East Asian emerging market economies – November 2014

National Australia Bank

Key Points:

- Moderate sub-trend growth continues across the emerging market economies of East Asia (S Korea, Thailand, Taiwan, Malaysia, Indonesia, Singapore, HK and Philippines). This reflects the impact of lack-lustre growth in world trade on activity in the region's open economies along with domestic economic problems in Indonesia, the region's biggest economy, that have reduced mineral exports and business investment.
- Sluggish regional export volume growth has flowed into modest rates of growth in key parts of East Asian domestic demand, such as consumer spending and business investment, placing downward pressure on household incomes, profits and business investment. Modest rates of growth in domestic spending across the region have, in turn, led to only modest growth in imports and that has led to a leveling out in exports from Australia and New Zealand to the Asian Emerging Market Economies.
- Modest growth in activity has contributed to very low rates of inflation across the region, with the exception of Indonesia where subsidy cuts have increased fuel prices. Low regional inflation has allowed central banks to cut their policy rates to historically low levels and, while we think policy rates have bottomed, there is no urgency to "normalise" them higher.
- The higher $US and lower oil prices should support growth across much of the region but the weaker yen will put pressure on exporters in S Korea and Taiwan. Although they have remained competitive by refusing to lift the prices their customers pay, this has been at the cost of a profit squeeze while their counterparts in Japan have boosted their earnings.
- We expect growth in the region to increase gradually through the next couple of years. Growth slowed to 3.7% yoy in June quarter 2014, well below its 5% long run trend, and we expect it to reach 3.8% this year before climbing to 4% in 2015 and 4¼% in 2016.

Figure 1: Moderate economic growth set to continue

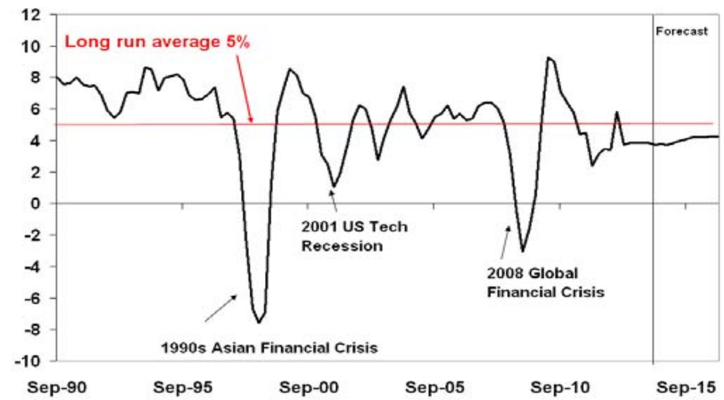

Table 1 : East Asian Economic growth – 2013 and forecasts

Average annual growth in GDP (%)	2013	2014	2015	2016
Hong Kong	2.9	2.3	2.7	2.6
Indonesia	5.8	5.1	5.3	5.7
Singapore	3.8	3.2	3.2	3.6
Taiwan	2.1	3.5	3.3	3.4
Thailand	2.9	0.7	3.3	3.5
Malaysia	4.7	5.9	5.3	4.9
S Korea	3.0	3.4	3.6	4.0
Philippines	7.2	6.1	5.8	5.5
Total	**3.9**	**3.8**	**4.0**	**4.2**

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Sluggish trade growth weighs on growth across export-oriented region

- With the exception of Indonesia, the Asian emerging market economies are very open export driven economies. In the past, domestic demand has tended to follow export cycles as trade-generated downturns in business investment and household income hit local spending.
- Predictably, the big slowdown in the growth of world trade since 2010 has hit regional export expansion. Growth in regional goods export volumes has picked up slightly since the end of 2013 but it is still only 3 to 4% yoy, around half its long run trend. Activity has, however, improved recently with a big pick-up in Taiwan's export orders in September and a small rise in Korean business survey results.
- Modest export growth has flowed into disappointing outcomes for regional industrial output and import volume growth has been sluggish too – as the region's export-oriented manufacturing relies heavily on imported raw materials and intermediate goods. Malaysia, a trade dependant economy where exports have a high content of imported inputs, had growth for both export and import volumes of under 3% yoy, less than half the long-run trend rate.
- This sluggishness in the growth of aggregate imports into the region has been reflected in the ending of the previously strong upward trend in Australian and New Zealand export values to Emerging East Asia. Partly reflecting commodity price fluctuations, Australasian export values to the region have been volatile with no clear upward trend since 2009 – a break from the upward trend seen up to then.

