Deutsche Bank

Asia: recovery postponed (again)

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Passion to Perform

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Forecast summary

- Global growth is expected to be flat for another four quarters at about the current QoQ(saar) pace. This implies very weak growth in the "high beta economies". Inflation is expected to pick up slowly next year – risks are the upside . We see generally lots of room for fiscal stimulus if needed. In 2013H2, we expect growth to pick up strongly led by the US. Slightly slower growth in China dampens the recovery in Asian aggregate growth.

	GDP growth (%yoy)					Inflation (%yoy)					Current account (% of GDP)					Fiscal balance (% of GDP)				
	2010	2011	2012F	2013F	2014F	2010	2011	2012F	2013F	2014F	2010	2011	2012F	2013F	2014F	2010	2011	2012F	2013F	2014F
US	2.4	1.8	2.1	2.0	3.1	1.6	3.1	2.1	2.4	2.6	-3.5	-3.1	-3.2	-3.5	-3.6	-7.6	-8.8	-8.3	-5.8	-5.6
Euroland	2.0	1.4	-0.5	0.0	1.0	1.6	2.7	2.5	1.8	1.7	-0.1	0.0	0.4	0.5	0.7	-6.3	-4.1	-3.2	-2.6	-2.0
Japan	4.6	-0.7	2.4	0.8	0.1	-0.7	-0.3	0.0	-0.4	1.7	3.8	2.0	1.6	2.3	2.5	-8.5	-10.0	-10.0	-9.3	-7.6
China	10.4	9.2	7.7	8.2	8.0	3.3	5.4	2.8	3.5	3.5	4.0	2.8	2.7	2.0	2.0	-1.7	-2.0	-1.5	-1.5	-1.5
Hong Kong	7.0	5.0	1.5	2.5	4.5	2.3	5.3	4.1	2.3	1.7	5.5	5.3	1.9	2.0	2.8	4.2	3.9	3.3	1.5	2.0
India	10.4	7.9	5.6	6.7	7.0	9.6	9.5	7.0	6.3	6.1	-3.3	-3.4	-3.2	-3.1	-3.0	-7.6	-8.3	-8.0	-7.5	-7.3
Indonesia	6.2	6.5	6.3	6.3	6.5	5.1	5.4	4.5	5.8	6.5	0.7	0.2	-1.8	-2.0	-2.0	-0.6	-1.1	-2.7	-2.3	-2.2
Malaysia	7.2	5.1	4.8	5.0	6.0	1.7	3.2	1.7	1.7	2.4	11.1	11.1	5.8	5.4	6.7	-5.4	-4.8	-6.1	-5.0	-4.0
Philippines	7.6	3.9	5.5	5.5	5.0	3.8	4.7	3.3	4.6	5.0	4.5	3.1	4.5	5.1	5.6	-3.5	-2.0	-2.0	-1.4	-0.7
Singapore	14.8	4.9	2.5	3.0	4.5	2.8	5.2	4.4	2.7	3.0	24.5	22.0	11.1	9.5	9.6	5.1	8.1	6.6	7.4	6.9
S. Korea	6.3	3.6	2.3	2.8	4.3	2.9	4.0	2.4	2.9	3.2	2.9	2.4	2.0	1.4	0.8	1.4	1.5	0.0	-0.7	0.0
Sri Lanka	8.0	8.3	6.2	6.5	7.5	6.2	6.7	7.5	6.6	6.3	-2.2	-7.8	-5.0	-3.7	-3.2	-8.0	-7.0	-7.0	-6.5	-6.0
Taiwan	10.9	4.0	1.3	3.2	4.7	1.0	1.4	1.6	2.4	1.8	9.2	8.9	8.5	7.1	4.8	-2.5	-2.2	-2.9	-2.5	-1.6
Thailand	7.8	0.1	5.5	4.0	5.0	3.3	3.8	3.1	3.6	3.8	4.1	3.4	-0.1	1.1	1.8	-1.1	-2.7	-3.5	-3.0	-1.9
Vietnam	6.8	5.9	4.7	5.1	6.0	9.2	18.6	9.2	10.8	11.5	-4.2	0.2	-1.1	-2.0	-1.1	-6.5	-5.3	-6.0	-5.0	-5.0
Asia ex-Japan*	9.6	7.5	6.1	6.7	7.0	4.6	6.0	3.8	4.2	4.2	3.4	2.5	1.9	1.4	1.3	-2.6	-2.9	-2.9	-2.8	-2.5
ex-CH, IN*	7.8	4.3	3.7	4.1	5.2	3.4	4.7	3.4	3.8	4.1	5.3	4.7	2.6	2.1	2.0	-0.8	-0.6	-1.7	-1.6	-1.1
Australia	2.5	2.1	3.6	2.4	3.4	2.9	3.4	1.8	3.0	2.8	-2.9	-2.3	-3.5	-4.5	-4.1	-4.2	-3.4	-3.0	0.1	0.1
Latin America	6.3	4.3	2.9	3.8	4.1	7.5	8.4	7.8	7.5	7.7	-0.9	-0.8	-1.3	-1.4	-1.6	-2.2	-2.2	-2.1	-1.8	-1.9
Emerging Europe	4.5	4.7	3.1	3.6	4.0	6.1	6.5	5.2	5.6	5.2	1.0	2.0	1.8	1.4	0.4	-3.8	-0.5	-0.6	-0.6	-0.7
World	5.0	3.7	2.9	3.2	3.8	3.4	4.5	3.3	3.4	3.5										

Sources: CEIC and Deutsche Bank.

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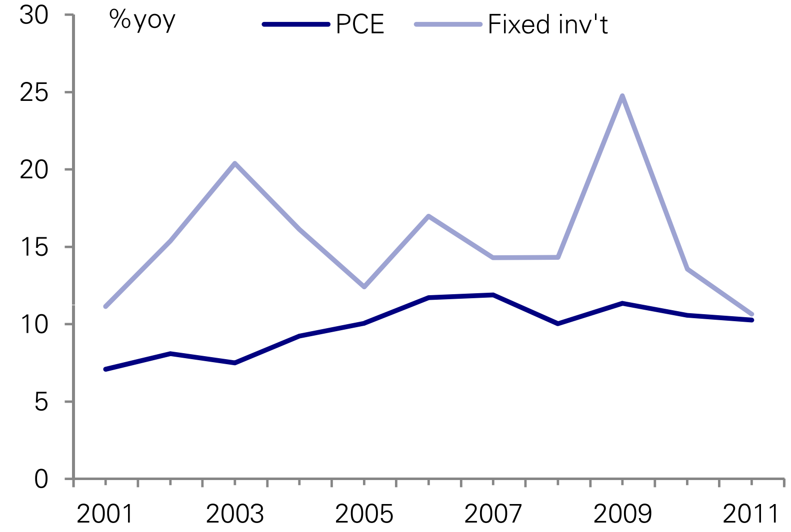
China's story….downshifting growth expectations

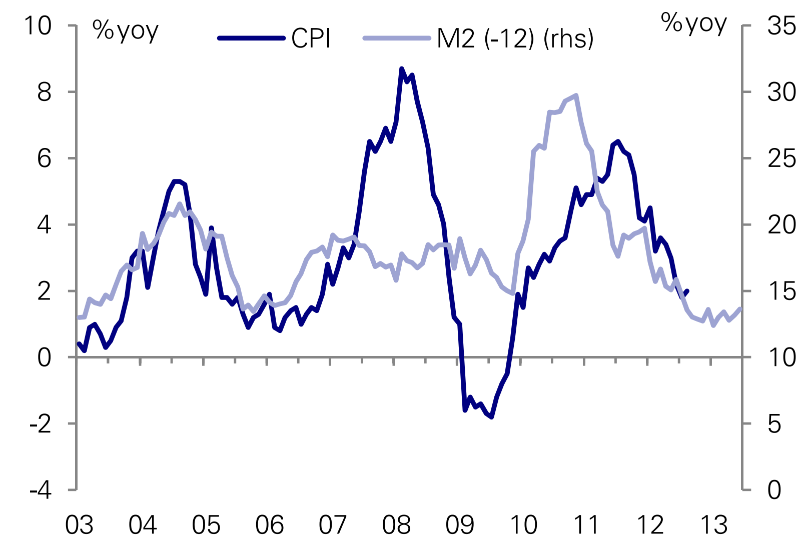
- The government announced a 7.5% growth target for 2012 and unlike past targets (8% for most of the last decade) they seem to take this seriously. We view it as perhaps a minimum – they will react with policy stimulus only if growth looks like it is heading below 7.5% for a sustained period.
- Broadly, policy is a little better than neutral while the external impulse is still negative. Real FAI growth is stable at about 21% versus last year's 18%. But real retail sales growth so far this year is just under 12% versus 13% last year.

Consumption and investment



- The recent bout of inflation had an in important monetary component as well as a supply shock to food prices. It took longer than "usual" for inflation to emerge, but money supply growth continues to guide inflation expectations down.

Inflation and money supply



Sources: CEIC and Deutsche Bank.

