Asia Pacific Economic Outlook

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China
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Malaysia
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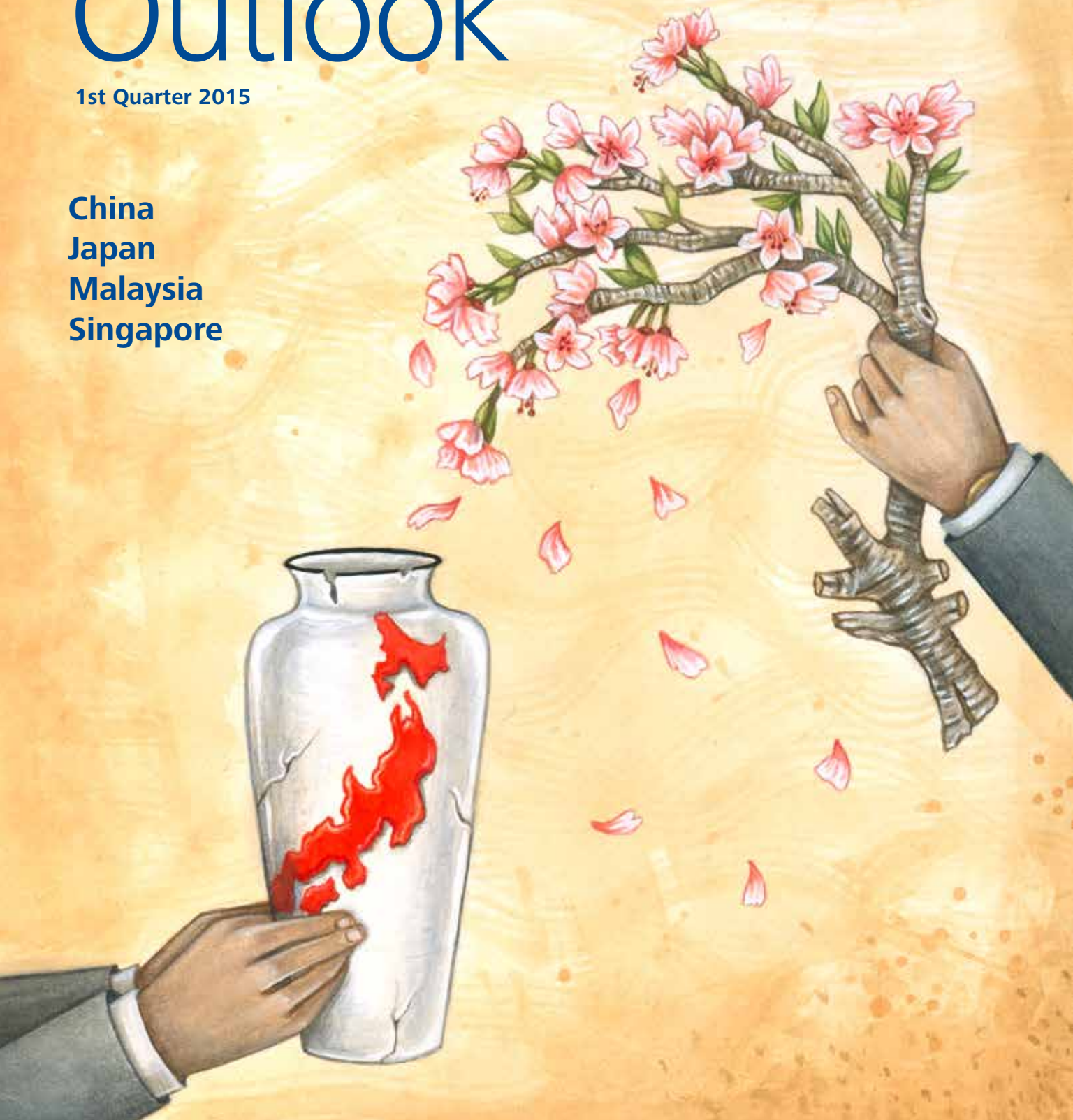

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China

Close to deflation?

