

Asia Pacific economic outlook



Outlook for Select Asia Pacific Economies

China

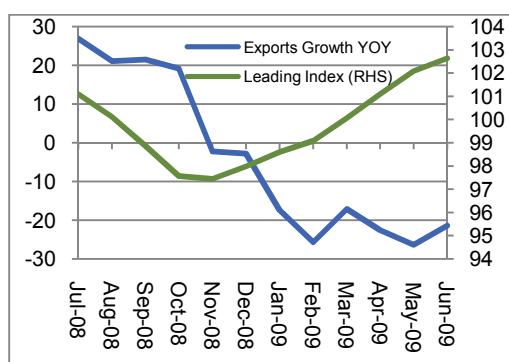
In the global fight against the economic slowdown, the highlight is surely the Chinese government's dedication to ensuring the economy grows at 8 percent in 2009. All signs point to them achieving it. The economy grew at 7.9 percent in 2Q09 on the back of the fiscal stimulus spending and loose monetary policy. Industrial production is back in double digits after many months, again a sign of the economy picking up. The co-incident index points to a recovery in the economy. Data indicates that the external economy remains weak, and much of the slack has been picked up by investment in fixed assets and cheap loans. The purchasing managers index points to an expansion.

Though the economy is forecast to grow above 8 percent in 2009 — it is likely to happen — there are significant vulnerabilities in the system. Much of the growth is being driven by the state and very little by consumers. For any sustained recovery, and because external markets still remain weak, domestic consumers must eventually become center stage in the recovery process, something yet to happen. Though car sales are up significantly, the high number is because of the base effect as well as government subsidies — it means car sales will falter sooner or later. Large swathes of migrant workers lost their jobs (they don't show up in official unemployment statistics) and haven't found new ones; the retail sector is at risk once subsidies on appliances are withdrawn.

The underdeveloped banking sector (compared to the West) is at significant risk, since a good percentage of the loans being granted are of lower quality —

anecdotal evidence suggests that loans are being used for speculative purposes. The balance sheets of banks are likely to see significant red ink in the coming years, though the government will likely write away the bad assets. However, since China wants to move up the ladder in terms of an economic structure, an underdeveloped banking sector will hamper that move.

Exports Growth (percent YoY) and Leading Index



Source: Bloomberg

Looking forward, officials have already sounded the alarm about the vast quantity of liquidity in the system, potentially inflationary down the line, and started applying the brakes. The People's Bank of China (PBC) has already started draining money out the system, and money market rates have been rising as a result. Inter-bank rates are still low, but they will likely rise as a result of the monetary tightening, though it is well below the benchmark interest rate. In its monetary policy meeting held in the July, the PBC released a very 'central bank-ish' statement (read deliberately vague) which said they would "implement a relatively loose monetary policy, maintain policy consistency and stability, and guide money and credit supply to grow in an appropriate manner." The benchmark interest rate, which has been constant since the end of December 2008, is unlikely to be raised until next year, once inflation starts forming in the economy.

Regarding the yuan, many China watchers expect the central bank to revalue the yuan once the economy has stabilized. However, many have lost that bet before, not least because the PBC has a \$2 trillion plus arsenal. While the cheap exchange rate has helped the export market in previous years, among other problems, it is helping create asset bubbles because of 'hot' money entering the system — a partial contributor to the phenomenal stock market growth this year. It is likely, though, that the PBC will keep the yuan at constant levels because the Central Committee of the communist party wants it to be that way. The yuan will likely be recalibrated in 2010 once there is data on whether the growth is sustainable or not. That said, if China's aspirations to move away from a manufacturing dependent economy need to be realized, they will need to move away from the fixed yuan policy sooner than later.

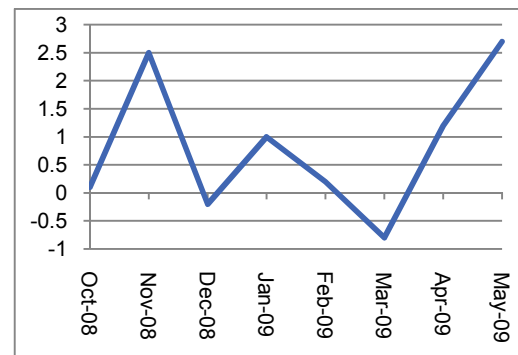
India

India has a rather unique problem in its economy. While the economy has been performing better than expected in recent months, it has been stuck in a problem over which it has no control whatsoever. The Indian economy is partly dependent on the monsoon rains and could face problems because the monsoon this year has been sub-optimal. Should the problem continue, there will be a downgrade in the performance of the Indian economy in FY10. Apart from the economic angle, there is likely to be a social angle given that over 60 percent of the population is dependent on agriculture.

