

EMERGING ASIA ECONOMICS WEEKLY

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Editor: Kevin Grice

Asian central banks moving towards the exit

- **The next wave of monetary policy tightening in Asia is likely to start soon. Inflation should remain low for a while and will provide some room for manoeuvre. Nevertheless, historically low interest rates are no longer needed: private sector spending across Asia is well-placed to sustain recovery even as the monetary and fiscal policy supports are gradually pulled back.**
- Australia is likely to hike rates again in early December and policy rates should move up for a first time in the current cycle from January or February in India, Korea, Indonesia, and Vietnam.
- However the bigger picture is that policy rates in most countries will probably move up by far less next year than the markets currently anticipate. In some countries, high household debt is likely to subdue domestic spending after an initial strong bounce. In addition, we forecast that the global upswing will fade in 2010, which will clearly have some impact on Asia's most trade-dependent economies.
- Most Asian currencies should rise further against the US dollar on the back of higher interest rates, continued strong capital inflows into local asset markets, and improved external trade. (Pages 2-4.)

Data Previews (page 5)

Singapore Non-Oil Domestic Exports (Tue. 17th Nov.) – *A much-reduced y/y decline*

Thailand Foreign Trade (Fri. 20th Nov.) – *Monthly exports gain to hold strong*

Malaysia Q3 GDP (Fri. 20th Nov.) – *More good news*

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Asia central banks moving towards the exit

Who will hike next and how far will they go?

It is hazardous to forecast the precise timing of interest rate moves and we prefer to focus most on the extent of the monetary tightening likely over the period to end-2010. Our views are summarised in Table 1. We see Australia continuing to hike at virtually all of its regular monthly policy meetings until Q2 2010, when there may then be a pause. The next wave in Asia to hike is likely to include India, Korea, Indonesia, and Vietnam.

TABLE 1: POLICY RATE FORECASTS (%)

	Now	Next move	End-2010 Forecast
Australia	3.50	Up 25bp, Dec. 09	5.00
India	4.75	Up 25bp, Q1 2010	6.75
South Korea	2.00	Up 25bp, Q1 2010	3.00
Indonesia	6.50	Up 25bp, Q1 2010	8.00
Vietnam	7.00	Up 25bp, Q1 2010	12.00
Philippines	4.00	Up 25bp, Q2 2010	5.00
Malaysia	2.00	Up 25bp, mid-2010	2.75
Thailand	1.25	Up 25bp, mid-2010	1.75
New Zealand	2.50	Up 25bp, mid-2010	3.50
Taiwan	1.25	Up 12.5bp, mid-2010	1.50
Pakistan	13.0	Down 25bp, Nov. 09	12.75
Singapore		Move to FX rate appreciation bias, Apr. 10	

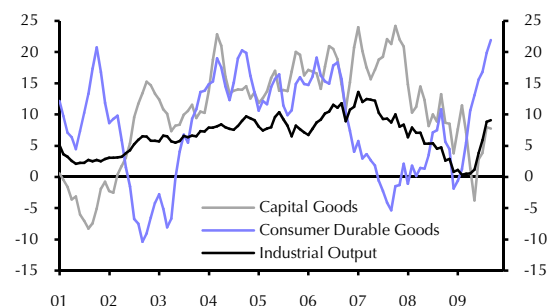
Sources – Bloomberg, Capital Economics

In Australia, we expect the Reserve Bank (RBA) cash rate to move up again in early December, especially after last week's October labour market data. The figures showed both another strong rise in overall employment and also a gain that is now spreading out to retailing and to services after being rapid for a while in construction and resource-based areas. The big picture is that the economy is picking up quite strongly at a time when there is less spare capacity than was thought likely in the first half of 2009. The outlook is good and we now expect that GDP growth will accelerate to around 3.0% in 2010 after averaging around 1.0% in the first half of 2009. GDP growth of 3.0% would be close to Australia's long-run sustainable rate and

implies that RBA rates will probably end up moving to the low end of a neutral range, which we judge to be 5-6%, by the end of next year.

