Macro
Currencies

Emerging Markets FX Roadmap

February 2010 – Issue 60

HSBC Global Research

- **In Latam, we provide fresh FX forecasts for ARS, BRL, CLP and UYU, highlight Argentina's likely pro-growth policy shift and report good news from Mexico**
- **In Asia, we offer our latest views on the CNY, INR, MYR and THB, as well as the latest intervention figures and analysis**
- **In EMEA, we examine what fiscal deterioration means for CEE's euro hopes and offer reports on EGP and RUB**

Even more normal

The US's 25bp discount rate hike on 18 February was described by the Fed as simply being a further move towards normalization of US monetary policy, along with the closure of other extraordinary credit programs. It was not, it said, a precursor to a Fed funds rate hike.

While we concur with that assessment, the move has still had repercussions: US rates and the USD edged higher post-announcement. However, we question the degree of influence this should have on the USD vs. EM currencies. That the Fed feels comfortable making this additional move towards normalization is a positive development, and should ultimately encourage capital into 'riskier' asset classes.

In this report, we offer fresh forecasts on a number of Latam currencies to reflect recent USD strength, and in Argentina's case, policy deterioration. Overall in EM, we still prefer Asian currencies, notably North Asia. In this regard, any short term USD strength should be used as USD selling opportunities for longer term positions, we believe.

Meanwhile the RUB continues to sail through global volatility, and while we see some potential hurdles for the RUB later in the year, for now Russian assets still look good.

Click below to listen to audio summaries for each region:

Latam audio summary

Asia audio summary

EMEA audio summary

Voting for the Euromoney FX Poll 2010 closes on 26 February 2010.
To vote for HSBC, please go to www.euromoney.com/PollsandAwards
Thank you for your support.

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2010 EM trade recommendations

Trade	Entry date	Entry level	Stop level	Target level	Settle / closing rate	Target / stop based on:	NDF value date (where appl.)	Approx. carry points per day	Positive/ negative carry to date	Status	Nominal P&L	Original stop (ref. only)	Scale	Trade notional (USD or equivalent)	Profit/ (loss) (USDs)	P&l (bp)	Capital at risk (USDs)	Car (bps)
Long USD-HKD	*14-Dec-09*	*7.7543*	*7.7480*	*open*	*7.7649*	*Spot*	*N/A*	*N/A*	*Included*	*Open through year-end*	*0.14%*	*7.7480*	*6*	*25,000,000*	*34,174.59*	*0.34%*	*54,412*	*0.54%*
Long USD-INR	16-Dec-09	46.52	46.20	48.00	46.20	NDF date	18-Jan-10	N/A	Included	S/L reached on 01/05/10	-0.69%	46.20	3	10,000,000	(68,787.62)	-0.69%	-	0.00%
Short USD-KRW	*17-Feb-10*	*1153.00*	*1178.00*	*1075.00*	*1144.00*	*NDF date*	*17-Mar-10*	*N/A*	*Included*	*Rolled on 2/17/10*	*0.79%*	*1195.00*	*2*	*5,000,000*	*39,335.66*	*0.39%*	*148,601*	*1.49%*
										Total Nominal P&L:	**0.24 %**			**Total P&L on $10m capital:**	**4,722.63**	**0.05%**	**CAR**	**2.03%**

Italics = Live Trades
Note: NDF currencies are traded using NDF dates, with target levels based on the outright forward for the value date of the trades. Deliverable currencies are traded spot and rolled daily, with positive/negative carry shown.
Assumed capital under management = USD10 million. Leverage scale: 1=25%, 2=50%, 3=100%, 4=150%, 5=200%, 6=250%
Source: HSBC

Recap

The year-to-date return on our Model Portfolio is a nominal gain of 0.24%, with a Sharpe Ratio over the life of the fund of 0.57.

Current trades

Long USD-HKD

The recent rise in USD-HKD is set to persist. USD-HKD faced a unique combination of events last year. Namely, flows into risk assets (such as HK equities) were strong, but very low US interest rates prevented any long USD-HKD carry trades from being established. It seems unlikely that this unique, and finely balanced, combination returns this year. It seems more likely that either risk assets find conditions to be difficult, or US tightening expectations escalate in the face of an ongoing global recovery. Either way, USD-HKD is unlikely to return to the bottom of the convertibility zone for long periods.

Short USD-KRW

Long KRW remains one of our favored long Asian currency exposures, as it benefits from a wide breadth of factors including one of the most attractive valuations in Asia, domestic repatriation, and strong capital inflows through equity, debt, and FDI channels. As such, appreciation pressure will remain large, even if the BoK disappoints in March by remaining on hold, and even as the trade surplus begins to narrow from here. More important is that USD-KRW recently re-broke below the key 1150 support level, and should continue lower from here.

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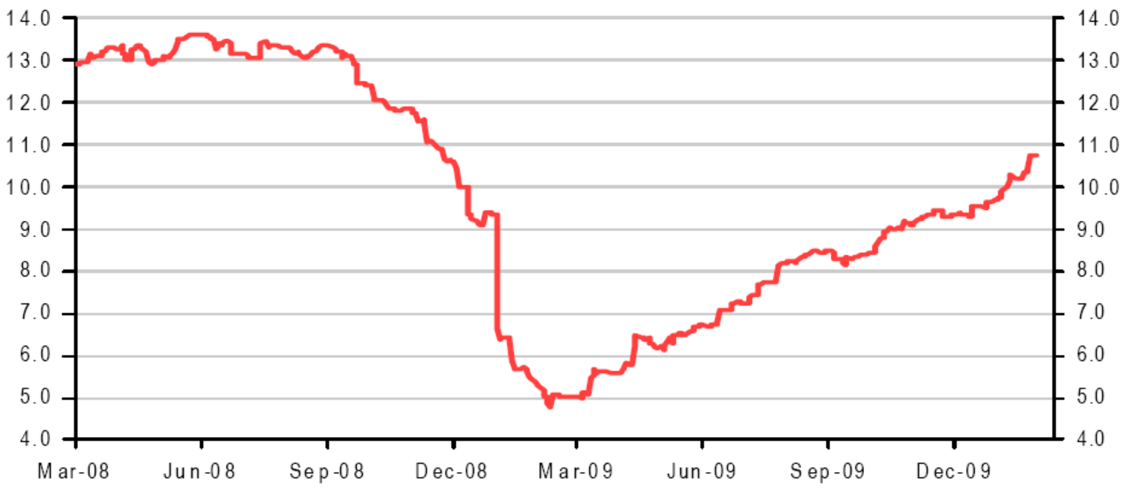
Chart of the month

- Data continue to support our view that Asia should perform the best among the three EM blocks
- We believe the North Asian countries offer the most value given their strong underlying fundamentals and cheap valuations
- In addition, the North Asian countries are likely to be the first to hike rates

Pan Asia surprise index



Source: HSBC

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Asian growth still surprisingly strong

We have broadly stuck with our bullish EM currencies call despite the recent bout of risk aversion. Key issues include the ongoing fiscal concerns in Europe, possible further monetary tightening in China, and increased pricing of possible tightening by the Fed in the wake of the discount rate hike.

Our chart of the month above shows the cumulative Asian activity surprise indicator, last released by our HSBC FX Quantitative Strategy Team earlier this month. It shows that the ability of the underlying Asian macro recovery to surprise markets has not waned in recent months. The strength of the macro indicators should convince markets that the region will not only be resilient to the policy normalization already in progress in China and India, but that the rest of

the region will also need to start normalizing policy in the coming months.

Recent volatility in global markets strengthens our argument to be selective in expressing currency strength as USD weakness is unlikely to be linear, as seen in 2009. Instead, we believe investors should focus on countries with strong underlying economic fundamentals. Given that we believe Asia fits that profile best, Asian currencies remain at the top of our favorites list.

Within Asia, our preference is for the North Asian countries such as Korea, Taiwan, and China where data in recent months have been strong and where our economists expect them to be the first three Asian countries to hike rates. In addition, looking at valuations, Taiwan and Korea remain the two most undervalued currencies relative to the rest of their peers, making long KRW and TWD trades attractive.

Given the volatility, it is worth also considering some intra-regional crosses. We recommend being short SGD and HKD against a portfolio of long Asian currencies.

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Latam at a glance

Currency	Three key points	Recommendation	End-1Q spot	Risk to forecast
ARS	▸ Central bank's changes suggest preferences will be heavily biased toward growth rather than inflation, while the BCRA head has previously argued for a weak ARS to boost activity ▸ Despite this, new governor's first signals on taking office point more in the direction of a stable ARS for the short term, and stronger harvest related inflows in 2Q; this should also help the peso ▸ However, a shift in favour of growth over inflation and fiscal considerations favours a more depreciated ARS in the medium-to-long term. We look for USD-ARS at 4.30 year-end.	Long USD-ARS	3.90	ARS weaker
BRL	▸ We have revised our USD-BRL forecast to 1.78 year-end (from 1.58). ▸ The BRL remains most vulnerable to global risk aversion: while fundamentals continue to support a stronger BRL, crowded positions in Brazil's FX and equity markets remain a drag ▸ In addition, we see room for increased political risk ahead of the October presidential elections.	Short USD-BRL	1.80	BRL weaker
COP	▸ The COP continues to outperform the region mostly on the back of USD sales by the Treasury and strong FDI. ▸ Political uncertainty surrounding Uribe's re-election remains an important source of risk for the COP for the next month ▸ Around 1920, we prefer to short COP against other crosses in the region, notably against BRL.	Short USD-COP	1875	COP weaker
CLP	▸ The new hedging rules for pension funds' overseas assets inspired significant USD purchases, either directly or through the lapsing of maturing NDF positions ▸ Another temporary factor that took USD-CLP higher was the expiration of the rule allowing local banks to post collateral on their FX deposits in CLP rather than USD ▸ However, after the current period of heightened volatility we would expect USD-CLP to settle back towards a 500-515 range in the medium term	Short USD-CLP	520	CLP weaker
MXN	▸ The MXN's range-bound trading likely to continue on further short-term USD strength ▸ Still, we see room for positive economic news to be priced into the MXN ▸ We prefer to express our constructive view on the MXN against the EUR for now	Neutral USD-MXN	12.90	MXN stronger
PEN	▸ The BCRP retains a tight grip on the PEN around 2.85/USD ▸ Still, we think risk reward favours positioning for a move higher and maintain our medium-term 2.75/USD forecast	Short USD-PEN	2.80	PEN weaker
VEF	▸ The devaluation of the official rate to 2.60/USD and 4.30/USD for basic and non-basic products, respectively, has had little impact on the parallel rate which has been trading around 6.40/USD ▸ This is due to slow official dollar approvals by the Cadivi, a trend we expect to normalize in 2Q10 as higher oil prices filter more dollars into the system ▸ However, increasingly the need for new measures to control the spread with the parallel rate seems more plausible. This could include more issuance of dollar-denominated bonds at the expense of the country's debt profile	Neutral USD-VEF	2.60	VEF stronger

Source: HSBC

Latam FX forecast revisions: The dollar wins, for now

- We are adjusting our BRL, CLP, ARS, and UYU forecasts in the wake of recent USD strength on unwinding of risk trades
- In the short-term, we see LATAM FX consolidating at weaker levels relative to our previous forecasts
- However, we maintain a moderate appreciating bias through year-end on the back of a still constructive fundamental view on the region and still abundant liquidity conditions in global markets

Summary

We see room for ongoing USD strength to continue running its course towards 1.30/EUR in the short-term. Accordingly, we now see Latin American currencies consolidating in the short-term at weaker levels relative to our previous forecasts. We thus revise our forecasts for ARS, BRL, CLP, and UYU as follows:

HSBC FX forecast revisions summary

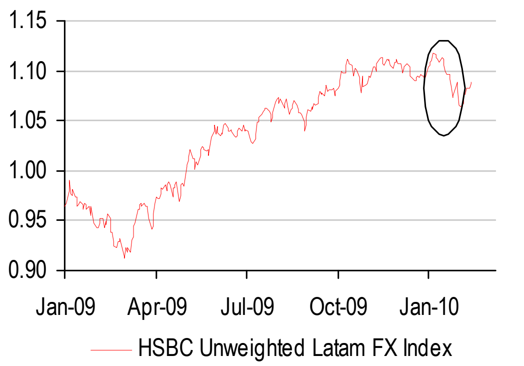
	ARS		BRL		CLP		UYU	
	Prior	New	Prior	New	Prior	New	Prior	New
1Q10	3.90	3.90	1.63	1.80	485	520	-	20.0
2Q10	3.92	3.92	1.58	1.72	465	510	-	20.0
3Q10	4.00	4.10	1.58	1.78	460	505	-	20.0
4Q10	4.10	4.30	1.58	1.78	460	505	19.5	20.0
1Q11	-	4.50	-	1.81	475	505	-	20.0
2Q11	-	4.60	-	1.84	485	505	-	20.0
3Q11	-	4.70	-	1.87	495	505	-	20.0
4Q11	4.40	4.80	1.70	1.90	505	505	19.3	20.0

Source: HSBC

The USD's correction may pass soon…

The USD has begun the year strongly, with the DXY dollar index up 2.8% since the end of last year. Meanwhile our index of Latin American currencies fell vs. the USD from this year's peak to trough by over 5% (see chart below).

USD recovery in early 2010 (circled)



Source: Bloomberg, HSBC

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As we discussed in our recent Currency Weekly, *The USD carry unwind… short, sharp and vicious*, 8 February 2010, having been used as a funding currency through the extended risk rally through most of 2009, profit-taking/unwinding of risk has lifted the greenback. The main reasons behind this price action have been three-fold:

1. Monetary policy tightening in Asia – particularly China – has led to concerns that a harder landing may be in store for that region,
2. Sovereign credit concerns in Europe have seen the USD as the natural beneficiary of EUR weakness, and, most recently,
3. The Fed's hiking of the discount rate to 0.75% from 0.50% on 18 February.

…but market concerns are likely to linger

It's quite possible that we see more gains for the USD in the short term, depending on the solution found to Europe's fiscal dilemma. However, we view the current USD strength primarily as being driving by anti-EUR sentiment and thus do not see arguments for a sustained reversal of the USD's long-term weakness. We expect EUR-USD to end the year at 1.45.

Accordingly, we now see Latin American currencies consolidating in the short-term at weaker levels relative to our previous forecasts. We also reinforce our view that historical volatility is likely to remain high. The recent turn of events highlights the increased sensitivity in global markets to political and regulatory risks. This shines the spotlight on uncertain electoral contests in the region, most notably the presidential election in Brazil, as well as on the risk of further intervention in FX markets.

Another key take-away from the recent episode of risk aversion is that despite Latam's strong (and continually improving) fundamentals, the region's currencies remain very much exposed to a contamination of global risk aversion. This reinforces our view that strategic trading rather than directional trades are most appropriate in the current environment.

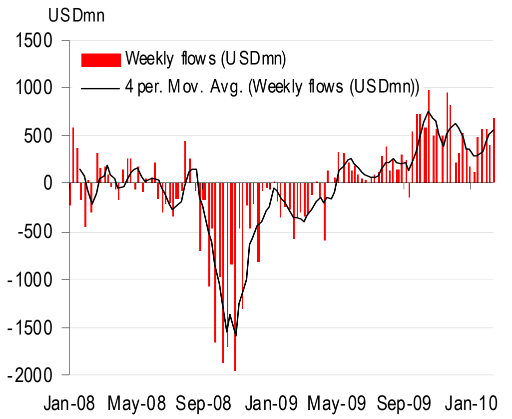
This means returns will be more modest in Latam FX

Overall, we remain constructive on the region's solid (and improving) fundamentals. We thus maintain a moderate appreciating bias for most currencies in the region, with the exception of the heavily managed ARS, in our new forecasts through year-end.

Highly important, we believe, are underlying capital and current account flows, and while the latter are generally turning negative for the region as domestic demand and imports pick up, strong capital inflows should still provide regional currencies with support.

Beyond fundamentals, we continue to find support for EM from still abundant global liquidity and continued uptrend in flows into the region (see graph below).

EM dedicated fund flows ($m)



Source: EPFR

We would note, however, that looking at the broader EM sphere, we see better appreciation prospects for Asian currencies over Latin

America. Regional growth is stronger in Asia, exports are picking up faster than expected, and the region's currencies generally underperformed during the EM rally last year.

Within the Latam region, we also see intrinsic factors playing a bigger role in terms of relative performance. As an illustration, we note that the ongoing USD strength has affected BRL, CLP, and ARS while COP, PEN, and MXN have proven quite resilient. As we discuss in more detail below, in the former group, we see the risk of changes in FX regulations and economic policy as exacerbating the effect of a stronger USD. Accordingly, we maintain a preference for cross-trades in the region.

Country by country: new FX forecasts

We have revised our Argentina, Brazil, Chile, and Uruguay FX forecasts and below we offer a brief synopsis with our latest view and figures.

Argentina

Likely new policy direction

The recent changes at the Central Bank of Argentina (BCRA) involved the appointment of Mercedes Marco del Pont as the new governor, as well as a new general manager. We believe these appointments have further aligned the BCRA Board with the executive branch.

Mercedes Marco del Pont's background suggests she will have a strong preference for growth in the usual trade-off with inflation. For most of her political life, she had a key role in a small – but influential – political party, usually referred to as *desarrollismo* (developmentalist). Also, for many years, she managed FIDE, a political think tank with a strong industrialist trait.

Meanwhile, the need for BCRA reserves to close the financing gap – public expenditure growth of 30% is running far above 14% revenue growth – increases the likelihood of more expansionary monetary policies. Lower interest rates and lower sterilization could be the preferred alternatives. These developments reinforce the view that inflation will accelerate in 2010. Therefore, we recently revised our inflation forecast for end-2010 upwards to 20.0% from 15.7%, previously.

Faster ARS depreciation

The incumbent BCRA head has previously argued for a weak ARS real exchange rate to boost activity. Despite this, her first signals upon taking office pointed more in the direction of a stable ARS for the short-term. A stable FX rate is crucial to keep capital flight pressures contained. In this period of transition in the BCRA management, in particular, the need to control incipient signs of FX demand noted above.

USD-ARS forecast revisions

	Previous	New
1Q10	3.90	3.90
2Q10	3.92	3.92
3Q10	4.00	4.10
4Q10	4.10	4.30
1Q11	-	4.50
2Q11	-	4.60
3Q11	-	4.70
4Q11	4.40	4.80

Source: HSBC

We thus see the continuation of relative ARS stability in the short-term, with the BCRA profiting from the upcoming agricultural exports FX supply (expected for 2Q) to continue purchasing USD.

However, the use of ARS as an anchor has become one, if not the only, tool at use to counter inflationary pressures. Thus, in the medium term, we believe higher inflation will exert upward (stronger ARS) pressure on the real exchange rate (RER). We expect the monetary authorities to react to this by weakening the ARS to maintain the RER close to current levels. Moreover, as we have noted in past reports, the increased reliance on the BCRA's reserve transfers to finance the

Treasury also supports a policy of weaker exchange rate.

FX policy in Argentina very much remains an exercise of careful calibration between costs (re-dollarization pressures) and benefits (competitiveness and fiscal boost). At present, a shift in favor of growth over inflation, and fiscal considerations favors, in our view, a more depreciated ARS. But given the on-going need to protect against capital flight, we anticipate that any additional deceleration will be managed gradually and in orderly fashion.

To summarise, we maintain our forecast for the ARS for 1H10 (ARS3.90/USD at the end of 1Q10 and ARS3.92/USD at the end of 2Q10), but we are raising our end-2010 and end-2011 targets to ARS4.30/USD and ARS4.80/USD, respectively. Most of the depreciation is expected to take place between 3Q10 and 1Q11. After that, we see the BCRA trying to moderate ARS fluctuations in the midst of the electoral process, with general elections expected for October 2011.

Brazil

A number of factors have conspired to take USD-BRL higher. Of all the currencies in Latin America, the BRL is the most vulnerable to a contamination of global risk aversion due to the high concentration of foreigners' positions in the local equity and fixed income markets. The accumulated 11% decline in the Bovespa in January and February increased demand of USDs by foreign investors seeking to hedge their exposure.

Domestic factors have also played a part. The government has been discussing the possibility of issuing domestic debt via the sovereign wealth fund and using such funds to purchase USDs in the market, as an alternative means to prevent BRL overvaluation. Contrary to past episodes, the risk of intervention is having a greater impact this time around, in our view, due to the overall market's heightened sensitivity to regulatory changes.

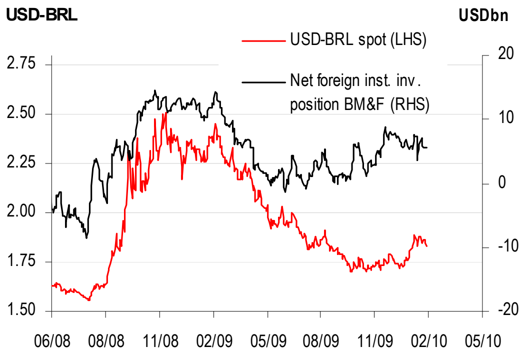
The local market is also starting to factor in the possible effects of October's presidential election. Both leading candidates (Serra and Rousseff) – and especially the opposition's most probable nominee, Serra– have stated on different occasions that they would be more comfortable with a weaker currency.

It is difficult to imagine what measures the next administration could, and whether these will effectively affect the FX trend. We don't see either of the candidates returning to a crawling peg regime. We also think the introduction of severe capital controls remains very unlikely. In absence of these, the trend set by flows would be only marginally affected.

While these discussions have not developed into any concrete action, they have still added to nervousness among portfolio investors and corporate hedgers, leading to some reduction in long BRL positions. Indeed, net long USD positions of foreign institutional investors on the local BM&F exchange rose from USD1.2bn in early November 2009 to USD8.9bn in mid-December, and currently stand at USD5.5bn (see chart below).

Since the peak in mid-December, we have seen a slight reduction in long USD positions but net positioning in the market still reflects some nervousness of further efforts by the government to limit BRL strength. However, at the same time, this positioning is also potentially positive for the currency, insofar as an unwinding of long USD-BRL positions back to neutral (or even to a net short USD stance), would help the BRL to strengthen.

Net foreign institutional investor positions on the BM&F and USD-BRL



Source: BM&F, HSBC

This effect could also be enhanced because positioning of domestic financial institutions also saw an important build up of long USD positions towards the end of last month.

Our original expectation of further BRL strength in 1H10 was predicated on strong capital inflows – both in terms of FDI and portfolio inflows – dominating a widening current account deficit (see *Revising BRL forecasts upward*, 23 November 2009). For the first half of 2010, we still believe the overall balance of payments will remain positive, with healthy capital inflows remaining a supportive influence for the BRL.

Extremely large IPOs last September and October drove the BRL to cyclical highs, and while the pace and volume of IPO deals has abated somewhat on the back of deteriorating market conditions, we still expect this to be a meaningful source of capital inflows.

Another factor to consider in this regard is Petrobras' funding plans during 2010. While this may favorably impact fixed income inflows, the largest potential impact could come from equity related flows.

Different from the regular model of auctions of oil fields that the Brazilian government has used since the 90s, the new pre-salt cushion of oil fields will be developed solely by the state-owned oil company. As a consequence, the Brazilian State will have to inject capital to Petrobras, in the form of rights of exploration of these new fields, generating subscription rights for the minority shareholders of the company, according to the corporate law.

Petrobras has recently stated it believes minority shareholders could inject something between USD10bn and USD30bn once this capital injection is announced. If we assume the mid point of this range, USD20bn, as a good guess – it would be compatible with a conservative valuation of USD4/barrel and minority shareholders subscribing around 50% of their rights – this could represent a sizeable amount of USD12.5bn as an inflow, as foreign investors currently represent 62% of the minority shareholders.

USD-BRL forecast revisions

	Previous	New
1Q10	1.63	1.80
2Q10	1.58	1.72
3Q10	1.58	1.78
4Q10	1.58	1.78
1Q11	-	1.81
2Q11	-	1.84
3Q11	-	1.87
4Q11	1.70	1.90

Source: HSBC

To summarize, while we expect strong capital account inflows to remain supportive for the BRL in the first half of 2010, external factors will remain equally, if not more, important. We believe the USD's strength globally will run out of steam some time in 1Q10, and this should also coincide with a peak in USD-BRL. We may already have seen this occur, but the uncertainties are such that this is a difficult call. We are therefore calling for USD-BRL to remain within a 1.80-1.90 range during the remainder of 1Q10, with an end-period forecast of 1.80, and thereafter expect the currency to strengthen through 2Q to 1.72 at end-June.

During the second half of the year, we become more concerned about two factors: (1) Brazil's then-rapidly-widening current account deficit, and (2) political risks into the October presidential election. For these reasons, we expect the BRL to weaken again vs. the USD during the second half of 2010, and have a year-end forecast of 1.78.

Chile

Recent distortions

The FX market in Chile has undergone some important distortions in recent weeks, the result of which have taken USD-CLP up from a low of 482 on 11 January to as high as 553 on 5 February and now back to 529 at the time of writing.

The biggest influence came from the new rules on local pension funds' hedging of overseas assets. The essence of the changes were to place a cap on the forward USD sales as hedges that pension funds could undertake against their foreign assets (for full details see *Pension fund regulator adjusts FX hedge rule*, 27 January). While the industry as a whole was not over the new 50% cap limits, the move nevertheless inspired significant USD purchases, either directly or through the lapsing of maturing NDF positions (if the positions are not rolled over, then this has the net effect of USDs being purchased in the market).

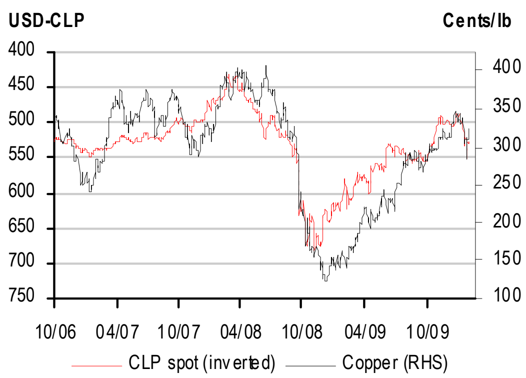
Another temporary factor that took USD-CLP higher was the expiration of the rule allowing local banks to post collateral on their FX deposits in CLP rather than USD. This was a temporary measure introduced at the height of the credit crisis to increase FX liquidity. When the measure expired in early February, some banks were seen buying USDs to switch their collateral from CLP.

Both of these effects should be transitory, although the effects of the new pension fund hedge cap will arguably last longer. Funds have 90 days to comply with the new measures although even beyond this, it may lower the pension funds' USD sales on an ongoing basis. As such, after the current period of heightened volatility, we would expect USD-CLP to settle back towards a 500-515 range, the lower end of which we would expect to offer longer term USD support.

Copper prices still influential

As ever, copper prices will remain an important influence for the CLP going forward. With copper demand set to remain strong from high commodity-intensive industrial growth from China and India, this should provide firm underlying support for the metal's price, and by derivative, the CLP. However, high stockpiles of copper suggest the metal's upside may well be limited, and our mining equity research team has a slightly-below-consensus forecast for copper prices. Correlation between the CLP and copper prices remain high (see chart below).

CLP and copper prices remain well correlated



Source: Bloomberg, HSBC

Finally, the other factor to monitor will be the government's decision on the mix of funding sources for the 2010 deficit between local debt and USD sales from the sovereign wealth fund. We see the incoming government as slightly more biased towards local debt, and this could also offer the USD some better support over the medium term. We expect a decision on this issue from the government sometime in March-April.

Our new USD-CLP forecasts are as follows:

USD-CLP forecast revisions

	Previous	New
1Q10	485	520
2Q10	465	510
3Q10	460	505
4Q10	460	505
1Q11	475	505
2Q11	485	505
3Q11	495	505
4Q11	505	505

Source: HSBC

Uruguay

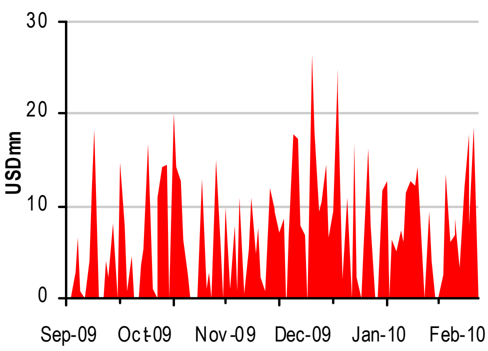
For Uruguay, we expect a stable UYU going forward. Reflecting the less bullish outlook for Latam currencies, we now see the UYU ending 2010 at UYU20.00/USD (currently 19.80).

The BCU intervened heavily, purchasing USD60m per week in mid-January and early-February. The late-January pause coincided with a retreat in flows to the region. Intervention in the market resulted in a floor of 19.60 for USD-UYU since the start of the year. Foreign exchange reserves increased 2% year-to-date due to the referred purchases.

We continue to see FX purchases as the most effective policy tool of the BCU to administer the exchange rate. The central bank lowered its policy rate in December to 6.25%, but inflows continued. With inflation running atop the target range, the BCU will try to avoid any substantial currency weakness. At the same time, we believe it will continue fighting nominal appreciation, to prevent further RER strength.

Our new outlook towards Latam currencies comes with weaker appreciation pressures. Thus, our new forecast sees the exchange rate ending 2010 close to current levels.

BCU daily FX net purchases



Source: BCU, HSBC

Argentina: Policy focus on growth at expense of inflation and FX stability

- Central bank's changes suggest preferences heavily biased towards growth rather than inflation
- Inflation has accelerated in the past few months; activity exceeded expectations in 4Q09
- We revise our targets for inflation to 20% and for USD-ARS to 4.30 by end-2010

New policy path

The changes at the Central Bank of Argentina (BCRA) appear to have been completed. The government appointed Governor Mercedes Marco del Pont and a new general manager, adding to a board that is currently aligned with the executive branch.

Ms. Marco del Pont has a pro-growth background. Before joining the FPV, she was for decades active in the *desarrollismo*, a local political movement. In 2007, she authored a bill to change the BCRA charter to add economic activity and employment to price stability to the central bank mandate. Under her leadership, Banco Nación more than doubled its lending to the Treasury, particularly following charter changes made in 2009's Budget Law.

The need for BCRA reserves to close the financing gap – public expenditure is growing at an annual rate of 30% and revenues at only 14% – increases the likelihood of more expansionary monetary policies. For us, lower interest rates and lower sterilization would be the preferred alternative.

Recent private-sector estimates show three-month annualized inflation above 20%, fuelled in part by higher-than-expected growth. We are raising our inflation forecast for 2010 to 20% from 15.7%. We also are updating our FX forecast for year-end, based on the BRL's recent weakening and the need to offset the effect of higher inflation on the real exchange rate.