Figure 2: World Trade and Regional Exports %

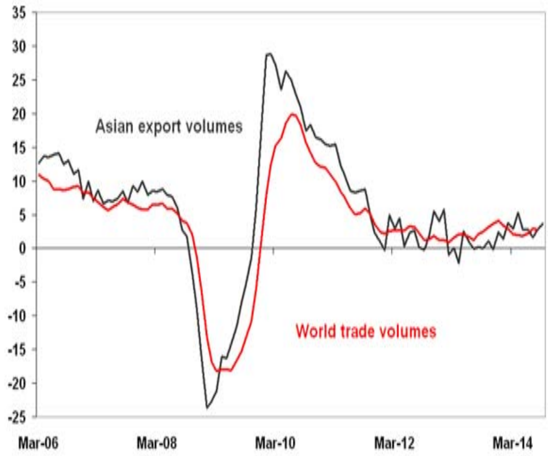


Figure 3: Industry output and exports %

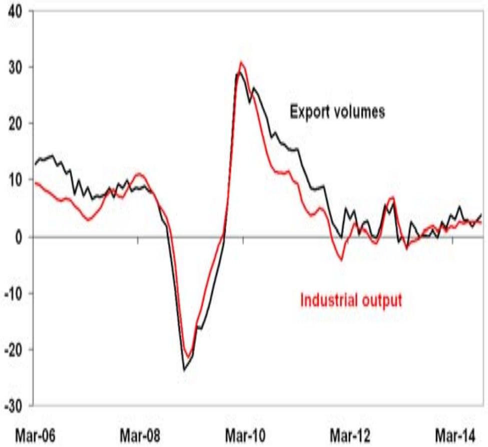


Figure 4: Regional imports and output %

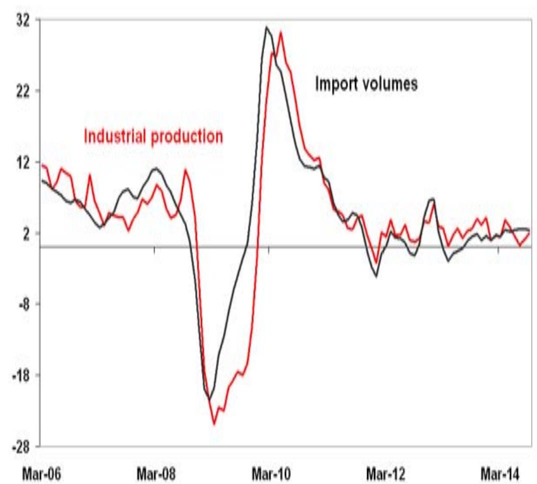
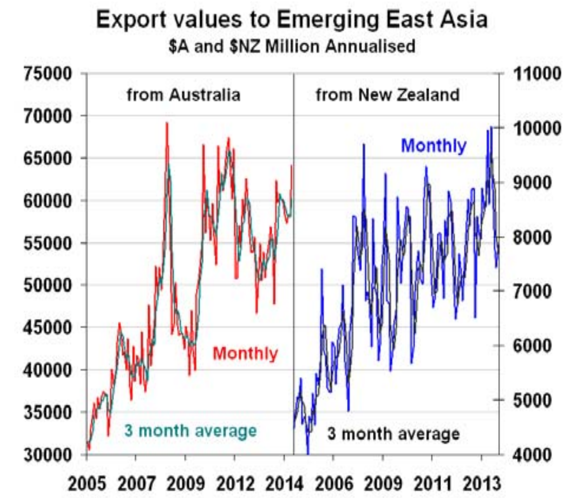


Figure 5: Australasian exports to the region



Sluggish exports accompanies slow growth in regional domestic demand

- Quarterly data on regional export volume growth for goods and services are also sluggish – mid-2014's 3% yoy growth for goods and services exports is only one-third of its 20-year average.
- As is usually the case, soft export growth has been accompanied by relatively modest (by East Asian standards) rates of growth in domestic demand. This occurs as the sluggish rates of export expansion feed into softer growth in household incomes and business investment. Consumer spending growth across the region has recently been around 3% yoy, well short of its 20-year average of 4% and business investment spending has been lacklustre as well.
- The monthly retail sales figures provide the most up to date picture of consumer spending and, after a period of weakness through the first half of the year, they began to lift in the third quarter. This particularly reflects the upturn in South Korean household spending evident in the third quarter (where public sentiment had been hit by April's ferry disaster) and recovery through August and September in Hong Kong and Singapore retailing after some poor sales.
- Third quarter data on investment is available for some East Asian economies with a recovery in South Korea from the second quarter's small fall, another modest outcome in Indonesia, a slowdown in Malaysia and an upturn in Taiwan. Monthly data shows stagnation in Thailand and the equipment based measure of Korean monthly business investment is trending down as Q3's investment growth was concentrated in the construction sector.

