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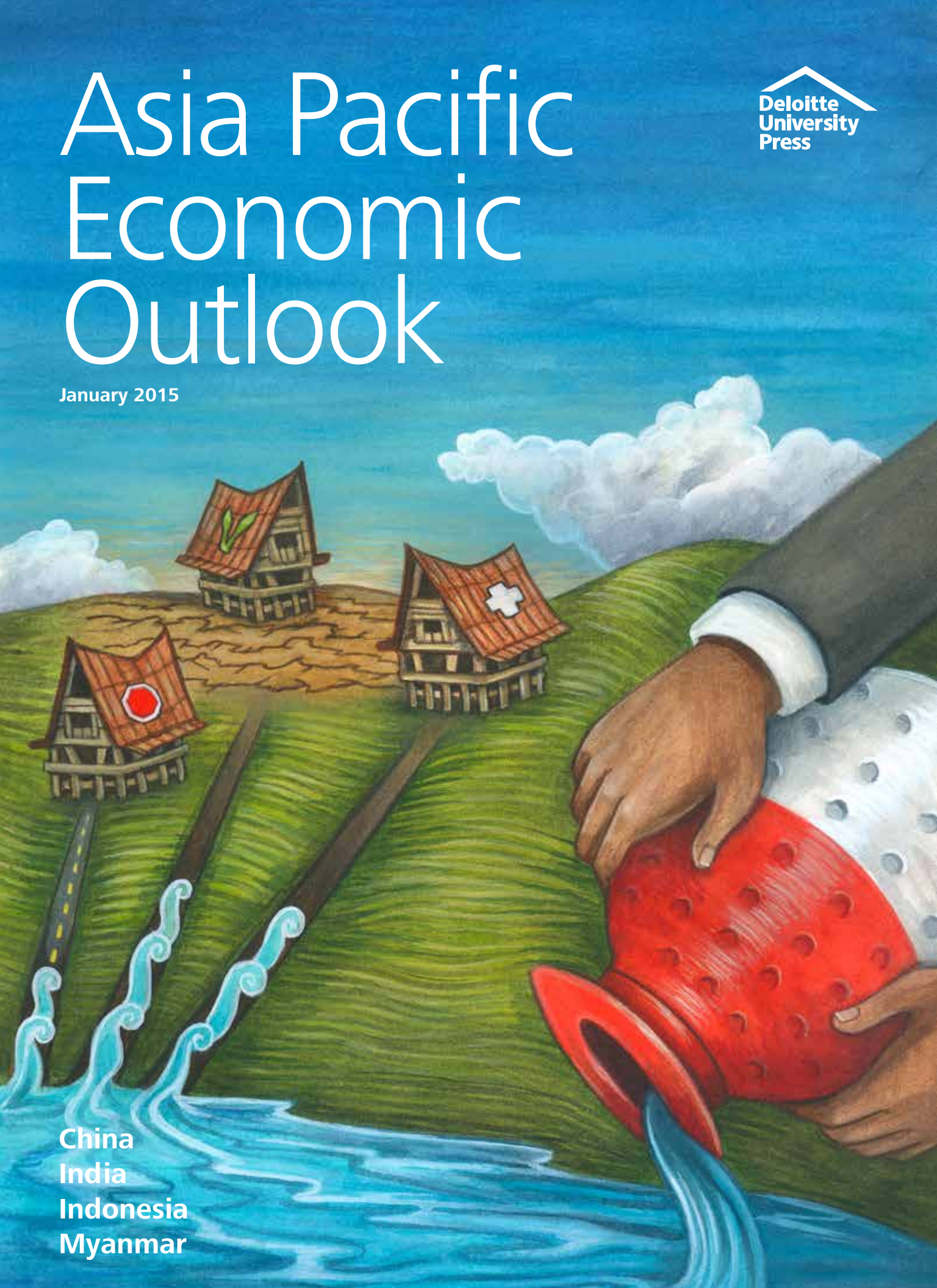

