

# Asia-Pacific Executive Brief

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This report summarises the current business environment analysis and short-term forecasts of the country directors running executive briefing programs across Asia.

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## Global outlook

### Diverging global growth paths

#### ... a mild upturn in advanced markets

#### ... & sustained strong growth in emerging markets

Mid-way through the third quarter global firms face two very different growth propositions. In the US and EU there is fear that a weak recovery will give way to a double dip recession. We think this fear is unjustified as the latest data suggests that both these markets remain on track for a mild recovery. By contrast, in emerging markets, particularly in Asia, a surprisingly strong first half is easing into a broad recovery that might deliver a better second half than many expect (see the Regional page). From a forecasting perspective the surprises for us – requiring regular monthly forecast upgrades - have mostly concerned the sustained strength of the emerging market recovery. By contrast, most of our clients expected a bumpy 2H'10 in the US and EU as inventory rebuilding finished and the fiscal stimulus was withdrawn. The bottom line is that 2010 will confirm that the delinking of emerging markets from the West in 2009 has transformed into a sustained divergence in growth trajectories over the medium term.

### Strong corporate profits will fall in advanced markets

From a corporate planning perspective this is a challenging time. The big surprise in advanced economies over the last year, particularly in the US, was the rebound in corporate profits at a time of financial market stress and falling consumer demand. Firms as a whole acted faster and more effectively in slashing costs than in any previous downturn. But this remarkable profit rebound is a one time fix. In the advanced markets a decline in profitability is now likely as firms start re-investing to support lower growth business plans. We'd like to suggest that margins might be better in high-growth Asia, but with the rush for Asia underway competition will limit profit opportunities.

### The US returns to 2008 activity levels by late 2010 or 2011

#### ... unemployment and bank lending will lag

The US economy is in a low-trajectory recovery that will likely return it to 2008 levels of activity in late 2010 or during 2011 depending on the sector. The two main exceptions are vehicle sales and housing starts with both these industries in the midst of a structural reduction in long-term capacity (the auto sector, with a few large players, has moved faster on this capacity adjustment). Industrial production grew 8.2%yoy in June, which brought the index back to 92.5, which is well above the 2009 average of 87.7 but still below the 2008 average of 96.7. Retail sales growth in June eased back to 4.8%yoy from over 8%yoy in March and April, but June quarter 2010 sales were still 3.8% below June quarter 2008 sales (in current dollars). The two most important monthly measures will take the longest to fix. Unemployment, at 9.5% in June, is unlikely to return to the 2008 average of 5.8% for three to four years. Lending growth to corporates (-16.4%yoy in June) and consumers (-3.5%) may not return to 2008 average levels (8.7% for corporates and 15.6% for consumers) until 2012.

### A stronger Q3 in the EU

Despite a flurry of news reports of rising risk in Europe, the latest data for Q3 suggests a steady acceleration in Euro area growth led by a strong industrial production recovery in Germany. The Bank of England has just cut the UK forecast for 2010 to 1.6% (previously 1.7%) and for 2011 to 2.7% (previously 3.4%) but its earlier forecasts were surprisingly optimistic and out of line with private sector forecasts.

### Less inflation

The low trajectory recovery in the US and EU will keep inflation at very low levels and allow central bank policy rates to remain low well into 2011.

#### IMA Asia's forecasts

	2007	2008	2009	2010	2011
World – Real GDP growth, %	5.2	3.0	-0.6	4.0	4.3
- US	2.1	0.4	-2.4	2.8	2.8
- Euro area	2.8	0.6	-4.1	1.2	1.3
- Asia/Pacific (14)	6.0	2.8	0.8	5.6	5.5
- NICs (4)	5.8	1.8	-0.8	6.9	5.6
- Developing Asia (7)	11.1	8.0	6.8	8.9	8.5
- ASEAN (5)	6.2	4.6	1.4	6.3	6.0
World goods & services trade volume, % growth	7.2	2.8	-11.3	9.0	6.3
Interest rates, US Fed target rate, year end, %	4.25	0.25	0.25	0.25	0.75
Inflation, CPI, US, year avg., %	2.9	3.8	-0.3	1.3	1.5
Inflation, CPI, Euro area, %	2.1	3.3	0.3	0.8	1.5
Crude oil, avg of 3 spot crudes, US\$	71	97	62	85	89
US\$ / Euro 1, year average rate	1.37	1.47	1.39	1.28	1.22
Yen / US\$1, year average rate	118	103	94	89	95

The Asia/Pacific 14 = the countries on the forecast summary page. NICs are the newly industrialised countries = Korea, Taiwan, HK, Singapore. The ASEAN 5 = Indonesia, Thailand, Malaysia, Philippines and Vietnam. Developing Asia = Asean 5 + China and India. IMA Asia forecasts.

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## Regional outlook

### Summary of forecasts in this month's Asia Brief

<b>GDP (Expenditure), real growth, %</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
Japan	2.4	-1.2	-5.2	1.6	1.2
China	13.0	9.6	8.7	9.8	9.4
Hong Kong	6.4	2.1	-2.7	6.8	5.7
Taiwan	6.0	0.7	-1.9	6.9	5.3
South Korea	5.1	2.2	0.2	6.0	5.8
Indonesia	6.3	6.0	4.5	6.0	6.7
Malaysia	6.2	4.6	-1.7	6.4	5.1
Philippines	7.1	3.8	0.9	6.8	5.4
Singapore	8.2	1.4	-2.0	14.0	5.1
Thailand	4.9	2.5	-2.3	6.7	5.0
Vietnam	8.5	6.3	5.3	6.1	6.5
India (CY)	9.9	6.3	5.7	8.5	8.1
Australia	4.9	2.2	1.4	3.5	4.2
New Zealand	3.1	-0.5	-0.5	2.9	3.6

<b>Inflation, CPI year average, %</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
Japan	0.0	1.4	-1.4	-0.3	-0.5
China	4.8	5.9	-0.7	3.3	4.0
Hong Kong (composite CPI)	2.0	4.3	0.6	4.0	3.5
Taiwan	1.8	3.5	-0.9	1.5	2.0
South Korea	2.5	4.7	2.8	2.8	3.3
Indonesia	6.4	9.8	4.8	5.5	7.0
Malaysia	2.0	5.4	0.6	1.7	2.0
Philippines	2.8	9.3	3.3	4.0	4.5
Singapore	2.1	6.5	0.2	2.0	2.0
Thailand	2.2	5.4	-0.9	3.8	3.5
Vietnam	8.5	23.1	6.7	8.0	7.0
India (CY CPI urban non-manual workers)	6.5	7.7	11.7	12.0	10.0
Australia	2.3	4.4	0.6	2.9	2.5
New Zealand	2.4	4.0	2.1	4.0	3.0

<b>Exchange rate to US\$1, year avg.</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
Japan	118	103	94	89	95
China	7.6	6.9	6.8	6.7	6.4
Hong Kong	7.8	7.8	7.8	7.8	7.8
Taiwan	32.8	31.5	33.1	31.8	30.7
South Korea	929	1,100	1,277	1,150	1,095
Indonesia	9,164	9,757	10,356	9,200	9,020
Malaysia	3.4	3.3	3.5	3.2	3.1
Philippines	46.1	44.5	47.6	45.8	44.9
Singapore	1.5	1.4	1.5	1.4	1.3
Thailand	32.2	33.0	34.3	31.8	30.5
Vietnam	16,063	16,506	17,860	19,000	19,588
India (FY)	41.2	43.8	48.3	45.6	44.7
Australia	1.19	1.20	1.27	1.15	1.10
New Zealand	1.36	1.43	1.60	1.39	1.39

Sources: CEIC, central banks, and national statistics offices. Forecasts are by country directors and IMA Asia.

## Regional outlook

### Political & policy issues to watch

- Asia's appetite for reform** Asia looks good to the rest of the world right now. But Asia's governments aren't sitting back waiting for the money to arrive. With the notable exception of Japan (see below) they are increasingly inclined to pro-market reforms even when they carry a high political risk.
- ... driven by a desire for growth** President Ma in Taiwan has just staked his future on a free trade agreement with China, which should be ratified this month. Newly elected President Aquino in the Philippines aims to slash corruption and chase tax evaders, which will pit him against powerful members of the elite. President Yudhoyono in Indonesia and PM Najib in Malaysia are also edging forward on reforms when they feel they can handle the voter backlash. Most of these reforms will support market growth and better opportunities for foreign firms. It is progress on reforms that has steadily reduced Asia's risk profile over the last five years.
- ... & bringing lower risk**
- Risks to watch** The risks to watch in the next six months have not changed much, although we've learnt a bit more about them:
- **Japan** **Japan:** The biggest risks lie in Japan because of the scale and severity of the problems. Analysts are getting a better understanding of the dangers in Japan's public debt (see the Japan page). We continue to warn that Japan is moving towards a fiscal and political crisis.
  - **Thailand** **Thailand:** The Thai economy looks great but Thai politics look awful. With the early announcement of Gen Prayuth as the new army head on October 1 more forceful suppression of the Red Shirt opposition is likely. This may help short-term stability at the expense of long-term stability.
  - **Vietnam** **Vietnam:** Hanoi has been remarkably inept at monetary policy, creating wild boom and bust cycles. Domestic demand is still trying to recover from a policy-induced credit contraction. Foreign firms are patiently riding out these cycles.

