5.0 Developing Markets Overview

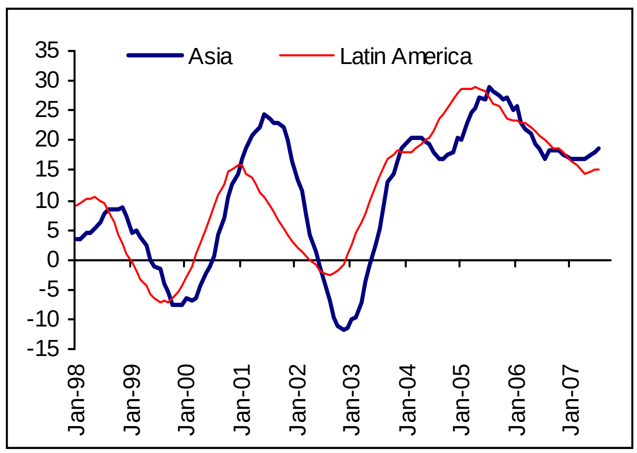
5.1 Developing Markets Summary Outlook – Rising Risk Perceptions

After several years of exceptional economic growth, the outlook for developing markets has been tarnished by slowing growth in the industrialized world. The US and Japanese economies have slowed significantly from last year's pace, and sluggish growth is expected to continue through 2008. In the case of the US, it will likely be 2009 before the economy fully shakes off the effects of the weak housing market and sub-prime mortgage meltdown. The Eurozone economy is also showing signs of slower growth, mainly due to weakness on the consumer front.

Slower growth in the US, Eurozone and Japan will inevitably spill over into the developing world. Indeed, a weaker consumer in these three markets (which constitute more than 40% of world GDP) will crimp export growth for developing countries. For many developing countries, export growth is already losing momentum, particularly for shipments to the US where the consumer slowdown is already in play. For 2007, we expect growth in the developing world will average 7.7%, up from last year's 7.3% pace. Much of the acceleration this year comes from stronger growth in China and India. Developing markets will lose momentum in 2008, with average growth slowing to 7.1% – a respectable pace of growth, but still the slowest since 2003.

EDC Economics is forecasting slower growth across most of the developing world through the remainder of 2007 and 2008. Solid domestic demand will put a floor under growth in many emerging economies, but we believe this will not be enough to offset the loss of momentum in external trade. An expected easing in commodity prices will also act to undermine economic activity. To be sure, weaker growth in exports combined with slower growth in commodities demand will filter through to domestic production.

Figure 14: Emerging Market Exports (6-month MA, y/y%)



Source: Bloomberg, EDC Economics.

As export growth slows, the impact on domestic consumption will be realized through a moderation in employment and wage gains. Moreover, much of the recent upturn in domestic consumption has been financed by households taking on increasing amounts of debt. The liquidity crunch experienced by the global banking system in recent months is likely to reduce the availability of such credit in emerging markets (through tighter lending standards), and further weaken consumption. Many developing economies are also struggling with higher inflation. This has caused authorities in a number of countries to tighten monetary policy, and we expect further action will be forthcoming to keep inflation in check. If the global slowdown fails to slow economic activity by a significant margin, central banks will ensure slower growth through continued tightening of monetary policy. Higher interest rates will affect consumer spending and business investment. India, Turkey, China and parts of Central Europe and Latin America stand out in this regard.

Developing market risk perceptions on the rise

Concerns are growing that emerging markets will be hit hard by the US-led global slowdown. The slowing US and world economies – a situation being exacerbated by the US housing-induced liquidity crunch – is forcing an upward reevaluation of risk perceptions. Yield spreads for emerging market debt have increased in recent months and further widening can be expected as slower growth in the US, EU and Japan produces knock-on effects across the developing world.

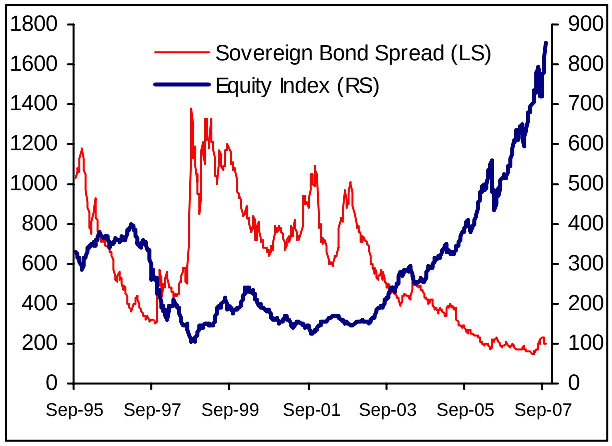
DEVELOPING MARKETS OVERVIEW

Yields on sub-investment grade corporate debt have also increased since the summer. Rather than a sharp and painful upward adjustment in risk, we expect a more gradual process that will allow developing economies to manage through the slowdown.

Nevertheless, it is understandable that observers are worrying. Emerging markets are typically hit quite hard during episodes of widespread "flight to quality" such as in 1994 and again in 1997-98. In addition, we believe that the scale of the central bank interventions in Augus

and September conveyed a heightened sense of urgency about the possible scope of the sub-prime debacle. Consider that just one week of combined interventions in August eclipsed the size of the entire S&L bailout announced in 1989. Central banks, which characteristically avoid being market-movers, had obviously calculated that any speculation surrounding their actions would be less disruptive than the effects of a potential crisis – leading many to wonder whether the monetary authorities knew something that the market did not.

Figure 15: Rising Equities and Narrowing Bond Spreads Point to Lower Developing Market Risk



Source: Bloomberg.

Nevertheless, we continue to believe that developing markets are better suited than ever before to withstand the current slowdown and re-pricing of risk. While the spectre of globalization makes developing countries even more exposed to contagion from global trade effects and worldwide capital movement, many countries have worked hard to better insulate themselves against financial turbulence. With deeper pockets, and foreign exchange reserves at all-time highs, governments have used the last few years of solid global demand, surging commodity prices and elevated liquidity to lower their external indebtedness, smooth maturity profiles, and improve currency and interest rate dynamics. Notwithstanding a few notable exceptions, policy credibility appears to be entrenched, and general consensus around orthodox market reforms (including the prevalence of free-floating currencies) will likely act as an important shock absorber going forward. Like most governments, the private sector has also experienced an improvement in its balance sheets. In addition, strong global integration, and healthy diversification of both trade partners and products, will further shelter the developing world from external volatility.

Table 6: Canadian Exports to Developing Markets (CAD mn)

	2005	2006	% Change	% of Total to Developing Markets
Central and Eastern Europe	2,033.6	2,640.6	29.8	9.3
Russia	513.0	793.0	54.6	2.8
Middle East	2,246.4	2,547.3	13.4	8.9
Africa	1,819.1	2,261.6	24.3	7.9
Asia	10,294.8	11,902.2	15.6	41.7
China	6,647.2	7,182.8	8.1	25.2
India	1,033.8	1,535.9	48.6	5.4
South America	2,982.1	3,454.0	15.8	12.1
Brazil	1,061.1	1,275.7	20.2	4.5
Argentina	154.6	166.1	7.5	0.6
Central America	1,482.0	1,663.8	12.3	5.8
Mexico	3,215.8	4,031.5	25.4	14.1
Total Goods	**24,108.6**	**28,533.2**	**18.4**	**70.2**
Total Services (est.)	**11,719**	**12,128**	**3.5**	**29.8**
Total Goods and Services	**35,827.6**	**40,661.2**	**13.5**	**100.0**

Source: Statistics Canada, EDC Economics. Data are domestic exports (customs basis).

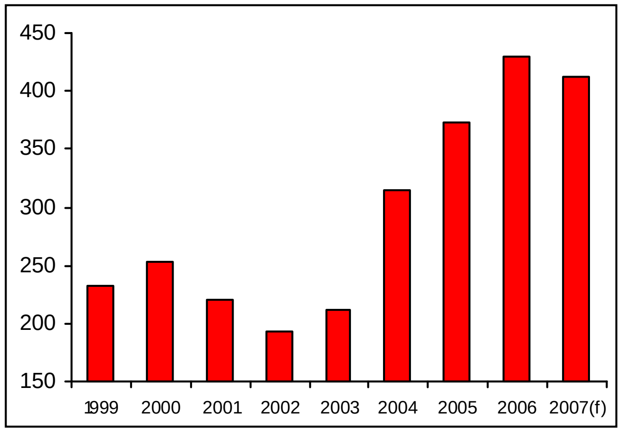
In sum, we do not believe that a broadly based financial meltdown will occur. Keeping our eyes on the big picture, we note that the recent movements of key financial indicators were still relatively small when plotted over the last 5 years.

Of course, a global financial meltdown and accompanying recessions in the world's largest consumer markets would have serious and varying impacts on a country-by-country basis. Should US and EU consumption experience a much deeper downturn (not our basecase scenario), then those economies that have become more reliant on sales to the US would also feel the crunch. This would include Mexico, China, and parts of East Asia and Latin America. Such a higher risk scenario also applies to countries in Eastern Europe (e.g. Russia, Poland, Hungary, Czech Republic and the Baltics) that have become reliant on sales to the EU.

Canadian exports and investment in developing markets

Canadian exports of goods and services to the developing world topped a record $40 billion in 2006, continuing several years of solid growth. This year is bringing more of the same, with Canadian export sales to most emerging markets posting double-digit growth rates so far in 2007. Canadian companies shipped a record $40 billion worth of goods and services to developing markets in 2006, an increase of 13.5% over 2005.

Figure 16: Global FDI Inflows to Developing Markets (US$ bn)



Source: UNCTAD, EDC Economics.

