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India: A worsening of the fiscal-monetary policy mix

We believe India's policy mix is worsening with a tighter-than-expected monetary policy and looser-than-expected fiscal policy.

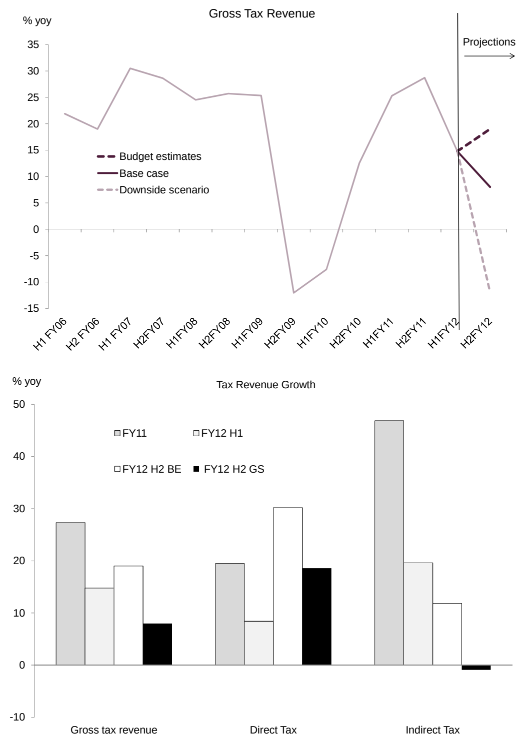
We now think the RBI may hike policy rates again on October 25, due to recent hawkish commentary coming from the RBI.

The government's finances are deteriorating. We now think the fiscal deficit in FY12 may rise to 5.8% of GDP (from 5.5% previously), compared with a budgeted 4.6% of GDP, largely due to a slowdown in revenues.

In our downside scenario of weaker GDP growth, we think the hit to revenues may be even more significant, given the high elasticity of revenues to GDP growth.

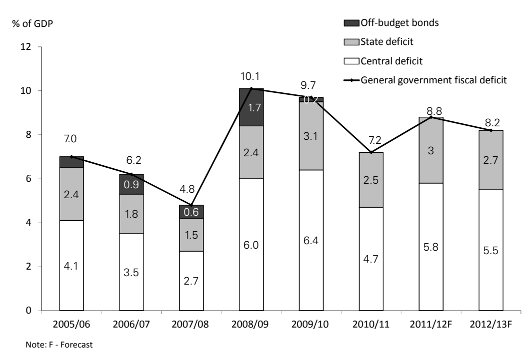
The worsening policy mix can put upward pressure on government bond yields. Our analysis of the supply-demand for government bonds suggests significant excess supply, and we think that the 10-year yield can rise to 9%-9.25% (against our earlier estimate of 8.5%-8.75%), close to historical highs.

India: Tax revenues to take a hit due to the slowdown



Source: CEIC, GS Global ECS Research estimates.

India: Fiscal deficit set to rise sharply again in FY12 and remain elevated in FY13



Source: CEIC, GS Global ECS Research.

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The economics research team would like to acknowledge intern, Tiffany Qiu for her contribution to this publication.

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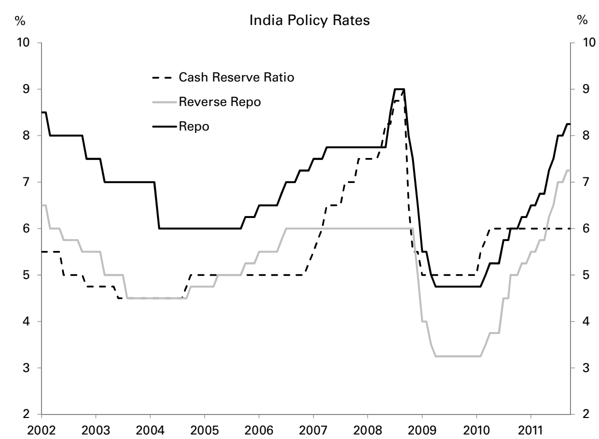
We believe India's policy mix is worsening with a much tighter-than-expected monetary policy and looser-than-expected fiscal policy. The Reserve Bank of India (RBI) has already raised policy rates by 150 bp since the start of the summer. With market and consensus expectations of a rate hike on October 25, monetary policy is likely to tighten further. Along with this has come a worsening in fiscal balances due to higher subsidies on oil and fertilizers but more importantly, a significant slowdown in revenues. After the government announced a significantly higher market borrowing calendar for the second half of FY12, the bond market has seen a sharp sell-off. The policy mix is contributing to the sell-off, and the question on investors' minds is how much more can bond yields rise.

While the RBI has been focused on the inflation expectations and the wage-price spiral, a risk to the economy is emanating from the fiscal front where slowing growth is causing a sharp increase in the fiscal deficit and rising bond yields, which can then put further downward pressure on growth, in our view.

Monetary policy to tighten further

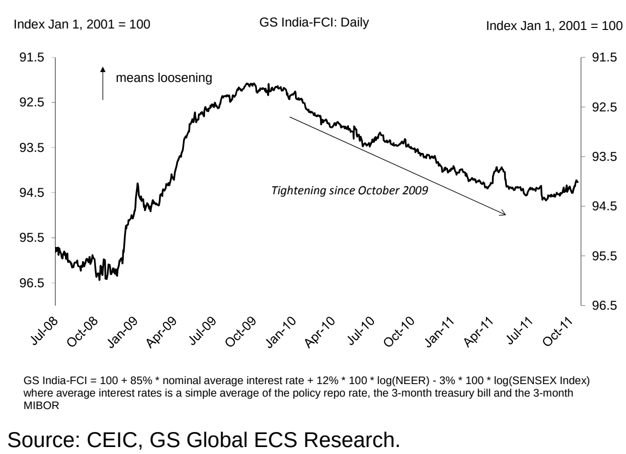
We now expect the RBI to hike by 25 bp on October 25. We had put our rate call under review after the September inflation print of 9.7%. Hawkish commentary from the RBI highlighting headline yoy inflation as still too high for comfort, elevated inflationary expectations, and no change in the policy stance suggests to us that the RBI may not be ready for a pause in its aggressive rate tightening cycle.

Exhibit 1: The RBI has tightened aggressively this summer...



Source: RBI, GS Global ECS Research.

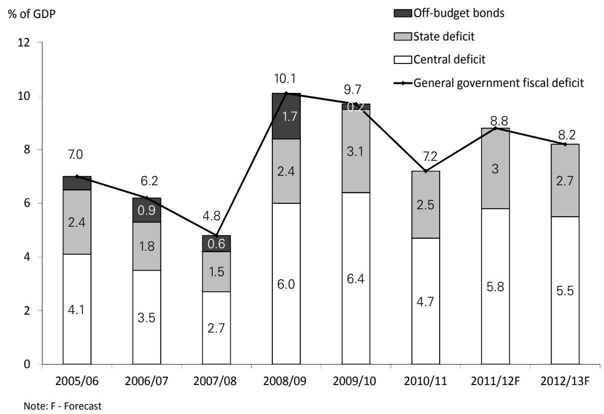
Exhibit 2: ...leading to a tightening in financial conditions as shown by our GS India-FCI



GS India-FCI = 100 + 85% * nominal average interest rate + 12% * 100 * log(NEER) - 3% * 100 * log(SENSEX Index) where average interest rates is a simple average of the policy repo rate, the 3-month treasury bill and the 3-month MIBOR

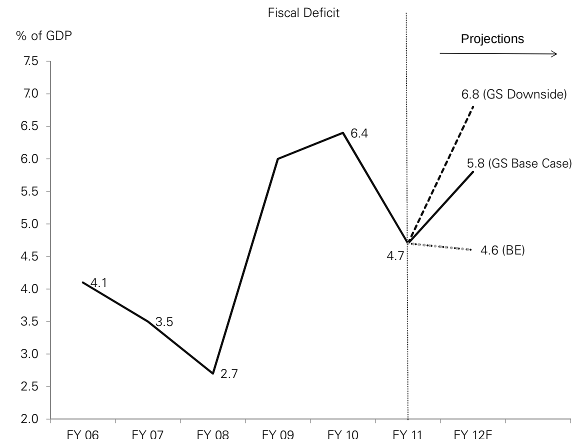
Source: CEIC, GS Global ECS Research.

Exhibit 3: Fiscal deficit set to rise sharply again in FY12 and remain elevated in FY13



Source: CEIC, GS Global ECS Research estimates.

Exhibit 4: We think fiscal deficit is likely to be much higher than budgeted



Source: CEIC, GS Global ECS Research estimates.

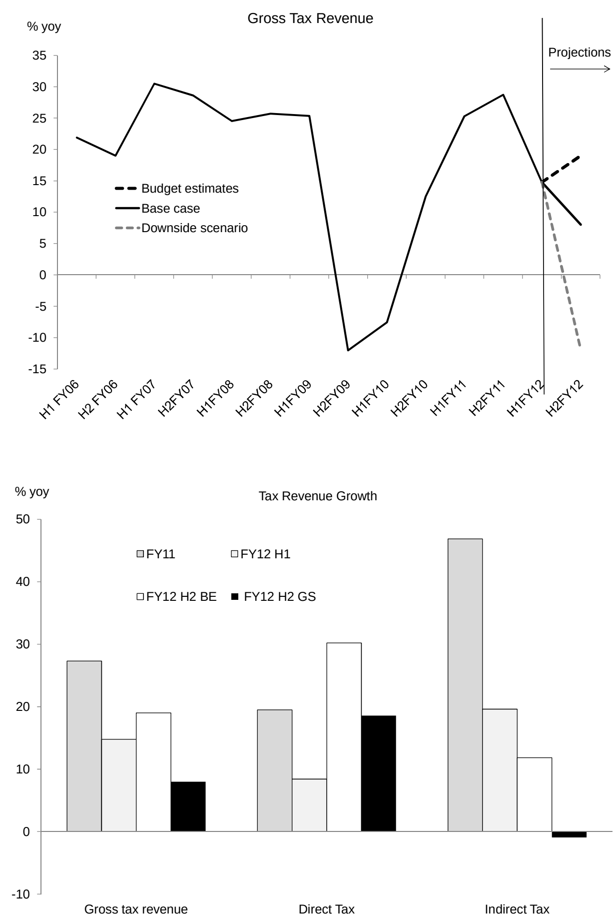
We think that the RBI may be over-tightening, given that there is a significant demand slowdown, and we see little inflationary pressures going into FY13 (see *India September WPI: Elevated headline inflation, sequentially falling core*, Asia Economics Data Flash, October 14, 2011). If the RBI hikes on October 25, we think it will tighten financial conditions further, put upside pressure on government bond yields, and create downside risks to our 7% GDP growth forecast for FY12.

Expected and unexpected deterioration in fiscal balances

We have held the view that the government budget deficit for FY12 will be much higher than budgeted. After the Union Budget was presented in end-February 2011, we had expressed concerns about the ability of the government to meet its fiscal deficit targets (see India Union Budget—a fiscal promise to keep and miles to go before it succeeds, Asia Economics Flash, March 1, 2011). At that time, we were of the view that the government had under-budgeted on subsidies—oil and fertilizers in particular, and was too optimistic on revenues and privatization receipts, and had pegged the central fiscal deficit at 5.5% of GDP, compared with government estimates of 4.6% of GDP. We had estimated gross market borrowing at Rs4.7 trillion compared to the government estimate of Rs4.1 trillion. The additional market borrowing of Rs529 billion the government has announced for the second half of the year on September 30, suggests a deficit in line with our expectations.

We now think that the deficit may be even higher than our earlier estimates primarily due to downside risks to GDP growth and revenues. In our base case, we now estimate the deficit at 5.8% of GDP, higher than our earlier estimate of 5.5%. The general government deficit may rise to 8.8% of GDP from our earlier

Exhibit 5: Tax revenues to take a hit due to the slowdown…



Source: CEIC, GS Global ECS Research estimates.

estimate of 8.2%, with state deficits higher at 3% of GDP in FY12 largely due to the slowdown in revenues (states receive approximately a third of all central government revenues).

Our estimates for FY13 suggest that the deficit may remain high at 5.5% of GDP. Given our expectation of a tepid recovery in activity in FY13, unless there are new tax proposals or cuts in subsidies, we do not see a large reduction in the fiscal deficit. The path of the deficit will be influenced by the timing of structural reforms on the taxation side. Our current expectation is that changes to the Direct Tax Code (likely to be implemented in FY13) will be largely revenue neutral. On the more important Goods & Services Tax (GST), we do not expect it to be implemented in full in FY13. The timing is of course subject to change, but even if implemented in mid-FY13, (as per official claims), the impact is unlikely to be felt until FY14.

Significant slowdown in revenues ahead

In our base case, the central fiscal deficit rises to 5.8% of GDP, compared with the government's budget estimate of 4.6% of GDP. For our base case scenario, we estimated tax revenues by each individual tax category, by looking at trends in the first half, seasonal trends in tax collections (on average 60% of collections happen in the second half of the year), and nominal GDP growth projections. In the first half of FY12, gross tax collections have grown by only 14.8% compared to the full year budgeted growth of 18.5%. With a sharper slowdown in GDP growth in the second half of FY12, we think that revenue growth may be significantly lower than in the budget.

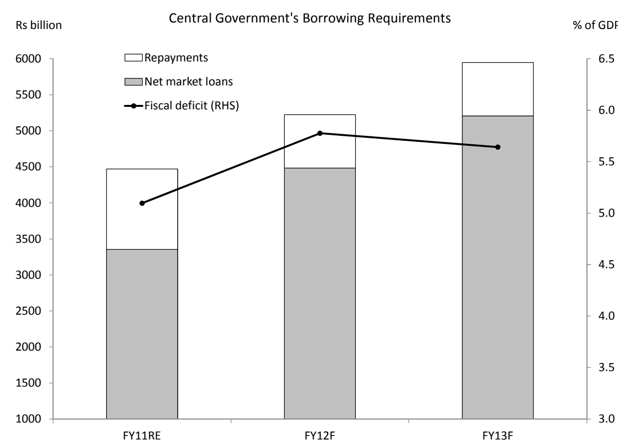
We think there is little scope for containing expenditure growth. With rigidity in wages and upside pressures on subsidies, there is little flexibility on the expenditure side. Our sector analysts estimate fertilizer and oil subsidies to be Rs650 billion and Rs600 billion respectively; higher than the budgeted amounts of Rs500 billion and Rs236 billion. Therefore, with conservative assumptions, we project expenditure growth at just over 9% compared with 3.4% in the budget.

Market financing of the deficit looks difficult

Given the higher fiscal deficit, we think that market borrowing may rise to Rs5.2 trillion from Rs4.7 trillion. With very little disinvestment (privatization) done year-to-date, and a challenging market environment, we think it will be very difficult for the government to garner more than Rs200 billion (compared to Rs400 billion in the budget). Therefore, market borrowings will have to rise to fund the additional deficit.

Our supply-demand analysis of government bonds suggests demand significantly less than supply. To ascertain supply, we project net market borrowings by considering the above the line fiscal deficit and netting out all other sources of funding including disinvestment proceeds. We projected demand by mapping out demand from the big buyers of government paper—banks, insurance companies, mutual funds, and foreign investors (see Exhibit 7). We assume further liberalization of foreign investor limits on government bonds by US$5 billion each in FY12 and FY13. The residual is the open market operations the RBI will have to do to mop up government securities. Therefore, we see the need for significant open market operations by the RBI in both FY12 and FY13.

Exhibit 6: Market borrowings to rise as the government struggles to contain the fiscal deficit



Source: CEIC, GS Global ECS Research estimates.

