Emerging Markets Research
J.P. Morgan Securities Inc.
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Emerging Markets Today

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Market commentary

Emerging markets external debt sold-off despite stable US Treasuries in a move that seems related to spillover from growing concerns in the US high yield market. Spreads of both high-beta and lower-beta credits widened, driving the EMBIG Diversified wider by 12bp. **Brazilian assets** suffered on many fronts, with its sub-index closing 24bp wider while the local stock market fell 4%. Local rates and the currency also ended weaker. In the Andean region, **Ecuador** widened 28bp, while **Peru** and **Venezuela** widened 19bp and 11bp respectively. We moved our recommendation on **Colombia** to a tactical overweight despite lingering fiscal and political concerns, as we note that the yield differential with other comparable credits stands at widest levels of the past 12 months and its recent underperformance has not been driven by any particular event (see page 2). In the investment grade sector, **Mexico, Russia,** and **South Africa** widened 10bp, 11bp and 9bp respectively. Note that in the latter, the SARB surprised markets with a 50bp rate cut, which drove ZAR moderately weaker and caused local rates to rally and steepen (see "South Africa: SARB surprises with 50bp rate cut" on page 6 and "Local market commentary" on page 5). Finally, **Uruguay** delayed its planned 12-year US$300 million issuance due to yesterday's volatility; bonds were weaker in the morning, but prices rebounded in the afternoon as the supply concerns eased. The sub-index closed 5bp wider on the day. Today's heavy schedule of US economic reports should attract most market attention, as recent price action suggest that local fundamentals have been playing a secondary role compared to US rates and recent events in the high-yield and high-grade sectors.

Eric Torres[AC]/Ben Ramsey

Summary market table

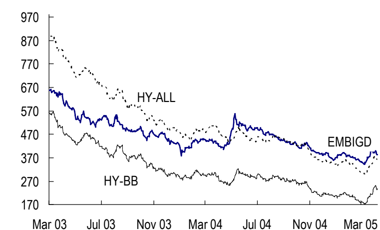
	Last	Daily	Weekly	YTD
External Debt (bp)				
EMBIGD Spread	398	12	12	27
EMBI+ Spread	389	15	11	32
EMBIGD Brazil	452	24	6	76
Brazil 40	515	18	9	57
EMBIGD Colombia	411	13	11	79
EMBIGD Mexico	196	10	6	23
UMS 15	161	10	3	21
EMBIGD Philippines	450	12	21	-7
EMBIGD Russia	198	11	9	-15
EMBIGD South Africa	121	9	4	19
EMBIGD Turkey	324	16	21	59
EMBIGD Venezuela	469	11	18	66
JPM US HY (prev day)	383	4	22	41

	Last	Daily	Weekly	YTD
FX				
USD / ARS	2.888	-0.3%	0.1%	3.0%
USD / BRL	2.590	-1.1%	0.2%	2.5%
USD / COP	2350	-0.7%	0.2%	0.9%
USD / CLP	579	-0.8%	0.3%	-3.6%
USD / CKZ	23.43	-1.1%	-0.9%	-4.8%
USD / HUF	192.62	-0.9%	-1.0%	-6.6%
USD / KRW	1,018	-0.6%	-0.6%	1.7%
USD / MXN	11.119	-0.4%	0.6%	0.3%
USD / PLN	3.214	-1.4%	-1.2%	-7.0%
USD / RUB	27.872	-0.3%	-0.2%	-0.3%
USD / TRY	1.365	-3.3%	-3.3%	-1.4%
USD / ZAR	6.243	-1.7%	-2.2%	-9.2%
Local Rates				
ARS Boden 12 (price)	83.60	1.7%	1.7%	2.4%
MXN 5Y TIIE IRS	10.73	8 bp	-9bp	90 bp
ZAR 5y swap rate	8.14	-27bp	-36bp	32 bp

Data releases today

	JPM Forecasts
US	
Apr NY FRB Mfg Index	19.0
Mar Import Prices (%m/m)	1.7
Mar Industrial Production (%m/m)	0.3
Mar Capacity Utilization (%)	79.5
Apr UMich Confidence prel	91.0
Czech Republic	
Feb Retail Sales(%oya)	3.5
Hungary	
Mar NBH Minutes	
Poland	
Mar Wages (%oya)	1.5
Turkey	
Mar Capacity Utilization	81.0
Thailand	*holiday*

EMBIGD, HY-ALL, HY-BB
Stripped spread



Source: JPMorgan

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Colombia

Move to tactical overweight

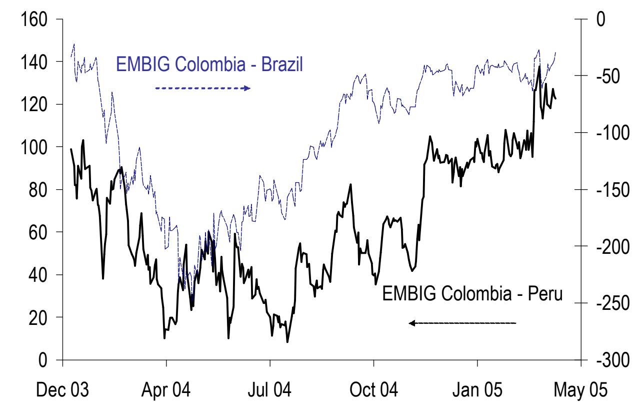
- **Colombian external debt has underperformed during the sell-off in March and the recovery month-to-date**
- **Yield differential between Colombia and comparable credits stands at the widest levels of the past 12 months**
- **While several question marks about Colombia's politics and fiscal outlook remain, the recent underperformance has not been driven by any particular event**
- **We see room for Colombia to catch up with the rest of the market in the near term and move to a tactical overweight**

Colombia has underperformed the market during the sell-off in March (a -2.8% return versus -2.5% for the EMBIG) and in the recovery month-to-date (+0.7% versus +1.4% for the EMBIG). This has pushed the yield differential between Colombia and comparable credits to the widest levels of the past 12 months (chart 1). For example, Colombia '33s now trade 122bp wide to Peru '33s, while the average yield differential of the past 12 months is 71bp (chart 2). In turn, Colombia '33s are now 4bp tight to Brazil '40s, while the average of the past 12 months is 75bp (chart 3).

