Asian Emerging Economies Update

National Australia Bank

- **Behind the volatility in the monthly data, the trend pace of growth in the emerging market economies of East Asia (which stretch from S Korea to Indonesia) remains weak. Industrial output and export volumes are barely above year-earlier levels, reflecting sluggish growth in world trade and the impact of domestic factors like the rise in prices and interest rates that are depressing consumer demand in Indonesia, the biggest economy in this group.**

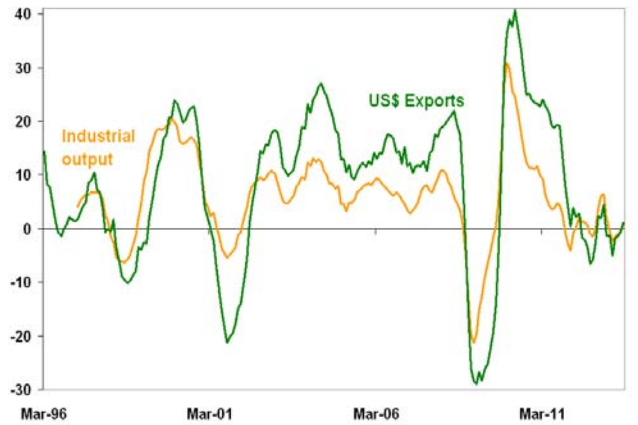
- **GDP growth in the region was running around 3½% yoy in the first half of 2013, about the same underlying pace as has been seen since early 2012. This reflects modest growth in exports that historically flows into a lack of investment demand in the many outward looking economies of the region. Government policies stimulating domestic demand have helped to put a floor under economic activity, ensuring a relatively soft landing from the sluggishness in world trade compared to similar episodes before.**

- **August showed a modest improvement in growth for industrial output and exports but, as it was only one months data, it is too early to call a recovery. The business surveys show a mixed picture with a modest improvement in sentiment in South Korea but not much movement elsewhere.**

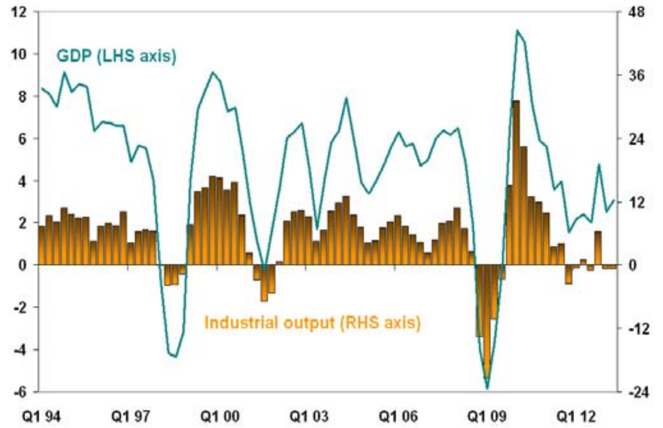
- **We are expecting a fairly modest upturn in growth, partly reflecting the absence of a prior recession to bounce back from. Growth across Emerging Asia of around 3½% and 3¾% is predicted for 2013 and 2014. Forecast growth is expected to reach 4¼% in 2015.**

Asian export volumes and world trade (% change 3MMA)

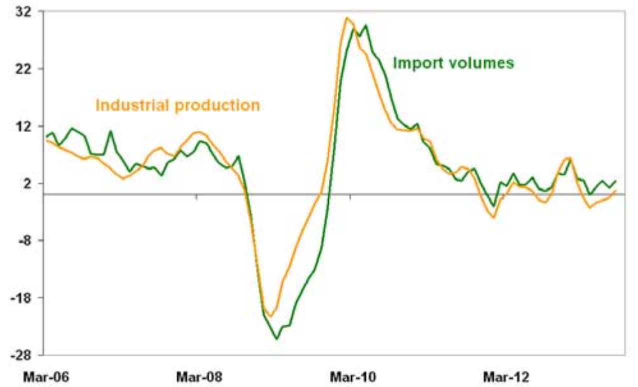
Asian export volumes and industrial output (% change yoy)



