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## Economic Update

### Executive Summary

- **United States:** Impact of Operation Twist and Obama's job plan on the economy likely to be limited in the near term. Latest economic readings still point to a weakening economy. Risk of another recession has certainly elevated. However, it is not yet conclusive.
- **China:** Still a soft landing scenario; bad loans to local governments and a fading real estate boom are growing concerns of this economy.
- **Japan:** With the passing of the third post earthquake reconstruction budget, there might be a lack of catalysts to propel the economy further.

### United States: Action packed September; no real impact on economy.

As the title goes, September has been a month where leaders "scramble" to put policies together in an attempt to revive a weak economy and to stabilize a volatile stock market. While these policies have helped to calm nerves, the impact on the economy in the near term might be limited.

### Operation Twist

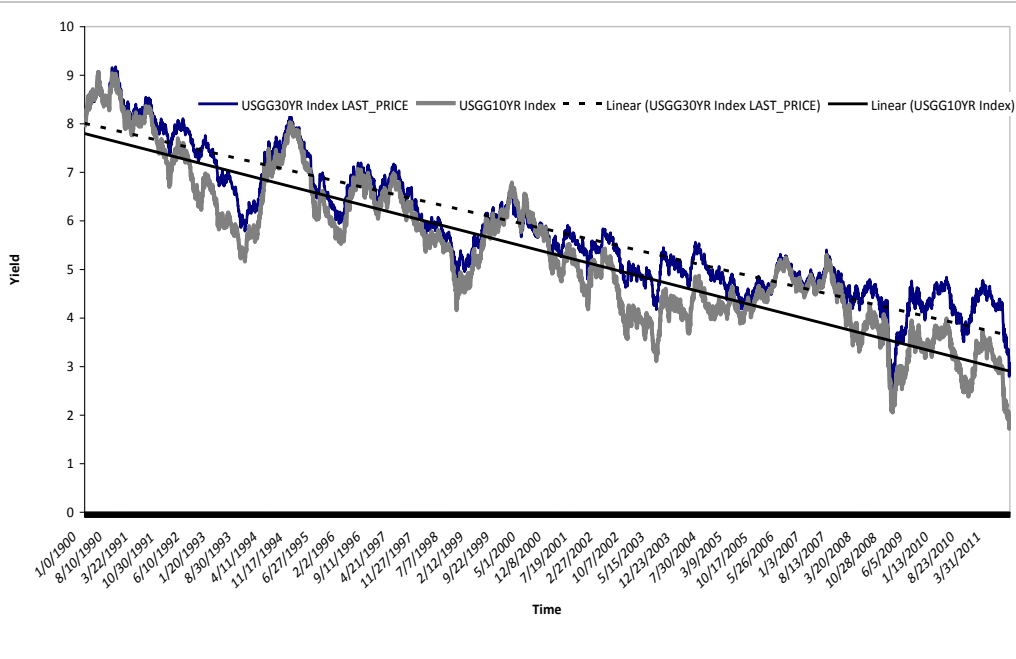
After a strong commitment to keep rates low till 2013, the Fed will step up its accommodation effort by lengthening the maturity of its balance sheet. In the latest Fed Meeting held between 20th and 21st Sept, the committee announced that it intends to purchase by the end of June 2012, \$400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less.

This program aims to put downward pressure on longer-term interest rates. The hope is that by lowering interest rates, there would be more opportunities for households and firms to borrow or refinance, and perhaps increase spending. On this note, we observe that long-term rates are already at a multi-decades low (figure 1); hence pushing them even lower is unlikely going to make much difference to consumption. Moreover, many are worried about their jobs and are therefore prudent in their spending. Meanwhile, businesses also have little reasons to borrow, as current sales do not justify expansion. Besides, many firms have kept large amount of cash, which they can use to draw down when the need arises. As such, on the whole, the aim to get money into the economy (with the implementation of operation twist) might be met with limited success.

