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EMEA Sovereign Strategy and Economics Research Team

Monthly

October 6, 2001

Inside the EMEA Economies

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EMEA Sovereign and Economics Team
Sept 5, 2001

European Emerging Markets: EMEA Catches a Whiff of Contagion
EMEA Sovereign and Economics Team
July 18, 2001

- **We have cut our growth forecasts due to terrorist attack**
  The new Morgan Stanley global growth forecast implies a continuation of the current downturn in 2002. EMEA will be affected through world trade, commodity prices, capital flows.

- **Israel, Turkey and South Africa significantly affected**
  Israel will be affected by the decline in world trade and regional tensions. Capital flows and interest rates will be negative factors for Turkey. Commodity prices are an issue for South Africa.

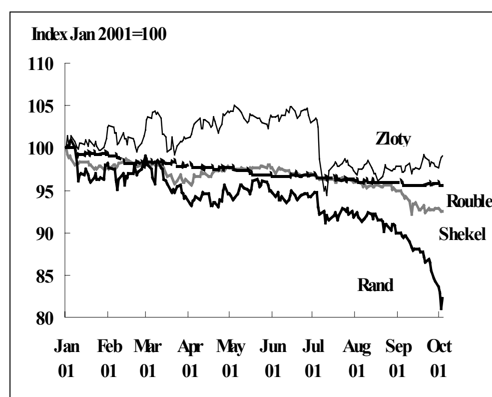
- **Russia and central Europe likely to be less affected**
  As long as oil prices do not collapse, Russia should not suffer in a major way. Central Europe will be affected by EU slowdown, but fiscal policy and lower oil prices will partially offset this.

- **Exchange rates will bear the brunt of the adjustment**
  This is a result of the higher degree of exchange rate flexibility in the region. The Turkish lira and the rand have depreciated sharply and have further to go, in our view.

- **Turkey's economic outlook is complicated by rise in NPLs**
  With the economy in deep recession, NPLs are rising sharply and pose another threat to the banking system. This is bound to have fiscal repercussions and may worsen the credit crunch.

- **Election outcome in Poland was worse than expected**
  The winning SLD will probably have to join forces with the Peasants' Party. This will constrain fiscal and structural policies. The case for easier monetary policy remains solid, though.

Selected EMEA Exchange Rates to US Dollar



Source: Morgan Stanley Research Estimates

Please refer to important disclosures at the end of this report.

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Overview

Growth Prospects Worsen, Exchange Rates Bear the Brunt

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We have cut our real GDP growth forecasts again following the terrorist attack against the US. Our economics team has cut its estimate for global real GDP growth from 2.1% to 1.7% this year, and from 3.4% to 2.1% in 2002. This qualifies as a global growth recession, and it implies a sharp deceleration in international trade. All countries in EMEA are likely to be affected, albeit to a different degree, depending on their trade openness and on the geographical and industry composition of their exports. The decline in oil and commodity prices is another key factor that can create asymmetric effects among the countries in our region.

The average cut in the EMEA growth forecast is small, but we have significantly reduced our projections for Turkey, Israel and South Africa. The weighted average of our EMEA growth for 2001-2002 has declined by only two-tenths of a percent (Exhibit 1). However, this is mostly due to Russia (which has a weight of around 40% in our coverage universe) having been revised down only marginally.

Russia's growth probably little affected. Our analyst Marcin Wiszniewski believes that as long as OPEC can keep oil prices around current levels, Russia's oil and gas revenues, and its economic growth, will not be affected in a significant way by the new global environment. It should be also noted that, with the anti-terrorism campaign led by the US still in its early stages, disruptions to oil supply and oil prices increases cannot be ruled out. As long as collateral damage to the world economy was contained, a spike in oil prices would be beneficial for Russia and thus represents an upside risk to our scenario.

Turkey's growth outlook appears more problematic. Serhan Cevik has cut the Turkish 2001 real GDP growth forecast from -6.8% to -8.2%, and the 2002 forecast from 2.8% to 1.2%, based on disappointing data releases for the third quarter and on the likely emotional and economic effects of the September 11 attack. For Turkey, increased risk aversion on the part of international investors raises the risk of reduced capital inflows and higher interest rates. Currency weakness will stimulate exports, but the worsening outlook for the European economy may more than offset this positive factor. Worsening growth prospects raise the issue of how the government will manage to maintain a large primary surplus (the IMF program envisages a 6.5%-of-GNP surplus in 2002).

Israel likely to suffer from the technology sector downturn, lower world trade and regional tensions. While the weaker shekel may provide some relief to the economy, everything else is pointing to a further worsening in economic conditions. The key drivers of Israel's excellent economic performance in 1999-2000 — notably exports and the technology sector — have reversed sign. Relatively lower interest rates are unlikely to provide sufficient support.

Exhibit 1

Real GDP Growth Forecast Revisions

	2000	2001 E		2002E	
		Old	New	Old	New
Poland	4.1	2.2	1.8	2.8	2.8
Czech Republic	2.9	3.2	3.7	3.3	3.3
Slovakia	2.2	2.8	2.7	3.3	2.9
Hungary	5.2	4.1	4.1	3.8	3.4
Russia	8.3	5.2	5.1	4.6	4.6
Turkey	7.0	-6.8	-8.2	2.8	1.2
Israel	5.8	1.2	0.2	3.1	1.7
South Africa	3.1	2.6	2.5	3.0	2.4
Weighted avg.	6.3	1.9	1.8	3.4	3.3

Source Morgan Stanley Research

Please refer to important disclosures at the end of this report.

South Africa will also be affected, albeit to a lesser extent. The rand has weakened sharply in recent weeks, thus raising South Africa's competitiveness. However, this may fail to boost the economy much, given the downturn in international trade. Lower metals prices (with the exception of gold) will reduce export earnings. In addition, the September SACOB survey showed a significant drop in business confidence on the back of the terrorist attack against the US. This points to slower growth in investment than expected before September 11.

Central Europe emerges as the least affected area in our coverage universe. In the Czech Republic, this is due in part to statistical factors, as the second quarter GDP figures came out stronger than expected and, other things being equal, warranted an upward revision to our forecast. However, there is also a policy factor, namely that fiscal policy is being or has been eased significantly. As we have been consistently arguing, structural problems and the approaching election have combined to produce a strong increase in government spending. While the Czech Republic has experienced the greatest worsening in 2000-2001, Hungary will probably take the lead in 2002 by increasing its infrastructure expenditures. Lower oil prices will also be a plus for central Europe. That said, our forecasts do imply a continuation of sub-par economic growth that should further weaken the budgetary position of these countries and, in the case of Poland, lead to a major easing in monetary policy.

Exchange rates are acting as the main buffer. Recent movements in exchange rates mirror the changes in the growth outlook that we have just outlined. Indeed, although growth is by no means the only driver of exchange rates in the region, it is interesting to note that the Turkish lira, the rand and the shekel have depreciated sharply in the third quarter. On the other hand, central European currencies have held up very well after the July shakeout and the rouble has barely moved. This is a result of the increased degree of exchange rate flexibility in EMEA (all the key countries operate a free or managed float).

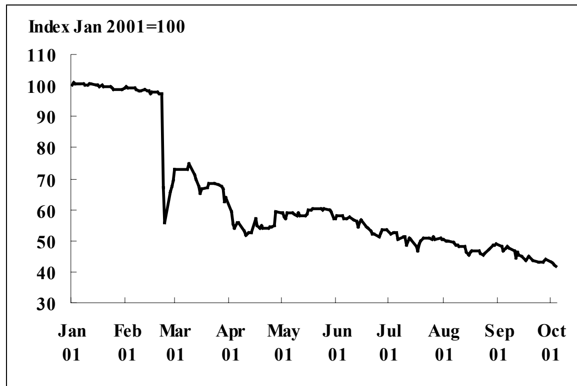
We have revised down our lira, rand and shekel forecasts. In part, this boils down to marking our forecast to market. The Turkish lira, for instance, has already reached our old year-end forecast, and the rand has moved even lower. However, while in the case of the lira a sustained recovery looks unlikely to most market participants and economists, there seems to be more hope that the rand may rebound from what most observers would describe as an "overshooting". On our part, we believe the rand has further downside given that international tensions are unlikely to completely disappear and the extent of the downturn in the US and global economy is yet to be determined (and observed). However, the lira is our main concern, given that the continued slide in the currency will boost Turkey's sizeable foreign currency debt.

Limited scope for conventional monetary policy response… The South African Reserve Bank (SARB) cut its repo rate by 50bp on September 20 following a similar move by the Fed and the ECB. This was the only such move in our region following the terrorist attack against the US. Given the steep drop in the currency, we believe this move is unlikely to be repeated. Until recently, the South African fixed income market was pricing in a further rate cut, but it has backed up following the recent bout of weakness in the rand.

…with the notable exception of Poland. The post-election scenario remains uncertain following a disappointing election outcome that deprived the SLD of a clear majority. However, a measure of fiscal consolidation can be expected, given the likely appointment of Marek Belka as Finance Minister. This should allow the National Bank to ease its policy rates, which are currently at an extremely high level in real terms (the 14.5% repo rate compares with a year-on-year inflation rate of 5.1%). As much as 400bp of rate cuts can be expected in the next 12 months, according to our strategist Steve Gilmore.

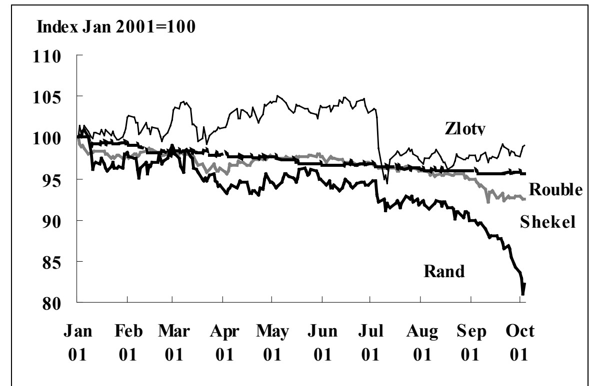
Scope for fiscal policy easing is generally limited. Fiscal policy was loosened in central Europe over the course of 2000 and 2001. The room for further easing looks limited, although, as noted above, Hungary looks likely to increase government spending ahead of its general elections. On the other hand, Turkey can at best negotiate a slight reduction in its primary surplus target with the IMF, but this would merely reflect cyclical factors, that is, the fiscal stance would not be relaxed. Likewise, South Africa will probably stick to fiscal prudence in 2002. Israel is the only exception, as it is already relaxing its fiscal policy stance significantly. Given the small size of the economy, however, this is of no significance for the region. All in all, while fiscal policy may be eased further in central Europe if economies turn out to be a lot weaker than expected, the bulk of the adjustment to the global downturn in EMEA will come from exchange rates, in our view.

Exhibit 2
Turkish Lira/US$ Exchange Rate: 2001 year to date



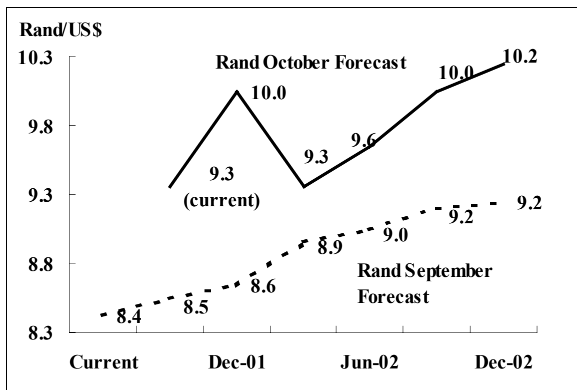
Source: Datastream, Morgan Stanley Research

Exhibit 5
Selected EMEA Exchange Rates Against US Dollar



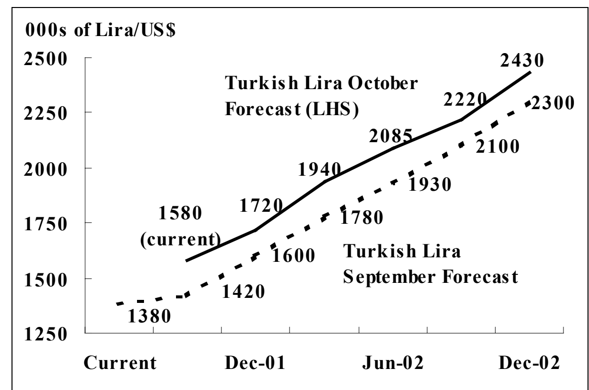
Source: Datastream, Morgan Stanley Research

Exhibit 3
Changes In Our Forecast for the Rand



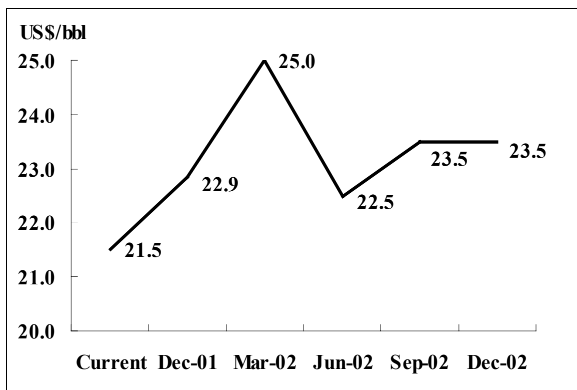
Source: Morgan Stanley Research

Exhibit 6
Changes in Our Forecast for the Turkish Lira



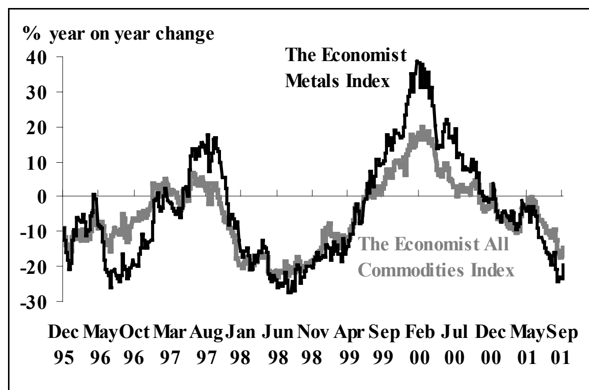
Source: Morgan Stanley Research

Exhibit 4
Brent Oil Price Forecast



Source: Morgan Stanley Integrated Oil Team

Exhibit 7
Commodity Indices are Heading Down



Source: Datastream, Morgan Stanley Research

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Essays & Comments

Turkey

Balance Sheet Effects and Non-Performing Loans

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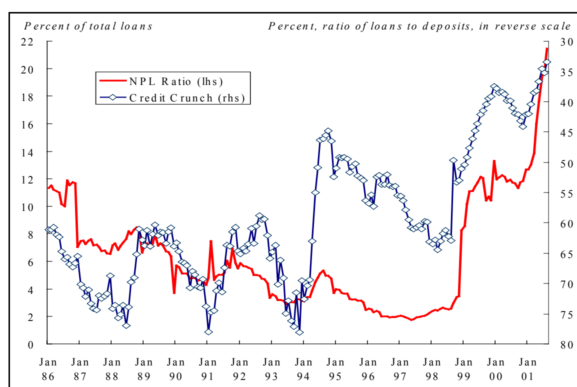
Rising non-performing loans represent the next challenge for the fragile banking system. The Turkish authorities have undertaken a complex systemic restructuring process in the financial sector and brought the country's banking laws and prudential regulations in line with international standards. Unfortunately, new banking laws and internationally accepted prudential regulations and accounting standards are just the beginning of a (long) bank restructuring process and hence don't ameliorate the 'stock' problem, we believe. The recapitalization of state and insolvent banks has already had a fiscal burden of about 30% of GDP and there may potentially be additional costs associated with the liquidation process and especially with the adjustment in the balance sheet of private-sector banks. We portrayed the adverse effects of the balance sheet channel in a recent research note (*Corporate Debt Burden, Credit Crunch and Growth,* September 14, 2001), and forewarned about non-performing loans (NPLs) as being the next tension point for the fragile banking industry. Moreover, financial statements provide a picture of realised rather than potential problems. One measure of current portfolio quality is the ratio of NPLs to gross loans (loans *plus* NPLs), in our view.