### Outlook for the market

- Upside risk in 2H'10** The risk in Asia (ex-Japan) remains on the upside of our forecast in 2H'10 so we are more likely to lift our 2010 growth estimates in the final quarter than cut them. There are three reasons for this. First, while exports and industrial production numbers soared like rockets in 1H'10, the fundamental story was a strong and broad-based domestic recovery led by a cyclical upturn in fixed investment. This is a classic post-recession rebound, but one that is sorely missing in the US and EU. It is hard to knock such a recovery over and much of Asia's 2H'10 growth will come from domestic demand. Second, most of us have been assuming that export growth will plunge from 36%yoy in 1H'10 (for the 14 countries in the Asia Brief) to 5-10% in 2H'10 due to a much higher base in 2H'09 and weakening global demand. Yet the latest indicators suggest the fall may not be that sharp. Finally, it all depends on China pulling off a soft landing. Despite some large and very real risks, China remains on track to do just that.
- ... as local demand lifts**
- ... & exports do better than expected**
- Capex has led the upturn** Asia's domestic demand recovery has been led by fixed investment, which kicked off last year with government stimulus spending but is being driven this year by plant and equipment spending. Watch for consumer spending to improve over the next six months even as export growth cools (admittedly this would be an unusual pattern for Asia). As employment is rising, wages should also lift, and interest rates, although edging up, will be low by traditional standards. Most global consumer surveys show strong consumer optimism in Asia.
- ... watch for better consumer demand**
- Indonesia wins back export manufacturing** In our forecasting meetings we've talked about some types of export manufacturing moving out of China (this story started in the textile sector in 2006). This month's Indonesia page notes that export manufacturing is finally returning to Indonesia and not just the shoe firms (although they are welcome back); Caterpillar (US) and LG (Korea) are putting in regional production facilities. This is a new strand to the already good Indonesia story.
- Asia faces more inflation** Asia's inflation rates are likely to head up over the next year as economies reach (or have already reached) capacity and labour rates rise. Food prices will need watching given Russia's decision to halt wheat exports until December.
- Rising Asian currencies** Asian currencies will continue to rise this year and next year at around 4-6%pa with China's yuan setting a modest appreciation pace for the region.

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## Japan

### Political & policy issues to watch

#### PM Kan faces a quagmire in parliament

PM Naoto Kan has had to change tack since the ruling DPJ lost its upper house majority in July. He now has little choice but to seek compromise with opposition parties if he wants to pass legislation without long delays. However, the LDP opposition is still smarting from the difficulties in their final year of government when the DPJ used its upper house majority to block their bills (the DPJ used the political momentum from blocking LDP bills to win government in 2009). The next lower house election is not due until 2013 but the DPJ may be forced into an earlier poll if their policies stall in the upper house.

#### ... and a battle within his party

Mr Kan's more immediate problem is his own survival as PM. In September the DPJ elect their party president and the DPJ's deputy secretary general, Goshi Hosono (a close associate of Ichiro Ozawa, the party's patriarch), is likely to challenge Mr Kan.

#### The public debt time bomb

#### ... they can now hear the ticking in Tokyo

When the editor in chief of the Ashai Shimbun (Japan's second largest national daily) entitles an article "Japan's bond market has become ticking bomb", as he did on August 11, two things are apparent: Japan's commentators have cottoned onto what ratings agencies and the IMF have been telling them for years; and time may be running out fast. Some 95% of bonds are held domestically, which might suggest there is little risk. But there are three problems. Public debt is now US\$83,000 per capita and Japan's rapidly ageing households are running down the savings that have supported this debt. Second, a large part of household savings is in the Post Office, which invests mostly in government bonds. Yet households can withdraw these savings overnight; think about that mismatch. Finally, with the local market choking on public paper, the government is looking for foreign buyers. China is obligingly stepping in at the short-term end, yet this is one factor driving the Yen to record highs. The IMF reckons a key aspect of any recovery strategy is hiking the consumption tax from 5% to 15% over 10 years, but the DPJ just lost the upper house over its commitment to lift that tax and has since backed away from it. The opposition LDP hints it will work with the government to avoid a crisis but that seems unlikely.

### Outlook for the market

#### An export-led upturn in 1H'10

#### ... but growth will stall by year-end

Japan's economy is likely to stall in 2H'10 and our forecast of 1.6% GDP growth in 2010 is front-loaded in 1H'10. The strongest rebound has been manufacturing, with growth of 27.4%yoy in Q1 and 20.9% in Q2, although the index for June (98.5) remains well below the year average index for 2005-08. On a seasonally adjusted basis, production has flat-lined and is still 14% below 2008 levels. The OECD's leading indicator peaked in April but fell in May and June, pointing to a slowdown in production beginning in Q4'10. Output may inch up across Q3'10 but by the end of the year the economy could be going backwards.

#### Exports have started to slow

Trade growth is slowing. June exports rose 38%yoy in US\$ terms, while imports rose 36%yoy, but both figures are now flat or falling on a seasonally adjusted basis. Export demand from the rest of Asia is strong with shipments to ASEAN, particularly Thailand (+67%yoy in June), surging ahead. Europe is weak but demand from the US has started to pick up. But with the yen rising, the sustainability of the export recovery is at risk.

#### The household sector struggles

Consumer confidence has risen lately but is still well below a neutral reading and most of the signs from the household sector remain weak. Unemployment ticked up to 5.3%yoy in June and retail sales growth was just 3.2%yoy. An unusually hot summer is driving higher sales of air conditioners and cold beverages so we might see a bounce in retail activity over July and August. But the overall outlook remains weak.

#### A painfully high Yen & deflation

The Bank of Japan isn't intervening as the yen rises towards 85 to US\$. But with a crisis likely in the next year or two a continued strong yen is quite uncertain. We've lifted our yen forecast for 2010 but we continue to signal a weakening in 2011. Consumer prices fell 0.7%yoy in June with deflation set to continue into 2011.

	2007	2008	2009	2010	2011
GDP, real growth, %	2.4	-1.2	-5.2	1.6	1.2
CPI, year average, %	0.0	1.4	-1.4	-0.3	-0.5
Overnight call rate, year end, %	0.50	0.21	0.10	0.10	0.10
Yen to US\$1, year average	118	103	94	89	95

Sources: 2007-2009 data from the BOJ and government sources; 2010-2011 forecasts by IMA Asia.

## China

### Political & policy issues to watch

#### Beijing has plenty of cash to support growth if needed

... thanks to very strong revenues

Beijing is well positioned to lift its stimulus to keep GDP growth above 8% through the next year. Fiscal revenues for 1H'10 jumped 27.6%yoy while expenditure rose 17%yoy and the surplus climbed to Yuan 953bn. China was meant to be running a Yuan 1 trillion deficit this year (about 2.3% of GDP) according to its budget. If anything Beijing needs to lift spending in 2H'10. The question is where. The central government component of the Yuan 4 trillion stimulus package for 2009 and 2010 is Yuan 1 trillion. We estimate that 50% of this has yet to hit the market but should arrive over the next 12 months. Watch for an increase in centrally funded infrastructure projects, particularly in western provinces. In a recent statement Finance Minister Xie Xuren also hinted that subsidies for rural households to buy appliances will be continued, which should help manufacturers as export growth slows. If needed, we expect additional fiscal stimulus to be announced.

#### Cleaning up the local government loan mess

... a gradual process

Beijing's main problem lies in the mess in local government finances, which must be sorted out if President Hu Jintao and Premier Wen Jiabao hope to step down over 2012-13 with their reputations intact. The latest estimates of local government public debt – Yuan 7.7 trillion with 23% likely to be bad – are close to those in our Q2 forecasting presentation. Pressure will increase on China's provincial, city and county level governments to cancel dud projects and end off-balance-sheet borrowing from banks via related finance units.

### Outlook for the market

#### GDP is on track for a soft landing

... as private demand lifts to replace the public stimulus

1H'10 GDP growth eased to 11.1%yoy from the 11.9%yoy in Q1. The latest data suggest that the economy is on track for 9.8% full year growth. Many of the indicators have just started to ease in volume or value measures with a slightly more pronounced slowdown in year-on-year percentage measures. This is what our clients expected at the start of the year. Growth in industrial value added peaked around 18%yoy from last November through to April and by June had eased to 13.7%yoy. We expect this measure to grow around 8-10%yoy through 2H'10. The IMF's latest report on China was released on July 29 and concludes that "the recovery is well established with increasing signs of a transition from public stimulus to private sector-led growth." This 64-page report is freely available at [www.imf.org](http://www.imf.org) and provides the best analysis available on China's economy.

