

Standard Chartered Asia Focus | 01 September 2011

Storm of economic uncertainty

Turbulence ahead



Highlights

- We have reviewed and revised our Asia economic forecasts, where necessary, to reflect the recent financial-market turbulence. The revisions have been modest, as economic developments this year have been broadly in line with our previous thinking.
- The strong growth outlook for domestically driven economies such as China, India and Indonesia remains intact. For export-oriented economies such as Singapore, Hong Kong, Taiwan, Thailand, South Korea and Malaysia, we have revised our growth projections in anticipation of a weaker Q3-2011 and a rebound in early 2012.
- Greater uncertainty implies that Asian central banks are likely to pause monetary tightening, and leave the option open to resume in 2012 if needed. Capital flows could re-emerge as a policy challenge for some Asian central banks, especially if they are reluctant to allow their currencies to appreciate on a trade-weighted basis.
- Loose monetary conditions in the West and the relative outperformance of Asian economies could continue to attract international capital inflows to the region's financial markets, barring a repeat of an economic downturn on the scale of 2008-09.

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Global overview – A two-speed world as Japan-style malaise grips the West

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Asia slows

In the wake of the recent financial-market turbulence, we have reviewed our economic forecasts and revised them where necessary. While we have tweaked some of the forecasts, there has been no large-scale revision. This is largely because economic developments this year have been in line with our previous thinking – in particular our view of a two-speed world economy in which we are cautious about the West and positive about the East.

We have cut our US growth forecasts to 1.6% from 1.8% for 2011 and to 2.0% from 2.4% for 2012. This largely reflects the expected hit to confidence and corporate investment plans as a result of recent events, and this will likely spill into next year. We still expect the US to grow in the second half of this year and, as before, we anticipate further policy stimulus. But this is a weak US recovery. Below I focus on this in more detail, and on why the West faces similar challenges to those that have faced Japan since its financial bubble burst. We have also tweaked our forecasts for Asian growth, anticipating some decline in confidence and a softening in export orders. But again, the overall story remains unchanged.

Some Asian economies could be in a 'technical recession' at the end of Q3-2011. Under this widely used (but not always appropriate) definition, a recession is two successive quarters of negative quarter-on-quarter growth. Despite this, based on annual growth rates, the overall picture in Asia is, as before, one of a region moving from strong to slower but sustainable rates of growth. The economic contraction in economies such as Hong Kong and Singapore also reflects the open and volatile nature of their economies, where exports plus imports are high in relation to overall GDP.

This slowdown also has to be put in the context of the strong recovery experienced in 2010 and early 2011. This phase of the cycle fits with our long-held view that the trend is up but that there may be setbacks along the way, reflecting both the interconnectedness of the world economy and the openness of many Asian countries. Steady job creation is likely to continue in these economies, in line with labour supply, ensuring that unemployment rates stay stable.

Asian economies saw a rapid rebound last year and strong momentum early in 2011. This prompted aggressive policy tightening to curb inflation. In turn, economies have started to slow. Asian economies were thus already slowing from rapid to solid growth rates before the latest bout of financial

turbulence. We have now factored in a hit to confidence overseas and at home, the net effect of which will be that some economies will experience back-to-back quarterly drops in economic activity.

In Q2, for instance, both Hong Kong and Singapore – Asia's most open economies – saw growth rates fall from the previous quarter but total output remain above levels a year earlier. Hong Kong contracted 0.5% q/q in Q2, translating into a y/y growth rate of 5.1%. Likewise, Singapore contracted 1.7% q/q but was up 0.9% y/y. Now, following a hit to confidence and some softening of export orders, we expect Hong Kong, Malaysia, Singapore and Taiwan to contract in Q3 compared with Q2. Hence, Hong Kong and Singapore will enter technical recessions (Chart 2).

In Q3, we expect Hong Kong to contract 0.3% q/q but to expand 3.8% y/y; Malaysia to contract 0.4% q/q and grow 3.0% y/y; Singapore to contract 0.9% q/q and be up 4.5% y/y; and Taiwan to contract 0.6% q/q and grow 3.4% y/y. The only Asian economy where we expect an outright contraction this year is Japan, which is perhaps not surprising given the earthquake. But even so, after an expected contraction of 0.4% in 2011, we think Japan can grow by 2.5% in 2012.

Elsewhere in South and East Asia, we think 2011 growth rates will range from a low of 3.2% in Thailand to a high of 9.3% in China. Growth rates in the region's three main domestically driven economies of China, India and Indonesia were in line with our expectations in H1. Recent forward-looking indicators still support our growth forecasts of 9.3% for China, 7.7% for India and 6.5% for Indonesia this year. Next year we expect all three of these domestically driven economies to see higher growth rates, of 10.0% in China, 8.2% in India and 7.0% in Indonesia.

This highlights many issues. The first is the very different economic picture across much of Asia compared with the West, with a slowdown to sustainable growth rates in Asia contrasting with a very weak West. The second is the open nature of many Asian economies, which makes them prone to sharp swings in activity. The third, following from this, is that Asia is not decoupled from events in the West. Indeed, as we saw at the height of the global financial crisis, events in the West can hit Asia hard. That being said, Asia is better diversified and protected now, with more room for policy manoeuvre if needed – either by putting monetary tightening on hold, as has already happened in China, or relaxing fiscal policy if necessary.



Global overview –A two-speed world as Japan-style malaise grips the West

Global context

Let's put this in a global context. Our main scenario has been a tale of two worlds. The phrase we have used this year is a divided and disconnected world facing many policy dilemmas. The divisions have been East versus West, core versus periphery in Europe, and big firms versus small in the US. This disconnect has been evident in many ways, particularly in high rates of youth unemployment. The policy dilemmas are very different: in the East, the challenge has been to tighten policy to curb inflation without hitting growth too much, whereas in the West, it has been to stimulate economies, despite misplaced market fears earlier this year about inflation and present market worries about budget deficits.

Both in the West and the East, the outlook depends on the crucial interaction between economic fundamentals, policy and confidence. In the West, the fundamentals are poor, the policy cupboard is almost bare and confidence is fragile. In recent weeks, confidence has taken a further hit. As we have previously written, the latest developments are not a new crisis but a continuation of the crisis that began three years ago. This is reflected in the painful economic adjustment process, where the overhang of debt and the scale of deleveraging are holding back many Western economies. The overall result has been very little growth in the West. Growth there has been largely driven by policy stimulus or by the growing impact of the East, as seen, for instance, in Germany's exports to China.

The West was already facing an era of austerity because of the need for people and firms to reduce their debt. That austerity will be made even worse if governments now embark upon fiscal tightening at a time when private-sector demand is sluggish. Policy stimulus has worked in the West. Without it, growth would have been a lot worse. The best the West can now hope for is a period of sluggish growth.

Our main scenario is much stronger growth in the East than in the West, but a slowdown this year because of domestic policy tightening as countries try to curb inflation and the impact of weaker global activity. We see this as a move from strong to slower (but still-solid) rates of growth. Recent events reinforce this picture.

We remain cautious about the US. The level of the economy now is still below its pre-recession peak (Chart 4),

and unemployment is still far higher than it was then. Moreover, it is hard to be too optimistic. The backdrop for the consumer is one of sluggish wage growth, little job creation, and a very weak housing market. Any turbulence in the financial markets will further erode confidence, not only in the immediate economic outlook but also in future pensions. This is not a great recipe to encourage people to spend and firms to invest.

A further challenge, not just in the US but in much of the West, is that firms that do have the ability to spend may think twice about doing so at home, either because of sluggish demand or because they may be attracted to emerging economies, where prospects look better. Increased uncertainty will further deter investment plans.

That being said, the US can still grow in H2 thanks to the recent decline in gasoline prices, a rebound in car production and sales following the disruption after the Japan quake, and a boost to investment in Q4 from the expiry of tax allowances at year-end. And then, in Q1-2012, we anticipate QE3 from the Fed. President Obama is also likely to unveil further stimulus measures, which may be aimed, among other things, at encouraging firms to take on staff. While the outlook is not encouraging by any means, all of these factors should keep US growth positive. It could be worse.

Over the last year, we have said that a double-dip would be possible if there was an external shock, a policy mistake or a loss of confidence. It is tempting to say that the US has just experienced all three in a short space of time.

This is not true only in the US. Europe, if anything, faces a bigger problem. At some stage the euro may suffer a crisis. For now, it appears more likely that the ongoing crisis of confidence seen over the last year will persist as we drift from one problem to another. The big issue is that the periphery faces recession; this in turn exacerbates governments' debt burden and feeds directly into the banking sector, given banks' large holdings of government bonds. It is quite possible that more banks will have to accept far larger write-downs, probably equal to half the face value of the Greek debt that they hold. Against this backdrop in the US and Europe, central banks are likely to come under increased pressure to provide liquidity and keep interest rates low.



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Can the West avoid repeating Japan's lost decade?

In recent weeks, a dominant question has been whether the US and European economies are to suffer the same fate as Japan in the 1990s. Japan's economic bubble burst 20 years ago. Since then, Japan has suffered weak growth and what became known as the 'lost decade'.

If anything, the immediate challenges facing the West now are worse than those that faced Japan when its bubble burst. The West faces little growth and low interest rates for the next few years. But the West can rebound, as it is more likely than Japan to face up to the need for supply-side reforms aimed at boosting productivity. It would require monumental policy mistakes for the outcome in the West over the next decade to be exactly the same as Japan's lost decade. For the West, the main message is to avoid deflation and boost demand.

An ominous lesson for the West from Japan is that when bubbles burst, economic pain cannot be avoided. One aspect that might appear worse for the West now is that it took a while for the full extent of Japan's problems to materialise. While the West had its economic and financial crises simultaneously, Japan's were spread over eight years. Japan's bubble burst at the end of 1989. Yet from 1990 to 1997, employment rose as firms expected growth to rebound and were reluctant to lose skilled staff. Then Japan had its financial crisis. In the autumn of 1998, Yamaichi Securities collapsed in what was then the biggest corporate failure in history. This had been immediately preceded by the failure of Hokkaido Takushoku, Japan's 10th-largest bank.

The West may display a greater sense of urgency in solving its current problems. At the time of its collapse, Japan was the world's second-largest economy and enjoyed high living standards. This, if anything, lessened the sense of urgency to take radical action. The lack of political debate did not help. Socially Japan could handle slow growth, as income disparities were not huge. Aspects of this social cohesion were apparent this year in the way Japan handled the aftermath of the earthquake and tsunami. This is in contrast to the US and some parts of Europe.

Avoid deflation

In the early 1990s, I wrote that Japan faced the four immediate D's – debt, deflation, de-industrialisation and

deregulation – and that it faced a longer-term challenge, demographics, because of its ageing population. Understand these factors, and you will see that there are both similarities and differences with the West.

Japan's debt problem was different to the West. Japan ran current account surpluses and was able to fund its debt easily at home. The US and the European periphery do not have that luxury, and have had to face up to their problems sooner than Japan ever did.

In Japan, people were large savers when the bubble burst and were able dip into their savings. In contrast, the Western countries that are in trouble now have high personal debt. This makes the economic pain in the West worse.

Deflation was Japan's biggest problem. Its stock market is still at a fraction of the 1989 peak. Land prices peaked in 1991 and took until 2006 to stop falling, and this added to collateral and bad-loan problems for Japan's banks. As consumer prices fell, people delayed spending. The West must avoid the deflation trap, particularly given the high level of debt.

The West faces a de-industrialisation challenge now, as Japan did then. Japan's industry 'hollowed out', moving production to lower-cost centres elsewhere and feeding downward pressure on costs and margins at home. The same is happening in the West now. This reinforces the need to boost growth to avoid a self-feeding downward spiral, and to encourage firms to invest.

The deregulation issue is one big difference between the West now and Japan during its crisis. Japan never came to terms fully with the need for supply-side reform and structural change, and was slow to adopt such change. Parts of the European periphery may be reluctant to adopt such reforms, but investors and governments in core Europe will demand progress in exchange for further support. Although the West cannot avoid weak demand in the coming years, there is more reason to think US industry will be able to bounce back and boost productivity.

Then there is the demographics issue. Japan's ageing population is even more of an issue now than it was 20 years ago. There are some similarities with parts of Europe, but not with the US, which has a young population.



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Policy urgency is key

Japan faced both demand- and supply-side problems. It focused largely on the demand side, but not well enough, and ignored supply-side solutions for a long time. In short, it did not fully address its problems. Therein lies the challenge for the West.

The West needs to learn the right lessons from Japan. It has done so on the monetary policy front. The Bank of Japan (BoJ) adopted a zero interest rate policy in February 2001, and carried out 'twist' operations to flatten the yield curve and 'rinban' operations to buy excess government bonds from banks. The BoJ even embarked upon quantitative easing in March 2001, and announced its preconditions for exiting from it many years before stopping QE in 2006. The big difference is that Western central bankers have acted more aggressively and over a far shorter time period. That is positive.

The fiscal lesson from Japan is more complex. Most worrying for the West now is that just ahead of its financial collapse, Japan had embarked on tough fiscal tightening in 1997. From the bursting of the bubble in December 1989 until 1997, Japan introduced various fiscal boosts. All of them worked, but 1997 marked a turning point as fiscal policy was tightened. The consumption tax was hiked and public spending squeezed. The economy suffered, and the financial sector imploded. One lesson was that premature fiscal tightening is not good in an economy that needs demand.

The other fiscal lesson has become clear over the subsequent 20 years: avoid weak growth, as it has continued to push Japan's government debt up to worrying levels. In fact, Japan's fiscal situation is a bigger worry now than it was two decades ago, largely because growth has been so weak and government debt has continued to rise.

In the West, there is much talk of inflating debt away. That proved hard in Japan. Its population was ageing and had savings, so there was no mandate to inflate. Also, the Japanese yen proved resilient, and this reinforced deflationary pressures. A lesson for the West now is that a strong currency policy does not help, and that inflating debt away is a hard policy to implement.

The East, too, can learn from Japan by setting policy to suit domestic needs, which Japan did not always do. In the mid- to late 1980s, currency policy dominated Japanese policy makers' thinking, and domestic interest rates were too low. This fed the bubble. In the 1990s, the debate Japan needed to address about the structure of its economy was sidelined as it boosted fiscal spending in response to G7 pressure. In 1989, Japan's gross debt was high, but a large pension surplus because of the ageing population meant net debt was low. Japan was encouraged by the G7 to spend. Its fiscal position has moved in one direction ever since.

The West faces a long, hard slog. Thus, the lesson from Japan for the West is the need for more quantitative easing, no premature fiscal tightening and further economic deregulation to encourage investment and growth. The main message is to avoid deflation at all costs.



Global overview – A two-speed world as Japan-style malaise grips the West

Table 1: Revisions to our Asia forecasts

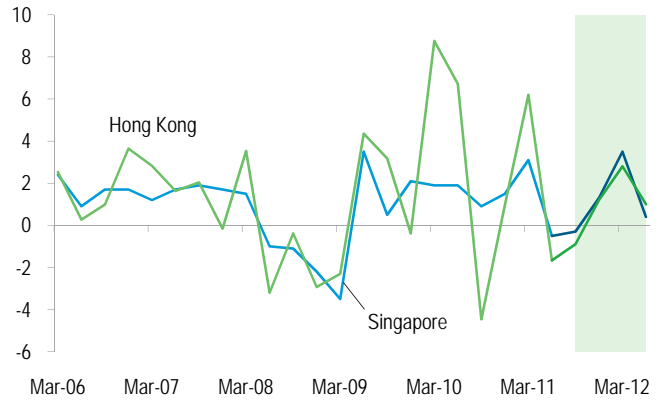
Real GDP growth, %/y

	Latest		Previous	
	2011	2012	2011	2012
US	1.6	2.0	1.8	2.2
Japan	-0.4	2.5	0.1	3.6
Bangladesh	6.5	6.5	6.0	6.6
China	9.3	10.0	9.3	10.0
Hong Kong	5.0	4.9	6.0	5.0
India	7.7	8.3	7.7	8.3
Indonesia	6.5	7.0	6.5	7.0
Malaysia	4.2	4.4	5.1	6.0
Philippines	4.3	5.5	5.7	6.0
Singapore	4.8	4.6	5.5	6.0
South Korea	3.5	4.0	3.9	4.8
Sri Lanka	7.8	7.5	7.8	7.5
Taiwan	4.6	5.1	5.6	6.0
Thailand	3.2	4.8	4.5	5.8
Vietnam	5.8	6.3	6.3	7.0

Sources: Standard Chartered Research

Chart 1: Brief contractions expected in HK and Singapore

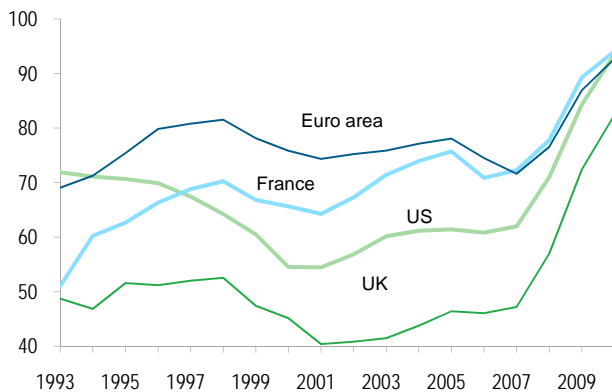
q/q real GDP growth, seasonally adjusted annualised rate



Sources: Bloomberg, Standard Chartered Research

Chart 2: Picking up the bill

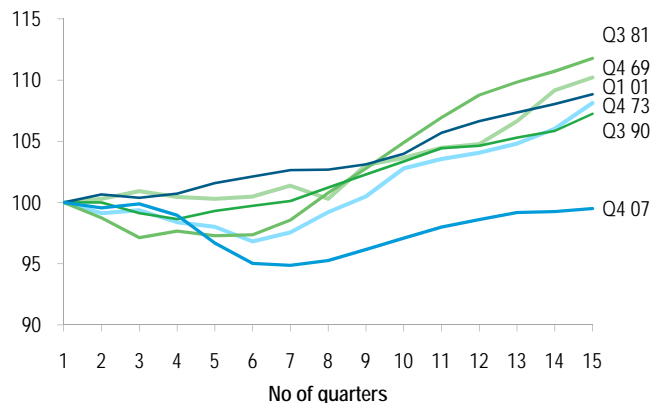
Public debt as % of GDP soared post-financial crisis



Sources: OECD, Standard Chartered Research

Chart 3: US is still below pre-crisis levels of activity

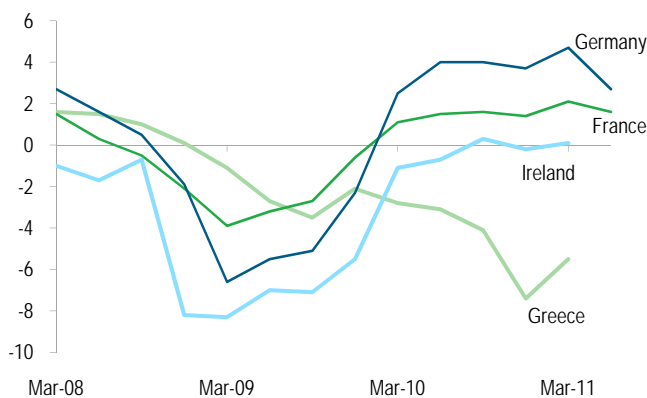
US GDP trends in previous recessions



Sources: CEIC, Standard Chartered Research

Chart 4: Divergence between EU core and periphery

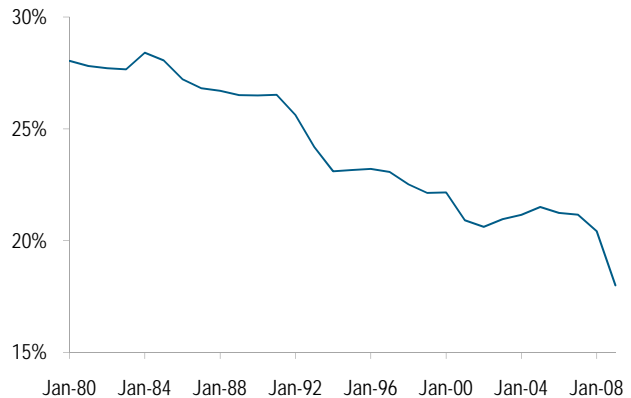
Real GDP growth (%/y)



Sources: Bloomberg, Standard Chartered Research

Chart 5: Japan's ongoing de-industrialisation

Manufacturing as % of GDP



Sources: CEIC, Standard Chartered Research



Asia overview – Please fasten your seat belts

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Déjà vu for Asian central banks

Economic links between Asia and the West look set to create some tough policy dilemmas for Asian policy makers again. In the near term, renewed weakness in US and European growth momentum is likely to weigh on Asia's economic outlook; hence the revisions to our Asian growth outlook for this year and next. While we believe Asian economies are more diversified and better insulated than before the global financial crisis, small, open economies such as Hong Kong, Taiwan, Singapore, Malaysia and Thailand will still be hurt by external uncertainties, with mild contractions expected.

Continuing economic growth in China and other large emerging economies is critical to the rest of Asia, in our view. After all, China's domestic demand grew more than that of the US in US dollar (USD) terms in 2010 (Chart 1), and we expect this outperformance to be more significant in 2011. The ongoing expansion of large emerging economies will help to offset the Western malaise to some degree.

Beyond the current bout of growth weakness in the West, prolonged low interest rates in the US, Japan and Europe are likely to spur further capital inflows to Asia. International investors see Asia as a safe haven due to its strong growth dynamics, low fiscal debt and healthy private-sector balance sheets. Global uncertainties are also likely to prompt Asian central banks to pause their monetary tightening or interest rate normalisation cycles. This could plant the seeds for another bout of inflation over the medium term, both in general consumer prices and asset prices.

Domestic demand offsets external weakness

While GDP growth data is backward-looking and the Q2-2011 figures do not reflect the recent market rout and decline in confidence, they still contain important messages.

First, large, domestically driven economies such as China and Indonesia continued their strong expansion in Q2. Growth was in line with Q1, both on a y/y and a q/q basis. The expansion of large emerging economies such as China, India and Indonesia has had a significant impact on global growth compared to traditional economic forces like the US.

For example, in 2010, domestic demand in the US economy (private and government spending plus investment) grew by USD 472bn (Chart 1), with 73% of this coming from personal consumption. Meanwhile, China's domestic demand grew USD 675bn, with 56% coming from investment and only 26%

from private consumption. India's domestic demand increased twice as much as the EU's in USD terms (by USD 251bn, versus USD 125bn for the EU).

Second, Asia's export-oriented economies posted much weaker headline growth. Economic activity in Hong Kong, Thailand and Singapore contracted in Q2-2011 versus Q1, and their y/y growth also decelerated significantly. That said, domestic demand in most Asian economies remains strong. Chart 2 shows the contribution of domestic demand (private and government spending plus investment) to headline growth. With the exception of South Korea, domestic demand contributed at least 50% of headline GDP growth. For Thailand and Malaysia, the contribution was more than 100%, implying a negative contribution from net exports.

The key message here is that strong domestic demand is likely to partly offset external weakness – at least in the near term – as Asian job markets continue to absorb more workers. According to feedback from our corporate clients, demand from China and other large emerging Asian economies is providing some relief to manufacturers in Asia (although sales to China are generally less profitable than sales to the US and Europe). Indeed, exports to China and the rest of Asia have made a considerable contribution to Asian export growth during past recoveries (Chart 4), even taking into account the processing trade that Asia exports to China for ultimate consumption in developed economies.

The need to differentiate within Asia

While a double-dip recession in the West is not our core scenario, it is worth considering its potential impact on Asian economies. We have highlighted for some time the relative performance of Asia's large, domestically driven economies (China, India and Indonesia) and its export-oriented markets (Singapore, Hong Kong, Taiwan, Malaysia, South Korea and Thailand). During the 2008-09 global financial crisis, China, Indonesia and India were spared y/y GDP contractions as stable domestic demand offset volatility in the export sector, which was modest in size relative to their overall economies.

