Asia Pacific Economic Outlook

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China

By Dr. Ira Kalish

HOW fast can China grow? That is the question underlying much of the discussion about China's economy these days. Clearly, double-digit growth is not in the cards and may even be a thing of the past. Growth of 7.7 percent in the first quarter was considered disappointing, and, until recently, many analysts were expecting growth to revert to the range of 8–9 percent. Yet now the government appears determined to reset expectations. The government has forecast that growth this year will be 7.5 percent, a good deal lower than many private analysts had forecast only recently. That is certainly slower than the 7.8 percent growth in 2012, which was the slowest rate of growth in 13 years.

Premier Li Keqiang, in a recent speech in Germany, said that growth for the remainder of the decade will average an even lower 7.0 percent per year. Although far slower than the growth experienced during the past two decades, Li indicated that China is "entering a range of reasonable growth." Given that China has become a more mature economy with a declining labor force, Li is probably correct in setting more modest expectations. Moreover, growth of 7.0 percent is not bad: It doubles the GDP in 10 years. Li said that a combination of industrialization, urbanization, improvements in agricultural productivity, and investments in technology can contribute to healthy growth, and that this requires more market-oriented reforms. He also said that "for a very big economy, this is not easy."

When and how such reforms will be implemented remains uncertain. While some reforms have been announced, many government statements have been relatively vague. With a new regime just installed, it could take some time to build the support necessary to implement much-needed reforms. In the interim, China faces some risks, including the ramifications of large

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local government debt, considerable leverage in the shadow banking system, and weaker-than-expected manufacturing activity. Manufacturing weakness stems from weakness in export markets. In addition, rising wages in China are having an adverse impact on export competitiveness, thereby leading to an exodus of manufacturing capacity. Thus, even growth in the range of 7–8 percent cannot be guaranteed.

Financial market reforms

One area of reform in which the government has begun to take action involves the financial system. Indeed, China appears to be on the verge of implementing significant reforms. A report from the central bank says that there is consensus that now is the time to introduce deposit insurance to the banking system. Analysts say that this bodes well for introducing liberalization of interest rates. Free movement of interest rates would eliminate the automatic nature of bank profitability that now exists under interest rate controls, which puts bank capital, and consequently deposits, at risk—hence the need for deposit insurance.

Freer interest-rate movement will be critical to eliminating some of the imbalances in the Chinese economy. Government-controlled interest rates mean that funds are not necessarily channeled to the most profitable uses. As such, currently there is often excessive and ineffective investment, not to mention incentives for excessive risk taking that puts the entire system at risk. Low interest rates have probably contributed to the property price bubble in China as well. Freer interest rates also would help reduce the demand for shadow banking services, which also create risks to the economy. Indeed, the central bank report called for greater supervision of such activities. Why is this so important?

China's shadow banking system could pose a systemic risk to China's financial system. In China, formal banks face interest rate regulations, both on deposits and loans. This restricts the supply of credit and channels most such credit to state-run companies. However, tens of thousands of non-bank entities have been established in order to operate outside interest rate controls. Some such entities, part of the shadow banking system, are operated off-balance-sheet by banks. They are funded not by deposits but by the wholesale market. They offer high-interest loans to businesses, households, and local governments. Their massive activity is unregulated, unsupervised, and not transparent. Part of the problem is that, although the formal banking system has a non-performing loan (NPL) ratio of only 1 percent, this number lacks meaning when an estimated 36 percent of credit is extended by non-banks—and their NPL ratio is unknown. The risk is that formal banks, which have provided wholesale funding for the shadow banking system, could face big losses. Already there have been some defaults. Ultimately, it would be more effective for interest rate controls to be abandoned. This would eliminate the need for shadow banks and lead to a more efficient system of financial intermediation.

Based on what many government officials have said, there is much to do on the financial front. Implementation of deposit insurance would certainly be an important first step.