#### The China story going forward

... it's imports not exports

The merchandise trade data doesn't show the slowdown yet but we expect it will soon. June exports returned to record territory (up 43.9%yoy to US\$137.4bn) for the first time since July 2008's record of \$136.7bn. We expect export growth to ease from 35%yoy for 1H'10 to 15%yoy in 2H'10, which will lift full year exports by around 23% from 2009. Imports soared 53%yoy in 1H'10 and we expect growth to slow to 25%yoy for 2H'10 bringing full year growth down to a very healthy 37%. The more striking measure is against 2008. Our forecast puts 2010 exports less than 5% above 2008 exports, which highlights a levelling off in export capacity over the last two years. By contrast our import forecast for 2010 is up more than 20% over 2008, highlighting a structural shift that has seen China become a major buyer from the rest of the world.

#### Watch for a gradual recovery in property

Most of China's homebuyers stopped buying in April as Beijing ratcheted up controls on an overheating residential property market. They are now waiting for the government to ease those controls or for prices to fall. Prices aren't falling yet but the year-on-year price gain has dropped from a high of 20% in February to 4.7% for June. As the government has signalled that it won't relent on the controls in 2H'10, which were mainly aimed at speculative buying, we expect a gradual recovery in turnover through 2H'10.

#### No interest rate increases

... and a slow rise for the Yuan

China has left its interest rates unchanged since December 2008, and with a gradual easing in the mid-year inflation spike it may well hold off any increase in 2H'10. The 1-year Yuan non-deliverable forward implies an appreciation of 1.5-2% on the US\$, although we expect a 4-6% rise in 2011 (the IMF also views the currency as substantially undervalued). Since June 19, when China restarted appreciation, the currency has risen less than 1%.

	2007	2008	2009	2010	2011
GDP, real growth, %	13.0	9.6	8.7	9.8	9.4
CPI, year average, %	4.8	5.9	-0.7	3.3	4.0
PBOC 1-year loan, at Dec., %	7.47	5.31	5.31	5.31	6.39
Yuan to US\$1, year average	7.61	6.95	6.83	6.66	6.41

Sources: 2007-2009 data from CEIC and government agencies; 2010-2011 forecasts by IMA Asia.

## Hong Kong

### Political & policy issues to watch

**The competition bill debate will start in autumn** The bill for HK's first competition law was introduced into the Legislative Council (Legco) in mid-July and is now available on Legco's web site ([www.legco.gov.hk/english/index.htm](http://www.legco.gov.hk/english/index.htm)). A new Competition Commission would have powers to investigate and prosecute uncompetitive behaviour, which may bring some changes to the way HK's economy, long dominated by a handful of firms, works. Some are concerned that this initiative, together with the minimum wage bill, marks an end to HK's "big market, small government" economy. Meanwhile consumer advocates believe that the proposed law would not affect the most visible areas of little or no competition, including some government-funded organisations. Debate on the bill is not expected to start until autumn.

**... HK may also have to consider a privacy law** HK may also have to consider a privacy law following the revelations that the service monopoly that supplies HK's ubiquitous Octopus card had been selling customer information to third parties for substantial sums. HK already has a privacy commissioner, whose preliminary report finds no laws were broken but raises troubling questions regarding how personal information is shared with third parties.

**Steps to curb a soaring property market**  
**... by increasing land supply** An even bigger policy challenge looms over how to control a soaring property market. House prices rose 39.6% in April from their December 2008 bottom. Prices eased slightly in May from April, the first monthly decline since early-2009. But property analysts expect prices to post another 10% increase in 2H'10. This is reflected in property transactions, which rebounded strongly in July after a brief decline in the previous few months. To ease the land shortage, the government is considering land reclamation outside the harbour (where it is now banned), and has increased the sale of public land to developers.

**And steps to internationalise the yuan in HK** China's central bank (PBOC), in conjunction with the HK Monetary Authority (HKMA), has announced that local banks can expand yuan trade settlement and clearing in HK and also lend yuan funds received from trade transactions to any corporate customers (but not consumers). To ensure liquidity, local banks are required to maintain yuan cash-plus-settlement balances at the Bank of China (HK) at no less than 25% of customer deposits.

### Outlook for the market

**A slight easing in growth in 2H'10** An inventory-led upswing lifted GDP growth to 8.4%yoy in Q1'10 from 2.5%yoy in the previous quarter. However, growth is likely to slow to 4-5%yoy in 2H'10. The forward-looking Purchasing Managers Index (PMI) edged lower to 51.3 in July from 52.6 in June. The PMI has been drifting downwards in recent months towards the 50 threshold that separates expansion from contraction, mostly on the back of slower new business growth. New orders received from companies in mainland China recorded their lowest reading in 13 months. Purchasing of inputs decreased in the last two months, even though input costs (mostly materials and wages) continued to move higher.

**Tourism drives a surge in retail sales** Domestic demand and tourists played a prominent part in Q2'10 growth. Retail sales growth accelerated to 18.8%yoy in Q2'10 from 16.9%yoy in Q1'10, as tourist arrivals grew by 30.8%yoy in Q2'10 (from 16.5%yoy growth in Q1'10). This may soften in the final two quarters of this year. The consumer confidence index dipped to 96.3 in Q2'10 from a post-recession peak of 97.8 in Q1'10. The employment confidence index also fell to 91.9 in Q2'10, after peaking at 101 in Q1'10.

**Mild inflation and continued low interest rates** Inflation edged up to 2.8%yoy in June, the fastest annual pace in 18 months. Mild upward pressures should continue into 2H'10, although it is still unlikely that inflation will become a serious problem in the next 12 months. Interest rates are likely to stay at record lows due mainly to the HK\$ link to the US\$.

	2007	2008	2009	2010	2011
GDP, real growth, %	6.4	2.1	-2.7	6.8	5.7
Composite CPI (04/05), year average, %	2.0	4.3	0.6	4.0	3.5
Discount window base rate, % year end	5.75	0.50	0.50	1.00	2.75
HK\$ to US\$1, year average	7.80	7.79	7.75	7.75	7.75

Sources: 2007-2009 from Censtat, HKMA, and CEIC; 2010-2011 by IMA Asia.

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## Taiwan

### Political & policy issues to watch

#### A breakthrough FTA with China

... as China  
knits together  
“Greater China”  
(with HK)

President Ma Ying-jeou is two years into his first four year term (a second is allowed) and this month should see the legislature ratify his signature policy, the Economic Cooperation Framework Agreement (ECFA) with China, which was signed in June. This broad ranging umbrella agreement (it opens the way for sector specific deals) should help Taiwan's economy in two ways. First, it should boost 2-way trade and investment, with implementation from Jan 2011 of “early harvest” tariff cuts and bigger cuts in Jan 2012 and Jan 2013. Taiwan's banks and life insurers also hope to gain from better, indeed preferential, access to the mainland. The preferential aspect of ECFA mirrors the 7-year old CEPA agreement that Hong Kong has with China and some degree of alignment between these two agreements may gradually emerge. Within a year or two the ECFA could make Taiwan a potential base for some MNCs to service the China market.

#### While Taiwan hopes it can now join Asia's FTA party

Second, the ECFA may open the way for Taiwan to sign free trade agreements (FTAs) with other countries. Until now Taiwan has been isolated by China's veto from the web of bilateral and multilateral FTAs that are gradually creating a pan-Asia market. Taiwan would love to strike a multilateral deal with Asean, which has become the region's de facto hub for such deals, and Singapore has just acknowledged it will discuss a bilateral FTA, which may open the way to a whole-of-Asean deal. Japan is also interested, as Japanese auto and electronics firms have massive sourcing deals with Taiwan.

#### Stop pointing that gun at me

... it hurts our  
relationship

President Ma is testing the post-ECFA feeling of goodwill across the Taiwan Strait by quietly calling on China to reposition its military away from its present confrontational stance – exemplified by the 1,000-odd missiles currently targeted on Taiwan. We are unlikely to see dramatic shifts in policy, but even a small or token reduction in the missile force and/or redeployment of PLA resources away from the coast would count.

### Outlook for the market

#### Surging exports push our 2010 GDP forecast up

Taiwan's strong start to the year continued through Q2'10. Industrial production rose 24%yoy in June and although this was slower than May's 31% increase, it was within expectations as global inventory rebuilding eased. Underlying export demand has been surprisingly strong, with 1H'10 export growth of 48%ytd to Asia, 31.8%ytd to Europe, and 24.5%ytd to the US. Exports to BRIC markets for 1H'10 were very strong: Russia up 95%, China up 54%, Brazil up 52%, and India up 25%. Most local forecasters now expect 2010 GDP growth of 5.9%-6.9%. We've nudged our 2010 forecast up to 6.9% as Q1 growth of 13.3%yoy is likely to be followed by 8-10%yoy in Q2 and some 3-4%yoy in Q3 and Q4.

