

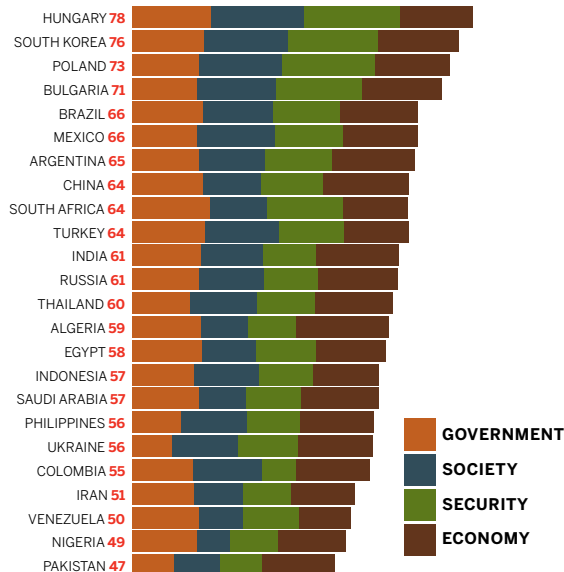
INSIGHTS FROM EURASIA GROUP

perspectives **POLITICS AND THE MARKETS** JUNE 2007



Global Political Risk Index (GPRI)

The GPRI, which is produced by Eurasia Group, measures a country's ability to absorb political shocks. The higher the number, the more stable the country.



Political Risk Comes of Age

In this issue of *Perspectives*, produced by the political analysts at Eurasia Group, we examine why political risk matters and how measuring it can help you make better decisions.

BY IAN BREMMER
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Investors fear unpredictable change, even as they seek to profit from the opportunities that uncertainty creates—a newly privatized industry in India, recently tendered oil blocks in Nigeria, a new pro-Western government in Ukraine. To balance risk and opportunity, those looking to invest abroad routinely consult economic-risk analysts. But economic data without political context provide a dangerously incomplete picture. In short, investors in foreign countries ignore political risk at their peril. Political risk is the impact of politics on markets. It is influenced by the rise of popular movements, personal relationships among political powerbrokers—any factor that can stabilize or destabilize a state's political and economic foundation. Investors in emerging markets are especially vulnerable to these sorts of risks.

Political risk is more difficult to measure than economic risk. Politics, after all, is influenced by such difficult-to-forecast variables as human nature and cultural change. To quantify political risk, analysts need proxies for their variables. Instead of trying to measure the independence of a nation's judges, analysts can determine whether jurists are paid a living wage, whether funded programs exist to inform them about new legislation and whether they are targeted for assassination.

Political-risk analysts also study the percentage of children who regularly attend school, how police and military salaries compare with criminal opportunities, and how much access to medical care is available

in towns with populations of 10,000 to 50,000 people. They then add economic variables to the mix: per capita income, balance of payments and national debt.

Taken together, this information reveals much about a country's strengths and vulnerabilities. Contrasting neighboring countries provides a good sense of where shocks from unstable nations might cross borders. Comparing a single nation's data points over time can reveal a trend—and provide early warning if this trend is gaining momentum. Armed with these insights, investors can seize opportunities and minimize risks.

Eurasia Group has developed a tool that comprises 20 composite indicators of risk in emerging markets. Distributed in partnership with Citi Private Bank, the Global Political Risk Index scores variables according to both structural and temporal components. Structural scores highlight underlying conditions. They then serve as a baseline for temporal scores, which reflect the impact of more-recent developments.

The indicators are organized into four equally weighted subcategories: government, society, security and the economy. Ratings for all four subcategories are aggregated into a single composite stability rating, which is expressed as a number on a scale of zero to 100—from a failed state to a fully institutionalized, stable democracy.

Politics has always been inseparable from markets; the world's first transnational trade organizations were moved by the political waves of their time. Today, ideas, information, people, money, goods and services cross borders with unprecedented speed—and the trend is intensifying. For investors seeking to profit in places that are socially, culturally and politically foreign, complementary insights on political and economic risk are vital.

