



Fixed Income Quarterly

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Issue # 9
February 2005

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WORLD ECONOMIC REPORT

The global economy has entered 2005 with a good degree of momentum but the expectation is for just around trend growth, a modest slowing from estimated increase of 4.9% in 2004, the fastest rate since 1973. The US and China should continue to be the main drivers, as there has been more recent weaker outcomes in Japan and the Euro zone. While an assessment of the full economic cost of the 26 December tsunami in the Indian Ocean is now underway, the overall impact on emerging Asia should be limited in relation to the size of the region's economy. In line with these global conditions, the region of Latin America and the Caribbean is experiencing a more broad-based recovery, and grew by a faster-than-expected 5.5% in 2004.

UNITED STATES



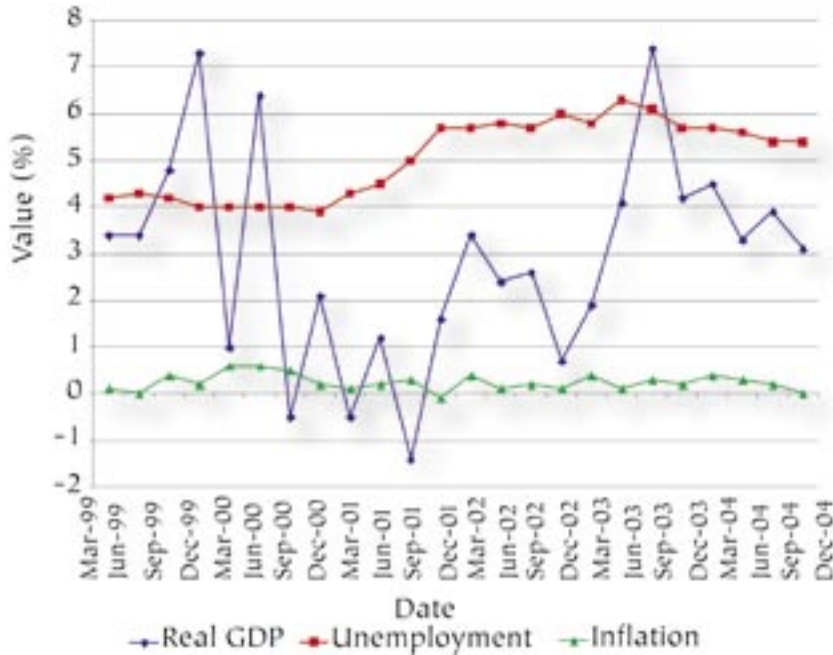
The US Fed raised its fed funds rate by 25 basis points at each of its six meetings since the start of its current tightening cycle in June 2004.

The US economy grew by 4.4% in 2004, the best showing since 1999. Brisk spending by consumers and an upswing in business investment contributed to the rapid growth experienced in early 2004. However rising interest rates, high oil prices and a weakening US dollar may have dampened consumer sentiment somewhat in the latter half of the year. Retail sales, for instance, rose by 1.2% in December 2004 down from a high of 1.6% in the previous quarter while the ISM index, an indication of spending in the manufacturing sector, closed 2004 at 58.6 from a high of 63 earlier in the year. Real GDP growth is now projected at 3.3% for 2005.

The US Fed raised its fed funds rate by 25 basis points at each of its six meetings since the start of its current tightening cycle in June 2004. The increase in the fed funds rate from a historical low of 1% to its current level of 2.5% mainly reflects robust US economic growth and concerns about a build-up of inflationary pressures. The Fed is expected to increase the fed funds rate by another 75 to 150 bps during 2005.

Supporting this outlook is the fact that core CPI inflation averaged 2.2% for the final quarter of 2004, up almost 1 percentage point from the beginning of the year. Oil prices are expected to average around US\$44 per barrel in 2005, up an average US\$3 per barrel from 2004, and imparting an inflationary impulse. Additional price pressures may also originate from improvements in the US labor markets, which recorded a net increase of 2.2 million jobs in 2004 as the unemployment rate fell marginally to 5.2% in December.

US GDP, INFLATION, UNEMPLOYMENT

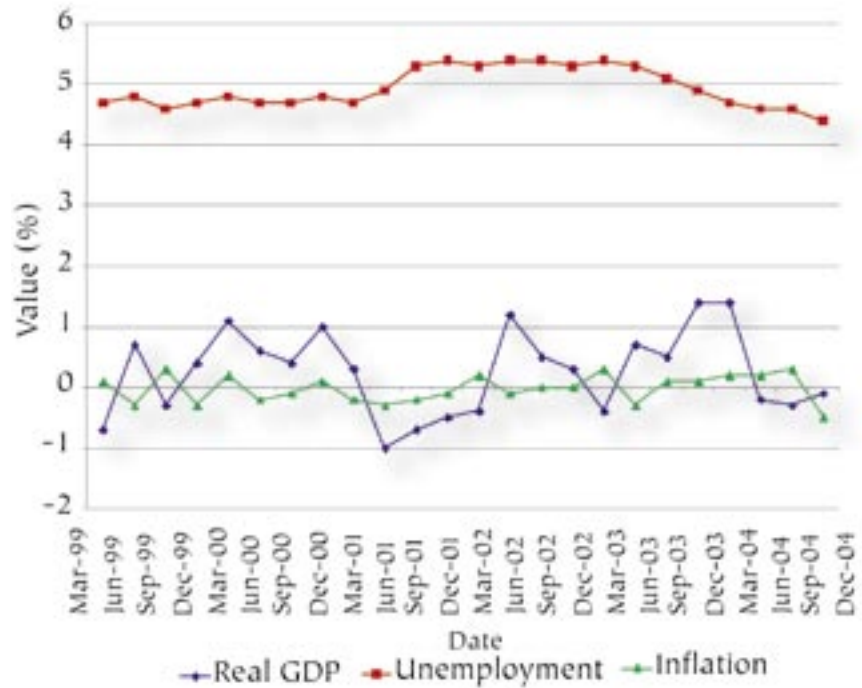


Source: CMMB Research Department

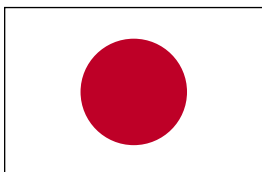
A major concern to investors is the broad-based decline in the US dollar which resumed in October 2004. The US dollar has fallen 15% over the past two years against a basket of currencies of the U.S.'s largest trading partners. The decline mainly reflects the market's focus on the large US current account, which reached a record US\$164.7 billion in the third quarter of 2004, or about 5.6% of GDP. This has emphasized the need to increase household saving in order to reduce the budget and trade deficits. However, even after successive interest rates increases, yields on many short-term savings accounts still hover around zero after adjusting for inflation. This policy is seemingly contradictory to this stance and in fact may be encouraging consumers' appetite for debt. In order to address these issues the US Government would need to firstly outline its policy for reducing the federal deficit, including reforms of Social Security and the tax code.

Going forward, disorderly weakening of the US dollar is likely if there is lack of policy coordination among the major advanced economies and if fiscal adjustments are not timely. A sharp decline in the US dollar would undermine growth efforts in the Euro area and Japan as well as disrupt financial markets.

JAPAN GDP, INFLATION, UNEMPLOYMENT



Source: CMMB Research Department



In an effort to provide further stimulus, the overnight call rate will remain at nearly 0% with short term interest rates at steady low levels.

JAPAN

After displaying some positive momentum in the first quarter of 2004, the Japanese economy recorded three consecutive quarters of decline in real GDP, officially slipping into recession. Real growth was nevertheless recorded at a healthy 2.6% in 2004.

The Bank of Japan's (BOJ's) Tankan survey, which earlier had indicated optimism over the sustainability of the recovery, subsequently slumped with news of a recession. The BOJ has responded by maintaining its current monetary stance, and left unchanged the level of cash it makes available to lenders as well as the level of purchases of government bonds. In an effort to provide further stimulus, the overnight call rate will remain at nearly 0% with short term interest rates at steady low levels. Increased consumer spending remains key to lifting the economy out of its current slump and the BOJ is not expected to raise interest rates as long as deflation persists.



CHINA

The Chinese economy continues to perform strongly, even though the pace of growth eased in 2004 as the authorities implemented a series of measures to curb overheating, especially in the autos, aluminium and steel industries. China's real GDP rose by 9.5%, but domestic demand declined from 11% in the first half of 2004 to 8.5% in the second half of the year. Similarly, consumer price inflation which peaked

at 5.3% in June fell gradually to 2.4% in December. Investment growth, which has been a main driver for the Chinese economy, fell from over 40% year-on-year to 13% in the fourth quarter.

Another development in China has been the move to a more broad based recovery. While industrial output and investments continue to be the main contributors to growth, agriculture and services are showing commendable performances. If sustained, this suggests a move away from a capital/energy intensive growth mode to a much more employment intensive pattern. In fact 9.8 million urban jobs were created in 2004, taking the registered unemployment rate down 0.1 percentage points to 4.1%, the first decline since 1995.

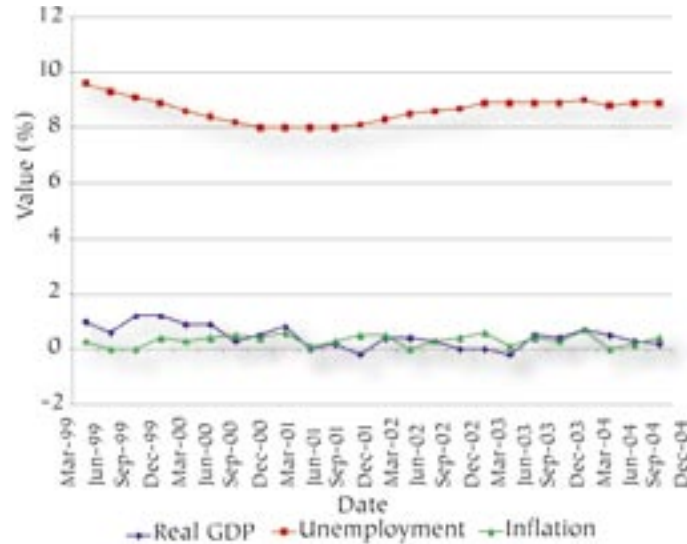
The outlook for the Chinese economy is favorable even as tighter conditions resulted in downward projections for growth of 7.6% in 2005. China is expected to gain increased global market share as output levels and its share of world trade continue to grow. A weaker US dollar may also help boost export sales as the Yuan remains pegged to this currency and a revaluation appears unlikely within the year.