The NPL ratio already rose to 17.7% in August – a harbinger of more troubles ahead. On the back of restructuring efforts and lately of the recession, the ratio of NPLs to gross loans for the banking system increased to 17.7% ($5.1 billion) in August from 11.2% at the end of last year – a harbinger of more troubles ahead, in our opinion. First, the size of the problem grows in a recessionary environment, undermining the efficiency of the banking system. Second, cleaning up the weak banking system is likely to present an additional bill to fiscal authorities. Our worry is that banking fragility, indicated by such symptoms as poor profitability, under-capitalisation and, most importantly, an alarmingly high level of NPLs, may trigger a second wave of crisis and the resulting budgetary burden would make the country's debt dynamics even more difficult to keep under control.

Exhibit 2
Credit Crunch and Non-Performing Loans, 1986-2001



Source: Central Bank of Turkey, Morgan Stanley Research

The economic downturn will further deteriorate loan quality in the coming months. The Turkish economy is in the midst of one of the steepest recessions in history and underlying economic conditions heavily influence changes in the share of NPLs. Recessions generally cause erosion in credit quality and thus damage the banks' balance sheets. With collapsing domestic demand, the rate of contraction in industrial production accelerated from 1.3% in the first quarter to 8.5% in the second quarter *(The Great Recession,* September 6, 2001). One alarming consequence of the ongoing crisis illustrates itself in the number of bankrupt firms. According to the data compiled by the State Institute of Statistics, the number of failed corporations, firms and co-operatives rose by 11.2% year on year to 10,287 in the first seven months of the year (the picture is worse if we just look at the failure rate among small firms, which increased by 36.8%). In brief, the current macroeconomic setting is forcing businesses to default disproportionately on bank loans. Given the bleak global outlook, risk aversion and credit crunch, the worsening financial position of companies will only increase bad loans in the coming months. As an inevitable consequence, the pressure on the banks' balance sheets is once again increasing and, without a significant equity injection, private banks will have difficulty in even keeping 'good clients' afloat by rolling over the existing loans. Besides, the State Deposit Insurance Fund's (SDIF) aggressive approach to loan collection is forcing private banks to follow suit in order to protect their own exposures by pursuing legal actions against troubled firms – a classic example of prisoner's dilemma.

Figures for private banks may understate the true level of NPLs, in our opinion. We believe the data, especially those

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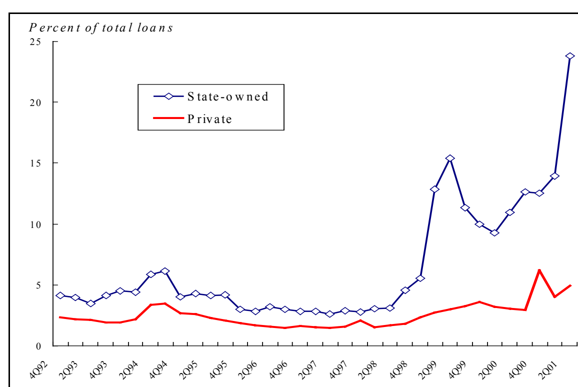
for private banks, understate the true level of NPLs. At the end of June, the NPL ratios for state-owned banks, insolvent banks under the management of the SDIF and private banks stood at 23.8% ($1.6 billion), 145.1% ($2.2 billion, due to fictitious loans) and 4.9% ($1.0 billion), respectively. The interesting issue is that private banks, which carry 71.2% of the country's outstanding loans to the non-financial sector, have a tendency for underreporting the true level of NPLs, in our view. Several (international) studies concur that banks tend not to fully report NPLs in order to avoid loan loss provisioning that actually lower earnings and worsen capital ratios. Therefore, the evident propensity suggests that the true extent of the problem could be much worse than the picture we present here with limited data.

Increased loan loss provisions have weakened banking sector profitability. Largely because of legislative ease, the ratio of loss reserves in the balance sheet to outstanding loans remained very low up until 1999, when a government decree introduced more stringent regulations. Based on the aggregate balance sheet for the banking sector compiled by the Central Bank of Turkey, between 1994 and 1999, the loan loss reserve ratio averaged 1.5% and increased to an average of 5.9% in the 1999-2000 period. Since the start of the year, owing to prudential regulations, the nationalisation of a large number of private banks and the recapitalization of public banks, the loan loss reserve ratio jumped to an average of 10.2% in the first half of the year. As the level of NPLs has started to creep up in recent quarters, the banks have had to book increased provisioning charges. On the aggregate basis, loan loss provisioning charges as a percentage of gross loans rose by 110% in the first half of the year, which has contributed to profitability being cut by more than half. In addition to foreign exchange losses and deteriorating interest margins, higher provisioning charges and a lower asset base

Exhibit 3

Non-Performing Loans by Banking Groups, 1992-2001



Source: Banks Association of Turkey, Morgan Stanley Research

due to lower net customer loans have meant that the industry has shown a pronounced decline in profitability. For example, return on assets (ROA), a common measure of bank profitability, declined by 8.8 percentage points to -14.7% in the first half of 2001, compared to the same period last year. All in all, to us, this suggests more downside than upside risk in bank earnings, as any future increase in bad loans would require additional provisioning, which would drag down earnings and the 'risk-carrying capacity'.

Loan penetration is low and credit rationing is paradoxically the only good news for banks. Compared to its peers, Turkey has a low loan penetration rate – credit stock to the private sector rose slightly from 14.1% of GDP in 1990 to 20.8% last year. Before the 1995 crisis, bank loans to the private sector in Mexico, for example, stood at 43.2% of GDP. Even though Turkish banks' minimal loan exposure to the corporate sector (due largely to the crowding-out effect of rising public-sector debt) has been a drag on growth, it has lowered the systemic NPL risk. Furthermore, credit rationing – channelling funds to favoured clients and related parties – that usually aggravates an economic slowdown is good news for banks in the current context. Therefore, save a prolonged recession, connected lending and concentrated credit exposure provide a cushion for the time being. In addition, though consumer loans recorded an impressive growth last year – rising from 2.7% of GDP in 1999 (and from 0.2% in 1990) to 5.4%, they have a rising but still relatively low NPL ratio – 6.5% in August, up from 2.7% at the end of last year. Nonetheless, with rising unemployment and evaporating income, consumer loans too could easily become a major portfolio risk *(Credit Crunch and the Indebted Consumer*, April 23, 2001).

Chicken or egg? Credit crunch worsens financing conditions, fuelling the deterioration in credit quality. The best indicator of risk on loan portfolio may be banks' own standards and terms for extending new loans. The above-mentioned data underscore the extent of tightening in the loan market. Against the backdrop of significant losses, banks have become risk averse and are providing fewer financial intermediary services. The collapse of the crawling peg exchange rate regime has reshaped liquidity preferences, leading to a significant contraction in lending activity. The ratio of bank loans to deposits dropped to 33.4% (38.8% including investment and development banks) in August, from 42.1% (47.0%) at the end of last year. As an inescapable side-effect, with troubled banks being forced to reduce exposure to the real economy and shrink their balance sheets to reduce the NPL ratio, the credit crunch aggravates

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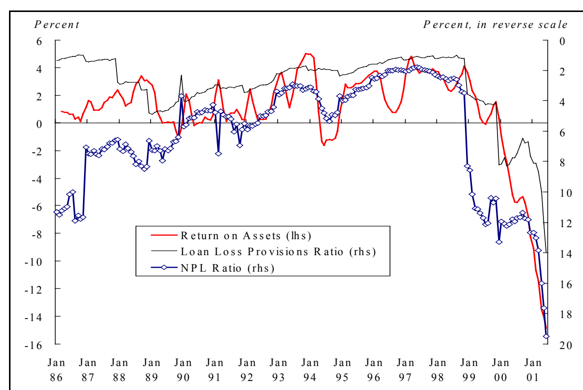
the steep economic slump and worsens financing conditions for the real economy. Of course, the very conditions that have caused the ongoing credit crunch also fuel the deterioration in credit quality.

Asset price deflation triggers 'margin calls' on loan collateral. Needless to say, financial and real asset prices in Turkey have been on a precipitous decline. The stock market index plunged by 58% in lira terms from this year's peak, while anecdotal evidence suggests significant deflation in property prices. All these mean that the value of collateral assets has eroded, possibly triggering demands for collateral increases. Furthermore, if a bank chooses to liquidate an asset amid a major financial crisis, the recovery ratio is likely to be substantially lower compared to the original estimate of asset value.

Turkey urgently needs a mechanism to maximise NPL recovery. Among other options, the authorities and private-sector representatives in Turkey are discussing setting up an asset-management company (AMC), along the lines of the US Resolution Trust Corporation (and more recent implementations in Indonesia, South Korea and Thailand), to deal with the coming NPL crisis. As a matter of fact, Turkey already has a similar institution – the SDIF's collection department. However, the problem is that Turkey doesn't have a secondary market for illiquid assets that would allow securitization of bad loans. Second, the recovery process could take much longer due to legal complications. In addition, even assuming the proposed AMC would purchase banks' NPLs at book value – that is, the purchase price will be determined by subtracting a bank's loan loss provisions from the value of its NPLs, the operation would have to involve 'some' public funds (i.e., a direct budgetary transfer or releasing banks' reserve requirements with the central bank). For example, to help reduce NPLs, Mexico provided for the banks to transfer part of its loan portfolio to the government, and gave the banks non-transferrable bonds in exchange. However, the government's involvement may generate concerns about the moral hazard of 'corporate bailouts', especially in Turkey, where institutional credibility has been damaged by numerous corruption allegations, and about the sustainability of public finances.

Exhibit 4
Non-Performing Loans and Bank Returns, 1986-2001



Source: Central Bank of Turkey, Morgan Stanley Research

Corporate workouts can ultimately lower the fiscal burden and accelerate the restructuring process. Although a 'one-off' operation is the best choice in the resolution of the NPL issue, the authorities simply don't have financial resources to write another big check, in our view. The available alternative is to let firms and banks work out individually tailored repayment plans. The so-called 'London Approach' basically involves a voluntary rescue operation for firms under financial distress by providing a breathing space. Through co-ordinated workouts and asset-backed securitization, banks could indeed minimise their losses and the economy at large suffers less as bankruptcies decline and moral hazard is minimised, we think. In short, given the concentration in credit diffusion and the country's already challenging public-sector debt dynamics, we see corporate workouts as the most appropriate way to resolve the NPL problem. In general, the speed and extent of recovering bad loans depend on legal efficiency and institutional credibility. Finally, the designers of a solution for the NPL problem should foremost consider the associated fiscal burden and its impact on the public-sector debt dynamics.

Non-performing loans are a financial accelerator, aggravating economic recession. The increasing number of failed business enterprises presents an apparent risk of bankruptcy contagion with further consequences for the financial system. Undoubtedly, the adverse balance sheet effects will remain a drag on the economy for a long time. Therefore, restructuring the banking industry ought to remain as one of the most important policy objectives. Hopefully, bank restructuring will eventually trigger a corporate restructuring as well, improving the country's economic fundamentals, competitive landscape, and thus potential growth rate.

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Essays & Comments

Poland

Pondering the Politics

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Surprising election outcome. Like most observers, we were surprised that the Democratic Left Alliance (SLD) did not manage to get an absolute majority during the September 23 election. Not only is the SLD well short of a clear majority, but the sudden rise of the populist Self-Defence party (SO) and the League of Polish Families has caused concern in some quarters. The final shares of the vote and seat numbers are given in Exhibit 5 and show that the SLD gained 216 seats in the 460-seat lower house (Sejm). In the medium term, however, we do expect the incoming government to be an improvement on that of the last two years, and believe the case for very substantial interest rate cuts remains strong.

New government should be forward by the end of October. The first sitting of the new parliament (Sejm) is now due on October 19. The president has nominated SLD leader Leszek Miller as Prime Minister. He must now propose a cabinet, to be sworn in no later than 14 days after the Sejm's first sitting. The Prime Minister then has another 14 days to submit a government work plan for the Sejm's approval. The SLD has already initiated discussions with the other parties.

PSL most likely coalition partner. The Peasant's Party (PSL) was the SLD's partner in the 1993-97 government. Whether or not the PSL has become more moderate since then, the risk of being outflanked by Andrzej Lepper's more extreme Self-Defence party will put it under pressure to drive a hard bargain. Before the elections, the PSL was demanding greater state aid for farmers, higher taxation for foreign companies and cuts in transfers to private pension funds. It expressed particular interest in agriculture, education, defence and economics portfolios. It remains highly protectionist and fiercely opposed to compromise on the 18-year moratorium on land sales to foreigners. Any such deal could be market-negative in the short term, although we would not expect the SLD to enter into a coalition unless it was reasonably confident that its main policy objectives were not being compromised. In that respect, senior officials from SLD and PSL have already come to agreement on some aspects of the 2002 budget.

Other coalitions less likely. We see few other realistic options for a formal coalition. Both the SO and the League of Polish Families contain populists who at first glance appear unlikely to be palatable to the SLD. Their strong showing is probably more a reflection of a low turnout, and perhaps an emphasis on security issues after the recent terrorist events, than a strong base of support. Both parties are likely to be wary of the experience of the Smallholders in Hungary, who were fairly quickly neutralised within government. Initial discussions between the SLD and the SO appear to have gone fairly well and there are some suggestions that Mr. Lepper is toning down his rhetoric. Like most observers, he is no doubt surprised to find himself heading the third-largest party in the Sejm. We would not rule out some form of co-operation agreement with the SLD, given both parties' left-wing leanings. A formal alliance between the SLD and the Civic Platform (PO) would be welcomed by the market but would not seem to be in the Platform's interest, leaving its aspirations to be the future of the right-wing opposition vulnerable to attack from the right.

