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Asia Pacific Economic Outlook: China, Japan, Malaysia, South Korea

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China

TThe big dilemma for China right now is inflation. In November, food prices were up 11.7 percent year over year. Given that food prices are a large component of the consumer price index, the steep rise in food costs translated into overall inflation of 5.1 percent. In addition, property prices have been rising for three months in a row, despite government efforts to cool the overheated market. Hence, the government now faces a dilemma. It can continue to tighten monetary policy with the goal of reversing inflation before it becomes more problematic. Yet, further tightening might cause the economy to slow down excessively. Alternatively, the government can wait and see if their current policies to avert inflation will eventually work with a lag. For now, the policy appears to be one of wait and see. As of this writing, the government has chosen to leave interest rates unchanged.

Future decisions about inflation policy will depend, in part, on what is causing inflation. When the government, in early 2010, implemented policies designed to deal with rising inflation, it was clear that rapid money supply growth was a contributing factor to the level of inflation. Since then, money supply growth has slowed significantly.

Yet now there appears to be two difficulties remaining. First, food prices are rising rapidly owing to problems with supply, not demand. The result is higher overall inflation even though non-food inflation remains extremely low (non-food prices were up only 1.9 percent in November from the previous year). Second, property price increases have resumed following a lull during the summer that followed government actions designed to cool the overheated property market. Since the summer, however, the housing market has once again tightened. Reduced inventories of vacant apartments, combined with rising wages, have conspired to push up housing prices. But this may not necessarily be a sign of a speculative bubble – something that would be cause for alarm with policymakers. Instead, it could simply reflect changed supply and demand conditions.

Thus, it could be that a tightening of supply in the markets for food and housing are the real culprits, not monetary policy. Moreover, it does not appear that China is growing faster than capacity. In November, industrial production was up 13.3 percent while retail sales were up 18.7 percent. Strong numbers to be sure, but not out of line with recent history. It could be, therefore, that further tightening of monetary policy at this point in time would merely slow the economy unnecessarily, without addressing the underlying inflation problem.

That, at least, is the argument for staying the course.

On the other hand, some analysts are concerned that the current US Federal Reserve policy of quantitative easing will export inflation to China and elsewhere. The argument goes as follows: printing lots of dollars in the United States pushes down the value of the dollar against other major currencies. In order to avoid currency appreciation (which would hurt export competitiveness), the Chinese central bank must purchase the dollars flowing into China. To do this, China's central bank must print renminbi. The result, of course, would be increased inflation within China. In other words, there is concern that, in the coming year, Chinese money supply growth will have to increase as a result of US policy. The alternative for China would be to let the renminbi rise (which would be disinflationary) and face serious problems in the critical export sector.

Critics of this argument make two points. First, the US policy of quantitative easing, by boosting US demand, will help Chinese exports. Thus, China benefits from quantitative easing. Second, China needn't continue to hold down the value of the renminbi in order to ensure export competitiveness. Many Chinese exporters are already shifting production to lower-wage locations within China. This helps to offset the impact of a rising currency. Moreover, a rising currency would boost Chinese consumer purchasing power, thereby stimulating domestic demand.

The bottom line, then, is that China is now experiencing rapid growth with low non-food inflation. That is not a particularly bad situation. Monetary policy has already been tightened and the currency is being left to slowly appreciate. The question remaining, then, is whether the government will stay the course or take new action on the monetary or currency fronts. Time will tell.

Japan

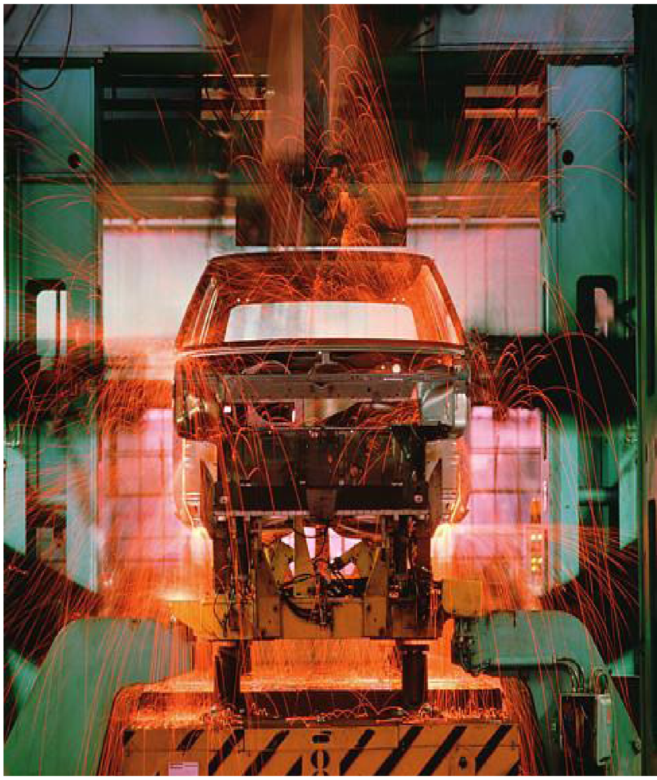
While Japan's economy expanded for the fourth straight quarter, there are still several weak spots in the country's economic recovery. The rapid momentum seen in late 2009 and early 2010 is tapering off, with GDP growth estimates moderating to around 3 percent for 2010. Export growth appears to have died down due to the rising value of the yen and competition with other Asian producers. Furthermore, Japan's long-standing battle with deflation continues and it remains to be seen whether Japan's economic policies will enable it to escape the vicious cycle of deflation and depressed economic growth.