By Dr. Ira Kalish

State of the economy

CHINESE economic activity continued to grow at a relatively modest pace in November. The government reports that industrial production was up 7.2 percent from a year earlier, slower than expected and slower than in October. Retail sales were up 11.7 percent from a year earlier, and investment in fixed assets was up 15.8 percent from a year earlier. The latter figure is relatively slow compared with recent years. However, the government also reported that credit creation accelerated considerably in November, likely due to the government's injection of liquidity into the system. Aggregate financing was 1.15 trillion Chinese yuan, compared with 663 billion yuan in October. New local currency loans were 853 billion yuan in November, up from 548 billion yuan in October. These are big gains and could bode well for a pickup in investment. Of course, China has been beset with too much investment. Thus acceleration in investment, while possibly helping short-term growth, could exacerbate the problems of excess capacity, empty apartment buildings, and poorly performing loans. Rather, China needs acceleration in consumer spending. While the relatively poor industrial production numbers suggest weakness, the loan data suggest promise for a rebound. On the other hand, Markit reported that its purchasing managers' index for manufacturing slipped into negative territory in December, suggesting that the massive industrial side of China's economy continues to struggle.[1]

Meanwhile, producer price deflation has accelerated, and consumer price inflation continues to decelerate in China. In November, producer prices continued, and accelerated, their 33-month consecutive decline, falling 0.5 percent from the prior month and 2.7

percent from a year earlier. This decline reflects declining energy and other commodity prices, weak domestic demand, and continued excess capacity in many industries. Consumer prices fell 0.2 percent in November from October and were up only 1.4 percent from a year earlier. The latter figure was the lowest since November 2009. This decline, too, reflects the impact of declining energy prices and weak domestic demand. It is also an indication that the central bank might engage in looser monetary policy without fear of stoking inflation. Some analysts are starting to discuss the possibility that China could get dangerously close to deflation. Others, including I, believe that a fear of deflation is not yet warranted. The drop in energy prices will actually boost consumer spending power, thus offering a stimulus to the economy that will help to alleviate deflationary pressures. The bigger risk now is a collapse of property prices given the massive excess supply of unoccupied homes following the speculative frenzy of property construction.

Policy responses

China's government is taking a number of steps to stabilize growth while not allowing too much credit creation. The government will accelerate spending on infrastructure projects this year to prevent economic growth from dipping below 7.0 percent. The problem with this policy is that it fails to attack the imbalance in the Chinese economy. China already spends excessively on investment and inadequately on consumer spending. Efforts to reverse this have not yet seen success, hence the decision to boost public investment. In response to the government's announcement, the Australian dollar increased in value. Australia's currency is heavily influenced by China's perceived demand for Australia's iron ore and other commodities. Indeed, the price of iron ore rose as well. The increased spending on infrastructure will come from central and regional governments, state-run companies, and the private sector. Much of it will be financed by debt, which is a concern given that China's economy has accumulated a large amount of debt. While China continues to implement short-term fixes to the economic slowdown, it has so far failed to implement major reforms aimed at shifting the structure of the economy.

In an effort to boost banks' lending ability and hopefully stem economic deceleration, the Chinese government has broadened the definition of a bank deposit. Banks are required to hold cash reserves equivalent to 25 percent of bank deposits. Rather than reducing the required reserve ratio, the government has simply changed the definition of deposits and waived the requirement for reserves for certain types of deposits. The end result will be the release of $800 billion in funds that banks will now be able to use for lending.

> Of course, China has been beset with too much investment. Thus acceleration in investment, while possibly helping short-term growth, could exacerbate the problems of excess capacity, empty apartment buildings, and poorly performing loans.

Also, it has been reported that the People's Bank of China is injecting another 400 billion yuan into the financial system to boost liquidity.[2] In addition, it is also reported that the government has instructed banks to lend more, and that rules regarding loan-to-deposit ratios will not be strictly enforced. These actions follow a recent cut in benchmark interest rates. The supply of credit has decelerated lately, and the government is intent on reversing that trend in order to prevent a further decline in growth. Yet many analysts suggest that the weakness in credit growth stems not from inadequate supply of loanable funds but rather from weak demand for loans on the part of businesses facing excess capacity. Indeed, Moody's, the bond rating agency, said that it expects an increase in loan defaults on the part of state-run enterprises, largely because of excess capacity.[3] It has also been reported that a good deal of credit extension is merely for the purpose of rolling over existing loans rather than investing in new projects.