This is not particularly good news for an economy trying to claw its way out of the slowdown. Indicators show that it is a bit successful in some areas, and, like pretty much every economy, there are risks present. An indicator that has been showing positive signs in recent months is industrial production. It grew at just 2.7 percent in May, but that is the best

number since August 2008. However, the cause for concern is that the capital goods sector has shrunk for three consecutive months, never a good sign. The auto industry has been one of the key reasons the industrial sector has picked up. Another good sign is that the rise in industrial production is driven mostly domestically, since the exports sector is still in a freefall. In tandem, there is also a rise in the purchasing managers index, a good sign.

Industrial Production (percent YoY)



Source: Bloomberg

Inflation, as measured by the wholesale price index (WPI) is negative, but it is vastly underestimating the actual inflation felt by consumers. The consumer price index (CPI) for industrial workers was 9.29 percent in June while it was 11.52 percent for agricultural laborers. The Reserve Bank of India (RBI) has kept its benchmark interest rate low for some months now because India hasn't had any fiscal stimulus spending as yet. Since real interest rates are negative, there is a real risk that it may lead to yet another asset bubble. It is very likely that inflation rates (WPI) will start increasing in the coming months, which means the CPI is going to go up even further. The RBI will likely start increasing interest rates towards the end of the year as the government stimulus plans pick up pace.

The stimulus plans are still unclear but it is likely to push up yields as the government issues debt worth about \$90 billion to

finance the spending plans. This means a double whammy for the private sector, both in terms of an investment crowd-out as well as increased cost of capital. The increased debt also means a higher fiscal deficit and a threat to India's sovereign rating. The government plans to cut the deficit by 1.3 percent next year but that is highly unlikely — it is difficult to cut government spending programs quickly and tax receipts are unlikely to rise that significantly — meaning that Indian companies may face funding issues and cost of funds issues next year too.

The rupee recovered partially from lows seen in March, but the recovery has been almost entirely because of foreign institutional investors bringing in money. It is likely to see weakness in the coming months, with the trade balance widening in recent months, and the export sector continuing its weak performance.

Japan

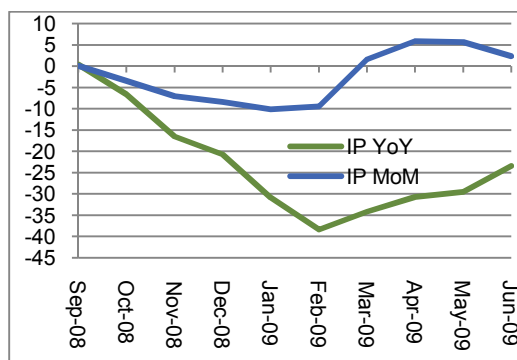
In the Index of Business Condition released by the Cabinet Office, the verdict given on the coincident index is a very crisp “halting to fall”. The coincident index, a measure of current economic performance, shows the economy to be recovering from the lows. The recovery is being helped by the green shoots of recovery seen elsewhere. Obviously this indicates the immense vulnerability of the Japanese economy, because it is still dependent on a very unclear external situation.

The recovery seen in the Japanese economy is fairly broad-based. June saw the fourth straight month of positive growth in the industrial sector. The data that needs to be considered to show the recovery is the MoM data, not the YoY data that still shows large decreases, albeit at a slower pace in the past few months. The economy is still close to its nadir, and only MoM numbers can bring out the finer picture.

Recent industrial production growth has largely been because of a buildup of inventory, but reports suggest that manufacturers plan to increase their production well past what would be considered normal inventory levels. This is borne out in the machinery orders data, which is a predictor of future capital spending — it looks to be recovering, again in MoM terms though. The forecast of the Tankan index for manufacturing companies shows an improvement in conditions. The other bright spot is the leading diffusion index, an indicator of economic performance in the next three to six months, which was up significantly in June. Consumer confidence is also up on the back of the stimulus spending measures.

Japanese companies, however, still have fairly significant excess capacity as well as excess labor, and the rise in machinery orders may be more of an anomaly than anything else. The Bank of Japan writes: “business fixed investment had declined substantially, reflecting the significant deterioration in corporate profits. It was likely to continue declining for the time being, given the severe situation in corporate profits and firms' funding and the strong sense of excessive capital stock among firms.” The export sector still remains fairly weak, and any fall in external demand will mean that industrial production goes down with it.

