ECONOMIC &
MARKET ANALYSIS:
ASIA PACIFIC

Asia-Pacific Economics/Strategy

24 July 2006

Asia Pacific

Asia Economic Outlook and Strategy

North Korea's Reforms

- **As North Korea's economic reforms have proceeded further than widely recognized, an imminent collapse of the regime looks highly unlikely**
- **Recent recoveries of many risky assets may reflect too sanguine a reading of global risks**
- **Asian growth is likely to continue to consolidate on weakening US demand, a dimming tech outlook, higher rates and rising oil prices**
- **An acceleration of Chinese growth supports the case for further policy tightening, including faster appreciation of the currency**
- **We recommend receiving in Asian local market curves while global uncertainties persist. Equity markets are likely to fall further before finding support**

Yiping Huang
+852-2501-2735
yiping.huang@citigroup.com
Hong Kong

Cliff Tan
+65-6328-5725
cliff.tan@citigroup.com
Singapore

Asia Economics Team

Beijing
Minggao Shen

Hong Kong
Yiping Huang
Joe Lo
Adrienne Lui
Michael Luk
Patricia Pong

Singapore
Hak Bin Chua
Puay Yeong Goh
Moh Siong Sim
Cliff Tan

Mumbai
Rohini Malkani
Anushka Shah

Jakarta
Anton Gunawan

Seoul
Suktae Oh

Manila
Jun Trinidad

Taipei
Renee Chen
Cheng Mount Cheng

Citigroup Key Economic Forecasts

Figure 1. GDP Forecasts (Growth Rate in Percent)

	2005 GDP Forecasts			2006 GDP Forecasts			2007 GDP Forecasts		
	Current	Previous	Consensus	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	7.3	7.3	6.8	7.3	7.1	7.3	7.0	7.0	6.7
Asian NIEs	4.6	4.6	4.3	5.0	5.2	5.2	4.5	4.7	4.6
SEA-4	5.1	5.1	5.0	5.2	5.2	5.0	5.5	5.4	5.2
Bangladesh	5.4	5.4	—	6.4	6.4	—	6.0	6.0	—
China	9.9	9.9	9.3	9.8	9.3	9.7	9.2	9.2	8.8
Hong Kong	7.3	7.3	6.9	5.7	5.7	6.1	5.0	5.0	4.9
India	8.4	8.4	7.5	7.6	7.6	7.6	8.0	7.5	7.2
Indonesia	5.6	5.6	5.4	5.4	5.4	5.2	6.0	6.0	5.6
Malaysia	5.2	5.2	5.2	5.5	5.5	5.4	5.5	5.5	5.2
Philippines	5.0	5.1	4.6	5.1	5.1	4.9	5.3	5.0	4.7
Singapore	6.4	6.4	5.1	6.5	6.5	6.7	4.5	4.5	5.1
South Korea	4.0	4.0	3.8	5.1	5.5	5.3	4.3	4.7	4.7
Taiwan	4.1	4.1	3.7	4.0	4.0	4.1	4.5	4.5	4.1
Thailand	4.5	4.5	4.4	4.7	4.7	4.5	4.9	4.9	4.8
Vietnam	8.4	8.4	8.0	7.3	8.0	7.9	8.0	8.0	7.6

Figure 2. CPI Forecasts (Growth Rate in Percent)

	2005 CPI Forecasts			2006 CPI Forecasts			2007 CPI Forecasts		
	Current	Previous	Consensus	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	3.1	3.1	3.1	3.5	4.1	3.4	3.5	3.5	3.2
Asian NIEs	2.2	2.2	2.3	2.3	2.3	2.4	2.4	2.4	2.5
SEA-4	7.1	7.1	7.1	8.7	8.8	8.5	5.5	5.5	5.1
Bangladesh	4.5	4.5	—	4.0	4.0	—	3.5	3.5	—
China	1.8	1.8	1.9	2.0	3.5	2.0	3.0	3.0	2.4
Hong Kong	1.0	1.0	1.2	2.2	2.2	2.2	2.7	2.7	2.7
India	4.5	4.5	4.3	5.3	5.0	4.8	5.0	5.0	4.7
Indonesia	10.5	10.5	10.5	13.7	13.9	13.3	7.2	7.2	6.7
Malaysia	3.1	3.1	3.0	4.1	4.1	3.8	2.5	2.5	3.0
Philippines	7.6	7.6	7.6	7.0	7.0	7.0	6.3	6.3	5.7
Singapore	0.5	0.5	0.5	1.7	1.7	1.4	1.7	1.7	1.4
South Korea	2.7	2.7	2.8	2.5	2.6	2.8	2.7	2.7	3.0
Taiwan	2.3	2.3	2.3	2.0	2.0	1.7	1.8	1.8	1.7
Thailand	4.5	4.5	4.5	5.2	5.2	4.8	4.6	4.6	3.7
Vietnam	8.3	8.3	8.2	7.5	7.5	7.6	6.0	6.0	6.4

Figure 3. Current Account Forecasts (Percent of GDP)

	2005 CAB Forecasts			2006 CAB Forecasts			2007 CAB Forecasts		
	Current	Previous	Consensus	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	5.0	4.9	4.3	4.0	3.9	4.4	3.5	3.6	3.8
Asian NIEs	6.0	6.0	6.9	4.8	4.7	6.3	4.3	4.2	5.9
SEA-4	2.8	2.8	3.0	2.6	1.9	3.5	2.8	2.1	3.0
Bangladesh	-1.0	-1.0	—	0.3	-1.8	—	0.4	-2.8	—
China	7.1	7.1	5.7	5.8	6.0	6.4	5.0	5.5	5.5
Hong Kong	11.1	11.1	11.0	9.7	9.7	11.6	9.5	9.5	11.6
India	-1.3	-2.1	-1.7	-1.9	-2.5	-2.1	-1.8	-2.0	-2.0
Indonesia	0.3	0.3	1.4	1.5	0.4	1.6	0.4	-0.1	1.2
Malaysia	15.2	15.2	13.7	12.7	12.6	14.6	11.1	11.1	13.9
Philippines	2.4	2.4	2.7	3.4	2.0	2.3	3.4	2.0	1.9
Singapore	28.5	28.5	28.1	24.6	24.7	28.3	22.7	22.7	27.0
South Korea	2.1	2.1	2.4	0.6	0.7	0.8	0.0	0.0	0.5
Taiwan	4.7	4.7	3.4	5.0	5.0	4.5	5.2	5.2	4.1
Thailand	-2.1	-2.1	-1.9	-1.6	-1.6	-0.5	-0.1	-0.1	-0.9
Vietnam	-2.6	-2.6	-4.0	-2.9	-2.8	-1.3	-2.8	-2.8	-2.4

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

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

Investment Summary

North Korea's reform progress in many areas, especially enterprise independence, exchange rates and free markets, is broadly comparable to that in China in the late 1980s. Commitments to continuous economic reforms appear to be strong and broad-based. Thus, an imminent collapse of the regime looks highly unlikely. A reduction of political difficulties could significantly boost the benefits of reform, which, in turn, may reduce risk for the region

Too soon for an "all-clear"

After recent rallies, current asset valuations may incorporate too sanguine a reading of global risks. Recent recoveries reflect, in part, more moderate expectations for monetary policy in key countries. But policy may have a way to go, especially in China amid continued strong growth. Given these uncertainties, recent recoveries in asset markets may be somewhat shaky. Markets may not fully reflect emerging geopolitical risks.

Rates, oil and China

While financial markets began to stabilize following the recent fallout, new risks emerged for Asia, including changing rate expectations, skyrocketing oil prices and overheating in China. We continue to expect Asian growth to moderate in the second half, outside China and India, on weakening US demand, a dimming tech outlook, higher interest rates and rising oil prices. Central banks are likely to stay cautious in the near term, especially with regard to currencies. An acceleration of Chinese growth supports the case for further tightening, but we think risks to our upwardly revised GDP forecasts are still on the upside.

Asian local markets: Receive in August while uncertainties persist

Over August, global/regional uncertainties seem unlikely to be fully settled to the satisfaction of markets. This argues for rangebound Asian FX markets, but on the rates side, we think overall conditions have turned to favor receiving. In FX, tactically we are prepared for more US$ strength, but strategically we are still positioned for a juncture in which Asian currencies rebound. By contrast, on both tactical/strategic grounds, we like the new receive view for Asia.

Contents

Macro Overview

- **Recent recoveries of many risky assets may reflect too sanguine a reading of global risks**
- **While financial markets began to stabilize following the recent fallout, new risks emerged for Asia, including changing rate expectations, skyrocketing oil prices and overheating in China**
- **We continue to expect Asian growth to moderate in the second half, outside China and India, but central banks are likely to stay cautious in the near term, especially with regard to currencies**
- **An acceleration of Chinese growth supports the case for further tightening, but we think risks to our upwardly revised GDP forecasts are still on the upside**

Too Soon for an "All-Clear"

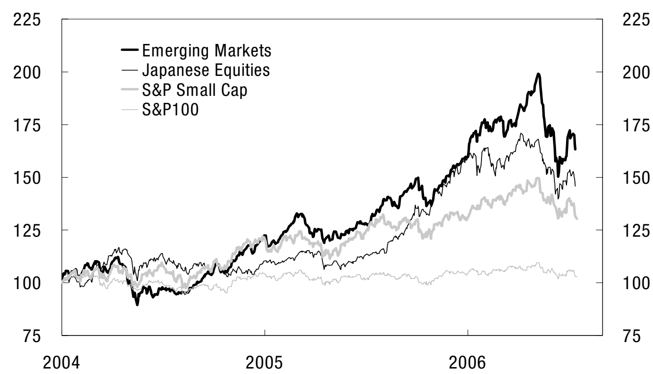
Lewis Alexander
(1-212) 816-9882
lewis.alexander@citigroup.com
New York

The strong positive reaction across a range of markets to Chairman Bernanke's testimony on July 19 suggests that many market participants are increasingly confident that fundamental risks are receding. But it may be too early to draw this conclusion. Much of the underlying economic uncertainty that contributed to the sell-offs in a range of markets in May and June remains unresolved. While we expect only moderate further tightening of monetary policy across an array of countries and regions, the risks around that base case are weighted toward higher rates than we or markets currently expect. In addition, the outbreak of conflict in Israel and Lebanon, which has caused many markets to correct somewhat in the last nine days, could have wider implications for the global economy as it raises the risk of oil supply disruptions. These developments suggest that current valuations may incorporate too sanguine a reading of global risks.

Despite the decline that started in May, values of risky assets are generally healthy. Equity prices in some markets fell by 20% or more (see Figure 4). But given the magnitude of earlier gains, equity prices in a number of these markets remain roughly where they were six months ago and substantially higher than they were a year ago. Likewise, credit spreads widened since early May, but the recent move was smaller than in the sell-offs of 2004 and 2005 (see Figure 5). Moreover, spreads for investment-grade emerging market borrowers remain significantly tighter than the average since the beginning of 2004. Markets for a number of key commodities also have shown surprising resilience. For example, copper prices are down about 10% from their late-May peak, but they are still up 70% from early March.

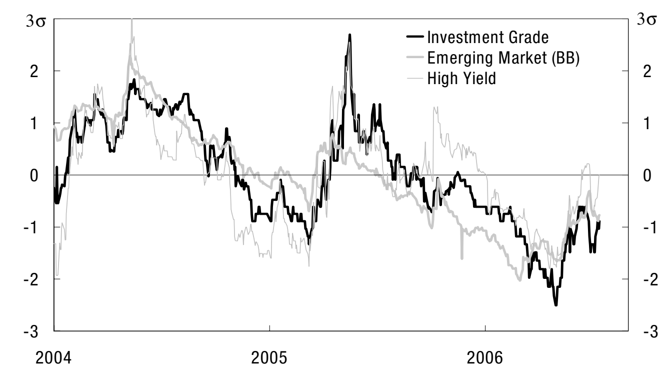
The recent recoveries of asset markets probably reflect, at least to some degree, more moderate expectations for the path of monetary policy in key countries. Forward interest rates have generally fallen in major markets since late June. Our base case forecast continues to be that in most countries moderate tightening of monetary policy should be sufficient to contain emerging inflationary pressures. But it may take some time to confirm this basic conclusion.

Figure 4. Global — Equity Prices (End 2003 = 100), 2004–July 2006



Sources: Haver Analytics and MSCI.

Figure 5. Global — Normalized Spreads for Credit Default Swaps, US Investment Grade, High Yield, and EM Borrowers, 2004–July 2006



Note: Normalized spreads are deviations of the log of the spread from its mean over the period divided by the standard deviation. Sources: Bloomberg and Citigroup.

Incoming data in a number of countries point to somewhat more robust near-term economic activity than we had expected, however, suggesting that policy still has work to do in a number of countries. For example, the Chinese economy continues to grow significantly faster than policymakers would prefer. We anticipate further policy measures intended to slow that economy and to restrain investment. This will likely include a somewhat more rapid pace of appreciation for China's currency. The Bank of Japan (BoJ) has begun to raise interest rates, and we expect the pace of further rates increases to be gradual. But the BoJ has moved more quickly first to end its policy of quantitative easing and then to raise interest rates than we had anticipated a few months ago. Moreover, the Japanese economy has shown surprising resilience in recent years. We also anticipate one more interest rate increase from the Federal Reserve in order to buy insurance against lingering inflation risks.

Importantly, the likely path of monetary policy in key countries is not independent of the performance of asset markets. Any easing of financial conditions due to recoveries in the markets for risky assets may prompt further monetary policy tightening. Given these uncertainties, the recent recoveries in asset markets may be somewhat shaky.

Rates, Oil and China

Yiping Huang
(852) 2501-2735
yiping.huang@citigroup.com

Financial markets, especially the equity markets, settled down somewhat during the past month. India's stock price index rose by 14.9% from the lowest level in June. Hong Kong and China markets recovered by 5.3% and 7.0%, respectively. Other regional markets also improved slightly. During the past two weeks, equity capital inflows also returned, especially to the China and India markets. Most currencies still showed weakening tendencies lately.

Some new changes, however, occurred during the past month. These include changing expectations of global rates, rapidly climbing oil prices triggered by conflicts in the Middle East and accelerating economic growth in China.

Changing rate expectations

Market expectations about the US Fed funds rate have been unstable recently. The softer-than-expected FOMC statement in late June reduced the probability of an August rate hike from close to 100% to barely above 50%. Chairman Bernanke's testimony on July 19 restated the Fed's earlier message, i.e., while growth has probably moderated to a non-inflationary path, lingering inflation remains a concern. We maintain our base case that the Fed funds rate will still peak in late August at 5.5%, although the actual FOMC decision will depend on economic data in the coming weeks. In Europe and Japan, we actually upgraded our forecasts for year-end rates. We think the ECB will likely hike two more times, one in early August and the other before the end of the year, with the policy rate peaking at 3.25%. BoJ may also increase the policy rate one more time before the end of the year, following the first change on July 14.

Against this global backdrop, we think short-term interest rates in some Asian economies may also rise further. However, Asian growth momentum has already started to moderate. In addition, outside Indonesia, the Philippines and Vietnam, actual inflation rates are still below, or within the ranges of, the official targets/forecasts (see Figure 6). But even in Indonesia and the Philippines, inflation rates have been falling for the past months. In some economies such as China, Hong Kong, India, Korea, Malaysia and Taiwan, CPI picked up recently.

Figure 6. Inflation Targeting in Asia

		Government Target or Forecast		Actual Core/Headline CPI	
Economy	Targeted Price Index	2005	2006	Most recent	3-months prior
China	No official inflation targeting policy	3.0-3.5	3.0	1.4 (May 06)	0.9
Hong Kong	No official inflation targeting policy	1.5	2.3	2.9 (May 06)	1.6
India	No official inflation targeting policy	5.0	5.0-5.5	4.4** (May 06)	4.1**
Indonesia	CPI	5.5-8.6	7.0-9.0	15.6 (May 06)	17.9
Korea	Core CPI (ex. ag and oil)	2.5 to 3.5 (BOK)	3.0 (BOK)	2.0* (May 06)	1.7*
Malaysia	No official inflation targeting policy	2.8	3.5-4.0	3.9 (May 06)	3.2
Philippines	CPI	5-6	4-5	6.9 (May 06)	7.6
Singapore	CPI	0 - 1	1 - 2	1.1 (May 06)	1.2
Taiwan	No official inflation targeting policy	2	1.8	1.58 (May 06)	0.98
Thailand	Core CPI (ex. ag and oil)	4-4.5	2.0-3.0	2.7* (May 06)	2.7*
Vietnam	No official inflation targeting policy	8.0	##	7.6 (May 06)	7.4

Note: * Core CPI, ** Wholesale Price Index. ## In Vietnam, the authorities hope to keep inflation rate below real GDP growth rate.
Source: Citigroup estimates.

In summary, current and expected changes in growth momentum and inflationary pressure do not provide strong support for substantial further hikes of policy rates in the region. China is an exception in this case where the economy shows some signs of overheating. Oil prices remain a key risk. And, in a number of economies such as China and India, adjustments of domestic oil prices could also lead to higher inflation rates. Therefore, the magnitudes of further increases in Asian policy rates are likely to be limited (see Figure 7).

Figure 7. Expected Additional Rate Hikes in Asia during the Remainder of 2006 (Basis Points)

	Short-Term Interest Rates		
	Current	Expected Additional Hikes	Comments
China	5.85	27	New phase of broad monetary tightening
Hong Kong	7.75-8.0	50	Prime rates mostly following the Fed
India	5.75	25	Containing capital outflows and potential inflation
Indonesia	12.50	-100	Cutting rates to stimulate growth
Korea	4.25	25	Containing the risks of inflation and housing market bubbles
Malaysia	3.5	50	Catching up of monetary tightening
Philippines	7.5	0	No more expected
Singapore	3.54	0	Limited scope for easing of short-term rates
Taiwan	2.5	12.5	Expect another rate hike in September meeting
Thailand	5.0	0	No more expected, but depending on inflation outlook
Vietnam	7.84	41	Interest rate increases likely following the Fed loosely

Source: Citigroup estimates.

Rapidly rising oil prices

With oil prices edging toward US$80 per barrel and fears of actual disruptions, we have again looked at which Asian emerging market countries are most exposed to an oil supply shock. We have looked at two different scenarios using the Oxford Economic Forecasting (OEF) model. In the first, we push oil prices to US$100 per barrel due to an assumed disruption of oil from the Middle East. However, we allow the fall in global demand to feed back into oil prices later. In the second scenario, we assume that oil rises US$20 per barrel, but stays US$20 above the assumed baseline in the model over five years. This second scenario implicitly assumes that the supply disruption persists and implies a higher price of oil in 2008 than under the US$100 shock with feedback.

Using the model as a guide, growth would suffer the most in Singapore, Thailand, the Philippines and China (see Figure 8). Even oil exporters like Malaysia and Indonesia would suffer lower GDP due to a preponderance of non-oil exports in their trade and lower demand in trading partners. Korea and Taiwan show relatively better performance among Asian economies. The relative impacts when oil prices are forced to remain US$20 higher are not so dramatically different, although the gaps between winners and losers widen over time.

Figure 8. Asia – Impact of Higher Oil Prices on GDP (Difference from Baseline in Percentage Points)

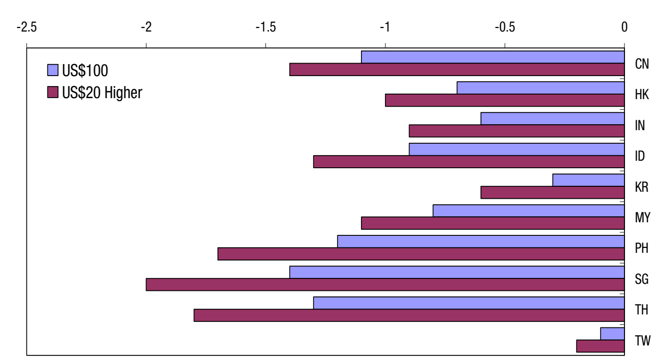
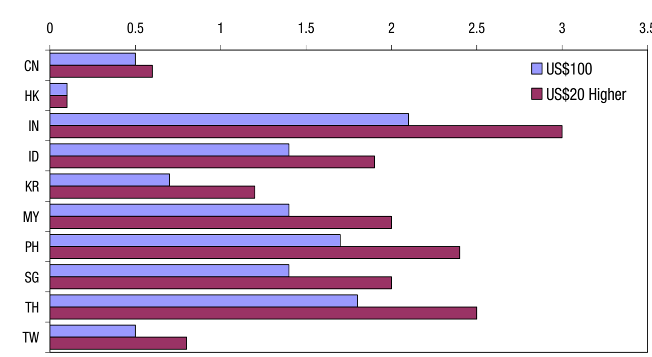


Figure 9. Asia – Impact of Higher Oil Prices on CPI (Difference from Baseline in Percentage Points)



Note: Scenario One assumes oil prices climb to US$100 per barrel temporarily while Scenario Two sets oil prices US$20 per barrel above the baseline.
Sources: Citigroup estimates using Oxford Economic Forecasting Model.

A surge in oil prices in the OEF model also boosts inflation in many emerging countries. India, the Philippines, Indonesia and Thailand stand out as showing relatively more inflation. Incidentally, these are also the "high inflation" economies in Asia. If the inflationary impact of high oil prices materializes, then the central banks in these countries may need to raise interest rates more than we currently expect.

Accelerating Chinese growth

China's acceleration of GDP growth to 11.3% in the second quarter from 10.3% in the first quarter, despite the measures introduced earlier to cool down investment, surprised the markets. The pickup of growth momentum began from the beginning of the year, on renewed political incentives before the expected change of local governments and the start of many new projects mandated by the Five-Year Plan. The authorities had already started to take steps to slow investment activities, including industrial consolidation through administrative measures, hikes in lending rates by an average of 27 basis points in April, and an increase in the reserve requirement ratios twice, in June and July, by 1 percentage point. Cooling the property market also became a policy target.

Most of these measures, however, haven't been very effective, judging from not only GDP acceleration in the second quarter but also faster paces of investment and production in June. And one of the key reasons was probably too much liquidity in the system, which effectively reduces the cost of capital. Because of expectations of currency appreciation, capital inflows remain very strong. Foreign exchange reserves reached US$941.1bn at the end of June. The central bank's ability to sterilize, however, declined recently due to very low market interest rates but increased pressure on commercial banks to improve their financial performance. Too much liquidity and too low market interest rates seriously reduce the effectiveness of any tightening policies by reducing the cost of capital.

The market now expects another 27bp hike in the base lending rate within the coming month or so. We think this is likely. The government may also reduce export tax rebates. But we also think the actual effect of such a modest move on credit growth is likely to remain limited. To rein in investment, the authorities are likely to also focus on efforts in two areas – administrative measures and liquidity controls. PBOC's hike of reserve requirement last Friday, the second one within almost a month, confirmed the central bank's determination to tighten the liquidity. To reduce liquidity, the central bank is likely to increase open market sales of short-term paper. That both requires, and could lead to, higher market interest rates, which would, in turn, add further pressure on the currency. We continue to expect faster appreciation of the renminbi in the coming months, with expected appreciation by 7.5%.

The market is concerned about further tightening in China. And while we recently raised our GDP forecast for 2006 on the strong performance in the first half of the year, we maintain our expectation of a modest slowdown in the second half due to the expected tightening policies, moderation of external demand and some renewed risks such as oil. But in the near term, any fears about a possible hard landing are likely to be overdone. Most government officials still believe that China needs strong growth to create jobs and that the current risks are more of structural imbalances than overheating. Any risk to our GDP forecast is likely to be on the upside.

Investment implications

While some of the risks are new, they are consistent with our view of moderating growth momentum. We expect the average Asian GDP growth to slow from 7.9% in the first half of the year to 6.7% in the second half, on slower US growth, cautious tech outlook, higher interest rates and likely much higher oil prices.

It may also be important to point out that currently downside risks also look limited. In both the US and China, we expect only a modest slowdown, not a hard landing, of the economies. In the financial markets, the worst may be behind us.

Of the three components of GDP, we think the contribution of net exports is likely to weaken visibly. And slowing exports and higher interest rates could hurt investment, unless government spending on infrastructure investment steps up significantly. Consumption could outperform in relative terms.

Central banks in the region may stay cautious in the very near term, especially with regard to the currencies. But we still see chances of the Indonesian rupiah and Thai baht outperforming the forward markets (see Figure 10). Recently, we also shifted our overweight recommendation for the Indonesian sovereign back to neutral but attached an overweight position on Vietnam's external debt.

Figure 10. Asian Debt and Currency Markets — Local and External Market Recommendations

	Local Market Instruments[a]		Sovereign Foreign-
Country	Currency	Interest Rates	Denominated Bonds
Asia			
China			Underweight
India	–	–	NA
Indonesia	+		Neutral
Korea			Underweight
Malaysia			Underweight
Philippines		+	Neutral
Taiwan		–	NA
Thailand	+		NA
Vietnam			Overweight

[a] For currencies and interest rates; "+" the instrument is likely to outperform forward markets; "–" the instrument is likely to underperform forward markets over the next three months, where market forwards are available; otherwise the symbols represent directional calls. NA Not Applicable.
Source: Citigroup.

Impressions on North Korea's Reforms

- **While political issues continue to dominate international discussions, North Korea's economic reforms have probably proceeded much further than what has been widely recognized**
- **Reform progress in many areas, especially enterprise independence, exchange rates and free markets, is broadly comparable to that in China in the late 1980s**
- **Recent changes in economic systems and associated payoffs suggest that, in the short term, any internal-factor-triggered collapse of the regime is highly unlikely**
- **Commitments to continuous economic reforms and internationalization, which began in July 2002, appear to be strong and broad-based**
- **A reduction of political difficulties could significantly boost the benefits of such reform efforts, which, in turn, may reduce risks for the region, particularly South Korea and Japan**

Food supply situation improved

Yiping Huang
(852) 2501-2735
yiping.huang@citigroup.com

Yiping Huang recently visited North Korea in a personal capacity, together with Peter Drysdale, an economics professor from the Australian National University. During the weeklong visit, they had meetings with policymakers and economists from various ministries, including the Cabinet Office, and paid visits to state-owned companies, banks, joint ventures, universities and some other cultural sites.

Several years ago, Yiping worked with a former colleague at the Australian National University, Heather Smith, on North Korea's famine problem.[1] Between 1988 and 1997, North Korea's grain output declined by nearly 50%, which, according to various estimates, caused total deaths of between 500,000 and 2,000,000. Their analysis suggested that, of the total output decline, about 69% was due to a reduction in inputs, especially tractors and fertilizers, and the remaining 31% was because of a deterioration in productivity, possibly attributable to bad weather and a collectivization policy. The sudden shortage of inputs was a result of the collapse of the former Soviet Union and the Eastern Block.

[1] Heather Smith and Yiping Huang. 2000. 'Trade disruption, collectivization and food crisis in North Korea,' Paper presented at the Conference *Achieving High Growth: Experience of Transitional Economies in East Asia*, August 2000, Canberra, Australia.

Since then, the authorities have made various efforts to improve the food situation, through the implementation of certain responsibility farming systems, an improvement in seed varieties and the extension of double cropping. Imports of oil and fertilizer, especially from China and South Korea, increased significantly. These, alongside increases in international food aid, helped to lift the food supply to levels of normal nutrition for the North Korean population.[2] North Korea does not look well positioned to achieve self-sufficiency in food. Ultimately, food imports on commercial terms are necessary to meet domestic demand. To do that, however, North Korea would need to develop a stronger export sector.

July 2002 reforms

In July 2002, North Korea launched a major wave of economic reforms. In retrospect, it has made significant progress in the following areas:

- Improving the independence of decision-making for enterprises
- Increasing the role of free markets, especially for non-essential goods
- Liberalizing the exchange rate policy
- Opening the economy

The most obvious evidence of progress in economic reform was the "marginalization" of the State Planning Commission (SPC). In recent years, the importance of the SPC has declined significantly, with its key roles shifting from detailed planning of economic activities to scenario analyses.

Managers of state-owned enterprises (SOEs) have gained freedom in determining output mixes and even product prices. Managers of profitable SOEs also have the freedom to hire employees from universities and other companies. While the base salary grades are still set by the government, which vary according to industries, professions, education and experience, managers can decide on benefits and bonuses. At some IT companies that we visited, the amounts of benefits and bonuses are well above 50% of base salaries. There is no taxation system for domestic enterprises. But most SOEs have a profit-retention plan, which allows companies to retain 40-50% of the total profits for their own development or compensation. The government also has set up microfinance joint ventures to promote the development of small and medium enterprises.

Free markets also play an important role in resource allocation. Some international analysts estimate that currently about 90% of farm surpluses (i.e., total output minus farm household consumption) go directly to free markets. The Public Distribution System (PBS), which used to handle all farm surpluses, is now mainly for distributing international aid products.[3] Not long ago, there were reports about North Korea re-introducing food rations. To us, this sounded more like providing subsidies to urban residents, as most urban households still buy additional food from the markets. But, currently, market prices are only marginally higher than state prices.

---

[2] Peter Drysdale, "The Economics of North Korea Settlement", *APEC Economies Newsletter,* October 2005, Australian National University, Canberra.

[3] Stephan Haggart and Marcus Noland, 2005, *Hunger and Human Rights: The Politics of Famine in North Korea*, U.S. Committee for Human Rights in North Korea., Washington DC.

This not only suggests that food supply conditions have improved but also that price subsidies to urban residents are not significant.

Exchange rate policy is another area that experienced significant reform. After the July 2002 reforms, the North Korean won depreciated sharply, from the official won 165 per euro to the current market rate of 2,200. Today, North Korea has three exchange rates. The first is the official rate, which is still at 165, but is used for official accounting purpose only. The second is the black market rate. And the third is called a corporate exchange rate, which tracks the black market rate very closely and is used for most corporate transactions.

The authorities also took steps to increase exports and attract foreign investment. They introduced laws on joint ventures and on foreign investment. Corporate income tax rates are set at 10-25%, which can be reduced to 0% for between two and seven years for foreign invested firms. The government also set up industrial/special economic zones in border areas with South Korea and China in order to boost trade and investment.

Experiences in the above areas suggest that North Korea's economic reforms are probably broadly comparable to those in China in the mid- to late-1980s. In some areas, such as foreign exchange rate policy, North Korea is probably already beyond the China of the early 1990s.

The farming system is one key area that has not experienced any significant reform. In the second half of the 1990s, North Korea introduced some elements of a group responsibility system, ie, the collectives were broken up into smaller groups that operated as relatively independent farms. That was, however, reversed in recent years. The explanation we were given was that de-collectivization did not generate productivity gains due to high levels of agricultural infrastructure and mechanization (as the small sizes of farms hindered the realization of scale efficiency).

Basis for another East Asian miracle?

Actual progress in economic reforms has been way beyond our expectations. North Korea's key risks are still more political than economic, as evidenced by the recent missile tests. But there is a lot more happening in the economy than most North Korea watchers would admit. Some analysts would simply dismiss North Korea's reforms as a means of survival. But reform, including that in China or the former Soviet Union, begins as ways of survival. The crucial questions are: whether such reform efforts will lead to a significant improvement in efficiency, income and welfare and whether the continuous progress eventually becomes self-sustaining.

It's too early to predict if North Korea may soon join the other rapidly growing East Asian neighbors. But it has already laid a good basis for achieving strong economic development if reforms continue. The two dynamic and large neighbors, South Korea and China, could serve as important launch pads for North Korea's economy. They may even play roles for North Korea similar to the roles played by Hong Kong for China in its early stage of reform. Interestingly, North Korea is rich in natural resources and has a well educated population. It has an 11-year compulsory free education policy, and its literacy rate is close to 100%, compared to only 20% some 60 years ago.