For 2007, EDC Economics expects Canada's exports of goods and services to the developing world will rise a further 20% or more. Commodities and resource-based intermediates are showing the strongest export gains this year, but shipments of high-tech equipment, consumer goods and industrial machinery are also recording solid growth. Exports of energy and mining equipment are doing particularly well, while sales of agricultural machinery are benefiting from rising global crop production. Overall, exports are forecast to grow at a slower pace (8 to 10%) in 2008 as economic activity across developing markets loses some momentum.

Table 7: Stock of Canadian Direct Investment to Developing Markets (CAD mn)

	2005	2006	% Change	% of Total to Developing Markets (2006)
Central and Eastern Europe	8,262	11,205	36	21
Africa	3,560	4,595	29	9
Developing Asia/Middle East	6,006	7,096	18	13
South America	18,833	20,172	7	38
Brazil	6,710	8,244	23	16
Chile	5,369	5,171	-4	10
Argentina	4,172	3,981	-5	8
Central America*	1,978	2,917	47	6
Mexico	3,453	4,369	27	8
Other Developing Markets	1,611	2,219	38	4
Total FDI in Developing Markets	**43,703**	**52,573**	**20**	**100**

Source: Statistics Canada, EDC Economics.
*Excludes Bahamas, Barbados, Bermuda and the Cayman Islands

Investment in developing economies has been strong in recent years as global investors looked to tap into these fast growing markets. Total foreign direct investment (FDI) flows into emerging markets amounted to an estimated US$ 430 billion in 2006. Although we expect some easing in investment flows during the remainder of 2007 and 2008, the annual totals will remain above historical norms. Large amounts of investment in infrastructure, energy, mining and telecom will continue to support Canadian exports of related equipment and services through the next 12 to 18 months, albeit at a slower pace of growth than experienced in the past couple of years.

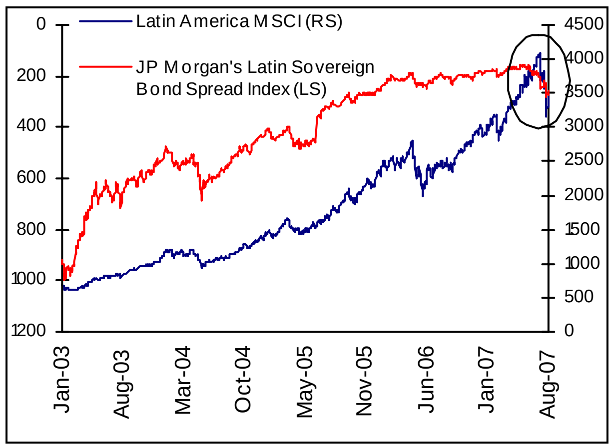
Canadian companies have also boosted their investment in developing countries, with CDIA (Canadian direct investment abroad) flows amounting to an estimated $11 to $12 billion in 2006. Preliminary data for the first half of 2007 show an easing in CDIA to developing markets. At the end of 2006, the stock of Canadian direct investment in the developing world amounted to $52 billion, a 20% increase over the previous year and nearly 2½ times bigger than a decade ago. Slower economic growth and increased risk perceptions suggest Canadian investment in emerging markets will slip back through the next 12 to 18 months. Long-term prospects remain quite favourable however, as strong economic growth and development will provide investment opportunities across the developing world.

5.2 Developing Market Outlook in Detail

5.2.1 Latin America

The US sub-prime fiasco has cast its pall far and wide over emerging markets, converging with several other forces to hasten a global reassessment of risk appetite. Investor concern over the potential effects of a widespread credit crunch on relatively risky Latin American assets surged after the world's leading central banks scrambled to inject critical sums of capital into tightening money markets in August. At the time of writing, JP Morgan's Latin sovereign bond spread index had jumped more than 100 basis points since May – led by Ecuadorian and Venezuelan dollar bonds. In addition, the risk of owning Brazilian debt, the region's most widely held security, had surged (as measured by credit default swaps). Meanwhile, the Latin America MSCI equity index had plunged almost 20% from its July peak, as investors worried that a new global risk aversion would reverse the flow of capital that had been pouring into the region's stock markets. Mexico's Bolsa index was 16% off its highest point of the year.

Figure 17: Latin America – Shaken, but Not Stirred



Source: Bloomberg.

As with the developing world in general, many developing countries in Latin America have taken advantage of the strong global growth and ample liquidity of recent years to improve their financial position. Although the effects of the US-led slowdown will certainly be felt in the region, many countries are now better able to withstand such ill effects. We expect growth in the region will slow in 2008, while recent developments in world financial markets have tilted the balance of risks toward the downside.

Table 8: Canadian Merchandise Exports to Latin America by Country (2005-2006)

Top 5 Markets	2005 (CAD mn)	2006 (CAD mn)	Growth (2006/2005)
Mexico	3,215.8	4,031.5	25.4
Brazil	1,061.1	1,275.7	20.2
Venezuela	512.7	631.2	23.1
Colombia	409.5	452.0	10.4
Chile	379.6	427.7	12.7
All Other	2,098.8	2,327.9	10.9
Total	**7,677.5**	**9,145.8**	**19.1**

Source: Statistics Canada, EDC Economics.

DEVELOPING MARKETS OVERVIEW

Mexico

Mexico is highly vulnerable to the US market. Weakness in the US economy has already spilled over into Mexico via stagnating family remittances, slower industrial production and now higher global risk perceptions. These represent the greatest sources of concern for our 2007 and 2008 Mexican GDP outlook. We expect growth of 2.7% and 3.1%, respectively. The government of Mexico is considered investment-grade risk, supported by low external debt ratios, an improved monetary policy, and a fairly stable currency. Despite recent improvements, however, Mexico's commercial operating environment remains challenging, especially with respect to labour market rigidities and contract enforcement. Nevertheless, the country continues to make strides, and the outlook remains positive. Exporting to, and investing in, Mexico present great opportunities for Canadian companies.

Demand for consumer goods will be supported by improved employment, expanding consumer credit and a strong housing market. Manufacturing output should see a modest expansion this year and next, benefiting Canadian exporters of raw materials, intermediate goods and M&E. The manufacturing industry continues to face intensifying competitive pressures from globalization, prompting productivity-enhancing investments. Government spending is also on the rise, particularly in infrastructure. To be sure, overall growth and globalization will stimulate Mexico's demand for transportation equipment and infrastructure investment. But with 35 to 40% of government revenues tied to oil, we caution some downside risk here. Absent any new major investment in oil-production capacity, energy production will probably decline, threatening future economic growth and government spending.

Table 9: Canadian Merchandise Exports to Latin America by Sector (2005-2006)

Top 5 Sectors	2005 (CAD mn)	2006 (CAD mn)	Growth (2006/2005)
Metals	541.9	862.5	59.2
Wheat Farming	665.9	801.9	20.4
Newsprint	641.3	780.5	21.7
Motor Vehicles and Parts	531.1	599.5	12.9
Chemicals	439.4	596.3	35.7
Total	**7,677.5**	**9,145.8**	**19.1**

Source: Statistics Canada, EDC Economics.

Central America and Caribbean

Canadian exports to Central America have seen double-digit growth in each of the past 3 years – with particular strength in petroleum products, building materials, helicopters, pharmaceuticals, food products, and various paper grades. Canadian investment in the region has also surged over that period, capped by a 93% jump in 2006. Going forward, however, Canadian businesses will find a more competitive environment on the isthmus, and will have to be more aggressive to hold onto (if not increase) their market shares. Central America is the only region in Latin America to have both an FTA with the US and stand a good chance of signing one with the EU. Further, after having begun to reduce tariffs unilaterally in the late 1980s, average tariff levels in Central America are today the lowest in all of Latin America.

But the proliferation of new trade and economic cooperation agreements are also expanding the region's potential and improving its investment climate, offering a multitude of new opportunities for Canadian businesses. In addition, large-scale infrastructure projects – including the US$5.2 billion Panama Canal expansion, the multi-billion dollar regional integration scheme known as the Plan Puebla Panamá, and local government infrastructure improvement plans – will offer a host of opportunities for Canadian suppliers and contractors, with overflow into related sectors.

In general, markets in the Caribbean now face elevated risk, not only because of recent global financial strains but also because of high energy costs (despite some offset from the PetroCaribe initiative). **Trinidad and Tobago** is the notable exception, as the country's gas reserves, as well as the government's robust spending plans, mean its appetite for foreign goods and services will stay strong through 2008. The **Dominican Republic** continues to boom, and for Canada the export outlook appears promising, with government spending likely to rise in 2008. Unfortunately, risks will rise too as the country faces elections in May 2008, while there are concerns the IMF program will not be renewed. Growth in Canadian exports to **Cuba** will moderate over the forecast period, but its economy will continue to benefit from high nickel prices and improved access to short-term financing. Meanwhile, exports to **Jamaica** will surge in 2007, but medium-term prospects remain modest, with tourism and resources standing out as potential bright spots.

Overall growth in Central America and the Caribbean is estimated to have slowed to 5.4% in 2007, and a further loss of momentum is expected for 2008 as growth slips to 4.3%. Economic growth averaged 6.8% in 2006, the strongest pace in years.

South America

The South American economy grew 5.6% in 2006 – driven by activity in Argentina and the Andean region. What's more, domestic demand now appears to be picking up at the same time as global trade flows ease and favourable commodity prices trend back toward historical norms. Almost across the board, South American businesses, governments and consumers are playing an increasingly important role in sustaining above-average growth rates. While uncertainty surrounding the US economy could dampen the outlook going forward, we expect average growth over the forecast horizon to fall only slightly. Although the region is better positioned to weather the coming downturn, the consequences of protracted financial market turbulence would differ significantly by country. Like the rest of Latin America, the resource-rich South can be divided into two camps – those that used the commodities boom as a stabilizing force, and those that regressed further into dependency.

