestingly, the rebasing found that Ghana's services sector had grown significantly, and accounted for more of the economy (51%) than either agriculture (30.2%) or the industrial sector (18.6%). Unlike many other Sub-Saharan African producers, Ghana has a fairly diversified GDP base in place even before oil production commences. The GDP projections, which forecast more growth in the non-oil economy even in the first year of oil production, reflect this. Ghana's challenge, in 2011 and beyond, will be to ensure that its fairly modest oil reserves do not crowd out other sectors of the economy.

### Financial issues

- Despite robust growth in 2008, and only a slight dip in 2009 as the newly elected National Democratic Congress (NDC) government sought to curb the budget deficit, Ghana's banking sector has been beset with a non-performing loan issue. Significant fiscal arrears, estimated at one point at as much as 6% of GDP, resulted in a sizeable increase in NPLs. This was despite more favourable capital adequacy ratios, resulting from the end-2009 requirement that foreign banks operating in Ghana raise their minimum capital requirements. With the authorities having begun to clear their arrears, sector-wide NPLs are expected to decline, leading to more robust credit growth in 2011.

# Ghana (con'd)

- Talk of more eurobond issuance has also revived, along with the offer of as much as USD 14bn in concessional lending from China. Although the joint GNPC-CNOOC bid for the Ghana National Petroleum Company (GNPC) to take a greater equity stake in the Jubilee field was rejected, some drawdown of concessional financing from China – for infrastructure purposes – has already begun.

- With domestic debt issuance limited to 3Y maturities (there has been no new 5Y issuance since the crisis), questions abound as to why Ghana does not rely more heavily on domestic debt in its overall financing plans. While a fear of locking in high rates has long prevented the authorities from issuing more longer-dated debt domestically, foreign investor appetite for Ghanaian assets remains high.

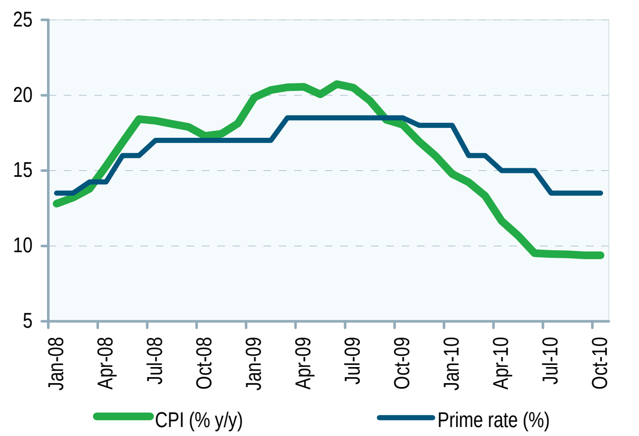
## Policy

- Regardless of the GDP rebasing, fiscal consolidation remains Ghana's biggest policy challenge. The deficit ballooned to 15% of GDP during the crisis; while it was reduced to the high single digits in 2009 as strict spending curbs were put in place, it appears to have expanded again, with public-sector salary reforms pressuring spending. The 2011 budget foresees a moderate narrowing of the budget deficit, to 7.5% of GDP. This is in part because old GDP data rather than rebased data was used for the budget's deficit calculations. Had the new GDP data been used, the overall fiscal ratio would look more benign.

- Still, higher GDP or not, the budget projections suggest that progress in closing the deficit will be slow. In part, this is because oil revenue in the first year of production has been conservatively assumed to contribute only 6% of total revenue, and around 1.9% of GDP. While this is a sound assumption, it is lower than projections in earlier studies that suggested (unrealistically, in our view) that Ghana would earn around 6% of GDP in additional revenue at the outset of oil production. While Ghana unveiled key spending priorities ahead of the 2011 budget, the authorities surprised many by revealing sweeping revenue-generating measures in the actual budget, aimed at boosting the revenue-to-GDP ratio.

**Chart 1: Inflation and policy rate**

%




Sources: BOG, Standard Chartered Research

- Despite aggressive easing in 2010 as inflation fell to its lowest level since 2006 (with the prime rate at 13.5% and CPI inflation just below 10%), Ghana's interest rate easing cycle appears to have ended. In the months ahead, inflation is expected to rise from current levels, albeit within a fairly narrow (by historic standards) 200-300bps range of current levels.

- While doubts over the monetary policy transmission mechanism persist, Ghana will become increasingly reliant on a strong exchange rate to keep inflation under control. We believe the authorities will accommodate moderate strengthening of the Ghana cedi (GHS), with USD-GHS reaching 1.37 on a one-year horizon.

## Other issues

- Ghana is adamant that it will not repeat the mistakes that have plagued other African oil producers, and will be transparent in its use of oil revenue. Part of the proceeds from oil will be saved in a long-term heritage fund, a sovereign wealth fund. Some will be used for a stabilisation fund, with only a portion contributing to fiscal revenue. The big determinant of Ghana's ability to earn more from oil production will be the development of gas infrastructure alongside oil, potentially driving down the country's energy costs. To date, however, such infrastructure investment has been missing.

## Politics

- Elections due at the end of 2012 will be closely fought between the ruling National Democratic Congress (NDC) and the opposition New Patriotic Party, which lost the 2008 presidential election by just 40,000 votes. With oil in the picture, efforts to win the election are likely to intensify, making it all the more surprising that the NDC government recently took the bold step of announcing a slew of revenue-raising measures in the 2011 budget.

# Kenya

**Razia Khan**, Regional Head of Research, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6914, Razia.Khan@sc.com

## Renewed confidence

### Economic outlook

- Despite some fears over the approaching La Niña weather phenomenon, Kenya's growth prospects in 2011 are more positive than they have been in years. The economy should continue to recover from the lows seen after its early 2008 political crisis. While progress since then has been halting (tempered by bouts of adverse weather which impacted agriculture, hydroelectricity supply and manufacturing), most factors are supportive of a full-blown economic recovery. Despite the persistence of weather-related risks, Kenya should make progress, with a return to trend growth.

- Confidence, perhaps the most important of positive influences, is back. The success of Kenya's constitutional referendum in August 2010 was an important step in the country's efforts to leave its political difficulties behind. The peaceful passage of the referendum, and the relative absence of an ethnic dimension to the vote (although opposition to the new constitution was strongest in Kenya's Rift Valley), suggests that Kenya has cleared an important political hurdle. Business and consumer confidence are up, and the economy should see the benefits in 2011.

- Although not commodity-rich in its own right, Kenya enjoys a large number of growth positives. With its well-established middle class and its traditionally open embrace of the private sector, Kenya has established itself as a regional leader in manufacturing and services such as banking and telecoms. Regionally, it is also noted for its financial-sector depth, including its record on debt-market reforms and liquidity management. This regional leadership should stand it in good stead in the medium term, when more meaningful regionalisation is expected following the signing of the East African Protocol in July 2010. East Africa's new oil producers also look set to increase their reliance on Kenyan ports. Regional trading partners now account for 47% of Kenya's exports, granting it some degree of immunity to a slowdown elsewhere. Given robust growth in the East African sub-region, cargo throughput at Kenyan ports has already risen significantly, and will benefit from infrastructure development in the years to come. Indicators such as cement consumption already hint at the boom that is unfolding.

**Standard Chartered forecasts: Kenya**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 4.1 | 5.8 | 6.3 | 6.5 |
| **CPI (% y/y)** | 3.8 | 7.8 | 6.9 | 4.1 |
| **Policy rate (%)*** | 6.0 | 7.0 | 7.5 | 8.5 |
| **USD-KES*** | 80.5 | 79.0 | 79.9 | 81.2 |
| **Current account balance (% GDP)** | -4.2 | -4.7 | -4.5 | -5.2 |
| **Fiscal balance** (% GDP)** | -6.6 | -5.5 | -4.9 | -4.6 |

*end-period **for fiscal year ending 30 June

Sources: CBK, IMF, Standard Chartered Research

### Financial issues

- More so than any other frontier African economy, Kenya received plaudits for the successful handling of its borrowing requirement during the crisis. The Central Bank of Kenya (CBK) introduced extensive measures aimed at increasing liquidity in the banking system in order to accommodate a higher domestic borrowing requirement, while continuing to support private-sector credit growth.

- Reserve ratios and the policy rate were eased, the threshold for investment in government securities was lowered, microfinance institutions best able to mobilise deposits came under the regulatory ambit of the CBK (boosting investible funds in the economy), and the schedules for T-bill and bond auctions were modified to ensure a sustainable low-interest-rate environment. Horizontal repos, allowing for more effective interbank borrowing between financial institutions, were introduced. Kenya was able to lengthen its domestic yield curve significantly (to 25Y) and raise over USD 1bn of infrastructure bonds, without pressuring interest rates higher. However, with the economic cycle now turning and the recovery likely to pose some risk to bond yields, the sustainability of Kenya's low interest rates will be a key focus in 2011.

- As domestic bond yields rise, Kenya's focus is likely to switch to external borrowing, provided that market conditions are conducive. (Earlier plans to issue a eurobond were delayed by the global crisis). Following

# Kenya (con'd)

S&P's recent upgrade of Kenya's long-term credit rating to B+ with a stable outlook, eurobond issuance is highly likely, perhaps early in FY12 (begins 1 July 2011).

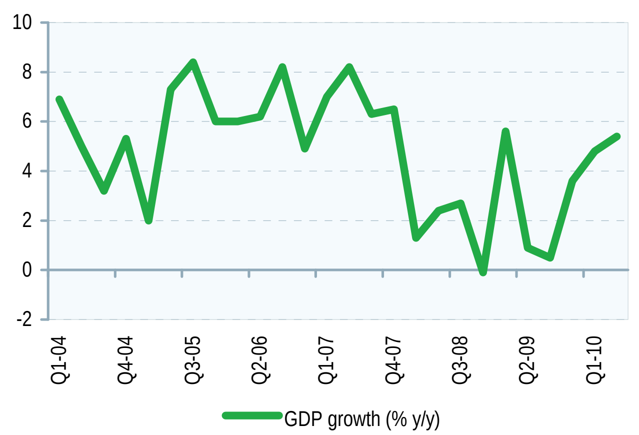
- The success of Kenya's approach to financial-market development has benefited the real economy, and will remain a key growth driver in 2011. Thanks to a regulatory environment that favours innovation (seen, for instance, in the widespread growth of mobile-phone banking), Kenya has had greater success with financial inclusion than many peer economies. The proportion of its population with access to formal banking rose to 40.5% in 2009 from 26.4% in 2006. Even more encouragingly, Kenya's 'financially excluded population' (with no access to financial services, formal or informal) fell to 32.7% in 2009 from 38.4% only three years earlier.

## Policy

- A key risk to robust credit growth in 2011 stems from the exposure that Kenyan financial institutions now have to a potential bond-market correction. During the growth slowdown, capital gains from holdings of government securities became one of the main drivers of banking-sector revenue. Current estimates suggest that government bonds account for roughly 26% of the aggregate balance sheets of Kenyan banks. While the reclassification of trading books into hold-to-maturity positions could mitigate losses associated with a steep correction in bond yields, this would be an additional negative for market liquidity. Recently, revenue collection has shown signs of underperforming ambitious targets. Although the front-loading of government borrowing has started to pressure yields, concerns about the wider banking environment – despite banks being well capitalised – will argue for monetary policy to remain accommodative in 2011. Inflation is currently stable at around 3%, but a less favourable base and La Niña-related pressure may alter this significantly.

- Exchange rate policy has been dominated by the need to build up FX reserves. IMF funding to achieve FX reserve targets has been mooted, with the IMF announcing an agreement in principle to lend USD 500mn to Kenya through December 2013 as part of its Extended Credit Facility programme. With a lower need to buy USD to build reserves, the Kenyan shilling (KES) is likely to gain further in 2011. However, pressure on Kenya to reduce its fiscal deficit, which has widened further in FY11, is also likely to grow. The IMF programme aims to support investment in infrastructure and the energy sector, especially geothermal power. New funding will also boost the authorities' efforts to implement Kenya's new constitution. The IMF hopes that the measures will reduce overall government and government-guaranteed debt to 45% of GDP from 47% currently. With a low external debt ratio, estimated at only 26%, Kenya has room to borrow from other sources as well.

**Chart 1: Quarterly real GDP growth**
*% change y/y*




Sources: KNBS, Standard Chartered Research

## Politics

- Given the shock experienced after flawed elections at the end of 2008, politics will remain a key driver of Kenya's economic outlook. While passage of the constitution is broadly positive, signaling widespread support for a devolution of power from the centre to more powerful regions, many of the tenets of the new constitution still require legislative changes to become operational. The process is not devoid of political risk.

- Encouragingly, Kenya has seen more co-operation in tackling high-profile corruption cases recently, with President Mwai Kibaki working more closely with Prime Minister Raila Odinga. Kenya's corruption score has improved marginally in recent years. However, a larger issue – the prosecution of those thought to have helped perpetrate post-election violence in 2007 and 2008 – remains unresolved.

# Nigeria

**Razia Khan**, Regional Head of Research, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6914, Razia.Khan@sc.com

## All about elections

### Economic outlook

- 2011 will be dominated by elections which, in the absence of constitutional change allowing for a delay, should be held in April, allowing for 'handover' in May. Government spending has been ramped up considerably ahead of the election. Revised budgetary projections and two supplementary budgets (including one to cover the costs of Nigeria's new voter registration system) suggest that spending will rise around 50% in 2010, with some spillover into 2011. While official data indicates that growth in the non-oil economy has held up, the impact of the Niger Delta crisis, the global financial-sector slump and reduced earnings from oil resulted in bouts of negative money supply growth in 2009. This was exacerbated by problems in Nigeria's own financial sector prior to regulatory intervention in its banks. Although money supply growth is now off its lows, it is likely to rise strongly again in 2011. Robust liquidity growth, combined with a recovery in bank lending, may allow a 'feel-good' sense to re-emerge.

- If this is complemented by far-reaching reforms in the power, oil and financial sectors, Nigeria may see a step-change in its growth prospects. Elections are not without their risks, however, and the concern is that while much reform is promised in the future, there is little to show for the reform agenda so far outside of ongoing financial-sector changes (a carryover from the regulatory intervention of 2009). Almost the entire focus has been on elections and what emerges thereafter, with comparatively little emphasis on structural reforms that would benefit the economy now.

**Standard Chartered forecasts: Nigeria**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 6.6 | 8.5 | 7.8 | 7.1 |
| **CPI (% y/y)** | 13.8 | 12.5 | 8.4 | 9.6 |
| **Policy rate (%)*** | 6.25 | 8.00 | 9.50 | 9.0 |
| **USD-NGN*** | 152 | 150 | 144 | 146 |
| **Current account balance (% GDP)** | 8.0 | 12.0 | 14.0 | 11.8 |
| **Fiscal balance (% GDP)** | -6.0 | -4.0 | -3.3 | 2.8 |

*end-period Sources: CBN, IMF, Standard Chartered Research

- Near-term risks are also elevated. A spate of kidnappings in the Niger Delta, although dealt with authoritatively by Nigeria's armed forces, served as a reminder of the potential threats. Militancy in the Delta – attacks on pipelines have reduced crude supply to Nigeria's refineries and compelled a key oil major to declare force majeure on its Bonny exports – are a reminder of what is at stake. Unrest in the Delta in the run-up to the elections, and perhaps even beyond, would dramatically impact Nigeria's growth outlook. While the consensus is for a decent growth recovery (Nigeria's oil output recently reached highs not seen since 2006), the economic impact of sustained volatility in the Niger Delta would be severe. Despite the favourable outlook – our core view is still that growth should rise strongly – risks to our GDP forecasts are significant, and hinge on political developments.

### Financial issues

- The resolution of Nigeria's banking-sector crisis, which saw the erosion of two-thirds of the sector's capital, is now drawing to a conclusion with the establishment of an Asset Management Company (AMCON). By the beginning of 2011, the AMCON will have purchased all non-performing loans from Nigeria's rescued banks, as well as NPLs related to margin trading from the entire banking sector, albeit at some discount to face value. In return, banks will be granted 3Y zero-coupon bonds, backed by the Federal Government of Nigeria (FGN) and eligible for repo at the Central Bank of Nigeria (CBN) window; these will be exchanged on maturity for 7Y interest-bearing paper. This should give Nigeria a comfortable 10-year period in which to deal with the cost of its banking-sector bailout.

- The AMCON will be jointly funded through a sinking fund established by the central bank, and will receive annual contributions from Nigeria's banks. Banks will be subject to a 30bps balance-sheet levy over the next 10 years, minimising the fiscal costs of the banking-sector bailout. Nonetheless, asset purchases alone are unlikely to bring the sector back to minimum capital adequacy levels. A further injection of equity capital into rescued institutions by the AMCON is expected, bringing net asset values to zero before new acquirers inject sufficient further capital to meet minimum capital requirements.

# Nigeria (con'd)

- There are two key implications: (1) The partial bailout of all institutions with NPLs related to margin trading raises significant moral hazard issues. While banks will eventually cover the cost of the bailout themselves, tighter regulation will nonetheless be required to prevent a repeat problem. Ongoing political backing for tighter regulation will need to be gauged. (2) Official involvement in Nigeria's banking sector, through the AMCON's injection of Tier 1 capital into rescued institutions, is set to rise. While few policy changes are anticipated at the outset, this raises the possibility of a more interventionist regulator, looking to boost lending to strategic sectors such as power and industry, and to fulfil broader financial inclusion aims. While there has been little indication that commercial considerations will not apply, the process will be watched carefully.

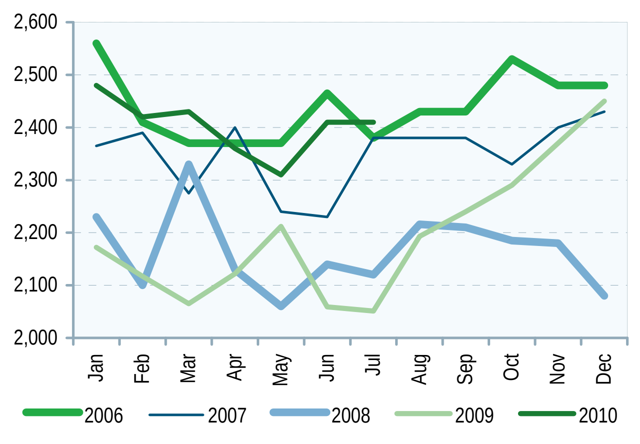
## Policy

- Fiscal expansion was widely acknowledged to be in overdrive in 2010, with a probable deficit of between 5% and 6% of GDP, despite recovering oil prices and rising output. The hope is that 2011, especially the post-election period, will see a return to a more conservative stance. The depletion in 2010 of Nigeria's excess crude account (representing windfall oil savings built up since 2004) is a concern, although hopes now rest on plans to establish a new sovereign wealth fund to institutionalise oil savings.

- Long-benign monetary policy will encounter a more difficult set of circumstances in 2011. Increased government borrowing could pressure bond yields further, posing risks to banks with sizeable exposure to FGN bonds (in Nigeria, however, there is no mark-to-market for bonds held to maturity, so losses will remain 'notional'). Planned reforms of electricity pricing and the downstream fuel sector will raise inflationary risks, calling for a continued tightening response. Despite improvements in oil earnings, Nigeria's FX reserves have spectacularly failed to increase, undermining confidence in continued FX stability. While reassurance from the CBN on its policy intentions has restored some calm to the FX market, it would not take much to reignite volatility, complicating the task of monetary policy.

**Chart 1: Nigerian oil production is back to its best levels since 2006, but elections pose a risk**

*Oil production, '000 barrels per day*




Sources: US Dept. of Energy, Datastream

## Other issues

- Two key issues will dominate, both in 2011 and in the medium term. The unveiling of plans for sweeping power-sector reforms by President Goodluck Jonathan, involving a break-up of the state-owned power monopoly and more private sector involvement, has raised hopes that Nigeria will finally overcome one of its key infrastructure bottlenecks. Currently, power generation in Africa's second-largest economy is estimated at 40 watts per person. However, the proposed reforms will take three to four years to achieve results.

- Attention will also be focused on the passage of Nigeria's Petroleum Industry Bill – a sweeping attempt to rewrite the regulatory framework of the key oil and gas sector. The hope is that Nigeria will be able to increase its current share of oil revenue, while also laying the foundation for investment and sound growth in the future. Passage of the legislation has been delayed by the number of variants of the bill, and it is unclear whether it will be passed ahead of the elections.

## Politics

- Although the powers of incumbency favour the electoral prospects of President Goodluck Jonathan, Nigeria's first leader from the oil-rich Delta region, there is considerable uncertainty over primaries for the ruling People's Democratic Party (PDP). The suggestion that rotation of power between north and south would not be adhered to had generated considerable controversy, triggering the emergence of a northern 'consensus' candidate, former Vice President Atiku Abubakar. The passage of elections will be a key determinant of the ability to enact sweeping reforms further out. Nigeria's constitution requires that the president wins an overall majority, and a further majority in at least two-thirds of the country's 36 states.

# Sierra Leone

**Amina Adewusi**, Economist, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6593, Amina.Adewusi@sc.com

## Recovery underway

### Economic outlook

- A further economic recovery is anticipated following the global crisis-related slump in mining. Sierra Leone's economy was significantly impacted by a 40% decline in diamond prices, as well as a dredging crisis in rutile mines. The rebound in diamond mining will continue in 2011, although rutile will continue to experience output problems. However, the discovery of iron ore deposits and offshore oil has reinvigorated foreign investor interest in Sierra Leone. Production of bauxite, another important commodity, has also resumed.

- GDP growth is likely to accelerate to 5.2% in 2011 as agricultural output improves and foreign investment boosts commodity exports. Growth in agricultural production will be led by the government's intention of achieving rice self-sufficiency. The government's tractorisation policy has boosted agricultural yields and is the main driver of growth in the rice sub-sector.

### Financial issues

- Donor support remains a key source of financing, and is forecast at over 30% of government spending in FY11 (ends 31 March 2011). The IMF's Extended Credit Facility (ECF) took effect in July 2010 and will disburse a total of USD 45.4mn over the next three years. Funding from Sierra Leone's largest donor, the UK, is likely to continue, despite concerns over the lack of progress in governance reforms.

### Policy

- The introduction of a 15% sales tax in early 2010 will contribute to a high base, driving inflation lower in 2011.

**Standard Chartered forecasts: Sierra Leone**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| GDP (real % y/y) | 5.0 | 6.0 | 6.0 | 6.0 |
| CPI (% y/y) | 16.5 | 9.0 | 8.5 | 8.5 |
| Policy rate (%)* | 11.0 | 10.5 | 10.0 | 10.0 |
| USD-SLL* | 4,250 | 4,350 | 4,400 | 4,600 |
| Current account balance (% GDP) | -9.3 | -9.5 | -9.0 | -8.7 |
| Fiscal balance (% GDP)** | -3.2 | -5.7 | -5.0 | -5.0 |

*end-period; **for fiscal year ending 31 March

Sources: IMF World Economic Outlook, Standard Chartered Research

(The replacement of indirect taxes by a goods and services tax, and the abolition of fuel subsidies, drove inflation higher in 2009, but were largely one-off factors.)

- The fiscal deficit is likely to widen further in FY11, putting pressure on infrastructure and social spending. The government has announced free health care for pregnant mothers and children aged under five, which will cost around 1.2% of GDP, as well as a six-fold pay rise for doctors. Revenues have improved with the increase in key import duties and taxes. However, this will not be enough to prevent a widening deficit. Domestic revenue collection is likely to remain at 12% of GDP in FY11. With a low revenue collection ratio, Sierra Leone will remain dependent on donor financing over the medium term.

### Other issues

- The Bumbuna hydroelectric dam, opened in November 2009, has boosted power supply. This is encouraging for the mining outlook, and while power supply has not yet reached optimal levels, it is improving. Unlike in many other African countries, Sierra Leone's market pricing for power supply favours further investment in the sector.

### Politics

- Preparations are already gearing up for elections due in August 2012. Intense competition expected between the All People's Congress (APC) and the Sierra Leone People's Party (SLPP) is expected. There is a possibility that the parties will attempt to manipulate tensions between ethnic groups in the run-up to the elections.

- President Koroma of the APC has already begun to introduce popular policies such as free health care. The opposition SLPP will hold its leadership election in March 2011. John Benjamin, the party's current chairman, is likely to stand as its candidate.

- There is growing impatience among the population about corrupt officials, and there have been recent clashes between civilians and police. The popular anti-corruption commissioner has been replaced. It remains to be seen whether his successor, Joseph Kamara, maintains the commission's independence.

# South Africa

**Razia Khan**, Regional Head of Research, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6914, Razia.Khan@sc.com

## Closely watching imbalances

### Economic outlook

- Although South Africa's contraction during the latest crisis was relatively shallow by global standards, the recovery since then has been unexciting. While other emerging markets have raced ahead, South Africa has only just pulled ahead of where it was in 2008 in terms of absolute levels. In 2011, the key question is whether the economy will continue to limp along or finally post a more robust recovery. Our expectations fall into the latter camp. Strong gains in household consumption expenditure look likely as South Africa benefits from the culmination of 650bps of monetary policy easing in this cycle. Indeed, it is one of the few emerging-market economies still easing policy at the time of writing. Much of the impact of lower interest rates has yet to feed through to the real economy.

- The recovery in private-sector credit extension – which, although still low in y/y terms, shows many of the characteristics of early-cycle growth – should underscore domestic consumption. Although unemployment rose from a cyclical low of 23% pre-crisis to over 25% recently, strong wage growth for those who do have jobs should provide further support to the growth outlook. Surveys suggest that wage gains in sectors with a high degree of unionisation may be running as high as 15% – several times South Africa's 3-6% inflation target. Moreover, increased state provision of social safety nets should go some way towards supporting higher consumption. While households remain weighed down by large debt burdens, this will be offset to some extent by increased wealth effects. In particular, evidence on durable-goods sales suggests that South Africa continues to see the emergence of a new middle class on a more structural basis.

**Standard Chartered forecasts: South Africa**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 3.0 | 3.6 | 3.8 | 4.4 |
| **CPI (% y/y)** | 4.3 | 4.3 | 5.1 | 5.2 |
| **Policy rate (%)*** | 5.5 | 5.5 | 7.0 | 8.0 |
| **USD-ZAR*** | 6.7 | 7.1 | 7.8 | 8.2 |
| **Current account balance (% GDP)** | -3.5 | -4.9 | -5.3 | -5.8 |
| **Fiscal balance (% GDP)**** | -6.8 | -5.3 | -4.6 | -3.9 |

*end-period; **for fiscal year ending 31 March

Sources: SARB, Stats SA, National Treasury, Standard Chartered Research

- Prospects on the supply side look less certain. While mining and manufacturing were early beneficiaries of the global economic recovery, more recently, the strength of the South African rand (ZAR) has started to take its toll. Concerns over the competitiveness of manufacturing abound, and it is unclear if recent weakness (with the PMI dipping below 50) was the result of sector-specific industrial action or symptomatic of a deeper malaise. 2011 should provide more clues. Manufacturing is likely to remain vulnerable to any growth downturn in Europe, which remains one of South Africa's key trading partners.