For Asia's export-oriented economies, GDP contractions during the global crisis ranged from 6.7% in South Korea to 9.2% in Malaysia, led by the export sector. However, it is worth noting that these economies also had very strong V-shaped rebounds in 2010. This reflects their more volatile nature, as well as aggressive reflationary policy responses from their respective authorities.



Asia overview – Please fasten your seat belts

Chart 3 shows the growth correlation of individual Asian economies with US and Europe, using quarterly growth data from 2005 to 2010. Indonesia has the lowest correlation, followed by China and India. At the other end of the spectrum, Hong Kong, Thailand and Malaysia are much more economically in sync with the West; this is likely to be reflected in a significant slowdown, led by exports.

Inflation threat still fresh in policy makers' minds

For now, we expect Asian governments and central banks to take a precautionary economic policy stance, rather than acting aggressively to prepare for a double-dip recession in the West. This cautious approach is likely to be driven by the inflation scare that Asia experienced in late 2010 and H1-2011. High inflation was initiated by rising food and energy prices, arguably a by-product of the Federal Reserve's second round of quantitative easing (QE2), as well as China's investment boom. The impact of commodity prices on headline inflation is now fading, helped by a sharp correction in energy prices in recent weeks.

The surge in headline inflation was followed by a rise in demand-led inflation amid tightening labour markets and strong domestic demand. We still expect job growth in Asia, but at a slower pace than during the recovery phase, and only enough to keep unemployment rates stable rather than lowering them. Lending growth is still rapid in many Asian economies and is accelerating in South East Asia, despite central banks' efforts to raise interest rates and tighten monetary policy.

Given the Federal Reserve's pledge to keep rates low for an extended period and the rising possibility of another round of quantitative easing, Asian central banks will keep an eye on the possible resumption of commodity-price increases, despite the more immediate threat of weakening growth. Our Commodity Research team notes that agricultural prices are already under upward pressure from supply-side factors and persistent demand from emerging markets.

Fine-tuning the policy mix

Since we do not anticipate a double-dip recession in the West, we expect most Asian central banks to pause, but not reverse, their rate-hiking cycles. At the same time, authorities are likely to fine-tune policies to target specific sectors. For example, China may relax lending restrictions for agriculture, social housing and SMEs. In South Korea, the Bank of Korea has been gradually raising interest rates in recent months, but is likely to shift its focus to curbing household debt growth to prevent further debt accumulation, which could raise the risk of instability in the long term.

Capital inflows to the region are another policy challenge likely to face Asian authorities in the next 6-12 months as international investors rotate assets from developed markets (DM) to emerging markets (EM). While wealth destruction in global financial markets caused by collapsing confidence in DM growth prospects is a genuine near-term threat, we believe Asian economies will remain a preferred destination for international investors once confidence stabilises.

Recall that in 2010, several Asian economies faced inflows that, if reversed, could have disrupted local markets. Hence, countries such as Indonesia, South Korea and Thailand introduced various measures aimed at stemming such inflows. The IMF and the Asian Development Bank have subsequently supported measures to manage capital flows when circumstances require such action, after traditional adjustments – such as fiscal consolidation, currency appreciation and monetary tightening – have been made. Most Asian authorities will still be cautious in adopting such curbs, but politics, rather than economics, may prompt some to protect their domestic economies and financial markets by avoiding excessive tightening and currency strength.

Investment allocations in a slowing DM world

From an asset allocation standpoint, the deteriorating environment for developed economies sharply increases near-term price risks for investments in emerging economies. As we have long argued, the slowdown in developed economies contributes to asset allocation to emerging economies – especially debt markets, where the combination of long-standing underweights and better fiscal outlooks has driven this shift. With EM currencies still relatively range-bound in real effective exchange rate terms, the upside potential from FX for global investors remains attractive.

Our concern, however, is the non-linear relationship of EM growth to DM growth. As noted above, many Asian economies still have high growth correlations to the US and EU, unsurprisingly given the openness of many of these economies. Beyond growth, however, we are concerned about the potential impact of a more serious economic downturn on overall funds invested. That is, we see an increasing risk of a shift from asset reallocation to wealth destruction.

One indicator of such a shift is total flows for all fund categories excluding money market funds (which should generally represent a risk aversion flows) – see Chart 5. This shows that funds have been withdrawn from mutual funds in the past month at a pace not seen since October 2008, although the size of outflows has been smaller than in October 2008.



Asia overview – Please fasten your seat belts

The overall pattern since April 2009 has been a steady pace of inflows. However, this more recent outflow does concern us. As assets shift from developed to emerging markets, the pace of such a move can accelerate as growth outperforms in emerging economies. However, if we hit the wealth destruction point, these flows can reverse sharply (as seen in 2008) and from a higher level, resulting in a potentially larger unwinding. While this is not our base case, the risks have increased.

The challenges for Asian policy makers are twofold: first, in the absence of such a reversal, the problem of feeding increased domestic leverage rises; second, the allocation shift is primarily a move out of DM allocations – that is, a strong ‘push’ factor – so Asian policy makers have a limited ability to control the pace of such a shift.

Indeed, the challenges for DM policy makers remain daunting. As we have argued previously, while both the Fed and the European Central Bank (ECB) have pursued multiple strategies to support the recovery, the reality is that the fiscal outlook dominates. Indeed, we believe monetary policy has been reduced to the traditional role of a lender-of-last-resort facility, preventing a full-scale funding collapse rather than meaningfully affecting the growth trajectory. It was this important message that Bernanke delivered at Jackson Hole.

From an Asian perspective, this suggests that while the Fed will continue to provide sufficient liquidity to prevent a liquidity-driven collapse, it may not be as aggressive in using such liquidity to drive growth. This is a welcome message for Asian policy makers concerned about significant liquidity injections under QE. However, as long as fiscal policy does not adjust and the pace of economic activity in developed countries remains anaemic, we expect the asset reallocation process to continue.

We remain overweight duration; FX risk down

As we have previously argued, the global economic and investment environment is characterised by multiple, unstable equilibria, as there is no quick fix to the deleveraging process in developed economies. We have seen little to change this view; however, we also believe that we are not currently at a short-term equilibrium point, given the upcoming key parliamentary approvals of the European Financial Stability Facility (EFSF) and deteriorating US macroeconomic data. During such periods between short-term equilibria, the investment environment is less supportive of significant risk allocations.

The current period differs from similar episodes since Q2-2009 in that the risk of a more serious downturn in economic activity has increased sharply. Hence, the potential for a move from asset reallocation into wealth destruction has also increased.

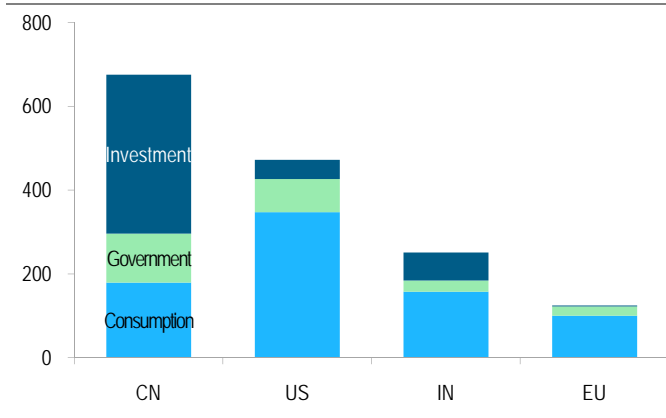
Consequently, while we remain biased towards longer-term appreciation among Asian currencies in aggregate versus G3 currencies, we are wary of adding aggressively to such positions now. However, we see this as a short-term issue of capital preservation rather than a strategic reversal, as real effective exchange rates across the region have failed to appreciate noticeably despite the strongly supportive global backdrop for such a trend move (Chart 6).

In rates markets, we retain an overweight duration bias, as we believe that DM rates will remain relatively range-bound against a backdrop of continued weak economic activity. With EM local bond yields still trading at the wide end of the range to US Treasuries, and with policy makers hitting the pause button earlier and for longer than previously expected against the current global backdrop, we expect near-term outperformance.

Asia overview – Please fasten your seat belts

Chart 1: China's domestic demand grew more than the US'

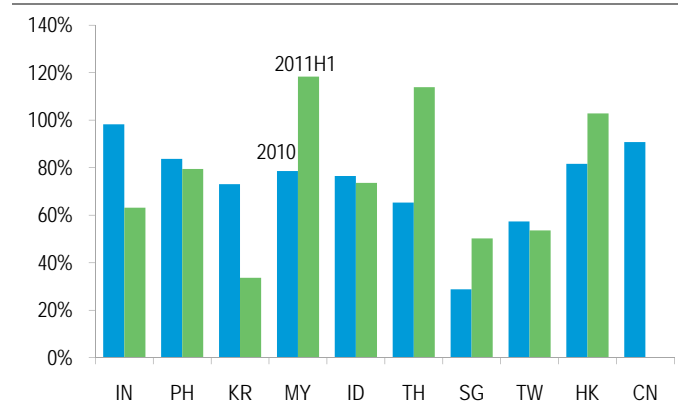
Growth in 2010 domestic demand in value terms, USD bn



Sources: IMF, Standard Chartered Research

Chart 2: The domestic demand driver

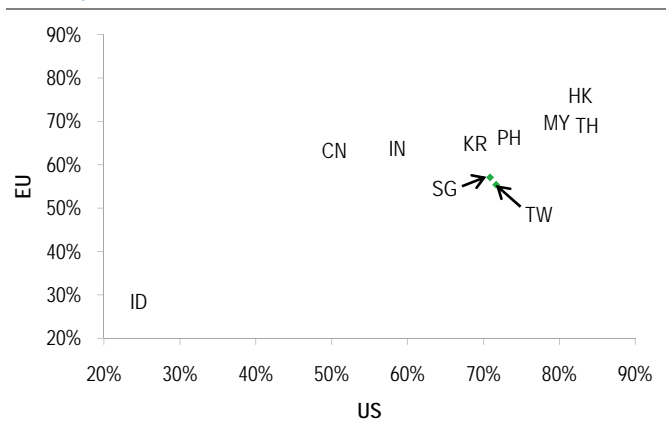
Share of GDP growth from consumption and investment



Sources: CEIC, Standard Chartered Research

Chart 3: Varying degrees of correlation with the West

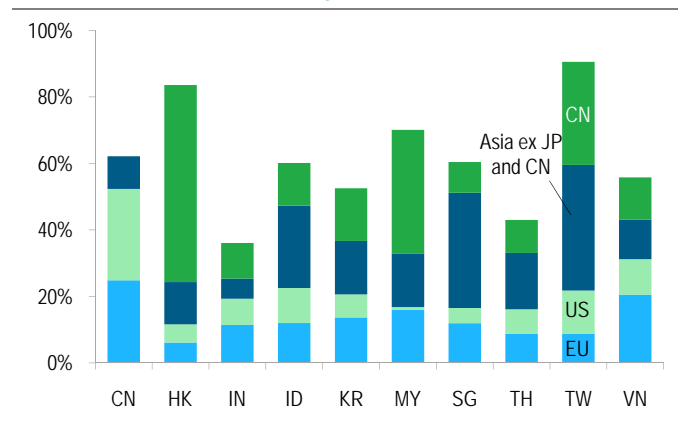
Asia's growth correlation with US and Europe



Sources: CEIC, Standard Chartered Research

Chart 4: Intra-regional trade boosts Asian exports

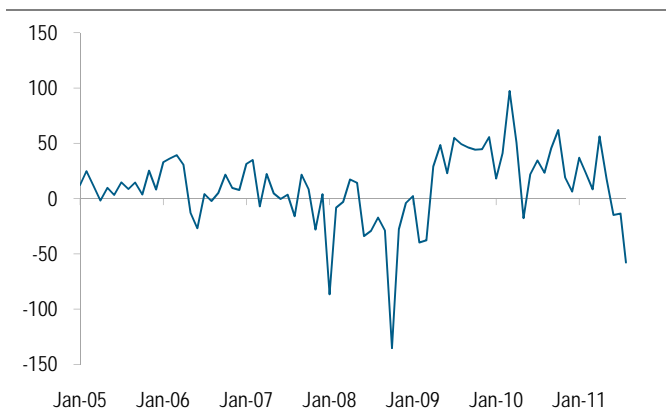
Contribution to Q1-11 export growth from selected economies



Sources: CEIC, Standard Chartered Research

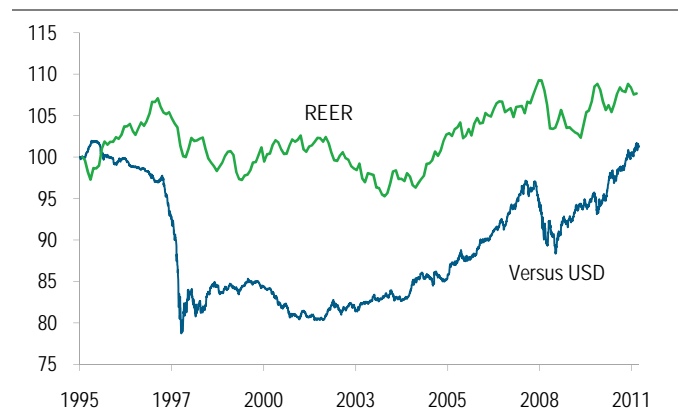
Chart 5: Total mutual fund flows have turned negative

USD bn



Sources: EPFR Global, Standard Chartered Research

Chart 6: While Asian FX has rallied vs. USD, it has barely moved in REER terms



Sources: Bloomberg LP, Standard Chartered Research



Australia – Dutch disease in action

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Mining – A double-edged sword

Given slowing growth in the non-mining sector over the past decade, Australia has relied increasingly on the mining sector to lead economic growth. The mining boom driven by strong demand from China and other Asian economies has resulted in record-high terms of trade. Significant investment in mining projects is underway, and we see a strong pipeline for the mining sector in the medium term, even if developed economies experience a prolonged slowdown.

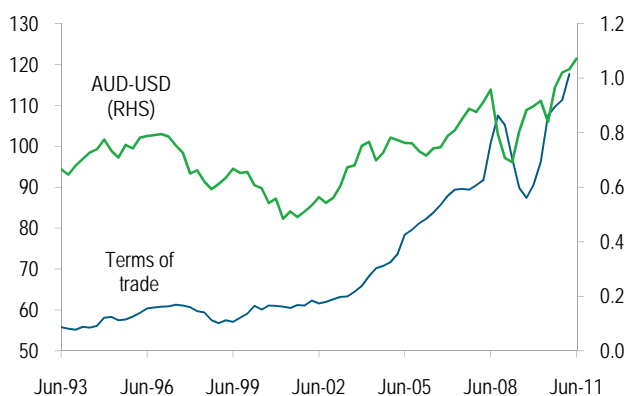
Coal and iron ore exports outperformed the manufacturing sector in Q2-2011, preventing a decline in overall exports in the wake of Japan's earthquake and economic weakness in the EU and US. While manufacturing exports contracted 3.3% y/y in Q2, mining exports continued to enjoy 7% y/y growth. Exports to China were particularly resilient, rising more than 10% y/y in June.

On the downside, however, the mining-sector boom has added to Australian dollar (AUD) strength, worsening the trading environment for other industries. One of Australia's biggest national steel producers and exporters reported a sizeable loss for the year ended in June 2011, blaming poor export performance caused in part by the strong AUD. Australia's heavy reliance on the mining sector also leaves the economy more exposed to swings in commodity prices.

Improvements in productivity are needed to boost the domestic economy should the mining boom fade over the longer term, as Reserve Bank of Australia (RBA) Governor Glenn Stevens stressed in July. Broad-based productivity declines have been seen during Australia's recent economic cycles – including in the mining sector. In fact, the mining

Chart 1: High terms of trade have pushed up the AUD

1993 to present



Sources: RBA, Reuters, Standard Chartered Research

boom has led to inefficiencies in managing production and monitoring the quality of output. Although we do not expect falling productivity to have a substantial impact on near-term growth momentum, failure to address the issue in the long run could be a hurdle to sustainable economic development.

RBA may opt to pause for now

The RBA again revised down its growth forecasts in its August monetary policy statement. It cited the slower-than-expected recovery in the coal sector following floods in late 2010 and early 2011, with production capacity unlikely to resume fully until 2012. In addition, consumers are still cautious and are inclined to save rather than spend, which will weigh on private consumption. Most importantly, given that the global economy may be facing an extended slowdown, we now do not expect the RBA to tighten before 2012.

However, medium-term inflation risks remain. Headline inflation climbed further to 3.6% y/y in Q2, while wages rose 3.8% y/y during the period. These factors, combined with the planned introduction of a carbon tax next year, may cause the RBA to consider hiking rates in Q1-2012 to pre-empt broad-based inflation.

The AUD as a proxy for China strength

After posting notable gains over the last several months, the AUD has softened from post-float highs both against the US dollar (USD) and a basket of its trading partners' currencies. Investor risk aversion amid uncertainty over global growth, rising financial-market tensions, and evidence of slowing domestic activity have weighed on the AUD. Investors have pared back long exposures, but a significant position overhang remains; this may suggest the possibility of further declines if sentiment deteriorates further.

Looking ahead, however, we think the AUD is likely to remain fairly well supported in the coming weeks unless global growth expectations – particularly those in China – deteriorate significantly. Commodity exports continue to fuel terms-of-trade gains, while the AUD's interest rate differential provides an attractive investment incentive. Valuation remains a concern, however, and the high level of the AUD is starting to create distortions within the domestic economy.



Bangladesh – Domestic political concerns outweigh external risks

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Steady growth amid turbulent politics

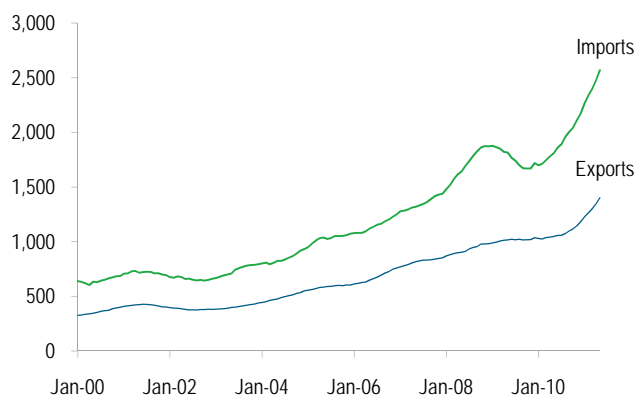
Political tension has returned to centre stage in Bangladesh with the filing of another raft of corruption charges against opposition BNP leader Khaleda Zia, prompting a new round of violent protests and demonstrations. Another arrest warrant has been issued for one of her sons as well. This is yet another example of the partisan nature of Bangladesh's political scene. More positively, relations with India are improving. A recent visit by Congress party President Sonia Gandhi cemented growing economic ties, which bode well for longer-term economic prospects.

Another drop in the stock market has added to the sense of grievance. The opposition has been trying to win political mileage from any fall in equity prices after serious volatility earlier in the year. Given the weakness in equity markets globally, this downturn may not be just domestically generated, but protests have followed regardless. Frequent and prolonged power outages have also prompted protests, further adding to the downside for growth, although outages tend to be a regular summer occurrence. The authorities have announced that the auction for the sale of 3G licences will be held soon. Provided this is transparent and perceptibly clean, it should be another longer-term boost to growth.

Economic momentum solid but exports slowing

Meanwhile, the economy is holding up, though activity likely dipped in August because of Ramadan, adding to the disruption from protests and power shortages. Provisional GDP growth in FY11 (ended June 2011) was steady at 6.66%, compared with the official forecast of 6.70% and 6.07% in FY10.

Chart 1: External position is slipping
USD mn, 12-month moving average



Source: Bloomberg

Exports in FY11 rose by over 41%. However, the pace of growth dipped to 28.7% y/y in July – still strong, but possibly starting to show a slowdown in textiles sales. These had gained through the global crisis as Bangladesh's low-cost advantage won it new demand from cash-strapped Western consumers, but may now be facing more headwinds. Industrial production is still growing strongly (based on data through February, the latest available) but food, beverages and tobacco are rising at a faster clip than textiles.

Despite this impressive export performance, faster import growth means that the trade deficit is widening (Chart 1), as is the services deficit due to higher services payments. Even though rising private transfers have provided some offset, the current account surplus has been falling and looks likely to be close to balance this year.

Liquidity conditions are tight but inflation is easing

Call money rates are moving up following the June hike in the repo rate, though the Bangladeshi taka (BDT) has remained steady. Reserves have risen, though in FY11 as a whole they were up by just 1.5%, compared with 43.9% in FY10. The July estimate suggests a slight decline to USD10.4bn, and central bank liquidity support measures may limit future gains, especially as the current account weakens. The fiscal balance remains in good shape, but government borrowing from the banking sector is rising, as is public debt.

More positively, inflation edged down to 10.17% y/y in June from 10.20% in May. Nonetheless, this pace is still uncomfortable and the central bank is keen to rein in credit growth, which has remained strong despite the lift in the banks' reserve requirements and 225bps of hikes. Domestic credit grew by 28.3% y/y in May. The challenge is to also maintain liquidity in markets. Liquidity has been tight recently, requiring injections practically on a daily basis, as FX reserves have been sold down to provide funds. This has pushed call rates higher.

The Finance Ministry has announced that it will issue bonds to finance new infrastructure projects, backed by the income stream from the projects. This is an important development both in terms of financial-market deepening and economic growth potential. If political spats hamper long-term policy strategy, any initiative that divorces infrastructure needs from politics must be positive.

All in all, the picture in Bangladesh is fair, and looks good by comparison to many others in the region.



China – Preparing for a storm of unknown proportions

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Limited impact, yet profound implications

The recent US rating downgrade and market turmoil have had only a limited impact on China so far. However, Beijing is well aware that it will be affected by what is now heading its way – further quantitative easing (QE3), more capital inflows, commodity-price hikes, and weaker global demand. This is clearly a challenging environment for China, but we believe the economy is still in a resilient position.

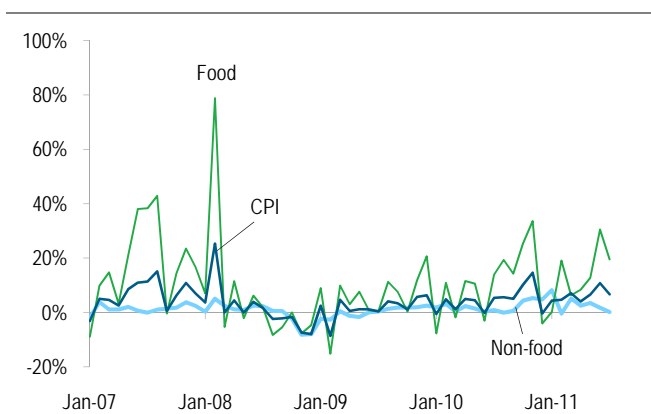
Real activity indicators, including the manufacturing PMI and industrial production, suggest a mild slowdown. We believe inflation pressures have peaked, with headline CPI inflation climbing to 6.5% y/y in July. Month-on-month price rises have started to slow, as Chart 1 shows. We expect headline CPI inflation to moderate to around 4.5% y/y in Q4, although tightening policies will remain in place to contain inflation. Policy makers also appear to believe that further monetary loosening in the US will push commodity prices up again, bringing imported inflation to China.

Policy makers in Beijing are walking a fine line between letting growth weaken too much and loosening before inflation is beaten. We expect the government to become more cautious and take a wait-and-see approach for the time being. We think China will probably loosen policy mildly starting in late Q3, assuming growth continues to weaken and CPI inflation peaks (see **On the Ground, 9 August 2011, ‘China – Tick tock, tick tock, moving to loosen’**).

