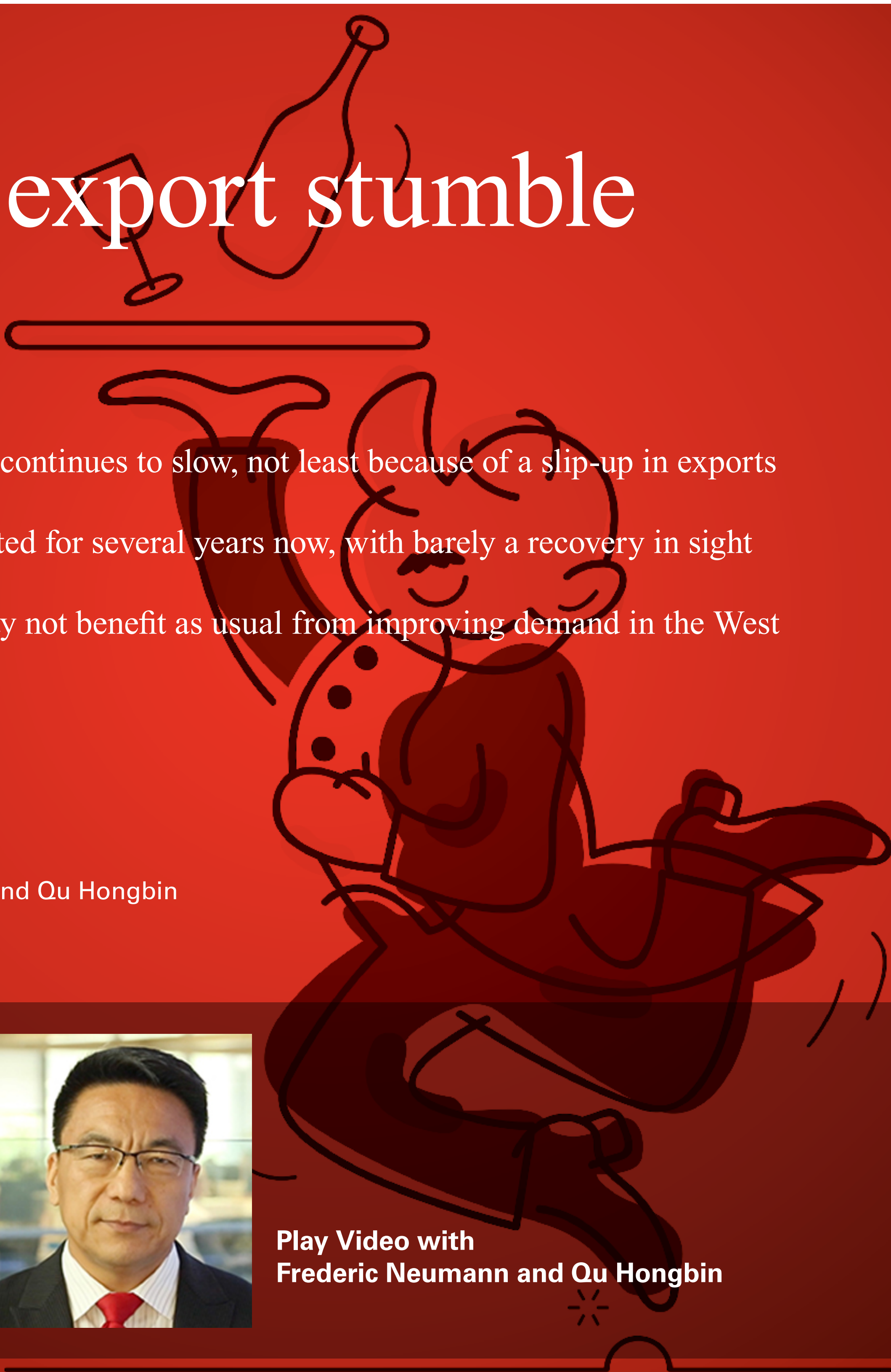
HSBC Global Research

Macro
Economics – Asia
Q3 2015

Asian
ECONOMICS

Asia's export stumble



- Growth across Asia continues to slow, not least because of a slip-up in exports
- Trade has disappointed for several years now, with barely a recovery in sight
- This means Asia may not benefit as usual from improving demand in the West

By Frederic Neumann and Qu Hongbin

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Frederic Neumann and Qu Hongbin

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Summary

Things aren't exactly going according to plan. The sharp drop in crude prices, policy easing, and stabilizing demand in the G3 markets were supposed to give Asia a little breather over the last couple of quarters. Instead, local demand – whether construction in China, auto sales in Indonesia, or real estate transactions in Taiwan – continues to slow. What's more, exports aren't coming to the rescue. Asia's traditional growth engine has failed to fire up, dragged down by weak investment globally and faltering demand in emerging markets. A quick fix seems unlikely. The good news: inflation is unlikely to constrain central banks any time soon. The bad news: amid high leverage, monetary easing isn't having the same traction as before. More fiscal spending would help, but few governments appear keen. We believe financial risks are manageable, but growth looks likely to stay soggy for a while.

Not quite there

You might be forgiven for feeling a little surprised: crude prices tumbled over the past year, Europe and Japan emerged from last year's growth doldrums (somewhat), the US looks perkier than in a long time (well, after stumbling in the first quarter), and Asian central bankers have cut interest rates – shouldn't growth across the region have picked up? It didn't. In fact, most indicators suggest that demand, both local and external, eased further in the second quarter. Some of it might be temporary, like the MERS outbreak in Korea that knocked out retail spending or new sales taxes in Malaysia that curtailed household purchases. But there is a sense that the malaise is cutting deeper than this.

Only look at exports. Across Asia these have weakened further over the past few months, contracting outright in most places – at a pace not seen since the height of the Eurozone crisis in 2011. That matters: since high and mounting debt in many economies was always going to constrain any rebound, hopes grew that a potential recovery in exports would lift the region out of its malaise. What's peculiar is that shipments to the US and the EU (in volume terms) indeed strengthened, but that this didn't lead to the customary revival in Asian trade. China's cooling economy, now a vast market for exporters in its own right, is partly to blame. And so is wobbly demand across emerging markets generally (due in part to the decline in commodity prices).

The focus, therefore, remains on a potential rebound in China. Of late, the data has remained disappointing. Housing construction, the key driver of demand in recent years, continues to slow, even if property purchases have started to respond to policy easing. This suggests that more stimulus is required, by both the central bank and fiscal authorities. The good news, as HSBC's Chief China economist Qu Hongbin explains in a later chapter, is that the policy transmission mechanism should still work well enough to yield some results. In the meantime, Hong Kong and Taiwan, arguably more exposed to China than most, are feeling the pinch.

Asia's other giant, Japan, has also lost steam. Starting off the year in robust shape, output stagnated in the second quarter, not least because of disappointing exports. Nevertheless, there is growing evidence that the weak yen is starting to squeeze competitors in Korea. Growth in the latter, therefore, had started to disappoint even before the MERS scare. The Bank of Korea may have to cut interest rates again to shore up growth, especially if export demand remains as lacklustre as it has been.

Australia and New Zealand are also feeling external headwinds, with falling commodity prices undercutting the terms of trade. In the former, rebalancing has not progressed quickly enough to fully make up the slack. In the latter, the central bank has become concerned enough to shift to an easing cycle.

India's economy, at least, is showing tentative signs of improvement, if still well short of earlier expectations. Rate cuts to date have done little to raise investment, with many firms still struggling with bloated balance sheets. With fiscal consolidation still paramount, further stimulus will have to be monetary, but the central bank appears hesitant to cut again any time soon. Sri Lanka, despite political turbulence, continues to perform well.

ASEAN is starting to struggle. In Indonesia, slow fiscal spending and cautious consumers have led to a sudden slowdown in domestic demand, compounding the effects of already weak exports. In Malaysia, too, consumer spending has weakened, although public investment is lending some support. In Thailand and Singapore, local demand also looks wobbly. The bright spots in ASEAN, therefore, continue to be the Philippines and Vietnam, the former thanks to booming consumption, the latter due to growing exports.

HSBC GDP growth forecasts (red denotes above consensus, grey below consensus, %)

	2013	2014	2015f (old)	2015f (new)	2015f Consensus	2016f (old)	2016f (new)	2016f Consensus
Australia	2.1	2.7	2.6	2.4	2.5	3.0	3.0	2.9
New Zealand	2.2	3.3	3.0	2.8	2.9	2.8	2.8	2.7
Bangladesh*	6.1	6.5	6.5	6.6	6.2	6.7	6.7	6.3
China	7.7	7.4	7.3	7.1	6.9	7.4	7.4	6.7
Hong Kong	2.9	2.3	2.5	2.3	2.4	3.0	2.3	2.7
India*	6.9	7.3	7.8	7.8	7.8	8.3	8.3	8.1
Indonesia	5.6	5.0	5.5	4.8	5.0	5.8	5.6	5.6
Japan	1.6	-0.1	0.8	0.8	1.0	1.1	1.1	1.7
Korea	2.9	3.3	3.1	2.8	3.0	3.1	2.8	3.4
Malaysia	4.7	6.0	4.8	4.8	4.8	5.5	5.1	5.1
Mongolia	11.6	7.0	8.0	5.0	n/a	9.0	6.0	n/a
Philippines	7.1	6.1	6.0	5.6	6.1	6.1	5.9	6.2
Singapore	4.4	2.9	2.6	2.7	2.8	3.6	3.2	3.3
Sri Lanka	7.2	7.4	7.2	6.8	7.2	7.2	6.8	6.9
Taiwan	2.2	3.8	3.5	3.5	3.5	3.3	3.5	3.6
Thailand	2.8	0.9	3.6	3.1	3.3	3.1	3.3	3.9
Vietnam	5.4	6.0	6.1	6.3	6.1	6.1	6.5	6.2
Asia ex JP	6.6	6.4	6.5	6.3	6.2	6.6	6.6	6.2
Asia ex JP & CN	4.9	5.0	5.2	5.0	5.1	5.5	5.3	5.5
Asia ex JP CN & IN	4.1	4.0	4.2	3.9	4.0	4.3	4.1	4.4

*On a FY basis; regional aggregates are nominal USD GDP weighted
Source: CEIC, Consensus Economics, HSBC

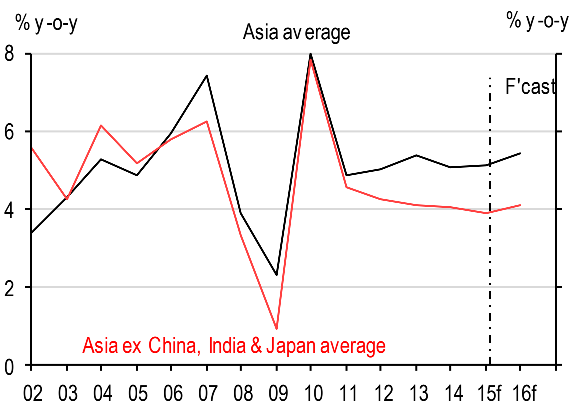
Contents

Key forecasts

(% y-o-y)	Asia Average	AU	CH	BA	HK	IN	ID	JA	KR	MA	MO	NZ	PH	SI	SL	TA	TH	VN
Real GDP%*																		
2013	5.4	2.1	7.7	6.1	2.9	6.9	5.6	1.6	2.9	4.7	11.6	2.2	7.1	4.4	7.2	2.2	2.8	5.4
2014	5.0	2.7	7.4	6.5	2.3	7.3	5.0	-0.1	3.3	6.0	7.0	3.3	6.1	2.9	7.4	3.8	0.9	6.0
2015f	5.1	2.4	7.1	6.6	2.3	7.8	4.8	0.8	2.8	4.8	5.0	2.8	5.6	2.7	6.8	3.5	3.1	6.3
2016f	5.4	3.0	7.4	6.7	2.3	8.3	5.6	1.1	2.8	5.1	6.0	2.8	5.9	3.2	6.8	3.5	3.3	6.5
Private consumption																		
2013	5.2	1.7	7.5	2.7	4.6	6.2	5.4	2.1	1.9	7.2	n/a	2.9	5.6	3.5	3.2	2.4	0.8	5.2
2014	4.5	2.5	7.5	4.4	2.7	6.3	5.1	-1.3	1.8	7.0	n/a	3.2	5.4	2.5	4.6	3.0	0.6	5.5
2015f	5.0	2.7	7.6	5.1	3.1	7.8	4.8	-0.1	1.9	6.9	n/a	3.2	5.4	1.9	9.1	2.0	2.2	5.6
2016f	5.3	3.1	7.3	5.2	2.7	8.3	4.9	1.5	2.2	5.2	n/a	2.5	5.6	1.2	8.7	3.5	3.1	5.8
Fixed investment																		
2013	10.9	-2.6	19.6	6.4	2.2	3.0	5.3	3.2	3.3	8.2	n/a	8.5	12.2	1.0	9.1	5.0	-0.8	5.3
2014	9.1	-2.7	16.0	9.0	-0.3	4.6	4.1	2.6	3.1	4.8	n/a	8.8	6.8	-2.0	2.2	1.8	-2.6	6.2
2015f	8.0	-3.5	13.5	9.9	2.5	7.0	4.8	0.5	2.6	7.9	n/a	3.6	6.7	4.8	1.1	1.3	4.7	8.5
2016f	9.6	-0.8	16.0	10.3	3.7	9.1	5.8	1.2	2.7	6.0	n/a	5.7	5.8	4.1	3.8	4.1	4.2	8.0
Current account balance (% of GDP)																		
2013	1.7	-3.3	1.5	0.8	1.5	-1.7	-3.2	0.8	6.2	3.5	-27.2	-3.2	4.2	21.2	-3.8	10.8	-0.9	5.5
2014	2.0	-2.8	2.1	-0.3	1.9	-1.3	-2.9	0.5	6.3	4.3	-11.8	-3.3	4.4	17.8	-2.7	12.4	3.3	3.4
2015f	3.0	-3.1	2.9	0.4	0.6	-1.5	-2.6	3.2	8.4	2.5	-14.2	-2.5	3.3	16.3	-2.9	12.3	4.6	2.9
2016f	2.6	-2.6	2.9	0.4	1.3	-1.7	-2.8	1.3	8.5	3.3	-12.3	-2.6	2.3	17.2	-3.0	10.9	4.2	2.8
CPI (period average)*																		
2013	2.8	2.4	2.6	7.5	4.3	9.8	6.4	0.4	1.3	2.1	10.4	1.1	2.9	2.4	6.9	0.8	2.2	6.6
2014	2.8	2.5	2.0	7.0	4.4	6.0	6.4	2.7	1.3	3.1	14.0	1.2	4.2	1.0	3.3	1.2	1.9	4.1
2015f	1.7	1.7	1.2	6.1	2.7	5.2	6.5	0.8	0.8	2.0	9.0	0.5	2.2	-0.3	1.1	-0.2	-0.4	1.4
2016f	2.0	2.5	1.3	6.2	3.8	5.8	4.5	1.1	2.2	2.8	10.0	2.0	3.9	1.2	5.6	1.5	2.3	4.0
Money market interest rate (%, year-end)**																		
2013	3.11	2.63	5.60	5.00	0.38	8.69	7.84	0.15	2.65	3.32	n/a	2.85	0.00	0.40	n/a	0.94	2.40	n/a
2014	3.01	4.69	4.22	5.00	0.38	8.31	7.17	0.11	2.13	3.86	n/a	3.68	1.42	0.45	n/a	0.94	2.18	n/a
2015f	2.76	2.10	3.00	5.00	0.80	8.00	6.90	0.10	1.50	3.30	n/a	3.00	0.00	1.80	n/a	1.20	1.45	n/a
2016f	2.88	2.10	3.00	5.00	1.20	7.50	6.90	0.10	2.20	3.40	n/a	3.00	0.00	1.90	n/a	1.40	1.90	n/a
Exchange rate (vs. USD, year-end)																		
2013	n/a	0.93	6.05	77.8	7.75	61.9	12,189	105.4	1,055	3.28	1,663	0.83	44.4	1.27	130.9	30.0	31.7	21,095
2014	n/a	0.87	6.20	78.0	7.76	63.3	12,440	119.8	1,099	3.50	1,889	0.77	44.6	1.39	131.9	31.7	32.7	21,420
2015f	n/a	0.72	6.26	78.0	7.80	66.0	13,800	125.0	1,130	3.75	1,950	0.70	45.4	1.37	134.0	31.8	33.7	21,750
2016f	n/a	0.70	6.32	79.0	7.80	67.0	14,500	125.0	1,140	3.80	1,950	0.68	45.9	1.39	134.0	32.0	34.1	22,000

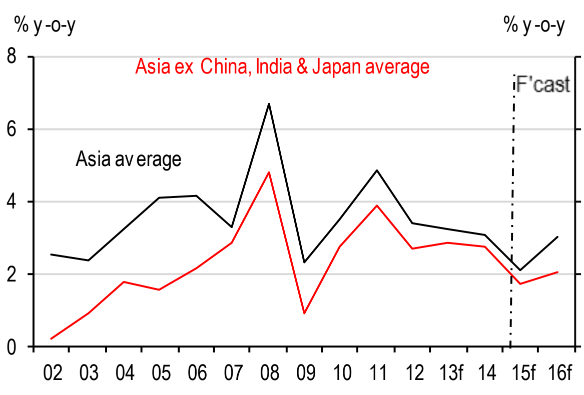
*India GDP and CPI forecasts are fiscal year basis, Bangladesh GDP on fiscal year basis.
**China: 3-month time deposit; Bangladesh: Bank rate; Hong Kong: 3mth HIBOR; India: 3-month T-Bill; Indonesia: 3 month SBI; Korea-3 month CD yield; Malaysia: 3-month KLIBOR; Philippines: 3-month T-bill; Singapore: 3-month SOR; Taiwan: 91-day secondary CP; Thailand: 3 month BIBOR
NB: Australia and New Zealand are not included in Asia aggregate and data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights. Mongolia FX for 2015 and 2016 are assumptions and not forecasts
Source: CEIC, HSBC

GDP (% y-o-y)



Source: CEIC, HSBC forecasts (nominal USD GDP weights)

CPI (% y-o-y)



Source: CEIC, HSBC forecasts (nominal USD GDP weights)

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Monetary policy assumptions

Monetary policy

Period end %		1Q 2015	2Q 2015	3Q 2015f	4Q 2015f	1Q 2016f	2Q 2016f	3Q 2016f	4Q 2016f
Australia	RBA Cash Target rate	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Bangladesh	Repo rate	7.25	7.25	7.25	7.25	7.25	7.25	7.25	7.25
China	1 year Base Lending rate	5.35	4.85	4.60	4.60	4.60	4.60	4.60	4.60
Hong Kong	Base Rate	0.50	0.50	0.50	0.75	1.00	1.00	1.25	1.25
India	Repo rate	7.50	7.25	7.25	7.25	7.25	7.25	7.25	7.25
Indonesia	BI Reference rate	7.50	7.50	7.25	7.25	7.25	7.25	7.25	7.25
Japan	Overnight Call rate	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Korea	7-day Repo rate	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25
Malaysia	Overnight rate	3.25	3.25	3.00	3.00	3.00	3.00	3.00	3.00
Mongolia	Base Rate	14.00	14.00	14.00	14.00	14.00	14.00	14.00	14.00
New Zealand	RBNZ Cash rate	3.50	3.25	3.00	3.00	3.00	3.00	3.00	3.00
Philippines	Reverse Repo rate	4.00	4.00	4.00	4.00	4.25	4.50	4.50	4.50
Singapore	3 month SOR	1.45	0.82	1.60	1.80	1.90	1.90	1.90	1.90
Sri Lanka	Reverse Repo rate	8.00	7.50	7.50	7.00	7.00	7.00	7.00	7.00
Taiwan	Discount rate	1.875	1.875	1.750	1.625	1.625	1.625	1.625	1.625
Thailand	1-day Repo rate	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25
Vietnam	OMO rate	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00

Source: CEIC, HSBC forecasts

Headline inflation

% y-o-y	Target*	1Q 2015	2Q 2015f	3Q 2015f	4Q 2015f	1Q 2016f	2Q 2016f	3Q 2016f	4Q 2016f
Australia	2 to 3	1.3	1.6	1.8	2.2	2.5	2.5	2.4	2.4
Bangladesh	*6.5*	7.2	7.0	6.2	5.9	6.7	6.6	5.9	5.4
China	*3.0*	1.2	1.2	1.3	1.3	1.4	1.3	1.3	1.2
Hong Kong	*3.5*	4.4	2.8	2.2	1.6	2.5	4.3	4.2	4.1
India	6.0	5.3	5.0	4.5	5.6	5.6	5.8	5.9	5.9
Indonesia	3 to 5	6.5	7.1	6.9	5.6	4.5	4.7	4.4	4.4
Japan	2.0	2.3	0.1	0.3	0.5	1.0	1.0	1.1	1.2
Korea	2.5 to 3.5	0.6	0.5	0.9	1.4	1.9	2.2	2.3	2.3
Malaysia	*2.0 to 3.0*	0.7	2.3	2.7	2.4	4.1	2.7	2.4	2.3
New Zealand	1 to 3	0.1	0.4	0.5	1.2	1.9	1.9	2.0	2.1
Philippines	2 to 4	2.4	1.8	1.7	2.9	3.5	4.4	4.1	3.3
Singapore	*-0.5 to 0.5*	-0.3	-0.4	-0.4	-0.2	0.3	0.9	1.5	2.1
Sri Lanka	*2 to 4*	1.3	0.1	0.2	2.6	4.2	6.1	6.2	5.9
Taiwan	*0.3*	-0.6	-0.7	-0.2	0.5	1.6	1.5	1.4	1.4
Thailand	1 to 4	-0.5	-1.1	-0.5	0.5	2.0	2.3	2.4	2.4
Vietnam	*less than 5*	0.7	1.0	1.4	2.3	3.9	4.2	4.1	3.8

*Forecasts in italics NB: Australia and New Zealand are quarterly data; India annual data are for fiscal year and target refers to January 2016 target as per new monetary policy framework transition path; Sri Lanka targets money supply; Malaysia has implicit preference; Hong Kong government forecasts headline composite CPI for 2015 at 3.5%; Taiwanese directorate general of budget's forecasts for 2015 is 0.9%; Singapore CPI forecast by MAS
Source: Various central banks, CEIC, HSBC

Foreign exchange rate

	2-yr Average	1Q 2015	2Q 2015	3Q 2015f	4Q 2015f	1Q 2016f	2Q 2016f	3Q 2016f	4Q 2016f
Australia	0.95	0.82	0.74	0.73	0.72	0.71	0.71	0.70	0.70
Bangladesh	77.76	77.80	77.50	77.75	78.00	78.30	78.50	78.80	79.00
China	6.16	6.20	6.22	6.24	6.26	6.28	6.30	6.32	6.32
Hong Kong	7.76	7.75	7.80	7.80	7.80	7.80	7.80	7.80	7.80
India	61.20	62.59	65.00	65.50	66.00	66.00	66.50	66.50	67.00
Indonesia	11,434	13,084	13,332	13,700	13,800	14,000	14,200	14,400	14,500
Japan	103.72	120.21	120.00	120.00	125.00	125.00	125.00	125.00	125.00
Korea	1078	1,105	1,110	1,120	1,130	1,130	1,140	1,140	1,140
Malaysia	3.26	3.72	3.79	3.70	3.75	3.77	3.78	3.79	3.80
New Zealand	0.83	0.76	0.71	0.70	0.70	0.69	0.68	0.68	0.68
Philippines	43.79	44.80	45.00	45.20	45.40	45.60	45.70	45.80	45.90
Singapore	1.27	1.37	1.35	1.36	1.37	1.38	1.38	1.39	1.39
Sri Lanka	130.44	133.32	133.70	133.83	134.00	134.00	134.00	134.00	134.00
Taiwan	30.27	31.40	31.07	31.50	31.80	31.90	31.90	32.00	32.00
Thailand	31.59	32.64	33.25	33.60	33.70	33.80	33.90	34.00	34.10
Vietnam	21,178	21,545	21,700	21,700	21,750	22,000	22,000	22,000	22,000

Source: Bloomberg, HSBC forecasts

What's up with exports?

- Despite stabilizing demand in the West, shipments have slowed of late, reflecting weakening demand in China and emerging markets
- A quick rebound in exports seems unlikely – even if long-term trade prospects are bright – weighing on growth as credit started to slow
- More stimulus is required, including further monetary easing in most economies, but this will be tricky to deliver as the Fed begins to hike

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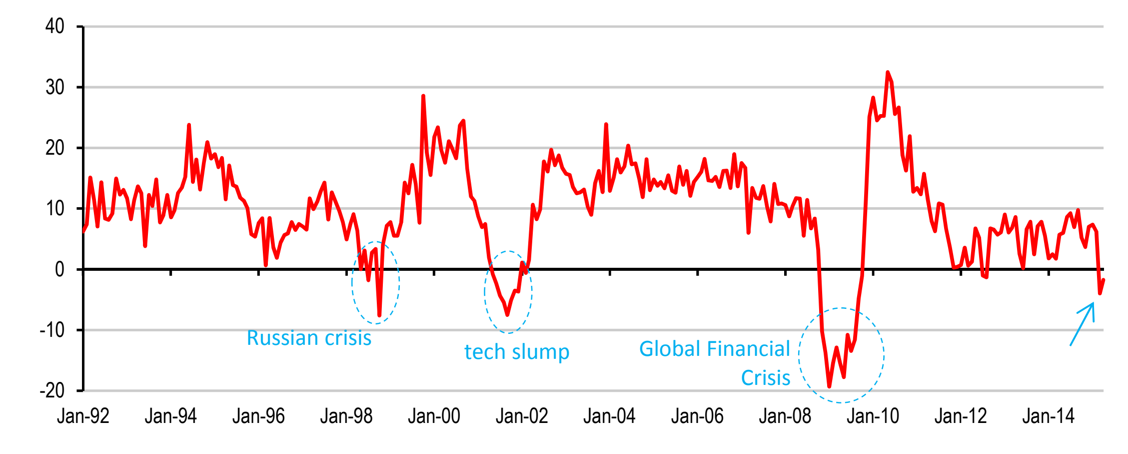
Missing a beat

2015 is shaping up to be a challenging year for Asia, perhaps more challenging than widely expected. The fall in oil prices, for example, didn't provide the expected boost to consumption. On the contrary, across the region, household spending has slowed further as credit and wage growth fizzled. Investment, too, despite the promises of greater infrastructure spending in many places, has languished. But the biggest worry of all is the continued export malaise. Without a revival in shipments, it is difficult to foresee a pick-up in growth more broadly.

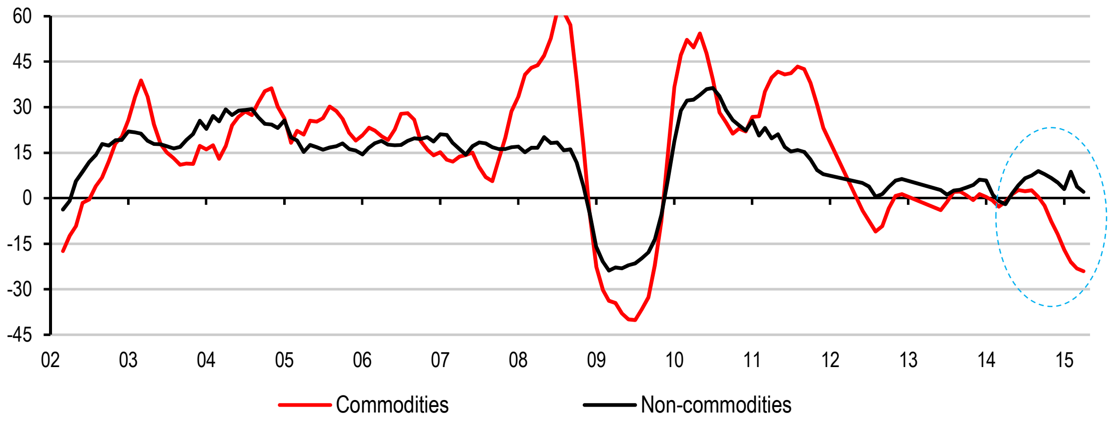
Take a look at the numbers. Chart 1 shows growth in export volumes – free of price and FX distortions – for emerging Asia. These are now contracting on an annual basis, something that rarely occurs; in fact, in the past two decades, this has happened only three times: during the Russian financial crisis of 1998, the tech slump in the early 2000s, and during the Global Financial Crisis. That's worrying in part because there is no

Chart 1: Emerging Asia: export volumes (sa, % y-o-y)



Source: CPB, HSBC

Chart 2: Emerging Asia: commodity and non-commodity export growth (% y-o-y)



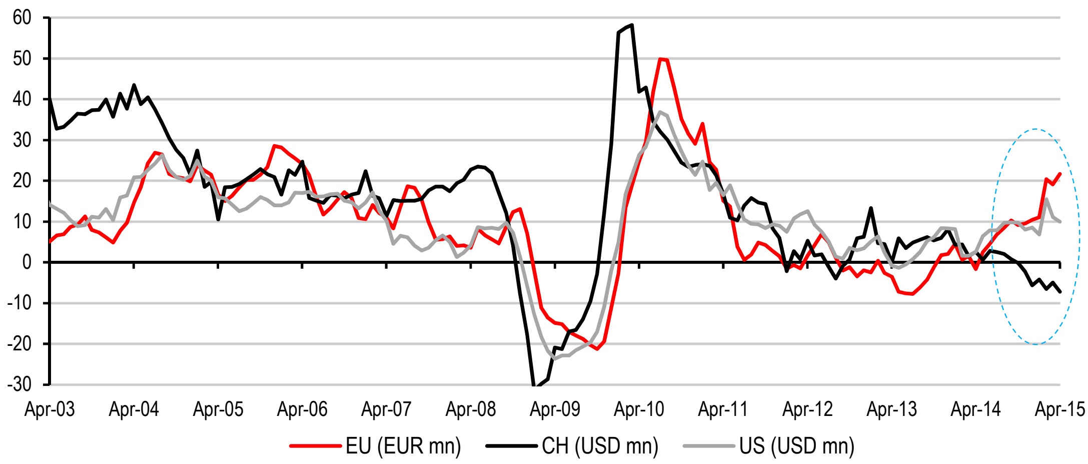
Source: UNCTAD, HSBC

ready explanation for this: unlike before, we cannot blame the usually temporary effect of financial stress anywhere in the world. This therefore looks like something more structural and longer-lasting.

Let's take a closer look for likely explanations. Chart 2 shows export growth of commodities and manufactured goods for the region. The first thing to note is the plunge in the value of commodity shipments. This primarily reflects a fall in prices, with Indonesia, Malaysia, India, Vietnam, and Thailand being mostly affected. But, even non-commodity exports have barely grown of late, suggesting that the region's export malaise cuts deeper than the recent rout in raw material prices.

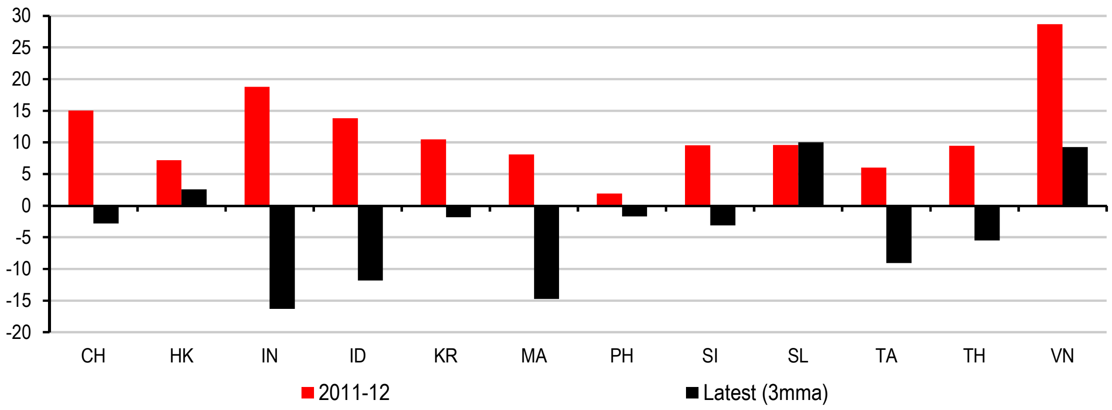
And it's here where things get really interesting. Chart 3 shows export growth by main destinations. Shipments to the US have been quite robust of late, roughly rising at the same pace as in 2011. Exports to the EU are also rising strongly in euro terms (a better proxy for volumes, as the currency has depreciated sharply over the past year). However, shipments to China are contracting at a pace not seen since the Global Financial Crisis. This highlights two things: first, the breakdown in correlation between exports to G2 and to China

Chart 3: Asia ex Japan export growth to the US, EU and China (3mma, % y-o-y)



Source: CEIC, HSBC

Chart 4: Export growth (% y-o-y)



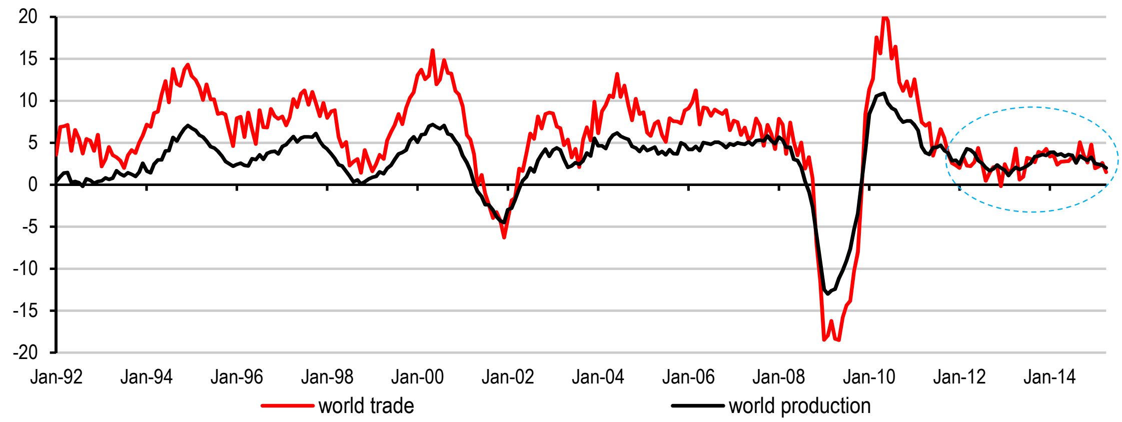
Source: CEIC, HSBC

suggests that shipments to the Mainland are no longer just parts and components for goods that ultimately find their way to the West (supply chain trading). Rather, China has become a vast market in its own right and as demand diverges, exports to the three main destinations are no longer tracking each other closely. Second, the overall contraction of Asian exports in volume terms highlights just how important demand in China and other emerging markets has become in recent years: their weakness is offsetting any improvement in the G2 economies (and may, indeed, restrain growth in the West itself).

Decoupled, the other way

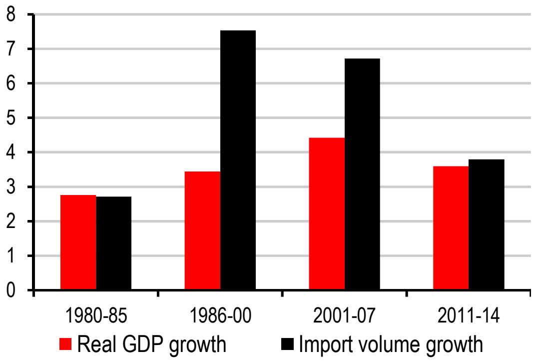
That's a worrying finding: if the slowdown in China is enough to knock out Asia's trade engine despite the pick-up in demand in the US and EU, the region has in a sense *decoupled* from the West. Optimists, of course, might argue that as G2 demand strengthens the traditional growth channel will re-assert itself, dragging Asia out of its current malaise. That requires, however, that economies in the West indeed improve, something that shouldn't be taken as a foregone conclusion (see, for example, Stephen King, et al., *Global Economics Quarterly: Alas, Kapital*, 25 June 2015). What's more, even if G2 growth bounces back, it is not clear that global trade will prove as vibrant as it has been in recent decades.

Chart 5: World industrial production and trade volume growth (% y-o-y)



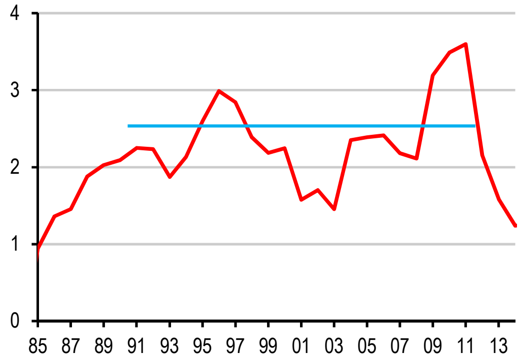
Source: CPB, HSBC

Chart 6: World GDP and import volume growth (avg, % y-o-y)



Source: IMF, HSBC

Chart 7: Ratio of world imports to GDP growth (3 year ma)



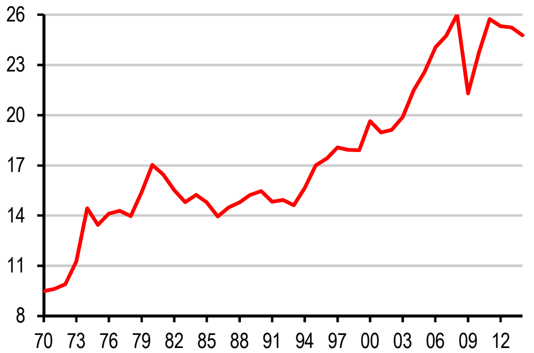
Source: IMF, HSBC

Worrying stuff. And this goes right to the heart of the debate about whether the global slowdown in trade is a merely cyclical phenomenon, and thus temporary, or structural, and thus long-term. Before looking at the arguments in detail, consider some broader observations. Chart 5 shows world industrial output and trade volume growth over time. Note that, in the past, trade usually grew faster than output, especially in periods when activity accelerated. Since late 2011, however, the two have expanded at roughly the same pace, which is unusual.

Chart 6 makes a similar point: over the last several decades, the relationship between global GDP and trade growth has varied. In the early 1980s, the two expanded equally rapidly. Over the following 15 years, trade took off, while growth improved only marginally. In the early to mid-2000s, global imports (or exports: the two are equal for the world as a whole) continued to expand briskly, but growth started to catch up. Since 2011, however, both have slowed, but trade more so than end-demand. Chart 7 presents the "trade elasticity" for the world economy (the degree to which GDP growth generates trade). From1990 and 2011, it averaged 2.4 – that is 1 percent growth, led, on average, to a 2.4 per cent rise in trade.

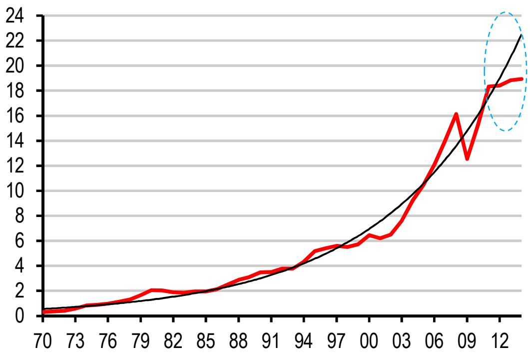
And just in case you are still in doubt about the relative slowdown in global trade, here are two more charts. The first shows how, after soaring between about 1990 and 2008, the share of exports in global GDP has since fallen slightly (chart 8). The second highlights the case of the "missing trillions": had trade increased in line with its trend over the last few decades, global exports (or imports, if you prefer) would

Chart 8: Exports as a share of world GDP (%)



Source: IMF, HSBC

Chart 9: World exports (USD bn)



Source: IMF, HSBC

have been USD 3 trillion higher today than they currently are (explaining all those empty cargo vessels bobbing about).

What gives?

Here's the thing, though: is subdued trade merely a function of relatively weak global growth? Or is something more fundamental going on? Let's start with the case for the former. Turn back to chart 5: note how exports tend to soar when activity accelerates, but also slow by more when output fizzles. From this angle: with output stuck in low gear in recent years, it doesn't seem too surprising that trade hasn't grown more rapidly. And, all this suggests that trade elasticities can be misleading: if the relationship between trade and growth is not linear, then trade elasticities might be low when growth is low and high when growth is high. Therefore, chart 7 cannot be taken as evidence in itself that the underlying relationship between world demand and imports has changed.

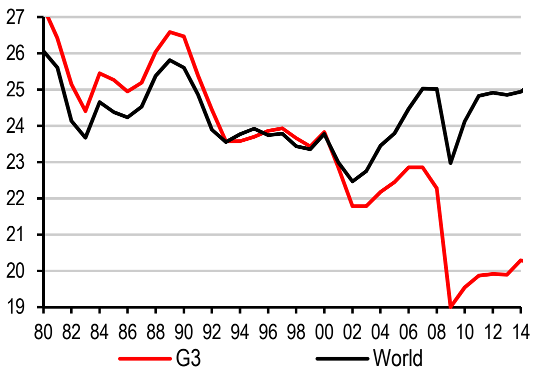
This, then, is the optimist's case that trade is only temporarily depressed and should rebound as global (and especially Western) growth recovers. Investment plays a critical role in this. Trade is generally more sensitive to capital spending cycles than it is to consumption (a lot of goods shipped around the world don't end up on retail shelves, but in factories and construction sites). However, investment has been especially depressed in the last several years in many advanced economies.

Chart 10, for example, shows that the investment to GDP ratio in the G3 economies collapsed during the Global Financial Crisis and has barely recovered since. Small wonder that import demand in these markets is lacklustre. Note that the world investment to GDP ratio held up better, but that's largely thanks to the housing construction boom in China (which is commodity intensive), and this has slowed sharply of late, explaining (in part) tumbling global commodity prices and rapidly weakening intra-emerging markets trade.

Chart 11 shows the change in the global investment to GDP ratio and world import growth. As mentioned, the two are highly correlated. Depressed investment activity, therefore, also entailed much slower trade gains relative to overall demand growth. From this perspective, all it would take is a cyclical uptick in capex, and – *voilà!* – global trade is restored to its earlier vibrancy.

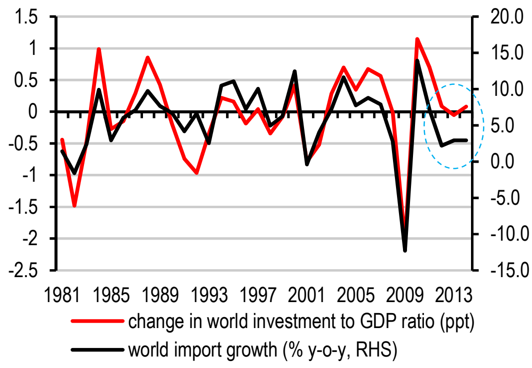
Well, it's not quite so easy. Two reasons. First, it's unclear that investment can indeed rebound: there are plenty of structural factors – population ageing, already high leverage, slow productivity growth, and general

Chart 10: Investment to GDP ratio (%)



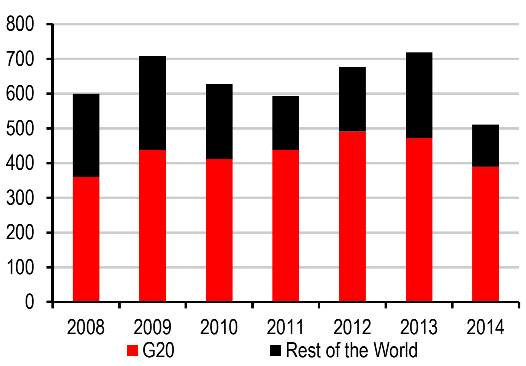
Source: IMF, HSBC

Chart 11: Trade and investment cycles highly correlated



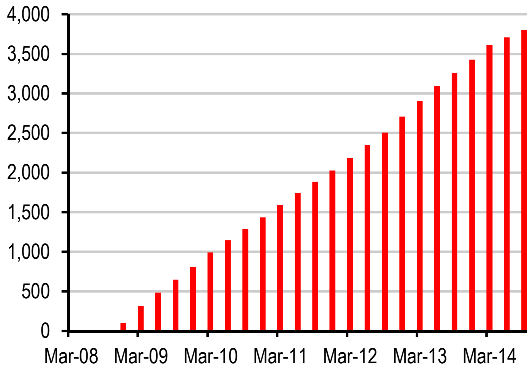
Source: IMF, HSBC

Chart 12: Annual incidences of protectionism



Source: Global Trade Alert, HSBC

Chart 13: Cumulative protectionist measures since 2008



Source: Global Trade Alert, HSBC

growth pessimism – that are bound to weigh on capex for a while (regardless, incidentally, of how low central bankers push interest rates). Second, if you take a close look at chart 11 you'll see that trade underperformed even what one might have expected from weak investment in recent years. We conclude that there must be something else going on.

Missing a piece, or two

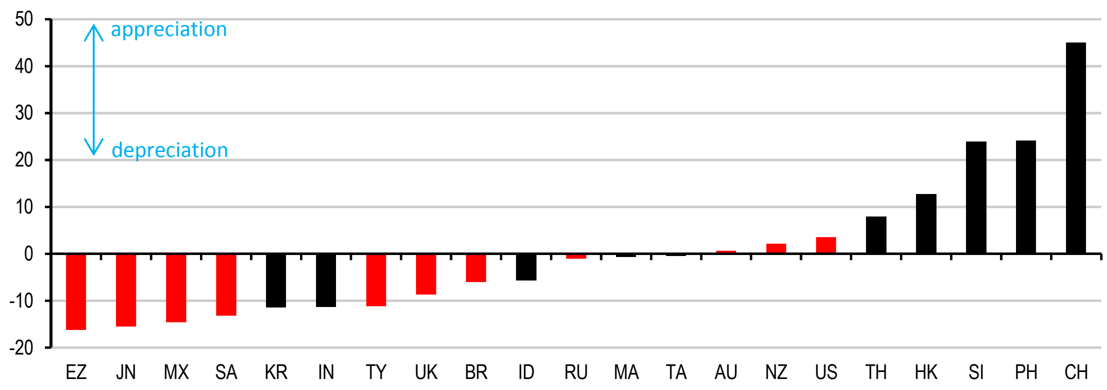
That "something" is likely structural, longer-lasting factors. We can think of a few, none of which will prove insurmountable over time, but all of which will constrain a near-term rebound in trade. First, perhaps the most obvious: protectionism. There are two elements to this argument. First: over the past decade, and especially since the Global Financial Crisis, governments around the world have taken various steps – each seemingly limited in scope, but arguably disruptive in aggregate – to protect local industries (charts 12 and 13).

Second, even if these individual measures only apply to a small portion of world trade, there is the broader issue that no major trade agreement has been implemented in well over two decades (although, one could argue that China's accession to the WTO in 2001 amounted to such). In fact, trade liberalization has been compared to pushing a boulder up a hill: unless one constantly presses ahead (with new deals), progress quickly reverses. Without major new agreements, in other words, the boost from past treaties has started to fizzle and the world trade system has gummed up.

Fortunately, there are signs that new trade deals may be signed. The most ambitious of all is the Trans-Pacific Partnership (TPP), which recently received a major boost when the US Congress authorized President Obama to finalize a deal (see Frederic Neumann: *Here comes the TPP*, 25 June 2015). The TPP could thus be signed before the end of the year. It currently comprises 12 members (around 40% of global GDP), with Japan, Vietnam, Brunei, Singapore, and Malaysia possibly being the Asian signatories (along with Australia and New Zealand). Taiwan, the Philippines, and Korea have also voiced interest in ultimately joining what amounts to one of the most ambitious free trade agreements ever undertaken (for an in-depth study see also Doug Lippoldt, et al, *Trading Up: Why the Trans-Pacific Partnership is so important*, 23 June 2015).

There are other major agreements in the works, too. For example, the Regional Comprehensive Economic Partnership (RCEP) amounts to a free trade area encompassing ASEAN, India, Japan, China, Korea, Australia and New Zealand. This has also made rapid progress, even if it is less ambitious in scope, and could be signed at the turn of the year. Meanwhile, the ASEAN Economic Community (AEC), a huge step towards integration

Chart 14: Change in real effective exchange rate since 2007 (%)



Source: BIS, HSBC

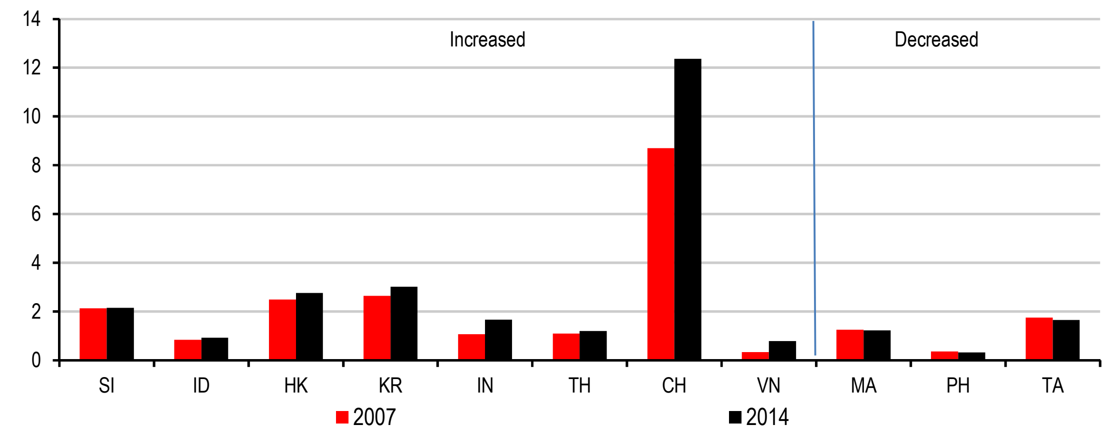
in Southeast Asia, will be launched by December of 2015, beginning a process designed to create a single market over subsequent years.

Still an edge

Is the poor performance of Asian exports of late a result of declining competitiveness? If so, that would be another structural factor weighing on regional trade that could take a while to correct. Competitiveness is hard to assess. But, as a short-hand measure, consider real effective exchange rates. Chart 14 shows their change since 2007, with an appreciation signifying, in principle, a loss in competitiveness. Led by China, many Asian economies (black bars) have seen their REER rise sharply over the last eight years. The Eurozone, Japan, Mexico, and South Africa have gained competitiveness; but so have Korea, India and Indonesia.

