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Monetary Policy Trajectory in Asia

- While we have upgraded our growth forecasts for most of the Asian economies following the 2Q09 GDP data, the lack of evidence of a broad-based recovery meant that growth will be a greater concern in the near-term.
- Most of the Asian economies are still experiencing declining consumer prices as a result of the high base last year since oil prices peaked in July 2008. But our inflation forecasts suggest that monetary tightening could happen as early as 1H10 in countries such as Indonesia, Philippine, South Korea and Thailand as the countries slip into negative real interest rates or inflation rate edges close to the policy rates in these countries.
- Taking into account the growth and inflation trajectories, including the current interest rate levels in the Asian countries, it appears that South Korea, Indonesia and Philippine will be the first to start hiking interest rates in 2Q09. The remaining Asian economies are likely to move sometime in 3Q10, tracking our forecast for the Fed funds target rate.
- Overall, we are expecting the Asian central banks to hike interest rates by between 50-125bps and the Fed by 50-75bps next year.

With tentative signs of economic recovery around the world, the question now surrounds the timing for the exit from the loose monetary and fiscal policies which may itself result in fresh worries and uncertainties. The interest rate hike by the Israeli central bank on August 24 further fanned expectation that Asian central banks might soon follow suit. In China, the run up in asset prices and transactions have heightened investors' concerns over credit quality, impact on equity and property prices, building up of excess capacity etc. The concern has caused the Shanghai Comp to come off more than 20% from its peak on 4 Aug of 3,471 at one point, and saw markets in Asia Pac move in similar direction. However, it is obvious from very beginning that those headline grabbing RMB1tn+ new lending every month cannot go on forever. YTD July, new lending in China is already RMB7.8tn or an average of RMB1tn per month, vs. RMB4.1tn+ in 2008 and an average of RMB3.6tn+ annually between 2006-08. At the same time, M2 money supply growth in China has been accelerating at a record 20% to even 30% each month for the last 6 months, from an average of 18% per month during those years of strong growth in 2003-2008.

Notwithstanding the low probability event of a double-dip recession, we believe Asian central banks are likely to begin to normalize interest rates in 2Q/3Q 2010 as they seek more balance between growth and inflation. In the near-term, growth concerns still dominate over inflation given the global economy has only bottomed-out of late even though most of the Asian countries have had their growth forecast upgraded since the release of their 2Q09 GDP data. Inflation is still not a major concern in Asia this year given that six out of the nine Asian countries that we cover are still facing declining consumer prices.

Looking at the trajectory in growth and inflation as well as the current level of the policy rates, we believe that South Korea, Indonesia and the Philippines could be the first to start hiking interest rates in Asia, possibly in 2Q10. Thailand could potentially move earlier-than-expected given that inflation is expected to rise to an average of 3.5%/y in 1H10 while the benchmark interest rate is just 1.25% and amongst the lowest in Asia. Nonetheless, political risk in Thailand might hold back the monetary normalization.

Growth has Bottomed-Out But No Firm Recovery Yet

The improvement in growth prospects has been particularly evident in the last three months. This was more so for data on domestic consumers but the manufacturing sector has also picked up, in part due to re-stocking. The PMI – leading indicator for the manufacturing sector – in China and Singapore have continued to improve in August to 16-month high and 33-month high respectively. Nonetheless, Asia's exports data have remained lackluster as external environment remains challenging. The latest exports data for South Korea – one of the key exporters in Asia to release its data early – showed a contraction of 20.6%/y in August. There was no clear trend of improvement compared with a contraction of 22.5%/y in the first seven months of the year. Similar trend was also observed in other Asian countries, most of which not tracking a strong recovery trajectory in exports.

While we have upgraded our growth forecasts for most of the Asian economies following the 2Q09 GDP data, the lack of evidence of a broad-based recovery meant that growth will be a greater concern in the near-term. In particular, there would be concerns that the growth momentum could not be sustained as the impact of the government spending and inventory rebuilding will begin to wane towards the later part of the year into 2010. As a result, policy makers will probably take a more cautious approach with regards to normalizing interest rates. For instance, the South Korean government recently said that it will start to use its 2010 budget from December this year to keep up the growth momentum in the country. State firms in Korea will also front-load part of their investment plans for next year in 2H09.

Afterall, with the exception of China, Indonesia and the Philippines, the remaining Asian economies are expected to contract for the full-year in 2009 despite the upgrades. For 2010, we are cautiously optimistic, expecting an average growth rate of around 4% in the Asian countries excluding China. As such, the current growth backdrop in Asia is not consistent with a quick unwinding in the loose monetary and fiscal policies.

Inflation Risks are Muted in the Short-Term

Most of the Asian economies are still experiencing declining consumer prices as a result of the high base last year since oil prices peaked in July 2008. However, the rebound in inflation should be fairly quick in 4Q09 due to higher commodity prices and strengthening domestic consumption and only Hong Kong is expected to remain in deflation in 1H10. The HKD peg means that prices will take a longer time to adjust.