*Putting downward pressure on longer-term interest rates is unlikely going to boost consumption significantly.*



**Figure 1: Long-term rates are already at multi-decade low**

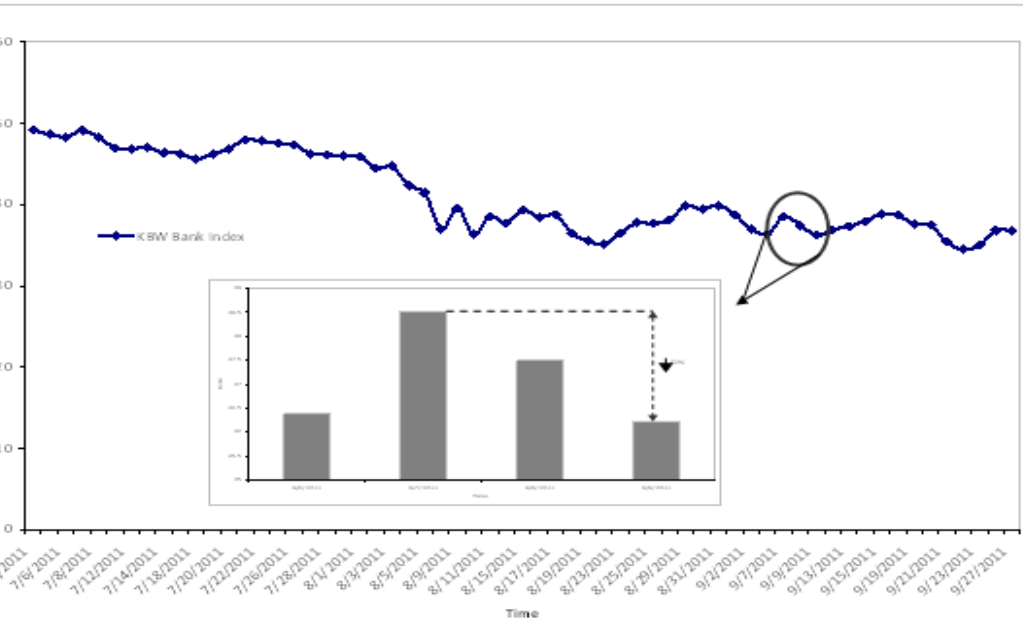


Source: Bloomberg, as of Sept 2011

Meanwhile, flattening of the yield curve is going to have the effect of putting downward pressure on banks' net interest margin. To some extent, this is also suggested by the sell off in US bank stocks upon Fed's announcement. The US KBW Banks Index fell approximately 5.5%. If bank profits were to come under pressure, banks might tighten their willingness to lend and they will only lend to credit worthy borrowers.

*Flattening of the yield curve on the other hand is going to have the effect of putting downward pressure on banks' net interest margin.*

**Figure 2: Banks declined when job plan was announced**



Source: Bloomberg, as of Sept 2011



## Obama Job Plan

While the Fed attempts to prop up the economy with Operation Twist, President Obama, on the other hand, introduced a job plan that will inject \$447 billion into the economy. The package is heavily geared towards tax cuts, which accounts for more than half the value of the stimulus. Specifically, the portion of taxes paid by workers next year will decline to 3.1% from 6.2%. Meanwhile, the reduced exemption would amount to a tax increase on the affluent. In addition, there will be an extension of the unemployment insurance benefits to include innovative work-based reforms so as to prevent layoffs and to give states greater flexibility to use the unemployment insurance funds to best support job-seekers. While the plan will put money directly into people's pocket, effect on consumption might not be significant. This is because the job plan allocates a larger budget to providing payroll tax cuts and those benefiting from this plan are likely to have a smaller propensity to consume. This is evident from the fact that saving rates remain at an elevated level. On the other hand, the multiplier effect associated with the unemployment benefits is likely to be higher. However, the budget allocated to this group is smaller.

Meanwhile, tax cuts are also extended to businesses that increase their payroll by adding new workers or increasing the wages of existing staff. This aims to help firms hire and grow. It is definitely positive that the private sector has been offered incentives to lift employment. However, whether firms will hire remain uncertain. Like we have mentioned earlier, current sales for firms do not justify an expansion in operation. Furthermore, they are unlikely to operate only in the present and ignore the tax burdens that will eventually come. Hence, we remain doubtful that hiring will pick up substantially in response to this incentive.