EUROPE

The Euro region continues to lag other major economic regions. Real GDP growth rose to 2% in 2004 with significant variation in the pace and composition of growth among member countries. The German and Italian economies, which together account for half of the euro zone's GDP, saw subdued performances and this was more than offset by stronger growth in France and Spain.

Exports account for about one fifth of the euro region's economy making the region particularly vulnerable to a stronger euro, which appreciated 9% against the dollar in 2004. Despite the weak economic growth, underlying inflation for the euro region has been below the 2% ceiling set by the European Central Bank (ECB). Given the softer economic outcomes, the ECB has kept its policy rate at 2% since June 2003 and is not expected to raise interest rates until much later in 2005. This outlook is supported in part by the recent strengthening of the euro which has helped to dull the effects of high oil prices and the cost of other imports.

EUROPE GDP, INFLATION, UNEMPLOYMENT



Source: CMMB Research Department



TRINIDAD & TOBAGO



Amid the strong global conditions in 2004, the Trinidad and Tobago economy continued with its robust performance, registering strong growth and surpluses on its fiscal and external current accounts.

Amid the strong global conditions in 2004, the Trinidad and Tobago economy continued with its robust performance, registering strong growth and surpluses on its fiscal and external current accounts. However, the country still faces structural problems in terms of a generally weak performance in the non-energy sector, which has helped to restrict employment opportunities. In addition, for some time sharp increases in food prices have been feeding into the general price level, indicating the need to deal with this upturn in inflationary pressures.

ECONOMIC GROWTH, INFLATION AND UNEMPLOYMENT

In its 2004 Article IV Consultation with Trinidad and Tobago, the International Monetary Fund (IMF) validated claims that the economy is showing signs of exceptional performance primarily driven by robust growth in the energy sector. Real GDP growth is projected at 6.2% in 2004 and compares with record growth of 13.2% in 2003, consequent on the rebasing of the national accounts to the year 2000. The energy sector remains the main driver of growth.

Although the performance of the non-energy sector was more modest, rapid expansion in the energy sector boosted activity in the construction industry, an important source of employment. The unemployment rate has been hovering around 10%, mainly reflecting structural imbalances, such as skills mismatch, capital-intensity of the energy sector, and wage pressures of energy inflows.

Inflationary pressures are building up, with the major thrust coming from the increased cost of food items. Over the year to December 2004, retail prices increased by 5.6%, but there was a 21% hike in food prices. Core inflation, which excludes the more volatile food prices, rose by 1.8% in 2004 from 1.5% in 2003.

CENTRAL GOVERNMENT FISCAL OPERATIONS

In the fiscal year ended September 2004, the Central Government recorded an overall surplus of \$437.1 million or 0.6% of GDP compared to \$775 million or 2% of GDP in the previous year. Transfers of \$1,263.2 million were made to the Revenue Stabilization Fund (RSF). Although the country's overall fiscal situation appears impressive, the underlying performance is deteriorating. Stripping away the impact of oil revenues, reveals an excess of total expenditure over non-oil revenue. The resulting non-oil deficit has averaged around 9% in the last five years, and its financing has been the main source of liquidity creation within the economy.

MONETARY POLICY

The Central Bank maintained its accommodative monetary stance, leaving the repo rate at 5% since September 2003 in an effort to stimulate growth in the non-energy sector. While this monetary stance has resulted in an increase in private sector credit, it remains to be seen whether this credit is financing productive investment in the non-energy sector or consumer imports. The Central Bank is also keeping an eye on the narrowing gap between TT and US interest rates. The differential between rates on TT 3-month Treasury bills and US 3-month Treasuries stood at 237 basis points in February 2005 compared with 389 basis points in September 2003. However, the Central Bank believes that with US rates still comparably low there is unlikely to be any major effect on capital flight.

In the domestic money market, short-term interest rates declined somewhat in early 2005. The interest rate on the 90-day Treasury bill has averaged 4.71% since the start of 2005 down from an average of 4.79% in the first half of 2004. The weighted average inter-bank lending rate was 3.87% in the period to 15 February 2005, down from an average of 4% in 2004.

FOREIGN EXCHANGE MARKET AND BALANCE OF PAYMENTS

Trinidad and Tobago is anticipated to record an overall balance of payments surplus of US\$734 million in 2004, compared to the surplus of US\$334 million in 2003. Total imports increased by 32% to US\$3.7 billion for the first nine months of 2004 while exports rose by 32% to US\$4.7 billion. By the end of 2004, the trade surplus is expected to reach US\$1.4 billion. The strong balance of payments position is reflected in a build up of official international reserves, which reached around US\$2.9 billion at the end of 2004, or equivalent to approximately 6.9 months of import cover.

The Central Bank has been facilitating the stability of the TT/US dollar exchange rate through the sale of US currency to the banking system, leading to a depreciation of the local currency against non-US dollar currencies. This, in turn, is spilling over into the rising cost of imports from these regions. Against the euro, the TT dollar fell by 8.4% in 2004 and by a further 6.4% over the period to late February 2005. Against the yen, the TT dollar depreciated by 6.2% in 2004, and by an additional 3.3% since the beginning of 2005.

HIGHLIGHTS OF THE 2004 IMF ARTICLE IV CONSULTATION WITH TRINIDAD AND TOBAGO

On 22 October 2004, the Executive Board of the IMF concluded its 2004 Article IV Consultation with Trinidad and Tobago. Executive Directors noted that the country experienced robust growth in 2003, led by a 30% expansion in the energy sector.

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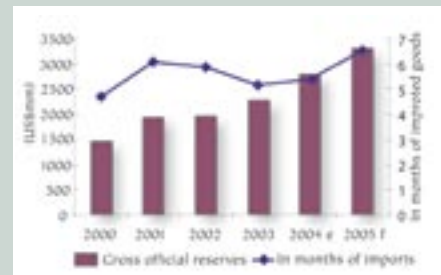
Strong energy output led to increases in exports and fiscal revenues, creating substantial external and fiscal current account surpluses. Still evident, however, was the inherent risks associated with a typical oil-dependent economy. According to the Directors, Trinidad and Tobago needs to boost non-energy investment and growth to reduce the level of unemployment which remains persistently high and to reduce dependence of government revenues on the energy sector. The Executive Board recommended implementation of a policy framework that emphasizes economic diversification and external competitiveness. The government was also advised to manage public expenditures prudently, containing the wage bill and transfers to households so that capital expenditure can be expanded to meet infrastructural and social sector needs. Directors were of the view that the effective peg of the exchange rate has helped to shield the non energy sector from pressures of real exchange rate appreciation, but welcomed the commitment not to resist depreciation pressures, if necessary. Directors attached importance to the planned restructuring of the port and reform of the National Insurance Scheme. ■

TRINIDAD & TOBAGO SELECTED ECONOMIC INDICATORS

INFLATION



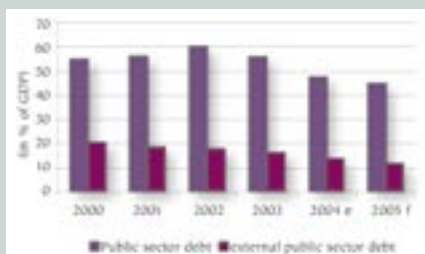
GROSS OFFICIAL RESERVE



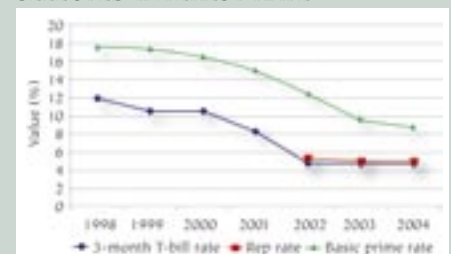
NARROWING T-BILL INTEREST RATE DIFFERENTIAL



PUBLIC SECTOR DEBT



SELECTED INTEREST RATE



Source: CMMB Research Department

TURBULENT TIMES OVER FOR THE DOMINICAN REPUBLIC?

ORIGINS OF THE CRISIS

After experiencing an extended period of strong economic performance in the 1990s, the Dominican Republic plunged into a serious crisis in 2003. A series of external shocks including the global slowdown, an increase in oil prices, and the September 11th attacks began to threaten growth and stability. The situation worsened in 2003 with the failure of BanInter (Banco Internacional) – the third largest bank in the country – following revelations of astounding fraudulent activities, which were simply undetected by the authorities for many years. The extent of embezzlement in the BanInter scandal was estimated at US\$2 billion or approximately 10% of the country's GDP.

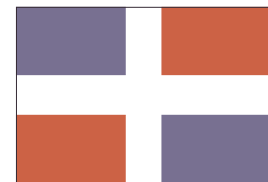
The Central Bank intervened in BanInter in April 2003, providing substantial liquidity support, but was unable to prevent contagion from spreading to two other medium-sized banks with governance problems. The banking problems triggered a general loss of confidence that in turn led to a bailout of depositors, a hike in public debt, significant peso depreciation, and soaring inflation. The Central Bank, in particular, began to issue large amounts of certificates at increasingly higher interest rates, generating quasi-fiscal losses, and contributing to the jump in public sector debt to 55% of GDP from a modest 22% in 2000. The run down of external reserves pressured the peso to depreciate to levels close to DR\$50/ US\$ from an average of DR\$17/ US\$ in the pre-crisis period. The Dom Rep economy fell into recession in 2003, contracting 1.9% as a result of weak domestic demand and falling investment.

WEAK POLICY RESPONSE

To address the macroeconomic crisis, the administration of then-President Mejía developed an economic program supported by a two-year US\$600 million IMF Standby Arrangement that began in August 2003. Unfortunately, there were severe policy slippages, especially in fiscal policy as stipulated revenue measures did not produce desired yields and extra budgetary expenditure ran unchecked.