Asian GDP and industrial output (% change year on year)



Asian imports and industrial output (% change yoy)



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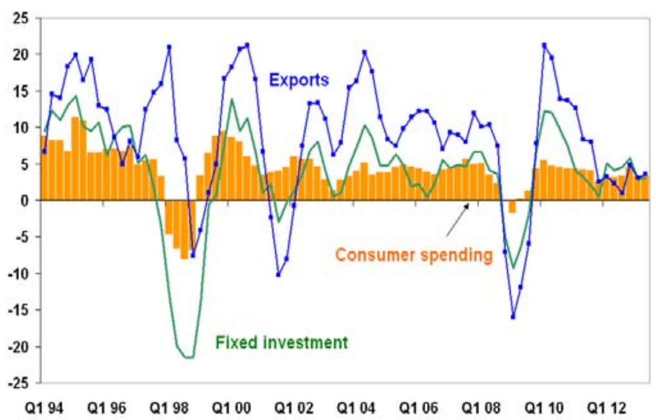
Moderate growth continues

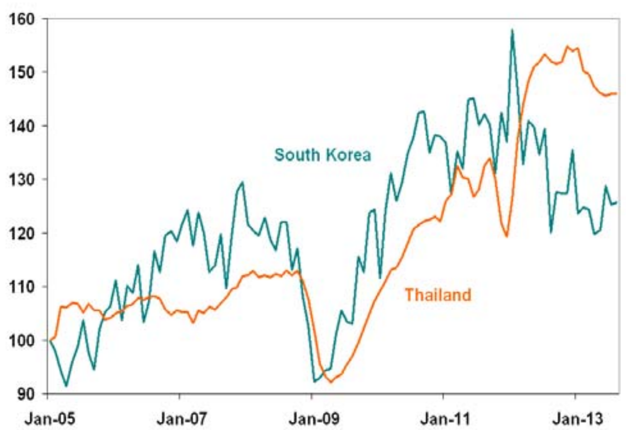
Moderate growth continues across East Asia with GDP growing by around 3½% yoy in the June quarter – around the average seen since early 2012. Domestic demand continues to increase at 3 to 4% yoy with consumer spending up by around 3½% yoy and fixed investment higher by about 3%. Although growth is well below the region's long run trend, this sub-par performance is actually quite a good outcome given the magnitude of the slowing in exports. Regional export volume growth peaked at around 20% yoy in 2010 and it was down to 3 to 3½% yoy in the first half of 2013. Past downturns in exports have tended to flow into significant recessions in domestic demand but this time a combination of the milder softening in exports with policy measures intended to support domestic spending have kept economic activity expanding, albeit modestly.

Neither the partial economic data nor the business surveys are pointing to a major acceleration in activity. Monthly data on retail sales volumes shows them still rising by around 3½% yoy in August and the national data on fixed investment spending and capital goods imports does not show any evidence of an upturn. Business surveys across key regional economies like South Korea, Taiwan, Indonesia and Thailand show a mixed picture with no sign of a great lift in business expectations of future trading conditions.

Private demand volumes (% change yoy)



Level of fixed investment spending January 2005=100 index



Retail trade volumes (% change yoy)

Business Surveys – Future trading conditions

Business Surveys – Future Trading Conditions

These lacklustre readings on business confidence and domestic demand underpin our forecast that the region is only going to experience a modest acceleration in growth. We expect GDP growth in the emerging market economies of East Asia to quicken from 3½% in 2013 to 3¾% in 2014 and 4¼% in 2015 – still slightly below the long-run trend. Indonesia is the best performing economy, based on the solid growth outlook for its huge domestic market.