Figure 6: Regional demand growth % yoy

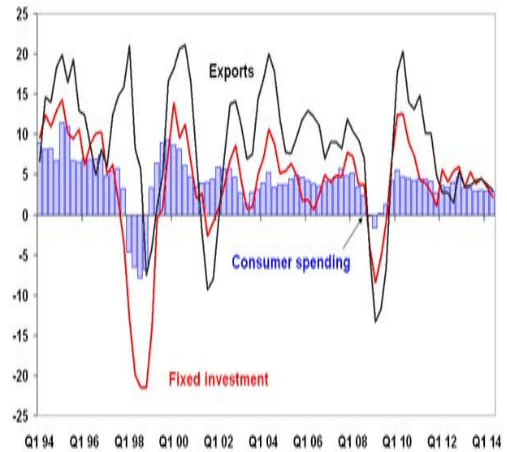


Figure 7: Regional retail volumes % yoy

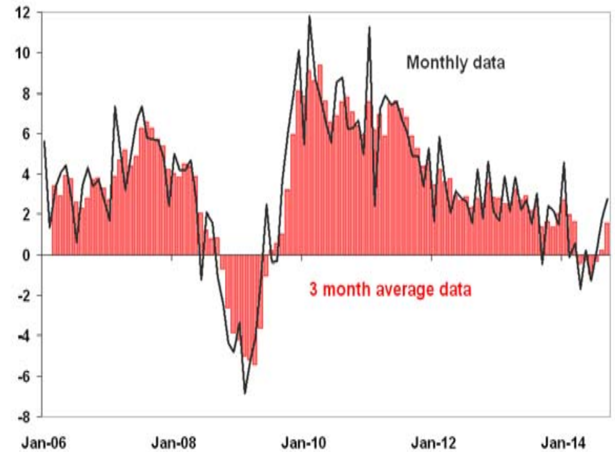


Figure 8: Retail trade in HK and Singapore

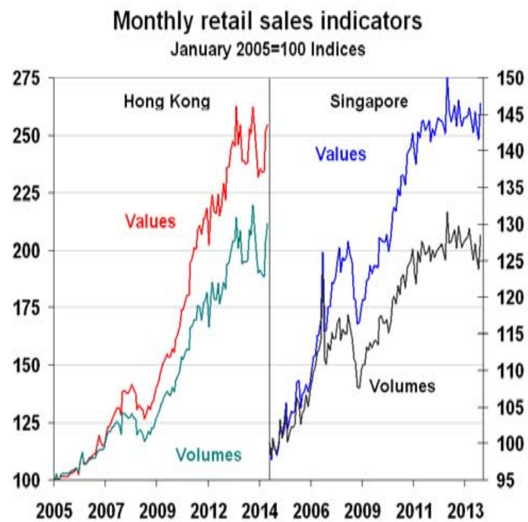
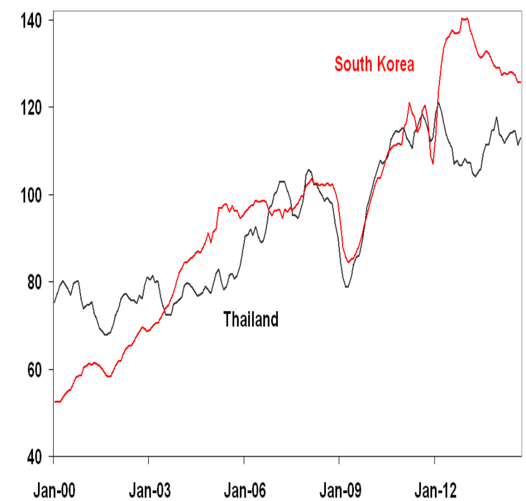