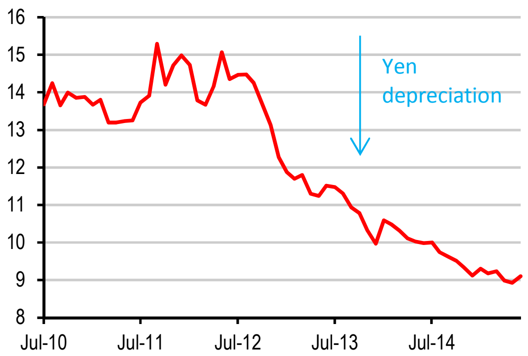
Does this really explain lacklustre export performance of late? We doubt it. First, as you may recall from chart 3, shipments to the EU (in volume terms) and the US are performing decently enough; it is exports to China (and other EMs) that are the problem. This most likely reflects weak demand in these markets. For example, China's REER appreciated far more than that of most other economies, yet the country's imports have tumbled (on the basis of real exchange rate moves, one would have expected the opposite). Also, looking at changes

Chart 15: Exports global market share (%)



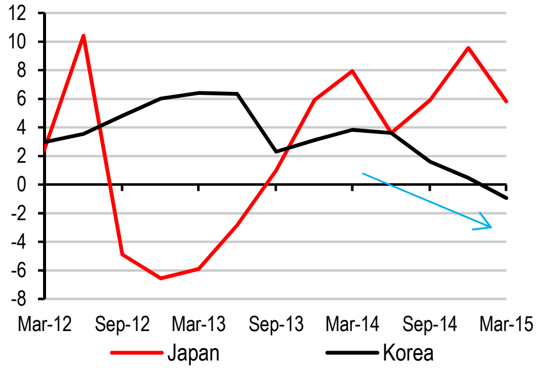
Source: CEIC, HSBC

Chart 16: JPY has been losing value against KRW



Source: Bloomberg, HSBC

Chart 17: Real export growth (% y-o-y)



Source: CEIC, HSBC

in global market share, most Asian economies have continued to make headway in recent years (including China; chart 15). This suggests that the slowdown in exports over the past year or so is not a reflection of the region suddenly losing its competitive edge.

Still, there is one exception: Korea. The rapid descent of the yen in recent years has put competitive pressure on Korean firms (others, such as Taiwan and China, don't compete as directly with Japan, so are more protected). Initially, this had little impact on Korean exports, but over the past year there has been a clear divergence, with shipments from Korea decelerating and Japan's picking up (chart 17). But that's not the whole story: to protect their market share, Korean firms had to lower dollar prices, which cut into their profit margins. This, in turn, put a dent in local capex spending and prompted managers to keep a lid on wages. Competitive pressure from a weaker yen has thus hurt local demand in Korea more than export volumes (at least initially). This, in turn, has pushed up the trade surplus, placing upward pressure on the won and making it even harder for Korean companies to stave off Japanese competitors. It's hard to see a quick fix for this.

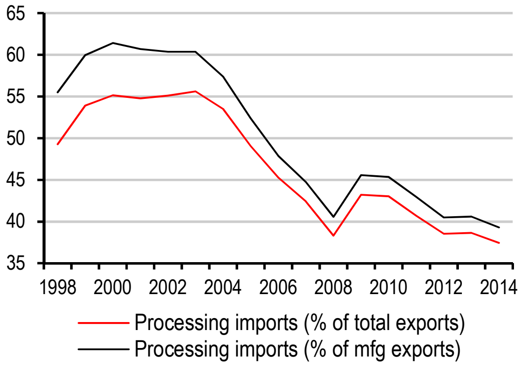
Supply unchained

It seems, therefore, that changes in competitiveness cannot fully explain Asia's current export malaise. But there is another, closely related factor that may account, at least in part, for slowing trade growth: supply chain "disintegration". Let's back up a little: the big jump in Asian trade over the 1990s and early 2000s to a large extent reflects supply chain integration, whereby components in various stages of production are shipped between countries before being finally assembled, usually in China, and shipped off to the West. An example: memory chips might be produced in Korea, welded onto motherboards in Taiwan, encased and connected in the Philippines, attached to a hard-drive in Thailand, and assembled into a computer, with parts from Malaysia, Japan and Singapore, in China, before being sent to a US retailer.

Supply chain integration, in short, allowed components to be produced in the most cost effective location, taking advantage of economies of scale and comparative advantage. It also meant a sharp rise in trade as goods were shipped back and forth between Asian destinations before heading west. Exports, as a result, rose faster than GDP, not just in Asia, but for the world at large.

The issue now is that supply chains are "disintegrating", with goods making fewer stops along the way towards final assembly in China. In fact, more and more production is taking place on the Mainland, rather than in other parts of Asia, particularly ASEAN (electronics). Take a look at chart 18. This shows processing imports (goods

Chart 18: China using less processing imports for its exports



Source: CEIC, HSBC

Chart 19: Less integration (24 months rolling correlation)

Source: CEIC, HSBC

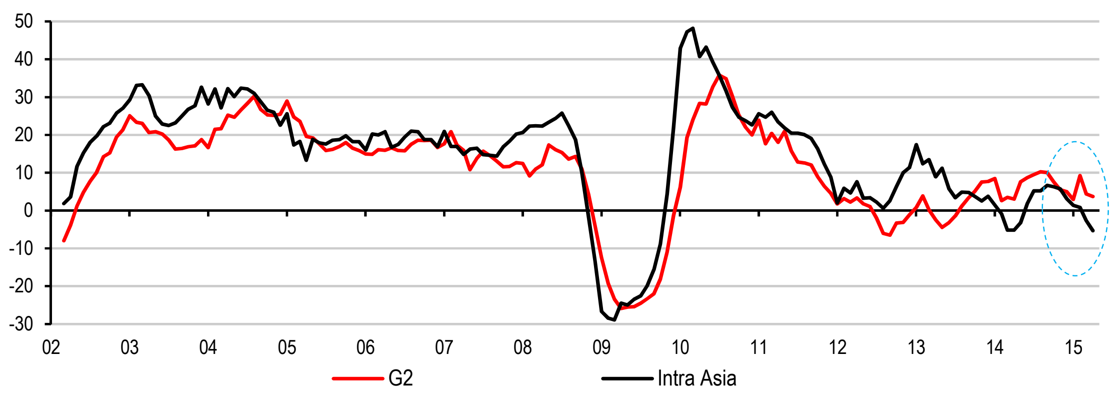
used for further assembly) as a share of exports. There has clearly been a big drop in recent years, implying that more and more value added is taking place in China. In turn, this suggests that, as Chinese exports to the US and EU pick up, less trade is generated within Asia than before. As further evidence consider chart 19. This shows the fall in correlation between exports from emerging Asia to China and China's shipments to the G2. Supply chains are simply no longer as integrated as before. Trade as a result tends to respond less and less to a pick-up in world GDP growth (thus: falling elasticity). Again, this is a structural factor that's unlikely to disappear any time soon.

Does it matter?

We are left, then, with two main observations: (1) Weak intra-Asian trade – reflecting weaker local demand in China and supply chain disintegration – is weighing on overall export performance (chart 20) and has led to subdued investment activity in the West; (2) this, coupled with growing protectionist weeds, explains why shipments haven't responded in their usual way to improving, if still subdued, demand in the EU and the US. But, the question is, does this really matter for Asia?

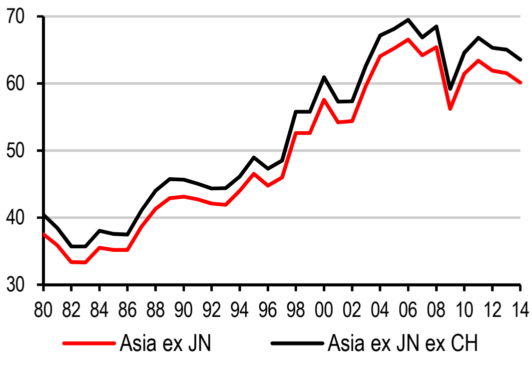
A quick look at export to GDP ratios suggests that it should matter less so than in the past: in many economies in Asia, though certainly not all, the importance of trade has seemingly diminished (charts 21 and 22). Still, the ratios remain comparatively high in places like Thailand, Malaysia, Hong Kong, Singapore, Vietnam,

Chart 20: Emerging Asia export growth (3mma, % y-o-y)



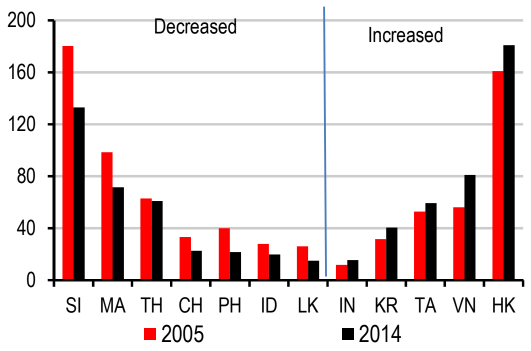
Source: CEIC, HSBC

Chart 21: Export to GDP ratio (%)



Source: CEIC, HSBC

Chart 22: Export to GDP ratio (%)



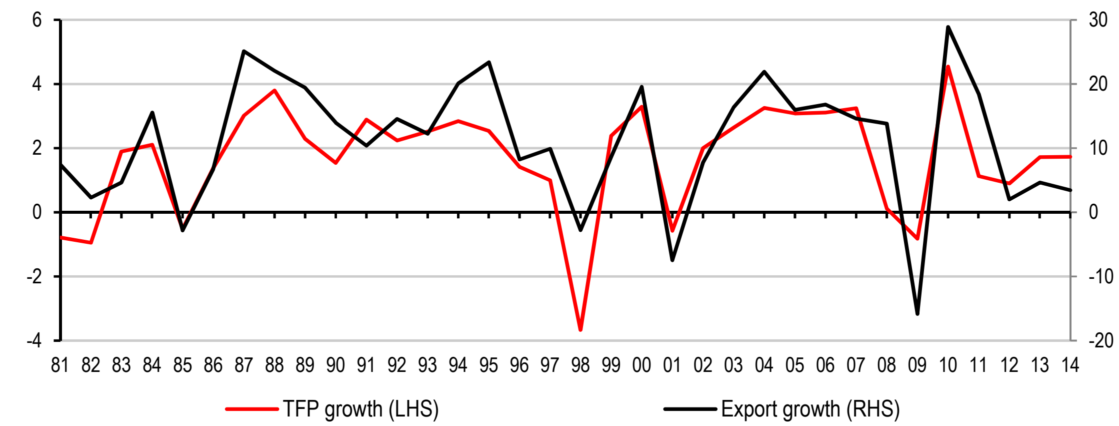
Source: CEIC, HSBC

Taiwan and Korea. In other words, exports may be playing a less important role in many places, but they still matter. But that's not all. Exports matter greatly in Asia because it is here where productivity gains are most readily attained. That has to do with the structure of the region's economies where domestic industries often remain sheltered and services, as a result, are not as vibrant an economic engine as they perhaps should be.

Take a look at chart 23. Here we show export and total factor productivity (TFP) growth for emerging Asia stretching back over three decades. The two are evidently highly correlated. When exports slow, as they have recently, economy-wide productivity gains also decelerate, limiting the overall speed limit of economies. From this perspective, if shipments remain subdued, it is difficult for efficiency gains to accelerate. Exports, clearly, matter far more for Asia not just in terms of their direct contribution to GDP, but because they spur productivity gains that are otherwise hard to achieve.

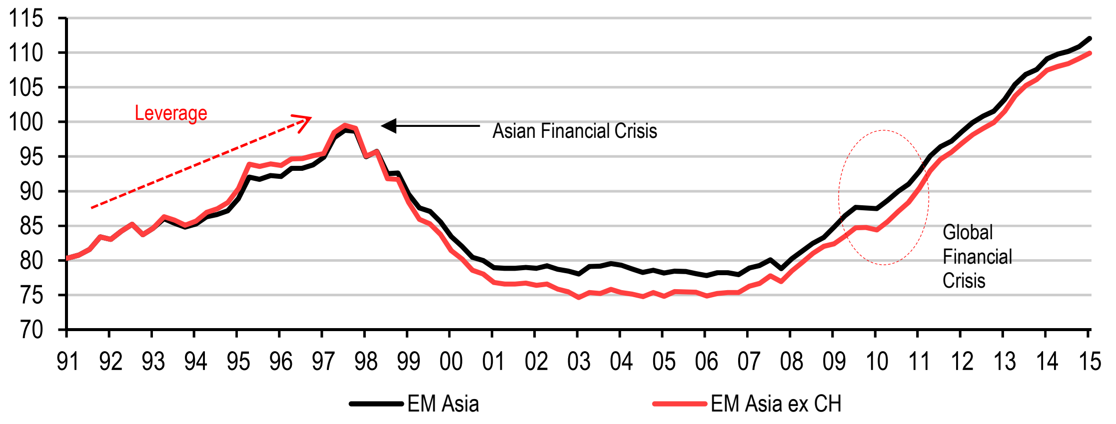
There is a solution to this export dependence, of course. This involves raising productivity growth in domestic sectors, predominantly services. And it's not that this is a secret: the various reform programs that have been talked about across the region – and are beginning to be implemented – are aimed primarily at raising the efficiency of local industries. Examples include: efforts in China to liberalize financial services to provide more funding for small and medium-sized enterprises and pruning the privileges of state-owned enterprises;

Chart 23: Asia ex Japan: export and total factor productivity (TFP) growth (% y-o-y)



Source: CEIC, UN, HSBC

Chart 24: Emerging Asia bank credit to GDP ratio (%)



Source: CEIC, HSBC

tax reform in India, along with attempts to improve energy supply; infrastructure for better internal connectivity in Indonesia, the Philippines, Vietnam, Thailand, and Malaysia; and even in Japan, Abe's third arrow of reforms is partly aimed at raising competition among service firms and cracking open the rigid labour market.

Pressure points

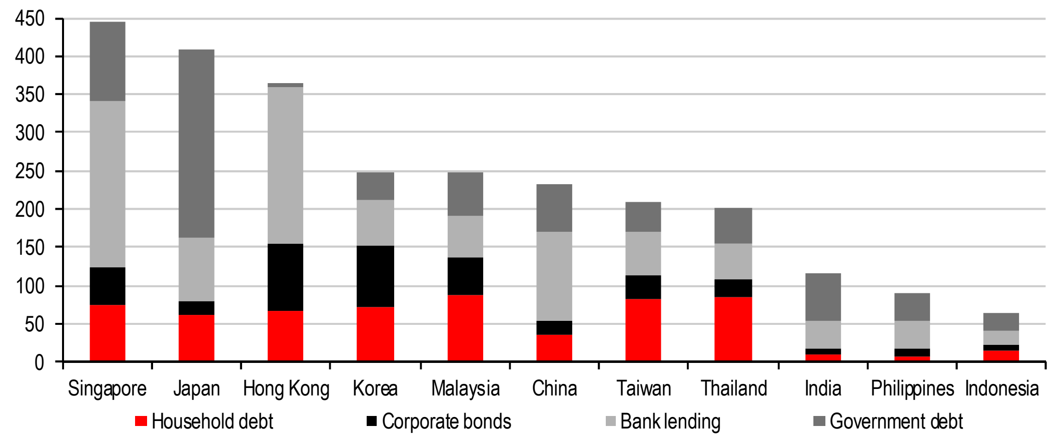
Progress on all these fronts has been halting, though not entirely absent. This, perhaps, was always inevitable: few countries have delivered sweeping reforms since the Global Financial Crisis, anywhere. Politics intrudes, some reforms are highly complex and need to be carefully staggered, and cheap funding may reduce the sense of urgency. Given the circumstances, Asia has arguably pushed on more quickly than others. But much of the work remains to be done. And even when implemented, the expected growth (or productivity) dividend will not be instantaneous. That, after all, is the dilemma facing all policy makers: structural reforms tend to be disruptive without immediate gains to show for it.

For a while, poor export performance did little to dent Asia's growth performance. There was a temporary solution at hand: leverage (chart 24). Expanding credit created local demand to fill the void. In the absence of rising productivity, however, this was always going to be just a temporary solution. And the limits of that strategy are now becoming apparent. Asia faces three problems in this regard.

The first is debt saturation. Credit to GDP ratios have risen to record highs in many economies. Households, companies, and many government entities, have bloated balance sheets as a result, making them reluctant to leverage up further. Financial institutions, too, have become more cautious, facing liquidity and capital constraints, and regulatory tightening aimed at avoiding (rightly) the build-up of financial excesses. This is not the case everywhere to the same extent. In Indonesia and the Philippines, for example, total debt as a share of GDP is still relatively low. India's aggregate leverage also has not increased significantly in the last several years, although relatively high public debt and stretched balance sheets among larger firms are limiting available funds for extra investment spending (chart 25).

Second, and related to the first point, is rising credit intensity. For a given increase in debt, GDP advances nowadays by less than several years ago. This reflects slowing productivity growth in many markets, which reduces the marginal productivity of capital. Think of it this way: taking out a loan to build the first subway in

Chart 25: Debt to GDP ratios in Asia (%)

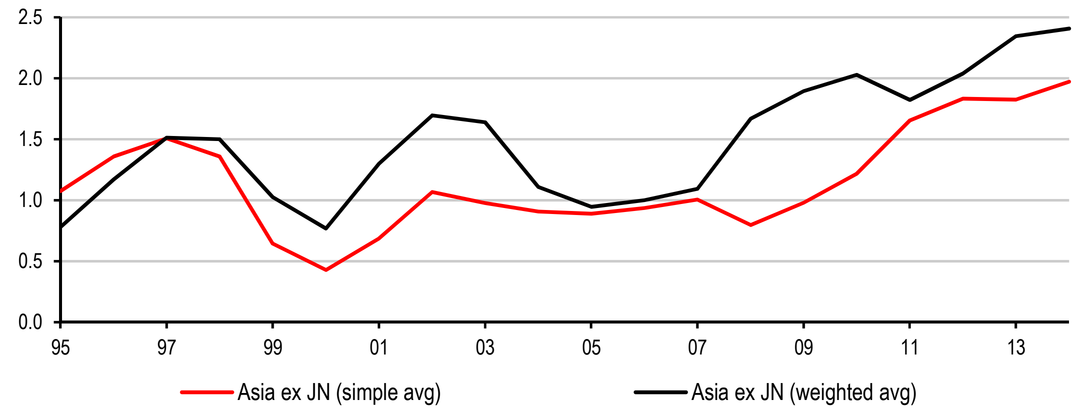


Source: CEIC, National Authorities, HSBC

a city enormously raises efficiency, but the fifth line will raise productivity by less (unless there are other efficiency improvements occurring in the economy in the meantime). Chart 26 shows the credit intensity of GDP growth in the region. This implies that credit would have to grow faster and faster simply to keep the economy expanding at the same pace.

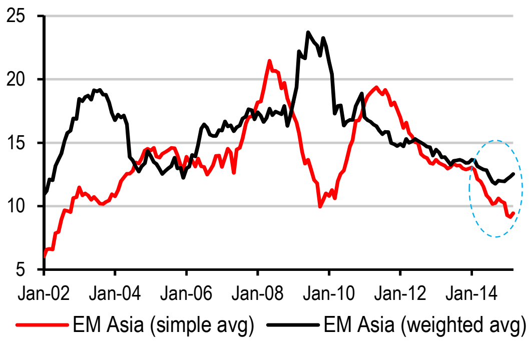
Third, funding conditions may tighten over the coming year. With the US Federal Reserve expected to raise interest rates before the end of the year, the headwinds will inevitably stiffen. The "taper tantrum" of 2013 already highlighted the sensitivity of financial conditions in emerging Asia to (potential) Fed tightening. But it's important to keep things in perspective: in themselves, the first few Fed rate hike are unlikely to cause acute financial stress. In fact, the region has weathered past Fed tightening cycles relatively well, at least initially (see Frederic Neumann, *Who's afraid of the Fed?*, 10 June, 2015). By and large, foreign exchange reserve buffers remain comfortable enough to avoid any balance-of-payments pressures. In addition, given rapid growth of local bond markets since the mid-2000s, and the growing involvement of foreign investors, what will arguably matter more over the coming year is the shape of the US yield curve, rather than higher short-term dollar rates (see Frederic Neumann, *Asia's all about the yield curve*, 19 June, 2015).

Chart 26: Change in bank credit relative to change in nominal GDP (ratio)



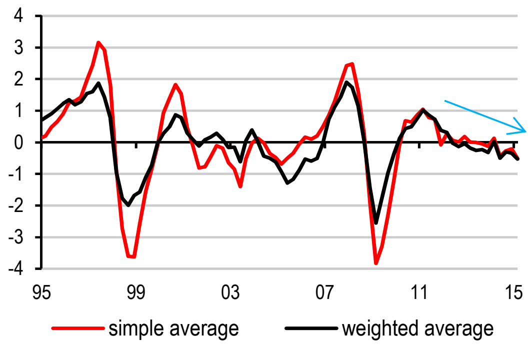
Source: CEIC, HSBC

Chart 27: Bank credit growth (% y-o-y)



Source: CEIC, HSBC

Chart 28: Emerging Asia output gap (%)



Source: CEIC, HSBC

In this regard, there is still cause for optimism: given the likely gradual path of Fed rate hikes in the coming years, ongoing quantitative easing by the ECB and BoJ (with the latter still expected to expand its program), and few signs that global inflation is set to accelerate, long-term external funding conditions should remain relatively benign for a while longer. But while all this means that an interest rate spike seems unlikely, funding costs are still bound to rise. Emerging Asia, in short, faces a growth problem, not imminent financial risk.

This presents officials in Asia with a dilemma. More stimulus is required to maintain growth. Credit growth, after all, is slowing (chart 27; on a weighted average basis it has recently stabilized due to faster lending in China, but note that shadow bank lending, not captured here, has slowed). Although inflation may have bottomed given stabilizing energy prices, output gaps are unlikely to close (chart 28). Thus, rate cuts still seem likely in many places, though central bankers will move cautiously to avoid triggering capital outflows as the Fed starts to tighten the screws.

HSBC policy and benchmark interest rate forecasts (grey denotes cut/decline, red denotes hike/rise, %)

	Q1 15	Q2 15	Q3 15f	Q4 15f	Q1 16f	Q2 16f	Q3 16f	Q4 16f
Australia	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00
New Zealand	3.50	3.25	3.00	3.00	3.00	3.00	3.00	3.00
Bangladesh	7.25	7.25	7.25	7.25	7.25	7.25	7.25	7.25
China	5.35	4.85	4.60	4.60	4.60	4.60	4.60	4.60
Hong Kong	0.50	0.50	0.50	0.75	1.00	1.00	1.25	1.25
India	7.50	7.25	7.25	7.25	7.25	7.25	7.25	7.25
Indonesia	7.50	7.50	7.25	7.25	7.25	7.25	7.25	7.25
Japan	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Korea	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25
Malaysia	3.25	3.25	3.00	3.00	3.00	3.00	3.00	3.00
Philippines	4.00	4.00	4.00	4.00	4.25	4.50	4.50	4.50
Singapore	1.45	0.82	1.60	1.80	1.90	1.90	1.90	1.90
Sri Lanka	8.00	7.50	7.50	7.00	7.00	7.00	7.00	7.00
Taiwan	1.875	1.875	1.750	1.625	1.625	1.625	1.625	1.625
Thailand	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25
Vietnam	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00

NB: For Singapore and Hong Kong benchmark money market rates
Source: CEIC, HSBC

China: How strong will the growth pickup be?

- Economic activity has showed tentative signs of bottoming out
- Growth to pick up further in H2 on more easing, led by accelerating infrastructure investment and stabilising property investment
- To sustain the recovery beyond 2015, Beijing should learn from earlier 'mini-cycles' and avoid ending policy easing prematurely

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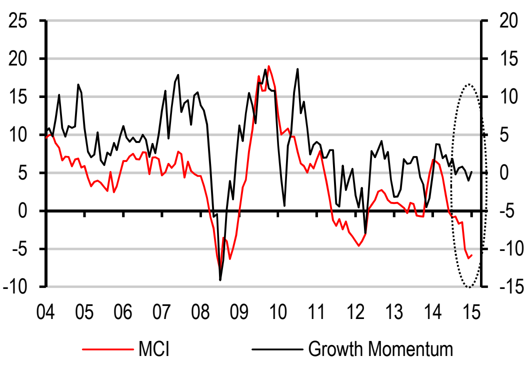
Tentative signs of bottoming out…

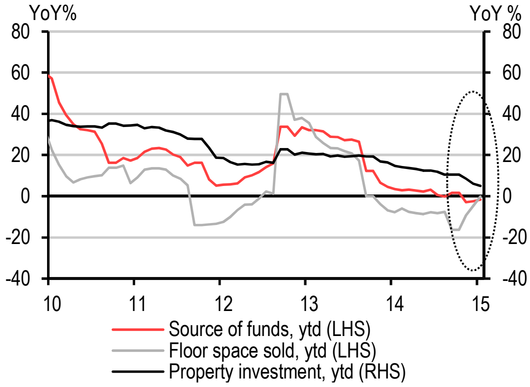
Belatedly, the Chinese economy has shown some tentative signs of stabilising. PMIs have finally started to steady, although they remain below the 50 waterline. Industrial Production growth edged up slightly to 6.1% y-o-y in May, from 5.9% in April and a post-crisis low of 5.6 % in March. Housing sales are also picking up in response to the relaxation of mortgage rules, such as the lowering of down payment requirements. Property sales volume in first tier cities rose 40% y-o-y as of May, while that in second term cities rose 17%. But as shown by the grey line in Chart 2, nationwide property sales volume has only rebounded to -0.2% y-t-d, y-o-y over the same period. This suggests a diverse market and differentiated demand response, based on different levels of urbanisation.

1. Leading indicators are stabilising



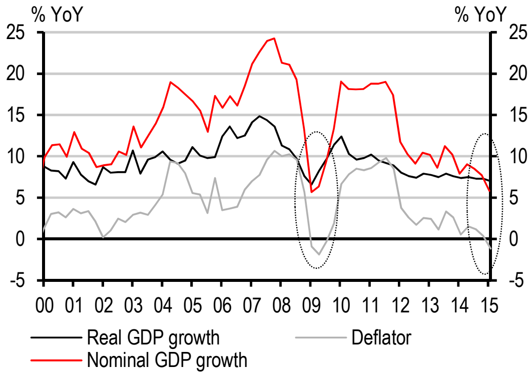
Source: NBS, Markit, HSBC

2. Property sales growth is recovering



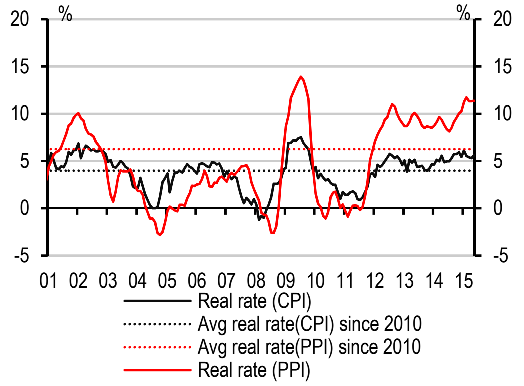
Source: NBS, HSBC

3. Inflation is still too low…



Source: NBS, HSBC NB: Average lending rate (not policy rate) is used after 2009; exclude latest 25bps policy rate cut delivered on 27th June, as June inflation readings are not yet available at the time of writing

4. … and real interest rates remain above post-crisis average levels



Source: NBS, HSBC NB: Average lending rate (not policy rate) is used after 2009; exclude latest 25bps policy rate cut delivered on 27th June, as June inflation readings are not yet available at the time of writing

Moreover, data from industrial production to investment growth are still deteriorating. This has already started to impact the labour market. Wage and income growth rates are also slowing down. Consumption growth is sliding and the employment sub-index of the manufacturing PMI has recently fallen to a six-year low.

And importantly, even the very few signs of 'bottoming out' appear unusually sluggish this time round compared with the previous cycles. The PMIs are still below the 50 waterline and the monetary conditions indicator is hovering around a multi-year low level.

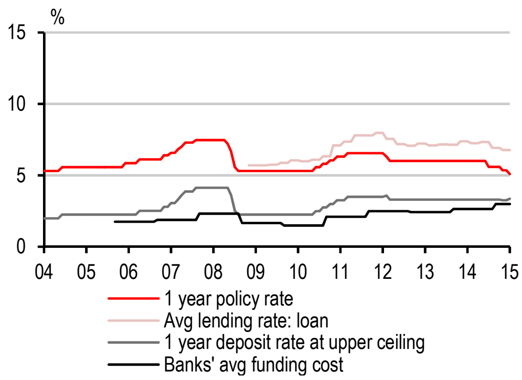
This has led many people to question whether the Chinese economy is less 'sensitive' to monetary policy now, perhaps as a result of interest rate reforms or possibly excess liquidity? In a recent report (see *China Inside Out: More decisive easing to lift growth*, 23 June), we addressed some of these concerns. Our view is that these concerns are in most cases overstated. And to the extent that these are valid concerns (for example, lack of a deep and liquid long-term bond market), the 'optimal' policy response is to ease more aggressively than otherwise the case, in order to compensate for these shortcomings.

Our view is that the cause of the sluggish recovery we are currently witnessing is insufficient policy easing, rather than ineffective policy easing.

This is most obviously evidenced by the continued rise in real interest rate (regardless of one's choice of inflation gauges). As of May 2015, the real interest rate deflated by CPI inflation was still higher than the average of 2014. Real interest rate deflated by PPI inflation was as much as 230bp higher than the average of 2014. This does not take into account the 25bp policy rate cut delivered on 27 June, as the corresponding inflation readings are not yet available, but the picture is unlikely to change materially.

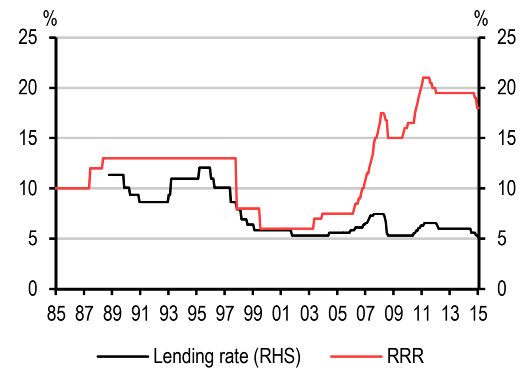
Chart 4 shows the trajectory of real interest rates against post-crisis average levels. Both CPI and PPI inflation deflated real interest rate remain considerably above their post-crisis average level. As of May 2015, the difference is 160bp for CPI inflation deflated real rate and 510bp for an equivalent measure based on PPI inflation (again this does not take into account the 25bp policy rate cut on 27 June).

5. Lending rates are still high



Source: NBS, HSBC

6. Monetary policy can ease further



Source: NBS, HSBC

Overly-cautious monetary easing, which falls short of anchoring real interest rates, can have negative consequences. A 'behind-the-curve' policy response is not only less effective, but can also create a false sense of optimism even as real economic activity continues to decelerate.

…more easing would help

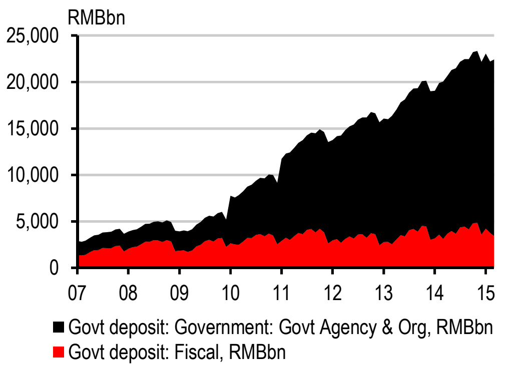
Therefore, our view is that policy makers should avoid the costly policy mistakes of indecision and deploy more timely and aggressive monetary and fiscal easing to consolidate the recovery.

The PBoC is fortunate in having a large stock of policy ammunition. In order to deploy this in the most effective way, policy easing should be aggressive enough to change market expectations and overcome institutional shortcomings such as the lack of a deep, liquid and long-term bond market. We believe it should be forward-looking enough to guide market expectations, and be clearly communicated in order to reduce the uncertainties that prevent a recovery from taking place.

In terms of options, our view is that there is plenty of policy room on both the policy rate as well as reserve requirement ratio. Chart 5 shows the lending rate, which in effective terms (the pink line) remains high. There is room to guide it lower through cuts to the nominal lending rate, and equally importantly through clearly-stated easing intentions to foster more optimistic expectations of the real economy. The recent removal of the mandatory loan to deposit ratio (see *China: Scrapping loan to deposit ratio: macro implications*, 25 June) should help to anchor the rise in funding costs of banks. Other channels of funding, such as interbank rates on short term (ie, 7 day repo rate) and medium term borrowing (interest rate on mid-term loan facilities) should also be lowered to facilitate the transmission of cuts to the one-year benchmark lending rate. As the interbank market is a place of both borrowing and lending, expectations of lower interbank rates should also increase banks' incentives to lend to the real economy.

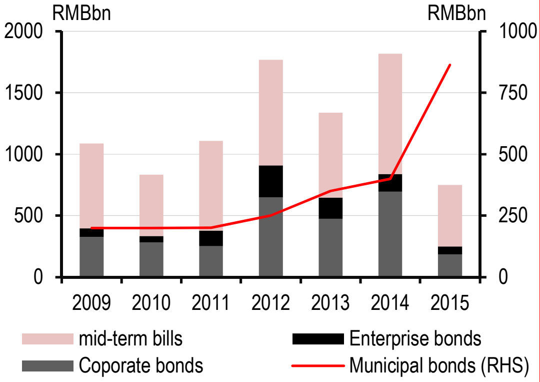
Meanwhile, the reserve requirement ratio, which was hiked from 7.5% to a peak of 21% over the past decade in response to strong FX inflows, has room to be unwound significantly over the medium term. In the absence of the strong inflows which passively increased the base money at a double-digit rate over the previous decade, the forced reduction in the money multiplier through a high reserve requirement ratio should be reversed in the coming years. This would achieve the dual role of ensuring adequate money supply growth and improving the transmission impact of monetary policy.

7. Room for fiscal expansion is large...



Source: NBS, HSBC

8. ...and it can be more sustainable than before



Source: Wind, HSBC

In addition to monetary policy, fiscal policy can also be more expansionary. The repeated lack of action on fiscal policy through the economic slowdown over the past few years risks making this seem like wishful thinking yet again. But our view is that the room for fiscal expansion is large and it can be more sustainable than has been the case in the previous easing cycles.

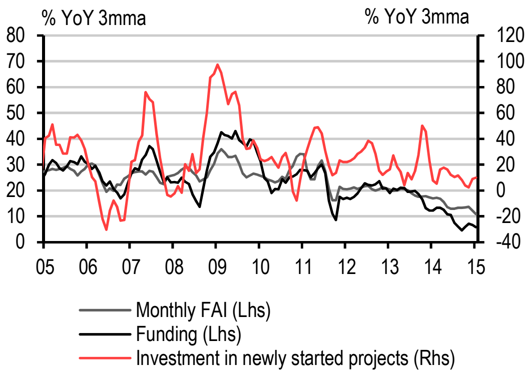
As we have discussed previously, as the result of the economic slowdown, room to expand the current expenditure side of the fiscal budget may not be large. Fiscal policy, with a targeted deficit at 2.3% of GDP, remains one of the most conservative amongst emerging markets. It does not need to be so conservative, though this would be more of a medium-term change if it was to happen. As far as the current year is concerned, the current expenditure side of the fiscal book will only be of modest help, in our view.

However, outside the current expenditure budget, several developments have taken place which helped to diversify funding channels for infrastructure investments. One is the State Council's decision to look into ways to utilise stock of fiscal surpluses accumulated over the years. As shown in Chart 7, the stock of fiscal deposits currently stands at close to RMB4trn, of which at least RMB3.4trn can be directly traced back to surpluses under each of the fiscal accounts. This is twice the size of the planned budget deficit for 2015. The wider government sector has close to RMB20trn of deposits, part of which may represent unspent fiscal subsidies and transfers. The utilisation of at least a small portion of this stock of surpluses should be sufficient to plug any unforeseen fiscal gaps and should be an additional source of fiscal support for needed infrastructure projects (see *China Inside Out: What fiscal cliff?*, 7 May 2015).

Meanwhile, municipal bond issuance kick-started in mid-May with a busy schedule ahead for the rest of the year. New issuance quota is set at RMB600bn, which is slightly larger than previous years. But more importantly, local governments have finally started to restructure their debt with the so called 'debt-to-bond' swap. RMB2trn municipal bonds could be issued to refinance short-tenor, high-yield debt borrowed elsewhere that is due to mature in 2015. This could take net issuance to as high as RMB2.6trn in 2015, almost three times the amount in 2014. This is a large step forward in making infrastructure financing more sustainable.

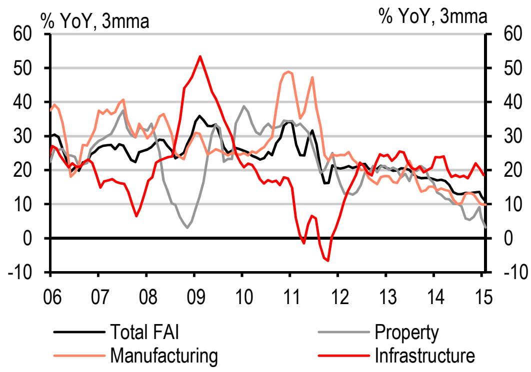
In our view, both fiscal deposits and municipal bonds not only have room to play a bigger counter-cyclical role, but are also more sustainable methods of financing.

9. Single monthly investment growth to recover...



Source: NBS, HSBC

10. ... as funding for infrastructure investment improves



Source: Thomson Reuters Datastream, HSBC

Infrastructure-led recovery

On the back of further monetary and fiscal easing, we expect growth to show a modest sequential recovery in Q2 from the multi-year low reading of 1.3% q-o-q in Q1 2015, and for the headline growth rate to start improving in Q3.

The recovery will be led by faster infrastructure investment growth as growth recovers. Infrastructure investment growth has weakened since early 2015, as the impact of tighter fiscal borrowing rules impacted financing (Chart 9). But the next few months should see faster municipal bond issuance and mobilisation of fiscal deposits, so we expect single monthly infrastructure investment growth to rebound from the six-month low reading of 15.1% in May. Less tight monetary conditions should also help ensure stable bank lending and more reasonable funding costs.

Apart from refinancing of existing investment, there are also signs that new investment growth will accelerate in the coming months. Policy makers have built up a longer project pipeline. The NDRC has announced that it built a RMB10trn project pipeline in 'seven key areas' which are ready to be rolled out over the coming months. This suggests that policy planning on infrastructure investment is now less ad hoc and better coordinated.

And there is the likelihood that a more broad-based recovery in property sales will take place. As is the case with infrastructure investment, less tight monetary conditions should support a sales recovery; if this lasts it may translate into some stabilisation in property investment towards year-end.

Avoid another 'mini-cycle'

When these early signs of recovery turn more broad-based, the question further down the road will inevitably be "is this another one of those mini-cycles'? Indeed, over the past years, China's economic growth cycles seem to have become much shorter, with both slowdown and recovery typically lasting less than two quarters. Meanwhile, the average annual growth rates continue to decline, raising concerns about more structural issues, such as potential growth.

Our view is that this concern is overdone, and to a large extent premature given China's current development stage. Both capital stock per worker and more broadly speaking productivity have significant room to grow. We still expect the growth rate to be quite rapid given China is less than half way through the ‘catch-up’ stage (capital stock per worker is currently only 20% of the level of the US). This does not preclude the need for structural reforms, but the reforms are there to facilitate future growth.

Instead, we believe that a large explanatory variable, if not the root cause, of the increasingly shorter economic cycle lies with insufficient policy easing, followed by over-hasty tightening. This is particularly the case since 2013, which saw a gradual shift in the default monetary stance to become tighter. Against the backdrop of a slowdown in FX inflows, the PBoC has further reduced liquidity injections in open-market operations while keeping the reserve requirement ratio close to an all-time high. As the ‘default’ monetary policy turned tighter, each round of policy easing becomes more cautious than the previous one. After the property market correction started in early 2014, the PBoC made no overt change to monetary policy until November 2014, opting only to halt and partially reverse the liquidity draining through open-market operations.

The combination of ‘doing too little’ and ‘stopping too soon’ meant that economic activities never get the chance of a proper reboot and therefore the recoveries fail to become sustainable.

The dangers of too many ‘mini-cycles’ are numerous, in our view. In the short term, this means economic growth remains subpar and policy ammunition becomes wasted. But the longer-term consequence is even more costly. It means that insufficient new investment is made to drive growth, and labour market slackness becomes entrenched. Economic potential can be eroded and growth becomes permanently lower.

In order to avoid another unnecessary ‘mini-cycle’, our view is that policy makers should act more aggressively in easing policy and keeping policies accommodative for enough time to ensure the recovery becomes self-sustaining.

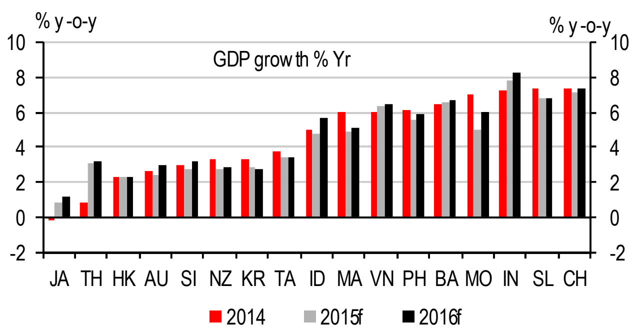
Indicators

GDP

% y-o-y	2007	2008	2009	2010	2011	2012	2013	2014	2015f	2016f
China	14.2	9.6	9.2	10.4	9.3	7.7	7.7	7.4	7.1	7.4
Hong Kong	6.5	2.1	-2.5	6.8	4.8	1.7	2.9	2.3	2.3	2.3
Japan	2.2	-1.0	-5.5	4.7	-0.5	1.7	1.6	-0.1	0.8	1.1
Korea	5.5	2.8	0.7	6.5	3.7	2.3	2.9	3.3	2.8	2.8
Mongolia	10.2	8.9	-1.3	6.4	17.5	12.2	11.6	7.0	5.0	6.0
Taiwan	6.5	0.7	-1.6	10.6	3.8	2.1	2.2	3.8	3.5	3.5
North Asia-ex Japan	11.4	7.6	7.0	9.7	8.2	6.6	6.8	6.7	6.4	6.6
Australia	4.5	2.7	1.6	2.3	2.7	3.6	2.1	2.7	2.4	3.0
Bangladesh	6.0	5.0	5.6	6.5	6.5	6.0	6.1	6.5	6.6	6.7
India	9.8	3.9	8.5	10.3	4.8	5.1	6.9	7.3	7.8	8.3
Indonesia	6.3	6.0	4.6	6.7	6.2	6.0	5.6	5.0	4.8	5.6
Malaysia	6.3	4.8	-1.5	7.5	5.3	5.5	4.7	6.0	4.8	5.1
New Zealand	3.4	-0.5	-1.4	1.6	1.8	2.4	2.2	3.3	2.8	2.8
Philippines	6.6	4.2	1.1	7.6	3.7	6.7	7.1	6.1	5.6	5.9
Singapore	9.1	1.9	-0.7	15.3	6.2	3.4	4.4	2.9	2.7	3.2
Sri Lanka	6.8	6.0	3.5	8.0	8.2	6.4	7.2	7.4	6.8	6.8
Thailand	5.4	1.7	-0.7	7.5	0.8	7.3	2.8	0.9	3.1	3.3
Vietnam	8.5	6.3	5.3	6.8	6.0	5.2	5.4	6.0	6.3	6.5
Asia-ex China, India & Japan	6.2	3.3	1.0	7.8	4.6	4.2	4.1	4.0	3.9	4.1
Asia-ex China & Japan	7.2	3.5	3.2	8.6	4.7	4.5	4.9	5.0	5.0	5.3
Asia-ex Japan	10.3	6.5	6.4	9.5	7.2	6.3	6.5	6.4	6.3	6.6
Asia	7.4	3.9	2.3	8.0	4.9	5.0	5.4	5.1	5.1	5.4

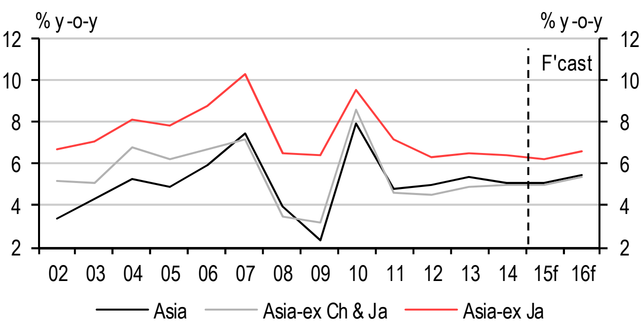
NB: Australia and New Zealand are not included in Asia aggregate and data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights. India and Bangladesh data are FY.
Source: CEIC, HSBC forecasts

GDP (% yr): India pulling ahead



Source: CEIC, HSBC forecasts

GDP (% yr): Steady, if disappointing, of late



Source: CEIC, HSBC forecasts

GDP

(% y-o-y)	2014				2015f				2016f			
	1Q	2Q	3Q	4Q	1Qf	2Qf	3Qf	4Qf	1Qf	2Qf	3Qf	4Qf
Australia	2.9	2.8	2.7	2.4	2.3	2.3	2.5	2.7	2.8	3.0	3.1	3.0
China	7.4	7.5	7.3	7.3	7.0	6.8	7.1	7.2	7.2	7.4	7.3	7.4
Hong Kong	2.7	2.0	2.9	2.4	2.1	2.8	2.9	1.5	2.4	2.5	2.5	2.0
India	6.7	6.7	8.4	6.6	7.5	8.4	8.4	7.5	6.9	8.2	8.2	8.4
Indonesia	5.1	5.0	4.9	5.0	4.7	4.7	4.9	4.9	5.5	5.6	5.7	5.8
Japan	2.4	-0.4	-1.4	-1.0	-0.9	0.8	1.8	1.7	0.9	1.4	1.1	1.1
Korea	3.9	3.4	3.3	2.7	2.4	2.6	2.8	3.5	2.9	2.7	2.7	2.9
Malaysia	6.3	6.5	5.6	5.7	5.6	4.7	4.9	4.2	4.4	4.9	5.4	5.7
New Zealand	3.1	3.4	3.3	3.5	2.6	2.8	2.7	3.0	3.4	3.0	2.6	2.2
Philippines	5.6	6.7	5.5	6.6	5.2	6.2	5.6	5.2	6.3	6.3	5.2	5.6
Singapore	4.6	2.3	2.8	2.1	2.6	2.9	3.0	2.4	2.4	3.1	3.4	3.9
Sri Lanka	7.6	7.8	7.7	6.4	6.4	6.6	6.4	7.6	7.5	7.1	6.5	6.0
Taiwan	3.4	3.9	4.3	3.5	3.4	3.0	3.8	3.6	3.7	4.2	3.2	2.9
Thailand	-0.4	0.9	1.0	2.1	3.0	1.8	6.6	1.2	-1.9	4.1	6.6	4.5
Vietnam	4.8	5.5	6.4	6.8	6.1	6.5	6.4	6.4	6.0	6.5	6.6	6.9

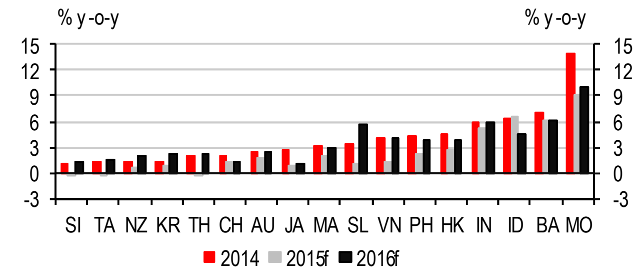
Source: CEIC, HSBC

Inflation

(% y-o-y)	2007	2008	2009	2010	2011	2012	2013	2014	2015f	2016f
China	4.8	5.9	-0.7	3.3	5.4	2.7	2.6	2.0	1.2	1.3
Hong Kong	2.0	4.3	0.6	2.3	5.3	4.1	4.3	4.4	2.7	3.8
Japan	0.1	1.4	-1.3	-0.7	-0.3	0.0	0.4	2.7	0.8	1.1
Korea	2.5	4.7	2.8	2.9	4.0	2.2	1.3	1.3	0.8	2.2
Mongolia	9.6	28.0	7.6	10.2	9.1	14.3	10.4	14.0	9.0	10.0
Taiwan	1.8	3.5	-0.9	1.0	1.4	1.9	0.8	1.2	-0.2	1.5
North Asia-ex Japan	4.0	5.5	-0.2	3.1	5.0	2.7	2.4	2.0	1.2	1.5
Australia	2.3	4.4	1.8	2.9	3.3	1.8	2.4	2.5	1.7	2.5
Bangladesh	9.1	8.9	5.4	8.1	11.7	7.2	7.5	7.0	6.1	6.2
India	6.2	9.1	12.3	10.3	9.0	10.2	9.8	6.0	5.2	5.8
Indonesia	6.7	9.8	5.0	5.1	5.3	4.0	6.4	6.4	6.5	4.5
Malaysia	2.0	5.4	0.6	1.7	3.2	1.7	2.1	3.1	2.0	2.8
New Zealand	2.4	4.0	2.1	2.3	4.0	1.1	1.1	1.2	0.5	2.0
Philippines	2.9	8.2	4.3	3.8	4.7	3.2	2.9	4.2	2.2	3.9
Singapore	0.0	6.6	0.6	2.8	5.2	4.6	2.4	1.0	-0.3	1.2
Sri Lanka	15.8	22.6	3.5	6.2	6.7	7.5	6.9	3.3	1.1	5.6
Thailand	2.2	5.5	-0.9	3.3	3.8	3.0	2.2	1.9	-0.4	2.3
Vietnam	8.4	23.1	6.7	9.2	18.7	9.1	6.6	4.1	1.4	4.0
Asia-ex China, India & Japan	3.3	6.7	2.3	3.5	4.9	3.4	3.2	3.1	2.1	3.0
Asia-ex China & Japan	4.1	7.4	5.3	5.6	6.1	5.4	5.1	3.9	3.0	3.8
Asia-ex Japan	4.4	6.6	2.1	4.4	5.7	3.8	3.6	2.8	2.0	2.3
Asia	2.9	4.8	0.9	2.7	3.9	2.7	2.9	2.8	1.7	2.1

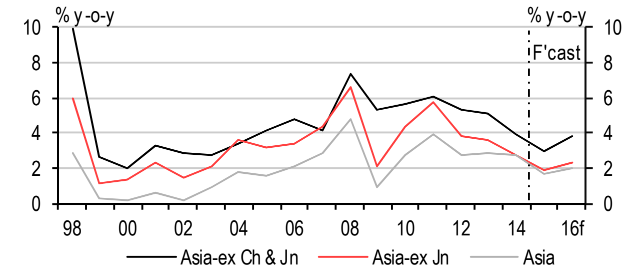
NB: Australia and New Zealand are not included in Asia aggregate and data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights. India data are FY. Japan 2015 forecasts reflect the effects of the April 2014 consumption tax hike.
Source: CEIC, HSBC forecasts