Elsewhere, the authorities in both Korea and India have been putting the markets on notice for some time to expect higher policy rates sooner rather than later. We expect a first hike in both countries in January 2010 and still believe that there is an outside chance India could also lift its cash reserve requirement before the end of year. In India, September industrial output published last week surprised on the upside yet again (see Chart 1), and the uncertainties surrounding the durability of its economic upswing are diminishing all the time, despite the negative impact of poor monsoon rains.

CHART 1: INDIA INDUSTRIAL OUTPUT (% 3M Y/Y)



Sources – Thomson Datastream

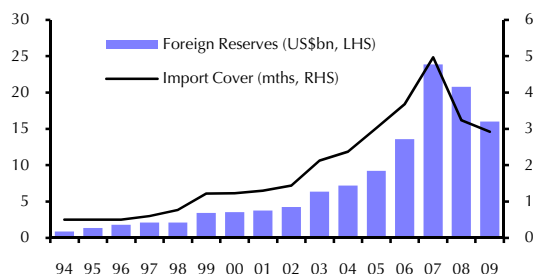
During 2010 as a whole, we expect a monetary tightening of around 100bps in Korea, which would still leave policy rates below a neutral range of 4-5%. In India, we anticipate a more aggressive tightening of 200bps which would take rates there to the bottom end of a neutral range.

It is a similar story of strong recovery and limited spare capacity in Indonesia, which we also anticipate will start to move policy rates up from January 2010. Vietnam should follow early next year too although policy-making there is less transparent than elsewhere in Asia and it is harder to judge what the authorities will do. We believe that the most likely outlook strongly argues for the State Bank base rate needing to move up soon.

Private sector spending looks well-placed to rise strongly even as the key part of Vietnam's stimulus programme, the loan subsidy scheme, is likely pulled back during the course of 2010. Meanwhile, inflation will probably rise sharply over the next 12 months as capacity constraints are hit earlier than in other Asian countries. Vietnam is also the Asian country most vulnerable to the risk that asset bubbles quickly develop in the property and equity markets. Finally, higher rates should also help bolster confidence in the Vietnamese dong.

This would likely reduce the threat of a disorderly devaluation which many in the markets fear has a high chance of happening in 2010 given the country's recently-depleted foreign reserves and Vietnam's history of balance of payment difficulties. (See Chart 2.) We expect that Vietnamese interest rates will move up the most of the countries we cover during the course of 2010.

CHART 2: VIETNAM FOREIGN RESERVES & IMPORT COVER



Sources – Thomson Datastream, Bloomberg

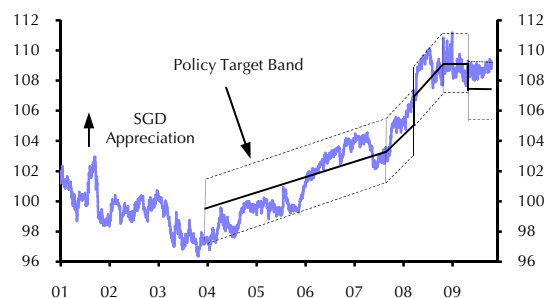
The slow lane countries

The next wave of countries to move, we forecast at some point in Q2 or Q3 2010, should be the Philippines, Malaysia, Thailand, New Zealand, and Taiwan. The GDP upswings in all these countries are likely to stay strong in coming quarters but spare capacity remains extensive, whilst deflation becoming entrenched remains the big risk in Taiwan. Central banks should be able to ensure that recovery is locked-in and can probably safely wait for some time before inflation expectations and actual inflation threaten to move up sharply. Furthermore, it is likely that rates in all these

countries will only move up modestly when the tightening does start.

The final countries in our Table 1 are the two extremes: Singapore and Pakistan. The monetary policy outlook in the two is very different. Singapore of course adjusts policy via the Singapore dollar nominal effective exchange rate (NEER) rather than through interest rates. (See Chart 3.) We expect Singapore to tighten by adopting a firming bias at its April 2010 monetary policy meeting and then anticipate that the slope of the band will allow for an annual appreciation of around 2% pa.