Further global integration

Another area of change involves China's economic relationship with the rest of the world. China's government now says it will study the possibility of joining the Trans-Pacific Pact (TPP), an effort to create a free-trade area in the Pacific Basin. Currently there are 12 countries involved in this effort: the United States, Japan, Canada, Mexico, Peru, Chile, Vietnam, Malaysia, Singapore, Brunei, Australia, and New Zealand. If China joins the group, the TPP will collectively account for more than half of global GDP. Freer trade would entail not simply lowering tariffs and quotas, although this would be an important component. It would also involve freeing up domestic markets so that they would have to compete freely with foreign companies. From China's perspective, this could be a positive development in that it would create pressure to privatize state-run companies, create a level playing field for the private sector, and allow free movement of prices of goods and credit. Still, agreement on the TPP is probably a long way off.

Japan

By Dr. Rumki Majumdar

It is "real" this time

There has been more good news for Japan's economy since our last outlook for the country in April: The "real" economy is responding to the prime minister's "Abenomics." Real economic activities have shown strong signs of growth in Q1 2013 relative to the previous quarter, while the overall economic sentiments continued to improve in April. Real GDP grew quarter over quarter by 0.9 percent, with strong private consumer spending and export gains respectively contributing 0.6 percent and 0.5 percent to the growth. The gains outweighed the weakest business investment in the wake of the March 2011 earthquake and tsunami. However, year-over-year consumer-price inflation (excluding energy) tumbled by 1 percent last quarter, the highest fall since Q3 2010, which is a setback for policy makers as they seek to end more than a decade of deflation. The financial sector, which witnessed substantial improvement in the last couple of months, probably has been seeing some short-term corrections lately.

Growth in real private consumption expenditure

Real private consumption expenditure, which accounts for 60 percent of GDP, grew at the same rate as real GDP. Two factors that have largely contributed to the strong growth in private consumption are steadily recovering consumer confidence and an improving consumer balance sheet.

According to the government survey in April, the consumer confidence index remained close to its highest level since 2008, as the outlook for livelihood, income growth, employment, and willingness to purchase improved among consumers. The other factor that contributed to the increase

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in consumption expenditure is the significant improvement in the household balance sheet. The household sector's net wealth improved substantially and consistently in the last year. The steep rise in the equity index led to a strong wealth effect—a term that describes consumers' tendency to spend more when their wealth increases. The Senior Loan Officer Opinion survey in April too shows a strong increase in demand for loans from the household sector, with housing and consumer loans rising sharply in Q1 2013.

The real gains in exports

Prime Minister Shinzo Abe's fiscal stimulus, combined with the Bank of Japan's massive bond-buying program that aims to double the monetary base in the next two years, has led to a 15 percent depreciation of the Japanese yen in May since the end of last year. The yen weakened against the US dollar, reaching 100 JPY/USD during May for the first time since 2009. This depreciation has helped improve Japan's export competitiveness and thus its exports, which grew by 3.8 percent quarter on quarter after declining for three consecutive quarters prior to Q1 2013. Exporters will likely continue to benefit as the currency is expected to weaken further this quarter. Early indications for Q2 are promising, with exports rising by 5 percent in the first 20 days of April compared to a year earlier.

Weak currency can be an important instrument for achieving the dual objective of high growth and inflation. While depreciated currency will likely help the export-oriented sectors—the signs of which are already visible—the impact on inflation via exchange rate pass-through can be substantial.

Prices yet to respond

Concerns about deflation persist as consumer-price inflation fell sharply in Q1 2013. However, the new monetary policy framework announced by the government in January, followed by quantitative easing by the central bank of Japan, has increased short-term inflation expectation in the economy. In a survey by the Bank of Japan conducted in April, the number of respondents that expect prices to rise by more than 2 percent increased by 15 percentage points, to around 60 percent, since Abe became leader in early December. Since the impact of monetary policy on prices comes with a lag, prices will likely trend up by the end of 2013.