- Trends in gross fixed capital formation – or investment – will also be a key determinant of South Africa's eventual growth path. During the crisis, South Africa was relatively fortunate, as World Cup preparations meant that public investment was ramped up considerably. In 2011, the key test will be whether private gross fixed capital formation rises to offset less robust public investment as fiscal consolidation gets underway. Investment rates will influence the extent to which South Africa's post-crisis growth remains fraught with the imbalances that characterised pre-crisis growth, with demand in overdrive and the supply side lagging behind. It was this imbalance that drove South Africa's current account deficit.

### Financial issues

- Although South Africa's financial institutions were largely unscathed by the financial crisis, a rise in global funding costs contributed to weak lending overall. This, together with the pre-crisis implementation of a National Credit Act aimed at curbing overheating consumer lending, has made banks relatively cautious about new asset growth. Mortgage securitisation, seen as a key means of increasing the provision of low-cost housing, ground to a halt. With the mandate of the South African Reserve Bank (SARB) now formally including financial stability as well as broader macroeconomic objectives, the regulatory response to any sustained recovery in lending will be key. Recently, with inflation close to the lower end of its target and most elements of credit extension below pre-crisis peaks, there has been little trade-off between

# South Africa (con'd)

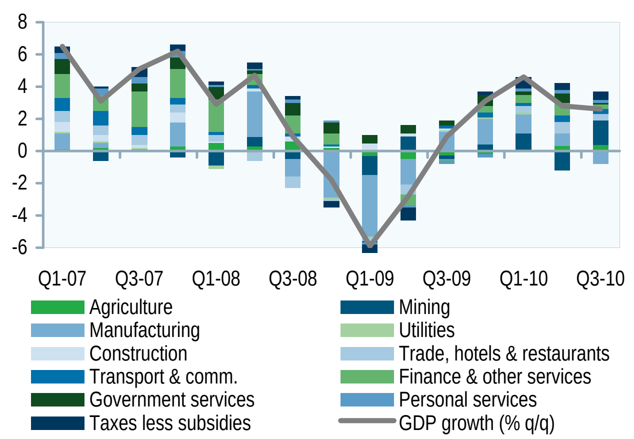
the SARB's goal of broad financial stability and its desire to boost growth. Over the course of the cycle, however, the potential for policy inconsistencies may become more important.

## Policy

- South Africa's Medium Term Budget has already outlined plans to reduce the deficit from 6.8% of GDP in FY10 (ended 31 March 2010) to 3.2% by FY14. Although revenue collection is expected to improve in line with the cyclical recovery, fiscal consolidation will largely be achieved through a decline in spending growth, with government expenditure expected to fall to 32.3% of GDP in FY14 from 33.7% in FY11. To put this in context, while real non-interest government spending has doubled over the last eight years, the pace of spending increases will slow to around 3% p.a. in real terms in the coming years. However, medium-term budget projections did not include estimates for the much-discussed introduction of a national health insurance scheme, suggesting that actual spending may be higher than currently indicated in the Treasury's plans.

- Even so, given official plans for fiscal consolidation, monetary policy is likely to take up the slack in providing economic stimulus. With inflation likely to rise gradually from current levels over the course of 2011 (the base will be less favourable, although inflation should remain well within the targeted band, helped by continued currency strength), monetary policy will remain accommodative. With the repo rate at a multi-decade low of 5.5%, normalisation may be required sooner rather than later. Nonetheless, the authorities will attempt to keep interest rates low for as long as possible, and we do not forecast tightening until after Q4-2011. Further easing – although not our core scenario – is possible in response to any renewed external deterioration.

**Chart 1: Contribution to quarterly GDP growth by sector**
*Percentage points*




Sources: StatSA, Standard Chartered Research

## Other issues

- As a liquid, high-yielding emerging market, South Africa has been the recipient of sizeable capital inflows, driving currency strength. The SARB's focus on the partial sterilisation of any FX market intervention has prevented a significant build-up of FX reserves to date. Unsterilised intervention would risk eroding the money market liquidity shortage, making policy relatively ineffective when interest rates are eventually raised. In 2011, however, the Treasury will bear the costs of some of the SARB's intervention. Greater FX market intervention through the use of long-term currency swaps has also begun. Such intervention is considered more 'neutral' for money supply growth, and should allow South Africa to improve its external liquidity ratios over the long term.

- The authorities have also announced a slew of measures to liberalise controls on FX outflows in the hope of reducing ZAR appreciation pressures. Relative to the magnitude of flows into emerging markets, it is unclear whether a trickle of outflows will make much difference to the currency. Longer-term, however, the chronic deficit on the income account of the current account imbalance may be narrowed.

## Politics

- The cabinet reshuffle towards the end of 2010, ostensibly to remove 'non-performing' ministers, is seen to have strengthened President Zuma's hand ahead of a bid to continue as leader of the ruling African National Congress (ANC) in 2012. Policy in the interim is likely to be dominated by positioning ahead of the ANC's internal congress. While unions have been vocal in their condemnation of rising patronage politics within the party, at the other end of the spectrum, the ANC Youth League (ANCYL) has increased its calls for mine nationalisation, seen as a bailout for key Black Economic Empowerment businesses with extensive mining interests. Nonetheless, the appointment of two former ANCYL leaders to the cabinet suggests that efforts to curb the influence of the current ANCYL leadership will continue.

# Tanzania

**Razia Khan**, Regional Head of Research, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6914, Razia.Khan@sc.com

**Lo Wing**, Economist, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 7142, Wing.W.Lo@sc.com

## Focus on fiscal revenue

### Economic outlook

- Tanzania has recently had one of the most attractive growth trajectories in Africa. Although growth slowed to an estimated 5% in 2009 from a pre-crisis trend of 6-7%, a near doubling of development assistance helped to prevent a more severe slowdown. 2011 may prove more challenging. Despite a decent recovery – growth of 7.0% and 7.1% was recorded in Q1 and Q2-2010, respectively – donors have scaled back assistance by 220mn in FY11 (ends 31 March 2011), citing disappointment with domestic revenue collection and governance/business climate reforms. Nonetheless, the broad-based nature of Tanzania's growth, with gains across sectors including mining, construction, agriculture and tourism, should help it withstand the pressure from reduced donor funding. Longer-term, there will be more pressure on Tanzania to raise revenue from domestic sources. Donors have traditionally financed over 40% of Tanzania's budget. The years ahead will see this level of engagement come under significant pressure. In the current fiscal year, grants will constitute only 25% of the budget.

### Financial issues

- Like most African economies, Tanzania eased monetary policy significantly during the global crisis. Although CPI inflation will remain moderate in the coming months, helped by a favourable base, monetary policy normalisation has already begun, with more frequent open-market operations. Yields are more attractive than in other East African countries, suggesting that Tanzania may see a rush of inflows once it opens its asset markets to portfolio investment from the East African Community (EAC). Despite talk of a eurobond, Tanzania's domestic debt and equity markets remain closed to foreign portfolio investors for now. The country has yet to receive a sovereign rating.

**Standard Chartered forecasts: Tanzania**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 6.5 | 6.7 | 7.5 | 7.7 |
| **CPI (% y/y)** | 6.9 | 4.0 | 6.2 | 5.4 |
| **Policy rate (%)*** | 5.6 | 6.0 | 6.8 | 6.7 |
| **USD-TZS*** | 1,500 | 1,550 | 1,640 | 1,680 |
| **Current account balance (% GDP)** | -8.8 | -9.1 | -8.7 | -7.8 |
| **Fiscal balance (% GDP)**** | -5.6 | -4.9 | -5.2 | -4.8 |

*end-period; **for fiscal year ending 31 March

Sources: BoT, IMF, Standard Chartered Research

### Policy

- Despite its successful growth record, Tanzania's transition from its socialist past – with large, easily identifiable SOEs – to an economy where much activity has moved into the informal sector has made its developmental challenges more acute. Expanding the tax base and rationalising the overly burdensome regime for a limited number of formal-sector companies has been a key policy thrust. Nonetheless, fiscal concessions to attract investment to the gold-mining sector a decade ago were seen as overly generous, and changes to the tax regime since then – for example, removing the ability of companies to defer tax payments for a 20-year period – have left Tanzania vulnerable to accusations of frequent regulatory changes. Nonetheless, the politicisation of the issue of low mining-sector royalties in recent elections (a key platform for the opposition) will likely force the subject back onto the agenda in 2011.

### Other issues

- Agriculture remains central to Tanzania's prospects, and to its efforts to lift its population out of poverty. Recent years have seen sizeable agri-related investments by Asian firms. China will continue to feature prominently in infrastructure development, seen as a key bottleneck.

- Despite the East African Protocol taking effect in July 2010, Tanzania remains reluctant to open its economy fully to the free flow of labour from elsewhere in the EAC. Given persistent talk of establishing a monetary union in 2012, Tanzania will have to do much to catch up with partner EAC states.

### Politics

- The October 2010 election victory of incumbent President Kikwete and the ruling Chama Cha Mapinduzi (CCM) was marred by allegations of irregularities. On Zanzibar, a pre-election power-sharing deal between the ruling CCM and the opposition Civic United Front prevented greater fallout, after the CCM was declared the victor in a tight election. While tensions will persist, little change to the status quo is seen.

# Uganda

**Razia Khan**, Regional Head of Research, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6914, Razia.Khan@sc.com

**Lo Wing**, Economist, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 7142, Wing.W.Lo@sc.com

## Boost from regional integration

### Economic outlook

- The outlook for Uganda's growth in 2011 remains broadly optimistic, despite the downside risks associated with elections due in early 2011. Uganda looks set to enjoy the dividends of its high level of economic liberalisation and ongoing improvements in regional integration. Demand from Southern Sudan in particular will continue to provide an important boost, and favourable harvests are expected to help fill a regional food gap. Cross-border trade should receive a further lift from the recent establishment of the East Africa Protocol in July 2010.

- The settlement of a tax dispute between the Ugandan government and its key oil-sector investor has cleared a potential delay to the start of oil production. First oil is somewhat optimistically expected by the end 2011; production should reach 200,000 barrels per day (bpd) by 2015, rising to a potential 350,000bpd by 2018, if existing production plans are modified. The infrastructure requirements for oil production are nonetheless considerable, with the 'waxy' nature of Ugandan oil requiring that it be heated before being transported. The costs of a domestic refinery and a pipeline to the East African coast will also be incurred, suggesting that production may only begin in two to five years.

### Policy

- While Ugandan inflation continues to decline near-term, helped by favourable food harvests, the base is likely to be less positive in 2011. Economic recovery, election spending and robust regional demand all pose some risk to the inflation outlook. Anticipating this pressure, the Bank of Uganda has already halted its liquidity injections into the market, as evidenced by recent pressure on short- and medium-dated tenors of the domestic yield curve. Although Uganda does not borrow domestically for deficit financing, a 10% reduction in donors' USD 360mn contribution to the FY11 budget (for the year ending 30 June 2011) on graft concerns will add to bearish market sentiment. Alongside rising market interest rates, however, recent Ugandan shilling (UGX) retracement should help to contain inflationary pressure. Most frontier economies in Africa have yet to benefit from the wave of inflows seen into more established emerging markets. But as Uganda draws closer to oil production, such inflows may grow.

#### Standard Chartered forecasts: Uganda

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 6.4 | 6.8 | 7.5 | 9.0 |
| **CPI (% y/y)** | 5.2 | 4.0 | 7.7 | 6.5 |
| **Policy rate (%)*** | 6.6 | 5.8 | 6.2 | 6.7 |
| **USD-UGX*** | 2,260 | 2,300 | 2,380 | 2,420 |
| **Current account balance (% GDP)** | -7.2 | -7.8 | -9.2 | -9.7 |
| **Fiscal balance (% GDP)**** | -4.5 | -5.2 | -6.0 | -5.1 |

*end-period; **for fiscal year ending 30 June

Source: BoU, IMF, Standard Chartered Research

### Financial issues

- Further financial-market development will remain a key focus in 2011. The spotlight is likely to fall on the opening up of Uganda's pensions market, allowing participation of authorised companies other than the state-run National Social Security Fund, which has monopolised the institutional market to date. The move is expected to boost domestic financial-market liquidity, in line with the government's strategy of developing domestic funding sources and reducing reliance on donors (which are estimated to contribute only 25% of the budget in FY11).

### Politics

- The focus will be on Uganda's presidential and parliamentary elections, due between 12 February and 1 March 2011. Although President Yoweri Museveni is widely expected to win an additional term in office, risks ahead of the election may remain elevated, especially if there are further ethnic tensions, as seen with the unrest during the September 2009 rioting by the Baganda. While the prospect of unrest will lead some to reject multi-party politics and favour the status quo, the external push for greater pluralism in Ugandan politics is likely to persist.

- Regional political risks will also feature strongly, given the referendum on political autonomy in Southern Sudan in January. Uganda's continued involvement in Somalia will also raise security concerns following the World Cup bombings in Kampala in July 2010, which are believed to have been the work of Somali militants.

# Zambia

**Razia Khan**, Regional Head of Research, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6914, Razia.Khan@sc.com

**Amina Adewusi**, Economist, Africa
Standard Chartered Bank, United Kingdom
+44 20 7885 6593, Amina.Adewusi@sc.com

## Copper-driven strength

### Economic outlook

- Significant increases in copper output will continue to underscore Zambian GDP growth in the coming year, with progress towards reaching a 2012 production target of 1 million tonnes (mt) well underway. Zambia has had several years of strong mining growth, with copper output rising an estimated 20% in 2010 to over 720,000 tonnes. Having already achieved a doubling of output on the copper belt before the crisis, Zambia now looks set to do it again. While copper production may be at an all-time high as the sector benefits from soaring metals prices, questions over effective taxation of mining (following the abolition of a proposed tax on windfall earnings) will remain the subject of much controversy.

- Near-term, infrastructure bottlenecks are likely to pose the most important headwinds to growth. Zambia's infrastructure is already under strain from rising copper output, much of which is transported by road. Constraints on power generation capacity – which will only increase meaningfully in the medium term – may also cap mine output plans. Nonetheless, capital spending is set to rise sharply in 2011 in an attempt to address infrastructure concerns.

- Recent years have seen an increasing focus on agriculture, with record grain harvests allowing Zambia to export 1.1mt of surplus maize in 2010. Although state involvement through the provision of subsidies to poor farmers has helped to drive up yields, permission from the Food Reserve Authority is required before any surplus can be exported. Large-scale commercial investment may require further liberalisation of the sector. With 40% of Southern Africa's water resources, Zambia has vast agri-potential. There is still scope for infrastructure development and other reforms to drive agricultural productivity and lift per-capita incomes.

#### Standard Chartered forecasts: Zambia

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 6.6 | 5.8 | 6.4 | 7.0 |
| **CPI (% y/y)** | 8.9 | 10.5 | 7.8 | 8.5 |
| **Policy rate (%)*** | 5.9 | 7.3 | 7.7 | 8.4 |
| **USD-ZMK*** | 4,700 | 4,500 | 4,600 | 4,800 |
| **Current account balance (% GDP)** | -2.4 | -3.9 | -6.7 | -6.9 |
| **Fiscal balance (% GDP)** | -3.3 | -3.7 | -4.0 | -4.4 |

*end-period Sources: BoZ, IMF, Standard Chartered Research

### Financial issues

- While Zambia's public debt ratios are generally sound (public debt will rise to 14.9% of GDP in 2011 from only 9.1% in 2010), concern is growing over the build-up of external debt since debt forgiveness was granted in 2005. External debt now stands at USD 3.5bn, although the majority of this (USD 2bn) represents private-sector commitments. Nonetheless, Zambia's plans for USD 1bn of eurobond issuance will be keenly watched in 2011.

### Policy

- A ramping up of infrastructure and social spending should see Zambia's traditionally moderate budget deficit widen to 3.7% of GDP in 2011 (from 3.3% in 2010). Donor financing of the budget is set to fall to only 7.7%, compared with 14.5% of spending in 2010 and as much as one-third of spending in earlier years. Although revenue collection looks likely to outperform targets by 12% in 2010 due to robust economic growth, spending pressure has also escalated; this should intensify in 2011, an election year. Revenue collection ratios have been fairly static in recent years despite the copper boom, although we project that the ratio will rise moderately to 18.5% of GDP in 2011.

- Rising copper prices and a sustained trade surplus have driven Zambian kwacha (ZMK) gains. We look for the ZMK appreciation bias to persist in 2011 as tight monetary policy aimed at achieving 8% inflation provides greater support to yields.

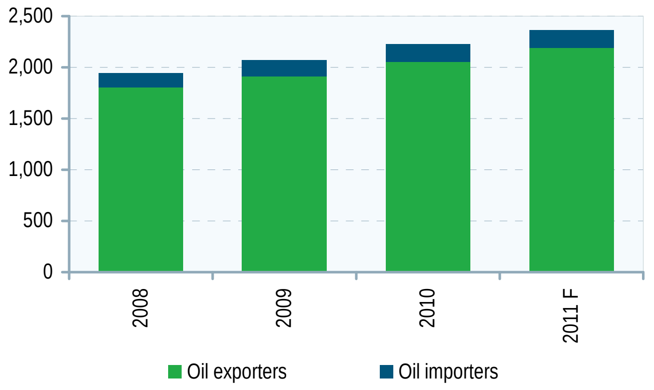
### Politics

- Presidential and parliamentary elections due by September 2011 will be a key focus. Despite an opposition alliance that brings together key figures from the centre and the left, the powers of incumbency and Zambia's recent growth trend are likely to favour the electoral prospects of President Rupiah Banda and the ruling Movement for Multiparty Democracy (MMD).

# Economies – MENA

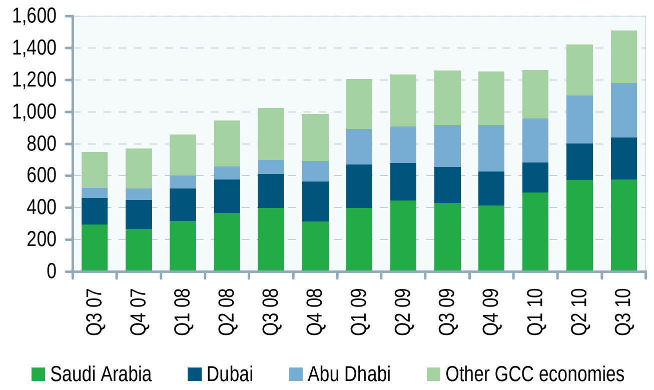
# MENA – Charts of the year

### Chart 1: MENA'S foreign assets are rising
*USD bn*



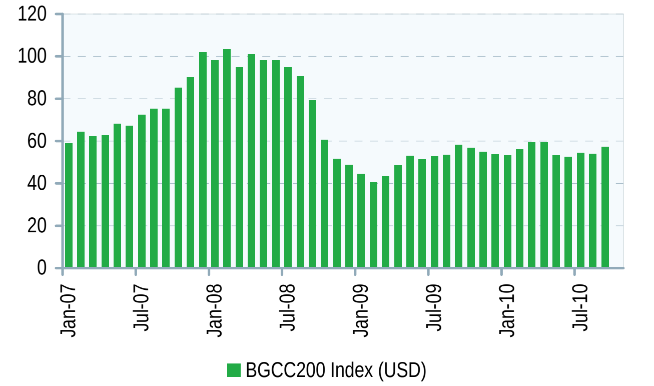

Sources: IIF, IMF, Standard Chartered Research

### Chart 2: GCC workers sending more money to Pakistan
*USD mn*



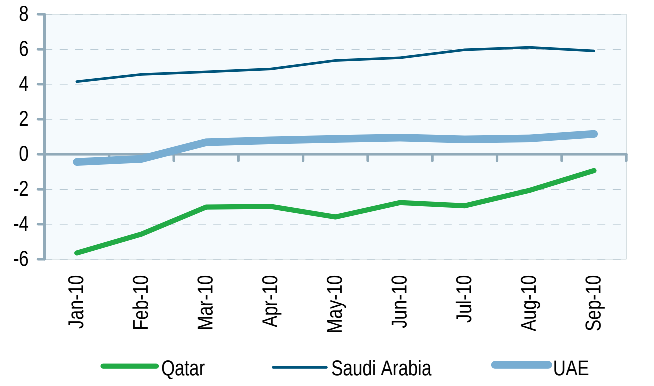

Sources: State Bank of Pakistan, Standard Chartered Research

### Chart 3: Bloomberg GCC 200 Equity Index



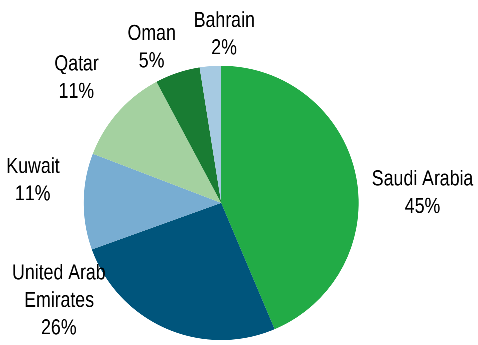

Sources: Bloomberg, Standard Chartered Research

### Chart 4: Selected GCC countries – monthly CPI inflation
*y/y, %*



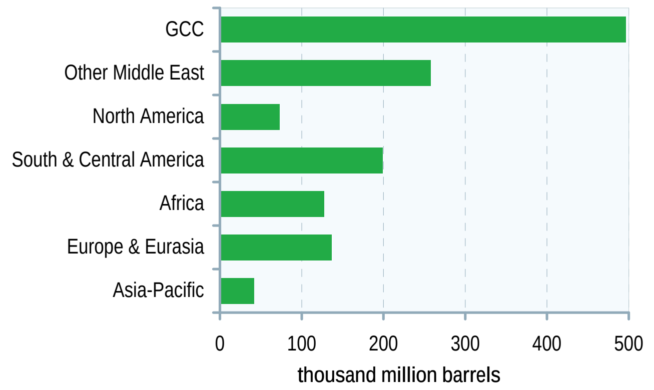

Sources: Bloomberg, Standard Chartered Research

### Chart 5: Saudi Arabia is the GCC's largest economy
*% contributions to GCC GDP, 2008*




Sources: IMF, Standard Chartered Research

### Chart 6: Global oil reserves by region




Source: BP Statistical Review of World Energy 2010

# MENA

**Marios Maratheftis**, Head of Research, West
Standard Chartered Bank, UAE
+971 4 508 3311, Marios.Maratheftis@sc.com

## Recovery to gain traction

### Economic outlook

- Economic recovery was the main theme for the Middle East and North Africa (MENA) region in 2010. Growth should accelerate further across the region in 2011, but MENA economies are unlikely to boom. Even though MENA is viewed as a single region, the countries that constitute the region are very diverse. On the one hand, it includes the oil-rich Gulf Cooperation Council (GCC) countries, which have some of the world's highest per-capita GDPs; on the other hand, it encompasses countries like Morocco that depend mostly on agriculture and trade links with Europe.

- Growth in the GCC in 2011 will be driven by hydrocarbons, infrastructure investment and private-sector activity. The outlook for oil prices and production will be key. Oil production in most of the GCC is unlikely to increase, as the region has to comply with OPEC quotas. We do not expect significant changes to these quotas in 2011, so the direct impact of the oil sector on real growth should be moderate. The two exceptions are Oman and Bahrain. Oman is not an OPEC member and enjoys a 'free-rider' benefit by taking advantage of higher prices (the direct result of OPEC quotas) and higher production. Bahrain is investing in its production capacity and may also get a short-term boost from higher production next year. It is interesting to note that both Bahrain and Oman have limited reserves compared to the rest of the region, and over the longer term, both will have to depend on their non oil-sectors for growth; hence their focus on diversification.

**Standard Chartered forecasts: GCC**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **Real GDP growth** | 1.5 | 3.8 | 4.2 | 3.8 |
| ***IMF*** | 0.7 | 5.1 | 6.3 | 5.1 |
| **Inflation** | 2.1 | 2.7 | 3.9 | 3.4 |
| ***IMF*** | 2.4 | 3.7 | 3.9 | 3.8 |
| **Current account balance (% GDP)** | 5.5 | 9.0 | 10.5 | 10.7 |
| ***IMF*** | 8.7 | 9.2 | 10.2 | 10.4 |

*end-period Sources: IMF, Standard Chartered Research

- The second growth driver in the GCC will be investment in infrastructure. This is directly linked with the push by GCC authorities to diversify their economies away from oil in line with their long-term ambitions; most GCC countries have published formal development plans for the next 20-30 years. While 2010 saw a slowdown in infrastructure spending in Qatar and Abu Dhabi, the momentum is likely to pick up again in the next three years, as several projects, including roads and railways, were delayed but not cancelled. Saudi Arabia is also investing heavily in infrastructure. The USD 400bn that was earmarked at the end of 2008 for non-oil projects is to be followed by another USD 500bn of infrastructure investments by 2020.

- Hydrocarbon-based economies tend to have large government sectors, and this is the case for the GCC. But one cannot underestimate the importance of the private sector. Credit growth was tight throughout the GCC in 2010. This took away from growth dynamics, and was particularly a concern for smaller businesses with no access to global markets. We expect a moderate pick-up in private credit growth in 2011 as the economic recovery gains traction, boosting confidence in the region. In Dubai, the economic recovery is currently driven by the logistics, retail and hospitality sectors. This is encouraging, as growth rates in the emirate are lower than during the boom years but are more sustainable.

- In the Maghreb countries, economic links with Europe will be key in determining growth. Lebanon has seen extraordinary growth, with tourism booming and remittances from non-resident Lebanese nationals supporting the economy. The outlook for 2011 is positive, but growth should decelerate as a result of a high base effect. Growth in Jordan should also pick up, and the country's prudent approach to fiscal policy will be a long-term positive. Egypt is at an important crossroads, and further modernisation and reform can help the country move closer to realising its huge potential.

- With growth picking up and the US dollar (USD) coming under pressure in H2-2010, there are concerns about inflation in the GCC. Inflation in the UAE and Qatar is

# MENA (con'd)

unlikely to be a major concern in 2011, in our view. The disinflationary impact of these economies' suppressed domestic housing markets should offset rising food prices. This is not the case in Saudi Arabia, where the tight housing market is adding to inflationary pressure. It is more worrisome to see inflation rising in countries with lower GDP per head, like Egypt and Jordan.

