

ECONOMICS: ASIAN PERSPECTIVES—MARCH 5, 2010

Asia's 2010 Outlook: Strong Growth and Tame Inflation Reduce Risks of Policy Shock

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As the first quarter of 2010 enters its final month, economic data show Asia's recovery remains robust and broadly based. Inflation is less of a risk than generally thought, providing room for some central banks to delay raising interest rates. Below, we update our assessment of the economic and policy outlook.

Growth Forecasts

We have raised our forecast for Japan's GDP this year from 1.9% to 2.3%, and have also lifted our projection for Asia's (excluding Japan) growth to 8% from 7.7% (**Display 1**). Our confidence in the strength of the region's recovery has been reinforced by the upside surprises in fourth-quarter GDP data in Japan, Singapore, Taiwan, Thailand, Hong Kong and Malaysia. The better-than-expected figures not only reflect each country's strong growth momentum, they also set a higher starting point for year-on-year growth in 2010. Indeed, industrial production and export momentum have remained healthy during the first two months of this year, and some leading indicators—such as Taiwan's export orders and Korea's business expectations—point to continuing firmness of activity in the second quarter.

One major downside surprise was India's weaker-than-expected fourth-quarter GDP growth, which increased 6% year on year compared with the consensus forecast of

6.9% and 7.9% in the third quarter. The slower pace, however, was mainly the result of the government's scaling-back of spending and the drought-induced slowdown in agricultural output. Excluding agriculture, the economy's underlying growth remains impressive, with a further pickup in manufacturing production and continuing strength in construction activity. As agricultural production normalizes, and as manufacturing production picks up even more—as indicated by the revival in India's Purchasing Managers' Index (PMI)—we expect GDP growth to resume this quarter. Consequently our full-year forecast of 7.8% remains unchanged.

Similarly, the relatively big dip in China's official PMI to 52 in February from 55.8 in January did not, in our view, signal a marked deceleration in growth momentum. Instead, the change reflected the usual lack of seasonal adjustment due to the Chinese New Year. We suspect that this year's relatively pronounced slowdown in the PMI should have been affected by the exceptionally bad weather conditions

Display 1
Strong Cyclical Recovery

Growth and Inflation Forecasts

	Real GDP Growth		
	2008	2009F	2010F
China	9.6	8.7	10.2
Hong Kong	2.5	(2.7)	5.8
India	7.8	6.9	7.8
Indonesia	6.1	4.5	6.0
Korea	2.5	0.2	5.4
Malaysia	4.1	(1.7)	5.4
Philippines	4.6	0.9	3.1
Singapore	1.2	(2.0)	5.5
Taiwan	0.1	(1.9)	6.4
Thailand	2.6	(2.2)	4.8
Asia ex Japan	6.7	5.0	8.0
Japan	(1.2)	(5.0)	2.3

	Headline Inflation		
	2008	2009F	2010F
China	6.0	(0.7)	3.5
Hong Kong	4.3	0.5	2.8
India	9.2	1.3	5.5
Indonesia	9.8	4.8	5.0
Korea	4.6	2.7	3.0
Malaysia	5.5	0.6	3.0
Philippines	9.4	3.3	4.5
Singapore	6.5	0.3	2.5
Taiwan	3.5	(0.9)	2.2
Thailand	5.5	(1.0)	2.5
Asia ex Japan	6.4	0.5	3.7
Japan	1.4	(1.4)	(0.8)

Source: CEIC Data and AllianceBernstein forecasts

in early 2010. We expect PMI growth to resume after the Chinese New Year; with preemptive policy tightening, however, GDP growth is expected to moderate from around 11% year on year in the first half to 9.5% year on year in the second half. For full year 2010, we maintain our projection of 10.2%.

Japan's Cyclical Recovery

Our main reason for increasing our 2010 GDP forecast for Japan was the higher base in fourth quarter 2009. External factors will continue to drive growth as a further recovery in exports supports industrial production, leading to a pickup in capital expenditure as manufacturers upgrade equipment and expand capacity. We expect private consumption to weaken from the first quarter onwards, however, as the effect of tax concessions on household spending starts to fade. Moreover, the new administration's partial budget squeeze will curb growth in public works.

The bottom line is that Japan's economy lacks a structural improvement in growth to lift it out of its deflationary spiral, and the current cyclical recovery, while firmer than expected, will still be insufficient to close the massive negative GDP gap (about 4%–5% below potential GDP). On this basis, we maintain our forecast for 2010 Consumer Price Index (CPI) at –0.8%.

We have raised our six-month forecast for the yield on 10-year Japanese government bonds (JGBs) by a modest 10 basis points to 1.6% (the yield is currently 1.32%), factoring in the likelihood that the Bank of Japan (BoJ) will come under pressure from the government to adopt some form of inflation-targeting policy. We think this is unlikely to occur any time soon, however, as the central bank will resist such a fundamental shift in policy. Central to our view, a half-hearted move by the BoJ will gain little policy credibility and its impact will be no more than a temporary effect on the yield curve. Generally speaking, a shift to inflation targeting would be negative for both JGBs and yen. On the latter, we maintain our six-month forecast at 95 against the greenback.

Non-Japan Asia's Policy Outlook

For non-Japan Asia, we continue to forecast 3.7% inflation for 2010, against 0.5% in 2009. Recent trends across the region have reinforced our relatively benign inflation outlook for the year.