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China

The slowdown continues

By Dr. Ira Kalish

THE Chinese economy continues to slow. The purchasing managers' index for Chinese manufacturing dropped from 50.4 in October to 50.0 in November—a six-month low—indicating that the manufacturing sector has stalled.[1] The subindex for output was in negative territory, while the subindex for new export orders decelerated. This is further evidence that the slowdown in the Chinese economy has not abated. In addition, the government reports that factory output was up 7.7 percent in October versus a year earlier.[2] This was the slowest rate of expansion since 2009. Investment in fixed assets during the first 10 months of the year was up 15.9 percent over the previous year, the slowest pace of increase since 2001. And retail sales increased 11.5 percent in October versus a year earlier. All of these figures were slower than in the previous month and slower than investors had expected. Evidently, efforts by the government to stave off deceleration have so far failed. This raises the question of whether the government will do more to stimulate demand.

The slowdown in China's housing market continues, with house prices continuing to decline. The government reports that prices fell in 69 of 70 cities analyzed from September to October.[3] In 67 of 70 cities, prices were down from a year earlier. Notably, prices fell in Beijing for the first time in two years. The decline in prices reflects weakening demand. In the first 10 months of this year, home sales were down 10 percent from the previous year. In recent months, the government has taken steps to stimulate more activity in the housing market. This does yet not appear to have borne fruit, with developers reluctant to boost construction until excess inventories are sold. On the other hand, housing transactions did

rebound in October. Still, the rebalancing of the housing market is likely to be a continuing drag on economic growth.

Credit market activity in China declined in October. New lending by banks totaled 548 billion yuan, down 36 percent from September. Aggregate financing was 663 billion yuan, down 34 percent from September. Chinese banks report that bad loans are increasing at a rapid pace and that deposits are shrinking. This explains the decline in the extension of credit. Meanwhile, the broad money supply grew 12.9 percent in October versus a year ago, the second-slowest rate of increase in more than two years. The weakness in credit growth comes despite the central bank's recent injection of liquidity into banks. This raises the question of whether the bank will choose to cut interest rates or lower the required reserve ratio (RRR). Many analysts are expecting the bank to take either or both actions in order to boost credit market activity. Yet the government is reluctant to do anything that will exacerbate the existing problem of excessive debt.

The weakness in credit growth comes despite the central bank's recent injection of liquidity into banks.

Not only is economic growth suboptimal, inflation appears to be decelerating rapidly, thus raising the possibility of deflation. China's producer prices fell 2.2 percent in October from a year earlier, faster than the 2.0 percent decline in September. This was the 32nd consecutive month of declining prices. Consumer prices were up 1.6 percent in October from a year earlier, unchanged from September. The last time consumer price inflation was this low was in January 2010. Among the factors driving down producer prices are lower costs of imported energy and other commodities as well as continued excess capacity in many industries. Indeed, the government has said as much.

The very low consumer price inflation and continued producer price deflation suggest several things. First, the economy is slowing considerably, given that businesses are struggling to unload excess inventories. Second, the continued efforts by the government to stimulate credit market activity could be counterproductive in the long run, as they will likely exacerbate the problem of excess capacity. Third, China is now at risk of overall deflation; there is now market commentary to that effect. Expectations of deflation can be very damaging and can be self-reinforcing. Fourth, wages continue to rise due to labor shortages, while producer prices fall. This can only imply that margins are being squeezed. Plus, there is anecdotal evidence that state-run companies are retaining workers they no longer need. This keeps the unemployment rate low but does little to improve the efficiency of the economy.

What should China do? Now would be the optimal time to implement more radical reforms in order to correct imbalances in the economy, stimulate consumer demand, and shift investment toward those areas that would support a more modern economy.

Policy response

The massive growth of credit outside the banking system, in the so-called shadow banking system, is a serious cause of concern given the high volume of debt, much of which may go bad. Consequently, the government has successfully slowed the growth of shadow banking, contributing to the slowdown in

the economy. On the other hand, the government does not want overall credit expansion to decelerate too much. Thus the central bank recently cut various benchmark interest rates by 25–40 basis points, which surprised investors and immediately led to a big increase in equity prices in China and elsewhere. This was the first time the central bank cut interest rates since 2012.

