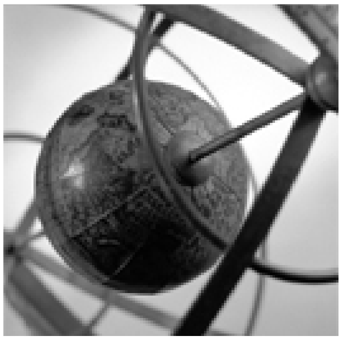
LEHMAN BROTHERS

Emerging Markets Weekly Economic Monitor

GLOBAL ECONOMICS | FRIDAY, FEBRUARY 22, 2008



Latin America
Guillermo Mondino
1-212-526-7791
gmondino@lehman.com

EMEA
Tolga Ediz
44-20-7102-7467
tediz@lehman.com

Asia Ex-Japan
Rob Subbaraman
852-2252-6249
rsuba@lehman.com

Extracted from the Global Weekly Economic Monitor. Available on LehmanLive: http://www.lehmanlive.com

GLOBAL LETTER

Debt deflation: Lessons from Japan

Paul Sheard
+1 212 526 0067
psheard@lehman.com

As risks mount, the lessons from Japan for US policymakers become more potent.

As concerns about a US credit crunch and recession steadily build, and policy proposals to head off a worst-case outcome are vigorously debated, it is worth reflecting on the lessons that can be drawn from Japan's recent "debt deflation"[1] experience.

We argued recently that there are some fundamental differences between the US housing and credit bubble of recent years and Japan's great real estate and equity price bubble of the 1980s, which make it much less likely that the US would follow in Japan's footsteps into a prolonged period of deflation. These related to their relative size (Japan's asset price bubble was bigger); the different nature of their respective financial systems (Japan's was much more conducive to allowing problems to fester and become chronic); and policy responses (the US seems less likely to repeat Japan's policy failures) (see "US and Japan bubbles compared", *Global Weekly Economic Monitor*, 1 February 2008).

The first two points are given; the third still to be seen. We draw the following lessons:

Prevention is better than cure. The biggest lesson from Japan is that it is easier to prevent a debt deflation than to deal with its consequences. Once the economy falls into deflation and a liquidity trap, self-sustaining dynamics can dominate and conventional monetary policy loses its effectiveness since nominal interest cannot be cut below zero. That argues for policymakers to act pre-emptively (early), aggressively (with force) and in a coordinated and comprehensive fashion (using all the policy tools available, together). It argues strongly for the central bank to adopt a "risk-management" approach to monetary policy, as the Fed is doing; it also argues for not relying on monetary policy to do all the heavy lifting: fiscal policy and "surgical" policies, aimed at the root of the problems, should also be used. That is also happening in the US.

Preventing the bubble (or at least leaning against it) is even better still. The Bank of Japan was slow to prick the bubble, not hiking rates until late in the game. The Greenspan Fed also may have been too slow to remove its easy money. Protestations that central banks are no better than markets at identifying bubbles seem to us oddly off cue.

Don't allow a debt overhang to hang around (let bygones be bygones). When an asset price bubble bursts, the debt overhang that is generated as a result can stymie the effectiveness of monetary policy because, even with interest rates going lower, borrowers are focused on paying down their debt rather than borrowing more money. This is where a financial system that facilitates debt being marked to market – and therefore eliminated quickly – comes in handy. Policies that facilitate – rather than hinder – that process, help.

Don't talk down the effectiveness of policy. Policy is partly (largely?) a confidence trick because it works on expectations. Policymakers should act resolutely but also talk and act as if they expect their policies to be effective, helping to create self-fulfilling expectations. This cuts both ways. If policymakers sound defeatist, they have probably lost the battle. For the Bank of Japan to implement quantitative easing was a bold and enlightened move; to suggest that it was unlikely to work was unhelpful, at best.

Use the market mechanism as much as possible. Policymakers, faced with a risk of a debt deflation, need to walk a fine line. As argued, strong policy intervention is needed but it should not kill the goose that lays the golden egg. Japan responded to its financial crisis in 1995 by fully guaranteeing all bank deposits – Alastair Darling and Northern Rock writ large. This nipped a bank run in the bud but it also turned off market forces.■

[1] *The term "debt deflation" is due to Irving Fisher ("The Debt Deflation Theory of Great Depressions",* Econometrica*, 1933) and refers to the vicious circle created by falling prices and a rising real debt overhang, such as can be triggered by an asset price collapse after a debt-financed asset price bubble.*

EMERGING MARKETS OVERVIEW

Spanish banks in Latam: Agents of contagion?

Guillermo Mondino
+1 212 526 7791
gmondino@lehman.com

Andrés Pardo
+1 212 526 8326
anpardo@lehman.com

Spanish banks face significant challenges at home. This could affect their lending activity in Latin America. However, we think any contagion will likely be small.

Over the past decade Spanish banks have made an aggressive entry into Latin America's banking sector. They stand out among foreign banks in the region (Figure 1), with Santander and BBVA leading the pack. As global financial institutions suffer the consequences of deteriorating credit portfolios, we wonder if problems at home could act as a contagion channel, increasing risk aversion and spreading the credit malaise to this corner of the emerging world.

Rapid expansion in bank credit has fueled growth in Latin America

As we have argued before, the fast rate of credit growth to the private sector, if truncated, could result in a sharp slowdown in economic activity (see "A credit question", *Emerging Markets Compass*, 30 November 2007). Indeed, bank credit still accounts for a relatively small fraction of GDP in most Latin countries (except for Chile), but it grew very quickly in 2007 (Figure 2). Growth in credit has oiled domestic expansion and facilitated very strong performance. In our view, sustained rapid credit expansion during 2008 is a key to keeping the region's growth relatively immune to a global slowdown.

Spain's economy is vulnerable

Lehman Brothers' European economics team regards Spain's economy as among the most sensitive in the current environment. Although the country is not expected to go into recession, vulnerabilities abound. Households and corporations are highly levered and dependent on bank funding. Corporations fund 75% of their gross capital formation from external sources, versus less than 40% in the euro area as a whole. Household debt is more than 100% of disposable income, making Spaniards the most indebted consumers in the euro area. Corporate debt stands at 112% of GDP and the current account deficit is 10% of GDP. Moreover, confidence has tanked. On the bright side, Spain has ample ability to conduct expansionary fiscal policy, having had three years of sizable fiscal surpluses. Indeed, even 2008 looks set to yield another 1% surplus.

The overheated housing market could correct

The Spanish housing market is overheated and looks set to slow sharply in 2008. House price inflation has been falling fast and in the two main metropolitan areas, Madrid and Barcelona, prices are falling (Figure 3). Valuations in Spain are among the highest in Europe. The ratio of home prices to rent is the highest and that of home prices to income stands at 160%, the historical mean and among the highest in Europe (Figure 4).

Figure 1. Foreign bank share in banking systems

	Foreign	Spanish	Domestic
Argentina	37.0%	13.0%	63.0%
Brazil	21.9%	11.9%	78.1%
Chile	28.8%	21.6%	71.2%
Colombia	20.6%	11.8%	79.4%
Mexico	80.4%	38.8%	19.6%
Peru	51.3%	26.8%	48.7%

Source: Lehman Brothers, LatinSource, various national sources.

Figure 2. Expansion of bank credit in Latin America

	Credit/GDP	Credit growth y-o-y
Argentina	16%	39%
Brazil	37%	25%
Chile	71%	15%
Colombia	31%	27%
Peru	20%	22%
Mexico	17%	20%

Source: Lehman Brothers, various national sources.

Spanish banks have heavy exposure to real estate

Banks in Spain are heavily exposed to the housing market. Total exposure to the sector (including construction, real estate and household mortgages) reaches 55% of total assets. Although exposure to the sector is heavy, the quality of the assets seems better than in other markets. The total bank non-performing loan (NPL) ratio remains comfortably low at 0.69%, with real estate at 0.18% and construction at 0.46%, in contrast with the 12% it had reached during the previous economic cycle. However, the total NPL ratio has increased by 0.2 percentage point since 2006, which we think warrants concern. For the time being, the issue appears contained, as the coverage ratio of NPLs is 276%. But, if conditions in the real estate market were to markedly deteriorate, bank capital could be under pressure.

Banks hold risky segments of CDOs and have a large inventory of unsold securities

Spanish banks hold almost no US subprime exposure and there is no equivalent market in Spain. Lending standards have been stricter as banks do not separate the origination/distribution process, resulting in a more prudent origination approach. Standard practice is for banks to hold most of the junior and equity tranches of securitized portfolios, which account for roughly 6% of securitized products, and the other 94% are triple-A rated. The current underlying delinquency rate is 0.5%, having reached 4% during the last recession. According to press reports, banks are also warehousing €53bn of securitized products which, for liquidity purposes, have been used in repo operations with the ECB. Therefore, bank exposure to a sizable shock to the housing market could still be significant.

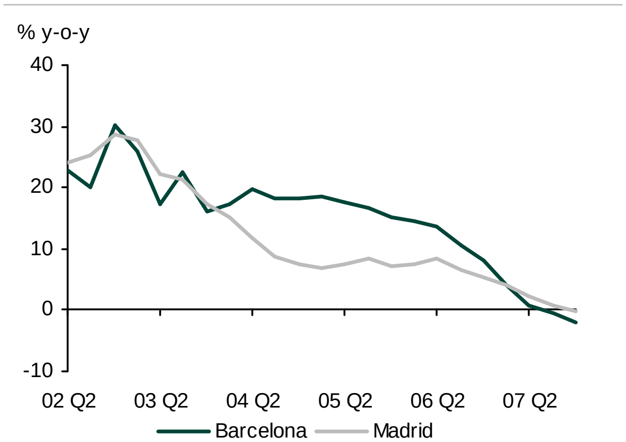
A macroeconomic shock could significantly reduce banks' ability to take risk

The slowing economy, a highly levered private sector and a deflating housing market are likely to hit Spanish banks' bottom lines in coming quarters. While most analysts take comfort in the absence of subprime exposure, we are concerned about the equity tranches of CDOs. A correlated drop in home prices and a pick-up in unemployment could result in a sharp escalation of delinquencies, which might affect the banks capital base. Smaller banks and saving institutions could be among the more seriously affected. However, the large internationalized institutions – the ones with a big presence in Latin America –have taken greater leverage and hold the largest equity segments of the securitized portfolios.

