ESSENTIAL ASIA

Greenback in the outback

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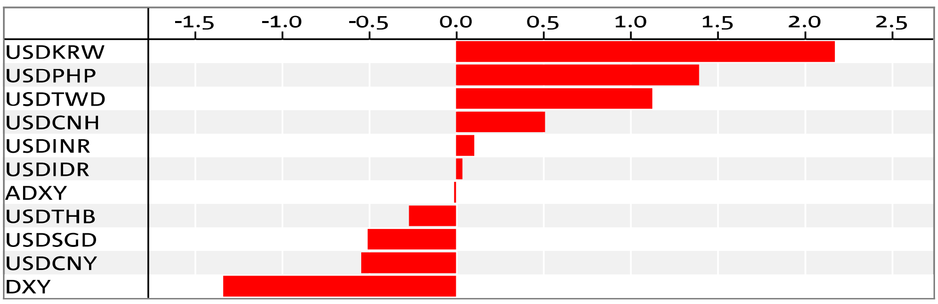
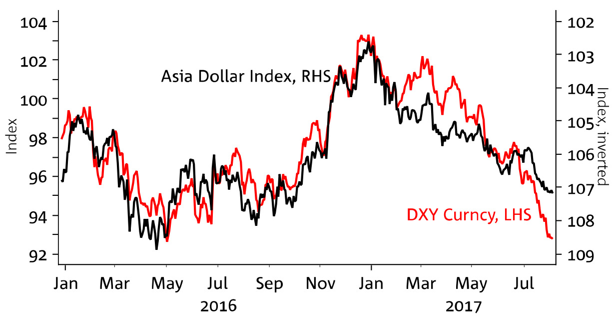
Asia FX in June

FX changes over the month (% change)



Source: National Australia Bank, Bloomberg, Macrobond

Chart of the month



Source: National Australia Bank, Macrobond, Bloomberg

Asia Policy Rates

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
Korea	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Thailand	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Malaysia	3.25	3.25	3.00	3.00	3.00	3.00	3.00	3.00
India	6.75	6.50	6.50	6.25	6.25	6.25	6.00	6.00
Indonesia	5.50	5.25	5.00	4.75	4.75	4.75	4.75	4.75
China	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35

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GREENBACK IN THE OUTBACK

- **The strength of global growth was the key highlight in the IMF's latest World Economic Outlook released in July.**
- **The obvious change since April forecast in the distribution of growth is the upward revision in Eurozone, China, other emerging Asia and even Japan. The key downgrade is in the US and UK.**
- **The USD's directional bias hinges on how much further the Trump discount will go, as the rest of the world experiences a synchronized upswing.**

The strength of global growth was the key highlight in the IMF's latest World Economic Outlook. The obvious change since April forecast in the distribution of growth is the upward revision in Eurozone, China, other emerging Asia and even Japan. The key downgrade is in the US. The IMF reduced its forecasts for US growth in 2017 and 2018 to 2.1%, in view of the US fiscal policy looking less expansionary than initially perceived in April.

China's growth upgraded domestically

Right on the heel of the IMF's upward revision on China's 2017 growth forecast to 6.7% from 6.6%, two major local institutions CASS and State Information Center updated their forecasts for China's full year GDP growth to 6.8%, a dip from 6.9% in 1H, but higher than official target of 6.5%. Basically, China's growth will depict the trend of stabilisation with sound momentum. The risks to China's growth lie with the existing issues of financial sector leverage, something that the Chinese authorities are not taking lightly. Key reiterations to reinforce the policy direction and coordination going forward could be found in the latest statement issued after a meeting of the Political Bureau of the Communist Party of China Central Committee, presided over by President Xi Jinping. China vowed to strengthen the coordination of financial regulation, stabilize the property market and prevent systemic financial risks.

The USD keeps getting hammered

The pace of decline in the USD index picked up in July, weakening a further 2.8% and breaking below 94.0. Year to date, the USD index has fallen about 9.2% and the latest pessimism stems from deepening Trump discount pertaining special counsel Robert Mueller's investigation into Russian interference in last year's presidential election and broad range of financial transactions that Trump and his associates are involved in. In addition to US politics, policy direction continues to provide little support for the global bellwether as Fed chairman Yellen's slight tweak in the July FOMC on balance sheet reduction was deemed as another opportunity to give the greenback another downward shove. The next key level to watch on the USD index is around 92.0 and investors are in two minds about it given how far the USD has gone, though most will wince and offload USD more rigorously should the level break.

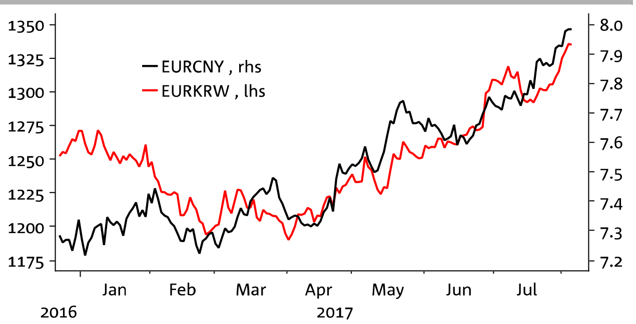
How vulnerable is Asia to a European taper tantrum

We are also cognizant that a large part of the USD index weakness is driven by EUR strength. Specifically, the EUR has strengthened markedly and uniformly against most Asian currencies since April this year. With the ECB already signalling policy tightening, it may add to concerns of massive outflows from emerging markets, not just back to the US, but also to Europe.

It is then reassuring that with regards to Europe's quantitative easing and the corresponding outflows, the extent that a policy tightening will lead to massive capital outflows from EM to Europe is limited. ECB Board Member Benoit Coeure recently disclosed that during the ECB's large scale asset purchase program, around two-thirds of net outflows went into securities issued by issuers in the United States, United Kingdom, Japan, Sweden and Canada. By contrast, and contrary to what has often been discussed in the wake of the Federal Reserve's asset purchase programmes, there was hardly any investment into emerging market economies, including the BRICs – Brazil, Russia, India and China.

