

Asia Pacific economic outlook: China, Indonesia, Malaysia, Philippines



Outlook for Select Asia Pacific Economies

China

There were three important political events in November 2009: the Asia Pacific Economic Cooperation (APEC) meeting hosted by Singapore, President Obama's visit to China, and the China–EU summit. All these events recognized China's growing importance in the global economy. Singapore's Prime Minister Lee Hsien Loong, for instance, reiterated China's importance to the prosperity and stability of the APEC countries.

Though President Obama's visit and the China–EU summit are supposed to have achieved little by way of concrete action, a high profile meeting of global heads was bound to raise the issue of maintaining the yuan fixed against the dollar. While the value of dollar has declined against most currencies, it has been amazingly stable against the yuan — in the past six quarters, the yuan–dollar exchange rate has ranged between 6.80 and 6.88 yuan. Any doubts about the Chinese position on the issue, however, were quickly dispelled by the complete silence President Hu Jintao maintained in response to President Obama's call to appreciate the currency.

It is unlikely that the currency will appreciate before exports recover strongly and/or inflation becomes a huge concern. With exports still below the previous year, there is likely to be substantial overcapacity in China. This means that inflationary expectations are likely to become a concern only if there is significant improvement in external demand. With the unemployment rate in the United States still high, and the European Union seeing rather modest recovery, consumption in the developed world is not expected to show a sharp recovery in this quarter or the next. The

yuan can be expected to appreciate against the dollar only after the recovery in the developed world is strong enough to pull Chinese exports back on track.

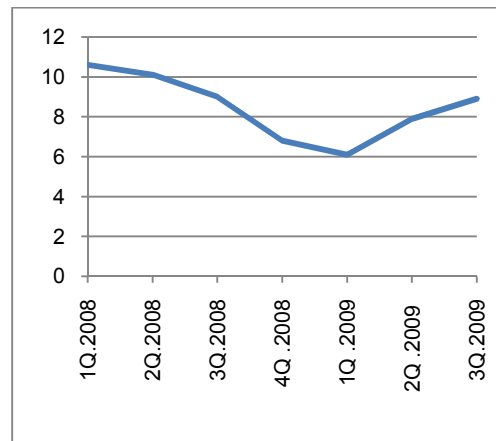
The economy returned to mild inflation in November, with consumer prices rising 0.6 percent (YoY). Compared with inflation, however, an asset price bubble is a bigger concern. Stock markets and property prices have shot up as the People's Bank of China (PBC) infused massive liquidity into the system — banks have lent 8.92 trillion yuan in the first ten months. With a fixed dollar-peg, and the Federal Reserve keeping the interest rate near zero, it is unlikely that the PBC will hike the interest rate immediately. An interest-rate hike at this point could boost capital inflows and fuel both inflation and an asset price bubble.

The exit strategy, it appears, is likely to come in stages. The immediate response is probably a withdrawal of liquidity from the system through open market operations, such as the issuing of three-month bills and 91-day repurchase agreements in October. Tighter lending norms are also likely to be imposed on banks. This is expected to be coupled with tighter control over capital inflows, which appears necessary given that the yuan has only a one-sided (appreciation) risk, making it an ideal bet for speculative or "hot money" inflows directed toward the stock and property markets. The next stage would likely be a calibrated de-pegging from the dollar that gives China greater control over its monetary policy. The recent statement by the Chinese Vice-Foreign Minister Zhang Zhijun that China will increase the flexibility of the RMB exchange rate at a controllable level seems to refer to this scenario. The People's Bank of China has also stated that it "will improve the yuan exchange rate formation mechanism."

In short, the "low interest rate–fixed exchange rate" policy stance will likely

continue beyond the first quarter of 2010, unless there is a surprisingly large turnaround in exports earlier. Coupled with the fiscal stimulus, low interest rates will continue to strengthen domestic demand and investment. The decline in exports has started tapering off, which suggests that exports are likely to show positive (if somewhat tepid) growth in the next quarter. Reports suggest that exporters have started re-hiring, though this has not completely wiped off the number of layoffs since last year. A rise in exports, through its impact on employment, can also work to strengthen domestic demand.