Exhibit 7: Excess supply of government securities likely to pull up bond yields

Center + State NET issuances Rs. bn	FY12 GS est	FY13 GS est
Supply of net gov securities: center + state	6313	6939
Demand for government securities		
SLR funds	3010	3552
Insurance funds (GS est)	1831	2197
Open Market Operations	1003	646
Mutual funds*	54	65
FIIs**	99	132
Others	316	347
as a % of net borrowing		
SLR funds	48	51
Insurance funds	29	32
Open market operations	16	9
Mutual funds	1	1
FIIs	2	2
Others	5	5

*Note: *Based on difference in outstanding amount of government securities in debt mutual funds.*
*** Assumes $5 billion additional allocation in FY12 as well as in FY13, over and above present limit of $10 billion.*

Source: CEIC, SEBI, GS Global ECS Research estimates.

Given the supply-demand imbalances, we think that there could be upward pressure on long bond yields. Our earlier forecast of 8.50%-8.75% on the 10-year yield has been reached. We think that as the market prices in a higher deficit—yields may climb to 9.0%-9.25%.

For FY13, we think that bond yields will likely come off due to monetary easing, but remain high at the 8.25-8.50% range. Unless the fiscal deficit comes off more substantially due to additional revenue measure, and/or the government eases restrictions on foreign participation in government paper more significantly, or the RBI indulges in even more aggressive open market operations, we find it difficult to see a very sharp fall in the long bond yield, despite our forecast of rate cuts by the RBI.

Downside growth scenario highlights fiscal risks

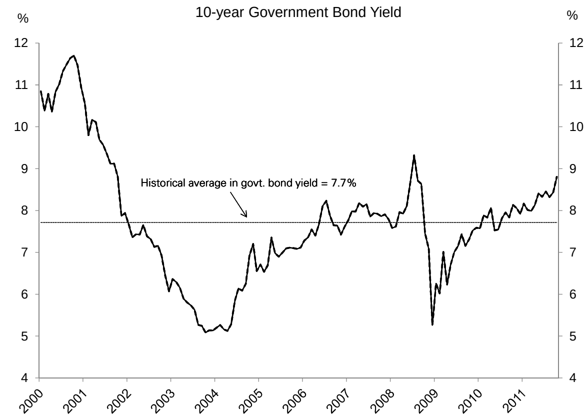
We considered a downside scenario of GDP growth to assess sensitivities of revenues and the fiscal deficit. We assumed a GDP growth rate of 6.1% for FY12, which is our forecast for a 'crisis' scenario. To estimate the sensitivity of revenues to much weaker growth, we looked at the performance of revenues during the 2008-2009 global financial crisis (GFC).

In our downside scenario, the central fiscal deficit increases markedly to 6.8% of GDP. With the view that the growth and revenue impact during recessions is markedly different and non-linear when compared with a normal slowdown, we estimated sensitivities of revenues for each tax category. We find that each tax category's sensitivity was much higher during the 2008-2009 GFC than otherwise. The taxes that are likely to be hit more are excise duties and corporate taxes, linked directly to investment and corporate profitability.

Lessons from history—what happened in 2008

The current situation has some loose parallels with 2008-2009, where tight monetary and loose fiscal policy in the first half of 2008 sent government bond yields very high, before the GFC allowed a sharp easing of policy. At the time, the RBI, fighting demand pressures and an oil-spike-led jump in inflation, tightened liquidity and interest rates aggressively. At the same time, the government presented an expansionary budget with wage hikes, a loan waiver to farmers, and rising oil subsidies. The benchmark 10-year bond yield spiked to 9.5%, before coming down. While there are parallels to the situation in 2008, there are a couple of policy options to ease the situation.

Exhibit 8: Bond yields are approaching historical highs



Source: CEIC, GS Global ECS Research.

Exhibit 9: Sensitivities during 2008-09 crisis much higher than during normal times

Sensitivity to GDP*	Normal sensitivity	2008-09 crisis
Gross tax revenue	1.4	3.5
Corporate tax	1.7	2.7
Income tax	1.6	2.2
Excise tax	1.3	4.5
Custom duty**	0.8	0.9
Service tax**	0.8	1.1

* % change in overall and individual tax revenue components as nominal GDP growth changes by 1 ppt.
** Custom duty sensitivity has been calculated with respect to imports and service tax with respect to non-agricultural GDP.
Source: CEIC, GS Global ECS Research estimates.

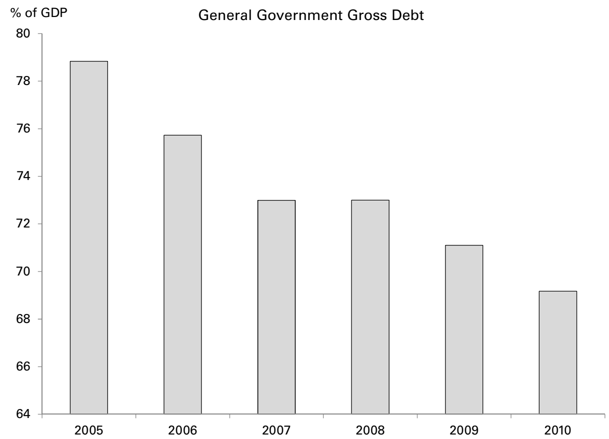
First, the RBI could substantially increase open market operations to buy government paper in the secondary market. The central bank has adequate space in its balance sheet to do this.

Second, the government could significantly increase the limit that foreigners can subscribe to in government bonds from the current US$10 billion. Although there is no guarantee that foreign investors will demand the increased availability, the over-subscription in recent foreign allocation auctions of government bonds suggests latent demand, which could alleviate pressure on yields.

Are the government's finances a systemic risk?

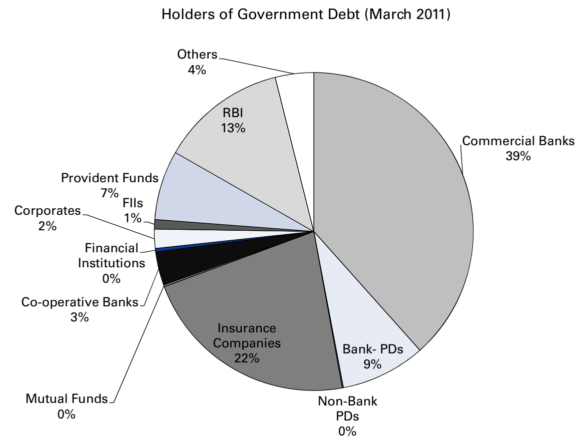
India's twin deficit problem of higher fiscal and current account deficits are relatively well-known. We think that during downturns, they do pose a much greater risk than is currently being discounted by markets. Further, if off-shore borrowing by corporates were to come under strain as in 2008-09, then it could increase demand for

Exhibit 10: India's general government debt has been declining due to higher nominal GDP growth



Source: Haver, GS Global ECS Research.

Exhibit 11: Government debt is primarily held by domestic banks and insurance companies



Source: Ministry of Finance, GS Global ECS Research.

domestic credit and squeeze liquidity. That said, we do not think that the high and deteriorating fiscal balance poses a systemic risk as of yet, and is a flow problem rather than a stock problem. India's government debt is primarily held by local banks and pension/insurance funds which typically tend to hold them to maturity. There is, therefore, little risk of a large-scale selling of government paper. Indeed, government debt to GDP ratio has come off in recent years, largely due to high inflation and a sharp increase in nominal GDP. Second, with a high savings rate which is channelled into banks, and banks required to hold at least 24% in government paper, there is a natural demand for sovereign bonds. We think, therefore, there is little systemic implications of a higher fiscal deficit. The bigger issue is the crowding-out effect of fiscal borrowing and higher yields and the negative feedback loop to lower investments and GDP growth.

Tushar Poddar, Prakriti Shukla, Vishal Vaibhaw

ASEAN: Impact of the Thai floods and who's next on the rate cut bandwagon

This article was first published on October 19, 2011.

Thailand has been grappling with its ongoing flood crisis, with the estimated damages rising in recent weeks as the floodwaters reached several major industrial estates. We discuss the potential impact to growth, as well as the potential policy responses. Our base case is for the Bank of Thailand (BOT) to be on hold, but the floods have raised the possibility of a potential relief rate cut.

Bank Indonesia's (BI) surprise rate cut last week has also raised the question of who in the region could be next in line to loosen monetary policy. Singapore last week also reduced the slope of its currency bands—that was a less aggressive move than what we were expecting but that also raises the likelihood of further easing moves in future meetings as we have discussed.

The balance of risks has no doubt shifted towards a greater likelihood of monetary easing in the ASEAN region. We see Indonesia as the most likely in ASEAN to continue with its rate cuts. We see room for 50 bp more in rate cuts—25 bp this year and 25 bp in 1Q2012. Thailand is next in line with the potential to cut rates, but probably not immediately as the BOT assesses the impact of the ongoing floods.

Thailand: A monetary policy response will depend on how protracted the post-flood recovery is likely to be—we see the BOT on hold for now but potential easing later

The severity of the flooding in Thailand has intensified in recent weeks, leading to estimates of the potential damage to be continuously revised higher. The BOT for example has most recently announced that the damage could be Bt100 billion or around 1% of GDP, from an initial estimate of Bt20 billion. The Ministry of Finance (MOF) puts the potential damage at between 1%-1.7% of GDP. The areas which have been affected has also broadened, causing widespread damage to agricultural and industrial areas. The floods have also caused significant disruptions to transportation and logistics, which will compound the supply-chain disruptions, in addition to the factory shutdowns.

Growth takes a big hit from natural disasters, but quick rebound usually the case

Our Global Economics Team published an interesting piece this year (see The Economic Impact of Japan's Earthquake, Global Economics Weekly 11/11, March 23, 2011), where they studied the impact from natural disasters over history and across countries, finding on average that a sharp reduction in growth occurs in the quarter the disaster strikes, but a quick rebound usually occurs in the subsequent quarter. Of course, this varies depending on the different circumstances surrounding the event, but as long as the disaster does not cause permanent damage to the productive capabilities of the economy, repairs to infrastructure and capex should in time restore the economy to its potential growth. In Thailand's case, we do expect a rebound in 2012, although the damage could potentially be longer lasting and the recovery will depend on how long the flooding lasts and how quickly supply-chain disruptions get resolved, as we discuss more below.

Significant hit to Thai growth in 2011…

There will undoubtedly be a significant hit to 2011 GDP growth, with official estimates centering around 1 percentage point (ppt) off this year's growth. The BOT's current forecast for 2011 stand at 4.1%, although this will likely be lowered soon. The MOF has recently lowered its 2011 GDP forecast to 3.7% from 4.1% previously. Our own forecast is currently at 3.8% for this year and we would likely be reviewing our 2011 growth targets upon greater clarity on the impact of the floods.

…but focus is on speed of potential recovery in 2012

The more important question is how quickly the economy is able to rebound in 2012. Much still depends on whether the flooding worsens, how long it takes for the waters to subside and also the swiftness of the government rehabilitation response. Preliminary reports are that factories affected could take up to the end of the year to be fully up and running again with certain sectors potentially requiring up to 6 months--which means that activity could remain suppressed into 1Q2012. The next few weeks also bear close watch to see if the floods intensify or come under control.

The swiftness of the government response is key to the speed of the post-flood recovery

The Thai government has been piecing together its rehabilitation response, with plans to spend around Bt120 billion on damage repair and reconstruction. The government is also planning on increasing the budget deficit to Bt400 billion from the current Bt350 billion to facilitate the rehabilitation process. The swiftness and effectiveness of the government's response will also be an important factor that could shore up investor confidence and help minimize any longer lasting negative impact on FDI trends.

Food prices likely to spike in 4Q2011, but will not see a monetary policy response

On inflation, the floods will likely cause a near-term spike in food prices, especially since large swathes of agricultural areas have been hit and transportation lines disrupted. 10% of the current rice harvest has also been reportedly damaged. But the BOT governor has indicated that the central bank is likely to look through the one-off price blip. Most recently, the Thai Wage Committee has also decided to postpone the proposed minimum wage hike to April 1 from January 1 originally to help offset some of the price pressures.

Indications of a more protracted post-flood recovery could illicit a monetary policy response

We have been forecasting rates to be on hold for the rest of the year, bringing an end to the rate hike cycle, in response to the deterioration in the external backdrop. Even though the probability of a relief rate cut in response to the flooding is rising, our baseline is still for them to remain on hold on October 19 (this is the result also widely expected by the consensus). But we do think the accompanying statement will be decidedly dovish, highlighting the downside risks to growth from both external and domestic factors, thus opening the door for potential rate cuts in future meetings, if it becomes clearer that the recovery process into 2012 may be more protracted. In the meantime, the central bank has already announced measures to help business cope with the flood damage—by extending debt repayment payment periods and modifying terms of interest payments.

Indonesia—a surprise rate cut…with room for more

Local bond markets have stabilized with some small net inflows from foreigners the past week.

Total domestic government bonds outstanding grew to Rp701.95 trillion as of October 13. Foreign bond ownership stood at Rp217.3 trillion, meaning that foreign ownership share had stabilized around 31% in recent days. Importantly, we also saw the tentative reversal in foreign selling of local bonds with foreign ownership rising around Rp5 trillion last week. The central bank's and SOEs' bond buying programs have helped stabilize the markets; while it also seems that the markets have viewed BI's pre-emptive rate cut favorably so far, which has also been aided by the stabilization in global risk sentiment over the past week or so.

Moderating inflation affords room for further moderate rate cuts

Inflation has trended lower, with the latest headline CPI at 4.6% yoy. Core inflation has been relatively sticky, but with the expected moderation in activity ahead, we should see pressure easing on this front going forward. There has also been arguably growing confidence in BI's inflation targeting framework, adopted formally since 2005—CPI inflation has come within or below targets set for the third year in a row. We see CPI inflation at 5% average for next year, again within BI's target of 3.5%-5.5% for 2012. With BI shifting in favor of buffering growth and inflation risks subsiding, we see room for further rate cuts, especially if markets remain relatively stable.

BI has to balance the desire to boost growth with consideration of market perception of its actions, given the recent market fragility.

Therefore, we think rate cuts will have to be enacted in conjunction with further confirmation of an easing inflation trend. For that matter, BI is unlikely to be pursuing an aggressive easing stance for now. CPI inflation is likely to stay around current levels of 4.6% yoy for the October print before subsiding more visibly from November onwards. We are now expecting another 25 bp in rate cuts for the year (more likely at the December meeting, after viewing confirmation of easing price pressures from the November CPI) and penciling in one more rate cut in early-2012 to bring the policy rate to 6.00%.

Mark Tan

Singapore: MAS Policy Statement and advanced 3Q2011 GDP review: A very modest shift to a less tight stance for now but more easing possibly to come later

This article was first published on October 14, 2011.

- The MAS announced a reduction of the slope of the SGD trading bands, but kept the modest upward crawl intact.
- The decision was more hawkish than we expected—we expected an easing of the slope to zero percent appreciation.
- The advanced 3Q2011 GDP print was better than expected boosted by the volatile biomedical sector, but the rest of the report was weak with services and construction declines…
- …while the forward growth trajectory is also expected to deteriorate further.
- The 3Q2011 GDP growth rebound (albeit biomed driven) and still high headline inflation prints probably made a greater degree of easing more difficult to justify; even if these are backward looking.
- We think the direction of future policy moves is possibly one of further easing, especially if the global backdrop continues to weaken as we expect.

Summary

The Monetary Authority of Singapore's (MAS) move to reduce the slope of the SGD trading bands but keep its modest appreciation stance intact was more hawkish than our expectations. We had expected a greater degree of easing, to a zero percent appreciation path, with no change to the width or centre.