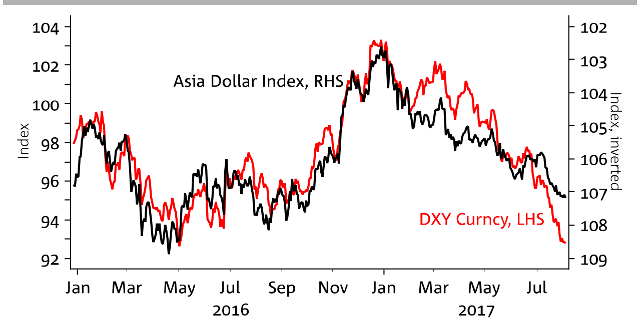
There are some signs of hesitation about pushing Asian currencies to significantly stronger levels than currently. While most will still respond to the US-centric factors in the USD price actions, but some domestic concerns could be kicking in. USD/KRW may resist further downside on concerns about rising intervention risks as JPY/KRW is testing the key support at 10.0. The cross touched a low of 9.8 in May and has since rebounded above 10.0 but is again inching closer to the figure again. Elsewhere, the S$NEER has climbed quite strongly over the month of July and is just under 1% from the mid-point of the policy band. The SGD climbed 1.54% through the month of July, only behind the JPY, THB and the KRW, all rising around 2%. With a lack of convincing recovery in domestic inflation, there's a good chance that going forward, there might be more resistance to strong rises in the S$NEER if and when the USD does take another tumble.

Chart 1: EUR outperformance vs Asian currencies



Source: National Australia Bank, Bloomberg, Macrobond

Chart 2: Tracking the USD, tentatively



Source: National Australia Bank, Macrobond, Bloomberg

CHINA SPOTLIGHT:

Stabilisation with sound momentum

- **Early Q3 data supports the slower growth prognosis, though the prospect of overshooting the 6.5% full year target remains intact.**
- **USD/CNY partially reflects the USD's softness, but CNY mostly underperforms the non-USD currencies within the basket, keeping the RMB index steady.**
- **6.70 is the key USD/CNY support, but could well be breached should the USD index break below key level 92.0.**

Growth outperformance unlikely to last

Q2 GDP grew 6.9% yoy and 1.7% qoq sa, against 6.8% expectations. The sequential growth rate accelerated from 1.3% in Q1, which is encouraging but might not be sustained into Q3. Nevertheless, the slowdown in H2 will probably be quite mild, barring shocks from the deleveraging process domestically or trade tension with the US internationally. After all, China's June economic data came in higher than both expectations and prior data. Retail sales accelerated slightly to 11.0% yoy from 10.7%, while FAI ytd maintained the pace at 8.6% yoy. Industrial production meanwhile accelerated to 7.6% yoy from 6.5%. Monetary policy might also start to be a bit tighter in the months ahead so overall growth momentum may decelerate.

An early piece of evidence supporting slower growth in Q3 is the deceleration in manufacturing PMI to 51.4 from 51.7 in June. The breakdown reflects weaker foreign demand as the new export orders fell by a larger margin than overall new orders. Domestic demand appears to have held up better. Meanwhile, price indices have rebounded, suggesting that the rally in domestic steel prices is pushing up producer price inflation. There are also emerging signs that the slowdown is broad-based. The official nonmanufacturing PMI declined from 54.9 to 54.5, with stronger construction activity more than offset by weaker service sector growth.

Financial reforms in the limelight

China concluded its National Financial Work Conference and the main takeaway is the commitment to better coordination between regulators to improve the financial sector's capabilities in serving the real economy while guarding against systemic risks. The conference happens every five years and this time three objectives were highlighted: making the financial sector better serve the real economy, containing financial risks and deepening financial reforms. Consequently, a committee under the State Council to oversee financial stability and development will be set up over the next few months. In addition, the central bank will play a stronger role in macroprudential management and guarding against systemic risks.

President XI's commitment towards reforms went above and beyond the financial sector. During the conference, he explicitly stated he wants the deleveraging efforts to be extended beyond the private sector, to include state firms. China's strong growth performance thus far in H1 helps to position the authorities to produce more results on reducing excess leverage within the real economy. Some options to reduce borrowing within the SOEs include debt-for-equity swaps, bankruptcy for "zombie" companies, partial privatisation and consolidation of various SOEs into a smaller group of national champions.

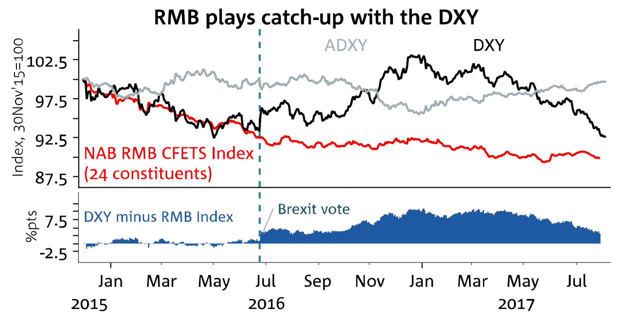
The delicate balance that the Chinese regulators have to strike going forward, is between allowing more bankruptcies while at the same time ensuring it does not become disorderly or a systemic risk for the financial sector.

Comfortably lagging the region, increasingly flexible

The RMB index has declined a modest 0.3% month-to-date – a sharp surge in the earlier part of July was swiftly followed by a 0.9% drop. Overall, the price actions continue to mirror - but pale in comparison - to the DXY's 1.5% drop. Consequently, the gap between the DXY and RMB index or "competitiveness buffer" that the PBoC built up after Brexit last June, narrows further (Chart 1), following the EUR-positive shift in the political landscape in the EU. Against other major currencies, the CNY has weakened visibly against the EUR and also the AUD (Chart 2), potentially raising concerns with regards to a possible decline in import demand for Australian services (e.g. tourism).