While there are several questions marks about Colombia's politics and fiscal outlook, the recent underperformance has not been driven by any particular event. The Constitutional Court's decision regarding the re-election of President Uribe remains a close call, but the ruling will only be announced in the third quarter of this year. On the fiscal/financing fronts, no reforms are expected this year beyond the expected approval of the pension reform by mid-year, but the financing of this year's requirements are well advanced (only $175 million out of $1.5 billion remains to be done in the external debt market to complete 2005 borrowing needs).

We see room for Colombia to catch up with the rest of the market in the near term and move tactically to overweight (0.6%) by buying 1.5 million Colombia '13s at $113 (stripped spread of 423bp). This still leaves our EMBIG model portfolio with an overall marketweight, with the overall beta moving from 0.98 to 0.99.

Chart 1: Colombia's EMBIG differentials against Peru and Brazil

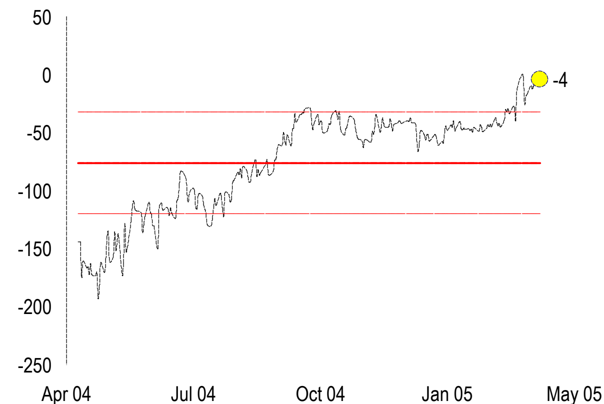


Source: JPMorgan

Chart 2: Colombia '33s versus Peru '33s yield difference

Source: JPMorgan

Chart 3: Colombia '33s versus Brazil '40s yield difference



Source: JPMorgan

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Brazil

February retail sales were up only 1.3%oya increase, well below consensus (5.9%) and JPMorgan estimates (5.5%), and down from an expansion of 6.2% in January. The sequential m/m (sa) comparison posted a surprising decline of 3.5%, following a fall of 0.3% in January. **Although we acknowledge that a moderation in consumer spending is on the way (we were forecasting flat sales %m/m, sa), it is too early to definitively label the strong reversion in the February data as a new trend;** indeed, consumer confidence is still at high levels, real labor income remains supportive, and credit to consumers is improving on the back of market innovations. Separately, the Supreme Court put off its probe into allegations that Central Bank President Meirelles made illegal money transfers and avoided taxes until the Court itself rules (probably next week) on the legislation that granted the head of the Central Bank ministerial status. In the absence of local releases today, the market will focus abroad, especially on US figures.

Julio Callegari[AC]

Local market comment: Jitters from high grade names fed through EM external debt and local markets. The *real* lost 0.55% to close at USD/BRL 2.577 following weakness across the board against the USD. Meanwhile the Ibovespa plunged about 4%. ***Reais*** **rates meanwhile held up well, as the yield curve portrayed a mild steepening.** Actually, lower-than-expected February retail sales pushed the Jan'06 down by 4bp to 19.39%. The Jan'07 widened 3bp to 18.55%, and the Jan'08 closed 9bp higher at 17.83%. However, the market continued to deteriorate in the after hours, which suggests some follow through in today's session.

Felipe Pianetti[AC]

Mexico

Local market comment: **The local fixed-income market saw a negative session with rates increasing around 10bp in the long-end of the curve despite tame US Treasuries** and the fact that the peso closed almost unchanged from its opening level. Long-term Bonos closed around 10bp higher, while medium-term Bonos did by 7bp and the Cete curve increased 3bp. In IRS, rates closed around 7bp higher on average with a steepening bias as short-term rates increased 4-7bp while the long-end ended 7-10bp higher. As in the cash market, most trading activity was concentrated among banks. In FX, the peso opened weaker following a sharp rebound of the USD versus major currencies, but closed almost unchanged at around USD/MXN 11.11 after trading in a tight 11.087-11.1225 range.

Eric Torres[AC]

Argentina

Local market comment: The currency reversed Wednesday's gains and weakened one cent to USD/ARS 2.89, in line with poor performance across FX markets in the region. Volume remained aloft. The peso was dragged down by steady official intervention (estimated to have been stepped up). Dollar sales by exporters continued to edge higher to stand at US$70 million (from US$56 million on Wednesday). Separately, the fixed income market saw a negative session affected by disappointing performance among Brazilian assets (in response to weak retail sales performance in February), and despite upbeat trends in the US fixed income market. Boden debt prices slid visibly but amid low volume

Florencia Vazquez[AC]

Colombia

The proponents of the pension bill agreed to present in the Lower House and the Senate a single report that will be used for the fifth debate scheduled for next week at the committee level of the Lower House. Finance Minister Carrasquilla noted at the end of a meeting with several congressmen yesterday that the updated version had been refined but still maintained intact the elimination in 2010 of the special pension regimes in state institutions (except the armed forces), a cap of 25 minimum wages for the highest pensions, and the elimination of a 14th annual pension payment. **The pension reform is necessary to curb the government transfers to the ISS, which manages most of the public social security system, and to trim the central government deficit that reached 5.6 % of GDP last year (the impact of the reform would only be seen over time).** This reform had already been approved in four debates during the previous legislature and will now need a second round of another four debates before it can be approved. **Final approval of the pension reform is expected by mid-year.**