#### ... spending on plant & equipment is also strong

With the Q2'10 industrial production index up 27% from the 2009 average and 17% above the 2008 average, the stage is set for a jump in investment in plant and equipment. Indeed fixed investment surged 26.3%yoy in Q1'10 (plant and equipment spending alone rose 52%yoy). We now expect private fixed investment to rise some 18% this year after falling 19% last year, with plant and equipment spending leading the rise.

#### A weak consumer upturn should improve

Growth in the consumer sector should gradually improve in 2H'10. Retail sales have recovered from the 2009 collapse but have been essentially flat on a seasonally adjusted basis since December 2009. Unemployment has dropped from a peak of 6% (seasonally adjusted) last September to 5.2% by June and we may need to see it fall below 5% in the next few months before we get a significant lift in consumer spending. Average monthly earnings grew 2.1%yoy in May but are still 1.5% below the peaks from 1H'08. However, confidence has risen through 1H'10 and is close to all time highs set in 2003.

#### A slow rise for interest rates and the NT\$

Despite very low inflation (CPI growth was 1.2%yoy in June), the central bank has begun to normalise interest rates as growth recovers, with rates expected to hit 1.75% by the end of the year. The NT\$ will creep up against the US\$ in tandem with the Chinese yuan.

	2007	2008	2009	2010	2011
GDP, real growth, %	6.0	0.7	-1.9	6.9	5.3
CPI, year average, %	1.8	3.5	-0.9	1.5	2.0
Official discount rate, year end, %	3.38	2.00	1.25	1.75	2.25
NT\$ to US\$1, year average	32.8	31.5	33.1	31.8	30.7

Sources: 2007-2009 government data and CEIC; 2010-2011 forecasts by IMA Asia.

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## South Korea

### Political & policy issues to watch

#### President Lee regains the initiative

##### ... on strong by-election results

Barely a month after being rebuked at the June local elections, President Lee Myung-bak and his Grand National Party (GNP) bounced back in the July by-elections, winning five out of the eight seats on offer. The result was particularly pleasing for Mr Lee as most of the seats were in the opposition heartland and Korea's ruling parties usually do badly in by-elections. The result increased the GNP's numbers in the unicameral National Assembly from 168 to 172 out of 299 seats, while the opposition Democratic Party won the other three seats and saw their count slide to 87. A merger between the GNP and the Future Hope Party, who split away in the run up to the 2008 election, takes the GNP coalition to 180 seats. The result doesn't alter the balance of power, but it does provide momentum for Lee heading into the second half of his five year term. President Lee will announce a cabinet reshuffle in August that will set out the direction of the second half of his term.

#### But Sejong City will continue

##### ... as a costly boondoggle

PM Chung Un-chan has resigned over the failed proposal to develop Sejong City as an industrial and technology centre. The development plan will now revert to the original proposal, which is that it become a second administrative centre. Half of the national administration will start relocating from Seoul beginning in 2012. The many problems surrounding this controversial project will likely dominate the 2013 presidential election.

#### A small chance for approval of KORUS by Nov

President Obama's recent interest in reviving the ratification effort in Congress for several stalled free trade agreements (FTAs) could get the Korea-US FTA (KORUS) approved in time for his visit in November. But with US unemployment sticking close to 10% and tough mid-term US elections ahead, any FTA faces an uphill battle in Congress.

### Outlook for the market

#### A strong 1H'10

##### ... with slower growth in 2H'10

After an 8.1%yoy surge in Q1'10 GDP, the Korean economy barely slowed in Q2'10 with GDP rising by 7.2%yoy. However, 2H'10 is likely to be much slower with GDP growth dropping to 3-4%yoy. The OECD's trend-restored leading index for Korea is now virtually flat, which suggests that 2H'10 production will level off in absolute terms. Industrial production growth eased to 17%yoy in June from 22%yoy in May, as expected. The seasonally-adjusted index is now 14% above the 2008 peak, which highlights the strength of the rebound. The economy remains on track for 6% growth this year.

#### Exports remain very strong

##### ... driven by China and even the US

If we do amend our 2010 GDP forecast it will likely be to lift it as export results remain surprisingly robust. Exports grew 30%yoy in July, unchanged from June and were 3.1% above 2008 levels. Growing trade ties with China, which now takes 25% of total exports, helped. Exports to China grew 49%yoy in 1H'10, including a 60%yoy surge in 1H'10 exports of machinery and transport equipment (such as autos). But Korea has also benefitted from better US demand, with June exports rising 36%yoy. Overseas machinery orders jumped 143%yoy in 1H'10 including a 383%yoy surge in June due to a 2 trillion won (US\$1.7bn) order for nuclear reactors.

#### A mild consumer recovery

In current prices 1H'10 retail sales were up 10.4% on both 1H'09 and 1H'08 (as sales fell in 1H'09 to about the same level they were at in 1H'08). In real or volume terms 1H'10 retail sales were up 7.3%yoy on 1H'09 and 5.6% on 1H'08. The Bank of Korea's consumer sentiment index stands at 112, easily above the neutral 100 mark.

#### A gradual rise for interest rates

##### ... and the Won

With the economy hitting full capacity, the Bank of Korea began raising rates in July and we expect the cash rate to be 2.75% by the end of the year. Inflation remains low – CPI growth was 2.6%yoy in July with core inflation at 1.7% – but the output gap is now closed and inflation will start to rise towards the end of 2010. The won has inched up to 1170 per US\$, which is where it was at the start of the year.

	2007	2008	2009	2010	2011
GDP growth, %	5.1	2.2	0.2	6.0	5.8
CPI, year average, %	2.5	4.7	2.8	2.8	3.3
BOK Overnight call rate, year end, %	5.00	3.00	2.00	2.75	3.25
Won to US\$1, year average	929	1,100	1,277	1,150	1,095

Sources: 2007-2009 government data (NSO, BOK) and CEIC; 2010-2011 forecasts by IMA Asia.

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## Indonesia

### Political & policy issues to watch

#### Watch the August 16 policy speech

... for more reforms & fuel subsidy cuts

President Yudhoyono's annual state of the nation address on August 16 will be the major political event this month. The major policy issues in focus will be fuel subsidies and broader budget reforms. There's been enough public debate over the past several months that the government will likely move ahead with some sort of plan to curb fuel subsidies. The other hot budget topic is Golkar's widely criticised pork barrel spending proposal. Yudhoyono has shown renewed interest in the idea as part of broader budget reforms. It might be the price he has to pay to push his own reform agenda like curbing fuel subsidies.

#### The political debate cools

... with a long haul to the 2014 elections

With the next elections not due until 2014, the government coalition is solidifying and most opposition parties are struggling to maintain their relevancy. Megawati Soekarnoputri (PDIP) has emerged as the main opposition leader with a strong critique of government policies. Prabowo Subianto (Gerindra) is keeping a low profile and focusing on the farmers association (HKTI) where he was re-elected chairman. His party has also become more accommodative with the government since the appointment of Prabowo ally Sjafrie Syamsuddin as deputy defence minister. Wiranto (Hanura) has also kept a low profile as his party faces internal rifts. Golkar (led by Aburizal Bakrie) appears content to maintain its position as a senior member of the government coalition.

#### A new central bank head

... not yet coordinating with the government

Less than a week after his confirmation as Bank Indonesia (BI) governor by parliament, Darmin Nasution unexpectedly suggested that the central bank was studying redenominating the rupiah. The idea isn't new and has been talked about for the past two years. However, Finance Minister Agus Martowardojo was clearly surprised as were all other government agencies. The stock market fell 3% following Darmin's comment. Vice President and former BI governor Boediono was subsequently forced to clarify that currency redenomination was not part of the government's agenda.

### Outlook for the market

#### A steady lift in growth into 2H'10

... driven by investment in infrastructure and factories

GDP growth edged up to 6.2%yoy in Q2'10 from 5.7%yoy in Q1'10 and nearly all indicators suggest growth will remain in the 6.0-6.5%yoy range for the next two quarters. Fixed investment is driving the upturn, rising 7.8%yoy in Q1'10 and 8.0% in Q2, with particularly strong growth in imported plant and equipment (up 16.4%yoy in Q2'10). A solid domestic economy, lower labour costs, favourable demographics and relative political stability is making Indonesia an attractive alternative for export manufacturing. Foreign direct investment (FDI) rose 49%yoy in 1H'10, much of this in infrastructure-related industries. Caterpillar (USA) and LG (Korea) have also announced plans to establish regional production centres in Indonesia. Nike and Adidas also relocated shoe factories to Indonesia from Vietnam and China, which will likely push Indonesia ahead of Vietnam as the world's second largest shoe producer this year.

#### Watch for a steady lift in consumer demand

Consumer spending growth accelerated to 5.0%yoy in Q2'10 from 3.9%yoy in Q1. The annual Indonesia International Motor Show that ended 1 August saw surprisingly high demand from middle-income consumers and younger buyers. Local automotive association Gaikindo believes the country is on track for a record year that could top 700,000 units in car sales and that Indonesia is also likely to surpass Thailand as Southeast Asia's largest automobile market.