### Financial issues

- The agreement to restructure part of Dubai's debt has been positive, and has allowed Dubai to regain access to international markets. Further restructuring is likely, but access to international markets will also be important, as Dubai faces approximately USD 30bn of maturities in 2011-12. Given the large-scale projects planned in the GCC, bond issuance by GCC sovereigns and quasi-sovereigns is likely to be an ongoing theme. Our expectation that US interest rates will remain low for the next two years, together with the Fed's decision to proceed with further quantitative easing, will improve the attractiveness of GCC bonds to investors looking for yield.

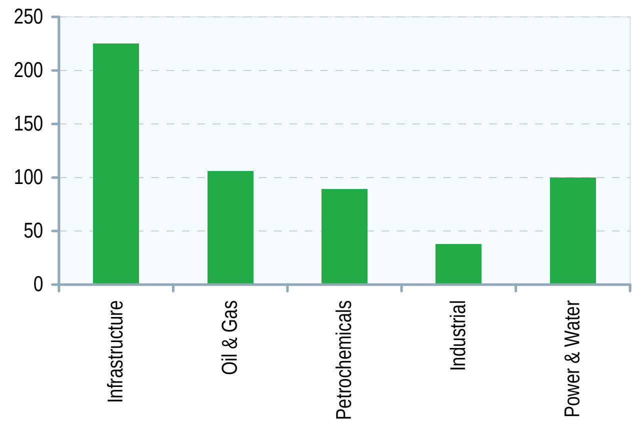
### Policy

- We do not share the view that the GCC should tighten fiscal policy in 2011 in response to inflationary concerns. First, inflation is very low in the UAE and Qatar; even in Saudi Arabia, where inflation is high, this is mainly because of rising food prices (imported inflation) and bottlenecks in the housing market. This is a very different environment from the inflationary period of 2006-08. Credit growth is tight, wage pressures are low and there are no signs of asset bubbles.

- Egypt and Jordan are right to be considering tightening fiscal policy, mainly because of their limited fiscal space. In fact, Jordan has already taken bold steps to rein in its budget deficit without derailing its economic recovery.

**Chart 1: GCC planned projects, 2011-13**

*Value of projects by sector, USD bn*




Sources: MEED, Standard Chartered Research

### Other issues

- Concerns over the possibility of currency wars, combined with a pick-up in GCC economic activity and higher oil prices, have revived the debate on the ground over the merits of the USD pegs. In our view, the region would be better off with more flexible exchange rate regimes, but this is not on policy makers' agenda right now. Ultimately, a change in GCC FX regimes would be a political decision, and the bloc is under no pressure from the West to allow more currency flexibility – unlike China and other emerging Asian economies. Economic pressures on the peg are also absent, as the region currently has no need to tighten monetary policy.

- According to the World Bank's Ease of Doing Business report for 2011, within the GCC, only Saudi Arabia's global ranking improved (to 11th). Oman remained in 57th place, while the remaining GCC countries dropped further in the rankings. In our view, it is important for GCC countries to invest further in the quality of their institutions and to improve governance standards and transparency. This will help to improve the absorptive capacity of their economies, and will also reduce the cost of borrowing from international markets. Although some progress has been made (for example, Abu Dhabi's Debt Management Office and Qatar's improved transparency), the region clearly lags others in this regard.

### Politics

- Political risk is always on the horizon in the region. There have been positive developments in Iraq – the free election in 2010 saw a healthy turnout, and there now appear to be agreement between political parties and prospects for a new government. There is some uncertainty over the presidential elections in Egypt and the possible successor to Hosni Mubarak. Developments related to the announcement of the findings of the Special Tribunal for Lebanon are also a key risk.

# Algeria

**Philippe Dauba-Pantanacce**, Senior Economist, MENA
Standard Chartered Bank, UAE
+971 4 508 3740, Philippe.Dauba-Pantanacce@sc.com

## Great potential, high frustrations

### Economic outlook

- Algeria's economy is heavily dependent on hydrocarbons (98% of export receipts and 45% of GDP). Growth is likely to have reached 4.0% in 2010, driven by the improved outlook for the hydrocarbon sector and a pick-up in demand. Algeria is the fourth-largest economy in the Middle East and North Africa (MENA) region after Saudi Arabia, the UAE and Egypt, and it has the second-biggest population after Egypt. However, the country has generally underperformed relative to its growth potential.

- Non-hydrocarbon growth likely reached 5% in 2010. This pace should be sustained going forward, supported by a USD 290mn, five-year public investment plan over the 2010-14 period. The hydrocarbon sector has benefited from a gradual pick-up in both demand and prices.

- Algeria's external position continues to improve. The country has accumulated huge international reserves, which were close to USD 160bn in Q3-2010, representing more than four years of imports.

- Inflation has settled in a range higher than historical levels (2.5% for 2000-07). It likely reached 5% in 2010, driven by food price pressures and structural economic rigidities such as monopolistic sectors and bans on certain goods. Inflation should revert gradually to trend.

### Financial issues

- The Algerian banking system has the highest government ownership in MENA, at 85%.

**Standard Chartered forecasts: Algeria**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 4.0 | 4.3 | 4.5 | 5.0 |
| **CPI (% y/y)** | 5.0 | 4.5 | 4.0 | 3.5 |
| **Policy rate (%)*** | 0.875 | 0.875 | 0.875 | 0.875 |
| **USD-DZD*** | 73.0 | 72.15 | 71.75 | 71.25 |
| **Current account balance (% GDP)** | 1.9 | 2.1 | 2.5 | 2.5 |
| **Fiscal balance (% GDP)** | -10.0 | -8.5 | -7.5 | -5.0 |

*end-period Source: Standard Chartered Research

- Capital markets are underdeveloped, as the authorities have eschewed public debt (with a debt/GDP ratio of less than 3%).

- Credit to the private sector is virtually non-existent, with a ban on all credit outside housing mortgages

### Policy

- Algeria's monetary policy targets inflation at 3%. While there is no official money supply growth target, the central bank, Banque d'Algérie (BdA), closely watches monetary aggregates. In order to achieve this objective, BdA manipulates the deposit auction rate, while the government uses a wide range of subsidies on staple consumption items. Liquidity absorption is controlled by regular deposit auctions. The level of interest rates has been stable since 2005: below 2% for the deposit rate, 4% for the discount rate and 8% for the lending rate.

- Recently, the authorities have preferred to control inflation though price controls rather than through interest rate manipulation.

### Other issues

- After pledging to conduct market-friendly reforms in the early 2000s, the government backtracked, introducing a series of measures that have spooked foreign investors.

- In 2008, majority foreign ownership of domestic companies was limited to 49%. Since July 2010, local firms have been required to be considered in private- and public-sector bids, even if their pricing is 25% higher. A tax regime that is volatile and detrimental to foreign investors was also put in place, as well as restrictions on certain imports (which sometimes turn into bans).

### Politics

- Political succession following the long-running regime of President Abdelaziz Bouteflika is a major concern.

- Social discontent and political disenfranchisement will persist. Roughly one-third of Algerians aged under 30 are unemployed.

- Sporadic militant activism will continue to pose a risk, although not a systemic one.

# Bahrain

**Nancy Fahim**, Economist
Standard Chartered Bank, UAE
+971 4 508 3627, Nancy.Fahim@sc.com

## Making the most of natural resources

### Economic outlook

- Unlike its Gulf neighbours, Bahrain is not heavily endowed with natural resources. As a result, the kingdom has positioned itself as a regional financial and business hub. That said, the government has improving oil exploration methods high on its agenda for the coming years and is making large-scale investments in the country's oil fields. It is going to unusual measures to do this, allowing foreign companies to share production agreements for the first time with the state-owned oil company. Bahrain is targeting an increase in oil production in the Awali field from the current 35 thousand barrels per day (kbd) to 75kbd by 2015 and 100kbd after another five years. Natural gas capacity is expected to expand from 500mn to 2bn cubic feet per day.

- Increased oil and gas output will be important growth drivers, as the hydrocarbon sector makes up about 13% of Bahrain's economy. Higher oil and gas production will also have indirect economic benefits. First, improved gas supply will facilitate the expansion of other industries that rely on gas as an energy source, including downstream petrochemicals and manufacturing. Second, oil revenues should be boosted in the short to medium term, particularly in light of our forecast oil-price trajectory. Although Bahrain is not reliant on the oil sector as the sole driver of growth, oil revenues are the government's main source of income, providing around 83% of total revenues. The expected increase in revenues should also help to narrow Bahrain's budget deficit.

**Standard Chartered forecasts: Bahrain**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 3.0 | 4.0 | 4.5 | 5.0 |
| **CPI (% y/y)** | 2.5 | 3.5 | 3.7 | 4.0 |
| **Policy rate (%)*** | 0.5 | 0.5 | 0.5 | 0.5 |
| **USD-BHD*** | 0.38 | 0.38 | 0.38 | 0.38 |
| **Current account balance (% GDP)** | 5.0 | 10.0 | 12.0 | 13.0 |
| **Fiscal balance (% GDP)** | -0.3 | -0.4 | -0.2 | 0.0 |

*end-period Source: Standard Chartered Research

### Financial issues

- The financial sector, which contributes 25% of GDP, has shown recent signs of improvement. Private-sector credit grew 10.5% y/y in September 2010, and we expect banks to slowly regain confidence in lending in 2011 as the regional recovery gains momentum. The loan-to-deposit ratio stood at 57% as of Q3-2010. The sector suffered a downturn during the crisis and is still some way from a full recovery. However, confidence should pick up, and we expect the private sector to drive much of the recovery. Private-sector credit accounted for 83% of total credit as of September 2010.

### Policy

- Bahrain is increasingly basing its budget on a higher oil price, leaving it vulnerable to oil-price shocks. The government forecasts deficits of BHD 373mn in 2011 and BHD 440mn in 2012. It commonly issues bonds to cover its deficits, and the deficits should be manageable.

### Other issues

- Nationals have yet to penetrate the private sector, holding only 18.1% of private-sector jobs (versus 87% of public-sector jobs). 'Bahrainisation' laws have helped the situation, but the imbalance will persist amid continuing mismatches in skills and type or quality of labour.

- Keen to enhance its role as a competitive regional hub, Bahrain has adjusted its 'sponsorship' law, allowing workers to move from one employer to another without- the employer's consent. It is hoped that the move, which was welcomed by the private sector, will have ripple effects across the Gulf Cooperation Council (GCC).

### Politics

- The king and the ruling family are likely to remain in power, and the threat of a change of leadership is low. Sectarian tensions emerged in 2010 in the run-up to parliamentary elections, but have been largely contained.

- Relations with the US will remain strong as the US Navy's Fifth Fleet expands its presence in the kingdom. Strong ties with Saudi Arabia should also continue, underpinned by oil and gas supply agreements and mutual commercial benefits.

# Egypt

**Sayem Ali**, Economist
Standard Chartered Bank (Pakistan) Limited
+92 3245 7839, Sayem.Ali@sc.com

## Recovery picking up momentum

### Economic outlook

- Egypt is emerging stronger from the crisis; proactive policy responses and key reforms drove an economic expansion of 5.1% in FY10 (ended June 2010). The government targets growth of 6% in FY11 as trade and investment flows recover. However, rising public debt and inflation concerns indicate less room for fiscal stimulus spending and accommodative monetary policy. We forecast that the economy will expand by 5.5% in FY11.

- After peaking at 13.6% in January 2010, CPI inflation had slowed to 11% as of October. Core inflation had inched up to 7.7% by October but remained within the central bank's comfort zone of 6-8%. Rising international commodity prices, a weaker Egyptian pound (EGP) and cutbacks in energy subsidies pose risks to inflation. However, we expect inflation to remain subdued in FY11.

- Egypt jumped up five places in the World Bank's Doing Business 2011 report, making it one of the top reformers in the region. Egypt is targeting FDI inflows of USD 8bn in FY11, up from USD 6.3bn in FY10.

### Financial issues

- The Financial Sector Reform Program (2004-08) helped the domestic financial system to weather the global financial crisis. The programme forced banks to strengthen their capital and clean up non-performing loans (NPLs), and led to a consolidation of the banking system. The NPL ratio declined further to 14.7% in 2009 from 14.8% in 2008, while banks' risk-weighted capital increased to 15.3% from 14.7% over the same period.

#### Standard Chartered forecasts: Egypt

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 5.1 | 5.5 | 6.0 | 6.5 |
| **CPI (% y/y)** | 11.7 | 11.5 | 10.2 | 9.7 |
| **Policy rate (%)*** | 8.25 | 8.5 | 8.5 | 8.5 |
| **USD-EGP*** | 5.71 | 5.71 | 5.75 | 5.70 |
| **Current account balance (% GDP)** | -1.6 | -1.2 | -0.6 | 0.5 |
| **Fiscal balance (% GDP)** | -8.1 | -7.6 | -6.8 | -6.0 |

Note: All forecasts except USD-EGP refer to the July-June fiscal year ending in the year in column heading; *end-period

Source: Standard Chartered Research

### Policy

- Public debt increased to 81.1% of GDP as of June 2010 from 79% in June 2009. The government plans to reduce the fiscal deficit to 7.6% of GDP in FY11 from 8.3% in FY10 in a bid to limit the build-up of debt. This will be achieved through power subsidy cuts estimated at 7% of GDP in FY10, an increase in transit trade receipts, and the implementation of a property tax.

- Monetary policy remained accommodative in 2010 after the Central Bank of Egypt (CBE) cut rates six times in 2009, bringing the overnight deposit rate to 8.25% and the lending rate to 9.75%. We expect the CBE to tighten rates by 25bps in 2011 as inflation picks up due to subsidy cuts and rising commodity prices.

- The EGP is a managed float and appears to be targeted against a basket of currencies. While the components of the currency basket are not disclosed, our own calculations based on constrained optimisation suggest that it is dominated by the US dollar (USD) and, to a lesser extent, the euro (EUR). We believe that the currency basket is allowed to fluctuate within a +/- 2.5% band.

- Our barometer shows greater pressures now than in 2000-03, when the EGP was devalued several times. However, we see limited risks of a change in the currency regime, as the balance of payments is currently in surplus and the FX reserves have strengthened to USD 33bn (6.9 months of import cover).

### Politics

- Presidential elections are set for 2011. Political tensions have risen in 2010 as the selection of President Hosni Mubarak's successor draws nearer. Mubarak has been president for nearly 30 years, and the possibility that he will serve another term cannot be ruled out.

- However, the more likely scenario is that he will be succeeded by his son, Gamal Mubarak. Gamal Mubarak appears to be the strongest candidate for president. Voting is via referendum, and as yet, no other candidate has a strong enough position to challenge the ruling-party candidate.

# Jordan

**Sayem Ali**, Economist
Standard Chartered Bank (Pakistan) Limited
+92 3245 7839, Sayem.Ali@sc.com

## New parliament to support reforms

### Economic outlook

- Elections held in November 2010 have strengthened the position of King Abdullah's loyalists in the 120-member parliament. Key reforms to limit the build-up of public debt will have to be endorsed by parliament to ensure macroeconomic stability and attract investment. The king dissolved parliament in November 2009 after it drafted a controversial bill to hike taxes on the banking, mining and telecom sectors. This was in sharp contrast to earlier efforts to improve investment laws and attract foreign investment to these sectors.

- Growth remains weak, as trade and investment flows have slowed. There is little room for counter-cyclical fiscal policy, as public debt increased to 61.5% of GDP at the end of 2009 from 58.3% in 2008. Jordan is targeting higher grants and FDI inflows from its oil-rich Gulf Cooperation Council (GCC) neighbors to stimulate growth. We expect the economy to expand 3.5% in 2011, versus 2.3% in 2010.

- Inflation picked up to 4.8% in January-October 2010 from -0.7% in 2009, primarily due to the pick-up in international commodity prices and cuts in power subsidies. Inflation is likely to slow in 2011 due to weak domestic demand.

### Financial issues

- The banking sector remains strong. Banks are profitable and well capitalised; their risk-weighted capital ratio rose to 19.6% in 2009 from 18.4% in 2008. The NPL ratio increased modestly to 6.7% of outstanding loans in 2009 from 4.2% in 2008.

#### Standard Chartered forecasts: Jordan

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 2.3 | 3.5 | 4.0 | 4.5 |
| **CPI (% y/y)** | 5.0 | 4.6 | 4.2 | 3.5 |
| **Policy rate (%)*** | 4.0 | 4.0 | 4.0 | 4.0 |
| **USD-JOD*** | 0.71 | 0.71 | 0.71 | 0.71 |
| **Current account balance (% GDP)** | -7.1 | -7.6 | -7.8 | -8.3 |
| **Fiscal balance (% GDP)** | -6.2 | -5.7 | -5.5 | -5.0 |

*end-period

Sources: Standard Chartered Research Central Bank of Jordan

### Policy

- Public debt increased to 61.5% of GDP at end-2009 from 58.3% in 2008. The government plans to reduce the fiscal deficit to 6.2% of GDP in 2010 from 8.5% in 2009 through a 33% cut in investment spending and reductions in oil and food subsidies. Public-sector employees' salaries were frozen for two years, and the government temporarily banned new hiring. Tough new tax measures were undertaken to boost revenue, including an increase in the gasoline tax to 18% (from 16%) and a hike in VAT rates on a wide range of consumer items, from alcohol to tobacco and coffee. These unpopular reforms will likely be endorsed by the new parliament, and the 2011 budget will focus on further fiscal consolidation.

- The Jordanian dinar (JOD) peg to the US dollar has played a key role in anchoring inflation expectations and is a pillar of financial stability. The real effective exchange rate remains broadly in line with medium-term fundamentals. The Central Bank of Jordan (CBJ) will maintain the USD-JOD peg at 0.71 over the medium term. The rise in FX reserves to over USD 10.7bn (7.4 months of import cover) will offset pressure on the currency stemming from short-term liquidity problems.

- The CBJ's monetary easing cycle ended in February 2010, with the overnight deposit and lending rates at 2% and 4%, respectively. The CBJ had reduced rates by 250bps since November 2008 as inflation declined in line with international commodity prices. The CBJ will follow the US Fed in policy rate-setting; we therefore expect rates to stay on hold until 2013, when we now expect the first Fed hike.

### Politics

- The November elections have strengthened King Abdullah's position, as tribal loyalists will dominate the new parliament. The main opposition party, Islamic Action Front (IAF), boycotted the polls to protest the amended electoral law; the law maintains the single non-transferable vote, which favours tribal candidates over the political parties. However, the strong turnout of 53% lends credibility to the election outcome and will strengthen the government's push for fiscal reforms.

# Kuwait

**Nancy Fahim**, Economist
Standard Chartered Bank, UAE
+971 4 508 3627, Nancy.Fahim@sc.com

## Progress or paralysis?

### Economic outlook

- Government spending should gain traction in 2011 as Kuwait's four-year development plan gets underway. The USD 104bn plan approved in February 2010 is the first of a series that Kuwait plans to roll out under its 'Kuwait Vision 2035' programme. The key goal is to develop Kuwait into a trade and financial hub in the next 25 years.

- Although the development plans are encouraging, we see a possibility that projects will face delays or be scrapped as decision-makers dispute the correct path to reform. Our growth forecasts reflect this caution. We are also cautious about the long-term execution of this vision, as Kuwait will have to work hard to catch up with regional players that have moved faster to diversify their economies. Oil revenues, which make up 94% of Kuwait's total revenues, have provided a comfortable cushion for the economy, in turn delaying major reforms. Pushing forward is possible but will require genuine backing from the government and parliament.

### Financial issues

- Unlike the other Gulf Cooperation Council (GCC) countries, Kuwait does not peg its currency strictly to the US dollar (USD), instead targeting a basket of currencies. The components of Kuwait's currency basket are not disclosed; however, our in-house calculations show that the USD component of the basket increased this year at the expense of the euro.

- The Kuwait Stock Exchange (KSE) is on the path to better governance. A capital-markets authority has been set up which separates the regulatory function from the KSE, as is the case with other GCC bourses.

#### Standard Chartered forecasts: Kuwait

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 3.0 | 3.5 | 4.0 | 4.5 |
| **CPI (% y/y)** | 3.5 | 4.0 | 3.7 | 3.4 |
| **Policy rate (%)*** | 2.5 | 2.5 | 2.5 | 3.0 |
| **USD-KWD*** | 0.28 | 0.29 | 0.29 | 0.29 |
| **Current account balance (% GDP)** | 26.0 | 27.0 | 28.0 | 27.0 |
| **Fiscal balance (% GDP)** | 20.0 | 22.0 | 21.0 | 20.0 |

*end-period

Source: Standard Chartered Research

### Policy

- The central bank cut its benchmark policy rate from 3.0% to 2.5% in February 2010. We do not expect the central bank to hike again until 2013, in tandem with our first forecast US Fed hike in Q1-2013.

- Kuwait's success in achieving sustainable growth will be determined by its ability to revamp laws to better suit its needs. A long-awaited privatisation law was passed in May 2010, and the government announced plans in November to privatise the postal service within two years. This is an important step, but there are signs that reform will be gradual. Sectors such as health care, education and oil production – which might have particularly benefited from the contribution of private-sector (potentially foreign) – expertise, are excluded from the law. The government will also maintain a share of the privatised companies and will have the right to veto decisions. While the pace of privatisation is uncertain, this law highlights the fact that change is coming to Kuwait.

### Other issues

- Labour laws were adjusted slightly in 2010, although ministry officials quickly corrected the perception that the 'kefala' sponsorship system had been abolished. Employees now have the right to change employers only if the existing employer can be proven to have engaged in illegal behaviour; domestic workers are excluded from this amendment. Kuwait's image has suffered on the subject of human rights, and some countries have suspended exports of workers to Kuwait until their rights were seen as better protected.

### Politics

- Relations between the government and parliament are improving. Strained relations had resulted in three dissolutions of parliament since May 2006, stalling reforms and progress. While the approval of the four-year development plan highlights that the two sides have agreed on necessary changes, the positive political environment may not be sustained, and standoffs between parliament and government may re-emerge.

# Lebanon

**Philippe Dauba-Pantanacce**, Senior Economist, MENA
Standard Chartered Bank, UAE
+971 4 508 3740, Philippe.Dauba-Pantanacce@sc.com

## Strong growth, political fragility

### Economic outlook

- Strong growth in tourism (+10% y/y for the first eight months of 2010, +66% since 2007), construction and financial services has underpinned real GDP growth of 7% in 2010 and 8.5% on average in the past three years. Growth should moderate to 6.5% in 2011 as the post-conflict catch-up effects wane.

- This growth, coupled with anaemic public spending (due to political paralysis), has led to a commendable decrease in the government debt/GDP ratio – Lebanon's most worrisome macroeconomic indicator. We project that it will fall to 134% in 2011 from 180% in 2006.

- Inflation is slightly above historic levels on higher commodity prices and a weaker US dollar, to which the currency is pegged. Inflation should reach 5.3% in 2011.

### Financial issues

- The strong banking system is the backbone of the Lebanese economy. The dollarisation of the economy will continue, although the substantial interest rate spread between the Lebanese pound (LBP) and the US dollar will encourage a slight de-dollarisation of deposits, while continuing to support deposit inflows from non-residents.

- NPLs are very low (around 2.2%), with good provisioning. Total deposits of commercial banks represent 275% of GDP. Most of these deposits are held by residents, non-resident Lebanese or other Arabs with vested interests in Lebanon, diminishing the potential vulnerability created by the high level of foreign deposits.

#### Standard Chartered forecasts: Lebanon

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 7.0 | 6.5 | 6.0 | 6.0 |
| **CPI (% y/y)** | 5.0 | 5.3 | 5.4 | 5.5 |
| **Policy rate (%)*** | -- | -- | -- | -- |
| **USD-LBP*** | 1,500 | 1,500 | 1,500 | 1,500 |
| **Current account balance (% GDP)** | -16.0 | -15.0 | -14.5 | -14.0 |
| **Fiscal balance (% GDP)** | -7.5 | -9.5 | -10.0 | -10.0 |

*end-period Source: Standard Chartered Research

### Policy

- Prudent and orthodox monetary policy is likely to continue under strong central bank supervision.

- The lending rate is likely to remain elevated (around 8%), which will continue to constrain SMEs' and households' access to credit.

### Other issues

- There has been much talk of a real-estate bubble in Lebanon, especially in Beirut. While we think that some market segments could be heading for a mild correction, we do not subscribe to the theory of an overall market bubble. The top end of the market could face higher vacancy rates, but developers' profitability is strong enough that they can sit on such properties without resorting to fire sales that would trigger a sudden price collapse. The smaller and mid-range apartment segment is still undersupplied.

- Property demand is strong, thanks to pent-up domestic demand after years of political instability, continuous purchases by wealthy non-residents, and growing demand from (mostly Arab) foreigners. Within this mix, a large proportion of the resident population will be priced out of the most desirable areas of Beirut, but this is a small part of the overall market. We do not expect a market-wide correction soon, based on fundamental geographical constraints, limited availibility of desirable plots, a regulatory limit of 60% bank financing, and a central bank estimate that only 17% of properties are bought with bank credit.

### Politics

- Political stability brought by the formation of Prime Minister Saad Hariri's compromise government faces serious challenges with the impending announcement of the findings of the Special Tribunal for Lebanon, which are expected to antagonise the majority Shia population.

- While the prime minister has a parliamentary majority, he does not hold the two-thirds quorum in the cabinet needed for major decisions. This often results in political deadlock and reform paralysis.

# Libya

**Nancy Fahim**, Economist
Standard Chartered Bank, UAE
+971 4 508 3627, Nancy.Fahim@sc.com

## Inching forwards

### Economic outlook

- Libya's oil sector dominates the economy, contributing 55% of GDP. Despite efforts to attract investors and boost exploration, successful new discoveries have been limited, and changing foreign investment laws have prompted some international companies to halt or stall investment plans in the country. Libya's production averaged 1.5 million barrels per day (mbd) in the first 10 months of 2010. An OPEC member, Libya is already exceeding its OPEC quota by about 96,000 barrels per day. Should Libya wish to take advantage of the forecast rise in oil prices during the 2010-13 outlook period, any increase in production will be limited to its current 1.8mbd capacity. Despite this constraint, Libya has an ambitious goal of ramping up output to 3mpd by 2015 and 3.5mbd by 2020, and significant investments will be needed to expand capacity. Given the pace of progress so far, such a target is likely to be difficult to achieve; while output may be increased, it is unlikely to exceed 2.5mbd by 2015, in our view.

- Higher oil prices and demand during the 2010-13 forecast period are likely to result in a comfortable current account surplus. Hydrocarbons make up nearly 95% of exports. Libya's close ties with Europe, its main trading partner, pose downside risks. However, Asia is gaining importance as an export destination: China is now Libya's fourth-largest overseas market, with exports having surged 126-fold since 2000. Exports to Korea have also grown 11-fold since 2000. We therefore see limited risks to overall exports, and the oil sector looks set to benefit in the coming years.