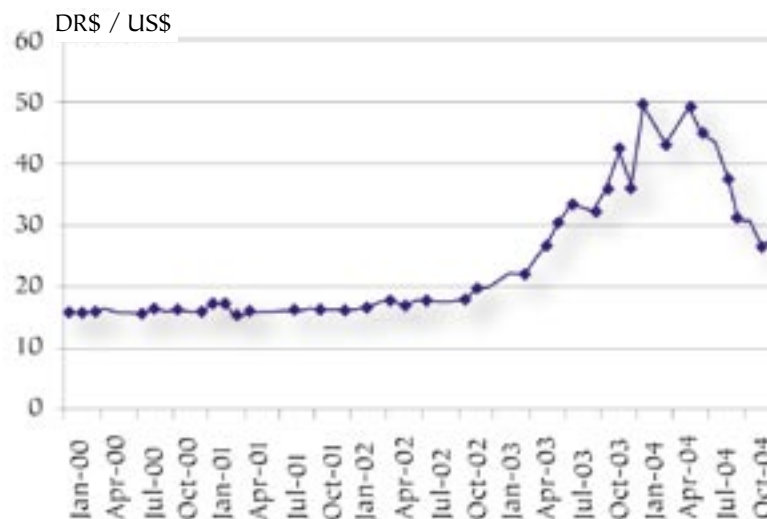
In addition, with an energy crisis plaguing the country, the government reached an agreement with Union Fenosa to repurchase its 50% stake in the two loss-making power distribution companies – EdeNorth and EdeSur. The high cost of re-nationalization worsened the already fragile fiscal position.

By Vangie Bhagoo



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THE DOMINICAN REPUBLIC PESO



Source: CMMB Research Department

In early 2004, the authorities put together a new program, but again policy implementation was weak, especially in the run-up to the May presidential elections.

In April 2004, Dom Rep approached the Paris Club with a request for bilateral debt relief in the context of an IMF agreement.

The Central Bank also sharply loosened monetary policy that induced another wave of peso depreciation. It began to face difficulty in rolling over its short-term debt and began issuing debt with maturities as short as 1 week. Progress on implementing key legal and institutional measures to reform the financial sector was slow with a strong resistance to recapitalization from vested interests in the banking sector.

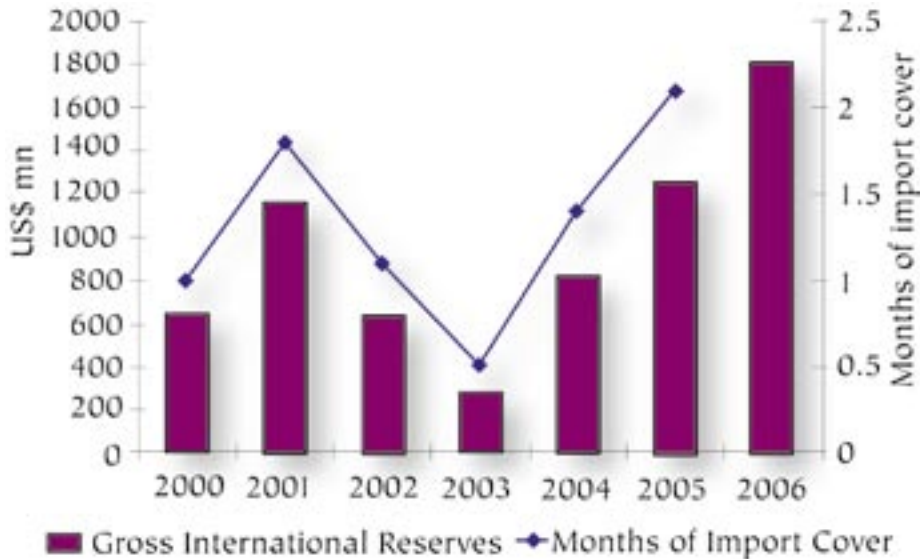
In early 2004, the authorities put together a new program, but again policy implementation was weak, especially in the run-up to the May presidential elections. In April 2004, Dom Rep approached the Paris Club with a request for bilateral debt relief in the context of an IMF agreement. The subsequent agreement rescheduled arrears accumulated over 2003 and maturities falling due in 2004 over a period of 12 years, with 6 years' grace. It was also agreed that cash flow relief of almost US\$200 million be provided over 2004 and an extension of the treated debt by almost 10 years. The authorities agreed to provide comparable treatment to its other creditors, but accumulated external arrears to some of its official and private creditors.

The election victory of former President Fernández in May 2004 marked a sharp turning point in the Dominican Republic's management of the crisis, but urgent policy measures were left pending in the subsequent 3-month transition period. The new administration began immediate fiscal tightening and negotiated a new IMF-supported program, measures which were welcomed by the markets.

SIGNS OF EMERGING MACROECONOMIC STABILITY

The recovery in the Dominican Republic began with the smooth transfer of presidential power from Mejía to Fernández and the latter's strong emphasis on fiscal

GROSS INTERNATIONAL RESERVES



Source: International Monetary Fund

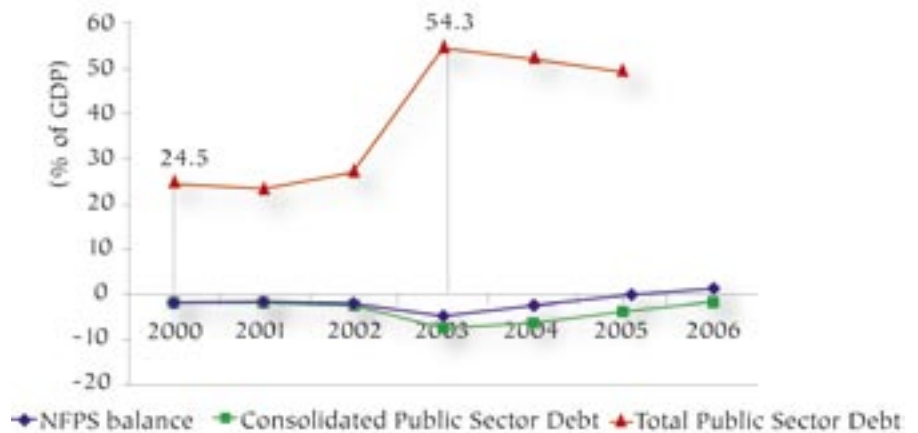
adjustment. The gradual restoration of confidence in Dom Rep's economy is evident by a more stable peso at around DR\$29/ US\$ at the end of 2004 from a high of DR\$49.2/US\$ in February 2004. Inflation has declined to around 29% from a peak of 65% in May 2004. Real GDP grew by an estimated 2% in 2004, fuelled by a pick up in domestic demand, a marked turnaround from the contraction in 2003. With modest economic expansion in 2004, the current account of the balance of payments ended the year with a surplus of US\$1.4 billion, equivalent to 8.1% of GDP, even as imports rose 21% in the final quarter of the year. Gross international reserves stood at US\$824.8 million at the end of 2004, while the government serviced debt obligations to the tune of US\$532.9 million.

The Central Government fiscal operations resulted in a deficit of DR\$21.7 billion, or 3.0% of GDP for the year ended 31 December 2004. Total government revenues increased to DR\$126.1 million, as total tax collections rose 56.8%. The tax burden increased from 16.1% of GDP to 16.3%, as a result of measures implemented. The tax reform package that was recently introduced by the government included:

- * An increase in VAT from 12% to 16%
- * An increase in excise taxes on alcohol and tobacco
- * An inflation adjustment to fuel excises
- * A retargeting of subsidies on liquefied gas (LPG)
- * A reduction in electricity subsidies, and their complete elimination in the case of corporate users and high-end residential users

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PUBLIC FINANCES



Source: International Monetary Fund

- * A reduction in the central government payroll
- * Greater use of the financial transaction tax

However, despite the signs of macroeconomic stability, the DR still faces substantial challenges especially in terms of closing its financing gap. The Dom Rep authorities have estimated that the financing requirement for 2004/2005 will be approximately US\$330 million.

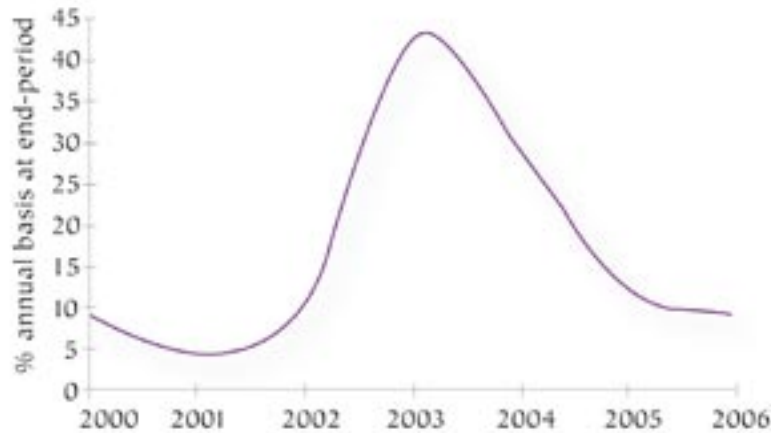
On 31 January 2005, the Executive Board of the IMF approved a 28-month US\$665 million Standby Arrangement with the Dominican Republic to support the country's economic program through 2007.

The government plans to deal with the financing gap for 2004/2005 through;

- * Restructuring the payment profile of external bonds,
- * The rescheduling of debts to external commercial banks and suppliers,
- * The rescheduling of pre-cut off date obligations to Paris Club creditors falling due in 2005, some of this was already done last year.
- * Obtaining new financing from a pool of private domestic banks.

On 31 January 2005, the Executive Board of the IMF approved a 28-month US\$665 million Standby Arrangement with the Dominican Republic to support the country's economic program through 2007. An amount of close to US\$80 million was available immediately for drawdown. Firm program implementation is expected to narrow the public sector budget deficit to 3.9% of GDP this year from 6.7% of GDP at the end of 2004. The gross accumulated public sector debt is projected to decline to 49.1% of GDP in 2005 from an estimated 52.1% in 2004.

INFLATION



Source: International Monetary Fund

In its Letter of Intent to the IMF dated 14 January 2005, Dom Rep’s government officials acknowledged the existence of arrears on its external commercial bank debt. Standard and Poor’s subsequently lowered the long-term foreign currency sovereign credit rating on the Dominican Republic to ‘SD’ (selective default) from ‘CC’, but its bonds remained unchanged at ‘CC.’ A country selectively defaults when it defaults on one obligation or class of obligations, but honors others in a timely fashion. Once Dom Rep formally announces a bond exchange proposal, S&P may lower the ratings on these bonds to D.