#### Inflation is rising

... watch for rate hikes

Inflation is becoming a problem, rising 6.2%yoy in July, its highest level in 15 months. High food prices are the main problem due to abnormally wet weather during this year's dry season harvests. Rising global food prices (following Russia's halt to wheat exports) may now become a factor. While a stronger rupiah (it recently broke 9,000 to US\$1) should help check imported inflation, we've lifted our year-average inflation forecast to 5.5% for 2010 (previously 4.5%) and 7.0 for 2011 (previously 5.5%).

	2007	2008	2009	2010	2011
GDP, real growth, %	6.3	6.0	4.5	6.0	6.7
CPI, year average, (2007=100), %	6.4	9.8	4.8	5.5	7.0
Central bank policy rate at end-Dec., %	8.00	9.25	6.50	7.00	8.50
Rupiah to US\$1, year average	9,164	9,757	10,356	9,200	9,020

Sources: 2007-2009 government data (BPS, BI) and CEIC; 2010-2011 forecasts by IMA Asia

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## Malaysia

### Political & policy issues to watch

#### PM Najib may move elections forward to 2011

##### ... if the ruling coalition wins in Sarawak this year

In the last six months PM Najib Razak's personal rating in opinion polls has soared, which may encourage him to move the 2013 election forward to 2011 in order to gain his own mandate as PM. This would strengthen his position within UMNO and help him push forward with his reformist agenda. Whether he takes this route will be partly determined by state elections in Sarawak, where Chief Minister Abdul Taib Mahmud is expected to call an early poll before December. Control of the two east Malaysian states (Sabah is the other) is critical to the survival of the UMNO-led national coalition. But Taib has been in power for 29 years and many are tiring of his government. If Taib wins, Najib is likely to consider an early national poll in 2011; if Taib loses, Najib will have to rethink his game plan.

#### The court case against Anwar may fail

A second factor for Najib is the possible collapse of the government's sodomy case against opposition leader Anwar Ibrahim, which is widely seen as politically motivated. The judge will shortly decide whether to strike out the case as it has been revealed that a female member of the prosecution team had an affair with the main witness in the case.

#### Policy goals

##### ... details for the national growth plan

##### ... more subsidy cuts

##### ... progress on an anti-corruption drive

Meanwhile, Najib needs to get on with demonstrating he can competently run the government. Three issues bear watching. Najib has said he will provide the details of his New Economic Model in August. The program promises to be less racially biased and friendlier to private investment. Yet some in the Malay community (55% of the population) will be unhappy with a loss of privileges. A second area to watch is fiscal policy. Najib wants to rein in the budget deficit, which he started to do in July by cutting M\$750m in fuel and food subsidies (10% of the M\$7.5bn in subsidies in the 2009 budget). Najib would like to do more in the October budget but it is again the Malay community that would be hit hardest by cuts. Finally Najib wants to burnish his anti-corruption credentials. The recent charging of former transport minister Ling Liong Sik over a dubious land deal at the Port Klang Free Zone (PKFZ) a decade ago will help in this regard if a conviction is secured.

### Outlook for the market

#### A good 1H'10 recovery

##### ... although investment is a bit weak

GDP growth surged to 10.1%yoy in Q1'10 as Malaysia's economy entered a broad-based domestic recovery helped by a rebound in exports. The recovery replicates that seen elsewhere in East Asia, although the upturn in investment (at 5.4%yoy in Q1) was weaker than in neighbours like Thailand (12.6%), Indonesia (7.9%), the Philippines (15.7%) or Singapore (12.7%). The expansion also seems to have cooled faster in Malaysia in Q2 with the trade account showing export growth easing to 21.7%yoy in Q2'10 and the trade surplus falling. We've retained our forecast of 6.5% growth this year and 5.3% next year.

#### Manufacturing is set to slow in 2H'10

##### ... as export growth slows

The export manufacturing sector staged a strong recovery in 1H'10, with industrial production up 11.1%yoy in Q1'10 and 10.8%yoy in Q2, which takes the index close to the highs set in 2007 and 2008. For 1H'10 as a whole the strongest recoveries were in electrical machinery (57.4%yoy) and radio/TV and communications equipment (51.9%yoy). The office equipment, accounting and computer segments fell 10.3% continuing two years of steady decline. With export growth slowing each month in Q2 it appears the peak of the growth recovery was in Q1 with much slower growth likely in 2H'10.

#### Local demand accelerates in 1H'10

Local demand recovered strongly in 1H'10 with loan growth steadily accelerating to 12.5%yoy in June and vehicle sales up 19.8%yoy for 1H'10 (although this was led by a 27.6%yoy rise in commercial vehicle sales while car sales rose just 6.1%yoy in 1H'10).

#### Higher rates and a strong M\$

Najib's mild reforms plus the strong 1H'10 recovery have helped boost the M\$ to 3.15 on US\$1 from its March 2009 low of 3.75, an impressive 19% rise. Bank Negara is the only Asian central bank to lift interest rates three times this year to 2.75% in July. The strong M\$ and the rate hikes kept inflation at 1.6%yoy in Q2'10 from 1.3%yoy in Q1'10.

	2007	2008	2009	2010	2011
GDP, real growth, %	6.2	4.6	-1.7	6.4	5.1
CPI, year average (2000=100), %	2.0	5.4	0.6	1.7	2.0
Central bank overnight policy rate, Dec, %	3.50	3.25	2.00	2.75	3.50
Ringgit to US\$1, year average	3.43	3.34	3.52	3.23	3.11

Sources: 2007-2009 government and Bank Negara data plus CEIC; 2010-2011 forecasts by IMA Asia.

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## Philippines

### Political & policy issues to watch

**The new Aquino government**  
**... plans to slash corruption**  
**... easy to say but hard to do**

Newly elected President Aquino set two broad objectives in his State of the Nation (SONA) speech on July 26. The first is a crackdown on corruption, which was the main plank in his election platform. While this is certainly needed, there is a danger that it will simply become a campaign to unearth corruption in the preceding administration led by President Gloria Arroyo. This would distract the government from tackling many ongoing sources of corruption. It might also undermine the new president's ability to work with Congress, where Mrs Arroyo's Lakas Kampi CMD holds the largest number of lower house seats and Mrs Arroyo herself resides having won her family's congressional seat. A genuine and substantial campaign against corruption would also pit Aquino against some powerful business interests so there is bound to be a gap between rhetoric and action.

**And also plans to boost fixed investment**  
**... which is possible with the right policies**

President Aquino's second goal is a lift in fixed investment from just 14.7% of GDP (in current prices) in 2009. Such a lift, if it could be achieved, would transform the economy. The potential exists as national savings were 19.3% of GDP in 2009 while the country ran a current account surplus of 5.3% of GDP (in other words the Philippines exported excess savings worth 5.3% of GDP). If the government could open up sufficient opportunities for local investment, national savings could support fixed investment at close to 20% with the current account surplus dropping towards zero. As most savings in the Philippines are held by companies (up from 0.7% of GDP in 1990 to 13% in 2009) the goal should be getting companies to invest; Aquino's plan aims at just that through greater use of Public Private Partnerships (PPPs) and slashing the red tape facing companies. Mr Aquino also hopes to cut the budget deficit from 349 billion pesos (US\$7.52 billion or 4.2% of GDP) in 2010 to 2% of GDP by 2013. There will be no new spending that isn't supported by revenue and Mr Aquino aims to clamp down on tax evaders, although this is often easier said than done and again would pit him against many of the country's elite.

### Outlook for the market

**On track for 6.8% growth in 2010**  
**... due to strong local demand**  
**... and a mild export recovery**

Strong local demand and a mild recovery in exports should lift GDP by 6.8% this year. Q1 GDP growth was 7.3%yoy and with a surge in pork barrel spending for the May elections, growth in Q2 could come close to 8.5%yoy. We expect growth to ease to 4-5% for the final two quarters of 2010. Exports have helped, growing 37%yoy in May to US\$4.2bn, although this simply marks a return to the average monthly rate set in 2007 (with about the same in 2009), which reflects the steady decline in competitiveness and capacity in this area. That has been partly offset by strong local demand, which helped lift the industrial production index 26%yoy in May. The IMF recently bumped up their 2011 forecast to 4.5% GDP growth. We may lift our 2011 outlook towards 6% if we see signs that President Aquino's policies can encourage a revival in private investment.

**Consumers are the main engine of growth**

Election spending, remittances from offshore Filipino workers (OFWs, up 6.5%yoy in May), and growth in production and services have all been positive for the consumer sector. Passenger car sales increased 32%yoy in 1H'10 and forward looking estimates of consumer confidence suggest that Filipinos are optimistic about the next 12 months. We expect real growth in consumer spending to lift from 3.8% last year to 4.2% this year and 4.4% next year.

