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China: challenges to policy response to slowing economy
Indonesian economy: Downbeat picture - weaknesses on all fronts

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China visit notes: Near term risks higher than expected

- Our recent visit left us more aware of the tremendous long term strengths of the Chinese economy but also more concerned about the near term economic and political risks.
- The long-term drivers of transformation are well in place in China – its investment in human capital is paying off in the form of innovation and high-value entrepreneurship.
- But the near term trends are more worrying than we had assumed. Recent data on employment creation, non-performing loans and corporates' willingness to invest point to further slowing in economic growth.
- Policy support is still likely to prevent a serious slowdown but policy is facing some challenges as well. In particular, the anti-corruption campaign has created so much fear in bureaucrats that approvals for projects are slow, stalling some of the fiscal stimulus.

Indonesian economy: Downbeat picture – weaknesses on all fronts

- Weak indicators and growth drivers do not paint a positive picture for the Indonesian economy which posted 4.7% y/y growth in 1Q15.
- Exports have contributed heavily to the slowdown with expected widening of the current account deficit looking to increase the vulnerability of the economy.
- Policies are being made in the right direction to rein in inflation, but without hard hitting pre-emptive reforms, weaknesses in the economy are likely to persist.

Key Drivers of Asian Economies

Variable	Development/Assessment
US economy strengthens, Fed on course to tighten by September	
US economy	Labour market strength suggests upside surprises in growth in 2H15 ▪ Non-farm payrolls grew 280,000 in May, up from 221,000 in April. While the unemployment rate edged up to 5.5% from 5.4%, the reason was a small rise in labour force participation, which is a good sign. Wage growth of 2.3% y/y in April was also solid. ▪ The data not only shows that the US economy is overcoming its early 2015 weakness. It also suggests that the negative impact of oil prices (driving down mining employment) is now being offset by the positive impact of lower oil costs, as employment in the non-oil sectors more than offsets the continued fall in mining jobs. Beige Book shows the American economy on its way to recovery ▪ The employment data is consistent with the findings of the Beige Book: 7 out of 12 districts registered modest or moderate growth, leading the Fed to conclude that "overall economic activity expanded" between early Apr 15 and late May 15. ▪ However, the Beige Book also noted that the strong dollar and low oil

Variable	Development/Assessment
	prices were a drag on some regions, with 5 out of 12 districts noting a negative impact on export sales. Other data suggest a stronger US economy ▪ ISM manufacturing and non-manufacturing PMIs indicated good growth, with new orders rising in most sectors. Construction spending soared 2.2% in April, from 0.5% in March. However, capital spending remained lacklustre. ▪ Non-farm productivity has fallen 3.1% q/q in 1Q15, pointing to an increase in labour-related production costs which could spur inflationary pressures.
Fed policy	Despite IMF urging Fed to delay, monetary normalisation now likely ▪ IMF Managing Director Christine Lagarde unprecedentedly called on the Federal Reserve to delay raising interest rates until 1H16, warning that a premature rate hike had far felt consequences especially in emerging markets. Several Federal Reserve governors also spoke in the past week, signalling a preference for a cautious pace of monetary normalisation. For example, governors Daniel Tarullo and Lael Brainard expressed reservations about the true strength of the recovery from the contraction in 1Q15 while Rosengren said that he did not see the Fed's unemployment and inflation targets improving to levels necessitating a rate increase anytime soon. ▪ **Implications**: Given the IMF's awkward relationship with the US, it is highly unlikely that the IMF's call will have much bearing on Fed policy. In our view, the balance of opinion within the Fed will shift as the labour market tightening progresses. Unit labour costs are rising and activity indicators suggest an upward drift in growth. We think the Fed is on course for rate life-off by September 2015.
OECD: Global growth weak	OECD lowers growth forecast for 2015 ▪ OECD expects global economic activity to expand at a slower pace in 2015, cutting its forecast to 3.1% from its Nov 14 forecast of 3.7%, mainly because of 1Q15 weaknesses in the US and in many emerging markets. Since the OECD itself believed this 1Q15 weakness was largely due to "transitory disruptions" from one-off events, it does not alter our view of a second half pick-up in global growth. ▪ The OECD also warned that the lack of investment and tepid productivity growth risk crimping economic growth in the longer term.
Eurozone: Greece default a real possibility	No compromise reached, Greece to delay IMF repayments to end-June ▪ The Greek leadership's brinksmanship raises the risk of extreme events involving Greece. Greek PM Tsipras has lashed out at Greece's creditors while ordering a delay in a key debt payment of EUR301mn to the IMF. While Greece does have the legal option of bundling the country's June payments by paying a single EUR1.7bn lump sum at the