Quarterly Growth Rate (YoY)



Source: Bloomberg

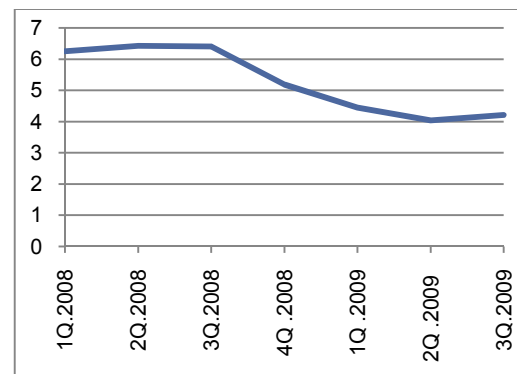
The numbers for November were very strong. Industrial production was up 19.2 percent and retail sales grew at 15.8 percent. With domestic demand expected to continue to drive growth, and exports to act as less of a drag on growth, the economy is expected to turn in a very strong performance — probably closer to 10 percent — in the last quarter of 2009. The trend will likely continue into the first quarter of 2010.

Indonesia

Indonesia is the only G20 country, other than India and China, which has continued to register positive growth through the global recession caused by the financial

crisis. The economy is expected to grow between 4 and 5 percent this year. A fairly large domestic market, with a population of 240 million and per capita income of close to US\$ 4000, has definitely helped. Household spending has remained resilient this year, growing at 4.75 percent in 3Q09. Consumer spending accounts for close to 60 percent of the GDP.

Quarterly Growth Rate (YoY)



Source: Bloomberg

Government spending, on the other hand, has increased at a rapid pace this year, compared with the past. Following the East Asian financial crisis, there has been a lot of emphasis on reducing and restructuring public debt. Debt now stands at the fairly low level of nearly a third of the GDP, and the external debt position is comfortable. Still, the government has continued to maintain a hawkish stand; the fiscal deficit is expected to remain well below 3 percent this year, and is likely to fall to 1.6 percent next year. Most of the fiscal stimulus was directed at reducing tax rates, and was targeted to keep consumer spending up to substitute for the decline in exports.

Exports continued their slide in the third quarter. This has been one of the primary reasons for the decline in economic growth from more than 6 percent in 2008 to slightly over 4 percent in the first three quarters of 2009. Though exports are a much smaller component of the GDP than in the GDPs of other ASEAN economies,

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they are still around one-third of the GDP. Given a much sharper contraction in imports, the current account continues to remain in surplus. This helped the rupiah strengthen about 16.5 percent against the dollar. Last year the rupiah depreciated against the dollar as foreign investors withdrew from the market due to dampened investment sentiments.

Looking ahead, growth could tick upwards. In October 09, exports reached a record high of US\$ 11.9 billion, which is around 10 percent higher than the same month last year, and 20 percent above September exports. This, for now, settles the fear of appreciating currency hurting exports. Domestic consumer sentiment continued to improve in November. Investment, which has grown at a very slow pace in the first three quarters, could pick up as consumer sentiment improves. Many sectors have seen both revenues and profits increase in recent times. Further, most of the spending on infrastructure, envisaged in the fiscal stimulus plan, is likely to come now as disbursement of funds was rather slow till September 09. This will add to the more optimistic outlook in the current and next quarter.

One key feature of the Indonesian economy has been the risk of high inflation. Inflation, however, remained subdued in November, declining over the previous month. This will allow Bank Indonesia (BI) to continue with the accommodative monetary policy and keep the BI interest rate at 6.5 percent for some more time. A number of factors are likely to keep inflationary concerns low. One, an appreciation in exchange rate means that the risk of importing inflation is low. Two, the budget deficit is fairly small, and not as inflationary as in some of the other Asian economies. Three, the risk of a sharp decline in subsidies on fuel, fertilizer, and electricity is also fairly low, though there is growing debate around it. A cut in subsidies carries the risk of raising

consumer prices fairly sharply in the short term. Given the controversy created by the cut in fuel subsidies in May 2008, the process is likely to be gradual. A cut in subsidies, however, can give the government more elbow room to direct expenditures toward infrastructure.

With private consumption driving growth, the economy is in good shape and can only be expected to improve from here. Net exports and investment are likely to pick up, while growth in private consumption will likely continue to drive growth. Expect the economy to accelerate to 6 percent growth next year.