The potential impact on Latam, however, looks small

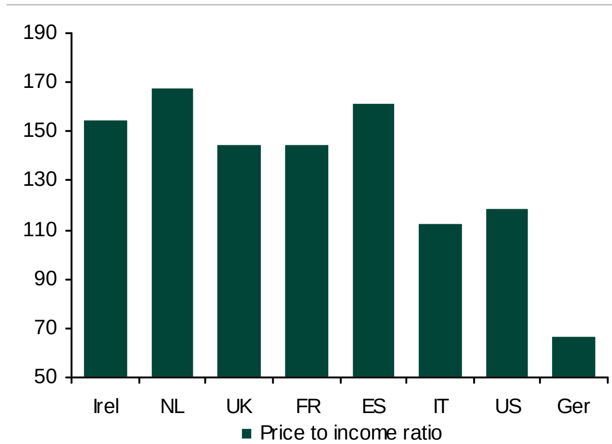
We think that the factors described above could spread contagion to Latin America, although the transmission channel is unclear: institutions that depend more on inter-group funds could suffer a sharper credit crunch; or contagion could operate through liquidation of banks' extensive holdings of trading and asset portfolios to raise liquidity. Also, if profitability at home is challenged, Latin American business units could face higher profitability hurdles or tighter risk limits. Nevertheless, the fact that Spanish banks still appear well capitalized and with reasonable quality assets is comforting. Any contagion seems unlikely to sicken the Latin American economies unduly.■

Figure 3. Home prices: Barcelona and Madrid



Source: Idealista, Lehman Brothers.

Figure 4. Home prices to income ratio



Source: OECD, Lehman Brothers.

ARGENTINA: OUTLOOK

Fast-paced muddling through

Guillermo Mondino
+1 212 526 7791
guillermo.mondino@lehman.com

Inflation and poor microeconomic policies will likely put Argentina to the test in 2008.

Rapid growth will likely be challenged by inflation and the distorted business environment

Argentina has managed five years of growth above 8%. Strong domestic momentum remains in place and we expect macro policies to attempt to maintain demand growth. On the other hand, potential output has failed to keep pace, spurring inflation. Although the authorities report inflation at 8.5% for 2007, other indicators put the genuine rate of price increases closer to 20%. To contain runaway inflation, the government has resorted to a number of microeconomic distortions which create a very negative business environment. As a result, Argentina sports the lowest foreign direct investment to GDP ratio amongst the major Latin American economies. The authorities' macro and microeconomic policies are increasingly being tested amidst a gradual fall in the government's popularity.

The pro-cyclical fiscal policy is not being cured, despite an effort to shore up fiscal revenues

After a pro-cyclical fiscal easing in 2006 and 2007, the government has partially tightened fiscal policy through a tax package and some expenditure restraint..We judge the taxes to be highly distortive, absorbing part of the positive impulse to aggregate demand stemming from the booming terms of trade, rather than containing burgeoning domestic demand. Nevertheless, the new revenues should aid the authorities on the financing front and be a handy political device by disbursing cash to needy governors. Provincial fiscal numbers, already in deficit, look set to keep deteriorating. On this issue, attention should be placed on public sector wages

Little progress expected on remaining defaulted debts

On the external front, debt negotiations (including the six-year-old Paris Club default and market debt still in default) have become less of a priority. In the meantime, Argentina's financing looks manageable, but challenging. In 2008, we estimate the government needs to raise $4.7bn in market debt, slightly less than in 2007. However, 2009 is expected to be more challenging.

The nominal exchange rate should remain stable

Fast inflation and low policy credibility, plus the comfort of an undervalued currency, have added value to the use of the exchange rate as a nominal anchor. We expect continued real appreciation of the peso against the dollar in 2008. In the meantime, the extraordinarily high terms of trade should slow the shrinking of the current account surplus. International reserves should accumulate, but at a slower pace.

The outlook at a glance

	2007	2008	2009
Real GDP, %chg	8.7	6.0	3.7
Unemployment rate % (end of period)	7.6	7.0	7.5
Consumer prices, % chg (Dec/Dec)*	8.5	12.0	15.0
Short-term interest rates (end of period)	13.6	15.0	18.0
Fiscal balance, primary % GDP	2.7	4.1	3.5
Total public sector debt % GDP**	56.7	50.9	46.7
Exchange Rate ARS/US$ (end of period)	3.14	3.23	3.40
Real Exchange Rate/US$ (avg Dec 2001=1)	1.84	1.74	1.63
Current account balance %GDP	2.6	1.5	0.2
International Reserves US$bn	45	50	50

Table last revised, 28 January 2007

** Estimated officially reported inflation*

*** Debt excludes bonds untendered in the 2005 exchange*

Source: Lehman Brothers.

Manageable financing needs (US$ bn)

	2007F	2008F
Financing Needs	**16.3**	**20.0**
Total interest payments	4.2	4.9
IFIs debt amortizations	2.6	2.2
Debt amortizations (ex IFIs)	7.3	9.1
Debt buyback and GDP warrant payments	1.3	2.5
Transfers to provinces and judicial claims	1.0	1.5
Financing Sources	**16.4**	**20.1**
Primary Surplus Treasury	4.4	8.7
Tax withholding from provinces (Bogar)	1.0	1.2
Use of previous-year financing cushion	1.0	0.0
WB/IADB rollover	2.3	2.3
Central Bank Assistance to Treasury	0.0	0.0
Intra-public sector debt (rollover + new resources)	1.5	3.2
Market debt	**5.6**	**4.7**
Other	0.6	
Memo: Surplus public agencies	*2.2*	*2.8*

Source: Lehman Brothers based on MacroVision Consulting.

BRAZIL: OUTLOOK

And now for something completely different…

John H. Welch
+1 212 526 5843
john.welch@lehman.com

Brazil's economy is shaping up very differently from the past four years. High GDP growth will likely tip the current account into deficit, keeping Banco Central cautious.

Growth should slow in 2008…

The economy continued to accelerate in H2 2007 and we do not expect it to start slowing until late 2008. We expect growth to end 2007 at 5.3%, well above our long-term sustainable growth estimate of 4.2%. Cautious monetary policy and a deteriorating current account should help GDP move back toward the mean in 2008, to end the year at 4.4%.

…but a stronger fiscal effort seems unlikely with the loss in CPMF revenue and ahead of regional elections

A stronger fiscal effort is a more efficient way to combat high real demand growth, but the Lula administration has shown no appetite for this. Faced with the loss of BRL40bn from CPMF transactions tax, the Finance Ministry announced a 38bp increase in the IOF (Financial Operations Tax) tax on loans, exports of goods and services, imports of services, and insurance policies as well as a rise in the CSLL (net profit tax) on financial institutions after denying that such an increase would come. The government hopes these measures will generate BRL10bn in revenue. The government also promised BRL20bn in expenditure cuts but with no specific details. The remaining BRL10bn is to come from growth in tax receipts from economic growth. We do not expect the government to completely compensate for the loss in revenue but we have reduced our forecast for the primary surplus by only a small amount. We had already expected a fiscal easing due to political pressure ahead of regional elections in October, and the elimination of the CPMF will generate cuts in expenditure that would otherwise not have occurred. Hence, we expect the public sector net debt/GDP ratio to decline at a snail's pace, falling below 40% in 2009.

Domestic demand growth should push the current account into deficit and keep Banco Central on hold

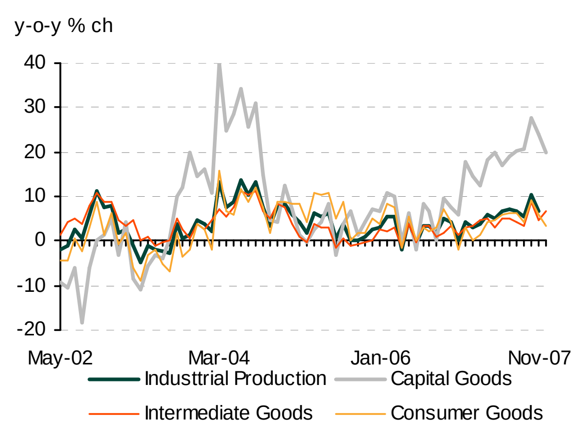
Robust domestic demand growth and a strong BRL are fostering high import growth. Despite continued strong exports, we expect the trade surplus to fall to $29bn, corresponding to a current account deficit of 0.3% of GDP in 2008 – the first such deficit in six years. We expect a trade surplus of $22bn in 2009 and a current account deficit of 0.7% of GDP. Amid this demand growth and in the likely absence of fiscal tightening, we expect Banco Central to be cautious throughout 2008. We expect it to stay on hold throughout the year and return to cutting in 2009. The October mid-term elections should encourage Banco Central to stay put for a while to avoid the appearance of trying to influence the outcome. The Q4 2007 spike in inflation should moderate in Q1 2008, enough to stay Banco Central's hand from increasing the SELIC rate in 2008.

The outlook at a glance

	2007	2008	2009
Real GDP, % y-o-y	5.3	4.4	3.3
Consumer prices, % y-o-y	4.4	4.	4.2
Short-term policy rate, end-yr, %	11.25	11.25	11.00
Fiscal balance, nominal, % GDP	-2.2	-1.7	-2.4
Total public sector debt, % GDP	42.8	40.0	37.6
BRL/US$, end-yr	1.78	2.00	2.10
Current account balance % GDP	0.6	-0.3	-0.7
International reserves US$bn	173	182	183
Trade balance US$bn	41	29	22
Total trade, %GDP	23.2	21.3	24.6
Total external debt, % GDP	16.3	13.4	14.6

Source: Lehman Brothers.

Industrial production growth



Source: IBGE and Lehman Brothers.

MEXICO: OUTLOOK

Slowing down *ma non troppo*

John H. Welch
+1 212 526 5843
john.welch@lehman.com

Mexican growth should slow in 2008 but not by as much as in the US. Food prices are putting more pressure on inflation and tax reform in 2008 will likely provide another price shock. Banxico is trying to cut inflation without further disrupting the economy.