Variable	Development/Assessment
	end of June 2015, it is the first time that a developed economy has resorted to this tactic. ▪ With stiff resistance domestically to creditor demands for further reforms and continued austerity, Tsipras has no good options. His government is reported to have accepted tough budgetary targets sought by creditors but is refusing to relent on other issues. Essentially, Greece will be forced to default unless its creditors agree to release EUR7.2bn from Greece's bailout programme. ▪ **Implications**: Investors have generally assumed that a last minute compromise will help avoid a full-blown Greek default and the disorderly exit from the Eurozone that such a move would involve. But the brinksmanship of the Greek government makes some kind of disruptive outcome a bit more possible.
Ukraine-Russia conflict intensifies	Fighting in Ukraine intensifies ▪ Ukrainian and pro-Russian forces clashed in Donetsk on 3 Jun, in one of the bloodiest battles since the Minsk ceasefire began in Feb 15. Monitors from the Organization for Security and Cooperation in Europe (OSCE) reported seeing troops in regular Russian army uniforms in the conflict zone. A Russian troop build-up on the border with eastern Ukraine has alarmed Ukrainian President Poroshenko, who warned of a "full-scale" Russian invasion. ▪ **Implications**: EU leaders will now hesitate about easing sanctions on Russia when sanctions will be reviewed in July. EU President Donald Tusk is pushing for a six-month extension of sanctions. NATO and non-NATO nations in the region have stepped up defensive exercises.
Asian economies	
Korea: MERS outbreak	Economic recovery likely constrained ▪ The outbreak of the Middle East Respiratory Syndrome (MERS) in Korea will scare off tourists. Taiwan has already raised its travel advisory for Seoul and others are likely to follow. Five deaths have been confirmed. ▪ The fall in tourist numbers will weaken domestic consumption and dent business confidence, further exacerbating the slowdown in Korea's economy. ▪ **Implications**: This new drag on growth will add pressure on the BOK to cut rates further.
Malaysia's political troubles mount	1MDB scandal: pressure increases on PM Najib ▪ 1MDB's release of a summary of how its MYR41.8bn debt was used left critics unconvinced, with more questions being asked on what they say are murky transactions. ▪ Feeling the increasing pressure for him to quit, PM Najib issued an ultimatum to his cabinet, asking them to quit if they did not support him. Najib was further criticised when he did not show up to debate

Variable	Development/Assessment
	ex-PM Mahathir at a town hall meeting as planned. PAS elections could spell the end of the opposition coalition ▪ The "Ulama" faction of harder-line religionists made a clean sweep of leadership positions in PAS internal elections. Datuk Seri Abdul Hadi Awang retained his post as the party president while Datuk Tuan Ibrahim Tuan Man, replaced the incumbent deputy president Mohamad Sabu, seen as the leader of the non-Ulama faction of pragmatists who despise the ruling UMNO party and favour a coalition with the secular PKR of Anwar Ibrahim and the mainly Chinese DAP. ▪ While PAS leader Hadi reiterated his commitment to remain in the Pakatan Rakyat (PR) coalition, the resolution passed to cut ties with the DAP and for all party officials to quit their positions in the Penang state government which DAP heads, suggests otherwise. A breakup of the PR is now likely, boosting the ruling party's prospects. ▪ **Implications**: First, the risk of a disorderly ouster of PM Najib have risen but we still believe that he can survive the worst challenge to his rule since he took office in 2009. Second, Najib will benefit from the likely breakup of the PR. He will step up efforts to woo PAS to break away and form some kind of parliamentary agreement with UMNO's Barisan Nasional coalition. If he can pull that off, he would strengthen his position in UMNO.
Singapore: Competitive edge under threat of erosion	Wage growth outpaced productivity growth ▪ According to the Ministry of Manpower's Report on Wage Practices, average labour productivity grew 0.7% per annum from 2004 to 2014 while real wages grew 1.9% over the same period. Real wages grew at a faster rate due to easing inflation. ▪ **Implications**: Falling productivity while real wages continue to rise suggests Singapore's competitive edge is eroding. This is already forcing a sharper restructuring within companies, which will exert stronger deflationary pressures on the economy.
Singapore: HDB resale prices look to be stabilising	A bottom in public housing (HDB) price declines? ▪ Resale prices of HDB flats was unchanged m/m in May 15 while falling 5% y/y. In contrast, the volume of flats sold grew by nearly 20% y/y, reflecting buoyancy in housing demand. The media highlighted some industry experts saying that the effects of the government's cooling measures were tapering. ▪ **Implications**: Unless the government eases up on its strict macro-prudential controls on housing, any recovery in the real estate market will be temporary or restricted to certain market niches where favourable dynamics such as inflows of foreign funds are prevalent. Otherwise, the huge increase in supply, the expected rise in interest rates and the continued weakness in the economy can only mean