## Our stance remains

Latest economic readings still point to a weakening economy. For instance, retail sales in August were virtually flat; housing prices though improved, remain at low levels. We continue to believe growth in the United States is likely to remain positive (but anemic) in the near term. However, risk of another recession has certainly elevated. Aggregate demand on the whole has not been picking up and this is a concern moving forward. For growth to be self-sustaining, private final demand (consumer spending and business fixed investment) must ultimately take the lead.

## China: Potential local government and property developer defaults –rising risk.

While lower property prices are something worth rejoicing by the Chinese government (as their measures to clamp down property prices have been effective), it is also a trend that developers are struggling to cope with. Aggravating matters is the fact that these developers have to further reduce prices in a bid to boost sales.

Slower sales have caused Chinese developers to increasingly turn to costlier funding sources. They are paying higher interest relative to official rates so as to borrow from private trust companies (as banks withdraw credit from them). This is a concern as it is leading to potential defaults among property developers. Rising potential default also applies to various local governments as they have set up thousands of financing vehicles to fund projects such as new roads and airports.

*While the Job Plan will put money directly into people's pocket, effect on consumption might not be significant. This is so as the Job Plan allocates a larger budget to providing payroll tax cuts and those benefiting from this plan are likely to have a smaller propensity to consume.*

*Meanwhile, whether the new tax incentive will encourage firms to hire remains unclear as current sales do not justify an expansion.*

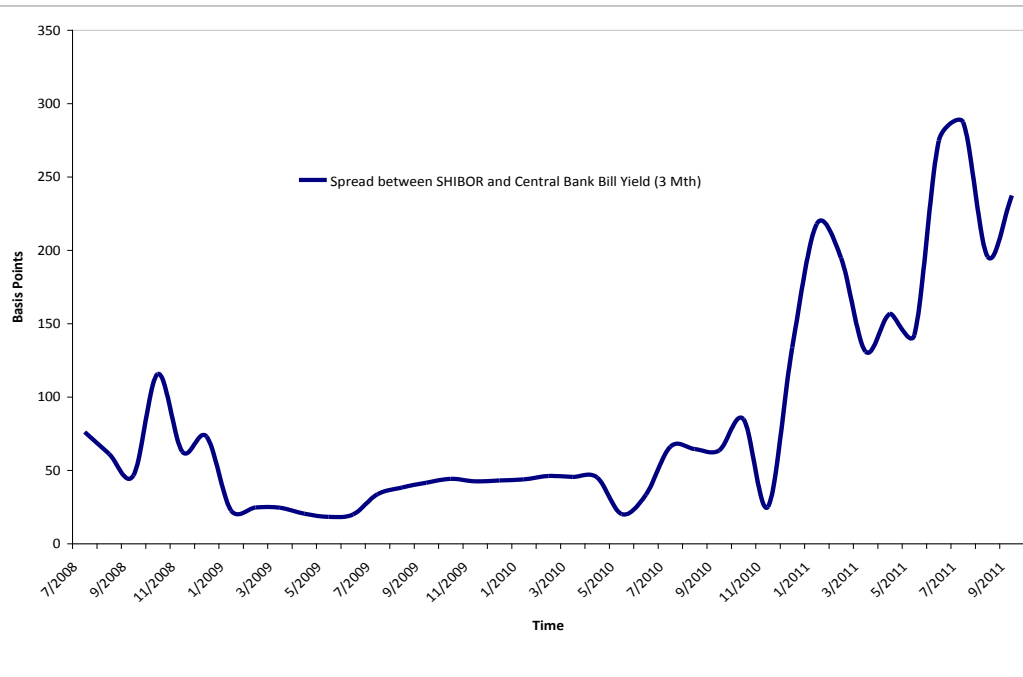
*We continue to believe growth in the United States is likely to remain positive (but anemic) in the near term. However, risk of another recession has certainly elevated.*



Indeed, evidence is building that Chinese property developers and local government financing vehicles, are struggling to repay their obligations as the economy slows. About 85 percent of the government financing vehicles in China’s Liaoning province, on the border with North Korea, had insufficient income last year to cover debt-servicing payments, according to a July speech by the provincial auditor.