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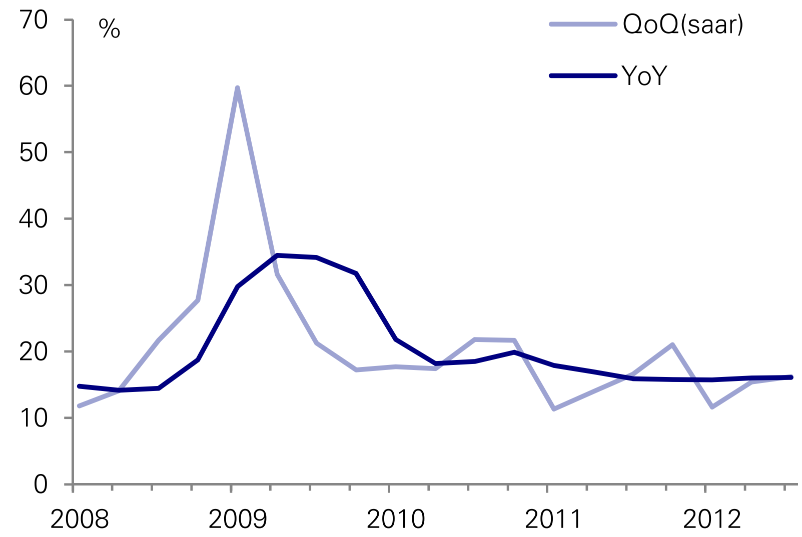
The key is credit…

- In 2010 and 2011, credit growth started the year weak – measured on a QoQ(saar) basis – and policymakers had to loosen up policy significantly in the second half of the year to achieve their targets.
- Loans rose at an average pace of RMB809bn per month in the first eight months of the year. Ytd, seasonally adjusted loan growth has been only 14.4%, we estimate.
- In 2011Q4, loans rose 21%QoQ(saar). To achieve a 15.5% credit growth target for this year, loans would have to rise about RMB1tn per month in the last four months of the year.
- Credit growth of that magnitude – approximately 18%QoQ(saar) – would be consistent with an official PMI averaging 52.5 (49.2 in Aug).

Credit growth in China

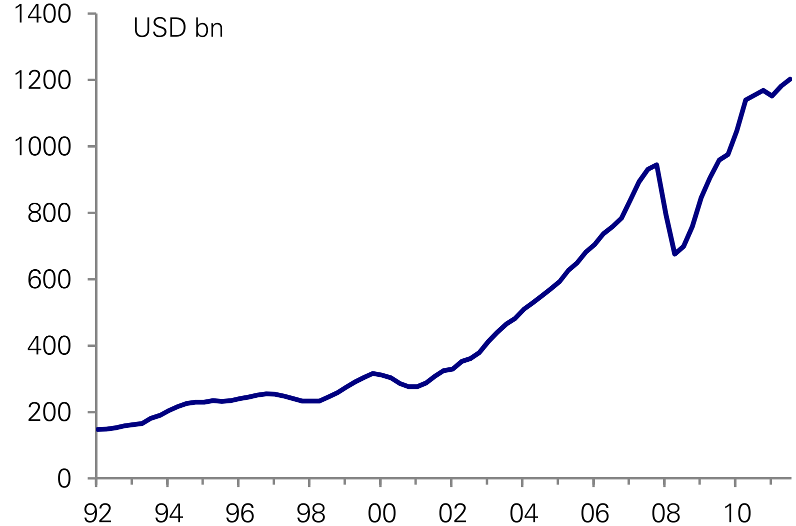


Sources: CEIC and Deutsche Bank.

Asia-ex CH/IN: exports run out of steam…

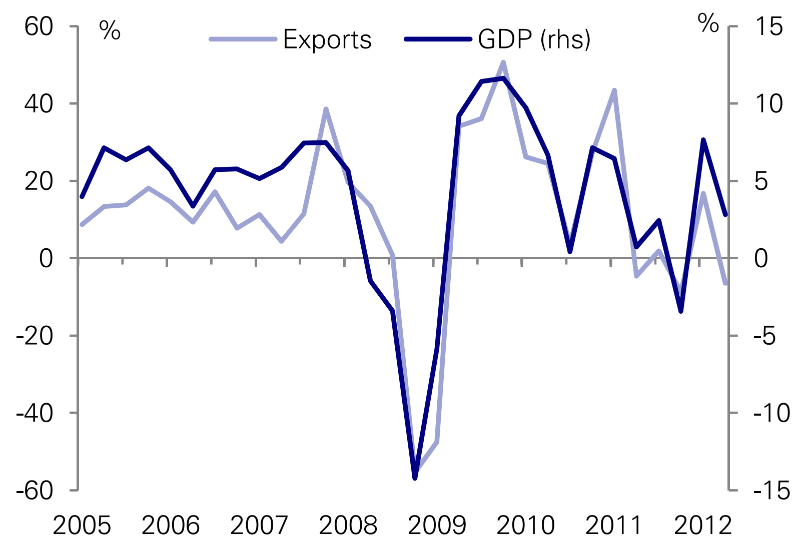
- Between 2008Q3 and 2009Q1, aggregate exports in Emerging Asia fell 29%. During the Asian Financial Crisis, the cumulative decline was 8.5%; after the "Tech Wreck" exports fell 12.6%.
- The recovery was almost as rapid – it took five quarters to return to the pre-crisis level of exports. Exports continued to grow rapidly into 2011Q1. But since then, exports have risen only about 1% per quarter. From 2002 until the crisis quarterly export growth averaged 4.4%.

Asian exports, seasonally adjusted



- For the region's small open economies, 2008/09 was a worse external shock than in 1997/98 although domestic demand generally held up better than in the earlier crisis. But for Singapore and Taiwan, 2008/09 was a far worse crisis than1997/98.
- For "Asia-6", GDP fell 6% during 2008Q2 – 2009Q1, only marginally less than during the Asian crisis. As exports have stagnated over the past year, GDP growth has struggled, although 2012Q1 saw very strong growth as exports rose, Thailand recovered from the floods and the Philippines responded to a surge in government spending.

Asia-6 GDP and exports (%QoQ(saar))



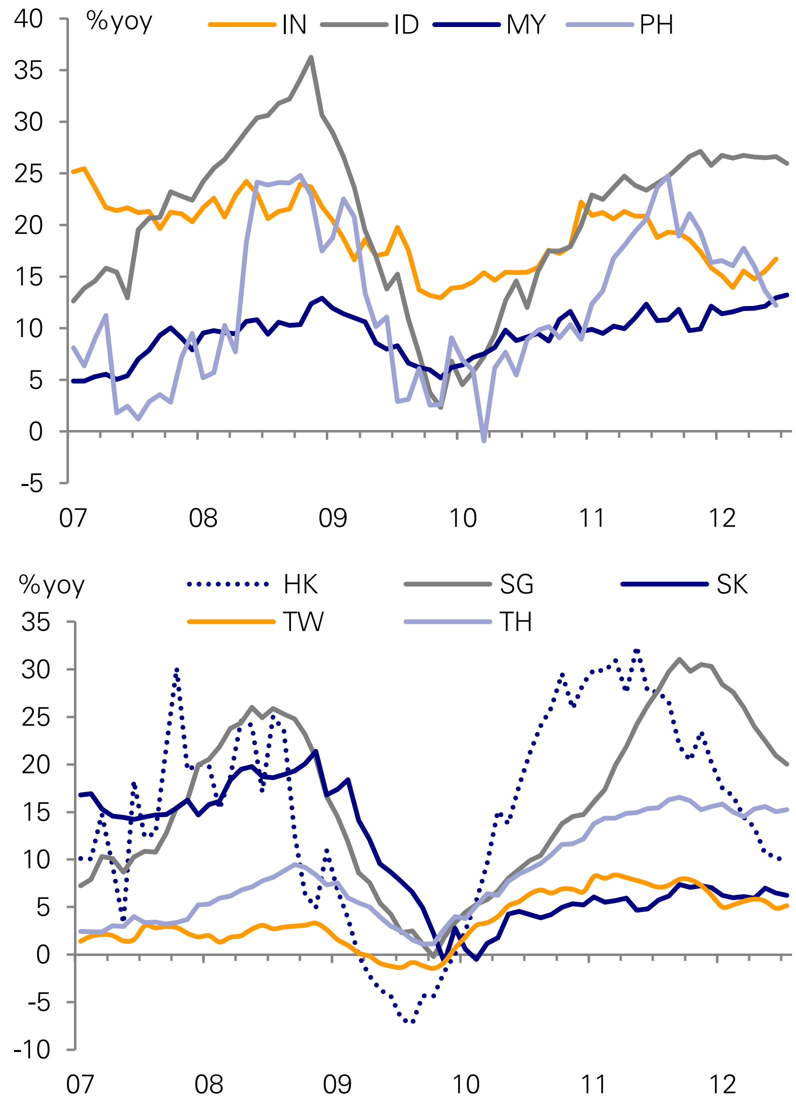
Sources: CEIC and Deutsche Bank. "Asia-6" is HK, Malaysia, Singapore, S. Korea, Taiwan and Thailand.

See "What Can Asia Do?" in *Global Economic Perspectives*, May 25, 2012.

…and so does credit growth

- Domestic demand has held up surprisingly well in Asia's small open economies despite the decline in export growth. This has been in part because of the very low level of interest rates.
- Surging credit growth in 2010/11 in Indonesia, the Philippines, Hong Kong, Singapore and Sri Lanka (not shown) led to worries about asset bubbles and NPLs. But except in Indonesia and Sri Lanka, credit growth in these economies has slowed sharply in recent months.
- In Malaysia and Thailand, credit growth has been stable at more than adequate rates. In South Korea and Taiwan, credit growth has been very weak.

Credit growth in Asia



Sources: CEIC and Deutsche Bank..

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“Growth betas” provide good guidance for risks

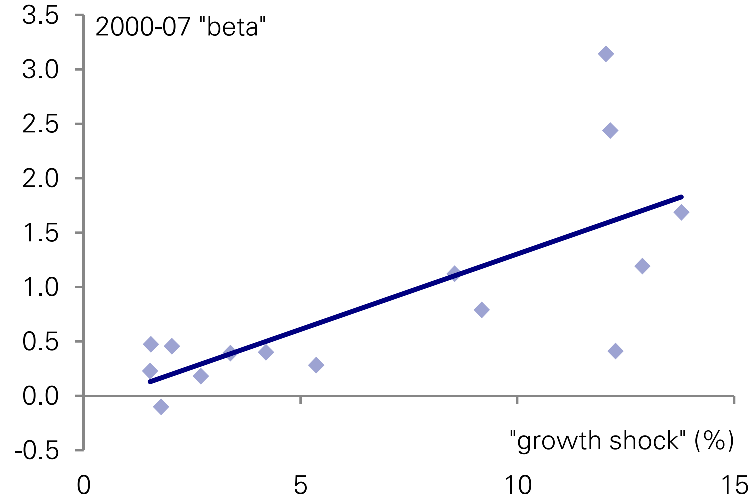
- “Growth betas” are the elasticity of GDP growth in Asia Pacific economies with respect to changes in “G2” (US+EU) GDP growth. “Betas” calculated over 2000-07 provided a good guide to which economies were vulnerable to the “Lehman shock” – the decline in GDP growth between 2008Q3 and 2009Q1.