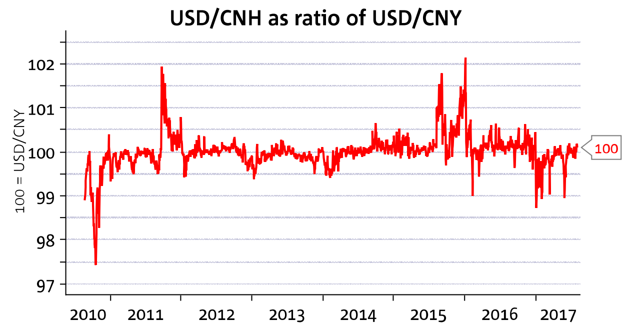
We expect the policy focus on the RMB index to mean a greater tolerance for USD/CNY flexibility. Indeed, the PBoC has reiterated twice in the recent weeks its intention to increase flexibility in the USD/CNY specifically and there have been increasing calls for a band widening move. In the months ahead, any movements in the broad USD will probably be matched in direction with the RMB albeit in an asymmetric low-beta fashion (see Asia Dashboard ---- RMB regime goes robust, 14 July 2017).

Chart 1: Slight tightening in monetary conditions



Source: National Australia Bank, Bloomberg, Macrobond

Chart 3: USD/CNH discount back to normal range



Source: National Australia Bank, Macrobond

KOREA SPOTLIGHT:

Maintaining some summer vigour

- **Near term KRW drivers, namely portfolio flows (bond market), North Korea tension and arbitrage incentive, are still quite supportive for the KRW.**
- **However, the KRW's outperformance in July may not persist, as geopolitical risks continue to simmer and the Fed's balance sheet reduction is an imminent event risk. The global USD trend will be a key determinant.**

Positive fiscal moves boost growth prospects

The won moved within 1110-1160 range in June and July, bottoming in early June and then peaking in early July before ending the month around 1120. Korean financial markets drew some cheer as lawmakers approved an 11 trillion won ($9.8 billion) extra budget on July 22, laying a foundation for President Moon Jae-in to create more jobs and help the Korean economy return to 3% GDP growth.

Despite the initial challenges, President Moon's public approval rating of more than 70% enabled him to win bipartisan support for his fiscal policy. If 110,000 new jobs are created to help with South Korea's youth joblessness, Moon will not only reinvigorate the economy but also consolidate his power, and that will make it easier for him to execute follow-up policies.

Geopolitical tension on the rise

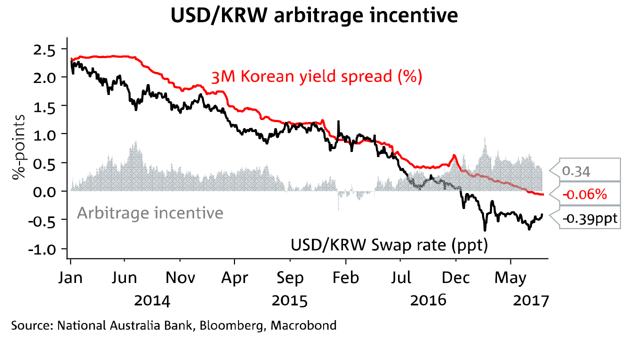
Meanwhile, North Korea continues to raise the geopolitical temperature with the second ICBM test in a month, and this time stating it was capable of hitting the US. The US responded with two supersonic bombers over the Korean Peninsula, escorted by South Korean fighter jets and also tested the Terminal High Altitude Area Defense (THAAD) system in Alaska by launching a ballistic missile over the Pacific Ocean. China continued to maintain a stance of restraint, even though President Xi took a stronger verbal stance during his latest speech, saying that China needs a strong military more than ever, urging building the PLA into world class armed forces with confidence and capability to "defeat all invading enemies" and "safeguard world peace". Geopolitical tension is expected to simmer on, but there is little indication that this will escalate into a full blown aggression but more sanctions and calls for talks are likely immediate options. That said, it is quite apparent that North Korea has been showing what it is capable of producing despite ongoing sanctions.

Portfolio flows could still be won supportive

Admittedly, the KRW has been lagging the strength in other regional currencies over the past month (SGD, THB, CNY), partly attributed to talk about rising intervention risks as JPY/KRW is testing the key support at 10.0. The cross touched a low of 9.8 in May and has since rebounded above 10.0 but is again threatening to break the figure again.

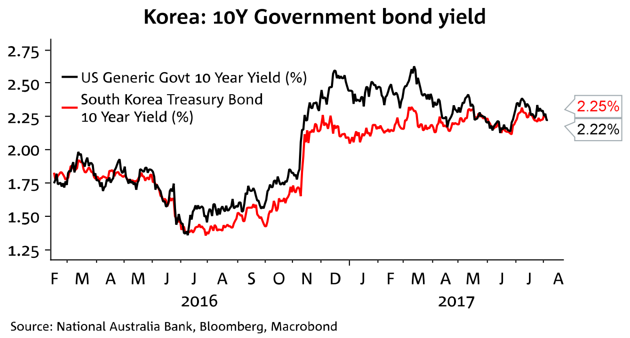
As mentioned in last month's report, the KRW's strength since the start of 2017 has been motivated, in part, by arbitrage incentives, as evidenced by the spread between the US and Korea 3M yield spread and 3M swap rate. This was observed by the Bank of Korea as the Fed's hike narrowed the yield spread and at the same time swap was continually declining. The arbitrage incentive expanded and spurred strong foreign buying into Korean bonds, by banks and global funds. The arbitrage incentive has reduced since, but still stays rather elevated at around and may sustain interests for Korean debt and consequently, limit significant upside in USD/KRW. The attractiveness in the long end remains, as 10Y KTB yield has stabilised higher since the start of the year and now hovers near the 10Y UST yield, but with virtually no risk of policy hike in Korea in the near term. On balance, the USD's performance in coming sessions will be a key determinant in reversing the won vigour in summer.