Policy fine-tuning could possibly include reducing commercial banks’ required reserve ratio (RRR) and introducing less restrictive loan quotas and financial support

Chart 1: Inflation is coming off

Inflation, m/m SAAR



Sources: CEIC, Standard Chartered Research

for SMEs, social housing projects, and the agriculture sector. However, another fiscal stimulate package is unlikely this year.

In addition, we do not think that regulators will ease policy restrictions on the real-estate sector in H2. On the contrary, we believe tighter policies are on the way. These will likely be targeted at the housing markets in more Tier 2 and Tier 3 cities, and designed to reinforce previous measures and prevent housing bubbles from inflating again.

Exports to slow, but not collapse

The slowdown in demand from the West will be partly offset as China sells into an increasingly diversified set of markets.

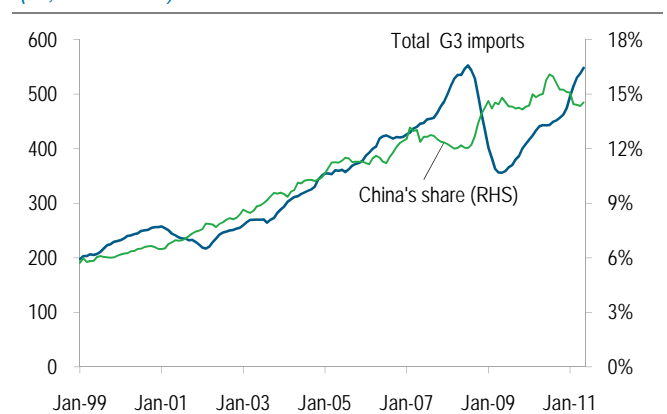
China's share of G3 imports is not as high as many may perceive, and it has begun to show signs of moderation. As we show in Chart 2, China now accounts for around 14% of total G3 imports, down from a peak of 16% in July 2010.

Furthermore, China's exports appear to be detached from the cyclical weakening of the G3 markets (the US, the EU and Japan). China's exports to the G3 declined less than overall G3 imports in H2-2008. As a result, its G3 market share rose from around 12% before the global financial crisis to 15% in H1-2010 (see Chart 2). China's exports to emerging markets (EM) have grown faster than its exports to the G3 ever since.

As such, we believe China's export sector is now more balanced in terms of final demand, with reduced exposure to the US and Europe.

Chart 2: China's share of G3 imports has stabilised

G3 imports (USD bn), China's share of total G3 imports (% SA 3mma)



Sources: CEIC, Standard Chartered Research



China – Preparing for a storm of unknown proportions

The need for ongoing CNY appreciation

With the door seemingly closed to further policy rate or RRR hikes, Chinese yuan (CNY) appreciation may be the last tool the People's Bank of China (PBoC) has at its disposal to contain inflation. The pace of CNY appreciation at the daily USD-CNY fixes accelerated in August, with the currency gaining 0.77% in the first half of the month.

It would make sense for this to continue, given the likelihood that the US dollar (USD) will continue to weaken. Given our expectation that the USD will depreciate over the medium term, CNY appreciation against the USD is necessary to maintain price stability, and to limit China's purchases of US Treasuries resulting from intervention in the FX market.

The key risk to this outlook is a further shock to global demand arising from a major credit event and/or renewed recession in the West. If this happened, Beijing would likely opt to re-peg, as it did in 2008. Even so, CNY depreciation against the USD would remain highly unlikely.

As the largest creditor of the US, China is under growing pressure to diversify its foreign reserves, especially after the US credit rating downgrade. We estimate that China's holdings of US securities accounted for about 60% of its total FX portfolio as of the end of June, at just under USD 2trn.

However, the lack of realistic investment alternatives due to the size of China's FX reserves means that China is likely to make only very slow progress in diversifying its reserves (see **On the Ground, 16 August 2011, 'China – What to**

do as the world falls apart, again'). There is also an expectation in the West that China will remain a responsible investor, and this could be a diplomatic decision as much as an investment decision.

Striking a fine balance

China now has less policy room to respond to a significant deterioration in domestic or external demand than in 2008, but adequate measures are still available.

As for monetary policy, loan controls may need to be relaxed, but this needs to be done in a controlled manner to prevent another round of explosive credit growth that could jeopardise the long-term stability of China's financial system. In addition to less restrictive loan quotas for specific sectors, as mentioned above, a modest relaxation of reserve requirements could also help. However, given that real borrowing costs (lending rates minus inflation) remain relatively low, the authorities will need to strike a fine balance between facilitating economic activity and keeping the inflation genie from getting out of the bottle again.

On the fiscal policy front, we expect the government to run a larger surplus this year, which implies contractionary fiscal policy. The good news is that this means China has room to move to a fiscal expansionary stance by increasing spending, if needed. Additional resources can be sent to viable local government infrastructure projects that are facing financing difficulties. Again, the experience of 2008-09 tells us that spending is easy, but proper funding channels are key to preventing a hangover once the stimulus is withdrawn.

Table 1: China forecasts for 2011-13

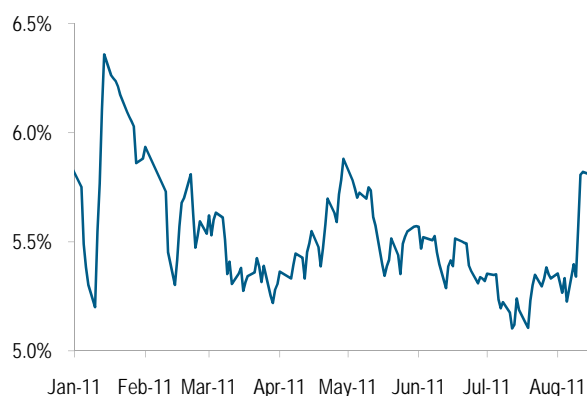
Growth, inflation and interest rates

	GDP	CPI	1Y lending rate	1Y deposit rate
Q3-2011	9.3%	5.50%	6.56%	3.50%
Q4-2011	9.0%	4.20%	6.56%	3.50%
Q1-2012	8.6%	3.90%	6.56%	3.50%
Q2-2012	9.4%	4.30%	6.56%	3.50%
Q3-2012	10.5%	5.50%	6.56%	3.50%
Q4-2012	10.9%	6.30%	6.81%	3.75%
Q1-2013	10.8%	6.30%	7.06%	4.00%
Q2-2013	10.5%	6.20%	7.31%	4.25%
Q3-2013	9.4%	4.90%	7.31%	4.25%
Q4-2013	8.6%	4.05%	7.31%	4.25%

Source: Standard Chartered Research

Chart 3: Annualised CNY appreciation since June 2010

The pace of CNY appreciation accelerated in August 2011



Sources: Bloomberg, Standard Chartered Research

Hong Kong – Two-speed, two-way

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Hong Kong vs. the world

Hong Kong is an avid taker of what the rest of the world has to offer. After benefiting from the post-Great Recession global rebound and capital inflows driven by QE2 and China's stimulus, Hong Kong suffered in Q2-2011 from weaker external trade as world growth entered a soft patch. We understand that Christmas orders have been weak so far, but still-favourable domestic demand should be able to bear most of the growth burden.

The Fed's commitment to keeping rates low until mid-2013, together with the increasing likelihood of QE3, means that medium-term risks for Hong Kong remain skewed towards inflation rather than growth. We expect HIBOR to stay low for the next 18 months. And in contrast to the financial volatility and uncertainty seen elsewhere, the development of the offshore CNY (CNH) market should remain impressive, thanks in part to strong political backing from Beijing.

Back to two-speed growth

Q2 GDP growth came in at 5.1% y/y, or -0.5% q/q seasonally adjusted; growth slowed from a revised 7.5% y/y in Q1. The main reason for the disappointing outcome was the larger-than-expected drag from net exports, which subtracted around 2ppt from headline growth – a reflection of regional supply-chain disruptions, weaker-than-expected demand from the West, and short-term destocking in mainland China.

However, domestic growth sources remained resilient. In particular, household spending growth accelerated further to 9.2% y/y from 8.0% prior, mainly thanks to a tight labour market and faster wage growth. Investment growth also rebounded, to 8.1% y/y from -0.3% prior. The 5.1% headline

growth rate, albeit a marked slowdown from Q1, remains above trend (which is around 4.0-4.5%).

This 'two-speed' phenomenon should be seen as a sign of Hong Kong's economic resilience. It should continue to offer comfort as long as one believes that the external soft patch – be it in China or the US – will be transitory. The recent crisis showed that Hong Kong would be vulnerable to another global recession, but this is not our core scenario. Growth in the West could stay weak and possibly disappoint in 2012, but that is different from an outright contraction. We revise down our 2011 GDP growth forecast to 5.0% from 6.0%. This partly reflects the softer set of Q2 numbers, but also the likelihood of still-weak exports for another quarter or two before a recovery in 2012.

Inflation still trumps growth

Inflation remains a bigger risk than growth in the coming years, in our view. Indeed, property prices have started to consolidate amid the recent bout of global risk aversion. Transaction volumes have dwindled, while some desperate sellers have reportedly slashed prices; the majority of homeowners, we believe, have simply stayed on the sidelines. This, together with previous rounds of policy tightening, should translate into more manageable housing inflation within the CPI in 2012. But for the rest of 2011, the prevailing uptrend should continue given the lagging nature of housing inflation. Medium-term, we still expect supportive fundamentals (including sustained low interest rates, a perceived supply shortage, and improved household income) to underpin upward property-price pressure. This will require a still-cautious policy stance from the authorities. We expect headline CPI inflation to peak (in y/y terms) only in late 2011 or early 2012.

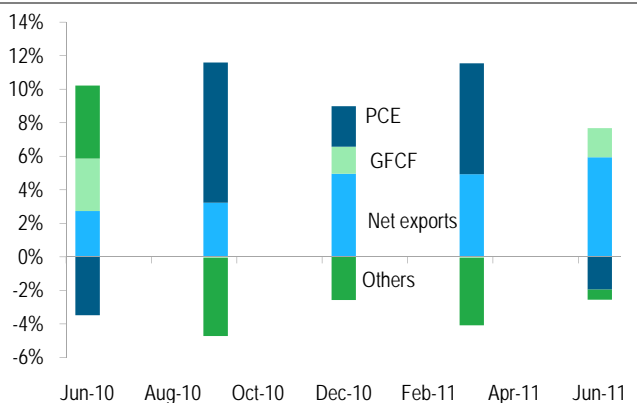
Low rates for longer

Renewed tightness in USD supply is dominating short-term local funding dynamics. Persistent credit concerns stemming from the European sovereign debt crisis have led to shorter tenors being offered in the local interbank market (offers for tenors beyond 1 week have clearly dwindled), and to higher implied yields for raising US dollars (USD) through the Hong Kong dollar (HKD) FX swap market. The HKD spot rate also weakened against the USD at one stage, indicating marginal capital outflows, in line with the sizeable stock-market correction of late.

Yet the Aggregate Balance – a gauge of interbank liquidity – is still close to HKD 150bn, versus a historical norm of less

Chart 1: Steadily rising private consumption

Contributions to GDP growth (ppt)



Sources: CEIC, Standard Chartered Research



Hong Kong – Two-speed, two-way

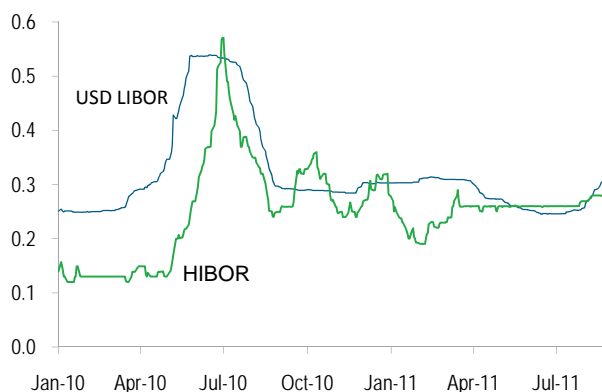
than HKD 5bn. USD-HKD would need to retest 7.85 before the Hong Kong Monetary Authority (HKMA) would intervene to buy HKD and sell USD; only then would the Aggregate Balance start to shrink. Our view is that any further capital outflows will be transitory in nature given Hong Kong's still-attractive growth story and the structural increase in capital inflows from mainland China. The USD-HKD spot rate is therefore unlikely to return to test the 7.85 weak-side convertibility threshold soon (we reiterate that we see no change in the HKD peg). Ample liquidity should keep a lid on short-term HIBOR relative to USD LIBOR.

It is therefore unsurprising that HIBOR has not fully matched the recent rise in USD LIBOR, and that the post-2003 norm of HIBOR trading below LIBOR has been restored. Longer-term, how much further this 'normalisation' process goes will depend on how fast USD LIBOR climbs. The Fed's recent commitment to keeping rates low until mid-2013 (we now expect the first hike in Q3-2013) means that the relationship is unlikely to normalise fully anytime soon. In the meantime, HIBOR should continue to mirror the subdued trajectory of LIBOR under the Linked Exchange Rate System. This should bode well for those worried about an imminent collapse in Hong Kong's growth or property prices in case of another sizeable external shock.

Government yields underpinned by low US rates

Government bond yields have collapsed since the beginning of August, with both the bond and swap curves bullish flattening by close to 60bps after the US credit downgrade by S&P. Concerns about a potential double-dip in the US and the lingering debt crisis in Europe have led to renewed safe-haven flows throughout the month in a clear risk-off environment.

Chart 2: HIBOR did not fully match recent LIBOR rise
3M interbank rate (%)



Sources: Bloomberg, Standard Chartered Research

Basis swaps also widened significantly over the period as concerns about USD funding pressures outweighed the modest rise in HIBOR driven by minor capital outflows.

While HKD government yields have now eased back to early-2009 levels, we expect the prospect of QE3 to cap any sustained correction in longer-term yields. At the same time, the Fed's commitment to low rates until mid-2013 is likely to keep the shorter end of the HKD curve well anchored around current levels, with HIBOR likely to remain range-bound amid flush liquidity.

Current levels, however, appear attractive for corporate hedging. Corporate investors will likely prefer the belly of the swap curve to enter paying positions.

A boost to the CNH market

China's Vice Premier Li Keqiang delivered an important message during his recent three-day visit to Hong Kong – that Beijing remains committed to strengthening Hong Kong's role as an offshore Chinese yuan (CNY) financial centre in the process of CNY internationalisation. To walk the walk, Li announced a raft of more than 30 measures, mainly to boost two-way investment and trade between Hong Kong and mainland China.

In particular, the new CNY-based Qualified Foreign Institutional Investors scheme, known as R-QFII (the 'R' stands for renminbi), effectively allows offshore CNY retail money to be invested through financial institutions in onshore exchange-traded securities. The overall quota for R-QFII is initially set at CNY 20bn. This is a mere 3.6% of the existing CNH deposit base in Hong Kong (CNY 554bn as of end-June). The short-term impact on offshore CNY deposit accumulation should therefore be limited. If anything, we believe that the increase in the availability of investible CNH assets (or more generally, the usage of CNH funds through 'recycling' back to the mainland) should ultimately encourage more CNY conversion offshore.

Other measures that expand existing CNH business should not be overlooked. For example, Li's explicit support for the use of CNY for foreign direct investment by Hong Kong companies in mainland China creates another use for offshore deposits, and potentially boosts CNH lending business. The further streamlining of the approval process for CNH FDI should also facilitate the remittance of funds raised through the Dim Sum market back to the mainland. This would make Dim Sum bond issuance an even more attractive proposition for overseas corporates.



India – Growth and inflation to slow, at last

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The engineered slowdown is underway

Elevated inflation for the past 18 months – WPI inflation has been above 8% since January 2010 and above 9% since December 2010 – has put policy makers in a difficult position. However, a significant respite is expected in H2-FY12 (ends March 2012), particularly in Q4-FY12. WPI inflation likely peaked in August (the July WPI reading was 9.22%), and to fall below 8% by end-2011 and to 6.5-7.0% by March 2012. While the base effect will be critical to this down-move, accounting for 160-175bps, other factors – especially monetary policy – are expected to play an equally important role.

Reasonably well-distributed rainfall so far this year (India receives rain from June to September) has helped to keep food prices stable in recent weeks. Barring supply shocks, this trend is likely to continue for the rest of the year. Moreover, the recent correction in global commodity prices has reduced cost-push pressure on headline inflation, at least for the time being. While we expect commodity prices to stay firm, we do not foresee a significant escalation like the one seen in H1-2011.

At the same time, a slowdown in aggregate demand should ease demand-side pressures on inflation. Underlying demand-side pressures in the economy remain, as evidenced by July core inflation of 7.3% y/y, but signs of moderating growth have emerged in some sectors. July auto production growth slowed to 13% y/y from an average of 28% in FY11, indicating that higher interest rates and inflation have started to dent consumer demand. Average industrial production growth eased to 6.8% in Q1-FY12 from 7.7% in Q4-FY11, underlining the moderation in the industrial sector. Excluding one-off

factors in the capital-goods sector (such as a 200% increase in production of cables and wires in June), industrial growth slowed to 5.2% in Q1-FY12 from 8.3% the previous quarter. Credit growth also eased to 18.5% y/y in July from an average of 21% in Q1-FY12.

On the other hand, an 81% y/y surge in July exports, steady corporate earnings and indirect tax collection growth of 16.4% y/y in July show that demand-side pressures are still strong. The wage-price spiral, which has already kicked in, has played an important role in the resilience of domestic demand, despite higher inflation and interest rates. Policy makers are understandably concerned about the potential threat to long-term growth from persistently rising inflation.

In the absence of significant policy efforts to increase supply, the onus has shifted to monetary policy to trim demand in order to manage price pressures. With the government also acknowledging the need to rein in inflationary pressures, even at the cost of sacrificing near-term growth, further tightening is likely. Even after 325bps of Reserve Bank of India (RBI) rate hikes since March 2010, 150bps of which have been delivered since May 2011, we expect another 50bps of increases in the repo rate to 8.5% by Q2-FY12. This should increase the pace of moderation in the economy. With interest rates at such high levels, we expect FY12 GDP growth to slow to 7.7% from 8.5% in FY11. Sub-8% growth in most quarters of the fiscal year should squeeze out excess demand, pushing inflation lower. If our core view of 7.7% GDP growth and 6.5-7.0% inflation materialises by March 2012, we expect a reversal of monetary policy in H2-2012.

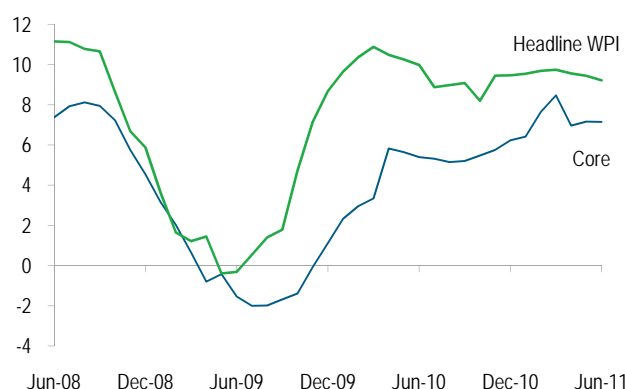
Table 1: India economic and market forecasts

	FY10(A)	FY11(A)	FY12	FY13	FY14
Real GDP growth	7.4	8.5	7.7	8.3	8.5
WPI inflation	3.9	9.6	8.4	6.0	6.0
C/A balance	-2.9	-2.6	-2.8	-2.5	-2.3
FX reserves/imports	11.2	9.5	9.8	10.0	10.2
End-period	Q3- 2011	Q4- 2011	Q1- 2012	Q2- 2012	Q3- 2012
Repo rate	8.50	8.50	8.50	8.50	8.25
USD-INR	44.00	43.50	43.00	43.00	42.50
10Y GolSec	8.50	8.25	8.25	8.25	8.00

Note: FY figures refer to fiscal year ending on 31 March; quarterly data is for calendar years. Source: Standard Chartered Research

Chart 1: Inflation remains elevated

WPI inflation, % y/y



Sources: CEIC, Standard Chartered Research



India – Growth and inflation to slow, at last

Global events are a risk to our view

Risks to our core view emanate from the fragile global environment. If the European debt crisis deepens further or a recession hits either the EU or the US, this would have direct and indirect negative implications for India, depressing FY12 GDP growth to below 7.7% and hastening the reversal of the monetary policy stance.

Exports would be the first casualty. While non-US and non-European economies have been the major driver of Indian export demand (almost 60% of FY11 export growth of 41% was driven by Asian and Middle Eastern demand), a significant slowdown in the US or Europe would affect exports to other markets. In FY10, India’s export growth collapsed to -3.5% y/y from a double-digit increase the previous year as the adverse impact of the financial crisis was felt across the world. While the strong domestic orientation of India’s economy provides a buffer for overall demand (India is a net importer), lower exports would inevitably cause near-term pain in the form of slower industrial activity and job losses. Heightened global uncertainty would also impact the rest of the economy, as it did in 2008.

The Indian rupee (INR) could face significant volatility due to a wider trade deficit in the short run and a drying-up of capital flows. India’s external weaknesses are apparent, as it runs a persistent trade deficit and depends on portfolio investment and other flows for its funding needs. The US and Europe accounted for 21% and 20%, respectively, of portfolio investment in India in 2009. A quick reversal of such flows would be highly likely if the market suffered another drop in confidence. Also, Europe and the US together account for c.68% of India’s foreign bank lending exposure (49% for European banks and the rest for US banks). Hence, availability of FX liquidity could become an issue in India. In

Q4-2008, in the immediate aftermath of the Lehman crisis, foreign bank lending to India fell by 7% (USD 15bn). Assuming a similar withdrawal this time, USD 22bn worth of FX outflows is possible.

Ample policy options to define a floor during crisis

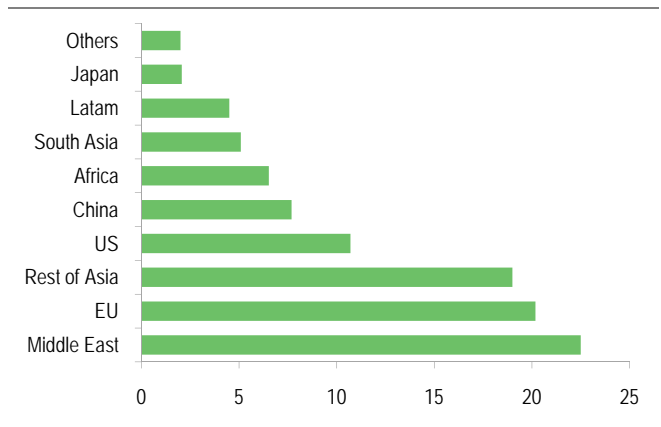
While a significant deterioration in the global environment would have inevitable near-term fallout for India’s markets and economy, policy makers have ample tools to ease the pain. For instance, India’s USD 315bn of FX reserves should be enough to meet FX liquidity requirements, even after accounting for valuation losses.

The RBI can also employ various monetary policy tools to boost confidence. In such an extreme scenario (not our core view), commodity prices are likely to correct significantly, easing domestic inflation. The RBI would thus have room to reverse its monetary policy tightening stance. Liquidity injection via a reduction in reserve requirements (the cash reserve ratio is currently at 6%) and policy rate cuts could be used to lower market rates, boosting confidence and eventually economic activity.

While there is less room for expansionary fiscal measures than in 2008, some fiscal support is still likely. Lower oil prices would reduce the subsidy burden, allowing the government to reallocate expenditure to boost demand. The government could also provide a big boost to investment by speeding up the closing of administrative loopholes in the investment approval and implementation processes. Despite the current challenges, India remains a relatively attractive investment destination. With liquidity in the major economies likely to remain ample, India is well positioned to attract long-term foreign investors, provided that it pushes ahead with strong policy reforms.