The benefits of pragmatic policy orientation and market-based reform underpin macroeconomic stability and structural soundness in Brazil, Colombia, Peru, Chile, and even Uruguay. Solid credit expansion, job creation in the formal sector of the economy, real wage gains, and government transfers have sparked the domestic consumer. Further, comfortable credit and regulatory conditions have facilitated longer planning horizons, leading to improved investment trends and widespread gains in potential growth. Looking ahead, we expect most central bank authorities to remain on alert against inflationary pressure – a result of buoyant domestic demand, and rising food and energy prices. Only Brazil appears to have further scope for monetary relaxation, especially given the sharp appreciation of the *real* and increasing reliance on imports.

The other end of the spectrum is characterized by a general predilection for populist rhetoric, a confrontational approach toward foreign investment, and an often pro-cyclical economic policy bent. In these cases, weak investment, low incentive for diversification and surging government expenditures have fostered increased dependence on commodity prices and rising inflation. The short-sighted policy approach of the Kirchner/Fernandez administration portend another period of economic instability in Argentina, especially in the face of persistent energy shortages. Venezuela remains vulnerable to a sudden and sharp reversal going forward, with oil making up more than half of fiscal revenues and over 90% of the country's export earnings. Ecuador's prospects are also severely constrained by an uncertain investment and macroeconomic backdrop. Like its newly adopted patron, the country's emboldened stabilization fund may allow for some latitude, but on-again off-again musings over a sovereign debt default cloud the outlook for much-needed foreign investment. Weak investment prospects will also undermine Bolivia's economic stability, as will the country's enduring legacy of social and political polarization.

Economic growth in South America is estimated to have averaged 5.5% in 2007, off slightly from last year's 5.6% pace. We expect the pace of economic activity to show a more meaningful slowdown in 2008, as average growth for the region is forecast to pull back to 4.6%. Leading the pack in 2007 is Argentina, Peru, Colombia, Venezuela and Chile with growth in the range of 6 to 8%. The remainder of the region, including Brazil, is on track to post growth in the neighbourhood of 4 to 4.5% in 2007. Growth for all major markets in South America is set to slow in 2008, as commodity prices ease and activity in key export markets loses momentum.

5.2.2 Sub-Saharan Africa

Sub-Saharan Africa has registered 3 years of GDP growth in excess of 5%, and the outlook is promising with GDP growth set to accelerate to 7% in 2007 before easing back to 6.4% in 2008. This performance reflects several years of reforms, strong commodity prices and capital flows from new global investors such as China, India and Russia. Moreover, international commercial lenders have been increasingly involved in large-scale development projects. In addition, the African Development Bank has been able to focus on Africa's large needs for infrastructure and social projects. An increasing share of Sub-Saharan resources can now be channeled to economic growth and development instead of servicing debts.

Table 10: Canadian Merchandise Exports to Sub-Saharan Africa by Country (2005-2006)

Top 5 Markets	2005 (CAD mn)	2006 (CAD mn)	Growth (2006/2005)
South Africa	400.6	575.5	43.6
Nigeria	90.8	212.6	134.2
Ghana	91.4	104.7	14.6
Kenya	37.7	53.2	41.0
Angola	71.4	45.7	-36.0
All Others	322.3	367.1	13.9
Total	**942.8**	**1,313.1**	**39.3**

Source: Statistics Canada, EDC Economics.

The global boom in commodities has certainly made its mark on Sub-Saharan Africa. Many countries have benefited from the run-up in oil and metal prices, including Angola, Madagascar, South Africa, Botswana, Ghana, Mozambique and the Democratic Republic of Congo. Cocoa prices have also been doing much better in 2007, boosting export earnings for Côte D'Ivoire and Ghana. Prospects are equally encouraging for the region's oil producers as crude prices are projected to remain well above their historical averages through the next 2 to 3 years. At the same time, firmer prices for non-energy commodities, donor support and increasingly generous debt relief have lessened the impact of higher oil prices on oil importing African countries.

Table 11: Canadian Merchandise Exports to Sub-Saharan Africa by Sector (2005-2006)

Top 5 Sectors	2005 (CAD mn)	2006 (CAD mn)	Growth (2006/2005)
Aircrafts and Parts	81.6	193.2	136.8
Wheat Farming	126.3	170.2	34.8
Industrial Goods, Other	100.2	130.6	30.4
Agricultural Machinery & Equip.	72.4	92.8	28.2
Other Machinery	43.5	68.6	57.9
Total	**942.8**	**1,313.1**	**39.3**

Source: Statistics Canada, EDC Economics.

Looking ahead, we can expect to see increased activity in the oil and gas sector as companies take advantage of the region's significant energy resources. To be sure, the Gulf of Guinea has emerged as the world's premier deepwater exploration and production basin. Some 55 billion barrels of proven oil reserves were discovered in the past decade and the Gulf of Guinea now accounts for almost 40% of total global deepwater oil production. The Gulf of Guinea is likely to add nearly 3 million barrels per day (b/d) to global oil production by 2012. Although the region presently accounts for less than 5% of proven global oil reserves, more than 20% of global reserves discovered in the past 10 years came from the Gulf of Guinea. Compared to longer established deepwater sites like the Gulf of Mexico, West Africa remains relatively unexplored and exhibits significant potential in oil and natural gas for countries like Nigeria, Angola, Equatorial Guinea, Gabon, Republic of Congo, and Sao Tome and Principe. The impact on investment, balance of payments and GDP growth for these countries will be significant.

Debt Relief Improves the Outlook for Africa

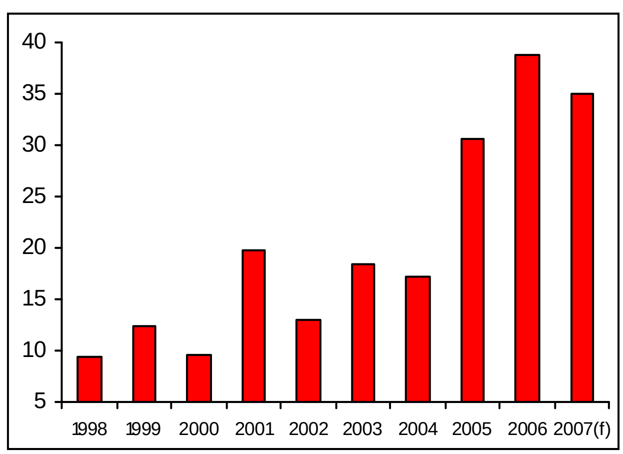
As of August 2007, 23 African countries have implemented macroeconomic policies that can be supported by formal IMF programs. These programs vary across countries, but most have embarked on a Poverty Reduction and Growth Facility (PRGF) program. There are countries, such as Democratic Republic of Congo (DRC), that have been building a track record under a Staff Monitored Program (SMP) to qualify for a formal IMF program. The good news is that these countries are serious about macroeconomic policy, but the bad news is the public sector cannot borrow on commercial terms if these countries want to respect IMF conditionality.

The Heavily Indebted Poor Countries (HIPC) Initiative has identified 40 eligible countries and most of them are in Africa. Among these, 18 Sub-Saharan African countries have reached their "Completion point" so far in 2007. This means that at least 90% of their external stock of debt has been cancelled. In addition, these countries had their debt to International Financial Institutions (IFIs) cancelled in 2006 under the Multilateral Debt Relief Initiative (MDRI). This debt forgiveness has enabled many of the region's countries to reach balance of payments viability and debt sustainability. Going forward, the focus will be on responsible lending and borrowing, especially in relation to productive investment.

GDP growth in South Africa accelerated to an annual rate of 5% during the past 2 to 3 years, thanks to sound policies, favourable global conditions, and public and private sector spending. Nevertheless, the pace of economic expansion is likely to be sensitive to the higher interest rates required to keep a lid on inflationary pressures, which have been testing the 6% upper limit of the central bank's target. Conservative policies have reined in the fiscal deficit to manageable levels. Large capital inflows have covered the wider external current account deficit, which have resulted in an accumulation of external foreign reserves equivalent to 6 months of imports cover. South Africa remains an investment grade country. South Africa's economy is estimated to have grown by 5.4% in 2007, and a similar pace of 5.5% is forecast for 2008.

Despite elections and changes in leadership, **Nigeria's** economic performance has been improving, and the outlook is encouraging with the new finance minister committed to the reforms introduced by the previous administration. The deputy governor of the central bank has voiced the need for spending discipline, further deregulation and macroeconomic stability. Oil output and earnings have been negatively affected by recurring violence in the Delta region and kidnappings, but the current account remains in surplus. Nigeria has met the performance criteria of the IMF program reviews and made serious progress with its banking sector. An attempt has been made to strengthen the naira (the country's currency) and check inflation through re-denomination. Credit rating agencies, such as Fitch and S&P, have confirmed their "BB-"rating to Nigeria, a couple notches shy of investment grade. We expect Nigeria's economy will finish 2007 with growth of 8% before slipping to just below 7% in 2008.

Figure 18: Global FDI Inflows to Africa (USD bn)



2006 is a preliminary estimate.
Source: UNCTAD, EDC Economics.

Angola's performance has been one of the strongest on the continent, and the outlook is equally promising with double-digit economic growth forecast to continue. GDP is estimated to have grown by 20% in 2007, and we expect an increase of 15% in 2008. The country is benefiting from buoyant oil conditions, diamond mining, agricultural earnings and reconstruction. Admittedly, growth is from a low base. Business conditions are characterized by a feverish macroeconomic climate, double-digit inflation, bottlenecks and shortages, which often result in project cost overruns. Angola is likely to record further large fiscal and external current account surpluses. While reducing external arrears, Angola has been accumulating foreign exchange reserves. The country has been reluctant to follow a multilateral approach to regularize its external debt arrears. However, bilateral oil-backed credit lines have been concluded with countries like China and Brazil.