Chart 1: Arbitrage incentive aided KRW strength in H1



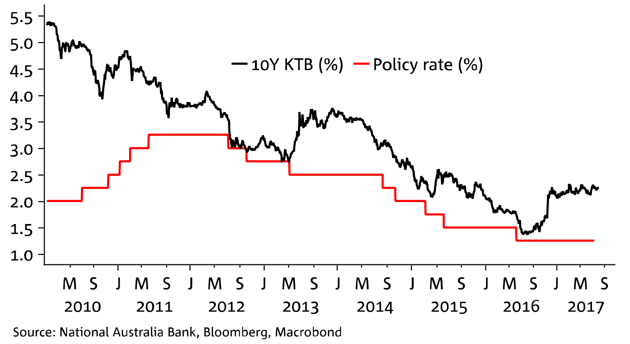
Source: National Australia Bank, Bloomberg, Macrobond

Chart 2: KTB "yielding" to the rise in USTs



Source: National Australia Bank, Bloomberg, Macrobond

Chart 3: 10Y KTB yield has stabilised higher



Source: National Australia Bank, Bloomberg, Macrobond

INDIA SPOTLIGHT:

Rate cut but no capitulation

- **RBI cuts its policy rates 25bps but maintains that its policy stance remains "neutral".**
- **RBI sees an "urgent need to reinvigorate private investment, remove infrastructural bottlenecks and provide subsidized credit for low income housing.**
- **Growth story has lost its luster somewhat and has to work through the disruption from the GST and the demonetization measure.**

Action and obfuscation

The latest Reserve Bank of India (RBI) Monetary Policy Committee (MPC) meeting delivered the market-expected 25bps cut, and then some. The MPC statement employed language that made abundantly clear that it viewed the sharply waning investor confidence as a clear and present danger.

However, the MPC still insisted on calling its monetary policy stance "neutral" despite noting that upside risks to inflation have "either reduced or not materialized". Inflation is at a historic low and bank credit growth has also decelerated sharply to under 5% yoy. The absence of any fundamental impediment to further easing suggests that their reticence there might be in part an attempt to assert their independence, given that the government has been lobbying aggressively for a rate cut for some time.

The RBI clearly believes that some of the drag on investment continues to emanate from structural problems like infrastructure bottlenecks and non-performing assets sitting on public sector banks' books. However, the fact remains that the rate cuts over the last 2 years have not been fully passed on by the banking sector. Barring a rebound in loan growth or inflation, the room remains further easing in the quarters ahead.

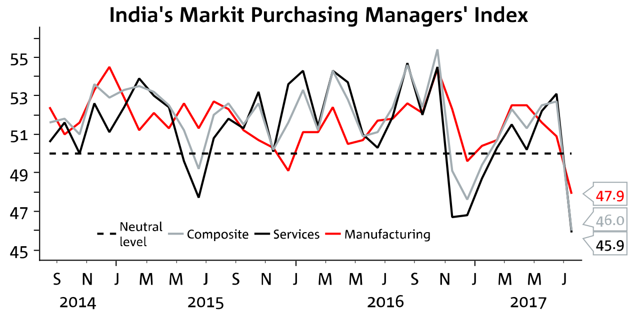
The reasons to cut were clear

For a few months now, it had been getting increasingly clear that investor sentiment was in need of help and a slew of economic activity indicators – most notably growth rates in bank credit, capital and infrastructure goods production, and cement – all slowed to varying degrees over the course of the year.

Most worryingly perhaps that almost uniformly, investment related activity indicators show substantial weakness after an initial rebound after the demonetization measure in November 2016. Most notably, bank credit growth has fallen sharply, along with the growth in production of capital goods and infrastructure/construction goods.

Also worrying is the sharp plunge in in July in the PMIs for both Services and Manufacturing to significantly below the neutral 50 level. Admittedly, this might be a bit of a kneejerk reaction to the introduction of the Goods & Services Tax (GST) on 1 July. While it is too early to say whether or not the introduction has been problematic, the tiered nature of the GST (5 tiers) is a potential source of legal contention. More data will be needed but this is definitely a source of concern.

Chart 3: Sharp dip in sentiment as GST is introduced



Source: National Australia Bank, Macrobond

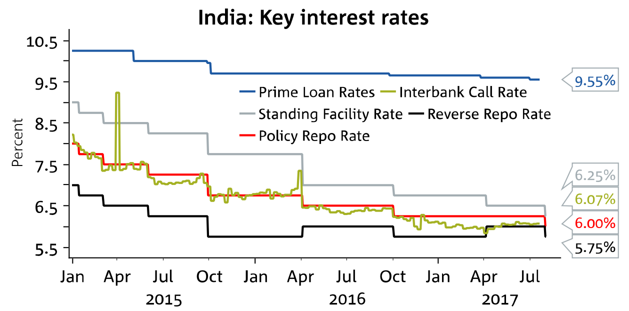
Structural reforms have a role to play

The RBI made it abundantly clear that it sees the problem as not being exclusively with the cost of borrowing. As such, structural reforms like the recent streamlining of bankruptcy laws, will continue. The citing of Pradhan Mantri Awas Yojana project also perhaps throws the ball back in the court of the government, which has been pressuring the RBI to cut rates for some time now.

Itching for a fight

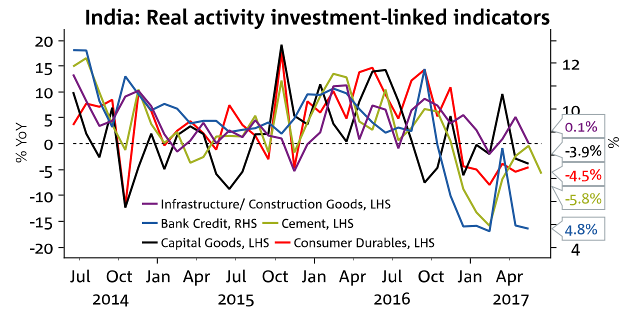
This in turn might have been the main reason for the RBI's reticence regarding the prospect for further cuts in the near future. Maintaining that its monetary policy continues to be "neutral" signals that it is not by default inclined towards more near term cuts, unlike what the government has suggested. While it is true that the fading of the erstwhile high-base effects in CPI inflation will leave it more supported, the RBI's stance might be more of an effort to maintain its independence than anything else.