The cut is meant to stimulate more credit market activity, especially lending to small businesses, within the traditional banking sector. However, the central bank has not yet cut the RRR, something it did earlier this year. A cut in the RRR would boost the money supply by increasing the share of bank assets that can be loaned. Also, most traditional bank lending has gone to state-owned enterprises rather than to the private sector. The growth of shadow banking has been meant, in part, to provide credit to the private sector that has not been readily available through traditional channels. Thus the cut in benchmark rates might not necessarily have the desired impact. The fear is that the main beneficiaries of the rate cuts will be state-owned enterprises, property developers, and local governments, rather than small business owners. As such, we may simply see these beneficiaries take advantage of lower rates to refinance existing debts.

Meanwhile, it has been suggested that the central bank is prepared to go further due to fears that China may now be facing the prospect of even lower inflation. One factor is the continuing decline in energy prices, which has contributed to lower inflation. On the other hand, the drop in oil prices is having a positive impact on Chinese purchasing power. Indeed, this will provide the central bank with greater room to engage in more expansive policy without risk of inflation.

The government is starting to take action designed to alleviate financial imbalances. The Chinese government intends to introduce bank deposit insurance in January. This will be a critical stage on the path to freeing up deposit interest rates, probably sometime in 2016. Currently such rates are capped—which has contributed to the growth of the shadow banking system, where nonbanking vehicles collect funds from wealthy individuals, promising them high returns, and lend that money to property speculators and local governments. Once deposit insurance and flexible deposit rates are introduced, there will be greater competition among banks. There is concern that once deposit insurance is introduced, depositors will become scared that banks could actually fail and may move their funds to the largest banks. This has happened in other countries when insurance was first introduced. The point of insurance will be to make banks riskier by forcing them to pay market rates to depositors. It will force them to cut back on foolhardy lending and better monitor the creditworthiness of borrowers. Ultimately, it should lead to more effective investments and, consequently, faster economic growth. This reform is clearly one of the most important to be introduced by this government.

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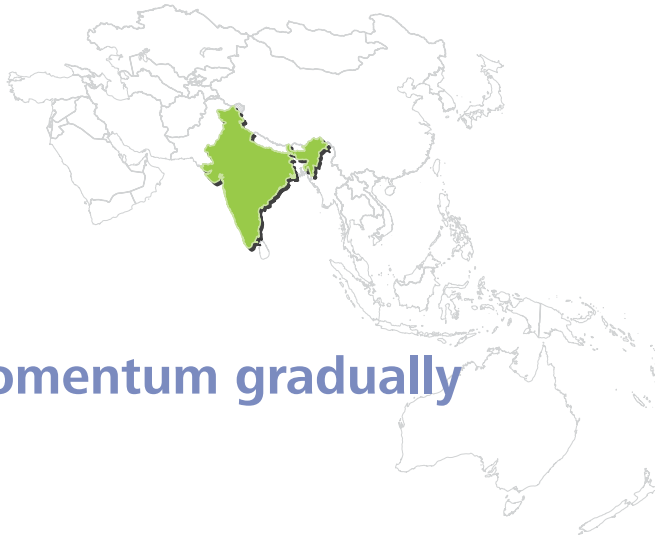

India

Growth gaining momentum gradually

By Dr. Rumki Majumdar

ECONOMIC growth has been gradually picking up since the beginning of FY 2014–15. GDP grew at a healthy rate of 5.5 percent year over year in the first half of FY 2014–15, while economic imbalances have reduced.[1] Although growth was slightly lower in Q2 at 5.3 percent, it was higher than market expectations, thanks to growth in services and stronger-than-expected farming. Subsectors in the services sector that registered significant growth in Q2 were electricity, gas, and water supply, which grew 8.7 percent; construction, which grew 4.6 percent; community, social, and personal services, which grew 9.6 percent; and financing, insurance, real estate, and business services, which grew 9.5 percent. The growth rate of agriculture, forestry, and fishing is estimated to be 3.2 percent. However, poor performance in the industrial sector, specifically in the manufacturing sector, hampered growth. The mining and quarrying sector grew 1.9 percent, while the manufacturing sector grew 0.1 percent.

