Global Economics
7 April 2004

Damocles:
Do Not Drop Your Guard

Rob Subbaraman, Russell Jones, Hiroshi Shiraishi

LEHMAN BROTHERS
Where vision gets built. SM

CONTENTS

EXECUTIVE SUMMARY AND CONCLUSIONS

DO NOT DROP YOUR GUARD

Rob Subbaraman
+81 (0)3 6440 1426

Russell Jones
+44 (0)207 102 1296

Hiroshi Shiraishi
+81 (0)3 6440 1427

Robert Beange
+44 (0)207 102 2232

Tolga Ediz
+44 (0)207 102 7467

Gianfranco Bertozzi
+1 (212) 526 3339

Paula Gandara
+1 (212) 526 7763

This is the second in a series of quarterly updates of the Damocles model that we launched in September 2003. Our country-by-country indices continue to suggest that the emerging market macroeconomic and financial environment is relatively benign. Indeed, there has been little substantive change since our initial publication, and none of the scores for the 17 economies we now cover exceed the initial danger threshold of 75, which indicates a one-in-three chance of a financial crisis over the next 12 months. Since December, the scores of eleven countries are unchanged, three have increased (Brazil, South Korea and Turkey) and three have decreased (Argentina, China and South Africa).

However, the aggregate current account surplus for emerging markets is in decline, with both the European and Latin American regions likely to run deficits in 2004, albeit probably of less than 1% of GDP. Furthermore, in all countries there is at least one area of concern, and in some, due to geopolitical risks, political uncertainties, and governance issues, Damocles is probably understating the potential for trauma. This is most likely to be the case for Hong Kong, Indonesia, South Korea, the Philippines, Poland, and Taiwan. There is also always the risk that problems migrate from the developed world to emerging markets, not least because of unaddressed global macroeconomic imbalances, terrorist attacks, or the possibility of earlier than expected monetary tightening in the US.

With FX reserves rising rapidly and growth robust, Damocles suggests that Asia remains the least vulnerable corner of the emerging market world. However, investors should not treat the region as one homogeneous group. There are pockets of risk, most notably in the Philippines. In Latin America, Mexico remains well insulated against a crisis, and external vulnerability has eased in Argentina, although the country remains in default. Brazil's Damocles index has risen somewhat of late, because of higher real interest rates, and we are concerned about fiscal policy slippage given political pressure to deliver more employment. Within the European time zone, Hungary's twin deficit problem renders it the most vulnerable of the countries we follow. Meanwhile, although Poland's Damocles index remains at zero, as in Brazil, the effects of political considerations on the budget deficit should be monitored closely. As for Turkey and South Africa, deteriorating current account imbalances could be their Achilles' heel.

With a relatively benign macroeconomic environment and global interest rates at very low levels, investors have been attracted to emerging markets in the search for yield. Private (net) capital flows into the developing world surged last year and in the early months of 2004. Portfolio inflows have been positive and bank lending has finally begun to recover from the trauma of the Asian crisis. However, the historical pattern of capital flows to emerging markets has always been one of ebb and flow, rather than stasis. A question that will likely become more topical is: have investors in emerging markets accurately priced in the risk to which they are exposed?

This question even applies to the emerging market with the lowest Damocles score: Asia. With strong capital inflows, an overall current account surplus and many countries artificially depressing their currencies, emerging world FX reserves have continued to escalate, ($260bn for 2003), with Asia accounting for the lion's share of the rise. The dramatic increase in emerging market reserve assets is understandable in the context of recent financial crises. However, it is now becoming excessive. In Asia, the distortionary costs to the domestic economy from further accumulation of FX reserves are starting to outweigh the diminishing external benefits. China is in the midst of an investment bubble, and with ample domestic liquidity, asset and consumer price pressures are building across the region. Over the medium term, monetary excess is likely to cause our Damocles indices to rise and could encourage portfolio inflows to reverse. Pressure from the developed world for greater exchange rate flexibility in Asia is bound to build and ultimately will prove irresistible. This conclusion extends to China.

EMERGING MARKET RISKS APPEAR TO REMAIN LOW AS CAPITAL FLOWS FREELY

LITTLE CHANGE SINCE THE DECEMBER DAMOCLES REPORT

According to the Damocles framework, emerging market risks remain relatively low…

Our Damocles indices of emerging market vulnerability remain generally low, indicating that the economic and financial environment is relatively benign.[1] There has been little substantive change since our last publication in early December, with none of the scores for the 17 economies covered exceeding the initial 75 warning threshold, which indicates a one-in-three chance of a financial crisis over the next 12 months. Since December, the scores of 11 countries are unchanged, three have increased (Brazil, South Korea and Turkey) and three have decreased (Argentina, China and South Africa). Most scores remain closer to zero than to 75.

…but geopolitical, domestic political and governance issues could intervene…

However, we would stress that in all countries there is still at least one area of underlying concern, and there are a number of economies where the terrorist threat and domestic political and governance issues mean that Damocles is probably understating the potential for trauma. Hong Kong, Indonesia, South Korea, the Philippines, Poland, and Taiwan are perhaps the most obvious examples.

…reserve accumulation is generating unpleasant side-effects…

What is more, in Asia, there have been further hints that the domestic monetary costs of foreign exchange (FX) reserve accumulation are now beginning to exceed the export sustaining benefits. China's investment boom has become a bubble, while in much of the rest of the region, there are growing signs of monetary excess and diminishing spare capacity, suggesting that higher inflation could be just around the corner.

…and problems could migrate from the developed world

Finally, the developed world, and in particular the US, remains vulnerable to further terrorism attacks and is still beset by serious macroeconomic imbalances. Furthermore, the latest (March) US employment report suggests that the risks of a mid-year transition to a Fed tightening cycle have increased. The implication is that problems could migrate from the industrial core to the developing periphery.

Figure 1. Recent Trends in Damocles Indices

Country	March 2004 Damocles Score	December 2003 Damocles Score	1 Year Trend	Key Concern(s)
Argentina	26	65	Lower	Debt rescheduling
Brazil	34	11	Higher	Real interest rates
China	10	24	Lower	Rapid domestic credit growth/over investment
Hong Kong	10	10	Lower	Budget deficit/politics
Hungary	42	42	Lower	Current account deficit
Indonesia	11	11	Lower	Banks/judicial system/politics
South Korea	24	10	Lower	Short-term external debt/politics/North Korea
Malaysia	10	10	Flat	Budget deficit
Mexico	0	0	Flat	Structural policy inertia
Philippines	50	50	Higher	Public debt/financial sector/low FX reserves/politics
Poland	0	0	Lower	Budget deficit/political instability
Russia	11	11	Flat	Structural policy/governance
Singapore	10	10	Lower	Contagion from Philippines/Indonesia
South Africa	41	54	Lower	Current account deficit
Taiwan	24	24	Higher	Domestic politics/Taipei-Beijing relations
Thailand	0	0	Flat	Private debt
Turkey	34	11	Lower	Current account deficit

Source: Lehman Brothers Global Economics.

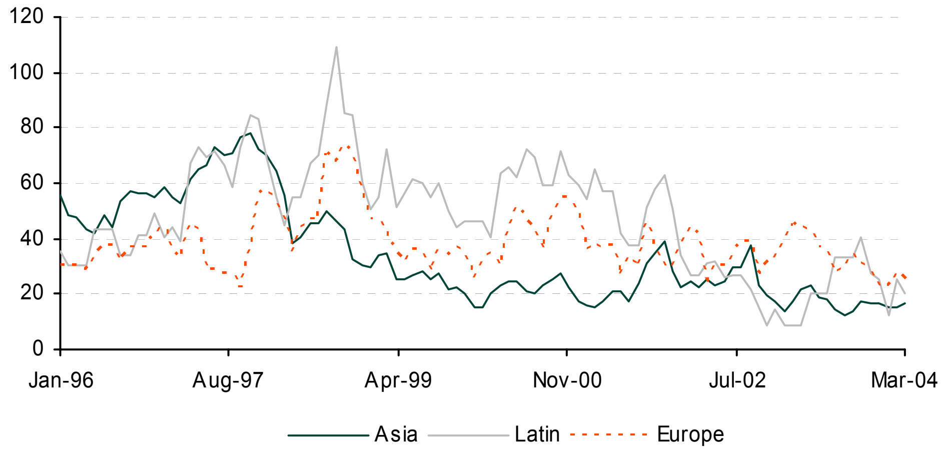
[1] *See the appendix for the methodology behind the Damocles model. For a more detailed explanation of the Damocles analytical framework, see R. Subbaraman, R. Jones and H. Shiraishi: Financial Crises: An Early Warning System, 1 September 2003.*

Asia continues unprecedented reserve accumulation

Asia remains the least vulnerable region of the emerging world…

With FX reserves rising rapidly, Asian central banks have built up a huge war chest to guard against unforeseen shocks. This, together with the strong economic recovery and the decline in external debt burdens over recent years, has kept our Damocles indices at comfortably low levels across the region. The simple average Damocles index for the Asian economies is a mere 17 and if the Damocles analytical framework is taken at face value, Asia remains the least vulnerable corner of the emerging market world (Figure 2).

Figure 2. Simple Average of Damocles Indexes for Emerging Markets

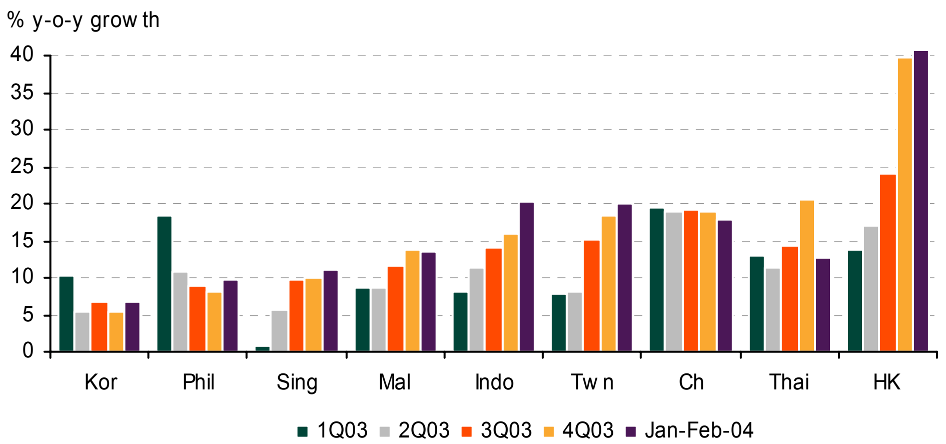


Source: Lehman Brothers Global Economics.

…although political uncertainties, monetary excess and inappropriate exchange rate policies remain of concern

However, this may paint an unduly optimistic view of the region's risk profile. Political uncertainties have multiplied in a number of these economies, and the build-up of FX reserves has now gone some way beyond optimum levels. Indeed, further rapid reserve accumulation risks the exaggeration of distortions and imbalances both within these economies and multilaterally. The persistent FX intervention by Asia's central banks has leaked into domestic monetary growth (Figure 3). China is already experiencing rapid domestic credit expansion and excessive investment and other countries in the region are facing higher inflation over the next two years. As the last two G7 communiqués have made clear, these economies and the world as a whole would generally be better served by adopting more flexible exchange rate policies, and our judgement is that such adjustments will be forthcoming in a number of economies before year-end.

Figure 3. M1 Money Supply (% y-o-y growth)



Source: CEIC Data Co. Ltd. and Lehman Brothers Global Economics.

Mixed messages from Latin America

A rise in real interest rates has increased Brazil's vulnerability…

While Mexico's index has remained at zero, Brazil's financial vulnerability has risen recently, with the Damocles index rising from 11 in January to 34 in February and March. Real interest rates have increased (although this consideration may be exaggerated by the simplistic and backward looking manner in which real rates are calculated in the Damocles model) while pressure is building on the government to deliver more economic growth and jobs. Our expectation is that further monetary easing will bring relief, but Brazil is not out of the woods, and an early rise in official US interest rates could certainly provide a stern test for confidence in the real and Brazilian asset markets.

…while Argentina's situation has improved a little

Argentina's Damocles index has continued to trend down from its near 75 level of last summer and sentiment has been underpinned by the IMF's decision to approve the country's latest economic programme. However, the nation remains in default and all eyes are now focused on the offer to be presented to creditors in June. Argentina is not yet out of the woods.