Our new end-2010 USD-ARS FX forecast is 4.30, versus 4.10 previously, and we are moving our end-2011 forecast to 4.80 from 4.50 (see the table on page 5).

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Growth a priority

Mercedes Marco del Pont is the new BCRA governor. In place until September – when Martin Redrado's term was supposed to finish – she is expected to be nominated again for a full six-year term, although President Cristina Fernández has yet to send her nomination to Congress.

Ms. Marco del Pont's background suggests a strong preference for growth in the usual trade-off with inflation. For most of her political life, she had a key role in a small but influential political party, usually referred to as *desarrollismo* (developmentalist). Also, for many years, she managed FIDE, a political think-tank with a strong industrialist trait. When she was president of Banco Nación, the bank more than doubled its lending to the Treasury from ARS6.7bn in December 2007 to ARS15.4bn in November 2009. Most of the credit expansion – ARS7.6bn – took place last year, after a modification of the Banco Nación charter made in the 2009 Budget Law.

In 2007, as a member of the Lower House, Ms. Marco del Pont authored a bill to change the central bank's charter to add economic activity and employment to the price stability mandate and increase co-ordination with the executive branch. As a result, President Fernández announced the creation of an economic council to create closer ties between the BCRA and the Ministry of Economy. In turn, Economy Minister Amado Boudou has appointed Benigno Velez – who was with him at the Ministry of Economy (MECON) and ANSES, the social security agency – as the new BCRA general manager.

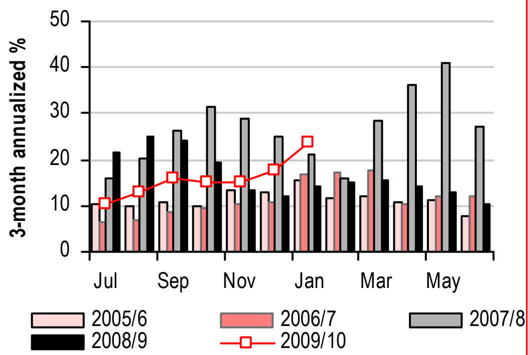
The majority of the BCRA board is aligned with the government. All in, it is evident to us that there will be full co-operation between BCRA and MECON.

There is a pressing need to tap FX reserves to close the financing gap. Accessing international capital markets appears unlikely under current market conditions even after the reopening of the debt exchange, and public expenditure is growing at 30% and revenues at only 14%, excluding the IMF SDR 2009 allocation. We expect the government to tap the FX reserves once the current legal obstacles are removed.

Inflation running high

According to private estimates (Buenos Aires City data), consumer prices in January increased 2.3% m-o-m, after rising 1.8% in December and 1.3% in November. Therefore, inflation is running at 15.7% y-o-y and at 24% annualizing the last three months. True, these months have high holiday seasonality, but this is the highest three-month annualized figure for January since 1991 (some private estimates, e.g. the local think-tank FIEL, put January 2008 on a similar level).

Consumer prices (3 month annualized, %)



Source: HSBC, INDEC, MyS, Buenos Aires City

February should bring some temporary easing but private estimates are forecasting a near 1.5% m-o-m increase.

Contrary to the previous inflation acceleration, this is not a global story as commodity prices are fluctuating with no definitive trend. There are several reasons for such a high level of inflation.

Inflation was already around 13-14% and it only fell to 13% when economic activity contracted in 2009 and now the economy is recovering rapidly. There was also a sizeable increase in the price of imports in 2H09, which can be traced to exchange-rate strength in several of Argentina's trade partners.

Close to 45% of consumer goods imports come from the Mercosur and Chile. There are also significant quantities of unfinished imported goods that end up being consumed with little local value added. While recent regional FX weakness could be a mitigating factor in the short term, we believe the mix of strong Latam currencies throughout 2010 with an expected weakening ARS in 2H10 will result in imported inflation making a comeback later in the year.

Adding to inflation, beef prices have increased 31% year-to-date[1] as a consequence of weather conditions. During last year's drought, beef producers were forced to sell cattle, pushing down the price. In contrast, rain has been abundant in the last few months, increasing the availability of pasture, encouraging farmers to continue feeding animals rather than sending them to market.

Private-sector wage negotiations should close around 20% y-o-y – aligned with inflation expectations. While non-tradable items are still growing at a slower pace than tradable goods, we expect them to catch up in the coming months. All in, we expect consumer prices to continue to grow at least at a pace similar to that seen since 2H09, leading us to raise our 2010 forecast to 20% (December, y-o-y).

Table 1.HSBC revised inflation forecasts

(%)	2010 Previous	2010 New	2011 Previous	2011 New
Headline inflation	15.7	20	13.9	18

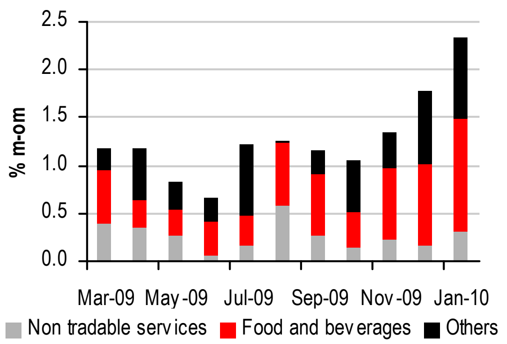
Forecasts reflect private estimates of inflation.
Source: HSBC

Reacting to inflation

While inflation *per se* is a problem, the government reaction could compound it. In the past, the government has reacted to the inflation threat in a number of ways:

- Restrictions on commodity exports or basic consumption goods or both.
- Price agreements boosted by moral suasion.
- Even more expansionary fiscal policies, to keep social transfers in line with increasing prices.

Consumer prices by item (m-o-m %)



Non-tradable services include healthcare, education, and "other goods and services."
Source: Buenos Aires City

- Avoiding tariff adjustments via subsidies to the energy and transport sectors.

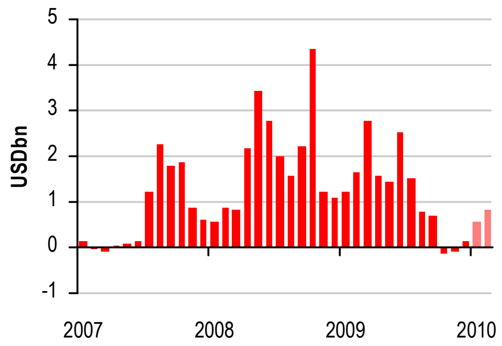
Additionally, expectations on monetary policy are shifting toward lower interest rates – or stable ones in a context of higher inflation.

FX assets showed only a minor increase in January, according to our estimates. However, late January and early February estimates suggest an incipient spike (see chart on next page). Should FX demand reignite due to rising uncertainty, the

[1] *Source: HSBC average of fresh meat prices at inflacionverdadera.com (February 16 vs. December 31) and cattle market average prices (February average vs. December average).*

government might resort to import restrictions to secure the FX trade surplus necessary to avoid a drain of reserves, affecting goods supply. In that scenario, additional inflationary pressures could mount.

Net foreign assets demand by the private sector (USDbn)

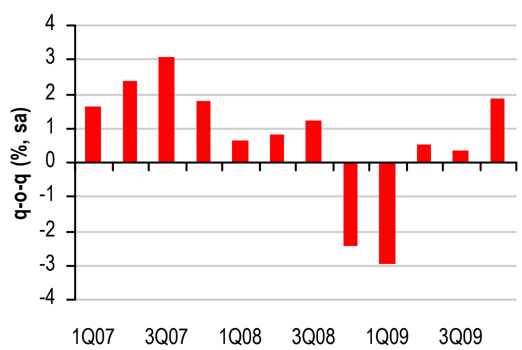


January and February 2010 are HSBC estimates.
Source: BCRA, HSBC

Activity at full speed

The first available private estimates for 4Q09 show faster-than-expected growth, which at 1.8% q-o-q was close to 8% annualized. With backward upward revisions, this leaves the estimate for the overall 2009 activity decline at -3.1%, above our previous -3.5% expectation. For 2010, there will be a strong statistical carry-over effect, with 4Q09 1.5% over the average 2009 level.

GDP growth (q-o-q%, seasonally adjusted)



Source: Broda, HSBC

Although these are all positive surprises, we still retain our 2010 forecast of 3.5% growth. Our forecast is based on global improvement and recovery by the agricultural sector following a severe drought. Additionally, we factored in the positive effects of completing the debt exchange, lower portfolio dollarization, and the corresponding remonetization of the economy.

We maintain these expectations, but the recent institutional conflict is enough to offset the better-than-expected 4Q09 figures, in our view. In previous research reports, we pointed out that political-related risks are factors that could affect the economy in 2010, and the events of the last few weeks have supported this.

Faster ARS depreciation

The incumbent BCRA head has previously argued for a weak ARS real exchange rate to boost activity. Despite this, her first signals upon taking office pointed more in the direction of a stable ARS for the short term. A stable FX rate is crucial to keep capital flight pressures contained. In this period of transition in BCRA management, in particular, the need to control incipient signs of FX demand is noted above.

We thus see the continuation of relative ARS stability in the short term, with the BCRA profiting from the coming agricultural export FX supply (expected for 2Q) to continue purchasing USD.

However, the use of ARS as an anchor has become one, if not the only, tool in use to counter inflationary pressures. Thus, in the medium term, higher inflation should exert upward (stronger ARS) pressure on the real exchange rate (RER). We expect the monetary authorities to react to this by weakening the ARS to maintain the RER close to current levels. Moreover, as we have noted in our past research reports, the increased reliance on the BCRA's reserve transfers to finance the Treasury also supports a policy of a weaker exchange rate.

FX policy in Argentina very much remains an exercise of careful calibration between costs (re-dollarization pressures) and benefits (competitiveness and fiscal boost). At present, a shift in favour of growth over inflation and fiscal considerations favours a more depreciated ARS, in our view. But given the continuing need to protect against capital flight, we anticipate that any additional deceleration will be managed gradually and in orderly fashion.

To summarize, we maintain our forecast for the ARS for 1H10 – ARS3.90/USD at the end of 1Q10 and ARS3.92/USD at the end of 2Q10 – but we are raising our end-2010 and end-2011 targets to ARS4.30/USD and ARS4.80/USD, respectively. We expect most of the depreciation to take place between 3Q10 and 1Q11. After that, we see the BCRA trying to moderate ARS fluctuations in the midst of the electoral process, with general elections expected for October 2011.

Table 2. USD-ARS forecast revisions

	Previous	New
1Q10	3.90	3.90
2Q10	3.92	3.92
3Q10	4.00	4.10
4Q10	4.10	4.30
1Q11	—	4.50
2Q11	—	4.60
3Q11	—	4.70
4Q11	4.40	4.80

Source: HSBC

HSBC

Mexico: Trip Report: Good news from the ground

- We present our impressions from meetings in Mexico City with local officials, economic and political analysts and fund managers
- Global risk aversion and uncertainty over new reserve policy will keep MXN upside capped in short-term. However, increasingly, fundamentals are looking more positive for the peso
- Local curve should remain steep due to supply risk concerns among local investors and expectations for lower rate hikes

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View from the ground

In this report, we present our impressions from our recent meetings in Mexico City with government officials, the central bank, local analysts (both economic and political) and fund managers. We also offer our latest thoughts on the outlook for the MXN, and discuss recent developments in the local debt market.

Separately, we also had the opportunity to speak with several government officials about the policy of FX reserve accumulation, which has been an important topic of debate for the market recently, and discuss this in more detail in the FX section below, and also in our recently published report, (*Mexico Economics & Strategy: More is better when it comes to reserves, 3 February 2010*).

On that issue, while we think that uncertainty over the accumulation of FX reserves may limit the MXN's near term upside until the measure is officially announced, we concluded that the authorities will choose a transparent and gradual mechanism. We thus do not anticipate a sustained impact on the MXN from this policy.

Regarding rates, we noted that the government's intention to increase the relative share of long-term bonds in the M-bono curve has local investors concerned about supply risk. However, the government's introduction of a syndicated issuance program to increase the initial size of bond placements – which would also make the country's debt eligible for world bond indexes – means increased prospects for FX-related flows on the back of higher appetite from foreign investors. This could provide timely support for the MXN around the time of bond placements.

Moreover, we also noted that local investors now believe that Banxico could be less aggressive raising rates than previously expected. In this sense, the curve is likely to remain steep for longer.

We have split the report into four sections:

Economics

Room for surprises?

A preliminary look into 2010 suggests that we are more likely to see surprises on the economic front than the political reform agenda. High frequency indicators confirm that Mexico is on a solid recovery path. The Central Bank of Mexico (Banxico) recognized as much, upgrading its 2010 real GDP forecast from a range of 2.5-3.5% to 3.2-4.2% in the last Quarterly Inflation Report.

Our 3.7% forecast is very much in line with this view. Overall, we found a growing sense of optimism with the 2010 outlook among local analysts while fund managers were somewhat more sceptical, citing lingering uncertainties in global markets. At present, we find that the risk of a contamination of expectations from a deteriorating global environment remains capped by the flow of positive economic data.

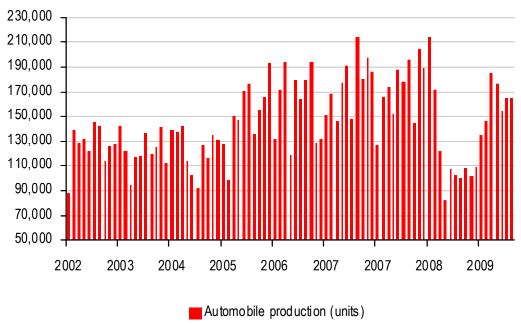
On inflation, the general perception is that the fiscal reform and energy price adjustments will have only a one-off effect. We found no concerns over second round effects. Wage negotiations seemed to be contained and still-weak demand remains an anchor to private sector price increases.

In terms of monetary policy, the key variable to monitor is long-term inflation expectations. At several of our meetings with government officials were reassured that for now these remain anchored within Banxico's 2-4% target range, but were reminded that any deviation could trigger a faster initiation of the tightening cycle.

FX flows stabilizing

Importantly, non-oil exports – which constitute the primary engine of growth in the country – have largely stabilized, helped by the quick recovery trend in auto exports. After hitting a low of 81.5K units built in January 2009, vehicle production rose to USD154K units by end-2009. Although comparable to 2008 levels, this is still ways away from the 215K units high in 2007.

Monthly auto production (units)



Source: Bloomberg

One must keep in mind that this recent improvement reflects an important inventory recomposition while a strong investment push in past years has left plenty of idle capacity to fill in the industry. Even so, however, the outlook for the automotive sector points towards continued, if gradual, improvements. Anecdotal evidence onshore suggests that lines of auto production continue to be transferred from the US to Mexico, in part, taking advantage of Mexico's competitiveness gains – the result of rising labour costs in countries like China and a stable REER. The government estimates an annual increase of 30% in car production in 2010.

There are also some encouraging signs, albeit preliminary, that the decline in oil production has stabilized. In 2H09, monthly oil production oscillated between 2.5-2.6 mbpd, thanks primarily to efficiency gains. If sustained, the stabilization of oil production, coupled with above-budget oil prices (budget uses an assumption of USD59bbl) implies an important boost to fiscal accounts as well as an acceleration of export revenues from Pemex, the national oil company. Since our trip, moreover, Pemex has announced the discovery of two new oil fields with the potential to increase production by another 0.3 mbpd.

Finally, the latest remittance data for the month of December signals normalization in the declining trend, consistent with incipient signs of stabilization in US employment. While not a hugely important component of foreign exchange flows, we find that remittances data has an important impact on expectations.

These factors should be positive for the overall balance of payments, and should offer a net positive for the MXN.

Politics

A year of conflicting interests

In politics, we found little conviction among local analysts that President Felipe Calderon's ambitious reform agenda will advance significantly. Recall that last December, the executive vowed to push for fiscal, labour, political, and energy reforms.

Of the above, the only proposal that has been formally presented by the executive is the political one. The main purpose of this initiative is to increase the efficiency of the legislative process and the accountability of politicians before the citizenship: it includes, among others, immediate re-elections for legislators, independent candidacies, second round votes for presidential elections, and the introduction of congressional line veto power over executive proposals. As tends to be the case with reforms that seek to overhaul political systems that benefit incumbents, this initiative has encountered opposition in many of the key points. As a result, the most likely outcome is a diluted reform.

The administration has not resumed talks or taken action on economic reforms, which could have more of an impact on the market. Interestingly, prominent PRI senator and opposition leader, Mario Fabio Beltrones, has taken the lead with the critical fiscal reform drafting a proposal of his own. And while this implies that the reform is not yet dead, the prospect of some convergence from the PRI around Beltrones' proposal is compromised by internal divisions within the party's leadership. Beltrones is one of three main party leaders vying for the party's candidacy in the 2012 presidential elections.

As a matter of fact, all eyes (and interests) are set on the upcoming gubernatorial elections which will take place in 12 of Mexico's 31 states on 6 July 2010. The stakes of these elections are high as they will set the stage for the presidential elections in 2012. The opposition PRI party controls 9 out of the 12 states that are up for grabs, making it the primary target for Calderon's PAN party, as well as the leftist PRD led by Jesús Ortega. Talk of an unnatural alliance between the PRD and PAN in at least 5 of these states suggest the campaign ahead is likely to be heated.

This situation is likely to create a deadlock in Congress which is also controlled by a PRI majority. Local political experts agree that negotiations on structural reforms at the federal level will be difficult while the ruling PAN seeks to undermine the PRI during the regional elections. *(Mexico Economics: Electoral alliances formed against the PRI, 16 February 2010)*

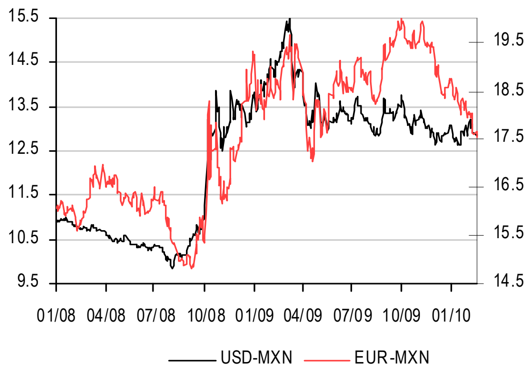
FX

MXN still attractive on valuations

For some time we have argued that fundamentals having been turning increasingly supportive for the currency. In brief, we do not see that the shift for the better – read disproportionate exposure to recovery in the US – has yet been priced into the MXN. For the time being, however, the MXN remains beholden to global macro events and amidst higher risk aversion and uncertainty regarding the government's intentions to accumulate reserves, we think the sideways pattern in USD-MXN will continue to prevail in the short term. We thus reaffirm our MXN12.90/USD forecast for 1Q10.

In our view, external events and sentiment continue to dominate over domestic fundamentals for USD-MXN price action. Externally we find sentiment towards MXN split. On the one hand, the MXN offers the most attractive valuations in LATAM FX (ex-ARS), even taken into account weaker levels for currencies like the BRL and CLP. It is also slated to post one of the most dramatic y-o-y improvements in GDP relative to last year. On the other hand, the MXN continues to trade as a proxy of the dollar, and in that respect, the recent appreciation of the USD has helped to maintain the MXN range-bound trading pattern. The more defined appreciation trend of the MXN against the EUR further illustrates this point (see graph that follows).

EUR-MXN and USD-MXN



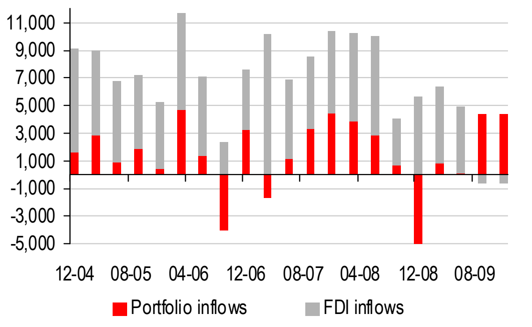
Source: Bloomberg

Our visit confirmed our view that there is room for upside surprises in domestic economic data that are yet to be reflected in the MXN. We thus continue to see an upside bias to our 12.90/USD forecasts for 2Q10. Eventually we do think that directional views should drive the MXN higher, but for now we continue to see erratic price action reflecting short-term trading strategies.

Official concerns over 'hot money' inflows

In general, we found the authorities concerned over potential carry trade pressures and short-term 'hot money' inflows. Namely, there is the perception that MXN appreciation in 2009 was due to portfolio inflows predominantly (see graph below). The authorities' fears are that a normalization of rates in the US could see a destabilizing unwinding of these positions. However, rather than studying new regulation to stop these flows, the authorities are focusing on the accumulation of reserves to help shield the system against external shocks.

Portfolio inflows and FDI inflows

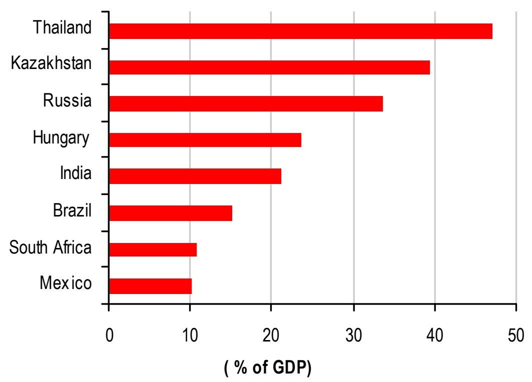


Source: Bloomberg

Reserve accumulation

A key lesson for Mexico from the global financial crisis was that sometimes the cost of accumulating reserves is worth paying. This has been recognized for a number of months now by the Mexican authorities, both in private and public forums. There is no question that Mexico's reserve levels are, by most metrics, comparatively low compared to its peers in the region and in the sovereign BBB-rated category.

Chart 1: Mexico international reserves vs other countries'



Source HSBC

However, more frequent and specific comments by Banxico Governor Agustin Carstens and Secretary of Finance Ernesto Cordero seem to have brought the point home that Mexico is serious about accumulating reserves to the market in recent weeks. Our conversations with officials from both Banxico and the Secretary of Finance, however, confirm our expectations that the policy of FX reserve accumulation will be pursued with parsimony and that it will be designed to be as market-neutral as possible.

Costs do matter

In contrast to most other countries that have embarked in the process of FX reserve accumulation over the last decade, in Mexico the authorities remain very wary of the cost of accumulating excess reserves. In all meetings we had with officials, we were reminded of the costs involved:

- Negative carry: Banxico assumes a negative carry between the return on its foreign currency reserves and the price it pays to sterilize a higher inflow of dollars. This financing cost is passed on to the Treasury as a quasi-fiscal expense.
- Crowding out of private sector credit: Any additional paper issued by Banxico to buy reserves would compete with private sector issuances. The result is higher rates at the expense of economic growth.
- Credibility concerns: There is a risk that the market could interpret the policy of reserve accumulation as implicitly targeting a specific FX level.

This suggests to us that the authorities will increase the stock of reserves only very gradually, and that rather than targeting a specific level, they will do so taking into account supply and demand in the FX and local credit markets.

What's next?

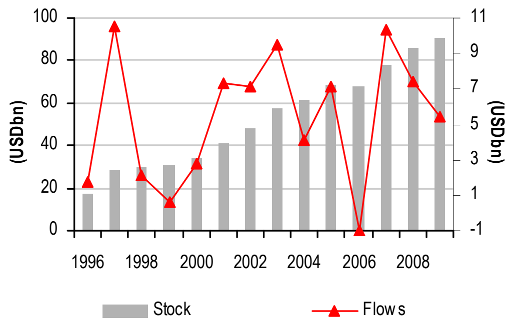
Importantly, no concrete action has been taken in implementing the policy of reserve accumulation. The first step would be for a proposal to be presented before the FX Commission – which is composed of 3 members from the Secretary of Finance plus 3 members of Banxico, including the Governor – which would then vote on it. The

proposal is expected to come up for voting, and be approved, sometime in February, around the same time the USD47bn FCL line with the IMF is due for renewal. Recall that the authorities have stated that the increase of reserves will be synchronized with a parallel reduction in the USD47bn FCL, to ensure access to foreign funding remains broadly unchanged. This should help to shore up the country's sovereign credit rating.

We see two main mechanisms to accumulate reserves:

- First, a *passive* scheme would depend primarily on oil export revenues from Pemex, the national oil company, which we estimate could amount to USD7-9bn per year. Recall that between 2003-2009, the central bank had a policy of auctioning off 50% of Pemex' net dollar inflows precisely to slow down the pace of reserve accumulation. Not doing anything thus constitutes a passive policy of faster reserve accumulation. The increase in reserves from a post-crisis low of USD12.6bn in August to USD90.84 by end-2009 is evidence that not doing anything is an implicit policy of reserve accumulation. While a large part of the jump in reserves in recent months has been due to public sector external financing, which tend to be transitory component of reserves, the recuperation trajectory is nonetheless clear (see graph below).

Chart 2: International reserves: stocks and flows



Source Banxico

- The second option would be an *active* market mechanism. Given Mexico's past precedents for rule-based option intervention policies, we think it most likely that they could re-introduce automated volatility options that were in place between 1996-2001. The advantage of this mechanism is that it takes into account the market's demand for the MXN.

Importantly, we do not expect any implicit or explicit price level for the MXN to be targeted. We also don't expect Banxico to set an objective for reserve accumulation.

Our interpretation of the reserve accumulation program is that it will necessarily be a gradual process. We estimate that just to maintain the same level of international reserves in terms of GDP, Mexico's reserves should grow an average of USD8.6bn per year. We think that an accumulation pace of up to 0.3% of GDP, which represents an average of USD13bn per annum through 2015, is achievable. However, to put this in perspective, it would take Mexico 15 years to match Brazil's reserves level of 15.1% of GDP. *(Mexico Economics & Strategy: More is better when it comes to reserves, 3 February 2010).*

Impact on the MXN

The accumulation of reserves should affect foreign money supply to some extent. In our view, this will likely keep MXN range-bound in the short-term, at the very least until the details of the mechanism are officially announced. However, we believe that the authorities will be very careful to implement a mechanism that has as little bearing as possible on the market. This means any additional dollar demand will take into account supply conditions. We thus don't view the policy of reserve accumulation as significantly altering our view on the MXN into 2010.

That said, we recognize that in the current environment of risk aversion, the market has tended to overreact to changes in regulation. The most recent example of the CLP´s overshooting in response to changes in the hedging limits is a case in point. Likewise, the recent experience in Brazil where the re-introduction of capital controls more successfully tempered sentiment vis-à-vis the BRL than in past episodes, suggests to us that amidst jittery markets, the element of uncertainty introduced by these measures has been enough to dissuade investors interest in these currencies.

Fixed Income

The 2010 financing program

We also met government officials to discuss the 2010 financing program. To begin, net financial needs for 2010 are 0.5% of GDP higher than in the previous year. The gross financial needs for the government this year are equivalent to 8.8% of GDP, of which 6.0% will be used to refinance debt amortizations (0.3% of external debt and 5.7% of domestic debt). In consequence, net financial needs will be around 2.8% of GDP. Congress approved a net domestic indebtedness ceiling of MXN380bn and a limit for net external indebtedness of USD8bn for the 2010 fiscal year.

External debt policy

The government is planning to sell up to USD3bn in the international markets, to pre-finance the USD2.4bn due in 2010. This is lower than the USD3.2bn of amortizations last year. For 2010, the Ministry of Finance (Hacienda) will focus on issuing in the 10- to 30-year sectors. It is worth mentioning, however, that Hacienda already sold USD1bn in 10-year bonds in international markets just a few weeks ago.

After the issuance of a 10-year bond denominated in JPY by an equivalent amount of USD1.7bn, Hacienda will continue to explore the possibility of issuing in currencies other than the USD with the purpose of widening the base of investors and expanding its sources of financing.

The government will maintain the same level of net indebtedness with agencies and international financial organizations under USD5bn. This strategy will allow government to get resources under very competitive financial conditions.

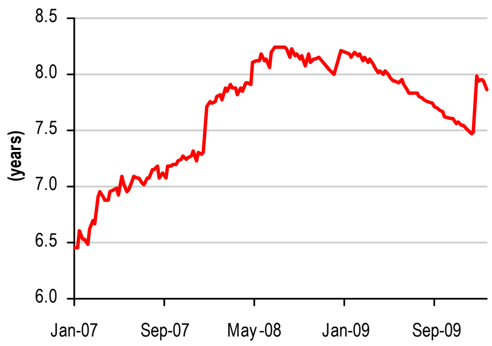
Domestic debt policy

The main changes that Hacienda will do in domestic debt policy issuance this year will be:

1. To increase the relative share of long-term bonds in government's debt portfolio
2. To introduce syndicated auctions

During the last two quarters, Hacienda has modified the auctions calendar to increase the relative share of long-dated bonds in the M-bono curve. At the beginning of the crisis, Hacienda had to reduce long-term bonds issuance triggering a reduction in the weighted average maturity of the nominal fixed-rate bonds portfolio. Now that the situation has improved, Hacienda wants to revert this situation increasing the amounts outstanding of 10, 20 and 30-year nominal bonds.

Chart 3: Weighted average maturity of M bonos portfolio



Source Banxico, HSBC

The introduction of syndicated auctions designed to increase the liquidity of the on-the-run benchmark bonds will take place in mid-February for the 10-year M bonos and in late March for 30-year udibonos. Hacienda is planning to sell between MXN15bn to 20bn of 10-year M bonos around MXN8bn for 30-year udibonos.

Local rates view

Curve to remain steep

During our trip, we found local pension and mutual funds cognizant of the supply risk that could come in the long end of the curve. Although there will not be a substantial increase in government issuance this year, the composition will be biased to long-duration bonds. Furthermore, corporate issuance in local currency could reactivate from last year's lows.

We saw good appetite for corporate bonds by local players as a diversification strategy. To illustrate this point, last week Pemex sold MXN15bn of bonds (MXN5bn of fixed-rate bonds, MXN8bn of floating rate bonds and MXN2bn more on inflation-linked) with a strong bid-to-cover of 2.4. The issuance was only allocated among local investors.

Afores have room to add duration into their portfolios according to their VaR limits. However, they have preferred to be invested in the short end or the belly of the curve. This reflects that the increase in supply is a risk.

Among local investors, inflation pressures are seen as temporal. Thus, interest rate hikes could be delayed or could be lower than previously anticipated. TIIE curve is currently pricing in 85bp of rate hikes starting in May. This contrasts with the 115bp that the market was pricing in just two weeks ago.