**Standard Chartered forecasts: Libya**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| GDP (real % y/y) | 5.0 | 5.3 | 5.0 | 4.8 |
| CPI (% y/y) | 3.0 | 3.5 | 4.0 | 4.3 |
| Policy rate (%)* | -- | -- | -- | -- |
| USD-LYD* | 1.23 | 1.29 | 1.29 | 1.27 |
| Current account balance (% GDP) | 30.0 | 35.0 | 38.0 | 40.0 |
| Fiscal balance (% GDP) | 10.0 | 18.0 | 15.5 | 15.0 |

*end-period Source: Standard Chartered Research

- Inflationary pressures should pick up in the medium term, driven by food prices, but inflation is unlikely to return to the highs of 2008. The government's focus is more likely to be on achieving sustainable growth via diversification than on inflation.

### Financial issues

- Lending is dominated by state-subsidised Specialized Credit Institutions (SCIs). The Libyan dinar (LYD) is targeted against the IMF's Special Drawing Rights (SDRs). Libya is unlikely to move away from this peg in the short to medium term.

### Policy

- Libya remains committed to privatising various sectors of its economy. Foreign banks can now partner with local banks, with foreign ownership capped at 49%. The telecommunications sector has undergone similar changes, resulting in a more prominent role for the private sector in other infrastructure-related projects. Earlier this year, officials stated that one-third of all public companies in Libya were privatised during the last decade, and that they seek to increase this figure to 50% in the coming decade.

### Other issues

- The oil sector has a limited ability to generate jobs, and the country suffers from a high unemployment rate, unofficially at 35-40%. Around 65% of Libya's population is of working age, and this share is growing. The government has made it mandatory for private-sector employers to provide training for workers, but has also lowered the quota for employing Libyan nationals from 90% to 75%. Transparency is an issue – Libya scored 2.2 out of 10 in Transparency International's 2010 Corruption Perceptions Index, and ranked 146th out of 178 countries.

### Politics

- The outlook for political succession is unclear. Muammar al-Qaddafi has led the country for more than 40 years, longer than any other African leader. Saif al-Islam Qaddafi, one of Qaddafi's seven sons, is the general co-ordinator of the Popular Social Command and is currently the nation's de facto second in command.

# Morocco

**Philippe Dauba-Pantanacce**, Senior Economist, MENA
Standard Chartered Bank, UAE
+971 4 508 3740, Philippe.Dauba-Pantanacce@sc.com

## On the right path

### Economic outlook

- Government spending, while tightly controlled, should partly offset softer private demand, and many previously announced projects are now being commissioned and/or started. The king has announced major plans to develop alternative energy, including a USD 4bn wind energy programme. Economic activity should also be supported by USD 740mn of EU-backed projects over the next two years. We expect 4.5% growth in 2011.

- The authorities have expressed a desire to cap spending given the uncertain economic environment. They are also seeking to reform the subsidy system, which in 2008 reached an all-time high of 5% of GDP, mainly because of the oil subsidy. The system is managed through a 'subsidy fund', which the government claims is now limited to 2% of GDP.

- On the revenue side, the government has substantially improved tax revenues in recent years by enforcing compliance and widening the tax base.

- Inflation is low (we forecast 2.2% on average for 2010-13), owing to subsidies on staple food items and a managed exchange rate, but also a likely failure of current statistics to fully reflect rises in the cost of living.

### Financial issues

- Morocco's bond market is one of the most active in the region, and is also deeper than regional peers. It is supported by a healthy banking sector, along with a growing culture of disintermediation.

- Morocco's banking sector and capital markets are comparatively modern and advanced, with the highest credit to the private sector as a proportion of GDP (80%) and the lowest state ownership of banks (27%) in North Africa.

- The loan-to-deposit ratio has been tight recently, hovering around 100%. It is closely monitored by the central bank

### Policy

- Morocco has been considering inflation targeting for some years, and the conditions to proceed are in place. However, it is unlikely to move officially to a fully fledged inflation-targeting system before 2012 or 2013.

- Traditionally, the central bank, Bank Al-Maghrib, has adopted prudent and orthodox monetary policies. Interest rates tend to be very stable. In recent years, the deposit rate has moved in a range of 3.6-4.0% and the discount rate in a range of 3.25-3.50%, with the money market rate just a few basis points above or below the discount rate.

### Other issues

- GDP growth depends heavily on the harvest, which results in volatile and unpredictable GDP figures.

- Morocco still needs to lift a substantial part of its population out of illiteracy and poverty.

### Politics

- Since the accession of King Mohamed VI in 1999, the kingdom has pursued an ambitious reform and modernisation programme, ranging from family law and justice to economics. The king has an established power base and largely controls the defence, foreign affairs and interior ministries. He is popular with the public, thanks to his genuine concern about the country's persistently high levels of unemployment and poverty.

- Morocco is a constitutional monarchy but has yet to become a mature democracy. While the first real election was held in September 2008, power is still concentrated in royal circles.

**Standard Chartered forecasts: Morocco**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 4.0 | 4.5 | 4.7 | 5.0 |
| **CPI (% y/y)** | 1.0 | 2.5 | 2.5 | 3.0 |
| **Policy rate (%)*** | 3.25 | 3.25 | 3.25 | 3.25 |
| **USD-MAD*** | 8.20 | 8.53 | 8.21 | 8.05 |
| **Current account balance (% GDP)** | -8.0 | -7.0 | -6.0 | -5.0 |
| **Fiscal balance (% GDP)** | 1.5 | 2.2 | 2.5 | 2.5 |

*end-period    Source: Standard Chartered Research

# Oman

**Nancy Fahim**, Economist
Standard Chartered Bank, UAE
+971 4 508 3627, Nancy.Fahim@sc.com

## Focus on diversification

### Economic outlook

- Oil production is expected to rise slightly next year, but the outlook for Oman's long-term production is more subdued. Current proven reserves (5.6bn barrels) are expected to last only another 25-30 years. Oman's oil production saw steady declines between 2001 and 2007, and the recent pick-up was driven by heavy government investment in the sector. Oil production grew 7.6% y/y in Q2-2010, and further gradual increases are expected in 2011.

- Oil and gas accounted for 48% of GDP in Q1-2010, up from 35% during the same period in 2009. The need for Oman to diversify away from oil is becoming increasingly clear. Policy spending is being correctly channeled into diversification, but this focus will need to be sustained.

- As Oman is a non-OPEC member, recent production increases have given rise to healthy trade balances, with oil and gas making up 65% of exports. Government debt is low, at 5.7% of GDP. We expect increased oil production, strong fiscal policy and improving credit conditions to drive GDP growth of around 4.5% in 2011, making the sultanate the region's second-fastest growing economy after Qatar.

### Financial issues

- Private-sector credit growth picked up in August 2010 (the latest period for which data is available, reaching 6.4% y/y. Credit growth has accelerated on a m/m basis throughout 2010, and we expect this trend to continue in 2011. The performance of the private sector, which contributes 53% of GDP, will have a significant impact on the overall economy.

### Policy

- The government is budgeting a fiscal deficit of USD 2.1bn for 2010 and expects a similar shortfall in 2011. While Oman is following through on its 2010 expenditure plans, having spent close to 63% of the budget in the first eight months of the year, the budget was based on conservative oil prices. A fiscal surplus is therefore likely for 2010. Oman's 2011 budget includes a 10.7% spending increase over the 2010 budgeted amount, with infrastructure and development projects being key focus areas. The 2011 budget is based on an oil price of approximately USD 55/barrel.

### Other issues

- 2011 will kick off Oman's eighth five-year development plan. The plan is fairly ambitious and targets the development of SMEs; job creation, especially among the youth; and changes to legislation aimed at encouraging further foreign investment.

- On the social front, the government aims to improve health-care and education services, narrow per-capita income differences among Omani citizens, and increase food security. Oman has been expanding its warehouse facilities to store commodities, but has so far been hesitant to invest in land overseas to increase food security.

### Politics

- The political situation is stable, and the rule of Sultan Qaboos bin Said Al Said faces no challenges. However, the lack of named successors to the sultan is a source of long-term ambiguity.

- Elections for the Majlis Al Shura (Consultative Council) are scheduled for October 2011. Members serve four-year terms. The council is mainly symbolic, with the sultan holding most of the power.

**Standard Chartered forecasts: Oman**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 4.0 | 4.5 | 4.7 | 4.6 |
| **CPI (% y/y)** | 3.5 | 4.0 | 5.0 | 6.0 |
| **Policy rate (%)*** | 2.0 | 2.0 | 2.0 | 2.0 |
| **USD-OMR*** | 0.39 | 0.39 | 0.39 | 0.39 |
| **Current account balance (% GDP)** | 6.5 | 7.0 | 7.5 | 8.0 |
| **Fiscal balance (% GDP)** | 0.5 | 0.6 | 1.0 | 0.8 |

*end-period    Source: Standard Chartered Research

# Qatar

**Shady Shaher**, Economist, MENA
Standard Chartered Bank, UAE
+971 4 508 3647, Shady.Shaher@sc.com

## After the gas boom

### Economic outlook

- We expect Qatar to be the fastest-growing Gulf Cooperation Council (GCC) economy in FY11 (began 1 April 2010), with an 8.0% expansion. The growth trajectory should begin to flatten out in FY12 as gas production stabilises, with growth expected to moderate to 5.0%.

- Qatar's oil and gas sectors are the largest contributors to GDP in real terms. Gas accounted for 25.5% of FY10 GDP, and oil accounted for 24%. Government services (which rely on oil and gas revenues) made up 11.6% of GDP, and the construction sector accounted for 9.13%. Manufacturing made up 5% of FY10 GDP.

- Heavy investment in liquefied natural gas (LNG) production capacity and increases in LNG production over the last couple of years have been the main drivers of robust growth**.** Qatar should reach its LNG production target of 77mn tonnes per annum in 2010. This suggests limited production upside in 2011, and LNG production will therefore no longer be the main driver of growth. According to our calculations, LNG production grew 16% in FY10 and is set to grow 15% in FY11. Production growth is likely to moderate to 5% in FY12.

- Given the dominance of the energy and government-driven sectors (close to 70% of GDP), the private sector has limited scope to drive growth, and policy spending will be the key driver. Infrastructure spending will be key over the next couple of years, as diversification spending should take over as the key theme.

#### Standard Chartered forecasts: Qatar

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 8.0 | 5.0 | 4.0 | 4.0 |
| **CPI (% y/y)** | -5.0 | 2.0 | 3.0 | 3.5 |
| **Policy rate (%)*** | 1.0 | 1.0 | 1.0 | 1.0 |
| **USD-QAR*** | 3.64 | 3.64 | 3.64 | 3.64 |
| **Current account balance (% GDP)** | 16.0 | 22.0 | 20.0 | 20.0 |
| **Fiscal balance (% GDP)** | 10.0 | 8.0 | 7.0 | 7.0 |

Note: All forecasts except policy rate and USD-QAR refer to the April-March fiscal year starting in the year in column heading; *end-period

Source: Standard Chartered Research

- Policy spending on the non-hydrocarbon sector in 2010 has been weak, with many key projects delayed. We believe the delays are probably related to Qatar's 2022 FIFA World Cup bid. The authorities are likely holding off on breaking ground on key projects until 2011, after the World Cup decision in December 2010 provides clarity on the scope of projects needed.

- We are positive on the longer-term outlook for infrastructure investment. The government plans to spend close to USD 20bn on new roads and transport infrastructure over the next five years, and a USD 36bn metro system is in the pipeline over the longer term. Qatar is also building a USD 11bn airport and a USD 5.5bn deepwater seaport.

- Qatar's economy may also benefit in the short term from higher infrastructure spending if the country succeeds in its bid to host the FIFA World Cup in 2022. In our view, the push towards economic diversification will continue irrespective of the World Cup bid. Qatar needs to generate jobs for its young population, and the capital-intensive hydrocarbon sector is not generating the necessary employment. Work on the metro and railway projects is scheduled to begin by mid-2011.

### Financial issues

- Credit growth in Qatar was weak in 2010 due to the absence of private-sector credit growth and weaker-than-expected policy spending. An additional obstacle to credit growth was the high central bank overnight rate, which was at 2% for most of the year and was reduced to 1.50% in August.

- Given Qatar's low inflation and subdued credit growth, there is scope for further rate cuts. A lower overnight rate, improving market sentiment and a revival of non-oil projects should lead to a moderate pick-up in credit growth in 2011.

- Qatar's banking system, which received strong support from policy makers in the aftermath of the global crisis via stake purchases and purchases of property loan portfolios, is unlikely to require the same type of support in 2011.

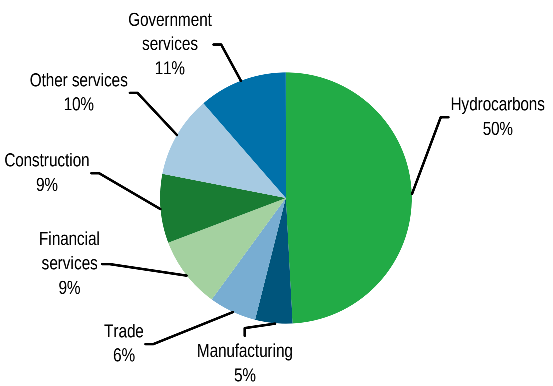
# Qatar (con'd)

- Banks showed strong resilience throughout the crisis, and the support measures have boosted confidence in the health of a banking system backed by government resources. The central bank is likely to scale back some of these support measures in 2011, particularly as credit growth rebounds more strongly on the back of government spending in the non-oil sector.

- We estimate that Qatar's total debt issuance – by the sovereign, banks and corporates – will reach a cumulative USD 103bn as of end-2010. Qatar's debt redemption schedule is manageable in the near to medium term, and the state's returns on LNG exports should help it build considerable reserve assets over the long term.

- We would be concerned if Qatar rapidly built up its debt profile in the near to medium term, given that its reserves – while significant – are smaller than those of some neighbouring GCC states. Yet if Qatar maintains a well-co-ordinated issuance programme, it should be able to avoid the near-term debt challenges faced by other states in the region. Furthermore, we are encouraged by the level of transparency on the government support profiles of various entities, with clear lines drawn between standalone and explicitly supported ones.

**Chart 1: Key drivers of Qatar's GDP**




Source: UAE Ministry of Economy

### Policy

- The budget for FY12 (begins 1 April 2011) is yet to be released, but the finance minister said it would at least match the USD 32.4bn FY11 budget, which saw a 25% increase in spending. The finance minister said 40% of budget spending until FY17 would be allocated to infrastructure investment.

- Given the weaker pace of infrastructure spending and higher energy prices, we expect a fiscal surplus of USD 2.6bn for FY11. Qatar will need to increase infrastructure spending in 2011 and beyond in order to support growth and reduce its excessive dependence on hydrocarbons.

### Other issues

- A period of record-high inflation ended in 2009 as falling property prices led to deflation, which averaged close to 5%. We believe the outlook for inflation remains subdued in 2011, as the property market continues to struggle with oversupply, particularly in light of the weak outlook for population growth.

- The capital-intensive hydrocarbon sector is simply not generating enough jobs to sustain Qatar's housing market. The private sector remains too small to drive significant inflows of buyers to boost demand. This year's low base effect and higher food prices should push Qatar from deflation to disinflation in 2011.

- Market estimates put Qatar's property price declines at close to 15% in 2010, with almost 10,000 new homes completed during the year. We estimate a further decline of about 5% in 2011; we then expect the market to stabilise somewhat as government non-oil spending creates new jobs. However, we remain more concerned about the commercial property market, and expect price declines of up to 10% in that segment in 2011.

### Politics

- Qatar's domestic political outlook remains stable. On the international front, Qatar has been pursuing an increasingly independent foreign policy agenda while maintaining strong relations with key Western allies. The country has played an active role in mediating disputes between a number of countries, which has given it the status of a regional political maverick.

# Saudi Arabia

**Shady Shaher**, Economist, MENA
Standard Chartered Bank, UAE
+971 4 508 3647, Shady.Shaher@sc.com

## Powering ahead on spending

### Economic outlook

- We expect Saudi Arabia's economic growth to accelerate to 4.0% in 2011 from 3.0% in 2010. Growth in 2011 will be driven by the country's massive capital investments in key strategic sectors and infrastructure.

- Hydrocarbons are the biggest driver of the Saudi economy, at 27% of GDP, followed by government services (18%), manufacturing (12%), financial services (11%) and construction (7%). We expect OPEC quotas to continue to cap hydrocarbon production in 2011. As a result, the two key growth drivers will be diversification-related spending (mainly infrastructure) and development spending in the hydrocarbon sector, both downstream and upstream.

- In 2010, the cabinet approved a USD 385bn spending programme for the 2010-14 period, largely allocated to infrastructure and social services. We expect infrastructure spending to set another record in 2011, exceeding the estimated USD 70bn spent in 2010.

- We believe the move towards infrastructure-driven spending is healthier for the Saudi economy than hydrocarbon-driven growth, given the better filter-through effect of such spending to the real economy. Even where spending is allocated to the energy sector, it will be concentrated in the downstream sector. This is positive, as it will create jobs for Saudi nationals due to the labour-intensity of the sector.

#### Standard Chartered forecasts: Saudi Arabia

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 3.0 | 4.0 | 4.0 | 4.5 |
| **CPI (% y/y)** | 5.5 | 5.0 | 4.0 | 4.0 |
| **Policy rate (%)*** | 0.25 | 0.25 | 0.25 | 0.25 |
| **USD-SAR*** | 3.75 | 3.75 | 3.75 | 3.75 |
| **Current account balance (% GDP)** | 6.5 | 7.0 | 7.0 | 8.0 |
| **Fiscal balance (% GDP)** | 2.0 | 6.5 | 7.5 | 7.5 |

*end-period Sources: Standard Chartered Research

### Financial issues

- Credit growth to the private sector started to rebound in 2010 and will grow further in 2011. Private-sector credit growth had reached a robust 4.9% y/y by July 2010. We expect credit growth to be within a range of 3-5% y/y in 2011. As strong policy spending moves into its third year in 2011, improving sentiment will be a key growth driver. As policy spending filters through to the broader economy, we expect lending growth momentum to be sustained in 2011.

- The Saudi banking sector remains robust, with loan-to-deposit ratios below 85%. This means banks have the capacity to lend and, unlike some banks in the region, they are not challenged by the structural problem of high loan-to-deposit ratios. Yet high provisions on the back of debts to family-related companies have restricted banks' ability to lend. As these provisions are absorbed in 2011, bank lending growth should remain within our forecast range of 3-5%.

### Policy

- Fiscal policy (in the form of government spending) will remain a key driver of the Saudi economy. We expect fiscal dynamics to be expansionary in 2011, underpinned by population growth dynamics and, equally importantly, the government's commitment to follow through on major infrastructure investments.

- We expect 2011 fiscal spending to be almost 5% higher than the previous year's fiscal budget (USD 125.3bn), with infrastructure-related expenditures (USD 70bn) increasing about 15% from 2010. Higher oil prices and government commitments under the five-year development plan are key factors behind out estimates.

- Given the US dollar (USD) peg of the Saudi riyal (SAR), domestic monetary policy is likely to continue to mirror US policy. However, there is a possibility that Saudi Arabia might move to tighten rates before the US does in 2013 (according to our forecast) – probably after H2-2011, once inflationary dynamics have built enough momentum to warrant such a move.

# Saudi Arabia (con'd)

### Other issues

- The Saudi oil minster continues to advocate strong oil prices; in November 2010, he raised the acceptable upper limit to USD 90/barrel from USD 80/barrel. Given that oil revenues account for 95% of budgeted revenues, this more hawkish outlook on oil prices signals that Saudi Arabia stands committed to current OPEC quotas. More importantly, it highlights the kingdom's fears of a fall in the USD, given that oil is USD-denominated.

- A key challenge for Saudi Arabia will be the level of domestic oil consumption, which has grown at an annual rate of 5.9% over the last five years. The head of the state oil producer has warned that the country's crude oil exports could begin declining as early as 2011. Another official at the same company said daily domestic demand could rise from 3.4mn barrels in 2009 to almost 8.3mn barrels in 2028. The government subsidises most of the country's energy needs, from fuel at the pump to the energy needs of its large downstream manufacturing base. This means that diversification needs to move at an even faster pace in order for the economy to hedge itself against dwindling hydrocarbon revenues.

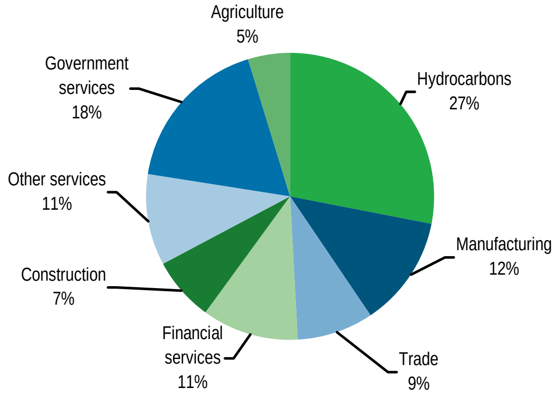
- The Saudi Arabian General Investment Authority (SAGIA) has announced that it plans to open to foreign investors opportunities worth USD 500bn in the energy, transport and industrial sectors. The authority seeks to attract foreign investment in underdeveloped regions such as Jazan and the Northern Border province. It aims to attract investors by subsidising part of the infrastructure and construction costs and offering tax breaks. SAGIA is also responsible for carrying out Saudi Arabia's four planned 'economic cities'.

- Officials are keen to point out that joint-venture investments with foreign investors in the country now total close to USD 153bn and employ more than 100,000 Saudis. 2011 is likely to see a number of new joint ventures signed on the back of the SAGIA initiatives.

- The World Bank ranked Saudi Arabia as the world's 11th most competitive country in its latest Doing Business survey, 17 steps ahead of the closest competitor in the Middle East. We expect Saudi Arabia to maintain its leading position in 2011, although competition is building from the UAE, Qatar and Bahrain.

- Inflation in Saudi Arabia averaged close to 5.5% in 2010, with food prices being the key driver. Consumer prices are likely to continue to reflect inflationary pressures in 2011, rising by an average 5%. This will be driven by higher food prices, but given the undersupply of residential housing, higher rents will be an even more important factor (rents rose 10.4% y/y in October 2010). The continued pick-up in the domestic economy, driven by strong policy spending, will also drive prices higher across the CPI basket.

**Chart 1: Key drivers of Saudi's GDP**




Source: Saudi Central Department of Statistics & Information

### Politics

- Saudi Arabia is the only Middle Eastern member of the G20 bloc of leading economies. It enjoys strong political relations with all key Western allies, and has recently adopted a more active approach to pan-Arab politics by hosting and joining negotiations on key regional conflicts.

- Relations with other GCC members remain strong. While the UAE's withdrawal from the common currency project increases tensions initially, the two countries enjoy strong ties, cemented by the GCC political union.

- Domestically, reforms are being carried out to modernise the economy. The Ministry of Labor, for example, is backing the right of women to work in retail outlets, despite opposition from the religious establishment.

# Tunisia

**Philippe Dauba-Pantanacce**, Senior Economist, MENA
Standard Chartered Bank, UAE
+971 4 508 3740, Philippe.Dauba-Pantanacce@sc.com

## Steady growth

### Economic outlook

- Tunisia's resilient exports and policy-induced private demand helped to maintain stable growth of 4.0% in 2010, according to our forecast. This should accelerate in 2011 on the back of even stronger domestic and external demand.

- The government plans substantial expenditure under its development plan for 2010-14, which should keep growth on an upward trajectory

- Inflation remains high (at 4.8% in 2010) compared to the historical trend, due to higher oil prices and more expensive imported food items, compounded by a poor harvest. Inflation should gradually revert to a lower trend during the 2010-13 outlook period.

### Financial issues

- The banking system is generally stable, well capitalised and very liquid. However, high NPLs (around 15%) and relatively low provisions to NPLs (around 58%) are cause for concern.

- Credit to the economy has been growing in a consistently healthy 10% range in recent years, helped by prudent regulations.

- Under a major financial-sector reform, the country's three majority government-owned banks (38% of banking assets) will be merged into one conglomerate.

**Standard Chartered forecasts: Tunisia**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 4.0 | 4.3 | 4.5 | 4.5 |
| **CPI (% y/y)** | 4.8 | 4.0 | 4.0 | 3.5 |
| **Policy rate (%)*** | 4.5 | 4.5 | 4.5 | 4.5 |
| **USD-TND*** | 1.39 | 1.45 | 1.43 | 1.38 |
| **Current account balance (% GDP)** | -2.3 | -1.1 | -1.0 | -1.0 |
| **Fiscal balance (% GDP)** | -3.0 | -2.8 | -2.6 | -2.5 |

*end-period Source: Standard Chartered Research

### Policy

- The authorities target moderate money supply growth, with the underlying aim of keeping inflation at low levels. Tunisia has repeated its commitment to adopting an inflation-targeting framework and is putting the necessary conditions in place for this. The authorities have also expressed their commitment to a free-floating currency over the medium term. However, we do not expect either of these two goals to be achieved anytime soon.

- The central bank, Banque Centrale de Tunisie (BCT), uses the reserve ratio requirement to absorb excessive liquidity. BCT intervenes in the FX market to manage liquidity or control the real effective exchange rate. The key interest rate was kept unchanged at 4.39% in June 2010. The money market rate has moved within a similar range of 4.10-5.20%, and averaged 4.52% in September.

### Other issues

- High and rising unemployment creates the potential for social discontent, and there have been occasional street protests.

- Tunisia's growing economic integration with its northern European partners (which account for 70% of its trade) has contributed to the country's modernisation, but it also represents an external vulnerability. Despite its proven resilience to the recent global crisis, Tunisia is dependent on the fortunes of the euro area.

### Politics

- The highly secular rule of the president and his party is repressive to any Islamist opposition. Islamist groups remain excluded, with their leaders generally located overseas and local support limited.

- The country is unique within the Maghreb in terms of social development. It has a very high level of education, the most advanced laws regarding women in the Arab world, and a resulting large middle class.

- While the government will likely persist with economic reforms, little political relaxation is likely, especially as uncertainty over the transition of power from President Zine el-Abidine Ben Ali grows in the coming years.

# UAE

**Shady Shaher**, Economist, MENA
Standard Chartered Bank, UAE
+971 4 508 3647, Shady.Shaher@sc.com

## Emerging from a challenging year

### Economic outlook

- 2010 was challenging, but it was nevertheless a year of economic recovery for the UAE. While no official numbers have been released to date, we estimate 2010 growth at 3.0%. The economy should gain momentum in 2011, but it is unlikely to boom – we expect a growth rate of 4.0%.