Globalizing China

China's offer of a large currency swap with Russia is just one of several instances in which China has provided funding to troubled emerging markets—other countries include Argentina and Venezuela. Why is China doing this? First, these loans and swaps help to promote the use of the renminbi as an international currency, one of China's long-term goals. Second, they give China leverage with these countries. While emerging countries can go to the International Monetary Fund for financing, such help usually comes with conditions involving economic reforms. China, on the other hand, is probably not setting such conditions. Rather, it is looking to boost its influence with these countries and set favorable terms for access to these countries' resources. In the case of Russia and Venezuela, that would be energy. In the case of Argentina, it would be food. Indeed, it is reported that China's considerable loans to Venezuela are paid back in oil, while loans to Argentina are paid back in agricultural commodities.

Endnotes

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Japan

New hopes in 2015 as policymakers spring into action

By Dr. Rumki Majumdar

AS 2014 came to an end, it was clear that the impact of the April 2014 tax hike was harder on economic activity than initially expected. Annualized real GDP growth for the third quarter was revised down by 0.3 percent to -1.9 percent due to weaker fixed investment. Earlier, the economy had shrunk by an annualized rate of 6.7 percent in real terms in Q2 2014, which implies that the economy fell into a technical recession by Q3 2014.

Ongoing efforts to get the economy out of deflation that has lasted a decade-and-a-half have been adversely affected by the recent sharp drop in oil prices. Consumer price inflation slipped to a 17-month low of 0.4 percent in November, after accounting for the effect of April's tax increase (which added 2 percent to inflation from May onward). Core consumer price inflation was merely 0.7 percent in November, down from 0.9 percent in October 2014. While the Bank of Japan (BOJ) expects inflation to reach the 2 percent target rate in the next six months, its quarterly survey showed that most companies forecast a weaker rise in output prices in December than they expected in October.[1]

Poor economic performance and falling investors' confidence in Japan's ability to pull itself out of deflation have raised several questions about the success of Japan's much-heralded, three-pronged Abenomics. Until Q2 2014, the economy responded positively to the first two arrows of Abenomics, which involved easy monetary and fiscal policies to boost the economy. However, post the tax hike in April, the economy started faltering. Although recent monthly data on retail sales, the industrial production, and exports suggest that the economy may exit recession in Q4, the growth outlook for the quarter remains grim.

Rapid policy actions

The policy authorities of Japan are now rapidly shifting gear to ease policies in order to boost growth. Following the release of the Q3 GDP numbers, Prime Minister Shinzo Abe called for an immediate snap election in November and decided to delay the consumption tax increase by an additional 18 months. The cabinet also approved a new economic package of 3.5 trillion Japanese yen to revitalize the economy. The stimulus is expected to provide some relief to consumers, who have been facing spending constraints due to the rise in taxes, and thereby boost consumer spending. A third of the proposed package is designed to assist small businesses and households, whose real income has been affected by the declining yen and increasing input costs. In addition, the stimulus is aimed at boosting Japan's local economies, infrastructure, and public works.

The government is also trying to persuade domestic companies to raise wages and boost investment spending by reducing corporate taxes. It recently announced that the corporate tax rate would be cut by 3.29 percent over the next two years and that it intends to gradually reduce the tax from the current rate of 34.6 percent to below 30 percent over the next five years.[2] Companies in Japan have record cash holdings worth 233 trillion yen. Economic uncertainties and poor domestic demand have dissuaded these companies from increasing business spending or raising wages. The government is hoping that these incentives will motivate companies to spend more.

Earlier in October, the BOJ stepped up quantitative and qualitative monetary easing. The BOJ governor surprised the financial market by announcing that the bank will increase its asset purchases each year from 60–70 trillion yen to 80 trillion yen.[3]

The government ended the year with expectations that it will engage in structural reforms aimed at boosting productivity in 2015. The combination of aggressive monetary and fiscal policies, together with the postponement of the tax increase, resulted in further depreciation of the yen, while the equity index soared by the end of 2014. Depreciation in the domestic currency is expected to raise the economy's export competitiveness, while rising equity may boost investors' confidence.

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Growth outlook for 2015

In 2015, the performance of the economy will likely depend, in part, on whether Abe goes ahead with his much-discussed reform agenda. The ruling coalition won a majority in the parliamentary election in December, giving Abenomics another chance to revive the economy. The implementation of the policies is only halfway through, and a lot more needs

to be done to win investors' confidence. The recent win may help Abe to push ahead politically unpopular economic reforms.