We believe that the local curve will remain steep during 1H2010 since monetary policy rate will not be raised before 3Q2010. Furthermore, recent deterioration in the appetite for risky assets will also reduce the willingness to receive long-term rates. Finally, local investors' concerns on supply risk should also support our view of a steep curve.

HSBC

Asia at a glance

Currency	Three key points	Recommendation	End-1Q spot	Risk to forecast
RMB	▸ Speculation about a near-term revaluation in China has intensified ▸ Recent moves to tighten policy suggest appreciation will occur in 2Q, although we expect it to be gradual ▸ We recommend selling the 1yr NDF, rather than the front end	Short 12m USD-CNY NDFs	6.80	Neutral
HKD	▸ We believe the risk for USD-HKD is to move to even higher levels within the convertibility band ▸ In our view either risk assets find conditions difficult, or US tightening expectations escalate in the face of an ongoing global recovery. Either way, USD-HKD is expected to move higher ▸ As such we recommend buying USD-HKD as a portfolio hedge	Long USD-HKD	7.80	Weaker
INR	▸ We expect rupee appreciation to remain gradual and volatile, despite the country's strong growth profile ▸ Equity flows remain the key to the currency, and these are already well above pre-crisis levels ▸ With the RBI starting to tightening monetary policy, any weakness in the equity market is likely to have a stronger impact on INR	Long USD-INR	48.0	Stronger
IDR	▸ IDR will remain a key beneficiary of the secular flow out of dollar assets and offers some of the best currency fundamentals among the high-yielders ▸ FX policy has been relatively permissive of currency strength ▸ The ongoing improvement in underlying fundamentals, especially in the trade balance, should keep USD-IDR well offered	Short USD-IDR	9,200	Stronger
KRW	▸ KRW is still our favoured Asian currency exposure ▸ Resident flows are an important but under-recognised component of the bullish KRW case ▸ FX policy has likely shifted from preventing appreciation to managing an adjustment to a new equilibrium	Short JPY-KRW Short USD-KRW	1150	Stronger
MYR	▸ Capital outflows reflect a structurally weak investment environment ▸ Politics remain unsettled, and resident outflows meaningful ▸ For the currency, structural weaknesses will continue to bias MYR underperformance, and leave MYR relatively vulnerable to episodes of risk aversion	Long USD-MYR	3.50	Stronger
PHP	▸ With PHP being one of the higher-yielding currencies in Asia and with the BSP expected to raise rates in 2Q10, the growing positive carry is likely to result in increasing home bias ▸ However, as we exit the strong remittance season, PHP appreciation is likely to lose some momentum ▸ In addition, politics (general elections in May) and fiscal concerns will start weighing more heavily on the currency	Neutral	45.5	Neutral
SGD	▸ SGD strength is constrained by the fact that it is trading on the strong side of the band ▸ Some recent softness in the domestic data pulse add to these near-term risks on the NEER ▸ We recommend selling SGD as a portfolio hedge given the limited appreciation room and low carry	Short S$NEER	1.40	Neutral
TWD	▸ The ongoing warnings of possible prudential measures and intervention activities have slowed TWD appreciation ▸ However, neither the prudential regulatory changes nor intervention activities are likely to prevent TWD strength, especially given the ongoing improvement in cross-Strait relations ▸ As such, the appreciation trend remains intact as offshore capital comes home	Short USD-TWD	31.0	Neutral
THB	▸ THB appreciation is likely to persist because of a widening trade surplus and ongoing repatriation by local investors ▸ The key obstacle is the ongoing intervention by the BOT ▸ Policymakers will also consider further liberalisation of regulations to encourage domestic capital outflows	Short USD-THB	32.5	Stronger
VND	▸ Depreciation pressure persists as the trade account worsens again ▸ Despite some normalisation in rates, the spot market remains long dollars ▸ Recent policy steps have stabilised conditions for now	Neutral	18,400	Weaker

Source: HSBC

CNY gradualism, but NDF value now

- Speculation about a near-term revaluation in China has intensified
- Recent moves to tighten policy suggest appreciation will occur in 2Q
- Any currency appreciation is expected to be relatively gradual, suggesting the longer-dated NDFs are better value

Questions over the timing, and manner, of China's exit from its de-facto dollar peg have gathered more urgency. Following the more hawkish stance from the Chinese authorities, despite their dovish statements into the close of 2009, it is only sensible that we also bring forward the timing of appreciation into 2Q.

Our key message, however, is that appreciation will likely begin more slowly than recent market expectations. Gradual appreciation has its problems as it clearly brings costs in terms of increasing speculative inflow. Beijing, however, is likely to be relatively confident in its ability to manage inflows, with worries about the stability of exports as a sustainable source of growth an ongoing issue. In fact recent developments in global financial markets are only likely to propagate onshore concerns. We continue to recommend selling the 1yr NDF, rather than the front-end, to position for eventual CNY appreciation.

The decision

The state of domestic policy has been our key cyclical indicator for the currency. Chart 1 shows the exchange rate against our domestic policy indicator (the 1yr lending rate plus the RRR).

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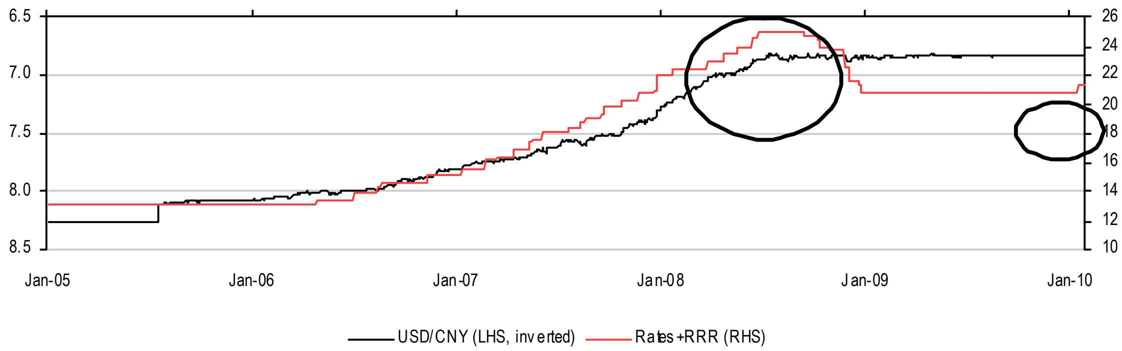
1. Domestic policy indicator and the CNY



Source: HSBC, Bloomberg

It is not that China necessarily views the currency as a key part of the domestic policy framework. It is certainly the case, however, that China has been more willing to appreciate the currency when it is tightening aggressively anyway. We continue to argue, therefore, that currency policy is likely to consider a range of factors that is much broader than a singular focus on exports.

The timing

The earlier-than-expected move to raise reserve requirements in January, and the strength of some of the data, has seen our economists bring forward forecasts for China's interest rate hikes. We now expect the first move in rates in 2Q. On the basis of the need China has shown for tighter domestic policy it makes sense to bring forward the timing of our appreciation call, and we now expect appreciation to start in the next quarter. What is key, however, is our expectation that initial currency gains are likely to be relatively modest.

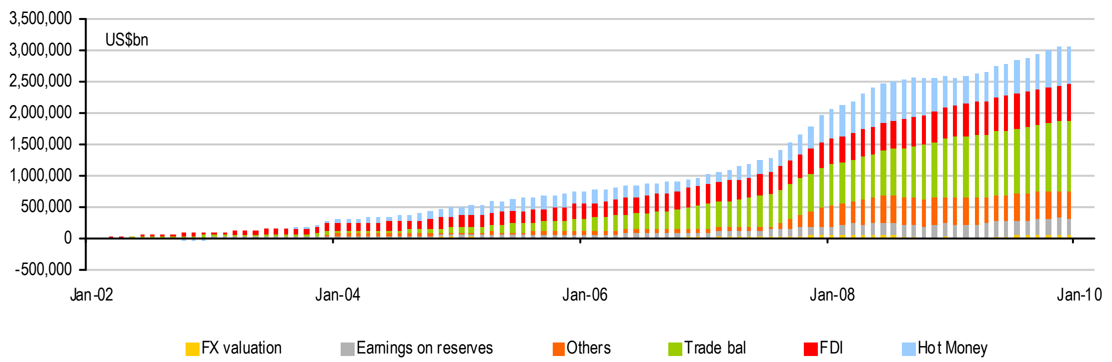
While the case for RMB appreciation, when viewed from offshore, may seem to be self-evident, onshore perspectives still hold much caution over significant and sharp moves in the currency. It is the onshore view that we think will dominate, and therefore our view is that a one-off large revaluation will not happen.

The manner

There are sound economic reasons for moving the CNY quickly towards levels which will bring the balance of payments closer into balance. However, the headwinds to such a move among policymakers are, in our view, substantial. Key here are fundamental questions about future sources of growth for China's economy. While growth currently is showing signs of being stronger than expected, this has come on the back of infrastructure and bank lending packages. These supports to growth are not self-sustaining and therefore worries about the sustainability of the growth path will remain a concern. While net exports may be gradually improving, there is little occurring globally to encourage policymakers that these will return to pre-crisis levels, especially with ongoing worries about sovereign risk. With this in mind, **a gradual appreciation is by far the most likely outcome in the near term, in our view**.

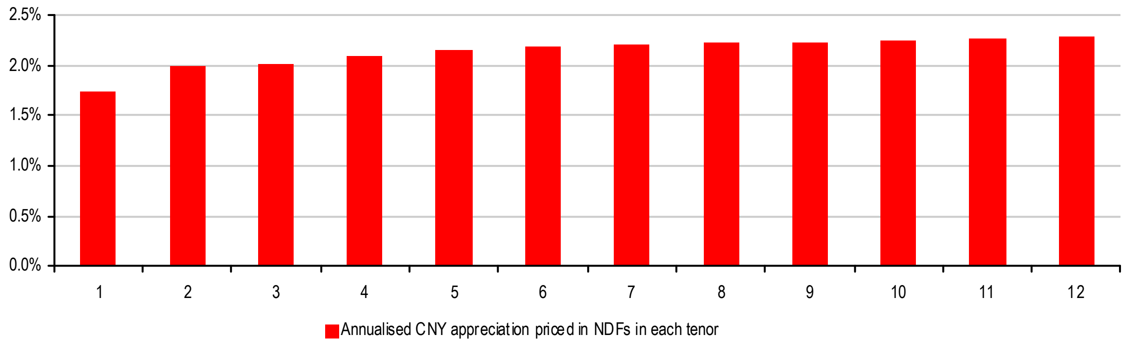
There is certainly recognition onshore that gradual appreciation brings with it costs in the form of increased hot money inflows. However, policy already appears to be turning to addressing those issues. The CBRC on 2 February warned banks specifically on the risks from hot money inflows. **More policy steps to manage inflows, and their effects, seem likely**. In addition, it is worth considering just how significant 'hot money' flows are to China's balance of payments surplus.

2. Sources of reserve accumulation



Source: HSBC, Bloomberg

3. NDF pricing to 12m



Source: HSBC, Bloomberg

According to our work, hot money flows contributed 20% to the growth in China's foreign exchange reserves since 2002 (Chart 2). This is comparable with the 19% contribution from FDI, and substantially less than the 37% contribution from the trade surplus. **Therefore, China will face a very substantial balance of payments surplus, and ongoing significant reserve accumulation, even if hot money inflows diminish.**

It would also be very unusual for China to deviate so significantly from public statements, in our view. Given they have argued that yuan reform should remain gradual, it would be out of character to then move the currency sharply. In late December Premier Wen gave an exclusive interview with the Xinhua news agency, in which he strongly defended the benefits of the stable yuan[2]. The fact the Premier requested the interview is interesting in itself. In mid-January the Commerce Minister also reaffirmed that yuan reform would be gradual, and that a stable yuan would aid the world recovery[3].

Some sort of one-off revaluation is certainly not impossible. In our view, however, it is much more likely further out than in the very near term. **The longer China delays appreciation, the greater the prospect that China delivers some appreciation through a rapid one-off move**.

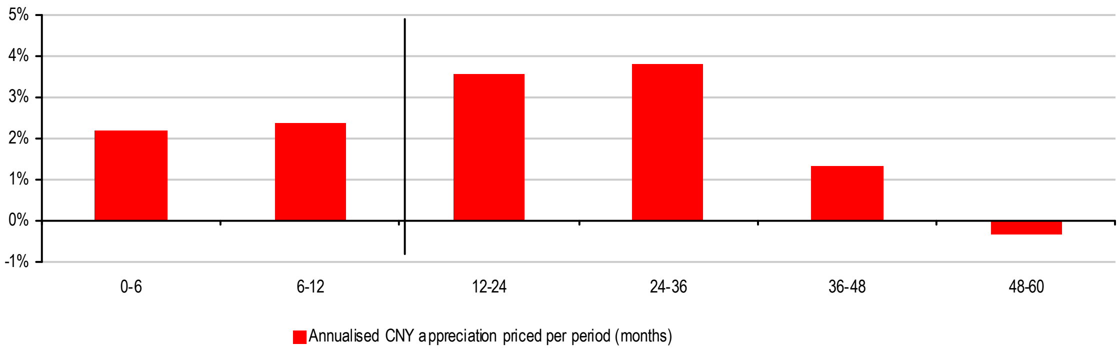
Where does this leave the NDFs?

The NDFs currently seem to offer relatively little in the way of value at the front end. Certainly the NDF curve is unusually flat given that the spot rate is still within established ranges (Chart 3). China needs to move by a meaningful quantum in the very short term to justify front-end pricing; something we have argued against. The long-end (the 1 or 2yr bucket) would still trade lower in price even if appreciation was front-loaded, and yet is the most attractive place to position if appreciation is gradual, as we expect. In other words, **the duration benefit offered by longer-end NDFs comes with relatively little cost at present.**

Historically this part of the curve has been influenced by the performance of the equity market and the USD – we expect these linkages to gradually loosen as policy in China normalises over time. Even if risk assets fear China tightening, that tightening should ultimately be consistent with currency appreciation. In addition, **with the onshore-offshore spread down to around 900pts at present, the pull from forward parity pricing is likely to be modest only**. On this basis, we continue to recommend selling the 1yr NDF as the optimal way to position for CNY appreciation.

[2] *http://news.xinhuanet.com/english/2009-12/27/content_12712433.htm*
[3] *http://www.reuters.com/article/idUSBJC00247020100119*

4. NDF pricing to 5yr



Source: HSBC, Bloomberg

What does CNY appreciation mean for USD overall?

When CNY was steadily appreciating prior to the crisis, it coincided with a steady decline in the USD overall. This time the arguments are less straightforward. On the one hand CNY appreciation should be seen as a broadly USD negative event, as in the past. Greater CNY or Asian FX flexibility would allow the USD to broadly deflate. On the other hand, if the market came to fear CNY appreciation as another form of tighter policy coming from China, then the USD could hold up. So the real question is whether or not the market comes to fear a renewed appreciation path by the CNY.

Even though we now expect greater CNY appreciation, our strategic thinking regarding the USD remains the same. We believe the USD negative story is still intact, as cyclical and structural forces should continue to work against the currency over time. In addition, we still believe that the internationalisation of other currencies like the CNY is ticking away in the background, which should undermine the USD from a long-term perspective.

INR complacency

- India's FDI inflows are on a stronger trajectory
- But a myriad of other vulnerabilities are being glossed over
- We prefer to express appreciation views in KRW, TWD or IDR

The rupee has become one of the more popular currency exposures in Asia. In our assessment, however, the consensus is glossing over India's vulnerabilities. There is little doubting the country's long-term potential, but much is already in the price.

The drivers of appreciation

The rupee has risen relatively strongly in recent months, primarily, according to the balance of payments, under the combination of stronger equity and FDI flows. Capital outflows from India remain infinitesimal, as residents continue to show faith in India's long-term potential. And while the current account deficit has widened, as a share of GDP this remains at a reasonable 1.5% of GDP or so.

The lack of any meaningful resident outflows is particularly significant for conceptualising India's balance of payments, in our view. In the capital account these have averaged almost nothing in the last two years. More informal measures of foreign asset demand, such as the share of NRI deposits that are in foreign currency (Chart 1), suggest, if anything, ongoing gradual de-dollarisation over recent years. With resident outflows tiny, any meaningful rupee selling pressure must come from a reversal of foreign capital inflows, or a deteriorating current account deficit.

Beyond these resident flows, there are also two elements of the foreign flow picture which deserve particular comment.

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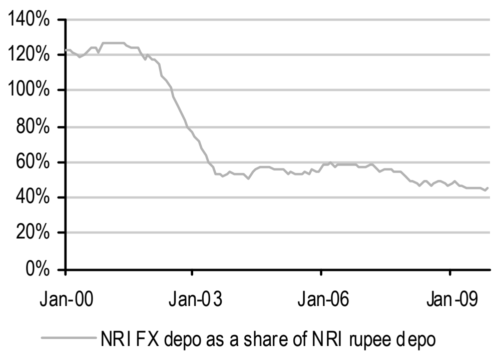
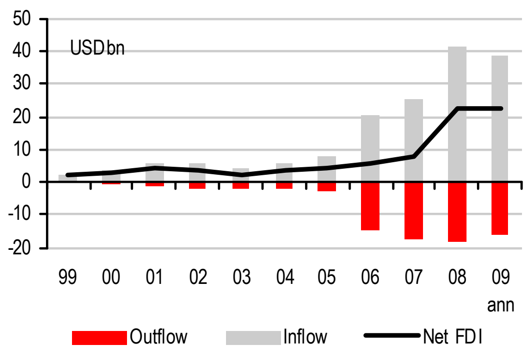
1. Foreign currency share of NRI deposits



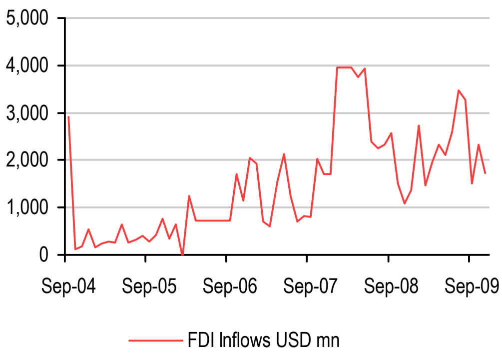
Source: HSBC, CEIC

2. FDI over the long term



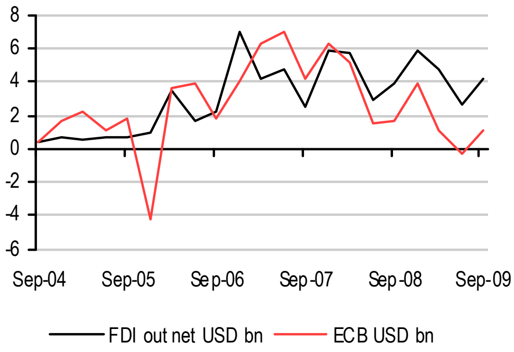
Source: HSBC, CEIC

3. Monthly gross FDI inflows



Source: HSBC, CEIC

4. FDI outflows and ECB's



Source: HSBC, CEIC

Foreign direct investment

Not only were FDI flows into India unaffected by the crisis, but they appear to be on a structurally stronger trajectory than has been the case previously. Chart 2 shows net FDI flows and Chart 3 shows gross inflows into India. Gross flows began to pick up materially in 2006, and net inflows clearly took a further step up over 2008.

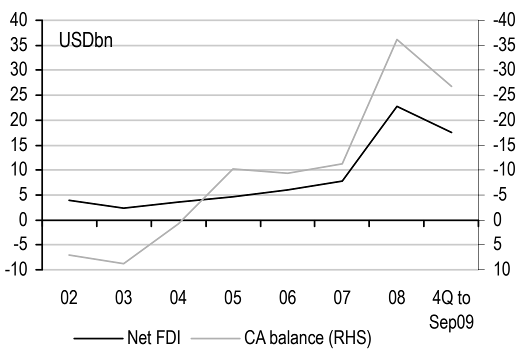
Given the low level of accumulated FDI, there is little reason to expect the inflows to return to their previous very modest levels. In either dollar terms or as a share of GDP, India continues to receive flows that are modest. If anything, there still appears to be plenty of scope for FDI flows to increase.

The picture is even more improved, at least from a short-term flow perspective, when we consider that most FDI outflows appear to be financed by external commercial borrowings (ECBs). While there needs to be a flow of income to service the offshore borrowing over time, the initial build-up of offshore assets entails little INR selling (Chart 4).

Before we get too carried away, however, some deeper analysis suggests being a little more cautious than a cursory read of the headline numbers might suggest. In the first instance, the rise in nominal FDI in recent years has also occurred at a similar time as the current account deficit has risen (Chart 5). As a result, FDI is funding about the same broad share of the current account deficit as in 2006 – around two-thirds (Chart 6).

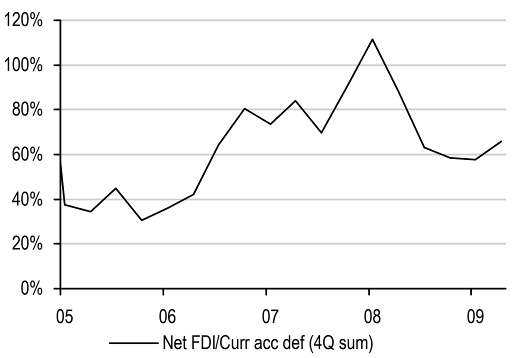
Secondly, while FDI appears to have reached a higher level, it is not clear that it is on a sustained growth track. Gross inflows (as presented earlier

5. FDI and the current account



Source: HSBC, CEIC

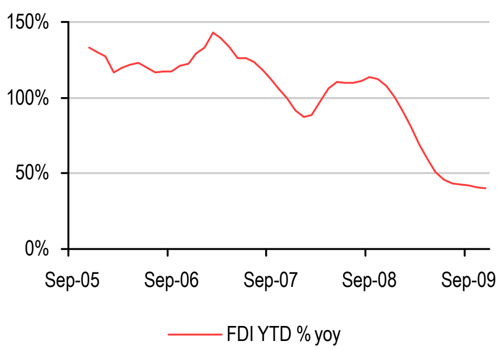
6. FDI as a share of the current account deficit



Source: HSBC, CEIC

in Chart 3) seem to have levelled off in the past two years. In addition, the growth of FDI (Chart 7) has been declining sharply since the initial burst of inflows over 2006 and 2007. While we might expect FDI to moderate when it reached significant levels, the fact it is occurring when FDI has only reached 2% of GDP (the peak in 2008), is notable.

7. FDI % y-o-y



Source: HSBC, CEIC

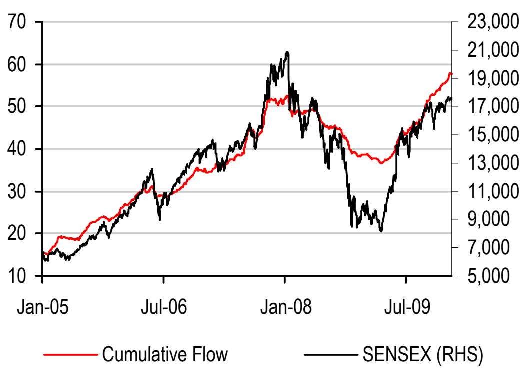
The third point of caution is the issue of reform. Despite the election of a new government last March, India has actually delivered little in the way of genuine reform, opening sectors previously closed to FDI, or offering significant improvements in infrastructure, to ensure that this burst of FDI continues to grow, or in fact is sustained. While there has been plenty of discussion, delivery has not been what it could have been. While India is regularly nominated as an attractive place for investment, it continues to rank poorly on measures such as the World Bank's Doing Business survey (133 out of 183 countries) and the Corruption Perception Index (85 out of 181 countries).

India's telecom sector is a case in point. The 3G auction has recently been delayed for the second time. Initially the planned auction was to take place on 14 January but later pushed back to 12 February. In recent days, however, the deadline seems to have been postponed again. The auctions are now expected to begin on 24 February, although the risk seems to be for further delays. The local press is also now reporting that the Department of Telecom will restrict foreign firms from investing in the 2G space if they win a 3G licence[4]. While India's FDI potential is clear, policy delivery remains patchy.

Equity flows

While FDI flows represent a potentially sustained and relatively stable source of foreign financing, the same cannot be said of equity flows. In the recent past, these flows have certainly been robust (Chart 8). Over 2009 foreigners more than returned the crisis-induced outflows to take cumulative foreign flows to a fresh record. In fact, this is the only market in Asia for which there is available comprehensive data which shows cumulative flows having exceeded the pre-crisis peak (there is no such data for China or Hong Kong). In the short term, moreover, with foreigners continuing to buy but the market making little headway, we essentially have a situation of foreigners continuing to allocate money to a market which locals do not wish to buy.

8. Equity flows into India



Source: HSBC, Bloomberg

The sustainability of these flows in the nearer term is questionable. Certainly our equity

[4] *http://economictimes.indiatimes.com/news/news-by-industry/telecom/Foreign-cos-cant-bid-for-3G-in-CDMA-space/articleshow/5446576.cms*

strategists list India as their largest regional underweight; and that in a region which they also have underweight in their global recommendations. They list it as being over-owned by foreigners (refer to our points immediately above), facing rising inflation and the resultant risk of aggressive monetary tightening, and the most expensive emerging market.

Certainly, our economists forecast India having the highest inflation in Asia this year, with the most rate hikes. The RBI is expected to begin tightening with a cash reserve ratio hike at the upcoming 29 January meeting, and the repo and reverse repo rate being hiked in March. In calendar 2010 as a whole they are looking for 200bps of CRR hikes and 125bps of policy rate moves.

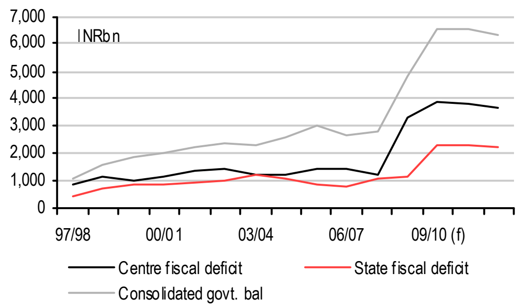
For the currency, the key is that rate hikes should not be viewed as currency positive. Higher interest rates are unlikely to result in much additional INR demand from locals – who already show no meaningful capital outflow – and the bond market is almost entirely closed to foreigners, suggesting little inflow from this channel either. In fact, given the predominance of equity flows into India, how an overvalued equity market handles the tightening cycle is likely to be the key driver of the currency's response.

Fiscal

Fiscal sustainability seems to be a discussion these days most held in the context of the major developed economies. India is one emerging market, however, where the fiscal policy has taken a noticeable deterioration as a result of the crisis.

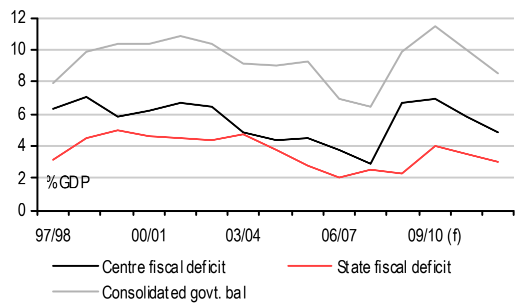
Our economist forecasts this year's (2009/10) deficit to be 11.5% of GDP, with modest improvement to 10.0% and 8.5% over the next two years. Charts 9 and 10 place these numbers in context; presenting the data in both rupee terms and as a share of GDP. Importantly, this forecast improvement "reflects a reassessment of cyclical effects on the deficit rather than a more optimistic view of the structural shortfall" (see *India Economic Watch (Issue 58): Fiscal deficit: Is the worst over?* by Robert Prior-Wandesforde). As a share of GDP these will be the largest deficits in non-Japan Asia over the three years.

9. India's fiscal deficit (INRbn)



Source: HSBC, CEIC

10. India's fiscal deficit (% GDP)



Source: HSBC, CEIC

There is an important connection here also with the FDI issues discussed earlier. India requires greater fiscal expenditure on infrastructure to facilitate FDI, but the budget is already stretched. So not only is improvement in the non-infrastructure budget necessary, but it needs to be large enough to allow some expansion in long-term expenditure. Certainly the Congress government's efforts at fiscal reform last year give little cause for optimism on this front.

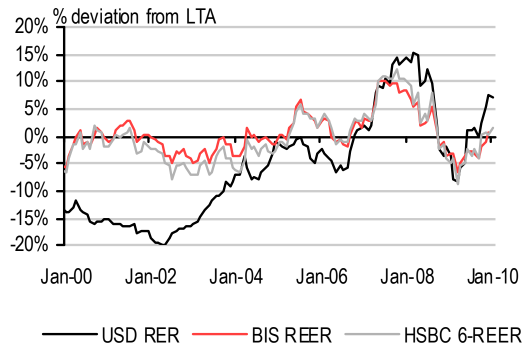
Our bond strategist further argues that despite the moderate improvement in the fiscal deficit, the still significant level of bond issuance, and bank holdings of bonds in excess of hold-to-maturity (HTM) limits, leaves the bond market more vulnerable to supply pressures. 2009 already saw several failed or partially cleared government bond auctions. As credit growth picks up, it is difficult to see these pressures diminishing substantially.

Foreign investors are currently limited to total collective exposure of USD5bn in local currency government bonds. Total holdings are presently less than that. Higher bond yields, therefore, are unlikely to impact the currency because they induce offshore bond selling. An over-owned and expensive equity market, however, is unlikely to adjust easily to higher bond yields. It is from here that the channel of currency influence is likely to focus.

Valuation

Against this backdrop of some identifiable stress points in both the capital account and domestic markets, the currency's recent appreciation run has seen it price in a lot. Chart 11 presents various measures of the rupee in real terms. The 'HSBC REER' is simply our updated estimate of the RBI's 6-country REER. The latest data for the official version is November, whereas the HSBC version extends to January.

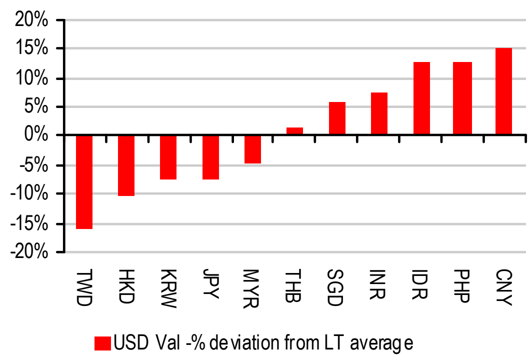
11. INR valuation



Source: HSBC, CEIC

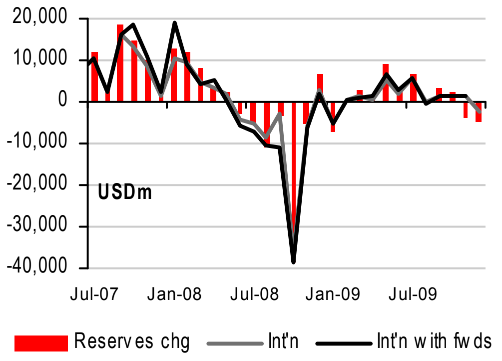
On all measures the INR is now above long-term averages in real terms. Moreover, the currency is only 8% from its all-time highs against the USD and 11% from all-time highs against the REER. While none of these measures is particularly stretched, they do leave the INR needing a continual flow of good news to continue appreciation at recent rates. Against the USD, the INR is now the fourth-most expensive currency in the region (Chart 12).