Several SE Asian economies were hit by financial market tensions in the last 6 months, reflecting global shifts in risk appetite more than region-specific problems. This raised concern that some of the weaknesses and imbalances seen in the 1990s before the Asian financial crisis could be developing again. Credit growth has certainly been very rapid in Indonesia and Singapore, house prices have risen sharply in Hong Kong and CPI inflation has picked up sharply in Indonesia but, taken overall, the evidence of growing economic fragility in the region is much less than was the case in the mid-1990s.

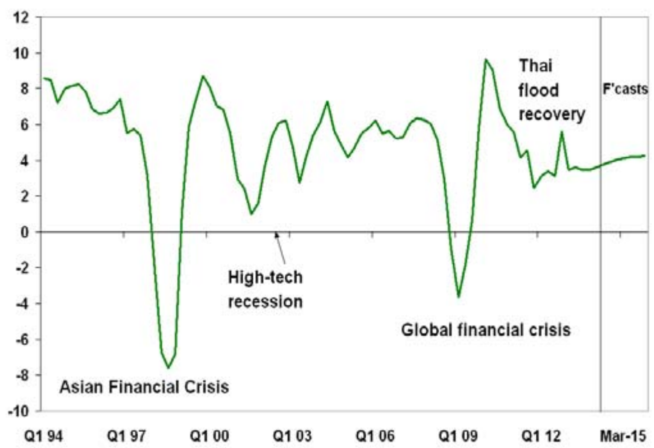
Economic Growth forecasts

Emerging Asian Real GDP Growth

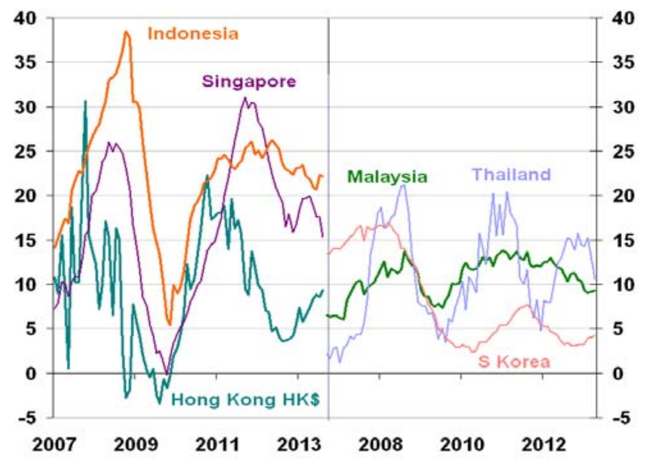
Average annual growth in GDP (%)

	2012	2013	2014	2015
Hong Kong	1.5	3.0	3.4	3.6
Indonesia	6.2	5.6	4.9	5.4
Singapore	1.3	2.6	3.5	3.8
Taiwan	1.3	2.4	3.3	3.5
Thailand	6.8	3.5	3.4	4.1
Malaysia	5.6	4.2	4.7	5.5
S Korea	2.0	2.2	3.1	3.4
Philippines	6.6	6.3	5.4	5.0
Total	**3.8**	**3.5**	**3.8**	**4.2**

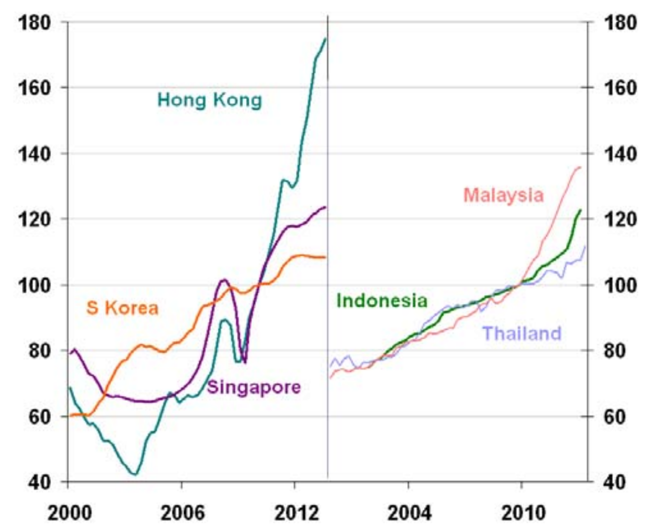
Economic growth in Emerging Asia (% change year on year)



