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ASIA EX-JAPAN: OVERVIEW

India: The hot-potato called "inflation"

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We are more concerned about the trade deficit than inflation.

Inflation has become the hottest economic topic in India today. Wholesale price (WPI) inflation increased to 6.7% y-o-y in early February, after averaging 6.3% in 2007, and 5.0% over the past five years[1]. This rise is commonly regarded as a symptom of the economy overheating. However, a close examination shows that domestic demand-pull price pressures are only part of the reason. Supply-side cost-push price pressures have probably been just as important, and some of these are likely to be temporary. Rather than inflation, our major concern is that the trade deficit looks set to widen further.

The economics of inflation

A detailed analysis of the components of inflation indicates that, while a varied basket is driving inflation, these can be broadly classified into three main categories:

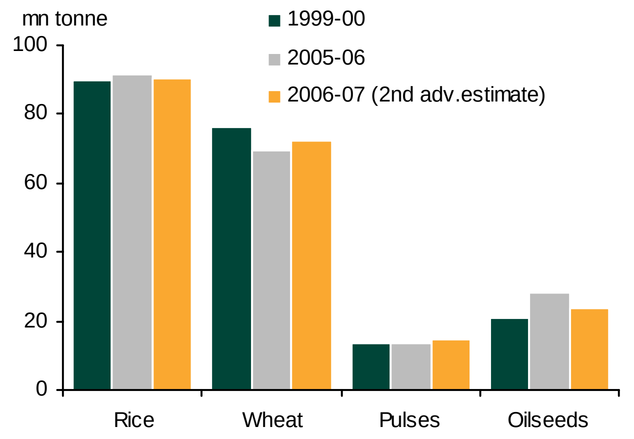
Food prices have risen very sharply, and have a high weight in the basket

1. Shortage in agriculture output: Primary food articles such as rice, wheat, pulses and oilseeds have been the main driver of inflation (food, primary and manufactured, has a hefty weight of 27% in the WPI basket). Due to structural inefficiencies in agricultural production, but also poor weather, output has not kept up with rising consumer demand (Figure 1). Lack of imported alternatives has further aggravated the situation. For example, only Kenya and Myanmar produce the kind of pulses that meet Indian tastes, and the drought in Australia has led to a global shortage of wheat. As a result, wheat prices are rising at close to 12% y-o-y, and pulses have increased by over 20%.

Industrial material prices should ease as investments come online

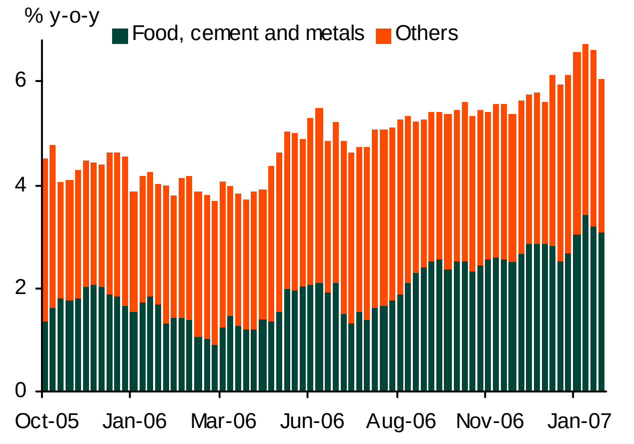
2. Investment-driven inflation: With the government stepping-up infrastructure spending and private large companies running short of capacity, investment is starting to take off. The investment-to-GDP ratio rose from 31.5% in 2004-05 to 33.8% in 2005-06, and the Reserve Bank of India (RBI) estimates that it could rise to 36-37% in 2006-07. This is fuelling tremendous demand for raw and industrial materials, bidding up their prices. India's imports of non-ferrous metals, cement, and steel rose in October 2006 in year-on-year terms by 74%, 33%, 156%, respectively.

Figure 1. Food grain and oilseed production



Source: Agriculture Ministry and Lehman Brothers.

Figure 2. Contribution to WPI inflation



Source: Bloomberg and Lehman Brothers.

[1] *In India, the WPI is the preferred measure of inflation because it is released more frequently (weekly) than the CPI (monthly) and has more items in the commodity basket (435 versus 120-160). In fact, the CPI for industrial workers has a much better coverage of services and its expenditure weights have been updated to 2001 versus 1993-94 for the WPI. The CPI for industrial workers was 6.7% y-o-y in January versus 6.2% for the WPI.*

3. Rising international prices: The prices of metals, wheat and edible oil have also risen sharply, due to rising international prices. WPI inflation in basic metal products, comprising iron and steel, steel ingots, aluminium and brass sheets, rose 16.2% y-o-y in January, not only due to strong investment demand in India, but also due to global shortages, reflecting the strong world demand, especially from China.

In essence, the contribution of three price categories – food, metals and cement – to WPI inflation has increased to 51% in February from 34% a year ago (Figure 2). Excluding these three categories, WPI inflation would be running at 5.2% y-o-y, instead of 6.6%.

The politics of inflation

Inflation is being tackled through monetary, fiscal and supply-side measures

Given that the current inflation surge is to a large extent driven by higher food prices, it is most detrimental to the poorer segments of the economy that have no hedge against inflation. With the ruling Congress party having lost in two of the three recent State assembly elections, a loss conveniently blamed on inflation, political parties want to secure their future in the national elections in 2009 and put the inflation genie back into the bottle. The RBI has been tightening the screws on monetary policy, but given the political significance of inflation the government has been busy implementing a flurry of tax and trade-related policies to ensure that inflation is brought under control (Figure 3).

The outlook

Inflation should ease to below 6%...

We expect WPI inflation to abate later this year to within the RBI's preferred band of 5.0-5.5%. Part of the reason for our optimism is the significant policy response, but also the surge in Indian investment, while adding to price pressures in the short run, should help ease inflation once the additional capacity comes online. Indeed, it is noteworthy that inflation is not higher, given the economy's extraordinary growth spurt to over 9%. We attribute this to a rising potential growth rate, underpinned by faster capital accumulation and stronger productivity growth (the latter helps explain why profits of large companies have remained healthy, despite rapid wage inflation).