We would have thought that the forward looking macro backdrop would be more consistent with a greater degree of easing. The MAS stated that growth could fall below the potential growth rate of 3%-5% (something we concur with) and also expect easing in both headline and core CPI inflation next year.

However, the bounce back in the 3Q2011 advanced GDP print (strong headline but underlying details portraying weakness) and the still high headline CPI inflation probably made further easing more difficult to justify right now, even though these are backward looking.

We think that further easing moves in the meetings ahead are more likely than not, especially if the global macro backdrop continues to weaken as expected.

The MAS announced a reduction of the slope but kept its modest and gradual appreciation stance intact

In its October 14 Biannual Monetary Policy Statement, the MAS announced that they would reduce the slope of its currency bands, but continuing its policy of a modest and gradual SGD NEER appreciation. We are currently assuming that this means a reduction of the slope from +3% to +2% per annum—a very modest move if indeed true, and the market reaction to the decision has been suitably muted. We also estimate the unchanged width of the band at +/- 2.25%. Our forecast was for a reduction of the slope to zero, with no change to the width or centre of the bands.

Advanced 3Q2011 GDP—strong headline boosted by biomedical

The advanced 3Q2011 GDP was better than expected at +1.3% qoq; seasonally-adjusted; annualized (qoq; s.a. ann.) and +5.9% yoy. Our estimate was for a decline of 3.6% qoq; s.a. ann. and +4.5% yoy (versus the Bloomberg consensus at +0.8% qoq s.a ann. and

Exhibit 1: Summary of GDP breakdown

	3Q2011*	2Q2011	1Q2011	4Q2010	3Q2010
QoQ%					
Annualized Growth	1.3%	-6.3%	27.4%	3.9%	-16.7%
Manufacturing	8.9%	-23.7%	97.6%	0.7%	-48.5%
Construction	-11.5%	13.3%	13.5%	-10.2%	-9.6%
Services-Producing	-0.7%	0.0%	10.3%	5.6%	0.5%
YoY% GDP at 2005 Prices					
Overall	5.9%	1.0%	9.3%	12.0%	10.5%
Manufacturing	13.2%	-5.8%	16.5%	25.5%	13.7%
Construction	0.4%	1.5%	2.4%	-2.0%	6.7%
Services-Producing	3.6%	4.0%	7.6%	8.8%	10.2%

* Latest quarterly figures are preliminary. The advance estimates for third quarter 2011 GDP were computed largely from the first two months' data (i.e., July and August 2011), as well as data (where available) and estimates for September. They are intended as an early indication of GDP growth in the quarter, and will be revised when comprehensive data are available.
Source: Ministry of Trade and Industry, GS Global ECS Research.

previous of -6.3% qoq s.a. ann.). Note that this is the advanced 3Q2011 GDP read, based mainly on July and August data; with no breakdown by expenditure components as yet, only by industry.

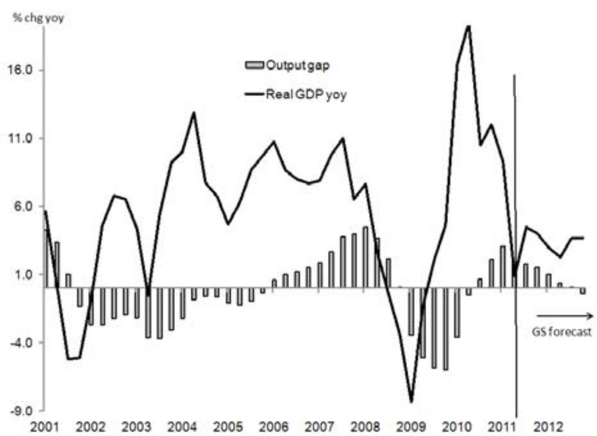
The better-than-expected GDP print was boosted by the biomedical bounce back, with the rest of sectors weak. Manufacturing came out stronger than expected, growing at 8.9% qoq ann. versus a decline of 23.7% qoq ann. in 2Q2011. This was likely boosted by the biomedical rebound (as indicated in the MAS statement). The rebound in the biomedical sector was also reflected in the August industrial production data, but we had thought the weakness in the other sectors would tip the headline sequential GDP print into negative territory. The outlook for manufacturing ahead is also less bright with the weakening global demand. Meanwhile, the rest of the sectors portrayed significant weakness. Construction dropped 11.5% qoq ann. versus growth of 13.3% qoq ann. previously while services continued to decline with a dip of 0.7% qoq ann. from flat growth previously.

More cautious on the growth outlook while core CPI expected to ease further

In its statement, the MAS flagged that growth in 2012 could be below its potential growth rate of 3%-5%. We concur with the assessment on the growth outlook—our 2012 GDP growth forecast is at 3.2% and the output gap is expected to turn less positive and even negative in the quarters ahead (see Exhibit 2).

The MAS statement stated that the official CPI forecast range for 2011 is at 5% and also revealed the forecast for 2012 at 2.5%-3.5%. This is similar to our forecast of 5% and 3.2% for 2011 and 2012 respectively. Headline CPI inflation is expected to stay elevated into next year, propped up by accommodation and transport costs. Headline CPI is expected to ease more visibly in 2H2012. The MAS emphasized that core CPI has been significantly lower than headline CPI over the past year.

Exhibit 2: Weaker growth ahead, with the output gap turning negative



Source: CEIC, GS Global ECS Research estimates.

They also expect core inflation to ease next year to the 1.5%-2% range from the current 2.2% yoy.

Forward looking macro backdrop is consistent with likely further easing ahead

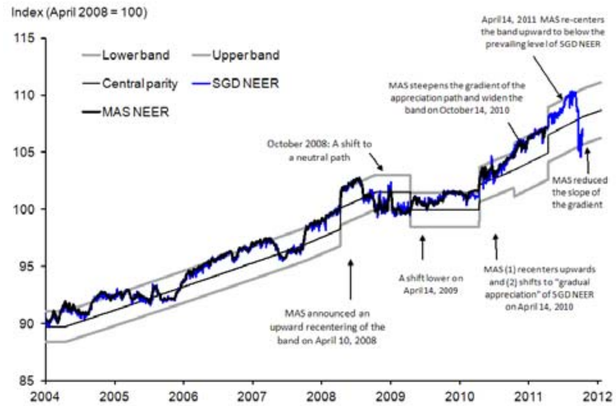
A negative delta in the output gap had prompted the MAS to move to a flat stance in July 2001 and October 2008. This is a similar growth situation to the one we are facing currently. We see a weaker US growth trajectory, a mild recession in Euroland around the turn of the year and more subdued growth in China (our full-year 2012 forecast at 8.6%). We believe the weaker global demand backdrop will weigh on Singapore's growth outlook going forward, pushing its output gap to slightly negative territory in the quarters ahead.

We would have thought this growth outlook warranted an easing to a flat stance consistent with past moves. However, the rebound in the advance 3Q2011 GDP reading (albeit biomedical driven) and the still high headline CPI prints probably made a further easing stance more difficult to justify at present, even though these are mainly backward looking.

Given the forward looking macro backdrop of output gap turning less positive and eventual easing in inflation, we think this makes further easing moves by the MAS in the meetings ahead more likely than not.

Mark Tan

Exhibit 3: The MAS has enacted a less tight stance, but only very slightly



Source: MAS, CEIC, GS Global ECS Research.

Taiwan: Limited toolbox to tackle the external downturn

This article was first published on October 12, 2011.

- We lower our GDP growth forecast to 3.2% from 4.6% for 2012, which is below the consensus expectation of 4.2%. For 2011, we lower our growth forecast to 4.4% from 4.7% previously.
- Our overall cautious stance on the Taiwanese economy is based on two key factors:

1) A very high beta to the global economic cycle.

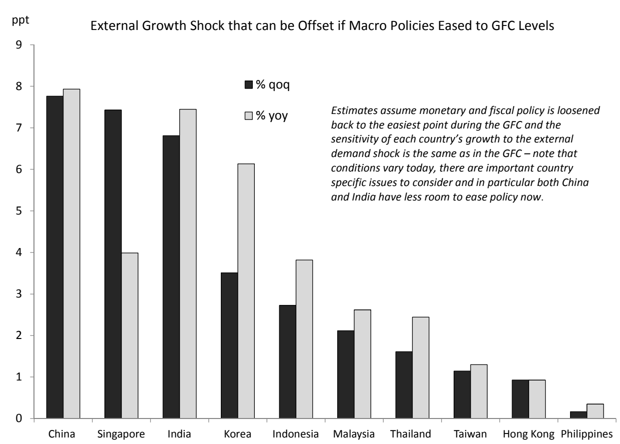
2) Little room for monetary policy maneuvering and limited potential impact from further easing in the current downturn.

- More specifically, we believe monetary policy would be ineffective due to poor policy rate transmission and its limited impact on simulating investment demand…
- …which leaves fiscal policy as the main policy tool.
- On the domestic front, the property price up-cycle is likely to moderate. While we do not expect a sharp correction to occur, this would potentially weigh on credit and consumption growth.
- The presidential and Legislative Yuan elections on January 14, 2012 would be important in their implications on cross-strait policies and the prospects of long-term supply-side expansion in Taiwan.

Taiwan's external outlook has deteriorated sharply, prompting us to lower our GDP growth forecasts for this year and next. Our European Economics Team has downgraded its growth forecast for both 2011 and 2012; it now expects the Euro area to fall into recession beginning in the fourth quarter, with full-year growth at only 0.1% in 2012 (see *Stagnation in the Euro area*, European Views, October 3, 2011). Our US Economics Team has also revised down their growth forecast for 2012 to 1.3% from 2.0% previously, with weak growth of 0.5% in 1Q2011. In Asia, we have lowered China's 2012 GDP growth forecast to 8.6% from 9.2%, reflecting weaker external demand, and weakness in private residential investments. As for Taiwan, we now lower our GDP growth forecast to 3.2% from 4.6% for 2012, which is below the consensus expectation of 4.2% compiled by Consensus Economics. For 2011, we lower our growth forecast to 4.4% from 4.7% previously on the back of the recent lackluster performance of economic indicators.

Our overall cautious stance on the Taiwanese economy is based on two key factors: 1) very high beta to the global economic cycle; 2) little room for monetary policy maneuvering and limited potential impact from further easing in the current economic cycle. We have previously highlighted in our regional research that the amount of growth shock each Asia ex Japan (AEJ) country can offset in this cycle differs widely across the region. Among AEJ, we find that Taiwan is one of the least well-placed. Our earlier estimates, assuming a return of policy settings to the most accommodative point during the global financial crisis (GFC), showed that Taiwan is able to offset only about 1 percentage point (ppt) of external growth slowdown (see *Asia: Quantifying the downside scenario responses*, Asia Economics Analyst 11/15, September 8, 2011).

Exhibit 1: Taiwan is least well placed across the region to offset an external slowdown



Source: CEIC, GS Global ECS Research.

Exports have embarked on a weakening trend as external demand falters. It is well-known among investors that Taiwan has a very high beta to the global economic cycle. Taking into account exports-driven domestic demand, and netting out the processing imports components, we estimate that Taiwan's overall exposure to external demand totals nearly 50% of GDP (see *The Asian exports decline–analysis of true value-added from exports and of export destinations suggests more pain to come*, Asia Economics Analyst 09/01, January 16, 2009). Reviewing Taiwan's trade performance in 1H2011, exports actually held up well, boosted by strong growth in high-value-added IT products, and also temporary export substitutions away from Japan's exports post the March earthquake. We have been expecting to see some slowdown in tech exports as the amount of "substitution" exports fade with the normalization of Japanese production, and as global growth momentum decelerates further. We now see a notable weakening in Taiwan's exports. September exports growth remained weak, with exports growth momentum to all major destinations staying firmly in negative territory. Export orders, which typically lead customs exports data by one to two months, have also embarked on a clear weakening trend.

An external sector slowdown is inevitable as G-3 growth remains the locomotive for Taiwan's export growth. Despite the increasing economic and trade ties between China and Taiwan, our analysis shows that G-3 demand remains the dominant growth driver for Taiwan exports. Taking into account the amount of processing trade that is exported to China and is ultimately driven by demand in the G-3, we estimate Taiwan's exports exposure to the G-3 to be about 40% (to the US: 15%). Accordingly, this implies total exposure to China (and Hong Kong) at 18%, compared to the trade share of 42% from the customs exports data.[1] Therefore, sub-trend final demand growth in the developed economies points to an inevitable slowdown in overall exports (for more details on the estimations, see *Taiwan: Near-term exports slowdown manageable; retain constructive stance on TWD*, Asia Economics Flash, November 11, 2010).

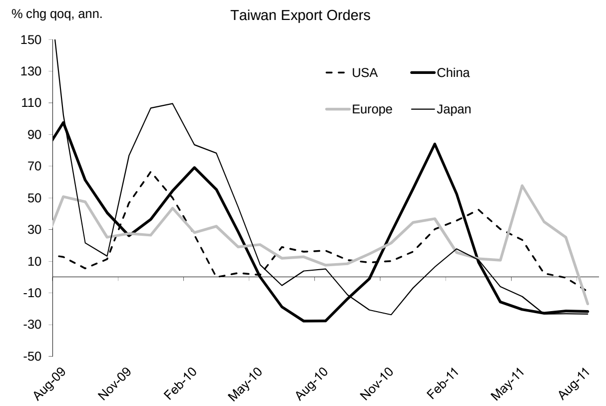
Our cautious stance on the economy is predicated on the limited possible policy response and the small impact any potential policy response would have in stimulating capex and the overall economy.

We believe the effectiveness of monetary policy is limited for two reasons: 1) there is little room to lower market rates further given its current low levels and the inefficiencies in policy rate transmission; and 2) interest rate moves are unlikely to lift domestic capex in a meaningful manner.

We now expect the central bank to put rates on hold for the rest of 2012, compared to hiking rates by another 62.5 bp next year in our previous baseline scenario. Nevertheless, we believe this would have limited impact on financial conditions and the economy for the reasons below.

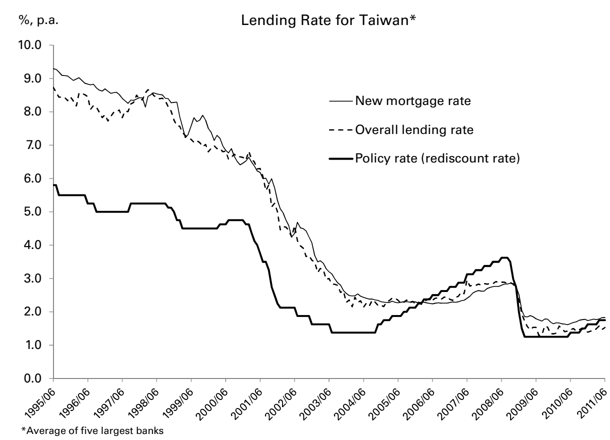
[1] Our findings also show the importance of China's domestic market has increased significantly over the last two decades, with the share of Taiwan's exports to China and Hong Kong steadily rising and the share of exports to the G-3 decreasing at the same time. In the longer run, we expect China's domestic demand to continue to grow in importance.

Exhibit 2: Exports momentum has turned negative in all major exports destinations



Source: CEIC, GS Global ECS Research.

Exhibit 3: Lending rates have barely moved despite the policy rate rise



Source: CEIC, GS Global ECS Research.