The main obstacles for North Korea's economic prospects are political, both domestic and international. Unlike the experiences of China, efforts to increase exports and investment generated very limited results, even though North Korea's trade with China and South Korea expanded by 40-50% annually. Other countries have not really expanded their economic links with North Korea significantly, either because of a lack of information or because of political constraints. These have seriously reduced the benefits of reform. Recently, for example, products produced in North Korea's Kaesong Industrial Zone became a sticky issue during negotiations for the US-Korea FTA. If products containing parts made in Kaesong have to be excluded in the FTA, this would discourage South Korea's investment in the North and would further discourage North Korea's integration into the international economy.

It might be in the best interests of the international community to help support and facilitate economic reforms in North Korea, while carefully managing political risks. Past experiences suggest that economic integration and income growth are often the best ways to reduce political and policy uncertainties. Therefore, economic engagement may increase the chance of continuous economic reforms in North Korea and, at the same time, reduce risks for everybody else.

Strategy — Asian Currencies and Interest Rates

Cliff Tan
+65-6328-5725
cliff.tan@citigroup.com
Singapore

Puay Yeong Goh
Singapore

- **Global concerns about macro and US Fed credibility seem unlikely to be resolved to the satisfaction of markets in August**
- **This suggests somewhat rangebound Asian FX markets, where tactically we are prepared against more US$ strength, but where strategically we expect Asian currencies to rebound later in the year**
- **On both our base case and an alternative case (in which growth slides) scenarios, receiving in Asian yield curves has become considerably more attractive; we suggest looking at India**
- **Market fears appear clustered around: (1) sliding growth; (2) unbridled inflation; and (3) a stumbling Fed**
- **We think you can't have (1) and (3) nor (1) and (2); we cannot rule out (2) and (3), but believe inflation manageability ultimately eliminates (2) and by implication also (3)**

Asian Local Strategy Summary

Over August, it seems unlikely that global/regional concerns about inflation and growth and about the credibility of new US Federal Reserve Chairman Bernanke can be fully settled to the satisfaction of markets. This will be particularly true if the usual holiday lull and recent risk aversion on the part of many investors prevail.

All of this argues for somewhat rangebound Asian FX markets in the near term (no fireworks in our forecast grid for the month ahead, below), but on the rates side we do think overall conditions have turned to favor receiving (more explanation at the end of this strategy). In FX, tactically we are prepared for more short-term momentum plays in the direction of US$ strength against Asia (motivations similar to what held at the end of August last year[4]), but strategically we are still positioned for a juncture in which widespread inflation fears ultimately prove unfounded and the US Fed scrapes through a tough first year under its new chairman. By contrast, on both tactical/strategic grounds we like the new receive view for Asia. Perhaps the key risk will be lingering uncertainty over the Fed, which could give rise to market volatility under thin liquidity and prices veering away from fundamentals.

[4] *Asia Economic Outlook and Strategy*, 29 August 2005, pp. 15-24.

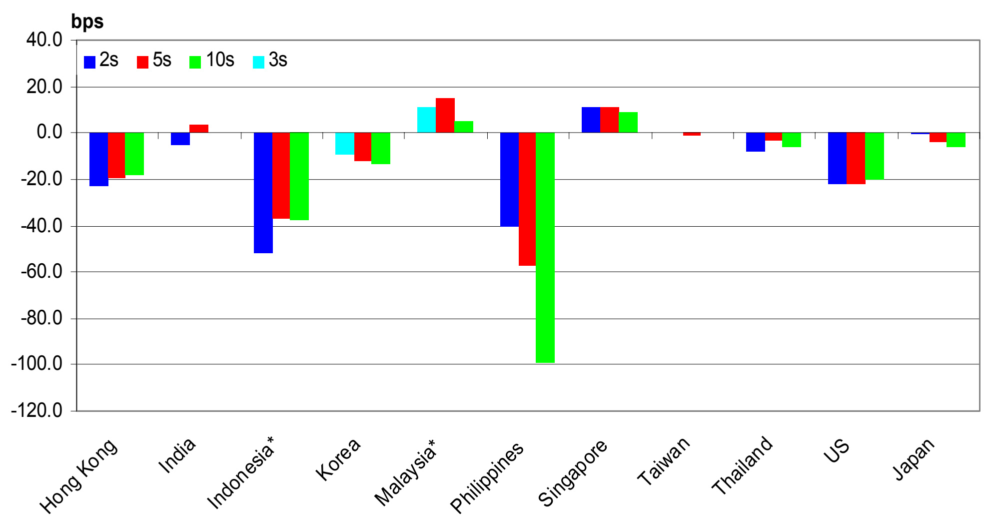
Asian FX/FI Market Lookback

Figure 11. Recent Performance of Asian FX, One- and Three-Month Changes

Currency	Spot	1 Month Ago Outright	% Gain/Loss	3 Month Ago Outright	% Gain/Loss
	21-Jul-06	21-Jun-06		22-Apr-06	
USD/JPY	116.91	114.35	-2.24	115.14	-1.53
EUR/USD	1.2633	1.2687	-0.42	1.2412	1.78
USD/CNY	7.9885	7.9795	-0.11	7.9255	-0.79
USD/HKD	7.7764	7.7600	-0.21	7.7447	-0.41
USD/INR	46.84	45.93	-1.98	44.71	-4.76
USD/IDR	9155	9400	2.61	8990	-1.84
USD/MYR	3.6845	3.6599	-0.67	3.6433	-1.13
USD/PHP	52.19	53.310	2.10	51.916	-0.53
USD/SGD	1.5854	1.5875	0.13	1.5892	0.24
USD/KRW	949.9	954.8	0.51	947.8	-0.22
USD/TWD	32.795	32.519	-0.85	32.013	-2.44
USD/THB	38.052	38.365	0.82	37.857	-0.52

Source: Reuters.

Figure 12. Recent Performance of Asian Fixed income, One-Month Change



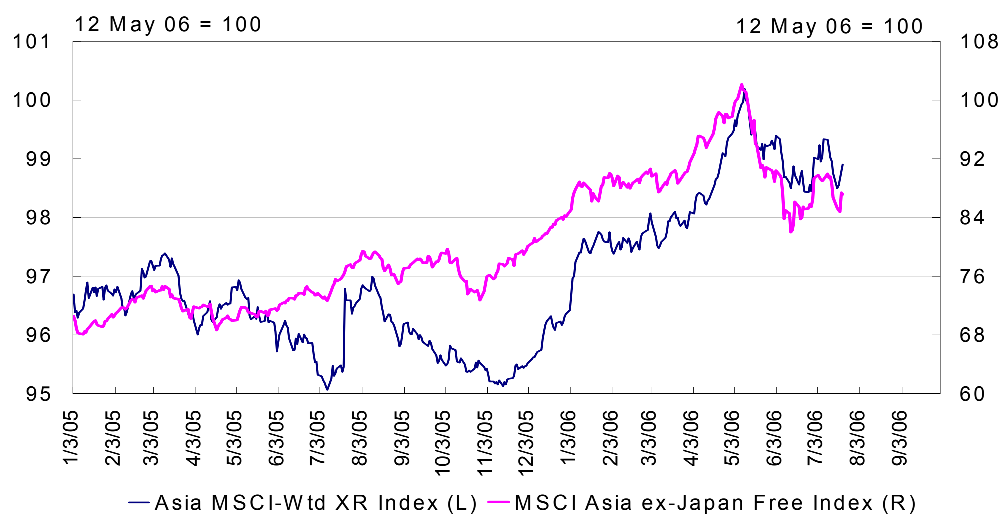
Note: Government curves used for India, Indonesia and Malaysia; IRS curves elsewhere. * Malaysia, Indonesia shorter tenor yields are 3-year.
Source: Bloomberg.

Over the past month we swapped what was initially an EM-specific set of uncertainties for a larger set of global geopolitical/policy uncertainties, spurred on by an outbreak of new Mideast tensions that raised market perceptions of geopolitical risk, pushed oil prices higher and resuscitated fears of slowing growth. Compounding this was angst about the US Federal Reserve possibly overshooting in the direction of tightening, which if it occurs could drag growth down even further. All of this lent a bid tone to the broad US$, to the US$ against Asia and to US Treasuries.[5]

[5] Despite fears of slowing US growth, the US$ remained bid, a pretty good piece of evidence that when the going gets tough, the US dollar is still a safe haven even with persisting global imbalances.

Before the handoff took place, from EM to global uncertainty, Asian currencies began to retrace and rally in line with prior expectations – as market sentiment stabilized and market volumes resuscitated – but new uncertainties put paid to the nascent rally. Despite new uncertainties, not all retracement gains in Asian currencies and equities have been given back:

Figure 13. Relative movement in Asian currencies and equities, 2005-2006



Source: Bloomberg, MSCI, Citigroup calculations

Fears and Dichotomies in Las Vegas (and Elsewhere)

Fears

To us, it appears market fears are clustered around three major issues, which we identify and label as: (1) sliding growth; (2) unbridled inflation; and (3) a stumbling Fed. In the table below, we show heuristically where we think the majority of market opinion in each major asset class might be poised (X marks the spot) at around the end of July; these judgments are made based on market price trends, color/commentary and our judgments about sentiment.

Figure 14. Major Market Concerns by Asset Class, End-July 2006

Asset Class	Sliding Growth (1)	Unbridled Inflation (2)	Stumbling Fed (3)
Equities	X		X
Fixed Income	X		
FX		X	X
Commodities		X	

Source: Citigroup estimates.

In equity markets, we often hear talk of both faster-than-expected slowing in growth but a Fed that nonetheless (bullheadedly) rushes to overtighten. We don't think equity markets are that concerned about inflation *per se*, but are concerned that the Fed might be overconcerned.

On inflation, we think fixed income and equity markets agree: There is no problem. Global yields have fallen, and the curve has yet to steepen (see the lookback above). But commodity prices have recovered since a month ago (though they remain off recent peaks). As commodities are always about *relative* prices rather than the overall price level, the interpretation they might have concerning inflation is a short-term judgment. As we shall argue (below), the recovery in such prices may be better evidence against sliding growth (1) than for unbridled inflation (2).

The US$'s rebound in the past month appears to have much to do with renewed Mideast tensions (about which we have more to say) and an implicit view that the Fed will continue to tighten even if it overshoots, so we would group FX fears under unbridled inflation rather than slowing growth. Slowing growth would logically mean a greater chance of the Fed pausing, so the maintained hypothesis in FX markets appears to be one in which inflation runs away and the Fed hikes but still somehow manages to mess it up.

Dichotomies

Now here are our views. As hinted above, we don't really think you can have (1) and (3) – sliding growth but a stumbling Fed. If growth really slides more than anticipated, the Fed would pause (as medium-term inflation forecasts will likely be revised lower) and hence would get no opportunity to get it wrong (over-tighten). If things are really bad for growth, the Fed might even cut, an outcome that has receded from market discussions in the past few months. We also discussed last month why we don't think you can get (1) and (2) – sliding growth and unbridled inflation – because we still think we are looking at aggregate demand movements rather than a negative aggregate supply shock.

But we cannot rule out (2) and (3), i.e., the FX market view – unbridled inflation and the Fed stumbles. We have more to say about this later, but for now we assert that if we see evidence that (2) is wrong – inflation would remain under control – then logically (3) has to be wrong, and that might present some trading/investing opportunities later down the road.

The Mideast: Watch Those Oil Prices

Before we discuss the case of (2) and (3), however, we feel we need to devote some space to the most pressing recent risk, the renewed open warfare between Israel and the Hezbollah being played out in Southern Lebanon and Northern Israel.

At this stage, it seems nearly impossible to conclusively know the extent and duration of the new tensions, but our strategy implicitly assumes that initial market judgments are correct: This should ultimately prove a conflict that is **contained** in terms of territory and in terms of not growing into a larger regional war. We will take Israel at its initial word that it does not want to extend to a regional war, particularly against Iran and Syria. We assume at this stage this means that Israel's perceived security needs do not make an extended conflict attractive on a risk/reward basis. On the opposing side, we also make the same implicit judgment about, primarily, Iran: That the risk/reward of a regional war, despite rhetoric, probably does not favor a wider conflagration. We also note continuation of multilateral efforts to bring peace back to the region.

But as we said already, it's impossible to know for sure. **The key for financial markets, we judge, will largely be captured by the state of oil prices.** Near-term oil futures prices up at around US$81/barrel for February 2007 (as of mid-July) probably give a reasonable idea of what the markets think represents a worst-case scenario. If Iran stays out of a regional war, the chances for a serious reduction in global oil supplies falls; we think drops in oil prices after mid-July were a good initial indication that the contained view is more likely to be correct (this despite heightened media attention). All of this means that while new Mideast tensions are unlikely to abate soon, their contributions to market prices in the month ahead might realistically consist of heightened volatility over one or several days, but no more than that. As we said, watch oil prices.

Gentle Ben: The Fed Has Some Skin in the Game

Both Chairman Bernanke's semiannual monetary policy testimony and the release of June 2006 FOMC minutes helped to cement a market perception that US EMA forecasts for Fed Funds to peak at 5.5% have become much more likely (compared to an even higher Fed Funds peak). But market uncertainties will also likely persist, despite both the Fed and BOJ in July trying to clarify policy outlooks (something we emphasized last month).

As noted, one reason is macro – those growth/inflation uncertainties take more time and data before arguments can be settled. But the other factor – it has to be said – is market uncertainty about, primarily, Chairman Bernanke's discretionary judgment in the conduct of monetary policy. This is not unusual when a new Fed chairman comes in, and while there is widespread market desire for the new chairman to succeed, we think that difficulties in communicating *certainty* in what is fundamentally an *uncertain* environment has probably lightened market confidence a bit. As we said, however, we think the Fed ultimately will scrape through this first year (full disclosure: your writer is a former Fed staff), but will likely have to come up with more *convincing communication* before markets sign off.

There appears to be an influential minority that expects the Fed to stumble anyway: That the Fed will get it wrong even though many think it will get it wrong and even though it can read every day that many think it will get it wrong. Bernanke, in the Q&A that followed his semiannual testimony, explicitly said the Fed is well aware of the risks that it might over-tighten and slow growth to below potential. We think fundamentally if the Fed is continuing to follow Greenspan's risk-management emphasis there could be an argument for a limited overshoot, in the sense of buying more insurance against inflation than needed, but we would add that an additional, important factor in the thinking of the influential minority is that the Fed, after all, remains a government bureaucracy (as opposed to market players who have real money on the line) and that is probably why it stumbles into over-tightening every time. We add, however, that members of the FOMC might also have some skin in the game – no one likes to look like an idiot, especially if many others are saying they have no choice.

Back to the Future, of Macro

Ultimately, inflation will rule as far as the Fed's report card goes, so we'll see. Our economic colleagues have and continue to write extensively about inflation prospects, both globally and in Asia, and we do not wish to add to that. But the moderating growth outlook that most economists – ourselves and the Fed included – expect should aid in the Fed's cause if it transpires.

Even weaker growth, however, will hurt Asian currencies. As we discussed last month, the best framework for understanding both the EM and then the subsequent global uncertainties has to do with possibly slower growth into 2007. This seemed the best fundamental justification for why EM assets sagged in the first place.

While overall we retain reasonably constructive views about the health of the US and regional economies, we acknowledge that continued equity market slides and higher oil prices represent more significant headwinds against a relatively constructive view.[6] US real activity in the 2Q06 appears to have slowed considerably from a rapid 1Q06 pace, with recent signs of knock-on slowing in the export-dependent Japanese and European recoveries, too. So it should not be too surprising if Asian economies also exhibit a period of softening, in line with just 2Q06 US trends alone. In addition, if global and regional equity market softness continues, that would signal persistence in risk aversion that could also slow activity as investment and other risk-taking ventures scale back.

Near-term risks and how to trade them

For momentum followers and those who believe our economic views are wrong, the directional trades seem close to where we found ourselves last August, when a previous updraft of global oil prices led to similar concerns about slower growth. The advice then is the same as now (again, risks of sliding growth have increased): Asian currencies would remain under pressure longer in this scenario, and we look to receive on various local curves if sliding growth is truly on its way. When we say sliding growth, what we have in mind is a US growth recession in which quarterly growth rates over the balance of 2H06 exhibit a "2-handle" relative to US EMA growth forecasts that have a "3-handle."

Still constructive on Asian currencies over the medium run

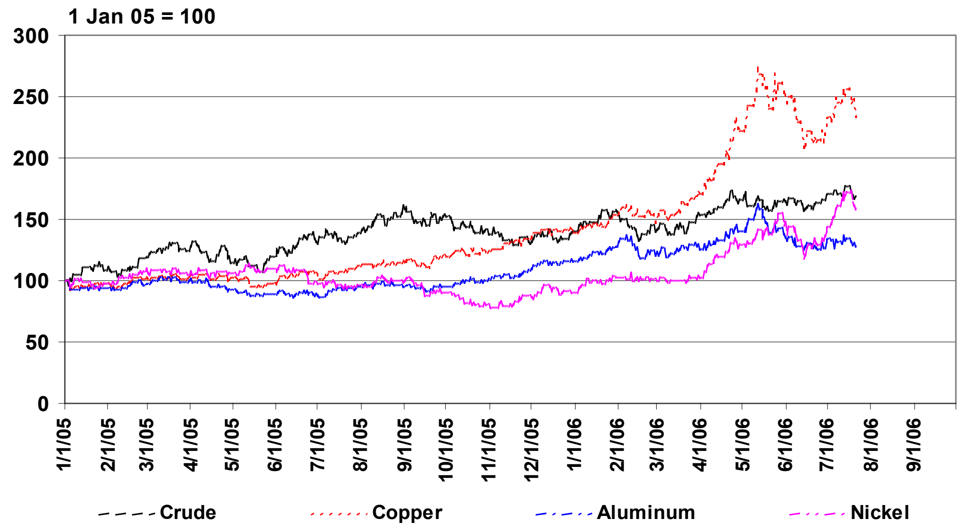
It has been interesting that during these months of uncertainties that the SGD has nonetheless and persistently stuck above its +1% strong level against the SLING© index. In the short run, this hurts one of our trade recommendations (which we also view as a hedge), but more importantly, this seems to signal to us that the market appetite for Asian currencies remains and should revive were we to move beyond this period uncertainty.

---

[6] See Hak Bin Chua, *Asia Macro Views: Tech Lull Dims Asian Growth Prospects* (AP559, EC255), 14 July 2006

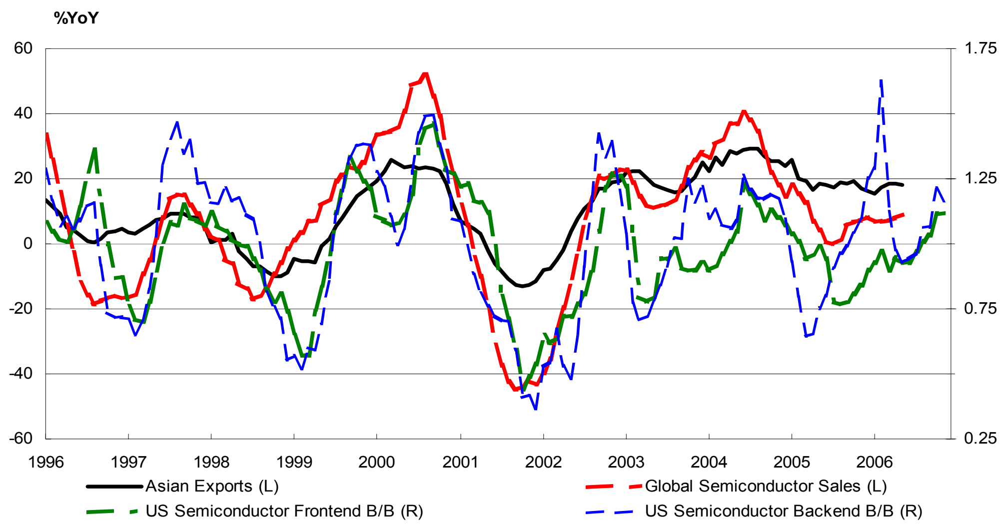
If US growth moderates to a sustainable pace (the "3-handle"), we still see reasons for Asian currencies to revive (as reflected in our forecast grid below). First, usual growth support for buying Asian currencies returns. Second, because we see recovering energy and base metals prices and a seasonal recovery in technology as less pessimistic on growth than perhaps what many in the markets fear.

Figure 15. Energy and Base Metal Prices Rebounded, Even Ahead of Mideast Tensions



Source: Bloomberg, Citigroup

Figure 16. The Global Technology Cycle and Asian Aggregate Exports, 1996-2006



Source: CEIC Data Company Limited, Citigroup

Finally, we see Asia/EM-specific support for currencies in the next one to three months as follows:

The Doha end-game: Pulling a rabbit out

We expect a renewed US push can help secure a final agreement out of the Doha round of trade talks, which, if the agreement includes increased access to developed markets that had been promised, would generally support a continuation of EM growth and development.

Faster renminbi appreciation

And as discussed earlier,[7] we see the next few months as a window of opportunity during which the turgid pace of renminbi appreciation might be modestly accelerated, in response to both macroeconomic and market development needs.

Bottom line overall is that if/when general risk aversion lifts – again, watch those oil prices – and the temporary safe-haven rationale for holding US$ lifts, the US$ may resume weakening (including against Asian currencies) as US growth moderates while the Federal Reserve interest rate support for the buck goes away.

Expect Inflation to Top Out

While we may feel uncertainty on the (3) stumbling Fed risks, we feel much more comfortable (still) that global and regional inflation (risk 2) remains under control. As the Fed moves to re-signal the possibility of a pause, the view of our global economists that bond yields are peaking becomes more attractive.[8]

Asian central banks can pause in the short term

Should we be wrong and the Fed nonetheless moves higher than 5.5%, it could be the case that some Asian central bank tightenings could be extended further. But in the month ahead, with both the Fed/BOJ sending more dovish signals, Asian central banks that had been planning to pause (e.g., in Thailand) should find few obstacles against doing so. A backdrop in which regional inflation also remains contained will support these strategies. Yield curves in the region remain tethered to just monetary policy alone – probably because of the slow pace of market development – so we think these factors put an attractive hue on receiving strategies in Asia.

Receive in India

To begin with, we suggest looking at the Indian curve. While we remain uncomfortable with overheating risks there, a receive position would nonetheless benefit from a more relaxed pace of government supply post-September. Dominant local banks, which have been reluctant to buy due to mark-to-market fears, should find lower supply a better environment for purchasing.

As we have noted, **receiving seems attractive both on our base case and on the alternative risk scenario (in which growth slides).**

[7] *The Renewed Renminbi at One: Possible Paths Ahead* (AP461, EC259), 5 July 2006

[8] *International Market Roundup,* 14 July 2006.

Figure 17. Currency Forecasts and Forwards

		Spot	1 Month		3 Months		6 Months		12 Months					
	Range in June	**19-Jul**	**Forecast**	**Forward**	**Forecast**	**Forward**	**Forecast**	**Forward**	**Forecast**	**Forward**	**3Q06**	**4Q06**	**1Q07**	**2Q07**
Versus USD														
Japan YEN**	111.46-116.35	117.27	115.00	*116.76*	112.00	*115.72*	106.00	*114.25*	104.00	*111.54*	112.00	106.00	105.00	104.00
Euro EUR**	1.2517-1.2942	1.2481	1.2800	*1.2507*	1.2800	*1.2559*	1.2700	*1.2627*	1.3000	*1.2746*	1.2800	1.2700	1.2900	1.3000
Bangladesh BDT	68.18-69.58	69.350	68.50	*NA*	70.00	*NA*	72.00	*NA*	75.00	*NA*	70.00	72.00	73.50	75.00
China RMB	7.9943-8.0243	8.0020	7.9800	*7.9720*	7.9000	*7.9225*	7.5000	*7.8530*	7.5000	*7.7160*	7.9000	7.5000	7.6500	7.5000
Hong Kong HK$	7.7582-7.7686	7.7754	7.7800	*7.7485*	7.7700	*7.7421*	7.7540	*7.7311*	7.7530	*7.7100*	7.7750	7.7540	7.7530	7.7530
India INR	45.71-46.33	46.57	47.00	*46.89*	47.00	*47.10*	47.50	*47.31*	46.00	*47.63*	47.00	47.50	46.00	46.00
Indonesia IDR	9258-9638	9240	9100	*9300*	9000	*9423*	8900	*9558*	9200	*9840*	9000	8900	9000	9200
Malaysia MYR	3.6348-3.6945	3.6855	3.6600	*3.6788*	3.6300	*3.6663*	3.5500	*3.6478*	3.5100	*3.6185*	3.6300	3.5500	3.5300	3.5100
Philippines P	52.74-53.58	52.630	52.500	*52.780*	51.500	*52.980*	51.000	*53.300*	52.000	*53.880*	52.000	51.000	52.000	52.000
Singapore SGD	1.5736-1.5990	1.5928	1.5900	*1.5904*	1.5700	*1.5856*	1.5500	*1.5782*	1.5300	*1.5636*	1.5700	1.5500	1.5400	1.5300
South Korea KRW	943.5-962.1	958.7	940.0	*957.9*	940.0	*956.1*	930.0	*953.2*	920.0	*947.7*	940.0	930.0	920.0	920.0
Taiwan TWD	32.045-32.720	32.879	32.500	*32.769*	32.000	*32.541*	31.750	*32.225*	31.500	*31.619*	32.250	31.800	31.625	31.500
Thailand THB	38.115-38.535	38.170	38.000	*38.169*	37.500	*38.169*	37.000	*38.163*	36.500	*38.160*	37.500	37.250	37.000	36.500
Vietnam VND*	15963-15999	15997	16000	*16020*	16025	*16075*	16050	*16160*	16100	*16471*	16025	16050	16075	16100

Note: * State Bank of Vietnam Forward Ceiling Rates

** Forecast as of Global Economic Outlook and Strategy (July 20, 2006)

Source: Reuters and Citigroup estimates.

Figure 18. Interest Rate Forecasts

		Range in June	19-Jul	In 1M	In 3M	In 6M	In 12M	3Q06	4Q06	1Q07	2Q07	3Q07
US*	Fed Fund Rate	5 - 5.25	5.25	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50
	10-Year Treasuries	4.96 - 5.24	5.13	NA	NA	NA	NA	5.00	4.90	4.90	4.90	4.90
EU*	Repo Rate	2.5 - 2.75	2.75	3.00	3.00	3.25	3.25	3.00	3.25	3.25	3.25	3.25
	10-Year Bunds	3.86 - 4.09	4.01	NA	NA	NA	NA	3.95	3.90	3.75	3.75	3.75
JP*	Call Money	0.0055 - 0.075	0.30	0.25	0.25	0.50	0.70	0.25	0.50	0.50	0.75	0.75
	10-Year JGBs	1.78 - 1.93	1.85	NA	NA	NA	NA	1.85	2.00	2.10	2.20	2.30
CN	1-year lending rate	5.85 - 5.85	5.85	5.85	6.12	6.12	6.12	6.12	6.12	6.12	6.12	6.12
	Bond repo rate (7-Day)	1.66 - 2.26	2.34	2.25	2.50	3.00	3.25	2.50	3.00	3.00	3.25	3.25
	Government bond yield (5-Year)	2.54 - 2.73	2.63	3.00	3.25	3.50	4.13	3.25	3.50	4.00	4.13	4.13
HK	3-Month Interbank Rate	4.49 - 4.70	4.52	4.60	4.80	5.05	4.95	4.80	5.05	5.05	4.95	4.95
	5-Year Exchange Fund Note	4.54 - 4.80	4.69	4.70	4.65	4.55	4.42	4.70	4.57	4.46	4.45	4.41
IN	Overnight Reverse Repo Rate	5.5 - 5.75	5.75	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
	91-Day T Bill	5.73 - 6.35	6.40	6.50	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75
	10-Year Gilt	7.65 - 8.14	8.37	8.50	8.25	8.50	8.25	8.50	8.50	8.50	8.25	8.25
ID	BI Rate	12.5 - 12.5	12.25	12.00	11.50	11.00	11.00	11.75	11.25	11.00	11.00	10.50
	1-Month SBI Rate	12.5 - 12.5	12.25	12.00	11.50	11.00	11.00	11.75	11.25	11.00	11.00	10.50
	FR0026 11% 10/15/2014	12.3 - 13.05	12.30	11.75	11.50	11.25	11.75	11.50	11.25	11.25	11.75	11.75
MY	Overnight Policy Rate	3.5 - 3.5	3.50	3.50	3.75	4.00	4.25	3.75	4.00	4.00	4.25	4.25
	3-Month Interbank Rate	3.92 - 3.92	3.92	3.80	3.95	4.20	4.45	3.95	4.20	4.20	4.45	4.45
	5-Year MJ 04/11	4.42 - 4.59	4.55	4.50	4.60	4.60	4.80	4.60	4.60	4.80	4.80	4.80
PH	O/N Rate	7.5 - 7.5	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50
	91-Day T Bill	5.82 - 8.82	6.64	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00
SG	3-Month Interbank Rate	3.41 - 3.55	3.56	3.60	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50
	10-Year SGS	3.35 - 3.6	3.62	3.50	3.50	3.40	3.40	3.50	3.40	3.40	3.40	3.40
KR	Overnight Rate	4 - 4.25	4.25	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
	91-Day CD	4.36 - 4.59	4.64	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75
	5-Year Treasury	4.86 - 5.17	4.99	5.00	5.10	5.00	4.80	5.10	5.00	4.90	4.80	4.80
TW	Overnight Rate	1.51 - 1.58	1.59	1.60	1.66	1.72	1.75	1.66	1.72	1.74	1.75	1.75
	91-Day CP Rate	1.59 - 1.64	1.63	1.67	1.73	1.80	1.85	1.73	1.80	1.83	1.85	1.85
	10-Year Government Bond	2.12 - 2.2	2.16	2.20	2.20	2.30	2.40	2.20	2.30	2.40	2.40	2.40
TH	14-Day Repo Rate	4.75 - 5	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
	3-Month Interbank Rate	5.25 - 5.40	5.41	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25
	10-Year Government Bond	5.37 - 5.75	5.63	5.75	6.00	5.88	5.75	6.00	5.88	5.75	5.75	5.75
VN	3-Month Interbank Rate	7.84 - 7.94	7.85	8.00	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25
BD	3-Month T-Bills		7.45	7.50	7.55	7.60	7.60	7.55	7.60	7.60	7.60	7.60
	5-Year Government Bond		10.62	10.72	10.85	11.00	11.00	10.85	11.00	11.00	11.00	11.00

Source: Datastream, CEIC Data Company Limited, Bloomberg, Moneyline Telerate, Citigroup estimates.

Note: Period Ends for Policy/Money Market Rates; Period Averages for Bond Yields.