High volatility in financial markets

The equity market went up by more than 40 percent since the end of 2012, before plunging a few points in the last week of May. The continuous rise in the equity market was fuelled by the continued currency depreciation and recent aggressive monetary easing by the Bank of Japan. Interest spreads and 10-year government yields are the lowest since 2008, signifying investors' rising confidence in Japanese leaders and the economy. Firms' funding costs have been hovering at low levels as financial institutions' lending attitudes maintain an improving trend.

The recent fall in the Nikkei index and the rise in bond yields and bond-market volatility have unnerved investors and banks, which are heavily exposed to the rise in yields of Japanese government bonds. Japan's burden of government debt, which is now at close to 250 percent of GDP, is a serious concern. Any rise in yields can quickly push the cost of servicing government debt to unsustainable levels. However, these recent events could be a short-term correction in Japan's financial market, and is most likely an impact of the Chinese slowdown and a signal from the US Federal Reserve of a possible exit in the near future. Japan's financial system is strong, as the Bank of Japan's April Financial Systems Report does not indicate any financial imbalances stemming from bullish expectations.

Corporate sector still cautious

The level of business investment in January–March was the lowest since Q2 2011. Private nonresidential investment continued to be a drag on growth for the fifth continuous quarter, while businesses reduced inventories last quarter, together shaving 0.3 percent from growth. The Bank of Japan's Tankan business-conditions survey forecasts that businesses will remain cautious, since perceived unfavorable business conditions may continue to outweigh favorable conditions.

Risks that can change the optimism

The rise in real growth in Q1 2013 is a positive sign for Japan's economy and for its policy makers, who are putting in a lot of effort to push the economy out of the 15-year deflation and low growth. But ensuring sustained long-term growth is going to be a challenge because of substantial domestic and external risks. High public debt and the fiscal imbalance continue to worry investors and weigh on business sentiments. In addition, uncertainties regarding global growth, changes in US monetary policies, and commodity prices can throw sudden surprises in the financial market and threaten desired policy outcomes.

South Korea

By Akrur Barua

SOUTH Korea's economy appears to be on its way up, as economic indicators and policy action point to improving growth prospects. Quarterly GDP growth hit a two-year high in the first quarter of 2013, aided by strong showing in construction, investment, and exports. Encouragingly, the pace of expansion is expected to pick up as fiscal stimulus measures and monetary policy easing start to have an impact. Among the key components, consumption spending is likely to benefit from low unemployment and a boost to real wages from low inflation. Despite a better showing in Q1 2013, investment remains relatively weak. However, it is expected to edge up as domestic consumer sentiment improves and the global trade cycle moves up. On the exports front, recovery in the near term is likely to be muted given continued Eurozone weakness and declining growth rates in China.

Improving prospects for industry and consumer spending

Economic activity has got a boost from a gradual strengthening of industrial output and consumer sentiment. Industrial production growth turned positive (1.7 percent year over year) in April after two previous contractions. On similar lines, purchasing managers' index figures for the month show manufacturing activity expanding at the fastest pace in more than two years. Growth was driven by new orders, both domestic and foreign, although the former's pace of expansion was higher. This augurs well for domestic consumption growth in the second quarter, given its subdued performance in Q1 2013. This view is supported by growing consumer sentiment: The Bank of Korea's (BOK's) composite consumer-sentiment index went up to 104 in May from

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102 in April, and matches the one-year high in March. Along with improving perceptions of economic activity, consumption growth is also likely to benefit from low inflation (which aids real wage growth) and low unemployment. Most importantly, both consumption and investment are likely to benefit from a recently approved fiscal stimulus plan as well as monetary policy easing.