Malaysia

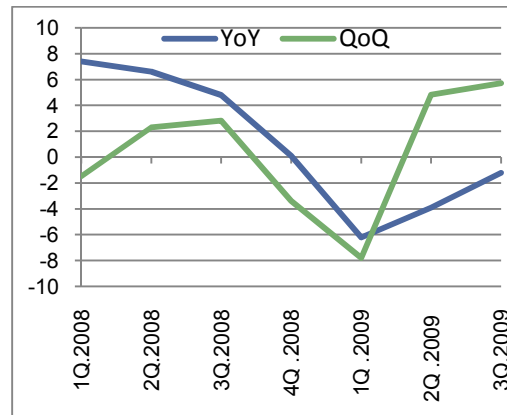
Malaysia, which has ambitions of becoming a high income nation by 2020, appears to be on the road to recovery. Achieving the high income nation status is estimated to require a growth rate of 5.4 percent (though estimates vary) every year for the next decade. However, the economy is expected to shrink between 2 and 3 percent this year (which is lower than earlier estimates that predicted it would shrink by 4–5 percent) and could show a growth of 4 percent plus next year.

The slide started in 4Q 08 and appears to have bottomed out in 1Q 09. Given the economy's huge dependence on exports — exports are more than 100 percent of GDP — the slump in key export markets was bound to trigger the recession. The contraction in exports, which started in 4Q 08, reached its peak in 2Q 09, when exports fell by 17.3 percent YoY. Private investment also suffered as businesses lost confidence following a compression of domestic and foreign demand.

Expansionary fiscal and monetary policies have pushed up private spending, though most of the recovery in 3Q 09 has come due to a nearly 11 percent rise in government spending. Bank Negara has persisted with an overnight policy rate (an

indicator of monetary policy stance since 2004) of 2 percent since February 2009, and left it unchanged in its monetary policy meeting on November 24, 2009.

Quarterly Growth Rate (YoY)



Source: Bloomberg

Though the QoQ growth has shown a sharp v-shaped recovery, the economy is still below the level it was at last year. There are signs that the recovery could strengthen this quarter. In October, exports grew YoY for the first time in the past one year. The 1.6 percent gain came as most export markets improved, though most of the growth came from ASEAN countries and China. Though exports to the United States and Japan improved MoM, they still remain subdued when compared with a year ago. Growth in exports of electrical and electronic products led this recovery. In the coming months, crude petroleum and liquefied natural gas could benefit from strengthening prices. Palm oil tends to track the prices of crude petroleum. Demand for palm oil is expected to remain firm and rising prices will help generate higher revenues for exporters.

The budget for 2010 remains expansionary, with an estimated budget deficit of 5.6 percent in 2010, though the deficit will come down from around 7.4 percent in 2009. Given the expected recovery in export markets, the return to fiscal prudence next year is a welcome

step. Not that the government needs to worry too much about its debt situation — the national debt as a percentage of GDP is relatively small and most (more than 95 percent) of it is domestic debt. A worrying feature could be that the lower budget deficit next year comes as a result of contraction in total government expenditure as revenues are expected to decline. However, a major portion of the fiscal stimulus of RM 60 billion unveiled in March 2009 is expected to carry over to the next year and will probably last till the middle of next year. The construction sector will likely benefit from the remaining fiscal stimulus spending, pushing up growth in related sectors. Further, most of the contraction in government expenditure in next year's budget is due to reduced operating expenditure not development expenditure.

Consumer prices continued to decline in October. Food prices did rise in October and energy prices could begin to firm up as the global economy recovers, which could take the economy toward mild inflation in 2010. There are no signs of an asset bubble forming. The ringgit has appreciated slightly this year against the dollar, and the trend is likely to continue next year. The change is not expected to be strong enough to hurt exports. All these trends mean that the monetary policy stance will likely remain loose for some time, at least till the middle of next year.

With the fiscal and monetary stimulus continuing, and exports expected to recover, the growth this quarter and in the next is likely to return to positive territory (YoY). The recovery could be stronger than expected.

In the long term, however, the performance could depend on whether the economy is able to make the structural changes that look necessary. A key feature would be the ability to attract private foreign investment, especially in the services sector. Some of the policy

measures announced recently, such as the abolition of the rule to offer an equity stake to *bumiputera* in many subsectors, are designed to do precisely that. Malaysia is also looking to attract investment from China and Singapore, apart from strengthening its trading ties with these countries.