CHART 3: SINGAPORE NOMINAL EFFECTIVE EXCHANGE RATE



Source – Bloomberg

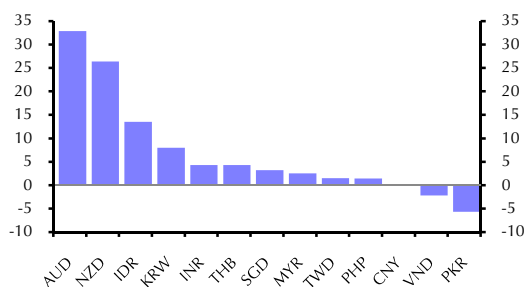
In Pakistan, capital inflows from the IMF have brought some stability to its economy but the deteriorating security situation, the volatile domestic politics, and on-going energy supply shortages, make the GDP outlook especially uncertain. Weak growth looks the best that can be expected. In this context and with inflation y/y continuing to slow, it is likely that Pakistan will be the only central bank that will continue to cut policy rates. Nevertheless, even in Pakistan, the easing cycle is just about over. We forecast a 25bps cut in late November followed by prolonged hold.

What are the currency market implications?

We have signposted for a while that sustained Asia monetary tightening well ahead of the US and Europe is likely to bring significant currency appreciation. The exceptions to this trend will likely be the Vietnamese dong and Pakistan rupee where further depreciation is most probable given balance of payment vulnerabilities and the likelihood that

inflation will stay well above the regional average. Asian currencies apart from these two have moved up strongly against the US dollar so far this year. (See Chart 4.) We expect further appreciation for another two reasons on top of the imminent move higher in onshore interest rates.

CHART 4: CHANGE AGAINST THE US\$ (2009 TO 13TH NOV. %)



Source – Bloomberg

Firstly, capital inflows into Asian asset markets should resume their upward trend in coming months. Inflows into the key equity markets actually dropped back in October but risk appetite has rebounded strongly since early November and should stay higher. Secondly, the turnaround in Asia's external trade should continue. In most countries, exports will start to climb y/y from November and external surpluses will grow.

Admittedly, a limiting factor is that China looks set to hold the renminbi stable against the dollar for a while longer. The peg against the US\$ in place since July 2008 means that Asian currencies have gained against the renminbi as well. The peg is likely to be relaxed over the next 12 months, we judge in the first half of next year. But until that happens, further Asian FX gains are likely to be modest rather than spectacular.

Furthermore, the authorities will continue to protest rapid appreciation and there is an outside chance that some countries may introduce capital controls or a Brazil-style tax on inflows if currency appreciation threatens to become too quick. Our latest forecasts are in Table 2.

TABLE 2: FX RATE FORECASTS

	Per USD now	Our forecasts per USD ¹	
		End Q1 10	End 10
Australian dollar (AUD)	0.93	0.98	0.92
Chinese renminbi (CNY)	6.8	6.8	6.6
Indian rupee (INR)	46.7	46.0	44.0
Indonesian rupiah (IDR)	9,410	9,300	9,000
Korean won (KRW)	1,158	980	1,050
Malaysian ringgit (MYR)	3.38	3.36	3.38
New Zealand dollar (NZD)	0.73	0.78	0.71
Pakistani rupee (PKR)	83.5	85.0	92.0
Philippine peso (PHP)	46.7	46.0	44.0
Singapore dollar (SGD)	1.39	1.36	1.38
Taiwanese dollar (TWD)	32.3	31.0	31.5
Thailand baht (THB)	33.3	32.0	31.0
Vietnamese dong (VND)	17,862	18,200	19,000

Sources – Bloomberg, Capital Economics¹ Except the Australian & New Zealand dollars where quoted as USD per local dollar

Where do our forecasts differ from the markets?

On the interest rate side, the markets now expect the tightening cycle to start early next year in India, Korea, and Indonesia. But the markets are also anticipating an earlier start to the tightening cycle than we believe is probable in all the other countries. Furthermore, in all the countries except Australia and India, the markets are pricing in a more aggressive tightening cycle than we think is likely. On the exchange rate side, the forwards have moved to expecting significant appreciation as well but our forecasts are still more aggressive. Furthermore, the slippage of the VND we expect is a lot lower than what is currently anticipated in its (admittedly illiquid) forwards market, where a 13% fall is expected over the next 12 months.