Note also that Latin America as a whole is likely to run a current account deficit in 2004.

Current account balances the key consideration in Europe

Emerging Europe is set to run a current account deficit in 2004 …

Poland's Damocles index remains at zero, and Russia's is also extremely low, as it has been for some time. In both economies, a virtuous circle of a stronger current account position, rising FX reserves and falling external debt has acted to reduce vulnerability since the turn of the millennium. However, circumstances are beginning to change, with their respective current account balances set to deteriorate over the next two years. As with Latin America, emerging Europe's current account balance will probably move into the red this year. What is more, the political situation is unstable in Poland, while foreign investor concerns about governance have increased in Russia.

…with Hungary still the most likely area of stress…

Hungary's Damocles index has continued to trend down from last summer's 75-plus reading, but it is still higher than most countries in our sample. The major concern remains a gaping external deficit (we estimate it to be equivalent to about 7.0% of GDP this year) driven by an even larger budgetary shortfall and strong wage growth. The question is whether the government's announced programme of fiscal adjustment is sufficiently aggressive to maintain confidence in the currency.

…and South Africa and Turkey of secondary concern

The South African and Turkish indicators remain below our danger thresholds – the latter rather more so than the former, but a word of warning is apt for both. South Africa continues to have one of the highest scores in our sample and is facing a potentially large deterioration in its external imbalance. As for Turkey, it is also facing a wider current account imbalance at a time when much of its external financing is short term in nature. There is also the threat to capital inflows from renewed terrorist activity to consider.

NET CAPITAL INFLOWS TO EMERGING ECONOMIES SURGE IN 2003

Recent months have seen net capital flows to the emerging world remain strong …

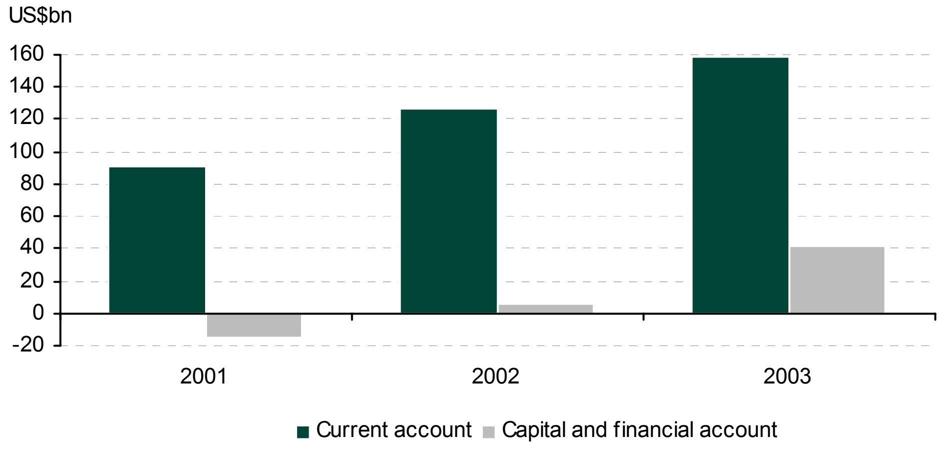
The net capital inflow to emerging market economies, which we documented in the two previous Damocles publications, accelerated sharply at the end of 2003, leaving the annual total at $187bn – an increase of approximately 50% on 2002 and a return to the average of the past ten years. The breakdown encompassed a sharp increase in portfolio equity investment, the return of commercial bank lending to these economies and a 260% increase in non-bank debt related flows as spreads collapsed and corporates and sovereigns expanded issuance. Foreign direct investment flows retreated from $112.1 to $93.6bn (a seven-year low), reflecting the residual effects of low growth, the deflation of the TMT bubble and a lacklustre M&A market, but with the emerging world running a current account surplus of more than $90bn, and many Asian governments artificially depressing their currencies, foreign exchange reserves surged by almost $260bn.

Figure 4. Emerging Market Economies' External Financing

$bn	2001	2002	2003e	2004f
Current Balance	26.0	76.9	91.0	37.4
Net Private Flows	126.5	124.2	187.5	196.2
Net Equity Flows	147.5	113.2	124.0	139.3
FDI	139.8	112.1	93.6	110.7
Portfolio Investment	7.7	1.1	30.3	28.6
Net Debt Flows	-20.9	11.0	63.5	56.9
Bank lending	-26.7	-6.2	18.8	11.9
Bonds	5.8	17.2	44.7	45.0
Official Flows	11.2	-4.6	-12.9	-9.8
Other	-76.0	-45.8	-6.5	-45.2
Reserves	87.7	150.6	259.1	178.6

Source: Institute of International Finance.

Figure 5. Asia ex-Japan's Balance of Payments (US$bn)



Source: CEIC Data Co. Ltd. and Lehman Brothers Global Economics.

Asia the favoured destination

...with Asia the most popular investment destination

On a region-by-region basis, Asia remained the favoured destination for private flows, taking more than 50% of the total in 2003, as it had done in 2002. Eastern Europe remained the second most popular destination, and Latin America the third.

The pickup can be traced to the low level of global interest rates, improved structural policies, as well as strong economic recoveries in emerging markets – as reflected in a series of credit rating upgrades. All of these factors combined to enhance risk appetite.

Figure 6. East Asia's Foreign Exchange Reserves

(US$bn)	Dec-00	Dec-01	Dec-02	Dec-03	Latest*
China	166	212	286	403	416
Hong Kong	108	111	112	118	124
Indonesia	29	28	32	36	36
South Korea	96	103	121	155	163
Malaysia	30	31	35	45	49
Philippines	15	16	16	17	16
Singapore	80	76	82	96	101
Taiwan	107	122	162	207	225
Thailand	33	33	39	42	43
Japan	362	402	470	674	777
Total East Asia ex-Japan	**663**	**732**	**885**	**1120**	**1172**
Total East Asia	**1025**	**1134**	**1355**	**1794**	**1949**
Memo item: World total	**1929**	**2041**	**2392**	**n.a.**	**n.a.**

Source: CEIC, Bank for International Settlements, and Lehman Brothers Global Economics.
The latest is February 2004 for all countries except China (January).

More to come?

The net capital flow is likely to increase further this year…

With these factors still active and all the evidence pointing to continued investor interest in these economies in the early months of 2004, the expectation is that the net capital flow figure will increase further this year, even if the overall current account surplus declines, with eastern Europe and Latin America dipping back into deficit. For example, the widely respected Institute of International Finance estimates total net inflows of $196.2bn, with direct inflows bouncing off their 2003 lows and portfolio equity and bond flows remaining firm, even if bank lending retreats somewhat.

…with equity portfolio investments and FDI to the fore…

Net equity flows (direct and portfolio), which typically follow the business cycle should remain strong, with Asia remaining the dominant recipient. Emerging Markets PEs remain some way below their 10-year average. Foreign direct investment should also respond positively to the cyclical upswing as multinational companies seek to expand into new markets and minimise factor costs. Privatisation should also provide a catalyst, with EU accession making the prospects for eastern Europe especially positive. In Asia, China can be expected to continue to dominate cross-border transactions because of the size and potential of its domestic market and its low labour costs. The pipeline of FDI commitments is already quite full and a prospective increase in offshore share listings should provide an additional positive.

…but debt investments struggling to exceed last year's total

Turning to bonds, with spreads having collapsed from more than 1000bp in late 2002 to about 300bp, it is difficult believe that these flows can significantly exceed last year's total, but as long as policy interest rates remain close to their recent historical lows, a large reversal is unlikely.

Foreign exchange reserves are expected to keep rising, although whether the increase will match the extraordinary accumulation of assets in 2003 is questionable.

The major risks to this outlook are a steeper than anticipated rise in official interest rates, a disappointingly shallow upswing in the OECD world, a deterioration in credit quality among the more highly indebted emerging market economies, and the risk that emerging market performance moves ahead of the fundamentals.

COUNTRY BY COUNTRY STUDY

Argentina: Still in default

2003 Nominal GDP (US$bn)	129
2003 GDP per capita (US$)	3,411

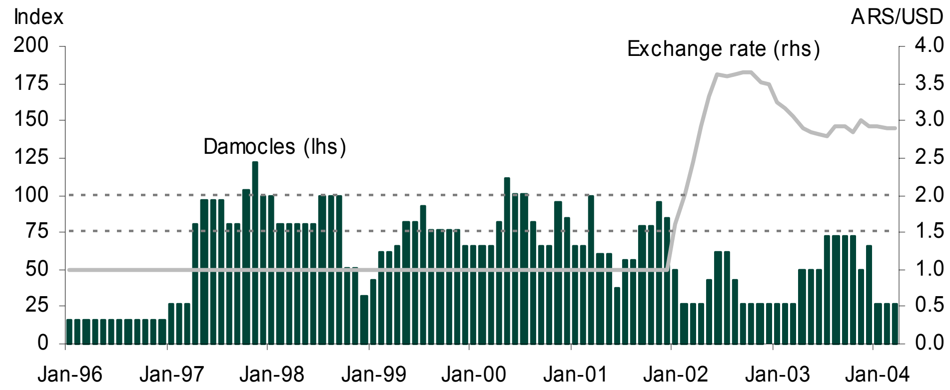
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	8.2	3.9	-3.4	-0.8	-4.4	-11.0	8.7	5.0	3.0
CPI (% y-o-y)	0.5	0.9	-1.2	-0.9	-1.1	35.0	13.4	7.0	10.0
Current account (% of GDP)	-4.2	-4.9	-4.2	-3.1	-1.7	9.0	6.2	4.4	3.4
Official interest rate (%)	10.0	9.75	12.0	14.0	40.0	7.5	7.5	4.0	10.0
Currency (per US$)	1.00	1.00	1.00	1.00	1.00	3.4	2.9	2.8	2.6
Credit rating : Moody's	Ba3	Ba3	B1	B1	Ca	Ca	Ca		
: S&P	BB	BB	BB	BB-	SD	D	D		

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

The Argentinean authorities have indicated a credible offer to creditors will be ready by June; restructuring to immediately follow

Argentina's Damocles index declined to 26 in 1Q, which is its lowest level since the first quarter of 2003. In the past year, the exchange rate has shown noteworthy stability, thanks in some measure to very supportive commodity prices, which are strongly bolstering exports. In the meantime, fiscal concerns are largely at bay, although we have yet to see real progress achieved on the defaulted debt. The IMF has recently approved revisions to Argentina's reform programme, with the unexpectedly broad support of the G7, yet it may be the last free pass the government receives. The authorities indicate a credible offer to creditors will be ready by June, restructuring to follow immediately. If otherwise, Damocles may have found its bottom, especially if the current positive external environment proves transient.