Growth in real private consumption expenditure remained steady at 5.8 percent in Q2. Although quarter-over-quarter growth in government consumption expenditure fell 13.1 percent relative to the previous quarter, year-over-year growth of 10.1 percent helped boost GDP. Poor performances in exports and private investments, which contracted 1.6 percent and 0.3 percent, respectively, caused the biggest drag on GDP.

A pickup in project clearances and reform initiatives by the government and improved business sentiments in the last six months have failed to affect the GDP numbers. A Q2 decrease in capital formation indicates that poor global demand, limited improvement in capacity utilization levels, and uncertainties

around the implementation of reforms are weighing on investment decisions. Businesses are waiting for a more predictable taxation system, faster regulatory clearances, and industry-friendly land acquisition and labor laws before they commit to long-term investments.

Businesses are waiting for a more predictable taxation system, faster regulatory clearances, and industry-friendly land acquisition and labor laws before they commit to long-term investments.

Falling prices have brought some relief to both policymakers and the general public. The wholesale price index grew 1.8 percent in October, which is the slowest increase in the past five years. Consistently falling food prices and declining international fuel prices have helped contain inflation. The fall in food prices was in part due to several factors: the monsoon's recovery; government actions such as lowering minimum support prices and selling stocks more efficiently; and benign global food prices. However, structural problems such as poor infrastructure, improper storage, and a lack of transportation facilities continue to exist. Unless these factors, which have contributed to rising food prices in the last decade, are addressed, the fall in prices may be short-lived. Inflation is expected to remain high, which implies significant upside risks.

Business sentiments are improving fast, as evidenced by the Manufacturing Leadership Survey 2014, which was conducted jointly by an industry lobby comprising the Confederation of Indian Industry and the Boston Consulting Group.[2] The survey was launched to gauge industry leaders' thoughts on the current scenario and future prospects of the Indian manufacturing sector; over 100 heads of Indian incorporations participated. The survey shows a distinct rise in confidence, with 85 percent of those surveyed expecting manufacturing growth to rise between 5 percent and 10 percent over the next five years (compared with expectations over the past five years of growth rising 3.4 percent). According to a survey by the Reserve Bank of India (RBI), the business expectation index has been rising sharply in the past few quarters.[3] The industrial outlook survey suggests that the overall business, production, and financial situations in India are perceived to be as good as they were in 2010.

A few challenges

However, a few economic indicators suggest that the economy is still not out of the woods. Factors such as the pace and quality of fiscal consolidation, high inflation, a poor performance by the manufacturing sector, poor exports, and the deteriorating quality of the banking sector's assets pose downside risks to the economy. So far, fiscal consolidation is mainly led by curbing government expenses rather than revenues rising. Tax collection remains poor, while the pace of disinvestment remains slow. It will be important for the government to find alternatives for raising revenue if the fiscal balance is to be met without impacting growth. While the current account deficit has narrowed since 2013 due to tight

monetary policy, restrictions on gold imports, and a fall in crude imports, export growth has remained weak in the last three months.

The Indian rupee has weakened against the US dollar in the past month, primarily due to the spillover effect of both a stronger US dollar and transient factors such as a sudden rise in dollar demand to pay for imports. That said, the currency has firmed against the euro, British pound, and Japanese yen, while the real effective exchange rate suggests that the rupee is appreciating against the currencies of India's peers.

The index of industrial production continues to remain weak as the manufacturing sector remains highly vulnerable. Growth in capital goods has been on an unsustainable trajectory, while contraction in the consumer durable goods sector indicates a poor outlook for consumer demand. Poor exports also contributed to the index's weakness. Activity is likely to be subdued in Q3 because of a moderate *kharif* harvest, deficiency in the northeast monsoon rainfall (which could affect the *rabi* harvest), and slow growth momentum in exports.

