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Asia Pacific Economic Outlook

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China

China's economic performance continues to disappoint expectations for a rebound. That is not surprising, given that much of the global economy is disappointing business leaders, consumers, and even economists. The biggest cause of this disappointment is the substantial slowdown in Europe where a recession is under way and leading to a drop in imports from the rest of the world. In addition, the region's continuing crisis involves an ongoing risk of Eurozone failure. This fact has led business leaders around the world to shy away from hiring and investing as they await news on the future of Europe. This reluctance to spend reflects the widespread fear that a Eurozone failure would result in a historically deep recession.

The European Union is China's largest export market. China's exports to Europe were up only 3.2 percent in May while exports to the United States were up 23 percent. Although overall export growth was strong, it was entirely due to the United States, and export growth would have been far stronger if not for the recession in Europe. The slowdown in exports to Europe is having a negative impact on industrial activity. For two months in a row, a purchasing manager's index for manufacturing in China has fallen below the critical 50.0 level that indicates declining activity.

A loosening of monetary policy has been under way for some time, but it has failed to render positive results. This, too, is cause for disappointment. Consequently, the central bank has embarked on a more aggressive stance. Initially, there were reductions in the required reserve ratio for banks, the goal of which was to boost the volume of lending. This didn't achieve much. Consequently, the central bank recently implemented two interest rate cuts in June and July of this year. The result has been accelerated growth of the money supply and of bank credit. In addition, the government has engaged in a more aggressive—but not too aggressive—fiscal policy. The central government is taking relatively small steps to boost growth. These include gradual easing of credit conditions, targeted spending on some infrastructure projects, tax incentives for consumers to spend on automobiles and appliances, and more lending to small businesses. Bigger projects, however, are being avoided in case the banking sector experiences further troubles.

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Given the recent history of excessive investment in infrastructure and other fixed assets, the government is keen to avoid a further buildup of debt. Indeed, the volume of non-performing loans held by Chinese banks increased in the two most recent quarters. This was the first time since 2005 that this measure had increased for two consecutive quarters. Consequently, while monetary policy has been aggressive, banking regulation has been equally aggressive in the opposite direction. Specifically, the China Banking Regulatory Commission plans to retain the maximum loan-to-deposit ratio at 75 percent and may take other actions aimed at constraining credit growth. In addition, the government has placed limits on bank lending to local governments in case their financial conditions worsen. The purpose of these actions is to reduce liquidity risk and the likelihood of default. The regulators are concerned that, with lower interest rates and lower reserve requirements, the already-large number of bad assets held by banks could increase if lending grows too quickly.

Last but not least, the government has taken action to retard the appreciation of the currency. China has chosen to prevent further appreciation lest exports become less competitive during a time of weak export demand. This, of course, is only a temporary measure, and it will be in China's long-term interest for the currency to rise in value. Still, China's action is in line with what is happening in a number of other emerging markets. In Brazil, India, and other emerging markets, currencies have recently been experiencing downward pressure. Many have cut interest rates to stimulate economic activity. The result is that they no longer offer global investors a favorable interest differential. At a time of heightened risk, investors are seeking safety by taking funds out of emerging markets and placing them in safe havens such as the United States, the United Kingdom, Switzerland, and Japan. If China allows its currency to appreciate, it would compromise its competitiveness with other emerging markets. The Chinese authorities are not likely to let this happen.

India

India's GDP growth has slowed down considerably, and its economy grew at 5.3 percent in the quarter that ended in March 2012—its lowest rate in seven years. Growth in the industrial, services, and agricultural sectors fell short of expectations. So far, the monsoon has been below average and could potentially affect the sowing season. These are worrying signs, and growth projections have been lowered on multiple occasions. While the global macroeconomic environment is contributing, at least partly, to India's decelerating growth, the economy has been hurt by uncertainty about future economic policies.