…but the trade deficit looks set to continue spiralling

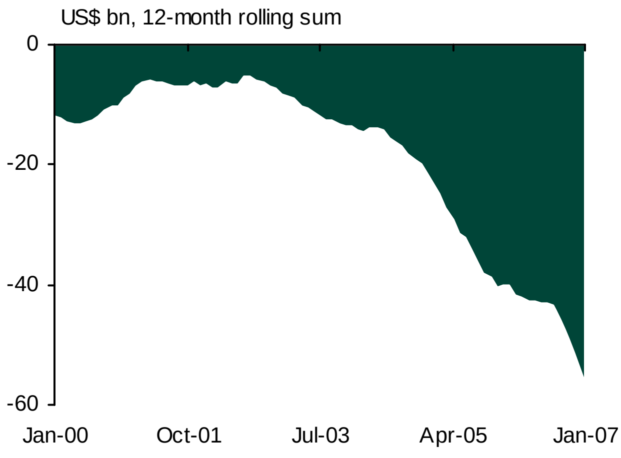
Instead of inflation, our major concern is that India's large trade deficit will increase further (Figure 4). Many of the new measures aimed at containing inflation are negative for the trade deficit in the short term, while the government's large subsidies on oil prices do not help promote efficient consumption of energy, which would be problematic were oil prices to rise sharply again, as we expect (our oil team's forecast is for Brent oil prices to average US$68/bbl this year). And India imports 70% of its oil. It is from this vantage point that, despite our positive 2007 forecasts for GDP growth (9.6%) and WPI inflation (5.9%), we do not expect much appreciation of the rupee this year.■

Figure 3. Recent anti-inflationary measures

Monetary measures	
31-Jan-07	Repo rate hiked by 25bp to 7.5%
13-Feb-07	Cash reserve ratio hiked by 50bp to 6.0%
28-Feb-07	Amount under market stabilisation scheme hiked to Rs800bn from Rs700bn
2-Mar-07	Daily amount under reverse repo capped at Rs30bn
Tax and trade-related measures	
22-Jan-07	Slashed import customs duty on inorganic chemicals, capital goods, alumina, refractories and cement
24-Jan-07	Banned futures trading in tur (red gram) and pulses
13-Feb-07	Banned wheat exports in 2007
16-Feb-07	Petrol prices cut by Re 2 and diesel prices cut by Re 1
27-Feb-07	Banned futures trading in wheat and rice
28-Feb-07	Excise duty on petrol, and diesel reduced from 8% to 6%; a tax imposed on iron ore exports; dual excise duty structure for cement; edible oil exempted from countervailing customs duty of 4%

Source: Lehman Brothers.

Figure 4. India's merchandise trade balance



Source: CEIC and Lehman Brothers.

ASIA EX-JAPAN: ECONOMIC OUTLOOK

Three possible surprises

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Low inflation, a revival of investment and the Southeast Asian economies starting to shine.

Asia ex-Japan's exports have started to weaken in most countries. However, there is ample room for policy responses. Government budgets are generally in good shape and, in most countries, public debt to GDP is below the OECD average. This leaves plenty of room to expand fiscal policy. Inflation is well under control, too. If some of the downside risks to growth were to materialise, nearly all Asian countries could cut rates. Against this backdrop, our outlook is cautious but positive. We forecast Asia ex-Japan's aggregate GDP growth to slow modestly, to 7.7%, in 2007, before rebounding to 8.2% in 2008.

The consensus could get it wrong in three areas. The first is inflation surprising on the low side. Asian inflation has remained benign in recent years, despite surging oil prices. We attribute this to prudent monetary policies, strong productivity growth after nine years of reform and intense competitive pressures from China and India.

The second potential surprise is resurgent investment. In China, tighter policies cooled investment slightly in 2006, but we do not expect much more cooling – there is huge demand for capital in less developed parts of the economy. In the rest of the region, investment has languished in most countries, since the Asian crisis. Nine years on there is a growing competitive need to upgrade the capital stock. Conditions seem ripe for a revival: economic fundamentals are much improved; interest rates are low; and public infrastructure spending looks set to soar which should spur private investment.

The third possible surprise is stronger-than-expected growth in the Southeast Asian economies. Despite recent setbacks in Thailand, Southeast Asian politics have become more stable and macro policies more prudent. Indeed, in recent years, the Southeast Asian cubs have made more progress than the Northeast Asia tigers in improving their economic fundamentals. The climate in Southeast Asia seems ripe for a resurgence in investment, which has been desperately lacking. This would set the stage for all of the economies to grow at their full potential in 2008 for the first time since the Asian crisis.

Asia ex-Japan is certainly "emerging": the aggregate size of the economies (in US$) in the region has shot past Japan's and, based on our growth and currency appreciation forecasts, should swell to US$7.7tr in 2008. As Asia ex-Japan becomes more important in the world economy, it will likely shift away from its export-led development growth model towards one where home-grown demand plays a more pivotal role.

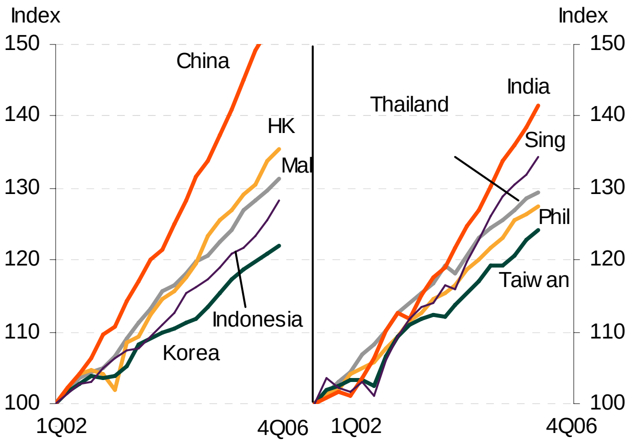
Forecast changes this week: None.

The outlook at a glance

	Real GDP (% growth y-o-y)				**CPI** (% y-o-y)			
	Latest*	**2006**	**2007**	**2008**	**Latest#**	**2006**	**2007**	**2008**
China	10.4	10.7	9.6	9.8	2.2	1.5	2.5	2.8
Hong Kong	7.0	6.8	5.5	6.5	2.0	2.0	2.5	3.5
India	8.6	9.1	9.6	9.9	6.1	4.8	5.9	5.7
Indonesia	6.1	5.5	5.7	6.5	6.3	13.1	6.5	5.0
Malaysia	5.7	5.9	5.0	6.0	3.2	3.6	2.2	3.0
Philippines	4.8	5.4	5.8	6.5	2.6	6.2	3.5	4.0
Singapore	6.6	7.9	5.0	7.0	0.3	1.0	1.6	2.1
South Korea	4.0	5.0	4.3	5.1	2.2	2.2	2.5	2.9
Taiwan	4.0	4.6	3.9	5.0	1.7	0.6	1.0	1.5
Thailand	4.2	5.0	3.5	5.5	2.3	4.6	2.8	3.5
Asia ex-Japan	8.0	8.4	7.7	8.2	3.0	3.0	3.2	3.4

** GDP data are for Q4.*
 # CPI data are for February, except for China, Hong Kong, Malaysia and Singapore (which is for January).
 # CPI data for India are based on the wholesale price index for the week of 24 February, 2007.
All forecasts are modal (ie, the most likely single outcome). Table last revised on 9 March 2007.
Source: CEIC and Lehman Brothers.

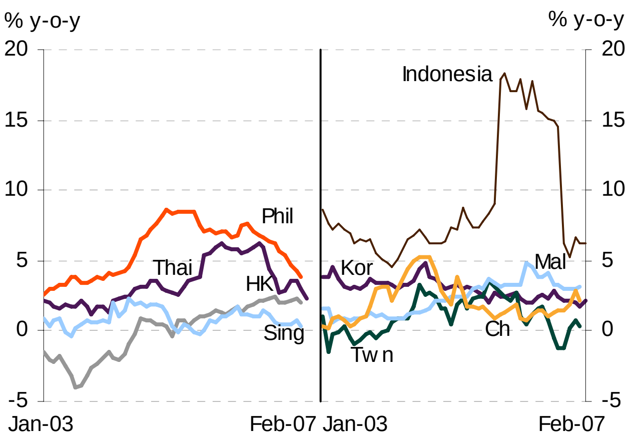
The region: The level of real GDP (seasonally adjusted, indexed 1Q2002 = 100)



- We expect an export slowdown this year, but the region has plenty of room to ease monetary and fiscal policies, rotating the mix of GDP towards domestic demand.
- Indexed to 100 in 2002, China's GDP (156) is off the chart and, encouragingly, growth is becoming more balanced. Southeast Asia is also starting to shine.
- The laggard economies have been Korea and Taiwan. Both have heavily indebted household sectors and are facing intense competitive pressures.