CPI (% yr): A sharp step-down in Indonesia next year



Source: CEIC, HSBC forecasts

CPI (% yr): Inflation rates stabilizing



Source: CEIC, HSBC forecasts

CPI

(% y-o-y)	2014				2015f				2016f			
	1Q	2Q	3Q	4Q	1Qf	2Qf	3Qf	4Qf	1Qf	2Qf	3Qf	4Qf
Australia	2.9	3.0	2.3	1.7	1.3	1.6	1.8	2.2	2.5	2.5	2.4	2.4
Bangladesh	7.5	7.3	6.9	6.3	7.2	7.0	6.2	5.9	6.7	6.6	5.9	5.4
China	2.3	2.2	2.0	1.5	1.2	1.2	1.3	1.3	1.4	1.3	1.3	1.2
Hong Kong	4.2	3.6	4.8	5.1	4.4	2.8	2.2	1.6	2.5	4.3	4.2	4.1
India	8.2	7.8	6.7	4.1	5.3	5.0	4.5	5.6	5.6	5.8	5.9	5.9
Indonesia	7.8	7.1	4.4	6.5	6.5	7.1	6.9	5.6	4.5	4.7	4.4	4.4
Japan	1.5	3.6	3.3	2.5	2.3	0.1	0.3	0.5	1.0	1.0	1.1	1.2
Korea	1.1	1.6	1.4	1.0	0.6	0.5	0.9	1.4	1.9	2.2	2.3	2.3
Malaysia	3.5	3.3	3.0	2.8	0.7	2.3	2.7	2.4	4.1	2.7	2.4	2.3
New Zealand	1.5	1.6	1.0	0.8	0.1	0.4	0.5	1.2	1.9	1.9	2.0	2.1
Philippines	4.1	4.4	4.7	3.6	2.4	1.8	1.7	2.9	3.5	4.4	4.1	3.3
Singapore	1.0	2.2	1.0	0.0	-0.3	-0.4	-0.4	-0.2	0.3	0.9	1.5	2.1
Sri Lanka	4.2	3.6	3.5	1.8	1.3	0.1	0.2	2.6	4.2	6.1	6.2	5.9
Taiwan	0.8	1.6	1.5	0.8	-0.6	-0.7	-0.2	0.5	1.6	1.5	1.4	1.4
Thailand	2.0	2.5	2.0	1.1	-0.5	-1.1	-0.5	0.5	2.0	2.3	2.4	2.4
Vietnam	4.8	4.7	4.3	2.6	0.7	1.0	1.4	2.3	3.9	4.2	4.1	3.8

Source: CEIC, HSBC forecasts

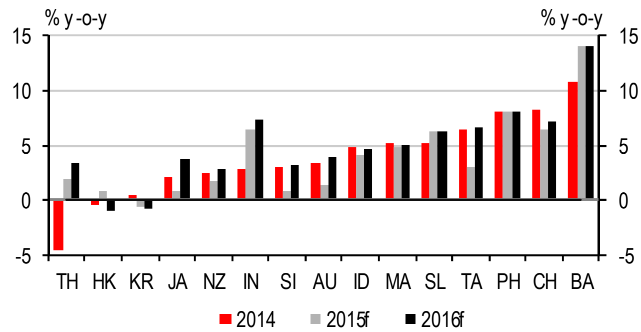
Industrial production & unemployment

Industrial production

(% y-o-y)	2007	2008	2009	2010	2011	2012	2013	2014	2015f	2016f
China (VAI)	16.0	12.9	12.9	15.7	13.9	10.0	9.7	8.3	6.5	7.2
Hong Kong	-1.5	-6.7	-8.3	3.5	0.7	-0.8	0.1	-0.4	0.8	-1.0
Japan	2.8	-3.4	-21.8	15.6	-2.8	0.6	-0.8	2.1	0.9	3.8
Korea	7.0	3.5	-0.8	16.5	6.0	1.7	0.4	0.5	-0.6	-0.7
Taiwan	7.8	-1.1	-7.9	24.2	4.4	-0.2	0.7	6.4	3.1	6.6
North Asia-ex Japan	8.4	6.6	6.2	10.7	8.3	5.8	5.8	5.2	3.9	4.5
Australia	3.4	2.8	-1.3	4.6	1.1	3.4	2.0	3.4	1.3	3.9
Bangladesh	6.4	8.3	6.4	9.6	16.3	8.7	9.4	10.7	14.0	14.1
India	15.5	2.5	5.3	8.2	2.9	1.1	-0.1	2.8	6.4	7.4
Indonesia	5.6	3.0	1.3	5.1	4.1	4.1	6.0	4.8	4.1	4.6
Malaysia	2.3	0.8	-7.6	6.2	2.4	4.2	3.4	5.1	4.9	5.1
New Zealand	6.1	-11.0	4.8	-4.3	0.6	-0.1	1.0	2.5	1.8	2.8
Philippines	3.6	4.3	-4.8	11.2	4.7	5.4	10.3	8.1	8.0	8.0
Singapore	5.9	-4.2	-4.2	29.7	7.8	0.3	1.7	3.0	0.9	3.2
Sri Lanka	7.6	5.9	-0.2	15.4	7.3	1.6	0.5	5.3	6.3	6.2
Thailand	8.4	4.7	-7.0	14.2	-8.5	2.2	-3.2	-4.6	1.9	3.4
Vietnam	17.1	14.6	7.1	10.9	6.9	7.0	n.a.	n.a.	n.a.	n.a.
Asia-ex China, India & Japan	6.2	2.2	-2.7	13.6	3.9	2.3	2.4	2.8	2.7	3.5
Asia-ex China & Japan	8.8	2.3	-0.3	12.0	3.6	2.0	1.7	2.8	3.8	4.7
Asia-ex Japan	12.0	7.6	6.7	13.9	9.2	6.6	6.4	6.1	5.4	6.2
Asia	8.7	3.8	-3.1	14.4	5.5	4.9	4.7	5.3	4.4	5.7

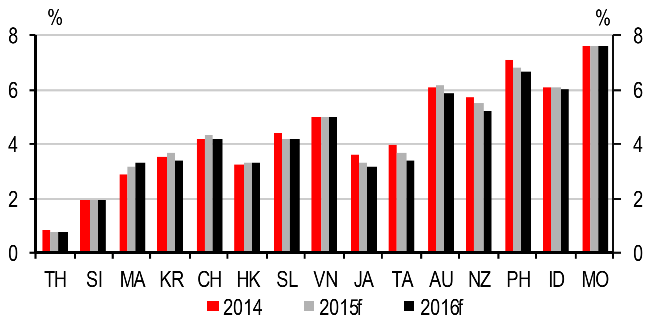
NB: Australia and New Zealand are not included in Asia aggregate and data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights
Source: CEIC, HSBC forecasts

Industrial production (% yr): Soaring in Bangladesh



Source: CEIC, HSBC forecasts

Unemployment rate (%): Still low in Thailand



Source: CEIC, HSBC forecasts

Unemployment rate (average)

%	2007	2008	2009	2010	2011	2012	2013	2014f	2015f	2016f
China	4.0	4.2	4.3	4.1	4.3	4.1	4.1	4.2	4.3	4.2
Hong Kong	4.1	3.5	5.2	4.4	3.5	3.3	3.4	3.2	3.3	3.3
Japan	3.8	4.0	5.1	5.1	4.6	4.3	4.0	3.6	3.4	3.2
Korea	3.3	3.2	3.7	3.7	3.4	3.2	3.1	3.5	3.7	3.4
Mongolia	2.8	2.8	3.6	3.6	5.2	7.1	7.6	7.6	7.6	7.6
Taiwan	3.9	4.3	5.9	5.2	4.3	4.2	4.2	3.9	3.7	3.4
North Asia-ex Japan	3.8	4.0	4.3	4.1	4.2	4.0	4.0	4.1	4.2	4.1
Australia	4.4	4.2	5.6	5.2	5.1	5.2	5.7	6.1	6.2	5.9
Indonesia	9.7	8.8	8.1	7.5	6.9	6.4	6.2	6.1	6.1	6.0
Malaysia	3.2	3.3	3.6	3.2	3.1	3.0	3.1	2.9	3.1	3.3
New Zealand	3.7	4.2	6.1	6.6	6.5	6.9	6.3	5.8	5.5	5.2
Philippines	7.2	7.5	7.4	7.4	7.0	7.0	7.0	7.1	6.8	6.7
Singapore	2.1	2.3	3.0	2.2	2.0	1.9	1.9	2.0	1.9	1.9
Sri Lanka	5.5	5.4	5.7	4.5	3.9	3.9	4.1	4.4	4.2	4.2
Thailand	1.3	1.4	1.5	1.1	0.7	0.7	0.7	0.8	0.8	0.8
Vietnam	4.6	4.7	4.6	4.3	4.5	4.6	4.6	5.0	5.0	5.0
Asia-ex China & Japan	3.1	3.1	3.3	3.1	2.8	2.7	2.7	2.7	2.7	2.6
Asia-ex Japan	3.5	3.7	3.8	3.6	3.6	3.5	3.5	3.6	3.7	3.6
Asia	3.6	3.8	4.3	4.1	3.9	3.7	3.6	3.6	3.6	3.5

NB: Australia and New Zealand are not included in Asia aggregate and data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights
Source: CEIC, HSBC forecasts

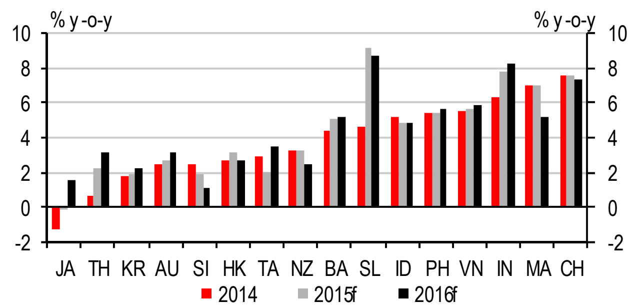
Consumption & saving

Consumer expenditure

(% y-o-y)	2007	2008	2009	2010	2011	2012	2013	2014	2015f	2016f
China	8.5	4.8	16.1	0.6	10.2	8.2	7.5	7.5	7.6	7.3
Hong Kong	8.6	1.9	0.2	6.1	8.4	4.1	4.6	2.7	3.1	2.7
Japan	0.9	-0.9	-0.7	2.8	0.3	2.3	2.1	-1.3	-0.1	1.5
Korea	5.1	1.4	0.2	4.4	2.9	1.9	1.9	1.8	1.9	2.2
Taiwan	2.4	-1.7	0.0	3.8	3.1	1.8	2.4	3.0	2.0	3.5
North Asia-ex Japan	7.3	3.7	12.5	1.5	8.8	7.1	6.5	6.6	6.6	6.5
Australia	5.7	1.9	0.8	3.3	3.1	2.5	1.7	2.5	2.7	3.1
Bangladesh	4.0	2.3	4.6	6.5	4.1	5.1	2.7	4.4	5.1	5.2
India	9.4	7.2	7.4	8.7	7.8	5.5	6.2	6.3	7.8	8.3
Indonesia	n/a	n/a	n/a	4.4	5.1	5.5	5.4	5.1	4.8	4.9
Malaysia	10.4	8.7	0.6	6.8	6.9	8.3	7.2	7.0	6.9	5.2
New Zealand	3.6	0.4	-0.8	3.1	2.0	2.9	2.9	3.2	3.2	2.5
Philippines	4.6	3.7	2.3	3.4	5.6	6.6	5.6	5.4	5.4	5.6
Singapore	6.1	3.5	-1.1	5.9	4.0	3.5	3.5	2.5	1.9	1.2
Sri Lanka	3.9	7.5	0.9	9.2	14.7	6.8	3.2	4.6	9.1	8.7
Thailand	1.2	2.8	-1.3	5.0	1.8	6.3	0.8	0.6	2.2	3.1
Vietnam	10.8	9.3	3.1	8.2	4.1	4.9	5.2	5.5	5.6	5.8
Asia-ex China, India & Japan	n/a	n/a	n/a	4.9	4.3	4.2	3.5	3.4	3.5	3.6
Asia-ex China & Japan	n/a	n/a	n/a	6.1	5.4	4.6	4.3	4.2	4.7	5.0
Asia-ex Japan	n/a	n/a	n/a	3.2	8.0	6.7	6.2	6.2	6.5	6.4
Asia	n/a	n/a	n/a	3.1	5.6	5.4	5.2	4.6	5.1	5.4

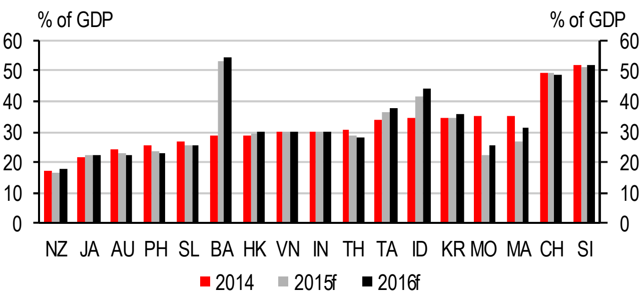
NB: Australia and New Zealand are not included in Asia aggregate and data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights
Source: CEIC, HSBC forecasts

Consumer expenditure (% y-o-y): To hold up in China



Source: CEIC, HSBC forecasts

Saving as a % of GDP: Singapore's saving rate even higher than China's



Source: CEIC, HSBC forecasts

Gross saving ratio

% GDP	2007	2008	2009	2010	2011	2012	2013	2014	2015f	2016f
China	50.4	51.4	51.5	51.8	50.9	50.5	50.2	49.6	49.0	48.4
Hong Kong	33.5	34.6	30.8	29.9	29.4	28.8	28.7	28.9	29.3	29.8
Japan	25.4	25.2	20.8	22.4	21.7	21.4	21.0	21.6	22.2	22.0
Korea	33.7	32.9	33.2	35.2	34.5	33.8	34.1	34.5	34.7	35.5
Mongolia	37.2	33.9	32.1	26.0	29.5	30.1	34.1	34.9	22.4	25.5
Taiwan	32.7	30.2	29.1	32.2	30.6	30.5	31.6	34.2	36.4	38.0
North Asia-ex Japan	44.8	46.4	47.0	47.7	47.1	47.0	47.0	46.8	46.4	46.1
Australia	23.4	24.7	22.9	23.6	25.0	24.4	24.1	24.0	23.2	22.4
Bangladesh	26.9	28.6	29.5	26.1	29.0	30.0	29.4	28.7	53.2	54.6
India	36.8	32.0	33.7	33.7	33.9	31.8	30.6	30.3	30.0	30.0
Indonesia	28.7	32.6	33.4	35.8	36.5	35.4	34.3	34.4	41.3	44.2
Malaysia	43.3	43.8	38.1	40.3	39.7	37.5	35.4	35.0	26.7	31.1
New Zealand	15.4	14.5	16.0	16.1	14.6	14.6	16.1	17.3	16.8	17.8
Philippines	22.6	19.4	21.6	27.4	23.0	21.0	24.3	25.3	23.8	22.9
Singapore	54.9	51.0	52.2	54.3	54.3	53.5	52.7	51.7	51.4	51.8
Sri Lanka	23.3	17.8	23.7	25.3	22.1	24.0	25.8	27.0	25.8	25.2
Thailand	33.5	32.0	30.9	32.0	31.0	30.8	31.1	30.6	28.7	27.8
Vietnam	30.6	25.6	30.9	32.0	29.9	33.1	32.1	30.0	29.8	29.8
Asia-ex China, India & Japan	33.7	33.1	32.9	35.0	34.4	33.8	33.7	33.9	35.5	36.7
Asia-ex China & Japan	34.6	32.8	33.1	34.6	34.3	33.2	32.8	32.8	33.9	34.7
Asia-ex Japan	41.6	42.2	42.8	43.5	43.3	43.1	43.1	42.9	43.0	42.9
Asia	35.8	36.2	35.3	36.7	36.7	36.8	37.9	38.4	38.6	38.5

NB: Australia and New Zealand are not included in Asia aggregate and data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights
Source: CEIC, HSBC forecasts

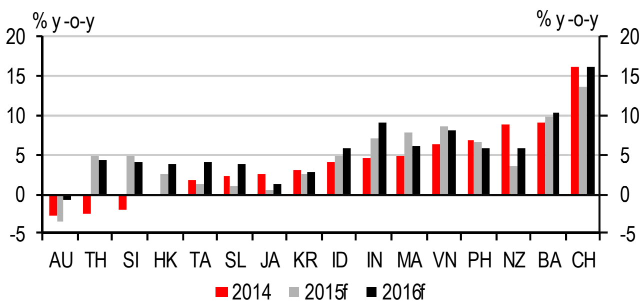
Investment

Total investment

(% y-o-y)	2007	2008	2009	2010	2011	2012	2013	2014	2015f	2016f
China	24.8	25.9	30.0	24.5	23.8	20.6	19.6	16.0	13.5	16.0
Hong Kong	3.2	1.4	-3.5	7.7	10.2	6.8	2.2	-0.3	2.5	3.7
Japan	0.3	-4.1	-10.6	-0.2	1.4	3.4	3.2	2.6	0.5	1.2
Korea	5.0	-0.9	0.3	5.5	0.8	-0.5	3.3	3.1	2.6	2.7
Taiwan	1.1	-11.1	-8.8	19.3	-1.1	-2.6	5.0	1.8	1.3	4.1
North Asia-ex Japan	17.9	18.1	22.5	21.0	19.1	16.6	16.7	13.6	11.5	13.7
Australia	9.1	8.0	-1.6	4.1	7.2	8.9	-2.6	-2.7	-3.5	-0.8
Bangladesh	9.8	7.4	8.6	9.6	10.6	5.4	6.4	9.0	9.9	10.3
India	16.2	3.5	7.7	11.0	11.3	-0.3	3.0	4.6	7.0	9.1
Indonesia	9.3	11.9	3.3	8.3	8.9	9.1	5.3	4.1	4.8	5.8
Malaysia	10.4	2.4	-2.7	12.1	6.4	19.0	8.2	4.8	7.9	6.0
New Zealand	7.6	-3.1	-11.8	0.6	5.8	7.9	8.5	8.8	3.6	5.7
Philippines	5.2	3.2	-1.7	19.1	-1.9	10.8	12.2	6.8	6.7	5.8
Singapore	16.1	11.3	3.5	8.0	5.0	8.9	1.0	-2.0	4.8	4.1
Sri Lanka	9.1	5.3	1.3	9.2	14.6	10.7	9.1	2.2	1.1	3.8
Thailand	1.8	2.3	-10.9	11.6	4.9	10.2	-0.8	-2.6	4.7	4.2
Vietnam	24.2	3.8	8.7	10.9	-7.8	1.9	5.3	6.2	8.5	8.0
Asia-ex China, India & Japan	6.4	2.0	-1.0	9.9	3.9	5.5	4.4	2.8	4.2	4.6
Asia-ex China & Japan	9.1	2.4	1.6	10.3	6.1	3.8	4.0	3.4	5.0	5.9
Asia-ex Japan	16.1	14.2	16.6	17.6	15.7	13.4	13.2	11.0	10.1	12.0
Asia	10.5	7.8	7.3	11.8	11.3	10.5	10.9	9.2	8.1	9.7

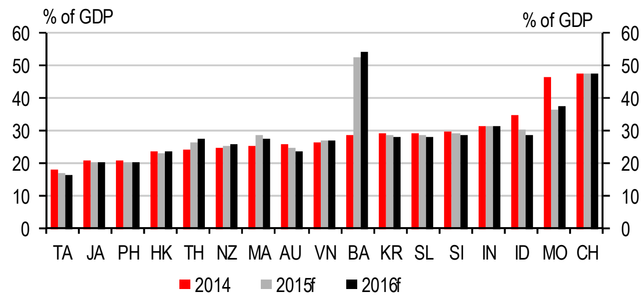
NB: Australia and New Zealand are not included in Asia aggregate and data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights
Source: CEIC, HSBC forecasts

Investment growth (% yr): Accelerating in India



Source: CEIC, HSBC forecasts

Investment-to-GDP ratio (%): China only gradually rebalancing



Source: CEIC, HSBC forecasts

Investment-to-GDP ratio

%	2007	2008	2009	2010	2011	2012	2013	2014	2015f	2016f
China	41.6	43.8	47.2	48.1	48.3	47.7	47.8	47.6	47.5	47.4
Hong Kong	20.6	20.5	20.5	21.8	23.5	25.4	24.1	23.7	23.2	23.8
Japan	21.9	21.2	20.1	19.1	19.5	19.8	20.1	20.6	20.6	20.6
Korea	32.6	33.0	28.5	32.0	33.0	31.0	29.1	29.2	28.9	28.3
Mongolia	38.7	43.6	34.4	40.8	58.5	61.4	61.3	46.7	36.7	37.7
Taiwan	21.3	21.5	17.0	21.5	20.0	19.0	18.3	18.1	16.8	16.5
North Asia-ex Japan	37.3	39.7	42.0	43.5	44.2	43.9	43.8	43.7	43.5	43.4
Australia	25.3	26.6	25.8	26.3	27.4	28.8	27.5	26.0	24.5	23.6
Bangladesh	26.2	26.2	26.2	27.4	28.3	28.4	28.6	29.0	52.8	54.2
India	38.1	34.3	36.5	36.5	38.2	36.6	32.3	31.6	31.4	31.6
Indonesia	25.6	34.3	31.8	32.9	33.0	35.1	34.0	34.7	30.2	29.0
Malaysia	23.4	21.5	17.8	23.3	23.2	25.9	26.1	25.2	28.9	27.4
New Zealand	24.2	23.6	20.8	20.5	21.4	22.4	23.7	25.0	25.2	25.9
Philippines	17.3	19.3	16.6	20.5	20.5	18.2	20.0	20.9	20.5	20.5
Singapore	23.1	30.4	27.7	27.9	27.3	30.4	29.1	29.7	29.2	28.8
Sri Lanka	27.3	27.1	24.3	27.2	29.4	30.3	29.5	29.4	28.7	28.2
Thailand	25.5	28.2	20.6	25.4	26.8	28.2	27.5	24.1	26.5	27.3
Vietnam	39.6	36.5	37.2	35.7	29.8	27.2	26.6	26.6	26.8	27.0
Asia-ex China, India & Japan	26.9	28.7	25.3	28.3	28.6	28.7	27.7	27.5	27.7	27.3
Asia-ex China & Japan	30.0	30.2	28.6	30.8	31.4	31.0	29.0	28.7	28.8	28.6
Asia-ex Japan	35.2	37.0	38.4	39.8	40.6	40.6	40.1	40.0	40.0	39.9
Asia	30.5	31.5	32.1	33.1	34.2	34.6	35.4	35.9	35.9	35.8

NB: Australia and New Zealand are not included in Asia aggregate and data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights
Source: CEIC, HSBC forecasts

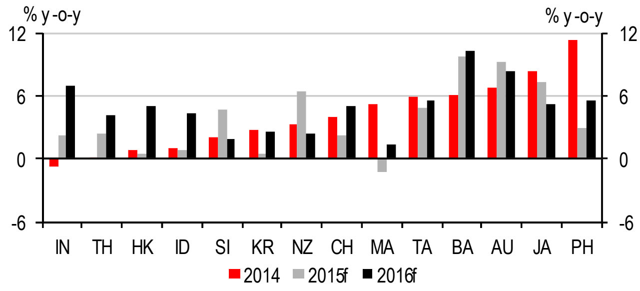
Trade

Real exports

(% y-o-y)	2007	2008	2009	2010	2011	2012	2013	2014	2015f	2016f
China	23.8	11.2	-17.9	29.3	18.3	5.9	5.8	4.1	2.2	5.0
Hong Kong	8.4	2.5	-10.0	16.8	3.9	1.9	6.2	0.9	0.4	5.0
Japan	8.7	1.4	-24.2	24.8	-0.4	-0.2	1.2	8.4	7.2	5.2
Korea	12.7	7.5	-0.3	12.7	15.1	5.1	4.3	2.8	0.5	2.5
Taiwan	10.4	0.6	-8.4	25.7	4.2	0.4	3.5	5.9	4.9	5.6
North Asia-ex Japan	19.7	9.6	-14.7	26.3	16.8	5.4	5.5	3.9	2.1	4.7
Australia	3.1	3.6	2.3	5.8	0.0	6.0	6.2	6.8	9.3	8.4
Bangladesh	7.1	0.0	0.9	29.3	12.5	2.5	6.3	6.1	9.7	10.3
India	5.9	14.6	-4.7	19.6	14.8	6.7	7.3	-0.8	2.2	7.0
Indonesia	8.5	9.5	-9.7	14.6	14.8	1.6	4.2	1.0	0.8	4.3
Malaysia	3.8	1.6	-10.9	11.5	4.2	-1.7	0.3	5.1	-1.2	1.4
New Zealand	4.8	-1.3	2.1	3.3	2.6	1.9	0.9	3.3	6.4	2.5
Philippines	6.7	-2.7	-7.8	21.0	-2.5	8.6	-1.0	11.3	2.9	5.5
Singapore	0.0	4.6	-7.6	17.4	5.9	1.7	4.4	2.1	4.7	1.9
Thailand	8.9	6.3	-12.5	14.1	9.2	5.1	2.8	0.0	2.4	4.2
Asia-ex China, India & Japan	8.9	4.9	-6.2	14.6	9.3	2.8	3.2	2.8	1.4	3.3
Asia-ex China & Japan	8.0	7.5	-5.7	16.2	10.9	3.9	4.4	1.8	1.7	4.4
Asia-ex Japan	15.0	9.4	-12.2	23.0	15.0	5.0	5.2	3.1	2.0	4.8
Asia	12.8	6.6	-16.3	23.6	10.3	3.5	4.3	4.3	3.1	4.8

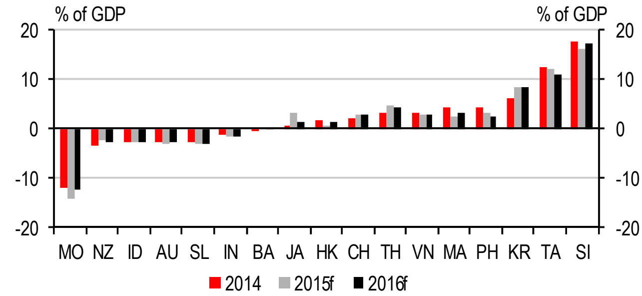
NB: Real Exports for G&S, Australia and New Zealand are not included in Asia aggregate & data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights
Source: CEIC, HSBC forecasts

Real exports (% yr): Bangladesh leads the way



Source: CEIC, HSBC forecasts

Current account (% GDP): Mostly in surplus



Source: CEIC, HSBC forecasts

Current account balance

% GDP	2007	2008	2009	2010	2011	2012	2013	2014	2015f	2016f
China	10.1	9.3	4.9	4.0	1.9	2.6	1.5	2.1	2.9	2.9
Hong Kong	13.0	15.0	9.9	7.0	5.6	1.6	1.5	1.9	0.6	1.3
Japan	4.9	3.0	2.9	4.0	2.2	1.0	0.8	0.5	3.2	1.3
Korea	1.1	0.3	3.7	2.6	1.6	4.1	6.2	6.3	8.4	8.5
Mongolia	4.1	-12.3	-7.5	-14.3	-32.2	-31.2	-27.2	-11.8	-14.2	-12.3
Taiwan	8.6	6.6	10.9	8.9	8.2	9.9	10.8	12.4	12.3	10.9
North Asia-ex Japan	8.1	7.8	5.2	4.2	2.2	3.1	2.5	3.0	3.8	3.8
Australia	-6.7	-4.9	-4.6	-3.6	-2.9	-4.3	-3.3	-2.8	-3.1	-2.6
Bangladesh	0.7	2.4	3.2	-1.3	0.8	1.6	0.8	-0.3	0.4	0.4
India	-1.3	-2.3	-2.8	-2.7	-4.4	-4.8	-1.7	-1.3	-1.5	-1.7
Indonesia	2.3	0.0	-2.9	0.7	0.2	-2.7	-3.2	-2.9	-2.6	-2.8
Malaysia	14.9	16.5	15.1	10.1	10.9	5.2	3.5	4.3	2.5	3.3
New Zealand	-6.8	-7.8	-2.2	-2.3	-2.8	-4.0	-3.2	-3.3	-2.5	-2.6
Philippines	5.3	0.1	5.0	3.6	2.5	2.8	4.2	4.4	3.3	2.3
Singapore	26.0	14.4	16.8	23.7	22.7	18.8	21.2	17.8	16.3	17.2
Sri Lanka	-4.0	-9.3	-0.5	-2.8	-7.8	-6.6	-3.8	-2.7	-2.9	-3.0
Thailand	5.5	0.7	7.8	2.9	2.4	-0.4	-0.9	3.3	4.6	4.2
Vietnam	-9.0	-10.9	-6.2	-3.7	0.2	5.8	5.5	3.4	2.9	2.8
Asia-ex China, India & Japan	5.5	3.6	5.3	4.7	4.1	3.5	4.2	4.7	5.1	5.1
Asia-ex China & Japan	3.6	2.0	2.9	2.4	1.5	1.1	2.5	2.9	3.2	3.1
Asia-ex Japan	6.5	5.6	3.9	3.2	1.7	2.0	2.0	2.4	3.0	3.0
Asia	5.9	4.7	3.6	3.5	1.9	1.7	1.7	2.0	3.1	2.6

NB: Australia and New Zealand are not included in Asia aggregate and data are based on IMF nominal USD weights for the respective year, for which 2015 and 2016 use 2014 weights
Source: CEIC, HSBC forecasts

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Country profiles

HSBC

Australia

Weak investment presents a challenge

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Australia's economy is in the process of rebalancing its growth as mining investment falls. Low interest rates are supporting solid growth in housing prices, which is feeding through to a strong housing construction upswing and a pick-up in durable goods sales. There is also strong growth in resources exports, as new capacity continues to come on line.

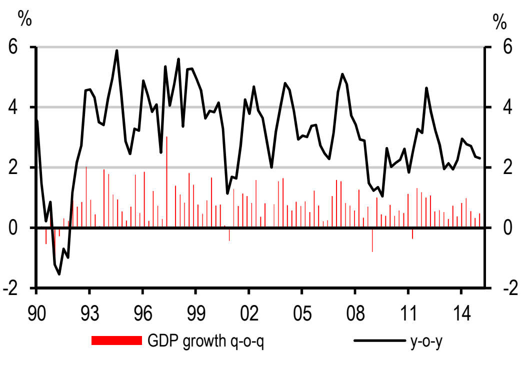
However, conditions in the non-mining business sector remain weak and public investment has continued to be a drag on growth, as state and federal governments have sought to consolidate their balance sheets. Despite strong household demand and exports growth, GDP grew at a below-trend pace of 2.3% y-o-y in the first quarter (trend is around 3.0%) as business and public investment fell.

As mining investment is expected to continue to fall over coming quarters, a pick-up in non-mining business investment and hiring will be needed for a return to trend growth. However, there is conflicting evidence on the outlook for non-mining business conditions. On one hand, key surveys of capital expenditure intentions continue to show weak investment intentions for the coming year. On the other hand, recent labour market data have shown a solid lift in jobs growth, led by the services sector, and some stabilisation in the unemployment rate, which is a sign of improving business conditions.

To provide further support for growth, the central bank cut its cash rate by 50bp in the first half of 2015, to a new record low of 2.00%. The government also delivered a growth-supportive budget in May, which included proposals for additional spending on childcare and tax cuts for small businesses.

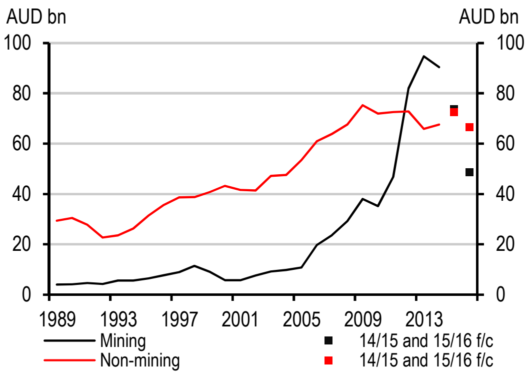
Reflecting HSBC's recent downward revision to its forecasts for China's growth in 2015 and uncertainty about local investment we revise down our Australian GDP growth forecast to 2.4% for 2015 (previously 2.6%). We retain our 3.0% GDP forecast for 2016, supported by forecasts for a solid recovery in China.

GDP growth is running at a below trend pace



Source: ABS, HSBC

Capital expenditure survey has weak investment intentions



Source: ABS; HSBC estimates

Policy issues

For the Reserve Bank of Australia (RBA), a key challenge is to continue supporting domestic demand by maintaining a low cash rate, but not to over-inflate asset prices in the process. With interest rates at record lows, there is growing evidence of over-inflation of prices in the Sydney housing market and in the commercial property market nationwide. As a result, the regulator has been gradually tightening its prudential settings since late 2014. This is increasingly allowing the central bank to focus its cash rate setting on managing the real economy rather than the financial cycle.

The central bank has also continued to seek a lower AUD to help support the rebalancing of growth. Although there has been no explicit intervention, the RBA has continued to comment publicly that a lower AUD is needed for growth to return to a balanced path. We now expect the RBA to keep its cash rate on hold for the whole of 2016 (we previously had hikes in 2H 2016), as we expect the RBA to keep rates lower for longer to encourage the AUD to fall further.

Risks

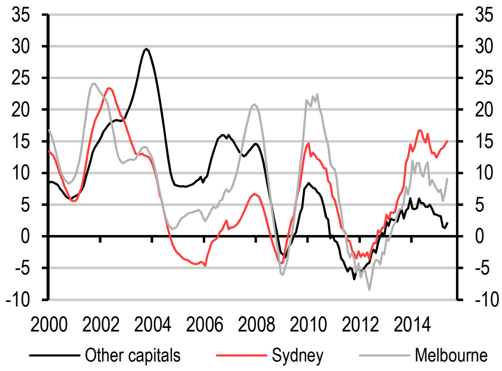
We judge the risks as tilted to the downside. First, there is a risk that growth in China does not pick up as much expected in 2016, dampening demand for Australia's exports. Second, there is a risk that non-mining businesses continue to lack confidence and that business investment remains weak for longer than expected. Third, there is a risk that the currency stays stubbornly high, relative to commodity prices, constraining the pace of rebalancing. Fourth, there is a risk that low interest rates drive asset price bubbles to inflate, particularly in the major city housing markets, causing problems in coming years.

On the upside, the recent pick-up in household demand could drive a stronger pick-up in non-mining business investment and hiring than expected. In addition, the recent budget measures could be more supportive of growth than we currently expect.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	2.7	2.4	2.3	2.3	2.5	2.7	2.8	3.0	3.1	3.0
GDP-sa (%q-o-q)	0.3	0.5	0.9	0.5	0.6	0.7	1.0	0.7	0.7	0.6
Industrial production (% y-o-y)	2.3	1.6	-0.8	0.3	2.6	3.2	3.9	3.9	3.9	4.1
CPI, end quarter (% y-o-y)	2.3	1.7	1.3	1.6	1.8	2.2	2.5	2.5	2.4	2.4
Core CPI, end quarter (%y-o-y)	2.4	2.1	2.2	2.2	2.5	2.5	2.6	2.5	2.6	2.7
PPI, end quarter (% y-o-y)	1.2	1.1	0.7	1.5	2.0	2.6	2.8	2.8	2.8	2.8
Trade balance (% GDP)	-1.1	-1.1	-0.8	-1.4	-1.5	-1.5	-1.0	-1.0	-0.8	-0.7
Current account (% GDP)	-3.1	-3.3	-2.7	-3.2	-3.3	-3.3	-2.8	-2.7	-2.5	-2.4
Policy rate, end quarter (%)	2.50	2.50	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00
10yr yield, end quarter (%)	3.5	2.8	2.3	3.1	2.9	2.7	2.6	2.6	2.6	2.6
USD/AUD, end quarter	0.95	0.87	0.82	0.74	0.73	0.72	0.71	0.71	0.70	0.70
EUR/AUD, end quarter	0.69	0.69	0.67	0.69	0.70	0.69	0.66	0.66	0.64	0.64
CPI, q-o-q ar	1.9	0.8	0.8	2.8	2.8	2.4	2.0	2.8	2.4	2.4
Exports G& S (% y-o-y)	-2.8	-2.8	-5.3	2.1	6.9	6.5	7.1	9.1	8.7	9.3
Imports G & S (% y-o-y)	-0.6	-0.9	1.9	3.5	9.0	11.4	8.0	6.6	5.0	5.3

Source: ABS, RBA, Thomson Reuters Datastream, HSBC forecasts

Housing prices are rising quickly in Sydney…

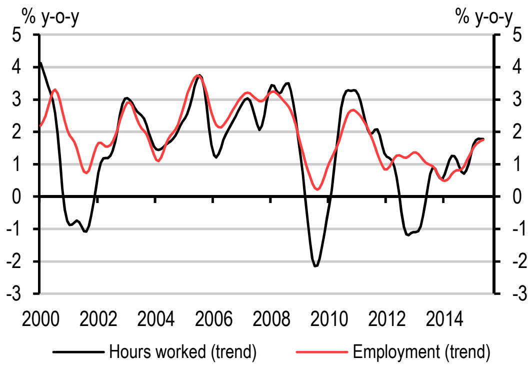


Source: RP-Data Core-Logic, HSBC

… prompting a tightening of micro-prudential settings

- Sydney housing prices have risen by 15% over the past year and by 39% since their mid-2012 trough. Prices in Melbourne are also rising quite quickly, up 9% y-o-y, while other capital cities have seen much more modest housing price growth.
- The Australian Prudential Regulatory Authority has gradually tightened its micro-prudential settings over the past year, including a warning of increased oversight of institutions that grow their investor mortgage lending by more than 10% a year.
- Timely indicators such as auction clearance rates continue to suggest exuberant conditions are continuing in the Sydney housing market. Given how far prices have risen, there are growing risks of a correction in Sydney housing prices at some point.

Labour market conditions have improved in recent months…

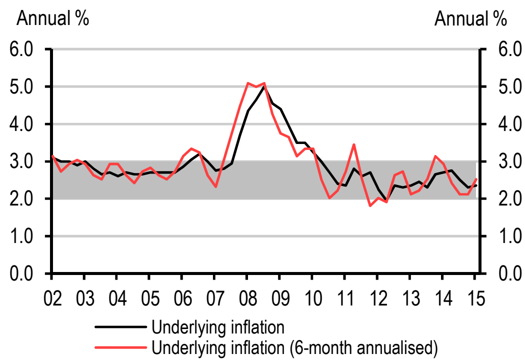


Source: ABS, HSBC

… and the unemployment rate has stabilised

- Employment growth has strengthened to around 2.0% y-o-y. This is strong enough to match the pace of growth in the labour force and stabilise the unemployment rate, after it had been gradually climbing for three years.
- The unemployment rate has steadied at around 6.0-6.2%. The trend measure of the unemployment rate has been slowly falling since October 2014. If this is sustained, the unemployment rate will have peaked earlier and lower than forecast by the RBA.
- There remains considerable measurement uncertainty in the official monthly employment survey figures. It is encouraging, though, to also see improvements in the measure of hours worked, quarterly jobs figures, vacancy rates and job advertisements.

Underlying inflation is in the bottom half of the target band…



Source: ABS, HSBC

… allowing the RBA to keep the cash rate at record lows

- Headline CPI inflation fell to 1.3% y-o-y in Q1, largely as a result of lower petrol prices. The RBA's preferred measures of underlying inflation were running at an average of 2.4% y-o-y in Q1, just below the middle of the 2-3% target band.
- With economic growth still running below trend, there appear to be limited near-term upside risks to inflation, although we expect inflation to pick up modestly through 2016.
- Our inflation outlook suggests that it will be some time before higher interest rates are needed. We expect the RBA will retain its current mild easing bias, but we do not expect further cuts.

HSBC

Australia: Macro framework*

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	2.3	2.7	3.6	2.1	2.7	2.4	3.0
Nominal GDP (USD bn)	1,295	1,505	1,535	1,535	1,469	1,268	1,207
GDP per capita (USD)	58,799	67,373	68,691	65,817	62,036	52,731	49,400
Private consumption (% y-o-y)	3.3	3.1	2.5	1.7	2.5	2.7	3.1
Government consumption (% y-o-y)	3.4	3.5	2.3	0.8	2.0	1.6	1.6
Investment (% y-o-y)	4.1	7.2	8.9	-2.6	-2.7	-3.5	-0.8
Stock building (% GDP)	0.0	0.4	0.4	-0.1	0.0	0.1	0.1
Business Investment (% y-o-y)	0.3	18.2	15.5	-3.1	-5.1	-7.3	-3.4
Dwelling Investment (% y-o-y)	4.9	1.8	-6.1	0.5	7.9	11.1	6.1
Public Investment (% y-o-y)	18.3	-9.8	6.4	-4.5	-4.3	-5.7	-0.3
Exports of G&S (vol growth) % y-o-y	5.8	0.0	6.0	6.2	6.8	9.3	8.4
Imports of G & S (vol growth)% y-o-y	15.2	11.0	6.2	-1.8	-1.6	3.7	4.3
Net Exports % of GDP	0.1	-2.0	-2.1	-0.5	1.2	2.4	3.3
Net exports (contribution to GDP growth, ppt)	-1.5	-2.1	-0.2	1.6	1.7	1.2	1.0
Final Domestic demand % y-o-y	3.5	4.3	4.2	0.3	1.0	0.9	1.9
Domestic Demand % y-o-y	3.9	4.6	4.2	0.1	1.1	1.3	2.0
Industrial production (% y-o-y)	4.6	1.1	3.4	2.0	3.4	1.3	3.9
Gross national saving (% of GDP)	23.6	25.0	24.4	24.1	24.0	23.2	22.4
Household saving rate (%)	9.7	10.9	10.4	10.3	9.3	8.2	8.0
Unemployment rate, avg (%)	5.2	5.1	5.2	5.7	6.1	6.2	5.9
Prices & wages							
Trimmed mean CPI, end (% y-o-y)	2.2	2.7	2.2	2.7	2.1	2.3	2.4
CPI (% y-o-y)	2.9	3.3	1.8	2.4	2.5	1.7	2.5
PPI (% y-o-y)	2.7	2.9	1.0	1.9	1.1	2.6	2.8
Core CPI (% y-o-y)	2.2	2.7	2.2	2.7	2.1	2.3	2.4
Labor Cost Index, nominal (% y-o-y)	3.4	3.7	3.6	2.9	2.5	2.3	2.8
Money, FX & interest rates							
Money Supply M1, average (% y-o-y)	3.7	4.8	0.4	7.5	9.7	n/a	n/a
Broad money supply, average (% y-o-y)	4.5	7.9	7.2	5.7	7.0	n/a	n/a
Private credit growth-nominal (% y-o-y)	4.7	4.8	4.7	3.7	5.1	6.6	7.1
Policy rate, end-year (%)	4.75	4.25	3.00	2.50	2.50	2.00	2.00
10yr yield, end-year (%)	5.55	3.81	3.28	4.26	2.81	2.70	2.60
USD/AUD, end-year	1.03	0.98	1.05	0.93	0.87	0.72	0.70
USD/AUD, average	0.93	1.03	1.02	1.00	0.92	0.78	0.71
EUR/AUD, end-year	0.71	0.72	0.81	0.69	0.69	0.69	0.64
EUR/AUD, average	0.66	0.74	0.78	0.76	0.68	0.69	0.65
Real Trade-Weighted-Index	156.0	157.9	162.5	151.5	146.4	n/a	n/a
External sector							
Exports of G&S (USD bn)	270.2	323.1	310.5	312.1	298.0	254.2	256.9
Imports of G&S (USD bn)	263.2	310.2	333.4	321.4	306.3	271.2	268.4
Goods and Services Balance (USD bn)	7.1	12.9	-22.9	-9.3	-8.3	-17.1	-11.5
Current account balance (USD bn)	-44.8	-44.1	-65.5	-51.9	-41.0	-39.4	-31.5
Current account balance (% GDP)	-3.6	-2.9	-4.3	-3.3	-2.8	-3.1	-2.6
Net FDI (USD bn)	17.3	54.4	59.3	58.2	53.4	n/a	n/a
Net FDI (% GDP)	1.3	3.6	3.9	3.8	3.6	n/a	n/a
Exports (% y-o-y)	13.4	11.1	-4.1	5.6	3.1	2.4	8.5
Imports (% y-o-y)	6.5	9.4	7.3	1.2	2.9	6.4	6.2
International FX reserves (USD bn)	33.2	34.7	38.1	44.7	47.4	n/a	n/a
Import cover (months)	1.5	1.3	1.4	1.7	1.9	n/a	n/a
Public and external solvency indicators							
Central government balance (% GDP)	-4.2	-3.4	-2.9	-1.2	-3.1	-2.6	-2.1
Net External debt (AUD bn)	636.4	716.8	755.7	848.4	924.8	n/a	n/a
Net External debt (% GDP)	46.9	49.3	50.3	54.6	57.7	n/a	n/a
Gross public domestic debt (AUD bn)	278.0	352.9	408.0	477.7	548.7	622.2	684.8
Gross public sector debt (% GDP)	20.5	24.3	27.2	30.7	34.3	38.1	40.2
Net public sector debt (% GDP)	3.3	6.0	9.9	10.1	12.8	15.6	17.3
Macro-prudential indicators							
Capital Adequacy Ratios	9.7	10.2	10.7	10.5	10.5	n/a	n/a
Non-performing loan ratio	1.6	1.4	1.2	1.0	0.9	n/a	n/a
Household debt/Income (%)	151.0	147.6	146.4	149.3	n/a	n/a	n/a
Total credit/GDP (%)	146.5	141.7	142.0	142.8	146.4	n/a	n/a
House prices growth (%y-o-y)	11.9	-2.1	-0.3	6.6	9.1	7.1	6.1
Loan/deposit ratio	1.2	1.1	1.1	1.1	1.1	n/a	n/a
Stock market capitalization/GDP (%)	102.1	89.9	83.4	94.0	n/a	n/a	n/a

*Macroeconomic forecasts based on market expectations for the Australian dollar exchange rate. Trimmed mean data represents Core CPI.
Source: ABS, RBA, Thomson Reuters Datastream, IMF, HSBC forecasts

HSBC

Bangladesh

Standing tall

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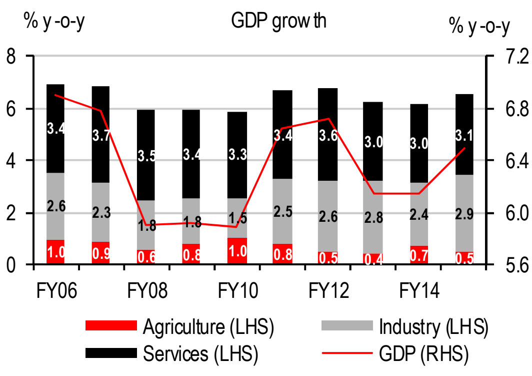
Economic growth surprised yet again with its strong performance in FY2014-15. Though political disruptions casted a dark shadow, the GDP report provided ample reasons to cheer. Solid expansion, coupled with accommodative monetary policy, improving business sentiment, easing price pressures and a development-oriented budget, has painted an optimistic economic outlook for FY2015-16. All eyes are now on the political landscape, which – if favourable – could launch the economy on a sustained development path.

The economy grew by a solid 6.5% y-o-y in FY2014-15, dismissing fears of a slowdown brought in by the political turmoil in the early part of this year. With the political situation stabilising, we expect a further pick-up in economic activity this year and forecast GDP growth a notch higher, at 6.6%, in FY2015-16. But it's not just about growth – easing inflation has also provided a much needed respite. From above 8% in 2013, headline CPI eased to 6.2% y-o-y by May 2015 and is likely to remain below the Bangladesh Bank's FY2014-15 target of 6.5%. However, for a stable inflation regime, it is important to tackle the volatile food inflation component through policies addressing structural bottlenecks and ensuring steady supplies.

The other boost to the economy comes from one of its strongest income sources: remittances, which rose sharply in the last few months. Remittances are likely to increase further following an expected rise in overseas workers as Saudi Arabia lifts its seven-year-old ban on recruitment from Bangladesh, while Malaysia plans to recruit over 0.5mn Bangladeshi workers under a new business-to-business manpower export mechanism. Firm remittances growth is expected to largely offset the widening trade deficit and help the current account move back to a surplus in FY2015-16 from an expected deficit in FY2014-15.

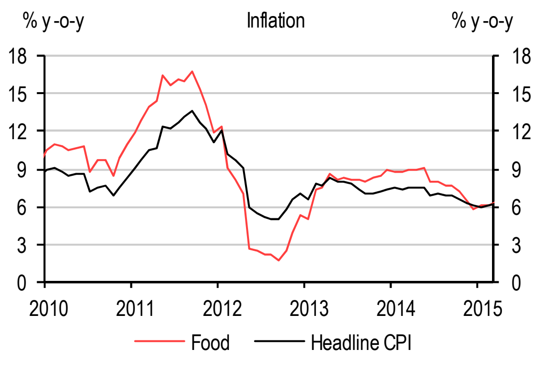
Monetary policy is also expected to be accommodative this year, with the policy rate held constant at 7.25%.

GDP growth picked up further in FY15



Source: CEIC, HSBC

Inflation eased over the last 12 months



Source: CEIC, HSBC

Policy issues

Bangladesh is set to record a strong expansion in FY16. However, along with growth, it is important that the country addresses structural bottlenecks such as transportation and power, which are necessary to improve productivity and allow the country to climb higher on the development ladder. The need for infrastructure development becomes even more important given the government's target to graduate from a least developed to a middle income country (as defined by the UN) by 2018.

The FY2015-16 budget is a positive step in this direction. In its budget, the government has proposed some key reforms to aid infrastructure development, which includes a major drive to revitalise public-private partnership initiatives. The plan to boost private and public investment to 24% of GDP (currently at 22%) and 7.8% of GDP (currently at 6.9%), respectively, in the medium term is another bold move. To tackle power shortages, a major bottleneck weighing down the economy, the government has chalked out a detailed roadmap aiming to increase power generation to 24,000 megawatt by 2021.

While the government has put forth several measures focussing on infrastructure and speeding up development projects, timely implementation of these proposals will be crucial.