* Forecast as of Global Economic Outlook and Strategy (July 20, 2006)

Figure 19. Asian FX and Interest Rate Market Outlook

Bangladesh	
Exchange Rate	The taka's recent maintained stability vs. the US$ should help counter imported inflation; meanwhile, textile exports have performed better than anticipated, allowing a slower pace of depreciation. Structurally, however, this economy remains on a footing that requires a degree of currency weakening over time
Interest Rate	The Bangladesh Bank will probably continue its contractionary stance to curtail inflation and credit growth, which should see rates edge up over time
China	
Exchange Rate	End-summer should see the convening of an important work conference on economic policy (one of an occasional series of such *ad hoc* but important meetings), which may include discussion on a faster pace of renminbi appreciation. While the run-rate of strengthening (currently about 1.5% p.a. against the US$) may not change immediately, we advise keeping an eye on this issue, which appears to be sliding toward resolution
Interest Rate	Markets and we anticipate another 27bp hike in lending rates, but judging by the latest growth of new lending and low onshore money market rates, such measures have yet to significantly crimp liquidity. For the latter to occur requires more effective administrative guidance, and higher bond yields should follow as a consequence
Hong Kong	
Exchange Rate	Renewed arbitrage between US$ and HK$ interest rates (with the discount of the latter to the former widening) may keep USD/HKD bid in the near months. Eventually, more effective tightening in China may drain some excess liquidity out of Hong Kong
Interest Rate	Dual IPO listings in both Hong Kong and Shanghai for China enterprises may reduce some of the excess liquidity in Hong Kong, but several large China-related IPOs that remain to be completed in 2006 may continue to attract liquidity into the SAR
India	
Exchange Rate	Pressure on the rupee to weaken has yet to abate. While export growth has climbed more vigorously than forecast, the same is also true for import growth, and the monthly trade deficits continue to grow. Unless we re-enter the pattern seen in recent years of continuous and growing portfolio inflows, the currency will find it difficult to strengthen
Interest Rate	The fear of inflation and more RBI tightening have pushed gilts yields up significantly in recent months. While headline inflation should continue to rise on base effects, some of this is likely priced; tighter supply of new government issues in the second fiscal half may eventually draw buyers back
Indonesia	
Exchange Rate	The EM retracement after a spirited May-June sell-off benefited the Indonesian rupiah the most among Asian currencies, as we had previously anticipated, but now a fresh round of global concerns, centered around higher oil prices and slower growth, have cut that rally short. While it is difficult to rule out even a disastrous outcome when it comes to Mideast tensions, our base view is for such uncertainties to recede and world and regional growth to sustain at healthy trends. This means that ongoing progress in lowering onshore inflation should eventually bring renewed interest into Indonesian assets and buoy the rupiah
Interest Rate	Local yields remain rangebound until the currency stabilizes. The central bank's further ability to cut interest rates at the pace it desires depends upon currency stability and lower domestic inflation. We see domestic inflation eventually edging lower, beyond the next month or two, helping to reduce local yields later this year
Korea	
Exchange Rate	BOJ's signaled intentions to keep policy rates low helped send USD/JPY up past technical barriers. This lent a bid tone to Asian floaters, perhaps most notably to the won. Won weakening, however, trailed the yen (i.e., JPY/'KRW fell), and if growth pessimism regarding 2H06 is largely priced, we see opportunities for the won to strengthen later in 2006
Interest Rate	In the near term, growth optimists and pessimists may not get sufficient data to prove/disprove either view, so local yields (which rose a bit in the past month but not by much) may remain rangebound. Our economist maintains a downbeat assessment of local growth, but much of that story may already be priced
Malaysia	
Exchange Rate	While seeing a bit of sell-off, in common with regional trends, the ringgit overall has remained fairly stable ahead of its own one-year de-peg anniversary. Should the renminbi shift toward faster appreciation, we anticipate a similar pattern for the ringgit
Interest Rate	Value seekers have been spotted looking over local yields. But beyond the short term, if the central bank continues to tighten periodically and steadily, as we expect, local yields should climb further
Philippines	
Exchange Rate	In the coming month, the peso may remain relatively weak as imports pick up with seasonal US$ supply constricted. But remittance growth remains healthier than projections, and offshore interest in the currency may pick up if onshore inflation improves. The biggest obstacle toward an even stronger peso in the medium term likely remains the lack of domestically driven growth
Interest Rate	Local bond yields appear evenly balanced, for now, between buyers and sellers. Global uncertainties about growth, oil prices and military tensions will probably make it difficult for yields to rally in the short run. But later in 2006 as uncertainties resolve, we see more downside for local yields as domestic inflation softens and fiscal outcomes exceed targets
Singapore	
Exchange Rate	Despite the EM sell-off and recent geopolitical tensions, the SGD has persistently hugged the +1% strong side of its policy band in the last three months. This seems to us reasonable evidence that offshore interest in Asian currencies, for which the SGD often serves as proxy, remains. Should the US$ turn south again and the renminbi turn stronger, we expect the SGD to benefit
Interest Rate	Upon any Fed pause in tightening, longer-tenor yields in the US may rally and lend the same tone to local paper. But structural and continued outflows of direct and portfolio investment from Singapore along with rising Japanese yields may constrain the rally. Any environment in which US yields decline but Japanese yields rise presents an interesting juncture to see how the Singapore fixed income market responds to global trends

Taiwan	
Exchange Rate	The Taiwan currency has sagged among the most of Asian currencies, in the wake of Mideast tensions and higher oil prices (this despite limited oil impacts on the economy in recent years); slower growth can also hurt the longer-term outlook. But there may remain some eventual opportunities to buy, particularly if technology rebounds in 2H06 (against most market prognostications)
Interest Rate	Here as in Thailand (below) one key risk appears to be even more Fed rate hikes. But this economy is not strong, and inflation remains quiescent. Allowing domestic insurers to buy more foreign bonds helped to raise yields in 2006, but perhaps the more decisive moment will come in 2007 if JGB yields rise even further
Thailand	
Exchange Rate	The weaker yen led to knock-on selling of the baht. While political tensions remain front and center, we see limited weakening of the currency on the back of politics alone. Instead, local assets appear cheap, so a resolution of the political standoff (even if messy) may turn the currency around
Interest Rate	Our modeling work suggests US policy rates have a limited impact on Thai policy rate settings, so a BOT pause should lead to an overall lower local yield curve (as domestic inflation falls in 2H06). But models aside, the main risk is if Fed uncertainty continues to roil global interest rate markets. Still, legging into receive positions in Thailand makes sense to us
Vietnam	
Exchange Rate	Despite an official turn toward a slightly faster pace of crawl, the USD/VND managed to dip below 16,000 once again, possibly reflecting the stronger capital inflows we expect for the coming year or two
Interest Rate	There is little change to our maintained view of a slow rise in onshore short rates. Slower 1Q06 and expected 2006 growth may not do enough to keep inflation risks at bay, but policy countermeasures remain limited

Source: Citigroup.

Strategy — Asian Equities

Markus Rösgen
+852-2501-2752
markus.rosgen@citigroup.com
Hong Kong
Elaine Chu
+852-2501-2768
elaine.chu@citigroup.com
Hong Kong
Chris Leung, CFA
+852-2501-2741
chris.w.leung@citigroup.com
Hong Kong

Markets to Fall Further Before Finding Support

What is it costing me? Too much

The debate continues between those who view Asia ex-Japan as cheap based on a 2006E forward P/E of 12.1 times and those like ourselves who fear that headline P/Es hide many sins. Roughly 47% of the MSCI Asia ex-Japan index comprises cyclical sectors (base commodities, energy, industrials and technology); at this stage of the cycle, some of these will depress the P/E and boost the ROE of the index. If these are indeed cyclicals, investors should be selling them, or at the very least being circumspect about valuing them on what are peak earnings and ROEs.

We propose two ways of looking at the earnings story. The first is to calculate the P/E multiple if ROEs were to return to their ten-year moving averages. On this basis, the P/E of Asia-ex would be 18.7x – not exactly cheap. The second approach is to adjust earnings based on prevailing US$ export prices. In the past, this has been exceedingly accurate in forecasting ROE in Asia-ex. On this basis, the region's P/E would be 15.4x. Lower than the multiple implied by a return to normalized ROE, but still far from cheap. Caution is warranted.

Our other main valuation tool is market cap to GDP, based on the ratio normalizing over time. Mcap/GDP is clearly off the peaks set in April, but it remains well above historical averages. And, no, we are not using this ratio just because it makes Asia look expensive; we are using it because it has worked substantially better as a trading strategy than many others. Nor do we see any reason why it should not work going forward.

Sentiment still too positive for comfort

Sentiment-wise, the perception seems to be that investors in Asia-ex have shifted from wearing rose-tinted sunglasses to poking themselves in the eye. Luckily, no one has poked out an eye. Neither have investors turned overly pessimistic, though. Our sentiment indicator shows correctly that investors are no longer in a pure euphoria mode and that a degree of reality has returned. Note, though, that sentiment remains well above the average for the past 14 years. Nor has sentiment reversed (i.e. moved back to euphoria) from current levels in the past 14 years. Historically, market returns have been best from investments made during periods of distress and worst from those made at times of euphoria. In the past, when our sentiment indicator has peaked and then trended down for three consecutive weeks, market returns over the next 26 and 52 weeks have been negative 75% of the time.

Fund flows: Fun while it lasted

Toward the end of 2005, fund flows became the main driver of Asian markets. Before that, they had historically peaked at 2 standard deviations above the mean. At their peak in early 2006, fund flows became a 5.3 SD event. These flows had to be invested, and so they were. That made us look like chumps for a while after the publication of our 2006 Road Ahead piece that was entitled "Hazards Ahead: Sell into 1Q Rally." Since peaking on May 10, fund flows have reversed. Over the five weeks to June 23, US$7bn in funds has flowed out – 32% of the funds that flowed in between January and mid May. Given such volatility and growth uncertainties, it is hard to see fund flows turning positive again.

Liquidity turns to stone

For the best part of a year, liquidity created within Asia-ex has been more a stream than a sea. Narrow money growth has been steady, but has not been accelerating, foreign reserve accumulation has flat-lined and money velocity has been falling since the first quarter of 2005. No, liquidity was an import (and one of the few successful ones from the USA). In Japan, reserve money growth has continued to decelerate and is now contracting at a rate of 15.4% yoy. In the US, MZM is growing at a mere 4%, and –0.05% in real terms. Until the global rate cycle reverses, we need to learn to live with less, which is never easy for the periphery.

On the deposit side, retail bank deposits have increased at 7% yoy ex China. Bank deposits are now greater than the region's GDP and are equivalent to 75% of the size of the equity market. Liquidity is not in short supply; what is relatively scarce is the courage to invest these funds. Given this, the loan-to-deposit ratio stands at 0.74 times in Asia. Theoretically, consumption could grow via a reduction in savings. In Asia, though, consumers have not tended to behave counter-cyclically by drawing down savings to maintain consumption. Savings are the constant, not consumption.

Corporate balance sheets are the other potential provider of liquidity. Net debt to equity in Asia-ex is set to fall to 23% in 2006. Whilst this is highly reassuring if you are a bondholder, it is far from great for an equity investor. If balance sheets were leveraged to just 50%, ROE could be some 10 percentage points higher. Sadly, with the exception of the telecoms sector, there is little evidence of corporates releveraging balance sheets in pursuit of higher ROEs. Nor is there a great desire to invest (bar China); hence the weak levels of loan demand.

Earnings are the big question mark

Earnings in Asia-ex have done exceedingly well post the 2003 SARS downturn. At 12.5% p.a,, earnings are at the upper end of their historical range. From this level, earnings pulled back in the early 1980s, the mid 1990s and 2000. What makes us nervous regarding the earnings cycle is that much of the recovery in earnings has been externally driven (ie, export growth not domestic consumption). Nor has the recovery been driven by margin improvements; much the opposite, as margins have been declining due to poor terms of trade. The US Leading Indicator has continued to decline, and expected weaker 2H growth in the US will impact demand. The Achilles' heel of the volume model is that as volume declines so do prices, given low brand recognition – the price taker's dilemma.

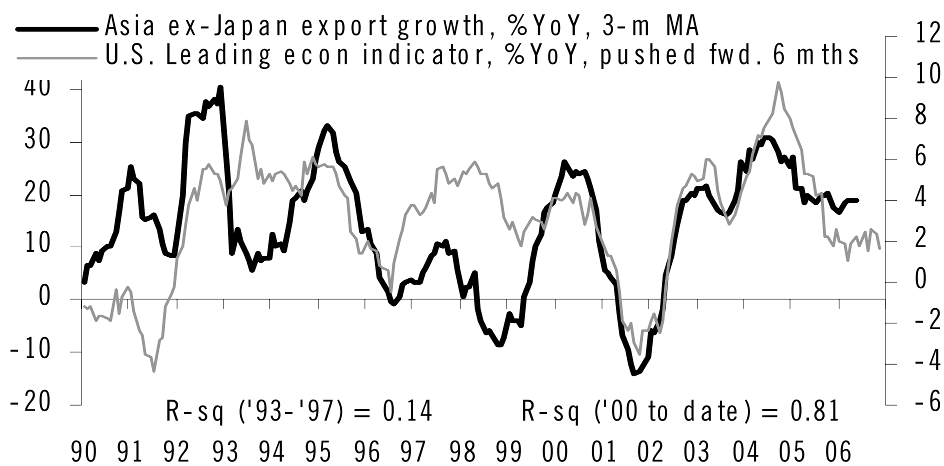
The history of earnings forecasts in Asia-ex is twofold. First, optimists have the upper hand. Over the past 15 years, earnings estimates have been too bullish 80% of the time. Second, earnings have a tendency to be revised in the summer months, when most investors are away. Given margin pressures and an expected slowdown in the second half, we believe that the earnings risk for 2006 is to the downside. Rather than the current consensus EPS forecast of 9.4% growth, we expect growth to be down by 20-30%.

Sectors most vulnerable to downward earnings revisions in Asia-ex are base materials, industrials and technology. Least vulnerable are telecoms, financials and consumers.

Resilience of domestic economies is overstated

How ready are Asian consumers to carry their local economies? That is a question coming up with greater regularity these days. Sadly, little evidence is around to support the view that local consumers will step up to the plate. In the chart below, we highlight the correlation between the US Leading Indicator and Asian export growth over the past 16 years. Between 1993 and 1997, the R2 between the two series was 0.14. Since 2000, the R2 has been 0.8. The US growth cycle has become more, and not less, important for the region. Equally, we looked at contributions to GDP in 1Q06 compared with 1Q05. In the case of Taiwan, Singapore, Thailand and Indonesia, exports rather than domestic consumption have carried the local economies. Only in Hong Kong and Korea has domestic consumption been a key contributor. Private and public consumption levels are now lower than in the mid 1990s; hence, the greater reliance on the export sector.

Figure 20. Asia-ex More Correlated to the US Leading Indicator Than during the 1990s



Source: Datastream, CEIC, Citigroup Investment Research.

'Tis the season of holding cash

The changing seasons have a significant impact on Asian markets. For the past 16 years, the US$ return of a buy-and-hold strategy is 4.9% p.a. Just sitting out the July-September period by holding cash would have increased the US$ return to no less than 9.4% p.a. Think about it: three months' holiday, zero beta risk and added alpha!

During the summer, the worst-performing markets in the last 16 years have been Taiwan, the Philippines, Indonesia and Thailand. Not only have these markets posted poor returns in the summer, they also have high probabilities of falling — at 88% for Taiwan and more than 60% for Indonesia, the Philippines and Thailand. Only India and Hong Kong have shown positive returns.

Among the individual sectors, energy, banks, technology and materials are all poor summer performers. In terms of high probability (above 60% probability of a decline), the worst are materials, consumer cyclicals, energy and technology. Only utilities and real estate have historically shown small gains.

The best period for Asia-ex market returns has historically been toward the end of the year, with November to early February having the most positive impact on market returns.

What to own and what to avoid

This is not the time for heroics. Pure momentum has had its day as the outperforming return strategy. As our quants analyst Paul Chanin highlights, whenever volatility increases, valuations parameters start to outperform more strongly and momentum indicators become an underperforming proposition. When volatility increases, price momentum and pure profitability ratios (ROEs and margins) go from being outperformers to underperformers. Even basing investment decisions on pure earnings growth shows fast declining outperformance. During periods of high volatility, sales yield, cash flow yield and book yield all show the best returns.

With this in mind, we like the return profile of the telecoms sector in Asia: visible earnings, high dividends and plenty of companies returning cash to shareholders, viz. Starhub (STAR.SI; S$2.21; 1L), SingTel (STEL.SI; S$2.47; 1L) and Digi.com (DSOM.KL; RM12.40; 1L). We also like the solid financials, including HSBC (0005.HK; HK$137.20; 1M), DBS (DBSM.SI; S$17.90; 2L) and some of the Korean banks. Credit risk among the financials is low on the back of low leverage, and net interest margins are expanding as rates rise. Finally, we like selected utilities, for growth potential (HKCG (0003.HK; HK$17.30; 1L)), as currency plays (KEPCO (015760.KS; W35,700; 3M)) or for tariff reform (Tenaga (TENA.KL; RM9.15; 1L))

Sectors to avoid are those that have little or no pricing power and are volume dependent. Currently in this un-enviable situation are the industrials – import prices are rising faster than ex-factory prices – and the technology sector, where demand looks to be weaker than expected and prices are under pressure. Consumer cyclicals (read autos) are in a similar situation. Finally, we are underweight the base commodity sector due to concerns about slowing demand.

Market selection: Our biggest overweights are Hong Kong and Singapore. In an environment of risk reduction, large liquid markets will trade at a premium. Cash flows and value will win out over hope, to the benefit of Hong Kong and Singapore. Our other sizable overweight is Malaysia. Many investors argue that the market is a write-off. We disagree. Valuation wise, Malaysia is trading at a discount to ten-year valuation averages whilst ROE is 1 standard deviation above the ten-year average. Free cash flow yields are the highest in 16 years. Unlike yesteryear, companies are actually paying out this cash flow to shareholders. The dividend yield is now 2 SD above the mean on the back of the pay-out rising from 35% to 56%. Finally, we have the smallest overweight on Korean domestics, consumers, banks and utilities, with an underweight in Samsung Elec (005930.KS; W597,000; 1L). We like the domestic demand story in Korea and the low multiples. Our key concerns are the high degree of operating leverage and the risk of an export slowdown.

Underweights: Taiwan is our biggest underweight and has been for the past three years. Sadly, the market is driven by asset turns and not margins, which has led to a continued de-rating. Clearly, a large part of the de-rating is now behind us. What is lacking is a positive catalyst, given a current cyclical downturn and the political overhang. Next in line is China. We like the oil stories and some of the telecoms exposure, but current and expected tightening leaves us not much interested in the property and utilities sectors. Worth noting also is that EPS continues to expand at a lower rate than nominal GDP. As an investment theme, we prefer to own suppliers to China (such as BHP (BHP.AX; A$28.16; 1M)) or China plays listed in Hong Kong, our biggest overweight. India is also an underweight. Valuations still don't stack up as far as we are concerned, and we look at 8000-8500 on the SENSEX as a fair-value target. Finally, Thailand, and the mystery of why foreign investors are so attracted to this market. Earnings growth has been negative in real terms for two years in a row. GDP growth is dependent on exports as opposed to domestic demand, the political situation remains in flux, and the market is a consensus overweight.

Figure 21. Model Portfolio (Asia/Pacific ex-Japan ex-Pakistan) Percentage Weighting Over/Under MSCI Benchmark

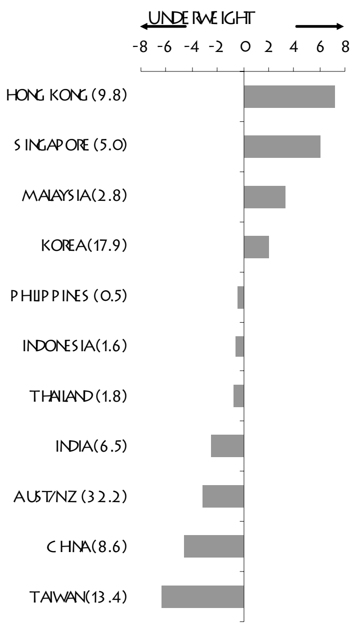


Figure 22. Model Portfolio (Asia/Pacific ex-Japan ex-Pakistan) Percentage Weighting Over/Under MSCI Benchmark

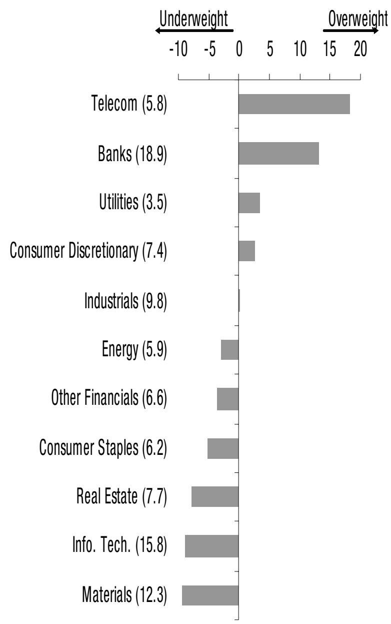
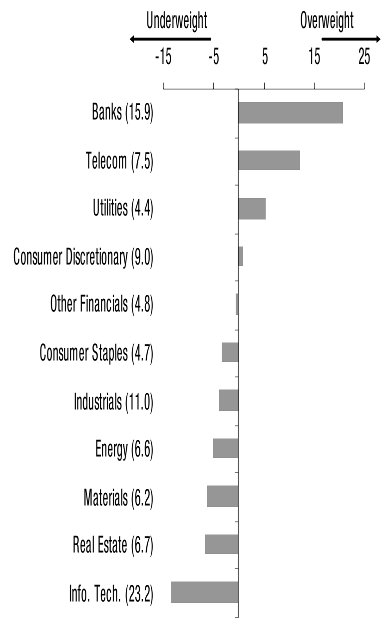


Figure 23. Model Portfolio (Asia ex-Japan ex-Pakistan) Percentage Weighting Over/Under MSCI Benchmark



Note: Numbers in brackets show neutral weights within MSCI Asia Free ex-Japan US$ Index as at Apr 6, 2005.
Consumer Staples includes food & staples retailing, food beverage & tobacco, household products, health care equipment & services, and pharmaceutical & biotechnology. Industrials include capital goods, commercial services & supplies and transportation. Information Technology includes technology hardware & equipment, semiconductors and semiconductor equipment, software & services. Other Financials include diversified financials and insurance. Source: MSCI, Smith Barney Estimates.

Investor Checklist & Asian Chart Summary

Asia Investor Checklist

Key Underlying Assumptions Behind Our Forecasts	Confidence	Citigroup Comments
Global		
Global inflationary pressures should be contained with moderate monetary policy tightening around the world	•	US growth moderated, but inflation remains a risk. We expect one more hike by the Fed in August, and we raised our year-end rate forecasts for Japan and euro area
A solid economic outlook in emerging markets probably will not suffer much from market turmoil	•	EM economies have started to stabilize following the latest fallout
Regional		
Growth is likely to consolidate further in much of Asia in 2006 before rebounding	+	Growth already started to moderate, outside China and India, which is likely to continue
Export outlook remains robust, and large current account surpluses continue	•	The export outlook probably dimmed slightly, and current accounts could deteriorate on higher oil prices
Limited monetary tightening through either currency appreciation or interest rate hikes	•	Interest rates may rise further, but central banks will likely stay cautious on currencies
Bangladesh		
Textile exports and workers' remittances to drive growth	•	Exports are currently in positive territory though the impact of quota dismantling continues to be a risk
Natural disasters will remain a risk	•	Flood disasters have impacted agricultural production in the past
Shifting political situation to hinder growth	–	Governance remains a problem and has slowed reform implementation. Political disruptions are also a risk given impending elections later this year
China		
Shifting sources of growth to emphasize the quality of growth	•	Such a policy shift has not yet resulted in growth moderation, but it could still occur late this year. Expect energy consumption efficiency to improve post the 18% rise in domestic oil prices
Likely tightening of monetary conditions in part via currency appreciation	+	The momentum of economic activity picked up again in June and the 2Q despite tightening measures. Besides the second reserve requirement hike within almost a month to 8.5%, we see faster appreciation in the near term
Accelerating reforms. Urbanization may speed up as local governments start to abolish the household registration system	•	Removing price distortions in the resource sector, abolishing the household registration system, broadening coverage of social security and restructuring the banking sector would foster structural adjustment
Hong Kong		
The interest rate rising cycle comes to an end	–	The risk of HKD interest rates is still on the upside. We expect a 50bp rise in the HKD prime rate in the coming months
A mild housing price correction	•	Home sales weakened in June after having recovered for five months. As market demand is still unable to absorb the new supply, a moderate decline in home prices is possible
Steady RMB appreciation and no change to the HKD peg	•	By keeping its peg system unchanged, Hong Kong would gain from having its currency weaken against the RMB
India		
Investment spending (infrastructure and business investment) should lead GDP growth	•	The investment ratio is at record highs. The government's latest budget focuses on rural development, fiscal consolidation and infrastructure
Consumption should stay strong and be supported by favorable demographics and the trickle-down impact; positive trends in outsourcing to continue	•	There is strong potential for food processing, bio-fuels, microfinance and knowledge process outsourcing
GDP is likely to continue to be driven by non-farm growth and supported by favorable demographics, rising incomes and outsourcing	•	We think a further hike in interest rates by 50-100bps will hurt, but not derail growth. We maintain our FY07 GDP growth estimate at 7.6%
Indonesia		
Macro stability persists despite recent hurdles, but there could be pressure from an unproductive government spending spree	•	Benign core inflation, healthy real interest rates and interest rate differentials support capital inflows and the IDR. Slow fiscal spending remains a problem. High oil prices create a destabilizing effect
Increasing role of investment through infrastructure spending and a better climate	–	Recent policy packages to improve the investment climate reflect commitment, but implementation is key. The government is still ambivalent to new risk sharing policies for fear of increasing contingent liabilities
Efforts to revitalize the agricultural sector to provide more jobs	–	Contrary to current government plans, we recommend creating incentives to increase agricultural productivity. Efforts to make the labor market more flexible face a major rejection from the labor union

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

Asia Investor Checklist (continued)

Key Underlying Assumptions Behind Our Forecasts	Confidence	Citigroup Comments
Korea		
Consumption recovery likely to be constrained by income growth	•	Consumer goods sales growth was strong, while service industry activity was soft in May. The job market continued to show steady growth, while consumer confidence appears to have stabilized
Exports should be capped by global monetary tightening and a strong won	•	Export strength in June was driven by price hikes, not quantities. A recent increase in the inventory/shipment ratio hints at a poor short-term outlook
BOK rate hike cycle will likely end soon with only one more hike	•	Comments by the BOK governor in July were more hawkish than we had expected. BOK expects a significant slowdown in 2H06 growth
Malaysia		
Fiscal consolidation should continue	•	Higher oil prices could lift fuel subsidies, but an improving fiscal balance according to BNM data should still put the 2006 fiscal deficit target well within reach
Prime Minister Abdullah steps up the reform drive	•	Downsizing of the MAS workforce and Tenaga's success in securing an electricity tariff hike marks further progress with the reform of government linked-companies
Prompt monetary tightening caps inflation fears	•	Moderating export momentum and steady core inflation continue to point to modest, not aggressive, monetary tightening
Philippines		
Shift in policy bias to neutral in 2H06E	+	Inflation decelerated in 2Q06, and the trend is likely to persist in the 2H06. A lackluster domestic demand setting is likely to deter a rapid pass-through of oil prices and moderate wage adjustments to inflation
Delayed approval of the 2006 budget program	+	There is a looming risk of a re-enacted 2005 budget, hence resulting in a lower fiscal deficit but lackluster fiscal contribution to growth
Political uncertainties continue	•	The economic policy bias remains unchanged despite political challenges, which sustains favorable market expectations amid increased political noise
Singapore		
Increasing domestic demand resilience reduces the vulnerability to external demand	+	The pharmaceutical, wealth advisory and property sectors are increasingly playing a greater role in supporting the economy
Improving bilateral ties with Malaysia	+	Malaysia scrapped plans for a bridge to replace the Johor Causeway, and talks with Singapore on various disputes are on hold for now
Domestic demand resilience and upside inflation risk trigger a more hawkish MAS	–	Favorable inflation developments suggest that the MAS will likely continue to resist excessive trade-weighted SGD strength
Taiwan		
Political uncertainties may affect confidence recovery	–	President Chen faces growing pressure to step down
Steady, but not strong, rising consumer spending	•	Consumption is supported by employment and wealth gains, but faces the constraint of subdued income growth and consumer card debt problems
A favorable trade surplus is supportive of growth; yet the contribution is likely to moderate as domestic demand gradually recovers	•	We expect a moderate export uptrend despite moderating global economies and lukewarm global tech demand. A capital good demand recovery and moderating output expansion suggest better imports
Thailand		
Downside risk to the current account deficit	+	Favorable export prospects and tourism recovery ought to hike the potential for a return to a current account balance in 2007
Unresolved political elections	+	A prudential policy environment, strong exports and resilient markets help to counter the political risk premia. Prolonged uncertainty that delays public investment will undermine the fiscal catalyst for growth
Risk of core CPI overshooting the MPC target sustains the rate tightening cycle	+	We expect a topmost rate by the MPC at 5% and the tightening cycle to end in 3Q06. Restoring positive real interest rates will likely be a medium-term goal
Vietnam		
High inflation subsides on a mix of monetary tightening and easing supply-side pressure	•	New data suggest that credit growth has eased, which should help contain medium-term inflation risk
Vietnam to enter WTO by 2006	+	Vietnam and the US signed a bilateral trade agreement that will pave the way for Vietnam's entry into the WTO
An improving external payment position limits depreciation pressure on the Vietnamese dong	+	A gentle VND depreciation trend appears intact, but a sustained increase in external reserves underscores growing appreciation pressure on the VND

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

Asia Chart Summary

Figure 24. Asia ex-Japan GDP growth expected to moderate as exports cool and interest rate and fuel increases bite

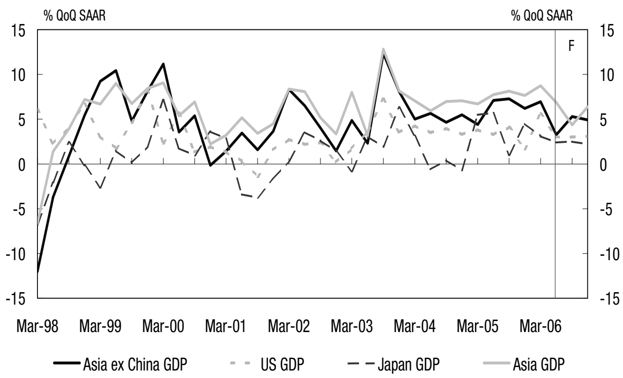
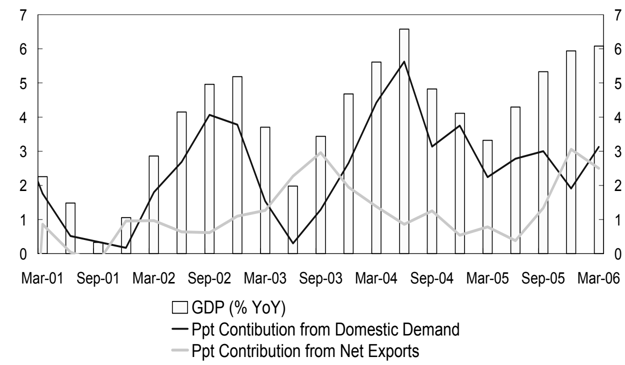


Figure 25. Asia's recent economic recovery largely due to external demand



Note: Asia Pacific ex-China, India and Vietnam

Figure 26. A slowdown will likely be more apparent in the coming months, especially in electronic production