The Bank of Japan set up a 5 trillion yen (US $60 billion) fund to buy bonds and other assets including exchange traded funds, corporate bonds and REIT funds. In the short term, these interventions may strengthen investor confidence and encourage participation in financial markets. REIT prices have risen following the announcement of BOJ's asset purchase program. The move may also help reverse the two-decade-long slide in land prices and revive investments in other asset classes. Looking at the bigger picture, however, a 5 trillion fund appears minuscule for an economy of Japan's size.

On October 5, the Bank of Japan also lowered its overnight policy rate to a range of 0 percent to 0.1 percent, down from 0.1 percent. Lowering the interest rate to near zero from 0.1 will probably make little difference. The new policy on quantitative easing is a step towards addressing the chronic issues facing the Japanese economy, but the magnitude of the measures adopted of late are probably insufficient.

Given Japan's reliance on exports, the rise in value of the yen and insufficient growth in global demand, particularly from the United States, are unfavorable conditions for Japan's export industries. As a result, net exports have decelerated sharply. China's role is of particular importance. Despite signs of a slowdown, the Chinese economy is projected to grow at over 8 percent during the next few years. Increased trade between the two nations may allow Japan to diversify its export markets in Asia and offset the lack of demand from western economies. Japan's proximity to China and China's emergence as a key export destination augurs well for Japanese manufacturers. Japanese exporters will also have to gear up for a potential price war after a free trade agreement (FTA) was recently signed between South Korea and the EU. The FTA, which could prove to be a thorn in the side of Japanese manufacturers, will take effect next year and is expected to upset the competitiveness of Japan's automobile exports to the EU.

Japan's healthy performance during third quarter was largely backed by an uptick in consumer spending. Private consumption improved owing to increased spending on tobacco products prior to the tobacco tax hike. Consumption expenditures were also boosted by purchases of automobiles before the rollback of incentives for fuel-efficient vehicles. But these factors will only have a temporary effect in propping up demand. On the other hand, private investment remains weak and the gains from the government's fiscal stimulus are also likely to reverse.



Thus, in the coming months, Japan's growth momentum will likely fade. GDP growth for 2011 will likely hover around 1 to 1.5 percent.

Wages have declined as Japanese firms resort to hiring part-time workers (at lower wage rates and minimum benefits) as opposed to the more expensive full-time employees. Furthermore, as the number of retirees increase, younger workers will be hired at relatively lower wages. Both of these factors will keep wages suppressed and negatively influence consumer spending. Inflation for 2010 and 2011 is projected at -1.3 percent and -0.4 percent, respectively. As long as growth in domestic demand remains anemic, any upward pressure on inflation is unlikely. If the deflationary environment persists, investment and consumer spending will likely suffer. Deflation can also cause a real increase in the value of debt and raise the likelihood of default, thus damaging the balance sheet of banks.

While the reintroduction of quantitative easing is a welcome step, the modest size of the asset purchase fund may not be sufficient to counter deflation. If wages rise, consumer spending and domestic demand may revive, making Japan's economic recovery sustainable.

Malaysia

Following a strong recovery, the Malaysian economy appears to be stabilizing at more sustainable levels. The country will likely achieve GDP growth in excess of 6.5 percent in 2010. The country's economic policy supported the economy well during the financial crisis and encouraged higher consumption spending and revived private investment. As a result, growth driven by domestic demand is the highlight of Malaysia's recent economic momentum. Inflation is currently manageable and short-term interest rates are expected to remain stable. However, an appreciating currency and human capital challenges, including a shortage of skilled labor, will likely hamper Malaysia's competiveness relative to its peers.

Positive consumer sentiment and continued growth in the export sector allowed the Malaysian economy to grow at 5.3 percent in the third quarter of 2010. Domestic demand was supported by expansion in private consumption and capital expenditures. Furthermore, increased gross capital formation and high levels of capacity utilization boosted employment. The manufacturing, agriculture, services and construction sectors all recorded increases during the third quarter; however, growth in some of these sectors was much slower compared to a quarter ago. In particular, growth in the country's key electronics and semiconductor industries decelerated in the wake of waning global demand.

Going forward, Malaysia's export sector will likely face mounting pressures from a lack of investment and labor shortages. The Malaysian ringgit appreciated considerably against the US dollar during 2010. The interest rate differential with the developed countries has resulted in a surge of capital inflows exerting upward pressure on the value of the ringgit. The strength of the currency and a shortage of skilled labor casts doubt over Malaysia's export competitiveness vis-à-vis other countries in the region. Malaysia is not able to attract enough high-value foreign direct investment and skilled labor industries. In addition, the country is not making sufficient investments in labor intensive units.