Risks

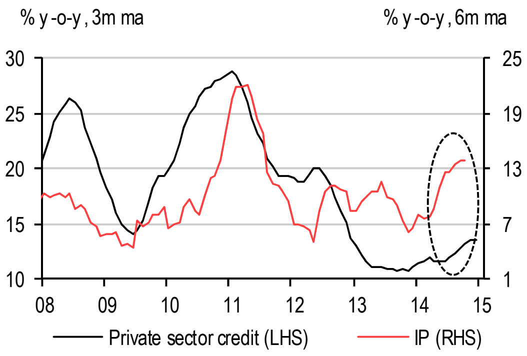
Politics poses the key risk to Bangladesh's economy. Though the blockade started by the opposition party in January this year has been lifted, thus restoring some normalcy to the economy, the political environment still remains fragile and vulnerable to disruptions and unrests. Moreover, political unrest at this juncture could fracture administrative efficiency and weigh significantly on growth.

Another concern for the economy at this time is the possibility of a deficient monsoon. With meteorological departments (domestic and international) forecasting strong chances of an El Niño effect this year, agriculture production could take a hit, thereby lowering the GDP growth rate for the economy and pushing inflation higher.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
Industrial production (% y-o-y)	15.3	11.9	14.6	14.5	13.7	13.4	14.0	14.2	14.0	14.2
CPI, (% q-o-q saar)	6.1	6.5	5.7	6.3	6.4	6.0	7.9	5.8	3.9	4.5
CPI, average (% y-o-y)	6.9	6.3	7.2	7.0	6.2	5.9	6.7	6.6	5.9	5.4
PPI, average (% y-o-y)	3.4	3.2	3.1	3.0	3.2	3.5	3.9	4.1	3.8	3.6
Exports, value (% y-o-y)	0.9	2.2	7.2	12.2	14.5	14.2	16.5	18.2	18.8	16.0
Imports, value (% y-o-y)	13.6	23.3	5.2	12.5	16.2	18.4	18.2	19.2	14.5	11.2
Trade balance (USD bn)	-2.4	-2.9	-2.5	-2.1	-2.9	-3.8	-3.1	-2.6	-3.0	-3.8
Remittances (% y-o-y)	22.6	-0.7	1.3	8.2	8.7	9.2	11.2	12.0	8.8	8.8
Current account (USD bn)	-0.36	-1.07	0.22	0.63	0.47	-0.36	0.18	0.62	0.14	-0.68
International reserves (USD bn)	21.8	22.3	23.1	23.6	24.1	23.2	23.4	23.5	24.2	23.4
Policy rate, end quarter (%)	7.25	7.25	7.25	7.25	7.25	7.25	7.25	7.25	7.25	7.25
5yr yield, end quarter (%)	9.5	9.6	9.4	9.5	9.5	9.5	9.4	9.4	9.4	9.4
BDT/USD, end quarter	77.4	78.0	77.8	77.5	77.8	78.0	78.3	78.5	78.8	79.0
BDT/EUR, end quarter	97.5	94.3	83.2	85.3	81.6	81.9	83.8	84.8	86.7	86.9

NB: 2016 FX forecasts are assumptions, not forecasts
Source: CEIC, HSBC forecasts

Leading indicators have picked up in the last few months …

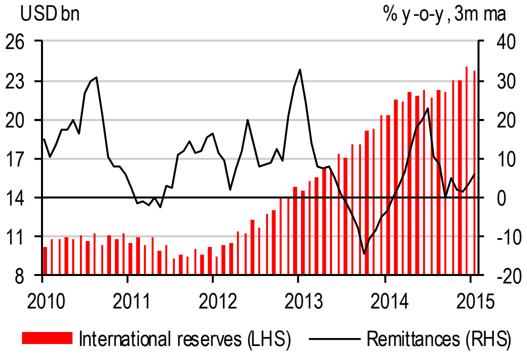


Source: CEIC, HSBC

… painting an optimistic outlook for growth

- Industrial growth surprised on the upside in FY15, rising by a whopping 8.2% y-o-y. Further pick-up is expected this year amidst accommodative monetary conditions.
- Private sector credit has picked up significantly, rising to a 25 month high of 13.7% y-o-y in March 2015.
- Leading growth indicators like industrial production also edged higher, adding to growth optimism.

A rebound in inward remittances growth …

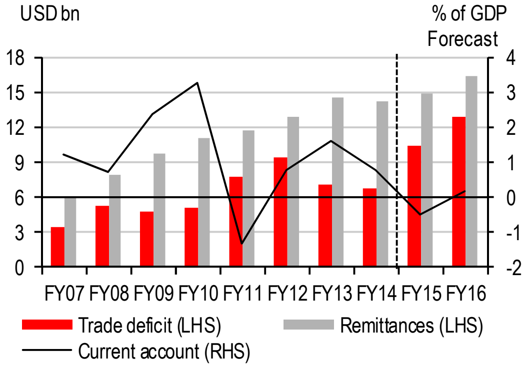


Source: CEIC, HSBC

… has led to further build-up of FX reserves

- Growth of inward remittances, a strong source of income for the economy has rebounded following a dismal start to the year.
- Remittances are likely to increase further this year with an expected rise in overseas workers as Saudi Arabia lifts a seven year old ban and Malaysia plans to recruit over 0.5mn workers from Bangladesh.
- Strong remittance inflows have led to a sharp build-up of reserves, which rose to an all-time high of USD 24.1 bn in April 2015, equivalent to close to 7 months of import cover.

Trade deficit is expected to widen further …



Source: ILO, HSBC

… but is likely to be partly offset by strong remittances growth

- The trade balance has been widened owing to sluggish export performance and a sharp rise in imports in the last few months.
- Dragged down by the trade deficit, the current account is expected to turn negative in FY15, for the first time in 4 years.
- However, the current account is likely to move back into surplus in FY16 aided by strong remittance inflows.

Bangladesh: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)*	6.5	6.5	6.0	6.1	6.5	6.6	6.7
Nominal GDP (USDbn)*	128.7	133.4	150.0	172.9	195.0	219.5	245.5
GDP per capita (USD)*	748.0	766.0	838.0	1,117.0	1,247.4	1,389.2	1,537.6
Private consumption (% y-o-y)*	6.5	4.1	5.1	2.7	4.4	5.1	5.2
Government consumption (% y-o-y)*	6.7	3.1	5.8	11.9	13.7	13.2	12.8
Investment (% y-o-y)*	9.6	10.6	5.4	6.4	9.0	9.9	10.3
Net Exports (contribution to GDP growth, ppt)*	-1.0	0.0	0.2	1.4	0.1	-0.5	-0.6
Industrial production (% y-o-y)	9.6	16.3	8.7	9.4	10.7	14.0	14.1
Gross domestic saving (% GDP)*	26.1	29.0	30.0	29.4	28.7	53.2	54.6
Prices & wages							
CPI, average (% y-o-y)	8.1	11.7	7.2	7.5	7.0	6.1	6.2
CPI, end-year (% y-o-y)	8.3	11.1	7.1	7.3	6.1	6.0	5.5
Non-food CPI, average (% y-o-y)	4.7	7.0	11.1	6.9	5.6	6.0	5.8
Non-food CPI, end-year (% y-o-y)	3.3	10.6	10.0	4.9	6.5	5.5	5.6
PPI, average (% y-o-y)	4.6	10.1	3.0	3.6	3.5	3.2	3.9
PPI, end-year (% y-o-y)	8.3	10.2	1.4	3.7	3.2	3.5	3.6
Manufacturing wages, nominal (% y-o-y)	4.1	4.6	9.1	9.2	10.3	10.5	11.5
Money, FX & interest rates							
Central bank money M0, end-year (% y-o-y)*	21.0	9.0	15.0	15.5	14.2	13.1	13.8
Broad money supply M2, average (% y-o-y)	22.3	18.8	19.0	16.1	12.9	12.9	13.4
Real private sector credit growth (% y-o-y)*	16.7	9.1	4.1	4.9	7.2	10.2	10.3
Policy rate, end-year (%)	5.50	7.25	7.75	7.25	7.25	7.25	7.25
5yr yield, end-year (%)	8.1	8.5	11.5	11.3	9.6	9.5	9.4
BDT /USD, end-year	70.8	81.9	79.8	77.8	78.0	78.0	79.0
BDT /USD, average	69.7	74.5	81.7	78.0	77.6	77.8	78.4
BDT /EUR, end-year	94.8	106.1	105.3	107.1	94.3	81.9	86.9
BDT /EUR, average	92.1	103.0	105.7	103.1	102.9	84.6	84.8
External sector							
Merchandise exports (USD bn)	19.2	23.9	24.7	28.7	30.0	33.6	39.4
Merchandise imports (USD bn)	25.1	33.8	32.2	34.5	39.7	44.9	51.9
Trade balance (USDbn)	-5.8	-9.9	-7.4	-5.8	-9.7	-11.3	-12.4
Remittances (% y-o-y)	2.7	10.6	16.5	-2.4	8.0	6.9	10.2
Current account balance (USDbn)	-1.7	1.0	2.4	1.3	-0.6	0.9	1.0
Current account balance (% GDP)*	-1.3	0.8	1.6	0.8	-0.3	0.4	0.4
Net FDI (USD bn)	0.8	1.2	1.7	1.5	2.0	2.9	2.9
Net FDI (% GDP)*	0.4	0.7	0.9	0.7	0.8	1.0	0.9
Current account balance plus FDI (% GDP)*	-0.9	1.4	2.5	1.5	0.5	1.4	1.3
Exports, value (% y-o-y)	26.9	24.4	3.4	16.0	4.5	12.0	17.4
Imports, value (% y-o-y)	27.6	34.8	-4.9	7.2	15.1	13.1	15.6
International FX reserves (USD bn)	11.2	9.6	12.8	18.1	22.3	23.2	23.4
Import cover (months)	5.3	3.4	4.8	6.3	6.7	6.2	5.4
Public and external solvency indicators							
Gross external debt (USDbn)*	25.3	22.1	22.4	23.5	26.3	29.6	33.1
Gross external debt (% GDP)*	19.7	16.6	14.9	13.6	13.5	13.5	13.5
Central government balance (% GDP)*	-4.5	-4.1	-4.4	-3.6	-5.0	-5.1	-4.9
Primary balance (% GDP)*	-2.4	-2.8	-2.8	-2.8	-2.8	-3.5	-3.5
Government domestic debt (BDT bn)	525	910	994	1,148	1,362	1,672	2,002
Government domestic debt (% GDP)*	8.0	9.0	9.2	10.2	10.4	10.6	10.8
Government debt (% GDP)*	42.9	42.7	43.2	43.2	43.2	43.5	43.5
Macro-prudential indicators							
Capital adequacy ratio	7.6	10.1	9.5	8.8	n/a	n/a	n/a
Non-performing loan ratio	7.3	6.1	10.0	8.9	n/a	n/a	n/a
Household Debt/ GDP (%)*	0.5	0.4	n/a	n/a	n/a	n/a	n/a
Total Credit/GDP (%)*	7.5	7.6	7.5	6.9	7.6	n/a	n/a
Loan/Deposit ratio	89.1	87.9	86.0	82.0	79.0	n/a	n/a
Stock Market Capitalization/GDP (%)*	30.8	23.5	21.1	21.9	21.1	n/a	n/a

*Data on fiscal year basis (July-June), e.g. fiscal year 2012-13 refers to 2012 in the table.
Source: CEIC, Bangladesh Bank, IMF, World Bank, HSBC forecasts

China

Growth to pick up, but only gradually

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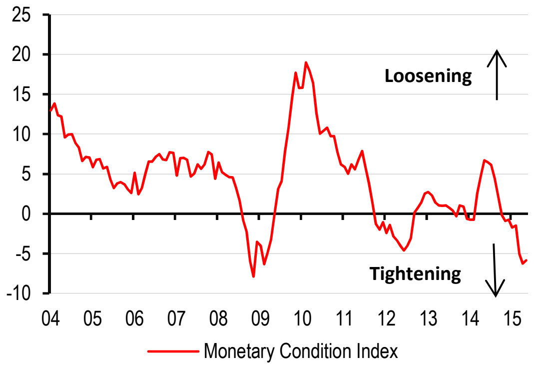
Halfway into 2015, economic activity remains weak. Export growth surprised on the downside relative to consensus and our forecast, growing only 0.6% y-o-y in the first five months of the year. This partly reflects weaker global demand for Asian exports as US growth turned out to be much softer than originally expected. But even as the US economy is widely expected to rebound in Q2, the lift to China's export growth will be limited given that the RMB will likely remain strong versus the currencies of its trade partners. As a result, we have lowered our 2015 export forecast to 4.2% from 7.1%

On the domestic front, the industrial deceleration continued, with Industrial Production growth improving only marginally from its multi-year low reading seen in March. Both weak, if not negative, profitability growth and deeply negative Producer Price Index (PPI) inflation suggest that conditions in the industrial sector remain challenging. Meanwhile, Fixed Asset Investment (FAI) growth slowed to an all-time low of 11.4% in May, weighed down by slower property investment. Infrastructure investment growth also eased.

But in recent weeks, there have been tentative signs of stabilisation. Leading indicators such as the PMIs and the HSBC China Monetary Conditions Indicator appear to have bottomed out. The central government has approved more subways, water treatment and other major infrastructure projects. Steps have also been taken to open further channels for local governments to raise funds. The latest round of monetary easing, delivered on 27 June, will also help to anchor the funding cost of fiscal borrowing. We expect infrastructure investment growth to pick up in the coming months as fiscal funding falls into place.

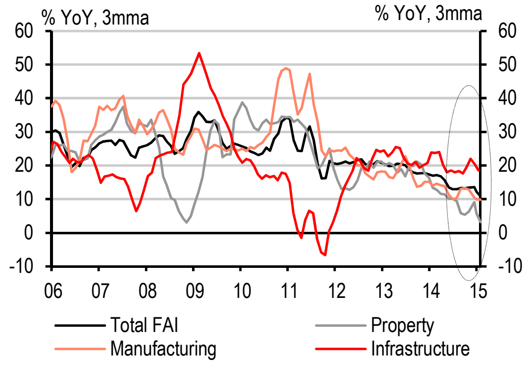
The weakness on both the external and domestic fronts has led us to trim our 2015 GDP forecast to 7.1% from 7.3%. We expect growth to improve sequentially from the multi-year low 1.3% q-o-q recorded in Q1. Additional policy easing is also needed to help sustain the recovery. We expect an additional 25bp policy rate cut and a 200bp reserve ratio cut in 2H 2015.

Both monetary and fiscal easing measures are still needed ...



Source: CEIC, HSBC

... to anchor investment growth in the coming months



Source: CEIC, HSBC

Policy issues

Tentative signs of stabilisation have emerged in recent weeks, but more easing measures are needed to strengthen the recovery. After the PBoC delivered a 25bp policy rate cut and a 50bp targeted reserve ratio cut on 28 June, we now expect an additional 25bp policy rate cut and a 200bp reserve ratio cut in 2H 2015.

Apart from monetary policy easing, we expect policymakers to roll out measures to alleviate the bottleneck in fiscal financing as well. The municipal bond issuance programme, kick-started in mid-May, is expected to accelerate in the coming months. The quota has reportedly been increased from RMB1trn to RMB2trn for 2015. We see this liability management exercise as another step in fiscal reform in order to reduce moral hazards and lower funding cost. The State Council is urging local governments to speed up the consolidation and utilisation of unspent fiscal surpluses accumulated over the years. Last, but not least, policy bank lending as well as Public-Private Partnership schemes are expected to play a more prominent role.

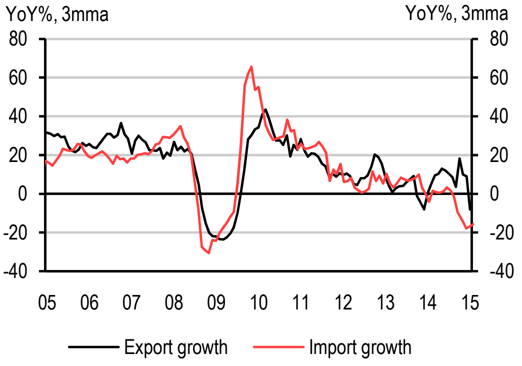
Risks

The main downside risk to our view is if the property market fails to stabilise. Property sales have seen some sequential and year-on-year improvement, in response to the cumulative mortgage rule easing measures. The improvement is notable in first and second tier cities, while not yet visible in others. If the improvement in sales can be broadened and sustained, property investment growth will likely start to bottom out by year end. However, if the improvement is not sustained, then potentially even more policy easing may be needed to offset the drag from property investment.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	7.3	7.3	7.0	6.8	7.1	7.2	7.2	7.4	7.3	7.4
GDP sa (% q-o-q)	1.9	1.5	1.3	1.6	2.0	1.7	1.7	1.8	1.9	1.8
Industrial production* (% y-o-y)	8.0	7.6	6.4	6.1	6.5	6.8	7.1	7.5	7.2	7.1
CPI, (% q-o-q saar)	0.5	0.3	0.1	0.5	0.4	0.2	0.3	0.4	0.4	0.2
CPI, average (% y-o-y)	2.0	1.5	1.2	1.2	1.3	1.3	1.4	1.3	1.3	1.2
PPI, average (% y-o-y)	-1.3	-2.8	-4.6	-3.8	-3.5	-4.1	-3.5	-3.3	-3.0	-2.8
Exports, value (% y-o-y)	11.0	8.5	4.6	-3.0	4.0	10.5	6.0	8.5	8.1	5.0
Imports, value (% y-o-y)	4.0	-1.6	-17.8	-10.0	2.0	5.0	9.0	7.5	6.0	4.0
Trade balance (% GDP)	3.2	4.6	5.4	4.7	5.3	5.5	4.9	5.0	5.7	5.5
International reserves (USD bn)	3,674	3,843	3,730	3,725	3,735	3,740	3,740	3,740	3,740	3,745
Policy rate, end quarter (%)	6.00	5.60	5.35	4.85	4.60	4.60	4.60	4.60	4.60	4.60
5yr lending rate, end quarter (%)	4.8	4.1	4.3	3.2	3.1	3.0	3.0	3.0	3.0	3.0
RMB /USD, end quarter	6.14	6.20	6.20	6.22	6.24	6.26	6.28	6.30	6.32	6.32
RMB /EUR, end quarter	7.74	7.50	6.63	6.84	6.55	6.57	6.72	6.80	6.95	6.95

*Industrial production is the output of companies with annual sales over RMB20m.
Source: CEIC, HSBC forecasts

Export growth weakened unexpectedly…

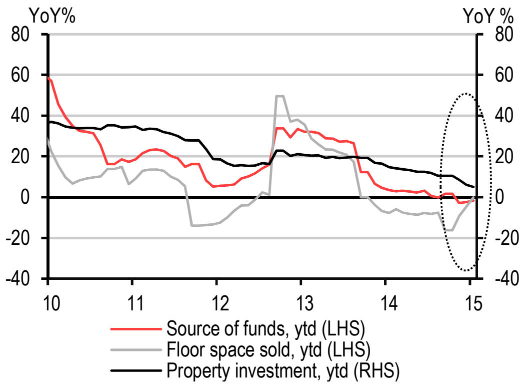


Source: CEIC, HSBC

…as external demand softened

- Export growth has turned out to be softer than expected in 1H2015. As of May, total exports grew only 0.6% y-o-y, a sharp slowdown from the 6% recorded for the full year of 2014
- The slowdown appeared to be quite broad-based as export growth to both G3 and non-G3 markets slowed. But the decline in exports to the Eurozone softened more than the rest, suggesting that a weaker EUR has likely played a part.
- Meanwhile imports continued to contract, falling by 17% y-o-y as of May 2015. The sizable decline in commodity prices apart, volume growth was also sluggish. We expect the contraction in imports to gradually ease on the back of the recovery in infrastructure investment.

Property sales showed signs of recovery…

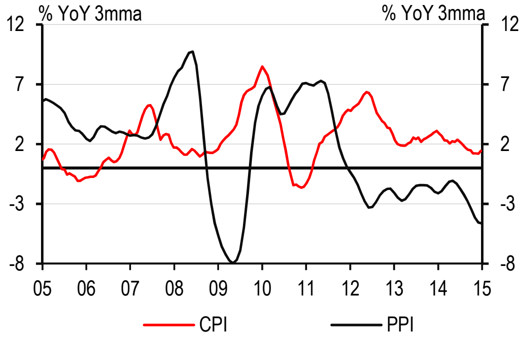


Source: CEIC, HSBC

…and could lead to more stabilisation of property investment towards year-end

- Following monetary easing and further relaxation of mortgage rules, property sales have showed some signs of recovery. Sales volume in first and second tier cities rebounded by 41% and 17% y-o-y respectively whereas the recovery looks much more muted outside these areas.
- If the sales recovery becomes more broad-based in the coming months, it could lead to some stabilisation of property investment. The lead time is around half a year. Therefore the earliest sign of a bottoming out in property investment growth will be in Q4 2015.
- A stabilisation of property investment means less of a drag on growth in 2015, and potentially a more neutral impact in 2016.

Inflation is still sluggish…



Source: CEIC, HSBC

…and will likely remain the case in 2H 2015

- Sequentially, pork prices have bottomed out since April and started to rise at a monthly growth rate of 2% to 3% over the last few months. The year-on-year base effect from oil price should also start to fade gradually in the coming months.
- But upside risks to inflation are limited. With data from investment growth to retail sales growth slowing, underlying inflationary pressures are expected to remain subdued.
- We expect headline CPI inflation to slow to 1.2% y-o-y in 2015, the lowest rate since the global financial crisis. PPI inflation is expected to stay in the negative territory as industrial output and investment growth remain soft.

HSBC

China: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	10.4	9.3	7.7	7.7	7.4	7.1	7.4
Nominal GDP (USD bn)	5,938	7,323	8,283	9,577	10,391	10,963	11,758
GDP per capita (USD)	4,367	5,351	6,015	6,912	7,455	7,822	8,345
Retail sales (% y-o-y)	18.5	17.1	14.3	13.1	10.3	10.0	10.5
Fixed Asset Investment (nominal, % y-o-y)	24.5	23.8	20.6	19.6	16.0	13.5	16.0
Net Exports (contribution to GDP growth, ppt)	-0.3	-0.4	1.0	0.3	1.3	2.1	0.6
Industrial production (% y-o-y)	15.7	13.9	10.0	9.7	8.3	6.5	7.2
Gross domestic saving (% GDP)	51.8	50.9	50.5	50.2	49.6	49.0	48.4
Unemployment rate, average (%)	4.1	4.3	4.1	4.1	4.2	4.3	4.2
Prices & wages							
CPI, average (% y-o-y)	3.3	5.4	2.7	2.6	2.0	1.2	1.3
CPI, end-year (% y-o-y)	4.6	4.1	2.5	2.9	1.5	1.7	1.7
Core CPI, average (% y-o-y)	0.9	2.2	1.5	1.7	1.6	1.1	1.2
Core CPI, end-year (% y-o-y)	1.7	1.6	1.6	1.8	1.7	1.5	1.5
PPI, average (% y-o-y)	5.5	6.1	-1.7	-1.9	-1.9	-4.0	-3.2
PPI, end-year (% y-o-y)	5.9	1.7	1.9	-1.4	-3.3	-4.2	-2.7
Manufacturing wages, nominal (% y-o-y)	15.3	18.6	13.6	11.5	10.8	10.0	10.0
Money, FX & interest rates							
Central bank money M0, average (% y-o-y)	12.1	16.0	9.6	9.4	6.0	5.0	6.0
Broad money supply M2, average (% y-o-y)	23.7	16.4	13.4	14.8	13.5	12.0	12.0
Policy rate, end-year (%)	5.64	6.56	6.00	6.00	5.60	4.60	4.60
5yr yield, end-year (%)	3.84	3.89	6.40	5.48	4.10	3.00	3.00
Real private sector credit growth (% Yr)	15.5	13.7	12.5	14.0	14.0	12.8	13.0
RMB /USD, end-year	6.62	6.30	6.23	6.05	6.20	6.26	6.32
RMB /USD, average	6.76	6.46	6.27	6.14	6.13	6.23	6.29
RMB /EUR, end-year	8.87	8.17	8.22	8.34	7.50	6.57	6.95
RMB /EUR, average	8.92	8.93	8.10	8.12	8.12	6.78	6.80
External sector							
Merchandise exports (USD bn)	1,578	1,898	2,049	2,209	2,343	2,441	2,612
Merchandise imports (USD bn)	1,396	1,743	1,818	1,950	1,960	1,843	1,953
Trade balance (USD bn)	181.5	154.9	230.3	259.0	382.5	598.5	658.8
Current account balance (USD bn)	238	136	215	148	220	318	339
Current account balance (% GDP)	4.0	1.9	2.6	1.5	2.1	2.9	2.9
Net FDI (USD bn)	45.9	49.3	33.3	9.7	3.6	3.9	4.3
Net FDI (% GDP)	0.8	0.7	0.4	0.1	0.0	0.0	0.0
Current account balance plus FDI (% GDP)	4.8	2.5	3.0	1.6	2.1	2.9	2.9
Exports, value (% y-o-y)	31.3	20.3	7.9	7.8	6.1	4.2	7.0
Imports, value (% y-o-y)	38.8	24.9	4.3	7.2	0.5	-6.0	6.0
International FX reserves (USD bn)	2,847	3,181	3,312	3,821	3,843	3,740	3,745
Import cover (months)	22.5	20.0	19.7	20.9	20.9	20.9	19.5
Public and external solvency indicators							
Gross external debt (USD bn)	548.9	695.0	737.0	863.2	983.2	1,103.2	1,223.2
Gross external debt (% GDP)	9.2	9.5	8.9	9.0	9.5	10.1	10.4
Short term external debt (% of int'l reserves)	13.2	15.7	16.3	17.7	19.9	22.6	24.7
Consolidated government balance (% GDP)	-2.5	-1.8	-1.5	-2.0	-2.1	-2.3	-2.6
Public Sector Debt (% GDP)	43.4	47.8	53.5	56.2	62.2	60.8	59.0
Macro prudential indicators							
Capital adequacy ratio	12.2	12.7	13.3	12.2	13.2	n/a	n/a
Non-performing loan ratio	1.1	1.0	1.0	1.0	1.3	n/a	n/a
Household Debt/ GDP (%)	18.4	18.3	19.6	22.1	24.2	n/a	n/a
Total Credit/GDP (%)	124.5	120.2	126.0	130.3	136.4	n/a	n/a
Residential House prices (% y-o-y)	7.5	6.5	8.1	7.7	1.4	n/a	n/a
Loan/Deposit ratio	69.4	70.4	71.3	71.6	73.9	n/a	n/a
Stock Market Capitalization/GDP (%)	87.4	66.8	67.7	67.6	88.7	n/a	n/a

Note: Industrial production is the output of all industrial companies with annual sales over RMB20m.
Source: CEIC, IMF, ADB, HSBC forecasts

Hong Kong

Feeling the Mainland slowdown

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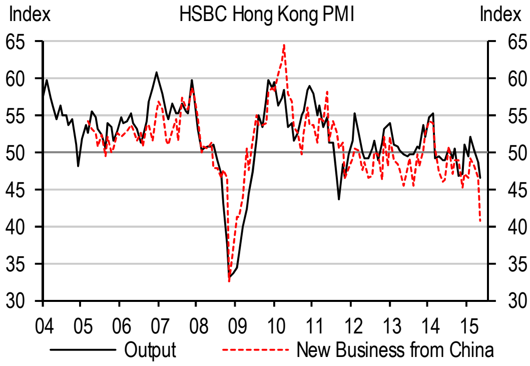
Given the slowdown in the economic data from Mainland China, it would be a surprise if Hong Kong's economy were immune. The sharp fall in new orders from the Mainland in the Hong Kong PMI indicates that Mainland orders are now contracting at the fastest pace since 2008. Year to date, exports to the Mainland, which account for more than half of total Hong Kong exports, have slowed more than exports to other markets. We therefore believe the external environment will continue to be relatively weak and expect net exports to pose downside risks to growth.

Domestically, retail sales have remained sluggish. The total value of sales is down from last year, while volumes have held up slightly better. There has been a notable divergence between headline CPI inflation (which is falling, but still positive) and the y-o-y change in the retail price deflator (which is falling at a faster pace). This suggests that retailers are having to discount heavily to protect volume growth. We therefore believe CPI inflation will continue to trend lower in the rest of the year, driven by lower food prices as well as more aggressive retail discounting.

However, lower prices may not be enough to give a large boost to demand. Growth in tourist arrivals has continued to slow and this will be a drag on both retail and exports of services such as travel and transportation, both of which had been significant contributors to Hong Kong's services trade surplus in recent years.

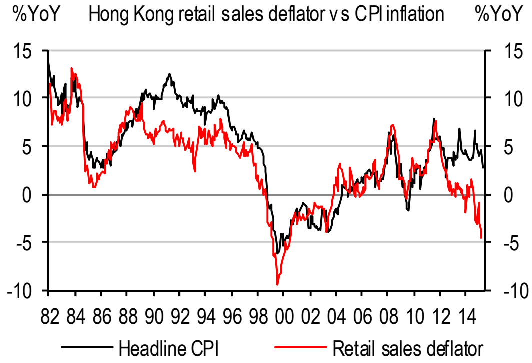
In the medium term, Hong Kong's economy still needs to transition to new sources of growth. Although tourism has been a strong growth sector in recent years, it still only contributes around 6% to GDP in total. The largest sector of Hong Kong's economy, import and export services, will come under pressure in both the short and long term due to the weakness in world trade and competition from other ports on the Mainland.

New orders from Mainland China fell sharply in May



Source: Markit, HSBC

Retailers have been discounting very heavily recently



Source: Census and Statistics Department, HSBC

Policy issues

Because of the long-standing peg to the US dollar, Hong Kong does not have its own interest rate policy. So rates will go up whenever the Federal Reserve decides to begin its rate normalisation, which should be in December 2015 according to our US economists.

We believe Hong Kong can handle the normalisation of interest rates from a macroeconomic perspective. Unemployment is at a multi-year low of 3.2%, while inflation is low but unlikely to turn negative anytime soon given the relatively low pass-through from low global commodity prices to Hong Kong's CPI basket, which is dominated by housing costs.

Risks

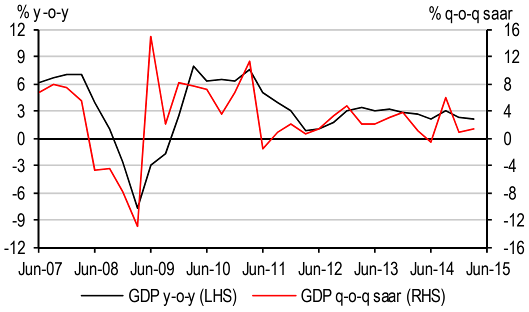
The housing market in Hong Kong has continued to rise in recent months. We estimate that affordability is close to 17 times average annual household income, which was last seen during the height of the previous peak in 1997, just before the Asian Financial Crisis.

The Hong Kong Monetary Authority (HKMA) is therefore likely to remain vigilant over financial stability risks. Much will depend on how the market reacts to the first couple of rate hikes from the US Fed. Should the housing market continue to take those in its stride, then the HKMA could impose further macroprudential tools to rein in the housing market, which it has done on multiple occasions in recent years. These could take the form of increases in stamp duty or lowering the cap on mortgage loan-to-value ratios, both of which have been used in the past.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	2.9	2.4	2.1	2.8	2.9	1.5	2.4	2.5	2.5	2.0
GDP sa (% q-o-q)	1.4	0.2	0.4	1.6	0.8	-0.6	0.7	0.5	3.5	-0.4
Industrial production (% y-o-y)	-1.7	-3.6	-1.6	-0.6	2.4	2.7	-1.0	-1.0	-1.0	-1.0
CPI, average (% y-o-y)	4.8	5.1	4.4	2.8	2.2	1.6	2.5	4.3	4.2	4.1
PPI, average (% y-o-y)	1.3	-1.2	1.3	1.0	0.9	0.9	0.9	1.1	1.1	0.9
Exports, value (% y-o-y) (BOP, goods)	3.0	2.0	1.7	0.1	0.2	0.5	2.4	3.3	2.7	2.4
Imports, value (% y-o-y) (BOP, goods)	3.2	3.3	0.7	0.0	2.0	0.2	2.2	2.8	2.3	2.3
Trade balance (% GDP) (BOP, goods)	-4.1	-7.4	-12.4	-15.4	-7.6	-7.2	-12.6	-14.4	-6.9	-7.0
Current account (% GDP)	6.8	2.7	0.1	-2.8	2.6	2.1	1.9	-2.3	2.9	2.5
International reserves (USD bn)	325.8	328.5	332.2	340.1	346.8	353.6	360.3	367.3	374.9	382.7
Policy rate, end quarter (%)	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.00	1.25	1.25
5yr yield, end quarter (%)	1.48	1.44	1.28	1.39	1.60	1.80	1.90	2.00	2.10	2.10
HKD /USD, end quarter	7.76	7.76	7.75	7.80	7.80	7.80	7.80	7.80	7.80	7.80
HKD /EUR, end quarter	9.78	9.38	8.30	8.58	8.19	8.19	8.35	8.42	8.58	8.58

Source: CEIC, HSBC forecasts

Chart 1. GDP growth picked up in q-o-q terms …

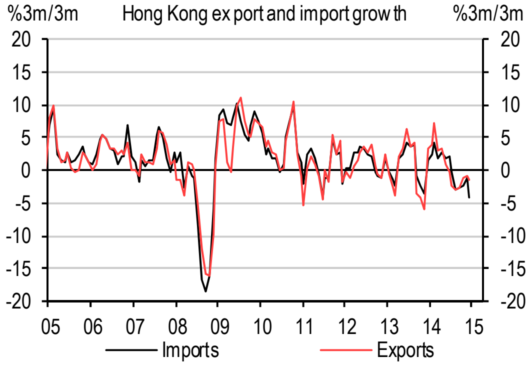


Source: CEIC, HSBC

… however, the weak external environment poses a challenge

- Q1 2015 GDP growth picked up in q-o-q terms to 0.4%, up from 0.2% q-o-q in Q4 2014.
- This translated into a fall in the y-o-y growth to 2.1%, down from 2.4% y-o-y in Q4. This was largely driven by strong investment growth and private consumption, although the contribution of the latter fell slightly.
- Although GDP growth has registered a steady start to the year, headwinds remain from a deteriorating external environment, largely driven by weak global growth and the slowdown in China.
- On a positive note, the low levels of inflation and unemployment imply that Hong Kong should be able to cope with the Fed tightening towards the end of the year.

Chart 2. Both import and export growth have been weak …

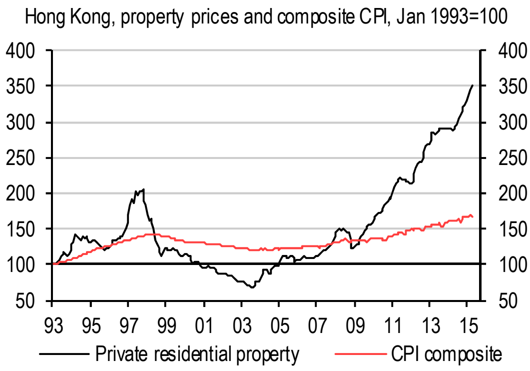


Source: CEIC, HSBC

… and net exports are unlikely to contribute meaningfully to GDP

- The external sector is feeling the pinch of weak global growth and the deepening slowdown in the Mainland. Both export and import data have been weak since the start of the year , with sharper falls being registered in YTD export growth to China.
- Furthermore, the new orders from Mainland China sub-index of the Markit Hong Kong PMI , has been in contractionary territory since August 2014, with orders in May contracting at their fastest pace since 2008. Exports of services are also likely to weigh down on growth, largely driven by the slowdown in tourist arrivals.
- The import/export trade services sector accounts for around a fifth of Hong Kong's GDP and is particularly sensitive to growth in China , and with the weakness likely to persist in the near term, net exports are unlikely to contribute meaningfully to GDP growth.

Chart 3. House prices continue to soar …



Source: Datastream, HSBC

… with housing affordability close to previous peaks

- Hong Kong house prices show no signs of abating, with the private domestic property price index indicating that prices rose 21% y-o-y, well above the average annual growth rate of close to 6% y-o-y in 2014.
- Housing affordability , measured by the price to income ratio is already at previous peaks reached back in 1997 and the HKMA could impose further macro prudential measures to contain the rise.
- Additionally, the performance of the housing market will also depend on how the market reacts to the Fed hiking rates, which is likely to happen before the end of the year.

Hong Kong: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	6.8	4.8	1.7	2.9	2.3	2.3	2.3
Nominal GDP (USD bn)	229	249	263	276	291	296	300
GDP per capita (USD)	32,551	35,147	36,713	38,364	40,164	40,372	40,895
Private consumption (% y-o-y)	6.1	8.4	4.1	4.6	2.7	3.1	2.7
Government consumption (% y-o-y)	3.4	2.5	3.6	3.0	3.1	4.8	4.6
Investment (% y-o-y)	7.7	10.2	6.8	2.2	-0.3	2.5	3.7
Net Exports (contribution to GDP growth, ppt)	0.0	-1.2	-8.9	-4.0	-2.6	-0.1	-1.0
Industrial production (% y-o-y)	3.5	0.7	-0.8	0.1	-0.4	0.8	-1.0
Gross domestic saving (% GDP)	29.9	29.4	28.8	28.7	28.9	29.3	29.8
Unemployment rate, end-year (%)	3.9	3.3	3.2	3.2	3.3	3.3	3.3
Prices & wages							
CPI, average (% y-o-y)	2.3	5.3	4.1	4.3	4.4	2.7	3.8
CPI, end-year (% y-o-y)	2.9	5.7	3.8	4.3	4.8	2.9	3.8
Core CPI, average (% y-o-y)	0.9	4.3	3.5	3.6	3.5	2.0	3.1
Core CPI, end-year (% y-o-y)	1.9	5.1	3.0	3.6	3.1	1.2	3.4
PPI, average (% y-o-y)	6.0	8.3	0.1	-0.7	-1.1	0.2	0.6
PPI, end-year (% y-o-y)	7.6	6.6	-1.0	0.5	-2.4	1.3	1.0
Manufacturing wages, nominal (% y-o-y)	3.3	9.3	5.2	4.1	4.1	4.5	4.5
Money, FX & interest rates							
Central bank money M1, average (% y-o-y)	24.2	13.4	13.5	15.8	12.8	15.9	13.9
Broad money supply M3, average (% y-o-y)	5.2	12.9	10.3	11.7	12.6	10.5	11.3
Real private sector credit growth (% y-o-y)	26.2	14.9	5.5	11.7	8.3	7.7	4.1
Policy rate, end-year (%)	0.50	0.50	0.50	0.50	0.50	0.75	1.25
5yr yield, end-year (%)	1.76	0.96	0.32	1.40	1.44	1.80	2.10
HKD /USD, end-year	7.77	7.77	7.75	7.75	7.76	7.80	7.80
HKD /USD, average	7.77	7.78	7.76	7.76	7.76	7.79	7.80
HKD /EUR, end-year	10.42	10.06	10.23	10.68	9.38	8.19	8.58
HKD /EUR, average	10.25	10.76	10.03	10.25	10.28	8.47	8.43
External sector							
Merchandise exports (USD bn) (BOP, goods)	388.9	437.7	440.5	506.2	519.2	522.3	536.5
Merchandise imports (USD bn) (BOP, goods)	385.6	445.2	452.5	534.1	549.4	553.4	566.8
Trade balance (USD bn) (BOP, goods)	3.3	-7.5	-12.1	-27.9	-30.1	-31.1	-30.3
Current account balance (USD bn)	16.0	13.8	4.1	4.2	5.4	1.7	3.9
Current account balance (% GDP)	7.0	5.6	1.6	1.5	1.9	0.6	1.3
Net FDI (USD bn)	-15.7	0.2	-13.2	-6.5	-39.4	-15.0	-10.0
Net FDI (% GDP)	-6.9	0.1	-5.0	-2.3	-13.6	-5.1	-3.3
G & S balance plus FDI (% GDP)	0.1	5.7	-3.5	-0.8	-11.7	-4.5	-2.0
Exports, value (% y-o-y) (BOP, goods)	22.8	12.6	0.6	14.9	2.6	0.6	2.7
Imports, value (% y-o-y) (BOP, goods)	27.1	15.5	1.6	18.0	2.9	0.7	2.4
International FX reserves (USD bn)	268.7	285.4	317.3	303.8	303.6	332.2	340.1
Import cover (months)	8.4	7.7	8.4	6.8	6.6	7.2	7.2
Public and external solvency indicators							
Commercial banks' FX assets (USD bn)	962	1,112	1,203	1,423	1,551	n/a	n/a
Gross external debt (USD bn)	879	985	1,031	1,161	n/a	n/a	n/a
Gross external debt (% GDP)	384	396	392	421	n/a	n/a	n/a
Consolidated government balance (% GDP)	1.5	3.9	3.6	3.0	1.0	3.5	0.7
Public Sector Debt (% GDP)	35.5	34.8	34.1	33.0	32.0	31.0	30.0
Macro prudential indicators							
Capital adequacy ratio (local Authorized Institutions)	15.8	15.8	15.7	15.9	n/a	n/a	n/a
Non-performing loan ratio	0.8	0.8	0.8	0.8	0.8	n/a	n/a
Household Debt/ GDP (%)	59.2	59.1	61.3	62.6	65.6	61.0	61.0
Total Credit/GDP (%)	168	174	177	186	201	180	180
Residential House prices (% y-o-y)	24.4	20.7	13.2	17.6	6.0	n/a	n/a
Loan/Deposit ratio	61.6	66.9	67.1	70.3	72.2	72.0	70.0
Average Mortgage Loan to Value Ratio	60.2	54.6	55.1	54.7	55.2	n/a	n/a
Mortgage loan-to-value ratio – mid market properties	60.0	60.0	60.0	60.0	60.0	n/a	n/a

Note: Public debt refers to government debt only.
Source: CEIC, IMF, ADB, HK Censtatd, HSBC forecasts

India

Modi's mixed bag, one year on

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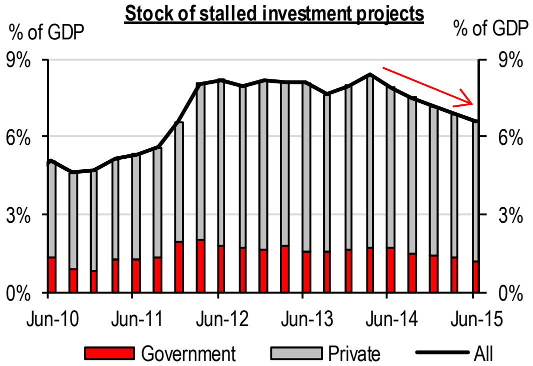
PM Modi has been busy over the past year, with overseas travels and bilateral agreements that promise funding and investments into India. At home, a solution was devised for inactive coal mines, fuel price controls were removed, a large proportion of stalled investment projects were revived, FDI norms were relaxed and, by keeping agriculture support prices contained, prudent policy was chosen over populism. However, foreign investors' perception of India's tax policies has not improved, numerous projects have still not revived with knock-on effects on banks, and progress in some key bills remains stalled. To be fair, it will take time for results from government actions (on subsidy reforms, improving business regulations and levying a uniform national indirect tax), to show up. Even so, the macro-economy is already much more stable with lower inflation, narrower deficits and record high foreign exchange reserves.

GDP growth in Q1 2015 improved (7.5% y-o-y vs. 6.6% in Q4 2014). However growth in GVA (a measure of activity on the supply side) slowed to 6.1% y-o-y from 6.8% in Q4. The divergence between the two measures of GDP is explained by the statistical artefact of higher net indirect taxes, which is likely to persist for a few quarters. While the true state of the recovery probably lies between the two figures, we prefer the supply-side measure, as that gives a cleaner read on activity. The reading is also in line with our analysis of coincident indicators, which shows that while about 50% of GDP is improving, 50% has not picked up speed. Recovery is therefore slow, but progressing steadily and is likely to gain momentum, led by higher public investment and improved urban consumption, although rural demand remains a drag. We expect headline GDP growth to rise gradually to 7.8% y-o-y in FY2015-16 from 7.3% a year ago. GVA growth will be a notch lower at 7.4% y-o-y in FY2015-16, up from 7.2% last year.

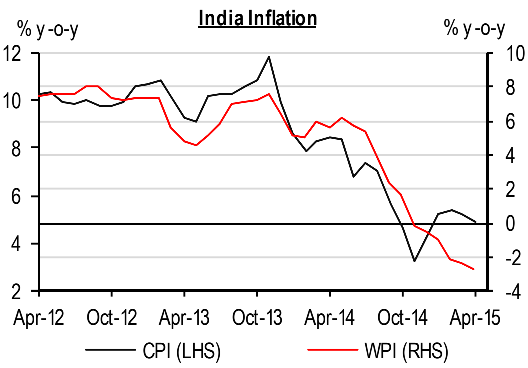
Inflation has halved in a matter of a few quarters; but with oil prices bottoming out and domestic recovery gaining ground, its dramatic decline may be over. Meanwhile, the current account deficit could widen slightly due to higher oil prices and poor exports. However, it is likely to remain manageable, financed easily by stable capital inflows (FDI, ECBs and NRI deposits).

Policy actions have helped resolve stalled investments, but more action is needed



Source: CMIE, HSBC

Inflation has fallen rapidly, across all measures



Source: CEIC, HSBC

Policy issues

The central government budget for FY2015-16 adopted a milder fiscal consolidation path than the one inherited, with the fiscal deficit falling to 3.9% of GDP in FY2015-16 instead of an earlier target of 3.6%. Apart from delayed consolidation for the purposes of financing public investment (signs of which have started to show up in central government expenditure data), a transformational feature of this budget was greater devolution of untied tax income to states. Our analysis of 17 state budget documents shows that states in aggregate are exhibiting signs of fiscal discipline. To match conservative revenue receipt estimates, they have slashed current expenditure much more than capex in order to keep fiscal deficits range-bound. We estimate a positive fiscal impulse to growth as the quality of expenditure improves.

The Reserve Bank of India delivered a 25bp rate cut in June (marking an overall of 75bp in rate cuts so far in 2015) with its forward guidance stating that policy now is neither aggressive, nor conservative, but just appropriate. Our base case forecast (of below normal but not-too-deficient rains through the next few months) is that CPI inflation will start to inch up from September, leaving no space for rate cuts for the rest of the year. But if the rains turn out to be normal and economic growth, especially investment revival, remains weak, the RBI may find some space to cut rates further in 2015. However this additional space will be small, given RBI's ambitious target of 4% inflation by early 2018.

The Fed's exit from lose monetary policy could be a prolonged affair, followed by exits from other central banks as well. Under such circumstances, it may not be a bad idea for emerging market countries such as India to maintain higher buffers. Taking account of India's peculiarities and main vulnerabilities (such as a persistent current account deficit, potential capital flow reversal and unhedged external corporate debt exposure), we estimate that the RBI may need USD60bn in additional FX reserves as a buffer against prolonged global stress, taking the overall stock of FX reserves to USD420bn.

Risks

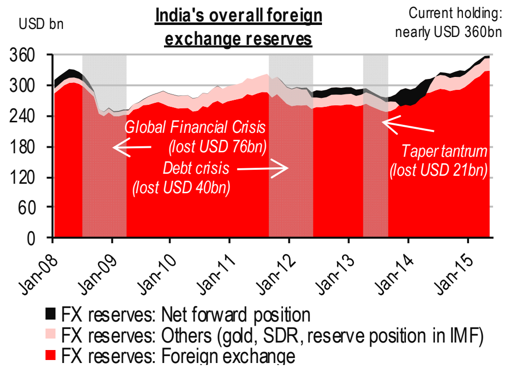
A drought caused by El Niño is the biggest risk to our forecasts, as it could depress rural demand further and stoke food inflation. While rains in June have been 18% above normal, July is the key month to monitor. A key risk to our medium-term view of steady growth recovery is a slackening in the reform process and the inability of public investments to "crowd in" the private sector.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	8.4	6.6	7.5	8.4	8.4	7.5	6.9	8.2	8.2	8.4
GDP sa (% q-o-q)	3.4	-0.7	2.5	3.0	3.4	-1.6	2.0	4.3	3.3	-1.5
Industrial production (% y-o-y)	1.3	2.0	3.4	5.4	5.5	8.2	6.5	7.1	7.4	7.6
WPI, (% q-o-q saar)	4.0	-6.2	-7.0	1.1	6.1	5.7	5.9	5.1	4.3	3.6
CPI, average (% y-o-y)	6.7	4.1	5.3	5.0	4.5	5.6	5.6	5.8	5.9	5.9
WPI, average (% y-o-y)	3.9	0.3	-1.8	-2.4	-1.7	1.4	4.8	5.7	5.3	4.7
Exports, value (G&S) (% y-o-y)	4.9	-1.0	-15.4	-8.2	-9.7	2.4	18.1	9.1	10.9	10.3
Imports, value (G&S) (% y-o-y)	8.1	4.7	-10.4	-9.7	-8.0	3.1	22.0	14.6	12.3	11.5
Trade balance (% GDP)	-7.6	-7.7	-5.9	-5.9	-7.1	-7.7	-7.3	-6.8	-7.3	-7.7
Current account (% GDP)	-2.0	-1.6	-0.2	-0.3	-1.5	-2.1	-1.8	-1.2	-1.3	-1.8
International reserves (USD bn)	288.0	295.9	317.3	332.1	340.5	349.1	361.7	375.5	389.1	403.7
Policy rate, end quarter (%)	8.00	8.00	7.50	7.25	7.25	7.25	7.25	7.25	7.25	7.25
5yr yield, end quarter (%)	8.6	8.0	7.8	8.1	7.7	7.3	7.0	6.8	6.6	6.5
INR /USD, end quarter	61.61	63.33	62.59	65.0	65.5	66.0	66.0	66.5	66.5	67.0
INR /EUR, end quarter	77.6	76.6	67.0	71.5	68.8	69.3	70.6	71.8	73.2	73.7

Source: CEIC, HSBC forecasts

HSBC

Record FX reserves despite three recent turmoil episodes …

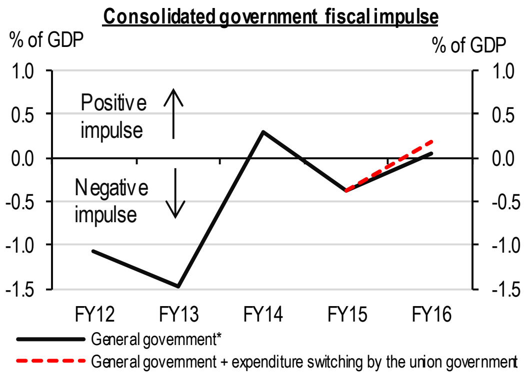


Source: CEIC, HSBC

… but more reserves may be needed to weather upcoming global financial stress

- Our study of India's reserve losses over three recent episodes (the global financial crisis, debt crisis, and taper tantrum) suggest that if similar losses were to hit again, the import cover of reserves would remain adequate but the short term external debt cover could fall notably.
- And indeed, India's main vulnerability has gradually transited from a trade imbalance to indebtedness. We estimate an additional USD60bn of reserves would help reduce India's key vulnerabilities.
- Having said this, other lines of defence, notably swap line arrangements with other countries, can prove as effective. And most effective of all is keeping the macro house in order. That single-handedly can insulate the economy against shocks.