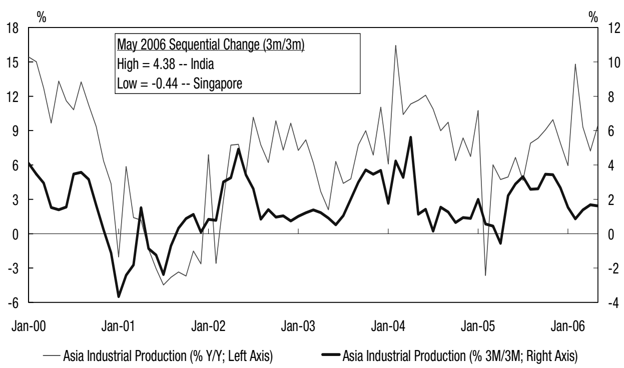
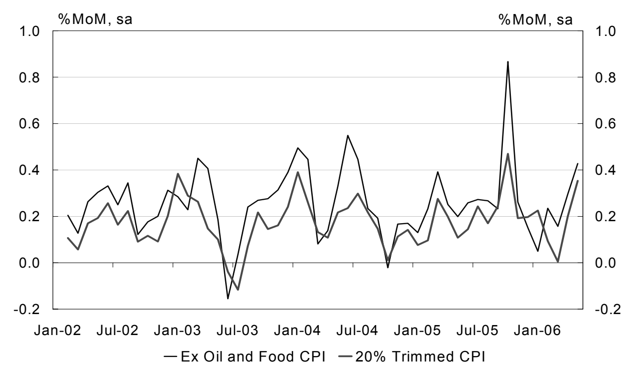


Figure 27. Core inflation is rising, although the levels remain modest



Note: Asia- Hong Kong, India, Indonesia, Korea, Philippines, Singapore, Taiwan, Thailand

Figure 28. New US orders continue to rise, and the inventory to shipment ratio does not imply an inventory overhang

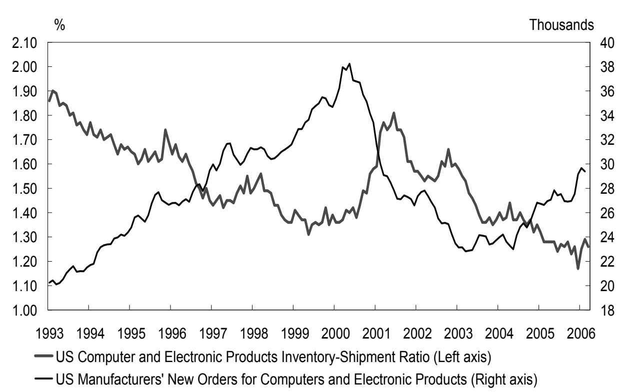
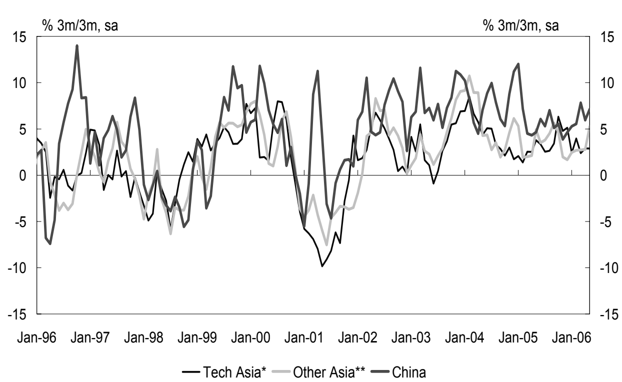


Figure 29. Bumpy export data wait for clear signs of a tech recovery



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

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

Citigroup vs. Consensus Foreign Exchange Forecasts

Figure 30. China RMB

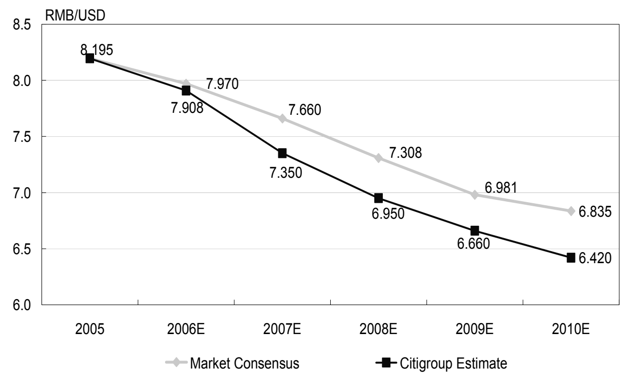


Figure 31. Hong Kong HKD

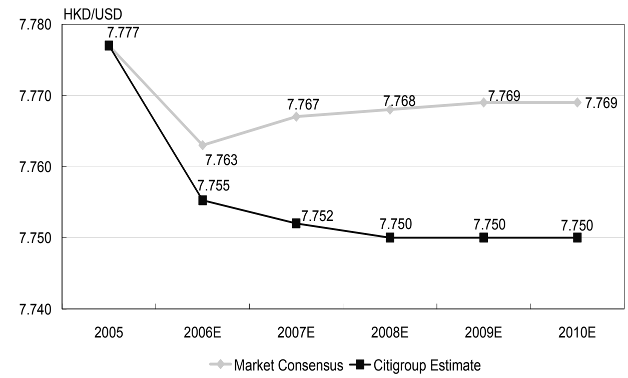


Figure 32. India INR

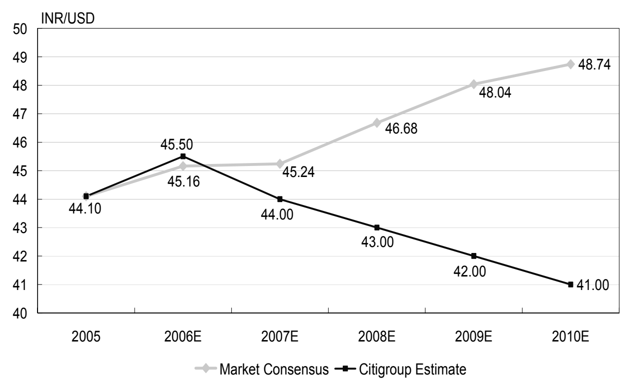


Figure 33. Indonesia IDR

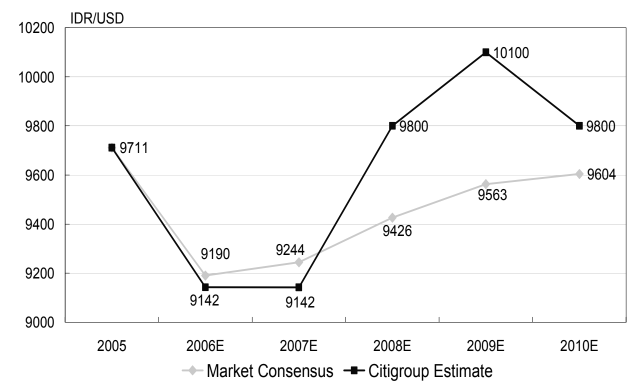


Figure 34. South Korea KRW

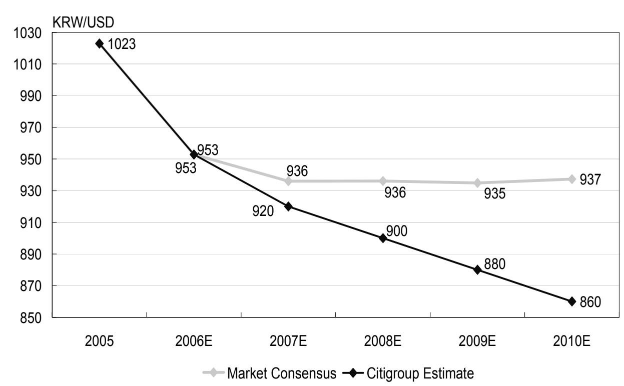
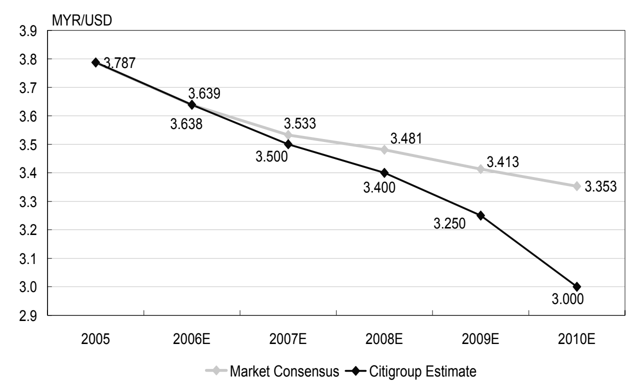


Figure 35. Malaysia MYR



Note: All forecasts are period average

Source: 2005 Data from CEIC Data Company Limited, Foreign Exchange Consensus Forecasts (10Jun and 12 Jul, 2006) by Consensus Economics Inc. and Citigroup estimates.

Figure 36. Philippines PHP

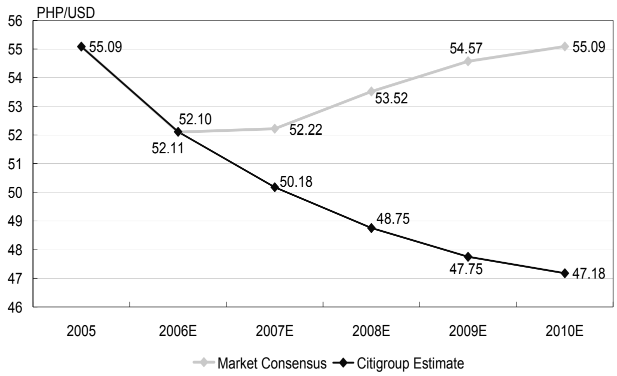


Figure 37. Singapore SGD

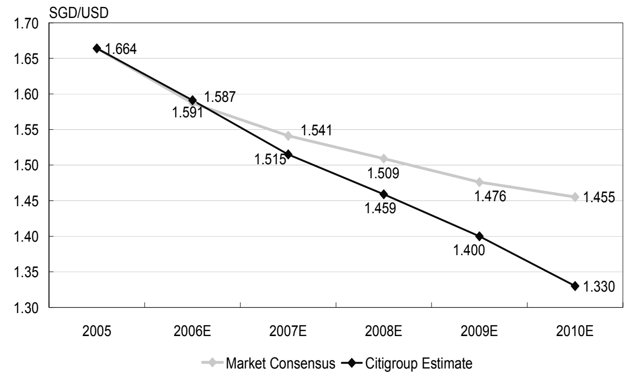


Figure 38. Taiwan TWD

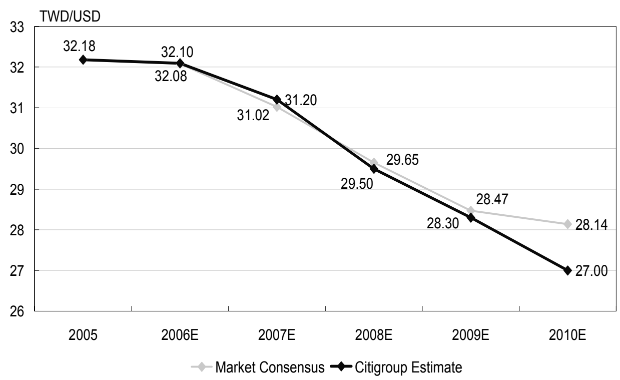
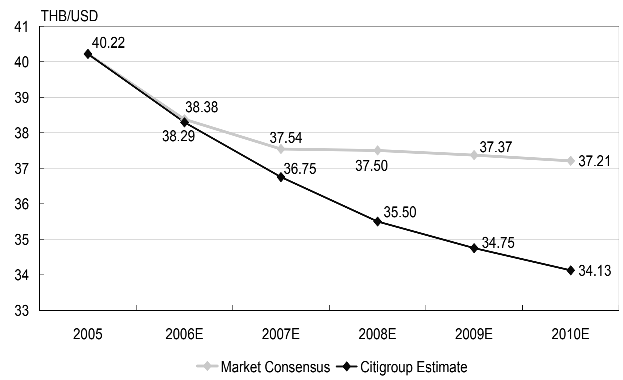


Figure 39. Thailand THB



Note: All forecasts are period average

Source: 2005 Data from CEIC Data Company Limited, Foreign Exchange Consensus Forecasts (10Jun and 12 Jul, 2006) by Consensus Economics Inc. and Citigroup estimates.

Long-Term Forecasts

Figure 40. Citigroup Long Term Forecasts

	GDP (Year-Year Growth Rate in Percent)						CPI (Year-Year Growth Rate in Percent)						Exchange Rate (Local Currency per US Dollar, period average))					
	2005	2006E	2007E	2008E	2009E	2010E	2005	2006E	2007E	2008E	2009E	2010E	2005	2006E	2007E	2008E	2009E	2010E
United States	3.5	3.6	3.2	3.5	2.9	3.4	3.4	3.5	2.7	2.3	2.0	2.0	N/A	N/A	N/A	N/A	N/A	N/A
Japan	2.6	3.0	2.3	2.1	1.3	2.0	-0.1	0.5	0.6	0.8	0.7	1.0	111.4	112.0	103.0	96.0	89.0	85.0
Euro Area	1.4	2.2	1.7	1.8	1.8	1.7	2.2	2.2	2.0	1.7	1.7	1.7	1.24	1.31	1.31	1.37	1.38	1.34
Asia-Pacific	7.3	7.3	7.0	7.4	7.0	6.8	3.1	3.5	3.5	4.4	4.0	3.5	N/A	N/A	N/A	N/A	N/A	N/A
China	9.9	9.8	9.2	10.2	9.5	9.4	1.8	2.0	3.0	5.5	4.5	3.5	8.195	7.949	7.350	6.950	6.660	6.420
India	8.4	7.6	8.0	7.5	7.5	7.5	4.5	5.3	5.0	5.0	5.0	5.0	44.30	45.53	44.00	43.00	42.00	41.00
Asian NIEs	4.6	5.0	4.5	4.9	4.5	4.5	2.2	2.3	2.4	2.5	2.7	2.7	N/A	N/A	N/A	N/A	N/A	N/A
of which: Hong Kong	7.3	5.7	5.0	5.3	4.8	4.5	1.0	2.2	2.7	3.5	5.0	5.0	7.78	7.76	7.75	7.75	7.75	7.75
Korea	4.0	5.1	4.3	4.7	4.7	4.7	2.7	2.5	2.7	2.7	2.7	2.7	1023	952	920	900	880	860
Singapore	6.4	6.5	4.5	4.5	4.5	4.5	0.5	1.7	1.7	1.7	1.7	1.7	1.66	1.59	1.52	1.46	1.40	1.33
Taiwan	4.1	4.0	4.5	5.0	4.0	4.0	2.3	2.0	1.8	1.7	1.7	1.7	32.2	32.2	31.2	29.5	28.3	27.0
SEA	5.1	5.2	5.5	5.3	5.4	5.4	7.1	8.7	5.5	4.8	4.6	4.2	N/A	N/A	N/A	N/A	N/A	N/A
of which: Indonesia	5.6	5.4	6.0	5.5	6.0	6.0	10.5	13.7	7.2	6.4	6.8	6.3	9711	9118	9142	9800	10100	9800
Malaysia	5.2	5.5	5.5	5.5	5.5	5.5	3.1	4.1	2.5	2.5	2.5	2.5	3.79	3.66	3.50	3.40	3.25	3.00
Philippines	5.0	5.1	5.3	4.9	5.0	5.0	7.6	7.0	6.3	5.5	4.8	4.3	55.1	51.9	50.2	48.8	47.8	47.2
Thailand	4.5	4.7	4.9	5.0	4.9	4.8	4.5	5.2	4.6	3.5	2.8	2.3	40.2	38.2	36.8	35.5	34.8	34.1
Bangladesh	5.4	6.4	6.0	6.1	6.1	6.1	4.5	4.0	3.5	5.0	5.0	5.0	63.3	69.2	72.8	75.4	79.2	83.2
Vietnam	8.4	7.3	8.0	8.0	8.0	8.0	8.3	7.5	6.0	6.0	6.0	6.0	15855	15973	16075	16050	15950	15850

Note: * US$/Euro

Source: Citigroup estimates.

Figure 41. Citigroup Long-Term Forecasts (Cont.)

	Short Team Interest Rates							Long term yields						
		2005	2006E	2007E	2008E	2009E	2010E		2005	2006E	2007E	2008E	2009E	2010E
United States	Fed Funds Rate	3.21	5.10	5.45	4.80	4.50	4.75	10-Year Treasuries	4.30	4.90	4.90	5.00	5.00	5.50
Japan	Call Money	0.00	0.18	0.75	1.38	1.75	2.00	10-Year JGB	1.38	1.85	2.25	2.50	2.00	2.50
Euro Area	Euro Repo Rate	2.00	2.72	3.10	3.25	3.25	3.25	10-Year Bunds	3.35	3.85	3.75	3.75	3.75	4.00
Bangladesh	3-Month T-Bills	6.90	7.20	8.00	8.25	7.50	7.00	10-Year Benchmark bond	10.00	11.00	11.80	12.50	11.25	10.25
China	1-Year Lending Rate	5.58	6.02	6.02	6.18	7.62	7.18	10-Year Benchmark bond	6.13	5.63	5.25	6.25	7.00	7.25
Hong Kong	3-Month Interbank Rate	3.15	4.58	4.96	4.45	4.30	4.30	5-Year Exchange Fund Note	3.68	4.50	4.41	4.45	4.70	4.90
India	91-Day T Bill	5.50	6.06	5.60	5.60	5.60	5.60	10-Year GOI	7.00	7.50	7.50	7.50	7.50	7.50
Indonesia	1-Month SBI Rate	9.63	12.06	11.81	9.50	9.00	10.00	FR0026 11% 10/15/2014	10.98	12.10	11.50	11.30	11.00	12.20
Korea	91-Day CD	3.60	4.58	4.30	4.30	4.30	4.30	5-Year Treasury	4.80	5.09	4.90	5.20	5.20	5.20
Malaysia	3-Month Interbank Rate	2.89	3.81	4.48	4.78	4.80	4.80	5-Year MGS	3.57	4.39	4.80	5.00	5.10	5.20
Philippines	91-Day T Bill	6.10	7.00	4.75	5.00	5.00	4.75	5-Year T Bond	10.61	9.00	1.50	1.00	1.00	0.75
Singapore	3-Month Interbank Rate	2.23	3.50	3.50	3.10	2.80	2.90	10-Year SGS	2.92	3.48	3.40	3.44	3.64	3.70
Taiwan	91-Day CP Rate	1.27	1.69	1.65	1.85	1.85	1.85	10-Year Government Bond	2.05	2.14	2.40	2.50	2.60	2.60
Thailand	3-Month Interbank Rate	3.23	5.19	4.75	4.25	4.00	3.50	10-Year Government Bond	5.01	5.82	5.75	5.00	4.80	4.50
Vietnam	3-Month Interbank Rate	7.64	8.13	8.25	8.13	8.00	8.00							

Source: Citigroup estimates.

Country Section

Bangladesh

Rohini Malkani
Anushka Shah
Mumbai

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	Healthy trends in overall growth continue to be underpinned by industrial production, which rose 13% over July-March FY06, compared to 9% growth during the same period last year. We expect industrial production trends to remain strong, with growth led by manufacturing and construction
External Sector	Recent external sector trends have been encouraging, with the trade balance recording a marginal improvement due to higher exports. A surge in remittances from overseas workers has continued unabated. As a result, the current account balance turned to a surplus of US$285mn during July-April from a deficit of US$767mn last year
Inflation	On the back of rising prices of essential commodities, coupled with higher government borrowings toward the end of the financial year, inflation continued to edge up. We expect prices to continue to rise. Measures taken by Bangladesh Bank (BB) to mop up excess liquidity may help quell the price pressure
Fiscal Policy	Mounting losses by state-owned companies (SOEs) continue to act as a drag on government finances. Unrealistic pricing policies, poor governance and a dwindling contribution of SOEs to the public exchequer have resulted in higher market borrowings. As SOE borrowings are financed by the banking sector, the health of the latter has also been undermined. During the last fiscal year, SOE loans totaled Tk25bn, crowding out private sector credit
Monetary Policy	In order to rein in rising inflation and support higher government borrowings, BB has continued its tight monetary policy stance. While broad money growth remains strong (+12% during July-April), trends in private sector credit have picked up, touching 17% levels in recent months. To stem rising prices, the bank mopped up liquidity through reverse repo operations
Other (eg Political) Developments	Politics has once again delayed the Tata Group's US$2.5bn investment proposal. The investments in steel, gas, coal and power have been suspended until elections next year due to "political and electoral compulsions." While the proposal has not been cancelled, the deferral will negate potential FDI flows that would have otherwise exceeded the total FDI that the country has attracted since independence
Issues to Watch/Key Risks	Political volatility, higher oil prices, labor unrest, higher oil prices, natural disasters and a deterioration in exports are key risks to our outlook

Figure 42. Key Economic Indicators and Forecasts*

	FY00	FY01	FY02	FY03	FY04	FY05	FY06E	FY07E	FY08E
Real Sector									
Real GDP (% YoY)	5.9	5.3	4.4	5.3	5.5	5.4	6.7	6.0	6.1
Total Investments (%YoY)	12.0	7.2	8.0	11.2	13.7	12.5	0.2	0.2	13.1
Total Consumption (%YoY)	7.7	6.8	7.5	9.4	9.6	9.8	9.2	9.5	9.5
GDP (US$ Bils.)	47	47	48	52	56	57	61	65	82
GDP Per Capita (US$)	368	362	362	389	421	419	446	469	547
External Sector									
Exports (% YoY)	7.9	12.6	-7.6	9.5	15.9	14.0	16.0	10.0	8.5
Imports (% YoY)	4.8	11.4	-8.7	13.1	13.0	20.6	10.0	8.0	7.5
Trade Balance (US$ Bils.)	-1.9	-2.0	-1.8	-2.2	-2.3	-3.3	-3.1	-3.2	-4.3
Current Account (% of GDP)	-0.3	-1.0	0.2	0.1	0.2	-0.6	0.2	0.3	0.4
External Debt (US$ Bils.)	16.2	15.1	16.3	17.4	18.5	16.9	16.7	16.7	22.0
Forex Reserves (US$ Bils.)	1.6	1.3	1.6	2.5	2.7	2.8	3.3	3.9	2.5
Import Cover (Months)	2.5	1.9	2.5	3.4	3.3	2.9	3.0	3.3	2.6
Currency/USD (Period Average)	50.3	54.0	57.4	57.9	58.9	63.3	69.2	72.8	75.4
Other									
Bank Rate (Period End, %)	7.0	6.0	6.0	5.0	5.0	5.0	5.0	5.0	6.0
Consumer Price Index (Period Average, % YoY)	2.8	1.9	2.8	4.4	5.8	6.5	7.0	6.5	5.0
Budget Balance (% of GDP)	-5.5	-5.2	-4.8	-4.2	-4.2	-4.5	-3.9	-3.7	-4.6

*Bangladesh Fiscal year runs from July-June.
Source: CEIC Data Company Limited and Bangladesh Bank.

Bangladesh Pictorial

Figure 43. Expect strong industrial production trend to continue, led by manufacturing and construction

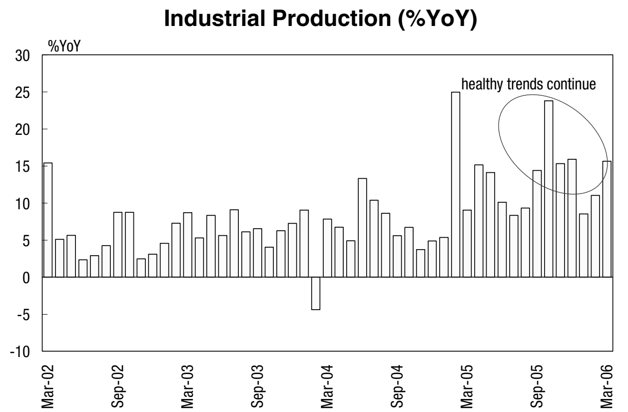


Figure 44. Buoyancy in remittances has helped turn the current account from a deficit last year to a surplus for July-March

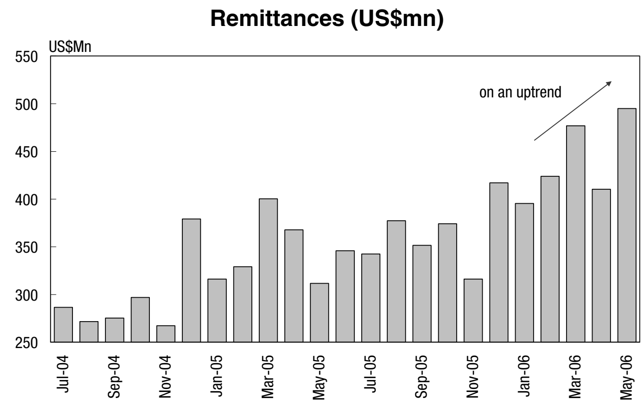


Figure 45. However, strong broad money growth…

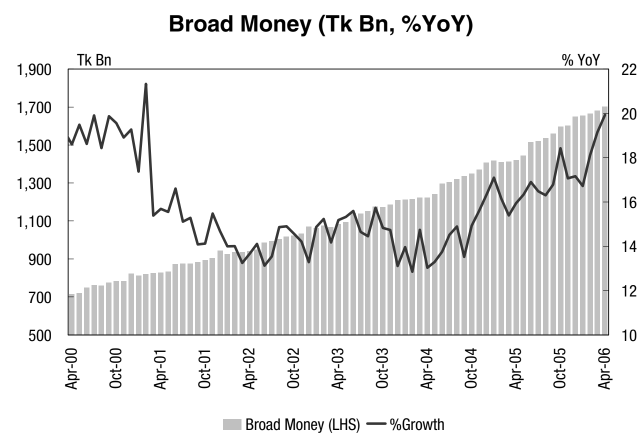


Figure 46. ... coupled with a pickup in private sector credit over the past months…

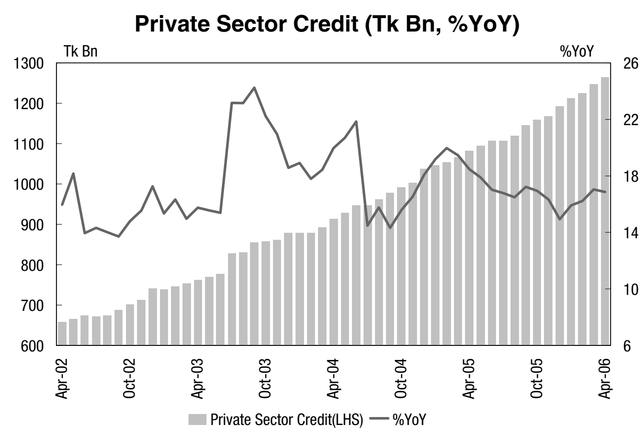


Figure 47. …is worrying for inflation, which once again edged up to cross 7% levels

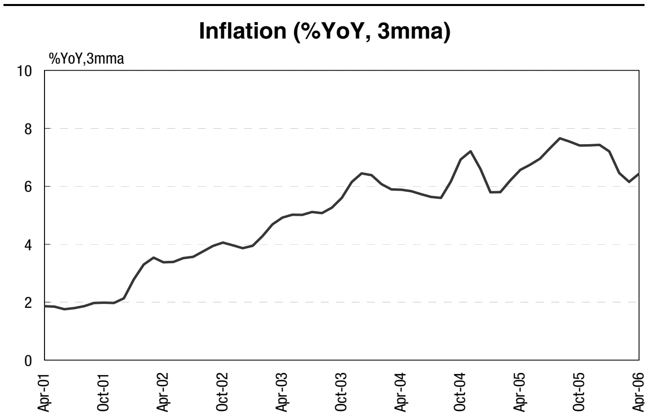
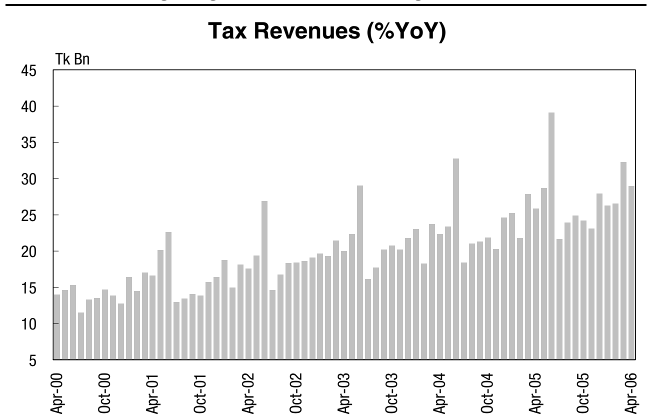


Figure 48. Despite healthy growth in tax revenues, one needs to watch out for higher government borrowings



Source: Bangladesh Bank and CEIC Data Company Limited

China

Minggao Shen
Beijing
Yiping Huang
Hong Kong

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	GDP growth accelerated to 11.3% in 2Q06, compared with 10.3% in 1Q06 and 9.9% in 2005. Although previous quarterly data were not directly comparable due to a GDP revision late last year, this was significantly above our and market expectations. Further tightening on liquidity and bank credit could add pressure to investment growth and lead to growth moderation late this year. We raised our GDP growth forecast for 2006 to 9.8% from 9.3% previously, but the risk could still be on the upside
External Sector	Export growth in 1H06 moderated to 25.2% from 32.7% a year ago, which is in line with our expectation. However, due to relatively weaker imports, the trade surplus in 1H06 surged by 55% to US$61.4bn. FX reserves also posted another record high of US$941.1bn by the end of June. While we expect exports may continue to normalize going forward, further policy tightening is likely to stabilize the trade surplus and FX reserves
Inflation	CPI in June edged up to 1.5% from a March low of 0.8%. Officials from the National Statistical Bureau warned of a buildup of inflationary pressure going forward. CPI late this year could exceed 2% on further price reform and strengthened consumption, in our view
Fiscal Policy	Income redistribution has become a hot topic among policymakers and scholars. Recently, the Guangzhou government raised the minimum wage to Rmb780 per month, the second highest only next to Shenzhen (Rmb810 per month). Other measures including tax cuts could also be proposed
Monetary Policy	Broad money supply (M2) moderated to 18.4% from 19.1% a month ago, but loan growth in June stayed on a fast track despite full range tightening policies. New RMB loans made in the first six months reached Rmb2.2trn, close to the PBOC's annual target of Rmb2.5trn. Further tightening, probably including another rate hike, a cut in export tax rebates and quicker currency appreciation, could aim to rein in surplus liquidity
Other (eg Political) Developments	The authorities published 2005 energy intensity baselines for individual provinces, which will be used for assessing achievements in 2006. The government hopes to achieve a 4% improvement in energy efficiency in 2006, which looks challenging unless more significant measures are introduced
Issues to Watch/Key Risks	(1) Excess liquidity problem remains a big concern; (2) high global oil price are still a risk; and(3) faster appreciation could trigger mergers and acquisitions in some industries

Figure 49. Key Economic Indicators and Forecasts

	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
Real Sector									
Real GDP (% YoY)	7.1	8.0	7.3	8.0	10.0	10.1	9.9	9.8	9.2
Domestic Demand (% YoY)	8.5	9.7	9.0	10.3	12.1	23.3	12.9	14.5	12.9
Real Consumption: Private (% YoY)	8.0	8.6	6.3	7.4	6.5	16.6	9.0	9.2	9.2
Real Gross Fixed Capital Formation (% YoY)	7.1	9.6	12.4	13.7	20.2	21.3	18.5	18.8	16.5
GDP (US$ Bils.)	999	1,079	1,191	1,304	1,471	1,936	2,264	2,705	3,374
GDP Per Capita (US$)	791	856	933	1,015	1,138	1,490	1,731	2,040	2,510
Industrial Output (% YoY)	8.9	11.4	9.9	12.6	17.0	16.7	16.4	17.0	16.8
External Sector									
Exports (US$, % YoY)	6.1	27.8	6.8	22.4	34.6	35.4	28.4	23.0	20.0
Imports (US$, % YoY)	18.2	35.8	8.2	21.2	39.8	36.0	17.6	22.0	23.0
Trade Balance (US$ Bils.)	29.2	24.1	22.5	30.4	25.5	32.1	102.0	132.1	134.3
Current Account (% of GDP)	2.1	1.9	1.5	2.7	3.1	3.5	7.1	5.8	5.0
International Reserves ex. Gold (US$ Bils.)	158	168	216	291	408	615	822	1000	1150
Currency/USD (Period Average)	8.28	8.28	8.28	8.28	8.28	8.28	8.19	7.95	7.35
Other									
1 Year Lending Rate (Period End, %)	5.9	5.9	5.9	5.3	5.3	5.6	5.6	6.0	6.0
10 Year Benchmark bond (Period End, %)			6.6	5.8	5.9	6.0	6.3	5.0	5.5
Consumer Prices (Period Average, % YoY)	-1.4	0.4	0.7	-0.8	1.2	3.9	1.8	2.0	3.0
Fiscal Balance (% of GDP)	-2.1	-2.8	-2.6	-2.9	-2.4	-1.3	-1.1	-1.0	-1.8