Display 2

Normalization of Interest-Rate Cycle

Policy Rate Forecasts

	Policy Rates	Forecast (%)		
		March 4, 2010	6 Months	12 months
China	1-Year Working Capital Loan	5.31	5.85	6.39
Hong Kong	Base Rate	0.50	1.00	1.50
India	Overnight Repo Rate	4.75	5.50	6.00
Indonesia	1-Month SBI Rate	6.50	7.25	7.75
Korea	1-Week Repo rate	2.00	2.50	3.00
Malaysia	Overnight Policy Rate	2.25	2.75	3.00
Philippines	Reverse Repo Rate	4.00	4.50	5.00
Taiwan	Official Discount Rate	1.25	1.75	2.25
Thailand	Overnight Repo Rate	1.25	1.75	2.25

Source: Bloomberg and AllianceBernstein forecasts

The Hawkish Cases

The biggest surprise to have occurred since January, when we published our first assessment of the region's 2010 outlook, is that Malaysia has led the region's rate-tightening cycle—by raising its policy rate by 25 basis points to 2.25% this week. Bank Negara Malaysia (BNM) Governor Tan Sri Dr Zeti Akhtar Aziz had spoken about the need for interest-rate normalization, but we were among those who did not think the statement actually meant an imminent rate increase. In our view, there is simply no strong economic reason for Malaysia to be so preemptive given that its nonfood CPI is running at a mere 1.4% year on year in January (compared with 6%–7% year on year before the global crisis), and its economic recovery still lacks support from private sector demand and lags that of its regional peers. We think BNM will increase rates by another 75 basis points before the end of the year and that the required tightening will be relatively modest (**Display 2**).

In India, the 2010–2011 budget targeted a reduction in the fiscal deficit to 5.5% of GDP from the previous year's 6.9%. The fiscal plan will be only mildly contractionary but the planned increase in fuel prices, excises and duties will immediately exacerbate cost-push inflationary pressures. Fuel subsidies—a key policy issue—were left untouched, but the

government said that it would review them in the next few weeks. Overall, the budget will increase pressure on the Reserve Bank of India to stay ahead of the tightening curve. We expect the central bank will further raise the cash reserve requirement and start raising the overnight repo rate by 25–50 basis points at its next policy meeting on April 29.

The People's Bank of China (PBOC) raised banks' reserve requirement ratio (RRR) by 50 basis points (to 16.5% for large banks) in February following January's 50 basis point increase. The direction of the move was certainly predictable, but the move came earlier than most people had expected. China, once again, has surprised the market with a preemptive strike. The consecutive RRR increases reflect the authorities' effort, in response to the origination of another heroic volume of new loans in January (RMB1.39 trillion), to curb banks' ability to expand their loan books. This is part of China's quantitative money-control strategy to achieve its target of RMB7.5 trillion of new loans for this year.

In the absence of an influx of hot money, we think a total RRR increase of 250–300 basis points should be a reasonable forecast for the year (that is, a further increase of 150–200 basis points). Recall that during the tightening cycle in

2007–2008 when China suffered from rampant speculative inflows, the PBOC was forced to increase the RRR by 800 basis points cumulatively. Given this history, our base-case scenario assumes that China can effectively manage market expectations regarding the extent of renminbi appreciation, and so prevent the inflow of speculative funds from turning into an inundation. Finally, we think an official lending-rate hike will come sooner than the market expects, probably before the end of the first quarter or early in the second quarter at the latest.

The Dovish Cases

At its policy meeting this week, the Indonesian central bank left the policy rate unchanged at 6.5% as widely expected. With the government's announcement that there will be no administrative fuel price increases before mid-year, however, and the monetary authority's well-publicized aim of pushing up credit growth to

17%–20% in 2010, we see a risk that Indonesia's first interest rate increase will be pushed out to the third quarter. We had expected it in the second.

Importantly, we are encouraged by the continuing tameness of core CPI which eased further to 3.9% year on year in February. Compared with the core inflation of 6%–7% year on year seen in previous economic expansions, the underlying inflation in the current cycle has been surprisingly benign. This may suggest that reduced economic bottlenecks, increased productivity, etc. have begun to result in a fall in the country's structural inflation. If this is the case, the economic implications are far-reaching and should, in the near term, constrain the upside risk of interest-rate tightening.

In Singapore, inflation risk remains remote (CPI increased 0.2% year on year in January) even though the low-base bounce

has turned the CPI from deflation to inflation. The government has just cut its 2010 inflation forecast by 50 basis points to 2%–3% (more in line with our projection), which makes a change in the Monetary Authority of Singapore's exchange-rate policy (to a gradual-appreciation stance from the current zero appreciation) increasingly unlikely at the April policy review meeting. This suggests that the appreciation in the Singapore dollar will be more modest than expected.

Similarly, Korea's headline inflation (up 2.7% year on year in February) remains comfortably within the Bank of Korea's (BOK) target zone of 2%–4% and, more importantly, core CPI continues to slow, reaching 1.9% year on year compared with the peak of 5.6% year on year 14 months earlier. In our view, this gives the government a stronger case with which to pressure the BOK to delay the rate increase into the second quarter. ■

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