Table 12: Canadian Foreign Direct Investment (CAD mn)

	2002	2003	2004	2005	2006
Algeria	--	78	--	268	278
Ghana	87	89	284	--	--
Libya	198	--	--	--	--
Mauritius	0	12	12	40	0
Namibia	18	18	19	--	--
South Africa	158	112	129	319	774
Zimbabwe	27	27	27	27	27
Total Africa	**2,804**	**2,218**	**3,277**	**3,560**	**4,595**

Source: Statistics Canada. Data refer to stock of FDI.

Madagascar has been implementing structural reforms for the past 25 years, and has been trying to recover from severe balance of payments and external debt problems since the early 1980s. It remains one of the poorest countries in Sub-Saharan Africa with low savings, poor infrastructure and institutional capacity. Economic growth of around 5% is projected for 2007 and 2008.

Cameroon's GDP growth is improving, but at 4%, it is far too low for an oil-producing country that has benefited from debt cancellation under the Enhanced HIPC initiative and MDRI treatment. Businesses face numerous challenges and foreign investment is held back by poor infrastructure. S&P gives Cameroon a "B-" rating. **Gabon** has benefited from buoyant oil and commodity prices. Far-reaching reforms under IMF guidance and the regularization of domestic and external arrears have boosted investor confidence. Growth appears to have accelerated a little in 2007 with GDP expected to rise by 4.3%. A gain of 4.2% is projected for 2008.

After having implemented back-to-back IMF programs, **Ghana** has experienced solid annual growth of 6% during the past 3 years. For 2007, growth probably accelerated to 6.2%. We expect this pace to continue through 2007. Most of its external official debt has been cancelled. Even though the private sector has to cope with high domestic interest rates and high inflation, private companies have always played a significant role in Ghana. S&P and Fitch have both assigned a B+ rating to Ghana. **Zambia** is emerging from a period of severe macroeconomic problems, which have plagued the country since the beginning of the millennium. The country is recording robust growth while exercising fiscal restraint following the implementation of its PRGF IMF program. Copper output should double by 2009. Zambia has also benefited from the Enhanced HIPC Initiative and MDRI treatment. Economic growth picked up a little in 2007 to an estimated 6.0%, and the momentum is expected to continue with growth forecast at 6.2% for 2008.

The **Democratic Republic of Congo's (DRC)** international financial rescue package is in trouble. The package is conditional on a formal IMF program being put in place. The last Fund program veered off track in 2006, and since then the country has been building a track record. DRC's outlook remains uncertain as the normalization of its financial situation will require additional debt relief under the Enhanced HIPC initiative. Economic growth slowed to 5.1% in 2006, and it looks like the country will not be able to post growth much above this rate through 2007 and 2008.

Kenya's economic growth accelerated to an annual rate of 6% in 2006, and the country is expected to finish 2007 with growth of 6.2% before easing back to 5.8% in 2008. Along with firm prices for tea and coffee, stronger trade flows, tourism and transport activity are adding to the upturn in growth. Kenya's international rescue package, which is back on track, has contributed to a normalization of its financial position while providing a manageable liquidity position. **Sudan**

has recorded high GDP growth and strong export earnings due to oil, but the problems in the Darfur region have made it difficult for the international community to address the country's huge debt arrears.

Canadian exports to Sub-Saharan Africa have been doing very well in 2007. During the first half of the year, exports increased by 45% compared with the same period in 2006. Canadian companies have been shipping more goods to countries such as South Africa (+50% y/y), Nigeria (+56%), Ghana (+42%) and Kenya (+41%). Ongoing investment in mining and energy projects will continue to support Canadian exports of related services and equipment through the next 12 to 18 months.

5.2.3 Middle East and North Africa

The Middle East and North Africa (MENA) countries are enjoying a fourth year of buoyant global oil markets. Macroeconomic performance in 2007 is turning out to be stronger than projected at the start of the year, and may be even better than in 2006 despite ongoing pockets of tension. The outlook for 2008 is equally promising given that global demand and pricing for energy will probably remain robust. In addition, countries such as China and India are looking to forge tighter trade alliances in an effort to secure future energy supplies.

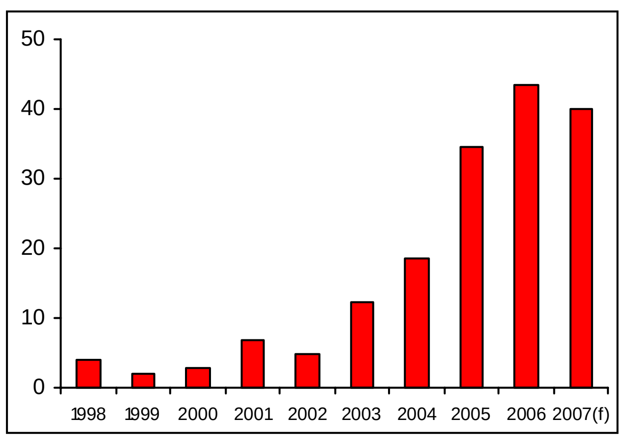
Table 13: Canadian Merchandise Exports to the Middle East and North Africa by Sector (2005-2006)

Top 5 Sectors	2005 (CAD mn)	2006 (CAD mn)	Growth (2006/2005)
Wheat Farming	257.7	674.4	161.7
Other Machinery	423.6	501.7	18.4
Oilseeds and Pulse	191.3	306.2	60.1
Computers and Parts	243.5	242.1	-0.6
Newsprint	248.2	211.2	-14.9
Total	**3118.3**	**3491.4**	**12.0**

Source: Statistics Canada, EDC Economics.

The region has been experiencing an unprecedented macroeconomic boom due to large petrodollar revenues, which have been recycled and re-invested across the region. Over the short term, the Middle East and North Africa is expected to grow faster than the rest of the world, with a GDP growth rate in the area of 5.5% a year during 2007 and 2008, which is respectable given the political difficulties being experienced in the region. The region is characterized by two zones of fast-growing economies – the Gulf Cooperation Council (GCC)[3] countries and the North African countries. The area also embraces a zone of volatility (Iran, Iraq, Syria, PAL and Yemen) where business conditions are challenging. The reconstruction of Iraq and Lebanon has the potential to further boost growth in the region, but violence overshadows prospects in these countries.

Figure 19: Global FDI Inflows to the Middle East (USD bn)



2006 is a preliminary estimate.
Source: UNCTAD, EDC Economics.

The inflow of successive oil windfalls has produced large current account surpluses, which during 2007 are expected to be roughly 10% of GDP for Bahrain and Oman, 20 to 25% of GDP in case of Saudi Arabia and Qatar, and over 30% of GDP in the case of Kuwait. These significant inflows of petrodollars, which coupled with fixed peg currency regimes, have led to a phenomenal accumulation in foreign exchange reserves way beyond simple liquidity needs and exchange rate stability. These earnings, however, have not been reflected in the stock of foreign exchange reserves held by the various central banks of the region. The funds have instead been directed

[3] The GCC includes Saudi Arabia, United Arab Emirates, Kuwait, Oman, Qatar and Bahrain.

into Sovereign Wealth Funds (SWF), which for the region have been estimated at between US$1.5 trillion and US$2.5 trillion. The UAE, for example, has the largest SWF, which is held by the Abu Dhabi Investment Authority, and has been estimated at US$875 billion.

Regional Governments Pursuing Structural Improvements and Economic Diversification

Last July, the largest bank in the region was created with the merging of the Emirates Bank International and National Bank of Dubai (EIB-NBD), with combined assets of US$55 billion. The financial sector has undergone four structural changes over the past few years, which have included: (1) increased lending to the private sector (up by 33% in 2006); (2) a larger role for Islamic banking (growing by 25% a year); (3) modest growth in foreign competition; and (4) reduced public sector involvement, which has been particularly pronounced in Qatar. Despite a relatively large number of banks per capita, particularly in the Gulf countries (e.g. the UAE has 46 banks for a population of 3.2 million), the banking sector remains concentrated with only a few banks holding the majority of lending and deposits. Larger domestic banks are small compared with the large foreign banks looking to participate in the GCC market. Thus, domestic banks have been marginalized in the region's booming project finance and long-term structured financing market. Moreover, domestic banks are heavily exposed to real estate and subsequently vulnerable to price corrections in the regional real estate market, and in particular in the Gulf, following the launching of mega-construction projects.

The pace of economic activity in the region is unprecedented and is due in part to the decision in the MENA countries of investing at home and embarking on economic diversification – especially in the higher value-added end of the hydrocarbon industry such as the petrochemical industry and/or gas production. Unlike the past, petrodollars are remaining in the region, with a greater focus on large-scale mega projects in the Gulf region and in countries with lesser oil resources (e.g. Jordan and Egypt) and in projects in North African countries. Increased spending in infrastructure, construction, real estate, tourism, finance and other non-oil industries (e.g. aluminum smelting) is adding to the area's diversification.

The MENA region has a better business climate than many other emerging countries and the GCC scores high when taking into account institutions, infrastructure and market orientation, according to a study done by Business Monitor International (BMI). The average score for the business environment for the MENA is 52 (over 100) compared with 35 for the rest of Africa. That said, a complex bureaucracy, corruption and skill shortages still undermine the MENA region's business environment.

A planned monetary union among the GCC members by 2010 is questionable after Oman's declaration earlier this year of not being in the position of meeting the criteria, which includes capping budgetary deficits at 3% of GDP, a public sector debt cap at 60% of GDP and an inflation rate cap of 2%. A monetary union has the potential to streamline the GCC's foreign exchange operations, as well as introduce greater monetary and fiscal discipline, which could attract more investment from outside the region.