1. Market rates have little room to move lower due to excessive liquidity

The central bank has raised interest rates by 62.5 bp to 1.875% since the tightening cycle began in June 2010. The pace of interest rate normalization has been slow, especially when compared to the aggressive rate cuts totalling 200 bp throughout the GFC. The transmission of the policy rate hikes to market rates (e.g., lending rates, deposit rates, etc.) has also been ineffective, largely due to the abundance of liquidity in the system. Exhibit 3 shows that average lending rates of the five largest banks remain below the rediscount rate (policy rate) of 1.875%, with lending rates staying largely flat as the policy (rediscount) rate gradually moves up.[2] Within the banking system, the loan-to-value ratio is low at around 66%, while banks' holdings of Negotiable Certificate of Deposits (NCD) have increased to 22% of total deposits (see Exhibit 4). This reflects the significant amount of liquidity in the system, and also the low pricing power of banks due to intense competition. For these reasons, financial conditions remain especially loose despite the rate hikes so far. Should the external environment deteriorate further, the extent to which lower policy rates could translate to even easier financial conditions is limited (also see *Taiwan: Gradual tightening continues; upward grind in short-term interest rates likely to remain slow*, Asia Economics Flash, April 1, 2011).

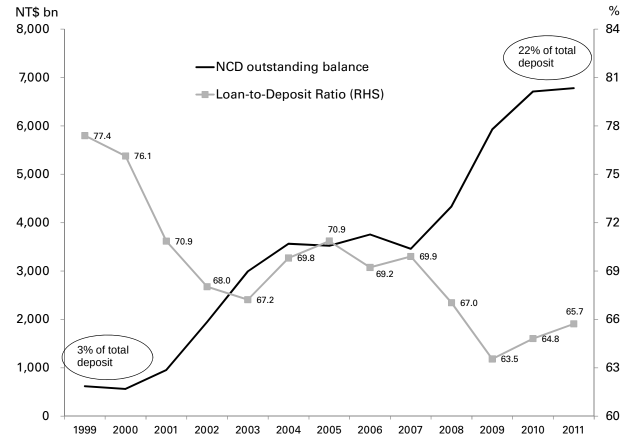
2. The impact on interest rate movements on capex investments is small, and therefore also limited on the general economy

In our view, there is little interest rate movements could do to boost investment demand and growth in Taiwan since the sluggish capex cycle is a result of fundamental problems in the economy. In theory, the impact of lower borrowing costs in stimulating the economy is dependent on whether there is any genuine credit demand for domestic investment, which should pick up on the back of lower costs and eventually translate into employment creation and consumption demand growth. In Taiwan's case, we believe there is now ample evidence that **it has slipped into a self-reinforcing cycle of low investments and low productivity growth, which has been intensified by the "productivity competition" posed by China**.

The so-called "hollowing out" phenomenon, with Taiwanese manufacturers continuing to move their operations to mainland China in efforts to lower operating costs, has been a fiercely debated issue over the last decade. In reality, this phenomenon has been occurring. Exhibit 5 shows that the share of manufacturing output that is produced outside of Taiwan (largely produced in manufacturing bases in China) climbed to over 30% of the total this year, from only 5% of the total ten years ago. During the same time, the domestic-facility-investment-to-GDP ratio has been on a steady decline (see Exhibit 6). Productivity growth remained depressed at an average of about 5%, in stark contrast to the double-digit growth seen in China (see Exhibit 7). **This productivity growth differential pushed Taiwan into a vicious cycle of low domestic investment and low productivity growth. This situation would likely persist unless there is a substantial boost in supply-side expansion, possibly**

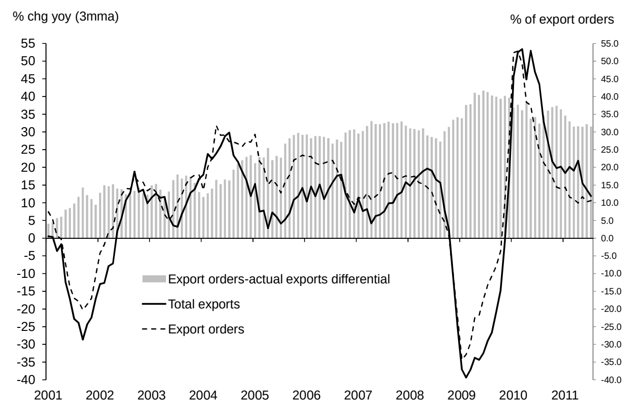
[2] Since these 5 banks are all state-owned banks, the overall sector lending rate would likely be 30 bp-50 bp higher.

Exhibit 4: The loan-to-deposit ratio remains below pre-crisis level, as banks' appetite for NCDs stays strong



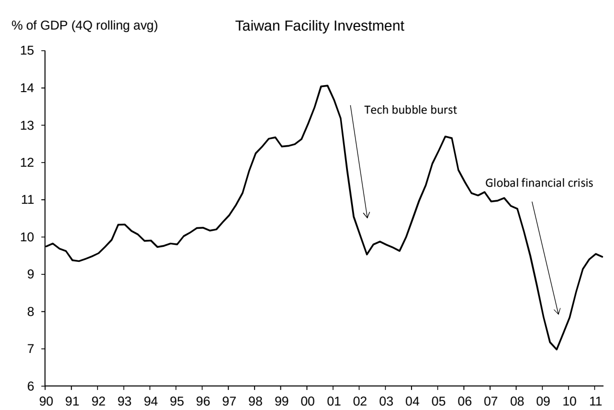
Source: CEIC, GS Global ECS Research.

Exhibit 5: A steadily rising share of Taiwanese export orders manufactured out of Taiwan



Source: CEIC, GS Global ECS Research.

Exhibit 6: Taiwan has experienced a significant capex reset during the GFC



Source: CEIC, GS Global ECS Research.

led by government initiatives, which have been limited (see Exhibit 8).

As a result, Taiwan has failed to develop credible domestic demand growth drivers and remains highly dependent on the global economic cycle, rendering domestic interest rate drivers ineffective. During the GFC, Taiwan experienced its second episode of significant capex reset (the first one during the tech bubble burst in 2001). Facility investment as a share of GDP fell to around 7% during the GFC. It has since picked up, though remains depressed at a historical low at around 9% of GDP. This is also one of the key reasons why Taiwan remains highly tied to the global economic cycle, since domestic demand could never "fully recover" after these resets.

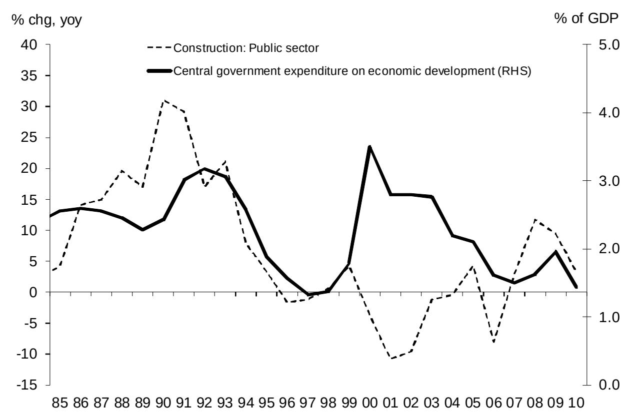
Against the backdrop of a low interest environment, we have seen some improvement in credit growth. We would however, hesitate from reading this pickup as a clear signal for a sustained boost in domestic investment demand. Total loan growth has been above trend and above GDP growth since 2H2010. In terms of sector, robust loan growth has been mainly contributed by strong credit demand from the corporate and SME sectors. Nevertheless, we believe a significant part of the loans made has been loans to Taiwan corporates operating in China. China credit tightening has increased the difficulty for Taiwan corporates to obtain funding onshore. This has contributed to increased offshore credit demand which is considered as credit growth in Taiwan. The notably stronger growth in FX loans, as well as offshore banking unit (OBU) loans, compared to local currency loans in 2010 and so far this year could be a reflection of this phenomenon. There is also evidence from the Balance of Payments data showing a substantial net outflows in the form of bank loans since 4Q2010 (see Exhibit 9 and *Taiwan: Financial Services: Play defensive amid cyclical slowdown; avoid life insurers*, September 2, 2011).

This leaves fiscal policy as the main policy tool. We believe it would be crucial for the government to be aggressive in boosting near-term economic growth, especially when monetary policy would likely be deemed ineffective. During the GFC, the government introduced a fiscal stimulus package of over 3% of GDP, consisting of measures from shopping vouchers, to tax measures and credit guarantees. We expect the government to also introduce fiscal stimulus measures, albeit of a smaller scale, in this downturn (this has already been incorporated into our growth forecasts). The main limitation in this cycle is the accumulation of government debt. Government debt is estimated to reach 37.5% of GNP by 2012, encroaching on the "*40% of average GNP over the last three years*" legal limit on central government debt as stipulated in the Public Debt

Exhibit 7: Stark differential in productivity growth between Taiwan and China for over a decade

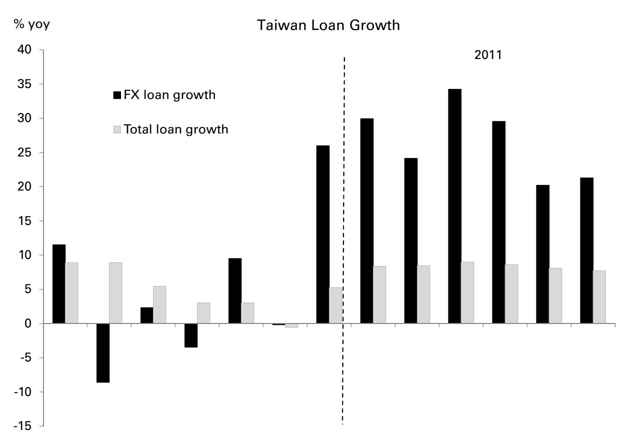
Source: CEIC, GS Global ECS Research.

Exhibit 8: Dearth of investment in infrastructure projects from the public sector



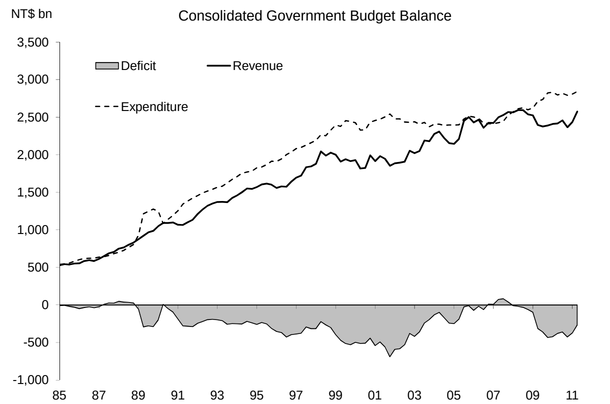
Source: CEIC, GS Global ECS Research.

Exhibit 9: FX loan growth has been much stronger than overall loan growth



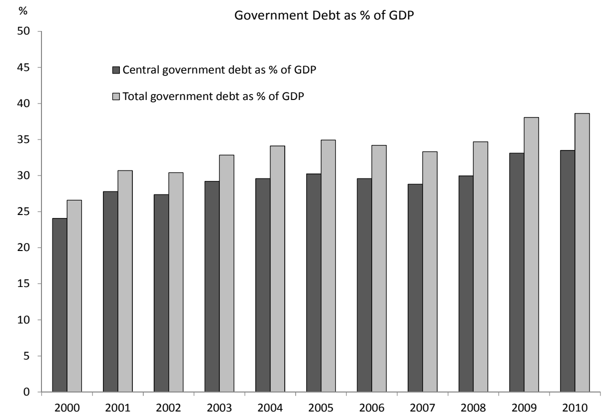
Source: CEIC, GS Global ECS Research.

Exhibit 10: Fiscal position deteriorated notably through the global financial crisis



Source: CEIC, GS Global ECS Research.

Exhibit 11: Government debt levels approaching the legal limit

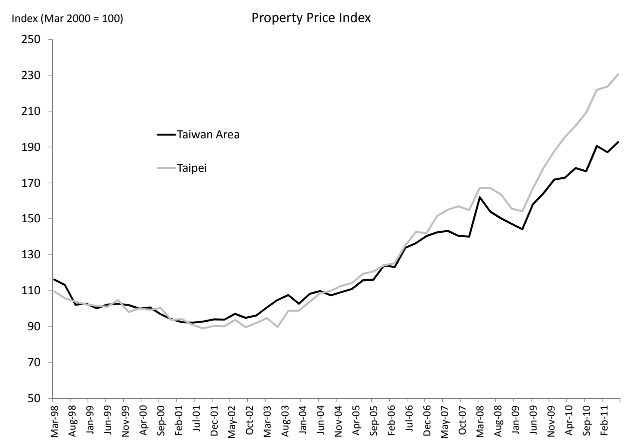


Source: CEIC, GS Global ECS Research.

Act (see Exhibit 11).[3] Nevertheless, we believe growth concerns should be the top priority at the moment, and total government debt remains comfortably under the statutory limit of 48%. In the longer run, the government should pursue initiatives to improve the tax collection system to boost revenues and improve its fiscal profile.

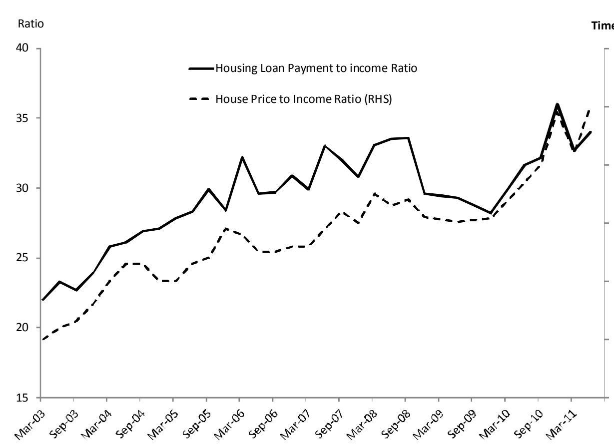
Meanwhile, Taiwan's benign inflation dynamics provides more room for a larger fiscal response. Taiwan's structurally low inflation is mainly contributed by insulated domestic food prices and anaemic wage growth. Compared to its neighbors, Taiwan's domestic food prices are more insulated from changes in global commodity prices. Local production supplies a majority of the major food products in Taiwan, including rice, vegetables, and meat. Furthermore, the government has active controls on food prices, for example, reducing import tariffs on food staples like wheat and milk powder to stabilize domestic food prices.[4] Structurally, low levels of capex investments and a declining trend in productivity, as elaborated earlier, have in turn suppressed wages, creating an environment of persistently low wage growth and inflation. **On the back of our growth downgrades and revised oil price forecasts, we also revise down our inflation forecasts to 1.5% for both 2011 and 2012, from 1.8% and 2.0% previously. With less imported price pressures, a potentially weaker external balance position, we have also revised our USD/TWD forecasts to 29.6, 29.0, 28.5 on a 3, 6 and 12-month basis respectively, from 28.3, 28.0, 27.8 previously. The new forecasts are now closer to market levels, while maintaining a general USD weakening path in line with our Global Markets Team's forecast for EUR/USD of 1.38, 1.42, and 1.48**.

Exhibit 12: Property prices on the rise



Source: CEIC, GS Global ECS Research.

Exhibit 13: Affordability ratio has worsened



Source: CEIC, GS Global ECS Research.

[3] The Public Debt Act was promulgated in 1996. So far, special legislation had been passed to bypass the Public Debt Act, e.g. the 921 Temporary Act for Post-Earthquake Reconstruction.

[4] Import duties on seven food staples, including wheat powder, milk powder, cassava starch have been reduced by up to 50%, to be effective between February 2010 and August 2011.