The government met the expectations of the Paris Club on progress toward comparable treatment on 12 January 2005 and is aiming to launch a bond exchange offer during the first quarter of 2005 and complete the restructuring of debt to commercial bank and suppliers by April 2005. Congressional approval is required for Dom Rep’s bond restructuring as the process requires the issuance of new bonds to be exchanged for old ones. The financing legislation also allows the use of bonds for the recapitalization of the Central Bank. This is expected to be passed in February 2005.

On February 15, the DR government announced the late US\$27 million payment on its 2013 bond. The government also stated that this would be the last payment made to either bond holders or foreign banks before the country’s commercial debt is restructured. Government officials expect that the bond restructuring will be finalized before the end of the grace period in late April to avoid having to make the coupon payment in full.

In its Letter of Intent to the IMF dated 14 January 2005, Dom Rep’s government officials acknowledged the existence of arrears on its external commercial bank debt.

THE ROAD AHEAD

Most macroeconomic fundamentals appear to be stable in Dom Rep. Real GDP is forecasted to expand at a 2.5% pace in 2005 and 4-5% a year over the medium term. Inflation is expected to decline to 11-13% in 2005, while the external current account surplus should decline from 5.8% in 2004 to 0.5% in 2006, driven by a hike in imports from an expanding economy and a stronger peso, as well as recently high oil prices. Additionally, net international reserves are forecasted to increase by US\$140 million in 2005 and by a further US\$300 million in 2006, reducing the country's vulnerability against external shocks. A complete overhaul of the electricity sector is expected with the help of the World Bank, the IADB and USAID. The aim is to stabilize the electricity sector through planned reductions in losses and raising collections, and to improve the cash flow of distribution companies.

Despite being fundamentally sound, significant fiscal and external financing gaps are expected for the current year.

Despite being fundamentally sound, significant fiscal and external financing gaps are expected for the current year. The non-financial public sector (NFPS) is likely to post a primary surplus of 2.3% of GDP in 2005, but a domestic financing gap of approximately US\$424 million may arise after taking into account negative net domestic financing. The NFPS is facing an estimated overall shortfall of approximately US\$190 million in 2005. The Balance of Payment account is also expected to record a financing gap of similar magnitude.

Further macroeconomic progress in the Dominican Republic is contingent on whether the Congress approves the financing legislation, which will determine the nature and pace of the much anticipated debt restructuring. ■

COUNTRY RISK REPORT: THE RUSSIAN FEDERATION

BBB-/STABLE/A-3

BACKGROUND

Russia has a population of 143 million and per capita GDP of US\$8,900. It was formed after the December 1991 dissolution of the Union of Soviet and Socialist Republics (USSR), becoming the largest of the fifteen Republics. It is located in Northern Asia, bordering the Arctic Ocean between Europe and the North Pacific Ocean. Russia is the largest country in the world by area - 17 million square km - and has a wide natural resource base, but formidable obstacles of climate, terrain, and distance make exploitation difficult. More than half of Russian exports are hydrocarbons, with the oil sector alone accounting for 40% of exports, and makes the country very vulnerable to commodity price swings.

Russia has defaulted on its debt obligations. In August 1998, Russia defaulted on Treasury Bills and on US dollar-denominated bonds in May 1999. Russia also rescheduled its commercial debts to the London Club and Soviet-era type debt owed to the Paris Club.

POLITICAL CONDITIONS

The extreme concentration of executive power, weak political institutions, and limited political maturity pose serious and growing risks to policy predictability and decision making in Russia. President Vladimir Putin has been in office since May 2000 and has achieved wide popularity by stabilizing the economy and consolidating power within a fragile political system, especially in the aftermath of the early, chaotic post-Communism years. In May 2004, President Putin was reelected with 71% of the vote. The next elections are scheduled for May 2008. The political climate is increasingly heated, as resistance to reform is on the rise from entrenched interests and the general public. Over the past decade, the crisis in Chechnya has seen numerous human rights violations, rooted in geopolitics and control of Caspian Sea oil, leading to periodic episodes of uncertainty.

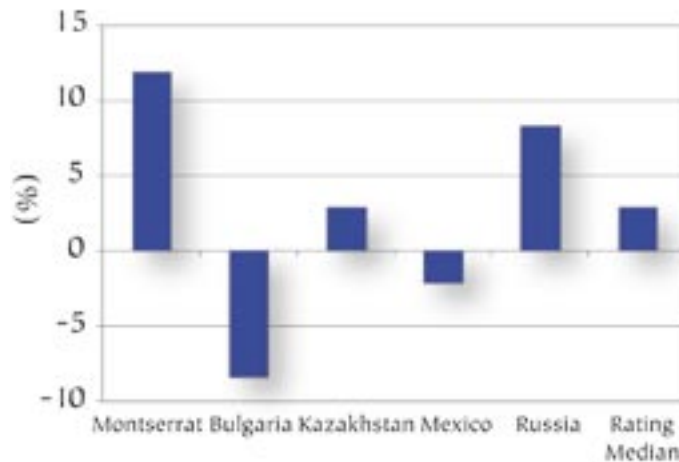
RECENT ECONOMIC PERFORMANCE

Russia's macroeconomic performance since the August 1998 financial crisis has been generally strong. In the immediate aftermath of the crisis, net exports were



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RUSSIA: PEER GROUP COMPARISON OF CURRENT ACCOUNT BALANCE / GDP BBB-



Source: Standard & Poor's

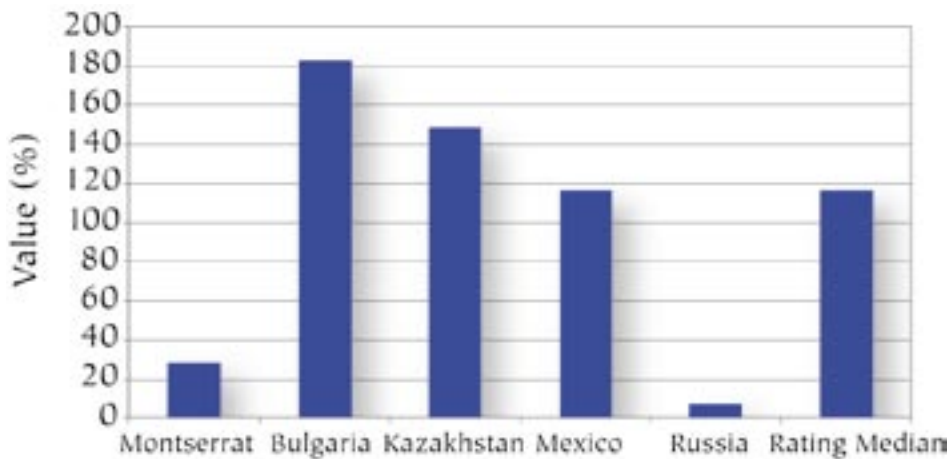
the main driver of growth due to a sharply depreciated ruble, but by mid-1999 rapidly increasing private consumption took over as the dominant driver. More recently, record high oil prices have provided a strong stimulus to economic activity. Russian growth in 1999-2003 averaged 6.5% per year and is expected to reach a respectable 6.8% in 2004. The Yukos affair as well as broader anxiety about corporate governance and the Putin administration's political agenda affected business and consumer confidence in the final months of 2004.

Sharply increasing energy exports and favorable terms of trade have generated an extremely healthy external financing position.

Sharply increasing energy exports and favorable terms of trade have generated an extremely healthy external financing position. The external current account surplus reached US\$58.2 billion in 2004, more than 10% of GDP and an all-time record high. The combined exports of oil, oil products and natural gas totaled US\$100 billion or 55% of all merchandise exports. Urals oil price averaged around US\$34.50 a barrel in 2004, 27% higher than the level in 2003. Russia is also reported to have boosted oil exports to 3.95 million barrels a day, making it the biggest oil exporter in the world.

The size and composition of capital flows to and from Russia have shifted significantly in recent years. Inflows to the Russian corporate and banking sectors recovered from negligible levels in 2000 to an estimated \$10 billion in 2004, but are still below their pre-crisis level. The increase reflects falling sovereign debt spreads and improved perceptions of the prospects for the Russian economy. Foreign direct investment (FDI) has continued at relatively modest levels since 1997. Uncertain policy enforcement and arbitrary regulatory actions depress FDI. Capital flight from Russia rose to US\$8 billion in 2004, a four-fold increase from US\$2 billion in 2003. This

**RUSSIA: PEER GROUP COMPARISON OF GROSS FINANCING REQUIREMENT/RESERVES
BBB-**



Source: Standard & Poor's

increase was due to a variety of factors including investor concern over the Yukos affair, apparent creeping "statism," a mid-year mini-banking crisis, and the inept intervention in the presidential election in neighboring Ukraine in late 2004.

The Central Bank of Russia (CBR) has intervened heavily in the foreign exchange market, making large purchases of US dollars to slow the real appreciation of the ruble. With limited sterilization instruments, the CBR has tried to keep inflation on a downward path, despite the pressures generated from a strong balance of payments. In real terms, the ruble is now appreciating at around 10% on an annual basis, and has reached 90% of the level prevailing before the 1998 financial crisis. The CBR has only sterilized a small part of its intervention in the belief that the ensuing upward pressure on interest rates would attract further capital inflows.

Heavy foreign exchange intervention has resulted in international reserves rising to a new record. Over 2004, official gross foreign exchange reserves rose by US\$46.7 billion to US\$124.5 billion, equivalent to around 325% of short-term debt or more than 10 months of import cover. The reserve coverage of gross external borrowing requirements remains strong at an estimated 365% at end-2004, down from 408% at end-2003.

Macroeconomic tensions are, however, rising. The CBR continues to unsuccessfully sterilize the excess liquidity resulting from the maintenance of a hefty current account

The CBR has only sterilized a small part of its intervention in the belief that the ensuing upward pressure on interest rates would attract further capital inflows.