Figure 9: Investment levels Jan 2010=100



Property and construction

- Property market conditions vary across the region with steep upward trends in house prices in Hong Kong, Taiwan and Malaysia since early 2009. Conditions have been much weaker in Singapore (where the market has been trending down since mid-2013) and South Korea.
- The Hong Kong commercial property market has also outperformed Singapore's since 2009 but office and retail values in the former have levelled off since late 2012. The Indonesian market has also shown some solid increases in the last few years but conditions appear to have cooled recently. Jakarta office prices and rentals virtually levelled off in the September quarter; the same holds for apartment prices while retail values are rising more slowly.
- The varying strength in regional property markets has been reflected in big differences in construction activity around the region. Indonesian and Malaysian construction activity has grown strongly. Activity in Thailand, S Korea and Taiwan shows little trend. Singapore has grown steadily with infrastructure and house building driving most of the growth. Hong Kong construction ramped up through the recovery from the global recession and has gone sideways since.
- Construction activity across the region has important implications for Australasia as the sector is an important end-market for a variety of commodities – forestry products from New Zealand for formwork, Australian iron ore and coking coal for the steel used in construction.

Figure 10: House price inflation

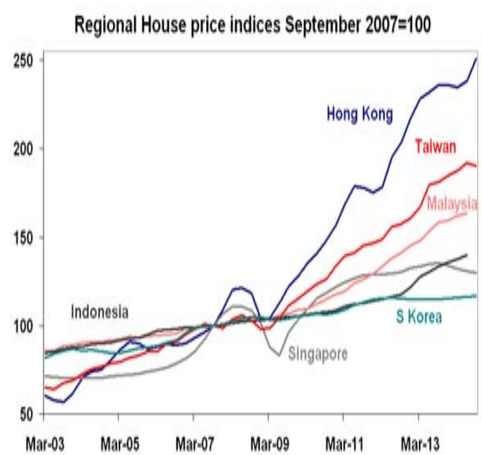


Figure 11: Commercial property prices

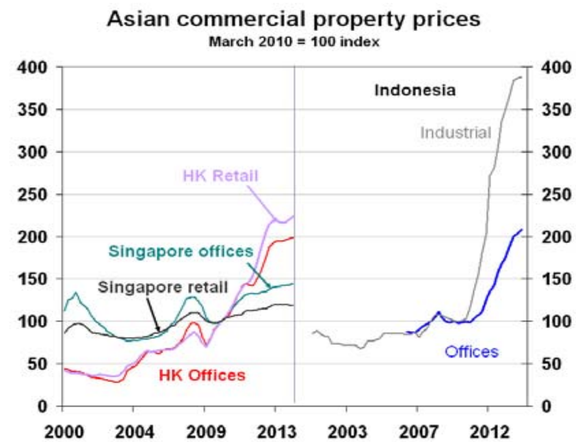


Figure 12: Construction Activity

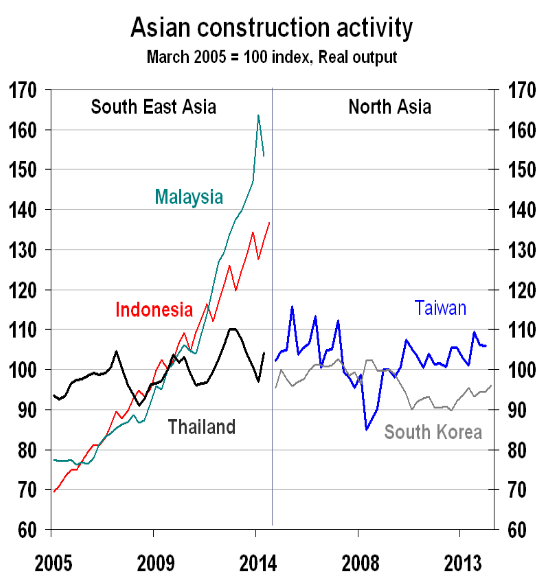
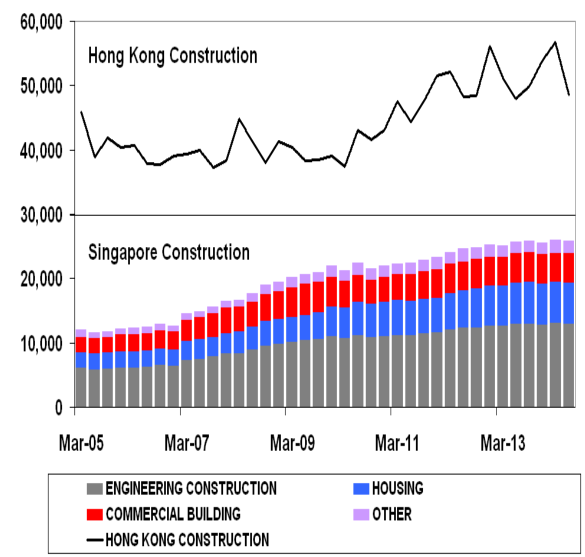


