

Asia Pacific Economic Outlook: China, Japan, Taiwan, Vietnam





China

The Chinese authorities are undertaking a tough balancing act. On the one hand, the implications of high property prices continue to cause some concern. As such, they are taking actions to cool the property market. In addition, authorities remain concerned about the inflationary implications of rapid money supply growth. Consequently, they have substantially tightened monetary policy and slowed the growth of the money supply. On the other hand, they are wont to halt the economic recovery. While a modest slowdown is desirable, a more serious slowdown would have a deleterious effect on employment, output, and potentially even the global economy. Hence, the government is being careful not to tighten too much lest they create new problems.

With respect to the property price issue, the government appears to have two concerns. First, very high property prices inhibit ordinary Chinese from purchasing homes. Home ownership is a key to the development of a stable middle class. It is also important in promoting a consumer culture and a shift away from growth based on exports. Second, the authorities are concerned about the impact of a potential drop in prices on the financial sector. As such, they have ordered banks to conduct stress tests against the prospect of a 50 percent drop in property prices. They have also ordered a halt to third mortgages in several large cities. This development is evidently aimed at cooling off speculative behavior.

The recent actions appear to be having their desired effect. Property prices fell in June, the first time this has happened since February 2009. In addition, sales of residential property dropped as well. Yet what happens next is unclear. If prices fall rapidly, there could be a sizable increase in the already large volume of non-performing bank assets. In the past, the Chinese government has assisted troubled state banks with re-capitalization and purchases of non-performing assets. This could happen again. Yet a bursting of the property price bubble would certainly have a negative impact on consumer wealth and spending, and on activity in the construction industry. Absent monetary easing, this would mean a more pronounced slowdown. Again, the government is attempting to avoid such an occurrence.

On the other hand, the recent strength of China's exports, combined with upward pressure on the wages of export-oriented workers, points to an area that could keep the economy growing even after a property market problem. Exports were, of course, one of the keys to China's growth

in the past two decades. The conventional wisdom is that this will have to change. Yet for now, exports remain an important ingredient in economic recovery.

Part of the government's balancing act will be to assist a smooth slowdown in export growth while promoting accelerated growth of domestic demand – all without fueling asset price bubbles. This is no easy task. Efforts by Japan in the early 1990s to effect such a transition led to serious economic disaster problems as an asset price collapse was followed by years of inadequate growth. China's many challenges include avoiding Japan's mistakes.

Japan

Japan recorded strong exports and robust industrial output during the first half of 2010 and appears on track to achieve GDP growth in excess of 3 percent, its highest since 1991. The upsurge in exports is supported by improved global activity and revived demand from the Eurozone, United States, China, South Korea and Taiwan. Growth may, however, be volatile and fizzle out unless domestic demand increases and reduces Japan's dependence on its exports. Investment has been lackluster due to existing unused capacity and, in nominal terms, is set to decline below 2009 levels.

Deflation remains a concern in Japan. In the 1990s, deflation resulted in a drag on consumption and investment while also increasing debt burdens. This time around, the consumption and investment environment in Japan is likely to experience similar negative effects. However, deflation will not necessarily be persistent. An increase in the rate of GDP growth, domestic demand and improved labor productivity has the potential to ease deflationary pressures. Prices may begin to rise gradually in 2011.



The central bank has not adopted a path of quantitative easing to offset deflation. Interest rates have been maintained at 0.1 percent and \$32 billion was made available to commercial banks to lend to various sectors in favor of spurring demand. Wages declined over the past three years but are expected to rise in the current year; however, unless domestic demand picks up significantly, any upward pressure on the price level is unlikely.

Numerous proposals to reform the tax system including a hike in the consumption tax and a cut in corporate taxes are being discussed. However it is unlikely that they will be implemented in the near future and the government will have to opt for other means to keep a check on the fiscal situation. At nearly 200 percent, Japan has the worst debt to GDP ratio amongst industrialized nations. Attaining fiscal sustainability is one of the primary challenges of the current government. The Prime Minister announced a target of achieving a primary budget balance by the end of 2020 and capped spending and bond issuance for 2011 at JPY 71 trillion and JPY 44 trillion respectively. However, the failure of the Democratic Party of Japan to retain control of the upper house in recent elections will force Prime Minister Naoto Kan to build coalitions with smaller parties. This could adversely affect the implementation of proposed fiscal reforms.

The financial fallout of the Greek debt crisis did not drastically affect the Japanese economy. The Bank of Japan was quick to inject into the economy JPY 2 trillion of overnight liquidity to avert any major repercussion. Japan received capital flows and reinforced its eminence as a safe-haven for global capital. This led to upward pressure on the yen, but the central bank intervened to weaken the currency.