Minority government is feasible, but less likely than a coalition. A more market-friendly option, which should definitely not be ruled out, would be for a minority government. This is a more feasible option in Poland than it might be elsewhere. The formation of a government requires a confidence vote from a majority of deputies present in parliament, and would require at least a short-term deal with part of the opposition. After that, however, votes of no-confidence require an absolute majority of eligible deputies, and have to be constructive, proposing an alternative prime minister. It is hard to imagine the present opposition uniting on a candidate. It is also quite possible to imagine the SLD achieving significant parts of its economic agenda with the co-operation or the abstention of the PO.

Government to be more effective than the outgoing one. While a coalition or minority government reduces the chances of active structural reform our expectations were not that high anyway. Whatever structure the final government takes it should however be an improvement on the current situation. The SLD/UP's final total of seats is greater than the outgoing AWS's 201 (many of whom were semi-detached at best), and the opposition is more fragmented. The SLD will also be able to count on the two German

Please refer to important disclosures at the end of this report.

minority deputies, who have an incentive to vote with the government of the day. The possibility of minority government also strengthens the SLD's hand in any coalition negotiations. We are hopeful that Marek Belka need not be sacrificed as finance minister (though it is worth noting his reservations about serving in a coalition). We also do not believe that the SLD would allow its prospects of EU accession in the first round to be seriously compromised. This remains a central platform of SLD policy, and there may even be pressure within the EU to respond to signs of discontent by offering negotiation concessions.

Rate cuts to continue. The short-term uncertainty on policy is likely to have been the main cause of the National Bank's pause on interest rate cuts in September. Near term, the focus for the market remains on the finance minister's position. In our view, confirmation of the appointment of Marek Belka would be positive for the market, while an alternative compromise candidate would disappoint in the near term. But as we have argued before, longer term the key factor is not so much who takes the finance minister's position, but that they have the support of the leadership. We see Belka's appointment as the most likely scenario, even if his pre-election comments about the need for fiscal austerity may have cost the SLD some votes and upset leader Miller. Any decision not to appoint Belka as part of a coalition compromise would be seen as a major back down for the SLD.

In the longer term, we believe the case for substantial interest rate cuts remains strong. Presuming that Marek Belka takes up the position of finance minister, we continue to expect a reasonable level of fiscal discipline to be maintained, despite possible pressure from the PSL. We now expect GDP growth this year to be as weak as 1.8% in 2001, with second quarter figures confirming a collapse in fixed investment. With oil prices at current levels, we also see downside risks to our end-year inflation forecast, which at 4.8% is already below The Monetary Policy Council's target for the end of next year. We continue to look for at least 400bp in rate cuts over the next 12 months, extending the recent fixed income rally and further improving equity valuations. With rate cuts likely to boost fixed investment, we are looking for GDP growth to recover to around 2.8% next year, despite the rapidly worsening external outlook.

Exhibit 5

Polish Election Results, 2001

Party	Sejm Seats	% of Votes	% of Eligible Voters	Senate Seats
SDL/UP (Reformed communists)	219	41.0	19.0	75
PO (Market-friendly right-wing alliance)	65	12.7	5.9	-
Self-Defence (Populist peasants party)	53	10.2	4.7	2
Law and Order (Hard right)	44	9.5	4.4	-
PSL (Rural lobbyists)	42	8.9	4.1	4
League of Polish Families (Catholic, anti-EU)	38	7.9	3.7	2
AWS (former government)	0	5.6	2.6	-
UW (Freedom Union, centre right)	0	3.1	1.4	-
German minority (guaranteed 2 Sejm seats)	2	0.4	0.2	0
RW Blok (Senate coalition of PO, PiS, AWS, UW)	-	-	-	15
Independent	-	-	-	2
Total	460	100	46.3	100

Source: Reuters, State Electoral Commission

Please refer to important disclosures at the end of this report.

Country Updates

Poland

Inflation, Current Account and Growth Remain Subdued

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We remain reasonably upbeat on the likely results of coalition/minority government discussions (see our essay, *Pondering the Politics*). Aside from the politics, macroeconomic developments have given some cause for cheer for fixed income investors, with a continued subdued inflation outlook, weaker-than-expected domestic demand growth in 2Q and a continued impressive current account performance. We have revised down our growth forecast for 2001 and now see year-end inflation below 5%. The big unknown, of course, remains the budget. We remain confident that the incoming government will implement a realistic budget for 2002.

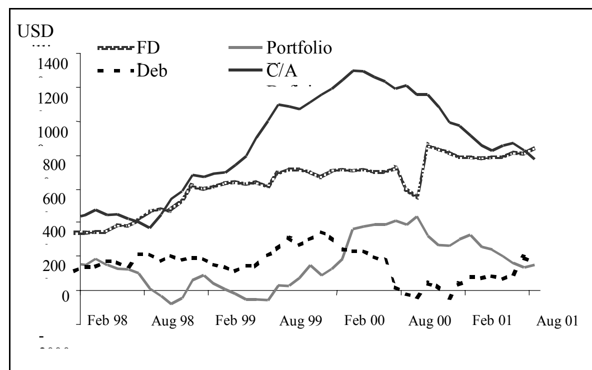
Headline inflation fell to 5.1% year on year as at August. All the National Bank's (NBH) measures of core inflation declined. With food prices continuing to remain subdued, we see prospects for inflation ending the year below 5% absent a large spike in oil prices and the imposition of import duties, even taking into account possible higher excise taxes and VAT.

GDP grew just 0.9% year on year in 2Q. That weak growth and a continued decline in domestic demand have led us to revise down our full year GDP forecast to 1.8%. We are, however, keeping our 2002 forecast at 2.8%. The slowdown in domestic demand has been sharper than anticipated and we expect that it is now reaching a plateau. There are signs, for instance, that industrial production may have bottomed. In addition, we continue to look for rate cuts of the order of 400bp or so over the next year. Cuts of that magnitude should help ensure that domestic demand takes over as the driver of growth in 2002.

Current account performance continues to improve, with August data showing a lower-than-expected deficit and better-than-expected export growth. While the 17.4% growth in August exports compared with a year ago may be something of an aberration, there is no denying the robust performance in the face of a European slowdown. The 12-month cumulative deficit has now fallen to well below 5% of GDP.

The budget remains the big area of uncertainty. The outgoing government submitted its 2002 budget to the Lower House of the parliament (Sejm) by the required date of September 30. Unfortunately, even though the budget targets a deficit of PLN 40 billion, it has failed to address most budgetary concerns and also incorporates a problematic import duty. The task of producing a budget acceptable to the MPC and the broader investor base will be left to the incoming SLD government.

Exhibit 6
Current Account Deficit and Financing, 1998-2001



Source: National Bank of Poland

Exhibit 7
Poland: Latest Economic Indicators

(%)	Latest: Reference Period	Latest: Outcome	Previous: Reference Period	Previous: Outcome
CPI	Aug	5.1YoY	Jul	5.2 YoY
PPI	Aug	0.8YoY	Jul	0.6 YoY
Industrial Production	Aug	0.7 YoY	Jul	0.9 YoY
Merchandise Exports (in $ Terms)	Aug	17.4 YoY	Jul	3.3 YoY
Merchandise Imports (in $ Terms)	Aug	3.1 YoY	Jul	-3.8 YoY
Trade Balance ($ million)	Aug	(1042)	Jul	(825)
Current Account Balance ($ million)	Aug	(392)	Jul	(285)
Official Reserves ($ billion)	Aug	28.0	Jul	27.9

YoY = Year on year *Source: NBP, GUS, Datastream, and Morgan Stanley Research*

Please refer to important disclosures at the end of this report.

Country Updates

Czech Republic

CNB Still on Guard

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The chances of the interest rate hike we expected before the end of the year have receded. We are making a small cut to our GDP growth forecast for this year to 3.7%, and a larger cut for next year, to 3.4%. Yet with domestic consumption growth accelerating, an interest rate hike within the next six months still cannot be entirely ruled out.

First half GDP growth very strong. GDP growth in the second quarter was 3.9% year on year, from an upwardly revised 4.1%Y in the first quarter. Gross fixed investment was particularly strong, up 9.3%Y, reflecting resilient green-field foreign investment inflows. With energy sector privatization apparently still on track, we believe that such high levels can be maintained into next year. Private consumption growth is also accelerating, to 4.2%Y in 2Q from 3.5% in 1Q. However, the external outlook has clearly deteriorated, and with 42% of industrial sales going abroad, and foreign-controlled companies accounting for 41% of sales, the Czech Republic is unlikely to emerge unscathed. We are cutting our export growth forecast for this year to 10.8%, and for next year to 8%, taking GDP growth for next year down from 3.9% to 3.4%.

Inflationary pressure already abating. August CPI was down 0.2% on the month to 5.5%Y, from 5.9%Y in July. Food prices were down 1.6% on the month, but even excluding these, we calculate that inflation ticked down to 5.3% from 5.4%. With net CPI, excluding regulated prices, down from 4.7%Y to 4.1%Y, inflation is now (just) back within the ranges forecast by the CNB in July. At the same time, money supply growth slowed slightly in August, M2 growth falling to 12.8% from 13.3% in July. Consumer credit continues to contract while lending to enterprises has slowed. Finally, current oil price levels, if sustained, will be highly welcome. With net oil and gas imports last year worth 7.7% of GDP, the Czech Republic is the most significant net beneficiary of lower oil prices in central Europe.

But CNB still on alert. National Bank Governor Tuma struck a relatively hawkish tone in comments after the latest monetary policy meeting, saying that inflation risks remained, and that the bank would be focusing on wage growth. Here the latest data show real industrial wage growth slowing to 1.6% year on year in July, a level that the bank is likely to be more comfortable with. However, wage growth in the whole economy, released only quarterly, is growing more quickly. Nor can the bank be reassured by fiscal developments. The loss of the CME arbitration case means a potential bill to the state of $500-600 million. The cabinet has approved an average 7.8% pension increase, effective from December, and further subsidies to all families with children. The chances of the current budget proposals receiving parliamentary approval look increasingly remote. Meanwhile, the National Property Fund has warned that delays and disappointing revenue from privatization have left it unable to fund mandatory transfers to Konsolidacni Agentura and the State Housing and Infrastructure Funds. With around $6 billion likely to come in from sales of energy utilities next year, domestic short-term borrowing is a viable option, but interest rate risks remain on the upside.

Exhibit 8
Czech Republic: Latest Economic Indicators

	Latest		Previous	
(%)	Reference Period	Outcome	Reference Period	Outcome
CPI	Aug	5.5 YoY	Jul	5.9 YoY
Net CPI	Aug	5.1 YoY	Jul	4.7 YoY
PPI	Aug	2.4 YoY	Jul	3.0 YoY
Industrial Production	Jul	9.3 YoY	Jun	3.7 YoY
Merchandise Exports (in Kcs Terms)	Aug	8.1 YoY	Jul	14.3 YoY
Merchandise Imports (in Kcs Terms)	Aug	6.7 YoY	Jul	16.8 YoY
Trade Balance (Kcs billion)	Aug	(14.2)	Jul	(18.6)
Current Account Balance ($ million)	2Q 01	(548)	1Q01	(583)
Official Reserves (€ billion)	Aug	14.8	Jul	14.9

YoY = Year on year
Source: CNB, Datastream, Reuters, and Morgan Stanley Research

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Country Updates

Slovakia

Improving Internally, Worsening Externally

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Domestic political developments have reinforced our optimism that the government will survive until next September's elections. However, the worsening external environment has caused us to lower our growth forecast for next year. Such conditions will clearly not make it easier for the governing pro-western coalition to recover its popularity as elections approach.

2001 GDP forecast remains at 2.7%. GDP growth in 2Q slowed to 2.8%Y, from 3.0% in the first quarter. Household consumption growth was strikingly weak, down to 1.7%Y from 4.0% in 1Q. Gross fixed investment remains the main source of growth, up 12.6%Y. Export growth fell sharply, from 13.1% to 7.2%, while imports actually accelerated slightly, from 15.0 to 15.8%. We continue to expect 2.7% GDP growth for the year as a whole, well below the government's 3.2% forecast. We expect a modest export recovery in 4Q as Volkswagen production picks up after recent holidays and model upgrades. Household consumption growth may also be boosted slightly by the repayment of privatization bonds, around SKK 15 billion of which are held by domestic households.

Cutting next year's GDP growth to 2.9%. For next year, however, the outlook has clearly worsened. We now see little prospect of a sustained export recovery before the end of next year. Indeed, we now expect the 2002 current account deficit to approach 10% of GDP, from around 7.6% of GDP this year. We remain optimistic that foreign investment and planned privatizations will not be affected significantly. The bulk of recent import growth has been in manufactured intermediate goods, vehicles and raw materials. Assuming no delays to the SPP sale, the current account will still be comfortably covered by FDI. However, with 60.3% of exports in the year to date going to the EU, and 27.4% to Germany, we have cut our forecast for real export growth next year from 12% to 8% and our GDP growth forecast from 3.3% to 2.9%. With inflation still at 7.8% in August, and administered rises to come, there is clearly little room for the National Bank to follow the global trend for monetary stimulus.

Political situation stabilizing. We continue to expect the current governing coalition to hold together. The cabinet's approval of a draft law transferring powers to the newly formed regional authorities clearly improves the prospect of the SMK staying within the coalition. The next hurdle is likely to be this autumn's gas price rises, an important precondition for SPP privatization but politically highly sensitive. We expect agreement to be reached on a 15-20% rise. With unemployment still at 17.8% in August, and the external environment worsening, rebuilding popularity ahead of next year's elections is likely to be challenging.

Exhibit 9
Slovakia: Latest Economic Indicators

	Latest		Previous	
(%)	Reference Period	Outcome	Reference Period	Outcome
CPI	Aug	7.8 YoY	Jul	8.0 YoY
Core CPI	Aug	4.9 YoY	Jul	5.2 YoY
PPI	Aug	6.1 YoY	Jul	6.6 YoY
Industrial Production	Jul	6.5 YoY	Jun	6.3 YoY
Merchandise Exports (in SKK Terms)	Aug	12.7 YoY	Jul	10.8 YoY
Merchandise Imports (in SKK Terms)	Aug	19.3 YoY	Jul	26.0 YoY
Trade Balance (SKK billion)	Aug	(8.1)	Jul	(8.4)
Current Account Balance (SKK billion)	Aug	(3.6)	Jul	(10.2)
Official Reserves ($ billion)	Sep	3.9	Aug	3.8

YoY = Year on year *Source: NBS, SUSR, Datastream, Reuters, and Morgan Stanley Research*

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Country Updates

Hungary

Vulnerable to More Risk Aversion

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Financial markets are vulnerable to risk aversion. During the last few weeks, the forint has been trading at levels seen immediately after the exchange rate band widening in May. Market participants who wanted to establish long forint positions against the EUR – or to add existing ones – would therefore have done so from around current levels (see Exhibit 10) That positioning opens up the possibility that both the currency and the bond markets could be vulnerable to any further periods of risk aversion and position reduction. Likewise, local participants (corporates) who have foreign currency liabilities must be wondering whether they should now hedge.