Source: CEIC and Lehman Brothers.

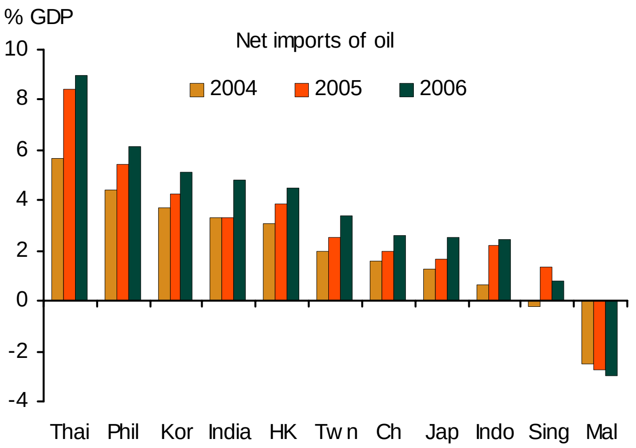
The region: Consumer price inflation (% y-o-y)



- After rising sharply on surging oil prices and cuts in government oil price subsidies, inflation has fallen sharply in Indonesia and remains benign elsewhere.
- We expect oil prices to rise again to average US$68/bbl in 2007, but the impact on the year-on-year CPI inflation should be modest given a high base year of comparison.
- How low inflation goes could be the big surprise. High productivity growth, prudent monetary policies and intense competition are keeping inflation low.

Source: CEIC and Lehman Brothers.

The region: Vulnerable to oil price shocks



- High oil prices hurt Asia ex-Japan's economies substantially more than most other regions, with Thailand, Philippines, Korea and India most exposed.
- Our Oil team expects oil prices to rise again, and our economic forecasts are based on this view. But if oil prices stay low, it will be a major plus for the region.
- If the recent drop in oil prices is sustained, it could result in larger current account surpluses, lower CPI inflation, more scope for rate cuts and stronger growth.

Source: CEIC and Lehman Brothers.

CHINA: ECONOMIC OUTLOOK

Towards more balanced growth

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We expect consumption to contribute more to economic growth and net exports to contribute less, provided that current economic policies and reforms continue.

The Chinese economy grew by 10.7% in 2006, the fastest pace in more than a decade. But the quality of growth needs to improve: overinvestment has led to excess capacity and a growing reliance on exports. We expect economic growth to moderate to 9.6% in 2007, but the mix of consumption, investment and net exports should become a little more balanced, provided the government sticks to its economic reform agenda.

In 2006, the government initiated efforts to build “a harmonious society” and started or committed to many reforms. These include: broadening the social security system; reducing tax burdens while increasing subsidies for health and education for rural households; raising minimum wages; improving protection for workers migrating to the cities; unifying corporate income tax rates for domestic and foreign-invested enterprises; and requiring SOEs to pay dividends to the government. The reforms will likely boost consumption, especially in the rural areas, since rapid income growth and an improving social welfare system should reduce precautionary savings. Government consumption should also increase as a result of a stronger fiscal position.

On investment, we do not expect a sharp slowdown, given the need to improve rural infrastructure and boost economic development in the mid-western regions. We expect the huge trade surplus to shrink slightly in 2007 as a result of numerous new measures, either implemented or in the pipeline. Stronger consumption should boost imports, while further appreciation of the renminbi (RMB), deregulation of pricing policies for energy and natural resources, stricter regulations on labour and environmental protection, and reduced tax incentives for exporters should all contribute to pushing up production costs and reducing the competitiveness of Chinese exports.

Rising production costs should lift CPI inflation to about 2.5% in 2007, but rapid growth in productivity, an abundant supply of cheap labour and excessive production capacity should ensure that inflation does not get out of hand. We expect the central bank to hike rates by 27bp in 2007 to prevent real deposit rates falling below zero.

We expect the RMB to appreciate to 7.50 CNY/USD by the end of 2007 as a result of continued imbalance in the current account. The appreciation should be gradual and the magnitude should be close to the interest rate differential between RMB and USD, because the central bank clearly wants to discourage “hot money” inflows.

The outlook at a glance

% y-o-y unless otherwise stated	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP	10.4	11.5	10.6	10.4	9.8	9.4	9.5	9.8	10.7	9.6	9.8
Retail sales	12.8	13.9	13.8	14.3	14.2	14.2	14.3	14.4	13.7	14.3	14.7
Fixed-asset investment (ytd)	27.7	29.8	27.3	24.0	22.0	20.0	20.0	18.0	24.0	18.0	25.0
Industrial production	15.9	18.0	16.2	14.8	14.3	15.7	16.0	16.0	16.2	15.5	16.0
Exports	26.5	24.1	28.8	29.0	24.6	20.0	18.0	15.0	27.2	19.0	19.7
Imports	24.9	18.5	22.1	15.5	20.9	22.7	24.4	26.0	20.0	23.6	23.7
Trade surplus (US$bn)	23.1	38.0	48.7	67.8	35.3	40.4	43.8	54.8	178	174	169
Current account surplus (% of GDP)									9.1	7.8	6.5
Consumer prices	1.2	1.4	1.3	2.0	2.4	2.5	3.0	2.3	1.5	2.5	2.8
1-yr bank lending rate	5.58	5.85	6.12	6.12	6.12	6.39	6.39	6.39	6.12	6.39	6.93
1-yr bank deposit rate	2.25	2.25	2.52	2.52	2.52	2.79	2.79	2.79	2.52	2.79	3.33
Reserve requirement ratio	7.50	7.50	8.50	9.00	10.00	10.50	11.00	11.00	9.00	11.00	12.00
CNY/USD	8.02	8.00	7.91	7.81	7.72	7.63	7.56	7.50	7.81	7.50	7.10

Note: All forecasts are modal (ie, the most likely single outcome). Table last revised on 9 March, 2007.

Source: CEIC and Lehman Brothers.

INDIA: ECONOMIC OUTLOOK

Rising potential growth

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Overheating symptoms are mild relative to the take-off in India's economic growth.

India is undergoing a remarkable growth spurt: average GDP growth has surged from 5.8% in the 1990s to 8.6% over the past four years. This does not look like a flash in the pan. India's low-cost economy is reaping the rewards of market liberalisation; Indian companies (initially in services, but now also in manufacturing) are seizing the opportunities of globalisation and the information technology revolution. A middle class is fast emerging.