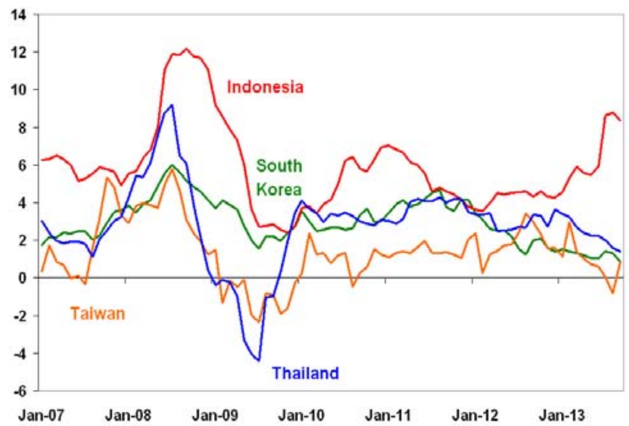
Credit growth (% change year on year)



House price indices 2010=100



CPI Inflation in emerging Asia (% change yoy)



Other economies – Vietnam, Myanmar, Cambodia & Laos

We are taking a closer look at a few ASEAN economies that we normally would not cover in this publication, but are increasingly gaining attention from foreign investors. Vietnam, Cambodia, Laos and Myanmar are rapidly growing and rapidly changing economies that present significant opportunities. However, relatively little data is available about them and that makes assessment of their economic environment difficult.

Vietnam is often seen as a successor to China as a major export-oriented manufacturing hub within the 'Asia factory'. Indeed, like China, Vietnam has been experiencing very rapid growth since it adopted the Doi Moi policy shift in 1986, giving a greater role to market (rather than Communist central planning). Since then, GDP per capita has grown rapidly, while annual economic growth has averaged around 6½% over the past 30 years – lifting around 50% of the countries population above the poverty line.

However, Vietnam's investment driven growth model has been fuelled by rapidly growing credit and rising fiscal deficits that had overheated the economy leading up to 2011 – a hangover from stimulus measures introduced during the global financial crisis. The credit-to-GDP ratio rose from 35% in 2000 to peak at 125% in 2010, which is high for a country at Vietnam's stage of economic development. Inflation also broke through 20% in 2011, peaking at 23% in August of that year, while a sizeable current account deficit triggered a run on the local currency – reserve assets halved between 2008 and 2011.

In response to growing concerns over imbalances in the economy, a pro-austerity shift in policy occurred from early 2011 (Resolution 11) that proved to be quite effective in lowering credit growth and averting hyper inflation. The fiscal deficit has improved and the CAD has moved into surplus. The central bank lifted its discount rate from 9% in early 2011 to 15% by the end of the year, targets for credit growth were cut as was public investment, as the Government apparently gave up on hitting its growth target in favour of achieving a more stable .economy. Growth has subsequently slowed to around 5% as fixed investment softened, particularly state investment which has greatest impact on domestic oriented industries. However, given the success of these policies, the central bank has been able to cut its discount rate back to 7% since early 2012. With the economic fundamentals improving, the Government hopes to achieve its growth target of 5.8% next year, but the IMF still expect sub-trend growth of 5.4%. Risks suggest that too much policy loosening should be avoided in favour of accelerated structural reforms (eg. SOE and financial reforms).

Myanmar is the second largest economy of the four covered here. Data for Myanmar is extremely limited, but its political liberalisation has encouraged much needed economic reforms that have started to re-open the country to global markets. One of the key policies has been the liberalization of the country's foreign exchange regime, under the supervision of the Central Bank of Myanmar. Other reforms include privatization of state-owned enterprises, liberalization of import duties, and the proposed implementation of a value-added tax (VAT). International re-engagement has improved investor optimism.