- Since 2008, the ordering of economies' “betas” has changed a little. Thailand and Japan have been more sensitive to global growth than they were pre-GFC, Singapore and HK a little less sensitive.

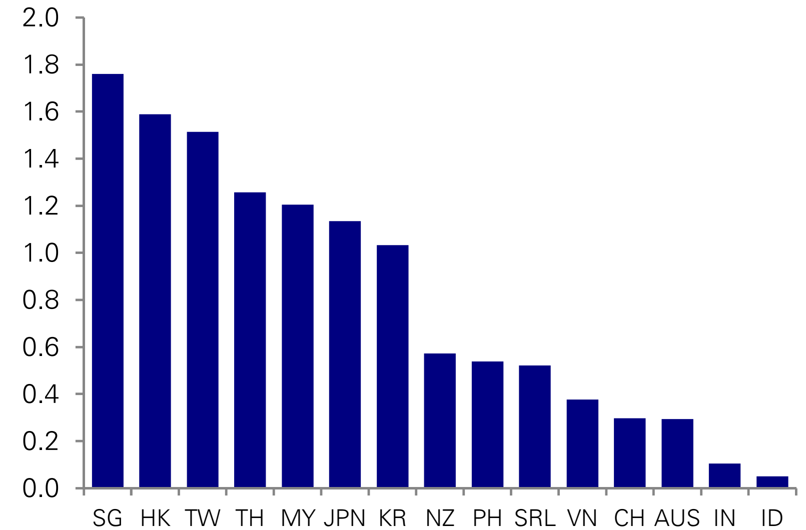
- So, in the event of a “Grexit” shock, we would be most concerned about growth in Singapore, Taiwan, Hong Kong, Thailand, Malaysia, Japan and South Korea. India, Australia, New Zealand, Indonesia, Vietnam and China would be expected to be less impacted.

- Note, importantly, that “betas” include the effects of policy responses – e.g., Australia and New Zealand are small open economies but have been successful in using policy responses (including FX depreciation) to dampen the impact of external shocks.

Asia-Pac “growth betas” and “Lehman shock”



“Growth betas” since 2000



Sources: CEIC and Deutsche Bank.

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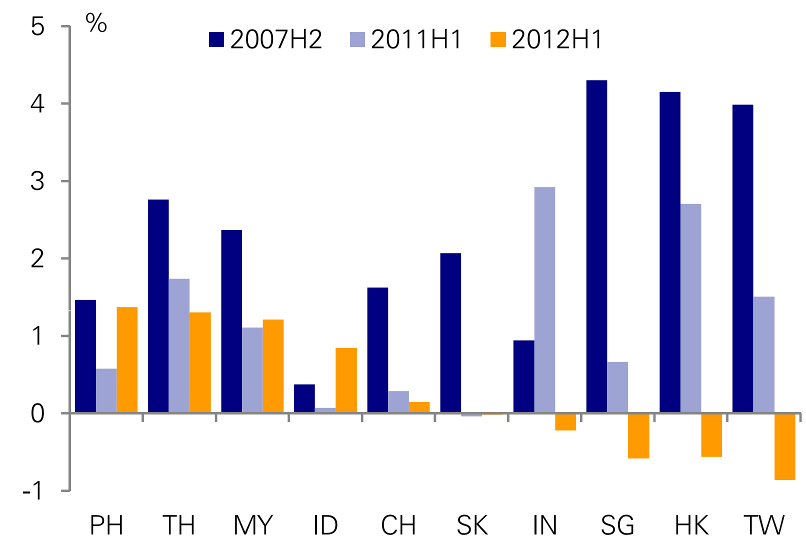
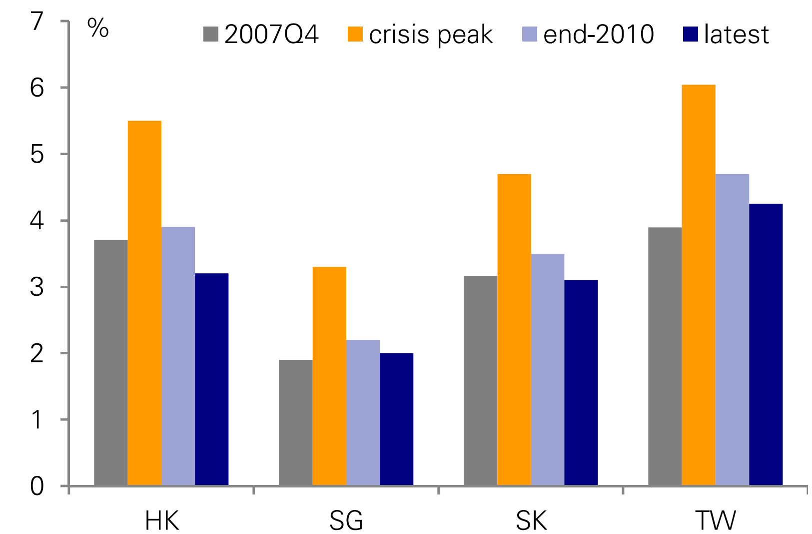
Why haven't we seen a response yet?

- Governments in most economies do not (yet) feel great pressure to respond to slowing growth because output gaps have only recently emerged and are in most cases not yet large.
- On average, Asian economies were operating at above full employment in late 2007 – an output gap of about 2.4% of potential GDP – with the largest gaps (4% of GDP or higher) in the "high-beta" economies of Singapore, Hong Kong and Taiwan.
- At the depth of the GFC, in 2009H1, output gaps averaged -4.1% and output was more than 7% below potential in Singapore and Taiwan and more than 5% below in Hong Kong, Malaysia and Thailand.
- By mid-2010, most economies were again operating above full employment and the subsequent slowdown has been so gradual that negative output gaps only emerged at the end of 2011. But the output gaps in Taiwan, Hong Kong and Singapore are still less than 1% in 2012H1.
- But strong growth in the Philippines, Thailand, Malaysia and Indonesia mean that output is again above full employment. Not surprisingly, it is in these economies that the inflation impulse is the greatest.
- As an alternative measure, unemployment rates today are stable if not falling in Hong Kong, Singapore, and South Korea. In Taiwan, the rate has increased by only 0.1% since March. The labour markets in these economies are not signaling that policy needs to be eased.

Output gaps in Asia



Unemployment rates



Sources: CEIC and Deutsche Bank.

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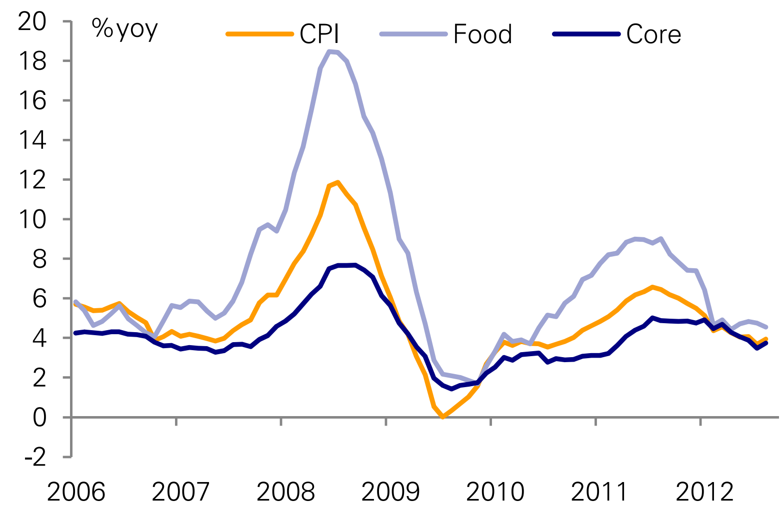
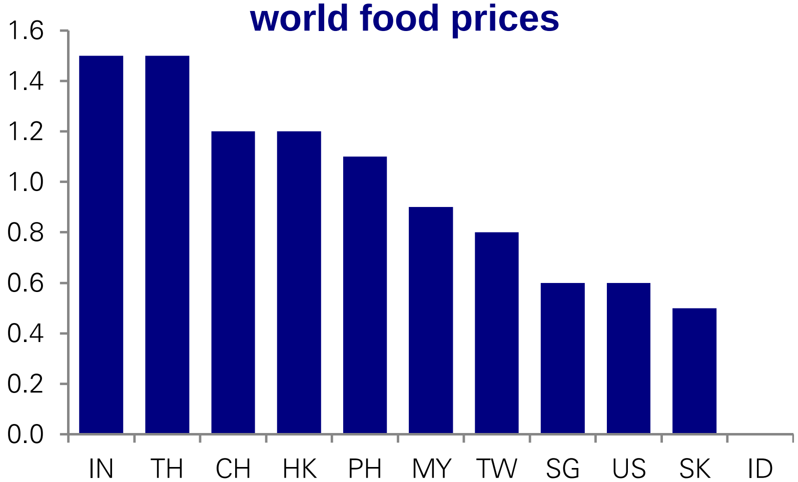
Food prices are a worry

- Inflation in Asia is – overall – relatively tame. Food inflation – the main driver of inflation with a 30% weight in CPI – has been low and stable for six months. Core inflation is still broadly declining.
- This summer's 20% jump in global wheat, corn and soybean prices is a warning, however. At present, it implies an increase in Asian food inflation of only about 1% by year-end.
- But since 1980 world food prices have tended to move in regular three-year cycles (missing only in the early 2000s). With the last cycle topping out in April 2011, we would be "due" for a renewed increase in food prices around the end of this year anyway. An expectation of higher food inflation next year – but not as severe as 2008 or 2011 -- is built into our forecasts.