**Construction looks strong**

Construction has been growing strongly in 2010. We only have data to March but private construction activity rose 59%yoy in Q1'10. This is being driven by a strong recovery in the business investment cycle. Non-residential construction jumped 131%yoy in Q1'10.

**Mild inflation and a gradual rise for the Peso**

Producer prices (PPI) are falling thanks to cheaper capital goods prices while consumer prices (CPI) are steady at 3.9%yoy in July. We may see PPI inflation rise as capacity constraints kick in, but CPI inflation should remain low. The stock market has risen 11% since Aquino's win, while the peso has firmed towards 45 to US\$.

	2007	2008	2009	2010	2011
GDP growth, %	7.1	3.8	0.9	6.8	5.3
CPI, annual average, %	2.8	9.3	3.3	4.5	4.5
Central bank overnight loan rate, year end	7.25	7.50	6.00	6.25	6.75
Peso to US\$1, annual average	46.1	44.5	47.6	46.7	45.8

Sources: 2007-2009 BSP data and CEIC; 2010-2011 forecasts by IMA Asia.

# Singapore

## Political & policy issues to watch

**The IMF report**  
**... a good fiscal stimulus in 2009**  
**... and a good return to neutral in 2010**

The IMF's recent Article IV report on Singapore, which is freely available on their web site, provides a comprehensive and largely favourable review of the government's policy settings. The size and timing of the fiscal stimulus during the 2008/09 recession and its subsequent withdrawal during the recovery has been well conducted and made the recession much smaller than originally feared according to the IMF. This helped cap the unemployment rate at only 3.3% (full employment by western standards) during the downturn. The IMF sees the current fiscal stance as neutral and in tune with internal balance. It commends the focus of the FY2010 budget on improving long-term productivity, the growth of which has been on a sustained decline in the last ten years.

**Monetary policy**  
**... a stronger S\$ would help**

The April monetary tightening - in the form of lifting the S\$ against an undisclosed basket of currencies – also gets an approving nod from the IMF. However, it feels that a faster pace of S\$ appreciation may be required, as the S\$ could be undervalued by as much as 8% against the basket. The report acknowledges that there are “hot spots” in Singapore's housing market, but plays down the likelihood of a destabilising property bubble.

**Massive reserves**  
**... and a different approach to social security**

On the government's massive accumulation of reserves, the IMF suggests that part of it should be used to fund the retirement of the baby-boomers and the adoption of a more formal social safety net to replace the current “invisible but real” safety net that the authorities operate. Previous IMF suggestions about adopting a western-style welfare system have been rejected by the Singapore authorities, who remain uneasy about the negative side-effects of such systems.

## Outlook for the market

**The world's fastest growing economy in 2010**

The breathtaking pace of manufacturing expansion (up 44.6%yoy in Q2) lifted GDP growth to 18.8%yoy in Q2'10 from a no-less-impressive 16.9%yoy in Q1'10. Singapore is set to become the world's fastest growing economy in 2010. Even when factoring in a slowdown in 2H'10, GDP should grow at the upper end of the government forecast range of 13-15%.

**Thanks to surging exports**

Industrial production soared 44.6%yoy in Q2'10 from 37.7%yoy in Q1'10, led by an explosive 89.1%yoy increase of the highly volatile pharmaceuticals component. Excluding pharmaceuticals, the pace of industrial production eased to 27.7%yoy from 31.7%yoy in the previous quarter. Non-oil domestic exports accelerated 27.7%yoy in Q2'10 from 23.2%yoy in Q1'10. Import growth also edged up to 26.5%yoy in Q2 from 25.5%yoy in Q1'10. Faster export growth relative to imports resulted in a 155.8%yoy rise of the trade surplus, providing a big push to Q2'10 GDP growth.

**... and a gamble on tourism paying off**

Singapore's two newly-opened casino resorts helped lift tourist arrivals. Using 2008 as the base Q2 arrivals were up 14.1%yoy after a modest 3.3% climb for Q1'10 over Q1'08. The big gain has been in arrivals from Indonesia, up 32.9% in Q2'10 over Q2'08 reflecting the buoyancy of the Indonesian market and the close personal ties with Indonesia. Arrivals from China were down 12.3% while those from the US rose 7.1% from Q2'08 to Q2'10.

**Watch for a lift in consumer demand**

Local consumer demand also has started to lift. Excluding cars, retail spending for the first five months as a whole was up 8.2%ytd in current prices and 6.4%ytd in constant prices. The strongest sales have been in tourism related areas (mostly up 10-11%ytd in constant prices) and housing goods (up 12.8%ytd); supermarket sales are up a weak 0.7%ytd. We expect consumer spending to rise over the next year as the job market improves. The economy added an estimated 26,500 jobs in Q2'10, after creating 36,500 positions in Q1'10. Most of the new jobs are in the booming services sector.

**A continued slow rise for the S\$**

Inflation accelerated to 3.1%yoy in Q2'10 from 0.9%yoy in Q1'10 due to the explosive pace of economic growth. The S\$ rose nearly 5% on the US\$ to a recent high of 1.35, although this mostly reflects recent US\$ weakness (it fell on most currencies in the last two months). A mild appreciation should continue on the US\$ through the next year.

	2007	2008	2009	2010	2011
GDP, real growth, %	8.2	1.4	-2.0	14.0	5.1
CPI, year average, %	2.1	6.5	0.2	2.0	2.0
3 month interbank interest rate, Dec, %	2.38	1.00	0.69	0.80	1.80
S\$ to US\$1, year average	1.51	1.41	1.45	1.36	1.33

Sources: 2007-2009 government data and CEIC; forecasts for 2010-2011 by IMA Asia.

## Thailand

### Political & policy issues to watch

- Temporary calm** A veneer of calm has fallen over much of Thailand since the military crackdown on Red Shirt protestors in May. Emergency rule has been lifted in six provinces, although it still applies in 10 of Thailand's 76 provinces, including Bangkok. PM Abhisit's coalition government looks secure in parliament and from pro-Thaksin protestors or military coups due to support from the top echelons of the Thai elite. A bigger threat is the Constitutional Court, which is examining whether Abhisit's Democrat Party broke election funding laws in 2005. A verdict is expected in October and if the Democrats are found guilty the party would be disbanded, its top officials (including Abhisit) banned from politics for five years, and a new election called. The pro-Thaksin opposition is well placed to win such a contest even though the remnants of the Democrat Party would quickly reform into a new party.
- ... emergency rule continues**
- ... an October court ruling might topple PM Abhisit**
- A new army chief from Oct 1** The defence ministry has moved earlier than expected to confirm that Deputy Army Commander General Prayuth Chan-ocha will become Commander in Chief on October 1. He is young enough to hold the position for four years before reaching retirement age. Prayuth is a strong monarchist who is expected to take a hard line against the pro-Thaksin Red Shirts. He played a role in ending the Red Shirt blockade in May as did several other commanders who are expected to be given significant appointments on October 1. By moving early on the annual military appointments the government hopes to ensure both military unity and rock solid support for efforts to suppress the Red Shirts. This may well force the Red Shirt movement underground creating a new set of risks.
- ... ensuring a tough anti Red Shirt line**
- A confused 3G auction in Sept.** Thailand's 3G broadband auction is due to be completed in September and could raise up to US\$1.2 billion from the sale of three licenses if foreign telco firms get on board. Yet the uncertainty over spectrum usage, interconnection charges, and pricing are making it hard for foreign players to develop business models.

### Outlook for the market

- 2010 forecasts are moving up on a domestic upturn** It is becoming increasingly clear that the political tensions will not prevent a strong economic performance in 2010. The Finance Ministry has upped its GDP growth forecast to 5.5%, while the Bank of Thailand expects 6.5-7.5% and the IMF leads the way with 7-8%. We've lifted ours to 6.7% (previously 5.5%) as a broad-based domestic recovery comes together with sustained export performance through the middle of the year.
- Strong exports also help** Export growth hit 46%yoy in US\$ terms in June, while imports rose 38%yoy and the June trade surplus expanded to US\$2.3bn. Exports in the year to June were 4% above 2008 levels and the outlook is upbeat. A Ministry of Commerce survey of exporters showed continued growth in new orders through the middle of 2010, though at a slower pace than Q1'10. This is good news for Thai manufacturers who booked a 21%yoy rise in June production. The inventory cycle will be complete by September but ongoing export demand will drive robust 2H'10 manufacturing.
- ... with steady growth expected in 2H'10**
- Strong consumer sales underpin local demand** Perhaps most surprising has been the strength of the retail sector even as tourism fell and the May disturbance which, among other things, burnt down one of Bangkok's best known shopping malls. Confidence and spending has rebounded sharply – June passenger car sales surged 76%yoy – and with confidence rising through May-June and tourist numbers recovering, 2H'10 could be even stronger.
- Higher rates and a rising baht** The Bank of Thailand's policy rate should lift to 2% by year-end as strong growth pushes inflation towards 4% in 2H'10. Thailand's stock market has more than doubled since Q4'08 and is now just off the 2007 peaks. The baht has risen 4% since the start of the year.