A relatively tight monetary policy, an inflow of capital and deflation translated into a strengthening yen. Although the yen has maintained a narrow trading band with the US dollar, it is likely to continue rising against the euro and the renminbi as the year progresses. A stronger yen makes Japanese exports less competitive for the European and Chinese markets. This, coupled with a scaling back of imports in the United States, bodes unfavorably for Japan's export-led recovery.

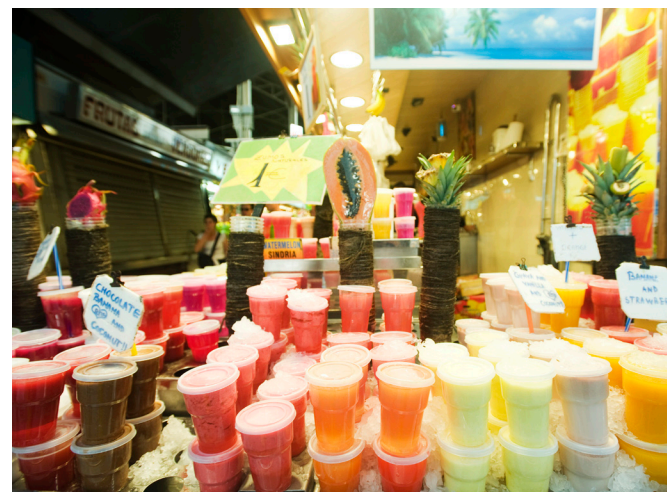
Japan's strong revival in 2010 is likely to be muted due to stringent fiscal constraints, a potentially explosive public debt, lack of a suitable monetary policy and weak domestic demand. The recovery will continue through 2011, however, growth is likely to decline from the highs of 2010.

Taiwan

Taiwan made an amazing recovery following the abyss of 2009. Strong investment and export growth will likely help Taiwan record its highest growth in more than a decade. The recently signed Economic Cooperation Framework Agreement (ECFA) will support the Taiwanese economy in building a strong presence in the region. Modest inflation, a strengthening currency and market-oriented investment policies will likely attract greater capital inflows.

On June 29, Taiwan signed a landmark quasi free trade agreement, the ECFA, with China. This will reduce tariffs of Taiwanese exports to China by about 15 percent, estimated at US \$13.8 billion each year. The agreement will primarily extend to sectors encompassing textiles, auto parts, machinery, petrochemicals and banking. Estimates suggest that the deal will create over 260,000 jobs in Taiwan and boost the economy by 1.5 to 1.7 percent annually. This, along with bilateral agreements with Japan and Singapore, is set to increase exports and provide a thrust to the economy going forward. Taiwan's export growth, however, will be closely linked to the performance of the global economy.

Over the past few months, the Taiwanese economy has been operating at near or above potential. With the help of investments, several capacity constraints on the manufacturing front are being addressed. The government has also brought forth policy reforms to attract foreign investment, both portfolio and direct, in the telecom and infrastructure sectors. The strength of investment will likely persist in the near term as firms expand production capabilities.



The rise in GDP is partly attributed to massive restocking of depleted inventories. Sustainability of such demand, however, remains uncertain. Domestic demand, on the other hand, has been unimpressive but is likely to catch up as the labor force recovers. The recessionary environment pushed unemployment in 2009 to 6 percent — the highest figure recorded in more than three decades. As Taiwan's external demand improves, capital flows boost asset prices and private consumption increases, setting the stage for labor conditions to improve in 2010. Thus, Taiwan will very likely see strong economic growth in 2010, after which it may experience moderation.

In 2010-2011, the overall fiscal position of Taiwan may remain weak since public spending is expected to remain high as the government continues to support the economy through stimulus packages. Revenue growth will likely improve over the year and, coupled with restrained expenditures, should narrow the budget deficit from 6 percent in 2009 to nearly 4 percent in 2010.

For the first time in two years, Taiwan's central bank hiked interest rates by 12.5 basis points in June 2010. The rate hike is largely aimed to counter excess liquidity and prevent asset price bubbles rather than target inflationary pressures. The central bank aggressively cut interest rates during the recession; current rate hikes will probably not have an adverse effect on economic growth. Inflation is relatively muted due to a weak revival of domestic demand and the strengthening Taiwanese dollar also helps keep inflation in check. If housing prices continue to rise, the central bank may further tighten monetary policy by increasing interest rates in subsequent policy meetings.