Chart 1: Disruption from demonetization in Q1 GDP



Source: National Australia Bank, Macrobond

Chart 2: Manufacturers' sentiment might be turning



Source: National Australia Bank, Macrobond

SINGAPORE SPOTLIGHT:

SGD's climb might by slowed

- **The sharp slide in the USD in July has seen the S$NEER surge from 0.5% above the mid-point to just below 1%.**
- **Despite the apparently strong growth momentum, inflation and the jobs market remain soft so further SGD strength might not be totally welcomed.**
- **MAS is considering introducing a minimum leverage ratio in line with Basel III.**

Too much of a good thing

Although not yet at a level that would cause the Monetary Authority of Singapore (MAS) to act in a robust fashion, it is quite likely that the pace of the rise in the S$NEER from just 0.5% above the mid-point of the policy band at the start of July 2017, to 0.99% at the end of the month, will cause a bit of hand-wringing.

The complication for the MAS when deciding how much SGD strength to allow, is that the data is a bit unclear as to just how strong the economy is at this juncture. Recent momentum has been robust, and market sentiment has picked up on that. However, there are structural changes still taking place and the jobs market remains somewhat soft. MAS might well try and limit the near term strength of the SGD, or at least reduce the pace of appreciation.

MAS has also begun soliciting feedback on its intention to introduce a minimum leverage ratio of 3%, in line with Basel III requirements. MAS' proposed introduction of the new requirement is scheduled for 1 January 2018, also in conjunction with Basel III.

Growth remains robust

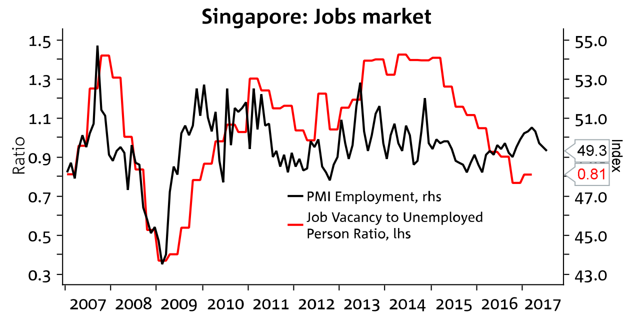
Latest economic data suggests that the growth momentum is still enjoying some feed through from the stronger global demand. Advance Q2 GDP growth estimate came in at 2.5% yoy, a slight deceleration from Q1's 2.7% yoy but overall the growth momentum is still fairly strong. On a QoQ saar basis, GDP grew 0.4%, with construction leading the way at 4.3%, a reflection of strong fiscal spending in the Mass Rapid Transit system. Manufacturing decelerated slightly to 2.4% from 0.4%, while services managed to recover 0.4% from -2.7%.

Of course this is based on April-May data and subject to sometimes quite significant revisions. June's other economic indicators were a bit mixed: NODX fell 2.7% mom sa but industrial production rose a rather strong 9.7% mom sa. The PMI for June though remained decent at 50.9, compared to 50.8 in May.

Jobs market remains soft

While the near term momentum might be quite decent, the medium term picture projected by the jobs market is a little less rosy. The most important indicator – the ratio of job vacancies to unemployed persons – rose marginally from 0.77 in Q4 2016 but remains low at 0.81 at the end of Q1 2017. Additionally, job vacancies in the key PMET (professionals, managers, executives and technicians) segment was 23.7k in Q1 from 26.5k in Q2 2016 and as high as 32.1k in Q2 2015. More recently, the PMI employment sub-index slid from 50.5 in March to 49.5 in June.

Chart 3: Jobs market still soft at the margin



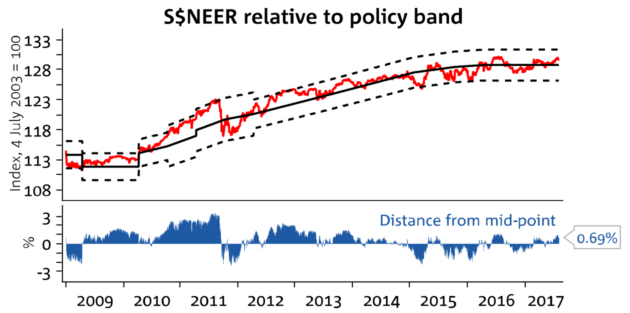
Source: National Australia Bank, Bloomberg, Macrobond

Leverage ratio requirements met

The impending introduction of the 3% minimum leverage ratio is not likely to be cause disruption to the local banking sector. The 3 major domestic retail banks have leverage ratios of above 7.5% as of end-2016. According to the Bank of International Settlements, the simple, transparent, non-risk based leverage ratio is intended to:

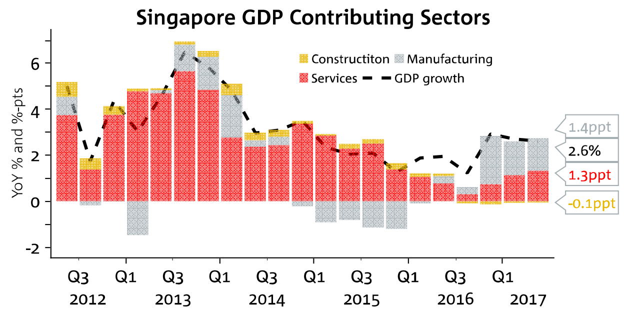
- restrict the build-up of leverage in the banking sector to avoid destabilising deleveraging processes that can damage the broader financial system and the economy;
- reinforce the risk-based requirements with a simple, non-risk-based "backstop" measure.