Chart 2: India’s export destinations

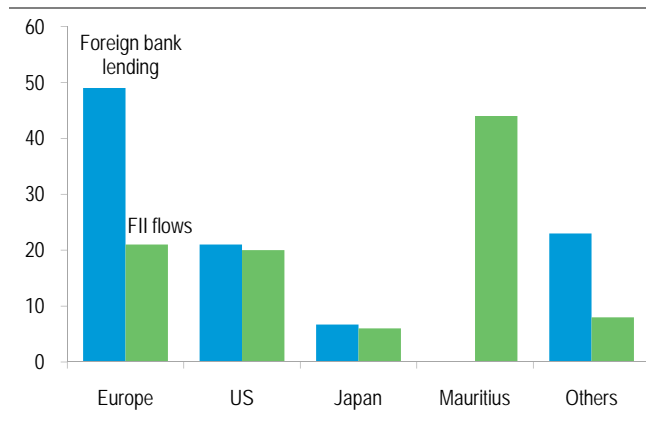
% share of total exports in FY11



Sources: DGFT, Standard Chartered Research

Chart 3: India’s exposure to EU and US

% of total flows



Sources: IMF, BIS, Standard Chartered Research



Indonesia – Sanctuary in the global storm?

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A perfect mix

Despite widespread turbulence in global financial markets and fears of another recession, particularly in developed economies, Indonesia's financial markets have been relatively resilient thus far. Indonesia has enjoyed a perfect mix of strong growth, low inflation and a magnet-like ability to attract foreign investors, enabling the central bank to keep policy rates steady. The economy's low exposure to trade (though it is vulnerable to commodity prices) protects it from external uncertainties. The fiscal position is reinforced by strong revenue growth and yet another year of below-budget expenditure.

The balance of payments (BoP), an Achilles' heel for Indonesia in the past due to the low level of FX reserves, is also posting surpluses in both the current and capital/financial accounts. Despite high foreign ownership of the local government bond market, at 35%, international investors have not been persuaded to sell, even amid the recent bout of risk aversion.

GDP growth is steady, inflation is down

GDP growth accelerated to 2.9% q/q in Q2-2011 from 1.5% in Q1; on a y/y basis, growth was steady at 6.5%. Growth in domestic consumption (63% of GDP) rose to 4.6% y/y from 4.3%, while growth in fixed investment (25%) picked up to 13% y/y from 9%, despite generally slow infrastructure investment. FDI rose to USD 13.5bn in H1-2011, up 24% compared to H1-2010. Despite the gloomier global scenario, given Indonesia's limited dependence on exports as source of growth, we maintain our GDP growth forecasts of 6.5% for 2011 and 7.0% for 2012.

Meanwhile, in the absence of a rise in domestic subsidised fuel prices, headline inflation eased to 4.6% y/y in July 2010 from 5.5% in June and 7.0% in December 2010. We expect inflation to edge back up to 6.0% by December 2011 as faster GDP growth pushes up core inflation. Without a domestic fuel-price hike (which is increasingly unlikely given the fiscal surplus in H1-2011 and falling global oil prices) or strong inflationary pressures, Bank Indonesia (BI) is likely to keep the BI rate at 6.75% until the end of 2011. We expect it to raise the policy rate to 7.25% only in Q1-2012, assuming the government raises subsidised fuel prices in H1-2012.

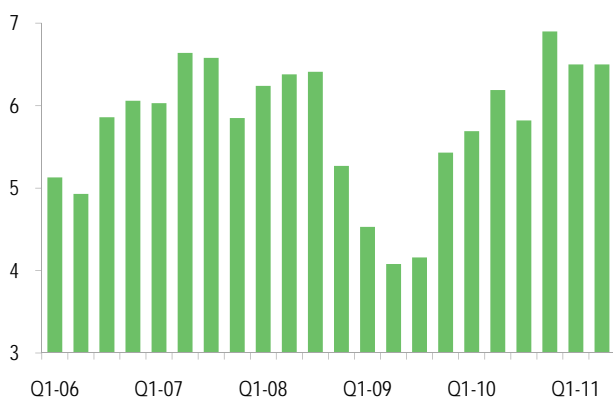
Strong fiscal revenue and underspending

As expected, the government booked a H1-2011 budget surplus of IDR 54.7trn – USD 6.4bn, or 0.9% of 2010 GDP. It has met almost 43% of its 2011 revenue target thanks to unexpectedly high tax revenue from commodity sectors. Meanwhile, only 34% of the expenditure targeted for 2011 has been disbursed. This is the result of slow infrastructure investment due to lingering issues such as slow land clearance for projects and local governments' limited project-building capacity. Furthermore, parliament's plan to pass a land acquisition bill in Q3-2011 may be further delayed, risking a continuation of infrastructure paralysis. The government targets a budget deficit of 2.0% of GDP in 2011 (versus an actual deficit of 0.6% in 2010). We maintain our forecast of 1.5%, with risks to the downside given the likely delay in resolving project implementation bottlenecks.

The government's 2012 draft budget seems more realistic, targeting a deficit of only 1.5% of GDP. The government's economic assumptions include: (1) GDP growth of 6.7%, versus our forecast of 7%; (2) average inflation of 5.3% (our forecast:

Chart 1: GDP growth, y/y

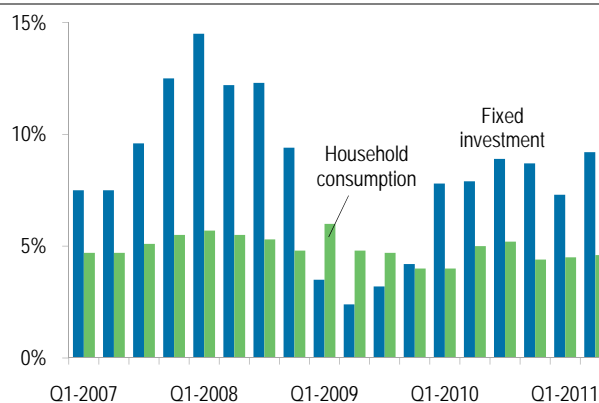
Robust and steady growth, albeit below potential



Source: National Statistics Agency

Chart 2: Investment and consumption growth, y/y

Rapid real investment



Source: National Statistics Agency



Indonesia – Sanctuary in the global storm?

6.9%); and (3) an average Indonesian rupiah (IDR) exchange rate of 8,800 versus the US dollar (our forecast: 8,125).

Balance of payments has remained strong

The BoP surplus rose to USD 11.9bn in Q2 from USD 7.7bn in Q1. Although the current account surplus shrank to USD 0.2bn from USD 2.1bn, the capital and financial account surplus almost doubled to USD 12.5bn from USD 6.4bn – driven by strong inflows of foreign portfolio investment and FDI. We forecast that the BoP surplus will increase to USD 31.6bn in 2011 from USD 30.3bn in 2010. We then expect it to fall to USD 22.0bn in 2012 on slowing export growth (driven by a sluggish global demand recovery and an IDR appreciation trend) and accelerating imports (driven by accelerating domestic GDP growth and IDR appreciation).

Resilient government bond market

The IDR bond market has shown resilience amid market turmoil in the past month. It remains vulnerable to the deterioration in global risk appetite, given that foreigners are the main net buyers of IDR government bonds and have funded 98% of net supply year-to-date. The growth slowdown in developed markets (DM) should increase asset allocation to emerging markets (EM), where fiscal and external balances are stronger. However, a more serious slowdown could lead to wealth destruction and a reversal of flows (see **Macro Strategy Views, 11 August 2011, ‘The Sisyphean climb to Jackson Hole’**).

Domestic factors such as inflation, the supply outlook and the fiscal position remain constructive for the bond market. The Ministry of Finance (MoF) is in a comfortable position to reduce debt issuance if market conditions turn unfavourable. A combination of slow spending, robust revenue collection

and debt issuance in H1-2011 resulted in a budget surplus of IDR 117tn (versus a targeted deficit of IDR 151tn for the full year), according to the latest MoF data.

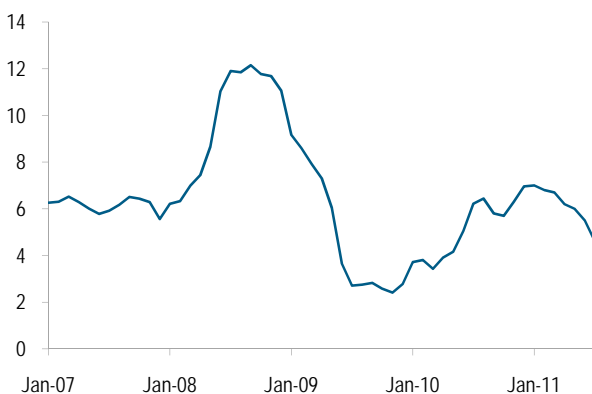
The government has also taken pre-emptive measures to limit the impact of the market turmoil. BI appointed state-owned enterprises are ready to buy government bonds in the secondary market if prices fall sharply. More recently, BI has begun to buy government bonds in the market and has introduced a new market operation (effective 8 August) to buy government bonds and sell US dollars directly to banks if needed.

We maintain an *Overweight* cash and duration position in the Indonesian bond market given positive underlying fundamentals. We acknowledge that volatility is likely to rise in the near term, and recommend that fast-money accounts that are sensitive to price volatility reduce risk and shift their cash and duration exposure to neutral.

We maintain our *Overweight* stance on the IDR

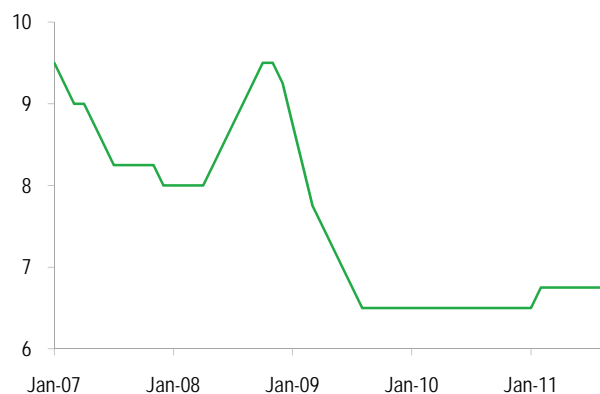
We believe Indonesia’s economic fundamentals will remain robust despite global economic turmoil, and that the economy will attract more capital inflows (in part due to a possible upgrade of Indonesia’s sovereign rating to investment grade by 2012 and the attractive rate of return from the stock market). We therefore maintain our short- and medium-term *Overweight* stance on the IDR. Moreover, BI has demonstrated its willingness to allow the IDR to appreciate to aid price stability, instead of using the exchange rate to boost export competitiveness. We forecast that the IDR will continue strengthening from 8,996 versus the USD by end-2010 to 8,300 by end-2011 and 7,900 by end-2012.

Chart 3: Headline inflation, y/y
Easing without hike in subsidised fuel prices



Source: National Statistics Agency

Chart 4: BI rate
No change expected until Q1-2012



Source: Bank Indonesia



Japan – Caught between JPY strength and fiscal pressure

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Strong JPY raises concerns

Recent worries about the impact of the strong Japanese yen (JPY) on the economic recovery have overshadowed the restoration of industrial production capacity and the improvement in consumer confidence following the March earthquake. The JPY has persistently appreciated against the US dollar (USD) on the back of external turmoil and global risk aversion, even testing the post-World War II low of 75.93 on 19 August. While local-currency appreciation is welcomed by importers and is favourable for overseas M&A and investment, a possible global recession could aggravate its negative impact on Japan’s export-reliant economy. To reflect this risk, we revise down our 2011 GDP growth forecast to -0.4% from 1.0%.

Meanwhile, recent economic data has confirmed that Japan’s gradual recovery from the earthquake is underway, although challenges remain. Q2 GDP contracted 0.3% q/q, much better than the market consensus and a significant improvement from 0.9% q/q contraction in Q1.

Private consumption and consumer confidence picked up somewhat in Q2, and demand for durable goods increased. Public and business investment both gained as the government restored damaged social capital and manufacturers resumed production after the earthquake. Capital expenditure grew 0.2% q/q in Q2 after a 0.9% decline in Q1.

Net exports were a significant drag on Q2 GDP growth, dropping by 0.8% q/q amid supply-chain disruptions following the disaster. Exports deteriorated sharply immediately after the earthquake (-12% y/y in April), but this was followed by a faster-than-expected recovery. In June, the pace of the decline slowed to 1.5% y/y as supply-side constraints eased.

However, the strong JPY, if not managed properly, may take a toll on fragile exports in the months ahead.

BoJ and MoF intervene to boost the economy

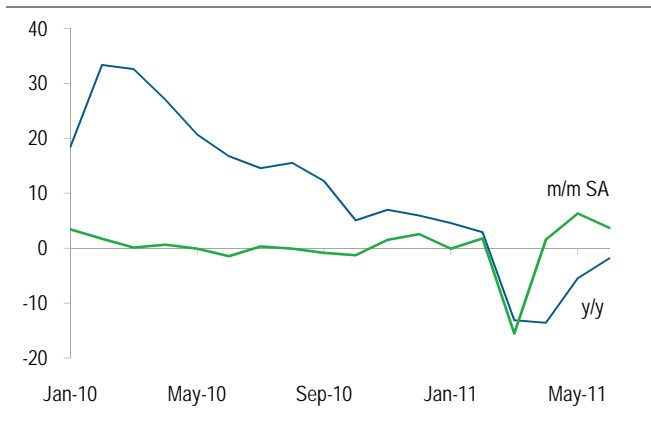
To combat the strong JPY and prevent a further hit to the economy and business sentiment after the earthquake, the Bank of Japan (BoJ) stepped into the FX market on 4 August and increased its existing asset purchase programme by JPY 10trn. Three weeks later, the Ministry of Finance (MoF) announced a plan to provide FX reserves to support overseas Japanese investment and introduced closer monitoring of currency trading by financial institutions. However, this fresh round of policy measures is likely to have a limited impact in boosting exports or preventing JPY appreciation, and the market is awaiting a more decisive policy response to boost business sentiment.

Deflation risk is another reason to expect further policy easing. Starting from August 2011, the base year of the CPI series will be changed to 2010 from 2005. As a result, inflation is likely to be revised downwards, according to the BoJ. While the government and the BoJ have largely run out of policy options to stimulate the economy, we expect further easing at the BoJ’s policy meeting on 6 September, after the formation of the new government.

Political instability remains, even after the election

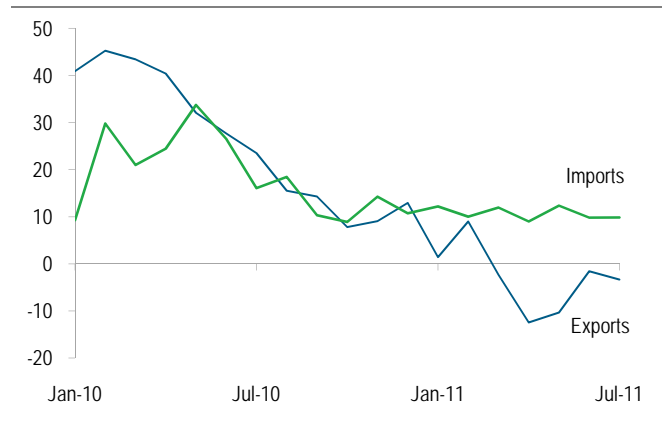
Having been broadly criticised for his handling of the nuclear crisis following the March disaster, Prime Minister Naoto Kan formally announced his resignation on 26 August. Yoshihiko Noda, Kan’s finance minister, won the leadership race within the ruling Democratic Party of Japan (DPJ) two days later and was approved by the Parliament on 30 August to become Japan’s sixth prime minister in five years. Noda inherits a set

Chart 1: Production resumed rapidly after the disaster
Industrial production, % y/y and m/m SA



Sources: CEIC, Standard Chartered Research

Chart 2: Exports have recovered faster than expected
% y/y



Sources: CEIC, Standard Chartered Research



Japan – Caught between JPY strength and fiscal pressure

of difficult economic challenges from his predecessor, including high government debt, post-earthquake restoration needs and a strong JPY. He also faces political challenges arising from a divided DPJ and the opposition. Like Kan, Noda advocates increasing the sales tax (VAT) rate to fund reconstruction and reduce government debt. In terms of energy policy, he appears to favour restarting suspended nuclear plants, unlike Kan. Noda will need to reunify his own party and get support from the opposition in order to realise his 'grand coalition' and deal with these issues. This will be critical to his success as prime minister.

Sales tax increase is needed, but timing is key

Moody's cut Japan's sovereign rating by one notch to Aa3 on 24 August after a three-month review, citing concerns about the build-up of debt and the indecisive government response. Although the market shrugged off the announcement given that Japan's debt problem is chronic and widely acknowledged, the issue still requires concerted government action. Keeping ballooning debt in check will be critical to the country's long-term development.

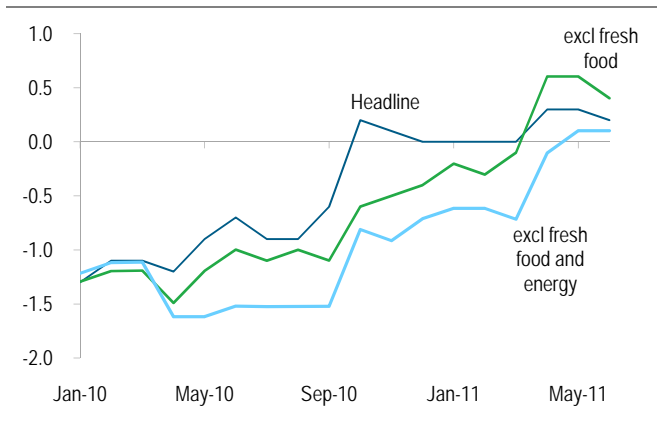
The VAT increase would be a reasonable way to address the problem, given the current low VAT rate (of 5%) and Japan's robust tax base supported by private consumption. Raising the rate once a cyclical recovery is underway would also help to improve Japan's sovereign credit standing. If the government takes this step towards reforming the tax system, along with an overhaul of the social welfare system, this would mark a turning point in terms of securing sustainable growth. The VAT hike was proposed by Kan last year but was suspended amid broad opposition both from within the DPJ and from opposition parties. Noda is likely to seek support from the opposition to push through this reform.

JPY strength to persist amid risk aversion

Despite the difficulties facing the domestic economy, the JPY continues to appreciate and now stands at an all-time high in trade-weighted terms. Amid the EU sovereign debt crisis, mounting fiscal pressures in the US, and the risk of slowing global growth, the JPY has reverted to its traditional role as a financial shelter in uncertain times. Low yields abroad have reduced the appeal of foreign investment, while Japan's still-large current account surplus provides support for the currency. In addition to existing government debt, post-earthquake reconstruction will cause a further marked deterioration in Japan's financial position. Reconstruction costs are projected to increase the 2011 fiscal deficit to 10.5% of GDP and the net debt/GDP ratio to above 130% of GDP.

We expect JPY strength to continue in the coming weeks as global investor sentiment maintains a negative bias. Economic uncertainties are likely to persist, keeping market participants on a cautious footing. While the Japanese authorities have taken steps to further loosen monetary policy, these efforts have proven ineffective, as JPY appreciation has had little to do with domestic factors. Similarly, periodic bouts of FX intervention, both co-ordinated and unilateral, have been unsuccessful in turning the tide and weakening the currency on a sustained basis. We expect similar actions in the future to have similar results. We forecast that USD-JPY will finish 2011 at 76, but see emerging downside risks to this forecast.

Chart 3: Inflation is likely to turn negative after rebasing
2010 to present, % y/y



Sources: CEIC, Standard Chartered Research

Chart 4: The trade-weighted JPY continues its climb
Bank of Japan nominal effective exchange rate index



Sources: Bloomberg, Standard Chartered Research



Malaysia – External headwinds negate domestic strength

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Concerns over external growth to dominate

While Q2 growth was better than expected, at 4% y/y, external growth headwinds result in a murkier outlook for H2-2011 given the Malaysian economy's high correlation to the US and EU. On a more positive note, a pick-up in government spending and still-strong domestic activity, along with a more favourable base effect, will help to mitigate the downside in the second half of the year.

Taking these factors into account, we cut our 2011 GDP growth forecast to 4.2% (lower than the central bank's recent guidance that growth could come in at the lower end of its 5-6% forecast range), and we lower our 2012 forecast to 4.4% from 5.2%. While the current global equity sell-off is capturing market attention, we do not think monetary policy easing is on the cards for Malaysia yet. Domestic inflation is still firm, and unless the external and domestic growth outlook worsens sharply, we expect the central bank to keep its policy rate at current levels for the remainder of 2011.

Services provide a lift as manufacturing falters

While Malaysia's 4% GDP growth in Q2-2011 was higher than consensus, it was still the lowest y/y figure since Q3-2009. An unfavourable base effect played a part, as the economy grew 9% y/y in Q2-2010. On a seasonally adjusted annualised basis (our estimate), the economy grew 2.3%, slowing from 7.6% in Q1 and 9.6% in Q4-2010. For the first half of the year, the economy grew 4.4%.

The manufacturing sector fared poorly in Q2, growing 2.1% y/y and contributing just 15% of overall growth. In addition to lower demand, which led to weakness in electrical and electronics production, supply-chain disruptions due to

Japan's earthquake affected manufacturing of motor vehicles. However, motor-vehicle production recovered strongly in June. The disruption to crude oil production at the Kikeh wells also affected the mining sector; as a result, mining subtracted 0.6ppt from Q2 growth.

On a more positive note, services remained strong, contributing 3.6ppt (90%) of Q2 growth. Loan growth has been robust this year, at 13.2% y/y in H1 – the strongest half-yearly growth rate since 2006. Growth in the wholesale and retail trade sector also stayed strong in Q2, at 7.3% y/y versus 6.8% y/y in Q1. The agriculture sector performed well, rising 6.9% y/y after a 0.2% contraction in Q1, led by a rebound in the palm oil sector.

Private consumption is the primary growth driver

From an expenditure perspective, domestic demand was the main contributor to the Q2 expansion. Consumption expenditure accounted for 97% of growth, with private consumption contributing the largest share. This is in line with vibrant onshore economic activity. Unemployment was at a multi-year low of 3% in Q1, while imports of consumer goods rose 16.8% y/y in Q2.

Investment growth was sluggish in Q2, at only 3.2% y/y. Imports of capital goods rose a modest 3.5% y/y, slowing from 9.4% in Q1. According to the central bank, slower federal government development expenditure curtailed investment activity. H1-2011 gross development expenditure was only MYR 14.8bn, or 30% of the full-year target (H1-2010: 38%). A pick-up in fiscal spending should underpin growth in H2. While exports of electronics were poor, commodities supported the overall export performance. Q2

Chart 1: External headwinds to become primary focus

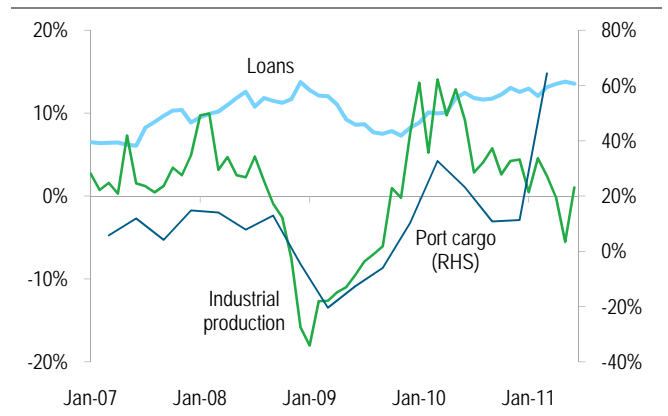
Correlation of MY to US and EU growth is high



Sources: Bloomberg, Standard Chartered Research

Chart 2: Services do more of the heavy lifting as manufacturing slows

(% y/y)



Sources: CEIC, Standard Chartered Research



Malaysia – External headwinds negate domestic strength

goods exports rose 8.3% y/y, with palm oil (crude and processed) accounting for nearly half of this growth. Imports were pulled down by lower purchases of capital and intermediate goods.