- The main contributors to GDP are hydrocarbons (29.2%), 'other services' (13%), manufacturing (16%), construction (11%), trade (9%) and financial services (6%). We expect Dubai's services and trade sectors to drive growth in 2011, while infrastructure plans in Abu Dhabi will boost the construction and services sector.

- We expect hydrocarbon production, the biggest contributor to the UAE's GDP, to remain flat as OPEC quotas constrain production. The direct contribution to real growth from the oil sector will be therefore neutral, but higher oil prices should be positive for government finances and the current account balance.

- Given Dubai's role as the world's third-largest re-export centre (trade activity makes up 40% of the emirate's GDP), global trade trends will be important. 2010 saw a significant rebound in global trade; this, along with rapid growth in the retail and hospitality sectors, drove Dubai's recovery, despite the challenges of a suppressed housing market and debt overhang. We expect Dubai's economy to grow 4.0% in 2011. With global trade looking unlikely to sustain the sharp rebound seen in 2010, re-exports and the logistics sector – of critical importance to Dubai – will be only moderately positive for growth.

**Standard Chartered forecasts: UAE**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 3.0 | 4.0 | 3.0 | 4.0 |
| **CPI (% y/y)** | 2.0 | 3.0 | 2.0 | 2.0 |
| **Policy rate (%)*** | 1.0 | 1.0 | 1.0 | 1.0 |
| **USD-AED*** | 3.67 | 3.67 | 3.67 | 3.67 |
| **Current account balance (% GDP)** | 5.5 | 6.0 | 7.0 | 7.0 |
| **Fiscal balance (% GDP)** | -2.5 | 4.0 | 4.5 | 4.5 |

*end-period Source: Standard Chartered Research

- Abu Dhabi's GDP (based on official 2008 GDP statistics, the latest available) remains heavily dependent on the hydrocarbon sector, which makes up 60% of the emirate's GDP. It is followed by manufacturing (9.5%), construction (5.1%), services (3.6%) and trade (3.3%). Despite the hydrocarbon sector's significant contribution to Abu Dhabi's GDP, it accounts for only 1.8% of employment in the UAE, reinforcing the need for diversification. Abu Dhabi accounts for 95% of the UAE's oil exports.

- Abu Dhabi's 2011 growth will depend on hydrocarbons and spending on new projects, either via direct government spending or quasi-sovereign entities. Projects in Abu Dhabi faced a number of delays and budget cuts in 2010, ranging from a USD 3.3bn budget cut on a key alternative energy development project to the cancellation of a USD 1.37bn stadium and delays in a USD 2.7bn highway project. According to the government's Plan Abu Dhabi 2030, Abu Dhabi aims to increase the GDP contribution of its non-oil sector to 64% by 2030. Investment in non-oil projects will be paramount to achieving this goal. We expect growth in Abu Dhabi to reach 5.0% in 2011.

### Financial issues

- UAE credit growth was weak throughout 2010. A key reason for this is that bank loans still exceed deposits. The gap narrowed from AED 47.1bn in January 2010 to AED 25.5bn in September, but this was the result of increased deposits and flat credit growth on a m/m basis. The lack of credit growth is taking away from growth dynamics, and is particularly problematic for SMEs. Credit conditions should begin to improve moderately in 2011 on the back of the economic recovery and improving market sentiment following Dubai's planned debt restructuring.

- Following the debt restructuring agreements, Dubai's government and quasi-sovereign entities have regained access to international markets. The subsequent pick-up in debt issuance, while it reflects improving investor sentiment, should also be viewed in light of strong investor appetite for emerging-market debt in general. Low interest rates in the rest of the world should give UAE entities increased access to global markets, which

# UAE (con'd)

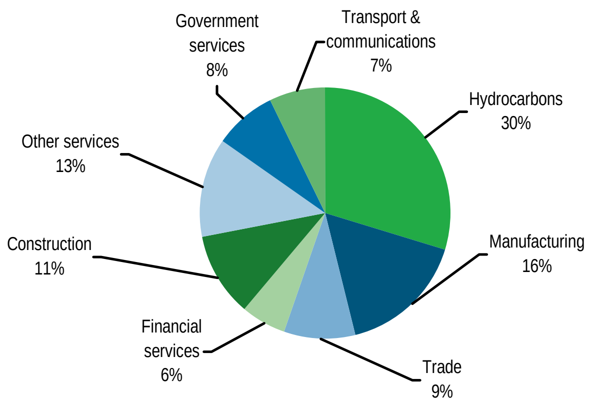
will help to meet Dubai's refinancing needs. We estimate that Dubai will face USD 18bn of maturities in 2011, so access to international markets will be important. The good news is that Dubai has already successfully tapped the credit markets in 2010 and is likely to be able to continue to do so in 2011 should extra funding be needed.

## Policy

- The UAE has approved a three-year federal budget for 2011-13. The budget foresees federal spending of AED 122bn over the period, with an allocation of AED 41bn for 2011. This is 6% lower than the 2010 budget. 46% of the 2011 federal budget will be allocated to social services-related spending. The federal budget is a balanced budget, with the emirate of Abu Dhabi covering close to 95% of the allocations. It is important to note that the UAE federal budget accounts for only a part of total government spending; the individual emirates have their own budgets that are much larger.

- The Abu Dhabi budget is the largest in the UAE. In addition to emirate-level spending, the budget is a key component of UAE-wide funding – it is the biggest contributor to the federal budget and provides support for federal entities through loans and funding. While the 2010 budget reduced expenditure by USD 12bn to USD 56bn, spending is likely to reach the USD 65-70bn range in 2011 as the sovereign pushes ahead with infrastructure development.

**Chart 1: Key drivers of UAE GDP**




Source: UAE Ministry of Economy

- Dubai, whose budget reached USD 9.6bn in 2010, will slash spending in the coming years, as most major infrastrucure projects have been completed, according to official statements. We believe the 2011 budget will be cut by at least 15% as Dubai scales back infrastructure spending allocations.

## Other issues

- We estimate that the value of all projects executed in the UAE increased to USD 61bn in 2010 from USD 47.1bn in 2009. Much of the spending increase was driven by Abu Dhabi quasi-sovereign entities. While project spending increased, it did so at slower pace than previously estimated due to budget cuts and project delays. We believe 2011 will see renewed investment in project development by quasi-sovereign entities, but we also expect a sharp rebound in sovereign spending on infrastructure. Project spending in the UAE is likely to rise to USD 85bn as projects delayed in 2011 break ground.

- Inflation in the UAE was subdued in 2010. Higher fuel prices resulting from local gasoline price hikes pushed up the transport component (9.9% CPI weighting). However, this was the result of subsidy cuts, and such price increases are unlikely to continue at the same rate in 2011. Housing costs have the highest weighting in the CPI basket (39%) and have been suppressed due to the severe correction in the UAE housing market. This component of the CPI basket probably underestimates the deflationary impact of the housing market; as a result, the UAE recorded positive inflation in 2009 and 2010, even as housing prices and rents dropped. The housing-market component rose by 0.42% in 2009, despite the fact that housing prices and rents fell by close to 50%. We expect inflation to pick up in 2011 on a stabilisation in the housing market, higher food prices, and improved credit conditions.

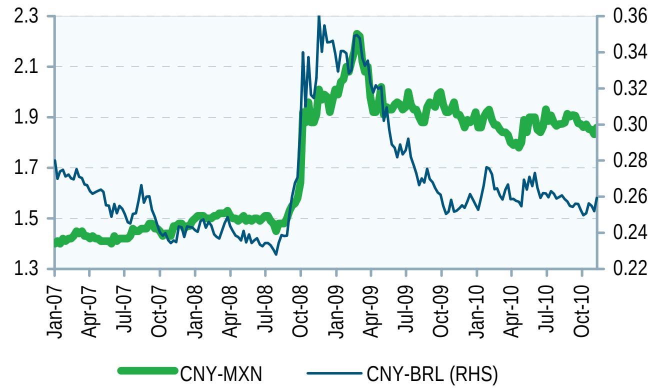
## Politics

- The political outlook is stable. While succession in the emirate of Ras al Khaima was disputed after the death in October 2010 of the emirate's ruler, Sheikh Saud Al Qassimi, federal officials were united, quick and resolute in supporting the incumbent heir. On the international front, the UAE continues to enjoy strong relations with all key Western powers. It has also built strong commercial links with key Asian countries, and signed an agreement with a Korean consortium in December 2009 to build its first nuclear power plant.

# Economies – Latin America

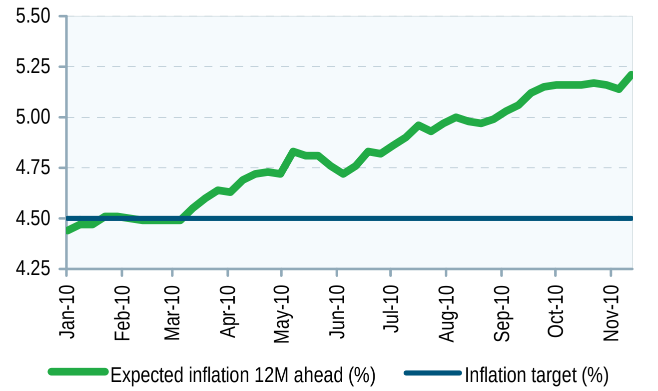
# Latin America – Charts of the year

**Chart 1: Mexico has gained competitiveness vs. China, Brazil has not**



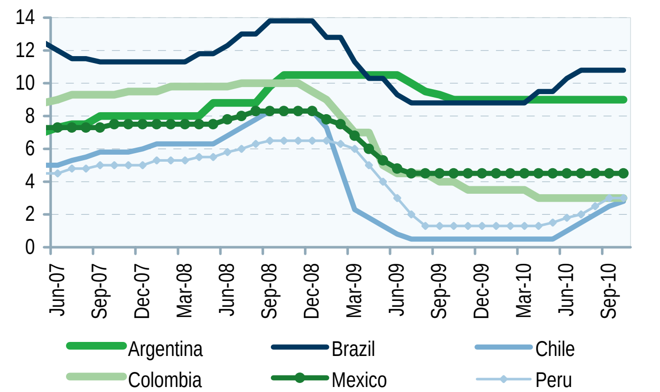

Sources: Bloomberg, Standard Chartered Research

**Chart 2: Time to worry about inflation in Brazil**
*%*



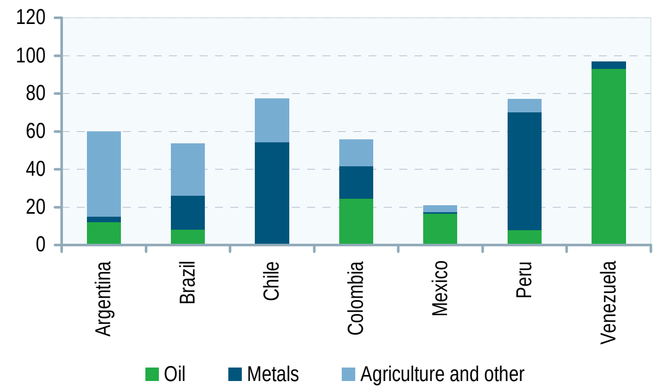

Sources: Central Bank of Brazil, Standard Chartered Research

**Chart 3: Policy rates are still well below pre-crisis levels**
*%*



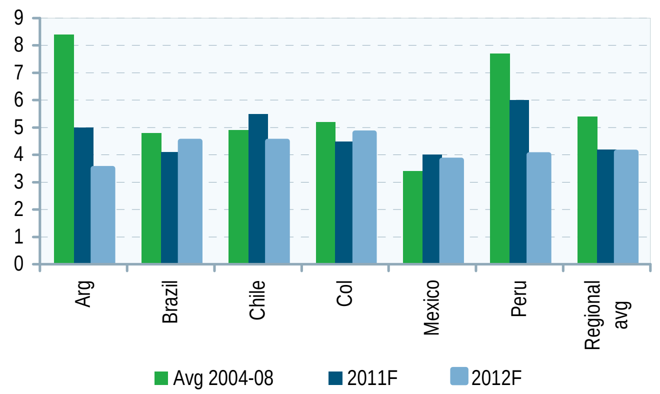

Sources: Bloomberg, Standard Chartered Research

**Chart 4: A heterogeneous commodity-exporting region**
*Breakdown of total exports by commodity*



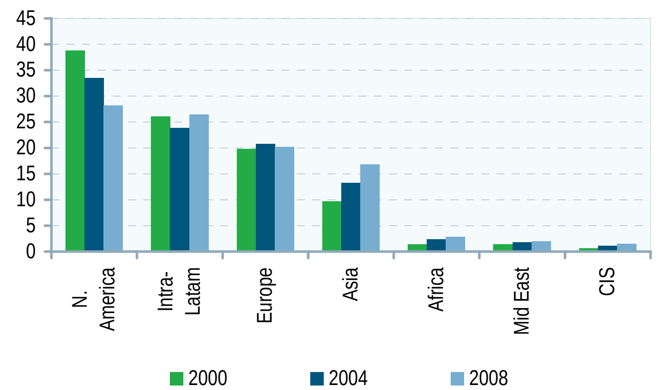

Sources: Country sources, Standard Chartered Research

**Chart 5: Growth to be near trend in Brazil, Chile, Colombia and Mexico in 2011-12**




Sources: Country sources, Standard Chartered Research

**Chart 6: Changing pattern of Latin America's exports**
*% of the region's exports by destination*




Sources: World Trade Organization, Standard Chartered Research

# Argentina

**Douglas Smith**, Regional Head of Research, Latin America
Standard Chartered Bank, United States
+1 212 667 0564, Douglas.Smith@sc.com

## President Kirchner to make her mark

### Economic outlook

- We expect growth to slow from 8.2% in 2010 to 5.0% in 2011. Nevertheless, the economy has strong cyclical momentum owing to continued expansionary fiscal and monetary policies. A benign external environment and strong growth in trade partners such as Brazil also aid growth. As such, there is some upside risk to our 2010 growth forecast.

- True inflation remains stuck in the double digits because of demand- and supply-side issues. Lack of investment due to political uncertainty is exacerbating the build-up of inflation pressures from demand stimulus, as are the generous wage settlements being offered to unions.

- Credible private surveys put expected inflation 12 months ahead in the 20-25% range, whereas government inflation data show price rises of about 10% (still quite high in the current global environment).

### Financial issues

- The government's policy is to keep the Argentine peso (ARS) competitive; this means the central bank is active in buying USD inflows in the market to offset appreciation pressures. These purchases are contributing to the country's inflation problem.

- The government intends to use FX reserves to pay down debt in 2011; thus, further heavy FX intervention is likely. This strategy relies on a robust trade surplus. While we see a moderation from 3.5% of GDP in 2010 to 1.5% of GDP in 2011, USD inflows should boost reserves.

#### Standard Chartered forecasts: Argentina

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 8.2 | 5.0 | 3.5 | 5.0 |
| **CPI (% y/y)** | 10.0 | 9.2 | 8.5 | 6.0 |
| **Policy rate (%)*** | 9.5 | 10.0 | 11.0 | 10.0 |
| **USD-ARS*** | 3.98 | 4.05 | 4.07 | 4.10 |
| **Current account balance (% GDP)** | 1.0 | 0.5 | 0.5 | -1.0 |
| **Fiscal balance (% GDP)** | -0.1 | -0.3 | 0.5 | 0.5 |

*end-period Source: Standard Chartered Research

### Policy

- The government's key challenge is to slow the pace of policy stimulus, which is inconsistent with the supply side of the economy. Any meaningful changes are unlikely because of political considerations as the October 2011 presidential election gets closer.

### Other issues

- Based on the same political considerations that will keep policy stimulative, the likelihood of normalising relations with the Paris Club, and the IMF in particular, is low. This would continue to deprive the economy of certain types of financing, but if the external environment remains benign, it is unlikely to be a big constraint on growth in 2011. Also, we think it is unlikely that there will be any reform of INDEC, the statistics agency.

### Politics

- The unexpected death of former President Nestor Kirchner (in office from 2003-07) in October 2010 radically changed the political environment in Argentina. The current president, Cristina Kirchner, is his widow, and he wielded a great deal of power behind the scenes. This is particularly true for economic issues, such as relations with the IMF and external creditors, in which the government took a confrontational stance.

- In 2011, President Kirchner may take greater control and define her own form of governing. But no one knows what that will be. Some argue that she will become more conciliatory, and others argue that nothing will change.

- Kirchner is eligible to stand for re-election in October 2011. In the very near term, her popularity will likely rise after her husband's death. The challenge will be to maintain high popularity if she wants to run again, which means continued expansionary policies and generous wage settlements for favoured groups.

- The opposition now has its first real chance in years of winning the presidency. Many opposition politicians earned their popularity simply by being against whatever the Kirchners favoured. This approach is now outdated; opposition figures will have to present real plans to the country. It will be a very interesting 2011 indeed.

# Brazil

**Douglas Smith**, Regional Head of Research, Latin America
Standard Chartered Bank, United States
+1 212 667 0564, Douglas.Smith@sc.com

## Passing the baton

### Economic outlook

- The outlook for Brazil's economy is good, with expected growth of 4.1% in 2011, following 7.0% in 2010. Growth in Brazil is driven by domestic factors, and the government was able to use expansionary fiscal and monetary policy to cushion the economy during the global financial crisis. The economy only contracted 0.2% in 2009.

- The concern is that these expansionary policies are still at work now. One challenge for the new government will be to pull back on fiscal policy and raise interest rates, as inflation and inflation expectations are picking up.

- The falling unemployment rate suggests that firms are confident enough to hire new workers, and consumer spending will remain robust thanks to transfer programmes and ample credit availability.

- The risk is that the incoming government will have a dovish bias and accept higher inflation as the price of higher growth.

- We expect rate hikes to resume in Q1-2011; a cumulative 75bps in hikes should bring rates to 11.50% by end-2011. However, the longer it takes to rein in fiscal policy, the more heavy lifting will be required of monetary policy.

- At issue for Brazil is the relatively low rate of non-inflationary potential growth. This stems from poor infrastructure and minimal government investment in recent years.

### Standard Chartered forecasts: Brazil

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 7.0 | 4.1 | 4.5 | 4.0 |
| **CPI (% y/y)** | 5.0 | 5.5 | 4.9 | 4.5 |
| **Policy rate (%)*** | 10.75 | 11.50 | 10.00 | 8.00 |
| **USD-BRL*** | 1.70 | 1.70 | 1.72 | 1.68 |
| **Current account balance (% GDP)** | -2.9 | -3.5 | -3.0 | -2.0 |
| **Fiscal balance (% GDP)** | -2.6 | -2.5 | -2.4 | -2.2 |

*end-period　　Source: Standard Chartered Research

- Public expenditure has focused on income transfer programmes, which have improved the lives of millions but left Brazil with a bloated public sector and no increase in the potential growth rate. As a result, tax rates must remain high to prevent an even higher deficit, which will affect private-sector investment.

### Financial issues

- The appreciation of the Brazilian real (BRL) exchange rate has been a hot topic in the country and among policy makers. Exporters have complained about their margins, and the government has argued that speculative inflows have added to asset bubbles.

- The policy response has included a range of actions, including verbal intervention, US dollar (USD) purchases by the central bank (which have boosted reserves sharply), and taxes on short-term USD inflows.

- We cannot rule out more measures, as appreciation pressures are likely to continue in 2011. At the same time, Brazil has the world's highest interest rates for a reason. The best way to deter speculative inflows is to lower fiscal spending, which will lower market interest rates.

### Policy

- The incoming president, Dilma Rousseff, is unlikely to break much from the popular policies of the Lula administration. She believes in an active role for the state in the economy, and is unlikely to advocate legal independence of the central bank. She will also support further market intervention if BRL appreciation continues.

- Rousseff believes that the source of economic growth will be consumption via social programmes and income transfers, and that state-owned banks can facilitate this with credit extension.

- She has little appetite for reforms to increase the long-term, potential economic growth rate of the economy, although this is precisely what is needed now that macro stability is not at risk. As a result, we do not expect any major initiatives on energy, labour or public

# Brazil (con'd)

expenditure/tax reform. Lula did not move forward on these contentious issues, even with very high approval ratings.

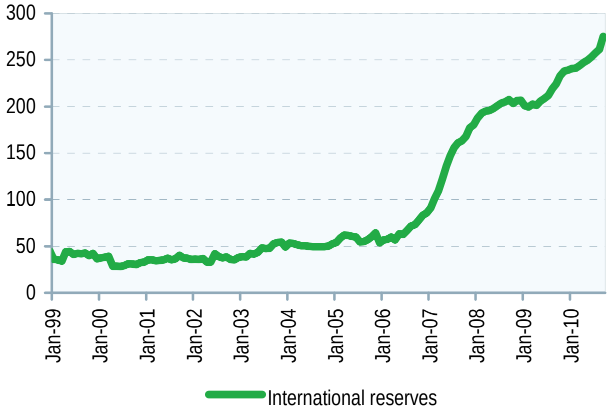
## Other issues

- A key step for Rousseff will be to develop a comprehensive strategy for Brazil's growing economic and financial relationship with China. The economies are increasingly linked: China has been Brazil's largest export market for some time now, and there is no reason to believe this will change.

- China has voracious demand for Brazil's commodity exports; as Brazil's middle class grows, it will generate higher demand for electronics and other manufactured goods from China and other Asian economies. During January-October 2010, Brazil's exports to China were USD 25.9bn, which was up 37% y/y and amounted to 15.9% of Brazil's total exports for the period. Brazil's imports from China were USD 20.7bn, up 63% y/y and 13.9% of Brazil's total imports for the same period.

- Brazil has allowed its exchange rate to appreciate significantly against the USD, and thus, the BRL has effectively appreciated against the Chinese yuan (CNY). As this makes Brazil's exports more expensive, we would not be surprised to see Brazil adding to pressure on China to further liberalise its currency. This is even more possible given the interventionist nature of Rousseff, who is more likely than Lula to try to stem FX appreciation pressures to please exporters.

**Chart 1: Meteoric rise in international reserves**
*USD bn*




Sources: Bloomberg, Standard Chartered Research

- Progress in discussions between Brazil and China on clearing trade in each other's currencies is likely to be minimal. This was an interesting idea some years ago, but remains impractical given the capital account controls and non-deliverable nature of the two currencies.

- A more recent dimension of the Brazil-China relationship is financial and has significant potential. Aside from huge infrastructure needs in Brazil – including preparations for the 2014 FIFA World Cup and the 2016 Olympics – there is also the considerable expense of developing the pre-salt oil fields off the Atlantic coast, where the oil is below the ocean floor and under a thick layer of salt. Petrobrás has mentioned the need for as much as USD 200-220bn of spending through 2014 to develop the Tupi oil field, which is the biggest oil discovery in the Americas since Mexico's Cantarell field in 1976.

- FDI from China into Latin America has not grown as quickly as in other parts of the world, but bilateral loans, to be paid back in commodities, are increasingly common. For example, in 2010, China Development Bank provided a USD 10bn credit line to Petrobrás to be repaid with oil. China has done similar deals with state-owned companies with Ecuador and Venezuela in recent years. We would not be surprised to see additional strategic, medium- and long-term arrangements.

## Politics

- Rousseff was the natural 'candidate of continuity' to follow President Lula. His very high popularity (and the booming economy) was a huge benefit to her during the campaign. Though she did not win the election in the first round as many expected, she took 56% of the vote in the second-round run-off. She will also have a more supportive congress than Lula did.

- Rousseff clearly has the wind at her back as she prepares to take office on 1 January. But we doubt she will use her high popularity to push through difficult but crucial reforms to lift the non-inflationary growth rate of the economy – even Lula, who enjoyed all-time-high popularity, did not tackle these reforms.

# Chile

**Douglas Smith**, Regional Head of Research, Latin America
Standard Chartered Bank, United States
+1 212 667 0564, Douglas.Smith@sc.com

## Dealing with appreciation pressures

### Economic outlook

- The economy bounced back sharply from a 1.5% decline in 2009 to estimated growth of 5.2% in 2010; we forecast 5.5% in 2011. This results from a resilient economy based on years of prudent fiscal and monetary policies.

- The central bank lowered interest rates to an emergency level of 0.5% during the financial crisis, and is now removing monetary stimulus. We expect the overnight rate to end 2011 at 4.25%, with further hikes to 5.0% by end-2012.

- However, expectations of monetary policy in Chile can be more volatile than in most other countries because of appreciation pressure on the Chilean peso (CLP). Chile is a small, open economy, and thus movements in the CLP quickly affect domestic economic and financial conditions. This means the central bank must be nimble in adjusting monetary policy, and tightening (or easing) cycles tend to be quick and aggressive.

### Financial issues

- In 2010, the central bank has employed a variety of tools to ease appreciation pressure on the CLP. But unlike other countries in the region, Chile has used market-friendly measures. These have included policies to streamline the process for granting export licences, encouraging outbound investment, and raising the limits on the foreign asset holdings of local pension funds.

#### Standard Chartered forecasts: Chile

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| GDP (real % y/y) | 5.2 | 5.5 | 4.5 | 6.0 |
| CPI (% y/y) | 1.4 | 3.6 | 4.0 | 3.6 |
| Policy rate (%)* | 3.25 | 4.25 | 5.0 | 5.5 |
| USD-CLP* | 485 | 465 | 480 | 470 |
| Current account balance (% GDP) | 0.2 | -0.4 | 0.1 | -1.5 |
| Fiscal balance (% GDP) | -4.5 | -4.0 | -3.0 | -1.0 |

*end-period Source: Standard Chartered Research

- Additional measures may be required to slow the appreciation of the CLP, but we expect any new measures to be transparent and market-friendly. For example, there could be a daily auction to purchase US dollars (USD). This was employed in the past, when the central bank announced a plan to buy USD 8bn from April 2008 to end-2008 via daily purchases of USD 50mn.

### Policy

- The challenge for 2011 will be to raise interest rates in the face of a strongly growing economy, while also trying to prevent excessive appreciation of the CLP. This is a fine balance and will likely to add volatility to expectations of central bank moves.

### Other issues

- Chile has led the way in Latin America in signing free-trade agreements, particularly with Asian countries. We expect Chile to continue its outward focus in 2011, deepening its integration with the world economy. This model of growth, which also includes a commitment to sound fiscal and monetary policies, is the consensus across the major political parties, so we do not expect much deviation from it.

### Politics

- President Piñera took office in March 2010. His first year in office was dominated by a massive earthquake in February 2010 and efforts to rescue 33 miners who were trapped underground. These events put his intended policy moves on hold.

- In 2011, we will see how Piñera progresses with the policies he advocated during his presidential campaign; these are similar to those of the prior Bachelet government, but with more of a business orientation. Examples of the policies Piñera supports include increased productivity in the public sector and lower corporate marginal tax rates to boost investment. Nevertheless, he faces a divided congress, so he will have to maintain a dialogue with the opposition.