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

China Pictorial

Figure 50. Real GDP grew by 11.3% yoy in 2Q06. The red hot economy supports our expectation of imminent tightening

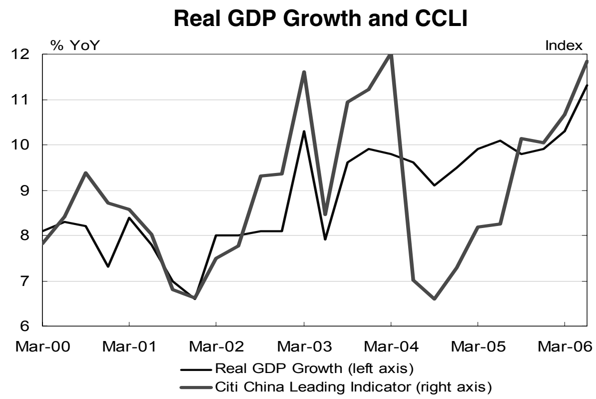


Figure 51. Growth of fixed asset investment could moderate late this year, but remain stronger than we had earlier expected

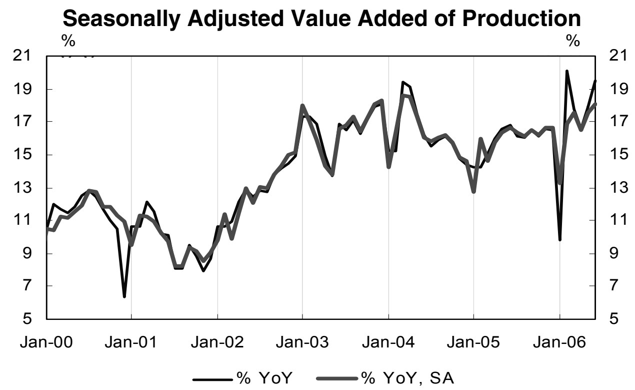


Figure 52. Fixed asset investment remained on a fast-track despite policy tightening

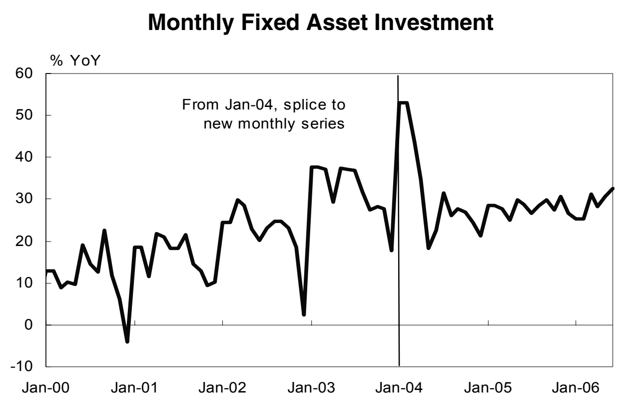


Figure 53. Another record trade surplus could accelerate the pace of currency appreciation

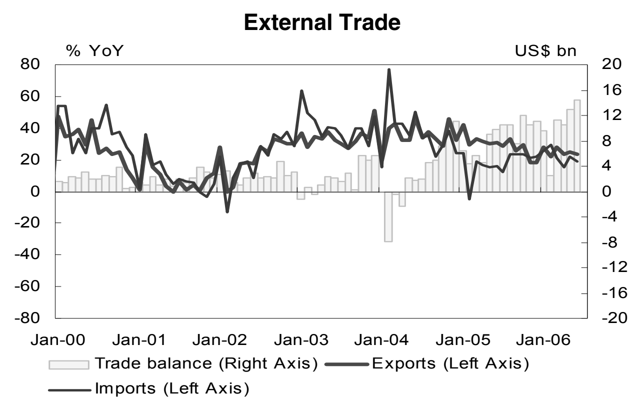


Figure 54. Retail sales weakened slightly in June. We expect the government to adopt more aggressive income enhancing policies

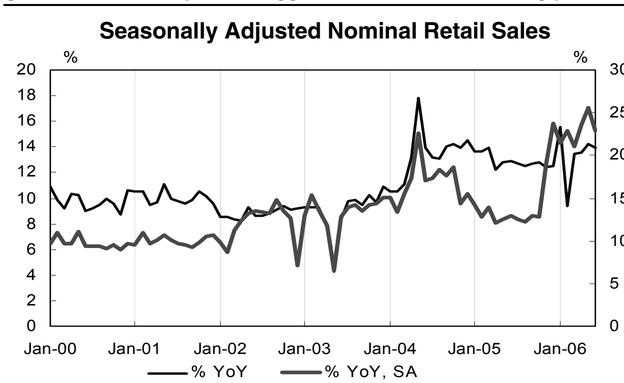
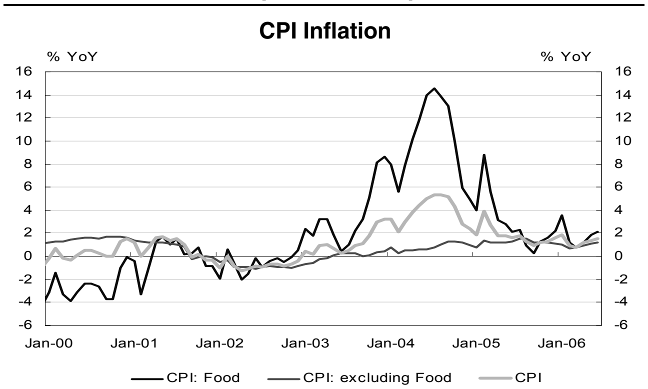


Figure 55. We expect CPI to move higher driven by price reform in the resource sector and improved consumption



Note: SA – Citigroup seasonally adjusted. See 1 April 2005 issue of Asia Economic Outlook and Strategy, "Clearer Picture of Economic Trends"
Source: CEIC Data Company Limited and Citigroup calculations.

Hong Kong

Joe Lo
Patricia Pong
Hong Kong

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	The economy remains buoyant, but the pace of growth is likely to be weaker than the 8.2% yoy in 1Q06. The Purchasing Managers' Index survey shows a marginal weakening in private sector output in 2Q06. In addition, the business sector has seen less rapid growth in new orders. Export weakness seems to the main factor restraining economic growth. The recent sell-off in global equity markets also hit activity in the local financial sector. Meanwhile, domestic demand continues to support the economy. Consumption grew steadily by 4.9% yoy in April-May, compared to 4.6% in 1Q06
External Sector	Exports fell surprisingly in May, due to weak overseas demand for electronic goods. The risk is that exports may weaken further in 2H06E, if US demand declines under the Fed's monetary tightening. Growth of tourist arrivals fell to 8.4% yoy in April-May from 13.8% in 1Q06 and likely weakened in June as the World Cup kept tourists at home watching TV. However, tourism may pick up in 2H06E thanks to more trade fairs and an expansion of the "individual visit scheme" to cover more Chinese cities
Inflation	The overall inflation trend remains upward. Firms are passing on higher costs to consumers, while house rent continues to increase
Fiscal Policy	The fiscal balance continues to improve after returning to a surplus in FY05-06. The government is consulting the public about levying a consumption tax to broaden the tax base and improve fiscal stability
Monetary Policy	The HKMA has adopted a convertibility undertaking to keep the exchange rate at HKD7.75–7.85/USD, but let the market decide interest rates. Excess liquidity has dampened HKD interbank offer rates (Hibors), which prompted Hong Kong banks not to follow the US Fed's interest rate hikes in 2Q06. As Hibors stayed low amid the rising USD interest rates, the widened interest rate differential prompted investors to sell the HKD and buy the USD. We expect Hibors to rise and the HKD to strengthen after the market's HKD sales cut excess liquidity. We also think the HKD prime rate may rise 50bps to 8.5-8.75% in the coming months
Other (eg Political) Developments	The chief executive maintains high popularity and is preparing for the 2007 election. The government has tightened controls on importing and raising poultry to lower the risk of bird flu
Issues to Watch/Key Risks	(1) Interest rates; (2) global equity markets; (3) US consumer spending; (4) RMB appreciation; (5) bird flu; and (6) protectionism against China

Figure 56. Key Economic Indicators and Forecasts

	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
Real									
Real GDP (% YoY)	4.0	10.0	0.6	1.8	3.2	8.6	7.3	5.7	5.0
Domestic demand (% YoY)	-4.0	7.0	2.6	-1.6	-0.1	5.4	2.9	3.7	3.1
Real Consumption: Private (% YoY)	1.4	6.0	2.1	-1.0	-0.9	7.3	3.4	4.3	3.2
Real Gross Fixed Capital Formation (% YoY)	-16.7	11.0	2.6	-4.5	0.9	3.0	4.1	3.4	3.5
GDP (US$ Bils.)	163	169	167	164	158	166	178	189	202
GDP per capita (US$)	24,994	25,319	24,765	24,121	23,278	24,081	25,624	27,074	28,601
Unemployment Rate (%)	6.2	4.9	5.1	7.3	7.9	6.8	5.6	5.0	4.5
External Sector									
Exports (US$, % YoY)	-0.1	16.2	-5.9	5.3	11.8	15.9	11.6	9.8	8.5
Imports (US$, % YoY)	-2.7	18.7	-5.4	3.1	11.7	16.9	10.6	10.6	8.8
Trade balance (US$ Bils.)	-5.6	-11.0	-11.4	-7.6	-8.1	-11.8	-10.5	-13.8	-16.0
Current account (% of GDP)	6.3	4.1	5.9	7.6	10.4	9.5	11.1	9.7	9.5
International Reserves ex. Gold (US$ Bils.)	96	108	111	112	118	124	124	130	133
Currency/USD (Period Average)	7.76	7.79	7.80	7.80	7.79	7.79	7.78	7.76	7.75
Other									
3M interbank Rate (Period Average, %)	5.9	6.1	3.4	1.8	1.1	0.5	3.1	4.6	5.0
Prime lending rate (Period End, %)	8.5	9.5	5.1	5.0	5.0	5.0	7.9	8.6	8.4
5-year Exchange Fund Note (Period Average, %)	7.0	6.8	5.1	4.2	3.1	3.1	3.7	4.5	4.4
Consumer prices (% YoY)	-4.0	-3.7	-1.6	-3.0	-2.6	-0.4	1.0	2.2	2.7
Fiscal balance (% of GDP; FY)	0.8	-0.6	-4.9	-4.8	-3.3	-0.3	1.0	0.6	0.5

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

Hong Kong Pictorial

Figure 57. PMI fell again in June, revealing a trend of weakening business activity and moderate hike in prices

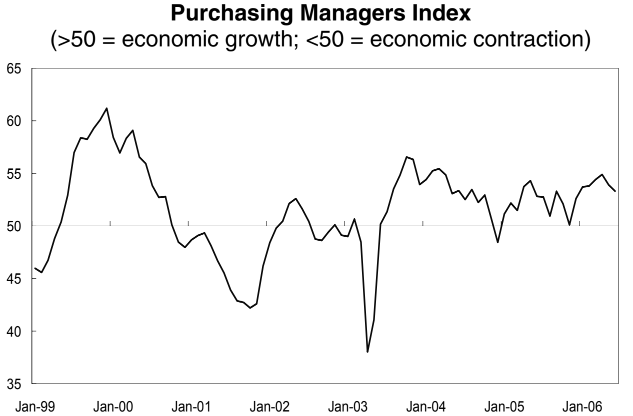


Figure 58. Solid underlying retail sales growth supported by mainland tourists and domestic demand

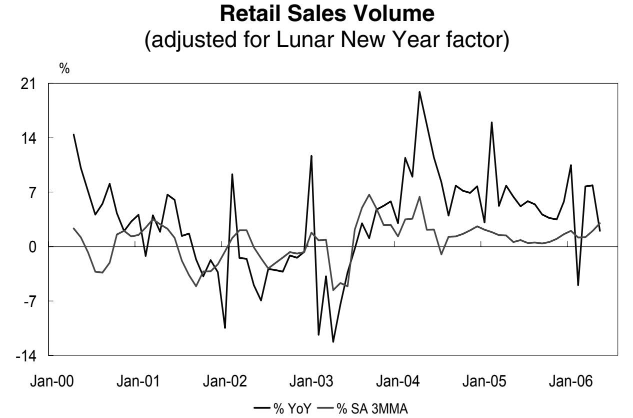


Figure 59. Dismal exports in May confirm the downside risk to exports and the local economy

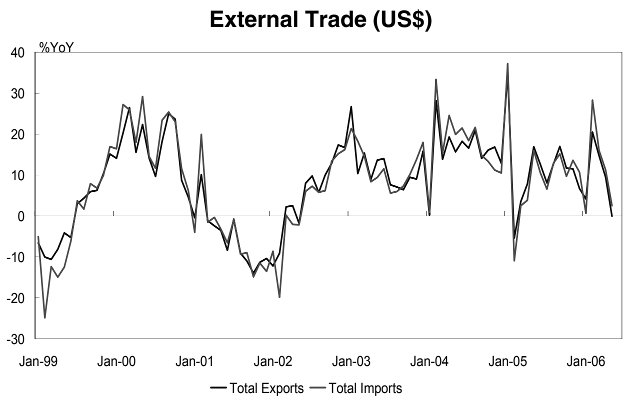


Figure 60. Prices increase as consumer demand was strong enough to let businesses pass on higher costs to consumers

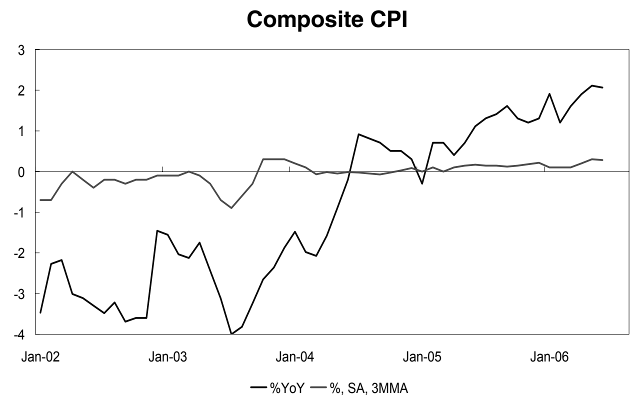


Figure 61. Divergence of short-dated Hibors and USD Libors lacks fundamental support and is unsustainable

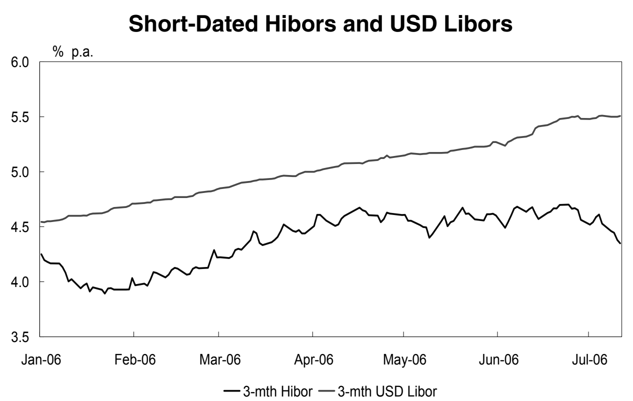
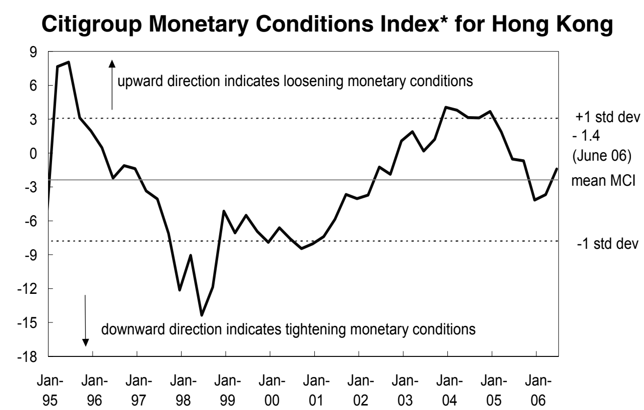


Figure 62. Monetary conditions loosened in 2Q06, due to a weaker HKD and lower real interest rates, and is positive for the economy



*See "Asia Economic Outlook and Strategy: Measuring Monetary Conditions" February 2005
Source: HKEx, CEIC Data Company Limited and Citigroup calculations.

India

Rohini Malkani
Anushka Shah
Mumbai

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	While near-term domestic sentiment is cautious due to reform roadblocks and there is concern about inflation, higher interest rates and recent bomb blasts in the country's financial capital, we maintain our FY07 GDP estimate of 7.6%, with agriculture, industry and services rising by 3%, 8.4% and 9%, respectively
External Sector	Despite a widening trade deficit, the 4Q FY06 current account posted a surplus on continued buoyancy in software exports and higher remittances. Incorporating Dubai crude prices at US$70/bbl, we expect the current account deficit to widen from US$10.6bn in FY06 to US$16.6bn in FY07. We maintain our comfortable stance on the external sector given that the current account deficit is largely due to imports of capital goods and industrial inputs, which, in our view, are positive given that India has moved to a higher growth trajectory
Inflation	Current trends in inflation (WPI) have risen from 3.5% at the start of this fiscal year to 5% levels currently. We believe that due to a favorable base impact, coupled with recent measures taken to curb prices, inflation during the next five months will likely be benign in a 4.5-5.5% range. However, by mid-December with the base effect wearing out, we expect inflation to cross 6% and end the fiscal year a little below 7% levels. We expect inflation to average 5.3% in FY07, compared to 4.5% in FY06
Fiscal Policy	Although revenue collection likely will pick up later in the year, we expect to see a Rs100bn slippage in the government's fiscal deficit estimate of Rs1487bn for FY07 (due to higher interest payments, the derailment of the disinvestment program and the reduction in customs duties in transport fuels)
Monetary Policy	Further global rate hikes and a turnaround in domestic liquidity conditions will likely result in the RBI hiking rates by 25bps on July 25, resulting in bond yields likely edging higher to 8.5%. However, given that Indian consumers and corporations are still underleveraged and that real interest rates are still benign, this is unlikely to derail growth
Political/Other	Although the Investment Commission's report came at a time of a stall in the divestment process, recommendations to target raising investment levels to 34% of GDP (from 30% currently) are positive. This would amount to investments of US$1.5trn over the next five years, largely through a net FDI increase by focusing on 25 key sectors including infrastructure, manufacturing, services and the knowledge economy
Issues to Watch/Key Risks	Our key risks to growth remain politics, higher oil prices, unemployment and a coal shortage

Figure 63. Key Economic Indicators and Forecasts

	FY00	FY01	FY02	FY03	FY04	FY05	FY06E	FY07E	FY08E
National Account									
Real GDP (% YoY)	6.0	4.4	5.8	3.8	8.5	7.5	8.4	7.6	8.0
Agriculture (% YoY)	0.5	0.0	6.2	-6.9	10.0	0.7	3.9	3.0	3.0
Industry (% YoY)	5.3	6.3	2.7	7.0	7.6	8.6	9.0	8.4	9.1
Services (% YoY)	9.7	5.6	7.1	7.3	8.2	9.9	10.0	9.0	9.1
GDP (US$ Bils.)	451	461	475	507	601	694	797	867	1010
GDP Per Capita (US$)	453	458	467	494	583	672	761	815	936
External Sector									
Exports (US$, % YoY)	9.5	21.1	-1.6	20.3	23.3	23.9	27.5	20.0	18.0
Imports (US$, % YoY)	16.5	4.6	-2.8	14.5	24.1	48.5	31.6	20.0	14.0
Trade Balance (US$ Bils.)	-17.8	-12.5	-11.6	-10.7	-13.7	-36.6	-51.6	-61.9	-65.5
Current Account (% of GDP)	13.7	9.8	15.0	17.0	27.8	31.2	40.9	45.3	49.3
International Reserves ex. Gold (US$ Bils.)	-0.9	-0.6	0.7	1.3	2.3	-0.8	-1.3	-1.9	-1.6
External Debt (% of GDP)	22.1	22.3	20.8	21.0	20.0	19.0	19.0	20.0	21.0
Import Cover (Months)	7.6	8.2	10.9	13.4	15.9	13.6	11.1	9.5	8.6
Currency/USD (Period Average)	43.4	45.7	48.0	48.3	45.9	45.0	44.3	45.8	44.0
Other									
Bank Rate (Period End, %)	8.0	7.0	6.5	6.3	6.0	6.0	6.0	6.0	7.0
Wholesale Prices (Period Average, % YoY)	3.3	7.2	4.5	3.4	5.4	6.5	4.5	5.3	5.0
Centre's Fiscal Balance (% of GDP)	-5.3	-5.6	-6.2	-5.9	-4.5	-4.0	-4.1	-3.7	-3.8
Consolidated Fiscal Balance (% of GDP)	-9.4	-9.5	-9.9	-9.6	-8.4	-8.4	-7.7	-7.6	-7.6

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

India Pictorial

Figure 64. Industrial production continues to remain strong, underpinning overall GDP growth

Industrial Production (%YoY)

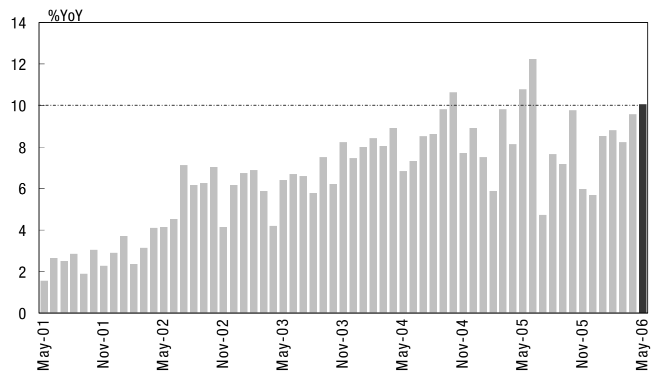


Figure 65. Buoyancy in invisibles - led by software and remittances - helped offset a rising trade deficit in FY06

Invisibles and the Trade Deficit (US$bn, %GDP)

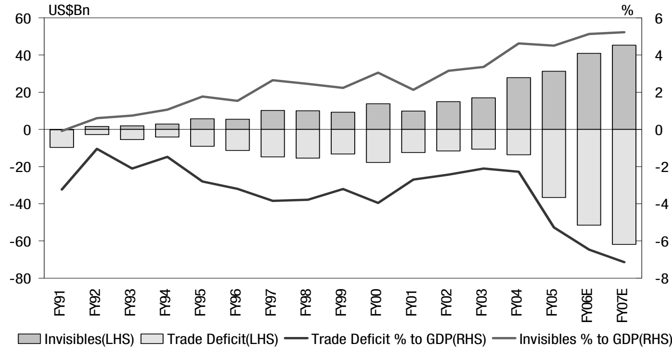


Figure 66. While inflation is likely to edge upward, we expect it to end the fiscal year close to 7% levels

Inflation (%YoY)

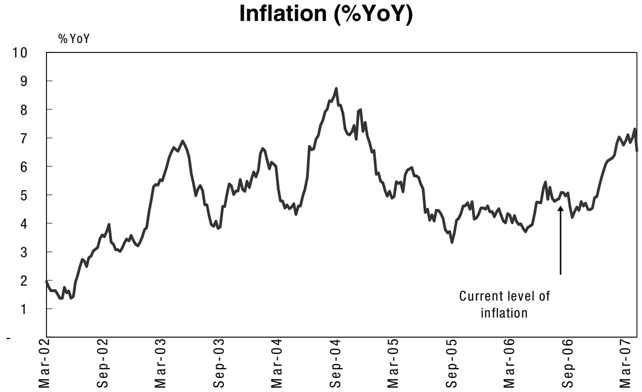


Figure 67. Higher interest rates are unlikely to derail growth due to benign real rates and underleveraged consumers and corporations

Real Interest Rates (%)

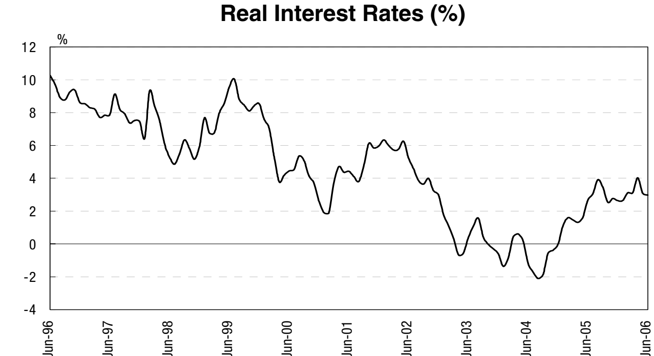


Figure 68. Given the recent derailment of the divestment program, upward pressure on interest rates and a reduction in customs duties…

Divestment Proceeds (Rs Bn)

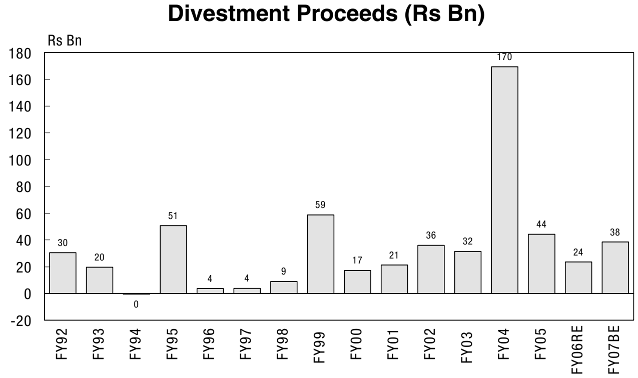
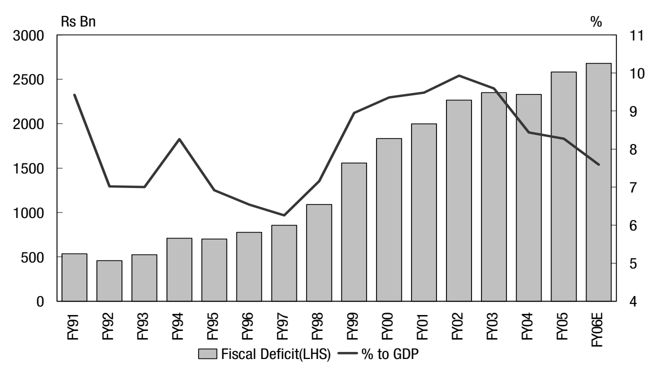


Figure 69. …we could see marginal slippage in the fiscal deficit, to the tune of Rs100bn

Combined Deficit (Rs Bn, %)



Source: CEIC Data Company Limited and Citigroup calculations.

Indonesia

Anton H. Gunawan
Jakarta

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	We saw signs of slow economic recovery in late 2Q06, reflected by a small MoM improvement in auto sales and an increase in the consumer confidence index. An expected small increase in 2Q06 GDP growth to 4.9% yoy may be supported by higher government expenditure and better net exports. Our 2006 growth forecast of 5.4% remains less optimistic than the government's forecast of 5.9%
External Sector	Exports of primary commodities continued to be strong, while imports of raw materials and capital goods continued to slow, resulting in higher trade and current account surpluses. We expect a higher current account surplus in 2006, at 1.5% of GDP versus 0.4% of GDP previously. After the high volatility seen in the financial markets in mid-May and June, we are seeing the return of portfolio capital inflows, which improved the balance of payments
Inflation	A low YTD inflation rate made BI confident that the inflation rate would reach the low end of its 7.0% - 9.0% range at year-end (versus our view of 8.0%). Higher world oil prices due to geopolitical conflicts will likely have a mild effect on domestic inflation, assuming subsidized domestic fuel prices remain constant. Another inflation risk is this year's drier season, which has caused water shortages in several food producing areas
Fiscal Policy	Although an improvement from last year, the 1H06 realization of the budget (Rp1.6trn deficit) still reflects the government's inability to spend quickly and timely. In order to limit the increase of new debts, the minister of finance cut spending to reach a fiscal deficit of 1.2% of GDP, instead of the previously planned 1.4%. Our fiscal deficit estimate is at 1.1% of GDP, slightly discounted due to the slow spending problem
Monetary Policy	Bank Indonesia (BI) cautiously cut its policy rate by 25bps at the July board of governor meeting. A softer tone on US Fed fund rate hikes provides more room for BI to cut rates slightly more aggressively. This and the lower expected inflation rate lead us to lower our BI rate forecast to 11.25% by year-end
Other (eg Political) Developments	Pre-payment of 50% of the IMF loans at the end of June reduced FX reserves to US$40.2bn, still enough to cover around 4.7 months of imports and short-term official debt repayment. The move is more for political reasons than economic ones. The delayed disbursement and implementation of direct cash subsidies and rural infrastructure projects have probably increased the number of people living under the poverty line
Issues to Watch/Key Risks	(1) A sudden reversal of an influx of short-term foreign portfolio investments, either because of a profit-taking cycle or sentiment turnaround, may depress the currency again; (2) widespread avian flu; (3) the labor law; and (4) tax law amendments

Figure 70. Key Economic Indicators and Forecasts

	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
National Account									
Real GDP (% YoY)	0.8	4.9	3.8	4.3	4.8	5.1	5.6	5.4	6.0
Domestic Demand (% YoY)	-1.3	4.6	4.5	4.7	3.6	7.0	5.7	5.6	6.8
Real Consumption: Private (% YoY)	4.6	1.6	3.5	3.8	3.9	5.0	4.0	3.6	4.5
Fixed Investment (% YoY)	-18.2	16.7	6.5	4.7	0.6	14.6	9.9	6.3	12.2
GDP - Nominal (US$ Bils.)	140	166	161	196	235	254	281	356.6	402.5
GDP Per Capita (US$)	694	742	697	927	1,099	1,170	1,282	1606	1790
External Sector									
Exports (US$% YoY)	-0.4	27.7	-9.3	1.5	6.8	17.2	19.5	12.8	4.7
Imports (US$% YoY)	-12.2	39.6	-7.6	1.1	4.0	42.9	23.7	2.4	15.3
Trade Balance (US$ Bils.)	24.7	28.6	25.4	25.9	28.5	25.1	28.0	37.6	33.1
Current Account (% of GDP)	4.1	4.8	4.3	4.0	3.5	1.2	0.3	1.5	0.4
International Reserves ex. Gold (US$ Bils.)	26.4	28.5	27.2	31.0	35.0	35.0	33.0	39.5	31.5
Currency/USD (Period Avg)	7847	8389	10247	9315	8573	8936	9711	9118	9142
Other									
1M SBI Rate (Average)	22.8	12.4	16.5	15.1	10.1	7.5	9.6	12.1	11.8
Consumer Price (% YoY)	20.8	3.8	11.5	11.8	6.8	6.1	10.5	13.7	7.2
Fiscal Balance (% of GDP)	-2.8	-1.2	-2.5	-0.9	-1.9	-1.3	-0.5	-1.1	-0.8

Source: CEIC Data company Limited and Citigroup estimates.