Industrial Production



Source: Bloomberg

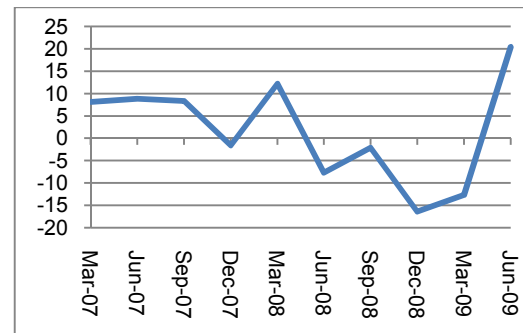
The weak spot, however, still remains domestic spending, and it doesn't help matters that the unemployment rate is at a six-year high, and the jobs-to-applicants ratio is plumbing new depths. This was Japan's vulnerable point during the 'lost decade' of the 1990s and it could return to haunt Japan if the fiscal stimulus plan isn't implemented effectively. The future of the fiscal stimulus plans are unclear because of the elections scheduled for September. It is very likely that the government, whichever it is post the election, will have another round of stimulus spending, if only to revive consumer spending.

The central bank is unlikely to change the benchmark interest rate from its current level of 0.1 percent. It certainly won't increase it for fear of upending an incipient recovery, and it won't reduce it because it will make no difference. Besides, the central bank is already conducting monetary policy through quantitative means, and feels it is achieving its objectives. The yen, which lost value from the highs seen early in 2009, has been range-bound in the 95–97 levels. It is likely that it will continue to remain at current levels in the near term.

Singapore

The field of economics is littered with a number of rules, with a lot of them having little real life applicability. However, if there was one rule that Singaporeans must have hoped works in real life, it would have been the Zarnowitz rule, which states that deep recessions are almost always followed by a sharp rebound. The economy, in the second quarter, rebounded like it had a point to prove; it expanded a massive 20.4 percent QoQ compared to a contraction of 12.7 in 1Q09 and 16.4 percent in 4Q08. Obviously some of the growth had to do with the base effect, but it doesn't take away from the fact the Singaporean economy is out of recession.

GDP Growth (Percent QoQ, Seasonally Adjusted Annual Rate)



Source: Bloomberg

That said, given the red flags still persisting in the global economy, a sober reminder that the economy is yet to cross the threshold is highlighted in the YoY growth numbers, which showed the economy contracting 3.7 percent in 2Q09. However, that is much better than the 9.6 percent YoY contraction in 1Q09. One of the main reasons for the improvement was the better than expected performance in the industrial sector in April. That spurt in growth, however, proved to be illusory and the industrial sector contracted in both May and June. The reason for the contraction was because of the renewed slowdown in the pharmaceuticals, electronics and chemicals sectors. The improving but still weak export sector and continuing weak external demand may prevent an immediate recovery in the industrial sector.

The Singapore dollar has been strengthening in recent months. This is contrary to what was expected in April. The Monetary Authority of Singapore (MAS), which controls monetary policy through the exchange rate, said that it widening the trading band, a move widely seen as a devaluation of the Singapore dollar. The unintended appreciation could have come about because of the general weakness of the U.S. dollar. The strengthening currency has helped keep the domestic inter-bank rate low, and inflation fears (caused by the increase in

inflows because of the strengthening currency) never panned out because of weak commodity prices and weak global demand. Any drastic change in the Singapore dollar is likely to happen only in October when MAS meets to review its policy. Until then, forwards point to little or no change in the dollar.

Going forward, according to forecasts by the Monetary Authority of Singapore and the IMF, the economy will definitely contract in 2009, partly because of the sharp contraction in the first quarter. The MAS has forecast that the economy will shrink 4 to 6 percent this year, a very plausible number. There are some numbers to support sustained growth in the coming months — chief among them is the manufacturing purchasing managers index (PMI). The PMI is slightly above 50 (51.5 in July) — a number above 50 indicates an expansion — but it has been stuck at around the same number for three months straight, perhaps reflecting the ambivalence in the industrial sector. Retail sales (ex. Motor vehicles) are seeing a flat line as opposed to a downward sloping one, not necessarily bad in this environment. Of concern, though, is the real estate sector, which is still seeing a fall in prices and a rise in office vacancies that could roughly translate to a higher unemployment rate.