	2007	2008	2009	2010	2011
GDP, real growth, %	4.9	2.5	-2.3	6.7	5.0
CPI (2002 index), year average, %	2.2	5.4	-0.9	3.8	3.5
Central bank, 14-day repo, year end, %	3.25	2.75	1.25	2.00	2.75
Baht to US\$1, year average	32.2	33.0	34.3	31.8	30.5

Sources: 2007-2009 NESDB, Bank of Thailand, and CEIC; 2010-2011 forecasts by IMA Asia.

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## Vietnam

### Political & policy issues to watch

#### Risky policies in Vietnam

... draw a late downgrade from Fitch

... despite some improvements

Fitch Ratings has cut Vietnam's sovereign rating to B+ from BB- with a stable outlook, citing inconsistent government policies, worsening external finances, higher funding needs, a highly dollarised economy and weak banks. Fitch highlighted the country's high budget deficit (7.6% of GDP in 2010), increased reliance on external funding and declining foreign reserves, which according to the IMF fell to an equivalent of 7 weeks of imports in mid-2010 from around 10 weeks at end-2009. The new rating is four rungs below investment grade and puts Vietnam three rungs below Indonesia and two under the Philippines, countries that are seen as its investment peers in Southeast Asia. The Asian Development Bank and private sector economists were surprised by the rating cut, as the problems mentioned by Fitch are not new and there have been recent signs of improvement. The 12-month rolling trade deficit eased to US\$16.7bn in July from a recent high of \$17.9bn in April, while inflation eased to 8.2%yoy in July, having peaked at 9.5%yoy in March.

#### Monetary policy is still messy

... based on central bank orders rather than markets

... which hurts smaller banks

Moreover, the chaotic conditions that followed the removal of interest rate subsidies and interest rate caps earlier this year (i.e. skyrocketing commercial interest rates and drying up of bank credit) are dissipating. Interest rates are coming down and loans are starting to flow again. Responding to pressure from the State Bank of Vietnam (SBV), commercial banks have lowered their deposit rates towards 10% and lending rates towards 12% while the SBV's policy rate has remained unchanged at 8%. The agreement has reduced interest rate competition between banks. This is hurting smaller banks most as they are unable to win deposits with higher rates and cannot source funds in the inter-bank market (as the SBV disallows inter-bank funding in excess of 20% of client deposits). Larger banks are forced to park their surplus deposits in short-term bonds instead of lending them to the smaller banks. On the plus side, lower interest rates helped lift bank credit growth to 11.3%yoy in July from 6.6%yoy in June. This is still way below the 25% credit growth target set by the authorities for 2010, but it is moving in the right direction.

#### China nudges Vietnam towards the US

... a mistake that will annoy Beijing

In late July, China declared its "indisputable sovereignty" over the South China Sea and held naval drills in the area, the sovereignty of which is partly claimed by Vietnam and other Asean countries. This is a 40-year old dispute that bubbles up occasionally. Lately China has pushed its case a bit more forcefully but this appears to have backfired. In a July visit to Hanoi, Secretary of State Hillary Clinton said that the US is ready to take relations with Vietnam to a new level. The US and Vietnam have just started two weeks of joint naval exercises, much to China's consternation.

### Outlook for the market

#### Capacity constraints will limit 2010 growth

GDP growth accelerated to 6.2%yoy in 1H'10 from 5.3% for the whole of 2009, and is set to record an expansion of just over 6% in 2010. The IMF recently lifted its 2010 growth forecast to 6.5% from 6% previously. This could be achievable, but we are concerned about capacity constraints stemming from frequent power shortages and recent floods, as well as emerging evidence of export weakness.

#### Tourism and retail continue to boom

... but exports are slowing

... as is the property market

Industrial production grew 14.4%yoy in July on a 3-month moving average, after slowing to 9.8%yoy in April. Retail sales and tourist arrivals have been growing at a furious pace, up more than 30%yoy in each of the five months to July. However, external trade growth is slowing. Export growth eased to 23.8%yoy in July from a recent peak of 43.5%yoy in May. Import growth dropped to 6.4%yoy in July from a peak of 75%yoy in January. The import slowdown likely reflects the impact of credit constrictions on domestic demand (see above), which includes a sharp slowdown in property transactions. Real estate agents report a 30-50% drop in trading volumes in Hanoi since late May.

#### Stable rates and a steady Dong

The Dong has been hovering just over 19,000 against the US\$ in recent months, as the SBV managed to guide bank interest rates lower without having to cut its own policy rate. The Dong should benefit from evidence of continuing improvement in macroeconomic stability, reflected in lower inflation and a declining trade deficit.

	2007	2008	2009	2010	2011
GDP, real growth, %	8.5	6.3	5.3	6.1	6.5
CPI, yoy, % (2005=100 from 2007)	8.5	23.1	6.7	8.0	7.0
Central bank's base rate, year end, %	8.25	8.50	8.00	8.50	9.50
Dong to US\$1, year average	16,063	16,506	17,860	19,000	19,588

Source: 2007-2009 data from the IMF and CEIC; 2010-2011 forecasts by IMA Asia.

## India

### Political & policy issues to watch

- Political stability under PM Singh** In the next month PM Singh, who is 14 months into his second 5-year term, will become India's third longest serving PM (after Nehru and Mrs Gandhi). The loosely knit coalition he has led since May 2004 has brought stability and a bit of reform. The next year will tell whether he is capable of lifting the pace on reform sufficiently to start a transformation of the economy. The BJP-led opposition is less of a barrier to him than the unwieldy 10-party UPA coalition government he heads and the upper echelons of the ruling Congress Party, headed by Sonia Gandhi, which often prefers a left-of-centre populist agenda.
- India's reform agenda**  
**... waiting for the bills to pass parliament** Big reforms are possible if you look at bills in parliament's current monsoon session. These include the GST bill (which would give India a single indirect tax and end a tangled web of state taxes), the Direct Tax Code (a new law on income tax), and the Companies Amendment bill. The first two will go to committees and are unlikely to be passed in this session, which may delay implementation of GST next March. Other bills include the Civil Nuclear Liability Bill, the Women's Reservation Bill and the Food Security Bill.
- Spending the 3G auction windfall** The government earned 1.06 trillion rupees (\$21.7bn) from its 3G and wireless broadband auctions, almost three times the amount in its February budget. The question was whether it would use this windfall to cut the budget deficit (projected at 5.7% of GDP this year) or spend it. It has decided to spend it. The government has asked parliament for an extra 546 billion rupees (US\$11.8bn) spending on development, fuel subsidies and education. Even more spending will be required if the Food Security Bill passes.
- ... but still winning a ratings upgrade** Encouraged by the petroleum price deregulation last month and the receipts of 3G spectrum sales, Moody's raised India's local currency debt rating to Ba1 from Ba2. This is still below investment grade, but will nevertheless help sustain foreign investor interest, which has rebounded strongly since fears of European crises receded in June. Moody's retained India's Baa3 rating on foreign-currency debt, the lowest investment grade.

### Outlook for the market

- A robust 2010 outlook**  
**... driven by domestic demand**  
**... as the late monsoon catches up** Industrial production growth eased to 11.5%yoy in May as underlying demand remains firm but the inventory cycle is now flattening out. India's business cycle probably peaked in the June quarter and production growth may cool through the second half of 2010. But the overall outlook remains favourable, driven chiefly by domestic demand, which could accelerate in 2H'10 thanks to a better agriculture yield. After a slow start to the season, monsoon rains from June 1 to August 4 were just 2% below average. There is still weak rainfall in central and eastern India but overall agricultural output this year will be well above 2009 levels. We expect GDP growth of 8.5% this year and 8.1% growth in 2011.
- Rising consumer demand**  
**... and strong exports** After a solid start to 2010, consumer spending should lift further in 2H'10 as rural incomes rise. New car sales rose 31%yoy in May and overall consumer demand is expected to be 6% higher in 2010. Indian corporates are also doing well with business confidence and new orders rising strongly in the latest Q3'10 business confidence survey. Export demand has held up in Q2'10 with exports rising 30%yoy in June. Sales to China rose 95%yoy in June and were 58%yoy higher across 1H'10, but it is the recent pick up in US demand (+59%yoy in June) that could be the big export driver in 2H'10.
- A tough battle to curb inflation** The RBI has at last started to move against inflation, with the CPI running at over 10% since February and the WPI at over 12% since last November. At the end of July the repo rate was raised 25 bps to 5.75% and the reverse repo was hiked 50 bps to 4.50% with more rate hikes imminent. However, much of the inflationary push is coming from food and fuel (both up 16%+yoy in May), neither of which is affected by interest rate movements.