Many Russian enterprises have restructured in order to remain competitive, but some of the more important and politically sensitive industries like gas and electricity have largely failed in these efforts.

surplus. Although headline inflation has continued to fall, reaching 11.5% in 2004, core inflation has become entrenched, remaining in the 10-11% range since mid-2002. The situation in the labor market is gradually improving but there are reports of labor shortages in Moscow and other high growth regions. The unemployment rate stood at 7.4% in August 2004 compared with 8.2% a year earlier. Real wages rose by more than 80% in 1999-2003 and are now 28% above pre-crisis levels. Concerns that growth may be slowing below trend, have triggered a lively debate between western-oriented reformers and the “statists” within government about whether the current structural reform agenda is sufficiently ambitious.

Many Russian enterprises have restructured in order to remain competitive, but some of the more important and politically sensitive industries like gas and electricity have largely failed in these efforts. Russia has been able to achieve high growth rates in recent years despite an investment rate – 18% of GDP – which is well below the shares in other fast-growing countries in Eastern Europe or Asia and well below the OECD average of around 22%. Russian enterprises have drawn upon idle or underutilized capital stock, much of which is obsolete.

Underlying Russia’s expansion has been a generally prudent fiscal policy, in sharp contrast to the pre-crisis period. Federal budgets have aimed for surpluses based on conservative oil price assumptions. The federal budget posted a surplus of 4.1% of GDP in 2004, with a primary surplus amounting to the equivalent of 5.4% of GDP. This outturn compares with a surplus about 1% of GDP in 2003. Adjusted for the impact of higher oil prices, however, the overall fiscal stance has been weaker. At a constant Ural oil price of US\$20 per barrel, the federal budget balance in 2004 swung from a surplus to a moderate deficit.

The Russian government has resisted the temptation to spend the oil windfall, instead using a significant part of the proceeds to retire debt and to accumulate reserves. In 2004, the authorities established a Stabilization Fund to accumulate windfall oil revenue when oil prices are above US\$21 a barrel. The stellar fiscal performance in 2004 boosted balances in Russia’s Stabilization Fund to RUB522.3 billion or US\$18.8 billion as of January 1, 2005. Under new rules, resources from the Stabilization Fund can only be used for debt service, and only when the balances exceeds RUB500 billion.

Generally prudent fiscal policy and rapid growth have led to a continuous decline in Russia’s public external debt. As at September 2004, Russia’s public external debt amounted to US\$93 billion or an estimated 16% of GDP compared with 36.5% of GDP at end-2001. The declining share of government debt reflects no new issuance and the steady amortization of existing obligations. In addition, the government plans in 2005 to

prepay as much as US\$10 billion of the US\$44.5 billion owed to the Paris Club creditors. Debt servicing has also fallen from 45% of exports during the 1998 crisis to 10% in 2003 and to under 6% in 2004.

Private sector debt is, however, rising rapidly. Corporate bond issuance on international markets rose in the first nine months of 2004 amounted to US\$9.3 billion, more than the level for all of 2003 and compared to US\$3.5 billion in 2002 and just US\$600 million in 2001. The total outstanding stock of private external debt reached US\$99 billion at end-September 2004, more than twice the level just three years ago.

Implementation of structural reforms has been limited partly due to the electoral calendar and partly to strengthening opposition from vested interests. Progress was achieved with the introduction of deposit insurance and the move to liberalize capital flows. Reforms of the pension system and the electricity sector were scaled down, however, reforms of Gazprom, the public administration, and the social and military sectors effectively stalled. Corruption remains a major obstacle to private sector investment and activity.

MEDIUM-TERM OUTLOOK AND RISKS

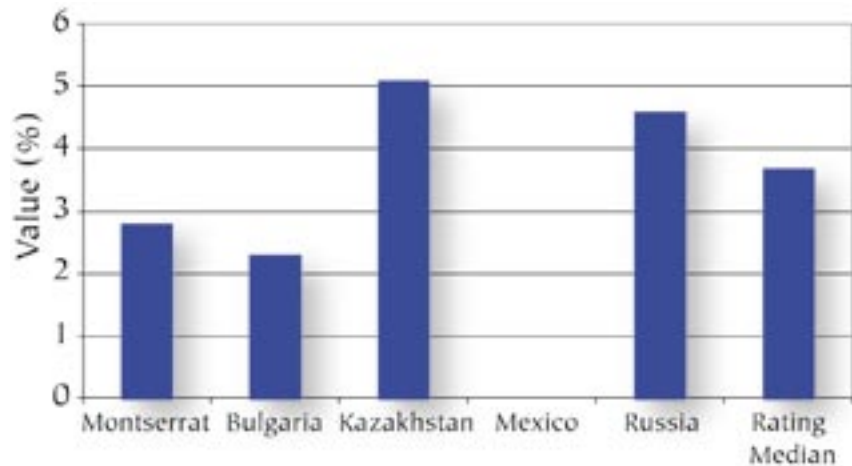
On the assumption that current policies are maintained and oil prices return to more normal levels, Russia's growth is likely to slow to about trend of 5% over the medium term. Under this scenario, the balance of payments should remain strong. The external current account is likely to decline, driven by lower oil prices and gradually increasing private investment. The capital account is projected to steadily improve, reflecting growth in foreign borrowing by Russian companies, moderately higher foreign direct investment as reforms take hold, and a gradual waning of capital flight.

External vulnerabilities are, therefore, likely to remain low and allow Russia to withstand sizable shocks. Reserve cover could stay at about 10 months of imports in 2010, well over 200% of short-term debt. Some further loosening in fiscal policy is expected in 2005, but budget plans appear quite cautious. The spending hike partly reflected increased expenditure on security and defense and the costs of the ambitious social security reform program. With little prospect of immediate fiscal tightening and strong political concern about real appreciation, the CBR would maintain its dual targeting regime. The envisaged fiscal position should allow a reduction in gross public external debt to below 10% of GDP by 2007, while total external debt is expected to stabilize at around 30% of GDP.

A major downside risk facing Russia stems from the oil price outlook. The Urals blend currently stands above US\$40 a barrel. If the current period of high oil prices persists for some time possibly aggravated by high foreign exchange inflows, then this would further test the ability of the CBR to contain inflation and/or the real appreciation

On the assumption that current policies are maintained and oil prices return to more normal levels, Russia's growth is likely to slow to about trend of 5% over the medium term.

**RUSSIA: PEER GROUP COMPARISON OF GOV'T GENERAL
PRIMARY BALANCE/GDP
BBB-**



Source: Standard & Poor's

of the ruble and could erode the competitiveness of the non-oil sector. Fiscal policy would need to sterilize the additional oil revenues, leaving monetary policy free to focus on the critical task of reducing inflation.

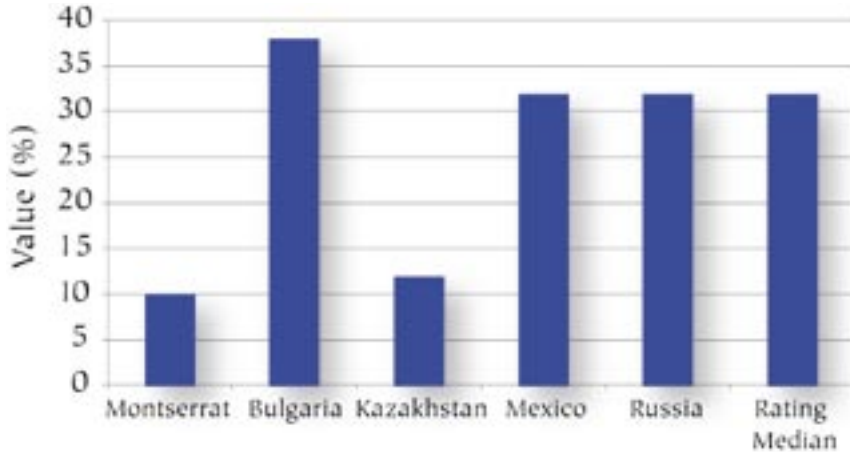
Another downside risk stems from the political environment. President Putin's enormous political success in engineering the transformation of the Russia economy is a source of credit risk not usually seen in other emerging economies. Moreover, with this consolidation of power, the application of laws and regulations is increasingly driven by personal agendas, rivalries and self-serving bureaucracies. The perception that property rights had become sufficiently secure was a main factor contributing to the recovery of investment in the oil sector, which jumped from roughly 25% of industrial investment before the crisis to around 35% from 2000 onwards. Moreover, although the financing position and debt profile are much improved from the 1998 crisis, the lack of unity in government could prove detrimental to the growth and investment outlook.

CONCLUSION

Since the 1998 financial crisis, Russia has confounded the skeptics. The recovery that began in 1999 has been stronger and more sustained than initially thought possible. This strong macroeconomic performance has had a direct, positive impact on wages, incomes and employment, which are now well above pre-crisis levels, and has helped to reduce vulnerabilities as reflected in lower spreads faced by Russian borrowers and positive investor sentiment. Yet there remain grounds for concern. There are two main challenges facing Russia policymakers over the coming years.

Yet there remain grounds for concern. There are two main challenges facing Russia policymakers over the coming years.

**RUSSIA: PEER GROUP COMPARISON OF GROSS DEBT / GDP
BBB-**



Source: Standard & Poor's

First, Russia needs to adopt policies to mitigate the risks associated with resource-dependent growth, especially on the oil sector. Fiscal prudence is crucial in this regard to mute the effects of commodity price fluctuations, preventing boom-and-bust-cycles. The decision to place windfall oil revenues into the Stabilization Fund to pay off debt is a welcome one.