Mexican GDP growth looks set to slow but not as much as in the US

Although Mexican economic growth has not slowed sharply in 2007 – in fact it picked up in H2 – the projected slowing of the US economy will ultimately affect Mexico. But unlike many observers, we do not think Mexico's economy will slow as much as that of the US. Lehman Brothers expects US GDP to slow to 1.8% in 2008 after 2.2% in 2007, but we expect Mexican growth to slow to 2.8% in 2008 from 3% in 2007. We estimate that a slowdown in exports will contribute most to the GDP slowdown while domestic demand will likely slow because of tight money but remain reasonably strong.

Banxico will keep money tight until growth slows

Banxico has raised its target rate to 7.5% in anticipation of more pressure on food prices in 2007 and of price increases from tax reforms that come into effect in 2008. Agricultural prices are again putting upward pressure on inflation. Although inflation is in line with its expected trajectory, the Bank has said it needs to hike to keep inflation on a path towards 3%. Banxico now sees inflation converging to the 3% target at the end of 2009 instead of at the end of 2008. With upside inflation risks outweighing downside risks, monetary policy is tightening in the face of future economic weakness. We expect Banxico to keep the fondeo at 7.5% until September 2008 and then to cut by 25bp in the face of a serious economic slowdown. We see two cuts of 25bp to 7.0 % at the end of 2008. We still expect 2008 inflation to come in at 3.7%, the same level that we expect for 2007.

Stronger growth in Mexico than in the US will keep the USD/MXN strong

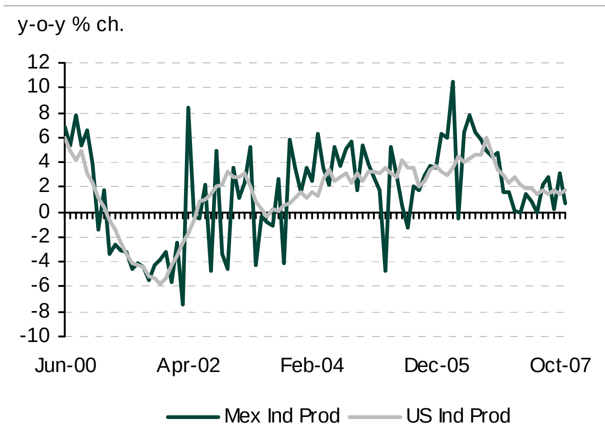
Given that we expect Mexican growth to outstrip US growth and our FX team expects USD to stop depreciating against EUR, USD/MXN should remain strong, ending 2008 at 11.09. Slower export growth should keep the trade deficit just under the $11.7bn deficit we expect in 2007 and, combined with flat worker remittances, increase the current account deficit to more than 1% of GDP in 2008. The expansion of the current account deficit should be sustainable because it represents about two-thirds of one month's imports. With monetary policy tight, the fiscal stance improving in the wake of fiscal reform and external solvency indicators strong, Mexico's assets should continue to outperform.

The outlook at a glance

	2007	2008	2009
Real GDP, % y-o-y	3.2	2.8	3.6
Consumer prices, % y-o-y	3.8	3.2	2.9
Short-term policy rate, end-yr, %	7.50	7.0	6.5
Fiscal balance, nominal, % GDP	-1.2	-0.9	-0.5
Total public sector debt, % GDP	35	32	30
MXN/US$, end-yr	10.85	11.09	11.25
Current account balance % GDP	-1.0	-1.1	-1.5
International reserves, US$ bn	78	74.9	74.9
Trade balance, US$ bn	-11.7	-11.4	-15.1
Total trade, %GDP	64.9	66.6	68.3
Total external debt, % GDP	11.7	12.2	13

Source: Lehman Brothers.

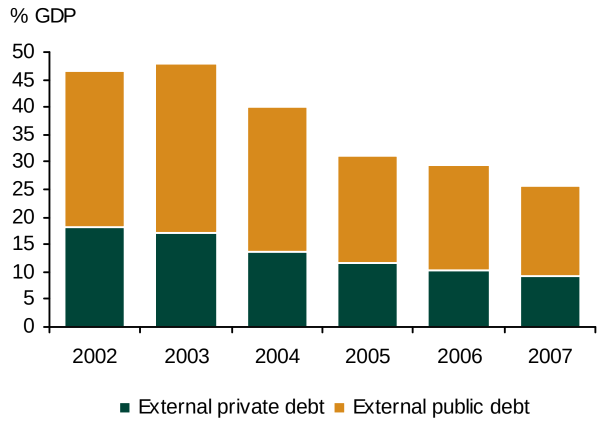
Mexican and US industrial production growth



Source: Banxico and Lehman Brothers.

EMERGING MARKETS – REST OF LATIN AMERICA: OUTLOOK

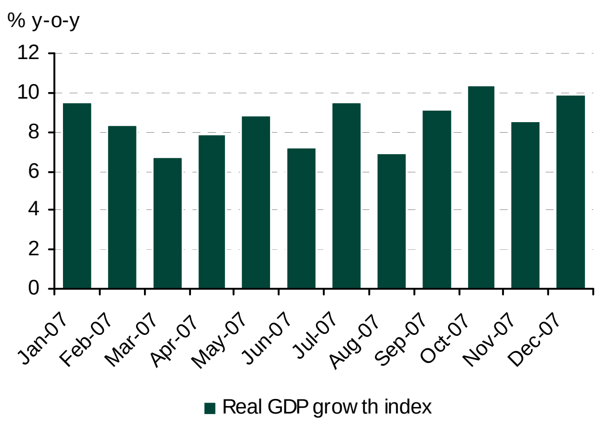
Colombia: Total external debt keeps falling



Source: DANE, Banco de la Republica, Lehman Brothers.

- December imports rose 20.7% y-o-y, raising total imports in 2007 to $33bn, up 25.7% from 2006. The share of capital goods on total imports has increased by about 4pp in the past four years.
- The central bank reported that total external debt fell to 26% of GDP in November from 29% in 2006. Public external debt dropped from 19.1% to 16.5% of GDP. The latter trend underscores the success of the government's liability management in recent years.
- FDI flows in January reached $1.1bn, more than double the inflows during the same period last year. We attribute the strong behaviour of the currency so far in 2008, in part, to this trend.

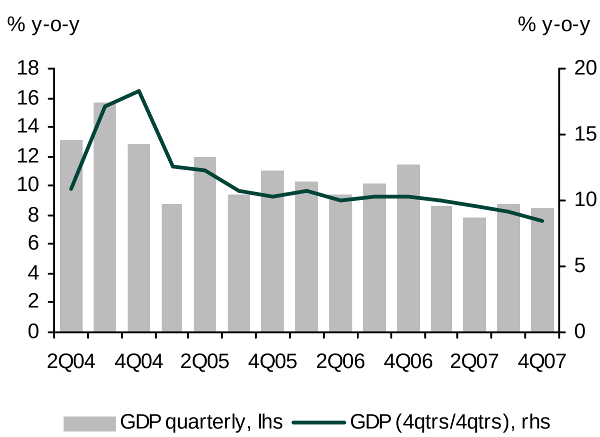
Peru: Impressive strong growth in 2007



Source: BCRP, LatinSource, Lehman Brothers.

- The economy grew 9.9% y-o-y in December, much higher than expected, led by construction at 24.5% and mining at 12.4% – mainly copper and natural gas. GDP expanded by an impressive 9% in full-year 2007.
- We forecast robust but less frenetic growth of at least 5.5% in 2008, driven by further domestic credit expansion. Risks to growth appear strongly weighted to the upside, yet inflation risks may remain in H1. We expect the public sector primary surplus to remain above 2.5% of GDP.
- The national exporters association is calling on the government to consider introducing capital controls on short-term inflows to curb the Sol's appreciation (up 3% in 2008 alone). Up to now, only the BCRP has taken measures such as regular intervention in the FX market, or introducing bank reserve requirements.

Venezuela: Deep freeze continues



Source: Banco Central de Venezuela, Sintesis Financiera, Lehman Brothers.

- Uncertainty continues in the ongoing dispute between ExxonMobil and Venezuela/PDVSA. Assets have only partially recovered as markets await more news next week about the asset freeze in the UK. We see a small chance the $12bn hold is lifted, yet it may be reduced.
- As oil prices topped $100/bl, Venezuela indicated it will not halt shipments. While this represents favourable news, government talk of a new oil windfall tax and of potentially suing ExxonMobil for unpaid bills was less supportive. The government also threatened to seize food producers, which it blames for ongoing food shortages.
- GDP expanded 8.5% in Q4, lifting total GDP growth for the year to 8.4%. Non-oil GDP was the driver; it expanded 8.8%, while the oil sector rose 0.7%.

LATIN AMERICA: PREVIEW

The week ahead

Guillermo Mondino
+1 212 526 7791
gmondino@lehman.com

Gianfranco Bertozzi
+1 212 526 3339
gbertozz@lehman.com

Andrés Pardo
+1 212 526 8326
anpardo@lehman.com

Mauro Roca
+1 212 528 9039
mroca@lehman.com

John H. Welch
+1 212 526 5843
john.welch@lehman.com

This week's focus will be on fiscal and external figures from Brazil and Mexico. Additionally, Colombia, Peru and Venezuela will release February inflation data.

In Brazil, January fiscal figures should show some temporary improvement, despite the recent easing. We still expect the nominal deficit and the debt-to-GDP ratio to remain on a downtrend.

In Colombia, we do not expect February CPI data to bring much relief to the inflation picture, as pressures are unlikely to subside for some time. The impact of this figure on expectations may act as a trigger for BanRep to hike rates in the months ahead.

In Mexico, we expect the current account to show further deterioration.

In Peru, after an impressive 9.9% growth of the monthly GDP index in December, the Q4 figure should confirm a stellar year for the economy. Construction and mining have been the main drivers of growth. Inflationary pressures should continue to show in CPI data.