Luis Oganes[AC]/Andres Ortiz

Ecuador

The minister of government, Oscar Ayerve, noted that the administration will continue to push its proposed mechanism to replace Supreme Court judges as the solution to the current political tensions. The civil and criminal committees of Congress met yesterday to prepare the report that will be used in the debate of the government's proposal next Tuesday, which would later have to be validated by a referendum. **Once again, the required 51 votes to approve the proposal is unlikely to be reached since the PRE and PRIAN parties, which recently gained control of the court, will probably oppose the proposal.**

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Peru

As we went to press, Congress was expected to vote on the constitutional amendment that would enable the transition from a unicameral to a bicameral Congress ahead of the 2006 elections. This amendment would institutionalize a Lower House with 130 deputies and a Senate with 50 members. The local press mentions that the proposal has the support of 78 congressmen, three votes short of the minimum 81 required to validate the constitutional amendment (out of 120 votes), so its passage remains in doubt. **The lack of consensus in Congress regarding the change is related to the additional costs that the increase in seats would involve, as well as the increased bureaucratic barriers that would need to be overcome in order to pass legislative initiatives going forward.**

Luis Oganes[AC]/Andres Ortiz

Turkey

Parliament passed the tax reform yesterday evening, fulfilling all the prior actions required by the IMF ahead of the signing of a new standby agreement in the first half of May. Separately, March consolidated budget data came in weaker than expected showing a primary surplus of TRY2.2 billion (market consensus: TRY2.7 billion; JPMorgan: TRY3-4 billion) and a headline budget deficit of TRY1.7 billion. **First quarter data, however, remains positive meaning that Turkey remains well on track to meet its full year primary surplus target of 6.5% of GDP.** The primary surplus totalled TRY8.96 billion in 1Q05 (about 33% of the full-year planned surplus) versus TRY7.88 billion in 1Q04, while the headline budget deficit reached TRY2.99 billion in 1Q05 versus TRY6.98 billion in 1Q04. The detailed breakdown of the March fiscal data due to be published by the Treasury today should shed some light on the reasons for the unexpectedly low result. We note that monthly data could be volatile, since the precise timing of revenue and expenditure cash flows could have a substantial impact on monthly results.

Eva Sanchez-Ampudia[AC]

Poland

March inflation data surprised slightly on the downside, with the over-year-ago CPI rate declining to 3.4%oya (JPMorgan and consensus: 3.5%) from 3.6%oya in February. The surprise came from lower-than-expected increases in food (0.2%m/m) and transport prices (0.3%m/m) despite high oil prices and a weaker zloty. According to our estimates, core inflation (excluding food and fuels) remained steady at 2.3%oya. We maintain our forecast for inflation to end the year in the bottom half of

Concerns over EU enlargement prospects raised by French vote are exaggerated

Some have perceived the possibility of a "NO" vote to the EU Constitution by the French as a threat to EU enlargement as a whole and to Turkey's accession process in particular. We remain of the view that the issues driving the French EU vote are mostly domestic (disenchantment with government and concerns over the potential loss of social/welfare benefits under a more integrated Europe), rather than the Constitution itself or Turkey's potential EU entry (for further details, including views on broader implications for the EU if the constitution is not adopted, see Pasquale Diana's "What if the French Say No" in *Global Data Watch,* April 1). Moreover, while Chirac is reminding the French population that they will have the opportunity to vote on Turkey's accession in due time (no new news here), EC enlargement commissioner Rehn has reassured that the start of accession talks with Turkey will not be influenced by the fate of the EU constitution. **We believe that if Turkey complies with the only condition set—extending its customs union agreement to the ten new EU members—it should start accession talks on October 3 as planned.** We also remain of the view that Turkey's EU entry negotiations will be long and bumpy with entry not expected before 2014 at the earliest and with a long line of EU members likely to hold referenda. **The accession process of Bulgaria and Romania, meanwhile, is too far advanced to be threatened, with both countries due to sign their accession treaties on April 25 and both on track for EU entry in 2007.** The only remaining official accession candidate, Croatia, also has a promise from the EU that talks will start once hurdles over ICTY cooperation are cleared (likely later this year), while its entry into the EU will likely occur in 2009-10. **However, for countries that do not yet have a clear commitment from the EU (some Balkan countries and potentially Ukraine), an EU that has to refocus on internal issues might take longer to extend new entry promises.** Finally, we do acknowledge that failure to ratify the EU constitution in key referenda such as France's on May 29 and The Netherlands' on June 1 would unleash media scrutiny of the reason behind the failure, with the issue of enlargement fatigue likely to be among the reasons examined. **Although these hurdles could raise market volatility in the region (as it has), we believe that these concerns will prove mostly unfounded.**

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the 1.5-3.5% CPI target range, which we anticipate will prompt a further 75bp of easing over the next three-four months. **We continue expect a 25bp rate cut at the April 27 MPC meeting.**

Nora Szentivanyi[AC]

South Africa

Local market comment: The SARB unexpectedly cut its policy repo rate by 50bp, bringing the rate down to 7.00% (see "South Africa: SARB surprises with 50bp rate cut" on page 6). **The market's reaction to the rate cut was less severe than in August 2004, when a similar surprise pushed USD/ZAR up more than 4% on the day. USD/ZAR climbed from 6.18 to settle at around 6.30 after the cut, which looks like a modest move in the context of broader dollar strength.** Exporter selling was apparent above 6.30, suggesting that we will hold close to these levels tomorrow in the absence of major EUR/USD moves. Regarding local rates, we recommended entering into 2s/5s swap steepeners on March 9 (at 42bp), arguing for higher term premia to be priced in the mid-part of the curve. **Due to the unexpected rate cut by, the rate market rallied and the curve steepened, and we recommend unwinding the trade (at 83bp) as it has reached its target.**