Additionally, a number of factors will likely influence growth, such as the monetary policy stance of the BOJ, the government's approach to fiscal consolidation, the pace of growth among Japan's important trade partners and the resulting foreign demand for its exports, the willingness of businesses to increase investment, and the shrinking workforce.

The BOJ will likely maintain its asset purchases through 2015 to prevent the economy from sliding back to deflation. Monetary easing will likely help reduce interest rates, boost the money supply, and depreciate the domestic currency further. The decision to delay the second tax hike will shift the negative impact of fiscal tightening on growth, which implies that there might be an upward revision of GDP projections for 2015. Poor growth and lower investment in China may hurt Japan's exports because the former is the biggest trading partner of the latter. However, stronger growth in the United States and a modest recovery in some of the EU regions may partially offset the impact of slowing growth in China.

One of the biggest near-term challenges will be to revive business investment as the economy continues to contract. Unless companies start investing their idle cash to build capital, expand operations, engage in new businesses, and boost wages, growth momentum will likely remain slow. On the other hand, Japan's shrinking workforce will likely cause the biggest long-term drag on the economy; the number of births hit an all-time low in 2014. While increasing women's participation in the labor force might offset the impact of a declining population for some time, in the long term, demographic pressures will significantly affect economic growth.

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Malaysia

On the path of fiscal reform

By Akrur Barua

IN November 2014, Malaysia's government announced that it will stop fuel subsidies from December. Domestic fuel prices will now track average international prices. The fuel subsidy removal was not the only move that the government has made in reforming public finances. From April 2015, a new goods and services tax (GST) is set to come into effect. While the GST is aimed at increasing revenues, it is also an attempt to diversify revenue sources, which are currently dominated by income tax and hydrocarbons.

These measures have not come without criticism. For example, there are concerns that the government will reinstate fuel subsidies if global fuel prices rise sharply. Criticism around the GST includes the long list of exemptions and the tax's impact on low-income households. Moreover, despite these measures, the government could miss its fiscal deficit target this year (3.0 percent of GDP). Such concerns notwithstanding, the government needs to continue on its fiscal reform path. Apart from greater fiscal legroom, the economy's structural fundamentals will improve, thereby enhancing investor attractiveness.

Economy slowed in Q3

GDP expanded 5.6 percent year over year in Q3 2014, down from 6.5 percent in Q2 and 6.2 percent in Q1. This was its slowest pace of growth since Q4 2012. Growth would have been slower had it not been for resilient consumer spending during the quarter. Private consumption grew 6.7 percent in Q3, up from 6.5 percent in the previous quarter. Consumers are likely to have benefitted from high wages due to a tight labor market. A rise in inflation and high debt levels do not seem to have

bothered consumers in Q3, although they are likely to weigh on the sector going forward.

Investments and exports were a drag on growth in Q3. While export growth slowed to 2.8 percent in Q3 from 8.8 percent in Q2, growth in gross fixed capital formation fell to a mere 1.1 percent from 7.2 percent over this period. Gross fixed capital formation recorded the weakest growth in five years, which could be a worry given the central role of investments in the government's target to become a developed nation by 2020. The drag on investments came from public investments, which fell 8.9 percent in Q3 due to delayed infrastructure projects; private investments, on the other hand, grew 6.8 percent.

External demand may weigh on exports and investments

Public sector investments are likely to revive this year, as delayed infrastructure projects finally get off the ground. Although these projects will affect private sector investments as well, the impact is likely to be partially offset by weakening external demand. Of particular concern will be a weak Eurozone economy and slowing growth in China, due to which exports fell 3.1 percent year over year in October. Moreover, with the Chinese economy trying to shift away from investments to a domestic consumption–driven growth model, demand and thus also prices of commodities have been hit. For example, in October 2014, export volumes of natural rubber from Malaysia fell 30.6 percent, while the average unit value fell 31.4 percent.

Overall fixed investment will also have to contend with slowing residential investment activity, which faces headwinds from weakening house prices and a tight monetary stance by Bank Negara (BN). Consequently, fixed investment growth is not likely to rise above 4.0 percent in 2015, while exports growth is likely to slow down to 4.0–4.5 percent.

Government finances to improve

Lower oil and gas prices will dent government revenues. Currently, 30 percent of government revenues come from oil royalties. The budget for 2015 assumes an oil price of $105 per barrel. Current trends indicate that the prices might end up lower. Low hydrocarbon prices, however, will help Malaysia reduce its import bill. The country is a net importer of hydrocarbons, albeit a small one. The government has ended subsidies on petrol and diesel effective December 1, 2014, which will likely save the government $6 billion annually and aid public finance.