The main concerns are supply-side bottlenecks resulting from inadequate public infrastructure, shortages of skilled labour, inefficiencies in the agricultural sector and too much red tape. To be sure, there are some symptoms of excess demand: credit is growing at 30% y-o-y, and WPI inflation rose to 6.6% in January from 4.0% a year earlier. However, we think fears of overheating should not be overplayed: the surge in credit is from a low base of 42% of GDP; WPI inflation is not that far above its 5.4% average over the past four years; and the Reserve Bank of India is in monetary policy-tightening mode.

The more important development, in our view, is emerging evidence that the economy's potential growth rate (i.e. how fast the economy can grow without stoking inflation) is rising, suggesting that the overheating symptoms could be cyclical. Recent data show that gross fixed capital formation jumped 16% in FY2005-06 (April to March), boosting the investment-to-GDP ratio to 33.8% from 31.5% in FY2004-05. And this ratio looks to have scope to climb further, especially with surging government revenues and FDI inflows set to rise to US$13bn in 2006, nearly double the value in 2005. This investment surge affects demand first – witness the sharp rise in the prices of metals and cement – but should eventually boost supply. Also, while India has no data on labour productivity, we think it has probably picked up, spurred by the implementation of new technologies and rising competition. This would help explain how large Indian companies are managing to sustain healthy profits, despite accelerating wages.

In the next year or two, a short-lived economic slowdown caused by overheating or an external shock cannot be ruled out, but far more important, in our view, is the scope for India's economy to sustain 9-10% growth in the medium term. Given that India's GDP per capita is just US$700, nearly three-fifths of its workforce is still in the countryside and half its population is under 25 years old, there is still huge growth potential to be unlocked. The key is more supply-side reforms without politics getting in the way.

The outlook at a glance

% y-o-y growth unless otherwise stated	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP	9.8	8.9	9.2	8.6	9.5	9.4	9.5	9.9	9.1	9.6	9.9
Agriculture	6.2	3.4	1.7	1.5	3.0	3.0	3.0	4.0	3.2	3.3	4.0
Industry	9.7	9.7	10.3	9.9	11.0	11.1	11.0	11.5	9.9	11.2	11.4
Services	11.1	10.5	10.8	11.3	11.0	10.8	10.5	11.5	10.9	11.0	11.1
Industrial output	8.7	10.5	11.8	10.2	10.4	10.7	11.0	12.0	10.3	11.0	11.8
M3 money supply	17.9	18.3	19.3	19.0	21.0	20.7	20.3	20.5	18.7	20.6	20.3
Non-food credit	34.7	32.9	32.4	30.1	31.4	30.0	29.7	29.0	32.4	30.0	28.0
Wholesale price index	4.0	4.6	5.1	5.5	6.3	5.9	5.9	5.5	4.8	5.9	5.7
Consumer price index (average)	5.0	6.2	6.5	7.5	7.8	6.9	6.7	5.7	6.3	6.8	5.4
Merchandise trade balance (% GDF	-5.9	-5.9	-6.1	-6.9	-7.7	-8.5	-9.2	-9.8	-6.9	-9.8	-10.9
Current account balance (% GDP)	-1.5	-1.6	-1.8	-2.3	-3.1	-3.1	-2.9	-2.8	-2.3	-2.8	-3.4
Fiscal deficit (% GDP)	-4.5	-5.1	-4.3	-3.7	-3.6	-3.5	-3.3	-3.2	-3.7	-3.2	-2.9
Repo rate (%)	6.50	6.75	7.00	7.25	7.50	7.75	8.00	8.00	7.25	8.00	8.50
Reverse repo rate (%)	5.50	5.75	6.00	6.00	6.00	6.25	6.50	6.50	6.00	6.50	7.00
Cash reserve ratio (%)	5.00	5.00	5.00	5.25	6.00	6.50	6.50	7.00	5.25	7.00	8.00
10-year bond yield (%)	7.53	8.13	7.68	7.61	7.90	8.20	8.50	8.50	7.61	8.50	8.75
Exchange rate (INR/USD)	44.6	46.1	46.0	44.2	44.2	43.9	43.6	43.0	44.2	43.0	42.0

Note: Consumer price index is a simple average of indices for industrial workers, non-manuel employees and agricultural labour. Fiscal deficit is for central government. All forecasts are modal (ie, the most likely single outcome). Table last revised on 9 March, 2007.
Source: CEIC and Lehman Brothers.

SOUTH KOREA: ECONOMIC OUTLOOK

Heading for a soft landing, but risks remain

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Policy support is more likely to come from fiscal stimulus than from interest rate cuts.

The sharp appreciation of the Korean won has not seriously hurt export volumes, helping to underpin a modest recovery in business investment. However, to maintain competitiveness, Korean exporters have had to lower their prices, thereby squeezing their profit margins. Weaker profits have in turn filtered down to smaller wage increases for workers. The combination of slowing growth in household disposable income and high personal debt has weakened consumption. We expect GDP growth to slow to 4.3% in 2007 from 5.0% in 2006.

However, the outlook is vulnerable, especially to external risks: a larger-than-expected slowdown in the US economy; a resurgence in oil prices; and uncertainty surrounding the North Korean nuclear issue. On 13 February, North Korea agreed to shut down its nuclear reactor, but we remain cautious on North Korea's implementations of the agreement. A major risk is that Korea's exports weaken by more than expected, which, with already soft consumption, could cause Korean firms to scale back business investment.

Low consumer price inflation, signs of easing house price, and slowing mortgage loan growth should provide strong support for the Bank of Korea (BOK) not to hike rates. But we do not expect rate cuts either: (1) The BOK's own forecast of 4.4% GDP growth in 2007 suggests an economy that is neither too hot nor too cold. (2) Even though money supply growth has moderated recently, liquidity conditions are still sufficient to support the economy. (3) Because policymakers now realize the negative side effects of too low interest rates over 2001 to 2004, they are probably more conservative about cutting rates. Therefore, we retain our call that the BOK will likely stay on hold for the rest of 2007, and look for more fiscal stimulus, especially ahead of December's presidential election.

The Korean won, Asia's third best performer in 2006, will likely appreciate less than other Asian currencies in 2007 for three reasons: (1) in real trade-weighted terms, it has already risen beyond the pre-Asian crisis level; (2) the current account surplus will likely be teetering close to a deficit for the first time since 1997; and (3) the BOK has hiked the reserve requirement ratio to absorb excess liquidity, which should help reduce the potential negative consequences for the domestic economy from FX intervention.