# Colombia

**Douglas Smith**, Regional Head of Research, Latin America
Standard Chartered Bank, United States
+1 212 667 0564, Douglas.Smith@sc.com

## Investment grade means fiscal efforts

### Economic outlook

- We expect growth to accelerate to 4.5% in 2011 from 4.1% in 2010. Colombia has been one of the slowest Latam countries to rebound from the financial crisis, and we estimate that it will continue to have a positive output gap (like Mexico) into the first half of 2011.

- The inflationary environment remains benign; this, coupled with lacklustre real activity data, means that the central bank will likely remain on hold until at least late Q1-2011. The central bank remains confident that inflation will remain on the lower side of its inflation target range of 3% +/- 1ppt through the end of 2011.

### Financial issues

- The central bank has faced a challenge with appreciation pressure on the Colombian peso (COP). As interest rates in Colombia have been relatively low for the region, inflows are less an issue of COP strength than of USD weakness. As such, the central bank has put up some ‘speed bumps’ to slow COP gains, but further measures are possible if pressure continues.

- The current Santos government has been unwilling to impose capital controls, differentiating itself from the former Uribe government. However, such controls are possible if pressure continues.

### Policy

- The key policy debates in 2011 will focus on various fiscal issues. A fiscal responsibility reform bill which has been in discussion for some time attempts to limit the central government budget deficit to 1-2% of GDP, down from an average deficit of 3.9% over 2000-09. This would allow the net debt as a share of GDP to fall by 10ppt to 29% by 2020, and faces the least opposition to passage.

- The much bigger fiscal challenge is reform of the royalty system. At present, royalties from oil and mining exploration accrue largely to the geographical areas where the exploration and transportation take place. So about 80% of the royalties accrue to less than 20% of the population.

- The government wants to distribute these revenues more equally around the country and to establish a stabilisation fund with future oil revenue, to be run by the central bank. Approval of the royalty bill requires a constitutional amendment, which itself requires eight debates in congress and runs a high risk of being watered down.

### Standard Chartered forecasts: Colombia

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 4.1 | 4.5 | 4.8 | 5.0 |
| **CPI (% y/y)** | 2.2 | 3.1 | 4.0 | 3.8 |
| **Policy rate (%)*** | 3.0 | 4.0 | 5.25 | 6.25 |
| **USD-COP*** | 1,870 | 1,790 | 1,920 | 1,850 |
| **Current account balance (% GDP)** | -2.5 | -2.6 | -2.0 | -1.5 |
| **Fiscal balance (% GDP)** | -3.5 | -3.0 | -2.8 | -2.0 |

*end-period

Source: Standard Chartered Research

### Other issues

- All three main rating agencies have Colombia one notch below investment-grade status, and S&P and Moody’s have a positive outlook on the country. We think that Colombia will re-attain investment grade status in 2011, based on approval of the key fiscal reforms discussed above.

- The desire to regain investment-grade status is one reason why Colombia may not impose capital controls if the COP continues to gain. Rather, it may implement more market-friendly reforms in line with what it has done already.

### Politics

- President Santos assumed office in August 2010 in a smooth transition from President Uribe that attests to the strength of Colombia’s underlying political institutions. The feeling on the ground is positive in light of the quality of the new economic team and its market-oriented approach.

- The government also continues to score military victories over the FARC, the narco-trafficking group, which appears to have weakened significantly in recent years. The challenge of the government in this area is to re-integrate former FARC members into society.

# Mexico

**Douglas Smith**, Regional Head of Research, Latin America
Standard Chartered Bank, United States
+1 212 667 0564, Douglas.Smith@sc.com

## Low rates for long

### Economic outlook

- We expect growth to slow to 4.0% in 2011 from 4.5% in 2010. Of all the large countries in the region, Mexico is the most vulnerable to a slowdown in the US, as over 80% of its exports (or about 30% of GDP) go to the US. This is a boon in good times, but a weakness during downturns.

- Domestic demand remains weak, with little sign of inflationary pressure. This is evident from a still-high unemployment rate and low demands in wage negotiations. This is the reason for our view that the central bank (Banxico) will keep interest rates steady at 4.5% at least until Q4-2011. As a result, the local yield curve is quite flat. Also, the inclusion of Mexico's government bonds in the Citigroup World Government Bond Index (WGBI) has helped to push market rates down.

### Financial issues

- Mexico is known for market-friendly policies; thus, we do not expect any type of capital controls in the event of a much stronger Mexican peso (MXN). At most, we would expect the resumption of a previous rule-based policy of pre-announced daily US dollar (USD) sales. Unlike many other currencies in the region, the MXN is not overvalued, based on our measures.

### Policy

- The fiscal deficit for 2011 should be 2.5% of GDP, down from 2.7% in 2010. This tightening of fiscal policy was an important success for the government in light of demands from the opposition to lower the VAT rate, with no offsetting spending cuts, ahead of the 2012 presidential elections. The opposition wanted to pay for the lower VAT rate by boosting the GDP growth assumption in the budget, but in the face of a weak USD growth outlook, an increase in Mexico's growth rate seems dubious.

#### Standard Chartered forecasts: Mexico

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| GDP (real % y/y) | 4.5 | 4.0 | 3.8 | 3.0 |
| CPI (% y/y) | 4.2 | 3.9 | 4.1 | 3.5 |
| Policy rate (%)* | 4.5 | 4.5 | 5.5 | 5.5 |
| USD-MXN* | 12.35 | 12.10 | 12.20 | 11.50 |
| Current account balance (% GDP) | -1.3 | -1.5 | -2.5 | -2.0 |
| Fiscal balance (% GDP) | -2.7 | -2.5 | -2.2 | -2.0 |

*end-period Source: Standard Chartered Research

### Other issues

- Mexico will begin negotiations with Brazil on a free-trade agreement in 2011. While Mexico and Brazil are not major trade partners at present, Mexico would benefit from a wider export market that is not so heavily focused on the US.

### Politics

- 2011 will not bring a presidential election in Mexico (as in Argentina and Peru) or a new government (as in Brazil). However, there will be gubernatorial elections in six states, including the State of Mexico, which has the largest population. To us, this means that the likelihood of congressional support for long-standing key reforms – such as labour and energy reform, including electricity reform – remains low.

- There seems to be a consensus on the need for additional legislation related to security matters. It is common to hear that the escalating drug-related violence in Mexico reflects the fact that the government is making progress in confronting the problem after many years of inaction. Whether this is true or not, drug-related violence commonly appears in the international media, which drives away tourists and raises the cost of investment because of increased security for businesses and executives.

- Presidential elections in 2012 may be the catalyst for progress. President Calderon is unable to run again, and his party does not have a strong candidate to replace him. Instead, the opposition PRI has set its sights on winning, and may be willing to move forward on security-related legislation in order to appear proactive on the issue.

- Important bills to watch will be the reorganisation of the police force and further anti-money-laundering legislation.

# Peru

**Douglas Smith**, Regional Head of Research, Latin America
Standard Chartered Bank, United States
+1 212 667 0564, Douglas.Smith@sc.com

## Presidential elections in April

### Economic outlook

- Peru will remain one of the top growth performers in the region in 2011, similar to Chile. We anticipate that growth will slow from 7.9% in 2010 to a still-robust 6.0% in 2011.

- The main contributors to growth will continue to be private consumption and investment, thanks to high business confidence and credit expansion. The slowing from 2010 reflects our expectation of some pullback in public investment growth, now that extraordinary stimulus is no longer needed. In addition, monetary policy will continue to be normalised, which will slow growth.

### Financial issues

- The central bank (BCRP) keeps a tight rein on the Peruvian sol (PEN). The economy remains heavily dollarised, with about 45% of domestic loans outstanding in US dollars (USD). This means that changes in the policy rate have a direct effect on just over half of the local economy. As a result, the BCRP also adjusts reserve requirement rates on foreign and local deposits.

- In response to strong USD inflows, the BCRP has fought PEN appreciation by buying USD in the spot market, taxing profits on foreign investment in short-dated futures contracts by 30%, and raising the reserve requirement on short-term foreign credit deposits in local currency by 120%. The BCRP will continue with such policies in 2011 whenever there is a risk of speculative inflows.

#### Standard Chartered forecasts: Peru

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **GDP (real % y/y)** | 7.9 | 6.0 | 4.0 | 4.5 |
| **CPI (% y/y)** | 2.4 | 2.5 | 3.1 | 2.8 |
| **Policy rate (%)*** | 3.0 | 4.25 | 5.5 | 6.0 |
| **USD-PEN*** | 2.81 | 2.76 | 2.82 | 2.73 |
| **Current account balance (% GDP)** | 2.4 | 2.4 | -1.0 | -1.5 |
| **Fiscal balance (% GDP)** | -1.2 | -1.0 | -0.5 | 0.5 |

*end-period Source: Standard Chartered Research

### Policy

- Inflation has picked up since the start of 2010, and the BCRP has been tightening monetary policy. We expect continued tightening, but the central bank will take the PEN into consideration, as the strength of the currency has a disinflationary effect because Peru is a small, open economy. We expect the overnight rate to hit 3.75% by mid-2011 and 4.25% by end-2011.

- Any political noise ahead could weaken the exchange rate temporarily, but growth in domestic demand warrants higher interest rates. The BCRP has removed most of its ‘emergency’ accommodation and is probably more comfortable keeping rates on hold temporarily in the face of market volatility.

### Other issues

- Peru is vulnerable to global commodity prices (and thus the US and Chinese economies), as about 80% of its exports are commodity-related. Any decline in global metal prices will hurt its terms of trade. The good news is that Peru has low external vulnerabilities and a wide base of trade partners.

### Politics

- With a presidential election in April 2011, the political arena is heating up quickly; incumbent President Garcia cannot run for office again.

- The polls – both in the capital (Lima) and nationwide – consistently show that centrist candidates are in the lead. Former Lima Mayor Luis Castaneda is first, followed by Keiko Fujimori (daughter of the former president). Leftist politician Ollanta Humala continues to lag, with just 6% of the vote.

- Our base scenario is that a centrist candidate will prevail either in the first or second round of voting if no one gets a majority. This could be Fujimori, who is thought to have the strongest base among the candidates. Nevertheless, even the possibility of a good showing in the polls by Humala will add volatility to the PEN and sovereign debt.

# Forecast snapshots

# FX strategy summary

| Currency | Fundamentals | S/T weighting (3 months) | M/T weighting (3-12 months) |
|---|---|---|---|
| **CNY** | • Faster CNY appreciation looks set to help curb inflation pressure<br>• CNY losses against a basket create room for faster gains vs. USD<br>• Current account surplus rebound underlines the need for CNY gains<br>• CNH asset has better carry characteristic than short USD-CNY NDF<br>• We raised our s/term FX rating to *Overweight* on 22 November 2010 | Overweight | Overweight |
| **HKD** | • Development of the CNH market does not threaten the HKD peg<br>• Constructive Greater China economic themes to underpin HKD<br>• USD-HKD likely to remain close to, but not threaten, lower limit<br>• Measures to cool asset prices key to underpinning confidence in peg<br>• We suggest clients use HKD *Underweight* to fund AXJ *Overweights* | Underweight | Neutral |
| **KRW** | • Choppy risk appetite conditions make for range trading near-term<br>• KRW NEER remains undervalued versus its decade average<br>• C/A surplus has improved due to weak KRW, strong exports<br>• KRW may extend gains in 2011 on valuations, global growth pick-up<br>• We raised our short-term FX rating to *Overweight* on 23 March 2010 | Overweight | Overweight |
| **TWD** | • USD-TWD is consolidating after abrupt decline in early Q4<br>• Persistent gradual CNY appreciation may be reflected in TWD<br>• Substantial external surplus remains important background positive<br>• Improved cross-straits relations are key medium-term TWD positive<br>• We raised our short-term FX rating to *Overweight* on 14 October 2010 | Overweight | Overweight |
| **IDR** | • Strong growth, solid external balances should support IDR in 2011<br>• Current muted CPI inflation supports local asset markets<br>• IDR REER appreciation should continue in 2011<br>• Higher CPI inflation and BI inaction are risks for 2011<br>• We reviewed and maintained both of our ratings on 13 August 2010 | Overweight | Overweight |
| **MYR** | • The MYR NEER has stalled on FX policy, slowdown<br>• Narrower trade surplus, BoP should be watched<br>• Seasonal analysis shows MYR tends to outperform in Q1, Q4<br>• Medium-term outlook is supported by strong external balances<br>• We remain *Neutral* MYR short-term given risks | Neutral | Overweight |
| **PHP** | • Economic recovery and BoP dynamics provide support for PHP<br>• Inward remittances should continue to drive PHP strength<br>• We expect PHP to be the best performer in SEA in 2011<br>• Higher CPI inflation and BSP inaction are risks for 2011<br>• We remain *Overweight* PHP despite recent BSP FX policy moves | Overweight | Overweight |
| **SGD** | • The SGD should continue to outperform on strong FX policy<br>• MAS likely to keep policy unchanged in 2011, but re-centring is a risk<br>• BoP, fundamentals underline trend SGD strength<br>• The SGD NEER trades at the strong end of the policy band<br>• We remain *Overweight* SGD, as policy risk is for more tightening | Overweight | Overweight |

# FX strategy summary (cont)

| Currency | Fundamentals | S/T weighting (3 months) | M/T weighting (3-12 months) |
|---|---|---|---|
| **THB** | • GDP rebound, robust trade are THB positives<br>• Seasonality and positioning are also near-term THB positives<br>• Growth slowdown and external balances should be watched closely<br>• We lowered our s/term FX rating to *Neutral* on 25 November 2010<br>• Medium-term *Neutral* FX rating on political risk, China competition | Overweight | Neutral |
| **VND** | • Upward pressure on USD-VND continues on devaluation expectations<br>• Further devaluations are likely given authorities' growth bias<br>• Wider trade deficit and rising CPI inflation are risks for 2011<br>• Further depreciation is already priced in by onshore forwards/NDFs<br>• We remain *Neutral* VND given cost of carry vs. risks | Neutral | Neutral |
| **INR** | • USD-INR has rebounded ahead of year-end on global factors<br>• FII inflows are slowing ahead of year-end; trade deficit remains large<br>• We expect USD-INR to range trade into year-end on offsetting factors<br>• INR should rebound in calendar Q1-2011 on strong seasonal inflows<br>• Renewed INR gains from Q1-2011 support our *Overweight* FX ratings | Overweight | Overweight |
| **PKR** | • USD-PKR has traded in a narrow band around 85.50 since July<br>• Significant pick-up in remittances has limited the upside to USD-PKR<br>• Export recovery, official aid remain key to limiting PKR losses<br>• Slow implementation of fiscal reforms poses risk to official inflows<br>• Real test of PKR strength will come after the IMF programme ends | Neutral | Neutral |
| **KES** | • Rebound in agriculture, manufacturing has supported growth recovery<br>• Inflation is currently low, but higher food/electricity prices pose risks<br>• KES stabilised after H1 sell-off on strong growth, tourism receipts<br>• Possible IMF financing to meet reserve targets may be KES-positive<br>• We are *Neutral* KES short-term, *Overweight* medium-term | Neutral | Overweight |
| **NGN** | • April 2011 presidential election is an increasingly important focus<br>• Despite favourable oil prices and output, FX reserves are falling<br>• USD-NGN is trading in a range of +/-3% around 150 for now<br>• Near-term risks are to the upside given inflation and the election<br>• We are *Underweight* NGN short-term and *Neutral* medium-term | Underweight | Neutral |
| **BWP** | • BWP's value is determined by a currency basket dominated by ZAR<br>• The recovery remains on track despite a weak Q2 q/q performance<br>• But much weaker growth, still-high inflation are likely to weigh in 2011<br>• Faster BWP downward crawl vs. basket is warranted medium-term<br>• We are *Neutral* BWP, but looking to go *Underweight* | Neutral | Underweight |

# FX strategy summary (cont)

| Currency | Fundamentals | S/T weighting (3 months) | M/T weighting (3-12 months) |
|---|---|---|---|
| **ZAR** | • ZAR is supported short-term by USD weakness, massive bond inflows<br>• The authorities will continue to talk down ZAR and build FX reserves<br>• FDI inflows will provide further support to the ZAR near-term<br>• Further out, C/A deficit, structural shortfalls are mild negatives<br>• We are *Overweight* ZAR, but looking to go *Neutral* in H1-2011 | Overweight | Neutral |
| **ARS** | • USD-ARS posted new 2010 high of 3.9780 in November<br>• Modest ARS depreciation trend to continue in Q1-2011, targeting 4.02<br>• Nov-10 consumer confidence was highest under current government<br>• This reflects the cyclical recovery of the economy<br>• We are *Neutral* ARS short-term and medium-term | Neutral | Neutral |
| **BRL** | • USD-BRL likely saw its 2010 low in October, at 1.6440<br>• FX measures, stronger USD have been enough to curb s/term flows<br>• Expectations for Rousseff's cabinet remain market-friendly so far<br>• Inflation pressures are rising, and we expect more rate hikes in 2011<br>• We are *Neutral* BRL short-term, *Overweight* medium-term | Neutral | Overweight |
| **CLP** | • USD-CLP hit new 2010 low of 473; now major technical support<br>• Risk of a break below 473 remains, but momentum has weakened<br>• Q3 GDP rose 7.0% y/y, driven by strong domestic growth<br>• The central bank is the only one in the region still hiking rates<br>• We raised our short-term rating to *Overweight* on 9 August 2010 | Overweight | Overweight |
| **COP** | • USD-COP is consolidating back to the 200-day MA at around 1,883<br>• COP has been expensive on a NEER and REER basis<br>• The economy is slowly improving, but inflation remains benign<br>• Talk of rate cuts may be premature; we think rates will stay on hold<br>• We are *Neutral* COP short-term and medium-term | Neutral | Neutral |
| **MXN** | • Firmer US data will keep USD-MXN near the bottom of trading range<br>• MXN remains one of the cheaper EM currencies on a REER basis<br>• The economy still has significant slack, and core inflation is falling<br>• Political system deadlocked; minimal progress before 2012 election<br>• We remain *Neutral* MXN short-term and medium-term | Neutral | Neutral |
| **PEN** | • PEN is forming a short-term floor at 2.78; correction to 2.81/82 is likely<br>• Peru is still posting strong GDP growth, at 9%<br>• Elections in April 2011; centrist candidates are ahead in the polls<br>• Economy is growing rapidly; GDP rose 10% y/y in September<br>• We are *Neutral* PEN, both short-term and medium-term | Neutral | Neutral |

# FX strategy summary (con’d)

| Currency | Fundamentals | S/T weighting (3 months) | M/T weighting (3-12 months) |
|---|---|---|---|
| **EUR** | • EUR has risen on QE2 and still-strong European growth<br>• EUR may have one more bout of strength ahead of year-end<br>• Concerns over Europe’s periphery have returned as a negative driver<br>• Longer-term, EUR to underperform amid slowing growth prospects<br>• We lowered s/term FX rating to *Underweight* on 11 November 2010 | Underweight | Neutral |
| **JPY** | • USD-JPY managed its first sustained rally in months in November<br>• Higher US yields and position unwinding have supported the gains<br>• Moderating Japanese export performance may also be playing a role<br>• JPY weakness should be more sustained in 2011 on rate spreads<br>• We remain *Neutral* JPY for now, but are looking to go *Underweight* | Neutral | Underweight |
| **AUD** | • AUD remains supported by growth, RBA rate hikes and commodities<br>• Resurgent Chinese growth is at the core of AUD strength<br>• However, AUD is increasingly overvalued on a trade-weighted basis<br>• We see it as vulnerable to risk aversion and investor over-positioning<br>• We raised our short-term rating to *Overweight* on 7 October 2010 | Overweight | Neutral |
| **NZD** | • Recent earthquake and faltering recovery have RBNZ on hold for now<br>• Rising soft commodity prices support the external balance<br>• Investor risk appetite and NZ rate differentials still provide support<br>• Medium-term, NZD to outperform AUD as RBNZ plays catch-up<br>• We remain *Neutral* NZD for now, but are looking to go *Overweight* | Neutral | Overweight |
| **CHF** | • Swiss growth is rebounding, despite deleveraging, unemployment<br>• Current account surplus is recovering, supporting CHF strength<br>• Capital outflows have not been enough to recycle this<br>• Overvaluation remains a major medium-term concern<br>• We are *Overweight* CHF for now, but looking to go *Neutral* | Overweight | Neutral |
| **GBP** | • The UK economy has generally outperformed expectations recently<br>• But fiscal tightening will start to hurt UK growth prospects soon<br>• BoE could ease further despite persistently high inflation prints<br>• Additional QE will remain a policy option, acting as a GBP headwind<br>• We are *Underweight* GBP heading into 2011, expecting more QE | Underweight | Neutral |
| **CAD** | • CAD has been consolidating against USD for nearly a year<br>• Vulnerability to a US slowdown has been a primary downside risk<br>• However, the domestic rebound and commodity exports are positives<br>• BoC still cautious, but more tightening to come in 2011; CAD to gain<br>• We downgraded our s/term FX rating to *Neutral* on 9 September 2010 | Neutral | Overweight |

# Commodities short-term views

| Commodity | Short-term (1M) view | Comments |
|---|---|---|
| **Energy** | | |
| ***Crude oil (nearby future, USD/b)*** | | |
| NYMEX WTI | Bullish | Crude oil prices have dipped from recent highs on profit-taking.<br>The supply-demand balance remains relatively stable, with OPEC output under control.<br>Inventories fell in Q2 and Q3, tightening supplies.<br>We expect renewed investor confidence to push prices back into the USD 85-90 range. |
| ***Refined oil products (USD/b)*** | | |
| Singapore gasoil | Bullish | Gasoil shortages due to China's increased demand should keep prices supported in the near term.<br>China has turned to gasoil usage to reach emissions targets.<br>Shortfall in China demand should last until Chinese New Year in February 2011.<br>Increased refinery run rates in China and tapping of domestic reserves should prevent price surges. |
| Singapore fuel oil | Neutral | Bunker sales in Singapore for October remained healthy and steady at 3.55mt, up 13% y/y.<br>Supplies are expected to increase as a by-product of China's push to regain self-sufficiency in gasoil.<br>Bunker demand should stay steady in the 3.5mt range until end-2010. |
| **Agricultural products** | | |
| ***Softs (nearby future)*** | | |
| NYBOT cocoa, USD/tonne | Neutral | Cocoa prices have consolidated near 13-month lows after slumping significantly in July 2010.<br>Upside will now be limited by seasonally strong outflows from Côte d'Ivoire and Ghana.<br>Demand in the EU and the US is weak but should recover in 2011. |
| NYBOT coffee, USc/lb | Bullish | Coffee market has been boosted by inadequate supply of washed Arabicas.<br>Robust underlying demand is supportive.<br>Further gains are seen next year as Brazil enters its low-yielding crop year. |
| NYBOT sugar, USc/lb | Neutral | Prices have dropped after reaching record levels.<br>Potential exports from India are keeping the market in check.<br>The market should moderate as global output expands in 2011. |
| ***Fibres*** | | |
| NYBOT cotton, USc/lb | Bearish | Cotton prices have firmed considerably as a result of tightening global stocks.<br>New data reveals cotton demand in China was underestimated in 2009/10.<br>Profit-taking and the likelihood of expanded acreage in 2011 will tame the current rally. |
| ***Grains & oilseeds (nearby future, USc/bu)*** | | |
| CBOT corn (maize) | Neutral | Corn has benefited from downward revisions to the US corn crop.<br>Corn is now likely to gain acreage from soybeans in next year's plantings in the US.<br>An increase in corn for fuel use in the US will limit the downside in 2011. |
| CBOT soybeans | Bullish | Soybean prices have lagged corn in recent weeks.<br>Soybean futures need to firm to avoid losing too much acreage to corn in 2011.<br>The market will be supported by continuing firm demand from China. |
| CBOT wheat | Neutral | Prices have been boosted by lower-than-expected global supply.<br>Market should remain elevated until planting intentions in the US and Russia become clearer.<br>Firm grain prices should also provide near-term support. |

# Commodities short-term views (con'd)

| Commodity | Short-term (1M) view | Comments |
|---|---|---|
| **Metals** | | |
| ***Base metals (LME 3M, USD/tonne)*** | | |
| Aluminium | Bearish | LME stocks remain high, and a flattening forward curve represents downside risks to prices.<br>China's government has started to sell metal from its strategic stockpiles.<br>There is some support from cutbacks in Chinese smelter output due to power restrictions. |
| Copper | Bullish | Chilean mine production fell by 4% y/y in September.<br>LME stocks remain very low and have fallen in recent weeks.<br>But China's imports fell sharply in October due to high prices and substitution. |
| Lead | Bullish | We are approaching a period of strong demand because of the battery season.<br>Significant amounts of capacity are under threat in China due to power restrictions.<br>LME stocks have been rising but remain very low. |
| Nickel | Bearish | A strong ramp-up in supply remains likely because of less strike action and new capacity coming through.<br>LME stocks are already high and have been rising in recent weeks.<br>Demand is not strong enough to offset increased supply. |
| Tin | Neutral | Indonesia's exports rose by 24% y/y in October 2010.<br>LME stocks are now being rebuilt from low levels. |
| Zinc | Neutral | The LME price has corrected sharply in recent weeks, but fundamentals are supportive.<br>Smelter closures in China are keeping supply in check.<br>Global demand is improving from a low base. |
| ***Precious metals (spot, USD/oz)*** | | |
| Gold | Neutral | Indian demand is easing now that the Diwali festival is over.<br>Investor flows into physical ETFs have dried up for now.<br>USD weakness seems to have abated, with increased focus on European woes. |
| Palladium | Bullish | Inflows into physical ETFs remain strong as investors look for gold alternatives.<br>Demand is being boosted by China's strong car sales, which were up 27% y/y in October.<br>Higher shipments from Russia are possible, but not considered likely for now. |
| Platinum | Bullish | Investor interest in physical ETFs has been very strong in recent weeks.<br>Weak European car sales are a worry and were down 17% y/y in October.<br>South African PGM supply was up 5% y/y in Q3-2010. |
| Silver | Neutral | The market is likely to consolidate after recent sharp falls.<br>Gold and USD are struggling to find direction.<br>Gold-silver ratio shows that silver is still expensive relative to gold. |