12. Asian currency valuation



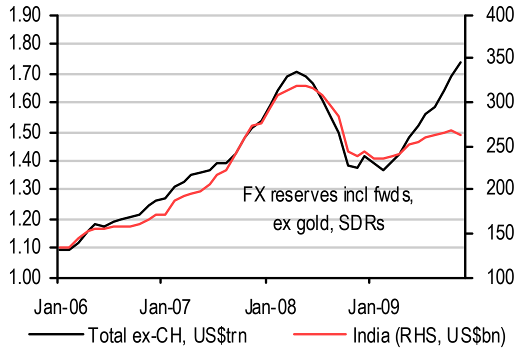
Source: HSBC, CEIC

13. FX intervention



Source: HSBC, CEIC

14. Asian FX reserves



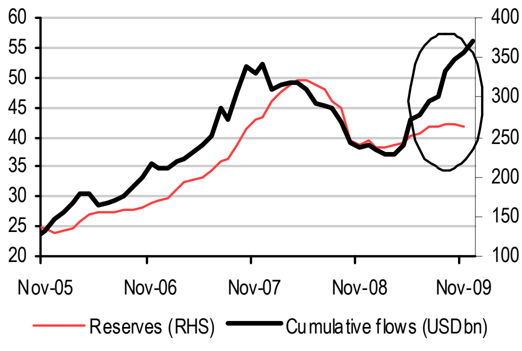
Source: HSBC, CEIC

FX policy

When undertaking a thorough review of any currency in Asia, we always consider FX policy. The most notable feature of the intervention numbers in India, however, is the mildness of intervention (Chart 13 is taken from our monthly *Asian FX Policy Dashboard*). This is interesting in a couple of respects. Firstly, reserve accumulation in India has clearly undershot the rest of the region (Chart 14), but this does not appear to have resulted in any greater currency appreciation. Over the past six months the INR has appreciated 4.6%, compared with 7.7% for the KRW and 6.1% for IDR. In other words, the flows supporting INR appreciation just seem to be weaker than in some other countries in the region.

Secondly, intervention has undershot equity flows quite significantly (Chart 15). India has typically based FX policy at least partly on the principal that a reasonable share of portfolio inflow should be absorbed through reserves, in case those inflows become destabilising outflows. It may be that the pick-up in inflation is encouraging the authorities to accede to more currency appreciation. An alternative is that with the cost of sterilisation creeping back again, the perceived benefit of accumulating even more reserves is becoming less desirable. Even with a combination of the two, it suggests that for now the authorities are likely to allow the rupee to fluctuate relatively freely, particularly compared to some other currencies in the region which are still subject to significant official influence.

15. India reserves and equity inflows



Source: HSBC, CEIC

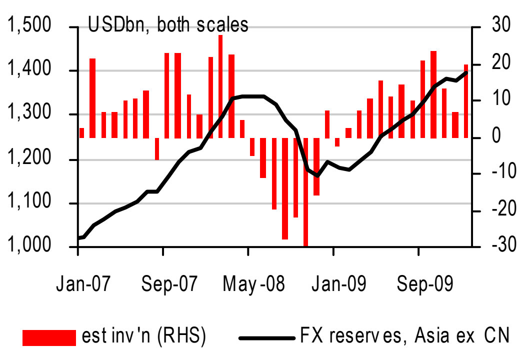
Conclusion

The rupee presents an attractive long-term story. FDI has stepped up in recent years and FX reserves are high. In our view, however, a number of issues are being glossed over, and in any case much is in the price. We prefer to express bullish Asian exposure elsewhere.

The dashboard this month

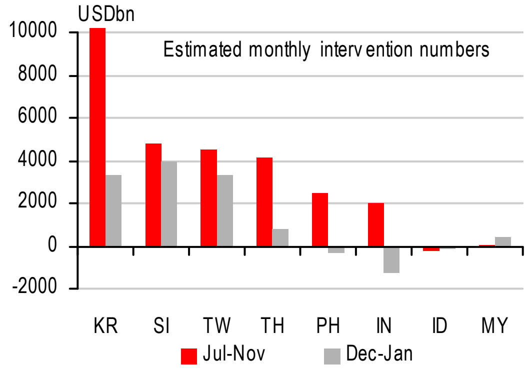
- Overall Asian FX reserve levels kept rising in January, even with continued risk aversion and USD strength in the latter half of the month
- However, aggregate numbers mask significant divergence in the region
- Details suggest significant continued net demand for KRW, SGD and TWD despite poorer risk conditions in the last two months

Chart 1: Estimated intervention remained large in January…



Source: HSBC, Bloomberg, CEIC

Chart 2: … but there was significant divergence intra-region



Source: HSBC, CEIC, Bloomberg

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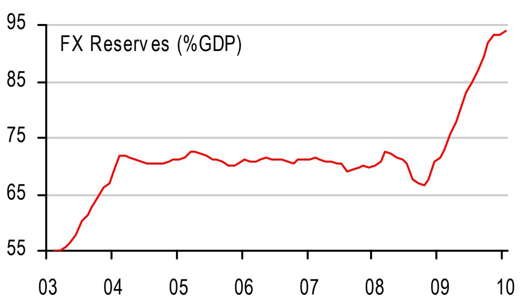
What reserves reveal about fundamental currency demand

Asia's headline FX reserves (excluding China) continued to reach new highs in January despite the pullback in global risk appetite and USD strength we saw in the latter half of the month (Chart 1). After accounting for FX valuations and earnings on reserves, intervention by regional central banks was sizeable, at an estimated USD20.5bn excluding China (Chart 1), not including forwards. This is the third-largest month of intervention post-crisis, clearly suggesting that aggregate flows into Asia remain strong despite the pullback in risk, and despite press reports that various regional central banks turned around and sold USD to curb volatility during the USD rally in the latter half of the month.

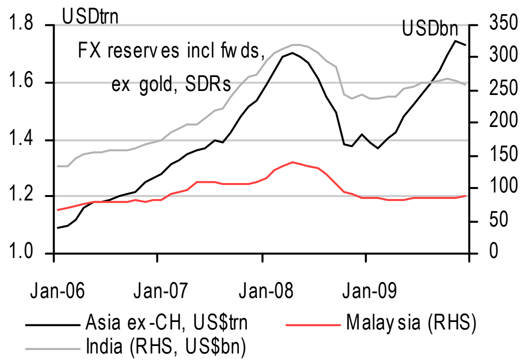
Breaking down our estimated intervention numbers reveals an interesting divergence across countries. The general pullback in risk in the past two months presents an opportunity to compare the net demand for Asian currencies with and without speculative inflows.

Chart 3: Taiwan FX reserves as a % of GDP is rising sharply



Source: HSBC, CEIC

Chart 4: Malaysia and India lagging in FX reserve re-accumulation



Source: HSBC, CEIC, Bloomberg

While estimated intervention was large across almost all of Asia during most of last year, they only remained sizeable in the past two months in Korea, Singapore, and Taiwan. This indicates fundamental net currency demand in these countries even under adverse risk conditions. On the other hand, the material intervention to sell USD by India in the past two months suggests that net demand for INR in the past year is relatively sensitive to risk appetite; this is an argument we continue to make (see *Asian FX Focus: INR complacency*, 27 January 2010).

Other developments in the Dashboard this month

- **China change in methodology** – SAFE on 5 February announced that it will adopt international standards in BoP accounting and reporting. Besides moving to quarterly reporting (from semi-annual), changes also include revisions of methodology of recording changes in reserves assets. Going forward, the "change in reserves" account in the BoP will exclude FX valuation, earnings on reserves and any other non trade and capital transactions – in other words, only accounting for actual flows. Thus, in the BoP accounts, changes in reserves will differ from that reported in the monthly FX reserves released by the PBoC, which we assume take into account FX valuation and earnings on reserves. We expect that PBoC's methodology for FX reserves will not change, as unlike BoP statistics, the official reserves statistics are intended to represent total available liquidity (which are impacted by valuation and interest effects), rather than simply cumulative flows. Under this new methodology, in 2009 FX reserves accumulation would be reported in the BoP as USD382bn, less than the net change of USD453bn reported by the PBOC. This suggests that the difference of USD71bn was a result of FX valuation and earnings on reserves. This will not change our methodology in analyzing China reserves in our dashboard.

- **Rising Taiwan reserves** – Taiwan's FX reserves growth, after having kept in line with GDP growth for the prior five years, accelerated notably in the past 18 months. The ratio has moved from a steady 70% of GDP, to 94% of GDP in the most recent data. In the region, this is only topped by Singapore (109% of GDP), and is far above the next largest holder of reserves as a % of GDP which is China (55%). Taiwan's negative carry status has meant that Taiwan generates net income from its stock of sterilized

Table 1: Policy tools – state of play

	Regulatory measures			FX intervention	Fiscal policy tightening	Monetary tightening
	Encourage outflows	Discourage inflows	Prudential tightening			
Asia						
China	Yes	No	Yes	Yes	No	Yes
Hong Kong	No	No	Yes	Yes	No	No
India	No	No	Yes	Yes	No	No
Indonesia	No	No	No	Yes	No	No
Korea	No	No	Yes	Yes	No	No
Malaysia	No	No	No	No	No	No
Philippines	No	No	No	Yes	No	No
Singapore	No	No	Yes	Yes	No	No
Taiwan	No	Yes	Yes	Yes	No	No
Thailand	**Yes***	No	No	Yes	No	No

Source: HSBC.
Note: * Changes from the prior month have been bolded

reserves. However, the risk is that if domestic market rates rise sufficiently enough such that this net income turns into a net cost, the large stock of reserves mean that sterilization costs would rise particularly quickly.

- **Reserve accumulation underperformance in India and Malaysia** – For the past several months we have been highlighting Malaysia's lack of reserve accumulation, an issue we explore in more depth in a recent note (see *MYR to lag Asia, but bonds offer value*, 10 February 2010). India is the only other economy in Asia where FX reserves remain significantly below pre-crisis peaks (19% below the peak, compared to Malaysia's 37%).

- **Thailand regulatory changes** – Recent regulatory changes were announced in Thailand which further encourage capital outflows as a way to better recycle current account surpluses (see *THB appreciation to persist despite policy change,* 3 February 2010). We note these changes in Table 1 where we track the ongoing mix of policy tools being used in Asia. In Asia we expect the trend of outflow liberalization will continue, particularly when the global risk environment stabilizes and Asian currency appreciation pressure re-intensifies. Ultimately, we view these moves as delaying, but not preventing the eventual currency appreciation that must take place (see *The response to currency appreciation matures*, 18 June 2007).

- Other adjustments made in calculating estimated intervention this month include a USD2bn bond offering in Indonesia which added to the estimated USD1.3bn in oil export receipts account for almost the full amount of reserve accumulation in January. This suggests that Indonesia continued to practise a laissez faire FX policy. Similarly, in the Philippines we also make adjustments for a USD1.5bn bond offering in January. After also making the standard adjustments for FX valuation and interest earnings, we estimate that there was a negligible amount of intervention in the Philippines in January. Finally in Malaysia, a rise in FX reserves was matched by a similar fall in the "Other reserve assets", leaving headline official reserves largely unchanged. We adjust for a likely reallocation in reserves and estimate that Malaysia intervention remains negligible.

Table 2: Estimated intervention activity dashboard: Latest changes in FX reserves

Country			Current, USD bn	MoM Chge USD bn	Interest Adjustments, USDbn	Valuation Adjustment, USDbn	Others, USDbn	Total adjustment, USDbn	**Estimated Intervention, USDbn***
China	Reserves	Dec-09	2,328	-60.5	-3.6	26.4	-	22.8	**-37.7**
India	Reserves	Jan-10	258	-0.5	-0.4	1.0	-	0.6	**0.1**
	Incl Fwds	Dec-09	259	-4.6	-0.4	2.4	-	2.0	**-2.6**
Indonesia	Reserves	Jan-10	64	3.5	-0.1	0.1	(3.29)	-3.2	**0.2**
	Incl Fwds	Dec-09	60	0.6	-0.1	0.4	(1.50)	-1.2	**-0.8**
Korea	Reserves	Jan-10	269	3.7	-0.4	1.7	-	1.3	**5.1**
	Incl Fwds	Dec-09	280	-2.2	-0.4	-0.4	-	-0.8	**1.5**
Malaysia	Reserves	Jan-10	88	1.3	-0.1	0.0	(1.05)	-1.2	**0.1**
	Incl Fwds	Dec-09	87	0.6	-0.1	0.3	-	0.2	**0.8**
Philippines	Reserves	Jan-10	39	1.3	-0.1	0.1	(1.50)	-1.4	**-0.2**
	Incl Fwds	Dec-09	51	-0.7	-0.1	0.3	-	0.3	**-0.4**
Taiwan	Reserves	Jan-10	351	2.5	-0.5	1.2	-	0.7	**3.2**
Thailand	Reserves	Jan-10	138	4.0	-0.2	0.8	-	0.6	**4.6**
	Incl Fwds	Jan-10	150	0.9	-0.2	0.8	-	0.6	**1.5**
Singapore	Reserves	Jan-10	193	5.3	-0.3	1.3	-	1.0	**6.3**
	Incl Fwds	Dec-09	244	-0.6	-0.3	2.4	-	2.2	**1.6**

Source: HSBC, Bloomberg, CEIC, Reuters; * Intervention number are calculated estimates based on public data, including FX reserves, FX and interest rates

Table 3: Changes in reserves including forward commitments (USDbn)

	Total					Reserves			Forward commitments		
Country	Date of Peak	Peak	Latest	Change	% Chg	Peak	Latest	Change	Peak	Latest	Change
China	Dec-09	2,389	2,328	-	-	2,389	2,328	-	-	-	-
India	May-08	320	259	-61	-19%	305	258	-47	17	1	-17
Indonesia	Dec-09	64	60	-4	-6%	64	64	-	0	0	0
Korea	Mar-08	307	280	-27	-9%	269	269	0	44	14	-30
Malaysia	Apr-08	139	87	-51	-37%	120	88	-32	21	1	-20
Philippines	Jan-10	52	51	-	-	39	39	-	15	14	-1
Taiwan	Jan-10	351	351	-	-	351	351	-	-	-	-
Thailand	Jan-10	150	150	-	-	138	138	-	23	13	-11
Singapore	Apr-08	270	244	-25	-9%	193	193	-	91	57	-34

Source: HSBC, Bloomberg, CEIC, Reuters

Table 4: Policy sustainability dashboard

		unit	China	Indonesia	India	Korea	Malaysia	Philippines	Singapore	Thailand	Taiwan	unit
Strength of flows	Net CA flows	USD bn, 3mma	Dec: 20.5 ↑	Dec: 2.6 ↑	Q3: -12.6 ↓	Dec: 3.5 ↓	Dec: 3.2 ↑	Nov: 1.5 ↑	Dec: 2.6 ↑	Dec: 1.4 ↓	Jan: 2.1 ↓	USD bn, 3mma
	(% GDP)	% GDP	Dec: 6.0 ↑	Dec: 5.9 ↑	Q3: -4.8 ↓	Dec: 5.2 ↓	Dec: 20.1 ↑	Nov: 11.1 ↑	Dec: 18.0 ↑	Dec: 6.6 ↓	Jan: 6.7 ↓	% GDP
	Net KA flows	USD bn, 3mma	Dec: 8.8 ↑	Jan: 0.7 ↑	Nov: 5.0 ↓	Dec: 1.6 ↓	Q3: -3.2 ↑	Sep: 0.0 ↑	Q3: -2.3 ↑	Dec: 1.2 ↑	Q3: 6.5 ↑	USD bn, 3mma
	(% GDP)	% GDP	Dec: 2.6 ↑	Jan: 1.5 ↑	Nov: 5.6 ↓	Dec: 2.3 ↓	Q3: -6.8 ↑	Sep: 0.4 ↑	Q3: -5.3 ↑	Dec: 5.4 ↑	Q3: 7.0 ↑	% GDP
	Foreign ccy deposits	% of total deposits	Dec: 2.4	Nov: 16.5 ↑		Nov: 2.0 ↓	Dec: 5.4 ↑	Oct: 21.9	Dec: 0.9 ↑		Dec: 10.8 ↑	% of total deposits
	(3m chg)	%-pts	Dec: 0.0 ↑	Nov: 0.6 ↑		Nov: -0.3 ↑	Dec: 0.3 ↑	Oct: -0.4 ↓	Dec: -0.1		Dec: 0.1 ↑	%-pts
Inflation / Liquidity pressure	Broad Liquidity	M2/M3 %y/y 3mma	Dec: 28.9 ↓	Nov: 11.6 ↓	Nov: 15.5 ↑	Nov: 10.1 ↓	Dec: 9.5 ↑	Nov: 11.4 ↓	Dec: 10.2	Dec: 6.7 ↓	Dec: 6.3 ↓	M2/M3 %y/y 3mma
	Narrow Liquidity	M0/M1 %y/y 3mma	Dec: 13.6 ↓	Nov: 8.9 ↑	Jan: 15.0 ↑	Dec: 6.4 ↓	Dec: -21.5 ↑	Dec: 9.6 ↑	Dec: 6.6 ↓	Dec: 6.7 ↓	Dec: 9.7 ↓	M0/M1 %y/y 3mma
	Inflation	CPI %y/y, 3mma	Dec: 0.7 ↑	Jan: 3.0 ↑	Dec: 4.5 ↑	Jan: 2.8 ↑	Dec: -0.2 ↑	Jan: 3.8 ↑	Dec: -0.3 ↑	Jan: 3.2 ↑	Jan: -0.5 ↑	CPI %y/y, 3mma
	Equity mkt	%y/y, 3mma	Jan: 67 ↓	Jan: 92 ↑	Jan: 80 ↑	Jan: 44 ↓	Jan: 44 ↓	Jan: 60 ↑	Jan: 60 ↑	Jan: 64 ↓	Jan: 76 ↑	%y/y, 3mma
	Govt bond yield	chg bp, 3m	Jan: -18 ↓	Jan: -73 ↓	Jan: 47 ↑	Jan: -12 ↓	Jan: -14 ↓	Jan: -12 ↓	Jan: -07 ↑	Jan: -36 ↓	Jan: -02 ↓	chg bp, 3m
	Property mkt	%y/y	Q4: 5.8 ↑	Q3: 2.6 ↓		Jan: 1.4 ↑			Q4: 1.8 ↑		Q4: 16.8 ↑	%y/y
Export competitiveness	Export growth	%y/y, 3mma	Dec: 0.9 ↑	Dec: 24.9 ↑	Dec: 7.0 ↑	Jan: 32.6 ↑	Dec: 5.6 ↑	Nov: -6.8 ↑	Dec: 9.5 ↑	Dec: 4.6 ↑	Dec: 20.5 ↑	%y/y, 3mma
	Relative appreciation	%12m chg less region ave	Jan: -6.7 ↓	Jan: 10.7 ↓	Jan: -1.6 ↓	Jan: 8.7 ↑	Jan: -1.6 ↑	Jan: -5.2 ↓	Jan: -0.3 ↑	Jan: -1.9 ↓	Jan: -1.9 ↑	%12m chg less region ave
Constraints on sterilized intervention	Unit sterilization cost	bp, 3mma	Dec: -18 ↑	Jan: 474 ↑	Jan: 249 ↑	Jan: 239 ↓	Jan: 32 ↑	Jan: -33 ↑	Jan: -42 ↑	Jan: 60 ↓	Jan: -134 ↑	bp, 3mma
	Annual Sterilization cost	% GDP, last 12m	Dec: -0.1	Jan: 0.2	Jan: 0.4	Jan: 0.3	Jan: 0.1 ↑	Jan: 0.0	Jan: -0.2	Jan: 0.2	Jan: -0.6	% GDP, last 12m
	FX valuation sensitivity	% GDP for a 1% chg in fx	Dec: 0.5 ↓	Jan: 0.1	Jan: 0.2	Jan: 0.3	Jan: 0.5	Jan: 0.2	Jan: 1.1	Jan: 0.5	Jan: 0.9	% GDP for a 1% chg in fx
	FX valuation cost	% GDP, last 12m	Dec: 0.0 ↓	Jan: 2.2 ↑	Jan: 1.4 ↑	Jan: 5.2 ↑	Jan: 2.5 ↑	Jan: 0.5 ↓	Jan: 7.6 ↑	Jan: 2.8 ↑	Jan: 4.9 ↑	% GDP, last 12m
	Size of reserves	% GDP	Dec: 55 ↓	Jan: 12	Jan: 24 ↓	Jan: 33	Jan: 46 ↑	Jan: 24	Jan: 112 ↑	Jan: 54 ↑	Jan: 94 ↑	% GDP
	Fiscal balance	% GDP (2010f)	-4.3	-1.6	-5.8	-1.8	-5.8	-4.3	-1.0	-6.1	-2.9	% GDP (2010f)
	Fiscal debt	% GDP		2009e: 42	2009e: 12	2009e: 33	2009e:61	2009e: 51		2009e: 51	2009e: 36	% GDP
Adequacy of Reserves	Import Cover	no. months	Dec: 27.8 ↓	Jan: 7.9 ↑	Dec: 11.4 ↓	Jan: 8.5 ↑	Dec: 8.4 ↓	Nov: 10.5 ↑	Nov: 20.1 ↑	Dec: 12.2 ↓	Dec: 20.7	no. months
	M2 Cover	% of M2	Dec: 26.2 ↓	Jan: 29.3 ↑	Oct: 95.2 ↓	Jan: 20.0 ↑	Jan: 29.4 ↑	Jan: 47.7 ↑	Jan: 73.1 ↑	Jan: 43.1 ↑	Jan: 38.0 ↑	% of M2
	ST Debt cover	% of ST-debt	Dec: 1725 ↓	Jan: 236 ↑	Jan: 614 ↓	Jan: 184 ↑	Jan: 702 ↑	Jan: 633 ↑		Jan: 706 ↑	Jan: 409 ↑	% of ST-debt
	Total Debt cover	% of total debt	Dec: 685 ↓	Jan: 43 ↑	Jan: 106 ↓	Jan: 68 ↑	Jan: 167 ↑	Jan: 76 ↑		Jan: 236 ↑	Jan: 353 ↑	% of total debt
	Port. inflow cover	% of 5yr portf inflow	Jun: 1462 ↑	Sep: 176 ↓	Sep: 45 ↓	Dec: 349 ↑		Sep: 418 ↓	Sep: 341 ↑	Sep: 762 ↑	Sep: 511 ↓	% of 5yr portf inflow
	Gross Liab Cover	% of Gross ext liabilities	Dec: 166 ↓		Dec: 42 ↓	Dec: 36	Dec: 14	Dec: 41 ↑	Dec: 17		Dec: 111	% of Gross ext liabilities
	Bond holdings cover	% of holdings		Jan: 520 ↓			Dec: 670 ↑					% of holdings
	Eqty holdings cover	% of holdings		Jan: 113 ↓	Jan: 41 ↓	Jan: 127 ↓					Jan: 59 ↓	% of holdings
Balance of policy choices	RRR hikes	chg %p.a., 12m	Jan: 100 ↑		Jan: 75 ↑	Jan: 0						chg %p.a., 12m
	Policy rate hikes	chg %p.a., 12m	Jan: 0	Jan: -225 ↑	Jan: -75 ↑	Jan: -50 ↑	Jan: -50 ↑	Jan: -100 ↑		Jan: -75 ↑	Jan: -25 ↑	chg %p.a., 12m
	Fwd position	% of reserves, 3mma		Dec: -1	Dec: 0	Dec: 6 ↑	Dec: 1	Dec: 37 ↑	Dec: 31 ↑	Jan: 11 ↓		% of reserves, 3mma
	Estimated Inv'n++	USDbn 3mma	Dec: 18.2 ↓	Dec: -0.2 ↓	Dec: 0.2 ↓	Dec: 7.4 ↓	Dec: 0.2 ↓	Dec: 2.1 ↓	Dec: 3.3 ↓	Jan: 1.8 ↓	Jan: 3.5 ↓	USDbn 3mma
	Inv'n, % of reserves	% reserves	Dec: 0.8 ↓	Dec: -0.3 ↓	Dec: 0.1 ↓	Dec: 2.8 ↓	Dec: 0.2 ↓	Dec: 5.7 ↓	Dec: 1.8 ↓	Jan: 1.3 ↓	Jan: 1.0 ↓	% reserves
Assessment of current policy regime+	Pressure on regime	Qualitative assessment	Moderate ↑	Low ↔	Moderate ↑	Moderate ↑	Moderate ↔	High ↔	Moderate ↑	Moderate ↑	Moderate ↑	Qualitative assessment
	FX Policy		FX Stability	Curb Volatility	Curb Volatility	Curb appreciation	Stability against region	Curb appreciation	Stable NEER	Curb appreciation	Curb appreciation	

Note: Arrow represents change from previous datapoint. Refer to appendix for other notes. + Arrows next to assessment denote growing/declining pressures. Changes in assessment (and bias) are bolded. ++ Intervention number are calculated estimates based on public data, including FX reserves, FX and interest rates. Source: HSBC, Bloomberg, CEIC, Reuters

MYR to lag Asia, but bonds still offer value

- Capital outflows reflect a structurally weak investment environment
- This will keep the currency underperforming the rest of Asia
- On local rates, the 5yr MGS has superior relative value amid long-end MGS supply; pay 5yr MYR IRS at par

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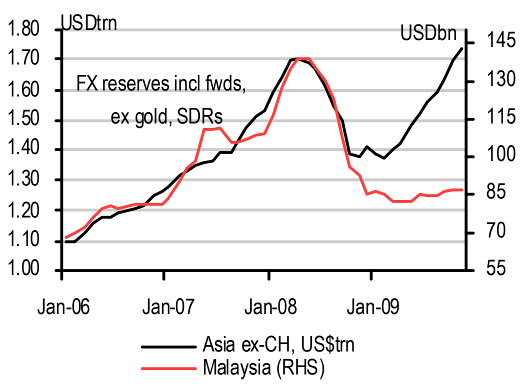
A solid domestic GDP recovery notwithstanding, we believe the ringgit will lag the region as Malaysia's structural weaknesses become increasingly apparent during the recovery cycle. Symptomatic of this weakness has been the unusual phenomenon of very large capital outflows, seen most visibly in Malaysia's lack of reserve accumulation (Charts 1 & 2), a phenomenon we first flagged in early 2008 (see *Asian FX Focus*, 11 February 2008). Better cyclical growth this year is unlikely to reverse these structural capital outflows. Findings from a recent visit to Malaysia suggest that the catalysts required to stoke foreign investment and the repatriation of savings moved offshore are unlikely to be seen at least until the next parliamentary election (not required until 2013). Meanwhile, a relatively weak fiscal position will constrain policy and poses some inflationary risks this year if the fuel subsidy regime is forced to be scaled back.

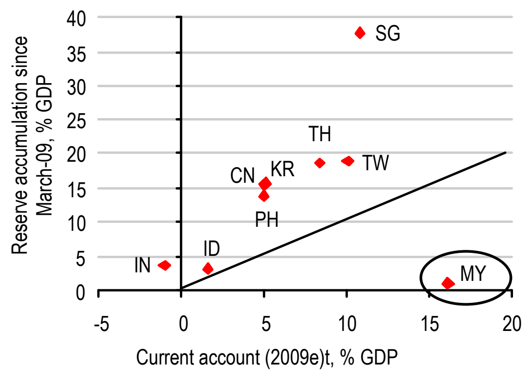
For the currency, structural weaknesses will

1. Malaysia has not reaccumulated reserves since the crisis



Source: HSBC, CEIC

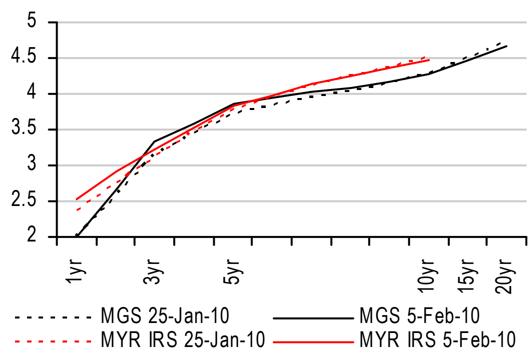
2. This is more unusual given the size of its current account surplus



Source: HSBC, CEI. The line represents the 45 degree line, the vertical distance from which represents the magnitude of capital flows

continue to bias MYR underperformance, and leave MYR relatively vulnerable to episodes of risk aversion. While USD-MYR will drift lower this year alongside the rest of USD-Asia, we recommend being underweight MYR in a generally bullish Asian currency portfolio, and would consider short MYR exposure as a hedge against long Asian currency exposure elsewhere.

3. Pre- and post-BNM MPC: MGS and MYR IRS curves



Source: Bloomberg

For bonds, we forecast MGS holdings to generate positive returns this year (in MYR terms), but the magnitude varies across tenors. We recommend **tactical switches** into the 5yr MGS at 3.85% yield at the upcoming auction. We also expect MYR IRS to underperform the bonds and hence recommend **hedging interest rate risk on bond holdings** by paying 5yr MYR IRS at par, targeting swap spread of 25bp (current: -3bp).

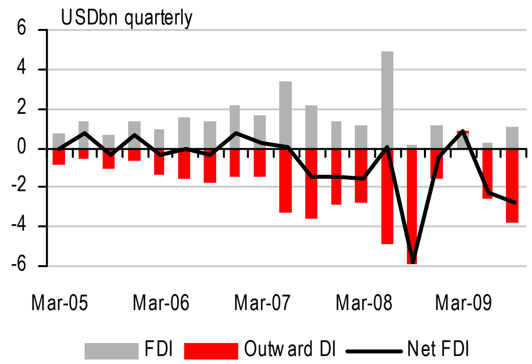
Outflows not just FDI, but savings and human capital too

Much of the discussion we had about capital outflows during our visit tended to focus on direct investment, for which net outflows have once again grown large after pausing during the crisis (Chart 4). However, this captures an almost insignificant aspect of a much wider capital outflow story. A broader look at the capital account balance shows that these **net FDI outflows are dwarfed by much larger net outflows through the "other account"** (Chart 5).