Graham Stock[AC]/ Chuan Woei Lim

Indonesia

Bank Indonesia (BI) has warned that an imbalance in Indonesia's oil trade account and a possible shortage in foreign exchange would hurt the country's monetary position, and therefore affect this year's economic growth projection of 5.5 % (JPMorgan 5.5%). In explaining the central bank's board of governors' first quarter assessment of the country's economy, BI governor Burhanuddin said BI had been observing that the country's trade account — particularly in the oil sector — had been experiencing a deficit of USD2 billion per year. The governor also suggested that "based on our projection, we also see that the country may experience a shortage in foreign exchange of between US$12 billion and US$15 billion this year." **Furthermore, judging by recent statements and SBI auction results, BI seems reluctant to allow policy rates to shift higher to stem inflationary pressures—thus the bulk of the adjustment is expected to be borne by the FX rate.** JPMorgan continues to stress that these pressures will continue to build over 2005 and thus reaffirms its IDR forecast of 9800 by end 2005.

Sin Beng Ong[AC]

Philippines

The VAT was passed by the Senate on Wednesday. However, the bill indicates no increase in the headline VAT rate of 10% but lifts certain exemptions. **This constitutes a watered down form of the VAT.** The bill will now likely go through the bicameral committee next week for further approval before being ratified by the president in late April/early May. And while details are not available, **revenue gains are unlikely to reach the PHP40 billion initial estimates had hoped with the 2% hike.** This implies that estimated revenue gains from the broader revenue program (at PHP49 billion) should fall further behind the 130 billion target. Underlying fiscal difficulties are accordingly expected to remain, but the PHP fallout has so far been limited, with USD/PHP trading higher on Thursday largely in line with the region.

Yen Ping Ho[AC]

Hong Kong

Local market comment: **The HKD curve continued its recent flattening trend on Thursday,** as participants rushed to cover their short positions at the front end of the curve after interbank rates hardened in anticipation of a series of upcoming IPOs. The HK-US spread widened out further as result. However, bond investments at the start of the quarter continue to drive the swap curve lower, in line with the overnight move in USTs.

Simon Klassen[AC]

Korea

Local market comment: In an otherwise directionless market, bonds rallied 2-4bp on Thursday, propelled by aggressive foreign buying in the 3-year KTB futures contracts. Accordingly, most of the rally was concentrated at the 3-year segment, and the curve steepened slightly at the long end. **Participants continue to focus on Monday's auction of 10-year KTBs to set near-term market direction.**

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South Africa

SARB surprises with 50bp rate cut

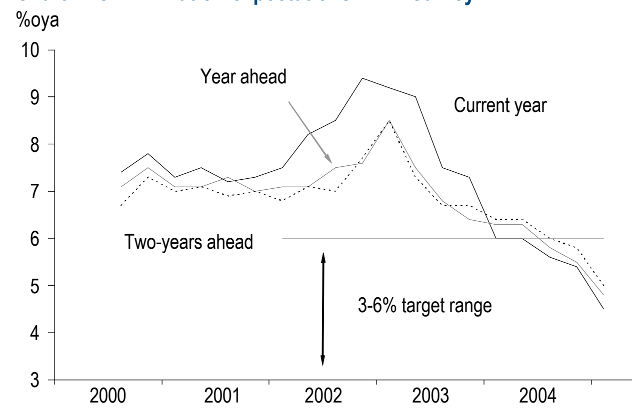
- **Concern over strong rand prompts surprise 50bp rate cut**
- **Falling inflation expectations underpin positive inflation outlook**
- **Little room for interest rates to fall further, but SARB will be keeping a close eye on the rand**

The South African Reserve Bank (SARB) unexpectedly cut interest rates by 50bp today, after a scheduled meeting of its monetary policy committee (MPC). All economists polled by Reuters, including JPMorgan, expected the repo rate to remain unchanged at 7.5%.

The move appears to have been motivated by concerns over the impact of the strong rand on the manufacturing and mining sectors. Earlier on Thursday, Stats SA published figures showing a sharp decline in manufacturing production in January (-3.9%m/m, sa) and only a modest pick-up in activity in February (+0.6%m/m, sa). The MPC appears to have taken advantage of the element of surprise to weaken the currency, much like it did in August last year when rates were also lowered by 50bp. Although the rand weakened sharply after the August rate cut, it rallied strongly in the fourth quarter of 2004 in response to the weakening dollar and strong commodity prices. We believe that movements in the dollar and global commodity prices will continue to be important drivers of the rand, although rand volatility is likely to increase on the back of the MPC's surprise decision. The decision to cut rates today may also have been motivated by the fact that with US rates moving higher, this may have been the last opportunity for the SARB to lower rates in this cycle.

Our interest rate view remains essentially unchanged, although we now expect interest rates to rise by 50bp in June next year, two months earlier than our previous forecast. The inflation outlook remains sound and our forecast see CPIX inflation firmly within the target range over the next two years. There should, thus, be little pressure on the SARB to hike rates any time soon, unless the currency weakens sharply and oil prices remain high. Indeed, the message from the latest MPC statement is that the SARB would welcome a more competitive and stable exchange rate. The nominal effective exchange rate has averaged 60.6 in the first few months of 2005 compared with an average level of 58.9 last year. Although we do not expect interest rates to fall further, the SARB has sent a strong message that it is not immune to the impact of currency movements on the real economy. The outlook for interest rates will therefore be closely linked to movements in the rand.

