Economic Research

Economic Monitors

January Issue

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Talking points

US

- *Worst quarterly GDP contraction in 26 years as consumer spending faltered for a second consecutive quarter in 4Q2008.*
- *Labour market continued to deteriorate with job losses surging to 2.6 million in 2008, the highest since 1945, with unemployment rate climbing to a 15-year high of 7.2%.*
- *International Monetary Fund (IMF) downgraded GDP growth forecast for the US to -1.6% from the previous estimate of -0.7%.*
- *Federal Reserve Bank (Fed) maintained its benchmark interest rate at 0%-0.25% while the new administration is pushing for the US$819 billion stimulus package to be quickly implemented..*

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Euro Zone

- *Economic indicators continued to flash gloomy outlook as export sector is hit by slowing demand from the US.*
- *Unemployment rate continued to rise as economic growth tumbled, signaling that the economy is nowhere near the bottom.*
- *Inflationary pressures dissipated with the decline in energy prices, providing more room for the European Central Bank (ECB) to cut rates.*
- *Fiscal pump priming could lead to more downgrades of sovereign rating as budget deficits are set to rise in 2009.*

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Japan

- *Bank of Japan (BoJ) downgraded its assessment for a third consecutive month employing the most pessimistic language to describe economic conditions since January 1998.*
- *Exports plummeted in December, pushing industrial output into severe contraction.*
- *Surging Yen is taking a toll on the export sector in particular on many car manufacturers such as Toyota and Honda electronic giant like Sony and Toshiba*

Malaysia

- *Recessions in the US, Euro Zone and Japan have become a major threat to Malaysia's external sector.*
- *Decline in exports to China is worrying as Malaysia's share of total exports to China has been on a rising trend*
- *BNM front-loaded its rate cut but bank lending is set to slow in 2009 reflected in slowing loan applications and approvals in the past 4 months.*
- *Implementation of second fiscal stimulus package will exceed the budget deficit's target of 4.8% of GDP in 2009.*

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US | Obama's new stimulus package to the rescue

Business outlook remains dismal

As anticipated, the year started off on a weak note with the ISM manufacturing index, a gauge which is highly sensitive to economic changes, drifted lower to 32.4 points in December. This was the fifth consecutive month the index fell below the 50-point level since August last year and the lowest since 1980. Likewise, industrial production fell by 2.0% month-on-month (m-o-m) in December (November: -1.3%), leading to a decline in capacity utilization rate to 73.6% (November: 75.2%), the lowest level since 1983. As demand continues to wane, businesses are likely to scale down production in order to stay afloat. As a result, many of them are expected to downsize their workforce, leading to higher unemployment in the near future.

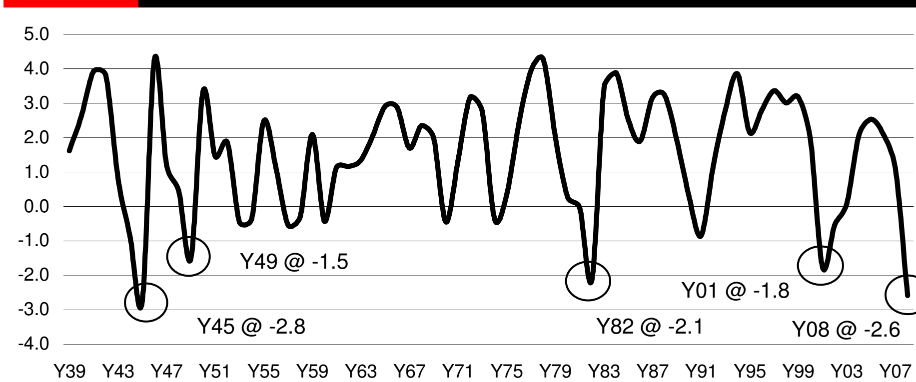
Worst economic contraction in 26 years

The economy contracted by 3.8% annual pace in the 4Q2008 (3Q2008: -0.5%), according to the preliminary estimate by the Commerce Department. The contraction was the most severe since the 4Q1982, led by a collapse in consumer spending which declined by -3.5%, the second consecutive negative growth. The back-to-back contraction exceeding 3% was the first since records began in 1947. The weakness in business sector as reflected by a 19% drop in business investment and a 28% plunge in the purchases of equipment and software compounded fears of a near collapse of the economy unless a massive stimulus package that President Obama has proposed is quickly implemented.

Weak labour market led to lower spending

Not surprisingly, job losses are expected to continue escalate even after December's non-farm payroll (NFP) snowballed to 524,000. Total job losses surged to 2.6 million for the whole of 2008, the highest since 1945 as unemployment rate soared to a 15-year high of 7.2% from 6.7% in the preceding month. On a similar note, Conference Board's consumer confidence index slipped to a record low of 37.7 points in January from 38.6 in December last year. The current situation and expectation index continued to sag to 29.9 and 43.0 points respectively (December: 30.2 and 35.0). Given the prevalent weak confidence, consumers are likely to cut back on their spending in the months to come. Retail sales statistics vindicated this view with December's figure showing a decline of 2.7% on a m-o-m basis.

Chart 1 **US Non Farm Payroll (NFP) in million**



Source: US Bureau of Labor Statistics (BLS)

IMF sees recession deepening in 2009

On January 28, the IMF revised its GDP forecast for advanced economies to -2.0% for 2009 from -0.7%, the first annual contraction during the post war period. It added that in 2010, advanced economies may register a marginal growth of 1.1%. The IMF also highlighted that the cumulative output loss is comparable to the 1974 -1975 and 1980 – 1982 i.e. periods of global oil shocks. The depth of the recession in US is expected to be more severe with a projected contraction of 1.6%, compared with an earlier estimate of a 0.7% decline. In 2010, the US economy is expected to rebound mildly with a growth rate of 1.6%. Comprehensive and coordinated financial policy actions that support a gradual normalization of financial market conditions and sizeable fiscal stimuli combined with large interest rate cuts are integral to initiate economic recovery.