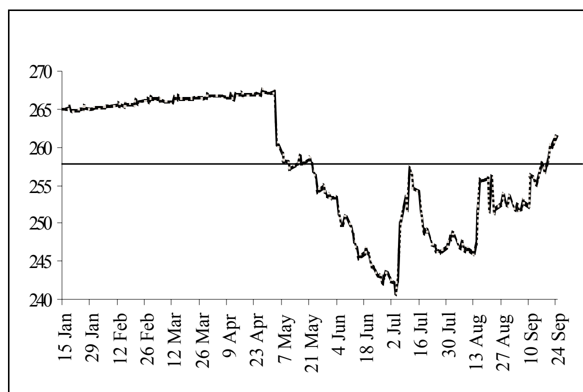
Hungary has been the regional market of choice for a number of investors for some time. When the choice was between Hungary and the relatively volatile Polish market with uncertainties over the budget, the elections and what was for a long time a very steeply inverted yield curve, or the low yielding Czech market, many investors preferred to have their overweight positions in Hungary. Foreign investors quickly built up Hungarian bond positions. Non-resident holdings grew from HUF 145 billion after the Russian crisis in 1998 to more than HUF 1,000 billion by June of this year (see Exhibit 11).

The importance of these inflows into the debt markets for the financing of the current account can be seen in Exhibit 12. When there was some perceived pressure on the current account deficit in 1999, the National Bank liked to focus on the fact that the deficit was financed by non-debt creating financing – essentially foreign direct investment and portfolio equity flows. Over time we would expect debt financing to be relatively more significant as large one-off investments decline and as the lowly geared corporate sector looks to increase leverage. When inflows take the form of a rapid build-up in foreign ownership of fixed income securities, there is always the potential for short-term outflows and currency adjustment during periods of risk reduction.

In our view, Hungarian bonds have looked expensive for some time on an implied forward basis, especially compared with Poland. It seemed as if market participants were taking the view that the currency would remain reasonably stable against the EUR and the bonds therefore provided a healthy pick-up to Bunds. Those assumptions were first shaken by the currency sell-off in early July. They are being challenged again now, and that could lead to a reduction in unhedged bond positions, with negative implications for the currency.

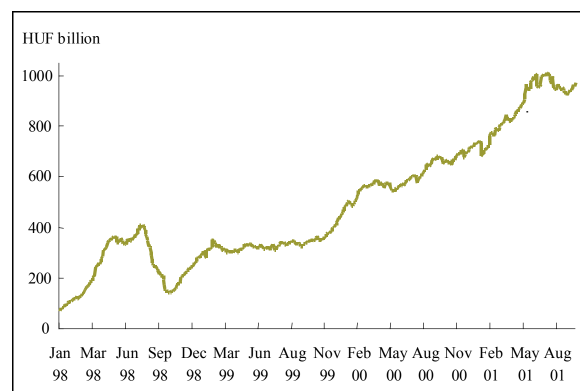
Present levels for the currency are now some way from the EUR/HUF 245-250 range deemed appropriate by the National Bank (NBH) back in July in order to meet its inflation target. NBH Governor Jarai has since then

Exhibit 10
EUR/HUF Exchange Rate, 2001



Source: Reuters

Exhibit 11
Non-Resident Holdings of Bonds,1998-2001



Source: AKK

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noted that the inflationary outlook is more subdued, with EUR/USD slightly stronger and oil prices lower. Given those factors, Jarai has suggested that inflation objectives would not be compromised with an EUR/HUF 250-260 target range. That may be so, but the risks to the 2002 target of 3.5-5.5% must have increased. With some exchange rate uncertainty, it came as no surprise that the National Bank Council decided to keep rates on hold at its first meeting following the events of September 11. It argued that, in these uncertain times, it was appropriate for the differential between Hungarian and euro rates to widen out. We agree. One of the implications of the more cautious NBH stance is that the aggressive interest rate cuts that the curve had been pricing in are now threatened. That, in turn, means that the cost of carry on longer-dated Hungarian bond positions might be higher than originally anticipated and some investors may look to reduce positions as a result.

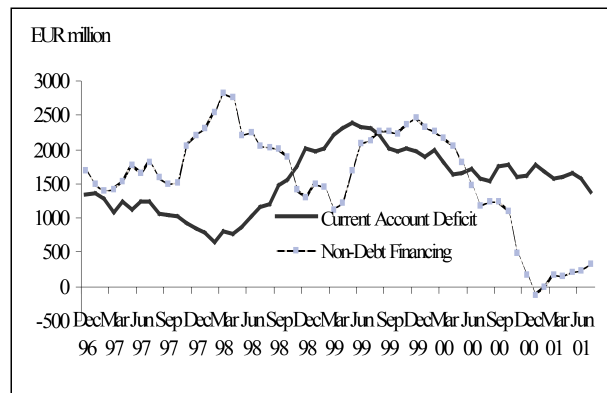
The government's more expansive fiscal stance, which will see higher-than-budgeted revenues being spent, will likely also pose its own challenges. The budget deficit for 2001 and 2002 will not change, but off-budget expenditures will be significantly higher than in 2000. Finance Minister Varga initially announced plans to increase expenditure back in August. That boost has taken greater relevance following the attack in the US and the further reduction in global growth expectations. The government, which faces elections next year, has now announced that it will accelerate spending on road building and housing among other things in an effort to keep growth at 4%. We have lowered our growth forecast for 2002 to 3.3% on the worsening global outlook.

While we consider that the inflation outlook is the most important factor influencing the yield curve, we cannot ignore the risk of a future potential increase in the supply of bonds. From this perspective, the NBH has confirmed that Hungary will not enter the foreign currency debt market next year and will instead issue local currency debt to repay the principal on maturing foreign currency debt (interest payments are already financed from local currency issuance). That will mean that the net issuance of domestic currency debt will increase from HUF 400 billion in 2001 to HUF 750 billion in 2002.

The increase in the supply of bonds gives reason to pause for thought. The concept of issuing more local currency debt clearly has longer-term merits for a country with higher-than-desired (and costly) foreign exchange reserves. Those reserves were built up as the NBH bought foreign currency when the forint traded at the strong end of its exchange rate band. Reserves are costly to maintain . So, the idea having the Ministry of Finance buy foreign exchange from the NBH, running down reserves, in order to pay down debt makes sense. Furthermore, over the longer term there is an expectation that there will be significant foreign inflows as the EMU convergence process continues. However, we have some doubts about the ability of the market to absorb significantly higher volumes of issuance without impacting the curve – particularly given the recent market performance and somewhat disappointing auctions.

Exhibit 12

Current Account Deficit & Financing (Rolling 12-Month)



Source: National Bank of Hungary

Exhibit 13

Hungary: Latest Economic Indicators

	Latest		Previous	
(%)	Reference Period	Outcome	Reference Period	Outcome
CPI	Aug	8.7 YoY	Jul	9.4 YoY
PPI	Aug	3.3 YoY	Jul	4.4 YoY
Industrial Production	Jul	0.0 YoY	Jun	-0.4 YoY
Merchandise Exports (in € Terms)	Aug	2.1 YoY	Jul	24.7 YoY
Merchandise Imports (in € Terms)	Aug	4.2 YoY	Jul	19.1 YoY
Trade Balance (€ million)	Aug	(96)	Jul	(110)
Current Account Balance (€ million)	Aug	259	Jul	191
Official Reserves (€ billion)	Aug	13.1	Jul	13.5

YoY = Year on year

Source: NBH, Datastream, Reuters, and Morgan Stanley Research

Please refer to important disclosures at the end of this report.

Country Updates

Russia

Oil, Budget and Banking Reforms

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We are slightly adjusting our growth forecast for Russia for 2001 to 5.1% from 5.2% on the back of recent declines in oil prices. Our forecast for 2002 remains unchanged at 4.6% as it already incorporates a decline in oil prices to an average of 22.7 dpb from this year's forecast average of 23.9 dpb. Still, if recent oil price declines prove lasting and result in revisions to our oil team's view for 2002, Russia's growth in 2002 is also likely to be revised downwards.

Our economic growth scenario is based on continued growth of household consumption, which over the last year has proved resilient to near-term fluctuations in Russia's economic activity and oil prices. The Russian consumer continues to be optimistic about the future and consumer spending continues to recover from the 1998-99 crisis. On the other hand, investment spending is clearly vulnerable to oil price volatility, as retained corporate earnings finance as much as 50% of fixed capital financing in the Russian economy.

The Duma approved the main parameters of the budget in the first reading, after the government revised the revenue side to reflect the demands by the Duma budget committee. We see this as a positive event, as it does not materially weaken the government's fiscal position but improves transparency and accountability of fiscal policy.

Banking sector development strategy, approved by the government, signals very gradual approach to reforms. The strategy finally defines medium-term goals and reform measures in the sector. However, the document effectively rules out any radical changes and adopts the least aggressive reform vision from various versions debated locally. Russia will continue to have an enormous number of small and poorly capitalized private banks (currently about 1,200). On the other hand, state-owned Sberbank's effective monopoly position will be maintained. Sberbank accounts for 75-80% of all household deposits and 32% of all commercial credits in the country.

The banking system's significance for the economy will likely remain marginal in the upcoming years in our view. Moreover, the slow pace of banking system reform will continue to hamper the broadening of Russia's economic growth outside the cash flow-rich commodity sectors. Total banking sector assets have struggled to grow in line with Russia's economy and account for only 33% of GDP. Total commercial bank credit to the private economy is only 13% of GDP and has remained at this level for the last three years. According to Goskomstat data, only 4% of capital investment in the economy is financed by commercial bank credit.

Still, certain elements of the newly approved strategy are important to point out. First, the strategy envisages that Sberbank's effective monopoly will be maintained. However, in the longer term, gradual competition will be introduced, although it will come from the other two state-owned banks, Vneshtorgbank and Vneshekonombank, which will expand their commercial banking activities. The latter will see its role as the government's agent for external debt

Exhibit 14
Revised Budget Targets Increased Surplus

% GDP	Budget 2002 (initial version)	Budget 2002 (current version)
Total revenues	18.8	19.4
Tax revenues	15.3	15.8
Total spending	17.7	17.8
Primary surplus	6.3	6.8
Budget balance	1.2	1.6

Source: Ministry of Finance

Exhibit 15
Sources of investment financing by large and medium-sized enterprises in 1Q01 (%)

	New capital formation
Enterprise savings (retained profit and amortization)	50.0%
Commercial bank credits	4.0%
Other non-budgetary loans	6.0%
Consolidated budget and off-budget funds	24.0%
New equity	0.1%
Other	15.9%

Source: Goskomstat

Please refer to important disclosures at the end of this report.

separated and transferred to a separate agency. The central bank is obliged to reduce its share in Vneshtorgbank by January 2003. Second, the strategy does not introduce a minimal capital requirement for existing banks, contrary to pressures from the country's larger banks. Third, the document envisages lifting of the restrictions on foreign banks to open branches in Russia. Fourth, deposit insurance is to be eventually introduced, but the system is to be in place only by 2004 at the earliest. Finally, the strategy calls for introduction of international accounting standards in the entire sector by 2004.

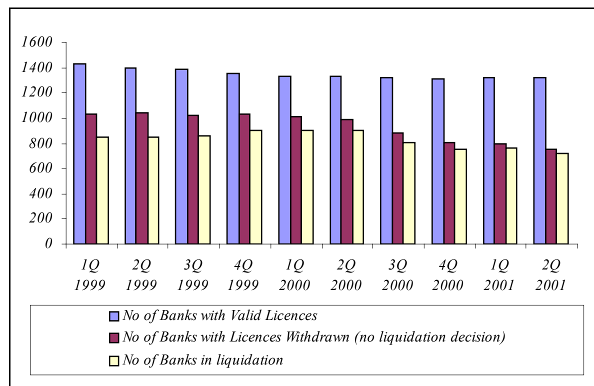
There are several important issues relating to banking sector reform that are only being addressed slowly, and will continue to hamper the sector's development.

Implicit support for state-owned banks. Sberbank continues to dominate the household deposit market and is increasing its share in commercial lending. In the reaction to the 1998/99 crisis, retail depositors fled to quality and moved deposits to Sberbank, which enjoys an implicit government guarantee. The process is very slow to unwind. The government's intention to encourage deposit-taking and greater commercial lending by the other two state-owned banks – Vneshekonombank and Vneshtorgbank – will continue to crowd out private banks from the retail deposits and the corporate lending business.

Deposit insurance. An effective deposit insurance system would be a critical instrument to boost public confidence in private banks, allow private sector banks to start competing for retail deposits and eventually to dismantle the Sberbank's monopoly. On the other hand, an introduction of deposit insurance should only cover banks which obey proper transparency and capital adequacy rules, and are effectively supervised to prevent future potential moral hazard issues.

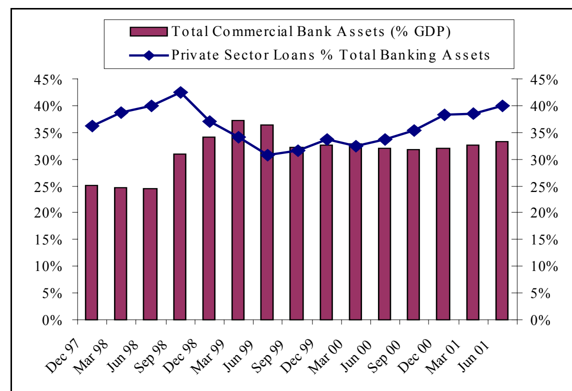
Minimal capital requirement. The banking development strategy failed to introduce a minimal capital requirement for existing banks. The central bank said it would consider introducing minimal capital requirements in the future but said it was reluctant to withdraw licenses "merely on the basis of undercapitalization". Lack of minimal capital requirement is largely responsible for the extraordinarily large number of banks in the country and restricts the consolidation that is needed in Russia's banking sector.

