Asia Economics Analyst

Issue No: 09/03

February 20, 2009

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at **https://360.gs.com**

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India: Rising deficit, steepening yields

India's consolidated fiscal deficit may increase to 10.3% of GDP in FY09 and 10% of GDP in FY10, according to our estimates. We do not think that the deficit will come down substantially over the next few years.

The increase in the supply of government securities may not be accompanied by a similar increase in demand, especially as the private sector increases credit demand towards the latter half of FY10. Therefore, we think that the long end of the yield curve will remain under selling pressure, and risk-free rates may rise.

Taiwan: 4Q2008 GDP slump; downgrading our already-below-consensus forecast

4Q2008 GDP growth slowed to -8.4% yoy, from -1.1% yoy in 3Q2008. We are revising down our GDP growth forecast to -6.5% for 2009.

Korea: Near-term balance of payment outlook points to further pressure on the KRW

Despite projected double-digit declines in exports in 2009, we believe that the annual balance will likely be positive due to falling commodity prices, lower import demands, and the effects of a weaker KRW on imports of services.

India union interim budget—no major changes

The government but did not announce any major policy changes in its interim budget for FY10. The Finance Minister's speech was more a statement of achievements in the past 5 years, and merely extended spending and revenue plans for FY10.

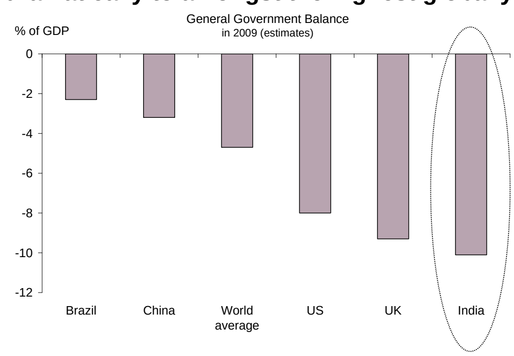
Temperature check on the macro growth recovery in China

In the past week, we have seen early signs of an economic recovery in China from released data and anecdotal evidence. Here is a summary of our views in a Q&A format.

Strategy: More weakness in the TWD, KRW and SGD

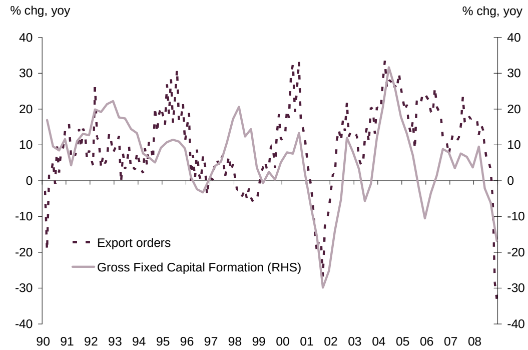
While sentiment may continue to influence the regions FX until the macro landscape is clearer, our strongest views remain further weakness in TWD, KRW, SGD, but stability of the CNY over the next 12 months.

India's fiscal deficit has increased dramatically to amongst the highest globally



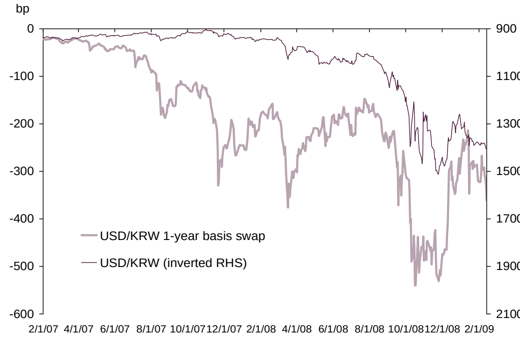
Source: CEIC, GS Global ECS Research.

Taiwan's capex is mainly export-led



Source: CEIC, GS Global ECS Research.

Korea: US funding tensions weigh on the KRW



Source: CEIC, GS Global ECS Research.

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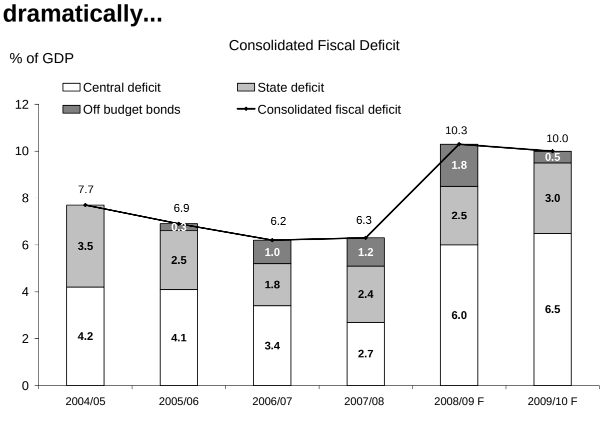
India: Rising deficit, steepening yields

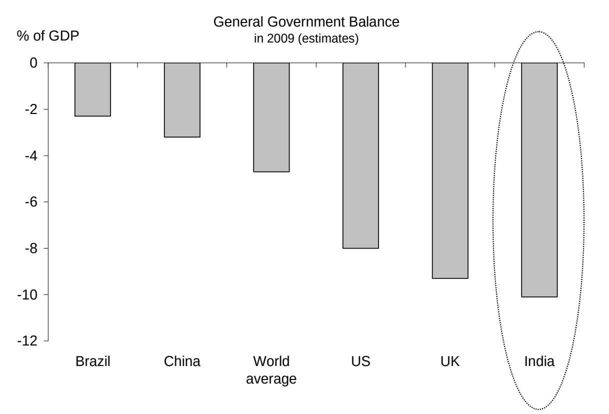
- India's consolidated fiscal deficit may increase to 10.3% of GDP in FY09 and 10% of GDP in FY10, according to our estimates, due to the cyclical downturn in tax revenues, election-related spending, and a large subsidy bill.
- We do not think that the deficit will come down substantially over the next few years due to a structural increase in spending, especially on higher wages and unemployment benefits, as well as a large increase in the government's interest burden—which is over 50% of the FY09 fiscal deficit.
- The increase in the supply of government securities may not be accompanied by a similar increase in demand, especially as the private sector increases credit demand towards the latter half of FY10. Therefore, we think that the long end of the yield curve will remain under selling pressure, and risk-free rates may rise.
- India's rising debt ratio, however, remains sustainable, although we estimate that the primary deficit, i.e., overall fiscal deficit minus interest bill, would need to decline from 4.6% of GDP currently to 2.3% for this to happen.
- We performed various stress tests on India's debt ratio, including a growth, interest rate, and inflation shock. Although the debt ratio is sustainable under most scenarios, a continued slowdown in GDP growth could cause it to rise unsustainably.
- The risks to our view that government long-end rates will rise is if growth bounces back stronger than expected, the new government announces a big privatization program, or takes major steps to improve its medium-term fiscal health.

Exhibit 1: India's fiscal deficit has increased dramatically...



Source: CEIC, IMF, RBI, GS Global ECS Research.

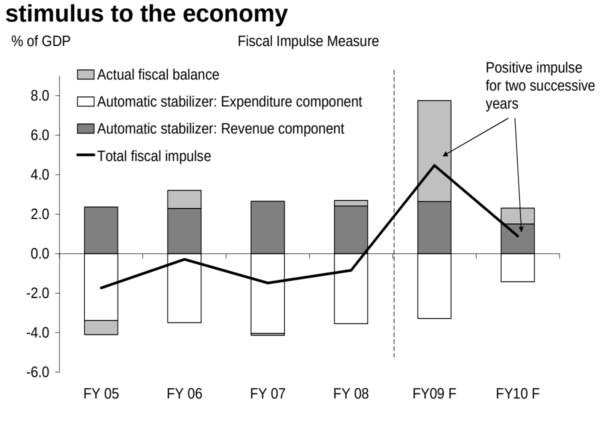
Exhibit 2: ...to amongst the highest globally



Source: CEIC, IMF, RBI, GS Global ECS Research.

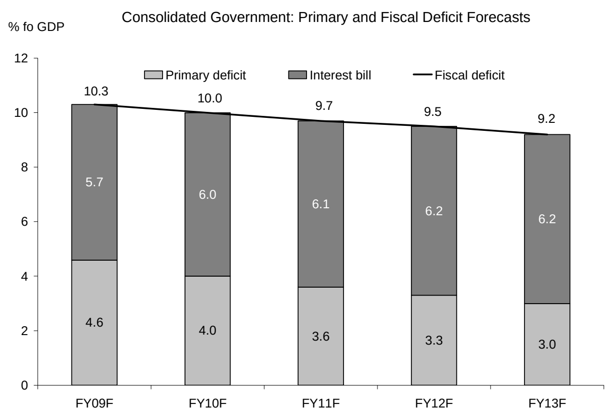
We estimate that the consolidated fiscal deficit will go up to 10.3% in FY09 and 10% in FY10, among the highest in the world (see Exhibit 1). India's interim budget announced on February 16, envisages a large increase in central government spending both in FY09 and FY10, making the central deficit rise to 6% of GDP in FY09 and 5.5%, with an expectation of a further 1 percentage point increase in FY10. Thus, the gains from a reduction in commodity prices and therefore in the subsidy bill, will be more than neutralized due to substantially weaker revenues and election-related spending pressures.

Exhibit 3: The high deficit will impart a positive stimulus to the economy



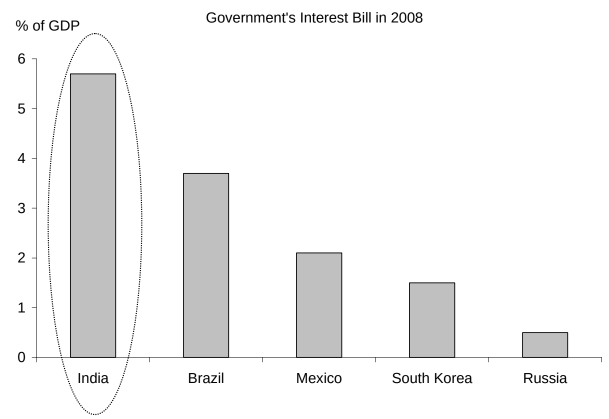
Source: CEIC, IMF, RBI, GS Global ECS Research.

Exhibit 4: India's interest burden may continue to rise…



Source: CEIC, IMF, RBI, GS Global ECS Research.

Exhibit 5: ...despite being high by global standards



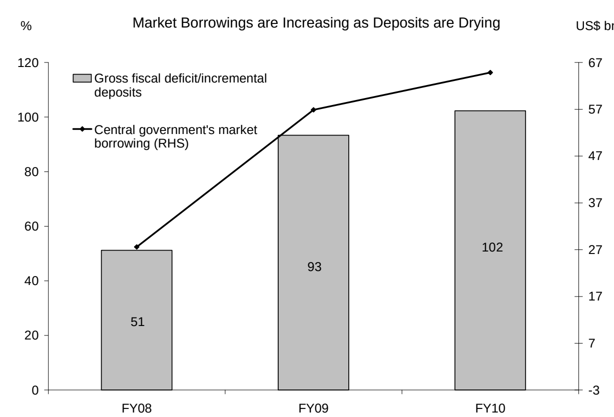
Source: CEIC, IMF, RBI, GS Global ECS Research.

Although the stimulus comes at an opportune time for the rapidly slowing economy, government spending may be permanently increased. Our fiscal impulse measure which takes account of automatic stabilizers, shows that there will be a big positive impulse in FY09 and a further impulse to activity in FY10 (see Exhibit 3). The fiscal deficit however, may remain high for the next few years (see Exhibit 4). The Sixth Pay Commission wage hike for civil servants and greater spending on the rural employment scheme is a permanent increase in spending. Importantly, the government's interest bill will continue to rise in the foreseeable future. Already, India's interest bill is one of the highest in the world, and will remain high due to the large increase in the stock of debt (see Exhibit 5).

The government's borrowing program will rise dramatically to a budget estimate of US$65 billion in FY10 from US$28 billion in FY08, and will likely remain at elevated levels. The estimated borrowing is large when compared to the growth in incremental deposits in the system (see Exhibit 6). Although currently there is not much fear of crowding out the private sector, as the latter has been crowded out already as banks are not willing to lend due to high credit risk. However, towards the second half of FY10, an increase in the supply of government securities may not be accompanied by a similar increase in demand, especially as the private sector's credit needs increase.

We think that pressures remain for the yield curve to steepen in the near term.

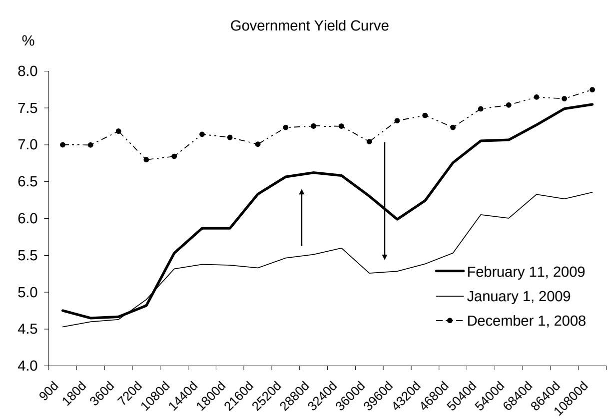
Exhibit 6: High borrowing relative to deposits...