Table 1: Revised forecast by IMF

			Projections	
	2007	2008	2009	2010
Wolrd Output	5.20	3.40	0.50	3.00
Advanced economies	2.70	1.00	(2.00)	1.10
United States	2.00	1.10	(1.60)	1.60
Euro Area	2.60	1.00	(2.00)	0.20
Germany	2.50	1.30	(2.50)	0.10
France	2.20	0.80	(1.90)	0.70
Italy	1.50	(0.60)	(2.10)	(0.10)
Spain	3.70	1.20	(1.70)	(0.10)
Japan	2.40	(0.30)	(2.60)	0.60
United Kingdom	3.00	0.70	(2.80)	0.20
Canada	2.70	0.60	(1.20)	1.60
Other Adv. Economies	4.60	1.90	(2.40)	2.20

Source: IMF World Economic Outlook Update, January 28, 2009

FFR was left unchanged between 0.00% - 0.25%

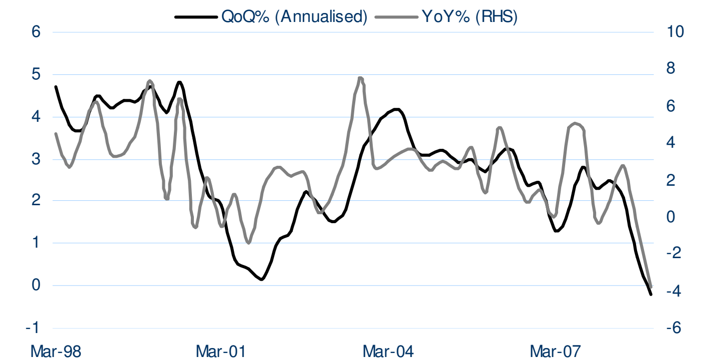
At the Federal Open Market Committee (FOMC) last meeting on January 28, the Fed left the Fed Fund Rate (FFR) unchanged at between 0.00% - 0.25%, the first pause after a series of rate cuts that began in late 2007. The weak economic conditions warrant exceptionally low levels of FFR for some time, the Fed stressed, while highlighting that its central focus will be on supporting the functioning of financial markets and stimulating the economy through an open market operation (OMO) and other measures that are likely to result in an expansion of its balance sheet. Among these are the purchases of large quantities of agency debt and mortgage backed securities and longer-term Treasury securities.

Much awaited fiscal stimulus package

As monetary policy is running out of options, a consensus for a more aggressive fiscal response needed to avert the economy from worsening has emerged, prompting the new administration under President Obama to unveil the US$819 billion fiscal package. This may result in the largest fiscal deficit since post World War. Despite facing resentment from Republicans on his plan, the US House passed the stimulus package on January 28. The Congressional Budget Office (CBO) estimated that the plan, which includes tax cuts for households and businesses as well as development spending, will boost the economy by 1.2% to 3.5% by the 4Q2010 and create between 1.2 million and 3.6 million jobs.