Chart 1: S$NEER surges in July



Source: National Australia Bank, Bloomberg, Macrobond

Chart 2: YoY growth less dependent on construction



Source: National Australia Bank, Macrobond

MALAYSIA SPOTLIGHT:

Policy conflicts emerge

- **The MYR has been the weakest in Asia over the month of July against the weak-USD backdrop.**
- **Weak growth versus lack of fiscal space remains a key theme as the government keeps one eye on the early elections in the months ahead.**
- **A meaningful political upset remains a tail risk at most but not beyond the pale.**

Tensions sprouting all over

After the rather strong showing in June, the MYR reversed its relative outperformance and effectively came in bottom of the Asian leader board, only beating the USD-pegged HKD. The surge in demand for Malaysian Government (debt) Securities (MGS) appears to have petered out in June and while July's data is still not out, it's likely that demand for MGS will have been lacklustre. FX reserves accumulation has ground to a halt as well, another indicator that inflows have ebbed materially.

Apart from managing the currency, Bank Negara Malaysia (BNM) also faces another dilemma with interest rates: growth remains tepid but household loan growth has been strong. The government is also in a bit of a bind juggling its fiscal deficit cap, slow growth, and impending elections.

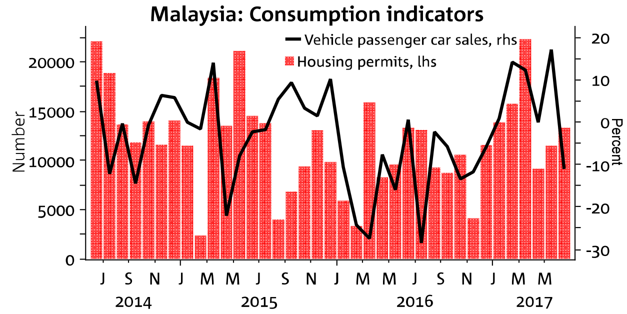
There are rumblings that suggest both sides are gearing up for snap elections to be called in the months ahead. Key opposition figures have formed a political alliance while the ruling party has engaged in its own manoeuvres. The shadow boxing will continue till an announcement probably nearer the end of the year and this risks colouring the market's view of government spending measures.

MYR falls back to earthly reality

After the strong rise in the MYR over April and May on the back of a surge in inflows into the MGS market, reality has hit home. From mid-March to mid-June, foreign reserve assets rose almost USD1.3 billion per month; this slowed to USD0.4 billion from then to mid-July, coinciding with a slide in the stock market. Although that has since stabilized, there is scant sign of a strong rebound in the offing For the MGS, the surge in inflows completely petered out in June but did not go sharply negative.

Along with this apparent ebbing in portfolio inflows, the strong domestic demand, in Q1 at least, appears to be leading to strong imports, which has seen the trade balance disappoint.

Chart 3: Reserve adequacy hovering at a lower level



Source: National Australia Bank, Bloomberg, Macrobond

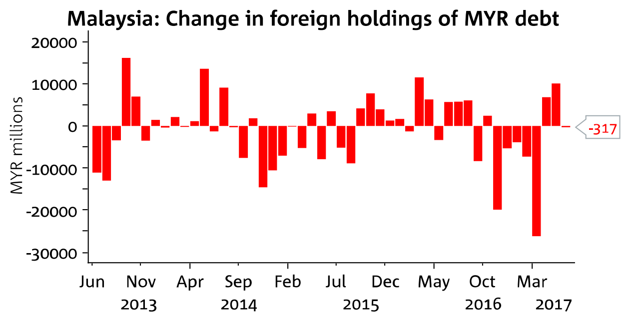
Fiscal temptations

In its July monetary policy statement explaining its decision to keep policy rates unchanged, BNM maintained that the interest rate remains accommodative but also highlighted the risk that household debt is at a rather high level. Indeed, household loan growth has continued to accelerate steadily through the year. This is likely going to limit the scope for further monetary policy stimulus, especially since keeping the MYR from depreciating sharply also seems to be another policy objective.

Fiscal policy also remains somewhat constrained given that it's already loose. Malaysia's fiscal deficit of 3.1% in 2016 is one of the highest in Asia and its debt level at 53.2% of GDP is near its self-imposed target of 55%. Prime Minister Najib Razak has committed to maintaining the 3% target on the deficit for 2017 but the budget handed a slew of goodies that we listed in last month's Essential Asia and that took effect in January 2017. Since then, the government has doled out MYR1.6 billion (USD373 million) to farmers, who form the majority in 54 of 222 federal seats and are a key constituent of the ruling party. Such spendidng measures are going to increasingly come under scrutiny from the market.

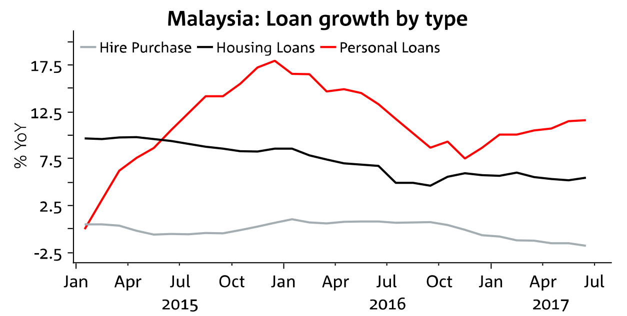
On the periphery, the opposition has also been coalescing around key figures. While it is probably too early to assess their potency, the market could get spooked by the prospect of increased political uncertainty and further government largesse might be seen through the lens of the upcoming elections.