Note: incremental deposits are calculated as the increase in bank deposits over the previous year. We assume deposits to grow by 18.7% yoy in FY09 and 15% yoy in FY10.

Source: CEIC, IMF, RBI, GS Global ECS Research.

Exhibit 7: ...may steepen the yield curve further



Source: Reuters, GS Global ECS Research.

Exhibit 8: Who holds government debt?

FY07	Central government securities		Central & State government securities	
	US$ bn	% of total	US$ bn	% of total
Commercial banks	122	48	147	47
Life Insurance Corporation of India	58	23	71	23
Reserve Bank of India	23	9	23	7
Employees Providend Fund Scheme	8	3	14	4
Others	42	17	58	18

Source: RBI, GoI, GS Global ECS Research.

Is India's debt sustainable?

Our baseline projections suggest India's debt will rise to 82% of GDP in FY10, from 77% of GDP in FY08. India's debt had been on a declining trend since FY04 due to high growth, and falling primary deficits. The current upsurge will reverse that trend.

Nearly all of the government's debt is domestically held. Domestic banks hold the largest portion, as they are mandated by law to hold a minimum of 24% of their deposits in government securities (SLRs). The other holders of government debt are the insurance company, Life Insurance Corporation of India, pension funds, and others. Since debt is domestically held, a large currency depreciation does not have a significant impact on debt sustainability. However, this does limit the funding sources for the government.

To project India's debt ratio, we forecast the primary fiscal deficit, as well as real GDP and real interest rates.[1] The difference between real GDP and real interest rates matters especially for automatic debt dynamics, with the debt ratio falling if GDP growth is above real interest rates. Therefore, in the past few years, GDP growth has outstripped real interest rates leading to a reduction in the *level* of the debt, even though there have been primary deficits. Going forward, given our expectations that in FY10 and FY11 primary deficits will remain high, and growth will remain below trend, the build-up in debt may be quite dramatic (see Exhibit 10).

To bring debt to a sustainable path, we estimate that the primary fiscal deficit will need to fall to 2.3% of GDP compared to 4.6% of GDP currently. We define sustainable debt to GDP as one that is not rising over time. In our baseline case, debt increases to 85% of GDP by FY13, primarily due to the large fiscal deficit. Under the assumption that GDP growth goes back to the trend growth of 8% by FY12, and inflation falls to 3%, we

[1] Change in public-sector debt to GDP ratio = primary deficit - automatic debt dynamics

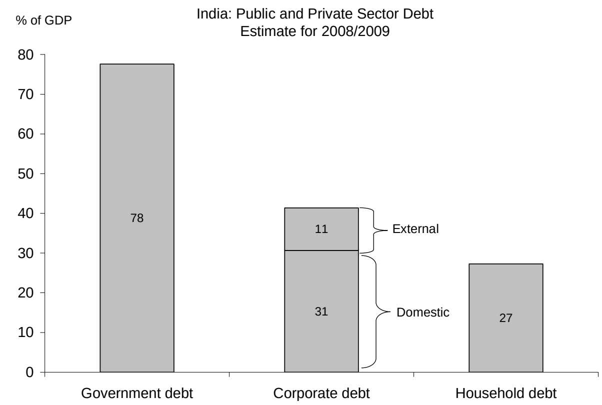
where Primary deficit is defined as gross fiscal deficit minus interest bill

Automatic debt dynamics = contribution from real GDP growth - contribution from real interest rate.

Contribution from real interest rate = [(r - p(1+g) - g]/(1+g+p+gp)) times previous year's debt ratio, and contribution from real growth = g/(1+g+p+gp) times previous year's debt ratio

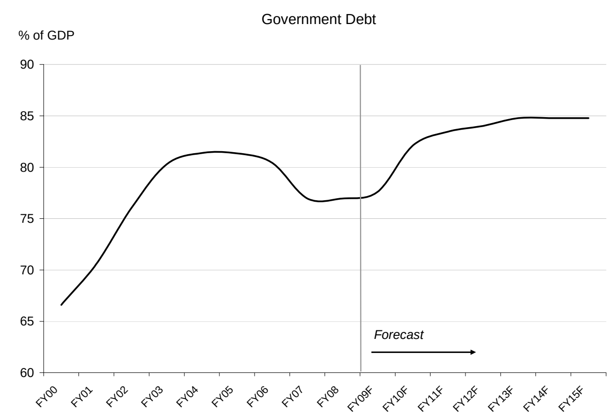
where r =nominal interest rate; p = inflation; g = real GDP growth rate

Exhibit 9: India's total debt profile—the government dominates



Source: CEIC, IMF, RBI, Ministry of Finance, GoI, GS Global ECS Research.

Exhibit 10: The cycle turns: higher deficits leading to increases in government debt



Source: CEIC, IMF, RBI, GS Global ECS Research.

Exhibit 11: Where does the primary balance need to be for debt to be sustainable?

	Baseline	Shock scenario	Debt sustaining primary balance (% of GDP)
Baseline			**-2.3**
Growth shock	8.0%	6.0%	**-0.8**
Extreme growth shock	8.0%	4.0%	**1.0**
Interest rate shock	8.2%	10.2%	**-0.8**
Deflation shock	3.0%	1.0%	**-0.7**

Note: interest rate on public debt is calculated as interest expenditure as a % of last year's debt stock.

Source: CEIC, IMF, RBI, GS Global ECS Research.

estimate that the primary fiscal deficit which will make the debt-to-GDP ratio stable is 2.3% of GDP.

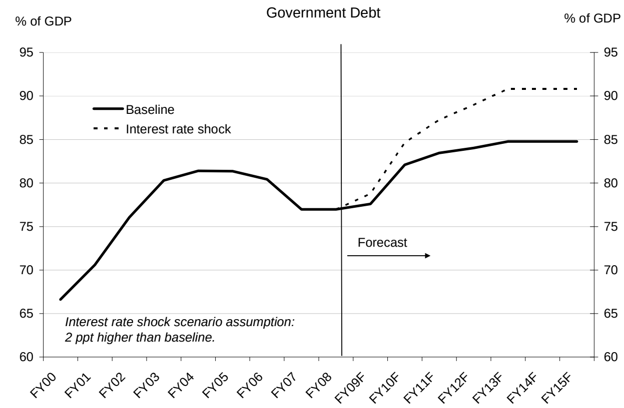
The results from a number of stress tests suggest that the debt-to-GDP ratio remains sustainable under most scenarios. We considered the impact on the debt-to-GDP ratio of the following shocks: 1) a higher interest rate; 2) lower GDP growth; 3) lower inflation. In most cases, debt remains sustainable, although the primary deficit reduction required is greater. The biggest negative shock in terms of impact on the debt ratio would be a sustained deceleration in GDP growth to 4%. In this case, the government would have to run a primary surplus of 1%. This suggests to us that even though the current deterioration in the fiscal position is a big vulnerability, if adequate medium-term steps were undertaken, and the economy returns back to its growth trend, the debt would be sustainable.

There are a number of factors which could cause the debt-to-GDP ratio to decline faster than we anticipate, and therefore constitute as risks to our view on government bonds. These are: 1) a sharper-than-expected bounce-back in GDP growth—which increases the denominator, and hence reduces the debt-to-GDP ratio; 2) a big privatization drive by the new government, and using those proceeds to retire debt; 3) success in reducing the primary deficit by the new government, in part by introducing a nation-wide Goods and Services Tax (GST), further improvements in tax administration and base broadening, and a reduction in subsidies. We do not currently think there is a high likelihood of any of these happening in the near term.

To move towards debt sustainability, India needs a medium-term strategy for deficit reduction—a successor to the Fiscal Responsibility and Budget Management Act. Such a strategy would provide several important benefits (see *Ten Things for India to Achieve its 2050 Potential*, Global Economics Paper No. 169, June 16, 2008). First, it would discipline the government and politicians, restrain populist spending, improve governance, and make the deficit independent of political and election cycles. Second, it would allow the central bank the space to follow meaningfully an independent monetary policy, as it would be unburdened from providing large amounts of financing to the government. Third, it would improve the overall savings rate by reducing government dis-savings; improve sovereign ratings; and allow for increased credit to the private sector. Fourth, the hard budget constraint would discipline spending and improve the composition towards more efficient and growth-enhancing purposes, such as health, education, and infrastructure. Over the medium term these would be necessary to win back lost ground on the fiscal.

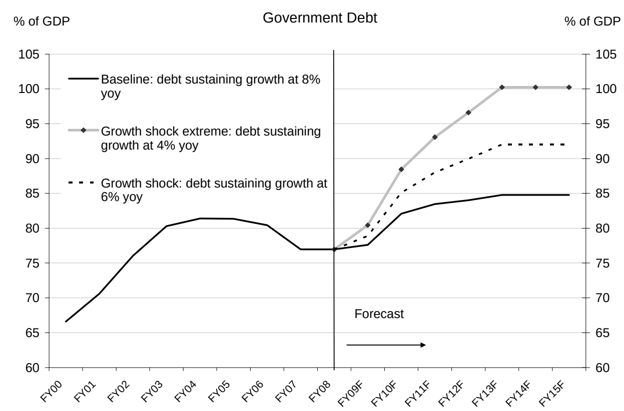
Tushar Poddar
Pranjul Bhandari

Exhibit 12A: Impact on debt of interest rate shock



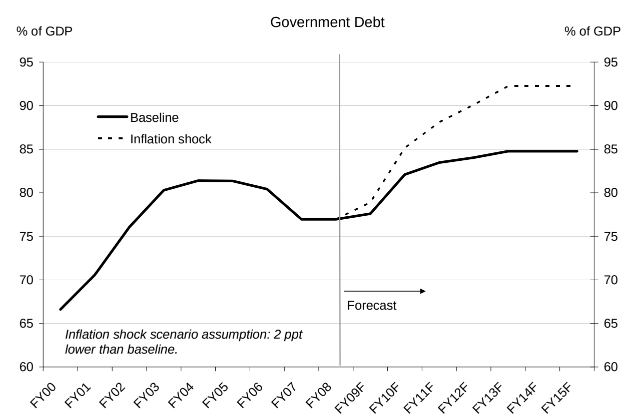
Source: CEIC, IMF, RBI, GS Global ECS Research.

Exhibit 12B: Impact on debt of growth shock



Source: CEIC, IMF, RBI, GS Global ECS Research.

Exhibit 12C: Impact on debt of inflation shock



Source: CEIC, IMF, RBI, GS Global ECS Research.

Taiwan: 4Q2008 GDP slump; downgrading our already-below-consensus forecast

This article was first published on February 18, 2009.

- 4Q2008 GDP growth slowed to -8.4% yoy, from -1.1% yoy in 3Q2008. This marks the largest quarterly slump in Taiwan's GDP on record. The sharp contraction in investment was the main culprit.
- The synchronized sharp drop in exports, imports and investments again highlights the significant dependency of the investment cycle on exports demand, and the high import content of exports.
- Given that the outlook for exports should remain bleak, we are revising down our GDP growth forecast to -6.5% for 2009, from our already-below-consensus GDP growth forecast of -3.0% (versus the consensus of -2.0%).

Exhibit 1: Breakdown of GDP growth by components

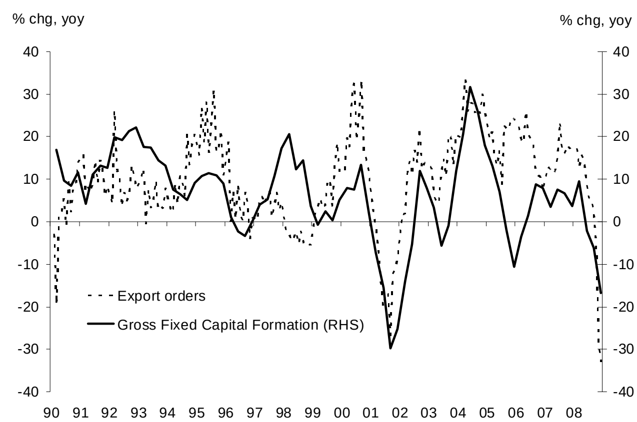
% chg yoy	4Q08	3Q08	2Q08	1Q08	4Q07
Real GDP	**-8.4**	-1.1	4.6	6.3	6.4
Domestic demand	**-7.7**	-2.4	-2.6	3.3	1.0
Private consumption	**-1.7**	-2.1	0.5	2.0	1.65
Fixed investment	**-23.2**	-11.8	-8.0	3.7	-0.8
Government consumption	**2.2**	1.1	-0.2	1.3	1.08
Exports (G&S)	**-19.8**	-0.6	9.9	12.7	12.9
Imports (G&S)	**-22.6**	-2.6	0.2	9.6	5.8

Source: Directorate-General of Budget, Accounting and Statistics, GS Global ECS Research.

Growth contracted sharply in 4Q2008. 4Q2008 GDP growth slowed to -8.4% yoy, from -1.1% yoy in 3Q2008. This marks the largest quarterly slump in Taiwan's GDP on record. On a seasonally-adjusted quarter-on-quarter basis, we estimate growth would have slumped by 22% annualized. The decline is also significantly larger than our forecast of -4.0% yoy and the consensus forecast of -6.8% yoy. Note that Singapore and Korea saw GDP growth declines of 3.7% yoy and 3.4% yoy respectively.