The week ahead

It is a relatively quiet week for incoming economic data. The standouts are Singapore October exports on Tuesday and Malaysia Q3 GDP due on Friday. Elsewhere, there is Thailand October foreign trade, which is also due on Friday.

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Data Preview – Singapore Exports (Oct.)

05.00 GMT Tues. 17th Nov.

Forecasts	Previous	Median	Capital Economics
Non-Oil Dom. Exports (Oct.)	+3.0%(-7.2%)	+0.4%(-0.6%)	+0.5(-0.5%)

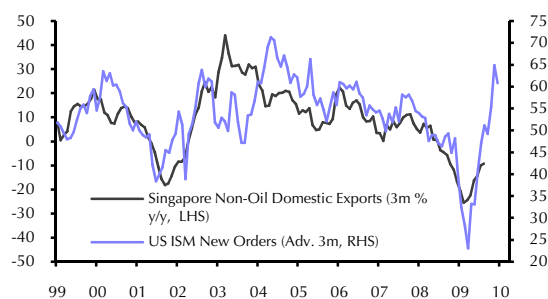
A much-reduced y/y decline

Non-oil domestic exports have climbed three months in a row and should improve again m/m in October. Industrial output has risen for several months too. In addition, while the industry and exports rebound is being led by biomedical, there have been recent signs that the electronics sector is starting to improve as well.

Non-oil domestic exports will remain negative in y/y terms. But the financial crisis-induced collapse in exports started in November 2008 and so, barring a highly unlikely collapse in exports, the y/y comparison will soon be rising sharply. On the face of it, the pull-back in October's Singapore PMI was led by lower export orders and points to a more disappointing exports performance soon. But

international trends, particularly the still-high level of US ISM New Orders, suggests that the improving trend in Singapore's external trade still has further to run. (See Chart 1.)

CHART 1: SINGAPORE EXPORTS & US ISM NEW ORDERS



Source – Thomson Datastream

Data Preview – Thailand Foreign Trade (Oct.)

07.00 GMT Fri. 20th Nov.

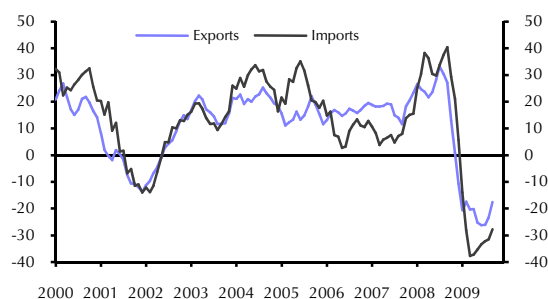
Forecasts	Previous	Median	Capital Economics
Exports	(-8.5%)	(-3.0%)	(-3.0%)
Imports	(-17.9%)	(-15.8%)	(-15.0%)
Trade Balance	+\$2.0bn	+\$1.5bn	+\$1.8bn

Monthly exports gain to hold strong

Exports bottomed out in April and have been climbing rapidly on a monthly basis since then. (See Chart 2.) The September surge was especially strong, up 12% m/m, and reflected the coming through of Christmas orders from the US and Europe, and from the rest of Asia too. It is likely that foreign orders will have remained high in October, whilst more generally the strong economic upswings now underway in the US, Japan, and in China, should continue to lift Thai exports in the coming months. The pick-up in monthly imports has been more sedate given that domestic private sector spending remains subdued. Overall, exports should drop by around 15% in 2009 as whole,

whilst 2010 should see a return to double-digit y/y gains.