Exhibit 16
Russian Banking System Structure is Slow to Change



Source: CBR

Exhibit 17
Banking Sector Assets and Loans



Source: CBR

Exhibit 18
Russia: Latest Economic Indicators

	Latest		Previous	
(%)	Reference Period	Outcome	Reference Period	Outcome
CPI	Sept	20.2 YoY	Aug	21.0 YoY
PPI	Aug	17.3 YoY	Jul	19.2 YoY
Industrial Production	Aug	5.1 YoY	Jul	4.5 YoY
Unemployment Rate	Aug	8.2	Jul	8.3
Merchandise exports ($ billion)	Jul	8.0	Jun	9.1
Merchandise Imports ($ billion)	Jul	4.2	Jun	4.6
Trade Balance ($ billion)	Jul	3.8	Jun	4.6
Current Accounts ($ billion)	2Q01	9.5	1Q01	11.7
Official Reserves	21 Sept 01	37.8	14 Sept 01	37.1

YoY = Year on year

Source: NBH, Datastream, Reuters, and Morgan Stanley Research

Please refer to important disclosures at the end of this report.

Country Updates

Ukraine

The Mighty Disbursements

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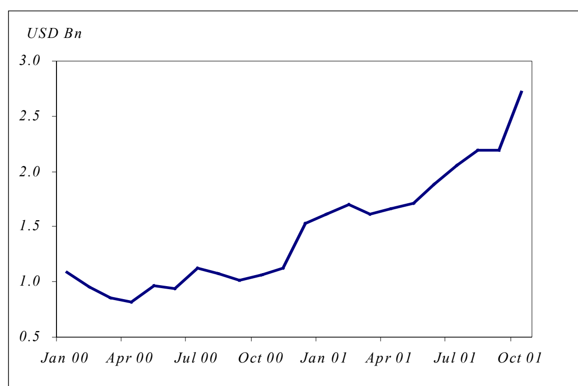
The $626 million IMF and World Bank loans approved on September 20 were a significant boost to confidence in the economy. The decisions to disburse funds to the central bank (NBU) for reserves and for structural reform projects were taken, as we expected, and further support is likely if structural reform gathers pace as we widely expect after parliamentary elections in March 2002. The impressive economic story remains intact, with double-digit growth in many sectors of the economy. We expect strong growth to continue through 2002, although it is likely to be somewhat weaker than in 2001. Furthermore, we expect parliamentary elections to improve the composition of parliament, with a stronger pro-reform contingent, which has been weak in previous parliaments.

IMF and World Bank disbursements are extremely positive to Ukraine's credit standing and economic stability, in our view. In addition, Ukraine can also get one more IMF tranche this year or after the 2002 budget discussions. The IMF disbursed $376 million, while the World Bank disbursed nearly $150 million immediately, with another $100 million to be released by year-end. The injection of reserves should promote stability and give the government an improved backdrop to pursue reforms. Ukraine had relatively low reserve levels of 1.4 months of imports in January 2001, which gradually rose to 1.9 months of imports in August 2001. Following the IFI disbursements, reserve levels have jumped to 2.3 months of imports, much closer to the 3 months of imports level that is considered a benchmark level of stability. Continuation of the program and further disbursements will undoubtedly be dependent on a renewed reform effort, following parliamentary elections, which has stalled since the political crisis faced by the government early in 2001.

Although likely to slow down in the coming months and in 2002, the economy is poised to continue to grow convincingly in the medium term, in our view. GDP growth registered 10.8% for the Jan-Aug 2001 period, helped significantly by strong growth rates in the industrial and agricultural sectors (see Exhibit 20). The boost in agriculture stems from favorable crop conditions throughout Eastern Europe, increased productivity and, in part, to the reforms initiated by the ex-PM Yuschenko. After years of decline or stagnant growth, the vibrancy of agricultural production is an extremely welcome sign, and could create some impetus for further agricultural reform in the near future.

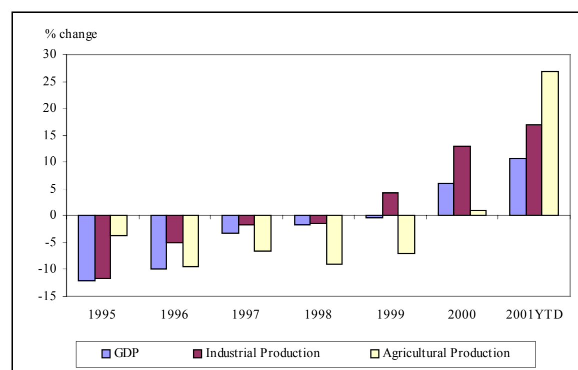
Industrial production is likely to remain near double-digit growth rates in the near term, though it is likely to decelerate, as it has been the past few months. Industrial production is up 16.9% for Jan-Aug 2001, despite the significant slowdown seen in the past three months –

Exhibit 19
IFI Disbursements Boost CB Reserves to All-Time Highs



Source: National Bank of Ukraine

Exhibit 20
Agricultural Production Now Also Contributes to GDP Growth



Source: State Statistics Committee

Please refer to important disclosures at the end of this report.

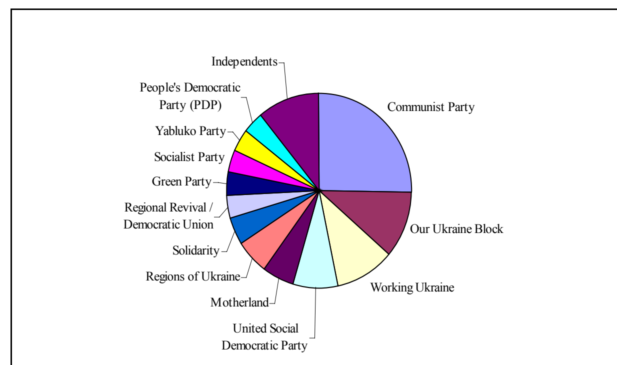
from 16.9% in June to 13.5% in July and 11.5% in August. Even with the deceleration, we still believe industrial production growth will end up in double digits for all of 2001. However, next year is likely to see meaningfully slower growth without a significant increase in the pace of structural reform after parliamentary elections.

The political landscape is set to improve after the March 2002 parliamentary elections, in our view. Part of our view takes into account the current anti-reform composition of parliament, which is dominated by communist, agrarian and "oligarch" factions. The Communist Party, led by Petro Symonenko, is likely to maintain most of its Duma influence, which currently stands at 25%. Aside from the entrenched communists, the key player in the upcoming election will be Victor Yuschenko, the former PM, who has created a block that is poised to secure a significant part of the parliament. However, the current PM, Anatoly Kinakh, may also be able to exert some influence, as he has made quick strides in trustworthiness with the population, and is currently the third most-trusted politician after Yuschenko and Symonenko, with a 13% approval rating.

Much hope lies in the former PM Yuschenko, who has created the "Our Ukraine" block to consolidate right forces for the upcoming March 2002 parliamentary elections. Yuschenko has already been successful in consolidating some parties into his coalition and would currently have 51 of the 450 seats of parliament. The success of his coalition will depend on his ability to manage many fractions with differing interests. While Yushcenko is the most trusted politician, with roughly 30% support in polls, public perception could be affected by whom he allies himself with. Thus far, Yuschenko has not been critical of Kuchma, but is also holding talks with anti-Kuchma parties. This balancing act may prove difficult in the longer term and, ultimately, we believe Yuschenko will be forced to choose one side. He has been reluctant to move into the opposition and believes this is not a beneficial strategy. This move could potentially alienate some of the smaller anti-Kuchma parties, but should not deal his movement a serious blow. Regardless, we would view any significant parliamentary block led by Yuschenko as likely to promote a higher level of reform and as positive for the political stability of the country.

Exhibit 21

The Current Parliamentary Breakdown with "Our Ukraine" Block



Source: Verhovna Rada of Ukraine

Exhibit 22

Ukraine Latest Economic Indicators

	Latest		Previous	
(%)	Reference Period	Outcome	Reference Period	Outcome
CPI	Aug	9.6 YoY	Jul	8.7 YoY
PPI	Aug	7.1 YoY	Jul	7.9 YoY
Industrial Production	Aug	11.5 YoY	Jul	13.5 YoY
Unemployment Rate	Aug	3.7	Jul	3.7
Merchandise exports ($ million)	Jul	1,317	June	1,502
Merchandise Imports ($ million)	Jul	1,228	June	1,330
Trade Balance ($ million)	Jul	134	June	173
Current Accounts ($ million)	2Q01	567	1Q01	278
Official Reserves	1 Oct 01	2,723	7 Sept 01	2,189

YoY = Year on year

Source: NBH, Datastream, Reuters, and Morgan Stanley Research

Please refer to important disclosures at the end of this report.

Country Updates

Turkey

In the Doldrums

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Domestic demand has collapsed and the global crisis will slow export growth. Following the unprecedented year-on-year contraction rate of 44.1% in the first half, we continue to project deteriorating domestic demand in the remainder of this year on the back of the negative income/wealth effect of rising interest rates and currency devaluation, tight fiscal and incomes policies, and the credit crunch. To boot, the global crisis introduces new barriers to Turkey's ailing export performance, which worsened to a real growth rate of 7.6% in the second quarter from 10.1% in the first quarter (and from an average of 19.2% last year).

Increased risk aversion and dollarisation will only aggravate the recession. Net foreign financing has always been the jet fuel for the Turkish economy. In the first seven months of the year, the country suffered from the "sudden-stop syndrome" in foreign capital flows, which posted a net outflow of $10.4 billion. Following the tragic events of September 11, global risk aversion is likely to inflict more pain on the Turkish economy.

Get ready for a new wave of negative demand shocks. The deterioration in consumer spending was nearly bottoming out in August, but along with evaporating disposable income and rising unemployment, the recent events are likely to have a significantly adverse impact on consumer confidence. Consequently, we now project a year-on-year decline in private consumption of 12.1% in the second half, following a 7.5% drop in the first half. Likewise, we estimate no turnaround in investment spending – declining further at a rate of 31.7%. In addition, coupled with adverse financing conditions, the sudden global slowdown will limit the gains from the weak currency in export performance. Furthermore, the tourism sector – the only industry to record a positive growth rate this year – is likely to suffer from the hunt for terrorists in the Middle East. We also expect a further worsening in the country's net factor income (causing an increased divergence between GDP and GNP), as Turkish workers and firms abroad remain reluctant to transfer their earnings to the crisis-ridden homeland and multinational companies based in Turkey repatriate their earnings.

We cut our 2001 growth forecast; uncertainty increases "margin of error" in our 2002 projections. We are marking down our annual growth forecasts for 2001 to -8.2% for GDP and -10.5% for GNP (from -6.8% and -8.0%, respectively). All the fundamental reasons that led us to call for "the great recession" this year have just been reinforced with the new global situation. As a result, we also cut our 2002 forecast to 1.2% for GDP and 1.9% for GNP, from 2.8% and 3.5%, respectively. Therefore, we now look for only a modest recovery, which is indeed not a "rebound" by Turkish standards and has a significant margin of error due to (policy) uncertainty.

Exhibit 23

Turkey: Latest Economic Indicators

	Latest		Previous	
(%)	Reference Period	Outcome	Reference Period	Outcome
CPI	Sep	61.8 YoY	Aug	57.5 YoY
WPI	Sep	74.7 YoY	Aug	69.6 YoY
Industrial Production	Jul	-11.3 YoY	Jun	-10.3 YoY
Capacity Utilisation	Aug	71.4	Aug 2000	75.8
Merchandise Exports (in $ Terms)[1]	Jul	1.1 YoY	Jun	19.8YoY
Merchandise Imports (in $ Terms)[1]	Jul	-28.3 YoY	Jun	-35.8 YoY
Trade Balance ($ billion) [1]	Jul	(0.71)	Jun	(0.38)
Current Account Balance ($ billion) [1]	Jul	0.27	Jul 2000	(0.10)
Official Reserves ($billion)	28 Sep	18.9	21 Sep	17.9
Primary Budget Balance ($ billion)	Aug	1.41	Aug 2000	2.73
Overall Budget Balance ($ billion)	Aug	(1.92)	Aug 2000	(1.01)

YoY = Year on year 1 Including shuttle trade

Source: Central Bank of Turkey, State Institute of Statistics, Ministry of Finance, Datastream, and Morgan Stanley Research

Please refer to important disclosures at the end of this report.

Country Updates

Israel

Out of Steam

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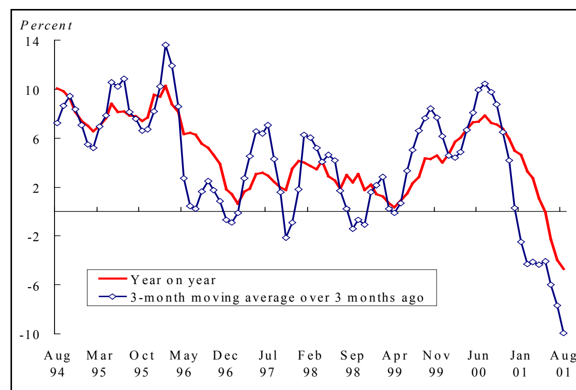
The Israeli economy has run out of steam. The state-of-the-economy index dropped for the tenth consecutive month in August to 127.3, posting a month-on-month worsening of 0.5% on a seasonally adjusted basis and a year-on-year deterioration of 4.7%. Even before the tragic events of September 11, the Israeli economy was suffering from the first synchronized global slowdown in decades, as it closely follows the US business cycle and it is highly dependent on international trade and capital flows.

The competitive advantage has all of a sudden turned into vulnerability. Although the decline of traditional industries and the rise of high technology sectors indeed symbolize the greatest transformation in Israel, the precipitous downturn in business spending around the world has brought the technology-driven virtuous circle to a temporary end. Unfortunately, Israel's ever-increasing integration with the global economy has suddenly turned into a burden on the back of deteriorating investor sentiment and rising (geographic) risk aversion.

Disappearing peace dividend widens fiscal imbalance. Given the highly fragmented nature of the domestic political scene, Israel has always been exposed to unexpected (political) shocks, especially stemming from the Middle East peace process. The latest developments will only increase market noise and actually have immediate fiscal consequences. The reduction in military spending – the peace dividend, which freed sizeable financial resources for civilian use and thus stimulated the private sector – is rapidly disappearing, as military spending is likely to be around 12% of GDP this year, after a period of stabilization below 9%. Israel enjoyed a significant peace dividend, as the defense expenditure declined from an average of 22% in the preceding two decades to below 9% in 2000 (*Disappearing Peace Dividend*, June 7, 2001).

Diminishing growth prospects. We have cut our growth forecast for 2001 from 1.2% to 0.2% and for next year from 3.1% to 1.7%. We expect a significant contraction in fixed investment spending and a (small) negative contribution from net international trade. The key drivers for growth will be private consumption (thanks to real wage growth) and, to a limited extent, public infrastructure spending.