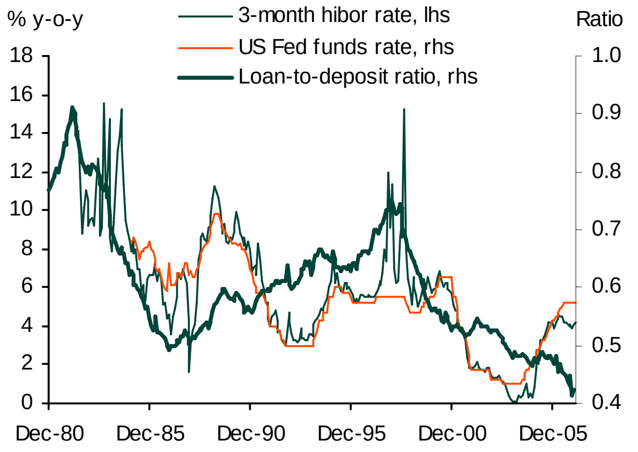
The outlook at a glance

% y-o-y growth unless otherwise stated	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP	6.1	5.3	4.8	4.0	3.7	4.0	4.5	5.0	5.0	4.3	5.1
Private consumption	4.8	4.4	4.0	3.6	3.7	3.7	4.0	4.1	4.2	3.9	4.0
Business investment	6.9	7.4	9.9	5.8	5.8	6.0	5.6	6.8	7.5	6.1	7.0
Construction investment	1.2	-3.9	-0.6	2.9	0.2	2.4	1.4	1.5	-0.1	1.5	2.0
Exports	11.6	16.2	13.4	11.0	10.4	9.0	9.4	13.8	13.0	10.6	11.8
Imports	11.8	14.3	11.8	7.6	9.0	9.4	10.0	16.9	11.3	10.9	12.0
Contributions to GDP:											
Domestic final sales	4.2	2.3	3.5	3.6	0.8	2.9	1.8	4.9	3.4	2.3	3.8
Inventories	1.1	0.5	-0.2	-0.9	-0.7	-0.6	0.0	-0.2	0.1	0.0	0.0
Net trade	0.8	2.4	1.5	1.3	3.5	1.7	2.7	0.3	1.5	2.0	1.3
Unemployment rate (sa, %)	3.5	3.5	3.5	3.4	3.5	3.6	3.6	3.6	3.5	3.6	3.6
Employment	1.5	1.2	1.3	1.2	1.1	1.2	1.3	1.3	1.3	1.2	1.3
Consumer prices	2.0	2.3	2.5	2.2	2.1	2.3	2.3	3.1	2.2	2.5	2.9
Core CPI	1.3	1.8	2.1	2.0	2.4	2.6	2.6	2.7	1.8	2.6	2.8
Current account (% of GDP)									1.0	0.0	-0.5
Bank loans	9.1	10.6	11.0	13.3	12.1	10.9	10.3	8.8	11.0	10.5	12.0
Residential property prices	0.9	2.3	1.2	4.5	0.2	0.5	0.8	1.0	6.2	5.9	5.0
BOK target call rate (%)	4.00	4.25	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	5.00
3-year T-bond yield (%)	4.93	4.92	4.57	4.92	4.90	4.90	4.90	4.90	4.92	4.90	5.30
Exchange rate (KRW per $)	975.9	960.3	945.2	929.8	940	950	940	930	930	930	900

Note: Interest rates and currency are end of period, other measures are period averages. Residential property prices are quarterly average changes. Table last revised on 9 March, 2007. All forecasts are modal forecasts (i.e., the single most likely outcome).
Source: Bank of Korea, CEIC, and Lehman Brothers.

REST OF ASIA: ECONOMIC OUTLOOK

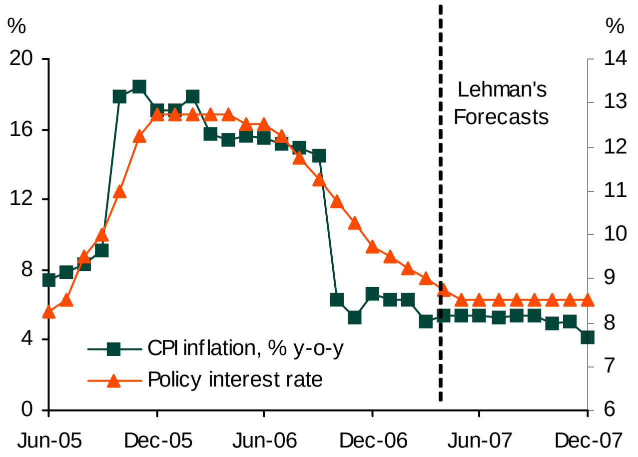
Hong Kong: The economy is humming along on liquidity



Source: CEIC and Lehman Brothers.

- China's booming economy is generating huge demand for Hong Kong's services and also appears to have a lot to do with Hong Kong's surfeit of liquidity.
- In an economy with large financial and property sectors, ample liquidity can set off a reinforcing spiral, with asset price gains and domestic demand feeding off each other.
- We expect GDP growth of 5.5% in 2007, but the number could be substantially higher or lower. Hong Kong is probably the most exposed in Asia to global conditions.

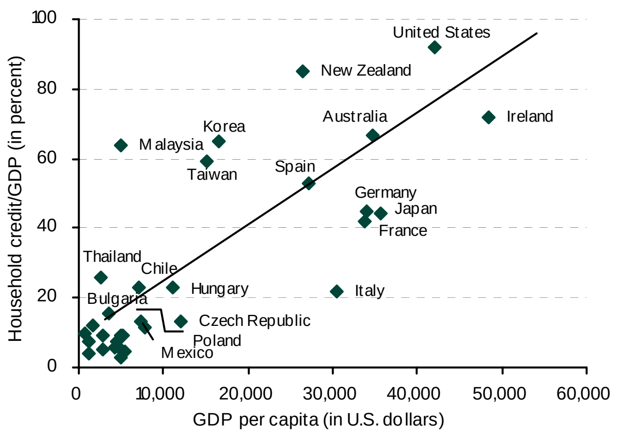
Indonesia: Investment revival could work wonders



Source: CEIC and Lehman Brothers.

- Inflation fell sharply in Q4 2006 and we expect it to remain low, averaging 6.5% in 2007, and to prompt further rate cuts of 50bp from the current level of 9.0%.
- External vulnerability indicators have improved, but the economy needs urgently to attract new investment to realise its full growth potential.
- We are positive, forecasting 5.7% GDP growth in 2007 and 6.5% in 2008. We could raise our forecast if reforms to improve the investment climate are implemented.

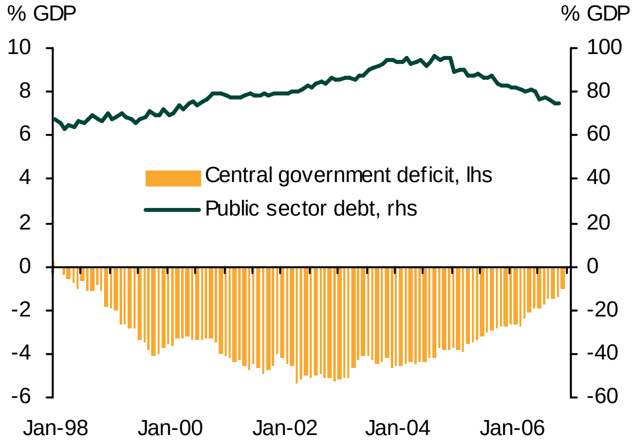
Malaysia: Household borrowing has risen sharply relative to GDP and relative to its stage of development



- Malaysia's GDP growth has held up well, helped by the country's position as a net exporter of oil and other commodities, plus low interest rates.
- Hefty household borrowing is now at a high ratio to GDP. Additionally, heavy government regulation risks hurting export competitiveness.
- Malaysia's economy is very open and hence vulnerable to a global economic slowdown. We expect GDP growth to slow from 5.8% in 2006 to 5.0% in 2007.