Fiscal position is moderately expansionary …

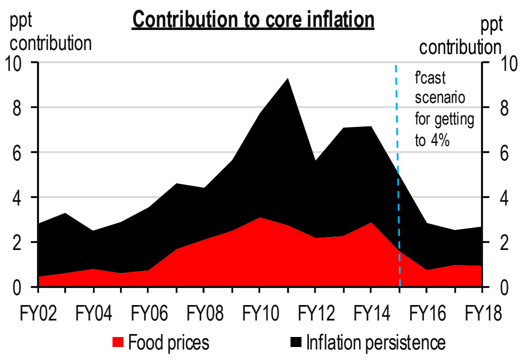


Source: HSBC estimates

… support growth further if the quality of spending improves

- The central government adopted easier fiscal consolidation targets this year in a bid to support growth …
- … by way of higher capital spending and providing more *untied* funds to states.
- At a general government level (centre and state combined), despite marginal fiscal consolidation this year, an improvement in quality of expenditure (switching from current to capital spending) is expected to support growth.

Tackling food prices is key to achieving …



Source: HSBC estimates

… the RBI's 4% CPI inflation target

- Inflation has declined sharply led by food, energy and weak demand. But as economic activity improves, and the output gap closes, it is likely to put upward pressure on prices.
- Our analysis shows that the output gap, while still significant in determining inflation, is not as important as before. On the other hand, the role of food prices has risen meaningfully.
- A high weight of food in the consumption basket has traditionally made it an important part of wage negotiations. And the importance only intensified as food prices sky-rocketed in the 2009-2013 period.
- Ultimately, guiding inflation lower towards the RBIs CPI target of 4% in 2018 hinges upon food reforms in production and distribution, and a much improved investment climate.

India: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)*	10.3	4.8	5.1	6.9	7.3	7.8	8.3
Nominal GDP (USD bn)*	1,720	1,784	1,831	1,863	2,049	2,119	2,388
GDP per capita (USD)*	1,451	1,462	1,483	1,489	1,617	1,653	1,840
Private consumption (% y-o-y)*	8.7	7.8	5.5	6.2	6.3	7.8	8.3
Government consumption (% y-o-y)*	5.8	4.2	1.7	8.2	6.6	9.3	7.6
Investment (% y-o-y)*	11.0	11.3	-0.3	3.0	4.6	7.0	9.1
Net Exports (contribution to GDP growth, ppt)*	0.2	-3.2	-0.2	4.4	0.4	0.0	-0.3
Industrial production (% y-o-y)	8.2	2.9	1.1	-0.1	2.8	6.4	7.4
Gross domestic saving (% GDP)*	33.7	33.9	31.8	30.6	30.3	30.0	30.0
Prices & wages							
CPI, average (% y-o-y)*	10.3	9.0	10.2	9.8	6.0	5.2	5.8
CPI, end-year (% y-o-y)*	8.5	9.4	10.2	8.2	5.3	5.6	5.7
Core WPI, average (% y-o-y)*	6.1	7.3	4.9	2.9	2.4	0.4	3.4
Core WPI, end-year (% y-o-y)*	8.5	5.0	3.6	4.0	-0.4	2.7	3.3
WPI, average (% y-o-y)*	9.6	8.9	7.4	6.0	2.0	0.5	4.9
WPI, end-year (% y-o-y)*	9.7	7.7	5.7	6.0	-2.3	5.4	3.9
Money, FX & interest rates							
Central bank money M0, average (% y-o-y)	18.5	15.9	12.4	10.4	10.3	11.7	12.0
Broad money supply M3, average (% y-o-y)	16.3	16.5	13.7	13.3	12.7	16.5	16.7
Real private sector credit growth (% y-o-y)	10.8	7.2	5.6	4.3	3.1	6.9	9.2
Policy rate, end-year (%)	6.25	8.50	8.00	7.75	8.00	7.25	7.25
5yr yield, end-year (%)	7.85	8.47	8.08	8.88	7.98	7.30	6.50
INR /USD, end-year	44.8	53.3	54.8	61.9	63.3	66.0	67.0
INR /USD, average	45.8	46.9	53.6	59.0	61.1	64.2	66.4
INR /EUR, end-year	60.0	69.0	72.3	85.3	76.6	69.3	73.7
INR /EUR, average	60.4	64.9	69.2	78.0	81.0	69.8	71.8
External sector							
Merchandise exports (USD bn)*	250.6	309.8	306.6	318.6	316.7	316.5	348.2
Merchandise imports (USD bn)*	381.1	499.5	502.2	466.2	460.9	466.0	528.3
Trade balance (USD bn)*	-130.4	-189.7	-195.7	-147.6	-144.2	-149.5	-180.1
Current account balance (USD bn)*	-46.0	-78.2	-87.8	-32.4	-27.5	-30.9	-40.2
Current account balance (% GDP)*	-2.7	-4.4	-4.8	-1.7	-1.3	-1.5	-1.7
Net FDI (USD bn)*	9.4	22.1	19.8	21.6	32.6	27.5	33.0
Net FDI (% GDP)*	0.5	1.2	1.1	1.2	1.6	1.3	1.4
Current account balance plus FDI (% GDP)*	-2.1	-3.1	-3.7	-0.6	0.2	-0.2	-0.3
Exports, value (% y-o-y)*	37.5	23.6	-1.1	3.9	-0.6	-0.1	10.0
Imports, value (% y-o-y)*	26.7	31.1	0.5	-7.2	-1.1	1.1	13.4
International FX reserves (USD bn)	274.3	260.1	259.7	276.4	317.3	361.7	416.2
Import cover (months)	8.6	6.2	6.2	7.1	8.3	9.3	9.5
Public and external solvency indicators							
Commercial banks' FX assets (USD bn)	294.8	340.0	305.1	321.8	341.1	315.0	315.0
Gross external debt (USD bn)	317.9	360.8	409.5	446.3	475.8	497.4	530.7
Gross external debt (% GDP)	18.5	20.2	22.4	24.0	23.2	23.5	22.2
Short term external debt (% of int'l reserves)	23.7	30.1	37.2	33.2	26.7	29.3	28.7
Consolidated government balance (% GDP)*	-7.8	-6.0	-6.9	-6.0	-6.4	-6.4	-6.1
Central government balance (% GDP)*	-4.8	-5.8	-4.9	-4.4	-4.0	-3.9	-3.5
Primary balance (% GDP)*	-1.8	-2.8	-1.8	-1.1	-0.8	-0.7	-0.6
Gross public sector debt (% GDP)*	65.5	65.2	64.9	66.2	66.3	66.3	63.9
Macro prudential indicators							
Capital adequacy ratio (system wide)*	13.6	13.0	13.9	13.0	12.8	n/a	n/a
- tier 1*	9.4	9.2	10.3	10.1	n/a	n/a	n/a
- tier 2*	4.1	3.8	n/a	n/a	n/a	n/a	n/a
Non-performing loan ratio	2.4	3.1	3.2	3.8	4.5	n/a	n/a
Household Debt/ GDP (%)	8.6	8.5	8.7	9.0	9.5	n/a	n/a
Residential house price index (Mumbai metropolis, % y-o-y)**	23.1	28.3	23.3	10.0	2.9	n/a	n/a
Loan/Deposit ratio*	75.7	78.0	77.9	77.8	76.3	n/a	n/a
Stock Market Capitalization/GDP (%)*	87.8	70.4	64.0	65.4	80.9	n/a	n/a
Total Credit/GDP (%)*	50.6	52.2	52.7	52.8	52.8	n/a	n/a

*Data on fiscal year basis (Apr–Mar), e.g., fiscal year 2010-11 refers to 2010 in the table
**RBI
Source: Central Statistical Organisation, Reserve Bank of India, Bloomberg, ADB, IMF, CEIC, HSBC forecasts

HSBC

Indonesia

Consumption to stall

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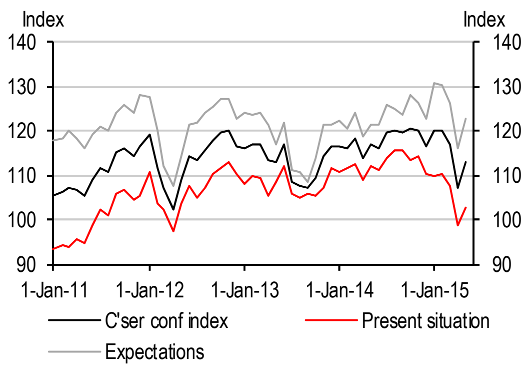
Contrary to popular perception, the weakness in Q1 2015 GDP did not stem from a collapse in domestic demand or even net exports. Private consumption was only a touch slower than in Q4, at 1.2% q-o-q sa, in line with the long-term trend. Meanwhile investment bounced 1.7% q-o-q sa following a lacklustre Q4 2014. Net exports added 0.2ppt to overall q-o-q growth, as the decline in imports outpaced that of exports. In contrast, inventories and statistical errors subtracted 0.6ppt from GDP growth. As a result, Q1 growth slowed to 4.7% y-o-y from 5.0%, the slowest pace since Q3 2009. This translates to an estimated expansion of just 0.8% q-o-q sa – well below potential of 1.3-1.5%, and the slowest pace since the Global Financial Crisis.

The weak start to the year leads us to downgrade our 2015 growth forecast to 4.8%, from 5.5%. For 2016, we trim our forecast to 5.6%, from 5.8%. Our 2015 forecast marks the slowest expansion since 2009. Although we have retained our previous q-o-q headline GDP growth profile, we have lowered our consumption and import forecasts. Although domestic demand didn't collapse in Q1, the headwinds facing consumption are building. Consumer confidence in April weakened to its lowest since September 2013, and was followed by only a feeble recovery in May. Consumers are worried about business conditions, employment and income – and rightly so. The PMI shows that, over the past year-and-a-half, employment in manufacturing – which accounts for more than 13% of total employment – has contracted moderately in most months. Meanwhile, wage growth across the manufacturing, hotel and non-oil mining sectors has averaged just over 6% y-o-y since 2014, down from double-digits in 2012 and 2013. After adjusting for inflation, which is set to average 6.5% this year, real wage growth has been close to zero or negative.

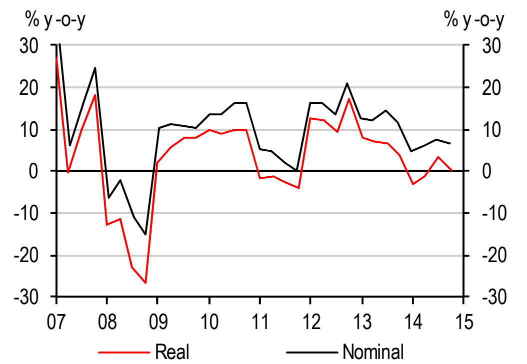
Policymakers have repeatedly pointed to the government's infrastructure plans as a bastion of hope. Until more evidence of activity on that front materialises, however, we maintain our expectation of only a moderate uptick in investment, to 4.8% (previously 4.9%) from 4.1%. As at end-April, the Public Works and Housing Ministry had spent just 2.4% of its annual IDR118trn budget, compared to 11.5% over the same period last year.

Consumer confidence at close to an eighteen-month low



Source: CEIC, HSBC

Real wage growth negative to zero since start of 2014



Source: CEIC, HSBC

Policy issues

Since unexpectedly cutting its reference rate in February, Bank Indonesia (BI) has appeared reluctant to deliver any further monetary easing. Along with the government, it has instead undertaken a number of macro-prudential measures to address the slowdown. These include relaxing loan-to-value limits on mortgages and automotive loans, and encouraging banks to lend to small-medium enterprises (SMEs). More recently, the government announced that public and state-owned banks will halve their lending rates for SMEs. The luxury tax on certain goods will also be slashed or exempted in order to spur consumption.

Perhaps BI is still smarting from the cool reception to its February rate cut (after all, the move did come on the heels of a 25bp hike – also unexpected – in November). Or maybe it fears triggering portfolio outflows, particularly ahead of an impending rate-hike cycle by the Fed. But we now expect the Fed to start hiking in December rather than September, and at a more gradual pace than initially forecast. More importantly, the macro-prudential measures are not likely to be broad or potent enough to materially boost credit and economic growth. At the time of writing, none of the measures had been implemented. Furthermore, BI officials have themselves acknowledged that this year's credit growth target of 15-17% looks ambitious, when credit growth has been 11-12% y-o-y in the year to date. To this end, we believe a 25bp rate cut to 7.25% will be necessary, possibly as soon as Q3 2015, lowering the cost of borrowing for all segments of the economy.

Risks

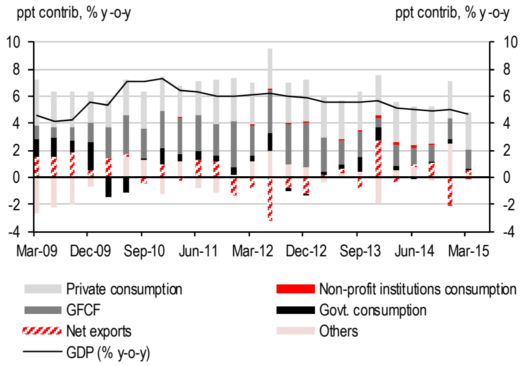
The direction of our growth forecasts in the coming quarters will hinge on whether infrastructure projects do indeed start to take off in a more material way in H2 2015. The other growth engines can no longer be relied on to propel the economy forward – external demand has been weak for the last two years, and consumption now appears to be on the cusp of heading down a similar path.

Against this backdrop of slower growth, we also worry about the government's commitment to earlier fuel subsidy reforms, particularly if global crude oil prices continue to grind higher over H2 2015.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	4.9	5.0	4.7	4.7	4.9	4.9	5.5	5.6	5.7	5.8
GDP sa (% q-o-q)	1.2	1.4	0.8	1.2	1.4	1.4	1.4	1.4	1.5	1.5
Industrial production (% y-o-y)	5.8	5.5	5.1	3.7	3.9	3.9	4.5	4.6	4.7	4.8
CPI, (% q-o-q saar)	3.5	12.4	6.3	6.2	2.6	7.4	2.0	6.8	1.5	7.4
CPI, average (% y-o-y)	4.4	6.5	6.5	7.1	6.9	5.6	4.5	4.7	4.4	4.4
Exports, value (% y-o-y)	-0.5	-10.0	-13.9	-16.9	-16.1	-9.3	0.2	5.3	6.7	5.0
Imports, value (% y-o-y)	-3.9	-5.9	-14.4	-21.7	-18.5	-6.5	1.3	8.6	9.6	4.4
Trade balance (% GDP)	0.7	1.1	1.5	0.9	1.1	0.5	1.2	0.3	0.7	0.6
Current account (% GDP)	-2.9	-2.6	-1.8	-2.8	-2.3	-3.3	-2.2	-3.3	-2.7	-3.0
International reserves (USD bn)	111.2	111.9	111.6	110.6	113.6	115.0	119.7	122.5	127.0	131.3
Policy rate, end-quarter (%)	7.50	7.75	7.50	7.50	7.25	7.25	7.25	7.25	7.25	7.25
5yr yield, end quarter (%)	8.2	7.8	7.2	8.2	8.6	7.8	7.5	7.0	7.0	7.0
IDR/USD, end quarter	12,212	12,440	13,084	13,332	13,700	13,800	14,000	14,200	14,400	14,500
IDR/EUR, end quarter	15,367	15,076	14,054	14,938	14,385	14,490	14,980	15,336	15,840	15,950

Source: CEIC, HSBC forecasts

Beyond headlines Q1 2015 GDP wasn't as bad as it looked …

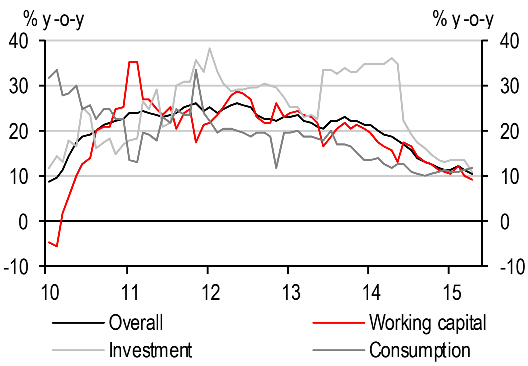


Source: CEIC, HSBC

… but headwinds facing consumption are building

- The economy expanded 4.7% y-o-y in 1Q 2015. Seasonally adjusted we estimate that this translates to an expansion of 0.8% q-o-q, nearly half the pace recorded in 4Q 2014 and the slowest since 1Q 2009.
- Despite the disappointing headlines, momentum in private consumer spending slowed only a touch to 1.2% q-o-q sa (5.0% y-o-y), from 1.3% in the previous two quarters. Meanwhile investment bounced 1.7% q-o-q sa following a lacklustre Q4 2014. Net exports added 0.2ppt to overall q-o-q growth, as the decline in imports outpaced that of exports.
- In the quarters ahead, however, the underlying growth components are likely to weaken. Infrastructure spending has been behind target, consumer confidence weak and recently-introduced macro-prudential easing measures could prove insufficient in boosting growth.

Policymakers have unveiled various plans to stoke growth …

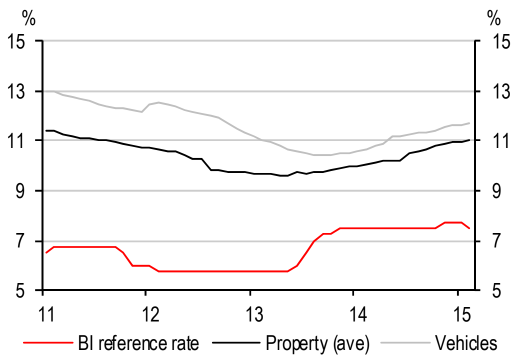


Source: CEIC, HSBC

… through macro-prudential measures and tax incentives

- These include laxer loan-to-value (LTV) limits on mortgages and automotive loans, and encouraging banks to lend to small-medium enterprises (SMEs). Luxury tax on certain goods will also be slashed or exempted, in order to spur consumption.
- In July – when most of these measures took effect – BI Governor Martowardojo said credit growth this year was likely to average 11-13%, versus a target of 15-17%. In April, bank loan growth cooled to a five-year low of 10.4% y-o-y, bringing loan growth for the year-to-date to just around 11.2.
- BI Deputy Governor Alamsyah estimated that the macro-prudential easing measures would boost GDP growth by 0.1-0.2-ppts, and increase bank loans by IDR 80trn (a 2.2% increase from the loans outstanding as of March 2015).

Macro-prudential measures might not be adequate …



Source: CEIC, HSBC

… and more potent interest rate cuts may be needed

- Collectively, macroprupential easing may eventually push credit growth beyond the lacklustre 11-12% y-o-y range seen since late 2014. But they will not be able to help the economy avert sub-trend growth over the remainder of the year.
- Although financing SMEs is important – they account for nearly 58% of GDP and 18% of total loans – BI's quarterly Bank Survey suggests mixed demand for credit by the sector. Meanwhile home and vehicle loans account for just 9% and 3% of total loans respectively. Furthermore, despite easier down-payment rules, the cost of home and auto loans has actually risen by over 100bps since late 2013, even as the policy rate has broadly remained unchanged over the period.
- Against this backdrop, we think BI may eventually have to deliver broader monetary policy easing through an interest rate cut.

Indonesia: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	6.7	6.2	6.0	5.6	5.0	4.8	5.6
Nominal GDP (USD bn)	756.0	893.1	918.1	913.8	888.3	866.9	897.1
GDP per capita (USD)	3,181	3,690	3,741	3,673	3,523	3,394	3,467
Private consumption (% y-o-y)	4.4	5.1	5.5	5.4	5.1	4.8	4.9
Government consumption (% y-o-y)	-3.3	5.5	4.5	6.9	2.0	3.1	6.2
Investment (% y-o-y)	8.3	8.9	9.1	5.3	4.1	4.8	5.8
Net Exports (contribution to GDP growth, ppt)	0.5	0.2	-1.5	0.6	-0.3	0.1	0.1
Industrial production (% y-o-y)	5.1	4.1	4.1	6.0	4.8	4.1	4.6
Gross domestic saving (% GDP)	35.8	36.5	35.4	34.3	34.4	41.3	44.2
Unemployment rate, end-year (%)	7.1	6.6	6.1	6.3	5.9	6.2	5.8
Prices & wages							
CPI, average (% y-o-y)	5.1	5.3	4.0	6.4	6.4	6.5	4.5
CPI, end-year (% y-o-y)	7.0	3.8	3.7	8.1	8.4	3.6	4.4
Core CPI, average (% y-o-y)	1.4	2.4	3.4	4.4	5.4	4.9	3.6
Core CPI, end-year (% y-o-y)	4.3	4.3	4.4	4.5	4.9	4.1	3.6
Manufacturing wages, nominal (% y-o-y)	12.2	3.4	20.4	14.9	13.8	6.1	5.4
Money, FX & interest rates							
Broad money supply M2, average (% y-o-y)	12.2	16.0	18.5	13.8	11.6	12.4	9.3
Real private sector credit growth (% y-o-y)	11.4	20.0	20.5	14.1	8.6	3.1	4.8
Policy rate, end-year (%)	6.50	6.00	5.75	7.50	7.75	7.25	7.25
5yr yield, end-year (%)	6.83	5.35	4.70	8.03	7.75	7.80	7.00
IDR /USD, end-year	8,991	9,068	9,670	12,189	12,440	13,800	14,500
IDR /USD, average	9,086	8,775	9,384	10,454	11,872	13,301	14,188
IDR /EUR, end-year	12,048	11,753	12,764	16,795	15,052	14,490	15,950
IDR /EUR, average	11,993	12,127	12,131	13,821	15,737	14,465	15,340
External sector							
Merchandise exports (USD bn)	150.0	191.1	187.3	182.1	175.3	150.7	157.1
Merchandise imports (USD bn)	119.0	157.3	178.7	176.3	168.3	142.2	150.7
Trade balance (USD bn)	31.0	33.8	8.7	5.8	7.0	8.4	6.4
Current account balance (USD bn)	5.1	1.7	-24.4	-29.1	-25.4	-22.1	-25.0
Current account balance (% GDP)	0.7	0.2	-2.7	-3.2	-2.9	-2.6	-2.8
Net FDI (USD bn)	11.1	11.5	13.7	12.2	15.5	10.1	17.6
Net FDI (% GDP)	1.5	1.3	1.5	1.3	1.7	1.2	2.0
Current account balance plus FDI (% GDP)	2.1	1.5	-1.2	-1.9	-1.1	-1.4	-0.8
Exports, value (% y-o-y)	28.8	27.4	-2.0	-2.8	-3.7	-14.1	4.3
Imports, value (% y-o-y)	38.5	32.2	13.6	-1.3	-4.5	-15.5	6.0
International FX reserves (USD bn)	96.2	110.1	112.8	99.4	111.9	115.0	131.3
Import cover (months)	9.7	8.4	7.6	6.8	8.0	9.7	10.5
Public and external solvency indicators							
Gross external debt (USD bn)	202.4	225.4	252.4	266.1	292.6	320.3	344.4
Gross external debt (% GDP)	26.8	25.2	27.5	29.1	32.9	36.9	38.4
Short term external debt (% of int'l reserves)	34.4	34.7	39.2	43.0	41.6	44.6	42.0
Private sector external debt (USD bn)	83.8	106.7	126.2	142.6	162.8	179.1	193.5
Central government balance (% GDP)	-0.7	-1.1	-1.9	-2.3	-2.2	-2.3	-1.7
Primary balance (% GDP)	0.6	0.1	-0.6	-1.0	-1.0	-1.0	-0.2
Central government domestic debt (USD bn)	100.4	109.4	113.4	103.5	118.5	128.3	137.2
Central government domestic debt (% GDP)	13.3	12.3	12.3	11.3	13.3	14.8	15.3
Public sector external debt (USD bn)	118.6	118.6	126.1	123.5	129.7	141.2	150.9
Public sector external debt (% GDP)	15.7	13.3	13.7	13.5	14.6	16.3	16.8
Public sector debt (% GDP)	29.0	25.5	26.1	24.8	28.0	31.1	32.1
Macro-prudential indicators							
Capital adequacy ratio	17.2	16.1	17.4	18.1	19.6	n/a	n/a
Non-performing loan ratio	2.6	2.2	1.9	1.8	2.2	n/a	n/a
Household Debt/ GDP (%)	9.7	10.5	11.5	12.2	12.4	n/a	n/a
Total Credit/GDP (%)**	25.5	27.5	30.2	33.8	35.1	n/a	n/a
Residential House prices (% y-o-y)	2.8	4.6	4.6	12.0	7.0	n/a	n/a
Loan/Deposit ratio	75.2	78.8	83.6	89.7	89.4	n/a	n/a
Stock Market Capitalization/GDP (%)	47.3	45.7	48.5	46.5	49.9	n/a	n/a

*Credit refers to commercial and rural bank loans.
Source: CEIC, ADB, HSBC forecasts

HSBC

Japan

Out of the woods

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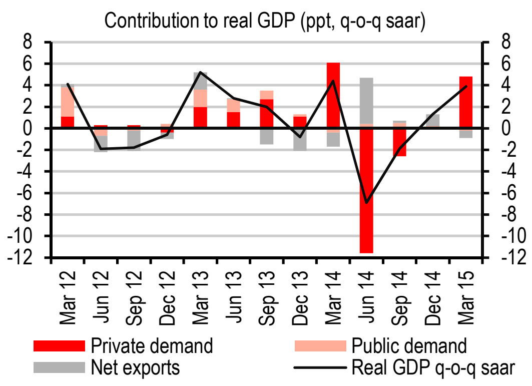
The Japanese economy got off to a surprisingly strong start in 2015. Growth accelerated to 3.9% q-o-q saar in Q1 2015, up from 1.2% in Q4 2014. The improvement was driven by stronger domestic demand. Business investment surged 2.7% q-o-q sa, marking the third consecutive quarter of expansion on the back of strong corporate profits. Private consumption, though still sluggish, continued to grow. Meanwhile, external demand made a smaller contribution to growth than we had expected at the beginning of the year. Export growth remained strong, rising 2.4% q-o-q sa (versus 3.2% in Q4 2014). However, imports expanded at an even faster pace, resulting in a negative net exports contribution. Overall, Japan's growth mix is shifting towards domestic private demand sooner than anticipated.

That doesn't mean there won't be bumps along the way. Given the large contribution from inventories to Q1 2015 GDP, there is likely to be some payback in Q2 2015. The latest supply side data backs this up. IP growth has been weak, and manufacturers have scaled back their production forecasts in response to inventory adjustment pressures and sliding external demand. We therefore look for industrial production to contract in Q2 2015. Demand-side data has also been mixed. Q2 2015 real exports are tracking -3.4% q-o-q sa as of May, and private consumption also got off to a sluggish start. We expect Q2 2015 GDP to slow to 0.0% q-o-q saar.

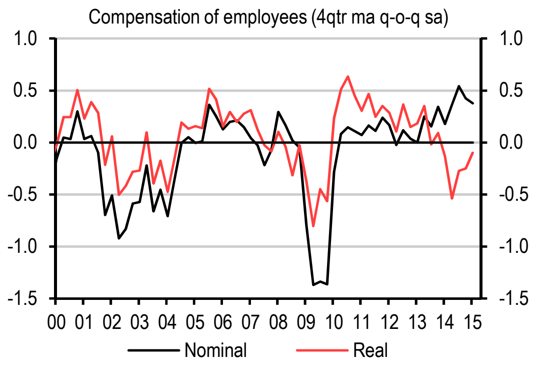
However, we remain optimistic that domestic demand will continue to expand gradually in H2 2015 and expect growth to average around 1.5% q-o-q saar for the remainder of the year. Private consumption has long been the laggard during the post-VAT-hike recovery but the picture is brightening. Sentiment has been improving since the start of the year thanks to a recovery in real spending power. Another positive is the strong recovery in nominal GDP, which surged 9.4% q-o-q saar in Q1 2015 on the back of lower oil prices. Assuming the labour share of income stays unchanged, the improvement in national income should translate into higher spending among households in H2 2015, which is crucial if Japan's economic recovery is to become self-sustaining.

Q1 GDP accelerated on the back of stronger private demand



Source: Cabinet Office, HSBC

Labour income is benefitting from a better terms of trade



Source: Cabinet Office, HSBC

Policy issues

We expect Japan-style core inflation to fluctuate around 0% through Q3 CY15 as the slowdown in energy prices offsets sluggish US-style core CPI growth. However, the slowdown in CPI inflation is not expected to prompt an immediate policy response from the Bank of Japan. In fact, at its 30 April 2015 meeting, the BoJ policy board trimmed its growth and CPI forecasts while pushing out the expected timing of hitting its 2% CPI target to H1 FY16 (ending September 2016), from "around FY15" previously.

For the moment, the BoJ seems comfortable holding pat as it monitors developments in the output gap, as well as the impact of lower headline CPI on inflation expectations. Barring large external shocks to growth or a sharp strengthening of the yen, we believe the probability of near-term stimulus is low.

However, it will likely be clear by late autumn whether "underlying inflation trends" are sufficiently powerful to justify the BoJ's expectations for sustained 2% inflation. We think that the central bank will embark on one final round of easing, centring on longer-dated bond and alternative asset purchases in Q4 CY15, most likely at the 30 October 2015 one-day monetary policy meeting. However, the potential for a large-scale increase in the monetary base target is limited, given JGB liquidity issues.

Risks

We see the risks to our forecasts as balanced.

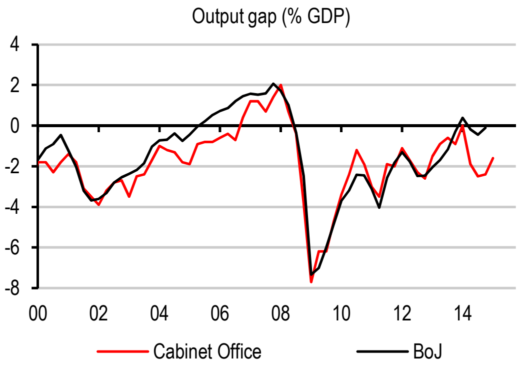
On the downside, the main risk is continued sluggishness in private consumption due to 1) a weaker-than-expected recovery in real labour income, or 2) increased saving among households, in response to uncertainties over the income outlook. Business investment may also revert to weak growth if the pick-up in the US recovery disappoints, or the Chinese economy slows further, thereby depressing exports and manufacturing sentiment.

On the upside, stronger-than-expected growth in the eurozone and the US would provide powerful tailwinds to Japanese exports. This, in turn, would support the on-going expansion in business investment. Meanwhile, there is also potential for private consumption to be boosted if wage growth accelerates more sharply than we expect.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	-1.4	-1.0	-0.9	0.8	1.8	1.7	0.9	1.4	1.1	1.1
GDP sa (% q-o-q)	-0.5	0.3	1.0	0.0	0.5	0.2	0.2	0.6	0.2	0.2
Industrial production (% y-o-y)	-0.8	-1.4	-2.1	0.0	2.7	3.0	2.4	4.5	4.2	4.1
CPI, (% q-o-q saar)	1.2	-0.6	-0.3	0.3	1.7	0.0	1.9	0.1	2.4	0.5
CPI, average (% y-o-y)	3.3	2.5	2.3	0.1	0.3	0.5	1.0	1.0	1.1	1.2
Dom. CGPI, average (% y-o-y)	3.6	1.8	0.7	-2.4	-1.5	-1.3	1.6	0.5	1.6	0.2
Exports, value (% y-o-y)	-0.5	-0.3	-6.8	-4.1	-1.1	2.5	2.1	3.5	3.2	4.3
Imports, value (% y-o-y)	-0.4	-7.7	-23.1	-21.7	-19.2	-8.3	4.5	13.2	17.8	21.0
Trade balance (% GDP)	-2.0	-1.4	-0.3	1.4	1.2	0.4	-0.7	0.1	-1.0	-2.1
Current account (% GDP)	0.4	2.2	3.0	3.7	3.2	2.7	2.0	2.2	0.9	0.0
International reserves (USD bn)	1,264	1,261	1,245	1,315	1,222	1,263	1,203	1,285	1,218	1,294
Policy rate, end quarter (%)	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
10-yr yield, end quarter (%)	0.6	0.4	0.4	0.5	0.4	0.3	0.4	0.5	0.6	0.7
JPY/USD, end quarter	109.42	119.80	120.21	120.0	120.0	125.0	125.0	125.0	125.0	125.0
JPY/EUR, end quarter	137.9	145.0	128.6	132.0	126.0	131.3	133.8	135.0	137.5	137.5

Note: We assume the next VAT hike will be implemented, as scheduled, on 1 April 2017, taking the consumption tax to 10%, from 8% currently. We also assume that the Bank of Japan announces further stimulus in Q4 CY15.
*Includes the effects of the April 2014 VAT hike
**Period end
Source: CEIC, Cabinet Office, MoF, BoJ, HSBC forecasts

Japan's output gap narrowed in Q1 2015 …

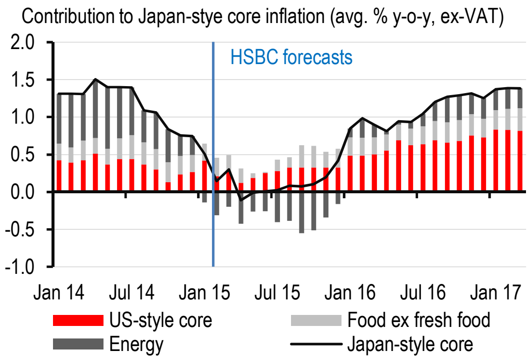


Source: Cabinet Office, Bank of Japan, HSBC

… as growth picked up on stronger domestic demand

- Japan's GDP growth in Q1 2015 was revised up to 3.9% q-o-q saar from the initial 2.4% estimate, thanks to a large upward revision in business investment.
- Also encouraging were improvements in nominal GDP and real labour income, which reflects stronger growth and lower oil prices.
- The Bank of Japan believes that the output gap is now largely closed. This is based on its estimate that Japan's trend growth has declined to 0-0.5%.
- The central bank is confident that the output gap will continue to improve on the back of above-trend growth and result in steady upward pressure on inflation.

We expect inflation to rise …

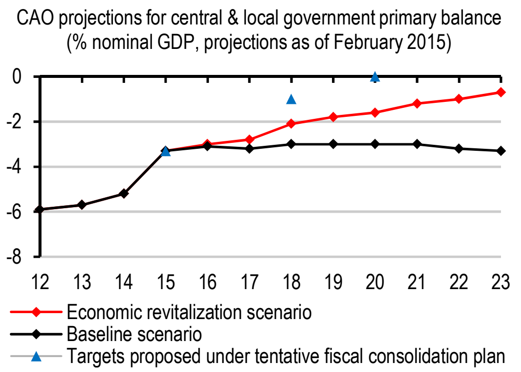


Source: MIA, HSBC

… the question is: how quickly?

- Actual inflation, however, staying weak owing to 1) falling energy prices and 2) lacklustre US-style core CPI (CPI ex food & energy) growth.
- We expect inflation to fluctuate around 0% for most of CY2015 before accelerating towards year-end as base effects from lower energy prices fade away and underlying US-style core inflation begins to rise gradually on the back of tighter supply-demand balance.
- That said, we think Japan-style core inflation (CPI ex fresh foods) will fall well short of the BoJ's forecasts, averaging 0.4% y-o-y in FY2015 and 1.2% y-o-y in FY2016. Below-target inflation is likely to trigger one more round of BoJ easing, most likely in Q4 2015.

The primary fiscal deficit has improved as of late….



NB: Economic scenarios as per the government's Feb 2015 update of its "Economic Projections for Medium-to-Long term Analysis."
Source: Cabinet Office, HSBC

….but the government's FY2020 primary balance (PB) surplus target still looks challenging

- On 30 June 2015, the Cabinet approved the new outline for its Basic Policies for Economic and Fiscal Management and Reform (*Honebuto no houshin).*
- In the policy outline, the government retained its FY2020 primary surplus target. It also stuck to its goal of reducing the primary balance deficit to 3.3% of GDP in FY2015, and established a new interim target of -1% of GDP in FY2018.
- Achieving a primary surplus in FY2020 requires plugging roughly JPY16.4trn in revenue shortfalls over the next 5 years.
- Unlike previous governments, PM Abe is placing much more emphasis on stronger economic growth to achieve fiscal consolidation. But hitting the FY2020 PB surplus target will be challenging: even the government's optimistic "economic revitalization scenario" sees the deficit remaining at 1.6% of GDP in FY2020.

Japan: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	4.7	-0.5	1.7	1.6	-0.1	0.8	1.1
Nominal GDP (USD bn)	5,548	5,929	5,935	4,909	4,586	4,231	4,271
GDP per capita (USD)	43,326	46,385	46,527	38,552	36,075	33,375	33,850
Private consumption (% y-o-y)	2.8	0.3	2.3	2.1	-1.3	-0.1	1.5
Government consumption (% y-o-y)	1.9	1.2	1.7	1.9	0.2	0.8	0.8
Investment (% y-o-y)	-0.2	1.4	3.4	3.2	2.6	0.5	1.2
Net Exports (contribution to GDP growth, ppt)	2.0	-0.8	-0.8	-0.2	0.3	0.3	-0.3
Industrial production (% y-o-y)	15.6	-2.8	0.6	-0.8	2.1	0.9	3.8
Gross domestic saving (% GDP)	22.4	21.7	21.4	21.0	21.6	22.2	22.0
Unemployment rate, average (%)	5.1	4.6	4.3	4.0	3.6	3.4	3.2
Prices & wages							
CPI, average (% y-o-y)	-0.7	-0.3	0.0	0.4	2.7	0.8	1.1
CPI, end-year (% y-o-y)	-0.4	-0.2	-0.1	1.6	2.4	0.6	1.2
Core CPI, average (% y-o-y)	-1.0	-0.3	-0.1	0.4	2.6	0.7	1.1
Core CPI, end-year (% y-o-y)	-0.8	-0.1	-0.2	1.2	2.6	0.6	1.3
Dom. CGPI, average (% y-o-y)	-0.1	1.5	-0.9	1.3	3.2	-1.3	1.0
Dom. CGPI, end (% y-o-y)	0.8	0.8	-0.7	2.5	1.8	-1.3	0.2
Total wages, nominal (% y-o-y)	0.6	-0.2	-0.8	0.0	0.8	0.8	1.6
Money, FX & interest rates							
Central bank money M0, average (% y-o-y)	7.0	13.5	11.8	46.6	38.2	23.7	16.6
Broad money supply M2+CDs, average (% y-o-y)	2.1	2.2	2.2	0.7	2.8	3.0	2.8
Policy rate, end-year (%)	0.05	0.05	0.05	0.05	0.05	0.05	0.05
10yr yield, average (%)	1.2	1.1	0.8	0.7	0.5	0.4	0.5
Nominal credit growth (% y-o-y)	-2.0	0.7	1.9	2.8	3.2	2.3	2.1
JPY /USD, end-year	81.5	77.6	86.3	105.4	119.8	125.0	125.0
JPY /USD, average	87.3	79.6	80.1	97.9	106.5	120.4	125.0
JPY /EUR, end-year	109.2	100.5	113.9	145.2	145.0	131.3	137.5
JPY /EUR, average	115.2	110.0	103.5	129.4	141.2	131.0	135.2
External sector							
Merchandise exports (USD bn)	740.0	791.8	774.1	693.1	696.1	679.4	701.8
Merchandise imports (USD bn)	630.8	796.2	827.3	782.5	795.0	649.7	741.9
Trade balance (USD bn)	109.2	-4.4	-53.2	-89.3	-98.9	29.7	-40.1
Current account balance (USD bn)	218.9	125.0	62.4	34.4	22.5	132.2	52.9
Current account balance (% GDP)	4.0	2.2	1.0	0.8	0.5	3.2	1.3
Net FDI (USD bn)	-72.7	-117.9	-116.7	-139.7	-110.0	-90.8	-81.9
Net FDI (% GDP)	-1.3	-2.0	-2.0	-2.9	-2.4	-2.1	-1.9
Current account balance plus FDI (% GDP)	2.7	0.2	-1.0	-2.0	-1.9	1.1	-0.6
Exports, value (% y-o-y)	34.9	7.0	-2.2	-10.5	0.4	-2.4	3.3
Imports, value (% y-o-y)	28.7	26.2	3.9	-5.4	1.6	-18.3	14.2
International FX reserves (USD bn)	1,096	1,296	1,268	1,267	1,261	1,263	1,294
Import cover (months)	20.9	19.5	18.4	19.4	19.0	23.3	20.9
Public and external solvency indicators							
Commercial banks' FX assets (USD bn)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross external debt (USD bn)	2,416	3,041	3,260	3,033	3,092	2,901	2,955
Gross external debt (% GDP)	44	51	55	62	67	69	69
Private sector external debt (USD bn)	1,637	1,902	2,092	2,035	2,034	1,908	1,944
General government balance (% GDP)	-9.3	-9.8	-8.7	-8.1	-7.1	-5.1	-4.4
Primary balance (% GDP)	-8.7	-9.0	-7.8	-7.3	-6.3	-4.4	-3.5
Gross public domestic debt (JPY trn)	974	993	1,032	1,065	1,091	1,107	1,121
Gross public domestic debt (% GDP)	201.7	210.6	217.0	221.7	223.7	217.2	210.0
Gross public external debt (USD bn)	778.8	1138.4	1167.9	997.8	1058.2	992.6	1011.1
Gross public external debt (% GDP)	14.0	19.2	19.7	20.3	23.1	23.5	23.7
Gross public sector debt (% GDP)	215.8	229.8	236.6	242.2	245.2	239.0	232.1
Macro-prudential indicator							
Capital adequacy ratio	13.3	13.8	14.2	15.2	15.6	15.6	15.6
Non-performing loan ratio	2.5	2.4	2.4	2.1	n/a	n/a	n/a
Household Debt/ GDP (%)	64.8	66.0	65.3	64.6	63.6	60.8	58.1
Total Credit/GDP (%)	104.7	107.2	108.2	107.1	105.5	100.9	96.3
Loan/Deposit ratio	71.6	69.7	69.3	68.2	68.4	68.5	68.6
Stock Market Capitalization/GDP (%)	62.4	60.7	57.4	84.8	97.1	111.0	110.3

Note: We assume the next VAT hike will be implemented, as scheduled, on 1 April 2017, taking the consumption tax to 10%, from 8% currently. We also assume that the Bank of Japan announces further stimulus in Q4 CY15.
*Includes the effects of the April 2014 VAT hike
**Period end
Source: CEIC, ADB, IMF, MoF, BoJ HSBC forecasts

Korea

Tough times

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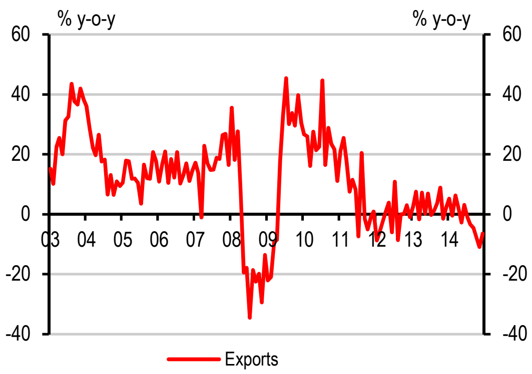
We forecast Korea's GDP to grow 2.8% in 2015, which is lower than our 3.1% forecast in the previous quarterly report. The main driver behind our downgrade is weaker-than-expected trade. Exports are likely to contract by the strongest sequential rate since early 2009. In particular, shipments to China are unlikely to recover anytime soon, as our China economists forecast lower growth in Korea's largest export market. By the type of goods, we think manufactured products will be most vulnerable to weak growth in China.

External weakness has filtered into domestic demand. Retail sales contracted on a year-on-year basis in Q1 2015, which is the first contraction since records began in 2011. Households' purchasing power is being squeezed by low wage growth, as companies cut costs to stay competitive. Furthermore, consumer sentiment weakened noticeably due to the recent outbreak of Middle East respiratory syndrome (MERS). Meanwhile, the uncertain macroeconomic outlook and low demand environment are set to weigh on investment growth. Inventories remain elevated, especially for electronics and automobiles. The incentive for companies to increase their productive capacity over the foreseeable future is therefore limited.

An absence of demand-pull inflation means the Bank of Korea may miss its inflation target for the third consecutive year. We forecast headline CPI to average 0.8% in 2015, which would be the lowest rate since 1999. The low inflation environment means that there is room for more accommodative monetary policy. We forecast the Bank of Korea to lower its policy rate by another 25bp in the third quarter.

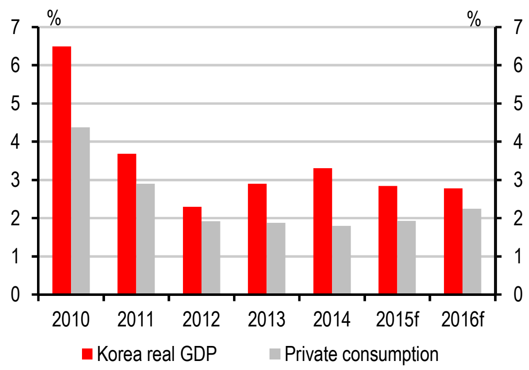
In the meantime, the government is pursuing fiscal stimulus. The government announced a supplementary budget of KRW11.8 trillion (USD10.7bn), or 0.8% of estimated 2015 GDP. However, roughly half of this is meant to make up for a shortfall in tax income. The rest is targeted at sectors impacted by MERS as well as the drought, which may be one of the most severe to hit the Korean peninsula in decades. Outside of the budget, the government announced KRW10 trillion of other stimulus measures to help give a boost to demand.

Exports have contracted sharply in recent months



Source: CEIC, HSBC forecasts

And private consumption is weighing down GDP growth



Source: CEIC, HSBC

Policy issues

On 20 April, Prime Minister Lee Wan-koo tendered his resignation over a bribery scandal after two months in the job. President Park Geun-hye accepted the resignation on 27 April. Since Park Geun-hye became president, two Prime Ministers have left office while three other nominees have stepped down before their National Assembly hearings. Former Justice Minister Hwang Kyo-ahn was recently appointed as Prime Minister. His background suggests greater focus on administrative and governance issues in Korea.

Korea held parliamentary by-elections on 29 April for four vacant seats. The seats were left open by the Unified Progressive Party (UPP), which had a pro-North Korea stance. The ruling Saenuri party won three of the four available seats, which gives the party a mandate to push through the Park administration's reform plans. The plans include the promotion of crowdfunding in Korea's business culture, which is relatively conservative when compared with its international counterparts. The main opposition party, the New Political Alliance for Democracy, won no seats.

Risks

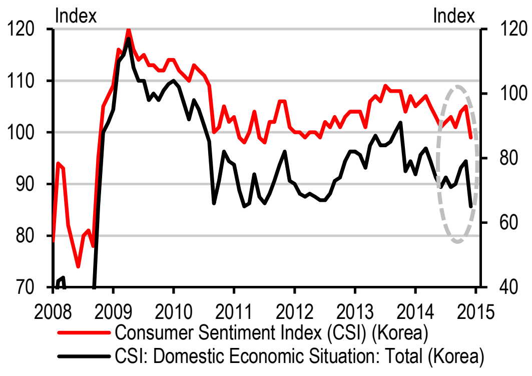
Our growth projections are below consensus but downside risks remain. The uncertainty from MERS and the impact it may have on the economy is hard to quantify, even if the virus appears now to be increasingly well contained. If, however, the spread of MERS picks up in July, there is a prospect of a large contraction in private consumption in Q3 2015. This is not our base-case scenario. However, when mixed with weak wage growth, it is clear that private consumption will remain an underperforming segment of the economy.

The downside risks to growth mean that inflation could be lower than we currently forecast. While we do not think the average headline CPI reading for 2015 will fall into negative territory, continued subdued inflation may reduce inflation expectations. This would increase pressure on the Bank of Korea to lower its policy rate by even more than 25bp over the second half of this year and could have implications for its new inflation target, which is scheduled to be announced in September 2015.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	3.3	2.7	2.4	2.6	2.8	3.5	2.9	2.7	2.7	2.9
GDP sa (% q-o-q)	0.8	0.3	0.8	0.7	1.0	1.0	0.1	0.5	0.9	1.3
Industrial production (% y-o-y)	1.1	-1.7	-1.6	-1.3	-0.8	1.1	-0.5	-1.0	-1.1	-0.4
CPI, (% q-o-q saar)	0.6	-0.2	-0.1	1.2	2.4	1.8	2.4	2.4	2.5	2.0
CPI, average (% y-o-y)	1.4	1.0	0.6	0.5	0.9	1.4	1.9	2.2	2.3	2.3
PPI, average (% y-o-y)	-0.2	-1.3	-3.6	-3.4	-2.7	-1.2	1.8	2.3	2.3	2.3
Exports, value (% y-o-y)	-1.3	-4.7	-11.3	-11.2	-8.5	-6.7	0.2	0.8	1.0	1.0
Imports, value (% y-o-y)	-0.2	-7.0	-18.3	-18.6	-20.0	-17.4	-5.0	-2.8	-1.2	-0.3
Trade balance (% GDP)	5.7	6.9	8.7	9.4	9.9	10.2	10.2	10.3	10.4	10.3
Current account (% GDP)	5.7	6.9	8.8	7.5	8.5	8.8	8.5	8.2	8.8	8.7
International reserves (USD bn)	367	363	362	387	415	445	466	494	523	553
Policy rate, end quarter (%)	2.25	2.00	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25
5yr yield, end quarter (%)	2.6	2.3	2.0	2.1	2.1	2.4	2.5	2.8	3.0	3.0
KRW /USD, end quarter	1,051	1,099	1,105	1,110	1,120	1,130	1,130	1,140	1,140	1,140
KRW /EUR, end quarter	1,354	1,355	1,195	1,221	1,176	1,187	1,209	1,231	1,254	1,254

Source: CEIC, HSBC forecasts

Consumption sentiment has deteriorated noticeably …

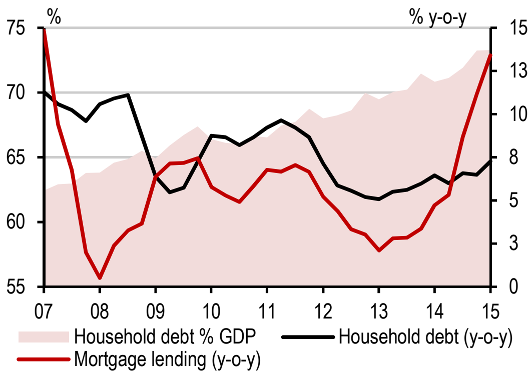


Source: CEIC, HSBC forecasts

… as the MERS outbreak impacted domestic demand

- The MERS outbreak had a tangible impact on consumer activity in June, with department stores reporting sharp declines in sales and consumer confidence tanking.
- The BoK cut rates to 1.50% in June partly to counter the new downside risks posed by the spread of the disease.
- Since then the spread of MERS has slowed, but private consumption will remain the weak link in the economy due in part to tepid wage growth.