The synchronized sharp drop in exports, imports and investments again highlights the significant dependency of the investment cycle on exports demand, and the high import contents of exports. From our recent analysis in *The Asian exports decline–analysis of true value-added from exports and of export destinations suggests more pain to come*, Asia Economics Analyst 09/01, January 16, Taiwan's total output is highly geared towards the exports sector due to a high exports to GDP ratio and a significant portion of export-led capex (see Exhibit 2). The sharp fall in fixed investment was the main culprit for the 4Q2008 GDP weakness, which experienced the largest contraction of 23.2% yoy, after declining 11.8% in 3Q2008. The relatively bright spot of the report lies in private consumption, where the decline actually narrowed to 1.7% yoy in 4Q2008, after registering a 2.1% yoy drop in 3Q2008. The decline in overall domestic demand

Exhibit 2: Taiwan's capex is mainly export-led



Source: CEIC, GS Global ECS Research.

contributed 6.3 percentage points to the overall GDP contraction. Exports of goods and services fell by 19.8% yoy in 4Q2008, after dropping 0.6% yoy in 3Q2008. Imports growth, on the other hand, continued to fall even more sharply than exports, declining 22.6% yoy in 4Q2008, after falling 2.6% yoy in 3Q2008.

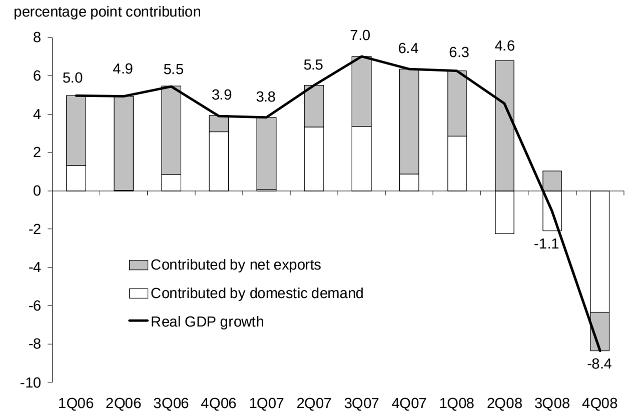
We are revising down our GDP growth forecast to -6.5% for 2009, from our already-below-consensus GDP growth forecast of -3.0% (versus the consensus of -2.0%). We had been below consensus on our GDP forecasts, as noted in our recent article (see *Taiwan: More favorable policy mix, but still overwhelmed by deteriorating external demand*, Asia Economics Flash, February 9) The significant downside surprise in the 4Q2008 data has pushed down the trajectory of our initial quarterly growth projection. Our new forecasts now imply GDP growth to remain in negative territory until 4Q2009, with growth hitting -10.0% yoy in 1Q2009 and 2Q2009 (versus around -6.0% yoy previously). Note also that the government has revised its annual GDP growth forecast for 2009 to -3.0% yoy from 2.1% yoy.

Exports should continue to fall sharply, as external demand falters. The decline in exports growth is consistent with the monthly customs trade data. Export orders, which typically lead customs exports data by one to two months, dropped 33.0% yoy in December, after registering a substantial 28.5% yoy decline in November. The sustained decline in export orders points to a much weaker exports cycle for Taiwan. Our Global Leading Indicator, an early indicator for the global industrial cycle, as well as the inventory data from the US, continues to foretell further deterioration in external demand (see Exhibit 4). Demand from China and other emerging market economies, which had been the main locomotive for Taiwan's exports growth, also saw substantial decline (see Exhibit 5).

We are also revising our USD/TWD forecasts to 36, 35.5 and 34.5 on 3, 6 and 12-month horizons. This compares to our previous forecasts of 34, 33.5 and 33. The new forecasts imply a weaker path then the forwards, and a modest depreciation on a trade-weighted basis. The central bank has noted that the impact of a weaker currency on boosting exports will only be short term, and their general view on its role in the currency market is to smooth out any excess volatility, rather than using the currency as an explicit policy tool. Therefore, we do not believe the central bank will likely engineer a deliberate devaluation of the TWD to bolster exports, especially as we believe the context of the weaker trade growth is the shrinkage in external demand, rather than a loss in relative competitiveness. As noted before, the correlation between exports and imports is high, and hence we believe the trade balance will likely remain fairly stable (trade balance has actually been rising in the past few months, along with an increase in foreign exchange reserves). However, capital flows will likely be the main driver for the TWD, which is a function of the market's assessment of growth risks. Given the downside surprise in the growth momentum in the near term, we believe the capital flows will turn less supportive of the TWD in the near term.

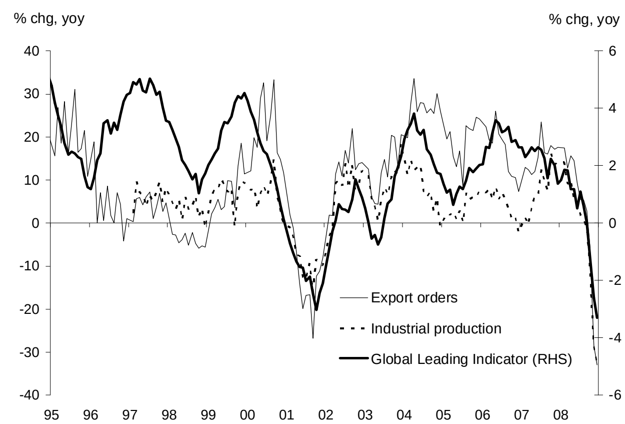
The central bank had announced a reduction in the policy rate by another 25 bp, bringing the policy rate down to 1.25%. Our forecast has been that the central bank would bring the policy rate down to 1%, implying another potential 25-bp rate cut in the upcoming policy

Exhibit 3: Significant contraction in both domestic demand and net exports



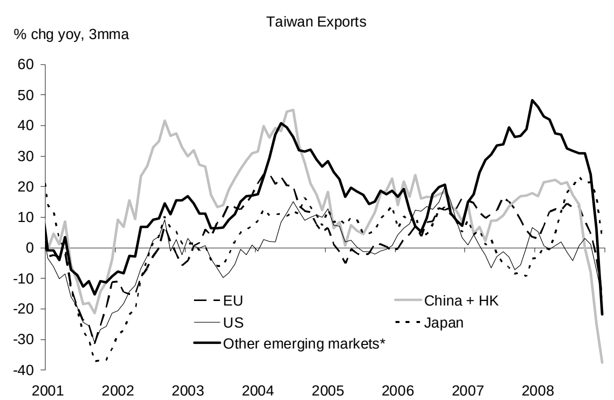
Source: CEIC, GS Global ECS Research.

Exhibit 4: Weakening external demand hitting hard on the manufacturing sector



Source: CEIC, GS Global ECS Research.

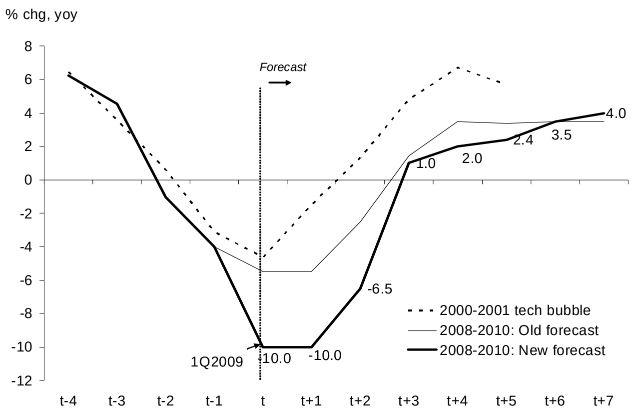
Exhibit 5: Taiwan's exports by destination: broad-based decline



*Other emerging market economies: BRICs, ASEAN (including Vietnam) and the Middle East, excluding China.

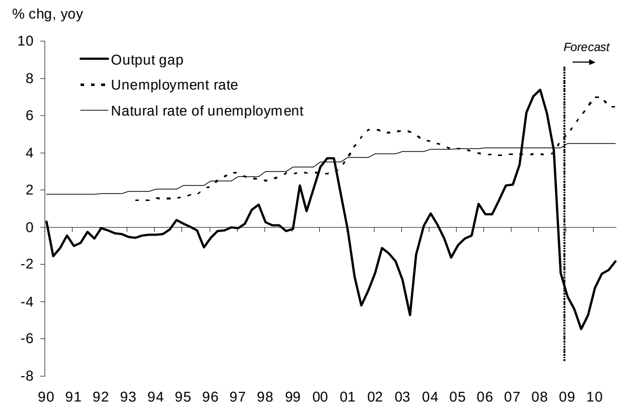
Source: CEIC, GS Global ECS Research.

Exhibit 6: A deeper downturn, followed by a more subdued recovery



Source: CEIC, GS Global ECS Research.

Exhibit 7: GDP growth to remain below trend, while unemployment rate rises



Source: CEIC, GS Global ECS Research.

meeting in March. The central bank has cumulatively reduced the policy rate by more than 200 bp since late-September. The proactive monetary easing by the central bank signals its intention to remain ahead of the curve in mitigating the downside risks to growth. We see the fundamentals supportive of an easing bias remains very much intact: 1) a stable currency; 2) a solid current accounts position and; 3) low inflation. Therefore, we believe the hurdle for the central bank to pursue further monetary easing is very low, if we see further downsides risks to growth.

We believe the main handicap is commercial banks' low appetite to extend credit, which is counteracting the effects of monetary easing on the economy. Real rates have remained low, on the back of monetary easing leading to lower nominal interest rates, despite falling inflation. The impact of lower borrowing costs fostering borrowing demand and therefore boosting economic growth is dependent on whether there is any improvement in banks' lending appetite, which is largely a function of the banks' assessments on credit quality and economic fundamentals. **Without breaking away from this vicious cycle, which is worsening as we highlighted earlier, we believe the impact of further monetary easing by the central bank is still constrained in the near term**.

Enoch Fung, Shirla Sum

Appendix: Table of Taiwan's GDP forecasts

	2005	2006	2007	2008F	2009F	2010F
GDP (%)	4.2	4.8	5.7	0.1	-6.5	3.0
Domestic demand (%)	1.7	1.5	2.2	-2.4	-5.3	2.9
Consumption (%)	3.0	1.8	2.3	-0.3	-2.3	2.2
Fixed asset investments (%)	1.2	0.9	1.9	-12.9	-22.0	5.0
Exports of goods and services (%)	7.6	10.3	8.8	-0.2	-20.7	4.5
Imports of goods and services (%)	3.8	5.6	3.8	-4.2	-23.7	4.9

Source: CEIC, GS Global ECS Research.

Korea: Near-term balance of payment outlook points to further pressure on the KRW

This article was first published on February 16, 2009.

Current account outlook for 2009 remains positive

We maintain our 2009 current account forecast, which envisages a surplus of US$13 billion. Despite projected double-digit declines in exports in 2009, we believe that the annual balance will likely be positive due to falling commodity prices, lower import demands, and the effects of a weaker KRW on imports of services (see Exhibit 1). Even in the event of weaker-than-expected exports in 2009, its impact on the current account would likely be muted considerably, in our view, given that commodity prices would likely accompany export declines and nearly 40% of imports are used for exports. It is also reassuring that, historically, domestic demand growth has been strongly negatively correlated with net exports growth (correlation of -0.92, over 1971-2007).

Near-term current account outlook is however negative

That said, we expect the current account balance to turn into a deficit of US$2-5 billion in 1Q2009. First, the current account is seasonally weak in 1Q2009. January's trade deficit of US$3 billion indicates it is large enough to turn the current account red again in January as acknowledged by the Ministry of Strategy and Finance. While we expect the trade deficit to decline in February and March on favorable seasonality, the recent trends and dividend payments will likely keep the non-trade deficit high, leading to an overall current account deficit.