Indonesia Pictorial

Figure 71. A record high trade surplus in May driven mostly by non-oil and gas commodity exports

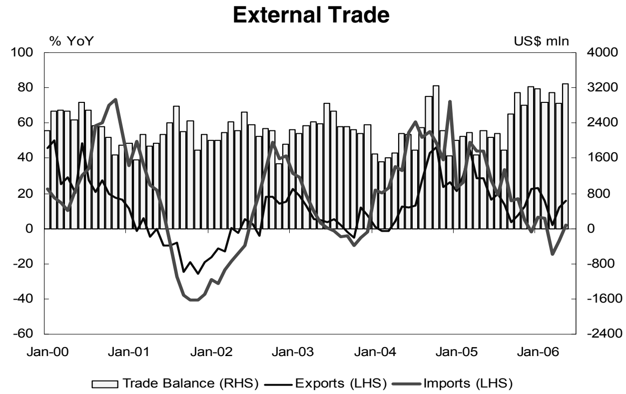


Figure 72. Our fiscal deficit estimate is slightly lower than the government's, as we factored in the slow spending problem

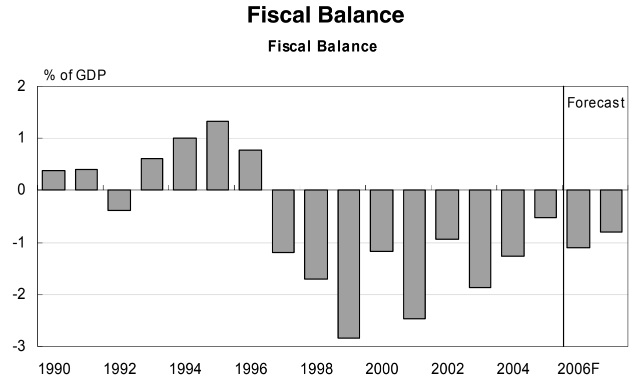


Figure 73. Small moderation in headline inflation, core rate inched up slightly

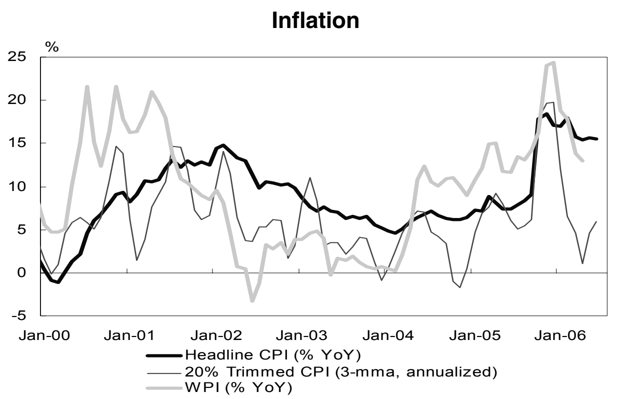


Figure 74. We lowered our BI rate forecast to 11.25% by year-end given a softer tone for US rate hikes and moderate inflation

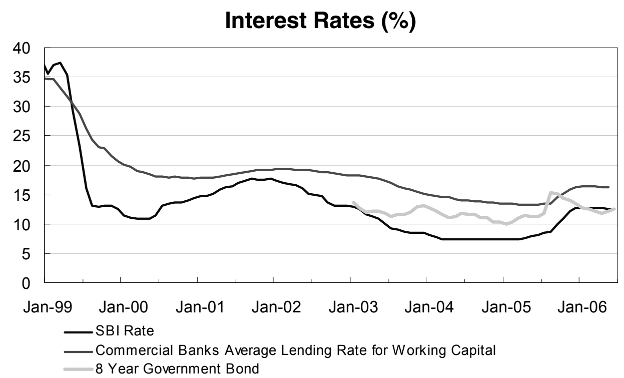


Figure 75. IDR/USD looks stable with a chance of slight strengthening after the investors pull out from Emerging Markets in mid-May

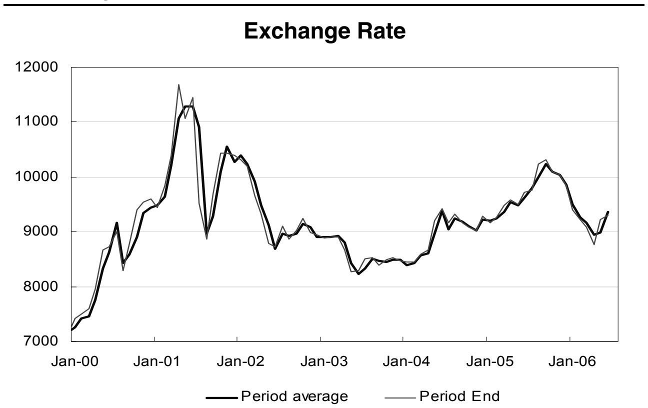
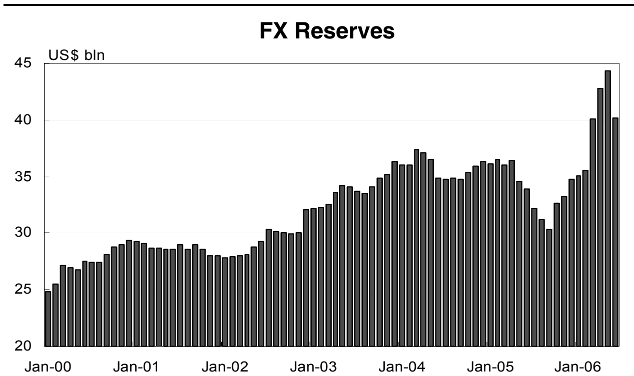


Figure 76. FX reserves fell in June due to the pre-payment of 50% of the IMF loans



Note: SA – Citigroup seasonally adjustment. See 1 April 2005 issue of Asia Economic Outlook and Strategy, "Clearer Picture of Economic Trends"
Source: Bloomberg, Bank Indonesia, CEIC Data Company Limited, Datastream and Citigroup calculations.

Korea (South)

Suktae Oh
Seoul

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	We continue to expect a decent slowdown ahead, as negative factors (strong won and higher oil prices) seem to outweigh positive ones. A pickup in industrial production in May was likely a technical rebound amid slowing momentum, while consumer goods sales maintained recent strength. Consumption growth is likely to slow to a sustainable pace that matches household income growth. Global monetary tightening and a strong won may lead to generally sluggish export/manufacturing production. Positive factors include a recent pickup in exports and a possible boom in semiconductors
External Sector	Strength in exports was maintained in June, but this was driven by increases in prices and hence should not lead to equally strong growth in production or GDP. Though a current account surplus was restored in May, the basic balance showed a surprisingly large deficit, which confirms that the current balance of payment conditions are not supportive of the won
Inflation	Both headline and core inflation extended a recent rising trend in June. An increase in inflation would likely continue for a while due to a recovery of domestic demand, but it may remain a "normalization" and its upside would likely be capped by sub-par growth
Fiscal Policy	The fiscal policy stance is likely to remain neutral, as the chance of a supplementary budget still appears low despite the ruling party's increasing concern about growth. Worries about "unintended" tightening were slightly eased by a narrower fiscal surplus in May
Monetary Policy	Despite no change in policy rates, Bank of Korea (BOK) confirmed its tightening bias by its hawkish comments at the July MPC meeting. But the slowdown of growth momentum that we (and BOK, too) expect would make it difficult for BOK to go beyond one more hike, probably in August, in our view
Other (eg Political) Developments	North Korea's missile test would worsen mid- to long-term geopolitical risk prospects on the Korean peninsular, but the short-term impact on financial markets was fairly limited, as we expected
Issues to Watch/Key Risks	(1) Sustainability of the consumption recovery; (2) sustainability of export growth; (3) changes in the won and oil prices; (4) path of further BOK tightening; and (5) changes in the North Korean issue after the missile tests

Figure 77. Key Economic Indicators and Forecasts

	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
Real Sector									
Real GDP (% YoY)	9.5	8.5	3.8	7.0	3.1	4.7	4.0	5.1	4.3
Domestic Demand (% YoY)	9.3	8.7	3.3	7.3	1.0	1.0	3.1	3.9	3.4
Real Consumption: Private (% YoY)	11.5	8.4	4.9	7.9	-1.2	-0.3	3.2	4.4	3.5
Real Gross Fixed Capital Formation (% YoY)	8.3	12.2	-0.2	6.6	4.0	2.1	2.3	3.0	3.2
GDP (US$ Bils.)	446	509	480	549	608	684	789	886	972
GDP Per Capita (US$)	9,562	10,820	10,140	11,526	12,701	14,221	16,328	18,275	19,965
Unemployment Rate (%)	6.4	4.2	3.8	3.1	3.4	3.5	3.7	3.5	3.5
Industrial Output (% YoY)	24.2	16.8	0.7	8.0	5.0	10.4	6.4	9.2	6.6
External Sector									
Exports (US$, % YoY)	9.9	21.2	-14.0	7.9	20.7	30.6	12.1	13.2	12.0
Imports (US$, % YoY)	29.1	36.2	-13.4	7.7	18.0	25.6	16.1	17.7	14.0
Trade Balance (US$ Bils.)	28.5	17.0	13.5	14.8	22.2	37.6	33.5	26.4	23.5
Current Account (% of GDP)	5.5	2.4	1.7	1.0	2.0	4.1	2.1	0.6	0.0
International Reserves ex. Gold (US$ Bils.)	74	96	103	121	155	199	210	230	245
External Debt (% of GDP)	34	29	27	26	26	25	24	24	24
Currency/USD (Period Average)	1188	1138	1296	1247	1192	1140	1023	952	920
Other									
Overnight Rate (Period Average, %)	5.0	5.1	4.7	4.2	4.0	3.6	3.3	4.3	4.4
5-year Treasury Yield (Period Average, %)		8.70	6.20	6.30	4.82	4.30	4.52	5.09	4.90
Consumer Prices (% YoY)	0.8	2.3	4.1	2.8	3.5	3.6	2.7	2.5	2.7
Fiscal Balance (% of GDP)	-2.5	1.1	1.2	3.3	1.1	0.7	0.6	0.8	2.0

Source: CEIC Data company Limited and Citigroup estimates.

Korea (South) Pictorial

Figure 78. A significant pickup in industrial production was likely a due correction after a dip in April

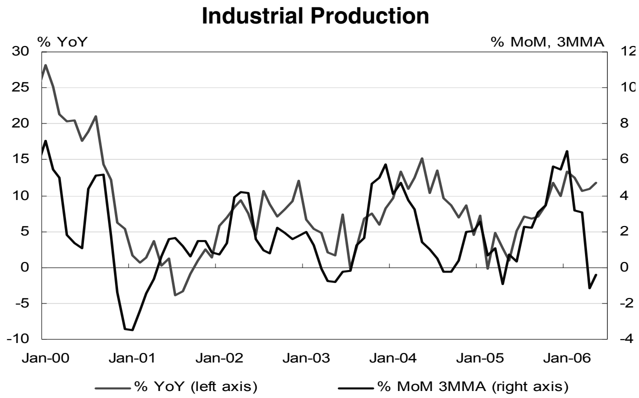


Figure 79. Consumer goods sales strength confirms the ongoing consumption recovery

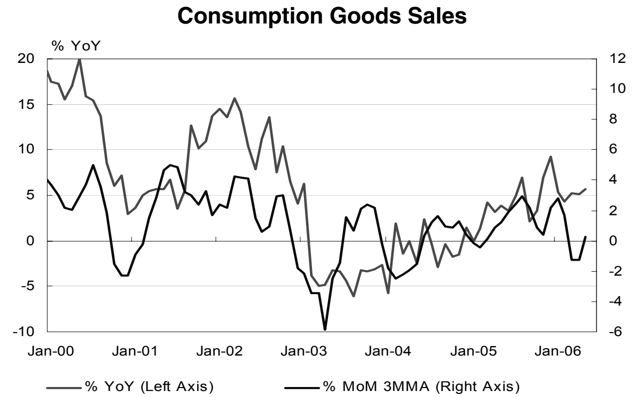


Figure 80. The leading indicator proposes that the short-term outlook is not bright

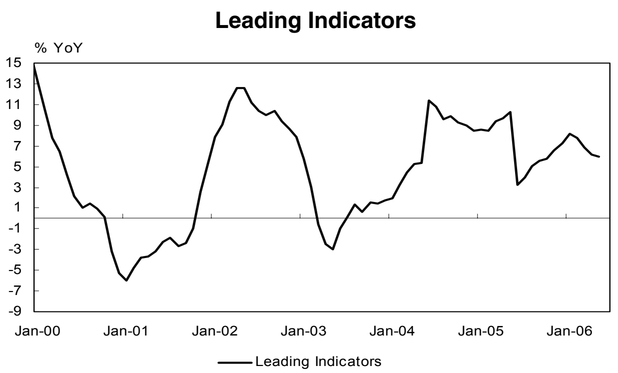


Figure 81. Despite recent strong trade data, we expect sluggish exports due to global monetary tightening and a strong won

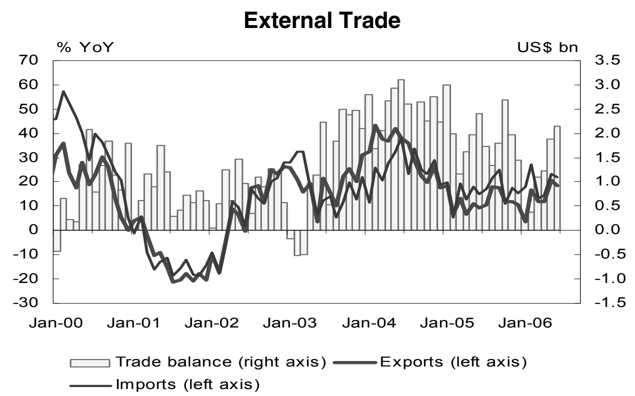


Figure 82. We expect core inflation to return to BOK's target range (2.5-3.5%) within the end of this year

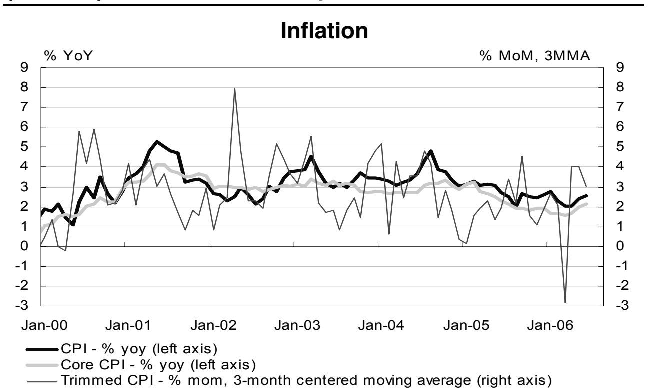
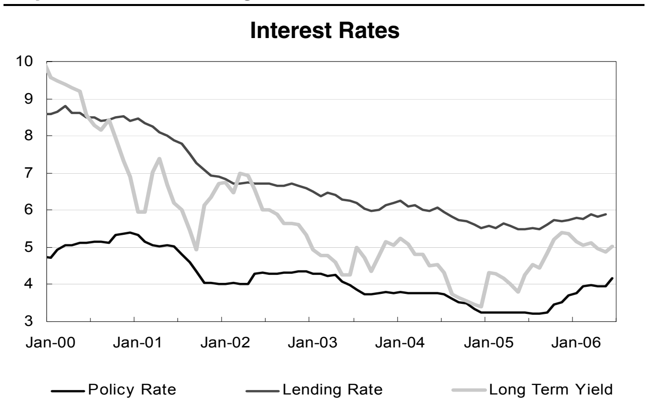


Figure 83. The current rate hike cycle is likely to end soon, with only one more hike in August



Source: CEIC Data company Limited and Citigroup estimates.

Malaysia

Moh Siong Sim
Singapore

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	The pace of economic activity remained in low gear, amid a modest slowing of export momentum and slippage of manufacturing output below trend-like growth. But the picture remains half full, as the May output data – in conjunction with the export reading – suggests that sharp and sustained economic weakness in 2H06 can be avoided. The Global Electronics Leading Index (GELI) points to a lull in the global tech cycle, not a crunch
External Sector	A widening interest rate gap in favor of the US and heightened risk aversion against emerging markets could continue to mute capital inflows, leaving ringgit movements more tightly tracking movements in regional currencies. Scope for a re-play of the ringgit strength in early 2006 may be limited in the near term
Inflation	The latest inflation report highlights more of the same: (1) headline inflation continues to overstate the inflation risk; and (2) a second-round pass-through from energy price increases remains muted
Fiscal Policy	Rising oil prices could lift fuel subsidies. While a late year surge in spending cannot be ruled out as the projects in the 9th Malaysia Plan are implemented, an improving fiscal balance amounting to a RM5bn surplus in the first five months of 2006 according to BNM data should still put the official 2006 fiscal deficit target well within reach
Monetary Policy	BNM may hike the OPR in late July to preempt inflation concerns and limit excessive ringgit volatility, but the pace of the rate hikes probably will remain gradual. We continue to expect at most a 50bp OPR hike for the rest of 2006, and this is less than what the interest rate markets have already discounted
Other (eg Political) Developments	Recent attacks made by former Prime Minister Mahathir against Prime Minister Abdullah's administration have raised worries that the growing rift could distract the authorities from pressing on with structural reforms to improve the economy
Issues to Watch/Key Risks	(1) Prime Minister Abdullah stepping up the reform drive; (2) fiscal consolidation; (3) prompt monetary tightening capping inflation concern; and (4) improving bilateral ties with Singapore could spark further win-win cooperation

Figure 84. Key Economic Indicators and Forecasts

	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
Real Sector									
Real GDP (% YoY)	6.1	8.9	0.3	4.4	5.5	7.2	5.2	5.5	5.5
Domestic Demand (% YoY)	1.4	15.5	2.5	3.9	6.1	7.5	7.3	6.9	7.2
Real Consumption: Private (% YoY)	2.9	13.0	2.4	4.4	6.6	10.5	9.2	5.9	6.0
Real Gross Fixed Capital Formation (% YoY)	-6.5	25.7	-2.8	0.3	2.7	3.1	4.7	9.1	9.8
GDP (US$ Bils.)	79	90	88	95	104	118	131	148	167
GDP Per Capita (US$)	3,485	3,844	3,665	3,884	4,152	4,631	5,005	5,560	6,146
Unemployment Rate (%)	3.4	3.1	3.7	3.5	3.6	3.6	3.6	3.5	3.4
Industrial Growth (% YoY)	9.0	19.2	-4.1	4.6	9.3	11.3	4.1	6.0	7.0
External Sector									
Exports (US$, % YoY)	15.3	16.2	-10.4	6.9	11.6	20.5	11.4	13.0	13.5
Imports (US$, % YoY)	12.2	25.5	-10.2	8.0	4.8	25.9	8.9	15.0	16.0
Trade Balance (US$ Bils.)	19.1	16.1	14.2	14.3	21.4	21.2	26.4	27.5	27.9
Current Account (% of GDP)	15.9	9.4	8.3	8.4	12.8	12.6	15.2	12.7	11.1
International Reserves ex. Gold (US$ Bils.)	30.9	29.9	30.8	34.6	44.9	66.7	70.5	85.0	90.0
Currency/USD (Period Average)	3.80	3.80	3.80	3.80	3.80	3.80	3.79	3.66	3.50
Other									
3-Month KLIBOR Fixing (Period Average, %)	4.11	3.22	3.25	3.24	3.13	2.94	2.89	3.81	4.48
5-Year MGS Yield (Period Average,%)	5.63	5.11	3.54	3.47	3.60	4.09	3.57	4.39	4.80
Consumer Prices (% YoY)	2.7	1.6	1.4	1.8	1.2	1.4	3.1	4.1	2.5
Fiscal Balance (% of GDP)	-3.2	-5.7	-5.5	-5.6	-5.3	-4.3	-3.8	-3.6	-3.2

Source: CEIC Data company Limited and Citigroup estimates.

Malaysia Pictorial

Figure 85. Industrial output momentum seems to have steadied following recent deceleration…

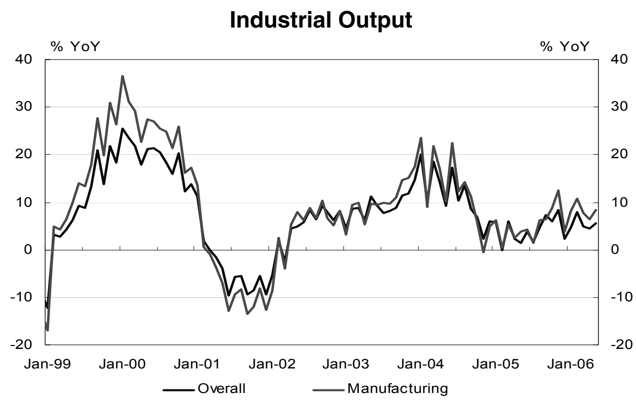


Figure 86. …together with a firm export reading suggests that sharp and sustained economic weakness in 2H06 can be avoided

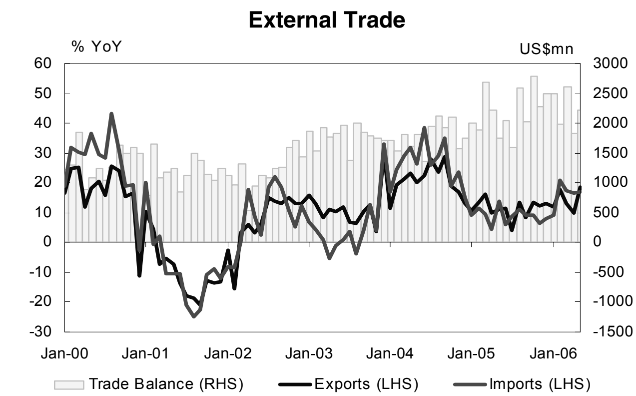


Figure 87. Softer-than-expected headline inflation, despite the hike in electricity tariff, underscores tame core inflation pressure

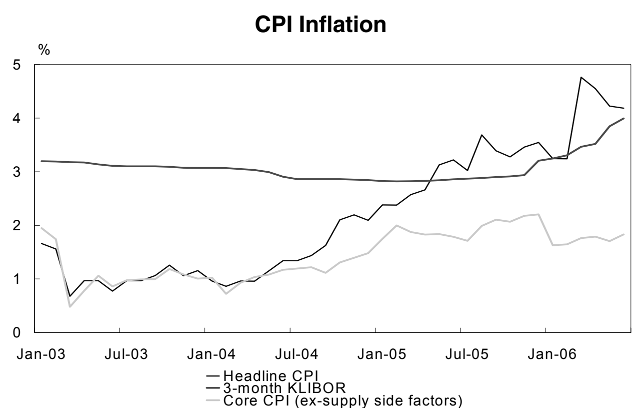


Figure 88. The Global Electronics Leading Index (GELI) does not point to imminent danger of a sharp tech crunch

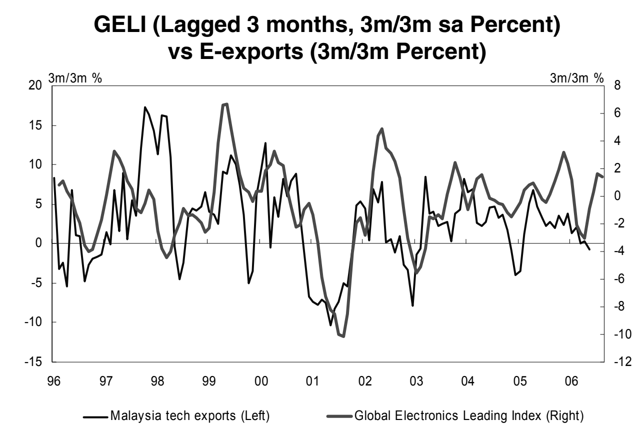


Figure 89. Any ringgit movements are likely to more tightly mirror movements in regional currencies

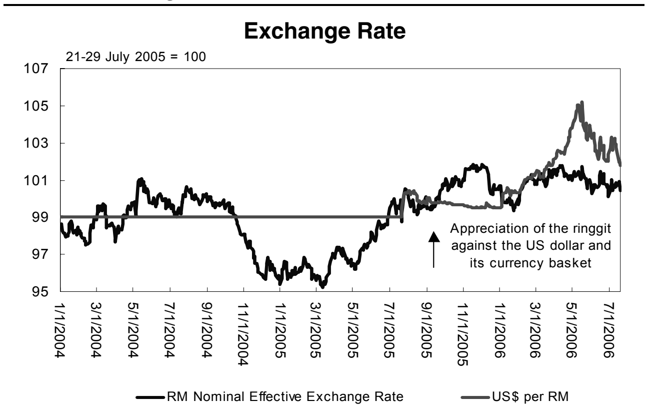
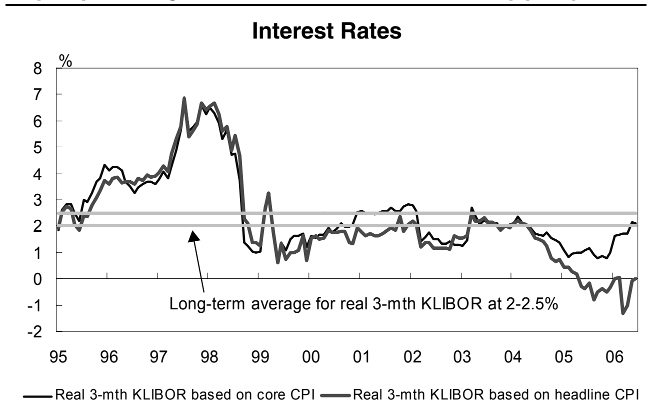


Figure 90. BNM likely will press with an OPR hike at the end of July as part of a gradual "normalization" of monetary policy



Source: BNM, CEIC Data Company Limited, Datastream, Malaysia Department of Statistics, Ministry of Finance, NEAC, Citigroup estimates.

Philippines

Jun Trinidad
Manila

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	Upbeat exports, higher non-interest fiscal spending and more conversion of remittances combined to shore up domestic consumption in 2Q06 and assure at least 5% yoy quarterly growth. Real peso remittances headed back to the double-digit range during the pre-school season coincident with the peso's weakness and decelerating inflation. No substantial change is expected for real investment with public investment activity held down by non-approval of the 2006 budget, unchanged capacity utilization rates and foreign investor appetite checked by US Fed rate uncertainty during the quarter. In 3Q06, we expect higher oil prices, lackluster fiscal spending and weak investments to weigh down on prospects
External Sector	We upgraded our 2006 current account surplus estimate to 3.4% of GDP. The improvement was conditioned on a lower trade gap, as we raised export growth to 12% and imports to 8.5% yoy. The surplus, lower external drain and modest portfolio inflows would likely enable USD reserves to end the year at US$20.8bn
Inflation	Second half inflation risks remain high with recent wage adjustments and renewed oil price pressure. Without fiscal subsidies, discretionary spending would be affected as consumers focus on essentials and turn more price-conscious. New inflationary risk spawned by high oil prices in 3Q06 would likely be offset by a slower pace of consumption
Fiscal Policy	The 2Q06 surplus and likelihood of a re-enacted 2005 budget compelled us to upgrade our fiscal deficit forecast to 1.6% of GDP in 2006 from the previous 2% ratio to GDP. Fiscal tightening appears evident in 2Q06 likely to result in weaker public investments—a drag to near term growth
Monetary Policy	BSP continues to sound off a balance of risks for future inflation skewed to the upside despite sharp improvements in 2Q06 inflation. While financial conditions have not been relaxed, abundant liquidity had been sterilized and parked in BSP's short-term facilities. We believe lower discretionary spending would be more of an offset to a new bout of inflation risks, easing the potential for policy rate adjustments
Other (eg Political) Developments	Political noise may have intensified, but with hardly any direct effect on fiscal reform progress. The recent capture of young military coup plotters strengthened President Arroyo's political position
Issues to Watch/Key Risks	Forthcoming major legal/political issues are the anti-graft court's decision on the plunder case of former President Estrada before the year is over and the Supreme Court's decision on charter change

Figure 91. Key Economic Indicators and Forecasts

	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
Real Sector									
Real GDP (% YoY)	3.4	6.0	1.8	4.4	4.9	6.2	5.0	5.1	5.3
Domestic Demand (% YoY)	1.9	7.0	-0.8	3.1	4.8	4.7	3.2	4.7	5.2
Real Consumption: Private (% YoY)	2.6	3.5	3.6	4.1	5.3	5.8	4.9	5.2	5.3
Real Gross Capital Formation (% YoY)	-2.3	19.9	-13.0	2.1	3.8	1.3	-3.9	0.8	3.9
GDP (US$ Bils.)	76	76	71	77	80	87	98	118	137
GDP Per Capita (US$)	989	985	906	956	972	1,037	1,153	1,345	1,532
Unemployment Rate (%)	9.9	11.7	10.9	11.5	11.5	11.9	11.0	11.0	10.5
External Sector									
Exports (US$, % YoY)	18.8	9.1	-16.2	9.9	2.7	9.8	3.7	12.0	7.5
Imports (US$, % YoY)	4.1	7.7	-13.3	6.3	3.1	8.0	7.4	8.5	6.8
Trade Balance (US$ Bils.)	-6.0	-6.0	-6.3	-5.5	-5.9	-5.7	-7.5	-6.8	-6.9
Current Account (% of GDP)	9.5	8.2	1.9	5.7	1.8	2.4	2.4	3.4	3.4
International Reserves ex. Gold (US$ Bils.)	13.1	13.0	13.4	13.2	13.5	13.0	15.8	17.2	18.5
Currency/USD (Period Average)	39.1	44.2	51.0	51.6	54.2	56.0	55.1	51.9	50.2
Other									
91-Day T-Bill (Period Average, %)	10.0	9.9	9.7	5.5	5.4	7.3	6.1	7.0	4.8
5-Year T-Bond (Period Average, %)			14.7	11.7	10.8	11.7	10.6	9.0	1.5
Consumer Prices (% YoY)	6.7	4.3	6.1	2.5	3.5	6.0	7.6	7.0	6.3
Fiscal Balance (% of GDP)	-3.8	-4.0	-4.0	-5.3	-4.6	-3.8	-2.7	-1.6	-1.2

Source: CEIC Data Company Limited and Citigroup estimates.