Household debt growth has trended up …

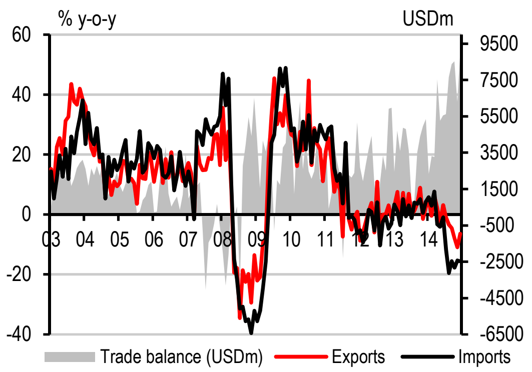


Source: CEIC, HSBC

… supported by higher mortgage loans

- Households have increased their debt at a faster rate over the past two years, which reflects both low wage growth and accommodative monetary conditions. Household debt as a percentage of GDP reached 73% at the end of 1Q15.
- Recent household debt growth was driven by mortgages, as the government loosened macro-prudential measures to support the property market.
- Household debt will likely remain a concern for policymakers in Korea, but will unlikely deter the Bank of Korea from further lowering its policy rate to support growth if deemed necessary.

Korea's trade surplus has surged …



Source: CEIC, HSBC forecasts

… driven by low global oil prices, even as exports slump

- We expect Korea's current account surplus to increase to 8.4% of GDP in 2015 from 6.3% in 2014. This would be the highest reading since 1998.The government recently revised upwards its current own account forecast as well.
- The main driver behind the increase is a strong trade balance. Net exports are rising, despite stagnant export growth, because low global commodity prices decrease the value of Korea's imports at a faster rate.
- In the absence of an increase in capital outflows, the high current account surplus will lead to a strong accumulation on FX reserves.

HSBC

Korea: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	6.5	3.7	2.3	2.9	3.3	2.8	2.8
Nominal GDP (USD bn)	1,092	1,203	1,226	1,306	1,412	1,385	1,423
GDP per capita (USD)	22,091	24,172	24,520	26,006	28,008	26,853	26,697
Private consumption (% y-o-y)	4.4	2.9	1.9	1.9	1.8	1.9	2.2
Government consumption (% y-o-y)	3.8	2.2	3.4	3.3	2.8	3.0	2.9
Investment (% y-o-y)	5.5	0.8	-0.5	3.3	3.1	2.6	2.7
Net Exports (contribution to GDP growth, ppt)	-1.3	0.8	1.6	1.5	0.5	0.7	1.0
Industrial production (% y-o-y)	16.5	6.0	1.7	0.4	0.5	-0.6	-0.7
Gross domestic saving (% GDP)	35.2	34.5	33.8	34.1	34.5	34.7	35.5
Unemployment rate, end-year (%)	3.5	3.0	2.9	3.0	3.4	3.4	3.4
Prices & wages							
CPI, average (% y-o-y)	2.9	4.0	2.2	1.3	1.3	0.8	2.2
CPI, end-year (% y-o-y)	3.0	4.2	1.4	1.1	0.8	1.5	2.3
Core CPI, average (% y-o-y)	1.8	3.2	1.7	1.6	2.0	2.2	2.0
Core CPI, end-year (% y-o-y)	1.7	3.6	1.1	1.9	1.6	2.2	2.1
PPI, average (% y-o-y)	3.8	6.7	0.7	-1.6	-0.5	-2.7	2.2
PPI, end-year (% y-o-y)	5.7	4.3	-1.2	-0.4	-2.1	-0.3	2.4
Manufacturing wages, nominal (% y-o-y)	6.4	1.7	3.8	4.4	5.0	1.7	1.7
Money, FX & interest rates							
Central bank money M0, average (% y-o-y)	11.4	7.4	12.3	11.6	11.7	12.7	11.6
Broad money supply M3, average (% y-o-y)	8.2	5.2	7.7	6.8	7.1	7.0	7.0
Real private sector credit growth (% y-o-y)	0.6	3.7	1.2	3.7	7.0	5.1	4.3
Policy rate, end-year (%)	2.50	3.25	2.75	2.50	2.00	1.25	1.25
5yr yield, end-year (%)	4.02	3.51	2.98	3.30	2.34	2.40	3.00
KRW /USD, end-year	1,139	1,153	1,071	1,055	1,099	1,130	1,140
KRW /USD, average	1,159	1,108	1,125	1,095	1,052	1,111	1,136
KRW /EUR, end-year	1,506	1,517	1,405	1,447	1,355	1,187	1,254
KRW /EUR, average	1,539	1,541	1,446	1,455	1,355	1,181	1,254
External sector							
Merchandise exports (USD bn)	464	587	604	618	621	563	567
Merchandise imports (USD bn)	416	558	554	535	529	430	420
Trade balance (USD bn)	48	29	49	83	93	132	147
Current account balance (USD bn)	29	19	51	81	89	117	122
Current account balance (% GDP)	2.6	1.6	4.1	6.2	6.3	8.4	8.5
Net FDI (USD bn)	-19	-20	-21	-16	-21	-13	-10
Net FDI (% GDP)	-1.7	-1.7	-1.7	-1.2	-1.5	-0.9	-0.7
Current account balance plus FDI (% GDP)	0.9	-0.1	2.4	5.0	4.9	7.5	7.8
Exports, value (% y-o-y)	27.4	26.6	2.8	2.4	0.5	-9.4	0.8
Imports, value (% y-o-y)	31.6	34.2	-0.7	-3.4	-1.3	-18.6	-2.4
International FX reserves (USD bn)	292	309	326	345	363	445	553
Import cover (months)	8.4	6.6	7.0	7.7	8.3	12.4	15.8
Public and external solvency indicators							
Gross external debt (USD bn)	356	400	409	424	425	470	490
Gross external debt (% GDP)	32.6	33.2	33.4	32.4	30.1	33.9	34.4
Short term external debt (% of int'l reserves)	46.8	45.3	39.3	32.4	31.7	35.4	29.7
Private sector external debt (USD bn)	276	317	312	321	322	305	329
Central government balance (% GDP)	1.5	1.5	1.5	1.1	0.6	0.5	0.8
Primary balance (% GDP)	2.4	2.5	2.4	1.9	1.5	1.5	1.7
Gross public domestic debt (USD bn)	314	355	371	417	471	436	417
Gross public domestic debt (% GDP)	28.7	29.5	30.3	31.9	33.4	31.5	29.3
Gross public external debt (USD bn)	9	9	7	7	7	10	10
Gross public external debt (% GDP)	0.8	0.7	0.6	0.5	0.5	0.7	0.7
Gross public sector debt (% GDP)	29.5	30.2	30.9	32.5	33.9	32.2	30.0
Macro prudential indicators							
Capital adequacy ratio	14.6	14.0	14.3	14.5	13.9	n/a	n/a
Non-performing loan ratio	1.1	1.1	1.1	1.2	1.2	n/a	n/a
Household Debt/ GDP (%)	66.6	68.7	70.0	71.5	73.3	n/a	n/a
Total Credit/GDP (%)	77.1	77.6	78.8	78.9	81.0	n/a	n/a
Residential House prices (% y-o-y)	2.4	5.3	2.9	-0.4	1.5	n/a	n/a
Loan/Deposit ratio	117.2	113.3	112.1	112.9	115.2	n/a	n/a
Stock Market Capitalization/GDP (%)	76.3	84.3	81.2	80.7	80.4	n/a	n/a

Note: Public debt refers to government debt only.
Source: CEIC, ADB, IMF, MoSF, HSBC forecasts

Malaysia

Still staring at the precipice

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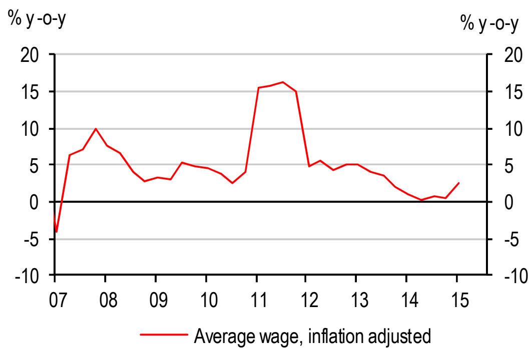
Although GDP growth moderated in Q1 2015 to 1.2% q-o-q- sa (5.6% y-o-y) in line with our forecast, it belied the distortionary effects ahead of the 6% Goods and Services Tax (GST) in April. Private consumption jumped 2.4% q-o-q sa, and in y-o-y terms reached a two-and-a-half year high of 8.8%. In contrast, net exports weighed more than expected on overall growth. Imports were not as weak as we had forecast, while exports moderated. Supply-side data was also very lop-sided. Construction soared 11.9% q-o-q sa from 1.2% in Q4 2014 (9.6% y-o-y versus 8.8%), supported by both non-residential and residential activity. In contrast, services momentum slowed, manufacturing was flat on the quarter, while output from mining contracted. Agricultural output was also down, after floods hurt palm oil production.

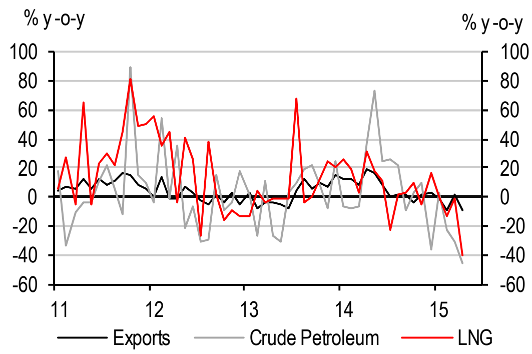
It is clear from the above that underlying growth in Q1 2015 was actually very weak. If it were not for the construction surge, the economy would have expanded just 0.7% q-o-q sa. More worryingly, in the quarters ahead, the post-GST adjustment in domestic demand could be worse than believed. Business sentiment and especially consumer sentiment have weakened noticeably. Contrary to the common perception that incomes have been rising, we also find that, after adjusting for inflation, wage growth has actually been flat at less than 1% y-o-y since Q2 2014. The GST is likely to keep y-o-y CPI inflation at the upper end of BNM's 2-3% comfort range for the rest of the year. Unless nominal wage growth accelerates more materially – unlikely, given how the economy is slowing on all fronts – then real wage growth, and in turn purchasing power, is likely to remain depressed. There is also the tricky question of rising global crude oil prices. This is positive for Malaysia's export earnings, but negative for consumers, who are no longer protected by fuel subsidies. The crude export gains may also be more than offset by LNG prices catching up with the earlier downswing in oil prices. History has shown that it could take as much as a year before Malaysia's gas export prices fully reflect changes in the oil price. This is an important point, considering that the bulk of Malaysia's net external energy balance is made up of gas, and not oil.

Flat real wage growth continues to weigh on consumption...



Source: CEIC, HSBC

... while the plunge in LNG exports is just beginning



Source: CEIC, HSBC

Policy issues

Despite the downside risks to growth, BNM has been reluctant to cut interest rates, having repeatedly said the economy remains on a steady growth path. Admittedly, with the ringgit around its pre-float level of 3.80 against the dollar and sovereign fund 1MDB causing much fiscal and political uncertainty, it is not an easy step to take.

But there are few alternatives with which to address the slowdown, although we think a 25bp rate cut to 3.00% in Q3 2015 would help. Macroprudential loosening has been generally absent, and would be too little too late now. Fiscal stimulus is out of the question, with low oil prices already having hurt the budget. Against this backdrop, it is interesting to note how BNM's tone and behaviour has shifted ever so slightly in the last few months. In January, the monetary policy committee downgraded its 2015 inflation view; since March, reverse repos have been deployed to add liquidity to the banking system and lower elevated interbank rates. Since then, the central bank has also refrained from using the word 'appropriate' to describe its policy stance. More recently, in May, it described the risks of destabilising financial imbalances as being 'contained', indicating that it is now not as worried about elevated household debt.

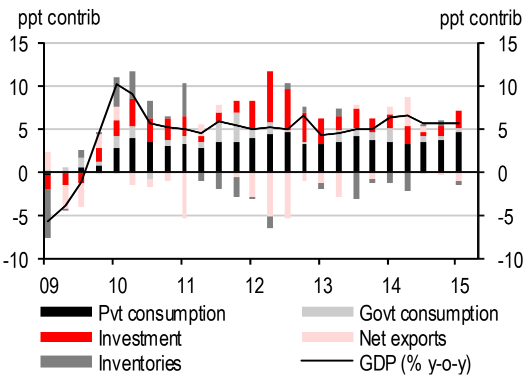
Risks

We see downside risks not only to growth, but also to capital flows and ringgit-denominated assets. One source of this risk is external, that being the likelihood of the US Federal Reserve normalizing interest rates from December. Of more immediate concern, however, is how 1MDB is resolved, and what impact this will have on Malaysia's finances and the political outlook generally. In turn this raises questions about policy continuity and the future of reforms. The coming months could prove tumultuous; at the end of June the Auditor General concluded its investigation into 1MDB. The Public Accounts Committee and BNM are also carrying out their own inquiries. The latter remains in a less robust position to counter any significant outflows, with FX reserves just about covering the country's short-term external liabilities.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	5.6	5.7	5.6	4.7	4.9	4.2	4.4	4.9	5.4	5.7
GDP sa (% q-o-q)	0.8	1.8	1.2	0.9	1.0	1.1	1.3	1.3	1.5	1.5
Industrial production (% y-o-y)	4.1	5.8	6.5	4.1	5.3	3.9	4.4	4.9	5.4	5.7
CPI, (% q-o-q saar)	1.7	3.7	-4.5	8.5	3.7	2.2	1.9	2.8	2.6	1.7
CPI, average (% y-o-y)	3.0	2.8	0.7	2.3	2.7	2.4	4.1	2.7	2.4	2.3
PPI, average (% y-o-y)	1.0	-2.2	-5.4	-5.8	-5.7	-4.5	-2.9	-1.5	0.3	1.7
Exports, value (% y-o-y)	2.7	1.6	-2.2	-9.6	-3.8	-3.0	6.4	10.3	10.8	8.4
Imports, value (% y-o-y)	2.0	2.5	0.0	-7.5	-6.3	-3.2	3.9	8.0	8.9	6.8
Trade balance (% GDP)	9.2	10.2	9.9	7.1	8.9	8.7	10.0	7.9	9.7	9.5
Current account (% GDP)	2.6	2.0	3.6	1.1	3.2	2.0	4.1	1.4	3.9	3.7
International reserves (USD bn)	130.6	120.5	107.6	109.4	108.1	108.6	108.4	106.2	107.9	107.6
Policy rate, end quarter (%)	3.25	3.25	3.25	3.25	3.00	3.00	3.00	3.00	3.00	3.00
5yr yield, end quarter (%)	3.67	3.84	3.59	3.67	3.60	3.70	3.70	3.70	3.70	3.70
MYR/USD, end quarter	3.27	3.50	3.72	3.79	3.70	3.75	3.77	3.78	3.79	3.80
MYR/EUR, end quarter	4.15	4.25	4.02	4.24	3.89	3.94	4.03	4.08	4.17	4.18

Source: CEIC, HSBC forecasts

Stronger-than-expected domestic activity in 1Q 2015 …

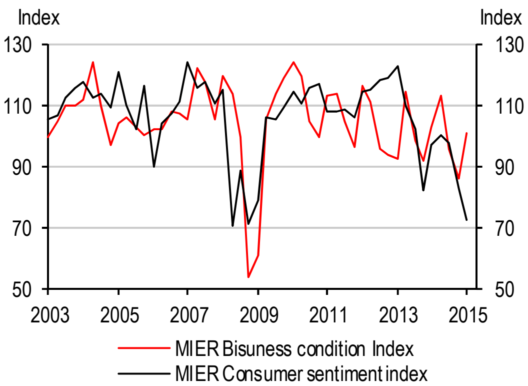


Source: CEIC, HSBC

… was a result of GST-related distortions

- 1Q GDP growth moderated to 5.6% y-o-y, from a downwardly revised 5.7% in 4Q 2014. Seasonally adjusted, growth lost momentum in 1Q 2015, slowing to 1.2% q-o-q from a downwardly revised expansion of 1.8% in 4Q 2014.
- Nevertheless domestic demand surprised us to the upside. Private consumer expenditure jumped 2.4% q-o-q sa, versus 1.6% in 4Q 2014. Meanwhile government consumption surged 5.1% q-o-q sa following a 2.4% contraction in 4Q 2014.
- In contrast to the unexpectedly large contribution from domestic demand, net exports subtracted about 0.2ppts from the q-o-q sa GDP headline, or 1.1ppts in y-o-y terms.
- In the quarters ahead, in addition to the domestic adjustment to the GST, depressed energy and commodity prices are likely to pose challenges to growth.

Business sentiment and especially consumer sentiment …

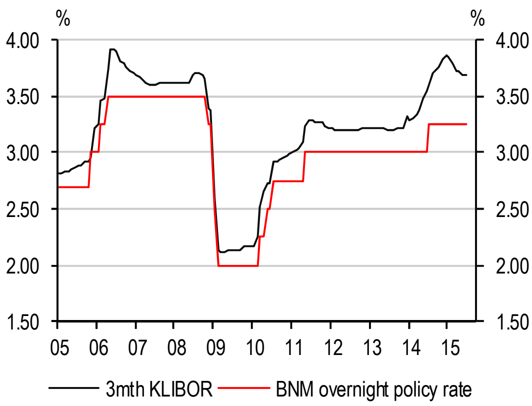


Source: CEIC, HSBC

… have weakened noticeably

- While the implementation of the GST is undoubtedly a positive development for Malaysia's longer-term fiscal position, it came at a time when both corporate and in particular consumer sentiment were extremely soft.
- The purchasing power of households has weakened, and will stay that way in the coming quarters. After adjusting for inflation, real wage growth in Malaysia has already been declining. A GST-led increase in inflation will further crimp this.
- Meanwhile if global crude oil prices continue grinding higher this will weigh on consumers, who are no longer protected by fuel subsidies. Export gains from higher crude prices may also be more than offset by falling LNG prices, which are only just starting to catch up with the earlier plunge in oil.
- Against such a backdrop, sentiment is likely to remain weak.

Weak growth outlook and elevated interbank rates …



Source: CEIC, HSBC

… make a case for a rate cut but currency concerns weigh

- Interbank rates have risen on a combination of tighter regulatory requirements and elevated loan-to-deposit ratios among banks.
- Since March, BNM has on three occasions injected a total of MYR2.16bn into the money market. This followed the relaxation of the liquidity coverage ratio (LCR) requirements in January.
- Despite ample liquidity and regulatory tweaks, the 3-month KLIBOR has eased by just 19bps since December 2014 peak, suggesting that funding particularly for smaller banks remains challenging.
- With the KLIBOR-OPR spread still remaining unusually wide, BNM may eventually resort to a rate cut to ease funding conditions. But with the ringgit within around its pre-float level of 3.80 against the dollar and sovereign fund 1MDB causing much fiscal and political uncertainty, timing is tricky.

Malaysia: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	7.5	5.3	5.5	4.7	6.0	4.8	5.1
Nominal GDP (USD bn)	255.2	298.2	314.8	323.5	338.3	332.0	361.4
GDP per capita (USD)	8,664	9,963	10,342	10,462	10,809	10,805	11,589
Private consumption (% y-o-y)	6.8	6.9	8.3	7.2	7.0	6.9	5.2
Government consumption (% y-o-y)	4.7	14.2	5.4	5.9	4.4	6.0	4.5
Investment (% y-o-y)	12.1	6.4	19.0	8.2	4.8	7.9	6.0
Net Exports (contribution to GDP growth, ppt)	-0.5	-0.8	-3.6	-1.0	1.1	-1.4	-0.8
Industrial production (% y-o-y)	6.2	2.4	4.2	3.4	5.1	4.9	5.1
Gross domestic saving (% GDP)	40.3	39.7	37.5	35.4	35.0	26.7	31.1
Unemployment rate, end-year (%)	3.1	3.1	3.2	3.0	3.0	3.3	3.3
Prices & wages							
CPI, average (% y-o-y)	1.7	3.2	1.7	2.1	3.1	2.0	2.8
CPI, end-year (% y-o-y)	2.1	3.0	1.2	3.2	2.7	2.5	2.2
Core CPI, average (% y-o-y)	1.2	1.9	1.4	1.4	2.2	3.5	2.0
Core CPI, end-year (% y-o-y)	1.1	2.1	1.2	1.9	2.1	3.9	1.2
PPI, average (% y-o-y)	5.6	9.0	0.0	-1.9	1.2	-5.4	-0.6
PPI, end-year (% y-o-y)	5.5	6.2	-5.0	4.3	-4.5	-3.4	2.1
Manufacturing wages, nominal (% y-o-y)	8.2	3.8	6.4	7.2	4.7	5.0	4.2
Money, FX & interest rates							
Central bank money M0, end-year (% y-o-y)	11.8	57.3	9.9	9.4	7.7	10.0	7.5
Broad money supply M3, average (% y-o-y)	8.1	10.9	13.3	8.3	5.9	10.3	8.4
Real private sector credit growth (% y-o-y)	10.2	9.8	9.2	8.1	6.3	5.9	5.6
Policy rate, end-year (%)	2.75	3.00	3.00	3.00	3.25	3.00	3.00
5yr yield, end-year (%)	3.39	3.23	3.24	3.66	3.84	3.70	3.70
MYR /USD, end-year	3.08	3.18	3.06	3.28	3.50	3.75	3.80
MYR /USD, average	3.22	3.06	3.09	3.15	3.27	3.69	3.78
MYR /EUR, end-year	4.13	4.12	4.04	4.52	4.23	3.94	4.18
MYR /EUR, average	4.25	4.23	3.99	4.16	4.34	4.01	4.09
External sector							
Merchandise exports (USD bn)	187.2	215.3	209.0	202.5	207.8	175.8	186.9
Merchandise imports (USD bn)	148.6	169.4	172.4	171.8	173.2	147.1	153.3
Trade balance (USD bn)	38.6	46.0	36.6	30.7	34.7	28.7	33.5
Current account balance (USD bn)	25.7	32.5	16.3	11.3	14.5	8.2	11.9
Current account balance (% GDP)	10.1	10.9	5.2	3.5	4.3	2.5	3.3
Net FDI (USD bn)	-4.3	-3.1	-7.9	-2.0	-5.6	-1.0	-2.0
Net FDI (% GDP)	-1.7	-1.0	-2.5	-0.6	-1.7	-0.3	-0.6
Current account balance plus FDI (% GDP)	8.4	9.9	2.7	2.9	2.6	2.2	2.7
Exports, value (% y-o-y)	9.0	9.3	-2.1	-1.1	6.6	-4.7	9.0
Imports, value (% y-o-y)	16.0	8.2	2.7	1.7	4.7	-4.3	6.9
International FX reserves (USD bn)	105.6	134.5	139.9	137.8	120.5	108.6	107.6
Import cover (months)	8.5	9.5	9.7	9.6	8.4	8.9	8.4
Public and external solvency indicators							
Gross external debt (USD bn)	134.9	175.8	195.1	221.2	228.5	210.3	222.0
Gross external debt (% GDP)	54.5	60.7	63.9	70.6	69.9	63.3	61.4
Short term external debt (% of int'l reserves)	56.1	62.4	65.7	78.1	92.1	93.9	100.1
Private sector external debt (USD bn)	81.9	110.0	120.7	141.8	150.6	139.8	148.1
Central government balance (% GDP)	-5.3	-4.7	-4.3	-3.8	-3.4	-3.4	-3.0
Primary balance (% GDP)	-3.4	-2.7	-2.3	-1.7	-1.3	-1.4	-1.0
Government domestic debt (MYR bn)	315.3	333.8	352.4	381.4	414.7	436.8	465.2
Government domestic debt (% GDP)	39.6	37.7	37.4	38.7	38.8	35.7	34.1
Government external debt (USD bn)	28.5	40.0	48.4	50.3	51.4	50.8	52.8
Government external debt (% GDP)	11.5	13.8	15.8	16.1	15.7	15.3	14.6
Government debt (% GDP)	51.1	51.5	53.3	54.7	54.5	51.0	48.7
Macro-prudential indicators*							
Capital adequacy ratio	17.5	18.3	18.1	14.9	15.9	n/a	n/a
Non-performing loan ratio	18.6	13.7	9.7	8.1	6.6	n/a	n/a
Household Debt/ GDP (%)	74.5	76.2	81.5	86.7	87.9	n/a	n/a
Total Credit/GDP (%)**	107.1	109.9	114.9	121.9	123.1	n/a	n/a
Residential House prices (% y-o-y)	6.9	9.8	11.8	10.9	8.5	n/a	n/a
Loan/Deposit ratio	81.3	80.9	82.1	84.6	86.2	n/a	n/a
Stock Market Capitalization/GDP (%)	144.0	136.4	148.5	159.1	134.9	n/a	n/a

*Macro-prudential indicators for 2013 are actual data as of December 2013.
**Credit refers to Banking System loans.
Source: CEIC, ADB, BNM, HSBC forecasts

Mongolia

Back to business?

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It's been a challenging year so far. Economic activity slowed sharply, with real GDP growth declining to 4.4% y-o-y in Q1 2015. That's almost half of the 7.8% growth rate recorded in 2014. Domestic demand weakened on the back of a fall in mining-related investment as well as the series of monetary tightening measures delivered since mid-2013 to defend the local currency, the Mongolian Tugrik.

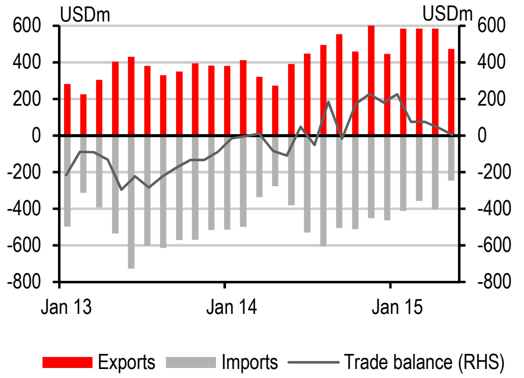
By and large, the causes of the difficulties faced by the economy remain unresolved. For one, the current account deficit remains sizeable, leaving the country in continued need of external financing. Indeed, more international borrowing will likely be needed later in the year, necessitating a tight monetary policy stance even as this has already taken a toll on growth. In addition, export growth tapered off again in early 2015 after a strong finish in 2014. Both volume and prices have weakened further. This dampens the prospects of an export-driven turnaround of the current account and will likely delay the economic recovery. As a result, we have lowered our 2015 GDP forecast to 5%, from 8% previously. The main driver for the downgrade is weaker export growth and the knock-on impact on investment.

But one recent development has the potential to lift Mongolia's growth prospects in the coming years, even if the near-term benefits are limited: After a two-year stand-off, the government and Rio Tinto have recently signed a deal to kick-start the second (and commercially more important) phase of the Oyu Tolgoi project. The pledge that Mongolia is now 'back to business', made by the new Prime Minister and widely quoted in the press, could represent a more serious effort to win back much-needed foreign direct investment. With commodity prices down, attracting large mining deals may no longer be as easy as it was a few years ago, and we expect a slow start as a result. But if the pledge is delivered, this could be the beginning of more promising growth trajectory for the coming years.

Caught in a dilemma

Source: CEIC, HSBC

Growth to slow further



Source: CEIC, HSBC

Policy issues

On 10 April 2015, the Bank of Mongolia opted to keep the policy rate unchanged. The Central Bank noted that inflation has slowed, with little prospect of further demand-pull boost in the near term. But the central bank's main concern lies with maintaining the yield on the local currency. In the near-term, we believe that foreign inflows are unlikely to make a meaningful return as investors take time to assess the implementation of the government's 'back to business' pledge. This means that further rate hikes may be needed later this year. We continue expect another 100bp hike to the policy rate in late 3Q 2015 as we approach the Fed's lift off date.

As growth slows, fiscal discipline will again be put to the test. On-balance sheet spending has fallen but revenue growth has slowed quite sharply too. The government may yet achieve its self-imposed fiscal deficit ceiling of 2% of GDP if it reins in expenditures further over time. But the temptation to be more accommodative will intensify as the export-driven economic slowdown hits investment and household consumption later in the year.

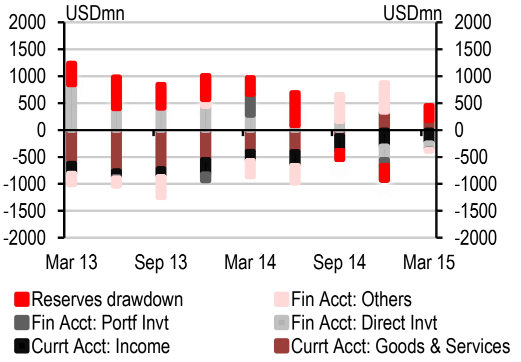
Risks

The government's relationship with foreign investors remains the biggest uncertainty. Sentiment has undoubtedly improved over the past few months as the new Prime Minister appears to be committed to winning back foreign investment. The start of Phase Two of the flagship Oyu Tolgoi project is certainly a positive development. But this is only a beginning and local political opposition may still be a point of concern for many. We believe it will take time to bring foreign direct investment back to Mongolia, particularly in an environment of sluggish global growth.

	2010	2011	2012	2013	2014	2015f	2016f
GDP (% y-o-y)	6.4	17.5	12.2	11.6	7.0	5.0	6.0
CPI, national (average, % y-o-y)	10.2	9.1	14.3	10.4	14.0	9.0	10.0
Exports, value (% y-o-y)	54.3	65.6	-9.0	-2.6	29.0	10.0	11.0
Imports, value (% y-o-y)	49.7	103.1	3.7	-5.7	-16.2	-20.0	0.0
Trade balance (% GDP)	-4.7	-19.7	-21.9	-17.9	1.6	14.3	16.8
Current account (% GDP)	-14.3	-32.2	-31.2	-27.2	-11.8	-14.2	-12.3
International reserves (USD bn)	2.1	2.2	3.9	2.0	n/a	n/a	n/a
Policy rate, end quarter (%)	11.0	12.3	13.3	10.5	12.0	14.0	14.0
MNT/USD, average	1,357	1,266	1,358	1,530	1,814	1,947	1,947
MNT/EUR, average	1,781	1,761	2,166	2,039	2,036	2,174	2,174

NB: 2015 and 2016 FX are assumptions, not forecasts
Source: National Statistics Office, Bank of Mongolia, ADB, World Bank, HSBC forecasts

Dependence on external demand remains high …

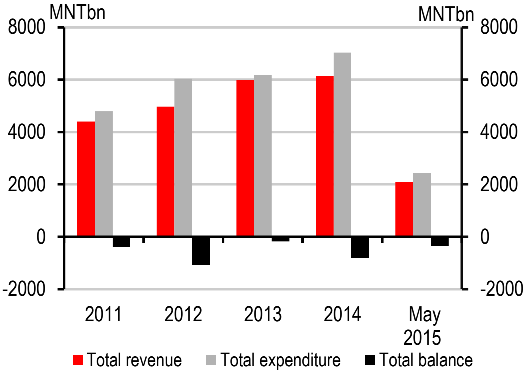


Source: Bank of Mongolia, HSBC

… and more borrowing will likely be needed later in the year

- The export recovery unexpected lost momentum in early 2015. Volume growth fell sharply for coal and iron ore. The impact on growth was subsequently exacerbated by large year-on-year drop in export prices of key commodity items.
- Export weakness has slowed the expected recovery of the current account. The current account recorded a deficit of USD43bn in Q1 2015, after recording a surplus in Q4 2014.
- Meanwhile, outflows have continued through the income, direct investment and portfolio investment channels. Therefore, the country's reliance on external financing has increased. Reserve drawdown was USD271bn in Q1 2015.

The fiscal balance may deteriorate …

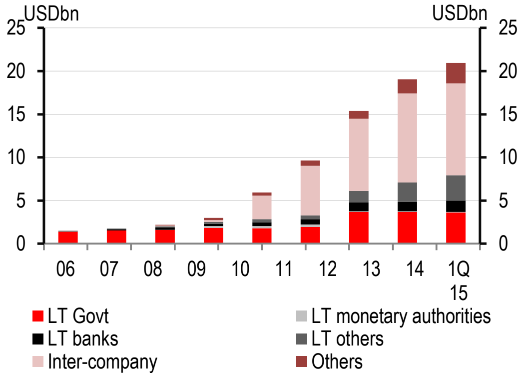


NB: balances shown are structural balances according to World Bank estimates
Source: Bank of Mongolia, HSBC

… as revenue growth slows more sharply than expected

- Mongolia has a self-imposed (structural) fiscal deficit ceiling of 2% of GDP. The government met this target in 2013 and 2014 after successfully reducing on-balance sheet fiscal spending.
- But the growth slowdown in 2015 may cause the government to miss the fiscal deficit target as 1) growth has turned out to be weaker than the assumption of 7.1% real GDP growth used in the budget 2) government revenue projections are based on more optimistic commodity price assumptions than turned out to be the case.
- The government still needs to consolidate more of the off-balance sheet spending onto the balance sheet to return fiscal spending to a more sustainable level.

External liabilities remain high …



Source: Bank of Mongolia, HSBC

… and may continue to grow given large funding needs

- Mongolia has around USD20bn in external debt, of which around USD11bn is inter-company lending. But the rest (around USD9bn) is equivalent to around 80% of 2013 GDP (estimated), half of which is long-term government bonds.
- Of the USD9bn, around USD3.6bn is in the form of long-term government debt (which includes USD1.5bn bonds), around USD1.8bn in the form of short-term monetary authority debt, UDD1.3bn in the form of bank liabilities (more long-term).
- Total short-term debt is still small, at around USD2.5bn.

Mongolia: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
Real GDP growth (% y-o-y)	6.4	17.5	12.2	11.6	7.0	5.0	6.0
Nominal GDP (USD mn)	6,697	7,755	10,763	11,662	12,184	12,638	14,660
Nominal GDP growth (% y-o-y)	27.7	28.7	35.0	22.0	21.0	14.0	16.0
GDP per capita (USD)	2,263	3,067	3,758	4,046	4,126	4,216	4,818
Nominal Private consumption (% y-o-y)	18.5	21.9	27.5	22.0	18.0	10.0	10.0
Nominal Government consumption (% y-o-y)	18.8	31.3	56.2	16.0	10.0	10.0	9.0
Nominal Investment (% y-o-y)	43.8	92.2	68.4	22.2	-5.8	-2.9	17.7
Net Exports (contribution to Nominal GDP growth, ppt)	-2.5	-21.5	-11.8	-4.7	14.2	9.1	3.1
Gross domestic saving (% GDP)	26.0	29.5	30.1	34.1	34.9	22.4	25.5
Unemployment rate (%)	3.6	5.2	7.1	7.6	7.6	7.6	7.6
Prices							
CPI, national (period average, % y-o-y)	10.2	9.1	14.3	10.4	14.0	9.0	10.0
CPI, Ulaanbaatar (average, % y-o-y)	14.3	11.1	15.0	12.0	11.0	13.0	8.0
LME Copper price, USD/ tonne	7,556	8,820	8,000	7,328	6,955	6,294	7,280
Hard coking coal price, USD/ tonne	191	289	210	158	126	113	125
Gold price, USD/oz	1,225	1,570	1,668	1,411	1,266	1,234	1,275
Money, FX & interest rates							
M1, end-year (% y-o-y)	77.8	50.4	5.4	8.1	0.3	-10.0	-5.0
M2, end-year (% y-o-y)	62.5	37.0	18.8	19.0	25.6	0.0	5.0
Nominal credit growth (total, % y-o-y)	23.0	72.8	23.9	54.1	30.0	3.0	4.0
Policy rate, end-year (%)	11.00	12.25	13.25	10.50	12.00	14.00	14.00
RRR, average (%)	5.00	8.33	11.50	n/a	n/a	n/a	n/a
MNT /USD, average	1,357	1,266	1,358	1,530	1,814	1,947	1,947
MNT /EUR, average	1,781	1,761	2,166	2,039	2,036	2,174	2,174
External sector							
Merchandise exports (USD bn)	2.9	4.8	4.4	4.3	5.5	6.1	6.7
Merchandise imports (USD bn)	3.2	6.5	6.7	6.4	5.3	4.3	4.3
Trade balance (USD bn)	-0.3	-1.7	-2.4	-2.1	0.2	1.8	2.5
Current account balance (USD bn)	-0.9	-2.8	-3.4	-3.2	-1.4	-1.8	-1.8
Current account balance (% GDP)	-14.3	-32.2	-31.2	-27.2	-11.8	-14.2	-12.3
Net FDI (USD bn)	1.6	4.6	4.4	2.0	3.1	3.1	3.1
Net FDI (% GDP)	26.3	54.0	41.0	17.0	2.3	24.4	21.1
Current account balance plus FDI (% GDP)	12.0	21.8	9.7	-10.2	-9.5	10.2	8.8
Exports, value (% y-o-y)	54.3	65.6	-9.0	-2.6	29.0	10.0	11.0
Imports, value (% y-o-y)	49.7	103.1	3.7	-5.7	-16.2	-20.0	0.0
International FX reserves (USD bn)	2.1	2.2	3.9	2.0	n/a	n/a	n/a
Import cover (months)	8.0	4.1	6.9	3.8	n/a	n/a	n/a
Public and external solvency indicators							
Government current budget balance, MNT bn	822.0	906.9	250.7	n/a	n/a	n/a	n/a
Government current budget balance, % GDP	9.8	8.4	1.7	n/a	n/a	n/a	n/a
Government overall budget balance, MNT bn	41.8	-769.8	-1,130.7	-297.3	-1,616.1	-1,588.6	-1,349.5
Government overall budget balance, % GDP	0.5	-7.1	-7.7	-1.7	-1.8	-3.7	-4.7
Macro prudential indicators							
Non-Performing loan (% total loan)	12.4	6.1	4.2	5.3	n/a	n/a	n/a
Total Credit/GDP (%)	38.8	52.1	47.8	60.4	64.9	58.6	52.5
Stock Market Capitalization/ GDP (%)	16.3	20.0	13.5	n/a	n/a	n/a	n/a

NB: 2015 and 2016 FX numbers are assumptions not forecasts
Source: National Statistics Office, Bank of Mongolia, ADB, World Bank, IMF, HSBC forecasts

New Zealand

Solid growth, but no inflation

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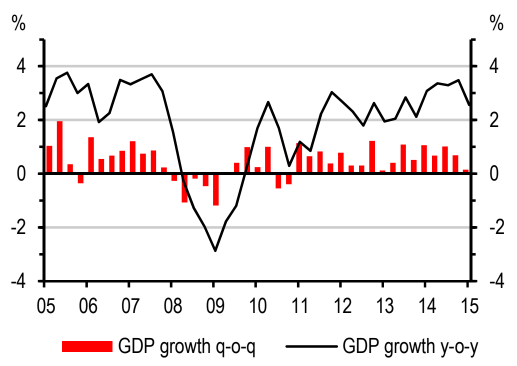
New Zealand's economy has been growing solidly for the past 18 months and has been one of the fastest growing countries in the developed world. A key impetus for growth has been a ramp up in post-earthquake re-construction in the Canterbury region and a housing construction boom in Auckland. The construction upswing has driven strong jobs growth, which has supported a pick-up in retail sales.

However, despite strong growth, inflation has been surprisingly weak. CPI inflation fell to 0.1% y-o-y in the first quarter and timely indicators continue to suggest limited price pressures. It appears that, in the face of strong demand, New Zealand has had a collection of positive supply shocks that have kept price pressures contained. Falling oil prices and the high level of the NZD have driven a sharp fall in imported goods prices. At the same time, record high rates of inward migration and labour market participation have meant that labour supply has been strong, which has kept wage growth subdued and held down domestically-produced inflation.

Very low inflation has seen the RBNZ become increasingly concerned that it may miss its mandated inflation target of 1-3% in the medium term and near the 2% midpoint. Headline CPI inflation has been below 2% for three and a half years. As a result, the central bank cut its cash rate by 25bp to 3.25% in June. The cash rate cut came despite the central bank's own strong GDP growth forecasts, with the RBNZ remaining of the view that recent falls in dairy prices are not enough to significantly dent the growth outlook. The RBNZ also cut despite its concerns about rapidly rising housing prices in Auckland.

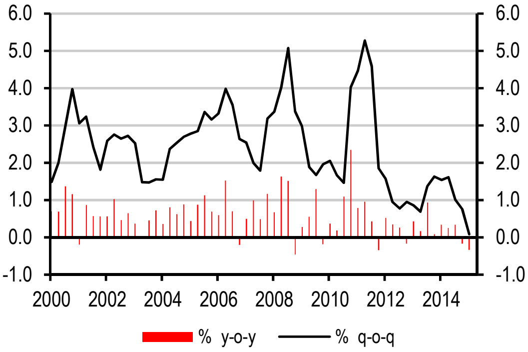
We expect GDP growth of 2.8% in 2015 (previously 3.0%) and 2.8% in 2016, and have revised down our CPI inflation forecast to 0.5% in 2015 (previously 0.8%) and 2.0% in 2016 (previously 2.1%). We expect the RBNZ to deliver a further 25bp cut in Q3 2015, taking its cash rate to 3.00%.

GDP growth has been strong, but so has supply potential



Source: Statistics New Zealand

Inflation has fallen to very low levels



Source: Statistics New Zealand

Policy issues

Authorities continue to face the challenge of managing strong housing price growth in New Zealand's major city, Auckland, while also loosening monetary policy settings to achieve the central bank's inflation targeting mandate. Auckland housing prices have risen by 18% over the past year and there are clear signs of exuberance in this market. Demand is being driven by the combination of below-neutral interest rates, strong investor interest and foreign demand.

To contain demand, the RBNZ has proposed further tightening of its macro-prudential settings. All investor purchases of Auckland properties will require a 30% down-payment from 1 October 2015, if these measures are implemented. The government has also introduced a capital gains tax for investor dwellings that are sold within two years of purchase. New laws will also tighten up controls on foreign investors, including requiring that all foreign investors have a local bank account. A key challenge for authorities is continuing to address the supply side of the Auckland housing market, where most estimates continue to suggest there is a shortfall of around 15,000-20,000 homes.

Risks

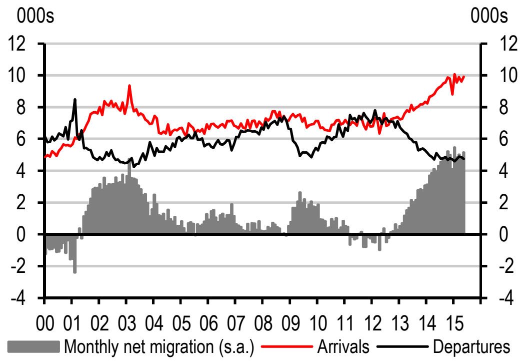
We judge that the risks to the outlook are balanced. On the downside, the recent fall in dairy prices, which is expected to weigh on the rural sector, could translate into a broader slowdown in investment than we expect. Our central case remains that most farmers should be able to smooth their spending in the face of one weak season. However, if low dairy prices persist, the financial strain could escalate further. There is also a risk that growth in China does not pick up as much as HSBC expects in 2016, dampening demand for New Zealand's exports and potentially driving commodity prices lower.

On the upside, the construction upswing is still underway and could deliver more support for growth than we currently expect. The recent RBNZ cash rate cut could help to support growth more than we are factoring in. The recent positive supply side developments could also prove to last longer than is assumed, presenting an upside risk to New Zealand's potential for further growth, though also a downside risk to the inflation outlook.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	3.3	3.5	2.6	2.8	2.7	3.0	3.4	3.0	2.6	2.2
GDP-sa (%q-o-q)	1.0	0.7	0.2	0.9	0.9	0.9	0.6	0.6	0.5	0.5
Industrial production (% y-o-y)	4.2	1.7	2.1	3.2	2.0	1.8	2.8	2.8	2.8	2.8
CPI (% y-o-y)	1.0	0.8	0.1	0.4	0.5	1.2	1.9	1.9	2.0	2.1
PPI (% y-o-y)	-2.2	-1.9	-4.0	-2.2	-0.1	0.9	2.7	2.7	2.8	2.9
G & S Balance (% GDP)	0.2	0.4	1.0	1.3	1.6	1.8	1.6	1.5	1.3	1.1
Current account (% GDP)	-4.1	-4.2	-3.0	-2.6	-2.2	-2.0	-2.4	-2.6	-2.7	-2.8
Policy rate, end quarter (%)	3.50	3.50	3.50	3.25	3.00	3.00	3.00	3.00	3.00	3.00
10yr yield, end quarter (%)	4.19	3.77	3.38	3.90	3.80	3.70	3.80	3.80	3.80	3.80
USD/NZD, end quarter	0.86	0.77	0.76	0.71	0.70	0.70	0.69	0.68	0.68	0.68
EUR/NZD, end quarter	0.66	0.60	0.63	0.60	0.60	0.61	0.61	0.60	0.61	0.61
CPI, q-o-q ar	1.3	-0.7	-1.3	2.4	1.6	2.0	1.6	2.2	2.2	2.4
Exports G & S (% y-o-y)	0.5	-2.4	-4.3	4.2	8.9	7.5	8.1	6.0	3.4	1.6
Imports G & S(% y-o-y)	0.3	7.3	3.2	3.9	3.4	2.3	5.8	5.4	4.6	3.9

Source: RBNZ, StatsNZ, Thomson Reuters Datastream, HSBC forecasts

Net inward migration is at record high levels …

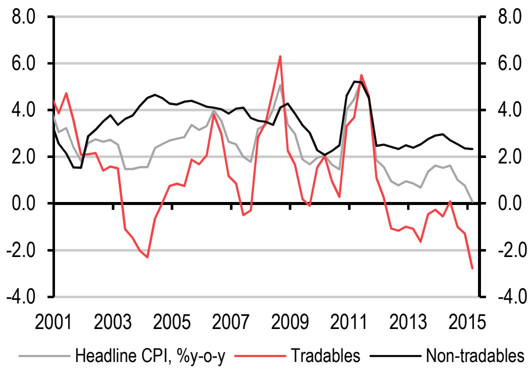


Source: Statistics New Zealand

… providing a strong supply of labour

- New Zealand recorded a net inflow of 57,800 people over the year to May, which is the strongest inflow on record. The flow has recently stabilised at around 5,000 people a month (in seasonally-adjusted terms).
- Fewer New Zealanders are moving abroad, especially to Australia. At the same time, arrivals have surged as New Zealanders return home, international student numbers rise and more foreigners arrive on short-term work visas.
- The migration inflow has boosted the supply of labour considerably and this has played a part in keeping the unemployment rate elevated and wage growth subdued despite strong growth in employment (up 3.2% y-o-y in Q1).

Tradable prices fell sharply, but are expected to rise …

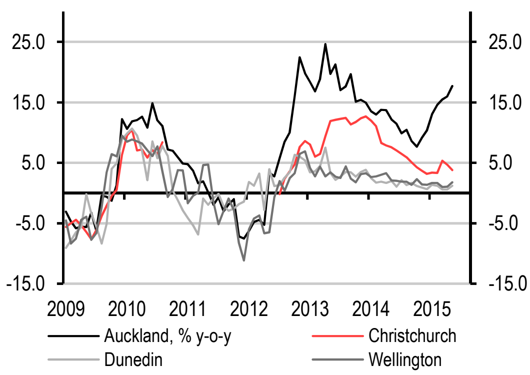


Source: Statistics New Zealand

… as petrol prices pick-up and the NZD falls

- CPI inflation has been below the RBNZ's 'near 2%' medium-term target for two and a half years and fell to just 0.1% y-o-y in Q1. Most of the weakness in inflation has been on the tradable side, as a result of the stubbornly high NZD and, more recently, the sharp drop in petrol prices.
- Those factors are likely to go into reverse over coming quarters. Petrol prices have rebounded in Q2 and the NZD has depreciated, which should increase imported goods prices. We expect inflation to rise towards 2% by H1 2016.
- The lack of a pickup in domestic inflation pressures and a soft Q1 GDP print should see the RBNZ cut its cash rate again in July. But we expect the lift in inflation will be enough to keep rates on hold thereafter.

Auckland housing price inflation is rising again …



Source: Statistics New Zealand

… motivating new policies from the RBNZ and the government

- Housing prices have risen by 58% over the past three years in Auckland and are currently increasing at an annual rate of 18% y-o-y.
- The RBNZ, which already has loan-to-value (LVR) restrictions in place for new mortgage lending, will impose a 70% LVR limit on all new investor mortgages from 1 October 2015. At the same time, the government will tighten taxation of capital gains from investment properties held for less than two years, as well as requiring all foreign buyers to have a New Zealand bank account and tax number.
- The RBNZ clearly intends to tackle house price inflation with macro-prudential tools. Housing should therefore not be a barrier to further rate cuts if the inflation picture necessitates it.