Issues facing individual MENA countries

Saudi Arabia has announced its largest budget ever for 2007, which could boost expenditures to US$110 billion this year for infrastructure development, capacity building and job creation. Expenditures are aimed at increasing oil capacity to 12.5 million barrels per day (b/d) by 2009 while maintaining 1.5 to 2 million b/d in spare capacity. The Kingdom has been planning a series of mega-projects, such as the US$6.7 billion Knowledge Economic City, the US$8 billion Prince Abdulaziz bin Mosaed Economic City and the US$27 billion King Abdullah City. These special economic zones are expected to focus on tourism, fishing, agriculture, energy and aluminum. Economic growth slipped to 4.6% in 2006, but has since picked up and should average 5% in both 2007 and 2008.

DEVELOPING MARKETS OVERVIEW

The **United Arab Emirates (UAE)**, which are one of the most vibrant economies (7.5 to 8.5% annual GDP growth) among the GCC countries, have embarked on a wave of large-scale investment projects in services, manufacturing and heavier industrial projects that offer a wide range of opportunities for investors. Not only Dubai, but Abu Dhabi has initiated a series of mega-projects. Rating agencies, such as Fitch and S&P, assigned a risk rating of "AA" to Abu Dhabi in July 2007. Economic growth in the UAE is expected to ease back to 8.2% in 2007 and 7.2% in 2008, following a rise of nearly 10% last year.

Kuwait needs major investment to maintain and increase current oil output of 2.5 million b/d. The country intends to build a new oil refinery, perhaps the world largest. Investments in Kuwait's upstream and downstream oil sectors could top US$55 billion by 2020. Kuwait's economy is forecast to grow 7% in 2007 and 6.8% in 2008, up from the 5% pace set in 2006. Last August, Fitch upgraded **Bahrain's** rating to "A". A series of investments to boost oil and non-oil revenues (like low-sulphur diesel and aluminum) is taking place. Bahrain has one of the most liberalized investment codes in the Gulf. Growth in Bahrain's economy has eased from last year's 7.7% to an estimated 6.7% in 2007. A similar pace of 6.6% is forecast for 2008.

Oman, which has aging oil fields, has been pursuing its diversification program through large construction, industrial and tourism projects. Growth is expected to average around 6% in both 2007 and 2008, in line with the past couple of years. **Qatar**, which is at the forefront of the global gas industry, could be the largest LNG producer in the world by the end of 2007 and have the leading role in developing gas-to-liquids (GTL). Qatar has been securing long-term export contracts with the US and countries in Asia and Europe. Developing Qatar's energy sector has involved massive capital spending of about US$40 billion so far, with a further US$10 billion a year required over the next 7 years. These investments will support GDP growth of 7.8% in 2007 and 7.5% in 2008.

Table 14: Canadian Merchandise Exports to the Middle East & North Africa by Country (2005-2006)

Top 5 Markets	2005 (CAD mn)	2006 (CAD mn)	Growth (2006/2005)
United Arab Emirates	511.9	706.4	38.0
Saudi Arabia	395.2	499.0	26.2
Egypt	304.5	405.7	33.2
Israel	396.8	391.7	-1.3
Iran	256.2	287.4	12.2
All Others	1,253.6	1,201.3	-4.2
Total	**3,118.3**	**3,491.4**	**12.0**

Source: Statistics Canada, EDC Economics.

The series of UN and US sanctions, imprudent economic measures and worsening business conditions have taken a toll on **Iran's** economy. Government spending and strong oil prices are boosting growth, for now. But inflation is also a concern. Economic growth is expected to average 4.3% in 2007 before slipping back to 4% in 2008. Investment of US$100 billion is needed to refurbish the oil and gas sector, but investors are nervous. Transferring payments out of the country is increasingly difficult. Tourism and FDI flows to **Lebanon** have fallen dramatically, and disbursements of the US$7.6 billion pledged earlier this year have been difficult due to political impasse and security risk. Economic growth will remain sluggish through the next 18 months.

Algeria's 2007 budget calls for a sharp rise in capital spending under its 2005 to 2009 public investment program. The country has been pre-paying its external debt and has accumulated foreign exchange reserves equivalent to several years of import cover. Algerian economic growth has picked up in 2007 and should average 4.8% for the year. The momentum should continue through 2008 with growth forecast at 5.2%. **Libya's** GDP growth is forecast to accelerate to 8% during 2007 to 2008 (vs. 5.6% in 2006), largely due to strong government spending. Large surpluses have led to foreign exchange reserves equivalent to several years of import cover.

Egypt's economy is benefiting from greater investment inflows, tourism earnings and workers' remittances, due largely to robust economic conditions in the GCC countries. The balance of payments is doing well, but the budgetary deficit and inflation are of concern. Although easing a little, economic growth in Egypt remains solid at an estimated 6.4% in 2007. A similar pace of

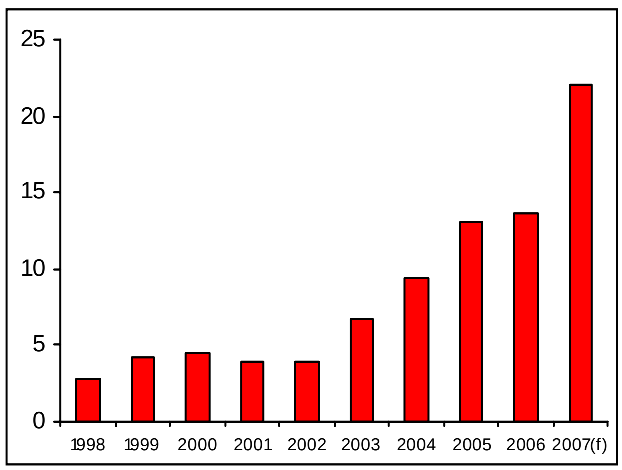
6.3% is projected for 2008. **Tunisia** aims to grow by 6% a year by boosting exports and investment to raise income and reduce unemployment. Tourism receipts, workers' remittances and FDI from the Gulf countries are supporting **Morocco's** economy, although growth has slipped to an estimated 3.5% this year. **Iraq's** reconstruction and oil production continue to be seriously affected by a lack of security. Despite restive neighbours, **Israel's** economy is doing well. Economic growth of around 5% is forecast for 2007 (in line with 2006), but 2008 will see growth slip to 4.5% as the Israeli economy is affected by the slower US and world economies.

5.2.4 Central and Eastern Europe

Central and Eastern Europe (CEE) is continuing its strong growth performance this year, driven by the larger economies of Russia, Turkey, Poland and Ukraine. These countries, with their trade access to developed international markets, have boosted economic activity among the smaller neighbouring countries. Looking forward, the global economic expansion and associated boom in commodity prices now appear to be moderating, led by the housing-related economic slowdown in the United States. The Eurozone, the most important export market for the larger economies in the CEE region, is forecast to grow by 2.4% in 2007 and 2.2% in 2008. This growth profile will frame CEE regional growth of 6.4% in 2007 and 5.4% in 2008.

Risks to the outlook continue to point to the downside. Among developing markets, the CEE region appears somewhat more vulnerable to a more prolonged liquidity crunch, on the basis of their respective weaker macroeconomic fundamentals. In particular, the large current account deficits of Turkey, Hungary and possibly Romania make them vulnerable to any major global financial revolt. Our baseline scenario is that the liquidity squeeze is short in duration, allowing a more gradual re-pricing of risk in developing markets.

Figure 20: Global FDI Inflows to Russia (USD bn)



2006 is a preliminary estimate.
Source: UNCTAD, EDC Economics.

The **Russian** economy continues to expand at a robust pace, driven by strong foreign investment, industrial production and domestic spending. World energy prices are central to the current expansion and improving external balance and will remain pivotal in 2007 and 2008. Even so, growth is forecast to slow somewhat during the remainder of this year and into next. Growth in 2008 is forecast at 5.9% compared with 6.8% in 2007. Demand from EU countries is expected to ease going forward. In addition, real ruble appreciation is expected to dampen export volume growth. Emerging capacity constraints and bottlenecks will impose progressively more binding constraints on real economic activity. And lastly, structural reforms that are either lagging or postponed could prove problematic for growth beyond 2008. But, slower real economic growth will not tarnish Russia's financial health. Although commodity prices are forecast to pull back, prices will remain at levels high enough to continue the feathering of the financial nest egg, helping to ensure strong import volume growth. This will bode well for Canadian exporters, particularly those who specialize in agricultural machinery and energy-related mining equipment. Opportunities also appear to be growing in transportation, electrical, medical and scientific equipment. Canadian companies continue to grow their export sales in Russia, with shipments rising by over 50% to reach $876 million in 2006. Canadian export sales are on track to post strong gains again in 2007, with industrial and mining machinery, aerospace components, automotive and meat products taking the lead.

Turkey's economy accelerated in the early part of this year, thanks primarily to strong exports.

Looking forward, net export volumes, robust capital investment and government spending will continue to generate respectable growth (of just over 5% in both 2007 and 2008). In contrast though, household spending activity will be fairly modest at best due to very high interest rates. Turkey's central bank has kept rates high for quite some time in an effort to bring down inflation, which is currently above inflation target goals. Interest rate relief next year, which is the more likely scenario, will depend upon inflation expectations and the pass-through effects of a weaker lira currency to prices of imported goods. Although Turkey's financial situation is in fairly good shape, with its large current account deficit mitigated by strong FDI and plentiful foreign exchange reserves, certain vulnerabilities are noteworthy. Among the central and eastern developing countries, Turkey's external financing needs are the greatest, which renders itself vulnerable to current turmoil unfolding in international markets. In addition, any potential unwinding of carry trades adds an additional layer of risk to the outlook. So far, global business confidence remains largely intact and the expected re-pricing of risk in financial markets has had little effect on Turkey's external debt. Although subdued household spending will dampen imports, Canadian exports to Turkey will still experience robust growth. Canadian merchandise exports to Turkey increased by 13% in 2006, reaching $540 million. So far this year, the steady upward trend seen in recent years has continued, with exports up around 20% over the first 6 months of the year compared to the last 6 months of last year. Apart from coal exports, the strongest export growth has been in pulp and paper, agricultural products, medical equipment and various machinery and electrical components.