Damocles index for Argentina*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	9.5	12.3	12.0	11.5	14.0	12.3	11.1
Foreign reserves / short-term external debt	Below 1, and/or	**0.6**	**0.6**	**0.4**	**0.5**	**0.6**	**0.6**	**0.6**
	Below 2 and falling	no	no	no	**Yes**	no	**Yes**	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	2.0	1.8	1.8	1.4	2.1	2.6	2.6
External debt as % of GDP	Above 50%	46.2	**51.4**	**52.2**	**62.2**	**157.3**	**121.6**	**113.3**
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	130.3	**153.7**	**190.9**	116.4	64.3	**76.8**	68.9
Current account deficit as % of GDP	Above 3%, and	**-4.9**	**-4.2**	**-3.1**	-1.7	9.6	6.5	6.2
	Above 3% and rising by 1pp y-o-y	no	no	no	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	23.6	24.1	23.2	20.2	13.5	10.7	9.6
	Above100% and rising by 5pp y-o-y	no	no	no	no	no	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	6.5	9.7	12.4	**201.5**	-34.7	-2.2	-0.7
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	3.7	7.1	**-13.4**	**-18.3**	29.0	30.6	17.6
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	1.3	1.9	2.1	1.1	-35.7	-20.8	-16.5

** Figures are for the end of period.*

Brazil: High real rates are a concern

2003 Nominal GDP (US$bn)	501
2003 GDP per capita (US$)	2,912

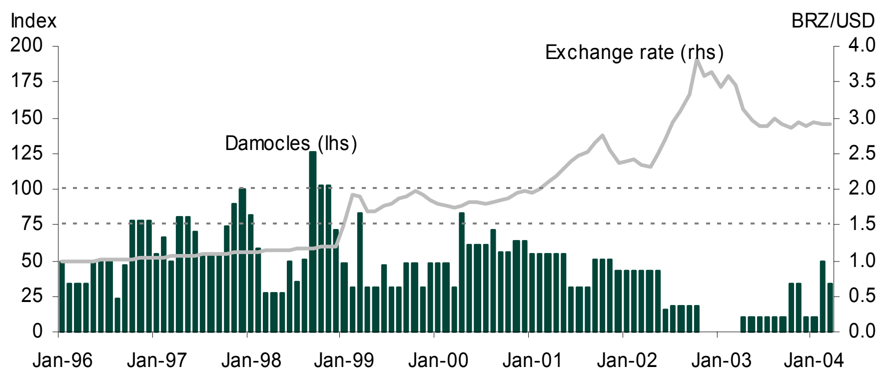
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	3.2	0.2	0.8	4.4	4.4	1.9	-0.2	3.7	3.1
CPI (% y-o-y)	6.9	3.2	4.9	7.1	6.8	12.5	9.3	6.2	4.5
Current account (% of GDP)	-3.8	-4.2	-4.7	-4.0	-4.5	-1.7	0.8	0.6	-0.2
Official interest rate (%)	39.1	29.0	19.0	15.8	19.0	25.0	16.5	14.0	13.0
Currency (per US$)	1.04	1.11	1.21	1.84	2.31	3.53	2.89	3.00	3.20
Credit rating : Moody's	B1	B2	B2	B1	B1	B2	B2		
: S&P	BB-	BB-	B+	B+	BB-	B+	B+		

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

We expect real rates to fall, but there are a number of other potential risks on the horizon

Brazil's Damocles index has recently risen somewhat from 11 to 34. The upward adjustment has coincided with heightened political uncertainty, but the dominant factor swelling the index has been higher real interest rates (which are calculated in a relatively simplistic and backward looking manner). Thankfully, the central bank has resumed its easing cycle, so that some respite is now in view. But there are a number of other concerns. Fiscal policy slippage is likely to grow in line with political pressure to deliver growth and employment. The current account and FX reserve positions have been supportive over recent years, but the expected deterioration in the former may well slow down the accumulation of the latter. Finally, the latest US payroll figures are a further risk factor. An early Fed rate hike could provoke a general widening of spreads from which Brazil is unlikely to be immune.

Damocles index for Brazil*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	9.3	8.9	7.1	7.7	9.6	11.7	12.2
Foreign reserves / short-term external debt	Below 1, and/or	**0.9**	**0.9**	**0.8**	**0.9**	1.2	1.2	1.2
	Below 2 and falling	**Yes**	**Yes**	no	no	no	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	7.0	7.0	**8.6**	7.3	5.0	6.2	6.0
External debt as % of GDP	Above 50%	23.0	33.4	28.7	35.9	42.4	42.5	39.0
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	82.3	76.7	65.1	61.0	44.1	48.7	46.7
Current account deficit as % of GDP	Above 3%, and	**-4.2**	**-4.7**	**-4.0**	**-4.5**	-1.7	0.8	0.8
	Above 3% and rising by 1pp y-o-y	no	no	no	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	31.3	30.5	26.7	28.5	23.5	30.9	29.1
	Above100% and rising by 5pp y-o-y	no	no	no	no	no	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	**27.3**	9.9	9.6	24.8	12.4	7.0	**10.2**
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	-5.5	32.6	**-12.7**	1.7	11.0	35.0	10.2
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	-2.7	-11.0	0.3	**3.6**	-9.5	**8.5**	**7.4**

** Figures are for the end of period.*

China: High on growth, low on quality

2003 Nominal GDP (US$bn)	1,410
2003 GDP per capita (US$)	1,091

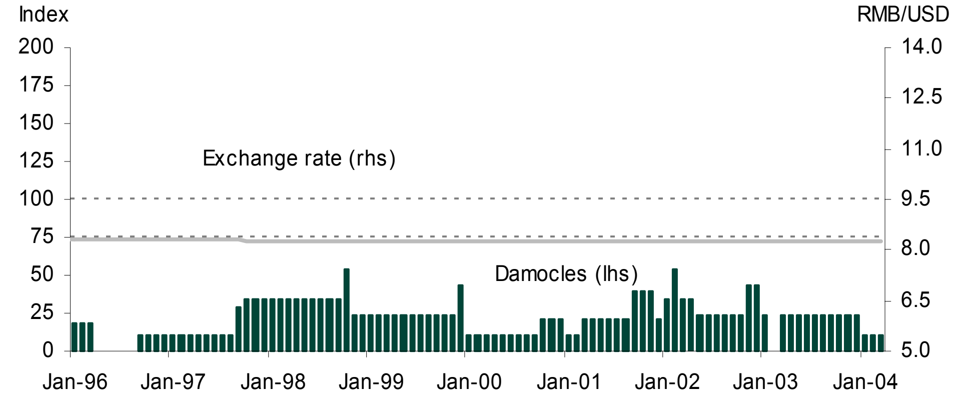
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	8.8	7.8	7.1	8.0	7.3	8.0	9.1	8.0	8.0
CPI (% y-o-y)	-5.1	-3.5	-0.6	1.8	0.4	-0.8	1.2	3.3	2.0
Current account (% of GDP)	3.3	3.1	1.6	1.9	1.5	2.9	1.6	0.0	-0.5
Official interest rate (%)	8.64	6.39	5.85	5.85	5.85	5.31	5.31	5.00	5.00
Currency (per US$)	8.28	8.28	8.28	8.28	8.28	8.28	8.28	7.80	7.50
Credit rating : Moody's	A3	A3	A3	A3	A3	A3	A2	A2	
: S&P	BBB+	BBB+	BBB	BBB	BBB	BBB	BBB	BBB+	

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

A more flexible exchange rate is needed to regain control over monetary conditions

China's economy is growing very fast, but quality is lacking. The Damocles index for China, at 10, shows that the chance of an external crisis is remote, thanks to the surge in FX reserves to US$416bn. However, the heavy FX intervention has started to take its toll on the domestic economy in the form of excessive money and credit growth, which is fuelling overinvestment in certain sectors. As a share of GDP, domestic credit and investment have risen to 175% and 45%, respectively. These are extraordinarily high levels by any standards. To avoid a hard landing, China's policymakers are implementing domestic measures to try to cool down investment. But the root of the problem is the fixed exchange rate regime in the face of a massive balance of payments surplus. To regain control over monetary conditions, we judge that some exchange rate flexibility needs to be introduced, while at the same time accelerating bank reform.

Damocles index for China*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	12.4	11.2	8.8	10.5	11.6	11.7	11.9
Foreign reserves / short-term external debt	Below 1, and/or	3.9	6.6	6.6	8.4	10.9	10.4	9.6
	Below 2 and falling	no	no	No	no	No	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	8.8	9.6	10.3	9.1	8.0	6.7	6.2
External debt as % of GDP	Above 50%	15.5	13.9	11.4	10.0	8.6	8.8	9.0
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	17.8	10.7	8.9	8.4	7.2	8.0	8.1
Current account deficit as % of GDP	Above 3%, and	3.1	1.6	1.9	1.5	2.8	1.6	0.0
	Above 3% and rising by 1pp y-o-y	no	no	No	no	No	no	no
Domestic private credit as % of GDP	Above 100%, and	**120.5**	**129.0**	**131.1**	**130.9**	**164.7**	**176.8**	**155.3**
	Above100% and rising by 5pp y-o-y	**Yes**	**Yes**	No	no	**Yes**	**Yes**	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	7.8	5.9	3.3	7.6	5.4	1.7	3.6
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	-2.7	**-10.2**	2.3	-8.1	**-12.1**	-0.6	17.6
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	1.0	-3.8	**3.0**	**4.6**	-2.0	-8.0	-7.4

** Figures are for the end of period.*

Hong Kong: Long-term challenges remain

2003 Nominal GDP (US$bn)	159
2003 GDP per capita (US$)	23,280

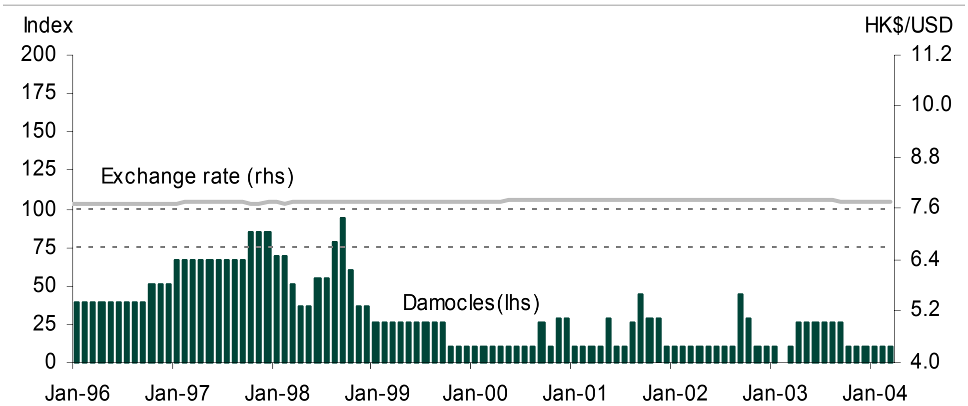
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	5.1	-5.0	3.4	10.2	0.5	2.3	3.3	6.0	4.5
CPI (% y-o-y)	5.8	2.8	-4.0	-3.7	-1.6	-3.0	-2.7	1.0	2.0
Current account (% of GDP)	-3.5	2.4	7.5	5.5	7.5	8.5	11.0	10.0	8.0
Official interest rate (%)	9.13	5.10	5.69	5.75	1.88	1.41	0.50	1.00	2.00
Currency (per US$)	7.74	7.74	7.77	7.80	7.80	7.80	7.80	7.80	7.80
Credit rating : Moody's	A3	A3	A3	A3	A3	A3	A1	A1	
: S&P	A+	A	A	A	A+	A+	A+	A+	

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

The Hong Kong economy is in a cyclical "sweet spot", but long-term challenges remain

Hong Kong's Damocles index remains low at 10, thanks to a large current account surplus (11% of GDP), and high FX reserves (US$124bn). The economy is recovering rapidly, with growth likely to pick up to close to double digits in 2Q, underpinned by hoards of visitors from China, a competitive currency, and rising asset prices. Deflation should end around mid-year. The economy is in a "sweet spot", and the authorities should use this window to deal with some of the longer-term challenges. These include reining in the budget deficit (5% of GDP), reducing the still high unemployment rate (7.2%), and promoting high value added services to China. The latter requires improving the education system and the environment to attract FDI and skilled labour. Near-term risks are public discontent over the slow pace of democratic reform in the lead-up to the legislative elections in September, and a sharp slowdown in China's economy.

