Country Analyst

UOB Economic-Treasury Research
Company Reg No. 193500026Z

Ho Woei Chen Ho.WoeiChen@uobgroup.com
Suan Teck Kin Suan.TeckKin@uobgroup.com
Jimmy Koh Jimmy.KohCT@uobgroup.com

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UOB Economic-Treasury Research

Asia: Policy Shifting Toward Growth Bias

- As flagged in our article on Asian inflation a few months earlier (dated 17 June), consumer prices in Asia are peaking in the current quarter. This should be the case, as higher prices have acted to curb demand.
- Meanwhile, the fallout from the yet-to-be settled US credit crunch remains a key uncertainty on the growth front. This is especially so for export-driven Asia, which is facing weaker external demand.
- Against a background of decelerating growth momentum and peaking inflation rate, Asian authorities are increasingly leaning towards a growth bias and away from their current tight policy stance.
- In addition, a firmer dollar backdrop also allows some breathing room for Asian central banks on the FX front and we expect this window to remain open for a somewhat weak bias on the Asian currencies. Political uncertainty is yet another factor undermining some regional currencies.
- In view of this shift in policy bias, we are adjusting our calls on Asian currencies on the 12-month horizon. Among others, our end-2008 forecast for RMB is lowered to 6.70/USD from 6.60 earlier, and to 6.37 by end-2009. For the SGD, we continue to see the unit ending the year at 1.42/USD, and to 1.37 at end-2009. We now expect MYR to end the year at 3.42/USD, 3.3% depreciation from 2007 and at 3.36 at end-2009.

Update on Asia's Inflation Condition

As flagged in our article on Asian inflation a few months earlier (dated 17 June), we noted that consumer prices in Asia should be peaking in the current quarter or early 4Q. Indeed that has been generally the case as higher prices have acted to curb demand and force consumers to modify their spending behavior. Among the nine Asian countries in our sample, some are already seeing a slower headline inflation figure as global commodities prices edge lower recently.

Asian Inflation : Hitting the Peak in 2008								
%y/y	2006	2007	May 08	Jun 08	Jul 08	Jan-Jul 08 Average	2008F	2009F
Singapore	1.0%	2.1%	7.5%	7.5%	6.6%	7.0%	6.0%	2.5%
Malaysia	3.6%	2.0%	3.8%	7.7%	8.5%	4.4%	5.7%	3.8%
Thailand	4.7%	2.2%	7.6%	8.9%	9.2%	6.7%	7.5%	4.8%
Indonesia	13.1%	6.4%	10.4%	11.0%	11.8%	9.3%	10.5%	8.0%
Philippines	6.2%	2.8%	9.5%	11.4%	12.2%	11.1%	9.7%	7.0%
Vietnam	7.7%	8.3%	25.2%	26.8%	27.0%	21.4%	23.8%	13.6%
China	1.5%	4.8%	7.7%	7.1%	6.3%	7.7%	6.7%	4.1%
Hong Kong	2.0%	2.0%	5.6%	6.1%	6.3%	5.3%	5.0%	3.5%
Taiwan	0.6%	1.8%	3.7%	5.0%	5.9%	4.2%	4.0%	3.0%
South Korea	2.2%	2.5%	4.9%	5.5%	5.9%	4.5%	4.9%	3.5%
India	6.7%	6.4%	7.8%	7.7%	8.3%	7.2%	8.1%	6.4%
Source: CEIC, Consensus Forecast, UOB								

Recall that the recent run-up in consumer prices in Asia was triggered by a surge in commodities prices, such as crude oil and food. This led to a number of Asian countries cutting back on their fuel subsidies and raising sharply retail prices of gasoline/diesel in places such as Indonesia, Malaysia, China, and Taiwan in May/June, as crude oil prices spiked from around US$100/bbl in early 2008 to around US$140 by end-June. Along with other commodity prices, crude oil prices have trended lower since then to below US$110/bbl level and the threats on Asia inflation has somewhat receded to the background.

Shifting Towards Growth Bias

With inflationary threats a lesser concern, there appears to be an apparent shift towards growth bias given the fallout from external demand has impacted exports performances of a number Asian countries.

One clear indication of such change in thinking is that a number of central banks are likely to see the tail end of their rate hike cycles, these include Bank of Thailand and Bank Indonesia, while Bank Negara Malaysia is likely to stay unchanged. We had expected China's central bank PBoC to hike interest rates in the second half to moderate the decline in real interest rates but the likelihood is diminishing rapidly given that top government officials appear to be alarmed by decelerating growth momentum. We also believe that Singapore's monetary policy (SGD NEER) may tilt toward a less aggressive posture at the October meeting, should data in the next 2 months point to a possibility of a technical recession.

Asian Government Fiscal Position				
% of GDP	2006	2007	2008F	2009F
Singapore	0.0%	2.5%	-0.5%	-0.6%
Malaysia	-3.3%	-3.2%	-4.8%	-4.2%
Thailand	2.3%	-4.6%	-4.8%	1.5%
Indonesia	-0.9%	-1.3%	-2.0%	-2.2%
Philippines	-1.1%	-1.5%	-1.4%	-1.4%
Vietnam	-1.3%	-1.2%	-1.5%	-1.2%
China	-0.8%	0.7%	-0.4%	0.2%
Hong Kong	4.0%	7.7%	1.5%	1.0%
Taiwan	-0.6%	-0.2%	-0.1%	-0.1%
South Korea	0.4%	3.8%	0.5%	0.5%
India	-5.0%	-5.0%	-5.2%	-5.0%
Source: CEIC, Consensus Forecast, UOB				

On the fiscal policy front, Malaysia was first off the block with a pro-growth budget for 2009 tabled at end-Aug, cutting personal tax rate by 1%pt and expecting another fiscal deficit for the year, which would be the 12th consecutive shortfall. Other Asian governments are expected to follow the same route as Malaysia to ease on the budget to cushion the fallout from external demand weakness. There are also widespread expectations that China would announce a fiscal stimulus package, perhaps as soon as October when the Communist Party holds its Central Committee meeting, with personal tax cuts one of the main components of the package.

Asian Interest Rate Policy: Plaeuting						
		Most Recent Change		Next Move		2008F
%	Current Rate	Quantum	Date	Quantum	Date	
Malaysia	3.50	+0.25	26-Apr-06	+0.00	24-Oct-08	3.50
Thailand	3.75	+0.25	27-Aug-08	+0.00	8-Oct-08	3.75
Indonesia	9.25	+0.25	4-Sep-08	+0.25	8-Oct-08	9.50
Philippines	6.00	+0.25	28-Aug-08	+0.25	9-Oct-08	6.25
Vietnam	14.00	+2.00	10-Jun-08	+0.00	NA	14.00
China	7.47	+0.18	21-Dec-07	+0.00	NA	7.47
Hong Kong	3.50	-0.25	2-May-08	+0.00	NA	3.50
Taiwan	3.63	+0.13	26-Jun-08	+0.13	18-Sep-08	3.75
South Korea	5.25	+0.25	7-Aug-08	+0.00	11-Sep-08	5.25
Source: CEIC, Bloomberg, Reuters, UOB						

Policy Responses

Interest Rate Policy: A Mixed Bag

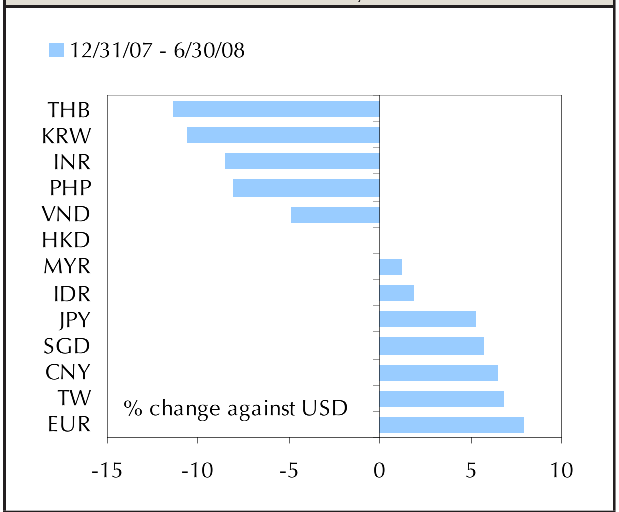
When headline inflation rates were running at decades high across most Asian countries, the natural response for the monetary authorities would be to raise policy rates to counter a deteriorating real interest rate environment. However, in actual fact very few central banks were able to do that as indicators on the growth front are pointing to an ongoing deceleration. In addition, traditional interest rate policy is not an appropriate response to the current supply side shocks, compared to a demand side shocks. One of the most aggressive Asian central banks has been Bank Indonesia, which has hiked interest rates five times this year and is seen ending its cycle soon. Aside from Taiwan's CBC, we expect to see a quiet interest rate policy front in Asia in the second half of 2008 and there is a possibility that easing may be on offer in 2009.

FX Policy: Weakening in the Face of Firmer USD

Along the line of less restrictive monetary policy, most Asian currencies have weakened against the USD since July. The RMB has barely moved in the second half, after gaining 6.5% against the USD in the first half. TWD, the strongest Asian unit in the first half, has declined 4.7% so far in 2H. Other Asian units also face similar predicaments. While Asia's fundamentals are generally supportive of stronger currencies in the medium term, short term market conditions have caused significant volatility in these units. One factor is a resurgence in the USD in the past 2 months as risk aversion intensified, with the broad USD dollar index DXY hitting at year's high. Another factor is Asian governments' general tolerance of softer home currencies to maintain export competitiveness, although excessive declines have been met with official intervention and dollar selling, which has happened in increased frequency this year.

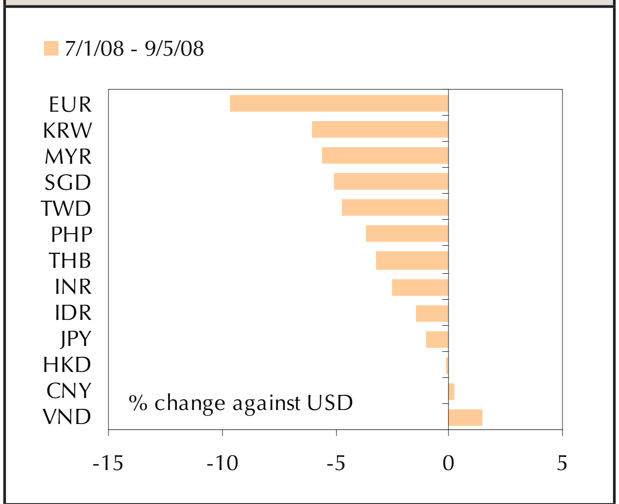
Nevertheless, we have downgraded our calls in a number of Asian currencies in view of the resurgent USD and less restrictive monetary policies. Among others, our end-2008 forecast for RMB is lowered to 6.70/USD from 6.60 earlier, and to 6.37 by end-2009. For the SGD, we see the unit ending the year at 1.42/USD, and to 1.37 at end-2009. We now expect MYR to end the year at 3.42/USD, 3.3% depreciation from 2007 and at 3.36 at end-2009.

Asian Currencies: Generally Firm in 1H08 ...



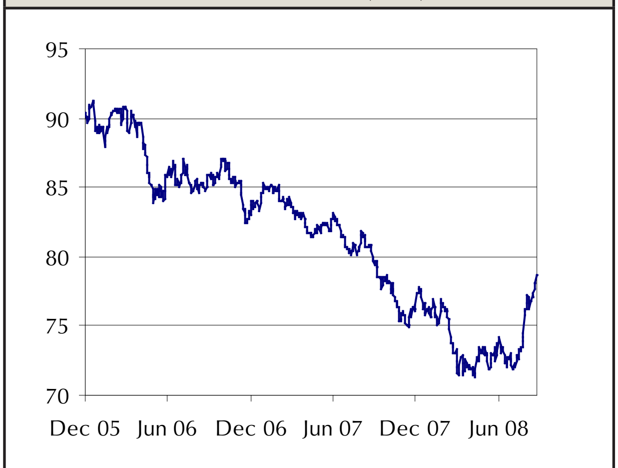
Source: Bloomberg

... but a Reversal of Fortune in the Second Half



Source: Bloomberg

US Dollar Index (DXY)



Source: Bloomberg

Asian Currencies : Staying Soft Ahead						
Against USD	8-Sep-08	End 2008F	1Q09F	2Q09F	3Q09F	4Q09F
SGD	1.41	1.42	1.43	1.42	1.40	1.37
MYR	3.40	3.42	3.42	3.40	3.38	3.36
THB	34.37	34.80	34.60	34.50	34.30	34.00
IDR	9,280	9,300	9,200	9,100	9,000	9,000
PHP	46.85	45.00	44.80	44.70	44.20	44.00
RMB	6.84	6.70	6.63	6.57	6.47	6.37
HKD	7.81	7.80	7.80	7.80	7.80	7.80
TWD	31.62	31.90	32.20	32.00	31.80	31.50
KRW	1,085.95	1,100	1,000	1,000	990	980
Source: CEIC, Bloomberg, Reuters, UOB						

Summary of Respective Country's Interest Rate and FX Responses:

Singapore's July CPI rose 6.5% y/y, moderating from the 7.1% y/y in 1H08. Inflation is likely to have peaked in June already, and will moderate to an average of around 5.0% y/y in 2H08. We expect inflation to trend lower in 2H08 and look for full-year inflation rate of around 6.0%. On the growth front, the risk of a technical recession has risen after the sharp decline in July industrial production, which was the biggest drop since the recession in 2001. With growth risk on the downside and inflationary threat on the backburner, the S$NEER has been hovering around the policy mid-point for around a month, after trading close to the top of the policy band (+2.5%) in our model since the MAS tightened further its monetary policy back in April. The market is now looking at a greater risk of MAS easing off its tight monetary policy stance at the coming October meeting. Incoming economic data will play a pivotal role ahead of the October as the risk of a switch to less tight policy will definitely increase if the August IP disappoints again and puts the economy at a risk of a technical recession. Until the August industrial output data, SGD should remain on a weak footing vs USD in the face of broad USD strength. Furthermore, if the Aug industrial production shows another large contraction, we could see the S$NEER trading to 1.0% to 1.5% below the mid-point from +0.5% to -0.5% around the mid-point currently. This translates to USD/SGD in the range of 1.4480-1.4560 based on current currency levels. We expect USD/SGD at 1.42 by year-end which should edge lower to 1.37 by end-2009, barring a sharper-than-expected downturn in the domestic economy.

Bank of Thailand hiked interest rates by 25bps at its monetary policy meeting on 27 August, to bring the benchmark rate to 3.75%. This comes as July inflation came in at a decade-high 9.2% y/y, while core inflation rose slightly above the BoT's target range of 0-3.5% y/y. This is likely to be the bank's last rate hike of the year, given the downside growth risks of the Thai economy and the pro-growth bias of the MoF. Situated between a rock and a hard place, the BoT is likely to keep interest rates on hold for the rest of 2H08, as it needs to balance slowing growth with soaring inflation. While inflation has hit a 10-year high, the government's THB50bn fiscal package is also likely to contain inflation in August and the rest of the year. Having hiked rates by 25bps each on 16 July and 27 August, or a total of 50bps this year, the BoT is likely to maintain the benchmark rate at 3.75% for the rest of the year. Against a backdrop of sustained dollar resurgence, Thailand's weaker growth outlook in 2H08, ongoing political uncertainty, and the risk of institutional unwinding of long positions in Thai assets, we are revising our THB forecast down to 34.50/USD in 3Q08 and 35.00/USD at end-4Q08.

Bank Indonesia has been one of the most aggressive Asian central banks in 2008, hiking its benchmark overnight rate by a total of 125bps to 9.25% by September. This was the fifth consecutive move since May when the government last hiked the domestic fuel prices, and probably the last rate hike for the current tightening cycle with at most another 25bps more next meeting. The monetary tightening was made on grounds of strong demand-side inflationary pressure even though pressures from high food and energy prices have eased. On the other hand, growth momentum in the country has remained robust in 2Q even as the external environment continued to deteriorate and the government hiked fuel prices by an average of 28.7% on 24 May. Consumption and fixed investment strengthened while exports stayed firm as commodities demand remained buoyant in the quarter.

Looking ahead, we expect Indonesia's inflation to peak in Dec at around 12.5%y/y compared with 11.85% in Aug. This is at the higher end of the BI's forecast range of 11.5-12.5%. Overall, Indonesia's inflation should average around 10.5% in 2008. The BI also said that it would "use all available monetary instruments to bring inflation down to 6.5%-7.5% by end-2009. In our view, the target is achievable if the recent ease in food and energy prices is sustainable.

The IDR was relatively stable in the last three weeks despite the broad USD strength, testament to strong domestic economy and active monetary policy to deal with high inflationary pressure. IDR fell below 9,200/USD but was still around 2% firmer compared to its value at the beginning of the year. Nonetheless, the risk is for IDR to weaken further in 4Q as the series of rate hikes and weaker global demand could start to have a more apparent impact on the domestic economy by then. We are now expecting the USD/IDR to end the year at around 9,300, up from 9,200 previously.