Inflation has moderated from its peak of 10 percent in September 2011, but it remains at worryingly high levels. Although crude prices have fallen significantly, the weakness of the rupee has offset its impact on domestic prices. A rise in vegetable prices resulted in double digit inflation in primary food articles in May 2012. With food prices contributing heavily to headline inflation, the monsoon will play a crucial role in determining inflationary trends in the coming quarters. Moreover, core inflation recorded double digit growth, suggesting that retail inflation remains elevated. In addition, India confronts a host of supply-side bottlenecks that have led to considerably higher inflation.

As a result, the Reserve Bank of India (RBI) kept its policy rates unchanged in its monetary policy review meeting in June 2012. Given that headline inflation remains above levels consistent with sustainable growth, the RBI anticipated that a rate cut would likely heighten inflationary pressure. The markets, however, were expecting a rate cut and were disappointed with the RBI's monetary stance. As a result, interest rates are expected to continue at current levels, and borrowing costs will likely remain elevated. There are two possible explanations for the RBI's current stance. First, the RBI surprised the market with a larger-than-expected rate cut in April but failed to adequately boost economic activity. Furthermore, the RBI believes that the role of interest rates in holding back investment is relatively small in the current environment. It also believes that high interest rates are not the only factor holding back investment.

Some of India's woes stem from its twin deficit problem; government expenditures exceed revenues, resulting in a fiscal deficit, and the country imports more than it exports, leading to a current-account deficit. Persistent current account deficits put pressure on the exchange rate while increased government borrowing elevates the borrowing cost for other market participants, thus crowding out private investment.

Poor growth in the agricultural sector could severely impact rural consumption, which could result in a magnified influence on the entire economy.

Meanwhile, the Indian Rupee (INR) experienced significant volatility and continued to depreciate. An uncertain global macroeconomic environment coupled with policy decisions around taxation of foreign investors has led to a huge outflow of funds from India. Moreover, India's widening trade deficit raises the demand for foreign currency as importers need to pay for their purchases. In times of excessive volatility, the reserve bank has intervened in the foreign exchange market, but its ability to stem the slide has been limited. The rupee is expected to weaken further, given the country's muted growth prospects and widening current account deficit.

The RBI has initiated several measures to restrict the rupee's declining value. The RBI relaxed the interest rate ceiling on foreign currency non-resident (FCNR) deposits and allowed higher limits on intraday trading. On June 25, the RBI increased the limit on external commercial borrowing to $40 billion in order to allow firms to benefit from cheaper foreign loans. The RBI has also allowed sovereign wealth funds, insurance funds, pension funds, etc. to invest in government bonds with a limit of $20 billion. By allowing the government to finance its budget deficit through external sources, the RBI is trying to prevent private investment from being crowded out. However, the policy changes failed to rally the market, and the rupee failed to recover as anticipated. The recent measures fail to address the deficit problem; instead, they give the government an option to borrow from elsewhere.

Poor growth in the agricultural sector could severely impact rural consumption, which could result in a magnified influence on the entire economy. Inflation remains high, indicating that structural macroeconomic factors might need to be addressed rather than simply relying on monetary policy. The agriculture sector relies heavily on the monsoons, and the overall economy will hinge largely on a favorable rainfall. Inadequate rainfall could lead to higher inflation and even slower GDP growth. GDP growth is likely to moderate in the coming quarters, and growth forecasts for the 2012–2013 fiscal year range between 6.0 and 6.5 percent.

Singapore

Singapore's economic performance exceeded expectations in May 2012. Economists surveyed by the Monetary Authority of Singapore (MAS) expect the economy to grow faster in the second quarter of 2012. Singapore's GDP is now expected to expand by 2.8 percent in Q2 2012, up from a previous forecast of 2.5 percent. This comes as a welcome sign as GDP growth during the first quarter was only 1.6 percent. However, recent developments in Europe and China have resulted in lower growth projections for the year as a whole.