BNM to stay in wait-and-see mode for longer

The global growth outlook has been severely affected by the protracted debate over amending the US debt ceiling, S&P's subsequent downgrade of the US' AAA credit rating, the sharp downward revision of US H1 growth, and ongoing debt concerns in the euro area. Global equity markets have responded in kind, and this will affect consumer sentiment. The University of Michigan US consumer confidence survey and the Philly Fed PMI have recently fallen off a cliff. The Fed has since committed to keeping interest rates low through mid-2013. We have also downgraded our US 2011 GDP growth forecast to 1.8% from 2.5%, and now expect the Fed to hike only in Q3-2013 (versus Q3-2012 previously). Similarly, EU growth has proven disappointing, at 0.2% q/q in Q2.

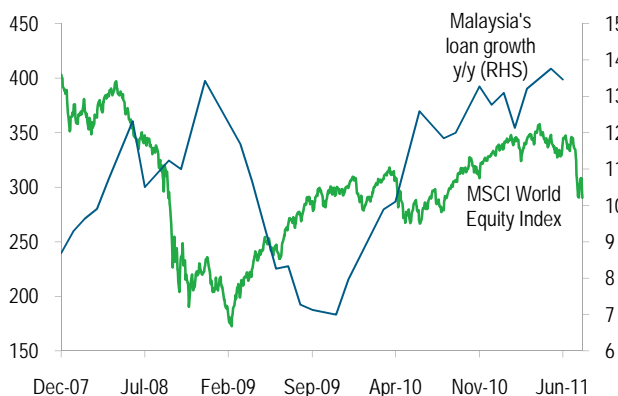
Bank Negara Malaysia (BNM) left rates unchanged on 7 July, noting its preference to monitor external market developments. Subsequent global market developments have proven that this decision was right. In light of the changes in the global growth outlook due to recent events, we now expect BNM to keep its Overnight Policy Rate (OPR) unchanged for the remainder of 2011, even though inflation may remain firm over the next few months. We had previously expected another pause in September, before a hike in November. We also expect the statutory reserve requirement (SRR) to be kept at 4% for the rest of the year (we previously expected one more 100bps hike).

Malaysia's exports are equal to about 110% of GDP. Commodities are an important component of exports, and a sharp downturn in global growth would have a negative impact on commodity prices and demand. The same goes for manufacturing, which accounts for around 27% of Malaysia's GDP.

Admittedly, the risk of a rate hike remains, considering strong M3 and loan growth and still-firm inflation. Given the recent increase in electricity tariffs and the robust domestic economy, we see inflation hovering around 3.5% for the remainder of the year (our 2011 inflation forecast is 3.4%). However, we do not expect BNM to send conflicting signals amid increased growth uncertainty.

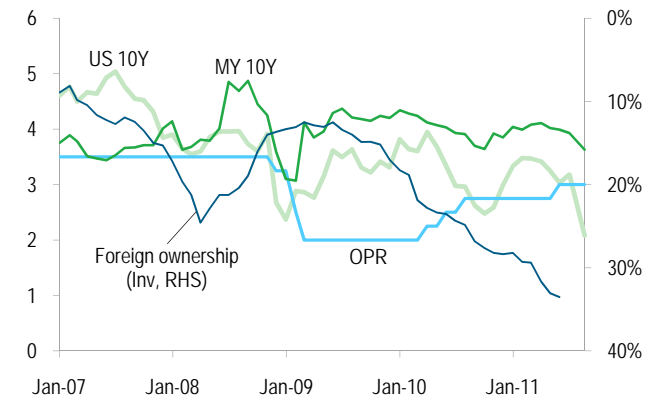
The deterioration in the growth outlook has positively impacted the local rates markets. Both the MGS and MYR IRS curves have bullish flattened so far in Q3, and their year-to-date performance is similar. The positive returns of the MGS market are particularly impressive considering the tighter monetary policy stance this year (25bps of OPR hikes) and record bond supply for the year (gross bond supply is estimated at MYR 96bn). Bond-market inflows (foreign ownership had risen to 34% as of July 2011), the sustained US Treasury rally and the downgrade in the global growth outlook have benefited rates bulls. Given the current market sentiment, rates are likely to stay low. Continued asset reallocation to this part of the world amid still-high interest rates and stronger fiscal profiles relative to many developed economies will also help to depress rates. We have a short-term *Neutral* FX rating on the Malaysian ringgit (MYR) given the outlook for limited gains and the easing global industrial production cycle, but we maintain our medium-term *Overweight* FX rating.

Chart 3: Domestic strength will not be immune to global weakness (%)



Sources: Bloomberg, Standard Chartered Research

Chart 4: Inflows and UST rally negate OPR hikes
Downward pressure on yields dominates



Sources: Bloomberg, Standard Chartered Research



New Zealand – Rising from the ashes

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Reconstruction after the tragedy

The September 2010 and February 2011 earthquakes in the Canterbury region, which accounts for 15% of GDP, destroyed infrastructure and tourism assets in the city of Christchurch. The IMF estimates the reconstruction costs at around NZD 15bn in 2011, or 7.5% of GDP, while infrastructure and commercial rebuilding are likely to boost growth after 2012. Even before the earthquakes, New Zealand had seen clearly investment-driven GDP growth since last year, and we expect this trend to continue in the medium term.

Although the earthquakes caused a decline in employment in the Canterbury region, the national job market has remained resilient, and the unemployment rate stabilised at 6.5% in H1-2011. Consumer confidence recovered in August, despite the pessimism dominating offshore markets. Retail sales increased 0.9% q/q in real terms in both Q1 and Q2-2011, after contracting 0.1% q/q in Q4 2010.

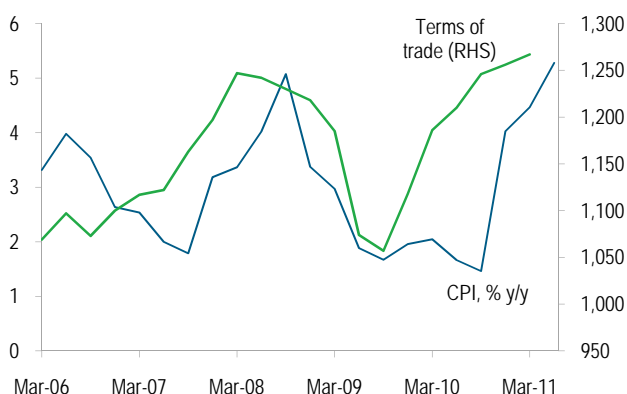
That said, we do not expect a strong rebound in private consumption, given that consumers are still cautious about spending and sensitive to interest rates due to the large household debt burden.

Broad export price gains push up terms of trade

New Zealand's terms of trade are at the highest level since 1974, and this should help to narrow the current account deficit going forward. The gains are mainly driven by broad-based increases in export prices, especially of dairy-related products, in the past year. Although dairy prices have shown signs of easing recently, solid demand from fast-growing emerging economies will continue to support prices and

Chart 1: Inflationary pressure remains

2006 to present



Sources: CEIC, Standard Chartered Research

benefit farmers in terms of higher incomes and debt reduction. Although exports to Europe dropped by 9.6% y/y in July, export growth to Asia remained positive, contributing to overall gains. As such, the monthly trade balance has posted a surplus for seven straight months. This is expected to reverse New Zealand's historical trend of a current account deficit and help to rebalance the economy.

External volatility may cause RBNZ to stay put

Headline inflation remained elevated in Q2, at 0.96% q/q and 5.3% y/y. According to the Q2 survey on the inflation outlook, inflation expectations for 12 and 24 months in the future eased to 2.94% and 2.86%, respectively, from 3.12% and 3.00% in the Q1 survey. In addition, respondents still expected a rise in hourly earnings one year ahead and a decline in the unemployment rate.

This points to persistent inflationary pressure and indicates that inflation is at risk of breaching the 1-3% target set by Reserve Bank of New Zealand (RBNZ). Inflation will remain under upward pressure in the medium term as post-earthquake reconstruction gets underway and the output gap closes.

Even so, given the recent global turmoil and the related downside risks to New Zealand's economy, it would be prudent to put monetary policy on hold until global market are back on track. As such, we now expect the RBNZ to be cautious about near-term tightening, despite acknowledging medium-term inflationary pressure. We do not expect policy rate normalisation to occur until Q1-2012.

Stimulus from the Rugby World Cup

New Zealand will host the Rugby World Cup in September and October 2011. The RBNZ has predicted that the tournament will bring around 95,000 international visitors and total spending of NZD 700mn – equivalent to around 1.4% of quarterly GDP. We expect a rise in domestic production and private spending before and during the tournament. However, these effects may be reversed after the event as spending normalises, resulting in a limited impact on overall 2011 growth.



Philippines – Resisting external shocks

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Maintaining economic resilience

Historically, the Philippines has been much more resilient to external shocks than many other Asian economies. In 2009, after the global financial crisis, almost half of Asia’s economies reported negative GDP growth in the wake of the financial turmoil stemming from developed countries. However, the Philippines escaped recession thanks to its strong – and often under-appreciated – domestic consumption and investment.

Nonetheless, we revise down our 2011 GDP growth forecast to 4.3% from 5.7% to reflect external uncertainties. This would still be a decent performance compared with some of the region’s export-oriented economies, which are more exposed to the global economic cycle.

Private consumption and investment have been the main drivers of GDP growth since 2010. Private consumption is consistently supported by solid inflows of overseas Filipino workers’ (OFW) remittances. In H1-2011, remittances grew at an average y/y rate of more than 6%. Remittances have become a stable source of household spending on education, medical care and durable goods. Local consumer sentiment appears to have remained steady despite continuous waves of bad news from Japan, the EU and the US since March.

Investment momentum remains strong, especially in the infrastructure sector. Total approved investments increased 76.5% y/y in Q1, led by a surge in the infrastructure and education sectors. According to local media reports, investment commitments rose 20% y/y in H1-2011. The government initiated the public-private partnership (PPP) model for infrastructure projects last year, and in July 2011, it

announced the start of the bidding process for the first of five PPP projects. Although the process is moving more slowly than expected, we are still bullish on the medium-term investment outlook given strong local demand.

External volatility weighs on monetary policy

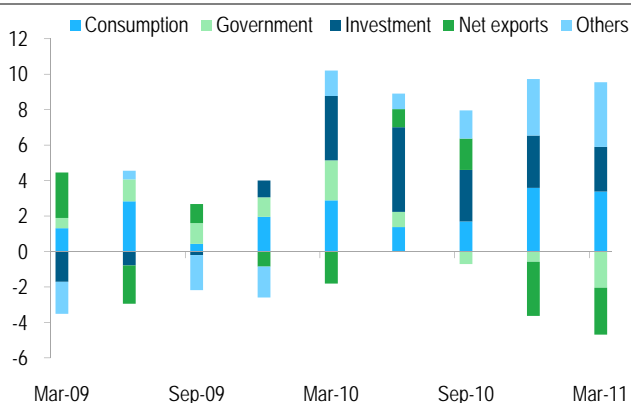
Inflation started to show signs of stabilisation in July, and Bangko Sentral Ng Pilipinas (BSP) policy makers have shifted their focus to controlling liquidity. They raised the reserve requirement twice, by 1ppt each time in June and July, restoring it to the pre-crisis level of 21%. Although capital inflows should be managed appropriately to anchor asset-price stability, the external outlook now holds the key to monetary policy decisions. We now expect BSP to hold off on tightening until Q1-2012, when either the global economy stabilises or possible QE3 pushes up the inflation outlook.

Rates market outlook

The Philippine bond market has been resilient to recent global risk aversion. Yields have eased by around 30-40bps since the end of July given the market’s positive fundamentals. We have pushed back our BSP rate-hike forecast to just 25bps in Q1-2012, and the government’s fiscal position remains robust. The H1 budget deficit was just PHP 17bn, versus the government’s initial full-year target of PHP 300bn (and PHP 197bn in H1-2010). We expect the government to increase spending in H2-2011, but the full-year budget deficit should come in at just PHP 128bn, still well below target.

On the supply front, Deputy Treasurer Mendiola said that the government is considering selling Retail Treasury Bonds (RTBs) in October 2011, according to a Bloomberg report. The Bureau of the Treasury is seeking approval to issue PHP 500bn worth of RTBs; Mendiola stressed that this amount will not be used for a single issue but for future RTB issues. The report suggested that the government may sell as much as PHP 100bn in October, and said the bonds may be sold in the 10Y and 15Y tenors. The long end of the curve (where the retail bonds will be issued) may sell off transiently ahead of the October auction date as market participants attempt to push the curve higher. We took profit on our long 20Y bond position on 22 August at 7.51%, with a profit of 49bps (target: 7.50%, stop-loss: 8.50%; trade initiated at 8.0% on 21 July 2011).

Chart 1: Consumption and investment drive GDP growth 2009 to present, contribution to the growth



Sources: CEIC, Standard Chartered Research



Singapore – Navigating a stormy sea

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High external exposure drives growth volatility

Singapore is likely to bear the brunt of recent concerns about global growth, considering the country’s high exposure to external trade in goods and services. We recently revised down our GDP growth forecasts to 4.8% for 2011 (from 5.5%) and 4.6% for 2012 (from 6.0%. We also now see a higher probability of even lower growth, although this is not our central scenario. Before the recent bout of poor economic data from the US, we saw a 30% chance that the Singapore economy would grow less than 4% in 2012. We believe this probability has now risen to 40%.

While domestic demand is well supported by a strong job market, this is unlikely to be sufficient to offset external weakness. Meanwhile, inflation has remained stubbornly firm, and the upward momentum in housing rents is likely to prevent a significant moderation in headline inflation in the months ahead. Still, with global inflationary pressure easing and the external growth outlook in greater doubt, we expect the Monetary Authority of Singapore (MAS) to opt for mild loosening by reverting to a “modest and gradual” appreciation stance. This would be consistent with Singapore dollar nominal effective exchange rate (SGD NEER) appreciation of 2% per annum, compared with our current estimate of 3.25%. With USD interest rates still very low and the SGD NEER appreciation stance remaining intact, we expect SGD interest rates to stay depressed for the next 12-18 months.

Domestic strength versus external weakness

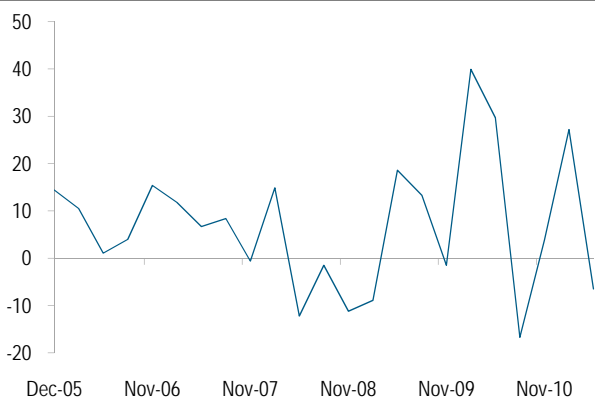
The Singapore economy expanded 4.9% y/y in H1; the pace slowed to 0.9% in Q2 from 9.3% in Q1. On a q/q basis, GDP contracted 6.5% in Q2 after growing 27.2% in

Q1 (seasonally adjusted annualised rate). The manufacturing sector was the main culprit of the weaker Q2 performance, contracting 5.9% y/y. The volatile biotech and pharmaceuticals sector contributed to the weak manufacturing performance and is expected to make a more positive contribution later this year. The more persistent contraction in electronics exports is of greater concern. We believe this is partly a reflection of weak demand from the West. However, the rising cost of doing business in Singapore also raises the risk that some electronics manufacturers will move to lower-cost locations such as Malaysia, Thailand or China. Hence, there is a structural aspect to Singapore’s manufacturing performance as well as cyclical factors.

The services sector decelerated in Q2 but still maintained positive y/y growth. The tourism-related sector outperformed thanks to a surge in tourist arrivals, also reflected in strong retail sales growth. Financial services also expanded strongly; this correlates with robust lending growth, despite more subdued trading volumes in Q2. Given our expectation of a prolonged period of low interest rates (see below for more on this), we expect lending growth to remain firm in the months ahead, although growing external uncertainty may moderate the pace.

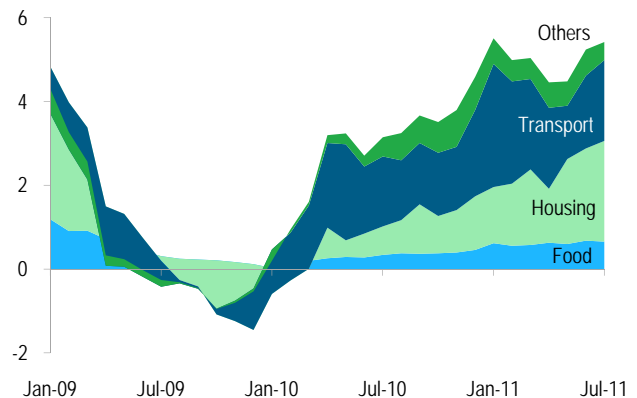
While another q/q contraction in Q3 cannot be ruled out, and this would constitute a ‘technical recession’, this ignores the volatile nature of Singapore’s economy and the breakneck pace of growth recorded in 2010 (Chart 1). We expect Singapore’s growth to moderate further in late 2011 and early 2012, led by the services sector.

Chart 1: Moderation following quarters of rapid growth
GDP growth, q/q SAAR



Sources: CEIC, Standard Chartered Research

Chart 2: Housing and transport to drive inflation
Contributions to inflation by component (ppt)



Sources: CEIC, Standard Chartered Research



Singapore – Navigating a stormy sea

Housing, transport costs keep inflation high

Headline inflation rose further to 5.4% y/y in July on the back of higher rents and transport costs (Chart 2). Housing rents are expected to continue to contribute to headline inflation as ongoing lease renewals reveal the extent of housing-cost inflation observed in recent months. Meanwhile, transport costs are largely driven by auction prices of Certificates of Entitlement (COE), or vehicle ownership permits. COE prices have been on a steady uptrend as the authorities continue to limit supply of the permits, while demand has remained firm. The latest COE bidding saw some decline in prices, possibly a reflection of stock-market weakness. However, on a y/y basis, COE prices were still up 45.4% y/y in August (on a weighted basis). We therefore expect headline inflation to remain at 4-5% for the rest of 2011.

Interest rates may stay negative for some time

The focus of the local rates market has been the decline of the SGD swap offer rate (SOR) into negative territory for the first time on 10 August (Chart 3), after the US Fed committed to keeping interest rates low through mid-2013. The short end of the SGD IRS curve (up to 2Y) also went negative, as the IRS curve is referenced to SGD 6M SOR. While interest rates typically do not fall below 0%, the zero-bound concept is less relevant to SGD SOR.

Hence, while negative interest rates make good headlines, this move is a simple case of interest rates falling further. Given very low USD rates and widely held expectations of SGD appreciation against the US dollar (USD), SGD SOR may stay negative for some time. We currently see a 6M SOR fixing of -1.5% as the implicit lower bound, taking into account market expectations of SGD appreciation. We note

that this assumes zero intervention, as the sterilisation of FX intervention can affect FX forward pricing (see **On the Ground, 12 August 2011, ‘Singapore – Interest rates to stay negative near-term’**).

Rates to stay depressed

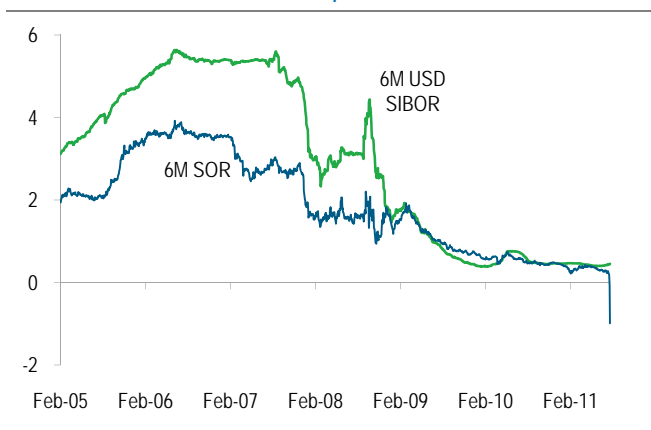
Fiscal woes in developed markets, underlined by the recent protracted debate over raising the US debt ceiling and the ongoing euro-area debt crisis, are supporting global asset reallocation to non-traditional markets. Singapore’s solid AAA-rated status is attracting strong inflows. Moreover, given that the SGD is a proxy for Asian currencies and that Asian currencies are widely expected to outperform, SGD assets give investors a channel to participate in the Asian currency rally without having to move down the credit curve (see **Rates Strategy, 2 August 2011, ‘Singapore – The case for increasing SGS allocation’**).

Meanwhile, we do not expect SIBOR or Singapore Government Securities (SGS) yields to dip into negative territory. If SGS yields do turn negative in a short-squeeze situation, we do not expect this to last.

Time for MAS to be less aggressive

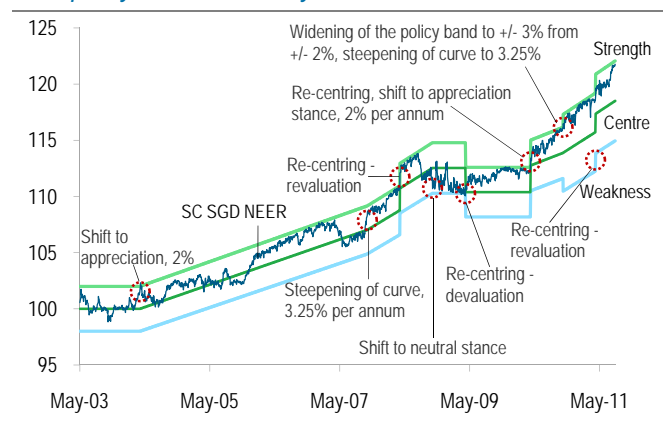
Given the more uncertain global growth outlook and Singapore’s vulnerability to the external environment, we expect the MAS to lower the slope of SGD NEER policy band appreciation by a notch. We expect the slope of the policy band to be lowered to 2% per annum from 3.25% currently. This is consistent with Singapore’s economy expanding at a trend growth rate. Inflation remains firm, and unless the growth outlook deteriorates sharply, it would be premature for the MAS to shift to a neutral stance in October.

Chart 3: SGD appreciation results in negative SOR
6M USD SIBOR and SGD swap offer rate



Source: Bloomberg

Chart 4: We expect SGD NEER appreciation to slow
MAS policy shifts in recent years



Sources: Bloomberg, Reuters, Standard Chartered Research



South Korea – Structural and cyclical headwinds to the tech sector

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Downward revision of our GDP forecasts

We revise down our 2011 and 2012 GDP forecasts to reflect increasing downside risks to growth. That said, we continue to expect steady growth, rather than a sharp slowdown or a 'double-dip' recession. We now forecast GDP growth of 3.5% for 2011 and 4.0% for 2012 (previously 3.9% and 4.8%). Exports and domestic demand will contribute to balanced growth. Exports will continue to be supported by the strength of emerging-market economies, while consumption will be boosted by the resilient labour market and the stabilisation of food and energy inflation. The severe contraction in the construction sector will soon end, also improving the growth momentum.

We revise up our 2011 and 2012 CPI inflation forecasts to reflect recent upside surprises to inflation and the upward revision of our energy price forecasts. However, we maintain our baseline scenario that headline inflation will return to the central bank's target range of 2.0-4.0%. We raise our headline CPI inflation forecasts to 4.2% for 2011 and 3.5% for 2012 (previously 4.0% and 3.2%). We continue to believe that base effects on vegetable and pork prices will contribute to lower headline and core inflation. Underlying inflation pressures from rising energy prices will persist, though the pace of increase in crude oil prices should ease. We have raised our forecast for the average Dubai crude oil price in 2012 to USD 115/barrel (bbl) from USD 99/bbl. The significant rise in housing rents, a key inflationary factor, could continue into 2012.