Variable	Development/Assessment
	further real estate deflation.
East and South China Sea disputes: Tensions unabated, spur anti-China alliances and rhetoric	
US-China tensions	Tensions are rising as posturing intensifies ▪ **Accusations against China are becoming more widespread:** U.S. President Barack Obama urged China to stop "throwing elbows" while asking it to respect the rule of law. President Aquino of the Philippines has also compared China's activities in the South China Sea to Nazi Germany. Both comments have provoked heated responses from China rejecting allegations of wrongdoing in the disputed areas. ▪ **Countries starting to form defense pacts with U.S. regional allies**: India and the U.S. have signed a 10-year pact which will encompass the development and manufacture of defense equipment and technology. Philippines has also agreed to buy a fleet of 10 patrol vessels from a Japanese shipbuilder, with Tokyo helping to finance the cost with a low-interest loan. These defence pacts are seen to be shoring up military ties in the face of increasing Chinese belligerence. ▪ **Implications**: Anti-China sentiment is rising in the Asia-Pacific region as tensions rise over the East and South China Sea disputes. Should involved parties refuse to back down from their aggressive stances, an inevitable outbreak of maritime conflict will occur.
Monetary policy in India and Thailand	
India: RBI cut rates in an attempt to front-load economy	RBI slashes benchmark rate by 25bps, but businesses think it insufficient ▪ India's central bank cut the repo rate by 25 basis points, a move judged insufficient by industry leaders who expected minimally a 50 basis point reduction. ▪ However, this is a fresh injection of monetary stimulus by the RBI which remains unconvinced by the strength portrayed in 1Q15 GDP figures. Consequently, the RBI is hoping that the rate cut would induce banks to lower the cost of credit for individuals and corporations to increase investments and growth. ▪ **Implications:** This rate cut by RBI would likely drive down borrowing costs for individuals and companies, spurring consumption and investment levels and providing a fillip to the economy.
Thailand: Finance Minister says no more rate cuts needed	Sommai: No more rate cuts required to spur economy ▪ The Bank of Thailand (BOT) has cut rates twice – by 25 basis points each time – in quick succession this year in March and April 2015. The BOT's policy rate at 1.5% is already among the lowest in Southeast Asia. ▪ Thailand's Finance Minister emphasized that monetary policy in the kingdom was "highly accommodative" and further cuts would have limited effects on the economy while paring returns for savers.

China visit note: near term risks remain high

In essence, our visit left us more aware of the tremendous long-term strengths of the Chinese economy but also more concerned about the near term economic and political risks.

Transformation into a more sophisticated one, with a widening impact on the global economy:

- Some parts of the new economy are performing strongly. Sectors related to urbanisation, internet-related services, defence industries, tourism/recreation, clean energy, retirement and healthcare are all set to do well even in a slowing economy.

- MNC CEOs spoke of the huge pool of engineering and scientific talent that is enabling their operations in China to switch from being simple assembly platforms to more sophisticated ones that are creating innovative new products for the global economy.

- China's bold moves to deploy its extraordinary financial resources in initiatives such as the New Development Bank, the Asian Infrastructure Investment Bank, and the One Belt, One Road initiative are being extended with Premier Li Keqiang offering something like USD 100 billion to Latin American economies. More such initiatives are likely.