Recent monetary policy actions

The RBI has been under immense pressure for some time, both from the industry and from policymakers, to cut rates as inflation rates ease while economic performance remains modest. However, the RBI governor decided to keep key policy rates unchanged in the recent monetary policy in line with market expectations, citing significant upside risks to inflation.[4] The RBI noted that the recent easing is because of transitory factors and favorable base effects. Factors such as administered price corrections, weaker-than-anticipated agricultural production in the coming months, the ability of the government to consolidate fiscal balance, and a possible rise in energy prices may alter the benign outlook. The inflation expectation continues to remain high.

The RBI also revealed that its baseline forecast for the consumer price index is now 6 percent for March 2015, and it expects inflation to be around 6 percent over the next year. If the inflation trajectory ends up being similar to the RBI's current policy stance, then the scope of easing in 2015 will be limited. Any rate cut could increase upside risks. However, the governor has also hinted that if inflation continues to remain steady and fiscal developments are encouraging, there might be a change in monetary policy stance early next year, including outside the policy review cycle. Most likely, the easing may be modest in 2015, unless the inflation trajectory significantly undershoots the RBI's projected path.

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Indonesia

Some promising signs

By Akrur Barua

INDONESIA'S new president Joko Widodo—or Jokowi, as he is popularly known—has started his term on a positive note. On November 17, he cut subsidies on gasoline and diesel by 31 percent and 36 percent, respectively. The cut in subsidies was a bold step by the new president and signals his intent to remove structural flaws in the economy. The move will also reassure investors. Some have been wary of the government's ability to enact tough reforms due to the ruling coalition's lack of a majority in the legislature.

A bold move

Indonesia's generous fuel subsidy regime has been one of its key drawbacks in recent times. Prior to the recent cuts (and post the cuts in 2013), fuel subsidies amounted to about 13 percent of budgeted spending for 2015, thereby stifling funds for infrastructure, skills, and health care. Without improvements in these areas, Indonesia will find it difficult to generate enough jobs for its large, young, and growing population. Currently, the country ranks 114 out of 189 countries in the World Bank's ranking of ease of doing business.[1] A competitiveness ranking by the World Economic Forum put Indonesia at 56th place in infrastructure and 61st in higher education and training out of 144 countries.[2]

Jokowi appears eager to change this. During his campaign, he was forthright about his intention to spruce up public finances by cutting wasteful subsidies, widening the tax base, and spending more efficiently. According to the coordinating minister for the economy, the fuel subsidy cuts will save the government about 120 trillion Indonesian rupiah (about $9.6 billion).[3] The government has

already announced its intention to channel these savings into irrigation, roads, and health care. Also, to help poor families cope with the immediate rise in fuel prices, the government has earmarked about 6 trillion rupiah for social assistance this year. Popular protests to the subsidy cuts have been muted so far. Markets, on the other hand, have cheered the cuts; the benchmark stock exchange went up 1 percent the day after the announcement, while the rupiah gained 0.5 percent.

The new administration is also trying to make top civil service appointments more transparent, cut administrative costs, and revamp operations in key ministries such as energy. These are welcome actions, given that an overbearing bureaucracy can stifle investments of the type Jokowi asked for during his address to business leaders in the Asia-Pacific Economic Cooperation summit in China.[4] Reforms will help Indonesia improve its competitiveness and benefit from greater economic integration within the Association of South East Asian Nations in the future. They will also help draw interest from global businesses who are concerned about the rising cost of production in China.

The cut in subsidies will also likely bring down Indonesia's oil imports by reducing demand distortions in the economy. In 2013, the country's net oil and gas imports amounted to $12.6 billion, a key contributor to the current account deficit of $29.1 billion. As oil imports come down, the resulting easing of the current account deficit will in turn aid the rupiah. It will also please rating agencies, which have been critical of Indonesia's high deficit at a time when capital flows have been vulnerable due to the winding down of quantitative easing in the United States and the likely rise in interest rates there.