Figure 13: Construction Activity



Regional trends in inflation

- Consumer price inflation is generally well under control across the region with headline CPI inflation of around 2% and core CPI inflation of around 2½% - pretty close to the definition of price stability adopted by most central banks.
- There is, however, quite a variation between inflation performance across the region's economies with Indonesia (by far the biggest economy in emerging market East Asia) having a much higher rate of inflation than most other economies.
- Indonesian headline CPI inflation is almost 5% and core inflation is 4%, within the central bank's inflation target corridor of 3½% to 4½% but well above the rates being seen elsewhere in the region.
- Hong Kong is the other regional economy with high inflation but September's 6.6% yoy was boosted by a distorted base period, excluding last year's Government payment of public housing rentals brings the inflation rate down to 3.3% - high by the standards of the region.
- Inflation elsewhere is generally coming in well within or below the target range and sometimes below forecast. Thai core CPI inflation is 1.7%, within the 0.5 to 3% target band. S Korean CPI inflation is only 1.2% yoy, below the 2½% to 3½% forecast range for the 2013 to 2015 period.
- This lack of inflationary pressures means the entire East Asian region – a key supplier in global sourcing decisions – is putting little upward pressure on import prices in key markets like the US or Australia.

Figure 14: Headline CPI Inflation % yoy

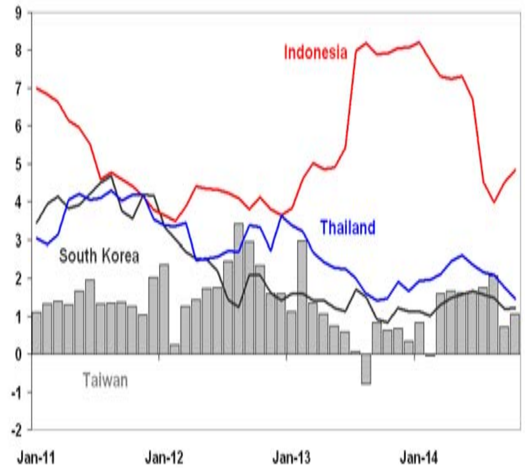


Figure 15: Core CPI Inflation % yoy

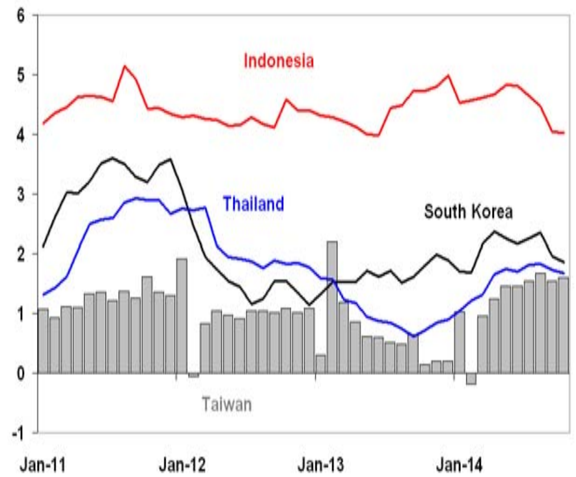


Figure 16: Core and headline CPI %

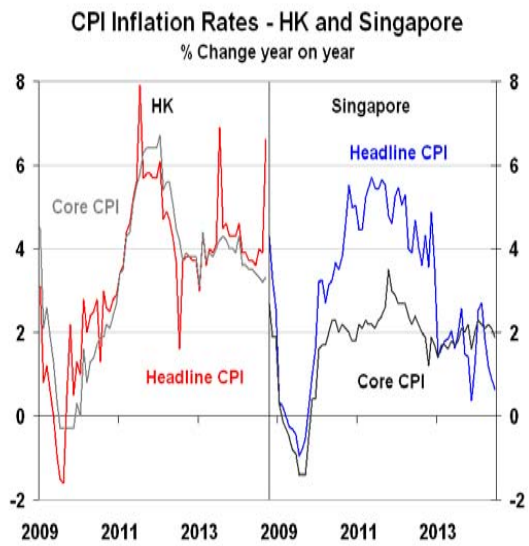
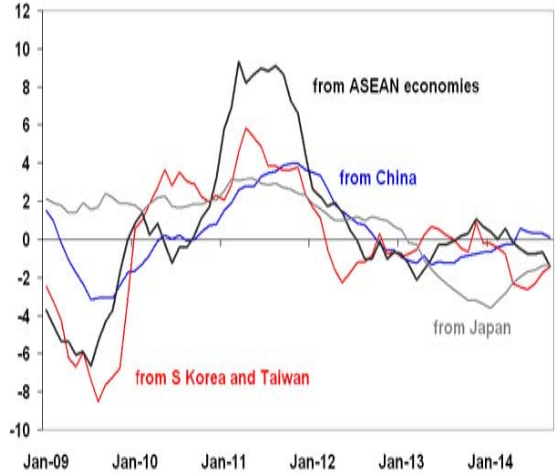


Figure 17: US Import prices % yoy



Monetary and exchange rate conditions