Source: IMF, World Economic Outlook, CEIC and Lehman Brothers.

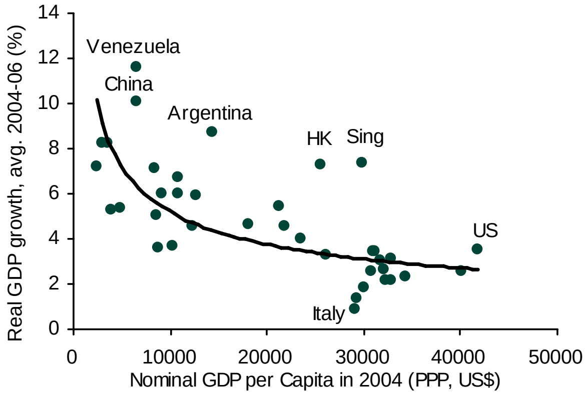
The Philippines: Improved fiscal position and strong overseas worker remittances support economy



- Philippine GDP grew by 5.4% in 2006 and there has been good progress on consolidating fiscal policy and reducing the non-performing loan ratio.
- The rolling 12-month sum fiscal deficit has fallen to 1.0% of GDP in December 2006, while public debt has fallen to 74.7%. Economic fundamentals are improving.
- With robust overseas worker remittances, a widening current account surplus, rising inward FDI and a recovery in bank lending, GDP should rise 5.8% in 2007.

Source: CEIC and Lehman Brothers.

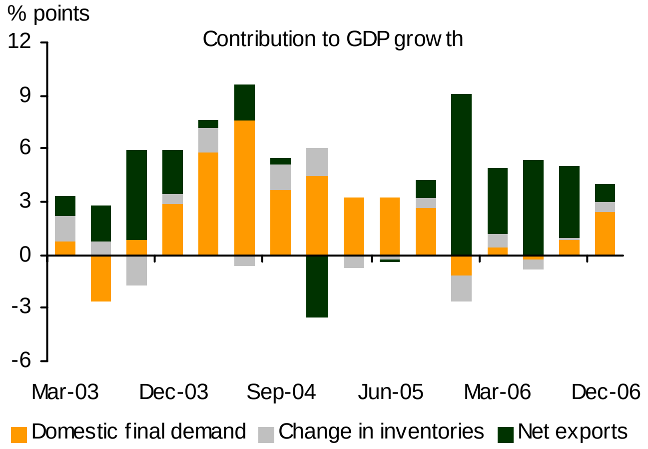
Singapore: Successfully re-inventing itself, but highly exposed to global economic cycle



- Singapore has risen to the challenge of competition, moving into high-end electronics and new niches (biotech, offshore engineering and wealth management).
- These new niche industries are thriving. It is striking that Singapore, a developed country, averaged 7.8% growth in 2004-06 (see figure), with just 1.0% inflation.
- The main risk for Singapore's economy is that, because it is small and so open (exports make up 260% of GDP), it is very exposed to a global economic slowdown.

Source: World Bank, CEIC and Lehman Brothers.

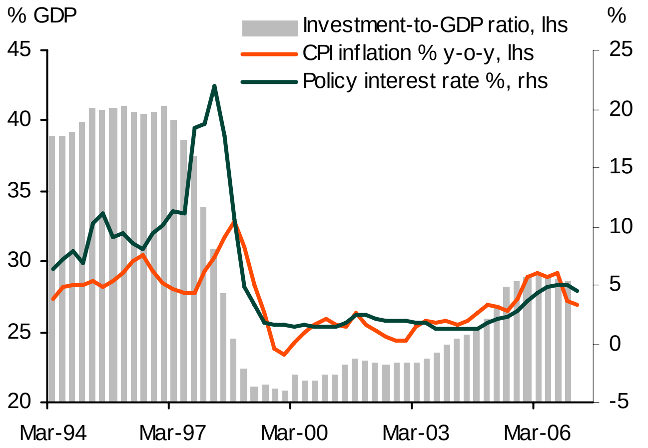
Taiwan: Political uncertainty is high and the economy is too reliant on net exports



Source: CEIC and Lehman Brothers.

- Taiwan's GDP growth was lopsided in 2006: it was driven mostly by exports; domestic demand was lacklustre, likely hurt by prolonged political uncertainty.
- The hollowing out of production to China also crimped investment, while the sharp rise in credit card debt, coupled with higher rates, has constrained consumption.
- Domestic demand did recover in Q4, but it is not clear if this is the start of a trend, given the still cloudy politics. We expect GDP growth to slow to 3.9% in 2007.

Thailand: Despite risks, investment may surprise



Source: Bank of Thailand and Lehman Brothers.

- Political uncertainty, bombs, and abrupt policy changes have started to weigh on the economy. We have lowered our 2007 GDP growth forecast from 5.0% to 3.5%.
- That said, the fundamentals are still healthy: FX reserves are high, the fiscal budget is near balance, and debt levels are low. Also, with inflation easing, rates are being cut.
- We have a cautious near-term outlook, but if the political uncertainty lifts (elections are expected around October), we would expect a strong economic rebound in 2008.

ASIA EX-JAPAN: PREVIEW

The week ahead

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A slew of Chinese data, particularly CPI, will be important in determining whether there is a need for further policy tightening in the coming months. Indian industrial output growth should slow while South Korea's unemployment rate will likely tick up.

CHINA

External trade (Sometime in the week)

China's export growth likely fell sharply, to 18.0% y-o-y, in February from 33.3% in January. But this is mainly because of the distorting effect of the Chinese New Year holiday, which fell in February this year (but in January last year) and caused less working days in the month. For similar reasons, we expect import growth to fall sharply, to 15.0%, from 27.5% y-o-y in January. The trade surplus should narrow to only US$4.4bn from US$15.9bn in January. While the February data look weak, the underlying growth for January and February combined should remain strong: our forecasts imply that the average export growth for these two months is 26.3% y-o-y (versus 24.8% in December) and the average import growth is 21.5% (versus 13.5% in December). The combined trade surplus for Jan-Feb will likely reach US$20.3bn, up 71% from the US$11.9bn surplus in the same period last year.

CPI inflation (Tuesday)

China's CPI inflation likely stayed at 2.2% y-o-y in February

We expect China's consumer price index (CPI) to rise 2.2% y-o-y in February, after gaining 2.2% in January (Figure 2). Our forecast is based on a 0.5% m-o-m gain in the February CPI, which is lower than the typical monthly gain during the month of the Chinese New Year. There are two main reasons why we expect this.

First, the effect of the Chinese New Year holidays on food prices, which has been significant in the past, should be less so this year given that food prices already surged by a hefty 4.0% m-o-m in December and another 2.0% in January. In fact, the government took various measures in late December, such as using grain reserves and channelling food supplies to regions with tight markets, to rein in food prices.