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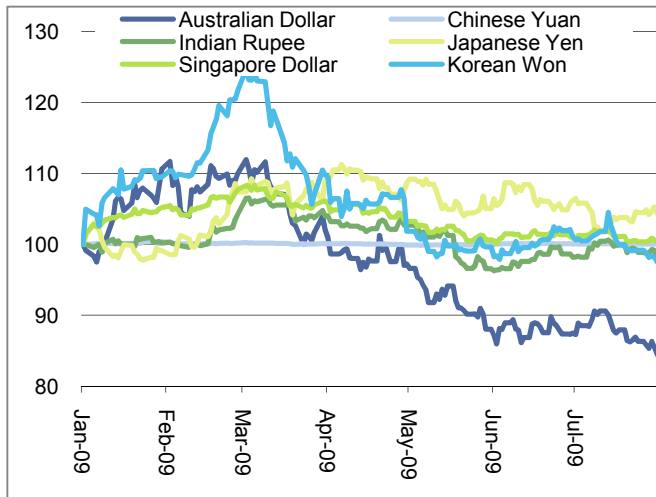
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Select Economic Indicators

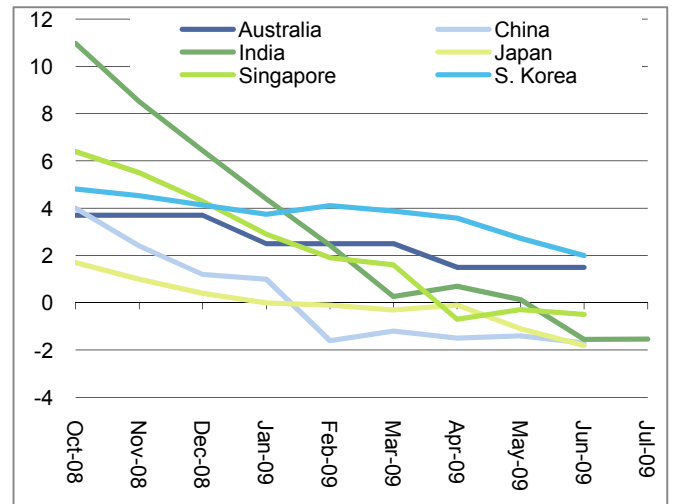
Indexed Daily Movement of Major Currencies (Jan 1, 2009 to July 31, 2009)



Source: Bloomberg

Note: Above 100 means depreciation and below 100 means appreciation. All exchange rates are against the U.S. dollar.

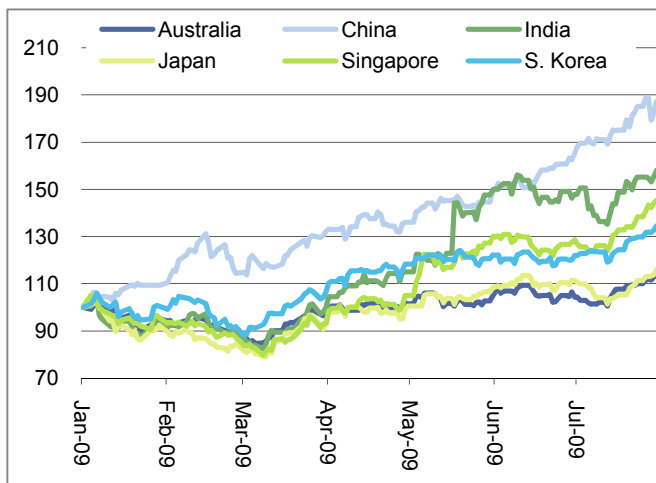
Inflation Rates



Source: Bloomberg

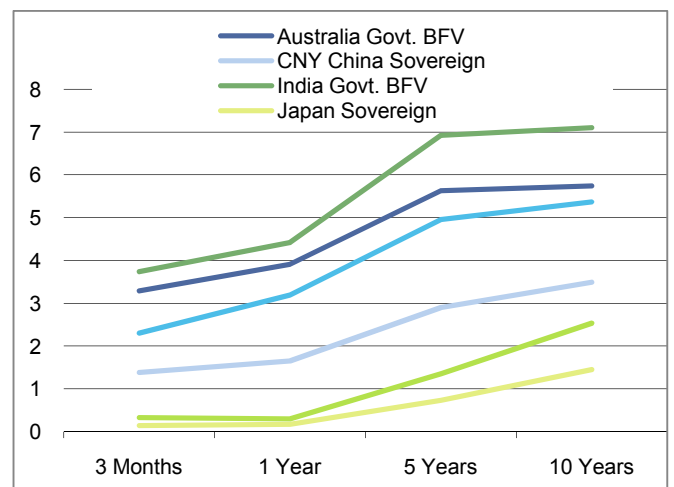
Note: Australia's inflation rate is a quarterly rate. India's is a weekly rate that is averaged.

Indexed Daily Movement of Major Stock Exchanges (Jan 1, 2009 to July 31, 2009)



Source: Bloomberg

Yield Curves*



Source: Bloomberg

* As on August 10, 2009

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