- Low regional inflation has generally flowed into low policy interest rates, by historical standards. With the exception of Indonesia's 7½% policy rate, official interest rates across inflation-focused central banks in the rest of the region are less than 4%. Thailand's policy rate is 2%, Malaysia's is 3¼%, S Korea is 2% and Taiwan's discount rate is less than 2%.
- Although the central banks in Hong Kong and Singapore use the exchange rate to set monetary policy, their structure of market interest rates is also very low. 3-month interbank rates in Hong Kong are under 40 bps, aggregate bank funding costs are around 40% and mortgage rates of around 2½% have been available. Singapore 3-month interbank rates have also been around 40 bps with housing loans from finance companies available for under 3%.
- These very low interest rates have contributed to the rise in property prices seen in several regional economies, underpinned by rapid rates of credit growth. Our expectation is that regional central banks will gradually move policy rates back to more "normal" levels (see table 2), a process already begun in Malaysia with July's rate rise and a policy that the central bank sees as "accommodative".
- A trend appreciation of the $US has already begun and we see it continuing against regional currencies through the next year – the details are in NAB's Asian FX Strategy publications [here](#) (registration required)

Figure 18: Central Bank Policy rates

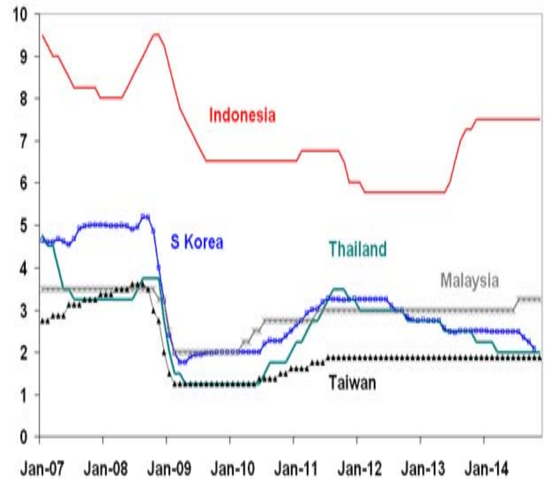


Table 2 NAB Interest Rate Forecasts

Policy rate	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015
Korea	2.50	2.25	2.00	2.00	2.00	2.25	2.5
Thailand	2.00	2.00	2.00	2.00	2.00	2.25	2.5
Malaysia	3.00	3.25	3.25	3.50	3.50	3.75	3.7
India	8.00	8.00	8.00	8.00	7.75	7.75	7.7
Indonesia	7.50	7.50	7.50	7.50	7.75	7.75	7.7
China	3.00	3.00	3.00	3.00	3.00	3.00	3.0