Table 15: Canadian Merchandise Exports to Central and Eastern Europe by Country (2005-2006)

Top 5 Markets	2005 (CAD mn)	2006 (CAD mn)	Growth (2006/2005)
Russia	513.0	793.0	54.6
Turkey	450.2	520.5	15.6
Poland	228.9	261.1	14.1
Romania	149.3	206.9	38.6
Czech Republic	130.7	205.8	57.5
All Others	561.6	653.3	16.3
Total	**2,033.6**	**2,640.6**	**29.8**

Source: Statistics Canada, EDC Economics.

The **Polish** economy broadly speaking is very solid, with its growing trade linkages into developed European markets acting as a real source of strength. Economic growth in the first half of 2007 year has been slightly stronger than last year, running at around 7%. Thanks to foreign direct investment targeted at export-oriented industries, Poland's industrial machine is operating in high gear, with growth up over 13% in the first quarter of this year. While FDI and business spending have added to growth, employment gains and healthy wage and salary growth have boosted household incomes, resulting in stronger consumer spending. Understanding that the real economy is firing on all cylinders, it is fairly remarkable that inflation remains low, clocking in at around 2%. Although there has been some upward momentum recently, inflation is unlikely to pose problems for monetary authorities, which will enable central officials to keep rates fairly accommodative at around 5%. On the financial side, Poland's situation is relatively good. Foreign exchange reserves are rising and FDI flows mostly cover the current account deficit (which is in the range of 2 to 3% of GDP). In addition, the dominance of foreign-owned banking institutions helps limit the financial stress risks to the real economy. Looking forward, the country's growth looks set to continue on the strength of trade linkages and strong domestic activity. But the pace of growth is forecast to slow to 4.4% in 2008 versus this year's expansion of 6.4%. Canadian exports to Poland in 2006 were $310 million, up 16% from $267 million in the previous year. Apart from base metals, export growth has been strong for pharmaceutical and medicine,

Table 16: Canadian Merchandise Exports to Central and Eastern Europe by Sector (2005-2006)

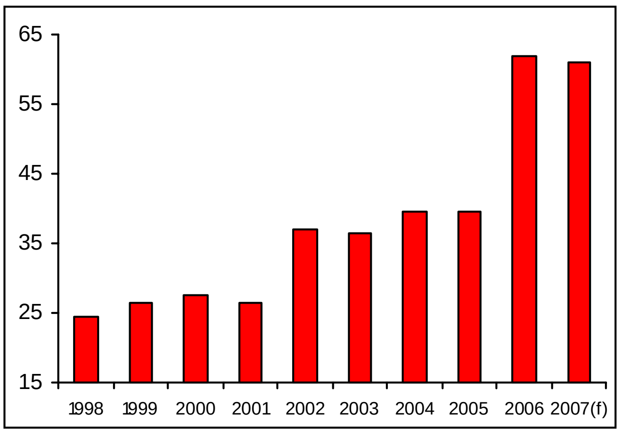
Top 5 Sectors	2005 (CAD mn)	2006 (CAD mn)	Growth (2006/2005)
Other Machinery	246.1	300.9	22.3
Meat Products	165.3	275.1	66.4
Agricultural Machinery and Equipment	131.9	220.1	66.8
Computers and Parts	153.4	187.9	22.5
Chemicals	107.8	177.1	64.3
Total	**2,033.6**	**2,640.6**	**29.8**

Source: Statistics Canada, EDC Economics.

aerospace parts, power transmission equipment, rubbers and plastics, and various industrial and electrical machinery and equipment.

Ukraine's economy is on track to expand briskly this year and next, thanks largely to strong capital investment and household spending. Net exports continue to act as a drag on overall growth though, with the bulk of export shipments (steel and agri-food products) destined for Russia, Turkey and Italy. Looking ahead, Ukraine's trade deficit is expected to rise later this year and into next, due to declines in their terms of trade (natural gas prices up, steel prices down). Strong domestic spending will drive import volume growth, which will also contribute to the trade deficit. Consequently, Ukraine's current account deficit is expected to widen further in 2007 and 2008. Canadian exports to Ukraine in 2006 were $106 million, up 30% from $82 million in the previous year. Growing export opportunities are in pharmaceutical and medicine, seafood products, agricultural machinery and other industrial equipment.

Figure 21: FDI Inflows to Central & Eastern Europe (USD bn)



2006 is a preliminary estimate.
Source: UNCTAD, EDC Economics.

The **Czech Republic** economy is growing at a strong pace, around 6% so far this year. Thanks to solid household spending, domestic demand has been the engine of growth. Looking forward, this is expected to continue, although to a somewhat lesser extent due to government tax reform and reductions in welfare entitlement benefits. We expect economic growth will ease to 4.3% in 2008. Underlying inflationary pressures will remain largely contained this year and next, owing to structural economic changes that are producing productivity improvements. A stable currency together with stronger trade integration with developed European economies will continue to support exports. A strong domestic economy will also ensure robust import demand, which will continue to present export opportunities for suppliers of pharmaceutical and medicine products, refined metals and alloys, aerospace parts, telecommunications equipment and other general industrial machinery and equipment. Canadian exports to the Czech Republic were $217 million in 2006, up 54% from $141 million in the previous year.

The **Romanian** economy is expanding briskly, but concern that the economy is over-heating is evident. Domestic demand growth is hot, driven by employment gains and rapid credit demand growth, compounded further by pro-cyclical fiscal policies with strong public sector wage growth. Domestic spending is now clearly in the driver's seat, as strong import growth pushes the current account deficit higher (over 10% of GDP and rising). Around one third of the deficit is covered by FDI at present, much lower compared to almost full cover in 2002. These developments increase the risk of a loss of financial market confidence, resulting in sudden capital outflows and greater volatility and depreciation of the local currency (the leu). Growth in Romania's economy is forecast to slow to 5.1% in 2008 (down from an estimated 6.3% in 2007) as EU demand softens, and tighter monetary policy dampens domestic consumption. Canadian exports to Romania in 2006 were $214 million, up 34% from $159 million in the previous year. Apart from base metals, Canada's export prospects remain positive for meat products, computer equipment, heat and boiler equipment, wire and wireless telecommunication equipment and industrial and electrical-type equipment.

The **Hungarian** economy is slowing this year, restrained by much weaker household and government expenditure. Consequently, the main growth support this year and into 2008 will come from net exports. Thus far, past appreciation of the local currency (the forint) has not had any substantial effect on exports, thanks to fairly strong foreign demand, particularly from

Germany. Looking forward, export growth is expected to remain relatively solid while weaker domestic spending softens import volumes. Consequently, the current account deficit is not expected to decline further, remaining within 4% to 5% of GDP. Risks to the outlook are noteworthy though. Recent financial market turbulence had a substantial negative impact on the forint, an indication of Hungary's potential vulnerability to further disturbances in financial markets. High external debt and dependence on foreign investors to finance its deficits leaves it vulnerable to a shift in investor confidence. Overall growth in Hungary weakened to an estimated 3.0% in 2007 and a further softening to 2.8% is projected for 2008.

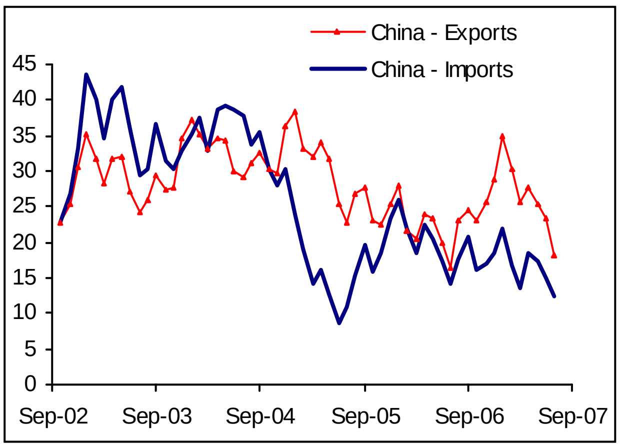
The Baltic economies – **Estonia, Latvia and Lithuania** – are expanding at a fast pace, maybe too fast. Inflation has begun to accelerate, particularly in Latvia and Estonia. These developments alone threaten to delay Eurozone admission, which would be a negative development for these countries given their large current account deficits (15% to 25% of GDP), rising private sector debt, and in some cases low external liquidity and high short-term debt (Latvia). Among the Baltic countries, Lithuania appears to be in a somewhat stronger economic and financial position.

5.2.5 Asia

China

China's economy continued its rapid expansion through the first half of 2007, with growth in the first half of the year averaging 11.5% y/y, above the 10.7% growth achieved in 2006. But the groundwork for an easing in economic growth has been laid – namely a weaker US consumer and ongoing tightening of monetary policy by the Chinese authorities. A strong external sector in recent years has increased the importance of exports to China's economy. Domestic demand remains an important source of growth, but its weighting in the economy has slipped in the past few years. In 2005, household consumption made up 38% of China's GDP, down from 46.4% in 2000. With a weaker US consumer in the outlook, China's growth is expected to lose some steam over the next 12 to 18 months. As a result, growth is forecast at 11.0% in 2007 and 10.0% in 2008.

Figure 22: China Exports and Imports Losing Some Momentum (6-month moving average – y/y % change)



Source: Bloomberg, EDC Economics.