Second, money supply is likely to grow rapidly, putting pressure on the external balance. Broad money increased

Exhibit 1: Balance of payments (US$ billion)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009F
Current account balance	**-9**	**-23**	**-8**	**40**	**25**	**12**	**8**	**5**	**12**	**28**	**15**	**5**	**6**	**-6**	**13**
Goods trade Trade balance	**-4**	**-15**	**-3**	**42**	**28**	**17**	**13**	**15**	**22**	**38**	**33**	**28**	**28**	**6**	**27**
Goods: Exports	**125**	**130**	**139**	**132**	**145**	**176**	**151**	**163**	**197**	**258**	**289**	**332**	**379**	**433**	**353**
Road vehicles	10	12	13	12	13	15	15	17	23	32	34	42	49	48	41
Semi-conductors	18	15	17	17	19	26	14	17	20	27	28	33	39	33	26
Info & comm equipments	8	9	10	9	17	23	22	27	35	46	41	44	51	53	45
Vessels	6	7	7	8	7	8	10	11	11	15	15	21	27	41	41
Oil and oil products	2	4	5	4	6	9	8	6	7	10	15	21	25	38	17
Chem & its products	9	9	11	10	11	14	13	14	17	23	26	32	38	43	32
Metal	0	9	10	11	10	11	10	10	13	19	21	27	32	38	29
Others	72	65	67	61	62	69	60	61	72	86	110	111	120	139	122
Goods: Imports	**129**	**145**	**142**	**91**	**117**	**159**	**138**	**149**	**175**	**220**	**256**	**304**	**351**	**427**	**326**
Fuel	19	24	27	18	23	38	34	32	38	49	66	85	95	143	64
Chem & its products	12	13	13	9	11	13	13	14	16	21	23	28	32	37	30
Iron & steel-related products	7	10	9	6	7	9	8	9	12	19	22	29	38	53	45
Iron ore & scraps	0	3	3	3	3	4	4	4	5	7	8	13	17	19	16
Iron and steel	0	7	6	3	4	5	4	6	7	12	14	16	21	34	28
Others	91	98	93	58	76	99	83	93	109	131	145	162	186	195	187
Services trade balance	**-3**	**-6**	**-3**	**1**	**-1**	**-3**	**-4**	**-8**	**-7**	**-8**	**-14**	**-19**	**-20**	**-17**	**-14**
Services: Credit	23	23	26	26	27	31	29	28	33	42	45	50	63	76	68
Services: Debit	26	30	30	25	27	33	33	37	40	50	59	69	83	93	82
Income	**-1**	**-2**	**-2**	**-6**	**-5**	**-2**	**-1**	**0**	**0**	**1**	**-2**	**1**	**1**	**5**	**0**
Current Transfers	**0**	**0**	**1**	**3**	**2**	**1**	**0**	**-2**	**-3**	**-2**	**-2**	**-4**	**-4**	**-1**	**0**
Capital and Financial Account	**17**	**23**	**1**	**-3**	**2**	**12**	**-3**	**6**	**14**	**8**	**5**	**18**	**7**	**-51**	
Financial Account	**17**	**24**	**2**	**-3**	**2**	**13**	**-3**	**7**	**15**	**9**	**7**	**21**	**10**	**-51**	
Direct Investment: Net	-2	-2	-2	1	5	4	1	0	0	5	2	-5	-14	-11	
Portfolio Investment: Net	12	15	14	-1	9	12	7	0	17	7	-4	-23	-26	-15	
Portfolio Investment (Asset	**-3**	**-6**	**1**	**-2**	**1**	**-1**	**-6**	**-5**	**-5**	**-12**	**-18**	**-31**	**-56**	**23**	
Equity Securities	0	-1	0	0	0	0	0	-1	-2	-4	-4	-15	-53	6	
Debt Securities	-3	-6	1	-2	2	0	-5	-4	-3	-8	-14	-16	-4	17	
Portfolio Investment (Liab.)	**15**	**22**	**13**	**1**	**8**	**13**	**12**	**5**	**23**	**18**	**14**	**8**	**30**	**-38**	
Equity Securities	4	6	3	4	12	13	10	0	14	9	3	-8	-29	-41	
Debt Securities	10	16	11	-3	-4	0	2	5	8	9	11	16	59	3	
Other Investment: Net	7	11	-11	-2	-11	-4	-10	7	-3	-4	7	48	44	-11	
Capital Account	**0**	**-1**	**-1**	**0**	**0**	**-1**	**-1**	**-1**	**-1**	**-2**	**-2**	**-3**	**-2**	**0**	
Changes in Reserve (-: Increase	**-7**	**-1**	**12**	**-31**	**-23**	**-24**	**-8**	**-12**	**-26**	**-39**	**-20**	**-22**	**-15**	**56**	
Errors and Omissions	**-1**	**1**	**-5**	**-6**	**-4**	**-1**	**3**	**0**	**0**	**3**	**0**	**-1**	**2**	**1**	
Memorandum Item:															
Foreign Reserves (end-period)	**33**	**33**	**20**	**52**	**74**	**96**	**103**	**121**	**155**	**199**	**210**	**239**	**262**	**201**	
Dubai spot prices (aveage)	**16.1**	**18.5**	**18.1**	**12.2**	**17.2**	**26.2**	**22.8**	**23.8**	**26.8**	**33.7**	**49.4**	**61.5**	**68.5**	**93.5**	**42.8**
Current account (in % of GDP)	**-1.7%**	**-4.2%**	**-1.6%**	**11.4%**	**5.5%**	**2.4%**	**1.7%**	**1.0%**	**2.0%**	**4.1%**	**1.9%**	**0.6%**	**0.6%**	**-0.7%**	**1.4%**

Source: CEIC, GS Global ECS Research.

Exhibit 2: Budget expenditure plan (general and special accounts)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
(KRW trn)												
Annual	**126**	**145**	**154**	**160**	**174**	**183**	**186**	**195**	**202**	**201**	**220**	**248**
1Q	31	57	53	58	69	69	74	82	77	83	84	109
2Q	35	37	41	43	45	44	45	48	48	48	54	65
3Q	30	25	31	30	30	35	34	33	38	35	41	37
4Q	30	25	31	30	30	35	34	33	38	35	41	37
(% of total)												
Annual	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
1Q	25%	39%	34%	36%	40%	38%	40%	42%	38%	41%	38%	44%
2Q	27%	26%	26%	27%	26%	24%	24%	25%	24%	24%	24%	26%
3Q	24%	17%	20%	18%	17%	19%	18%	17%	19%	17%	19%	15%
4Q	24%	17%	20%	18%	17%	19%	18%	17%	19%	17%	19%	15%

Source: Ministry of Strategy and Finance, GS Global ECS Research.

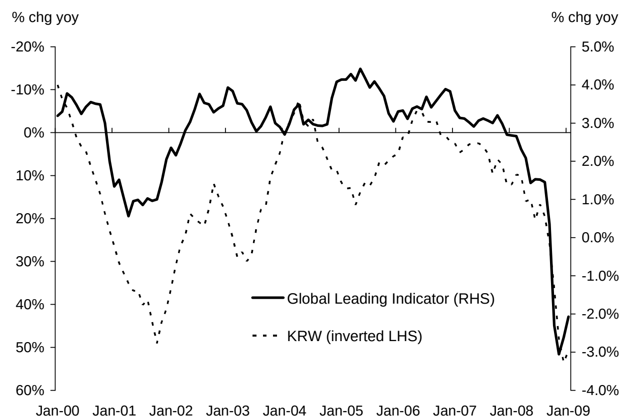
12% yoy in January, a moderate slowdown compared to 13.1% yoy growth in December and one of highest in the region. The budget plan envisages spending of W108.8 trillion in 1Q2009, 44% of annual spending, with W33 trillion already spent in January (see Exhibit 2). Given our estimate of revenue undershooting W25-45 trillion in 1Q2009, the budget gap is likely to be financed by the use of last year's surplus (W9.3 trillion) and bond issuance. Under the assumption of all budget gaps being financed by the Bank of Korea in 1Q2009, we estimate that the fiscal stimulus will increase M2 by 2%-3% (M1 by 8%-14%) and raise import demand roughly by US$3-5 billion in 1Q2009.

We expect pressure on the KRW in the near term

Korea is an economy that is very sensitive to the global cycle and the KRW has understandably been hit by the global recession woes. We have been exploring the possibility of going long KRW given the tentative signs of stabilization in the global growth cycle as hinted by our Global Leading Indicator (see Exhibit 3).

We nonetheless believe that the KRW faces weakening pressure in the near term possibly to 1500 although we maintain our USD/KRW forecasts at 1450, 1400 and 1300 on 3, 6 and 12-month horizons. The current account deficit in 1Q2009 alone would unlikely weaken the KRW significantly to the extent that the gap is temporary. Nonetheless, there would be three exacerbating factors in the near term. First, the 1Q2009 deficit on a cash basis is likely to be higher than the deficit in an accrual basis by about US$3 billion. Much of ship export receipts (18 % of total exports in December) have been presold through cross-currency swaps. With new orders falling sharply, many of existing swaps are unlikely to be rolled over upon expiration. Moreover, cancellation of existing contracts and delays in payments, which appears to be still on the rise, would disrupt USD flows to the swap contracts, exerting pressure on the KRW.

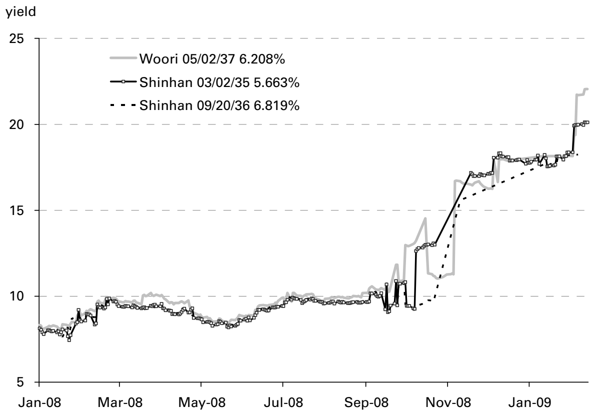
Exhibit 3: Better prospects for the KRW on stabilization of the global cycle?



Source: CEIC, GS Global ECS Research.

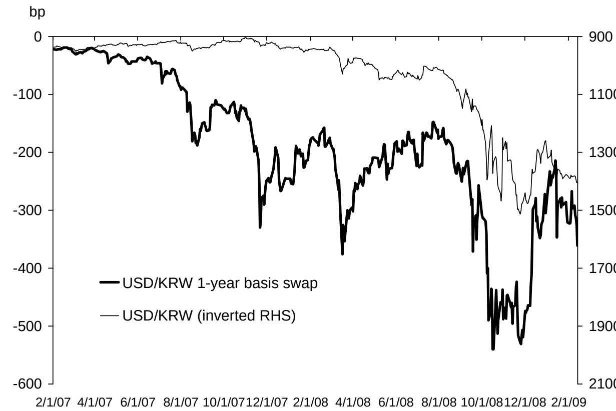
Second, net financial flows could deteriorate again in the near term, given the substantial repayment needs of Korean banks and their low incentives for external funding. We estimate that Korean banks, excluding domestic branches of foreign banks, need to repay nearly US$20 billion in 1Q2009 as some of foreign debt due in 4Q2008 (US$33 billion) was rolled over short term. The catch here is that external borrowing costs remain prohibitively high, with secondary market rates for USD bonds hovering at 18%-20% although borrowing rates are not uniform and Eurobond markets are thin (see Exhibit 4). Moreover, Korean banks do not have strong incentives for external funding given low local interest rates and USD liquidity support by the central bank (see *The Government Unveils a Financial Market Stabilization Package of $130 billion plus*, Korea Views, October 20, 2008). The outcome would be the lack of overseas funding, which would put pressure on the balance of payments. Our regression analysis of USD/KRW, the Global Leading Indicator, and KRW 1-year basis swaps shows that USD funding pressure has indeed been a significant contributing factor in the KRW's weakness, in addition to global cyclical

Exhibit 4: Indicative offer yields of USD Eurobonds of Korean banks



Source: Bloomberg, GS Global ECS Research.

Exhibit 5: US funding tensions weigh on the KRW



Source: CEIC, GS Global ECS Research.

weakness (see Exhibit 5). An increasingly negative spread reflects an increase in the premium for USD funding, as was vivid in the negative spread during the October post-Lehman period.

Third, direct purchase of government bonds (KTB) by the Bank of Korea, which the central bank is currently considering, is likely to undermine confidence in the KRW. Such a scheme has been introduced by the US and Japan, without necessarily weakening their currencies. However, given that the KRW is not an internationally-accepted means of payment and hence Korea's payment capacity is strictly limited by foreign reserves, we are concerned that an outright monetization of a potentially open-ended budget deficit or a perception of such a risk could evoke a concern about external sustainability and hence weaken the KRW. A case in point is a drop of the GBP last week on the back of the announcement by the Bank of England's governor that the central bank would be buying gilts. We are also unsure about the rationale for the scheme, given ample liquidity in the financial system and the strong preference for the liquidity and safety of KTBs. We believe that an expansion of the existing repo markets is a more efficient and market-friendly way of injecting liquidity, which would help ensure price discovery in the bond markets.

Goohoon Kwon
Mark Tan

India union interim budget—no major changes

This article was first published on February 16, 2009.

The government but did not announce any major policy changes in its interim budget for FY10. The Finance Minister's (FM) speech was more a statement of achievements in the past 5 years, and merely extended spending and revenue plans for FY10. The speech had both eyes firmly on the upcoming election, and suggested that further policy changes needed a fresh mandate.

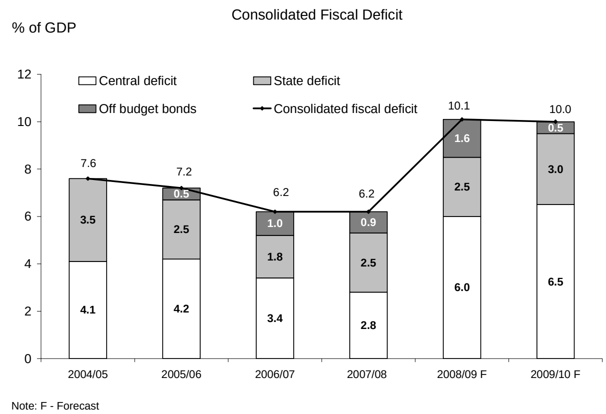
The government provided its estimate of the central fiscal deficit for FY09 at 6%, in line with our estimate of 6.1%. Along with state deficit and off-budget liabilities, the consolidated deficit would sum to 10.1% of GDP in FY09. The government also gave guidance to the central fiscal deficit for FY10 at 5.5% of GDP. However, the FM stressed that additional plan expenditures of 0.5%-1% of GDP may be required to boost the economy and allow for bank recapitalization. These are in line with our estimates of central deficits of 6.5% in FY10, and a consolidated deficit of 10% of GDP in FY10. Such large deficits will provide a stimulus to activity, as our fiscal impulse measure, stripped off automatic stabilizers demonstrates (see Exhibits 1 and 2).