Central bank gets into the act

The hike in fuel subsidies will impact inflation in the short term. Indeed, inflation jumped to 6.2 percent in November from 4.8 percent in October. The spike comes after Bank Indonesia's (BI's) success in forcing inflation down to its target range of 3.5–5.5 percent in 2014 post similar fuel price hikes in 2013. In July, inflation had gone down to 4.5 percent and had stayed within the target range until October. Encouragingly, just a day after the cuts, BI raised its key policy rate by 25 basis points to 7.75 percent in an emergency session. Clearly, the bank is keen to keep inflation expectations in check, reflected in the fact that it has kept its 2015 inflation target unchanged at 3.0–5.0 percent. It could cut the rate by another 25–50 basis points in 2015 if the rupiah weakens more than expected due to any monetary tightening in the United States. Weak global commodity prices and a high base from November 2015 will, however, keep downward pressure on prices and help BI. In the medium term, if savings from subsidy cuts are invested in infrastructure, some supply-side bottlenecks will ease, thereby aiding consumer prices.

Popular protests to the subsidy cuts have been muted so far. Markets, on the other hand, have cheered the cuts.

Growth momentum slows

BI's rate hike was despite a slowdown in economic momentum, with GDP growing 5.0 percent year over year in Q3 2014, its slowest pace in five years. Investments in particular lost steam and grew a mere 4.0 percent in Q3, down from 5.2 percent in Q2 and the lowest rate since Q3 2009. Businesses are likely to hold on for some more time as they seek policy

clarity from a new government. The recent fuel price hikes will also weigh on investment in the near term as the cost of production rises. In fact, this was the primary reason behind a decline in the manufacturing purchasing managers' index in November.

Indonesian businesses will also face pressure from slowing growth in key export destinations, especially China, and the mineral ore export ban since January 2014. Exports fell 0.7 percent in Q3, the third straight quarter of contraction. Household spending, however, is expected to remain strong despite rising inflation in the near term. Evidence from 2013–14 suggests that Indonesian consumers have bounced back from previous fuel price hikes. Private consumption expanded 5.4 percent in Q3, marginally down from 5.6 percent in Q2, and is likely to grow at an annual rate of 5.0–5.5 percent next year.

A small step on a long road

Jokowi will find it tougher to implement other structural reforms as he encounters entrenched interests and opposition in the legislature. In fact, the recent fuel subsidy cut is only the first step in overhauling public finances. Even now, fuel prices in the country are 10–15 percent lower than international prices. Moreover, low global prices of oil have reduced the margin between domestic and global fuel prices. This dynamic will change when oil prices rise again. Consequently, the government's best medium- to long-term bet would be to deregulate fuel prices completely. Politically this will be a difficult pill to swallow, but investors will hope that the government holds its nerve. After all, the country is at the crossroads of choosing its next growth path—and the road to higher rewards is not easy.

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Myanmar

Riding high on foreign investment

By Lester Gunnion

MYANMAR'S economy continues to make progress, drawing on the benefits of greater integration with the rest of the world. Economic growth is set to remain strong in the medium term on the back of foreign direct investment (FDI) inflows into telecommunications, oil and gas, banking, and construction. The economy will also benefit from infrastructure development and institution building. To accomplish these, the country has been actively partnering with international organizations such as the World Bank and the International Monetary Fund (IMF) as well as key economies such as Japan. Myanmar's increasing global engagement was most evident this year, when the country took over the rotating chairmanship of the Association of South East Asian Nations for the first time.