Economic events in the week ahead

			Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Some time in the week								
	Peru	GDP (y-o-y %)	4Q	7.9	7.9	8.4	n.a.	n.a.
Monday 25 Februrary								
13:00	Argentina	Trade balance ($ mn)	Jan	1139	1039	1786	n.a.	n.a.
6:00	Brazil	FGV CPI IPC-S (%)	22-Feb	0.97	0.82	0.48	n.a.	n.a.
8:30	Brazil	Current account monthly ($ mn)	Jan	-42	-1344	-699	n.a.	n.a.
10:00	Mexico	Current account balance($ mn)	4Q	-2523	-1444	-1346	n.a.	-2479
Tuesday 26 Februrary								
7:00	Brazil	IBGE CPI IPCA-15 (m-o-m %)	Feb	0.23	0.70	0.70	n.a.	n.a.
15:30	Mexico	GDP Current (y-o-y %)	4Q	6.9	1.7	7.0	n.a.	7.8
Wensday 27 Februrary								
8:30	Brazil	Primary budget balance (BRL bn)	Jan	15.3	6.8	11.8	8.75	n.a.
8:30	Brazil	Nominal budget balance (BRL bn)	Jan	-0.5	-5.2	-24.1	-0.28	n.a.
8:30	Brazil	Net debt GDP (%)	Jan	43.7	42.6	42.8	42.2	n.a.
Thursday 28 Februrary								
13:00	Argentina	Construction activity (y-o-y %)	Jan	12.7	8.8	10.4	n.a.	n.a.
13:00	Argentina	Construction activity (m-o-m %)	Jan	2.8	2.3	-0.3	n.a.	n.a.
7:00	Chile	Industrial production (y-o-y %)	Jan	5.05	4.17	3.35	n.a.	3.0
7:00	Chile	Industrial sales (y-o-y %)	Jan	4.9	2.7	4.6	n.a.	n.a.
Friday 29 Februrary								
15:30	Mexico	Mexican public balance (MXN bn)	Jan	50.3	3.6	-191.1	n.a.	n.a.
Saturday 1 March								
	Colombia	CPI (m-o-m %)	Feb	0.47	0.49	1.06	1.00	n.a.
	Colombia	CPI (y-o-y %)	Feb	5.41	5.69	6.00	5.82	n.a.
9:30	Peru	CPI (m-o-m %)	Feb	0.1	0.5	0.2	n.a.	n.a.
9:30	Peru	CPI (y-o-y %)	Feb	3.5	3.9	4.2	n.a.	n.a.
	Venezuela	CPI (m-o-m %)	Feb	4.4	3.3	3.4	n.a.	n.a.
	Venezuela	CPI (y-o-y %)	Feb	20.7	22.5	24.1	n.a.	n.a.

NY Time

HUNGARY: OUTLOOK

Between a rock and a hard place

Silja Sepping
+44 20 710 26837
ssepping@lehman.com

The National Bank of Hungary is likely to be more cautious than we originally expected. We revise our rate call but think a hike is still unlikely.

ECONOMIC OUTLOOK

High inflation and low growth pose a policy challenge

In our view, 2008 is unlikely to be an easy one for Hungarian policymakers. The National Bank of Hungary (NBH) faces supply-side inflation pressures and wage concerns, while economic growth has collapsed to its weakest rate in more than 10 years. We expect inflation to fall to 5.5% on average next year from 8% in 2007 but higher and more sustained food price inflation is the key risk to the outlook.

Fiscal consolidation remains on track

Economic slowdown was an expected side effect of the government's fiscal austerity measures, but growth slowed by far more than generally expected in 2007. Although raising Hungary's competitiveness is likely to be a key government objective in the coming years, it has to be balanced with the country's euro adoption aims. We expect fiscal policy to remain restrictive in 2008, with the budget deficit falling from 6% of GDP in 2007 to 4%, closer to the rest of the region. Continued low popularity of the Socialist party and an opposition-initiated referendum are the key risks to the fiscal outlook.

Growth is set to recover but clear downside risks

We think 2007 will prove to have been the low point for growth and that gradually recovering domestic demand should boost growth to around 2.2% in 2008 from 1.3% in 2007. Domestic demand should benefit from rising real incomes after falls in 2007, but the high leverage of households could pose a downside risk amid the global tightening of credit conditions. Given Hungary's openness and reliance on external demand, a sharper-than-expected slowdown in the euro area could also imply a downside risk to our growth forecast. With only moderate recovery of domestic demand and continued fiscal restraints, the current account deficit should fall further, to around 4.2% of GDP, in 2008.

MARKET OUTLOOK

Delayed monetary easing

Global growth fears and Hungary's reliance on external growth and FX borrowing have been weighing on the forint this year and we expect HUF to remain an underperformer in the region. Given the higher-than-expected inflation readings, the NBH seems to have taken a more cautious approach. We now expect easing to resume only in the second half of the year and the Bank to deliver just two 25bp cuts to 7% this year.

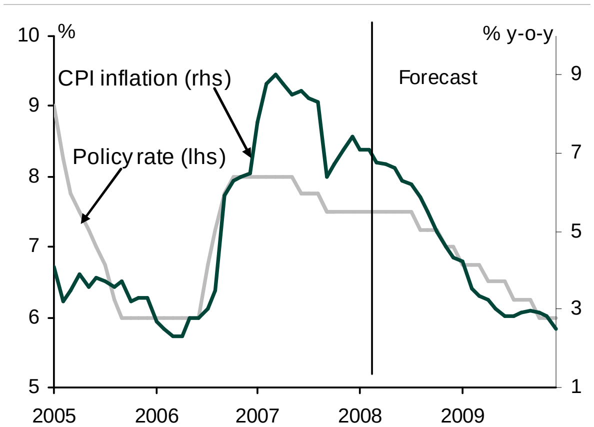
The outlook at a glance

% y-o-y, unless stated otherwise	**2007**	**2008**	**200**
Real GDP	1.3	2.2	3.
Current account, % GDP	-5.2	-4.2	-3.
Fiscal balance, ESA 95, % GDP**	-5.8	-4.0	-3.
Unemployment rate	7.7	7.0	6.
Real gross wages	0.2	2.4	3.
Consumer prices*	7.4	4.5	2.
Industrial output	8.5	8.0	8.
Intervention rate*	7.50	7.00	6.0
HUF basket*	-10.3	-9.7	-13.
EUR/HUF*	253	255	24
USD/HUF*	173	182	18

Table last revised 14 February 2008.
** End-of-period. ** Including pension reform costs.*

Source: Lehman Brothers.

CPI inflation and interest rate outlook



Source: KSH, NBH and Lehman Brothers.

SOUTH AFRICA: OUTLOOK

Perfect storm

Tolga Ediz
+44 20 710 27467
tediz@lehman.com

Peter Attard Montalto
+44 20 710 28440
pattardm@lehman.com

Sticky inflation, the currency and a host of other risks are creating a perfect storm. We expect rates on hold for the rest of the year, with inflation peaking at 9.3% in February and second-round effects keeping core inflation high. Politics should not be ignored.

ECONOMIC OUTLOOK

Inflation seems the biggest risk especially with second-round effects emerging

Inflation remains a pressing concern and second-round effects should become evident in 2008. We expect inflation to peak in February at 9.3% y-o-y, ending the year above target at 6.1% (8.0% year average) as food price growth slows from 15.3% to 7.0%. CPIX should then dip into target and remain near the upper band through 2009. High inflation expectations (now a record 5.8% for 2008, according to the latest survey) and unit wage costs should slow the fall of inflation via second-round effects. The most direct impact of these effects will likely be on core CPIX, and we expect our "super-core" measure (excluding oil- and food- items) to move from 4% currently to 5% in Q3.

Underlying growth should remain robust, but will diversify away from consumption

We look for growth to moderate through 2008 as consumption slows in the wake of recent rate hikes and the housing market slows. That said, our projected slowdown in consumption is not sharp; given that real rates should remain low and credit growth strong. There are significant downside risks from the current electricity crisis effecting mainly Q1, as such we revise 2008 growth down to 4.4%. We see growth picking up in the fourth quarter and through 2009 as investment, by government and private sector, picks up pace. Overall, growth should remain above our 3.7% estimate of potential.

Do not ignore the politics

Politics should not be ignored. With Jacob Zuma now ANC leader and favourite to win the 2009 election, he is already outlining a programme of increased spending with inflation targeting as a key issue for change too. Zuma has been charged with corruption and will stand trial on 14 August, between now and then there is no love lost with President Mbeki. Market-unfriendly noise risks capital outflows, weakening the currency and driving up inflation. Finance Minister Manuel, a despite uncertainty over his future has delivered a strong 2008/9 though many of the measures are more pro-inflation than pro-growth.

Rates should be on hold for the rest of the year, but risks are to the upside

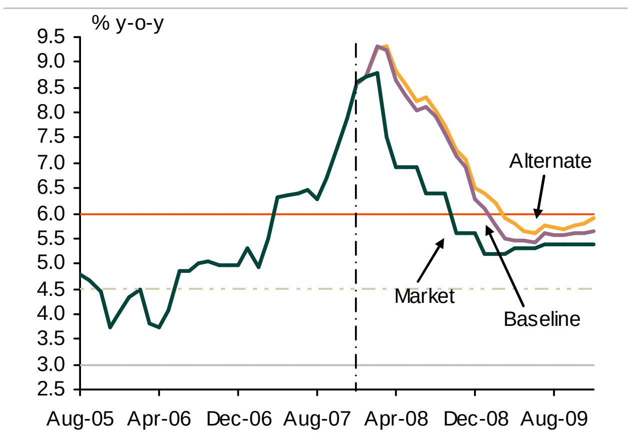
We view not hiking at the last meeting as a policy mistake given the inflation outlook. However, we do not believe that the SARB will hike in April given that the inflation peak will have passed and it will remain concerned over growth. We expect the SARB to keep rates at 11.00% for the rest of the year before cutting at the start of 2009 to a terminal rate of 9.50% as it sees inflation falling and remaining in target. Risks of a hike are very much present however and a spike in oil, faster rand depreciation and an update of forecasts given the CPIX peak could push the SARB to get ahead of the curve. We think the rand will likely depreciate through year-end as worries over domestic and global risks continue.

The outlook at a glance

	2007	2008	2009
Real GDP % y-o-y	5.0	4.4	5.5
Current account % GDP	-6.5	-8.0	-8.0
PSCE % y-o-y*	21.46	18.35	21.00
Fiscal balance % GDP	0.43	0.2	0.0
FX reserves, gross USD bn*	33.0	41.9	53.5
CPIX % y-o-y *	8.5	6.1	5.6
Manufacturing output % y-o-y	4.1	3.0	3.2
SARB policy rate %*	11.00	11.00	9.50
EURZAR*	10.00	11.60	11.50
USDZAR*	6.80	8.25	8.50

Source: Lehman Brothers. *End of period

Inflation forecast- differing opinions



Source: Lehman Brothers. Alternate: forward prices and priced-in rate cuts

TURKEY: OUTLOOK

Risky easing policy

Tolga Ediz
+44 20 710 27467
tediz@lehman.com

The central bank looks set to ease policy, even though inflation is unlikely to hit target next year. We think this is risky.