The yield curve steepened on the back of the interim budget announcement, as we had expected. The 10-year bond yield which was at 6.14% before the speech, rose to 6.3% after the speech. We continue to expect the curve to steepen further. There is currently not much fear of crowding out as the spread between corporate bonds and government securities remains elevated. However, towards the end of FY10, such a large borrowing program may lead to difficulties in credit availability for the private sector.

The focus of the interim budget was to increase allocations on current central government sponsored schemes. Accordingly there were increases in spending on rural employment (NREG) and rural infrastructure (Bharat Nirman). Defense spending was also increased from 2.1% of GDP to 2.4% of GDP. These play to our macro themes of the year of the rural consumer and the government (see *India: Four macro themes for 2009*, Asia Economics Flash, January 20).

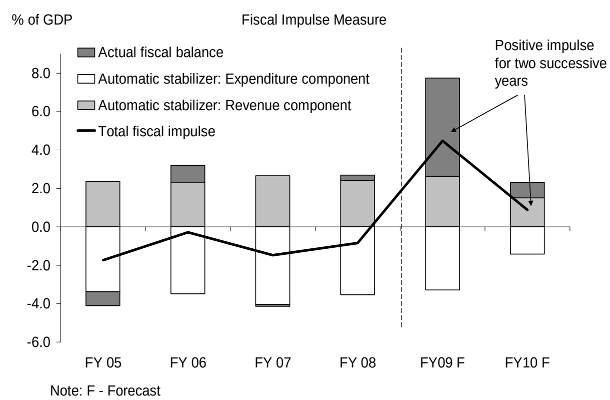
Going forward, the mantle of providing stimulus to the economy will fall disproportionately on the Reserve Bank of India (RBI), as the government cannot take any further measures before a new Parliament is elected. We expect the RBI to cut the reverse repo and repo rates by 50 bp each before end-March, and the cash reserve ratio of banks by 150 bp by the summer. We believe the inability to cut administered savings rates below 3.5% before elections may act as a binding constraint, not allowing the RBI to cut rates further.

Exhibit 1: Gross fiscal deficit remains elevated



Source: Finance Ministry, GoI, RBI, CEIC, GS Global ECS Research.

Exhibit 2: Expansionary fiscal policy to provide some much needed stimulus



Source: Finance Ministry, GoI, RBI, CEIC, GS Global ECS Research.

Tushar Poddar

Temperature check on the macro growth recovery in China

This article was first published on February 13, 2009.

In the past week, we have seen early signs of an economic recovery in China from released data and anecdotal evidence. Although in recent days, there has been some softness in some of the indicators (including forward freight rates), the net move is still incrementally positive, in line with our baseline forecasts that growth momentum will pick up after 4Q2008. Here is a summary of our views in a Q&A format:

1. How trustworthy are the strong money and credit data? Will that translate into higher real growth?

Our views: Although the headline credit growth numbers should be viewed with some caution, the overall loan and money growth has undoubtedly remained high in the past 3 months. Under normal circumstances, this should be translated into higher demand growth in 4–6 months. We expect the time lag to be shorter this time, given the government has prioritized a faster pace of implementing the fiscal stimulus package.

Positive signals:

- Medium to long-term loan growth has picked up since November, which suggests the effects of public infrastructure investments have likely started to emerge.

Reasons to be cautious about the true impact:

- There is a large share of discounted bills in newly increased loans (Rmb0.6 trillion out of a total of Rmb1.62 trillion). Part of it could be driven by interest arbitrage motives, as discount bill lending rate is around 1.4% p.a., compared to the 3-month benchmark deposit rate of 1.71% p.a., indicating that customers can earn a positive carry by borrowing at the discount bill rate and depositing back with the bank at the term deposit rate.

- At lease some switching of trust loans (around Rmb300 billion) for formal loans and a retrenching of the curb market lending activities could have happened, reducing the net impact of the new lending on real activity.

What's new: There is conflicting information on of February lending: initial indications were for very weak lending during the first week of Feb, but latest information suggests lending during the first two weeks may have reached as much as Rmb600 billion.

2. What's going on with real activity growth in January?

Our views: Despite the Chinese New Year effect, growth deceleration seems to have slowed down from very weak levels, judged by some indicators we track (since the National Bureau of Statistics does not release January real activity data).

The **Purchasing Managers Index (PMI)** rebounded for the second month in a row from its November trough. Despite the rebound, the January PMI level was still below 50, suggesting manufacturing activities were still worsening albeit at a slower rate. But more managers seem to be more positive on the current inventory situation of raw materials.

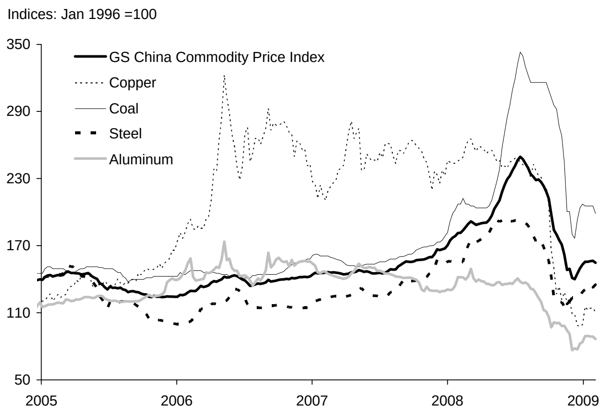
Oil and electricity demand: Our sector analysts estimated China's January apparent oil demand was likely down 1%-2% yoy and crude throughput likely down 6%-8% yoy in January, compared with +6.8% and -7.4% yoy growth in December respectively. Meanwhile, the China Electricity Association announced that electricity production growth was -13.1% yoy in January, down from -6.4% yoy in December. While these headline numbers are either worse or no better than their December readings, they are fairly strong considering there were only 17 working days this January compared with the last one because of the Chinese New Year effects.

3. How do commodity prices and shipping rates fit into the picture?

Our views: Both commodity prices and shipping rates have increased, but the direction of their future movements will depend on new orders, which are determined by investment demand strength.

Commodity prices in China have clearly rebounded from their lows (see Exhibit 1), but the inventory build-up seems to have started again. **The Baltic Dry Index** has also rebounded strongly since early February (see Exhibit 2), amid considerable noise from the Chinese New Year effect and the ongoing iron ore price negotiations (some believe sellers are artificially boosting the rate to help their negotiations). Very recently, there has been some softness in front-month forward freight rates, but the overall move in recent months is still positive.

Exhibit 1: Commodity prices started to rebound since mid-December



Source: CEIC, GS Global ECS Research.

Exhibit 2: Shipping rates have also recovered from the trough

Source: CEIC, GS Global ECS Research.

These developments are mostly consistent with our expectations that sequential growth will rebound from its trough in 4Q2008 and would continue to accelerate in 2009. However, given the sharpness and severity of the recent slowdown, the recovery path is likely to be volatile as well.

We will follow closely any other signs of a growth recovery and provide timely updates. Meanwhile, please watch out for any further policy catalyst especially on industrial sector development, which are scheduled to come out in the next few weeks.

Helen (Hong) Qiao
Yu Song

Strategy: More weakness in the TWD, KRW and SGD

FX markets have been driven more by sentiment than macro factors over the opening weeks of this year. In this past week, sentiment took another turn for the worse, weighing on many of the region's currencies. While sentiment may continue to influence the region's FX until the macro landscape is clearer, our strongest views remain further weakness in the TWD, KRW and SGD, but stability of the CNY over the next 12 months.

After worse-than-expected Taiwanese GDP data, we have notably revised our USD/TWD forecasts and see the cross trading at 36, 35.50 and 34.50 in 3, 6 and 12 months. Our new path envisages that the TWD will reach multi-decade levels of weakness against the USD. Taiwanese financial conditions remain tighter than the rest of the region, largely because of a relatively more stable exchange rate. A weaker exchange rate and easier financial conditions would be a positive factor for growth. As Enoch Fung notes in his article, *Taiwan: 4Q2008 GDP slump; downgrading our already-below-consensus forecast*, on page 7 of this publication, the central bank is likely to smooth out adjustments in the exchange rate, therefore the move from the current spot is more likely to take a steady rather than a one-off adjustment.

The recent weakness in the exchange rates has occurred in conjunction with foreign selling of Taiwanese equity. Indeed, according to the most timely data, Taiwan recorded the largest foreign selling of domestic equity in the region outside of Japan in the year to date. This has further deteriorated the country's broad balance of payments position and leaves the currency vulnerable.

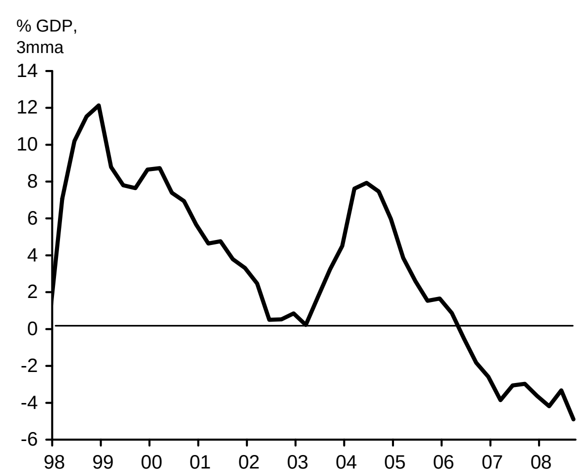
Despite being the only Asian country to receive net equity inflows this year (according to the most timely data), Korea has seen its currency steadily depreciate since the start of the year. We have long held the view that the KRW would weaken to 1450, and after surpassing that target, the KRW has marched swiftly towards 1500 once again. Part of the KRW weakness is fundamental, namely that the macro backdrop has deteriorated, as Goohoon Kwon illuminates in his article, *Korea: Near-term balance of payment outlook points to further pressure on the KRW*, on page 10 of this publication, the current account is likely to sink into deficit in 1Q2009 on the back of declining exports and temporarily resilient imports. This deterioration more than offsets the better foreign buying of Korean equity recorded in the year to date. Thus Korea's broad balance of payments position remains in a fragile position.

The unwinding of currency hedges by the export sector, particularly shipping companies has also been a factor in weakening the KRW, the currency remains vulnerable to this influence at present as many of the option structures put in place are due to expire in 1H2009.

The KRW is also likely to be suffering under the vagaries of global sentiment. The 'risk on' rally towards the end of 2008 saw the KRW appreciate by 16% versus the USD despite deteriorating domestic news. When we surveyed our clients at our macro conference in Hong Kong, most thought that the KRW would likely respond more to global sentiment than domestic factors. If global growth or more specifically Asian growth picks up strongly, the KRW may benefit. In that regard the JPY/KRW cross looks stretched. However, until it is clear that global sentiment has turned, the KRW is likely to remain under weakening pressure.

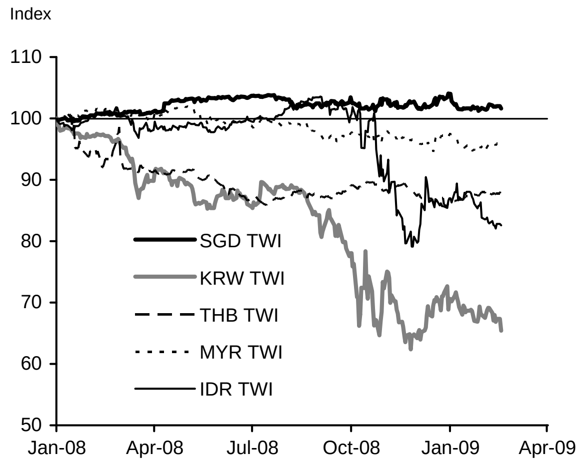
We have long held the view that the SGD needs to weaken further in order to ease financial conditions in Singapore which remain tight in comparison to the rest of the region and in light of the notable downturn in the economy. There is a chance that the authorities choose to move the band before the next meeting in April. However, if they do not, the re-centering of the band lower is likely to be a larger move than usual. As it stands, USD/SGD has rapidly moved towards our 3-month target of 1.56 in recent weeks in conjunction with the broader USD move. Our bias is to remain short the currency.

Exhibit 1: Korean BBoP remains in notable deficit



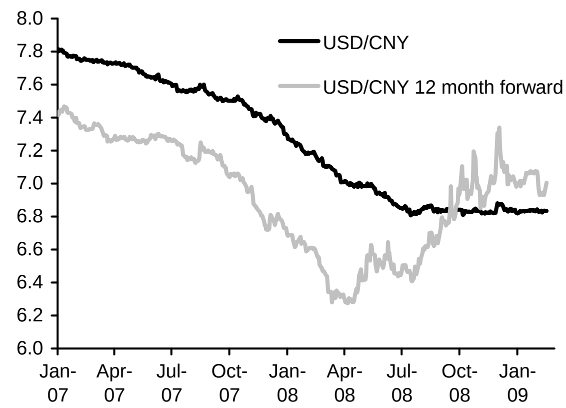
Source: CEIC, GS Global ECS Research.