New Zealand: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	1.6	1.8	2.4	2.2	3.3	2.8	2.8
Nominal GDP (USDbn)	143.6	163.7	173.5	184.2	197.9	176.7	177.6
GDP per capita (USD)	32,829	37,211	39,210	41,149	43,543	38,594	38,329
Private consumption (% y-o-y)	3.1	2.0	2.9	2.9	3.2	3.2	2.5
Government consumption (% y-o-y)	0.8	2.5	-0.9	2.0	3.4	2.0	2.0
Investment (% y-o-y)	0.6	5.8	7.9	8.5	8.8	3.6	5.7
Exports of G&S (vol growth) % y-o-y	3.3	2.6	1.9	0.9	3.3	6.4	2.5
Imports of G & S (vol growth)% y-o-y	10.8	7.0	2.8	6.1	7.9	5.8	3.6
Net Exports % of GDP	0.6	-0.7	-1.0	-2.5	-3.9	-3.8	-4.2
Contribution of Net exports to Growth, ppt	-1.9	-1.3	-0.3	-1.6	-1.5	-0.1	-0.5
Final Domestic demand % y-o-y	2.1	2.9	3.2	4.0	4.5	3.1	3.2
Domestic Demand % y-o-y	3.7	2.7	3.2	4.0	4.7	2.8	3.2
Industrial production (% y-o-y)	-4.3	0.6	-0.1	1.0	2.5	1.8	2.8
Gross national saving (% of GDP)	16.1	14.6	14.6	16.1	17.3	16.8	17.8
Unemployment rate, average (%)	6.6	6.5	6.9	6.3	5.8	5.5	5.2
Prices & wages							
CPI (% y-o-y)	2.3	4.0	1.1	1.1	1.2	0.5	2.0
PPI (% y-o-y)	2.7	4.7	1.0	1.5	0.1	-1.4	2.8
Core CPI (% y-o-y)	1.7	1.6	1.4	1.4	1.5	1.5	1.8
Labor Cost Index (% y-o-y)	1.6	1.9	2.0	1.7	1.8	1.8	2.3
Money, FX & interest rates							
Money Supply M1, average (% y-o-y)	5.6	8.0	7.0	9.5	6.2	n/a	n/a
Broad money supply M3, average (% y-o-y)	3.2	6.5	6.0	5.0	6.3	n/a	n/a
Private credit growth (% y-o-y)	0.5	1.7	3.7	4.6	4.5	6.4	4.3
Policy rate, end-year (%)	3.00	2.50	2.50	2.50	3.50	3.00	3.00
10yr yield, end-year (%)	5.82	3.91	3.56	4.76	3.77	3.70	3.80
USD/NZD, end-year	0.75	0.77	0.83	0.83	0.77	0.70	0.68
USD/NZD, average	0.71	0.78	0.80	0.82	0.84	0.73	0.71
EUR/NZD, end-year	0.57	0.58	0.63	0.61	0.60	0.61	0.61
EUR/NZD, average	0.54	0.57	0.62	0.62	0.63	0.61	0.61
External sector							
Exports (G&S, USDbn)	43.1	51.1	50.9	53.1	56.7	50.7	50.6
Imports (G&S, USDbn)	39.7	47.6	50.1	51.1	54.2	48.2	48.1
G&S Balance (USDbn)	3.4	3.4	0.8	2.0	2.5	2.5	2.4
Current Account Balance (USDbn)	-3.3	-4.6	-6.9	-5.8	-6.4	-4.4	-4.7
Current account balance (% GDP)	-2.3	-2.8	-4.0	-3.2	-3.3	-2.5	-2.6
Net FDI (USD bn)	0.5	0.8	0.7	0.5	n/a	n/a	n/a
Net FDI (% GDP)	0.3	1.9	1.5	1.1	n/a	n/a	n/a
Exports (NZD, % y-o-y)	6.5	8.3	-3.6	3.5	4.9	3.9	4.7
Imports (NZD, % y-o-y)	6.0	9.8	1.7	1.2	4.3	3.2	4.9
International FX reserves (USDbn)	16.3	17.0	17.8	16.5	15.6	n/a	n/a
Import cover (months)	4.9	4.3	4.3	3.9	3.5	n/a	n/a
Public and external solvency indicators							
Central government balance (% GDP)	-3.2	-9.0	-4.4	-2.0	-1.3	-0.3	0.1
Gross External Debt (NZD bn)	238.9	240.1	243.2	234.2	242.4	n/a	n/a
Gross External Debt (% GDP)	119.5	115.1	113.8	104.0	102.0	n/a	n/a
Gross public sector debt (NZD bn)	53.6	72.4	79.6	78.0	82.0	83.9	87.2
Gross public sector debt (% GDP)	27.4	35.5	37.5	36.0	35.0	35.0	34.9
Macro-prudential Indicators							
Capital Adequacy Ratios- Tier 1 capital ratio	9.9	10.0	11.2	11.3	11.4	n/a	n/a
Capital Adequacy Ratios- Total capital ratio	12.9	12.7	13.1	12.5	12.5	n/a	n/a
Non-performing loan ratio	2.0	1.9	1.5	1.2	0.9	n/a	n/a
Household debt/Income (%)	157.8	152.4	151.2	153.2	157.9	n/a	n/a
Total credit/GDP (%)	147.5	143.4	143.4	144.2	142.9	146.3	144.7
House prices growth- Dwelling sales price (%y-o-y)	2.0	1.2	4.7	9.0	6.5	n/a	n/a
Loan/deposit ratio	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Stock market capitalization/GDP (%)	24.5	23.1	33.0	37.6	n/a	n/a	n/a

Source: RBNZ, StatsNZ, Thomson Reuters Datastream, ADB, IMF, HSBC forecasts

The Philippines

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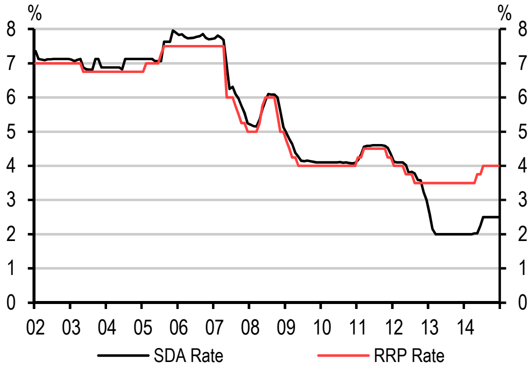
Not immune

The Philippines will host and chair the Asia-Pacific Economic Cooperation (APEC) meetings this year, for the first time since 1996. This underlines the country's remarkable comeback – the Philippines has transformed into one of the region's best performing economies from being one of the laggards of Asia. In contrast to its regional counterparts, growth has exceeded trend in the past three years. In Q4 2014, amidst slowing demand globally, GDP accelerated to 6.6% y-o-y from 5.5% y-o-y, thanks to strong construction spending, favourable net exports and firm private consumption. Favourable demographic transitions, lower debt interest payment, and excess liquidity will keep domestic demand firm in the years ahead.

Indeed, private consumption kicked off with a strong start – it accelerated to 5.4% y-o-y in Q1 2015 versus 5.0% in Q4 2014. Investment, too, was resilient, growing 10.1% y-o-y from 8.0% in Q4 2014. But the Philippines was not immune to weak global demand – net exports contracted and subtracted almost 2ppt from y-o-y GDP due to slowing exports. Slower-than-expected government spending also did not help. We forecast GDP to slow in 2015 to 5.6%, below 2014's growth rate of 6.1%.

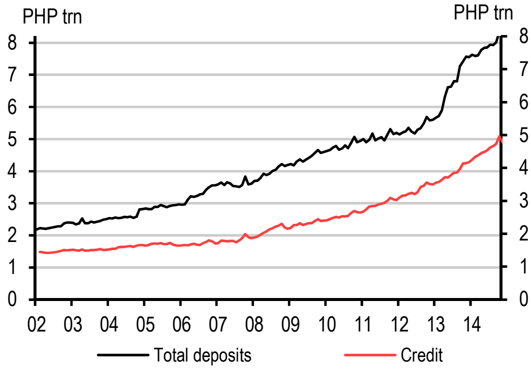
The country's increasing consumption will be further boosted by the fall of oil prices. As a net importer of oil, historically, the oil trade balance has punched a large hole in the country's overall trade balance. Given its dependence on imported petroleum for domestic consumption, the fall in the value of imports due to the lower oil price is substantial. This should lead to lower transport and household costs, dampening inflationary pressures. Inflation has already decelerated to 1.2% y-o-y in June 2015 from its peak of 4.9% in August 2014. This has been a welcome respite, as the economy was beleaguered by supply shortages in 2014. Falling oil prices are thus keeping price pressures contained and inflation within the central bank's 2-4% target in 2015.

Interest rates are low and should stay there for longer



Source: CEIC, HSBC

The economy is awash with liquidity: credit growth is rising



Source: CEIC, HSBC

Policy Issues

The Disbursement Acceleration Program (DAP), which was designed to speed up inefficient fiscal spending, was declared unconstitutional by the Supreme Court on 1 July 2014. As a result of the decision, government spending contracted sharply in Q3 2014, and expanded by only 1.8% in 2014. However, on 3 February 2015, the Supreme Court removed the prohibition on "funding of projects, activities and programs that were not covered by any appropriation in the General Appropriations Act".

Despite the reversal of the DAP, government spending was still disappointing, dragging down growth in Q1 2015. We expect the government to speed up spending and support growth.

President Aquino's term will end in 2016. Filipinos will go to the polls in May 2016, and the upcoming 2016 presidential elections will be on both investors' and politicians' minds (see *After Aquino, Mapping out the economic impact of the 2016 Philippine presidential election*, 13 November, 2014). We expect investment to be cautious in the lead-up to the presidential election while private consumption should be robust.

Risks

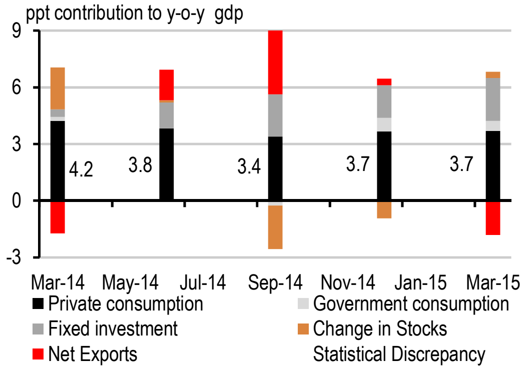
The low level of investment remains a concern. The private-public partnership (PPP) initiative has been sluggish at best. The administration has promised to raise infrastructure investment, but, thus far, key shortages such as electricity and air transport remain unaddressed. This will drag down the economy's competitiveness as well as potential output. Coupled with this, the rapid increase of the population means that the Philippines need to generate new jobs to productively absorb its potential labour force. We expect public investment to slow and private consumption and investment to pick up the slack. Should government spending slow more than expected and household expenditure weaken (not our assumption), then growth may slow sharply.

Capital outflow is also another concern. The BSP has ample foreign reserves to support the currency. That said, we believe weakness from the external factors will motivate the BSP to tolerate some PHP weakness, while keeping rates on hold.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	5.5	6.6	5.2	6.2	5.6	5.2	6.3	6.3	5.2	5.6
GDP sa (% q-o-q)	0.4	2.5	0.3	2.9	-0.2	2.1	1.4	2.9	-1.2	2.4
Industrial production (% y-o-y)	7.3	7.3	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
CPI, (% q-o-q saar)	4.1	1.1	0.8	1.3	4.3	7.4	5.3	4.6	3.4	1.7
CPI, average (% y-o-y)	4.7	3.6	2.4	1.8	1.7	2.9	3.5	4.4	4.1	3.3
PPI, average (% y-o-y)	-0.6	0.4	1.4	2.4	3.4	4.4	5.4	6.4	7.4	8.4
Exports, value (% y-o-y)	8.3	1.2	0.0	0.0	2.0	4.0	2.0	8.1	7.9	8.1
Imports, value (% y-o-y)	-4.4	-6.2	2.0	5.1	4.8	4.5	8.9	10.9	7.8	9.8
Trade balance (% GDP)	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1
Current account (% GDP)	4.8	5.9	1.6	2.2	3.8	5.2	0.0	1.2	3.2	4.6
International reserves (USD bn)	79.6	79.5	80.5	80.8	82.8	84.5	82.7	81.7	81.3	83.7
Policy rate, end quarter (%)	4.00	4.00	4.00	4.00	4.00	4.00	4.25	4.50	4.50	4.50
10yr yield, end quarter (%)	4.3	4.2	4.0	3.9	3.7	3.9	4.1	4.3	4.5	4.5
PHP /USD, end quarter	45.0	44.6	44.8	45.0	45.2	45.4	45.6	45.7	45.8	45.9
PHP /EUR, end quarter	56.7	54.0	47.9	49.5	47.5	47.7	48.8	49.4	50.4	50.5

Source: CEIC, HSBC forecasts

GDP slowed in Q1 2015 but consumption was steady

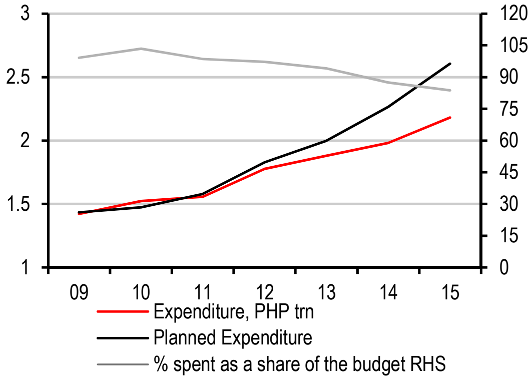


NB: Output gap is lagged two quarters
Source: CEIC, HSBC

However, net exports were a big drag on GDP

- Growth slowed in Q1 2015 by more than expected to 5.2% y-o-y from 6.6% in the previous quarter; net exports were behind the deceleration as exports weakened by much-more-than-expected.
- Private consumption accelerated to 5.4% y-o-y in Q1 2015 from 5.0% in Q4 2014, providing a solid floor to GDP growth.
- Fixed investment was also resilient, reflecting the demand for better infrastructure in the Philippines as well as excess liquidity in the financial system.
- Despite efforts to speed to up spending, government consumption remains a challenge; it slowed in Q1 2015 despite a weak base effect; we believe the government will try to speed up spending to support growth.

Fiscal consolidation efforts have been successful …

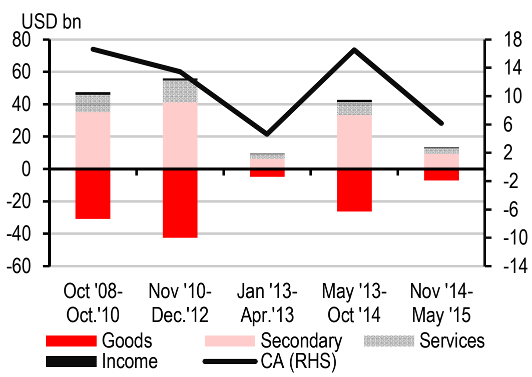


Source: National Statistics Coordination Board, HSBC

… but resulted in more conservative spending behaviour

- The red line on the left chart shows actual fiscal spending while the black line shows planned expenditure; the gap has widened over time, dragging down growth.
- In 2014, the Philippines underspent its fiscal budget by 2.2% of GDP while total government expenditure was only 15.7% of GDP.
- We forecast fiscal spending to rise by 10% in 2015 due to higher spending in H2 2015; however, this would still result in a 3.4% of GDP gap between actual and planned expenditure.
- We believe that increased public capital expenditure is the way for the Philippines to solve both: a) excess liquidity in the financial system and b) limited spending on physical infrastructure.

Despite slowing export growth, the balance of payment (BOP) …



Source: CEIC, HSBC

… remained in surplus, thanks to sticky secondary account growth

- The Philippines has about 10.5m workers abroad, mostly located in the US and Saudi Arabia; despite increasingly challenging economic conditions in host countries, especially in the Eurozone, remittances were sticky in 2014, rising 5.9% in 2014. We expect inflows to slow to 5.3% in 2015.
- Capital flows are more volatile. After receiving substantial capital injections thanks to quantitative easing in the US, the Philippines experienced sharp capital outflows in Q1 2014; however, we do not expect the capital account to have the surplus it had in the past.
- A potential interest rate hike by the Fed could weigh on capital inflows into the Philippines; while slowing remittance inflows are mitigated by savings from oil imports, exports will likely suffer.

Philippines: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	7.6	3.7	6.7	7.1	6.1	5.6	5.9
Nominal GDP (USD bn)	200	224	250	272	285	301	325
GDP per capita (USD)	2,279	2,561	2,595	2,767	2,851	2,957	3,129
Private consumption (% y-o-y)	3.4	5.6	6.6	5.6	5.4	5.4	5.6
Government consumption (% y-o-y)	4.0	2.1	15.5	5.0	1.7	10.2	11.8
Investment (% y-o-y)	19.1	-1.9	10.8	12.2	6.8	6.7	5.8
Net Exports (contribution to GDP growth, ppt)	-0.6	-1.0	1.4	-2.6	1.0	-0.9	-0.1
Industrial production (% y-o-y)	11.2	4.7	5.4	10.3	8.1	8.0	8.0
Gross domestic saving (% GDP)	27.4	23.0	21.0	24.3	25.3	23.8	22.9
Unemployment rate, average* (%)	7.4	7.0	7.0	7.0	7.1	6.8	6.7
Prices & wages							
CPI, average (% y-o-y)	3.8	4.7	3.2	2.9	4.2	2.2	3.9
CPI, end-year (% y-o-y)	3.6	4.2	3.0	4.1	2.7	3.7	3.2
Core CPI, average (% y-o-y)	3.6	4.3	3.7	2.9	3.0	2.7	3.9
Core CPI, end-year (% y-o-y)	3.7	4.2	3.4	3.2	2.3	3.9	3.9
PPI, average (% y-o-y)	-4.9	1.0	-0.6	-7.5	-1.0	0.2	3.9
PPI, end-year (% y-o-y)	-5.8	1.5	-4.0	-4.1	-2.8	-2.7	0.0
Manufacturing wages, nominal** (% y-o-y)	3.4	6.0	4.7	4.6	4.5	4.5	4.5
Money, FX & interest rates							
Central bank money M0, average (% y-o-y)	10.9	7.2	8.5	14.6	11.5	10.0	10.0
Broad money supply M3, average (% y-o-y)	9.5	8.4	8.5	22.6	18.3	7.0	7.0
Real private sector credit growth (% y-o-y)	6.5	9.6	11.8	11.7	15.2	11.8	14.1
Policy rate, end-year (%)	4.00	4.50	3.50	3.50	4.00	4.00	4.50
10yr yield, end-year (%)	5.89	5.08	4.85	3.70	4.21	3.90	4.50
PHP /USD, end-year	43.9	43.9	41.2	44.4	44.6	45.4	45.9
PHP /USD, average	45.1	43.4	42.1	42.9	44.3	44.9	45.7
PHP /EUR, end-year	58.8	56.9	54.4	61.2	54.0	47.7	50.5
PHP /EUR, average	59.6	59.9	54.4	56.7	58.8	48.9	49.4
External sector							
Merchandise exports (USD bn)	36.8	38.3	46.4	44.5	47.8	48.5	51.7
Merchandise imports (USD bn)	61.1	58.7	65.3	62.2	63.6	66.2	72.4
Trade balance (USD bn)	-24.3	-20.4	-18.9	-17.7	-15.9	-17.8	-20.7
Current account balance (USD bn)	7.2	5.6	6.9	11.4	12.6	10.0	7.6
Current account balance (% GDP)	3.6	2.5	2.8	4.2	4.4	3.3	2.3
Net FDI (USD bn)	0.2	-1.6	-0.3	-1.0	0.1	-0.8	0.3
Net FDI (% GDP)	0.1	-0.7	-0.1	-0.4	0.0	-0.3	0.1
Current account balance plus FDI (% GDP)	3.7	1.8	2.6	3.8	4.5	3.0	2.4
Exports, value (% y-o-y)	26.2	4.1	21.2	-4.0	7.3	1.5	6.8
Imports, value (% y-o-y)	42.0	-3.9	11.3	-4.8	2.3	4.1	9.4
International FX reserves (USD bn)	62.4	75.3	83.8	83.2	79.5	84.5	83.7
Import cover (months)	12.3	15.4	15.4	16.1	15.0	15.3	13.9
Public and external solvency indicators							
Commercial banks' FX assets (USD bn)	20.2	22.3	24.5	25.9	26.6	28.1	29.6
Gross external debt (USD bn)	60.0	60.4	60.3	58.5	77.7	77.7	77.7
Gross external debt (% GDP)	30.0	27.0	24.1	21.5	27.3	25.8	23.9
Short term external debt (% of int'l reserves)	10.1	9.3	10.1	13.5	20.4	19.2	19.4
Private sector external debt (USD bn)	15.7	12.5	5.1	5.2	27.5	28.0	28.8
Consolidated government balance (% GDP)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Central government balance (% GDP)	-3.5	-2.0	-2.3	-1.4	-0.6	-0.1	-0.4
Primary balance (% GDP)	-0.4	1.9	1.7	3.7	5.6	6.8	5.7
Gross public domestic debt (PHP bn)	2,718.2	2,873.4	3,612.6	3,864.9	3,938.7	3,970.0	3,970.0
Gross public domestic debt (% GDP)	22.2	21.4	22.0	19.8	17.6	16.5	15.0
Gross public external debt (USD bn)	44.3	47.9	55.3	53.3	50.1	49.7	48.9
Gross public external debt (% GDP)	22.2	21.4	22.0	19.8	17.6	16.5	15.0
Gross public sector debt (% GDP)	52.4	51.0	56.3	52.8	48.8	45.8	41.8
Macro-prudential measures							
Capital adequacy ratio	16.0	16.7	n/a	n/a	n/a	n/a	n/a
Non-performing loan ratio	3.1	2.4	1.9	2.2	n/a	n/a	n/a
Household Debt/ GDP (%)	5.3	5.6	6.0	6.3	n/a	n/a	n/a
Total Credit/GDP (%)	29.2	31.0	32.8	34.4	37.5	39.8	42.8
Loan/Deposit ratio	52.0	56.7	60.8	53.5	56.8	62.6	71.4
Stock Market Capitalisation/GDP (%)	98.5	89.6	103.4	n/a	n/a	n/a	n/a

*September 2005; the ILO definition of unemployment has been adopted by official sources.
**Refers to minimum wage index.
Source: CEIC, ADB, IM, HSBC forecasts

Singapore

A slower stride

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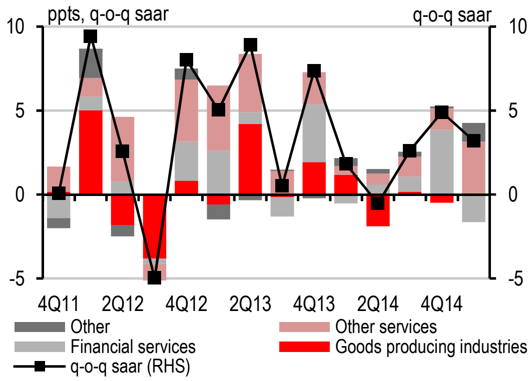
Moving into 2015, we predicted that various obstacles would cause Singapore's growth to slow. As a small and highly open economy, the city state is sensitive to global conditions, and accordingly its growth tends to appear quite volatile. Above all, soft global trade and a fall in commodity prices have posed, and continue to pose, risks to the economy. Add expectations of higher US and domestic interest rates to the mix and Singapore's already-feeble private consumption will likely slow further.

Thus far, growth in Singapore has belied this unfavourable backdrop. Both 4Q14 and 1Q15 GDP growth came in above consensus expectations. In the case of 4Q, Singapore witnessed a break-neck pace of expansion in the finance & insurance industry, while last quarter a boost in construction did the trick (thanks to an increase in private accommodation supply) in addition to robust wholesale trade activity. The manufacturing sector managed to expand sequentially despite weak global demand due to a surge in volatile pharmaceutical output. This allowed Singapore to buck the regional trend of slumping exports in 1Q.

In 2Q, however, Singapore is starting to suffer a bit more broadly from the slowdown in China and US early in the year. Indeed, industrial production is tracking a sequential decline and non-oil domestic export (NODX) growth is set to grind to a near halt. Fortunately, the dominant services sector should help compensate for the decline in manufacturing in 2Q, and allow the economy to see tepid sequential growth. Note that conditions are far from recessionary and we expect momentum to pick up gradually in the latter half of the year; we forecast 2015 GDP growth of 2.7%

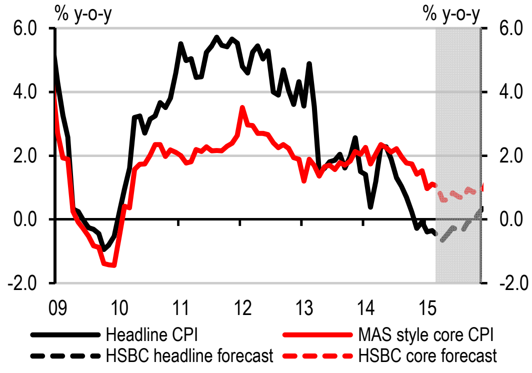
All the while, the economy has dug deeper into deflation, as expected. We continue to see headline CPI falling 0.3% in 2015, while we lower our core CPI forecast to 0.6% (from 0.7%) due to the disinflationary impact of various budget measures. Going into 2016, base effect and rising energy prices should help prices pick up.

Growth momentum held up well in 1Q15, thanks to a surge in construction and wholesale trade



Source: CEIC, MTI, HSBC

Headline inflation is in deflationary territory, while core has moderated substantially



Source: CEIC, MAS, HSBC

Policy issues

In terms of monetary policy, the first half of 2015 has been a roller coaster by Singapore standards. First the Monetary Authority of Singapore (MAS) surprised markets by lowering the SGDNEER policy slope in January in an off-cycle monetary policy meeting. This engendered many months of speculation about monetary policy leading up to the April monetary policy statement, alongside heightened currency volatility. Contrary to market expectations, the MAS kept policy settings on hold in April, and surprisingly sounded increasingly hawkish due to tight labour markets, despite domestic and global disinflation.

Although wage pass-through is constrained in the short-term by soft domestic activity, the MAS is expecting wage pressure to materialize as labour force growth slows materially in the coming years. As a result, even if core CPI moderates further and falls below the MAS forecast range of 0.5-1.5% for a few months, MAS will likely look through short-term disinflation and keep the policy setting on hold in October.

As for growth, the government still sees 2015 growth coming in between 2-4%. However, it moderated the medium-term forecast (until 2020) to 2-4% per annum, compared to 3-5% previously. We think Singapore's potential GDP is between 2-3%, in line with our 2015 forecast of 2.7%. On the political stage, Prime Minister Lee Hsien Loong may call elections for the end of this year, coinciding with Singapore's 50th anniversary. We don't think this will change the policy direction much, but there may be speculation of alterations to foreign worker policy over the coming years if businesses start to feel constrained.

Risks

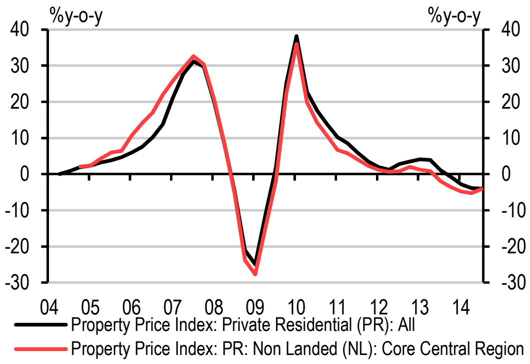
A key risk to Singapore's economy in 2015 is that a faster-than-expected rise in interest rates and tightening of liquidity conditions may contribute to weak growth. Increasing mortgage payments tied to short-term rates will cause private consumption to slow even further, even if we don't necessarily expect potentially over-leveraged households to experience much financial stress. Meanwhile, the housing market will likely continue to deflate. We do, however, see a chance that the MAS starts to unwind some of the macro-prudential measures in 2H15.

Another key risk is that external conditions deteriorate further, particularly in China where growth is slowing, or the Eurozone if there is a political event. From a longer-term perspective, we worry that labour productivity may continue to contract over the coming quarters. We believe this poses longer-term risks for the Singapore economy, as it implies a lower potential growth rate, especially as demographic pressures intensify.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	2.8	2.1	2.6	2.9	3.0	2.4	2.4	3.1	3.4	3.9
GDP sa (% q-o-q)	0.6	1.2	0.8	0.2	0.8	0.6	0.7	1.0	1.1	1.0
Industrial production (% y-o-y)	-1.2	-1.8	-5.5	-1.5	-0.6	0.5	0.6	2.4	2.1	1.8
CPI, (% q-o-q saar)	-0.8	-0.4	-0.7	0.0	0.2	2.0	1.4	2.5	2.7	0.0
CPI, average (% y-o-y)	1.0	0.0	-0.3	-0.4	-0.4	-0.2	0.3	0.9	1.5	2.1
PPI, average (% y-o-y)	-5.2	-9.7	-9.0	-4.5	-5.3	-5.5	-6.0	-5.5	-4.2	-3.0
Exports, value (% y-o-y)	-2.0	-7.4	-11.6	-6.0	-4.5	-2.3	-1.3	0.7	1.1	2.7
Imports, value (% y-o-y)	-3.9	-8.8	-20.8	-6.6	-3.7	-2.8	1.8	1.8	1.1	1.2
Trade balance (% GDP)	26.6	25.3	31.8	26.2	25.9	26.0	28.0	24.4	25.5	27.3
Current account (% GDP)	22.4	19.2	27.2	19.2	21.2	20.2	23.7	18.0	21.5	22.2
International reserves (USDbn)	266.1	256.9	248.4	n/a	n/a	n/a	n/a	n/a	n/a	n/a
3M interbank rate, end-quarter (%)	1.45	1.45	1.45	0.82	1.60	1.80	1.90	1.90	1.90	1.90
5yr yield, end-quarter (%)	1.7	1.6	1.8	1.9	1.9	2.0	2.0	2.2	2.4	2.4
SGD /USD, end-quarter	1.273	1.321	1.370	1.35	1.36	1.37	1.38	1.38	1.39	1.39
SGD /EUR, end-quarter	1.60	1.60	1.47	1.49	1.43	1.44	1.48	1.49	1.53	1.53

Source: CEIC, HSBC forecasts

Property prices continue to decline in Singapore …

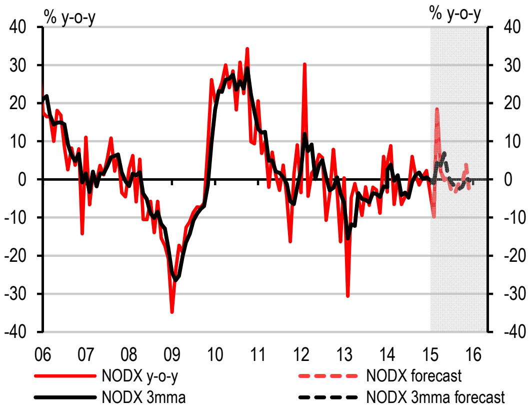


Source: CEIC, HSBC

… and will likely continue falling in 2015 by 5-10%

- Several rounds of macro prudential measures and an abundance of supply have resulted in a ~5% fall in residential property prices since their peak in 2013.
- Housing supply growth for 2014-2016 is estimated at around 3.7% per annum compared to population growth of around 1.5%.
- The MAS is likely to maintain its macro-prudential policy to assist in the deleveraging of households; however, it is possible that they tweak some measures in 2H15.
- The Additional Buyers Stamp Duty (ABSD) for Singaporeans may be repealed in 2H15.

Non-oil domestic exports contracted 0.7% in 2014 …

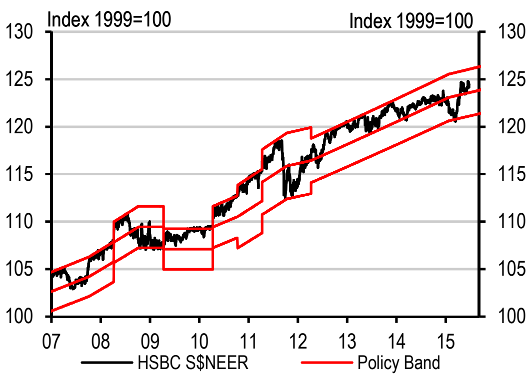


Source: CEIC, HSBC

… and growth in 2015 will only be modest at best

- Electronics export growth turned positive in December following 28 months of y-o-y declines.
- Underlying growth momentum will be weak in 1H15 as external conditions, particularly in China, are weakening.
- However, pharmaceutical shipments jumped in 1Q, mostly in March, bringing overall NODX growth to 18.5% y-o-y, the highest rate in over three years.
- Part of this jump has been corrected, NODX will likely see continued growth through 2015, but at a very tepid rate.

The SGDNEER has dropped to the bottom of the band …



Source: Bloomberg, HSBC

… leading to speculation that the MAS will further ease policy

- The MAS surprised markets by easing the SGDNEER policy slope on 28 January due to a large revision of its headline and core inflation outlook, and kept settings on hold in April.
- In spite of disinflation intensifying, we expect the MAS to keep its policy settings on hold in October.
- The central bank will likely look to 2016 when wage-induced inflationary pressures may materialize.
- Instead of changing the SGDREER, the MAS may tweak some macro prudential measures in 2H15, specifically the Additional Buyers Stamp Duty (ABSD) for Singaporeans.

Singapore: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	15.3	6.2	3.4	4.4	2.9	2.7	3.2
Nominal GDP (USD bn)	236.9	274.5	285.8	297.7	303.5	283.7	293.3
GDP per capita (USD)	47,500	54,078	55,139	56,034	56,317	51,945	52,963
Private consumption (% y-o-y)	5.9	4.0	3.5	3.5	2.5	1.9	1.2
Government consumption (% y-o-y)	9.8	-1.4	-1.1	11.4	1.5	1.9	4.6
Investment (% y-o-y)	8.0	5.0	8.9	1.0	-2.0	4.8	4.1
Net Exports (contribution to GDP growth, ppt)	6.3	3.6	-2.0	2.5	1.7	0.1	2.0
Industrial production (% y-o-y)	29.7	7.8	0.3	1.7	3.0	0.9	3.2
Gross domestic saving (% GDP)	54.3	54.3	53.5	52.7	51.7	51.4	51.8
Unemployment rate end-year (%)	2.2	2.1	1.8	1.8	1.8	1.8	1.8
Prices & wages							
CPI, average (% y-o-y)	2.8	5.2	4.6	2.4	1.0	-0.3	1.2
CPI, end-year (% y-o-y)	4.6	5.5	4.3	1.5	-0.1	0.0	2.2
Core CPI, average (% y-o-y)	1.4	4.1	4.4	2.4	2.6	3.3	3.1
Core CPI, end-year (% y-o-y)	3.3	4.8	3.4	1.9	3.4	3.1	3.3
PPI, average (% y-o-y)	1.7	5.4	0.4	-3.1	1.4	1.8	7.4
PPI, end-year (% y-o-y)	-0.9	7.4	5.1	0.3	2.2	1.4	1.9
Manufacturing wages, nominal (% y-o-y)	5.6	6.0	2.3	4.3	3.3	4.0	4.0
Money, FX & interest rates							
Central bank money M0, average (% y-o-y)	10.0	8.7	14.1	11.1	9.8	10.3	10.6
Broad money supply M3, average (% y-o-y)	8.4	10.2	7.6	7.9	7.8	8.8	9.0
Real private sector credit growth (% y-o-y)	5.6	12.4	10.5	12.0	11.1	12.0	12.0
3M interbank rate, end-year (%)	0.44	0.39	0.38	0.40	0.45	1.80	1.90
5yr yield, end-year (%)	1.40	0.60	0.31	1.08	1.60	2.00	2.40
SGD /USD, end-year	1.29	1.30	1.22	1.27	1.39	1.37	1.39
SGD /USD, average	1.36	1.26	1.25	1.25	1.28	1.37	1.39
SGD /EUR, end-year	1.73	1.69	1.61	1.74	1.68	1.44	1.53
SGD /EUR, average	1.80	1.74	1.62	1.66	1.69	1.49	1.50
External sector							
Merchandise exports (USD bn)	371.1	436.1	439.6	441.7	437.5	410.8	414.1
Merchandise imports (USD bn)	308.5	364.9	373.1	366.3	365.7	341.9	349.0
Trade balance (USD bn)	63.3	71.7	67.7	74.3	73.6	67.3	70.5
Current account balance (USD bn)	56.1	62.4	53.8	63.2	53.9	46.3	50.6
Current account balance (% GDP)	23.7	22.7	18.8	21.2	17.8	16.3	17.2
Net FDI (USD bn)	22.0	23.6	41.4	36.0	23.5	27.8	28.3
Net FDI (% GDP)	9.3	8.6	14.5	12.1	7.7	9.8	9.7
Current account balance plus FDI (% GDP)	33.0	31.3	33.3	33.3	25.5	26.1	26.9
Exports, value (% y-o-y)	28.7	17.5	0.8	0.5	-1.0	-6.1	0.8
Imports, value (% y-o-y)	28.0	18.3	2.3	-1.8	-0.2	-6.5	2.1
International FX reserves (USD bn)	224.4	237.1	259.2	272.4	236.7	234.0	238.8
Import cover (months)	8.7	7.8	8.3	8.9	7.8	8.2	8.2
Public and external solvency indicators							
Budget balance (% GDP)	0.2	1.2	1.9	1.4	1.1	-1.0	-0.3
Gross external debt (USD bn)	1,063	1,138	1,217	1,271	1,275	1,206	1,261
Gross external debt (% of GDP)	449	415	426	427	420	425	430
Public sector debt (% of GDP)	105	99	110	104	103	115	117
Macro prudential indicators							
Capital adequacy ratio (system wide)	18.6	16.0	18.1	16.1	16.0	n/a	n/a
- tier 1	15.5	13.5	14.9	13.5	13.5	n/a	n/a
- tier 2	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Non-performing loan ratio	1.6	1.2	1.2	1.1	0.9	n/a	n/a
Household Debt/ GDP (%)	68.8	72.7	73.3	75.0	76.3	n/a	n/a
Residential House prices (% y-o-y)	17.6	5.9	2.8	1.1	n/a	n/a	n/a
Loan/ deposit ratio	69.8	86.1	94.6	106.8	110.0	n/a	n/a

Source: CEIC, IMF, ADB, MAS, HSBC forecasts

Sri Lanka

Policy uncertainty to persist

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Sri Lanka is in a transitional phase after 10 years of political stability. Early Presidential elections in January resulted in a surprise victory after a dissenting group within the ruling party joined the opposition to defeat the incumbent. The initial excitement, reflected in stock market outperformance, quickly fizzled as policy uncertainty grew amid a coalition government of disparate political groups. The parliament has now been dissolved, with elections scheduled for 17 August.

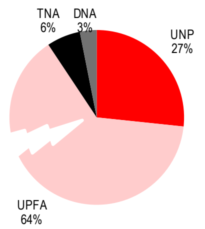
Growth momentum, meanwhile, suffered as investment slowed. GDP growth in 1Q was unchanged at 6.4% y-o-y, but decelerated sequentially for the third consecutive quarter. Looking ahead, growth is likely to come under pressure since the atmosphere of policy uncertainty is likely to persist even after the elections, although improving agriculture output and consumption will provide some support. We lower our GDP growth forecast to 6.8% y-o-y in 2015 and 2016 from 7.2% earlier. This is not a drastic decline in growth and is broadly in line with the 10 year average, but the quality of growth could suffer as consumption picks up in lieu of investment.

Inflation has declined rapidly and has stayed below 1% since the beginning of the year, reaching 0.1% y-o-y in March, which is more than a two decade low for Sri Lanka. Low inflation is the result of weak international commodity prices and budget measures that lowered prices of essential products. In addition, a stable exchange rate has helped as well. Looking ahead, price pressures from the recovery in oil prices and currency depreciation are likely to push up inflation next year, but it should remain within the comfort zone of the central bank, which is loosely defined as mid-single-digit levels in the central bank's annual communication.

Strengthening consumption and the recovery in oil prices will likely erode benefits from lower crude prices on the external account. We expect the current account deficit to widen slightly from here as consumption demand strengthens. However, the overall deficit can be securely financed due to scheduled public debt issuance, and other bilateral and multi-lateral funding assistance.

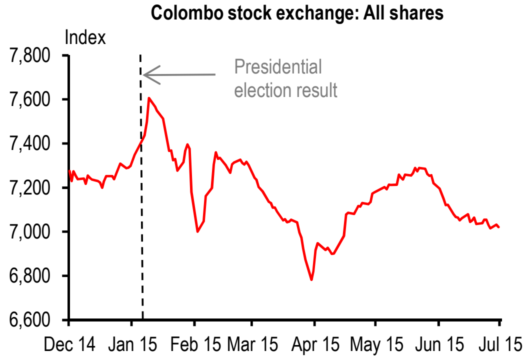
Coalition government straddled opposing groups…

	Sri Lanka parliament composition	Seats
Governing party	United National Front (UNF)	60
	United People's Freedom Alliance (UPFA)	144
Opposing party	United People's Freedom Alliance (UPFA)	
	Tamil National Alliance (TNA)	14
	Democratic National Alliance (DNA)	7
	Total seats	225



Source: HSBC

…leading to policy uncertainty and a weaker investor sentiment



Source: CEIC, HSBC

Policy issues

The President finally dissolved parliament after the impasse on the political situation made it difficult to achieve consensus on electoral reforms. It was becoming cumbersome for the minority government to function with frequent appeals for no-confidence motions against ministers in the administration. President Maithripala's 100-day promise has been achieved in spirit, even though it was not implemented strictly. To end the climate of policy uncertainty, the new government may have to quickly outline its reform agenda. We think the next budget in November will be the likely platform. Elections may not result in a single-party majority; a coalition with the current alliance appears the most likely outcome.

On monetary policy, the lagged impact of the central bank's 225bps in cumulative rate cuts since November 2012 will continue to help the economy through this transitional phase. Policy rates in real terms are still fairly restrictive and the space to cut further is available if needed. Moreover, with inflation continuing to surprise on the downside, another 50bp rate cut is still on the cards this year.

We find that the fiscal policy stance last year was mildly expansionary after the deficit exceeded the budget by 0.6% of GDP, which is a departure from consistent consolidation seen in previous years. This year, we think fiscal consolidation will be lower than targeted due to revenue shortfalls. Moreover, market borrowing is likely to go up due to unpaid claims from last year.

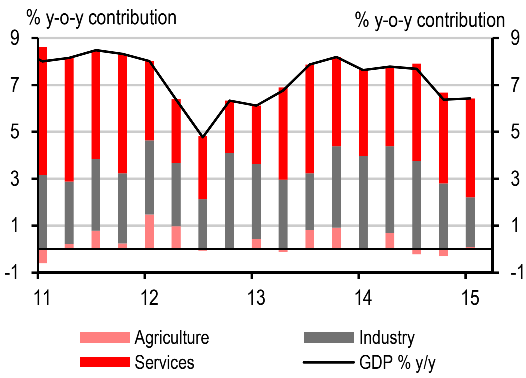
Risks

Policy choices are a key concern going into elections. Insufficient fiscal consolidation could easily put macro-economic stability at risk. Also, the climate of policy uncertainty could persist if elections result in a fractured mandate.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	7.7	6.4	6.4	6.6	6.4	7.6	7.5	7.1	6.5	6.0
GDP sa (% q-o-q)	1.9	1.3	1.2	2.0	1.9	1.9	1.8	1.3	1.3	1.3
Industrial production (% y-o-y)	9.2	7.6	6.5	6.2	6.1	6.3	6.6	6.3	6.1	5.9
CPI, (% q-o-q saar)	4.5	-2.6	0.0	-1.3	5.0	6.8	6.4	6.1	5.6	5.5
CPI, average (% y-o-y)	3.5	1.8	1.3	0.1	0.2	2.6	4.2	6.1	6.2	5.9
WPI, average (% y-o-y)	3.0	1.9	3.4	5.3	5.0	6.5	6.2	6.2	6.2	6.2
Exports, value (% y-o-y)	6.5	-7.6	1.6	-5.6	-3.8	3.3	2.5	9.6	10.0	11.0
Imports, value (% y-o-y)	19.2	15.1	0.9	8.5	-5.8	0.9	11.2	13.5	13.6	12.9
Trade balance (% GDP)	-12.9	-11.3	-9.9	-11.5	-11.2	-10.1	-10.9	-11.9	-11.7	-10.4
International reserves (USD bn)	8.8	8.2	6.8	7.6	7.6	7.6	8.0	8.5	8.5	9.0
Policy rate, end-quarter (%)	8.00	8.00	8.00	7.50	7.50	7.00	7.00	7.00	7.00	7.00
LKR/USD, end quarter	130.43	131.87	133.32	133.7	133.8	134.0	134.0	134.0	134.0	134.0
LKR/EUR, end quarter	165.4	160.5	144.3	149.6	140.5	140.7	143.4	144.7	144.7	144.7

Source: CEIC, HSBC forecasts

Growth was unchanged in annual terms …

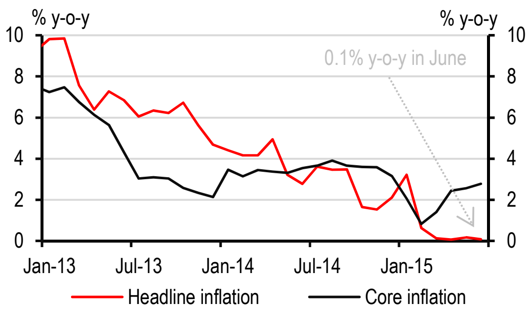


Source: CEIC. HSBC

… but it continues to slow sequentially

- Headline GDP growth was underwhelming due to weak agriculture where a ban on fish exports to the EU and poor weather conditions dampened output growth.
- However, the underlying details are far more reassuring since sequential growth in industry held steady and picked up for services.
- We suspect that external demand and consumption supported growth this quarter even as investment pulled in the other direction. This contest is likely to continue in the quarters ahead with consumption being helped by cheaper credit and public sector salary hikes, but investments falling as they are put off for want of more policy clarity. Growth is likely to come under downward pressure as policy uncertainty persists, but improving consumption is likely to support momentum.

Headline CPI inflation has decelerated sharply …

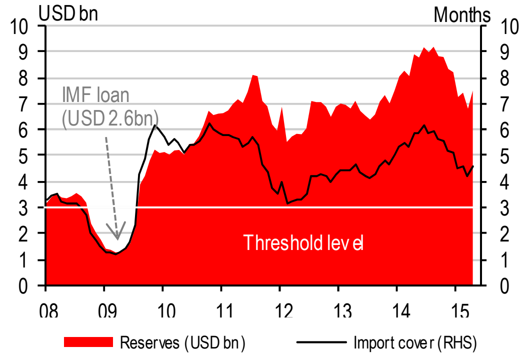


Source: CEIC, HSBC

… to a more than two decade low

- CPI inflation has been below 1% since February this year and at 0.1% y-o-y in March, inflation is back to its two decade low. The central bank expects inflation to stay below 4% through the year, but we believe CPI inflation would average just 1.1% in 2015.
- Low inflation in Sri Lanka is the result of weak international commodity prices and budget measures that lowered prices of essential products. In addition, stable exchange rates have helped as well.
- Looking ahead, price pressures from the recovery in oil prices and currency depreciation are likely to push up inflation next year, but would remain within the comfort zone of the central bank, which is loosely defined as mid-single digit levels in the central bank's annual communication.

Decline in reserves has lowered the import cover …



Source: CEIC. HSBC

… and needs careful attention

- The trade deficit for the first four months has widened by 3.9% y-o-y. This is largely due to stronger consumer-led import demand and the decline in exports, particularly to the EU, Russia and Ukraine. Commodity exports like tea, rubber and fish have especially taken a knock, due to unfavourable prices and regulation.
- Strengthening consumption and the recovery in oil prices will likely erode benefits from lower crude prices on the external account. However, the overall deficit should be comfortably financed due to scheduled public debt issuance, and other bilateral and multi-lateral funding assistance.
- Gradually building adequate FX reserves would help safeguard the external account against risks. A USD 1.5bn currency swap with India will act as a useful backstop.

Sri Lanka: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	8.0	8.2	6.4	7.2	7.4	6.8	6.8
Nominal GDP (USD bn)	49.6	59.1	59.0	66.9	74.8	81.0	91.0
GDP per capita (USD)	2,400	2,831	2,891	3,253	3,603	3,862	4,299
Private consumption (% y-o-y)	9.2	14.7	6.8	3.2	4.6	9.1	8.7
Government consumption (% y-o-y)	1.6	5.5	-0.6	3.6	11.4	-3.8	4.3
Investment (% y-o-y)	9.2	14.6	10.7	9.1	2.2	1.1	3.8
Net Exports (contribution to GDP growth, ppt)	-2.2	-4.5	-0.2	1.7	-2.2	3.4	-1.2
Industrial production (% y-o-y)	15.4	7.3	1.6	0.5	5.3	6.3	6.2
Gross domestic saving (% GDP)	25.3	22.1	24.0	25.8	27.0	25.8	25.2
Unemployment rate, average (%)	4.5	3.9	3.9	4.1	4.4	4.2	4.2
Prices & wages							
CPI, average (% y-o-y)	6.2	6.7	7.5	6.9	3.3	1.1	5.6
CPI, end-year (% y-o-y)	6.8	4.9	9.2	4.7	2.1	2.9	5.8
Core CPI, average (% y-o-y)	7.0	6.9	5.8	4.5	3.5	2.8	4.3
Core CPI, end-year (% y-o-y)	8.9	4.7	7.5	2.1	3.2	4.2	3.7
WPI, average (% y-o-y)	11.2	11.0	3.9	9.2	3.2	5.0	6.2
WPI, end-year (% y-o-y)	17.6	-6.1	13.8	6.0	2.1	4.3	5.3
Minimum wages, nominal (% y-o-y)	7.1	9.2	0.0	32.9	10.5	10.5	10.5
Money, FX & interest rates							
Central bank money M1, end (% y-o-y)	20.9	7.7	2.6	7.7	26.3	15.2	15.3
Broad money supply M2, end (% y-o-y)	18.0	20.9	18.3	18.0	13.1	12.4	13.8
Real private sector credit growth (% y-o-y)	18.6	27.8	10.0	0.5	5.5	17.1	16.8
Policy rate, end-year (% y-o-y)	9.00	8.50	9.50	8.50	8.00	7.00	7.00
LKR /USD, end-year	111.1	114.0	127.2	130.9	131.9	134.0	134.0
LKR /USD, average	112.7	111.1	129.6	130.0	130.8	133.7	134.0
LKR /EUR, end-year	147.8	147.5	168.1	180.5	160.5	140.7	144.7
LKR /EUR, average	147.9	152.9	168.6	172.7	170.8	143.8	144.4
External sector							
Merchandise exports (USD bn)	8.6	10.6	9.8	10.4	11.1	11.0	11.9
Merchandise imports (USD bn)	13.5	20.3	19.2	18.0	19.4	19.6	22.1
Trade balance (USD bn)	-4.8	-9.7	-9.4	-7.6	-8.3	-8.6	-10.1
Current account balance (USD bn)	-1.4	-4.6	-3.9	-2.6	-2.0	-2.4	-2.7
Current account balance (% GDP)	-2.8	-7.8	-6.6	-3.8	-2.7	-2.9	-3.0
Net FDI (USD bn)	0.4	0.9	0.8	0.9	0.9	0.6	0.8
Net FDI (% GDP)	0.9	1.5	1.4	1.3	1.2	0.7	0.9
Current account balance plus FDI (% GDP)	-1.9	-6.3	-5.2	-2.5	-1.5	-2.2	-2.1
Exports (% y-o-y)	21.8	22.4	-7.4	6.3	7.1	-1.1	8.2
Imports (% y-o-y)	31.8	50.7	-5.3	-6.2	7.9	0.8	12.8
International FX reserves (USD bn)	6.6	6.0	6.9	7.5	8.2	7.6	9.0
Import cover (months)	5.9	3.5	4.3	5.0	5.1	4.7	4.9
Public and external solvency indicators							
Gross external debt (USD bn)	21.4	32.7	37.1	39.9	43.0	45.6	47.6
Gross external debt (% GDP)	43.2	55.4	62.8	59.6	57.4	56.3	52.3
Short term external debt (% of int'l reserves)	39.6	121.6	93.3	90.3	88.6	99.0	84.6
Budget balance (% GDP)	-8.0	-6.9	-6.5	-5.9	-6.0	-5.2	-4.8
Gross public domestic debt (USD bn)	22.7	25.3	25.2	29.6	32.7	34.3	36.7
Gross public domestic debt (% GDP)	45.8	42.9	42.7	44.2	43.7	42.3	40.3
Gross public external debt (USD bn)	17.9	21.0	21.6	22.8	23.8	26.0	28.0
Gross public external debt (% GDP)	36.1	35.6	36.5	34.1	31.8	32.1	30.8
Gross public sector debt (% GDP)	81.9	78.5	79.2	78.3	75.5	74.5	71.1
Macro prudential indicators							
Capital adequacy ratio (system wide)	16.2	16	16.4	16.3	n/a	n/a	n/a
- tier 1	14.3	14.4	14.7	13.7	n/a	n/a	n/a
- tier 2	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Non-performing loan ratio	5.4	3.8	3.7	5.6	4.2	n/a	n/a
Household Debt/ GDP (%)	26.6	30.7	31.1	29.2	28.2	n/a	n/a

Source: CEIC, ADB, IMF, HSBC forecasts

HSBC

Taiwan

Joining in the easing

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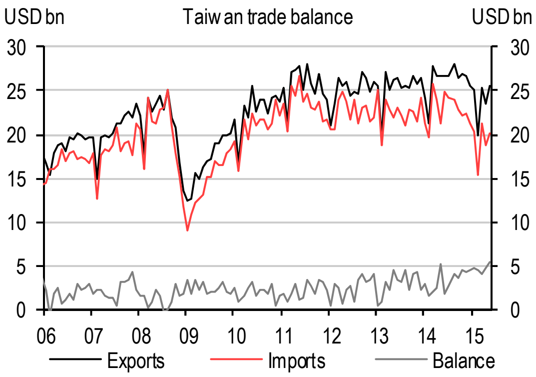
We believe Taiwan's economy will grow by 3.5% y-o-y in 2015 (versus 3.7% in 2014), which is respectable in a region where many countries are slowing down much more rapidly. We expect Taiwan's growth to remain relatively robust on the back of steadily improving domestic demand prospects. The performance of the labour market is the main driver, with the headline rate of unemployment down to its lowest since 2008. Wage growth is stable while consumer prices are falling, which should boost consumers' real spending power.