Chart 1: CPIX inflation expectations: BER survey



Source: JPMorgan

Chart 2: SARB nominal effective exchange rate

Source: JPMorgan

Other factors impacting on the SARB's decision include:

- **A further material decline in inflation expectations.** The latest BER survey showed a marked decline in inflation expectations in the first quarter of 2005. Average expectations for CPIX inflation in 2005 declined to 4.5%oya from 5.5% previously. All respondents saw inflation remaining within the target range over the next three years, with both business and

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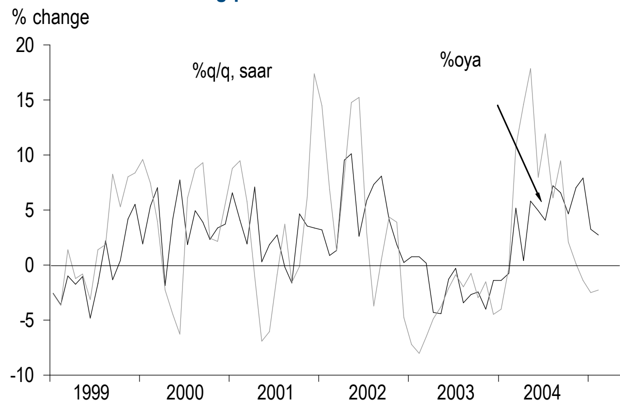
labor expectations falling sharply. This shows that inflation targeting is gaining traction as a policy tool and it is only a matter of time before lower inflation expectations start putting downward pressure on wage demands.

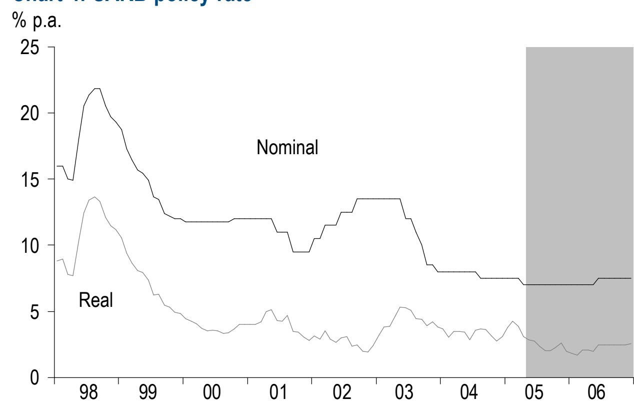
- **Favorable fiscal outcome.** The government recently announced that the fiscal deficit for last year narrowed to only 1.6% of GDP as revenue receipts outperformed expectations. At the MPC meeting in February, there might have been some concern that government's expansionary fiscal policy could become inflationary. The latest figures, however, show that the fiscal situation remains well under control.
- **Favorable inflation outlook.** The MPC statement emphasized that the inflation outlook remains favorable, despite the current high level of oil prices. Services inflation has moderated substantially and fell below 6% for the first time in January, which along with lower inflation expectations, contributed to a more optimistic inflation outlook. SARB forecasts see CPIX inflation "rising moderately over the coming months to peak at a level of around 5.25% in early next year before resuming a downward trajectory towards the mid-point of the inflation target range." The pattern of inflation in the SARB forecast, thus, looks very similar to our own.
- **Signs of supply-side weakness.** Although the numbers were not explicitly quoted in the MPC statement, the manufacturing production statistics released by Stats SA today must surely have had an impact on the SARB's decision. Manufacturing production declined by 3.9%m/m (sa) in January reducing growth in production to 3.2%oya from 7.9% in December. Production increased marginally by 0.6%m/m in February, but growth moderated further to 2.7%oya. Despite the sharp jump in the March PMI, these figures must have added to concerns about the impact of the strong rand on the supply-side of the economy. Growth in manufacturing declined to -2.6%q/q (saar) in the three months to February, which poses downside risk to our first quarter GDP forecast of 4.5%q/q (saar). The SARB must have been referring to the Stats SA figures when it pointed to recent "evidence of some slackening of activity in the manufacturing sector."
- **Caution on the global economic outlook.** The MPC statement highlighted that the IMF and World Bank have become more cautious about the global economic outlook with downward revisions to GDP growth forecasts for the eurozone and Japan. Continued references in the MPC statement to "imbalances in the US economy" also suggest that the MPC is concerned about the impact of dollar weakness on the rand.

Chart 3: Manufacturing production



Source: JPMorgan

Chart 4: SARB policy rate



Source: JPMorgan

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Ukraine

A divided country's rocky journey westward

- **Divisiveness is about more than westward/eastward, but also about winners/losers due to the jump in pensions, public-sector salaries, and inflation**
- **The reform-oriented government's formation is a plus, but the March 2006 parliamentary election may result in the government's ouster**
- **Strong current account position and higher capital inflows suggest 10% nominal appreciation by the end of June**
- **2005 budget based on overly optimistic assumptions, 1.6% deficit target likely to be missed**

Basking in the fading light of the Orange revolution, Ukraine conjures up three images: courage, western orientation, and indecision. The rest of the world will not easily forget the courage of the Ukrainian people and the promises made by the new Ukrainian leadership. In particular, President Viktor Yushchenko promised to end corruption, make government decision-making transparent and ensure that the Ukrainian people would enjoy democratic rights and freedoms. Yet even with that heady cocktail of charismatic honesty and optimism, only 52% of the Ukrainian people voted for Yushchenko for president in late December compared to 44% for his opponent and 4% against all candidates. Many observers have rationalized that result as indicating that the country wants to move toward Europe, while a large part of the population is still reluctant to abandon ties with Russia. JPMorgan sees the December electoral results as also representing anger against a political status quo that was non-democratic and ineffective. In other words, the westward versus eastward dichotomy is just part of the story. In particular, the Ukrainian people are awaiting effective actions from their democratically elected President and his prime minister, Yulia Timoshenko.