Economic events in the week ahead

			Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Sometime during the week								
	China	Exports, % y-o-y	Feb	32.8	24.8	33.3	18.0	25.2
	China	Trade balance, US$bn	Feb	22.9	21.0	15.9	4.4	7.3
Monday 12 March								
8.30	Australia	Home loans, % m-o-m	Jan	-0.1	-0.4	0.1	1.5	1.0
15.00	India	Industrial production, % y-o-y	Jan	4.4	15.4	11.1	10.4	10.1
Tuesday 13 March								
10.00	China	Consumer price index, % y-o-y	Feb	1.9	2.8	2.2	2.2	2.8
Wednesday 14 March								
10.00	China	Retail sales, % y-o-y	Feb	14.3	14.1	14.6	17.0	n.a.
11.30	S. Korea	Unemployment rate, % sa	Feb	3.4	3.3	3.3	3.4	n.a.
Thursday 15 March								
8.30	Australia	Employment change, ('000) m-o-m	Feb	42.9	46.0	-3.6	20.0	20.0
10.00	China	Industrial production, % y-o-y	Feb	14.7	14.9	14.7	8.0	n.a.
12.00	Singapore	Retail sales, % y-o-y	Jan	1.4	8.2	4.9	5.5	6.0
Friday 16 March								
10.00	China	Urban fixed-asset investment (ytd), % y-o-y	Feb	26.8	26.6	24.5	22.0	24.0
12.00	Singapore	Non-oil domestic exports, % y-o-y	Feb	8.0	-14.2	11.1	2.5	5.5
14.30	India	Wholesale price index, % y-o-y	3-Mar	6.6	6.1	6.1	6.0	6.0

Hong Kong Time

Second, a drastic change in railway ticket pricing will avoid the typical surges in transportation prices around the Chinese New Year. Since 2002, the Chinese government has used a floating pricing scheme during the so-called "Spring Festival Transportation Period" (SFTP), which starts 15 days before the Chinese New Year and ends 25 days after. In the past, ticket prices were raised by 15-20% during the 40-day SFTP. The rationale was to reduce the number of railway passengers during SFTP – which exceeded 156 million in 2006 – via higher ticket prices. However, given the importance of the Chinese New Year to Chinese families, the demand for railway transportation was inelastic to ticket price hikes during the SFTP and the number of railway passengers did not fall as expected. The government decided to drop the floating pricing scheme this year. As a result, we do not expect a big jump in the transportation price index (TPI) – which has 10.4% weighting in the CPI basket – this February.

Based on our CPI inflation forecast, we expect the People's Bank of China to keep the interest rate unchanged until Q2 when there are further signs of inflation picking up.

Retail sales (Wednesday)

We expect China's retail sales to remain strong in January and February…

China's retail sales should grow at an average rate of 14.3% y-o-y in the first two months of 2007, after gaining 14.6% in December 2006. Because of the Chinese New Year, the Chinese government has not yet released the data for January. We expect retail sales to grow 11.5% y-o-y in January and 17.0% in February, with the volatility resulting from the timing of the Chinese New Year. With strong income growth and a bullish stock market, the underlying momentum of consumption growth should remain strong.

Industrial output (Thursday)

… and industrial production growth to slow slightly

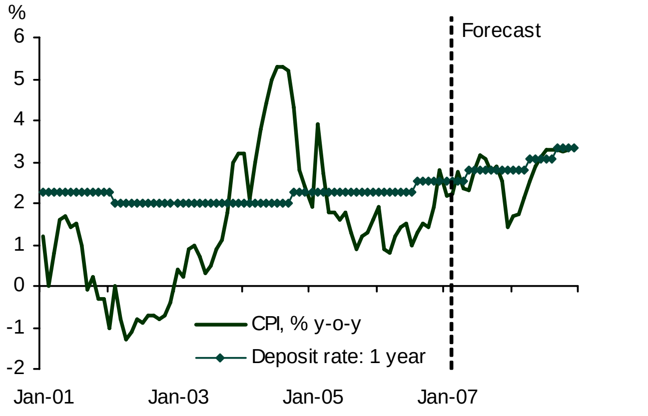
We expect the growth of China's industrial production to slow to 14.0% y-o-y in the first two months of 2007, after gaining 14.7% in December. As for retail sales, the Chinese government has delayed the release of data for January. We expect industrial production to grow 20.0% y-o-y in January and 8.0% in February, with the volatility again resulting from the timing of the Chinese New Year. Our forecast is consistent with China's official Purchasing Managers' Index, the output component of which has also demonstrated a similar trend in the past two months.

Urban fixed-asset investment (Friday)

China's urban fixed-asset investment growth likely rebounded in Jan-Feb

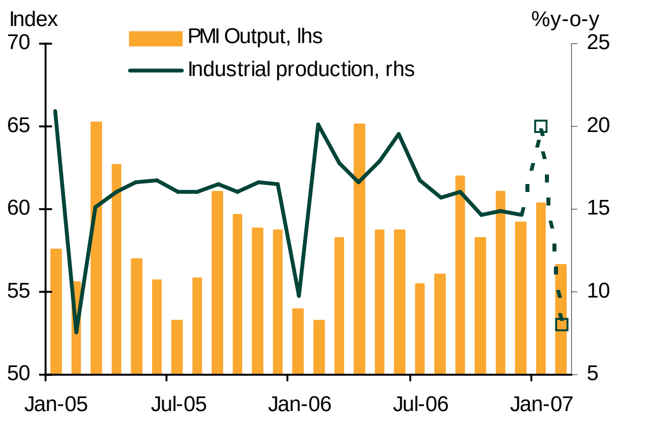
China's urban fixed-asset investment likely grew 22.0% y-o-y in the first two months of 2007. While the growth is lower than the 24.5% gain in 2006, it is much higher than the 13.8% y-o-y gain in December. However, the data are not seasonally adjusted, and the growth rate is typically weaker toward the end of the year. Moreover, compared with Jan-Feb 2006 when the growth was 26.6% y-o-y, urban fixed-asset investment growth in

Figure 1. China's CPI inflation and bank deposit rate



Source: CEIC and Lehman Brothers.

Figure 2. China's industrial production and the output index of the official PMI



Source: CEIC and Lehman Brothers.

the first two months of this year seems to be under control after the slew of tightening measures introduced last year. The caveat is that investment activities in China usually start heating up after the Chinese New Year. Therefore, it is too early to make much inference on potential tightening policies from the Jan-Feb data unless they are sharply higher than expected.

INDIA

Industrial production (Monday)

India's industrial output growth will likely slow

We expect India's industrial output growth to decelerate to 10.4% y-o-y in January from 11.1% in December (Figure 3). However, this is not a concern as the cumulative growth from April-January remains high at 10.8% y-o-y, compared with 8.1% over the same period last year. Strong domestic demand and exports have been underpinning production activity, although in recent months exports have softened, growing 5.5% y-o-y in January versus double-digit growth for most of last year. However, domestic demand remains solid, bolstered by rising incomes and rapid credit growth. Indeed, leading indicators, such as motor vehicle production, rebounded sharply in January to 13.4% y-o-y from 9.4%, while demand for infrastructure spending also remains buoyant with a particularly sharp pickup recently witnessed in the electricity sector.