Revenues will also benefit from the new GST, set to come into force from April 1, 2015. At 6 percent, however, the GST rate is lower than desired, while the list of exemptions appears to be increasing. Nevertheless, the GST marks a positive beginning for better public finance management. In the medium term, the taxation regime will need more reforms. Income tax is one such area where the government will have to widen the tax base: Only 1.7 million workers pay income tax out of a workforce of 12 million.

Lower oil and gas prices will dent government revenues. Currently, 30 percent of government revenues come from oil royalties.

Consumers face headwinds from inflation

Private consumption has been a key driver of economic growth in the last few years. However, a rise in leveraged spending has left households in debt. For example, household debt stood at about 87 percent of GDP in 2013, one of the highest ratios in Asia. This has strained household finances, especially in the wake of slowing house prices, a key component of household balance sheets. As households repay debt amid a hike in interest rates, consumption growth is likely to slow down in 2015.

While a tight labor market (unemployment rate of 2.7 percent in October 2014) has helped keep nominal wages high so far, real wages are likely to face pressure from rising inflation due to an easing of fuel subsidies and the introduction of the GST. In November 2014, inflation rose to 3.0 percent from 2.8 percent a month before. Price pressures could rise if sharp monetary tightening by the US Federal Reserve in 2015 leads to Malaysian ringgit depreciation, thereby pushing up imported inflation, which, in turn, could induce BN to hike rates by 25–50 basis points. In such a scenario, private consumption growth will likely grow 4.0–4.5 percent in 2015, down from 6.0–7.0 percent in 2014.

Not the expressway, but a good road ahead

As Malaysia's economy enters 2015, fundamentals appear good enough to ensure medium-term growth of 4.0–5.0 percent. While it is likely to face headwinds from short-term inflation, high household debt, and slowing growth in China, the economy will benefit from a gradually improving fiscal situation and strong growth in the United States. Moreover, as stalled projects are cleared, the country is likely to witness more public investment in infrastructure. If the government couples this with efforts to reform education and the labor market, 2015 will indeed turn out to be a good year for Malaysia.

Singapore

Subdued growth due to global volatility

By Lester Gunnion

SINGAPORE'S near-term growth prospects have been curbed by an uneven recovery in the global economy. The city-state's economic engine is fueled by export earnings: In 2013, non-oil domestic exports accounted for 45 percent of Singapore's GDP. Currently, however, a slowdown in China, a recession in Japan, and near-zero growth in the Eurozone are weighing upon trade in Singapore. An overvalued housing sector and high household debt are also on the country's list of concerns. Moreover, Singapore's monetary policy continues to grapple with above-average core inflation due to higher wages and an anticipated hike in interest rates in the United States later in 2015.

Growth picked up in Q3 before dipping in Q4

Singapore's economy grew 2.8 percent year over year in Q3 2014, accelerating from a 2.3 percent expansion in Q2. There was positive news from both services and manufacturing in Q3. Growth in services was driven by a surge in the finance and insurance subsector. Business services also picked up in Q3. Manufacturing grew 1.9 percent year over year in Q3, a modest improvement from 1.5 percent in the previous quarter. However, growth in manufacturing was driven by biomedical manufacturing clusters, which tend to be volatile. Manufacturing in the electronics subsector, which performed better in Q3 than in Q2, will continue to remain under pressure due to weakness in the global market as well as restrictions on the influx of foreign labor, as evidenced by Singapore's export data. Electronics exports continued downward, contracting 6.3 percent in Q3. Total merchandise trade declined 3.5 percent from a year earlier, but net exports remained positive due

to a sharp slowdown in imports, primarily on account of lower oil prices.

Subdued trade activity was evident in the transportation and storage subsector, which slowed compared with Q2 levels. Sluggish growth in global trade is a setback for Singapore's position as an international trade hub. Another worry for policymakers is the construction sector: Construction slowed from 6.9 percent year over year in Q1 to 3.7 percent in Q2, and has slowed further to 1.7 percent in Q3.

Advance estimates for Q4 indicate that the economy has grown 1.5 percent from a year ago.[1] In addition, manufacturing has contracted 2.0 percent, and construction has slowed further. Much of the slowdown in the construction sector is due to subdued private construction activity, which is linked to softness in the housing sector.