Ukraine is seriously pursuing entry into the WTO, NATO, and the EU in an effort to become fully European. Indeed, the EU nations and the US are fully supportive of Ukraine's WTO membership, and we would expect entry to occur no later than in 2006. With regard to NATO, the USA is fully behind this Ukrainian initiative, but actual entry will be a multi-year effort given that Ukraine's armed forces need to be modernized in terms of leadership, mentality and equipment. Most difficult will be to start EU-Ukrainian accession negotiations in large part because the EU population has begun to become fatigued with EU expansion.

Table 1: Ukraine economic indicators

Official statistics, 2005—JPMorgan forecast

	2001	2002	2003	2004e	2005f
Real GDP, %y/y	9.2	5.2	9.6	12.1	6.0
Nominal GDP, US$ bil	38.0	42.4	50.1	64.9	84.7
CPI, %y/y, eop	6.1	-0.6	8.2	12.3	13.5
Consolidated budget balance, % of GDP*	-1.6	0.5	-0.7	-4.4	-6.0
Current account balance, % of GDP	3.7	7.5	5.8	10.5	5.5
Inward FDI, US$ billion	0.7	0.9	1.2	1.7	2.4
International reserves, US$ billion	3.1	4.5	6.9	9.5	15.0
Public debt / GDP	37.1	33.5	29.0	24.8	
20.30361446					
Memo: Russia					
Real GDP, %y/y	5.1	4.7	7.3	7.1	6.0
Public debt / GDP	47.9	41.4	33.1	23.7	16.2

* IMF methodology, 2004 derived from NBU statements
Source: National Statistics Agency, National Bank of Ukraine, IMF, JPMorgan

Lastly, Ukraine's recently appointed reformist government appears confused about how to resolve the many dilemmas it faces. Should those who purchased state assets via non-transparent, corrupt privatization procedures be punished? Should the social promises made by the previous government be honored? How should rising inflation be controlled? How can the widening fiscal deficit be reduced in future years given that the government seems to be determined to cut the tax burden on business?

Latest developments incite to draw three inter-related conclusions. First, seemingly disappointing 2005 outcomes, in reality, will be major achievements because internal and external factors in 2005 are vastly different than they were in 2004. For example, in our view, the government's 2005 GDP growth target of 8.2% and fiscal deficit forecast of 1.6% of GDP are overly optimistic. Instead, we believe a 2005 growth outcome of 6% and a budget deficit of 6% of GDP would be fine achievements as long as the government puts into action policies that will gradually reduce the budget deficit over the next several years to say 3% of GDP.

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Second, Ukraine's recently enhanced medium-term economic and political characteristics have ironically complicated near-term policy tradeoffs during a period when the government has only a fragile hold on power. In particular, Ukraine has become a convergence story precisely because its leadership has such a compelling and encouraging vision. Yet convergence related-capital inflows have complicated the NBU's monetary policy to an extent that JPMorgan predicts that the NBU will revalue the UAH 10% relative to the USD in order to control inflation.

Third, the government's policy decisions this year will be heavily influenced by the fact that the constitutional changes scheduled to become operative between September this year and January next year will increase the role of parliament and dilute presidential powers (see "Constitutional reform" box). Thus, the government realizes that electoral success in the March 2006 parliamentary elections is a necessary condition for its medium-term western-oriented goals to have a decent chance of being reached.

Constitutional reform: changes on track before 2006

On December 8, 2004 Ukraine's parliament Verkhovna Rada approved a compromise package of laws calling for changes to the constitution and special provisions for the electoral law. The constitutional reform will turn Ukraine into a parliamentary-presidential republic, reducing presidential power and increasing that of parliament. In particular, the power of the president will be limited to the appointment of the Prime Minister (upon the decision of the majority coalition in Parliament); the Defense and Foreign Affairs Ministers; the head of the National Bank and the General Prosecutor (requiring subsequent parliamentary approval). The president has the right to dissolve parliament if it fails to form a majority coalition within one month after parliamentary elections or if it fails to form a Cabinet of Ministers within 60 days of the Cabinet's resignation. Parliamentary powers were broadened to include the right to approve other Ministers and heads of state committees by motion of the Prime Minister, without requiring presidential approval. The parliament of Ukraine will be elected for five years on a proportional vote system, replacing the previous four-year term and the mixed (proportional-majority) vote system. Under the compromise agreement the constitutional changes will come into force between

Immediate challenges facing the government: reprivatization and revaluation

Given that Yushchenko and Timoshenko have repeatedly stated that those who have stolen from the state need to be prosecuted, the issue of re-privatization is in the spotlight. Without a doubt, the controversial sale of 93% stake in Ukraine's metallurgy plant Krivorozhstal by the previous government to the son-in-law of the former president Kuchma for only $0.8 billion will be the first target of the government's examination of previous privatizations. Currently, the re-privatization of the steel plant is on track, but the government has delayed revealing the details of how extensive these investigations into previous privatizations will be.

In January, Yushchenko suggested that the government will announce 30-40 privatizations to be reviewed, while Timoshenko suggested the government might look into 3,000 sales of state assets. Those contradictory statements revealed a fundamental difference over policy between the President and the Prime Minister, and also have caused investors some concern. Yet last week's appointment of the Socialist Party's MP Valentyna Semenyuk, who has been a close ally of Yushchenko, to head the State Property Fund (SPF) is a positive development from several points of view. She is expected to severe all links the SPF has had with Ukraine's financial oligarchs. Her appointment also suggests that Yushchenko's sensibilities are likely to prevail with regard to re-examining past sales of state assets. More concretely, JPMorgan expects re-privatizations to be limited to a dozen or so cases in large part because both Yush-chenko and Semenyuk appear to be sensitive to the business uncertainty that is generally associated with prolonged investigation into previous privatizations. Finally, future privatization processes are expect to be much more transparent and the management of state property may well improve.