Damocles index for Hong Kong*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	5.8	6.4	6.1	6.6	6.5	6.1	6.2
Foreign reserves / short-term external debt	Below 1, and/or	**0.9**	1.2	1.3	1.6	1.9	1.8	1.9
	Below 2 and falling	no	no	no	no	No	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	4.6	4.6	4.4	4.1	4.1	4.2	4.2
External debt as % of GDP	Above 50%	203.0	172.6	125.9	110.5	108.0	114.2	114.0
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	48.9	40.0	33.1	30.1	24.3	24.5	25.4
Current account deficit as % of GDP	Above 3%, and	2.4	6.4	4.3	6.1	8.5	11.5	12.2
	Above 3% and rising by 1pp y-o-y	no	no	no	no	No	no	no
Domestic private credit as % of GDP	Above 100%, and	**153.2**	**145.8**	**144.4**	**141.0**	**138.4**	**138.9**	**140.0**
	Above100% and rising by 5pp y-o-y	no	no	no	no	No	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	7.2	4.7	9.2	6.2	3.1	2.0	1.8
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	32.5	15.7	**-11.3**	-1.8	-1.9	14.9	6.8
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	**3.9**	-7.3	-5.5	1.4	-1.5	-3.9	-8.4

* *Figures are for the end of period. External debt as % of GDP was "turned off", given that it largely reflects Hong Kong's role as a large offshore banking sector.*

Hungary: Current account problems

2003 Nominal GDP (US$bn)	83
2003 GDP per capita (US$)	8200

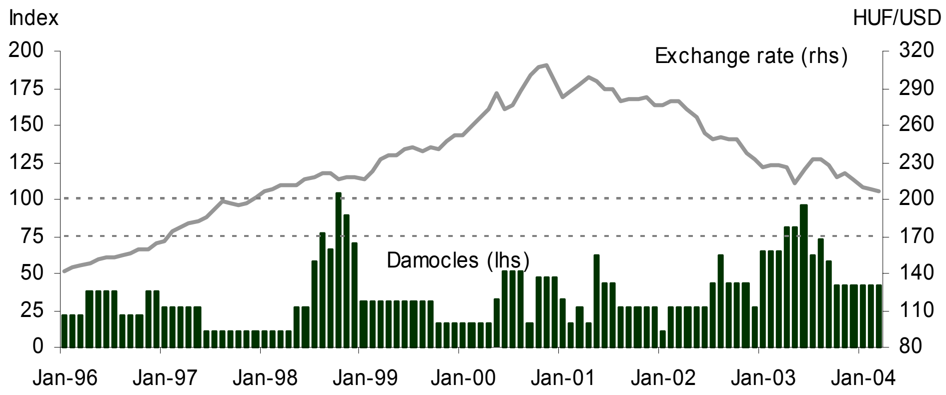
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	4.6	4.9	4.2	5.2	3.8	3.3	2.8	3.0	3.5
CPI (% y-o-y)	18.3	14.3	10.0	9.8	9.2	5.3	5.8	6.0	4.5
Current account (% of GDP)	-2.1	-4.9	-4.3	-2.8	-2.2	-4.1	-9.0	-7.0	-5.5
Official interest rate (%)	20.50	17.00	14.50	11.00	9.75	8.50	12.50	9.5	7.5
Currency (per US$)	203.50	219.03	252.52	284.73	279.03	225	208	185	179
Credit rating : Moody's	Baa3	Baa2	Baa1	A3	A3	A1	A1		
: S&P	BBB-	BBB	BBB	A-	A-	A-	A-		

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

Hungary's current account deficit could provoke a speculative attack

Hungary's Damocles index has fallen from the recent highs of last year, but the country is still in a somewhat precarious situation. A few years ago, the central bank allowed the forint to appreciate sharply in an effort to curb inflation expectations and lower medium-term inflation. Unfortunately, shortly afterwards, the government's incomes policy became highly stimulative. Rapid wage increases resulted in a marked appreciation of the real exchange rate and strong household consumption growth. The outcome was a gaping current account gap. Although fiscal measures have been adopted that have begun to curb the external deficit, it will take some time to come down to a more sustainable level. Until then, the recent recovery of the currency will be vulnerable to reversal.

Damocles index for Hungary*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	4.3	4.6	4.2	3.8	3.3	3.2	3.2
Foreign reserves / short-term external debt	Below 1, and/or	1.1	1.5	1.6	1.6	1.2	1.0	1.0
	Below 2 and falling	**Yes**	no	**Yes**	no	No	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	2.3	1.9	1.9	2.4	3.3	3.2	3.2
External debt as % of GDP	Above 50%	46.1	43.4	40.7	35.0	32.8	31.5	30.1
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	**28.8**	23.0	19.8	17.1	20.7	23.7	22.4
Current account deficit as % of GDP	Above 3%, and	**-4.7**	**-5.1**	**-6.2**	**-3.4**	**-4.1**	**-6.2**	**-5.9**
	Above 3% and rising by 1pp y-o-y	**Yes**	no	**Yes**	no	No	**Yes**	**Yes**
Domestic private credit as % of GDP	Above 100%, and	26.4	26.8	30.9	35.1	39.9	44.4	47.6
	Above100% and rising by 5pp y-o-y	no	no	no	no	No	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	6.7	3.3	0.9	3.0	3.7	6.8	5.4
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	-2.5	8.2	-8.1	9.9	5.8	6.8	8.9
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	1.6	-1.5	0.4	**7.6**	**9.5**	**3.1**	**4.5**

** Figures are for the end of period.*

Indonesia: High political risk premium

2003 Nominal GDP (US$bn)	208
2003 GDP per capita (US$)	952

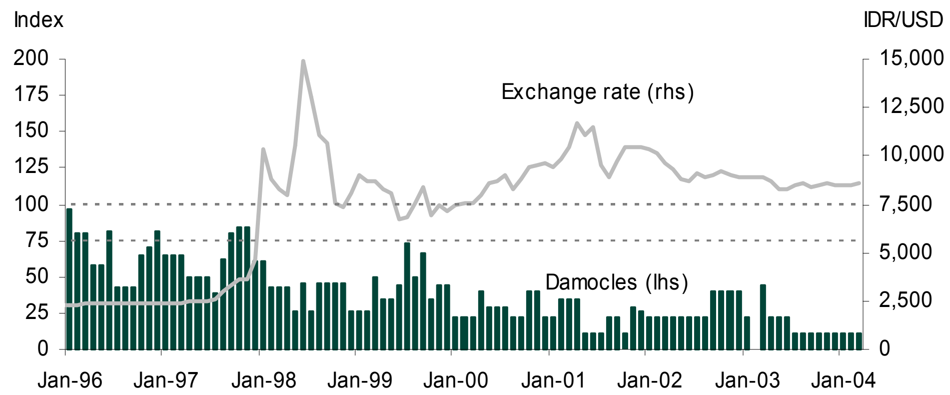
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	4.7	-13.1	0.8	4.9	3.5	3.7	4.1	4.5	5.0
CPI (% y-o-y)	6.2	58.0	20.7	3.8	11.5	11.9	6.6	6.0	5.5
Current account (% of GDP)	-2.4	4.2	4.1	5.4	4.9	4.5	3.7	2.0	1.0
Official interest rate (%)	20.0	38.4	12.5	14.5	17.6	12.1	8.0	7.0	7.0
Currency (per US$)	4650	8025	7100	9595	10400	8950	8423	8300	8100
Credit rating : Moody's	Ba1	B3	B3	B3	B3	B3	B2	B2	
: S&P	BB+	CCC+	CCC+	B-	CCC	CCC+	B	B	

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

The elections could reignite social instability, while the economy is still growing below potential

Indonesia's Damocles index has held steady at a low level of 11, thanks to a current account surplus, a rise in FX reserves to a record high of US$37bn, and a sharp drop in the ratio of external debt-to-GDP to 48% from over 100%. Also, the reduction in the fiscal deficit to about 2% of GDP has helped to reduce public debt-to-GDP. And lower inflation has led to a sharp decline in interest rates, which has underpinned a pickup in GDP growth to 4.1% in 2003. But the economy is still growing below its potential, and consequently the unemployment rate remains high, at over 8%. The financial system is also fragile, and the country is struggling to attract foreign direct investment, because of a weak judiciary system. Finally, Indonesia exited its IMF arrangement last year, and so can no longer receive debt rescheduling from the Paris Club. The biggest risk facing Indonesia is social/political instability in the lead-up to the presidential election in July.

Damocles index for Indonesia*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	10.4	12.2	10.5	10.9	12.3	13.4	13.3
Foreign reserves / short-term external debt	Below 1, and/or	**0.9**	1.1	1.3	1.5	2.1	2.4	2.3
	Below 2 and falling	no	no	no	**Yes**	No	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	3.0	3.7	2.6	2.9	3.1	3.1	3.1
External debt as % of GDP	Above 50%	**118.2**	**82.3**	**74.2**	**69.1**	**57.5**	48.3	49.0
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	52.7	42.5	35.8	31.3	24.4	23.3	24.2
Current account deficit as % of GDP	Above 3%, and	4.2	4.1	5.4	4.8	4.5	3.8	4.0
	Above 3% and rising by 1pp y-o-y	no	no	no	no	No	no	no
Domestic private credit as % of GDP	Above 100%, and	62.8	22.5	18.9	20.7	23.5	24.8	24.3
	Above100% and rising by 5pp y-o-y	no	no	no	no	No	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	-44.1	**10.1**	2.1	3.1	-1.9	-0.4	-0.1
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	-1.4	8.3	-9.4	-9.1	**-10.7**	18.3	15.6
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	-13.3	**8.5**	**3.7**	2.8	**16.4**	7.9	**5.0**

* *Figures are for the end of period.*

South Korea: Strong growth; political worries

2003 Nominal GDP (US$bn)	605
2003 GDP per capita (US$)	12,628

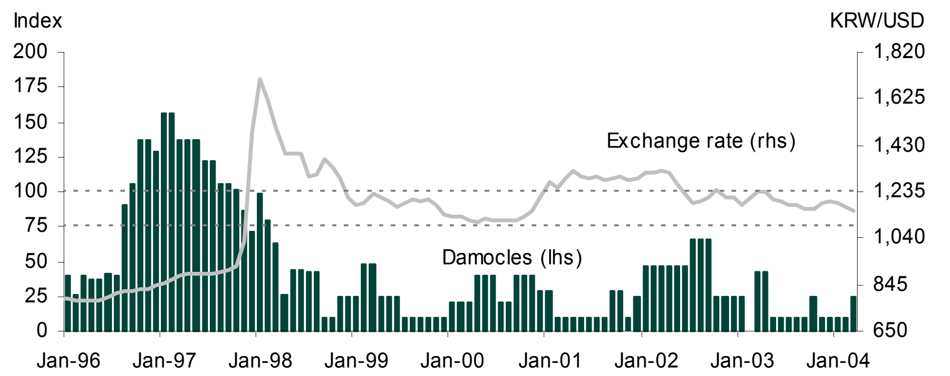
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	4.7	-6.9	9.5	8.5	3.8	7.0	3.1	6.5	5.5
CPI (% y-o-y)	4.4	7.5	0.8	2.3	4.1	2.8	3.5	4.0	3.0
Current account (% of GDP)	-1.7	12.7	6.0	2.7	1.9	1.0	2.0	2.0	-1.0
Official interest rate (%)	8.64	6.39	4.75	5.25	4.00	4.25	3.75	4.25	5.00
Currency (per US$)	1484	1214	1138	1214	1290	1186	1192	1040	1000
Credit rating : Moody's	Baa2	Ba1	Baa2	Baa2	Baa2	A3	A3	A3	
: S&P	B+	BB+	BBB	BBB	BBB+	A-	A-	A-	

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

Watch out for positive surprises on growth, provided the political situation stabilises soon

South Korea's Damocles index remains low at 24, thanks to US$164bn-worth of FX reserves, low external debt, a current account surplus, and stronger GDP growth. The economic recovery is broadening out, spreading from exports to domestic demand, and supporting our bullish outlook of 6.5% growth this year. But downside risks and challenges remain. The debt workout of credit card companies must proceed as fast as possible, and banks and regulators need to carefully monitor the financial position of the small-to-medium enterprise sector, which has become a larger borrower. The double-digit youth unemployment rate needs to be reduced, as does the relatively high level of short-term external debt (41% of total debt). And to maintain business confidence and attract foreign investment, the political situation needs to stabilise quickly after the elections this month. Perhaps the biggest risk remains the implosion of North Korea.