CLOSE-UP: TURKEY

RISKS AND FORECASTS



Though Turkey should remain relatively stable in the near term, recent political upheaval has triggered an early parliamentary election that increases uncertainty for investors in Turkish assets, as reflected in the sharp downward movement in several components of the Global Political Risk Index.

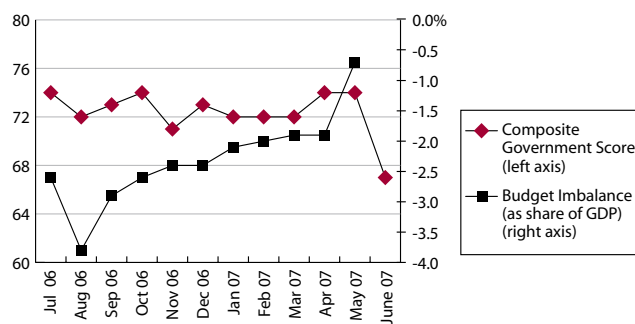
The outlook for a continued Justice and Development Party (AKP) majority government is uncertain. The election could result in a fragmented legislature and make building a new cabinet very difficult. Opposition parties have taken steps toward consolidation that increase the probability of a fractious parliament. This foreshadows problems for Turkey's budget deficit and for monetary and economic reform policies. Fragmented governments commonly result in larger budget deficits and reduced macroeconomic stability.

The falling government score hints at future budget problems.

The political fight that precipitated this election was over the parliament's selection of a president, in which intrusion by the army, a boycott by the opposition of the parliamentary vote and a questionable supreme-court ruling invalidated the ruling AKP's selection of its own deputy prime minister and foreign minister, Abdullah Gul, as the candidate for president. Together these actions raise concerns about the equal and systematic application of the law and the supremacy of civilian government. Near term, the AKP may indeed weather this storm and prevail in the July 22 election, but the potential for three or more parties winning parliamentary representation, but no single party winning a clear majority, is great enough to warrant close monitoring of the campaign.

	GOVERNMENT	SOCIETY	SECURITY	ECONOMY
JUNE.06	74	73	54	45
MAY.07	74	73	61	60
JUNE.07	67	68	60	60

FALLING GOVERNMENT SCORE HINTS AT FUTURE BUDGET PROBLEMS



Source: Eurasia Group

Inside the Index

In the following briefs, Eurasia Group analysts highlight the connections between stability and key political issues in important emerging markets.

LEGEND

- GOVERNMENT
- SOCIETY
- SECURITY
- ECONOMY

▲▼ Colombia

GPRI 55

SCANDAL UNDERMINES URIBE'S AGENDA

Colombia's mounting paramilitary scandal is closing in around President Alvaro Uribe and his supporters in congress, undermining Uribe's economic-reform agenda. Uribe has so far successfully fended off allegations that he promoted right-wing paramilitary activities, but members of his coalition are in the spotlight as the Supreme Court continues its investigation. Uribe's loosening grip on his congressional coalition has made it increasingly difficult to secure final approval of the transfers-reform bill, while Colombia's mounting negative press has reinforced heavy congressional opposition to a free-trade agreement in Washington.

▼▼ Iran

GPRI 51

INTERNAL OPPOSITION IS GROWING

The Iranian government's revised inflation statistics for the first quarter of 2007 suggest that prices are rising faster than previous estimates indicated and could reflect growing opposition efforts to undermine



President Mahmoud Ahmadinejad. In turn, this could threaten policy continuity and promote regime instability. The government revised trailing 12-month inflation to 22% from 12%. Such an increase indicates that internal government opponents to the president are attempting to undermine his populist image on economic policy. However, Ahmadinejad will likely continue to enjoy wide support for his firm stance on Iran's nuclear program.

▲▼▲ Nigeria

GPRI 49

PDP DOMINANCE BRINGS STABILITY

Despite broad-ranging doubts about the April general elections, the dominance of the ruling People's Democratic Party (PDP) will bolster near-term stability. The PDP government will quell resistance throughout the country but especially in the restive Niger Delta, where it will offer financial incentives to the people.

Unlike outgoing President Olusegun Obasanjo, who had to contend with a fractious federal legislature, President Umaru Musa Yar'Adua will enjoy a newly elected legislature dominated by party loyalists who will approve a critical spending plan to aid infrastructure development in the Niger Delta that should help restore stability.