Philippines

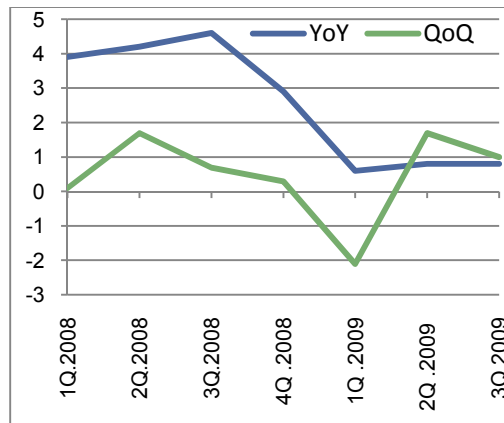
The recovery in 3Q09 was surprisingly subdued at 0.8 percent (YoY). The trend is in strong contrast to most other Asian economies, which have shown a sharp V-shaped recovery. Though private and government consumption grew at a fairly good pace, investment and exports continued their slide. Industry suffered as a consequence. Despite strong growth in mining, industry declined by 4.4 percent, mainly on account of a 7.6 percent decline in manufacturing, which accounts for slightly more than one-fifth of GDP.

Tropical storms in September and October destroyed homes and caused significant damage to the rice crop. This could have a negative impact on consumption, and rising food prices could build momentum for inflation. Consumer prices increased 2.8 percent in November, driven by a 4.8 percent rise in food prices. India has also suffered damage to its rice crop this year, and the international price of rice could rise next year due to increased demand. This is an area of concern going forward, as the government has limited room to maneuver its fiscal policy and will likely rely on monetary policy to drive up growth. The Bangko Sentral ng Pilipinas (the central bank) left the overnight interest rates unchanged at 4 percent for borrowing and 6 percent for lending on November 5, and is likely to hold on to this position as long as it can.

The prospect of inflation could become more likely if the peso, which has appreciated relatively mildly against the dollar in 2009, were to depreciate strongly

in 2010. There is considerable uncertainty caused by the fiscal situation coupled with the possibility of political instability in the 2010 elections. Given that the Philippines is a large importer of oil, a depreciating peso and rising crude oil prices could further build the inflationary pressures being created by a supply-side shock to food prices.

Quarterly Growth Rate



Source: Bloomberg

On the positive side, remittances, which constitute nearly 10 percent of the GDP, continued to support domestic consumption as they grew nearly 7 percent in 3Q09. September saw a surge of 8.2 percent over a year ago, bringing the growth in the first nine months to 4.2 percent. This is good news. As remittances fell sharply in January, they were generally expected to decline this year. The rise is likely to be due to both improved demand for Filipino workers and increased remittances to help support the reconstruction work after the typhoons. The demand for Filipino workers is expected to remain strong, which could support stronger growth in 4Q09. A strong growth in remittances is also likely to support the peso.

Commodity exports do not form as large a share of the GDP in the case of Philippines as in the case of other ASEAN economies. Still, the decline was so sharp in the first quarter (nearly -25 percent) that

it had an impact on economic growth. Electronics, which constitute nearly half of all exports, were the worst hit — first due to a freeze in key markets and then the falling dollar. The decline has started slowing, and there could be a return to positive growth early next year.

All in all, the economy is likely to register positive growth this year and accelerate next year. The key to its continued growth is likely to lie in strong growth in remittances that support private consumption, political stability following the 2010 elections, and continued consolidation of its fiscal position. With national debt close to 58 percent of the GDP and nearly half of it financed by foreign sources, fiscal weakening is probably the most serious threat to the economy.

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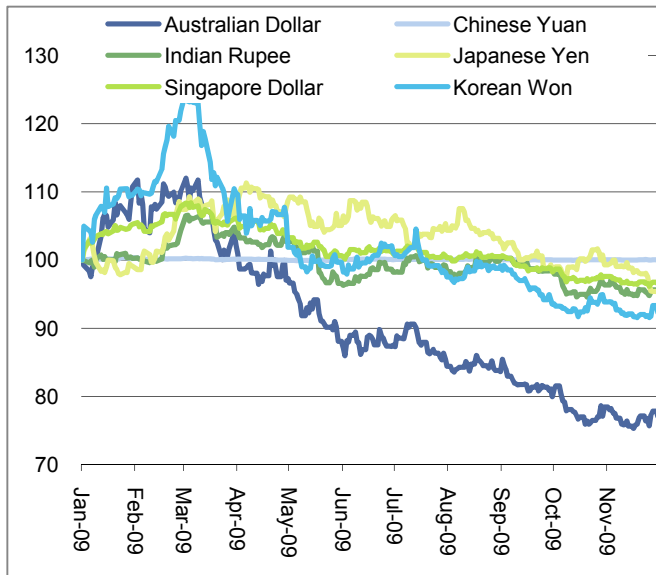
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Select Economic Indicators