Damocles index for South Korea*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	6.7	7.4	7.2	8.7	9.6	10.4	10.5
Foreign reserves / short-term external debt	Below 1, and/or	1.2	1.7	2.3	2.4	2.6	3.1	3.0
	Below 2 and falling	no	no	no	no	No	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	10.3	8.1	6.1	5.8	6.0	4.9	4.9
External debt as % of GDP	Above 50%	41.7	29.4	23.9	22.9	22.5	20.5	21.5
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	26.3	25.7	20.4	23.4	24.4	21.9	22.1
Current account deficit as % of GDP	Above 3%, and	11.7	5.5	2.4	1.7	1.0	2.0	3.4
	Above 3% and rising by 1pp y-o-y	no	no	no	no	No	no	no
Domestic private credit as % of GDP	Above 100%, and	**173.8**	**143.5**	**113.8**	**126.5**	**141.5**	**137.7**	**143.4**
	Above100% and rising by 5pp y-o-y	**Yes**	no	no	**Yes**	**Yes**	no	**Yes**
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	3.0	3.4	2.6	0.8	0.6	0.4	1.0
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	47.1	4.2	**-23.9**	19.7	-4.3	10.1	9.3
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	-8.9	2.5	2.6	-4.3	-0.3	-2.2	-0.6

* *Figures are for the end of period.*

Malaysia: Fiscal consolidation required

2003 Nominal GDP (US$bn)	103
2003 GDP per capita (US$)	4,118

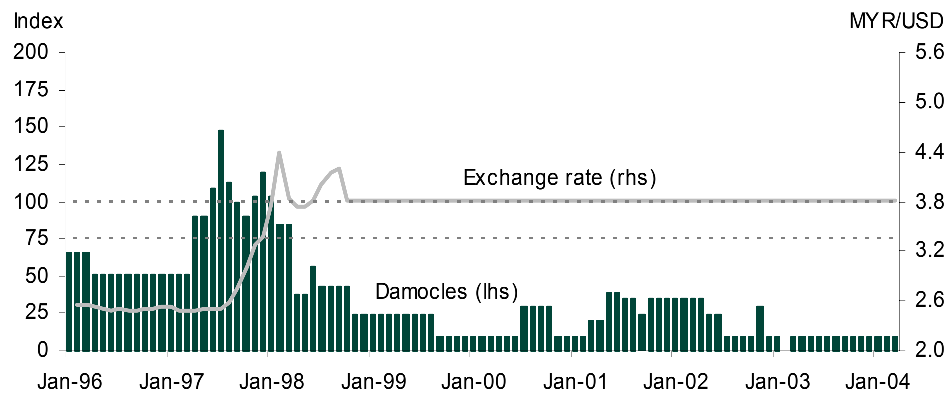
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	7.3	-7.4	6.1	8.6	0.3	4.1	5.2	6.3	6.0
CPI (% y-o-y)	2.6	5.1	2.8	1.6	1.4	1.8	1.1	2.5	3.0
Current account (% of GDP)	-5.9	13.2	15.9	9.4	8.3	8.5	13.0	12.0	11.0
Official interest rate (%)	8.70	6.50	5.50	5.50	5.00	5.00	4.50	5.00	5.50
Currency (per US$)	3.77	3.80	3.80	3.80	3.80	3.80	3.80	3.80	3.80
Credit rating : Moody's	A2	Baa3	Baa3	Baa2	Baa2	Baa1	Baa1	Baa1	
: S&P	A	BBB-	BBB	BBB	BBB	BBB+	A-	A-	

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

There has been a crackdown on corruption, helping raise FDI inflows, but the budget deficit needs to be reduced

Malaysia's Damocles index has held steady at 10 for over a year, helped by a huge current account surplus (12% of GDP), record high FX reserves (US$49bn), manageable external debt and low inflation. The economy has bounced back strongly after SARS, and Prime Minister Badawi, has cracked down on corruption and cancelled some high-cost infrastructure projects. FDI inflows jumped to US$6.8bn in 2H 2003 from US$2.6bn in 1H 2003. Still, Malaysia faces challenges. Public debt (67% of GDP) is quite high, and the budget deficit (5.4% of GDP) needs to be reined in. Despite progress in consolidating the banking sector, the NPL ratio is too high, at 8.7%. And, although the fixed exchange rate is serving the economy well, the authorities need to be alert to the risk of destabilising external imbalances developing, which may warrant a change to the peg.

Damocles index for Malaysia*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1997	1998	1999	2000	2001	2002	Latest
Foreign reserves/imports	Below 3	5.4	5.7	4.4	4.4	5.2	6.4	7.1
Foreign reserves / short-term external debt	Below 1, and/or	2.4	3.5	3.4	3.4	3.2	3.8	4.3
	Below 2 and falling	no	no	no	no	no	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	4.0	3.7	4.0	4.0	4.1	3.3	2.9
External debt as % of GDP	Above 50%	49.9	44.7	39.5	39.5	46.6	44.4	45.0
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	13.1	9.1	7.8	7.8	9.7	9.8	9.8
Current account deficit as % of GDP	Above 3%, and	13.2	15.9	9.4	9.4	7.6	13.0	13.6
	Above 3% and rising by 1pp y-o-y	no	no	no	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	**164.6**	**153.5**	**142.1**	**142.1**	**148.4**	**144.8**	**142.9**
	Above100% and rising by 5pp y-o-y	**Yes**	no	no	**Yes**	no	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	0.2	0.1	1.5	1.5	1.1	1.6	1.4
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	38.4	3.6	-6.3	-6.3	-6.6	8.8	8.7
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	-15.5	-10.3	2.2	**2.2**	-0.3	-6.4	-7.2

* *Figures are for the end of period.*

Mexico: Rising on the global tide

2003 Nominal GDP (US$bn)	622
2003 GDP per capita (US$)	6,140

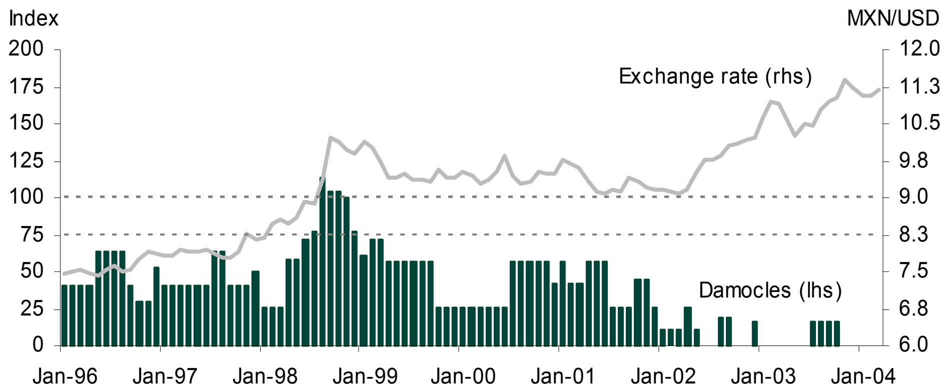
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	6.7	5.0	3.6	6.5	-0.2	1.5	1.3	4.4	3.5
CPI (% y-o-y)	20.6	15.9	16.6	9.5	6.3	5.7	4.0	4.2	3.5
Current account (% of GDP)	-1.9	-3.8	-2.9	-3.1	-2.9	-2.2	-1.5	-1.9	-2.2
Official interest rate (%)	20.1	34.7	18.8	18.9	7.9	7.2	7.3	7.1	7.0
Currency (per US$)	8.13	9.89	9.42	9.47	9.17	10.46	10.80	11.30	11.70
Credit rating : Moody's	Ba2	Ba2	Ba1	Baa3	Baa3	Baa2	Baa2		
: S&P	BB	BB	BB	BB+	BB+	BBB-	BBB-		

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

Reserve levels are high, the debt stock is relatively low and stable, and the export sector is showing resilience

Mexico's Damocles index remains at zero, suggesting minimal vulnerability. Reserve levels are high, the debt stock is comparatively low and stable, and a major deterioration in the external balance looks unlikely. Buoyant commodity prices, particularly oil, are helping to provide insulation, and the strength of the US upswing in the run up to the November presidential election indicates that the demand for Mexican products will remain firm in the short term. However, it is not all plain sailing. On a more negative note, the prospects for further structural reform are less than encouraging and longer-term concerns on the competitiveness front endure.

Damocles index for Mexico*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	**2.9**	**2.6**	**2.3**	**2.9**	3.4	4.0	4.1
Foreign reserves / short-term external debt	Below 1, and/or	**0.9**	1.0	1.0	1.2	1.6	1.6	1.6
	Below 2 and falling	**Yes**	no	no	no	**Yes**	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	5.7	7.0	7.5	7.5	6.3	5.5	5.4
External debt as % of GDP	Above 50%	37.7	32.2	24.1	20.9	20.7	20.5	20.5
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	25.4	19.5	17.4	19.7	17.3	20.0	19.9
Current account deficit as % of GDP	Above 3%, and	**-3.8**	-2.9	**-3.1**	-2.9	-2.2	-1.5	-1.4
	Above 3% and rising by 1pp y-o-y	**Yes**	no	no	no	No	no	no
Domestic private credit as % of GDP	Above 100%, and	20.8	19.5	17.1	14.9	16.3	15.8	15.4
	Above100% and rising by 5pp y-o-y	no	no	no	no	No	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	16.1	6.4	9.9	3.5	2.8	2.3	3.6
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	9.2	21.6	-9.3	-2.5	1.6	11.6	17.8
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	2.9	**12.5**	**12.0**	**9.9**	0.0	-7.3	-4.8

** Figures are for the end of period.*

Philippines: Vulnerable to shocks

2003 Nominal GDP (US$bn)	81
2003 GDP per capita (US$)	976

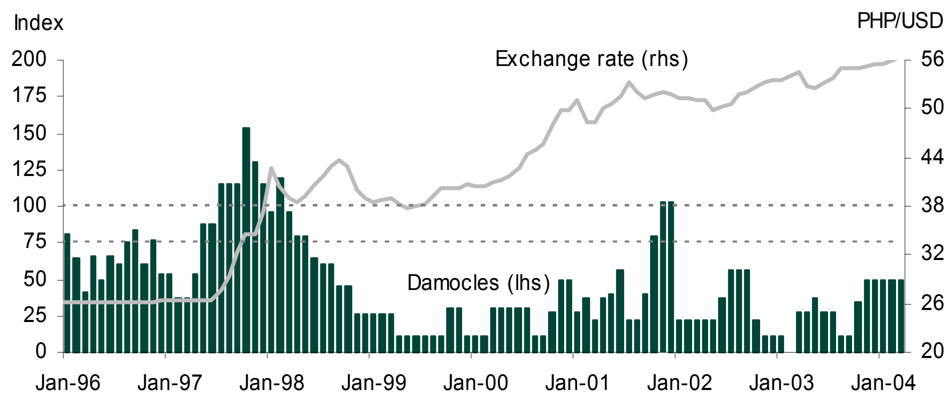
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	5.2	-0.6	3.4	6.0	3.0	4.4	4.5	3.0	4.0
CPI (% y-o-y)	5.0	9.8	6.7	4.3	6.1	3.1	3.0	4.0	5.0
Current account (% of GDP)	-5.3	2.4	9.7	12.1	1.8	5.6	4.2	3.0	2.0
Official interest rate (%)	11.40	13.38	8.75	13.98	7.94	7.00	6.75	9.00	8.00
Currency (per US$)	37.2	39.1	40.6	49.9	51.8	53.4	55.5	60.0	58.0
Credit rating : Moody's	Ba1	Ba1	Ba1	Ba1	Ba1	Ba1	Ba1	Ba2	
: S&P	BB+	BB+	BB+	BB+	BB+	BB+	BB	BB	

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

The economy is fundamentally weak, and vulnerable to a shock in the lead-up to the presidential elections

The Damocles index for the Philippines has risen quite sharply to 50 over recent months, reflecting the economy's deteriorating fundamentals. Public sector debt has increased to 108% of GDP, and the public sector deficit remains large at 6.1% of GDP. External debt has risen to 71% of GDP, and the current account surplus is shrinking. The unemployment rate has risen to 11%. The financial sector is weak, with the official bank nonperforming loan ratio at 14.5%. Foreign direct investment plummeted by 82% last year, and it is a worrying sign that the central bank has had to borrow from overseas to top up its net FX reserves, which have fallen to just US$12.9bn. And in spite of all these problems, the Philippines has cancelled its monitoring programme with the IMF. Note also that the presidential elections on 10 May could provoke social instability, something that the Damocles model does not capture explicitly.

Damocles index for Philippines*



* *A reading above 75 is a warning signal that a county's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	3.2	4.6	3.9	4.1	4.3	4.4	3.8
Foreign reserves / short-term external debt	Below 1, and/or	**0.7**	1.3	1.3	1.2	1.6	1.3	1.1
	Below 2 and falling	no	no	**Yes**	**Yes**	no	**Yes**	**Yes**
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	3.6	2.9	2.5	2.6	2.4	2.2	2.5
External debt as % of GDP	Above 50%	**71.6**	**70.3**	**68.2**	**72.0**	**71.8**	**72.2**	**72.0**
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	31.8	23.7	20.8	**27.1**	21.3	27.8	28.1
Current account deficit as % of GDP	Above 3%, and	2.4	9.5	8.2	1.8	5.4	4.2	3.3
	Above 3% and rising by 1pp y-o-y	no	no	no	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	55.4	45.1	39.8	39.2	35.5	33.6	32.8
	Above100% and rising by 5pp y-o-y	no	no	no	no	no	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	6.1	4.7	**10.8**	**13.8**	4.3	4.1	4.1
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	40.4	-6.9	-4.6	**-12.4**	-7.2	11.4	5.4
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	-16.8	-9.1	-7.6	**7.4**	2.2	-4.4	-3.7

** Figures are for the end of period.*

Poland: Out of danger, but for how long?