Avg inflation in Asia

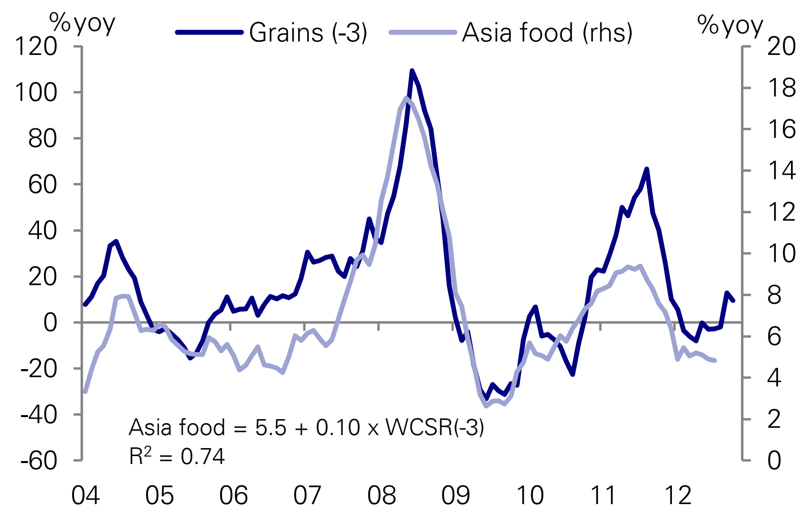


Impact on CPI of a 10% increase in world food prices



"Exchange rate and commodity price pass-through in Asia" Global Economic Perspectives, June 17, 2011..

World grains and Asian food prices



Sources: CEIC, IMF and Deutsche Bank.

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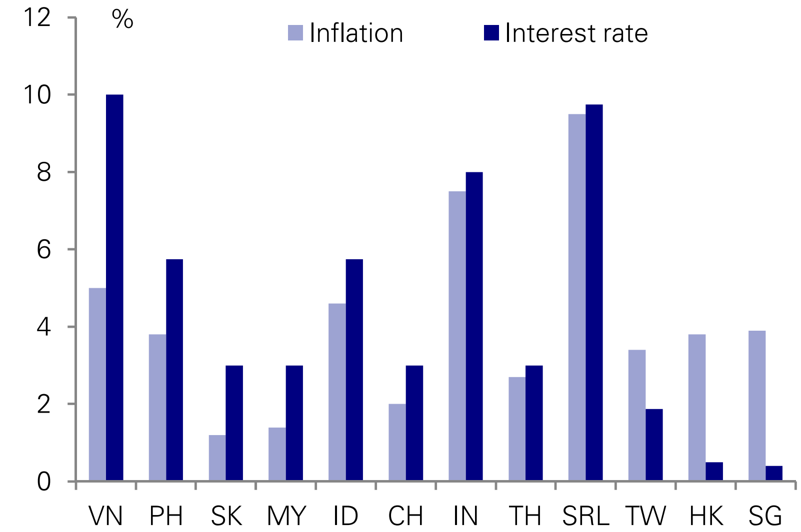
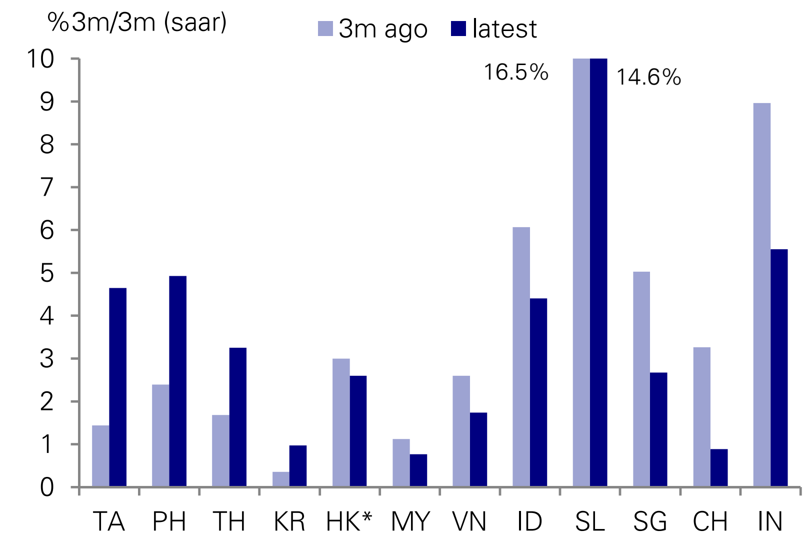
Inflation constraints on monetary policy

- The exchange rate response to a potential European crisis is constrained in Hong Kong (we don't expect a devaluation), China and Singapore (we expect RMB and SGD to be relatively stable currencies) and Japan (appreciation is more likely).
- Interest rate policy is constrained in Sri Lanka, India and Indonesia by relatively high and/or rising inflation and in Hong Kong and Singapore where interest rates are already near zero.
- But in China, Malaysia, South Korea, Thailand and Vietnam we think central banks have room to cut rates as inflation is already quite low or is falling.

Latest inflation and policy rates



Inflation trends in Asia

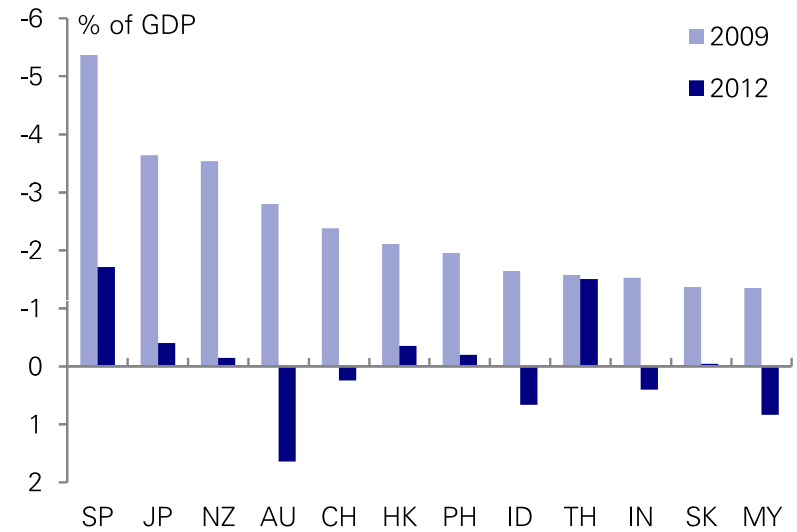


Sources: CEIC and Deutsche Bank.

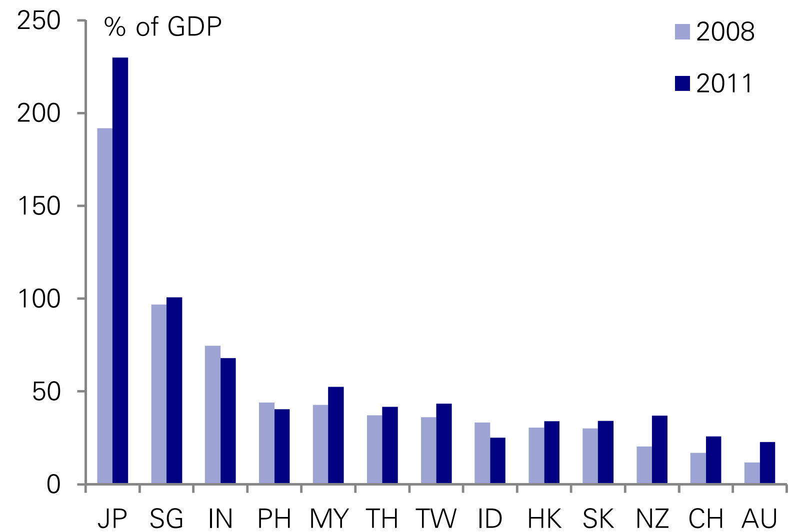
Fiscal policy seems unconstrained in most places

- The fiscal policy response to the Lehman's crisis was strong. In China, it was "quasi-fiscal" – bank lending to government-identified infrastructure projects. But even there the conventional fiscal stimulus was 2.4% of GDP. On average in Asia Pacific, the fiscal stimulus applied in 2009 was also 2.4% of GDP.
- Latest IMF fiscal projections imply essentially neutral fiscal policy in 2012 – some stimulus in Singapore and Thailand, notably contractionary policy in Australia and some continued stimulus withdrawal in Indonesia and Malaysia.
- Most governments have "fiscal space" to provide stimulus – even as great as 2009's' – if needed. Government debt levels are generally very low – about half that of the "advanced" G20 countries.
- In Asia Pacific, we think fiscal stimulus would be ill-advised in India and Japan and faces administrative/constitutional constraints in Indonesia and Thailand. In HK and Singapore, given the constraints on monetary policy, we expect fiscal policy would play the dominant role in responding to a European crisis.

Fiscal stimulus in Asia



Government debt/GDP



Sources: IMF and Deutsche Bank.