Singapore's manufacturing sector emerged stronger in May after two months of declines. The Purchase Manufacturer's Index (PMI) also signaled an expansion. Manufacturing output grew 6.6 percent year-over-year in May, exceeding the median expectation of a 4.5 percent. Transport engineering expanded by a staggering 35.4 percent, while marine and offshore engineering grew 44 percent. Furthermore, the pharmaceuticals segment recorded a 39.1 percent increase over May 2011. However, electronics and chemicals declined 9.7 and 4.1 percent respectively. Weakness in the electronics cluster, which accounts for nearly a third of the country's manufacturing output, is a cause for concern.

Following a 1.7 percent increase in non-oil domestic exports (NODX) in April 2012, NODX upheld its upward trend and rose 3.2 percent in May. Electronic NODX grew 3.9 percent, owing to higher exports of electronic chips, telecommunications equipment, and capacitors. On the other hand, non-electronic product exports benefitted from an uptick in petroleum, civil engineering equipment, and aromatic chemical exports. However, overall export growth in the non-electronic segment was only2.8 percent. While exports to the United States, China, and Japan contracted, Singapore's export sector was bolstered by double digit export growth to Hong Kong (23 percent), Indonesia (16 percent), and South Korea (15 percent). Furthermore, trade with the EU surged in spite of the crisis. Trends in electronics exports hint at higher demand for tablet computers and smartphones and augur well for the economy. However, Europe, China, and the United States are extremely important export markets for Singapore, and lackluster growth in these regions is a concern for Singapore's export-dependent economy. As a result, export growth is likely to remain muted.

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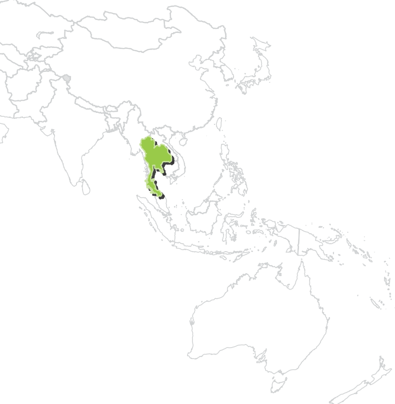
The labor market remains strong, but it is showing signs of moderation. Total employment rose by 27,200 in Q1 2012—much lower than the 37,600 increase in Q4 2011 and slightly lower than the 28,300 increase from a year ago. Unemployment remains fairly low, but it rose in the first quarter of 2012 to 2.1 percent. Meanwhile, labor productivity continued to decline. After contracting 0.5 percent in Q4 2011, labor productivity fell 2.2 percent in the first quarter of 2012, the second worst quarterly showing in nearly three years. Productivity dipped in both the manufacturing and services sectors. While the productivity data seems worrying given the country's push for higher productivity, economists believe that the decline is temporary, owing to a decline in output. Several companies are avoiding layoffs amid hopes of a rebound even though sales are falling.

Meanwhile, inflation remains at levels well beyond the long-term average. Singapore's Consumer Price Index (CPI) rose 5.0 percent in May compared to 5.4 percent in April. All segments of the CPI recorded increases in May, albeit at a slower pace. Housing and transportation costs rose 8.2 and 9.2 percent respectively, and food prices are up 2.5 percent over last year. Private road transportation increased after a spike in Certificate of Entitlement (COE) premiums. Price increases for oil-related goods eased to 7.8 percent in May compared to 8.9 percent in April. Price levels are expected to decline during the latter half of the year, but government restrictions on foreign labor will likely put upward pressure on wages for low-skilled workers. Wages and business costs will continue to pass through to consumer prices.

Singapore's economy is likely to perform better in the second quarter of 2012, but growth for the entire year is expected to decline. Inflation dented real wages, and real average monthly wages fell 3.9 percent in Q1 2012, following a 1.4 percent decline in the last quarter of last year. As a result, disposable incomes have taken a hit, and retail sales growth has declined. The prospects for the economy hinge precariously on the turn of events in the global economy. If the political logjam in Greece remains unresolved and the debt crisis escalates, Singapore may experience a severe credit crunch, and growth projections may be lowered considerably.