# Forecasts – Economies

*Forecasts in BLUE (RED) indicate upward (downward) revisions over the past month*

| Country | Real GDP growth (%) | | | | Inflation (yearly average %) | | | | Current Account (% of GDP) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 | 2010 | 2011 | 2012 | 2013 | 2010 | 2011 | 2012 | 2013 |
| ***Majors*** | | | | | | | | | | | | |
| US^ | 2.6 | 1.9 | 2.7 | 3.0 | 0.9 | 0.5 | 1.0 | 1.5 | -3.5 | -3.6 | -3.8 | -4.0 |
| Euro area | 1.7 | 1.7 | 2.2 | 2.5 | 1.5 | 1.6 | 1.9 | 1.9 | -0.5 | -0.2 | -0.2 | -0.4 |
| Japan | 3.3 | 0.5 | 1.1 | 1.5 | -0.8 | -0.2 | 0.2 | 0.7 | 3.2 | 2.9 | 2.5 | 2.3 |
| UK | 1.8 | 1.4 | 1.9 | 2.3 | 3.1 | 3.1 | 1.9 | 1.9 | -1.7 | -1.6 | -1.4 | -1.6 |
| Canada | 3.0 | 2.2 | 2.5 | 3.0 | 1.6 | 2.1 | 2.5 | 2.5 | -2.4 | -2.2 | -2.0 | -1.8 |
| Switzerland | 2.7 | 2.2 | 2.4 | 2.8 | 0.5 | 0.0 | 1.0 | 1.3 | 12.5 | 11.0 | 10.5 | 10.7 |
| Australia | 3.2 | 3.4 | 3.8 | 3.8 | 3.0 | 3.4 | 3.9 | 4.1 | -3.7 | -3.6 | -3.2 | -2.8 |
| New Zealand | 1.7 | 2.0 | 3.0 | 3.0 | 2.3 | 3.9 | 2.4 | 2.9 | -3.5 | -4.0 | -5.0 | -5.0 |
| ***Asia**** | 8.1 | 6.8 | 7.4 | 6.8 | 3.8 | 4.7 | 3.6 | 3.5 | 3.3 | 3.2 | 3.2 | 3.3 |
| Bangladesh* | 5.5 | 6.0 | 6.6 | 6.9 | 7.3 | 6.8 | 6.3 | 5.0 | 3.7 | 0.8 | 0.3 | 0.0 |
| China | 10.0 | 8.5 | 9.0 | 8.0 | 3.2 | 5.5 | 3.0 | 3.0 | 5.5 | 5.8 | 5.8 | 5.9 |
| Hong Kong | 6.5 | 5.0 | 5.0 | 4.5 | 2.5 | 4.0 | 4.0 | 3.5 | 7.5 | 8.0 | 8.5 | 9.0 |
| India* | 8.1 | 8.5 | 8.8 | 9.0 | 8.2 | 5.0 | 4.5 | 4.5 | -3.5 | -3.0 | -2.0 | -1.8 |
| Indonesia | 6.0 | 6.5 | 7.0 | 7.0 | 5.0 | 6.0 | 6.2 | 5.0 | 0.9 | 0.5 | 0.5 | 0.0 |
| Malaysia | 6.8 | 5.1 | 6.0 | 5.0 | 1.7 | 3.4 | 2.5 | 2.5 | 17.0 | 15.0 | 15.5 | 16.5 |
| Pakistan* | 4.1 | 2.5 | 4.5 | 5.0 | 11.7 | 16.0 | 13.0 | 10.0 | -2.0 | -3.0 | -3.4 | -3.5 |
| Philippines | 7.2 | 5.4 | 6.0 | 6.0 | 3.8 | 4.3 | 5.4 | 5.8 | 6.5 | 6.1 | 5.5 | 4.2 |
| Singapore | 14.0 | 4.6 | 6.0 | 5.0 | 2.9 | 3.4 | 2.5 | 2.5 | 17.0 | 15.0 | 16.7 | 15.5 |
| South Korea | 6.1 | 4.0 | 5.2 | 4.6 | 2.9 | 2.8 | 3.0 | 3.0 | 3.0 | 2.0 | 1.0 | 1.0 |
| Sri Lanka | 6.8 | 7.1 | 7.5 | 8.0 | 5.7 | 6.5 | 7.0 | 7.2 | -6.0 | -3.5 | -2.5 | -2.0 |
| Taiwan | 9.7 | 4.6 | 6.0 | 4.6 | 1.0 | 2.2 | 2.2 | 1.8 | 9.6 | 8.4 | 7.5 | 7.0 |
| Thailand | 6.3 | 4.4 | 5.8 | 6.0 | 3.2 | 3.7 | 3.8 | 4.2 | 3.0 | 1.3 | 0.4 | -0.8 |
| Vietnam | 6.7 | 7.2 | 7.0 | 6.5 | 8.9 | 10.5 | 9.5 | 8.0 | -8.5 | -10.5 | -8.5 | -7.5 |
| ***Africa**** | 4.4 | 5.9 | 5.8 | 5.8 | 8.3 | 7.7 | 6.8 | 6.9 | 0.4 | 0.9 | 1.5 | 0.8 |
| Angola | 2.5 | 7.0 | 6.5 | 6.5 | 13.3 | 11.0 | 10.5 | 9.0 | 2.0 | 1.5 | 3.0 | 4.0 |
| Botswana | 7.9 | 4.9 | 5.4 | 3.2 | 6.9 | 5.1 | 5.6 | 5.9 | -0.5 | 1.5 | 3.5 | 6.0 |
| Cameroon | 2.6 | 2.9 | 3.2 | 3.5 | 3.0 | 2.7 | 2.5 | 2.5 | 1.6 | 1.3 | 1.4 | 1.2 |
| Côte d'Ivoire | 3.0 | 4.5 | 5.5 | 6.0 | 1.4 | 2.5 | 2.5 | 2.5 | 6.8 | 2.5 | 1.0 | -0.5 |
| The Gambia | 5.0 | 5.5 | 6.0 | 6.0 | 4.0 | 5.0 | 5.0 | 5.0 | -11.1 | -10.8 | -10.3 | -10.0 |
| Ghana | 6.5 | 12.3 | 8.0 | 7.7 | 10.9 | 9.6 | 10.3 | 8.9 | -19.0 | -13.0 | -7.0 | -6.0 |
| Kenya | 4.1 | 5.8 | 6.3 | 6.5 | 3.8 | 7.8 | 6.9 | 4.1 | -4.2 | -4.7 | -4.5 | -5.2 |
| Nigeria | 6.6 | 8.5 | 7.8 | 7.1 | 13.8 | 12.5 | 8.4 | 9.6 | 8.0 | 12.0 | 14.0 | 11.8 |
| Sierra Leone | 5.0 | 6.0 | 6.0 | 6.0 | 16.5 | 9.0 | 8.5 | 8.5 | -9.3 | -9.5 | -9.0 | -8.7 |
| South Africa | 3.0 | 3.6 | 3.8 | 4.4 | 4.3 | 4.3 | 5.1 | 5.2 | -3.5 | -4.9 | -5.3 | -5.8 |
| Tanzania | 6.5 | 6.7 | 7.5 | 7.7 | 6.9 | 4.0 | 6.2 | 5.4 | -8.8 | -9.1 | -8.7 | -7.8 |
| Uganda | 6.4 | 6.8 | 7.5 | 9.0 | 5.2 | 4.0 | 7.7 | 6.5 | -7.2 | -7.8 | -9.2 | -9.7 |
| Zambia | 6.6 | 5.8 | 6.4 | 7.0 | 8.9 | 10.5 | 7.8 | 8.5 | -2.4 | -3.9 | -6.7 | -6.9 |
| ***MENA**** | 3.6 | 4.0 | 4.1 | 4.5 | 5.5 | 6.1 | 5.7 | 5.5 | 6.0 | 6.9 | 7.2 | 7.4 |
| Algeria | 4.0 | 4.3 | 4.5 | 5.0 | 5.0 | 4.5 | 4.0 | 3.5 | 1.9 | 2.1 | 2.5 | 2.5 |
| Bahrain | 3.0 | 4.0 | 4.5 | 5.0 | 2.5 | 3.5 | 3.7 | 4.0 | 5.0 | 10.0 | 12.0 | 13.0 |
| Egypt* | 5.1 | 5.5 | 6.0 | 6.5 | 11.7 | 11.5 | 10.2 | 9.7 | -1.6 | -1.2 | -0.6 | 0.5 |
| Jordan | 2.3 | 3.5 | 4.0 | 4.5 | 5.0 | 4.6 | 4.2 | 3.5 | -7.1 | -7.6 | -7.8 | -8.3 |
| Kuwait | 3.0 | 3.5 | 4.0 | 4.5 | 3.5 | 4.0 | 3.7 | 3.4 | 26.0 | 27.0 | 28.0 | 27.0 |
| Lebanon | 7.0 | 6.5 | 6.0 | 6.0 | 5.0 | 5.3 | 5.4 | 5.5 | -16.0 | -15.0 | -14.5 | -14.0 |
| Libya | 5.0 | 5.3 | 5.0 | 4.8 | 3.0 | 3.5 | 4.0 | 4.3 | 30.0 | 35.0 | 38.0 | 40.0 |
| Morocco | 4.0 | 4.5 | 4.7 | 5.0 | 1.0 | 2.5 | 2.5 | 3.0 | -8.0 | -7.0 | -6.0 | -5.0 |
| Oman | 4.0 | 4.5 | 4.7 | 4.6 | 3.5 | 4.0 | 5.0 | 6.0 | 6.5 | 7.0 | 7.5 | 8.0 |
| Qatar | 8.0 | 5.0 | 4.0 | 4.0 | -5.0 | 2.0 | 3.0 | 3.5 | 16.0 | 22.0 | 20.0 | 20.0 |
| Saudi Arabia | 3.0 | 4.0 | 4.0 | 4.5 | 5.5 | 5.0 | 4.0 | 4.0 | 6.5 | 7.0 | 7.0 | 8.0 |
| Tunisia | 4.0 | 4.3 | 4.5 | 4.5 | 4.8 | 4.0 | 4.0 | 3.5 | -2.3 | -1.1 | -1.0 | -1.0 |
| Turkey | 8.0 | 5.8 | 5.5 | 6.2 | 8.5 | 6.7 | 6.0 | 5.5 | -5.0 | -5.5 | -6.0 | -6.0 |
| UAE | 3.0 | 4.0 | 3.0 | 4.0 | 2.0 | 3.0 | 2.0 | 2.0 | 5.5 | 6.0 | 7.0 | 7.0 |
| ***Latin America**** | 6.1 | 4.3 | 4.2 | 4.0 | 4.8 | 5.0 | 4.8 | 4.2 | -1.7 | -2.1 | -2.2 | -1.8 |
| Argentina | 8.2 | 5.0 | 3.5 | 5.0 | 10.0 | 9.2 | 8.5 | 6.0 | 1.0 | 0.5 | 0.5 | -1.0 |
| Brazil | 7.0 | 4.1 | 4.5 | 4.0 | 5.0 | 5.5 | 4.9 | 4.5 | -2.9 | -3.5 | -3.0 | -2.0 |
| Chile | 5.2 | 5.5 | 4.5 | 6.0 | 1.4 | 3.6 | 4.0 | 3.6 | 0.2 | -0.4 | 0.1 | -1.5 |
| Colombia | 4.1 | 4.5 | 4.8 | 5.0 | 2.2 | 3.1 | 4.0 | 3.8 | -2.5 | -2.6 | -2.0 | -1.5 |
| Mexico | 4.5 | 4.0 | 3.8 | 3.0 | 4.2 | 3.9 | 4.1 | 3.5 | -1.3 | -1.5 | -2.5 | -2.0 |
| Peru | 7.9 | 6.0 | 4.0 | 4.5 | 2.4 | 2.5 | 3.1 | 2.8 | 2.4 | 2.4 | -1.0 | -1.5 |
| ***Global**** | 3.8 | 2.9 | 3.4 | 3.4 | 2.3 | 2.5 | 2.3 | 2.4 | -- | -- | -- | -- |

** Fiscal year starts in April in India, March in Iran, July in Bangladesh, Pakistan, and Egypt*

Source: Standard Chartered Research

*** 2008 USD GDP weighted total of the regional economies covered in this publication*

*^ Inflation: Core PCE deflator used for US*

# Forecasts – Markets

*Forecasts in BLUE (RED) indicate upward (downward) revisions over the past month*

| | Exchange rate vs. USD | | | | | | Short-term interest rates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 25-Nov-10 | Q4-10 | Q1-11 | Q2-11 | Q3-11 | Q4-11 | 25-Nov-10 | Q4-10 | Q1-11 | Q2-11 | Q3-11 | Q4-11 |
| **Majors** | | | | | | | | | | | | |
| US^ | N.A. | N.A. | N.A. | N.A. | N.A. | N.A. | 0.25 (FFTR) | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| Euro area | 1.33 | **1.36** | **1.28** | **1.20** | **1.26** | **1.30** | 1.00 (Refi Rate) | 1.00 | 1.00 | 1.00 | 1.00 | 1.75 |
| Japan | 83.5 | 84.0 | 87.0 | 90.0 | 92.0 | 94.0 | 0.10 (O/N Call Rate) | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| UK | 1.58 | 1.60 | **1.53** | **1.45** | **1.48** | **1.52** | 0.50 (Bank Rate) | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Canada | 1.01 | **1.01** | 1.00 | 0.98 | 0.99 | 1.00 | 1.00 (O/N Lending Rate) | 1.00 | 1.00 | 1.00 | 1.50 | 2.00 |
| Switzerland | 1.00 | **0.97** | **1.02** | **1.10** | **1.08** | **1.07** | 0.25 (LIBOR Target) | 0.25 | **0.25** | **0.25** | **0.50** | **0.75** |
| Australia | 0.98 | 1.00 | 0.94 | 0.92 | 0.90 | 0.88 | 4.75 (OCR) | 5.00 | 5.00 | 5.25 | 5.50 | 5.50 |
| New Zealand | 0.76 | **0.79** | 0.74 | 0.73 | 0.72 | 0.70 | 3.00 (OCR) | 3.00 | 3.25 | 3.50 | 3.75 | 4.00 |
| **Asia** | | | | | | | | | | | | |
| Bangladesh* | 70.35 | 70.2 | 69.8 | 70.5 | 70.5 | 70.8 | 5.50 (RP) | 5.50 | 5.50 | 5.50 | 5.50 | 5.50 |
| China | 6.65 | **6.59** | **6.49** | **6.37** | **6.28** | **6.20** | 5.56 (1Y Base Lending) | **5.81** | **6.31** | **6.56** | **6.56** | **6.56** |
| Hong Kong | 7.76 | 7.76 | 7.76 | 7.76 | 7.76 | 7.76 | 0.33 (3M HIBOR) | **0.25** | **0.25** | **0.25** | **0.25** | **0.25** |
| India* | 45.75 | 45.50 | 44.00 | **45.80** | 44.20 | **43.00** | 6.25( Repo rate) | 6.25 | 6.25 | 6.25 | **6.50** | **6.75** |
| Indonesia | 8,960 | **8,900** | **8,900** | **9,100** | 8,800 | 8,500 | 6.50 (BI Rate) | 6.50 | **6.75** | 7.50 | 7.50 | 7.50 |
| Malaysia | 3.13 | **3.10** | **3.10** | 3.18 | 3.12 | **2.98** | 2.75 (OPR) | 2.75 | 3.00 | 3.50 | 3.50 | 3.50 |
| Pakistan* | 85.50 | **86.80** | **87.58** | **88.00** | **89.00** | **89.80** | 12.96 (6M KIBOR) | 13.90 | 14.80 | 14.80 | 14.80 | 14.80 |
| Philippines | 44.11 | 43.50 | 43.50 | 44.50 | 43.00 | **41.00** | 4.00 (RRP) | 4.00 | 4.25 | 4.50 | 4.75 | **5.25** |
| Singapore | 1.31 | **1.30** | 1.29 | 1.32 | 1.28 | **1.23** | 0.50 (3M SIBOR) | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| South Korea | 1,144 | 1,120 | **1,075** | **1,100** | 1,050 | 1,025 | 2.50 (Base Rate) | **2.50** | **2.50** | **3.00** | **3.25** | **3.50** |
| Sri Lanka | 111.22 | **111.5** | **111.0** | **111.6** | **110.9** | **110.2** | 7.25 (RP) | 7.25 | **7.25** | **7.25** | **7.75** | **7.75** |
| Taiwan | 30.42 | **30.30** | **29.60** | **29.90** | **29.10** | **28.75** | 1.50 (Discount Rate) | 1.63 | 1.75 | 1.88 | 2.00 | 2.13 |
| Thailand | 30.04 | **30.00** | **30.25** | **31.50** | 30.20 | **29.00** | 1.75 (1-day Repo) | 1.75 | 1.75 | 1.75 | 1.75 | 2.25 |
| Vietnam | 19,480 | 19,900 | 20,000 | 20,400 | 20,500 | 20,800 | 9.00 (Base Rate) | **9.00** | **9.00** | **10.00** | **11.00** | **11.00** |
| **Africa** | | | | | | | | | | | | |
| Angola | 92.0 | 93.0 | 93.5 | 93.4 | 93.1 | 93.0 | 20.3 (91-day T-bill) | 18.50 | 18.50 | 18.00 | 18.00 | 18.00 |
| Botswana | 6.69 | **6.44** | **6.51** | **6.67** | **6.82** | **6.73** | 10.0% (Bank Rate) | 10.00 | 10.00 | 10.00 | 10.00 | 10.50 |
| Cameroon | 492 | **469** | **497** | **525** | **512** | **497** | 4.00 (TIAO) | 4.00 | 4.00 | 4.00 | 4.00 | 4.25 |
| Côte d'Ivoire | 492 | **469** | **497** | **525** | **512** | **497** | 4.25 (Discount Rate) | 4.25 | 4.25 | 4.25 | 4.25 | 4.25 |
| The Gambia | 27.00 | 30.50 | 29.75 | 30.40 | 31.00 | **31.50** | 9.93 (91-day T-bill) | 9.70 | 10.00 | 10.00 | 10.00 | 10.00 |
| Ghana | 0.93 | 1.45 | 1.44 | 1.42 | 1.38 | 1.37 | 12.68 (91-day T-bill) | 11.50 | 10.70 | 10.30 | 9.90 | 9.60 |
| Kenya | 80.30 | 80.5 | 79.8 | 79.5 | 79.4 | 79.0 | 2.20(91-day T-bill) | 2.40 | 2.80 | 3.00 | 3.60 | 4.20 |
| Nigeria | 150.6 | **152** | **154** | **154** | **152** | **150** | 6.25% (MPR) | 6.25 | 6.50 | 7.00 | 7.50 | 8.00 |
| Sierra Leone | 4,150 | **4,250** | **4,270** | **4,300** | **4,320** | **4,350** | 16.67 (91-day T-bill) | **22.00** | **20.50** | **20.00** | **18.50** | **18.00** |
| South Africa | 7.06 | 6.70 | 6.80 | 7.00 | 7.20 | 7.10 | 5.50 (Repo Rate) | **5.50** | **5.50** | **5.50** | **5.50** | **5.50** |
| Tanzania | 1,485 | 1,500 | 1,520 | 1,480 | 1,530 | 1,550 | 2.51 (91-day T-bill) | **5.60** | 5.20 | 6.20 | 5.80 | 6.00 |
| Uganda | 2,285 | 2,260 | 2,280 | 2,220 | 2,260 | 2,300 | 4.68 (91-day T-bill) | **6.65** | **5.50** | 5.60 | 5.40 | 5.80 |
| Zambia | 4,720 | **4,700** | **4,600** | **4,400** | 4,600 | 4,500 | 5.56 (91-day T-bill) | 5.90 | 6.40 | 6.70 | 7.00 | 7.30 |
| **Middle East and North Africa** | | | | | | | | | | | | |
| Algeria | 72.76 | 73.00 | 73.50 | **73.20** | **72.50** | **72.15** | 3.28 (Interbank Rate) | **3.53** | **3.55** | **3.50** | **3.50** | **3.50** |
| Bahrain | 0.38 | 0.38 | 0.38 | 0.38 | 0.38 | 0.38 | 0.50 (1-wk Deposit Rate) | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Egypt* | 5.77 | **5.71** | **5.75** | **5.70** | **5.68** | **5.71** | 8.25 (O/N Depo Rate) | 8.25 | 8.25 | 8.50 | 8.50 | 8.50 |
| Jordan | 0.71 | 0.71 | 0.71 | 0.71 | 0.71 | 0.71 | 4.00 (Repo Rate) | **4.00** | **4.00** | **4.00** | **4.00** | **4.00** |
| Kuwait | 0.28 | **0.28** | **0.28** | **0.28** | **0.29** | **0.29** | 2.50 (Discount Rate) | **2.50** | **2.50** | **2.50** | **2.50** | **2.50** |
| Lebanon | 1,498 | **1,500** | **1,500** | **1,500** | **1,500** | **1,500** | … | … | … | … | … | … |
| Libya | 1.25 | **1.23** | **1.24** | **1.25** | **1.26** | 1.29 | … | … | … | … | … | … |
| Morocco | 8.38 | **8.20** | **8.20** | **8.40** | **8.47** | **8.53** | 3.25 (Discount Rate) | **3.25** | **3.25** | **3.25** | **3.25** | **3.25** |
| Oman | 0.38 | 0.39 | 0.39 | 0.39 | 0.39 | 0.39 | 2.00 (Repo Rate) | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| Qatar | 3.64 | 3.64 | 3.64 | 3.64 | 3.64 | 3.64 | 1.50 (O/N Deposit Rate) | **1.00** | **1.00** | **1.00** | **1.00** | **1.00** |
| Saudi Arabia | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 0.25 (Reverse Repo Rate) | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| Tunisia | 1.43 | **1.39** | **1.40** | **1.43** | **1.44** | 1.45 | 4.50 (TAO) | 4.50 | 4.50 | **4.50** | **4.50** | **4.50** |
| Turkey | 1.48 | **1.41** | **1.49** | **1.55** | **1.51** | **1.48** | 7.00 (1-week repo) | 7.00 | 7.00 | 7.00 | 7.00 | 8.00 |
| UAE | 3.67 | 3.67 | 3.67 | 3.67 | 3.67 | 3.67 | 1.00 (Repo Rate) | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| **Latin America** | | | | | | | | | | | | |
| Argentina | 3.97 | **3.98** | **4.02** | **4.05** | **4.07** | **4.05** | 9.50 (7d Rev Repo) | **9.50** | **9.50** | **10.00** | **10.00** | **10.00** |
| Brazil | 1.72 | **1.70** | **1.78** | **1.80** | 1.78 | 1.70 | 10.75 (Selic) | 10.75 | 11.25 | 11.50 | 11.50 | 11.50 |
| Chile | 482 | 485 | **495** | **500** | 475 | **465** | 3.00 (Overnight Rate) | **3.25** | **3.50** | **3.75** | **4.00** | **4.25** |
| Colombia | 1,891 | **1,870** | **1,970** | **1,950** | 1,840 | 1,790 | 3.00 (Min Rev Repo) | **3.00** | **3.25** | **3.50** | **3.75** | **4.00** |
| Mexico | 12.37 | **12.35** | 12.25 | 12.60 | **12.20** | 12.10 | 4.50 (TdF) | 4.50 | 4.50 | 4.50 | **4.50** | **4.50** |
| Peru | 2.81 | **2.81** | **2.83** | 2.78 | 2.77 | 2.76 | 3.00 (Reference Rate) | **3.00** | **3.50** | **3.75** | **4.00** | **4.25** |