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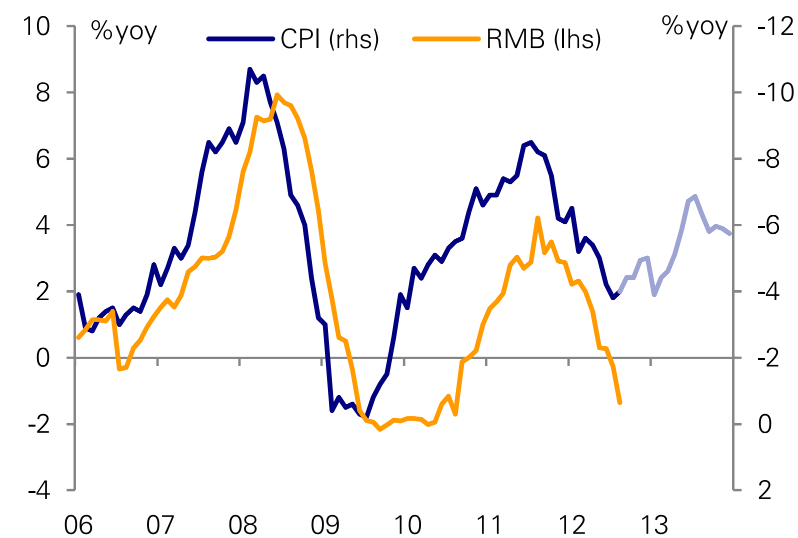
China: an end to “structural” RMB undervaluation

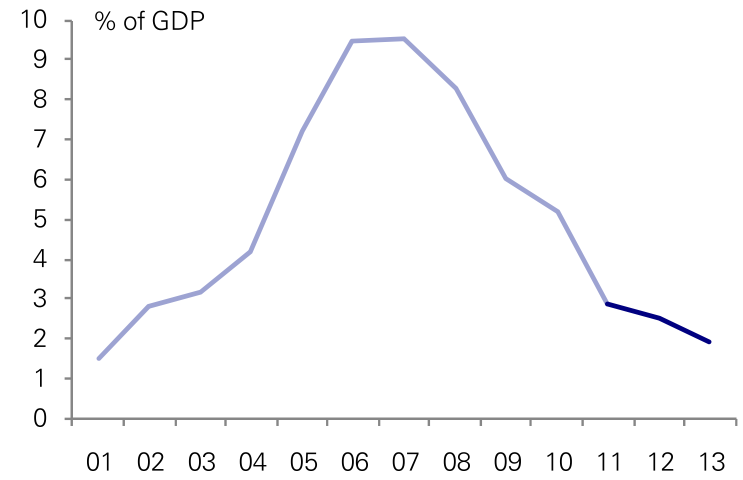
- Since de-pegging in 2005, China has used the RMB as an anti-inflation tool. With inflation likely to remain relatively subdued for the rest of this year at least, we see limited (3.5%) upside to RMB vs USD. There may be scope for faster RMB appreciation in the second half of 2013.

- Fundamentally, though, it is getting harder to justify being structurally bullish RMB. The current account surplus is already below the 3% level the IMF has historically viewed as a threshold of excess. As China engineers capital outflows – not necessarily deliberately – there is fundamentally more two-way risk to RMB.

China: inflation and CNY



China: current account balance



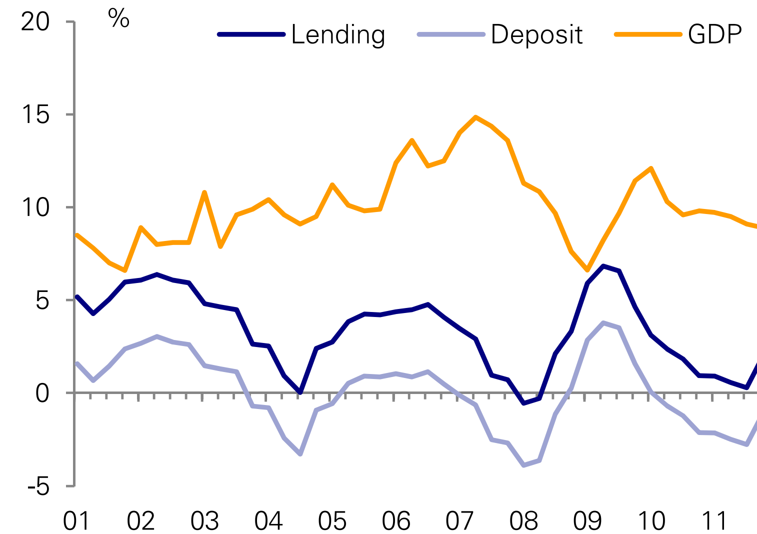
Sources: CEIC and Deutsche Bank

Is China ready for capital account convertibility?

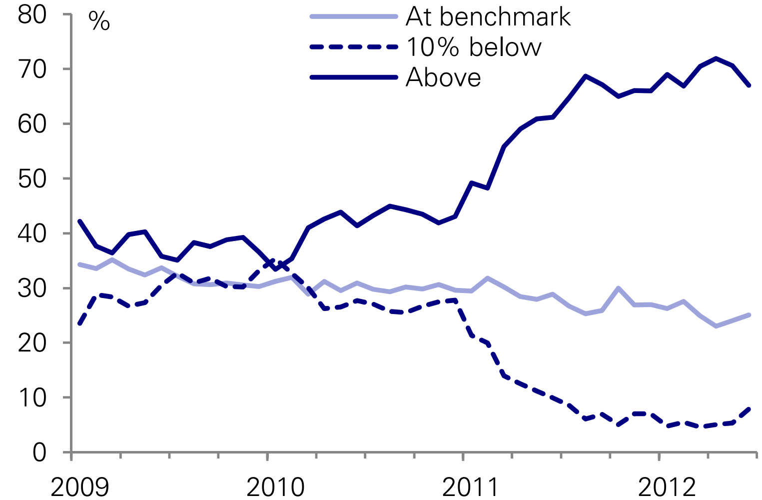
- Capital account convertibility will in principle lead to an end to financial repression – real deposit rates that are 0%, real lending rates of 3.5% while real GDP growth averages 10%.
- Given a choice, as the emergence of "off balance sheet" intermediation demonstrates, depositors will demand higher interest rates and borrowers will be expected to pay higher rates on loans.
- These new deposit-like instruments are used to finance non-traditional sources of lending. Whereas in 2006 bank loans accounted for 85% of total outside financing for corporates and households, by 2016 that ratio was only about 65%. And whereas in 2009 the average lending rate was slightly below the benchmark lending rate, by end-2011 the average interest rate on bank loans was 150bps above the benchmark.
- China's investment –led growth model will not be sustainable without explicit subsidies. While this is, ostensibly, what the government says it wants, we question whether they can face this fundamental re-engineering of the economy in such a short – four or five year – time frame.
- Capital account convertibility is happening in stages – quotas on inflows and outflows are being expanded, a greater presumption of approval for inward CNH FDI. But Q4 last year saw the first BoP deficit since 1998Q1 and arbitrage by Chinese corporates taking advantage of a depreciated CNH played a small part in this.
- As the capital account opens up it will force domestic interest rate liberalization to occur faster than it might otherwise happen – just as WTO accession forced SOE restructuring.

See "China's Financial Revolution, *Global Economic Perspectives*, April 20, 2012"

Real interest rates and growth in China



Distribution of loans bv interest rate



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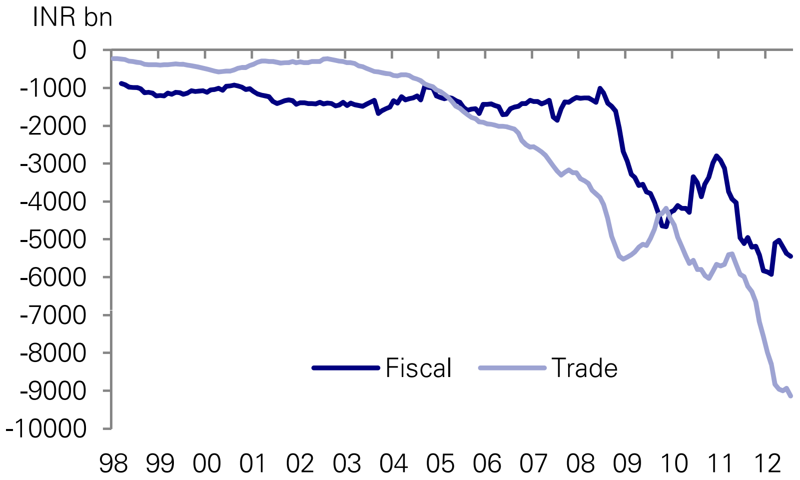
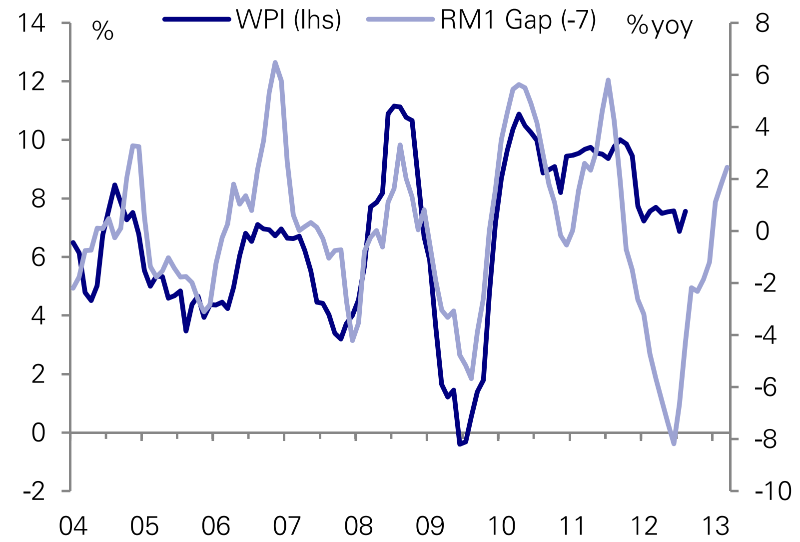
India is a question of political will

- India is one of the few “twin deficits” economies in Asia, so international shocks affect the economy both through growth channels (weak export demand) and financial channels (inability to finance external deficits).
- Both deficits continue to widen even after a 20%+ depreciation of the INR and falling oil prices over the past year. Monetary policy has been tight – money supply and credit growth were brought down sharply last year but inflation responded much less than expected. Is it “structural” or fiscal?
- With inflation still too high – and even though RBI seems to have raised its inflation tolerance level – we think there is little scope for monetary easing. High deficits already imply a constraint on fiscal stimulus.
- Instead, the government has – belatedly – tried to improve investor sentiment by cutting diesel subsidies and encouraging FDI into key sectors. These are positive signals, but are they enough?