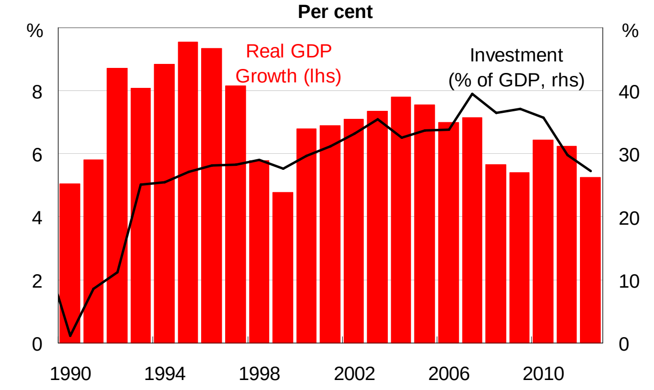
Economic growth in Myanmar was around 6½% in 2012 and should pick up to around 6¾% this year, supported by gas production, construction and services. Gas is Myanmar's largest export commodity and the completion of the Shwe and Zawtika gas fields will raise production during the

Country economic growth forecasts (IMF)

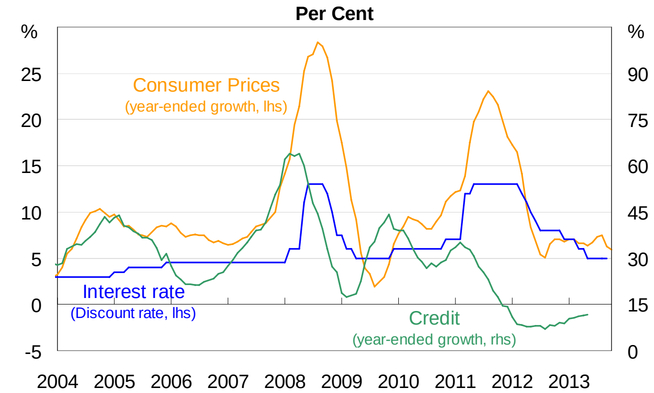
Average annual growth in GDP (%)

	Share of world (PPP)	2011	2012	2013(f)
Vietnam	0.40	6.2	5.2	5.3
Myanmar	0.12	5.9	6.4	6.8
Cambodia	0.04	7.1	7.3	7.0
Lao PDR	0.02	8.0	7.9	8.3

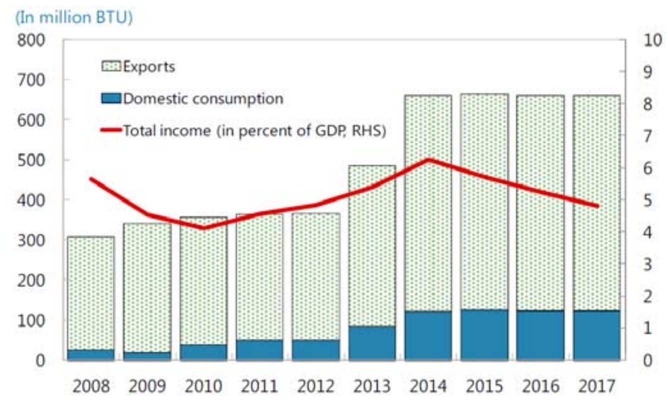
Vietnam – economic growth



Vietnam – policy responded to overheating pressures in 2011



Myanmar – Gas sector to contribute to growth (IMF)



Source: Ministry of Energy.

second half of the year. On the services side, tourism has been performing well with the number of visitor arrivals rising sharply in 2012. However, data for tourist visas indicate a sharp slowing in the number of visitor arrivals this year, although they are still up on last year's levels and Myanmar's peak tourism season tends to be from November to February.

While gas and tourism exports have seen robust growth, changes to foreign exchange restrictions and solid import demand stemming from increased investment, have kept the trade balance in deficit. The current account deficit has been widening, but this has been largely funded by foreign direct investment and it is still low compared to some of its peers. The IMF considers Myanmar's external balances to be stable and expectsits international reserves to grow as capital inflows strengthen. In addition, after reaching agreement on arrears with the ADB and World Bank this year, the IMF's debt sustainability analysis indicates the Myanmar is now at low risk of debt distress.