▼▼ Saudi Arabia

GPRI 57

PRESSURES GROW

The war in Iraq and the escalating violence in northern Yemen are harming Saudi Arabia's security, a condition that will require continued, careful monitoring by both energy markets and investors in the kingdom. The intensification of combat between the Yemeni forces and the Shia-led Zaidi rebellion heightens pressure on Saudi authorities to prevent any negative reaction by its own Shia community. Though these external pressures compli-

cate matters, Saudi Arabia will remain on the offensive against internal terrorism.

▼▼ Ukraine

GPRI 56

UNCERTAINTY SUSTAINS INVESTOR CONCERNS

Continuing uncertainty over the timing of new parliamentary elections will raise investor concerns that the current political crisis will be protracted, and this could have negative implications for the economy. Although President Viktor Yushchenko and Prime Minister Viktor Yanukovich agreed on May 4 to form a working group to discuss a new election, disagreements remain over timing. Yushchenko, who most recently called for a June 24 vote, is willing to delay it until July 8, but Yanukovich wants an October vote to allow more time for campaigning.

The Outlook

Key issues and possible outcomes for the coming month. The individual country reports are available on request.

COUNTRY	GPRI*	OUTLOOK	WHAT TO WATCH FOR
Algeria	59	▲	A pending cabinet shuffle could result in stagnation, but renewed counter-terrorism efforts should lessen security risks.
Argentina	65	▼	The government will resist adjusting fiscal and monetary policy in spite of growing inflationary pressures.
Brazil	66	▲	The government's reform agenda should continue despite ongoing congressional investigations into the country's aviation crisis.
Bulgaria	71	■	The European Parliament elections in May should be a key indicator of political momentum for Bulgaria's parties.
China	64	▼	Deadlock on US-China economic dialogue will likely spur punitive legislation.
Colombia	55	▼	Investigations into links between congressmen and paramilitary forces will continue to generate waves, raising the costs of reform.
Egypt	58	▼	Labor strikes should continue unabated, but President Mubarak's consolidated power will push an economic-liberalization program.
Hungary	78	■	Health-sector reforms should continue despite a new health minister and their poor performance in opinion surveys.
India	61	▲	The government is making gradual progress with its economic-reform plans.
Indonesia	57	■	The coordinating minister for the economy could resign over a spat with the vice president about the Jakarta monorail project.
Iran	51	■	Mounting international pressure along with increased domestic dissent will undermine President Ahmadinejad's popularity.
Mexico	66	▼	Strikes, marches, electoral disputes and high-profile murders will hamper President Calderon's reform efforts.
Nigeria	49	▲	The uncertainty surrounding Umaru Yar'Adua's presidential election could linger, even as stability grows in the Niger Delta.
Pakistan	47	▼	Tensions sparked by the ouster of Chief Justice Chaudhry and the Waziri militancy will weaken President Musharraf's grip on power.
Philippines	56	▲	Speculation about another impeachment should subside after another pro-administration majority emerges in the House.
Poland	73	■	While tensions rise about the ruling coalition, the economy will continue to benefit from strong fundamentals and foreign investment.
Russia	61	▲	A slow summer will be marked by high-profile international gatherings and speculation on President Putin's succession plans.
Saudi Arabia	57	■	Saudi Arabia is likely to face heightened security risks due to internal militancy and cross-border stress.
South Africa	64	■	Concerns about inflation and the central bank's willingness to tackle rising prices will dominate the second half of 2007.
South Korea	76	■	Political parties on the left and right will be under increasing internal strain as the presidential election approaches.
Thailand	60	▲	A final draft of the constitution is due by the end of June; while it will generate substantial noise, no serious resistance is expected.
Turkey	64	▼	Elections and institutional uncertainties will raise political risks.
Ukraine	56	■	Political leaders will decide on a date for a new parliamentary election, likely in mid-to-late 2007.
Venezuela	50	▼	Inflation should increase as growing government spending continues to underpin growth and support for President Chavez.

Legend: ▲ Positive outlook ▼ Negative outlook ■ Neutral outlook

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