The Turkish economy has so far remained resilient to global credit market turbulence. There has been no liquidity crunch in the domestic money markets and local banks have not found it difficult to gain access to new funding. This is good news, but the continuation of such a benign scenario cannot be counted on forever. That said, Turkey's capital account has improved on significantly higher FDI flows, helping to finance Turkey's still-large current account deficit. In addition, Turkey's *Damocles* score of external vulnerability has remained reasonably benign. But on a negative note, the trade deficit has continued to expand, even though domestic demand has been subdued. Moreover, recent data on the current account suggest we are right to expect a further expansion of the deficit to well above 8% of GDP next year. Unless FDI flows can keep pace, Turkey's vulnerability to external shocks could rise.

The central bank is likely to miss its inflation target again next year …

The inflation outlook is uncertain. Because of significant supply-side pressures, inflation overshot the central bank's target by a lot this year. But the Central Bank of Turkey's (TCMB) monetary policy committee (MPC) has begun to ease policy already, stating its belief that core inflation is a much more benign. Disinflation is on track, allowing the borrowing rate to be reduced by 150bp in the past three months. The central bank has clearly been encouraged by the resilience of the Turkish economy and of the lira, as well as by signs of falling service price inflation, but appears to remain concerned on commodity prices which led them to only cut 25bp at the last meeting, verses the 50bp expected.

We think the TCMB is taking a risk. Although we expect 2007's supply-side shock to prices to unwind gradually in 2008, we see inflation remaining above target for most of 2008. But given its view on inflation, we expect the MPC to cut the overnight borrowing rate by 25bp in February and then continue to 14.5% by the middle of the year.

…but is still likely to ease policy further

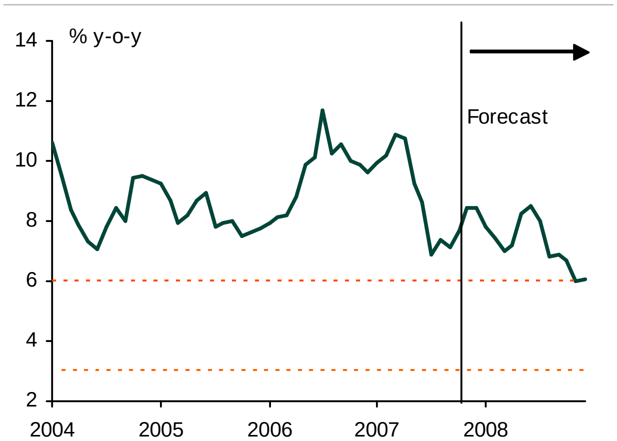
Politics could be less of an issue in 2008. With the general election out of the way, the government should be free to concentrate on the next generation of reforms, which the economy badly needs. But so far the government has been bogged down by, first, discussions on a new constitution and, second, by cross-border operations against PKK terrorists in Northern Iraq. The key political risk, in our view, is that the government tries to push through a reform of the constitution without gaining consensus support.

The outlook at a glance

	2007	2008	2009
Real GDP, % y-o-y	4.5	5.5	6.2
Contributions to GDP (pp)			
Domestic demand	4.5	5.7	6.5
Stockbuilding	0.1	0.8	0.8
Net trade	-0.1	-1.0	-1.1
Consumer prices*, y-o-y	8.4	6.1	5.7
Producer prices*, yoy	6.0	5.5	5.5
Primary budget **	4.0	5.5	5.5
Current account**	-7.7	-8.5	-8.7
Repo rate*	15.75	14.0	13.0
Benchmark T-Bill comp yield*	16.5	14.0	13.5
$/TL rate*	1.20	1.27	1.38

** end of period   ** % of GNP Source: Lehman Brothers.*

Inflation outlook



Source: TUIK, Lehman Brothers.

EMERGING MARKETS – REST OF EMEA*: OUTLOOK

Poland: Improved medium-term outlook

% y-o-y, unless stated otherwise	2007	2008	2009
Real GDP	6.5	5.5	5.0
Current account, % of GDP	-4.0	-4.5	-4.5
Budget deficit (ESA 95), % of GDP**	-2.5	-3.2	-3.0
Unemployment rate*	11.3	9.0	8.0
Wages	9.0	8.0	7.5
Consumer prices*	4.0	3.0	2.5
Industrial output	10.0	8.0	7.0
Intervention rate*	5.00	5.50	5.50
EUR/PLN*	3.58	3.50	3.50
USD/PLN*	2.44	2.50	2.59

Table last revised 8 February 2008.

** End-of-period.** Excluding allowable pension reform deductions.*

Source: NBP, GUS and Lehman Brothers.

- Civic Platform's (PO) election victory looks positive for Poland's medium-term macro outlook. The new government is likely to consolidate the fiscal deficit (albeit not significantly in 2008) and move ahead with privatisations and euro adoption.
- Inflation is likely to stay above the National Bank of Poland's (NBP) 2.5% target for most of 2008 given supply-side and underlying wage pressures.
- The NBP has hiked rates three times in 2007 and we expect just one more, to 5.5%, early in 2008, given the split and, at times, backward-looking views of the board. Should net inflation start to adjust to wage pressures, more hikes could be delivered.

Czech Republic: Inflation spike in January

% y-o-y, unless stated otherwise	2007	2008	2009
Real GDP	6.6	4.8	5.5
Current account, % GDP	-3.7	-3.2	-2.7
Fiscal deficit, ESA 95, % GDP	-3.2	-2.9	-2.5
Unemployment rate (ILO)	7.0	6.5	6.0
Real wages, % y-o-y	4.9	2.5	4.0
Consumer prices*	5.4	4.7	2.5
Industrial output	10.9	7.5	9.0
Intervention rate*	3.5	3.75	3.50
EUR/CZK*	26.6	25.0	25.0
USD/CZK*	18.1	17.9	18.5

Table last revised 15 February 2008.

** End-of-period.*

Source: CNB and Lehman Brothers.

- We expect growth to slow to around 4.8% in 2008 from 6.1% in 2007, with tighter fiscal and monetary policies crimping the domestic demand that has been the key driver of growth so far.
- Inflation rose sharply in January this year on the back of a VAT and various administered price hikes, and looks to stay at around 7.5% y-o-y in Q1 before falling to around 4.7% y-o-y by year-end.
- The Czech National Bank (CNB) has been keen to normalise rates given buoyant growth and worsening inflation outlook. We expect CZK strength and on-target underlying inflation to curb the CNB's appetite to hike. We project rates at 3.75% by the end of 2008.

Israel: Solid fundamentals

% y-o-y, unless stated otherwise	2007	2008	2009
Real GDP	5.4	4.3	4.3
Current account, % GDP	3.5	3.0	2.0
Budget deficit, % GDP	0.0	-0.9	-1.3
Consumer prices*	3.4	2.2	2.0
Intervention rate*	4.25	4.25	3.50
USD/ILS*	3.85	3.68	3.68

Table last revised 22 February 2008.

Note: CPI forecast based on a constant ILS/US$ at 3.70

** End-of-period.*

Source: CBS and Lehman Brothers.

- Israel has the strongest economic fundamentals in EMEA and we expect this to remain the case in 2008. A sharper and broader-than-expected slowdown in core markets could dent 2008 growth but so far the economy has been quite resilient.
- With the ILS likely to remain strong given supportive fundamentals, we expect inflation to continue rising in the first half of 2008 on the back of a low base to but fall close to the target of 2% y-o-y by year-end.
- With Fed policy looking more accommodative and the shekel having appreciated notably again, we now expect the BoI to stay on hold at 4.25%.

** EMEA: Europe, Middle East and Africa*

EMEA: PREVIEW

The week ahead

Tolga Ediz
+44 20 7102 7467
tediz@lehman.com

Silja Sepping
+44 20 7102 6837
ssepping@lehman.com

Peter Attard Montalto
+44 20 710 28440
pattardm@lehman.com

A busy end month week. We expect rates to stay on hold in Hungary and Israel on Monday, Slovakia on Tuesday and in Poland on Wednesday. Also, watch out for a raft of South African data.

Hungary: MPC meeting (Monday)

The NBH is to publish its updated *Inflation Report* and decide on interest rates on Monday. The expected upward revisions to the inflation forecast and the latest weakness of the forint have fuelled expectations of a rate hike. We have sided with the "no change" view but admit that the probability is pretty much even now. We do think that the NBH should not be tightening at this point but pressure from the markets may force it to deliver what has been priced in. (See the focus article "To hike or not to hike" *Global FX Strategies*, 21 February 2007 for more details.)

Hungary: MPC meeting (Monday)

The Bank of Israel is also due to decide on rates on Monday. The continued strength of USD/ILS has led some market participants to expect easing from the BoI. We expect it to stay on hold at 4.25% given that we think inflation is likely to stay above the 2% target in the first half of the year. We had expected the BoI to hike once more given underlying inflation pressures, but we think that rates unchanged for the reminder of the year is the most likely scenario. Once inflation eases in H2 and if USD/ILS strength persists and growth slows, easing might be possible.

Poland: MPC meeting (Wednesday)

The data this month (CPI, wages, IP and PPI) have consistently surprised to the upside, increasing the risks of a hike as soon as this month. Our call has been for the next 25bp to happen in March but the recent data and the hawkish mode at the RPP have increased risks of an earlier move.

South Africa: Calm before the storm

We see **Q4 GDP** on Tuesday softening from the third quarter after several weak manufacturing, mining and retail numbers during the quarter. The number is the activity measure, but it is useful to consider it in expenditure terms (the breakdown of which will be published on 20 March) and we see the trade deficit and rate hikes taking their toll on consumption, dampening the effect of stronger investment. The y-o-y number is skewed by a strong base effect, and the move in q-o-q sa annualised is much less pronounced. Risks are broadly balanced around our forecast.

CPIX on Wednesday may prove to be the calm before the storm, with continued strength in food and other commodity-related components, a weaker currency in the lead up to the month and a number of surveys all potentially being offset by base effects to give an unchanged reading from last month (8.6%). It is probably too early to see any effect from the electricity crisis yet, though this may add some upside risks to the number. However we think the next number (for February) will be key, breaching 9.0%, though with recent moves in the rand and oil, the peak in inflation may well be in March, not in February as we originally thought.