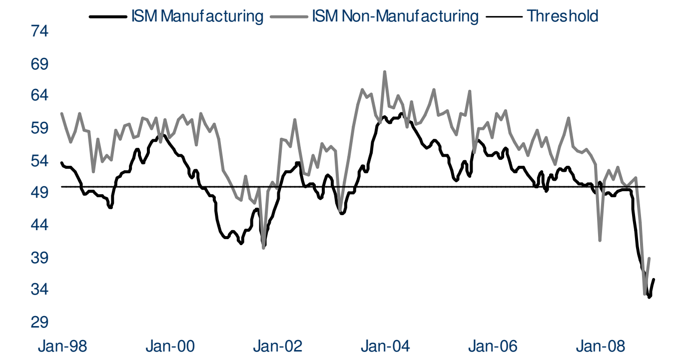
US in charts

Figure1 Economic Growth Profile



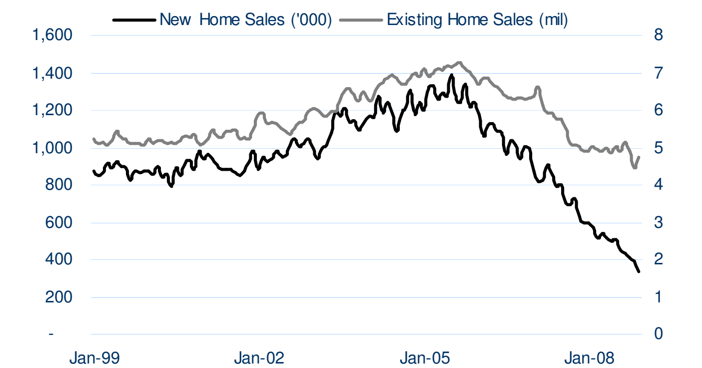
Source: Bloomberg

Figure 2 Business Activities



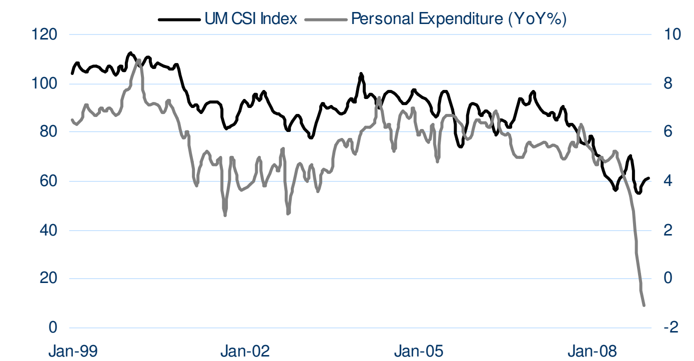
Source: Bloomberg

Figure 3 Housing Market Dynamics



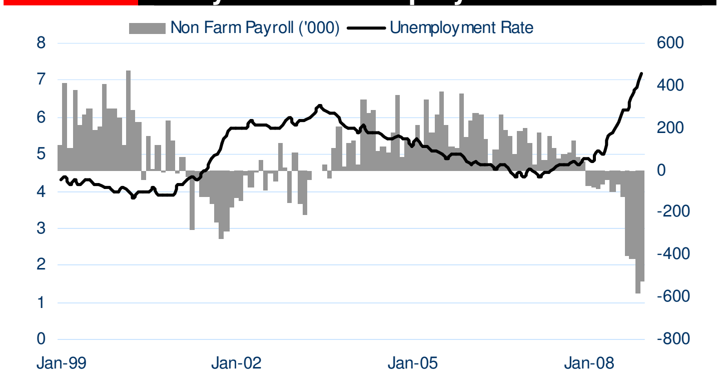
Source: Bloomberg

Figure 4 Consumer Spending & Confidence



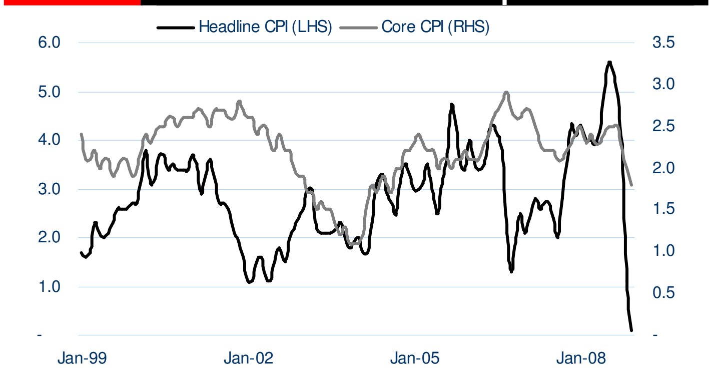
Source: Bloomberg

Figure 5 Payrolls & Unemployment Rate



Source: Bloomberg

Figure 6 Inflation Backdrop



Source: Bloomberg

Euro Zone | Budget deficit blowout

Gloomy outlook to persist

The Euro zone economic malaise is deepening as reflected by indicators that continued to flash gloomy outlook. The Composite Purchasing Managers' Index (PMI), an important gauge for business activity in the manufacturing and services sectors, fell further to 38.2 points in December 2008 compared with 43.6 and 38.9 in October and November respectively, following sharp declines in demand from the region's major trading partner, the US. Although the Euro continued to weaken against the USD, exports have failed to rebound due to lethargic demand from overseas. As demand is not expected to pick up anytime soon, manufacturers have scaled down production by 7.7% year-on-year (y-o-y) in December after declining by 2.5% and 5.7% in October and November respectively.

Deteriorating labour market

Weak consumer demand has forced many employers to layoff workers in order to preserve profit margins as well as cash flows. As a result, labour market is under tremendous pressure with unemployment rate continuing to rise. Germany, the largest economy within the Euro's economic bloc, had its unemployment rate ratcheting up to 7.8% in January this year after remaining steady at 7.6% between September and November last year.

Economic sentiment remained in doldrums

Economic Sentiment Indicator (ESI) deteriorated further to a new record low (since 1993) of 68.9 points in January compared with 78.4 and 70.4 points in November and December respectively. Industrial confidence, which accounts for about 40% of the ESI, dropped to -34 as orders for products were not forthcoming on anticipation of sliding demand. Similarly, consumer confidence (20% of ESI) dropped to -31 from -30 in the preceding month, signaling deteriorating confidence following weak labour market. Other components such as services (30% of ESI), retail (5% of ESI) and construction (5% of ESI) also remained below the boom-or-bust threshold level of 100 points, highlighting an overall weak sentiment in the economy.

Table 1: Economic Sentiment Index (ESI) and its component

	Sep-08	Oct-08	Nov-08	Dec-08	Jan-09
Economic Sentiment Index (ESI)	90.1	83.1	78.4	70.4	68.9
Industrial Confidence	-12	-18	-25	-33	-34
Services Confidence	0	-7	-12	-17	-22
Consumer Confidence	-19	-24	-25	-30	-31
Retail Confidence	-8	-13	-13	-20	-20
Construction Confidence	-15	-20	-23	-27	-30

Source: European Commission

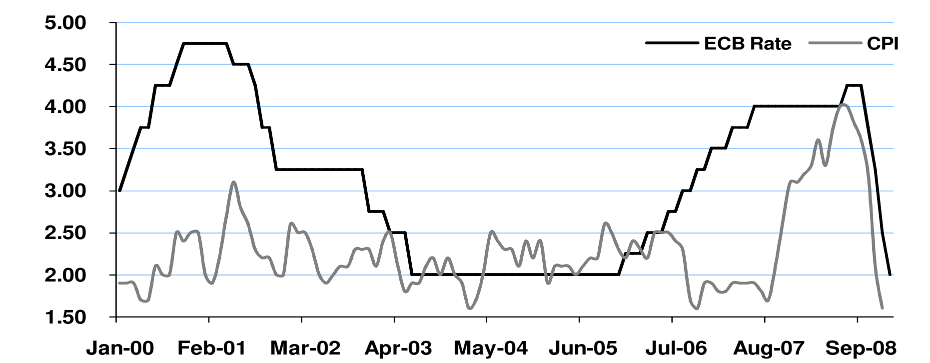
Inflationary pressure dissipated

Inflationary pressure which escalated following the upsurge in oil prices last year finally dissipated as oil prices tumbled and other commodity prices collapsed. As a result, the region's CPI slipped further, registering a 1.6% y-o-y growth in December 2008. Prior to that, the inflation rate stood at 3.2% and 2.1% in October and November last year. The recent decline in inflation rate was largely driven by the slump in energy prices which fell by 3.7% in December after registering a small positive increment of 0.7% in November last year. The core index, which excludes the energy component, moderated further to 1.8% after sustaining at 1.9% in the past few months. Due to continuous weak consumer demand, inflationary pressure is expected to remain subdued in the next several months, giving more room for the ECB to further reduce its benchmark rate.

ECB continued easing its monetary stance

As expected, the Governing Council decided to cut its main refinancing rate by 50 bps on January 15, bringing it to 2.00%. Thus far, the ECB has reduced a total 225 bps since October last year. The ECB chief, Jean Claude Trichet hinted that the next rate cut may not happen immediately as the central bank fears a rapid decline in interest rates could cause the economy to fall into a liquidity trap, a situation in which the monetary policy becomes ineffective to promote economic growth.

Chart 1 **ECB's policy rate vs CPI (%)**



Source: Bloomberg & ECB

More sovereign rating downgrades possible

At a time when fiscal pump priming is needed, a slew of sovereign rating downgrades have taken place. The S&P, in its latest move, downgraded Spain's rating by one notch to AA+ from AAA, citing the country's first recession in 15 years as the main reason that could swell its budget deficit. Greece also faced a similar fate when its sovereign rating was downgraded by one notch to A- while rating outlooks for Portugal and Ireland were revised to negative, signaling increasing likelihood of downgrades in the future.