Chart 1: Foreign demand for MGS petered out in June



Source: National Australia Bank, Bloomberg, Macrobond

Chart 2: Growth in personal loans keeps accelerating



Source: National Australia Bank, Bloomberg, Macrobond

INDONESIA SPOTLIGHT:

Time to tax and spend

- **The IDR remains firmly stuck in a narrow range and the focus for portfolio investors should continue to shift toward domestic growth engines.**
- **The market is likely to be unfazed by a slightly wider fiscal deficit but if anything wider than 3% might spook bond holders.**
- **The government has been given license to increase infrastructure spending but tax revenue reforms will be a necessary precursor.**

Potholes in the road ahead

The IDR was a heavy underperformer in July as Bank Indonesia (BI) demonstrated the discipline that has seen the USD/IDR exhibit an extraordinary level of stickiness on either side. The IDR carries the highest yield (at least year-to-date), which will comport with the stickiness in the USD/IDR topside to make the IDR relatively attractive during potential upcoming periods of USD strength. For now though, the IDR is likely to remain an underperformer.

Discipline is also coming to the fore on the fiscal side. Credit is due to the authorities for being transparent about the underperformance in revenue collection, which is set to see the 2017 fiscal deficit widen to 2.9% of GDP, relative to the initial target of 2.4%. S&P has chimed in to say that a wider fiscal deficit does not necessarily represent a material policy easing.

To complicate matters, the government is being pressured to increase infrastructure spending. To square these competing demands, tax collections need to be increased. While the scope for higher tax collections exists, making it happen can be a long-drawn process.

Not too much rope…

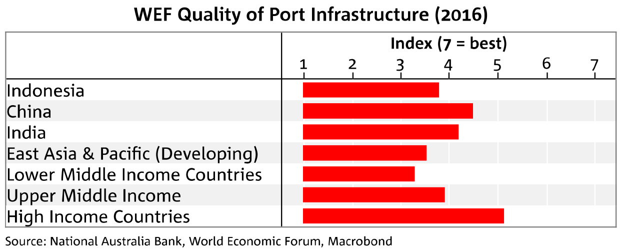
Revenue pressures mean that the original projection of a deficit of 2.4% of GDP will very likely be exceeded. The revised deficit is now projected at 2.9% of GDP, although Finance Mister Sri Mulyani suggests the government will probably only end up spending 95%-97% of its expenditure so the deficit might come in at only around 2.7% of GDP. While a narrower deficit is a good thing, this is hardly a good way to get there.

The tail risk here is that as we get closer to the end of the year, the 3% legislative fiscal deficit cap on might start to appear under threat. Although not in and of itself a serious risk to macroeconomic stability, given that debt levels have fallen significantly, a breach of the 3% cap could spook bond holders and lead to some pressure on the IDR from related outflows.

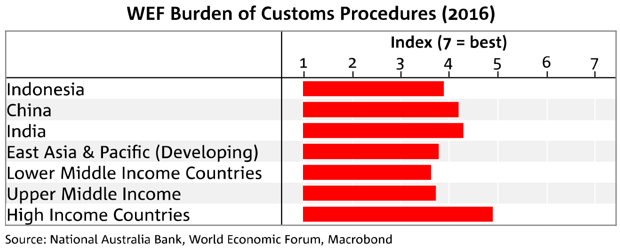
Finding the money

Despite the need to cap the fiscal deficit, the government has been urged by the World Bank (WB) to increase infrastructure spending to 4.7% of GDP by 2020 from 2.0% currently. The WB has also suggested that Indonesia needs USD500 billion over the next 5 years to "build roads, ports and bridges and should remove hurdles to encourage greater private sector investment". The tables below illustrate the need for Indonesia to play catch up.

Chart 3: Both hardware and software need upgrading



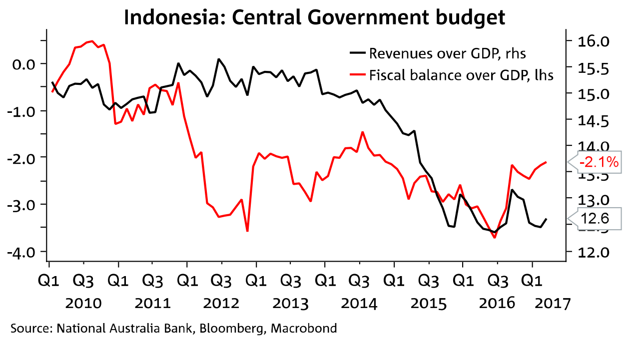
Source: National Australia Bank, World Economic Forum, Macrobond



Source: National Australia Bank, World Economic Forum, Macrobond

To balance the bottom line though, the government will need to increase its revenue collections. Our smoothed Q1 2017 estimate for revenues-to-GDP is at 12.6% but the latest number as given by the government is even lower at 10.3%. This is far below the 15% that the IMF estimates is needed. The government has committed to raising this to 16% by 2019 but it remains to be seen whether the government will be able to pass required tax legislation and then execute on it. If it succeeds, the outlook for onshore bond and equity markets could improve substantially.

Chart 1: Revenue to GDP remains too low



Source: National Australia Bank, Bloomberg, Macrobond

Chart 2: Broad infra spending remains needed

Global Competitiveness Index Infrastructure sub-component rankings

World ranking out of 138 countries (lower = better)	Transport infrastructure	Electricity and telephony infrastructure
Australia	19	14
China	18	75
Hong Kong	3	1
India	24	106
Indonesia	36	81
South Korea	10	16
Malaysia	11	46
Philippines	90	95
Singapore	2	5
Taiwan	16	15
Thailand	37	73