We have in the past calculated the uncategorised capital flow account combined with the "errors and omissions" account as a proxy for BoP leakage – either unremitted current account receipts or savings otherwise transferred abroad. This leakage has swelled in recent quarters (Chart 6). While generally across Asia we consider leakage to be most sensitive to yield differentials, and thus cyclical in nature, the most recent growth in outflows appear structural. This also accords with a similar shift of onshore of ringgit deposits into foreign currency (Chart 7).

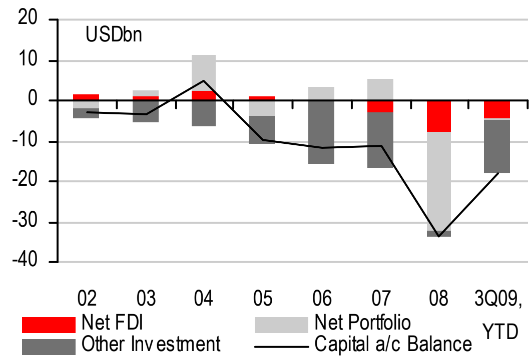
The forces driving the outflow can also be seen in broader indicators. In December 2009, deputy foreign minister A. Kohilan Pillay reported to parliament that over 300,000 Malaysians had emigrated in the 17 months to August 2009 – a 50% rise in the rate of emigration seen in 2007.

4. Net FDI outflows resuming



Source: HSBC, CEIC

5. Capital outflows much more than just FDI



Source: CEIC, HSBC

To put this into perspective, this represents 2.7% of Malaysia's estimated labour force of approximately 11m people.

These outflows tell a structural story

The preponderance of evidence suggests that these outflows are not cyclical, and that **even under the much stronger growth rebound our economists forecast these outflows will not be repatriated – a view that our onshore discussions corroborated.**

The reasons for the outflows include a lack of opportunities for foreign businesses to build and expand capacity, for resident skilled labour to find good income opportunities, and for resident household savings to earn acceptable returns.

The dominance of the public sector and government-linked companies in the economy was mentioned by some as constraining private-sector development necessary for moving up the value chain. Some mentioned specifically that disappointment over the lack of a hike in the commercial bank foreign ownership cap was a signal of the ongoing resistance to substantial change in the economic structure of the country.

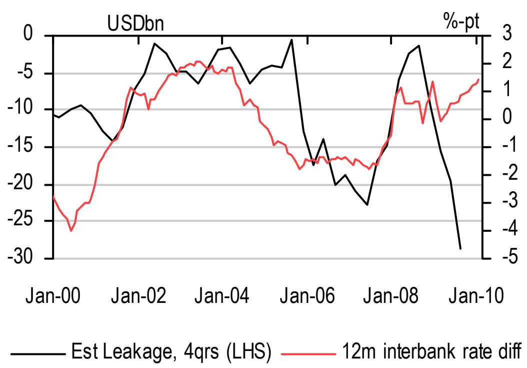
While the government actively tries to attract inward FDI, our onshore discussions revealed discontent about regulation "volatility" and high fees for foreign companies after arriving onshore, with some suspicion that they are driven by entrenched onshore interests. For example, while Malaysia overall ranks highly in the annual World Bank Ease of Doing Business survey, in areas such as "dealing with permits", "registering property" and "employing workers" Malaysia scores only around the median of the 186 countries ranked (Chart 8).

8. Ease of Doing Business survey

Source: World Bank, HSBC

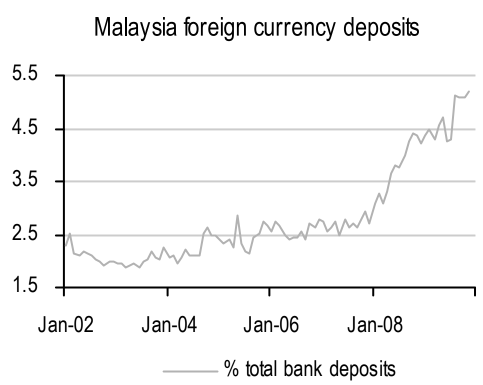
Finally, while the near-term political environment looks more stable, there is ongoing uncertainty about the medium-term social/political environment, and how the ruling political party may respond to the opposition in the next elections. For example, an alliance between UMNO (the ethnic Malay party) and PAS (the

6. Estimated leakage has swelled...



Source: HSBC, CEIC

7. ... as has the FX deposit ratio



Source: HSBC, CEIC

Islamic party) based on race and religion was an option suggested that, while unlikely, could not be ruled out. The recent church bombings over a religiously oriented court case and the ongoing trial of opposition leader Anwar Ibrahim only reinforced these concerns.

Implications for the currency

Structurally, this creates a situation not unlike that of TWD in the middle of the decade, which had remained persistently undervalued despite a very large current account surplus. The combination of achievement of middle-income status and erosion of traditional areas of international competitive advantage in high-tech manufacturing reduced investment opportunities for both firms and investors (domestic and foreign). The widening savings investment gap then keeps the current account perpetually high but is recycled through large capital outflows. Low interest rates due to weak demand for credit only reinforce these flows. Meanwhile, the outflow of skilled labour further reduces the investment attractiveness of the economy (indeed, our discussions onshore repeatedly highlighted the lack of skilled labour as hampering investment).

The policy response

The capital outflow issue has recently gained widespread attention onshore. While most of our discussions about the policy response centred around planned efforts to restructure the economy and to boost inward FDI, a regulatory response was not ruled out. For example, this past December already saw a crackdown by the central bank on money changers[5] allegedly illegally remitting funds offshore. Also flagged was the prime minister's new sponsored 1Malaysia Development Berhad (1MDB) strategic development company, seeking to boost inward FDI by using its initial MYR11bn to co-invest in foreign-funded investment initiatives one-for-one. However, as we argue above, weakness in FDI has not been primarily due to issues with cost of funding. Much attention was placed on the New Economic Model (NEM) to be released this month, a strategic plan to move Malaysia towards high-income status. However, nobody we met with onshore was able to give any details about what the plan would entail.

Ultimately, the consensus we found onshore was that regardless of forthcoming policy announcements, structural change substantial or credible enough to cause a return of domestic and foreign capital was unlikely until after the next round of elections in 2013. This was seen as being crucial to give a future government a strong mandate to reform the system. Recall that the current government came into power without an elected mandate (by succeeding Abdullah Badawi, who stepped down last year), and thus will likely be internally constrained on pushing through reform.

Monetary policy

On 26 January, Bank Negara refrained from raising the benchmark Overnight Policy Rate (OPR) during its monetary review, but surprised the market with uncharacteristically hawkish rhetoric. BNM said that an eventual increase in the OPR may be necessary to "prevent a build-up of financial imbalances" that could arise due to a prolonged period of low interest rates. *The Edge*, quoting Governor Zeti[6], interpreted "financial imbalances" to refer to the increased outward investments by Malaysians, giving credence to our view that the **structural capital outflow phenomenon is something the authorities will be taking a closer look at in coming months**.

[5] "KL money changers aiding capital flight", Malaysia Today, 4 December 2009, http://www.malaysia-today.net/index.php?option=com_content&view=article&id=28865:kl-money-changers-aiding-capital-flight&catid=19:newscommentaries&Itemid=100131

[6] 29 January 2010, "Zeti: Interest rates need normalization", http://www.theedgemalaysia.com/business-news/158786-zeti-interest-rates-need-normalisation.html

Nevertheless, our economist holds to the view that BNM will be one of the last to hike in the region, only in 3Q. For one, moderately higher interest rates are unlikely to be in magnitudes large enough to meaningfully reverse resident capital outflows, if our interpretation of these outflows is correct. For the currency, our expectation that BNM will be the last in the region to hike rates only adds to our view that MYR will lag the region.

On the rates side, even though we are not expecting rate hikes until 3Q, we recommend hedging long 5yr MGS positions by paying 5yr MYR IRS. With 5yr bond-swap spreads near par, valuations are attractive for (re-)establishing these positions, targeting a swap spread of 25bp through 1H10.

Budget deficit: From subsidies to GLCs

When the government announced a FY10 budget deficit target of 5.6% of GDP (FY09: 7.4%), it was well received by the market as a sign of the Najib administration's intention to consolidate government finances. However, questions remained on how the government would achieve this aggressive target, specifically cutting operating expenses by 15% to MYR138bn. **Two likely answers suggest that the fiscal burden may simply be transferred elsewhere:** 1) to households via inflation through a revamping of the subsidy structure; 2) into contingent liabilities through shifting public spending from the central government to government-linked companies (GLCs).

First, the government aims to reduce food and fuel subsidy expenditures by 15% from MYR25bn during FY09 to MYR20.9bn (an estimated 2.8% of GDP) during FY10. Of this, fuel subsidies account for the majority[7] and the government is currently in the process of revamping its gasoline subsidy structure and is expected to announce this in May, effective end-2Q10. Details on the new fuel subsidy regime are scarce, but it appears that: 1) only Malaysian citizens can purchase subsidised fuel; 2) the subsidy regime will not apply to the states of Sabah and Sarawak; 3) the subsidised gasoline purchases will be subject to monthly quotas and restricted to one car per person[8].

Generally, the shape of the new subsidy structure changes from "blanket" coverage to a "two-tiered" system. Details of the reform are intended to ensure that it does not disproportionately impact lower-income groups and that loopholes are closed. To this end, the government is considering an identification card system called "MyKad" that would include income data on Malaysian citizens.

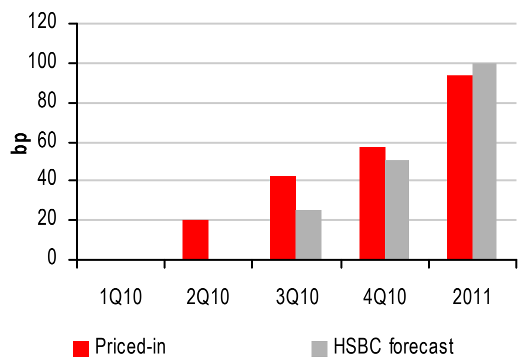
Restructuring of the fuel subsidy regime is a bold move for the Najib administration and signals that other subsidy programmes may also be rolled back including subsidies to sugar, cooking oil, flour, and rice. Will it be inflationary? Although it ultimately depends on the magnitude of the increase in gasoline prices (current: 51 US cents/litre), the impact on inflation should be moderate since: 1) it is a one-off event; 2) the government may choose to implement price hikes at a staggered pace; 3) it does not involve diesel which is most likely to have a multiplier effect transmitted through public transport fares and transport of agriculture goods.

The second trend that could support a smaller budget deficit is the suspected shift in public spending from the central government accounts to those of government-linked companies (GLCs). These GLCs include state governments and state credit guarantor Danajamin as well as other entities whose bonds/notes issuance carry a government guarantee (implicit or explicit), such

[7] *MYR5.6bn during FY09, MYR18.8bn during FY08*

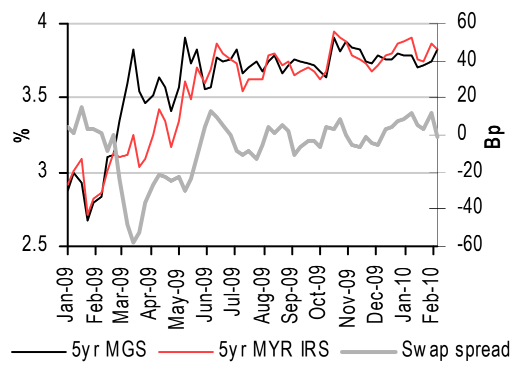
[8] *Once drivers have used the monthly quota (estimated at 100-300 litres based on income and/or auto engine capacity), they will be required to purchase fuel at unsubsidised rates*

9. Cumulative policy tightening: Priced-in versus HSBC forecasts



Source: HSBC, CEIC

10. Hedge long bond investments by paying MYR IRS at par



Source: Bloomberg, HSBC

as utility company PAAB. Recently, the government launched the "1MDB" (1 Malaysia Development Berhad) initiative to promote FDI by matching investments in four sectors (agriculture, oil and gas, tourism and real estate) one-to-one. 1MDB has already raised MYR3bn (out of MYR11bn planned) through a bond issue. Although there has been much talk about the expansion in the GLC sector, actual bond issuance in this sector has lagged but is worth watching.

Implications for rates

Our recent visit corroborates our view that the 5yr MGS still offers superior relative value versus the 3yr and 10yr MGS. Following the announced MYR3.5bn 5yr MGS auction to be held on 11 February, the 10-5yr spread has narrowed again to a historically tight 40-45bp. We think this is temporary and therefore expect the 10yr MGS to suffer from longer-issuance duration (particularly acute in 2Q10). Meanwhile, the 3yr MGS is particularly vulnerable to the BNM's recently hawkish rhetoric.

Although we maintain a benign inflation outlook for Malaysia, a planned gasoline price hike from May 2010 – at a minimum – has the *potential* to reignite medium-term inflation concerns, particularly if the government follows through with additional price liberalisation measures. Therefore, we recommend tactical switches into the 5yr MGS at 3.85% yield at the upcoming auction. We also expect MYR IRS to underperform the bonds and hence recommend hedging interest rate risk on bond holdings by paying 5yr MYR IRS at par, targeting swap spread of 25bp (current: -3bp).

THB appreciation to persist despite policy change

- THB appreciation path intact as trade surplus remains large
- Loosening of regulations is likely to create a more liquid offshore deliverable forward market
- The risk to our bullish THB view is the ongoing political situation

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The THB's appreciation path remains intact, despite changes to regulations announced on 1 February (summarised in Table 1) by the Bank of Thailand (BoT). According to the statement issued by the BoT, policymakers hope that loosening regulatory measures will create a two-way FX market and also reduce some appreciation pressure.

Policy resistance to appreciation remains vigorous. Over the course of 2009, the BoT has been actively intervening in the FX market to limit currency appreciation. Including the forward book, the BoT has accumulated USD35.3bn and FX reserves are now at a record level. Taking into account FX valuation and earnings on reserves, we estimate that the BoT bought about USD21.5bn in 2009, the largest estimated annual intervention on our record.

However, we doubt these regulation changes will help to relieve much of the appreciation pressure on the THB. During the cycle of Asian currency appreciation from 2005-2008, many countries including Thailand similarly resorted to liberalising restrictions on capital outflows in efforts to get the private sector to play a greater role in recycling current account surpluses. The Thai authorities allowed Thai exporters to keep foreign earnings in USD and also relaxed restrictions on the ability of investment funds, individuals and corporates to access foreign currency and offshore investment markets. Furthermore, in early 2008, the authorities also announced that the government pension fund, the social security fund and domestic financial institutions would be encouraged to invest more abroad. The Securities Exchange Commission approved another USD12 billion in overseas portfolio investment quotas.

Yet the THB continued to appreciate. This time around we do not expect things to be any different as our economist forecasts the trade surplus to remain large (4.7% of 2009 GDP). In addition, with the interest rate differential between Thailand and the US likely to widen, this should attract more domestic savers to repatriate funds back home. Our economist is expecting the BOT

Table 1: Regulatory changes introduced on 1 February

Effective on	Changes to the regulations
2 February	Thai corporates are allowed to unwind foreign exchange hedging transactions freely, ending a previous USD20,000 limit on unwinding of hedging contracts by exporters and importers
2 February	Raise limit on foreign investment by mutual funds to USD50bn from USD30bn
End of February	Thai residents will be allowed to transfer up to USD10 million per year to purchase overseas real estate
End of February	Limit for Resident FX accounts (local source without obligation) will be increased to USD500,000 for both corporates and individuals
End of February	Thai corporates will be allowed to lend up to USD50 million per year to offshore companies (not affiliated to their group)
End of February	Thai corporates will be allowed to invest or lend an unlimited amount to their offshore group companies

Source: BOT, HSBC

to hike 25bp in both 3Q and 4Q this year, bringing the policy rate to 2.0% by the end of 2010.

One positive by-product of these changes, however, is that the liberalisation of regulation should limit the onshore and offshore deliverable forward gap since corporates no longer need to get consent from the BOT when they unwind their hedges. This should add liquidity to the offshore market, making it easier for offshore investors to gain exposure to the THB.

The risk to our view, apart from the global factors, is the ongoing domestic political uncertainty. In our view, if the situation onshore was to deteriorate significantly, there could be a flight to safety by domestic savers and investors, resulting in THB weakness. In addition, exporters could face a drop in exports if clients shift their orders elsewhere due to concerns about possible delays and disruption. Given these risks, we continue to prefer to express our bullish Asia view by being long KRW, TWD, and IDR.

EMEA at a glance

Currency	Three key points	Recommendation	End-1Q spot	Risk to forecast
CZK	▸ 4Q09 GDP growth surprised sizeably to the downside, underscoring the need for maintaining monetary stimulus in the near term by keeping rates unchanged at 1.0%... ▸ … while a limited tightening cycle (c50bp) is lying ahead in the second half of 2010 ▸ Path of the CZK is very much dependent on Eurozone's economic performance, while the koruna is still a good funding currency for other CE longs with its low rates and stability	Buy PLN-CZK	EUR/25.75	Neutral
EGP	▸ A higher-than-anticipated January inflation reading strengthens our expectation that CBE will begin to tighten from May ▸ With growth still fragile and the political calendar full, the pickup in rates is likely to be cautious ▸ Strengthening growth and improved external account flows will support EGP but currency is likely to weaken if EUR continues to decline against USD	Hold USD/EGP	5.50	EGP stronger
HUF	▸ HUF vulnerability is falling with substantial narrowing in its twin deficits, while yield support still remains high despite our expectations of further easing ▸ Market pricing for political/fiscal risks pertaining to April general elections appears overdone… ▸ …while we are still cautious towards the HUF in the near term given protracted Greek fiscal overhang on the region	Hold EUR/HUF	EUR/265	HUF weaker
ILS	▸ Monetary tightening will be postponed to 2Q due to low inflation in January-February ▸ Rebounding growth and a structural c/a surplus and net FDI support further appreciation ▸ Although FX purchases by the BoI accelerated in January, intervention will be phased out as exports rebound on the back of stronger global trade	Sell basket/ILS	USD-ILS=3.77 EUR-ILS= 5.05	ILS weaker
PLN	▸ Poland's economic outperformance story is likely to continue into 2010 ▸ We expect the zloty to firm this year given noticeable improvement in external balances… ▸ …the presence of IMF's FCL facility and lingering undervaluation on a REER basis	Sell EUR/PLN	EUR/3.95	Neutral
RUB	▸ While a seasonally high trade balance provides appreciation pressures… ▸ … an elevation of global risk aversion could prevent the RUB from further appreciation in 1Q10 and prompt some weakness ▸ We expect the RUB to break the low band boundary of RUB/basket35.0 when global market sentiment improves	Hold basket/RUB	USD-RUB=31.4 EUR-RUB= 40.9	RUB stronger
RON	▸ The RON has assumed a noticeable appreciation cycle since early January thanks to resolution of lingering political strains, positive newsflow on the IMF front… ▸ …high yield support and international investors' appetite for the growing local debt market… ▸ …however, current pace of firming may prove unsustainable given the NBR's covert intention to keep the leu stable at low levels (to support exports/growth)	Hold EUR/RON	EUR/4.15	RON stronger
TRY	▸ Headline inflation and expectations are deteriorating fast, though CBRT remains focused on specific core inflation measures, hence would likely keep rates on hold as long as possible ▸ Real rates are -ve at short end and hopes of IMF deal are waning. We are cautious on TRY	Hold USD/TRY	1.55	TRY stronger
UAH	▸ Presidential elections brought some comfort for investors, although they have not completely eliminated risks of a political stalemate and early parliamentary elections… ▸ …while the NBU keeps holding tough monetary stance ▸ Unwinding of some short UAH positions post-elections and the run for yields could marginally strengthen the UAH while the NBU would be readily buying FX supply into its reserves	Hold USD/UAH	8.0	UAH stronger
ZAR	▸ Economic recovery is fairly sluggish, while inflation flirts with top end of target band ▸ ZAR remains vulnerable to global risk aversion due to large twin deficits. While a credible fiscal plan could support ZAR, debates on monetary policy need to be watched closely	Hold USD/ZAR	7.75	ZAR stronger

Source: HSBC

CEE: Fiscal deterioration dents euro hopes

- Euro adoption plans are mainly shelved owing to battered fiscal balances, slippages in inflation and looming election cycles
- We do not expect any of the CE4 countries to join the Eurozone before 2015…
- …while Brussels may also be reluctant to welcome new member states in the near term

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Updated convergence reports lack explicit target dates

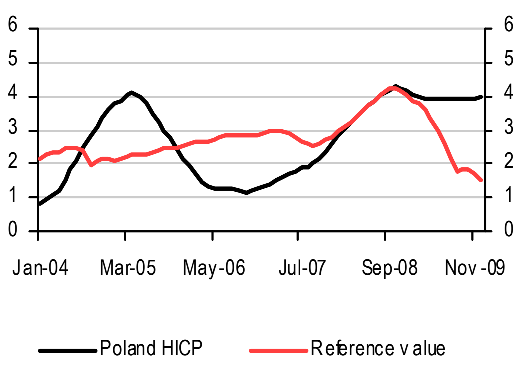
CEE has undoubtedly been the region hardest hit by the global financial crisis owing to its over-dependence on Western Europe both in financial and economic terms. The crisis had already cut deep as domestic demand plummeted, currencies were oversold, and fiscal balances deteriorated markedly across the region; but recently the long-term impact has become much more apparent.

Beyond downgraded potential growth, the most obvious problem is the damage to prospects for euro adoption. In the latest euro convergence reports sent to Brussels, Romania has maintained its official 2015 target with a compatible entry into ERM-II mechanism in 2012; however, Poland, Hungary and the Czech Republic have all adopted an open-ended rhetoric that specifies no explicit target date, but mainly highlights the governments' plans to rein in worsening fiscal balances. We think this approach will suit the European Commission (EC) given that the financial stability of the currency union is already under threat from mounting concerns over fiscal problems in Southern-Mediterranean member states.

Maastricht criteria remain unsatisfied

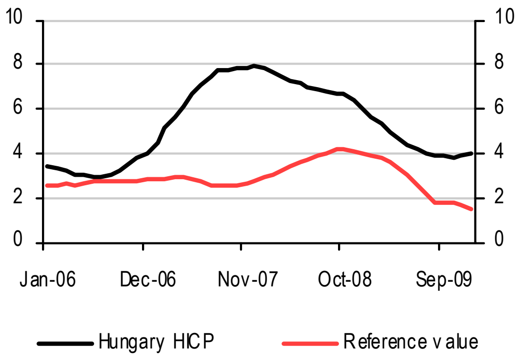
The adverse impact of the global crisis is very apparent in fiscal balances. Given lower-than-expected tax revenues and increasing government spending, involving a high burden of social transfers, fiscal deficits across CE4 have deviated substantially

1. Polish inflation (y-o-y %) misses Maastricht criterion…



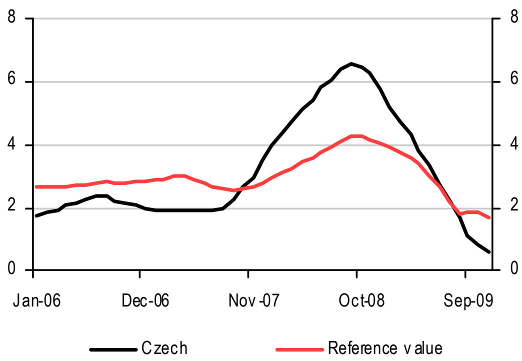
Note: HICP refers to harmonised Index of consumer prices
Source: Eurostat, Thomson Datastream and HSBC

2. ...as does Hungary's (y-o-y %)...



Note: HICP refers to harmonised Index of consumer prices
Source: Eurostat, Thomson Datastream and HSBC

3. ...while Czech inflation (y-o-y %) undershoots benchmark



Source: Eurostat, Thomson Datastream and HSBC

from the Maastricht threshold (3% of GDP) over the course of 2009; Hungary appears to be the fittest country in fiscal terms thanks to its stringent IMF-induced budget reforms.

Similarly, the inflation criterion has been missed widely in Poland (chart 1), Hungary (chart 2) and Romania as the EU's average HICP inflation plummeted last year, while consumer prices remained high in these countries owing to tax changes and administered price hikes. Czech inflation, on the other hand, has undershot the benchmark value since September 2009 with strong base effects over the course of the year from declining fuel and food prices and recession induced downward pressure on profits (chart 3).

All in, setting aside the ERM-2 mechanism, none of the countries appears to have satisfied macro criteria fully at end-2009, while Hungary seems to have missed them all (table 4).

Looking ahead, we believe it will not be difficult to satisfy the inflation criterion as the reference value is likely to normalise in tandem with a gradual recovery in the Eurozone, while Romanian convergence may take longer than the others owing to its relatively high base (i.e. current deviation exceeds 400bp). But the main challenge will likely stem from the fiscal side, given the looming election cycle in the region.

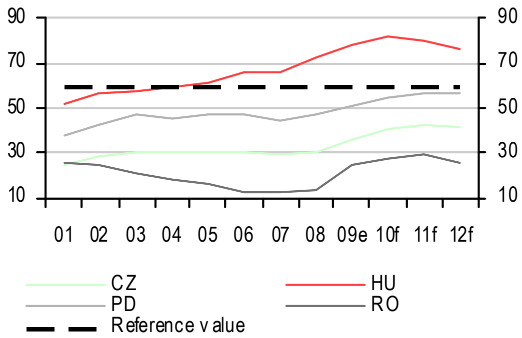
Hungary, Poland and the Czech Republic are already under the EC's Excessive Deficit Procedure (EDP) and have deadlines of 2011, 2012 and 2013, respectively, to bring the budget gap below 3% of GDP. Romania is also under the EDP, while its deadline has been extended by one year to 2012 due to worse-than-envisaged economic contraction seen in 2009 (-7.2% y-o-y). Updated convergence reports indicate that

4. Current snapshot of CEE versus Maastricht criteria

	Inflation rate (%)		Govt deficit to GDP (%)		Debt-to-GDP ratio (%)		LT interest rates (%)		ERM-2
Reference value	1.54		3.00		60.00		5.68		YES
	Dec-09	Deviation (bp)	2009e	Deviation (bp)	2009e	Deviation (bp)	Dec-09	Deviation (bp)	Latest
Czech Republic	0.59	-0.95	6.60	3.60	36.50	-23.50	3.98	-1.70	NO
Hungary	4.03	2.49	3.90	0.90	78.00	18.00	7.69	2.01	NO
Poland	3.98	2.44	7.20	4.20	51.20	-8.80	6.22	0.54	NO
Romania	5.59	4.05	7.20	4.20	24.70	-35.30	9.05	3.37	NO

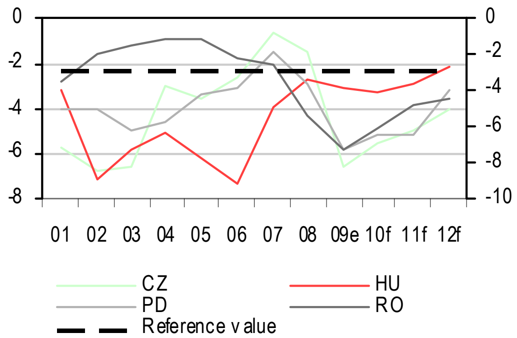
Notes: i)) Figures refer to latest official available data, if not HSBC estimate
ii) Shaded regions refer to criteria currently unfulfilled by the respective member state
Source: Eurostat, Thomson Datastream and HSBC

5. Hungary's public debt-to-GDP ratio (%) is likely to stay above Maastricht-compliant 60% in the foreseeable future



Source: Eurostat and HSBC

6. Fiscal consolidation may be delayed due to looming election cycle (% of GDP)



Source: Eurostat and HSBC

although a consolidation path has been set in all countries, most of the correction is reserved for the post-election period (particularly in Poland and the Czech Republic), underlining the importance of the political backdrop for euro adoption.

In the end, it's a political decision

All new EU member states are required to join the euro but the pace of convergence mostly depends on political will. The CE countries are facing a tight election cycle this year: Hungary and the Czech Republic will hold general elections in April and May, respectively. This will be followed by presidential elections in Hungary (June-July) and Poland (October).

As to the details, in Poland, ruling euro-friendly Civic Platform (PO) still aims to enter the Eurozone as soon as possible; however, the constitutional amendment that this will require dims the prospects in the short term. Accordingly, a PO victory in the presidential election this year, combined with a higher number of seats in the upper and lower parliaments after the autumn 2011 general elections could pave the way for constitutional obstacles to be overcome in early 2012, making ERM-2 entry possible later in the year. That would allow for euro adoption in 2015 at the earliest, assuming that fiscal balances have been put in order in accordance with the EDP-set deadline of 2012.

In Hungary, the centre-right opposition party Fidesz is currently ahead in opinion polls and appears to be in a convincing position to form a single-party government following the April elections. Fidesz has yet to unveil a formal election manifesto outlining the party's economic policies, but local media have previously mentioned that setting a credible euro adoption strategy would be among the party's top priorities.

Although uncertainty prevails, it is obvious to us that the biggest challenge on convergence criteria is likely to stem from fiscal balances (particularly the country's high debt-to-GDP ratio). On ERM-2, we believe officials will decide to enter only after the country has successfully exited the excessive deficit procedure (in 2011), although this is not a pre-requisite. This suggests late 2011 or early 2012 as potential dates for ERM-2 entry, paving the way for euro adoption in 2014 at the earliest, with 2015 looking more likely given uncertainty on the fiscal front.

In the Czech Republic, recent opinion polls put CSSD (Social Democrats) ahead of euro-sceptic ODS (Civic Democrats). However, neither of them seems to be garnering a majority of votes,

pointing to another (probably shaky) coalition government. Recent comments from both parties suggest that they view euro adoption as possible from 2015 onwards.

Meanwhile, the convergence programme prepared by the current caretaker government – formed mainly by technocrats – envisages a public sector deficit of 4.2% of GDP in 2012 and a Maastricht-compliant figure (i.e. below 3%) by around 2013-14, meaning that ERM-2 entry may be possible in H2 2013 or early 2014, paving the way for euro adoption in 2016 at the earliest; 2017 appears to be a more realistic target date for us. The euro's low public popularity also shores up this timeframe as the current local perception is that the country already enjoys many of the benefits of economic links to the Eurozone but has the additional flexibility of an independent monetary policy with a free-floating local currency.