Exhibit 2: SGD remains stronger than the rest of Asia ex Japan



Source: GS Global ECS Research.

Exhibit 3: Market pricing less CNY depreciation in 12 months



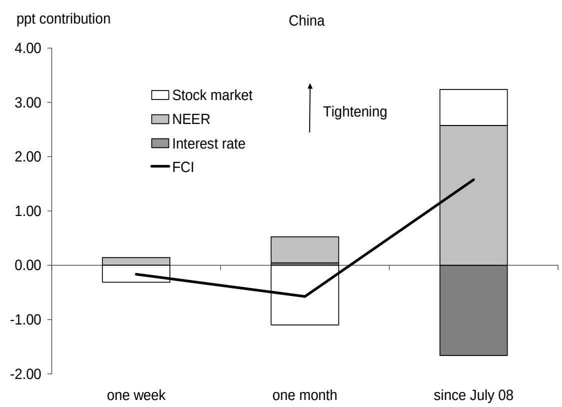
Source: GS Global ECS Research.

We continue to expect the CNY to remain stable versus the USD over the next 12 months. The chance of depreciation is unlikely despite the weak data, largely due to the likely howls of protest from the US and it is not clear how beneficial such a move would be unless it was large. The forwards rapidly reduced the amount of expected future depreciation for the CNY after the Chinese New Year holiday and now price in only limited weakness over the next 12 months. There is still scope for the forwards to further lower the expectation of depreciation over the next 12 months, however, that is a tough risk reward trade. Any deterioration in the news out of China is likely to cause the forwards market to price in a greater degree of CNY depreciation.

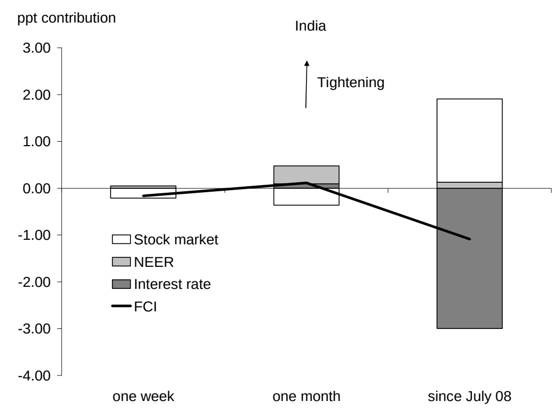
Fiona Lake

Appendix: FCI contribution charts for Asia ex Japan

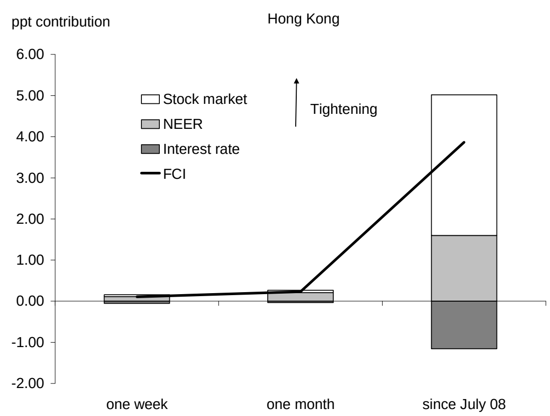
This section tracks the tightening of financial conditions in the region as measured by the Financial Conditions Index (FCI) that we have constructed for each country. The charts below show the contribution to the tightening/loosening of the FCI by the subcomponents of interest rates, nominal effective exchange rates (NEER) and equity markets (for more detail, please refer to *Financial conditions tightening in Asia—further policy responses needed to mitigate additional downside risks*, Asia Economics Flash, November 14, 2008).



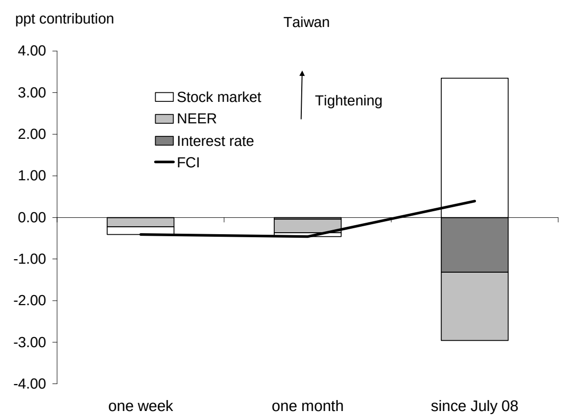
Source: Bloomberg, CEIC, GS Global ECS Research.



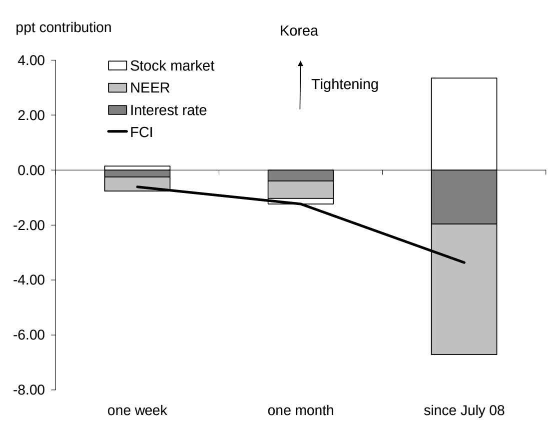
Source: Bloomberg, CEIC, GS Global ECS Research.



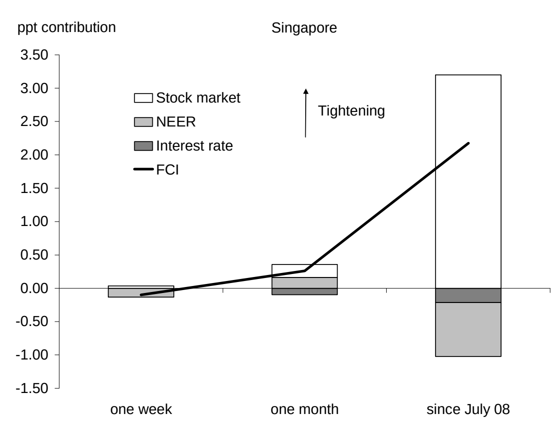
Source: Bloomberg, CEIC, GS Global ECS Research.



Source: Bloomberg, CEIC, GS Global ECS Research.

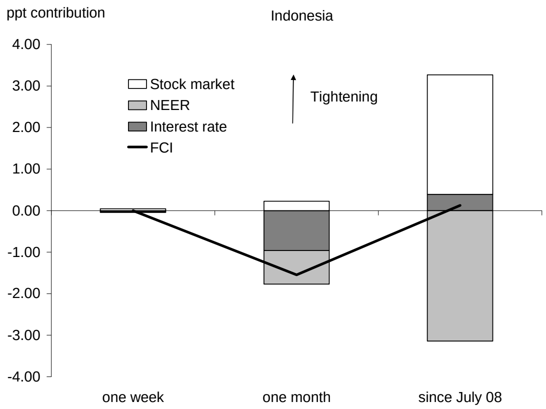


Source: Bloomberg, CEIC, GS Global ECS Research.

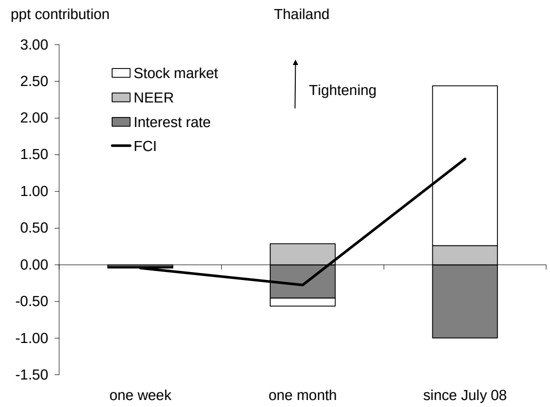


Source: Bloomberg, CEIC, GS Global ECS Research.

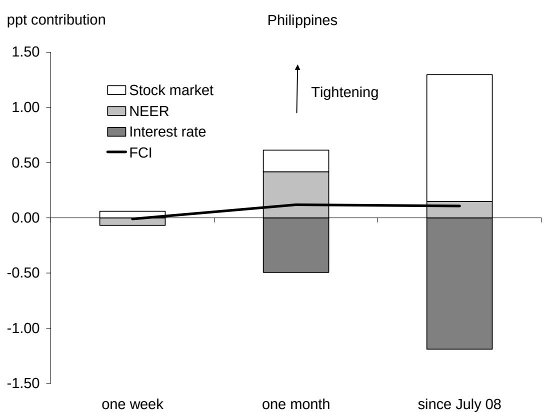
Appendix: FCI contribution charts for Asia ex Japan…continued



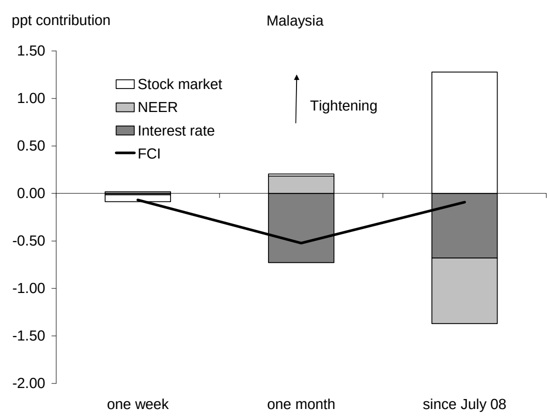
Source: Bloomberg, CEIC, GS Global ECS Research.



Source: Bloomberg, CEIC, GS Global ECS Research.



Source: Bloomberg, CEIC, GS Global ECS Research.

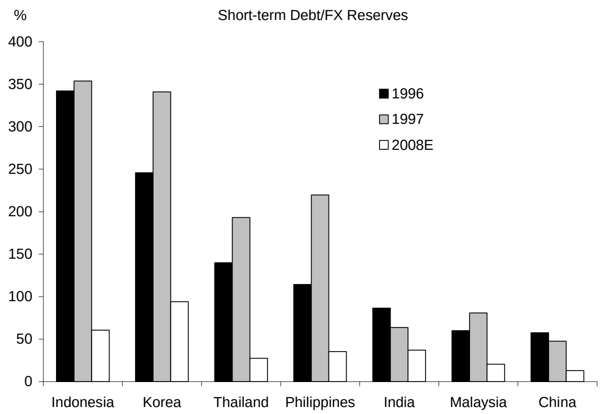


Source: Bloomberg, CEIC, GS Global ECS Research.

Regional Risk Indicators

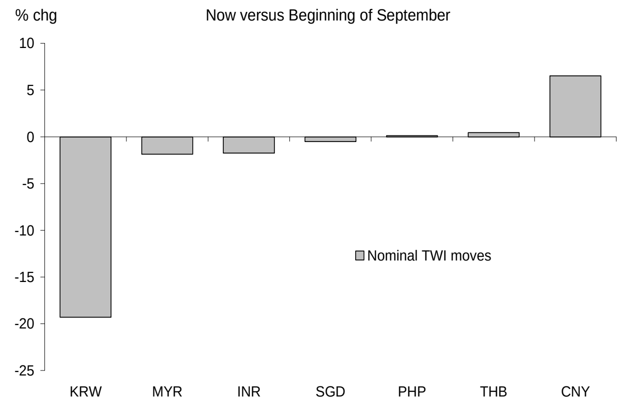
These are the key risk indicators that we continue to keep a close eye on amidst the ongoing global financial crisis, as discussed in our Asia Economics Analyst 08/20 issue published on October 27, 2008. Going forward, we will continue to provide updates on these key metrics.

Short-term debt: Much improved but Korea a touch more exposed than others



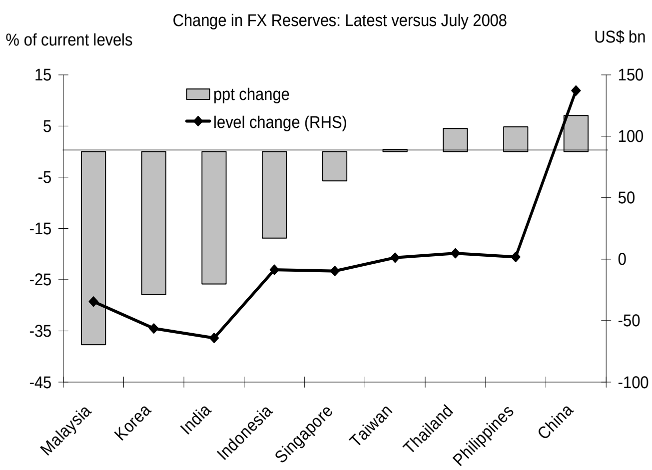
Source: IIF, IMF, GS Global ECS Research.

The KRW has fallen most despite intervention



Source: GS Global ECS Research.

Reserves under pressure in Korea, India and Malaysia



End January or latest data for all countries.
Source: CEIC, GS Global ECS Research.