Philippines Pictorial

Figure 92. YTD remittance growth is higher than our full-year forecast (10.5%), driven by seasonal factors and a weak peso

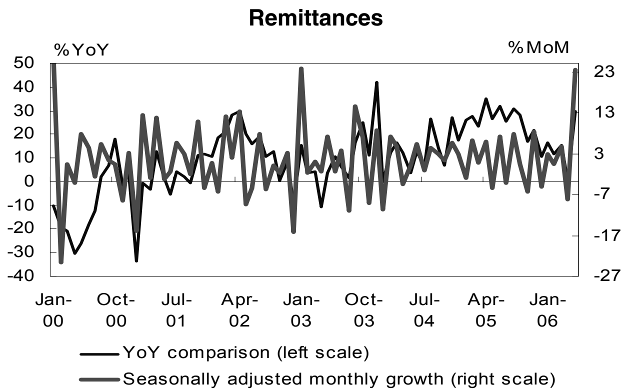


Figure 93. We anticipate a less buoyant export outlook in 2H06 consistent with a slower economic outlook in the Philippines' trading partners

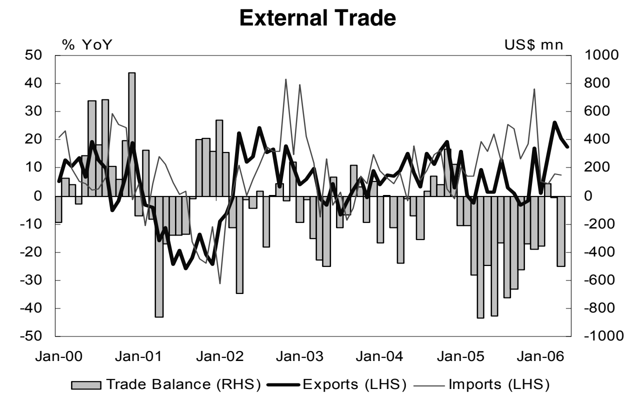


Figure 94. We upgraded our current account estimate to 3.4% of GDP from the previous 2% on strong remittances and exports

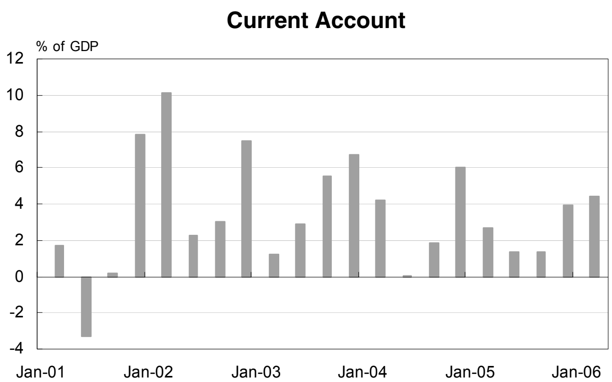


Figure 95. Another fiscal surplus in June highlighted fiscal tightening in 2Q06. We upgraded our surplus forecast to 1.7% of GDP

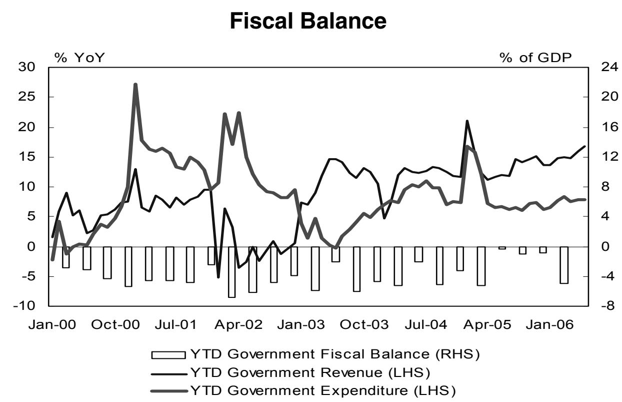


Figure 96. Decelerating inflation trend likely to continue into 2H06

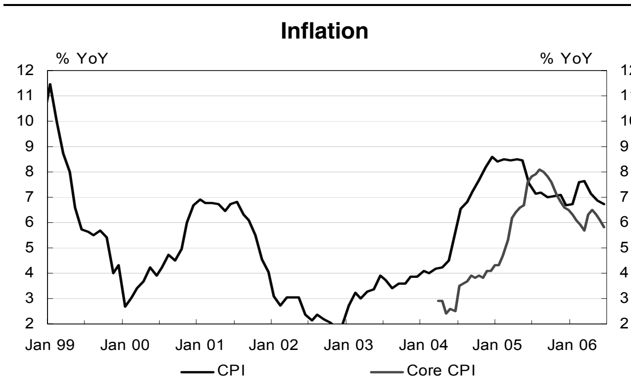
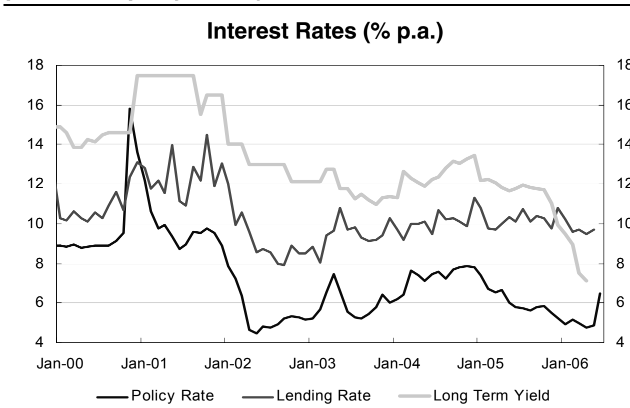


Figure 97. Lower discretionary spending likely help ease the potential for policy rate adjustments



Source: CEIC Data Company Limited, www. Treasury.gov.ph, Citigroup estimates.

Singapore

Moh Siong Sim
Singapore

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	The economy downshifted in 2Q06 to below trend-like growth in qoq saar terms on the back of cooling manufacturing output that likely reflects the lull in tech production (not helped by lower pharmaceutical output) and softer services output caused by slowing intra-regional trade activity. An increase in the June PMI should not be seen as a sign of a renewed pickup in manufacturing momentum given conflicting signals from the less-than-flattering dip in the tech gauge
External Sector	Softness in June tech exports hints of a lull in global tech demand although overall non-oil domestic exports were well supported by the pharmaceutical and petrochemical sectors, mitigating the risk that the modest GDP downshift will spiral into a protracted slowdown
Inflation	Notwithstanding the pass-through from rising oil prices such as a scheduled electricity tariff hike in 3Q06 and dearer taxi fares, well-behaved domestic inflation along with a stronger trade-weighted Singapore dollar should help keep overall inflation under control
Fiscal Policy	Having already implemented measures in past budgets to make the Singapore economy more competitive, the focus is increasingly turning to containing the side effects of globalization. A key emphasis of the 2006 budget is to limit the risk of social fallout from globalization. The authorities announced a S$2.6bn Progress Package that is skewed to benefit lower-income groups
Monetary Policy	Given favorable inflation developments, MAS will likely continue to keep its gradual trade-weighted SGD appreciation stance intact and steadfastly resist excessive currency strength to avoid hurting export competitiveness
Other (eg Political) Developments	Singapore's pact with Indonesia to jointly develop Special Economic Zones (SEZ) in Batam and Bintan has the potential to transform into win-win cooperation. A successful take-off of the SEZs could encourage further relocation of manufacturing production away from Singapore to Indonesia, but Singapore's financial, logistical and other services stand to benefit over the medium term given the SEZs proximity to Singapore
Issues to Watch/Key Risks	(1) Gradually increasing domestic demand resilience reduces Singapore's vulnerability to external demand; (2) improving bilateral ties with Malaysia; and (3) domestic demand resilience and upside inflation risk trigger a more hawkish MAS

Figure 98. Key Economic Indicators and Forecasts

	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
Real Sector									
Real GDP (% YoY)	7.2	10.0	-2.3	4.0	2.9	8.7	6.4	6.5	4.5
Domestic Demand (% YoY)	3.1	13.4	1.7	-0.6	-0.6	6.2	1.6	4.9	4.9
Real Consumption: Private (% YoY)	9.1	14.9	4.7	4.9	0.9	5.9	2.5	5.0	4.3
Real Gross Fixed Capital Formation (% YoY)	-4.9	9.8	-3.9	-11.4	-3.2	10.2	-1.9	5.6	7.3
GDP (US$ Bils.)	83	93	86	88	93	107	117	132	147
GDP Per Capita (USD)	20,909	23,077	20,724	21,209	22,156	25,351	26,833	29,941	32,923
Unemployment Rate (%)	2.8	2.7	2.7	3.6	4.0	3.4	3.2	2.8	2.5
Industrial Growth (% YoY)	10.8	15.2	-11.6	8.5	3.0	13.9	9.2	8.0	8.5
External Sector									
Exports (US$, % YoY)	4.4	20.2	-11.7	2.8	16.9	25.0	25.5	18.0	15.0
Imports (US$, % YoY)	9.3	21.1	-13.8	0.4	12.0	26.9	20.8	19.3	16.5
Trade Balance (US$ Bils.)	3.6	3.3	5.8	8.7	15.9	17.4	29.6	32.3	33.6
Current Account (% of GDP)	17.4	11.6	13.8	13.4	24.1	24.5	28.5	24.6	22.7
International Reserves ex. Gold (US$ Bils.)	77.2	80.4	75.8	82.3	96.3	112.8	116.6	132.0	136.0
Currency/USD (Period Average)	1.70	1.72	1.79	1.79	1.74	1.69	1.66	1.59	1.52
Other									
3M Interbank Rate (Period Average, %)	2.1	2.6	2.0	0.9	0.7	1.0	2.2	3.5	3.5
10-year SGS Yield (Period Average, %)	4.5	4.4	3.6	3.5	2.9	3.2	2.9	3.5	3.4
Consumer Prices (% YoY)	0.0	1.3	1.0	-0.4	0.5	1.7	0.5	1.7	1.7
Fiscal Balance (% of GDP)	11.7	10.0	-1.5	-0.5	6.8	6.4	8.5	8.0	6.5

Source: CEIC Data Company Limited and Citigroup estimates.

Singapore Pictorial

Figure 99. Export performance steady, but split hints of softness in tech exports

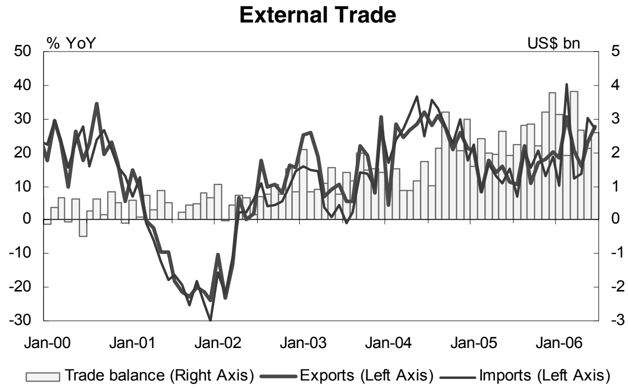


Figure 100. Aside from a mild snapback in pharmaceuticals, industrial production tells of moderating momentum

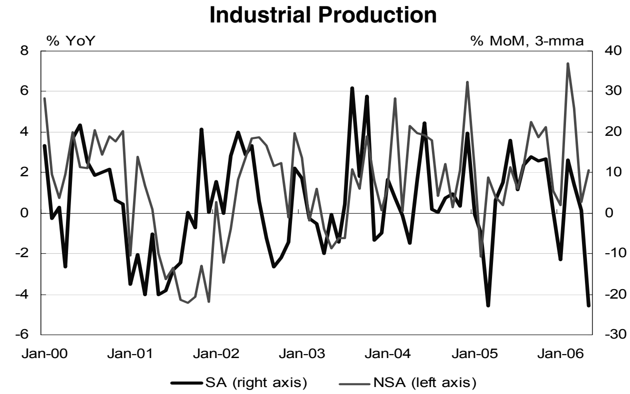


Figure 101. Well-behaved inflation from contained labor costs will likely continue to help offset the pass-through from high oil prices

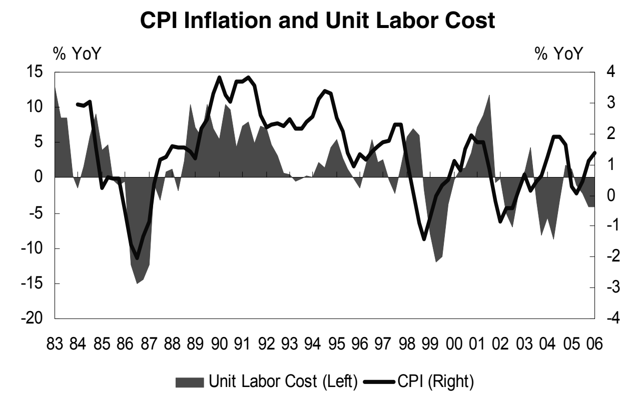


Figure 102. An increase in PMI should not be seen as a sign of renewed manufacturing momentum given conflicting signals

Figure 103. Signs of softening growth likely will reinforce policy caution against excessive trade-weighted SGD strength

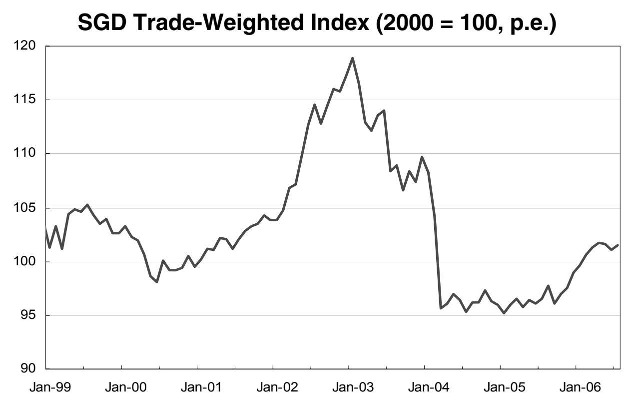
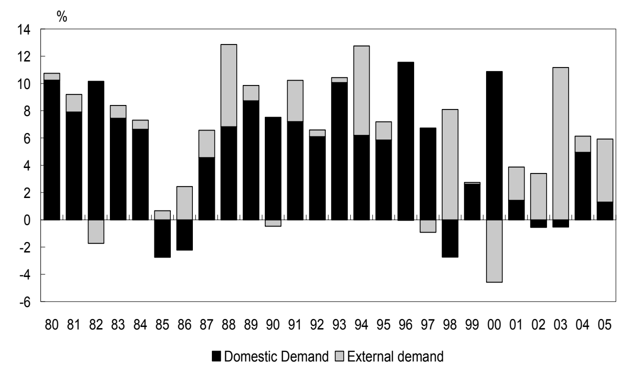


Figure 104. If exports moderate, domestic demand will probably not be enough to keep the economy in an accelerating mode



Source: Bloomberg, CEIC Data Company Limited, Datastream, MAS, Ministry of Trade and Industry, Reuters, Singapore Institute of Purchasing and Materials Management, Citigroup.

Taiwan

Cheng-Mount Cheng
Renee Chen
Taipei

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	Growth in the 2Q was resilient despite an equity market correction. Better-than-expected external demand continued to underpin the economy, while domestic demand was still weak. Market concern about the short-term global tech outlook would likely lead to a mild moderation in 3Q06 growth. Nonetheless, we maintain our GDP forecast of 4.0% in 2006 and 4.5% in 2007
External Sector	The buoyant export expansion continued in June and was more robust than we had expected in 2Q06. Imports were on a high note on rising prices of commodities and energy and less decline in capital equipment imports. The trade surplus remained relatively large, up 107.2% yoy in 2Q06. In coming months, we expect export momentum to likely slow down but remain at a healthy pace
Inflation	A recent increase in the price of gasoline, natural gas and electricity, and higher vegetable prices due to flood damage led a mild acceleration in CPI in June. In 1H06, headline CPI increased 1.4% yoy, while core CPI gained only 0.6% yoy. We see slight upside inflationary risks mainly from high oil and commodity prices
Fiscal Policy	The legislature passed some of the central government's budget in an extraordinary session, but the overall fiscal stance remains neutral for this year. In 1H06, tax collection increased 2.5% yoy. We continue to expect a neutral fiscal policy in coming years
Monetary Policy	We expect one more CBC rate hike by 12.5bps in 3Q06 and further hikes if necessary, as global rate tightening continues. Continued auctions of one-year NCDs showed the CBC's determination to support long-term interest rates and to maintain a positively sloped yield curve
Other (eg Political) Developments	Cross-strait relations remained stable. After opposition parties failed to recall President Chen, we see diminishing downside risk coming from domestic politics. Despite President Chen remaining in position, he is likely to continue to face pressure to step down. We think he is less likely to take further provocative moves
Issues to Watch/Key Risks	(1) Development of cross-strait relations and domestic politics; (2) oil prices; (3) high-tech cyclical turns; (3) bird flu; (4) potential spillover effect from hikes in utility fees and rising import/production costs; (5) potential financial retrenchment of households due to tightening of bank (credit/cash card) credit extension, lingering cash/credit card debt problems and consumer credit tightening; and (5) sharp capital movements and associated FX fluctuations

Figure 105. Key Economic Indicators and Forecasts

	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
Real Sector									
Real GDP (% YoY)	5.7	5.8	-2.2	4.2	3.4	6.1	4.1	4.0	4.5
Domestic Demand (% YoY)	3.3	5.0	-4.3	1.7	0.5	5.9	2.1	2.2	3.6
Real Consumption: Private (% YoY)	5.5	4.6	0.7	2.3	0.9	3.9	3.0	2.6	3.3
Real Gross Capital Formation (% YoY)	2.9	9.0	-19.9	-0.6	-0.9	17.5	0.5	2.2	6.4
GDP (US$ Bils.)	299	321	292	295	300	322	346	360	390
GDP Per Capita (US$)	13,609	14,519	13,093	13,163	13,327	14,271	15,271	15,766	16,991
Unemployment Rate (%)	2.9	3.0	4.6	5.2	5.0	4.4	4.1	4.0	4.0
Industrial Output (% YoY)	7.4	6.9	-7.8	7.9	7.1	9.8	4.1	5.2	4.5
External Sector									
Exports (US$, % YoY)	9.9	22.8	-16.9	7.1	11.3	21.1	8.8	9.1	9.3
Imports (US$, % YoY)	5.7	26.6	-23.3	4.9	13.0	31.8	8.2	10.3	9.7
Trade Balance (US$ Bils.)	12.5	11.2	18.3	22.1	22.6	13.6	15.8	15.1	15.6
Current Account (% of GDP)	2.8	2.8	6.3	8.7	9.8	5.7	4.7	5.0	5.2
International Reserves ex. Gold (US$ Bils.)	106.2	106.7	122.2	161.7	206.6	241.7	253.3	263.0	275.0
Currency/USD (Period Average)	32.3	31.2	33.8	34.6	34.4	33.4	32.2	32.2	31.2
Other									
Money-market 90-day (Period Average)	4.8	4.7	3.6	2.0	1.1	1.0	1.3	1.6	1.6
10-Year Government Bond (Period Average, %)	5.8	5.6	4.0	3.5	2.2	2.7	2.1	2.1	2.4
Consumer Prices (% YoY)	0.2	1.3	0.0	-0.2	-0.3	1.6	2.3	2.0	1.8
Fiscal Balance (% of GDP)	-5.7	-4.5	-6.4	-4.3	-2.8	-2.9	-2.4	-3.0	-3.2

Source: CEIC Data Company Limited and Citigroup estimates.

Taiwan Pictorial

Figure 106. Robust high-tech demand continued to underpin upbeat output and order expansion

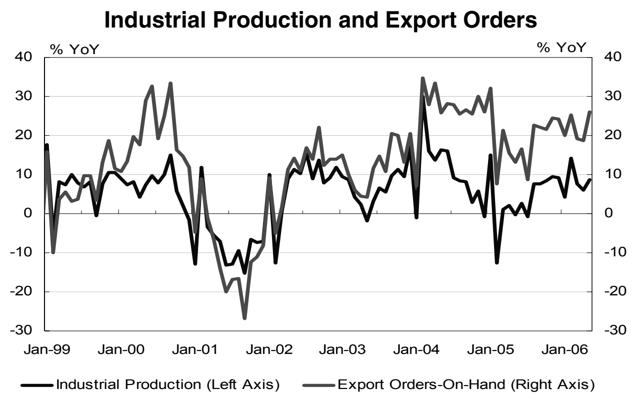


Figure 107. Buoyant exports and a relatively large trade surplus should continue to underpin growth

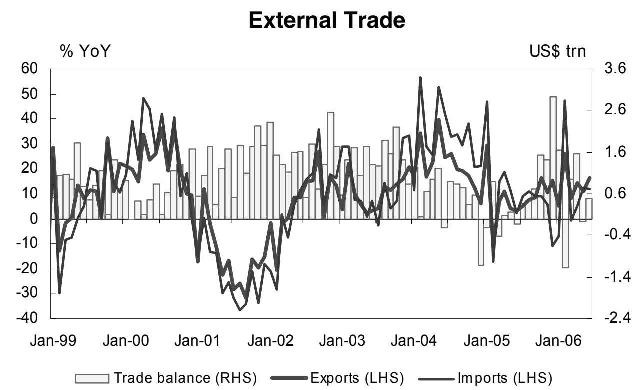


Figure 108. Strong momentum in real sector activity lifted the leading indicators, signaling a moderate economic expansion ahead

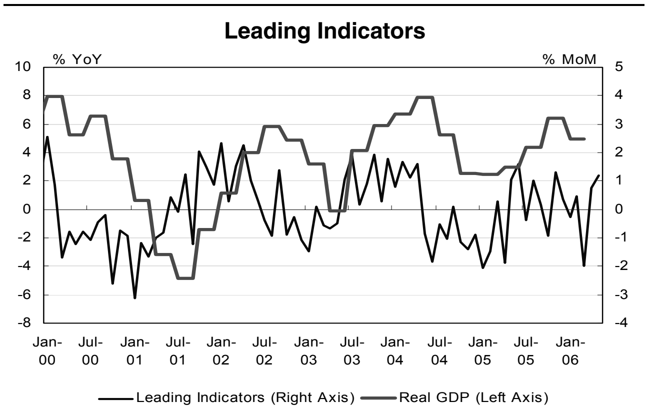


Figure 109. Contained price pressure, but upside risks with rising WPI inflation and potential spillover from the electricity fare hike

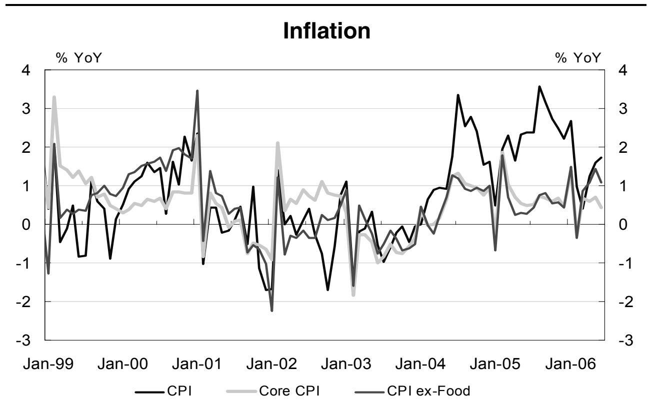


Figure 110. Limited labor cost pressure and tepid consumer demand suggest a measured pace of policy tightening

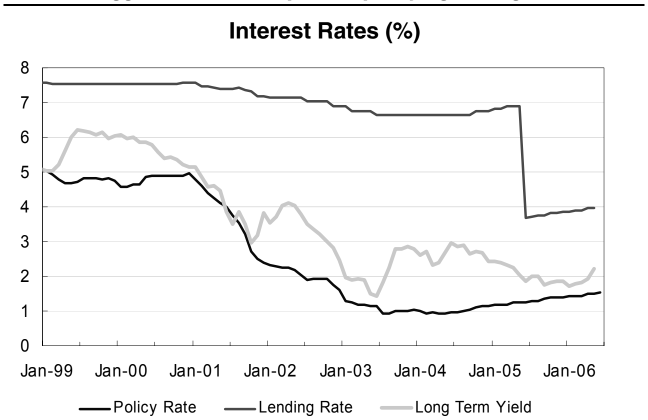
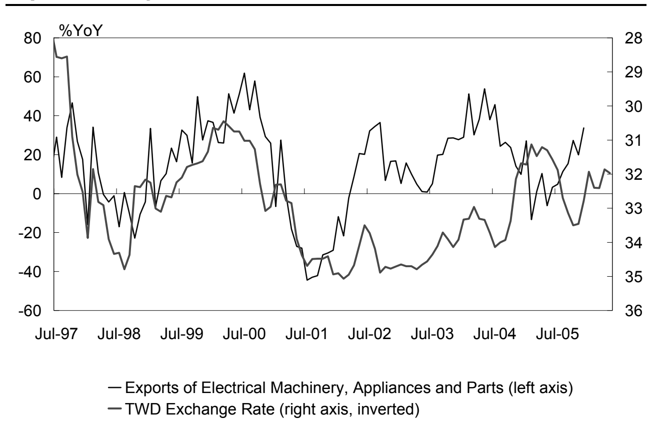


Figure 111. Recent TWD strength since 4Q06 led by the tech export recovery



Source: CEIC Data Company limited, CBC, CEPD, DGBAS, MOF and Citigroup calculations.

Thailand

Jun Trinidad
Manila

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	Buoyant export volume growth sustained in 2Q06 and private consumption gains may not be enough to check the downslide of GDP in 2Q06. We think GDP growth in a range of 4.8%-5% in 2Q06 is attainable, down from 6% yoy in 1Q06. New oil price shocks would pose a serious threat to consumer demand rather than future inflation risk. We rule out a consumption recovery in 4Q06 if we see another round of oil price shocks
External Sector	Upbeat exports in April and May were matched by decelerating imports, consistent with domestic demand. Despite a hefty trade deficit in May, the threat of a large current account deficit is unlikely given unexciting imports of capital goods. The unresolved political situation dulled real investment with delays in mega project implementation. Nonetheless, portfolio investment recovered soon after a reduction in the heightened EM-risk in May, enabling gross international reserves to resume posting a high of US$58bn as of end-June
Inflation	We expect lower inflation risk in 2H06 although the downturn in core inflation would probably be at a much slower pace than headline. While an unexciting domestic demand setting would ensure that the pass-through of high oil prices is restrained, higher oil prices in the near term may derail core from heading down. We estimate the average pass-through to core from high oil prices would exceed that from the exchange rate
Fiscal Policy	The lack of an elected cabinet and with elections scheduled sometime 4Q06 practically ensure indefinite postponement of about Bt1.7trn of public investment projects that could have provided a strong lift to near-term growth while supporting the creation of more jobs. We believe the risk of the fiscal deficit falling below our forecast of 1.4% of GDP this year looms large on the horizon. The absence of the mega projects ensures GDP growth in line with our forecast of 4.7% although government forecasts seem to range lower at 4.5%
Monetary Policy	Slower economic pace flag lower 2H inflation risks that would trigger a shift to a neutral monetary policy bias. This policy shift was formalized in the latest MPC meeting that left the policy rate unchanged at 5%. While we see looming risk of higher oil prices in 3Q06, we believe that lower discretionary consumer spending would bear the brunt of future higher energy prices and ease the risk of resuming policy rate tightening
Other (eg Political) Developments	There is a risk of the TRT and other political parties being disbanded by the courts. We think this could only prolong the political agony and risks further eroding of a fiscal catalyst for near-term growth
Issues to Watch/Key Risks	A reorganization of the electoral tribunal would be a key first step toward a firm election schedule and credible election outcome

Figure 112. Key Economic Indicators and Forecasts

	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
Real Sector									
Real GDP (% YoY)	4.4	4.8	2.2	5.3	7.0	6.2	4.5	4.7	4.9
Domestic Demand (% YoY)	2.3	5.0	3.2	5.2	7.3	7.7	7.0	4.6	5.0
Real Consumption: Private (% YoY)	4.3	5.2	4.1	5.4	6.4	5.9	4.4	4.4	4.5
Real Gross Capital Formation (% YoY)	-3.2	5.5	1.1	6.5	12.1	13.8	11.3	5.0	7.5
GDP (US$ Bils.)	123	123	116	127	143	162	177	209	239
GDP Per Capita (US$)	1,985	1,965	1,835	1,999	2,234	2,484	2,711	3,096	3,499
Industrial Growth (% YoY)	12.4	6.7	2.7	9.1	13.9	11.4	9.3	5.5	4.5
External Sector									
Exports (US$, % YoY)	7.4	19.5	-7.1	4.8	18.2	21.6	15.0	11.0	10.3
Imports (US$, % YoY)	16.9	31.3	-3.0	4.6	17.4	25.7	26.0	12.0	10.0
Trade Balance (US$ Bils.)	9.3	5.5	2.5	2.7	3.8	1.5	-8.6	-10.7	-11.4
Current Account (% of GDP)	10.2	7.6	5.4	5.5	5.6	4.2	-2.1	-1.6	-0.1
International Reserves ex. Gold (US$ bn)	34.1	32.0	32.3	38.1	41.1	48.7	50.7	54.0	55.0
Currency/USD (Period Average)	37.8	40.1	44.4	43.0	41.5	40.2	40.2	38.2	36.8
Other									
3M Interbank Rate (Period Average, %)	5.00	3.90	3.04	2.17	1.56	1.59	3.23	5.19	4.75
10 Year Government Bond (Period Average, %)		6.51	5.82	5.06	3.76	5.06	5.01	5.82	5.75
Consumer Prices (% YoY)	0.2	1.6	1.7	0.6	1.8	2.8	4.5	5.2	4.6
Fiscal Balance (% of GDP, FY)	-2.9	-2.4	-2.1	-2.4	0.4	0.3	-0.3	-1.4	-2.0

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

Thailand Pictorial

Figure 113. A buoyant external trade account implies that the net export contribution to real GDP will persist in 2Q06

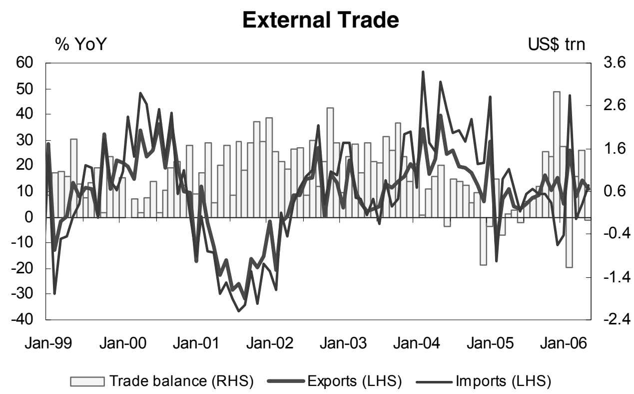


Figure 114. A huge trade deficit coinciding with profit and dividend repatriations led to a hefty current account deficit

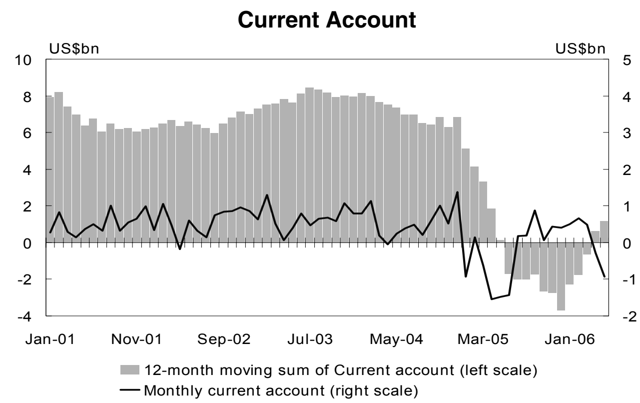


Figure 115. Manufacturing production was firm due to export strength and improving consumer demand

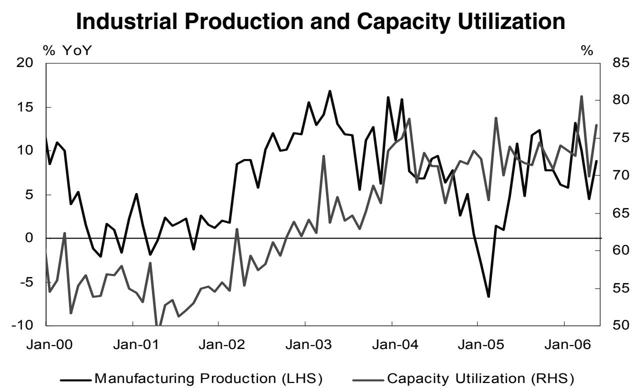


Figure 116. The demand for cash balances may have risen with political uncertainty that sustained double-digit M2 growth

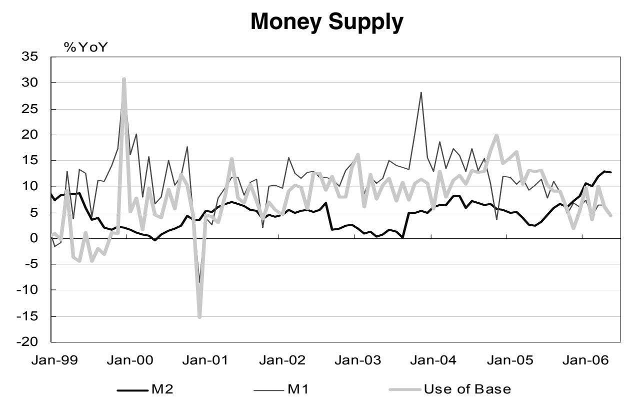


Figure 117. Core inflation was steady, but we see oil prices as a residual inflation risk in 2H06, though the pass-through effect is likely to be limited

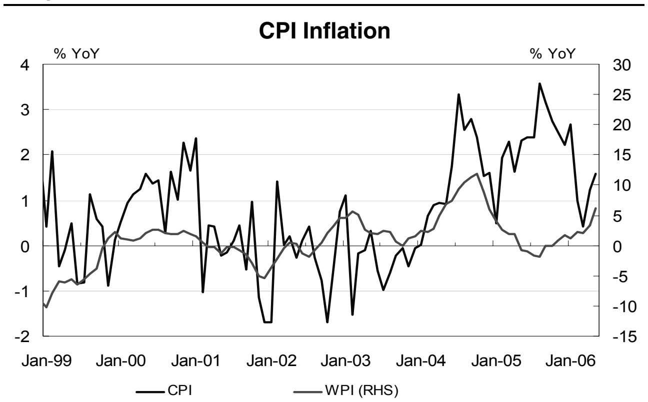
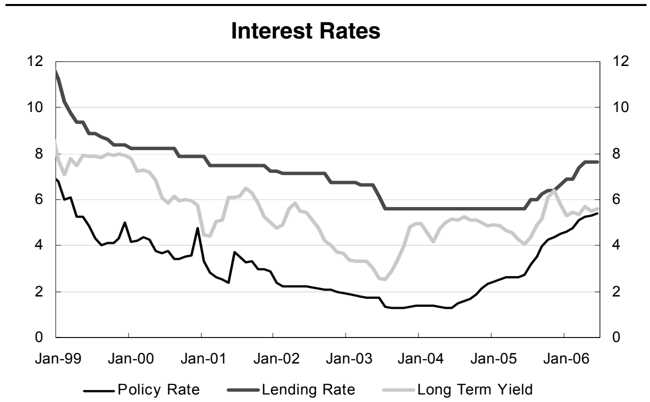


Figure 118. The MPC kept the policy rate unchanged, which formalizes a shift to a neutral policy bias



Source: CEIC Data Company Limited, BOT and Citigroup.