Vietnam

The Vietnamese economy endured the crisis far better than its neighbors due to strong domestic demand, aggressive policy reforms and exports of non-manufacturing goods. The economy recorded growth of 5.3 percent in 2009 making it one of the fastest growing countries in the region. Strong economic growth will likely continue as the Vietnamese economy rides on higher consumption expenditures, investment and the revival of global demand. Yet policymakers will face a tough challenge ahead as they attempt to rein in inflation, manage the fiscal deficit and tackle a depreciating currency.

The Vietnamese Dong (VND) came under severe downward pressures and the central bank devalued its currency twice between November 2009 and February 2010. Expectations of a future depreciation and a loss of investor confidence in

the VND led to higher imports of gold as a store of value, which worsened the already bleak current account deficit. Weakened foreign direct investment (FDI) flows, the trade deficit and a decline in the foreign exchange reserves will likely continue to put pressures on the currency. This may prompt the authorities to widen the currency trading band or further devalue the Dong later this year.

The government raised US\$ 1 billion through the issuance of sovereign bonds in January 2010 and, if FDI flows revive during 2010, the foreign reserve position will improve after declining in 2009. The wide trade gap is also a reason for concern and as imports grow faster than exports, the trade deficit continues to expand. Whether the currency devaluations will succeed in narrowing the trade gap is still uncertain.

Vietnam's aggressive fiscal stimulus insulated the economy from the aftermath of the financial crisis but residual effects show a significant impact on the country's deficit. The government, however, has streamlined efforts to reduce the fiscal deficit from about 9 percent in 2009 to between 6 and 7 percent in 2010. The rollback in the loan subsidy and tax incentives will ease some pressure on the budget deficit but continued spending on infrastructure projects, social welfare programs, as well as the recent fuel subsidy will require significant expenditures. Devising a strategy to finance last year's stimulus expenses and ensuring stability in growth will be a critical challenge in the coming months.



Inflation, which soared to dangerously high levels during 2008, came down in 2009 due to a drop in food and fuel prices. However, inflation is headed toward double-digits once again in 2010. The government had pursued a loose monetary policy by making credit cheaper and encouraging domestic banks to lend. But as inflationary pressures build up, the government will have to strike a balance between economic growth and macroeconomic stability. The central bank increased base rates by 100 basis points in December 2009 and has kept them unchanged, but it is likely that interest rates will be hiked further in the latter half of 2010 and early 2011. The central bank also raised the Capital Adequacy Ratio (CAR) from 8 to 9 percent effective from October 1, 2010 and also placed restrictions on lending limits at 80 percent of deposits at banks and 85 percent at non-bank credit institutions.

Infrastructure development in Vietnam is struggling to keep pace with the growth of economic activity. Inadequate road networks, power shortages and other logistical bottlenecks weigh heavily on Vietnam's growth potential. The government is seeking to attract foreign investment in the infrastructure sector over the next few years which would also boost construction activity and increase employment.

Non-manufacturing exports, buoyancy in the services sector growth, and investment in infrastructure and real estate will lead to growth over the medium term. The Vietnamese economy is poised to benefit from a revival in demand from western countries and China. In addition, trends suggest that private consumption, which has been one of the strengths of the Vietnamese economy, will continue to fuel economic growth.

Long-term outlook

Whether Vietnam can replicate its success from the early part of the decade hinges decisively on the governments' ability to develop adequate physical and economic infrastructure. Addressing deficiencies in the legal, financial and regulatory framework, along with shortages in skilled labor, will be key challenges for policy makers. The government intends to usher in several initiatives, including administrative and bureaucratic reforms, but more is probably needed.

Restructuring State Owned Enterprises (SOEs) and fostering more competition by providing firms with a level playing field will encourage both foreign and domestic investors. Although privatization of SOEs has been at the core of Vietnam's reform policy, progress has been modest. The government continues to hold controlling stakes in partly privatized SOEs, thereby suppressing the likelihood of efficiency and productivity gains. Since privatization was targeted to the smaller SOEs leaving the larger ones untouched, SOEs still dominate the Vietnamese economy.

Developing a strategic relationship with China will allow smoother technology transfers to enhance productivity and position Vietnam as a major player in China's supply chain for both exports and domestic consumption. The Socio Economic Development Strategy (SEDS) pursued from 1991-2010 enabled Vietnam to transition from a poor, agricultural economy to a richer, developing nation. The forthcoming SEDS 2011-2020 will likely strengthen Vietnam's economy through focused investments in education and human capital formation to ensure higher per capita incomes.

Vietnam's strong growth potential will be unleashed only if the government undertakes structural and institutional reforms, failing which, it may stall progress towards becoming an upper middle income nation.



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