Exhibit 24
Israel: State of the Economy Index, 1994-2001



Source: Bank of Israel, Morgan Stanley Research

Exhibit 25
Israel: Latest Economic Indicators

	Latest		Previous	
(%)	**Reference Period**	**Outcome**	**Reference Period**	**Outcome**
CPI	Aug	1.7 YoY	Jul	0.8 YoY
WPI	Aug	-0.5 YoY	Jul	-0.7 YoY
Industrial Production	Jul	-7.0 YoY	Jun	-9.1 YoY
S-Index (Seasonally Adjusted)	Aug	127.3	Jul	127.9
Unemployment Rate	Jun	8.6	May	8.6
Exports (in $ Terms)	Jul	-11.5 YoY	Jun	-11.9 YoY
Imports (in $ Terms)	Jul	-10.2 YoY	Jun	-11.6YoY
Trade Balance ($ million)	Jul	(661.0)	Jul 2000	(699.0)
Current Account Balance ($ million)	2000	(1.42)	1999	(3.05)
Official Reserves ($ billion)	Sep	24.5	Aug	23.9

YoY = Year on year

Source: Bank of Israel, Central Bureau of Statistics, Reuters, Datastream, and Morgan Stanley Research

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Country Updates

Egypt

Dangerous Liaison

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The period of fiscal consolidation is over. Egypt achieved one of the most remarkable fiscal consolidation experiences in the early 1990s, as its budget balance moved from a deficit of 18% of GDP to 1.2% in 1995. Regrettably, that effort was not sustained and public finances have worsened markedly since 1998. This year, the budget deficit is projected to be close to 6%, well in excess of the revised target of 4.9% (previously 3.4%).

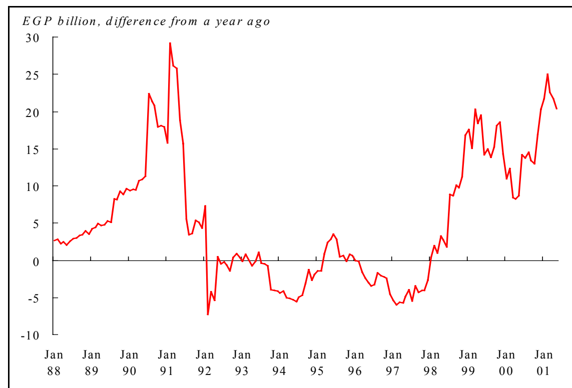
The government relies heavily on monetary financing. The widening budget deficit has been covered by increased monetary financing from the central bank. As a matter of fact, the government's dependence on central bank lending has become quite visible since the beginning of 1998, as the stock of monetary financing jumped from EG£ 44.4 billion to EG£ 97.2 billion. The monetization of the fiscal deficit reached a cumulative 17.0% of GDP in the 1998-2000 period. The current fiscal year is no exception, as we have already witnessed a 28% increase in central bank lending to the government.

The risk of inflationary pressures from monetary financing is rising. In the absence of fiscal consolidation, the portfolio reallocation in commercial banks' balance sheets out of government securities increases the reliance on monetary financing. Central bank lending will cover the entire budget deficit this year – reaching 6% of GDP. This creates inflationary pressures and undermines the exchange rate regime. In our view, the rising monetary financing is the underlying reason for the currency weakness and an indication of outstanding devaluation pressures.

Privatization is crucial for sustainable fiscal consolidation. As a consequence of slower economic growth, tax revenues are projected to be below 24% of GDP. On the other hand, coupled with administrative difficulties, political considerations, especially in a time of global unease, don't allow the introduction of spending cuts to meet fiscal targets. Therefore, the need for structural reforms becomes more evident. Even though we believe privatization isn't just a scheme for revenue generation and should be utilized to improve the overall productivity of an economy, the Egyptian government no doubt urgently needs to accelerate the privatization process to initiate sustainable fiscal consolidation.

Exhibit 26

Monetary Financing of Budget Deficit, 1988-2001



Source: Datastream, Morgan Stanley Research

Exhibit 27

Egypt: Latest Economic Indicators

	Latest		Previous	
(%)	Reference Period	Outcome	Reference Period	Outcome
CPI	Jul	2.2 YoY	Jun	2.2 YoY
Crude Oil Production	Sep	-7.6 YoY	Aug	-8.7 YoY
Tourist Arrivals	Jul	-7.5 YoY	Jun	-10.4 YoY
Suez Canal Dues (in $)	Jul	7.0 YoY	Jun	2.3
Government Budget Balance (LE billion)	3Q00	(1.13)	2Q00	(0.63)
Merchandise Exports	Jun	-18.9 YoY	May	-11.2 YoY
Merchandise Imports	Jun	5.3 YoY	May	-10.4 YoY
Trade Balance ($ billion)	Jun	(0.81)	May	(0.73)
Current Account Balance ($ billion)	3Q00	0.17	2Q00	(0.22)
Foreign Exchange Reserves ($ billion)	Jul	15.4	May	14.2

YoY = Year on year Source: Datastream, Central Bank of Egypt, Ministry of Finance, and Morgan Stanley Research

Please refer to important disclosures at the end of this report.

Country Updates

South Africa

Further Rate Cuts Unlikely

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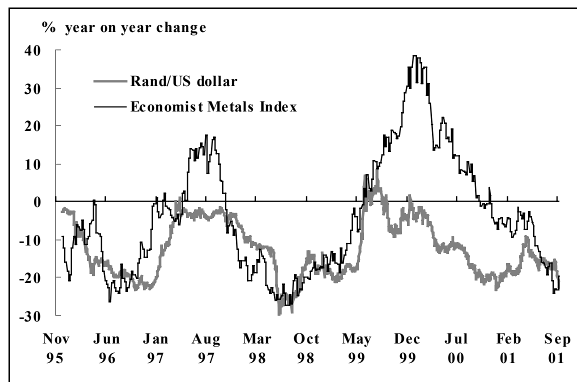
Inflation down, SARB cut rates in September. After a batch of disappointing inflation figures for June and July, the August CPI data came out even better than expected by the market, with CPIX inflation falling to 6.0% year on year from 6.4% in July. PPI inflation fell even more sharply, to 7.9% from 8.6% in July. These data supported the decision by the central bank (SARB) to cut its repo rate by 50bp to 9.5% on September 20.

But rand depreciation is gaining momentum. As we go to print, the rand has fallen to 9.35 against the dollar, which marks an 18.8% depreciation since the beginning of the year, and 13.9% since mid-year. The acceleration in the rand's depreciation in the third quarter was triggered first by the Argentina and emerging markets jitters in July, and then by growing concerns on the US and global outlook. The September 11 terrorist attack against the US was the latest blow for the rand.

Negative news flow adds to gloom. Ongoing concerns on land seizures in Zimbabwe have compounded the weakness in the South African currency. Receding prospects for key privatization initiatives (mostly telecom companies) have also weighed on the rand. In addition, dealers have been worrying about the effect of the Swissair bankruptcy on South African Airlines and FDI inflows (the Swiss airline owns 20% of SAA and had an option to buy an additional 10%).

Exhibit 28
Commodity Prices and the Rand Exchange Rate



Source: Datastream

Further weakening is likely. Whatever the rationale for financial and economic contagion, the South African rand has been traditionally sensitive to global economic and emerging markets trends. In particular, the correlation between the rand and commodity prices is very high (Exhibit 28). The recent drop resembles the one in 1998, which was prompted by a correction in world equity markets and then by the Russian crisis (Exhibit 29). Like then, we will probably see an overshooting along the rand's secular downward trend. This means that the South African currency may retrace some of its recent losses. But, if we assume that uncertainty, international tensions and the global slowdown will persist, it makes sense to expect that pronounced weakness in the rand will continue for a while.

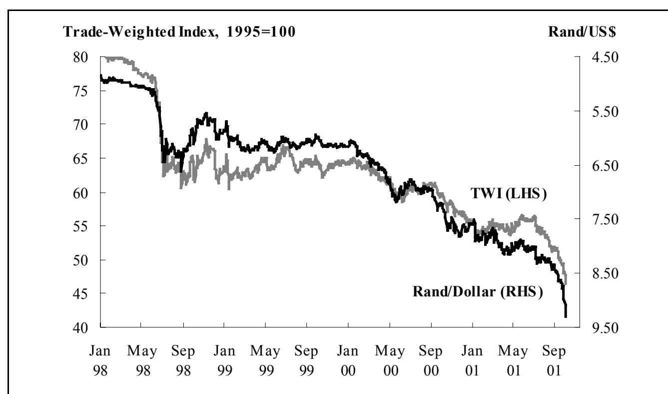
A 9.6 level to the dollar is our near-term target. The rand will probably weaken further by year-end. Based on the extent of currency depreciation in 1998, we believe a 9.6 exchange rate to the dollar is a near-term target that could be reached in a matter of days. Even assuming a subsequent retracement, there are significant chances in our view that the rand will reach and even exceed the 10 level between now and the year-end. Indeed, our new forecast for December is 10.0 against the dollar.

Hopes for a rebound in the rand are pinned on global recovery… The drop in the rand should be followed by a temporary recovery in spring next year as the global outlook improves. By the end of 2002, however, we expect that the rand will weaken again versus the dollar, albeit moderately, to 10.4. Needless to say, a V-shaped global recovery would be the most favorable scenario for the rand. However, we have based our forecast on the Morgan Stanley global forecast, which calls for persisting weakness into early 2002.

...but the rand is in an uncharted territory. Given the speed at which the rand is depreciating, a steeper depreciation is entirely possible, in our view. Technical analysis is of limited help, given that the rand has broken into uncharted territory.

Please refer to important disclosures at the end of this report.

Exhibit 29
Rand Exchange Rate: A Repeat of 1998, or Worse?



Source: Datastream, Morgan Stanley Research

The trend risks becoming self-enforcing, as exporters do not have an incentive to hedge, while importers and foreign investors may still need to do so.

Impact on inflation will be muted by decline in oil and commodity prices. The recent drop in oil prices exceeds by far the depreciation in the rand in percentage terms. As we go to print, Brent oil prices in rand terms are roughly 5% lower than at the beginning of the summer. Industrial commodity prices have also declined on the back of lower growth expectations for the global economy. While this will hurt South Africa in terms on export earnings (with the only partial offset of higher gold prices), it is good news for inflation.

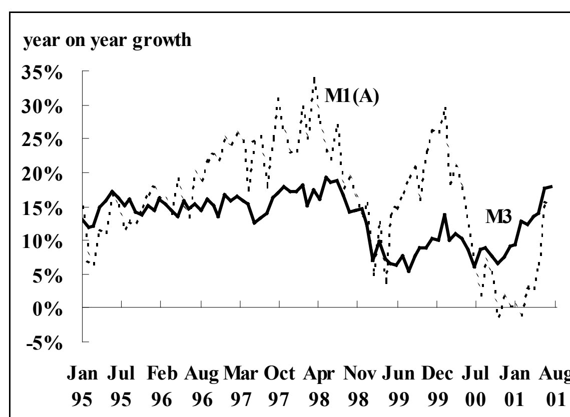
Economic growth will probably slow in coming quarters (we are cutting our real GDP growth forecast), but domestic demand looks well supported. Until September, economic indicators were evolving in line with our annual real GDP growth forecast of 2.6% for this year. The competitiveness of the rand should allow South Africa to gain market share in global trade. Strong credit growth (see below) and the increase in real labor income entailed by recent wage contracts suggest that domestic demand should remain well supported. However, the anti-US terrorist attacks will probably have a negative impact on business and consumer confidence in South Africa (which were stable until September), and export volumes and prices will be negatively affected by the global slowdown. As a result, we are cutting our 2001 real GDP forecast from 2.6% to 2.5%, and our 2002 forecast from 3.0% to 2.4%.

SARB warns about excessive rise in wages... The statement by the MPC of the central bank mentions recent wage contracts and "continued high increases" in administered prices as the most relevant domestic risks to the inflation outlook. Indeed, workers in mining, coal, auto, electricity and steel went on strike to demand above-inflation wage increases and eventually negotiated increases in the 7.5-9.0% range, which in some cases exceeded significantly the inflation-plus-productivity formula. Civil servants and public health workers were slightly less successful, eventually agreeing to 7.0-7.5% wage increases. The SARB would like the 3-6% target level to be the cap for all wage increases net of productivity increases.

…and administered prices. Medical, utility, communication, municipal charges and other regulated costs have spiked up in recent months when pressure from oil prices and imported inflation has been mild. Sustained increases in these costs in the absence of regulatory or competitive pressure could undermine the secular fall in inflation.

Money supply is another concern. Money supply growth has been strong this year. In August, M3 was up 18.0% year on year, following 17.8% growth in July. Until recently, the SARB attributed most of the growth to longer-dated deposits in the M3 aggregate. More recently, however, year-on-year growth in M1 has also picked up significantly, to 14.6% in July and 16.9% in August (Exhibit 30). Private sector credit growth has accelerated as well in recent months, reaching 10.7% in August, up from 9.4% in July.

Exhibit 30
Money Supply Growth is Accelerating



Source: Datastream, Morgan Stanley Research

Please refer to important disclosures at the end of this report.

Further rate cuts are unlikely for the foreseeable future. Exhibit 31 summarizes the key factors in favor and against further reduction in the SARB repo rate. Given that the inflation rate is currently at the top of the 3-6% target band for 2002, which must be met on average, a prudent conduct of monetary policy would recommend no change in policy rates. The big unknown in this scenario is the pass-through from the exchange rate to inflation. If inflation surprises on the downside in coming months, given its clear pro-growth bias, the SARB may take the opportunity to cut interest rates. A sequence of external shocks would also provide justification for missing the inflation target. Our baseline scenario, however, remains that the SARB will keep policy rates unchanged for the foreseeable future due to the worrying weakness in the exchange rate and the inflation risks it poses. The announcement by the government of the 2003 and 2004 inflation targets (which should take place by the end of this month) would add further arguments for caution, if such targets are lower than the one for 2002, albeit marginally.

Little or no easing priced into the money market curve. Money market rates and bond yields have backed up following the latest weakening in the rand and the release of the August money supply figures. Hardly any decline in the SARB repo rate is now priced into the curve. As noted above, this coincides with our current thinking. Only a positive surprise on the inflation front would change this state of affairs. However, we expect that the September CPIX figures, which are due out on October 16, will point at best to a slight decline in year-on-year inflation, to 5.9%. Hence, we believe that risks to interest rates are stacked on the upside.

Exhibit 31

Key Arguments in Favour and Against Monetary Easing

In Favour	Against
Downturn in the Global Economy	Rand depreciation
Lower oil and commodity prices	Money and credit growth
	High wage growth
	Administered prices

Morgan Stanley Research

Exhibit 32

South Africa: Latest Economic Indicators

	Latest		Previous	
(%)	Reference Period	Outcome	Reference Period	Outcome
CPI	Aug	4.6 YoY	Jul	5.3 YoY
CPIX	Aug	6.0 YoY	Jul	6.4 YoY
PPI	Aug	7.9 YoY	Jul	8.6 YoY
Industrial Production (Manufacturing)	Jul	1.0YoY	Jun	3.1 YoY
Merchandise Exports (in R Terms)	Aug	15.0YoY	Jul	18.3 YoY
Merchandise Imports (in R Terms)	Aug	21.8YoY	Jul	3.1 YoY
Trade Balance (R billion)	Aug	0.7	Jul	2.95
Current Account Balance (R billion)	2Q01	6.3	4Q00	6.9
Gross Reserves (R billion)	Sep	67.5	Jul	62.8

YoY = Year on year   Source: SARB, STATS SA, Datastream, Morgan Stanley Research

Please refer to important disclosures at the end of this report.