- We understand that reforms to strengthen the financial sector while opening up the capital account and eventually freeing the CNY will go ahead, even with the slowing of the economy. China is determined to get the CNY included in the International Monetary Fund's Special Drawing Rights basket. As financial institutions around the world understand this, they are making way for greater Chinese participation in the global financial system. For example, Morgan Stanley Capital Indices will soon decide on according a greater weight to Chinese equities in its indices. The net effect will be a much bigger Chinese foot print on the world financial system.

But the near term challenges are deepening

No one seriously believed government data showing that the economy was growing at close to 7%. Most estimated that the true rate of growth was more like 4%-5%. A number of observations:

First, the slowdown in the economy is intensifying despite policy easing:

- Urban sector new employment growth has collapsed, from roughly a 2 million job creation rate each quarter to a contraction of 200,000 in 1Q15. There is a massive employment challenge because of the number of jobs that have to be created - continued inflow of rural migrants to towns (13 million a year), natural work force growth in urban areas (5 million), and a huge expansion of tertiary education (7 million) which is producing a surge in university graduates, half of whom have not been able to find good jobs.

- Nominal industrial production growth has fallen sharply to around just 2%. In a highly leveraged economy with massive corporate debt, the squeeze on cash flows is becoming severe.

- Consequently, non-performing loans surged 42% y/y in 2014 – albeit off a low base.

- Companies seeing reduced profitability have less incentive to invest at the same pace they have been in recent years, which aggregated to around 47% of GDP. In other words there is less reason for close to half of aggregate demand to grow. The question is whether investment in the dynamic sections of the economy can offset the slowing parts – it is not clear if the former has a large enough weight in the economy to do so.

Second, some trends in the economy are creating potential future problems:

- The one success of policy easing has been to boost the asset markets. There are clear signs of real estate recovery and equity markets are booming. But this may not be healthy for the long-term. There is already significant excess supply in real estate in Tier 2,3 and 4 cities, so a revival of the real estate sector could aggravate excess supply and force yet another correction in time.

- There is little doubt that the equity market is in a bubble – not only are valuations excessively high, but the equity market mania is spreading, with virtually everyone we spoke convinced that this can only surge higher because of likely policy moves. Given the likely monetary easing, it may well be that equities surge even higher. But we have all seen this movie before. At some point, the boom will turn into bust and the financial and economic dislocations could well be material.

- State interventions themselves may be an obstacle to the economy's long-term health. Local governments are determined to keep unprofitable local champions going, directing credit and other resources to such companies in industries with massive excess capacity such as solar panels, steel and so on. This means that the more efficient companies are denied the resources that are stuck in these zombie companies whose price competition also reduces profits and cash flows for the more efficient companies.

Formulating an effective policy response is harder today than before.

At one level, the government retains powerful tools to stimulate the economy. The reserve requirement for banks is still high at 18.5% and can easily be cut to 8% without compromising financial stability: each 1% point reduction in RRR unleashes CNY1 trillion worth of extra liquidity.

- First, China's economy is a far more complex one than before, a dual economy comprising a dynamic services sector and a lagging manufacturing sector. There are severe regional variations as well. Some points to note about how policy makers see the new normal:
  - The economy is structurally changing, with a new normal emerging which means that policy makers themselves are uncertain about the parameters of this new normal and how to calibrate policy settings optimally.
  - Their response is to see, as far as possible, how economic growth settles to a new level without policy support – thus their caution in responding to the stimulus, avoiding aggressive actions until they are clearer as to where the economy is naturally settling down to. A key issue is employment creation and wage growth – so long as they judge these to be in good shape, they will not hurry to stimulate.
  - Greater emphasis on GNP rather than GDP: China wants to relocate more low-end activities within steel, shipbuilding, engineering goods etc to other developing economies. The idea is to reduce consumption of natural resources in China itself.
  - One key consideration for policy makers in the new normal is to switch the emphasis from investment in physical capital to investment in human capital. This entails (a) Stepping up expenditure on social welfare to around 4% of GDP; and (b) Increasing spending on R&D from about 1.5% now to at least 2% over the next few years.

- Second, the anti-corruption campaign has significantly slowed decision making in the government on project approvals and implementation. From the senior levels to the lower levels, bureaucrats fear making any decision lest they be accused of corruption or favouritism. In a recent example, the National Development Reform Commission prepared seven major stimulus programmes but found little response from local and provincial governments unlike in 2008-09 when these layers of government competed intensively to bid for projects.