Cloudy outlook for tech sector, developed markets

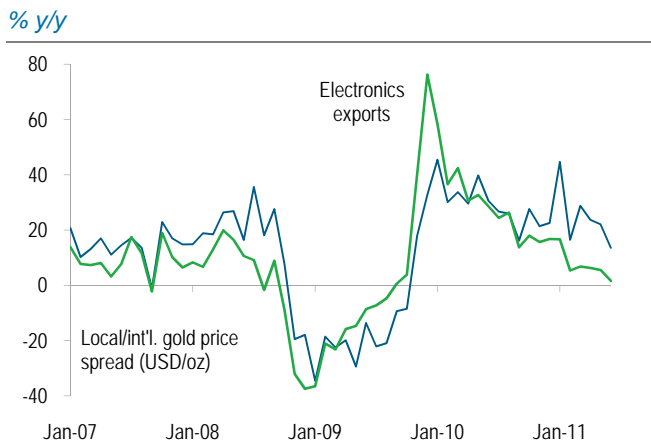
We no longer expect a significant recovery in high-tech (electronics) exports, and this is the main reason for the

downward revision of our GDP forecasts. High-tech exports have shown pronounced weakness since H2-2010 (see Chart 1). Until now, we viewed this weakness as a short-term phenomenon caused by inventory adjustment; this led us to the conclusion that the sector would soon show a meaningful recovery, in line with the recovery in global demand. However, there is growing evidence that the slowdown in high-tech manufacturing is the result of a structural change that may not be easily reversed. Part of this change is the shift in global tech-industry profitability from hardware to software, and the Korean economy is highly dependent on the high-tech hardware (manufacturing) sector.

We expect high-tech exports to remain weak in H2-2011, and to shift from a y/y expansion to a contraction soon. We expect positive growth to resume in 2012 as unit prices for memory chips and display panels stabilise, barring a new US recession. But the structural weakness in high-tech manufacturing will reduce Korea's potential GDP growth rate, given that this sector has been the main source of GDP growth since the mid-1990s.

Another downside risk to exports that led us to lower our GDP forecast is the slower growth expected in developed economies, especially the US. While our base scenario for the US is not a double-dip recession, we recently revised down our US GDP growth forecasts to 1.8% for 2011 (from 2.5%) and 2.2% for 2012 (from 3.4%) to reflect the downward revision of Q1-2011 GDP and the recent hit to sentiment. Lingering concerns about the euro-area fiscal crisis should also affect European economies. Meanwhile, Japan's recovery from earthquake damage may be bad news for Korea's exports, which benefited from the related supply-chain disruptions.

Chart 1: Slowdown in high-tech exports



Source: Korea International Trade Association

Exports to developed economies outperformed those to emerging economies in H1-2011 (excluding ships, oil and high-tech products, which may not be directly related to cyclical conditions; see **On the Ground, 8 August 2011, 'South Korea – Export leaders and laggards in H1'**). We believe the outperformance of exports to developed economies can be explained by the later recovery in these economies relative to emerging markets. Exports to emerging economies were much stronger in 2009, when the recovery started there, than they are currently. The fact that Korea's exports excluding ships, oil and electronics are primarily dependent on developed economies does not bode well for the export outlook given the continued bad news from the US and Europe.



South Korea – Structural and cyclical headwinds to the tech sector

Continuing household debt burden

The burden of household debt will continue to be the biggest downside risk to domestic demand. Household debt growth has been relatively resilient so far, at 9.0% in Q1-2011. Household lending continues to outpace corporate lending growth, despite persistent concerns about the household debt burden. Persistent household debt growth has been a key factor supporting consumption. But the build-up of household debt could come at the cost of the long-term stability of the domestic economy, as the debt overhang could trigger concerns over credit quality.

Given such considerations, we cannot rule out the possibility of policy-induced deleveraging of household debt, which would be negative for consumption, construction and the housing market. A shift into fixed-rate mortgages from the current floating-rate structures, part of the government's household debt stabilisation measures announced in June, is likely to increase households' interest payment burden. This would reduce disposable income and hit the already-fragile property market by further reducing housing affordability. Though we expect policy makers to implement these measures with caution, the chances of a policy mistake clearly exist – particularly in light of the recent curb on banks' household lending, which was lifted the very next day.

BoK to pause rate-hiking cycle until year-end

Recent global events prompted the Bank of Korea (BoK) to pause its rate-hiking cycle at the August monetary policy meeting, and we now expect the BoK to remain on hold through the end of this year. Concerns about the global economic outlook will overwhelm inflation worries as long as financial-market jitters continue. Headline inflation should ease back into the BoK's 2-4% range from September

onwards thanks to a favourable base effect on vegetable prices. This will also support a cautious BoK stance.

We expect the BoK to resume its rate-hiking cycle in Q1-2012, taking the policy rate towards 4% from the current level of 3.25%, as domestic inflation concerns again overshadow growth risks in 2012. Furthermore, general elections are due in April 2012 and presidential elections in December 2012. Since inflation will continue to be the main concern of the public, we see little chance that the BoK will reverse its policy direction and start cutting rates. The authorities should only allow Korean won (KRW) strength in line with regional currencies. They are unlikely to use FX as the main policy tool to curb inflation, as FX intervention is directed by the Ministry of Strategy and Finance (MoSF), which emphasises export competitiveness.

Foreign demand to keep KTB yields low

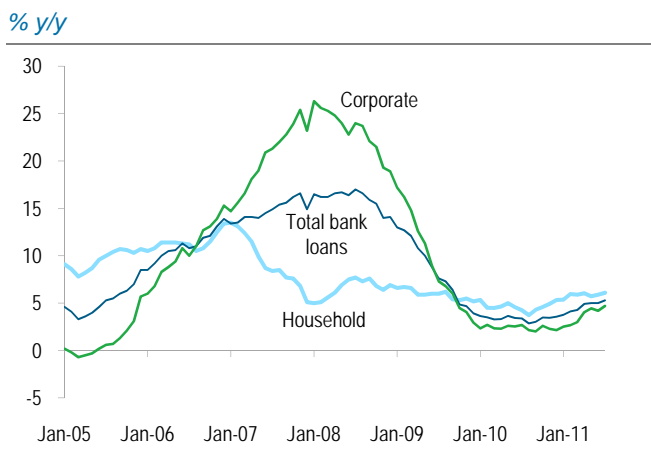
During the recent bout of risk aversion, Korea Treasury Bonds (KTBs) behaved like a safe-haven asset and rallied. Going forward, we remain constructive on the KTB market, underpinned by favourable demand/supply dynamics and a less hawkish BoK outlook.

Foreign inflows continue to fuel persistent demand for KTBs. In the first seven months of the year, foreigners bought around KRW 10trn (USD 9.35bn) worth of KTBs, versus net supply of KRW 27trn (USD 25bn). The US and Luxembourg have been two largest buyers of KTBs this year. Thailand has reduced its holdings through the roll-off of Kimchi funds, while China has continued to purchase around USD 300-400mn worth of KTBs each month. In terms of tenors, foreigners invest mostly in 3Y KTBs. However, more recently, there was a notable shift in demand to the 10Y in July.

On the supply side, the MoSF issued KRW 46trn worth of KTBs between January and July 2011, compared with its full-year target of KRW 82.4trn. This leaves around KRW 7.3trn to be issued each month for the rest of the year. With the government in fiscal consolidation mode, there is unlikely to be more supply of KTBs than planned, which leaves demand/supply conditions favourable.

We maintain our *Neutral* duration stance on KTBs. We are reluctant to be *Overweight* duration since yields are already very low and the curve is very flat, with the policy rate/3Y spread at just 30bps and the 3/10Y spread at 40bps.

Chart 2: Household loans are growing faster than corporate loans



Source: The Bank of Korea

Sri Lanka – Growth will withstand risks

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Growth prospects to remain intact

The uncertain global environment presents new challenges and risks, but we are confident that Sri Lanka's growth prospects for H2-2011 and 2012 will remain intact. Given the current strength in domestic demand, we see potential upside to our 7.8% full-year growth forecast. Loans for construction of houses, business premises and property development increased by 40.5% y/y in Q1, while new motor-vehicle registrations increased by 65.1% y/y, versus a 56.5% gain in Q1-2010. With market volatility likely to continue in H2-2011, Sri Lanka's strong macro fundamentals should help it withstand the external risk of weaker global growth. We expect stronger FDI inflows and significant government infrastructure spending to help Sri Lanka buck the global slowdown trend in H2-2011. FDI inflows of USD 413mn in H1-2011 are encouraging, given that inflows for full-year 2010 totalled about USD 500mn.

The LMD-Nielsen business confidence index showed an 8% m/m increase in August, while private-sector credit demand growth reached 34.4% in June. Fears of a renewed US recession might undermine near-term business and consumer confidence until market volatility subsides, but the manufacturing, construction and tourism sectors remain buoyant. We expect these sectors to continue to be the key drivers of growth in H2-2011 and 2012.

Inflation is less of a threat, but concerns linger

Inflation, the downside risk which we previously believed would weigh the most on growth, has become less of a threat as the global downturn has caused food and energy prices to fall and as domestic food supply has risen. We expect headline inflation to moderate further in H2-2011, and

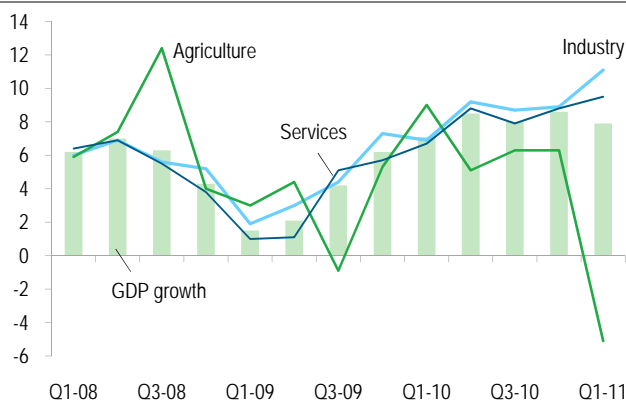
maintain our average annual forecast of 7.4%. However, we remain cautious about the prospect of rising core inflation, which reached 8.9% y/y in July, given robust domestic consumption demand.

Moderating inflation raises the odds that the central bank will keep policy rates at current levels (repo rate at 7.0% and reverse repo rate at 8.5%) to support growth. However, the strong upward trend in money supply growth (at 20.7% y/y) and in particular consumption lending growth (at 46.8% y/y) indicate that the central bank needs to stay vigilant on demand-driven inflation. Policy rates have remained unchanged for seven consecutive months. The US and euro-area crises could shake confidence and dent consumer demand, easing pressure on domestic aggregate demand and providing further impetus for the central bank to keep interest rates low for a longer period. This would be supportive of the authorities' pro-growth policy stance. However, we expect policy makers to start gradually tightening interest rates, with a 25bps hike in early Q3-2012, when domestic demand pressures may start to build.

Low exposure to external risks

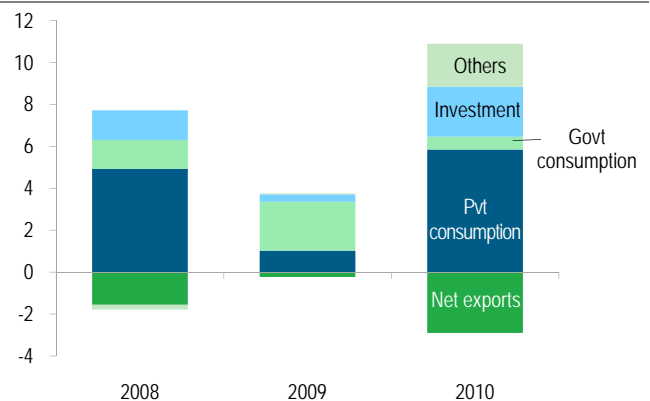
Due to its large domestic-demand component, Sri Lanka's economy has relatively low exposure to external trade and a limited correlation with the global economic cycle. Exports have shown robust growth – they rose 8% in volume terms in H1-2011, while export earnings increased by almost 41% y/y. The US is Sri Lanka's second-largest market for garment exports, accounting for almost 40% of total garment exports. The garment sector is Sri Lanka's primary source of foreign exchange earnings, contributing c.8% of GDP. Our key near-term concern is the composition of trade, as Sri Lanka's

Chart 1: Industry and services sectors driving growth
% y/y



Sources: CBSL, Standard Chartered Research

Chart 2: Private consumption is the main contributor
ppt contribution to growth



Sources: CEIC, Standard Chartered Research



Sri Lanka – Growth will withstand risks

export basket is focused primarily on textiles and garments (40% share) and agricultural products (24% share), and the US and Europe are significant markets. Growing competition from Vietnam and Bangladesh could also put pressure on textile exports. An export-driven slowdown is therefore a threat even for Sri Lanka, and we expect export growth to come under pressure in 2012.

Inflows to the services account in H1-2011 were largely driven by higher tourism earnings, which rose 51% y/y. However, should the bleak outlook for European economies persist, we expect Sri Lanka's European tourist markets to take a significant hit. Tourist arrivals from the Middle East and Asia are currently driving growth in the sector, while Western Europe's contribution is flattening. That said, Western Europe remains the largest source of tourist arrivals, with a share of almost 38% and growth of 32.5% y/y in H1-2011, according to the Pacific Asia Travel Association (PATA). It is of some comfort that South Asia is not far behind, with a 29% share of tourist arrivals, which are growing at a faster pace of 45.2% y/y. Although the tourism sector's direct contribution to GDP is modest, at c.2%, it is an emerging growth driver, creating over 52,000 direct employment opportunities in 2010.

Strong fundamentals to counter headwinds

Despite Sri Lanka's low exposure to external trade, the poor diversification of its export markets and products (with a heavy reliance on the US and the EU) and weak capital inflows are cause for concern. The slowdown in the West is likely to disrupt the trade sector and financial inflows to Sri Lanka. However, the country's strong fundamentals give policy makers leeway to counter such headwinds. The level of government debt to GDP is high but manageable at

c.82% and is trending lower, implying that fiscal stimulus could be used to support economic development. Also, the fall in commodity prices should reduce balance-of-payments pressures and significantly improve the inflation outlook; overseas workers' remittances remain strong, rising 26.4% y/y to USD 2.5bn in H1-2011. The further relaxation of foreign exchange controls, such as allowing foreigners to invest in unit trusts (mutual funds) and thereby participate in LKR debt, should boost investor confidence and strengthen FX reserves, which are at a healthy USD 8.1bn. These relatively high reserves give Sri Lanka more room for policy manoeuvre.

Furthermore, Sri Lanka's sovereign bond issuance in July, which was well received by the market and 7.5 times oversubscribed, will help to buffer capital flows. The proceeds of the bond issue have been used to retire high-cost domestic debt and will also be used to meet future debt repayment obligations.

The improvement in the country's sovereign credit standing in July (outlook upgrades from Moody's and S&P to positive from stable, and a rating upgrade by Fitch to BB- from B+) reflect sustained robust growth momentum, an improving external liquidity position, and progress on fiscal consolidation in 2011. The government's fiscal deficit target of 6.8% of GDP in 2011 looks increasingly achievable based on current fiscal trends. These developments bode well for investor appetite and improved capital inflows. The US and euro-area crises and growing fears that the US may enter a new recession will likely dampen confidence, but we expect Sri Lanka's economic rebound to withstand these external risks.

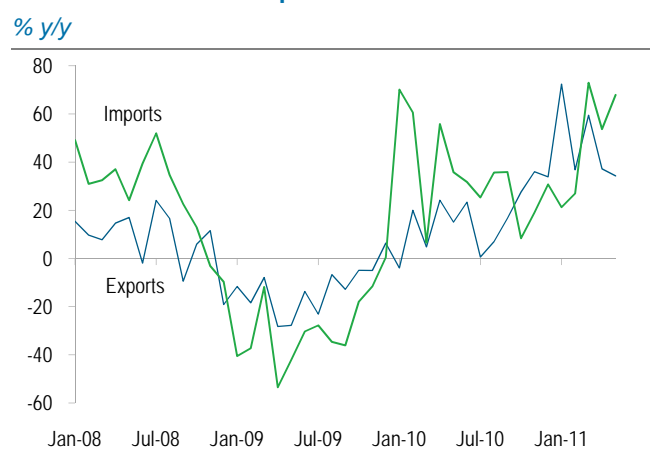
Table 1: Standard Chartered forecasts for Sri Lanka

	2009	2010	2011	2012F	2013F
GDP (real % y/y)	3.5	8.0	7.8	7.5	8.0
CPI (% annual average)	3.4	6.2	7.4	7.7	8.0
Policy rate (%)*	7.50	7.25	7.00	7.25	7.50
USD-LKR*	114.4	111.0	108.4	106.0	104.8
Current account balance (% GDP)	-0.5	-2.9	-2.8	-2.5	-2.0
Fiscal balance (% GDP)	-9.8	-7.9	-7.5	-6.5	-6.0

* End-period;

Sources: CBSL, Standard Chartered Research

Chart 3: Threat of an export slowdown lurks



Sources: CBSL, Standard Chartered Research



Taiwan – Quiet confidence among manufacturers

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Weak exports cloud growth outlook

Recent signs of weakening growth in key overseas markets such as the US and Europe have cast doubt on Taiwan's growth outlook, given the island's strong reliance on external demand. Softer exports were already a key factor behind the cooling growth momentum in Q2-2011, when real GDP growth slowed to 5.02% y/y from a revised 6.16% y/y in Q1.

There are also fears that the recent global market turmoil may dampen overseas buyers' confidence and heighten downside risks to Taiwan's export growth. This may cause local firms to turn more cautious on hiring and capital spending. This threatens to undermine the relatively buoyant domestic demand recovery, which has so far largely mitigated weakness in the export sector (see Chart 1).

The latest economic data releases (including industrial production and export shipments and orders) point to an extended soft patch in economic activity. We therefore revise down our real GDP growth forecasts to 4.6% for 2011 (from 5.6%) and 5.1% for 2012 (from 6.0%). This implies that real economic growth will average a slower 4% y/y in H2-2011, before rebounding to the trend rate of 5% in 2012.

Domestic confidence holds the key

The government has turned more pessimistic on the domestic investment outlook following the release of Q2 data. It now expects private-sector investment to decline by more than 8% y/y in H2-2011 after registering strong growth of 8.5% y/y in H1, amid fears that local businesses may reduce investment spending for the rest of this year and in 2012.

Table 1: Key Taiwan forecasts

	2010	2011F	2012F
Real GDP (% y/y)	10.8	4.6	5.1
Inflation (% y/y)	1.0	1.6	1.5
Re-discount rate (%)*	1.625	1.875	2.125
Current account bal (% GDP)	9.6	7.5	7.0
Fiscal balance (% GDP)	-1.3	-1.1	-0.7
USD-TWD*	29.299	28.00	27.00

*end period;

Source: Standard Chartered Research

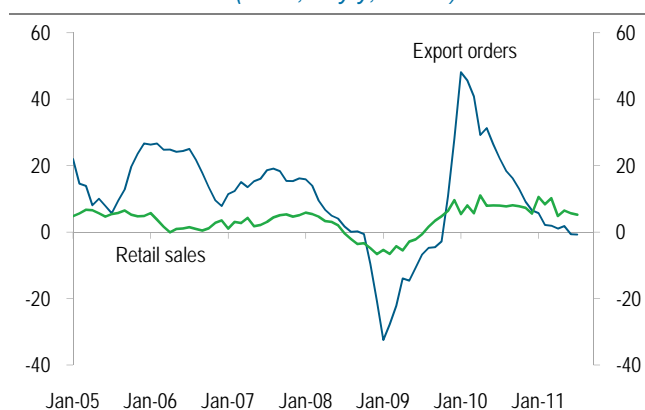
However, we are less bearish. Although there are growing concerns among local exporters that overseas orders have not picked up as strongly as hoped ahead of the year-end festive season, most reportedly do not expect orders to collapse as they did in 2008. One leading wafer producer is confident that its factory utilisation rate will begin to pick up in Q4-2011 on signs of improving order visibility.

The latest survey by the Taiwan Institute for Economic Research (TIER) shows a rebound in manufacturing confidence. 40.8% of those surveyed in July expected overall business conditions to improve in the next six months. This was higher than the 37.4% reported previously. We therefore believe that local businesses will delay rather than significantly cut planned investment spending, barring an imminent risk of a double-dip in the US.

Growing credit appetite among local SMEs is another sign that business confidence is likely to remain resilient amid external headwinds. Total net bank lending to the SME sector increased by TWD 280bn in H1-2011, versus TWD 166bn during the same period last year. Unlike large corporates, local SMEs rely almost solely on domestic banks for operating and investment capital.

This bodes well for the broader economy, as local SMEs – which are less dependent on external demand than larger companies – employ more than 70% of local workforce. This will continue to support the job market (see Chart 2), which has been a key factor behind relatively robust consumer confidence and private consumption spending.

Chart 1: Strength in retail sales has mitigated weakness in external demand (TWD, % y/y, 3mma)



Sources: Bloomberg, Standard Chartered Research



Taiwan – Quiet confidence among manufacturers

Taiwanese banks have lower exposure to Europe

Local banks and non-bank financial institutions had TWD 214bn (about USD 7.4bn) of exposure to Portugal, Italy, Ireland, Greece and Spain as of end-Q1-2011, according to local media reports. This is slightly more than the sector's TWD 193bn in combined profit before tax for the whole of 2010. It is also estimated to be around 0.5% of Taiwan's total banking assets, and 8% of the local banking sector's net asset value.

However, in the event of default by debtors in peripheral euro-area economies, this exposure would likely lead to an increase of only 1ppt in Taiwanese financial institutions' overall NPL ratio, which stood at 0.5% as of end-June 2011. More importantly, with loan-loss coverage currently standing at 176%, the potential fallout from Europe's widening debt crisis is likely to have a limited impact on the underlying health of the local banking sector.

Inflation to remain elevated; upside risks receding

We also lower our inflation forecasts to 1.6% in 2011 (from 2.2%) and 1.5% in 2012 (from 2.2%). We believe that upside risks to our headline inflation forecast have receded, as benign weather conditions kept food prices relatively stable during the first seven months of 2011.

However, we see little room for headline inflation to ease significantly from its current level. Relatively stable food prices this year indicate potential upside risks to headline inflation next year in the event of severe weather. Also, the state-owned oil company recently announced a net loss of TWD 4.6bn for the first seven months of 2011. The loss for

full-year 2011 could be as high as TWD 10bn unless global oil prices (WTI) fall to USD 75 per barrel from USD 85/bbl currently. This suggests that there is limited room for local fuel prices to move lower.

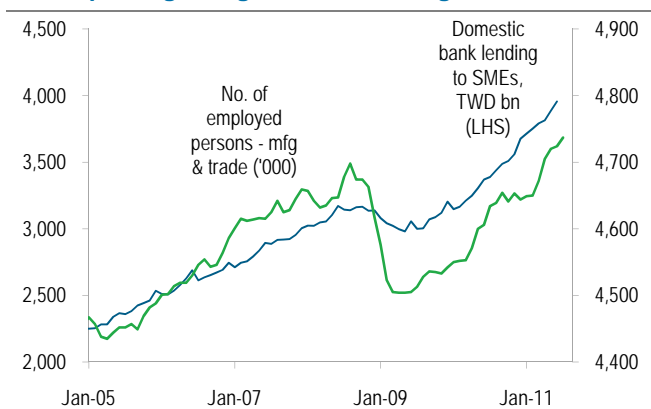
Also, core inflation – the key gauge of underlying inflation risk tracked by the Taiwan central bank (CBC) – has remained stubbornly high. It exceeded 1% for the fourth consecutive month in July due to rising housing costs, as Chart 3 shows. Housing-related costs, which make up more than one-third of the CPI basket, registered the fastest y/y rise since September 2010. This points to a continuing impact from rising rents and suggests that domestic inflation could remain elevated, even though headline inflation is expected to peak in Q3-2011.