<i>Calendar year starting January</i>	2007	2008	2009	2010	2011
GDP (Expenditure), real growth, %	9.9	6.3	5.7	8.5	8.1
Inflation - WPI, year average, %	4.6	8.5	2.0	10.0	9.0
Inflation - CPI, urban non-manual, yr avg, %	6.5	7.7	11.7	12.0	10.0
RBI lending (repo) rate, year end, %	7.75	6.50	4.75	6.75	7.50
Rupee to US\$1, RBI Ref Rate, yr avg.	41.2	43.8	48.3	45.6	44.7

Sources: 2007-2009 data from the government (NCI, RBI) and CEIC. 2010-2011 forecasts by IMA Asia with guidance from IMA India.

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## Australia

### Political & policy issues to watch

#### An election too close to call on August 21

#### ... Labor hopes for a 2<sup>nd</sup> term under a new leader

Australia faces a close election on August 21 with PM Julia Gillard, who took over from Kevin Rudd on June 24 in a surprise coup within the Labor party, fighting to prove that Labor is more than a single term government. Rudd had led Labor to a landslide victory in November 2007 after five straight wins for the Liberal-National Party Coalition led by PM John Howard (1996-2007). The Liberals have since tried two other leaders before settling on Tony Abbott in December 2009. Abbott is a conservative in the Howard mould but with a stronger interest in religion (Howard's passion was cricket). This has helped reenergize the Liberal's conservative base. But of greater importance in the Coalition's jump in opinion polls was the implosion of PM Rudd's leadership over big policy flops (climate change and a super tax on mining) and a dictatorial leadership style that excluded most of his cabinet from decisions. Gillard immediately changed tack in both areas.

#### The Greens could win the balance of power in the senate

The Greens could do well enough in the half senate election on August 21 to hold the balance of power in the upper house. Their environmentalist and interventionist policies are closer to Labor's policies than to the Coalition's but neither of the main parties would be comfortable in meeting their demands. If Abbott wins, he might call a double dissolution of parliament within a year, which would include all senate seats (as opposed to half the seats in a normal election), in the hope of gaining a more amenable senate.

#### Watch for big policy shifts on:

- + the mining tax
- + climate change
- + broadband

While some have called this a "Seinfeld election" the reality is three massive policies with a major impact on the economy and businesses are at stake. If elected, Abbott would drop Labor's modified mining tax (Gillard cut the rate from 40% to 30% and restricted it to iron ore and coal, which satisfied the big mining companies). He would also set a different course on emissions reduction, favouring a carbon-emissions reduction fund over Labor's preferred carbon tax & trading scheme. Finally, he would halt the roll-out of a A\$43bn National Broadband Network in favour of a much smaller and cheaper option.

### Outlook for the market

#### A strong national story

#### ... thanks to fundamentals and the resource boom

Australia's macro story is solid. It dodged a 2009 recession thanks to strong banks and a big fiscal stimulus. Yet it entered 2010 with public debt at little more than 5% of GDP, which bodes well for long-term growth and stability. This year growth should come close to 3.5% thanks to a booming resource sector and a related jump in investment in mining and infrastructure projects. Break out the components of demand, however, and the story is quite different. The resource/investment story is driving the low population but resource rich states of Queensland and Western Australia. By contrast, the high population states of Victoria and NSW are suffering from a collapse in consumer spending.

#### But outside of mining investment is weak

China's commodity demand lifted May exports by 37%yoy in US\$ terms, which puts exports back at 2008 levels. The RBA's commodity price index has risen 43%yoy and is now just 5% below its 2008 peak, pushing up both the A\$ and the export outlook. By contrast, investment elsewhere is weak, with business confidence plunging in Q2'10 as sales fell.

#### ... as firms are hit by a slump in consumer demand

Retail sales grew just 1.2%yoy in May as consumers retreated in the face of six 25 basis points rate hikes since October 2009. With rates now expected to stay on hold, a mild recovery is likely through 2H'10. Unemployment is just 5.1% and should continue dropping thanks to labour demand from the big resource projects. Consumer sentiment remains high and house prices for the June quarter were up 18.4%yoy.

#### Rates put on hold

Headline inflation cooled to 3.1%yoy in Q2'10 as local demand slowed. The RBA could pause in its "normalisation" of rates at 4.50% for the rest of the year. The A\$ has risen above US\$0.90 but will (as always) remain volatile.

#### Year ending December 31

	2007	2008	2009	2010	2011
GDP, real growth, %	4.9	2.2	1.4	3.5	4.2
CPI, year average, %	2.3	4.4	0.6	2.9	2.5
RBA cash rate, year end, %	6.75	4.25	3.75	4.50	5.00
A\$1 = US\$, year average	0.84	0.83	0.79	0.87	0.91
US\$1 = A\$, year average	1.19	1.20	1.27	1.15	1.10

Source: 2007-2009 data from the ABS; 2010-2011 forecasts by IMA Asia.

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## New Zealand

### Political & policy issues to watch

<b>PM Key has a strong lead</b>  ... and should win a 2 <sup>nd</sup> term	Over a year out from the next election (due by Nov 2011), PM John Key's National Party has a strong hold on government with 53% support in the latest opinion polls compared to 29% support for the opposition Labour Party led by Phil Goff. The Nationals hold 59 seats in the 122 seat legislature and comfortably govern with the support of several minor parties. At this point it is quite likely that John Key will win a second three year term in 2011.
<b>Tinkering with FDI approvals</b>  ... to protect land ownership  ... while still encouraging FDI	Foreign purchases of land have become a hot topic and to keep in front of the issue Finance Minister Bill English, who is reviewing the Overseas Investment Act with the aim of encouraging more foreign investment, may actually increase protection for "strategic assets" and assets linked to land with a special heritage value. A few recent bids (including one by a Chinese company for a clutch of bankrupt dairy farms) have triggered popular concern. In reality few foreign investment applications are rejected. Moreover, an agreement is ready for signing that would allow automatic approval for purchases between Australia and New Zealand up to a certain threshold.
<b>Deregulation</b>  ... the case for private accident insurance	The government is assessing whether private insurers should be able to cover accidents at work in competition with the Accident Compensation Corporation (a state monopoly on insuring for accidents and compensating victims). The government will also consider reports on water allocation and management and steps to improve the linkages between the Resource Management Act and a range of other laws in areas like development.

### Outlook for the market

<b>A gradual export-led recovery</b>  ... has lifted manufacturing  ... and should be sustainable	NZ is three quarters into a mild recovery, the strongest component of which is exports. Commodity export prices have eased a bit from the record high in May but are still up 47%yoy on demand from China. Export growth on our US\$ measure hit 31%yoy in January and has remained close to that level through to June (27.2%yoy). This has fed through to industry but not yet to consumers. In June the manufacturing index (with 50 being the point at which contraction turns into expansion) was 56.2, up from 54.0 in May, and services hit 55.7 (54.0 in May) despite flat retail and tourism. New orders were 58.0 for manufacturing (56.4 in May) and 59.0 for services (56.1 in May). These indicators suggest that the economy is rebalancing a little in favour of the productive sector. While this makes for a slower recovery, it should be more sustainable.
  ... a weak consumer upturn has just started	While companies are doing better, they are not yet hiring. Unemployment rose to 6.8% in Q2 from 6% in Q1 as companies hired fewer workers following a brief surge in hiring in Q1. However, anaemic wage growth also restarted in Q2'10 with non-government salaries including overtime up 1.5%yoy. Better labour market data should emerge in Q3 and should be clearly apparent by Q4'10, which will help with a mild consumer recovery. Retail sales (excluding cars and fuel) fell for a second straight month in May.
<b>No recovery yet for property and construction</b>	House sales remain flat at less than half their 2007 peak. Prices have hardly moved in two years yet remain, according to The Economist magazine, 23% overvalued. New building permits are low and so the construction industry is anaemic. Until household balance sheets are in better shape, this is likely to remain the picture.
<b>More rate hikes ahead</b>	The central bank (RBNZ) raised its policy rate by 25 basis points in July to 3%. Inflation will rise towards 5%yoy in 2H'10 with the introduction of an emissions trading scheme in July and a hike in the GST in October. But the RBNZ remains focussed on growth and considers a neutral level to be around 5%. They will probably raise rates by 25bps at each of the three remaining 2010 meetings. The NZ\$ has been steady around 70-73 US cents since December but may edge up as global risk concerns ease towards the end of 2010.

#### Calendar years

	2007	2008	2009	2010	2011
GDP(Expenditure), real growth, %	3.1	-0.5	-0.5	2.9	3.6
CPI, year average, %	2.4	4.0	2.1	4.0	3.0
Official cash rate, year end, %	8.25	5.00	2.50	3.75	5.00
NZ\$1 = US\$, year average	0.74	0.70	0.63	0.72	0.72
US\$1 = NZ\$, year average	1.36	1.43	1.60	1.39	1.39

Source: 2007-2009 data from Statistics NZ; 2010-2011 forecasts by IMA Asia.

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