*Forecasts are for end of period*

Source: Standard Chartered Research

# Forecasts – Commodities

*Forecasts in BLUE (RED) indicate upward (downward) revisions over the past month*

| | Market close | m/m | Change YTD | y/y | Q3-10 | Q4-10 | Q1-11 | Q2-11 | Q3-11 | Q4-11 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 24-11-10 | % | % | % | A | F | F | F | F | F | A | F | F | F |
| **Energy** | | | | | | | | | | | | | | |
| ***Crude oil (near future, USD/b)*** | | | | | | | | | | | | | | |
| NYMEX WTI | 83.9 | +1.8 | +5.9 | +7.8 | 76 | 85 | 87 | 89 | 92 | 93 | 62 | 80 | 90 | 95 |
| ICE Brent | 85.8 | +3.0 | +10.4 | +9.7 | 77 | 87 | 88 | 90 | 93 | 94 | 63 | 80 | 91 | 95 |
| Dubai spot | 83.3 | +3.0 | +6.4 | +8.4 | 74 | 85 | 86 | 88 | 90 | 92 | 62 | 78 | 89 | 93 |
| ***Refined oil products cracks and spreads*** | | | | | | | | | | | | | | |
| Singapore naphtha (USD/b) | 3.7 | -7.3 | +33.2 | -1410.7 | -1.8 | 3.0 | 2.0 | 1.0 | -2.0 | 2.0 | -0.9 | 1.0 | 0.8 | 0.5 |
| Singapore jet kerosene (USD/b) | 14.3 | -3.0 | +52.2 | +87.5 | 12.9 | 14.0 | 13.8 | 14.2 | 14.4 | 14.4 | 8.3 | 12.0 | 14.2 | 14.5 |
| Singapore gasoil (USD/b) | 13.0 | +0.3 | +91.2 | +121.3 | 12.4 | 13.5 | 13.0 | 13.3 | 14.0 | 14.1 | 7.3 | 11.6 | 13.6 | 13.5 |
| Singapore regrade (USD/b) | 1.3 | -27.0 | -49.8 | -25.7 | 0.5 | 0.5 | 0.8 | 0.9 | 0.4 | 0.3 | 0.9 | 0.5 | 0.6 | 1.0 |
| Singapore fuel oil 180 (USD/t) | -7.1 | +8.4 | +231.9 | +42.2 | -4.8 | -6.5 | -7.0 | -5.5 | -6.5 | -6.0 | -4.6 | -5.3 | -6.3 | -6.2 |
| ***Coal (USD/t)*** | | | | | | | | | | | | | | |
| API4 | 104.3 | +7.3 | +27.2 | +52.2 | 89 | 95 | 102 | 94 | 102 | 106 | 65 | 90 | 101 | 111 |
| API2 | 106.8 | +4.8 | +27.0 | +36.3 | 93 | 95 | 103 | 98 | 104 | 108 | 70 | 88 | 103 | 113 |
| globalCOAL NEWC* | 108.5 | +9.5 | +28.0 | +31.9 | 94 | 105 | 115 | 108 | 115 | 125 | 72 | 98 | 116 | 128 |
| **Metals** | | | | | | | | | | | | | | |
| ***Base metals (LME 3m, USD/tonne)*** | | | | | | | | | | | | | | |
| Aluminium | 2,259 | -4.4 | +1.7 | +10.8 | 2,108 | 2,300 | 2,300 | 2,200 | 2,100 | 2,250 | 1,706 | 2,184 | 2,213 | 2,300 |
| Copper | 8,250 | -3.0 | +12.0 | +18.3 | 7,282 | 8,300 | 8,100 | 8,300 | 8,400 | 8,700 | 5,207 | 7,482 | 8,375 | 8,750 |
| Lead | 2,223 | -13.0 | -7.5 | -5.9 | 2,064 | 2,400 | 2,400 | 2,450 | 2,550 | 2,600 | 1,740 | 2,170 | 2,500 | 2,650 |
| Nickel | 22,500 | -3.8 | +22.5 | +33.4 | 21,269 | 22,000 | 21,500 | 21,500 | 22,500 | 22,500 | 14,762 | 21,489 | 22,000 | 23,000 |
| Tin | 24,300 | -10.0 | +42.8 | +60.8 | 20,561 | 25,500 | 24,000 | 24,500 | 25,000 | 26,000 | 13,412 | 20,307 | 24,875 | 25,000 |
| Zinc | 2,122 | -16.8 | -16.7 | -7.6 | 2,043 | 2,300 | 2,300 | 2,350 | 2,400 | 2,450 | 1,690 | 2,180 | 2,375 | 2,400 |
| ***Steel** (CRU assessment, USD/t)*** | | | | | | | | | | | | | | |
| HRC, US | 573 | -9.0 | -6.4 | +0.2 | 642 | 623 | 626 | 638 | 642 | 659 | 531 | 667 | 641 | 705 |
| HRC, Europe | 680 | -8.0 | +19.7 | +8.3 | 722 | 729 | 740 | 755 | 763 | 780 | 569 | 692 | 760 | 828 |
| HRC, Japan | 795 | -6.4 | +14.4 | +7.9 | 848 | 852 | 861 | 887 | 895 | 907 | 757 | 800 | 888 | 941 |
| HRC, China | 662 | +1.1 | +13.6 | +29.0 | 634 | 640 | 649 | 669 | 682 | 703 | 528 | 628 | 676 | 703 |
| ***Precious metals (spot, USD/oz)*** | | | | | | | | | | | | | | |
| Gold (spot) | 1,373 | +2.4 | +25.1 | +15.1 | 1,228 | 1,350 | 1,300 | 1,375 | 1,475 | 1,450 | 974 | 1,221 | 1,400 | 1,200 |
| Palladium (spot) | 697 | +14.0 | +70.5 | +86.4 | 496 | 650 | 550 | 600 | 625 | 675 | 265 | 521 | 613 | 800 |
| Platinum (spot) | 1,662 | -2.5 | +12.9 | +12.4 | 1,555 | 1,750 | 1,700 | 1,800 | 1,900 | 2,000 | 1,210 | 1,625 | 1,850 | 2,050 |
| Silver (spot) | 27.6 | +16.1 | +62.7 | +45.6 | 20.0 | 25.0 | 24.0 | 26.0 | 27.0 | 26.5 | 14.7 | 20.0 | 26.0 | 22.0 |
| **Agricultural products** | | | | | | | | | | | | | | |
| ***Softs (near future)*** | | | | | | | | | | | | | | |
| NYBOT cocoa, USD/tonne | 2,765 | -2.8 | -15.9 | -13.7 | 2,861 | 2,800 | 2,900 | 2,950 | 3,100 | 2,900 | 2,797 | 2,932 | 2,963 | 3,206 |
| LIFFE coffee, USD/tonne *** | 1,813 | -2.8 | +40.1 | +38.0 | 1,678 | 1,800 | 1,700 | 1,675 | 1,625 | 1,500 | 1,462 | 1,536 | 1,625 | 1,344 |
| NYBOT coffee, USc/lb | 207 | +4.2 | +52.4 | +52.3 | 174 | 195 | 205 | 220 | 200 | 180 | 125 | 161 | 201 | 161 |
| NYBOT sugar, USc/lb | 28.0 | -1.0 | +3.7 | +26.6 | 20.1 | 25.0 | 23.0 | 20.0 | 18.0 | 18.0 | 18.0 | 21.0 | 20.0 | 17.0 |
| ***Fibres*** | | | | | | | | | | | | | | |
| NYBOT cotton No.2, USc/lb | 119.4 | -0.3 | +57.9 | +66.9 | 88 | 130 | 125 | 120 | 115 | 115 | 57 | 94 | 119 | 109 |
| ***Grains & oilseeds (nr future)*** | | | | | | | | | | | | | | |
| CBOT corn (maize), USc/bushel | 539 | -3.8 | +30.0 | +43.3 | 421 | 550 | 535 | 535 | 525 | 549 | 374 | 424 | 536 | 526 |
| CBOT Soybeans, USc/bushel | 1,255 | +4.6 | +20.7 | +20.0 | 1,034 | 1,300 | 1,350 | 1,400 | 1,500 | 1,500 | 1,031 | 1,062 | 1,438 | 1,200 |
| CBOT wheat, USc/bushel | 648 | -3.5 | +19.6 | +21.5 | 651.0 | 685 | 675 | 650 | 605 | 605 | 529.8 | 575 | 634 | 575 |
| CBOT rice, USc/cwt | 13.6 | -4.7 | -6.9 | -11.2 | 10.9 | 13.0 | 12.5 | 12.0 | 11.0 | 10.0 | 13.3 | 12.0 | 11.0 | 11.0 |
| Thai B rice 100%, USD/tonne* | 530 | +5.0 | -10.2 | -6.2 | 473 | 470 | 490 | 490 | 480 | 475 | 562 | 491 | 484 | 464 |
| ***Edible oils (3m future)*** | | | | | | | | | | | | | | |
| Palm oil (MDV, MYR/tonne) | 3,372 | +9.7 | +30.8 | +37.4 | 2,554 | 3,050 | 3,350 | 3,400 | 3,500 | 3,750 | 2,228 | 2,662 | 3,500 | 3,425 |
| Soyoil (CBOT, USc/lb) | 50 | +4.0 | +24.5 | +26.5 | 40 | 47 | 52 | 53 | 55 | 60 | 35 | 41 | 55 | 54 |

**weekly quote **monthly average ***10 tonne contract*

Source: Standard Chartered Research

# Forecasts – Interbank rates

*Forecasts in BLUE (RED) indicate upward (downward) revisions over the past month*

| | Q3-10A | Q4-10 | Q1-11 | Q2-11 | Q3-11 | Q4-11 |
|---|---|---|---|---|---|---|
| **US** | | | | | | |
| 3M USD LIBOR | 0.29 | 0.30 | 0.30 | 0.30 | 0.30 | **0.30** |
| 6M USD LIBOR | 0.46 | 0.40 | 0.40 | 0.40 | 0.40 | **0.40** |
| 12M USD LIBOR | 0.78 | **0.70** | **0.70** | **0.70** | **0.70** | **0.70** |
| **Euro area** | | | | | | |
| 3M EUR LIBOR | 0.89 | **1.00** | **1.15** | **1.30** | **1.50** | 2.20 |
| 6M EUR LIBOR | 1.16 | **1.25** | **1.40** | **1.55** | **1.75** | 2.45 |
| 12M EUR LIBOR | 1.45 | **1.50** | **1.65** | **1.85** | **2.10** | 2.85 |
| **Japan** | | | | | | |
| 3M JPY LIBOR | 0.22 | 0.30 | 0.35 | 0.36 | 0.38 | 0.40 |
| 6M JPY LIBOR | 0.43 | 0.45 | 0.48 | 0.39 | 0.50 | 0.52 |
| 12M JPY LIBOR | 0.66 | 0.67 | 0.70 | 0.70 | 0.70 | 0.75 |
| **UK** | | | | | | |
| 3M GBP LIBOR | 0.74 | 0.75 | 0.75 | 0.80 | 0.85 | 0.90 |
| 6M GBP LIBOR | 1.03 | 1.05 | 1.10 | 1.15 | 1.20 | 1.25 |
| 12M GBP LIBOR | 1.47 | 1.50 | 1.60 | 1.85 | 1.90 | 1.90 |
| **Canada** | | | | | | |
| 3M CAD LIBOR | 1.25 | 1.25 | 1.25 | 1.25 | 1.75 | 2.25 |
| 6M CAD LIBOR | 1.43 | 1.50 | 1.50 | 1.50 | 2.00 | 2.50 |
| 12M CAD LIBOR | 1.92 | 1.85 | 1.75 | 1.75 | 2.25 | 2.75 |
| **Switzerland** | | | | | | |
| 3M CHF LIBOR target | 0.26 | 0.25 | **0.25** | **0.25** | **0.50** | **0.75** |
| 6M CHF LIBOR | 0.30 | 0.40 | **0.45** | **0.60** | **0.70** | **1.15** |
| 12M CHF LIBOR | 0.55 | **0.60** | **0.65** | **0.85** | **1.00** | **1.45** |
| **Australia** | | | | | | |
| 3M AUD LIBOR | 4.87 | 5.40 | 5.50 | 5.80 | 6.05 | 6.00 |
| 6M AUD LIBOR | 5.09 | 5.60 | 5.70 | 6.00 | 6.30 | 6.25 |
| 12M AUD LIBOR | 5.65 | 5.80 | 5.90 | 6.20 | 6.50 | 6.45 |
| **New Zealand** | | | | | | |
| 3M NZD LIBOR | 3.31 | 3.40 | 3.65 | 3.90 | 4.15 | 4.45 |
| 6M NZD LIBOR | 3.55 | 3.60 | 3.85 | 4.15 | 4.35 | 4.65 |
| 12M NZD LIBOR | 4.10 | 4.30 | 4.55 | 4.85 | 5.15 | 5.45 |
| **Hong Kong** | | | | | | |
| 3M HKD HIBOR | 0.34 | **0.25** | **0.25** | **0.25** | **0.25** | **0.25** |
| 6M HKD HIBOR | 0.45 | **0.35** | **0.35** | **0.35** | **0.35** | **0.35** |
| 12M HKD HIBOR | 0.80 | **0.65** | **0.65** | **0.65** | **0.65** | **0.65** |
| **Korea** | | | | | | |
| 3M CD rate | 2.66 | **2.90** | **2.90** | **3.40** | **3.60** | **3.80** |
| **Indonesia** | | | | | | |
| 3M JIBOR | 6.92 | 7.00 | **7.30** | **8.20** | **8.00** | 7.80 |
| 6M JIBOR | 7.13 | 7.30 | **7.60** | **8.50** | **8.30** | 8.10 |
| 12M JIBOR | 7.33 | 7.60 | **8.00** | **8.80** | **8.60** | 8.40 |
| **Malaysia** | | | | | | |
| 3M KLIBOR | 2.93 | 2.85 | 3.10 | 3.60 | 3.60 | 3.60 |
| 6M KLIBOR | 2.97 | 2.90 | 3.15 | 3.65 | 3.65 | 3.65 |
| 12M KLIBOR | 3.08 | 3.05 | 3.30 | 3.80 | 3.80 | 3.80 |
| **Singapore** | | | | | | |
| 3M SGD SIBOR | 0.51 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| 6M SGD SIBOR | 0.63 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 |
| 12M SGD SIBOR | 0.85 | 0.90 | 0.90 | 0.90 | 0.90 | 1.00 |
| **Thailand** | | | | | | |
| 3M BIBOR | 1.91 | 1.95 | 2.00 | 2.10 | 2.15 | 2.45 |
| 6M BIBOR | 2.00 | 2.10 | 2.15 | 2.25 | 2.35 | 2.50 |
| 12M BIBOR | 2.15 | 2.15 | 2.20 | 2.30 | 2.40 | 2.55 |
| **South Africa** | | | | | | |
| 3M JIBAR | 6.05 | **5.54** | **5.52** | **5.58** | **5.70** | **5.94** |
| 6M JIBAR | 6.22 | **5.68** | **5.72** | **5.80** | **5.92** | **6.30** |
| 12M JIBAR | 6.44 | **5.90** | **5.93** | **6.18** | **6.27** | **6.66** |
| **Turkey** | | | | | | |
| 3M TRLIBOR | 7.25 | 7.25 | 7.25 | 7.30 | 8.00 | 8.60 |
| 6M TRLIBOR | 7.75 | 7.75 | 7.75 | 7.80 | 8.50 | 9.10 |
| 12M TRLIBOR | 8.16 | 8.20 | 8.20 | 8.30 | 8.80 | 9.80 |

Source: Standard Chartered Research

# Forecasts – Rates

*Forecasts in BLUE (RED) indicate upward (downward) revisions over the past month*

| Country | Government bonds | | | | | | Swaps | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 18-Nov-10 | Q4-10 | Q1-11 | Q2-11 | Q3-11 | Q4-11 | 18-Nov-10 | Q4-10 | Q1-11 | Q2-11 | Q3-11 | Q4-11 |
| **Asia** | | | | | | | | | | | | |
| ***China*** | | | | | | | *Interest Rate Swap (against 7-Day repo), Act/365, Quarterly* | | | | | |
| **2Y** | 2.68 | 2.70 | 2.90 | 3.10 | 3.20 | 3.30 | 3.05 | 3.00 | 3.20 | 3.35 | 3.40 | 3.45 |
| **5Y** | 3.57 | 3.25 | 3.40 | 3.55 | 3.70 | 3.80 | 3.78 | 3.80 | 3.95 | 4.10 | 4.20 | 4.30 |
| **10Y** | 3.80 | 3.80 | 3.90 | 4.00 | 4.10 | 4.20 | 4.18 | 4.20 | 4.30 | 4.40 | 4.40 | 4.30 |
| ***Hong Kong*** | | | | | | | *Interest Rate Swap, Act/365, Quarterly* | | | | | |
| **2Y** | 0.51 | 0.55 | 0.60 | 0.70 | 0.90 | 1.20 | 0.61 | 0.70 | 0.80 | 1.00 | 1.20 | 1.50 |
| **5Y** | 1.29 | 1.00 | 1.00 | 1.10 | 1.20 | 1.35 | 1.62 | 1.45 | 1.45 | 1.60 | 1.70 | 1.80 |
| **10Y** | 2.39 | 1.85 | 1.80 | 1.90 | 2.15 | 2.30 | 2.79 | 2.25 | 2.20 | 2.30 | 2.40 | 2.50 |
| ***India*** | | | | | | | *Overnight Index Swap, Act/365, Semi-Annual* | | | | | |
| **2Y** | 7.21 | 7.25 | 7.00 | 7.00 | 7.25 | 7.50 | 6.75 | 6.75 | 6.50 | 6.50 | 6.75 | 7.00 |
| **5Y** | 7.85 | 7.75 | 7.50 | 7.50 | 7.75 | 8.00 | 7.28 | 7.25 | 7.00 | 7.00 | 7.25 | 7.50 |
| **10Y** | 8.07 | 8.00 | 7.75 | 7.75 | 8.00 | 8.25 | | | | | | |
| ***Indonesia*** | | | | | | | *Interest Rate Swap, Act/360, Semi-Annual* | | | | | |
| **3Y** | 5.93 | 5.85 | 6.00 | 6.50 | 6.85 | 6.75 | 7.30 | 7.15 | 7.25 | 7.45 | 7.20 | 7.00 |
| **5Y** | 6.40 | 6.15 | 6.25 | 6.70 | 7.00 | 6.90 | 7.75 | 7.45 | 7.55 | 7.75 | 7.40 | 7.15 |
| **10Y** | 7.86 | 7.00 | 7.50 | 7.65 | 7.75 | 7.60 | | | | | | |
| ***Malaysia*** | | | | | | | *Interest Rate Swap, Act/365, Quarterly* | | | | | |
| **3Y** | 3.19 | 3.10 | 3.35 | 3.70 | 3.70 | 3.75 | 3.44 | 3.35 | 3.60 | 3.90 | 3.90 | 3.95 |
| **5Y** | 3.26 | 3.25 | 3.50 | 3.85 | 3.85 | 3.90 | 3.83 | 3.80 | 4.00 | 4.30 | 4.25 | 4.25 |
| **10Y** | 3.87 | 3.65 | 3.85 | 4.15 | 4.15 | 4.20 | 4.45 | 4.25 | 4.40 | 4.65 | 4.65 | 4.70 |
| ***Pakistan*** | | | | | | | | | | | | |
| **3Y** | 13.64 | 14.40 | 15.20 | 15.10 | 15.00 | 15.00 | | | | | | |
| **5Y** | 13.73 | 14.60 | 15.40 | 15.30 | 15.20 | 15.10 | *See Note 1.* | | | | | |
| **10Y** | 13.83 | 14.70 | 15.50 | 15.40 | 15.30 | 15.20 | | | | | | |
| ***Philippines*** | | | | | | | *Interest Rate Swap, Act/360, Quarterly* | | | | | |
| **2Y** | 4.05 | 4.20 | 4.40 | 4.70 | 4.95 | 5.20 | 2.98 | 3.15 | 3.40 | 3.80 | 4.10 | 4.40 |
| **5Y** | 4.60 | 4.50 | 4.70 | 4.90 | 5.10 | 5.30 | 3.90 | 3.80 | 3.95 | 4.10 | 4.20 | 4.30 |
| **10Y** | 5.60 | 5.80 | 5.85 | 6.05 | 6.20 | 6.30 | | | | | | |
| ***Singapore*** | | | | | | | *Interest Rate Swap, Act/365, Semi-Annual* | | | | | |
| **2Y** | 0.50 | 0.40 | 0.40 | 0.40 | 0.60 | 0.70 | 0.86 | 0.80 | 0.90 | 1.00 | 1.30 | 1.50 |
| **5Y** | 1.24 | 0.70 | 0.70 | 0.70 | 0.75 | 0.90 | 1.75 | 1.20 | 1.30 | 1.35 | 1.50 | 1.70 |
| **10Y** | 2.19 | 2.05 | 2.05 | 2.10 | 2.20 | 2.30 | 2.76 | 2.60 | 2.60 | 2.60 | 2.70 | 2.80 |
| ***South Korea*** | | | | | | | *Interest Rate Swap, Act/365, Quarterly* | | | | | |
| **3Y** | 3.35 | 3.40 | 3.50 | 3.80 | 3.90 | 4.10 | 3.61 | 3.50 | 3.55 | 3.75 | 3.80 | 3.95 |
| **5Y** | 3.99 | 4.00 | 4.15 | 4.35 | 4.45 | 4.60 | 3.84 | 3.95 | 4.00 | 4.15 | 4.15 | 4.25 |
| **10Y** | 4.44 | 4.40 | 4.55 | 4.70 | 4.85 | 5.00 | 4.14 | 4.20 | 4.30 | 4.35 | 4.45 | 4.50 |
| ***Taiwan*** | | | | | | | *Interest Rate Swap, Act/365, Quarterly* | | | | | |
| **2Y** | 0.65 | 0.60 | 0.70 | 0.90 | 1.15 | 1.25 | 0.94 | 1.30 | 1.50 | 1.65 | 1.80 | 1.85 |
| **5Y** | 1.03 | 1.00 | 1.00 | 1.10 | 1.25 | 1.40 | 1.46 | 1.20 | 1.30 | 1.45 | 1.60 | 1.80 |
| **10Y** | 1.34 | 1.10 | 1.10 | 1.30 | 1.45 | 1.60 | 1.74 | 1.45 | 1.45 | 1.60 | 1.70 | 1.90 |
| ***Thailand*** | | | | | | | *Interest Rate Swap, Act/365, Semi-Annual* | | | | | |
| **2Y** | 2.42 | 2.45 | 2.50 | 2.60 | 2.75 | 3.00 | 1.83 | 1.90 | 2.15 | 2.50 | 2.85 | 3.20 |
| **5Y** | 2.96 | 3.00 | 3.10 | 3.20 | 3.30 | 3.50 | 2.88 | 2.95 | 3.15 | 3.30 | 3.50 | 3.75 |
| **10Y** | 3.64 | 3.60 | 3.70 | 3.80 | 3.40 | 4.10 | 3.61 | 3.60 | 3.75 | 3.90 | 3.55 | 4.30 |
| ***Vietnam*** | | | | | | | | | | | | |
| **2Y** | 11.20 | 11.25 | 11.25 | 12.00 | 11.75 | 11.50 | | | | | | |
| **5Y** | 11.75 | 11.50 | 11.50 | 12.25 | 12.00 | 11.75 | *See Note 1.* | | | | | |
| **10Y** | 11.75 | 11.50 | 11.50 | 12.25 | 12.00 | 11.75 | | | | | | |

*Note 1: Forecasts are not available, as these financial instruments are at a nascent stage of development.*

Source: Standard Chartered Research

# Forecasts – Rates (con’d)

*Forecasts in BLUE (RED) indicate upward (downward) revisions over the past month*

| Country | Government bonds | | | | | | Swaps | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 18-Nov-10 | Q4-10 | Q1-11 | Q2-11 | Q3-11 | Q4-11 | 18-Nov-10 | Q4-10 | Q1-11 | Q2-11 | Q3-11 | Q4-11 |
| **Majors** | | | | | | | | | | | | |
| ***United States*** | | | | | | | *Interest Rate Swap, 30/360, Semi-Annual* | | | | | |
| **2Y** | 0.49 | 0.60 | 0.60 | 1.10 | 1.30 | 1.60 | 0.67 | 0.80 | 0.85 | 1.30 | 1.50 | 1.70 |
| **5Y** | 1.47 | 1.50 | 1.50 | 1.60 | 1.70 | 2.10 | 1.71 | 1.65 | 1.65 | 1.75 | 1.85 | 2.25 |
| **10Y** | 2.88 | 2.75 | 2.75 | 2.80 | 2.80 | 2.90 | 3.01 | 2.85 | 2.85 | 2.90 | 2.90 | 3.00 |
| **Africa** | | | | | | | | | | | | |
| ***Ghana*** | | | | | | | | | | | | |
| **2Y** | 13.00 | 13.50 | 13.25 | 12.50 | 12.00 | 12.00 | | | | | | |
| **3Y** | 13.00 | 13.25 | 13.00 | 12.75 | 12.25 | 12.25 | *See Note 1.* | | | | | |
| ***Kenya*** | | | | | | | | | | | | |
| **2Y** | 4.00 | 4.00 | 4.50 | 5.00 | 5.30 | 5.60 | | | | | | |
| **5Y** | 5.25 | 4.50 | 4.80 | 5.20 | 5.50 | 5.90 | *See Note 1.* | | | | | |
| **10Y** | 7.20 | **7.20** | **7.00** | **7.10** | **7.20** | 7.30 | | | | | | |
| ***Nigeria*** | | | | | | | | | | | | |
| **2Y** | 9.67 | **9.00** | **10.00** | **10.50** | **11.00** | **11.50** | | | | | | |
| **5Y** | 11.89 | **11.80** | **12.30** | **12.60** | **13.00** | **13.20** | *See Note 1.* | | | | | |
| **10Y** | 8.31 | 9.20 | 9.30 | 9.50 | 9.80 | 9.90 | | | | | | |
| ***South Africa*** | | | | | | | *Interest Rate Swap, Act/365, Quarterly* | | | | | |
| **2Y** | 6.23 | 6.30 | 6.50 | 6.80 | 7.10 | 7.50 | 5.92 | 6.20 | 6.40 | 6.70 | 7.00 | 7.40 |
| **5Y** | 7.12 | 6.90 | 7.10 | 7.30 | 7.50 | 7.70 | 6.83 | 6.80 | 7.00 | 7.20 | 7.40 | 7.60 |
| **10Y** | 7.97 | 7.60 | 7.80 | 8.10 | 8.40 | 8.70 | 7.37 | 7.15 | 7.30 | 7.50 | 7.90 | 8.30 |
| ***Uganda*** | | | | | | | | | | | | |
| **2Y** | 10.00 | **8.00** | 7.75 | 7.85 | 7.60 | 7.70 | | | | | | |
| **5Y** | 11.15 | 9.40 | 9.50 | 9.70 | 9.35 | 9.15 | | | | | | |
| **10Y** | 11.50 | 11.20 | 11.30 | 11.40 | 11.10 | 10.90 | | | | | | |
| **Middle East** | | | | | | | | | | | | |
| ***Saudi Arabia*** | | | | | | | *Interest Rate Swap, Act/360, Annual* | | | | | |
| **2Y** | | | | | | | 1.10 | 2.20 | 2.60 | 2.70 | 2.90 | 3.20 |
| **5Y** | | *See Note 1.* | | | | | 2.39 | 3.30 | 3.40 | 3.50 | 3.60 | 3.70 |
| **10Y** | | | | | | | 3.96 | 4.50 | 4.65 | 4.70 | 4.80 | 5.10 |
| ***United Arab Emirates*** | | | | | | | *Interest Rate Swap, Act/360, Annual* | | | | | |
| **2Y** | | | | | | | 2.23 | 2.80 | 3.20 | 3.30 | 3.50 | 3.60 |
| **5Y** | | *See Note 1.* | | | | | 3.31 | 4.10 | 4.30 | 4.30 | 4.50 | 4.60 |
| **10Y** | | | | | | | 4.77 | 5.25 | 5.40 | 5.40 | 5.60 | 5.70 |

*Note 1: Forecasts are not available, as these financial instruments are at a nascent stage of development.*

Source: Standard Chartered Research

# Disclosures appendix

### Definition of credit outlook

| | Standard Chartered terminology | Impact | Definition |
|---|---|---|---|
| Credit outlook | Positive | Improve | We expect the fundamental credit profile of the issuer to <Impact> over the next 12 months |
| | Stable | Remain stable | |
| | Negative | Deteriorate | |

**Apart from trade ideas described below, Standard Chartered Research no longer offers specific bond and CDS recommendations. Any previously-offered recommendations on instruments are withdrawn forthwith and should not be relied upon.**

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| Credit trend distribution (as at 18 November 2010) | Coverage total (IB%) |
|---|---|
| Positive | 8 (25.0%) |
| Stable | 136 (17.6%) |
| Negative | 24 (16.7%) |
| **Total (IB%)** | **168 (17.9%)** |

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Subject companies: **PT Adaro Energy, PT Bumi Resources Tbk., CNOOC Limited, Country Garden Holdings Co. Ltd, Dubai World, Evergrande Real Estate Group, Ghana National Petroleum Corporation, Hopson Development Holdings Limited, PT Indosat Tbk., Korea Electric Power Corporation, Perusahaan Listrik Negara, Mubadala, Petroliam Nasional Berhad, Petroleos Brasileiros SA, Qatari Diar, State of Qatar**

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SCSK is a liquidity provider for the equity-linked warrants of this company and beneficially owned 3497100 units of **Korea Electronic Power** call warrants as of 26 November 2010.

SCSK is a liquidity provider for the equity-linked warrants of this company and beneficially owned 3499990 units of **Korea Electronic Power** call warrants as of 26 November 2010.

# Disclosures appendix (cont)

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Document approved by
**Mr Michael Preiss**
Head of Consumer Bank Client Research

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