Economic Forecasts

Exhibit 33

% Annual Change	Turkey 1999	Turkey 2000	Turkey 2001E	Turkey 2002E	Poland 1999	Poland 2000	Poland 2001E	Poland 2002E
Real GDP	-4.7	7.0	-8.2	1.2	4.1	4.1	1.8	2.8
Private Consumption	-6.0	6.0	-9.4	1.9	5.1	2.6	1.8	2.3
Gross Fixed Investment	6.8	6.8	-27.0	1.9	6.9	3.4	-3.0	4.0
Exports	-15.9	16.0	10.1	-4.7	-2.6	12.8	8.5	8.0
Imports	-6.9	19.2	-22.0	8.2	1.0	9.1	3.0	8.0
Unemployment Rate (%)	6.9	6.3	8.4	8.2	12.0	13.4	16.5	18.0
CPI Inflation (Annual Average)	64.8	56.4	54.0	55.8	7.3	10.1	5.7	5.0
Current Account Balance (%of GDP)	-0.7	-4.6	1.1	0.4	-7.5	-6.2	-4.6	-4.9
Govt. Budget Deficit (%of GDP)	10.9	10.1	17.8	15	-3.2	-3.2	-4.0	-5.0
Govt. Debt (%of GDP)	51.9	53.8	111.0	117.1	42.9	44.5	44.0	46.0
Short-term Deposit Rate[1]	41.7	80	98	57	17.9	19.2	13.0	10.0
Exchange Rate against US$[1]	541.4	673.4	1720	2490	4.2	4.3	4.3	4.3

Exhibit 34

% Annual Change	Russia 1999	Russia 2000	Russia 2001E	Russia 2002E	Czech Republic 1999	Czech Republic 2000	Czech Republic 2001E	Czech Republic 2002E
Real GDP	**5.4**	**8.3**	**5.1**	**4.6**	**-0.4**	**2.9**	**3.7**	**3.4**
Private Consumption	**-4.4**	**8.1**	**9.5**	**8.5**	**2.3**	**1.8**	**4.0**	**3.9**
Gross Fixed Investment	**4.7**	**15.5**	**6.4**	**3.1**	**-0.6**	**4.2**	**8.5**	**8.5**
Exports	**16.5**	**14.1**	**7.5**	**8.6**	**6.3**	**18.7**	**10.8**	**8.0**
Imports	**-28.7**	**20.9**	**20.3**	**17.0**	**4.0**	**18.7**	**12.2**	**9.4**
Unemployment Rate (%)	**12.6**	**10.4**	**9.0**	**9.5**	**8.7**	**9.3**	**9.5**	**9.4**
CPI Inflation (Annual Average)	**92.6**	**21.0**	**21.7**	**15.2**	**2.1**	**3.9**	**5.0**	**5.0**
Current Account Balance (%of GDP)	**13.5**	**18.5**	**13.3**	**10.1**	**-3.0**	**-4.8**	**-5.8**	**-5.7**
Govt. Budget Deficit (%of GDP)	**-1.4**	**2.5**	**2.4**	**2.6**	**-3.7**	**-5.1**	**-9.5**	**-9.0**
Govt. Debt (%of GDP)	**87.4**	**61.8**	**48.4**	**42.7**	**30.7**	**30.8**	**31.9**	**33.0**
Short-term Deposit Rate[1]	**13.1**	**12.8**	**13.6**	**13.0**	**5.3**	**5.4**	**5.3**	**5.8**
Exchange Rate against US$[1]	**27.6**	**28.7**	**29.8**	**31.3**	**35.5**	**35.2**	**35.0**	**35.0**

Exhibit 35

% Annual Change	South Africa 1999	South Africa 2000	South Africa 2001E	South Africa 2002E	Hungary 1999	Hungary 2000	Hungary 2001E	Hungary 2002E
Real GDP	**1.9**	**3.1**	**2.5**	**2.4**	**4.5**	**5.2**	**4.1**	**3.3**
Private Consumption	**1.1**	**3.2**	**2.7**	**2.1**	**4.6**	**3.3**	**4.4**	**4.0**
Gross Fixed Investment	**-6.0**	**1.3**	**5.5**	**3.2**	**6.6**	**6.6**	**4.6**	**3.0**
Exports	**1.3**	**8.2**	**6.4**	**6.0**	**13.2**	**21.8**	**12.0**	**4.8**
Imports	**-7.4**	**7.4**	**1.1**	**6.9**	**12.3**	**21.1**	**11.0**	**5.0**
Unemployment Rate (%)	**NAV**	**NAV**	**NAV**	**NAV**	**9.7**	**6.5**	**6.0**	**6.5**
CPI Inflation (Annual Average)	**5.2**	**5.3**	**6.5**	**5.7**	**10.0**	**9.8**	**9.3**	**5.6**
Current Account Balance (%of GDP)	**-0.4**	**-0.4**	**0.7**	**0.2**	**-4.3**	**-3.5**	**-3.9**	**-4.3**
Govt. Budget Deficit (%of GDP)	**-2.1**	**-2.1**	**-0.5**	**-1.5**	**-3.7**	**-3.5**	**-3.4**	**-3.2**
Govt. Debt (%of GDP)	**48.9**	**48.0**	**47.0**	**45.5**	**60.0**	**56.0**	**55.0**	**53.0**
Short-term Deposit Rate[1]	**10.9**	**10.3**	**9.5**	**9.5**	**14.0**	**12.0**	**10.5**	**9.5**
Exchange Rate against US$[1]	**6.2**	**7.6**	**10.0**	**10.2**	**252.0**	**264.0**	**254.0**	**254.0**

Please refer to important disclosures at the end of this report.

Economic Forecasts

Exhibit 36

% Annual Change	Slovakia 1999	2000	2001E	2002E	Israel 1999	2000	2001E	2002E
Real GDP	**1.9**	**2.2**	**2.7**	**2.9**	**2.1**	**5.8**	**0.2**	**1.7**
Private Consumption	**-0.2**	**-3.4**	**3.5**	**4.0**	**3.4**	**5.9**	**2.0**	**2.8**
Gross Fixed Investment	**-18.8**	**-0.7**	**12.0**	**10.0**	**-0.1**	**-0.8**	**-5.8**	**1.0**
Exports	**3.4**	**15.9**	**10.0**	**8.0**	**9.3**	**23.4**	**3.5**	**3.8**
Imports	**-6.0**	**10.2**	**11.0**	**10.0**	**14.2**	**12.4**	**4.4**	**6.0**
Unemployment Rate (%)	**17.5**	**18.2**	**18.0**	**17.0**	**8.8**	**8.7**	**9.0**	**8.8**
CPI Inflation (Annual Average)	**10.5**	**12.2**	**7.6**	**6.0**	**5.3**	**1.1**	**1.4**	**3.0**
Current Account Balance (%of GDP)	**-5.0**	**-3.7**	**-7.7**	**-10.0**	**-1.9**	**-1.1**	**-3.0**	**-2.4**
Govt. Budget Deficit (%of GDP)	**-3.7**	**-4.0**	**-3.9**	**-3.5**	**22.5**	**0.6**	**2.8**	**2.6**
Govt. Debt (%of GDP)	**23.8**	**25.3**	**27.0**	**25.0**	**101.0**	**94.0**	**93.5**	**92.0**
Short-term Deposit Rate[1]	**8.8**	**8.0**	**7.8**	**7.5**	**10.7**	**8.3**	**6.8**	**6.2**
Exchange Rate against US$[1]	**42.3**	**48.4**	**48.0**	**45.0**	**4.2**	**4.0**	**4.4**	**4.2**

1. End of period *2. For Turkey, average Treasury bill rate* *3. For Turkey, exchange rate is in thousand units against the US dollar*
E = Morgan Stanley Research Estimates *Source: Morgan Stanley Research*

Currency and Interest Rate Forecasts

Poland

	USD/PLN	Policy rate	3-month deposit	10-year bond
Current	4.16	14.50	14.80	10.75
Dec 01	4.30	13.00	13.00	10.75
Mar 02	4.20	11.50	11.50	10.50
June 02	4.25	10.50	11.00	10.25
Sept 02	**4.25**	**10.50**	**10.50**	**10.00**
Dec 02	4.30	10.00	10.50	10.00

Czech Republic	EUR/CZK	Policy rate	3-month deposit	10-year bond
Current	33.70	5.25	5.60	6.10
Dec 01	34.50	5.50	5.50	6.50
Mar 02	35.00	5.75	5.70	6.75
June 02	35.00	6.00	5.70	6.75
Sept 02	35.00	6.00	5.70	7.00
Dec 02	35.00	6.00	5.70	7.00

Slovakia	USD/SKK	Policy rate	3-month deposit	10-year bond
Current	43.50	7.75	7.75	8.30
Dec 01	43.00	7.75	7.75	8.50
Mar 02	42.75	7.50	7.50	8.50
June 02	42.75	7.50	7.50	8.30
Sept 02	42.75	7.50	7.50	8.00
Dec 02	42.75	7.50	7.50	7.80

Please refer to important disclosures at the end of this report.

Currency and Interest Rate Forecasts

Hungary	EUR/HUF	Policy rate	3-month deposit	10-year bond
Current	257.00	11.00	10.50	8.00
Dec 01	254.00	10.50	10.25	8.00
Mar 02	254.00	10.00	10.00	8.00
June 02	254.00	10.00	10.00	8.00
Sept 02	254.00	**9.75**	**9.75**	**7.80**
Dec 02	254.00	9.50	9.50	**7.80**

Russia	USD/RUB	Policy rate	3-month deposit	10-year bond
Current	29.47	22.00	13.91	21.68
Dec 01	29.90	20.00	13.65	21.25
Mar 02	30.25	20.00	13.50	20.75
June 02	30.55	18.00	13.38	20.50
Sept 02	30.90	18.00	13.25	20.25
Dec 02	31.25	16.00	13.13	20.00

Turkey	USD/TRL	Policy rate	3-month deposit	Benchmark T-bill
Current	1600	62.00	70.00	89.10
Dec 01	1720	60.00	69.00	98.00
Mar 02	1940	65.00	78.00	98.00
June 02	2085	67.00	83.00	110.00
Sept 02	2220	50.00	61.00	75.00
Dec 02	2430	44.00	53.00	65.00

Israel	USD/ILS	Policy rate	3-month deposit	10-year bond
Current	4.35	6.30	6.7	N/AV
Dec 01	4.38	6.20	6.8	N/AV
Mar 02	4.35	6.00	6.4	N/AV
June 02	4.30	5.80	6.2	N/AV
Sept 02	4.25	5.80	6.2	N/AV
Dec 02	4.25	5.80	6.2	N/AV

South Africa	USD/ZAR	Policy rate	3-month deposit	10-year bond
Current	*9.35*	9.50	9.20	10.80
Dec 01	9.30	9.50	9.50	11.00
Mar 02	9.60	9.50	9.20	10.50
June 02	9.60	9.50	9.30	10.60
Sept 02	10.00	9.50	9.50	10.80
Dec 02	10.20	9.50	9.50	10.80

Source: Reuters, Datastream, and Morgan Stanley Research Estimates
N/AV - Not Available

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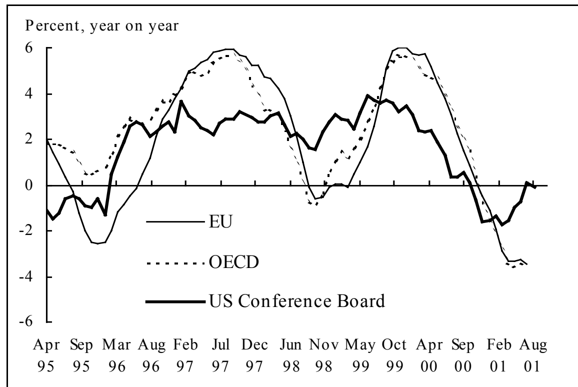
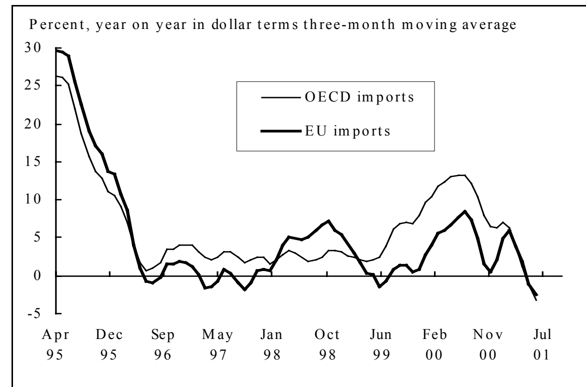
Global Economic Gauges

Exhibit 37
Leading Indicators



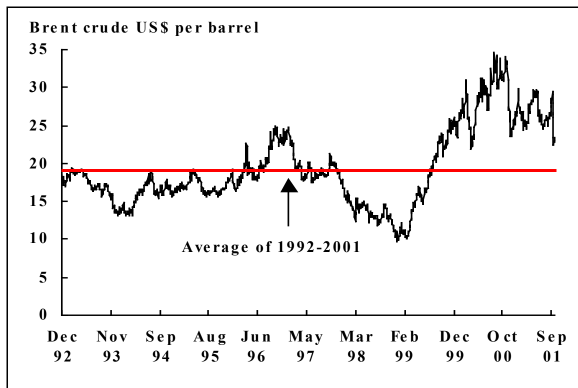
Source: Datastream, Morgan Stanley Research

Exhibit 40
International Trade



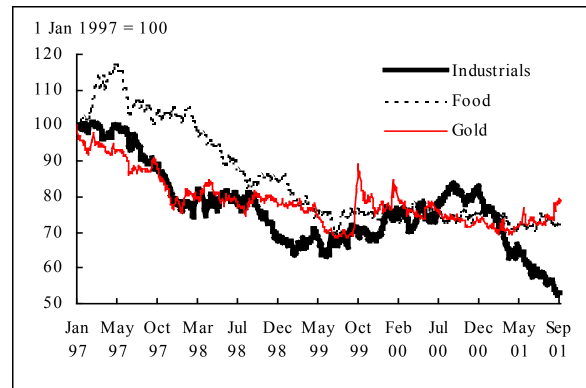
Source: Datastream, Morgan Stanley Research