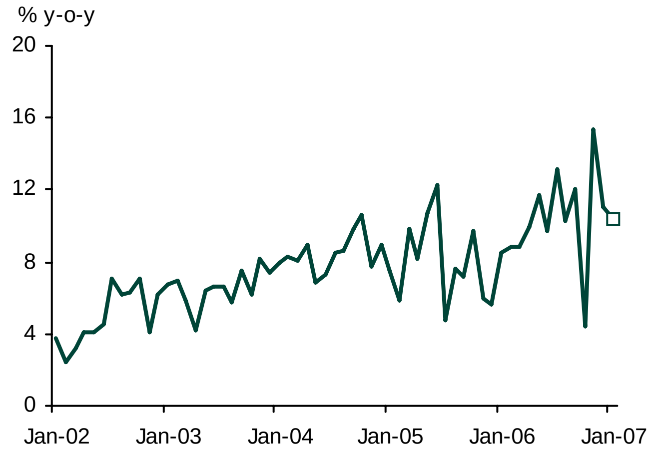
SOUTH KOREA

Unemployment rate (Wednesday)

South Korea's unemployment rate should tick up

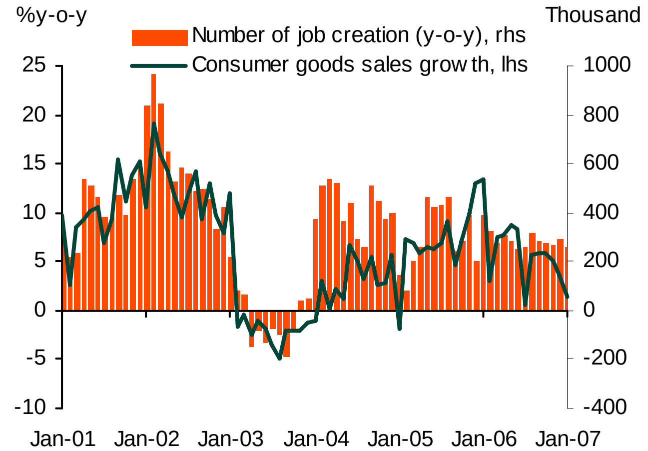
South Korea's unemployment rate should tick up to 3.4% (sa) in February from 3.3% in January. The level of unemployment is quite low but that is largely the result of a growing number of discouraged job seekers opting to drop out of the labour force. Those individuals who have given up looking for work comprise a hefty 41% of the non-working population, the highest share since 2000. So we judge that employment growth rather than the unemployment rate is the relevant indicator by which to judge the job market. The number of jobs increased by 258,000 in January from a year earlier, which was the smallest gain since March 2005. Job market recovery has been delayed as economic output growth has been driven by the capital-intensive IT-sectors. The mismatch between demand and supply in the labour market is another reason: young people want high-paying jobs but many industries still need low- and medium-skilled workers. This mismatch has been causing the high unemployment rate among young people. All in all, sluggish job creation and softened wage gains are holding back the recovery in private consumption growth (Figure 4).

Figure 3. India's industrial output



Source: CEIC and Lehman Brothers.

Figure 4. South Korea's job creation and consumption



Source: CEIC and Lehman Brothers.

GLOBAL LETTER

Response and responsibility

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The policy responses being priced in after last week's mini-shock seem appropriate.

A degree of calm has returned since last Tuesday's free fall in the Shanghai stock market sent tremors around global financial markets. Stock prices and bond yields are both down and risk premia are up. But the net moves have turned out to be modest. For example, the Shanghai index is now down just 3.4% and 10-year Treasury yields down 11bp. These are relatively small moves and are consistent with a data flow that continues to point to decent prospects for the global economy to register good, if somewhat bumpy, growth.

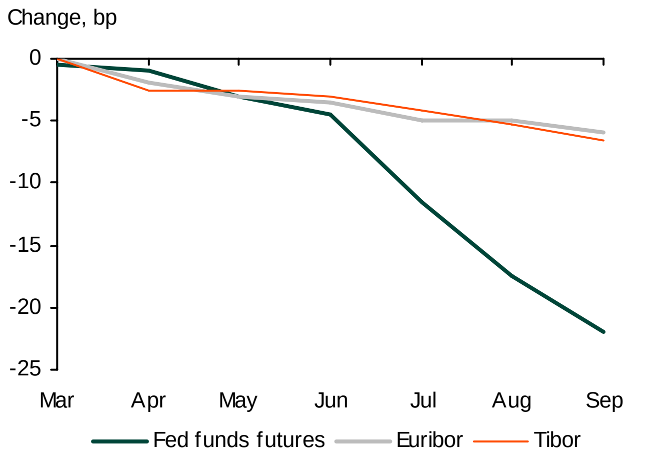
Even so, as the focus of investors' attention quickly shifted to the problems in the US sub-prime mortgage market, markets have started to factor in the possibility of some form of policy response: interest rate expectations have edged down in all major regions.

Perceptively, markets are looking for a differential impact, with short-term interest rate expectations for September having fallen by 22bp in the US, but only 6bp in the euro area and Japan (Figure 1). The larger shift in US rate expectations appears warranted. As an economy with a high level of stock market capitalisation relative to GDP and as the home of the sub-prime market, the US stands to be affected most. It also has a central bank that shoulders a special responsibility for maintaining global financial stability.

The euro area and Japanese responses also look reasonable. Japan's stock market, the market capitalization of which is larger than that of the euro area, despite Japan's smaller economic size, has fallen by more than those in Europe. Recent economic data have also been of more concern in Japan than in the euro area, where confidence in the recovery remains firm. At the same time, however, with official rates at 50bp, the Bank of Japan has barely begun the process of normalising interest rates. For the ECB, which hiked interest rates to 3.75% this week, that process would appear to be at, or near, its end.

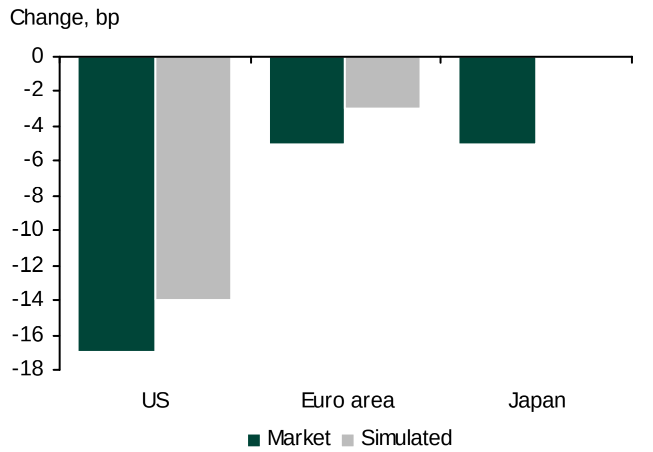
This analysis is borne out by simulations from our replica of the OECD's small global macroeconomic model. According to this model, following a 5% stock market correction, forward-looking markets should factor in much more of a policy response in the US than in the euro area or Japan (Figure 2). Partly this result is likely an artefact of the model's assumption of only indirect effects on the economies of the euro area and Japan. Even so, it does seem that markets are responding appropriately – both to the data and to the contours of any policy response should things turn out to be less benign.■

Figure 1. Change in interest rate expectations



Source: Bloomberg, Lehman Brothers.

Figure 2. Simulated policy response, Q3 2007 (average)



Source: Lehman Brothers.

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