2003 Nominal GDP (US$bn)	210
2003 GDP per capita (US$)	5,550

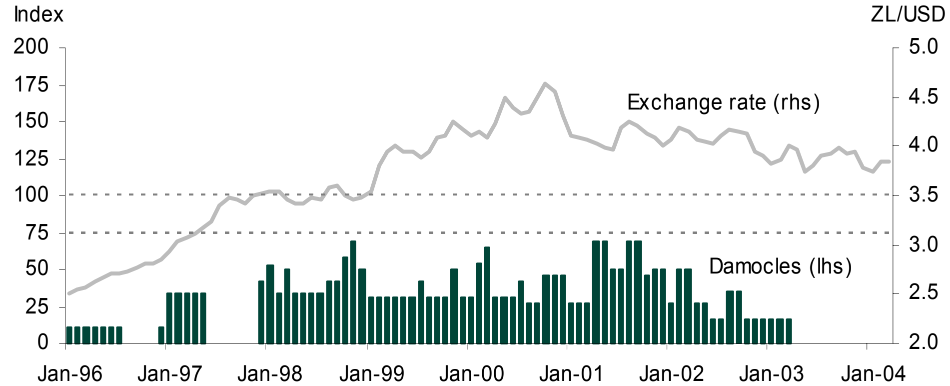
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	6.9	4.9	4.0	15.8	1.0	1.3	3.5	4.5	4.5
CPI (% y-o-y)	15.1	11.7	7.3	10.2	5.5	2.3	1.7	3.0	3.0
Current account (% of GDP)	-3.0	-4.3	-7.5	-6.1	-3.9	-3.5	-2.0	-2.8	-3.5
Official interest rate (%)	24.50	15.50	16.50	19.00	11.50	6.75	5.25	5.25	5.75
Currency (per US$)	3.53	3.49	4.17	4.31	4.01	3.84	3.87	3.39	3.27
Credit rating : Moody's	Baa3	Baa3	Baa1	Baa2	Baa3	A2	A2		
: S&P	BBB-	BBB-	BBB	BBB+	BBB+	BBB+	BBB+		

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

Growth is at last picking up, but the current account balance may deteriorate as a result

Poland's Damocles index has remained out of the danger area over recent years. Indeed, currently, the index is at rock bottom. That said, the current account imbalance is set to widen and we are concerned that political factors, not explicitly captured by the index, present risks to the currency. The government is facing conflicting challenges. On the one hand, the large public sector deficit has pushed debt toward the constitutional limit. Fiscal policy must be tightened now to avoid constitutionally enforced austerity in future years. On the other hand, the unemployment rate stands at above 20%, and the ruling party is deeply unpopular. This has led to the collapse of the ruling coalition government. The choice now seems to be between the appointment of a weak government until next year's scheduled election or the election of a populist government in an early poll. Neither is positive for fiscal reforms.

Damocles index for Poland*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	7.8	7.8	7.8	7.5	8.3	7.8	8.6
Foreign reserves / short-term external debt	Below 1, and/or	3.9	3.5	3.3	2.4	2.3	2.8	3.2
	Below 2 and falling	no	no	no	no	no	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	2.3	2.4	2.5	3.1	2.8	2.6	2.3
External debt as % of GDP	Above 50%	20.6	20.7	20.7	18.1	20.4	22.5	22.0
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	21.7	26.4	26.6	**32.1**	35.1	25.2	23.7
Current account deficit as % of GDP	Above 3%, and	**-4.1**	**-7.0**	**-6.0**	**-3.9**	**-3.5**	-1.9	-1.7
	Above 3% and rising by 1pp y-o-y	**Yes**	**Yes**	no	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	23.6	25.7	28.7	29.8	30.8	31.0	30.9
	Above100% and rising by 5pp y-o-y	no	no	no	no	no	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	7.2	7.7	10.9	8.2	6.0	3.7	3.7
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	**-12.7**	2.1	**-10.1**	10.8	10.4	2.3	10.6
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	2.6	-0.5	**6.3**	**11.9**	-0.2	-8.8	-11.3

** Figures are for the end of period.*

Russia: Focus on reforms

2003 Nominal GDP (US$bn)	434
2003 GDP per capita (US$)	3,000

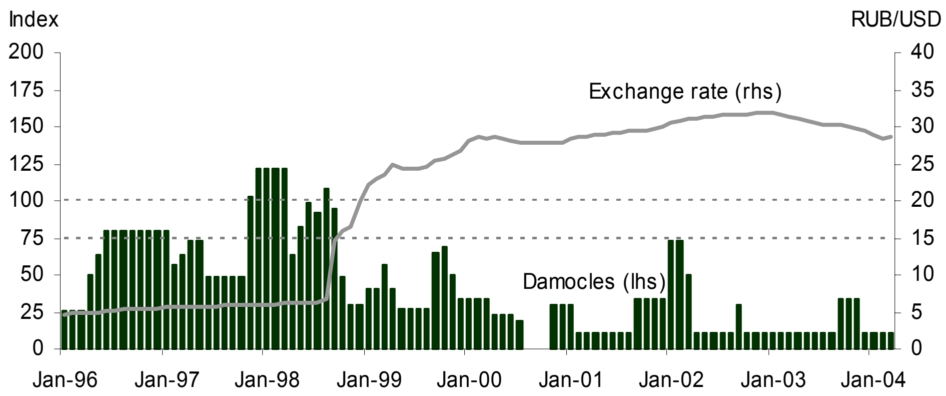
ital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	1.4	-5.3	6.4	10.0	5.0	4.3	6.5	4.5	4.0
CPI (% y-o-y)	14.8	27.4	92.6	21.0	21.7	16.0	19.0	10.0	9.0
Current account (% of GDP)	0.0	0.1	12.6	18	11.3	9.0	8.5	5.5	4.0
Official interest rate (%)	28.0	60.0	55.0	25.0	25.0	21.0	16.0	13.0	13.0
Currency (per US$)	5.94	19.99	26.80	27.97	30.09	31.84	29.3	27.5	27.0
Credit rating : Moody's	Ba2	B3	B3	B3	Ba3	Ba2	Baa3		
: S&P	BB-	CCC-	SD	B-	B+	BB	BB		

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

Russia's growth performance and debt situation have improved sharply, but political and governance issues remain

Had it existed at the time, Russia's Damocles index would have given ample warning of the banking and currency crisis of 1998. Subsequently, Russia's macroeconomic performance has improved dramatically. Benefiting from real exchange rate depreciation, a consistently high crude oil price and the advancement of reforms under President Putin, the economy has expanded rapidly since 1999. Furthermore, the budget and current accounts are now in substantial surplus, and the foreign debt burden has been reduced. Accordingly, the Damocles index suggests that a repeat of the 1998 crisis is improbable, unless the crude oil price were to remain low for a prolonged period. That said, concerns remain about the significant structural shortcomings of the economy, not least of which relate to governance issues.

Damocles index for Russia*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	**2.5**	3.8	7.5	8.2	9.4	12.2	13.0
Foreign reserves / short-term external debt	Below 1, and/or	**0.7**	1.0	2.2	2.3	2.7	3.3	3.7
	Below 2 and falling	no	no	no	no	no	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	1.9	2.1	1.5	1.5	1.4	1.4	1.5
External debt as % of GDP	Above 50%	46.6	**56.6**	37.3	31.0	28.8	25.4	23.7
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	21.5	14.4	11.1	13.9	14.8	15.3	14.8
Current account deficit as % of GDP	Above 3%, and	0.1	12.6	18.0	10.9	8.5	8.9	8.2
	Above 3% and rising by 1pp y-o-y	no	no	no	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	7.6	12.0	13.3	15.8	17.4	21.7	21.5
	Above100% and rising by 5pp y-o-y	no	no	no	no	no	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	-52.2	**-23.2**	-13.8	**2.3**	-9.6	-10.5	-9.6
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	52.1	38.3	**-21.1**	15.8	7.2	2.0	23.4
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	-62.0	-36.2	**5.4**	**24.1**	**8.3**	**8.5**	**10.1**

** Figures are for the end of period.*

Singapore: Facing intense competition

2003 Nominal GDP (US$bn)	91
2003 GDP per capita (US$)	21,638

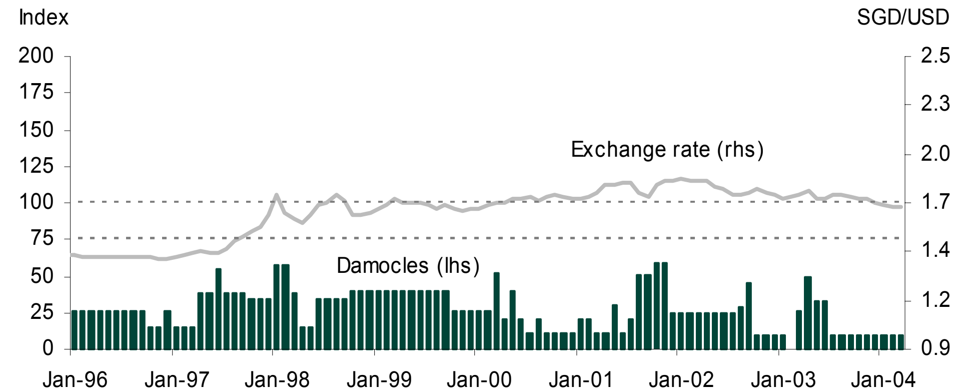
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	8.5	-0.9	6.9	9.7	-1.9	2.2	1.1	5.2	4.0
CPI (% y-o-y)	2.0	-0.3	0.1	1.4	1.0	-0.4	0.5	1.5	2.0
Current account (% of GDP)	15.6	22.6	18.7	14.5	19.0	21.4	30.9	27.0	24.0
Official interest rate (%)	9.00	1.75	2.63	2.81	1.25	0.81	0.75	0.90	1.90
Currency (per US$)	1.65	1.65	1.67	1.74	1.84	1.73	1.70	1.63	1.60
Credit rating : Moody's	Aa1	Aa1	Aa1	Aa1	Aa1	Aaa	Aaa	Aaa	
: S&P	AAA	AAA	AAA	AAA	AAA	AAA	AA+	AA+	

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

Singapore must continue to seek out high value-added niche industries to maintain competitiveness

Singapore's Damocles index has held steady at 10, which is among the lowest in Asia. Singapore's external position is one of the strongest in the world: its current account surplus is equal to a huge 30% of GDP, it has scant external debt (when allowance is made for offshore banking), and its FX reserves have risen to a record high of US$101bn. Singapore's very open economy is benefiting from the global recovery, but it is facing long-term competitive pressures due to its relatively high cost structure. Singapore must keep moving up the value-added ladder into niche industries. The successful development of the pharmaceutical industry is a good example, but there is no room for complacency, lest the S$ will be under pressure to steadily weaken. A more immediate risk is financial contagion from Indonesia or the Philippines if social/political instability were to occur in the lead-up to the presidential elections in both countries in the coming months.

Damocles index for Singapore*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	9.6	9.2	8.1	9.0	9.8	10.5	10.4
Foreign reserves / short-term external debt	Below 1, and/or	**0.7**	**1.0**	1.2	1.1	1.4	1.5	1.6
	Below 2 and falling	no	no	no	no	no	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	1.4	1.4	1.3	1.4	1.3	1.2	1.2
External debt as % of GDP	Above 50%	325.6	271.5	237.7	258.0	265.3	274.1	274.0
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	83.8	54.9	40.1	44.4	43.2	40.6	39.7
Current account deficit as % of GDP	Above 3%, and	22.6	18.4	14.3	18.8	21.4	30.9	30.4
	Above 3% and rising by 1pp y-o-y	no	no	no	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	**114.4**	**108.9**	98.9	**117.1**	**109.3**	**114.1**	111.2
	Above100% and rising by 5pp y-o-y	**Yes**	no	no	**Yes**	no	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	2.3	-0.1	0.6	1.3	0.2	-0.4	-1.3
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	42.8	7.6	-5.5	-2.9	-3.5	8.6	7.3
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	-9.7	1.5	**6.6**	-2.6	0.0	-2.5	1.4

** Figures are for the end of period. External debt as % of GDP was "turned off", given that it largely reflects Singapore's role as a large offshore banking sector.*

South Africa: The rand under threat?