PPI on Wednesday may be tricky, with a shift in both the methodology and the weightings, and there has been some disagreement between market analysts and StatsSA over the impact. The reweighting is relatively simple: bringing the index into line with the latest survey data on volumes of production of various goods. Key changes are the inclusion of gold for the first time, decreases in manufactured foods and textiles and increases in fuel, coal and utilities (electricity, water and gas) – the weighting of which is almost doubling.

On the methodology side, the old headline index (which was the price of goods for consumption in South Africa that were produced both domestically and abroad) is being discontinued and replaced with a new headline index of all goods produced in South Africa, whether consumed domestically or exported. The new index is already published but is only a secondary table within the PPI publication. The change means the old and new headline indices are not directly comparable. The last old index rate was 10.3% y-o-y for December, in the new index that was 9.5%, reweighting however should lead the next number to jump to 10.5-10.7% as the weighting is not being backdated.

PSCE on Thursday should remain robust at 22.00%.

We expect the **trade balance** on Thursday to show a large deficit of ZAR12bn, up from a deficit of ZAR1.2bn previous as the effect of power shortages on mining operations and exports added pain to an already weak month.

Economic events in the weeks ahead

			Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Monday 25 February								
14.00	Hungary	NBH MPC meeting (%, policy rate)	Feb	7.50	7.50	7.50	7.50	7.50
17.30	Israel	BoI MPC meeting (%, policy rate)	Feb	4.25	4.25	4.25	4.25	4.25
10.00	Poland	Retail sales (% y-o-y)	Jan	19.4	19.2	12.4	13.0	15.4
10.00	Poland	Unemployment rate (%)	Jan	11.3	11.2	11.4	11.7	11.7
Tuesday 26 February								
10.00	Iceland	CPI (% y-o-y)	Feb	5.2	5.9	5.8	n.a.	n.a.
10.30	South Africa	GDP (% y-o-y)	Q4	5.7	5.0	5.1	4.3	4.5
	Slovakia	MPC meeting (%, policy rate)	Feb	4.25	4.25	4.25	4.25	4.25
	Slovakia	Current account (SKK bn, cumul)	Dec	-59.6	-74.4	-80.1	n.a.	n.a.
Wednesday 27 February								
	Poland	NBP MPC meeting (%, policy rate)	Feb	5.00	5.00	5.25	5.25	5.25
10.30	South Africa	CPIX (% y-o-y)	Jan	7.3	7.9	8.6	8.7	8.4
10.30	South Africa	CPI (% y-o-y, core)	Jan	6.4	6.9	7.8	8.0	7.8
Thursday 28 February								
9.00	Hungary	Unemployment rate (%)	Jan	7.3	7.5	7.7	n.a.	7.8
10.30	South Africa	PPI (% y-o-y)	Jan	9.5	9.1	10.3	10.6	10.5
9.00	Slovakia	PPI (% y-o-y)	Jan	1.8	2.0	2.8	n.a.	n.a.
Friday 29 February								
9.00	Hungary	PPI (% y-o-y)	Jan	-1.4	0.4	1.6	n.a.	2.2
10.00	Iceland	Trade balance (ISK bn)	Jan	-6.7	-2.5	-9.8	n.a.	n.a.
10.00	Poland	GDP (% y-o-y)	Q4	7.2	6.4	6.4	6.0	6.0
7.00	South Africa	PSCE (% y-o-y)	Jan	22.27	22.62	21.46	22.00	22.00
13.00	South Africa	Trade balance (ZAR bn)	Jan	-14.7	-0.6	-1.2	-12.0	-8.0
16.00	Turkey	Trade balance (USD bn)	Jan	-5.6	-5.3	-6.4	n.a.	-5.0

CET Time

CHINA: OUTLOOK

A bumpy ride down

Mingchun Sun
+852 2252 6248
minsun@lehman.com

China's economy is set for a bumpy ride this year, mainly due to one-off factors.

We have forecast China's GDP growth in 2008 to fall below 10% for the first time in six years as a result of weaker global growth, an appreciating currency and policies that stand to raise firms' production costs. In terms of the quarterly growth profile, we had expected a steady slowdown as the impact of these factors gradually came through.

The weather has now put paid to that idea. The recent snowstorms that swept across southern China – the worst in 50 years – are set to drag Q1 growth down significantly to 9.2% y-o-y. We expect growth to climb back to 10.5% for Q2 as reconstruction efforts and increased factory production compensate for storm-induced closures.

As reconstruction and compensating production fade, and as the global slowdown hurts the overall economy, growth in Q3 should fall to below 10% again. While the Olympic Games will boost consumption, we doubt the impact will be significant given the huge size of the economy. In Q4, with no specific factors to stimulate consumption or investment, growth could slide below 9.0% y-o-y as the pinch of the global slowdown is fully felt by Chinese firms, exposing overcapacity in the industrial sector. For the full year, we are lowering our GDP forecast to 9.5% from 9.8%.

On the inflation front, the snowstorms caused shortages of food and power, which should push CPI inflation to 7.2% y-o-y in Q1. However, we then expect sharp declines in H2 as food supply shortage alleviates. For the full year, we have raised our inflation forecast to 4.4% from 3.8%, solely because of the surge in Q1.

While export growth should decline because of the global slowdown, the trade surplus is unlikely to narrow in 2008 because import growth is also set to slow – a result of the high import content of China's exports and weaker domestic demand. As such, pressure on the renminbi (RMB) to appreciate will continue. The PBC has started to allow the RMB to appreciate faster – at an annualized pace of 18% against USD in January – in an attempt to reduce the surplus as well as to lower inflation via cheaper imports. While the pace of appreciation will remain fast in H1, FX intervention by the PBC should slow it significantly in H2, in response to easing inflation pressures and weaker exports.

Despite the Q1 surge in inflation, we expect interest rates to be kept on hold this year as the PBC looks beyond the temporary surge and focuses more on the looming growth outlook. However, the reserve requirement ratio should be hiked by another cumulative 300bp as the liquidity surfeit will continue due to the PBC's FX intervention.

The outlook at a glance

% y-o-y unless otherwise stated	**1Q07**	**2Q07**	**3Q07**	**4Q07**	**1Q08**	**2Q08**	**3Q08**	**4Q08**	**2007**	**2008**	**2009**
Real GDP	11.1	11.9	11.5	11.2	9.2	10.5	9.6	8.8	11.4	9.5	8.5
Retail sales	15.0	15.8	16.8	19.0	17.0	16.0	14.3	13.0	16.7	15.1	15.0
Fixed-asset investment (ytd)	23.7	25.9	25.7	24.8	15.0	22.0	20.0	18.0	24.8	18.0	16.0
Industrial production	18.2	18.3	18.1	17.5	13.0	18.0	14.0	12.0	18.0	14.3	12.0
Exports	27.9	27.4	26.2	22.2	19.1	18.0	14.0	12.0	25.7	15.5	10.0
Imports	18.2	18.2	20.7	25.4	19.7	18.0	17.0	16.0	20.8	17.6	14.0
Trade surplus (US$bn)	46.5	66.2	73.2	76.0	54.0	78.2	75.7	74.6	262	282	266
Current account surplus (% of GDP)									11.0	9.8	8.8
Consumer prices	2.7	3.6	6.1	6.6	7.2	6.0	3.4	1.1	4.8	4.4	2.6
1-yr bank lending rate (%)	6.39	6.57	7.29	7.47	7.47	7.47	7.47	7.47	7.47	7.47	7.47
1-yr bank deposit rate (%)	2.79	3.06	3.87	4.14	4.14	4.14	4.14	4.14	4.14	4.14	4.14
Reserve requirement ratio (%)	10.00	11.50	12.50	14.50	15.50	16.50	17.50	18.00	14.50	18.00	18.00
Exchange rate (CNY/USD)	7.73	7.61	7.51	7.30	7.05	6.90	6.85	6.80	7.30	6.80	6.40

Note: All forecasts are modal (ie, the most likely single outcome). Table last revised on 22 February, 2008.

Source: CEIC and Lehman Brothers.

INDIA: OUTLOOK

More resilient than before

Rob Subbaraman
+852 2252 6249
rsuba@lehman.com

Sonal Varma
+91 22 4037 4087
sonal.varma@lehman.com

US recession or not, the structural drivers of India's rising potential growth remain intact.

Following further downward revisions to our global economic growth forecasts, we have revised down India's GDP growth forecast to 8.2% in 2008 from 8.5% previously. India faces mounting short-term cyclical headwinds from weakening global growth, fairly tight monetary conditions at home, and increased financial market turbulence.

Under our core view, in which the US avoids a full-blown recession but slows considerably, we expect India's GDP growth to slow in 2008 because of its growing trade and financial sector linkages, but growth should stay above 8%. Already, growth is slowing, notably sales of consumer durables, because of higher real interest rates and an appreciating currency. Meanwhile, inflation risk remains due to firm commodity prices, an adverse base effect and excess liquidity. For the Reserve Bank of India (RBI), the dilemma of rising inflation and slowing growth is set to intensify. We judge that a slowdown in growth to below the RBI's target of 8.5% will impel the RBI to take some insurance against the downside risks to growth and cut the repo rate by 50bp in 2008.

In the event of a US recession, besides a larger hit to Indian exports, there could be serious second-round effects. Global risk aversion would likely rise, causing inflows to reverse. India's growth shave-off could be much larger than in past US recessions, as the trade and financial linkages have strengthened. Still, India remains one of the least exposed in Asia: its exports make up 24% of GDP versus 55% for Asia ex-Japan. Even with a severe US recession, it is unlikely, in our view, that India's growth would fall much below 7%, given its economy is so heavily driven by domestic demand, and the ample scope for policy responses. The RBI can use its US$290bn of FX reserves to counter outflows and cut rates even further. There is also more room for fiscal stimulus than in the past: the consolidated fiscal deficit (as a % of GDP) is at a three-decade low.

Notwithstanding weaker growth this year, we are structurally bullish on India's potential, expecting growth to rebound to 9.2% in 2009, as the economy is exhibiting many of the characteristics that Japan, Korea and China did during their take-offs: GDP per capita is accelerating; investment and saving are surging; the economy is rapidly opening up and the trends of demography and urbanisation are still ahead. If India tackles its infrastructure, bureaucracy and labour market problems, our work suggests that it can lift the economy's potential growth rate to 10% (see *India: Everything to play for*, October 2007).