Trade and fiscal balances



Inflation and money supply



Sources: CEIC and Deutsche Bank

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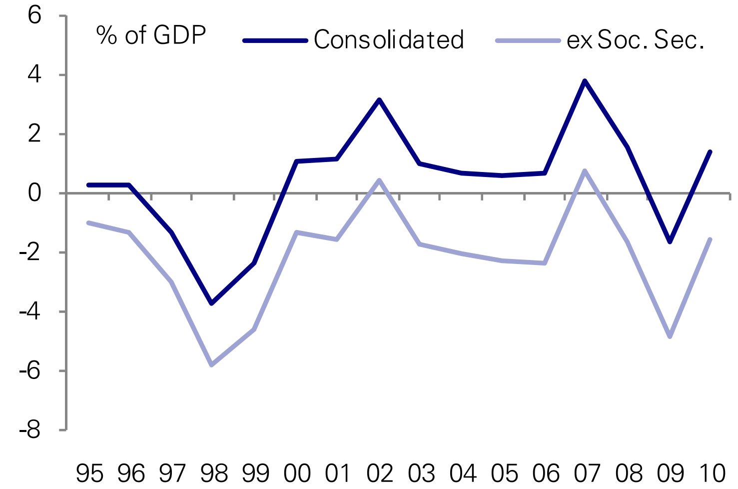
Korean government has a strong balance sheet…

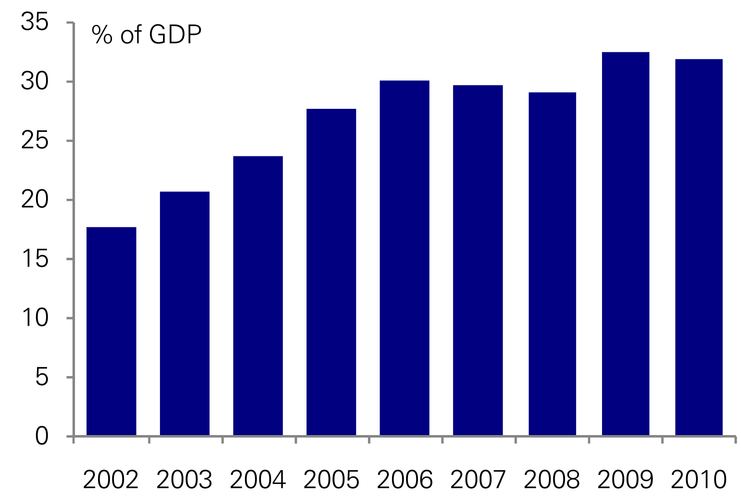
- The government's consolidated fiscal surpluses reflect large surpluses (3% of GDP) on social security. Theses surpluses are "invested", leaving modest bond issuance to finance the resulting deficits.

- At about 30% of GDP, Korean government debt is the lowest among the G20 advanced economy members except for Australia and in EM Asia only Hong Kong's and Indonesia's is lower.

Central gov't surplus



Central gov't debt



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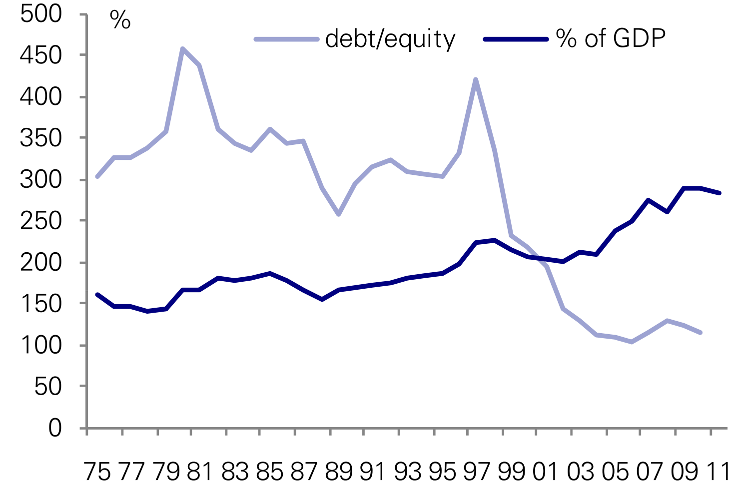
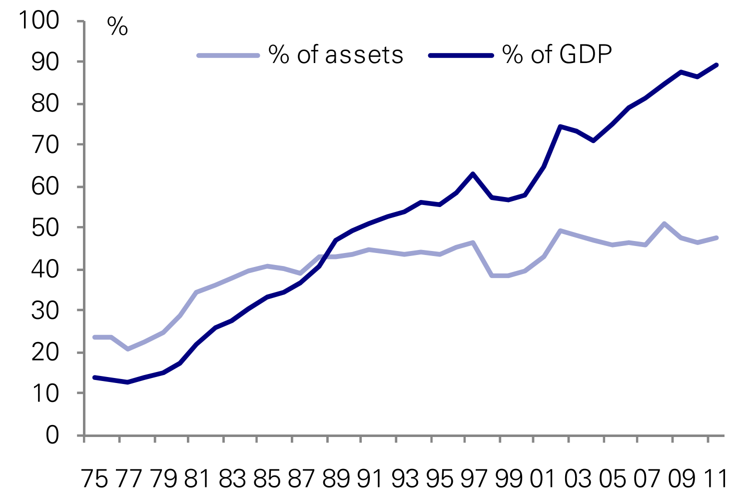
…but a highly levered private sector

- The private sector, though, is in a relatively weaker position than the sovereign. While corporate balance sheets were strengthened dramatically in the wake of the Asian Financial Crisis, gearing levels remain high.
- Household debt relative to assets has been only creeping up over the years, but is higher than even peak US household debt/assets.
- Relative to disposable income, at 163% household liabilities in Korea are comparable to those in Australia.
- These large debt burdens in the private sector constrain monetary policy. The Bank of Korea refrains from raising interest rates too quickly – 125bps over 12 months from mid-2010 to mid-2011 – but also is reluctant to cut rates for fear of encouraging more borrowing.

Corporate liabilities



Household liabilities



Sources: CEIC and Deutsche Bank. "Household" includes nonprofit businesses prior to 2002..

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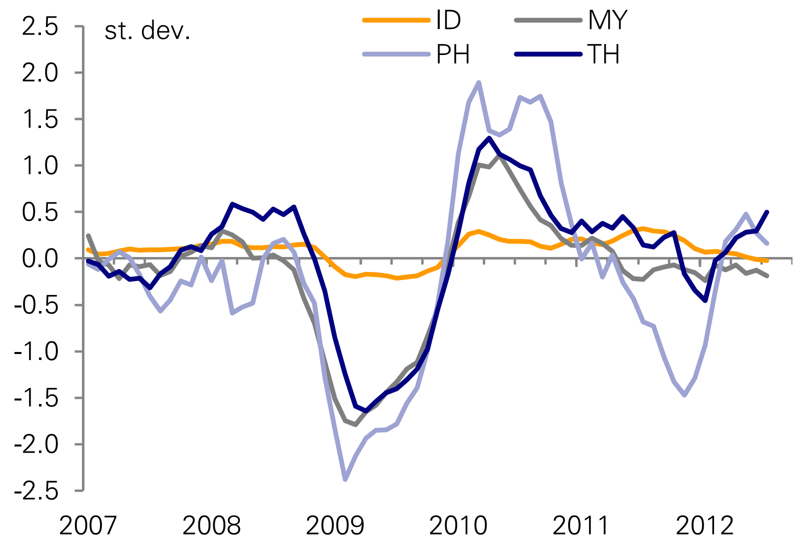
ASEAN

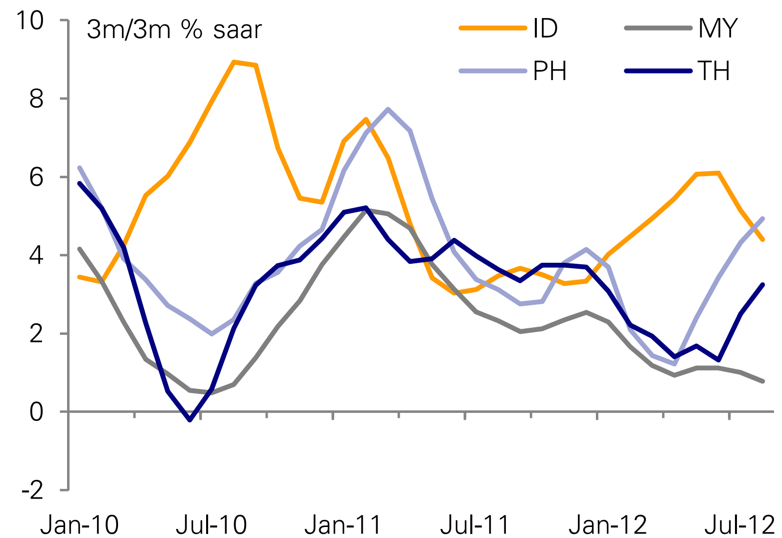
- Indonesia is a "low beta" economy and has been remarkably – but not unexpectedly – stable in recent years. The Philippines, historically a "low beta" economy also, is clearly becoming more globally integrated as its remittances and services exports rise in importance.
- In recent months, growth in Indonesia has tapered off – back to its long-run average. Malaysia continues to grow at a stable, albeit slightly below average, rate. Growth in the Philippines recently has been very strong and Thailand has also posted a stronger-than-expected recovery from the floods.