Short-term credit indicators worsening in AEJ

%	Policy rate	3m OIS	3m bank borrowing	Short corp borrowing rate	3m T bills	3m Deposit rates	3m bank and policy spread	Corporate-policy rate spread	Corporate and 3m bank spread
China	2.25	-	1.3	5.3	1.0	1.7	-0.96	3.1	4.02
Hong Kong	-	0.2	0.8	5.0	0.1	0.5	-	-	4.23
Singapore	-	0.4	0.7	4.3	0.3	0.4	-	-	3.56
Taiwan	1.25	-	0.1	3.9	0.1	0.5	-1.11	2.7	3.77
Malaysia	2.50	-	2.6	6.0	2.4	2.6	0.07	3.5	3.38
Thailand	2.00	-	2.2	6.5	1.5	1.3	0.16	4.5	4.34
Korea	2.50	-	2.6	3.0	2.6	1.9	0.08	0.5	0.40
Philippines	7.00	-	5.3	9.4	4.6	3.9	-1.75	2.4	4.13
India	5.50	3.9	7.0	12.5	4.7	3.7	1.50	7.0	5.50
Indonesia	8.25	-	9.9	14.0	9.2	8.6	1.65	5.7	4.08

Short bank rates: China: SHIBOR; Hong Kong: 3-month HIBOR, CEIC, Indonesia: 3-month JIBOR, Korea: 3-month certificate of deposit, Malaysia: 3-month KLIBOR, Philippines: 3-month PHIBOR, Singapore: 3-month SIBOR, Taiwan: 31-90 day commercial paper, Thailand: 3-month BIBOR, India: 3-month MIBOR.

Policy rates: China: 1-year deposit rate, Indonesia: 1-month SBI rate, Korea: 7-day repo, Malaysia: overnight policy rate, Philippines: repo rate, Taiwan: rediscount rate, Thailand: 1-day repo, India: repo rate.

Short-term corporate borrowing rate: China: 1-year lending rate; India: Prime LR, Korea: 6-month corp bond; Singapore: PLR, Malaysia: Base LR, Indonesia: Base LR; Thailand: Min LR; Taiwan: Base LR; Hong Kong: Best LR.

Source: Bloomberg, CEIC, GS Global ECS Research.

External and fiscal stresses vary widely

	Current Account as % of GDP (2008F)	Fiscal balance as % of GDP (2008F)	FX reserves: Latest (US$ bn)	FX reserves: change from July 2008 (US$ bn)	FX reserves: Change from July 2008 (% of current levels)
China	8.0	-0.3	1946	137	7.1
India	-3.5	-10.1	248	-64	-25.8
Korea	-0.7	2.3	202	-56	-27.9
Taiwan	6.4	-0.8	293	1	0.4
Singapore	12.5	-1.2	167	-10	-5.7
Malaysia	14.0	-4.3	91	-34	-37.7
Indonesia	0.0	-1.8	51	-9	-16.9
Thailand	-0.1	-2.4	108	5	4.5
Philippines	0.8	-0.8	38	2	4.8

Source: CEIC, GS Global ECS Research.

Statistical Appendix

Interest Rate Outlook

(%)		Current	3-Month Horizon		6-Month Horizon		12-Month Horizon	
		Feb 18	Forward	Forecast	Forward	Forecast	Forward	Forecast
Japan	3M	0.70	0.60	0.70	0.50	0.60	0.50	0.50
NJA								
ASEAN								
Indonesia	3M	9.90	10.63	10.00	10.67	9.50	10.91	9.50
Malaysia	3M	2.60	2.54	2.50	2.52	2.00	5.48	1.50
Philippines	3M	4.30	4.78	4.00	4.75	3.50	4.84	3.50
Thailand	3M	2.16	2.25	2.00	14.78	1.00	18.59	1.00
Singapore	3M	0.69	0.82	1.00	1.02	1.50	1.11	2.00
China	3M	0.97	NA	NA	NA	NA	NA	NA
India	3M	4.65	4.50	5.00	4.50	4.80	4.50	4.50
NIE								
Hong Kong	3M	0.78	1.48	1.50	1.78	1.50	2.07	1.50
Korea	3M	2.56	2.57	2.90	2.58	2.55	3.00	2.73
Taiwan	3M	0.70	0.89	0.50	0.46	0.50	0.77	0.50

Hong Kong: 3M HIBOR, CEIC, Bloomberg (GINAY91), **India:** 91D T-bill, **Indonesia:** 3M JIBOR, CEIC, **Korea:** 3M certificate of deposit, CEIC, **Malaysia:** 3M KLIBOR, CEIC, **Philippines:** 3M T-bill, CEIC, **Singapore:** 3M Interbank, CEIC, **Taiwan:** 61-90D New Taiwan dollar, Secondary, Bloomberg (NTSEC90), **Thailand:** 3M BIBOR, GS estimates, **China:** 3M PBOC Bill yield.

Exchange Rate Outlook

(Local per USD)	Current	3-Month Horizon		6-Month Horizon		12-Month Horizon	
	Feb 18	Forward	Forecast	Forward	Forecast	Forward	Forecast
Japan	90.6	90.0	90.0	89.7	90.0	89.2	90.0
NJA							
ASEAN							
Indonesia	12,050	13,220	13,500	14,120	13,000	14,950	13,000
Malaysia	3.66	3.69	3.65	3.70	3.55	3.72	3.45
Philippines	47.81	49.29	51.00	49.79	50.00	50.79	50.00
Thailand*	35.48	35.54	35.50	35.55	36.50	35.56	36.50
Singapore	1.53	1.53	1.56	1.53	1.60	1.53	1.52
China	6.84	6.88	6.87	6.90	6.87	6.96	6.87
India	50.00	50.98	50.50	51.47	48.00	52.20	46.90
NIE							
Hong Kong	7.76	7.75	7.80	7.75	7.80	7.74	7.80
Korea	1,473	1,469	1,450	1,459	1,400	1,428	1,300
Taiwan	34.64	34.72	36.00	34.67	35.50	34.46	34.50

* Forecasts are for onshore Thai baht.

Global Macroeconomic Outlook

					2008				2009				2010			
	2007	2008E	2009E	2010E	1Q	2Q	3QE	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE
Real GDP Growth (% yoy)																
Advanced Economies	2.7	1.0	-2.1	1.4	2.6	1.9	0.8	-1.2	-2.6	-2.9	-2.4	-0.4	0.8	1.3	1.6	1.9
United States	2.0	1.3	-1.8	1.3	2.5	2.1	0.7	-0.2	-1.5	-2.5	-2.1	-0.9	0.6	1.2	1.5	1.7
Euroland	2.6	0.7	-1.9	1.2	2.1	1.4	0.6	-1.2	-2.5	-2.6	-2.2	-0.5	0.5	1.2	1.5	1.8
Japan	2.4	-0.7	-4.6	0.4	1.5	0.7	-0.2	-4.6	-6.0	-5.4	-5.1	-1.7	-0.3	0.2	0.7	1.1
CPI Inflation (% yoy, avg.)																
Advanced Economies	2.2	3.4	-0.1	1.3	3.4	3.7	4.4	2.2	0.6	-0.2	-1.0	0.4	1.4	1.4	1.3	1.2
United States	2.9	3.8	-0.8	0.8	4.2	4.3	5.3	1.5	-0.3	-1.0	-2.2	0.4	1.4	1.0	0.6	0.4
Euroland	2.1	3.3	0.2	1.9	3.4	3.6	3.8	2.3	0.8	-0.1	-0.4	0.6	1.8	2.0	2.0	1.9
Japan	0.1	1.5	-0.7	-0.1	1.0	1.4	2.4	1.1	0.2	-0.5	-1.6	-1.0	-0.6	-0.1	0.1	0.3
Interest Rates (% p.a. eop.)																
Fed funds	4.25	0.13	0.13	0.13	2.25	2.00	2.00	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
UST 10-year	4.03	2.25	2.90	3.50	3.43	3.98	3.82	2.25	2.50	2.70	2.80	2.90	3.00	3.20	3.40	3.50
Euro yield 10-year	4.33	2.94	3.00	3.60	3.90	4.58	4.01	2.94	2.60	2.70	2.90	3.00	3.10	3.20	3.40	3.60
Exchange Rates (eop.)																
USD/EUR	1.46	1.39	1.45	1.45	1.58	1.57	1.41	1.39	1.30	1.40	1.43	1.45	1.45	1.45	1.45	1.45
JPY/USD	113.1	96.0	90.0	90.0	105.2	104.5	107.6	96.0	90.4	90.0	90.0	90.0	90.0	90.0	90.0	90.0
WTI Oil (average $)	72.4	99.7	45.0	70.0	97.9	123.8	118.0	59.1	30.0	40.0	50.0	60.0	70.0	70.0	70.0	70.0

Central Bank Watch

Country	Likely Decision / Reasons	Date of Next Policy Meeting
UNITED STATES	The Federal Reserve cut the Fed Funds rate to a range of 0%-0.25% on December 16, 2008. We expect the Fed to keep the Fed Funds rate near 0% through the end of 2010.	March 17
JAPAN	The Bank of Japan cut the overnight call rate by 20 bp to 0.10% on December 19, 2008. We expect the Bank of Japan to keep the policy rate at 0.10% through 2010.	March 16/17
EUROLAND	The European Central Bank cut rates by 50 bp to 2.0% on January 15, 2009. We expect the European Central Bank to cut rates to 0.50% by 3Q2009.	March 5

Main Economic Indicators

	GDP						Inflation					
	2007	2008E	2009E	2010E	Latest	(yoy)	2007	2008E	2009E	2010E	Latest	(yoy)
Pan Asia*	8.4	5.2	2.2	5.5	5.5	(3Q)	3.4	5.7	0.5	1.8	3.0	(Dec)
NIE + ASEAN	6.0	3.5	(0.5)	3.4	3.6	(3Q)	3.4	7.0	2.7	2.6	5.6	(Dec)
ASEAN	6.4	5.0	1.4	3.7	4.8	(3Q)	4.3	9.3	4.0	3.6	7.8	(Dec)
Indonesia	6.3	6.1	3.0	4.6	5.2	(4Q)	6.4	10.3	6.0	4.8	9.2	(Jan)
Malaysia	6.3	5.0	1.7	3.2	4.7	(3Q)	2.0	5.4	2.1	3.0	4.4	(Dec)
Philippines	7.2	4.6	0.4	3.2	4.5	(4Q)	2.8	9.3	4.6	5.0	7.1	(Jan)
Thailand	4.9	4.1	(0.8)	1.4	4.0	(3Q)	2.2	5.5	0.1	2.2	0.4	(Dec)
Singapore	7.7	1.2	(4.0)	2.5	(3.7)	(4Q)	2.1	6.5	1.1	1.3	4.3	(Dec)
Vietnam	8.5	6.2	5.5	6.8	5.7	(4Q)	8.3	23.1	10.0	3.0	17.5	(Jan)
Japan	2.4	(0.7)	(4.6)	0.4	(4.6)	(4Q)	0.1	1.5	(0.7)	(0.1)	0.4	(Dec)
China	13.0	9.0	6.0	9.0	6.8	(4Q)	4.8 #	5.9	(0.5)	1.0	1.0	(Jan)
India (FY Basis)	9.0	6.7	5.8	6.6	7.6	(3Q)	4.6	8.8	1.0	4.5	5.2	(Jan)
NIE	5.4	1.8	(3.0)	3.1	2.0	(3Q)	2.2	4.3	1.0	1.4	3.0	(Dec)
Hong Kong	6.4	2.5	(3.0)	3.5	1.7	(3Q)	2.0	4.3	0.4	(1.5)	2.1	(Dec)
Korea	5.0	2.5	(1.0)	3.1	(3.4)	(4Q)	2.5	4.7 #	2.0	2.5	3.8	(Jan)
Taiwan	5.7	0.1	(6.5)	3.0	(8.4)	(4Q)	1.8	3.5	(0.4)	0.5	1.6	(Jan)

	3 M Interest Rates					Exchange Rates				
ASEAN										
Indonesia	8.0	12.1	9.5	9.5	9.9	# 9419	10950	13000	12000	12050
Malaysia	3.6	3.4	1.5	1.5	2.6	# 3.31	3.46	3.45	3.45	3.66
Philippines	3.7	6.1	3.5	3.5	4.3	# 41.4	48.4	50.0	45.0	47.8
Thailand	3.9	3.0	2.3	2.3	2.2	# 33.7	35.0	36.5	36.5	35.5
Singapore	2.4	1.1	2.0	2.0	0.7	# 1.44	1.44	1.52	1.52	1.53
Vietnam	—	—	—	—	—	15995	17380	19200	19200	17483
Japan	0.9	0.7	0.5	0.5	0.7	113.1	96.0	90.0	90.0	90.6
China	—	—	—	—	—	7.30	6.84	6.85	6.65	6.84
India	7.2 #	5.0	4.3	5.0	4.7	40.0 #	50.5	46.7	45.7	50.0
NIE										
Hong Kong	3.3	1.0	1.5	1.5	0.8	7.80	7.75	7.80	7.80	7.76
Korea	5.8	3.9	2.7	3.4	2.6	938	1258	1300	1100	1473
Taiwan	2.0	1.1	0.5	0.5	0.7	32.4	32.9	34.5	34.5	34.6

*Pan Asia includes India.

GDP and inflation are annual averages. Interest rates and exchange rates refer to end-period. Figures in bold indicate recent revisions.