Romania will have an election-free two years ahead as the country completed its general and presidential elections in 2008 and 2009, respectively. Assuming the absence of any new political crisis, which is still a possibility given the fragile nature of support in the Parliament for the PDL-led minority government and mounting public dissatisfaction with IMF-induced reforms in state budget sector, undisrupted IMF/EU scrutiny (until mid-2011) would likely support the ongoing fiscal consolidation efforts.

However, parliamentary elections due in 2012 now coincide with the extended EDP deadline, raising doubt over the official aim to bring the deficit down to 3% by end-2012 and enter ERM-2 mechanism in the same year, although satisfaction of other Maastricht criteria is not a prerequisite for the latter. Hence, we believe although euro adoption seems probable in 2015, in line with the official target, fiscal correction may come a bit later than expected, suggesting 2016 or 2017 may be a more realistic date for entering the Eurozone.

Meanwhile, we are also doubtful that the European Commission (and the Council) would be keen to welcome new member states into the EMU in the near term as it has recently become apparent that fiscal problems in peripheral eurozone countries may pose considerable risks to the overall financial stability of the currency union. Setting aside the case of Estonia – which currently appears to satisfy all the Maastricht criteria, including the ERM-2 mechanism – owing to its small economy accounting only for 0.2% of total Eurozone GDP, we believe the EC will likely be hesitant to accept large new members (such as Poland) before being fully convinced that their fiscal balances are sustainably under control.

All in all, we do not expect any of the CE4 countries to join the Eurozone before 2015, and believe most of the entries will probably take place in the second half of the decade.

Egypt: tailwinds strengthen

- Political pressures are likely to slow economic reform, and rising public debt is a medium-term focus for concern
- But for now, Egypt's economic story looks strong, underpinned by assertive policy action, a liquid banking sector and a broad-based economy that will catch the updraft of global recovery
- EGP will trade on the dollar, but high yield and strong external account point to underlying gains

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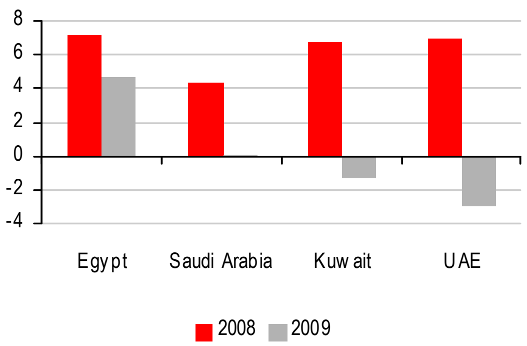
MENA's unexpected star

As the global downturn deepened, we were hopeful that the wealth and power of the MENA region's oil producers would afford them some protection from global market dislocation and allow them to outperform some of their EM peers. Our optimism was misplaced. From 6% in 2008, growth slumped to near zero in 2009, the sharpest deceleration in economic activity in a generation.

In contrast, we had looked at pre-crisis Egypt with concern. Stretched public finances, a history of exchange rate instability and an export sector tied to global trade suggested the economy was at risk of a hard landing. Substantial capital outflows in late 2008 and the first part of 2009 only added to our anxieties.

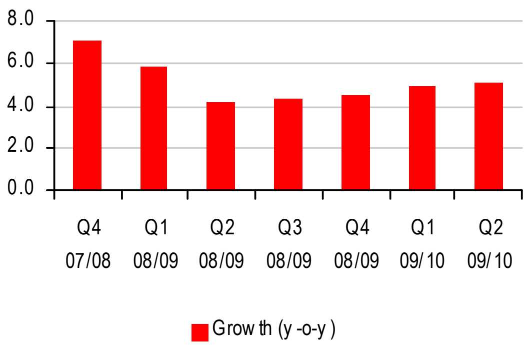
The reality has, again, been rather different. Egyptian growth decelerated as the global

Egypt had a shallower fall...



Source: HSBC

...and has been quicker to recover



Source: CBE

recession hit, but the decline of just over two percentage points was better than we had feared. At more than 4%, the low point of the downturn stood well ahead of the regional trend. Moreover, the downturn was not just shallower than that experienced by its neighbours, but it was briefer too. Since the 2Q08-09 low point, growth has accelerated y-o-y for four consecutive quarters, rising back above 5% in 2Q09-10.

The headline data overstate the quality, if not the pace, of economic growth that Egypt has been able to generate. Egypt's banking sector and its public finances also face significant structural challenges that will weigh on growth and leave the economy vulnerable to abrupt reverses in fortune. For now, however, the outlook appears strong, with the economy well placed to catch the updraft of an ongoing recovery in global growth.

Slow to tighten

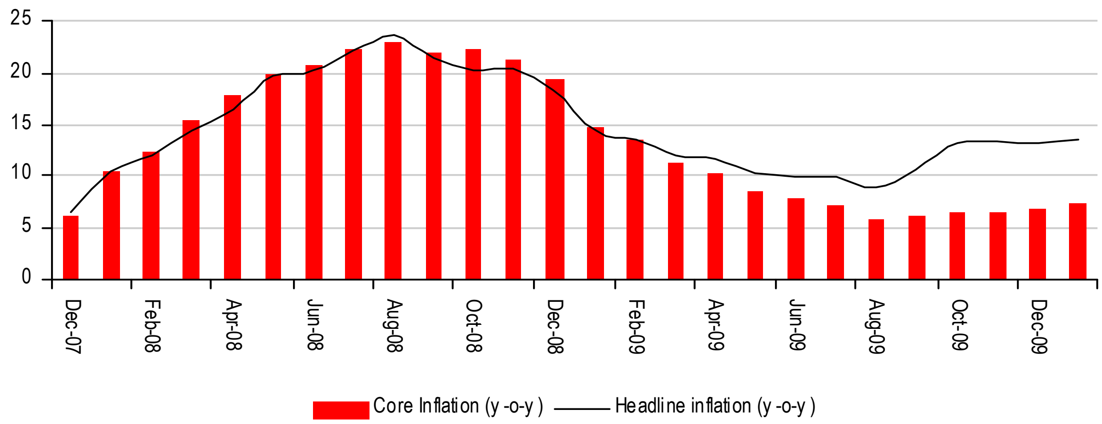
Our cautious optimism stems in part from the expansionary stance policymakers have maintained. Having raised rates sharply to counter a surge in headline inflation over 2006-09, CBE held rates flat from September 2008 before starting to cut aggressively, reducing and narrowing its policy corridor (the overnight deposit and overnight lending rates) from 13.5-11.5% in January 2009 to 9.75-8.25% eight months later. The discount rate also fell 300bps in less than eight months. In nominal terms, the rate is high for an economy operating a currency regime closely linked to the dollar. For Egypt, however, the rate is the lowest in three years and in real terms is highly accommodative, standing more than four points below the headline rate of inflation.

CBE has signalled that the loosening has run its course, and the pickup in inflation recorded over the last months of 2009 and first month of 2010 has strengthened our view that the next changes in rates will be upward. However, we do not believe that the shift in policy rates is imminent or that the change in stance will be pronounced.

The rate of headline inflation rate is uncomfortably high, standing at 13.5% in January 2010, up 4ppt in just five months. However, CBE has stressed that its focus is on its newly unveiled measure of core inflation. By that measure price pressures have increased, but at 7.4% the rate is 130bps below the rolling 12m average and within the 6-8% comfort range many in the market have come to believe CBE is operating.

In early 2008, core and headline inflation picked

Headline price pressures are rising, but core inflation (%) does not yet look threatening



Source: CBE

up in lockstep. That the two measures have not been as closely correlated over recent months, however, suggests that during a period of weaker economic growth, the spillover from headline to core inflation has been muted, easing pressure for an immediate hike.

When CBE held policy rates stable in January, it referred to its optimism that price pressures would stabilise, but also noted that though the pickup in economic growth was encouraging, growth fell short of pre-crisis levels. The comment is significant, and adds to our view that though CBE will be mindful of price pressures, it will be more cautious of taking steps that choke growth.

As a consequence, we currently expect rates to be held flat until May, when we look for an increase of just 25bps. We do not anticipate a further rise in rates until fiscal 2010-11, when we look for a 50bps rise in the first half. The pickup will only likely come, however, if core inflation has not fallen back below 7% and growth has continued to climb.

More spending to come

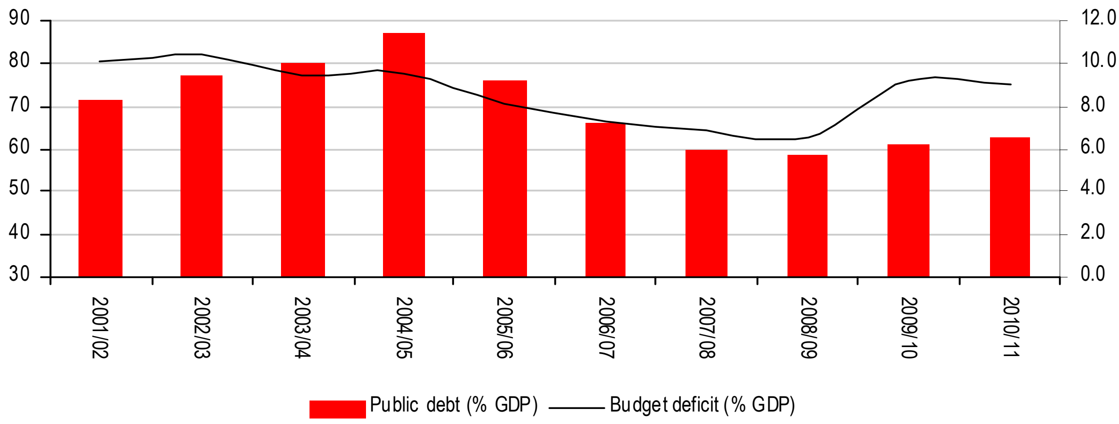
We also expect Egypt to maintain a growth-supportive fiscal stance alongside its accommodative approach to rates.

The government of Egypt announced stimulus programmes in both 2008-09 and 2009-10 to counter the downturn. In November, the government also announced a far larger USD24bn infrastructure build-out programme, stating that it hoped to have the funds fully committed by mid-2011.

We are sceptical that this timetable can be met but we do believe that the spending plans are indicative of the government's expansive stance. The sum is beyond the government's own reach, but the state has been successful in drawing local and foreign private funding into domestic development projects in the past and has led the region in adopting non-traditional financing mechanisms such as Public Private Partnerships to fund and execute domestic development programmes.

As well as lifting public outlays, the government has sought to support domestic demand by delaying promised reforms to the revenue system.. These include cuts to subsidies on fuel and energy costs that were put on hold in 2008-09 and look likely to remain in abeyance over the 2009-10 as well. A proposed VAT law also seems to have been put on hold.

Fiscal reform in the good times has given the government space to act in the bad



Source: CBE, HSBC

The increase in expenditure and clear reluctance to introduce additional revenue generating taxes has already put pressure on the fiscal balance. The government has formally confirmed that plans to reduce the budget deficit to 3% of GDP by 2012 have been delayed by two years. We estimate that the deficit will likely breach 9% of GDP this year and will show only a modest improvement in 2010-11.

For now, this deterioration appears unthreatening. The government has won itself some room for manoeuvre as a result of the programme of fiscal reform run in the early part of the decade that cut the deficit from an average of 10% of GDP over 2001-05 to less than 7% in 2007-08 and reduced the debt stock from 90% of GDP in 2004-05 to less than 60% in 2008-09.

However, we have concerns that the more accommodative fiscal stance could lead to a more threatening downturn in public finances in due course. The high deficit figure we already anticipate is predicated on both a pickup in trade, consumption and corporate tax receipts as domestic demand strengthens and an improvement in oil, gas and Suez-related income as global growth strengthens. Should these expectations prove misplaced, the deficit could rise above 10% of GDP.

An early return to fiscal discipline also informs our expectation that 2009-10 will be the cyclical peak for the deficit which will fall thereafter. However, we are aware that the electoral cycle may make this difficult. Parliamentary elections in 2010 and presidential elections in 2011 look more likely to result in spending overshooting rather than undershooting the levels we have targeted. A desire to maintain popular support could also lead to less populist aspects of the fiscal programme being delayed for longer than we envision.

Uncertainty surrounding the future of the presidency weighs heavily in the minds of local and foreign investors alike. Our expectation, and that of the market, is that the eventual transfer of power between the current president and his successor will be effected smoothly and without disruption. However, after 30 years of political rule dominated by the incumbent, Hosni Mubarak, the establishment of a new leadership is likely to take to embed, with difficult to predict implications for economic policy making.

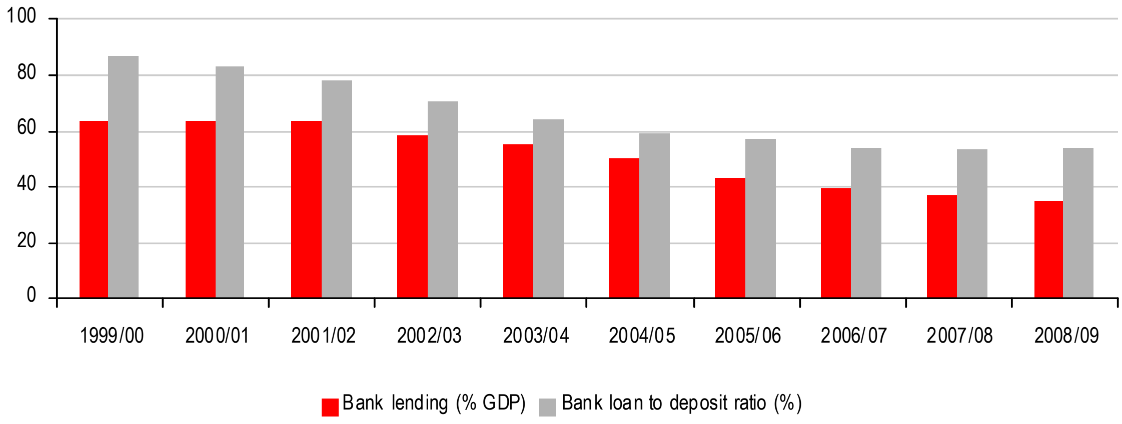
Egypt's vulnerability to political or economic shocks is compounded by the maturity structure of public debt which is heavily skewed towards the near end of the curve. This creates potential refinancing risk, particularly given the growing role that yield-hungry foreign investors have begun to play in the short-term local currency market. Marked increases in the borrowing requirements or signs that fiscal largesse is translating into a pickup in core inflation will lead to a rise in market rates. Political uncertainty would also quickly weigh on international appetite for government risk.

Banks backstop government funding risk

Although funding costs will rise if fiscal discipline is seen to be deteriorating, the government's ability to fund its shortfall and meet refinancing calls is strongly supported by the stability of the banking sector.

Unlike other EMs, the Egyptian banking system went through its own period of deleveraging and balance sheet adjustment well before the global crisis hit. At 55%, the system-wide loan to deposit ratio is exceptionally low by regional standards, and stands 30ppt down on pre-reform levels. At the equivalent of less than 40% of GDP, credit penetration rates are 20ppt down on earlier levels.

Egyptian banks had deleveraged long before the crisis



Source: CBE

The banking sector is also overwhelmingly funded by domestic deposits with little exposure to the international wholesale market.

As a consequence, dislocation on the global markets had little impact on Egyptian banks' funding, preserving the pool of liquidity on which the government can draw. Banks have shown a strong appetite for government paper, increasing their holdings of government securities by almost USD15bn during the course of 2009. The banks' strong liquidity base, the spread of 3 percentage points or more between 12m deposits and 12m t-bills and the low risk of the EGP-denominated paper make it likely that banks will be willing as well as able to meet near term funding needs.

Catching the updraft

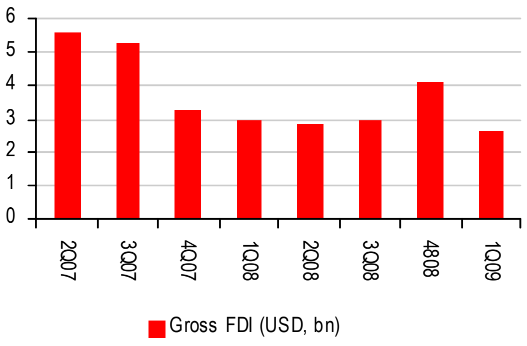
Heavy issuance of government paper will continue to impede the private sector's access to credit. At the end of November 2009, lending to private sector business stood down 4% y-o-y, having risen by an average of just 2% over the preceding five years.

The provision of additional credit to private corporates has been identified as a policy objective and banks continue to point to retail as a priority growth area. However, we are sceptical that the pace of loan growth will increase significantly, particularly against a backdrop of attractively priced government paper.

However, while the shortcomings of the banking system will act as an impediment to growth, we expect Egypt to benefit from the both the diversity and structural balance of its economy. The economy's strong internal focus (domestic demand accounts for just over 100% of GDP) insulated Egypt from the deterioration in key overseas markets. Investment spending fell away as previously high levels of foreign direct investment waned and confidence fell. However, a pickup in government consumption and continued gains in private consumption has kept domestic demand positive. We expect this to continue, buoyed by further growth in government spending and the upward bias to private consumption that stems from strong growth in the adult population.

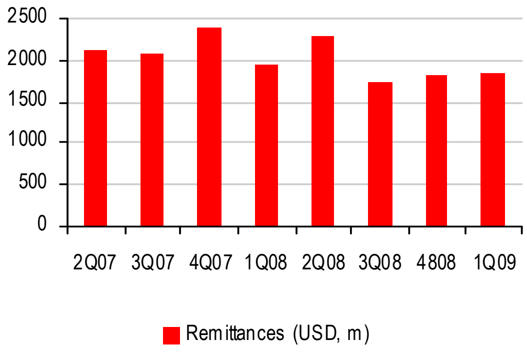
The uptick in the global economy should also support Egyptian domestic demand. Remittances from Egyptians working overseas held up reasonably well during the recession. Global recovery should, at least, ensure that the downturn in inflows has run its course, offering support to private consumption. Foreign direct investment is

FDI weakened but didn't fall away...



Source: CBE (fiscal year)

...and remittances held up pretty well, too



Source: CBE (fiscal year)

also likely to strengthen as the global recovery picks up pace, supporting gross fixed capital formation particularly in the energy and infrastructure sectors.

The structure of its export sector means that Egypt is well placed to benefit from stronger external demand. The oil and gas sectors are the most immediate beneficiaries, and should show growth in value if not in volume as average prices strengthen. Suez revenues are highly correlated to global trade patterns and fell away markedly as the global recession deepened. Revenues, however, returned to y-o-y growth in January 2010 and should continue to gain speed over the coming year.

Tourism, Egypt's other key export sector also weakened in 2009, drawn downward by weakness in European markets that have historically accounted for roughly 70% of overall demand. Provisional estimates, however, suggest that income fell by just 2% – a better performance than had seemed likely this time last year and a reflection of the industry's underlying strength. The data also suggest a pickup in the last quarter of the year, a trend we expect to accelerate in the 12 months ahead.

The contribution of net exports to economic growth is offset in our model by an anticipated pickup in import demand as consumption and investment spending strengthen. However, there will be a pickup, and a net export sector held in check by imports rising as quickly as exports is much healthier, than one in which balance is maintained because both are in decline. Overall, we expect growth to average 5.3% in 2009-10 on a rising quarterly trend. We expect to headline growth to run at close to 6% over 2010-11.

Pound trades on USD but has support

The shift in domestic and external account trends should offer support to EGP. Near term, we expect Egypt's large merchandise trade deficit to widen as a more rapid pickup in export earnings is unable to offset gains in the larger import bill. We expect tourism income and revenues from the Suez Canal to pick up, with the gains likely to build speed. We also expect remittances to resume their upward trend as growth in the Gulf and elsewhere begins to rise. This is likely to leave Egypt with a current account shortfall of around USD6bn in 2009-10 and 2010-11 – the equivalent to around 2.5-3% of GDP.

Although high by historical standards, we expect the shortfalls to be comfortably covered by capital inflows. The largest proportion is likely to be FDI which, having held up well during the global

recession, is likely to strengthen. We also anticipate further gains in portfolio flows, particularly into Egyptian debt instruments. We expect these net flows to allow Egypt to add to its reserves in 2009-10 and 2010-11 following the previous year's fall.

The anticipated pickup in economic growth, an external account surplus and gains in foreign reserves to over USD35bn (eight months of import cover) will offer support to EGP. However, though this will create an upward bias to the pound and strengthen CBE's hand, we do not view it as the dominant factor and expect CBE to continue to manage the value of EGP closely.

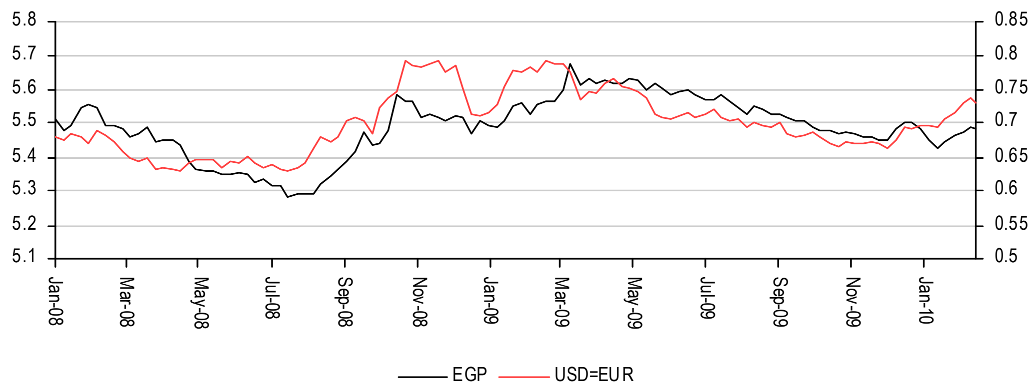
Moreover, CBE has indicated that it is paying additional attention to the value of EUR in a bid to maintain the Egypt's export sector. The relationship between EUR and EGP seems to have been strengthened over the past year and we see no reason for it to diminish.

As a consequence we expect EGP to weaken modestly against the dollar as EUR falls, despite the anticipated improvement in its external account position. We do not anticipate that the decline will extend past EGP5.55, however, and look for a recovery in the second half of the year as USD begin to weaken, ending 2010 at around EGP5.4.

Conclusions

- External demand for Egyptian goods and services were impaired during the global recession and formerly ready access to international capital diminished. Growth slowed but the downturn was shallower than we had feared and compares favourably with the more abrupt deceleration experienced by regional peers.
- Robust policy action and an underleveraged banking sector have allowed domestic demand to maintain positive momentum over the past year. We expect this continue over the coming 12 months, with gains in external demand for Egypt's core goods and services likely to push growth above 5% throughout 2009-10.
- After the painful inflationary experiences of recent years, we expect CBE to monitor price trends carefully and to begin tightening rates from May. However, we do not view core inflation readings as threatening, and suspect that policymakers will be slow to put growth at risk at what remains an early stage of the recovery cycle. As a result we do not anticipate that the adjustment in rates will be aggressive or sustained.

The relationship between EGP and EUR seems to be strengthening



Source: HSBC

- The government is likely to maintain its expansionary fiscal stance, both by lifting capital spending and delaying additional tax raising measures. The consequent deterioration in public finances is sustainable in the near term given the stability and liquidity of the domestic banking sector.
- Rising capital flows will likely enhance Egypt's external account position despite an anticipated trade-driven widening of the current account deficit. While this will strengthen CBE's hand and create an upward EGP bias, we expect the central bank to manage the value of the currency carefully, with a close eye on the value of EUR against the dollar.
- Egypt's key vulnerability remains public finances. Although the authorities stabilised the budget deficit earlier in the decade, a political calendar that has a presidential election following hard on the heels of a parliamentary poll creates conditions for a sustained deterioration in the fiscal balance.
- It is likely to prove difficult for policymakers to extend what is currently a troublingly short debt maturity profile until the medium term political outlook has been clarified. Although we believe that funding from local and foreign sources will be forthcoming, the heavy rolling refinancing burden will necessarily be a risk and will leave rates vulnerable to upward pressure if inflation begins to accelerate, funding needs expand more rapidly than we anticipate or political uncertainty deepens.

Russia: RUB sailing through global volatility

- Russia macroeconomic environment is RUB positive in 1H 2010…
- …with deterioration expected to occur by year-end…
- …which should prompt RUB weakness after initial strength

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Predictable RUB volatility?

As we had argued in *EM FX Roadmap – Promising signs* for October 2009, end-year global risk aversion combined with seasonal deterioration of the trade balance has indeed weakened the RUB and prompted an increase in implied NDF yields in November-December 2009. In line with our expectations, 2010 started with a RUB rally. It was accompanied by a decline in RUB NDF implied yields to below 6%. From then until mid-February, the RUB traded in the 35.20-35.90 range against the basket as global markets became worried about tightening in China and Greek public debt.

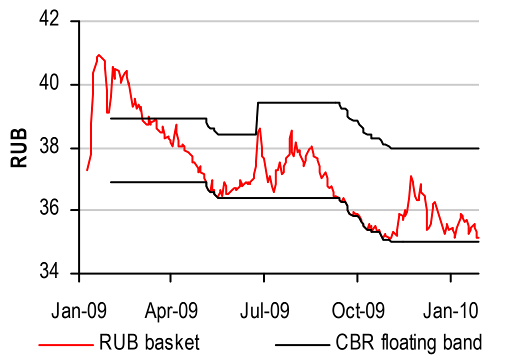
In this report we discuss both the macroeconomic and market environment for the RUB in 2010 and beyond. We show that although the factors that affect the RUB remain the same, their relative powers have been changing.

Rebalancing RUB drivers

Trade balance and current account

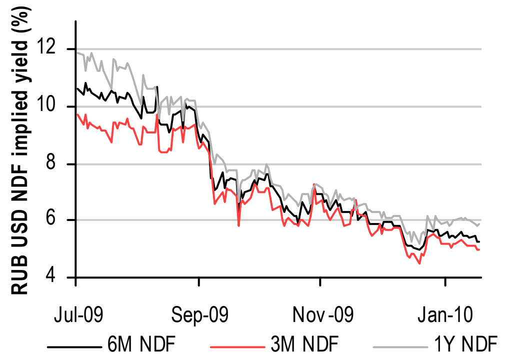
Compared to 4Q 2009, in 1Q 2010 foreign trade is improving seasonally. Exports are benefiting from higher natural gas consumption in Europe during a winter season that has experienced lower than usual temperatures this year. Imports saw a seasonal contraction in January-February. Overall, this produces an improvement in the trade balance

Chart 1. RUB basket and CBR floating band



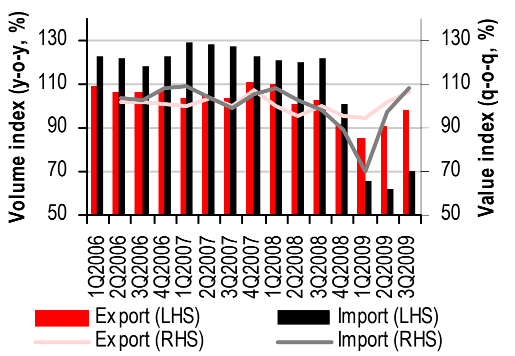
Source: CBR, Reuters

Chart 2. Falling implied NDF yields



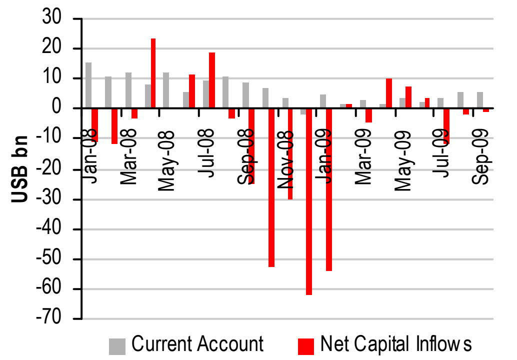
Source: Reuters

Chart 3. Price-led exports, volume-led imports



Source: Rosstat, HSBC

Chart 4. Current account vs Capital flows



Source: CBR, HSBC

from USD15.6bn in 4Q 2009 to cUSD24bn on our estimates in 1Q 2010.

No doubt, it is a strong RUB-supportive factor in the very short term.

In the longer term, then, the current account trend becomes something of a concern over time under the assumption of stable oil prices. Specifically, we estimate that from USD49bn surplus in 2009 current account would move into deficit in 2011 without exchange rate adjustment.

In the absence of positive terms-of-trade shocks, especially, related to energy prices, Russia's exports can grow only modestly in volumes. This is due to a big share of energy and other natural resources in exports. It is difficult to boost exports of these commodities quickly given the circumstances in Russia. Imports are a different animal. Benefiting from Russia's economic growth, high inflation and stronger currency, imports tend to grow fast, both in volumes and value. Thereby, the trade surplus narrows over time, other things being equal. So does the current account.

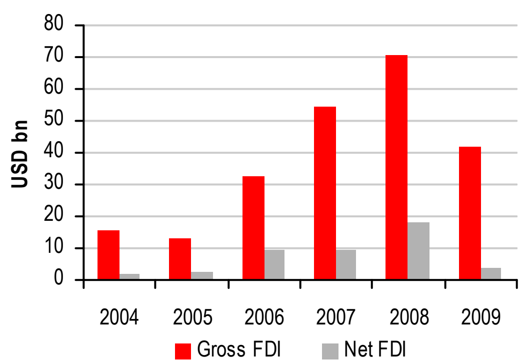
Smaller current account surpluses mean that their role in pushing up the RUB diminishes and the role of capital flows in determining RUB dynamics increases.

It follows that, with the RUB depending more on capital flows, high volatility of capital flows increases RUB volatility, other things being equal.

More powerful financial account

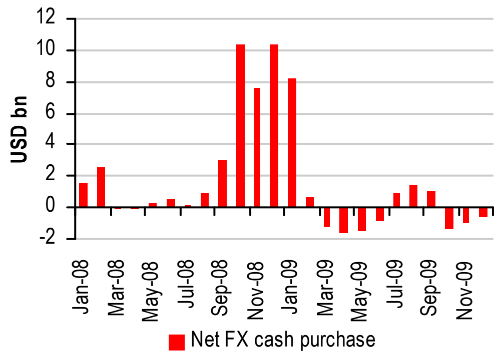
So, it is worth looking at financial account of balance-of-payments in more detail. Foreign direct investment is the first important category of financial account that is worth singling out. In many developing countries, incoming FDI provides strong support for the balance-of-payments. Russia is different in that respect. Although incoming FDI is substantial in size, it is not bigger than Russia's GDP of USD1.2trn. Besides, Russia itself invests a lot overseas, so that *net* FDI – incoming FDI less outgoing FDI – is a much lower amount than *gross* FDI.