CHART 2: THAILAND EXPORTS & IMPORTS (% 3M, Y/Y)



Source – Thomson Datastream

Data Preview – Malaysia GDP (Q3)

10.00 GMT Fri. 20th Nov.

Forecasts	Previous	Median	Capital Economics
Malaysia GDP (Q3)	(-3.9%)	(-2.0%)	(-2.0%)

Q3 GDP to show more good news

Industrial output slipped back m/m in both August and September but the expansion in July was large which meant that in Q3 overall industrial production was up around 6% on Q2. Exports have also been improving faster than the pick-up in imports, so net foreign trade should continue to make a positive contribution to GDP growth. On the domestic side, the benefits from loose fiscal and monetary policies should have kept coming through, so there likely to be another big contribution from government consumption. Household spending is likely to have risen too, investment should be less of a drag, and the aggressive de-stocking of late 2008/early 2009 is probably over now as well.

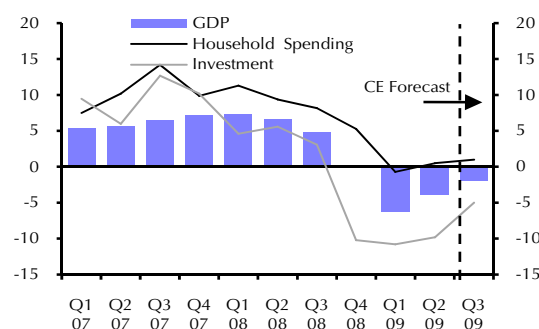
The government has already signposted that the upswing stayed on track in Q3. The focus tends to be on y/y GDP which will likely show a narrowing in the annual decline to around 2.0% from Q2's 3.9% drop. (See Chart 7.) This implies that the GDP gain q/q likely held around the 4.8% pace of Q2 but this data is not seasonally-adjusted and is not worth too much analysis. Looking forward, Q3 will almost certainly be the last period that GDP is down y/y: Q4 should see a y/y gain of 2-3%. For 2009 as a whole it now looks probable that GDP will drop around 2.0%.

The outlook for next year is far more impressive with private sector spending set to take over as the fiscal and monetary stimulus is gradually pulled back. We have now revised our forecasts and expect GDP to climb 5.0% in 2010, which would

be close to Malaysia's long-run sustainable economic growth rate.

Finally, Malaysia's October consumer price data are also released this Friday and we forecast that that y/y deflation will ease to 1.4% y/y from 2.0%, driven by unwinding base effects. That said, overall capacity use is still below long-term average levels, so inflation is likely to remain subdued and will creep up rather than surge in coming quarters: we forecast to the 2.0-2.5% range by late 2010. As a consequence of this, we expect Bank Negara to remain in the slow lane in terms of monetary policy tightening. We expect that a first hike can wait until mid-2010 and then anticipate that rates will only rise to 2.75% by end-2010.

CHART 7: MALAYSIA GDP (% Y/Y)














Sources – Thomson Datastream, Capital Economics

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Emerging Asia Diary

EMERGING ASIA

Date	Country	Release/indicator/event	Time (GMT)	Previous*	Median*	CE Forecast*
Mon 16 th	-	No Significant Data Released	-	-	-	-
Tue 17 th	 Spr	Electronic Exports (Oct)	05.00	(-14.4%)	(-10.5%)	(-10.0%)
	 Spr	Non-Oil Domestic Exports (Oct)	05.00	+3.0%(-7.2%)	+0.4%(-0.6%)	+0.5%(-0.5%)
	 HK	Unemployment Rate (Oct)	s.a. 08.30	5.3%	5.3%	-
Wed 18 th	-	No Significant Data Released	-	-	-	-
Thu 19 th	 Spr	GDP (Q3 Final)	00.00	(+0.8%p)	(+0.5%)	(+0.5%)
Fri 20 th	 Tha	Exports (Oct)	07.00	(-8.5%)	(-3.0%)	(-3.0%)
	 Tha	Imports (Oct)	07.00	(-17.9%)	(-15.8%)	(-15.0%)
	 Tha	Trade Balance (Oct)	07.00	+\$2.0bn	+\$1.5bn	(+\$1.8bn)
	 Tw	Current Account (Q3)	USD 08.20	+\$9.9bn	+\$8.5bn	-
	 HK	CPI (Oct)	08.30	(+0.5%)	(+1.2%)	-
	 Mly	CPI (Oct)	09.00	(-2.0%)	(-1.5%)	(-1.4%)
	 Mly	GDP (Q3)	10.00	(-3.9%)	(-2.0%)	(-2.0%)