- Another challenge for fiscal policy is that growth in fiscal revenues is also falling sharply, down to just 2.4% in 1Q15.

- Third, the effectiveness of monetary policy has been weakened as credit demand is itself weak, which means that the People's Bank of China's easing of liquidity is not translating as quickly as before into actual credit growth.

Indonesian economy: weaknesses on all fronts

The Indonesian economy is increasingly vulnerable to contagion from global and emerging markets. Weaker than expected growth in 1Q15 at 4.7% y/y has brought with it much speculation as to whether the growth slowdown reflects a cyclical downturn post a commodity boom, or the beginning of an extended period of weakness for Indonesia's economy. To assess this, we take a closer look at Indonesia's growth drivers and cyclical indicators.

- **Investment and consumption growth rates could decelerate further**. The fiscal push for infrastructure spending, so critical to "crowding in" private investment is facing shortfalls as tax collections weaken. Consumer confidence in Indonesia increased to 152.2 in May 15, above the 2015 average of 151.9 as reported by ANZ Research. However this high is unlikely to be sustained as confidence is highly sensitive to economic and political drivers.

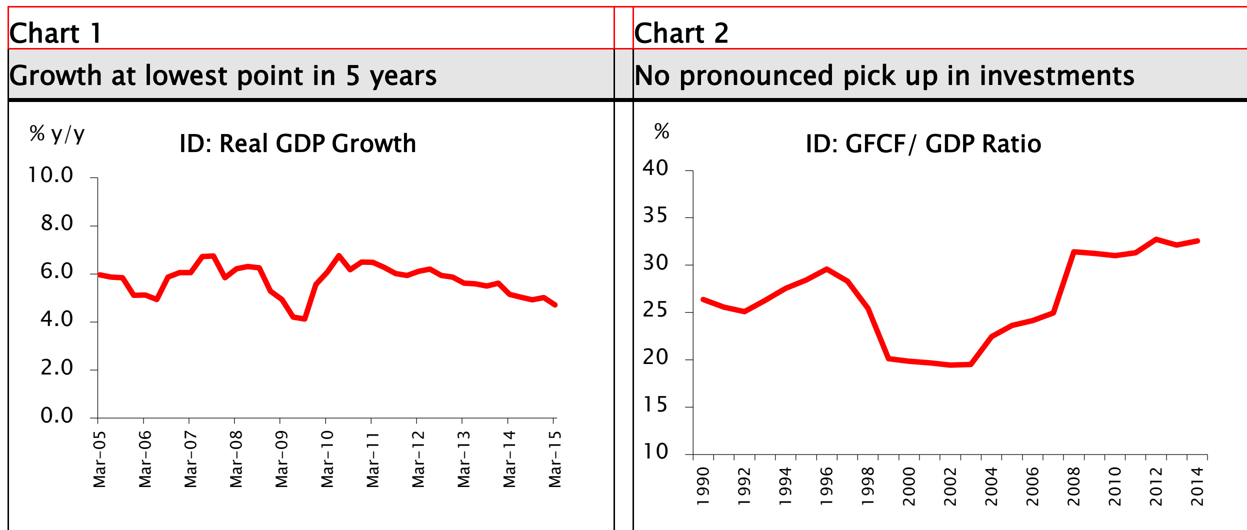


Chart 1
Growth at lowest point in 5 years

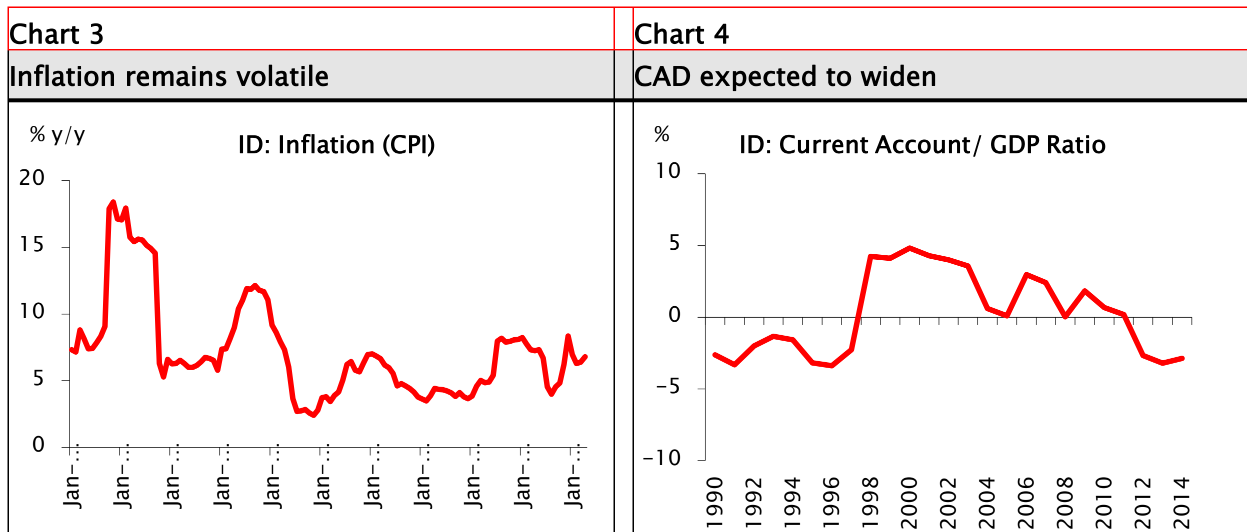
Chart 2
No pronounced pick up in investments

Source: Calculated by Centennial Asia Advisors using CEIC Database

- **Inflation at a 5 month high**: CPI inflation increased 7.1% y/y in May 15, up from 6.8% y/y in Apr 15, well above Bank Indonesia (BI)'s 3-5% inflation target. BI's expectation that inflation would fall to 4.2% by end-2015 appears increasingly unlikely to materialize given uncertain crude oil prices and the impact of the depreciating Rupiah. High and volatile inflationary and currency expectations fundamentally curb BI's room for manoeuvre in monetary policy. Thus, while it is concerned about economic growth, cutting rates at a time of rising investor concerns about inflation and emerging markets would be risky.

- **External resilience improved modestly**: Indonesia's current account deficit (CAD) narrowed to 1.8% of GDP in 1Q15, down from 2% of GDP in 1Q14. However, BI expects a widening of the CAD in 2Q15. BI has forecasted FY15 CAD to come in at 2.8% of GDP, close to the 3% level which investors feel uncomfortable about. Indonesia will thus be increasingly vulnerable to an emerging market sell-off if there is another taper tantrum in asset markets once the US raises rates.