Second, Russia needs to further implement further structural reforms aimed at diversification away from the resource sector. Progress in this area will depend on restructuring large, state monopolies in natural gas and electricity, the implementation of which could be subverted by entrenched special interest groups. Further reform of the banking sector is also a priority. The arbitrary exercise of state power remains a principal threat to the establishment of secure, clearly defined property rights in Russia and the emergence and growth of many firms. The Russian government needs to provide assurances about the transparency, fairness and even handedness of the enforcement of laws and regulations. ■

RUSSIA: SELECTED ECONOMIC INDICATORS

TABLE 1
RUSSIA SELECTED INDICATORS

| | 2000 | 2001 | 2002 | 2003 | BB Median 2004 | 2004e | 2005f |
|--|----------|----------|----------|----------|-------------------|----------|----------|
| Per capita income (\$) | 1,783.00 | 2,116.00 | 2,391.00 | 3,062.00 | 1,989.00 | 3,658.00 | 4,240.00 |
| Real GDP (% change) | 9 | 5.1 | 4.7 | 7.3 | 4 | 6.8 | 5.8 |
| Real GDP per capita (% change) | 9 | 5.6 | 4.7 | 7.5 | 2.4 | 7.3 | 6.5 |
| General government balance (% of GDP) | 3.1 | 4.8 | 0.9 | 1.3 | -3.3 | 2 | -0.5 |
| Net general government debt (% of GDP) | 42.2 | 48.2 | 38.4 | 31.1 | 48.8 | 27.7 | 24.2 |
| General government interest expenditure/Revenue (%) | 10.3 | 7.9 | 6.9 | 5.6 | 13.4 | 5.1 | 5 |
| Domestic credit to private sector and NFPE (% of GDP) | 12.9 | 16.4 | 18.4 | 20.7 | 40.6 | 23.7 | 26.8 |
| CPI (average % change) | 20.8 | 21.5 | 15.8 | 13.8 | 4.5 | 11.6 | 10.5 |
| Gross external financing requirement/Foreign exchange reserves | -168.3 | -13.1 | 20.3 | 24.5 | 86.9 | 27.6 | 42.2 |
| Net public sector external debt/CAR | 93.5 | 76.9 | 56.2 | 24.5 | 27.9 | 11.7 | 9.4 |
| Financial-sector net external debt/CAR | -6 | -5.7 | -4.8 | 1.6 | 2.3 | 2.3 | 2.3 |
| Nonfinancial private sector net external debt/CAR | -27.2 | -28.4 | -21.6 | -10.6 | 2.1 | -9 | -6.3 |

TABLE 2
RUSSIA ECONOMIC INDICATORS
 (% change, unless otherwise indicated)

| | 2000 | 2001 | 2002 | 2003 | 2004e | 2005f |
|--------------------------|-------|-------|-------|-------|-------|-------|
| Real GDP | 9.1 | 5.1 | 4.7 | 7.3 | 6.8 | 5.8 |
| Real domestic demand | 14.4 | 8.9 | 6.5 | 7.8 | 9.5 | 7.5 |
| Real Investment | 17.4 | 10.5 | 3.5 | 12.9 | 11.8 | 8.3 |
| Real private consumption | 9.4 | 8.7 | 8.5 | 7.2 | 6.5 | 5 |
| Real exports | 7 | 2 | 3.2 | 11 | 6.9 | 6.5 |
| Unemployment (%) | 9.8 | 8.8 | 8 | 7.9 | 7.9 | 7.5 |
| Real GDP per capita | 9 | 5.6 | 4.7 | 7.5 | 7.3 | 6.4 |
| GDP per capita (US\$) | 1,783 | 2,116 | 2,385 | 3,069 | 3,509 | 4,034 |

e-Estimate. f-Forecast.

TABLE 3
RUSSIA FISCAL INDICATORS
 (as a % of nominal GDP)

| | 2000 | 2001 | 2002 | 2003 | 2004e | 2005f |
|---|-------|-------|--------|--------|--------|--------|
| General government revenue | 36.9 | 34.7 | 32.4 | 31.1 | 31.3 | 31.9 |
| General government expenditure | 33.8 | 30 | 31.5 | 29.7 | 29.3 | 32.4 |
| General government balance | 3.1 | 4.7 | 0.9 | 1.4 | 2 | -0.5 |
| Central government | 1.4 | 1.6 | 1.3 | 1.7 | 2.4 | 1 |
| Social security | 1.6 | 1.6 | 0 | 0 | 0 | 0 |
| Local government | 0.5 | 0 | -0.5 | -0.4 | -0.3 | -0.3 |
| General government gross debt (as a % of general government revenue) | 71.1 | 52.3 | 44.2 | 35.8 | 31.3 | 27.8 |
| General government balance | 8.5 | 13.8 | 2.8 | 4.3 | 6.4 | -1.7 |
| General government interest payments | 10.3 | 7.9 | 6.9 | 5.6 | 5.1 | 5 |
| Memo item: Nominal GDP (RUR bil.) | 7,302 | 8,944 | 10,863 | 13,305 | 15,950 | 18,342 |

Source: S&P

TABLE 4
RUSSIA FINANCIAL INDICATORS

| | 2000 | 2001 | 2002 | 2003 | 2004e | 2005f |
|--|--------|--------|--------|--------|--------|--------|
| CPI (average % change) | 20.8 | 21.5 | 15.8 | 13.8 | 11.6 | 10.5 |
| Refinancing rate (%) | 25 | 25 | 21 | 16 | 14 | 10 |
| Real effective exchange rate (% change) | 12.8 | 18 | 2.6 | 4.1 | 4.8 | 4 |
| Domestic credit to private sector and NFPE* (% of GDP) | 12.9 | 16.4 | 18.4 | 20.7 | 23.7 | 26.8 |
| Domestic credit to private sector and NFPE (% change) | 65.5 | 56 | 35.9 | 38.1 | 37.2 | 30.1 |
| M2 (% change) | 58.3 | 36.1 | 23.5 | 21.8 | 26.3 | 24.1 |
| Official forex reserves, excluding gold (\$US mil.) | 24,264 | 32,542 | 44,052 | 73,175 | 91,575 | 95,675 |

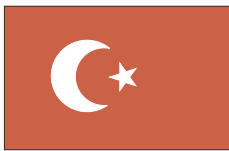
TABLE 5
RUSSIA EXTERNAL INDICATORS
 (as a % of nominal GDP)

| | 2000 | 2001 | 2002 | 2003 | 2004e | 2005f |
|---|-------|-------|-------|-------|-------|-------|
| Exports of goods and services plus net transfers | 46.7 | 39.1 | 36.9 | 36.1 | 32.8 | 28.1 |
| Current account balance | 18.2 | 11.4 | 8.4 | 8.1 | 6.2 | 1.9 |
| Foreign direct investment | -0.2 | 0 | -0.1 | -0.8 | -0.6 | -0.3 |
| (as a % of exports of goods and services plus net transfers unless noted otherwise) | | | | | | |
| Trade balance | 50.1 | 40.2 | 36.2 | 37.8 | 34.1 | 26.9 |
| Current account balance | 39.1 | 29.2 | 22.8 | 22.4 | 18.9 | 6.9 |
| Net external liabilities | 73.6 | 64.3 | 61.6 | 33.6 | 35.9 | 35.4 |
| Gross external debt | 139.2 | 131.7 | 125.8 | 113.8 | 123.9 | 132.9 |
| Net external debt | 60.3 | 42.9 | 29.7 | 15.5 | 19.5 | 20.7 |
| Net general government external debt | 93.5 | 76.9 | 56.2 | 24.5 | 11.7 | 9.4 |
| Net private nonfinancial sector external debt | -27.1 | -28.4 | -21.6 | -10.6 | -9 | -6.3 |
| Net financial sector external debt | 2.8 | 2.2 | 1.8 | -0.6 | -0.8 | -0.7 |
| Net external interest payments | 7.6 | 5.8 | 4.8 | 5.3 | 6.1 | 7.9 |
| External debt service including short-term debt | 30.8 | 34.3 | 35.8 | 37.7 | 49.2 | 57.8 |
| External debt service excluding short-term debt | 16.4 | 15.9 | 16.3 | 18.7 | 18.3 | 22.4 |
| Principal payments | 7.4 | 7.8 | 9.1 | 10.9 | 9.6 | 11.9 |
| Reserves/Imports (months) | 4.5 | 5.2 | 6.2 | 4.7 | 7.5 | 7.3 |
| Reserves/Financing gap | -0.6 | -7.6 | 492.6 | 408.2 | 362.6 | 236.7 |
| Reserves/Short-term debt | 125.5 | 145.8 | 159.5 | 145.1 | 159.6 | 148.9 |
| Memo item: Nominal exports (US\$ billions) | 121.1 | 119.9 | 127.9 | 159.9 | 172.7 | 170.5 |
| Memo item: Nominal GDP (US\$ billions) | 259.6 | 306.6 | 346.5 | 442.8 | 526.4 | 606.6 |

Source: S&P

COUNTRY RISK REPORT: TURKEY

BB- / STABLE / B



Turkey's economy is large and well diversified. Industry and commerce (including tourism-related services) account for more than 40% of GDP, and traditional agriculture represents about 12% of GDP.

BACKGROUND

Turkey, with a population of approximately 70.7 million and per capita GDP of US\$3,224, straddles southeastern Europe and southwestern Asia. It borders the Black Sea between Bulgaria and Georgia, and the Aegean Sea and the Mediterranean Sea between Greece and Syria.

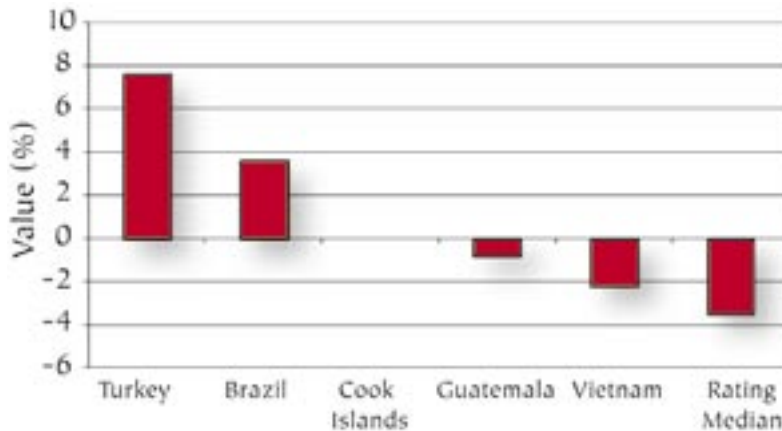
Turkey's economy is large and well diversified. Industry and commerce (including tourism-related services) account for more than 40% of GDP, and traditional agriculture represents about 12% of GDP. The state still plays a major role in basic industry, banking, transport and communications. Official estimates place unemployment at 9% of the workforce, but there is a large informal economy.