The twin policy push: Fiscal and monetary policy gear up to support the economy

In May, the South Korean parliament ratified a $4.8 billion stimulus plan to aid small and medium enterprises, prop up worker incomes, and boost corporate investments and the real estate sector through tax incentives. The government expects these measures to push up GDP growth by 0.3 percentage points and create 40,000 jobs. The stimulus package is part of a $15.4 billion supplementary budget by the new government, to be funded entirely through new borrowing. As a result, the fiscal deficit is projected to rise to about 1.8 percent of GDP in 2013 from a previous target of 0.3 percent. However, the deficit is manageable, and sovereign risk perceptions are not likely to rise given the low level of public debt (36 percent of GDP), current account surplus (3.8 percent of GDP), and high total reserves ($323 billion excluding gold).

The fiscal push this quarter has been complemented by monetary policy easing. With inflation at a 14-year low (1.0 percent year over year) in May and well below its target rate of 2.5–3.5 percent, the BOK eased its policy rate by 25 basis points in May to boost growth and prevent the South Korean won's sharp rise against the Japanese yen. In the six months prior to the rate cut, the yen had fallen more than 20 percent against the won, denting South Korea's export competitiveness vis-à-vis Japan. The BOK's move is likely to help break this trend.

No sharp uptick in export growth in the near term, though prospects seem better for 2014–2015

Demand for South Korean exports remains subdued, given economic weakness in key export destinations. Deteriorating price competitiveness in relation to Japanese firms (due to strong yen depreciation) has not helped either, although the recent BOK rate cut is likely to help partially bridge the gap. In such a scenario, a sharp recovery in exports is not expected. However, the country is likely to benefit from a gradual improvement in the global trade cycle in 2014–2015 due to recovering global growth. Also providing encouragement is the fact that the US economy has proved resilient against sharp fiscal cuts. Signs of improving export fortunes for South Korea are already visible, with exports rising 3.2 percent year over year in May on the back of surging shipments of mobile and telecommunication goods. Most importantly, demand seems to have risen sharply in two key markets: the United States (21.6 percent year over year) and China (16.6 percent year over year).

The country faces both economic and political risks

The economy, however, continues to face near- and medium-term risks. On the external front, any growth destabilization in the United States and China will hit exports. Things could get worse if the BOK's recent rate cut fails to dent appreciation of the won. On the domestic front, high household debt poses a risk to consumer spending in the medium term. Household debt as a share of disposable income currently stands at about 150 percent, and any potential bout of deleveraging would dent consumer spending and thereby GDP growth. Other irritants likely to weigh on growth include the lack of reforms to boost the country's services sector, the high concentration of economic power in a few large corporates (chaebol), and reconciling social-sector spending objectives with greater fiscal prudence. In addition to economic factors, the risk from a conflict with North Korea seems elevated. However, any full-scale conflict with the North is not likely (despite rising rhetoric from that country), although small skirmishes cannot be ruled out.

Despite risks, growth is likely to pick up in 2013

These risks notwithstanding, economic growth is likely to increase in 2013 and then accelerate in 2014–2015. GDP growth is expected to be in the range of 2.5–3.0 percent this year (up from 2.0 percent in 2012), aided by a policy push and consumer spending recovery in the latter half. The pace is then expected to accelerate to 3.5–4.0 percent in 2014–2015, as export growth picks up due to faster global economic growth. Export recovery and improved consumer sentiment will also push up domestic investment. However, growth is not likely to move above the levels witnessed prior to the global economic crisis.

Taiwan

By Navya Kumar

TAIWAN'S trade-dependent economy continues to struggle with lackluster growth, due to weak demand for its exports, even as domestic consumption also performs poorly. GDP growth for the first quarter this year was 1.7 percent year over year, similar to the 1.3 percent growth for the whole of 2012 but far lower than the 3.3 percent growth predicted for Q1 2013 by government agencies. While the government is taking a series of policy measures to revive the economy, including launching a stimulus program, growth is likely to be limited to the 2–3 percent range for the year.