Source: National Australia Bank, World Economic Forum

SELECTED INDICATORS

Table 1: NAB Asian FX Forecasts

		Sep 17	Dec 17	Mar 18	Jun 18	Sep 18	Dec 18	Mar 19	Jun 19		Sep 17	Dec 17	Mar 18	Jun 18	Sep 18	Dec 18	Mar 19	Jun 19
New	**USD/CNY**	6.81	6.82	6.81	6.81	6.80	6.79	6.74	6.73	**AUD/CNY**	4.97	4.77	4.77	4.77	4.76	4.75	4.72	4.78
Old		6.96	6.97	7.00	7.05	7.07	7.07	7.05	7.02		5.08	4.88	4.83	4.79	4.81	4.88	4.94	4.98
New	**USD/IDR**	13450	13500	13500	13480	13460	13400	13360	13350	**AUD/IDR**	9819	9450	9450	9436	9422	9380	9352	9479
Old		13400	13450	13450	13550	13600	13600	13550	13500		9782	9415	9281	9214	9248	9384	9485	9585
New	**USD/INR**	65.0	65.3	65.5	65.8	65.6	65.4	65.2	65.0	**AUD/INR**	47.5	45.7	45.9	46.1	45.9	45.8	45.6	46.2
Old		64.5	64.6	64.8	65.0	65.0	65.2	65.4	65.5		47.1	45.2	44.7	44.2	44.2	45.0	45.8	46.5
New	**USD/KRW**	1160	1200	1200	1180	1160	1160	1150	1150	**AUD/KRW**	847	840	840	826	812	812	805	817
Old		1160	1200	1200	1180	1160	1160	1150	1150		847	840	828	802	789	800	805	817
New	**USD/MYR**	4.25	4.40	4.35	4.35	4.35	4.30	4.25	4.20	**AUD/MYR**	3.10	3.08	3.05	3.05	3.05	3.01	2.98	2.98
Old		4.48	4.50	4.55	4.55	4.55	4.55	4.50	4.45		3.27	3.15	3.14	3.09	3.09	3.14	3.15	3.16
New	**USD/PHP**	50.3	50.5	50.0	49.5	49.2	49.0	48.6	48.5	**AUD/PHP**	36.7	35.4	35.0	34.7	34.4	34.3	34.0	34.4
Old		50.3	50.5	50.6	50.7	50.8	50.8	50.5	50.0		36.7	35.4	34.9	34.5	34.5	35.1	35.4	35.5
New	**USD/SGD**	1.385	1.405	1.400	1.400	1.398	1.395	1.385	1.380	**AUD/SGD**	1.01	0.98	0.98	0.98	0.98	0.98	0.97	0.98
Old		1.430	1.435	1.440	1.440	1.450	1.450	1.440	1.420		1.04	1.00	0.99	0.98	0.99	1.00	1.01	1.01
New	**USD/THB**	34.1	34.5	35.0	34.6	34.5	34.5	34.4	34.3	**AUD/THB**	24.9	24.2	24.5	24.2	24.2	24.2	24.1	24.4
Old		34.8	35.0	35.3	35.6	35.5	35.5	35.3	35.3		25.4	24.5	24.4	24.2	24.1	24.5	24.7	25.1
New	**USD/TWD**	30.2	30.2	30.4	30.5	30.6	30.5	30.3	30.2	**AUD/TWD**	22.0	21.1	21.3	21.4	21.4	21.4	21.2	21.4
Old		30.2	30.2	30.4	30.5	30.6	30.5	30.3	30.2		22.0	21.1	21.0	20.7	20.8	21.0	21.2	21.4

Table 2: NAB Key FX Forecasts

		Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Australian Dollar	AUD/USD	0.73	0.70	0.70	0.70	0.70	0.70	0.70	0.71
New Zealand Dollar	NZD/USD	0.71	0.68	0.68	0.68	0.69	0.69	0.71	0.71
Japanese yen	USD/JPY	114	118	120	120	122	122	120	118
Euro	EUR/USD	1.17	1.15	1.17	1.18	1.20	1.23	1.23	1.25
British Pound	GBP/USD	1.28	1.27	1.28	1.28	1.26	1.25	1.28	1.30
Swiss Franc	USD/CHF	0.96	0.96	0.96	0.97	0.99	0.97	0.97	0.98
Canadian Dollar	USD/CAD	1.33	1.37	1.35	1.34	1.33	1.34	1.35	1.34
Chinese New Yuan	USD/CNY	6.81	6.82	6.81	6.81	6.80	6.79	6.74	6.73

Table 3: NAB Asia Macro Forecasts

	2013	2014	2015	2016	2017	2018
Hong Kong	3.1	2.7	2.4	1.6	1.6	1.6
Indonesia	5.6	5.0	4.9	5.0	5.0	5.0
Singapore	4.6	3.3	2.0	1.5	1.5	1.5
Taiwan	2.2	3.9	0.7	1.3	1.3	1.3
Thailand	2.7	0.8	5.0	4.2	4.2	4.2
Malaysia	4.7	6.0	2.6	2.7	2.7	2.7
S Korea	2.9	3.3	2.8	3.3	3.3	3.3
Philippines	7.1	6.2	5.9	6.8	6.8	6.8
Total	**4.2**	**4.1**	**3.6**	**3.8**	**3.8**	**3.8**
China	7.7	7.3	6.9	6.7	6.5	6.5
India	6.3	7.0	7.2	7.1	7.2	7.2

Table 4: NAB Key Macro Forecasts

Country/region	2013	2014	2015	2016	2017	2018
United States	1.7	2.4	2.6	1.6	2.1	2.3
Japan	2.0	0.3	1.2	1.0	0.8	0.6
Euro-zone	-0.3	1.1	1.9	1.7	1.9	1.8
United Kingdom	1.9	3.1	2.2	2.0	1.8	1.7
Emerging Asia	4.2	4.1	3.5	3.7	3.7	3.6
Latin America	2.5	0.9	-0.2	-1.2	0.1	1.9
China	7.7	7.3	6.9	6.7	6.5	6.3
Canada	2.5	2.6	0.9	1.2	1.7	2.0
Australia	2.1	2.8	2.4	2.4	2.3	2.4
New Zealand	2.2	3.4	2.5	3.2	2.9	2.5
India	6.3	7.0	7.2	7.1	7.2	7.2
Africa	5.2	5.1	3.4	1.6	2.8	3.7
Eastern Europe	2.8	2.8	3.7	2.9	3.1	3.1
Middle East	2.4	2.2	2.5	3.8	3.1	3.5
Other advanced	2.2	2.8	2.0	2.0	2.0	2.0
World	**3.36**	**3.39**	**3.10**	**2.94**	**3.18**	**3.35**

Source all tables: National Australia Bank

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