2003 Nominal GDP (US$bn)	160
2003 GDP per capita (US$)	3600

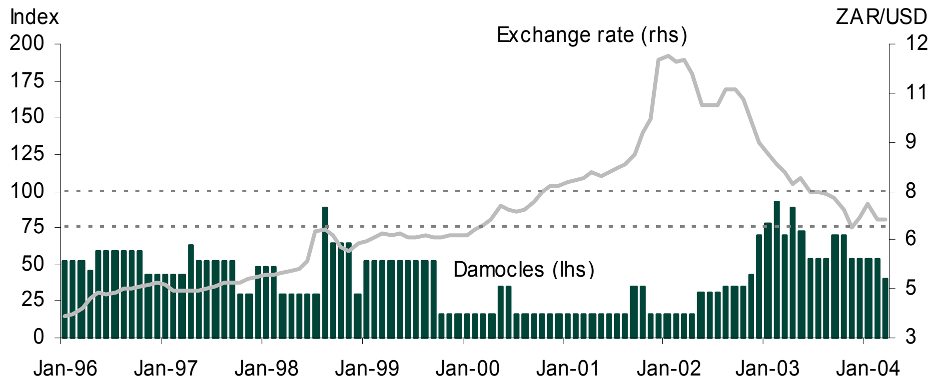
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	2.7	0.7	2.0	3.5	2.8	3.1	1.2	3.2	2.6
CPI (% y-o-y)	8.6	6.9	5.2	5.3	5.6	10.0	6.5	4.1	&.0
Current account (% of GDP)	-1.5	-1.7	-0.5	-0.4	-0.3	0.1	-1.5	-3.0	-3.0
Official interest rate (%)	15.75	19.00	12.00	12.00	9.50	13.50	8.00	8.50	9.00
Currency (per US$)	4.9	5.9	6.1	7.6	11.5	9.5	6.3	7.5	8.2
Credit rating : Moody's	Baa3	Baa3	Baa3	Baa3	Baa2	Baa2	Baa2		
: S&P	BB+	BB+	BB+	BBB-	BBB-	BBB-	BBB		

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

A worsening current account could push the rand lower later in 2004

South Africa's Damocles index dropped in March to 41 because of a surge in FX reserves, but the rand is still vulnerable at current levels. Although the central bank has continued to rebuild its reserves, it still does not have a lot of ammunition with which to defend the currency. Furthermore, the rand has continued to appreciate in real terms, putting pressure on exports. We expect the strength of consumer demand eventually to lead to a surge in imports, pushing the current account deficit sharply higher. If so, the rand could weaken in the second half of the year. That said, the recent newsflow has been positive, with the PMI suggesting that the manufacturing sector might be expanding again. There is some possibility therefore that the recovery in world trade pushes exports higher, and so reduces the vulnerability of the currency.

Damocles index for South Africa*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	**2.4**	**2.4**	3.3	3.2	4.5	**2.7**	**2.1**
Foreign reserves / short-term external debt	Below 1, and/or	**0.4**	**0.4**	**0.5**	**0.6**	**0.7**	**0.8**	**0.7**
	Below 2 and falling	no	no	no	no	no	**Yes**	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	13.2	13.6	10.4	8.9	6.5	**10.1**	**13.7**
External debt as % of GDP	Above 50%	14.7	16.8	16.6	16.7	19.7	23.0	16.5
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	55.8	58.8	58.9	43.8	39.1	35.5	32.5
Current account deficit as % of GDP	Above 3%, and	-1.5	-1.7	-0.5	-0.4	-0.3	0.3	-1.4
	Above 3% and rising by 1pp y-o-y	no	no	no	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	57.9	62.3	66.2	60.3	50.2	74.8	79.3
	Above100% and rising by 5pp y-o-y	no	no	no	no	no	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	13.1	14.0	13.3	7.5	8.4	4.6	11.2
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	**-10.1**	-6.9	12.2	-0.8	14.9	-1.6	8.6
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	1.4	-12.2	-3.4	-6.0	-29.3	**4.6**	**35.7**

** Figures are for the end of period.*

Taiwan: Sound economy, but political risk

2003 Nominal GDP (US$bn)	286
2003 GDP per capita (US$)	12,690

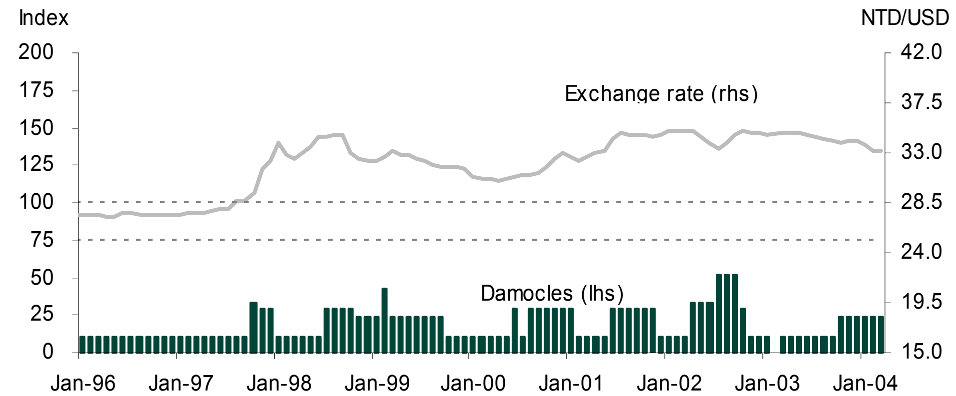
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	6.7	4.6	5.4	5.9	-2.2	3.6	3.2	6.0	5.0
CPI (% y-o-y)	0.9	1.7	0.2	1.3	0.0	-0.3	-0.3	2.0	2.0
Current account (% of GDP)	2.4	1.3	2.9	2.9	6.4	9.1	10.0	8.0	6.0
Official interest rate (%)	5.25	4.75	4.50	4.63	2.13	1.63	1.38	2.00	4.00
Currency (per US$)	32.3	32.3	31.6	33.1	34.7	34.8	34.0	30.0	29.0
Credit rating : Moody's	Aa3	Aa3	Aa3	Aa3	Aa3	Aa3	Aa3	Aa3	
: S&P	AA+	AA+	AA+	AA+	AA.	AA-	AA-	AA-	

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

The biggest uncertainty is politics at home, which could destabilise Taipei-Beijing relations

Taiwan's Damocles index is in safe territory, at 24, because of a very strong external position: FX reserves are at a record high of US$225bn, the current account surplus has swelled to 10% of GDP, and the country has scant external debt. Moreover, the economy is recovering rapidly, underpinned by over 100% y-o-y growth in direct exports to China, a very competitive exchange rate and record low domestic interest rates. What is more, progress on financial reform has reduced the NPL ratio to 4.5% from a peak of 8.4% in March 2002, and consequently banks are lending again. Consumer credit growth accelerated to 12.7% y-o-y in January, a five-year high, and this is helping spur the housing market, which has been in the doldrums for over a decade. Taiwan still needs to reduce its large budget deficit, and strengthen its non-bank financial institutions, but the biggest uncertainty is politics at home, which could destabilise Taipei-Beijing relations.

Damocles index for Taiwan*

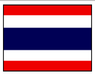


* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	10.4	11.5	9.1	13.7	17.2	19.5	20.1
Foreign reserves / short-term external debt	Below 1, and/or	4.8	6.0	7.7	9.5	10.5	8.4	8.8
	Below 2 and falling	no	no	no	no	no	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	5.6	5.2	5.3	4.6	3.6	3.0	2.9
External debt as % of GDP	Above 50%	10.9	8.6	6.6	8.5	12.1	18.4	19.0
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	14.8	12.8	8.3	9.0	10.2	14.8	14.8
Current account deficit as % of GDP	Above 3%, and	1.3	2.9	2.9	6.4	9.1	10.0	9.3
	Above 3% and rising by 1pp y-o-y	no	no	no	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	**141.0**	**138.6**	**127.0**	**126.6**	**124.1**	**131.1**	**133.0**
	Above100% and rising by 5pp y-o-y	**Yes**	no	no	no	no	**Yes**	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	2.8	4.6	3.1	4.1	0.9	1.1	-0.2
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	-1.3	4.1	**-29.1**	11.2	-1.6	6.8	10.7
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	-9.4	-4.4	-1.6	-4.3	-4.9	-6.1	-3.3

** Figures are for the end of period.*



Thailand: Private debt must not grow too fast

2003 Nominal GDP (US$bn)	142
2003 GDP per capita (US$)	2,211

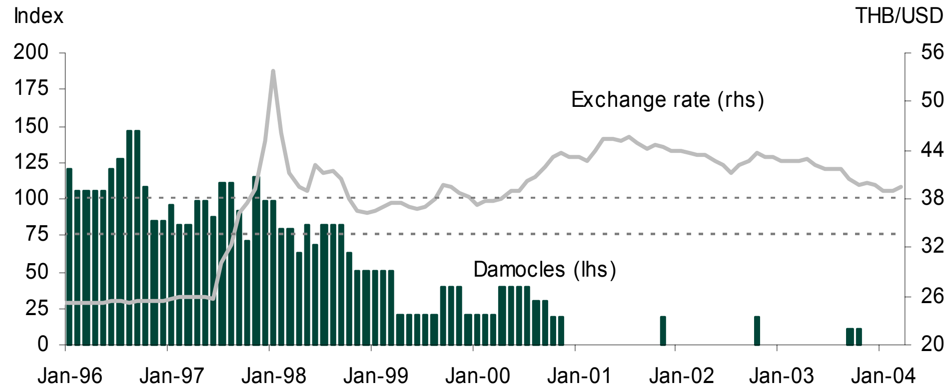
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	-1.4	-10.5	4.5	4.8	2.1	5.4	6.7	7.0	6.0
CPI (% y-o-y)	5.6	8.1	0.3	1.6	1.7	0.6	1.8	2.5	3.5
Current account (% of GDP)	-2.1	12.8	10.2	7.6	5.4	5.5	5.6	3.0	0.5
Official interest rate (%)	22.22	3.98	1.48	1.50	2.46	1.75	1.25	2.00	3.00
Currency (per US$)	45.2	36.2	38.2	43.1	43.9	43.1	39.6	36.0	34.0
Credit rating : Moody's	Ba1	Ba1	Ba1	Baa3	Baa3	Baa3	Baa1	Baa1	
: S&P	BBB	BBB-	BBB-	BBB-	BBB-	BBB-	BBB	BBB	

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

The focus needs to shift from rapid growth to maintaining high quality growth

Thailand's Damocles index, at 0, is the lowest in Asia, because of a large current account surplus, record high FX reserves, a reduction in external debt-to-GDP, low inflation, and a big improvement in public finances. Moreover, the economic expansion has been broad based, with GDP growth of almost 8% y-o-y in 4Q, the fastest in Asia after China. However, corporate restructuring has been quite slow, and the NPL ratio of private banks is still too high, at 16.8% in December. Meanwhile, households have increased their borrowings significantly − credit card debt outstanding rising from Bt41bn in 2001 to Bt76bn in 2003 - and this has fuelled a boom in some segments of the real estate market. For a long-lasting economic expansion, high quality growth is crucial. Banks' lending must be allocated efficiently into productive investments, and Thailand's regulators need to ensure that Thai households and companies do not become overly indebted.