Should Malaysia resort to capital controls? Following the announcement of quantitative easing in the United States, Malaysia and other emerging economies are concerned that excessive capital flows could give rise to asset bubbles and speculative activity in financial markets. South Korea, Indonesia, Thailand and Taiwan have resorted to macroeconomic measures, including currency controls and withholding taxes on foreign investments, in order to limit the vulnerability of their economy to a reversal of investor sentiment. So far, Malaysia has not imposed any restriction on foreign capital; however, policymakers will likely monitor the inflow of capital in important asset classes. Some experts believe that the Malaysian economy can absorb foreign capital flows and the central bank need not rush to implement measures to deal with these inflows. If quantitative easing in the developed nations is successful in reviving demand in the short run, Malaysia's export industries could in turn benefit through a revival of global demand.

A hike in the price of food products, non-alcoholic beverages and transport pushed inflation to 2 percent compared to last year. While further increases in consumer prices is likely due to rising commodity and food prices, inflation remains manageable. In the past, the central bank has pursued its monetary policy proactively. Since March 2010, interest rates were hiked 75 basis points allowing policymakers an option to pause any further rate hikes in a slowing economy. However, if inflation rises beyond the central bank's target range, or foreign inflows cause a rapid rise in Malaysia's inflation rate, the central bank will likely intervene by imposing further rate hikes.

Robust domestic demand and increased capital expenditures provide a positive outlook for the Malaysian economy. However, a moderation in the global recovery will likely slow the momentum. Challenges related to labor skill shortages and inadequate foreign investments in skilled labor industries are headwinds to Malaysia's growth. The country's GDP growth rate will likely range between 5 and 6 percent in 2011.

South Korea

After a strong start to the year, South Korea experienced slower GDP growth during the third quarter of 2010. Sluggish global demand coupled with an appreciating currency weighed down exports. However, strong domestic demand kept positive sentiment afloat, prompting an upward revision in GDP growth estimates. The Bank of Korea forecasts GDP growth at 6 percent in 2010. South Korea has recovered well since the lows of the financial crisis, but regional geopolitical tensions will probably cast a shadow of doubt over the stability of the economy.

Although lackluster global demand put a damper on the export sector, South Korea's exports together with private consumption were the main drivers of GDP growth. Exports account for nearly half of Koreas GDP and steady growth in technology exports is a welcome sign. However, exports to China and other emerging markets in Asia are not expected to make up for lethargic demand in the United States and Europe. South Korea's growth prospects hinge on the momentum in domestic consumption and an uptick in global demand.

Following months of negotiations, the South Korea-EU free trade agreement (FTA) was recently signed and will be effective starting July 1, 2011. The agreement is expected to contribute substantially to South Korea's GDP growth over the next decade and will also boost job creation. The South Korea-EU FTA is the EU's first FTA with an Asian country, but South Korea has not been able to achieve similar success with the United States. The FTA between South Korea and the United States (signed in June 2007) has not been ratified. However, the two countries have recently reached an agreement on automotive trade that clears the way for conclusion.

Meanwhile, the Bank of Korea has resorted to monetary tightening by hiking the base rate by 25 basis points to 2.5 percent. The rate hike followed the October release of inflation data indicating a 4.1 percent annual increase, which is beyond the Bank of Korea's target of 2 to 4 percent. Higher prices of farm products drove up consumer price inflation, but going forward farm product prices are expected to decline slightly. However, commodity prices and prices of raw materials show an upward trend and may contribute to higher inflation in the near term. The Bank of Korea expects consumer price inflation to exceed 3 percent in late 2010 and hover around 3.4 percent in 2011. To prevent the economy from overheating, the Bank of Korea will likely pursue a tight monetary policy and may resort to hiking interest rates gradually over the next few quarters in order to keep a lid on inflation.

Following the G20 summit in Seoul, South Korea's finance ministry indicated that it would reinstate the 14 percent withholding tax and a 20 percent capital gains tax for foreign investment in treasury bonds. The appreciating value of the Korean won and strong short-term capital inflows are reasons for concern. Volatility of these flows and their potential to fuel speculative activity may result in policymakers placing further reliance on capital inflow regulations and interventions in the foreign exchange market. However, the success of these policy measures in stemming the inflow of foreign capital still remains unclear.

Furthermore, a stronger won negatively affects Korea's export competitiveness. However, as long as the currencies of South Korea's competitors are also rising in tandem, Korean exports will unlikely suffer significant damage. Thus, China's currency policy will probably attract the attention of Korean policymakers.

One of the biggest risks to South Korea's economy stems from tense relations with North Korea. If geopolitical risks do not escalate, recent attacks will probably have a temporary impact on South Korea's economy and financial markets. Despite external risks, however, the South Korean economy will likely continue on its upward growth path. Foreign investors continue to invest in Korean stocks and bonds indicating confidence in the country's economic fundamentals. Improved business and investor confidence will probably support economic growth in 2011. Current estimates project South Korea's GDP growth at 4 percent in 2011.

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