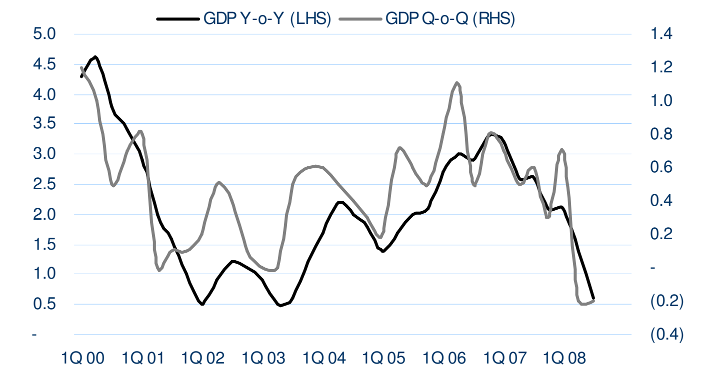
Output loss is set to widen in 2009

The IMF, in its latest World Economic Outlook Update, forecasts a widening GDP contraction for the region to 2.0% from November's estimate of -0.5%. Citing large interest rate cuts and sizeable fiscal pump priming measures as the key elements for the recovery in the region, IMF viewed the monetary policy actions alone as insufficient to pull the economy out of the slump, instead they might lead to a liquidity trap.

Given such a backdrop, we foresee several countries in the region to register fiscal deficits exceeding the 3% limit set by the European Union (EU). For instance, Ireland is expected to see its deficit to balloon to 11% of GDP while Spain, France and Germany will likely see their budget gaps to widen to 6.2%, 5.4% and 2.9% respectively in 2009. For the region as a whole, budget deficit is anticipated to reach 4.5% of GDP in 2009, up from 2.0% in 2008.