Exhibit 14: List of property measures introduced so far

1. Luxury tax imposing a 15% tax on any property transactions within a year of the last sale, and a 10% tax on transactions in the second year after the last transaction (effective June 1, 2011)
2. The central bank capped second home mortgages in Taipei at 60% of purchase price in December 2010, from 70% previously; also extended limit to other areas
3. Restricted loans using land as collateral to 65% of the real estate value
4. Continued moral suasion from the SFC advising banks to reduce their amount of mortgage lending
5. Construction of social housing complexes in suburban Taipei City and New Taipei city; supply of 1600 homes in 2013 upon completion

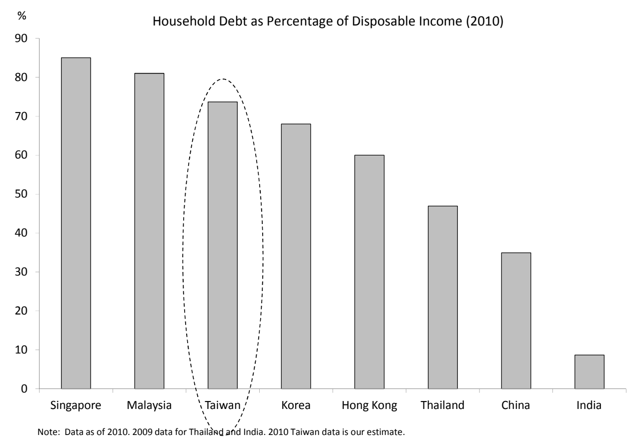
Source: CEIC, GS Global ECS Research.

On the domestic demand front, Taiwan's property sector has experienced a sustained asset reflation cycle, though affordability has now worsened and property measures are beginning to bite (see Exhibits 12 and 13). Against the backdrop of a widening income gap in Taiwan, property price increases have become a politically charged issue especially ahead of the upcoming elections. The government has been proactively introducing government measures which would likely rein in the rate of price increases (see Exhibit 14). One of the more drastic measures is the luxury tax introduced in June, imposing a 15% tax on any property transactions within a year of the last sale, and a 10% tax on transactions in the second year after the last transaction. This follows similar measures introduced in Hong Kong and Singapore.

Taiwan has experienced a long property boom cycle since 2002, when the government first introduced a series of measures such as mortgage rate subsidies and a reduction in land value incremental tax rates to pull the property sector out of the decade-long slump post its 1986-1990 up-cycle. Property prices increased 10.5% in 2010, after an average increase of 8% in the previous five years. The sharpest price increases are seen in the Taipei and New Taipei areas, which make up around 30% of total housing stock in Taiwan. Fundamentally, this reflects a distortion in the property market created by the different phases of development in southern and northern Taiwan, which requires a significant infrastructure build-up to better link up the country and attract people to live in the 'less popular south'.

In our view, Taiwan's property prices have risen on the back of four factors: 1) low interest rates since the burst of the tech bubble, and interest rate cuts during the GFC have spurred mortgage loan growth. Taiwanese banks have also been offering competitive pricing to gain market share in the consumer loan business; 2) **lowering of the Inheritance Tax in early-2009** has increased the repatriation of funds to the housing market;[5] 3) **lack of transparency on property transactions** which opens opportunities for speculation and unreasonably inflated prices; 4) **low costs of conducting property transactions** since property transaction taxes are based on government assessments, and not reflective of market prices. While it might not be a key factor contributing to the run-up in property prices, the opening up of the property sector for mainland China investments has also helped boost sentiments in the market.[6]

Exhibit 15: Household leverage in Taiwan is now higher than that in Korea



Source: CEIC, GS Global ECS Research.

The property measures are starting to bite just as external risks are rising. We are now seeing a slowdown in transaction volumes and also the rate of price increases since the introduction of the luxury tax in June. Nevertheless, we do not expect a sharp correction in property prices, since interest rates are likely to stay low, mortgage loan quality is decent, and sustained repatriation flows would also provide support. With that said, a slower pace of increase in property prices would still negatively impact credit and household consumption through the wealth effect with a lag. Besides, the average Taiwanese household is now more financially leveraged than that of its neighbors in the region (see Exhibit 15). This further lowers the prospect of consumption being a growth driver in this downturn.

5 Inheritance and gift taxes were cut to a uniform tax rate of 10% in 1Q2009, from as high as 50%. High taxes previously had led to capital outflows to areas with lower taxes such as Hong Kong and Singapore.

6 Taiwan's property sector was officially opened for mainland Chinese investments in June, 2009. From then on, in conjunction with the relaxation of investments in Taiwan by mainland Chinese investors, individuals, and Chinese investors that have set up offices in Taiwan already can buy properties in Taiwan to address their business needs. Applications are required to be filed with the local government and the approval from the Ministry of the Interior is also needed.

Exhibit 16: Potential benefits to key service sectors in Taiwan from closer cross-strait economic ties

Top service sectors in Taiwan	% of GDP	% of employment	Benefits of further liberalization of cross-strait policies
Wholesale, retail, hotel and restaurants	20.8	25.8	Arrival of more tourists will rejunvenate the retail sector, and spur recovery in local consumption
Finance & insurance (FI)	15.4	6.6	Liberalization of cross-strait banking regulations will allow banks to gain better access to their client base in the mainland
Transportation, storage & communication	6.7	6.5	Direct air links will increase demand for logistic services, bringing Taiwan closer to the rest of the supply chain in China
Healthcare & social welfare services	3.1	5.1	Arrival of mainland Chinese tourists presents business opportunities for Taiwan medical services
Professional, scientific & technical services	2.3	3.0	Increase interaction between Taiwan's technology professionals spurs more activities in scientific services in Taiwan
Construction	2.9	6.5	Allow mainland Chinese capital to invest in public infrastructure projects, production facilities and other real estate help spur demand for construction services
Educational services	4.8	1.1	Mutual recognition of education qualifications and exchanges will likely lead to more demand in education services
Cultural, sporting & recreational services	0.9	0.8	More exchange in people and cultural activities as a result of direct flights and tourism will foster further developments in cross-strait cultural activities
Agriculture, forestry, fishing & animal husbandry	1.6	8.3	Allowing Taiwan's agricultural technology to be exported to China is a key business opportunity. Direct air cargo links also facilitate Taiwan's agricultural exports to the mainland
Total	**58.5**	**63.7**	

Source: CEIC, GS Global ECS Research.

Looking ahead, the presidential and Legislative Yuan elections would be key to watch in the next few months…

Taiwan will hold presidential and Legislative Yuan elections on January 14, 2012. In our view, the elections are important in its implications on cross-strait policies and the prospects of supply-side expansion. At the moment, the presidential race is still a close tie between the Kuomingtang's (KMT) incumbent president, Ma Yingjeou and the Democratic Progressive Party's (DPP) Tsai Ingwen, with the KMT's bid leading the DPP's by a small margin in recent polls.[7] The addition of James Soong Chuyu of the People's First Party (PFP) has also increased uncertainties to the election outcome, which warrants a close watch in the final run-up to the election. November 5 would be the deadline for Soong to garner signatures to run for president officially. The amount of votes he could garner would shed light on the strength of Soong as a candidate and his impact on the race.[8]

In terms of implications on cross-strait policies, it is likely that there would be less uncertainties should the status quo be maintained. Currently, we believe the costs of a dramatic turnaround in the course of cross-strait progress would be very significant economically. There are also official frameworks that have been set up, such as the Economic Cooperation Framework Agreement (ECFA), which would help sustain progress. We would watch for the implications on the legislative progress arising from the newly-elected president and the new composition of the Legislative Yuan.

In the context of our analysis so far, cross-strait developments are critical in lifting Taiwan out of is sluggish investment cycle through increased foreign investments and further development in its services sectors. We believe the signing of the ECFA last year has solidified a formal trade relationship between Taiwan and mainland China, which importantly, decreases the amount of political sensitivities related to Taiwan, and paves the way for more formalized economic integration with the rest of the world. Also, by allowing more convenient access to the mainland economy, through closer trade ties and people exchanges, companies in Taiwan can service China's needs in high-tech services more efficiently. We believe there is still significant opportunity for Taiwan to continue to serve their counterparts in China by providing high-quality supply-chain management services, while still being located in Taiwan. And more recently, the introduction of the Individual Visitors Scheme to allow tourists from China to visit Taiwan on an 'individual' basis (versus within a tour group) could also boost tourism-related infrastructure investments in Taiwan (see *Taiwan: Perspective on sustaining the "game changing" cross-straits developments*, Asia Economics Flash, May 21, 2009).

Shirla Sum

[7] Global Views Survey Research Center, http://www.gvsrc.net.tw/dispPageBox/GVSRCCP.aspx?ddsPageID=NEWS&&dbid=3470362989

[8] According to the Central Election Commission, Soong is required to garner about 250,000 votes, 1.5% of the total voting population, in order to become an official candidate.

Malaysia 2012 budget review—juggling the twin goals of buffering growth against the external slowdown and medium-term fiscal consolidation

This article was first published on October 10, 2011.

- The 2012 budget is targeting the twin goals of increasing fiscal stimulus in the face of an external slowdown…
- …and bringing down the deficit to keep the medium-term fiscal consolidation on track.
- Bolstering domestic demand arguably appropriate now given the external growth risks.
- The goal of a reduced deficit of 4.7% of GDP in 2012 (from 5.4% in 2011) may be hard to meet though given the slowing growth expected next year.
- We have recently revised our GDP growth target for 2012 to 4.2% versus the government's target of 5%-6%.
- Continued focus on boosting investments via the Economic Transformation Program remains a key priority.
- Tough reforms including tax and subsidies were untouched—these reforms are expected only after the upcoming elections, which will be key for showing commitment to "change".

Summary

Overall, we see this as a "people friendly" budget that aims to fulfil the twin goals of bolstering domestic demand in the face of an external slowdown and keeping the medium-term target of fiscal consolidation on track.

The increased fiscal spending is arguably coming at an opportune time, given the threats to the growth outlook from external risks. However, the aim of narrowing the budget deficit to 4.7% of GDP in 2012 from 5.4% in 2011 may be a tougher one to meet, given the potential growth and revenue shortfall. We recently revised our 2012 GDP growth forecast to 4.2%, which is markedly below the government's own assumptions of 5%-6% stated in the budget.

Longer term, there continues to be a focus on attracting private investments under the broader Economic Transformation Program (ETP). Ultimately, we will need to see tougher reforms such as the GST and subsidies reforms being enacted, which is something that we are keeping a watch on after the upcoming elections which will potentially be held early next year.

Increased expenditure as a buffer against the impending external slowdown…

We believe one of the main objectives of the 2012 budget is to provide a buffer against the impending external slowdown by boosting private consumption and investments. The 2012 budget proposes to raise expenditures by 1.8% to RM233 million, of which RM182 million is from operating expenditures and RM51 million is from development expenditures. One of the main areas of increased spending is targeted at easing the cost of living and enhancing the well-being of the "Rakyat" or people—this includes giving cash handouts to lower-income groups and bonuses for civil servants (see Exhibit 1).

Exhibit 1: Table of operating expenditures

Federal Government Expenditure (RM bn)	2009	2010	2011F	2012F
Emoluments	42.8	46.6	49.9	52
Debt service charges	14.2	15.6	18.5	20.5
Grants to state governments	4.9	4.7	5.5	5.8
Pensions and gratuities	10.1	11.5	13	12.1
Supplies and services	26.4	23.8	29.5	30.5
Subsidies	20.3	23.1	32.8	33.2
Grants to statutory bodies	12	12.4	13.4	14.5
Refunds and write-off	0.6	0.6	1.1	1.4
Others	25.7	13.2	16.6	11.7
Total	157.1	151.6	180.2	181.6
% GDP	**23.1**	**19.8**	**21.3**	**19.8**

Source: Ministry of Finance, GS Global ECS Research.

Exhibit 2: Summary table of budget measures

Boosting Investments
- To allow 100% foreign ownership of 17 service sub-sectors, including health care and logistics
- To implement a RM98.4 billion rolling plan until 2013 for high impact development projects
- To grant tax benefits to investors who use the Malaysia Treasury Centre to accelerate financial markets development
These include income tax exemption of 70% for five years, withholding tax exemption on interest payments on borrowing and
stamp duty exemption on loan and service agreements
- Providing tax incentives to new 4 and 5-star hotels that are built in Peninsular Malaysia, previously available only to Sabah and Sarawak
These include a pioneer status with income tax exemption of 70% of statutory income for 5 years; or investment allowances of 60% for 5 years
- Allocation of RM978 million to accelerate development in 5 regional corridors
- A tax deduction on expense incurred for Sukuk Wakala will be given for a 3-year period
- To extend 3 years for income tax exemption given for non ringgit sukuk issuances and transactions
- To grant tax benefits to investors who assist in the development of Kuala Lumpur International Financial District
companies
Industrial building allowance and accelerated capital allowance for KLIFD Marquee status companies
Income tax exemption of 7% for a period of 5 years for property developers in KLIFD
- Fund of RM200 million seed money for shariah compliant ETFS
- Listing of FELDA Global Ventures Holding on Bursa Malaysia by mid 2012
- Five-year extension of concessionary tax rate of 10% on dividends of non-corporate institutional and individual investor in Real Estate Investment Trusts
- To establish RM2.6 billion worth of funds for small and medium enterprises (SME) to tap on
- RM100 million fund to be set up to encourage entrepreneurs to revive their businesses
- To extend import duty and excise duty exemption on hybrid cars and electric cars until end 2013
- RM420 million Langkawi Five Year Tourism Development Master Plan will be launched
- Review of real property tax gain (RPGT), 10% will be applied for properties held and disposed within 2 years, 5% for those between 2 and 5 years
For properties held and disposed after 5 years will not be subjected to RPGT

Easing Costs of Living and Enhancing the Well Being of Ratyat
- Allocation of RM1.2 billion for 1Malaysia Rakyat's Welfare Programme; providing monthly assistance to senior citizens RM300 , to poor children
RM100-450 per month and to disabled people between RM150 and RM300 per month.
- Doubling of ceiling to RM400,00 for house prices under a government deposit guarantee scheme for first time buyers
- 100% stamp duty exemption on loan instruments for the purchase of houses built in Cyberjaya, Putra Heights, Seremban,Damansara and Bukit Raja
- Introduction of Skim Amanah Rakyat 1Malaysia scheme to allow household income below RM3,000 to borrow RM5,000 over 5-year period
- Senior citizens aged 60 and above will be exempted from paying all outpatient registration fee in all government hospitals, health clinics and dental clinics
- Senior citizens will be entitled to 50% discount on LRT and Monorail fares
- One-off RM100 school assistance for each pupils from Year 1 to Form 5
- One-off RM200 in book voucher each for those above 17 years in school
- Additional bonus of half month salary with a minimum payment of RM500 and an assistance of RM500 to government pensioners

Source: Ministry of Finance, GS Global ECS Research.

Increased fiscal stimulus up until a few months ago, with a rising positive output gap, would be regarded as inflationary and worrisome, but with the external risks intensifying as we have seen now, the increased stimulus is coming at an arguably opportune time.

Longer term, the continued efforts towards maintaining the intensity on attracting private investments remain intact. The government has announced a Second Rolling Plan (RP2) for high impact projects under the 10 Malaysia Plan, spending RM98.4 billion over two years. There are also plans to liberalize 17 subsectors in the services sector, allowing up to 100% foreign equity participation in these sectors (see Exhibit 2).

…as well as with an eye towards the upcoming elections

The increased spending has also been billed as "populist" by some quarters, unsurprising, given the prospect of upcoming elections that has to be called by 2013. This "people friendly" budget has also come on the back of announcements by the Prime Minister in recent weeks, such as the repealing of the previous long standing security laws. All this has led to speculation of impending elections that could be possibly held sometime early next year.

While there may be some truth to the populist nature of the budget, we think the inflationary impact of such an increased fiscal stimulus is much less worrisome now and arguably appropriate given the rising threats to external growth, as we discussed above.