Figure 19: Credit growth

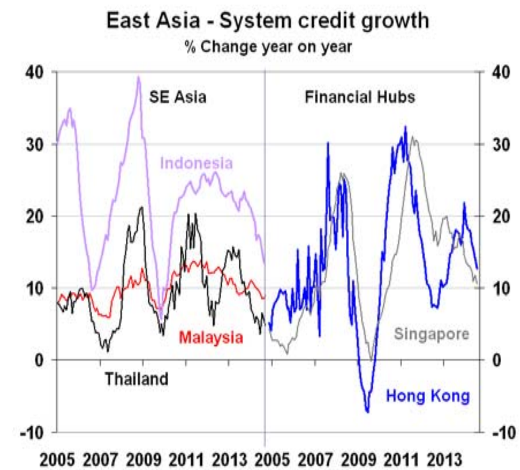
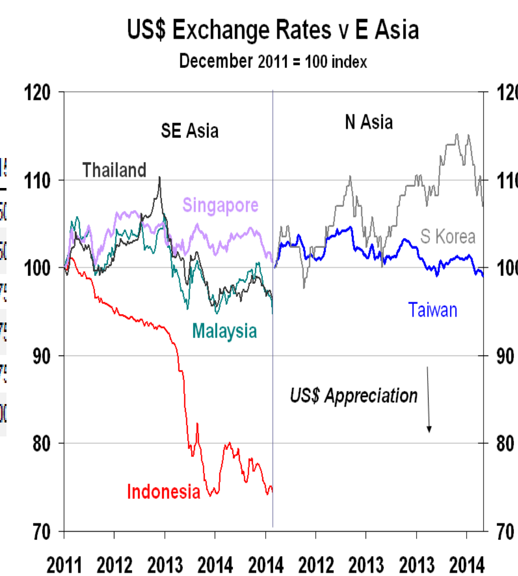


Figure 20: US$ Exchange rates



Currency changes in North Asia not affecting exports much

- The yen has fallen sharply against the US$ as the US central bank stops increasing its balance sheet and prepares the markets for eventual increases in interest rates. By contrast, the Bank of Japan has recently increased its target level of asset purchases – "printing even more money".
- The Bank of Japan's October 31st decision to increase its asset buying program has produced another bout of yen depreciation against the South Korean won and the New Taiwan $. Currency movements of this magnitude generally have a big impact on the relative competitive positions of firms in each economy, helping Japan-located operations at the expense of those offshore.
- Currency-driven gains in competitiveness were expected to drive export-led growth in Japan, at the expense of Korean and Taiwanese rivals who are often key competitors. In the event firms in the latter two economies have made sure that their competitive positions do not suffer by absorbing currency-related changes into their profit margins rather than passing on higher foreign currency prices to their customers.
- As a result, Taiwanese exporters have cut the prices their customers actually pay in $US and the S Koreans have held theirs fairly flat and taken the hit from their stronger currencies in the form of lower Taiwan $ and Won returns, probably squeezing their margins.
- The outcome of this competitive strategy has been that Japanese exports have not risen to the extent expected from the yen's depreciation.

Figure 21: Yen falls v Won and Taiwan $

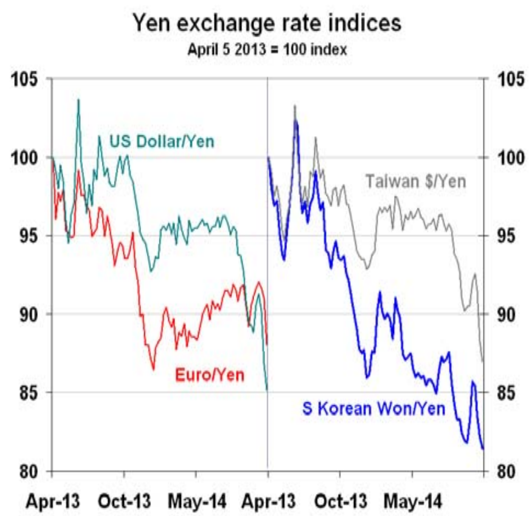


Figure 22: S Koreans forced to cut won prices

Figure 23 Taiwan export prices fall

Figure 24: Japanese exports stall despite lower ¥

Indonesia

- Third quarter growth in Indonesia was 5% yoy, the weakest rate since the global economic downturn 5 years ago. Indonesia is a much less trade dependant economy than most others in the region and its soft export outcomes owe more to official bans on exports of some key minerals than sluggish offshore demand.
- An investment slowdown to 4% yoy growth explains much of this disappointing outcome. High corporate lending rates (of 10 to 12% when inflation is 4 to 5% yoy) along with a downturn in commodity export prices are limiting firms' willingness to invest. In contrast, consumer spending has held up better since the General Election than the central bank had feared.
- High business lending rates reflect the high 7½% central bank policy rate, propped up by inflation concerns (involving higher fuel prices as subsidies are cut) and a need to support the Rupiah exchange rate as the Fed gets ready to lift US interest rates. Previous episodes of tightening US monetary policy led to falls in the Rupiah as capital moved to the US.
- Until recently it looked as if Indonesia was far better placed to cope with another bout of currency market volatility than previously but recent data has been disappointing. The Q2 current account deficit was not much smaller than the same period of 2013, previously there had been a bigger reduction in this deficit. Although recent capital inflows were dominated by equity, which is good, there is also a large amount of foreign capital invested in short term government securities which could exit if investor appetite altered.