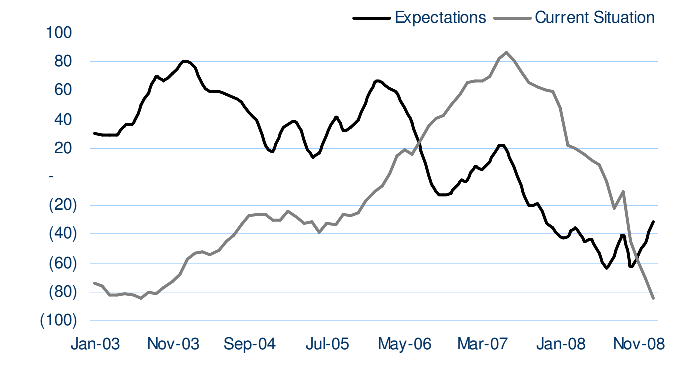
Euro Zone in charts

Figure 1 Economic Growth



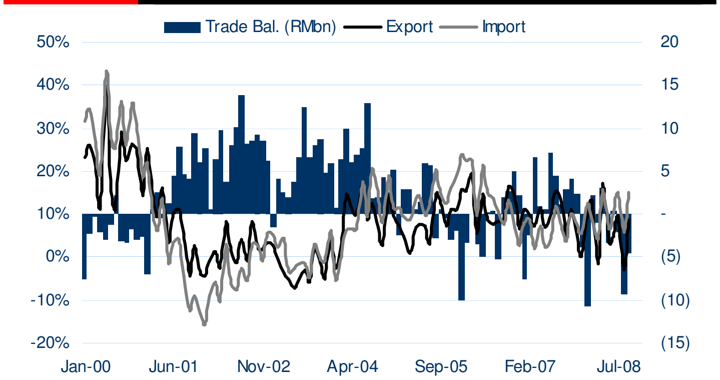
Source: Bloomberg

Figure 2 ZEW Economic Growth Index



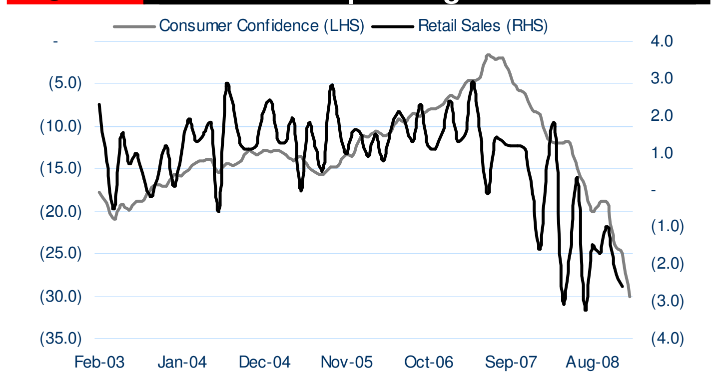
Source: Bloomberg

Figure 3 International Trade



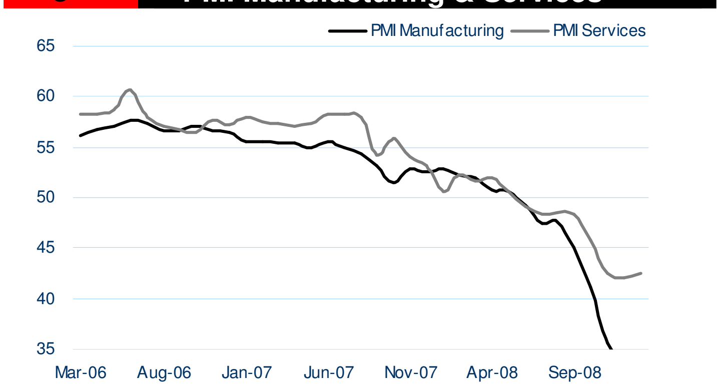
Source: Bloomberg

Figure 4 Consumer Spending & Confidence



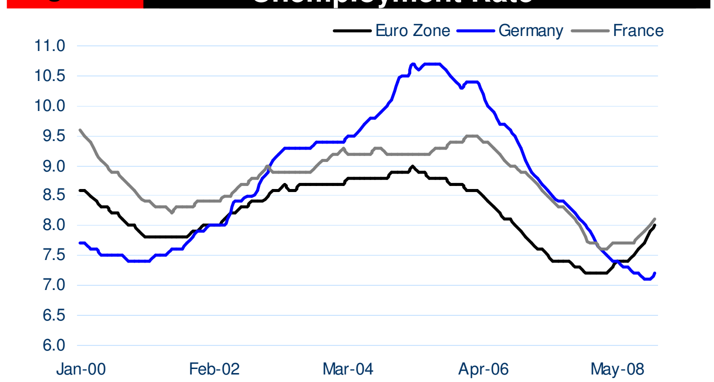
Source: Bloomberg

Fugure 5 PMI Manufacturing & Services



Source: Bloomberg

Figure 6 Unemployment Rate



Source: Bloomberg

Japan | Sinking deeper and deeper

The verdict from BoJ

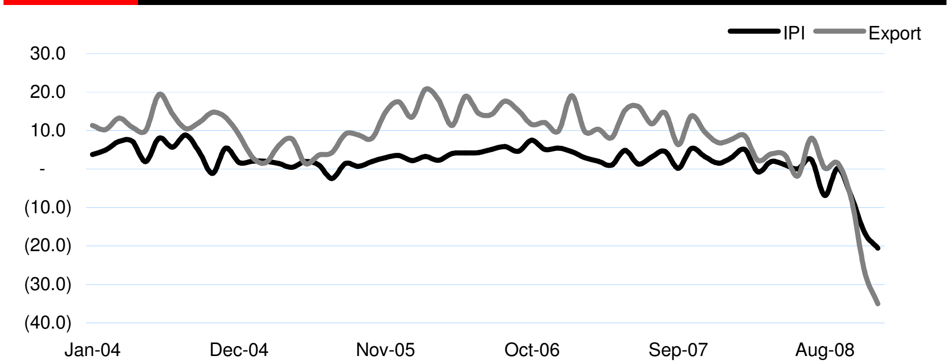
In the wake of worsening global economic conditions, the Bank of Japan (BoJ) released another downgrade in its economic assessment. Using the most pessimistic language to describe the conditions since January 1998, BoJ and expect Japan's GDP to shrink 1.8% in the year ending March 2009 and another 2% in the next year. Such a verdict was not unexpected, coming as it is on the heels of a plunge in exports in December, a sharp contraction in factory output and an escalating Yen against major world currencies.

Export and production collapsed

The weakening of global economy is taking a toll on Japan's major growth driver – the export sector. Overseas shipment plummeted by 35% y-o-y in December 2008 (Nov: -26.7%), worse than economists' prediction of a 30% decline. What is more worrying is the fact that exports to Asia, where the growth prospects are less grim have also taken a beating, contracting by 36.4% in December. Exports to China alone plunged by 35.5% as the economy slowed to a 6.8% clip in the 4Q2008. Waning demand from developed nations also led to a sharp decline in exports to US (-36.9%) and Euro (-41.8%).

Plunging exports have also paralysed Japan's industrial production. Industrial output plummeted 9.6% in December, the biggest contraction since record began. Adding to the bleak prospect for a quick recovery is the Yen's continued appreciation against major world currencies in recent months.

Chart 1 **Japan's external sector (Y-o-Y%)**



Source: Bloomberg

Yen is defying gravity

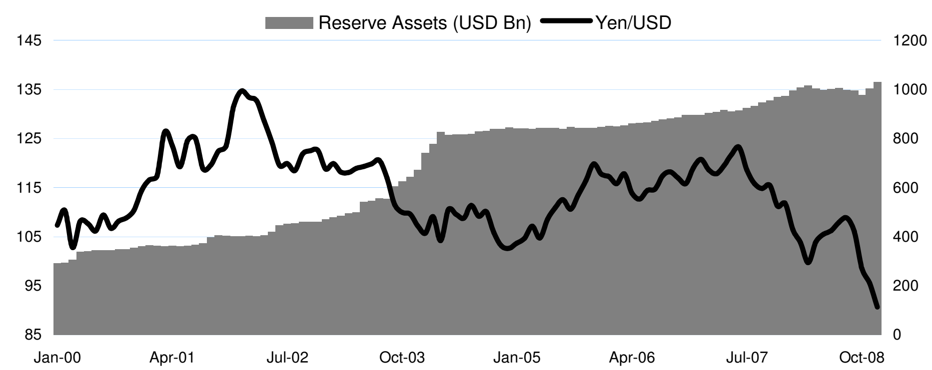
At a time when the growth engine for Japan is sputtering, Yen is surging against major world currencies, compounding the problem for the country's export sector. The strength of Yen, which is supported by a material change in global economic outlook, is not likely to fade in the near term. Against the Euro, it reached a 7-year high of 112.12 on January 21. The IMF is now projecting a 2% contraction of the Euro economy in 2009. Against the British pound, the Yen rose to a 23-year high following a report that showed the UK economy shrank the most in the 4Q2008 since 1980 while against the greenback, it recorded the biggest weekly gain in more than a month in the third week of January 2009.

The reasons for the mighty Yen are as follows:

- ► A continued surplus in Japan's current account of the balance of payments despite narrowing in recent months
- ► A resilient banking sector that has continued lending with the fastest pace in 16 years recorded in December 2008
- ► A currency considered as safe haven at a time when other major economies are crumbling

Surging Yen however, is putting downward pressures on profits of many major companies. It was reported that for every one Yen gain against the USD and Euro, Toyota's annual operating profit declines by 40 billion Yen and 6 billion Yen respectively. Similarly, a one Yen gain against the greenback will cut Honda's operating profit by about 18 billion Yen.

Chart 2 **Japans's currency vs. Reserve assets**



Source: Bloomberg

BoJ is getting aggressive and government is pushing for fiscal stimulus

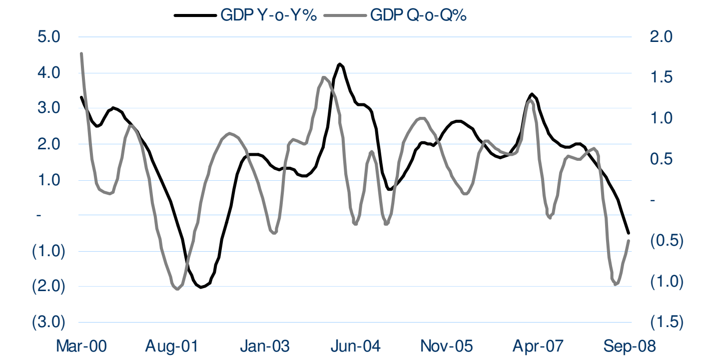
In December last year, BoJ pledged to purchase commercial papers for the first time and accepted a wider range of collaterals from lenders. This includes corporate bonds with a maturity of up to one year and A1-rated commercial papers of up to three-month maturity. The central bank will also raise the amount of bonds it buys each month in order to add more funds into the financial system.