Unsurprisingly, the tougher reforms such as the GST and subsidy reforms (especially fuel) were not touched upon. The total subsidy bill for next year is projected to be RM33.2 billion, up from an estimated RM32.8 billion in 2011 (see Exhibit 3). These tougher reforms will likely only be tackled after the elections. While it is encouraging to see continued focus on attracting private investments via the ETP, the ability to push through tough reforms could be the much-needed catalyst that drives the success of the government's transformation efforts as we discuss further below.

Reduced deficit targets may be harder to meet given slowing growth

The government's growth assumptions tabled in the budget for next year are at 5%-6%, which is above our own forecast of 4.2%. We had recently revised our GDP forecasts for Malaysia mainly on the back of slowing global demand. We recently revised our 2012 global GDP growth forecast to 3.5% from 4.3%, led by reductions in the US (to 1.4% from a forecast of 2.0% previously), the Euroland (down to 0.1% from 1.3% previously) and China (now at 8.6% from 9.2% previously) (see *Asia: Greater impact of Eurozone and US downgrade amid China credit concerns*, Asia Economics Analyst 11/17, October 4, 2011).

Potential revenue shortfalls from growth undershooting expectations notwithstanding, a potentially wider-than-projected fiscal deficit is also plausible, especially if one considers that, with the external slowdown and upcoming elections, there will be more pressure to deliver on expenditures. We do think that the targets of meeting the reduced deficit of 4.7% of GDP in 2012 from an estimated 5.4% in 2011 may thus be tougher to achieve.

Pushing through tougher reforms is ultimately what is needed to catalyze the economic transformation process

The government has stepped up efforts over the past year to address the main impediment to Malaysia's potential growth—that is, the lacklustre recovery in private investments after the Asian crisis. This trend of private investments has arguably been partly held back over the years by skepticism over the government's transformation efforts over the years.

Exhibit 3: Breakdown of estimated subsidies in 2011

2011 Subsidies	**32.8**
% of GDP	**3.9**
Fuel Subsidies	15.9
Cooking oil	1.6
Tolls compensation	0.2
Flour	0.1
Rural air and rail services	0.3
Electricity	0.2
Interest rate differentials loan subsidy	1.6
Food subsidies for self sufficiency	2.4
Incentives for food self sufficiency programme	0.5
Educational scholarships, professional development	7.2
Financial assistance for poor, disabled and other vulnerable groups	2.6

Source: Ministry of Finance, GS Global ECS Research.

Exhibit 4: A reduced deficit may be tougher to achieve in a slowing growth environment

Government Finance (RM bn)	2008	2009	2010	2011F	2012F
Revenue	**160**	**159**	**160**	**183**	**187**
as a % of GDP	21.6	23.3	20.8	21.6	20.4
Direct Tax	82	78	79	96	102
Indirect Tax	31	28	31	33	34
Non-Tax Revenue	47	52	50	54	51
Expenditure	**196**	**206**	**203**	**229**	**233**
(as a % of GDP)	26.4	30.3	26.4	27	25.1
Operating Expenditure	154	157	152	180	182
Net Development Expenditure	42	49	51	49	51
Balance	**-36**	**-47**	**-43**	**-46**	**-46**
(as a % of GDP)	-4.8	-7	-5.6	-5.4	-4.7

Source: Ministry of Finance, GS Global ECS Research.

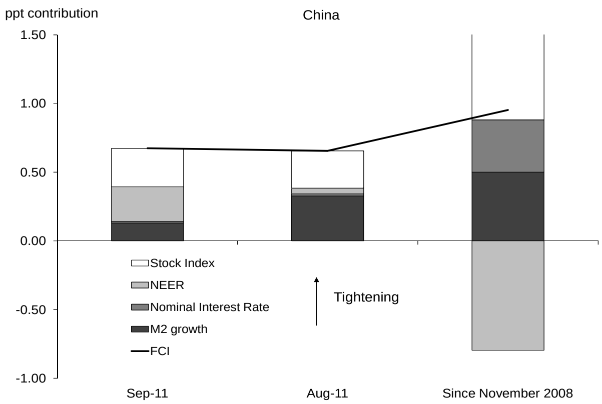
The ability to push through tougher reforms such as the GST and fuel subsidies reforms (likely only post elections) would be the clearest way to signal to investors the commitment to change. The tangible benefits are the freeing up of more "fiscal space" for spending on key areas of national development while the other arguably more important intangibles will be the gain in investors' confidence. The timing and extent to which the government is able to deliver on these key reforms will partly depend on the performance at the upcoming general elections, which we think could potentially occur early next year; which is something that we and the markets are watching closely.

Mark Tan

Appendix: FCI contribution charts for Asia ex Japan

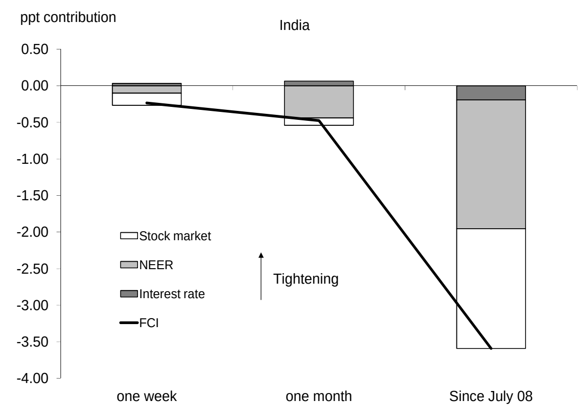
This section tracks the tightening of financial conditions in the region as measured by the Financial Conditions Index (FCI) that we have constructed for each country. The charts below show the contribution to the tightening/loosening of the FCI by the subcomponents of interest rates, nominal effective exchange rates (NEER) and equity markets (for more detail, please refer to *Financial conditions tightening in Asia—further policy responses needed to mitigate additional downside risks*, Asia Economics Flash, November 14, 2008).

China: The FCI tightened because of depressing stock market and stronger currency



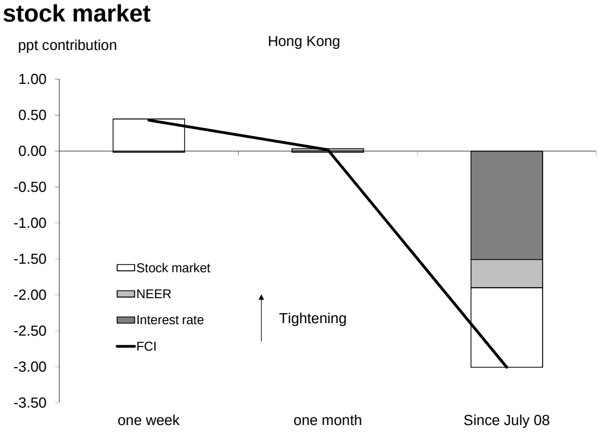
Source: Bloomberg, CEIC, GS Global ECS Research.

India: FCI loosened due to prosperous stock market



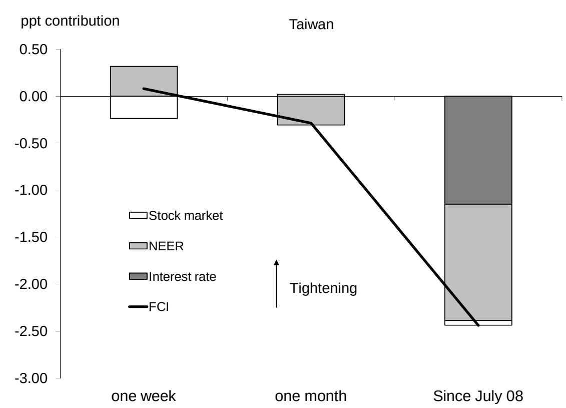
Source: Bloomberg, CEIC, GS Global ECS Research.

Hong Kong: FCI tightened due to the depressing stock market



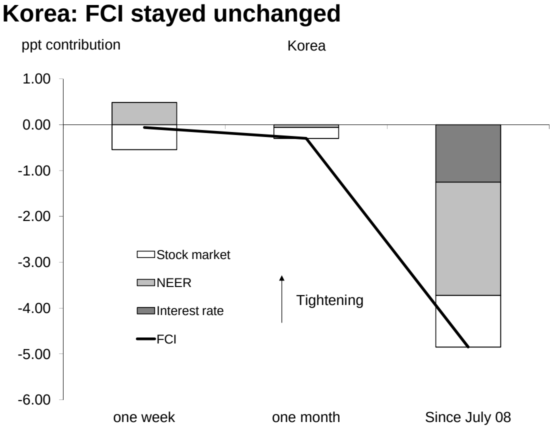
Source: Bloomberg, CEIC, GS Global ECS Research.

Taiwan: FCI tightened slightly on strong currency



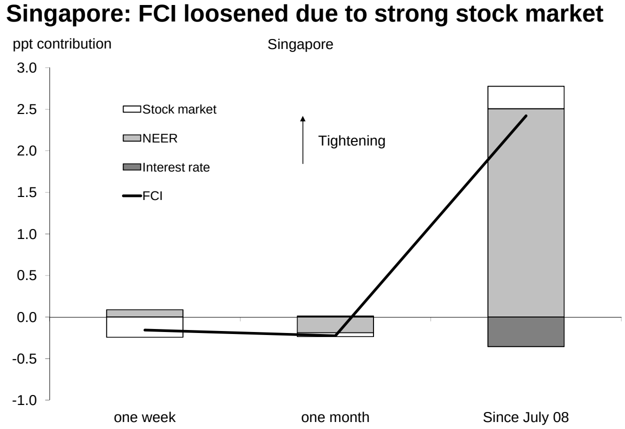
Source: Bloomberg, CEIC, GS Global ECS Research.

Korea: FCI stayed unchanged



Source: Bloomberg, CEIC, GS Global ECS Research.

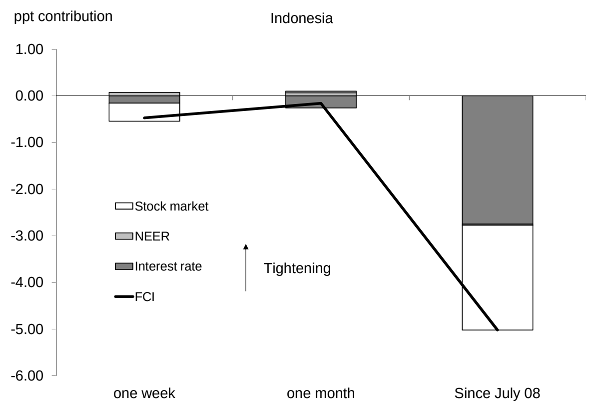
Singapore: FCI loosened due to strong stock market



Source: Bloomberg, CEIC, GS Global ECS Research.

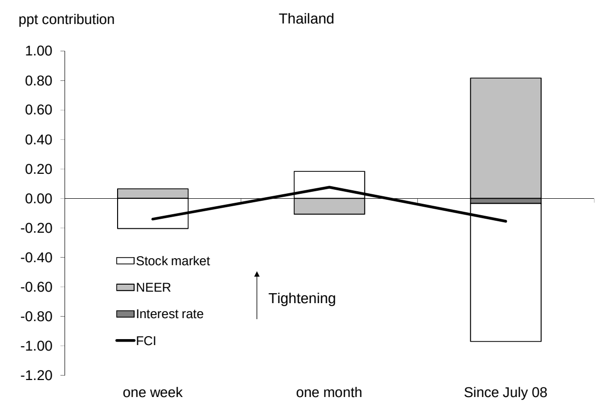
Appendix: FCI contribution charts for Asia ex Japan…continued

Indonesia: FCI loosened because of stronger stock market and weaker currency



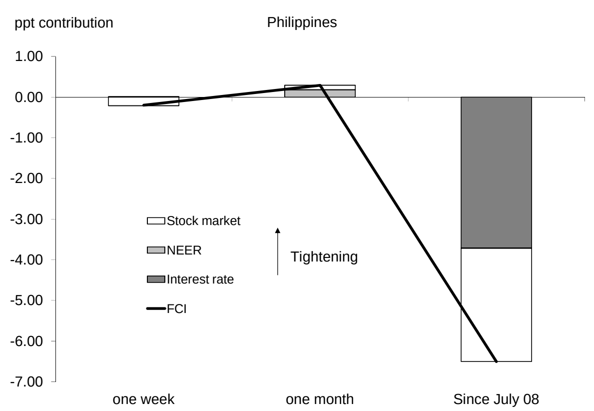
Source: Bloomberg, CEIC, GS Global ECS Research.

Thailand: FCI loosened on the prosperous stock market



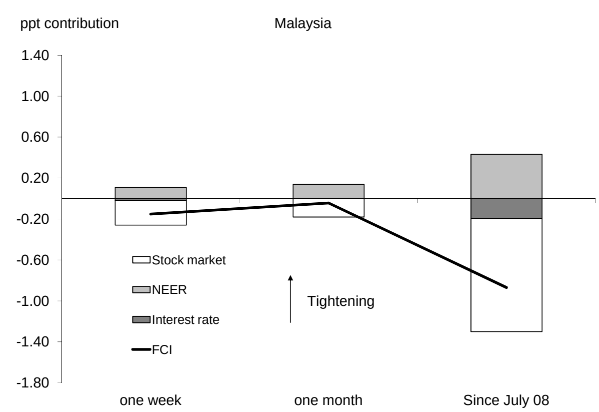
Source: Bloomberg, CEIC, GS Global ECS Research.

Philippines: FCI loosened slightly due to the recovering stock market



Source: Bloomberg, CEIC, GS Global ECS Research.

Malaysia: FCI loosened because of strong stock market

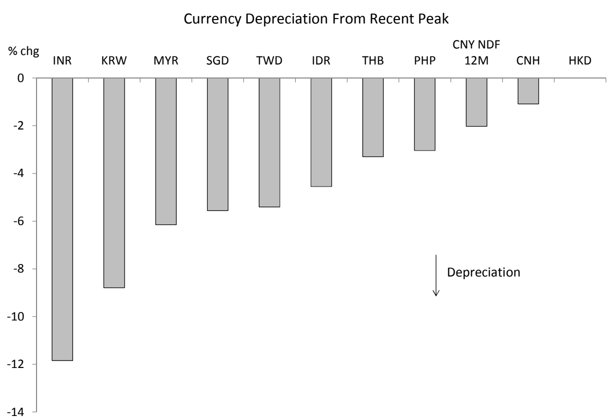


Source: Bloomberg, CEIC, GS Global ECS Research.

Regional Key Economic and Financial Indicators

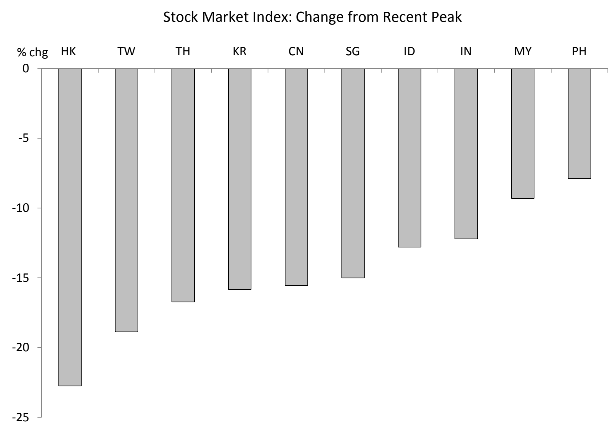
These are the key economics and financial indicators that we continue to keep a close eye on amidst the ongoing global financial crisis, as discussed in our Asia Economics Analyst 08/20 issue published on October 27, 2008. Going forward, we will continue to provide updates on these key metrics.