The government defaulted on foreign currency bank debt in 1978-79 and in 1982. Turkey is the first European Union (EU) candidate for full membership with a predominantly Muslim population. On 16 December 2004, EU leaders offered a start date of 3 October 2005 for full membership accession talks. Turkey also agreed to extend existing EU customs union accord to the 10 new member states, implying tacit recognition of Cyprus, in which it had intervened militarily in 1974 to prevent a Greek takeover of the island.

POLITICAL CONDITIONS

The Islamist Justice and Development Party (AKP), which was victorious in the 2002 elections, has a large majority of two-thirds in the Parliament, engendering greater political stability than in recent years. However, the AKP's majority is still not large enough to guarantee the enactment of constitutional amendments required for EU accession. The secular establishment, especially the President, the military, the judiciary and business groups that own the media, still regard the Islamist tendency of the AKP with some suspicion. Parliament has already approved several constitutional reforms, including measures to weaken the influence of the military in policy-making, limiting the possibility of a military coup. The next Parliamentary election is scheduled for November 2007.

**TURKEY: PEER COMPARISON OF
GENERAL GOV'T. PRIMARY BALANCE / GDP
BB-**



Source: Standard & Poor's

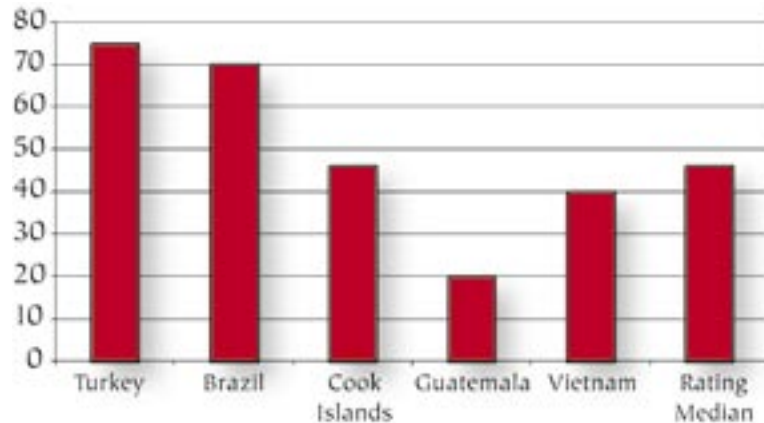
RECENT ECONOMIC DEVELOPMENTS

Turkey is at a cross roads. After hitting the most severe economic crisis of its recent history in 2000-2001, the Turkish economy bounced back and is now among the fastest growing economies in the OECD. The crisis resulted from the emergence of huge fiscal imbalances over the 1990s and the lack of attention to the accumulation of systemic banking sector risks. Turkey ended 2001 with deep cuts in output, employment and income as well as a heavy public debt overhang. The crisis triggered the start of fundamental reform. Strong implementation of a 3-year IMF Standby Arrangement in 2002, supported by exceptionally high access to Fund resources, finally allowed Turkey to break free from its inflationary past, curb real high interest rates, and set the stage for a rapid and powerful recovery. The IMF-supported program expired at the end of 2004.

Growth has rebounded strongly, but output remains below potential. The Turkish economy posted strong, real growth over the last three years, with cumulative real GDP growth totaling more than 30%, and GNP some 6% higher in real terms than in 2000, just prior to the collapse of the crawling peg exchange rate regime. Growth has been driven by robust private consumption, exports and tourism, and has not been affected by cuts in government spending. Indicators of capacity utilization in manufacturing and of agricultural production are on the upswing and the latest business survey data show signs of optimism. Export growth has picked up with the improving strength of the global economy and spending has increased due to higher levels of workers' remittances. Yet it is too early to determine to what extent the rebound reflects a transition to a higher medium term growth path.

The crisis resulted from the emergence of huge fiscal imbalances over the 1990s and the lack of attention to the accumulation of systemic banking sector risks.

TURKEY: PEER COMPARISON OF
GOV'T. DEBT / GDP
BB-



Source: Standard & Poor's

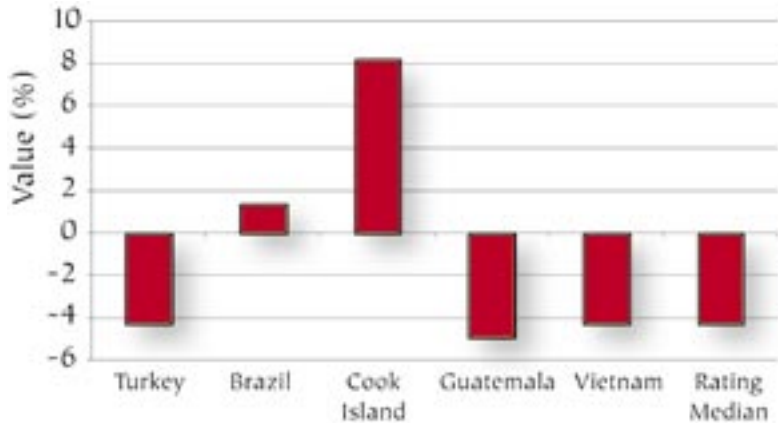
Financial market conditions have improved markedly from their post-September 11 lows. Skilful monetary management under the floating exchange rate regime helped to facilitate a dramatic decline in interest rates as confidence recovered.

Inflation is on a steep downward path. After the collapse of the 2000 exchange rate-based disinflation program and the floating of the lira in February 2001, inflation soared to 68.5% at end-2002. Tight fiscal policies and a focus on the achievement of price stability, which is main objective of the Central Bank of Turkey that became independent by law, resulted in an impressive process of disinflation. The inflation rate fell sharply to less than 20% in 2003 and to single digit levels of 9.3% in 2004 for the first time in three decades. Expectations for inflation in 2005 converge around 8%. While the large public sector borrowing requirements continue to heavily influence interest and exchange rates, the CBT has been successful in building up credibility over time and is increasingly shaping inflation and interest rate expectations.

Financial market conditions have improved markedly from their post-September 11 lows. Skilful monetary management under the floating exchange rate regime helped to facilitate a dramatic decline in interest rates as confidence recovered. The benchmark Treasury bill rate fell from 90% in 2002 to its current level of 20%, and is expected to further decline to an average of around 17% in 2005 once there is continuation of current policies as obtained under the recently expired IMF-supported program. The lira has appeared much more stable, appreciating marginally on a real basis in 2004. The trend towards dollarization has also abated while the stock market rose by 50% in lira terms since mid-September 2002.

The fiscal turnaround achieved since 1999 is impressive. The public sector primary balance improved from a deficit of 2% of GNP in 1999 to a large surplus of almost 6% of GNP in 2001, and reached the ambitious target of 6.5% of GNP in 2004,

**TURKEY: PEER COMPARISON OF
CURRENT ACCOUNT BALANCE / GDP
BB-**



Source: Standard & Poor's

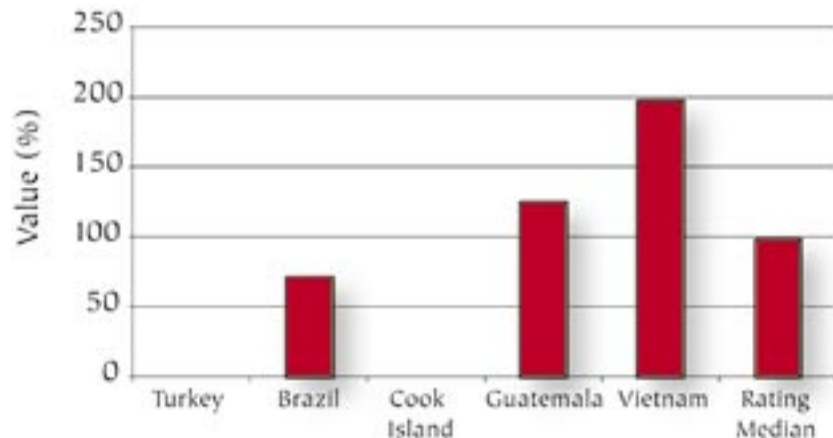
which is the highest level among its B rated peers. Success in broadly meeting this sizeable primary surplus target has played a key role in macroeconomic stabilization. While the speed of fiscal consolidation is on track, the quality has still to be improved. Spending cuts did not touch the politically difficult areas such as public wages and social security, but have been effected elsewhere on an ad hoc basis, including in infrastructure investment and important public services. A primary surplus of 5% of GNP is targeted for 2005.

Concerns about public debt sustainability have diminished, but the debt service ratio will remain high. Strong growth, real lira appreciation and the maintenance of high primary fiscal surpluses have contributed to easing and stabilizing the public debt, which fell to 68% of GNP in 2004 from over 90% in 2001. With government debt interest expenditure consuming almost 60% of revenue, Turkey still has the highest debt service burden among its peers even though its fiscal adjustment is more ambitious.

The debt stock's short maturity and the large share of foreign currency-linked securities make Turkey more susceptible to rollover risk, raising its vulnerability to interest rate and currency shocks. The Treasury has been lengthening the maturity of domestic borrowing. Moreover, Turkey's access to the international market has been restored as the sovereign tapped the Eurobond market for US\$ 5.4 billion in 2003 and US\$5.75 billion in 2004 while seeing a significant fall in the market risk premium. In 2005, Turkey intends to issue some US\$5.5 billion in Eurobonds, of which US\$2 billion was already raised in January.

With government debt interest expenditure consuming almost 60% of revenue, Turkey still has the highest debt service burden among its peers even though its fiscal adjustment is more ambitious.

**TURKEY: PEER COMPARISON OF
GROSS FINANCING REQUIREMENT / RESERVES
BB-**



Source: Standard & Poor's

Good progress has been made in reforming Turkey's banking system, especially in restructuring the state banks.

The CBT is making use of a better-than-anticipated balance of payments position to build up foreign exchange reserves. The recent improvement in the external position provided an opportune moment for the CBT to accumulate foreign exchange reserves, especially given longer-term repayment needs. Turkey's repayments to the IMF will peak at US\$10.6 billion or 15% of exports of goods and non-factor services in 2006, but some of this could be deferred if a successor program is approved with the IMF. Official gross international reserves reached a record high of US\$34 billion in 2004. Although the current account deficit could widen to about 4% of GDP in 2004, lira flexibility and the comfortable cushion of external reserves mitigate against the risk of another financial crisis.