Our inflation forecasts suggest that monetary tightening could happen as early as 1H10 in countries such as Indonesia, Philippine, South Korea and Thailand as the countries slip into negative real interest rates or inflation rate edges close to the policy rates in these countries. While there would be pressure to hike interest rates in these countries, we note that there is scope for Asia to tolerate short bouts of negative real interest rates if growth has not returned to satisfactory levels. For instance, in 2008 when global crude oil prices hit record high, headline inflation rates in countries such as Indonesia and South Korea have overshoot the policy rates for a brief period. Conversely, inflation is less of a concern in Greater China in 1H10 based on our forecasts.

Growth Outlook in Asia					
	1Q09 (%y/y)	2Q09 (%y/y)	2009F	2010F	Recent upgrade to UOB/Govt 2009F?
Singapore	-9.50	-3.50	-5.00	4.50	Yes
Malaysia	-6.20	-3.90	-3.00	4.90	Yes
Indonesia	4.40	4.00	4.00	5.20	No
Thailand	-7.10	-4.90	-3.20	4.30	Yes
Philippines	0.40	0.60	1.20	3.50	No
South Korea	-4.20	-2.20	-1.00	4.50	Yes
China	6.10	7.90	8.00	8.50	Yes
Hong Kong	-7.80	-3.80	-3.50	3.50	Yes
Taiwan	-10.10	-7.50	-4.50	3.60	Yes

Source: CEIC, UOB Forecasts

Loose Monetary Policy will Begin to Unwind as Early as 1H10

Monetary normalization in Asia is a matter of time, particularly as the Asian central banks slashed interest rates aggressively to record lows in the easing cycle in response to the global crisis. The BoK, BI and HKMA (by virtue of its monetary policy, HKMA follows the US rate moves on a one-to-one basis) stood out as the most aggressive central

Inflation Outlook in Asia					
	Current Policy Rate	CPI (latest month)	CPI Forecast		
	(%)	%y/y change	4Q09 (%y/y)	1H10 (%y/y)	2010 (%y/y)
Singapore	na	-0.50	0.30	3.50	4.00
Malaysia	2.00	-2.40	0.00	2.10	2.30
Indonesia	6.50	2.75	3.40	6.20	6.50
Thailand	1.25	-1.00	1.70	3.50	4.00
Philippines	4.00	0.10	3.00	4.50	5.20
South Korea	2.00	2.20	3.10	3.10	3.10
China	5.31	-1.80	-0.50	0.10	0.40
Hong Kong	0.50	-1.50	-0.30	-0.50	-0.50
Taiwan	1.25	-2.33	-1.50	0.40	0.30

Source: CEIC, UOB Forecasts

banks after having cut rates by at least 300bps within a short time span. BI was the last Asian central bank to end its easing cycle, stopping only in August.

Taking into account the growth and inflation trajectories, including the current interest rate levels in the Asian countries, it appears that South Korea, Indonesia and Philippine will be the first to start hiking interest rates in 2Q09. The BoK is already starting to sound hawkish on inflation, particularly due to its concerns for the real estate market.

Although Thailand's policy interest rate is one of the lowest in Asia and inflation is expected to rise above the policy rate by 4Q09, the political uncertainty in the country might postpone the interest rate hike in Thailand to 3Q10, in line with our forecast for the first hike to the Fed funds target rate. Similarly, the remaining Asian economies are likely to move sometime in 3Q10, tracking our forecast for the Fed funds target rate.

In China, while it is obvious that China is rethinking those loose monetary policy measures, adjustments for now are limited to "fine tuning" at the edges, thus leaving broad policy direction unchanged. Some recent examples include: applying more stringent measures/higher standards e.g. raising credit standards, funds going straight to the projects being funded / payees as opposed to going to the borrowers; banks to have sufficient capital in place; PBoC has also begun to issue central bank bills to drain excess liquidity out of the system. It is still premature to call for an outright policy tightening as China's growth profile is not broad based, while global recovery prospects are far from certain. Therefore, we are unlikely to see - at least over the next 6 months or so - outright tightening, e.g. interest rate/reserve requirement ratio hikes or cut in new loans in China. Overall, we are expecting the Asian central banks to hike interest rates by between 50-125bps and the Fed by 50-75bps next year.

Monetary Policy in Asia					
	Current Policy Rate	Period of Monetary Easing	Total Rate Cuts (bps)	Expected Quarter to Begin Normalising Interest Rates	Policy Rate Expected End-2010 (%)
Malaysia	2.00	Nov 08 - Feb 09	150	3Q10	2.75
Indonesia	6.50	Dec 08 - Aug 09	300	2Q10	7.75
Thailand	1.25	Dec 08 - Apr 09	250	3Q10	1.75
Philippines	4.00	Dec 08 - Jul 09	200	2Q10	5.25
South Korea	2.00	Oct 08 - Feb 09	325	2Q10	3.25
China	5.31	Sep 08 - Dec 08	216	3Q10	5.85
Hong Kong	0.50	Oct 08 - Dec 08	300	3Q10	1.50
Taiwan	1.25	Sep 08 - Feb 09	237.5	3Q10	1.75

Source: CEIC, UOB Forecasts

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