Chart 5. High gross and low net FDI



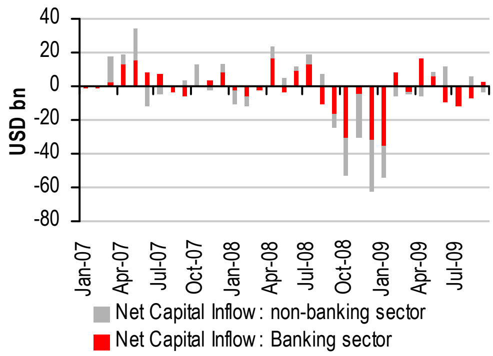
Source: CBR

Chart 6. Net FX cash purchases by households



Source: CBR

Chart 7. Net private sector capital flows, banks and non-banks



Source: CBR, HSBC

This underpins a significant role of debt, portfolio and other short-term financial flows that are more volatile components of financial account than FDI. What do we know about them?

Households in Russia historically are active players on the FX market but they follow market moves, and so augment, rather than drive them. During the managed RUB depreciation in November 2008-January 2010 households have bought more than USD30bn of FX cash, according to the CBR data. Yet, since then households started selling part of their FX cash holdings on a net basis as the RUB got firmer.

So, households may join a rally to or from the RUB, but do not trigger it. At present, in the absence of significant RUB moves, households will likely offload their FX cash holdings slowly – a kind of development that occurred in the years post 1998 crisis. We believe it to be marginally positive for the RUB.

Behaviour of debt-related capital flows is more complicated. Russian corporates as a whole managed to avoid any significant foreign debt de-leveraging during the 2008 crisis. A combination of debt refinancing, restructuring and new borrowing was the mechanism they employed for that. After just two quarters of some net foreign debt reduction they have become net borrowers again since 2Q 2009.

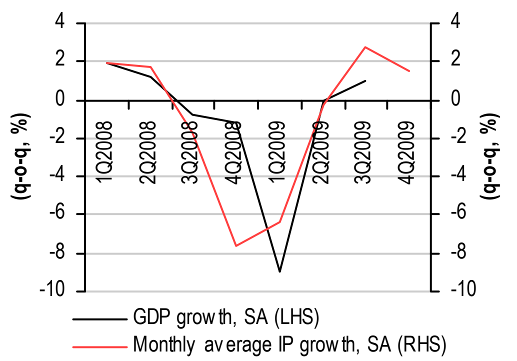
In contrast, Russian banks have been steadily reducing foreign liabilities since 4Q 2008. The speed of their deleveraging has slowed down over time and recently some top banks, including private ones, have tapped international capital markets or revealed their plans to do so soon.

Taking this fact into account, we project that the Russian corporate and banking sector in aggregate will be able to maintain or gradually increase its stock of foreign debt, notwithstanding still sizeable repayment schedule of USD111bn of short- and long-term debt maturing in 2010. All in all, this is RUB neutral, at worst, or positive, at best.

Other portfolio flows are extremely volatile and follow changes in sentiment on global financial markets. Bearing this in mind, we still can try to single out an idiosyncratic (i.e. Russia-specific) factor in these flows. The rule of thumb is simple: if a country's macroeconomic environment is benign and investors see an upside in its financial assets, the country will likely benefit from portfolio inflows even when risk appetite is modest.

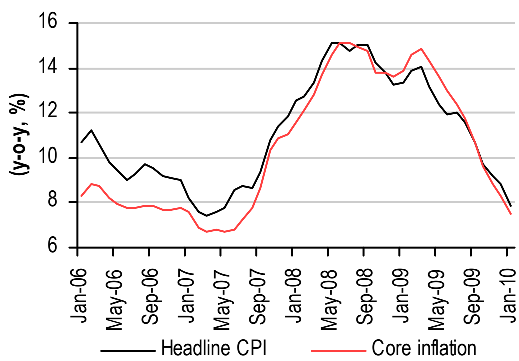
Where does Russia stand in that respect?

Chart 8. GDP and IP, seasonally adjusted



Source: Rosstat, MOED

Chart 9. Headline and core inflation decline



Source: Rosstat

Still a favourable macroeconomic picture…

It appears to us that, macroeconomically, Russia will be looking solid in 1H 2010. The economy is quickly pulling out of recession. This is not captured in official statistics yet since y-o-y GDP and industrial production data carried substantial negative base effect in 2009 while seasonally-adjusted data come with a significant time lag. Yet, the MOED in its monthly macroeconomic reports publishes its estimates of seasonally-adjusted economic growth that show quite robust economic recovery in 2H 2009.

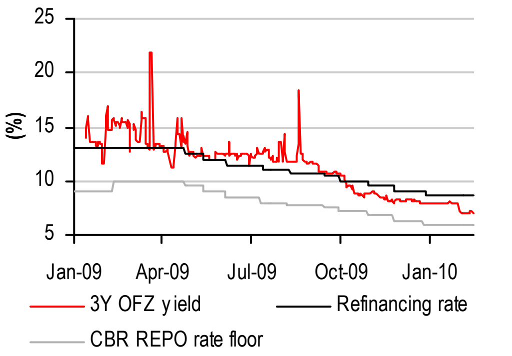
The annual 7.9% GDP fall in 2009 officially reported by Rosstat marks a significant improvement from Jan-Sep data that also point to strong recovery in 4Q 2009. Looking forward, y-o-y GDP and IP growth data for 1Q and 2Q 2010 promise to be quite solid even if economic growth moderates. This is because y-o-y numbers in 1H 2010 will be free from negative base effect of the crisis quarters of 3Q 2008-1Q 2009 and start showing output recovery achieved since then. We expect y-o-y GDP growth of 5.7% in 1Q and 6.0% in 2Q 2010. Such numbers should please investors.

Decelerating inflation is another good development for investors. Responding to decline in RUB money supply and a fall in consumer demand, inflation has been coming down steadily since April 2009 and ended last year with the historically lowest 8.8% y-o-y rise in consumer prices (Dec/Dec). Since then CPI price growth moderated further to 8.0% in January 2010.

That said, January 2010 brought strong seasonal inflation acceleration to 1.6% m-o-m that exceeded official expectations and raised concerns. At the same time, core inflation stood low, at 0.5% m-o-m in January, and weekly CPI growth has moderated sharply since last week of January. Altogether this suggests that negative January data were a one-off seasonal spike and that inflation deceleration is to continue in the coming months. It follows from our inflation model that inflation is likely to diminish to 6.0-6.5% y-o-y range in 2Q 2010 and stabilize thereafter.

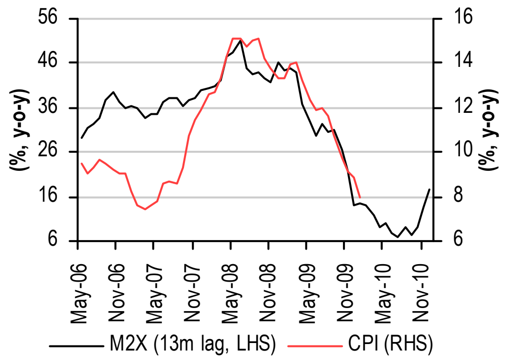
Falling inflation prompted the CBR to resume policy rates cuts in February after a pause in January on the poor inflation release. We keep expecting a cumulative incremental cut of 150bp to 7% for the refinance rate and 50-75bp to 5-5.25% for the overnight repo rate floor. Thereby the refinance rate would end up being 75-100bp higher than our projection of the inflation rate. We think this would be consistent with the CBR rate-setting benchmarks.

Chart 10. OFZ yields and repo rate decline with inflation



Source: CBR

Chart 11. Inflation may pick un by end-2010



Source: CBR, Rosstat

With these inflation and policy developments in mind, OFZ and MM rates should decrease accordingly. It means there is an upside from local bonds and local rates perspective that make them attractive for investors.

For equity investors it also represents a convincing macroeconomic story. Besides, Russia has one of the lowest PEs among top EM economies and could be rewarded for that from the comparative country perspective, when the market sentiment strengthens again.

So, what we have at the end: robust economic growth, solid external accounts, falling inflation and rates, and relatively cheap equities. We believe this is a good combination for investors in various Russian financial assets and should have positive implications for the RUB.

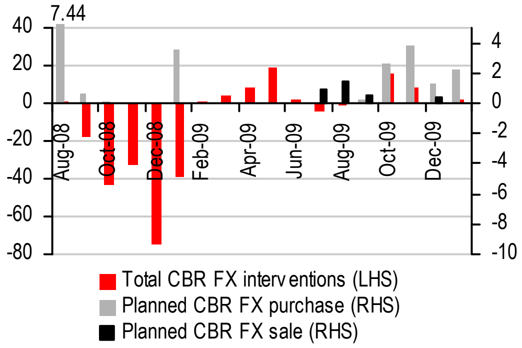
…that may worsen in 2H 2010

The Russian case appears to be less straightforward when we look beyond 1H. There are good reasons to expect economic growth moderation in a quarter or so after dissipation of strong bouncing-off effect. Export demand growth – the key driver of Russia economic recovery so far – promises to increase less quickly on the structural problems in the developed world and the need to reduce fiscal stimuli globally. Russian domestic demand has stayed weak and its rebound is likely to be gradual. Fiscal policy tightening and stagnation of banks' lending drag on the economic growth. Further to these considerations, we expect that the likely slowdown of economic growth will be reflected in lower y-o-y GDP growth numbers for 3Q and 4Q that could be preceded by negative PMI surprises.

As we have discussed in the beginning, economic growth and stronger currency (especially, in real effective terms) boosts imports and gradually erodes trade and current account surpluses in Russia. Augmented by the negative trade seasonality, the current account could record a weak balance or small deficit already in 4Q 2010 unless crude oil prices resume their growth to 80+ USD/bbl.

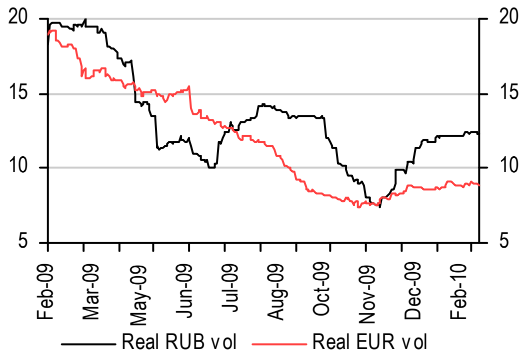
As far as inflation is concerned, we see high chance for its acceleration to above 8.0% by the year-end on the back of resumed fast growth of monetary base. In that case the CBR would have to start hiking policy rates, which would disappoint portfolio investors. The monetary authorities have already admitted that they also see risks of higher inflation in 2H 2010 and expressed their readiness to raise policy rates in response. By the end-2009 base money and M2 growth rates had already speeded up to the levels exceeding the CBR's policy range for 2010.

Chart 12. CBR interventions



Source: CBR, HSBC

Chart 13. RUBUSD and EURUSD volatility



Source: Bloomberg

Finally, 2H 2010 could bring more global risk aversion as China tightens its monetary policy further and economic growth in the developed world likely moderates along with curbing fiscal stimuli.

That sort of global and Russia developments would be RUB negative, in our opinion.

Developing CBR stance

What can be said about the CBR FX policy in that respect? We got new facts that helped us to better understand it and noticed some new developments compared to the time when we had extensively commented on the RUB (*EM FX Roadmap – Promising signs, October 2009*).

In contrast with our initial understanding, the CBR had not widened its floating RUB band after July 2009. When the RUB was under strong appreciation pressure, both the lower and upper boundaries of the CBR band moved in parallel, keeping the band range of three roubles unchanged. Since then and until February 18, 2010 we have had a band of RUB/basket35.0-38.0 (see Chart 1). On Februay 18-19 the band shifted down to RUB/basket34.80-37.80 on the resumed appreciation pressures.

We note that the CBR has deliberately increased the role of its so-called 'planned' FX interventions. The CBR started experimenting with 'planned' interventions before the 2008 crisis. Their objective is to reduce excessive RUB volatility through CBR's purchases or sales of hard currency (mostly, USD). CBR performs such interventions inside the floating RUB band. Their amount varied from USD1.4bn to USD3.9bn per month in 4Q 2009 – January 2010. Since December 2009, the CBR has been making only 'planned' FX interventions, mostly buying FX, as the RUB was not touching band boundaries and did not make sharp intraday movements.

The CBR explained in its comments that the amount of FX interventions reflects its expectations about current account and financial flows. As opposed to the CBR interventions at RUB band boundaries, its 'planned' interventions are typically small in size, in the order of USD50-400mln for a single day, and can hardly be identified by the markets. Our understanding is that the CBR intervenes with 'planned' interventions only when the RUB is outside the central part of the RUB band, which we believe is 35.80-36.80 (or marginally wider) at the moment.

Speaking about excessive RUB volatility, the CBR specifically referred to RUBUSD volatility, which the authorities would like to see lower, in line with EURUSD volatility. As Chart 13 illustrates, the CBR has not succeeded yet in

achieving this objective despite that RUBUSD volatility has diminished in the course of 2009.

The current size of 'planned' interventions appears relatively small to prevent a directional RUB move to a band boundary when capital inflows or outflows are strong. Yet, 'planned' interventions proved to be sufficient to keep the RUB away from the band boundaries in the absence of strong capital flows.

Against the overall positive macroeconomic and policy backdrop, recent comments made on the RUB outlook by Alexei Ulyukayev, the CBR's first deputy chairman, puzzled markets to some extent. Mr Ulyukaev shared his expectations that the RUB might test the upper boundary of the floating currency band relatively soon. He said that when the RUB/basket stood below 36.0 and some market participants interpreted his words in the sense that the RUB would start weakening from that point of time. It is a wrong interpretation, we think. However, Mr Ulyukaev's comments performed a function of verbal intervention, discouraging markets from aggressive bidding on strong RUB and reducing the need for CBR's FX interventions.

What had been later added in media coverage of Mr Ulyukaev's comments gave a completely different perspective for the RUB. While referring to potential for a downside RUB move, he clarified that if that happens, the upper boundary of the RUB floating band could be found at a different level. It would be consistent with the RUB strengthening first, the floating band moving to RUB/basket 34.8-37.8 at least, we think. So, in fact, the CBR's comments were RUB positive in the very short-term. That said, we share the CBR's view about possible RUB weakening, which we think is quite likely towards the year-end.

Looking forward, one could expect some further developments in the CBR FX policies. Once the CBR gets a proof that its new mechanism works efficiently during times when there are depreciation pressures on the RUB, it might widen the floating RUB band while probably increasing the amount of 'planned' FX interventions when the RUB gets close to new boundaries as a safeguard. The next logical step and a task for 2011 might be completely abandoning official RUB bands (hard and floating ones). A version of the floating band might be preserved for internal CBR regulation purposes. This would leave us only with 'planned' FX interventions mechanism – a version of Brazil's FX policy that the CBR was studying carefully. It would mark a completion of a transition to quasi-floating currency regime in Russia – the ultimate objective of monetary authorities.

Getting all it together

Summary for the RUB

So, what do we derive from the above analysis? First, the RUB can not be viewed in isolation from other EM currencies and international financial markets. If, as HSBC expects, the concerns about some Eurozone members' sovereign credits continue pressing the EUR down during coming weeks, it would likely be supporting more risk aversion. In such circumstances, the RUB would unlikely be put under strong appreciation pressures by capital inflows, albeit seasonally strong current account should prevent the RUB from any substantial weakness.

Second, once markets adequately price in European sovereign credit risk, risk appetite could return as global liquidity remains ample. In that case, we believe Russia would be an obvious choice to invest in. We expect that supportive macroeconomic environment in the short-term and upside potential in bonds and equities will trigger international capital inflows that could push the RUB further down through the lower

boundary of the floating band of RUB/basket 34.80.

Third, once inflation and official policy rates stabilize in 3Q 2010, we expect some profit-taking to take place. If, as we expect, economic growth moderates and inflation picks up in 4Q, it could trigger more intense outflows from the country that should weaken the RUB, provided global market sentiment is not outright bullish by that time.

Trade implications

Clearly, the RUB is not an easy child to play with anymore. However, the timeframe for likely macroeconomic and market developments that we outlined above should allow developing a two-pronged strategy for the RUB market for 2010.

In spite of the strong RUB/basket performance in early-January, our recommendation is to be in long RUB positions. Our target level is RUB/basket 34.50 and 1Y NDF implied yields 5.3-5.5%. We expect to see these levels before end-2Q 2010. If risk aversion that still prevails on global financial markets moves RUB spot lower towards RUB/basket 36.0, it should be considered as a natural entry point for any new long positions. This is the first part of the strategy.

Once target levels are achieved, we would argue for going out of long RUB positions. At some point in 3Q this year, the timing should be right to enter short RUB positions when the RUB is strong and yields are low. As before, we would prefer 1-2Y NDF for that trade.

Real effective exchange rates

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For full details of the construction methodology of the HSBC REERs, please see *HSBC's New Volume-Weighted REERs* in the *Currency Outlook*, April 2009.

The value of a currency

Since FX prices are always given as the amount of one currency that can be bought with another, the inherent value of a currency is not defined. For example, if EUR-USD goes up, this could be because the EUR has increased in value, the USD has decreased in value, or a combination of both. One possible method for getting some insight into changes in the value of a currency is to look at movements in the value of a basket of other currencies against the currency of interest. For example, if EUR-USD increased over some time period, one could see how EUR had performed against a range of other currencies to determine whether EUR has become generally more valuable or whether this was simply a USD-based move. An effective exchange rate is an attempt to do this and to represent the moves in index form.

There are two main approaches to building an effective exchange rate: Nominal Effective Exchange Rates (NEERs) and Real Effective Exchange Rates (REERs). NEERs simply track the weighted average returns of a basket of other currencies against the currency being investigated; REERs deflate the returns in an attempt to compensate for the differing rates of inflation in different countries. The reason for doing this is that, particularly over long time frames, inflation can have a large impact on the purchasing power of a currency.

How should we weight the basket?

If we are trying to create an index for the change in value of a currency against a basket of other currencies, we now need to decide on how to weight our basket. One possible solution would be to simply have an equally-weighted basket. The rationale for this would be that there is no a priori reason for choosing to put more emphasis on any one exchange rate. However, this could clearly lead to the situation where a large move in a relatively small currency can strongly influence the REERs and NEERs for all other currencies. To avoid this, the indices are generally weighted so that more "important" currencies get higher weighting. This, of course, begs the question of how "importance" is defined.

Trade weights

Weighting the basket by bilateral trade-weights is the most common weighting procedure for creating an effective exchange rate index. This is because the indices are often used to measure the likely impact of exchange rate moves on a country's international trade performance.

Volume weights

The daily volume traded in the FX market dwarves the global volume of physical trade. From this it is possible to make a convincing argument that the weighting which would be really important would be to weight the currency basket by financial market flows, rather than bilateral trade.

To do this properly would require us to have accurate FX volumes for all currency pairs considered in the index. However, these are not available. The BIS triennial survey of FX volumes only gives data for a small number of bilateral exchange rates. However, the volumes are split by currency for over 30 currencies. From these volumes we can estimate financial weightings for each currency. We believe that this gives another plausible definition for "importance", and one which may be more relevant for financial investors than trade weights. We call this procedure volume weighting and the indices produced through this procedure we call the HSBC volume-weighted REERs.

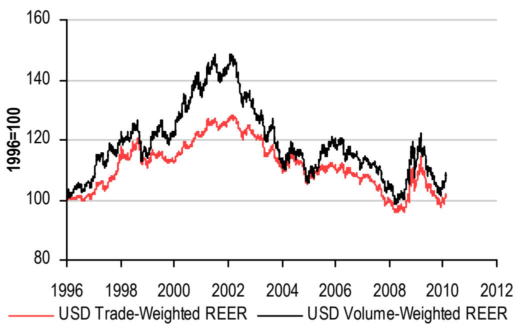
We would argue that if you are a financial market investor, the effective value of a currency you would be exposed to is more accurately represented by the HSBC volume-weighted index rather than the trade-weighted index.

Data frequency

This is something which is rarely considered when constructing REERs – inflation data is generally released at monthly frequency at best so the usual procedure is to simply create monthly indices by default. However, some countries release their inflation data only quarterly. The usual procedure for these countries is to simply pro-rata the change over the period. Here there is an implicit assumption that the rate of inflation changes slowly. We take this assumption one step further and assume that it is valid to spread the inflation out equally over every day in the month.

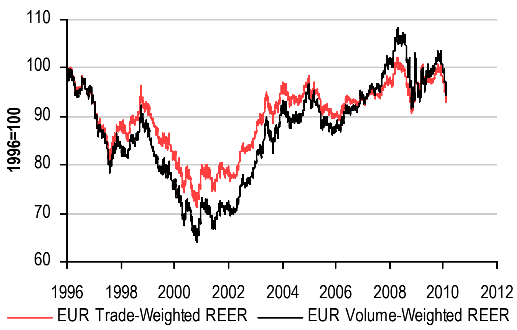
Trade-weighted and volume-weighted REERs

USD REER index



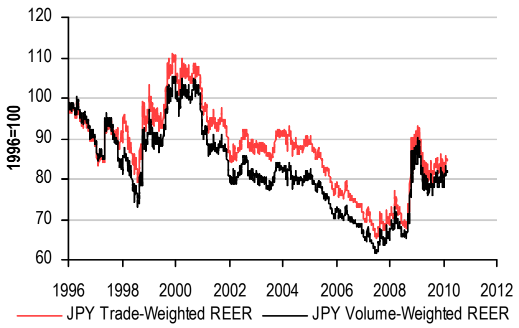
Source: HSBC

EUR REER index



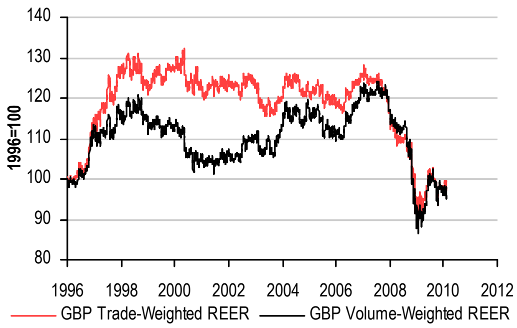
Source: HSBC

JPY REER index



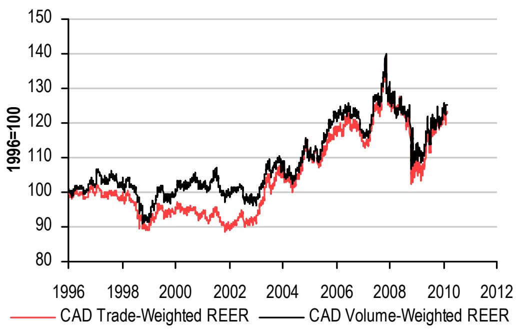
Source: HSBC

GBP REER index



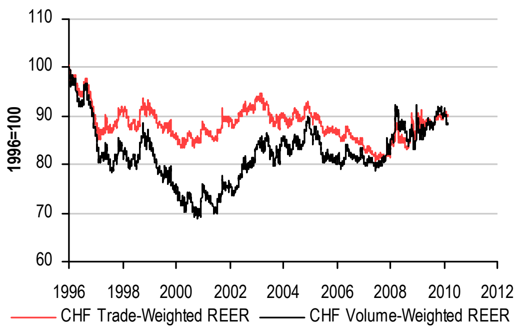
Source: HSBC

CAD REER index



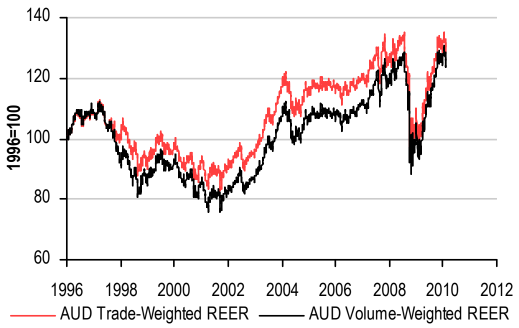
Source: HSBC

CHF REER index



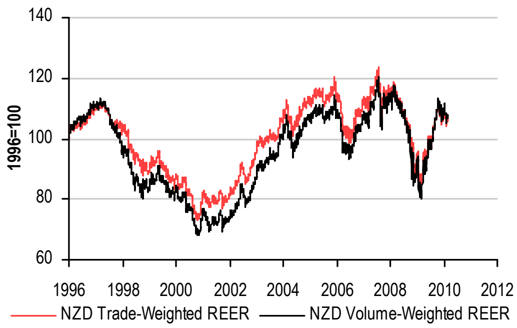
Source: HSBC

AUD REER index



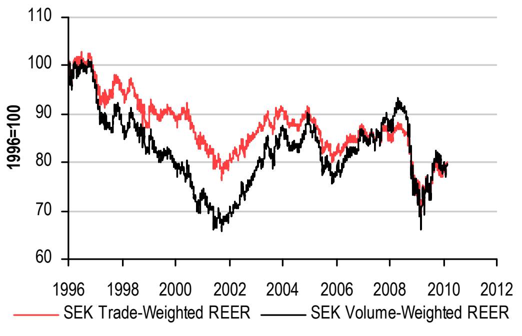
Source: HSBC

NZD REER index



Source: HSBC

SEK REER index



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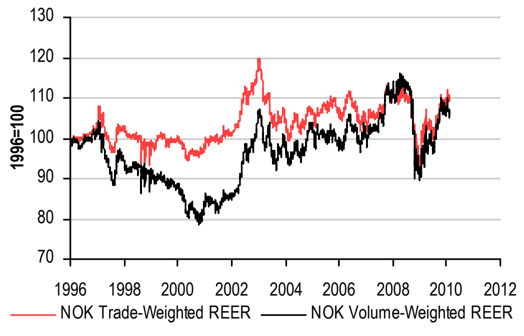
NOK REER index



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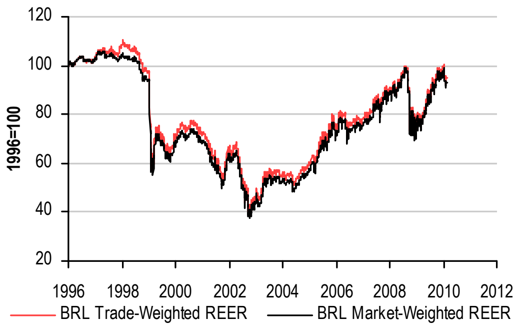
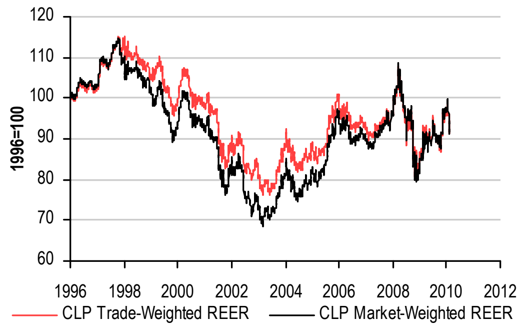
BRL REER index