External reserves passed the quasi-mythical level of $1 trillion early this year, and have since continued growing, thus strengthening the country's external position. Export growth in the first 7 months of 2007 increased still further, to 30% y/y versus last year's average growth of 26% during the same period. Import growth has remained relatively stable at around 20%. This has created a burgeoning trade surplus, adding fuel to the potential war of words between the US and Europe over the value of China's currency, the yuan. The top destinations for Chinese exports are the US, EU and Japan. As these economies slow,

Table 17: Canadian Merchandise Exports to Developing Asia* by Sector (2005-2006)

Top 5 Sectors	2005 (CAD mn)	2006 (CAD mn)	Growth (2006/2005)
Metals	1,043.9	1,654.5	58.5
Chemicals	1,474.4	1,524.9	3.4
Pulp	1,160.7	1,497.5	29.0
Wheat Farming	682.7	975.9	42.9
Oilseeds and Pulse	625.7	886.7	41.7
Total	**10,297.2**	**11,905.2**	**15.6**

Source: Statistics Canada, EDC Economics.
*Developing Asia refers to all Asian countries except Japan, Hong Kong, Singapore, South Korea and Taiwan.

DEVELOPING MARKETS OVERVIEW

China will inevitably lose momentum as well – an outcome that will have a negative spillover effect on countries that ship a significant portion of their exports to China. Much of East Asia and commodity exporters in Latin America and Africa will feel these knock-on effects.

An important corollary of rapid economic growth is inflation. After having been contained from March 2005 to December 2006, inflation has increased this year, reaching a 10-year high of 5.6% in July (above the Central Bank's 3% target). Chinese authorities have attempted to rein in economic growth by tightening bank reserve requirements and raising interest rates, along with other administrative actions. It remains to be seen how much effective tightening the authorities can carry out given that China's financial markets remain relatively shallow. Slower US growth will certainly have a more pronounced effect on China's exports, which has been the country's economic engine.

Table 18: Canadian Merchandise Exports to Developing Asia* by Country (2005-2006)

Top 5 Markets	2005 (CAD mn)	2006 (CAD mn)	Growth (2006/2005)
China	6,647.2	7,182.8	8.1
India	1,033.8	1,535.9	48.6
Indonesia	682.7	779.5	14.2
Thailand	428.3	491.1	14.6
Malaysia	346.5	461.9	33.3
All Other	1,158.5	1,453.9	25.5
Total	**10,297.2**	**11,905.2**	**15.6**

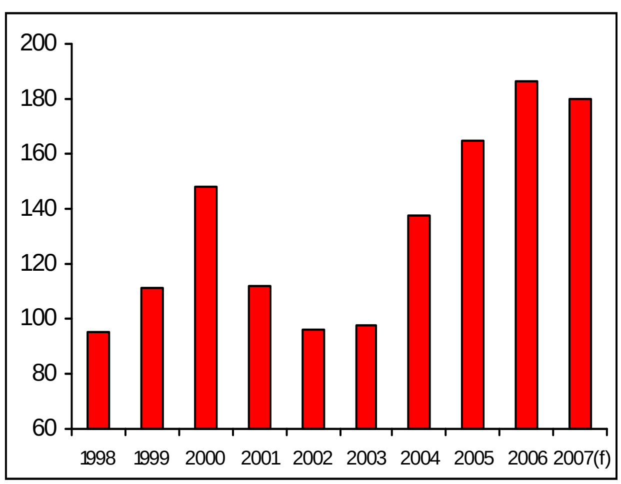
Source: Statistics Canada, EDC Economics.
*Developing Asia refers to all Asian countries except Japan, Hong Kong, Singapore, South Korea and Taiwan.

South Asia

India's economy is continuing its rapid expansion with GDP growth of 9.2% in 2006, ahead of the 8.5% pace set in 2005. But surging economic growth coupled with supply-side constraints, rapid credit growth and a rising current account deficit have raised fears of overheating, prompting a reaction by the Central Bank to cool the economy through successive interest rate hikes and higher bank reserve requirements. Despite these measures, the Indian Central Bank (RBI) is still clearly worried about the growing threat of inflation. The latest data (June 2007) show inflation running between 5.7% and 7.8% in three of the four principal consumer indexes. While this is down from the average of nearly 8% recorded in April-May 2007, it remains higher than the RBI target of 5.0 to 5.5%. Tighter monetary policy could be the reason why industrial production is losing some momentum. Export growth, while still strong, has also been generally weaker in 2007. With the world economy slowing through the next 12 to 18 months, India's economy is also expected to slow. Domestic demand is expected to continue its solid performance, although more restrictive monetary policy will dampen some of the growth in consumption and investment. As a result, Indian GDP growth is forecast to slow to 8.2% in 2007 and 7.9% in 2008.

The political situation in **Pakistan**, **Sri Lanka** and **Bangladesh** will overshadow the solid growth forecast for these countries in 2007 and 2008. Slower growth in the main export destinations of the region, especially the US and Europe, will dampen prospects for the important textile and garment industry of those countries. Nonetheless, we expect the current account balances to improve going forward, based on a smaller oil import bill and rising remittances from abroad, which will remain an important source of foreign exchange. Strong global prices for agricultural commodities including wheat and rice will support farmers' income, but at the same time maintain inflation at elevated levels. As such, monetary policy

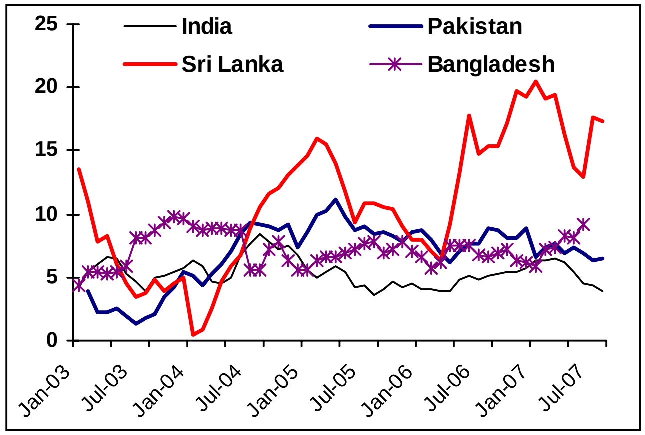
Figure 23: Global FDI Inflows to Asia (US$ bn)



2007 is a preliminary estimate.
Source: UNCTAD, EDC Economics.

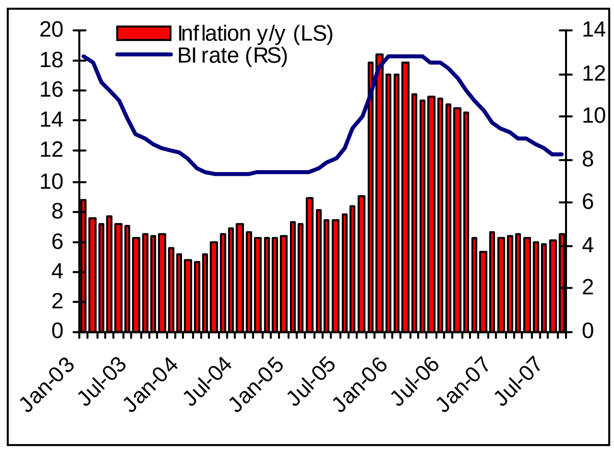
easing is unlikely in the near future. At the same time, risk perceptions for the region remain high and capital flight is a possibility. Political instability, governments' fiscal situation and macroeconomic instability are the main downside risks in the region, which could result in capital flight, a more rapid depreciation in local currencies against the US dollar and much weaker growth. Overall, we expect economic growth in Pakistan to remain just above 6% in 2007 and 2008, in line with 2006. In Sri Lanka, economic growth will slow to a still respectable 6.0% in 2007 and 2008 after expanding 7.4% in 2006, as tighter monetary and fiscal policies take their toll. Growth in Bangladesh will slow to 6.3% in 2007 and 6.2% in 2008, as weaker export demand for textiles and garments, and more moderate growth in the agriculture sector take hold.

Figure 24: Inflation Pressures Remain in South Asia (y/y % change in consumer price indices)



Source: Bloomberg, IMF, Bangladesh Bank.

Figure 25: Monetary Policy Easing Continues in Indonesia



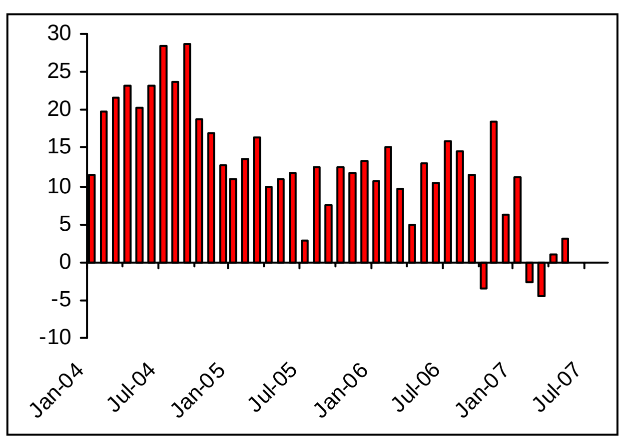
Source: Bloomberg. Note: Before July 2005, the reference rate for Indonesia was the SBI 1-month auction yield.

Southeast Asia

Indonesia's growth will hold steady through 2007 and 2008, driven by government spending, and greater investment and household consumption generated by aggressive interest rate cuts. With inflation sitting comfortably within the target range of 5 to 7%, rate cuts will be sparser from now on. A new investment law passed in March will also encourage FDI inflows, and provide further support to growth. Real GDP growth will reach 6.1% in 2007 and 6.0% in 2008, up from 5.5% in 2006. The proposed 2007-08 budget includes substantially higher government spending in transportation safety, education and infrastructure, three major roadblocks to improving the country's growth potential. Other reforms in mining, labour, customs and taxation are underway, which could support stronger growth in 2008 and beyond.