KRW & IDR have depreciated the most from the recent peak



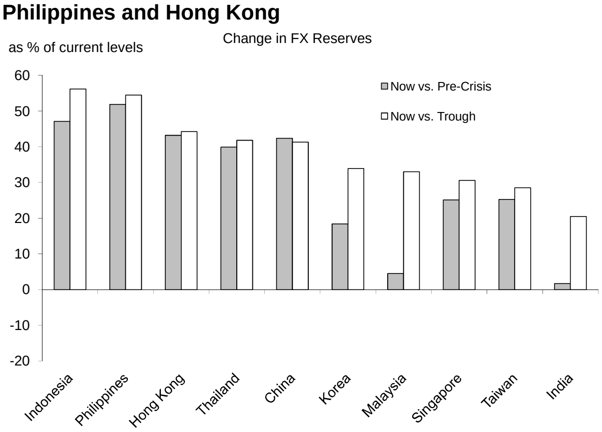
Note: USD spot rates. Recent strongest point selected from Jun 2011 till today.
Source: Bloomberg, GS Global ECS Research.

Equity markets have fallen the most in Taiwan and Hong Kong since the recent peak



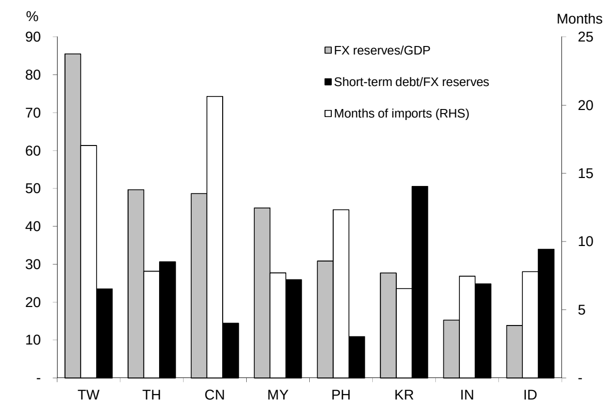
Note: Recent peak selected from Jun 2011 till today.
Source: Bloomberg, GS Global ECS Research.

Reserves have increased the most for Indonesia, the Philippines and Hong Kong



Note: Pre-crisis refers to July 1, 2008 levels. Trough selected from August 2008 onwards.
Source: CEIC, GS Global ECS Research.

Short-term debt: Korea still a touch more exposed than the others



Source: CEIC, GS Global ECS Research.

Short-term credit indicators have improved since peak stress days

%	Policy rate	3m bank borrowing	Short corp borrowing rate	3m T bills
China	6.56	5.6	6.56	3.16
Hong Kong	-	0.3	5.00	0.10
Singapore	-	0.4	4.25	0.26
Taiwan	1.875	0.4	2.86	0.40
Malaysia	3.00	3.3	6.60	2.93
Thailand	3.50	3.6	7.25	3.46
Korea	3.25	3.6	3.76	3.57
Philippines	6.50	2.6	7.81	2.54
India	8.25	9.1	11.00	8.55
Indonesia	6.50	5.9	12.00	6.37

Short bank rates: China: SHIBOR; Hong Kong: 3-month HIBOR, CEIC, Indonesia: 3-month JIBOR, Korea: 3-month certificate of deposit, Malaysia: 3-month KLIBOR, Philippines: 3-month PHIBOR, Singapore: 3-month SIBOR, Taiwan: 31-90 day commercial paper, Thailand: 3-month BIBOR, India: 3-month MIBOR.

Policy rates: China: 1-year lending rate, Indonesia: 1-month SBI rate, Korea: 7-day repo, Malaysia: overnight policy rate, Philippines: repo rate, Taiwan: rediscount rate, Thailand: 1-day repo, India: repo rate.

Short-term corporate borrowing rate: China: 1-year lending rate; India: Base LR, Korea: 6-month corp bond; Singapore: PLR, Malaysia: Base LR, Indonesia: Base LR; Thailand: Min LR; Taiwan: Base LR; Hong Kong: Best LR.

Source: Bloomberg, GS Global ECS Research.

External and fiscal stresses vary widely

	Current Account as % of GDP (2011F)	**Fiscal balance as % of GDP (2011F)**	**Total debt as % of GDP (2010)**	**Public debt as % of GDP (2010)**
China	4.7	-1.4	136.3	17.7
India	-3.5	-8.2	125.1	69.2
Korea	1.6	-0.6	111.8	30.9
Taiwan	8.1	-2.5	159.9	36.7
Singapore	17.2	-0.7	-	97.2
Malaysia	9.0	-5.4	168.9	54.2
Indonesia	0.2	-1.0	54.7	26.9
Thailand	5.1	-3.0	129.8	44.1
Philippines	3.5	-2.8	-	61.9

Note: Singapore fiscal number refers to primary balance.
Source: IMF, CEIC, GS Global ECS Research.

Statistical Appendix

Interest Rate Outlook

(%)		Current	3-Month Horizon		6-Month Horizon		12-Month Horizon	
		Oct 17	Forward	Forecast	Forward	Forecast	Forward	Forecast
Japan	3M	0.20	0.50	0.40	0.30	0.40	0.40	0.40
NJA								
ASEAN								
Indonesia	3M	5.88	6.38	7.14	6.42	7.14	6.56	7.14
Malaysia	3M	3.26	3.35	3.25	3.47	3.25	3.13	3.25
Philippines	3M	1.61	2.39	3.75	2.00	4.00	2.23	4.50
Thailand	3M	2.59	2.43	3.25	2.56	3.25	2.59	3.25
Singapore	3M	0.38	0.51	0.34	0.69	0.34	0.77	0.34
China	3M	3.16	NA	NA	NA	NA	NA	NA
India	3M	8.43	8.25	8.19	7.71	8.44	7.37	8.44
NIE								
Hong Kong	3M	0.28	0.48	0.40	0.59	0.40	1.19	0.50
Korea	3M	3.57	3.47	3.48	3.38	3.81	3.43	3.81
Taiwan	3M	0.81	1.07	0.92	0.81	1.04	0.89	1.23

Hong Kong: 3M HIBOR, CEIC, Bloomberg (GINAY91), **India:** 91D T-bill, **Indonesia:** 3M JIBOR, CEIC, **Korea:** 3M certificate of deposit, CEIC, **Malaysia:** 3M KLIBOR, CEIC, **Philippines:** 3M T-bill, CEIC, **Singapore:** 3M Interbank, CEIC, **Taiwan:** 61-90D New Taiwan dollar, Secondary, Bloomberg (NTSEC90), **Thailand:** 3M BIBOR, GS estimates, **China:** 3M PBOC Bill yield.

Exchange Rate Outlook

(Local per USD)	Current	3-Month Horizon		6-Month Horizon		12-Month Horizon	
	Oct 17	Forward	Forecast	Forward	Forecast	Forward	Forecast
Japan	76.8	76.7	77.0	76.6	76.0	76.2	74.0
NJA							
ASEAN							
Indonesia	8,880	8,953	8,800	9,075	8,700	9,320	8,600
Malaysia	3.12	3.13	3.12	3.14	3.08	3.16	3.04
Philippines	43.2	43.2	43.0	43.2	42.4	43.3	41.8
Thailand*	30.7	30.9	30.6	31.0	30.3	31.3	30.0
Singapore	1.27	1.27	1.28	1.27	1.26	1.27	1.24
China	6.38	6.39	6.27	6.39	6.21	6.40	6.09
India	49.1	49.8	47.5	50.2	47.0	50.8	46.0
NIE							
Hong Kong	7.78	7.77	7.80	7.76	7.80	7.75	7.80
Korea	1,153	1,159	1,100	1,163	1,070	1,165	1,037
Taiwan	30.1	30.0	29.6	29.9	29.0	29.6	28.5

* Forecasts are for onshore Thai baht.

Global Macroeconomic Outlook

					2010				2011				2012			
	2009	2010	2011E	2012E	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE	1QE	2QE	3QE	4QE
Real GDP Growth (% yoy)																
Advanced Economies	-3.8	2.8	1.5	1.2	2.4	3.1	3.3	2.7	2.0	1.4	1.4	1.2	1.1	1.2	1.2	1.4
United States	-3.5	3.0	1.7	1.4	2.2	3.3	3.5	3.1	2.2	1.6	1.6	1.3	1.3	1.4	1.2	1.6
Euroland	-4.2	1.7	1.6	0.1	0.9	2.0	2.0	2.0	2.4	1.6	1.4	1.0	0.1	0.0	0.0	0.3
Japan	-6.3	4.0	-0.6	2.2	5.7	3.1	5.0	2.2	-1.0	-1.1	-1.0	0.1	1.8	2.9	2.2	1.9
CPI Inflation (% yoy, avg.)																
Advanced Economies	0.1	1.5	2.7	1.8	1.6	1.5	1.3	1.6	2.2	2.8	2.9	2.7	2.1	1.7	1.6	1.7
United States	-0.3	1.6	3.2	2.2	2.4	1.8	1.2	1.2	2.2	3.3	3.7	3.5	2.7	2.2	1.9	1.9
Euroland	0.3	1.6	2.6	1.4	1.1	1.6	1.7	2.0	2.5	2.8	2.7	2.4	1.8	1.1	1.3	1.5
Japan	-1.3	-0.7	0.1	0.1	-1.2	-0.9	-0.8	0.1	0.0	0.3	0.1	-0.1	0.0	0.1	0.1	0.3
Interest Rates (% p.a. eop.)																
Fed funds	0.12	0.18	0.10	0.10	0.14	0.09	0.08	0.18	0.14	0.09	0.08	0.10	0.10	0.10	0.10	0.10
UST 10-year	3.84	3.31	2.25	2.75	3.83	2.94	2.51	3.31	3.45	3.16	1.93	2.25	2.25	2.50	2.50	2.75
Euro 3m interest rate	0.72	1.02	1.15	1.20	0.66	0.69	0.88	1.02	1.10	1.25	1.65	1.15	1.18	1.18	1.20	1.20
Exchange Rates (eop.)																
USD/EUR	1.39	1.33	1.40	1.53	1.38	1.27	1.29	1.36	1.37	1.44	1.36	1.44	1.50	1.53	1.55	1.55
JPY/USD	93.5	87.8	79.8	74.8	90.7	92.0	85.9	82.6	82.3	81.6	78.3	77.0	76.0	75.0	74.1	74.0
WTI Oil (average $)	61.9	79.7	104.9	120.0	77.4	79.4	77.0	85.2	94.6	102.3	108.0	110.0	115.0	120.0	120.0	125.0

Central Bank Watch

Country	Likely Decision / Reasons	Date of Next Policy Meeting
UNITED STATES	The Federal Reserve cut the Fed Funds rate to a range of 0%-0.25% on December 16, 2008. We expect the Fed to keep the funds rate near 0% through the end of 2012.	November 2
JAPAN	The Bank of Japan lowered the overnight call rate to a range of 0%-0.10% on October 5, 2010. We expect the Bank of Japan to keep the current extremely easy policy stance through the end of 2012.	October 27
EUROLAND	The European Central Bank raised its policy rate by 25 bp to 1.50% on July 7, 2011. We expect the European Central Bank to cut the policy rate by 50 bp in December.	November 3
KOREA	The Bank of Korea kept the 7-day repo rate on hold at 3.25% on October 13, 2011. We now expect the rate hike cycle to be over amid the weakening growth outlook and heightened external uncertainties.	November 11
INDIA	The Reserve Bank of India hiked both the repo and reverse repo rates by 25 bp to 8.25% and 7.25% respectively on September 16, 2011. We now expect the Reserve Bank of India to hike rates by 25 bp on October 25 in a close decision.	October 25

Main Economic Indicators

	GDP						Inflation					
	2009	2010	2011E	2012E	Latest	(yoy)	2009	2010	2011E	2012E	Latest (yoy)	
Pan Asia*	5.2	8.4	6.1	6.3	6.2	(2Q)	0.5	3.6	4.8	3.0	5.4	(Aug)
NIE + ASEAN-5	0.2	7.6	4.6	3.9	4.4	(2Q)	1.9	3.1	4.2	3.4	4.3	(Aug)
ASEAN-5	1.2	7.6	5.0	4.3	4.8	(2Q)	2.3	3.8	4.7	4.1	4.5	(Aug)
Indonesia	4.6	6.1	6.2	5.2	6.5	(2Q)	4.8	5.1	5.5	5.2	4.6	(Sep)
Malaysia	(1.6)	7.2	4.6	4.2	4.0	(2Q)	0.6	1.7	3.2	2.6	3.3	(Aug)
Philippines	1.1	7.6	4.4	4.0	3.4	(2Q)	3.2	3.8	5.0	3.7	4.6	(Sep)
Thailand	(2.3)	7.8	3.8	3.6	2.6	(2Q)	(0.9)	3.3	3.8	3.6	4.0	(Sep)
Singapore	(0.8)	14.5	4.6	3.2	5.9	(3Q)	0.6	2.8	5.0	3.2	5.7	(Aug)
Japan	(1.4)	4.0	(0.6)	2.2	(1.0)	(2Q)	(1.4)	(0.7)	0.1	0.1	0.2	(Aug)
China	9.2	10.4	9.1	8.6	9.1	(3Q)	(0.7)	3.3	5.5	3.2	6.1	(Sep)
India (FY Basis)	7.9	8.4	7.0	7.4	7.7	(2Q)	3.8	9.6	8.6	5.1	9.7	(Sep)
NIE	(0.8)	7.6	4.1	3.4	4.1	(2Q)	1.4	2.3	3.7	2.8	4.1	(Aug)
Hong Kong	(2.7)	6.8	5.2	3.8	5.1	(2Q)	0.6	2.4	5.3	3.8	5.7	(Aug)
Korea	0.3	6.2	3.7	3.4	3.4	(2Q)	2.8	3.0	4.4	3.3	4.3	(Sep)
Taiwan	(1.9)	10.8	4.4	3.2	5.0	(2Q)	(0.9)	1.0	1.5	1.5	1.4	(Sep)

	3 M Interest Rates					Exchange Rates				
ASEAN-5										
Indonesia	7.1	6.6	7.1	7.1	5.9	9400	8991	8800	8600	8880
Malaysia	2.2	3.0	3.3	3.3	3.3	3.42	3.08	3.12	3.04	3.12
Philippines	3.9	0.8	2.7	2.7	1.6	46.4	43.9	40.8	40.3	43.2
Thailand	1.4	2.2	3.9	3.9	2.6	33.3	30.2	30.6	30.0	30.7
Singapore	0.7	0.4	0.3	0.3	0.4	1.40	1.29	1.28	1.24	1.27
Japan	0.5	0.4	0.4	0.4	0.2	93.5	87.8	79.8	74.8	76.8
China	—	—	—	—	—	6.83	6.62	6.27	6.03	6.38
India (FY basis)	4.4	7.3	8.4	7.4	8.4	45.1	44.7	47.0	46.0	49.1
NIE										
Hong Kong	0.1	0.3	0.3	0.5	0.3	7.76	7.77	7.80	7.80	7.78
Korea	2.9	2.8	3.7	3.7	3.6	1168	1139	1060	1010	1153
Taiwan	0.4	0.7	0.8	0.8	0.8	32.0	30.4	29.6	28.5	30.1

*Pan Asia includes India.

GDP and inflation are annual averages. Interest rates and exchange rates refer to end-period. Figures in bold indicate recent revisions.