Vietnam

Moh Siong Sim
Singapore

Direction of Change in Views Since Last Month

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

Note: (+) implies rise since last write-up. (–) implies a fall. (•) implies no change.
Source: Citigroup estimates.

Recent Economic Developments and Prospects

Real Sector	We are nudging down our 2006 GDP forecast to 7.3% from 8.0% while maintaining our 2007 projection at 8%. Despite the tempering of 2006 GDP forecast, we continue to expect strong medium-term growth prospects for Vietnam on the back of structural reforms made to secure WTO entry. The downgrade was made mainly in response to the soft GDP outcome in 1Q06 but momentum appeared to have revved up anew in 2Q06, as the Vietnamese economy overcomes the earlier sluggishness that was partly caused by labor strikes and weather-related setback in agriculture output
External Sector	Renewed pickup in machinery and steel imports suggests strengthening investment growth, perhaps tied to infrastructure spending and the growing FDI. Vietnam's improving external position is underlined by the increase of external reserves to US$9.1bn in Jan 2006, up US$2.1bn since end-2004
Inflation	Pass-through from elevated global oil prices, especially into non-food prices, prevented inflation from easing. CPI inflation, at 7.6% yoy in June, has been stuck in the 7-8% range for the fourth consecutive month after moderating from 8.8% in Dec 2005
Fiscal Policy	Strong growth in oil-related revenue should help offset upward pressure on expenditures from fuel subsidies and increases in the minimum salary for state workers. The budget deficit as a share of GDP is likely to remain manageable in 2006
Monetary Policy	We expect the Vietnamese dong (VND) to remain broadly stable against the US dollar. The authorities, in a trial that will last for six months, have allowed Eximbank to set a more market-driven USD/VND rate for transaction on a cash basis. Domestic interest rates are likely to modestly follow the upward march in US interest rates, with the US Fed expected to hike by one last round of 25bps in August
Other (eg Political) Developments	Recent appointment of a younger generation of pro-reform leaders such as Nguyen Minh Triet as the president and Nguyen Tan Dung as the prime minister should not result in any major shifts in policy, with the focus likely to remain one of gradual economic (but not political) liberalization
Issues to Watch/Key Risks	(1) WTO entry by 2006 reinforces reform drive; (2) inflation subsides on a mix of monetary tightening and easing supply-side pressure; and (3) an improving external payment position limits depreciation pressure on the Vietnamese dong

Figure 119. Key Economic Indicators and Forecasts

	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
National Account									
Real GDP (% YoY)	4.8	6.8	6.9	7.1	7.3	7.8	8.4	7.3	8.0
Real Consumption, Private (% YoY)	2.6	3.1	4.5	7.6	8.0	7.1	7.8	7.2	7.7
Government Spending (% YoY)	-5.7	5.0	6.6	5.4	7.2	7.8	5.9	6.0	6.0
Gross Fixed Investment (% YoY)	1.6	10.2	10.7	12.9	11.9	10.4	11.0	11.0	13.0
External Sector									
Export (% YoY)	23.3	25.5	3.8	11.2	20.6	31.5	21.6	20.0	17.0
Import (% YoY)	2.1	33.2	3.7	21.8	27.9	26.5	15.4	18.5	15.9
Trade Balance (US$ Bils.)	-0.2	-1.2	-1.2	-3.0	-5.1	-5.4	-4.6	-5.0	-5.4
Current Account Balance (% GDP)	4.5	2.1	2.1	-1.2	-4.7	-4.3	-2.6	-2.9	-2.8
External Debt (% of GDP)	41	40	37	39	37	33	31	28	26
International Reserves ex. Gold (US$ bn)	3.3	3.4	3.7	4.1	6.2	7.0	9.0	10.5	12.0
Exchange Rate (Dong/US$, Period Average)	13927	14174	14808	15270	15513	15732	15855	15973	16075
Other									
3-Month Interbank Rate (Period Average, %)					7.2	7.0	7.6	8.1	8.3
Consumer Prices (% YoY)	4.3	-1.6	-0.3	3.9	3.1	7.8	8.3	7.5	6.0
Fiscal Balance (% of GDP)	-4.4	-2.8	-2.5	-2.4	-2.0	-1.6	-2.0	-2.5	-2.5

Source: CEIC Data Company Limited and Citigroup estimates.

Vietnam Pictorial

Figure 120. Despite our lowered 2006 GDP forecast, we continue to expect strong medium-term growth prospects

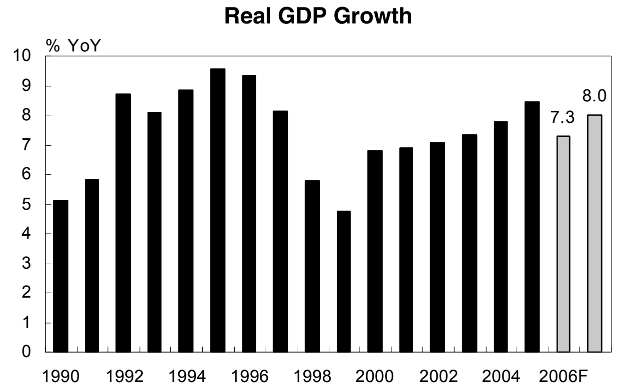


Figure 121. Retail sales have been firm since the beginning of 2006

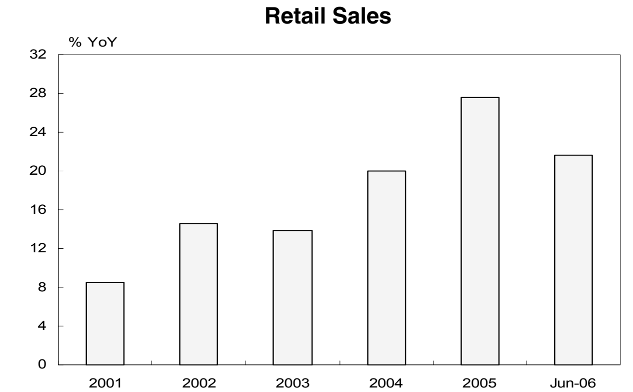


Figure 122. Pass-through from elevated global oil prices, especially into non-food prices, prevented inflation from easing

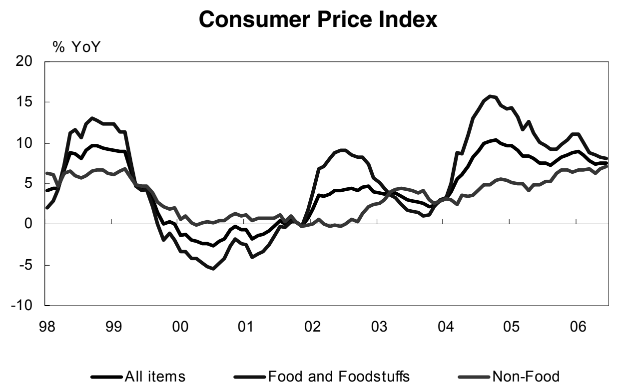


Figure 123. New data suggest that credit growth has eased, which should help contain medium-term inflation risk

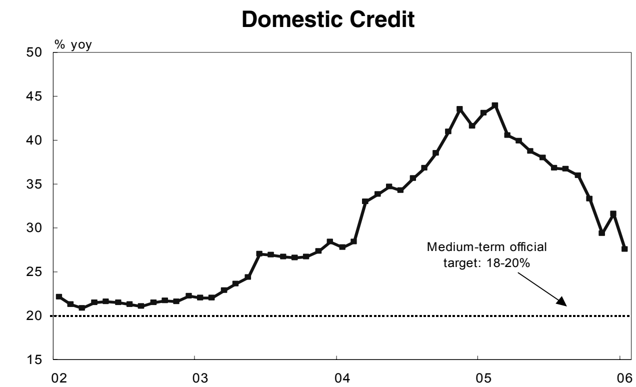


Figure 124. Renewed pickup in machinery and steel imports suggests strengthening investment growth

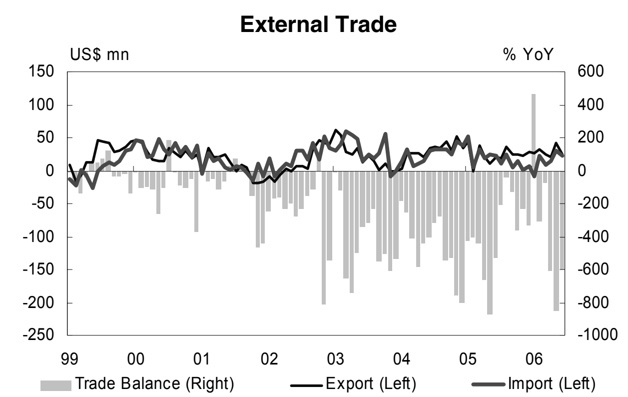
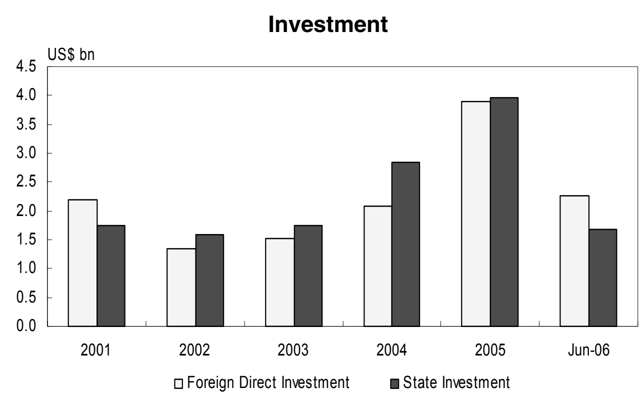


Figure 125. WTO accession could spur improvements in the business environment, which should reinforce an increasingly positive FDI trend



Source: General Statistics Office of Vietnam, CEIC Data Company Limited and Citigroup.

Notes

Disclosure Appendix

ANALYST CERTIFICATION

This report contains equity strategy, foreign exchange strategy and emerging markets analysis. Each of the individuals responsible for those sections hereby certifies that, with respect to the material contributed by him/her, all of the views expressed in this report accurately reflect his/her personal views about any and all of the subject securities, issuers, currencies, strategies, or emerging markets. Further, each of these individuals also certifies that no part of his/her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

Other Disclosures

ADDITIONAL INFORMATION AVAILABLE UPON REQUEST

Citigroup Global Markets Inc, including its parent, subsidiaries and/or affiliates ("CGMI"), may make a market in the securities discussed in this report and may sell to or buy from customers, as principal, securities recommended in this report. CGMI may have a position in securities or options of any issuer recommended in this report. An employee of CGMI may be a director of an issuer recommended in this report. CGMI may perform or solicit investment banking or other services from any issuer recommended in this report.

Within the past three years, CGMI may have acted as manager or co-manager of a public offering of the securities of any issuer recommended in this report. Securities recommended, offered, or sold by CGMI : (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested.

Investing in non-U.S. securities entails, including ADR's, certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of, the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations.

Although information has been obtained from and is based upon sources CGMI believes to be reliable, we do not guarantee its accuracy and it may be incomplete or condensed. All opinions and estimates constitute CGMI 's judgement as of the date of the report and are subject to change without notice. This report is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security.

Investing in non-US securities by US persons may entail certain risks. Investors who have received this report from CGMI may be prohibited in certain US States from purchasing securities mentioned in this report from CGMI ; please ask your Financial Consultant for additional details.

This report is distributed in the United Kingdom by Citigroup Global Markets Limited , Citigroup Centre, Canada Square, Canary Wharf, London E14 5LB, UK. This material is directed exclusively at market professional and institutional investor customers and is not for distribution to private customers, as defined by the rules of the Financial Services Authority, who should not rely on this material. Moreover, any investment or service to which the material may relate will not be made available to such private customers. This material may relate to investments or services of a person outside of the United Kingdom or to other matters which are not regulated by the Financial Services Authority and further details as to where this may be the case are available upon request in respect of this material. If this publication is being made available in certain provinces of Canada by Citigroup Global Markets (Canada) Inc. ("CGMI Canada"), CGMI Canada has approved this publication. If this report was prepared by CGMI (excluding Nikko Citigroup Limited) and distributed in Japan by Nikko Citigroup Limited, it is being so distributed under license. This report is made available in Australia, to non retail clients through Citigroup Global Markets Australia Pty Limited (ABN 64 003 114 832), and to retail clients through Smith Barney Citigroup Australia Pty Ltd (ABN 10 009 145 555), Licensed Securities Dealers In New Zealand it is made available through Citigroup Global Markets New Zealand Limited, a member firm of the New Zealand Stock Exchange. This report does not take into account the investment objectives, financial situation or particular needs of any particular person. Investors should obtain advice based on their own individual circumstances before making an investment decision. Citigroup Global Markets (Pty) Limited is incorporated in the Republic of South Africa (company registration number 2000/025866/07) and its registered office is at Citibank Plaza, 145 West Street , Sandown, Sandton, 2196, Republic of South Africa. The investments and services contained herein are not available to private customers in South Africa. This publication is made available in Singapore through Citigroup Global Markets Singapore Pte. Ltd., a Capital Markets Services Licence holder. This report is being distributed in Hong Kong by or on behalf of, and is attributable to Citigroup Global Markets Asia Limited, 50th Floor, Citibank Plaza, 3 Garden Road, Central, Hong Kong.

Korea Electric Power Company (015760.KS)

Ratings and Target Price History - Fundamental Research

Analyst: Sameer Kakakhel, CFA

#	Date	Rating	Target Price	Closing Price
1:	13 Aug 03	*2L	*21,500.00	18,550.00
2:	12 Sep 03	Stock rating system changed		
3:	12 Sep 03	*2L	*21,500.00	NA
4:	9 Jul 04	*2M	21,500.00	19,400.00
5:	17 Nov 04	2M	*27,000.00	24,750.00
6:	19 Aug 05	*3M	*30,500.00	32,450.00
7:	7 Dec 05	3M	*33,000.00	35,450.00
8:	14 May 06	3M	*37,000.00	41,850.00

*Indicates change.

Samsung Electronics (005930.KS)

Ratings and Target Price History - Fundamental Research

Analyst: Jay Choi (covered since March 1 2005)

#	Date	Rating	Target Price	Closing Price
1:	12 Sep 03	*1L	525,000.00	NA
2:	16 Jan 04	1L	*564,000.00	506,000.00
3:	17 Feb 04	1L	*650,000.00	560,000.00
4:	13 Apr 04	1L	*744,000.00	616,000.00
5:	17 May 04	1L	*592,000.00	458,000.00
6:	19 Jul 04	1L	*515,000.00	426,500.00
7:	15 Sep 04	*2L	515,000.00	478,000.00
8:	18 Oct 04	2L	*468,000.00	432,500.00
9:	4 Jan 05	2L	*464,000.00	447,000.00
10:	11 May 05	*1L	*610,000.00	472,000.00
11:	13 Sep 05	1L	*675,000.00	606,000.00
12:	2 Jan 06	1L	*780,000.00	659,000.00
13:	25 Jan 06	1L	*820,000.00	714,000.00
14:	29 May 06	1L	*800,000.00	622,000.00
15:	14 Jul 06	1L	*770,000.00	584,000.00

*Indicates change.

Customers of the Firm in the United States can receive independent, third-party research on the company or companies covered in this report, at no cost to them, where such research is available. Customers can access this independent research at http://www.smithbarney.com (for retail clients) or http://www.citigroupgeo.com (for institutional clients) or can call (866) 836-9542 to request a copy of this research.

Citigroup Global Markets Inc. or its affiliates beneficially owns 1% or more of any class of common equity securities of Korea Electric Power Company and Samsung Electronics. This position reflects information available as of the prior business day.

Citigroup Global Markets Inc. or its affiliates has received compensation for investment banking services provided within the past 12 months from Korea Electric Power Company.

Citigroup Global Markets Inc. or an affiliate received compensation for products and services other than investment banking services from Korea Electric Power Company and Samsung Electronics in the past 12 months.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as investment banking client(s): Korea Electric Power Company.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as clients, and the services provided were non-investment-banking, securities-related: Korea Electric Power Company and Samsung Electronics.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as clients, and the services provided were non-investment-banking, non-securities-related: Korea Electric Power Company and Samsung Electronics.

Citigroup Global Markets Inc. and/or its affiliates has a significant financial interest in relation to Korea Electric Power Company and Samsung Electronics. (For an explanation of the determination of significant financial interest, please refer to the policy for managing conflicts of interest which can be found at www.citigroupgeo.com.)

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability, which includes revenues from, among other business units, the Private Client Division, Institutional Equities, and Investment Banking.

For important disclosures regarding the companies that are the subject of this Citigroup Investment Research product ("the Product"), please contact Citigroup Investment Research, 388 Greenwich Street, 29th Floor, New York, NY, 10013, Attention: Legal/Compliance. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments, are contained on the Firm's disclosure website at www.citigroupgeo.com. Private Client Division clients should refer to www.smithbarney.com/research. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company.

Citigroup Investment Research Ratings Distribution

Data current as of 30 June 2006	Buy	Hold	Sell
Citigroup Investment Research Global Fundamental Coverage (2754)	46%	39%	15%
% of companies in each rating category that are investment banking clients	45%	43%	34%
South Korea -- Asia Pacific (43)	47%	28%	26%
% of companies in each rating category that are investment banking clients	30%	17%	36%
Citigroup Investment Research Quantitative World Radar Screen Model Coverage (5493)	31%	41%	29%
% of companies in each rating category that are investment banking clients	29%	26%	22%
Citigroup Investment Research Quantitative Decision Tree Model Coverage (337)	45%	0%	55%
% of companies in each rating category that are investment banking clients	44%	0%	43%
Citigroup Investment Research Quantitative European Value & Momentum Screen (565)	30%	40%	30%
% of companies in each rating category that are investment banking clients	39%	37%	36%
Citigroup Investment Research Asia Quantitative Radar Screen Model Coverage (1608)	20%	60%	20%
% of companies in each rating category that are investment banking clients	27%	18%	16%
Citigroup Investment Research Quant Emerging Markets Radar Screen Model Coverage (1256)	20%	60%	20%
% of companies in each rating category that are investment banking clients	24%	26%	26%
Citigroup Investment Research Australia Quantitative Top 100 Model Coverage (97)	30%	39%	31%
% of companies in each rating category that are investment banking clients	38%	39%	40%
Citigroup Investment Research Australia Quantitative Bottom 200 Model Coverage (157)	30%	39%	31%
% of companies in each rating category that are investment banking clients	9%	2%	6%
Citigroup Investment Research Australia Quantitative Scoring Stocks Model Coverage (10)	50%	0%	50%
% of companies in each rating category that are investment banking clients	20%	0%	20%

Guide to Fundamental Research Investment Ratings:
Citigroup Investment Research's stock recommendations include a risk rating and an investment rating.
Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).
Investment ratings are a function of Citigroup Investment Research's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.
For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings are: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).
Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

Between September 9, 2002, and September 12, 2003, Citigroup Investment Research's stock ratings were based upon expected performance over the following 12 to 18 months relative to the analyst's industry coverage universe at such time. An Outperform (1) rating indicated that we expected the stock to outperform the analyst's industry coverage universe over the coming 12-18 months. An In-line (2) rating indicated that we expected the stock to perform approximately in line with the analyst's coverage universe. An Underperform (3) rating indicated that we expected the stock to underperform the analyst's coverage universe. In emerging markets, the same ratings classifications were used, but the stocks were rated based upon expected performance relative to the primary market index in the region or country. Our complementary Risk rating system -- Low (L), Medium (M), High (H), and Speculative (S) -- took into account predictability of financial results and stock price volatility. Risk ratings for Asia Pacific were determined by a quantitative screen which classified stocks into the same four risk categories. In the major markets, our Industry rating system -- Overweight, Marketweight, and Underweight -- took into account each analyst's evaluation of their industry coverage as compared to the primary market index in their region over the following 12 to 18 months.

Guide to Quantitative Research Investment Ratings:
Citigroup Investment Research Quantitative Research World Radar Screen recommendations are based on a globally consistent framework to measure relative value and momentum for a large number of stocks across global developed and emerging markets. Relative value and momentum rankings are equally weighted to produce a global attractiveness score for each stock. The scores are then ranked and put into deciles. A stock with a decile rating of 1 denotes an attractiveness score in the top 10% of the universe (most attractive). A stock with a decile rating of 10 denotes an attractiveness score in the bottom 10% of the universe (least attractive).
Citigroup Investment Research Quantitative Decision Tree model recommendations are based on a predetermined set of factors to rate the relative attractiveness of stocks. These factors are detailed in the text of the report. Each month, the Decision Tree model forecasts whether stocks are attractive or unattractive relative to other stocks in the same sector (based on the Russell 1000 sector classifications).
Citigroup Investment Research Quantitative European Value & Momentum Screen recommendations are based on a European consistent framework to measure relative value and momentum for a large number of stocks across the European Market. Relative

value and momentum rankings are equally weighted to produce a European attractiveness score for each stock. The scores are then ranked and put into deciles. A stock with a decile rating of 1 denotes an attractiveness score in the top 10% of the universe (most attractive). A stock with a decile rating of 10 denotes an attractiveness score in the bottom 10% of the universe (least attractive).
Citigroup Investment Research Asia Quantitative Radar Screen and Emerging Markets Radar Screen model recommendations are based on a regionally consistent framework to measure relative value and momentum for a large number of stocks across regional developed and emerging markets. Relative value and momentum rankings are equally weighted to produce a global attractiveness score for each stock. The scores are then ranked and put into quintiles. A stock with a quintile rating of 1 denotes an attractiveness score in the top 20% of the universe (most attractive). A stock with a quintile rating of 5 denotes an attractiveness score in the bottom 20% of the universe (least attractive).
Citigroup Investment Research Quantitative Australian Stock Selection Screen rankings are based on a consistent framework to measure relative value and earnings momentum for a large number of stocks across the Australian market. Relative value and earnings momentum rankings are weighted to produce a rank within a relevant universe for each stock. The rankings are then put into deciles. A stock with a decile rating of 1 denotes an attractiveness score in the top 10% of the universe (most attractive). A stock with a decile rating of 10 denotes an attractiveness score in the bottom 10% of the universe (least attractive).
Citigroup Investment Research Quantitative Research Australian Scoring Stocks model recommendations are based on a predetermined set of factors to rate the relative attractiveness of stocks. These factors are detailed in the text of the report. Each month, the Australian Scoring Stocks model calculates whether stocks are attractive or unattractive relative to other stocks in the same universe(the S&P/ASX 100) and records the 5 most attractive buys and 5 most attractive sells on the basis of the criteria described in the report.

For purposes of NASD/NYSE ratings-distribution-disclosure rules, a Citigroup Investment Research Quantitative World Radar Screen and European Value & Momentum Screen recommendation of (1), (2) or (3) most closely corresponds to a buy recommendation; a recommendation from this product group of (4), (5), (6) or (7) most closely corresponds to a hold recommendation; and a recommendation of (8), (9) or (10) most closely corresponds to a sell recommendation.
For purposes of NASD/NYSE ratings distribution disclosure rules, a Citigroup Investment Research Asia Quantitative Radar Screen or Quantitative Emerging Markets Radar Screen recommendation of (1) most closely corresponds to a buy recommendation; a Citigroup Investment Research Asia Quantitative Radar Screen or Quantitative Emerging Markets Radar Screen recommendation of (2), (3), (4) most closely corresponds to a hold recommendation; and a recommendation of (5) most closely corresponds to a sell recommendation.
For purposes of NASD/NYSE ratings-distribution-disclosure rules, a Citigroup Investment Research Quantitative Research Decision Tree model recommendation of "attractive" most closely corresponds to a buy recommendation. All other stocks in the sector are considered to be "unattractive" which most closely corresponds to a sell recommendation.
Recommendations are based on the relative attractiveness of a stock, they can not be directly equated to buy, hold and sell categories. Accordingly, your decision to buy or sell a security should be based on your personal investment objectives and only after evaluating the stock's expected relative performance.
For purposes of NASD/NYSE ratings-distribution-disclosure rules, a Citigroup Investment Research Quantitative Australian Stock Selection Screen model ranking in the top third of the universe most closely corresponds, subject to market conditions, to a buy recommendation. A ranking in the bottom third of the universe, subject to market conditions, most closely corresponds to a sell recommendation. All other stocks in the universe correspond to a hold recommendation. However, because Citigroup Investment Research Quantitative Australian Stock Selection Screen model rankings are based on the relative attractiveness of a stock as compared to other stocks in the same universe, they can not be directly equated to buy, hold and sell categories. Accordingly, your decision to buy or sell a security should be based on your personal investment objectives and only after evaluating the stock's expected absolute performance.
For purposes of NASD/NYSE ratings-distribution-disclosure rules, membership of the Citigroup Investment Research Quantitative Australian Scoring Stocks Model buy portfolio most closely corresponds to a buy recommendation; membership of the Citigroup Investment Research Quantitative Australian Scoring Stocks Model sell portfolio most closely corresponds to a sell recommendation. However, because Citigroup Investment Research Quantitative Australian Scoring Stocks Model recommendations are based on the relative attractiveness of a stock, they can not be directly equated to buy, hold and sell categories. Accordingly, your decision to buy or sell a security should be based on your personal investment objectives and only after evaluating the stock's expected absolute performance.

OTHER DISCLOSURES

Citigroup Global Markets Inc. or its affiliates beneficially owns 5% or more of any class of common equity securities of Korea Electric Power Company and Samsung Electronics.

Citigroup Global Markets Inc. or its affiliates holds a long position in any class of common equity securities of Korea Electric Power Company and Samsung Electronics.

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the subject company(ies) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. In producing Products, members of the Firm's research department may have received assistance from the subject company(ies) referred to in the Product. Any such assistance may have included access to sites owned, leased or otherwise operated or controlled by the issuers and meetings with management, employees or other parties associated with the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Although Citigroup Investment

Research does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of Citigroup Investment Research to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by. The Product is made available in Australia to wholesale clients through Citigroup Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992) and to retail clients through Citigroup Wealth Advisors Pty Ltd. (ABN 19 009 145 555 and AFSL No. 240813), Participants of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. If the Product is being made available in certain provinces of Canada by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. The Product may not be distributed to private clients in Germany. The Product is distributed in Germany by Citigroup Global Markets Deutschland AG & Co. KGaA, which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). Frankfurt am Main, Reuterweg 16, 60323 Frankfurt am Main. If the Product is made available in Hong Kong by, or on behalf of, Citigroup Global Markets Asia Ltd., it is attributable to Citigroup Global Markets Asia Ltd., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Product is made available in Hong Kong by The Citigroup Private Bank to its clients, it is attributable to Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. The Citigroup Private Bank and Citibank N.A. is regulated by the Hong Kong Monetary Authority. The Product is made available in India by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. If the Product was prepared by Citigroup Investment Research and distributed in Japan by Nikko Citigroup Ltd., it is being so distributed under license. Nikko Citigroup Limited is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Akasaka Park Building, 2-20, Akasaka 5-chome, Minato-ku, Tokyo 107-6122. The Product is made available in Korea by Citigroup Global Markets Korea Securities Ltd., which is regulated by Financial Supervisory Commission and the Financial Supervisory Service. Hungkuk Life Insurance Building, 226 Shinmunno 1-GA, Jongno-Gu, Seoul, 110-061. The Product is made available in Malaysia by Citigroup Global Markets Malaysia Sdn Bhd, which is regulated by Malaysia Securities Commission. Menara Citibank, 165 Jalan Ampang, Kuala Lumpur, 50450. The Product is made available in Mexico by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, which is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In New Zealand the Product is made available through Citigroup Global Markets New Zealand Ltd., a Participant of the New Zealand Exchange Limited and regulated by the New Zealand Securities Commission. Level 19, Mobile on the Park, 157 lambton Quay, Wellington. The Product is made available in Poland by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Papierów Wartosciowych i Gield. Bank Handlowy w Warszawie S.A. ul. Senatorska 16, 00-923 Warszawa. The Product is made available in the Russian Federation through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in Singapore through Citigroup Global Markets Singapore Pte. Ltd., a Capital Markets Services Licence holder, and regulated by Monetary Authority of Singapore. 1 Temasek Avenue, #39-02 Millenia Tower, Singapore 039192. Citigroup Global Markets (Pty) Ltd. is incorporated in the Republic of South Africa (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in Taiwan through Citigroup Global Markets Inc. (Taipei Branch), which is regulated by Securities & Futures Bureau. No portion of the report may be reproduced or quoted in Taiwan by the press or any other person. No. 8 Manhattan Building, Hsin Yi Road, Section 5, Taipei 100, Taiwan. The Product is made available in Thailand through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in United Kingdom by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. This material may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in United States by Citigroup Global Markets Inc, which is regulated by NASD, NYSE and the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is regulated by Financial Services Authority. Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to Citigroup Investment Research's Products can be found at www.citigroupgeo.com. Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations. The Product may have been distributed simultaneously, in multiple formats, to the Firm's worldwide institutional and retail customers. The Product is not to be construed as providing investment services in any jurisdiction where the provision of such services would be illegal. Subject to the nature and contents of the Product, the investments described therein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Certain investments contained in the Product may have tax implications for private customers whereby levels and basis of taxation may be subject to change. If in doubt, investors should seek advice from a tax adviser. Advice in the Product has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST