EYE ON ASIAN ECONOMIES

ASIAN ECONOMICS RESEARCH

CLSA

ASIA-PACIFIC MARKETS

1Q12

December 2011

Kicking the can down the road

Prepared for: ThomsonReuters

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Kicking the can...

...down the road

"Recession" is one of those words where everyone knows the approximate meaning but opinions on the precise definition differ. In 1975 Julius Shiskin suggested several rules of thumb, including "two down consecutive quarters of GDP". The other benchmarks he suggested have been forgotten but recession as "two consecutive quarters of negative growth" is about as general a definition as economics offers.

But while this is adequate as a description it does not help with analysis. CLSA economists have always tried to put economic growth into an explicit cyclical framework. In this, recession is the period in which the imbalances built up during the boom - typically excessive leverage and an overbuild of physical capital - are corrected. Slow or negative growth and rising unemployment are consequences of this process not causes. But for most politicians they are the most important thing. And they are to be avoided. Post war economic history has (mostly, Reagan and Thatcher have to be considered exceptions) been one of politicians attempting to minimise recessions without appreciating the essential, cathartic, process of clearing the previous boom's excesses they really represent.

So politicians don't like recessions. Neither, in the last fifteen years have central bankers. This has proven a bigger problem. The flexibility inherent in fractional reserve banking systems requires careful management. Even in commodity money systems credit and money can be created by banks to multiply the value of claims on assets beyond the value of the gold in the central bank's vaults. Financial engineering and its complicated derivatives and structures boost this process but are not qualitatively different from it. What has been different is the willingness of central banks to step in to try to prevent asset prices from deflating.

NEITHER A BORROWER…

The Global Financial Crisis represented a recession that was absolutely typical in all respects except one: scale. This had its beginnings in the behaviour of the Greenspan Fed trying to minimise the impact of the bust that followed the dot.com boom. The Fed in 2000-2004 went to, then, unprecedented steps to try and stop asset prices from falling. It did so at a time when financial engineers were particularly confident in their belief that they had quantified and, therefore, tamed risk. This combination elevated the size of the subsequent boom so that the overinvestment that it financed - focussed in residential and commercial real estate - became large enough to represent a systemic risk to the US economy. Separately monetary union in Europe gave economies previously corralled within relatively small national bond markets access to a continental scale funding

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source. Relaxed of discipline, cross border imbalances surged. Fuelled by faith in the euro currency, Europe too had a super-sized credit cycle of sufficient scale to create a systemic problem.

…Nor a lender be

The elevated US and European credit cycles occurred at a time when China was increasing its integration into the world economy and, through restructuring of its SOEs, redeploying resources on an immense scale. It was not alone. The Asian crisis had depreciated exchange rates and squeezed domestic demand across the region. Asian and Chinese exports and current account surpluses rose providing the elastic supply of goods needed to keep western price inflation low and the financing needed to keep western investment booms running.

Super boom to super stimulus

More than two years on from the end of the super boom that occurred in the 2000s the global economy remains dominated by the correction process. The world was spared the short, sharp, shock that would have happened if asset bubbles (which had taken years to build) had simply been allowed to burst. Instead governments stepped in with supersized fiscal stimuli. Monetary policy was taken to new extremes of easiness and each and every attempt was made to reduce the perception of risk. It worked. The global economy was spared the super recession that would have been the mirror of the super boom. At least for the moment. Because by preventing crises politicians and central bankers lay themselves open to the argument that they have simply postponed the true correction, prevented markets from clearing and laid leverage on top of leverage.

Kicking the can down the road

This is the global environment in which Asia in 2012 finds itself. We use the first *Eye on Asian Economies* of the New Year to outline which factors will drive Asian growth in the coming twelve months. We have titled this report **Kicking the can down the road** because, even more than in 2008, Asia's outlook will be determined by the efforts of policymakers to prevent the adverse effects of deleveraging.

Postponed reorientation, grandfathered loans

China's policymakers will ease credit and encourage an increase in investment to compensate for the weakness of external demand. Currency appreciation will be suspended. In so doing China will be postponing the reorientation that it claims is necessary for its economy and grandfathering loans made during the 2009 stimulus in order to expand credit again. It will work but at the end of the process China bears will have even higher levels of whole-economy leverage to worry about than they do today.

Fighting constitutional limits

In Europe constitutional limits on the central bank mean that, for much of 2012, kicking the can down the road will not be an option. While, in theory, this will correct imbalances more quickly, in practice it will generate intense risk. Europe is caught in a vicious circle where high risk generates high yields which make deleveraging harder thereby perpetuating high risk. This is an occasion when kicking the can - giving policymakers some space to undertake deleveraging - is a better option. We expect that the ECB will eventually recognise this but it will take deflation in Europe to do it.

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HAVING KICKED THE CAN ONCE, KICK IT AGAIN

First, though, we look at the US. Having acted aggressively to mitigate the effects of a disorderly unwind of leverage the US now finds itself with a significantly better growth outlook for 2012 than Europe. But "better" in this case does not mean "good". Supporting markets has prevented them from clearing. More than two years after the unexpected bankruptcy of Lehman Brothers the US still has more than 8½% unemployment and will see growth in 1H12 back below one per cent. But the US has one critical advantage for its 2012 outlook. Its private sector has substantially degeared. Its government needs to do so but, unlike Europe, can choose when. Having kicked the can down the road in 2008, 2009 and 2010 the US government is likely to kick it further in 2012. At some point it will have to face up to its fiscal problems, but, not just yet… And this should allow its deconstructed business cycle time to accelerate GDP growth again in 2H12 and 2013.

USA: DECONSTRUCTED CAPEX

We laid out our expectations for US growth in the 2Q10 *Eye on Asian Economies*: **Fibrillation USA**. That model is still working well and forms the core of our forecast for the US in 2012 and 2013.

FIBRILLATION USA IS STILL A VALID MODEL

Fibrillation USA argued that recoveries which occurred against a background of aggressive private-sector deleveraging lacked the breadth of investment growth that is essential to impart stress resilience and (therefore) longevity to the business cycle. Specifically we were worried that US growth would stall in mid-2011 because investment had been concentrated in a replacement cycle for corporate PCs and software and this replacement cycle would complete (having started in 2H2009) after eight or nine quarters. Excess capacity in, and the leverage overhang from, residential and non-residential real estate would preclude these sectors taking over as equipment and software spending slowed leaving the US, on our March 2010 forecast, approaching recession levels of growth by end-2011.

ONLY TIMELINE REFINEMENTS NEEDED

This roadmap remains valid for analysing the US. However, the detail has been a little different from the timeline described above. Figure 1 shows the quarter on quarter change in the three components of US fixed capital formation. Equipment and software spending is emphasised (in the bars). Measured in QoQ growth rates investment peaked in mid-2010 and was declining steadily to 2Q11. Third quarter equipment and software spending however was a robust 15.6% QoQ saar as investment spending was front loaded to exploit the increased depreciation allowances in the Tax Relief, Unemployment Reauthorisation and Job Creation act.

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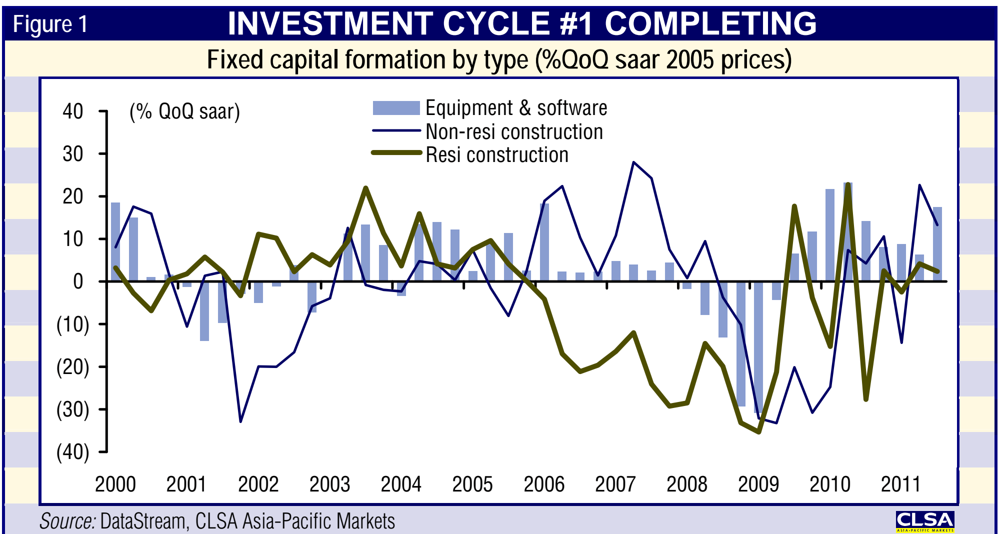
US INVESTMENT CYCLE #1

Figure 1 **INVESTMENT CYCLE #1 COMPLETING**

Fixed capital formation by type (%QoQ saar 2005 prices)



Source: DataStream, CLSA Asia-Pacific Markets

THERE WILL BE A HOLE IN INVESTMENT SPENDING IN 1H12

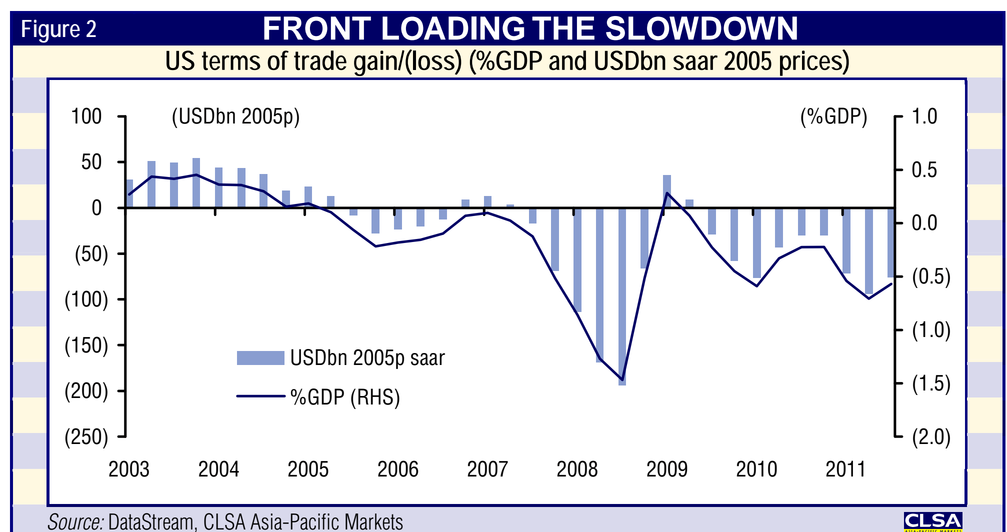
The depreciation allowances are reduced from 1 January 2012 and 4Q11 business spending on equipment and software should be elevated for the same reason: exploiting tax reliefs while they last. However such frontloading will also have a visible impact in 2012. We expect equipment and software spending to dip negative in 1H12 as the expenditures of 3Q and 4Q11 are paid back.

Early cycle GDP growth is dominated by fluctuations in investment spending (this is why the narrowness of the investment cycle is such an important factor in **Fibrillation USA**). Ordinarily we would expect GDP growth to shadow the profile of the dominant investment cycle. In this case, equipment and software spending. However, as Figure 2 shows, the terms of trade moved sharply against the US in the first and second quarters as QE2 inflated USD commodity prices. This squeezed household spending and "front loaded" the slowdown in GDP. The stronger 3Q11 numbers (and we would expect 4Q to be even stronger) reflect these terms of trade effects reversing as well as the last gasp of the equipment and software replacement cycle.

TERMS OF TRADE LOSSES WERE SUBSTANTIAL IN 1H11

Figure 2 **FRONT LOADING THE SLOWDOWN**

US terms of trade gain/(loss) (%GDP and USDbn saar 2005 prices)



Source: DataStream, CLSA Asia-Pacific Markets

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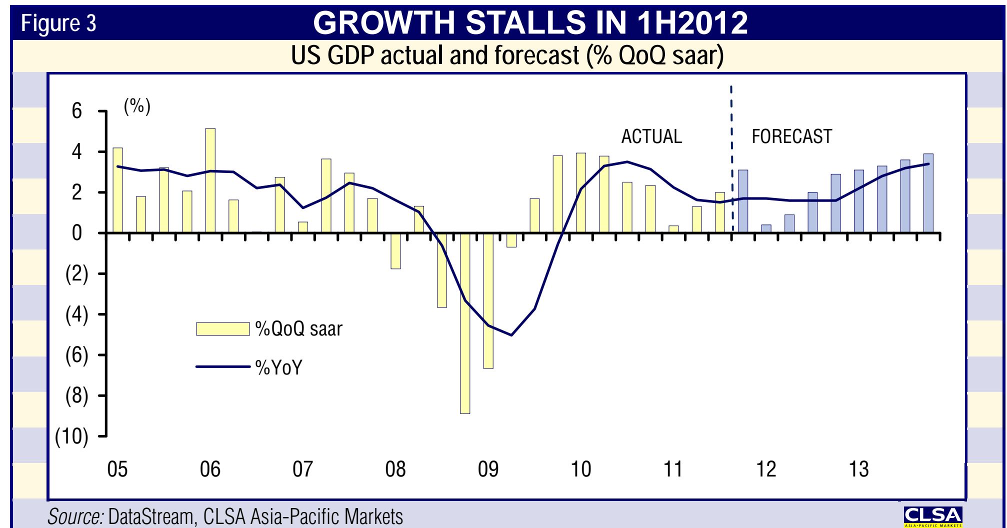
The "hole" left in spending by the accelerated replacement in 3Q and 4Q11 dominates our 2012 forecast. We expect a QoQ contraction in equipment and software spending in 1Q12. This will appear in significantly weaker economic growth. Figure 3 shows our forecast quarter-on-quarter profile; growth troughs in the first quarter below 0.5% QoQ saar. With real world data volatility negative growth at the start of 2012 is a real possibility.

Growth dip in 1H2012

Figure 3 **GROWTH STALLS IN 1H2012**

US GDP actual and forecast (% QoQ saar)



Source: DataStream, CLSA Asia-Pacific Markets

Figure 3 also shows that we expect growth to accelerate in 2H2012. This also is in line with the roadmap we laid out in **Fibrillation USA**. An investment cycle that occurs against a background of deleveraging is unlikely to persist for long. As it rolls over growth will slow sharply because, early in the cycle, other expenditure drivers remain weak. But the early end to the upswing means that the US has had no time to build new financial and physical imbalances.

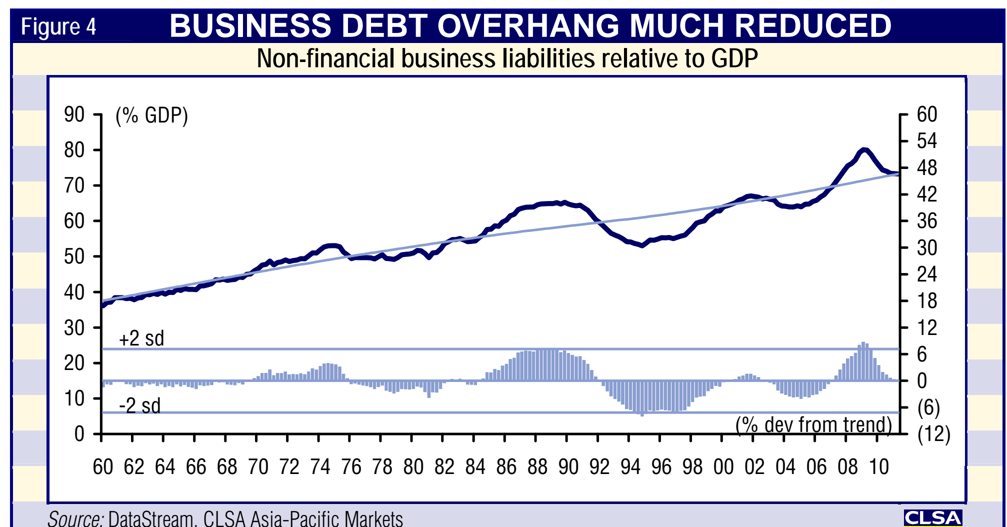
Deleveraging is doing its work

US private sector balance sheets have been steadily improving since mid-2009. Figure 4 shows our visualisation of the credit cycle in non-financial businesses. After peaking at more than two standard deviations above trend the debt overhang has now been eroded. This is not to say deleveraging stops but the worst of the balance sheet adjustment is over.

Credit relative to trend for businesses

Figure 4 **BUSINESS DEBT OVERHANG MUCH REDUCED**

Non-financial business liabilities relative to GDP



Source: DataStream, CLSA Asia-Pacific Markets

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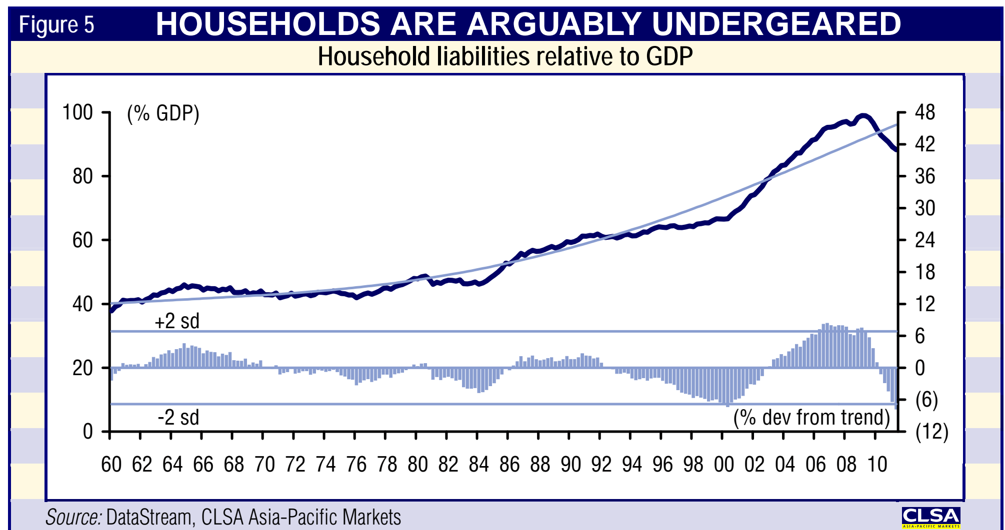
Figure 5 repeats the analysis for households. The pace of degearing here has been much more aggressive and remains ongoing. While consumer credit has started to increase again, including mortgages US households are still shedding leverage.

Credit relative to trend for households



However this process has resulted in a substantial improvement in household balance sheets. Indeed on the "credit relative" chart shown in Figure 5 the household sector now appears under geared and, on historical precedent, may be approaching a period of releveraging.

Upswing waiting to happen

A fibrillating economy might have short lived upswings but with no new physical or financial imbalances it is also an upswing "waiting to happen". "All" that is required is a new investment cycle to take over from the one that has just completed.

"All" in this case is in inverted commas with good reason. A particular problem for the US is that the capital assets that were overbuilt in during the boom, commercial and residential real estate, are long lived and slow to depreciate. This has left gaps between investment cycles in the three separate components of gross fixed capital formation: equipment and software, commercial real estate and residential real estate. In the gaps risk aversion can rise and the economy can stall. In a more normal US cycle, in which the leverage and the overbuild were less extreme, the investment cycles would be more contiguous, merging into one broader, more robust and ultimately longer whole. In mimicry of fashionable restaurants we describe our Fibrillation USA forecast as a deconstructed investment cycle. All the parts are there but smeared out over time so that mutual reinforcement does not happen.

Physical imbalances are correcting slowly. However, in time they will. We looked in some detail at the US residential property market in *Triple-A* on 23 November: **US housing – Recovery? Not yet**. As may be guessed from the title we came away unimpressed. From that report:

> *…while the stock of new homes is dwindling, the overhang in the market for existing homes is proving far more stubborn. Despite fairly significant improvement since mid-2011, the stock of unsold existing homes (in months' supply terms) is still higher than it was at the end of 2009.*

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PERCEIVED RISK OF BUYING PROPERTY REMAINS HIGH

Most critically perceptions about the risk attached to property purchase remains high:

> *Fannie Mae's monthly national housing survey for October showed respondents expect house prices to fall by 0.3% over the next twelve months, an improvement from the 1.1% YoY fall expected in September. Even with the improvement, however, while price expectations remain negative there is clearly little incentive for buyers to come to the market.*

This last point is critical and represents the cost attached to governments and central banks intervening to cushion the effects of deleveraging. Unless assets are allowed to find a true price buyers will not be willing to return to the market. Figure 5 suggests that the worst of the financial overhang for residential property has passed. The physical overhang is the limiting factor now.

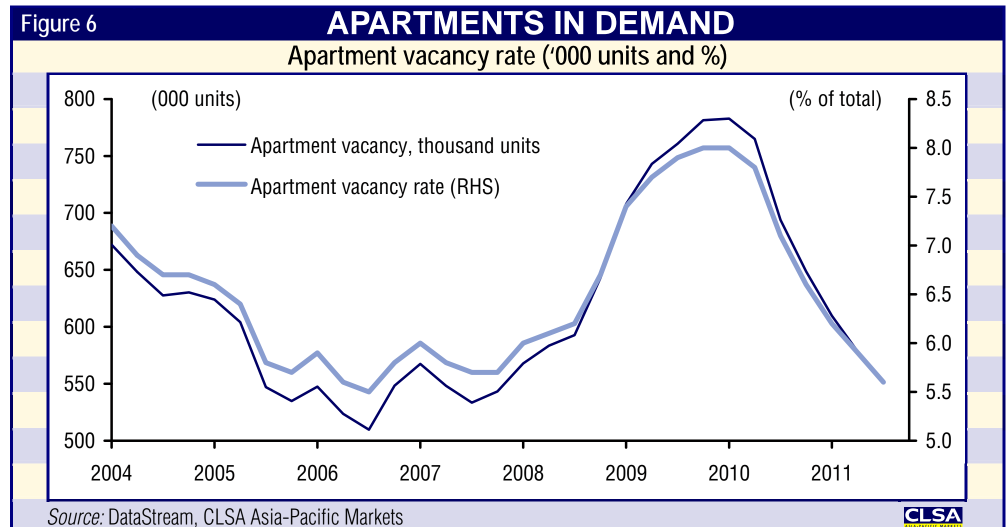
BUT AT SOME POINT PRICE EXPECTATIONS WILL BOTTOM

At some point price expectations will find a bottom and when this happens we would expect the demand for residential property to start to recover. Figure 5 shows that there will be no financial impediment for this and implies that a turnaround in US residential investment could be surprisingly powerful.

APARTMENTS

There is an additional dynamic. Historical trends suggest that commercial rather than residential real estate is closer to taking over from equipment and software spending (see again Figure 1 but this time focusing on the QoQ changes in residential and non-residential construction) and industry bodies are bullish. However the statistics show the most compelling part of commercial real estate is residential property to rent. As Figure 6 shows vacancy rates are approaching levels seen ahead of the cycle peak. Rents have been increasing.

VACANCY RATES ARE APPROACHING CYCLE LOWS



Source: DataStream, CLSA Asia-Pacific Markets

This is unsurprising. This sector has a far smaller physical overhang. The overinvestment that occurred in residential real estate in the 2000s was concentrated in single family homes only. Apartment construction did not explode and fell only in the Global Financial Crisis: Figure 7.

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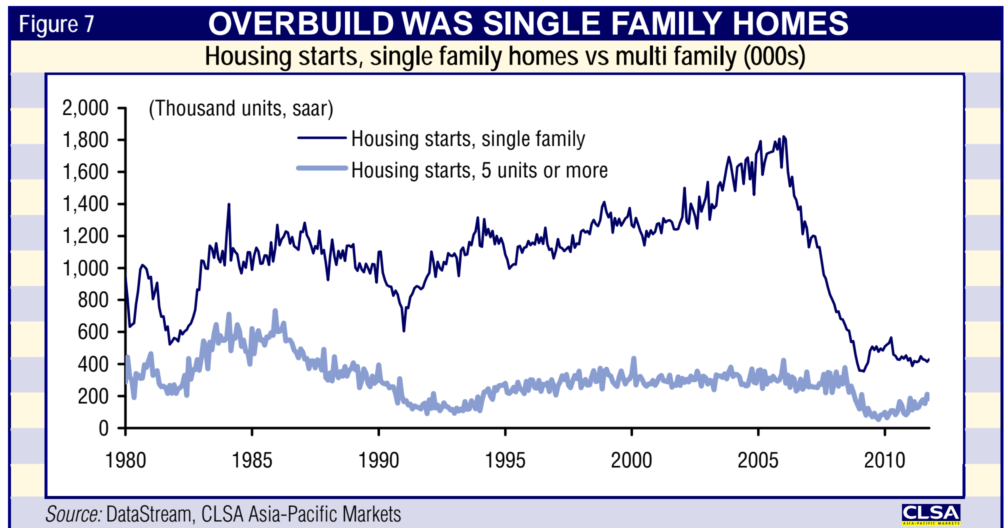
NO OVERBUILD IN MULTI-FAMILY UNITS

Figure 7 **OVERBUILD WAS SINGLE FAMILY HOMES**

Housing starts, single family homes vs multi family (000s)



Source: DataStream, CLSA Asia-Pacific Markets

Added to this is an increased preference for renting as a way of avoiding exposure to the negative price expectations referred to above. These shifting preferences amount to an accelerated depreciation mechanism (beyond wear and tear and demographic trends) in the sector that had the smallest overbuild to start with.

A SECOND HALF UPSWING

The historical trends towards improvement in non-residential construction combined with the tightness of the rental market, the recovery already seen in apartment construction (which is roughly 20% of property starts) and the extent of improvement in household and corporate balance sheets justifies an expectation that the next US investment cycle will start to form before the end of our forecast horizon. We have tentatively included it in our forecasts starting in the second half of 2012 and continuing through 2013. Growth will accelerate on the back of this, exceeding 2% QoQ saar for the first time in a year in 3Q12. Full year 2012 growth will, on our estimation, be around 1.6%. We have pencilled in a figure of close to 3% GDP growth for 2013.

The exception to the delevered rule: the US government

INCREASING FEDERAL LEVERAGE

The reducing pressure for deleveraging on US private sector balance sheets is a key part of this forecast. We cannot, however, be so optimistic about the state of US public finances. As Figure 8 makes clear there has been an immense increase in leverage at the US government level at the same time that the private sector has been degearing (with the explosion in US government debt occurring entirely at the Federal level).

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FEDERAL DEBT HAS RISEN BY NEARLY USD5TN SINCE 2008

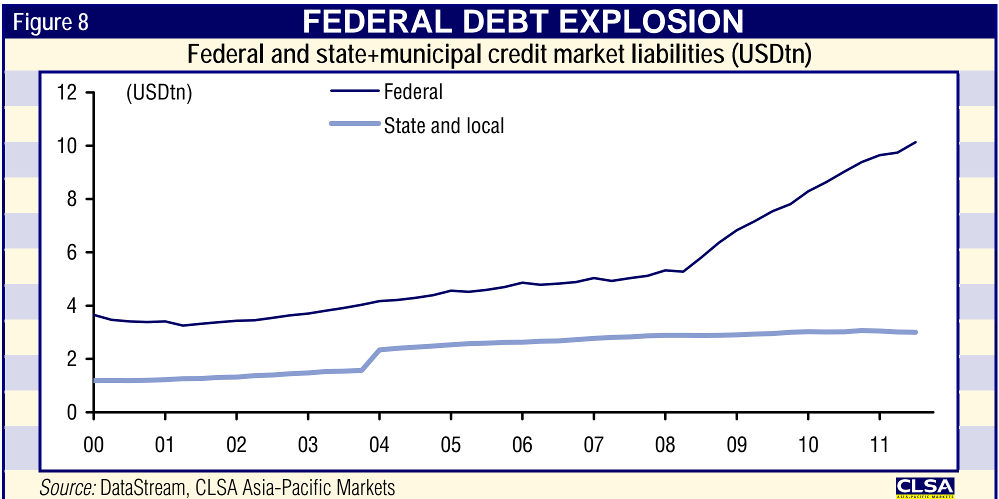

Figure 8 **FEDERAL DEBT EXPLOSION**

Federal and state+municipal credit market liabilities (USDtn)

Source: DataStream, CLSA Asia-Pacific Markets

Using the Fed's flow of funds data shows the US Federal government owes (at end-2Q11) USD11.37tn, with USD4.44tn of this owing to foreign (private and official) investors. Of the USD6.9tn domestically held Federal liabilities, USD1.62tn is held by the US Federal Reserve and a further USD484bn is held by other government agencies. These arguably "cancel out" but this is still an awful lot of debt. Compared with 2007 US Federal government liabilities have increased by USD4.83tn (USD2.1tn to foreigners and USD2.7tn domestic). This represents an almighty can being given an almighty kick down what the US administration can only hope is a very long road.

One casualty of a fibrillating business cycle is that politicians cannot rely on nominal GDP growth to boost tax revenues and deflate debt relative to GDP. In nominal level terms our growth forecast is close to those of the Congressional Budget Office for the coming two years. Further out though the CBO's nominal growth assumptions look decidedly optimistic. But even on these figures, the US national debt in five years is equal as a proportion of GDP to its estimate for end-2011: Figure 9.

DEBT IN 2016 IS VIRTUALLY UNCHANGED FROM WHERE IT IS TODAY

Figure 9 **NO FEDERAL DEGEARING**

Congressional Budget Office federal budget projections

% GDP unless stated	2010a	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenues	14.9	15.3	16.8	19.0	20.2	20.2	20.1	20.4	20.5	20.6	20.7	20.9
of which: income taxes	6.2	7.2	7.7	9.3	9.8	10.2	10.4	10.6	10.8	10.9	11.1	11.2
Outlays	23.8	23.8	23.0	22.8	22.4	22.0	22.2	22.2	22.1	22.4	22.6	22.7
of which: spending	22.5	22.4	21.5	21.2	20.7	20.1	20.1	19.8	19.5	19.7	19.8	19.9
of which: net interest	1.4	1.5	1.5	1.6	1.7	1.9	2.1	2.4	2.6	2.7	2.8	2.8
Deficit(-)/Surplus(+) ex BCA2011 provisions(1)	(8.9)	(8.5)	(6.2)	(3.9)	(2.2)	(1.8)	(2.1)	(1.8)	(1.7)	(1.8)	(1.9)	(1.8)
Budget Control Act 2011 provisions(1)	0.0	0.0	0.0	0.7	0.7	0.6	0.6	0.7	0.7	0.7	0.7	0.7
Total deficit(-) /surplus(+)(1)	**(8.9)**	**(8.5)**	**(6.2)**	**(3.2)**	**(1.6)**	**(1.1)**	**(1.5)**	**(1.2)**	**(1.0)**	**(1.2)**	**(1.2)**	**(1.2)**
Debt held by public (y/e)	**62.1**	**67.3**	**71.2**	**72.8**	**71.6**	**68.7**	**67.2**	**65.8**	**64.3**	**63.1**	**62.0**	**61.0**
Memo: CBO GDP USDbn	14,512	15,095	15,663	16,182	16,974	18,132	19,110	20,028	20,948	21,901	22,856	23,830
Memo: CBO GDP %YoY	4.2	4.0	3.8	3.3	4.9	6.8	5.4	4.8	4.6	4.6	4.4	4.3
Memo: CLSA GDP USDbn	14,512	15,150	15,559	16,260	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Memo: CLSA GDP %YoY	4.2	4.4	2.7	4.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Note: (1) The Budget Control Act of 2011 (Public Law 112-25) created the Joint Select Committee on Deficit Reduction to propose further deficit reduction totalling at least $1.5 trillion over 10 years. The act also specified automatic procedures for reducing spending by as much as $1.2 trillion if legislation originating with the new deficit reduction committee does not achieve savings of at least $1.2 trillion. CBO has incorporated that amount of deficit reduction (which includes savings in debt-service costs) in its baseline but has no basis for allocating that amount between revenues and outlays. Policy changes were allocated evenly across the 2013–2021 period; the incremental increase in the annual effects results from the compounding of debt-service savings.

Source: Congressional Budget Office, CLSA Asia-Pacific Markets

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Despite assumed tax increases

Even worse the CBO projections assume, as is currently on the statute books, that the Bush era tax cuts expire at the end of 2012. It is for this reason that income tax receipts as a proportion of GDP rise in the CBO numbers from 7.7% estimated in 2012 to 9.3% in 2013.

Even with a second half upturn we would be surprised to see this aggressive a tightening being allowed to happen. Fibrillating business cycles lack stress resilience and even though expiry of the Bush tax cuts would impact household rather than corporate disposable income, a 2.5% of GDP fiscal tightening might well be sufficient to reverse the investment cycle that is driving 2013 growth. The US therefore faces a dilemma - weaker growth or worse government indebtedness.

We suspect that the US will choose worse government indebtedness, because it can. There is nothing in the behaviour that we observe of either current US Treasury yields or the dollar that suggests we should assume financial markets force deleveraging on the US government. Our forecasts, which see the dollar outperforming the euro and yields only rising when it is clear that US growth is accelerating again (see pp33-36), reveal that we expect this absence of market pressure to continue for the next two years. This can will continue to be kicked down the road. The weakness of the US budget position will greatly limit the ability of government to respond to any future weak growth period (including the weak patch we expect of 1H12) but it will not force crisis.

QE1, QE2...

QE, too much or not enough?

The final comment on the US outlook for 2012 and 2013 concerns monetary policy. Ultra aggressive central bank action was a key way in which the US tried to counter deflation risk in 2008 and 2009. Fibrillation shows the policy to have been only partially successful, but does this mean that it won't be tried again or merely that previous attempts were insufficient?

In the absence of negative consequences, not enough

Ben Bernanke is an even more aggressive can kicker than Alan Greenspan so we think the second. We have long had a third bout of US quantitative easing as our central case and with growth expected to slow in 1H2012 we retain this forecast. Inflation expectations are also critical. As Figure 10 shows they are declining. They are not yet back to the levels which prevailed ahead of QE2; but we would argue that for a central bank tasked with raising medium-term inflation expectations they should not be allowed to fall to this level. The need to keep large amounts of USD liquidity to guard against a Eurozone bank crisis also argues for QE3 and it is worth noting that, though the FOMC statement in December disappointed the market, it did signal heightened concern about "global" growth. We expect a third bout of quantitative easing, most likely introduced at either the March or April FOMC meetings, and lasting around six months.

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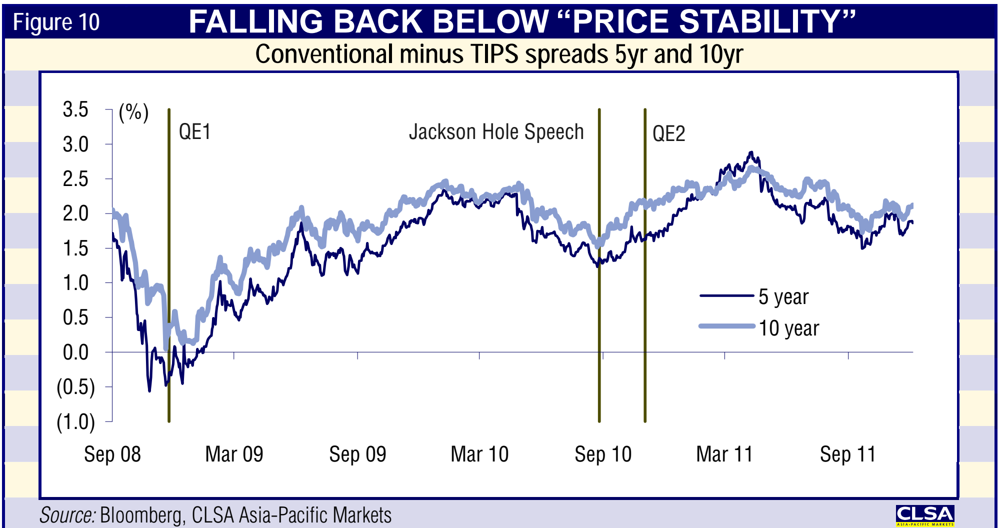
PRICE EXPECTATIONS ARE EASING

Figure 10 **FALLING BACK BELOW "PRICE STABILITY"**

Conventional minus TIPS spreads 5yr and 10yr



Source: Bloomberg, CLSA Asia-Pacific Markets

LOSE-LOSE FOR THE EUR

The currency implications of this are a function of actions taken by other central banks, most notably that of the ECB, as much as the Fed. In 1H12 the absence of quantitative easing by the ECB is likely to create a period of persistent risk aversion frustrating the effects of QE3 in weakening the dollar. In the second half, markets may feel better about the world but will be looking forward to QE3 coming to an end. At this point, finally, we expect the deflation in the Eurozone to overcome the ECB's reticence about Euro quantitative easing. Risk may start to come back "on" but the USD in 2H12 will look a much more attractive asset than the EUR on fundamentals, irrespective of its safe haven status.

There is thus no reason to expect that the currency implications of QE3 will be the same as for QE2. On the contrary we would advise investors to be long dollars over euro in 2012 as the US recovery we expect for 2H12 will not be matched by any pickup in European growth.

NO DEBASEMENT OF THE NUMERAIRE

In a world which measures commodity prices in US dollar terms this suggests limited commodity price inflation. With the US weak in the first half, Europe on the edge of contraction and doubts over emerging market growth there is little reason to expect commodity prices to rise beyond the debasement of the numeraire. If there is a spike higher in commodity prices it will therefore be early in the year and concentrated in those commodities where futures trading, rather than contract or spot pricing, determines price.

IT'S HARDER THAN IT LOOKS TO GENERATE NOMINAL GROWTH

This means limited CPI inflation. In fact US experience with QE suggests that while it is a key part of "can kicking" by keeping markets liquid and suppressing nominal yields it is much less efficient at generating nominal growth. This is something that Europe will find to its cost in the coming years.

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EUROPE: CAN KICKER STILL NEEDED

THE FISCAL COMPACT

As this *Viewpoint* is being written the ink is drying on the statement from euro area heads of state which announced a fiscal compact consisting of a "debt brake" under which structural deficits will have to be contained to less than 0.5% of GDP and sanctions will be imposed if total deficits exceed 3% of GDP. True there are still problems in how the agreement will be enforced or even whether it can be adopted by all Euro member states (Russell Napier is adamant that it cannot). It is impossible to say how quickly real world economic pressures will chip away at its fiscal restrictions. Nonetheless the progress made by EU leaders should not be underestimated. The fiscal compact with all its faults:

- Reveals a pragmatism and a willingness to compromise that has been absent from much of the earlier brinkmanship-riddled negotiations.
- Incorporates the IMF to bring some international credibility and potential non-EU partners (though the amount, at EUR150bn is small in relation to EU governments' financing needs).
- Marks a genuine attempt to reduce Eurozone member's fiscal autonomy.

More than this it represents a rare occasion when elected governments choose to confront problems rather than attempt to delay the day of reckoning.

NOT SUFFICIENT

What the fiscal compact is not, is sufficient.

2 PROBLEMS, DEAL WITH TODAY'S MESS AND STOP ANOTHER ONE

Europe has two problems to deal with. First, it has to deal with the mess that it is in today. Second it has to prevent a repeat. These issues while closely linked, ultimately, are separate. The fiscal compact addresses the second (in theory at least). But even assuming it works, it does not address the first. It is not enough to convince markets that fiscal autonomy has been taken away such that the mistakes of the last ten years could not be repeated. Investors still need to be convinced that the periphery's *current liabilities* will be honoured.

INCREASED IMBALANCES BY DESIGN

The mess that Europe is in today reflects two issues. First, the imbalances that built following monetary union are large and pervasive. Figure 11 shows current account surpluses and deficits which, in the discipline-less environment that the single currency represented, exploded until the Global Financial Crisis. This represents a systemic deterioration in the savings-investment balances of 60% of the post monetary union economy: between 1999 and 2007 current account balances worsened in every large Eurozone member apart from Austria, Italy and Germany.

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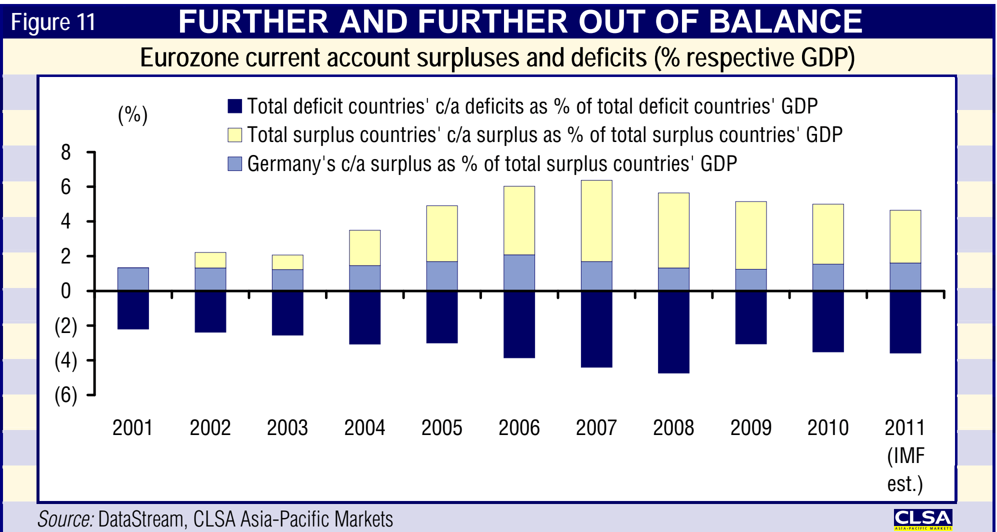
Increased savings shortfalls for 60% of the Eurozone

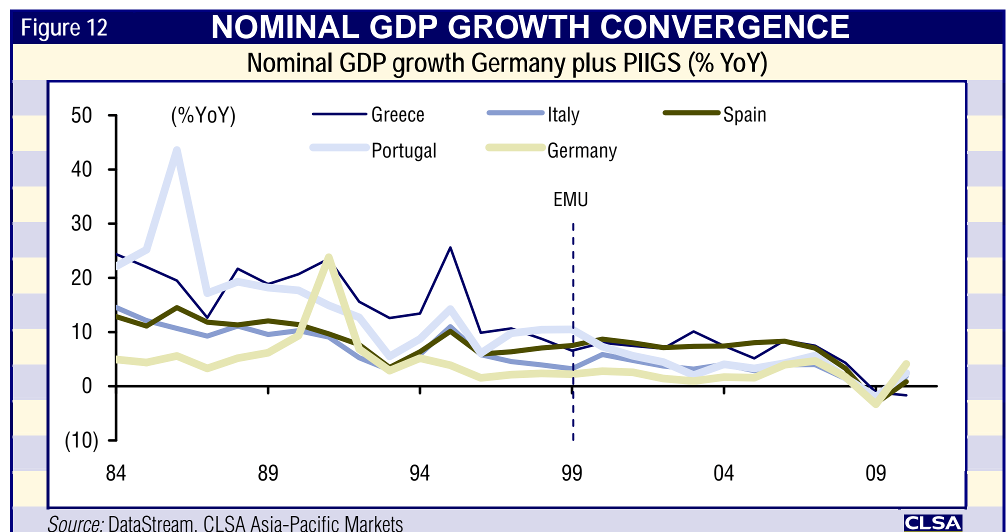


Further, this deterioration was *by design*. EMU was a culmination of greater and greater integration of the European Union capital and goods markets with the intention of promoting intra-EU investment and goods flows. In the introduction we described the role that the "vendor financing" arrangement between the US and China played in extending the US credit cycle, ultimately making the correction worse. The widening of intra-Eurozone cross border imbalances was of similar scale (current account deficits relative to GDP doubled) but was held together by financial markets' faith in a political commitment rather than the US dollar's status as a reserve currency.

The Maastricht criteria were watered down for political reasons

Second, Europe is now paying the price for decisions made by politicians in the run up to EMU. The fiscal criteria for inclusion in the single currency were compromised in order to have the project start on time with the desired quorum of countries. Most importantly the requirement that government debt levels not exceed 60% of GDP was not enforced. But monetary union has caused nominal growth rates across the Eurozone to converge on those of the low inflation and low leverage core (Figure 12). So doing it has depressed affordable bond yields for indebted economies and made the system vulnerable to any rise in risk spreads.

High nominal growth countries were turned into low



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IT'S NOT JUST THAT INSTITUTIONS ARE DIFFERENT

Europe needs more than political commitment

It is the job of the fiscal compact to start to restore market faith in the viability of the Eurozone as a currency area. But financial markets will not return to believing that each Eurozone member is a close substitute for every other just because mechanisms are being created to prevent the imbalances repeating. This is because they are not. The fiscal compact might work if monetary union were only just starting, but it isn't. The fiscal compact can level the differences in the strength of institutions in each member state. But it will not make them close to equivalent credits.

FISCAL DYNAMICS ARE DIFFERENT

The imbalances shown in Figure 11 mean that irrespective of the differences in the strength of their institutions the risk of lending to EU members is dramatically different. The exceptions made to the Maastricht criteria mean that EMU started with each country having different fiscal dynamics. The lack of discipline in the first eight years of monetary union has increased the differences.

Figure 13 shows some summary statistics that frame the debt dynamics of the major Eurozone members. Current bond yields are shown as the mean of 2, 5 and 10 year bonds to approximate the government's average funding cost. Gross debt to GDP ratios are taken from European Commission estimates. 2011 nominal growth is shown but because one might argue that trend or sustainable growth is more relevant we have shown three averages. The whole period of monetary union (1 January 1999 to date), 1 January 1999 to 2007 to exclude the GFC (to represent the 'best case' scenario) and 2002 (postdating EMU to allow some of the convergence shown in Figure 12 to occur) to 2007.

HORRIBLE DEBT DYNAMICS

Figure 13 **DISPARATE FISCAL DYNAMICS**

Eurozone nominal growth rates, debt levels and bond yields

	Avg nominal GDP growth					
	2011[1]	1999-date	1999-2007	2002-2007	end 2011 Debt/GDP	Current bond yield[2]
Austria	5.1	3.6	4.1	4.4	72.2	2.2
Belgium	4.5	3.8	4.4	4.6	97.2	3.8
Finland	5.6	3.9	5.0	4.6	49.1	1.4
France	2.8	3.2	4.1	4.1	85.4	2.2
Germany	3.6	2.2	2.5	2.6	81.7	1.1
Greece	(4.2)	4.6	6.9	7.3	162.8	80.3
Ireland	0.1	5.3	10.2	7.7	108.1	8.7
Italy	1.9	2.9	4.0	3.6	120.5	6.4
Netherlands	3.2	4.1	5.3	4.2	64.2	1.4
Portugal	(0.5)	3.5	4.9	3.8	101.6	15.1
Spain	2.2	5.5	7.8	7.6	69.6	5.0

Notes: [1] Eurostat/EC estimates [2] average of 2, 5 and 10yr yields as at 14 Dec 2011
Source: EC, OECD, CLSA Asia-Pacific Markets

Figure 14 takes these numbers and plugs them into standard sustainable debt equations. If we assume no change in primary balance in 2012 compared with 2011 the gross government debt stock as a percentage of GDP will rise or (fall) by the first of the "change in debt levels" columns (so Austria's debt to GDP ratio would rise by 0.2ppts if its primary deficit in 2012 was the same as it was in 2011: 0.8% of GDP). Countries are already committed to fiscal tightening so the second

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"change in debt level" column assumes that the 2012 primary balance achieves the European Commission's forecast (for example Italy's primary surplus is forecast by the EC to rise to 3.1% of GDP. If this happens its debt level will still rise by 2.1ppts of GDP). The final "change in debt level" column shows what happens assuming a zero primary balance. For many countries this represents a sharp tightening of fiscal policy and in many it is still not sufficient to start to get debt levels down.

Struggling to live with current interest rates

Figure 14 **BEING PUSHED INTO PONZI-DOM**

Change in debt levels given current debt metrics and bond yields

	Primary surplus/(deficit)		Change in debt level (ppts of GDP)		
	2011 EC estimate	2012 EC forecast	No change in primary balance from 2011	EC 2012 primary balance forecast	Zero primary balance
Austria	(0.8)	(0.3)	0.2	(0.3)	(0.6)
Belgium	(0.3)	(1.3)	1.0	2.0	0.7
Finland	0.1	0.5	(1.4)	(1.8)	(1.3)
France	(3.2)	(2.5)	3.3	2.6	0.1
Germany	1.1	1.3	(2.0)	(2.2)	(0.9)
Greece[1]	(2.1)	1.0	n.a.	n.a.	n.a.
Ireland	(6.7)	(4.3)	14.0	11.6	7.3
Italy	0.9	3.1	4.3	2.1	5.2
Netherlands	(2.4)	(1.2)	1.7	0.5	(0.7)
Portugal	(1.6)	0.8	19.3	16.9	17.7
Spain	(4.5)	(3.5)	6.7	5.7	2.2

Note: [1] *Greek haircut prevents calculation*
Source: EC, OECD, CLSA Asia-Pacific Markets

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Trying to break out of Catch 22

High yields mean high risk justifying high yields

Europe's Catch 22 is that for many of its countries the debt dynamics are so malign that credit risk justifies yields being high. But high yields (combined with high indebtedness and low growth) are the main cause of the malign debt dynamics. This vicious circle has to be broken because we severely doubt that the Eurozone can get out of it any other way. All of the options hit problems.

Option 1: Socialising the problem

Eurobonds wouldn't be AAA rated

If markets now (correctly) differentiate between individual Eurozone credits the most logical solution is to socialise European debt issuance. This is what lies behind Chris Wood's calls for a complete fiscal union. The Eurozone need not go that far but the bottom line is that the core has to be willing to subsidise the periphery to a greater extent than it appears willing to. Specifically the AAA rated countries in Europe have to be willing to sacrifice their top notch credit rating.

The systemic problems that we describe above are too large for the Eurozone as a single debt issuer to be rated AAA. This is true whether fiscal integration occurs, with the European Union issuing bonds, or it happens via a transfer union with the tax receipts from the strong backstopping the weak. This is the implication of both Moody's and S&P having all Eurozone members, including the six AAA rated nations, under review for downgrade. But it was already implicit in bond market movements. Figure 15 shows the four "tranches" of Eurozone sovereign debt, from worst (Greece, Ireland and Portugal) to best (Germany). The progress of market pressure, starting with the lowest

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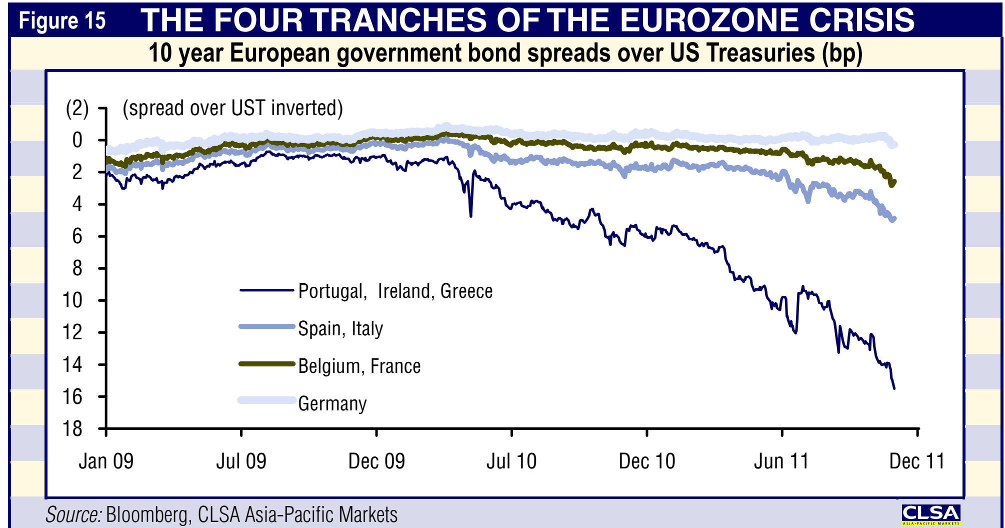
credit quality but eventually moving all the way up the credit curve, is similar to that of CDOs in the sub-prime crisis. It is illustrative of a financial market recognising that a problem believed initially to be isolated is, in fact, systemic.

MARKETS RECOGNISING A SYSTEMIC PROBLEM

Figure 15 **THE FOUR TRANCHES OF THE EUROZONE CRISIS**

10 year European government bond spreads over US Treasuries (bp)



Source: Bloomberg, CLSA Asia-Pacific Markets

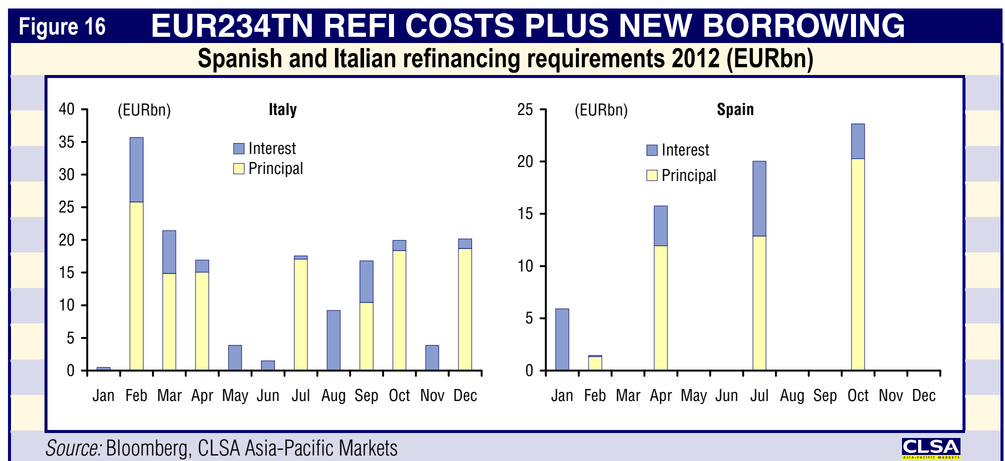
THE FISCAL COMPACT DOESN'T SUGGEST THAT GERMANY WOULD BE HAPPY LOSING A AAA RATING

In the Eurozone this boils down to the proposition that Germany needs to accept that it will lose its credit rating if it is to make Italian and Spanish bonds close substitutes for German ones. The fiscal compact suggests that appetite for this is limited. Fiscal transfers were limited in scope with the government guarantees that capitalise the EFSF and the ESM limited to EUR500bn. The EUR150bn provided to the IMF (down from a planned EUR200bn because of inadequate international participation) is new money (some of it may be printed), but is also limited given the scale of the problem. Figure 16 shows refinancing needs in 2012 for Italy and Spain. Add in their estimated fiscal deficits and they will need to raise EUR336bn in the next twelve months alone. The EFSF is likely also to have to finance a large portion of the recapitalisation of Europe's banks (whose capital needs have been estimated by the European Banking Association at EUR114.4bn). The fiscal compact gives European leaders the option of revisiting the size of the ESM in March 2012. However at its current size of EUR500bn it just doesn't look big enough.

ONLY DEEP POCKETS NEED APPLY

Figure 16 **EUR234TN REFI COSTS PLUS NEW BORROWING**

Spanish and Italian refinancing requirements 2012 (EURbn)



Source: Bloomberg, CLSA Asia-Pacific Markets

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GETTING DEBT DOWN BY AUSTERITY IS A SLOW PROCESS

Option 2: Austerity

Large backstops are needed because this is long haul problem. A glance back at the CBO projections we quoted for the US (Figure 9) is enough example. Despite fiscal tightening and high nominal growth assumptions US government debt will be unchanged from current levels (relative to GDP) in five years time. And Europe's fiscal arithmetic is much worse than that in the US.

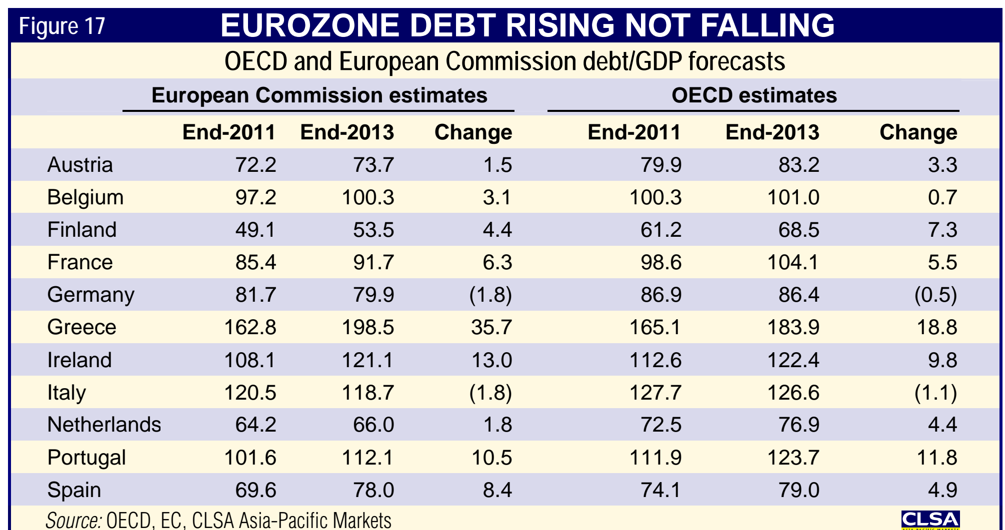
DEBT-DEFLATION

Eurozone members are already trying hard to improve their finances but against the numbers shown in Figures 13 and 14 it is an almost impossible task. While yields stay at their Catch 22 highs, it takes huge primary surpluses to make inroads into debt/GDP levels. But generating larger and larger primary surpluses is deflationary – as the negative GDP growth rates being recorded in the periphery of Europe demonstrate. This is turn makes degearing harder by pushing government cyclical balances into deficit. After re-reading Irving Fisher's paper on debt deflation (*Econometrica* 1933 **The debt-deflation theory of great depressions**) because of the sub-prime crisis it appears that it is Europe where it is most applicable.

Rolling the growth squeeze into sustainable debt equations makes them even less affordable. Without detailed fiscal models for each Eurozone country we cannot produce accurate forecasts of how quickly current austerity measures and the additional tightening in the fiscal compact will bring debt levels down, however OECD and EC forecasts suggest it will be an extraordinarily slow process. Figure 17 shows the OECD and the European Commission's latest estimates of government debt levels at end-2011 and end-2013. With both forecasts debt to GDP ratios are lower at end-2013 for only two countries: Germany and Italy. And in Italy's case the end-2013 estimates may be lower but they are still high enough to render the forecast acutely sensitive to rising bond yields.

ONLY GERMANY AND ITALY SEE THEIR DEBT LEVELS FALL IN THE NEXT TWO YEARS

Figure 17 **EUROZONE DEBT RISING NOT FALLING**



OECD and European Commission debt/GDP forecasts

	European Commission estimates			OECD estimates		
	End-2011	End-2013	Change	End-2011	End-2013	Change
Austria	72.2	73.7	1.5	79.9	83.2	3.3
Belgium	97.2	100.3	3.1	100.3	101.0	0.7
Finland	49.1	53.5	4.4	61.2	68.5	7.3
France	85.4	91.7	6.3	98.6	104.1	5.5
Germany	81.7	79.9	(1.8)	86.9	86.4	(0.5)
Greece	162.8	198.5	35.7	165.1	183.9	18.8
Ireland	108.1	121.1	13.0	112.6	122.4	9.8
Italy	120.5	118.7	(1.8)	127.7	126.6	(1.1)
Netherlands	64.2	66.0	1.8	72.5	76.9	4.4
Portugal	101.6	112.1	10.5	111.9	123.7	11.8
Spain	69.6	78.0	8.4	74.1	79.0	4.9

Source: OECD, EC, CLSA Asia-Pacific Markets

These numbers predate the debt brake proposals of the fiscal compact, so they are arguably too high, but they demonstrate the problem. Austerity may chip away at the problem, but much too slowly to be considered a way of short circuiting the Catch 22 of high yields, result in high default risk, results in high yields.

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Option 3: Euro-QE

Austerity needs to be given the space to work

The solution adopted in the US to avoid Fisher's debt deflation suggests the most viable option for Europe also. A solution needs to be found that gives Eurozone governments the "space" in which they can pursue austerity because at current interest rates and nominal growth rates they will never succeed in reducing indebtedness. From the perspective of global growth and asset prices Europe's sovereign debt crisis is a can that needs kicking down the road as far as possible.

The ECB can make the most difference

The most effective can kicker in any economy is its central bank. And, the ECB is the institution that can make the biggest difference to the outcome of the Eurozone crisis. In this respect its last words are disappointing; the ECB clearly feels that its hands are tied by Article 123 of its founding charter which prohibits the monetary financing of governments.

But is limited by its charter

This was clear in the press conference that followed the December ECB council meeting. However at that conference Draghi was also explicit on one additional point. The ECB does not yet see deflation as the dominant risk in the Eurozone economy. Draghi here was explicit: "at the present time we do not see a high probability of deflation". Adding: "That is one point to keep in mind".

The implication is that if the deflation risk rises the response will be forthcoming. This causes us to retain an expectation that the ECB will, at some point in the coming twelve months, start its own form of quantitative easing. Draghi's Q&A session did suggest that the ECB was open to increasing the scale of its purchases of debt in the secondary market so long as the bulk of this intervention was sterilised (he indicated that the ECB was "aware of the technical complexities that would arise with the SMP having an infinite size") and argued that "there may be technical aspects that sometimes do not ensure the complete sterilisation immediately". Occam's Razor suggests that the ECB will, in the end, start large scale purchases of government bonds because there is no other viable alternative.

Deflation risk will have to be obvious before Euro-QE

However it is clear that the hurdle rate is high. Deflation risk will have to become the central bank's primary concern for the ECB to begin to act - and it is not there yet despite it cutting its Eurozone growth forecast to encompass a contraction in 2012. This suggests that the ECB will be reactive not proactive. "Euro-QE" (it is unlikely ever to be called that name) is likely to take the form of a scaled up SMP purchase program, with no published yield target but rather a maximum weekly amount and duration. And it is likely only in 2H12. Market and economic turmoil is likely to be extreme for the next six months.

Boosting the denominator is as hard as cutting the numerator

Expanding the ECB's balance sheet has an additional advantage beyond the potential for unlimited scale and therefore actually making a difference to bond yields. With EMU having converged nominal growth across the Eurozone on the low inflation core, the adjustment process would be facilitated were inflation in the core higher.

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Creating inflation is tougher than it looks

Here Europe runs into two problems – one practical the other ideological. The practical issue is that the Fed's experience in QE1 and QE2 shows that, while monetary expansion can be an effective lever on asset prices, it appears much harder to encourage bank lending to the non-bank private sector. There is no reason to expect Europe to be more responsive to QE than was the US. On the contrary banks are being forced to increase their capitalisation and their preferred way of doing this is to be through shrinking their risk books. This is visible in Asia as tightening trade finance, but it means credit contraction in Europe.

And anyway would run into German opposition

The ideological issue is that which motivated the ECB Treaty writers to include Article 123 in the first place: Germany's legacy of hyperinflation. It is unrealistic to expect the ECB to pursue inflation with the same enthusiasm as the Fed. If the ECB were actually to succeed at pushing CPI inflation higher there is every chance that it would stop the policy in consequence.

Zero growth

Clearly this does not make for a bullish growth forecast for the Eurozone. As we argued in Triple-A on 30 November even an early monetisation of Eurozone debt would not remove the forced government deleveraging and the pressure on banks' cyclical balance sheets. Pushing the point at which the ECB acts aggressively back into the second half reinforces this negative outlook. We have cut our forecast for Eurozone growth for 2012 to zero.

And weak in 2013 also

This is in the bottom third of the ECB's central tendency forecast (which was reduced to -0.4% to +1% at the December ECB council meeting) and a little below the OECD's revised 2012 forecast (of 0.2%). We may be being too optimistic about 2012, but we have more issue with official forecasts for 2013. Both the ECB and the OECD expect 2013 to be materially better. While we might expect sentiment to improve consequent the ECB delivering, the imposed government deleveraging will be just as aggressive. 2013 will be a better year than 2012 but growth will still be anaemic. We are assuming around 1%.

Euro lose-lose

QE3 - risk off - sell euro on strength

The final comment concerns the euro. It will survive but not as a strong currency. The single currency is in a lose-lose situation. While US growth is weak and until the ECB has finally moved to QE financial markets will be "risk off". In this scenario the euro will be an unloved asset by virtue of sovereign debt risk. As we write above (p11) we have kept QE3 in our US forecast. But we do not expect it to usher in a period of significant dollar weakness. We have included a small euro "pop" in our forecast for end-1Q12 (to USD1.35/EUR1) but would advise investors to sell into it. Euro gains will prove temporary.

Euro-QE, stronger US, sell EUR on fundamentals

Looking into the second half, and assuming that the ECB starts to deliver, some of the sovereign risk issues surrounding the euro should start to ease. However by this stage our outlook sees the US economy looking better. On fundamentals the

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dollar will simply be a better looking currency and the Fed will be approaching the end of QE while the ECB is starting it. Our end-2012 forecast for the euro is USD1.20/EUR1 (see pp33-36 for more details).

China: Policy vs pragmatism

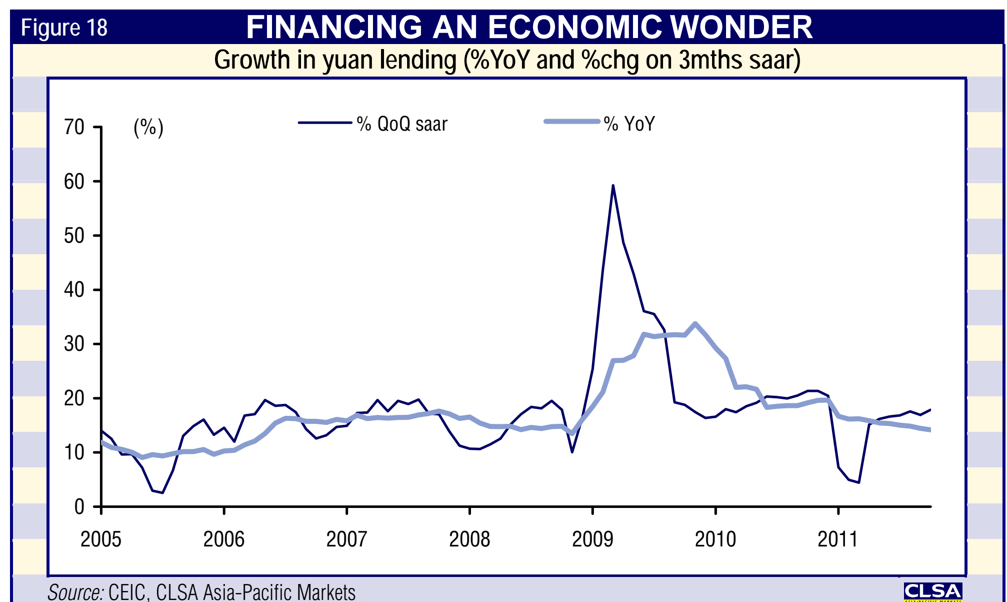
A concerted fiscal and monetary stimulus

China's response to the Global Financial Crisis remains one of the wonders of the modern economic world. Government fiscal policy became sharply expansionary with central government restraints on local authority spending reversed to become encouragement. Coming after two to three years of cyclical tightness this unleashed a surge of pent up investment demand. To finance it China introduced an equally effective monetary stimulus. Any credit system which underprices loans and limits lending with loan quotas guarantees excess unsatisfied demand for credit. Remove the restrictions and credit growth rises explosively. Figure 18 shows China's on-quota lending. At a time when rising risk aversion crushed lending elsewhere China's loans jumped. On a three month annualised basis credit growth peaked, in March 2009, at 59% saar.

Full on and quickly

Figure 18 **FINANCING AN ECONOMIC WONDER**

Growth in yuan lending (%YoY and %chg on 3mths saar)



Source: CEIC, CLSA Asia-Pacific Markets

What is less recognised is how quickly China started to put it into reverse. Lending growth started to decelerate as quickly as it had accelerated. That all of this dates from 2H2009 is remarkable. It supports the view now prevalent in Beijing that the stimulus, with hindsight, was unnecessarily large. Objectively this is true. On a quarter-on-quarter saar GDP growth fell to 1% in 4Q2008 but was 14% six months later. This level approaches the peak of the 2007 business cycle when policy was single minded in trying to stop the economy from overheating.

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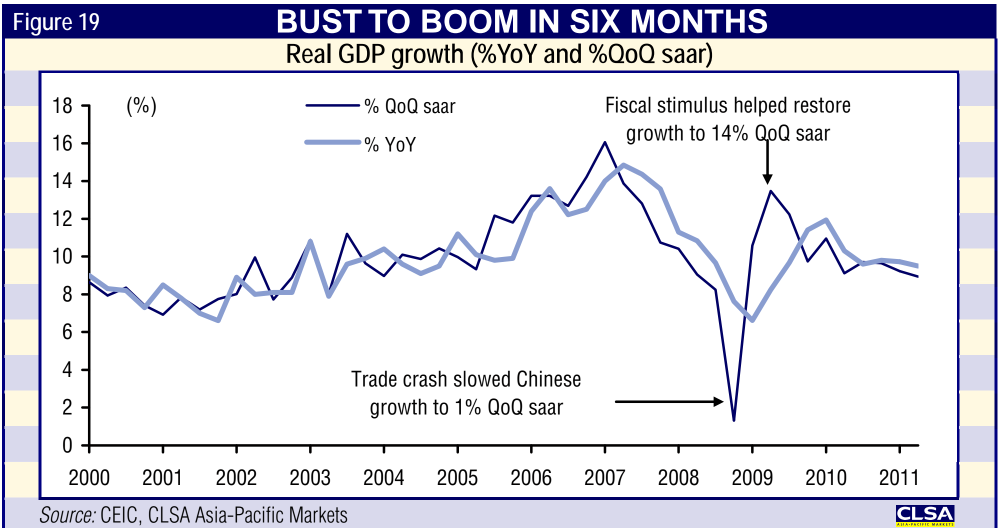
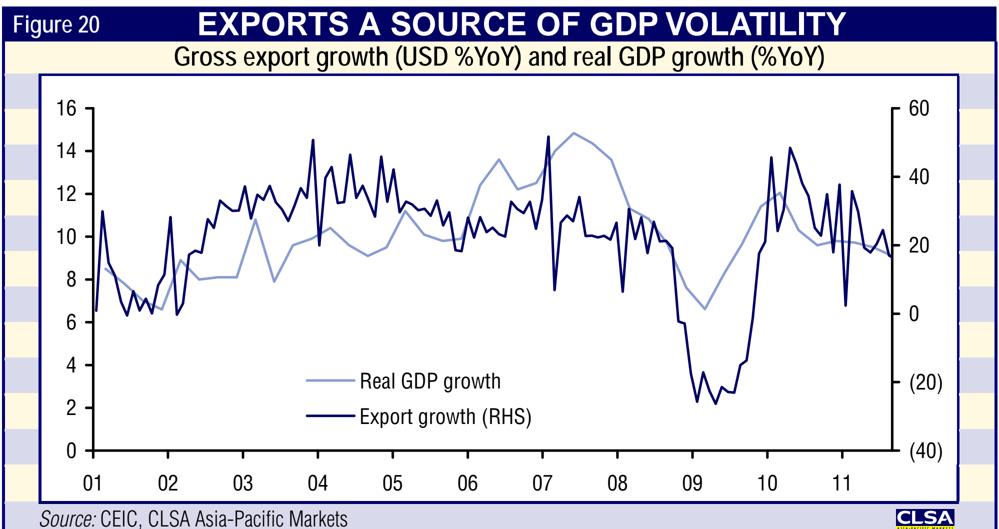
OVERSTIMULATED IN 2009



Some of this reflects the scale of the stimulus itself but we doubt that China's policymakers expected global trade flows to rebound as quickly as they did. China now has one of the lowest export to GDP ratios in Asia (27%) but statistically 40% of the fluctuation in China's GDP growth can be explained by fluctuations in export growth: Figure 20. This helped the 2009 rebound but implies weaker growth in 2012.

FLUCTUATIONS IN EXPORT GROWTH CAN EXPLAIN 40% OF FLUCTUATIONS IN GDP GROWTH



TRADE FINANCE SQUEEZE IS SLOWING EXPORTS

Asian exports, including those of China, have already slowed. This is not just Europe. For most of 2011 the US was a weaker market, a reflection of the terms of trade squeeze on consumer durables spending. But Europe is now the principle threat. Its share of China's exports, at 17.8%, is equal to the US. But the impact of its banking system deleveraging goes beyond squeezing exports just to the EU. Asian trade finance is being squeezed in a way similar to that which happened after Lehman Brothers failed as Eurozone banks shed risk. It is happening slower than it did in 2008 but still represents a rapid unwind from the perspective of economic statistics. It is most visible in drops in new orders and export orders indices in Asian PMIs, China's PMI included. It will be apparent in significantly weaker economic growth as production cuts catch up in 1Q2012 to reduce unwanted finished goods inventory builds: Figure 21.

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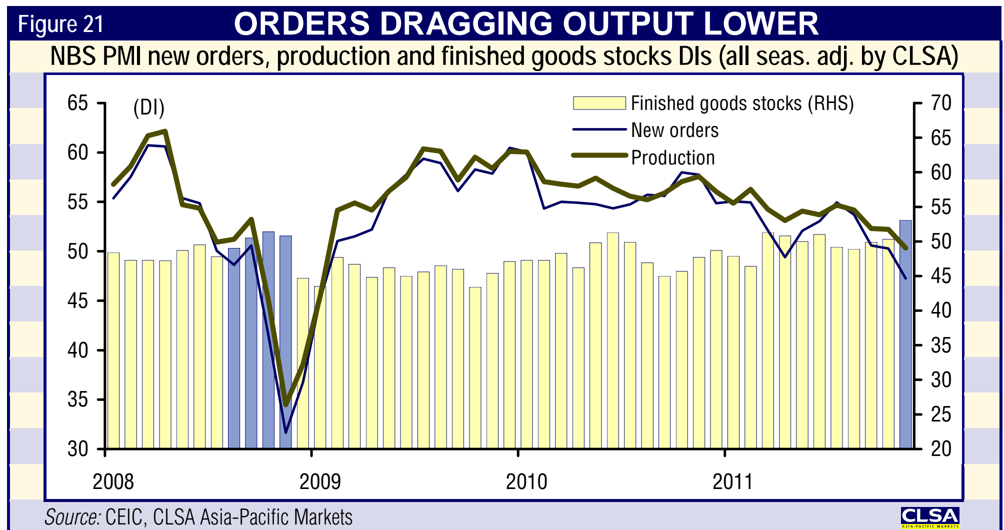
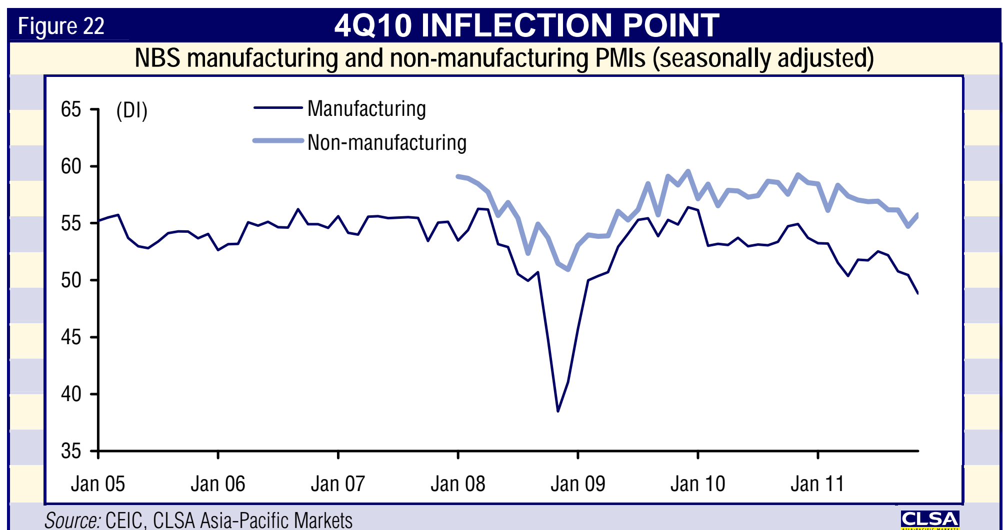


THERE'S ALSO AN ONGOING DOMESTIC SQUEEZE

The external environment is not the only thing pressuring Chinese growth. The manufacturing *and services PMIs* have been declining since 4Q10: Figure 22 (both data series in this chart are seasonally adjusted, this is something we believe necessary for the manufacturing PMI but is absolutely essential to make any sense from the non-manufacturing index). The underperformance of manufacturing in the last quarter is clearly visible and will become more marked as the production trends described above unwind. But most of the deceleration implied in Figure 22 reflects domestic conditions not international. The 4Q10 inflection point coincides with the point at which Beijing became serious about taming China's credit cycle.

MANUFACTURING AND NON-MANUFACTURING PMIS HAVE BEEN FALLING SINCE 4Q10



AN EARLY EASING IN 2012

Our central case remains that Beijing is intolerant of a significant slowdown in growth and will step in to try to prevent the Chinese economy from decelerating. An early 2012 easing of policy has therefore long featured in our forecasts. The weakness we see in the US and our intensified concerns about the Eurozone increases this conviction and also increases the size of the necessary boost, even though there is a genuine desire not to repeat the excessive policies of 2009.

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PRAGMATISM OVER MEDIUM TERM GOALS

This represents economic pragmatism overtaking medium term policy. In acting to protect growth Beijing will have to employ policies that conflict with its medium-term objectives of moving the economy towards a more consumption-driven growth model. It will also be acting contrary to the preference revealed by its early reversal of policy in 2009 against excessive stimulus and excessive leverage. Both these policies represent cans that China will be happy to "kick down the road" to be picked up again when the growth environment is more positive. China's advantage is that this can happen quickly. Policy will loosen in 2012 but we expect that China will start to tighten again in late 2012 and 2013.

Controlling lending in and out of quota

WHEN A MEASURE IS MADE A TARGET, IT CEASES TO BE A RELIABLE MEASURE

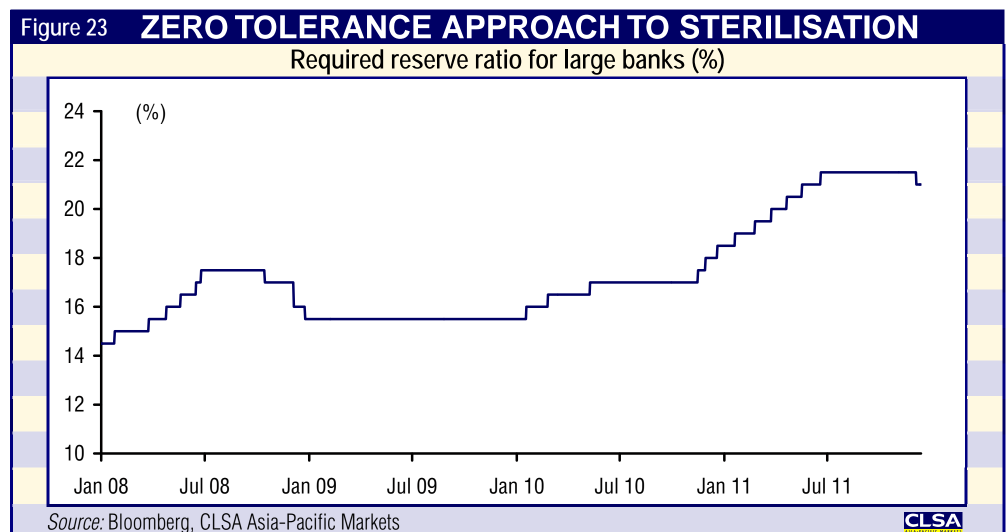
Any forecast is complicated by China's quota based lending system. Historically this has dominated total credit supply. However Goodhart's Law operates in China as everywhere else and significant amounts of credit moved off quota in 2010 as the People's Bank of China started to limit loan quota while banks still had balance sheet available to lend and the balance of payments was recording large surpluses.

Total social financing (TSF) is the Chinese authorities' now favoured measure of total credit supplied, outside as well as inside loan quota. Governments measure things for the purpose of controlling them and while, in 2010, the bulk of Chinese "tightening" was in the form of reduced quotas for new yuan lending 2011 saw a much broader approach. Lending quotas were accompanied by moral suasion on the now visible off-quota credit. Importantly the large balance of payments surpluses, though still monetised, were tackled by aggressive hikes in required reserve ratio.

UNDOING THE EFFECTS OF MONETISING THE SURPLUS

Figure 23 **ZERO TOLERANCE APPROACH TO STERILISATION**

Required reserve ratio for large banks (%)



Source: Bloomberg, CLSA Asia-Pacific Markets

These measures worked. Official data on TSF are incomplete, presented only as a short history of year to date changes. Figure 24 converts these to an estimated year on year growth to compare against yuan lending data (we remove equity issuance which is also included in TSF). TSF is still growing faster but its deceleration has been more marked. The latest (3Q11) data show TSF up by 18.8% YoY, Figure 24.

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TSF started to be brought under control around end-2010

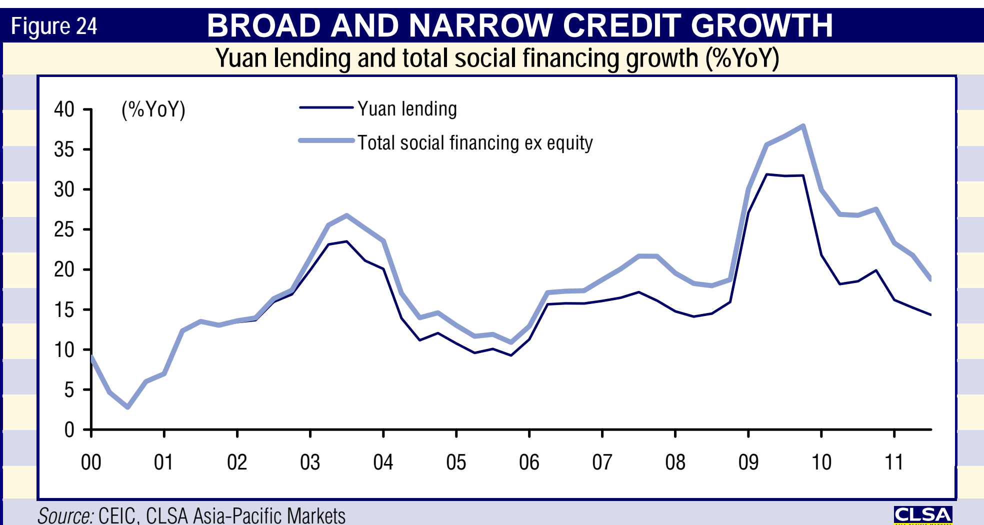
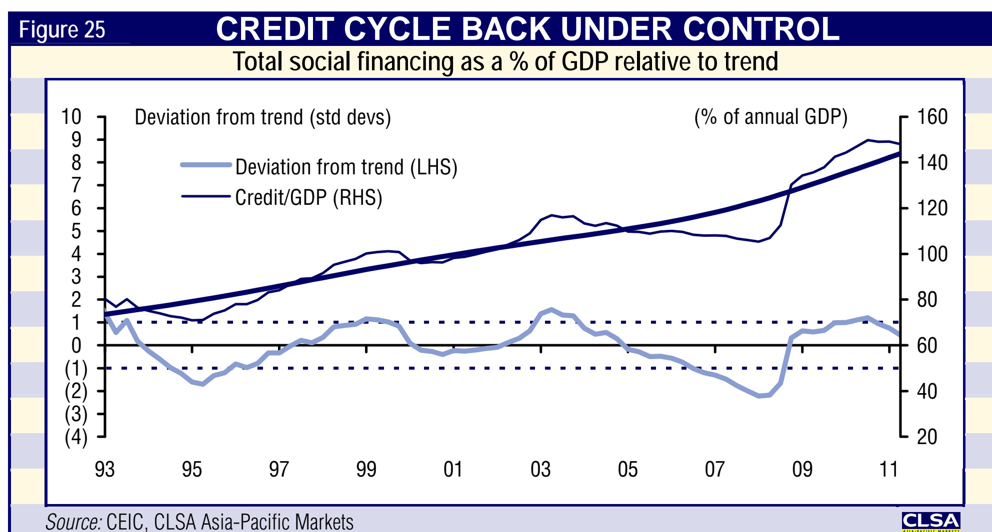


Figure 25 rolls TSF into a credit relative chart. As with the US equivalents (Figure 4 and 5) this shows a credit cycle with the purpose of identifying potentially dangerous periods of under or overextension of credit. It took until 1Q2011 for TSF growth to start to converge back onto trend, highlighting just how much disintermediation around the official lending quota was taking place. But progress in the last three quarters has been rapid (providing the context for Figure 22). At end-3Q2011 TSF relative to nominal GDP was approaching long-run trends.

We estimate that TSF relative to GDP is returning to the long run trend



What goes down, now needs to go up

Having tightened, Beijing can loosen

This act of bringing the credit cycle back under control has contributed to the growth squeeze at precisely the time that world conditions have become disadvantageous. However the fact that TSF has started to slow now opens the opportunity for policy to be relaxed again as a way of protecting growth.

But what if the tightening does not represent Beijing's intentions?

The composition as well as the aggregate growth rate is important. All credit is not created equal. Credit supplied within the official loan quota is significantly cheaper than off-quota lending. It is also, important from Beijing's perspective, more controllable. This represents two characteristics of much "shadow banking" credit.

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- First, shadow banks are often not deposit taking institutions. They can lend their own balance sheet but not grow it through the process of lending, like a fractional reserve bank can. This makes informal credit systems sensitive to balance of payments fluctuations. The swing to deficit of China's BoP as risk aversion has risen, USD credit supply has dwindled and the USD has appreciated has contributed to a hardening in domestic credit supply. So far this is not visible in official (lagging) statistics but we believe is apparent in the spike in market perceptions of stress.
- Banks have fallen into line now that it is clear that they can no longer evade detection but off-quota lending amounts to an institution pursuing profit by working around a restriction. Chinese shadow banking is a little bit of capitalism in what otherwise is a government directed sector. Practically this means that it might be harder to prevent a secondary credit contraction in China's shadow banks than its conventional ones.

The policy prescription is still to raise loan quota

In a slowing growth, rising risk, weaker balance of payments environment these characteristics represent an additional source of credit tightening. Bears on China believe that this makes the situation irretrievable. Our own view is much less reactionary. There is a policy solution for both of these problems: bring credit supply back within the quota system and in the process back onto the balance sheets of fractional reserve banks.

First create the ability of banks to grow their balance sheet

The reduction in required reserve ratio effective 5 December was the first stage in this process. It was necessary to sterilise the balance of payments outflows in September and October and also to create the ability for commercial banks to begin to increase their lending. One RRR cut will not be sufficient for either objective. We have pencilled in around 200-300bp cuts in RRR for 2012.

Then increase loan quotas

We also expect the PBoC to encourage commercial banks to increase lending. We expect a CNY10tn increase in on-quota yuan lending for 2012 as a whole. This seems aggressive but reintermediation of off-quota credit alone can justify this number (so far Beijing is guiding for TSF growth in 2012 to be similar to 2011, though obviously this may change as the world situation evolves). TSF increased by CNY9.5tn in the year to September 2010. Given global stresses we see upside rather than downside risk to our loan quota forecast.

Third, try and steer it to sectors that need it most

The behaviour of policymakers in 4Q11 suggests that as lending is increased attempts will be made to steer it towards the SME manufacturing sector. This is critical for employment – the variable that Chinese policymakers (rather than growth) are most sensitive to. SME manufacturers have also been badly impacted by international developments – liquidity as well as trade – they have a much higher exposure to exports than does the economy as a whole.

Monetary easing – Your fungible friend

But lending to manufacturers doesn't mean that they will use it for capex

The question is whether it will work. Beijing has tried to push banks towards allocating a greater proportion of their loan quota to SMEs before with limited success. It is unreasonable to assume that 2012 will be materially different.

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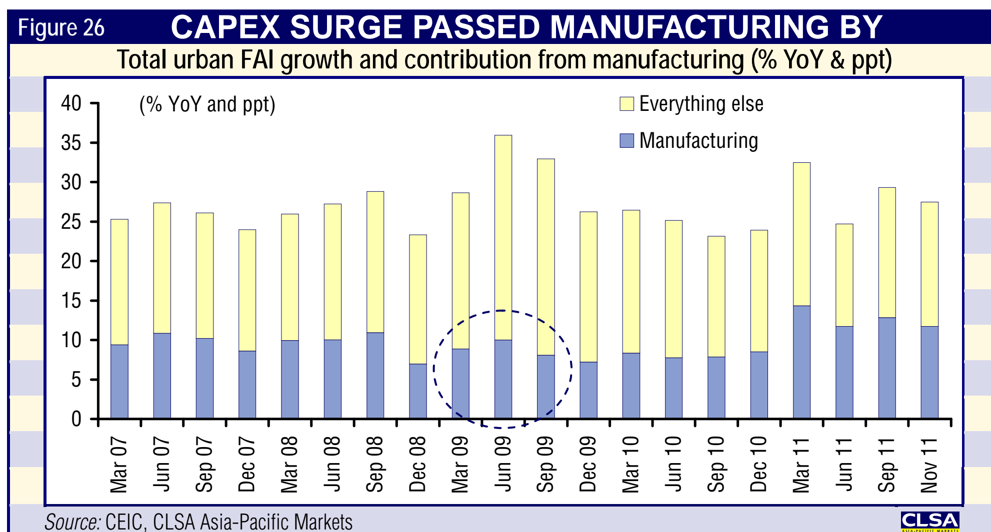
Manufacturing was weak as a source of FAI growth in 2009

Certainly there is no reason to expect that, given global demand and risk conditions, looser credit will be enough to support an increase in manufacturing investment. As Figure 26 shows even the FAI surge of 2009 left manufacturing little affected.

Figure 26 **CAPEX SURGE PASSED MANUFACTURING BY**

Total urban FAI growth and contribution from manufacturing (% YoY & ppt)



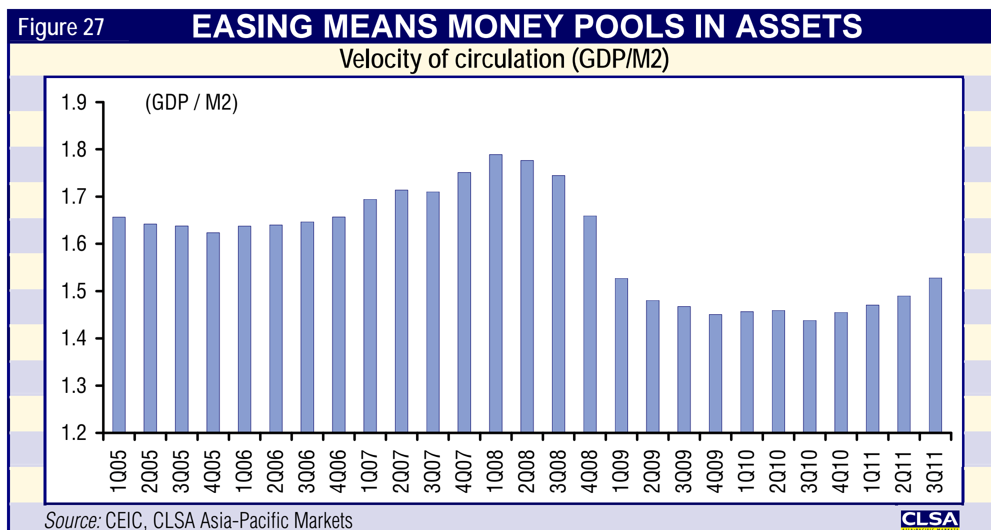
Source: CEIC, CLSA Asia-Pacific Markets

Velocity falls when monetary policy is eased

Instead Chinese lending will continue to favour state owned enterprises and, as in 2009, will pool in assets. Velocity of circulation will fall in 2012 in a similar way to how it did in 2009: Figure 27.

Figure 27 **EASING MEANS MONEY POOLS IN ASSETS**

Velocity of circulation (GDP/M2)



Source: CEIC, CLSA Asia-Pacific Markets

As money pools in assets it inflates their price. In market economies this is a part of the transmission mechanism. In China's quota driven lending system the quota size, defining the limit of access to loans priced at (underpriced) official interest rates, is more important. But the asset inflationary part of a Chinese easing still applies. We would expect Chinese asset prices to rise as policy becomes expansionary in 1H12.

Resi property is one of the assets it pooled in. We expect a repeat in 2012

This includes residential property. It is no coincidence that residential construction is one of the sectors worst affected by the present, tight, credit environment. Of course policy to counter speculation has been tight, but additionally velocity is starting to rise. Residential property will perform much better in 2012 as liquidity

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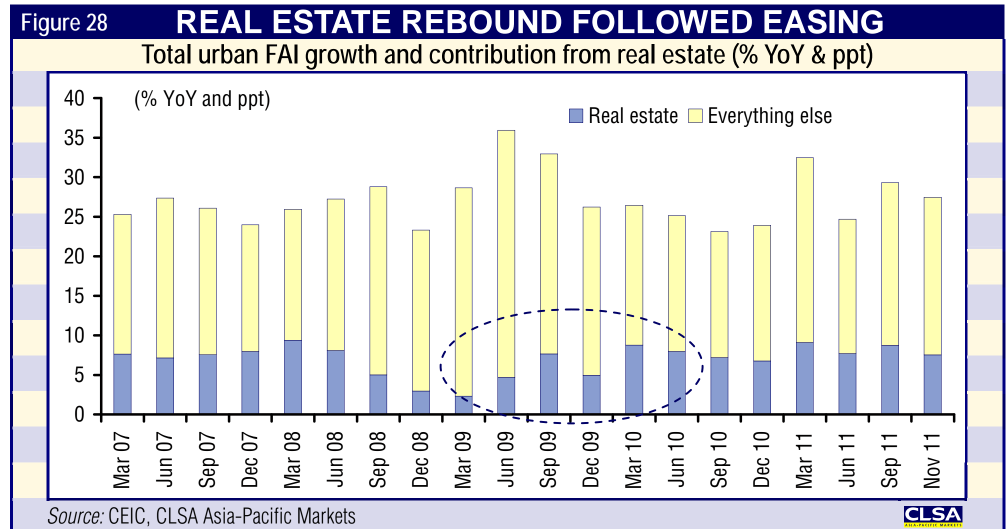
eases. Additionally we expect enforcement of purchase restrictions to be eased in 2012, most likely in 2Q (see *GREED & fear* 15 December 2011). Although most of the initial surge in FAI in 2009 was infrastructure there was a large increase in residential construction as credit conditions remained loose: Figure 28.

Figure 28 **REAL ESTATE REBOUND FOLLOWED EASING**

Total urban FAI growth and contribution from real estate (% YoY & ppt)



Source: CEIC, CLSA Asia-Pacific Markets

Over the period shown in the chart the acceleration in real estate construction added around 6.5ppts to total urban FAI growth (in March 2010 real estate made a bigger contribution to urban FAI growth than all manufacturing sectors combined). Its importance in 2012 will be even greater. Despite the very visible weakness of private residential construction social housing starts are keeping the aggregate growth in real estate FAI robust. The liquidity induced acceleration will be from a higher level.

We expect more infrastructure also

Even so we doubt that easier credit alone will be able to support Chinese growth at desired levels. Fiscal policy will also be eased. By this we mean an increase in federally mandated infrastructure spending (for example, healthcare, education, the resumption in the high speed rail programme). We do not expect that China will be willing to repeat the same "free-for-all" in local authority spending that characterised 2009.

Holding GDP growth around 8%

Such a policy should be able to prevent overall FAI growth from slowing and potentially even generate a small acceleration. It should therefore be sufficient to hold GDP growth around 8% for the year as a whole. However even with China's speed of response investors should brace themselves for a soft first and second quarter. We expect year on year headlines to dip sharply in 1Q as they catch up to where sequential growth indicators are now. As stimulus starts to come through activity will accelerate in the second half and China's growth will be reapproaching 9% YoY by year end as the effects of the domestic monetary stimulus are reinforced by the same sort of normalisation of international trade finance that caused the rebound in exports in 2H2009. For full details of the forecast please see the China country pages on pp41-44.

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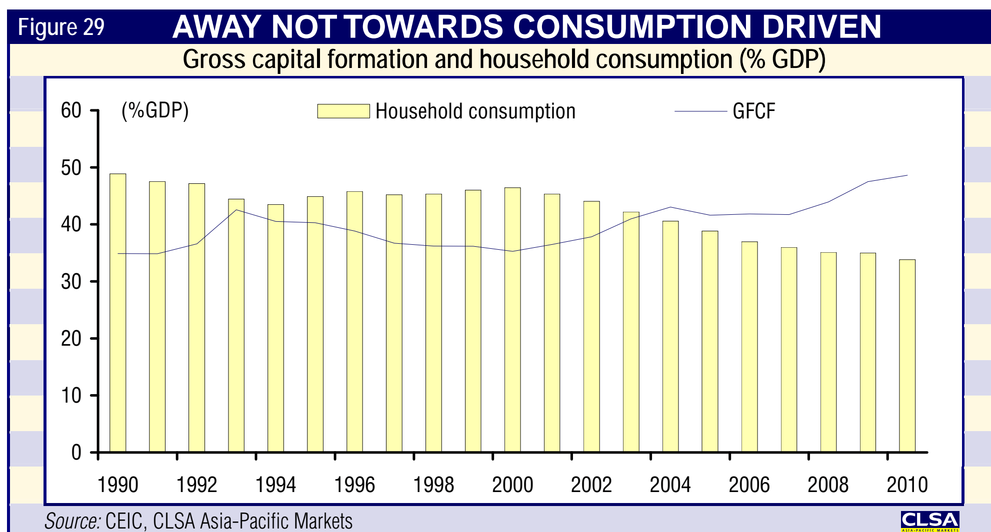
Pragmatism trumps policy

This stimulus may be more moderate and conservative than that of 2009 but it still represents China's medium-term objectives being sidelined in the interests of protecting growth. The Chinese banking system is again being asked to do "national service". This is particularly true as it is inevitable that a large portion of lent funds will end up financing property speculation rather than fixed asset investment. And the stimulus will generate another ratchet higher of China's investment to GDP ratio at the expense of consumer spending: Figure 29.

So in what sense is this moving towards being consumption led?



The financial reflection of this will be that China's (non-government) credit to GDP ratio will rise again, back towards or potentially above the 2 standard deviation mark that we regard as a "danger zone" in Figure 24. At the end of this process we would be unsurprised were China's (non-government) credit to GDP ratio to exceed 160%. The question is how big a risk this represents.

China's debt dynamics are very affordable, thanks to its low interest rates

In this respect China is very different from Europe. The problem today facing Italy is that it is a highly indebted economy paying market-demanded interest rates that are high relative to its nominal GDP growth. China may be highly indebted but its government administered interest rates (1 year working capital rates are presently 6.56% we expect them to be cut in 2012) are very low compared with nominal GDP growth rates (20.3% YoY in 3Q11, a long run nominal growth rate between 12-15% would seem reasonable as a gauge of "sustainable"). Plug these numbers into a sustainable debt equation and China's level of liabilities looks unproblematic. With a zero "primary balance" (EBIT is the closest company accounting analogue), a bottom of range 12% nominal growth rate and current interest rates, the debt to GDP ratio will fall by around 8ppts per annum through growth alone.

Making the fact that debt/GDP levels have risen a bigger indictment

From a long run perspective this fact is not entirely good news. Given the extremely benign debt dynamics, the fact that trend debt levels have risen so steeply is testament to either an extraordinary increase in the economy's capital intensity, or the fact that past misallocations of capital are never written off, or both. But these

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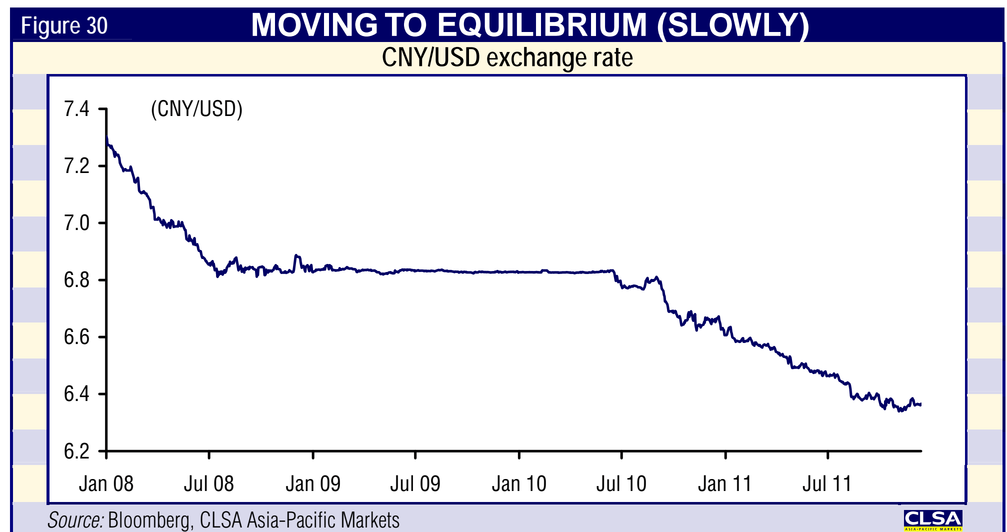
numbers do mean that for as long as a liquidity shortage or a (cyclical or localised) solvency issue does not force NPLs to be crystallised, they can remain on balance sheet, latent. Subject to the caveat that living with the legacy of the existing system means that you can never change it.

Renminbi 5? Not just yet

Exchange rate policy too is likely to be put into service keeping China's economy stable in 2012. In fact, this has already have happened. As Figure 29 shows, the renminbi has been moving sideways, albeit with a high degree of volatility, since October.

Appreciation policy sidelined in 2008-2009



And again in 2012

Again this reflects pragmatism overturning long run objectives. When we wrote the "**Renminbi 5**" report (**Asia at equilibrium**) in summer 2008 we argued that a fairly valued exchange rate would be an important step towards rebalancing China's economy away from trade and manufacturing and towards consumption and services. The renminbi is nearly 10% stronger than when we wrote the report. The relative return for producing for domestic consumption versus producing for export is therefore substantially higher. But progress has not been linear. China halted the renminbi appreciation in 3Q08. It will repeat this in 2012 and for the same reason: a conscious decision not to worsen the pressure on an already suffering export sector. We have changed our currency forecast accordingly: we expect the renminbi to move sideways at its current USD exchange rate for the next twelve months.

Asia: Regional themes

We said at the outset that 2012 would be a year in which Asia's economic performance was dominated by the policymakers in the US, Europe and China kicking, or trying to kick, various economic cans down the road. Having assessed what this means in practice, where does this leave Asia? Our detailed answers are contained in the country sections that follow however some regional themes are immediately obvious.

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A SLOW MOTION LEHMANS RERUN

Crunchy credit

The main impact of the escalation of Europe's sovereign debt crisis is in squeezing dollar liquidity. This reflects risk aversion and the withdrawal of European banks, whose balance sheets are under pressure from sovereign losses and who need to raise capital, from non-core businesses. It is similar, though thankfully less severe than, the interruption to trade finance that followed the failure of Lehman Brothers. And it threatens a similar sharp deceleration in international trade. As in 4Q08 this appears to have taken exporters by surprise; unsold inventories of finished goods are appearing. As such its impact on national production indices will become more visible in the coming 3-6 months. We have cut our Asian export and GDP growth forecasts in consequence.

BUT THE WORLD IS MUCH BETTER PREPARED

Compared with 2008 however the world economy has a couple of big advantages. The first is central bankers who are much more prepared. At the moment this is an orderly unwind of non-Euro asset and liabilities. Were it to be disorderly it would be much more rapid and harder for trade financiers to manage. The biggest risk that it become disorderly would be a wholesale funding crisis for European banks. The dollar swap lines set up between the ECB, Fed, SNB, BoE, BoC and BoJ are therefore important especially given the dramatic surge in their use in the last two weeks. Second is the ability of alternative financiers to step in. The Asian Development Bank has reported record applications for its trade finance facilities. We hear of ExIm companies in Singapore seeking alternate credit lines in case their established credit facilities are compromised. All the same it is clear from the behaviour of trade that so far these offsets are incomplete and there are also reports of exporters being pressed for more generous payment terms as their customers are squeezed for working capital finance.

AND THE EFFECT IS TEMPORARY, EXPECT A SECOND HALF REBOUND

We expect that credit effects will be as important as fluctuations in end-user demand for much of the first half of 2012 (the world will therefore have another synchronised inventory cycle). However it is important to recognise that this process is finite. Just as in 2009, trade patterns will start to converge back on final demand trends in the second half of the year. Export and manufacturing weakness in the next few months should not be extrapolated forward.

IN FACT MOST ECONOMIC FACTORS SUGGEST A STRONGER SECOND HALF

A game of two halves

This is one factor that suggests that the biggest growth risk for Asia will be in the next six months. The second half of 2012 and 2013 should be much better. The trade dynamics that we refer to above are part of this process. However, the second investment cycle that we see for the US will also be concentrated in the second half. So too will the effects of China's monetary stimulus. Relative to those in other countries, China's policy easing will bring rapid economic benefits but compared with 2009 we expect the rebound in economic activity to be slower.

AND 2013

The regional growth profile will therefore be better in the second half of 2012 than the first. For many countries this will not be saying much, the next six months will be very difficult. Nonetheless sequential growth rates are likely to at or about trend

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by the end of 2012. This will keep calendar year 2012 average growth rates from being a train wreck but it will be most apparent in 2013. 2013 in many Asian countries should be a good year.

Inflation is last year's problem

Consumer price inflation in most countries has already peaked. It will fall further as 2012 progresses. Given the weakness of first half aggregate demand this would be an unremarkable forecast were it not for the fact that our central case has quantitative easing first from US Fed and second from the ECB.

MUTED COMMODITY PRICES DESPITE EASIER MONEY

If we were hard monetarists we would be rushing out to buy gold on this forecast. In fact our projections do suggest some upside for precious metals (see p35) but this will be surprisingly muted. And for industrial commodities, foods and oil, the stuff that matters more for an Asian CPI forecast, we see no persistent price rises at all. We would expect CY2012 averages for these products to be little different to CY2011.

This reflects our conviction that global liquidity is as much driven by perceptions of risk as the supply of reserve money. Because the USD is the unit of account the biggest threat to this benign commodity price forecast is our expectation that a weak first half US will cause the Fed to have another go at quantitative easing. But with US growth weak and the ECB standing back while EU deflation risk builds we expect risk aversion to matter more than looser money.

ASIAN INFLATION RATES SHOULD BE UNPROBLEMATIC

For most Asian countries flat food and fuel prices automatically mean muted inflation pressures. India's decorrelated food inflation cycle plus its currency weakness means that risk is highest here but our central case has inflation unproblematic across the region.

Asia in a weak euro world

We don't like the euro but we also have to observe that Asian exporters don't like a strong dollar. Historically Asian export growth to Europe is much more volatile than its export growth to the US and periods of the most rapid export expansion have always been periods of euro currency strength. Unfortunately the reverse is true.

ASIAN EXPORTERS DON'T LIKE A WEAK EURO

Our expectation that the euro will be a weak currency in 2012 therefore reinforces a weak Eurozone growth forecast implying that Europe will be a much worse market than the US for Asian exporters for the next twelve months.

The sensitivity of Asian exports to euro currency movements reflects the fact that large parts of Asia's export chains are dollarized and most Asian countries manage their currencies with reference to the dollar. A period of persistent euro risk may start to change this.

EXPECT WEAKER ASIAN CURRENCIES

Practically this implies some downside for Asian currencies. Aside from the renminbi, where politics precludes devaluation, and Hong Kong we see Asian currencies underperforming the USD across the board.

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Easier policy but tighter credit?

Balance of payments will be pushed into deficit

The Eurozone crisis is not just impacting international liquidity. Asian balance of payments have swung into deficit. Some of this reflects the credit crunch we discussed above, from an Asian BoP perspective this represents a forced capital outflow as trade credit is repaid (and, hopefully, replaced with domestic credit). Some of it reflects currency movements, Asian companies borrow dollars when they see it weak and repay in the event of currency strength. And some reflects international portfolio flows, meaning that in the "risk off" world we expect for the first half outflows will continue.

But historical surpluses have supported Asian credit growth

The cause is immaterial, the effect is the same. Asian central banks have been adept at monetising balance of payments surpluses and Asian commercial banks have been adept at turning the monetised inflows into domestic credit. Even if Asian central banks allow their currencies to fall (rather than defend them) the absence of these inflows will tighten the funding of domestic credit at precisely the time that banks will, in any case, be becoming more risk averse.

We are much more concerned about slowing domestic credit than three months ago

We discussed this mechanism in China on pp41-44 but the pressures are regional and in most cases banking systems are much less amenable to control than that in China. The policy response followed will be the same – we see monetary policy eased across the board – but the effectiveness outside of China will be much lower. In our forecasts three months ago we were happy to give Asian domestic credit cycles the benefit of the doubt. Now we are much less sure.

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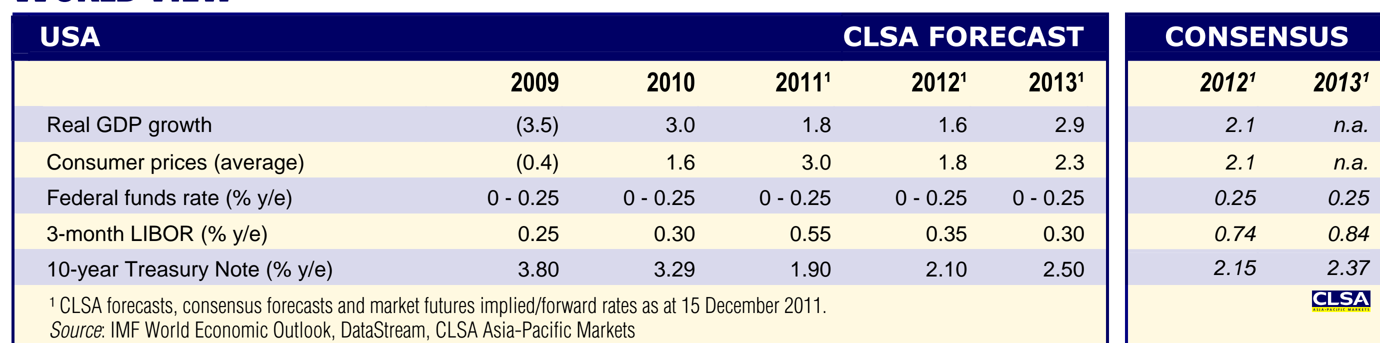
WORLD VIEW



USA	CLSA FORECAST					CONSENSUS	
	2009	2010	2011[1]	2012[1]	2013[1]	2012[1]	2013[1]
Real GDP growth	(3.5)	3.0	1.8	1.6	2.9	2.1	n.a.
Consumer prices (average)	(0.4)	1.6	3.0	1.8	2.3	2.1	n.a.
Federal funds rate (% y/e)	0 - 0.25	0 - 0.25	0 - 0.25	0 - 0.25	0 - 0.25	0.25	0.25
3-month LIBOR (% y/e)	0.25	0.30	0.55	0.35	0.30	0.74	0.84
10-year Treasury Note (% y/e)	3.80	3.29	1.90	2.10	2.50	2.15	2.37

[1] CLSA forecasts, consensus forecasts and market futures implied/forward rates as at 15 December 2011.
Source: IMF World Economic Outlook, DataStream, CLSA Asia-Pacific Markets

GDP growth

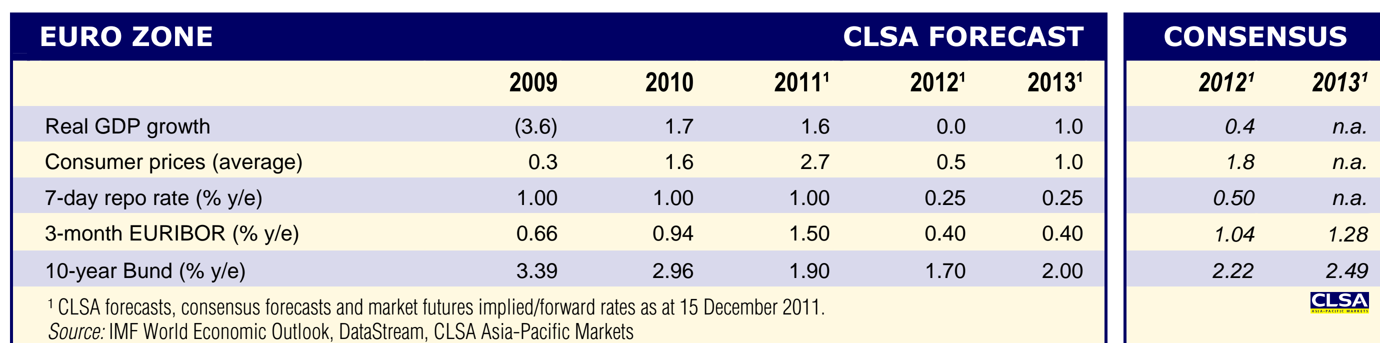
- We discuss the US forecast in detail in the *Viewpoint* section. 1H12 will see growth drop below 1% QoQ saar as investment, front loaded by depreciation allowances into 2H11, slows again. We are more optimistic about the second half. The US private sector is no longer overgeared. We expect a new commercial real estate centred investment cycle to be forming in 2H12. By mid-2013 QoQ saar growth will again approach 3%.

Inflation

- This growth profile, together with the weakness we expect of commodity prices, suggests muted inflationary pressures. We expect CPI inflation to drop to 1.8% in 2012. Inflation is likely to pick up again in 2013 but modestly. Consumer prices are not a driver of our monetary policy forecast at any point in 2012 or 2013.

Interest rates

- QE3 remains in our forecast for the first half, most likely the March (13) or April (25) FOMC meetings. The program will be time-limited to around six months and stronger 2H growth will permit its removal before end-2012. However, as following QE2, the Fed will be unwilling to shrink its balance sheet. No change in policy rates is expected in 2012 or 2013. The Treasury curve will steepen in 2H12 and 2013 on, first, QE3 and then stronger growth expectations.



EURO ZONE	CLSA FORECAST					CONSENSUS	
	2009	2010	2011[1]	2012[1]	2013[1]	2012[1]	2013[1]
Real GDP growth	(3.6)	1.7	1.6	0.0	1.0	0.4	n.a.
Consumer prices (average)	0.3	1.6	2.7	0.5	1.0	1.8	n.a.
7-day repo rate (% y/e)	1.00	1.00	1.00	0.25	0.25	0.50	n.a.
3-month EURIBOR (% y/e)	0.66	0.94	1.50	0.40	0.40	1.04	1.28
10-year Bund (% y/e)	3.39	2.96	1.90	1.70	2.00	2.22	2.49

[1] CLSA forecasts, consensus forecasts and market futures implied/forward rates as at 15 December 2011.
Source: IMF World Economic Outlook, DataStream, CLSA Asia-Pacific Markets

GDP growth

- As we discuss in the *Viewpoint,* the Eurozone growth outlook is very weak as institutionalised government deleveraging, risk aversion, harsh bank lending attitudes and a chronic squeeze on business and investor confidence combine. We have cut our 2012 forecast to zero, in the bottom third of the ECB's central tendency forecast. 2013 should be better but not good. We have pencilled in 1% growth.

Inflation

- Current inflation is proving sticky but this will not persist in face of the deflationary forces referenced above. We expect inflation rates to fall sharply in the coming twelve months. Deflation not inflation will be the dominant risk in 2013 also.

Interest rates

- Rates will be cut in the coming 6 months but the reluctance of the ECB to start quantitative easing was clear in Draghi's press conference in December. We expect that economic and market pressures will give him no choice, but that the ECB will lag. We expect Euro-QE to start up early in 2H12. We suspect that it will be impossible to remove the policy before mid-2013, the deciding factor will be how successful it is at compressing sovereign spreads.

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JAPAN			CLSA FORECAST			CONSENSUS	
	2009	2010	2011[1]	2012[1]	2013[1]	*2012[1]*	*2013[1]*
Real GDP growth	(5.2)	3.9	(0.5)	2.5	1.3	*2.1*	*n.a.*
Core CPI (average)	(1.0)	(0.7)	(0.3)	0.3	0.0	*(0.2)*	*n.a.*
Overnight call rate (% y/e)	0.10	0.10	0.10	0.10	0.10	*0.10*	*0.10*
3-month LIBOR (% y/e)	0.28	0.19	0.33	0.30	0.20	*0.36*	*0.45*
10-year government bond (% y/e)	1.29	1.13	1.00	1.20	1.20	*1.18*	*1.39*

[1] CLSA forecasts, consensus forecasts and market futures implied/forward rates as at 15 December 2011.
Source: IMF World Economic Outlook, DataStream, CLSA Asia-Pacific Markets

GDP growth

- Our Japanese forecast remains substantially unchanged aside from incorporating a weaker export profile as a result of Eurozone problems. Typically this would be the swing factor in a Japanese forecast but reconstruction spend means that this is not true for 2012 - our forecast therefore remains a decent 2.5%. Sustainability is suspect however: Japan is the original fibrillating economy. Most of the 1.3% growth we've pencilled in for 2013 is carry from 2012.

Inflation

- Inflation has dipped back negative after turning positive in 3Q11. It will increase modestly from here as a relatively rapid pickup in growth combines with some lingering supply-side disruptions. In our opinion the consensus (-0.2% YoY) looks too low for 2012.

Interest rates

- The global preference for debt has not bypassed JGBs. 10 year yields are presently 1%. We would expect them to rise as the growth consequences and financing requirement of the earthquake reconstruction appear more clearly in 2012, but only modestly. There will be no change in Japanese policy rates with the Fed and ECB easing though some of the pressure for the BoJ to follow will dissipate as the JPY softens a little vs the USD.

CHINA			CLSA FORECAST			CONSENSUS	
	2009	2010	2011[1]	2012[1]	2013[1]	*2012[1]*	*2013[1]*
Real GDP growth	9.1	10.3	9.2	8.0	9.2	*8.5*	*n.a.*
Consumer prices (average)	(0.7)	3.3	5.4	2.9	3.1	*3.8*	*n.a.*
1-year savings rate (% y/e)	2.25	2.75	3.50	3.00	3.25	*lower*	*lower*
1-year lending rate (% y/e)	5.31	5.81	6.56	6.06	6.31	*lower*	*lower*
CNY/USD (y/e)	6.83	6.61	6.36	6.36	6.05	*6.45*	*6.50*

[1] CLSA forecasts, consensus forecasts and market futures implied/forward rates as at 15 December 2011.
Source: IMF World Economic Outlook, DataStream, CLSA Asia-Pacific Markets

GDP growth

- Sequential growth indicators declined in 4Q11 as tightening international credit, risk aversion and capital outflows reinforced the effects of Beijing's increasingly restrictive domestic credit policy. We expect tightening to reverse in 2012 with RRR cuts and increased loan quota early in the year. Year on year GDP growth will dip in 1Q and 2Q12 but by 2H12 looser policy and normalising exports should be working: 9¼% growth in 2013.

Inflation

- Inflation has fallen away more rapidly than we expected as sequential growth indicators have weakened. This will persist through 1H12 and we have cut our 2012 CPI forecast by 2ppts. Inflation will edge up in 2013 but slowly as long as global commodity prices stay soft.

Currency and rates

- We have changed our CNY/USD forecast. The weak international environment suggests the currency will move sideways against the USD. This policy is likely to have to stay in place until end-2012 but a gradual CNY appreciation can resume in 2013. We assume around a 6% saar. We expect two 25bp rate cuts in 2012 consequent the mid-year fall in inflation.

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TRADE AND COMMODITIES			CLSA FORECAST			CONSENSUS	
	2009	2010	2011[1]	2012[1]	2013[1]	*2012[1]*	*2013[1]*
Oil price (Brent crude average)	62.7	80.3	110.0	108.0	105.0	*102.8*	*99.1*
Oil price (Brent crude y/e)	77.9	93.5	107.0	100.0	110.0	*101.7*	*97.7*
CRB index (y/e)	283.4	332.8	290.0	290.0	290.0	*295.2*	*n.a.*
Gold (y/e)	1,097	1,421	1,500	1,800	1,800	*1,589*	*n.a.*
Global trade volume	(11.0)	10.0	6.0	(1.0)	6.0	*n.a.*	*n.a.*

[1] CLSA forecasts, consensus forecasts and market futures implied/forward rates as at 15 December 2011.
Source: OECD World Economic Outlook, DataStream, CLSA Asia-Pacific Markets

Oil prices

- Brent crude is likely to end 2011 around USD105-110/bbl, USD10-15 short of our forecast as QE3 is happening later than we thought. The Fed's next bout of quantitative easing suggests an early increase in futures driven commodity prices, oil included. Expect a test of USD120 around end-1Q. Thereafter global growth risks and a stronger USD argue for commodity prices slipping back. We expect USD100 for Brent by December 2012.

Industrials

- A China-centric "policy vs growth worries" profile is expected for industrials. Growth concerns will peak early in 2012 and depress industrial commodity prices. However the realisation that Chinese policy is again working to protect growth plus a pick up in world trade will support prices later in the year. Industrials are less liquidity driven (than oil) so a strong USD matters less. Industrials will lag in 1H12, but be stronger in 2H and into 2013.

Global trade

- Trade finance is being squeezed by European banks shedding risk. This will drive world trade lower for around the next 3 months and causes a cut in our 2012 world trade forecast. However, as was demonstrated in 2009, this is a finite process. Trade volumes will bounce back in 2H12 and 2013 will see good growth.

EXCHANGE RATES			CLSA FORECAST			FORWARDS	
	2009	2010	2011[1]	2012[1]	2013[1]	*2012[1]*	*2013[1]*
USD/EUR (y/e)	1.44	1.34	1.25	1.20	1.20	*1.31*	*1.31*
JPY/USD (y/e)	92.0	81.1	79.0	83.0	83.0	*77.3*	*76.3*
USD/GBP (y/e)	1.62	1.56	1.50	1.48	1.48	*1.54*	*1.54*
JPY/EUR (y/e)	132.1	108.7	98.8	99.6	99.6	*100.9*	*100.0*
GBP/EUR (y/e)	0.89	0.86	0.83	0.81	0.81	*0.85*	*0.85*

[1] CLSA forecasts, consensus forecasts and market futures implied/forward rates as at 15 December 2011.
Source: Bloomberg, DataStream, CLSA Asia-Pacific Markets

Euro

- 2012 sees the EUR vulnerable. In the first half, US monetary policy will be loosening while the ECB will remain stubbornly conventional. This *suggests* a weaker USD but with risk high the USD's status as a haven currency will limit downside (the weakest point in our forecast is USD1.35/EUR1 at end-1Q). Stronger growth in the US plus the eventual adoption of QE in Europe *should* start to reduce risk aversion. But, by this time, the US currency will be backed by obviously better economic fundamentals. Short any US-QE3 related EUR gains.

Yen

- A broadly stronger USD will grant some breathing space for Japanese exporters, though they will have to wait until 2H12 to get it. The first half, characterised by "risk off" will keep the Japanese currency in a JPY70-75/USD1 range. A move to JPY80-85/USD1 should be expected for 2H12.

Sterling

- The Eurozone crisis suggest that sterling can outperform the EUR but not to the same extent as the US dollar. Cable to ease to USD1.48/GBP1 over 2012.

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Asian forecast summary

Real GDP growth (%YoY)

(average)	2010	2011	2012	2013
Australia	2.6	2.0	4.2	3.4
China	10.3	9.2	8.0	9.2
Hong Kong	7.0	5.1	1.3	5.4
India	8.5	6.7	6.3	7.2
Indonesia	6.1	6.5	6.0	7.0
Korea	6.2	3.7	2.6	4.5
Malaysia	7.2	5.2	2.8	4.5
Philippines	7.6	3.8	2.9	4.4
Singapore	14.5	5.0	0.0	5.0
Taiwan	10.7	4.2	1.2	4.9
Thailand	7.8	1.5	3.8	4.6

Inflation (%YoY)

(average)	2010	2011	2012	2013
Australia	2.8	3.5	2.3	2.8
China	3.3	5.4	2.9	3.1
Hong Kong	1.9	5.3	4.3	3.6
India	9.6	8.9	6.7	6.5
Indonesia	5.1	5.3	4.2	5.9
Korea	3.0	4.4	2.8	3.2
Malaysia	1.7	3.2	2.7	2.8
Philippines	3.8	4.4	3.3	3.5
Singapore	2.8	5.2	3.5	2.2
Taiwan	1.0	1.3	1.2	1.9
Thailand	3.3	3.9	3.4	3.6

Current account balance (USD bn)

(total)	2010	2011	2012	2013
Australia	(35.2)	(23.7)	(22.8)	(21.5)
China	306.2	254.7	178.2	157.2
Hong Kong	11.6	9.1	8.7	11.0
India	(44.3)	(57.3)	(60.1)	(66.3)
Indonesia	5.6	5.2	(4.3)	(10.5)
Korea	29.4	24.9	30.9	37.3
Malaysia	27.3	31.9	27.7	26.6
Philippines	8.9	5.0	3.5	3.8
Singapore	49.5	47.3	44.1	44.3
Taiwan	39.9	41.3	42.6	49.6
Thailand	13.7	6.2	(6.4)	(8.5)

Current account balance (% GDP)

(average)	2010	2011	2012	2013
Australia	(2.8)	(1.6)	(1.5)	(1.3)
China	5.2	3.5	2.1	1.5
Hong Kong	5.2	3.7	3.4	4.0
India	(2.6)	(3.1)	(3.2)	(3.2)
Indonesia	0.8	0.6	(0.5)	(1.0)
Korea	2.9	2.2	2.8	3.2
Malaysia	11.5	11.4	10.1	9.1
Philippines	4.5	2.2	1.5	1.6
Singapore	22.2	18.5	17.7	16.7
Taiwan	9.5	9.0	9.8	11.4
Thailand	4.3	1.8	(1.8)	(2.3)

Exchange rates (vs USD)

(y/e)	2010	2011	2012	2013
Australia[1]	0.99	0.98	1.00	1.02
China	6.61	6.36	6.36	6.05
Hong Kong	7.77	7.80	7.80	7.80
India	44.65	51.00	57.00	54.00
Indonesia	8,991	9,200	9,450	9,150
Korea	1,133	1,080	1,250	1,150
Malaysia	3.08	3.23	3.35	3.30
Philippines	43.89	44.80	47.20	46.60
Singapore	1.29	1.32	1.36	1.32
Taiwan	30.37	30.50	32.50	33.50
Thailand	30.12	31.60	33.30	34.00

Note: [1]Rates are quoted in USD/AUD.

Policy rates (%)

(y/e)	2010	2011	2012	2013
Australia	4.75	4.25	3.75	3.75
China	2.75	3.50	3.00	3.25
Hong Kong	0.33	0.33	0.30	0.20
India	6.75	8.25	7.50	7.50
Indonesia	6.50	6.00	5.50	6.00
Korea	2.50	3.25	2.50	2.50
Malaysia	2.75	3.00	2.50	2.50
Philippines	4.00	4.50	4.00	4.00
Singapore	0.40	0.40	0.50	0.80
Taiwan	1.63	1.75	1.38	1.38
Thailand	2.00	3.25	2.75	3.00

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RBA ahead of the curve

- Aggregate growth is still good but disguises varying fortunes amongst different sectors.
- Falling commodity prices does nothing to dent our enthusiasm for resource sector strength.
- The RBA eased more quickly than we expected but a weaker domestic picture in 2012 argues for more cuts.

Mixed bag

The Australian macro picture has developed largely in line with our expectations over recent months. Broadly, growth is good, GDP increasing 1.0% QoQ in 3Q11 (from 1.4% QoQ in 2Q). At 2.5% YoY, we judge growth to be right on trend, with mining production still fully to recover from the after-effects of the flooding earlier in the year.

Below the surface of decent headline growth, however, sectoral differences in performance remain as stark as ever. Mining's strength continues to be reflected in robust export receipts, despite the drags of lingering flood impacts and falling commodity prices. But beyond resource-related production, growth is fragile. As an indication, both monthly PMI (manufacturing) and PSI (services) indices are tracking consistently in sub-50 contractionary territory.

Households appear to be positioned somewhere in the middle. Cracks are appearing in the labour market (full-time employment fell heavily in November) and house prices are in modest decline. Consumer confidence is shaky, with pessimists outnumbering optimists again in December's WMI reading.

But we still do not subscribe to the popular characterisation of the household sector as a major drag on the economy. Although a lagging (and lagged) indicator, household disposable income growth is still very strong,

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005	2006	2007	2008	2009	2010	2011clsa	2012clsa	2013clsa
Real GDP growth	3.1	2.7	4.7	2.5	1.4	2.6	2.0	4.2	3.4
Domestic demand (contr. to growth)	4.1	3.0	6.9	3.6	(1.0)	4.0	4.3	4.1	3.9
Nominal GDP growth	7.8	7.7	9.2	9.4	1.5	8.4	6.0	6.3	6.0
Consumer prices (y/e)	2.8	3.3	3.0	3.7	2.1	2.7	3.4	2.2	2.8
Cash target rate (% y/e)	5.50	6.25	6.75	4.25	3.75	4.75	4.25	3.75	3.75
USD/AUD (y/e)	0.74	0.79	0.87	0.67	0.90	0.99	0.98	1.00	1.02
Money supply M1 (y/e)	7.1	12.6	12.9	6.6	4.1	5.2	6.0	7.7	6.1
Current account balance (USD bn)	(41.6)	(41.4)	(59.1)	(46.9)	(43.7)	(35.2)	(23.7)	(22.8)	(21.5)
- as a % of nominal GDP	(5.7)	(5.3)	(6.3)	(4.5)	(4.4)	(2.8)	(1.6)	(1.5)	(1.3)
General government deficit (% GDP)	(1.3)	(1.7)	(1.6)	(1.8)	2.3	4.2	3.1	1.6	0.8

Note: % YoY rates unless otherwise stated.
Source: ABS, RBA, OECD, DataStream

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accelerating to 6.8% YoY in 3Q11, from 6.6% YoY. Retail activity is sluggish but sales growth is only running just below trend. Real household spending as measured in the national accounts – a broader measure encapsulating overseas travel – is unequivocally strong, up 1.2% QoQ in 3Q, the fastest growth since 2Q10. Such is the benefit of a stronger currency for the consumer.

Parity prevails

In the face of a significant lift in global risk aversion (reflected in declines in the prices of virtually all risk assets), the value of USD/AUD has remained remarkably robust. This relative resilience provides confidence in our view that the Aussie can sustain a long term average price of parity against the USD. Such a view still leaves room for fluctuations away from that level, however, and we expect investor uncertainty (primarily relating to the European debt crisis and China's growth prospects) to continue to weigh on the USD/AUD in coming months. We plot a trough of USD0.95/AUD1 at mid-2012 before regaining parity at the end of the year.

Slight growth downgrade

We've made only minor changes to our real growth forecasts, implying still robust GDP growth of 4.2% next year. Private consumption in 2012 will be supported by currency strength (households have shown that if local retailers are not prepared to lower prices then they will purchase online) and lower interest rates, offset by rising unemployment and falling house prices. As the above suggests, however, the key driver will remain the mining sector, via two channels: exports and capex.

Export volumes will grow at a double digit pace in 2012, helped by recovery from flooding but also the consequence of massive expansion in mining capacity undertaken thus far. We see little threat to our bullish mining export volume outlook from falling commodity prices. Even the collapse in iron ore prices – which appear now to have stabilised above USD120/tonne – leaves spot well above the marginal cost of production in Australia (which our resources team puts at USD45-70/tonne). By the

GDP GROWTH FORECASTS

Government (FY)

Updated:	Nov
2011/12:	3.25

Consensus

Updated:	Dec
2012:	3.7

CLSA

2012:	4.2

CLSA

THE CLSA DIFFERENCE

GDP growth

- 2012 growth will be a mining story, both in terms of exports and investment.

Inflation

- Reweighting of the CPI basket provided a catalyst for a downgrade in inflation expectations.

Interest rates & exchange rate

- We look for the RBA ease further in 2012. AUD will weaken in 1H but to regain USD parity at year end.

CLSA

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AUSTRALIA BY NUMBERS	2009	2010	2011clsa	2012clsa	2013clsa
Breakdown of real GDP					
Private consumption	1.0	2.9	3.6	2.8	3.2
Public consumption	0.7	3.4	1.7	1.4	2.7
GFCF	(3.1)	5.1	6.2	8.3	4.8
Domestic demand (contr. to growth)	(1.0)	4.0	4.3	4.1	3.9
Exports, goods & services	2.1	5.8	(1.6)	10.7	6.9
Imports, goods & services	(8.6)	14.1	11.3	9.8	7.7
Real GDP growth	**1.4**	**2.6**	**2.0**	**4.2**	**3.4**
Prices					
Consumer prices (y/e)	2.1	2.7	3.4	2.2	2.8
Consumer prices (average)	1.8	2.8	3.5	2.3	2.7
Producer prices (y/e)	(1.5)	2.7	3.1	2.3	2.6
Currency & interest rates					
USD/AUD (y/e)	0.90	0.99	0.98	1.00	1.02
USD/AUD (average)	0.78	0.91	1.02	0.97	1.01
Cash target rate (% y/e)	3.75	4.75	4.25	3.75	3.75
Lending rate - big corporates (% y/e)	6.00	6.70	6.10	5.80	6.00
External sector					
Exports (USD, % YoY)	(18.5)	38.1	29.8	10.8	9.6
Imports (USD, % YoY)	(18.0)	23.2	23.8	11.2	10.4
Trade balance (USD bn)	(4.4)	17.6	34.3	37.2	38.5
Current account balance (USD bn)	(43.7)	(35.2)	(23.7)	(22.8)	(21.5)
- as a % of nominal GDP	(4.4)	(2.8)	(1.6)	(1.5)	(1.3)
FDI (USD bn)	11.4	6.2	36.0	13.0	10.0
CA + net FDI (% GDP)	(3.3)	(2.3)	0.8	(0.7)	(0.7)
External debt (total, USD bn)	594.7	643.8	780.0	850.0	900.0
Debt service ratio (% exports)	14.7	12.3	8.9	8.9	8.8
International reserves (USD bn, y/e)	33.2	32.0	35.5	38.0	38.5
Money supply					
Money supply M1 (y/e)	4.1	5.2	6.0	7.7	6.1
Money supply M3 (y/e)	6.3	9.1	7.8	8.2	7.2
Private sector credit (y/e)	0.9	3.0	3.4	7.0	5.6
Private sector credit (% GDP)	153.4	145.7	142.1	142.9	142.4
Government sector					
General gov't deficit (% GDP)	2.3	4.2	3.1	1.6	0.8
General gov't debt (% GDP, y/e)	19.4	23.6	26.8	27.9	27.9
Nominal GDP					
Nominal GDP (USD bn)	982.2	1,238.6	1,467.5	1,480.0	1,641.4
Nominal GDP per capita (USD)	44,717	55,472	64,433	63,709	69,271
Nominal GDP (AUD bn)	1,251.9	1,357.0	1,438.5	1,529.8	1,621.2
Nominal GDP (AUD, % YoY)	1.5	8.4	6.0	6.3	6.0
Other data					
Industrial production	(1.7)	4.3	(0.9)	2.1	1.8
Retail sales	5.9	2.5	2.6	2.8	3.2
Unemployment (% y/e)	5.6	5.1	5.3	6.0	5.4
Population (millions)	22.0	22.3	22.8	23.2	23.7

Note: % YoY rates unless otherwise stated. Fiscal deficit estimates are for the fiscal year ending in June eg, 2010/11 is under 2011. *Source:* ABS, RBA, OECD, DataStream

Households are still spending but avoiding local retailers who are too slow to pass on high-AUD benefits.

Capex intentions of miners have lifted further, despite falling commodity prices.

We share a softer inflation outlook with the RBA.

Annual profile disguises a 1H12 depreciation to USD0.95/AUD.

RBA backed up an easing in tone with an easing in rates. We think more cuts will follow in 2012 to mitigate domestic slowing.

Falling commodity prices leave volumes as the sole driver of export receipts in 2012.

Mortgage growth likely to remain downbeat in 2012 given the house price correction that is underway.

Retailers are struggling to adjust to a backdrop of an AUD much stronger than in the past. Households are rationally preferring online sales.

More broadly, the transition to a strong-currency economy will result in job losses, at least in the short term.

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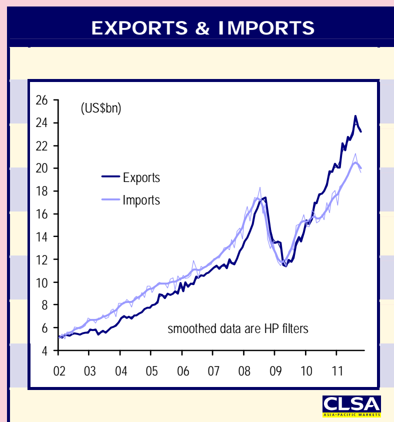
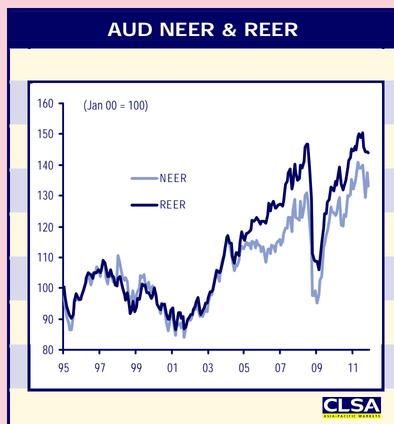
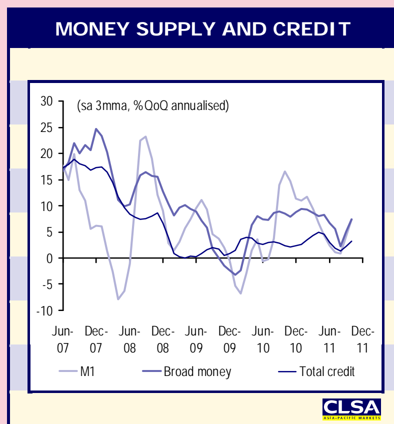
EXPORTS & IMPORTS



AUD NEER & REER



MONEY SUPPLY AND CREDIT



same rationale, we expect mining capex to continue apace. Surveyed capex intentions for fiscal 2012 are still edging higher, implying a doubling in investment over FY 2010 levels.

Though not affecting mining volumes, falling commodity prices will translate directly into lower export receipts. We've lowered our forecast for total nominal export growth to around 10% in 2012 (from 20% previously), all of which is effectively from volume expansion. (Sequential declines in 1H12 still leave export prices broadly flat on an annual average basis). Weaker commodity prices also means a decline in the terms of trade and a slower reduction in the current account deficit than we previously forecast.

RBA ahead of the curve

Monetary policy easing from the Reserve Bank of Australia surprised us. While the RBA's previously hawkish tone clearly softened in 1H11, we did not believe that it would go as far as to cut rates given an environment of robust aggregate growth (both current and forecast) and uncomfortably high inflation. In our defence we'd note the inflation problem was effectively solved by a reweighting of the CPI index, providing a catalyst for a downgrade in expected headline inflation, which the RBA now sees falling comfortably into the 2-3% target band. With inflation in check and growth no better than trend the RBA could justify lowering the policy rate by 50bp during the past quarter, bringing market rates in line with decade averages.

2012 will be a juggling act for the RBA. As we argue above, headline growth will be strong but the ongoing transition of the Australian economy to a more resource-oriented one will not be without its casualties, most notably sectors exposed to the stronger currency (and without the benefit of high sales prices), such as manufacturing and tourism. Against a backdrop of slowing world growth this will result in job losses; we expect the unemployment rate to reach 6.0% by the end of 2012. Having already started the easing cycle, rising unemployment is likely to provoke further cuts from the RBA. We expect 50bp of easing in 2012.

CURRENCY FORECAST

Period-end	Annual					Coming 12 months by quarter			
	2009	2010	2011clsa	2012clsa	2013clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
USD/AUD	0.90	0.99	0.98	1.00	1.02	0.95	0.95	0.98	1.00
JPY 100/AUD	82.8	80.3	77.4	83.0	84.7	69.4	73.2	78.4	83.0
GBP/AUD	0.56	0.63	0.65	0.68	0.69	0.58	0.59	0.61	0.68
EUR/AUD	0.63	0.74	0.78	0.83	0.85	0.70	0.73	0.78	0.83
Memo: USD/EUR	*1.44*	*1.34*	*1.25*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*92.0*	*81.1*	*79.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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Policy vs pragmatism

- Manufacturing weakened in 4Q as international effects reinforced the lagged squeeze from domestic tightening.
- The solution to both is to ease credit policy. On the back of this asset prices will rise and property will pick up.
- Currency appreciation to be suspended for 2012. Rates will be cut after inflation has slowed – mid year.

Short term pragmatism vs long term goals

China, we know, is trying to move its economy away from being driven by investment. A bigger role is planned for consumption. Exports and manufacturing will still be important but at a higher price point and with greater local value added. Leverage will be reduced and interest rates raised to be closer to a fair cost of capital. Excessive growth and excessive environmental degradation will be avoided. The renminbi will have a bigger role in international exchange and, in the very long run, will become fully convertible.

History suggests that long-run economic plans are all well and good, but that the world economy often does not give them space or time to be enacted. This was true in 2008. The global financial crisis was met with an aggressive response from China which raised the investment to GDP ratio (by 5ppts) and involved a huge surge in bank credit. The appreciation of the renminbi, which, from mid-2005 had raised the currency's value by more than 20% versus the USD, was abandoned. True, measures were also introduced to promote household consumption and Beijing was equally quick to start to withdraw the stimulus. But the overwhelming impression from 2008-2009 is one of economic pragmatism. Changing the nature of economic growth is one thing, but the need to protect the economic structure of the day is what drives immediate policy.

The spread of the European bond crisis into the international credit markets makes a repeat performance something to be expected in 2012. What form this stimulus will take and what is motivating it are discussed in detail in the

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005	2006	2007	2008	2009	2010	2011clsa	2012clsa	2013clsa
Real GDP growth	11.3	12.7	14.2	9.6	9.2	10.3	9.2	8.0	9.2
Domestic demand (contr. to growth)	8.7	10.7	11.7	8.8	12.8	9.5	9.2	8.9	9.2
Nominal GDP growth	15.7	17.0	22.9	18.1	8.6	16.7	19.0	13.8	16.8
Consumer prices (y/e)	1.6	2.8	6.5	1.2	1.9	4.6	4.2	2.9	3.1
1-year savings rate (% y/e)	2.25	2.52	4.14	2.25	2.25	2.75	3.50	3.00	3.25
CNY/USD (y/e)	8.08	7.82	7.37	6.83	6.83	6.61	6.36	6.36	6.05
Money supply M1 (y/e)	11.8	17.5	21.0	9.1	32.4	21.2	8.7	11.5	16.8
Current account balance (USD bn)	160.8	253.3	371.8	426.1	297.1	306.2	254.7	178.2	157.2
- as a % of nominal GDP	7.1	9.3	10.6	9.4	6.0	5.2	3.5	2.1	1.5
Public sector deficit (% GDP)	1.2	1.0	(0.2)	0.8	2.8	1.6	1.0	1.5	1.0

Note: % YoY rates unless otherwise stated.
Source: IMF, World Bank, China Economic News, CEIC
CLSA

Prepared for: ThomsonReuters

Viewpoint of this *Eye on Asian Economies* (pp1-33) leaving this forecast section to focus more on the growth consequences. So briefly we believe that China is facing a combined export demand and credit squeeze with the latter reflecting a combination of historical government policy and the swing in balance of payments position as investors have fled risk assets and European banks have started – in the name of recapitalisation – to shrink their risk books.

Stimulate but not overstimulate

The response will use some of the same mechanisms that were seen in 2009 but will be rather less extreme. Beijing may be worried about global developments but neither does it wish to overstimulate and there are good reasons to expect export conditions in the second half to be better. We expect:

- Increased lending quota in 2012 (we have pencilled in CNY10tn) to bring credit supply back into the fractional reserve banking system.
- Cuts in RRR to free up banks' ability to lend and to avoid a monetary tightening during (more frequent) periods of BoP deficit.
- An easing of restrictions on residential property.
- Some increases in federally mandated (as opposed to local authority) infrastructure.

Much of this was in our forecast three months ago, though the Eurocentric international liquidity squeeze has increased the urgency somewhat. We have however added two additional stimuli to what we thought likely three months ago:

- CNY appreciation will be suspended until early 2013 in favour of a constant USD rate. This has already started, revealing more offical concern about the global environment than we earlier thought.
- Lending and deposit rates will be cut late 2Q12 or early 3Q12. By end-2012 we see them 50bp lower. This reflects cuts in our inflation forecast due, firstly, to growth pressures and, secondly, the very good end to 2011 (which itself may reflect economic stress).

GDP GROWTH FORECASTS

Government	
Updated:	Dec
2012:	~8.5-9
Consensus	
Updated:	Dec
2012:	8.5
CLSA	
2012:	8.0

CLSA

THE CLSA DIFFERENCE

GDP growth
- A weaker first half justifies a below consensus forecast, note though that our forecast implies no crisis.

Inflation
- Has dropped away quickly, we have cut our inflation estimate for 2012 to below the consensus.

Interest rates & exchange rate
- NDFs signal depreciation, this won't happen but we expect CNY appreciation to pause for a year.

CLSA

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2012 will be another year in which PCE lags.

Boost to GFCF mainly construction. Note also that gov't consumption continues to be strong.

Weak start to 2012 as trade finance squeezed. Rebound in 2H12 is most visible in 2013 forecast.

Soft first half reflects an unwillingness to stimulate as hard as 2009. 8% growth is a policy success.

Inflation has fallen rapidly and we have cut our 2012 forecast. Mid year trough...

...allows lower rates in early 2H12. Rising again in 2013.

FDI and current a/c provide bulk of reserve growth. There will be more months when reserves fall but China's BoP surpluses, though reduced, are not quite over yet.

This equates to around CNY10tn increase in lending quota.

Credit and property will form bulk of stimulus, but we would be unsurprised to see transfer payments to households also.

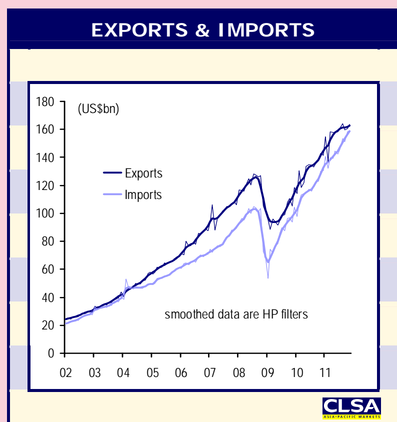
CHINA BY NUMBERS

	2009	2010	2011clsa	2012clsa	2013clsa
Breakdown of real GDP					
Private consumption	8.3	6.0	5.5	5.0	6.0
Public consumption	8.2	13.1	13.0	13.0	13.0
GFCF	23.9	11.8	11.0	11.5	11.0
Domestic demand (contr. to growth)	12.8	9.5	9.2	8.9	9.2
Exports, goods & services	(10.3)	29.5	10.0	0.0	10.0
Imports, goods & services	3.3	24.4	10.0	7.0	10.0
Real GDP growth	**9.2**	**10.3**	**9.2**	**8.0**	**9.2**
Prices					
Consumer prices (y/e)	1.9	4.6	4.2	2.9	3.1
Consumer prices (average)	(0.7)	3.3	5.4	2.9	3.1
Producer prices (y/e)	1.7	5.9	0.0	3.0	4.0
Currency & interest rates					
CNY/USD (y/e)	6.83	6.61	6.36	6.36	6.05
CNY/USD (average)	6.83	6.77	6.47	6.36	6.21
1-year savings rate (% y/e)	2.25	2.75	3.50	3.00	3.25
1-year lending rate (% y/e)	5.31	5.81	6.56	6.06	6.31
External sector					
Exports (USD, %YoY)	(16.1)	31.4	19.9	1.4	16.6
Imports (USD, %YoY)	(11.1)	39.1	25.4	6.7	17.7
Trade balance (USD bn)	249.5	254.2	231.9	148.4	153.5
Current account balance (USD bn)	297.1	306.2	254.7	178.2	157.2
- as a % of nominal GDP	6.0	5.2	3.5	2.1	1.5
FDI (USD bn)	70.3	124.9	50.0	50.0	50.0
CA + net FDI (% GDP)	6.6	7.3	4.2	2.7	2.0
External debt (total, USD bn)	428.6	548.9	n.a.	n.a.	n.a.
Debt service ratio (% exports)	2.9	n.a.	n.a.	n.a.	n.a.
International reserves (USD bn, y/e)[1]	2,399.2	2,847.3	3,212.0	3,340.2	3,547.4
Money supply					
Money supply M1 (y/e)	32.4	21.2	8.7	11.5	16.8
Money supply M2 (y/e)	27.7	19.7	12.9	15.1	15.5
Financial institutions loans (y/e)	31.7	19.9	15.7	18.1	14.6
Financial institutions loans (% GDP)	117.2	120.4	117.0	121.5	119.2
Government sector					
General government deficit (% GDP)	2.8	1.6	1.0	1.5	1.0
Nominal GDP					
Nominal GDP (USD bn)	4,990.7	5,879.5	7,322.5	8,474.6	10,146.0
Nominal GDP per capita (USD)	3,739	4,384	5,436	6,263	7,464
Nominal GDP (CNY bn)	34,090	39,798	47,377	53,899	62,956
Nominal GDP (CNY, %YoY)	8.6	16.7	19.0	13.8	16.8
Other data					
Industrial production	11.0	15.7	13.5	11.0	14.0
Retail sales	15.5	18.4	17.1	16.7	17.7
Unemployment (% y/e)	4.3	4.1	n.a.	n.a.	n.a.
Population (millions)	1,335	1,341	1,347	1,353	1,359

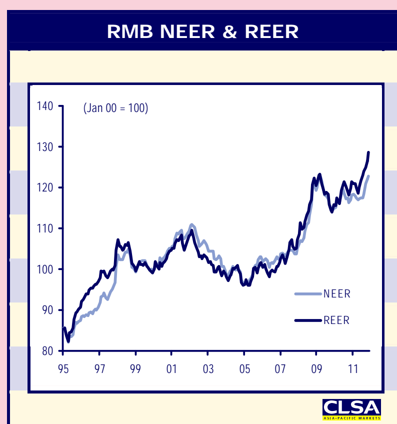
Note: % YoY rates unless otherwise stated. [1]PBoC foreign exchange balances.
Source: IMF, World Bank, China Economic News, CEIC

Prepared for: ThomsonReuters

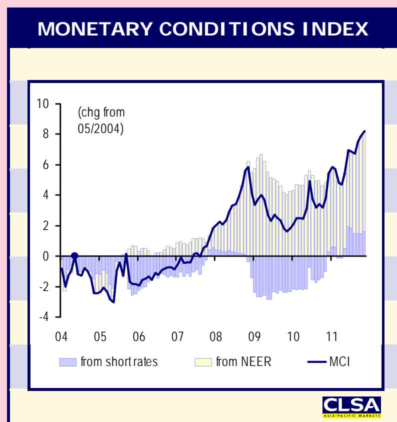
EXPORTS & IMPORTS



RMB NEER & REER



MONETARY CONDITIONS INDEX



Results – containment pretty successful

The anticipated success of this policy is shown in our 8% growth forecast for 2012. This is a fraction less than we thought three months ago but still constitutes a good result that will help regional exporters (at least those with a diversified export mix) as well as China.

The stimulus will not be able to compensate for external weakness real time. First and second quarter growth will be soft with 7.9% and 7.5% on a year on year basis (on a quarter on quarter annualised basis this represents 6.1% QoQ saar followed by 7.0% QoQ saar). However the weakness will be short lived. The effects of the credit easing will be cumulative and together with a potentially sharp rebound in intra-Asia trade as the risk shedding by European banks slows (around mid-year) suggest accelerating growth in 2H12 and into 2013. We have pencilled 9¼% GDP growth in for CY2013 with a peak of a little more than 9½% YoY in 2Q13.

Back on track, so pull it back

This profile will allow the stimulus to be withdrawn early. In fact the first "tightening" is likely before the end of 2012 in the form of stepped up moral suasion on banks to be mindful of credit risk. Loan growth will decelerate in 2013 and with much more recognition of the risks of promoting off quota lending than occurred in 2009. China's balance of payments surpluses are unlikely ever to regain the immense level that they had during the "QE2" period (forex reserve growth peaked at USD743bn in the 12 months to June 2011). RRR hikes will therefore be much less aggressive in 2013 than they were in 2011. But they will be necessary and for the same reason, to help back up a cut in loan quota which, otherwise, might be evaded.

Interest rates have a role to play here also and they are likely to be increased early in 2013, even though we expect inflation to remain low. Finally, currency appreciation will be reinstated. Our CNY forecast is for a 6% annualised rate of appreciation from early 2013; the currency will approach six to the USD by the end of the year.

CURRENCY FORECAST

Period-end	Annual					Coming 12 months by quarter			
	2009	2010	2011clsa	2012clsa	2013clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
CNY/USD	6.83	6.61	6.36	6.36	6.05	6.36	6.36	6.36	6.36
CNY/JPY 100	7.42	8.15	8.05	7.66	7.29	8.71	8.26	7.95	7.66
CNY/GBP	11.06	10.31	9.54	9.41	8.95	10.43	10.30	10.18	9.41
CNY/EUR	9.81	8.86	7.95	7.63	7.26	8.59	8.27	7.95	7.63
Memo: USD/EUR	*1.44*	*1.34*	*1.25*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*92.0*	*81.1*	*79.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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The battle renewed

- Hong Kong is highly exposed to weak global trade. We have lowered our growth expectations accordingly.
- Retail growth will slow. But tourist spending will remain a major positive next year.
- Extra housing supply will battle monetary loosening in a renewed house price battle in 2012.

Economy of contrasts

As a barometer of the strength global trade, Hong Kong has suffered over the past six months. Merchandise flows have dropped sharply; re-export volumes fell 0.9% QoQ in 3Q11, following a 6.2% QoQ decline in the previous quarter. Hong Kong has avoided a technical recession, but only just; after falling 0.4% QoQ in 2Q11, GDP squeezed higher by 0.1% QoQ in 3Q.

Yet it remains an economy of contrasts. The after-effects of a sustained period of excess liquidity continue to provide a boost to the domestic economy. Retail sales growth remains extremely robust, increasing 2.6% QoQ in October. Favourable price differentials for luxury goods in Hong Kong versus the mainland help; as of October, mainland tourist arrivals were increasing at an annualised rate of over 12%.

But this is not just a tourism story. Real household consumption increased 1.1% QoQ sa in 3Q, to be up nearly 9% YoY. Excess liquidity again plays a part, driving a substantial wealth effect. Property prices have flattened out in recent months but are up around 10% in year-on-year terms, a still extreme pace of asset price inflation given secondary residential transaction volumes have fallen by more than a half over the same period.

Worse to come

The trade picture will remain weak for at least the next six months. Europe's economy will contract next year and US growth will slow sharply in coming quarters (see the *World View* section on pp33-36). The west cannot be relied

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005	2006	2007	2008	2009	2010	2011clsa	2012clsa	2013clsa
Real GDP growth	7.1	7.0	6.4	2.3	(2.7)	7.0	5.1	1.3	5.4
Domestic demand (contr. to growth)	1.4	5.3	7.1	1.4	0.7	6.6	5.3	3.1	4.1
Nominal GDP growth	7.0	6.7	9.5	3.8	(3.3)	7.5	9.1	4.9	8.7
Consumer prices (y/e)	1.3	2.3	3.8	4.6	0.3	2.7	5.0	4.0	3.5
3-month HIBOR (% y/e)	4.16	3.84	3.31	0.89	0.13	0.33	0.33	0.30	0.20
HKD/USD (y/e)	7.75	7.77	7.80	7.75	7.76	7.77	7.80	7.80	7.80
Money supply M1 (y/e)	(10.3)	13.1	25.4	4.7	39.6	12.8	11.2	9.3	15.3
Current account balance (USD bn)	6.0	7.3	9.8	10.6	11.4	11.6	9.1	8.7	11.0
- as a % of nominal GDP	3.4	3.9	4.7	4.9	5.4	5.2	3.7	3.4	4.0
Public sector deficit (% GDP)[1]	(1.1)	(3.9)	(7.5)	(0.1)	(1.6)	(4.2)	0.5	(1.3)	(0.8)

Note: % YoY rates unless otherwise stated. [1] Fiscal year starting April.
Source: CEIC, CLSA estimates, HK government

Prepared for: ThomsonReuters

upon to drive a recovery in Hong Kong trade volumes in 1H12. At the same time, China's economy will be in a period of transition, moving toward a steadily looser policy footing. This process will not be rushed by Beijing, however, implying that benefits to Hong Kong's trade services sector will be drip-fed rather than delivered en masse. Moreover, not all of China's potential policy measures are created equal. Provision of new trade credit to fill the void left by risk-shunning European banks will obviously be a support to Hong Kong trade. However, benefits from a lift in infrastructure spending – dependent more on commodities than the manufactured goods that pass across Hong Kong's borders – would be scant.

The result is that we are downbeat on Hong Kong trade in 2012. We have lowered our real export growth forecast to 0.6%. That's a substantial cut from our previous expectation of 5.7% but recent trade data have already proven much worse than we anticipated a quarter ago. And in the context of the 0% export growth we expect for China, our Hong Kong forecast is appropriate. The turning point will most likely come in 2H12, by which time growth in both the US and China will be improving.

Changing domestic fortunes

Belying strong spending data, there are already signs that the domestic economy is also slowing. Businesses are consolidating, reflected in falling investment in 3Q11 (although, to be fair, QoQ gross fixed capital formation has been extremely volatile since the Global Financial Crisis). A more worrying sign, for households at least, is that unemployment has troughed, creeping higher since August's post-GFC low. Given businesses' decisions regarding both investment and employment tend to be made in reaction to slower demand, our gloomy export forecast necessitates continued domestic slowing. Unemployment will lift to 4.5% by the end of 2012 (from 3.4% in November), before slowly easing again in 2013.

GDP GROWTH FORECASTS

Government
Updated:
2012: n.a.

Consensus
Updated: Dec
2012: 3.9

CLSA
2012: 1.3

CLSA

THE CLSA DIFFERENCE

GDP growth
- The consensus has yet to appreciate that HK is caught between synchronised slowdowns in the west and China.

Inflation
- Inflation will drift lower in 2012 but super-low interest rates will prevent a normalisation to historical norms.

Interest rates & exchange rate
- Still no material change in HKD rates in our forecast horizon given an easing US Fed.

CLSA

Prepared for: ThomsonReuters

A weaker labour market and housing market uncertainty will see consumption slow.

The slump in exports surprised even our gloomy outlook but is entirely in keeping with the global backdrop...

...and we have pulled down our growth forecasts as a consequence. 2012 will be weak.

Repatriation of funds by EU banks is a risk, but global liquidity will expand in 2012.

Credit growth will be much slower in 1H12. But global liquidity will again start to pool in Hong Kong later in the year. Banks will be motivated to lend.

Our forecast slowing in retail spending is benign compared to the GDP slump. Mainland tourists will prove the difference.

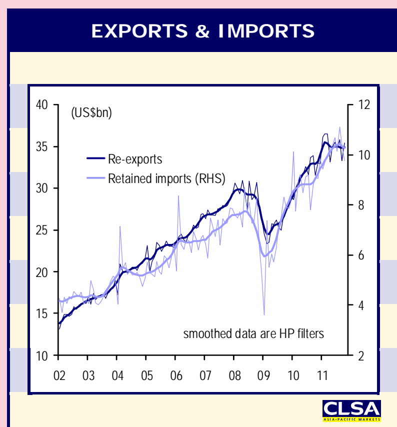
HONG KONG BY NUMBERS

	2009	2010	2011clsa	2012clsa	2013clsa
Breakdown of real GDP					
Private consumption	0.7	6.2	8.1	3.6	4.4
Public consumption	2.3	2.7	2.0	1.2	1.2
GFCF	(3.9)	7.8	5.9	3.5	5.4
Domestic demand (contr. to growth)	0.7	6.6	5.3	3.1	4.1
Exports, goods & services	(10.3)	16.8	4.0	0.6	8.1
Imports, goods & services	(9.0)	17.3	4.6	0.4	7.9
Real GDP growth	**(2.7)**	**7.0**	**5.1**	**1.3**	**5.4**
Prices					
Consumer prices (y/e)	0.3	2.7	5.0	4.0	3.5
Consumer prices (average)	1.0	1.9	5.3	4.3	3.6
Currency & interest rates					
HKD/USD (y/e)	7.76	7.77	7.80	7.80	7.80
HKD/USD (average)	7.75	7.77	7.79	7.80	7.80
3-month HIBOR (% y/e)	0.13	0.33	0.33	0.30	0.20
Prime rate (% y/e)	5.00	5.00	5.00	5.00	5.00
External sector					
Domestic exports (USD, % YoY)	(24.9)	7.6	8.3	1.3	4.3
Re-exports (USD, % YoY)	(11.8)	23.2	10.7	1.6	8.7
Exports (USD, % YoY)	(12.3)	22.7	10.7	1.6	8.6
Imports (USD, % YoY)	(10.6)	25.6	12.2	2.9	8.5
Trade balance (USD bn)	(26.9)	(43.0)	(54.0)	(61.2)	(66.2)
Current account balance (USD bn)	11.4	11.6	9.1	8.7	11.0
- as a % of nominal GDP	5.4	5.2	3.7	3.4	4.0
FDI (USD bn)	3.6	(2.1)	3.6	2.0	1.7
CA + net FDI (% GDP)	7.2	4.3	5.2	4.2	4.6
International reserves (USD bn, y/e)	255.8	268.7	288.7	296.7	308.7
Money supply					
Money supply M1 (y/e)	39.6	12.8	11.2	9.3	15.3
Money supply M2 (y/e)	5.3	8.1	11.9	8.2	12.0
HKD bank lending (y/e)	2.0	17.6	10.9	5.1	9.1
HKD bank lending (% GDP)	148.0	162.0	164.6	164.9	165.4
Government sector					
Public sector deficit (% GDP)[1]	(1.6)	(4.2)	0.5	(1.3)	(0.8)
Fiscal reserves (HKD bn)[1]	520.3	595.4	585.4	635.4	685.4
Min permitted reserves (HKD bn)[2]	315.1	292.5	301.4	370.0	330.0
Nominal GDP					
Nominal GDP (USD bn)	209.3	224.4	244.2	255.9	278.2
Nominal GDP per capita (USD)	29,849	31,710	34,303	35,622	38,275
Nominal GDP (HKD bn)	1,622	1,744	1,902	1,996	2,170
Nominal GDP (HKD, % YoY)	(3.3)	7.5	9.1	4.9	8.7
Other data					
Industrial production	(8.3)	3.5	n.a.	n.a.	n.a.
Retail sales	0.4	18.5	25.0	13.6	14.5
Unemployment (% y/e)	5.1	4.0	3.6	4.5	4.2
Population (millions)	7.0	7.1	7.1	7.2	7.3

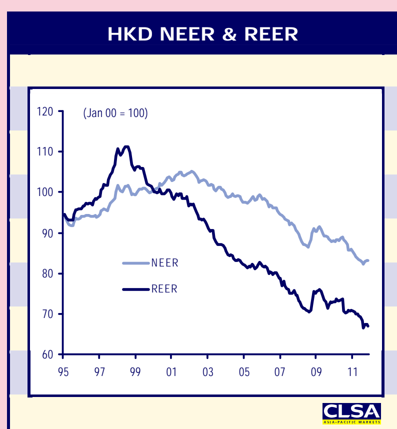
Note: % YoY rates unless otherwise stated. [1] Fiscal year starting April. [2] Equals 12 months government expenditure.
Source: CEIC, CLSA estimates, HK government

Prepared for: ThomsonReuters

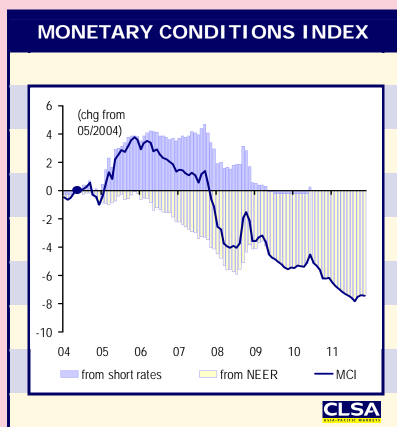
EXPORTS & IMPORTS



HKD NEER & REER



MONETARY CONDITIONS INDEX



Retail spending will suffer the consequence of rising unemployment and, possibly, falling property prices. But local spending has not been the swing factor in Hong Kong's retail boom; that distinction rests with mainland arrivals, which continue to flood into the SAR despite slowing in aggregate mainland growth (and in China's retail sales growth, incidentally). Cumulative taxes on luxury products in China are substantial (by way of illustration, our retail team judges Swiss-made watches are around 10-30% cheaper in Hong Kong) and while such levies remain in place, Hong Kong will remain a favoured shopping destination. A halt of RMB appreciation in 2012, as we expect, will barely make a difference.

House prices: A lingering problem?

Having pushed against the residential property market for over a year, the government stepped up its efforts to curb excessive house price appreciation. In his final policy address as Hong Kong Chief Executive, Donald Tsang announced a series of measures designed to strike at the heart of the supply-demand imbalance implied by soaring prices; in summary, the government will increase supply of public housing units and make more land available for private development. The target is an increase of 40,000 housing units per year for the next decade. This alone represents a significant increase over the 25,000 homes added to the housing stock in 2011. But the scheme is also designed to be front-loaded, so the incremental increase in supply from 2011 to 2012 is greater still. 2012 has the hallmarks of being a year in which the battle between the government and the property market will at its most intense for some years.

Such a large lift in supply, at a time when the property market is already in the midst of a correction (as evidenced by the drop-off in secondary transactions) would normally be a certain catalyst for a price correction. But 2012 is also shaping up to pan out very similarly to 2010, in which easier monetary policy in China led to an influx of mainland capital into Hong Kong, destined primarily for the property market. The side-effects of Beijing easing policy will run counter to the wishes of the Hong Kong government. Reining in property prices may prove harder than it expects.

CURRENCY FORECAST

Period-end	Annual					Coming 12 months by quarter			
	2009	2010	2011clsa	2012clsa	2013clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
HKD/USD	7.76	7.77	7.80	7.80	7.80	7.80	7.80	7.80	7.80
HKD/JPY 100	8.43	9.58	9.87	9.40	9.40	10.68	10.13	9.75	9.40
HKD/GBP	12.57	12.12	11.70	11.54	11.54	12.79	12.64	12.48	11.54
HKD/EUR	11.14	10.41	9.75	9.36	9.36	10.53	10.14	9.75	9.36
Memo: USD/EUR	*1.44*	*1.34*	*1.25*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*92.0*	*81.1*	*79.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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CLSA
ASIA-PACIFIC MARKETS

EoAE Forecasts

1Q12

India

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Double whammy

- **GDP growth forecast for FY12 and FY13 cut to 6.7% and 6.3%, respectively.**
- **Headline inflation falling and likely to decline further, positioning the RBI to ease from early 2012 onwards.**
- **Muted capital inflows amplify the pressure of current account deficit on INR, which is expected to weaken more.**

Home-grown problems take a toll on growth

2011 will probably go down in history as the year of the perfect storm for India. Whatever could go wrong, did. This was a year where India had an opportunity to stand out globally, not so much from doing too many things right but merely by avoiding wrong moves. Alas, India blew the opportunity, thanks to the politicians and to some mistakes by policymakers.

India's economic growth has been moderating since early 2010 and slipped below the 7%-mark in 3Q11 when it printed 6.9% YoY (non-agriculture growth was better at 7.3%). The service sector remained the star performer, with output rising 9.3% YoY in 3Q11, offsetting the sizeable deceleration in the industrial sector. There are two drivers of India's growth slowdown; first a cyclical deceleration that is a direct result of tighter monetary policy and was a key policy objective; and, second, broader policy inertia and corruption scandals that have hurt confidence. These domestic factors have added to the adverse impact of global headwinds, and have taken a bigger toll on growth.

We have cut our GDP growth forecast to 6.7% (from 7.3% in 4Q11 *EoAE*) and to 6.3% (from 7.5%). 2H FY13 is expected to be better than 1H if the government gets its act together even partially, otherwise there could be further downside risk to this forecast. While tight monetary policy was intended to moderate growth, the uneven deceleration is due mainly to government inaction. Consequently, the slowdown in investment has been much more pronounced than in consumption. The virtuous cycle of higher project approvals leading to higher investment, which in turn raises growth, stalled in 2011 owing to a combination of factors that are an offshoot of political inaction, corruption scandals and the hit to business confidence.

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	11/12clsa	12/13clsa	13/14clsa
Real GDP growth	9.5	9.6	9.3	6.8	8.0	8.5	6.7	6.3	7.2
Domestic demand (contr. to growth)	11.1	10.2	11.2	7.8	9.8	7.7	6.5	6.1	7.1
Nominal GDP growth	13.9	16.3	16.1	12.0	17.3	20.2	16.6	12.5	12.1
Wholesale prices (y/e)	4.2	6.7	7.7	1.6	10.4	9.7	7.0	6.5	6.0
Repo rate (% y/e)	6.50	7.50	7.75	5.00	5.00	6.75	8.25	7.50	7.50
INR/USD (y/e)	44.61	43.60	39.99	50.95	45.14	44.65	51.00	57.00	54.00
Money supply M1 (y/e)	27.6	17.1	19.4	9.0	18.2	9.8	5.0	10.0	13.0
Current account balance (USD bn)	(9.9)	(9.6)	(15.7)	(27.9)	(38.4)	(44.3)	(57.3)	(60.1)	(66.3)
- as a % of nominal GDP	(1.2)	(1.0)	(1.3)	(2.3)	(2.8)	(2.6)	(3.1)	(3.2)	(3.2)
Central gov't deficit (% GDP)	4.0	3.3	2.6	6.0	6.4	4.7	5.5	5.0	4.7

Note: All figures % YoY growth rates, unless otherwise stated. All data refer to fiscal years starting April.
Source: CMIE, Reserve Bank of India, IMF, ADB, World Bank, IIF, CEIC

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The production accounts of GDP, which tend to be more reliable than the expenditure data, show that the slowdown has been due mainly to a deceleration in the industrial sector. This has been worsened by the decline in mining output (due to a fall in coal output, unrelated to cyclical factors) and sharply lower capital goods production. The latter is a casualty of weak project approvals and higher interest rates.

It is difficult firmly to establish when the policy inaction will sufficiently reverse, which in turn underscores the risks to even our below-consensus forecast. Importantly, unlike 2008, the problems now are largely home-grown with greater political inertia and lower flexibility for using fiscal and monetary policies to counter the economic moderation. One of the remarkable features of India's reaction to the 2008 Global Financial Crisis was the aggressive and well-coordinated policy response. Unfortunately this is unlikely to be repeated.

Politics is the weakest link in India's growth and was a major spoilsport in 2011. As discussed in **Different track – India's unique rise** (11 November 2011) unlike the Asian authoritarian political regimes, which favoured political openness after becoming sufficiently economically open, India is moving ahead with the reverse combination, and with the additional liability of weak coalition governments. There are several well-documented shortcomings and missteps that the ruling UPA-II can legitimately be accused of. However, attempting to push through a bold reform like foreign direct investment (FDI) in the retail sector is not one of them. The recent backtracking by the government on retail FDI reveals more about the opposition than about the government, and is yet another rude reminder about the lack of strong political consensus on reforms in India.

Good news on inflation, finally

In *India unplugged,* **Tracking inflation,** (11 November) we reiterated that inflation will begin to ease towards the end of CY2011 and then decline more meaningfully to hit 7-7.5% YoY by March 2012. Indeed, WPI inflation in November came in at a one-year low of 9.1% YoY, led by a dramatic fall in food composite inflation to 7.9% YoY from 9.9%

GDP GROWTH FORECASTS

Government

Updated:	Dec
2011/12:	7.5

Consensus

Updated:	Dec
2011/12:	7.4

CLSA

2011/12:	6.7

THE CLSA DIFFERENCE

GDP growth
- We remain below consensus for GDP growth for both FY12 and FY13.

Inflation
- Headline WPI inflation has begun to ease and will soften further through the end of the fiscal year.

Interest rates & exchange rate
- RBI to ease from January onwards, possibly with a CRR cut. INR poised to be hit hard if USD rallies.

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INDIA BY NUMBERS

	2009/10	2010/11	2011/12clsa	12/13clsa	13/14clsa
Breakdown of real GDP					
Private consumption	7.3	8.6	6.8	6.3	7.0
Public consumption	16.4	4.8	4.0	3.0	3.0
GFCF	7.3	8.6	2.0	5.0	7.0
Domestic demand (contr. to growth)	9.8	7.7	6.5	6.1	7.1
Exports, goods & services	(5.5)	17.9	17.0	4.0	13.0
Imports, goods & services	(1.8)	9.2	12.0	5.0	13.5
Real GDP[1]	**8.0**	**8.5**	**6.7**	**6.3**	**7.2**
Prices					
Wholesale prices (y/e)	10.4	9.7	7.0	6.5	6.0
Wholesale prices (average)	3.8	9.6	8.9	6.7	6.5
Currency & interest rates					
INR/USD (y/e)	45.14	44.65	51.00	57.00	54.00
INR/USD (average)	47.44	45.56	49.66	55.50	55.50
Repo rate (% y/e)	5.00	6.75	8.25	7.50	7.50
Reverse repo rate (% y/e)	3.50	5.75	7.25	6.50	6.50
External sector					
Exports (USD, %YoY)	(3.6)	37.4	27.0	7.0	16.0
Imports (USD, %YoY)	(2.6)	26.7	24.0	7.0	13.0
Trade balance (USD bn)	(118.4)	(130.5)	(154.3)	(165.1)	(176.3)
Current account balance (USD bn)	(38.4)	(44.3)	(57.3)	(60.1)	(66.3)
- as a % of nominal GDP	(2.8)	(2.6)	(3.1)	(3.2)	(3.2)
FDI (USD bn)	18.8	7.1	20.0	15.0	15.0
CA + net FDI (% GDP)	(1.4)	(2.1)	(2.0)	(2.4)	(2.5)
External debt (total, USD bn)	261.0	305.9	335.0	365.0	400.0
Debt service ratio (% exports)	6.8	5.6	5.0	5.3	4.6
International reserves (USD bn, y/e)	279.1	304.8	308.0	315.0	320.0
Money supply					
Money supply M1 (y/e)	18.2	9.8	5.0	10.0	13.0
Money supply M3 (y/e)	16.8	16.0	16.0	15.0	17.0
Private sector credit (y/e)	16.9	21.5	16.0	16.0	17.0
Private sector credit (% GDP)	49.5	50.1	49.8	51.3	53.6
Government sector					
Central gov't deficit (% GDP)	6.4	4.7	5.5	5.0	4.7
General gov't deficit (% GDP)	9.3	7.3	8.0	7.7	7.2
Central gov't debt (% GDP, y/e)	53.7	49.9	49.0	48.5	48.0
General gov't debt (% GDP, y/e)	69.2	64.3	63.5	62.5	61.5
Nominal GDP					
Nominal GDP (USD bn)	1,380.6	1,728.5	1,848.7	1,861.5	2,087.4
Nominal GDP per capita (USD)	1,180.0	1,457.5	1,538.0	1,528.3	1,691.7
Nominal GDP (INR bn)	65,503	78,756	91,813	103,314	115,853
Nominal GDP (INR, %YoY)	17.3	20.2	16.6	12.5	12.1
Other data					
Industrial production	8.0	7.9	3.0	3.8	5.5
Population (millions)	1,170	1,186	1,202	1,218	1,234

Note: All figures % YoY growth rates, unless otherwise stated. All data refer to fiscal years starting April.
[1] At factor cost.
Source: CMIE, Reserve Bank of India, IMF, ADB, World Bank, IIF, CEIC

Investment has been hurt mainly by a combination of policy inaction and weaker business confidence.

Private consumption growth will cool although the slowdown in rural spending will be less pronounced.

Slower growth and decline in commodity prices in 2012 will be positive for inflation.

After temporary 1Q12 USD weakness (due to anticipation of QE3), the INR is likely to weaken significantly.

RBI will begin easing from January with a CRR cut followed by a rate cut soon after the federal budget.

Global risk aversion will make financing the CA deficit more challenging and increase INR worries.

Credit growth will moderate as economic growth cools.

The slippage in the federal government's fiscal deficit will be more than we earlier estimated at around 5.5% of GDP (official: 4.6%) in FY12.

Industrial activity continues to be hurt by both cyclical factors and the ongoing policy inaction.

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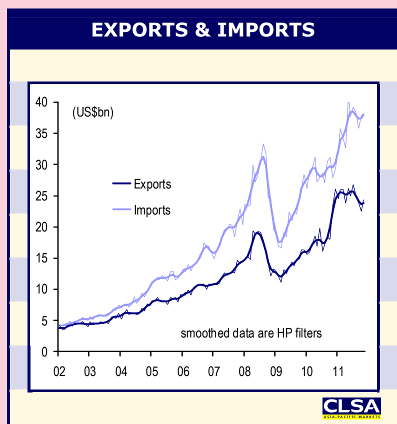

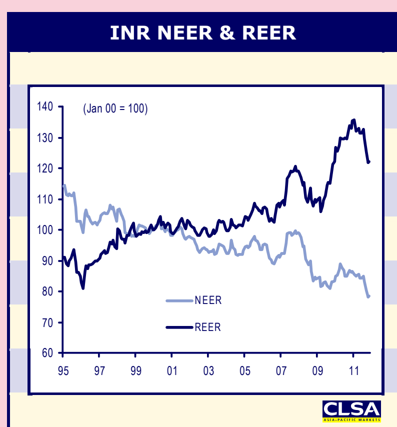

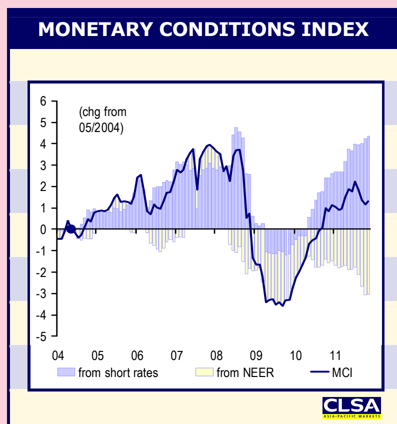

in October. However, core (non-food manufactured goods) inflation moved up, primarily due to the INR's depreciation. Still, as aggregate demand softens, pricing power will suffer, which in turn should improve core inflation and position the RBI to ease. As expected, the RBI adopted a dovish tone and signalled easing but refrained from cutting rates or the cash reserve ratio (CRR) at its December meeting. Our view is that monetary easing will kick off from January with the RBI likely to ease by 100-150bp in the coming twelve months and also announce cuts in the CRR. Still, there is only so much monetary easing will help as it cannot fix the fallout from government's inaction.

Fiscal and INR should be key investor focus

Given our revisions and the incoming data, we now expect the federal government's FY12 fiscal deficit to be around 5.5% of GDP (revised from 5.2%) versus 4.6% announced by the government. All eyes will be on the federal budget for FY13 at the end of February. The government has little choice but to announce a credible fiscal consolidation plan and limit the fiscal deficit to around 5% of GDP. Credit rating agencies will be watching the budget closely.

India runs a chronic current account (CA) deficit and the INR comes under pressure every time capital inflows suffer due to global and/or local factors. The additional factor, which was not present during the 2008 collapse in the INR, is that the RBI has been largely absent from the currency market, and some its own guidance has added fuel to the fire (see *India unplugged*, **RBI's rupee folly**, 22 November 2011). As pointed out in *Infofax,* **Tracking external debt dynamics** (25 November 2011) India's external pressures are manageable. The RBI's recent measures to check speculation in the currency market and to boost capital inflows will help the INR but a strong USD rebound could easily cause Asian currencies, including the INR, to depreciate significantly. As always, INR will suffer more as India runs a CA deficit compared to surpluses by other economies, and could plunge to around INR58/USD due to the anticipated strong USD rebound in 2012.

CURRENCY FORECAST

Period-end	Annual (Fiscal years)					Coming 12 months by quarter			
	2009/10	2010/11	2011/12clsa	2012/13clsa	2013/14clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
IRs/US$	45.14	44.70	51.00	57.00	54.00	51.00	53.00	55.00	58.00
IRs/Yen 100	48.33	53.86	69.86	68.67	65.06	69.86	68.83	68.75	69.88
IRs/GBP	68.52	71.61	83.64	84.36	79.92	83.64	85.86	88.00	85.84
IRs/Euro	60.98	63.25	68.85	68.40	64.80	68.85	68.90	68.75	69.60
Memo: USD/EUR	*1.35*	*1.42*	*1.35*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*93.4*	*83.0*	*73.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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Resilient view maintained

- Real GDP growth will hold up at 6% in 2012 despite the global downturn and accelerate to 7% in 2013.
- Resilience stems from the structural forces driving domestic demand and an advantage in attracting FDI.
- Loose monetary policy will have inflation consequences but this will be delayed until 2013.

Structural forces too powerful to resist

Our forecast for 6% real GDP growth in 2012, slightly below our 6.5% estimate for 2011, contrasts with sharply slowing growth forecasts for our other Asian economies. The argument for Indonesia's resilience was made in the *Viewpoint* of the 4Q11 *Eye on Asian Economies*, **Arise Indonesia**, with our bullish view reinforced by data trends over the last three months.

There are three key factors behind Indonesia's resilience. First, powerful structural forces will continue to drive domestic demand, specifically urbanisation and the expanding middle class. Second, rising foreign direct investment will sustain the investment upswing which has lifted Indonesia's investment to GDP ratio to the second highest in Asia, after China. Third, Indonesia is less exposed than Asia's manufacturing exporters, both because of the high commodity content of total exports (close to 50%) and the relatively small share of exports to the US and EU (18% combined).

Does the prospect of declining FDI in a global downturn undermine our resilience argument? No, Indonesia will have an advantage over other Asian economies in attracting FDI on the basis of its extensive resources and its rapidly expanding consumer market. The resources argument has been made before so what is different now? With the rapid pace of growth, Indonesia's own demand for resources has outstripped the available supply which will make the government less obstructive to foreign investment in resources exploration and development.

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005	2006	2007	2008	2009	2010	2011clsa	2012clsa	2013clsa
Real GDP growth	5.7	5.5	6.3	6.0	4.6	6.1	6.5	6.0	7.0
Domestic demand (contr. to growth)	5.7	3.0	3.7	6.7	4.6	5.1	5.5	6.9	8.2
Nominal GDP growth	20.8	20.4	18.3	25.3	13.2	14.6	14.9	10.1	15.3
Consumer prices (y/e)	17.1	6.6	5.7	11.1	2.8	7.0	3.9	4.7	7.0
BI policy rate (% y/e)	12.75	9.75	8.00	9.25	6.50	6.50	6.00	5.50	6.00
IDR/USD (y/e)	9,830	9,020	9,419	10,950	9,400	8,991	9,200	9,450	9,150
Money supply M1 (y/e)	10.2	28.0	29.7	1.5	12.9	17.4	19.0	16.6	21.0
Current account balance (USD bn)	0.3	10.9	10.5	0.1	10.6	5.6	5.2	(4.3)	(10.5)
- as a % of nominal GDP	0.1	3.0	2.4	0.0	2.0	0.8	0.6	(0.5)	(1.0)
Public sector deficit (% GDP)	0.5	0.9	1.3	0.1	1.6	0.6	1.5	1.8	1.9

Note: % YoY rates unless otherwise stated.
Source: IMF, IFS, CEIC, CLSA estimates, Bank Indonesia

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This argument relies on rational responses by policymakers and therein lies the biggest risk to our bullish GDP forecast. This is that the government panders to nationalist and protectionist sentiment and policy remains obstructive to foreign investment. While this risk cannot be ignored, we believe that the structural changes in Indonesia are too powerful to resist. The economy will be increasingly opened to foreign investment, even as the government continues to drag its heels, for the simple reason that domestic savings are insufficient to finance the huge demands for physical and social infrastructure development.

FDI will support the BOP

The domestic savings shortfall will be underlined by the shift of the current account into deficit which we forecast for 2012. The surplus has already narrowed to less than 1% of GDP. While export growth moderates with easing commodity prices, imports will be sustained by strong domestic demand. The narrowing trade surplus will provide a smaller offset against the structural services and income deficits, thereby pushing the current account into deficit.

Urbanisation and an expanding middle class drive our strong domestic demand forecasts for 2012 and 2013. Jakarta had the tenth largest population among the world cities in 2010, at an estimated 9.6 million. Including the workers commuting to the city each day, this estimate swells to over 12 million. Jakarta's GDP per capita was 3.7 times higher than the national average in 2010 at around USD11,000. The emerging middle class has been a similar phenomenon in cities across Indonesia. The rapidly expanding consumer market will spur investment by domestic firms and, if the government follows through on removing regulatory barriers, it will be a compelling attraction for FDI.

Net FDI in 2011 probably topped the USD10.7bn surge in 2010. Our estimate is USD12.2bn, with USD9.1bn already notched up in the first three quarters. Our forecast for sustained net FDI at USD12bn in 2012 may be challenged given the likelihood that FDI will become scarce in a global downturn. Our argument is that China, India, Korea and other economies, with a longer term objective to secure a supply of resources,

GDP GROWTH FORECASTS

Government
Updated: Dec
2012: 6.3 – 6.7

Consensus
Updated: Dec
2012: 6.1

CLSA
2012: 6.0

CLSA

THE CLSA DIFFERENCE

GDP growth
- BI says monetary easing is needed to achieve 6.5% GDP growth. Our forecast is driven by structural forces.

Inflation
- BI's 3.5-5.5% inflation target for 2012 is achievable in the global deflationary environment that we expect.

Interest rates & exchange rate
- We forecast a 50bp interest rate cut in 2012 in line with BI's accommodative monetary stance.

CLSA

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INDONESIA BY NUMBERS	2009	2010	2011clsa	2012clsa	2013clsa
Breakdown of real GDP					
Private consumption	4.9	4.6	4.7	5.0	5.4
Public consumption	15.7	0.3	2.9	9.0	7.1
GFCF	3.3	8.5	8.3	13.8	17.4
Domestic demand (contr. to growth)	4.6	5.1	5.5	6.9	8.2
Exports, goods & services	(9.7)	14.9	14.5	7.2	8.4
Imports, goods & services	(15.0)	17.3	13.4	11.8	13.4
Real GDP growth	**4.6**	**6.1**	**6.5**	**6.0**	**7.0**
Prices					
Consumer prices (y/e)	2.8	7.0	3.9	4.7	7.0
Consumer prices (average)	4.8	5.1	5.3	4.2	5.9
Wholesale prices (y/e)	4.6	6.2	7.1	5.4	7.4
Currency & interest rates					
IDR/USD (y/e)	9,400	8,991	9,200	9,450	9,150
IDR/USD (average)	10,408	9,087	8,804	9,254	9,300
BI policy rate (% y/e)	6.50	6.50	6.00	5.50	6.00
Base lending rate (% y/e)	12.83	11.98	11.60	11.30	11.80
External sector					
Exports (USD, % YoY)	(14.3)	32.1	33.5	7.0	10.5
Imports (USD, % YoY)	(24.0)	43.7	34.0	11.6	15.4
Trade balance (USD bn)	30.9	30.6	40.2	35.1	33.9
Current account balance (USD bn)	10.6	5.6	5.2	(4.3)	(10.5)
- as a % of nominal GDP	2.0	0.8	0.6	(0.5)	(1.0)
FDI (USD bn)	2.6	10.7	12.2	12.0	14.5
CA + net FDI (% GDP)	2.4	2.3	2.1	0.9	0.4
External debt (total, USD bn)	172.9	202.4	216.1	235.0	250.0
Debt service ratio (% exports)	16.9	10.3	8.9	7.2	6.6
International reserves (USD bn, y/e)	66.1	96.2	111.0	118.0	138.0
Money supply					
Money supply M1 (y/e)	12.9	17.4	19.0	16.6	21.0
Money supply M2 (y/e)	13.0	15.4	17.5	16.0	22.0
Private sector credit (y/e)	10.1	23.3	25.0	17.5	30.0
Private sector credit (% GDP)	25.5	27.5	29.9	31.9	36.0
Government sector					
Public sector deficit (% GDP)	1.6	0.6	1.5	1.8	1.9
Public sector debt (% GDP, y/e)	28.6	27.4	25.3	24.8	23.5
Nominal GDP					
Nominal GDP (USD bn)	543.0	706.8	838.4	878.2	1,007.3
Nominal GDP per capita (USD)	2,347	2,975	3,469	3,567	4,007
Nominal GDP (IDR tn)	5,604	6,423	7,382	8,126	9,368
Nominal GDP (IDR, % YoY)	13.2	14.6	14.9	10.1	15.3
Other data					
Industrial production	2.2	4.5	6.1	3.7	4.8
Unemployment (% y/e)	7.9	7.1	6.5	6.5	6.1
Population (millions)	231.4	237.6	241.7	246.2	251.4

Note: % YoY rates unless otherwise stated.
Source: IMF, IFS, CEIC, CLSA estimates, Bank Indonesia

CLSA

The expanding middle class will drive consumption.

Residential construction is the main investment driver; added boost from resources capex.

Urbanisation is key structural force driving domestic demand.

Inflation risk will manifest in 2013.

Rupiah depreciation in 2012 as the interest rate differential narrows.

Another 50bp rate cut in 2012; but it will be reversed in 2013 due to rising inflation.

Current account will shift into deficit in 2012 due to robust import demand.

FDI will be relied upon to support the balance of payments.

Bank Indonesia will cut rates in 2012 in order to sustain the domestic credit cycle.

Less than 50% of budgeted capex was realized in the first 11 months of 2011. Poor implementation keeps the deficits below 2%.

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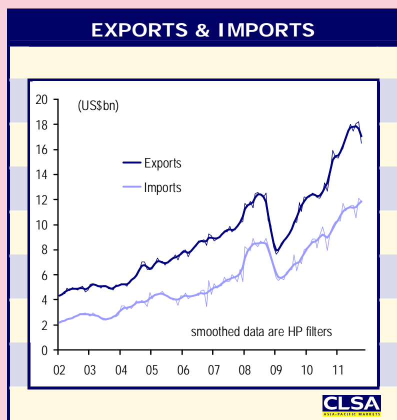
EXPORTS & IMPORTS



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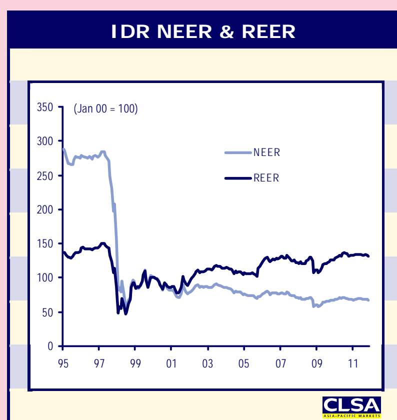
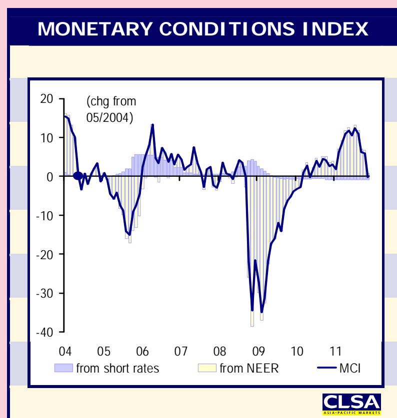


MONETARY CONDITIONS INDEX



will invest in Indonesian resources development, irrespective of the stage of the commodity cycle. As for infrastructure investment, parliamentary passage of the land acquisition bill in mid-December has removed a stumbling block to speeding up infrastructure projects. It would be wrong though, to conclude that all obstructions have now been removed. Other issues are private sector financing (largely FDI) and efficient implementation. Of these two, the latter will be the bigger constraint.

Sustained FDI, if our forecast proves correct, will support the balance of payments, providing a crucial offset to sporadic portfolio outflows and the current account shift to deficit. From this perspective, net FDI will be vital for sustaining exchange rate stability.

Monetary stimulus, fiscal 'mis-implementation'

Exchange rate risk will be reinforced by loose monetary policy. Bank Indonesia cut its policy rate by 75bp to 6% in 4Q11 and hinted at further cuts in 2012. BI stressed the need for counter-cyclical policies in the face of a worsening global economy, while reassuring investors that inflation would be maintained in its 3.5 – 5.5% target range for 2012. This is achievable in the global deflationary environment that we expect in 2012. Even so, the declining interest rate differential argues for IDR/USD depreciation in 2012, notwithstanding the strong domestic demand fundamentals driving our 6% GDP forecast.

The inflation risk will manifest in 2013 as real GDP growth accelerates to our forecast 7%. Along with loose monetary conditions and robust domestic demand, inflation pressures will be exacerbated by high distribution costs as infrastructure deficiencies lead to capacity constraints and bottlenecks. A grudging implementation of infrastructure projects will only barely keep pace with the rapid pace of urbanisation. Progress on improving Indonesia's inter-connectivity through modernised and expanded transportation links will remain slow. On that basis, public spending will be a minor contributor to our bullish GDP forecasts. Poor government implementation (less than 50% of budgeted capex in 2011 was realised in the first 11 months) is also a key reason for keeping our fiscal deficit forecasts below 2% of GDP.

CURRENCY FORECAST

Period-end	Annual					Coming 12 months by quarter			
	2009	2010	2011clsa	2012clsa	2013clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
IDR/USD	9,400	8,991	9,200	9,450	9,150	9,150	9,200	9,340	9,450
IDR/JPY 100	10,217	11,086	11,646	11,386	11,024	12,534	11,948	11,675	11,386
IDR/GBP	15,228	14,026	13,800	13,986	13,542	15,006	14,904	14,944	13,986
IDR/EUR	13,498	12,048	11,500	11,340	10,980	12,353	11,960	11,675	11,340
Memo: USD/EUR	*1.44*	*1.34*	*1.25*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*92.0*	*81.1*	*79.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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External-led slowdown

- Soft global demand remains Korea's biggest threat. Growth will slow to 2.6% in 2012.
- A favourable won-yen cross will be the saving grace that prevents export growth from hitting previous crisis levels.
- The BoK will cut rates by 75bp in 2012 but starting from a low level how much benefit will easing provide?

Soft exterior

Korea's 3Q11 GDP increased 0.8% QoQ, on trend, driven mostly by a 2.2% QoQ gain in export volumes. Such gives the impression of a certain degree of external resilience in the face of waning export demand (by comparison, Taiwan's SNA export volumes dropped 1.3% QoQ in 3Q11). This resilience is illusory, or at least temporary, with more recent monthly trade figures resuming a downward trend. Indeed, the advance reading for November showed exports contracted 1.2% QoQ, the first such decline since March 2009. Similarly, industrial production growth slowed to -1.4% QoQ in October, the slowest since the end of 2010.

Korean exporters have one major positive in support which is that the KRW/JPY cross remains very much in Korea's favour, trading at close to 15 (versus a long term average rate much closer to 10). Furthermore, on our currency projections we foresee both won and yen weakening against USD at similar rates, leaving KRW/JPY around 15.

A favourable cross helps Korean producers gain market share from their Japanese rivals, but does not provide insulation from soft global demand in absolute terms. As a barometer of Chinese demand, manufacturing there weakened further in recent months. The European outlook is clearly fraught and US growth will slacken sharply in 1H12 (see *World View* section on pp33-36). This all implies a tough trading environment for Asian exports. As we noted last quarter, the first sign of relief is likely to take the shape of

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005	2006	2007	2008	2009	2010clsa	2011clsa	2012clsa	2013clsa
Real GDP growth	4.0	5.2	5.1	2.3	0.3	6.2	3.7	2.6	4.5
Domestic demand (contr. to growth)	3.8	4.8	4.4	1.4	(2.6)	5.5	2.2	2.5	3.7
Nominal GDP growth	4.6	5.0	7.3	5.3	3.8	10.1	6.3	4.7	6.4
Consumer prices (y/e)	2.6	2.1	3.6	4.1	2.8	3.5	4.3	3.0	3.2
Call rate (% y/e)	3.75	4.50	5.00	3.00	2.00	2.50	3.25	2.50	2.50
KRW/USD (y/e)	1,037	938	921	1,363	1,169	1,133	1,080	1,250	1,150
Money supply M1 (y/e)	2.5	11.0	(13.9)	4.8	18.2	10.3	2.4	5.1	7.7
Current account balance (USD bn)	18.6	14.1	21.8	3.2	32.8	29.4	24.9	30.9	37.3
- as a % of nominal GDP	2.2	1.5	2.1	0.3	3.9	2.9	2.2	2.8	3.2
Federal deficit (% GDP)	(0.4)	(0.4)	(3.5)	(1.2)	1.7	(1.4)	0.1	1.8	0.3

Note: % YoY rates unless otherwise stated.
Source: IMF, World Bank, Bank of Korea, CEIC

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policy easing by Beijing but even this will take time to filter through to export demand and (as we note in the *China* section on pp41-44) Chinese policy measures will be less aggressive than they were in 2008/09. The net result is that we expect export volumes to expand 3.4% in 2012.

Domestic slowdown

At the same time as exports have faltered, internal growth has also begun to ease. From the national accounts, domestic demand growth dropped to 0.4% QoQ in 3Q11 (from 0.9% QoQ in 2Q) with both private consumption and business investment slowing. Monthly retail sales figures have been volatile but depict a slowing trend, with sales growth easing to 1.2% QoQ October, from around 3% QoQ in preceding months.

The Korean labour market remains relatively tight; the unemployment rate has hovered at a cyclical low of around 3.1% in recent months, courtesy of steady private sector employment growth. We believe this is effectively the trough in unemployment, however, with business expansion set to slow on the back of the weaker export environment. From the monthly industrial production survey, business investment intentions took a sharp leg lower in October, a clear indication that slower sales, combined with uncertain prospects ahead, are dominating business planning. By the same logic, employment growth is also set to slow to below 'replacement' rates. We see the unemployment rate lifting to 3.9% by the end of 2012.

This puts the spending outlook for next year in some jeopardy. Consumer sentiment is still good, with the index on spending expectations trending higher in recent months. We'd also note that household consumption has proven relatively resilient during previous downturns (it looks defensive compared to the swings in export volumes). We expect similar in 2012, forecasting 2.4% real private consumption growth.

GDP GROWTH FORECASTS

Government

Updated:	Dec
2012:	3.7

Consensus

Updated:	Dec
2012:	3.2

CLSA

2012:	2.6

CLSA

THE CLSA DIFFERENCE

GDP growth
- Consensus expectations have dropped dramatically over the past quarter. We are now in line.

Inflation
- Inflation will drop quickly in 2012, mostly due to favourable base year effects…

Interest rates & exchange rate
- …allowing the Bank of Korea to ease. We look for 75bp of cuts in 2012, beginning in 1Q.

CLSA

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KOREA BY NUMBERS	2009	2010	2011clsa	2012clsa	2013clsa
Breakdown of real GDP					
Private consumption	(0.0)	4.1	2.6	2.4	3.2
Public consumption	5.6	3.0	2.9	3.7	3.3
GFCF	(1.0)	7.0	(1.6)	3.2	3.5
Domestic demand (contr. to growth)	(2.6)	5.5	2.2	2.5	3.7
Exports, goods & services	(1.2)	14.5	10.8	3.4	7.3
Imports, goods & services	(8.0)	16.9	7.7	3.8	6.9
Real GDP growth	**0.3**	**6.2**	**3.7**	**2.6**	**4.5**
Prices					
Consumer prices (y/e)	2.8	3.5	4.3	3.0	3.2
Consumer prices (average)	2.8	3.0	4.4	2.8	3.2
Producer prices (y/e)	1.8	5.3	4.9	3.3	3.2
Currency & interest rates					
KRW/USD (y/e)	1,169	1,133	1,080	1,250	1,150
KRW/USD (average)	1,278	1,156	1,092	1,200	1,188
Call rate (% y/e)	2.00	2.50	3.25	2.50	2.50
Average lending rate (% y/e)	5.8	5.4	5.8	5.8	5.8
External sector					
Exports (USD, % YoY)	(17.8)	28.9	21.1	4.4	7.8
Imports (USD, % YoY)	(25.5)	31.5	25.6	3.6	7.3
Trade balance (USD bn)	37.9	40.1	29.9	35.6	41.2
Current account balance (USD bn)	32.8	29.4	24.9	30.9	37.3
- as a % of nominal GDP	3.9	2.9	2.2	2.8	3.2
FDI (USD bn)	(14.9)	(22.2)	(16.1)	(18.0)	(18.0)
CA + net FDI (% GDP)	2.1	0.7	0.8	1.2	1.6
External debt (total, USD bn)	345.4	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% exports)	n.a.	n.a.	n.a.	n.a.	n.a.
International reserves (USD bn, y/e)	270.0	291.6	311.6	321.6	331.6
Money supply					
Money supply M1 (y/e)	18.2	10.3	2.4	5.1	7.7
Money supply M2 (y/e)	9.8	5.9	5.9	6.1	8.2
Private sector credit (y/e)	2.1	4.1	6.6	5.2	7.2
Private sector credit (% GDP)	129.3	122.2	122.5	122.3	124.0
Government sector					
Federal deficit (% GDP)	1.7	(1.4)	0.1	1.8	0.3
Federal debt (% GDP, y/e)	32.5	31.9	30.5	31.3	31.4
Nominal GDP					
Nominal GDP (USD bn)	841.0	1,014.4	1,143.1	1,087.4	1,171.8
Nominal GDP per capita (USD)	17,252	20,748	23,310	22,129	23,799
Nominal GDP (KRW tn)	1,065.0	1,172.8	1,246.9	1,305.0	1,389.3
Nominal GDP (KRW, % YoY)	3.8	10.1	6.3	4.7	6.4
Other data					
Industrial production	(0.8)	16.6	7.4	3.2	7.9
Retail sales	4.0	9.6	8.9	5.3	5.7
Unemployment (% y/e)	3.5	3.5	3.2	3.9	4.0
Population (millions)	48.7	48.9	49.0	49.1	49.2

Note: % YoY rates unless otherwise stated.
Source: IMF, World Bank, Bank of Korea, CEIC

Softer spending growth in 2012, consistent with rising unemployment.

Implied investment intentions have fallen in recent months. The shaky export outlook will temper expansion plans.

Already slowing sequentially, weaker exports will be more visible in 2012's annual figure.

Inflation will drop quickly from the beginning of 2012, courtesy of flat commodity prices and favourable base effects...

Providing the BoK with the scope to loosen in reaction to weaker export growth.

Credit growth has picked up from a low base, but weak business investment and overhang of existing household debt implies a slowing is ahead.

The labour market has proven stronger than we expected in recent months. But unemployment is a lagging indicator and will lift in 2012.

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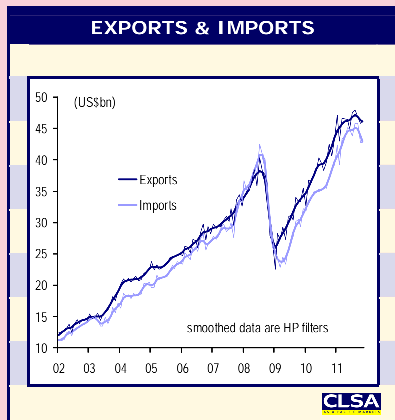

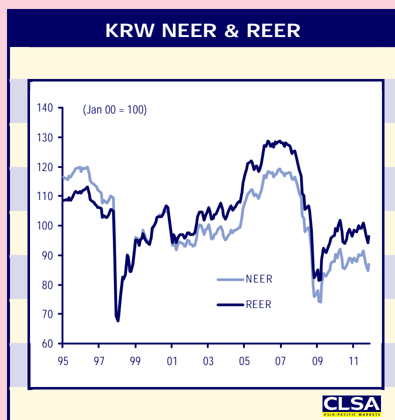

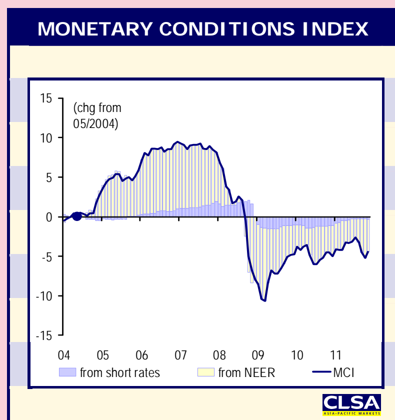

Room to ease

Inflation is set to soften fairly quickly in 2012, a combination of domestic slowing and helpful base year effects. That will leave the Bank of Korea with the headroom to cut rates. Indeed, we are somewhat surprised that the BoK has not cut already given the sustained slowing in exports in recent months and the clear risk of slower global growth in 2012. We can only presume that the BoK prefers to wait until inflation prints below its 4% upper target before pulling the trigger. On our numbers, inflation will fall below 4% in January or February, leaving the way clear for the easing cycle to begin from 1Q12. As we have previously noted, by not tightening more aggressively when growth was good during 2010-11, the BoK has left itself little room to ease, in real terms.

A softer KRW will add to easier monetary conditions more broadly. The won's high beta status will see it weaken on the back of soft exports and global risk aversion, even against the backdrop of QE3. We target KRW1,250/USD1 at end-2012.

North Korea: Status quo most likely

Against an already uncertain global backdrop, the death of North Korea's "Dear Leader", Kim Jong-il, has the potential to provide further headwinds to South Korea's financial markets. The knee-jerk reaction to the announcement of Kim's death was poor; the KOSPI dropped 2% and the won weakened to 1,175, from 1,165 beforehand.

While such a reaction was predictable we'd hesitate before concluding that this regime change heralds any great economic changes for South Korea. Only the extreme outcomes – a renewed bout of military aggression from the North or a rapid drive to reunification – would be enough to move the dial on South Korea's growth trajectory. Both of these outcomes strike us as being unlikely, given the massive incentive in the region to maintain political stability. The central ground, and the far more likely outcome in our view, is that the status quo will prevail.

CURRENCY FORECAST

Period-end	Annual					Coming 12 months by quarter			
	2009	2010	2011clsa	2012clsa	2013clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
KRW/USD	1,169	1,133	1,080	1,250	1,250	1,120	1,200	1,230	1,250
KRW/JPY 100	1,271	1,397	1,367	1,506	1,506	1,534	1,558	1,538	1,506
KRW/GBP	1,894	1,767	1,620	1,850	1,850	1,837	1,944	1,968	1,850
KRW/EUR	1,679	1,518	1,350	1,500	1,500	1,512	1,560	1,538	1,500
Memo: USD/EUR	*1.44*	*1.34*	*1.25*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*92.0*	*81.1*	*79.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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Terms of trade: reversal of fortune

- Terms of trade gain has boosted GDP growth in 2011 but this will reverse for sharply slowing growth in 2012.
- Household income will be hit by manufacturing wage cuts and reduced rural income from falling commodity prices.
- Fiscal spending boost ahead of an early election; with an added monetary stimulus from a 50bp rate cut in 1H12.

Going from strength to weakness

The Malaysian economy has been stronger than we predicted lifting our estimate for 2011 real GDP growth to 5.2%, from the 4.8% forecast we made in the 4Q11 *Eye on Asian economies*. The increasing gain in Malaysia's terms of trade from mid-2011 has spurred growth. Buoyant oil and commodity prices lifted GDP growth both through a strong export contribution and through boosting rural income for firming domestic demand. Private consumption contributed as much as 3.5 percentage points to our 5.2% real GDP growth estimate for 2011.

Investment also surprised on the upside in 2011, contributing 1.1ppt to GDP growth. We had underestimated investment, which only rose above 2010 levels from mid-2011, with the acceleration only apparent after the 3Q11 national accounts release in November. Investment projects initiated under the Economic Transformation Programme between October 2010 and November 2011 were officially valued at MYR177bn, with around 33% operational/completed and another 17% work in progress. While this estimate, equivalent to 20% of GDP, is impressive, the effective GDP impact will be spread over a number of years. That said, continuity of public infrastructure spending should support GDP growth in 2012.

Buoyant GDP growth in 2H11 raises the starting point for 2012 which, with an unchanged quarterly growth profile, will lift our 2012 real GDP forecast. Infrastructure spending will be reinforced by a more generalised boost to public spending in the lead up to an anticipated early election. However, in

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005	2006	2007	2008	2009	2010	2011clsa	2012clsa	2013clsa
Real GDP growth	5.3	5.8	6.5	4.8	(1.6)	7.2	5.2	2.8	4.5
Domestic demand (contr. to growth)	4.5	6.3	7.9	5.0	(2.0)	10.7	6.3	5.4	5.5
Nominal GDP growth	10.2	10.0	11.8	15.6	(8.4)	12.7	12.3	4.0	8.1
Consumer prices (y/e)	3.4	3.1	2.3	4.5	1.0	2.1	3.4	2.4	3.1
Overnight policy rate (% y/e)	3.00	3.50	3.50	3.25	2.00	2.75	3.00	2.50	2.50
MYR/USD (y/e)	3.78	3.53	3.31	3.46	3.42	3.08	3.23	3.35	3.30
Money supply M1 (y/e)	8.5	13.7	19.6	8.3	9.8	11.7	12.0	4.1	9.5
Current account balance (USD bn)	20.6	26.1	29.8	39.6	31.9	27.3	31.9	27.7	26.6
- as a % of nominal GDP	15.0	16.7	15.9	17.8	16.5	11.5	11.4	10.1	9.1
General gov't deficit (% GDP)	3.6	3.3	3.2	4.8	7.0	5.6	5.2	6.2	5.7

Note: % YoY rates unless otherwise stated.
Source: CEIC, Bank Negara Malaysia, IMF, DataStream, Bloomberg, CLSA estimates

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spite of all this, we have maintained our 2012 GDP forecast at 2.8%. Sharply slowing exports will cap GDP growth, irrespective of a large public spending stimulus. We forecast 4.5% real GDP growth in 2013 led by an export rebound.

Commodity price windfall has ended

Falling external demand and an end to the commodity price windfall will lower nominal export growth to our 2.6% forecast in 2012, from an estimated 13.8% in 2011. Demand from China, India and the rest of Asia will support Malaysia's commodity exports by volume but revenues will still decline due to easing oil and commodity prices. Moreover, commodities comprise only 31% of total exports compared to the 62% share for manufactured goods (and remaining 7% share for chemicals, all 2010 estimates). Manufactures will be vulnerable to falling external demand, in particular electronics exports which comprise 39% of total exports.

China became Malaysia's largest export market in 2011 (first ten months) with a 13.3% share, followed by Singapore with 12.7% and Japan with 11.2% shares. The combined US and EU share has fallen to 18.6%, a 4.4ppt drop from three years ago. However, the implicit export resilience to falling EU-US demand should not be overstated. As part of Asia's intermediate technology chain, Malaysia will still be exposed to the global electronics downswing despite the declining share of direct exports to the US and EU. Malaysia will be especially vulnerable given its high 97% export to GDP ratio (2010 estimate) and high concentration of electronics exports.

The terms of trade gain which boosted GDP growth in 2011 will have a reverse effect in 2012. Real private consumption will be the major casualty with growth slowing to our 4% forecast in 2012 from an estimated 6.6% in 2011. In perspective, private consumption has grown at a 7% average annual rate over the last

GDP GROWTH FORECASTS

Government
Updated: Dec 5 - 6
2012:

Consensus
Updated: Dec
2012: 4.1

CLSA
2012: 2.8

CLSA

THE CLSA DIFFERENCE

GDP growth
- Gov't and consensus forecasts are underestimating the external demand dip and the terms of trade shift.

Inflation
- Bank Negara expects inflation to moderate in 2012. We agree, inflation is forecast to fall 1ppt to 2.4% by end-12.

Interest rates & exchange rate
- BNM has talked about growth risks but no hints of easing. Slowing consumption will be the trigger for a rate cut.

CLSA

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Prepared for: ThomsonReuters

MALAYSIA BY NUMBERS	2009	2010	2011clsa	2012clsa	2013clsa
Breakdown of real GDP					
Private consumption	0.7	6.5	6.6	4.0	4.7
Public consumption	3.9	0.5	13.2	13.0	9.0
GFCF	(5.6)	9.8	4.8	6.0	6.6
Domestic demand (contr. to growth)	(2.0)	10.7	6.3	5.4	5.5
Exports, goods & services	(10.5)	9.9	3.0	2.7	7.3
Imports, goods & services	(12.2)	15.1	4.4	5.5	8.5
Real GDP growth	**(1.6)**	**7.2**	**5.2**	**2.8**	**4.5**
Prices					
Consumer prices (y/e)	1.0	2.1	3.4	2.4	3.1
Consumer prices (average)	0.6	1.7	3.2	2.7	2.8
Producer prices (y/e)	3.6	5.5	9.0	2.1	3.5
Currency & interest rates					
MYR/USD (y/e)	3.42	3.08	3.23	3.35	3.30
MYR/USD (average)	3.52	3.23	3.07	3.26	3.31
Overnight policy rate (% y/e)	2.00	2.75	3.00	2.50	2.50
Base lending rate (% y/e)	5.51	6.27	6.54	6.04	6.04
External sector					
Exports (USD, % YoY)	(20.9)	25.8	13.8	2.6	8.0
Imports (USD, % YoY)	(20.5)	33.5	14.2	5.3	9.0
Trade balance (USD bn)	40.3	41.6	46.8	43.3	43.5
Current account balance (USD bn)	31.9	27.3	31.9	27.7	26.6
- as a % of nominal GDP	16.5	11.5	11.4	10.1	9.1
FDI (USD bn)	(6.7)	(4.3)	(1.1)	(2.8)	(2.0)
CA + net FDI (% GDP)	13.0	9.7	11.0	9.1	8.4
External debt (total, USD bn)	68.4	73.3	88.0	102.0	110.0
Debt service ratio (% exports)	6.5	7.6	8.3	8.9	8.6
International reserves (USD bn, y/e)	96.7	106.5	137.0	143.0	156.0
Money supply					
Money supply M1 (y/e)	9.8	11.7	12.0	4.1	9.5
Money supply M3 (y/e)	9.2	6.8	11.6	3.6	9.0
Private sector credit (y/e)	7.8	12.7	12.5	4.2	8.8
Private sector credit (% GDP)	115.3	115.3	115.5	115.7	116.4
Government sector					
General gov't deficit (% GDP)	7.0	5.6	5.2	6.2	5.7
General gov't debt (% GDP, y/e)	53.3	53.1	55.0	61.2	64.4
Nominal GDP					
Nominal GDP (USD bn)	193.7	238.0	279.8	274.6	292.1
Nominal GDP per capita (USD)	6,946	8,426	9,777	9,474	9,952
Nominal GDP (MYR bn)	679.9	766.0	860.3	894.7	967.2
Nominal GDP (MYR, % YoY)	(8.4)	12.7	12.3	4.0	8.1
Other data					
Industrial production	(7.6)	7.3	1.0	0.5	4.4
Unemployment (% y/e)	3.5	3.2	2.9	3.4	3.2
Population (millions)	27.9	28.3	28.6	29.0	29.4

Note: % YoY rates unless otherwise stated.
Source: CEIC, Bank Negara Malaysia, IMF, Datastream, Bloomberg, CLSA estimates

Slowing consumption on easing commodity prices and falling manufacturing wages.

Increased government spending in 2012 ahead of expected early election.

Protracted global downturn will limit the recovery in 2013.

Inflation will not be a constraint on monetary easing.

Slowing consumption growth will trigger a 50bp rate cut in 2012.

High export to GDP ratio and electronics concentration underlines Malaysia's vulnerability in 2012.

Huge current account surplus protects Malaysia against a debt crisis.

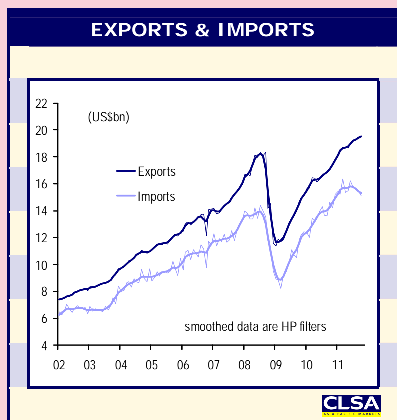
FDI inflows increased in 2010 and 2011 but may not be sustainable.

Reduced consumer credit demand in 2012; banks' lending stance will also be tighter.

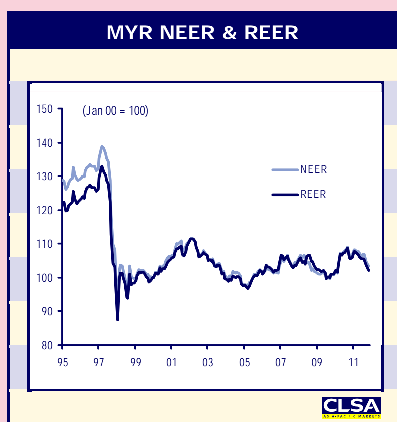
Public debt will breach the 60% of GDP tolerance cap in 2012.

Prepared for: ThomsonReuters

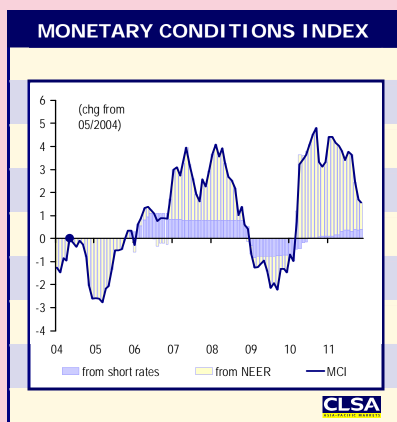
EXPORTS & IMPORTS



MYR NEER & REER



MONETARY CONDITIONS INDEX



ten years (including the 2009 GFC slump). Our historically low 4% consumption forecast for 2012 has factored in declining wage income growth from dual sources. Wages and overtime will be cut in a manufacturing downturn and falling commodity prices will reduce rural income. Workers are already feeling the pinch with manufacturing employment growth slowing to 1.5% YoY in October from 2.9% in 3Q11 and manufacturing payrolls growth slowing to 3.8% YoY in October from 7.4% in 3Q11.

FDI inflows will dry up

Private investment should not be relied on as an offset to the anticipated downswing in the export sector. The low private investment to GDP ratio at just over 10% (2010 estimate) is the Achilles' heel of the Malaysian economy, resulting from longstanding displacement by the pervasive public sector. Net FDI is typically negative in Malaysia as private firms seek more profitable opportunities offshore. We were encouraged, therefore, by rising FDI inflows to USD9.3bn in 2010 and USD8.6bn in the first three quarters of 2011. However, this may not be sustainable with global FDI drying up over the next two years. There is the added risk that infrastructure projects reliant on private sector financing, will need to be curtailed.

Monetary and fiscal stimulus in 2012

With the economy growing at 6.8% QoQ annualised in 3Q11 and inflation contained in a 3.3 – 3.5% range in the last six months, there has been no urgency to cut interest rates. The trigger will come from slowing private consumption growth, we forecast a 50bp policy rate cut to 2.5% in 2012. Fiscal policy will be stimulatory with the fiscal deficit widening to our 6.2% forecast in 2012 from the 5.2% estimate for 2011. We expect the public debt to GDP ratio to top 60% in 2012. While the huge current account surplus shields Malaysia against a debt crisis, restructuring is crucial for restoring the primacy of the private sector, a prerequisite for sustainable debt and fiscal management. Realistically, this will not happen until the election is out of the way.

CURRENCY FORECAST

Period-end	Annual					Coming 12 months by quarter			
	2009	2010	2011clsa	2012clsa	2013clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
MYR/USD	3.42	3.08	3.23	3.35	3.30	3.21	3.23	3.30	3.35
MYR/JPY 100	3.72	3.80	4.09	4.04	3.98	4.40	4.19	4.13	4.04
MYR/GBP	5.55	4.81	4.85	4.96	4.88	5.26	5.23	5.28	4.96
MYR/EUR	4.92	4.13	4.04	4.02	3.96	4.33	4.20	4.13	4.02
Memo: USD/EUR	*1.44*	*1.34*	*1.25*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*92.0*	*81.1*	*79.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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Tough year, will Aquino deliver?

- The export downtrend will continue for persistent weak GDP growth in 2012, with a modest recovery in 2013.
- PPP infrastructure programme may have finally taken off but more progress is needed to convince investors.
- Uncertain overseas worker deployment prospects introduce an element of risk to the private consumption outlook.

Export drag and subdued investment

Real GDP growth in 2011 has fallen short of our 4.2% forecast, which was already well below consensus. Consecutive quarters of sub-trend growth in 2Q11 and 3Q11 have reduced our 2011 GDP estimate to 3.8%. The export downturn came earlier and was more severe than we had expected, for a significant drag on growth. When the 2011 GDP is released, the data will probably show as much as a 2.7 percentage point **negative** contribution from exports. The data will also show only a partial offset from domestic demand, specifically from private consumption which rebounded convincingly in 3Q11. Investment growth, on the other hand, was disappointingly weak with the 3Q11 rebound leaving investment below the end-2010 level.

These trends may not change significantly in 2012, shaping our bearish GDP forecast. Exports will remain depressed in the global electronics downturn. Private consumption will provide the key support for growth but with only modest reinforcement from investment. On that basis, we forecast slowing real GDP growth to 2.9% in 2012 with a moderate upturn to 4.4% in 2013.

We recognise the potential for much stronger growth. As a services driven economy with an export-to-GDP ratio of 35%, the Philippines should be among the regional economies least vulnerable to falling external demand. However, stronger growth prospects will require much improved policy implementation by the Aquino administration, a prerequisite to boosting business confidence for a renewed investment upswing.

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005	2006	2007	2008	2009	2010	2011clsa	2012clsa	2013clsa
Real GDP growth	5.0	5.3	7.1	4.6	1.1	7.6	3.8	2.9	4.4
Domestic demand (contr. to growth)	3.6	5.2	6.3	3.4	1.1	8.2	7.0	4.1	4.8
Nominal GDP growth	11.8	10.8	10.2	12.3	4.0	12.2	8.2	5.9	8.1
Consumer prices (y/e)	6.7	4.3	3.9	8.0	4.3	3.1	4.8	3.1	3.8
O'night reverse repo rate (% y/e)	7.50	7.50	5.25	5.50	4.00	4.00	4.50	4.00	4.00
PHP/USD (y/e)	53.07	49.13	41.40	47.49	46.36	43.89	44.80	47.20	46.60
Money supply M1 (y/e)	8.8	24.4	17.7	20.9	13.6	10.6	10.0	7.2	8.4
Current account balance (USD bn)	2.0	5.3	7.1	3.6	9.4	8.9	5.0	3.5	3.8
- as a % of nominal GDP	1.9	4.4	4.8	2.1	5.6	4.5	2.2	1.5	1.6
Public sector deficit (% GDP)	2.6	1.0	0.2	0.9	3.7	3.5	1.9	3.6	2.9

Note: % YoY rates unless otherwise stated.
Source: IMF, IFS, CEIC, CLSA estimates, National Statistical Coordination Board, Philippines

Prepared for: ThomsonReuters

One out of ten for PPP implementation

There was a spark of optimism in late 2011 with the bidding of the first private public partnership (PPP) infrastructure programme. This raised hopes that the PPP programme has finally taken off (see *CLSA Manila Research* report, **Construction: Disappointment no more**, December 2011). Now that the programme has started, the pace of implementation will arguably pick up. Maybe, but we need to see more progress before being convinced. In perspective, it took eighteen months to bid only one out of ten targeted PPP projects. Moreover, this was a small project valued at PHP1.96bn, which is equivalent to 0.02% of GDP.

Our criticism of the Aquino administration's weak policy implementation has been substantiated by the fiscal accounts. While the official deficit target for 2011 was around 3% of GDP, the actual deficit reached only 0.8% of GDP in the first ten months. The government responded with a Disbursement Acceleration plan to push out PHP72.1bn in public spending (equivalent to 0.7% of GDP).

The positive perspective is that the 2011 fiscal deficit will come in below 2% of GDP, from 3.5% in 2010 and 3.7% in 2009. Fiscal deficit control should indeed remain a priority, but not by sacrificing capital expenditure. Hopes have been raised for stepped up implementation of the planned PPP projects in 2012. The difficulty though, is that it will be a tougher external environment for securing foreign capital financing. We estimate only PHP1.2bn net FDI in 2011, the same as in 2010. With declining global FDI, this could drop below USD1bn in 2012.

Remittances: deployment risk

Public spending will make a much stronger contribution to GDP growth in 2012 than in 2011, both through infrastructure and social spending initiatives. This will push the fiscal deficit back up to 3.5% of GDP in 2012. In perspective though, public spending (combined consumption and investment), at less than 15% of GDP, is dwarfed by private consumption with a 72% share of GDP (2010 estimates). Private consumption will provide the mainstay support for growth in 2012 largely financed by overseas worker remittances. Remittances were up

GDP GROWTH FORECASTS

Government
Updated: Dec
2012: 5.5 – 6.5

Consensus
Updated: Dec
2012: 4.5

CLSA
2012: 2.9

CLSA

THE CLSA DIFFERENCE

GDP growth
- We are much lower than gov't and consensus forecasts because of our doubts on a renewed investment upswing.

Inflation
- We expect inflation to drop to the lower end of the BSP's fixed 3- 5% inflation target in 2011.

Interest rates & exchange rate
- BSP has hinted at easing policy; we forecast a 50bp rate cut in 2012.

CLSA

Prepared for: ThomsonReuters

PHILIPPINES BY NUMBERS

	2009	2010	2011clsa	2012clsa	2013clsa
Breakdown of real GDP					
Private consumption	2.3	3.4	6.0	3.2	4.2
Public consumption	10.9	4.0	1.0	9.5	7.3
GFCF	(1.7)	19.1	2.2	4.2	5.2
Domestic demand (contr. to growth)	1.1	8.2	7.0	4.1	4.8
Exports, goods & services	(7.8)	21.0	(5.4)	2.0	7.6
Imports, goods & services	(8.1)	22.5	1.5	4.2	7.8
Real GDP growth	**1.1**	**7.6**	**3.8**	**2.9**	**4.4**
Prices					
Consumer prices (y/e)	4.3	3.1	4.8	3.1	3.8
Consumer prices (average)	3.2	3.8	4.4	3.3	3.5
Producer prices (y/e)	(2.2)	(5.8)	1.5	1.2	4.0
Currency & interest rates					
PHP/USD (y/e)	46.36	43.89	44.80	47.20	46.60
PHP/USD (average)	47.64	45.11	43.50	45.35	46.90
O'night reverse repo rate (% y/e)	4.00	4.00	4.50	4.00	4.00
Prime lending rate (%y/e)	8.19	7.22	6.80	6.25	6.25
External sector					
Exports (USD, % YoY)	(22.1)	34.9	(5.0)	1.8	8.2
Imports (USD, % YoY)	(24.0)	32.9	3.6	4.0	8.6
Trade balance (USD bn)	(8.8)	(11.0)	(15.8)	(17.5)	(19.2)
Current account balance (USD bn)	9.4	8.9	5.0	3.5	3.8
- as a % of nominal GDP	5.6	4.5	2.2	1.5	1.6
FDI (USD bn)	1.6	1.2	1.2	0.8	1.1
CA + net FDI (% GDP)	6.5	5.1	2.8	1.9	2.0
External debt (total, USD bn)	64.9	73.7	82.0	88.5	93.0
Debt service ratio (% exports)	12.5	9.2	9.5	12.6	13.4
International reserves (USD bn, y/e)	44.2	62.4	76.1	79.5	86.0
Money supply					
Money supply M1 (y/e)	13.6	10.6	10.0	7.2	8.4
Money supply M3 (y/e)	8.3	10.6	8.0	7.0	10.0
Private sector credit (y/e)	9.1	8.9	17.5	7.5	11.0
Private sector credit (% GDP)	29.6	28.8	31.3	31.7	32.6
Government sector					
Public sector deficit (% GDP)	3.7	3.5	1.9	3.6	2.9
Public debt (% GDP, y/e)	65.7	61.7	61.3	64.1	64.2
Nominal GDP					
Nominal GDP (USD bn)	168.5	199.6	223.9	227.5	237.8
Nominal GDP per capita (USD)	1,827	2,123	2,336	2,328	2,387
Nominal GDP (PHP bn)	8,026	9,003	9,741	10,316	11,155
Nominal GDP (PHP, % YoY)	4.0	12.2	8.2	5.9	8.1
Other data					
Industrial production	(1.9)	11.6	0.8	2.7	4.3
Unemployment (% y/e)	7.3	7.4	7.0	7.8	7.3
Population (millions)	92.2	94.0	95.9	97.7	99.6

Note: % YoY rates unless otherwise stated.
Source: IMF, IFS, CEIC, CLSA estimates, National Statistical Coordination Board, Philippines

CLSA

OFW deployment risk is reflected in slowing consumption forecast.

Subdued investment outlook for 2012 and 2013.

Inflation will be contained within the BSP's 3 – 5% fixed inflation target over the next two years.

Peso will weaken in 2012 against a strong USD; we forecast a 5% depreciation.

Scope for a 50bp rate cut in 1H12.

Export weakness will persist in 2012 with the global electronics downturn.

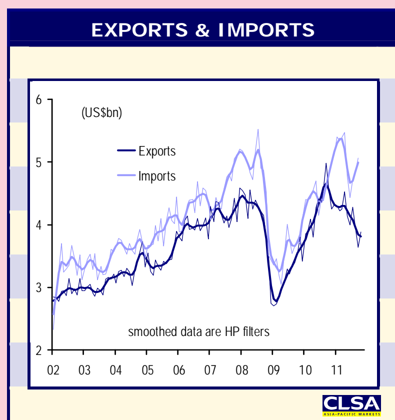
Widening trade deficit but remittances will keep the current account in surplus.

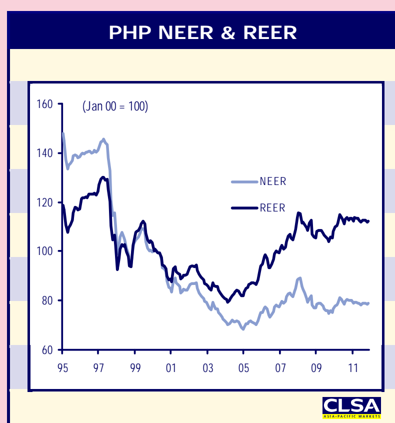
Moderating credit in 2012 due to easing domestic demand.

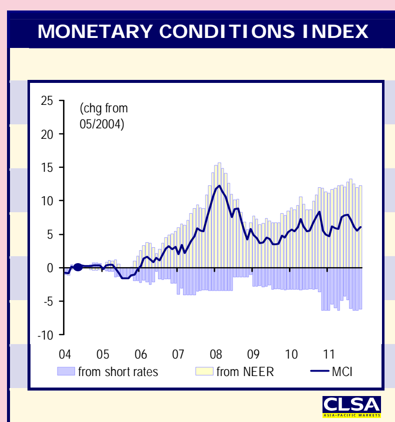
Poor implementation behind the low 2011 deficit; rebound in public spending will lift the deficit in 2012.

High public debt above 60% of GDP underlines Philippines exposure in a global downturn.

Prepared for: ThomsonReuters







by 7% YoY in the first ten months of 2011. Assuming this same growth rate for the full year, we estimate total remittances at USD20.1bn in 2011, equivalent to 8.9% of GDP. This compares with 2010 remittances at USD18.8bn or 9.4% of GDP and 2009 remittances at USD17.3bn or 10.3% of GDP. Remittances have gradually declined as a % of GDP over the last three years. This largely reflects the increasing contribution to GDP from other services, notably the rapidly expanding business process outsourcing (BPO) sector. However, it does introduce an element of risk to the private consumption outlook.

The risk pertains to deployment of Filipino workers which contracted by 7% YoY in 1H11. Saudi Arabia's revoking of permits for Filipino domestic workers could displace 150,000 workers, around 10% of total deployment. Filipinos will seek work in other countries but in a recessionary global environment, the Saudi ban reinforces the risk of slowing remittances growth. Our forecast reflects this with private consumption growth moderating to 3.8% in 2012, from 6% in 2011.

Scope for monetary easing

Philippines export vulnerability is underlined by its high electronics concentration (more than 50% of total exports) and reliance on the US and EU markets (combined 25% share). Two thirds of electronics exports are semiconductors, hit by depressed global semiconductor sales in 2011 (1.6% YoY increase in the first ten months). This led to a significant widening of the trade deficit in 2011 with a further widening expected in 2012. Despite this, we expect the current account to remain in surplus, again highlighting the importance of overseas remittances for balance of payments and exchange rate support.

With inflation drifting down to the lower end of Bangko Sentral's inflation target (we forecast 3.1% by end-2012), there will be scope for monetary easing. A 50bp cut in 1H12 will lower the policy rate to 4% with the accommodative monetary stance maintained until the end of 2013. The peso has historically been vulnerable in a risk averse global environment. With the expected rate cuts lowering the interest rate differential, we forecast a 5% PHP/USD depreciation in 2012.

CURRENCY FORECAST

Period-end	Annual					Coming 12 months by quarter			
	2009	2010	2011clsa	2012clsa	2013clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
PHP/USD	46.36	43.89	44.80	47.20	46.60	44.60	44.80	46.00	47.20
PHP/JPY 100	50.39	54.11	56.71	56.87	56.14	61.10	58.18	57.50	56.87
PHP/GBP	75.10	68.46	67.20	69.86	68.97	73.14	72.58	73.60	69.86
PHP/EUR	66.57	58.81	56.00	56.64	55.92	60.21	58.24	57.50	56.64
Memo: USD/EUR	*1.44*	*1.34*	*1.25*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*92.0*	*81.1*	*79.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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No growth economy

- GDP growth forecast for 2012 cut to 0% from 2% due to the global downshift but 2013 forecast unchanged at 5%.
- Economy remains highly cyclical. 2H12 is expected to be better than 1H12, in line with the global growth profile.
- Inflation will become less of an issue in 2012, MAS poised to shift to a neutral stance in April.

Below-trend growth in 2012

Singapore has one of the most volatile economic cycles in Asia. To be sure, growth hit a record high of 14.5% in 2010 and is estimated to have decelerated to a better-than-expected 5% this year. But this does not mean anything about a 2012 forecast. On our forecast, the Singapore economy will not grow in 2012 (the official forecast sees only a 1-3% expansion). This is the direct fallout of the heavy reliance on external trade (export/GDP ratio of 211%) as the main engine of growth. Singapore's policymakers have made the economy less susceptible to global shifts by diversifying the industrial base away from the singular reliance on electronics and by launching the integrated resorts. However, the economy still remains a warrant on global growth.

Singapore's GDP grew 6.1% YoY in 3Q11 following a 1% gain in 2Q11. Quarter on quarter (seasonally adjusted and annualised) GDP grew 1.9% after contracting 1.6% in the prior quarter. The government estimates 2011 full year GDP growth at 5% which implies a 3.9% QoQ annualised contraction in 4Q11. Manufacturing was the only sector supporting growth in 3Q11. More specifically, support was provided by the biomedical sector. Electronics output continued to contract. There was a large contraction in private construction and a smaller contraction in services output. Within services, only the information & communication and financial sectors had positive QoQ growth in 3Q11, with the latter only modest at 0.8% QoQ (saar) versus a decline of 0.5% in 2Q11.

The volatile biomedical output boosts headline GDP but fluctuations in its value added have a much smaller impact on the rest of the economy than does, for example, the electronics sector. The latter's much higher employment generates

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005	2006	2007	2008	2009	2010	2011clsa	2012clsa	2013clsa
Real GDP growth	7.4	8.7	8.8	1.5	(0.8)	14.5	5.0	0.0	5.0
Domestic demand (contr. to growth)	2.0	5.5	5.1	10.2	(5.3)	5.3	5.0	(0.2)	2.0
Nominal GDP growth	9.6	10.6	15.7	0.3	(0.5)	13.9	7.3	2.2	7.1
Consumer prices (y/e)	1.3	0.8	3.7	5.5	(0.5)	4.6	4.9	2.5	2.4
3-month interbank rate (% y/e)	3.3	3.4	2.4	1.0	0.7	0.4	0.4	0.5	0.8
SGD/USD (y/e)	1.66	1.53	1.44	1.44	1.40	1.29	1.32	1.36	1.32
Money supply M1 (y/e)	4.4	13.4	22.4	18.4	23.5	20.3	17.0	13.0	15.0
Current account balance (USD bn)	26.5	36.1	48.5	27.6	34.9	49.5	47.3	44.1	44.3
- as a % of nominal GDP	21.1	24.8	27.3	14.6	19.0	22.2	18.5	17.7	16.7
Government fiscal deficit (% GDP)[1]	(0.7)	0.0	(2.8)	(0.3)	(0.3)	(0.1)	(0.0)	0.5	0.0

Note: % YoY rates unless otherwise stated. [1]Fiscal years beginning 1 April.
Source: CEIC, MAS, MTI, Datastream, Bloomberg, CLSA estimates

Prepared for: ThomsonReuters

second round multiplier effects, primarily stronger consumption, that biomedical sciences cannot match. Thus, while the growth of the biomedical sciences industry has been an effective route to supporting the GDP statistics the economy qualitatively remains as cyclical as ever; witness the sharp slowdown we expect in household consumption in 2012. Additionally the increased reliance on biomedical production has increased the month to month volatility in the monthly external trade and industrial production (IP) data. To be sure, headline IP grew 8.8% YoY in January-October 2011, but IP ex-biomedical declined 0.9%.

With the expectation of a biomedical pullback in 4Q11, manufacturing will no longer provide support to growth. This will result in a sharp 4Q11 GDP contraction. Incoming monthly data are also supportive of the view that the economy contracted in 4Q11. Non-oil domestic exports (NODX) unexpectedly surged 5.9% MoM (sa) in November but due mainly to a technical payback for the outsized decline of 6% in October. The average level of NODX (sa) for October-November is 7.4% (not annualised) lower than the average level in 3Q11.

On our 0% forecast, growth in 2012 will be at a three-year low due to subdued demand from advanced economies and slowing growth in Asia (the anticipated pro-growth policy response in China will not be a complete offset for Singapore). Electronics demand and trade activities will continue to wane while biomedical production and tourism related industries will provide some support. On our growth trajectory, the Singapore economy will contract again in 1Q12 after shrinking in 4Q11. However the economy should be picking up again before end-2012 as we expect, first, that international trade finance conditions will stabilise around mid-year and, second, that US growth will start to accelerate in the second half.

Unemployment rate to rise, inflation to ease

The Singapore unemployment rate (sa) has been in a narrow range of 1.9% to 2.2% in the seven quarters to 3Q11 reflecting the tightness in the labour market that can broadly be taken as "full employment".

GDP GROWTH FORECASTS

Government	Updated:	Dec
	2012:	1 - 3
Consensus	Updated:	Dec
	2012:	3.8
CLSA	2012:	0.0

CLSA

THE CLSA DIFFERENCE

GDP growth
- 2012 GDP forecast well below consensus and government forecast. Consensus will be marked down significantly.

Inflation
- Inflation will ease in 2012.

Interest rates & exchange rate
- Global risk-off could cause local money market rates to rise. MAS to shift to neutral stance in April, SGD to weaken on the anticipated USD strength in 2012.

CLSA

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Prepared for: ThomsonReuters

Cyclical export-led deceleration will hurt investment spending.

Growth will stall in 2012 due to the global downshift but will recover in the following year.

Inflation to come off due to softer commodity prices, lower growth and weaker labour market.

MAS is expected to shift to a neutral stance in April on deceleration in growth and improved outlook for inflation.

Singapore remains successful in attracting FDI.

Loan growth should moderate after being unexpectedly strong.

Fiscal balance remains in good shape and offers scope for counter-cyclical measures.

Unemployment rate will rise but by less than it did following the 2008 GFC.

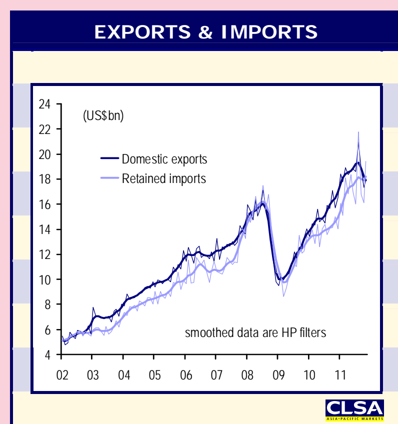
SINGAPORE BY NUMBERS

	2009	2010	2011clsa	2012clsa	2013clsa
Breakdown of real GDP					
Private consumption	0.2	4.2	5.5	1.5	4.[illegible]
Public consumption	3.5	11.0	3.2	5.0	3.0
GFCF	(2.9)	5.1	10.2	(5.9)	1.3
Domestic demand (contr. to growth)	(5.3)	5.3	5.0	(0.2)	2.0
Exports, goods & services	(8.1)	19.2	1.4	(3.4)	9.0
Imports, good & services	(11.0)	16.6	2.6	(4.0)	9.0
Real GDP growth	**(0.8)**	**14.5**	**5.0**	**0.0**	**5.0**
Prices					
Consumer prices (y/e)	(0.5)	4.6	4.9	2.5	2.4
Consumer prices (average)	0.6	2.8	5.2	3.5	2.2
Domestic supply prices (y/e)	12.4	2.7	8.1	2.0	4.0
Currency & interest rates					
SGD/USD (y/e)	1.40	1.29	1.32	1.36	1.32
SGD/USD (average)	1.45	1.36	1.28	1.34	1.34
3-month interbank rate (% y/e)	0.7	0.4	0.4	0.5	0.8
External sector					
NODX (USD, % YoY)	(13.0)	31.1	7.7	(9.4)	5.0
Retained imports (USD, % YoY)	(27.5)	24.7	25.1	(16.8)	10.0
Trade balance (USD bn)	29.2	46.7	48.8	49.1	54.3
Current account balance (USD bn)	34.9	49.5	47.3	44.1	44.3
- as a % of nominal GDP	19.0	22.2	18.5	17.7	16.7
FDI (USD bn)	(3.2)	18.9	15.7	11.2	9.0
CA + net FDI (% GDP)	17.3	30.7	24.7	22.2	20.0
External debt (total, USD bn)	0.0	0.0	0.0	0.0	0.0
Debt service ratio (% exports)	0.0	0.0	0.0	0.0	0.0
International reserves (USD bn, y/e)	187.8	225.8	241.0	251.0	266.0
Money supply					
Money supply M1 (y/e)	23.5	20.3	17.0	13.0	15.0
Money supply M2 (y/e)	11.3	8.6	11.0	6.0	10.0
Private sector credit (y/e)	3.3	14.7	26.0	5.0	10.0
Private sector credit (% GDP)	105.5	106.3	124.9	128.3	131.7
Government sector					
Government fiscal deficit[1](% GDP)	(0.3)	(0.1)	(0.0)	0.5	0.0
Nominal GDP					
Nominal GDP (USD bn)	183.4	222.8	254.9	248.4	266.1
Nominal GDP per capita (USD)	36,765	43,891	49,173	46,982	49,385
Nominal GDP (SGD bn)	266.7	303.7	325.7	332.9	356.5
Nominal GDP (SGD, % YoY)	(0.5)	13.9	7.3	2.2	7.1
Other data					
Industrial production	(4.2)	29.7	6.0	(1.0)	7.0
Retail sales	(7.8)	(1.0)	4.5	1.0	4.0
Unemployment (% y/e)	2.3	2.2	2.1	2.6	2.3
Population (millions)	5.0	5.1	5.2	5.3	5.4

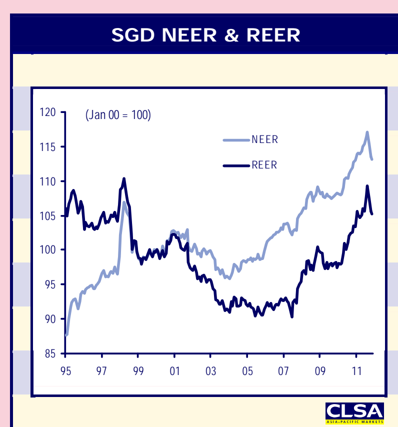
Note: % YoY rates unless otherwise stated. [1]Fiscal years beginning 1 April.
Source: CEIC, MAS, MTI, DataStream, Bloomberg, CLSA estimates

Prepared for: ThomsonReuters

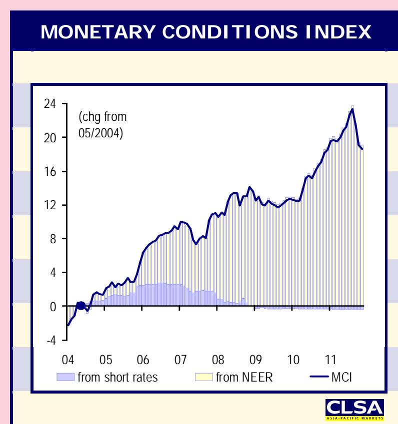
EXPORTS & IMPORTS



SGD NEER & REER



MONETARY CONDITIONS INDEX



However, as growth decelerates, we expect the unemployment rate (sa) to rise to 3% by mid-2012. Better second half growth will start to see unemployment easing back in 4Q12. To put this forecast in context, during the Global Financial Crisis the unemployment rate (sa) increased to a peak of 3.3% in 3Q09 from around 2% in 1H08.

Inflation continues to remain high due to higher imputed rents of owner occupied housing and increase in private road transport costs, the latter because of higher COE prices. CPI Inflation rose 5.4% YoY in October and YTD inflation stands at 5.2% YoY compared to 2.5% in the same period in 2010. Food inflation has been elevated due to SGD depreciation and the supply fallout from the Thai floods.

However, MAS' core inflation measure, which excludes the costs of accommodation and private road transport, remained broadly stable at 2.3% YoY in October. The recent hike in taxi fares will have a minimal impact on headline inflation. Looking ahead, inflation will become less of an issue in 2012 due to a combination of the deceleration in growth, higher unemployment rate and softening in commodity prices. Separately, the latest set of property measures suggest that the government has not taken its eyes off the sector.

Move to neutral in April

In October, the MAS reduced the slope of the SGD NEER policy band but kept its width and the centre unchanged. The motivation for easing the currency-centred monetary policy was slowing growth and an improved outlook for inflation. The MAS' next policy will be announced in April 2012, and we expect it to shift to neutral by lowering the slope of the SGD NEER band to zero from the current stance of slight appreciation. We forecast the USD to weaken in 1Q12 (see *World view* section, pp33-36) but then to strengthen significantly for the remainder of the year including against the components of the SGD's trade-weighted basket. We expect a modest SGD depreciation to SGD1.36/USD by end-2012.

CURRENCY FORECAST

Period-end	Annual					Coming 12 months by quarter			
	2009	2010	2011clsa	2012clsa	2013clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
SGD/USD	1.40	1.29	1.32	1.36	1.32	1.29	1.32	1.34	1.36
SGD/JPY 100	1.52	1.59	1.67	1.64	1.59	1.77	1.71	1.68	1.64
SGD/GBP	2.27	2.01	1.98	2.01	1.95	2.12	2.14	2.14	2.01
SGD/EUR	2.01	1.73	1.65	1.63	1.58	1.74	1.72	1.68	1.63
Memo: USD/EUR	*1.44*	*1.34*	*1.25*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*92.0*	*81.1*	*79.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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Nosedive

- Exports have continued to contract sharply. We have lowered our 2012 GDP forecast to 1.2% as a result.
- The CBC will cut but the ability of policy to counter a trade slowdown is hampered by already-low interest rates.
- Businesses have already reacted by scaling back investment. Rising unemployment will follow in 2012.

Export strife... continued

The collapse in Taiwan's export growth has been among the fastest in Asia. The trend in merchandise exports (measured as the three-month rolling average) has been falling since July and, as of November, exports were only just above year-ago levels. Shipments to major trading partners have deteriorated rapidly over the past quarter; exports to China were down 6.1% QoQ in November, to the US down 8.2% QoQ and to the EU down 7.0% QoQ.

That external weakness translated directly into a 0.7% decline in 3Q11 export volumes as measured in the national accounts, driving a 0.1% contraction in GDP – the first since 1Q09. The impact on GDP from falling exports would have been greater were it not for a sizable decline in imports, which fell 2.2% QoQ in 3Q (from 2.5% QoQ in 2Q). The squeeze on trade credit as European banks shed risk (see *World View* section on pp33-36) is clearly not helping merchandise flows in either direction.

The decline in Taiwan's exports is still nowhere near as severe as that experienced during 2008/09, when merchandise shipments were contracting at up to 20% *per month*. Nonetheless, the current downturn will likely be more protracted. World trade flows were resurrected during the Global Financial Crisis by concerted (if not co-ordinated) policy action, sparked in turn by the collapse of Lehman Brothers. The lack of a similar "crisis event" this time (presuming the EU does not implode) means that policy responses are likely to be much more measured and their positive spin-offs more gradually realised.

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005	2006	2007	2008	2009	2010	2011clsa	2012clsa	2013clsa
Real GDP growth	4.7	5.4	6.0	0.7	(1.8)	10.7	4.2	1.2	4.9
Domestic demand (contr. to growth)	1.8	0.9	1.3	(1.9)	(2.9)	7.7	1.0	0.6	2.5
Nominal GDP growth	3.3	4.3	5.4	(2.2)	(1.1)	2.3	3.5	1.0	5.0
Consumer prices (y/e)	2.2	0.7	3.3	1.3	(0.2)	1.2	1.2	1.6	2.3
Rediscount rate (% y/e)	2.25	2.75	3.38	2.00	1.25	1.63	1.75	1.38	1.38
TWD/USD (y/e)	32.85	32.60	32.44	32.86	32.03	30.37	30.50	32.50	33.50
Money supply M1b (y/e)	6.6	5.4	1.1	(2.2)	30.3	8.8	5.1	4.6	7.7
Current account balance (USD bn)	17.6	26.3	35.2	27.5	43.2	39.9	41.3	42.6	49.6
- as a % of nominal GDP	4.7	6.8	8.6	6.6	11.0	9.5	9.0	9.8	11.4
Public sector deficit (% GDP)	0.1	(0.1)	(0.3)	0.5	3.5	3.3	4.6	4.3	3.4

Note: % YoY rates unless otherwise stated.
Source: CEIC, CLSA estimates, Central Bank of China, DGBAS

Prepared for: ThomsonReuters

As Taiwan's largest trading partner, China's policy easing has the greatest potential for halting Taiwan's trade slump. However, as we note in the *China* section (see pp41-44) Beijing will be wary of over-stimulating, implying an incremental approach to easing in 1H12. At the same time, US growth will be weakening; of particular relevance to Taiwan's tech producers, this slowdown will be driven by a downswing in IT and software investment. Throughout, European growth will be near recessionary.

Our core view for Taiwan, then, sees export weakness persisting until mid-2012. Thereafter the rebound should be aggressive; easier policy in China will be kicking in and US growth will be fibrillating upwards. In terms of annual numbers, however, this strength will be more visible in 2013's figures. We forecast 2012 exports to grow just 0.9% YoY, lower than the rate seen in the Asian Financial Crisis.

Domestic policy response limited

Given its massive offshore exposure, Taiwan's ability to influence its own business cycle is extremely limited. The CBC can be expected to cut but room to ease is constrained by the fact that the policy rate is only 1.875% at present. We have pencilled in 12.5bp cuts for each of the next four (quarterly) policy meetings, beginning at the end of December, taking the discount rate to 1.38% by the end of 2012, equivalent to the low set during the GFC.

Public expenditure will pick up in the coming twelve months. 2012 is an election year (Presidential and Legislative Yuan elections are scheduled for January), however, and voter concerns are likely to dominate spending decisions, at least initially. As part of its campaign, the current Kuomintang-led government (which our Taiwan research team judges will be retained; see research note *KMT extends its lead*, 15 December) proposed a series of policy initiatives with social as much as economic imperatives. These included labour market reforms (reducing the working week, improving maternity pay, etc) which although

GDP GROWTH FORECASTS

Government		
Updated:	Nov	
2012:	4.2	
Consensus		
Updated:	Dec	
2012:	1.6	
CLSA		
2012:	1.2	

CLSA

THE CLSA DIFFERENCE

GDP growth

- Taiwan has been amongst the worst affected by the global slowdown. We've lowered 2012 expectations further.

Inflation

- Inflation hasn't risen above 2% since before the GFC and will remain a non-issue in 2012.

Interest rates & exchange rate

- The CBC will cut and the TWD will soften. Looser monetary conditions will not offset soft external demand.

CLSA

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Prepared for: ThomsonReuters

Consumer confidence is falling rapidly. Rising unemployment and a property downturn will hurt consumption prospects.

Slowing in 2012 masks a mid-year trunaround, and paves the way for a much stronger 2013.

Clearly no hurdle to monetary policy easing.

A stronger USD will amplify the TWD depreciation driven by slower exports.

The CBC will cut steadily in 1H12 but benefits will be muted given already very low real interest rates.

Business borrowing has been surprisingly robust but will struggle to keep pace with economic growth in 2012.

The collapse in industrial production has mirrored that of exports. Our weak external outlook implies a weak production forecast.

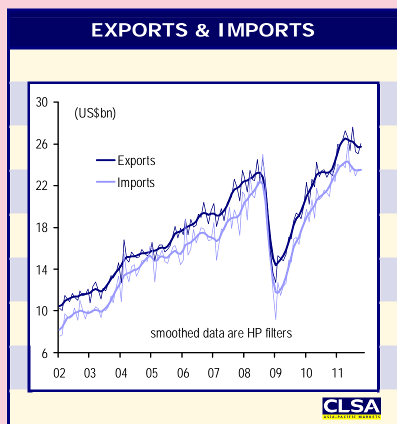
Unemployment will lift consistent with the drop in capex.

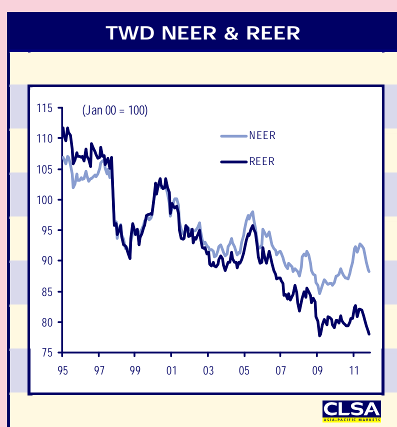
TAIWAN BY NUMBERS

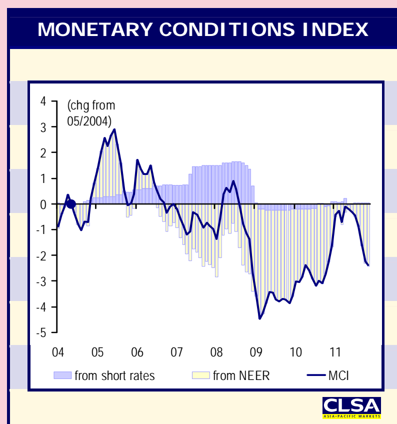
	2009	2010	2011clsa	2012clsa	2013clsa
Breakdown of real GDP					
Private consumption	1.4	2.6	3.4	1.4	2.5
Public consumption	4.0	0.6	1.7	2.6	1.8
GFCF	(11.2)	24.0	(5.4)	(1.6)	5.3
Domestic demand (contr. to growth)	(2.9)	7.7	1.0	0.6	2.5
Exports, goods & services	(8.7)	25.6	4.7	0.9	7.9
Imports, goods & services	(13.1)	28.2	0.2	(0.0)	6.1
Real GDP growth	**(1.8)**	**10.7**	**4.2**	**1.2**	**4.9**
Prices					
Consumer prices (y/e)	(0.2)	1.2	1.2	1.6	2.3
Consumer prices (average)	(0.9)	1.0	1.3	1.2	1.9
Producer prices (y/e)	5.8	2.3	6.5	2.9	4.5
Currency & interest rates					
TWD/USD (y/e)	32.03	30.37	30.50	32.50	33.50
TWD/USD (average)	32.74	31.45	29.81	31.56	33.38
Discount rate (% y/e)	1.25	1.63	1.75	1.38	1.38
Base lending rate (% y/e)	2.56	2.68	2.75	2.38	2.63
External sector					
Exports (USD, % YoY)	(20.2)	34.6	13.9	2.3	7.1
Imports (USD, % YoY)	(26.9)	43.1	15.1	2.0	5.4
Trade balance (USD bn)	30.6	26.5	27.1	28.6	35.6
Current account balance (USD bn)	43.2	39.9	41.3	42.6	49.6
- as a % of nominal GDP	11.0	9.5	9.0	9.8	11.4
FDI (USD bn)	(3.1)	(8.7)	(11.0)	(6.2)	(8.5)
CA + net FDI (% GDP)	10.5	7.7	6.8	8.6	9.8
External debt (total, USD bn)	82.0	101.6	125.0	135.0	130.0
Debt service ratio (% exports)	2.6	1.2	2.5	4.0	3.5
International reserves (USD bn, y/e)	348.2	382.0	395.0	400.0	410.0
Money supply					
Money supply M1b (y/e)	30.3	8.8	5.1	4.6	7.7
Money supply M2 (y/e)	6.0	5.1	5.2	3.6	5.0
Private sector credit (y/e)	(0.2)	7.3	7.0	1.0	6.4
Private sector credit (% of GDP)	122.9	128.9	133.3	133.3	135.2
Government sector					
Public sector deficit (% GDP)	3.5	3.3	4.6	4.3	3.4
Public debt (% GDP, y/e)	36.9	39.4	42.7	46.6	47.8
Nominal GDP					
Nominal GDP (USD bn)	381.2	405.9	443.2	422.8	419.8
Nominal GDP per capita (USD)	16,563	17,605	19,187	18,264	18,100
Nominal GDP (TWD bn)	12,481	12,765	13,211	13,344	14,011
Nominal GDP (TWD, % YoY)	(1.1)	2.3	3.5	1.0	5.0
Other data					
Industrial production	(8.1)	26.9	4.8	(0.8)	7.0
Retail sales	2.4	0.9	4.2	1.5	2.2
Unemployment (% y/e)	5.7	4.7	4.6	5.3	4.9
Population (millions)	23.0	23.1	23.1	23.1	23.2

Note: % YoY rates unless otherwise stated.
Source: CEIC, CLSA estimates, Central Bank of China, DGBAS

Prepared for: ThomsonReuters







undoubtedly fostering a more dynamic economy in the longer run, will do little to provide counter-cyclical support during a downturn. Ongoing export weakness may prompt more direct stimulus measures as 2012 progresses. The state of the government's finances provides some scope for this but we'd note that at 4.6% of GDP (our 2011 estimate) the public deficit is already near a cyclical peak (and far worse than the surplus prevailing prior to the GFC).

Domestic squeeze

The domestic economy is already showing signs of being adversely affected by weaker external demand. Real business investment has slumped, falling 7.3% QoQ in 3Q11, after -5.4% QoQ in 2Q. This effectively contradicts our earlier thesis, that capex would remain relatively robust even in the face of an export downturn, as businesses sought to make up for years of chronic underinvestment. As a result, we now expect fixed asset spending to contract again in 2012 (falling 1.6%), following a forecast 5.4% fall in 2011, in effect postponing the fixed asset rebuild to 2013.

With interest rates already low (real rates are barely positive) access to cheap credit is obviously not the impediment to increased business spending. Business borrowing has indeed been robust, surprising given the sequential declines in investment. This reinforces the difficulty that the CBC has in stimulating the economy via monetary easing, however.

Households are hanging in there. Real consumption growth was 0.6% QoQ in 3Q11, the lowest growth since 1Q10 but still on trend. Monthly retail sales have held up more recently, running at around 1.5% QoQ (our seasonally adjusted estimate). Furthermore, the unemployment rate has remained stable at around 4.3%, essentially its lowest since the GFC.

Nonetheless, prospects are poor. November's consumer sentiment index slumped to its lowest level since mid-2010, a poor omen for durables spending in coming months. Rising unemployment and falling house prices – reaction to government measures to curb property speculation will further weigh on households next year.

CURRENCY FORECAST

Period-end	Annual					Coming 12 months by quarter			
	2009	2010	2011clsa	2012clsa	2013clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
TWD/USD	32.03	30.37	30.50	32.50	33.50	30.75	31.25	31.75	32.50
TWD/JPY 100	34.82	37.45	38.61	39.16	40.36	42.12	40.58	39.69	39.16
TWD/GBP	51.89	47.38	45.75	48.10	49.58	50.43	50.63	50.80	48.10
TWD/EUR	46.00	40.70	38.13	39.00	40.20	41.51	40.63	39.69	39.00
Memo: USD/EUR	*1.44*	*1.34*	*1.25*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*92.0*	*81.1*	*79.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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Yingluck's mighty challenge

- **Restoring confidence is the priority requiring efficient flood relief management and strict accountability.**
- **Post-flood recovery will run bang into a global downturn with nominal export growth slowing to our 2.6% forecast.**
- **Deficits on the fiscal and current accounts will expose the baht; renewed FDI will be needed as an effective counter.**

Main objective is to restore confidence

The flood has significantly altered our real GDP forecasts from the 4Q11 *Eye on Asian Economies*. We have revised our 2011 forecast down by 2 percentage points to 1.5%, while revising our 2012 forecast up by 0.8ppt to 3.8% and our 2013 forecast up by 0.4ppt to 4.6%. This assumes a 20% QoQ contraction in 4Q11 followed by a moderate rebound in 1Q12 and a much bigger rebound in 2Q12. But it is still impossible to quantify with any certainty the extent of economic disruption or the subsequent boost to growth from restructuring. Actual GDP forecasts are less important than the direction they are signalling and should be assessed from this perspective.

Total flood damage has been estimated at up to USD46bn (World Bank). This is equivalent to 13% of GDP. The government has frontloaded THB120bn of 2011/12 budget expenditure for flood relief efforts, of which THB20bn will be disbursed by the end of January 2012. It has assigned a larger THB800bn for reconstruction which includes future flood prevention and water management programmes, to be spent over a three year period.

Restoring business and consumer confidence is the key challenge. This will require efficient flood relief management by the Yingluck administration. With large sums of money changing hands, there will need to be maximum transparency and accountability to prevent misappropriation of public funds. Even before the flood, we argued in favour of Ms Yingluck's fiscal initiatives for a counter-cyclical stimulus to the anticipated external sector downturn in 2012. The challenge for Ms Yingluck is to implement the

LONG-RUN HISTORY AND FORECAST SUMMARY

	2005	2006	2007	2008	2009	2010	2011clsa	2012clsa	2013clsa
Real GDP growth	4.6	5.1	5.0	2.5	(2.3)	7.8	1.5	3.8	4.6
Domestic demand (contr. to growth)	6.5	1.0	2.0	3.6	(5.9)	8.4	1.6	4.8	4.3
Nominal GDP growth	9.3	10.6	8.7	6.5	(0.4)	11.8	5.6	7.6	8.2
Consumer prices (y/e)	6.0	3.2	2.9	2.1	1.9	2.9	4.5	3.4	3.8
1-day repo rate (% y/e)	4.00	5.00	3.25	2.75	1.25	2.00	3.25	2.75	3.00
THB/USD (y/e)	41.03	35.78	33.66	34.98	33.18	30.12	31.60	33.30	34.00
Money supply – Narrow (y/e)	7.3	2.4	9.7	4.1	12.8	10.9	10.8	7.4	13.6
Current account balance (USD bn)	(7.6)	2.3	15.7	2.2	21.9	13.7	6.2	(6.4)	(8.5)
- as a % of nominal GDP	(4.3)	1.1	5.9	0.8	8.3	4.3	1.8	(1.8)	(2.3)
Public sector deficit (% GDP)[1]	(1.1)	0.3	1.3	0.5	4.9	0.3	2.1	5.0	4.2

Note: % YoY rates unless otherwise stated; [1] Fiscal year ending September.
Source: IMF, IFS, CEIC, CLSA estimates, Bank of Thailand

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stimulus while maintaining reasonable control of the fiscal accounts. We forecast a rise in the deficit to 5% of GDP in 2011/12 (fiscal year ends in September) from 2.1% in 2010/11. Strict auditing of the fiscal accounts will be needed to prevent a much bigger blow out.

Recovery prospects blunted by global downturn

The manufacturing sector was hardest hit by the floods, accounting for over two thirds of the estimated damage. Electronics and auto production, in particular, were severely disrupted. In addition, Thailand has suffered revenue losses in the agricultural and tourism sectors, along with extensive losses by firms in the services sectors such as retail, financial, real estate etc. Tourism though, has proved remarkably durable after recurrent political and climatic setbacks.

In a favourable global demand environment, one would expect a reasonably fast recovery. However, post-flood recovery prospects will be complicated by an adverse global demand environment. Electronics and auto companies will strive to restore full capacity by 1Q or 2Q12, only to find that external demand has tanked. Thailand is among Asia's more vulnerable economies, underlined by its 71% export to GDP ratio.

Export vulnerability is reinforced by the high share of manufacturing in GDP at close to 40%. On the positive side, there has been a shift in Thailand's export markets with a declining share to the US and EU (19% combined) and a rising share to China (12%) and Asean (17%). However, as the world second largest producer of hard-disk-drives after China, Thailand is tied into the intermediate technology chain and is therefore still reliant on end-user demand in the US and EU.

Post-flood electronics production recovery in Thailand will initially be spurred by global shortages of hard-disk-drives. This will not be sustained beyond one or two months though, as the global electronics downturn weighs on demand. Weak global demand will affect manufacturing exports more generally, dragging down overall export growth to our 2.6% forecast for 2012, from an estimated 17.6% in 2011.

GDP GROWTH FORECASTS

Government
Updated: Dec
2012: 4.5 – 5.5

Consensus
Updated: Dec
2012: 4.3

CLSA
2012: 3.8

CLSA

THE CLSA DIFFERENCE

GDP growth
- We agree that there will be a post-flood rebound but are more cautious on the global demand outlook.

Inflation
- We forecast subdued inflation, well within BOT's target ie, core inflation at 0.5 – 3% and headline 2ppt higher.

Interest rates & exchange rate
- BOT will likely cut rates, reinforcing recovery efforts. We think 50bp maximum, given the exchange rate risk.

CLSA

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Prepared for: ThomsonReuters

THAILAND BY NUMBERS

	2009	2010	2011clsa	2012clsa	2013clsa
Breakdown of real GDP					
Private consumption	(1.1)	4.8	2.4	3.7	3.8
Public consumption	7.5	6.4	1.6	12.0	4.0
GFCF	(9.2)	9.4	4.0	8.0	8.4
Domestic demand (contr. to growth)	(5.9)	8.4	1.6	4.8	4.3
Exports, goods & services	(12.5)	14.7	11.5	2.8	9.3
Imports, goods & services	(21.5)	21.5	15.0	5.3	11.0
Real GDP growth	**(2.3)**	**7.8**	**1.5**	**3.8**	**4.6**
Prices					
Consumer prices (y/e)	1.9	2.9	4.5	3.4	3.8
Consumer prices (average)	(0.8)	3.3	3.9	3.4	3.6
Producer prices (y/e)	9.9	6.7	6.0	4.3	4.6
Currency & interest rates					
THB/USD (y/e)	33.18	30.12	31.60	33.30	34.00
THB/USD (average)	34.31	31.70	30.48	31.99	33.19
1-day repo rate (% y/e)	1.25	2.00	3.25	2.75	3.00
Minimum lending rate (% y/e)	5.85	6.12	6.75	6.50	6.75
External sector					
Exports (USD, % YoY)	(14.0)	28.5	17.6	2.6	11.5
Imports (USD, % YoY)	(25.2)	36.7	26.6	9.9	15.2
Trade balance (USD bn)	32.6	32.2	23.4	9.1	2.0
Current account balance (USD bn)	21.9	13.7	6.2	(6.4)	(8.5)
- as a % of nominal GDP	8.3	4.3	1.8	(1.8)	(2.3)
FDI (USD bn)	0.9	0.5	(3.4)	2.6	3.2
CA + net FDI (% GDP)	8.6	4.4	0.8	(1.1)	(1.4)
External debt (total, USD bn)	75.3	100.6	118.0	132.0	150.8
Debt service ratio (% exports)	5.3	4.3	3.4	4.0	4.8
International reserves (USD bn, y/e)	138.4	172.1	181.0	186.0	194.0
Money supply					
Money supply - Narrow (y/e)	12.8	10.9	10.8	7.4	13.6
Money supply - Broad (y/e)	6.8	10.9	13.0	7.0	14.0
Private sector credit (y/e)	3.1	12.6	12.4	8.0	14.2
Private sector credit (% GDP)	97.7	98.4	104.7	105.2	111.0
Government sector					
Public sector deficit (% GDP)[1]	4.9	0.3	2.1	5.0	4.2
Public sector debt (% GDP, y/e)	43.9	42.4	43.2	46.6	49.0
Nominal GDP					
Nominal GDP (USD bn)	263.5	318.8	350.2	359.0	374.3
Nominal GDP per capita (USD)	3,929	4,728	5,157	5,251	5,442
Nominal GDP (THB bn)	9,042	10,105	10,675	11,482	12,423
Nominal GDP (THB, % YoY)	(0.4)	11.8	5.6	7.6	8.2
Other data					
Industrial production	(6.1)	13.9	0.6	2.7	7.2
Population (millions)	67.1	67.4	67.9	68.4	68.8

Note: % YoY rates unless otherwise stated; [1]Fiscal year ending September.
Source: IMF, IFS, CEIC, CLSA estimates, Bank of Thailand

Declining rural income and weak labour market will curb consumer spending; partial offset from minimum wage hike.

Sustained investment upswing depends on restoring confidence by efficient post-flood management.

Subdued inflation outlook will provide flexibility for a rate cut.

Fiscal and current account deficits argue for continued THB/USD depreciation.

Anything more than a 50bp rate cut will pressure the baht; we forecast a 25bp hike in late 2013.

Exposed by high export to GDP ratio.

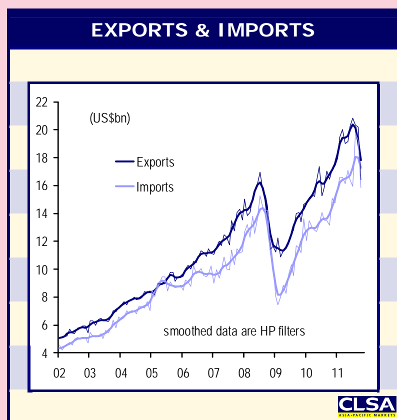
Current account shift to deficit as trade surplus narrows.

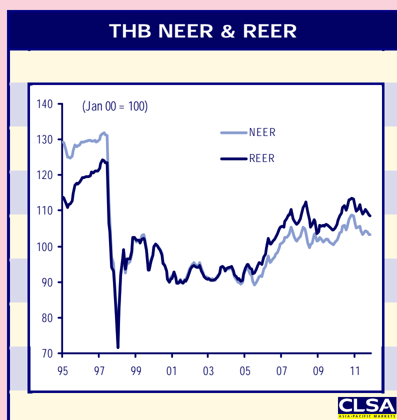
Challenge to boost FDI as BoP surplus falls.

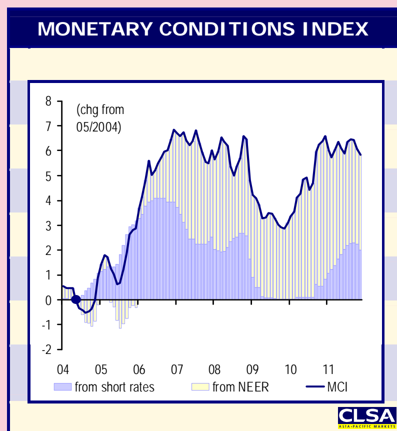
Domestic credit cycle will slow with the falling BoP surplus.

Rising fiscal deficit to 5% of GDP in 2012 stresses the need for strict accountability.

Prepared for: ThomsonReuters







Credit cycle will slow without BoP surplus

Commodity exports, which comprise 23% of total exports, will provide a partial offset given sustained demand from China and the Asean economies. However, this will be without the commodity price windfall which boosted revenues over the last two years. Easing commodity prices will curb rural income growth, thereby moderating consumption prospects in 2012. On this basis, our view is that the minimum wage hike, which still provokes considerable controversy, will benefit the economy by supporting low income household consumption.

Flood relief will include a THB325bn provision for soft loans through the policy banks, both to large businesses as well as to SMEs and individuals affected by the flood. The commercial banks have already been urged to maintain lending so as to compliment flood relief efforts. Confidence will be key, both among borrowers and lenders, for maintaining the domestic credit cycle. Given the diminishing balance of payments surplus though, we forecast slowing credit growth to 8% in 2012 from 12.4% in 2011.

Foreign investors need reassurance

The Bank of Thailand will do its bit to maintain credit growth with a further 50bp cut in its policy rate to 2.75% by mid-2012. This will be facilitated by a 1.1 percentage point decline in inflation to 3.4% by end-2012. That said, more aggressive monetary easing would risk undermining the exchange rate. The baht will be more exposed in 2012 on our expectation that the current account will shift into deficit.

While exports are pressured by the global downturn, imports will be sustained by post-flood reconstruction. The narrowing trade surplus will push the current account into deficit in 2012. The deficit will persist in 2013.

On the capital account, exchange rate risk has been reinforced by net FDI turning negative in 2011 as Thai firms have found it more profitable to invest offshore. In order to lift FDI inflows, Ms Yingluck needs to convince foreign investors that there will not be recurrence of the 2011 disaster by establishing a convincing flood defence system. With both the current and fiscal accounts in deficit, we forecast continued THB/USD depreciation in 2012 and 2013.

CURRENCY FORECAST

Period-end	Annual					Coming 12 months by quarter			
	2009	2010	2011clsa	2012clsa	2013clsa	1Q12clsa	2Q12clsa	3Q12clsa	4Q12clsa
THB/USD	33.18	30.12	31.60	33.30	34.00	31.40	31.60	32.50	33.30
THB/JPY 100	36.07	37.14	40.00	40.12	40.96	43.01	41.04	40.63	40.12
THB/GBP	53.76	46.98	47.40	49.28	50.32	51.50	51.19	52.00	49.28
THB/EUR	47.65	40.36	39.50	39.96	40.80	42.39	41.08	40.63	39.96
Memo: USD/EUR	*1.44*	*1.34*	*1.25*	*1.20*	*1.20*	*1.35*	*1.30*	*1.25*	*1.20*
Memo: JPY/USD	*92.0*	*81.1*	*79.0*	*83.0*	*83.0*	*73.0*	*77.0*	*80.0*	*83.0*

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