Malaysia's real GDP growth will soften to 5.5% in 2007 (after showing a strong 5.9% increase in 2006), as electronics exports (49% of total) weaken with the US and global tech slowdown. The ringgit's recent depreciation will benefit exporters, but will not be sufficient to

Figure 26: Malaysian Exports Faltering (y/y % growth)

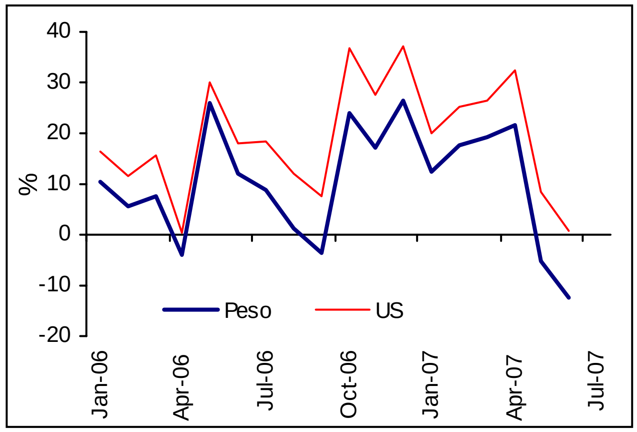


Source: Bloomberg.

offset weakening demand from key markets. Higher public investment from the Ninth Malaysia Plan will put a floor under economic growth in 2007 and 2008, along with the expansion of the palm oil sector for the biofuel industry and the manufacturing sector. Government spending pressure will also come from generous public service wage increases announced in May, the construction of a US$7 billion oil pipeline bypassing the Malacca Strait, and the Northern Economic Corridor Region development program. Nonetheless, the government's deficit-to-GDP ratio will continue to improve and remain manageable. With inflation under control, the Central Bank will maintain its neutral stance regarding monetary policy. In 2008, growth is expected to stabilize at 5.5%, as greater government spending offsets weaker external trade.

Philippines' real GDP growth hit a 17-year high in the first half of 2007, reaching 7.2%, on the strength of greater household consumption and election-related spending from the government. While government spending will ease in the remainder of 2007, record levels of remittances, which rose 18% y/y in the first half of 2007, will continue to support household spending. Electronics exports, which represent over half of total exports, have been weakening in recent months as global demand for electronic goods slows, and are expected to weaken further going forward. Exporters will also be affected by the strong peso, which had increased 13% y/y against the US dollar at the end of August. Excess liquidity, related to record levels of remittances and portfolio investment inflows, will prevent the Central Bank from easing monetary policy in the short term despite low inflation. GDP growth should accelerate to 6.4% in 2007 before slowing to less than 6.0% in 2008.

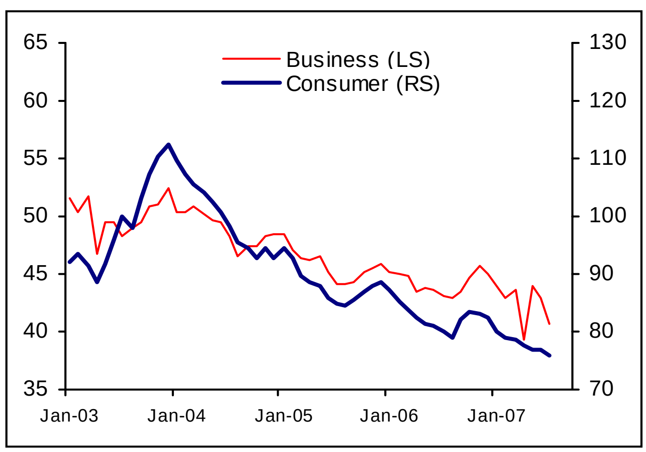
Figure 27: Philippines' Remittances (y/y % change)



Source: Bloomberg.

Thailand's real GDP growth will slow markedly to 4.0% in 2007, as a series of controversial decisions by the military government has sapped business and consumer confidence, leading to sharp declines in household consumption and investment. At the same time, the rapid appreciation of the baht and weaker growth in the US and Japan are putting more and more pressure on exporters, the last remaining engine of growth in Thailand. The baht's appreciation and the retreat of private demand have created a low inflationary environment, which allowed the Central Bank to repeatedly cut interest rates in a bid to stimulate growth. Growth in 2008 will be a little stronger at 4.3%, as we anticipate pent-up personal consumption will be released following the return of a democratically elected government and supported by the interest rate cuts in 2007.

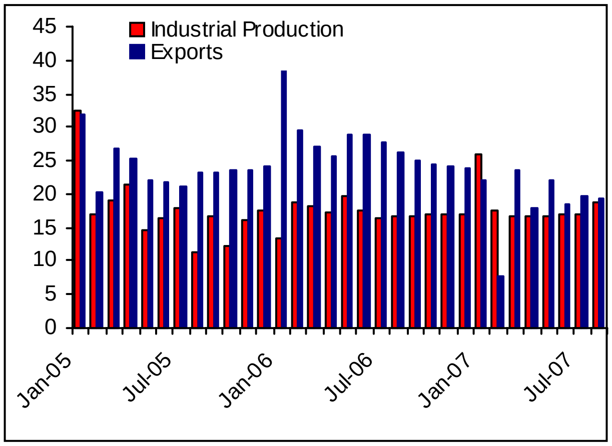
Figure 28: Thailand's Business and Consumer Confidence Continue to Deteriorate



Source: Bloomberg.

Vietnam export growth will remain strong over the next 2 years as large inflows of FDI build up export capacity. Oil exports will soften with reduced production at existing fields and lower prices, but will be compensated by high agricultural prices and increased textile exports. FDI inflows have boosted inflationary pressures, leading the government to take a series of measures to rein it in. Letting the *dong* appreciate was not one of them, as the government wants to support its exporters. Imports will also expand rapidly, because of greater consumer demand and investment. With greater investment and the related construction boom, real GDP growth will remain high in 2007 and 2008 at 8.0%. The government's fiscal balance will come under pressure with weaker oil production and prices, reduced tariffs (WTO obligations), higher public sector wages and greater investment in infrastructure.

Figure 29: Vietnam Exports and Industrial Production Still Strong (y/y % change)



Source: Bloomberg.

Canadian exports to developing Asia continued to increase rapidly in the first half of the year, gaining 18.4% y/y. Rising exports to China (+41%) and India (+52%) represent almost two thirds of the increase. China is now the main export destination of Canadian goods in emerging Asia, and is closing in on Japan as the number one market for Canada in the region. Canada's exports to other countries have also increased substantially, including Indonesia (+16%), Thailand (+34%), Pakistan (+41%), Philippines (+47%), Malaysia (+12%), Bangladesh (+47%) and Vietnam (+30%). Surging economic growth and industrialization have increased the demand for Canadian industrial goods, energy, and machinery and equipment. Exports of agricultural commodities have also increased rapidly so far this year, thanks to higher prices for some of Canada's major crops, especially wheat, canola and barley.

Table 19: Quarterly GDP Growth in Select Asian Countries (y/y % change)

	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007
China	10.4	11.5	10.6	10.4	11.1	11.9
Indonesia	5.0	5.0	5.9	6.1	6.0	6.3
India	10	9.6	10.2	8.7	9.1	9.3
Malaysia	6.0	6.1	6,0	5.7	5.5	5.7
Philippines	5.7	5.5	5.1	5.5	7.1	7.5
Thailand	6.1	5	4.7	4.3	4.2	4.4
Hong Kong	8.1	5.6	6.8	7.3	5.7	6.9
South Korea	6.3	5.1	4.8	4.0	4.0	4.9
Taiwan	5.0	4.7	5.1	4.0	4.2	5.1

Source: Bloomberg

Central Asia

Strong global demand for oil, gas and metals will sustain high growth rates in much of Central Asia in 2007 and 2008, but at a generally softer pace than in 2006. The rapid industrialization of China, India and Russia will only partly offset softening demand from the US, Europe and Japan, weakening overall export demand for metals and petroleum. As in recent years, the continued development of mining and hydrocarbon projects will again be supported by greater public spending and infrastructure investment. The high level of investment capital flowing into the region has in most cases driven up inflation, which

Table 20: Stock of Canadian FDI in Major Asian Markets (CAD mn)

	2002	2003	2004	2005	2006
Hong Kong	2,642	3,037	3,062	3,361	3,801
Singapore	4,228	3,703	3,577	3,532	4,007
Indonesia	4,193	3,436	3,248	2,639	3,127
China	721	838	1,034	1,344	1,563
Korea, South	749	698	1,362	356	431
Malaysia	718	435	564	494	568
Thailand	923	534	610	802	972
India	222	204	214	314	327
Taiwan	66	72	69	98	103
Philippines	153	117	119	114	141

Source: Statistics Canada.

monetary authorities have had little, if any, success in keeping under control. Outside the mining and energy sectors, FDI in the region will be limited, as political instability and a generally difficult operational environment continues to drive away many potential investors.

In Kazakhstan, oil output will increase only slightly in 2007, so economic growth will mostly come from the construction industry and the rapidly expanding services sector, particularly financial, banking, telecommunications and transportation. The development of oilfields will continue to generate high FDI inflows in the future, despite the ongoing problems at the Kashagan oilfield. High inflation and credit growth are potential sources of macroeconomic instability, especially considering the rapid increase of external borrowing to finance domestic credit demand.

Canadian exports to Central Asia and Caucasus have increased significantly over the past few years, but declined 8% y/y in the first half of 2007 to $106 million. Almost 70% of the total so far in 2007 was destined for Kazakhstan. High prices for metals and oil and gas will sustain mining projects and the demand for mining and construction machinery and equipment. At the same time, the push to develop commercial wheat farming in Kazakhstan and its high price will continue to sustain demand for Canadian agricultural machinery.