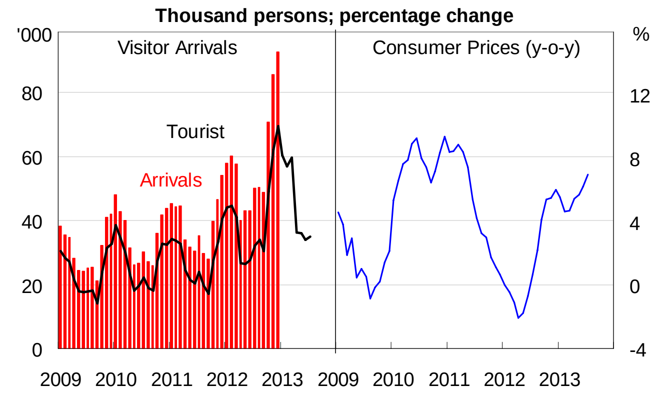
Regarding the domestic policy environment, it will be vital for Myanmar to maintain low inflation to retain public confidence in the reform program and safeguard external stability. However, with monetary tools still in development, it must rely on fiscal policy as the main instrument of macroeconomic management. The government has committed to keeping deficits of around 5% over the medium term and widen the revenue base (currently dependant on resource revenues). Reduced monetization of fiscal deficits should help to reduce a source of inflationary pressure, but CPI inflation is again accelerating – lifting to 7% y-o-y in July. Higher food prices and sharp currency depreciation are both contributing. Credit has also been growing at a rapid pace although this is largely related to the financial deepening that has taken place. Credit expansion is not considered to be an immediate concern at this stage, but needs to be monitored closely, particularly as inflation pressures rise.

Cambodia's economy has held up well with growth accelerating to 7.3% in 2012, but it is expected to moderate to around 7% this year. The economy has been supported by solid exports and tourism as well as a recovery in the real estate sector. Tourist arrivals reached 2.8 million in the first 8 months of the year, up nearly 20% from the previous year, buoyed by new flight routes into the country. Exports of garments have also been solid despite the soft global economy. Garment exports to the EU and US were up, with total garment exports increasing 18% y-o-y (3mma) in August. Nevertheless, the current account deficit reached around 10% of GDP in 2012 and deficit persists as exports are more than offset by solid imports – related to strong demand for construction materials for use in large infrastructure projects. However, foreign reserves have risen and the current account deficit is largely funded by foreign direct investment, suggesting a sustainable external balance.

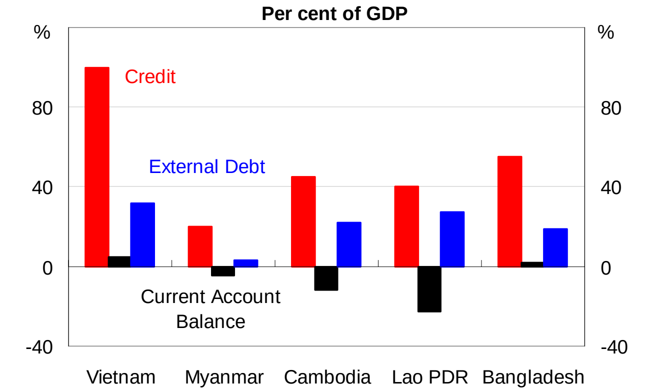
Construction has been supported by easy finance conditions that have contributed to rapid credit growth and a sharp increase in project approvals during the first half of the year. However, limited monetary policy tools are a concern, particularly given the high degree of dollarization. This means more reliance is placed on fiscal policy, but fiscal space is also limited as authorities have made little progress in consolidating their fiscal position. Fortunately, inflationary pressures have remained under control, although food prices have started to pick up more recently; headline CPI has accelerated to 3½% y-o-y in August from a low of 1% in March.