The rise in probability of nonperforming loans has raised concerns with the banking sector and especially the extent of the “shadow banking system”. The widening of spread between Shibor and PBOC bill rate (which measures the anxiety banks feel about lending money to each other in the short term) is an indication of this rising issue.

**Figure 3: Widening spread between Shibor and PBOC Bill Rate (3-months)**



Source: CEIC, as of Sept 2011

There are a couple of issues/outcomes with a large amount of non-performing loans in the banking system. Firstly, banks may have to raise more capital to support expansion of lending and also to increase their cushion against bad debt. In any case, this situation is likely to add onto the supply of shares and weigh on prices. Secondly, large amount of non-performing loans could possibility lead to a bank failure. Thirdly, each non-performing loan in the financial sector can be viewed as a mirror image of an ailing unprofitable enterprise. All in all, the greater the amount of non-performing loans, the larger the impact on the economy. This is a big concern in China as the extent of the shadow banking system is unknown. Hence, the impact could be even larger than what one can imagine. The level of default remains an area to be watched.

Meanwhile, latest economic reading continues to point to a softening economy. For instance, the Purchasing Managers’ Index in September was at 51.2, slightly higher than the 50.9 in August. Exports declined 1% in August from the previous month. Retail sales however held up. It continues to rise 17% y-o-y in August; just slightly lower than the 17.2% y-o-y increment registered in July.

*Evidence is building that Chinese property developers and local government financing vehicles, are struggling to repay their obligations as the economy slows.*

*Widening of spread between Shibor and PBOC is an indication of rising concerns over nonperforming loans.*

*The greater the amount of non-performing loans, the larger the impact on the economy. This is a major concern as the extent of the shadow banking system is unknown. Therefore, the impact could be even larger than what one can imagine.*

*Latest economic readings continue to point to a softening economy.*



On the whole, we continue to believe that China will go through a soft landing scenario. Private consumption will remain resilient. While this sector will provide support for the economy, support might be limited to some extent as inflation erodes purchasing power. Meanwhile, room for further tightening may be limited by a heightened risk of recession in the U.S. and euro-area economies. Bad loans to local governments and a fading real estate boom are growing concerns for this economy.

#### **Japan: Third budget passed – What is next?**

On September 28, Japan's government and the ruling Democratic Party of Japan agreed to a third budget for reconstruction-related spending worth 12 trillion yen. This is by far the largest budget of the three. As mentioned in last month's report, we expect the latest sum to be spent on other forms of public investments as the first two budgets were used to clear debris and to build temporary homes. As such, this should provide some form of support for the economy in the near term.

Beyond that, we are concerned that there is a lack of catalysts to propel economic momentum in Japan. There are two reasons for this. Firstly, while the new budget is likely to be raised through the sales of government held-shares of Japan-Tobacco Inc, and government owned assets of energy-related companies, part of it will also come through higher income and corporate tax. Consumer's concern over the looming tax increase may have already weighed on spending; as suggested by the latest retail sales figures. Sales slid 1.7 percent from a month earlier as demand for appliances and autos fell. The impact of a rate hike on consumption should not be neglected as consumption accounts for a significant portion of Japan's GDP after-all.

Secondly, yen continues to strengthen and it is weighing on exports. In August, exports growth slows to 2.8%. As mentioned previously, officials may have resigned to the strength of the currency. This is so as they have announced a \$100 billion effort to help companies cope with a surging yen rather than attempting to intervene in the currency market.

On the whole, while we believe that the third reconstruction budget will provide support to the economy in the near term, there is a lack of catalysts to spur activities moving forward. Also, economic recovery in Japan might be hindered by global economic slowdown, a stronger yen and ongoing Europe's sovereign debt crisis.

*Still a soft landing scenario for China. Bad loans to local governments and a fading real estate boom are growing concerns for this economy.*

*With the passing of the third post earthquake reconstruction budget, there might be a lack of catalysts to propel economic momentum further.*



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