Separately, on the macro front deteriorating inflationary expectations will remain the short-term policy focus. Indeed, CPI increased to 14.7%oya in March 2005 from 12.3%oya in December 2004, largely responding to a surge in food prices, especially meat prices. Importantly, the delay in this year's planting of grains suggests that food prices are likely to disappoint for much of the rest of this year. Consequently, the government's current December 2005 inflation forecast of 9.8%oya looks unattainable. JPMorgan predicts December inflation at 13.5% due to cost-push inflation caused by loose fiscal policy and due to tremendous liquidity connected to un-sterilized, massive BOP inflows. In fact, the only reason the JPMorgan inflation forecast is not higher is that we assume that the authorities will allow the hryvnia to appreciate against the USD.

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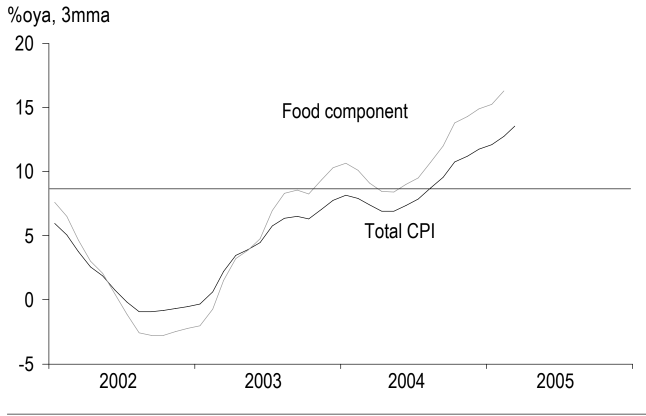
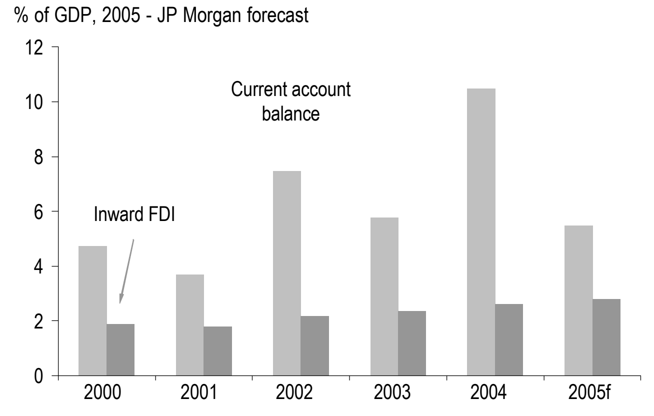
Chart 1: Total CPI and food component
%oya, 3mma



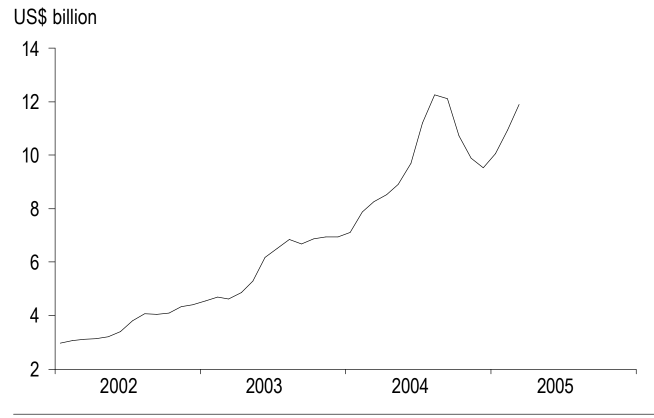
Source: JPMorgan

Chart 2: Current account balance and inward FDI
% of GDP, 2005 - JP Morgan forecast



Source: JPMorgan

Chart 3: Gross international reserves
US$ billion



Source: JPMorgan

A key factor underpinning our view for hryvnia appreciation is that Ukraine's balance of payments position remains exceptionally strong. The January-February trade surplus was up 50%oya to US$0.9 billion. Despite that development, JPMorgan expects the 2006 current-account surplus to be 5.5% of GDP, versus 2004's 10.5% of GDP surplus because this year's much higher real wages will translate into an upsurge in demand for imported consumer goods and because agricultural exports are likely to fall this year due to the delayed harvest. Separately, growing capital inflows (including FDI and foreign investment into real estate and the domestic bond debt market) will continue to add to the upward pressure on the hryvnia. The combined effective of these BOP inflows along with the population's monthly sale of an estimated US$200 million of FX has led the National Bank of Ukraine (NBU) to increase its international reserves by US$2.4 billion (24% from end-2004) during the first quarter. That compares to international reserve accumulation during all of 2004 of only US$2.6 billion. Of course, last year's modest reserve accumulation when measured BOP inflows were high was due in part to the election-related fourth-quarter 2004 loss of US$2.6 billion in reserves (chart 3).

Most importantly, the NBU seems to have little alternative than to re-value in part because initial NBU responses have been entirely ineffective. For example, one NBU deputy governor suggested that nonresident-participation in the primary local government bond auctions should be restricted. Thankfully that idea has not been introduced because it would be easily circumvented. In addition, the decision to eliminate the obligatory 50% sale of export revenues, approved last month, has had no effect because exporters want to be long the hryvnia in anticipation that it will appreciate. Finally, Yushchenko himself, other government ministers, and NBU top officials have voiced their agreement with the notion of hryvnia nominal appreciation.