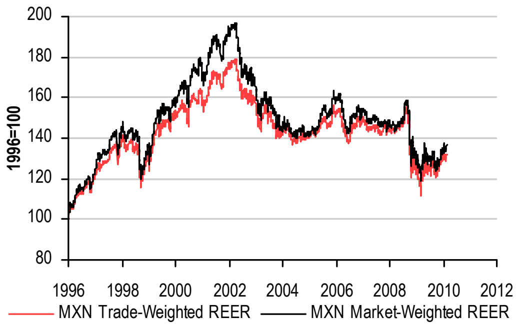
Source: HSBC

CLP REER index



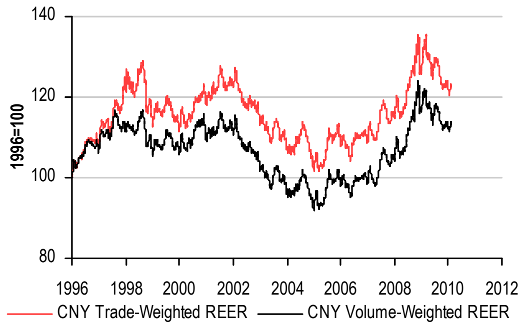
Source: HSBC

MXN REER index



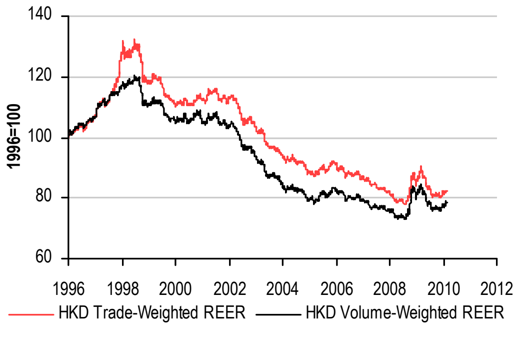
Source: HSBC

CNY REER index



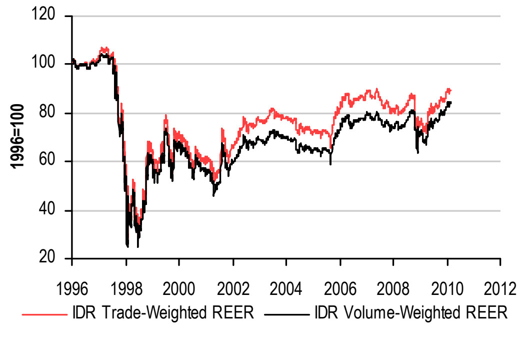
Source: HSBC

HKD REER index



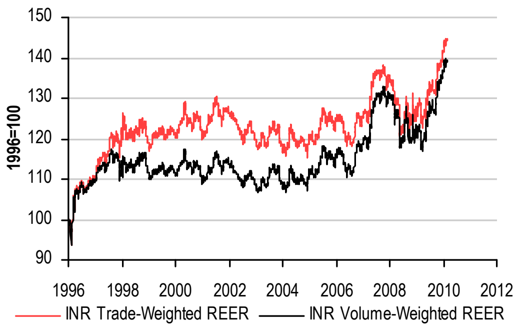
Source: HSBC

IDR REER index



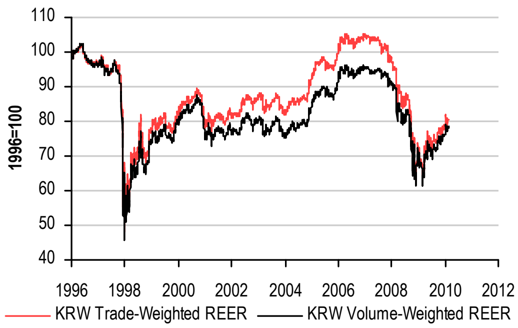
Source: HSBC

INR REER index



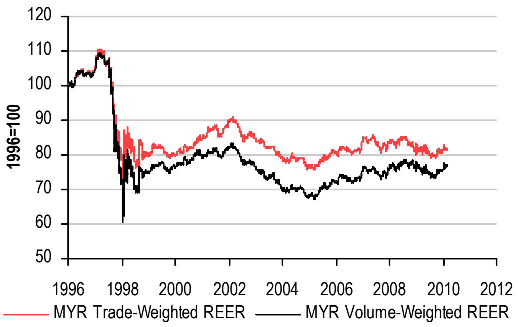
Source: HSBC

KRW REER index



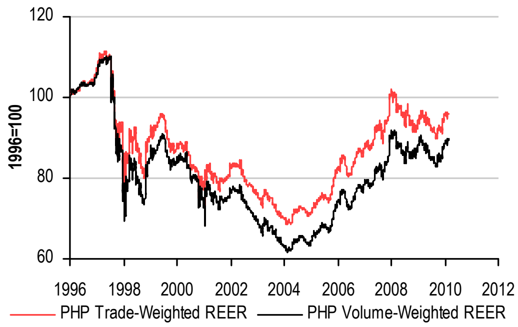
Source: HSBC

MYR REER index



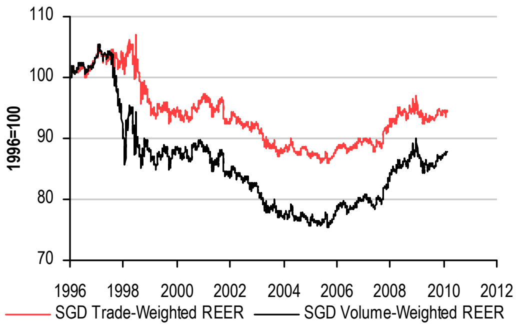
Source: HSBC

PHP REER index



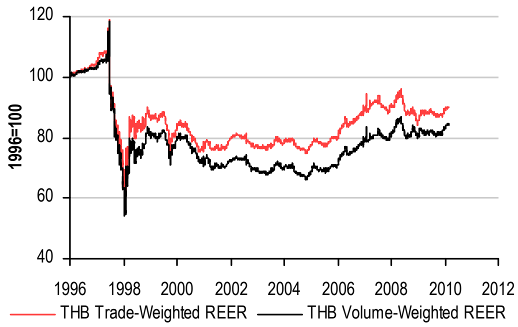
Source: HSBC

SGD REER index



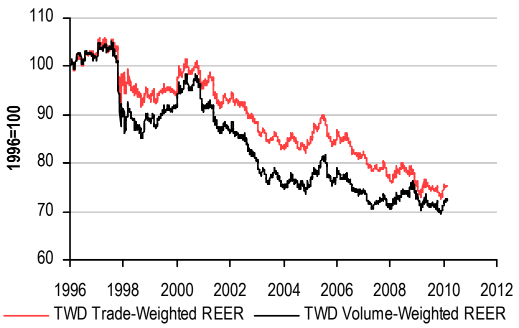
Source: HSBC

THB REER index



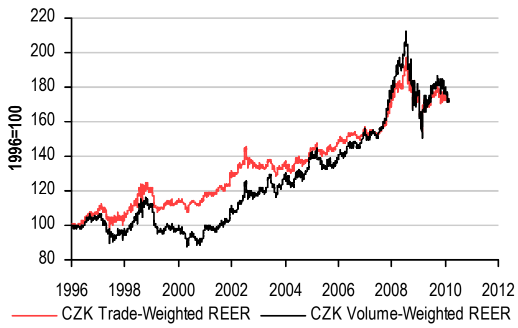
Source: HSBC

TWD REER index



Source: HSBC

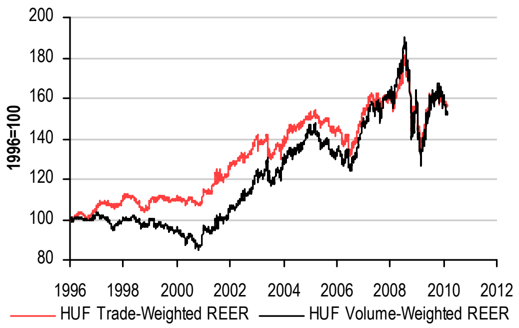
CZK REER index



Source: HSBC

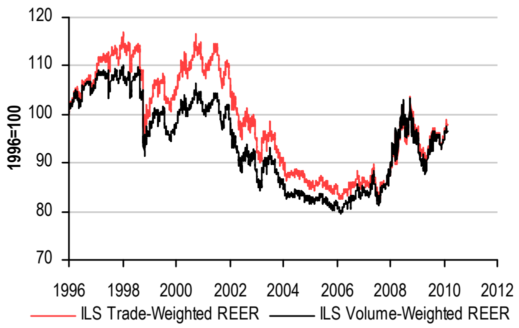
HSBC

HUF REER index



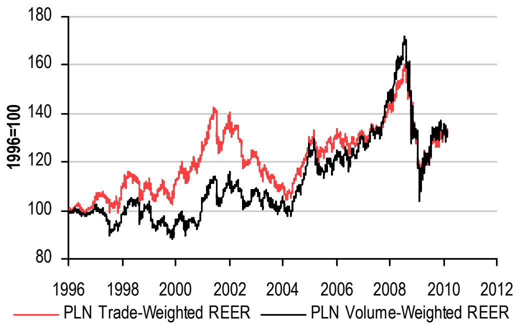
Source: HSBC

ILS REER index



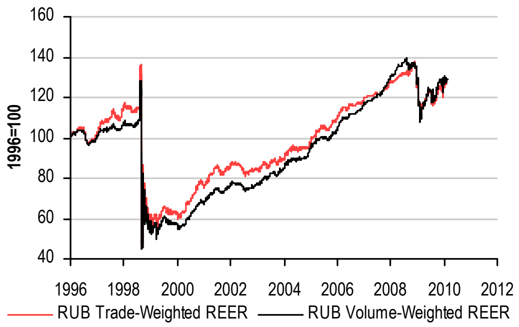
Source: HSBC

PLN REER index



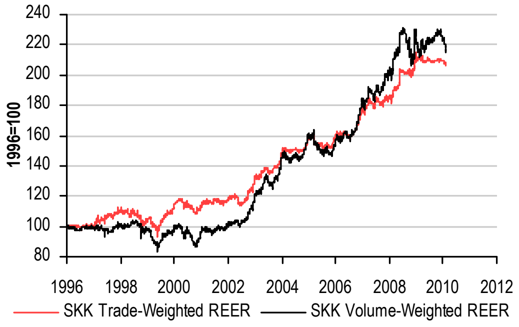
Source: HSBC

RUB REER index



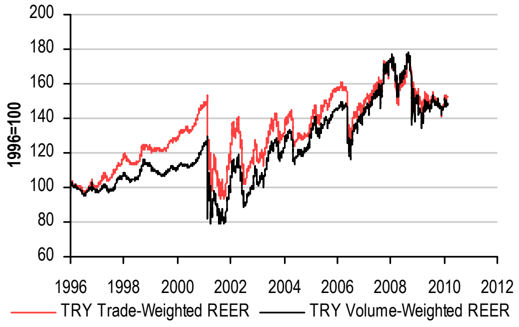
Source: HSBC

SKK REER index



Source: HSBC

TRY REER index



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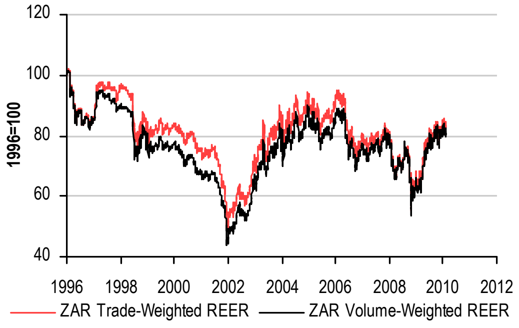
ZAR REER index



Source: HSBC

HSBC

Key global economic and FX assumptions

Key global economic and FX assumptions

	Global			Latam						Asia				
	US	Euro zone	Japan	Argentina	Brazil	Chile	Colombia	Mexico	Peru	China	HK	India	Indonesia	Korea
Real GDP (% y-o-y)														
2007	2.1	2.6	2.4	8.7	6.1	4.7	7.5	3.3	8.9	13.0	6.4	9.0	6.3	5.1
2008	0.4	0.5	-1.2	4.8	5.1	3.2	2.4	1.3	9.8	9.6	2.4	6.7	6.1	2.2
2009(f)	-2.4	-3.9	-5.2	-3.5	-0.2	-1.8	-0.2	-6.6	0.6	8.5	-3.6	7.2	4.3	0.4
2010(f)	2.8	1.2	1.0	3.5	5.6	4.5	2.6	3.6	2.9	9.5	3.8	8.5	5.8	5.2
Private consumption (% y-o-y)														
2007	2.7	1.6	1.6	9.0	6.1	6.9	7.6	3.9	8.3	9.0	8.5	8.5	5.0	5.1
2008	-0.2	0.3	-0.7	6.5	7.0	4.3	2.5	1.5	8.3	8.9	1.7	2.9	5.3	0.9
2009(f)	-0.6	-1.0	-0.9	-0.4	2.5	-0.8	-0.1	-5.2	1.5	8.0	-1.0	3.5	5.1	0.1
2010(f)	1.6	-0.1	1.4	2.8	5.1	4.5	3.2	3.6	2.0	9.2	3.4	8.0	5.4	3.9
Fixed investment (% y-o-y)														
2007	-2.1	4.8	-1.2	13.6	13.9	12.0	13.7	7.2	22.6	25.8	3.4	12.9	9.4	4.2
2008	-5.1	-0.7	-2.6	8.7	13.4	19.5	7.5	4.9	28.1	26.1	0.0	8.2	11.7	-1.7
2009(f)	-18.4	-9.8	-14.0	-12.7	-10.0	-14.4	-6.4	-13.9	-3.2	29.5	-5.5	8.0	3.8	-1.0
2010(f)	1.9	0.7	-5.2	5.0	16.0	8.0	5.0	8.6	9.0	26.0	6.6	14.0	8.7	4.9
Current account balance (% of GDP)														
2007	-5.2	0.1	4.9	2.8	0.1	4.4	-2.9	-0.8	1.1	11.0	10.8	-1.0	2.4	0.6
2008	-4.9	-1.1	3.2	2.2	-1.7	-2.0	-2.8	-1.4	-3.3	9.4	10.9	-3.1	0.0	-0.7
2009(f)	-2.9	-0.9	2.8	2.7	-1.5	3.9	-2.2	-0.8	-1.2	4.9	9.7	-1.1	1.6	5.1
2010(f)	-2.3	-0.5	4.3	1.3	-2.3	0.7	-2.2	-1.3	-1.4	4.1	10.3	-2.0	0.6	2.6
Total fiscal balance (% of GDP)														
2007	-2.2	-0.6	-1.4	1.1	-2.8	8.8	-0.7	0.0	3.1	0.6	7.7	-2.8	-1.3	3.8
2008	-5.4	-1.4	-3.5	1.4	-2.0	5.3	-1.0	-0.1	2.0	-0.4	0.1	-6.3	-0.1	1.2
2009(f)	-10.0	-6.1	-10.5	-0.6	-3.3	-4.7	-2.7	-2.3	-2.1	-2.8	0.1	-6.9	-2.4	-5.0
2010(f)	-8.3	-7.1	-10.5	0.5	-2.4	5.3	-3.8	-2.8	-1.8	-3.3	0.0	-5.8	-1.7	-2.5
Official policy rate (year-end)														
2007	4.25	4.00	0.10	8.00	11.25	6.0	9.50	7.50	5.00	7.47	5.75	7.75	8.00	5.00
2008	0-0.25	2.50	0.10	10.50	13.75	8.3	9.50	8.25	6.50	5.31	0.50	6.50	9.25	3.00
2009(f)	0-0.25	1.00	0.10	9.00	8.75	0.5	3.50	4.50	1.25	5.31	0.50	5.00	6.50	2.00
2010(f)	0-0.25	1.50	0.10	8.50	11.75	2.8	4.00	5.50	1.25	5.85	0.50	6.25	8.00	3.00
External debt (% of GDP)														
2007	-	-	32.0	57.8	14.1	34.2	21.7	12.0	30.9	11.0	40.1	20.1	31.6	39.5
2008	-	-	26.8	49.5	12.1	38.1	18.8	12.0	27.1	8.3	22.1	19.1	28.8	40.1
2009(f)	-	-	24.6	54.5	12.9	43.5	21.8	18.9	25.5	7.1	19.2	20.0	27.8	41.7
2010(f)	-	-	26.5	48.6	10.1	37.3	17.3	17.9	24.6	5.9	20.5	17.9	21.6	32.8
FX reserves														
2007	-	-	952.8	46.2	180.3	22.0	20.9	78.0	27.7	1,528	153	267	57	262
2008	-	-	1030.6	46.4	193.8	23.1	23.6	85.4	31.2	1,946	183	247	52	201
2009(f)	-	-	1060.0	48.0	238.5	26.3	25.5	90.8	32.3	2,250	256	288	64	277
2010(f)	-	-	1100.0	46.5	256.8	21.6	27.7	101.3	32.7	2,400	247	361	66	307
CPI (% y-o-y)														
2007	2.9	2.1	0.0	20.1	4.5	7.8	5.7	3.8	3.9	4.8	2.0	6.4	6.4	2.5
2008	3.8	3.3	1.5	22.9	5.9	7.1	7.7	6.5	6.7	5.9	4.3	8.3	10.2	4.7
2009(f)	-0.3	0.3	-1.2	14.8	4.3	-1.4	2.0	3.6	0.2	-0.9	0.7	10.5	4.8	2.8
2010(f)	2.0	1.3	-1.4	15.7	5.0	2.3	3.4	4.9	1.9	2.6	2.7	9.6	6.8	3.4
		EUR/USD	USD/JPY	USD/ARS	USD/BRL	USD/CLP	USD/COP	USD/MXN	USD/PEN	USD/CNY	USD/HKD	USD/INR	USD/IDR	USD/KRW
FX														
1Q09		1.33	99	3.71	2.32	584	2539	14.17	3.15	6.83	7.75	50.6	11,550	1,375
2Q09		1.40	96	3.80	1.95	533	2145	13.18	3.00	6.83	7.75	47.8	10,208	1,275
3Q09		1.46	90	3.84	1.77	550	1930	13.50	2.88	6.83	7.80	47.7	9,645	1,177
4Q09		1.43	93	3.80	1.75	500	1900	12.90	2.85	6.83	7.80	46.4	9,425	1,166
1Q10(f)		1.30	90	3.90	1.80	520	1875	12.90	2.80	6.80	7.80	48.0	9,200	1,110
2Q10(f)		1.35	95	3.92	1.72	510	1850	12.90	2.75	6.70	7.80	47.5	9,000	1,085
3Q10(f)		1.40	100	4.10	1.78	505	1850	12.90	2.75	6.60	7.80	47.0	8,900	1,060
4Q10 (f)		1.45	100	4.30	1.78	505	1850	12.90	2.75	6.50	7.80	46.5	8,800	1,035

Source: HSBC, IMF

Key global economic and FX assumptions (continued)

Asia						EMEA							
Malaysia	Philippines	Singapore	Taiwan	Thailand	Vietnam	Czech Rep	Hungary	Poland	Romania	Russia	Turkey	S Africa	
													Real GDP (% y-o-y)
6.2	7.1	7.8	6.0	4.9	8.5	6.0	1.3	6.8	6.2	8.1	4.7	5.5	2007
4.6	3.8	1.1	0.7	2.5	6.2	2.7	0.7	5.0	7.1	5.6	0.9	3.7	2008
-2.0	1.1	-2.2	-2.8	-2.9	5.3	-4.4	-6.3	1.7	-7.2	-7.9	-5.8	-1.7	2009(f)
6.8	4.2	6.5	5.1	4.6	6.8	1.5	-0.3	2.2	1.1	3.7	4.0	2.6	2010(f)
													Private consumption (% y-o-y)
10.4	5.8	5.2	2.1	1.7	9.6	4.8	-1.8	4.9	11.6	13.7	5.5	6.6	2007
8.5	4.7	2.4	-0.6	2.7	7.6	3.6	-0.1	5.9	9.1	11.3	-0.1	2.3	2008
2.1	3.6	-1.2	0.9	-1.5	3.4	1.2	-6.5	2.3	-10.8	-8.1	-2.9	-2.5	2009(f)
5.7	4.7	4.4	2.4	3.0	5.8	0.4	-1.7	1.9	1.0	5.0	3.0	1.9	2010(f)
													Fixed investment (% y-o-y)
9.6	10.9	19.2	0.6	1.5	23.0	10.8	1.5	17.6	28.9	21.1	3.1	17.1	2007
0.8	2.9	13.7	-11.2	1.2	13.2	-1.5	-2.6	8.2	19.3	10.0	-5.0	10.2	2008
-8.0	-3.8	-4.9	-14.2	-8.1	3.2	-6.8	-6.1	-1.2	-16.2	-18.2	-19.6	5.6	2009(f)
4.1	5.6	8.0	7.1	5.4	8.0	1.7	0.4	3.6	2.0	3.0	3.2	7.8	2010(f)
													Current account balance (% of GDP)
15.7	4.8	23.5	8.4	6.6	-9.8	-3.2	-6.8	-4.7	-13.9	6.0	-5.9	-7.3	2007
17.5	2.3	14.8	6.2	0.6	-11.6	-3.1	-7.2	-5.1	-12.6	6.1	-5.7	-7.4	2008
16.1	4.9	10.8	10.1	8.3	-7.6	-0.7	-1.5	-1.6	-4.4	4.0	-2.3	-4.8	2009(f)
13.9	5.2	10.3	6.5	3.5	-13.3	-1.0	-2.0	-2.2	-4.7	2.7	-3.5	-5.7	2010(f)
													Fiscal balance (% of GDP)
-3.2	-0.2	2.9	0.2	-2.3	-5.0	-0.7	-5.0	-1.9	-2.5	5.4	-1.6	0.7	2007
-4.8	-0.9	1.2	-0.7	-1.1	-5.0	-2.1	-3.8	-3.6	-5.4	4.1	-1.8	-0.3	2008
-8.5	-4.0	-2.5	-3.5	-4.2	-8.0	-6.6	-3.9	-7.2	-7.2	-6.0	-5.5	-7.7	2009(f)
-5.8	-4.4	-0.7	-2.6	-4.7	-7.0	-5.5	-4.1	-6.5	-6.1	-5.4	-5.3	-6.8	2010(f)
													Official policy rate (year-end)
3.50	5.25	2.38	3.375	3.25	8.25	3.50	7.50	5.00	7.50	6.0	15.75	11.00	2007
3.25	5.50	0.96	2.000	2.75	8.50	2.25	10.00	5.00	10.25	9.0	15.00	11.50	2008
2.00	4.00	0.68	1.250	1.25	8.00	1.00	6.25	3.50	8.00	6.0	6.50	7.00	2009(f)
2.50	4.75	0.80	2.000	2.00	12.00	1.50	5.50	4.00	6.00	6.0	9.00	7.50	2010(f)
													External debt (% of GDP)
29.9	37.3	N/A	24.0	26.1	27.1	46.0	104.5	55.1	47.1	35.5	37.5	26.5	2007
24.4	32.2	N/A	22.3	23.9	27.4	42.5	109.0	48.2	53.5	28.8	37.9	26.0	2008
27.2	32.4	N/A	24.8	22.9	25.0	45.5	139.4	64.4	63.5	38.3	44.2	29.4	2009(f)
24.9	27.0	N/A	23.8	18.8	23.9	44.5	128.5	57.2	64.0	34.3	40.1	27.2	2010(f)
													FX reserves
89	34	163	270	87	24	34.9	23.8	62.7	37.2	465.9	71.3	29.2	2007
92	36	174	292	111	24	37.0	33.6	58.9	36.7	412.5	70.1	30.3	2008
93	43	184	350	139	16	41.5	42.5	73.4	40.8	416.7	69.6	35.0	2009(f)
101	53	204	380	159	15	43.0	44.0	77.5	53.5	472.4	73.0	40.5	2010(f)
													CPI (% y-o-y)
2.0	2.8	2.1	1.8	2.2	8.3	2.8	7.9	2.5	4.8	9.0	8.4	7.1	2007
5.4	9.3	6.5	3.5	5.5	23.0	6.4	6.1	4.2	7.9	14.1	10.1	11.5	2008
0.7	3.3	0.2	-0.9	-0.8	7.8	1.0	4.2	3.4	5.6	11.7	6.5	6.3	2009(f)
3.3	5.2	2.9	1.2	3.0	10.1	1.9	4.3	2.3	4.5	7.1	8.8	5.8	2010(f)
USD/MYR	**USD/PHP**	**USD/SGD**	**USD/TWD**	**USD/THB**	**USD/VND**	**EUR/CZK**	**EUR/HUF**	**EUR/PLN**	**EUR/RON**	**USD/RUB**	**USD/TRY**	**USD/ZAR**	
													FX
3.65	48.3	1.52	33.9	35.5	17,776	27.34	308	4.65	4.24	34.0	1.67	9.52	1Q09
3.52	48.2	1.45	32.8	34.0	17,798	26.00	273	4.45	4.21	31.2	1.52	7.75	2Q09
3.46	47.6	1.41	32.2	33.5	18,200	25.23	269	4.20	4.22	30.0	1.48	7.51	3Q09
3.42	46.5	1.41	32.1	33.3	18,200	26.35	270	4.10	4.23	30.1	1.49	7.38	4Q09
3.35	45.5	1.40	31.0	32.5	18,400	25.75	265	3.95	4.15	31.4	1.55	7.75	1Q10(f)
3.33	45.0	1.38	30.0	32.0	18,400	25.50	265	3.90	4.10	30.1	1.54	7.40	2Q10(f)
3.31	44.5	1.36	29.5	31.5	18,400	25.00	260	3.80	4.10	29.9	1.51	7.50	3Q10(f)
3.29	43.5	1.34	29.0	31.5	18,400	24.50	255	3.70	4.00	30.7	1.50	7.50	4Q10(f)

Source: HSBC, IMF

HSBC

Currency reference table

FX markets performance

Country/region	Spot	Local currency performance m-o-m	q-t-d	y-t-d	12mth fwd/NDF	Implied 12mth interest rate	3 month option volatility	3 month 25-delta RR
Asia								
China	6.8330	-0.09%	-0.09%	-0.09%	6.6515	-1.67%	2.8	-1.6
Hong Kong	7.7675	0.02%	-0.17%	-0.17%	7.7492	0.78%	0.6	-0.3
India	46.11	-0.02%	0.92%	0.92%	46.89	2.73%	10.4	1.9
Indonesia	9280	0.36%	2.16%	2.16%	9985	8.69%	12.0	cfp
Korea	1143.07	0.29%	1.31%	1.31%	1155.0	2.07%	13.1	3.2
Malaysia	3.3885	0.33%	1.56%	1.56%	3.4115	1.70%	N/A	N/A
Philippines	46.07	0.39%	0.07%	0.07%	47.32	3.76%	10.1	cfp
Singapore	1.4065	-0.55%	-0.12%	-0.12%	1.4082	1.14%	6.0	0.9
Thailand	33.20	-0.63%	0.51%	0.51%	33.34	1.44%	6.0	0.9
Taiwan	32.06	-0.31%	-0.23%	-0.23%	31.09	-2.05%	6.0	-0.4
Vietnam	18900	-2.28%	-2.23%	-2.23%	20820	11.28%	12.6	5.0
EMEA								
Czech Republic*	25.83	0.65%	2.36%	2.36%	25.98	1.60%	8.3	1.6
Egypt	5.4875	-0.67%	-0.05%	-0.05%	N/A	N/A	N/A	N/A
Hungary*	271.16	0.44%	-0.24%	-0.24%	282.63	5.21%	11.0	2.8
Israel	3.7395	-0.48%	1.26%	1.26%	3.767	1.76%	8.2	1.0
Poland*	3.9783	2.32%	3.19%	3.19%	4.0739	3.39%	11.9	2.3
Romania*	4.1174	-0.03%	2.78%	2.78%	4.3339	6.24%	11.0	2.9
Russia	30.14	-0.07%	-0.34%	-0.34%	31.88	6.86%	cfp	cfp
Slovakia*	30.13	0.00%	0.00%	0.00%	30.17	1.15%	cfp	cfp
South Africa	7.6194	-0.58%	-3.02%	-3.02%	8.14	7.92%	17.4	4.3
Turkey	1.5122	-1.71%	-0.90%	-0.90%	1.6219	8.34%	cfp	cfp
Latin America								
Argentina	3.8595	-1.23%	-1.57%	-1.57%	4.4050	15.08%	9.5	cfp
Brazil	1.8305	-0.46%	-4.70%	-4.70%	1.979	9.19%	16.6	4.0
Chile	529.9	-4.59%	-4.24%	-4.24%	525.33	0.14%	15.2	3.7
Colombia	1927.1	1.69%	6.01%	6.01%	2015.5	5.57%	15.8	4.5
Mexico	12.868	-0.09%	1.73%	1.73%	13.4872	5.79%	14.1	3.1
Peru	2.8480	0.12%	1.37%	1.37%	2.8562	1.29%	cfp	cfp
Uruguay	19.65	-0.13%	-0.51%	-0.51%	N/A	N/A	N/A	N/A
Venezuela	4.29	0.00%	-50.00%	-50.00%	N/A	N/A	N/A	N/A

Notes: RR=Risk Reversal. Prices represent the cost in volatility terms of simultaneously purchasing a USD call CCY put and selling a USD put CCY call (or vice versa).
Positive numbers represent a higher net cost for USD calls and negative numbers for USD puts
* quoted vs EUR
cfp – call for price
Data is as of 17 February 2010

Source: Bloomberg, HSBC

Emerging markets FX strategy biographies

Clyde Wardle

Senior EM Currency Strategist

Clyde is a New York-based emerging markets currency strategist, focusing mainly on Latin America. He also provides emerging market risk management advice to HSBC's global client base. He has been with the bank for 14 years.

Richard Yetsenga

Asian Regional FX Strategist

Richard is a Hong Kong-based member of HSBC's global emerging markets FX research team covering Asia. Prior to joining HSBC in 2004, he worked in currencies and economics research, including four years with the Australian government.

Stacy Williams

Head of FX Quantitative Strategy

Stacy publishes quantitative research, develops currency overlay programs, and constructs bespoke hedging strategies for HSBC's clients. He is also responsible for proprietary model trading, concentrating on models based on transactional flow information, high-frequency price data, and economic activity data. Stacy has an MA in physics from the University of Oxford and an MPhil in nanoscale engineering.

Dr. Murat Ulgen

Chief Economist, Turkey

Murat joined HSBC Turkey in early 2006 as Chief Economist for Turkey. Prior to joining HSBC, he worked for a year and a half as emerging markets economist & strategist at one of the leading financial houses in London and for seven years at a leading brokerage house in Istanbul. Murat holds a PhD in finance and has covered 12 EMEA countries in his career so far.

Kubilay Ozturk

Economist, EMEA

Kubilay Ozturk is a London-based analyst working in Global Economics team covering Europe. He previously worked in HSBC's Equity Derivatives and Quantitative Research team. He joined HSBC in 2007.

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Marjorie is a New York-based FX strategist covering Latin America. She was formerly part of HSBC's global emerging markets research team as an economist focusing on the Andean region. She joined HSBC in 2005.

Mark McDonald

Associate, FX Strategy

Mark is a quantitative strategist based in London. Before joining HSBC, he studied for his DPhil at Oxford University in collaboration with the HSBC FX strategy team. Mark has an MPhys in physics, also from Oxford University.

Simon Williams

Chief Economist, Gulf Markets

Simon joined HSBC in mid-2006. Prior to that, he worked at the Economist Intelligence Unit and in other roles as an analyst on Middle East economies for the last 12 years. Simon has degrees from the London School of Economics and the School of Oriental and African Studies, London University.

André Loes

Chief Economist, Brazil

André Loes joined HSBC in August 2008 as chief economist for Brazil. Previously, he was a partner at an asset management concern and chief economist, head of equity research and head of equity at a major Spanish bank based in Brazil. Earlier, he served as aide to Brazil's foreign trade secretary in the Ministry of Industry and Foreign Trade, and he led the economic department of the Brazilian National Association of Investment Banks (ANBID). Andre holds a bachelor's degree and a master's degree in economics, both from the Federal University of Rio de Janeiro, and a doctorate in economics from Université de Paris, France.

Javier Finkman

Chief Economist, Argentina

Javier joined HSBC in 1996 as Argentine Director of Equity Research, and went on to become Chief Economist in 1998. He is a regular writer on financial newspapers and teaches finance at the graduate level in the Universidad de Buenos Aires. He is an economics undergraduate from UBA and a master level graduate from IDES.

Alexander Morozov

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Alexander joined HSBC in 2005. Prior to this, he has held senior positions at the World Bank and Russian Academy of Sciences, specialising in monetary and fiscal issues concerning the countries of the former Soviet Union. He is based in Moscow from where he also covers Ukraine and Kazakhstan.

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Jorge Morgenstern is an economist with the Latin America Research Team based in Argentina, covering Argentina, Chile, and Uruguay. Jorge received a graduate degree in economics from the Universidad Torcuato Di Tella and holds a bachelor in arts from the Universidad de Buenos Aires, where he teaches macroeconomics. Prior to joining HSBC, he worked for a local consulting firm and the Center for Financial Research at the Universidad Torcuato Di Tella.

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Chief Economist, Central America

Sergio Martin joined HSBC in 2008 as the Chief Central America Economist. His responsibility is now concentrated on Mexico. Previously he was senior economist at the International Monetary Fund for more than 7 years. Earlier he was the Chief Economist for Mexico for two major banks in Mexico. His work experience also covers government positions in the Planning and Budget Ministry and the Council of Economic Advisors to the President of Mexico. Mr. Martin holds a PhD in Economics from the New School for Social Research.

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Perry joined HSBC in 2005 as part of the global FX strategy team. He is based in Hong Kong and covers Asia. Perry received his master’s degree in finance from Imperial College London.

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Notes

Notes

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Stacy Williams, Clyde Wardle, Richard Yetsenga, Perry Kojodjojo, Marjorie Hernandez, Mark McDonald, Daniel Hui, Kubilay Ozturk, Murat Ulgen, Javier Finkman, Simon Williams, Sergio Martin, Alejandro Martinez-Cruz, Andre Loes, Alexander Morozov and Jorge Morgenstern

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