CBC to consider a pause in interest rate hikes

Central bank policy makers have repeatedly stressed the need for monetary policy to both maintain growth and ensure price stability. With upside risks to inflation stabilising, the recent market turmoil is likely to weigh heavily on interest rate policy decisions going forward. We therefore see an increasing chance that the CBC will pause its rate-hiking cycle at its next monetary policy meeting, scheduled for September.

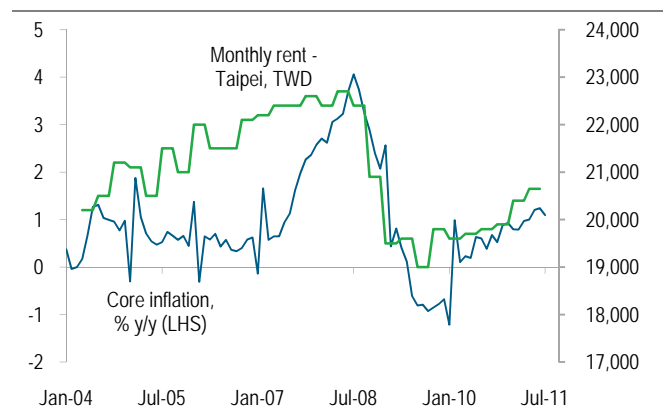
We expect the CBC to keep policy rates steady in H1-2012, before resuming a modest tightening stance on clearer signs of a growth rebound and underlying pressure on core inflation stemming from rising wage growth, higher housing costs, solid credit growth and ample market liquidity.

Chart 2: Rising credit appetite among SMEs coincides with improving hiring in manufacturing and trade sector



Sources: Bloomberg, Standard Chartered Research

Chart 3: Continuing rise in housing rents poses a threat to the core inflation outlook



Sources: Bloomberg, Standard Chartered Research



Thailand – Government is leading domestic demand

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Possible tests of political stability

After persistent political problems since the bloodless military coup in September 2006, we are now seeing positive signs of a more stable political environment, at least for the foreseeable future. The landslide victory of the Puea Thai Party (PTP) in the 3 July election not only prevented a political dispute, but it also allowed the PTP to secure a strong majority in the parliament by forming a coalition with smaller parties. Furthermore, the newly appointed economic ministers have been well received by the business community and investors given their strong credentials as regulators in Thai financial markets. This bodes well for the longevity of the coalition government led by Prime Minister Yingluck Shinawatra.

That said, the new government’s honeymoon period is likely to be short-lived. The immediate challenges are the unfavourable global economic environment and the need to strike a balance between the interests of voters (given the populist policies promised by the PTP) and the business community. In the medium term, threats to political stability remain, including potential reactions from groups that oppose amnesty for exiled former Prime Minister Thaksin Shinawatra and legal challenges to the election of PM Yingluck (Thaksin’s sister) and the PTP. Any attempt by the government to grant amnesty to Thaksin could jeopardise the government’s stability.

Domestic demand-led growth model

Private consumption was the key driver of growth in H1-2011, and is likely to remain so in H2. Consumption is in turn driven by private credit expansion and the restoration of consumer and business confidence due to political clarity

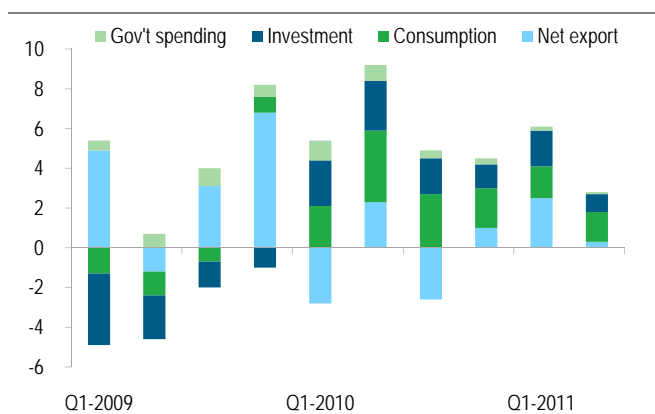
and populist policies to be implemented from Q4-2011 onwards. The Paddy Rice Mortgage scheme will raise farm incomes, and measures to reduce the cost of living should provide another boost to consumption. Nonetheless, the external environment will be less supportive of Thai exports given the growing risk of a serious slowdown in developed economies. In light of this, we revise down our Thai GDP growth forecasts to 3.2% for 2011 (from 4.4%), and to 4.8% for 2012 (from 5.8%).

Government-led policy is a swing factor for growth

The new coalition government led by PM Yingluck announced an economic policy platform aimed at stimulating domestic demand on 24 August. The government plans to implement measures within one year aimed at reducing the cost of living and boosting consumption. Meanwhile, long-term policies to be implemented over the next four years will emphasise public investment in infrastructure. Despite these stimulus measures, the government will maintain its fiscal discipline by complying with the budget law, which states that the planned deficit shall not exceed 20% of the annual budget.

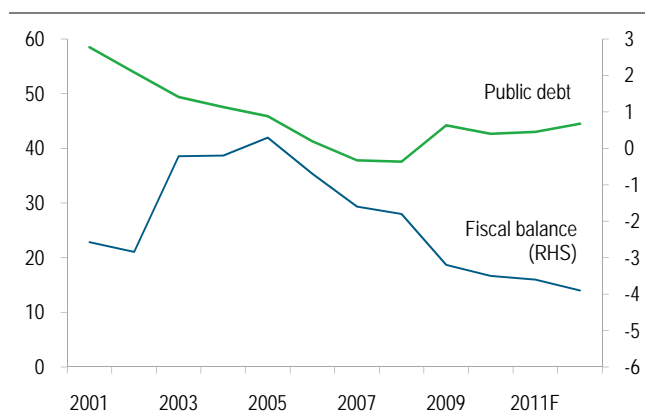
The government’s tax revenue in the current fiscal year (FY11, ending 30 September 2011) has already exceeded the full-year target by about THB 180bn and is likely to reach THB 200bn (1.9% of GDP). This should provide a buffer against increased spending in FY12, if needed, while leaving the planned budget deficit for FY12 unchanged at THB 350bn. With public debt at a manageable 42% of GDP, Thailand’s fiscal position is not cause for concern, at least for the foreseeable future.

Chart 1: Private consumption supports growth



Sources: NESDB, Standard Chartered Research

Chart 2: Fiscal position remains in good shape
% of GDP



Sources: MoF, Standard Chartered Research



Thailand – Government is leading domestic demand

BoT has completed interest rate normalisation

Declining global crude oil prices and the new government's measures to reduce the cost of living are the two key reasons for the downward revision of our 2012 inflation forecast to 3.0% from 3.8%. We expect minimum wage hikes to be implemented gradually, while the reduction in corporate taxes and the suspension of fuel levies should have the net effect of lowering production costs. As a result, we expect inflation in Thailand to peak in Q3-2011.

Even so, those expecting a reversal of monetary policy to a loosening stance will be disappointed, as negative real rates are likely to remain a medium-term concern for the Bank of Thailand (BoT). Domestic inflation risks arising from the new government's spending plans will also keep the BoT cautious. Hence, we do not expect rate cuts. Furthermore, we expect the BoT to use interest rates and macro-prudential measures to curb inflation. FX is unlikely to be the tool of choice to tackle inflation, as policy makers have explicitly stated on many occasions that FX is ineffective in curbing inflation in Thailand.

Given indications from the BoT that the policy rate is now close to normal, combined with greater uncertainty surrounding the global outlook, we expect the BoT to keep its policy rate on hold at 3.5% for the rest of this year. The resumption of rate hikes in 2012 will be premised on firm growth and the threat of core inflation breaching the policy target (0.5-3.0%) again.

Thai government bonds to remain well bid

The THB rates market has rallied extensively over the past few weeks, in line with our expectations (see **Rates Strategy, 22 July 2011, 'Thai bonds sell-off overdone;**

buy 1Y paper'). We expect the bond market to remain well bid as external growth risks become an increasing concern. The three key drivers of the Thai bond market are: (1) the BoT monetary policy outlook, (2) the Public Debt Management Office's FY12 supply plan, and (3) asset rotation from money market funds to deposits.

On the first, we expect the BoT to keep rates on hold at 3.5% for the rest of this year. On the second point, local laws limit the size of the FY12 budget deficit to THB 450-500bn, so gross Loan Bond supply should not exceed THB 500bn during the fiscal year. We see quarterly issuance of THB 125bn as manageable. Finally, we expect outflows from money market funds to deposits to ease starting in September.

These factors are fairly conducive to the bond market, and we therefore expect bonds to remain well bid. However, we are reluctant to recommend an *Overweight* duration position on the market, since yields are already very low and the curve is very flat, with the 2/10Y spread around zero. As such, we maintain our *Underweight* duration recommendation, given that Thai bond yields are lower than their Asian peers (for markets which are in the GBI-EM Global Diversified).

THB outlook is still bullish

We maintain our *Overweight* FX rating on the Thai baht (THB), for both the short and medium term, given improved political stability following the election and light foreign positioning in government bonds (relative to other countries in the region) and equities (relative to the pre-election sell-off). Although the BoT claims that it does not use FX to curb inflation, we believe it is tolerant of orderly currency appreciation.

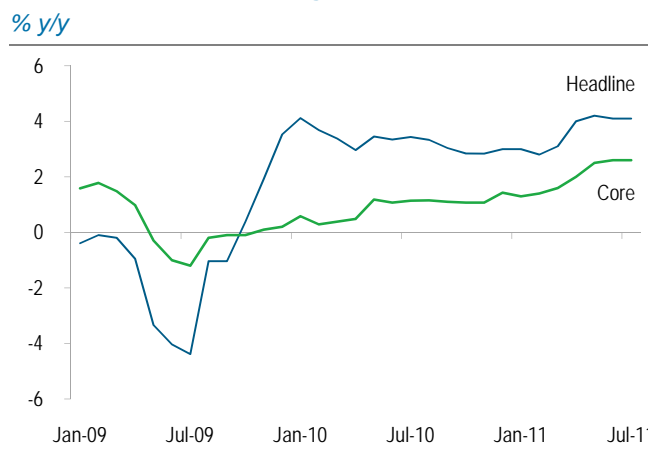
Table 1: Macroeconomic forecasts for Thailand

	2009A	2010A	2011	2012	2013
GDP (%)	-2.3	7.8	3.2	4.8	5.5
Inflation (%)	-0.8	3.3	3.7	3.0	3.9
Exports (%)	-14.0	28.5	15.0	16.8	18.5
Imports (%)	-25.2	36.8	23.1	19.4	20.8
C/A					
(% of GDP)	8.3	4.6	1.5	0.5	-0.8
Govt. budget*					
(% of GDP)	-3.2	-3.5	-3.6	-3.9	-4.0
Policy rate (%)	1.25	2.00	3.50	3.50	4.25
THB (end-pd.)	33.32	30.12	29.00	28.00	27.50

*For fiscal years ending on 30 September;

Sources: BoT, Standard Chartered Research

Chart 3: Inflation is peaking



Sources: MoC, Standard Chartered Research



Vietnam – Staying the course

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Tight monetary policy is impacting growth

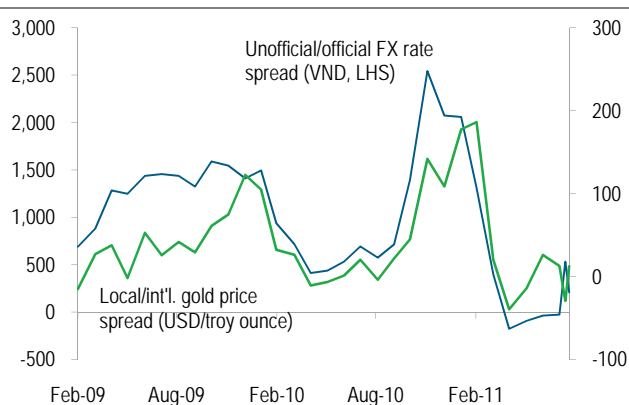
Inflation is on track to peak in August at 23%, in line with our expectations, and is likely to ease towards 20% by the end of the year. This view was echoed recently by Le Xuan Nghia, vice chairman of the National Financial Supervisory Commission. Vietnamese dong (VND) stability in recent months and a stabilisation of fuel and food prices have helped to cap inflation. However, the concern now is the economic impact of high interest rates and the 22% cap on loan growth.

Official economic data still paint a picture of stability. Export growth in June and July stayed above 30%. Industrial production also remained remarkably stable, at around 14%. Freight traffic, both cargo and passenger, shows little sign of moderating. While retail sales have shown a slowdown in volume terms, the nominal growth rate was sustained at an average of 18% in May-July. Nominal sales have been buoyed by rising wages, including a rise in farmers' incomes due to higher commodity prices. This has helped to prevent rising inflation from undermining living standards.

However, feedback on the ground suggests that a surge in commercial lending rates – generally quoted at 20-25% – is causing real pain in the corporate sector, especially among small and medium-sized enterprises. The rigid loan growth quota of 22% is also limiting corporates' access to capital. The economy expanded by 5.6% in H1-2011, and we expect a similar pace of growth in H2. We therefore revise down our 2011 growth forecast to 5.8% from 6.3%. We also lower our 2012 growth forecast to 6.3% from 7% to reflect the more challenging external environment.

Chart 1: High global gold prices unsettle the VND

Demand for USD rises in tandem with gold



Sources: Reuters, SJC, Standard Chartered Research

Newly appointed State Bank of Vietnam (SBV) Governor Nguyen Van Binh was quoted as saying that the central bank will look to reduce commercial lending rates to 17-18%. However, commercial banks may find it difficult to cut lending rates substantially given that the current effective deposit rate is 17-18%, despite the deposit rate cap of 14%.

VND vulnerable to year-end USD demand

Despite the surge in gold prices both domestically and internationally, the USD-VND exchange rate has remained broadly stable. Corporates have been keen to borrow USD to take advantage of lower interest rates (5-7%, versus the VND lending rate of 20-25%), and convert it into VND. This has created supply of USD in recent months, aiding currency stability.

One concern is that if these USD loans are not rolled over at maturity, either at the end of 2011 or in early 2012, the balance of USD supply and VND demand could reverse, reviving downward pressure on the VND. This implies that the SBV cannot aggressively narrow USD-VND interest rate spreads unless there are additional factors supporting the VND, such as a smaller trade deficit, a higher level of reserves, and a significant decline in inflation. Hence, we see the risk of mild VND depreciation in 2012 to further restore imbalances.

Neutral outlook for VGBs

We have lowered our outlook for Vietnamese Government Bonds (VGB) to *Neutral* from *Overweight*. We believe bond yields have found support after falling by around 150bps between May and July 2011, especially without offshore inflows to sustain the rally.

On the demand front, improved VND liquidity conditions and lower short-term lending rates in the interbank market should provide near-term support to bonds. However, we expect VND liquidity to tighten when USD loans mature near the end of 2011. This could put upward pressure on VND interbank lending rates and VGB yields approaching the year-end. Meanwhile, supply pressure is manageable. The State Treasury has successfully raised gross debt financing of VND 48trn (net: VND 28trn) year-to-date, comparable to 2010 full-year issuance of VND 52trn (net: VND 24trn). We estimate the government's gross 2011 issuance target at VND 50-80trn, depending on market conditions.



Forecasts – Economies and FX

Country	Real GDP growth (%)				Inflation (yearly average %)				Current account (% of GDP)				FX					
	2010	2011	2012	2013	2010	2011	2012	2013	2010	2011	2012	2013	Q3-11	Q4-11	Q1-12	Q2-12	Q3-12	Q4-12
Majors																		
US [^]	2.8	1.6	2.0	2.5	1.3	1.5	1.7	1.8	-3.5	-3.6	-3.8	-4.0	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Euro area	1.7	1.8	1.5	2.3	1.6	2.6	1.9	1.9	-0.7	-0.4	-0.2	-0.4	1.45	1.48	1.45	1.42	1.38	1.42
Japan	3.9	-0.4	2.5	2.0	-0.8	-0.2	0.2	0.7	3.2	2.2	2.5	2.3	77.00	76.00	80.00	85.00	88.00	88.00
UK	1.3	1.1	1.9	2.3	3.3	4.3	2.2	1.9	-2.4	-1.8	-1.4	-1.8	1.64	1.67	1.66	1.65	1.64	1.69
Canada	3.1	2.6	2.5	2.3	1.8	2.4	2.5	2.1	-2.4	-2.2	-2.0	-1.8	0.96	0.92	0.93	0.94	0.95	0.96
Switzerland	2.6	1.9	1.8	2.4	0.7	0.6	1.0	1.1	12.5	11.0	10.5	10.8	0.77	0.77	0.81	0.85	0.83	0.81
Australia	2.8	2.7	3.8	3.8	2.8	3.4	3.9	4.1	-3.7	-3.6	-3.2	-2.8	1.08	1.13	1.09	1.06	1.05	1.05
New Zealand	1.5	1.9	2.7	3.0	2.3	4.3	2.4	2.9	-3.5	-4.0	-5.0	-5.0	0.86	0.93	0.94	0.89	0.88	0.86
Asia																		
Bangladesh*	5.5	6.5	6.5	6.5	7.3	9.5	7.5	6.0	3.7	0.8	0.3	0.5	74.50	74.80	74.80	74.50	74.30	72.80
China	10.3	9.3	10.0	9.8	3.3	5.1	4.8	5.4	5.5	3.6	3.4	3.4	6.39	6.31	6.24	6.18	6.12	6.06
Hong Kong	7.0	5.0	4.9	5.5	2.4	5.2	4.0	3.5	6.2	7.0	7.5	8.0	7.785	7.780	7.775	7.770	7.775	7.780
India*	8.5	7.7	8.3	8.5	9.6	8.4	6.0	6.0	-2.6	-2.8	-2.5	-2.3	44.00	43.50	43.00	43.00	42.50	42.00
Indonesia	6.1	6.5	7.0	7.1	5.1	5.9	6.9	5.8	0.8	0.5	0.1	0.1	8,500	8,300	8,200	8,300	8,100	7,900
Malaysia	7.6	4.2	4.4	5.0	1.7	3.3	3.0	2.5	12.0	17.0	15.5	16.5	2.93	2.88	2.83	2.90	2.85	2.75
Pakistan*	4.1	2.4	4.0	4.8	11.7	13.9	14.0	12.0	-2.0	0.3	-0.5	-1.2	86.80	87.50	89.00	89.00	90.00	91.00
Philippines	7.2	4.3	5.5	6.0	3.8	4.7	5.4	5.8	6.5	6.1	5.5	4.2	42.00	41.00	40.00	41.00	40.00	38.50
Singapore	14.5	4.8	4.6	5.0	2.8	4.8	2.9	2.5	22.2	15.0	16.7	15.5	1.19	1.17	1.15	1.18	1.16	1.13
South Korea	6.2	3.5	4.0	4.6	2.9	4.2	3.5	3.0	2.8	2.0	1.5	1.0	1,045	1,020	995	975	975	970
Sri Lanka	8.0	7.8	7.5	8.0	6.2	7.4	7.7	8.0	-1.4	-2.8	-2.5	-2.0	109.0	108.4	107.0	106.8	106.0	106.0
Taiwan	10.5	4.6	5.1	4.6	1.0	1.6	1.5	1.5	9.6	7.5	7.0	6.5	28.60	28.00	27.70	27.50	27.40	27.00
Thailand	7.8	3.2	4.8	5.5	3.3	3.7	3.0	3.9	3.0	1.5	0.5	-0.8	29.50	29.00	28.50	29.00	28.50	28.00
Vietnam	6.8	5.8	6.3	6.5	9.2	18.7	11.3	8.0	-8.5	-10.5	-8.5	-7.5	20,600	20,600	21,400	21,400	22,000	22,000
Africa																		
Angola	2.5	4.0	6.5	6.5	13.3	11.0	10.5	9.0	2.0	1.5	3.0	4.0	93.10	93.00	92.50	92.50	92.00	91.50
Botswana	7.2	4.9	4.8	5.2	6.9	8.2	6.7	6.5	-0.5	-1.5	3.5	3.3	6.73	6.69	6.69	6.77	6.875	6.98
Cameroon	2.6	4.5	5.5	5.5	3.0	3.5	2.5	2.5	1.6	1.3	1.4	1.2	462.00	452.00	452.00	462.00	475.00	462.00
Côte d'Ivoire	2.4	-7.0	5.0	6.0	1.4	2.5	2.5	2.5	6.8	2.5	1.0	-0.5	462.00	452.00	452.00	462.00	475.00	462.00
The Gambia	5.7	5.5	5.5	6.0	5.0	6.0	5.0	5.0	-11.1	-10.8	-10.3	-10.0	28.00	28.50	29.00	29.50	30.00	30.50
Ghana	6.5	12.3	8.0	6.8	10.9	10.2	12.7	11.3	-7.2	-6.8	-5.2	-4.0	1.54	1.53	1.52	1.48	1.47	1.48
Kenya	5.2	5.8	6.3	6.8	3.8	12.8	8.5	4.8	-7.9	-9.3	-7.9	-6.0	95.00	92.00	91.00	88.00	86.00	85.00
Nigeria	6.6	8.5	7.8	7.2	13.8	12.5	8.4	9.2	6.4	14.6	13.3	11.1	154	152	151	150	150	149.5
Sierra Leone	4.5	5.2	6.0	6.0	16.5	9.7	8.7	8.5	-9.3	-9.5	-9.5	-9.3	4,320	4,350	4,370	4,390	4,450	4,440
South Africa	2.8	3.6	3.8	4.2	4.3	5.3	5.8	5.2	-3.2	-4.2	-4.9	-4.8	7.00	6.90	6.90	7.05	7.15	7.40
Tanzania	6.5	6.7	7.5	7.3	6.9	9.3	7.7	5.0	-8.6	-9.5	-10.6	-10.0	1,640	1,670	1,660	1,640	1,680	1,700
Uganda	6.4	6.8	7.5	7.0	5.2	14.1	7.3	4.5	-9.9	-10.6	-9.2	-6.8	2,900	2,800	2,800	2,600	2,500	2,520
Zambia	7.1	6.2	6.4	6.9	8.9	10.5	7.8	7.7	3.8	5.9	3.3	3.4	5,100	4,800	4,700	4,650	4,600	4,400
Middle East and North Africa																		
Algeria	3.3	4.0	4.5	5.0	5.0	5.0	4.0	3.5	1.9	15.0	12.0	10.0	72.75	72.45	72.45	72.75	73.10	72.75
Bahrain	4.1	3.0	4.5	5.0	2.5	1.0	3.5	4.0	5.0	10.0	12.0	13.0	0.38	0.38	0.38	0.38	0.40	0.40
Egypt*	5.1	1.4	2.0	3.5	11.3	12.5	10.2	10.0	-2.0	-1.6	-1.9	-2.1	6.10	6.26	6.30	6.15	6.13	6.11
Jordan	2.3	3.5	4.0	4.4	5.0	4.6	4.2	4.5	-5.0	-5.5	-5.1	-4.6	0.71	0.71	0.71	0.71	0.71	0.71
Kuwait*	3.0	3.5	4.0	4.5	4.0	5.0	4.5	4.0	30.0	27.0	28.0	27.0	0.28	0.29	0.29	0.28	0.28	0.28
Lebanon	7.5	3.0	5.0	1.5	5.0	6.0	5.4	5.5	-16.0	-15.0	-14.5	-14.0	1,500	1,500	1,500	1,500	1,500	1,500
Morocco	3.1	3.5	4.7	5.0	1.0	2.7	2.5	3.0	-8.0	-7.0	-6.0	-5.0	7.88	7.93	7.93	7.88	7.82	7.88
Oman	4.0	4.5	4.7	4.6	3.2	4.0	4.0	4.5	6.5	10.0	9.0	8.0	0.39	0.39	0.39	0.39	0.39	0.39
Qatar	12.5	18.7	6.3	5.2	-5.0	2.0	3.5	3.5	16.0	32.0	30.0	30.0	3.64	3.64	3.64	3.64	3.64	3.64
Saudi Arabia	3.8	6.6	4.0	4.5	5.5	7.0	5.8	5.2	8.5	18.0	12.0	8.0	3.75	3.75	3.75	3.75	3.75	3.75
Tunisia	3.7	-0.5	4.5	4.5	4.8	4.0	4.0	3.5	-2.3	-8.0	-5.0	-1.0	1.36	1.37	1.37	1.36	1.35	1.36
Turkey	8.2	5.8	4.7	6.0	8.6	6.7	6.0	6.0	-6.5	-8.5	-5.9	-5.0	1.80	1.75	1.70	1.72	1.70	1.63
UAE	1.5	4.0	4.5	4.5	0.9	3.0	2.5	2.8	8.0	9.0	9.0	8.0	3.67	3.67	3.67	3.67	3.37	3.67
Latin America																		
Argentina	9.2	7.0	4.0	4.0	10.5	9.2	11.0	12.0	1.0	0.4	-0.5	-0.8	4.20	4.38	4.48	4.60	4.68	4.75
Brazil	7.5	4.1	4.0	4.9	5.0	6.3	5.3	4.5	-2.3	-2.4	-2.6	-2.7	1.55	1.50	1.55	1.60	1.55	1.48
Chile	5.2	6.4	4.8	5.0	1.4	3.6	3.0	3.0	1.9	0.4	0.1	0.0	450	440	450	460	450	445
Colombia	4.3	5.1	5.0	4.5	2.0	3.2	3.3	3.3	-3.3	-3.4	-2.8	-2.7	1,800	1,730	1,750	1,790	1,730	1,700
Mexico	5.4	4.0	3.8	4.0	4.2	3.7	3.8	3.8	-0.5	-1.0	-1.5	-1.5	11.80	11.40	11.25	11.50	11.20	10.90
Peru	8.8	6.5	4.5	5.0	2.1	3.2	2.5	2.5	-1.5	-0.6	-0.3	-1.0	2.73	2.70	2.70	2.75	2.70	2.67