The outlook at a glance

% y-o-y growth unless otherwise stated	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	2007	2008	2009
Real GDP	9.7	9.3	8.9	8.2	8.1	8.1	8.3	8.2	9.0	8.2	9.2
Agriculture	4.8	3.8	3.7	2.2	2.5	3.0	3.0	3.0	3.5	2.9	3.0
Industry	11.7	10.6	9.1	8.5	8.0	8.5	8.5	9.0	10.0	8.5	10.3
Services	10.5	10.6	10.3	10.5	10.0	9.6	9.5	9.8	10.5	9.7	10.6
Industrial output	12.5	10.3	8.7	8.1	7.1	7.8	9.4	9.3	9.9	8.4	10.4
M3 money supply	21.4	20.4	21.3	22.7	23.2	24.3	23.5	23.1	21.5	23.5	18.9
Non-food credit	29.5	26.7	23.6	23.1	22.1	23.7	24.4	27.0	25.6	24.4	26.1
Wholesale price index	6.4	5.4	4.1	3.3	4.3	5.1	5.7	6.1	4.8	5.3	5.3
Consumer price index (average)	8.1	7.2	7.2	5.7	6.4	6.5	6.0	5.9	7.0	6.2	5.9
Merchandise trade balance (% GDP)	-6.0	-6.6	-6.6	-6.5	-6.8	-7.0	-7.3	-7.5	-6.5	-7.5	-8.1
Current account balance (% GDP)	-1.1	-1.1	-0.9	-1.1	-1.4	-1.8	-1.9	-2.0	-1.1	-2.0	-2.8
Fiscal deficit (% GDP)	-3.4	-4.1	-3.1	-2.8	-3.3	-3.3	-3.7	-3.5	-2.8	-3.5	-3.8
Repo rate (%)	7.50	7.75	7.75	7.75	7.75	7.75	7.50	7.25	7.75	7.25	7.50
Reverse repo rate (%)	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Cash reserve ratio (%)	6.00	6.50	7.00	7.50	7.50	7.50	7.50	8.00	7.50	8.00	9.00
10-year bond yield (%)	7.94	8.16	7.92	7.81	7.40	7.25	7.00	7.00	7.81	7.00	7.30
Exchange rate (INR/USD)	43.6	40.8	39.7	39.4	39.0	38.7	38.2	37.5	39.4	37.5	34.1

Note: Consumer price index is a simple average of indices for industrial workers, non-manuel employees and agricultural labour. Fiscal deficit is for central government. All forecasts are modal (ie, the most likely single outcome). Table last revised on 22 February 2008.
Source: CEIC and Lehman Brothers.

SOUTH KOREA: OUTLOOK

Multiple rate cuts ahead

Young Sun Kwon
+852 2252 1370
youngsun.kwon@lehman.com

We have lowered our growth forecast again and now expect 100bp of rate cuts in 2008.

Korean economic growth has been driven by resilient exports to diverse markets, a situation that has continued into early 2008. However, there are signs that a synchronized slowdown in the advanced economies is spreading to emerging market economies, which could soon start to hurt Korean exports and depress business investment. The recent equity market slump could also start to have negative wealth and confidence effects on Korea's heavily indebted households. Furthermore, housing construction should remain sluggish outside the Seoul metropolitan area until the very high number of unsold houses is reduced. All in all, we have revised down our 2008 GDP growth forecast from an already below-consensus 4.6% to 4.3%.

We judge that the risks to our new growth forecast are still tilted to the downside. Our near-term concern is that any global (or local) credit problems, or signs of weaker exports, could lead to a rise in risk aversion. Meanwhile, inflation is starting to spread beyond food and energy, suggesting firms have started to pass higher commodity prices on to their customers. We have revised our 2008 CPI inflation forecast from 3.3% to 3.5%.

In response to higher inflation, we expect the new government to freeze some public service charges and possibly cut the fuel tax, which could help ease "measured" CPI inflation and thereby ease the hurdle for a rate cut. Historically, the Bank of Korea (BOK) has placed more importance on growth prospects than on the prevailing inflation rate. Given our below-potential growth forecast, we have also changed our interest rate call: instead of staying on hold, now expect the BOK to cut rates by 100bp to 4.00% in 2008. We would not be surprised if the BOK cut rates by 25bp on 7 March meeting.

The current account surplus is poised to turn to a deficit for the first time since 1997. In real trade-weighted terms, the Korean won has already surpassed pre-Asian crisis levels, and multiple rate cuts by the BOK should help limit strong capital inflows. Thus, we have changed our end-2008 Korean won forecast from 920 to 950 KRW/USD.

Our 2008 outlook is more like a "mild stagflation" story. But, further out, we believe that the prospects for the Korean economy are encouraging given the new government's pro-growth fiscal policies and structural reforms and the lagged effects of our forecast monetary easing. In 2009, we expect above-potential GDP growth of 5.2%.

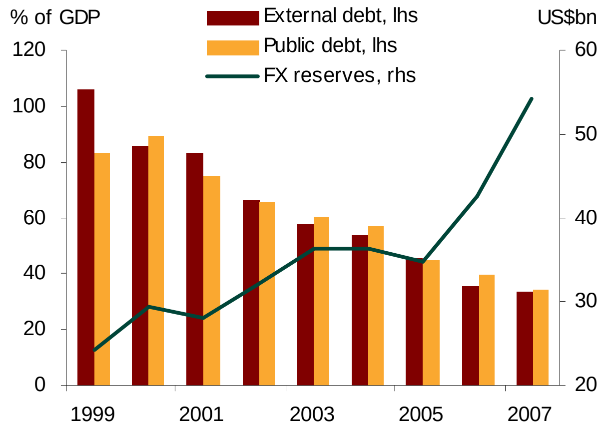
The outlook at a glance

% y-o-y growth unless otherwise stated	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	2007	2008	2009
Real GDP	4.0	5.0	5.2	5.5	5.4	4.4	4.0	3.6	4.9	4.3	5.2
[sa, % q-o-q]	0.9	1.8	1.3	1.5	0.8	0.8	0.9	1.1			
Private consumption	4.1	4.2	4.7	4.7	4.3	4.0	3.8	3.6	4.4	3.9	4.4
Business investment	10.8	11.9	1.6	5.7	3.0	4.5	6.0	5.0	7.5	4.6	7.3
Construction investment	3.9	3.2	0.9	-0.5	1.5	2.0	3.0	3.0	1.6	2.5	3.6
Exports (goods & services)	11.0	10.7	9.2	16.1	10.7	9.5	8.5	6.0	11.8	8.6	9.4
Imports (goods & services)	11.7	12.3	6.5	16.4	9.7	9.0	10.0	7.5	11.8	9.0	9.6
Contributions to GDP:											
Domestic final sales	4.5	4.7	3.4	3.4	3.6	3.4	3.5	3.2	3.7	3.6	4.3
Inventories	-1.2	-0.1	-0.4	0.5	0.2	-0.3	0.2	0.4	0.0	0.0	0.0
Net trade (goods & services)	0.8	0.4	2.2	1.6	1.6	1.3	0.2	-0.1	1.3	0.7	0.9
Unemployment rate (sa, %)	3.2	3.3	3.3	3.1	3.2	3.2	3.3	3.3	3.2	3.3	3.3
Employment	1.2	1.2	1.3	1.2	1.2	1.2	1.3	1.3	1.2	1.3	1.4
Consumer prices	2.0	2.4	2.3	3.3	3.8	3.6	3.6	3.1	2.5	3.5	3.4
Core CPI	2.2	2.3	2.3	2.4	2.7	2.6	2.7	2.8	2.3	2.7	2.5
Current account (% of GDP)									0.6	-0.3	-1.0
Liquidity Aggregate	11.6	12.3	12.1	11.6	11.8	11.1	10.8	10.6	11.9	11.6	11.8
Residential property prices (%q-o-q)	3.5	0.4	0.8	1.0	1.1	1.2	1.4	1.6	9.1	4.3	5.4
BOK target rate (%)	4.50	4.50	5.00	5.00	4.75	4.50	4.25	4.00	5.00	4.00	4.50
3-year T-bond yield (%)	4.76	5.28	5.46	5.47	4.80	4.55	4.30	4.10	5.47	4.10	4.60
10-year T-bond yield (%)	4.93	5.50	5.60	5.50	4.90	4.65	4.40	4.20	5.50	4.20	4.70
Exchange rate (KRW/USD)	943	923	915	936	940	950	960	950	936	950	910

Notes: Interest rates and currency are end of period, other measures are period averages. Table last revised on 22 February 2008. All forecasts are modal forecasts (i.e., the single most likely outcome).
Source: Bank of Korea, CEIC and Lehman Brothers.

EMERGING MARKETS – REST OF ASIA: OUTLOOK

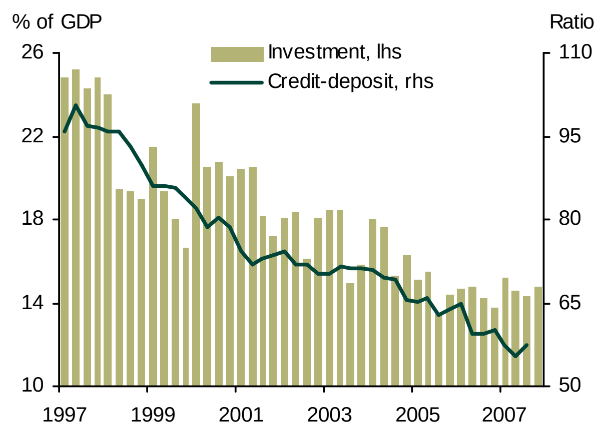
Indonesia: Much improved economic fundamentals but vulnerable to higher oil prices



- Better fundamentals have facilitated rate cuts and fiscal stimulus, helping buoy domestic demand, which should continue in 2008, a pre-election year.
- Efforts are under way to improve the investment climate, but implementation is critical if the economy is to achieve its full growth potential of at least 7%.
- Still-large government oil price subsidies are a risk. If oil prices rise, the fiscal deficit stands to widen, while cutting subsidies would result in higher inflation.

Source: CEIC and Lehman Brothers.