Macroeconomic momentum



- Along with this strong growth, though, the inflation impulse in the Philippines and Thailand has risen sharply. The core inflation impulse in the Philippines is 6.9%. Indonesia, historically a higher-inflation economy has seen its inflation impulse taper off a bit as growth has eased. But we view inflation risks as still important there.
- A year without subsidy cuts has taken inflation in Malaysia down to 1.4%yoy (0.8% 3m/3m(saar)).

Inflation impulse



Sources: CEIC and Deutsche Bank.

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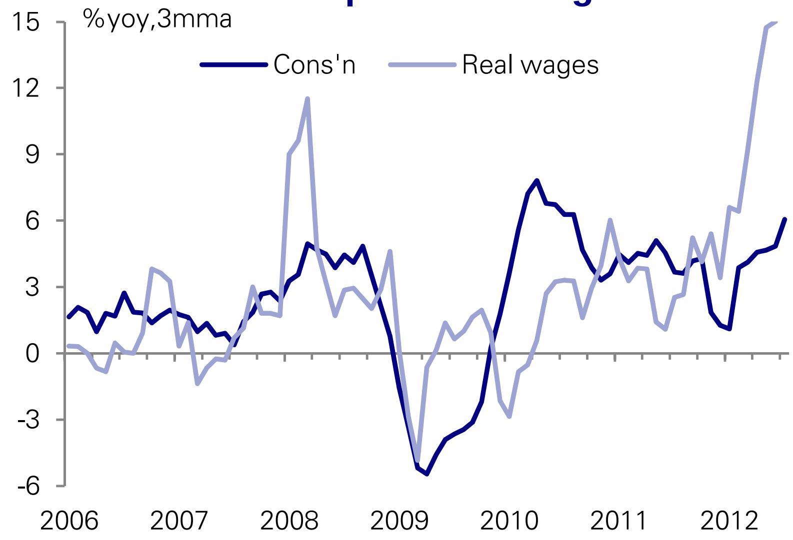
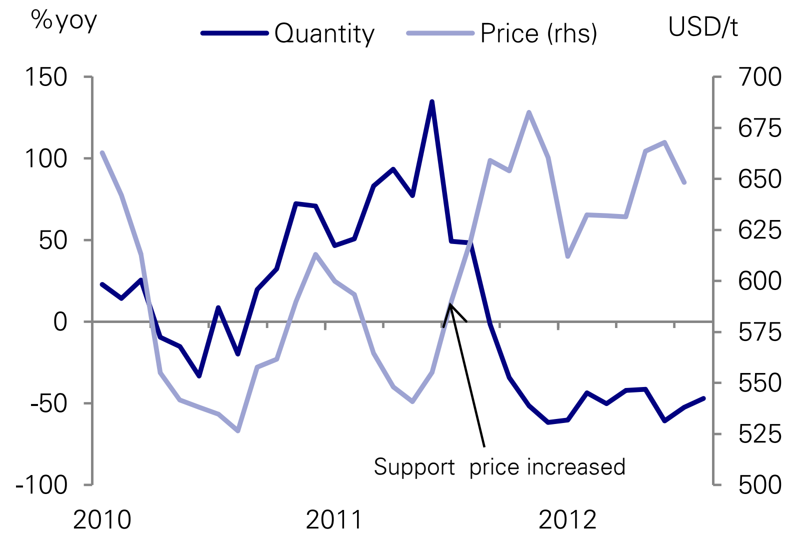
Thailand: a (temporary) consumption stimulus

- Real wages rose about 15%yoy in Q2 and 9% in Q1. Note that the 40% minimum wage increase took effect in April. Wages were rising quickly even prior to this. To some extent, this reflects firms adjusting wages in anticipation of the mandated increase.
- In the manufacturing sector conditions are even worse. Real wages rose 19% in the first half of the year but productivity growth was only 10%.
- Labour market conditions are tightening. Migrant workers are moving back to Myanmar and farmers have seen a windfall in the near-40% increase in the government support price for rice after the July 2011 election.
- Not surprisingly, farmers have stayed on the farm rather than return to factories. Rice production has doubled this year. But Thailand's share of world rice exports has fallen by one-third (to the benefit of Vietnam and India) as its export price has been pushed up to about 40% above the others'.
- The government has already bought 16mnT under this program (exports last year were 10.7mnT) and is committed to buying even more next year.
- This "rural consumption boom" is fiscal stimulus – and unsustainable fiscal stimulus because it is crowding out private activity and driving up the deficit.

Consumption and wages



Rice exports

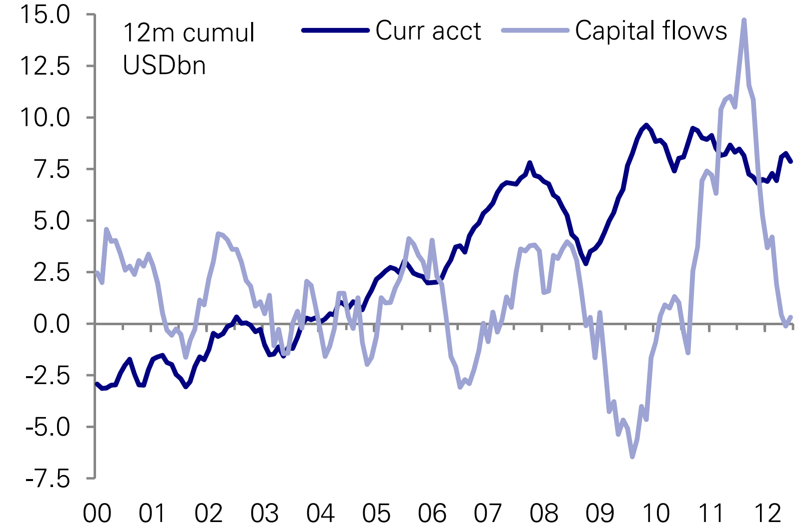


Sources: CEIC and Deutsche Bank.

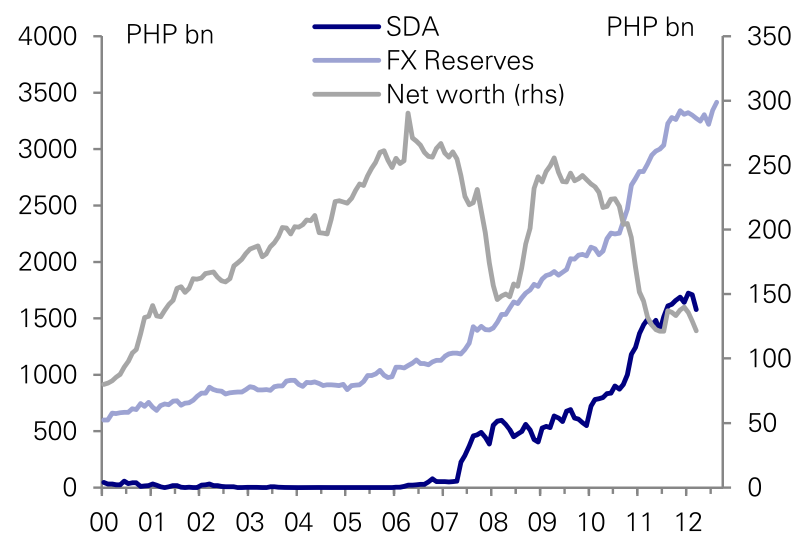
The Philippines: how to manage liquidity?

- Remittances and services exports have grown to about 15% of GDP and so even with a widening trade deficit (although that too has improved in recent months) the current account balance is stable at about 4% of GDP.
- Capital flows come and go but we see improving prospects for FDI and expect that through the cycle net flows will remain positive.
- This poses a challenge for the BSP. To protect these new export-oriented growth centers it has accumulated USD80bn of foreign exchange reserves. To sterilize these reserves it has taken on PHP1.6tn in its Special Deposit Account.
- But SDA's pay just under 4%, well below what the BSP likely earns on its FX reserves. The central bank's net worth has fallen by half . At this rate, in two years it will be insolvent.
- To lower its sterilization cost, the BSP may be tempted to cut rates on SDAs. But with rising inflation and strong growth this is not wise. Instead, we think a hike in reserve requirements (currently 18%) may be needed – effectively shifting the cost of sterilization onto the banks.

Current and capital accounts



BSP's challenge



Sources: CEIC and Deutsche Bank.