The government is also pushing hard for more stimulus packages amounting to 4.8 trillion Yen which was recently approved by the Parliament for the Prime Minister Taro Aso. His total plan now amounted to US$277 billion (26.9 trillion yen) that includes tax cuts, direct benefits to households and loans for small businesses.

At the same time, the government is considering measures to eliminate the 40% capital gains tax to attract investments from abroad, in particular Middle Eastern sovereign funds and private equity firms. This will be in line with the government's effort to retain its leading position in the Asia's leading financial industry.

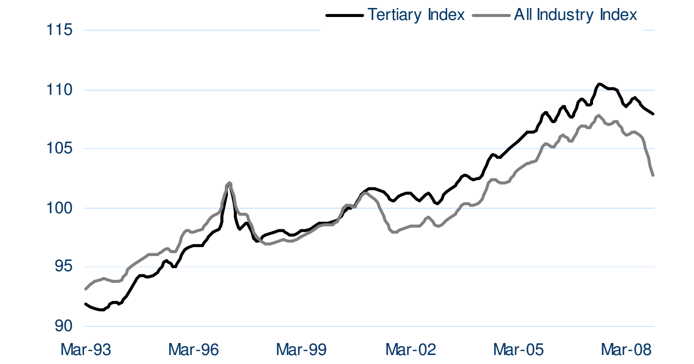
Japan in charts

Figure 1 Economic Growth



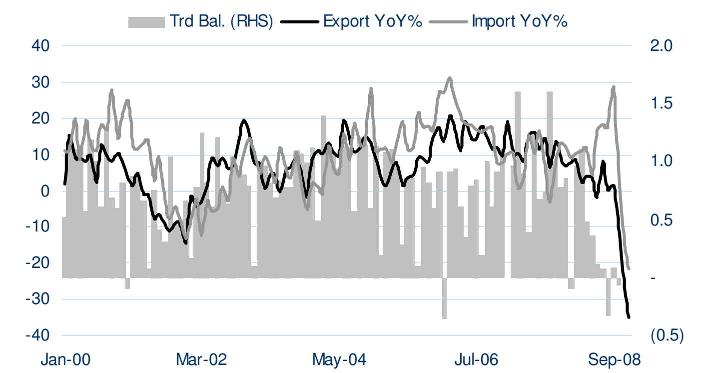
Source: Bloomberg

Figure 2 Tertiary & All-Industry Index



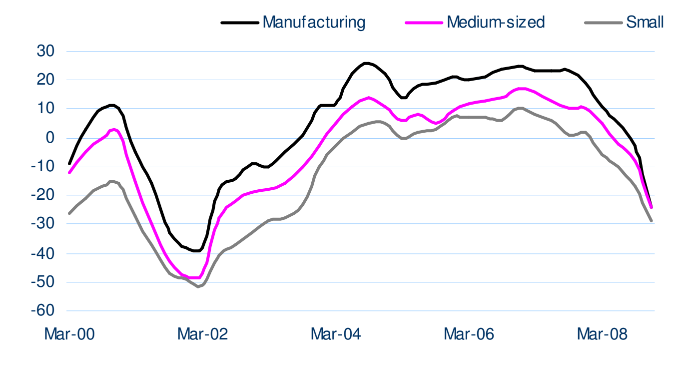
Source: Bloomberg

Figure 3 International Trade



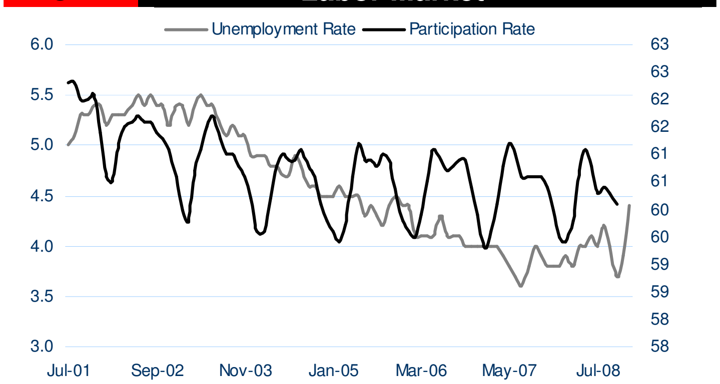
Source: Bloomberg

Figure 4 Tankan Survey



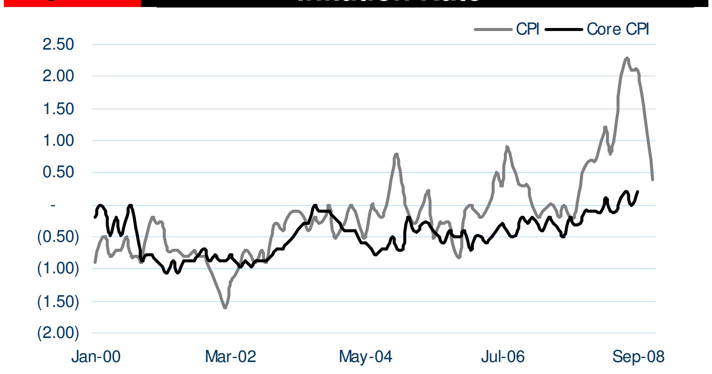
Source: Bloomberg

Fugure 5 Labor Market



Source: Bloomberg

Figure 6 Inflation Rate



Source: Bloomberg

Malaysia | Hit by external storm

A challenging year for Malaysian economy

Recessions in the US, Euro Zone and Japan have become a major threat to Malaysia's external sector. Two consecutive monthly contractions in exports in September and October last year suggest that the worst is yet to come. More importantly, weaknesses in the external sector have also led to rising retrenchments in export-oriented industries that have become a major issue among policy makers. A failure to curtail the rise in unemployment will drastically affect private consumption, the key pillar for the economy and thereby potentially causing economic activity to grind to a halt, leading to a full blown recession.