- **Dismal import and export performance**: Imports and exports in Indonesia have been contracting since October 2014 with imports contracting 22.3% y/y in Apr 15, down from 13.2% y/y in Mar 15 while commodity exports have taken a hit following declining oil prices. Trade policies that place limits on imports into the country are not helping matters, there is a need for policies to evolve along with trade developments. Global value chains are gaining traction in Southeast Asia pointing at imports not necessarily being bad – increasing limitations will prevent Indonesia from gaining a competitive advantage in the region and realizing growth opportunities.



- **Currency expectations are volatile and potentially destabilizing.** The weakening Rupiah and the currency's susceptibility to global volatility has seen BI intervening in foreign exchange and bond markets. The limited the supply of foreign exchange will reduce BI's ability to implement regulations going forward. BI has however revised regulations on foreign currency regulations aiming to improve the liquidity of foreign currency in Indonesia to bolster the IDR. While illiquidity in the economy has posed as a threat to the IDR's stability, revised regulations enable foreign investors to hedge risks more affordably, which will hopefully reduce risks associated with holding IDR.

Policies moving in the right direction but administrative capabilities questionable

- On the policy end, positive steps are being taken to rein in inflation. BI is actively encouraging better farming methods to bridge the gap between supply and demand, while Jokowi's administration relaxed import restrictions on live stocks and volatile items that significantly contributed to the recent inflation spike.
- BI officials are having to assess structural constraints to inflation at the ground level rather than allocated state agencies providing the ground work – preventing BI concentrating solely on monetary policy and bank supervision.

As we have assessed, indicators point to weaknesses in the Indonesian economy. With recent policy moves being made in the right direction, we hope to see improvements post-Ramadan. However, without accommodative policies and reforms, weaknesses are likely to persist.

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