Expected During the Period:

13 th -18 th	 Chn	Foreign Direct Investment (Oct)	-	(-14.2%)	(-10.9%)	-
19 th -26 th	 VN	CPI (Nov)	-	(+3.0%)	-	(+3.6%)

*m/m(y/y) unless otherwise stated; p = provisional estimate

KEY FORTHCOMING EVENTS/DATA

Date	Event	Date	Event
22 nd -26 th Nov	Vietnam Trade Balance, Industrial Output (Nov)	26 th Nov	Philippines GDP (Q3)
22 nd -26 th Nov	Vietnam Retail Sales (Nov)	26 th Nov	Singapore Industrial Production (Oct)
23 rd Nov	Thailand GDP (Q3)	26 th Nov	Hong Kong External Trade (Oct)
23 rd Nov	Taiwan Unemployment Rate (Oct)	26 th Nov	Taiwan GDP (Q3)
23 rd Nov	Taiwan Export Orders, Industrial Production (Oct)	26 th Nov	New Zealand External Trade (Oct)
24 th Nov	Malaysia Interest Rate Announcement	27 th -29 th Nov	South Korea Current Account (Oct)
25 th Nov	Philippines External Trade (Sep)		

Selected Recent Publications

Date	Publication	
Mon 9 th	Capital Daily	Markets shrug off rise in US unemployment.
	Germany Industrial Production & Trade (Sep.)	Industrial data point to strong growth in Q3.
	Global Economics Update	Are we any closer to a global Tobin tax?
	Latin America Economics Update	Mexico: disinflation process has further to run.
	Emerging Europe Update	Latvia: Still no sign of growth.
	US Economics Update	Extended tax credit is a shot in the arm for housing.
	UK Treasury Monthly	Bounce in gilt yields may not last.
Tue 10 th	Capital Daily	Fed survey suggests credit crunch fading fast.
	UK RICS Housing Sur. (Oct.) & CLG House Prices (Sep.)	Bank costs to rise, regardless of Tobin tax.
	Asian Economics Update	Slow rebalancing of the housing market continues.
	UK Trade (Sep.) & BRC Retail Sales (Oct.)	Is Japan's recovery already faltering?
	Asian Economics Update	Trade boost still in doubt.
	Global Markets Update	Indonesia's impressive upswing to stay on track.
	UK Commercial Property Update	Bond yields to drop back in 2010 as inflation fears fade.
	Asian Economics Focus	Why have leisure and hotels held up relativ. well during downturns?
Wed 11 th	Capital Daily	New Zealand facing a long hard slog.
	Global Markets Update	The macroeconomic implications of the lower dollar.
	UK Labour Data (Sep./Oct.)	Inflation expectations may not have much further to rise.
	Asian Economics Update	A tough six months ahead for Indian stocks.
	UK Bank of England Inflation Report (Nov.)	Employment unlikely to keep rising.
	Emerging Europe Update	China's commodity imports slow.
	Global Markets Update	Dovish Report leaves door to further policy action open.
Thu 12 th	Capital Daily	Price pressures continue to fade.
	UK Mortgage Arrears and Possessions (Q3)	Turning bearish on the yen.
	UK CML Buy-to-let Lending (Q3)	Office development cut, but not enough to prevent rental declines.
	Latin America Economics Update	A darker outlook for the yen.
	Asian Economics Update	Labour market flexibility helps keep possessions low.
Fri 13 th	Capital Daily	Buy-to-let lags the wider upturn in the mortgage market.
	Japan Economics Weekly	Mexico: Industry drives economic recovery.
	Euro-zone Preliminary GDP (Q3)	Markets too aggressive on Korean rate hikes to come.
	Emerging Asia Economics Weekly	UK faces a decade of high unemployment.
	US External Trade (Sep.)	Bonds and equities are not breaking up just yet.
	UK Economics Weekly	Is Japan facing a sovereign debt crisis?
	US Economics Weekly	-
	European Economics Weekly	Asian central banks moving towards the exit.

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