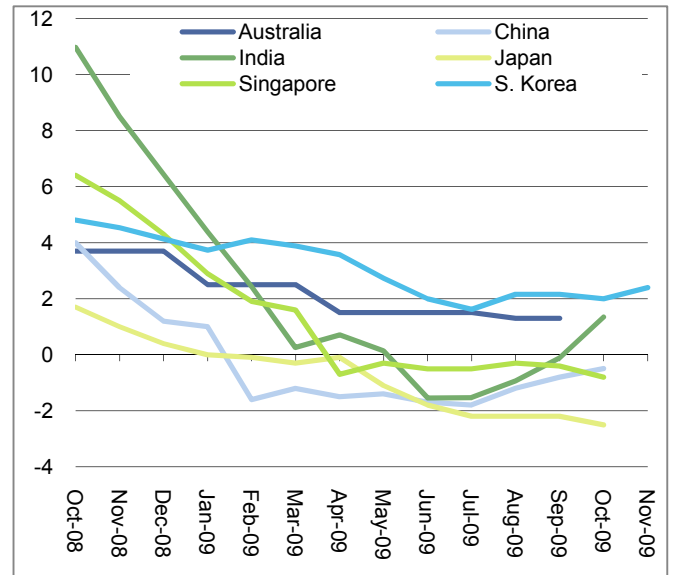
Indexed Daily Movement of Major Currencies (Jan 1, 2009 to Nov 30, 2009)



Source: Bloomberg

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

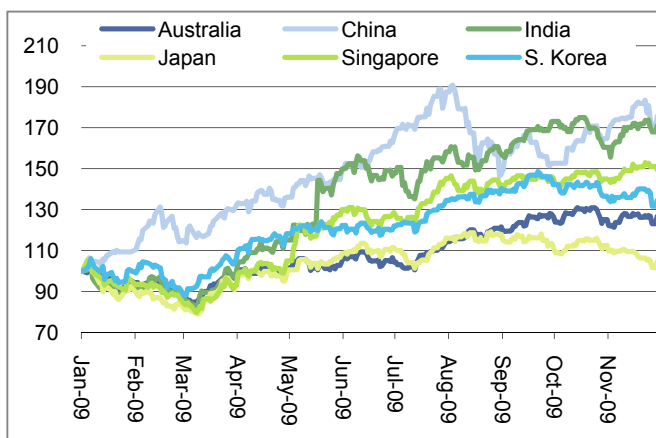
Inflation Rates



Source: Bloomberg

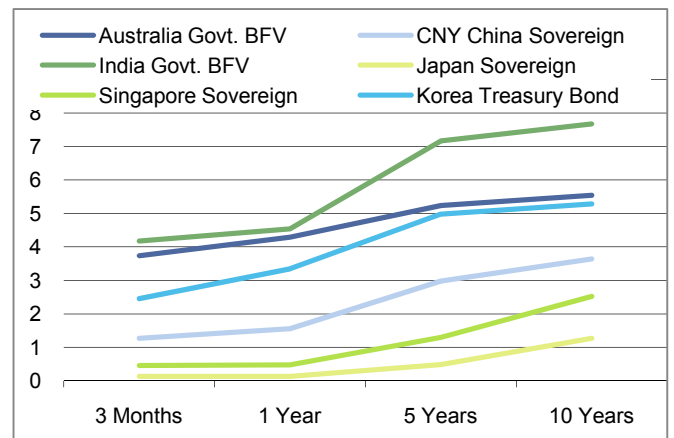
Note: Australia's inflation rate is a quarterly rate. India's is a weekly rate that is averaged.

Indexed Daily Movement of Major Stock Exchanges (Jan 1, 2009 to Nov 30, 2009)



Source: Bloomberg

Yield Curves*



Source: Bloomberg

* As on December 1, 2009

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