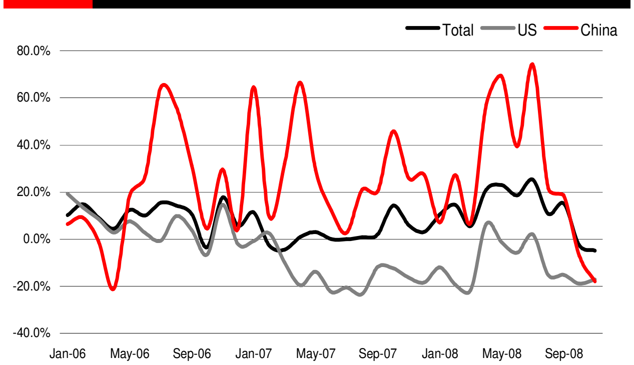
Weakness of China spells trouble for Malaysia

Malaysian exports which have contracted in two consecutive months in October (-2.6%) and November (-4.9%) will remain lackluster as demand for electronic products continues to fizzle. In particular, demand from the US has significantly dropped, evidenced by contractions in the value of shipments since December 2006. The latest statistics in November 2008 showed exports to US declined further by 17.2% after a 18.9% drop recorded in the preceding month. Exports to another key destination, China, also fell by 18.0% in November last year, after declining by 7.1% in the earlier month. This was a stark contrast with the earlier 9 months which saw Malaysia's exports to China growing by 35.7%.

The declining trend in exports to China is worrisome considering the fact that Malaysia's share of total exports to the country has consistently increased since the beginning of the new millennium (see Chart 2). The latest GDP forecast by the IMF suggests that China's economic growth will moderate to 6.7% in 2009, far lower than the minimum growth of 8.0%, critical in the government's view to ensure sufficient jobs for its growing urban population.

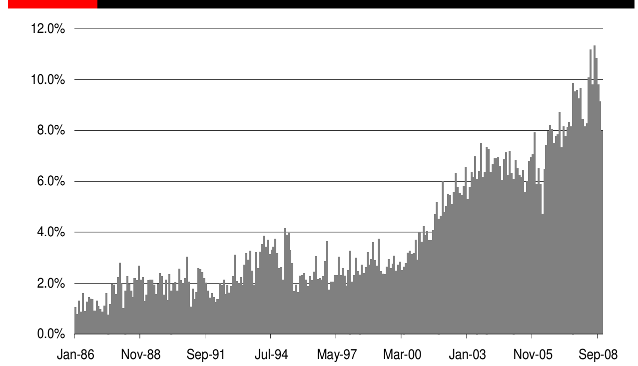
Against such backdrop, we do not foresee a quick recovery for Malaysia's export sector. As major economies are expected to bottom only in the 2H2009, Malaysia's exports will likely rebound towards the end of the year. As such we see a significant downside risk to our exports growth forecast of -0.5% for this year.

Chart 1 Exports growth y-o-y%



Source: CEIC

Chart 2 China's export as % of total export



Source: CEIC

BNM front-loaded its monetary easing campaign

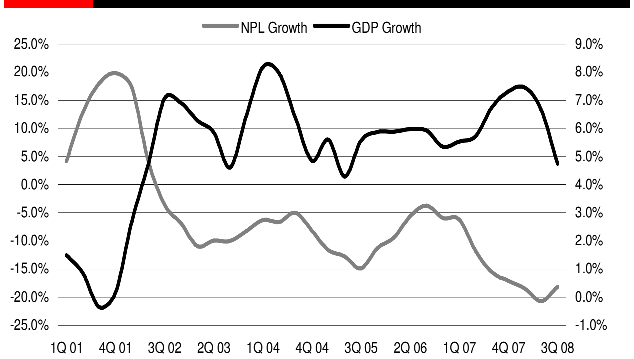
As the downward risk to growth increases, Malaysia's central bank took a swift action by front-loading its monetary easing campaign. On January 21, the BNM slashed its policy rates by a more-than-expected 75 bps, bringing the overnight policy rate (OPR) to 2.50%. The OPR's upper and lower corridor was also lowered to 2.75% and 2.25% respectively. At the same time, the Statutory Reserve Requirement (SRR) was cut significantly by 150 bps to 2.00%. Our estimate suggests that the steep reduction in SRR would release a total of RM9.6 billion worth of liquidity into the banking system that could translate into higher bank lending.

In view of the sizeable cut in the policy rate, we believe the BNM would keep the OPR unchanged in the near term. However, should the macro picture worsens, another rate cut cannot be ruled out in 2009. Thus far, the banks in general have responded to the rate cut by reducing its Base Lending Rate (BLF) and Base Financing Rate (BFR) by 55bps to 5.95% which will take effect in early February.

Lending activities to remain lackluster in the immediate term

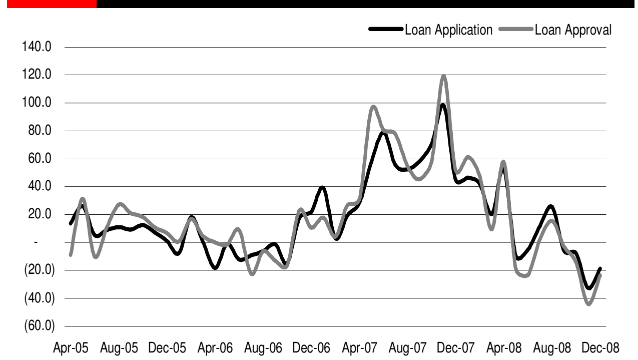
Despite aggressive rate cuts by the BNM, we believe that loan growth is set to slow in 2009, judging from forward looking indicators. Loan applications and approvals continued to contract by 18.8% and 23.7% respectively in December for a fourth consecutive monthly decline. The contraction in leading activities do not come as a surprise as weak business and consumer sentiments tend to induce banks to tighten their lending standards in order to avoid a significant increase in non-performing loans (NPLs). In addition, the inverse relationship between the growth in NPL and GDP indicates that slower economic activity may result in higher NPLs in 2009. Our estimate shows that the negative correlation is as high as 0.78.