Thailand

GDP growth projections for Thailand have been revised upward, and the economy is recovering much faster than expected. Led by a strong performance in the services sector, the economy made a strong comeback in the first quarter of 2012 after contracting nearly 9 percent in Q4 2011. Moreover, a substantial increase in domestic consumption and private investment bolstered GDP growth. The government's post-flood investments in infrastructure projects along with a host of other measures are expected to maintain the momentum of Thailand's economy in the coming months. Revised estimates from Thailand's Fiscal Policy Office (FPO) peg GDP growth for 2012 at 5.7 percent, up from 5.5 percent in a previous forecast.

Factory output in Thailand rose for the first time since last year's flood, achieving a growth rate of 5.5 percent in May 2012 over the previous year. Output growth was more than double the market expectation of 2.5 percent. While part of the increase is attributable to a low base, the improvement was supported by a recovery in key industries, particularly the auto sector. Production and sales of automobiles registered a staggering increase in May 2012, producing over 200,000 cars—a 50-year high.

However, Thailand's electronics and hard drive industry is still far from a recovery. Output of the electronics sector contracted 29.4 percent. In addition, the textile sector experienced a 21.7 percent contraction. While the recent uptick in manufacturing is a positive sign, the sector may find it difficult to sustain a recovery amid downside risks emanating from Europe.

Meanwhile, the 300 baht daily wage hike and the 15,000 baht minimum salary for graduate state officials will likely result in strong household income growth. The wage hike and robust consumer lending are expected to drive private consumption growth. An increase in domestic demand can potentially boost the manufacturing sector and offset, at least to some extent, weak external demand. Moreover, the central bank is expected to keep its policy rate unchanged at 3.0 percent for the remainder of the year if domestic factors remain strong. It believes that the risks to the Thai economy are skewed toward growth rather than inflation. On the other hand, if the global economy deteriorates, the central bank has the flexibility to ease its monetary stance.

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A slew of populist policies, reconstruction expenditure, and the rice price pledge scheme will add to the government's fiscal deficit. The rice price scheme offers rice farmers $500 for any surplus of rice not sold on international markets. While the scheme has, so far, not led to a rise in consumer prices for rice, it will likely widen the budget deficit significantly. The government's policies, however, will also have a positive impact on the economy, and domestic growth may be boosted over the next few quarters.

Contrary to consensus forecasts, Thailand's exports rose 7.7 percent in May 2012 over last year. Exports were expected to soften in line with a slowdown in external demand, but Thai exports to China and other Asian countries expanded remarkably. Industrial product exports, accounting for over 73 percent of all exports, rose 9.5 percent. An increase in automobile production was accompanied by a rise in auto exports, which rose 83 percent in May. Furthermore, exports of electric appliances and electronic parts rose 11.8 and 10.9 percent respectively. However, the future is less certain, and the recent rise in exports may be temporary. The threat of an escalation of the crisis in Europe will weigh on Thailand's export sector. Although Thailand's direct exposure to the European markets is barely 9 percent of its entire export basket, Thailand's other export markets depend heavily on Europe. As a result, Thai policy makers have shifted their attention to seek new export markets to compensate for the decline in exports in Q1 2012.

While GDP growth is back to positive territory, downside risks persist. Thailand's reliance on export-led growth makes its economy vulnerable to a deteriorating global macroeconomic environment. In addition, Thailand's tourism sector may be adversely affected by deceleration in Europe. Strong performance in the automobile sector is a positive sign, and as supply-side disruptions are addressed, growth in the manufacturing sector will likely accelerate. Moreover, reconstruction expenditure, investment, and private consumption will likely bode well for growth.

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