Sluggish growth in global trade is a setback for Singapore's position as an international trade hub.

Housing sector correction continues

Singapore's housing sector continues to display signs of weakness. Prices of private residential properties declined for the fourth consecutive quarter. Prices declined 0.7 percent quarter over quarter in Q3 after declining 1.0 percent in Q2. Corresponding rentals also continued downward. The fall in prices stems from government curbs on the private residential property sector. Measures to cool the sector, introduced in 2009 to avert a housing bubble, were intensified in 2013, creating a drag on the demand for residential property. Developers sold significantly fewer private residential units in Q3 than in Q2. Furthermore, the stock of completed private residential units increased in Q3, while the vacancy rate remained at 7.1 percent. The Urban Redevelopment Authority's flash estimate for Q4 indicates that private residential property prices slipped a further 1.0 percent from Q3.[2]

Potential risks posed by household debt

Measures to rein in the overvalued housing sector are also aimed at keeping household debt in check. As per Q3 data, household debt in Singapore stood at 76.3 percent of GDP, having expanded 5.6 percent year over year. As of September 2014, housing loans accounted for three-quarters of household liabilities. Additionally, in Q2, debt held by property sector companies as a proportion of equity rose to 65 percent from 55 percent a year ago. A deep and prolonged fall in private residential prices and transaction volumes could hurt indebted property firms as well as leveraged households. The good news is that Singapore's banking system remains resilient. As of Q3, the banking system's ratio of housing sector nonperforming loans remained low at 0.36 percent. The Monetary Authority of Singapore (MAS), however, is expected to keep monetary policy tight through the next few quarters, as housing prices remain elevated despite recent moderations. Further correction in the housing market is expected in 2015.

MAS to maintain tight monetary policy

Monetary policy in Singapore is centered on the management of the exchange rate, with the main objective being price stability for

sustainable economic growth. The Singapore dollar is managed against a basket of currencies comprising the country's major trading partners. In 2014, MAS allowed for a gradual and modest appreciation of the Singapore dollar's nominal effective exchange rate policy band. This policy stance is expected to continue in 2015 in order to keep inflation in check. Though consumer price inflation for all products declined in November, core inflation remains stubborn. MAS's measure of core inflation, which excludes accommodation and private road transport, is projected to remain above its historical average for the next few quarters on account of higher wages and business costs. This is closely linked to Singapore's policy on foreign labor. Measures to limit the inflow of cheap foreign labor are aimed at enhancing productivity of the domestic workforce. A tight labor market, though, will ensure that wage inflation persists in the medium term. An important fact that traders will be cognizant of is that Singapore's real effective exchange rate (REER) has been trending upward compared with the average REER of its regional competitors. The divergence in REER since January 2010 indicates a loss in export competitiveness stemming from Singapore's economic restructuring efforts to raise incomes and productivity.

Because Singapore's monetary policy approach targets the exchange rate, its domestic interest rates are closely linked to interest rates in the United States, leaving it vulnerable to a hike in US interest rates in the second half of 2015. Rising domestic interest rates in Singapore could erode economic activity in the medium term, with loan borrowers, in particular, likely to feel the burden of higher debt-servicing costs.

Growth to remain moderate in the next few quarters

Singapore's growth is expected to remain less than robust in the next few quarters. On the internal front, the government will need to closely monitor the pace and trajectory of the housing market correction to ensure that there are no sudden downturns. Singapore's 10-year economic restructuring plan, which was launched in 2010, is now at the halfway mark. Interestingly, while income has grown as per plan, productivity growth has been lagging. Until growth in productivity starts to gather pace, Singapore will continue to face wage inflation sans corresponding gains in output. The subsequent loss in export competitiveness, along with an uneven global recovery and subdued global trade, will continue to exert a negative influence on economic growth.

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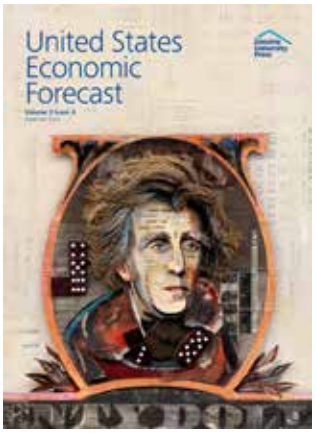
Additional resources



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