Figure 25: Economic growth ppts yoy

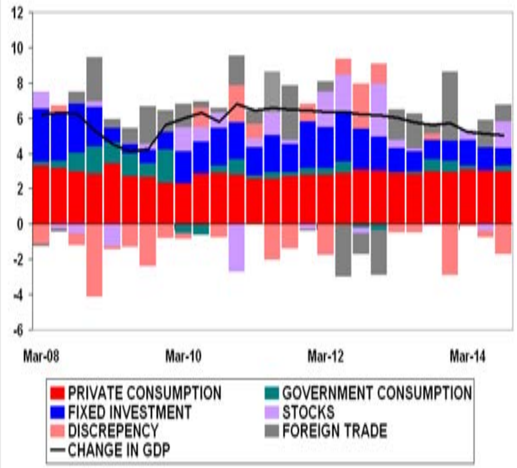


Figure 26: Inflation % year on year

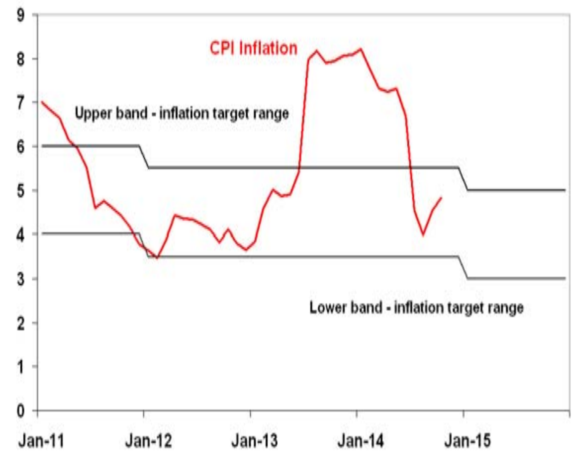


Figure 27: Current account balance

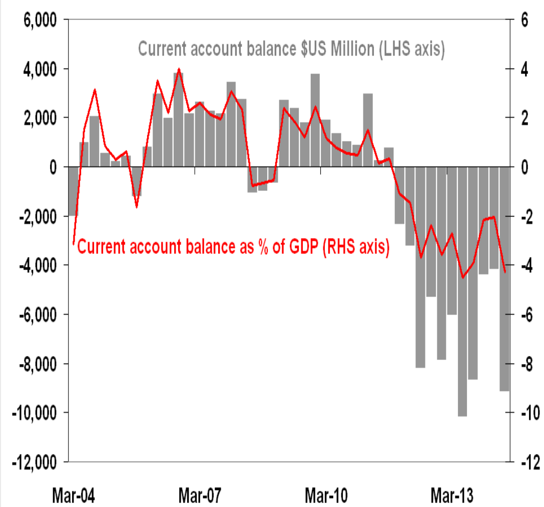
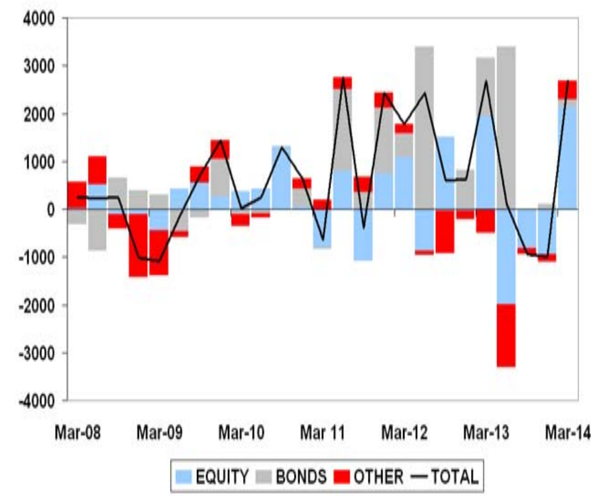


Figure 28: Portfolio capital inflow US$M



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