* Fiscal year starts in April in India and Kuwait, July in Bangladesh, Pakistan, and Egypt

[^] Inflation: Core PCE deflator used for US

Source: Standard Chartered Research



Forecasts – Rates

		Current	Q3-11	Q4-11	Q1-12	Q2-12	Q3-12	Q4-12
		%	%	%	%	%	%	%
United States	Policy rate	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
	3M LIBOR	0.29	0.25	0.25	0.25	0.25	0.25	0.25
	10Y bond yield	2.17	2.50	2.60	2.50	2.60	2.70	2.80
Euro area	Policy rate	1.50	1.50	1.50	1.50	1.50	1.75	2.00
	3M LIBOR	1.48	1.50	1.50	1.50	1.75	2.00	2.25
	10Y bond yield	2.16	2.25	2.50	2.60	2.70	2.75	2.85
United Kingdom	Policy rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50
	3M LIBOR	0.85	0.83	0.85	0.85	0.90	0.95	1.00
	10Y bond yield	2.51	2.55	2.65	2.75	2.80	2.90	3.00
Australia	Policy rate	4.75	4.75	4.75	5.00	5.25	5.25	5.25
	3M money	4.91	5.00	5.15	5.25	5.45	5.55	5.60
	10Y bond yield	4.37	5.65	5.85	6.05	6.10	6.25	6.30
China	Policy rate	6.56	6.56	6.56	6.56	6.56	6.81	7.06
	7D repo rate	4.20	3.00	2.50	2.50	2.50	3.00	3.50
	10Y bond yield	4.09	3.80	3.60	3.80	4.00	3.90	3.70
Hong Kong	3M HIBOR	0.26	0.25	0.25	0.25	0.25	0.25	0.25
	10Y bond yield	1.79	2.15	2.25	2.15	2.25	2.40	2.50
India	Policy rate	8.00	8.25	8.50	8.50	8.50	8.25	8.00
	Money market rate	8.32	8.50	8.25	8.00	8.00	8.25	8.00
	10Y bond yield	8.32	8.50	8.25	8.25	8.25	8.00	7.75
Indonesia	Policy rate	6.75	6.75	6.75	7.25	7.25	7.25	7.25
	JIBOR 3M	6.70	7.00	7.00	7.70	7.60	7.50	7.50
	10Y bond yield	6.84	7.00	7.00	7.25	7.25	7.00	6.75
Malaysia	Policy rate	3.00	3.00	3.00	3.00	3.00	3.25	3.25
	3M KLIBOR	3.29	3.25	3.25	3.25	3.30	3.35	3.45
	10Y bond yield	3.64	3.80	3.90	3.90	4.10	4.10	4.10
Philippines	Policy rate	4.50	4.50	4.50	4.75	5.00	5.00	5.00
	3M PDST-F	2.56	3.30	3.80	4.20	4.50	4.80	5.20
	10Y bond yield	5.92	6.70	7.00	7.00	7.25	7.35	7.45
Singapore	3M SGD SIBOR	0.44	0.35	0.35	0.35	0.35	0.35	0.35
	10Y bond yield	1.64	1.85	1.85	1.75	1.80	1.90	2.00
South Korea	Policy rate	3.25	3.25	3.25	3.50	3.75	4.00	4.00
	Money market rate	3.59	3.60	3.60	3.80	4.05	4.30	4.30
	10Y bond yield	3.86	4.50	4.50	4.60	4.80	4.80	4.80
Taiwan	Policy rate	1.88	1.88	1.88	1.88	1.88	2.00	2.13
	3M TAIBOR	0.89	0.90	0.90	0.90	0.90	1.00	1.15
	10Y bond yield	1.43	1.70	2.00	2.10	2.30	2.40	2.30
Thailand	Policy rate	3.50	3.50	3.50	3.50	3.50	3.50	3.50
	BIBOR 3M	3.56	3.60	3.65	3.65	3.70	3.75	3.80
	10Y bond yield	3.49	4.00	4.10	4.20	4.30	4.30	4.30
Vietnam	Policy rate (Refi rate)	14.00	14.00	14.00	14.00	13.00	11.00	10.00
	Overnight VNIBOR	12.43	13.00	13.00	13.00	12.00	10.00	10.00
	2Y bond yield	12.17	12.00	12.00	12.00	11.00	11.00	11.00
Ghana	Policy rate	12.50	12.50	12.50	13.50	14.00	14.00	14.50
	91-day T-bill rate	9.33	10.80	11.00	11.70	12.30	12.70	12.90
	3Y bond yield	12.85	12.80	13.20	13.40	13.50	13.20	12.80
Kenya	Policy rate	6.25	6.50	7.00	7.00	7.25	7.50	7.50
	91-day T-bill rate	9.15	9.20	9.40	10.30	10.20	9.60	8.70
	10Y bond yield	15.00	15.00	15.50	15.00	14.50	14.00	14.20
Nigeria	Policy rate	8.75	8.75	9.00	9.25	9.50	9.50	10.00
	91-day T-bill rate	7.43	10.00	10.20	10.40	10.60	11.00	10.90
	10Y bond yield	11.51	11.50	11.00	10.70	10.30	10.10	9.80
South Africa	Policy rate	5.50	5.50	6.00	6.50	7.00	7.00	7.50
	91-day T-bill rate	5.61	5.72	6.12	6.66	7.05	7.24	7.54
	10Y bond yield	7.78	8.40	8.20	8.00	7.70	7.80	8.00

Source: Standard Chartered Research



Forecasts – Commodities

Forecasts in **BLUE** (RED) indicate **upward** (downward) revision

	Market close	m/m	Change YTD	y/y	Q2 -11	Q3 -11	vs Fwd	Q4 -11	vs Fwd	Q1 -12	vs Fwd	Q2 -12	vs Fwd	Q3 -12	vs Fwd	Q4 -12	vs Fwd	2010	2011	vs Fwd	2012	vs Fwd
	24-Aug-11	%	%	%	A	F	%	F	%	F	%	F	%	F	%	F	%	A	F	%	F	%
Energy																						
Crude oil (near future, USD/b)																						
NYMEX WTI	85	-13.6	-6.2	+18.1	102	90	0.8%	95	10.3%	97	11.0%	102	15.0%	116	29.4%	117	29.5%	80	97	13.4%	108	21.3%
ICE Brent	110	-5.9	+17.1	+51.0	117	112	0.1%	110	0.6%	112	2.9%	114	5.0%	126	16.5%	127	18.1%	80	112	2.2%	120	10.6%
Dubai spot ₁	106	-4.9	+19.9	+50.8	111	107	-	105	-	107	-	109	-	121	-	122	-	78	107	-	115	-
Refined oil products cracks and spreads																						
Singapore naphtha (USD/b) ₁	-1	-46.7	-116.3	-65.1	-2.2	3	-	2	-	1	-	1	-	1	-	1	-	1.2	1	-	1	-
Singapore jet kerosene (USD/b) ₁	19	-2.1	+23.3	-80.8	20.4	21	-	22	-	21	-	23	-	25	-	28	-	12.1	20.9	-	26	-
Singapore gasoil (USD/b) ₁	17	-8.0	+10.9	+76.8	19.4	21	-	22	-	20	-	22	-	23	-	24	-	11.4	20	-	23	-
Singapore regrade (USD/b) ₁	2	+80.2	+537.8	-165.5	0.9	1	-	1	-	2	-	3	-	3	-	3	-	0.6	1	-	3	-
Singapore fuel oil 180 (USD/b) ₁	-4	-37.9	-57.8	+655.4	-8.7	-5.0	-	-4.5	-	-6.0	-	-5.0	-	-5	-	-5	-	-5.7	-7	-	-5	-
Coal (USD/t)																						
API4	119	+0.4	-9.0	+34.8	121	115	-2.4%	123	2.3%	125	2.4%	128	4.5%	128	3.9%	128	3.2%	92	120	0.3%	127	3.5%
API2	123	-0.1	-5.6	+35.3	125	120	-3.6%	125	-0.5%	127	0.0%	128	0.5%	128	0.1%	128	-0.4%	92	123	-2.0%	128	0.0%
globalCOAL NEWC ₁	121	+1.3	-5.9	+23.0	121	122	-	131	-	134	-	137	-	137	-	137	-	99	125	-	136	-
Metals																						
Base metals (LME 3m, USD/t)																						
Aluminium	2,364	-8.7	-4.3	+16.6	2,627	2,600	7.6%	2,550	7.8%	2,500	4.4%	2,367	-2.0%	2,367	-2.8%	2,367	-3.6%	2,202	2,577	9.3%	2,400	-1.0%
Copper	8,875	-8.3	-7.6	+24.4	9,185	9,500	3.8%	10,000	12.7%	10,500	18.1%	9,833	10.6%	9,833	10.6%	9,833	10.7%	7,570	9,578	7.9%	10,000	12.5%
Lead	2,348	-12.7	-7.9	+16.7	2,532	2,600	5.4%	2,700	15.0%	2,700	14.4%	2,633	11.1%	2,633	10.6%	2,633	10.1%	2,173	2,602	10.6%	2,650	11.5%
Nickel	20,825	-13.1	-15.9	+1.1	24,339	26,000	17.6%	24,000	15.2%	24,000	15.1%	22,667	8.6%	22,667	8.7%	22,667	8.8%	21,910	25,308	21.6%	23,000	10.3%
Tin	23,250	-17.8	-13.6	+14.0	28,849	30,000	20.9%	32,000	37.6%	34,000	45.9%	28,667	22.8%	28,667	22.5%	28,667	22.4%	20,448	30,179	29.9%	30,000	28.4%
Zinc	2,178	-12.7	-11.3	+9.4	2,273	2,400	6.7%	2,450	12.4%	2,450	11.2%	2,383	7.3%	2,383	6.4%	2,383	5.6%	2,188	2,384	9.7%	2,400	7.6%
Iron ore (USD/t)																						
Iron ore ₂	172	-2.3	-	+21.1	176	170	-	182	-	187	-	182	-	171	-	184	-	147	177	-	181	-
Steel** (CRU assessment, USD/t)																						
HRC, US ₁	834	-6.4	-	+13.5	896	837	-	860	-	870	-	880	-	870	-	880	-	665	868	-	875	-
HRC, Europe ₁	820	-0.5	-	+15.5	844	810	-	820	-	830	-	840	-	840	-	840	-	685	823	-	838	-
HRC, Japan ₁	935	+0.9	-	+14.4	924	945	-	960	-	960	-	960	-	960	-	960	-	788	922	-	960	-
HRC, China ₁	760	-1.1	-	+20.8	757	745	-	760	-	780	-	780	-	780	-	780	-	633	748	-	780	-
Precious metals (spot, USD/oz)																						
Gold (spot)	1,759	+7.9	+22.6	+40.5	1,509	1,725	1.6%	1,800	2.5%	1,700	-3.4%	1,675	-4.9%	1,725	-2.3%	1,750	-1.0%	1,227	1,605	-8.5%	1,713	-2.9%
Palladium (spot)	748	-7.3	-6.6	+51.3	760	800	4.7%	840	12.7%	860	15.2%	913	22.3%	913	22.3%	913	-	529	798	7.2%	900	20.6%
Platinum (spot)	1,812	+1.1	+2.2	+18.3	1,785	1,850	2.7%	1,950	6.7%	2,000	9.2%	2,050	11.7%	2,050	11.5%	2,100	14.2%	1,613	1,845	0.9%	2,050	11.7%
Silver (spot)	40	-1.2	+29.0	+110.9	38.5	38	-2.9%	42	7.1%	40	2.0%	40	2.0%	40	2.1%	40	2.3%	20.2	38	-4.0%	40	2.1%
Agricultural products																						
Softs (near future)																						
NYBOT cocoa, USD/t	3,080	+0.5	+1.5	+10.9	3,043	3,300	8.0%	3,500	13.1%	3,600	15.4%	3,467	10.8%	3,467	10.2%	3,467	9.8%	2,945	3,286	6.4%	3,500	11.5%
LIFFE coffee, USD/t***	2,365	+0.5	+13.6	+47.8	2,461	2,250	-1.1%	2,000	-15.9%	1,950	-18.6%	2,250	-7.3%	1,767	-27.2%	1,767	-26.6%	1,553	2,246	-5.4%	1,934	-19.9%
NYBOT coffee, US¢/lb	273	+12.8	+13.3	+63.3	271	275	5.9%	250	-8.8%	220	-20.4%	207	-25.0%	207	-24.3%	207	-23.4%	164	263	-3.8%	210	-23.3%
NYBOT sugar, US¢/lb	30	-3.7	-6.0	+49.7	24.5	24	-18.7%	26	-10.9%	26	-9.0%	28	5.8%	28	11.6%	28	13.5%	22.3	26	-11.6%	28	5.0%
Fibres																						
NYBOT cotton No.2, US¢/lb	105	+5.5	-27.8	+18.3	168	110	2.7%	115	10.4%	115	13.2%	122	22.0%	122	23.5%	122	25.5%	94	143	37.2%	120	21.0%
Grains & oilseeds (nr future)																						
CBOT corn (maize), US¢/bushel	732	+7.1	+15.6	+79.6	732	700	-1.5%	750	0.7%	775	2.7%	735	-3.0%	700	-0.4%	725	10.5%	428	713	-3.6%	734	2.3%
CBOT Soybeans, US¢/bushel	1,387	+1.3	-0.8	+38.3	1,361	1,350	-1.5%	1,380	-1.3%	1,375	-2.1%	1,308	-6.8%	1,308	-4.7%	1,308	-2.1%	1,049	1,368	-2.0%	1,325	-4.0%
CBOT wheat, US¢/bushel	749	+7.5	-6.8	+14.2	747.3	715	-0.3%	700	-1.5%	715	-11.5%	642	-21.6%	630	-24.5%	642	-24.9%	581.5	737	-4.2%	657	-20.7%
CBOT rice, USD/cwt	17	-2.4	+19.7	+48.8	14.2	15	-9.7%	14	-19.3%	13	-26.8%	12	-34.0%	11	-37.6%	12	-	12.5	14	-16.1%	12	-32.8%
Thai B rice 100%, USD/tonne ₁	617	+8.8	+12.6	+26.2	509	520	-	515	-	500	-	485	-	475	-	480	-	518	520	-	485	-
Edible oils (3m future)																						
Palm oil (MDV, MYR/t)	3,130	+1.1	-17.9	+18.6	3,289	3,400	9.4%	3,400	12.1%	3,500	16.0%	3,600	19.3%	3,833	27.2%	3,833	27.1%	2,721	3,431	12.1%	3,692	22.4%
Soyoil (CBOT, US¢/lb)	56	-0.7	-3.5	+42.3	58	57	2.2%	58	3.0%	60	5.7%	61	7.1%	61	7.1%	61	7.5%	43	58	2.8%	61	6.9%

*weekly quote **monthly average ***10 tonne contract ₁no forward price comparison available ₂cost and freight at China's Tianjin port, 62% iron content, Indian origin.

Sources: Bloomberg, Standard Chartered Research



Forecasts and references

Quarterly forecasts

	Real GDP growth (y/y)								Consumer price inflation (y/y)							
	Q1-11A	Q2-11A	Q3-11F	Q4-11F	Q1-12F	Q2-12F	Q3-12F	Q4-12F	Q1-11A	Q2-11A	Q3-11F	Q4-11F	Q1-12F	Q2-12F	Q3-12F	Q4-12F
US^	0.4	1.3	1.8	2.4	1.6	2.3	2.1	2.4	1.0	1.3	1.7	2.0	2.0	1.8	1.5	1.5
Euro area	2.0	1.6	1.7	1.6	1.1	1.3	1.5	1.9	2.5	2.8	2.6	2.4	2.2	1.7	1.8	1.6
Japan	-1.0	-1.0	-0.9	1.0	2.5	3.3	2.8	2.5	0.0	0.2	-0.2	0.0	0.0	0.0	0.0	0.1
UK	1.6	0.7	0.5	1.4	1.4	1.8	2.1	2.2	4.1	4.4	4.6	4.5	2.6	2.2	1.8	1.7
Bangladesh	6.6	6.3	6.4	6.6	6.5	6.4	6.5	6.5	9.8	10.3	9.2	8.5	7.5	7.2	7.5	7.7
China	9.7	9.5	9.3	9.0	8.6	9.4	10.5	10.9	5.1	5.7	5.5	4.2	3.9	4.3	5.5	6.3
Hong Kong	7.5	5.1	3.8	3.6	4.0	5.0	4.8	5.6	3.8	5.1	6.4	5.9	5.2	4.2	3.5	3.5
India	7.8	7.7	7.6	7.4	7.9	8.1	8.2	8.4	9.6	9.6	9.2	8.3	6.7	6.4	6.3	6.6
Indonesia	6.5	6.5	6.7	6.4	6.9	7.2	7.1	6.9	6.7	5.5	5.2	6.0	5.9	7.7	7.6	6.5
Malaysia	4.9	4.0	3.6	4.4	3.7	3.8	5.7	4.6	2.8	3.3	3.4	3.7	3.2	3.1	3.1	2.8
Philippines	4.6	3.4	3.8	4.2	5.0	5.3	5.7	6.0	4.3	4.6	4.6	4.7	4.8	5.0	5.2	5.4
Singapore	9.3	0.9	4.5	4.8	1.4	4.1	5.6	7.5	5.2	4.7	5.1	4.2	2.9	3.1	2.4	3.3
South Korea	4.2	3.4	3.2	3.6	3.4	3.8	4.4	4.6	4.5	4.2	4.6	3.7	3.2	3.6	3.4	3.7
Sri Lanka	7.9	7.5	7.7	8.0	7.6	7.2	7.4	7.8	7.0	8.1	7.4	7.3	7.4	7.5	7.8	8.1
Taiwan	6.2	5.0	3.4	4.8	5.0	4.5	4.8	6.0	1.3	1.7	1.8	1.5	1.1	1.3	2.0	1.8
Thailand	3.2	2.6	3.2	4.0	4.1	5.0	4.9	5.1	3.0	4.1	3.9	3.6	2.8	2.7	2.9	3.4
Vietnam	5.4	5.8	5.8	6.3	6.1	6.2	6.3	6.4	12.8	19.4	22.7	21.2	17.0	10.9	8.9	7.9

^q/q SAAR

Source: Standard Chartered Research



Forecasts and references

Economy

	Size (USD bn)	Population (mn)	Private consumption (% of GDP)	Government spending (% of GDP)	Investment (% of GDP)	Exports of goods (% of GDP)	Imports of goods (% of GDP)	FX reserves (USD bn, latest)
Bangladesh	104.2	164.5	75.6	5.4	25.0	18.5	24.9	10.4
China	5,878.0	1,339.7	33.8	13.6	48.6	4.0*		2,847.0
Hong Kong	225.0	7.1	62.2	8.4	23.7	175.5	194.7	277.2
India	1,538.0	1,215.9	58.3	11.2	34.1	21.9	27.5	285.3
Indonesia	707.5	237.6	56.7	9.1	32.5	24.6	23.0	122.7
Malaysia	238.0	28.3	48.0	12.7	21.4	97.3	79.5	129.8
Philippines	188.7	94.0	71.6	9.7	20.5	34.8	36.6	71.0
Singapore	222.7	5.2	37.9	10.7	23.8	211.1	183.0	249.2
South Korea	1,007.1	48.9	52.5	15.4	29.2	52.4	49.6	311.0
Sri Lanka	49.7	20.4	65.8	22.9	27.8	16.8	24.3	8.1
Taiwan	430.6	23.3	58.0	12.2	22.6	73.7	66.5	400.8
Thailand	318.9	67.4	51.7	10.0	20.9	69.5	52.9	187.3
Vietnam	103.5	88.3	66.5	6.5	38.9	77.5	87.8	13.5

*Net exports

Sources: IMF, ADB, Standard Chartered Research

Policy

	Politics and fiscal policy			Monetary policy		
	Date of next election	Type of election	Date of next budget announcement	Policy objectives	Explicit inflation target	Key monetary policy tools
Bangladesh	2013	Parliamentary	Jun-12	Ensuring growth and price stability	NA	Repo and reverse repo rates
China	Late 2012	Party Congress	N/A	Stable economic growth and price levels	NA	1Y benchmark deposit and lending rates
Hong Kong	25-Mar-2012 and Sep-2012	Chief Executive and Legislative Council	Feb-12	Exchange rate stability	NA	Linked Exchange Rate System
India	01-May-2014	Parliamentary	Mar-12	Price stability	NA	Repo rate
Indonesia	2014	Parliamentary and presidential	Oct-11	Price stability	4-6%	BI rate
Malaysia	01-Mar-2013	Parliamentary	07-Oct-11	Sustainable growth and monetary stability	N/A	Overnight policy rate
Philippines	13-May-2013	Local/senatorial	26-Jul-11	Low and stable inflation and sustainable economic growth	4-5%	Overnight repo and reverse repo rates
Singapore	01-May-2016	Parliamentary	Feb-12	Non-inflationary economic growth	N/A	SGD NEER policy band
South Korea	11-Apr and 19-Dec-2012	Parliamentary and presidential	Sep-11	Price stability	2-4%	Base rate
Sri Lanka	2016	Parliamentary and presidential	Nov-11	Price stability	4-6%	Repo rate, Statutory required reserve
Taiwan	14-Jan-2012	Legislative and presidential	Q3-2011	Ensuring growth and price stability	N/A	Re-discount rate, OMO
Thailand	01-Jul-2016	Parliamentary	Oct-11	Price stability	0.5-3.0% (core)	1-day repo
Vietnam	2016	National Party Congress	Q4-2011	Price stability	N/A	Refinance rate

Source: Standard Chartered Research



Disclosures Appendix

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Data available as of

11:30 GMT 01 September 2011

Document is released at

11:45 GMT 01 September 2011

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