Chart 3 Negative correlation between NPL growth & GDP



Source: MARC Economic Research

Chart 4 Loan application and approval y-o-y%



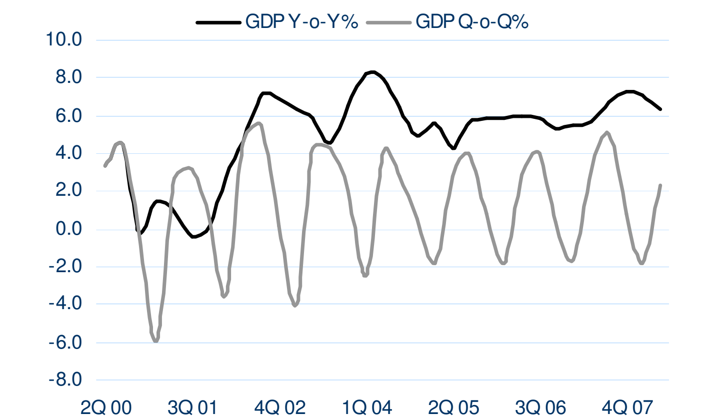
Source: BNM

Second fiscal stimulus is in the pipeline

We believe that more aggressive fiscal pump priming efforts are urgently needed as the first stimulus package of RM7 billion announced in November last year is not sufficient to keep the economy from slipping further. Recent news indicate that the government is making a serious effort to craft out a more comprehensive and effective second package. As a result, Malaysia's budget deficit target of 4.8% of GDP for 2009 is likely to be exceeded as more spending is required and further tax cuts and incentives would have to be introduced. Additionally, heavy reliance on crude oil related revenue implies that the government's coffer could be adversely affected especially when crude oil prices are hovering below last year's average of US$95.4 per barrel.

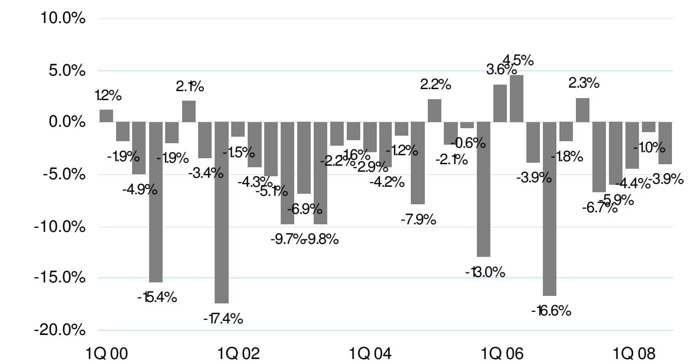
Malaysia in charts

Figure 1 Economic Growth



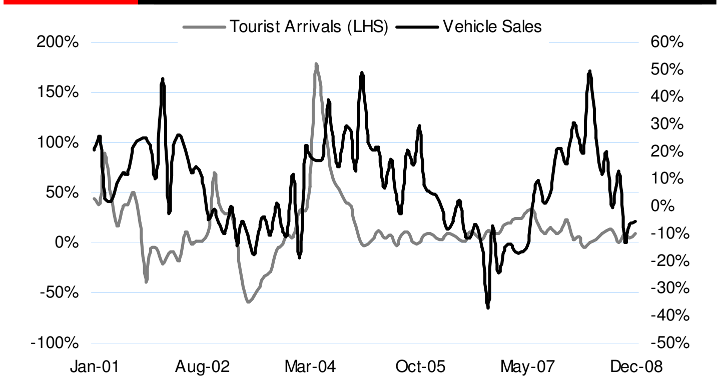
Source: Bloomberg

Figure 2 Fiscal Position



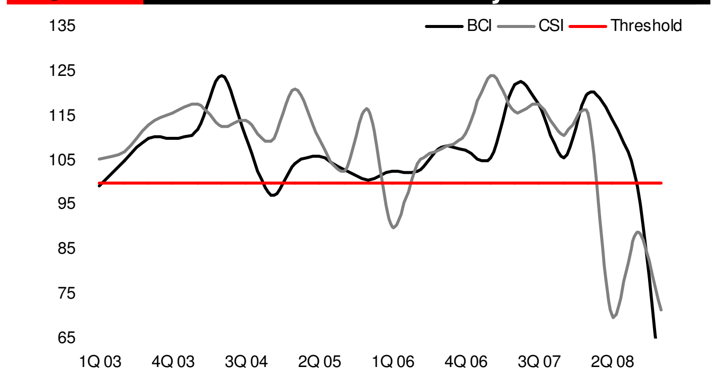
Source: Bloomberg

Figure 3 Tourists arrivals & vehicle sales



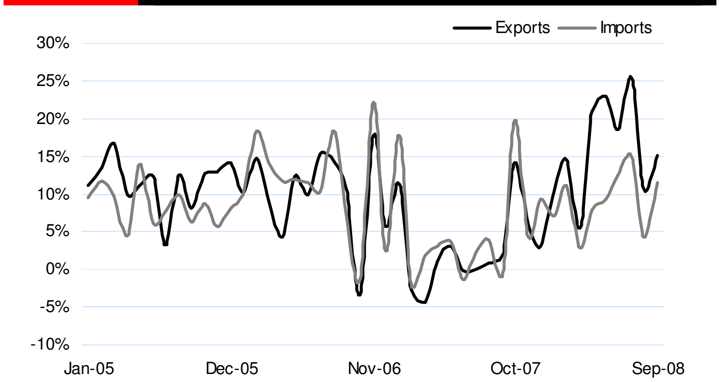
Source: Bloomberg

Figure 4 MIER Survey



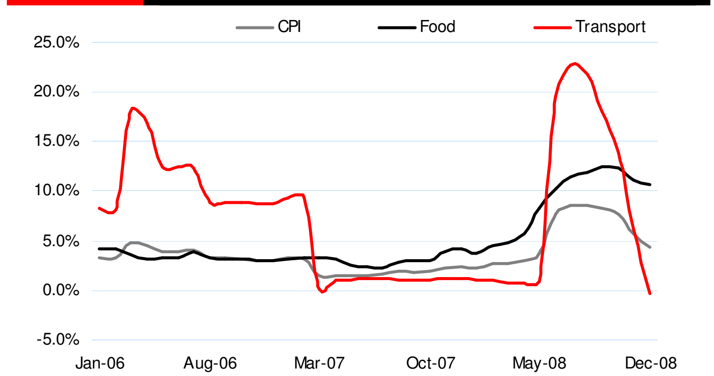
Source: Bloomberg

Fugure 5 International Trade



Source: Bloomberg

Figure 6 Inflation Rate



Source: Bloomberg