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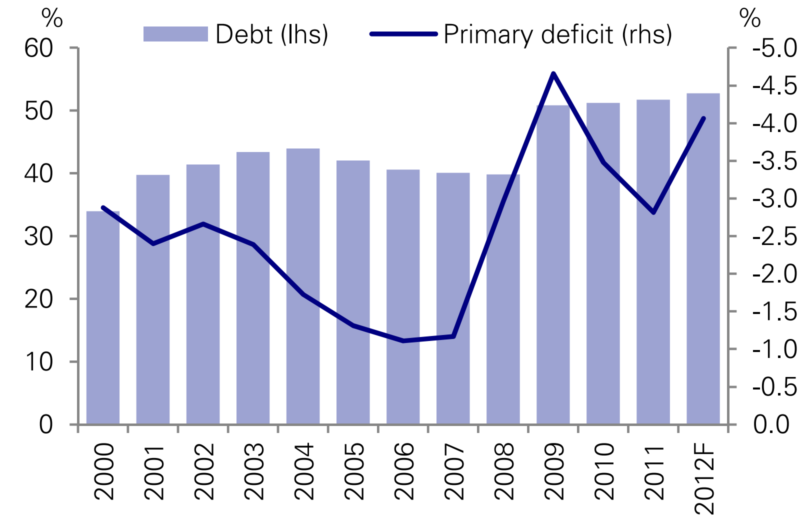
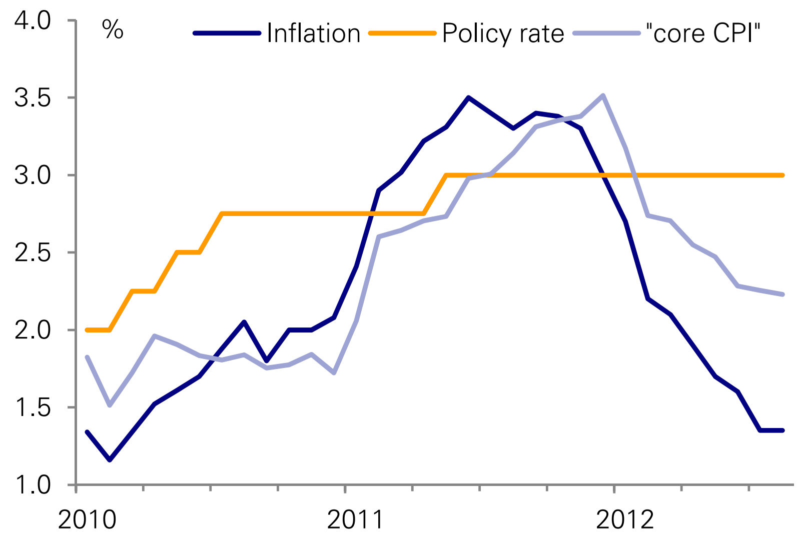
Malaysia: fiscal stimulus to give way to monetary?

- Malaysian growth has been supported to a considerable extent by fiscal stimulus. The deficit for 2012 was originally projected at 4.5% of GDP. We now forecast it will be 6%. The primary budget has been in deficit since 1999.
- Stimulus has involved higher public investment spending, higher wages and salaries for civil servants and subsidies on housing loans and the postponement of subsidy cuts.
- In order to avoid a ratings downgrade, the government will have to show a commitment to fiscal restraint in 2013 – subsidy cuts, timetable for GST and lower spending.
- To maintain support for domestic demand, therefore, we expect a shift to monetary stimulus. With inflation falling below the historical average, we think there is room for a rate cut (or two) next year.

Gov't debt and deficits



Inflation and interest rate



Sources: CEIC and Deutsche Bank.

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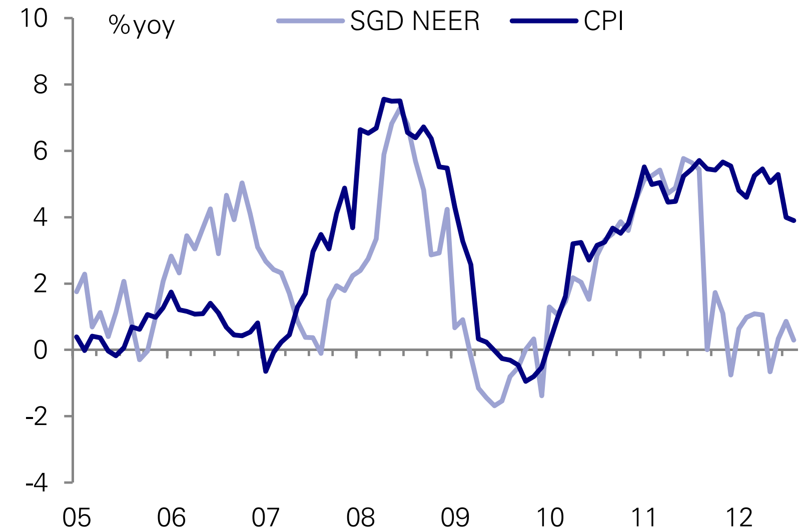
Singapore: how to contain inflation?

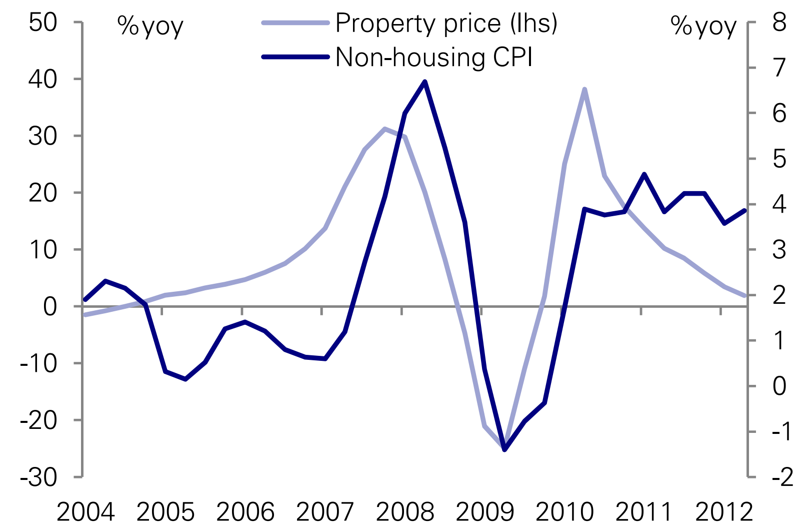
- Historically, MAS has used the exchange rate as its main policy tool. A 1% appreciation of the trade-weighted SGD was estimated to lower inflation by 0.1%. Since most goods and services are tradeable, that policy seemed to make sense.
- But in recent years, it seems the ultra-low level of interest rates globally has neutralized this NEER-based policy. NEER appreciation seems to draw in more capital, fuelling price increases (especially in housing) that offset the decline in imported goods' prices.
- So the MAS continues to direct the currency in line with inflation but it doesn't seem to help. And with the depreciation in Q4 last year, any benefit from a 'strong' currency appears to have been lost.

- However, inflation in recent years shows considerable sensitivity to property prices – and hence, if the strong SGD policy attracts more inflows into property it may be self-defeating.
- We count 18 measures in the past two years aimed at trying to limit property price inflation. Inflation doesn't yet appear to have responded.

SGD NEER and CPI



Property prices and non-housing CPI



Sources: CEIC and Deutsche Bank.

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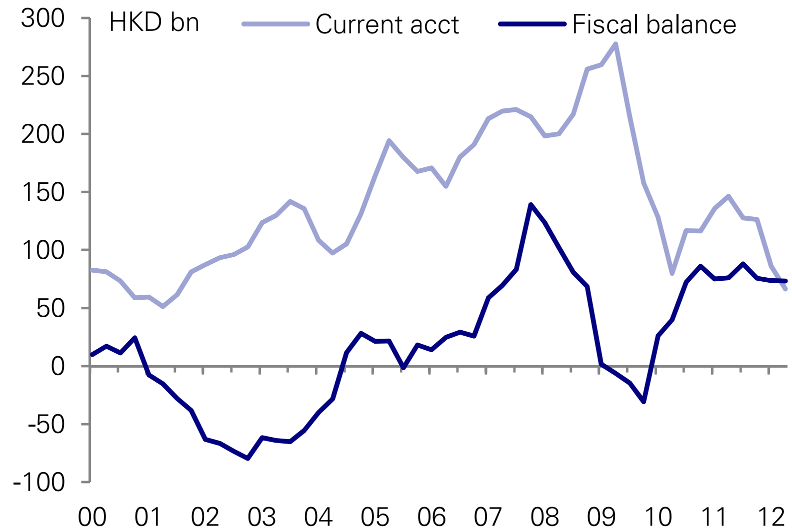
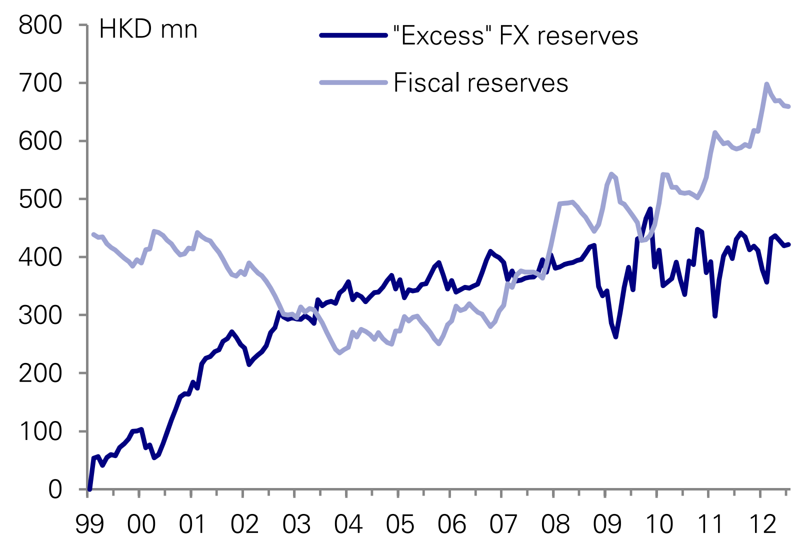
HK: the end of two good things?

- Hong Kong ran a current account deficit in Q2 for only the second time in 15 years. Its trade deficit has doubled since 2009 but net services exports (which includes tourism) have not kept pace.
- Despite the slowdown in growth, the government continues to post a large fiscal surplus. With growing populist pressures, we think this too may end.
- Fiscal reserves total nearly USD12k per person. We expect the government will soon start to dip into these.
- The current account is likely to remain in surplus this year, but the days of huge surpluses underpinning a "strong HKD" view are gone (for now, at least). With the economy posting growth of only 0.7% over the past five quarters, the HKD-reval trade may soon be reversed.
- Excluding fiscal reserves and the minimum FX reserves needed to back the monetary base, the HKMA still has "excess" reserves of USD54bn – more than 20% of GDP.

Current account and fiscal surpluses



"Excess" FX and fiscal reserves



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