Hong Kong: 3M HIBOR, CEIC, Bloomberg (GINAY91), **Indonesia**: 3M JIBOR, CEIC, **Korea**: 3M certificate of deposit, CEIC, **Malaysia**: 3M KLIBOR, CEIC, **Philippines**: 3M T-bill, CEIC, **Singapore**: 3M Interbank, CEIC, **Taiwan**: 61-90D New Taiwan dollar, Secondary, Bloomberg (NTSEC90), **Thailand**: 3M BIBOR, CEIC. **India:** 91 D T-bill

Asia in a Nutshell

	Present Situation	Key Issues
CHINA	We acknowledge there are some upside risks to our current GDP growth forecast of 6.0% for 2009, given the recent rebound in money and credit growth. January CNY loans growth accelerated strongly to 21.3% yoy in January from 18.8% yoy in December. New CNY loans extended came in at Rmb1.62 trillion, more than double the previous record of Rmb803 billion in January 2008. In addition, we expect the Chinese government to continue to loosen policies on the back of continued weakness in activity growth and rising deflationary pressures.	The acceleration in public investment projects and other government initiatives to help boost growth in the short term may likely add to the upside risks to our forecasts. However, downside risks from weaker external demand, a less enthusiastic response from private sector investment and a possible deceleration in credit growth after February also help balance our views. Therefore, we maintain our full-year forecast on real GDP growth of 6.0% yoy for 2009 and continue to expect the sequential growth momentum to pick up in 2Q2009.
HONG KONG	Headline CPI inflation continues to trend downwards. After netting out the effects of various one-off fiscal measures like the electricity charge subsidy and rates concessions. CPI inflation came in at 4.6% yoy in December, easing from the 5.6% yoy seen in November (before netting out the effects of these one-off measures, the official CPI inflation reading was 2.1%). The slowdown in inflation is notable across most major components of the CPI.	We continue to see GDP growth to slow to -3.0% in 2009, and private consumption growth to slow to -2.8%, from 1.9% in 2008. Our -3.0% GDP growth forecast for 2009 is substantially below the consensus of -1.3%. We also expect labor demand to weaken further, pushing the unemployment rate towards 6.5% by 2010, and continuing to weigh down on consumption.
INDIA	The Industrial Production Index fell by 2% yoy in December from a revised 1.7% yoy growth in November. Other indicators of activity such as the PMI, exports growth, tax revenues, tourism revenues and motor vehicle sales have also shown a contraction in December and are slated to be weak in January as well. We continue to expect activity to slow considerably in the second half of FY09, after growing by 7.8% in the first half.	We think that the WPI and CPI will fall significantly going forward and the RBI needs to take account of this. Already, the wholesale price levels are showing absolute declines unprecedented since the start of the series in 1988. We think that deflation will be a much bigger risk for the economy in the rest of 2009. We continue to maintain our growth forecasts of 6.7% for FY09, 5.8% for FY10, and our average WPI inflation forecast of 1% in FY10.
INDONESIA	Indonesia 4Q2008 real GDP growth came in at 5.2% yoy. For 2008 as a whole, GDP grew by 6.1%. We expect GDP growth to slow from 6.1% in 2008 to 3% yoy in 2009, which is well below the consensus forecast of 3.9%. We expect growth to deteriorate due to: 1) a weaker external demand environment; 2) a more negative terms-of-trade effect, resulting from lower commodity export prices; and 3) tighter financial conditions.	Given the deteriorating growth outlook, we continue to expect a further 75 bp in rate cuts by the central bank by mid-2009, bringing the policy rate to 7.50%. We believe the increasingly evident downtrend in inflation also adds confidence and credibility to this monetary easing cycle. However, BI is likely to keep a watchful eye on the IDR, given Indonesia's high pass-through from exchange rate depreciation to inflation. Any additional cuts above 75 bp will depend on the IDR.
KOREA	We maintain our 2009 current account forecast, which envisages a surplus of US$13 billion. Despite projected double-digit declines in exports in 2009, we believe that the annual balance will likely be positive due to falling commodity prices, lower import demands, and the effects of a weaker KRW on imports of services. Even in the event of weaker-than-expected exports in 2009, its impact on the current account would likely be muted considerably, in our view, given that commodity prices would likely accompany export declines and nearly 40% of imports are used for exports.	The BOK cut its policy rate by 50 bp on February 12 to 2.00% p.a. We reiterate our view that the BOK will likely pause soon. Room for further flexibility in monetary policy is somewhat limited in the case of Korea in our view, given a still weak external balance and the risk of destabilizing the currency markets. Besides, the stimulus effects of further rate cuts are increasingly tapering off in our view, given the scale and pace of rate reductions so far. We hence expect the BOK to pause in the next meeting while not ruling out a 25-bp cut. For the year as whole, we think that the BOK could push rates down to 1.50%, through successive modest reductions in 2Q2009.

Asia in a Nutshell (Cont'd)

	Present Situation	Key Issues
MALAYSIA	December inflation moderated to 4.4%, from 5.7% in November. We currently forecast GDP growth to slow to 1.7% (versus the government's forecast of 3.5%), from 5% in 2008. Both domestic demand and exports will likely slow more, and on the latter, quite a lot more than the consensus currently expects given the negative terms-of-trade shock from declining commodity prices. The central bank's larger-than-expected 75-bp rate cut on January 21 clearly signals the authorities' intent to respond to a rapidly deteriorating growth outlook.	We expect BNM to follow up with an additional 100 bp in cuts to bring the overnight policy rate to 1.50% this year. We also think that to pursue an easier monetary stance now would be appropriate for Malaysia as unlike some countries in the region, its huge current account buffer would afford them the room to cut rates, without the fear of triggering currency weakness and higher inflation expectations.
PHILIPPINES	Philippines headline CPI inflation eased further to 7.1% yoy in January, from 8.0% yoy in December. It is likely that non-core inflation will bring down core inflation even further. Overseas Foreign Workers' remittances grew 0.8% yoy in December, which is the slowest growth pace since April 2006. Looking forward, we believe flows will be less PHP supportive, as we expect remittances growth to slow in the coming quarters on a slowing global economy.	We continue to expect the growth momentum to slow in the coming quarters. This should be led by weakening consumption as remittances growth moderates while exports are also expected to slow further. Our 2009 GDP growth forecast stands at 1.8% (consensus at 3.6%) which is also below the government's recently-revised forecast range of 3.7%-4.7%. We expect another 100 bp in reductions to the policy rates as inflation and growth continue to slow.
SINGAPORE	Singapore's January non-oil domestic exports fell sharply again by 34.8% yoy, following the sharp decline of 20.8% yoy previously. Retail sales fell by 1.6% in December, following a 3.4% yoy drop in November. We maintain our GDP growth forecast of -4.0% for 2009, which is the lowest in the region, and below the consensus forecast of -3.3%. We believe the intensifying macro headwinds will likely hamper the effectiveness of the fiscal boost to the economy.	We recognize that currently, there is still room within present settings for the SGD NEER to weaken, even without an explicit policy shift. We believe the falling inflation will also not pose any obstacle to monetary easing and we still expect a downward re-centering of the policy band in April. For now, we maintain our USD/SGD forecasts of 1.56, 1.60 and 1.52 on 3, 6 and 12-month horizons.
TAIWAN	4Q2008 GDP growth slowed to -8.4% yoy, from -1.1% yoy in 3Q2008. The synchronized sharp drop in exports, imports and investments again highlights the significant dependency of the investment cycle on exports demand, and the high import contents of exports. We are revising down our GDP growth forecast to -6.5% for 2009, from our already-below-consensus GDP growth forecast of -3.0%. The government has also revised its annual GDP growth forecast for 2009 to -3.0% yoy from 2.1% yoy.	We are revising our USD/TWD forecasts to 36, 35.5 and 34.5 on 3, 6 and 12-month horizons. The new forecasts imply a weaker path then the forwards, and a modest depreciation on a trade-weighted basis. Capital flows will likely be the main driver for the TWD, which is a function of the market's assessment of growth risks. Given the downside surprise in the growth momentum in the near term, we believe the capital flows will turn less supportive of the TWD in the near term.
THAILAND	As we have been highlighting, the focus of the BOT is firmly on alleviating the slowdown in growth, exacerbated by the political turmoil that had gripped the country over the past few years. While the political situation seems to have stabilized, with some encouraging results for the current government from the recent by-elections, there is little doubt that the domestic demand growth impulse will still be very weak this year, providing little offset to the external slowdown.	We are forecasting GDP growth to slow to -0.8% in 2009 (from 4.1% in 2008). Meanwhile, inflation is falling fast and is likely to remain subdued in the coming quarters. It was thus likely, in our opinion, that the BOT would favor front-loading its rate cuts, as has been the trend among other central banks in the region. It is clear from their 75-bp rate reduction on January 14 that the BOT is in favor of a swifter monetary response, to complement the Bt115 billion stimulus package that the government is planning for this year.

Key Things to Watch

A series of central bank policy meetings, production and growth data in the coming fortnight. In the US, ISM and durable goods would reflect renewed weakness in the manufacturing sector, while the payrolls report would emphasize the ongoing weakness in the labor market. For Asia, Taiwan export orders and Korea capex, consumption and trade data will demonstrate the speed in which both external and domestic demand is slowing. In the rest of Asia, central bank policy meetings in Indonesia, Malaysia and Thailand may all have more cuts to offer.

US S&P/Case Shiller Home Price Index (Dec) (Feb 24) Durable goods orders (Jan) (Feb 26) GDP annualized (4Q P) (Feb 27) ISM (Feb) (Mar 2) Non-farm payrolls (Feb) (Mar 6) Unemployment (Feb) (Mar 6)	Renewed weakness in the manufacturing sector? ▪ The very weak January industrial production report and various manufacturing surveys all point to renewed weakness in the manufacturing sector. Both the ISM and durable goods report would likely show significant declines. ▪ S&P/Case Shiller: the current level of excess supply, low sales volumes, and persistence of past home price trends point to further home price declines. Our US economists expect the Case-Shiller Index to fall another 20%-25% through mid-2010. ▪ Payrolls/unemployment: as initial claims remain over 600,000 and continuing claims climbing yet higher, further job losses are yet to be seen. Our US economists expect the unemployment rate to climb to 9.5% by the end of 2010.
Korea Industrial production, capex and consumption indicators, construction orders (Jan) (Mar 2) CPI (Feb) (Mar 2) Trade (Feb) (Mar 2)	Another steep decline in exports? ▪ We expect exports to contract further after falling 32.8% yoy in January. In face of a global recession, we expect a decline in real exports of goods and services by 17% yoy in 1H2009, and a relatively limited decline of 5% yoy in 2H2009. ▪ Industrial production in January is also likely to continue its fall, after declining sharply by 9.7% yoy in December, given the flagging momentum in exports and domestic demand.
Taiwan Export orders (Jan) (Feb 24) Industrial production (Jan) (Feb 24) CPI (Feb) (Mar 5)	Further deterioration in the exports and growth outlook? ▪ We expect export orders to point to further deterioration in the exports outlook, following the sharp 33.0% yoy fall in December, ▪ We have recently downgraded our GDP growth forecast to -6.5% for 2009, from our already-below-consensus forecast of -3.0%. We have also revised our USD/TWD forecasts to 36, 35.5 and 34.5 on 3, 6 and 12-month horizons.
Hong Kong CPI (Jan) (Feb 23) GDP (4Q) (Feb 25) Budget speech (Feb 25) Retail sales (Jan) (Mar 2)	A bold budget to buffer against the economic downturn? ▪ We forecast 4Q GDP growth to be -2.5% yoy, after coming in at +1.7% yoy in 3Q, with risks to the downside. Going into 2009, we see GDP growth slowing to -3.0% (vs. consensus expectation of -2.1%), and unemployment rate rising to 6.5% by 2010. ▪ We expect the Financial Secretary's budget speech to focus on generating employment, expanding infrastructure investment and supporting low-income groups.
Indonesia CPI (Feb) (Mar 2) Central bank policy meeting (Mar 4)	Moderating inflation gives way for more policy easing? ▪ Yes. With inflation moderating, growth concerns increasing and high real interest rates, we believe Bank Indonesia can continue its easing stance. We expect the central bank to cut rates by 50 bp in the upcoming meeting. A 25-bp cut is also likely given the recent volatility seen in its currency.
Singapore CPI (Jan) (Feb 23) Industrial production (Jan) (Feb 26)	Another decline in industrial production? ▪ Very likely. The manufacturing sector remains weak in the face of rapidly deteriorating external and domestic demand. We expect industrial production to fall further, after declining sharply by 13.5% yoy in December.
Malaysia GDP (4Q) (Feb 27) Central bank policy meeting (Feb 24) Exports (Jan) (Mar 6)	Rate cut in store? ▪ We expect 4Q GDP growth to slow to 1.5% yoy from 4.7% yoy in 3Q. We currently forecast GDP growth to slow to 1.7% (versus the government's forecast of 3.5%), from 5% in 2008. ▪ With growth slowing and inflation risks receding, we expect Bank Negara Malaysia to cut rates by 50 bp in the upcoming meeting.

Additional things to watch: **Philippines CPI (Feb)** (Mar 5); **central bank policy meeting** (Mar 5); **fiscal budget (Dec)** (Feb 24), **Thailand central policy meeting** (Feb 25); **manufacturing production** (Feb 27); **CPI** (Mar 2).