However, the external environment has been deteriorating for several months now. Export orders and exports have slowed sharply in recent months. This is partly due to the continued weakness in Mainland China, now Taiwan's largest trading partner. Exports to the Mainland and Hong Kong were down by 5.7% in the first five months of 2015 compared with in the same period a year ago. This has been partly offset by stronger exports to the US, although given the recent weakness in the US data, it is unclear whether this shift in demand will be enough to keep exports steady.

However, there has been an even more rapid decline in imports in recent months due to low commodity prices, especially for food. This has meant that Taiwan's trade surplus reached a new record high in May. This should mean that the overall contribution of net exports to GDP growth should be positive.

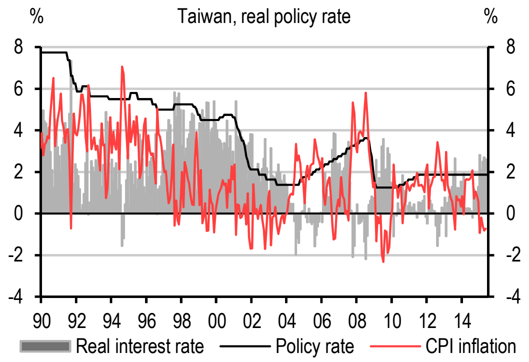
Headline CPI is likely to remain in deflation until Q4, and average significantly below the already-low official forecast of +0.1% for 2015 as a whole. This also means that real interest rates have remained relatively high for much of 2015. With core inflation (excluding food and energy prices) also falling to its lowest rate in over a year, we expect that the central bank will cut rates twice this year.

Weak exports offset by even sharper fall in imports



Source: Directorate-General of Budget, Accounting and Statistics, Executive Yuan

Real interest rates are rising due to deflation



Source: CBC, DGBAS

Policy issues

We forecast the central bank to cut the benchmark interest rate twice in 2015 to combat deflation. Growth will likely remain relatively robust driven by domestic demand. However, the risk of sustained deflation has risen in recent months. This would pose a risk to future inflation expectations as well if steps are not taken to move the economy away from deflation.

There has also been a string of policy loosening measures elsewhere in the region, including in Taiwan's major trading partners as well as its competitors – China and South Korea being the main examples. And given that the Central Bank of China (CBC) only meets every quarter, and usually only moves in 12.5bps steps, it should probably start cutting sooner rather than later (see *Taiwan Monetary Policy (Q2 15): Boat against the current*).

Risks

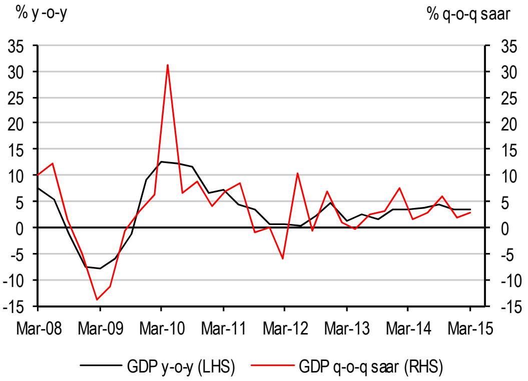
The main risks to growth remain weaker global trade. The data from Mainland China continues to be weak, while the US economic data has also surprised more towards the downside in recent months. On the other hand, the likely later timing of the first rate hike from the Federal Reserve should ease some of the risk of capital outflows from Taiwan.

Domestically, there appear to be signs that the housing market is going into a correction. Prices are falling in y-o-y terms in the Taipei area, which is a sign that the CBC's macroprudential measures introduced previously are working. However, there is a risk that the falls will be sustained and have a knock-on impact on consumer spending and sectors such as construction.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	4.3	3.5	3.4	3.0	3.8	3.6	3.7	4.2	3.2	2.9
GDP sa (% q-o-q)	1.5	0.5	0.7	0.1	1.5	0.7	0.4	1.3	1.1	-0.3
Industrial production (% y-o-y)	7.7	7.9	5.8	2.8	1.4	2.7	5.2	7.0	7.0	7.0
CPI, average (% y-o-y)	1.5	0.8	-0.6	-0.7	-0.2	0.5	1.6	1.5	1.4	1.4
WPI, average (% y-o-y)	0.0	-3.0	-8.5	-0.5	0.0	1.0	1.2	1.5	2.0	1.5
Exports, value (% y-o-y) (BOP, goods)	7.6	6.5	5.9	4.9	4.8	4.2	5.9	6.9	5.3	4.4
Imports, value (% y-o-y) (BOP, goods)	9.2	6.1	2.5	1.9	0.3	2.1	6.0	6.7	5.7	4.6
Trade balance (% GDP) (BOP, goods)	7.6	10.4	10.6	6.6	6.5	9.3	7.6	3.8	4.0	6.5
Current account (% GDP)	11.2	14.0	16.8	10.2	9.4	12.7	12.2	6.5	6.1	9.0
International reserves (USD bn)	420.7	419.0	414.7	413.0	409.8	410.4	410.3	402.7	394.6	391.0
Policy rate, end-quarter (%)	1.875	1.875	1.875	1.875	1.750	1.625	1.625	1.625	1.625	1.625
5yr yield, end-quarter (%)	1.17	1.17	1.04	1.60	1.50	1.60	1.60	1.60	1.60	1.60
TWD /USD, end-quarter	30.44	31.72	31.4	31.1	31.5	31.8	31.9	31.9	32.0	32.0
TWD /EUR, end-quarter	39.6	38.4	39.3	38.9	39.4	39.8	39.9	39.9	40.0	40.0

Source: CEIC, HSBC forecasts

Chart 1. GDP growth has had a good start ...

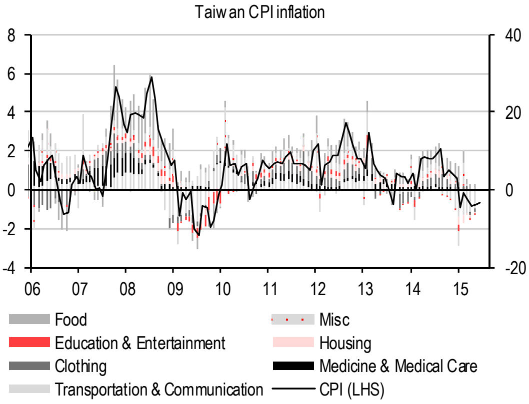


Source: CEIC, HSBC

... however, headwinds from weak global activity remain

- Growth in Q1 2015 held steady, with the economy growing by 3.4% y-o-y, revised down from the initial 3.5% y-o-y estimate.
- The main contributors to growth were private consumption and net exports. The latter however was driven by a bigger drop in imports owing to low oil prices.
- With trade at 130% of GDP, a weak external environment could hamper the growth prospects for the open economy. Export orders, which are a leading indicator of export performance , have been falling driven largely by the slowdown in China and recent weakness in the US data.
- We forecast GDP to grow by 3.5% in 2015, however given the challenging global environment, the risks to growth are on the downside.

Chart 2. CPI has been in deflation since the start of the year ...



Source: CEIC, HSBC

... and we expect the CBC to act by cutting rates twice this year

- CPI inflation has been on a deflationary trend since the start of the year and we believe that this is likely to be a theme that persists until Q4.
- Not only has headline inflation been extremely low, but core inflation (excluding energy and food prices) has also been on the weaker side. Furthermore, the downward pressure on prices are also reflected in the input and output prices sub-indices in the Markit PMI, which have continued to remain in contractionary territory.
- We forecast full year inflation at -0.2% y-o-y in 2015, which is well below the downwardly revised official forecast of 0.1%. We also expect the CBC to cut interest rates twice this year, in order to stave off deflationary risks.

Chart 3. The labour market has remained resilient ...

Source: DataStream, HSBC

... and consumer confidence has touched historic highs

- The labour market however, continues to remain a bright spot for the economy, with the unemployment rate hovering close to the lowest levels of 2008.
- Stable wage growth, coupled with falling inflation could boost real incomes in the short run. Furthermore, consumer confidence has also been strong, hitting record highs this year. All of these could boost domestic demand and improve growth.
- However, the recent weakness in the PMI suggests that economic activity has been sluggish in recent months. Additionally, global growth remains weak and trade volumes have been poor. These factors, if persistent, could halt the momentum in the labour market later this year.

Taiwan: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	10.6	3.8	2.1	2.2	3.8	3.5	3.5
Nominal GDP (USD bn)	446.7	485.4	497.3	510.5	528.6	535.7	551.8
GDP per capita (USD)	18,503	20,057	20,423	20,952	22,692	22,970	23,634
Private consumption (% y-o-y)	3.8	3.1	1.8	2.4	3.0	2.0	3.5
Government consumption (% y-o-y)	1.0	2.0	2.2	-1.2	3.7	-0.9	1.8
Investment (% y-o-y)	19.3	-1.1	-2.6	5.0	1.8	1.3	4.1
Net Exports (contribution to GDP growth, ppt)	-0.3	3.4	1.5	0.4	0.6	2.5	0.5
Industrial production (% y-o-y)	24.2	4.4	-0.2	0.7	6.4	3.1	6.6
Gross domestic saving (% GDP)	32.2	30.6	30.5	31.6	34.2	36.4	38.0
Unemployment rate, ave (%)	5.2	4.3	4.2	4.2	3.9	3.7	3.4
Prices & wages							
CPI, average (% y-o-y)	1.0	1.4	1.9	0.8	1.2	-0.2	1.5
CPI, end-year (% y-o-y)	1.2	2.0	1.6	0.3	0.6	0.6	1.5
Core CPI, average (% y-o-y)	0.6	1.3	1.0	0.7	1.3	0.1	1.2
Core CPI, end-year (% y-o-y)	1.1	1.3	1.1	0.2	1.4	0.3	1.4
WPI, average (% y-o-y)	5.5	4.3	-1.2	-2.4	-0.6	-2.0	1.6
WPI, end-year (% y-o-y)	2.3	4.3	-4.0	0.0	-4.8	1.0	1.4
Manufacturing wages, nominal (% y-o-y)	8.4	2.3	0.8	0.3	3.2	3.0	3.0
Money, FX & interest rates							
Central bank money M0, average (% y-o-y)	7.2	9.2	5.9	7.9	5.9	6.3	6.4
Broad money supply M2, average (% y-o-y)	4.5	5.8	4.2	4.8	5.7	5.6	5.6
Real private sector credit growth (% y-o-y)	3.1	3.1	0.3	2.3	2.7	3.7	2.9
Policy rate, end-year (%)	1.625	1.875	1.875	1.875	1.875	1.625	1.625
5yr yield, end-year (%)	1.10	0.99	0.89	1.17	1.17	1.60	1.60
TWD /USD, end-year	30.4	30.3	29.1	30.0	31.7	31.8	32.0
TWD /USD, average	31.6	29.5	29.5	29.8	30.4	31.3	31.9
TWD /EUR, end-year	40.6	39.2	38.4	38.9	38.4	39.8	40.0
TWD /EUR, average	41.7	41.3	38.2	39.4	39.8	39.0	40.0
External sector							
Merchandise exports (USD bn) (BOP, goods)	273.8	306.0	299.1	303.2	311.4	323.0	345.7
Merchandise imports (USD bn) (BOP, goods)	247.3	279.4	269.1	267.8	269.9	278.7	315.3
Trade balance (USD bn) (BOP, goods)	26.5	26.5	29.9	35.5	41.5	44.2	30.4
Current account balance (USD bn)	39.9	39.9	49.0	55.3	65.4	65.7	60.3
Current account balance (% GDP)	8.9	8.2	9.9	10.8	12.4	12.3	10.9
Net FDI (USD bn)	-9.1	-14.7	-9.9	-10.7	-9.9	-8.3	-8.8
Net FDI (% GDP)	-2.0	-3.0	-2.0	-2.1	-1.9	-1.5	-1.6
Current account balance plus FDI (% GDP)	6.9	5.2	7.9	8.7	10.5	10.7	9.3
Exports, value (% y-o-y) (BOP, goods)	34.6	11.7	-2.3	1.4	2.7	3.7	7.0
Imports, value (% y-o-y) (BOP, goods)	43.1	13.0	-3.7	-0.5	0.8	3.3	13.1
International FX reserves (USD bn)	382	386	403	417	419	410	410
Import cover (months)	18.5	16.6	18.0	18.7	18.6	17.7	15.6
Public and external solvency indicators							
Financial institutions' FX assets (USD bn)	571.3	665.5	699.2	785.5	890.9	943.1	1,018.1
Gross external debt (USD bn)	101.6	122.5	130.8	170.1	177.9	197.5	223.0
Gross external debt (% GDP)	22.7	25.2	26.3	33.3	33.7	36.9	40.4
Private sector external debt (USD bn)	93.5	118.0	127.5	167.8	176.1	195.0	220.0
Central government balance (% GDP)	-1.1	-0.4	-1.5	-0.8	-0.8	-0.7	-0.7
Central government domestic debt (TWD bn)	4,538	4,764	5,011	5,136	5,264	5,389	5,515
Central Government domestic debt (% GDP)	32.1	33.3	34.1	33.7	32.7	32.1	31.3
Gross public external debt (USD bn)	8.0	4.5	3.3	2.3	1.9	2.5	3.0
Gross public external debt (% GDP)	1.8	0.9	0.7	0.5	0.4	0.5	0.5
Gross public sector debt (% GDP)	38.3	40.1	41.0	41.3	40.8	39.9	38.8
Macro prudential indicators							
CAR – Tier 1	9.18	9.08	9.49	9.14	n/a	n/a	n/a
CAR – Total	12.0	12.1	12.6	11.9	n/a	n/a	n/a
Non-performing loan ratio	0.60	0.42	0.39	0.36	0.24	n/a	n/a
Household Debt/ GDP (%)	84.2	84.7	85.2	n/a	n/a	n/a	n/a
Total Credit/GDP (%)	132.7	138.5	138.7	137.8	136.4	n/a	n/a
Residential house price – Taipei city (%y-o-y)	20.7	11.0	7.1	11.7	2.0	n/a	n/a
Residential house price – Taiwan area (%y-o-y)	17.0	13.9	8.9	14.5	6.4	n/a	n/a
Loan/deposit ratio	71.6	72.0	71.7	70.5	69.9	n/a	n/a
Stock Market Capitalisation/GDP (%)	175.7	140.2	151.7	168.4	n/a	n/a	n/a

Note: Public debt refers to government debt only.
Source: CEIC, ADB, IMF, HSBC forecasts

HSBC

Thailand

Uncertainties on two fronts

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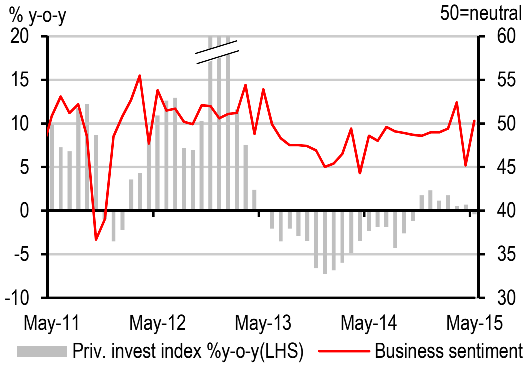
The economy grew 3% y-o-y in Q1 2015 and sustained four straight quarters of expansion in sequential terms. Nevertheless, the pace of growth has decelerated to 0.3% q-o-q sa from 1.1% in 4Q 2014. The main drag has been goods exports, due to weak demand in East Asia and structural issues domestically. Private consumption and investment have stayed sluggish due to weak sentiment, high leverage, and low income growth. In light of the tepid recovery so far, as well as persistent negative risks for exports, we lower our 2015 GDP growth forecast further to 3.1% from 3.6%. Given the benign price pressures in 1H, we also lower 2015 headline inflation forecast to -0.4% from 0.0%, but expect inflation to rebound to 2.3% in 2016 as the energy price effect fades.

To pre-empt further downside risks to growth, we expect the Bank of Thailand (BoT) to deliver one more 25bps policy rate cut, to 1.25%, possibly as soon as 3Q 2015. There will also be more fiscal stimulus. In April, the government approved a supplementary budget of THB78bn (0.6% of GDP) to expedite road construction and water-management projects. About half of this is planned for disbursement in 2015, and the rest in 2016 and 2017. Nevertheless, the consolidated budget deficit is expected to be close to our previous forecast – we had earlier assumed a bigger spending budget and fiscal revenue is partly supported by higher oil tax collection and the telecom-sector bandwidth auction.

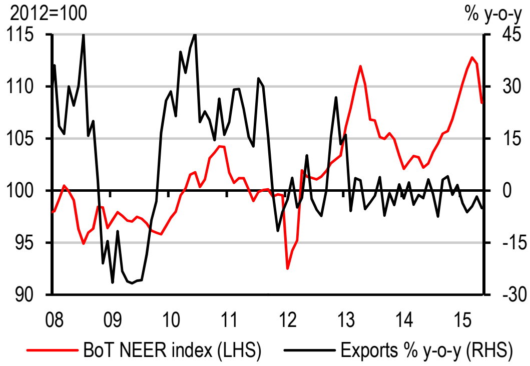
Uncertainties have also surfaced on the political front. The government now expects the next election to be held in 3Q 2016 instead of 1Q, but subject to the National Reform Council's and the public's acceptance of the draft charter by early 2016. Although the economic recovery should be maintained in the absence of political unrest, we are concerned that prolonged uncertainty could restrain private investment.

Business sentiment is fragile, affecting investment spending



Source: CEIC, HSBC

BoT changed its tone on the currency due to tepid exports



Source: CEIC, HSBC

Policy issues

The BoT has welcomed the recent weakness in the Thai baht by saying that it is positive for the economic recovery. This change of tone, departing from the 'limited interventionist' stance, was partly a response to tepid export growth. But apart from announcing further relaxation of FX and capital flow regulations on 30 April (the bulk of these implemented between 2010-13), foreign reserves do not suggest an aggressive selling of Thai baht. The BoT's nominal effective exchange rate has not risen since April. The BoT is likely to continue curbing FX volatility and ensure that the Thai baht moves in line with regional currencies.

In Q3 the Ministry of Finance (MoF) will unveil a plan to restructure THB720bn of public debt – most arising from rice subsidies. Apart from issuing new debt, the MoF will sell stakes in unprofitable businesses (excluding listed companies). The expected outcome is a reduction of the debt servicing burden and lower leverage in a few state enterprises. The MoF said this was necessary since the new inheritance tax will not provide a big boost to fiscal revenue and property tax legislation is still underway. Also, the consumption tax rate will remain at 7% until the economy is on a firmer footing. We think that taking an active stance for long-term fiscal health management is positive, especially in the anticipation of rising spending needs for infrastructure and social welfare, and uncertainties in borrowing costs.

Risks

Risks to growth remain biased to the downside, mainly due to weak exports and farm income growth. The timing of public infrastructure project implementation remains uncertain, but if spending is accelerated, it could boost both domestic demand and private sector confidence. Separately, severe drought is threatening to reduce agriculture output significantly, according to the Office of Agricultural Economics. The sector accounts for 7% of GDP, but a lion share of the labour force (>35%) will be affected.

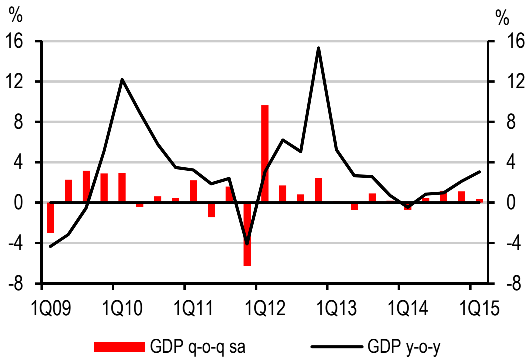
The nationwide THB300 daily minimum wage, frozen since a 40% rise in 2013, is due for review in 2016. Workers' associations have proposed a 20% increase. The wage increase, if substantial, would hurt business profits, particularly among small businesses, in an environment of a tight labour market. However, private consumption will likely be supported. Meanwhile, the government may re-adopt the variable-wage system to better reflect costs and competitiveness in different regions.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	1.0	2.1	3.0	1.8	6.6	1.2	-1.9	4.1	6.6	4.5
GDP sa (% q-o-q)	1.2	1.1	0.3	-0.9	6.0	-4.0	-2.7	5.2	8.5	-5.9
Industrial production (% y-o-y)	-3.9	-2.3	0.1	2.1	2.2	3.3	4.6	3.6	3.0	2.4
CPI, (% q-o-q saar)	-0.2	-0.7	-3.1	-0.4	2.2	3.4	2.6	1.0	2.6	3.5
CPI, average (% y-o-y)	2.0	1.1	-0.5	-1.1	-0.5	0.5	2.0	2.3	2.4	2.4
PPI, average (% y-o-y)	-1.1	-3.6	-5.0	-3.7	n/a	n/a	n/a	n/a	n/a	n/a
Exports, value (% y-o-y)	-1.8	1.5	-4.3	-3.0	0.6	2.0	3.7	3.5	3.3	1.4
Imports, value (% y-o-y)	-0.8	-5.8	-7.2	-8.0	2.5	3.1	4.1	6.0	4.5	7.1
Trade balance (% GDP)	4.7	7.5	7.1	8.5	3.7	7.1	7.5	7.2	3.0	4.1
Current account (% GDP)	-0.5	8.7	7.9	3.4	0.2	6.7	8.4	2.7	0.4	5.4
International reserves (USD bn)	153	149	148	148	149	152	157	161	161	164
Policy rate, end-quarter (%)	2.00	2.00	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25
5yr yield, end-quarter (%)	3.04	2.47	2.38	2.37	2.30	2.40	2.50	2.60	2.80	2.80
THB /USD, end-quarter	32.1	32.7	32.6	33.3	33.6	33.7	33.8	33.9	34.0	34.1
THB /EUR, end-quarter	40.4	39.6	34.9	36.6	35.3	35.4	36.2	36.6	37.4	37.5

Source: CEIC, HSBC forecasts

HSBC

GDP continues to grow, at least in the past 4 quarters …

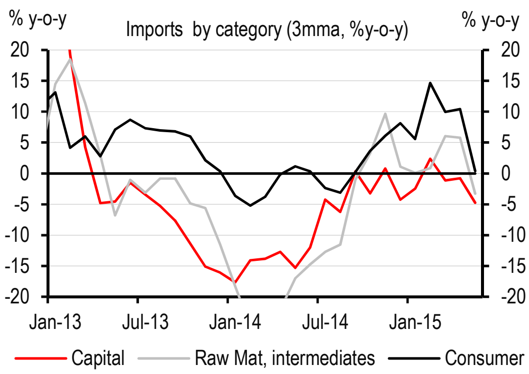


Source: CEIC, HSBC

… but momentum has slowed as exports have weakened

- In 1Q 15, GDP expanded at a slower pace of 0.3% q-o-q sa in sequential terms vs. 1.1% in 4Q 14. Public investment and services exports accelerated, but private spending grew at a moderate pace. Goods exports were a key drag.
- The BoT kept its policy rate at 1.50% on 10 June, following two surprise cuts earlier. We expect one more 25bps rate cut in 3Q 15 and no hikes through 2016. Headline inflation is likely to turn positive in 4Q 15 but stay low through 2016.
- GDP data is now based on a chained volume measure (CVM) instead of a fixed-weighted measure. Nominal GDP in 2014 is thus adjusted upwards by 8.3% to THB 13.1trn. Thus, the household debt ratio is lowered to 80% from 86%; and public debt ratio is lowered to 46.3% from 42.7%.

Weak imports reflect weak external and domestic demand …

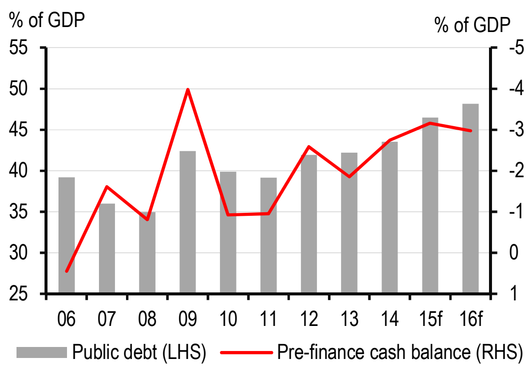


Source: CEIC, HSBC calculations

… but also support current account position

- Exports (BPM6) fell -4.1% y-o-y in the first 5 months, and will likely record a 0.9% contraction this year, partly due to lower commodity prices and the bleak outlook on external demand. Also, structural issues such as reduced competitive advantage in some sectors will likely take time to resolve.
- Imports contracted 10.3% y-o-y, mainly due to lower energy bills. Separately, deceleration of imports in raw materials and intermediate goods suggests that export orders remained tepid.
- The current account surplus has averaged USD 2.3bn a month from January-May, as higher trade surpluses offset seasonal income outflows.
- The direct investment account also recorded a net inflow of USD 4.1bn in the first 4 months (vs. USD 3.7bn last year), and provided a counterbalance to portfolio outflows.

A slightly more aggressive budget planned for FY16…



Note: Both measures in fiscal year (Oct-Sep)
Source: CEIC, HSBC

…to ensure sufficient support for the economy

- In the first 8 months, fiscal expenditure grew 5.5% y-o-y on the back of stimulus efforts. This came from the 63% disbursement of the total budget (regular + investment + carry – over). Meanwhile, fiscal revenue grew 4.8% y-o-y, supported by robust oil tax revenues and income from telecom bandwidth auctions.
- The fiscal cash deficit (pre-finance) rose to 4.1% of GDP so far (THB543bn), but should decline to our forecast of 3.2% at end-FY15 as seasonal corporate tax payment start to build.
- The government plans to increase fiscal spending by 5.6% in FY16 to ensure continued support for the economy. Investment budget will be raised by 20% raise (4% of GDP). The planned budget deficit (2.8% at THB390bn) is a more realistic fiscal gap vs. the 2% gap in FY15. Still, we forecast a shortfall of 3%.

Thailand: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	7.5	0.8	7.3	2.8	0.9	3.1	3.3
Nominal GDP (USD bn)	343.5	369.1	398.9	415.5	404.8	404.7	420.8
GDP per capita (USD)	5,094	5,450	5,864	6,076	5,890	5,860	6,062
Private consumption (% y-o-y)	5.0	1.8	6.3	0.8	0.6	2.2	3.1
Government consumption (% y-o-y)	9.3	3.4	7.5	4.7	1.7	3.4	4.3
Investment (% y-o-y)	11.6	4.9	10.2	-0.8	-2.6	4.7	4.2
Net Exports (contribution to GDP growth, ppt)	-3.9	-1.8	-0.5	1.1	4.0	-0.4	1.4
Industrial production (% y-o-y)	14.2	-8.5	2.2	-3.2	-4.6	1.9	3.4
Gross domestic saving (% GDP)	32.0	31.0	30.8	31.1	30.6	28.7	27.8
Unemployment rate, end-year (%)	0.8	0.6	0.5	0.6	0.6	0.8	0.8
Prices & wages							
CPI, average (% y-o-y)	3.3	3.8	3.0	2.2	1.9	-0.4	2.3
CPI, end-year (% y-o-y)	3.1	3.5	3.6	1.7	0.6	1.1	2.4
Core CPI, average (% y-o-y)	1.0	2.4	2.1	0.9	1.6	1.0	1.4
Core CPI, end-year (% y-o-y)	1.2	2.8	1.8	0.8	1.7	0.9	1.6
PPI, average (% y-o-y)	10.0	5.1	0.6	0.6	-0.5	n/a	n/a
PPI, end-year (% y-o-y)	6.3	4.1	0.9	0.4	-2.2	n/a	n/a
Manufacturing wages, nominal (% y-o-y)	3.1	6.4	20.6	9.6	9.2	6.3	12.0
Money, FX & interest rates							
Central bank money M0, end (% y-o-y)	12.7	9.8	9.7	5.6	5.4	n/a	n/a
Broad money supply M2, end (% y-o-y)	10.9	15.1	10.4	7.3	4.7	4.9	5.1
Real private sector credit growth (% y-o-y)	6.6	10.6	12.6	9.4	1.9	4.9	3.5
Policy rate, end-year (%)	2.00	3.25	2.75	2.25	2.00	1.25	1.25
5yr yield, end-year (%)	3.28	3.12	3.18	3.50	2.47	2.40	2.80
THB /USD, end-year	30.0	31.0	30.7	31.7	32.7	33.7	34.1
THB /USD, average	31.5	30.6	31.0	31.1	32.5	33.4	33.9
THB /EUR, end-year	40.1	40.2	40.5	43.7	39.6	35.4	37.5
THB /EUR, average	41.5	42.3	40.0	41.1	43.1	36.3	36.7
External sector							
Merchandise exports (USD bn)	191.6	219.1	225.7	225.4	224.8	222.2	228.8
Merchandise imports (USD bn)	161.9	202.1	219.1	218.7	200.2	195.5	206.1
Trade balance (USD bn)	29.8	17.0	6.7	6.7	24.6	26.7	22.7
Current account balance (USD bn)	10.0	8.9	-1.5	-3.9	13.4	18.5	17.5
Current account balance (% GDP)	2.9	2.4	-0.4	-0.9	3.3	4.6	4.2
Net FDI (USD bn)	4.5	-4.7	-1.4	2.1	5.0	6.0	6.0
Net FDI (% GDP)	1.3	-1.3	-0.3	0.5	1.2	1.5	1.4
Current account balance plus FDI (% GDP)	4.2	1.1	-0.7	-0.4	4.5	6.1	5.6
Exports, value (% y-o-y)	27.1	14.3	3.0	-0.1	-0.3	-1.1	3.0
Imports, value (% y-o-y)	37.0	24.9	8.4	-0.1	-8.5	-2.4	5.4
International FX reserves (USD bn)	165.7	165.2	171.1	159.0	149.1	152.3	164.4
Import cover (months)	12.3	9.8	9.4	8.7	8.9	9.4	9.6
Public and external solvency indicators							
Gross external debt (USD bn)	100.6	104.3	130.7	141.9	140.7	144.0	148.0
Gross external debt (% GDP)	29.3	28.3	32.8	34.2	34.8	35.6	35.2
Short term external debt (% of int'l reserves)	30.6	28.6	34.0	38.9	38.0	39.1	38.1
Private sector external debt (USD bn)	87.9	88.1	104.5	116.7	115.4	118.4	121.4
Central government balance (% GDP)*	-0.9	-1.0	-2.6	-1.9	-2.7	-3.2	-3.0
Public domestic debt (THB bn)	3,868	4,098	4,597	5,052	5,333	5,895	6,455
Public domestic debt (% GDP)	35.8	36.3	37.2	39.1	40.6	43.7	45.3
Public external debt (USD bn)	11.9	11.3	11.1	12.0	11.0	11.3	12.2
Public external debt (% GDP)	3.5	3.1	2.8	2.9	2.7	2.8	2.9
Public sector debt (% GDP)	39.9	39.1	41.9	42.2	43.5	46.5	48.1
Macro-prudential indicators							
CAR: Capital Funds/Risk Assets (%)	16.5	15.5	15.6	15.9	16.3	n/a	n/a
CAR: Tier 1 Capital/Risk Assets (%)	16.4	15.4	15.4	15.7	16.0	n/a	n/a
Non-performing loan ratio	4.6	3.2	2.7	2.4	2.4	n/a	n/a
Household Debt/ GDP (%)	57.9	62.6	70.0	73.8	78.1	n/a	n/a
Total Credit/GDP (%)**	79.4	85.8	90.7	94.2	96.4	n/a	n/a
Residential House prices (% y-o-y)	2.6	5.7	4.0	5.5	7.0	n/a	n/a
Loan/Deposit ratio	114.3	124.4	113.7	111.8	109.4	n/a	n/a
Stock Market Capitalization/GDP (%)	69.2	73.4	89.4	96.7	103.1	n/a	n/a

*On FY basis, e.g. 2012 refers to Sept 2011 to Oct 2012.
**Credit refers to commercial bank loans
Source: CEIC, ADB, IMF; HSBC forecasts

Vietnam

Open for business: trade and investment

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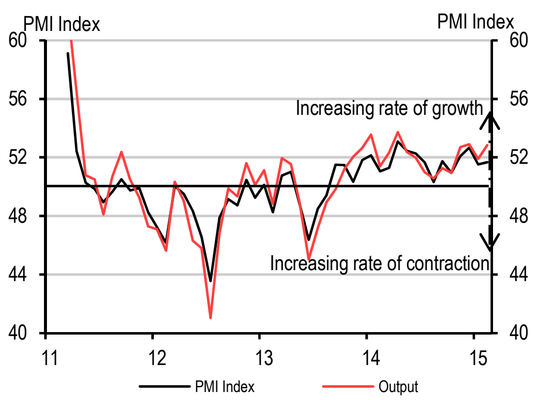
With all the turbulence in the world, Vietnam stands out with more upbeat news flow and economic data. Exports accelerated in June by 18% y-o-y, and taking the year-to-date growth close to 10%. The PMI is equally positive, expanding sharply in Q2 2015. While the June number decelerated to 52.2 from 54.8, the leading indicator – new orders minus inventories – rose sharply, suggesting output will rise in the months ahead. Credit growth, too, picked up to 17% y-o-y, thanks to improving demand. GDP accelerated to 6.5% y-o-y in Q2 2015 from 6.1% in Q1 2015. The manufacturing sector did most of the lifting, up 10% in H1 2015, from 8.5% in 2014.

On 29 June 2015, President Obama signed the Trade Promotion Authority (TPA), suggesting that the Trans-Pacific Partnership (TPP) negotiation may be concluded in the months ahead. This is particularly positive for Vietnam, which still does not have a free trade agreement with its largest export market – the US. The TPP also has investment and service clauses, which may force Vietnam to liberalize its protected sectors. At the same time, the Vietnamese government issued Decree 60 on its website, stating that it will remove the 49% foreign ownership cap in many sectors, with the exception of key industries such as banking, effective September 2015. Unequivocally, we believe the TPP will be very beneficial for Vietnam. The country is rich in cheap labour and the trend should continue for the next two decades. The question is whether Vietnam can move beyond the easy gains of using its cheap labour endowment. Despite numerous reforms, the state sector continues to dominate investment, contributing less to output.

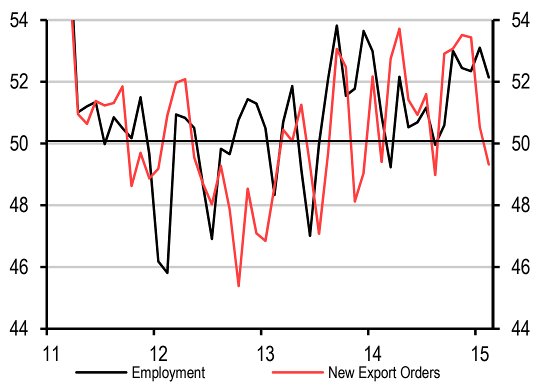
We expect GDP to accelerate in the coming years. We forecast private consumption to accelerate to 5.6% in 2015 from 5.4% in 2014. Inflation eased to 1% y-o-y in June and has remained low. We expect the expansion of credit growth, improving domestic demand and rising oil prices to put upward pressure on the CPI.

Steady growth for the manufacturing sector



Source: Markit, HSBC

Weak external demand is a concern (PMI components)



Source: CEIC, HSBC

Policy issues

The government will likely maintain its reform-minded rhetoric, taking a measured approach to mending the banking sector and state-owned enterprises. For example, the Vietnam Asset Management Company (VAMC) has identified, purchased and classified bad debts in the banking system. But it is still hesitant to ramp up reforms to improve the regulatory framework for resolving business insolvencies. The government issued a decree that allows overseas investors' holdings increase in a "number of industries to 100% from 49%", albeit without specifying which sector.

Additionally, the government stated that sectors with specific ownership regulations, such as banks, in which total foreign stakes are limited to 30%, would remain unchanged. There are no indications that the government plans to promote far-reaching privatization. On the flip side, we expect significant efforts on trade liberalization. Key trade agendas such as the TPP and Eurozone Free Trade Agreement are in the works and depend on successful negotiations regarding the service and investment areas. Major infrastructure projects are being implemented, including the building of railway systems for large urban cities as well as upgrading national highways. In politics, a leadership transition will occur in 2016. In the run up to the transition, there could be some jockeying for power; but this should not have much impact on growth.

Risks

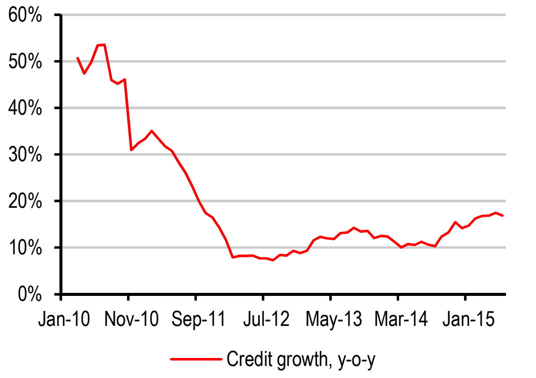
Lower oil revenues will likely hurt Vietnam's fiscal position. In 2012, oil made up 19% of total revenue. Therefore, we believe revenue collection, especially from the oil side, will decline, dragging down the fiscal balance. Thus far this year, the MOF has been unsuccessful at bond auctions due to rising credit growth and low appetite for longer tenure bonds. Resolution 78 states that the MOF can only issue 5-year or longer tenures. Recently, the MOF has accepted bids with higher coupon payments. One solution is to reduce fiscal expenditure. Another is to have Resolution 78 repealed. And a third one being proposed is using foreign reserves, which we do not expect to be implemented any time soon.

Vietnam has built up its foreign reserves to about USD34bn. While this is a large increase over past figures, the amount is still only about 2.5 months of imports. The State Bank of Vietnam (SBV) stated that it will not devalue the currency by more than 2%, which it already did in H1 2015. This means that should the VND face pressures to depreciate, the SBV would have to sell USD to support the exchange rate. External demand is another source of concern . While exports are rising, domestic firms have suffered due to the commodity-intensive nature of their exports. We expect the trade deficit to widen in 2015.

	3Q 14	4Q 14	1Q 15	2Q 15e	3Q 15f	4Q 15f	1Q 16f	2Q 16f	3Q 16f	4Q 16f
GDP (% y-o-y)	6.4	6.8	6.1	6.5	6.4	6.4	6.0	6.5	6.6	6.9
GDP sa (% q-o-q)	2.2	2.5	-1.0	1.0	2.0	2.0	-1.0	1.0	2.0	2.0
CPI, (% q-o-q saar)	3.2	0.8	-1.7	1.8	4.7	4.6	4.3	3.0	4.2	3.8
CPI, average (% y-o-y)	4.3	2.6	0.7	1.0	1.4	2.3	3.9	4.2	4.1	3.8
Exports, value (% y-o-y)	11.6	12.7	6.4	12.0	14.9	15.1	27.7	9.7	6.7	5.0
Imports, value (% y-o-y)	12.6	12.5	13.0	15.5	18.5	21.0	14.1	24.9	12.7	4.9
Trade balance (% GDP)	1.6	-0.2	-4.7	-4.2	-2.9	0.4	-3.0	-6.8	-1.3	0.1
International reserves (USDbn)	37.2	34.6	33.0	33.0	34.0	34.0	35.0	35.0	35.0	35.0
Policy rate, end quarter (%)	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
5-yr yield, end quarter (%)	5.28	6.25	5.45	6.40	n/a	n/a	n/a	n/a	n/a	n/a
VND/USD, end quarter	21,228	21,420	21,545	21,700	21,700	21,750	22,000	22,000	22,000	22,000
VND/EUR, end quarter	26,747	25,918	23,053	23,870	22,785	22,838	23,540	23,760	24,200	24,200

Source: CEIC, HSBC forecasts

Credit growth has picked up after years of lacklustre demand…

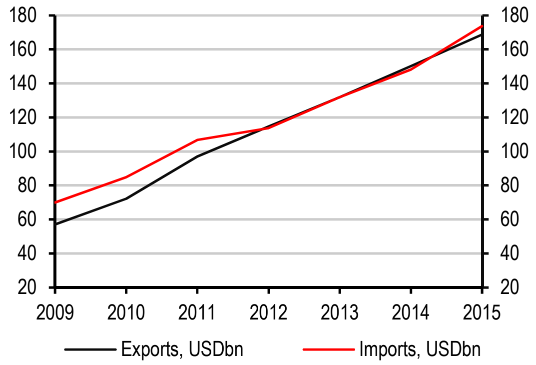


Source: CEIC, HSBC

…this suggests that domestic demand is gradually recovering

- The PMI index has shown a noticeable bounce in output since September 2013, increasing demand for headcount and quantity of purchases; rising foreign investment has helped new orders stay strong and a recent rebound in external demand has helped.
- Input prices contracted, allowing producers to pass on savings to consumers; we expect lower oil prices to have a positive supply effect on the economy, especially as Vietnam tries to industrialize and demand for energy and commodities rises.
- The real estate sector is showing signs of life, with sales of both low and higher-end properties performing well in Ho Chi Minh City
- We expect credit growth to reach 15% y-o-y in 2015; credit as a share of GDP is declining but is high at 100%. While domestic demand is improving, the still-high level of debt will remain a drag on economic activity.

The trade balance has deteriorated due to high import growth…

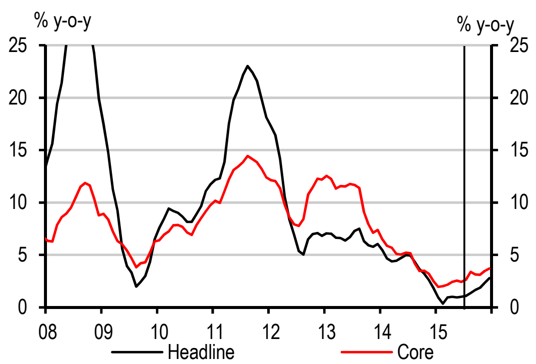


Source: CEIC, HSBC

…while export growth has slowed

- Vietnam is an export-oriented economy, with exports accounting for 81% of GDP in 2014. But sluggish global demand and an appreciating nominal and real effective exchange rate have dampened export growth.
- Rising FDI in the manufacturing sector has provided some external buffer; as a result, Vietnam enjoys the fastest growth rate of exports in Asia.
- Increased imports of automobiles and machinery have caused imports to spike, causing a deteriorating of the trade balance.
- We expect the trade balance to deteriorate this year but still not pose a balance of payments (BOP) crisis as Vietnam receives sticky remittances and FDI inflows.

Inflation has trended downward but we expect it to increase



Source: CEIC, HSBC

The SBV will keep rates on hold as credit demand is strong

- Inflation has decelerated sharply in Vietnam thanks to a glut of supply in the global commodity market and deceleration of demand in China, appreciation of the trade-weighted exchange rate and modest growth of money supply.
- The question is how long low oil prices will last; if they stay at this level, we expect inflationary pressures to be very weak.
- However, given that the economy is expected to stage a gradual recovery and taking account of the low base, risks tilt to the upside for inflation.
- We expect CPI to increase only marginally in H2 2015; the SBV should hold rates steady as it has already eased through the exchange rate channel.

Vietnam: Macro framework

	2010	2011	2012	2013	2014	2015f	2016f
Production, demand and employment							
GDP growth (% y-o-y)	6.8	6.0	5.2	5.4	6.0	6.3	6.5
Nominal GDP (USD bn)	116.0	135.5	155.8	171.2	186.2	200.5	221.5
GDP per capita (USD)	1,302	1,507	1,716	1,868	2,012	2,147	2,352
Private consumption (% y-o-y)	8.2	4.1	4.9	5.2	5.5	5.6	5.8
Government consumption (% y-o-y)	12.3	7.1	7.2	7.3	7.5	7.0	6.5
Investment (% y-o-y)	10.9	-7.8	1.9	5.3	6.2	8.5	8.0
Gross domestic saving (% GDP)	32.0	29.9	33.1	32.1	30.0	29.8	29.8
Unemployment rate, end-year (%)	4.3	4.5	4.6	4.6	5.0	5.0	5.0
Prices & wages							
CPI, average (% y-o-y)	9.2	18.7	9.1	6.6	4.1	1.4	4.0
CPI, end-year (% y-o-y)	11.8	18.1	6.8	6.0	1.8	2.8	3.9
Core CPI, average (% y-o-y)	11.6	12.0	10.7	7.0	4.0	3.7	6.1
Core CPI, end-year (% y-o-y)	9.8	12.4	12.2	7.4	2.5	3.7	4.3
PPI, average (% y-o-y)	12.6	18.4	3.4	5.3	3.0	2.1	4.0
PPI, end-year (% y-o-y)	12.6	18.4	3.4	5.3	4.0	4.2	4.2
Manufacturing wages, nominal (% y-o-y)	9.6	19.0	12.0	8.3	5.2	6.0	6.0
Money, FX & interest rates							
Broad money supply M2, average (% y-o-y)	29.7	11.9	24.5	21.4	17.7	14.0	14.0
Real private sector credit growth (% y-o-y)	32.4	14.3	8.8	12.7	14.2	15.0	15.0
Policy rate (OMO rate), end-year (%)	10.00	14.00	7.00	5.50	5.00	5.00	5.00
5yr yield, end-year (%)	11.50	12.60	9.75	8.55	6.25	n/a	n/a
VND /USD, end-year	21,034	21,034	20,843	21,095	21,420	21,750	22,000
VND /USD, average	20,842	20,842	20,871	21,087	21,269	21,674	22,000
VND /EUR, end-year	27,231	27,231	27,483	29,049	25,918	22,838	24,200
VND /EUR, average	28,709	28,709	27,126	28,025	28,193	23,570	23,788
External sector							
Merchandise exports (USD bn)	72.2	96.9	114.5	132.0	150.0	168.7	188.0
Merchandise imports (USD bn)	84.8	106.7	113.8	132.0	148.1	173.6	193.3
Trade balance (USD bn)	-12.6	-9.8	0.7	0.0	2.0	-4.9	-5.3
Current account balance (USD bn)	-4.3	0.2	9.1	9.5	6.2	5.9	6.2
Current account balance (% GDP)	-3.7	0.2	5.8	5.5	3.4	2.9	2.8
Net FDI (USD bn)	11.0	11.0	10.0	11.5	11.5	12.0	15.0
Net FDI (% GDP)	9.5	8.1	6.4	6.7	6.2	6.0	6.8
Current account balance plus FDI (% GDP)	5.8	8.3	12.3	12.2	9.5	8.9	9.6
Exports, value (% y-o-y)	26.5	34.2	18.2	15.3	13.6	12.4	11.5
Imports, value (% y-o-y)	21.3	25.8	6.6	16.0	12.1	17.3	11.3
International FX reserves (USD bn)	12.9	14.0	26.1	26.3	34.6	34.0	35.0
Import cover (months)	1.8	1.6	2.8	2.4	2.8	2.3	2.2
Public and external solvency indicators							
Gross external debt (USD bn)	51.4	51.4	60.8	66.9	71.3	76.8	84.8
Gross external debt (% GDP)	44.3	37.9	39.0	39.1	38.3	38.3	38.3
Short term external debt (% of int'l reserves)	53.8	70.9	37.9	37.7	28.6	29.1	28.3
Private sector external debt (USD bn)	23.4	19.3	25.9	30.9	33.3	36.8	44.8
Consolidated government balance (% GDP)	-2.8	-1.1	-4.8	-5.7	-6.7	-6.0	-5.9
Primary balance (% GDP)	-1.6	0.0	-3.4	-4.3	-5.2	-4.6	-4.4
Gross public domestic debt (VND trn)	28.1	31.3	40.7	52.4	64.0	74.5	86.5
Gross public domestic debt (% GDP)	24.2	23.1	26.1	30.6	34.4	37.2	39.0
Gross public external debt (USD bn)	28.0	32.0	34.9	36.0	38.0	40.0	40.0
Gross public external debt (% GDP)	24.2	23.6	22.4	21.0	20.4	19.9	18.1
Gross public sector debt (% GDP)*	48.4	46.7	48.5	51.6	54.8	57.1	57.1
Macro-prudential indicator							
Total credit/GDP (%, year-end)	114.7	101.8	94.8	96.8	100.0	n/a	n/a
Loan/deposit ratio	101.0	102.7	94.8	92.9	88.6	n/a	n/a
Stock market capitalisation/GDP (%)	31.9	25.6	32.7	56.7	55.2	n/a	n/a

Note: Public debt refers to government debt only.
Source: CEIC, ADB, IMF, HSBC forecasts

Notes

Disclosure appendix

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