JPMorgan expects roughly a 10% appreciation relative to the USD over the next three months once a joint government-NBU agreement on exchange rate policy has been reached. That appreciation will translate into slower growth of monetary aggregates and will soften the impact of generally high global commodity prices on domestic prices. Note that is not yet clear to us which foreign-exchange regime will be adopted in conjunction with the projected appreciation.

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Medium-term issues: support for economy growth and removal of fiscal imbalances

Growth in the economy has slowed sharply despite the powerful stimulus to domestic demand engendered by much higher pensions and public-sector wages. Following the average GDP growth of 7.5%oya in 2000-2003 and 12.1%y/y in 2004, GDP advanced only 5.4%oya in the first quarter of 2005 on the back of a broad-based slowdown. Indeed, growth in industry slowed to 7.1%oya in the first quarter versus the exceptionally strong increase of 12.5%y/y in 2004 as a whole, while the construction industry declined modestly in the first quarter versus the 17.2%y/y increase in 2004. JP Morgan foresees GDP growth of 6% in 2005 versus the revised official forecast of 8.2%. Near-term we expect private consumption to be the driver of economic activity, given that pensions have been roughly doubled this year and there has been scheduled a large increase in the minimum wage for public sector workers (a 10.7% increase from April 1, 2005, while a 6.9% rise is scheduled for July 1, 2005).

Growth prospects beyond this year will depend on controlling inflation, implementing structural reforms, and improving the business climate so as to attract private investment. In particular, the announced administrative reform to fight corruption within the government merits careful watching. Russia's experience with administrative reform—currently completely stalled—provides evidence that successful implementation of such reforms not only require strong political will from the top, but also need to be broadly endorsed on the provincial and municipal levels.

The substantial fiscal loosening in the run-up to the autumn 2004 presidential elections has weakened the fiscal outlook. In order to appreciate the magnitude of the deterioration, remember that in August 2004 the planned 2004 budget deficit of 1.7% of GDP seemed achievable in part because the economy was growing faster than assumed in the budget law. Yet the actual 2004 consolidated budget deficit, according to the IMF methodology, reportedly soared to 4.4% of GDP. In addition, the government has made only marginal efforts, in our view, to improve the medium-term sustainability of the budget. For example, the initially approved 2005 budget was based on assumptions and parameters that did not take fully into account the upsurge in pensions and public-sector wages. Then on March 25 the parliament approved revisions to the 2005 budget incorporating increased social obligations, while at the same time financing the large expenditure increases by assuming much higher revenues. Revisions introduced to the 2005 budget incorporate a substantial increase in social obligations, suggesting a revised budget deficit of 1.6% for the government budget. JPMorgan expects the deficit to be much higher at 6.0%, as both government's revenue and growth assumptions look overly optimistic.

The government found additional funds by canceling tax privileges (especially in free economic zones), improving the corporate management of state-run enterprises, and increasing revenues from state monopolies, while somewhat reducing top-priority budget expenditures. Note, that the initial 2005 budget already had quite an optimistic revenue assumption of an almost 23%y/y increase in nominal terms. Revisions suggest nominal revenue up 54%y/y, in our view a challenging target. Also remember that while first two month's budget performance was strong—a cash surplus of 1.9% of GDP—budget revenues amounted to only 10.9% of the total revised 2005 revenue target. The unrealistic revenue assumption on top of the substantial increase in non-interest spending will make budget targets difficult to achieve and add upward pressure to inflation. JPMorgan expects the 2005 deficit to be much higher at 6.0% of GDP.

Finally, government's EU and NATO accession ambitions are two medium-term goals worth watching, amid encouraging signals from both institutions. While the EU has confirmed its desire to support Ukraine's WTO entry (targeted by the end of this year), it has noted that EU entry can only be a long-term objective for the country. The Orange Revolution and the arrival to power of Yushchenko have given birth to a much more constructive international perception of Ukraine. That sea change has opened a new era in EU-Ukrainian relations, with first signs of rapprochement including specific steps, such as the intention to prepare a joint 2006-08 three-year action plan. This plan will determine the future steps in the EU's relationship with Ukraine, with a more precise understanding to be developed after Ukraine's March 2006 parliamentary elections.

Corporate Spotlight

Vimpelcom (B1/BB-; VIP)

Russia's Vimpelcom reports strong fourth-quarter results despite a seasonal decline in margins and rapid subscriber additions. Fourth quarter results typically include distortions due to increased purchases of SIM cards over the holidays. High subscriber additions, especially in the regions, drove a strong top line, including 56% revenue growth year-on-year to US$636 million. Net subscriber additions were over 6 million during the quarter including nearly 5 million additions of pre-paid subscribers in the regions. Margins fell due to a continued migration of the subscriber base toward customers with lower spending power, promotions, and other factors. EBITDA was US$284 million, up 52% over last year. The EBITDA margin declined to 44.7%, by 4.4 points quarter-on-quarter and fell by 1.1 point year-on-year.

Nevertheless, the full-year margin was higher at 47.5%, up by 1.6%. The company's net debt position crept up by US$140 million, or 12%, compared with September to US$1.3 billion, but credit indicators remained very strong relative to ratings. Debt/EBITDA was 1.4x in the quarter and 1.6x for the year. EBITDA/interest was 8.4x in the quarter and 11.9x for the year. **Uncertainties related to a disagreement between Vimpelcom's shareholders over the company's potential expansion into Ukraine is currently a more important driver for Vimpelcom's notes as compared with the importance of quarterly results. We maintain an overweight recommendation on Vimpelcom's '09, '10 and '11 notes despite uncertainties about the shareholder group** (see *Emerging Markets Today* dated April 13, 2005 for a discussion of the shareholder situation).

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