Hong Kong: 3M HIBOR, CEIC, Bloomberg (GINAY91), **Indonesia**: 3M JIBOR, CEIC, **Korea**: 3M certificate of deposit, CEIC, **Malaysia**: 3M KLIBOR, CEIC, **Philippines**: 3M T-bill, CEIC, **Singapore**: 3M Interbank, CEIC, **Taiwan**: 61-90D New Taiwan dollar, Secondary, Bloomberg (NTSEC90), **Thailand**: 3M BIBOR, CEIC. **India:** 91 D T-bill

Asia in a Nutshell

	Present Situation	Key Issues
CHINA	China's 3Q2011 GDP growth moderated to 9.1% yoy, down from 9.5% yoy in 2Q2011. The National Bureau of Statistics estimated sequential GDP growth moderated to 2.3% from 2.4% (or 9.1% and 9.5% annualized). However, our own estimates suggest sequential growth strengthened to 8.5% qoq s.a. ann., up from 8.3% qoq s.a. ann. in 2Q2011. September IP yoy growth rose to 13.8% yoy, up from 13.5% yoy in August. This implies a sequential growth of 17.9% mom s.a. ann. in September. Nominal retail sales growth rose to 17.7% yoy in September, up from 17.0% yoy in August. Real retail sales growth rose to 11.0% yoy, up from 10.4% yoy in August. This implies a sequential growth of 22.2% mom s.a. ann., up from 12.2% mom s.a. ann. in August.	The stronger-than-expected September activity data tend to alleviate the concerns policy makers have on the slowing economy and therefore keep the tightening bias for longer. However, 1) we expect external demand growth to weaken in 4Q2011 which tends to raise downside pressures on activity growth; and 2) inflation to show a meaningful fall in 4Q2011 towards the below 5% level. As a result, we believe the policy stance is likely to see some relaxation in the coming months (the exact timing and magnitude of the relaxation will be to a very large extent depend on external demand as it has a much higher level of uncertainty compared with CPI inflation despite the obvious importance of the latter).
HONG KONG	Hong Kong 2Q2011 GDP expanded by 5.1% yoy, after growing 7.5% yoy in 1Q2011. On a sequential basis, GDP growth declined 2.0% qoq; annualized (ann.), after expanding 13.0% qoq. ann. in 1Q2011. Private consumption, which makes up more than 60% of total GDP increased 9.2% yoy, compared to 8.0% yoy growth in 1Q2011. Meanwhile, fixed investment expanded 8.1% yoy compared to a decline of 0.3% yoy in 1Q2011. On the trade side, growth in goods exports decelerated to 0.3% yoy, from 16.8% yoy in the previous quarter.	We maintain our GDP growth forecast for 2011 at 5.2% but have revised our 2012 forecast downwards to 3.8% from 5.1% previously. We estimate that Hong Kong has a fairly high sensitivity to changes in global growth. We believe the HKD-USD peg is likely to remain in place for some time, given the lack of a better alternative monetary policy regime for now. Our core view remains that accommodative financial conditions, a continued improvement in the labor market and steady growth in China should continue to support growth.
INDIA	April-June real GDP growth came in at 7.7% yoy, a tad below the 7.8% yoy growth registered in the previous quarter. India's Industrial Production Index (IP) growth rose to 4.1% yoy in August from 3.8% yoy (revised from 3.3% yoy) in July. Sequentially, IP declined by 0.9%, mom s.a. in August similar to the fall of 1.0%, mom s.a in July. On qoq; s.a. basis, the growth trend remained similarly weak. On inflation front, India's September WPI inflation came in at 9.7% yoy, a tad lower than the 9.8% yoy in August. This was in line with the Bloomberg consensus and a tad below our expectation of 9.8% yoy.	We now expect the RBI to hike by 25 bp on October 25. We had put our rate call under review after the September inflation print of 9.7%. Hawkish commentary from the RBI highlighting headline yoy inflation as still too high for comfort, elevated inflationary expectations, and no change in the policy stance suggests to us that the RBI may not be ready for a pause in its aggressive rate tightening cycle. If the RBI hikes on October 25, we think it will tighten financial conditions further, put upside pressure on government bond yields, and create downside risks to our 7% GDP growth forecast for FY12.
INDONESIA	Indonesia's 2Q2011 real GDP growth came in at 6.5% yoy. On a sequential basis, GDP grew 6.6% qoq; seasonally-adjusted; annualized in 2Q2011, up from 3.9% qoq; annualized growth in the previous quarter. Indonesia's September headline CPI inflation eased to 4.61% yoy versus 4.79% yoy in August. On a month-on-month basis, headline CPI inflation eased to 0.27%, versus 0.93% in August. Core CPI inflation moderated to 4.93% yoy in September from 5.15% yoy in August. In a move widely unexpected, BI cut rates by 25 bp to 6.50% in its October meeting.	We have lowered our GDP growth forecast for 2012 to 5.2% from 6.2% mainly on the back of a global growth downgrade in US and Europe. We continue to forecast CPI inflation for this year at 5.5%, within BI's target of 4%-6%. We now see reduced inflationary pressures into next year on the back of slower activity and lower global commodity prices than expected previously—we lower our CPI forecast for 2012 to 5.2% from 6% previously. With increased risks to the growth outlook and a possible reduction in inflationary pressures, our forecast is for BI to cut rates by another 50 bp-25 bp this year and 25 bp in 1Q2012.
KOREA	Korea's exports in September slowed but were above expectations and the underlying growth remained strong. Exports rose 19.6% yoy, while non-ship exports per day, a better proxy for underlying demand, were stronger than the headline, rising 26.5% yoy. September Headline CPI inflation fell sharply to 4.3% yoy, from 5.3% yoy in August. Sequentially, headline inflation was up only 0.1% mom, a sharp deceleration from the 0.9% mom in August while core inflation rose 0.2% mom from 0.3% mom in August. Core inflation fell from a peak of 4.0% yoy in August to 3.9% yoy in September, the first decline since April, although it remained unchanged at 1.1% on a seasonally-adjusted; quarter-on-quarter basis.	We think that the rate hike cycle is over, given a weakening global outlook. We have downgraded our 2012 global growth forecast to 3.5% yoy from 4.2% yoy, mainly on a stagnating Europe. Given the weakening global backdrop, we have revised down our Korean growth forecast to 3.4% for 2012 from 4.2% and to 3.7% from 4.2% for 2011. On the policy rate, we do not expect any rate cuts since the current rate remains accommodative and inflation pressure is likely to stay for a while given a recent fall in the KRW and pent-up pressure for administered prices including electricity, natural gas and public transportation tariffs. Our revised inflation forecast for 2011 is 4.4% and 3.3% for 2012.

Asia in a Nutshell (Cont'd)

	Present Situation	Key Issues
MALAYSIA	Malaysia 2Q2011 real GDP growth came in at 4.0% yoy, moderating from 4.9% yoy in 1Q2011. We estimate that on a sequential basis, GDP expanded by 3.7% qoq; seasonally-adjusted; annualized (s.a. ann.), after the 5.9% qoq s.a. ann. expansion in 1Q2011. Meanwhile, the latest August CPI inflation also printed 3.3% yoy, down from 3.4% yoy in July. This was in line with ours and the Bloomberg consensus expectation of 3.5% yoy. An increased risk to the global outlook has raised the downside risks for the domestic economy.	We have lowered our 2011 and 2012 GDP growth forecasts to 4.6% and 4.2% respectively from 5.0% and 5.2% previously. The main sources of downgrades stem from the external slowdown in Malaysia's largest export markets of US, EU and China. As a result of slower activity growth than previously assumed, we have also lowered our CPI forecasts for 2012 to 2.6% from 3.2% previously. Consequently, we also expect BNM to now remain on hold through 2012, versus our previous forecast of a 25-bp hike next year.
PHILIPPINES	Philippines August CPI inflation came in at 4.7% yoy, down from 5.1% yoy in July (based on 2006 prices). Based on 2000 prices, CPI increased 4.3% yoy, compared to 4.6% yoy previously. The Philippines' exports posted a sharp decline of 15.1% yoy in August, after falling 1.7% yoy in July. This marks the largest yoy fall since September 2009. The Philippines' Overseas Foreign Workers' remittances growth accelerated to 11.1% yoy in August, up from 6.1% yoy in July. Sequentially, remittances grew 4.0% mom (seasonally adjusted), after growing 1.2% mom in July. In value terms, remittances decreased to a level of US$ 1.67 billion.	We have lowered our 2011 and 2012 GDP growth forecasts to 4.4% and 4.0% respectively from 5.0% and 5.2% previously. The external performance of the Philippines has disappointed so far this year. Our recent growth downgrades, notably in Europe and in China, adds further risks to external sector growth in the rest of 2011, and throughout 2012. On the monetary policy front, we now expect the central bank to keep rates on hold through 2012, versus our previous expectation of another 50 bp of hikes. Benign inflation dynamics provides room for the central bank to maintain a more accommodative monetary stance.
SINGAPORE	Singapore's advanced 3Q2011 GDP growth was better than expected at 1.3% qoq; s.a. ann. and +5.9% yoy. Our estimate was for a decline of 3.6% qoq; s.a. ann. and +4.5% yoy. In October MAS meeting, the central bank announced that they would reduce the slope of the SGD trading bands, but keep their modest upward crawl intact. For the full year, the MAS expects GDP growth to be around 5% in 2011 and 2.5%-3.5% in 2012. Given the weak external outlook, the prospects for growth in Singapore's major trading partners have deteriorated. The MAS expects that the slowdown in global demand will see core inflation ease to about 1.5%-2% in 2012, compared to about 2.1% in 2011.	We have recently lowered our 2011 and 2012 GDP growth forecasts to 4.6% and 3.2% respectively from 4.8% and 5.0% previously. The downgrades stem mainly from increased downside risks to the external outlook as reflected in our growth downgrades in the US, EU and China. We have revised up our 2011 CPI forecast to 5.0% from 4.4% as the interest rate sensitive sectors of housing and accommodation continue to underpin inflationary pressures.
TAIWAN	Taiwan's export growth came in at 9.9% yoy in September, compared to 7.2% yoy in August. On a mom, seasonally-adjusted basis, exports increased 4.5% in September, after a sharp fall of 7.4% in August. Imports increased 10.8% yoy in September, after rising 6.4% yoy in August. This implies a trade surplus of US$1.78 billion, compared to US$2.63 billion in August. Taiwan's August headline CPI inflation came in 1.34% yoy, slightly higher than the 1.32% yoy print in the previous month. On a seasonally-adjusted basis, the CPI stayed roughly unchanged from July, compared to the 0.1% mom increase in the past several months.	We have revised our GDP growth forecasts to 4.4% and 3.2% for 2011 and 2012 respectively, down from 4.7% yoy and 4.6% previously. The main driver to the change is the weaker activity momentum recently, especially in the external sector. The weaker external outlook for 4Q2011 and also increased concerns on the European sovereign debt crisis have also weighed on consumer and business sentiments. We believe Taiwan remains very vulnerable to the global cycle, since monetary policy transmission to the economy is rather ineffective in the current environment, and domestic investment is likely to remain depressed.
THAILAND	Thailand's 2Q2011 real GDP growth moderated to 2.6% yoy, after expanding a revised 3.2% yoy in 1Q2011. On a sequential basis, real GDP dipped 0.2% qoq (0.8% annualized); seasonally adjusted in 2Q2011 from 2% qoq (8.1% annualized growth) in 1Q2011. Thailand's September headline CPI inflation came in at 4.03% yoy, below the 4.29% yoy in August. The lower headline inflation was in part due to the lowering of retail fuel prices as a result of the removal of Oil Fund tax levies. Core CPI inflation, which the central bank targets with a range of 0.5%-3.0%, crept up to 2.92% yoy from 2.85% yoy in August. As expected, the BOT left rates unchanged at 3.50% in its October meeting.	Thailand has been grappling with its ongoing flood crisis, with the estimated damages rising in recent weeks as the floodwaters reached several major industrial estates. The flood damages will lower Thailand's 2011 annual GDP growth figures, with official estimates centering around 1 percentage point off this year's growth. Our own GDP forecast is currently at 3.8% for this year and we would be reviewing our 2011 GDP growth figures upon greater clarity on the impact of the floods.

We, Tushar Poddar, Mark Tan, Shirla Sum, Prakriti Shukla and Vishal Vaibhaw, hereby certify that all of the views expressed in this report accurately reflect personal views, which have not been influenced by considerations of the firm's business or client relationships.

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Key Things to Watch

<table>
<tr><td colspan="2">In India, we expect the Reserve Bank of India to hike rates by 25 bp on still high September inflation and hawkish comments from the central bank. In Korea, we revise down our GDP growth forecast for 3Q2011 and expect inflation to moderate in October. We are looking for Hong Kong's CPI inflation to ease slightly from August levels while Singapore's inflation is likely to inch up in September. In the US, we expect 3Q2011 GDP to come in at 2.5% but going forward, however, we expect the pace of growth to slowdown to a 0.5%-1% over the next two quarters.</td></tr>
<tr><td>India
Central bank policy meeting (Oct 25)
Trade (Sep) (Nov 1)</td><td>The central bank to hike rates
▪ We now expect the Reserve Bank of India to hike by 25 bp on October 25. We had put our rate call under review after the September inflation print of 9.7%.
▪ Hawkish commentary from the central bank highlighting headline yoy inflation as still too high for comfort, elevated inflationary expectations, and no change in the policy stance suggests to us that it may not be ready for a pause in its aggressive rate tightening cycle.</td></tr>
<tr><td>Korea
GDP (3Q) (Oct 27)
Industrial production (Sep) (Oct 31)
CPI (Oct) (Nov 1)
Trade (Oct) (Nov 1)</td><td>GDP growth to moderate in 3Q2011
▪ Given the weakening global backdrop, we have revised down our Korean GDP growth forecast to 3.6% from 4.1% for 3Q2011. The economy should show moderation but still solid growth thanks to the still strong exports and domestic demand.
▪ Industrial production fell further in August, sequentially, on sustained weakness in tech and a dip in autos. We expect the overall outlook to weaken in the coming months although not as weak as in late-2008.
▪ We expect CPI inflation to moderate to 4.2% yoy in October. That said, inflation moderation is likely to be slow in coming months due to the recent KRW depreciation and pent-up pressure for administered prices including electricity, natural gas and public transportation tariffs.
▪ September exports slowed were but better than expected, on strong non-ship exports and emerging markets demand. We continue to expect slowing growth momentum but positive growth unlike in late-2008.</td></tr>
<tr><td>Hong Kong
CPI (Sep) (Oct 21)
RMB deposits (Sep) (Oct 31)
Retail sales (Sep) (Nov 1)</td><td>CPI inflation to ease slightly
▪ We expect September headline CPI inflation to moderate slightly to 5.5% yoy, down from 5.7% yoy in August and the three-year peak of 7.9% yoy in July. The consensus forecast is at 5.4% yoy.</td></tr>
<tr><td>Singapore
CPI (Sep) (Oct 24)
Industrial production (Sep) (Oct 25)</td><td>Inflation to likely inch up
▪ We expect September CPI Inflation to come in at 5.8% yoy, up from 5.7% yoy in August. The consensus forecast is at 5.7% yoy.</td></tr>
<tr><td>US
Durable goods orders (Sep) (Oct 26)
GDP (3Q) (Oct 27)
ISM (Oct) (Nov 1)
FOMC rate decision (Nov 3)</td><td>3Q2011 GDP to pick up from 2Q2011
▪ We forecast GDP growth of 2.5% in 3Q2011, up from 1.3% in 2Q2011. Incoming data have mostly surprised to the upside over the last month. In particular, the employment and ISM reports for September beat expectations and are consistent with trend-like growth in the economy.
▪ Going forward, however, we expect a slowdown to a 0.5%-1% GDP growth pace over the next two quarters.</td></tr>
</table>

Additional things to watch: **China PMI (Oct)** (Nov 1), **Taiwan industrial production (Sep)** (Oct 24); **advance GDP (3Q)** (Oct 31), **Indonesia CPI (Oct)** (Nov 1); **Thailand CPI (Oct)** (Nov 1), **Malaysia CPI (Sep)** (Oct 21).