Finally, Lao PDR is by far the smallest of these four economies, but it has been experiencing robust growth – consistently averaging around 8% in recent years – driven by strong investment in the mining sector and hydroelectric development. This period of

Myanmar -- Indicators

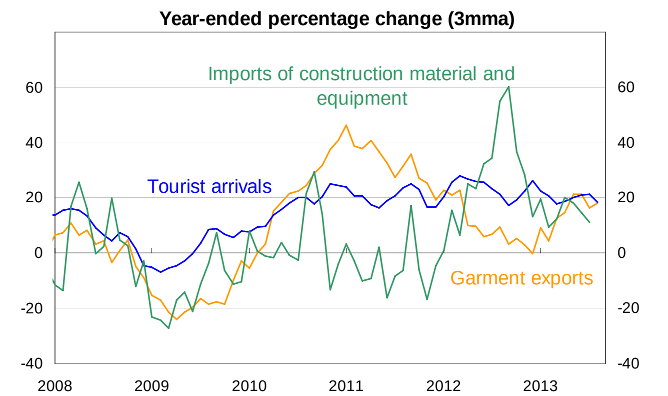


Financial & external vulnerability



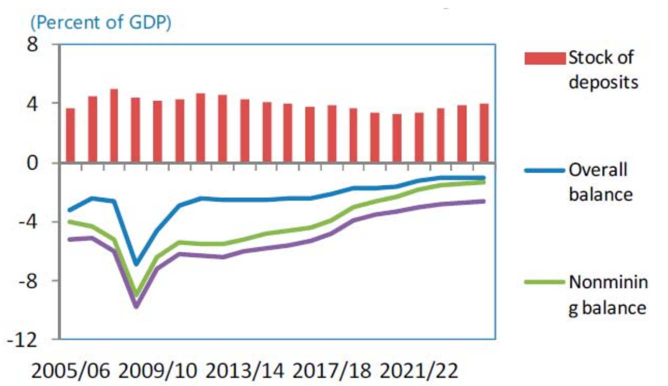
Sources: ADB, IMF Article IV's

Cambodia – activity indicators



Sources: CEIC; NAB

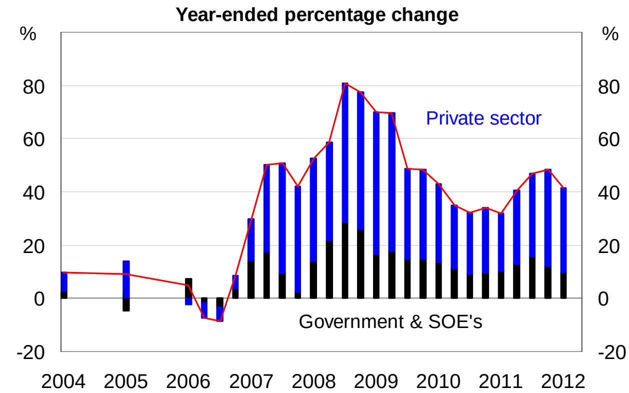
Lao PDR – IMF projections require further fiscal consolidation



Sources: Country authorities; and IMF staff estimates expansion has lifted half of the countries poor above the poverty line, which has fed into more robust private consumption. Unfavourable weather conditions have weighed on the countries agricultural sector, while softening economic conditions in the region have slowed foreign investment from regional partners such as China and Vietnam; the IMF expect GDP growth to moderate slightly to 7.9% this year

Similar to most other countries in the region, inflation pressures have risen on the back of higher food costs; headline inflation has averaged above 6% for much of this year. The trade deficit has widened (Lao PDR has the largest CAD relative to GDP of the four countries examined here), as has the fiscal deficit – to fund domestic debt and salary increases for government employees. In August, the authorities introduced restrictions on the sale of foreign currency and tightened some import regulations to try and contain the deteriorating external deficit.

Lao PDR – Public credit growth a concern for the banking sector



Sources: CEIC; NAB

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