Damocles index for Thailand*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	6.5	7.2	5.9	6.0	7.2	7.6	7.7
Foreign reserves / short-term external debt	Below 1, and/or	**0.8**	1.8	2.2	2.4	3.5	4.1	4.0
	Below 2 and falling	No	no	no	no	no	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	6.2	4.5	4.0	4.1	3.3	3.1	3.0
External debt as % of GDP	Above 50%	**74.4**	**60.3**	49.8	44.8	35.7	30.3	31.0
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	41.5	23.7	17.1	16.7	15.7	14.3	14.9
Current account deficit as % of GDP	Above 3%, and	12.8	10.2	7.6	5.4	5.5	5.6	5.4
	Above 3% and rising by 1pp y-o-y	No	no	no	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	**159.2**	**114.5**	85.2	80.7	84.2	87.9	88.8
	Above100% and rising by 5pp y-o-y	**Yes**	no	no	no	no	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	-1.6	0.5	0.3	1.4	0.0	-0.8	-1.4
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	42.8	1.0	-0.1	-3.2	0.9	28.5	0.2
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	-3.0	-3.0	-4.1	-0.6	-0.6	1.7	**1.8**

* *Figures are for the end of period.*

Turkey: Terrorist threat?

2003 Nominal GDP (US$bn)	240
2003 GDP per capita (US$)	3400

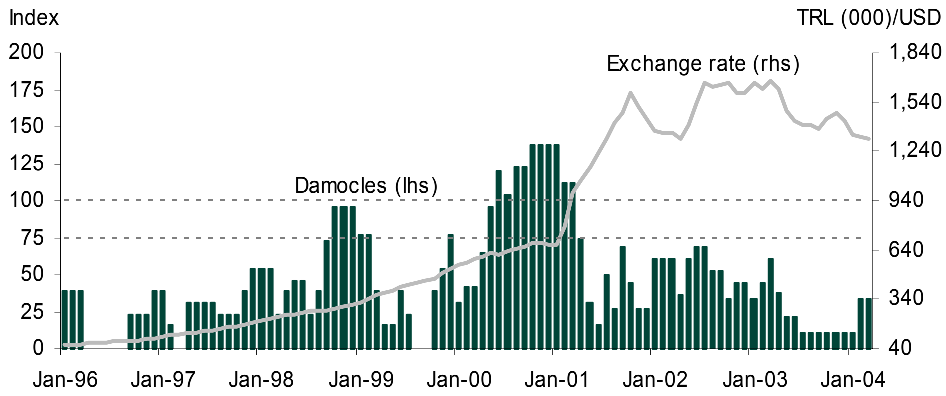
Vital Statistics*	1997	1998	1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP (% y-o-y)	7.6	3.0	-4.7	7.2	-7.3	7.8	4.5	4.0	4.0
CPI (% y-o-y)	85.8	84.6	64.9	54.9	54.4	30.0	19.0	10.0	9.0
Current account (% of GDP)	-1.4	1.0	-0.7	-4.8	2.2	-1.0	-2.5	-3.5	-3.0
Official interest rate (%)	60.00	46.00	55.00	65.00	59.00	42.00	26.00	18.00	16.00
Currency (per US$)	200	308	529	677	1442	1600	1470	1470	1650
Credit rating : Moody's	B1	B1	B1	B1	B1	B1	B1		
: S&P	B	B	B	B+	B-	B-	B+		

* *Economic variables are period average. Financial variables are end period. Credit ratings are for foreign currency long-term debt.*

Terrorism and a larger current account deficit are potential risks

Although Turkey's Damocles index has risen over the past few months, it remains quite low and suggests that the external vulnerability of the Turkish economy is limited. However, this is not to deny that there are short-term risks. Terrorism is one potential catalyst for capital outflows, and the continued appreciation of the real exchange rate, the short-term nature of contemporary financing of the current account and the reliance of the private sector on external borrowing all leave the country vulnerable to shocks. Indeed, we expect the lira to come under pressure in 4Q after a strong summer. Over the longer term, the prospect of EU accession in the years ahead can provide an important anchor for foreign investors, helping Turkey to garner a greater share of global capital flows and producing a structural reduction in the external vulnerability of the country.

Damocles index for Turkey*



* *A reading above 75 is a warning signal that a country's balance of payments is vulnerable to a crisis; a reading above 100 signals that a crisis could erupt at any time. For more details see the appendix.*

Vulnerability indicators* (*Figures exceeding the thresholds are highlighted in bold)

Indicators	Threshold	1998	1999	2000	2001	2002	2003	Latest
Foreign reserves/imports	Below 3	5.2	7.0	4.9	5.7	6.6	6.4	6.5
Foreign reserves / short-term external debt	Below 1, and/or	**0.8**	**0.9**	**0.7**	**0.7**	1.1	1.3	1.3
	Below 2 and falling	**Yes**	**Yes**	**Yes**	no	no	no	no
Broad money / foreign reserves	Rising by more than 1.5 points y-o-y	3.2	3.1	3.7	3.8	3.1	3.1	3.2
External debt as % of GDP	Above 50%	29.7	34.0	40.5	**52.9**	**50.5**	43.1	39.3
Short-term external debt as % of exports	Rising by more than 5pp y-o-y	**79.0**	**86.7**	**104.5**	72.9	59.2	52.9	50.5
Current account deficit as % of GDP	Above 3%, and	1.0	-0.7	**-4.8**	2.2	-1.0	-2.7	-2.3
	Above 3% and rising by 1pp y-o-y	no	no	**Yes**	no	no	no	no
Domestic private credit as % of GDP	Above 100%, and	16.4	15.0	18.4	14.0	10.6	13.5	14.5
	Above100% and rising by 5pp y-o-y	no	no	no	no	no	no	no
Real short-term market interest rate (%)	Rising by more than 3pp (3m-o-3m)	**9.0**	**-13.8**	**14.0**	-9.5	**14.3**	7.6	**9.6**
Stock market index (%, 3m-o-3m)	Falling by more than 10% (3m-o-3m)	**-31.9**	52.3	**-10.8**	15.4	18.3	37.8	17.4
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.	0.0	1.5	**8.5**	2.1	**5.2**	**9.6**	**14.4**

** Figures are for the end of period.*

APPENDIX: THE DAMOCLES FINANCIAL CRISIS INDEX

THE INDICATORS

Damocles is compromised of ten balance of payments related indicators

The Damocles index uses ten monthly indicators, which are widely recognised as possible predictors of balance of payments crises. These are shown in Figure 1. For the indicators that are available only on a quarterly or annual basis, monthly series were interpolated from longer frequency data. Damocles is calculated for 17 countries: Argentina, Brazil, China, Hong Kong, Hungary, Indonesia, Malaysia, Mexico, South Korea, the Philippines, Poland, Russia, Singapore, South Africa, Taiwan, Thailand and Turkey. The sample period spans from January 1996 to March 2004.

THE THRESHOLD VALUES

Each indicator is then allocated a signalling threshold and a weight in the composite index

For each indicator, a threshold value needs to be determined, so that whenever it breaches a certain level, it is interpreted as a warning signal that a crisis could soon occur. The threshold values are, to some extent, subjective, but they are grounded in theory and practical experience so as to strike a balance between the risk of having too many false signals and the risk of missing too many crises. Ordinarily, each indicator has a value of zero, but whenever an indicator breaches its threshold, it is assigned a value of one. The values of the individual indicators are then aggregated to form a composite index, with the weight for each indicator determined by its relative performance in predicting a crisis during the sample period.

Figure 1. The components of the Damocles index

Reserve-related indicators	
Foreign reserves/imports	Below 3
Foreign reserves / short-term external debt	Below 1, and/or Below 2 and falling
Broad money / foreign reserves	Rising by 1.5 points from a year ago
External debt-related indicators	
External debt as % of GDP	Above 50%
Short-term external debt as % of exports	Rising by more than 5pp y-o-y
Other macroeconomic indicators	
Current account as % of GDP	Above 3%, and Above 3% and rising by over 1pp y-o-y
Domestic private credit as % of GDP	Above 100%, and Above 100% and rising by over 5pp y-o-y
Real short-term market interest rate	Rising by more than 3pp (3m-o-3m)
Stock market index	Falling by more than 10% (3m-o-3m)
Real trade-weighted exchange rate (%, deviation from 3-year avg)	More than 3% above 3-year avg.

THE WEIGHTS

The first step in the weighting process is to decide what constitutes a crisis. We have defined a crisis simply as a month-on-month nominal exchange rate movement (against the US$) of more than three standard deviations from the sample mean. In practice, historically two or more crises defined in this way have often occurred close together, although they were in fact part of the same overall "crisis". Therefore, for crises to be considered as separate events, they have to be at least 12 months apart.

Noise-to-signal ratios are computed for each indicator to determine the weights

The second step is to determine the so-called "signalling horizon". The reality is that the lead-time in predicting crises varies by indicator and differs among crisis episodes and across countries. Nevertheless, in order to make the model operational and to classify warning signals as true or false, a maximum period has to be set. Because our main forecast horizon tends to be one year, we set the signalling horizon at 12 months. Therefore, a warning signal offered by an indicator (ie, when that indicator moves beyond its threshold value) is said to be "true" if a crisis follows within 12 months (case A in Figure 2), or "false" if no crisis follows within 12 months (case B). Similarly, when the observed value of an indicator stays in the normal region and hence issues no warning signals, this could be "false" if a crisis follows within 12 months (case C); or "true" if no crisis follows within 12 months (case D).

Figure 2. True and false warning signals

	A crisis follows within 12 months	No crisis follows within 12 months
Signal	A	B
No Signal	C	D

In this framework, the reliability of an indicator can be measured by calculating its so-called "noise-to-signal ratio" (NSR). The NSR is defined as the ratio of the probability of an indicator signalling a crisis during non-crisis periods (noise), to the probability of the indicator signalling a crisis during crisis periods (signal). That is:

$$NSR = [B/(B+D)]/[A/(A+C)]$$

By construction, the lower its NSR, the more reliable the indicator. We have calculated the NSR for each indicator, based on past crises experienced in our sample countries with monthly data from 1996. The observed value of each indicator is then weighted by using the inverse of the NSR to arrive at the composite Damocles index for each country:

$$DAMt = \Sigma\ (Sit\ /NSRi)$$

Damocles gives the greatest weight to the better performing indicators

DAMt is the composite index in month t, Sit is the signal from indicator i and NSRi is the noise-to-signal ratio of indicator i. Therefore, Damocles gives more weight to better performing indicators (those with smaller NSRs).

INTERPRETING DAMOCLES

A score above 100 implies a 50% chance of a crisis within 12 months. A score above 75 implies a one-in-three chance

The next question is "how high does the Damocles index need to go to embody a serious risk of a crisis?" Clearly, the higher the cut-off value of Damocles, the lower the possibility that it will falsely call a crisis (case B in Figure 2, or Type 2 error). On the other hand, if the cut-off value is set too high, there is a high risk that Damocles will miss signalling a crisis (case C in Figure 2, or Type 1 error). For ease of interpretation, we have re-indexed the Damocles indices and, based on past experience, selected the cut-off values such that a reading above "100" means that there is a 50-50 chance of a financial crisis erupting over the next 12 months, and a reading above "75" means that there is a one-in-three chance of a financial crisis, and so should be interpreted as a strong warning signal that the country in question is vulnerable to a crisis.

LIMITATIONS OF DAMOCLES

Damocles should not be looked at in isolation

We are under no illusions that this approach has its limitations, and clearly the Damocles index needs to be treated with caution. One of the most obvious problems is that, in practice, the level of vulnerability of a country implied by a particular variable differs depending on the surrounding environment. For instance, high external debt may not matter if that country's other structural fundamentals are strong and international financial markets are orderly. By the same token, low international reserves may not be problematic if international investors exhibit favourable sentiment toward emerging markets. In addition, the model fails explicitly to take account of considerations such as the soundness of banking sectors, real estate prices, and political stability due to a lack of comparable and user-friendly data. Therefore, the Damocles index should always be open to interpretation, and used as only one tool among many others for analysis of external risks.

We hereby certify (1) that the views expressed in this research report accurately reflect my/our personal views about any or all of the subject securities or issuers referred to in this report and (2) no part of my/our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report. Rob Subbaraman; Russell Jones.

Any reports referenced herein published after 14 April 2003 have been certified in accordance with Regulation AC. To obtain copies of these reports and their certifications, please contact Larry Pindyck (lpindyck@lehman.com; 212-526-6268) or Valerie Monchi (vmonchi@lehman.com; 44-207-102-8035).

LEHMAN BROTHERS

Where vision gets built. SM