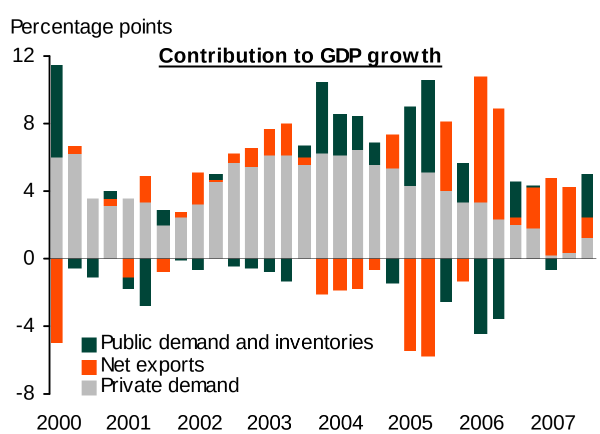
The Philippines: The main challenge is to revive investment



- Consumption has been buoyed by overseas worker remittances and makes up 80% of GDP. On the flipside, investment is just 15% of GDP, the lowest in Asia.
- Conditions seem ripe for a revival in investment. They include nearly negative real rates, a very low loan-to-deposit ratio and much improved fiscal finances.
- GDP growth is set to slow to 5.0% in 2008 before surging to 7.0% in 2009. Fiscal slippage is a risk, as the increase in one-off sales of state assets is unsustainable.

Source: CEIC and Lehman Brothers.

Thailand: A lot hinges on politics and oil



- Last year, growth was driven by net exports, as political uncertainty and high exposure to oil prices (Thailand is the most exposed in Asia) hurt domestic demand.
- Still, the fundamentals are healthy: FX reserves have risen to US$85bn and fiscal finances are in good shape. Real policy interest rates are already negative.
- Weaker exports should slow growth in 2008, but if political risk eases, solid fundamentals, loose policies and pent-up demand should lift growth to 6.7% in 2009.

Source: CEIC and Lehman Brothers.

ASIA EX-JAPAN: PREVIEW

The week ahead

Rob Subbaraman
+852 2252 6249
rsuba@lehman.com

Mingchun Sun
+852 2252 6248
minsun@lehman.com

Young Sun Kwon
+852 2252 1370
youngsun.kwon@lehman.com

Sonal Varma
+91 22 403 4087
sonal.varma@lehman.com

Stephen Roberts
+61 2 8062 8431
stephen.roberts@lehman.com

Growth in Q4 should be up in Thailand and Malaysia, but weaker in India. Rising inflation should pose a dilemma to Asian central banks: we expect them to focus on the prospect of weaker growth over inflation. Bank of Thailand could cut by 25bp next week.

South Korea's current account deficit should widen to US$3.0bn in January from US$0.8bn in December. The trade deficit of US3.4bn in January was the largest monthly deficit seen since January 1997.

Thailand's GDP growth should rise to 5.1% y-o-y in Q4 2007 from 4.9% in Q3, underpinned by strong external demand. Export volume growth rose from 4.9% in Q3 to 8.7% in Q4, while import volume fell by 0.4% after gaining 3.7%. Similarly, we expect Malaysia's real GDP growth to accelerate to 6.9% y-o-y in Q4 from 6.7% in Q3 as growth momentum remained strong in Q4. On the other hand, India's GDP growth could moderate to 8.2% y-o-y in Q4, led by weaker agriculture and industrial sectors.

We expect Bank of Thailand to cut its policy rates by 25bp to 3.00%. While CPI inflation has risen, the darkening growth outlook might justify a cut to pre-empt the impact on economy from the global slowdown. In February, Samak Sundaravej, the premier of the new government, said that the "urgent policy is to strengthen the economy and regain investors' confidence". We judge that the central bank will likely see growth as its priority as well. In the meantime, we expect Malaysia's Bank Negara to keep its policy rates unchanged at 3.50%. CPI inflation was still low at 2.4% y-o-y in December, but has been on a rising trend since June 2007. With a rising inflation trend and weakening growth outlook, we expect the central bank to stand pat through 2008.

Economic events in the week ahead

			Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Sometime during the week								
	S. Korea	Business confidence index - manufacturing (BOK)	Mar	90	87	84	80	n.a.
Monday 25 February								
10.30	Thailand	Real GDP, % q-o-q, sa	Q4	1.1	1.3	1.5	1.1	1.3
10.30	Thailand	Real GDP, % y-o-y	Q4	4.2	4.3	4.9	5.1	5.3
13.00	Singapore	Consumer price index, % y-o-y	Jan	3.6	4.2	4.4	6.1	5.6
18.00	Malaysia	Central bank policy meeting, overnight call rate, %	Feb	3.50	3.50	3.50	3.50	3.50
Tuesday 26 February								
9.00	The Philippines	Trade balance, US$m	Dec	-0.4	-0.5	-1.1	-0.1	n.a.
13.00	Singapore	Industrial production, % y-o-y	Jan	2.8	-0.5	-1.7	5.2	5.8
16.00	Taiwan	Unemployment rate, % sa	Jan	3.9	3.9	4.0	4.0	4.0
16.00	Taiwan	Export orders, % y-o-y	Jan	18.0	17.2	17.6	14.2	15.0
16.00	Taiwan	Industrial production, % y-o-y	Jan	15.9	11.9	10.7	9.4	9.0
Wednesday 27 February								
	Malaysia	Real GDP, % y-o-y	Q4	5.5	5.8	6.7	6.9	6.5
11.00	Hong Kong	Fiscal Year 2008/09 Budget	08/09					
15.30	Thailand	Central bank policy meeting, 1 day repo rate	Feb	3.25	3.25	3.25	3.00	3.25
16.15	Hong Kong	Real GDP, % q-o-q, sa	Q4	0.9	1.9	1.7	0.4	n.a.
16.15	Hong Kong	Real GDP, % y-o-y	Q4	5.6	6.6	6.2	5.0	6.0
Thursday 28 February								
7.00	S. Korea	Current account balance, US$bn	Jan	2.5	1.5	-0.8	-3.0	n.a.
8.30	Australia	Private capital expenditure, % q-o-q, sa	Q4	9.4	7.1	-6.5	4.0	3.1
16.15	Hong Kong	Exports, % y-o-y	Jan	9.8	6.6	8.2	10.9	9.0
16.15	Hong Kong	Trade balance, HK$bn	Jan	-8.7	-16.0	-27.4	-20.0	n.a.
Friday 29 February								
	India	Real GDP, % y-o-y	Q4	9.7	9.3	8.9	8.2	8.4
	India	Union Budget	FY09					
	India	Consumer price index, industrial workers, % y-o-y	Jan	5.5	5.5	5.5	6.3	n.a.
14.30	India	Wholesale price index, % y-o-y	16-Feb	4.1	4.1	4.4	4.7	n.a.
15.30	Thailand	Exports, % y-o-y	Jan	27.9	24.5	19.5	15.8	n.a.
15.30	Thailand	Trade balance, US$bn	Jan	1.4	2.0	1.1	1.5	n.a.
15.30	Thailand	Manufacturing production, % y-o-y	Jan	12.6	12.1	11.6	9.4	11.8

Hong Kong Time

CONTACTS

Global Economics

Paul Sheard	Global Chief Economist	psheard@lehman.com	1-212-526-0067

Emerging Markets

Guillermo Mondino	Head of Emerging Markets Research	gmondino@lehman.com	1-212-526-7791
Peter Attard Montalto		pattardm@lehman.com	44-20-7102-8440
John H Welch		jwelch@lehman.com	1-212-526-5843
Gianfranco Bertozzi		gbertozz@lehman.com	1-212-526-3339
Mauro Roca		mroca@lehman.com	1-212-528-9039
Andrés Pardo		anpardo@lehman.com	1-212-526-8326
Tolga Ediz		tediz@lehman.com	44-20-7102-7467
Silja Sepping		ssepping@lehman.com	44-20-7102-6837
Ivette Tineo	Administrative Assistant	itineo@lehman.com	1-212-526-7499

Asia

Rob Subbaraman	Chief Economist Asia ex-Japan	rsuba@lehman.com	852-2252-6249
Young Sun Kwon		youngsun.kwon@lehman.com	852-2252-1370
Stephen Roberts		sroberts@grangesecurities.com.au	61-2-8259-4846
Mingchun Sun		minsun@lehman.com	852-2252-6248
Sonal Varma		sonal.varma@lehman.com	91-22-4037-4087
Madeleine Lee	Administrative Assistant	madlee@lehman.com	852-2252-6227

Analyst Certification

The views expressed in this report accurately reflect the personal views of Tolga Ediz, Guillermo Mondino and Rob Subbaraman, the primary analysts responsible for this report, about the subject securities or issuers referred to herein, and no part of such analysts' compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed herein.

Important Disclosures

Lehman Brothers Inc. and/or an affiliate thereof (the "firm") regularly trades, generally deals as principal and generally provides liquidity (as market maker or otherwise) in the debt securities that are the subject of this research report (and related derivatives thereof). The firm's proprietary trading accounts may have either a long and / or short position in such securities and / or derivative instruments, which may pose a conflict with the interests of investing customers.

Where permitted and subject to appropriate information barrier restrictions, the firm's fixed income research analysts regularly interact with its trading desk personnel to determine current prices of fixed income securities.

The firm's fixed income research analyst(s) receive compensation based on various factors including, but not limited to, the quality of their work, the overall performance of the firm (including the profitability of the investment banking department), the profitability and revenues of the Fixed Income Division and the outstanding principal amount and trading value of, the profitability of, and the potential interest of the firms investing clients in research with respect to, the asset class covered by the analyst.

Lehman Brothers generally does and seeks to do investment banking and other business with the companies discussed in its research reports. As a result, investors should be aware that the firm may have a conflict of interest.

To the extent that any historical pricing information was obtained from Lehman Brothers trading desks, the firm makes no representation that it is accurate or complete. All levels, prices and spreads are historical and do not represent current market levels, prices or spreads, some or all of which may have changed since the publication of this document.

Lehman Brothers' global policy for managing conflicts of interest in connection with investment research is available at www.lehman.com/researchconflictspolicy.

To obtain copies of fixed income research reports published by Lehman Brothers please contact Valerie Monchi (vmonchi@lehman.com; 212-526-3173) or clients may go to https://live.lehman.com/.

Legal Disclaimer