Exhibit 38
Oil Prices, 1997-2001



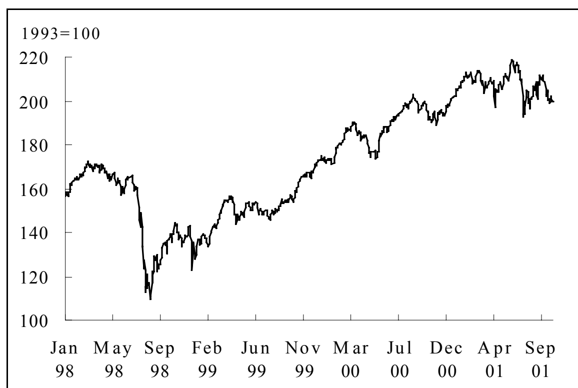
Source: Datastream, Morgan Stanley Research

Exhibit 41
Commodity Prices, 1997-2001



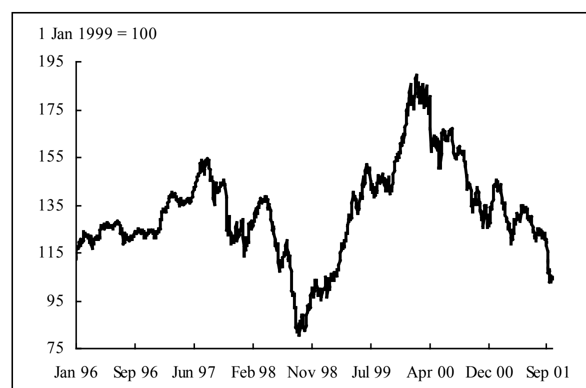
Source: Datastream, Morgan Stanley Research

Exhibit 39
Emerging Market Bond Index 1998 - 2001



Source: Datastream, Morgan Stanley Research

Exhibit 42
Emerging Market Equity Index 1996-2001



Source: Datastream, Morgan Stanley Research

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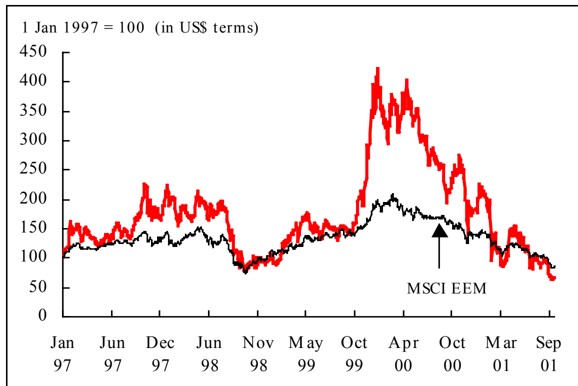
Stock Market Indices

Exhibit 43

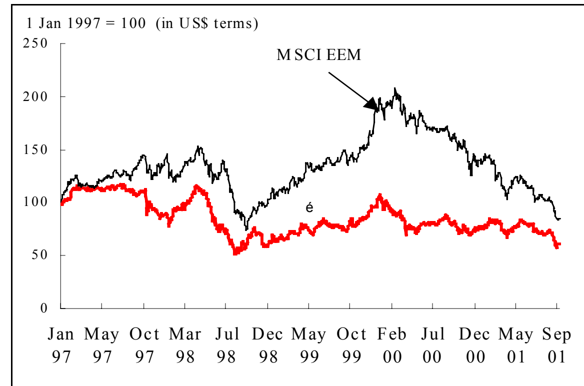
Turkey: 1997-2001



Source: MSCI, Morgan Stanley Research

Exhibit 46

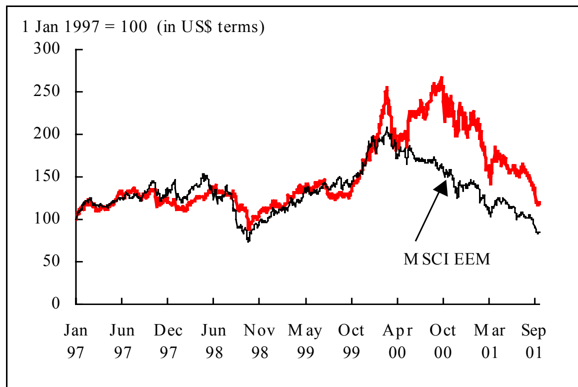
South Africa: 1997-2001



Source: MSCI, Morgan Stanley Research

Exhibit 44

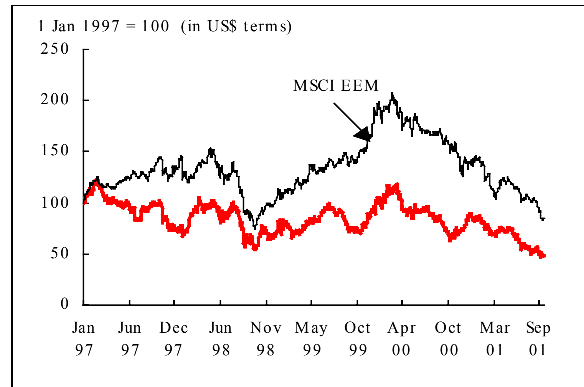
Israel: 1997-2201



Source: MSCI, Morgan Stanley Research

Exhibit 47

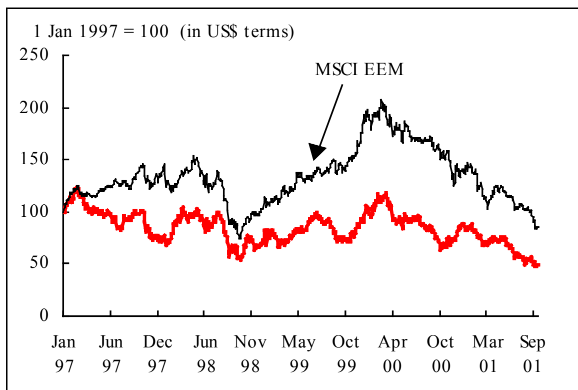
Poland: 1997-2001



Source: MSCI, Morgan Stanley Research

Exhibit 45

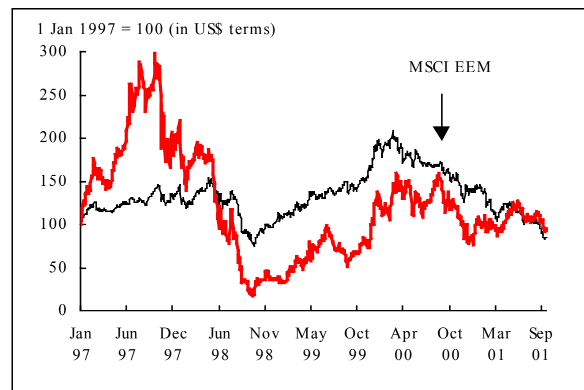
Hungary: 1997-2001



Source: MSCI, Morgan Stanley Research

Exhibit 48

Russia: 1997-2001

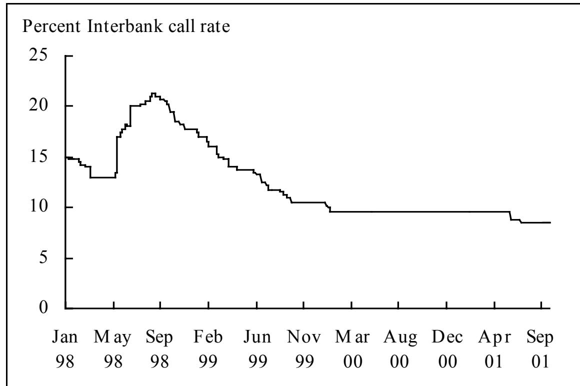


Source: MSCI, Morgan Stanley Research Note MSCI EEM: European Emerging Markets Index

Please refer to important disclosures at the end of this report.

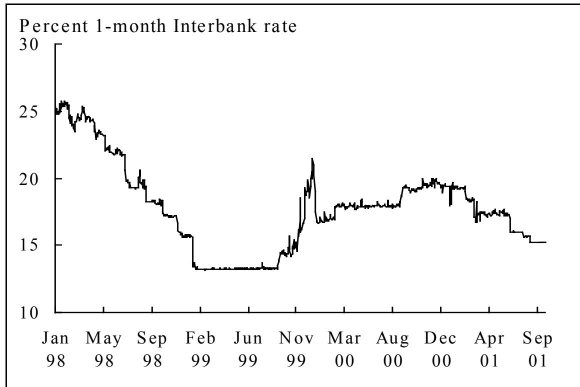
Money Market Rates

Exhibit 49
South Africa: 1998-2001



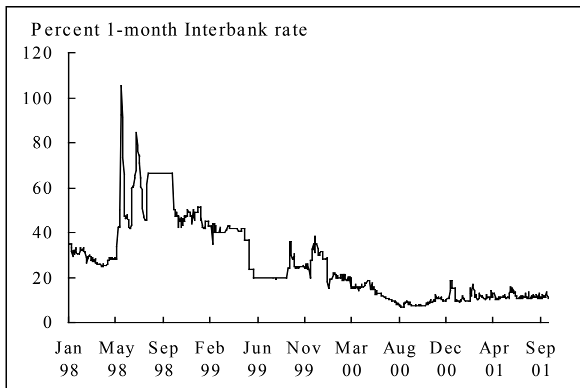
Source: Datastream, Morgan Stanley Research

Exhibit 50
Poland: 1998-2001



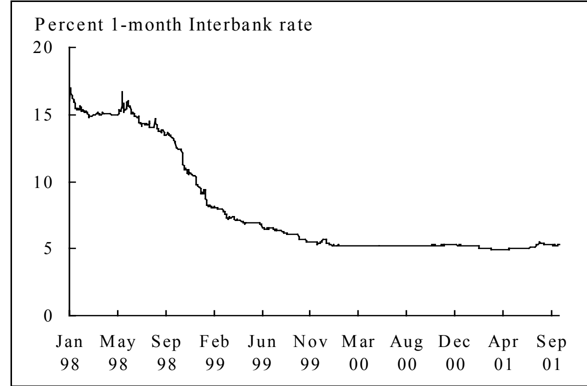
Source: Datastream, Morgan Stanley Research

Exhibit 51
Russia: 1998-2001



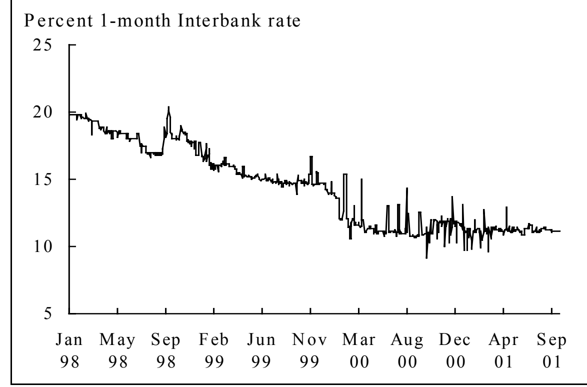
Source: Datastream, Morgan Stanley Research

Exhibit 52
Czech Republic: 1998-2001



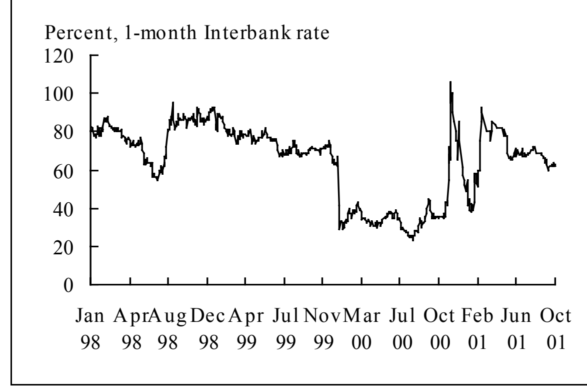
Source: Datastream, Morgan Stanley Research

Exhibit 53
Hungary: 1998-2001



Source: Datastream, Morgan Stanley Research

Exhibit 54
Turkey: 1998-2001



Source: Datastream, Morgan Stanley Research

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Data Release Calendar: October 2001

Date	Country	Event	Period	MSDW Forecast	Last
5-Oct	HU	Industrial output (% year on year)	Aug	3.0	-0.8
8-Oct	CZ	Consumer Price Index (% year on year)	Sep	5.4	5.5
	HU	Monetary Policy meeting		no change	
9-Oct	SA	Manufacturing Production (% year on year)	Aug		1.0
12-Oct	CZ	Industrial output (% year on year)	Aug	5.0	9.3
11-Oct	HU	Consumer Price Index (% year on year)	Sep	8.1	8.7
	CZ	Producer Price Index (% year on year)	Sep	2.2	2.4
	TU	Official FX Reserves ($ billion)	5 Oct	N/AV	18.9
15-Oct	IS	Consumer Price Index (%, year on year)	Sep	2.5	1.7
	PO	Consumer Price Index (% year on year)	Sep	4.5	5.1
16-Oct	TU	Capacity Utilization Rate (%)	Sep	70.5	71.4
	SA	Consumer Price Index (% year on year)	Sep	4.4	4.6
	SA	CPIX (% year on year)	Sep	5.8	6.0
18-Oct	PO	Industrial production (% year on year)	Sep	0.5	0.7
	PO	Producer price index (% year on year)	Aug	0.0	0.4
	TU	Official FX Reserves ($ billion)	12 Oct	N/AV	N/A
19-Oct	TU	Domestic Debt Stock ($ billion)	Sep	N/AV	74.8
22-Oct	CZ	Trade balance (CZK billion)	Sep	(8.0)	(14.3)
24-Oct	HU	NBH Monetary Policy meeting		no change	
	SA	Producer price index (% year on year)	Sep	7.9	7.9
25-Oct	CZ	CNB Monetary Policy meeting		no change	
	TU	Official FX Reserves ($ billion)	19 Oct	N/AV	N/A
28-Oct	PO	Current account balance ($ million)	Sep		(392)
	PO	Trade balance ($ million)	Sep		(1,040)
29-Oct	TU	Tourist Arrivals (%, year on year)	Aug	12.5	16.5
	IS	Bank of Israel Interest Rate Decision	Nov	6.3	6.3
	SA	Money Supply growth (% year on year)	Sep		17.95
	SA	Private Credit Extension Growth (% year on year)	Sep		10.73
31-Oct	SA	Trade Balance (R billion)	Sep		0.7
	SA	Net Open Forex Position ($ billion)	Sep	4.8	4.8
	SA	Gold and FX Reserves (R billion)	Sep	69.5	67.5
3-Nov	TU	Consumer Price Index (%, year on year)	Oct	66.2	61.8
	TU	Wholesale Price Index (%, year on year)	Oct	79.4	74.7

CZ = Czech Republic, GR = Greece, HU = Hungary, PO = Poland, RU = Russia, SA = South Africa, TU = Turkey
NA = Not applicable, N/AV = Not available
Source: Morgan Stanley Dean Witter Research

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