Exports account for nearly three-quarters of the Taiwanese GDP and have been significantly challenged by the slowdown in the United States, European Union, and more recently China. The situation has been exacerbated by the depreciation of currencies in Japan and South Korea, Taiwan's competitors in the electronics market, who together account for 28 percent of Taiwanese exports. In Q1 2013, Taiwan's trade balance shrank a sharp 63 percent year over year, as exports grew just 2 percent compared to a 4 percent expansion in imports. Exports were hit by a 6 percent year-over-year decline in sales to the United States and European Union (19 percent of exports). With April 2013 sales to mainland China and Hong Kong (40 percent of exports) coming in flat, Taiwan's trade situation looks unlikely to improve significantly in the short term.

Meanwhile, domestic consumption has also stalled. While private consumption grew a low 0.3 percent year over year in Q1 2013 as a result of sluggish wage growth, government consumption fell 0.5 percent. The outlook for private and government consumption for the rest of the year is also not encouraging. As a result of subdued demand externally and internally, Taiwan's industrial production index registered its third consecutive month of year-over-year decline in

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April 2013. With the May 2013 purchasing managers' index coming in at 47.1, the lowest in eight months, business conditions only appear to be deteriorating further.

In order to revive the economy, the Taiwanese government unveiled an economic stimulus package of TWD 3.2 billion in May 2013 to boost consumption and investment over the next five years. The package earmarks TWD 1 billion for supporting start-up companies. Another TWD 400 million is allocated toward replacing public transport vehicles and incentivizing spending on items such as energy-efficient home appliances and cars. Projects to build a new port and expand an international airport are also being considered. Specifically to improve foreign direct investments, which fell 14.8 percent year over year in the first four months of 2013, Taiwan plans to establish five free economic zones (FEZs). The FEZs are expected to offer investors a more liberal credit, land, labor, and taxation environment. In other measures, Taiwan's cash-rich life insurance companies will now be allowed to invest in public construction projects. Visa regulations will also be eased for Chinese travelers to encourage trade and tourism.

Furthermore, Taiwan is taking several steps to bolster exports. The government is working to forge free-trade agreements (FTAs) with Singapore, New Zealand, and the United States. The FTAs are aimed at diversifying Taiwan's trade, which currently relies heavily on China, as well as countering competitor South Korea, which has already established agreements with important trade partners such as the United States and European Union. In addition, the central bank has increased US dollar purchases to prevent the Taiwanese dollar from becoming even stronger than the Japanese yen and the South Korean won.

However, the immediate impact of all these policy efforts to improve the Taiwanese economy appears limited. Not only is the stimulus program's spending spread over five years, but the success of the FEZs is also uncertain, given strong competition from established economic zones in neighboring China. In addition, the FTA with the United States, potentially the most impactful trade agreement for Taiwan, is likely a long way from materializing, due to several contentious issues such as the protectionist approach of certain segments of Taiwanese industry. Even the central bank's currency intervention measures need to be careful to avoid any sharp fall in the Taiwanese dollar, which could bloat the country's import bill and further jeopardize a trade balance already hit by sluggish exports.

Meanwhile, the government faces political challenges domestically and internationally. At home, the government's moves to expand Taiwan's nuclear power capacity and reform an ailing public-pension system by potentially hiking out-of-pocket contributions and lowering certain benefits are facing resistance. In the larger region, Taiwan's relations with the neighboring Philippines, a major trade partner, are strained over territorial disputes in the South China Sea.

All in all, 2013 is a challenging year for Taiwan, as an immediate resolution of its economic or political problems appears unlikely.

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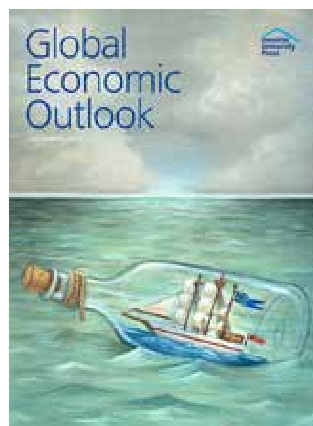

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