A surge in FDI

FDI into Myanmar surged in the first few months of the fiscal year, resulting in an upward revision to the FDI forecast for 2014–15. According to the Myanmar Investment Commission, FDI in the first five months of the fiscal year stood at $3.32 billion, a 113 percent year-over-year rise.[1] The commission now expects FDI to cross $5 billion this fiscal year, up from an earlier estimate of $4 billion. Telecommunications has been a key recipient of FDI, accounting for 31 percent of total inflows into the country from April to August. Oil and gas (23.8 percent), real estate (18.4 percent), and hotels (13.3 percent) have been the other key beneficiaries of FDI.[2] While rising housing demand has been a key factor aiding

real estate, the sector, along with the hospitality industry, is increasingly benefitting from rising tourism inflows. According to the Ministry of Hotels and Tourism, tourist arrivals went up about 93 percent to 2 million in 2013; the ministry expects this figure to touch 3.1 million by the end of this year.[3]

Ooredoo and Telenor start operations

In January, Qatar-based Ooredoo and Norway-based Telenor received licenses to operate in the country. The two companies emerged successful from a bidding process; they are the first foreign telecom operators in the country. Both companies have started offering services, with Ooredoo starting in August, followed a month later by Telenor. Telenor has expanded operations to the city of Yangon after launching in Mandalay and Nay Pyi Taw. Earlier Ooredoo had launched operations in all three cities and has now expanded coverage to 35 townships in the Yangon region.[4] Both companies are eager to tap into a market where the mobile penetration level is one of the lowest in the world, with just 12.3 percent of the population having access to a mobile phone.[5] The rollout of services, however, has not been easy for the two companies. They have faced electricity shortages, poor road networks, and stifling rules related to land acquisition for setting up towers.

In October 2014, Myanmar's central bank granted operating licenses to nine foreign banks, all from the Asia-Pacific region.

Hydrocarbon sector expanding

Proven hydrocarbon reserves in Myanmar amount to 50 million barrels of oil and 280 billion cubic meters of natural gas.[6] Given limited exploration so far, the figures are likely to increase as foreign oil companies start prospecting in offshore sites, especially deep-water wells. In March 2014, the government had awarded 20 offshore blocks. In October, they announced that another nine offshore blocks will be auctioned in 2015; five of them are deep-water blocks, while four are shallow-water ones. Rising exploration is likely to add to hydrocarbon exports in the medium to long term, thereby offering much-needed revenue for the government as it starts to invest in infrastructure, skills, and poverty alleviation. Gas exports alone accounted for nearly 30 percent of total exports in the last fiscal year. Earnings from gas exports are likely to increase in the medium term as rising production helps offset domestic demand while boosting supplies to China and Thailand.[7]

Foreign banks set to start operations

In October 2014, Myanmar's central bank granted operating licenses to nine foreign banks, all from the Asia-Pacific region. These banks are expected to begin operations in the first half of 2015. This is a positive first step

in increasing credit flows into the economy and introducing advanced technology into the sector. However, rules relating to foreign banks appear tight at the moment. First, lending by foreign banks will be limited to foreign businesses in Myanmar. Second, they will be allowed only one branch and will not be involved in retail banking. Finally, they will be allowed to offer only US dollar–denominated loans to companies; any Burmese kyat–denominated loans to local companies will only be allowed in partnership with local banks. This last restriction may disappoint policymakers, who appear keen to keep in check dollarization, which is rising due to the opening of the economy to foreign firms and a steady weakening of the kyat.

Despite strong growth, concerns remain

Buoyed by increasing FDI and growth in construction, manufacturing, and tourism, Myanmar's economic momentum is likely to continue in the medium term. According to the IMF, the economy is expected to grow at about 8.50 percent during the current and next fiscal years; this is up from an estimated 8.25 percent in 2013–14 and 7.30 percent in 2012–13.[8] Myanmar, however, has a long way to go before it emerges as a key player in Asia. There are tangible risks in sight, including a slowdown in reforms before elections scheduled for the end of 2015. Moreover, years of economic isolation have led to poor infrastructure, low skills, and data inadequacy, thereby stifling businesses and preventing prudent policymaking. These factors have also delayed the building of institutions, especially those critical for a well-functioning free-market economy. Such institutions include financial markets, regulatory bodies, and legal systems. The government will need to fix these loopholes if it wants to ensure strong growth over the medium term. Otherwise the benefits of opening the economy to the world might just dry up.

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