Progress in the structural areas needs to be more even. Good progress has been made in reforming Turkey's banking system, especially in restructuring the state banks. Further work on the "Istanbul Approach" to corporate restructuring is required to make the framework operational. Since state enterprises are major influences behind Turkey's disappointing growth performance, the government plans to sell stakes in several entities, including Turk Telecom and Turkish Airlines. The government has to demonstrate a commitment to dealing with the inefficiencies in the investment environment and perceptions of corruption that have plagued Turkey in the past.

MEDIUM TERM OUTLOOK AND RISKS

Turkey's medium term outlook is positive. This reflects the prospects for an upgrade if the government makes further progress in macroeconomic stability and growth as well as makes clear its commitment to such policies, preferably supported

by a new 3-year Standby Arrangement with the IMF. Further progress in EU accession negotiations later this year will also improve sovereign creditworthiness. This will help boost capital market sentiment, which, in turn, will keep real interest rate and debt dynamics in a virtuous circle. Nevertheless, there are several downside risks.

Public sector debt is still high, limiting the fiscal response to shocks. Although net public sector debt is projected to fall further in 2004, it will remain high at 64-65% of GNP by year's end. This path assumes that the positive momentum will continue on the reform front, supported by domestic political stability, a new IMF program, and the EU accession process. The reduction is also dependent on exchange rate trends, given the still relatively high proportion of foreign exchange-linked debt in total public sector debt.

High, albeit declining, real interest rates. Forward real interest rates on government debt are now estimated to average 8-10%, a significant decline from an average of 15-20% in 2003. Further reductions are, however, necessary to secure the benefits of disinflation and this may prove difficult in the absence of an IMF-supported program. Inflation has continued to decline, but the CBT has not yet announced the formal adoption of inflation targeting, which would entail increased transparency and further strengthen its commitment to price stability.

High implementation risks. Despite the government's encouraging track record thus far and its repeated declarations of commitment to an IMF-supported program, it faces difficulties in moving ahead with its ambitious fiscal and structural reform agenda. The AKP government still faces fierce opposition from the powerful nationalist establishment, especially the military, on the grounds that it is rolling back the secular foundations of modern Turkey.

CONCLUSION

Turkey is no longer on the brink of a vicious debt cycle, but doubts about debt sustainability will linger. As long as Turkey has such a huge weight of public sector debt, which stands at over US\$180 billion, reducing this heavy debt burden will require the continuation of recent policies over an extended period, regardless of Turkey's relations with the EU and the IMF. Of course, delays in accession negotiations and in approval of an IMF-supported program would make this process even more difficult. The potential political impact is, however, harder to predict. So far, the Islamist AKP government and the secular establishment have moderated their own positions to prevent tensions from developing into crises, but an international anchor policy is clearly necessary to underpin Turkey's shift to a new economic regime. ■

Forward real interest rates on government debt are now estimated to average 8-10%, a significant decline from an average of 15-20% in 2003.

TABLE 1
TURKEY: SELECTED INDICATORS

| | 2002 | 2003 | 2004 | 2004e | 2005f | 2006f |
|--|-----------|----------|----------|----------|----------|----------|
| | BB Median | | | | | |
| GDP per capita (\$) | 2,645.00 | 3,402.00 | 2,278.00 | 4,214.00 | 4,845.00 | 5,480.00 |
| Real GDP (% change) | 7.9 | 5.8 | 4.9 | 8.7 | 5.3 | 6 |
| Real GDP per capita (% change) | 6.3 | 4.6 | 3.3 | 7.4 | 4.1 | 4.7 |
| General government balance (% of GDP) | -13.9 | -11.5 | -3.3 | -7.7 | -5.5 | -4 |
| General government debt (% of GDP) | 97.7 | 79 | 49.9 | 72.8 | 68.6 | 62.5 |
| Net general government debt (% of GDP) | 91.2 | 73 | 42.3 | 67.1 | 62.3 | 57.6 |
| General government interest expenditures (% of revenues) | 65 | 58 | 13.4 | 48.4 | 3.8 | 31.8 |
| Domestic credit to private sector and NFPEs* (% of GDP) | 14 | 15.6 | 35.2 | 18.6 | 21.3 | 24.1 |
| Consumer price index (average; % change) | 44.9 | 25.3 | 5.4 | 10.6 | 8 | 8 |
| Gross external financing requirement (% of foreign reserves) | 272.8 | 159.5 | 79.2 | 186.9 | 167.5 | 179.1 |
| Net general government external debt (% of CARs) | 69 | 42.2 | 63.4 | 27.2 | 20.5 | 13.1 |
| Net banking sector external debt (% of CARs) | -6.6 | -2.2 | 2.9 | -0.8 | 2.8 | 6.6 |
| Net nonbank private sector external debt (% of CARs) | 41.5 | 34.5 | 6.3 | 34.9 | 41 | 46.9 |

TABLE 2
TURKEY: ECONOMIC AND FINANCIAL INDICATORS

| | 2002 | 2003 | 2004e | 2005f | 2006f |
|--|-------|-------|-------|-------|-------|
| Nominal GDP (bil. TRY) | 277.6 | 359.8 | 430 | 489 | 559.5 |
| Nominal GDP (bil. \$) | 184.2 | 239.7 | 300.3 | 349.3 | 399.7 |
| GDP per capita (000 \$) | 2.6 | 3.4 | 4.2 | 4.8 | 5.5 |
| Real GDP (% change) | 7.9 | 5.8 | 8.7 | 5.3 | 6 |
| Real GDP per capita (% change) | 6.3 | 4.6 | 7.4 | 4.1 | 4.7 |
| Real domestic demand (% change) | na | 7.7 | 11.1 | 0.8 | 6 |
| Real investment (% change) | 6.8 | 10 | 29.9 | -1.7 | 7.5 |
| Gross domestic investment (% of GDP) | 21.3 | 22.8 | 24.6 | 22 | 21.7 |
| Gross domestic savings (% of GDP) | 19.3 | 19.4 | 19.5 | 19 | 18.5 |
| Real exports (% change) | 0 | 11.1 | 16 | 9.8 | 8 |
| Unemployment rate (average claimant count; %) | 11 | 12 | 13 | 14 | 15 |
| Consumer price index (% change) | 44.9 | 25.3 | 10.6 | 8 | 8 |
| Domestic credit to private sector and NFPEs (% change) | 8 | 44.4 | 42.8 | 30.1 | 29.9 |
| Domestic credit to private sector and NFPEs (% of GDP) | 14 | 15.6 | 18.6 | 21.3 | 24.1 |

TRY--New Turkish lira. NFPE--Nonfinancial public enterprise. f--Forecast. e--Estimate.

TABLE 3
TURKEY: FISCAL INDICATORS
 (% of GDP)

| | 2002 | 2003 | 2004e | 2005f | 2006f |
|--|-------|-------|-------|-------|-------|
| Public sector gross debt | 96.3 | 80.9 | 75.1 | 72.4 | 66 |
| Of which general government debt | 97.7 | 79 | 72.8 | 68.6 | 62.5 |
| Of which central government debt | 93.7 | 79.2 | 73 | 68.7 | 62.6 |
| Public sector net debt | 89.8 | 74.8 | 69.4 | 66.1 | 61.2 |
| Of which general government net debt | 91.2 | 73 | 67.1 | 62.3 | 57.6 |
| Of which central government net debt | 87.2 | 73.2 | 67.2 | 62.4 | 57.7 |
| General government revenues | 31.5 | 31.2 | 29.5 | 31.6 | 32.3 |
| Of which central government | 27.2 | 26.9 | 25.3 | 26 | 24.1 |
| General government expenditures | 45.4 | 42.7 | 37.2 | 37.1 | 36.1 |
| Of which central government | 41.6 | 38.9 | 33.3 | 31.7 | 29.9 |
| General government balance | -13.9 | -11.5 | -7.7 | -5.5 | -4 |
| Of which central government | -14.4 | -12 | -8 | -5.8 | -4.3 |
| Of which local authorities | -0.1 | 0 | -0.1 | -0.1 | -0.1 |
| General government primary balance | 6.5 | 6.6 | 6.6 | 6.6 | 6.5 |
| Central government primary balance | 4.3 | 4.3 | 5.4 | 5.7 | 5.7 |
| General government balance (% of revenues) | -44.3 | -37 | -26.2 | -17.4 | -11.7 |
| General government interest payments (% of revenues) | 65 | 58 | 48.4 | 38.4 | 31.8 |
| Central government interest payments (% of revenues) | 68.6 | 60.6 | 53 | 44 | 37.3 |

TABLE 4
TURKEY: EXTERNAL INDICATORS

| | 2002 | 2003 | 2004e | 2005f | 2006f |
|--|-------|-------|-------|-------|-------|
| (% of GDP) | | | | | |
| Current account balance | -2.1 | -3.4 | -5.2 | -3 | -3.2 |
| Trade balance | -4.5 | -5.8 | -8 | -5.3 | -5 |
| Net foreign direct investment | 0.5 | 0.5 | 0.6 | 0.6 | 0.7 |
| (% of CARs) | | | | | |
| Current account balance | -6.5 | -10.9 | -16.5 | -10.2 | -11.6 |
| Net external liabilities | 168.5 | 132.4 | 116.5 | 118.4 | 122.1 |
| Total external debt | 235.5 | 193.2 | 162.1 | 159.8 | 157.1 |
| General government external debt | 117.6 | 90.5 | 65.8 | 56.1 | 45.5 |
| Net general government external debt | 69 | 42.2 | 27.2 | 20.5 | 13.1 |
| Net nonbank private sector external debt | 41.5 | 34.5 | 34.9 | 41 | 46.9 |
| Net banking sector external debt | -6.6 | -2.2 | -0.8 | 2.8 | 6.6 |
| Net investment payments | 7.8 | 7.6 | 5.9 | 5.8 | 5.6 |
| Net interest payments | 6.2 | 5.4 | 3.6 | 3.1 | 2.6 |
| Reserves/imports (months) | 3.9 | 4.2 | 3.9 | 3.9 | 3.6 |
| Gross external financing requirement (% of foreign reserves) | 272.8 | 159.5 | 186.9 | 167.5 | 179.1 |

CARs--Current account receipts. f--Forecast. e--Estimate.

Source: S&P



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