Malaysia's CPI accelerated to 27 year high of 8.5%y/y in July from 7.7% in June following the substantial increase in the electricity tariff in the month. This was significantly higher than 7.8% that market was predicting. However, the announced cut in the administered gasoline prices by around MYR0.15 to MYR2.55 per liter effective 23 Aug, equivalent to reversing 19.2% of the price hike in June will help to stabilise the inflation rate in Aug and Sep. Diesel prices was also be cut by MYR0.08 to MYR2.50 per liter. As a result of the change in fuel prices, the inflation rate should revert to around 7.5%-8.0%y/y in Aug, with our full-year inflation forecast of 5.7% remaining intact. The government has revised its 2008 inflation forecast to 4.4% from 5.5-6.0% previously, indicating that it could be looking at the possibility of further fuel price adjustment as oil prices correct. Global crude oil prices have corrected as much as 25% since the peak of USD145.31pbl in July.

So far, Malaysia is the only major central bank in Asia which has not tightened monetary policy despite the surge in domestic inflation which was exacerbated by the fuel price hike in June. With the country reversing some of the fuel price hike, it is even more unlikely of any hike in interest rates in coming months. We now expect the BNM to maintain its OPR at 3.50% for the rest of the year and in 2009 as well, baring any sharp surge in oil prices next year. In general, Asian central banks have turned more cautious in tightening monetary policy as export and growth slowdown becomes more evident.

USD/MYR has risen in line with broadly firmer greenback. Going forward, the MYR is likely to remain under pressure from the economic and political risk and Bank Negara's stand to keep interest rates steady. We now expect MYR to end the year at 3.42/USD, 3.3% depreciation since end-2007. While USD/MYR is likely to be biased higher in 1H09, we expect the pair to end year 2009 at 3.36 as a result of some monetary easing in the US.

South Korea's inflation came in at a weaker-than-expected 5.6%y/y in August against consensus expectation of 6.2%. While the sharp weakening in the KRW and anticipated increase in utility charges should continue to put upward pressure on prices in coming months, we expect that the inflation has already peaked at 5.9% in July. Nonetheless, we expect the monthly inflation rate to stay above 5% for the rest of the year. We are maintaining our full-year inflation forecast at 4.9% with inflation in the first eight months averaging 4.7%y/y. The inflation rate will likely remain above the BoK's target of 2.5%-3.5% until 2H09.

In terms of the monetary policy, with economic growth clearly on a moderating trend, we do not expect the BoK to raise interest rates further for the rest of the year. The BoK has hiked its benchmark base rate by 25bps to 5.25% in August for the first time in a year. Going forward, there is also a possibility of a rate cut in 2H09 in response to the global uncertainties.

The KRW has weakened sharply against the USD in August. Besides the stronger USD, there were concerns over the economic slowdown in South Korea and the large KRW19 tn worth of treasury bonds maturing in early September. The country's foreign reserves dropped US$21 bn since March, partly due to the FX intervention. Although the authorities have vowed to continue intervening in the FX market to prevent excessive volatility in the KRW, the weak sentiment towards the currency will likely remain until we see improvement in the current account and easing in foreigners' net sales at the local equity market. We have revised our year-end USD/KRW forecast lower to 1,100 from 1,000 previously.

China's inflationary pressures have eased significantly since headline CPI hitting a peak of 8.5%y/y in Apr. For the first 7 months of the year, headline inflation rate is down to 7.7% from peak of 8.2% in the Jan-Apr period. This is partly due to the easing of global commodities prices in recent months, as well as increased food supply domestically. Nevertheless, for the full year of 2008, China's inflation rate would still hover around 6% or so, which is well above official target of 4.8%.

With consumer prices a relatively lesser threat, policymakers are turning their attention to downside risk of growth, as local exporters are buffeted by external demand, fallout from the US credit crisis, a stronger RMB, as well as domestic factors such as tight credit conditions, changes in labour laws, removal of exports incentives, and tighter environmental/land use regulations. There have been reports of failures of exporters in China's coastal regions and cities and these have alarmed policymakers enough to see top leaders embarking on an inspection tour in late June/early July. As a result, newsflows out of China in recent months have been dominated by talks of relaxation of the current tight monetary policy and on implementation of fiscal stimulus measures. The forex market has also reflected such a shift away from hawkish sentiment, with the RMB stagnating against the USD since beginning of July. These would mean that policy tools such as reserve requirement ratio and credit growth limits could be reversed in by end-2008. On the RMB front, we have revised down our RMB call to 6.70/USD for end-2008 from 6.60 earlier and for 6.37 at end-2009. On the fiscal policy front, there is also a likelihood that some stimulus measures may be announced over the next few months, with market speculating on changes in the tax system and increased infrastructure investment.